

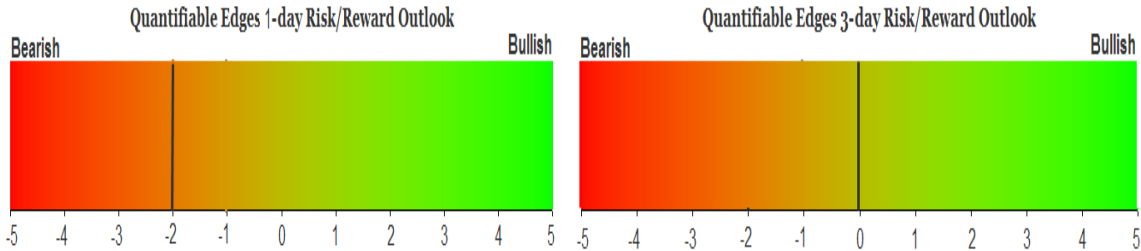
# QUANTIFIABLE EDGES SUBSCRIBER LETTER

ASSESSING MARKET ACTION WITH INDICATORS AND HISTORY

July 1, 2011

Volume 4 Issue 126

## Market Overview



## Signals Overview

Aggregator	Aggressive VIX	Conservative VIX	NDX Trend Timer
Flat	50% Long XIV	Flat	Flat

## Tonight's Research Points

- The extremely low VXO is suggesting a market pullback.
- The very low 3/10 offset HV indicates a big move may be on tap.
- Finishing a month on a high often leads to a strong start the next month.
- 3 unfilled up gaps in a row has consistently been followed by short-term weakness.

## *Short-term Outlook*

### *The Bottom Line*

There is a small downside edge for Friday, but after that expectations are positive. I will look to cover my small short position on Friday and get back to flat until a stronger edge again appears.

*Summary of Recent Active Studies (see Letters from listed dates for details)*

Study Date	Description	Time span	Bias	Avg Max Move
<b>Active</b>				
July 1, 2011	SPY closes month at high	1-6 days	Bullish	
July 1, 2011	3 unfilled up-gaps	1-2 days	Bearish	
July 1, 2011	VXO 15% under 10ma. SPX > 200ma	1 day	Bearish	
<b>Active - Long Term</b>				
June 22, 2011	FTD with Up Issues % 1-yr Rank > 95%	int term	Bullish	
May 31, 2011	4 Weeks Down. Close > 40ma.	1-10 weeks	Bullish	9.00%
March 22, 2011	3 Days Up Issues % > 70%	8 months	Bullish	19.00%
November 22, 2010	POMO	int term	weakening	
October 25, 2010	SPX Golden Cross	int term	Bullish	

If the avg max move is achieved the study will appear in ***bold italic blue*** and no longer be active.

***The Evidence***

The market put in another day of solid gains. Action was again strong for most of the day and the major indices all finished higher. The SPX gained 1%, the Nasdaq added 1.2%, and the Russell 2000 rose 0.9%. Breadth was also strong as the NYSE Up Issues % came in at 73% and the Up Volume % was 77%. Total volume rose slightly.

First off, both studies from last night triggered again. This includes the study that examined the very low VXO and the study that examined the very low 3/10 Offset HV indicator. If you'd like to review those studies again you may use the link below:

[2011-06-30 QE Subscriber Letter.pdf](#)

Additionally, there were 2 other studies that triggered tonight with compelling stats. One suggested bullish implications and the other bearish implications. Let's first consider the bullish study.

