

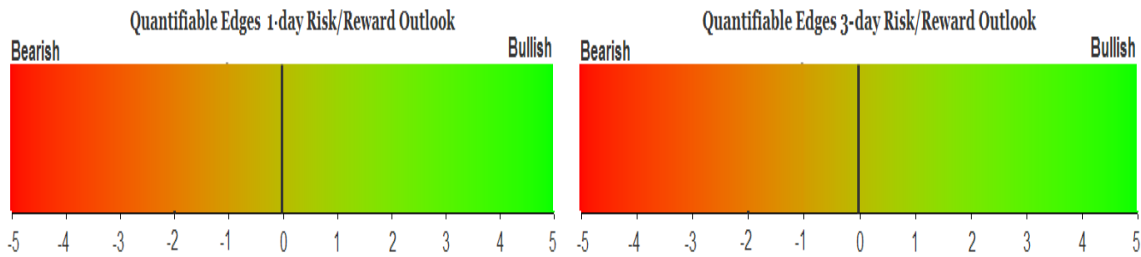
QUANTIFIABLE EDGES SUBSCRIBER LETTER

ASSESSING MARKET ACTION WITH INDICATORS AND HISTORY

October 28, 2011

Volume 4 Issue 209

Market Overview



Signals Overview

Aggregator	Aggressive VIX	Conservative VIX	NDX Trend Timer
Flat	50% Long XIV	Flat	Flat

Tonight's Research Points

- A huge price thrust on strong volume suggests more upside.
- 2 strong breadth days and a 50-day high also suggest further upside.
- The unfilled gap pattern in SPY at an intermediate-term high is often followed by a pullback.

Short-term Outlook

The Bottom Line

Thursday's strong move change expectations from negative to positive. Still the market is massively overbought. I am looking to get flat and await the next favorable setup.

[List not updated tonight]

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

Study Date	Description	Time span	Bias	Avg Max Move
Active				
October 27, 2011	2% dn. Then up solid breadth & volume	1 day	Bullish	
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%
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 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%

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

The Evidence

Wow. What a difference in a day and a half. SPX rose over 70 points from Wednesday’s low to Thursday’s high. A truly remarkable reaction to a European bailout. Thursday started off very strong and kept on chugging. The SPX closed up 3.4%, the Nasdaq rose 3.3% and the Russell 2000 rallied 5.3%. Breadth was extremely positive. The NYSE Up Issues % came in at 87% (in the top 2% of all readings over the last year). The Up Volume % was a whopping 95%. Total NYSE volume spiked on the rally.

Thursday's action was extreme and triggered quite a bit to look at. I could probably write 30 pages of studies tonight, but I don't have time to do that and you probably don't have time to read it. So I'm going to categorize what I saw, and show what I believe are the most relevant studies in each area. We'll look at price & volume, breadth, patterns, and VIX action.

