

QUANTIFIABLE EDGES SUBSCRIBER LETTER

ASSESSING MARKET ACTION WITH INDICATORS AND HISTORY

November 10, 2011

Volume 4 Issue 218

Market Overview



Signals Overview

Aggregator	Aggressive VIX	Conservative VIX	NDX Trend Timer
Long	75% Long XIV	100% Long SPY	Flat

Tonight's Research Points

- 20% VIX spikes are often followed by a rise in the SPX the next day.
- 3% SPX drops are often followed by bounces. That edge would be greater under certain circumstances.
- The 2% gap down in the SPY and further selling is also indicative of a bounce.

Short-term Outlook

The Bottom Line

Selling was strong enough on Wednesday that it is often followed by a bounce. The position of the market makes it questionable. There appears to be a bit of an upside edge that would likely increase if the selling continues another day or two.

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

Study Date	Description	Time span	Bias	Avg Max Move
Active				
November 10, 2011	VIX rises 20%.	1 day	Bullish	
November 10, 2011	3% drop and close near intraday low	1 day	Bullish	
November 10, 2011	2% gap down and close 1% below open	1 day	Bullish	
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				
November 8, 2011	Low volume up day >10ma < 200m	1-2 days	Bearish	

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

The Evidence

The market got thumped on Wednesday, suffering its worst day in months. The SPX declined 3.7%, the Nasdaq fell 3.9% and the Russell 2000 lost 4.8%. Breadth was extremely negative as the NYSE Up Issues % came in at 9% and the Up Volume % was just 1.5%. Total NYSE volume spiked up a bit on the selloff.

After boring action that inspired nothing in the way of studies on Tuesday, Wednesday delivered with a bang. One index that showed a real extreme move was the VIX. It spiked up over 30% on Wednesday as fear struck options traders. In the past I have shown how spikes of 20% or greater have generally suggested an upside edge. I've rerun that study tonight, which last appeared in the 8/11/11 letter.

VIX closes > 20% above yesterday's close. Buy SPX on close. Sell X days later. \$100k/trade. 1990 - 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	42,630.18	42	28	14	66.67	2,530.26	-2,015.51	1.26	2.51	1,015.00
4	46,096.33	44	30	14	68.18	2,560.15	-2,193.45	1.17	2.50	1,047.64
3	29,103.66	44	31	13	70.45	1,836.60	-2,140.85	0.86	2.05	661.45
2	20,923.21	45	26	19	57.78	1,992.77	-1,625.73	1.23	1.68	464.96
1	43,355.29	46	34	12	73.91	1,603.62	-930.66	1.72	4.88	942.51

In most cases the upside edge largely played out on Day 1. Below is a profit curve that assumes a 1-day exit strategy.



The last 2 instances haven't played out but the general upslope and bullish edge appear to be intact.

In the 9/23/11 subscriber letter I discussed 2 aspects of 3% selloffs that had a demonstrable impact on whether the selloff was likely to lead to a bounce and whether the bounce was likely to last beyond just a day or 2. The 2 points I made were:

- 1) 3% drops from a 5-day low have exhibited a strong upside tendency over the next few days when the SPX closed at a 5-day low the day *before* the 3% drop. When it did not close at a 5-day low the day before, then there was no strong inclination for the market to bounce.
- 2) When SPY closed down 3% and near the bottom of its range then the next day showed a strong upside edge. When it closed down 3% but at least 1% above its intraday low, then that upside edge was no longer apparent.

There is a link below for those that may want to see the details of these studies.

