

# QUANTIFIABLE EDGES SUBSCRIBER LETTER

ASSESSING MARKET ACTION WITH INDICATORS AND HISTORY

September 27, 2011

Volume 4 Issue 186

## Market Overview



## Signals Overview

Aggregator	Aggressive VIX	Conservative VIX	NDX Trend Timer
Flat	Flat	Flat	Long

## Tonight's Research Points

- 2 up days from a 20-day low that fail to make up the losses of the 1 day before during a downtrend often suggest a short-term bearish edge.
- With the CBI still at 8, the odds seem to favor further gains looking out 4-5 days.

## *Short-term Outlook*

### *The Bottom Line*

With a new bearish study and the elimination of some bullish ones, expectations have turned mildly negative. Still, the market was slightly oversold at the close on Monday, leaving the Aggregator neutral and me looking to get flat my index exposure.

*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 27, 2011	Bounce < 25% yesterday's drop	1-2 days	Bearish	-1.20%
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 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>				
<b>September 23, 2011</b>	<b>3 % drop from 5-day low</b>	<b>1-2 days</b>	<b>Bullish</b>	
<b>September 23, 2011</b>	<b>Up Issues &lt; 33% 2 days. SPX &lt; 2001</b>	<b>1-2 days</b>	<b>Bullish</b>	
September 22, 2011	2% below high and down on Fed Day	1-3 days	Bullish	3.00%

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

***The Evidence***

After a volatile overnight session and early morning the market caught fire in the afternoon on Monday. While large caps led the way all day, the Nasdaq and Russell played a little bit of catch up at the end. The SPX finished up 2.3%, the Nasdaq rose 1.4%, and the Russell 2000 gained 2.0%. Breadth was strongly positive as the NYSE Up Issues % came in at 73% and the Up Volume % just missed a 90% day according to Tradestation, which showed 89.75% up volume. Total NYSE volume did not impress and declined for the 2<sup>nd</sup> day in a row.

So last night's bearish studies were run over and the bullish broad Aggregator expectations won out on Monday. At first blush, it might appear Monday's move was very strong. But volume was weak, and even with the 2.3% SPX gain, it still hasn't made back even Thursday's 1-day drop. In the 3/21/11 letter I looked at other times the SPX had risen for 2 days in a row off a 20-day low and still couldn't manage to make up for the losses of the previous day. The downtrending results of that study have not changed so I have copied them below.

After making a 20-day low 2 days ago SPX closes up the last 2 days but still closes below the close of 2 days ago. 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	-14,097.57	14	6	8	42.86	1,988.01	-3,253.21	0.61	0.46	-1,006.97
4	-8,288.18	14	7	7	50.00	1,726.30	-2,910.33	0.59	0.59	-592.01
3	-13,150.48	15	4	11	26.67	1,962.53	-1,909.15	1.03	0.37	-876.70
2	-14,574.89	15	5	10	33.33	1,573.44	-2,244.21	0.70	0.35	-971.66
1	-9,041.41	15	5	10	33.33	1,731.22	-1,769.75	0.98	0.49	-602.76

As you can see, there appears to be a downside inclination over the next few days. Most of the downside has generally been realized by day 2. Below is a list of all instances assuming a 2-day holding period.

After making a 20-day low 2 days ago SPX closes up the last 2 days but still closes below the close of 3 days ago.  
Buy on close. Sell X days later. \$100k/trade. 2000 - present.

