

# QUANTIFIABLE EDGES SUBSCRIBER LETTER

ASSESSING MARKET ACTION WITH INDICATORS AND HISTORY

September 26, 2011

Volume 4 Issue 185

## Market Overview



## Signals Overview

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

## Tonight's Research Points

- The weak bounce following Thursday's big drop suggests a downside edge.
- The inside day with an up close following a 20-day low suggests the bounce may fail.
- The Fed announced a new stimulus policy this past week, the impacts of which I intend to manage a few different ways.

## *Short-term Outlook*

### *The Bottom Line*

Though the bounce was not impressive, net expectations still point higher. The market remains extremely oversold so a powerful rally could emerge, but at this point risks appear high. Therefore, I'm keeping my index position size relatively small for the time being.

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

Study Date	Description	Time span	Bias	Avg Max Move
<b>Active</b>				
September 26, 2011	Bounce < 25% yesterday's drop	1-4 days	Bearish	
September 26, 2011	Inside day up after 20-day low	1-2 days	Bearish	
September 23, 2011	3 % drop from 5-day low	1-2 days	Bullish	
September 23, 2011	Up Issues < 33% 2 days. SPX < 200ma	1-2 days	Bullish	
September 22, 2011	2% below high and down on Fed Day	1-3 days	Bullish	3.00%
September 21, 2011	1% up 10-high then close down	1-7 days	Bullish	3.25%
<b>Active - Long Term</b>				
September 12, 2011	Nasdaq leading SPX	int term	Bullish	
September 6, 2011	1% drop prior to 3-day US weekend	1-20 days	Bearish	
August 24, 2011	IBD Follow Through Day strong breadth	int term	Bullish	
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>				
September 23, 2011	Down 3% but 1% above low.	1 day	Bearish	

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

***The Evidence***

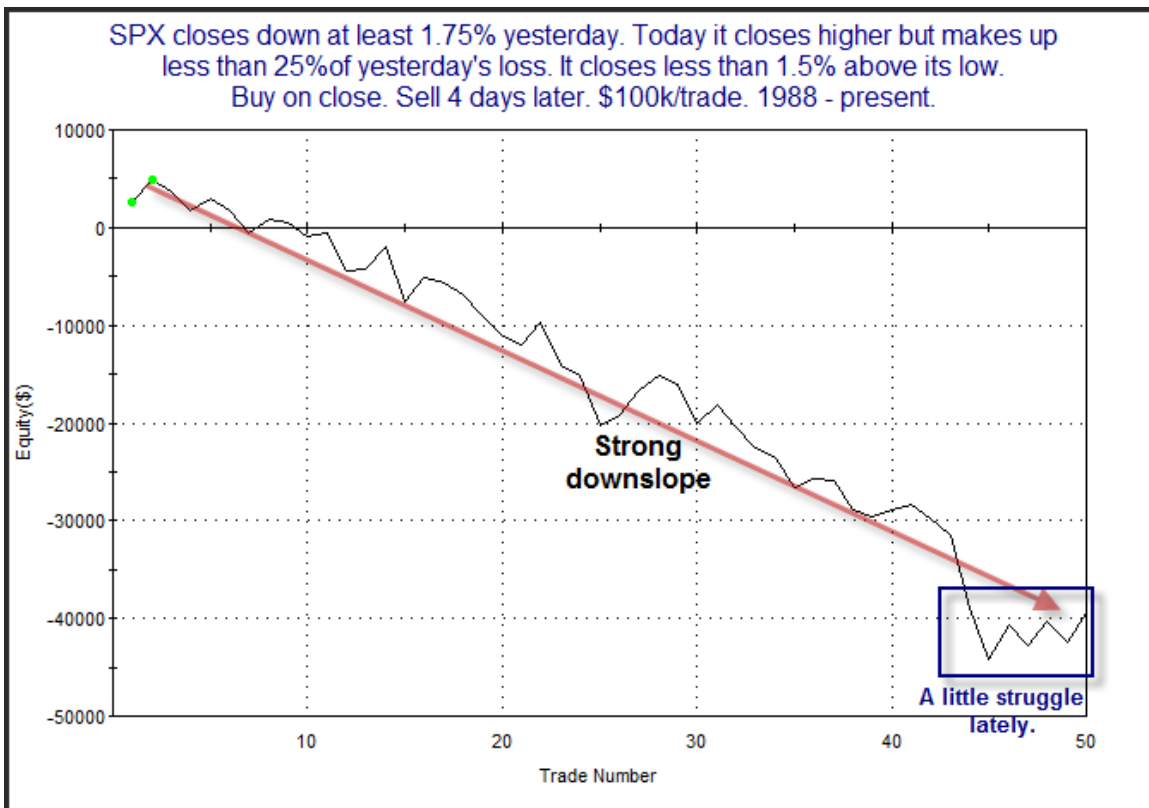
The bounce arrived on Friday, but considering the intensity of the drop over the last few days, it wasn't too impressive. The SPX rose 0.6%, the Nasdaq gained 1.1% and the Russell 2000 finished up 1.3%. Breadth was positive as the NYSE Up Issues % came in at 62% and the Up Volume % was 67%. Total NYSE volume dropped quite a bit from Thursday's very high level.

