

QUANTIFIABLE EDGES SUBSCRIBER LETTER

ASSESSING MARKET ACTION WITH INDICATORS AND HISTORY

November 3, 2011

Volume 4 Issue 213

Market Overview



Signals Overview

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

Tonight's Research Points

- Unfilled gaps higher that close above the open while under the 200ma on a Fed Day have normally been followed by 1-2 day pullbacks in the past.

Short-term Outlook

The Bottom Line

Short-term evidence now tilts in favor of the bears. Still, the SPX is strongly oversold so I am sidelined awaiting a more favorable opportunity.

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

Study Date	Description	Time span	Bias	Avg Max Move
Active				
November 3, 2011	Unfilled Gap & Close > Open Fed Day	1-2 days	Bearish	-1.60%
November 2, 2011	2 strong down days	1-2 days	Bullish	3.00%
Active - Long Term				
October 30, 2011	SPX & bond yields hit 50-day highs	1-50 days	Bearish	
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	
March 22, 2011	3 Days Up Issues % > 70%	8 months	Bullish	19.00%
Dropped Tonight				
October 28, 2011	Double 90% breadth & 50-day high	1-4 days	Bullish	
November 2, 2011	1% drop before a Fed Day	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

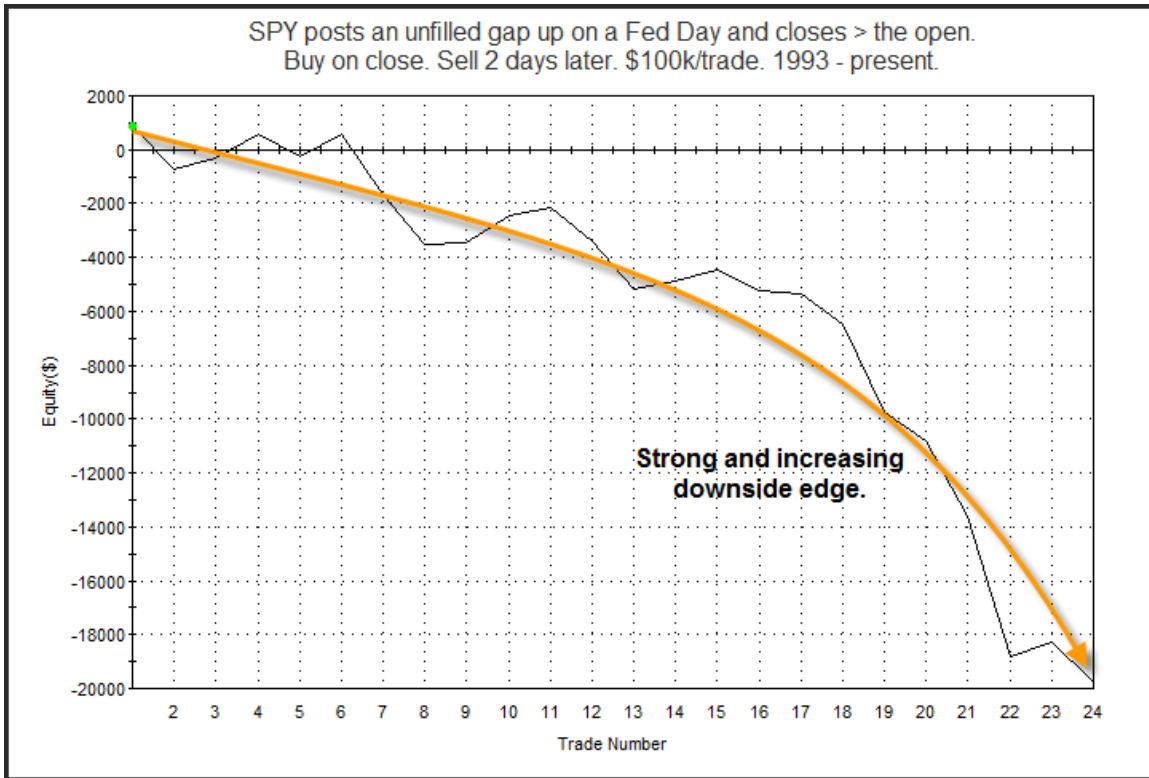
After 2 days of strong selling the market bounced back a bit on Wednesday. The SPX rallied 1.6%, the Nasdaq rose 1.3%, and the Russell 2000 gained 2.7%. Breadth was very strong as the NYSE Up Issues % came in at 82% and the Up Volume % was just under 90%. Total NYSE volume was the lightest in over a week.

