

QUANTIFIABLE EDGES SUBSCRIBER LETTER

ASSESSING MARKET ACTION WITH INDICATORS AND HISTORY

August 25, 2011

Volume 4 Issue 164

Market Overview



Signals Overview

Aggregator	Aggressive VIX	Conservative VIX	NDX Trend Timer
Short	100% Long VXX	100% Long VXX	Long

Tonight's Research Points

- Normally bearish studies don't appear so when considering yesterday's Follow Through Day.

Short-term Outlook

The Bottom Line

There still appears to be an edge to the short side and I will look to take on a small amount of index exposure to take advantage of it. The fact that the market is embarking on a potential new rally increases risks for shorting, so my position will remain light.

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

Study Date	Description	Time span	Bias	Avg Max Move
Active				
August 24, 2011	VXO drops 15%-20%. SPX < 200ma	1-3 days	Bearish	
August 24, 2011	Follow through day on strong breadth	1-3 days	Bullish	
August 23, 2011	SPY up 3. Vol down 3 days.	1-3 days	Bearish	
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 5, 2011	QE2 Over	int term	Bearish	
March 22, 2011	3 Days Up Issues % > 70%	8 months	Bullish	19.00%
Dropped Tonight				
August 16, 2011	90% Up Vol on 3rd day higher	1-7 days	Bullish	

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

The Evidence

In a rare show of strength, yesterday's VIXO crush did not halt the bulls today. The major indices put in solid gains and the market closed near its high. The SPX gained 1.3%, the Nasdaq was up 0.9%, and the Russell 2000 rose 1.4%. Breadth was squarely positive as the NYSE Up Issues % came in at 69% and the Up Volume % was 77%. Total NYSE volume declined.

So the question I am asking myself tonight is whether the market is beginning a runaway move to the upside? Everything that appeared in the Quantifinder suggested that the market is likely to pull back. Three days higher in a downtrend is typically all the signal you need suggesting a downside edge. But the market is coming from a very low level. It is NOT the initial bounce off the low. That happened a couple of weeks ago. Instead we are coming off a retest of that bottom. If we were coming off the initial bottom then I could point to several studies suggesting that risk is elevated and we are best off not attempting short positions. An example of what I am referring to can be found in this blog post from a few years back:

<http://quantifiableedges.blogspot.com/2008/11/dangers-of-shorting-near-potential.html>

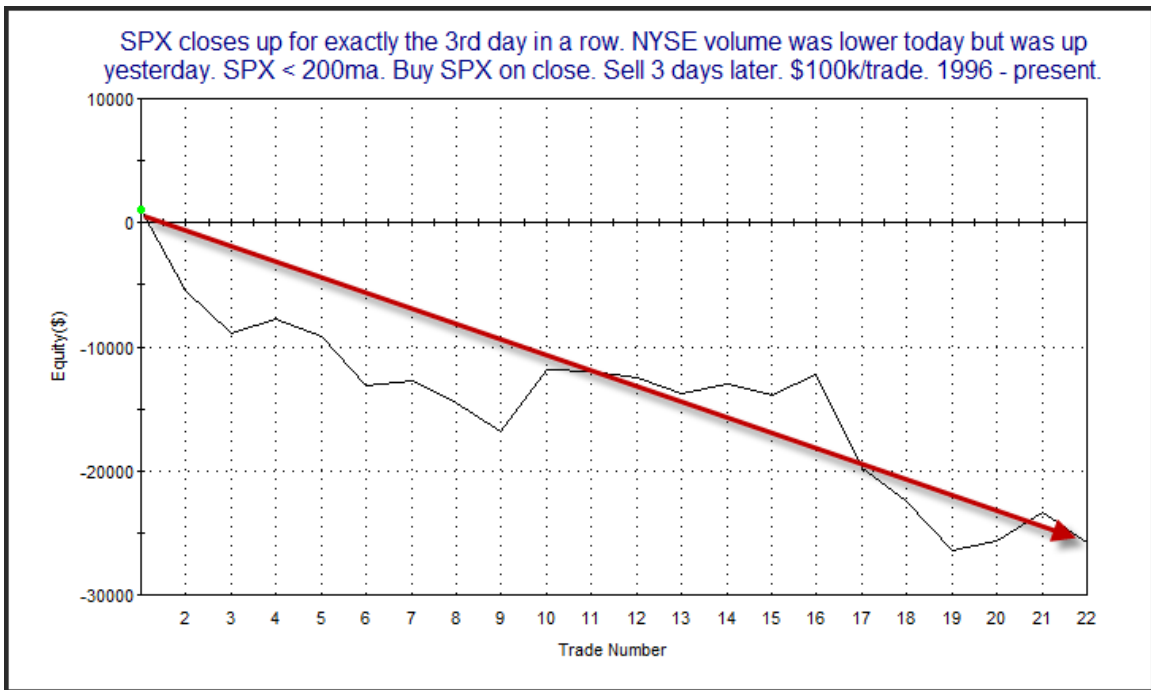
So my gut says a strong rally could emerge since we are coming off a potential double bottom here. Another sign that a new rally may be emerging is the fact that yesterday was a Follow Through Day (FTD). I therefore decided to try the FTD as a filter rather than requiring a 50-day low. Let's see how this affected one study that was typical of what I was seeing tonight.

