

QUANTIFIABLE EDGES SUBSCRIBER LETTER

ASSESSING MARKET ACTION WITH INDICATORS AND HISTORY

October 4, 2011

Volume 4 Issue 191

Market Overview



Signals Overview

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

Tonight's Research Points

- 2 days of poor breadth under the 200ma have consistently been followed by a bounce. The reliability and performance is even better when it occurs on a Monday.
- 2.5% drops in SPX following a 5-day low have typically been followed by a strong and quick bounce..

Short-term Outlook

The Bottom Line

The studies continue to suggest a bounce is due. I am partially long and looking to maintain that position. I will only increase it if I see the VIX or the CBI spike higher.

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

Study Date	Description	Time span	Bias	Avg Max Move
Active				
October 4, 2011	33% Up Issues % 2 days in a row. C<200	1-2 days	Bullish	
October 4, 2011	2.5% drop from 5-day low	1-2 days	Bullish	
October 3, 2011	1.75% drop 2 of 3 days. No 7-day low.	1-2 days	Bullish	3.40%
Active - Long Term				
September 12, 2011	Nasdaq leading SPX	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				
August 24, 2011	IBD Follow Through Day strong breadth	int term	Bullish	
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	

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

The Evidence

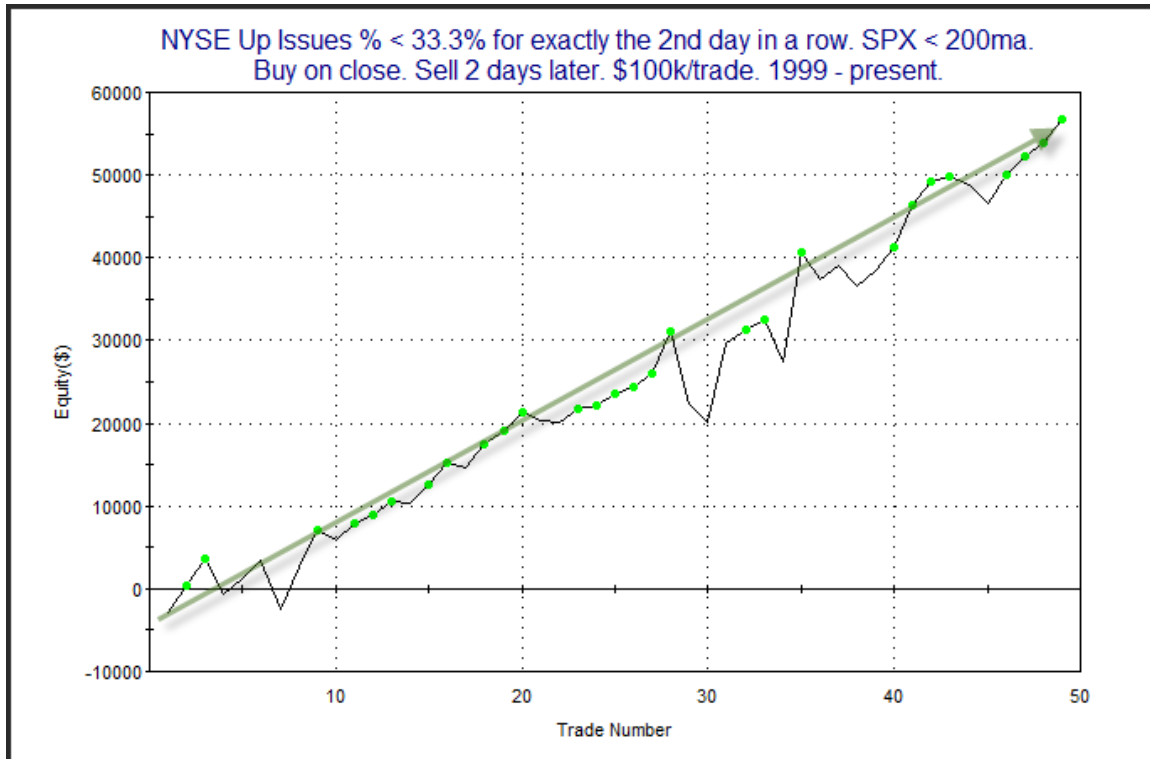
If there was any doubt about the market being in a downtrend it was erased Monday. While the Nasdaq and Dow didn't quite reach new lows, the SPX and Russell 2000 closed well below the August lows. Selling was broad and strong throughout the day. The SPX lost 2.9%, the Nasdaq fell 3.3%, and the Russell 2000 cratered 5.4%. Breadth was extremely weak as the NYSE Up Issues % came in at 10% and the Up Volume % was 3%. Volume rose from Friday's level.