As we approached the close on Wednesday the number I was watching was \$123.83. That was the level that the SPY opened at. A close below that level would have triggered a short-term bullish study based on the pattern. But we closed above it. In doing so we triggered a bearish Fed Day study. It last appeared in the 1/27/11 subscriber letter. I have updated the results below.

SPY posts an unfilled gap up on a Fed Day and closes > the open. Buy on close. Sell 2 days later. \$100k/trade. 1993 - 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	-23,545.75	24	9	15	37.50	1,218.88	-2,301.04	0.53	0.32	-981.07
4	-14,028.04	24	12	12	50.00	1,167.36	-2,336.36	0.50	0.50	-584.50
3	-20,337.37	24	8	15	33.33	967.95	-1,872.07	0.52	0.28	-847.39
2	-19,757.34	24	10	14	41.67	575.28	-1,822.15	0.32	0.23	-823.22
1	-12,182.08	24	9	15	37.50	362.75	-1,029.79	0.35	0.21	-507.59

21 of 24 instances (87.5%) closed below the entry price at some point in the next week.

Based on the numbers it appears the unfilled gap and higher close will frequently be followed by a move lower over the next few days. Below I have produced a profit curve that assumes a 2-day holding period.



While always downsloping, the edge appears to have gained strength in recent times. I believe it is worth taking this study under consideration.

There were some other studies that looked at the bounce following a big down day yesterday. Basically the studies suggested that when the bounce occurred on decent breadth then volume could act as a valuable predictor. High volume on the bounce was perceived as a good thing and low volume a negative. The study below was last seen in the 9/30/11 letter. I updated the results tonight and have listed below all instances along with their 1-day returns.

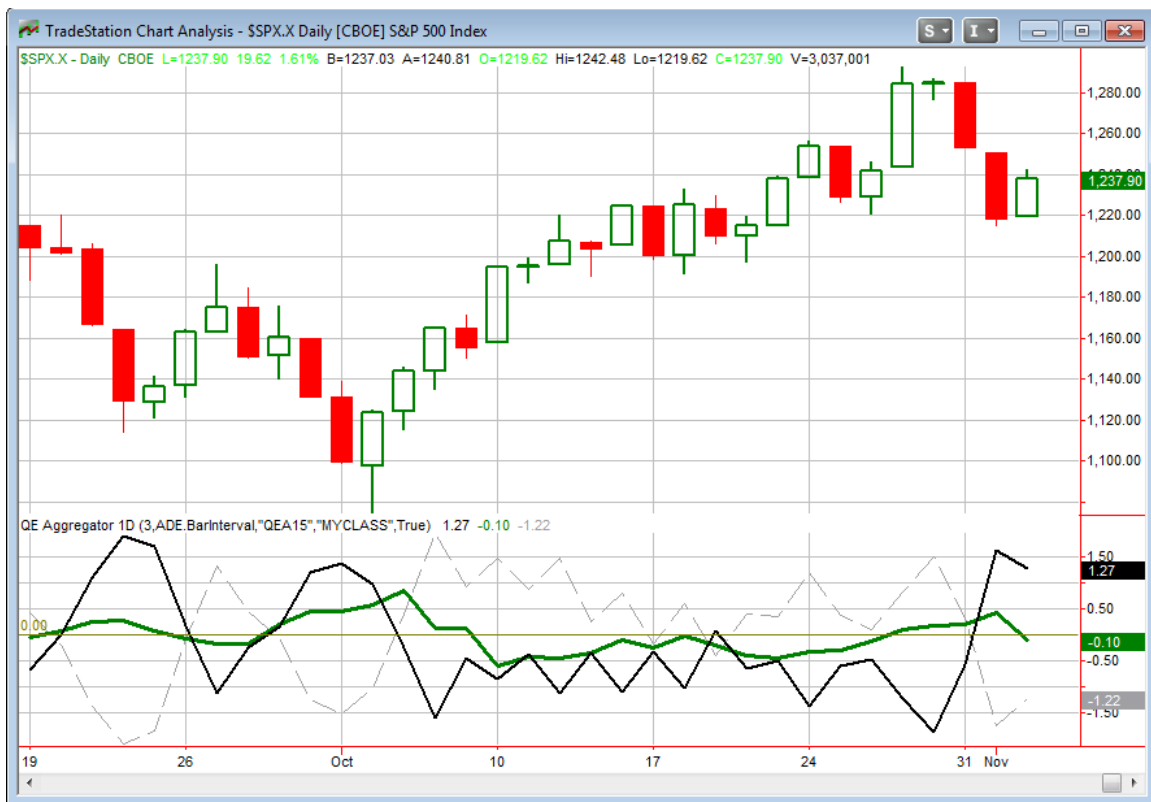
SPX drops over 2% yesterday. Today NYSE Up Issues % > 60% but volume declines.
Buy SPX on close. Sell 1 day later. \$100k/trade. 4-10-2001 - present.

