

QUANTIFIABLE EDGES SUBSCRIBER LETTER

ASSESSING MARKET ACTION WITH INDICATORS AND HISTORY

September 30, 2011

Volume 4 Issue 189

Market Overview



Signals Overview

Aggregator	Aggressive VIX	Conservative VIX	NDX Trend Timer
Long	75% Long XIV	100% Long SPY	Long

Tonight's Research Points

- The solid breadth and volume following a large down day suggests further upside follow through.
- When SPY closes well off its high but still positive there is often more buying over the next few days..

Short-term Outlook

The Bottom Line

The Aggregator flipped to positive. I am now looking to take on some long exposure if I can get a favorable entry opportunity.

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

Study Date	Description	Time span	Bias	Avg Max Move
Active				
September 30, 2011	Solid breadth & vol after 2% drop	1-2 days	Bullish	
September 30, 2011	SPY 1% below high but up on day < 200	1-2 days	Bullish	
September 28, 2011	3 up. Vol weak. No 50-low. Close < 200	1-3 days	Bearish	
September 21, 2011	1% up 10-high then close down	1-7 days	Bullish	3.25%
Active - Long Term				
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%
Dropped Tonight				
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	

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

The Evidence

It was a wild day in the markets on Thursday. Strong up and down action was seen and there was a great split among the indices. The SPX finished up 0.8% and the Russell 2000 did even better with a 1.6% gain, but the Nasdaq fell 0.4% (and the Nasdaq 100 was down over 1%). NYSE breadth was positive as the Up Issues % came in at 71% and the Up Volume % was 75%. Total NYSE volume rose from Wednesday's levels. As you'll see below the rise in volume was a good thing.

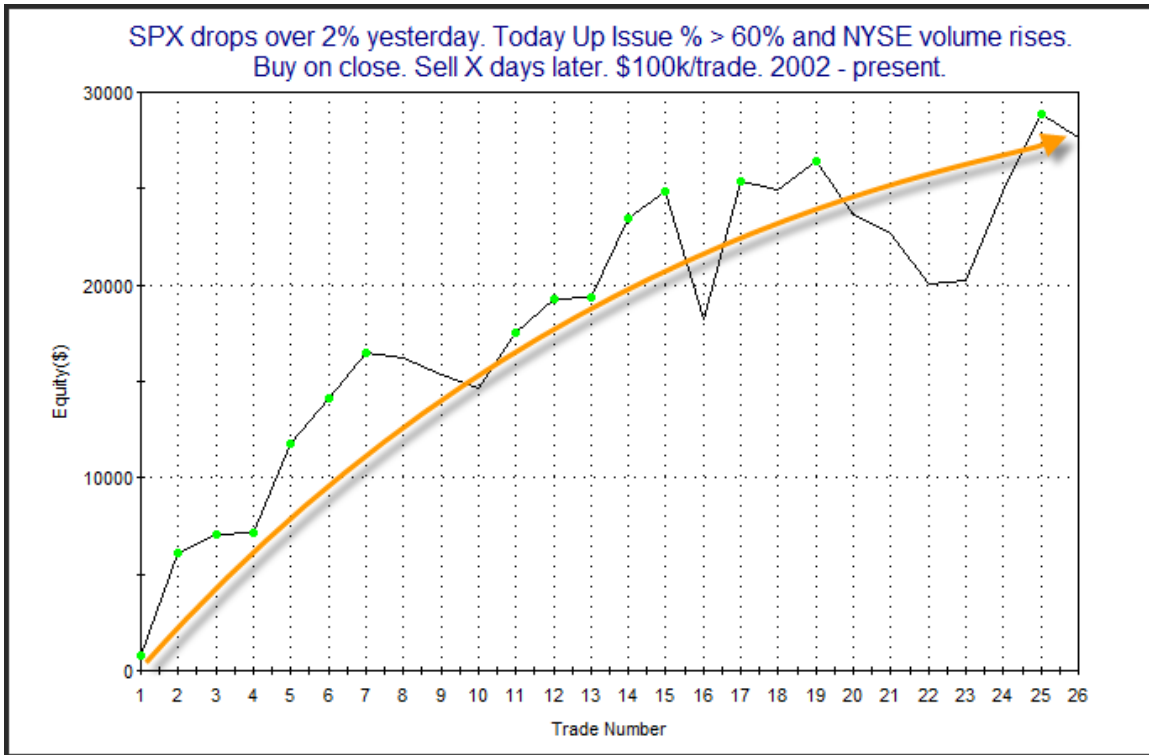
We seem to be in a bit of a bizarre market the last couple of days. Yesterday despite extreme selling there were no bullish studies that suggested a short-term bounce. On Thursday afternoon I was monitoring the Quantifinder closely and looking at the studies a number of different ways. The theme that was coming across was that if the SPX could put in a late-day rally and finish positive, then that would be bullish. And if the SPX closed down, then that would lead to negative expectations. This is the opposite of what we often see where reversals rule more often than not. As it turned out the SPX closed positive, and as you'll see, expectations did too.