Date/Time	Signal	Price	% Profit	Run-up Drawdown
02/23/00	Buy	\$1,360.69	(2.01%)	\$0.00
02/25/00	Sell	\$1,333.36		(\$2,302.42)
10/05/00	Buy	\$1,436.21	(2.38%)	\$489.21
10/09/00	Sell	\$1,402.03		(\$3,017.37)
12/04/00	Buy	\$1,325.05	2.00%	\$3,863.25
12/06/00	Sell	\$1,351.54		\$0.00
12/17/01	Buy	\$1,134.36	1.34%	\$1,591.04
12/19/01	Sell	\$1,149.56		\$0.00
01/31/02	Buy	\$1,130.20	(3.16%)	\$0.00
02/04/02	Sell	\$1,094.44		(\$3,339.60)
06/05/02	Buy	\$1,049.90	(2.13%)	\$0.00
06/07/02	Sell	\$1,027.53		(\$3,553.95)
12/31/02	Buy	\$879.82	3.27%	\$3,551.59
01/03/03	Sell	\$908.59		\$0.00
02/03/03	Buy	\$860.32	(1.94%)	\$151.96
02/05/03	Sell	\$843.59		(\$2,335.08)
08/10/04	Buy	\$1,079.04	(1.47%)	\$0.00
08/12/04	Sell	\$1,063.23		(\$1,492.24)
10/21/04	Buy	\$1,106.49	(1.06%)	\$164.70
10/25/04	Sell	\$1,094.80		(\$1,467.00)
04/19/05	Buy	\$1,152.78	0.62%	\$616.62
04/21/05	Sell	\$1,159.95		(\$1,430.18)
05/28/08	Buy	\$1,390.84	0.68%	\$1,099.08
05/30/08	Sell	\$1,400.35		(\$159.75)
09/08/08	Buy	\$1,267.80	(2.82%)	\$67.08
09/10/08	Sell	\$1,232.04		(\$3,603.60)
09/11/08	Buy	\$1,249.05	(4.43%)	\$483.20
09/15/08	Sell	\$1,193.75		(\$4,424.00)
01/16/09	Buy	\$850.12	(1.16%)	\$0.00
01/21/09	Sell	\$840.24		(\$5,360.94)

Looking over the individual trades the edge seems to be both strong and fairly consistent. The average drawdown was -2.2% while the average run-up was only 0.8%, suggesting a very positive reward/risk for a short trade.

I discussed the rather high CBI readings yesterday. A CBI of 8 is pretty high, and generally suggests a bit of an upside edge. What was unusual about Monday's action is that the SPX put in a 2%+ rally and the CBI didn't budge. None of the Catapult trades reached their targets. So I looked at other instances where the CBI remained high despite a strong up day. I looked at this a couple of different ways. First I simply required a 2% rise and a CBI  $\geq$  8.

SPX closes up > 2% today while CBI closes $\geq$ 8. Buy on close. Sell X days later. \$100k/trade. 1995 - 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	26,057.95	16	13	3	81.25	3,167.67	-5,040.58	0.63	2.72	1,628.62
4	24,633.25	19	11	5	57.89	4,016.89	-3,910.51	1.03	2.26	1,296.49
3	14,789.30	22	12	8	54.55	3,311.29	-3,118.28	1.06	1.59	672.24
2	-2,596.83	23	12	10	52.17	2,269.06	-2,982.55	0.76	0.91	-112.91
1	-5,343.83	23	10	13	43.48	1,204.76	-1,337.81	0.90	0.69	-232.34

We see there have been a decent number of instances. It appears the next day or 2 have often seen a consolidation or slight pullback, but by the time you get out 5 days the market has almost always managed to gather some traction and put in some nice gains.

I looked at this one other way as well. Monday was interesting because not only did the CBI remain high, but it didn't budge. Not a single Catapult triggered an exit. So I looked at other times this occurred with a CBI of 8 or higher.

SPX closes up > 2% today while CBI closes >= 8. CBI does not decline from yesterday.  
Buy on close. Sell X days later. \$100k/trade. 1995 - 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	3,587.13	9	7	2	77.78	2,502.75	-6,966.04	0.36	1.26	398.57
4	11,274.32	9	6	3	66.67	4,416.41	-5,074.71	0.87	1.74	1,252.70
3	9,780.90	9	6	3	66.67	3,291.49	-3,322.68	0.99	1.98	1,086.77
2	10,263.05	9	5	4	55.56	3,192.30	-1,424.61	2.24	2.80	1,140.34
1	1,709.24	9	4	5	44.44	2,160.01	-1,386.16	1.56	1.25	189.92

Fewer instances – same message. A day or 2 of consolidation are typically followed by further gains.

