

# QUANTIFIABLE EDGES SUBSCRIBER LETTER

ASSESSING MARKET ACTION WITH INDICATORS AND HISTORY

August 29, 2011

Volume 4 Issue 166

## Market Overview



## Signals Overview

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

## Tonight's Research Points

- Strong moves in opposite directions over the last 3 days suggest Monday could see more buying.
- Back to back outside days in QQQ have often been followed by short-term strength.
- The SPY pattern of a gap down, further selloff and then strong reversal upwards has typically been followed by selling when it takes place under the 200ma.

## *Short-term Outlook*

### *The Bottom Line*

Friday's action has moved the Aggregator back into a bearish configuration. I expect some downside over the next couple of days and will look to take advantage of it with a small short position.

*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 29, 2011	1% up, 1% down, 1% up	1 day	Bullish	
August 29, 2011	Gap dn and reverse higher	1-3 days	Bearish	-3.10%
August 26, 2011	1% drop. Decliners 2x advancers.	1-3 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 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	

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

***The Evidence***

After a weak start to the day the market reversed higher and put in some solid gains. The SPX rose 1.5%, the Nasdaq was up 2.5% and the Russell 2000 gained 2.6%. Breadth was strong as the NYSE Up Issues % came in at 83% and the Up Volume % was just below 90%. Total NYSE volume dropped from Thursday's level.

Short-term Quantifinder studies were mixed tonight. There were a couple that suggested bullish implications, and I'll go over those first.

The pattern over the last 3 days has been interesting. Wednesday saw a strong rise, Thursday a big drop, and then Friday another big rise. Using a 1% move requirement I looked at this type of pattern in the 7/23/10 subscriber letter. I found that there has typically been some follow through to the upside on the day after the pattern. Below I have updated the performance report.

SPY closes up > 1%, then down > 1%, then up > 1%.  
 Buy on close. Sell next day's close. \$100k/trade. 2000 - present.

TradeStation Performance Summary <span style="float: right;">Collapse ^</span>			
All Trades			
Total Net Profit	\$28,275.88	Profit Factor	6.45
Gross Profit	\$33,463.60	Gross Loss	(\$5,187.72)
Total Number of Trades	19	Percent Profitable	84.21%
Winning Trades	16	Losing Trades	3
Even Trades	0		
Avg. Trade Net Profit	\$1,488.20	Ratio Avg. Win:Avg. Loss	1.21
Avg. Winning Trade	\$2,091.47	Avg. Losing Trade	(\$1,729.24)
Largest Winning Trade	\$4,377.20	Largest Losing Trade	(\$2,348.90)

These numbers look very strong. Below I have listed all 19 instances along with their individual returns.

SPY closes up > 1%, then down > 1%, then up > 1%.  
Buy on close. Sell next day's close. \$100k/trade. 2000 - present.

