

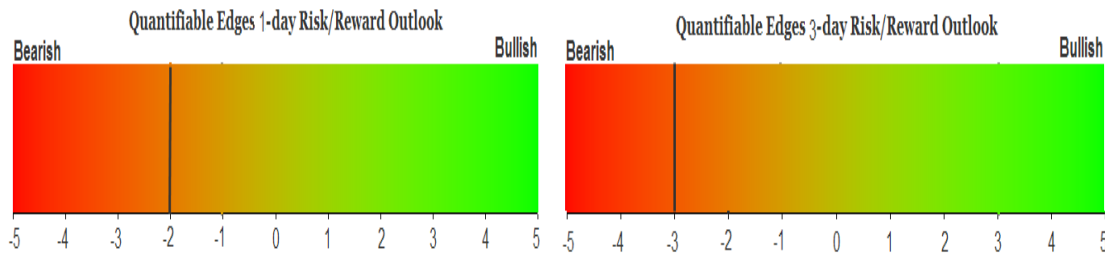
# QUANTIFIABLE EDGES SUBSCRIBER LETTER

ASSESSING MARKET ACTION WITH INDICATORS AND HISTORY

January 25, 2012

Volume 5 Issue 16

## Market Overview



## Signals Overview

Aggregator	Aggressive VIX	QE Buy Pwr Swing	NDX Trend Timer
Short	100% Short SPY	Flat	Long

## Tonight's Research Points

- SPX dips after 5 up days and a 50-day high are often followed by a move higher.
- SPX dips after 50-day highs that come on very low volume often continue to sell off.
- When the SPX closes near a 50-day high just before a Fed Day, Fed Days have not shown their typical bullish inclinations.

## Short-term Outlook

### The Bottom Line

There still appears to be an edge to the short side, but risks are a bit elevated. I continue to hold a small short position and will take profits on Wednesday if the market posts a solid down day.

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

Study Date	Description	Time span	Bias	Avg Max Move
<b>Active</b>				
January 24, 2012	SPX 50-high. VIX up.	1-2 days	Bearish	
January 23, 2012	SPX up 1%-2% op-ex week	1-4 days	Bearish	
January 20, 2012	Op-ex Thursday closes near high	1-4 days	Bearish	-1.60%
<b>Active - Long Term</b>				
January 17, 2012	Nasdaq leading SPX	int term	Bullish	
December 5, 2011	POMO activity flat to negative	int term	Bearish	
October 19, 2011	FTD on strong breadth/20day high	int term	Bullish	
<b>Dropped Tonight</b>				
January 23, 2012	Up 3. 50-high. Vol up at least 3.	1-2 days	Bullish	

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

## The Evidence

Tight trading again led to mixed results on Tuesday. The SPX fell 0.1% while the Nasdaq rose 0.1% and the Russell 2000 gained 0.7%. Breadth finished mildly positive as the NYSE Up Issues % came in at 53% and the Up Volume % was 52%. Total NYSE volume came in at the lowest level in 2 weeks.

