

QUANTIFIABLE EDGES SUBSCRIBER LETTER

ASSESSING MARKET ACTION WITH INDICATORS AND HISTORY

August 31, 2011

Volume 4 Issue 168

Market Overview



Signals Overview

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

Tonight's Research Points

- The gap down and reverse up action in the SPY suggests a short-term downside edge.
- 3 days higher with the most recent being the small during a downtrend suggests a sizable downside edge.
- VIX up and SPX up slightly mid-week suggests bearish short-term implications.

Short-term Outlook

The Bottom Line

There were several indications of a downside edge today. I am already partially short and I may add more short exposure on Wednesday. At this point the edges are all very short-term (1-2 days), so I may end up covering my shorts quickly, especially if the market moves in my direction.

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

Study Date	Description	Time span	Bias	Avg Max Move
Active				
August 31, 2011	Gap dn and reverse higher	1-2 days	Bearish	-3.00%
August 31, 2011	SPX up < 0.25%. VIX up midweek.	1-2 days	Bearish	-3.40%
August 31, 2011	3 up days < 200ma. No 50-low.	1-2 days	Bearish	-2.20%
August 30, 2011	1% Up 2 days. 10 high and < 200ma	1-3 days	Bearish	-3.20%
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%

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

The Evidence

Some big gyrations occurred Tuesday but in the end there was not a whole lot of progress for the market. The major indices did all manage higher close, though. The SPX gained 0.2%, the Nasdaq was up 0.6%, and the Russell 2000 rose 0.5%. Breadth was moderately positive as the NYSE Up Issues % came in at 61% and the Up Volume % was 57%. Total NYSE volume rose from Monday's extremely low levels.

There was a good amount to consider today from a studies standpoint. One compelling study triggered just 2 days ago and was featured in the 8/29 subscriber letter. Below is an excerpt with updated statistics.

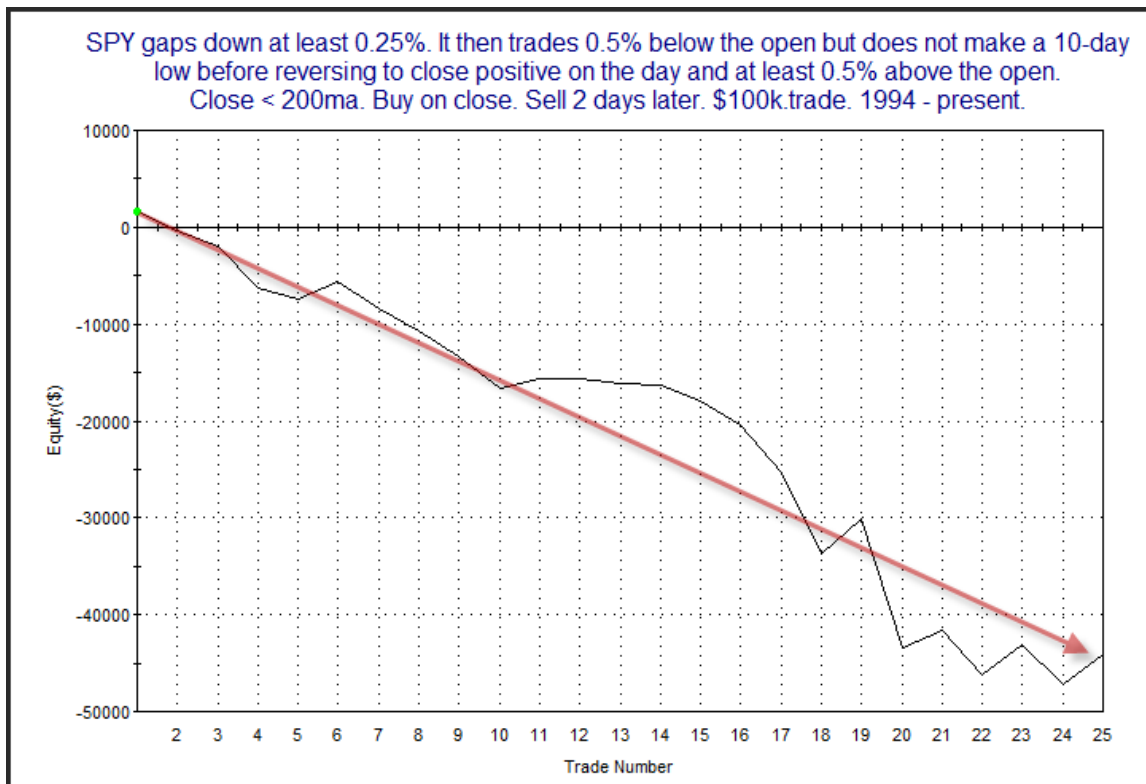
On the bearish side the Quantifinder identified a few similar studies that examined the action in the SPY. They required a gap down, a move lower after the open, and then a strong finish, all while the SPY was trading below its 200ma. (Results updated in the study below.)

