

QUANTIFIABLE EDGES SUBSCRIBER LETTER

ASSESSING MARKET ACTION WITH INDICATORS AND HISTORY

August 19, 2011

Volume 4 Issue 160

Market Overview



Signals Overview

Aggregator	Aggressive VIX	Conservative VIX	NDX Trend Timer
Long	100% Long SPY	100% Long SPY	Long

Tonight's Research Points

- 2% gaps down and a close 1% below the open but not at a 10-day have been rare but powerful short-term long signals.
- The 35% spike in the VIX is also rare and typically bullish the next day.
- Strong price drops under similar circumstances have seen quick bounces.
- 95% down volume and no 10-day low has also almost always led to an immediate bounce.

Short-term Outlook

The Bottom Line

Thursday's large drop moved the Aggregator from short to long. Risk is elevated but I am looking to begin taking on some long exposure.

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

Study Date	Description	Time span	Bias	Avg Max Move
Active				
August 19, 2011	5% Up Vol. No 10-day low.	1-2 days	Bullish	
August 18, 2011	SPY closes up but 1% below high. C<200	1-2 days	Bullish	2.40%
August 16, 2011	90% Up Vol on 3rd day higher	1-7 days	Bullish	
Active - Long Term				
August 16, 2011	90% Up Vol on 3rd day higher	1-14 days	Bullish	
August 16, 2011	SPY up 3. Vol down 3 days.	1-20 days	Bearish	
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	
Dropped Tonight				
August 18, 2011	VXO 15% below 10ma	1-3 days	Bearish	-3.50%
August 18, 2011	SPX up on lowest volume in 10 day	1-2 days	Bearish	-1.80%
August 16, 2011	SPY up 3. Vol down 3 days.	1-3 days	Bearish	

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

The Evidence

In case anyone thought those massive selling days were all behind us the market issued a reminder of what it is still capable of. It started with a big gap down and never got better. Despite a push up in the last 10 minutes the SPX finished with a 4.5% loss, the Nasdaq dropped 5.2%, and the Russell 2000 shed 5.9%. Breadth was again extremely negative as the NYE Up Issues % came in at 6% and the Up Volume % was just 3%. Total volume spiked up but didn't reach the levels it was at early last week.

The market action remains pretty amazing. On a very short term time frame the market has already become strongly oversold and several studies appeared suggesting a bounce. As I've mentioned before, generating accurate historical probabilities and estimates becomes substantially more difficult when the market is historically extreme. Simply put, there just isn't that much that compares the current environment. But with that in mind, and understanding that the studies tonight will all show a low number of instances, let's take a look at some historical comparisons.

Some of the most favorable results came when I examined action in the SPY. Thursday opened with a gap down of 2.65% and closed over 1.5% below the open. **I've shown in the past that 2% gaps down will typically reverse at some point in the next few days.** I therefore decided to look at other instances where the bounce was not immediate (day 0), and instead of reversing the gap down, SPY closed more than 1% below it. I also filtered out any instances where the market closed at a 10-day low. The suggests the market must

have had a sharp rise at some point in the last 2 weeks leading up to the large “gap-n-crap” formation. Results can be found below.

SPY gaps down at least 2%. It closes more than 1% below the open but > the lowest close of the last 10 days. 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	25,185.54	5	5	0	100.00	5,037.11	0.00	100.00	100.00	5,037.11
4	31,915.13	5	5	0	100.00	6,383.03	0.00	100.00	100.00	6,383.03
3	19,148.90	5	4	1	80.00	6,631.99	-7,379.07	0.90	3.60	3,829.78
2	15,154.62	5	4	1	80.00	4,781.35	-3,970.80	1.20	4.82	3,030.92
1	14,657.06	5	5	0	100.00	2,931.41	0.00	100.00	100.00	2,931.41

The instances are too low to put much faith in but all 5 have seen strong rebounds. An average 4-day return of over 6% is about as high as I’ve ever seen. And as you’ll see in the graphic below, 4 of the 5 rose between 6% - 8% while the last one rose 3.44%.

SPY gaps down at least 2%. It closes more than 1% below the open but > the lowest close of the last 10 days. Buy on close. Sell 4 days later. \$100k/trade. 1993 - present.				
Date/Time	Signal	Price	% Profit	Run-up Drawdown
09/10/98	Buy	\$97.25	7.97%	\$8,224.00
09/16/98	Sell	\$105.00		(\$257.00)
10/15/08	Buy	\$90.02	6.49%	\$10,078.80
10/21/08	Sell	\$95.86		(\$3,862.80)
10/22/08	Buy	\$90.64	3.44%	\$3,970.80
10/28/08	Sell	\$93.76		(\$7,654.82)
12/01/08	Buy	\$82.11	7.09%	\$7,679.27
12/05/08	Sell	\$87.93		(\$85.19)
03/30/09	Buy	\$78.79	6.94%	\$7,398.27
04/03/09	Sell	\$84.26		(\$583.74)

Stellar results.