Date/Time	Signal	Price	% Profit	Run-up Drawdown
04/09/01	Buy	\$114.56	1.82%	\$2,781.68
04/10/01	Sell	\$116.65		\$0.00
04/17/01	Buy	\$119.26	3.97%	\$5,648.12
04/18/01	Sell	\$124.00		\$0.00
02/22/02	Buy	\$109.64	1.65%	\$1,979.04
02/25/02	Sell	\$111.45		\$0.00
08/21/02	Buy	\$95.75	0.97%	\$1,461.60
08/22/02	Sell	\$96.68		(\$709.92)
10/10/02	Buy	\$80.63	4.38%	\$5,084.00
10/11/02	Sell	\$84.16		\$0.00
10/17/02	Buy	\$88.27	0.42%	\$950.88
10/18/02	Sell	\$88.64		(\$1,516.88)
07/07/03	Buy	\$100.70	0.45%	\$585.87
07/08/03	Sell	\$101.15		(\$526.29)
11/27/07	Buy	\$142.57	3.20%	\$3,434.90
11/28/07	Sell	\$147.13		\$0.00
03/20/08	Buy	\$132.08	2.00%	\$2,823.61
03/24/08	Sell	\$134.72		\$0.00
09/18/08	Buy	\$120.07	3.37%	\$6,206.72
09/19/08	Sell	\$124.12		\$0.00
12/02/08	Buy	\$85.27	2.40%	\$3,000.32
12/03/08	Sell	\$87.32		(\$2,496.36)
12/05/08	Buy	\$87.93	3.49%	\$5,059.65
12/08/08	Sell	\$91.00		\$0.00
12/16/08	Buy	\$91.88	(0.97%)	\$598.40
12/17/08	Sell	\$90.99		(\$1,980.16)
03/25/09	Buy	\$81.45	2.04%	\$2,269.95
03/26/09	Sell	\$83.11		(\$159.51)
05/08/09	Buy	\$92.98	(1.87%)	\$0.00
05/11/09	Sell	\$91.24		(\$2,085.50)
05/28/09	Buy	\$90.92	1.77%	\$2,472.75
05/29/09	Sell	\$92.53		(\$263.76)
05/03/10	Buy	\$120.35	(2.35%)	\$0.00
05/04/10	Sell	\$117.52		(\$2,846.90)
07/22/10	Buy	\$109.46	0.87%	\$1,013.43
07/23/10	Sell	\$110.41		(\$483.89)
08/11/11	Buy	\$117.33	0.67%	\$1,601.76
08/12/11	Sell	\$118.12		(\$42.60)

The edge doesn't appear to have been quite as potent recently, but I still think it is worth considering.

Friday also market the 2<sup>nd</sup> day in a row where the QQQ made a lower low and a higher high. Days that do this are often referred to as "outside days" because they trade outside

the range of the previous day. When QQQ has posted back to back outside days in the past, it has often been followed by a short-term rally. I last showed this in the 11/10/10 subscriber letter. I have updated the stats table below.

QQQ posts 2 outside days in a row. Buy 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	31,126.39	19	14	5	73.68	2,823.72	-1,681.13	1.68	4.70	1,638.23
4	31,385.57	19	15	4	78.95	2,548.45	-1,710.30	1.49	5.59	1,651.87
3	31,690.93	20	14	6	70.00	2,748.48	-1,131.29	2.43	5.67	1,584.55
2	17,043.43	20	15	5	75.00	1,623.44	-1,461.63	1.11	3.33	852.17
1	15,737.68	20	15	5	75.00	1,208.01	-476.50	2.54	7.61	786.88

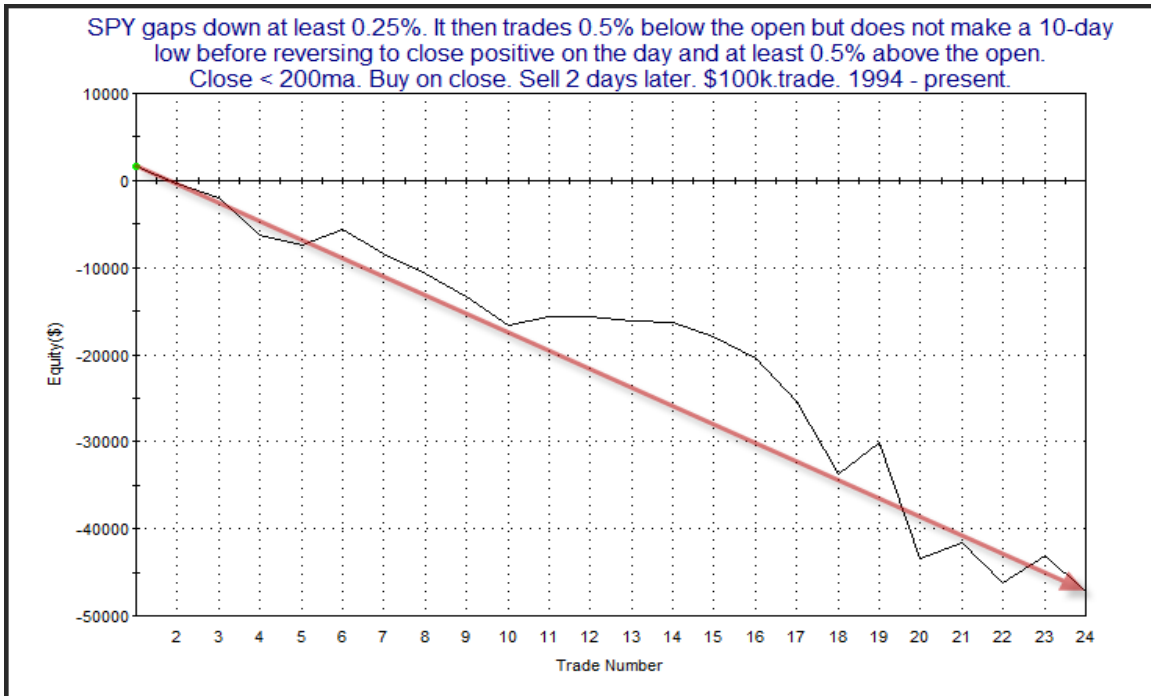
Results still appear quite positive.

