

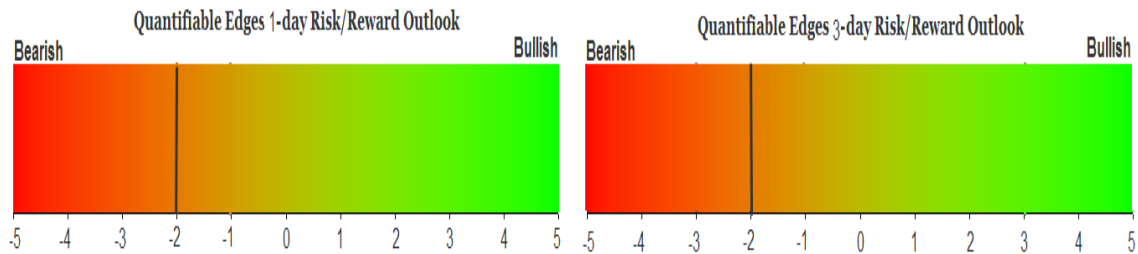
QUANTIFIABLE EDGES SUBSCRIBER LETTER

ASSESSING MARKET ACTION WITH INDICATORS AND HISTORY

October 26, 2011

Volume 4 Issue 207

Market Overview



Signals Overview

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

Tonight's Research Points

- 2% drops don't reliably bounce when they originate from a 20-day high.
- Unfilled gaps down from a 50-day high are often followed by another day or two of selling.

Short-term Outlook

The Bottom Line

Selling arrived on Tuesday. Odds favor a bit more downside over the next few days. I'm still short but will be looking to cover into weakness tomorrow.

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

Study Date	Description	Time span	Bias	Avg Max Move
Active				
October 26, 2011	Unfilled gap down from 20-day high	1-2 days	Bearish	-1.10%
October 25, 2011	SPY up > 1% 2x. 10-high < 200ma	1-4 days	Bearish	-3.50%
October 25, 2011	SPX up 3 days. No 50-low. Close < 200.	1-3 days	Bearish	-2.85%
October 25, 2011	2 Unfilled up gaps. 50-day high	1-3 days	Bullish	0.90%
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 25, 2011	SPY 50-high on 20-low vol	1-2 days	Bearish	-1.20%

