

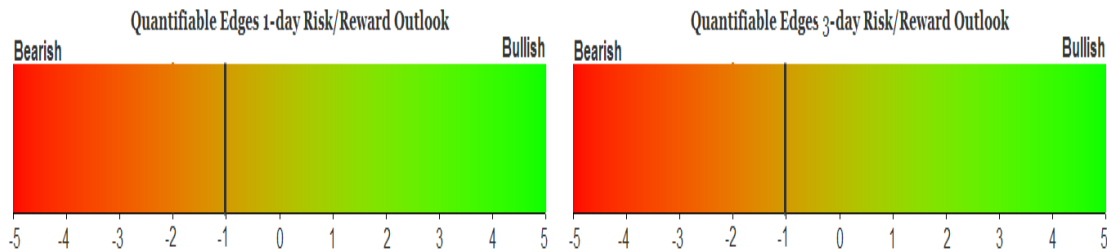
# QUANTIFIABLE EDGES SUBSCRIBER LETTER

ASSESSING MARKET ACTION WITH INDICATORS AND HISTORY

September 29, 2011

Volume 4 Issue 188

## Market Overview



## Signals Overview

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

## Tonight's Research Points

- Today's extreme down move does not appear to suggest the strong upside reaction that it once did.

## Short-term Outlook

### The Bottom Line

The Aggregator remains negative, but I'm inclined to take profits on my 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>				
September 28, 2011	3 up. Vol weak. No 50-low. Close < 200	1-3 days	Bearish	
September 28, 2011	SPY 1% below high but up 1% on day	1-2 days	Bullish	
September 26, 2011	Bounce < 25% yesterday's drop	1-4 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 27, 2011</b>	<b>2 days up from 20-low but &lt; 3 days</b>	<b>1-2 days</b>	<b>Bearish</b>	<b>-1.20%</b>

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

### *The Evidence*

Negative expectations certainly played out on Wednesday as the major indices took a tumble. The SPX closed down 2.1%, the Nasdaq fell 2.2%, and the Russell 2000 lost a whopping 4.1%. Breadth was abysmal as the NYSE Up Issues % came in at 17% and the Up Volume % was a little under 4%. Total NYSE volume came in at the lowest level in a little over a week.

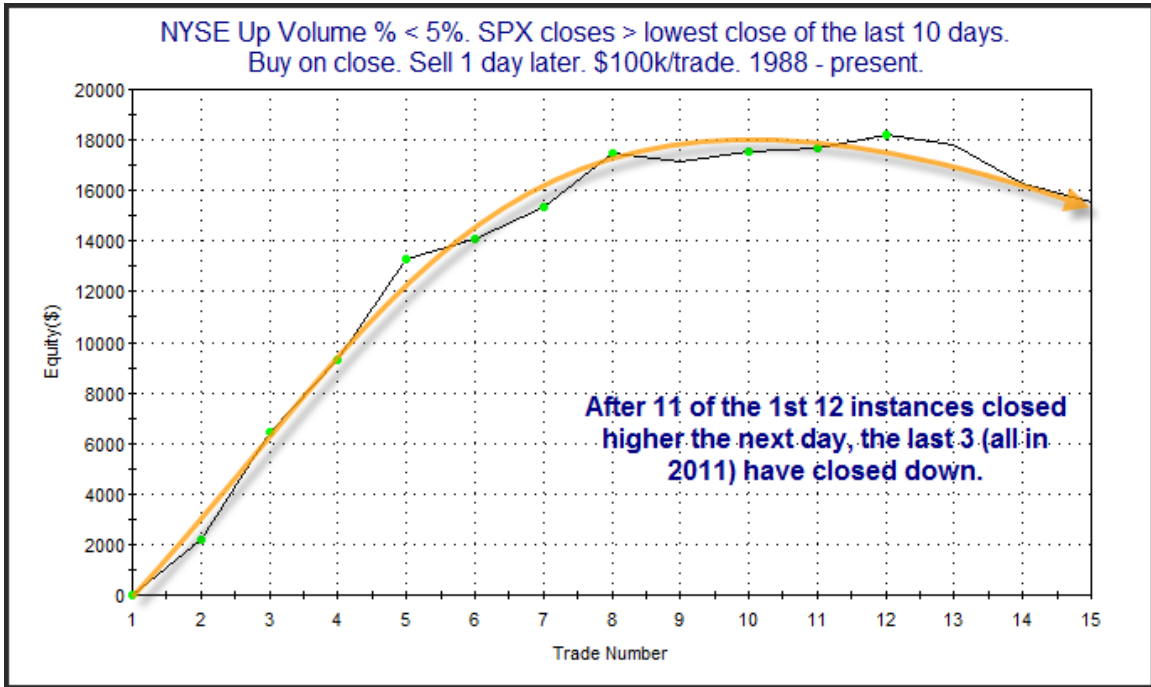
I believe tonight's research produced some of the most surprising results I have seen in a very, very long time. Often times we see that very strong reactions (like 2% drops or 5% Up Volume % days such as today) are overreactions. This is the reason that very strong moves in one direction are often soon followed by a sharp retracement in the opposite direction. For a long period of time simply buying any really big down day seemed to give you a good chance of making money the next day or two. But lately that approach would have struggled mightily. I'll show this a few different ways. The Quantifinder was able to find a decent number of studies suggesting some sort of bullish edge. But the recent results of those studies have not done well. I primarily focused on the more extreme ones that most closely resembled current market action.