I mentioned earlier studies were mixed. On the bearish side the Quantifinder identified a few similar studies that examined the action in the SPY. They required a gap down, a move lower after the open, and then a strong finish, all while the SPY was trading below its 200ma. The study below was last seen in the 5/13/11 subscriber letter. Results are unchanged since then.

SPY gaps down at least 0.25%. It then trades 0.5% below the open but does not make a 10-day low before reversing to close positive on the day and at least 0.5% above the open. Close < 200ma. Buy on close. Sell X days later. \$100k.trade. 1994 - 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	-34,218.80	22	9	13	40.91	1,660.30	-3,781.66	0.44	0.30	-1,555.40
4	-54,817.26	23	7	16	30.43	1,193.37	-3,948.18	0.30	0.13	-2,383.36
3	-40,046.02	24	9	15	37.50	1,589.14	-3,623.22	0.44	0.26	-1,668.58
2	-47,198.57	24	6	17	25.00	2,141.51	-3,532.21	0.61	0.21	-1,966.61
1	-18,605.08	26	11	15	42.31	1,359.38	-2,237.21	0.61	0.45	-715.58

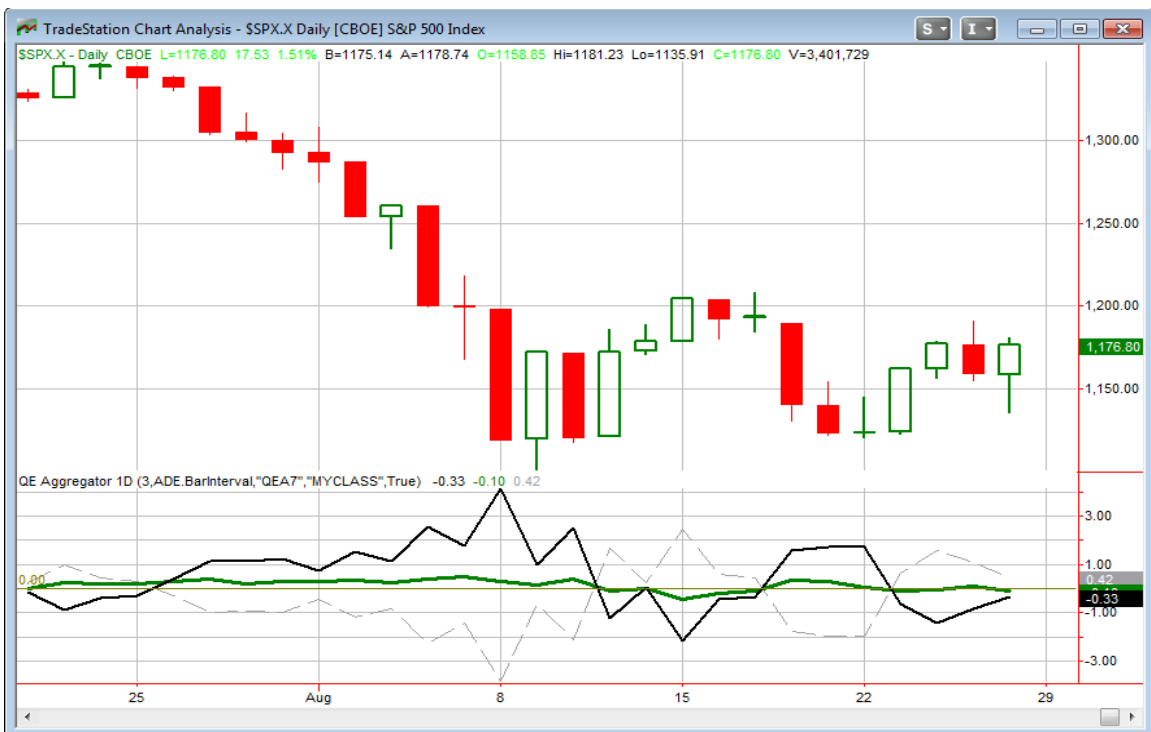
87% of instances closed below the entry price at some point in the next week.

