

QUANTIFIABLE EDGES SUBSCRIBER LETTER

ASSESSING MARKET ACTION WITH INDICATORS AND HISTORY

July 26, 2011

Volume 4 Issue 142

Market Overview



Signals Overview

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

Tonight's Research Points

- Unfilled gaps down from short-term highs are often followed by more short-term selling.

Short-term Outlook

The Bottom Line

Despite another bearish study overall expectations remain up when looking out beyond Tuesday. The market is short-term overbought but that could wear off in 1 more day. Should the 1-day bearish inclinations win out on Tuesday I will be a buyer.

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

Study Date	Description	Time span	Bias	Avg Max Move
Active				
July 26, 2011	SPY unfilled gap from 10-high	1-2 days	Bearish	-1.00%
July 25, 2011	10-day high on 20-day low volume	1-2 days	Bearish	-1.10%
July 22, 2011	Up Issue% > 75% 2 of 3. Close 10 high.	1-6 days	Bullish	2.70%
Active - Long Term				
July 22, 2011	Up Issue% > 75% 2 of 3. Close 10 high.	1-20 days	Bullish	5.50%
July 5, 2011	QE2 Over	int term	Bearish	
July 5, 2011	3 days higher. Up vol % > 90% today.	1-20 days	Bullish	5.00%
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%
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

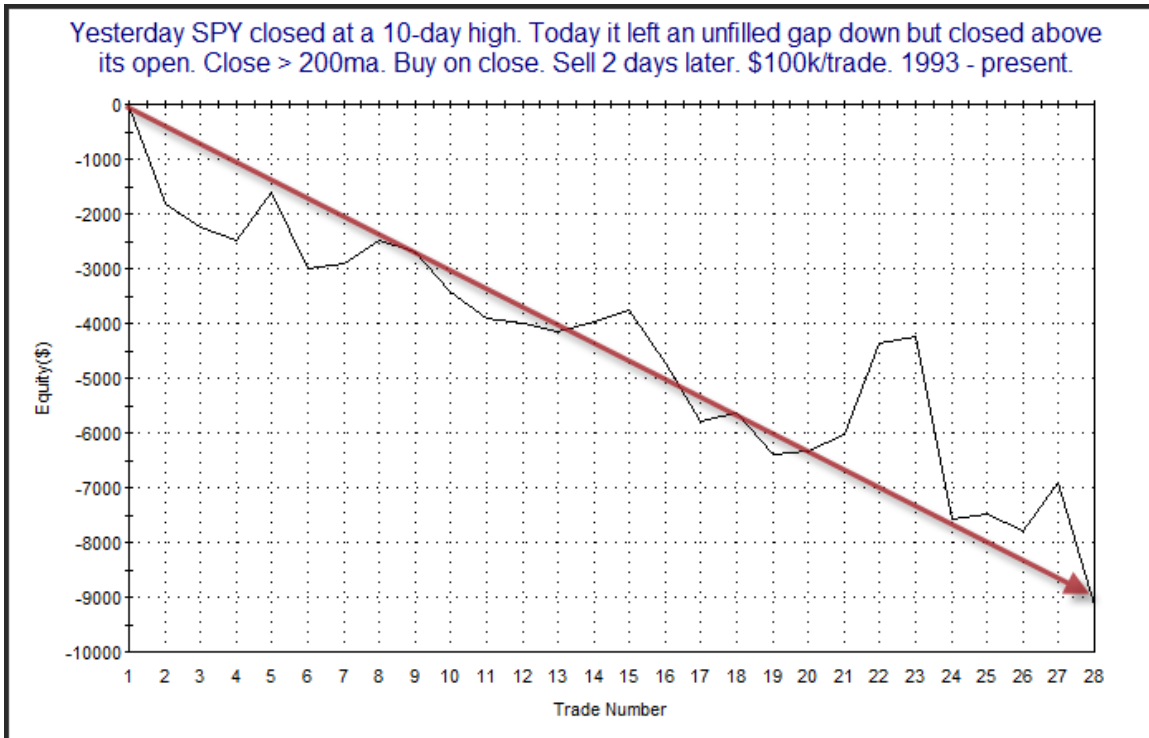
The market opened the day with a big gap down. The fear didn't stick though and the low was achieved in the 1st few minutes. By 1pm the gap was nearly filled (and QQQ did fill) but the rally ran out of gas. The afternoon was a drift lower and the SPY closed in the middle of its range. At the close the SPX and Nasdaq had lost 0.6% and the Russell 2000 was down 1.2%. Breadth was very weak as the NYSE Up Issues % came in at 19% and the Up Volume % was 22%. Total NYSE volume was on the light side but still higher than Friday.