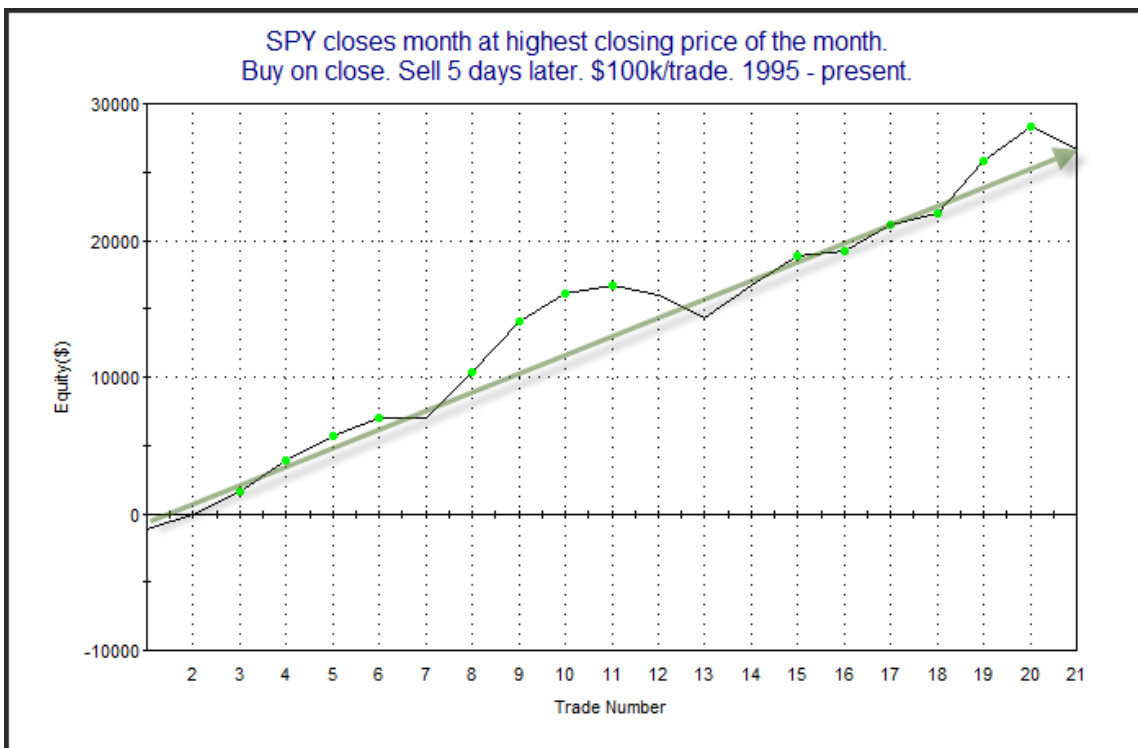
In the 5/2/11 Subscriber Letter I noted that times the SPY has closed the month at a closing high for the month the market has typically been able to continue its momentum into the early part of the following month. I have updated that study below.

SPY closes month at highest closing price of the month.  
Buy on close. Sell X days later. \$100k/trade. 1995 - present.

X Days	All: Net Profit	All: Total Trades	All: Winning Trades	All: Losing Trades	All: % Profitable	All: Avg Winning Trade	All: Avg Losing Trade	All: Win/Loss Ratio	All: ProfitFactor	All: Avg Trade
10	32,824.11	21	17	4	80.95	2,536.05	-2,572.19	0.99	4.19	1,563.05
9	33,624.14	21	16	5	76.19	2,577.23	-1,522.29	1.69	5.42	1,601.15
8	28,604.50	21	17	4	80.95	2,223.93	-2,300.56	0.97	4.11	1,362.12
7	25,563.90	21	15	6	71.43	2,171.94	-1,169.21	1.86	4.64	1,217.33
6	28,489.98	21	16	5	76.19	2,188.46	-1,305.07	1.68	5.37	1,356.67
5	26,643.49	21	16	4	76.19	1,991.64	-1,305.67	1.53	6.10	1,268.74
4	19,087.33	21	14	7	66.67	2,157.42	-1,588.08	1.36	2.72	908.92
3	13,218.78	21	13	8	61.90	1,846.02	-1,347.44	1.37	2.23	629.47
2	8,742.91	21	11	10	52.38	1,681.72	-975.60	1.72	1.90	416.33
1	5,170.33	21	11	10	52.38	934.16	-510.54	1.83	2.01	246.21

18 of 21 instances (86%) closed above the entry price at some point in the next week.

The numbers are very compelling. Most of the upside edge occurs in week 1, but there is some follow through into week 2. Below is an equity curve showing results using a 5-day holding period.



The steady upslope supports the bullish hypothesis suggested by the stats table.

So this study suggests momentum typically carries through nicely over month-ends. But there are other studies, like the VIX study from last night, that are suggesting the momentum is overdone and the market is likely to pull back.

I find it especially notable that Thursday marked the 3<sup>rd</sup> day in a row that the SPY posted an unfilled up gap. The fact that the gaps went unfilled could suggest that a good portion of the buying may have been done by shorts who were forced to cover as prices began to get away from them. The study below is from the 9/7/10 Subscriber Letter and it examined this setup.