We can often get some pretty good hints about whether a bounce is likely to succeed or fail based on the day-1 action. In general, strong day-1 bounces often lead to more upside, and weak day-1 bounces have a tendency to roll over. This can be seen in a number of ways. The study below is one example. It was last seen in the 8/4/11 subscriber letter. It makes sure there is neither a substantial recovery of the previous day's losses, nor a strong reversal from the intraday low. All stats have been updated.

SPX closes down at least 1.75% yesterday. Today it closes higher but makes up less than 25% of yesterday's loss. It closes less than 1.5% above its low.  
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
10	-60,601.17	44	13	31	29.55	2,834.80	-3,143.66	0.90	0.38	-1,377.30
9	-61,375.28	45	15	30	33.33	2,019.44	-3,055.56	0.66	0.33	-1,363.90
8	-38,870.79	47	17	30	36.17	2,327.64	-2,614.69	0.89	0.50	-827.04
7	-37,254.95	48	21	27	43.75	2,285.73	-3,157.60	0.72	0.56	-776.14
6	-30,901.64	48	20	28	41.67	2,101.16	-2,604.46	0.81	0.58	-643.78
5	-43,700.79	50	20	30	40.00	1,908.48	-2,729.01	0.70	0.47	-874.02
4	-39,508.52	50	19	31	38.00	1,731.71	-2,335.84	0.74	0.45	-790.17
3	-34,831.12	51	17	34	33.33	1,660.03	-1,854.46	0.90	0.45	-682.96
2	-20,360.50	52	24	28	46.15	1,049.66	-1,626.87	0.65	0.55	-391.55
1	-21,033.16	52	22	30	42.31	692.87	-1,209.21	0.57	0.42	-404.48

The numbers suggest a fairly consistent tendency to close lower. We also see that risk has outsized reward for every holding period shown (win/loss ratio). In looking at the equity curves, while they were all similar, I found the 4-day trade curve to be the most appealing. It is shown below.



The downslope has been fairly steady and strong throughout the entire period. The setup has not been quite as bearish over the last few instances. That bears watching, but at this point the edge still appears to be intact.