One study that appeared looked at 3 up closes with today's volume being lower than yesterday, all during a long-term downtrend. It was last seen in the 4/25/11 Subscriber Letter. (Stats remain unchanged.)

SPX closes up for exactly the 3rd day in a row. NYSE volume was lower today but was up yesterday. SPX < 200ma. Buy SPX on close. Sell X days later. \$100k/trade. 1996 - 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	-19,857.24	22	10	12	45.45	2,053.41	-3,365.95	0.61	0.51	-902.60
4	-17,612.57	22	9	13	40.91	1,671.68	-2,512.13	0.67	0.46	-800.57
3	-25,732.59	22	8	14	36.36	1,615.99	-2,761.46	0.59	0.33	-1,169.66
2	-16,435.53	22	8	14	36.36	1,355.86	-1,948.74	0.70	0.40	-747.07
1	-12,272.60	22	7	15	31.82	1,174.60	-1,366.32	0.86	0.40	-557.85

The stats here appear quite strong, and the equity curve...



..confirms the downside edge suggested by the stats.

So what happens if I use similar criteria but say that yesterday must've been a FTD?

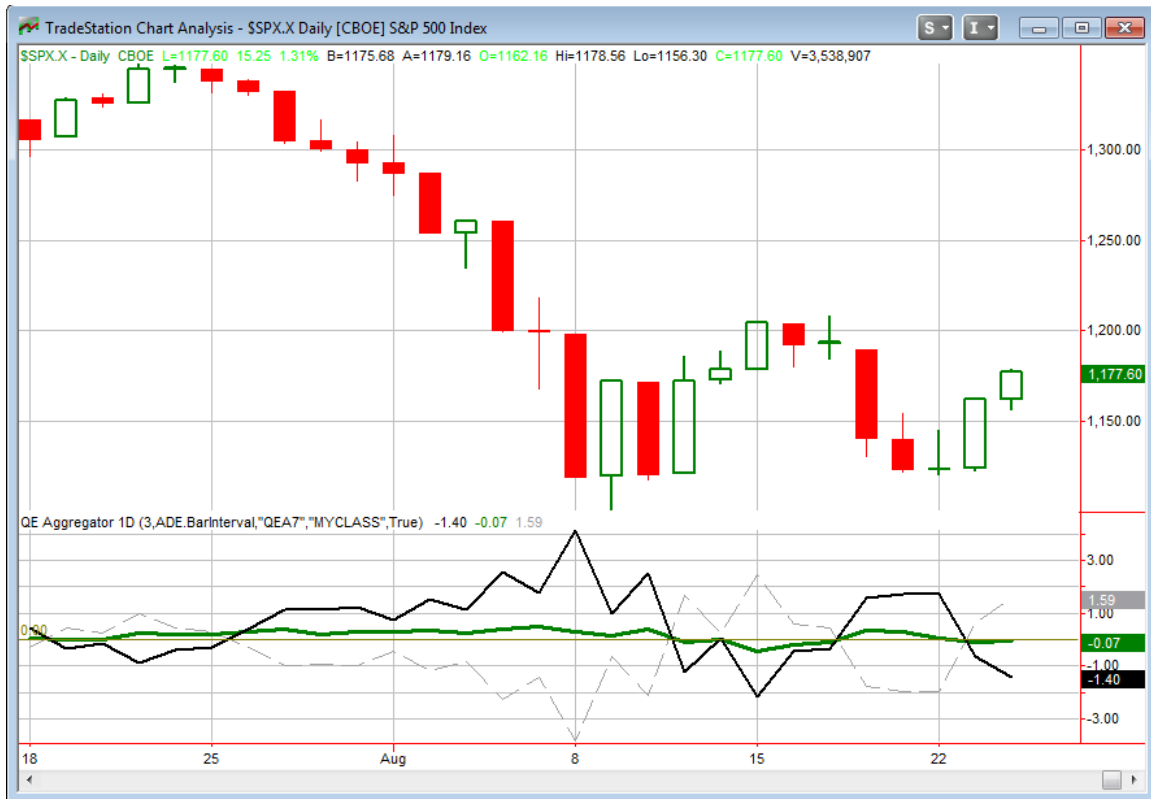
SPX closes up for at least the 3rd day in a row. NYSE volume declines today. Yesterday was a Follow Through Day. Close < 200ma. Buy on close. Sell X days later. \$100k/trade. 1971 - present.