SPY leaves an unfilled up gap for the 3rd day in a row. Buy on close. Sell X days later. \$100k/trade. 1993 - present.										
X Days	All: Net Profit	All: Total Trades	All: Winning Trades	All: Losing Trades	All: % Profitable	All: Avg Winning Trade	All: Avg Losing Trade	All: Win/Loss Ratio	All: ProfitFactor	All: Avg Trade
10	-1,660.74	9	4	5	44.44	1,420.20	-1,468.31	0.97	0.77	-184.53
9	-5,901.85	9	3	6	33.33	1,204.31	-1,585.80	0.76	0.38	-655.76
8	-4,406.86	9	3	6	33.33	1,522.28	-1,495.62	1.02	0.51	-489.65
7	-5,060.04	9	2	7	22.22	1,847.37	-1,250.68	1.48	0.42	-562.23
6	-4,624.51	9	4	5	44.44	1,124.90	-1,824.82	0.62	0.49	-513.83
5	-2,667.99	10	6	4	60.00	1,010.73	-2,183.09	0.46	0.69	-266.80
4	-4,160.45	10	5	5	50.00	652.62	-1,484.71	0.44	0.44	-416.04
3	-6,936.78	10	2	8	20.00	335.37	-950.94	0.35	0.09	-693.68
2	-5,541.24	10	3	7	30.00	106.31	-837.17	0.13	0.05	-554.12
1	-3,781.20	10	1	9	10.00	87.00	-429.80	0.20	0.02	-378.12

**All 10 instances closed below the entry price on either day 1 or day 2.**

The number of instances has been quite low. On average we've only seen this occur about once every 2 years. In every case there has been a move lower in the next day or two. Statistics strongly favor the downside. I also listed below all 10 instances along with their day 1 returns.

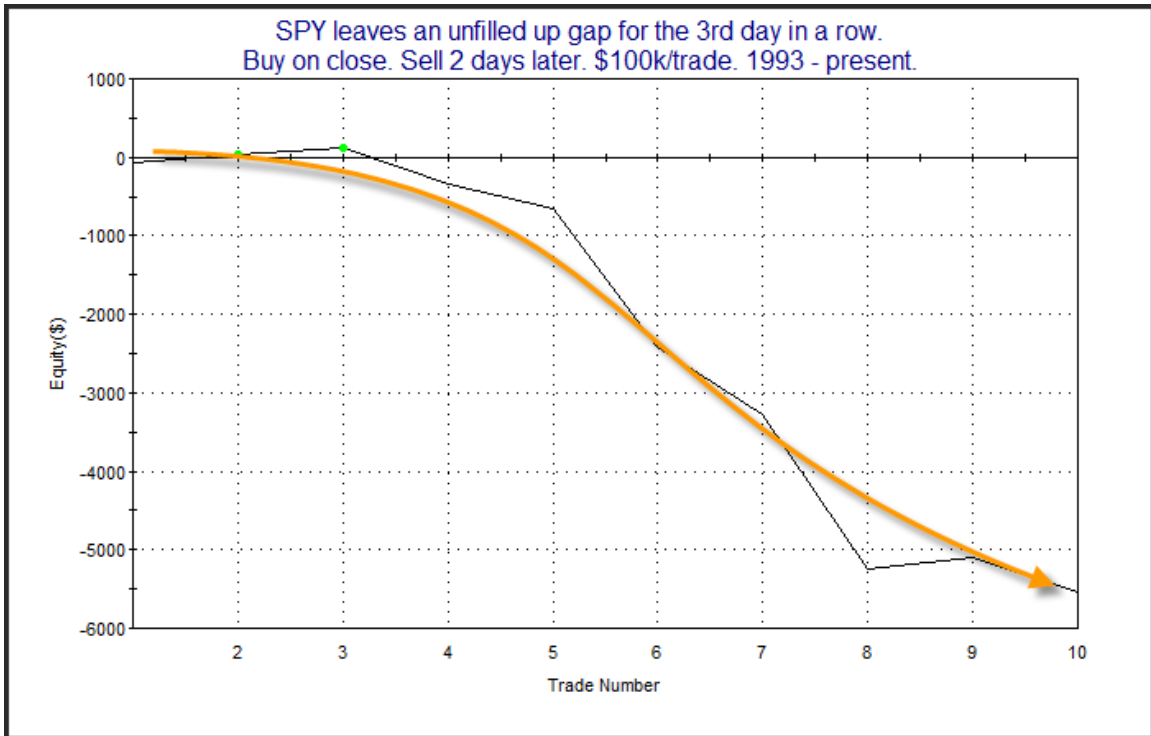
SPY leaves an unfilled up gap for the 3rd day in a row.  
Buy on close. Sell next day's close. \$100k/trade. 1993 - present.