Also notable about Thursday is that it marked the 6th time since the inception of the VIX in 1990 that it closed up over 35% for the day. It was also the 3rd time this month that it has done it. The previous 5 instances mostly showed a quick 1-2 day bounce followed by a dip lower. Below are all instances along with their 1 and 4-day results.

VIX rises over 35% today. Buy SPX on close. Sell next day's close. \$100k/trade. 1990 - present.				
Date/Time	Signal	Price	% Profit	Run-up Drawdown
11/15/91	Buy	\$382.62	0.68%	\$722.97
11/18/91	Sell	\$385.23		(\$767.34)
02/04/94	Buy	\$469.81	0.42%	\$483.36
02/07/94	Sell	\$471.76		(\$474.88)
02/27/07	Buy	\$1,399.14	0.55%	\$1,189.25
02/28/07	Sell	\$1,406.82		(\$176.79)
08/04/11	Buy	\$1,200.07	(0.06%)	\$1,497.32
08/05/11	Sell	\$1,199.38		(\$2,654.34)
08/08/11	Buy	\$1,119.46	4.74%	\$4,754.38
08/09/11	Sell	\$1,172.53		(\$1,594.88)

VIX rises over 35% today. Buy SPX on close. Sell 4 days later. \$100k/trade. 1990 - present.				
Date/Time	Signal	Price	% Profit	Run-up Drawdown
11/15/91	Buy	\$382.62	(0.67%)	\$722.97
11/21/91	Sell	\$380.06		(\$2,017.53)
02/04/94	Buy	\$469.81	(0.19%)	\$763.20
02/10/94	Sell	\$468.93		(\$474.88)
02/27/07	Buy	\$1,399.14	(1.79%)	\$1,189.25
03/05/07	Sell	\$1,374.12		(\$1,787.07)
08/04/11	Buy	\$1,200.07	(6.61%)	\$1,497.32
08/10/11	Sell	\$1,120.76		(\$8,177.99)

The 8/8/11 instance is not shown because it overlapped with the 8/4/11 instance.
Four days after the 8/8/11 instance the SPX closed **5.3% higher**.

The quick bounce followed by a drop is a theme that I saw among some other tests tonight. In the study below I looked for other instances where the market had risen off of a 100-day low, and then suffered a 1-day 3.5% drop that did NOT put it at a new low.

After closing at a 100-day low within the last 10 days SPX closes down at least 3.5% but does not make a new 100-day low. Buy on close. Sell X days later. \$100k/trade. 1960 - 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	-23,439.71	8	2	6	25.00	8,956.73	-6,892.19	1.30	0.43	-2,929.96
4	-3,782.35	8	4	4	50.00	4,858.03	-5,803.61	0.84	0.84	-472.79
3	144.09	8	5	3	62.50	4,038.98	-6,683.60	0.60	1.01	18.01
2	1,160.05	9	5	4	55.56	3,707.56	-4,344.44	0.85	1.07	128.89
1	11,466.79	10	6	4	60.00	3,224.64	-1,970.26	1.64	2.45	1,146.68

Results here seem to hint at a quick bounce that rolls over to new lows. I also decided to ignore the 100-day low requirement and increase the selloff requirement to 4%. Doing so yielded similar results. See below.

SPX closes down at least 4% but does not make a 10-day low. Buy on close. Sell X days later. \$100k/trade. 1960 - 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	-17,384.83	9	3	6	33.33	8,917.23	-7,356.09	1.21	0.61	-1,931.65
4	-3,284.66	10	5	5	50.00	6,710.70	-7,367.63	0.91	0.91	-328.47
3	7,031.09	10	5	5	50.00	5,875.54	-4,469.32	1.31	1.31	703.11
2	10,983.39	10	6	4	60.00	3,363.80	-2,299.85	1.46	2.19	1,098.34
1	12,169.70	11	8	3	72.73	2,632.41	-2,963.19	0.89	2.37	1,106.34

The last study I want to cover tonight is one that was last shown in the 7/12/11 subscriber letter. Like some of the other tests it required a close above a 10-day low, but rather than price action, it looked for extreme breadth. I have updated the results below.

NYSE Up Volume % < 5%. SPX closes > lowest close of the last 10 days. Buy SPX on close. Sell X days later. \$100k/trade. 1970 - present.