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	-44,056.20	25	7	17	28.00	2,284.49	-3,532.21	0.65	0.27	-1,762.25
1	-15,733.75	27	12	15	44.44	1,485.37	-2,237.21	0.66	0.53	-582.73

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 1st 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.

Obviously the last instance just a couple of days ago did not work out but that hardly appears to be a blip on the downward sloping chart at this point.

With Tuesday marking the 3rd day higher in a row a number of overbought studies also triggered. The one below is similar to a study I ran in the 7/9/10 subscriber letter. The difference here is that tonight I used SPX instead of SPY and required exactly 3 up days instead of at least 3 up days.

SPX closes higher for exactly the 3rd day in a row. It is not coming off a 50-day low. Close < 200ma. Buy on close. Sell X days later. \$100k/trade. 1988 - 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	-64,414.23	66	30	36	45.45	1,202.39	-2,791.28	0.43	0.36	-975.97	
4	-69,134.24	70	28	42	40.00	1,267.41	-2,491.00	0.51	0.34	-987.63	
3	-74,354.02	70	26	44	37.14	952.12	-2,252.48	0.42	0.25	-1,062.20	
2	-56,701.40	70	21	49	30.00	809.92	-1,504.28	0.54	0.23	-810.02	
1	-21,392.79	70	27	43	38.57	995.77	-1,122.76	0.89	0.56	-305.61	

As you can see, results appear to be quite bearish over the next week.

Over the last couple of weeks I have mentioned that there is a big difference between a market that is bouncing off an intermediate-term low and one that isn't. I've discussed how when bouncing from an intermediate-term low there is a real risk of the bounce turning into a runaway up move. The 50-day low filter above incorporates this concept. To see why it is so important, take a look at the study below which keeps everything else the same but flips the 50-day low requirement.

SPX closes higher for exactly the 3rd day in a row. It <i>is</i> coming off a 50-day low. Close < 200ma. Buy on close. Sell X days later. \$100k/trade. 1988 - 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	17,302.66	24	15	9	62.50	2,832.61	-2,798.50	1.01	1.69	720.94	
4	15,966.60	24	14	10	58.33	2,288.40	-1,607.10	1.42	1.99	665.28	
3	12,421.23	24	14	10	58.33	2,187.99	-1,821.06	1.20	1.68	517.55	
2	13,252.56	24	17	7	70.83	1,534.05	-1,832.33	0.84	2.03	552.19	
1	8,049.01	24	12	12	50.00	1,480.92	-810.17	1.83	1.83	335.38	

Under these circumstances, the typically bearish setup actually turns bullish.