The stats appear to strongly suggest a downside edge, especially over the 1<sup>st</sup> 2 days. Below I have produced an equity curve to show how the edge has played out over time.



The strong, steady downslope provides confirmation of the bearish edge.

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



After just 1 day positive the green Aggregator line dropped back down below 0 on Friday night. Levels below 0 mean net expectations from the Active List are for downside over the next few days. Meanwhile, the Differential Line is also 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. It can be seen on the Aggregator chart whenever both lines are below 0. Due to this the Aggregator System turned from flat to short at the close.

At this point the green Aggregator line is set to close negative on Monday. But with so few studies on the board this could easily change if bullish evidence emerges. Meanwhile, the Differential Pivot will be 1,176.07. This is less than 1 point below Friday's close. So any close higher will keep the Differential negative (SPX overbought) and just about any down close will move it positive (SPX oversold).

The market has been chopping quite a bit here. At this point I am anticipating that will continue and we will see a move lower in the next couple of days. I will be looking to take on some short exposure on Monday.

***Intermediate-term Outlook (2 weeks – 2 months)– updated 8/29 – neutral***

The SPX rose 4 out of 5 days this past week and posted a gain of close to 5%. It also posted an IBD Follow Through Day (FTD) on 8/23. FTD's are intermediate-term timing tools that are supposed to signal the beginning of a new uptrend after the market has made an extended move lower. Overall, their track record isn't great, but sometimes they can provide nice hints when combined with other factors.

One plus that Tuesday's FTD had going for it was that it came on very strong breadth. The NYSE Up Issues % came in higher than 98% of all other days over the past year. In the 6/22/11 subscriber letter I showed how strong breadth on a FTD appeared to have a positive influence on its chances of success. Below is an excerpt from that letter. (Charts and stats are not updated.)