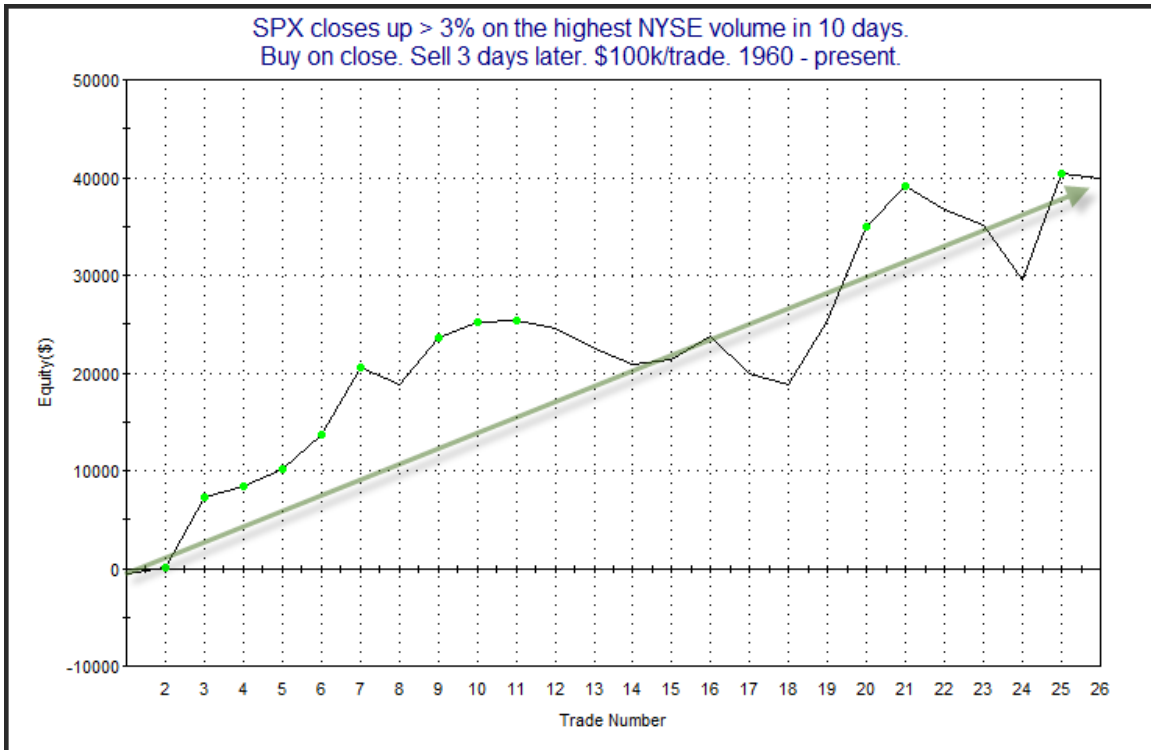
Strong price thrusts like we saw today carry a much different meaning when they are backed by high volume than when they aren't. The study below carries a decent sample size and is nicely representative of today's action.

**SPX closes up > 3% on the highest NYSE volume in 10 days.
Buy on close. Sell X days later. \$100k/trade. 1960 - present.**

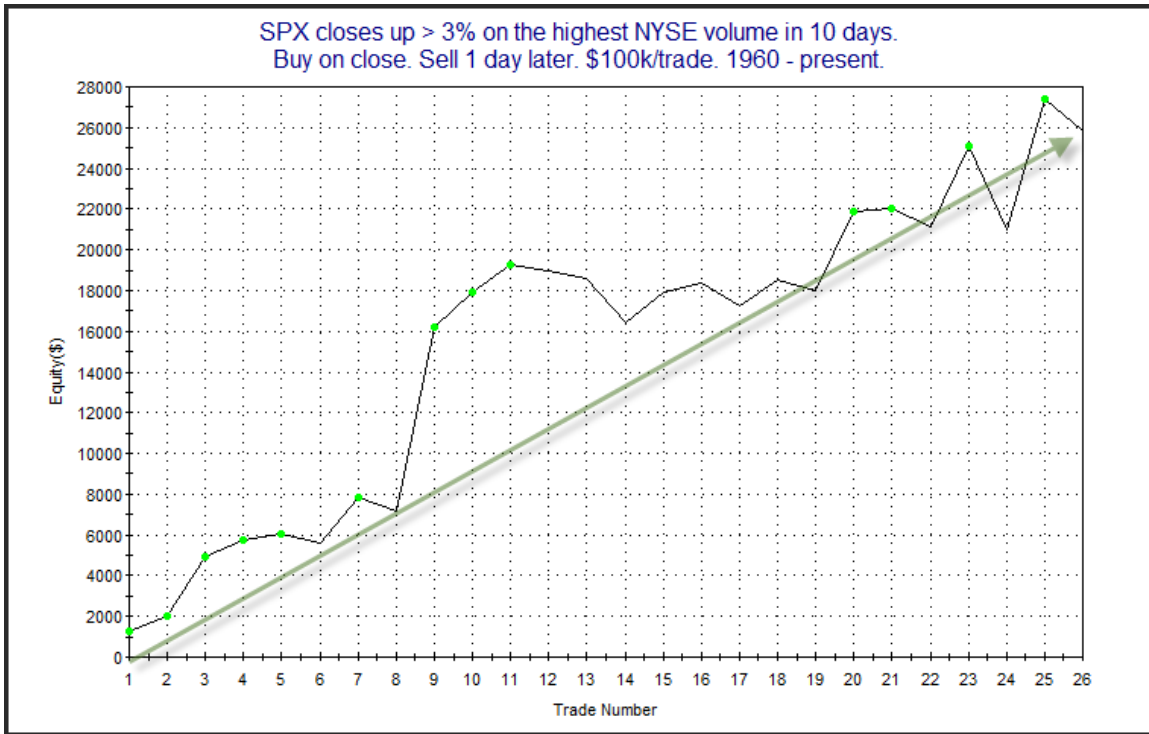
X Days	All: Net Profit	All: Total Trades	All: Winning Trades	All: Losing Trades	All: % Profitable	All: Avg Winning Trade	All: Avg Losing Trade	All: Win/Loss Ratio	All: ProfitFactor	All: Avg Trade
10	56,512.80	25	19	6	76.00	4,205.06	-3,897.21	1.08	3.42	2,260.51
9	61,452.11	25	18	7	72.00	4,564.48	-2,958.37	1.54	3.97	2,458.08
8	49,824.98	25	18	7	72.00	4,146.45	-3,544.45	1.17	3.01	1,993.00
7	43,901.12	25	19	6	76.00	3,720.28	-4,464.04	0.83	2.64	1,756.04
6	45,852.78	26	18	8	69.23	4,031.27	-3,338.75	1.21	2.72	1,763.57
5	39,064.13	26	20	6	76.92	3,347.97	-4,649.20	0.72	2.40	1,502.47
4	38,336.78	26	18	8	69.23	3,688.18	-3,506.30	1.05	2.37	1,474.49
3	39,886.10	26	15	11	57.69	4,107.28	-1,974.83	2.08	2.84	1,534.08
2	19,398.68	26	15	11	57.69	2,488.74	-1,630.22	1.53	2.08	746.10
1	25,871.74	26	16	10	61.54	2,378.22	-1,217.98	1.95	3.12	995.07