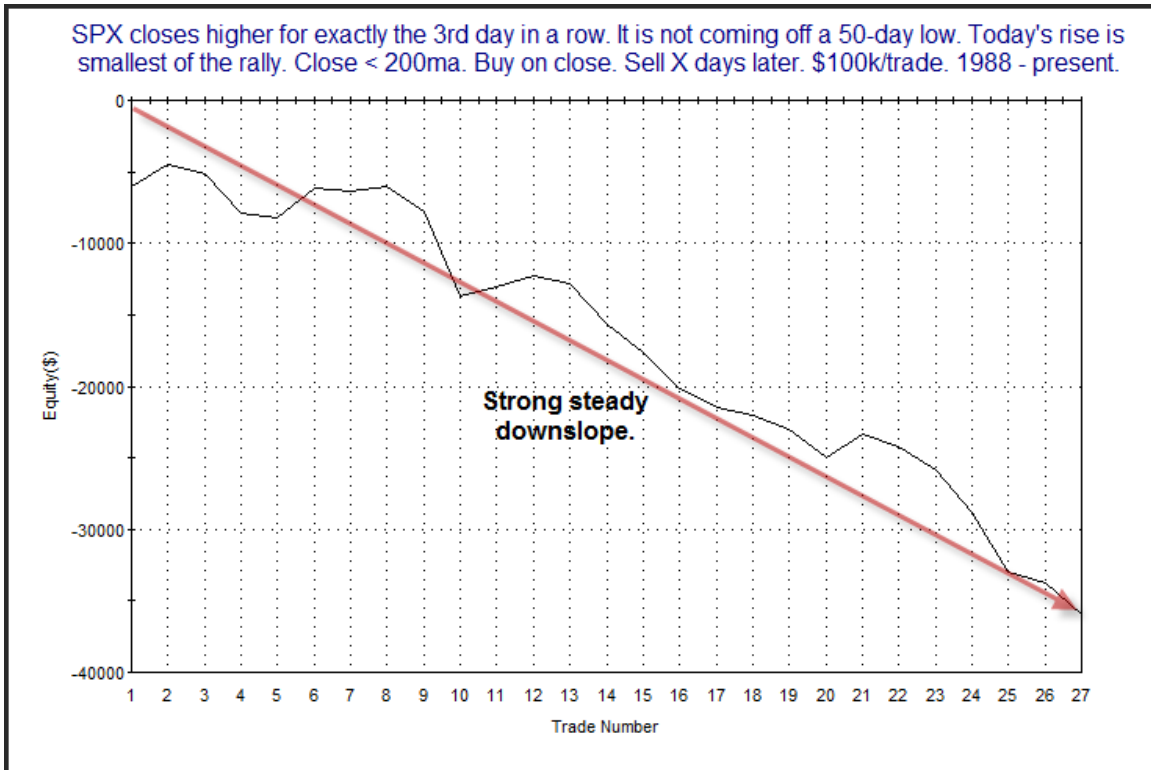
There were other filters in similar tests included in some Quantifinder studies. One simple and effective condition required today be the smallest rise of the 3-day rally. I used that in the 6/17/08 blog (though without the 50-day low filter). Below is an updated stats table from 1988 – present.

SPX closes higher for exactly the 3rd day in a row. It is not coming off a 50-day low. Today's rise is smallest of the rally. Close < 200ma. Buy on close. Sell X days later. \$100k/trade. 1988 - 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	-45,715.77	26	10	16	38.46	1,095.18	-3,541.72	0.31	0.19	-1,758.30
4	-44,349.15	27	8	19	29.63	1,242.97	-2,857.52	0.43	0.18	-1,642.56
3	-41,734.86	27	9	18	33.33	952.58	-2,794.90	0.34	0.17	-1,545.74
2	-35,971.84	27	6	21	22.22	1,169.46	-2,047.08	0.57	0.16	-1,332.29
1	-14,532.02	27	12	15	44.44	772.59	-1,586.88	0.49	0.39	-538.22

24 of 27 instances (89%) closed below the entry price at some point in the next week.

Stats here are a bit more bearish than without the filter. Below is an equity curve.



I also find the equity curve very appealing.

Another indicator that seemed to be hinting at downside today was the VIX. It rose along with the SPX. The below study is from the 7/16/10 subscriber letter. I have updated the results.