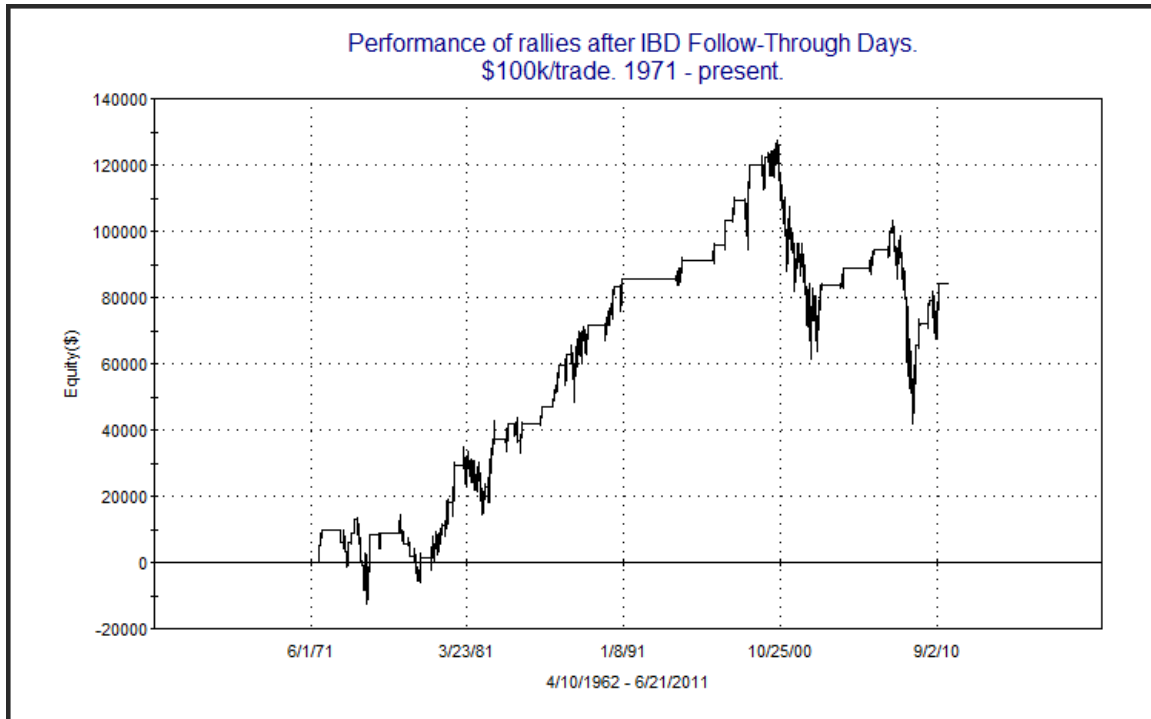
*I ran several tests that examined how strong breadth on a FTD might affect its chances of success.*

*Before I show those tests I thought I would point you to the rules of FTDs and some of the assumptions I used in testing them. I basically followed all of the rules as IBD laid them out. Two rules that IBD has never clearly defined are what entails “success” or “failure”. I defined “failure” to be a close below the intraday low of the bottom prior to the FTD. I defined “success” as a move either 1) twice as large as the distance from the low of the potential bottom to the close of the FTD, or 2) a new 52-week high. More detailed explanations of the rules may be found using the link below:*

*<http://quantifiableedges.blogspot.com/2008/01/ibd-follow-through-days-pt-1-are-they.html>*