23 of 26 instances (88.5%) closed above the entry price at some point in the next week.

The statistics look good from day one and remain strong throughout the period. The number of instances that show some follow-through over the next week is quite impressive considering the strong move that has already taken place. I looked at a few different equity curves, and decided to share both the 3-day and the 1-day curves below.



As you can see the 3-day is a bit choppy but the general upslope remains in place the entire time. Now let's look at the 1-day.



This appears to be even a bit more consistent. Many traders may find this somewhat surprising that such a strong move has a tendency to carry through rather than to revert. Without the heavy volume this would not be the case. To demonstrate this I also ran the study below.

SPX closes up > 3% on less than the highest NYSE volume in 10 days.
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	-29,266.73	47	24	23	51.06	3,672.28	-5,104.41	0.72	0.75	-622.70
9	-35,064.02	49	24	25	48.98	3,619.98	-4,877.74	0.74	0.71	-715.59
8	-28,943.58	49	25	24	51.02	2,984.63	-4,314.97	0.69	0.72	-590.69
7	-51,770.99	51	21	30	41.18	3,659.10	-4,287.07	0.85	0.60	-1,015.12
6	-30,194.70	52	27	25	51.92	3,243.43	-4,710.70	0.69	0.74	-580.67
5	-22,741.52	55	32	23	58.18	3,064.28	-5,252.10	0.58	0.81	-413.48
4	-26,325.27	59	34	25	57.63	2,575.39	-4,555.54	0.57	0.77	-446.19
3	-22,451.59	60	32	28	53.33	2,106.12	-3,208.83	0.66	0.75	-374.19
2	-38,329.01	65	33	32	50.77	1,790.83	-3,044.57	0.59	0.61	-589.68
1	-21,388.45	66	32	34	48.48	1,071.35	-1,637.40	0.65	0.62	-324.07

The all-green profit columns from the previous test are all red here.