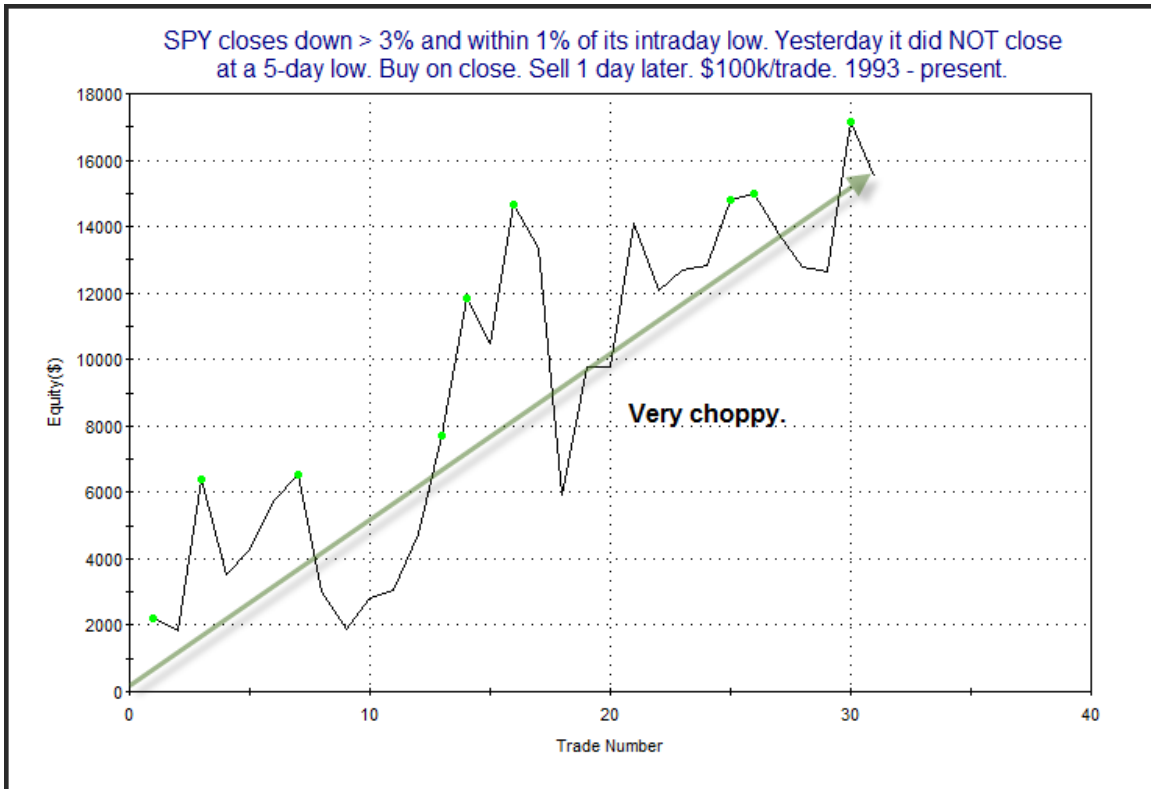
[2011-09-23 QE Subscriber Letter.pdf](#)

Wednesday's drop did NOT come after a 5-day low, but it did close near the bottom of its intraday range. I decided tonight to see how this combination has played out versus times when the selloff WAS initiated after a 5-day low. First let's look at the current setup.

SPY closes down > 3% and within 1% of its intraday low. Yesterday it did NOT close at a 5-day low. Buy on close. Sell X 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	-1,408.01	26	13	13	50.00	3,314.69	-3,422.99	0.97	0.97	-54.15
4	9,261.87	27	13	14	48.15	4,023.95	-3,074.96	1.31	1.22	343.03
3	11,839.57	30	17	13	56.67	3,316.82	-3,426.65	0.97	1.27	394.65
2	7,806.59	31	16	15	51.61	3,051.65	-2,734.66	1.12	1.19	251.83
1	15,508.70	31	19	12	61.29	2,080.63	-2,001.94	1.04	1.65	500.28

We see here what appears to be a moderate 1-day upside edge. A profit curve using a 1-day holding period is below.



The chart here is quite choppy. Still, it does appear to have demonstrated an upslope over longer periods. Overall this study appears worthy of 1 day of consideration.

Now let's consider what the results would look like if the market had closed at a 5-day low prior to Wednesday's selloff.

SPY closes down > 3% and within 1% of its intraday low. Yesterday it closed at a 5-day low. Buy on close. Sell X 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	95,784.44	23	18	5	78.26	5,689.76	-1,326.24	4.29	15.44	4,164.54
4	64,910.23	25	16	9	64.00	5,320.78	-2,246.92	2.37	4.21	2,596.41
3	55,227.16	25	17	8	68.00	4,397.55	-2,441.40	1.80	3.83	2,209.09
2	61,106.65	26	21	5	80.77	3,769.07	-3,608.75	1.04	4.39	2,350.26
1	52,099.32	26	20	6	76.92	3,122.09	-1,723.76	1.81	6.04	2,003.82

Only 1 instance failed to close above the entry price at some point in the next week. It triggered on 2/17/09.

