

QUANTIFIABLE EDGES SUBSCRIBER LETTER

ASSESSING MARKET ACTION WITH INDICATORS AND HISTORY

October 18, 2011

Volume 4 Issue 201

Market Overview



Signals Overview

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

Tonight's Research Points

- While often bearish, big drops like today on strongly negative breadth have not been so when coming off intermediate-term highs.
- When SPY leaves an unfilled gap down from a 50-day high it is often followed by further selling.
- When an unfilled gap up is followed by an unfilled gap down then that also often indicates further selling.

Short-term Outlook

The Bottom Line

The market fell quite a bit today but the evidence I uncovered suggests it should fall farther. I continue to hold a 50% short position. I expect more selling in the next day or two.

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

Study Date	Description	Time span	Bias	Avg Max Move
Active				
October 18, 2011	SPY Unfilled Gap Down from 50 high	1-2 days	Bearish	-1.10%
October 18, 2011	Unfilled gap dn after unfilled gap up	1-4 days	Bearish	-4.20%
October 17, 2011	VXO > 20% below 10ma	1-2 days	Bearish	
October 17, 2011	50-day high breakout. Unfilled gap lo vo	1-5 days	Bullish	1.70%
Active - Long Term				
October 17, 2011	50-day low to 50-day high in 10 days	1-20 days	Bullish	
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	
March 22, 2011	3 Days Up Issues % > 70%	8 months	Bullish	19.00%
Dropped Tonight				
October 13, 2011	3 up days. No 50-day low. < 200ma.	1-3 days	Bearish	-2.90%
October 12, 2011	5 higher highs no 20-day high	1-4 days	Bearish	-2.25%
October 17, 2011	SPX 20 high / up 1% on 20-low volu	1-2 days	Bearish	

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

The Evidence

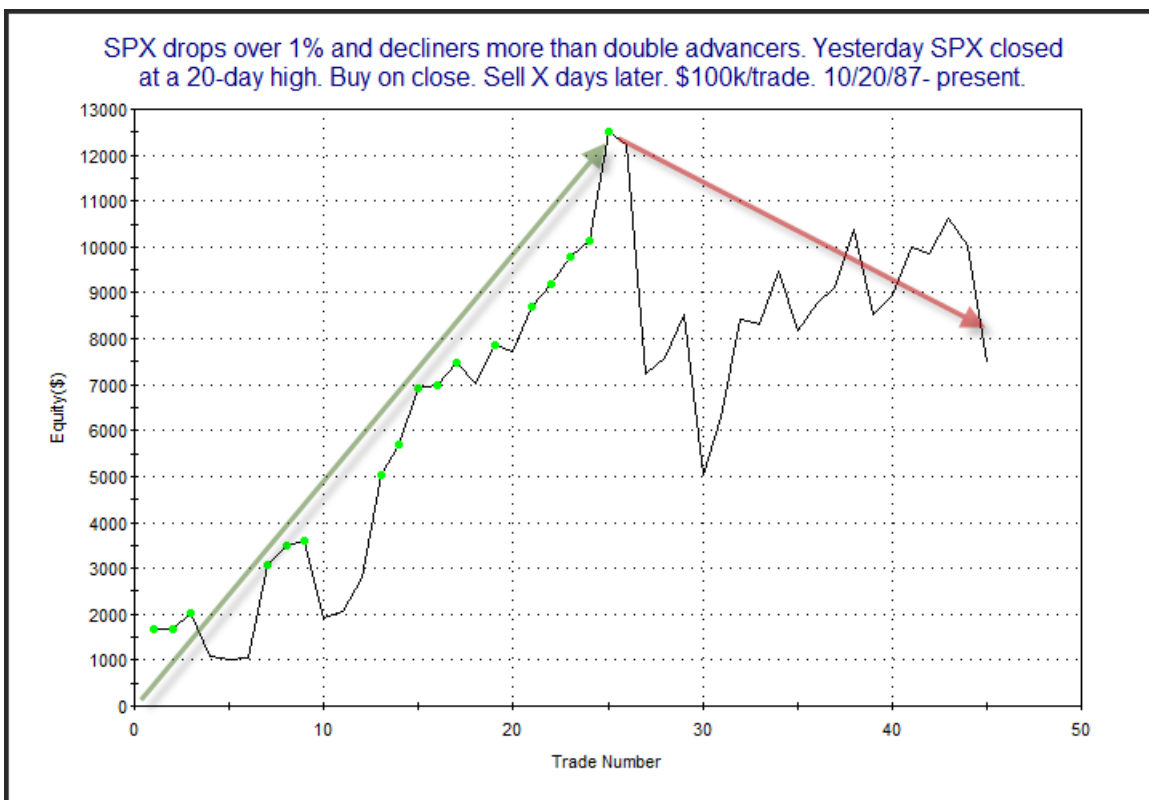
The abundance of short-term bearish studies we've seen the last few days finally kicked in on Monday. The market gapped down and then sold off much of the day. The SPX ended down 1.9%, the Nasdaq lost 2.0%, and the Russell 2000 dropped 3.3%. Breadth was also strongly negative as the NYSE Up Issues % came in at 19% and the Up Volume % was 10%. Total NYSE Volume rose from Friday's anemic level but was still fairly light.