Perhaps the most compelling study in the Quantifinder tonight is one that we've seen a few times in the past several weeks – the most recent instance being in the 9/23/11 subscriber letter. It looks at buying after 2 days of very negative breadth during a downtrend. I have updated all results.

NYSE Up Issues % < 33.3% for exactly the 2nd day in a row. SPX < 200ma. Buy on close. Sell X days later. \$100k/trade. 1999 - 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	57,214.14	43	31	12	72.09	2,999.21	-2,980.10	1.01	2.60	1,330.56
4	37,566.83	46	28	18	60.87	3,061.56	-2,675.38	1.14	1.78	816.67
3	43,508.05	49	30	19	61.22	3,518.66	-3,265.88	1.08	1.70	887.92
2	56,734.87	49	34	15	69.39	2,874.22	-2,732.59	1.05	2.38	1,157.85
1	39,359.62	49	32	17	65.31	2,009.89	-1,468.05	1.37	2.58	803.26

47 of 49 instances (96%) closed above the entry price at some point in the next week. 48 of 49 did so within 6 trading days.

For the considerable sample size and low number of criteria these results are astonishingly consistent. The stat at the bottom of the table is what seems most striking. Below is an equity curve using a 2-day exit.



As I've mentioned in the past I especially like this study because it has produced such consistently positive returns in a downtrending environment. That's fairly unusual to see.

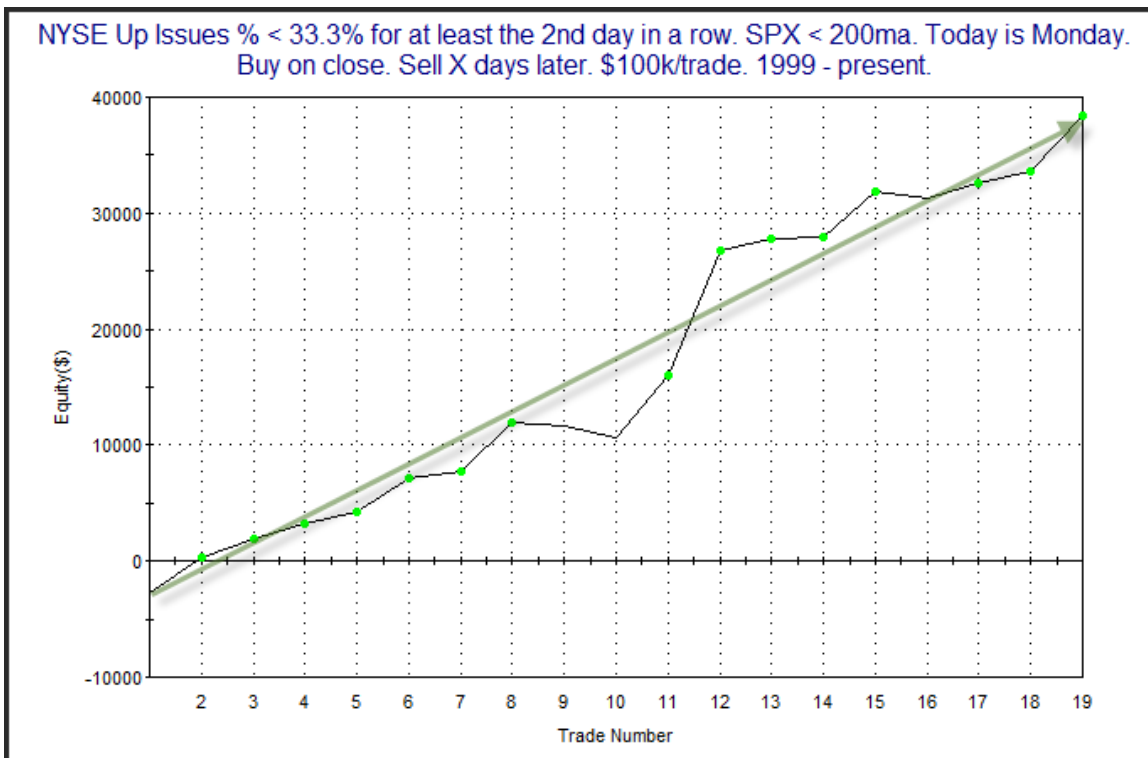
I should also point out that tomorrow is Tuesday, which happens to be the most likely day of the week for a turnaround – or at least a bounce. I examined this in the [1/13/09 blog](#). In the 6/8/10 letter I re-ran the above study with the following 2 adjustments: 1) I said that the Up Issues % had be below 33.3% for AT LEAST the 2nd day in a row, rather than EXACTLY the 2nd day in a row. 2) The trigger only occurred at the close if today was Monday. I've also updated these results.