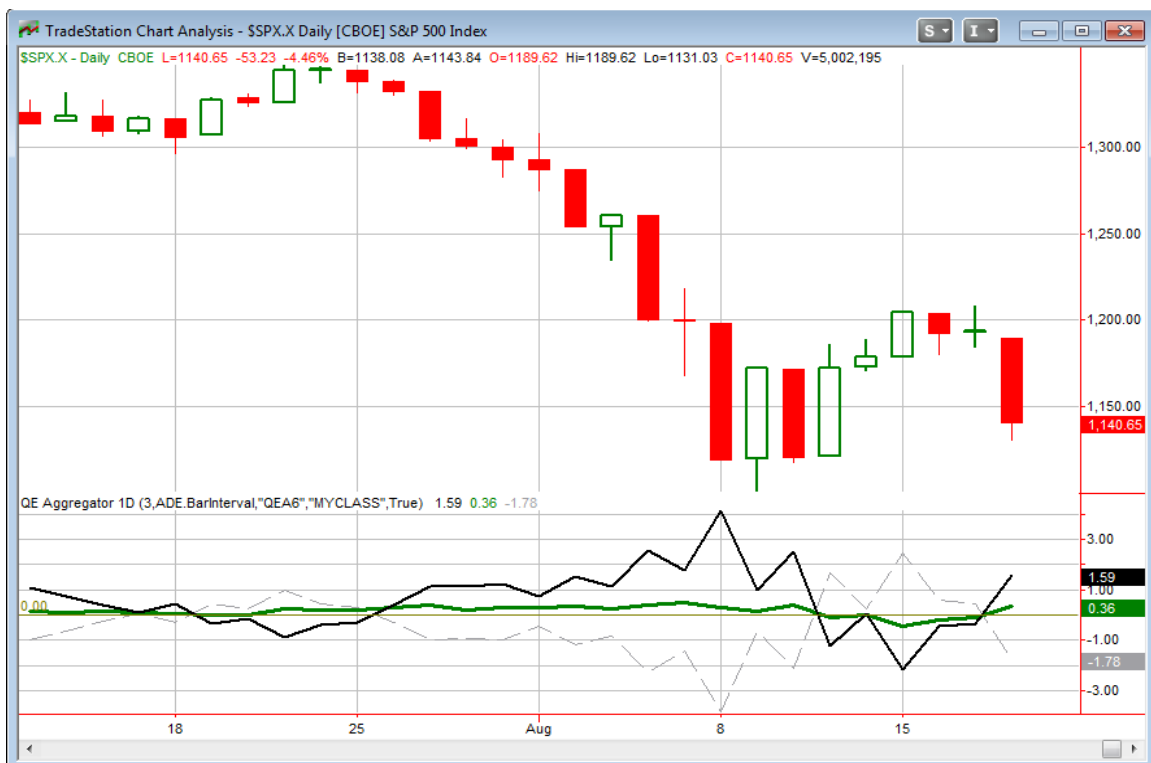
X Days	All: Net Profit	All: Total Trades	All: Winning Trades	All: Losing Trades	All: % Profitable	All: Avg Winning Trade	All: Avg Losing Trade	All: Win/Loss Ratio	All: ProfitFactor	All: Avg Trade
5	32,193.04	14	9	5	64.29	4,957.54	-2,484.97	2.00	3.59	2,299.50
4	26,559.86	14	9	5	64.29	4,909.73	-3,525.54	1.39	2.51	1,897.13
3	30,580.45	14	9	5	64.29	3,843.29	-801.84	4.79	8.63	2,184.32
2	23,480.44	14	11	3	78.57	2,284.89	-551.13	4.15	15.20	1,677.17
1	20,222.76	14	12	2	85.71	1,749.21	-383.88	4.56	27.34	1,444.48

The only instance not to close above the entry price within 2 days was 7/11/11. It took 6 days before closing above the entry price.

The instance last month was the 1st one not to bounce immediately. These results are similar to the 1st study I showed where there is no strong suggestion of a dip after the 1st day or 2. Again, instances are lower than I would prefer for all these tests.

It's difficult to determine which script the market is most likely to follow – whether it be a quick bounce and then another drop that is just as quick, or whether it be a strong rebound that persists for close to a week. I'm not inclined to guess which it will be and don't feel the need. The very short-term edge appears to be for a sharp 1-2 day bounce. I suspect that bounce will provide better clues about the following days than anything I am seeing now. Of course with so few examples and the market acting historically abnormal risks are elevated. The edge is up but the market has already proven it can do anything. Therefore I think it is prudent to take a conservative approach and scale in to any positions somewhat slowly here.

With so many studies providing similar results based on Thursday's extreme action I elected to simply use the last one (with the most instances) to generate estimates. I have updated the [Aggregator](#) chart below.