Date/Time	Signal	Price	% Profit	Run-up Drawdown
04/12/02	Buy	\$1,111.04	(0.76%)	\$343.80
04/15/02	Sell	\$1,102.55		(\$1,046.70)
08/26/02	Buy	\$947.95	(1.39%)	\$826.35
08/27/02	Sell	\$934.82		(\$1,846.95)
11/27/02	Buy	\$938.87	(0.27%)	\$306.34
11/29/02	Sell	\$936.31		(\$336.02)
02/28/07	Buy	\$1,406.82	(0.26%)	\$187.44
03/01/07	Sell	\$1,403.17		(\$1,842.45)
08/29/07	Buy	\$1,463.76	(0.42%)	\$317.56
08/30/07	Sell	\$1,457.64		(\$850.68)
09/30/08	Buy	\$1,166.36	(0.45%)	\$56.95
10/01/08	Sell	\$1,161.06		(\$2,175.15)
11/07/08	Buy	\$930.99	(1.27%)	\$2,242.72
11/10/08	Sell	\$919.21		(\$2,516.64)
12/10/08	Buy	\$899.24	(2.85%)	\$598.29
12/11/08	Sell	\$873.59		(\$3,386.61)
12/12/08	Buy	\$879.73	(1.27%)	\$553.70
12/15/08	Sell	\$868.57		(\$2,487.13)
01/08/09	Buy	\$909.73	(2.13%)	\$239.80
01/09/09	Sell	\$890.35		(\$2,334.78)
04/15/09	Buy	\$852.06	1.55%	\$2,139.93
04/16/09	Sell	\$865.30		(\$587.34)
04/21/09	Buy	\$850.08	(0.77%)	\$1,368.90
04/22/09	Sell	\$843.55		(\$1,112.67)
05/14/09	Buy	\$893.07	(1.14%)	\$432.90
05/15/09	Sell	\$882.88		(\$1,568.43)
08/18/09	Buy	\$989.67	0.69%	\$1,003.94
08/19/09	Sell	\$996.46		(\$914.05)
07/19/10	Buy	\$1,071.25	1.14%	\$1,180.17
07/20/10	Sell	\$1,083.48		(\$1,336.41)
08/09/11	Buy	\$1,172.53	(4.42%)	\$0.00
08/10/11	Sell	\$1,120.76		(\$4,634.20)
08/11/11	Buy	\$1,172.64	0.53%	\$1,394.00
08/12/11	Sell	\$1,178.81		(\$161.50)
09/23/11	Buy	\$1,136.43	2.33%	\$2,415.12
09/26/11	Sell	\$1,162.95		(\$466.32)

Seemed to suggest downside edge for a while, but since 2009 bottom that has not been the case.

For a good amount of time this study appeared to suggest a downside edge. Over the last 2+ years that edge has not played out. I am not inclined to include this study on the Active List.

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



Tonight's bearish Fed Day study caused the green Aggregator Line to drop back 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 remains far above 0. A positive Differential reading means the SPX has underperformed expectations over the last few days. So net expectations are negative but the SPX is strongly 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. This means the Aggregator long signal only lasted for 1 day. The Aggregator System turned back to flat at the close. This was indicated on the systems page as we approached the close.

