

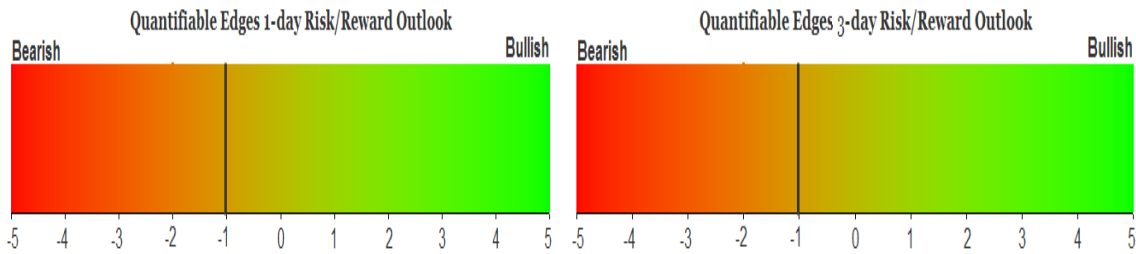
QUANTIFIABLE EDGES SUBSCRIBER LETTER

ASSESSING MARKET ACTION WITH INDICATORS AND HISTORY

October 20, 2011

Volume 4 Issue 203

Market Overview



Signals Overview

Aggregator	Aggressive VIX	Conservative VIX	NDX Trend Timer
Flat	Flat	Flat	Long

Tonight's Research Points

- When a 1% drop doesn't even give back $\frac{3}{4}$ of yesterday's gain, that suggests a 1-day downside edge.
- A 1% drop immediately after a Follow Through Day in the past has commonly led to more selling the next day.

Short-term Outlook

The Bottom Line

There still appear to be bearish inclinations but the market is no longer overbought. Therefore I have stepped aside and am awaiting the next highly favorable opportunity.

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

Study Date	Description	Time span	Bias	Avg Max Move
Active				
October 20, 2011	1% drop after FTD	1 day	Bearish	
October 20, 2011	1% drop doesn't erode 3/4 of yest gain	1 day	Bearish	
October 19, 2011	Gap dn then 50-day high	1-3 days	Bearish	
October 19, 2011	50-day high on 90% up vol	1-2 days	Bullish	
October 19, 2011	FTD on strong breadth/20 day high	1-3 days	Bullish	
October 18, 2011	Unfilled gap dn after unfilled gap up	1-4 days	Bearish	-4.20%
October 17, 2011	50-day high breakout. Unfilled gap lo vo	1-5 days	Bullish	1.70%
Active - Long Term				
October 19, 2011	50-day high on 90% up vol	1-50 days	Bullish	
October 19, 2011	FTD on strong breadth/20 day high	int term	Bullish	
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 18, 2011	SPY Unfilled Gap Down from 50 high	1-2 days	Bearish	-1.10%
October 19, 2011	1% up 1% down 1% up	1 day	Bullish	