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	2,010.57	7	6	1	85.71	1,570.10	-7,410.00	0.21	1.27	287.22
4	4,793.45	7	6	1	85.71	1,672.91	-5,244.00	0.32	1.91	684.78
3	8,383.91	7	5	2	71.43	2,424.53	-1,869.38	1.30	3.24	1,197.70
2	4,166.01	7	5	2	71.43	1,544.32	-1,777.80	0.87	2.17	595.14
1	2,323.61	7	4	3	57.14	950.26	-492.48	1.93	2.57	331.94

Instances are low here and the results are not statistically significant, but any hint of an edge would have to be interpreted as bullish. The volume pattern is the same and the market is in a long-term downtrend, and it has closed higher 3 days in a row. The primary difference between the 2 studies is that this one occurs right after a FTD. The post-FTD new rallies showed a possible propensity to turn into runaway moves, and this does seem worth considering.

One other note here is that the time span for the FTD study is much larger. In fact several of the instances occurred between 1971 – 1981. Since this is well outside the scope of the 1st study, I ran the 1st study over this time frame as well. It showed mild bearish tendencies, which confirms the idea that the pattern coming directly after a FTD is more dangerous to try and short. I looked at a number of different studies tonight and the same theme held true. The upmove over the last 2-3 days would suggest a bearish edge if not for the FTD yesterday. That FTD could POSSIBLY turn the expectation to positive. I did not find evidence compelling enough to make that determination. I did find it compelling enough to ignore the possible bearish edges suggested by the last couple of days price/volume action. Therefore, while I could have added some bearish evidence to the Active List, I chose to ignore those studies I saw tonight and simply base my estimates on the studies that were already there.

With all this in mind I have updated the [Aggregator](#) chart below.



Without additional evidence tonight the green Aggregator line held near the same reading. Levels below 0 mean net expectations from the Active List are for downside over the next few days. Meanwhile, the Differential Line dropped further below 0. A negative Differential reading means the SPX has outperformed expectations over the last few days. So net expectations are negative and the SPX is overbought versus recent expectations. Historically this combination has suggested a downside edge. Bearish configurations can be seen on the Aggregator chart whenever both lines are below 0. Due to this the Aggregator System remained short at the close.

At this point the green Aggregator line is set to close negative again on Thursday. This could change if bullish evidence emerges. Meanwhile, the Differential Pivot will be 1,130.16. This is about 4% below Wednesday's close. In other words, it is highly unlikely the Differential line will turn positive tomorrow. That would take a multi-day drop at this point.

A pullback still appears to be the more likely scenario, but the new rally increases short-side risks. I will look to take on a minimal amount of index short exposure tomorrow. It is also highly unlikely I will increase this position greatly anytime soon.

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.

