

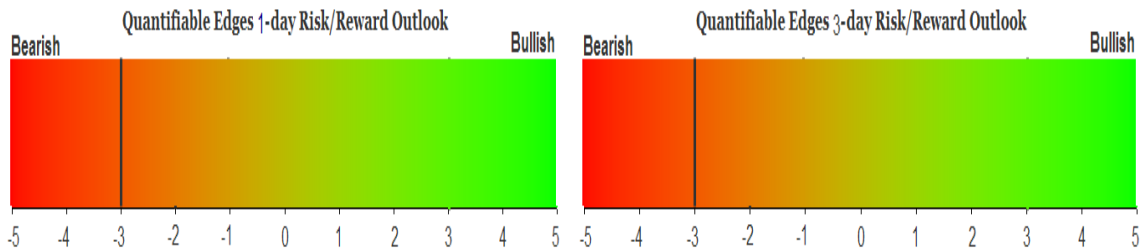
QUANTIFIABLE EDGES SUBSCRIBER LETTER

ASSESSING MARKET ACTION WITH INDICATORS AND HISTORY

February 22, 2012

Volume 5 Issue 35

Market Overview



Signals Overview

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

Tonight's Research Points

- The SPY gap and partial reverse pattern over the last few days have always led to higher prices a week later.
- The rising VIX with the SPX closing at a 50-day high appears to suggest a downside edge.
- The low VIX:VXV ratio at a 50-day SPX high suggests downside risk outsizes upside reward for the following day.

Short-term Outlook

The Bottom Line

The market is strongly overbought and short-term evidence favors the bears. I have some short exposure to try and take advantage of the apparent downside edge. I may add to that short exposure on Wednesday if we get a “gift” higher open.

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

Study Date	Description	Time span	Bias	Avg Max Move
Active				
February 22, 2012	SPX 50 high. VIX:VXV < 0.85	1 day	Bearish	
February 22, 2012	SPX 50-day high. VIX up.	1-2 days	Bearish	
February 22, 2012	SPY gap up close < open & > yest > 200	1-5 days	Bullish	2.10%
February 21, 2012	SPX gains 1%-2% op-ex week. SPX > 200	1-5 days	Bearish	
February 21, 2012	SPY 2 50-highs on lower volume	1-2 days	Bearish	
February 17, 2012	Top 10% of 10-day range before opex	1-4 days	Bearish	
February 15, 2012	Unfill gap up. 20-high. Unfill gap dn.	1-6 days	Bearish	-1.40%
February 14, 2012	20-high. Gap down. Gap up.	1-6 days	Bearish	-1.90%
Active - Long Term				
February 6, 2012	Up Issues % > 75% 2 of 3. 10 high.	1-16 days	Bullish	4.70%
February 1, 2012	Golden Cross	int term	Bullish	
January 31, 2012	SPY 1st close < 10ma in over 25 days	1-20 days	Bullish	4.70%
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	
Dropped Tonight				
February 13, 2012	60-day low SPY range. Close > 200ma	1-6 days	Bearish	-2.15%

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

The Evidence

A morning rally gave way to an afternoon fade and then a late bounce left the market with a mixed finish. The SPX gained 0.1% but the Nasdaq lost 0.1% and the Russell 2000 fell 0.7%. Breadth was also mixed as the NYSE Up Issues % came in at 49.5% and the Up Volume % was 51%. Total NYSE volume dipped from Friday's level.