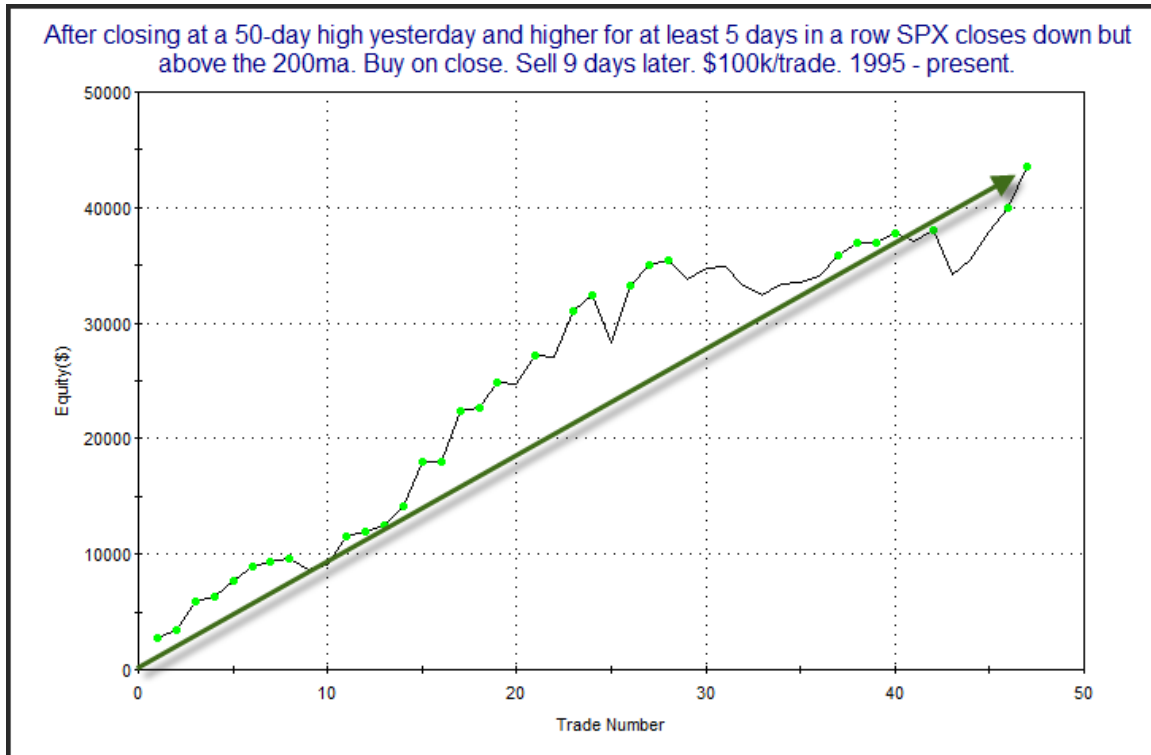
When I give talks about trading and quantitative analysis, one point I always stress is the importance of market position when evaluating a pattern's meaning. A large move at a 50-day high will often suggest something much different than a similar move that takes place at a 50-day low. In looking at tonight's Quantifinder I was reminded of this simple lesson over and over. Many of the studies actually offset each other because of either the market's current position (near a 50-day high, above the 200ma, etc.) or for other reasons (like volume). In the end the mild move on Tuesday doesn't seem to be suggesting any very strong edges, but I learned some interesting things when examining the action. If you're interested in what I learned, keep reading. If not, you may skip down to the Aggregator chart to see the current net results of the Active Studies.

There were a few studies that looked at pullbacks from 50-day highs as we experienced on Tuesday. The one below was last seen in the 1/31/11 letter. It considered what happens after the market has made a persistent move higher to a 50-day high. The persistency in this case is defined by 5 or more higher closes. Results below are updated.

After closing at a 50-day high yesterday and higher for at least 5 days in a row SPX closes down but above the 200ma. Buy on close. Sell X days later. \$100k/trade. 1995 - present.												
X Days	All: Net Profit	All: Total Trades	All: Winning Trades	All: Losing Trades	All: % Profitable	All: Avg Winning Trade	All: Max Winning Trade	All: Avg Losing Trade	All: Max Losing Trade	All: Win/Loss Ratio	All: ProfitFactor	All: Avg Trade
10	43,450.00	44	35	9	79.55	1,559.90	5,131.35	-1,238.51	-3,672.90	1.26	4.90	987.50
9	43,486.77	47	38	9	80.85	1,517.59	5,023.20	-1,575.73	-4,151.40	0.96	4.07	925.25
8	36,355.30	48	32	16	66.67	1,746.14	4,878.08	-1,220.06	-4,874.10	1.43	2.86	757.40
7	30,700.05	49	31	18	63.27	1,672.89	3,874.76	-1,175.52	-3,912.48	1.42	2.45	626.53
6	30,742.47	51	33	18	64.71	1,516.94	4,307.20	-1,073.14	-3,637.71	1.41	2.59	602.79
5	23,315.35	51	32	19	62.75	1,263.24	4,252.50	-900.43	-2,466.75	1.40	2.36	457.16
4	22,571.74	51	31	20	60.78	1,265.86	3,843.00	-833.50	-3,003.39	1.52	2.35	442.58
3	11,924.02	51	31	20	60.78	943.87	2,472.85	-866.80	-1,992.34	1.09	1.69	233.80
2	13,054.23	51	33	18	64.71	855.46	2,437.50	-843.10	-2,614.95	1.01	1.86	255.97
1	6,784.28	51	31	19	60.78	561.91	1,751.19	-559.73	-1,744.10	1.00	1.64	133.03

**44 of 51 instances (86%) posted a close above the entry price at some point in the next week.**

These results suggest a decent edge that gets stronger and more consistent as you look out over the next several days. Below is an equity curve that assumes a 9-day holding period.