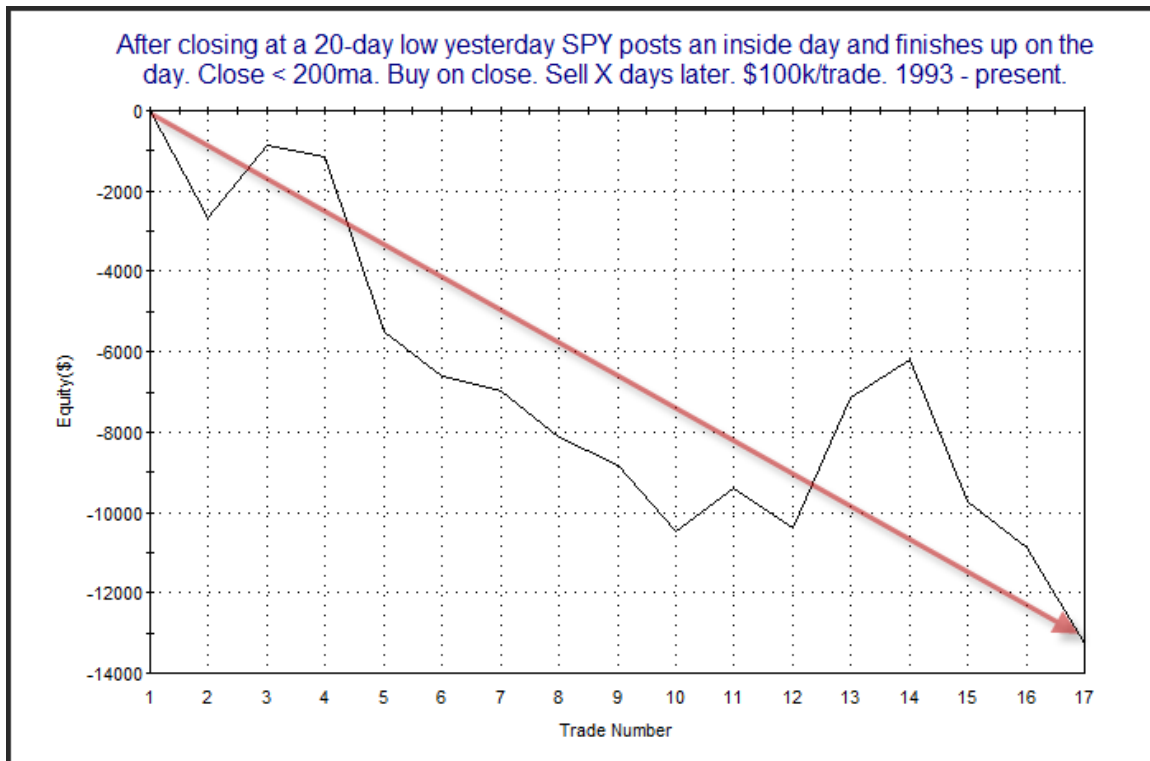
There were also a number of studies suggesting the fact that Friday was an inside day in a long-term downtrend could have bearish implications. (An inside day is a day where the market makes a higher low and a lower high than the day before.) I decided to put the inside day in closer context with the current environment. So I constructed the following study.

**After closing at a 20-day low yesterday SPY posts an inside day and finishes up on the day. 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: Max Losing Trade	All: Win/Loss Ratio	All: ProfitFactor	All: Avg Trade
10	-40,572.77	16	4	12	25.00	3,179.31	-4,440.83	-14,778.12	0.72	0.24	-2,535.80
9	-36,311.49	16	5	11	31.25	3,491.90	-4,888.27	-13,525.44	0.71	0.32	-2,269.47
8	-44,817.03	16	7	9	43.75	2,160.88	-6,660.35	-23,696.38	0.32	0.25	-2,801.06
7	-43,428.87	16	6	10	37.50	2,442.06	-5,808.13	-21,799.98	0.42	0.25	-2,714.30
6	-33,197.34	16	6	10	37.50	1,836.49	-4,421.63	-15,929.76	0.42	0.25	-2,074.83
5	-31,495.90	16	5	11	31.25	2,275.92	-3,897.77	-13,757.52	0.58	0.27	-1,968.49
4	-25,977.30	16	7	9	43.75	1,330.40	-3,921.12	-9,714.74	0.34	0.26	-1,623.58
3	-10,108.09	16	6	10	37.50	1,731.29	-2,049.58	-4,870.30	0.84	0.51	-631.76
2	-13,266.46	17	4	12	23.53	1,768.86	-1,695.16	-4,336.68	1.04	0.35	-780.38
1	-4,173.98	17	7	10	41.18	981.60	-1,104.52	-2,683.80	0.89	0.62	-245.53

**I show max losing trade here as well because it is so large. When I 1st ran the test I thought it was likely 1 big outlier. But looking out 8 days, while the 9/30/2008 instance was down 23%, the 8/31/01 and 2/24/09 instances were both down over 10% and had seen declines as large as 13%.**

Results here appear quite bearish. As I note below the chart I also included a column showing the Max losing trade. While it is extra large, it was not just one outlier, but several large decliners that cause the average trade to look so weak. Below I have constructed the equity curve using a two day exit strategy. I believe keeping me timeframe short in this case provides more reliable estimates. It may be worth keeping in mind, though, that this setup has been followed by some monumental selloffs.