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

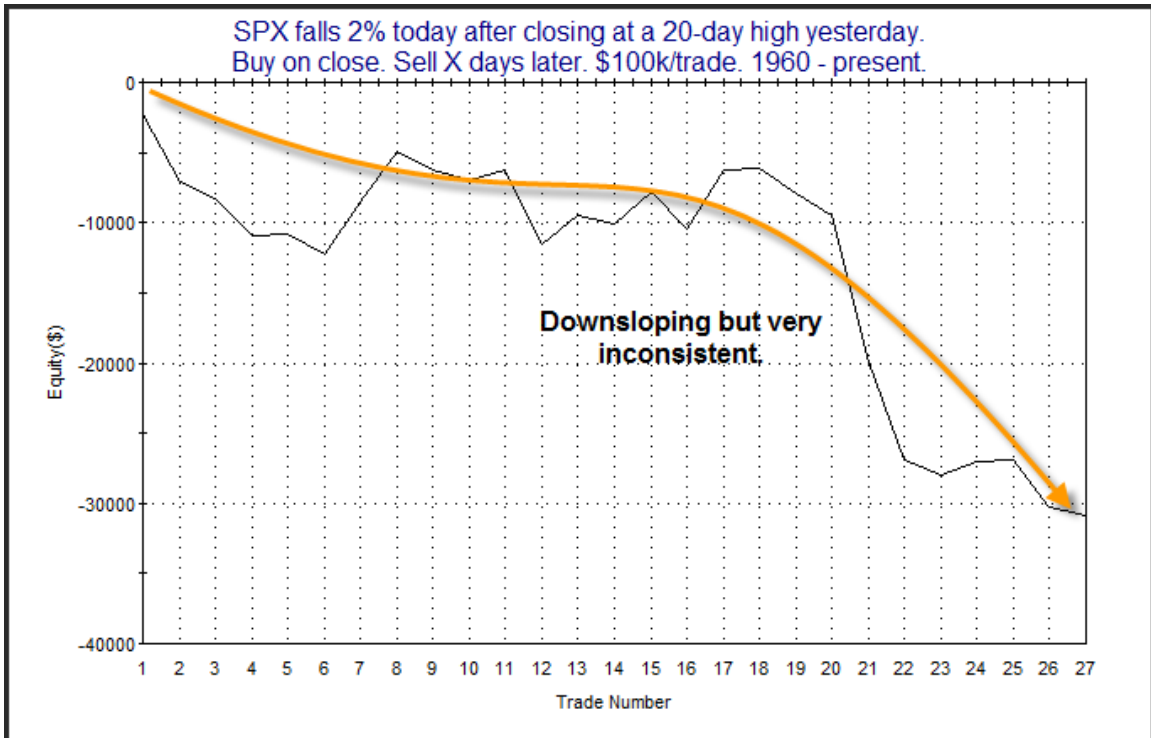
The Evidence

The bearish inclinations I noted over the last couple of days kicked in Tuesday. The SPX fell 2%, the Nasdaq dropped 2.3%, and the Russell 2000 closed down 3.0%. Breadth was extremely negative as the NYSE Up Issue % came in at 18% and the Up Volume % was just 9%. Total NYSE volume rose a bit from Monday's level.

Whether a strong drop like we saw today is reliably followed by a bounce is largely dependent on where the drop initiates. This is something I have covered a large number of times in both the subscriber letter and the blog. In the 4/20/09 subscriber letter I demonstrated this by comparing 2% drops that originate from a 20-day high to those that don't. When a 2% drop does not come immediately after a 20-day high then there is a solid positive expectancy over the next several days. When the 2% drop does come right after a 20-day high (like happened on Tuesday) then the expectancy turns negative. The study below is taken from that letter. It looks at the current scenario, and the results have been updated.

SPX falls 2% today after closing at a 20-day high yesterday. Buy on close. Sell X days later. \$100k/trade. 1960 - 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	-52,705.13	27	15	12	55.56	2,070.01	-6,979.61	0.30	0.37	-1,952.04
9	-57,017.76	27	12	15	44.44	2,014.13	-5,412.49	0.37	0.30	-2,111.77
8	-39,077.63	27	11	16	40.74	2,269.69	-4,002.77	0.57	0.39	-1,447.32
7	-26,669.44	27	12	15	44.44	2,043.87	-3,413.06	0.60	0.48	-987.76
6	-29,740.74	27	11	16	40.74	1,467.02	-2,867.37	0.51	0.35	-1,101.51
5	-30,925.79	27	10	17	37.04	1,788.44	-2,871.18	0.62	0.37	-1,145.40
4	-19,958.07	28	9	19	32.14	1,850.14	-1,926.81	0.96	0.45	-712.79
3	-5,979.90	29	12	17	41.38	1,526.52	-1,429.30	1.07	0.75	-206.20
2	-5,099.12	29	11	18	37.93	1,596.21	-1,258.74	1.27	0.77	-175.83
1	528.55	29	17	12	58.62	1,015.03	-1,393.91	0.73	1.03	18.23

Based on the numbers there appears to be a substantial downside edge over the 1st week or two. Much of the edge plays out in the 1st 4-5 days. But below is a profit curve that assumes a 5-day exit strategy.



