

QUANTIFIABLE EDGES SUBSCRIBER LETTER

ASSESSING MARKET ACTION WITH INDICATORS AND HISTORY

October 24, 2011

Volume 4 Issue 205

Market Overview



Signals Overview

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

Tonight's Research Points

- Friday's gap up and rally higher to a new high is something that is often followed by a pullback over the next few days.
- Even with a potential new rally in effect, this appears to be the case.

Short-term Outlook

The Bottom Line

The SPX is overbought and the evidence the last couple of days says we should see a pullback. I am short and hoping to take advantage of the pullback.

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

Study Date	Description	Time span	Bias	Avg Max Move
Active				
October 24, 2011	Gap-n-go new 10-day under 200ma	1-3 days	Bearish	-2.80%
October 21, 2011	SPX up VIX up. Tues, Wed, Thurs < 200	1-4 days	Bearish	-3.20%
Active - Long Term				
October 19, 2011	50-day high on 90% up vol	1-50 days	Bullish	
October 19, 2011	FTD on strong breadth/20day 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	
March 22, 2011	3 Days Up Issues % > 70%	8 months	Bullish	19.00%
Dropped Tonight				
October 19, 2011	Gap dn then 50-day high	1-3 days	Bearish	
October 19, 2011	FTD on strong breadth/20day 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	1-5 days	Bullish	1.70%
September 12, 2011	Nasdaq leading SPX	int term	Bullish	
October 7, 2011	90% Up Volume on 3rd day up.	1-14 days	Bullish	

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

The Evidence

Friday showed strength from the opening bell and finished near its highs. The SPX gained 1.9%, the Nasdaq was up 1.5%, and the Russell 2000 rose 2.3%. Breadth was strongly positive as the NYSE Up Issues % and Up Volume % came in at 86%. Thanks in part to options expiration total NYSE volume rose to the highest level in the last few weeks.

When the market gaps up and moves strongly higher during a long-term downtrend then you will often see a pullback over the next few days. The study below exemplifies this. It was last seen recently in the 10/11/11 letter. All stats are updated.

SPY gaps up at least 1% above yesterday's close. It never fills gap, makes a 10-day intraday high, and closes > open. Close < 200ma. Buy on close. Sell X days later. \$100k/trade. 1994 - 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	-22,976.98	18	8	10	44.44	1,478.64	-3,480.61	0.42	0.34	-1,276.50
4	-21,672.86	20	7	13	35.00	1,511.26	-2,480.90	0.61	0.33	-1,083.64
3	-25,527.39	20	5	15	25.00	1,334.80	-2,146.76	0.62	0.21	-1,276.37
2	-19,698.68	21	12	9	57.14	502.51	-2,858.75	0.18	0.23	-938.03
1	-17,591.41	21	9	12	42.86	389.58	-1,758.14	0.22	0.17	-837.69
18 of 21 instances (86%) posted a close below the entry price at some point in the next 3 days.										

The numbers seem to suggest a sizable downside edge over the next few days. Below I have listed all instances for those interested in exploring them further.