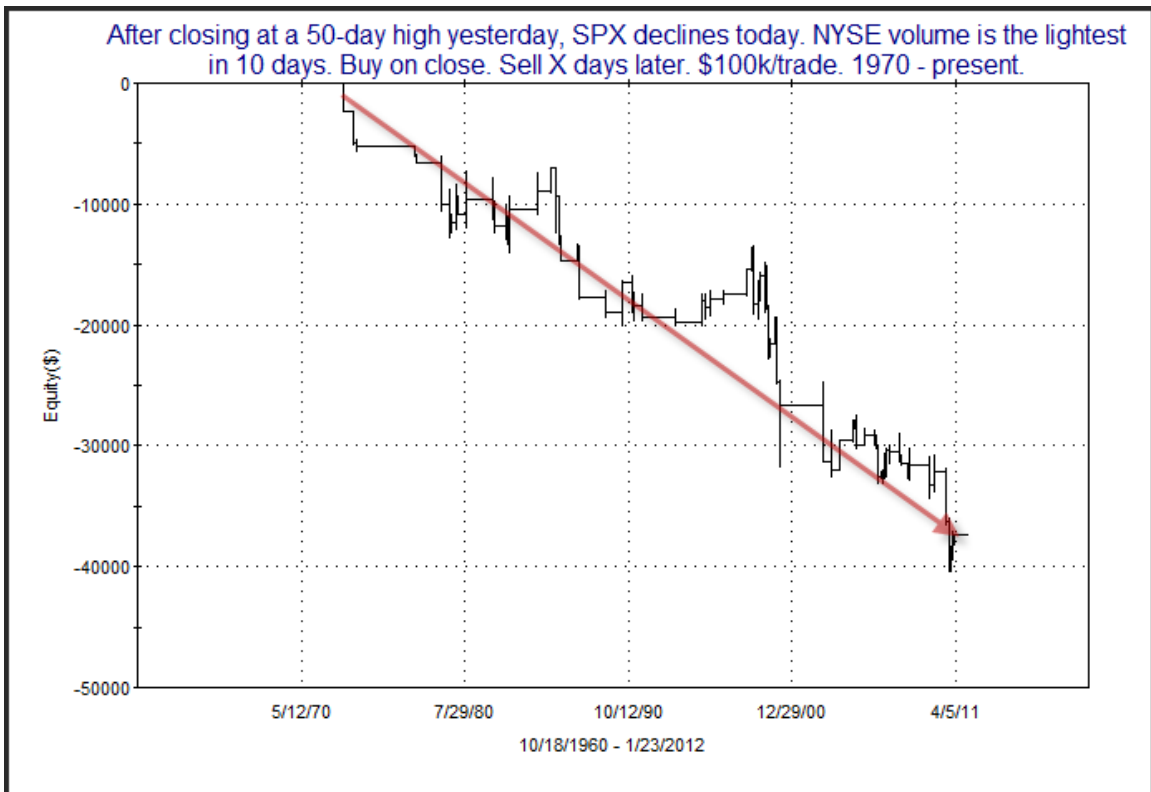
The strong upslope serves as confirmation of the bullish edge.

But while the persistent move up helped identify a bullish inclination, the low volume on Tuesday was worrisome. It triggered the following study, which was last seen in the 2/3/11 letter. I have also updated these stats.

After closing at a 50-day high yesterday, SPX declines today. NYSE volume is the lightest in 10 days. Buy on close. Sell X days later. \$100k/trade. 1970 - present.