SPX rises between 0% and 0.25% and closes < 200ma. VIX closes up. Today is Tuesday, Wednesday, or Thursday. Buy on close. Sell X days later. \$100k/trade. 1998 - 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	-22,544.17	9	0	9	0.00	0.00	-2,504.91	0.00	0.00	-2,504.91
4	-25,224.16	9	1	8	11.11	126.15	-3,168.79	0.04	0.00	-2,802.68
3	-17,160.81	9	1	8	11.11	856.95	-2,252.22	0.38	0.05	-1,906.76
2	-24,600.00	9	0	9	0.00	0.00	-2,733.33	0.00	0.00	-2,733.33
1	-10,260.62	9	3	6	33.33	575.54	-1,997.87	0.29	0.14	-1,140.07

The reason it only looks at Tuesday, Wednesday, and Thursday is that Monday and Friday VIX prices tend to be affected by weekend time decay in the options market.

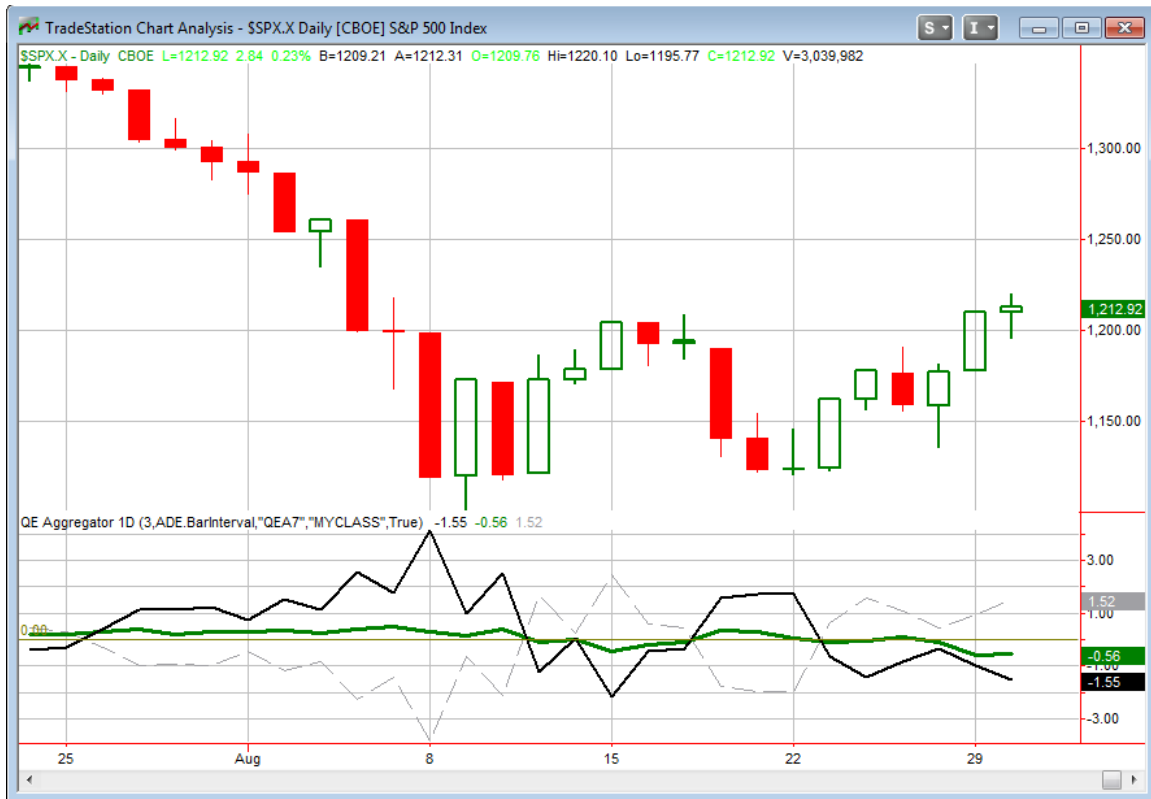
Instances are a little low but really could not appear more bearish over the next 2 days. Below I have listed all instances assuming a 2-day holding period.

