

# QUANTIFIABLE EDGES SUBSCRIBER LETTER

ASSESSING MARKET ACTION WITH INDICATORS AND HISTORY

August 23, 2011

Volume 4 Issue 162

## Market Overview



## Signals Overview

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

## Tonight's Research Points

- SPY closing positive but off its highs often precedes a move higher.
- Weak bounces from oversold conditions are more susceptible to failure.

## Short-term Outlook

### The Bottom Line

There still appears to be an upside edge, but odds appear somewhat up in the air after Tuesday. I am partially long. I am not looking to increase my exposure at this point, but may lighten it if the SPX rallies strongly on Tuesday.

## 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 23, 2011	SPY up but 1% below high.	1-2 days	Bullish	
August 23, 2011	SPY up 3. Vol down 3 days.	1-3 days	Bearish	
August 22, 2011	2 days of 33% Up Volume. SPX < 200ma	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>				
August 19, 2011	5% Up Vol. No 10-day low.	1-2 days	Bullish	
August 20, 2011	Down Op-Ex Friday	1 day	Bullish	

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

## *The Evidence*

A strong start to the day never gained traction. Most of the day was spent giving up early morning gains and the market closed near its lows with the indices all near breakeven. The SPX gained 0.03%, the Nasdaq was up 0.15% and the Russell 2000 lost 0.08%. Breadth was moderately negative as the NYSE Up Issues % came in at 44% and the Up Volume % was 46%. Total NYSE volume fell for the 2<sup>nd</sup> day in a row.

For a day with such a small final % change I found quite a bit worth discussing tonight.

One study I ran during the day looked at what happens after 2 big down days like Thursday and Friday are followed by a gap up that fails to spark a further rally but the SPY still manages to close positive. Results of one set of parameters I used can be found below.

After closing down > 1% the last 2 days SPY closes up today, but below its open. 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	-7,188.44	14	5	9	35.71	2,230.18	-2,037.71	1.09	0.61	-513.46
4	-5,616.88	14	6	8	42.86	1,824.90	-2,070.78	0.88	0.66	-401.21
3	-3,102.66	14	8	6	57.14	1,696.23	-2,778.75	0.61	0.81	-221.62
2	8,068.37	14	11	3	78.57	1,413.89	-2,494.80	0.57	2.08	576.31
1	392.42	14	5	7	35.71	1,895.21	-1,297.66	1.46	1.04	28.03

These results are not unlike many we have seen lately, predicting a brief bounce and then possibly seeing the market roll over after said bounce.

Of course Thursday and Friday were quite a bit worse than just 1% drops (especially Thursday). So I increased that requirement from 1% to 1.5%. This reduced the number of instances to just 5. I have listed them all below along with their 2-day returns.

After closing down > 1.5% the last 2 days SPY closes up today, but below its open. Buy on close. Sell 2 days later. \$100k/trade. 1993 - present.

Date/Time	Signal	Price	% Profit	Run-up Drawdown
05/04/00	Buy	\$141.81	0.45%	\$1,543.95
05/08/00	Sell	\$142.45		(\$613.35)
02/22/01	Buy	\$125.81	1.44%	\$1,437.14
02/26/01	Sell	\$127.62		(\$3,183.94)
09/24/08	Buy	\$118.93	1.61%	\$2,503.20
09/26/08	Sell	\$120.85		(\$411.60)
03/31/09	Buy	\$79.52	4.92%	\$6,398.13
04/02/09	Sell	\$83.43		(\$1,495.83)
01/25/10	Buy	\$109.77	0.05%	\$637.00
01/27/10	Sell	\$109.83		(\$1,310.40)