X Days	All: Net Profit	All: Total Trades	All: Winning Trades	All: Losing Trades	All: % Profitable	All: Avg Winning Trade	All: Max Winning Trade	All: Avg Losing Trade	All: Max Losing Trade	All: Win/Loss Ratio	All: ProfitFactor	All: Avg Trade
10	-21,088.52	58	31	27	53.45	1,760.92	5,104.00	-2,802.86	-6,121.74	0.63	0.72	-363.60
9	-18,573.19	58	30	28	51.72	1,772.12	3,955.23	-2,562.02	-6,236.87	0.69	0.74	-320.23
8	-28,841.03	58	28	30	48.28	1,514.30	3,521.07	-2,374.72	-6,661.66	0.64	0.60	-497.26
7	-36,537.45	58	27	31	46.55	1,363.16	3,732.48	-2,365.90	-7,193.64	0.58	0.50	-629.96
6	-37,369.40	59	26	33	44.07	1,172.57	2,563.47	-2,056.25	-5,426.99	0.57	0.45	-633.38
5	-25,608.50	60	28	32	46.67	978.77	2,273.04	-1,656.69	-4,288.68	0.59	0.52	-426.81
4	-20,097.84	62	31	31	50.00	901.80	2,457.84	-1,550.12	-4,263.60	0.58	0.58	-324.16
3	-4,018.83	63	34	29	53.97	909.38	2,169.48	-1,204.75	-3,726.24	0.75	0.88	-63.79
2	-1,544.50	63	32	31	50.79	792.58	2,328.05	-867.97	-4,049.40	0.91	0.94	-24.52
1	-4,630.70	63	32	31	50.79	535.74	2,235.13	-702.40	-3,068.81	0.76	0.79	-73.50

The first few days don't show a huge edge but once you get out 6-7 days there appears to be a possible downside inclination. To confirm this I took a look at the equity curve. In this case I decided to show time on the x-axis rather than instances to demonstrate how consistent the edge has been over the years.



For a study without strongly lopsided results the steadiness is very impressive.

So the persistence suggests a move back up but the volume says down more. It appears to be a bit of a wash. What if I combined the 2 and looked for low volume on the pullback after 5 higher closes and a 50-day high? This is shown below.

After closing at a 50-day high yesterday and higher for at least 5 days in a row, SPX closes down but above the 200ma. NYSE volume is the lightest in 10 days. Buy on close. Sell X days later. \$100k/trade. 1995 - present.												
X Days	All: Net Profit	All: Total Trades	All: Winning Trades	All: Losing Trades	All: % Profitable	All: Avg Winning Trade	All: Max Winning Trade	All: Avg Losing Trade	All: Max Losing Trade	All: Win/Loss Ratio	All: ProfitFactor	All: Avg Trade
10	3,628.80	8	5	3	62.50	1,524.73	3,047.22	-1,331.62	-2,058.21	1.15	1.91	453.60
9	4,212.54	8	5	3	62.50	1,572.72	3,955.23	-1,217.01	-1,905.12	1.29	2.15	526.57
8	5,890.01	8	5	3	62.50	1,797.09	3,521.07	-1,031.82	-2,151.36	1.74	2.90	736.25
7	3,795.66	8	5	3	62.50	1,606.18	3,732.48	-1,411.75	-3,617.46	1.14	1.90	474.46
6	-130.50	8	5	3	62.50	984.37	1,500.12	-1,684.12	-3,637.71	0.58	0.97	-16.31
5	-240.71	8	5	3	62.50	558.95	1,609.05	-1,011.82	-2,065.50	0.55	0.92	-30.09
4	-50.71	8	4	4	50.00	745.90	1,638.80	-758.58	-1,947.24	0.98	0.98	-6.34
3	16.01	8	4	4	50.00	476.28	730.15	-472.27	-786.51	1.01	1.01	2.00
2	1,065.65	8	3	5	37.50	845.29	1,258.74	-294.04	-582.33	2.87	1.72	133.21
1	-851.95	8	3	5	37.50	275.58	665.82	-335.74	-797.85	0.82	0.49	-106.49

Instances are low but they sure appear to be simply canceling each other out so far.