Big drops on poor breadth will often suggest an upside edge over the next few days. But when the drop is initiated from a 20-day high, then the edge has not been as forceful or as lasting. I've gone over this a few times before. The study below was last seen in the 9/2/11 letter. It examines this concept. The point of the study was to illustrate that the upside edge was not as strong. Tonight I decided to update the stats and look at the possible edge a little closer.

SPX drops over 1% and decliners more than double advancers. Yesterday SPX closed at a 20-day high. 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
10	1,622.95	38	27	11	71.05	1,801.43	-4,274.15	0.42	1.03	42.71
9	4,589.66	38	26	12	68.42	1,859.72	-3,646.92	0.51	1.10	120.78
8	-2,183.89	39	24	15	61.54	1,890.75	-3,170.79	0.60	0.95	-56.00
7	5,803.32	40	23	17	57.50	2,069.50	-2,458.54	0.84	1.14	145.08
6	-308.28	40	23	17	57.50	1,716.83	-2,340.90	0.73	0.99	-7.71
5	-10,995.83	40	22	18	55.00	1,601.43	-2,568.19	0.62	0.76	-274.90
4	-1,926.26	42	23	19	54.76	1,432.93	-1,835.98	0.78	0.94	-45.86
3	12,087.15	44	29	15	65.91	1,164.35	-1,445.26	0.81	1.56	274.71
2	4,244.11	45	25	20	55.56	1,191.44	-1,277.10	0.93	1.17	94.31
1	7,495.94	45	31	14	68.89	839.34	-1,323.11	0.63	1.40	166.58

The only possible edge here appears to be a 1-day bounce. To scrutinize it further I decided to generate a profit curve for a 1-day hold.