NYSE Up Issues % < 33.3% for at least the 2nd day in a row. SPX < 200ma. Today is Monday.
Buy on close. Sell X days later. \$100k/trade. 1999 - 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	47,439.70	19	13	6	68.42	5,516.67	-4,046.18	1.36	2.95	2,496.83
4	48,806.47	19	13	6	68.42	4,940.70	-2,570.45	1.92	4.16	2,568.76
3	31,416.90	19	14	5	73.68	3,677.33	-4,013.14	0.92	2.57	1,653.52
2	30,053.73	19	16	3	84.21	2,465.91	-3,133.63	0.79	4.20	1,581.78
1	38,370.88	19	15	4	78.95	2,870.20	-1,170.52	2.45	9.20	2,019.52

All 19 instances closed above the entry price on either day 1 or day 2.

This appears to have been a powerful combination. The curve below assumes a 1-day holding period (Turnaround Tuesday.)



Here again we see a strong, consistent upslope that confirms the bullish tendency.

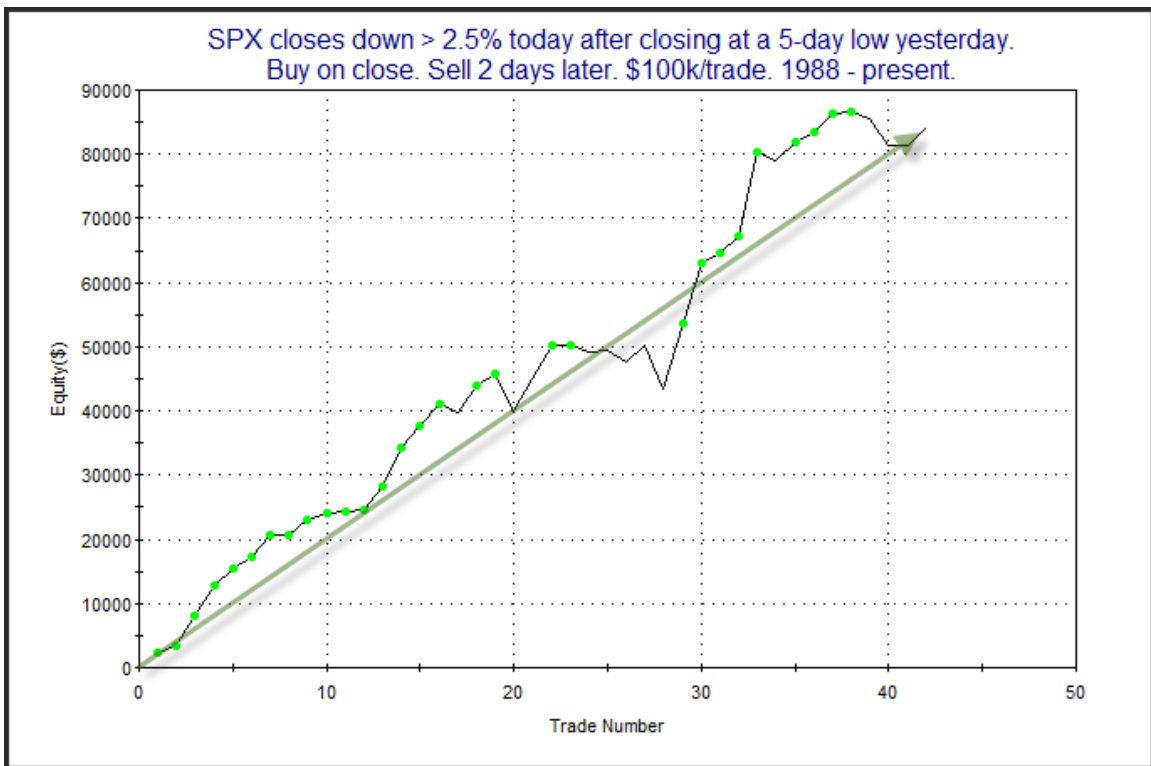
In the 7/19/10 subscriber letter I looked at 2.5% drops a few ways. I showed that when they occur following a 5-day high they often lead to further selling but when they occur