SPX rises between 0% and 0.25% and closes < 200ma. VIX closes up. Today is Tuesday, Wednesday, or Thursday. Buy on close. Sell X days later. \$100k/trade. 1998 - present.				
Date/Time	Signal	Price	% Profit	Run-up Drawdown
09/29/98	Buy	\$1,049.00	(5.97%)	\$0.00
10/01/98	Sell	\$986.40		(\$6,431.50)
03/08/01	Buy	\$1,264.76	(6.68%)	\$0.00
03/12/01	Sell	\$1,180.30		(\$6,950.42)
05/02/01	Buy	\$1,267.42	(0.06%)	\$7.02
05/04/01	Sell	\$1,266.60		(\$2,762.76)
11/14/01	Buy	\$1,141.21	(0.22%)	\$456.75
11/16/01	Sell	\$1,138.65		(\$982.23)
06/04/02	Buy	\$1,040.69	(1.11%)	\$904.32
06/06/02	Sell	\$1,029.15		(\$1,322.88)
06/08/06	Buy	\$1,257.93	(1.71%)	\$367.35
06/12/06	Sell	\$1,236.41		(\$1,716.67)
01/15/09	Buy	\$843.74	(4.57%)	\$1,698.02
01/20/09	Sell	\$805.22		(\$4,633.86)
07/15/10	Buy	\$1,096.48	(2.30%)	\$0.00
07/19/10	Sell	\$1,071.25		(\$3,218.67)
08/18/10	Buy	\$1,094.16	(2.05%)	\$0.00
08/20/10	Sell	\$1,071.69		(\$2,752.75)
Avg Run-up: \$0.38%. Max Run-up: 1.70% Avg Drawdown: -3.42%				

Risk/reward stats are incredibly lopsided with the average drawdown nearly 10 times the average run-up and over twice the max run-up.

So Tuesday's action seems to have provided a fair amount of bearish evidence. Between the gap & reverse intraday action in the SPY, the overbought but decelerating rise in the SPX, and the VIX study above, everything is pointing down.

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



Tonight's bearish studies kept the green Aggregator line strongly negative. Levels below 0 mean net expectations from the Active List are for downside over the next few days. Meanwhile, the Differential Line is also well below 0. A negative Differential reading means the SPX has outperformed expectations over the last few days. So net expectations are decidedly negative and the SPX is strongly 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 remained short at the close.

At this point the green Aggregator line is set to close negative again on Wednesday. But without many studies, and all of them expiring within 2 days, this could change if bullish evidence emerges. Meanwhile, the Differential Pivot will be 1,174.74. This is 3.1% below Tuesday's close. This means it would take a drop of at least this much in order to move the SPX in "oversold" territory. Since a drop that big is extremely unlikely, it would probably take a multi-day move lower at this point to flip the Differential line.

The evidence tonight is all quite compelling. I currently have a ½ size index position short. I believe we will see a pullback in the next day or two. I was somewhat torn

tonight whether to get aggressive or whether to be content with the ½ position. Ultimately I decided I would look to add to the short if the SPY tested Tuesday's highs on Wednesday. Some traders may be worried about the 1st of the month bullish seasonality on Thursday. I've found in past studies when the market closes up the last 2 days of the month that it no longer carries a bullish edge. An up day tomorrow would not face a strong seasonal Thursday. A down day tomorrow would. So I will also pay close attention to Wednesday's action. If the market pulls back as expected there is a good chance I will take off all or part of the short position.

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.)