Results here are considerably stronger. The 1-day gains are more than doubled and a week later the average instance had gained over 4%.

Another aspect of Wednesday's selling to consider is that it started with a huge gap down. The study below is from the 8/19/11 subscriber letter. It looked at other times the SPY had gapped down over 2% and then sold off another 1% by the close. I have updated the results.

SPY gaps down at least 2%. It closes more than 1% below the open but > the lowest close of the last 10 days. Buy on close. Sell X 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	26,730.75	6	6	0	100.00	4,455.13	0.00	100.00	100.00	4,455.13
4	35,031.74	6	6	0	100.00	5,838.62	0.00	100.00	100.00	5,838.62
3	20,833.79	6	5	1	83.33	5,642.57	-7,379.07	0.76	3.82	3,472.30
2	13,600.68	6	4	2	66.67	4,781.35	-2,762.37	1.73	3.46	2,266.78
1	13,024.55	6	5	1	83.33	2,931.41	-1,632.51	1.80	8.98	2,170.76

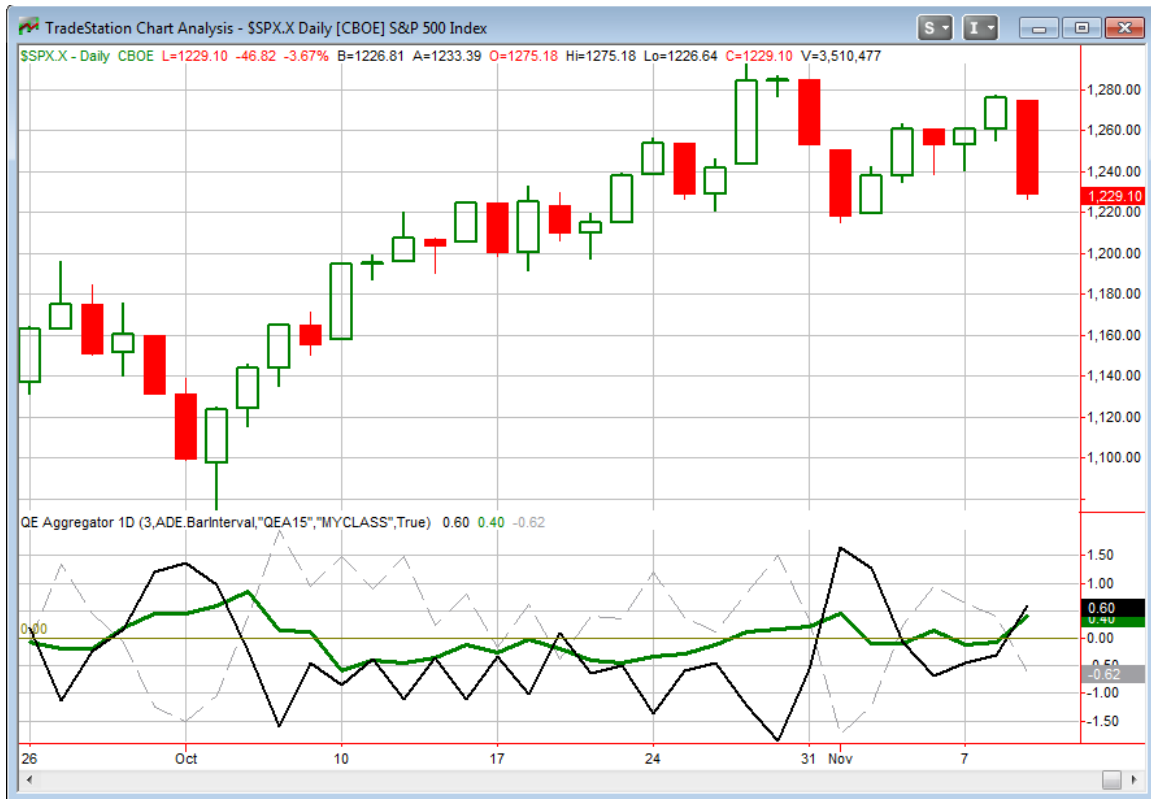
Instances are very low but the numbers appear extremely strong. Below I have listed all 6 instances along with their 4-day results.

