

# QUANTIFIABLE EDGES SUBSCRIBER LETTER

ASSESSING MARKET ACTION WITH INDICATORS AND HISTORY

August 15, 2011

Volume 4 Issue 156

## Market Overview



## Signals Overview

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

## Tonight's Research Points

- Volume on the bounce remains low, but that is not necessarily a bad thing.
- Breadth has recovered quickly, but from such depths it often struggles to continue over the short-term.

## Short-term Outlook

### The Bottom Line

The market is in a tricky place. Evidence isn't overwhelming in either direction and both the Aggregator and Differential lines are near 0. I'm slightly long with the CBI still at a high level but not strongly committed to either side.

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

Study Date	Description	Time span	Bias	Avg Max Move
<b>Active</b>				
August 12, 2011	CBI >= 10		Bullish	
August 12, 2011	SPY gap-n-go under 200ma	1-2 days	Bearish	
August 12, 2011	SPY 1% below high but still up 1%	1-2 days	Bullish	
August 12, 2011	3% rise on lowest volume in 5 days	1-3 days	Bearish	
August 11, 2011	Reversal from low then dip	1-3 days	Bullish	3.50%
<b>Active - Long Term</b>				
August 8, 2011	SPX Down 9 of 10 days and > 7.5%	1-20 days	Bullish	13.30%
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	
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*

Compared to the mayhem that has ruled the markets lately, Friday was an extremely quiet day. After gapping up to start the day the market pulled back to fill the gap and then fell into a range for the rest of the day. In the end the SPX rose 0.5%, the Nasdaq was up 0.6% and the Russell 2000 gained 0.3%. Breadth was positive as the NYSE Up Issues % came in at 65% and the Up Volume % was 60%. Total NYSE volume fell for the 4<sup>th</sup> day in a row.

After triggering oodles of studies almost every day recently the Quantifinder was remarkably quiet on Friday. There was only one study that triggered and it simply noted that this week is op-ex week. Some months op-ex has shown bullish tendencies. And although the net numbers are positive, the record for August has not been consistent enough to suggest a quantifiable edge.

The drop in volume over the last 4 days has stood out as an obvious point to research. I looked at it a number of different ways to see if it suggested any kind of strong inclinations. I've seen in the past that after strong capitulative downside moves volume on the bounce will often decline. And this isn't always a bad thing. Sometimes so much volume comes on the washout that the bounce is destined to show lower volume. And if the initial thrust isn't believed by many then that will sometimes provide the move an even better chance of success. The problem with the current situation is that action has been so extreme over the past couple of weeks that comparisons are few no matter how I look at the market. Below are a couple of studies with interesting but inconclusive results.

This first one looked at periods where the market saw volume decline 4 days in a row following a 100-day bottom.

After SPX closes at a 100-day low 4 days ago the NYSE volume declines 4 days in a row without SPX making a new closing low.  
Buy on close. Sell 10 days later. \$100k/trade. 1970 - present.

Date/Time	Signal	Price	% Profit	Run-up Drawdown
07/22/96	Buy	\$633.14	4.28%	\$4,788.50
08/05/96	Sell	\$660.23		(\$2,623.47)
09/27/01	Buy	\$1,018.61	7.74%	\$7,893.90
10/11/01	Sell	\$1,097.43		\$0.00
06/19/06	Buy	\$1,240.14	3.23%	\$3,219.20
07/03/06	Sell	\$1,280.19		(\$204.00)

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Instances were much more rare than I would have expected. In every instance the market was higher two weeks later and the risk/reward appears strongly favorable. Only one of the 3 instances had an intraday drawdown of even 0.25%. Still, it is just 3 instances. There is no way I would feel comfortable generating expectations off of 3 instances, but the low volume certainly does not seem to imply a bearish implication based on this study.

I also wondered whether two up days that occurred on declining volume while the CBI still suggested a strongly oversold market might provide any clues. So I concocted the below test.