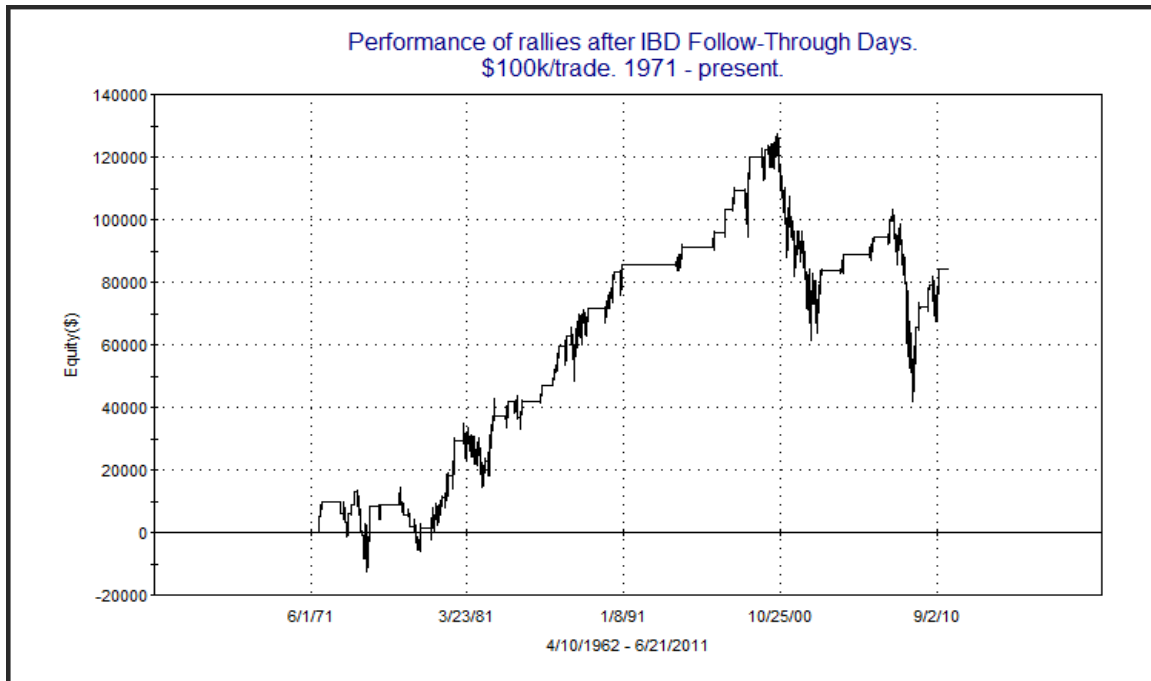
I ran several tests that examined how strong breadth on a FTD might affect its chances of success.

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.

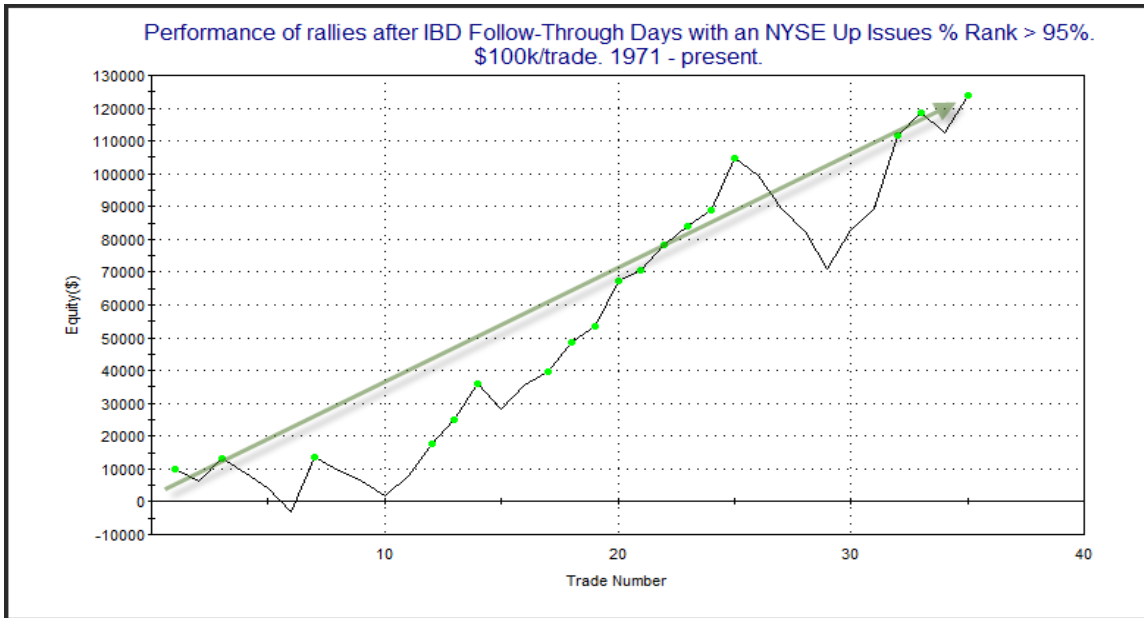
Using the original parameters as described in the post I linked to above there have been 74 FTDs since 1971. Thirty-eight of them (53%) led to successful rallies. This is an interesting stat but it doesn't tell the whole story. Below is an equity curve that I don't believe I've ever shown before. It 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.