after a 5-day low like Monday then they are typically followed by a bounce. Tonight I decided to look at the “2.5% drop after a 5-day low” scenario in a bit more detail. First, let’s look at updated results for the base scenario, then I will show it in uptrends vs. downtrends.

**SPX closes down > 2.5% today after closing at a 5-day low yesterday.
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	96,256.57	36	26	10	72.22	4,538.47	-2,174.36	2.09	5.43	2,673.79
4	57,138.82	40	26	14	65.00	4,183.54	-3,688.09	1.13	2.11	1,428.47
3	74,275.79	41	27	14	65.85	3,900.93	-2,217.80	1.76	3.39	1,811.60
2	84,367.65	42	34	8	80.95	3,160.43	-2,885.88	1.10	4.65	2,008.75
1	60,460.50	44	32	12	72.73	2,499.05	-1,625.76	1.54	4.10	1,374.10

Indications here are for a very strong upside tendency over the 1st 2 days. Below is an equity curve that assumes a 2-day holding period.



The persistent upslope confirms the upside edge.

Now let's look at times where the setup occurred while the SPX was under its 200ma.

SPX closes down > 2.5% today after closing at a 5-day low yesterday. 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	74,207.21	27	20	7	74.07	4,743.25	-2,951.11	1.61	4.59	2,748.42
4	33,579.64	30	18	12	60.00	4,470.68	-3,907.71	1.14	1.72	1,119.32
3	54,420.09	31	19	12	61.29	4,441.14	-2,496.80	1.78	2.82	1,755.49
2	63,779.01	32	24	8	75.00	3,619.42	-2,885.88	1.25	3.76	1,993.09
1	47,685.23	34	23	11	67.65	2,855.42	-1,635.40	1.75	3.65	1,402.51

94% of instances closed above the entry price
at some point in the next week.

Here again the 2-day upside edge appears strong. And again I produced an equity curve...



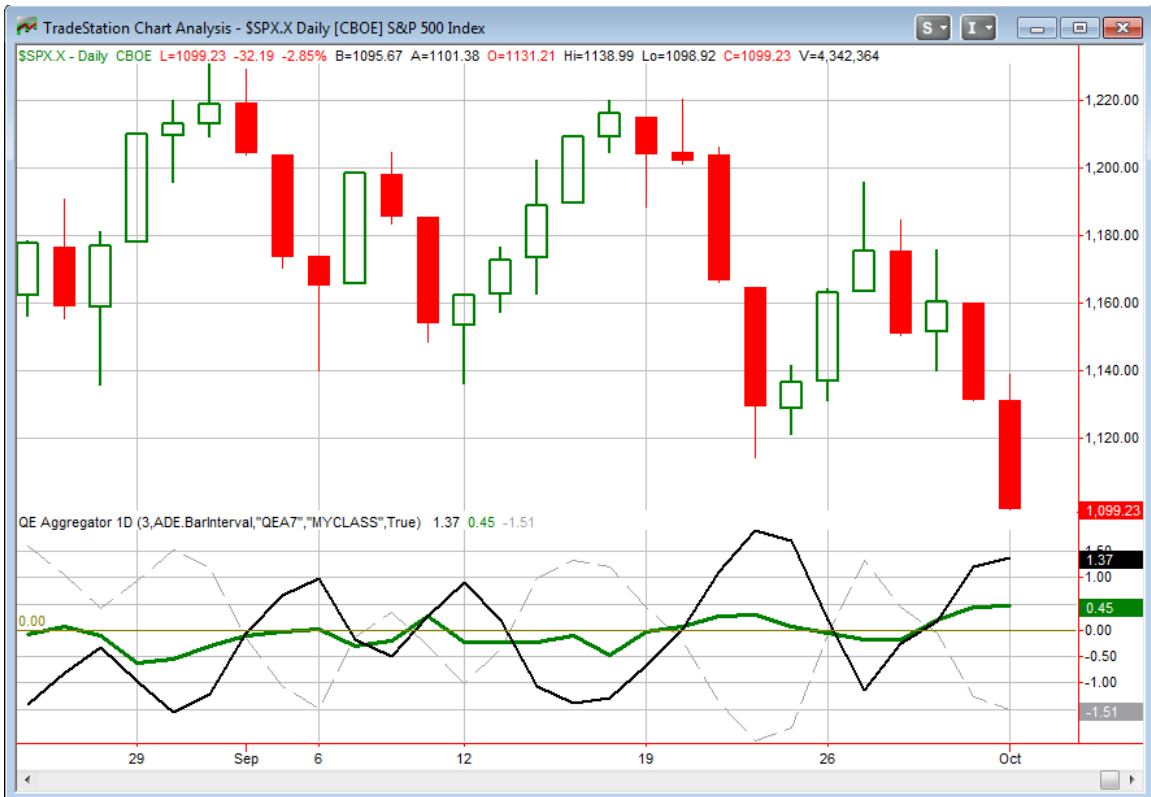
While not perfectly smooth there is nothing with this curve that causes me concern.