SPX rises on lower volume for at least the 2nd day in a row and the CBI >=10.  
Buy SPX 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	5,748.56	2	2	0	100.00	2,874.28	0.00	100.00	100.00	2,874.28
9	6,761.14	2	2	0	100.00	3,380.57	0.00	100.00	100.00	3,380.57
8	6,653.42	2	2	0	100.00	3,326.71	0.00	100.00	100.00	3,326.71
7	7,035.34	2	2	0	100.00	3,517.67	0.00	100.00	100.00	3,517.67
6	7,793.22	2	2	0	100.00	3,896.61	0.00	100.00	100.00	3,896.61
5	4,664.76	2	2	0	100.00	2,332.38	0.00	100.00	100.00	2,332.38
4	2,908.08	2	2	0	100.00	1,454.04	0.00	100.00	100.00	1,454.04
3	3,401.90	2	2	0	100.00	1,700.95	0.00	100.00	100.00	1,700.95
2	-31.64	2	1	1	50.00	621.32	-652.96	0.95	0.95	-15.82
1	-1,348.54	2	0	2	0.00	0.00	-674.27	0.00	0.00	-674.27

**Instances too low to seriously consider, but no hint of the the declining volume being a disadvantage yet. Dates were 9/25/01 and 2/3/04.**

Here again we see an extremely low number of instances. And the 9/2001 instance is a repeat from the 1<sup>st</sup> test. So again here the takeaway is more a failure of a bearish edge to appear than any strong bullish tendency.

We still have the bearish volume study active from a few nights ago. The influence from that study will expire at the close on Tuesday. It suggests we should close below Thursday's close by then. Still, with that evidence very short-term and nothing new supporting the "volume is bad" theory I'm not terribly worried about it.

My friend and fellow trader Tom McClellan is one market technician for whom I have great respect. Tom is the person I heisted the TICK Tomoscillator from (and subsequently named after him). His parents created the McClellan Oscillator and Tom is as good as anybody at interpreting its movements. One thing Tom has mentioned in [his subscriber service](#) is that when the oscillator undergoes a rapid advance and still can't get positive that it can be left with little energy to continue the push higher. I decided to play around with this concept as related to the current setup a bit today. I used the Ratio Adjusted McClellan Oscillator (RAMO) for my test. Doing this allowed me to test over a long period of time and use constant settings. Below is one example of the short-term results I was seeing.

Ratio Adj. McClellan Oscillator rises at least 75 points over the last 4 days and posts the highest reading of the last 4 days. It also still closes below 0.  
Buy SPX 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
5	-15,126.72	21	7	14	33.33	1,976.67	-2,068.82	0.96	0.48	-720.32
4	-3,713.46	21	8	13	38.10	2,201.85	-1,640.64	1.34	0.83	-176.83
3	-8,543.97	21	9	12	42.86	1,668.83	-1,963.62	0.85	0.64	-406.86
2	-9,668.71	23	8	15	34.78	1,747.11	-1,576.37	1.11	0.59	-420.38
1	-10,924.63	25	12	13	48.00	886.43	-1,658.60	0.53	0.49	-436.99