The curve is a bit choppy, but part of that is that we're dealing with a fairly low number of instances. Overall the move from upper left down to lower right appears persistent enough to include this study on the active list.

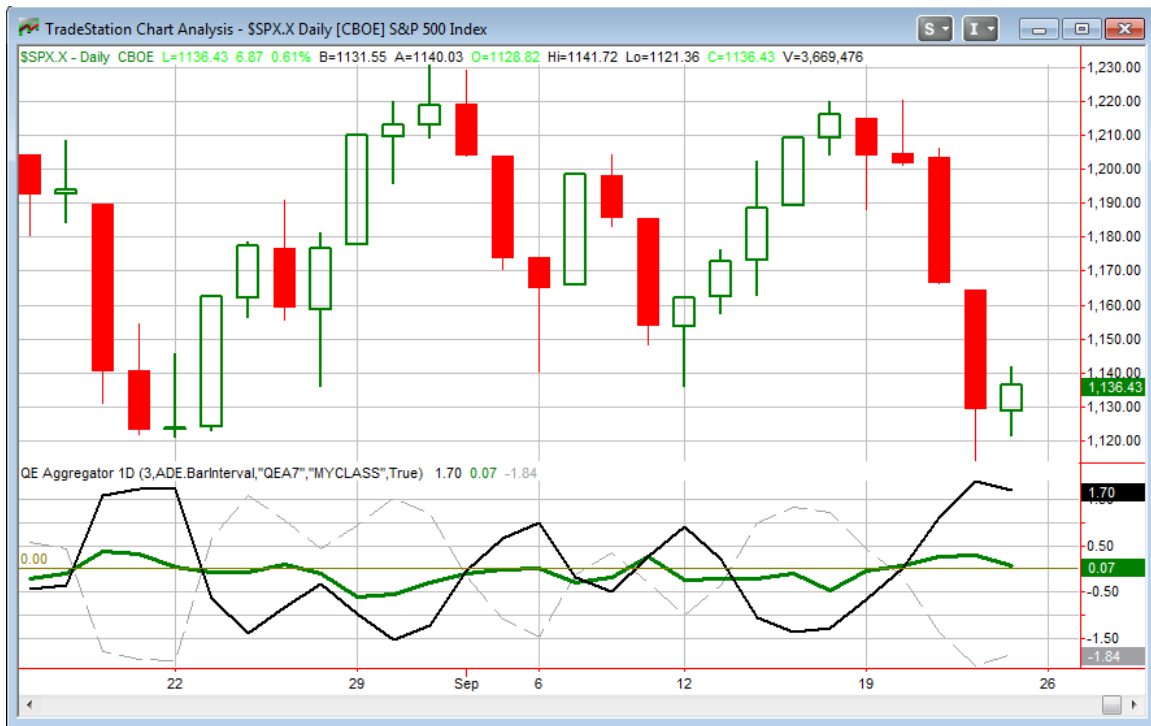
So I'm seeing a fair amount of evidence suggesting the bounce is starting weak, and may roll over. But as you'll see below net expectations did not turn bearish. The bullish studies from the last couple of days are currently outweighing today's bearish studies. As we approached the close on Friday it appeared expectations were instead going to end up negative. The discrepancy here is due to late VIX action. When the market closed at 4 PM the VIX was still positive on the day. But the VIX doesn't close until 4:15 PM when futures and options stop trading. During that last 15 min. the VIX turned from positive to negative. If it had remained positive it would have triggered the below study from the 9/20/10 subscriber letter.

SPX and VIX both close up on Friday. SPX < 200ma.  
Buy on close. Sell 1 day later. \$100k/trade. 1998 - present.