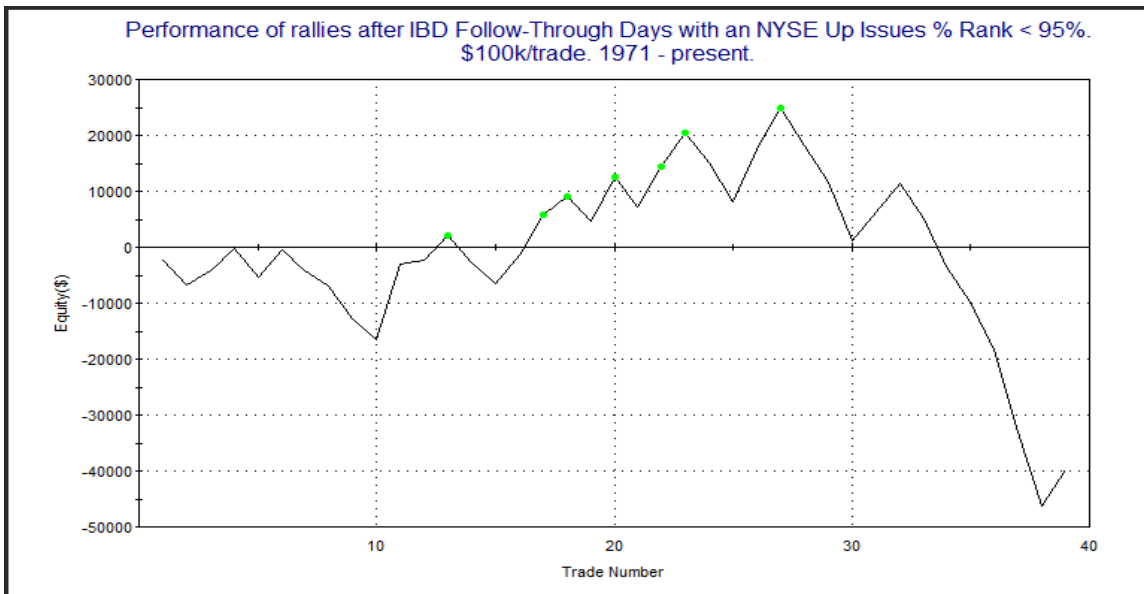
As I mentioned earlier breadth was also very strong on Tuesday. When compared to the past year the Up Issues % on the NYSE was higher than 98.4% of all days. I used the Up Issues % Rank to normalize breadth over the long test period, and broke down FTD

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.

