

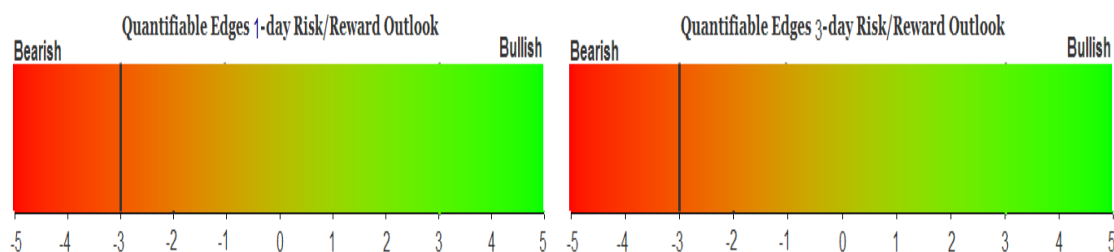
QUANTIFIABLE EDGES SUBSCRIBER LETTER

ASSESSING MARKET ACTION WITH INDICATORS AND HISTORY

October 14, 2011

Volume 4 Issue 199

Market Overview



Signals Overview

Aggregator	Aggressive VIX	Conservative VIX	NDX Trend Timer
Short	75% Long VXX	100% Short SPY	Flat

Tonight's Research Points

- The stretched VXO continues to suggest a short-term SPX pullback.
- The Nasdaq is also at a point where a pullback is likely.

Short-term Outlook

The Bottom Line

Thursday didn't change much. The market is still overbought and indications still suggest a pullback. I'm holding on to my short position.

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

Study Date	Description	Time span	Bias	Avg Max Move
Active				
October 13, 2011	3 up days. No 50-day low. < 200ma.	1-3 days	Bearish	-2.90%
October 13, 2011	VXO > 15% below 10ma for 3 days	1-2 days	Bearish	-1.80%
October 12, 2011	5 higher highs no 20-day high	1-4 days	Bearish	-2.25%
Active - Long Term				
October 11, 2011	2nd 90% up vol in a week	1-14 days	Bullish	
October 7, 2011	90% Up Volume on 3rd day up.	1-14 days	Bullish	
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				
October 11, 2011	SPY gap-n-go to new 10-day high < 200	1-3 days	Bearish	-2.90%
October 12, 2011	Low vol & range 20. Close > 10ma < 200	1-2 days	Bearish	-2.40%

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

The Evidence

Thursday threatened weakness for much of the day, but by the end the market was mixed. The SPX finished down 0.3% and the Russell 2000 lost 0.2%, but the Nasdaq gained 0.6%. Breadth was somewhat weak as the NYSE Up Issues % came in at 38% and the Up Volume % was 35%. Total NYSE volume dipped down around the levels seen on Monday and Tuesday.

There isn't much new to discuss tonight. Despite the mild pullback in the SPX it remains overbought. I was unable to find any indications based on today's action suggesting an upside edge. The bearish indications I went over yesterday came through today, but the magnitude of the pullback is expected to be quite a bit larger. Of course there is always a chance that the market can power through these bearish tendencies, but I find it encouraging that some of the conditions remain in place. Most encouraging in my eyes is that the VXO remains stretched far to the downside despite the drop in the SPX on Thursday.

I showed last night that a 20% downside stretch from the 10ma is rare for VXO, and it has signaled short-term market weakness in the past. It closed more than 20% below the 10ma again on Thursday. I looked back at other times it closed more than 20% below its 10ma for 2 days in a row. There were only 3 instances. While it's dangerous to draw solid conclusions from just 3 instances I decided to show them below:

VXO close over 20% below its 10ma for the 2nd day in a row. Buy SPX on close. Sell 2 days later. \$100k/trade. 1987 - present.					
Date/Time	Signal	Price	% Profit	Run-up Drawdown	
10/30/87	Buy	\$251.78	(0.38%)	\$1,576.09	
11/03/87	Sell	\$250.82			(\$3,576.97)
12/24/87	Buy	\$252.02	(2.95%)	\$0.00	
12/29/87	Sell	\$244.58			(\$3,100.68)
11/19/90	Buy	\$319.34	(1.04%)	\$0.00	
11/21/90	Sell	\$316.03			(\$2,169.09)

It hasn't happened in about 21 years, which makes the setup even more questionable, but the run-up / drawdown stats were so lopsided I thought it was worth pointing out. Over the next 3 days the instances all saw a drawdown between 2.1% - 3.8%. Only 1 instance saw any run-up, and it was only 1.6%.

