

# QUANTIFIABLE EDGES SUBSCRIBER LETTER

ASSESSING MARKET ACTION WITH INDICATORS AND HISTORY

August 22, 2011

Volume 4 Issue 161

## Market Overview



## Signals Overview

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

## Tonight's Research Points

- Down closes on op-ex Friday have been followed by an up Monday 80% of the time over the last 5 years.
- Since 1999, 2 days of extremely weak breadth while under the 200ma have suggested a short-term bullish edge and have led to a bounce 98% of the time.
- The Nasdaq has lost its leading position over the SPX, which is not suggestive of a healthy market.
- The market has become extremely choppy over the last few weeks.

## Short-term Outlook

### The Bottom Line

A re-test of the August lows seems underway. Whether we get all the way down there before bouncing remains to be seen. There is currently ample evidence suggesting a bounce should materialize very soon. I'm partially long and will look to get longer if we get closer to the August lows.

*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 20, 2011	2 days of 33% Up Volume. SPX < 200ma	1-2 days	Bullish	
August 20, 2011	Down Op-Ex Friday	1 day	Bullish	
August 19, 2011	5% Up Vol. No 10-day low.	1-2 days	Bullish	
August 16, 2011	90% Up Vol on 3rd day higher	1-7 days	Bullish	
<b>Active - Long Term</b>				
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 5, 2011	QE2 Over	int term	Bearish	
March 22, 2011	3 Days Up Issues % > 70%	8 months	Bullish	19.00%
<b>Dropped Tonight</b>				
July 22, 2011	Up Issue% > 75% 2 of 3. Close 10 high.	1-20 days	Bullish	5.50%
August 18, 2011	SPY closes up but 1% below high. C<200	1-2 days	Bullish	2.40%

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

***The Evidence***

A wild up and down day started and ended poorly. The major averages all suffered losses and the SPX dropped 1.5%, the Nasdaq declined 1.6% and the Russell 2000 fell 1.7%. Breadth was also very poor as the NYSE Up Issues % came in at 23% and the Up Volume % was 15%. Total NYSE volume declined from Thursday's level.

The market environment continues to act in a historically extreme manner, increasing risks and messing with the odds a bit. But while we may be somewhat outside of "normal", prices are still driven by emotional reactions that can be seen in the charts and price action. Unless there are additional shocks (like a US debt downgrade after the market is already in a freefall), then those emotions often manifest themselves in ways that lead to reliable market reactions. The increased risk during volatile times means a more conservative approach may be warranted, but there are still edges to be exploited. The Quantifinder identified a few of them on Friday. I'll go over those that I found most compelling.

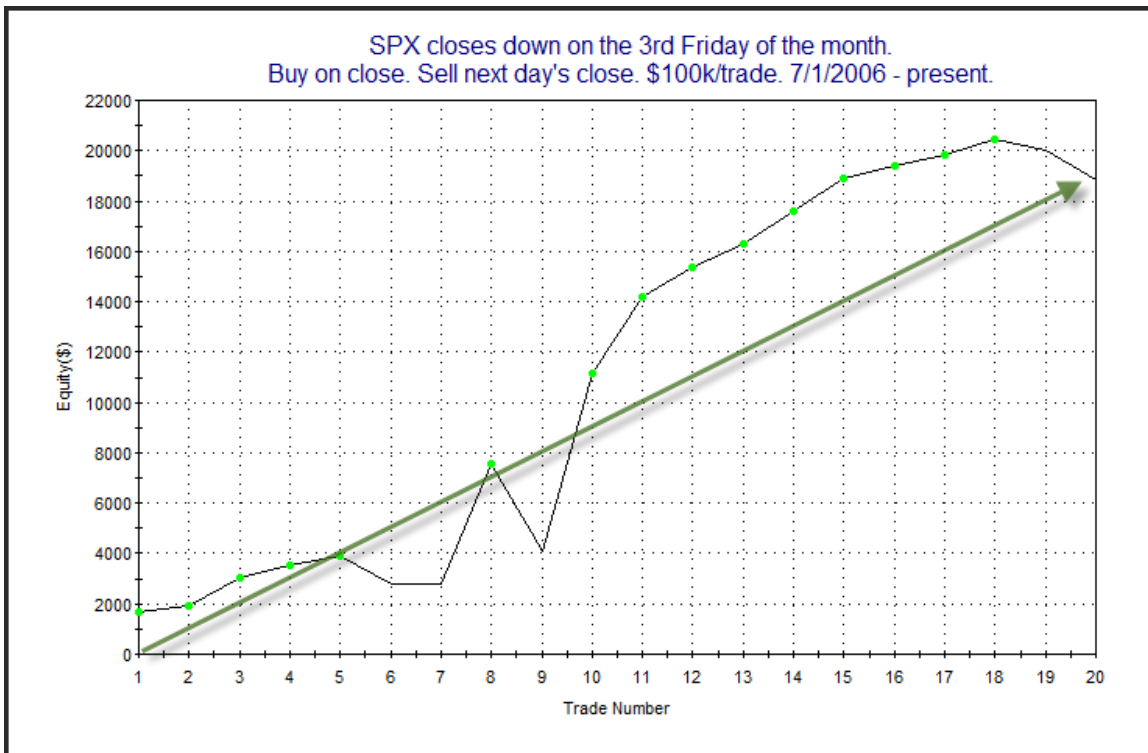
In the 5/23/11 subscriber letter I discussed how over the last 5 years down closes on op-ex Fridays have often been followed by a rebound on Monday. I have updated the performance report below.