SPY gaps down at least 2%. It closes more than 1% below the open but > the lowest close of the last 10 days. Buy on close. Sell 4 days later. \$100k/trade. 1993 - present.				
Date/Time	Signal	Price	% Profit	Run-up Drawdown
09/10/98	Buy	\$97.25	7.97%	\$8,224.00
09/16/98	Sell	\$105.00		(\$257.00)
10/15/08	Buy	\$90.02	6.49%	\$10,078.80
10/21/08	Sell	\$95.86		(\$3,862.80)
10/22/08	Buy	\$90.64	3.44%	\$3,970.80
10/28/08	Sell	\$93.76		(\$7,654.82)
12/01/08	Buy	\$82.11	7.09%	\$7,679.27
12/05/08	Sell	\$87.93		(\$85.19)
03/30/09	Buy	\$78.79	6.94%	\$7,398.27
04/03/09	Sell	\$84.26		(\$583.74)
08/18/11	Buy	\$114.51	3.12%	\$3,256.29
08/24/11	Sell	\$118.08		(\$1,833.30)

Avg Run-up is 6.8%

Four of the six instances closed up between 6%-8% 4 days later. The 2 remaining rose 3%. These results are very impressive. With instances so low I'm not inclined to generate estimates beyond 1-day just yet. I do think it is suggestive of a bounce, though.

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



With tonight's short-term bullish studies the green Aggregator Line turned positive. Readings above 0 mean net expectations from the Active List are for upside over the next few days. Meanwhile, the black Differential Line also spiked above 0. A positive Differential reading means the SPX has underperformed expectations over the last few days. So net expectations are bullish and the SPX is oversold versus recent expectations. Historically this configuration has provided a bullish edge. Bullish configurations are visible on the chart whenever both lines close above 0. This caused the Aggregator System to change from short to long at the close. This was shown on the systems page shortly before the bell.

The short-term Active List is again light on studies. Activity on Thursday and the studies that arise from it will have a strong impact on the Aggregator value. If no new studies arise then the Aggregator Line would remain positive based on the intermediate-term studies. Meanwhile the Differential Pivot will be 1,258.65 on Thursday. This is 2.4% above Wednesday's close. So for the Differential Line to drop back to negative it would take a rally of at least this much. That will likely require more than 1 day.

Wednesday's selloff was strong enough by several measures that it would typically be followed by a bounce. The caveat is that it originated from a relatively high level. Had it come from a 5-day low or after an extended down move, then the reliability and potential

upside of that bounce would be significantly greater. I think it is worth a shot with a small position on the long side. If we get another strong day of selling on Thursday then I will begin to ramp up my position size.