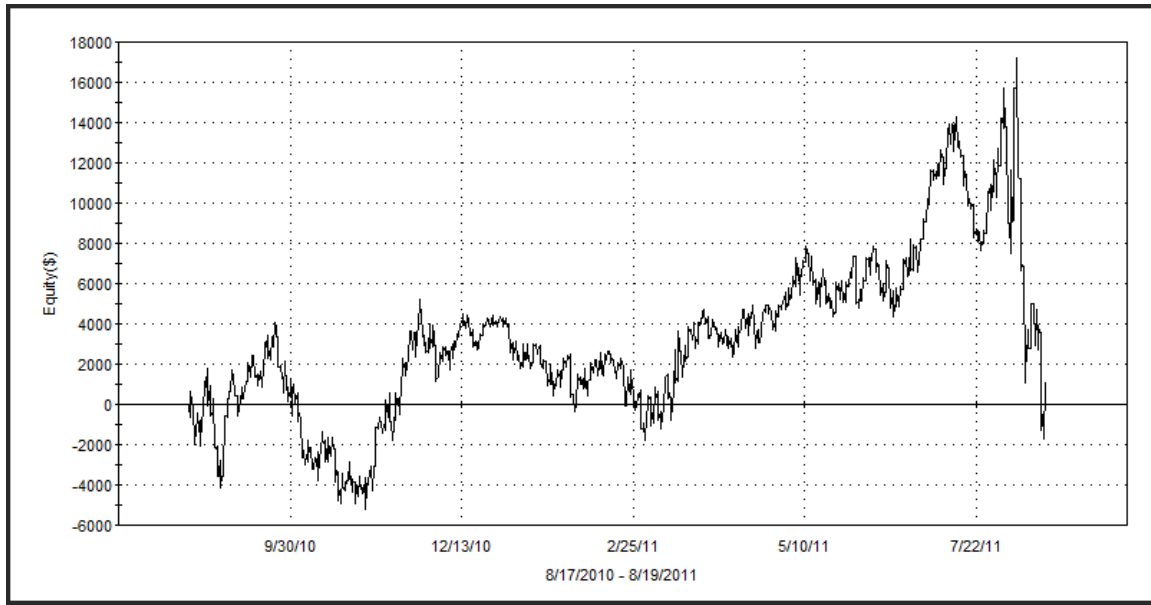
<http://quantifiableedges.blogspot.com/2009/05/simple-powerful-timing-indicator.html>

<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 2nd 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.

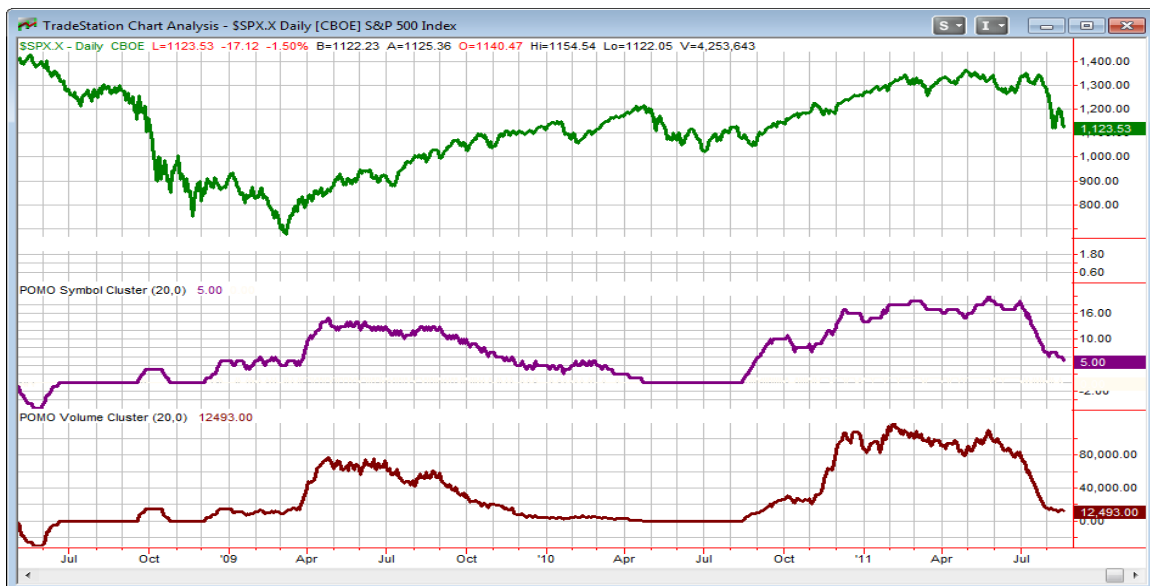
More research based on this indicator can be found by using the "Trend vs. Chop" label on the blog or by clicking the link below:

<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 3rd 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

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

Catapult for ETF's Trades

None.

Broad Market Large Cap CBI – 1 (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.

SPY – short 1/4 index position @ \$118.08 limit. Based on short-term outlook above.

Current Open Trade Ideas

Symbol	Entry Date	Entry Price	Current Price	% Gain/Loss	Stop	Notes
<i>ALL(1/3)</i>	<i>8/9/2011</i>	<i>\$24.57</i>	<i>\$24.81</i>	<i>0.98%</i>		<i>Sold on open</i>
VXX	8/24/2011	\$41.74	\$40.90	-2.01%		<i>Bought on open</i>

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