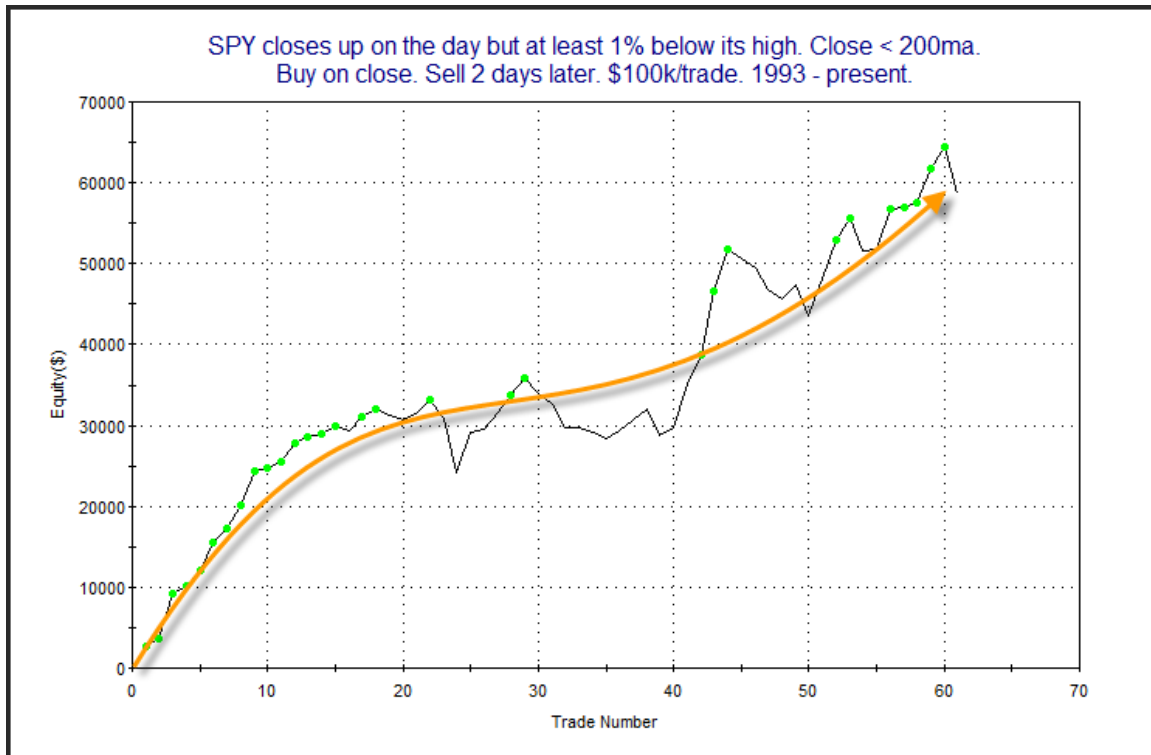
Instances are low here if these results are all you have to go by, but they certainly don't raise any warning flags about the big drop negatively impacting the results of the first test.

Another study that considered positive closes occurring off the highs of the day was one that triggered just a couple of days ago. I wrote about it in the 8/18 Letter and have updated the study again tonight.

SPY closes up on the day but at least 1% below its high. 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	38,280.72	52	28	23	53.85	3,678.85	-2,814.22	1.31	1.59	736.17
4	41,823.64	54	32	22	59.26	3,316.25	-2,922.57	1.13	1.65	774.51
3	44,845.82	56	33	23	58.93	3,090.90	-2,484.95	1.24	1.78	800.82
2	58,641.68	61	42	19	68.85	2,382.76	-2,180.75	1.09	2.42	961.34
1	28,153.62	68	43	25	63.24	1,718.98	-1,830.50	0.94	1.62	414.02

Based on the stats table this pattern appears to suggest a solid upside edge over the next couple of days. The "avg trade" appears especially sizable for a study with so many instances. Below I have produced an equity curve to see how the edge has played out over time.