The excerpt below is from the 9/22/11 subscriber letter, which is just a week old. Stats are NOT updated.

*The selling was extreme on Wednesday, but surprisingly few studies triggered that were strongly compelling. And some of those that once appeared very strong no longer appeared so persuasive. One example of that can be found in the stats table below.*

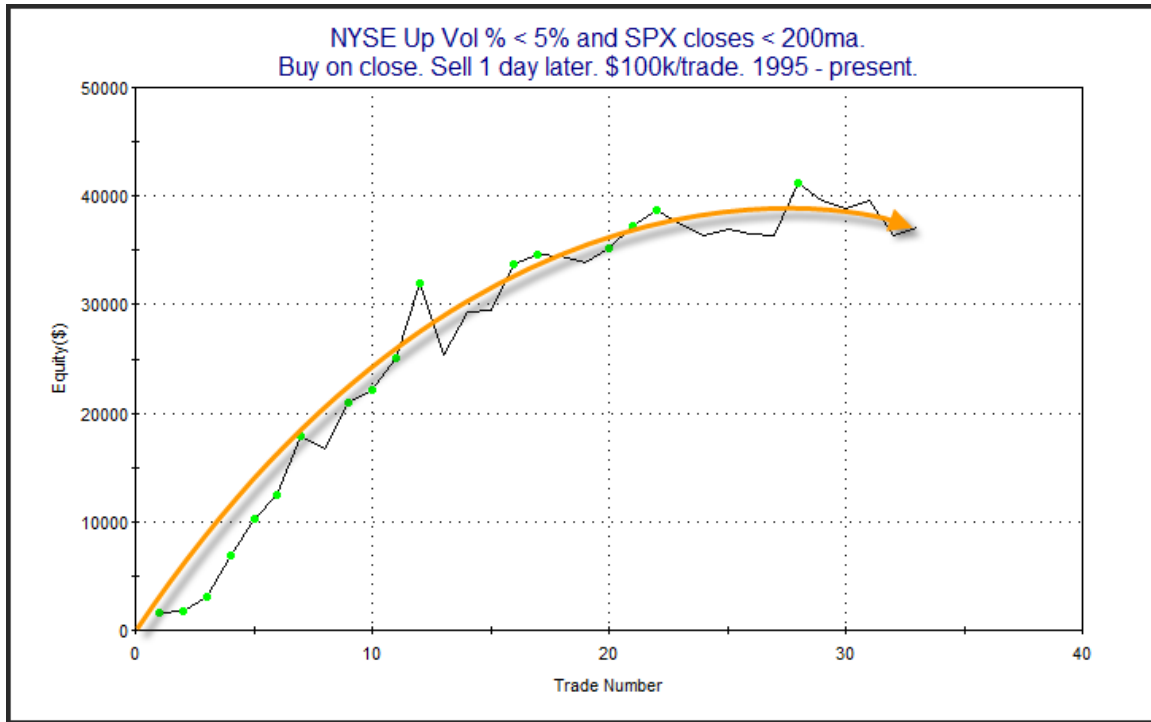
NYSE Up Volume % < 5%. SPX closes > lowest close of the last 10 days. Buy on close. Sell X days later. \$100k/trade. 1988 - present.										
X Days	All: Net Profit	All: Total Trades	All: Winning Trades	All: Losing Trades	All: % Profitable	All: Avg Winning Trade	All: Avg Losing Trade	All: Win/Loss Ratio	All: ProfitFactor	All: Avg Trade
5	20,486.98	15	9	6	60.00	3,767.37	-2,236.56	1.68	2.53	1,365.80
4	17,507.93	15	9	6	60.00	4,090.39	-3,217.60	1.27	1.91	1,167.20
3	25,971.11	15	10	5	66.67	2,998.03	-801.84	3.74	7.48	1,731.41
2	21,648.69	15	11	4	73.33	2,251.48	-779.40	2.89	7.94	1,443.25
1	15,563.60	15	11	4	73.33	1,687.53	-749.81	2.25	6.19	1,037.57