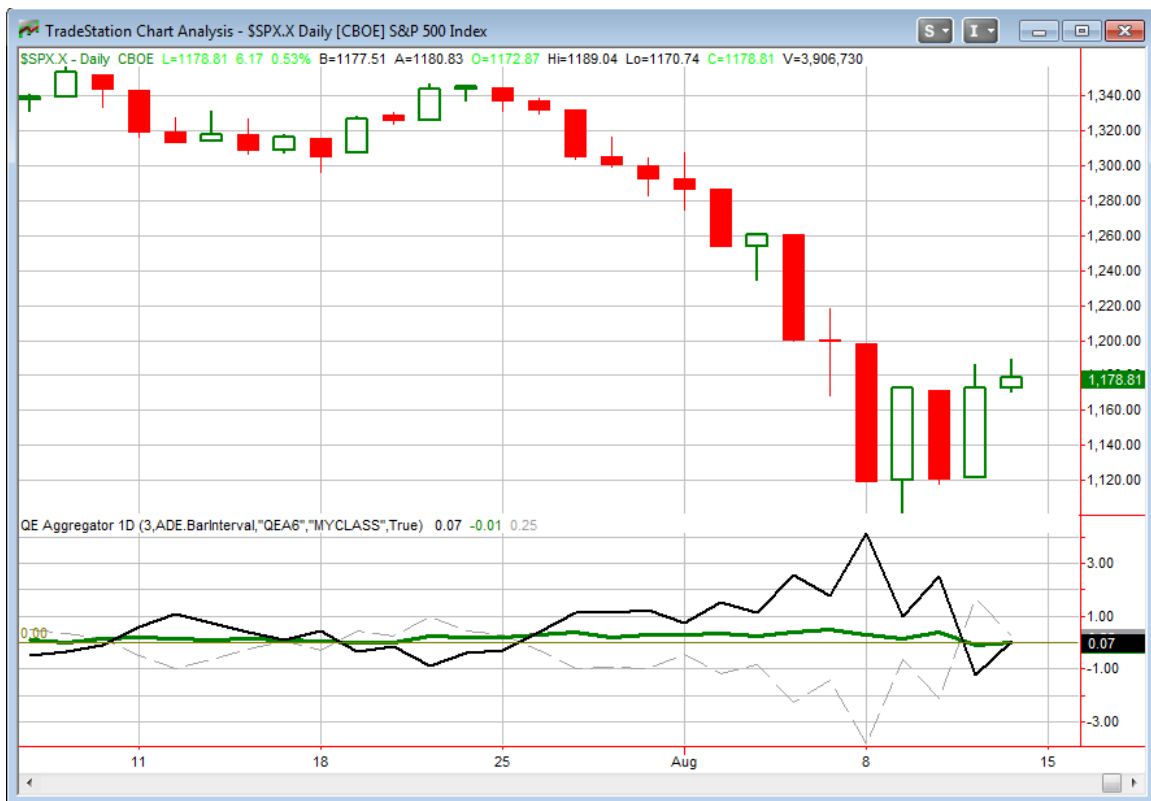
I should note a few things here. The RAMO has risen over 130 points in the last 4 days, but there were no other instances with such extreme numbers. The most extreme instances did appear to suggest more bearish implications than the less extreme ones. I had to lower the required difference to 75 in order to get a decent sample size. Further, while the results appear to be somewhat bearish on the surface, when I looked at the equity curves I found them to be highly inconsistent. So overall it appeared to me that this concept may contain a bearish edge, but it was not one that I could quantify with my limited testing.

So unfortunately, tonight we are left with some volume studies with “not bearish and hinting at bullish” conclusions and a breadth study with a “possible but inconclusively bearish” conclusion. Overall, some things to consider but nothing suggesting a strong edge.

It will therefore continue to be important to monitor action over the next few days to see if more solid edges emerge. The volume study from 2 nights ago that examined 3% rises on the lowest volume in 5 days is the strongest piece of short-term bearish evidence and the CBI is providing the strongest bullish evidence currently.

Should the market manage a strong gain on higher volume in the next few days that would signal a Follow Through Day (FTD). I have written a large amount on FTD's over the years. They can provide some decent hints for both the short and intermediate-term depending on how they play out. It is one indicator I will be on the lookout for.

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



Both lines ended quite close to 0 tonight so you aren't able to make out the readings in the above chart. The green Aggregator line remained negative, but just barely. Levels below 0 mean net expectations from the Active List are for downside over the next few days. Meanwhile, the Differential Line edged just barely back above 0. A positive Differential reading means the SPX has underperformed expectations over the last few days. So net expectations are negative but the SPX is oversold versus recent expectations. This is considered a neutral configuration. Neutral configurations can be seen on the Aggregator chart whenever both lines are on opposite sides of 0. Due to this the Aggregator System changed to flat.

The green Aggregator line is in a bit of a tricky place right now. If the current situation doesn't change, then the Aggregator will turn positive tomorrow. But one indicator that could easily affect the reading is the CBI. If the CBI drops below 10 then the Aggregator would likely close negative. I noted in the intraday update on Friday that there were several stocks that were near their exit targets. None of them got there, but doing so will be quite easy for them on Monday. I would be very surprised if an up close (or even an intraday spike up) did not cause a good-sized drop in the CBI. So the Aggregator reading tomorrow will be heavily dependent on intraday action and also what new studies emerge

as we approach the close. As far as the CBI reading, I will be sure to alert subscribers via [twitter](#) if it is likely to drop. Meanwhile, the Differential Pivot is going to drop all the way to 1,127.72. This means that unless the SPX drops over 4.3% that it will change from “oversold” to “overbought” versus recent expectations. I should also note that the Differential Pivot for Tuesday is likely to be back up around 1,175.50. The big swings in the Differential Pivot are thanks to the big 1-day market moves last week that will be falling out of the calculation over the next few days.

