

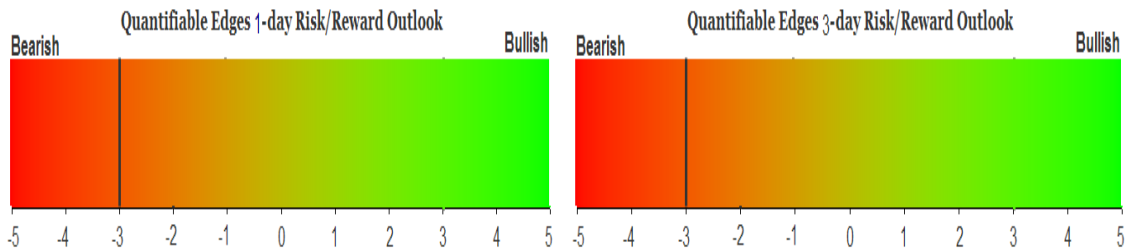
QUANTIFIABLE EDGES SUBSCRIBER LETTER

ASSESSING MARKET ACTION WITH INDICATORS AND HISTORY

February 27, 2012

Volume 5 Issue 38

Market Overview



Signals Overview

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

Tonight's Research Points

- Extremely low volume (NYSE and SPY) while the SPX is at a new high, suggests a short-term dip.
- VIX action is also suggesting a dip – both through the VIX:VXV ratio and Friday's VIX rally.

Short-term Outlook

The Bottom Line

A short-term selloff appears probable. This may only last 1-2 days. I am looking to take advantage of the potential dip with a small short position.

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

Study Date	Description	Time span	Bias	Avg Max Move
Active				
February 27, 2012	SPX & VIX up on Friday	1-3 days	Bearish	-1.30%
February 27, 2012	High close but lowest vol in 20 days	1-2 days	Bearish	-1.25%
February 24, 2012	SPY open < low 2 days ago. Close 50-hi	1-3 days	Bearish	-2.60%
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	
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	

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

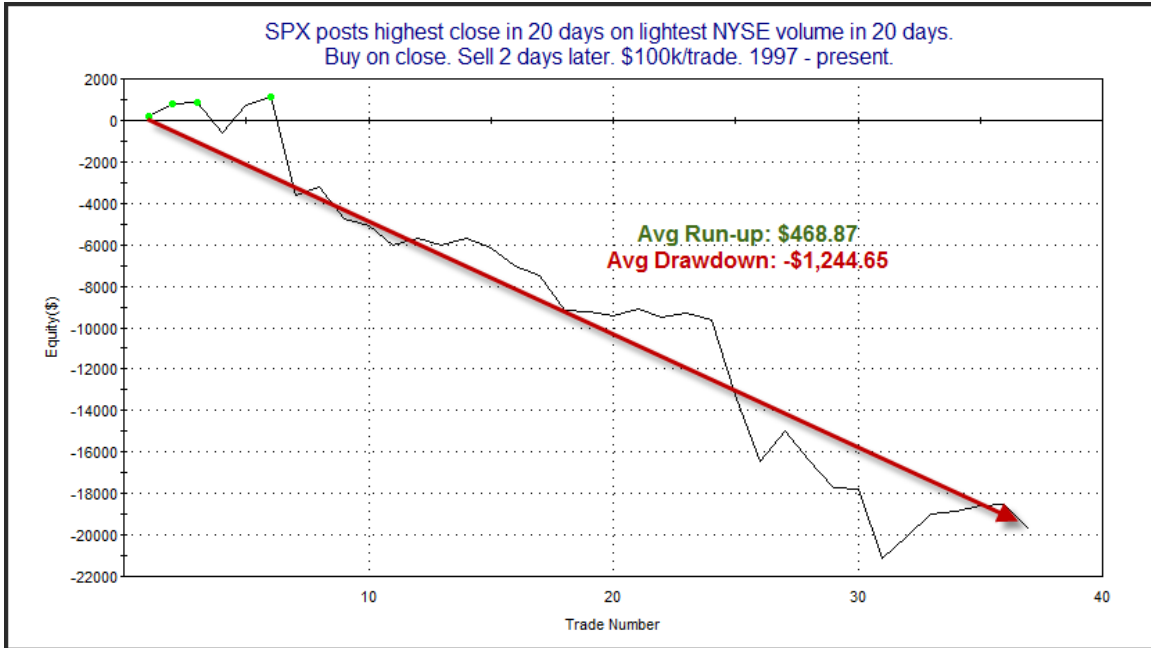
The Evidence

Trading was very quiet on Friday and the indices finished with mixed results. The SPX and the Nasdaq gained 0.2% while the Russell 2000 lost 0.3%. Breadth was mildly positive as the NYSE Up Issues % came in at 55% and the Up Volume % was 52%. Total NYSE volume came in at the lowest level in 2012.