*I last looked at this study in the 9/6/11 subscriber letter. I decided not to include on the active list that day and again today. The equity curves across the 1-3 period where there appears to be a substantial edge in the table above has lost much of its appeal. To illustrate, below is the 1-day curve.*



*All the gains were made in the 1<sup>st</sup> half of the instances here. It will be a while before I include this study on the active list again.*

Another similar study I examined tonight was from the 7/19/10 subscriber letter. It looked at 5% up volume days when the SPX was below its 200ma. It also suggested an upside edge that played mostly played itself out on day 1. An (updated) equity curve using a 1-day holding period can be found below.



There are many more instances here than in the previous test, but the shape of the curve is very similar. What was once a strong upslope is beginning to curl down.

I also looked at Wednesday's low volume to see if that provided any clues. There have only been 2 other times that the NYSE Up Volume % came in under 5% and volume came in at a 1-week low. Those instances occurred on 10/15/08, and 11/27/09. Both saw the market rise in the short-term, but just 2 instances isn't enough to try and draw any conclusions.

Of course 5% days were rare for a very long time and have become more common in the last few years. I also thought it would be interesting to use the 1-yr. Up Volume % Rank to see if results there differed.

NYSE Up Vol % 1-yr Rank < 2%. SPX closes > 10-day low but close < 200ma.  
Buy on close. Sell 1 day later. \$100k/trade. 1995 - present.