The current studies still are only providing a very brief window of influence. This means the value of the green Aggregator line over the next few days will continue to be highly dependent on market action and the studies that are subsequently triggered. Meanwhile, the Differential Pivot will be 1,258.62 on Thursday. This about 1.7% above Wednesday's close. It would take a fairly strong move on Thursday to achieve this. If that fails to happen the Differential Line will remain in positive territory.

The move predicted by yesterday's studies played out quickly on Wednesday. Unfortunately the trade ideas section of the letter was not able to participate thanks to the large gap up that went unfilled. Even if the long signal were still in place I am not sure I would be looking to buy near Wednesday's closing price. It is already a bit extended from the buy point. In an environment that's less news-driven I may consider it, but this market continues to show great volatility associated with news out of Europe related to their debt situation. So for now I'll prefer more favorable entries. Of course the point is moot since expectations are negative tonight. I'm flat and will wait a day before looking to commit new capital.

Intermediate-term Outlook (2 weeks – 2 months)– updated 10/31 – bullish

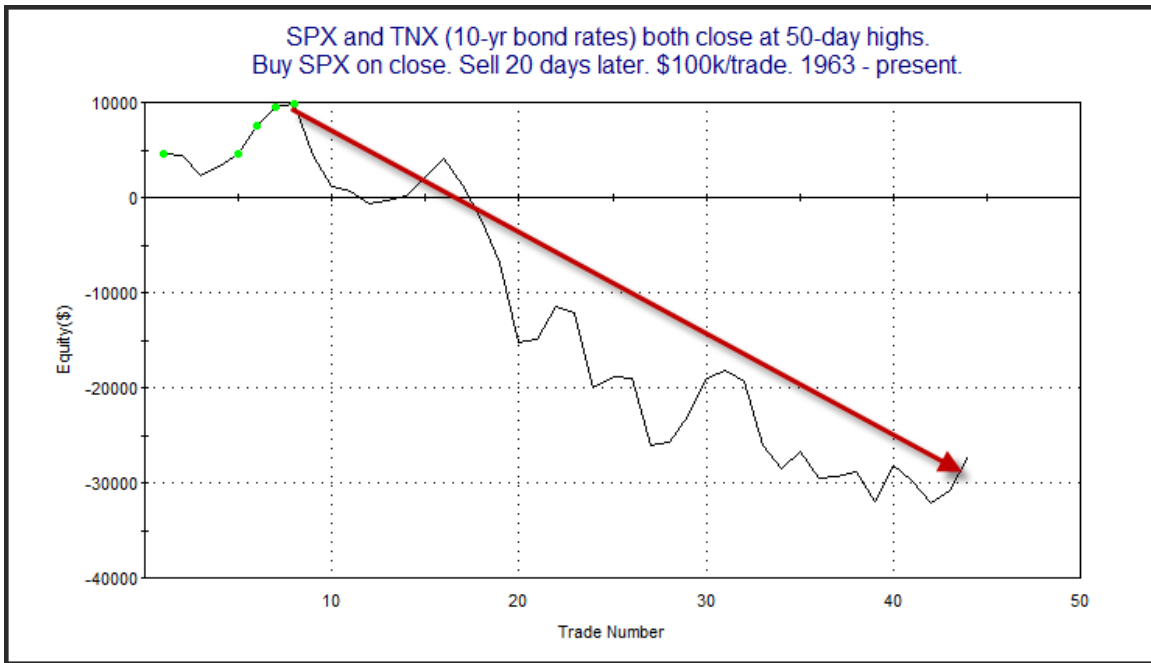
With the market hitting new 50-day highs again the intermediate-term picture continues to look fairly strong. I did notice one bearish indication though on Thursday. It came not from the stock market, but from the bond market.

The fact that the 10-year bond rates hit new highs on Thursday along with the SPX is notable. The study below last appeared in the 2/7/11 letter. Stats are updated.