SPX closes down on the 3rd Friday of the month.  
Buy on close. Sell next day's close. \$100k/trade. 7/1/2006 - present.

All Trades

Total Net Profit	\$18,825.91	Profit Factor	4.06
Gross Profit	\$24,969.73	Gross Loss	(\$6,143.82)
Total Number of Trades	20	Percent Profitable	80.00%
Winning Trades	16	Losing Trades	4
Even Trades	0		
Avg. Trade Net Profit	\$941.30	Ratio Avg. Win:Avg. Loss	1.02
Avg. Winning Trade	\$1,560.61	Avg. Losing Trade	(\$1,535.96)
Largest Winning Trade	\$7,069.40	Largest Losing Trade	(\$3,446.88)

There was a long streak of Monday winners until the last 2 instances, which both closed modestly down. Still, that stats appear to be strong bullish. Below is an equity curve.



At this point the recent dip does not appear terribly concerning and I still believe this study is worth taking into consideration from a seasonal point of view. Of course it doesn't take into consideration the very strong selling the last two days or the current downtrend. But the study below DOES take those things into account and I find its

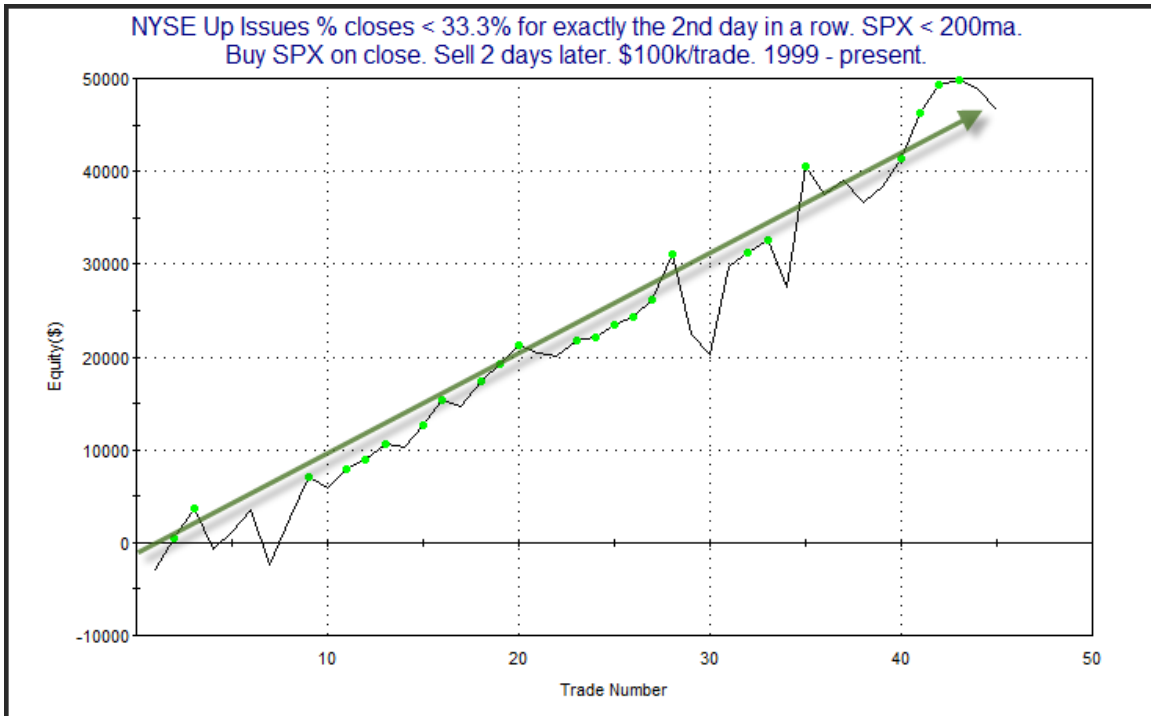
results to be even more compelling. It was last seen in the 6/8/10 subscriber letter and I have updated the research tonight.