In last night's letter I mentioned that Fed Days typically carry a bullish edge, but that edge failed to hold when the SPX closed at a 20-day high just prior to the Fed Day. By closing down 0.1% Tuesday the SPX narrowly missed closing at a 20-day high.

A theory behind the Fed Day edge is that the Fed is able to exert a strong influence on the market for at least the announcement day. The optimism that is often seen around Fed Days is desired, and that is especially true during uncertain times. The Fed often tries to carefully balance economic expectations through both monetary policy and their statements. They don't want panic to ensue during difficult times and they don't want the economy to overheat during good times. During good times they will focus more on risks in their statements and will keep a bit of a lid on the excitement. During tough times they will focus more on positives. A panicky public is not good for either the market or the economy so they will act as the voice of reason when it appears panic may set in. And during those times when it seems neither overheating nor panicking is much of a danger, they simply look to instill confidence. Confidence in the economy, the market, the government, and their own abilities.

So when is the market least in need of a confidence boost? I'd say when it is already trading at (near?) an intermediate-term high. And that is something we saw with the 20-day high filter. But are we now safe because the market just missed a new high by 0.1%? I suspected not. And so I ran the below test. Since we are at a 50-day high I used that as the filter rather than a 20-day high. I looked at times where the SPX did NOT close at a 50-day high, but in fact closed less than 0.5% below it. So although it is not a new high, the environment still appears generally positive. Let's look at the results.

Tomorrow is a Fed Day. SPX closes below a 50-day high, but by less than 0.5%.  
Buy on close. Sell Fed Day close. \$100k/trade. 1982 - present.

TradeStation Performance Summary <span style="float: right;">Collapse ^</span>			
All Trades			
Total Net Profit	(\$112.21)	Profit Factor	0.99
Gross Profit	\$8,904.54	Gross Loss	(\$9,016.75)
Total Number of Trades	25	Percent Profitable	48.00%
Winning Trades	12	Losing Trades	13
Even Trades	0		
Avg. Trade Net Profit	(\$4.49)	Ratio Avg. Win:Avg. Loss	1.07
Avg. Winning Trade	\$742.05	Avg. Losing Trade	(\$693.60)
Largest Winning Trade	\$1,820.44	Largest Losing Trade	(\$2,267.20)

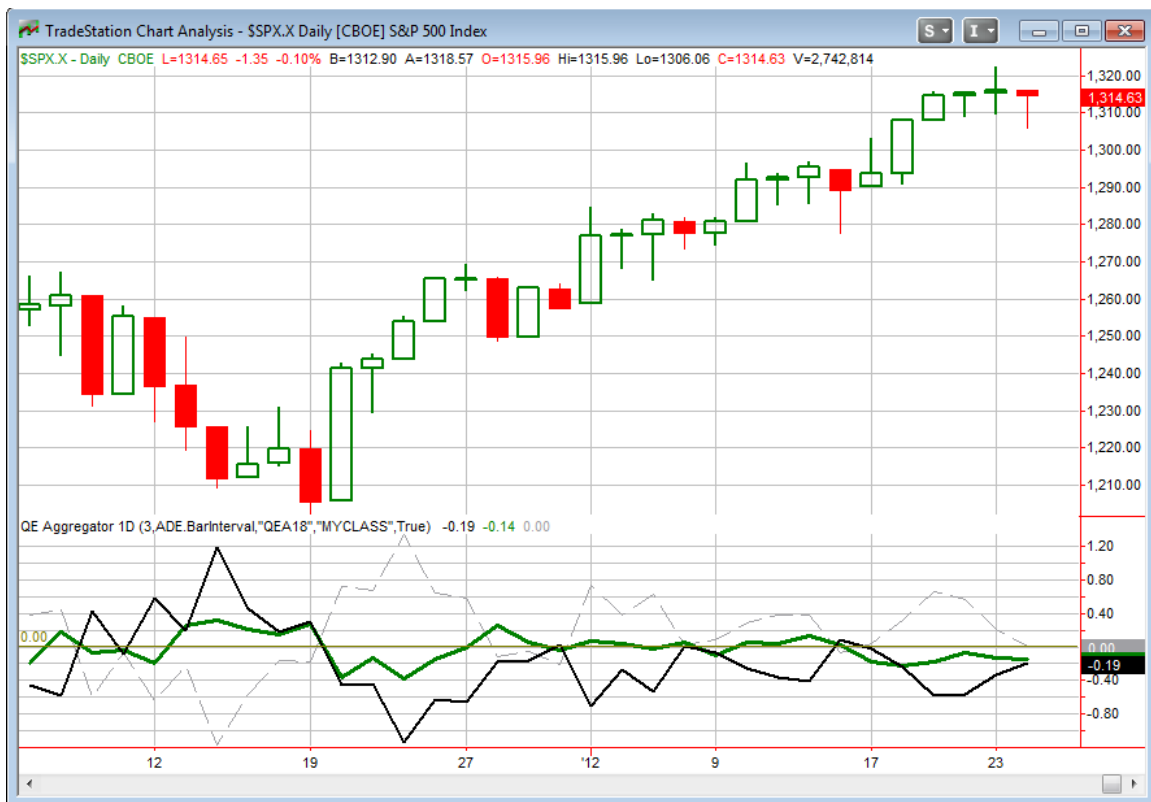
Twenty-five instances and the result is nearly dead-even. With the SPY also closing in the upper-end of its range, I'm not viewing tomorrow as a typical strongly-bullish Fed Day, but see it more as a crap-shoot.