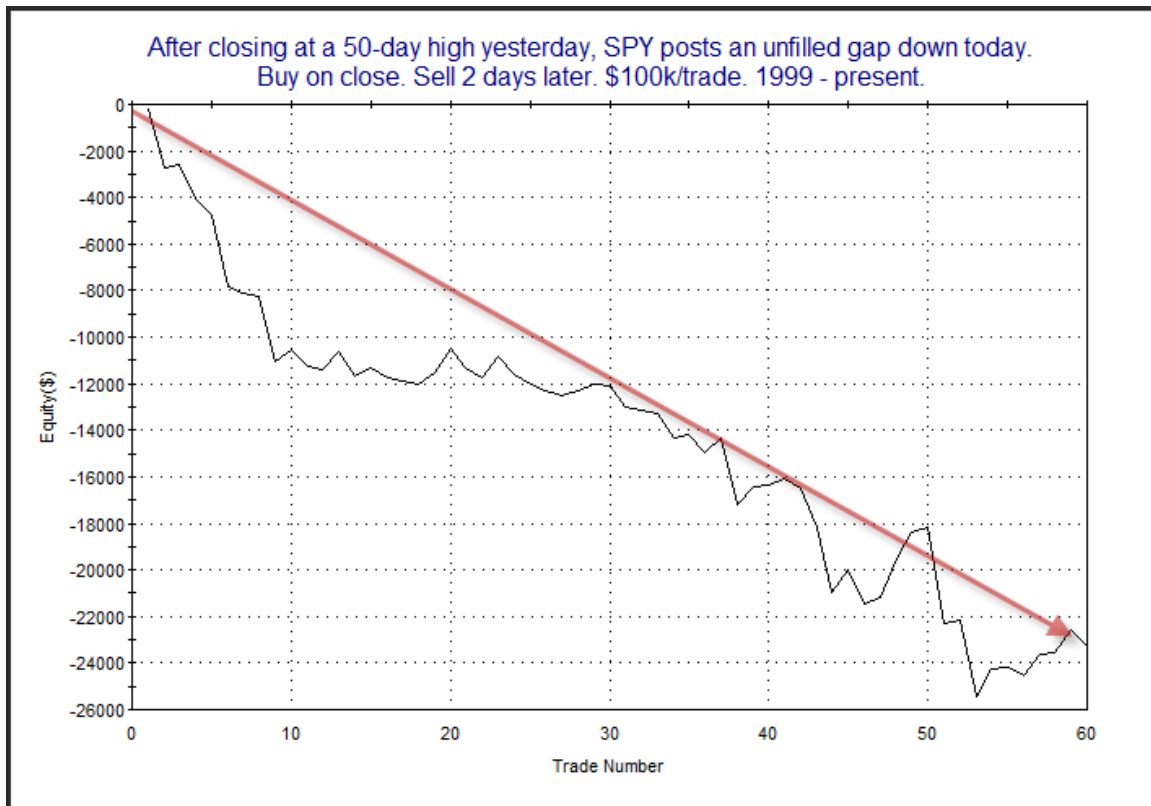
Here we see something the stats table doesn't show us. Namely that while there may have been an upside edge suggested at one point by this study, that edge no longer appears to exist. This study will no longer appear in green in the Quantifinder. And I obviously will not be including it on the Active List tonight.

In addition to the above, the Quantifinder also identified a few studies that considered the unfilled gap down on Monday and what that may imply going forward. This first one looked at unfilled gaps from 50-day highs. I last showed this study in the 1/13/10 subscriber letter. I have updated it below.

After closing at a 50-day high yesterday, SPY posts an unfilled gap down today.
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	-17,290.76	53	23	30	43.40	1,025.67	-1,362.71	0.75	0.58	-326.24
4	-12,986.75	54	27	27	50.00	843.06	-1,324.06	0.64	0.64	-240.50
3	-13,807.39	55	26	29	47.27	554.69	-973.42	0.57	0.51	-251.04
2	-23,282.92	60	25	35	41.67	562.28	-1,066.86	0.53	0.38	-388.05
1	-12,049.46	60	25	35	41.67	577.91	-757.06	0.76	0.55	-200.82

As you can see the stats appear to suggest another day or two of selling. Below is an equity curve.



It's a little choppy but the downslope appears persistent enough to act as confirmation of the short-term bearish edge.

It's unusual to have a 50-day high along with a close under the 200ma, but that is what we currently have, so I thought it would be interesting to incorporate that filter as well.

After closing at a 50-day high yesterday, SPY posts an unfilled gap down today. Close < 200ma. Buy on close. Sell 1 day later. \$100k/trade. 1999 - present.				
Date/Time	Signal	Price	% Profit	Run-up Drawdown
11/07/02	Buy	\$90.76	(1.22%)	\$891.81
11/08/02	Sell	\$89.65		(\$1,365.24)
04/22/08	Buy	\$137.94	(0.16%)	\$608.16
04/23/08	Sell	\$137.72		(\$593.68)
05/07/08	Buy	\$139.52	(0.26%)	\$572.80
05/08/08	Sell	\$139.16		(\$386.64)
05/20/08	Buy	\$141.89	(1.69%)	\$161.92
05/21/08	Sell	\$139.49		(\$2,034.56)
05/11/09	Buy	\$91.24	(0.30%)	\$646.64
05/12/09	Sell	\$90.97		(\$1,523.44)

With so few instances I wouldn't view this as a viable study on its own. But with every instance closing down the next day I thought it was at least worth noting.

This next study looked the 2-day action of an unfilled gap up and an unfilled gap down – both of which saw further moves in the direction of the gap. The study was last shown in the 5/5/10 subscriber letter. Tonight upon closer examination I noticed that prior to 2003 there were only a few instances, and they were not indicative of any edge. Therefore I shortened the study period to 2003- present.