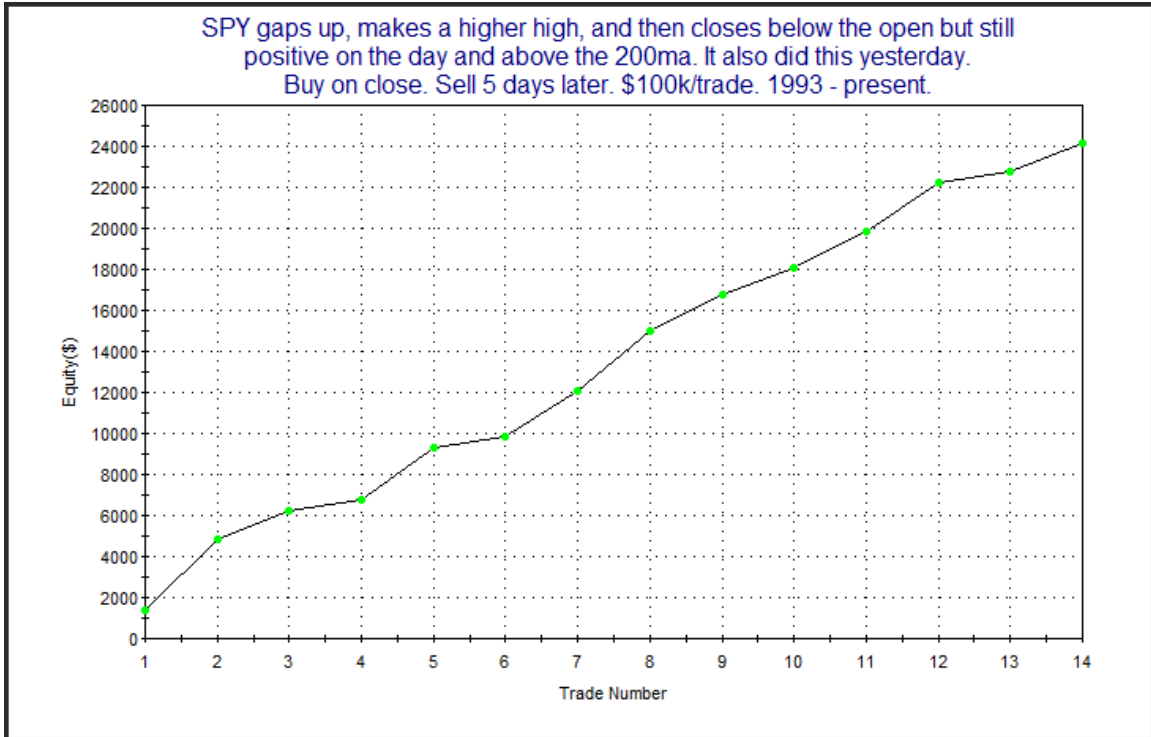
The pattern of the last 2 days is a rare and interesting one. Both days had a gap higher, a move up above the previous day's high, and then a reversal that led the SPY to close below its open but still in positive territory. I looked at this 2-day setup in the 12/30/10 subscriber letter using a long-term trend filter. I have updated that study below.

SPY gaps up, makes a higher high, and then closes below the open but still positive on the day and above the 200ma. It also did this yesterday. 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: Max Winning Trade	All: Avg Losing Trade	All: Max Losing Trade	All: Win/Loss Ratio	All: ProfitFactor	All: Avg Trade	
5	24,142.30	14	14	0	100.00	1,724.45	3,458.95	0.00	0.00	100.00	100.00	1,724.45	
4	17,654.70	14	12	2	85.71	1,543.72	3,132.80	-434.94	-813.74	3.55	21.30	1,261.05	
3	15,110.99	14	10	4	71.43	1,579.79	3,282.40	-171.73	-296.74	9.20	23.00	1,079.36	
2	11,974.49	14	11	3	78.57	1,250.95	2,640.00	-595.33	-855.50	2.10	7.70	855.32	
1	8,751.50	16	13	3	81.25	776.03	2,570.70	-445.65	-721.00	1.74	7.55	546.97	

Only 14 instances but the results are overwhelmingly positive. Below are all 14 instances listed using a 5-day exit strategy.