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



Between the new bearish study and the expiring bullish ones the green Aggregator line could hold not its positive reading. Levels below 0 mean net expectations from the Active List are for downside over the next few days. Meanwhile, the Differential Line is still

marginally above 0. A positive Differential reading means the SPX has underperformed expectations over the last few days. So net expectations are negative and the SPX is mildly oversold versus recent expectations. With the lines now on opposite sides of 0, this is now considered a neutral configuration. Due to this the Aggregator System turned from long to flat at the close.

At this point the green Aggregator line is poised to flip back above 0 on Tuesday. Of course this could easily change if compelling bearish studies emerge. Meanwhile, the Differential Pivot will be 1,135.95. This is about 2.3% *below* Monday's close. In other words, the SPX will need to fall at least this much, effectively giving back all of Monday's gains, in order to keep the Differential Line from turning negative. So if the market traded flat tomorrow and no new studies emerged we would see both lines cross 0 in opposite directions – keeping the Aggregator system flat.

At this point with the Aggregator back to neutral I am going to look to exit my index position. I will let my individual Catapult positions ride. (More discussion on this below the trade ideas at the bottom of the letter.) With the market as volatile as it has been I expect it won't be long before the next favorable entry opportunity avails itself.

***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.

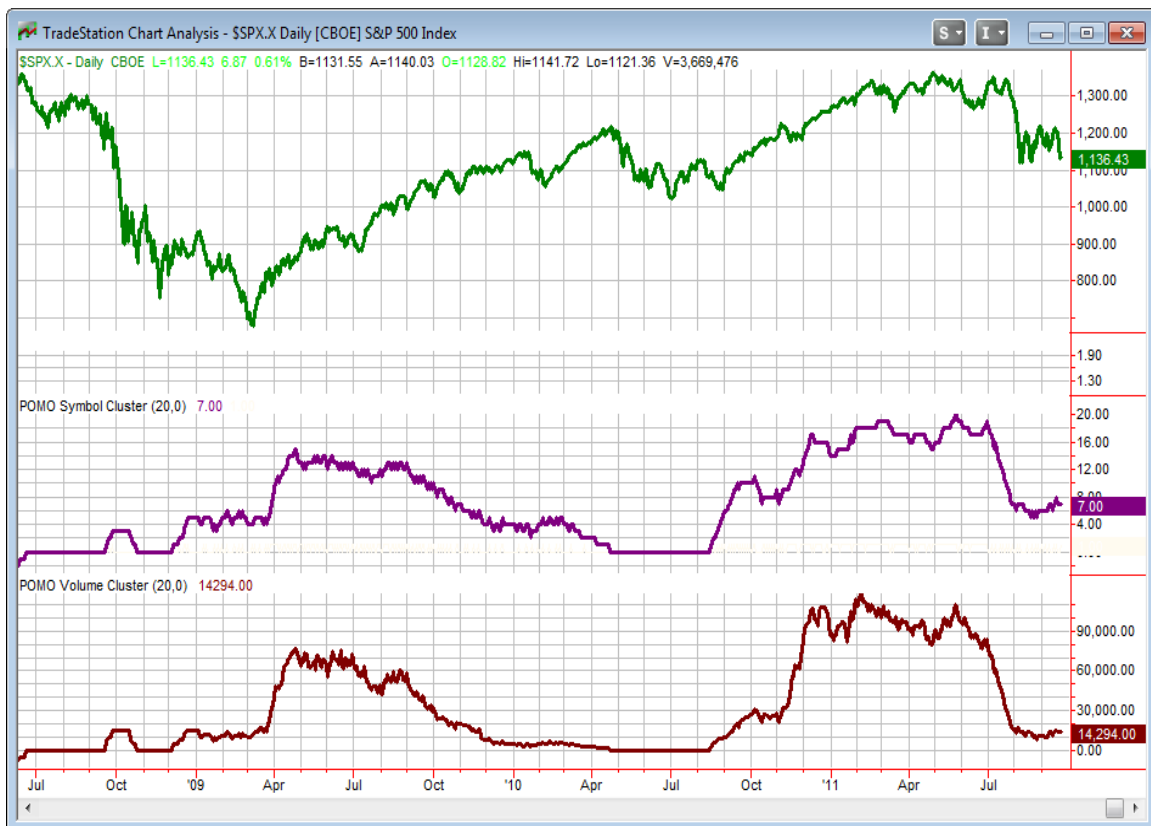
I didn't notice any study this past week that suggested compelling intermediate-term implications, but that doesn't mean nothing of intermediate-term import occurred. The big news occurred on Wednesday when the Fed provided some details of "Operation Twist". It is their next attempt to stimulate the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