The study below was last seen in the 7/20/10 subscriber letter. It looks at solid bounces that occur on strong breadth and volume just after a 2%+ drop. I have updated the results.

SPX drops over 2% yesterday. Today Up Issue % > 60% and NYSE volume rises. Buy on close. Sell X days later. \$100k/trade. 2002 - 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	1,955.71	24	14	10	58.33	3,170.77	-4,243.51	0.75	1.05	81.49
4	16,511.18	25	15	10	60.00	3,681.97	-3,871.84	0.95	1.43	660.45
3	30,915.55	26	15	11	57.69	3,780.32	-2,344.48	1.61	2.20	1,189.06
2	27,657.08	26	17	9	65.38	2,599.29	-1,836.75	1.42	2.67	1,063.73
1	24,931.90	26	16	10	61.54	2,415.48	-1,371.58	1.76	2.82	958.92

22 of 26 instances (85%) closed above the entry price at some point in the next week. 24 of 26 did so within 6 trading days.

As you can see there appears to be a pretty strong inclination for the market to rise over the next few days. Below is an equity curve that assumed a 2-day exit strategy.



The edge may be weakening a bit in recent times but the upside inclination still appears intact. I also double-checked to see what impact the volume had on this study. Below you can see how the results would look using the exact same setup (over the same time period) but with the bounce occurring on lower volume instead.

SPX drops over 2% yesterday. Today Up Issue % > 60% and NYSE volume declines.
Buy on close. Sell X days later. \$100k/trade. 2002 - 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	-28,659.63	14	6	8	42.86	2,085.49	-5,146.57	0.41	0.30	-2,047.12
4	-8,666.00	16	9	7	56.25	1,856.53	-3,624.97	0.51	0.66	-541.63
3	-17,142.35	16	8	8	50.00	1,779.11	-3,921.91	0.45	0.45	-1,071.40
2	-1,448.25	18	10	8	55.56	1,804.26	-2,436.36	0.74	0.93	-80.46
1	-11,112.63	18	5	13	27.78	1,240.79	-1,332.04	0.93	0.36	-617.37

Without rising volume the average trade goes from strongly green to strongly red.