Such low volume when the market is hitting new highs can often be a sign that the rally is tired and likely to pull back at least briefly. This was shown in several studies that appeared in the Quantifinder on Friday. The one below was last seen in the 10/17/11 subscriber letter. Results are updated.

SPX posts highest close in 20 days on lightest NYSE volume in 20 days. Buy on close. Sell X days later. \$100k/trade. 1997 - 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	-17,382.10	34	14	20	41.18	1,216.75	2,124.32	-1,720.83	-5,584.17	0.71	0.49	-511.24
4	-18,869.77	35	12	23	34.29	1,001.71	1,831.72	-1,343.06	-4,567.80	0.75	0.39	-539.14
3	-18,222.00	35	13	22	37.14	793.43	1,874.04	-1,297.12	-3,887.84	0.61	0.36	-520.63
2	-19,739.89	37	16	21	43.24	516.42	1,456.36	-1,333.45	-4,748.44	0.39	0.30	-533.51
1	-12,466.09	40	16	24	40.00	293.70	1,111.50	-715.22	-2,378.78	0.41	0.27	-311.65

The stats here appear squarely bearish. Most of the damage is done in the 1st 2 days. I have posted the 2-day equity curve below.



There was a slight bump up with some recent instances, but the downslope still appears to be squarely intact.

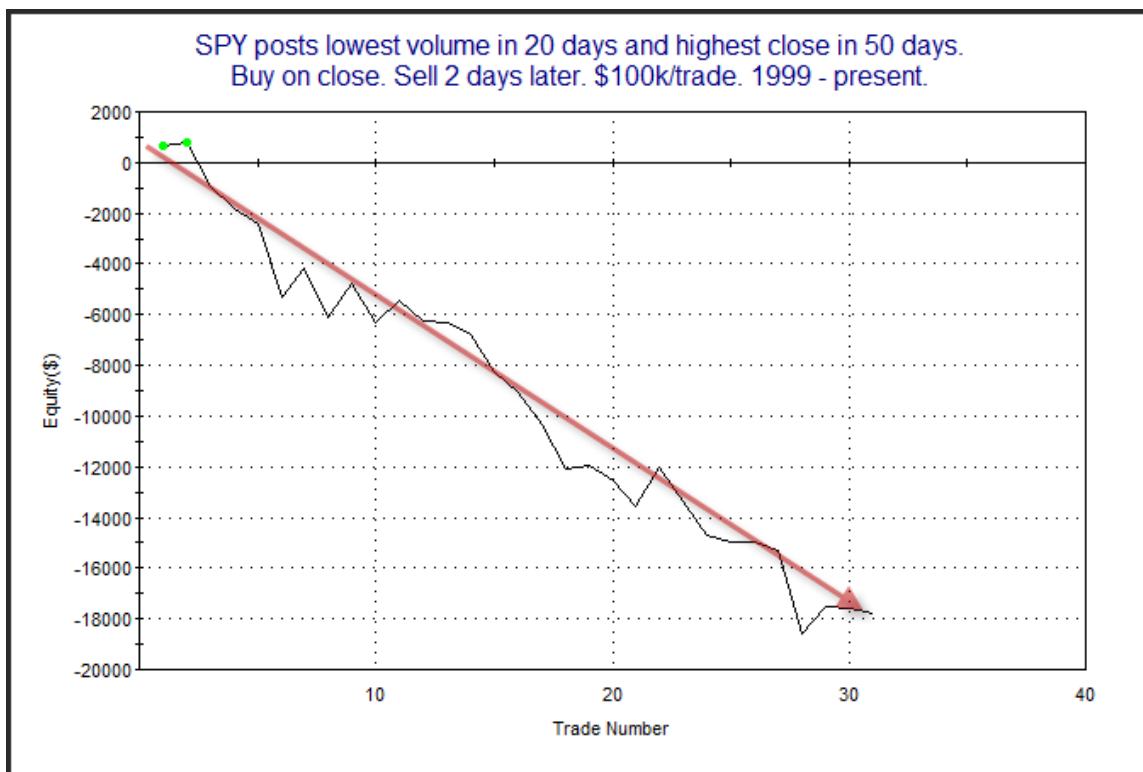
It wasn't just NYSE volume that was low. SPY volume was also low. I have found SPY volume to be a very useful indicator over the years as well. The study below is similar to the 1st one. It looks at 20-day volume lows as well, but it uses SPY volume and it also demands a 50-day price high, rather than just a 20-day. It was last seen in the 10/25/11 letter.