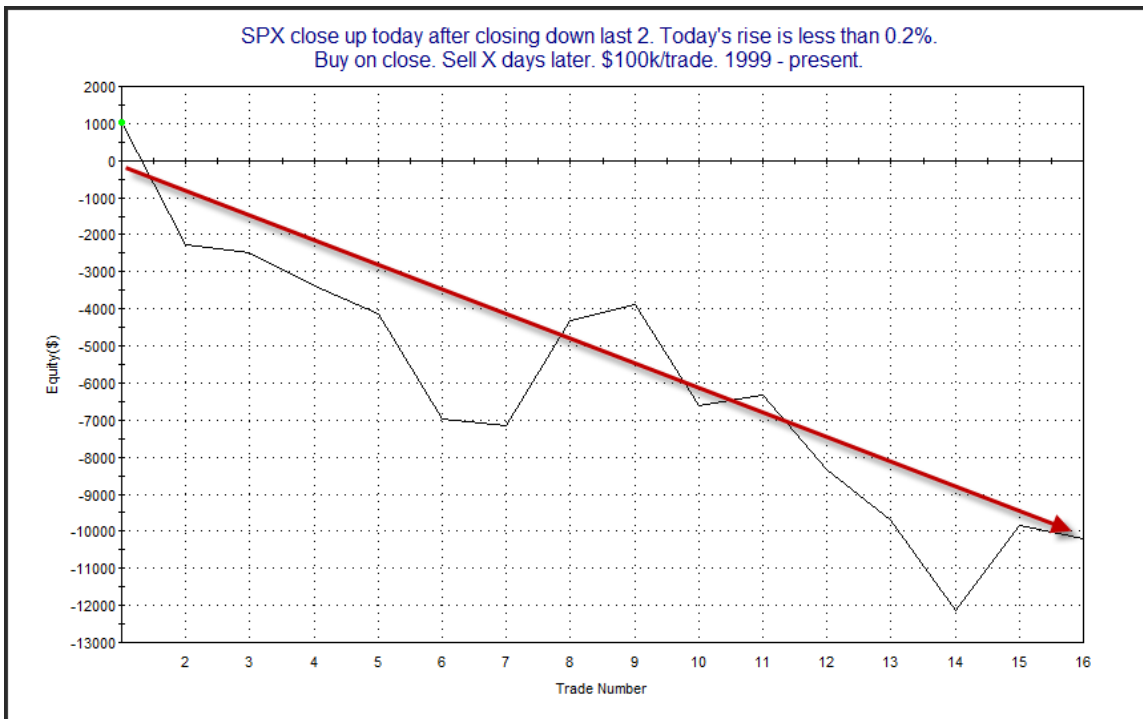
The edge seemed to take a break in the middle of the chart (which was between mid-2001 and mid-2008) but it now appears to be back on track. Aside from the last instance, I find the recent action encouraging and have included this study on the Active List.

One concern I have about Monday's action is that as far as rebounds go, Monday ended up quite weak. Typically when the market gets extremely oversold you would prefer to see the first day of a bounce be a powerful one. If this occurs then the bounce typically has a better chance of following through on a short-term basis. Weak bounces, on the other hand, are more susceptible to rolling over and suffering another leg down. I have shown this a number of ways over the years. One such study from the 8/2/10 subscriber letter triggered Monday. I have updated that study below.

SPX closes up today after closing down last 2. Today's rise is less than 0.2%.  
Buy 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	-10,327.85	15	6	9	40.00	1,763.95	-2,323.50	0.76	0.51	-688.52
4	-15,254.15	16	7	9	43.75	1,356.83	-2,750.21	0.49	0.38	-953.38
3	-10,192.74	16	5	11	31.25	1,369.22	-1,548.99	0.88	0.40	-637.05
2	-7,388.55	16	7	9	43.75	970.88	-1,576.08	0.62	0.48	-461.78
1	-2,455.40	16	6	10	37.50	1,375.23	-1,070.68	1.28	0.77	-153.46

Instances are a little low but the results clearly favor the bears, especially over the 3-4 day period. Below is an equity curve showing how the trades would have performed using a 3-day exit strategy.



It isn't completely smooth, but the general downward slope appears intact and I believe the study is worth taking under consideration.

Another study, from the 6/17/11 subscriber letter, showed much more impactful negative results. It looked at weak bounces as measured by breadth. I have updated that study below as well.