SPY gaps up at least 1% above yesterday's close. It never fills gap, makes a 10-day intraday high, and closes > open. Close < 200ma. Buy on close. Sell 3 days later. \$100k/trade. 1994 - present.				
Date/Time	Signal	Price	% Profit	Run-up Drawdown
09/14/98	Buy	\$103.44	(1.39%)	\$1,748.46
09/17/98	Sell	\$102.00		(\$1,603.56)
12/05/00	Buy	\$137.72	(2.72%)	\$1,023.66
12/08/00	Sell	\$133.97		(\$2,947.56)
12/11/00	Buy	\$138.63	(3.04%)	\$562.38
12/14/00	Sell	\$134.41		(\$3,316.60)
04/18/01	Buy	\$124.00	(1.42%)	\$1,483.04
04/23/01	Sell	\$122.24		(\$1,684.54)
11/13/01	Buy	\$114.55	(0.17%)	\$741.20
11/16/01	Sell	\$114.36		(\$1,002.80)
05/14/02	Buy	\$110.22	0.62%	\$934.21
05/17/02	Sell	\$110.90		(\$843.51)
10/15/02	Buy	\$88.70	(0.07%)	\$676.20
10/18/02	Sell	\$88.64		(\$3,133.06)
04/01/08	Buy	\$136.61	0.20%	\$988.20
04/04/08	Sell	\$136.89		(\$658.80)
11/04/08	Buy	\$100.41	(6.52%)	\$298.50
11/07/08	Sell	\$93.86		(\$10,298.25)
12/08/08	Buy	\$91.00	(3.36%)	\$1,240.74
12/11/08	Sell	\$87.94		(\$3,985.74)
01/28/09	Buy	\$87.39	(5.50%)	\$0.00
02/02/09	Sell	\$82.58		(\$6,955.52)
03/23/09	Buy	\$82.22	1.08%	\$1,313.28
03/26/09	Sell	\$83.11		(\$3,842.56)
04/02/09	Buy	\$83.43	(2.13%)	\$1,425.62
04/07/09	Sell	\$81.65		(\$2,300.16)
04/09/09	Buy	\$85.81	(0.65%)	\$850.45
04/15/09	Sell	\$85.25		(\$2,563.00)
04/29/09	Buy	\$87.39	3.99%	\$4,095.52
05/04/09	Sell	\$90.88		(\$766.48)
05/06/09	Buy	\$92.14	(0.98%)	\$1,171.80
05/11/09	Sell	\$91.24		(\$2,018.10)
07/13/10	Buy	\$109.66	(2.74%)	\$382.62
07/16/10	Sell	\$106.66		(\$2,924.31)
08/29/11	Buy	\$121.36	(0.35%)	\$1,769.45
09/01/11	Sell	\$120.94		(\$1,168.66)
10/10/11	Buy	\$119.58	0.78%	\$2,140.16
10/13/11	Sell	\$120.51		(\$693.88)
10/14/11	Buy	\$122.57	(1.17%)	\$757.95
10/19/11	Sell	\$121.13		(\$2,746.55)

The individual results look solidly bearish as well.

One theme I've been harping on the last few days is that action immediately following an IBD Follow Through Day (FTD) will often differ from action during downtrends that isn't part of a possible emerging rally. Tuesday marked the first FTD for this rally. The study above is a little too narrow to filter further to check for a recent FTD. In the past I found that the setup above was still bearish even if a 10-day high was not achieved (just not to the same level). So I took out the 10-day high requirement and looked at these gap-n-go scenarios when they occurred shortly after a FTD. I did this to see if a bearish impulse was still present, or whether the emerging rally had might overwhelm this tendency. Results are below.

SPY gaps up at least 1% above yesterday's close. It never fills gap and closes > open. Close < 200ma. There was a FTD within the last 5 days. Buy on close. Sell X days later. \$100k/trade. 1994 - 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	-24,524.30	6	1	5	16.67	3,302.20	-5,565.30	0.59	0.12	-4,087.38
4	-22,373.99	6	1	5	16.67	1,459.92	-4,766.78	0.31	0.06	-3,729.00
3	-13,954.24	6	1	5	16.67	1,390.40	-3,068.93	0.45	0.09	-2,325.71
2	-9,258.83	6	2	4	33.33	1,107.37	-2,868.39	0.39	0.19	-1,543.14
1	-5,723.47	6	2	4	33.33	431.14	-1,646.44	0.26	0.13	-953.91

Based on the numbers there seems to be no reason to worry that this strong initial rally will offset the short-term bearish inclinations. I've listed below all instances assuming a 5-day holding period.