Another way I looked at the VXO/SPX action today was that the VXO finished with a 20% downstretch despite the fact that the SPX closed lower. This has only happened 5

times, and they were all bunched in November and December of 1987. Like the instances in the previous test, a pullback was generally in order during the next few days after each instance.

Of course the Nasdaq did buck the SPX and Russell today and managed to close higher. Out of curiosity I decided to take the study I ran yesterday on the SPX and run it for the Nasdaq. Since it is up 4 days in a row instead of 3 I did change that one requirement. Results are below.

Nasdaq closes higher for exactly the 4th day in a row. It did not close at a 50-day high 4 days ago.
Close < 200ma. 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
10	-46,935.96	16	3	13	18.75	1,629.84	-3,986.57	0.41	0.09	-2,933.50
9	-38,799.91	16	4	12	25.00	1,687.09	-3,795.69	0.44	0.15	-2,424.99
8	-30,108.11	17	6	11	35.29	1,782.61	-3,709.43	0.48	0.26	-1,771.07
7	-33,312.52	17	4	13	23.53	1,527.13	-3,032.39	0.50	0.15	-1,959.56
6	-36,589.50	17	3	14	17.65	1,606.88	-2,957.87	0.54	0.12	-2,152.32
5	-25,711.79	17	4	13	23.53	1,429.39	-2,417.64	0.59	0.18	-1,512.46
4	-16,993.09	17	7	10	41.18	946.86	-2,362.11	0.40	0.28	-999.59
3	-15,890.87	17	6	11	35.29	1,439.23	-2,229.66	0.65	0.35	-934.76
2	-17,201.19	17	8	9	47.06	873.05	-2,687.28	0.32	0.29	-1,011.83
1	-14,688.74	17	6	11	35.29	493.60	-1,604.58	0.31	0.17	-864.04

All 17 instances closed below the entry price at some point in the next week.

Like the SPX study from last night, this one has shown a consistent bearish edge since 2002.

So really what we are seeing tonight is confirmation of what we've seen the last few days. The market is overbought and there appears to be a decent amount of complacency among options traders. Tonight's studies, as confirmation studies, are helpful, but if I included them on the Active List, they would just be duplication. So no new studies will be added tonight.

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



Without anything new being added to the Active List tonight, the green Aggregator line remained negative. Readings below 0 mean net expectations from the Active List are for downside over the next few days. Meanwhile, the black Differential Line also remains 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 provided a bearish edge. Bearish configurations are visible on the chart whenever both lines close below 0. Due to this the Aggregator System stayed short at the close.

With short-term evidence again all bearish the green Aggregator line is set to close negative on Friday. Of course this could change if compelling bullish evidence emerges. Meanwhile, the Differential Pivot will be 1,184.91. This is about 1.5% below Thursday's close. So it would take a drop of at least this much in order to flip the Differential line positive.

I'm still ½ size short and I'm still comfortable with that size. I won't be looking to add to my short on Friday. If the market does collapse and closes below the Differential Pivot, then I will take profits ahead of the weekend.

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

New lows were made this week but they were quickly followed by strong buying. The market is trying to carve out a bottom but to this point there have been few clues as to whether it will be successful. I suspect we will see more studies with intermediate-term implications this upcoming week.

There was one study that triggered on Thursday night with intermediate-term implications. Extremely strong breadth occurring after there has already been a rally of a few days will often help to kick off a further move to the upside over the next 2-3 weeks. This can be seen in the study below, which last appeared in the 8/16/11 subscriber letter.

SPX closes higher for at least the 3rd day in a row and the NYSE Up Volume % > 90%. Buy on close. Sell X days later. \$100k/trade. 10/20/87 - 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
20	30,884.79	16	10	6	62.50	4,685.94	-2,662.43	1.76	2.93	1,930.30
19	24,295.23	16	11	5	68.75	3,713.93	-3,311.61	1.12	2.47	1,518.45
18	26,677.11	16	12	4	75.00	3,449.55	-3,679.38	0.94	2.81	1,667.32
17	32,076.57	16	11	5	68.75	4,024.64	-2,438.89	1.65	3.63	2,004.79
16	34,462.02	16	12	4	75.00	3,618.49	-2,239.97	1.62	4.85	2,153.88
15	33,166.10	17	12	5	70.59	3,668.62	-2,171.47	1.69	4.05	1,950.95
14	35,527.81	17	15	2	88.24	2,696.46	-2,459.53	1.10	8.22	2,089.87
13	28,604.70	18	14	4	77.78	2,345.57	-1,058.30	2.22	7.76	1,589.15
12	24,509.61	18	14	4	77.78	2,188.52	-1,532.42	1.43	5.00	1,361.64
11	23,145.77	18	11	7	61.11	2,534.41	-676.11	3.75	5.89	1,285.88
10	24,931.29	18	13	5	72.22	2,610.27	-1,800.43	1.45	3.77	1,385.07
9	21,787.14	18	13	5	72.22	2,259.75	-1,517.91	1.49	3.87	1,210.40
8	15,691.15	18	13	5	72.22	2,141.96	-2,430.86	0.88	2.29	871.73
7	20,988.83	18	12	6	66.67	2,446.42	-1,394.69	1.75	3.51	1,166.05
6	12,740.05	18	11	7	61.11	2,184.08	-1,612.11	1.35	2.13	707.78
5	8,101.47	18	13	5	72.22	1,796.47	-3,050.52	0.59	1.53	450.08
4	6,465.60	18	13	5	72.22	1,447.35	-2,470.00	0.59	1.52	359.20
3	-972.56	18	11	7	61.11	1,345.71	-2,253.63	0.60	0.94	-54.03
2	2,036.36	18	14	4	77.78	818.75	-2,356.54	0.35	1.22	113.13
1	6,232.88	18	9	9	50.00	961.74	-269.20	3.57	3.57	346.27