I looked at a few different things tonight. The only substantial edge came in examining the SPY pattern over the last couple of days. What struck me most about the action was that we saw an unfilled gap down occur in conjunction with a close above the open, and that it followed a short-term high. The study below examined similar setups.

Yesterday SPY closed at a 10-day high. Today it left an unfilled gap down but closed above its open. Close > 200ma. 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
5	-14,246.52	27	10	16	37.04	1,101.70	-1,578.97	0.70	0.44	-527.65
4	-14,094.65	27	12	15	44.44	772.17	-1,557.38	0.50	0.40	-522.02
3	-8,492.62	28	13	15	46.43	467.62	-971.45	0.48	0.42	-303.31
2	-9,147.20	28	12	16	42.86	422.94	-888.90	0.48	0.36	-326.69
1	-6,485.31	28	12	16	42.86	475.52	-761.97	0.62	0.47	-231.62

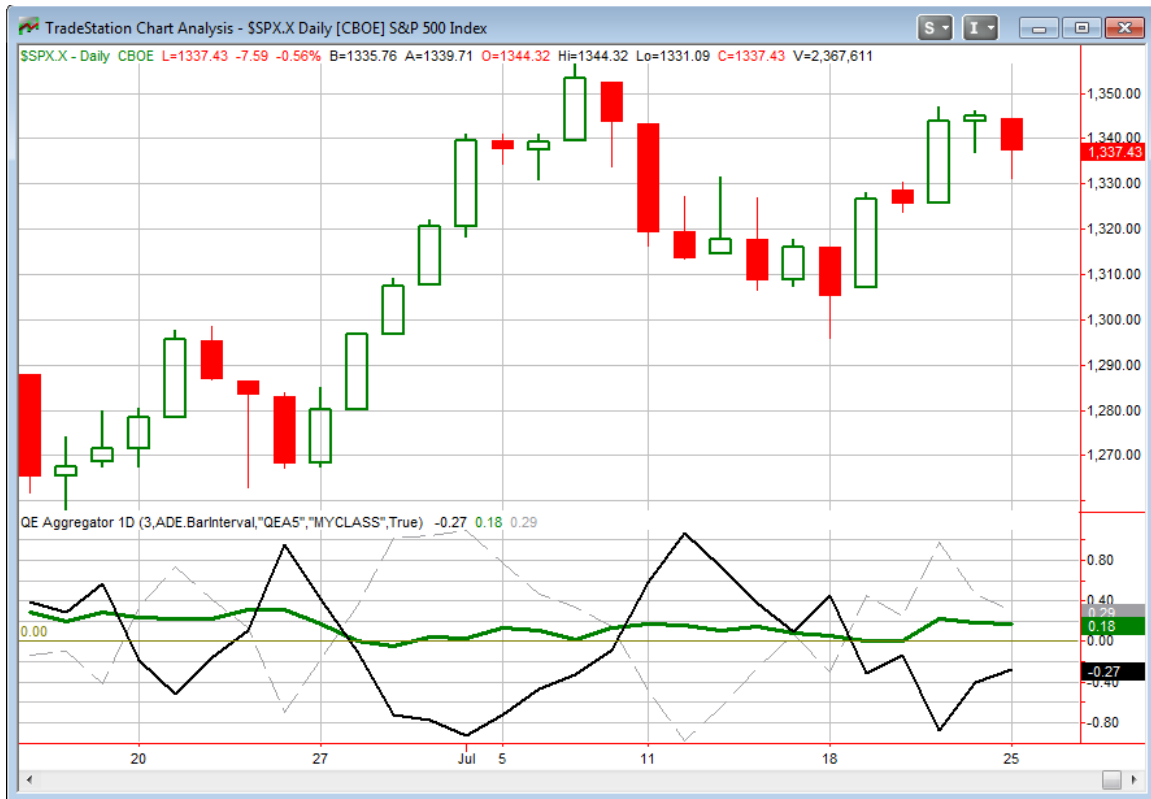
23 of 28 instances (83%) closed below the entry price at some point in the next 4 days. Of the 5 instances that bucked the norm, 1 closed below the entry price for the 1st time on day 14. The others all went at least a month before closing below the entry price.