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

The Evidence

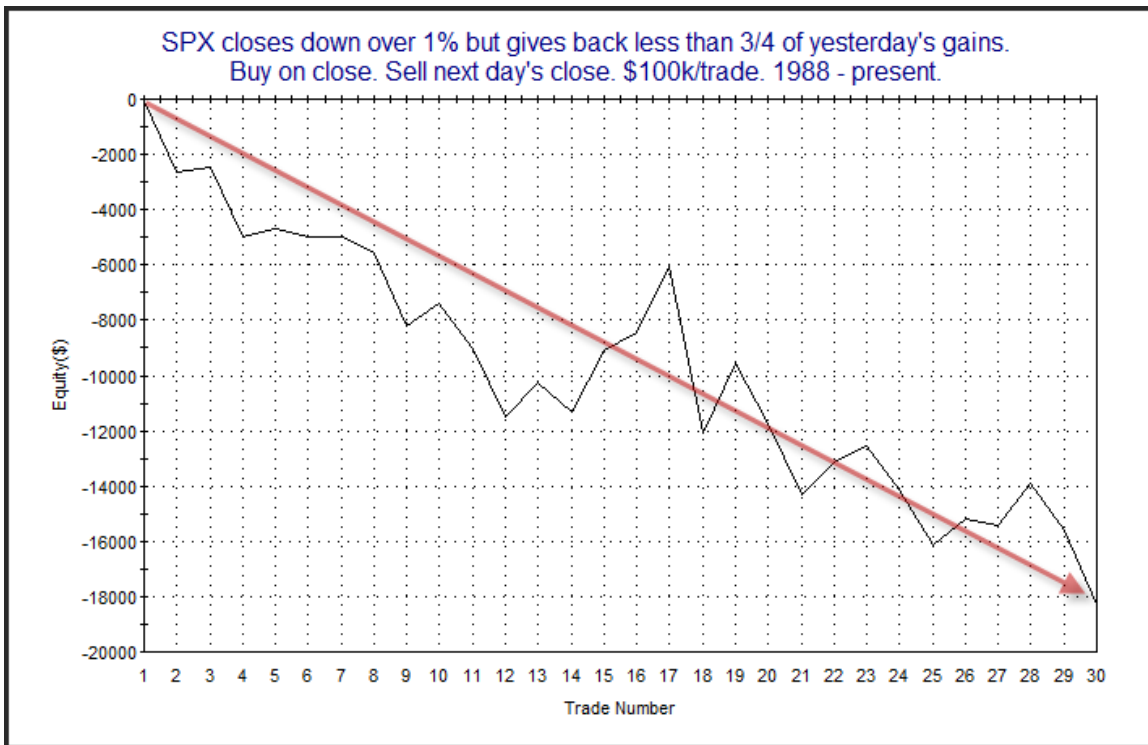
The market changed direction on Wednesday for the 5th day in a row. And it was the 4th day in which the move was greater than 1%. The SPX lost 1.3% on Wednesday, but that was tame compared to the Nasdaq's 2.0% loss and the Russell 2000's 2.1% decline. Breadth was strongly negative as the NYSE Up Issues % came in at 28% and the Up volume % was 19%. Total NYSE volume declined a little from Tuesday's level.

Big drops that come after really big gains will often see further selling the next day. Those that bought into the excitement will tend to be easily shaken out and this shakeout often lasts at least 1 day beyond the reversal day. This is illustrated in the study below, which was last seen in the 6/1/10 letter.

SPX closes down over 1% but gives back less than 3/4 of yesterday's gains.
Buy on close. Sell next day's close. \$100k/trade. 1988 - present.

TradeStation Performance Summary		Collapse ^	
All Trades			
Total Net Profit	(\$18,287.27)	Profit Factor	0.44
Gross Profit	\$14,563.56	Gross Loss	(\$32,850.83)
Total Number of Trades	30	Percent Profitable	40.00%
Winning Trades	12	Losing Trades	18
Even Trades	0		
Avg. Trade Net Profit	(\$609.58)	Ratio Avg. Win:Avg. Loss	0.66
Avg. Winning Trade	\$1,213.63	Avg. Losing Trade	(\$1,825.05)
Largest Winning Trade	\$2,568.00	Largest Losing Trade	(\$6,060.08)

There appears to be a possible downside edge based on the numbers. Here is a look at the profit curve.



The numbers were moderately enticing but the profit curve serves as a solid confirmation of the downside inclinations.

I also found it notable that Wednesday's selloff came on the heels of a Follow Through Day (FTD) on Tuesday. Here is why I like using FTDs as a filter: a FTD can by itself tell us a lot about the current environment. It tells us the market has undergone a correction.

It tells us the market has made a multi-day move off the bottom. And it tells us that strong volume and price action have come into the market. Enthusiasm is picking up.

We understand that the rally is only going to succeed about 40%-50% of the time based on the FTD, but we don't need to know right away whether it is going to succeed or not to make good use of the information. While many of the past FTD studies on the blog and in the Subscriber Letter have focused on action on and around FTDs and what that might mean for the intermediate-term, it can also be useful to simply put the current day's action in proper context so that we may better understand what that action may imply over the next few days and weeks. I use context in many other ways and people hardly notice anymore. Studies are always framed by where the market is. Is it above or below the 200ma? At a 20-day high? At a 20-day low? These are all helpful, but recent work has led me to believe that FTDs can be just as useful in defining context, if not more so. So I'll continue to incorporate them and am optimistic that doing so may uncover some real gems. Anyway...we had a FTD Tuesday and then Wednesday the market sold off strongly. Strong enthusiasm has quickly turned. Let's look at other instances and what has followed.