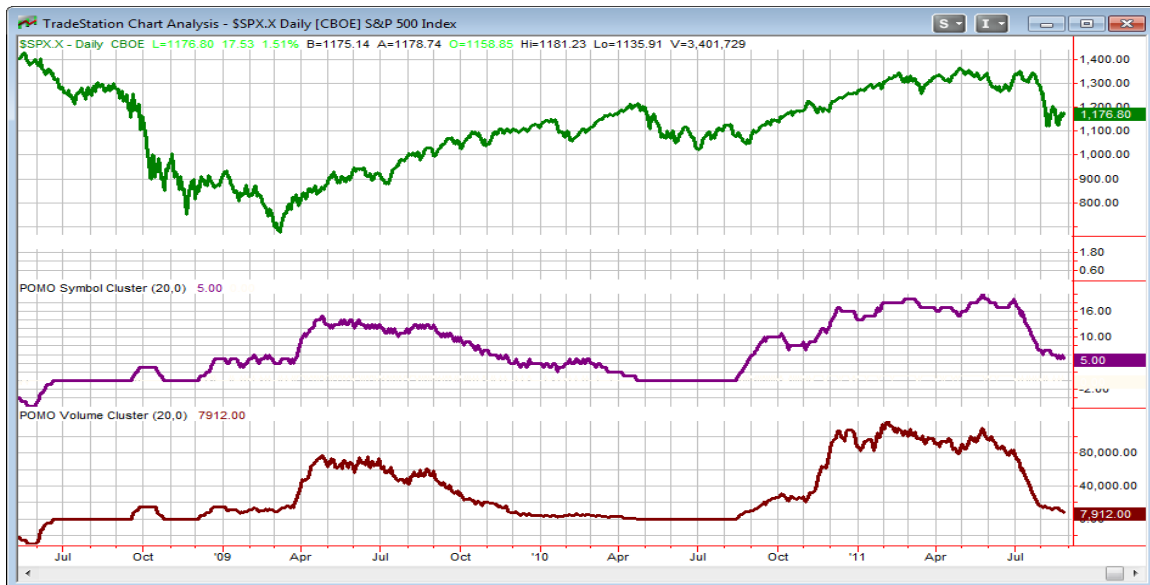
Bottom line with the FTD at this point is that it came with some positive aspects, but after such a large decline the chances of success aren't quite as good as they would normally be. One last thing to watch in regards to the FTD is the action in the week following it. I have shown in the past that 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 5th 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 3rd 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

None

Catapult for ETF's Trades

None.

Broad Market Large Cap CBI – 0

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 @ \$122.42 limit.** Based on short-term outlook above, I will place a limit order for a 3rd lot just under Tuesday’s high.*

Current Open Trade Ideas

Symbol	Entry Date	Entry Price	Current Price	% Gain/Loss	Stop	Notes
SPY(1/4)(s)	8/29/2011	\$119.56	\$121.68	-1.77%		Aggregator
SPY(1/4)(s)	8/30/2011	\$121.36	\$121.68	-0.26%		shorted at limit

If SPY closes lower tomorrow there is a decent chance I will take at least part of the SPY position off. Should I elect to do so I will alert subscribers via intraday email.

Note to subscribers

There have been some issues with email delivery for the last few days. Several subscribers have complained that they have not received some recent letters via email. Most of them were gmail accounts. I am trying to work out the issue but do not have a solution yet. If you have not received some letters, and have had to download it from the website, please let me know. Also, if you have a gmail account and HAVE been getting the letters, please let me know. One problem with email not getting through is that subscribers don’t know when the letter is posted. Until this problem is resolved I will send a Tweet to alert subscribers that aren’t getting the emails. (Follow me on twitter @QERob.) I will also continue send these tweets if subscribers request.

Two things to keep in mind always. First, in the 3 ½ years since I began the letter I have never gone a night without publishing something. That includes publishing through vacations, hurricane power outages, family deaths, and surgeries. I don’t intend to maintain the perfect record forever, but if the letter doesn’t arrive, you can be pretty certain there is a problem. Please alert me that it isn’t getting there. The 2nd thing to keep in mind is that if it doesn’t get to you for some reason you can always download it from the site using the “Current Nightly Letter” link. Thanks for your patience and assistance as I work through this email snafu.

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