These appear to be fairly compelling results. I found it especially interesting that those instances that didn't quickly dip showed a strong propensity to rally for a substantial time longer. While the edge seems to max out around day 5, much of the bearish inclinations were realized in the first 2 days. Also, when I examined the equity curves I found the 2-day equity curve to be the most compelling. I have therefore reproduced the 2-day curve below.



There's certainly some chop evident, but the persistence has been quite good for a bearish edge above the 200ma. In all I find this setup well worth including on the Active List.

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



Despite tonight's bearish study the green Aggregator line only dipped slightly. It is still solidly positive. Readings above 0 mean net expectations from the Active List are for upside over the next few days. Meanwhile, the Differential Line is still below 0. A negative Differential reading means the SPX has outperformed expectations over the last few days. So net expectations are positive and the SPX is overbought versus recent expectations. This is considered a neutral configuration. It can be seen on the Aggregator chart whenever both lines are on opposite sides of 0. Due to this the Aggregator System remained flat at the close.

With the current studies the green Aggregator line is again set to close above 0 on Tuesday. This could change if strong bearish evidence emerges. Meanwhile, the Differential Pivot will be 1,346.90. This is about 0.7% *above* Monday's close. This means that unless the SPX rises more than 0.7% or the expectations change, the Aggregator System will likely trigger a buy signal tomorrow. I sometimes refer to scenarios like today where even a flat close would trigger an entry as an "inverted Differential Pivot". We don't need the price to move at this point to create a favorable entry opportunity. We just need the consolidation/pullback to last long enough to provide the edge.

I'll again note for the 2nd night in a row note that while the short-term expectations are positive, expectations for Tuesday are slightly negative. This is reflected at the top of the letter in the 1-day risk/reward outlook. Very aggressive or day-traders could consider looking for a quick short trade on Tuesday. I'm hoping the 1-day bearish tendency plays out and provides a favorable long-side entry point on Tuesday afternoon.

So I'm thinking long and hoping to catch some of the next leg up. The breadth thrust signal from Thursday looms large over the next few days and weeks. But to this point there hasn't been a consolidation or pullback strong enough to trigger an entry. If price dips or moves sideways tomorrow then that trigger should occur. If the market moves strongly higher then I may miss an entry opportunity. I've place parameters for a potential SPY entry in the Trade Ideas section further down.

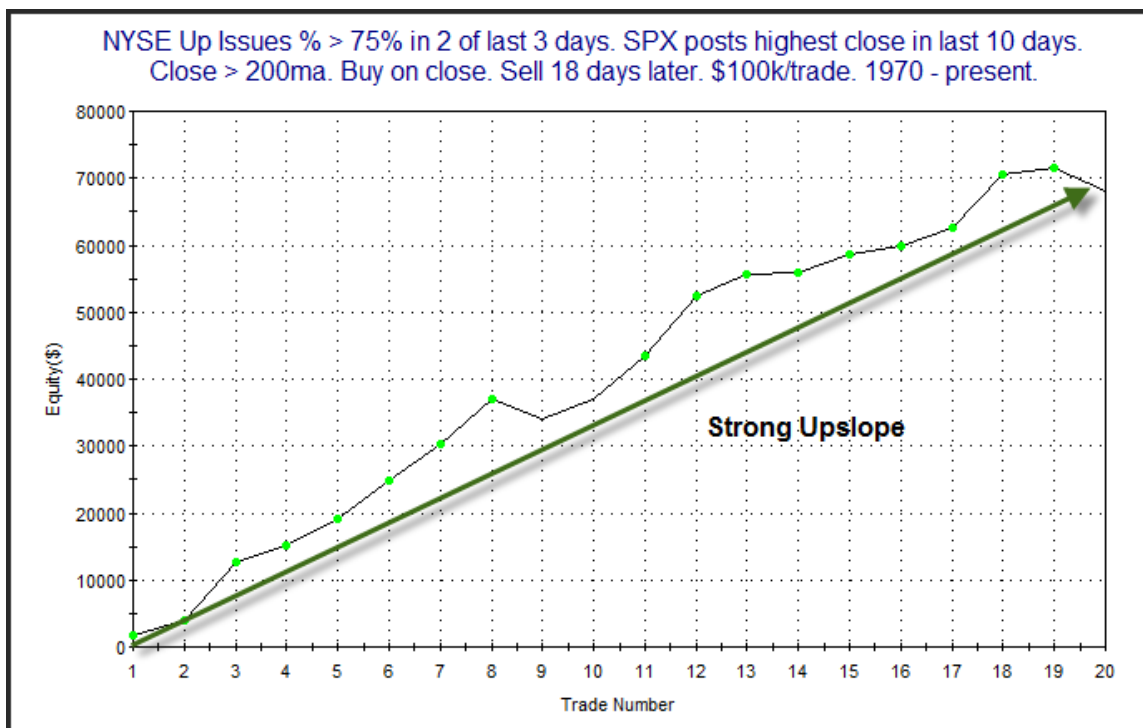
Intermediate-term Outlook (2 weeks – 2 months)– updated 7/25 – moderately bullish