After a brief consolidation, results appear to strongly favor the bull case, especially over the 2-3 week timeframe. Below I have listed all instances assuming a 14-day holding period.

SPX closes higher for at least the 3rd day in a row and the NYSE Up Volume % > 90%. Buy on close. Sell 14 days later. \$100k/trade. 10/20/87 - present.

Date/Time	Signal	Price	% Profit	Run-up Drawdown
10/29/87	Buy	\$244.77	0.32%	\$5,071.44
11/18/87	Sell	\$245.55		(\$2,913.12)
05/12/89	Buy	\$313.84	3.72%	\$3,746.04
06/02/89	Sell	\$325.52		\$0.00
05/11/90	Buy	\$352.00	3.17%	\$3,271.68
06/01/90	Sell	\$363.15		(\$17.04)
01/02/03	Buy	\$909.03	(2.39%)	\$2,862.20
01/23/03	Sell	\$887.34		(\$3,535.40)
03/17/03	Buy	\$862.79	1.86%	\$3,807.65
04/04/03	Sell	\$878.85		(\$2,197.65)
03/21/07	Buy	\$1,435.04	0.27%	\$944.61
04/11/07	Sell	\$1,438.87		(\$1,803.66)
11/26/08	Buy	\$887.68	1.89%	\$3,491.04
12/17/08	Sell	\$904.42		(\$8,062.88)
03/12/09	Buy	\$750.74	8.04%	\$10,933.93
04/01/09	Sell	\$811.08		(\$1,101.24)
04/02/09	Buy	\$834.38	2.10%	\$4,908.75
04/23/09	Sell	\$851.92		(\$2,362.15)
07/15/09	Buy	\$932.68	7.82%	\$7,965.08
08/04/09	Sell	\$1,005.65		(\$559.61)
08/21/09	Buy	\$1,026.13	1.62%	\$2,138.85
09/11/09	Sell	\$1,042.73		(\$3,313.52)
11/09/09	Buy	\$1,093.08	0.23%	\$1,875.51
11/30/09	Sell	\$1,095.63		(\$849.94)
03/05/10	Buy	\$1,138.70	2.37%	\$3,653.13
03/25/10	Sell	\$1,165.73		(\$330.60)
07/13/10	Buy	\$1,095.34	2.79%	\$2,908.36
08/02/10	Sell	\$1,125.86		(\$3,499.86)
09/03/10	Buy	\$1,104.51	4.00%	\$3,995.10
09/24/10	Sell	\$1,148.67		(\$1,202.40)
07/01/11	Buy	\$1,339.67	0.40%	\$1,243.94
07/22/11	Sell	\$1,345.02		(\$3,237.50)
08/15/11	Buy	\$1,204.49	(2.53%)	\$2,176.26
09/02/11	Sell	\$1,173.97		(\$6,922.20)