So I remain unenthused about either direction for the short-term. I still have a small amount of index exposure on the long side, and when the market has experienced such a strong washout I will often hold a piece long until the CBI drops back down to a neutral level. I don't intend to rush into a position tomorrow, but will consider all my options as the market unfolds over the next day or so to determine whether I am more inclined to bet on a continuation up or another leg down.

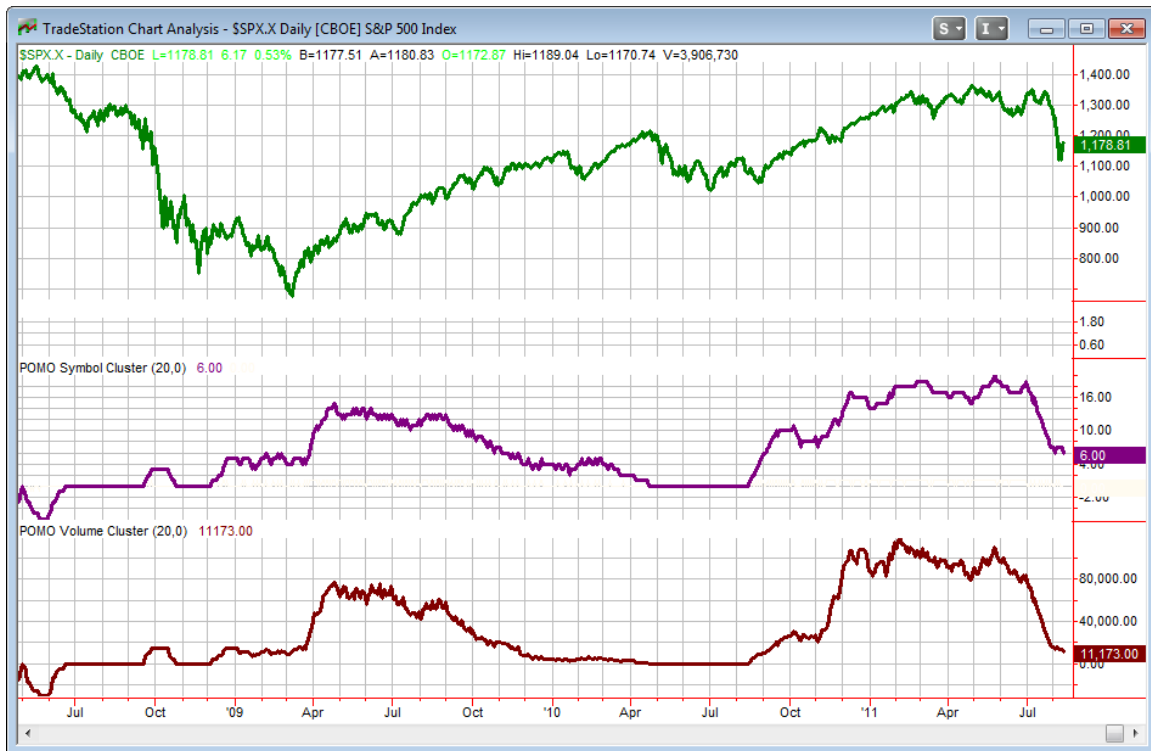
***Intermediate-term Outlook (2 weeks – 2 months)– updated 8/15 – neutral***

The trend is obviously down at this point. Some readings were reached this past week that were so extreme that they suggested a long-term bottom could be in place. Still, the market has yet to provide any confirmation of that beyond a few up days. To me it appears dangerous to bet big on either side at the moment.

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>



POMO indicators dipped a little more this past week. In the past when POMO stimulus ended – it ended. This time the end of QE2 marked a period of substantially less stimulus, rather than none. This made it tricky in determining whether the end of QE2 would completely pull the rug out from under the market. At this point it appears it has. The new operations schedule was released by the Fed on Wednesday and it is calling for about the same level of stimulus as we saw this past month. While there IS still liquidity pumping going on, it appears the reduced level is akin to providing a heroin addict a couple of aspirin to try and get high. The link below shows the new schedule.

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

If you click it you will notice there is a tab on the page where you can see “All Schedules” rather than just the “Current Schedule”. Clicking that tab you will see that the monthly estimate of POMO activity for last month and this month is about \$14 billion. During QE2 the level was normally around \$100 billion/month. So is the market capable of mounting a serious new bull move with the modest amount of stimulus currently being provided? So far I have seen no evidence of that.