NYSE Up Issues % closes < 33.3% for exactly the 2nd day in a row. SPX < 200ma.  
Buy SPX on close. Sell X days later. \$100k/trade. 1999 - 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	50,753.68	40	29	11	72.50	2,948.98	-3,160.61	0.93	2.46	1,268.84
4	29,452.19	42	25	17	59.52	3,037.25	-2,734.06	1.11	1.63	701.24
3	30,686.92	45	26	19	57.78	3,566.87	-3,265.88	1.09	1.49	681.93
2	46,643.28	45	30	15	66.67	2,921.07	-2,732.59	1.07	2.14	1,036.52
1	38,779.86	45	29	16	64.44	2,172.23	-1,513.43	1.44	2.60	861.77

43 of 45 instances closed above the entry price at some point in the next week. 44 of 45 (98%) did so within 6 days.

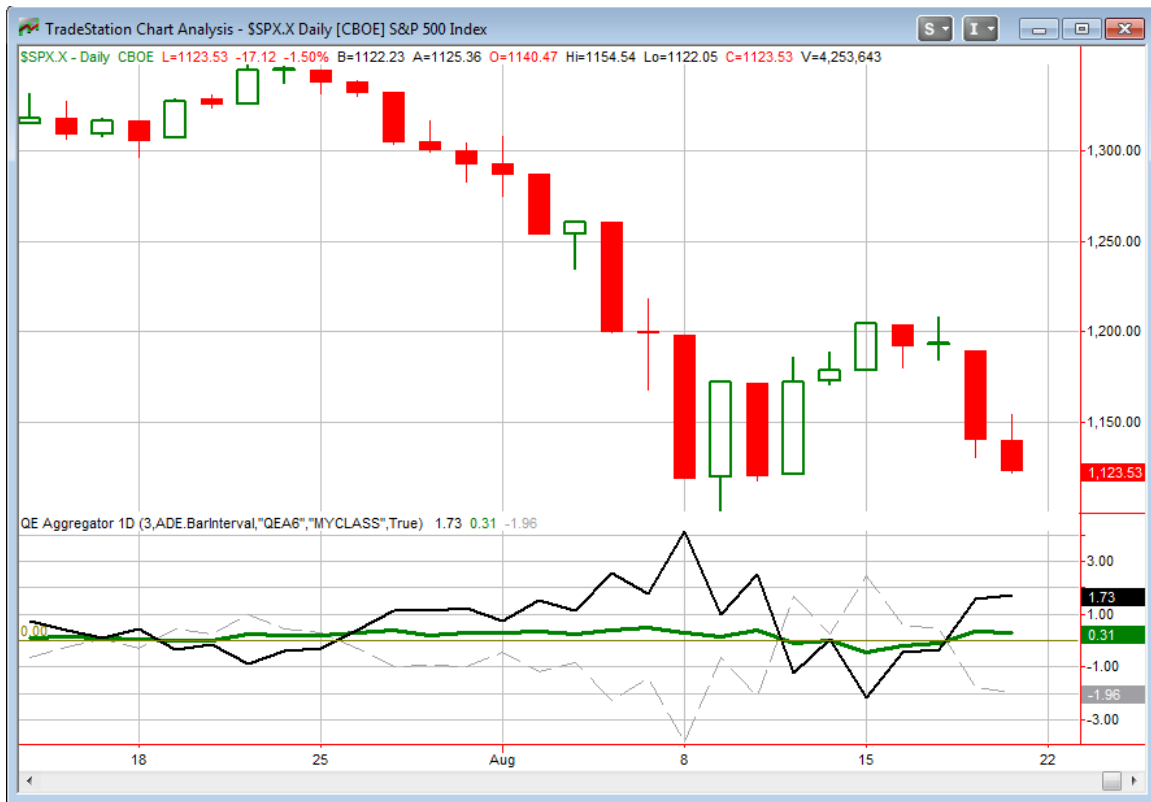
For the considerable sample size and low number of criteria the results are astonishingly consistent. The stat at the bottom of the table is what seems most striking.