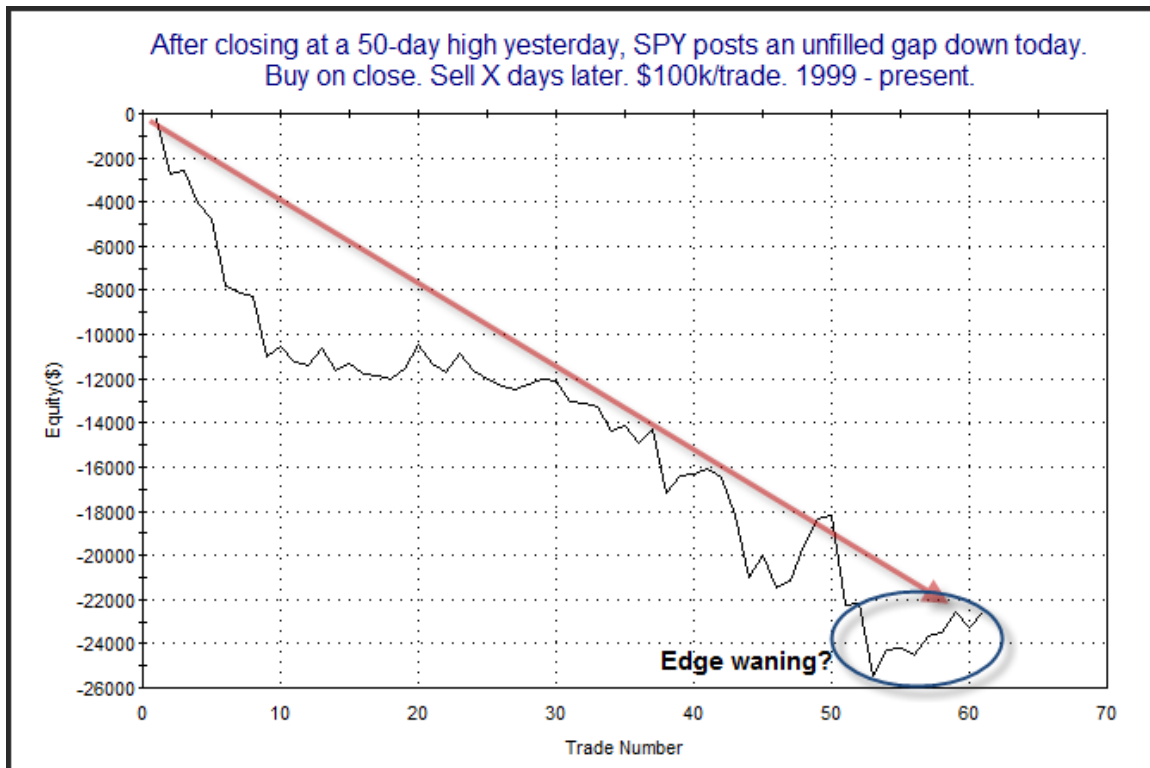
While the curve was never upward sloping, it was also never terribly consistent. I don't believe this study is compelling enough to generate downside expectations from. I do think it drives home the point that a bounce is not expected from this setup.

In the 10/18/11 letter just last week I showed a study that examined unfilled gaps down from 50-day highs. Below is an updated results table for that study.

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	-12,919.70	54	24	30	44.44	1,165.06	-1,362.71	0.85	0.68	-239.25
4	-9,878.81	55	28	27	50.91	923.95	-1,324.06	0.70	0.72	-179.61
3	-12,619.06	56	27	29	48.21	578.16	-973.42	0.59	0.55	-225.34
2	-22,535.02	61	26	35	42.62	569.42	-1,066.86	0.53	0.40	-369.43
1	-10,096.61	61	26	35	42.62	630.79	-757.06	0.83	0.62	-165.52

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 consistent enough to act as confirmation of the short-term bearish edge. I do have some concern with the recent action though. If we don't see the curve begin to reassert its move lower soon, then I may have to suspend this study. For now, I will include it. It's on probation, though.

The overall message I am getting from the market tonight is that while Tuesday's selloff was strong, there is a decent chance there is more to come. The evidence isn't overwhelming for the short side, but long doesn't seem to be a high probability short-term bet just yet.

Interestingly, this is somewhat confirmed by the systems triggers page. Despite the strong market dive there was not a single numbered system that triggered on Tuesday. That is very unusual when action is this strong (and especially in the middle of earnings season). In my eyes it speaks to the fact that showing a little patience may be more advisable than jumping in to the long side on the 1st day of a much needed pullback.

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



With tonight's study factored in the green Aggregator line didn't move much and remained squarely negative. 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 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 still 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 mostly bearish the green Aggregator Line is scheduled to close negative again on Wednesday. Of course new bullish evidence could change this. Meanwhile, the Differential Pivot will be at 1,225.07 on Wednesday. This is only about 0.3% below Tuesday's close. So if the market does provide the additional downside the studies are expecting then there is a good chance the Differential line will flip to positive and the Aggregator signal will no longer be short.