Yesterday SPX drops > 1.5%. Today SPX closes higher but NYSE Up Issue % < 45%. Buy SPX on close. Sell X days later. \$100k/trade. 2000 - 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	-22,654.98	23	7	16	30.43	3,529.40	-2,960.05	1.19	0.52	-985.00
4	-22,275.82	23	6	17	26.09	3,095.08	-2,402.72	1.29	0.45	-968.51
3	-27,707.42	23	7	16	30.43	2,591.02	-2,865.28	0.90	0.40	-1,204.67
2	-32,659.92	23	8	15	34.78	1,575.90	-3,017.81	0.52	0.28	-1,420.00
1	-26,971.75	23	5	18	21.74	1,694.64	-1,969.16	0.86	0.24	-1,172.68

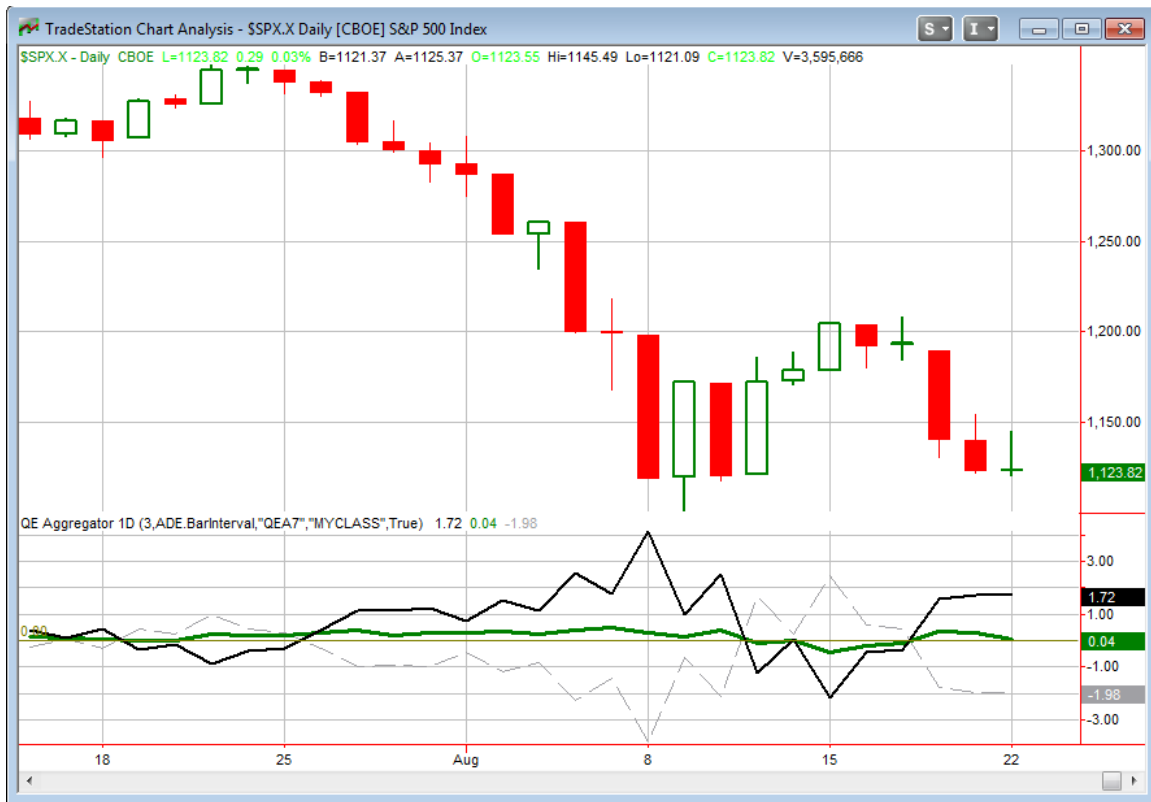
These results are certainly strongly negative over the 1<sup>st</sup> 2 days. Still, I had some concerns when deciding whether to include it in my analysis. The problem is that there are 3 basic criteria and the current set just barely qualified for all 3. Friday needed to drop 1.5% or more. The SPX lost 1.5009% on Friday. It needed to close higher today. It rose by 0.03% today. Lastly, the Up Issue % needed to be < 45% and it came in at 44%. The fact that the current setup just barely qualified for all 3 criteria suggests to me that this instance is not typical of the sample set. So to see how a sample set that may be closer to the current situation might perform I adjusted the parameters some. Rather than requiring a drop of 1.5%+ I looked for drops between 1.25% and 1.75%. Also I bracketed the Up Issues % to 43%-47% instead of saying it had to be below 45%. Doing this yielded the following results.