The most recent instance triggered on 8/5/11 (the Friday that S&P downgraded US debt at night), so its 2-day return was poor. It was also the instance referred to above that took

6 days to close positive. Aside from the other obvious bullish qualities I especially like this study because it has produced such consistently positive returns in a downtrending environment.

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



Tonight's studies haven't done much to move the green Aggregator line, which remains strongly positive. Levels above 0 mean net expectations from the Active List are for upside over the next few days. Meanwhile, the Differential Line also remained well 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 remained long at the close.

Without any short-term bearish studies the green Aggregator line is set up to close positive again on Monday. Of course this could change if strong bearish evidence

emerges. Meanwhile, the Differential Pivot is will be 1,181.85. This is a whopping 5.2% above Friday's close. 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, but have begun taking on some long exposure. The August lows are nearby for most indices. Should the SPY get close to its August intraday lows I will look to add some more exposure in anticipation of a bounce of support.

***Intermediate-term Outlook (2 weeks – 2 months)– updated 8/22 – neutral to slightly bearish (more bearish if we break the August lows)***

Another down week has the SPX and other indices near their recent lows. All of Wall St. will be watching these levels since a break could suggest a deeper and longer downtrend is taking place.

Two indicators that I thought worth mentioning this weekend are tracked on a weekly basis on the charts page of the site. The first one looks at the relative strength between the S&P 500 and the Nasdaq. Since the inception of the Nasdaq in 1971, the S&P has gained more points when the Nasdaq was in a leading position than it has in total. In other words, a leading Nasdaq has been one sign of a healthy market. Up until this week the Nasdaq had been leading and providing some hope. That changed this week and you can see on the site that the Nasdaq is now lagging. More detailed historical results were discussed in the blog posts below a couple of years ago.

<http://quantifiableedges.blogspot.com/2009/05/simple-powerful-timing-indicator.html>

<http://quantifiableedges.blogspot.com/2009/06/tweaking-nasdaqs-leadlag-model.html>

Also, subscribers may download the models in either Tradestation or Excel format from the downloads page on the website. (They are download numbers 3 and 4.)

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

A 2<sup>nd</sup> indicator that has provided interesting action lately is the trend/chop indicator. The chart below is copied from the website. As a brief refresher, the chart represents an equity curve of a strategy that buys the SPX after every positive day and reverses to a short position after every down day. If the market is following through on a day to day basis and trending well, then the equity curve will rise. If the market is more inclined to reverse moves on a daily basis then the indicator will decline.



For most of the markets history the indicator was represented by a rising line. Around 2000 this changed and chop began to dominate. Except for a period in 2006-2007 chop ruled until mid-2009. Since then neither daily follow through nor daily chop has been strongly favored.

Volatile markets will often contain volatile reversals. This was evident in 2008 which saw the steepest decline ever in this indicator, and it has also been evident over the last couple of weeks.

It's too early to tell if chop will continue to be favored but I will watch developments here closely because trend/chop tendencies can have strong implications on optimal trading approaches.

If daily follow through is favored, then short-term traders can maximize profits by sticking with their winning trades as long as possible and trailing a stop to help time their exit. This is optimal because whatever direction the market is moving in, odds favor a continuation over the short-term. Systems that will perform best in this type of environment will use tight stops and no profit targets.

In a chop-dominated environment you are much better off taking profits very quickly. This is because a move in one direction is likely to reverse over the short-term. Short-term systems that perform best in this type of environment use no stops and easy-to-hit profit targets.

The sharp move down in the indicator over the past couple of weeks could suggest a new chop-dominated period is emerging, or it simply could be the results of the unusually volatile market we've had to deal with. Either way, I suggest traders keep this trend/chop indicator in mind as we move forward.