SPX closes down > 1% on the day after a FTD. Buy on close. Sell next day's close. \$100k/trade. 1971 - present.			
TradeStation Performance Summary			Collapse ^
All Trades			
Total Net Profit	(\$15,331.91)	Profit Factor	0.03
Gross Profit	\$523.86	Gross Loss	(\$15,855.77)
Total Number of Trades	10	Percent Profitable	20.00%
Winning Trades	2	Losing Trades	8
Even Trades	0		
Avg. Trade Net Profit	(\$1,533.19)	Ratio Avg. Win:Avg. Loss	0.13
Avg. Winning Trade	\$261.93	Avg. Losing Trade	(\$1,981.97)
Largest Winning Trade	\$267.24	Largest Losing Trade	(\$4,302.72)

I'm only showing 1-day returns here because beyond that any possible edge was not as apparent. The number of trades is a bit low, but the early indications appear to strongly favor another day of selling. Below is a more detailed look at the instances.

SPX closes down > 1% on the day after a FTD.
Buy on close. Sell next day's close. \$100k/trade. 1971 - present.

Date/Time	Signal	Price	% Profit	Run-up Drawdown
03/30/73	Buy	\$111.52	(1.20%)	\$0.00
04/02/73	Sell	\$110.18		(\$1,200.64)
08/03/82	Buy	\$107.83	(1.58%)	\$0.00
08/04/82	Sell	\$106.13		(\$2,085.75)
08/18/83	Buy	\$163.55	0.26%	\$898.17
08/19/83	Sell	\$163.97		(\$782.08)
04/22/87	Buy	\$287.18	(0.13%)	\$675.12
04/23/87	Sell	\$286.82		(\$1,009.20)
09/09/98	Buy	\$1,006.20	(2.58%)	\$0.00
09/10/98	Sell	\$980.20		(\$3,717.45)
04/26/00	Buy	\$1,460.99	0.27%	\$558.96
04/27/00	Sell	\$1,464.92		(\$1,780.24)
10/25/00	Buy	\$1,364.90	(0.03%)	\$570.86
10/26/00	Sell	\$1,364.44		(\$1,980.49)
01/04/01	Buy	\$1,333.29	(2.61%)	\$111.00
01/05/01	Sell	\$1,298.47		(\$2,875.50)
03/09/01	Buy	\$1,233.42	(4.31%)	\$0.00
03/12/01	Sell	\$1,180.30		(\$4,587.84)
04/02/01	Buy	\$1,145.85	(3.44%)	\$0.00
04/03/01	Sell	\$1,106.40		(\$3,972.42)

Avg Run-Up: 0.28% Avg Drawdown: 2.4%

Two things really strike me here. 1) There hasn't been an instance in over 10 years. 2) Risk/reward is heavily skewed in favor of the bears. Overall I find these results compelling enough to include this study on the Active List.

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



Tonight's studies helped push the green Aggregator line down a bit 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 flipped above 0 for the 1st time in a while. A positive Differential reading means the SPX has underperformed expectations over the last few days. So net expectations are negative but the SPX is already oversold versus recent expectations. This is considered a neutral configuration. Neutral configurations are visible on the chart whenever both lines close on opposite sides of 0. Due to this the Aggregator System turned flat.

With the current studies on the board the green Aggregator Line is scheduled to close negative again on Thursday. There are a lot of studies on the board right now, but none of the short-term ones will still be there beyond Friday. This means new studies will have an unusually large influence on the short-term estimates. So bullish evidence that appears Thursday and/or Friday could easily cause the Aggregator reading to flip positive. Meanwhile, the Differential Pivot will be 1,191.89. This is about 1.5% *below* Wednesday's close. This is what I often refer to as an inverted pivot, because the Differential Line will flip if the market just goes sideways. In order to prevent the Differential Line from turning back to negative and the SPX from being considered "overbought", the SPX will need to close down nearly 1.5%.