And while we are certainly not in an uptrend, below are results for those times where this has been the case.

SPX closes down > 2.5% today after closing at a 5-day low yesterday. 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	22,049.36	9	6	3	66.67	3,855.86	-361.93	10.65	21.31	2,449.93
4	23,559.20	10	8	2	80.00	3,537.48	-2,370.33	1.49	5.97	2,355.92
3	19,855.70	10	8	2	80.00	2,617.93	-543.86	4.81	19.25	1,985.57
2	20,588.65	10	10	0	100.00	2,058.87	0.00	100.00	100.00	2,058.87
1	12,775.27	10	9	1	90.00	1,588.34	-1,519.76	1.05	9.41	1,277.53

The 2-day results here appear to be the strongest and most consistent yet.

With tonight's studies now included, I have updated the [Aggregator](#) chart below.



Tonight's bullish studies have kept the green Aggregator line strongly positive. Levels above 0 mean net expectations from the Active List are for upside over the next few days. Meanwhile, the black Differential Line is also well 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 strongly 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 remained long at the close.

At this point the green Aggregator line is poised to remain above 0 on Tuesday. The low number of studies allows for the potential to change if compelling bearish studies emerge. Meanwhile, the Differential Pivot will be 1,156.14. This *over 5%* above Monday's close. So the SPX would need to rise at least this much in order for the Differential Line to turn negative. It is highly unlikely this will happen in 1 day. More likely it will take a very strong multi-day move in order to flip the Differential Line, signaling the SPX has moved to an overbought condition.

So the market is quite stretched, and we are seeing some compelling evidence suggesting a bounce. Unfortunately, I was a little early to this party with my 1st 2 entries. I now have a ½ size position and will not be looking to add to it at this point. The main reasons for my conservative approach are the position of the market and the lack of extreme readings in either the VIX or CBI.

The fact that the range was broken to the downside on Monday means the market could be susceptible to more sharp selling in the next few days as people panic out of positions. Rather than risk being caught in the downdraft with a large position, I will wait until I see evidence in the form of a large VIX spike, or a CBI reading of at least 10 before getting aggressively positioned. I suspect it won't take more than another couple days of selling before we would see these kinds of indicators spike to significant levels. I do think there is an upside edge here, and I will maintain my current ½ size index position in the hopes of taking advantage of that bounce if it arrives immediately. Traders who would like to add more exposure may find several trade ideas on the Triggers Spreadsheet. (More on that in the trade ideas section below.)