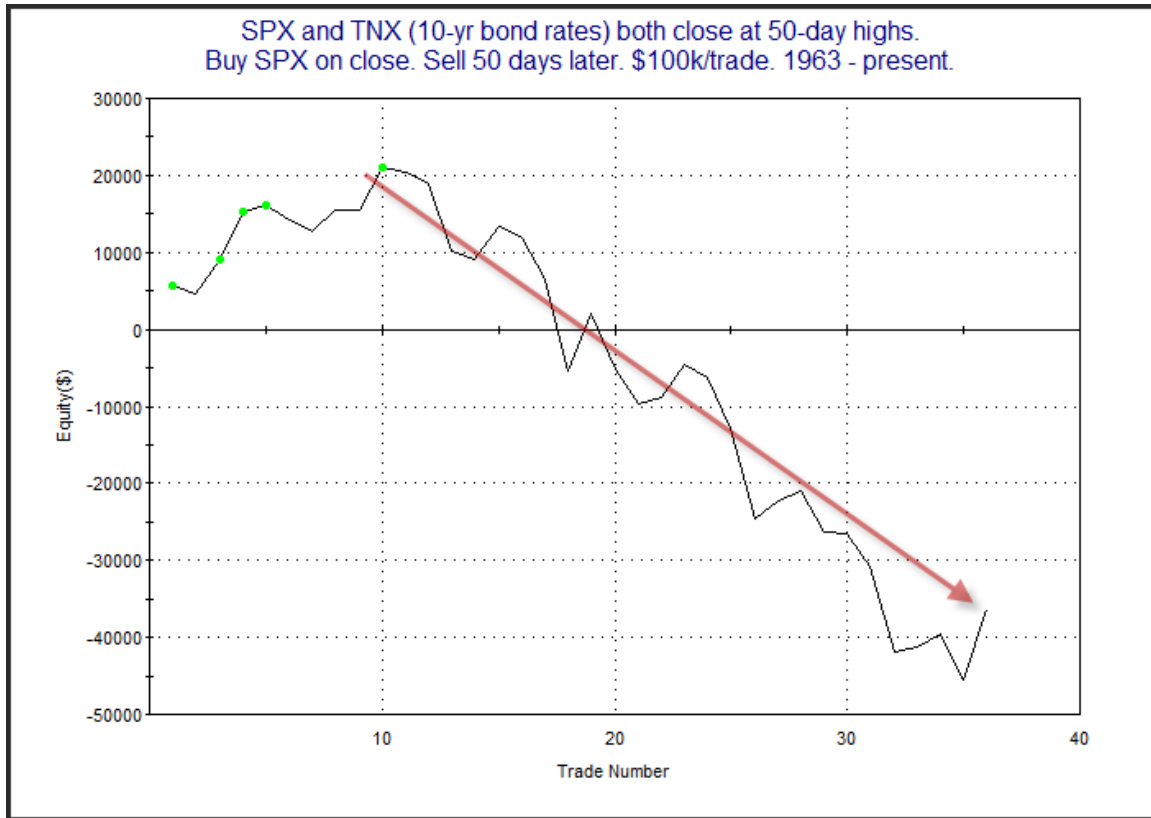
SPX and TNX (10-yr bond rates) both close at 50-day highs. Buy SPX on close. Sell X days later. \$100k/trade. 1963 - present.										
X Days	All: Net Profit	All: Total Trades	All: Winning Trades	All: Losing Trades	All: % Profitable	All: Avg Winning Trade	All: Avg Losing Trade	All: Win/Loss Ratio	All: ProfitFactor	All: Avg Trade
50	-45,542.79	35	15	20	42.86	3,202.43	-4,678.96	0.68	0.51	-1,301.22
45	-39,401.07	36	15	21	41.67	3,787.60	-4,581.67	0.83	0.59	-1,094.47
40	-19,283.93	38	18	20	47.37	3,912.18	-4,485.16	0.87	0.79	-507.47
35	-26,508.60	40	18	22	45.00	3,350.01	-3,945.85	0.85	0.69	-662.72
30	-15,725.48	41	17	24	41.46	3,582.60	-3,192.90	1.12	0.79	-383.55
25	-3,159.70	42	19	23	45.24	2,969.29	-2,590.27	1.15	0.95	-75.23
20	-27,184.54	44	23	21	52.27	1,781.90	-3,246.11	0.55	0.60	-617.83
15	-25,104.25	44	23	21	52.27	1,700.03	-3,057.37	0.56	0.61	-570.55
10	-7,819.95	49	29	20	59.18	1,287.83	-2,258.36	0.57	0.83	-159.59
5	-5,191.54	65	35	30	53.85	1,028.57	-1,373.05	0.75	0.87	-79.87

Generally it seems that higher interest rates have often made bonds an attractive investment. This may lead people to forsake stocks in favor of lower risk returns with improved yield. Implications of this study appear to be longer-term in nature than we usually see. To help visualize how this edge has played out over time I have pasted

below equity curves using a 20-day and a 50-day exit strategy. First let's examine the 20-day exit strategy equity curve.