The two lots of SPY that I had been holding short were covered at the close today. With expectations still negative and the Differential Pivot inverted tomorrow I did give some consideration to holding some of the position another day. This trade has jerked me around quite a bit already though. At this point I don't really mind taking a small loss. Pressing shorts when a new rally is attempting to emerge can be dangerous. Stepping back now that my edge is greatly reduced, showing a little patience, and then looking to put money back to work when a more favorable setup occurs seemed like a better plan to me than pressing my luck in a volatile environment. And from a psychological standpoint I am more comfortable taking a small loss, even if the market would have continued to drop, than I would be continuing to hold against my plan and having the position turn into a large loss.

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.

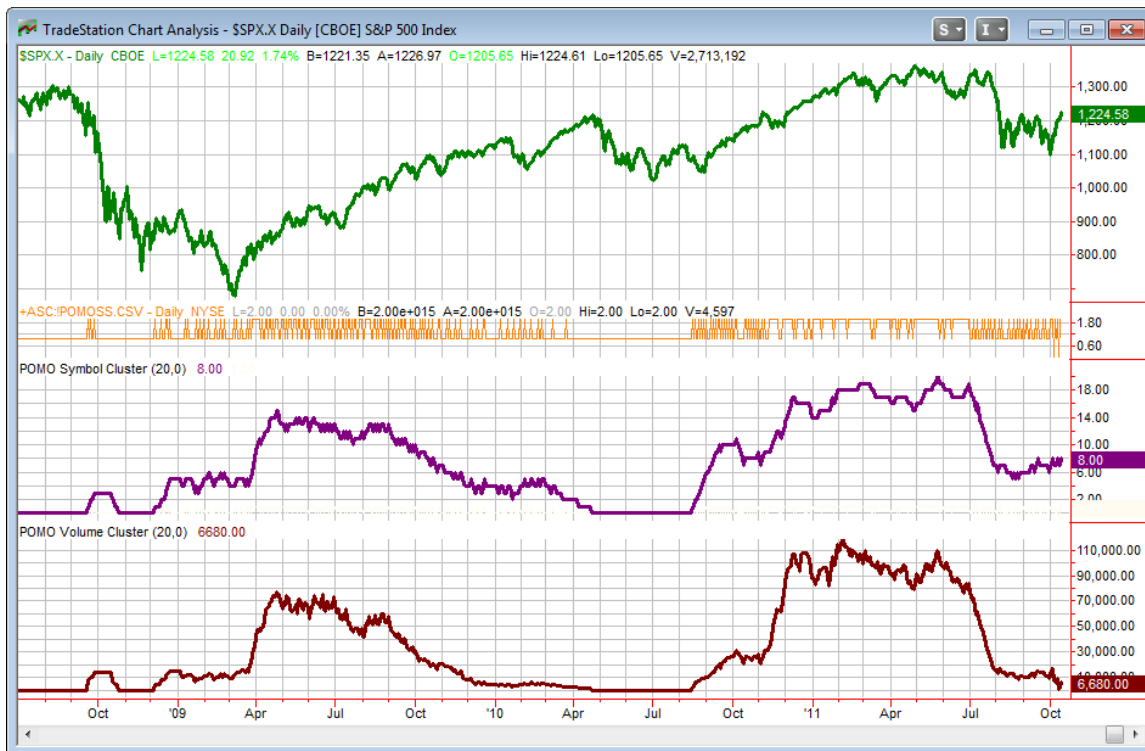
This puts this rally in uncharted territory, which is always a little bit of an uncomfortable place for me. A FTD could still occur, and just because we have had a strong 9-day rally does not mean a bull market has already been missed. But a primary purpose of the FTD concept is to help in identifying 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	\$121.13	-1.30%		covered on close
SPY(1/4)(s)	10/12/2011	\$120.60	\$121.13	-0.44%		covered on close

SPY was covered on close as per the instructions in last night's letter.

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