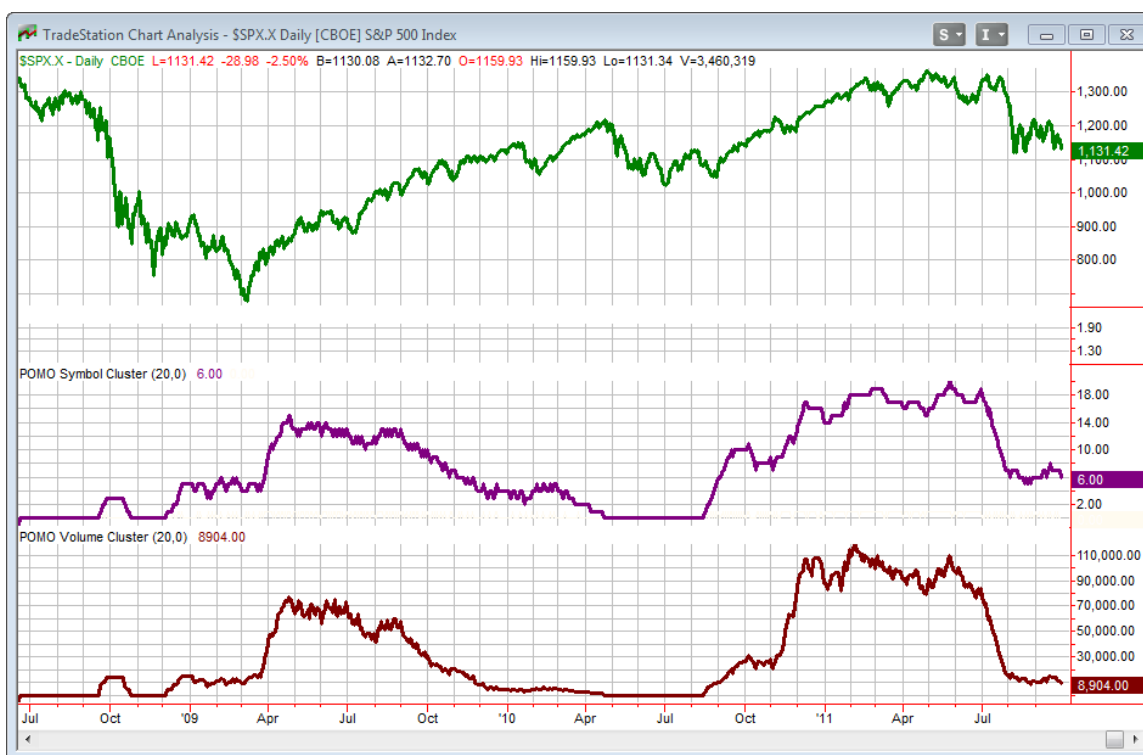
Intermediate-term Outlook (2 weeks – 2 months)– updated 10/3 – slightly bearish

The up and down action this past week left the SPX almost where it closed the week before. So while action was wild, neither bulls nor bears prevailed. From a studies standpoint nothing terribly compelling from an intermediate-term standpoint emerged.

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 dipped slightly this week. The purchase amounts over the last month are now a bit below 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. Since the end of QE2 it appears the very modest stimulus amount has failed to exert a

positive effect, similar to the periods of 0 stimulus in recent years. I discussed “Operation Twist” in some detail last week. That may help some, but it hasn’t kicked in yet.

The market has traded in a wide range over the last 2 months. A break of that range in either direction could be a significant event. At this point we are not far from the bottom of the range, so we will see if it can hold. I don’t see myself getting bullish on the market until we see either a massive downside washout, or we are able to break some resistance levels and begin an uptrend. At this point that would require a move at least through the August highs. The SPX is not close to there yet. So it will continue to be conservative long-side plays and perhaps a little more aggressive on the short-side for me.

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.

None tonight.

More aggressive traders have several setups on the systems triggers page to choose from tonight. I am not going to take any, but if I were I would be more apt to take triggers in stocks that are already extended down rather than ones that have just broken down. For instance, IWM and THD both triggered System 81119 on Monday. The chart of THD is much more appealing to me because it is not a fresh breakdown. It is extremely oversold both short and intermediate-term. So it has more room to the upside without hitting resistance, and it is also likely closer to having weak hands “sold out”.

Current Open Trade Ideas

Symbol	Entry Date	Entry Price	Current Price	% Gain/Loss	Stop	Notes
APA(1/3)	9/23/2011	\$82.91	\$76.50	-7.73%		Catapult
APA(1/3)	9/26/2011	\$82.73	\$76.50	-7.53%		Catapult
SPY(1/4)	9/30/2011	\$114.45	\$109.93	-3.95%		bought on open
SPY(1/4)	9/30/2011	\$112.49	\$109.93	-2.28%		bought on open

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