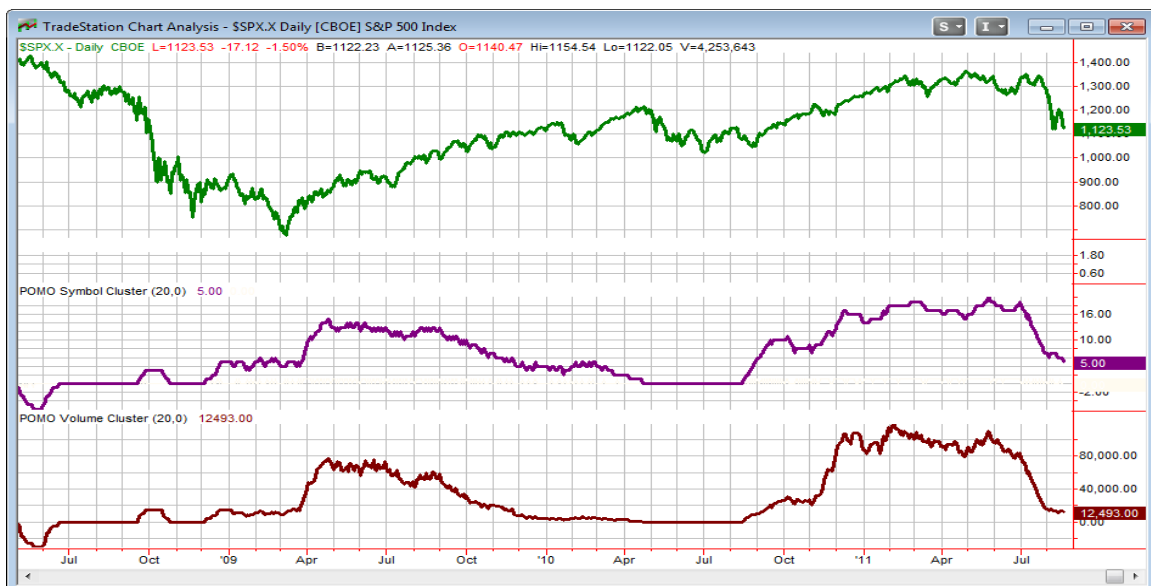
More research based on this indicator can be found by using the "Trend vs. Chop" label on the blog or by clicking the link below:

<http://quantifiableedges.blogspot.com/search/label/Trend%20Vs.%20Chop>

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 seem to be settling in to their new low level. At this point there has been no evidence that the market is capable of mounting a serious bull move with this reduced (from QE2) level of liquidity pumping. Still, if you start at a level low enough, then a bull move becomes more probable.

Are we “low enough” yet? Intermediate-term bullish evidence has waned greatly over the past few weeks. Right now we are looking at some studies that looked at strong breadth readings (which so far have been run over). Also there is one bullish study that looked at the extreme selloff a couple of weeks ago and noted that such extreme selling often marked the end of a down move.

On the bearish side, trend and momentum are clearly negative. POMO doesn't appear to be showing any support, and we also have a bearish volume study on the intermediate-term active list. Technically, the market is near or at levels that are testing the early August lows. Should those break it could mean another leg down (or several legs). I likely won't play either the long or short side terribly aggressively at this point, but will look for opportunities in both directions.

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

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

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

*ALL – 1/3 @ \$24.57*

*New*

*HPQ – 1/3 @ \$23.60*

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

*None.*

***Broad Market Large Cap CBI – 2 (ALL, HPQ)***

### **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.

**HPQ – buy 1/3 position @ \$23.60 limit.** Based on Catapult trigger above.

**SPY – buy ¼ index position @ \$111.00 limit.** With the Aggregator already bullish I'll look to take on a bit more exposure should we begin to approach the August intraday lows.

### **Current Open Trade Ideas**

Symbol	Entry Date	Entry Price	Current Price	% Gain/Loss	Stop	Notes
ALL(1/3)	8/9/2011	\$24.57	\$24.36	-0.85%		Catapult
SPY(1/4)	8/19/2011	\$112.96	\$112.64	-0.28%		Aggregator

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

### **Tip of the Day**

The nightly archives are currently up to date. Since it is a manual process I don't update them every day though. Sometimes I won't do so for a couple of weeks. If you are ever looking for a recent letter and the archives are not updated – send an email to [support@quantifiableedges.com](mailto:support@quantifiableedges.com) and I will see that they are quickly brought up to date. Of course the “current” nightly letter may always be found by using the “Current Nightly Letter” link.

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

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