SPY is getting pretty close to its exit target. I'm still a little uncomfortable fighting the strong upside momentum we have been seeing. Therefore, I will begin to scale out Wednesday if we trade at or below Tuesday's closing price. I had considered using Tuesday's low as the place to begin scaling out, but it really isn't much below the close. Should the SPX *close* below the Differential Pivot I will cover my entire short position.

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

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.

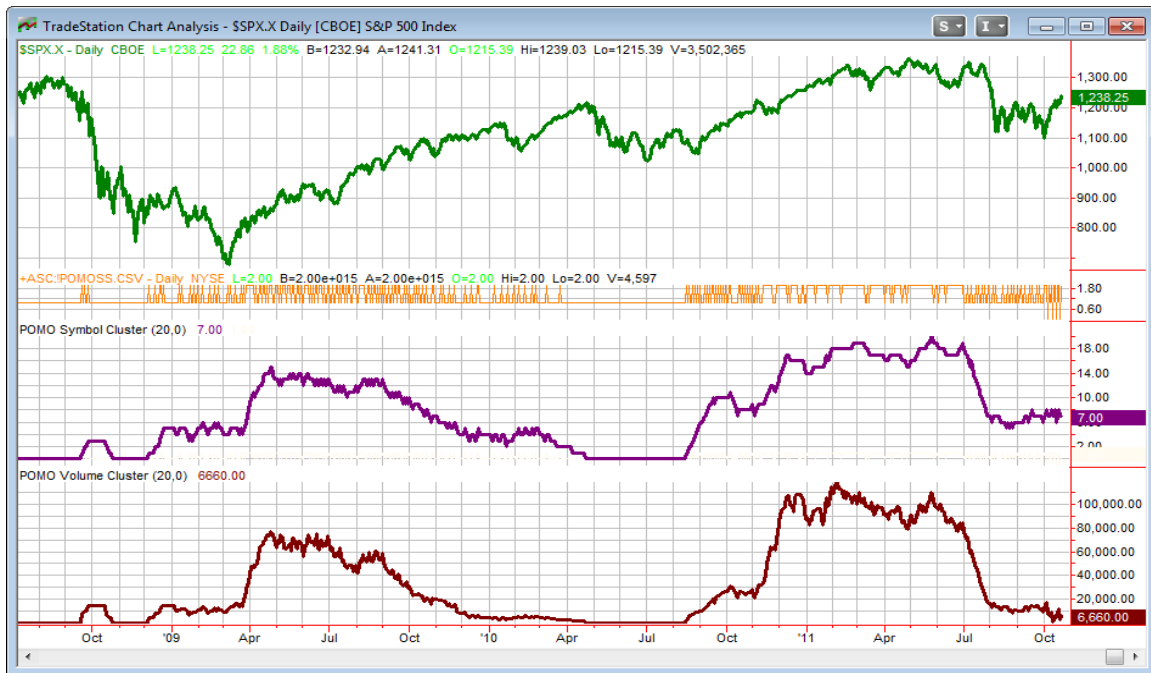
One indication that no longer favors the bulls is the Nasdaq/SPX lead-lag model. It has now turned back to neutral. This was caused by the relative weakness of the Nasdaq over the last 2 weeks. Since the inception of the Nasdaq, the SPX has gained over 1,350 points when then Nasdaq was in leading position 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.

***None tonight.** Unfortunately the VXX trade idea from last night did not fill due to the market gap on Tuesday. VXX closed up over 6% on Tuesday. I will not keep the trade idea active at this point.*

Current Open Trade Ideas

Symbol	Entry Date	Entry Price	Current Price	% Gain/Loss	Stop	Notes
SPY(1/4)(s)	10/21/2011	\$123.09	\$123.05	0.03%		Cover @ \$123.05 limit
SPY(1/4)(s)	10/21/2011	\$123.09	\$123.05	0.03%		Exit on SPX close<1225.08

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