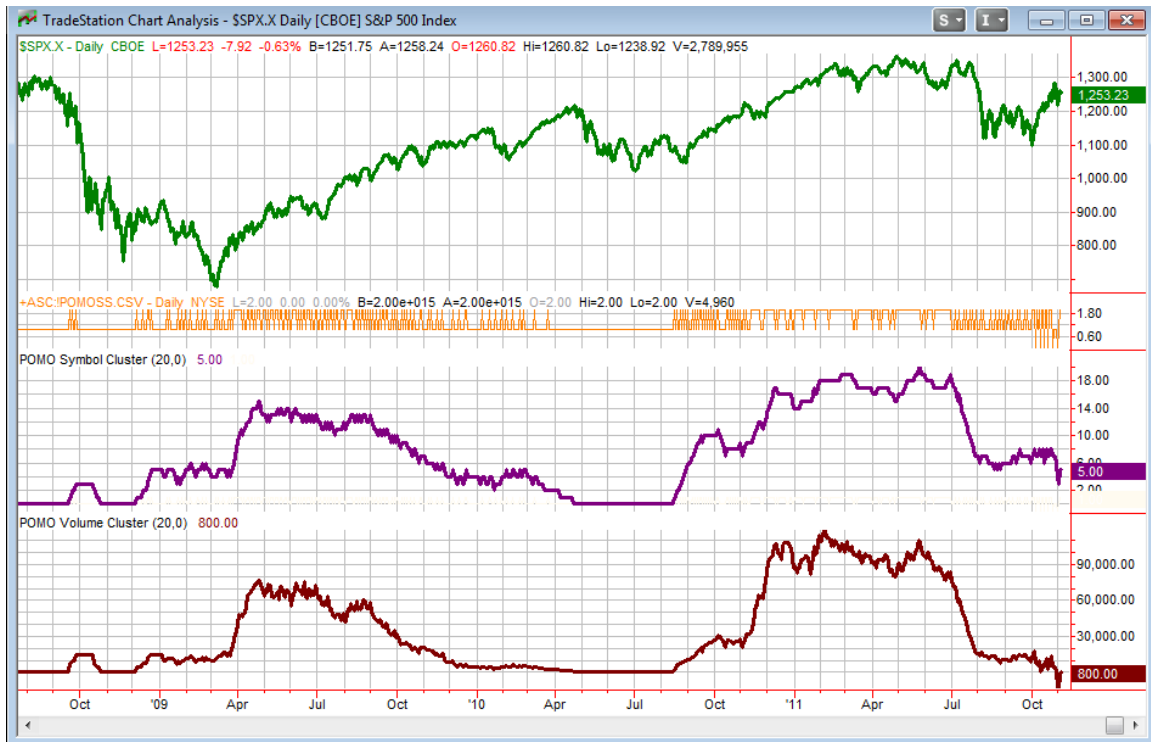
Intermediate-term Outlook (2 weeks – 2 months)– updated 11/7 – bullish

After 4 strong weeks in a row the market suffered its first down week. At this point it just appears to be a pause in the move higher, as most of the intermediate-term evidence remains positive.

I do have some concern with the POMO action, though. 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 net rolling number of days in the last 20 that have been POMO days. In other words, a day the Fed buys on the market will add +1 while a day of selling will count as -1. The bottom pane is the total amount of money infused into (or taken out of) 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>



Again this past week we saw 2 days of buying and 1 day of selling activity from the Fed. But as has been the case recently, selling days when the Fed drains liquidity from the system have been larger than buying days where they inject liquidity. The net result over the last 4 weeks is a very mild positive number. And for the 1st time since Spring 2008 the net number went negative briefly this past week.

There was a strong thrust in the market that began at basically the same time as Operation Twist. At this point it is becoming clear that Operation Twist will not provide a liquidity injection similar to QE1 or QE2. The net numbers may actually be negative. If that turns out to be the case, POMO activity could end up as a strong negative influence on the market. I'll continue to monitor the situation closely.

Overall there still appears to be more favoring the bulls at this point than the bears. I'm currently considering POMO activity as neutral. Bears can look to our SPX/TNX study from last week to support their case. Bullish evidence is based on price and breadth thrusts from a few weeks ago as well as the positive aspects of the IBD Follow Through Day in October. I think this rally has further to go, and we will soon be entering a very bullish time of year for the market. So as I mentioned above, I'm more inclined to favor longs than shorts. I also may look to hold some longs 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.

SPY – buy ¼ index position at \$123.16 LIMIT. This is based on the short-term outlook above. I will look to begin building a long position.

SPY – buy ¼ index position at \$120.69 LIMIT ON CLOSE. Another day of strong selling would surely trigger more bullish evidence. Should SPY close down 2% or more I will look to take on this 2nd lot.

Current Open Trade Ideas

Symbol	Entry Date	Entry Price	Current Price	% Gain/Loss	Stop	Notes
HNZ	11/7/2011	\$52.65	\$52.60	-0.09%		system 90609
<i>SPY (1/4)(s)</i>	<i>11/8/2011</i>	<i>\$126.92</i>	<i>\$125.25</i>	<i>1.32%</i>		<i>covered on stop</i>

My intraday stop placement on Wednesday was unfortunate as I did not benefit from the afternoon selling, just the morning.

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