SPY gaps up, makes a higher high, and then closes below the open but still positive on the day and above the 200ma. It also did this yesterday. Buy on close. Sell 5 days later. \$100k/trade. 1993 - present.				
Date/Time	Signal	Price	% Profit	Run-up Drawdown
04/19/96	Buy	\$64.54	1.39%	\$1,967.23
04/26/96	Sell	\$65.44		\$0.00
11/28/97	Buy	\$95.63	3.46%	\$3,521.65
12/05/97	Sell	\$98.94		\$0.00
11/05/99	Buy	\$137.88	1.36%	\$1,522.50
11/12/99	Sell	\$139.75		(\$1,305.00)
12/10/99	Buy	\$141.88	0.57%	\$1,006.72
12/17/99	Sell	\$142.69		(\$1,302.40)
12/17/99	Buy	\$142.69	2.52%	\$2,863.00
12/27/99	Sell	\$146.28		(\$1,120.00)
07/13/00	Buy	\$149.78	0.57%	\$1,467.40
07/20/00	Sell	\$150.63		(\$1,020.51)
05/24/04	Buy	\$110.27	2.21%	\$2,500.56
06/01/04	Sell	\$112.71		(\$607.02)
11/02/04	Buy	\$113.55	2.93%	\$3,599.20
11/09/04	Sell	\$116.88		\$0.00
01/26/05	Buy	\$117.23	1.74%	\$2,013.08
02/02/05	Sell	\$119.27		(\$528.86)
01/25/06	Buy	\$126.66	1.37%	\$1,696.35
02/01/06	Sell	\$128.39		\$0.00
03/30/07	Buy	\$142.00	1.72%	\$1,971.20
04/09/07	Sell	\$144.44		(\$781.44)
03/03/10	Buy	\$112.30	2.38%	\$2,652.20
03/10/10	Sell	\$114.97		(\$240.30)
12/14/10	Buy	\$124.67	0.58%	\$641.60
12/21/10	Sell	\$125.39		(\$737.84)
12/29/10	Buy	\$125.92	1.37%	\$1,429.20
01/05/11	Sell	\$127.64		(\$468.46)
The Average Run-up was 2.1% while the MAX Drawdown was 1.3% and the Average Drawdown was 0.6%.				

Not only has the setup consistently been followed by gains, risk/reward has strongly favored the bulls. And the consistency of the gains can easily be seen by examining the profit curve below.



It looks almost like a straight shot, which adds confidence in the edge despite the somewhat low number of instances.

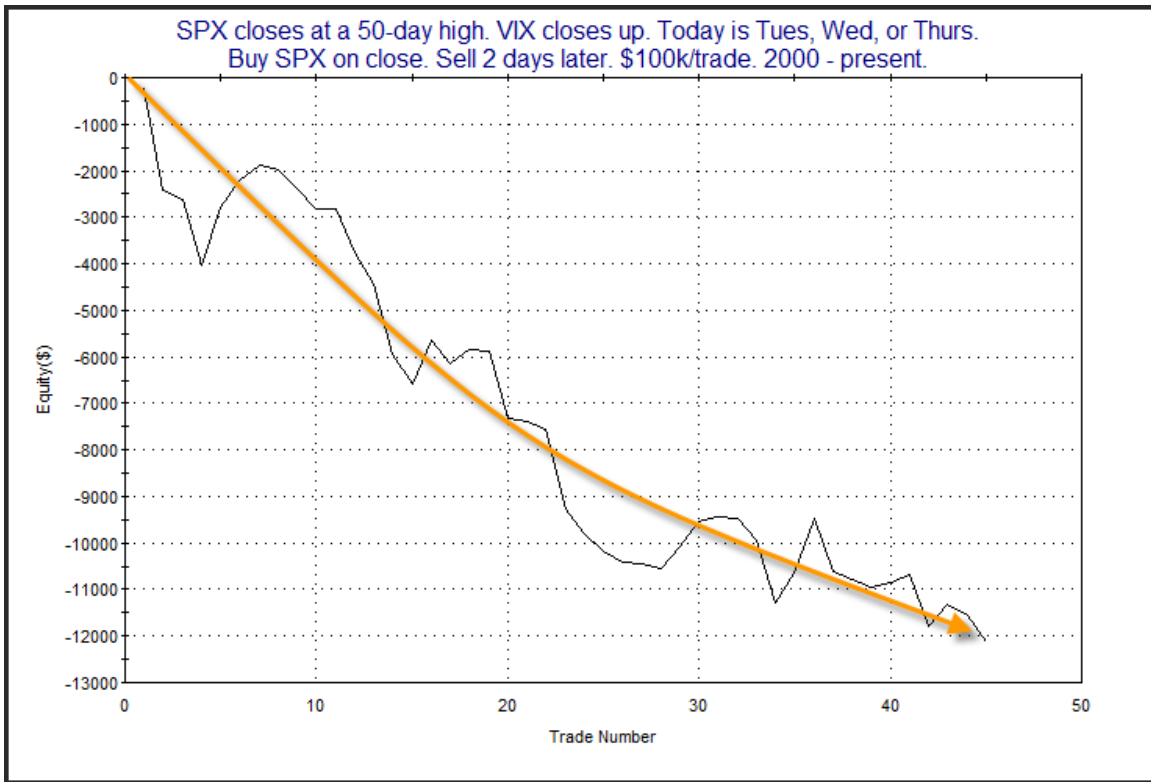
On the bearish side, VIX action seemed to suggest a pullback in the next 1-2 days could be in the making. The study below was last seen in the 1/12/12 subscriber letter. I have updated the results.