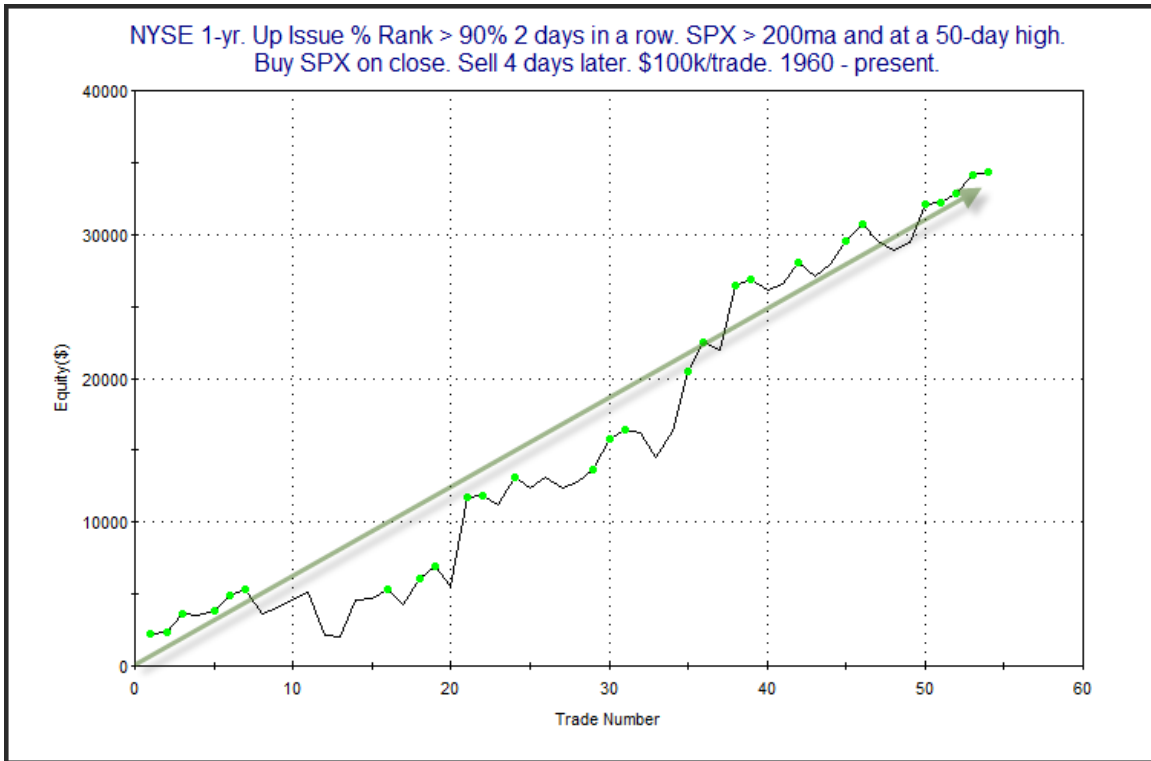
There were several studies identified by the Quantifinder that suggested the strong breadth over the last two days was also a positive. One of the most compelling was from the 2/3/10 subscriber letter. It looked at times where the NYSE Up Issues % came in above 75% for two consecutive days. Results were all very positive, until the last two instances. These were also the only two instances of the last couple years. An issue with many breadth studies over the last few years is that herding has become more prominent. In other words, breadth numbers that were at one time "extreme" aren't that extreme anymore. An Up Issues % of 75% just isn't as powerful now as it was three or four years ago. Because of this, I've taken to using the Breadth % Rank calculation. For those unfamiliar, Breadth % Rank takes all of the breadth readings over a specified period and assigns a percentile rank rather than just using the raw breadth %. (Tradestation users may download this calculation as part of the QE Indicators & Functions package which is available on the members section of the website. It is free for all gold members.)

Using a one-year look back, Wednesday's Up Issues % Rank was a little over 90% and Thursday's was 98%. The study below simply looks for two consecutive days with a percent rank over 90%. It also requires that the SPX is making a 50-day high while the breadth thrust is occurring.