Not only is the market full of conflict and uncertainty at the moment, but it appears primed for a big move. The 3/10 Offset HV indicator, viewable on the charts page and available for download as part of the QE Indicators and Functions for Tradestation, is now very low.

I first introduced this indicator in July of 2009. It essentially takes a short 3-day measure of Historical Volatility and compares that to the 10-day measure of 3-days ago. Low readings indicate there has been a contraction in volatility. High numbers indicate there has been an expansion. Anything at or below 0.25 is regarded as extremely low. Often after sharp contractions like this we see a volatility expansion take place. Sometimes I

will look to daytrade Opening Range Breakouts (ORBs) when the 3/10 Offset HV gets very low. With tomorrow being a Fed Day that will not be a focus of mine. My primary purpose of pointing out the low reading tonight is simply to make readers aware of the possibility of a strong move, so that they be prepared if it occurs – either for them or against them. And at the least traders should understand that the low 3/10 Offset HV suggests the market is now carrying more risk than usual.

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



Yet again bearish studies remain in control and the green Aggregator line is 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 below 0. A negative Differential reading means the SPX has outperformed expectations over the last few days. So net expectations are bearish and the SPX is still overbought versus recent expectations. This is considered a bearish configuration. Bearish configurations are visible on the chart whenever both lines close below 0. This caused the Aggregator System to remain short. This was indicated as likely on the systems page before the close.

Based on the current active studies, expectations are scheduled to remain negative on Wednesday. But evidence is starting to wane as studies are expiring and it won't take much to flip expectations positive. Meanwhile, the Differential Pivot will be 1,309.13 on Wednesday. This is 0.4% below Tuesday's close. So it will take a drop of at least this much in order for the Differential Line to turn positive.

I'm still holding some small short positions. My outlook remains negative but I will likely take quick profits Wednesday if the market finally puts in a decent down day. I am not looking to add more exposure at this time. The uncertain news environment (Fed Day) and low 3/10 Offset HV are raising risk to a level where I am not inclined to get aggressive.