SPX closes at a 50-day high. VIX closes up. Today is Tues, Wed, or Thurs.
Buy SPX on close. Sell X days later. \$100k/trade. 2000 - 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
5	-8,531.27	42	21	21	50.00	724.67	2,108.40	-1,130.92	-4,116.72	0.64	0.64	-203.13
4	-7,320.79	44	19	25	43.18	704.70	1,629.60	-828.40	-2,917.76	0.85	0.65	-166.38
3	-8,148.29	44	20	24	45.45	514.62	1,315.00	-768.36	-2,091.82	0.67	0.56	-185.19
2	-12,111.62	45	13	32	28.89	546.64	1,223.00	-600.56	-2,182.68	0.91	0.37	-269.15
1	-11,027.63	52	21	31	40.38	260.88	1,108.05	-532.46	-1,721.70	0.49	0.33	-212.07

96% of instances posted a close below the entry price at some point in the next week.

Pullbacks of some kind have been quite reliable, with most of the damage occurring in the 1st two days. Below is an equity curve that shows how the edge has played out over time.



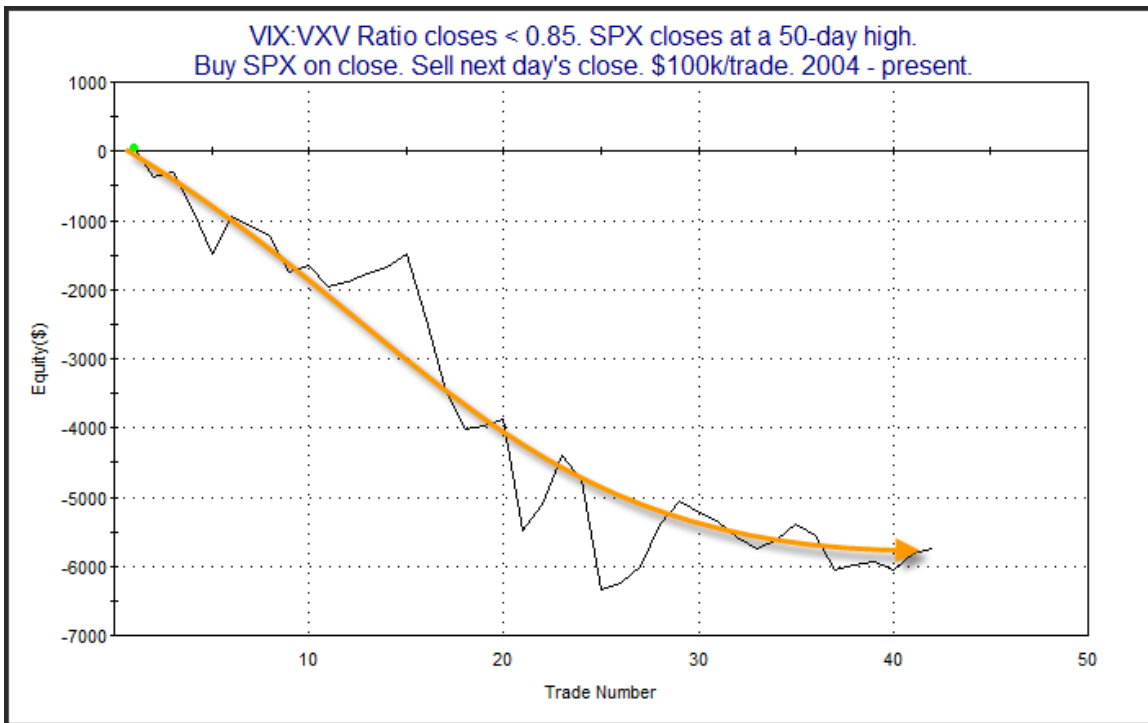
The fairly steady decline seems to support the idea of a short-term downside edge.