Date/Time	Signal	Price	% Profit	Run-up Drawdown
10/16/98	Buy	\$1,056.40	0.57%	\$827.20
10/19/98	Sell	\$1,062.40		(\$202.10)
10/05/01	Buy	\$1,071.38	(0.83%)	\$0.00
10/08/01	Sell	\$1,062.44		(\$1,348.50)
04/04/03	Buy	\$878.85	0.12%	\$2,942.52
04/07/03	Sell	\$879.93		\$0.00
10/21/05	Buy	\$1,179.59	1.68%	\$1,663.20
10/24/05	Sell	\$1,199.39		\$0.00
12/28/07	Buy	\$1,478.49	(0.69%)	\$0.00
12/31/07	Sell	\$1,468.29		(\$895.12)
05/16/08	Buy	\$1,425.34	0.09%	\$1,043.00
05/19/08	Sell	\$1,426.63		(\$259.70)
09/12/08	Buy	\$1,251.70	(4.63%)	\$0.00
09/15/08	Sell	\$1,193.75		(\$4,578.05)
09/26/08	Buy	\$1,213.53	(8.83%)	\$0.00
09/29/08	Sell	\$1,106.42		(\$8,783.02)
11/28/08	Buy	\$896.24	(8.93%)	\$0.00
12/01/08	Sell	\$816.21		(\$8,941.05)
03/13/09	Buy	\$756.55	(0.35%)	\$2,373.36
03/16/09	Sell	\$753.89		(\$419.76)

This set up appears to suggest at least a 1-day struggle and it has performed especially poorly over the last four years. Including estimates from the study would have turned the net expectations negative, but the VIX flip after the bell prevented this from happening.

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



So the green Aggregator dipped but still remains in positive territory. Levels above 0 mean net expectations from the Active List are for upside over the next few days. Meanwhile, the Differential Line is still way 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 extremely oversold versus recent expectations. Historically this combination has suggested a bullish edge. Bullish configurations can be seen on the chart whenever both lines close above 0. Due to this the Aggregator System remained long at the close.

Based on the current active studies the green Aggregator line is poised to remain above 0 on Monday. The readings are not terribly positive, though, so this could easily change if compelling bearish studies emerge. Meanwhile, the Differential Pivot will be 1,169.20. This is about 2.9% above Friday's close. So the SPX would need to rise by at least this much in order to flip the Differential line negative. It therefore appears unlikely that we will see the line flip until at least Tuesday.

Another thing to keep in mind is that although the SPX closed higher on Friday, we still saw the CBI rise from 4 to 8. Readings of 10 or higher have been pretty reliable signals of an upcoming bounce. That is now close by and could be achieved on Monday (and likely will if we have a down day).

So even though the market remains severely oversold and the Aggregator is suggesting an upside edge, I'm not terribly excited about either long or short side. I put a trade idea in Friday's letter to buy at \$112.00. That missed filling by \$0.02. More aggressive traders would have gotten filled, and hopefully some of you were able to take advantage. Personally, when I saw the market come so close to my target and then bounce I decided to move my limit up and took the trade. At the end of the day when it appeared expectations were likely to flip back to negative I exited that position. So my personal account still has a small amount of long exposure, similar to the ¼ size position we see in the trade ideas section below. This feels like a reasonable amount at the moment. Today's studies suggest this bounce is unlikely to immediately catch fire. But if they hold true, and the market does take a dip early next week, I believe we will see enough bullish evidence emerge that I will want to become more aggressively long. The Catapult System is one way I am gaining long exposure. I'll also be looking to up my index exposure on a pullback.

While the CBI may spike to 10 or higher on Monday and we could also get some other long indications, I am keeping an eye on the August lows around 1100. A drop below there could bring in a large number of sellers and cause a sharp additional dive. Therefore, regardless of how compelling bullish evidence may be on Monday or Tuesday, I won't be increasing my index exposure to more than a half-size position unless we have already broken below that 1100 level.

***Intermediate-term Outlook (2 weeks – 2 months)– updated 9/26 – slightly bearish***

If not for the small bounce on Friday, we would've seen every day close lower this past week. That's quite a contrast to the week before when every day closed higher. While the movement the last two weeks up and down has been sizable, it has been completely contained by the trading range established between 8/9/11 and 8/31/11. The market is down near the lower end of its range now, but until we see a decisive break it may not be a good idea to choose sides.