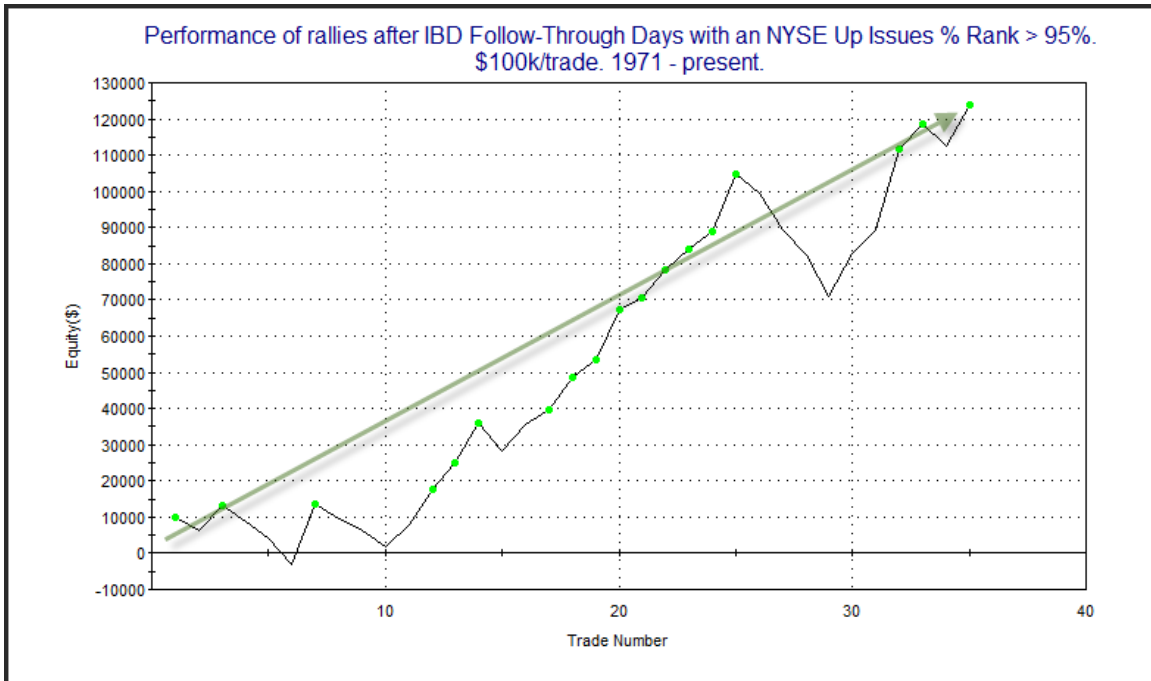
*Whether a FTD successfully predicts a rally is not an indication of whether someone trading individual stocks using IBD’s techniques would make money or not. What it does measure is the usefulness of FTDs as a market timing indicator. I believe this is a fair way to test them since IBD claims they are extremely valuable in identifying when downtrends are ending and new uptrends are emerging.*

*Using the original parameters as described in the post I linked to above there have been 74 FTDs since 1971. Thirty-eight of them (53%) led to successful rallies. This is an interesting stat but it doesn’t tell the whole story. Below is an equity curve that I don’t believe I’ve ever shown before. It shows how someone trading the SPX would have performed using FTDs as a buy trigger and then exiting the trade when the rally either “succeeded” or “failed”.*



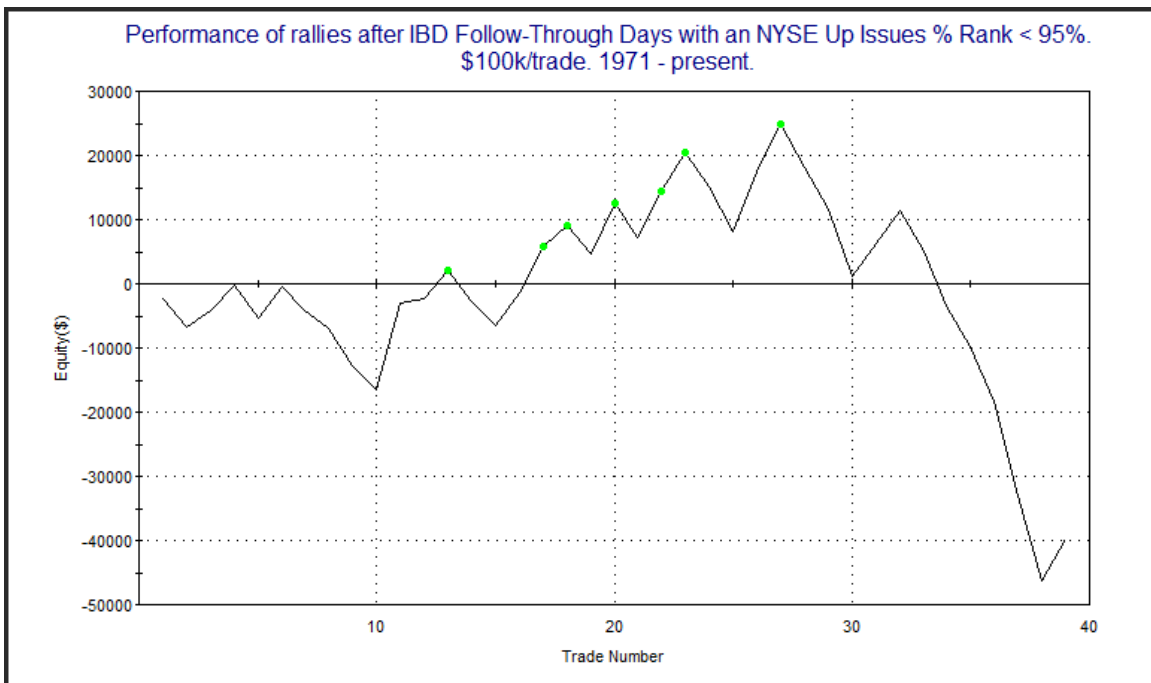
*As you can see FTDs worked very well during the long bull market of the 80s and 90s. But in the 70s, and again since 2000, FTDs have struggled as a market timing tool.*