SPY has an unfilled gap up that closes higher than the open followed by an unfilled gap down that closes lower than the open. Both gaps are at least 0.25%. Close > 200ma. Buy on close. Sell X days later. \$100k/trade. 2003 - 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	-7,987.77	10	2	8	20.00	1,384.38	-1,344.57	1.03	0.26	-798.78
4	-26,536.44	10	1	9	10.00	2,808.96	-3,260.60	0.86	0.10	-2,653.64
3	-21,498.41	10	3	7	30.00	694.55	-3,368.87	0.21	0.09	-2,149.84
2	-13,349.85	10	2	8	20.00	583.68	-1,814.65	0.32	0.08	-1,334.98
1	-10,638.77	10	2	8	20.00	472.07	-1,447.86	0.33	0.08	-1,063.88

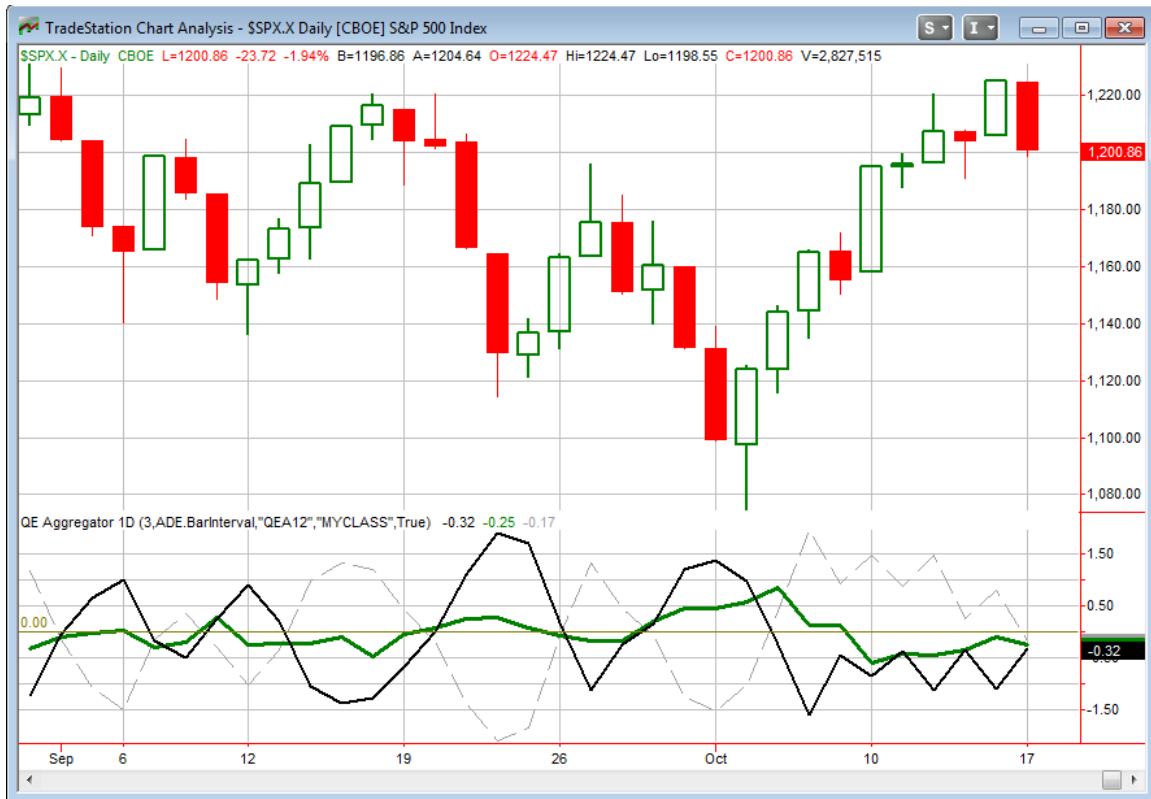
The number of instances is lower than I would normally prefer but the results are so lopsided that I believe it is worth consideration. Below I have listed all instances along with their 4-day statistics.