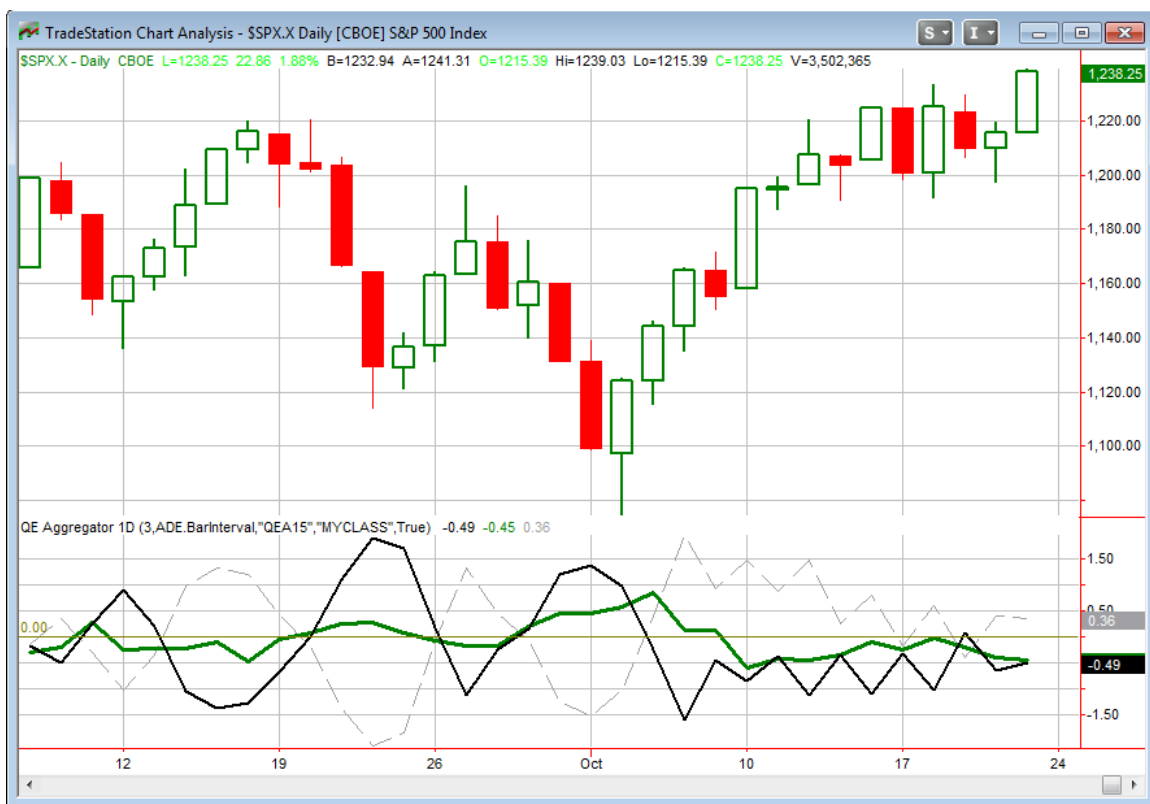
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12/18/00	Sell	\$132.72		(\$5,818.47)
04/05/01	Buy	\$115.05	3.30%	\$3,423.86
04/12/01	Sell	\$118.85		(\$2,598.31)
10/20/08	Buy	\$98.81	(15.04%)	\$0.00
10/27/08	Sell	\$83.95		(\$15,291.32)
12/08/08	Buy	\$91.00	(3.57%)	\$1,240.74
12/15/08	Sell	\$87.75		(\$6,368.40)
08/29/11	Buy	\$121.36	(3.60%)	\$1,769.45
09/06/11	Sell	\$116.99		(\$5,744.54)

The ones that I circled would've also qualified for the 1st study, since they also posted a 10-day intraday high. The 10/20/08 trade skews the summary results quite a bit. Still,

even the lone winner on 4/5/01 saw a drawdown of over 2.5%. And the other drawdowns were all over 4%. So there certainly seems to be some potential for a strong drop following this setup.

I also looked at the tendencies follow options expiration rallies a number of ways. Results were mixed depending on how I looked at it, and none of the studies I examined were overly compelling based on the current market environment.

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



With the additional bearish evidence the green Aggregator line dipped a bit more 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 also 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 downside edge. Bearish configurations are visible on the chart whenever both lines close below 0. Due to this the Aggregator System remained short at the close.

With the current studies on the board the green Aggregator Line is scheduled to close negative again on Monday. Of course new bullish evidence could change this. Meanwhile, the Differential Pivot will be at 1,203.36 on Monday. This is *over 2.8%* below Friday's close. While the studies are suggesting a sharp pullback could occur, one of this magnitude seems unlikely. A multi-day pullback or consolidation appears more likely.

On Friday I took on a ½ position short in the SPY. European news allowing, I believe we should see a dip here in the next day or 2. I am looking to take advantage of that dip.

Intermediate-term Outlook (2 weeks – 2 months)– updated 10/24 – neutral

The short-term outlook is fairly bearish right now, but the intermediate-term evidence continued to shift in favor of the bulls this week. Tuesday's FTD seems to be a potential positive. Below are a few quick points about the FTD.

- The fact that it came [in conjunction with a 20-day high](#) appears to be a positive.
- The [strong breadth on Tuesday](#) also favors a successful rally.
- Another positive is that the FTD came [over 10 days after the bottom](#).
- A negative is [that it occurred under the 200ma](#).
- Also [FTDs that occur after large declines](#) have a lower success rate.

While there is room to doubt this rally, I'm of the opinion that it certainly has a decent chance based on the FTD studies.