Yesterday SPX drops > between 1.25 and 1.75%. Today SPX closes higher but NYSE Up Issue % is between 43% and 47%. Buy SPX on close. Sell X days later. \$100k/trade. 2000 - 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	5,219.69	5	4	1	80.00	1,342.54	-150.48	8.92	35.69	1,043.94
4	4,585.64	5	4	1	80.00	1,156.18	-39.06	29.60	118.40	917.13
3	3,363.68	5	3	2	60.00	1,367.18	-368.93	3.71	5.56	672.74
2	4,711.23	5	5	0	100.00	942.25	0.00	100.00	100.00	942.25
1	3,691.53	5	4	1	80.00	945.08	-88.80	10.64	42.57	738.31

I don't feel that so few instances are worthy of letting this study stand on its own. But they do provide enough evidence that I have decided not to include the previous test on the Active Studies List.

In all I am adding 1 bullish and 1 bearish study tonight. There is nothing on the list that lasts more than 3 days. Therefore you can expect estimates to change rapidly as more evidence emerges over the next few days.

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



Despite tonight's studies being mixed the green Aggregator line dipped a little tonight. Still, it remained positive. Levels above 0 mean net expectations from the Active List are for upside over the next few days. Meanwhile, the Differential Line barely budged and is still 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 remained long at the close.

At this point the green Aggregator line is set up to close very near 0 on Tuesday. This means that the studies that emerge tomorrow will almost certainly determine whether the

green Aggregator line finishes positive or negative. Meanwhile, the Differential Pivot will be 1,140.85. This is about 1.5% above Monday's close. For the Differential line to turn negative it will take a rally of at least this much.

While the outlook remains bullish, evidence has weakened a bit over the last few days. If the market does bounce tomorrow and bearish studies overrule the bullish ones then the Aggregator System could finish flat or even short. With this in mind I am going to give it a day and see how things play out before looking to add more exposure.

***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.

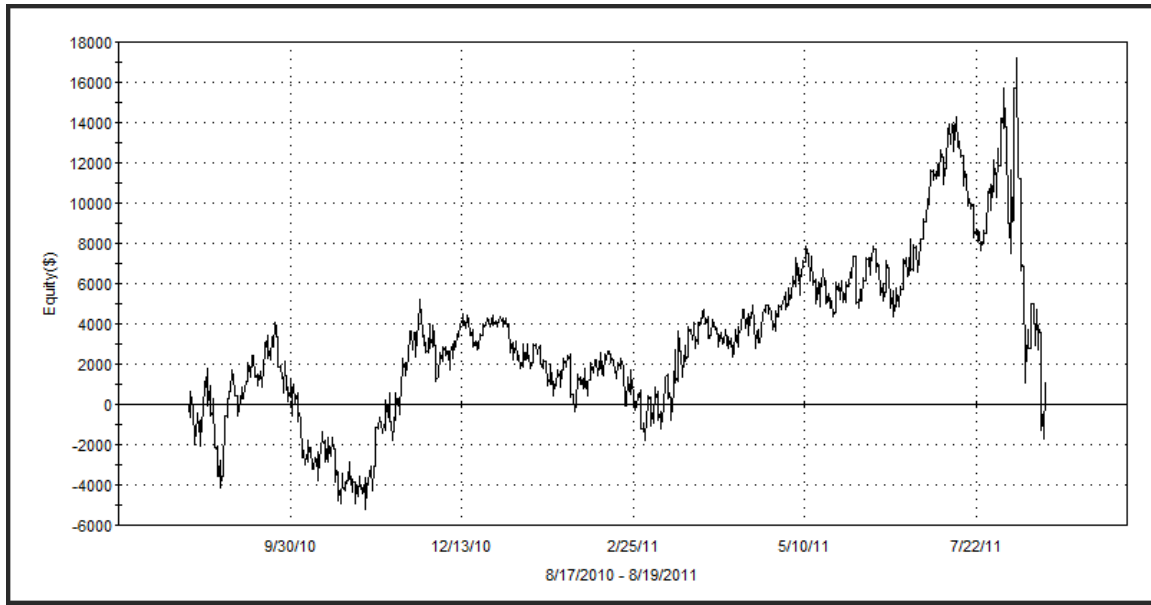
<http://quantifiableedges.blogspot.com/2009/05/simple-powerful-timing-indicator.html>