SPY has an unfilled gap up that closes higher than the open followed by an unfilled gap down that closes lower than the open. Both gaps are at least 0.25%.
Close > 200ma. Buy on close. Sell X days later. \$100k/trade. 2003 - present.

Date/Time	Signal	Price	% Profit	Run-up Drawdown
02/19/03	Buy	\$85.18	(0.83%)	\$656.88
02/25/03	Sell	\$84.47		(\$3,472.08)
06/16/06	Buy	\$124.65	(0.15%)	\$842.10
06/22/06	Sell	\$124.46		(\$882.20)
01/15/08	Buy	\$138.17	(5.39%)	\$686.85
01/22/08	Sell	\$130.72		(\$8,798.91)
06/06/08	Buy	\$136.29	(1.35%)	\$886.93
06/12/08	Sell	\$134.45		(\$2,030.41)
06/26/08	Buy	\$128.23	(1.60%)	\$724.47
07/02/08	Sell	\$126.18		(\$1,791.70)
08/29/08	Buy	\$128.79	(3.39%)	\$1,489.92
09/05/08	Sell	\$124.42		(\$5,269.04)
10/21/08	Buy	\$95.86	(12.42%)	\$0.00
10/27/08	Sell	\$83.95		(\$12,682.88)
01/29/09	Buy	\$84.55	(1.44%)	\$1,004.70
02/04/09	Sell	\$83.33		(\$3,829.68)
05/11/09	Buy	\$91.24	(2.77%)	\$646.64
05/15/09	Sell	\$88.71		(\$3,386.64)
09/07/10	Buy	\$109.64	2.81%	\$3,018.72
09/13/10	Sell	\$112.72		\$0.00

The only instance of a move higher came on the most recent occurrence. That triggered during September of 2010 when many short-side edges were being run over. My feeling about that period of time was that the persistent move higher was largely due to QE2, which had recently been initiated. QE2 is not in effect this time, but Operation Twist has seemed to have a positive impact on the market so far. I doubt the impact will be as forceful since it involves both buying and selling of securities, and is not a “pure” stimulus package. Still, the possibility exists and I thought it was worth mentioning.

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



Today's evidence has caused the green Aggregator line to drop further into negative territory. Readings below 0 mean net expectations from the Active List are for downside over the next few days. Meanwhile, the black Differential Line is still solidly 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 strongly 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 the current studies on the board the green Aggregator Line is scheduled to close negative again on Tuesday. Essentially we are looking at tonight's bearish reversal gap studies versus last night's bullish breakout studies. Tonight's studies appear more impactful over the next few days. Of course new bullish evidence that emerges on Tuesday could cause the Aggregator reading to flip positive. Meanwhile, the Differential Pivot will be 1,188.70. This is about 1% below Monday's close. So it would take a close lower of at least this much to flip the Differential Line positive. In this market a 1% move isn't that large, so it is certainly feasible.

With the big drop today I was strongly tempted today to take off part of my short position. I examined the market a number of ways and could find no compelling evidence to suggest that this was the proper course of action. The fact that the

Differential Pivot will again be lower than Monday's close on Tuesday suggested to me that I am likely better off holding on to my short. So I did. I don't intend to add to the position at this point, but will monitor the market closely tomorrow and may close it out if we do get a sizable amount of further selling.

Intermediate-term Outlook (2 weeks – 2 months)– updated 10/17 – neutral

This past week certainly changed things in a hurry. As noted above we have moved from 50-day lows to 50-day highs and also above the consolidation of the last 2 months.