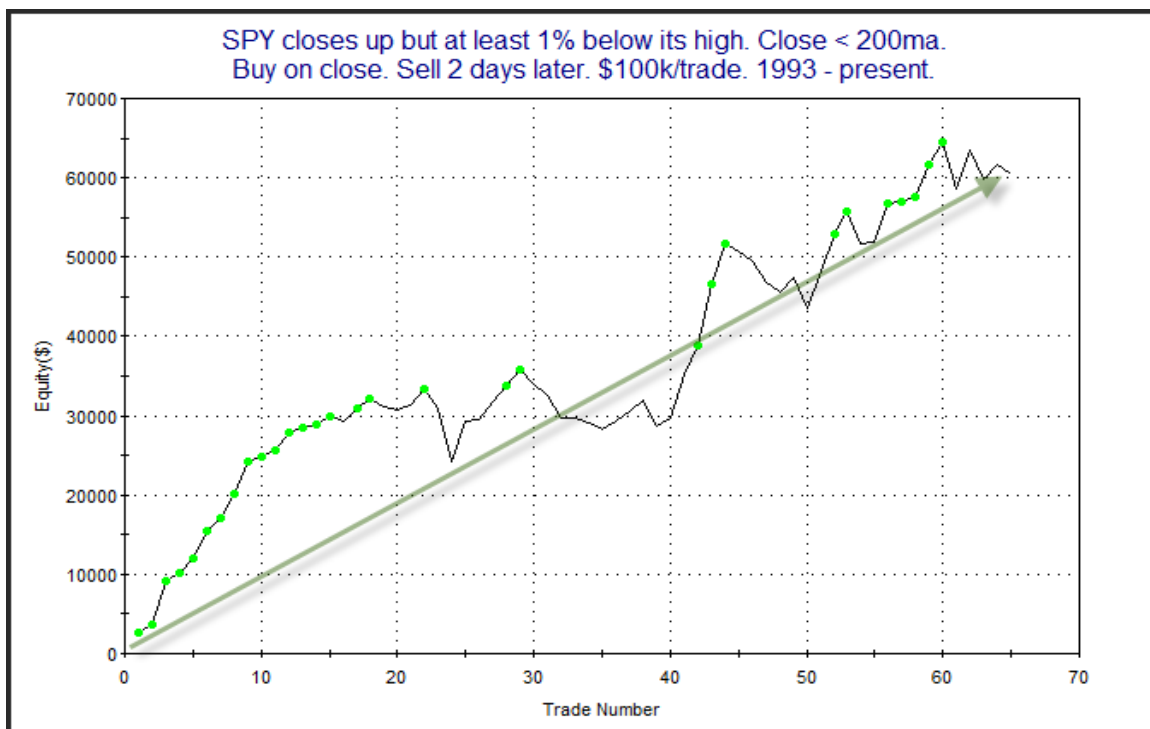
Another study that triggered was last seen just 2 days ago in the 9/28/11 letter. Below is an excerpt from that letter. (All stats are updated.)

When SPY closes higher but well off its highs of the day, then it has a tendency to rise back towards (or above) those highs over the next few days. This can be seen in the study below...

SPY closes up but at least 1% below its high. 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: Win/Loss Ratio	All: ProfitFactor	All: Avg Trade
10	58,460.23	45	28	17	62.22	4,465.26	-3,915.70	1.14	1.88	1,299.12
9	51,048.61	47	27	20	57.45	4,396.53	-3,382.88	1.30	1.75	1,086.14
8	35,428.74	47	24	23	51.06	4,473.62	-3,127.74	1.43	1.49	753.80
7	37,140.10	50	29	21	58.00	4,558.46	-4,526.44	1.01	1.39	742.80
6	34,188.61	53	29	24	54.72	4,101.14	-3,531.02	1.16	1.40	645.07
5	41,040.91	55	29	25	52.73	3,815.95	-2,784.87	1.37	1.59	746.20
4	38,217.45	57	33	24	57.89	3,236.05	-2,857.18	1.13	1.56	670.48
3	44,503.31	59	35	24	59.32	3,026.72	-2,559.66	1.18	1.72	754.29
2	60,345.52	65	44	21	67.69	2,423.20	-2,203.59	1.10	2.30	928.39
1	30,081.57	72	45	27	62.50	1,754.02	-1,809.24	0.97	1.62	417.80