And once again the study below triggered – now for the 3rd night in a row. It looks at instances of the SPX closing at a 50-day high while the VIX:VXV ratio was below 0.85. I have updated the results again below (but kept the comments the same).

VIX:VXV Ratio closes < 0.85. SPX closes at a 50-day high.
Buy SPX on close. Sell next day's close. \$100k/trade. 2004 - present.

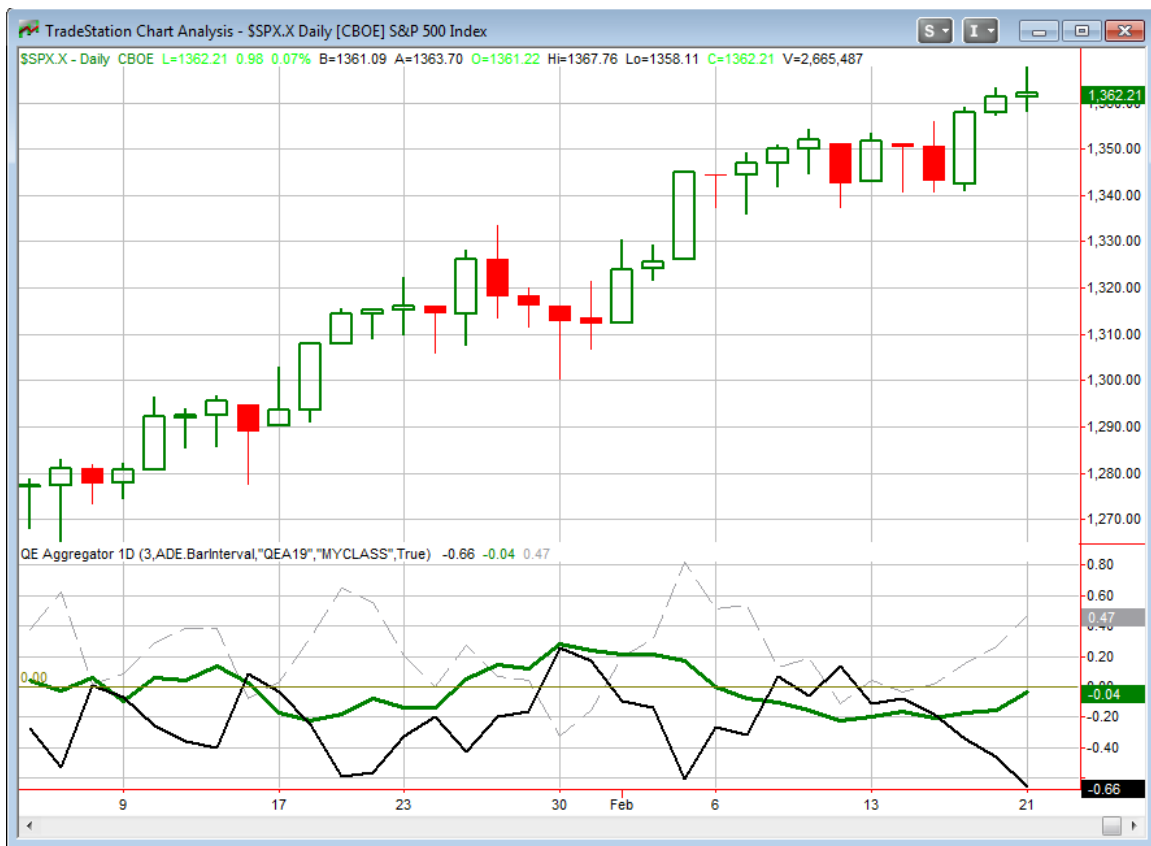
All Trades			
Total Net Profit	(\$5,739.30)	Profit Factor	0.44
Gross Profit	\$4,564.90	Gross Loss	(\$10,304.20)
Total Number of Trades	42	Percent Profitable	52.38%
Winning Trades	22	Losing Trades	20
Even Trades	0		
Avg. Trade Net Profit	(\$136.65)	Ratio Avg. Win:Avg. Loss	0.40
Avg. Winning Trade	\$207.50	Avg. Losing Trade	(\$515.21)
Largest Winning Trade	\$708.05	Largest Losing Trade	(\$1,602.28)