Date/Time	Signal	Price	% Profit	Run-up Drawdown
01/31/94	Buy	\$48.22	(0.52%)	\$0.00
02/01/94	Sell	\$47.97		(\$642.63)
04/06/95	Buy	\$50.75	(0.08%)	\$236.40
04/07/95	Sell	\$50.71		(\$551.60)
05/14/96	Buy	\$66.77	(0.12%)	\$808.38
05/15/96	Sell	\$66.69		(\$179.64)
09/16/96	Buy	\$68.80	(0.23%)	\$261.54
09/17/96	Sell	\$68.64		(\$828.21)
12/01/97	Buy	\$98.09	(0.60%)	\$0.00
12/02/97	Sell	\$97.50		(\$1,559.07)
10/29/99	Buy	\$137.00	(1.05%)	\$0.00
11/01/99	Sell	\$135.56		(\$1,049.76)
11/05/99	Buy	\$137.88	0.09%	\$362.50
11/08/99	Sell	\$138.00		(\$819.25)
07/02/01	Buy	\$124.13	(0.02%)	\$0.00
07/03/01	Sell	\$124.10		(\$869.40)
06/15/07	Buy	\$153.07	(0.12%)	\$208.96
06/18/07	Sell	\$152.89		(\$267.73)
09/03/10	Buy	\$110.89	(1.13%)	\$0.00
09/07/10	Sell	\$109.64		(\$1,207.34)

 5 of 10 instances posted unfilled gaps down the next day.

I find it especially interesting that so many instances gapped down and never filled the next day after 3 consecutive unfilled up-gaps. The only gap down that did fill was 11/5/99. This also happened to be the largest gap down, and was also the only instance to finish day 1 in positive territory.

And while losses saw a peak on day 3, it seems day 2 provides a more compelling equity curve. The 3-day hold generated higher total losses, but much of them were thanks to the 7/2/01 instance. Below is the 2-day equity curve which is much smoother and more suggestive of a consistent downside edge.



So we have 2 studies on the active list suggesting a pullback, and 1 short-term study suggesting further upside (along with a few long-term bullish studies). It appears from these studies that tomorrow may be rough but over the next several days the market should put in some higher prices.

I have updated the [Aggregator](#) chart below.



The current mix of studies caused the green Aggregator line to squeak back above 0 tonight. Readings above 0 mean net expectations from the active list are for upside over the next few days. Meanwhile, the rally Thursday caused the Differential Line to drop even further below 0. A negative Differential reading means the SPX has outperformed expectations over the last few days. So net expectations are positive but the SPX is overbought versus recent expectations. This is considered a neutral configuration. Neutral configurations are visible on the Aggregator chart whenever both lines close on opposite sides of 0. Due to this the Aggregator System changed from short to flat at the close.

The green Aggregator line is again set to close above 0 on Friday, but that could easily change if additional bearish studies arrive. I will be sure to monitor the market action and studies closely during the day. Meanwhile, the Differential Pivot will be 1,302.67. This is about 1.4% below Thursday's close.

I should note that while the 3-day expectations that the Aggregator uses are positive, the 1-day expectations are negative. This is reflected in the 1-day reading at the top of the letter. It is the reason I did not send out an intraday alert on Thursday closing out the short trade. The studies appear to suggest a better exit will likely be available on Friday. I am hoping to cover my short into weakness on Friday, but won't let a gap up get too far away from me. Details in the trade ideas section lower down.

**Intermediate-term Outlook (2 weeks – 2 months)– updated 6/27 – neutral**

The SPX posted a higher high than last week, a higher low than last week, and a Follow-Through Day in the middle of the week – and still it closed down on the week. In the 2/1/08 blog I looked at possible implications of action immediately after an FTD. I have updated those tests below.