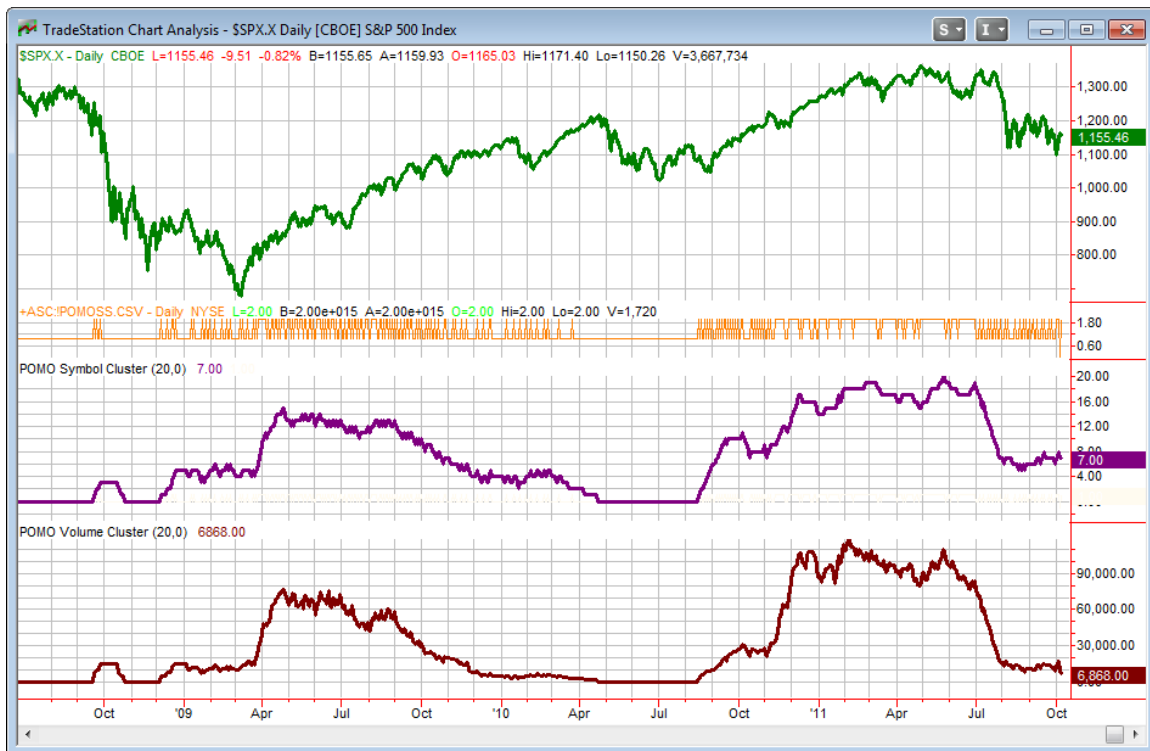
The August instance was a loser, but there still appears to be a healthy upside edge.

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>



Operation Twist kicked in this week. The Fed began buying more long-dated securities and selling some short-term ones. This came in the form of small amounts of buying on Mon, Tues, Wed, and Fri and a large amount of selling on Thursday. The result of the transactions was a small amount of net buying. Two weeks ago I discussed how the effect of Operation Twist may end up helping some sectors and hurting others. It is a bit soon to see how it will all play out, but below is an early scorecard showing how the sectors have perform both since operations began this past week and since the announcement 13 trading days ago.

Sector ETF Returns			
Symbol	Description	%Change this week	%Chg since announcement
IYR	iShares DJ US R/E Index Tr	(2.00)	(10.56)
IYZ	iShares DJ US Telecom Sect Ind	(1.62)	(7.43)
XLU	S&P Sel Utilities Spdr Fund	(0.65)	(2.57)
XLF	S&P Sel Financial Spdr Fund	0.17	(5.51)
XLV	S&P Sel Health Care Spdr Fund	0.54	(3.36)
XLP	S&P Sel Consum Staples Spdr Fu	1.38	(1.86)
XLK	S&P Sel Technology Spdr Fund	2.97	(2.25)
XLI	S&P Sel Industrial Spdr Fund	3.83	(3.50)
IYT	iShares DJ Transp Avg Ind Fd	3.87	(4.32)
XLE	S&P Sel Energy Spdr Fund	4.08	(7.19)
XLY	S&P Sel Consum Discretion'y Sp	4.27	(3.07)
XLB	S&P Sel Materials Spdr Fund	6.03	(7.41)

Real estate and telecom appear to be the losers so far. At this point there does not appear to be a clear leader. It will be interesting to see how this plays out over the next several weeks and months.

The market is trying to mount a rally. So far there has not been much indication that a new rally is likely to be successful. I suspect we will see more directional clues over the next few days. At this point I am not seeing any reason to start betting heavily on the long side. The market is only a few short days off its lows. I'll give this rally attempt some time to prove itself before taking a bullish stance.

Catapult and Capitulative Breadth Statistics

[Catapult & CBI Presentation Link](#)

Open Catapult Triggers

None.

Catapult for ETF's Trades

None.

Broad Market Large Cap CBI – 0

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)(s)	10/11/2011	\$119.58	\$120.51	-0.78%		Aggregator
SPY(1/4)(s)	10/12/2011	\$120.60	\$120.51	0.07%		Aggregator

I will cover both lots if the SPX closes \leq the Differential Pivot of 1,184.91.

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