The odds are 50/50 but the losers have been more than twice the size of the winners. This suggests the complacency we are seeing at these high levels is more likely to lead to a big down day than be followed by a big up day. To see how the edge has played out over time I have posted the profit curve below.



The equity curve seems to have flattened out a bit lately. I noted last time that I was going to keep an eye on this one, and I will continue to do so. For now I find it compelling enough to keep under consideration.

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



With tonight's mix of studies factored in the green Aggregator line is now just slightly 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 now quite far 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 strongly 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 at the close. This was indicated on the Systems page before the bell.

Based on the current evidence expectations are scheduled to remain negative on Wednesday. This could change if more bullish evidence emerges. Meanwhile, the Differential Pivot will be 1,350.66 on Wednesday. This is 0.8% below Tuesday's close. So the SPX would need to close lower by at least this much in order to be considered oversold and have the Differential Line turn positive.

The short-term bullish study tonight was the first triggered in a while. And while the results were compelling, there is still ample evidence suggesting we could get a dip in the next few days. I have a small short position that has remained very close to my entry price the last couple of days. With the market now very strongly overbought versus expectations I have decided I will look to take on a 2nd lot if there is a large gap up. Otherwise I will simply maintain my small short position.

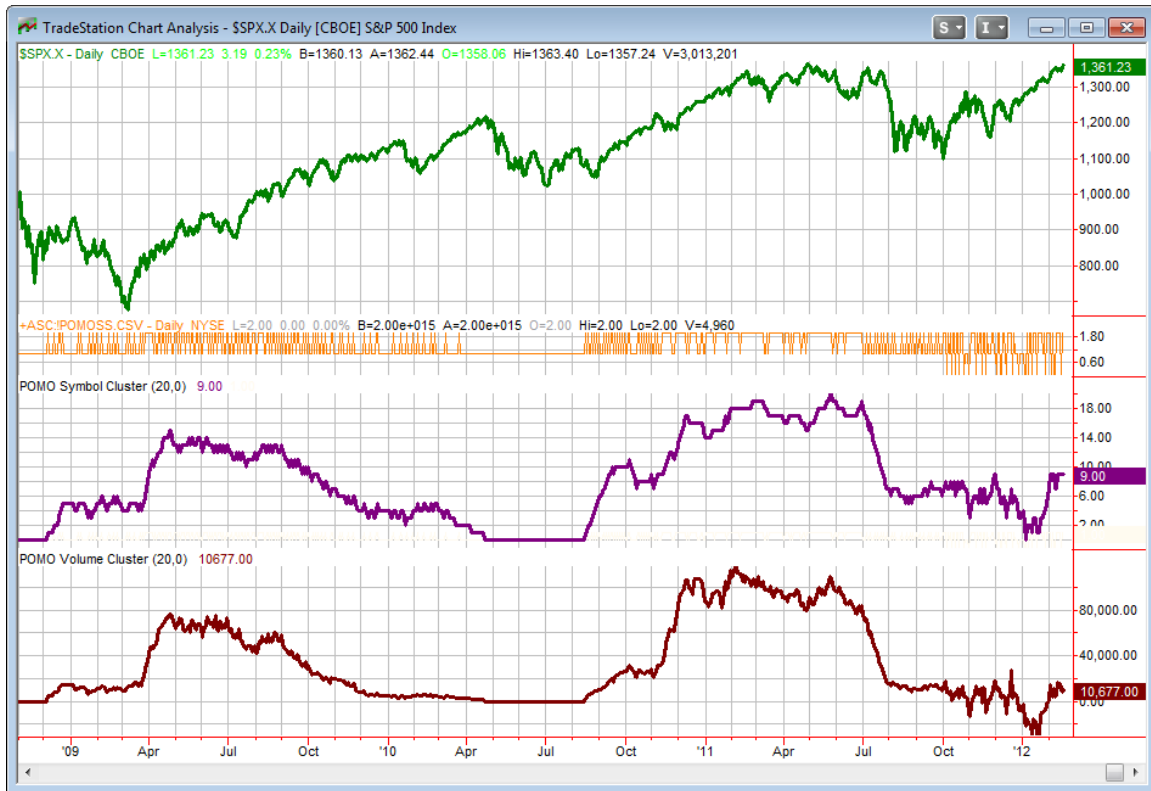
Intermediate-term Outlook (2 weeks – 2 months)– updated 2/21 – bullish