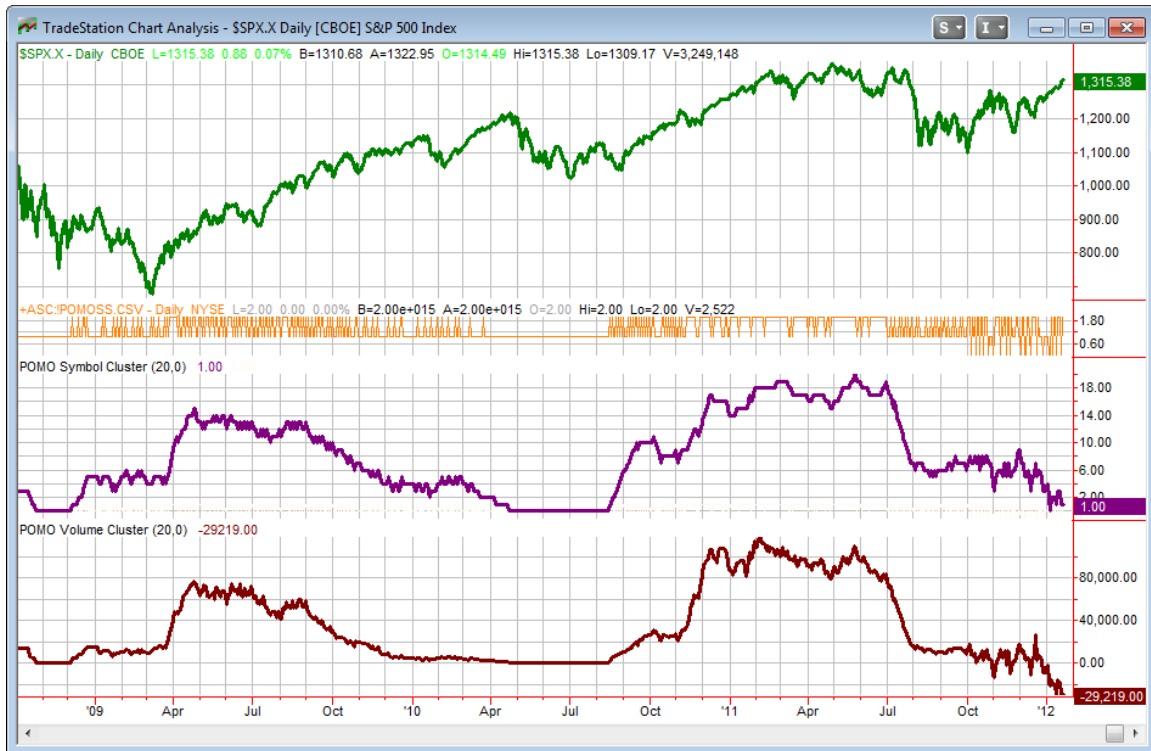
***Intermediate-term Outlook (2 weeks – 2 months)– updated 1/23 – bullish***

The SPX again hit new rally highs this week as it posted a rare all-up op-ex week. Despite overbought readings and bearish short-term studies the long-term trend and momentum pushed forward. Both continue to look good.

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 3<sup>rd</sup> POMO presentation linked below. (Not available for trial users.)*

<http://www.quantifiableedges.com/members/pomo.php>



For the first time in five weeks POMO numbers showed net gains. The fed added about \$5.9 billion to the system. But because an even bigger week came off the back end of our POMO indicator calculations, we are still seeing strongly negative net volume over the last 20 days. This should flip this upcoming week as several negative and neutral days will be falling out of the calculation and several positive days are scheduled.

The negative POMO numbers are running out of time to exhibit a bearish impact on the market. If the market can continue to rally despite all the negative readings we've seen in the last few weeks then that could be a very bullish sign. It has been several years since the market has managed to rally strongly without the aid of liquidity inflows from the Fed. The rest of January is slated to see primarily POMO buying, and that could aid in helping the market continue to rally higher over the next few weeks.

So the intermediate-term still appears to be looking up. The SPX again made new rally highs. The Nasdaq is still in a leadership position, and there also appears to be strong upside momentum with a POMO tailwind just begun. So my outlook remains bullish. From a trading standpoint this simply means I will take a more aggressive approach with longs than with shorts.

## **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**

<b>Symbol</b>	<b>Entry Date</b>	<b>Entry Price</b>	<b>Current Price</b>	<b>% Gain/Loss</b>	<b>Stop</b>	<b>Notes</b>
SPY(1/4)(s)	1/19/2012	\$131.22	\$131.46	-0.18%		Aggregator
DIA(s)	1/23/2012	\$126.96	\$126.43	0.42%		System -80514

*I will cover my SPY if SPX closes  $\leq$  1,309.13 (the Differential Pivot).*

*I will cover DIA on a close  $<$  \$125.51 as per the system -80514 rules.*

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