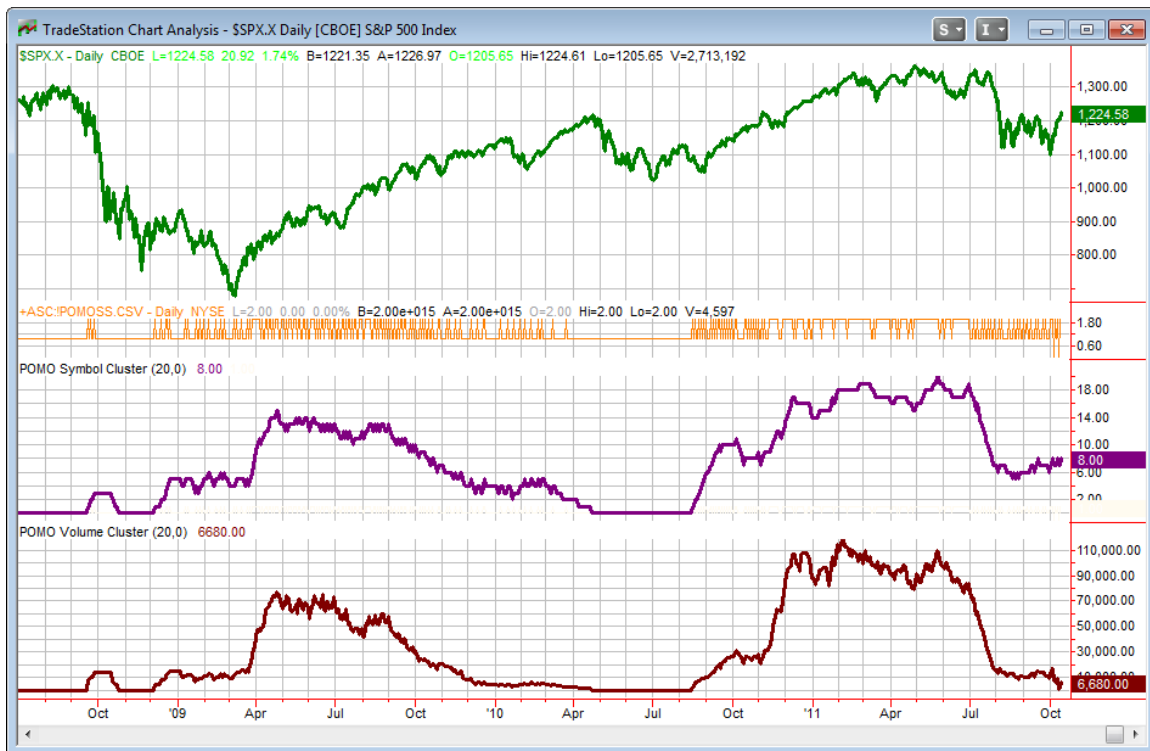
From an intermediate-term perspective, one of the more amazing things I've notice about this rally is that it has come without any 1% Follow Through Day (FTD) on rising volume. Investors' Business Daily first published and popularized the concept of the Follow Through Day (FTD). Though they have changed the definition slightly over the years, I have found their original definition to be useful in several studies. My tests go back to 1971, which was the inception of the Nasdaq, and also as far as some of my volume data goes. Since that time there has never been a rally that has taken the SPX from a drawdown of at least 8% to a new 50-day high that was not inclusive of a FTD – until Friday.

This puts this rally in uncharted territory, which is always a little bit of an uncomfortable place for me. A FTD could still occur, and just because we have had a strong 9-day rally does not mean a bull market has already been missed. But a primary purpose of the FTD concept is to help in identifying market bottoms. If we are already at a 50-day high, then I would say this is one case where the FTD concept has failed us.

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>



The market began its rally almost exactly when Operation Twist began. This could be coincidental, and seems odd since the net amount of the buying has been reduced versus previous buying. This is because we have seen increased buying on the long end largely offset by selling short-dated securities. Perhaps the focus on purchasing longer-dated securities has somehow helped. It is difficult to draw any solid conclusions yet. At this point I can say we are seeing a new rally occur in conjunction with new Fed action. I may not be smart enough to fully explain “why”, but I am smart enough to know I shouldn’t dismiss it, especially after observing the impact QE1 and QE2 had on the market.

I’m somewhat neutral at this point. I’ll trade in either direction with similar aggressiveness. As we’ve seen the last couple of weeks, things can change quickly. I suspect the quick move from a 50-day low to a 50-day high may turn out to be a bullish intermediate-term sign as it has in the past. Still, I’d prefer to see some volume behind the move, and I want to see the VIX and VXO exhibit more normal behavior. If some of these things can occur this upcoming week, then I may turn outright bullish.

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	\$120.23	-0.54%		Aggregator
SPY(1/4)(s)	10/12/2011	\$120.60	\$120.23	0.31%		Aggregator

I will cover both lots if the SPX closes \leq the Differential Pivot of 1,188.70.

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