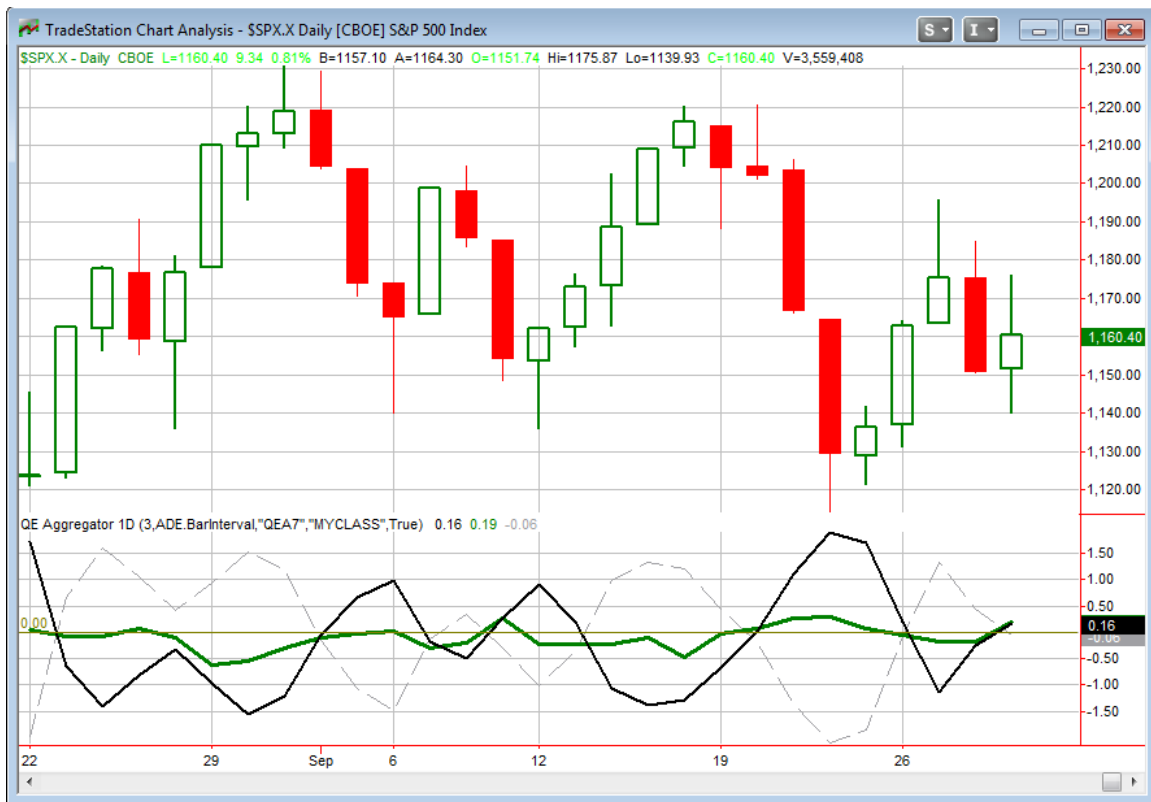
Ample occurrences and solid numbers over the first few days appear to suggest an upside edge. Below is an equity curve with a 2-day exit strategy.



A little choppy but the general upslope remains intact throughout, providing further evidence of an upside edge.

So breadth, volume, and the price pattern today all seem to be supportive of a rally over the next few days.

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



Tonight's bullish studies pushed the green Aggregator line back above 0. Levels above 0 mean net expectations from the Active List are for upside over the next few days. Meanwhile, the black Differential Line also crossed 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 oversold versus recent expectations. Historically this combination has suggested an upside edge. The configuration can be seen on the chart whenever both lines close above 0. Due to this the Aggregator System changed from short to long at the close.

At this point the green Aggregator line is poised to remain above 0 on Friday. Of course this could change if compelling bearish studies emerge. Meanwhile, the Differential Pivot will be 1,173.02. This is about 1.1% above Thursday's close. So the SPX would need to rise at least this much in order for the Differential Line to turn negative and signal the SPX has moved from oversold to overbought.

In this wild and somewhat negative environment I am not thrilled about getting aggressively long. The Aggregator suggests a long-side edge though and I feel the evidence is strong enough to at least take on some exposure. As wild as the action has been I will insist on a favorable entry price, though. Therefore, I have set some parameters describing how I would initiate long exposure 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.