*As I mentioned earlier breadth was also very strong on Tuesday. When compared to the past year the Up Issues % on the NYSE was higher than 98.4% of all days. I used the Up Issues % Rank to normalize breadth over the long test period, and broke down FTD results based on those times the % Rank was > 95% and those times it was < 95%. First let's look at times like now where the NYSE Up Issues % Rank was > 95%.*



*In this case 22 of 35 FTDs (63%) have been followed by successful rallies and gains have been fairly steady over the years.*

*Now let's look at FTDs that came without very strong relative breadth.*



*Results here were never strong and they've turned quite negative in recent years. Rather than a 63% success rate as happened with strong breadth, only 44% of instances here succeeded.*

In addition to the strong breadth there were also some other factors that I discussed a few days ago in the 8/24/11 subscriber letter that may also affect this rallies chances of success. Below is an excerpt from that letter.

*Tuesday was day 11 of the attempted rally off the 8/8/11 closing low. Investors' Business Daily teaches that FTDs after day 10 are less reliable. Evidence suggests this is not the case. This is the first FTD that has occurred after day 10 since 3/15/2000. Since 1971 there have been 8 FTDs that occurred after day 10. Seven of the eight have been followed by successful intermediate-term rallies. The list below is taken from the 2/29/08 blog post that examined such occurrences.*

Date	Day #	Successful?
October 2, 1975	12	Yes
December 1, 1978	24	Yes
July 9, 1984	14	No
October 16, 1985	14	Yes
April 21, 1994	13	Yes
August 1, 1996	12	Yes
November 13, 1997	13	Yes
March 15, 2000	13	Yes

*So the fact that the FTD is coming later than usual appears to be a good thing. But a warning flag goes up when you consider the size of the market drop prior to the FTD. In the 2/15/2008 blog post I examined success and failure of rallies following FTDs that came after large vs. small market declines. I showed that a FTD after a 5% decline was much more likely to succeed than a FTD after a 12%+ correction. Since then the stats have even worsened. Since 1971 there have been 44 FTDs following market declines of at least 12%. Only 18 of them (41%) have led to successful rallies.*