NYSE 1-yr. Up Issue % Rank > 90% 2 days in a row. SPX > 200ma and at a 50-day high. Buy SPX 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	43,289.04	48	32	16	66.67	2,415.28	-2,125.00	1.14	2.27	901.86
9	39,784.17	49	31	18	63.27	2,389.91	-1,905.72	1.25	2.16	811.92
8	44,488.28	50	34	16	68.00	2,163.44	-1,816.80	1.19	2.53	889.77
7	45,884.65	51	36	15	70.59	1,977.36	-1,686.69	1.17	2.81	899.70
6	33,047.46	52	34	18	65.38	1,720.94	-1,414.69	1.22	2.30	635.53
5	28,035.22	52	33	19	63.46	1,575.32	-1,260.55	1.25	2.17	539.14
4	34,386.05	54	38	16	70.37	1,311.45	-965.57	1.36	3.23	636.78
3	22,673.55	55	35	19	63.64	1,123.97	-877.12	1.28	2.36	412.25
2	17,513.46	56	35	21	62.50	804.99	-507.68	1.59	2.64	312.74
1	8,156.66	62	38	24	61.29	510.72	-468.78	1.09	1.72	131.56

56 of 62 instances (90%) closed above the entry price at some point in the next week. The last instance that failed to do so was 2/4/93. There have been 15 instances in a row since then that saw some additional buying in the next week.

The numbers here are all solidly positive, and the consistency in more recent times has been especially impressive. Below you can see the profit curve.



The strong, steady upslope serves as confirmation of the short-term bullish edge.

But the unfilled gap pattern that emerged in the SPY today is one that has been frequently followed by a pullback over the last 17 years. The study below is from the 11/5/10 subscriber letter. All stats have been updated.

SPY gaps up > 1% above yesterday's close and never fills. It makes a 50-day intraday high and close > 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	-4,561.10	11	4	7	36.36	557.13	-969.95	0.57	0.33	-414.65
4	-3,412.61	12	5	7	41.67	613.34	-925.62	0.66	0.47	-284.38
3	-6,131.73	12	3	9	25.00	304.59	-782.83	0.39	0.13	-510.98
2	-2,810.36	12	6	6	50.00	257.90	-726.30	0.36	0.36	-234.20
1	-375.95	12	7	5	58.33	364.38	-585.32	0.62	0.87	-31.33

11 of 12 instances (92%) closed below the entry price at some point in the next 3 days.

The number of instances is a bit low, but the consistency is strong enough and the statistics lopsided enough that I think it is still worth taking the study under consideration. Below I have listed all of the instances assuming a 3-day holding period.