## **Catapult and Capitulative Breadth Statistics**

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

### ***Open Catapult Triggers***

WAG – 1/3 @ \$37.05

WAG – 1/3 @ \$37.03

BAC – 1/3 @ \$8.17

WAG – 1/3 @ \$35.22 (final lot)

ALL – 1/3 @ \$24.57

BAC – 1/3 @ \$6.51 (2<sup>nd</sup> lot) *not filled (and not looking for entry)*

BAX – 1/3 @ \$50.31

EXC – 1/3 @ \$39.94

F – 1/3 @ \$9.93 *not filled (and not looking for entry)*

HON – 1/3 @ \$44.29

RTN – 1/3 @ \$39.41

TXN – 1/3 @ \$26.19

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

*None.*

**Broad Market Large Cap CBI – 12 (WAG-3, BAC-2, ALL, BAX, EXC, F, HON, RTN, TXN)**

### **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
<b>SPY(1/4)</b>	<b>7/26/2011</b>	<b>\$133.33</b>	<b>\$118.40</b>	<b>-11.20%</b>		<i>Sold on open</i>
<b>SPY(1/4)</b>	<b>7/28/2011</b>	<b>\$130.60</b>	<b>\$118.40</b>	<b>-9.34%</b>		<i>Sold on open</i>
SPY(1/4)	7/28/2011	\$130.22	\$118.15	-9.27%		
WAG(1/3)	8/5/2011	\$37.05	\$35.22	-4.94%		Catapult
<b>XIV</b>	<b>8/5/2011</b>	<b>\$12.50</b>	<b>\$9.94</b>	<b>-20.48%</b>		<i>Sold on open</i>
WAG(1/3)	8/8/2011	\$36.00	\$35.22	-2.17%		Catapult
BAC(1/3)	8/8/2011	\$7.40	\$7.19	-2.84%		Catapult
WAG(1/3)	8/9/2011	\$35.22	\$35.22	0.00%		Catapult
ALL(1/3)	8/9/2011	\$24.57	\$25.12	2.24%		Catapult
EXC(1/3)	8/9/2011	\$39.94	\$40.72	1.95%		Catapult
HON(1/3)	8/9/2011	\$44.29	\$46.88	5.85%		Catapult
RTN(1/3)	8/9/2011	\$39.41	\$40.76	3.43%		Catapult
TXN(1/3)	8/9/2011	\$26.19	\$27.18	3.78%		Catapult
<b>COF(1/3)</b>	<b>8/9/2011</b>	<b>\$37.63</b>	<b>\$44.70</b>	<b>18.79%</b>		<i>Sold on open</i>
BAX(1/3)	8/9/2011	\$50.31	\$53.29	5.92%		Catapult

*I will be sure to send out a Catapult and CBI update intraday alerting of possible exit triggers.*

#### Note on XIV

The XIV trade was exceptionally poor. And even on Friday when the market rose a bit and the VIX fell, XIV still could not muster a gain. At least part of the reason for this is that the futures term structure flipped from contango to backwardation. As I discussed in the VIX webinars (see Videos page) and demonstrated in the VIX-based ETFs trading systems it has typically paid to remain long XIV even if the market moves into backwardation during an Aggregator long signal. In most instances the Aggregator signal does not last very long, so the negative term-structure impact is minimal. Also, backwardation rarely lasts a very long time, also minimizing the term-structure affect. In this case we got a double whammy. The backwardation has lasted longer than normal and the Aggregator signal was about as bad as we've ever seen. The S&P downgrade seemed to really exacerbate things as traders were unsure of the impact it would have on the market therefore options premium spiked even more than they typically would and have remained fairly high during the bounce.

So it was a bad trade. And while such an extreme scenario may not occur again for quite some time, it still suggests to me that there is more work to do on the risk-control side of the VIX-based trading systems (at least the conservative one). I mentioned when I released them that I considered them a work-in-progress and may make changes over time until I was completely confident in them. I'm now inspired to test out some further ideas I have on how to possibly exploit the directional and term-structure edges as these systems do but with a much higher sensitivity to drawdown as opposed to alpha. I hope to hold another webinar on this topic in the next month or so to discuss more of this ongoing research with subscribers.

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