Bearish results started appearing around 1965 and they've generally remained bearish ever since. Next is the equity curve for the 50-day exit strategy.

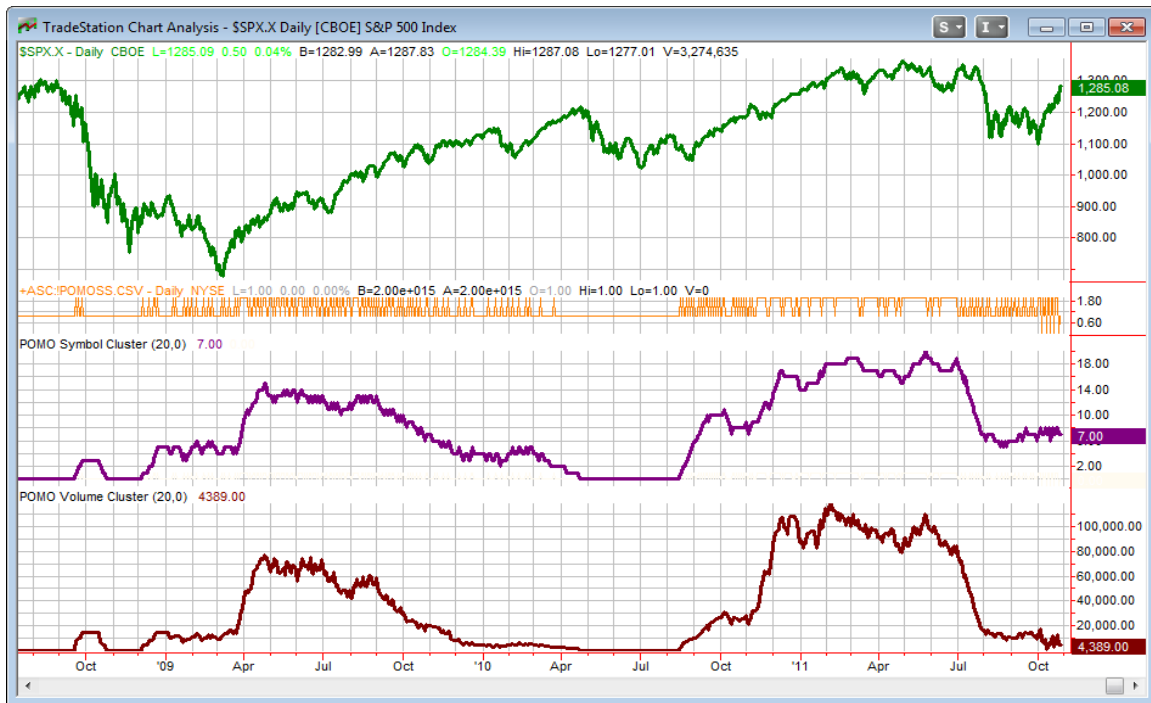


This one looks very similar to the 20-day exit strategy. In this case the downside edge didn't begin to exert itself until the 1970s but it too has persisted lower for a long time.

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 buying and 1 day of selling. 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 has been weak lately, the market's upward move since the beginning of Operation Twist has been anything but weak.

There is a good amount of evidence now favoring the bulls. Still, the market is very volatile, news-dependent, and overbought. Bond prices are a possible red flag. Aside from that, studies related to breadth, price thrusts and Follow-Through Days all suggest the rally should continue. Overall I am looking for this move higher to persist a while longer. I am still willing to take quick shots on the short side. I will tend to be more aggressive with longs, 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 and no fills from last night.](#)

Current Open Trade Ideas

None

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