<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 market's 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.

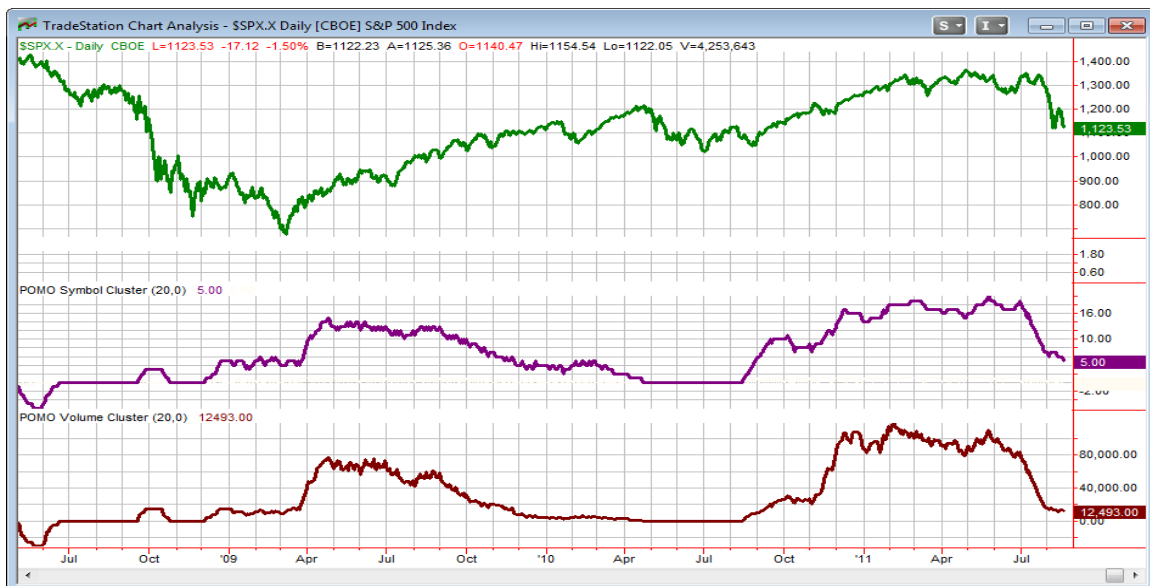
More research based on this indicator can be found by using the "Trend vs. Chop" label on the blog or by clicking the link below:

<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*

*HPQ – 1/3 @ \$23.60 (not filled and now not looking to enter)*

### ***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.*

*No new trade ideas tonight.*

### **Current Open Trade Ideas**

<b>Symbol</b>	<b>Entry Date</b>	<b>Entry Price</b>	<b>Current Price</b>	<b>% Gain/Loss</b>	<b>Stop</b>	<b>Notes</b>
ALL(1/3)	8/9/2011	\$24.57	\$24.46	-0.45%		Catapult
SPY(1/4)	8/19/2011	\$112.96	\$112.73	-0.20%		Sell on SPX close > 1,140.84

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

*I will exit the SPY trade if SPX closes at or above the Differential Pivot.*

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