Thursday's action caused the green Aggregator line to spike well above 0 tonight. Levels above 0 mean net expectations from the Active List are for upside over the next few days. Meanwhile, the Differential Line also spiked above 0. A positive Differential reading means the SPX has underperformed expectations over the last few days. So net expectations are positive and the SPX is oversold versus recent expectations. Historically this combination has suggested an upside edge. Bullish configurations can be seen on the Aggregator chart whenever both lines are above 0. Due to this the Aggregator System flipped from short to long at the close.

Without any short-term bearish studies the green Aggregator line is set up to close positive again on Friday. Of course this could change if strong bearish evidence emerges. Meanwhile, the Differential Pivot is will be 1,182.79. This is a whopping 3.7% above Thursday's close. It's unlikely we'll see a bounce that strong on Friday. For the Differential line to turn back negative it will probably take a multi-day bounce.

Evidence is suggesting a bounce should occur shortly. Under such extreme market conditions I'm not inclined to get too aggressive. As I show in the Trade Ideas section below I will look to begin scaling in to an index position on Friday.

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

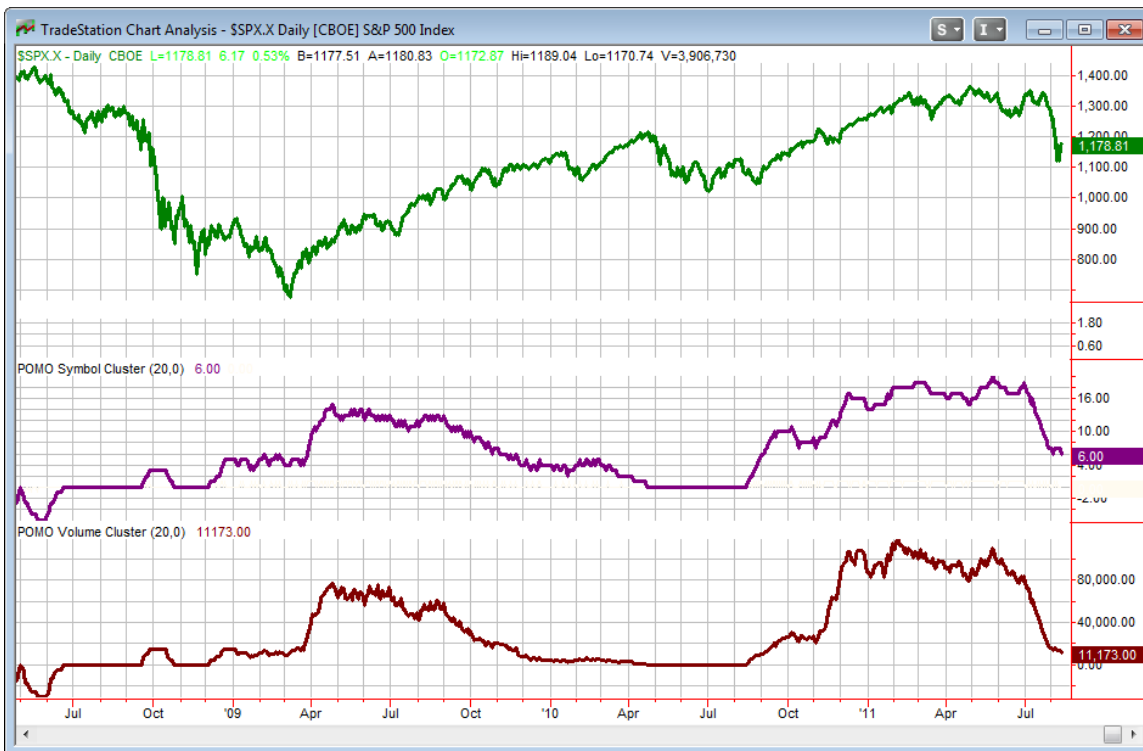
The trend is obviously down at this point. Some readings were reached this past week that were so extreme that they suggested a long-term bottom could be in place. Still, the market has yet to provide any confirmation of that beyond a few up days. To me it appears dangerous to bet big on either side 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 3rd 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

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

ALL – 1/3 @ \$24.57

Catapult for ETF's Trades

None.

Broad Market Large Cap CBI – 1 (ALL)

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 1/4 index position @ \\$114.51 limit.](#) Based on short-term outlook above.

Current Open Trade Ideas

Symbol	Entry Date	Entry Price	Current Price	% Gain/Loss	Stop	Notes
ALL(1/3)	8/9/2011	\$24.57	\$24.33	-0.98%		Catapult

Should ALL come close to an exit trigger tomorrow I will send out an intraday email.

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