Short-term performance after FTDs that failed to complete successful rallies. \$100k/trade. 1971-present.										
X Days	All: Net Profit	All: Total Trades	All: Winning Trades	All: Losing Trades	All: % Profitable	All: Avg Winning Trade	All: Avg Losing Trade	All: Win/Loss Ratio	All: ProfitFactor	All: Avg Trade
5	-32,145.83	35	15	20	42.86	1,852.06	-2,996.34	0.62	0.46	-918.45
4	-27,660.43	35	14	21	40.00	1,870.00	-2,563.83	0.73	0.49	-790.30
3	-26,864.21	35	15	20	42.86	1,450.39	-2,431.00	0.60	0.45	-767.55
2	-31,610.28	35	13	22	37.14	975.59	-2,013.31	0.48	0.29	-903.15
1	-3,521.06	35	17	18	48.57	591.36	-754.12	0.78	0.74	-100.60

Short-term performance after FTDs that went on to complete successful rallies. \$100k/trade. 1971-present.										
X Days	All: Net Profit	All: Total Trades	All: Winning Trades	All: Losing Trades	All: % Profitable	All: Avg Winning Trade	All: Avg Losing Trade	All: Win/Loss Ratio	All: ProfitFactor	All: Avg Trade
5	71,249.18	39	30	9	76.92	2,833.70	-1,529.10	1.85	6.18	1,826.90
4	61,869.64	39	27	12	69.23	2,846.70	-1,249.28	2.28	5.13	1,586.40
3	57,445.82	39	26	13	66.67	2,744.05	-1,069.20	2.57	5.13	1,472.97
2	55,597.73	39	29	10	74.36	2,260.79	-996.53	2.27	6.58	1,425.58
1	26,842.15	39	22	17	56.41	1,611.25	-506.20	3.18	4.12	688.26

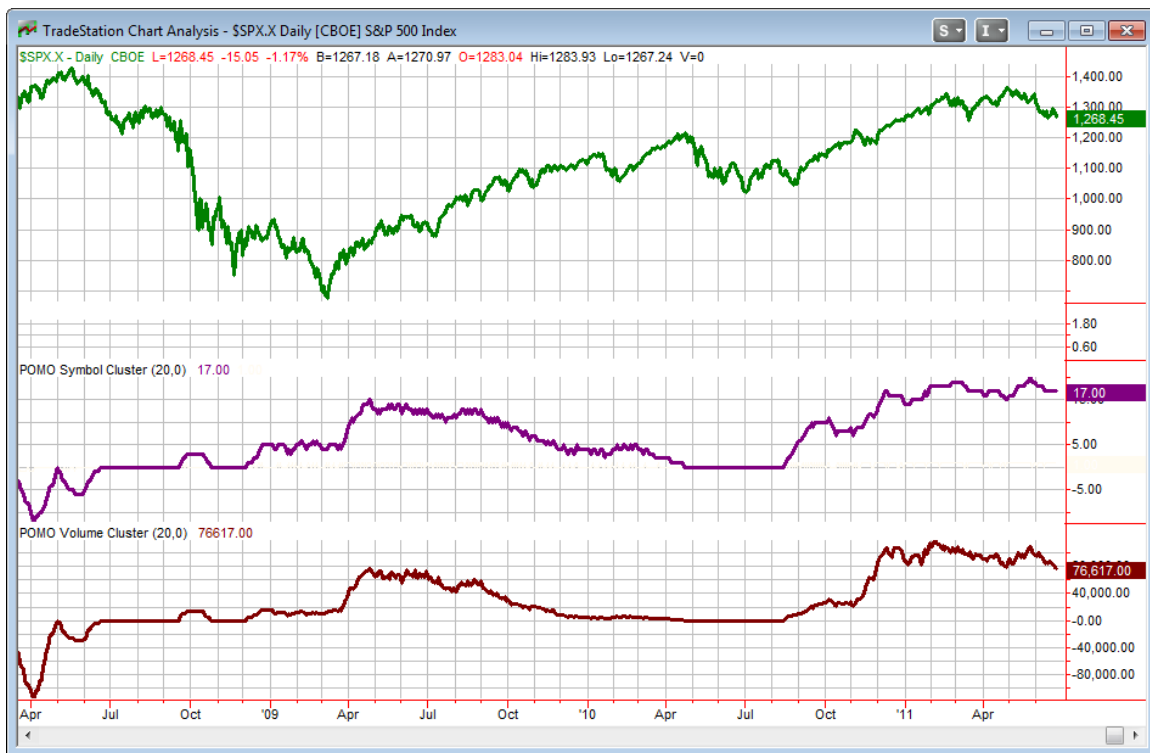
A couple of points here. First, FTDs that went on to successful rallies generally saw additional gains within the 1<sup>st</sup> week after the FTD. Likewise, FTDs that eventually failed tended to suffer losses quickly after the FTD. Another point to consider is that the success or failure was determined with about 67% reliability within the first week after a FTD. For instance, note there were a combined 45 total trades that were in the black after 5 days. Thirty of them (or 2/3) went on to complete successful rallies. The same ratio applies for the losers. There were 29 losers after 5 days. Twenty of them ended up with failed rallies and the other 9 were successful.