I didn't notice any study this past week that suggested compelling intermediate-term implications, but that doesn't mean nothing of intermediate-term import occurred. The big news occurred on Wednesday when the Fed provided some details of "Operation Twist". It is their next attempt to stimulate the economy.

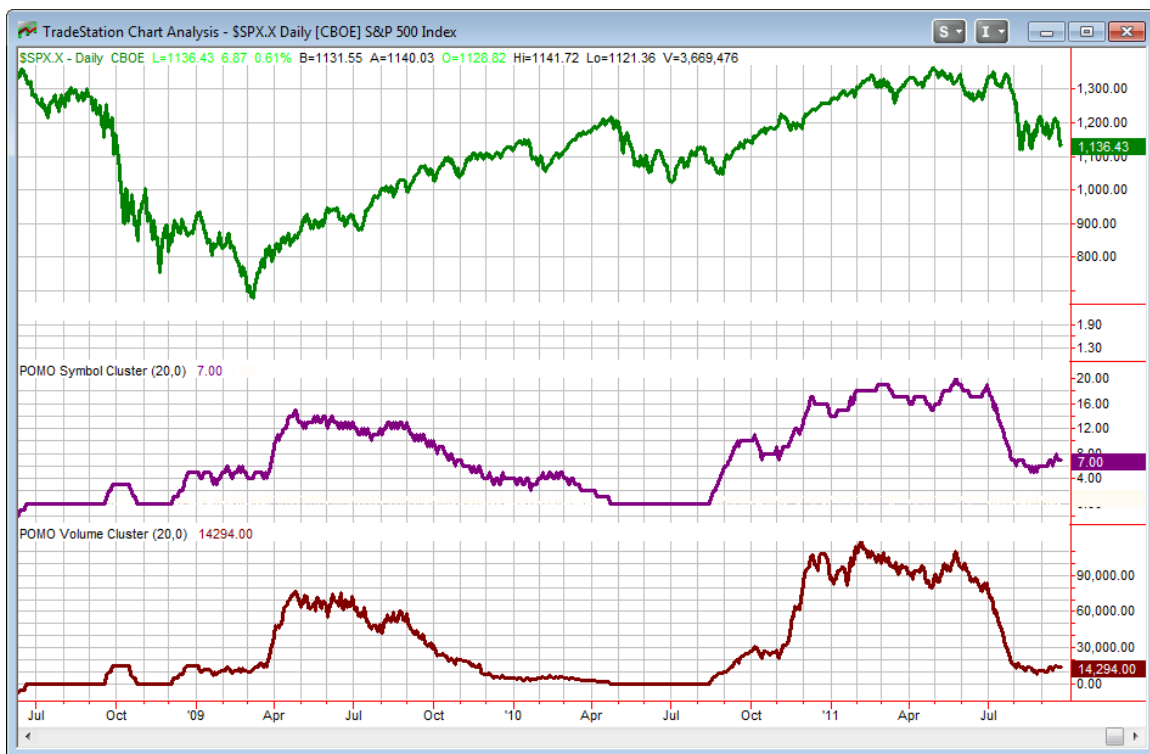
QE1 and QE2 were there last two attempts. Those programs appeared to have a strongly bullish impact on stock prices. Gains were significant during both. The objective of both programs was to inject liquidity into the system by purchasing treasury securities in the open market. Operation Twist is different in that the fed will be buying longer dated securities and selling shorter dated securities. Exactly how it will all unfold is unclear, but

I'll be sure to monitor it closely and the net buying numbers will be reflected the POMO chart.

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 barely budged and remain relatively low. The purchase amounts over the last month are extremely close to the \$14billion number shown on the Fed's website.

Stimulus still remains well below the levels that helped propel the market higher during QE1 and QE2. And without any program in place the market has struggled mightily over the last several years. It will be interesting to see how Operation Twist impacts the market. My initial thoughts are below.

Being that this is not a straight liquidity injection like we saw in QE1 and QE2, the impact may not be as broad. It could be that certain industries or groups will benefit from the yield curve shift the fed is forcing while other groups will be negatively impacted. I don't know at this point how this will play out, but I do think it may be worthwhile to track sector relative strength as operation twist gets underway. I'll conduct some more research in this area over the next several weeks, but as a starting point I thought it would be interesting to take a look at the best and worst performing sectors since Tuesday's close.