After a dip to new short-term lows on Monday the market gathered itself and finished out with a nice week. The SPX is now less than 1% from its July high and within 2% of its May high. An intermediate-term study triggered on Thursday that suggested that these levels should be taken out. Below I have copied the results from Thursday night's letter.

NYSE Up Issues % > 75% in 2 of last 3 days. SPX posts highest close in last 10 days. Close > 200ma. Buy on close. Sell X days later. \$100k/trade. 1970 - 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
20	72,673.56	19	16	3	84.21	4,912.07	-1,973.20	2.49	13.28	3,824.92
19	70,576.96	20	17	3	85.00	4,593.61	-2,504.78	1.83	10.39	3,528.85
18	68,169.46	20	18	2	90.00	4,150.05	-3,265.74	1.27	11.44	3,408.47
17	65,698.31	20	18	2	90.00	4,089.68	-3,957.99	1.03	9.30	3,284.92
16	64,695.52	20	18	2	90.00	4,015.19	-3,788.93	1.06	9.54	3,234.78
15	54,962.15	20	16	4	80.00	4,043.82	-2,434.73	1.66	6.64	2,748.11
14	50,742.27	20	18	2	90.00	3,381.83	-5,065.35	0.67	6.01	2,537.11
13	48,932.78	21	17	4	80.95	3,442.08	-2,395.64	1.44	6.11	2,330.13
12	48,351.39	22	17	5	77.27	3,423.88	-1,970.90	1.74	5.91	2,197.79
11	50,348.14	22	18	4	81.82	3,193.65	-1,784.37	1.79	8.05	2,288.55
10	45,265.78	22	18	4	81.82	3,002.75	-2,195.91	1.37	6.15	2,057.54
9	43,659.47	22	17	5	77.27	3,118.12	-1,869.70	1.67	5.67	1,984.52
8	38,392.06	22	18	4	81.82	2,516.31	-1,725.40	1.46	6.56	1,745.09
7	38,493.16	22	17	5	77.27	2,580.25	-1,074.22	2.40	8.17	1,749.69
6	39,010.37	23	20	3	86.96	2,145.86	-1,302.27	1.65	10.99	1,696.10
5	32,659.62	23	18	5	78.26	1,996.35	-654.95	3.05	10.97	1,419.98
4	25,157.02	24	19	5	79.17	1,497.08	-657.52	2.28	8.65	1,048.21
3	16,066.83	24	16	8	66.67	1,382.97	-757.59	1.83	3.65	669.45
2	10,142.47	27	17	10	62.96	1,072.59	-809.16	1.33	2.25	375.65
1	5,976.39	29	17	12	58.62	692.62	-483.18	1.43	2.03	206.08

All 29 instances posted a close above the entry price at some point in the next 6 days.

The intermediate-term implications appear strongly positive. I showed a short-term equity curve on Thursday. Today I have run an intermediate-term curve, which can be found below.