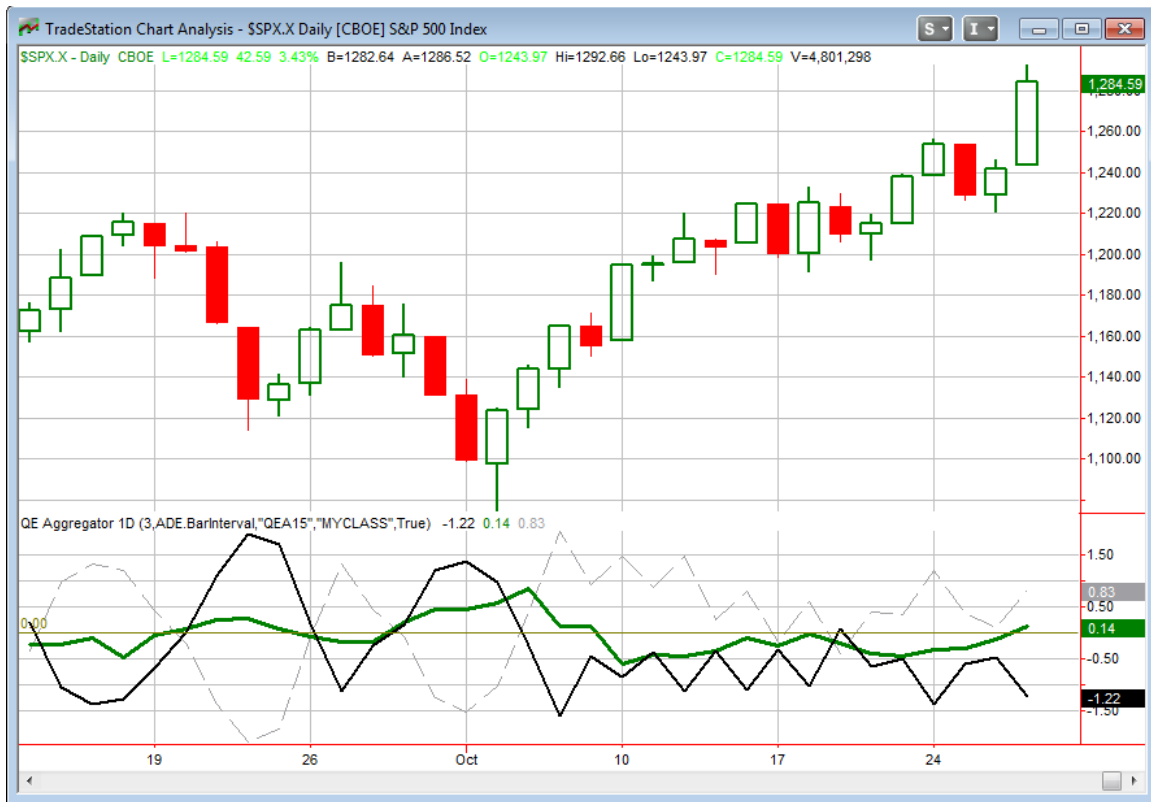
SPY gaps up > 1% above yesterday's close and never fills. It makes a 50-day intraday high and close > open. Close > 200ma. Buy on close. Sell X days later. \$100k/trade. 1994 - present.				
Date/Time	Signal	Price	% Profit	Run-up Drawdown
09/13/96	Buy	\$68.53	(0.07%)	\$919.17
09/18/96	Sell	\$68.48		(\$452.29)
07/03/97	Buy	\$92.06	(1.09%)	\$477.84
07/09/97	Sell	\$91.06		(\$2,204.58)
02/02/98	Buy	\$100.13	0.37%	\$1,457.08
02/05/98	Sell	\$100.50		(\$409.18)
01/06/99	Buy	\$127.44	(0.71%)	\$831.04
01/11/99	Sell	\$126.53		(\$1,740.48)
12/03/99	Buy	\$143.84	(2.17%)	\$0.00
12/08/99	Sell	\$140.72		(\$2,321.30)
06/01/09	Buy	\$94.43	0.11%	\$994.52
06/04/09	Sell	\$94.53		(\$1,766.86)
08/03/09	Buy	\$100.44	(0.55%)	\$577.10
08/06/09	Sell	\$99.89		(\$1,014.90)
08/07/09	Buy	\$101.20	(0.40%)	\$355.68
08/12/09	Sell	\$100.80		(\$1,719.12)
10/14/09	Buy	\$109.31	0.44%	\$749.48
10/19/09	Sell	\$109.79		(\$987.12)
11/23/09	Buy	\$110.82	(1.23%)	\$613.36
11/27/09	Sell	\$109.46		(\$2,282.06)
09/24/10	Buy	\$114.82	(0.30%)	\$191.40
09/29/10	Sell	\$114.47		(\$1,426.80)
11/04/10	Buy	\$122.26	(0.53%)	\$563.73
11/09/10	Sell	\$121.61		(\$931.38)

So the SPY price pattern appears to suggest it would be unusual for the market to continue to run higher without at least a brief pause here.

For much of the day on Thursday it appeared we were going to have some strongly bearish VIX-based studies trigger as well. The most significant of these was one that looks for a 1-day drop in the VIX of at least 15%. Since 1998 this is happened 20 times, and all 20 instances saw the SPX close lower in one of the next two days. But it didn't quite trigger since the VIX managed to bounce late in the session. So I looked at statistics for numbers close to where we actually finished and found that the edge was either extremely mild or inconclusive. Had the VIX managed to stay at the extremely low levels

it was at then expectations would have remained negative. But without that study, and with the volume and breadth-based studies we've seen tonight, short-term expectations have actually turned positive.

This can be seen in the [Aggregator](#) chart below.



You'll note the green Aggregator line has now flipped to positive. Readings above 0 mean net expectations from the Active List are for upside over the next few days. Meanwhile, the black Differential Line is still far below 0. A negative Differential reading means the SPX has outperformed expectations over the last few days. So net expectations are positive but the SPX is already overbought 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 changed from short to flat.