Sector ETF Returns Over Last 3 Days		
Symbol	Description	%Chg
		%Chg
XLU	S&P Sel Utilities Spdr Fund	-2.54
XLK	S&P Sel Technology Spdr Fund	-3.46
XLP	S&P Sel Consum Staples Spdr Fu	-3.72
XLV	S&P Sel Health Care Spdr Fund	-4.63
XLY	S&P Sel Consum Discretion'y Sp	-4.72
IYZ	iShares DJ US Telecom Sect Ind	-5.91
XLF	S&P Sel Financial Spdr Fund	-6.71
XLI	S&P Sel Industrial Spdr Fund	-6.77
IYT	iShares DJ Transp Avg Ind Fd	-7.27
IYR	iShares DJ US R/E Index Tr	-7.44
XLB	S&P Sel Materials Spdr Fund	-10.03
XLE	S&P Sel Energy Spdr Fund	-10.55

Everything has fallen, but the disparity so far is quite large. Utilities, technology, and consumer staples have held up relatively well over the last 3 days while real estate, materials, and energy have been whacked. There is a good chance this initial thrust down is a short-term overreaction, but I'll start showing this table using a few different time frames going forward. Doing so may provide some insight into what groups are benefitting from Operation Twist, and what ones aren't.

Of course there are always groups that lead and groups that lag, but my suspicion is that the difference between the 2 may become more pronounced and more persistent thanks to the yield curve manipulation of Operation Twist. This isn't an original idea of mine. As some subscribers may be aware I am a member of the American Association of Professional Technical Analysts (AAPTA). Ken Safian, who is a long-time AAPTA member, suggested this idea to the AAPTA group this past week. He also discussed how

the Fed took on a similar operation in 1961. In 1961 it seemed to help create a large disparity between growth and cyclical stocks. There is no telling at this point how this theory will pan out, but I do think paying a little extra attention to sector strength may be worthwhile.

Overall, I'll continue to slightly favor the short side with my index trades until more signs of a bottom emerge. I'll also take a keen interest in the effects of Operation Twist and anticipate measuring them through us of the POMO chart and industry group analysis.

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

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

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

*SLB – bought 1/3 position @ \$65.15.*

*SLB – bought 1/3 position @ \$60.50(2<sup>nd</sup> lot)*

*APA – bought 1/3 position @ \$82.91*

*FCX – bought 1/3 position @ \$31.40*

#### ***New***

*SLB – buy 1/3 position @ \$61.20 (final entry)*

*APA – buy 1/3 position @ \$82.73 (2<sup>nd</sup> lot)*

*AA – buy 1/3 position @ \$10.07*

*HAL – buy 1/3 position @ \$31.67*

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

*None.*

***Broad Market Large Cap CBI – 8/5 (SLB-3, APA-2, FCX, AA, HAL)***

### **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.

**SLB** – buy 1/3 position @ \$61.20. From catapult section above.

**APA** – buy 1/3 position @ \$82.73. From catapult section above.

**AA** – buy 1/3 position @ \$10.07. From catapult section above.

**HAL** – buy 1/3 position @ \$31.67. From catapult section above

**SPY** – buy ¼ index position @ \$112.25 limit. If not filled during the day, then buy @ \$113.53 LIMIT ON CLOSE. Based on short-term outlook above. I will look to gently increase my long exposure if I can get a favorable entry price..

### **Current Open Trade Ideas**

Symbol	Entry Date	Entry Price	Current Price	% Gain/Loss	Stop	Notes
SPY(1/4)	9/20/2011	\$120.17	\$113.54	-5.52%		Aggregator
SLB(1/3)	9/22/2011	\$62.49	\$61.20	-2.06%		Catapult
SLB(1/3)	9/23/2011	\$60.50	\$61.20	1.16%		Catapult - bought on open
APA(1/3)	9/23/2011	\$82.91	\$82.73	-0.22%		Catapult - bought on open
FCX(1/3)	9/23/2011	\$31.40	\$32.37	3.09%		Catapult - bought on open

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