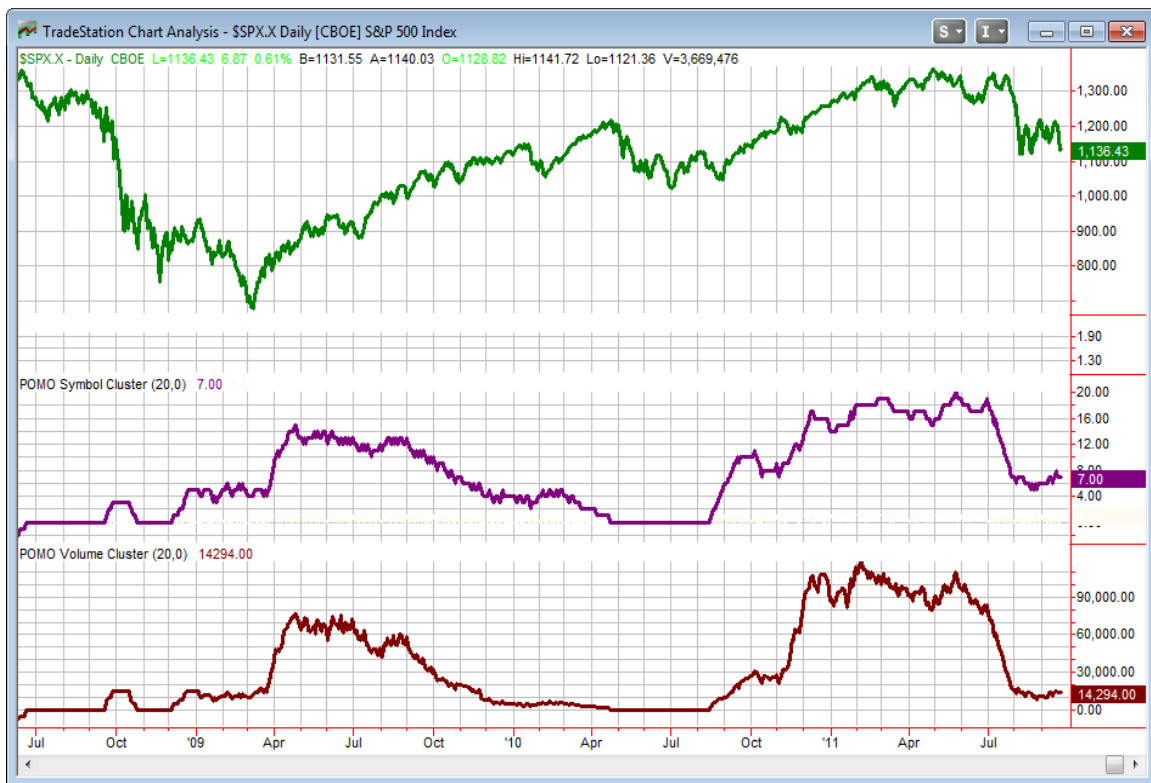
QE1 and QE2 were there last two attempts. Those programs appeared to have a strongly bullish impact on stock prices. Gains were significant during both. The objective of both programs was to inject liquidity into the system by purchasing treasury securities in the open market. Operation Twist is different 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 3rd 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 (2nd 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.

SPY – buy 1/4 index position at \$115.50 LIMIT ON OPEN. If NOT filled on open, then cancel and look to buy at \$114.25 LIMIT. If not filled by end of day then buy @\$116.05 LIMIT ON CLOSE. As discussed in the short-term section above I am looking to build long exposure if I can get a favorable price. The strategy here is to buy either 1) A gap down, 2) A test of Thursday's low, or 3) A lower close.

Current Open Trade Ideas

Symbol	Entry Date	Entry Price	Current Price	% Gain/Loss	Stop	Notes
APA(1/3)	9/23/2011	\$82.91	\$82.88	-0.04%		Catapult
APA(1/3)	9/26/2011	\$82.73	\$82.88	0.18%		Catapult
SPY(1/4)(s)	9/28/2011	\$117.78	\$115.70	1.77%		Avg exit price

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