This past week saw the market post some solid gains and hit new highs. With new highs being reached on Friday the trend clearly remains up. And though the market looks susceptible to a short-term pullback there still appears to be ample evidence suggesting more upside over the intermediate-term. No new intermediate-term studies emerged in the last few days. The Active List here remains populated with studies seen in previous weeks.

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>



POMO numbers were strong this past week. There were 4 days of buying and 1 day of selling and the net over the week was about \$5 billion in buying. This kept the POMO indicators fairly flat as a similar week fell off the back end of the equations.

Thus upcoming week is expected to see strong POMO selling. There are 2 small buying days and 2 large selling days schedule that will result in a net sale of over \$14 billion in securities. This could have a negative short-term impact on the market. While the QE Buying Power Index is scheduled to post moderate values of “+1” all week, the strong selling days will actually mean negative volume. If there is an opportune time for the market to pull back with all the bearish studies already on board, this upcoming week would seem to be it.

So the intermediate-term still appears to be looking up. The SPX is in rally mode. We are still seeing studies related to momentum, trend, breadth, and Nasdaq leadership all point higher. Therefore, 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

FCX – 1/3 position @ \$42.40 limit (\$42.17 fill)

GILD– 1/3 position @ \$47.00 limit (\$46.50 fill)

New

GILD – buy 1/3 position @ \$44.69

Catapult for ETF's Trades

None

Broad Market Large Cap CBI – 3/2(FCX, GILD-2)

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.

GILD – buy 1/3 catapult position @ \$44.69 limit. This is a Catapult trade idea from above.

SPY – short 1/4 index position at \$137.07 LIMIT ON OPEN. If this is not filled at the open the order will be cancelled. This is based on the short-term outlook. The limit price is just above Tuesday's high. I anticipate strong morning excitement in an already overbought environment could provide a nice entry point to take advantage of the short-term downside edge suggested by the Aggregator. I'll only take this at the open, and will re-evaluate tomorrow night if not filled.

Current Open Trade Ideas

Symbol	Entry Date	Entry Price	Current Price	% Gain/Loss	Stop	Notes
FCX(1/3)	2/16/2012	\$42.17	\$43.95	4.22%	\$42.25	Catapult
SPY(1/4)(s)	2/17/2012	\$136.52	\$136.47	0.04%		Aggregator
GILD(1/3)	2/21/2012	\$46.50	\$44.69	-3.89%		Catapult

We have a small cluster of Catapult triggers now. Traders are encouraged to review the Catapult & CBI presentation available on the [videos page](#), and the Catapult Exit Designer package available on the [members downloads page](#) for more Catapult info.

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