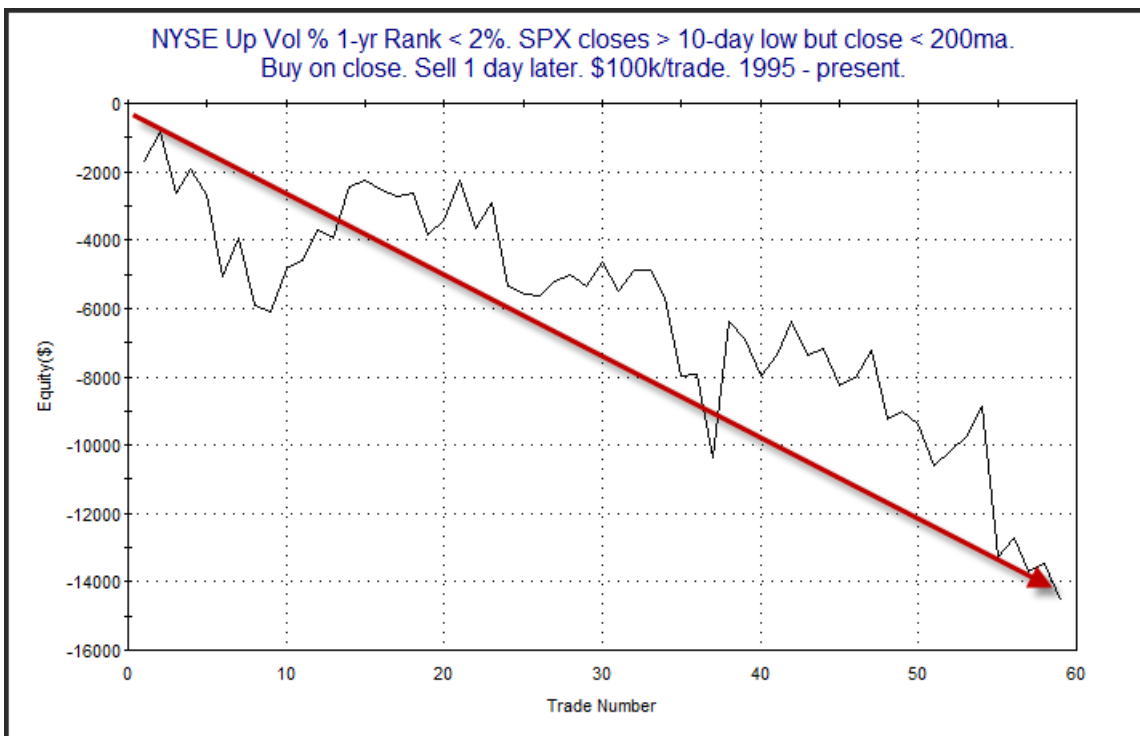
TradeStation Performance Summary

Collapse ^

All Trades

Total Net Profit	(\$14,530.56)	Profit Factor	0.59
Gross Profit	\$20,699.74	Gross Loss	(\$35,230.30)
Total Number of Trades	59	Percent Profitable	49.15%
Winning Trades	29	Losing Trades	30
Even Trades	0		
Avg. Trade Net Profit	(\$246.28)	Ratio Avg. Win:Avg. Loss	0.61
Avg. Winning Trade	\$713.78	Avg. Losing Trade	(\$1,174.34)
Largest Winning Trade	\$3,982.74	Largest Losing Trade	(\$4,400.45)

Direction has been a tossup but the losers have been much bigger. I have included an equity curve below.



The curve isn't too bad, but with winners and losers split evenly I decided not to include it my estimates. With only a 1-day edge, it wouldn't make much different anyway.

As I mentioned earlier, the lack of an upside edge was a bit of a surprise considering the extreme breadth and action. There is a chance that such strong days could begin favoring follow through as opposed to reversion. While no substantial edge is currently offered by these studies, they appear well worth keeping an eye on. The market evolves over time. That is one reason I constantly monitor and update all the studies. We may be witnessing an evolution now. If so, we will be aware of it and able to adjust.

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



Without anything new the green Aggregator line barely budged. Levels below 0 mean net expectations from the Active List are for downside over the next few days. Meanwhile, the Differential Line is also still 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. The configuration can be seen on the chart whenever both lines close below 0. Due to this the Aggregator System remained short at the close.

At this point the green Aggregator line is poised to remain below 0 on Thursday. Of course this could change if bullish studies emerge. Meanwhile, the Differential Pivot will be 1,165.91. This is about 1.3% *above* Wednesday's close. So if the SPX closed flat tomorrow, we would see the Differential line move into positive territory. To prevent the Differential line from turning positive the SPX will need to rise the 1.3% and close above the pivot.

So the Aggregator is still negative. But the SPY position that was entered in the morning is strongly positive and the Differential Pivot is inverted. Inverted meaning even a flat close would flip it tomorrow and cause the current open trigger to close. With those 2 things in mind, I will be looking to take profits on the short SPY lot on Thursday. Details in the Trade Ideas section below.