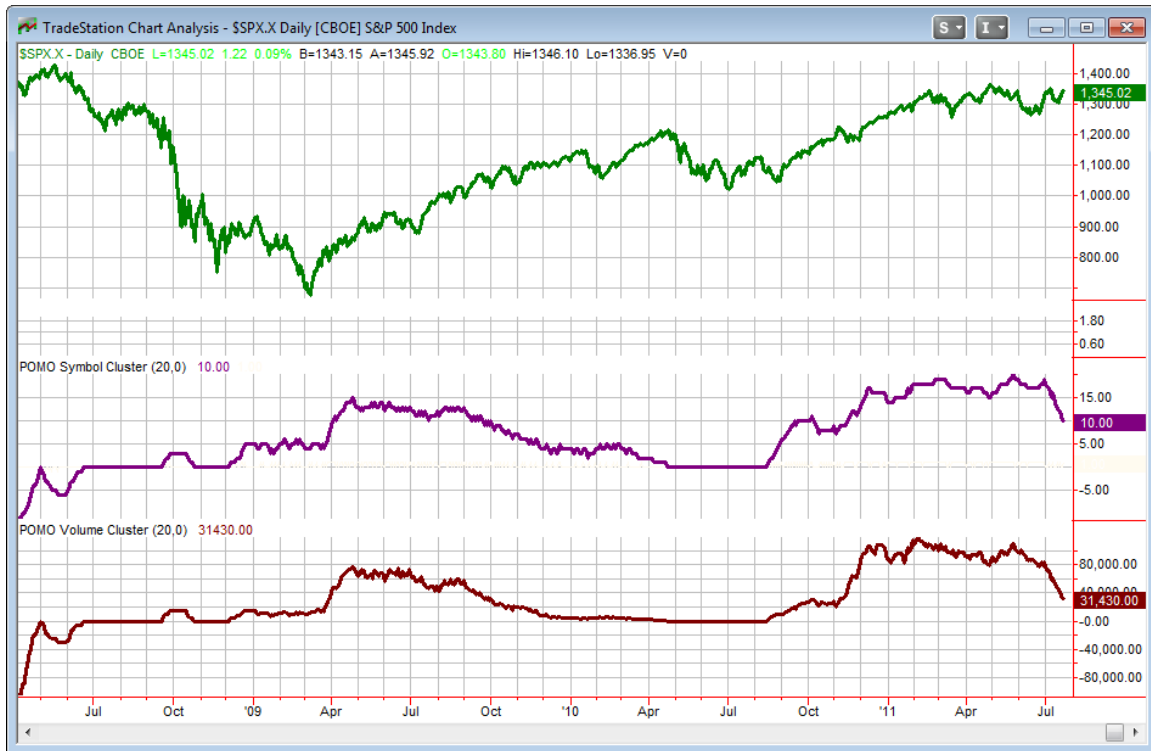


The strong upslope creates greater confidence in the upside edge.

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 3rd POMO presentation linked below. (Not available for trial users.)

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



There were again 2 days of POMO buying this past week. They were extremely light days from a volume perspective. In looking at the upcoming schedule it appears 2 days a week may be par for the course for a while. So even without QE2, there will still be a decent amount of liquidity pumping occurring. It certainly isn't at the levels that the market was accustomed to, but it does not appear the POMO indicators above will be hitting 0 any time soon. The "Days" indicator may even settle in around 7-8, which is far higher than I originally anticipated. Below is a link to the upcoming schedule.

http://www.newyorkfed.org/markets/tot_operation_schedule.html

With buying so light this past week it will be interesting to see where the POMO volume indicator begins to level off. Action over the next couple of weeks will be especially interesting as the QE2 program completely falls out of the backwards-looking calculation.

There remain a number of intermediate-term market positives that can be pointed to. Breadth seems to be the #1 indication of higher prices. Thursday's study created the 3rd active intermediate-term breadth-thrust study. The other 2 were from March 22nd and July 5th. There is also still a high-probability Follow-Through Day signal active, the

Nasdaq is leading the SPX, and price action and momentum are providing positive indications as well. The big concern remains the rapidly weakening POMO activity. The combination of evidence is enough to keep me slightly favoring the bull side for the time being.

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.

SPY – buy ¼ index position @ \$133.82 LIMIT ON CLOSE. If SPY closes down then the odds of strong bearish evidence emerging would shrink even further and we will almost certainly see a long Aggregator signal trigger. In anticipation of that I will look to begin scaling into a long position on a down close.

Current Open Trade Ideas

None.

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