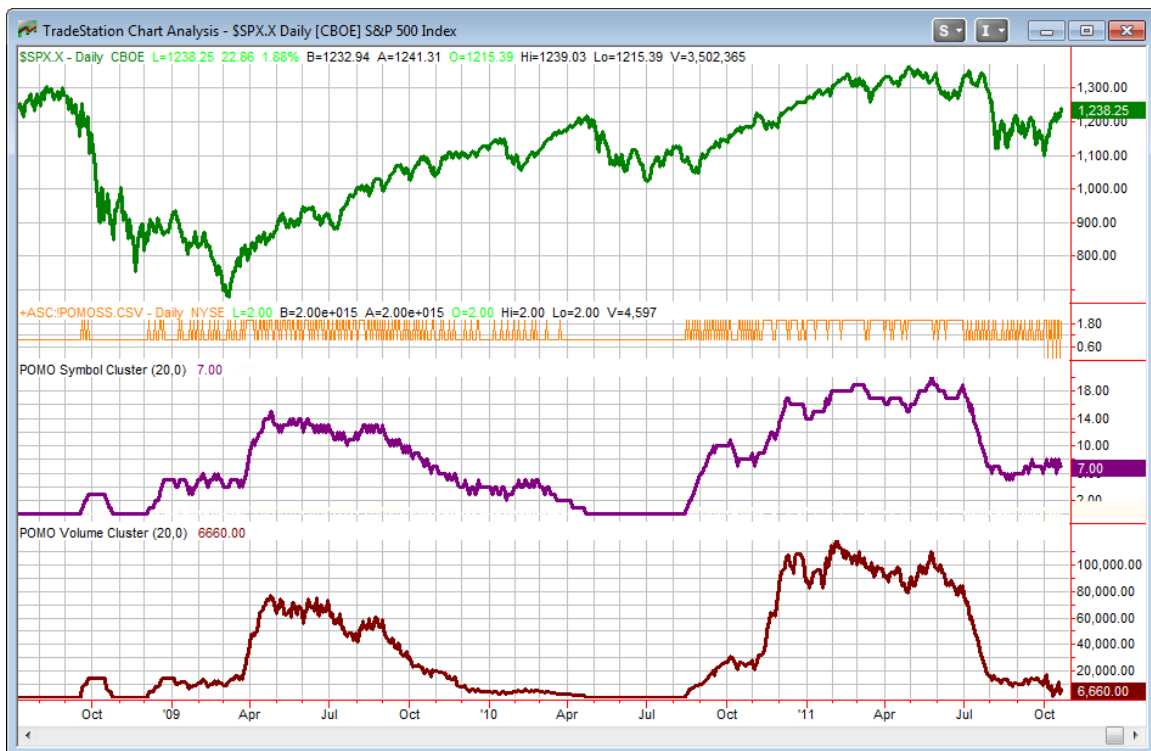
One indication that no longer favors the bulls is the Nasdaq/SPX lead-lag model. It has now turned back to neutral. This was caused by the relative weakness of the Nasdaq over the last 2 weeks. Since the inception of the Nasdaq, the SPX has gained over 1,350 points when then Nasdaq was in leading position and has lost ground when the SPX is leading. The indicator has been less consistent over the last few years, but I would still prefer to see a leading Nasdaq. More information on the indicator may be found [in this old blog post](#). Any subscriber who wants to download the model may do so on [the Downloads page](#). The data in the Excel version has not been updated in a while, but the calculations are all there.

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 (purple) 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>



Traders need to keep in mind when looking at the chart that both the purple (days) indicator and the maroon (volume) indicator represent net activity. So this past week there were 2 days of selling and 3 days of buying. Fed buying has a positive impact on the indicators, but selling days have a negative impact. So while Operation Twist has generated a large amount of buying and selling activity, it is not a simple liquidity pump like QE1 and QE2. And while the net buying so far has not been strong, the potential market impact certainly has been over the last couple of weeks.

There is a good amount of evidence now favoring the bulls and price action seems to be improving. Still, the market is very volatile and news-dependent. It appears shocks (often related to European financial difficulties) could happen at any time. News this

weekend is likely to have an impact on Monday's trading. At this point I am starting to lean bullish. I am still willing to take quick shots on the short side. I will tend to be more aggressive with longs right now, though, and may look to hold them a bit longer if circumstances allow.

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.

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Current Open Trade Ideas

Symbol	Entry Date	Entry Price	Current Price	% Gain/Loss	Stop	Notes
SPY(1/4)(s)	10/21/2011	\$123.09	\$123.97	-0.71%		shorted on open
SPY(1/4)(s)	10/21/2011	\$123.09	\$123.97	-0.71%		shorted on open

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