For the current setup to show a winner over the 5-day period, Monday and Tuesday will need to produce strong upside results.

I've been updating the POMO chart most weekends in the letter. For those who may not recall below is a brief refresher on POMO. Beneath that I have updated our POMO indicator chart.

*POMO stands for Permanent Open Market Operations and it is how the Fed goes into the open market to buy securities. The net effect of this buying is an influx of cash into the system. It appears a portion of that cash makes its way to the stock market and works as a bullish influence. A "POMO Day" is simply a day where these operations take place... The chart below (shows a couple of POMO indicators). The top pane is the S&P 500. The middle pane is the rolling number of days in the last 20 that have been POMO days. The bottom pane is the total amount of money infused into the system over the previous 20 days. Information on acquiring the data and constructing the chart can be found in the January 3<sup>rd</sup> POMO presentation linked below. (Not available for trial users.)*

<http://www.quantifiableedges.com/members/pomo.php>



My POMO interpretation remains similar to the last 2 weeks.

Both the POMO Days and POMO Volume indicators remain at fairly high levels. Still, they are beginning to trend lower. The current schedule calls for steady but decreased buying until the end of the month, but after that there will be little in the way of Fed

stimulus. Starting July 1 we will see these indicators begin to head back towards the 0 line. There are 2 small days of buying currently scheduled in July which is associated with the reinvestment of principal payments rather than the \$600billion of QE2 money. The past few times POMO stimulus was halted, it took the market about a month after the halt until prices began to decline.

For those that would like to view the current schedule I have provided a link below.

[http://www.newyorkfed.org/markets/tot\\_operation\\_schedule.html](http://www.newyorkfed.org/markets/tot_operation_schedule.html)

Intermediate-term studies are moderately bullish but we remain in the midst of a correction. Tuesday's FTD appears in jeopardy. It will need to right itself quickly if a rally is to emerge. A short-term bounce does appear likely, but unless it comes quickly and with substantial force the market will be looking for a lower bottom than the 6/16 low. My outlook remains neutral for now. This means I will approach both longs and shorts with some caution but am willing to bet either way should short-term evidence suggest an edge.

### **Catapult and Capitulative Breadth Statistics**

*[Catapult & CBI Presentation Link](#)*

***Open Catapult Triggers***

*None*

***Catapult for ETF's Trades***

*None*

***Broad Market Large Cap CBI – 0***

### **Additional New Trade Ideas**

*A full listing of system triggers can be found at the [system triggers page](#) each night. I will cherry pick some of my favorite setups from the S&P 100 and ETF lists along with occasional other trade ideas to track below.*

*No new trade ideas tonight.*

### **Current Open Trade Ideas**

Symbol	Entry Date	Entry Price	Current Price	% Gain/Loss	Stop	Notes
SPY(1/4)(s)	6/30/2011	\$131.14	\$131.97	-0.63%		shorted on open

*According to the “3 unfilled up-gaps” study, 5 of the 6 times that SPY gapped down following that setup the gap down was never filled. Therefore, if the market gaps down I will not rush to cover but will give it room to sink further. So my exit parameters on a gap down will be 1) a stop at \$131.97 (Thursday’s close), and 2) an exit at the close if not stopped out during the day. If we do get a gap down I will likely look to trail a stop lower and perhaps set a downside exit target depending on how action unfolds.*

*If the SPY gaps up I will look to exit at a limit price of \$131.97. If not filled in the 1<sup>st</sup> half hour I will most likely place a stop above the high of the morning consolidation.*

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