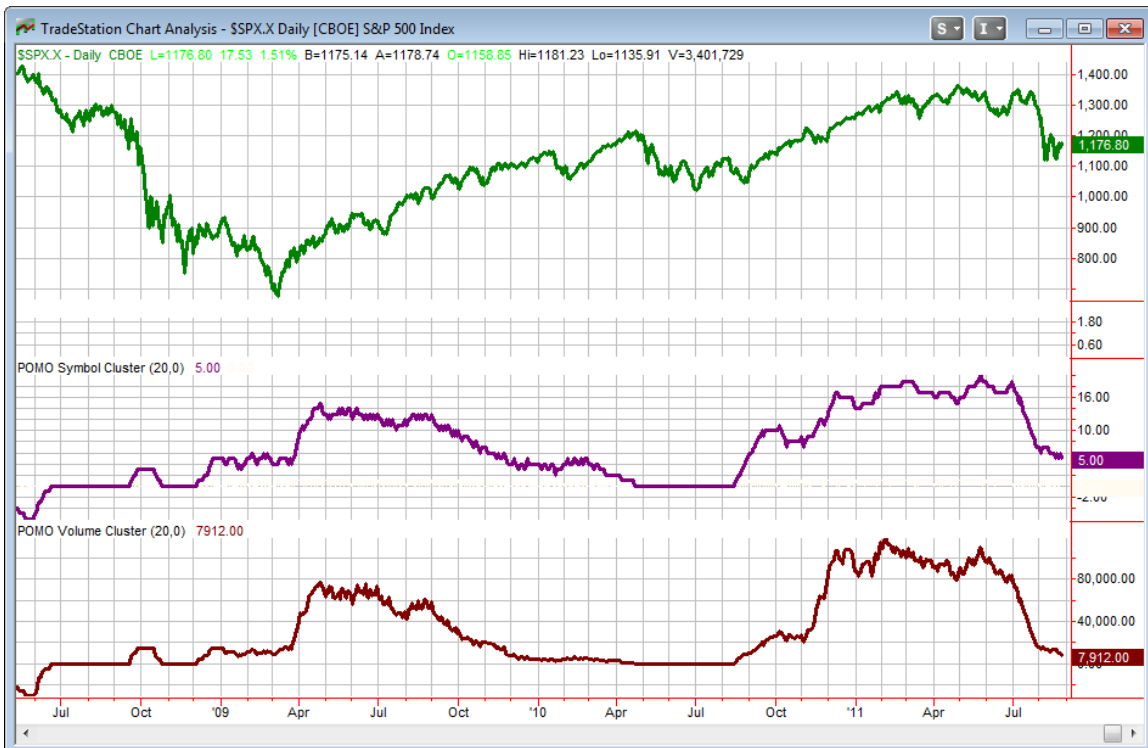
Bottom line with the FTD at this point is that it came with some positive aspects, but after such a large decline the chances of success aren't quite as good as they would normally be. One last thing to watch in regards to the FTD is the action in the week following it. I have shown in the past that the week following the FTD has correctly predicted its

success or failure about 2/3 of the time. In other words, if the SPX closed higher than the close of the FTD on the 5<sup>th</sup> day following it then the rally was successful about 2/3 of the time. If the SPX closed lower 5 days after the FTD then the rally failed about 2/3 of the time. This suggests Monday's and Tuesday's action could be important.

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 fell a bit further this week. The Fed's published schedule is calling for about \$14 billion in purchases each month. Over the last 20 trading days there have only been \$8 billion in purchases. So at this point stimulus appears to be coming in at lower levels than advertised. Bernanke's speech on Friday was highly anticipated and some wondered whether he would announce a QE3-type plan. Instead he gave the same line he has been using for a long time saying that the Fed has many tools at their disposal and they will use them if necessary.

Regardless of what I or anyone else believes the Fed and the rest of the government should do to promote a healthy long-term economy, the market has shown a strong propensity to rally when there has been stimulus and to struggle when there hasn't been. Eventually the market will need to put together a rally on its own. And it's easier to start a rally when the market has undergone a sharp correction. We've had a sharp correction, but at this point there is no telling whether it has been deep enough.

Overall, intermediate-term indicators remain mixed. POMO remains a negative along with a volume study from a couple of weeks ago. On the other hand last Tuesday's FTD does provide some hope, and there are also some older breadth thrust signals still on the intermediate-term Active List. I'm not terribly excited about either direction right now and will continue to take quick stabs at both long and short positions as opportunities avail themselves.

### **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 ¼ index position @ \$117.97 limit.** Based on short-term outlook above, I will look to take advantage of the apparent downside edge with a small position.*

### **Current Open Trade Ideas**

Symbol	Entry Date	Entry Price	Current Price	% Gain/Loss	Stop	Notes
VXX	8/24/2011	\$41.74	\$43.25	3.62%		<i>sold on open</i>

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