Based on the current studies it appears the green Aggregator line is likely to close above zero again on Friday. Of course this could change should new bearish evidence emerge. Meanwhile, the Differential Pivot will be at 1,213.30 on Friday. This is a whopping 5.5%

below Thursday's close. It is highly unlikely we will see that occur in one day. More probable is that we will need to see a multi-day pullback or consolidation in order for the market to no longer be considered "overbought".

While I was glad to have reduced my short position yesterday, Thursday still felt pretty bad. It's been a very frustrating couple of weeks. I noted in my intermediate-term outlook that I was becoming more inclined to favor the long side, but action has been so strong that it has not allowed for a decent pullback in which to enter. And until today short-term bearish evidence has outweighed bullish evidence. At this point I'd be surprised if we didn't see a pullback here at some point in the next few days. There is a very good chance that traders who have a short position will be able to get out at a more favorable price than the extended one we are currently at. But with the evidence turning bullish tonight, I'm not inclined to get terribly fancy about an exit. Rather I will take my lumps on this small position, and hope the market does pull back and perhaps allows for a decent long side entry. In any case, I expect I will see a more pronounced edge in the next few days than I see now.

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.

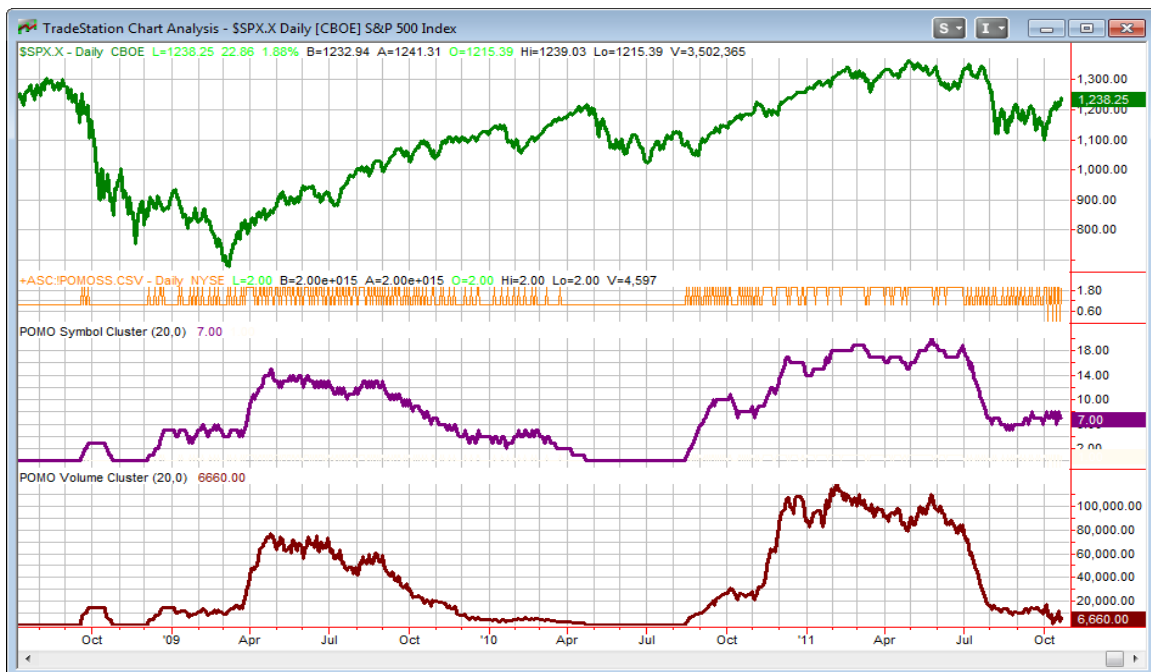
While there is room to doubt this rally, I'm of the opinion that it certainly has a decent chance based on the FTD studies.

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.

Current Open Trade Ideas

Symbol	Entry Date	Entry Price	Current Price	% Gain/Loss	Stop	Notes
SPY(1/4)(s)	10/21/2011	\$123.09	\$128.60	-4.48%		cover @ \$128.60 limit

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