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

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

*AA – bought 1/3 position @ \$10.07*

*HAL – bought 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.

*None tonight.*

### **Current Open Trade Ideas**

Symbol	Entry Date	Entry Price	Current Price	% Gain/Loss	Stop	Notes
SPY(1/4)	9/20/2011	\$120.17	\$116.21	-3.30%		<i>sell @ \$116.21 limit</i>
SLB(1/3)	9/22/2011	\$62.49	\$63.27	1.25%		Catapult
SLB(1/3)	9/23/2011	\$60.50	\$63.27	4.58%		Catapult
APA(1/3)	9/23/2011	\$82.91	\$85.56	3.20%		Catapult
FCX(1/3)	9/23/2011	\$31.40	\$33.77	7.55%		Catapult
SLB(1/3)	9/26/2011	\$61.20	\$63.27	3.38%		Catapult - bought at limit
APA(1/3)	9/26/2011	\$82.73	\$85.56	3.42%		Catapult - bought at limit
AA(1/3)	9/26/2011	\$10.07	\$10.44	3.67%		Catapult - bought at limit
HAL(1/3)	9/26/2011	\$31.67	\$33.74	6.54%		Catapult - bought at limit

With the Aggregator now flat I will look to exit the open lot of SPY.

### **A note on the open Catapult Trades**

Should any of the Catapults near their exit targets tomorrow I will send out an email with those levels. All of them are nicely positive at this point, yet oddly none have hit their exit triggers. I have made a number of attempts over the years to devise a method for instituting a trailing stop when the position becomes nicely positive but still has not triggered an exit. My attempts to do so have been unsuccessful. I have consistently found that long-term results have been better by simply waiting for the stock to hit its exit trigger.

While the Catapult System does not use any of the triggers used by the numbered systems, the idea is somewhat similar in that it is looking for a bounce before exiting. If someone wanted to test their own Catapult exit techniques they could easily do so and compare the results to the subscriber letter results. All entries and exits can be found on the trade idea results spreadsheet (downloadable at the bottom of the systems page). So while there may be a way to improve returns by trailing a stop under circumstances like this, I have not come up with it.

Of course it might be quite painful to watch all of these unrealized gains turn into losses if the market takes a turn for the worse. And what is best over the long haul is not necessarily best in the short run. If you have taken positions in any of these Catapult trades and are feeling antsy and would like to lock in some profits, then the way I prefer to do it is to simply take some off the table. Sell  $\frac{1}{4}$ , or  $\frac{1}{2}$ , or  $\frac{3}{4}$  or whatever fraction of the position you feel comfortable with right now. That will take the pressure off and you can let the rest ride and wait for the standard exit. If you take  $\frac{1}{2}$  profits with the position up

3%, for example, then the 2<sup>nd</sup> half of the position would need to fall about 6% from there before the trade becomes a net loser. That is a nice cushion, and if the position does pull back 2%-3% at some point you hopefully won't be as emotionally distressed about it.

Now, to restate my own plan – I will not be taking any early exits at this point. Should we get some more follow through Tuesday which would cause any of the open Catapults to near their exits, then I will let you know. Also, if the Aggregator turns outright negative on Tuesday and I want to take more off the table and some Catapults are very close to their targets then I may consider some partial profits at that time.

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