***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.

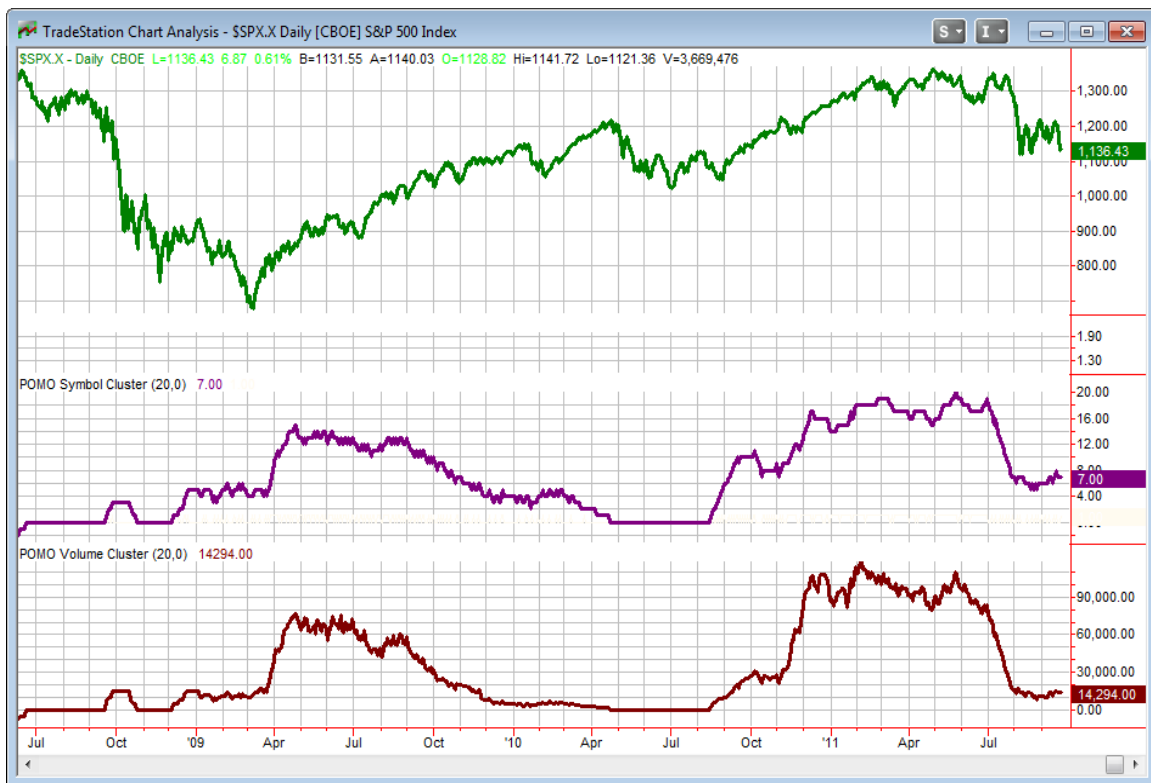
QE1 and QE2 were there last two attempts. Those programs appeared to have a strongly bullish impact on stock prices. Gains were significant during both. The objective of both programs was to inject liquidity into the system by purchasing treasury securities in the open market. Operation Twist is different 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***

APA – bought 1/3 position @ \$82.91

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

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

None.

### ***Broad Market Large Cap CBI – 2/1 (APA-2)***

## **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
APA(1/3)	9/23/2011	\$82.91	\$82.57	-0.41%		Catapult
APA(1/3)	9/26/2011	\$82.73	\$82.57	-0.19%		Catapult
SPY(1/4)(s)	9/28/2011	\$117.78	\$115.14	2.24%		Shorted on open

*I will look to cover 1 half my SPY position at a limit of \$115.35. I will exit the 2<sup>nd</sup> half if the SPX closes below the Differential Pivot of 1,165.91.*

This report has been prepared by Hanna Capital Management, LLC and is provided for information purposes only. Under no circumstances is it to be used or considered as an offer to sell, or a solicitation of any offer to buy securities. While information contained herein is believed to be accurate at the time of publication, we make no representation as to the accuracy or completeness of any data, studies, or opinions expressed and it should not be relied upon as such. Robert Hanna, Hanna Capital Management, LLC or clients of Hanna Capital Management, LLC may have positions or other interests in securities (including derivatives) directly or indirectly which are the subject of this report. This report is provided solely for the information of Hanna Capital Management, LLC clients and prospects who are expected to make their own investment decisions without reliance upon this report. Neither Hanna Capital Management, LLC nor any officer or employee of Hanna Capital Management, LLC accepts any liability whatsoever for any direct or consequential loss arising from any use of this report or its contents. This report may not be reproduced, distributed or published by any recipient for any purpose without the prior express consent of Hanna Capital Management, LLC.

Copyright © 2011 Hanna Capital Management, LLC.