SPY posts lowest volume in 20 days and highest close in 50 days.
Buy on close. Sell X days later. \$100k/trade. 1999 - 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	-27,038.24	25	9	16	36.00	1,029.66	-2,269.07	0.45	0.26	-1,081.53
9	-21,524.91	25	11	14	44.00	920.84	-2,261.01	0.41	0.32	-861.00
8	-13,162.63	27	12	15	44.44	1,358.56	-1,964.35	0.69	0.55	-487.50
7	-18,496.30	27	12	15	44.44	877.80	-1,935.33	0.45	0.36	-685.05
6	-15,267.65	28	12	16	42.86	859.62	-1,598.94	0.54	0.40	-545.27
5	-10,912.08	30	13	17	43.33	1,036.58	-1,434.57	0.72	0.55	-363.74
4	-14,457.42	30	14	16	46.67	811.43	-1,613.59	0.50	0.44	-481.91
3	-17,555.48	30	10	20	33.33	879.35	-1,317.45	0.67	0.33	-585.18
2	-17,775.78	31	8	22	25.81	851.74	-1,117.71	0.76	0.28	-573.41
1	-5,712.28	32	11	21	34.38	562.78	-566.81	0.99	0.52	-178.51

28 of 32 instances (87.5%) closed below the entry price at some point in the next 3 days.

Here too there appears to be a solid downside edge over the next 2-3 days. In this case it is also interesting that the downside edge seems to persist a bit longer. Two weeks out the stats are still in favor of the bears. Below is a curve for the 2-day holding period.



The consistently downsloping curve appears as impressive as the numbers.

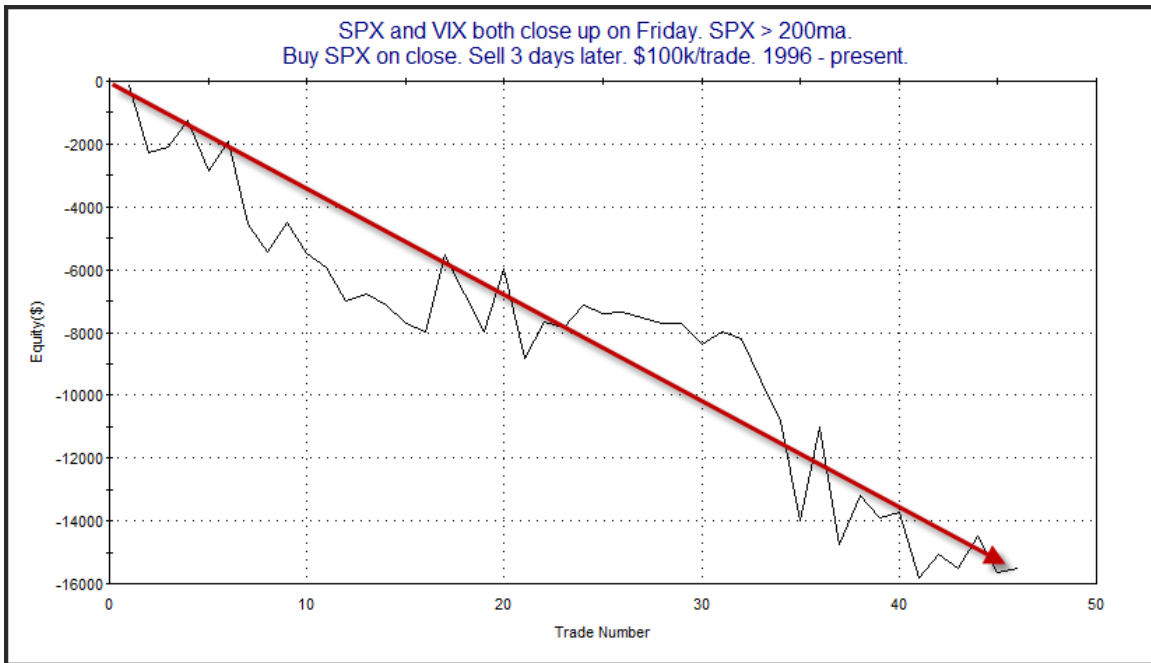
Whether you consider NYSE volume or SPY volume the message appears the same. A downside edge is in effect over the next 2 days.

In addition to volume, the VIX is also suggesting a risk/reward favors the bears. The study below is from the 5/9/11 subscriber letter. It looks at instances of SPX and VIX both closing positive on a Friday. The VIX has a tendency to move opposite the SPX, so when they move in the same direction, it can often suggest an edge over the next few days. Due to calendar effects the VIX has a natural tendency to sink on Friday afternoons as we approach the weekend. So seeing the SPX and VIX both rise is less common on Fridays than any other day of the week. This is why I use Friday as a filter in the below test.

SPX and VIX both close up on Friday. SPX > 200ma.
Buy SPX on close. Sell X days later. \$100k/trade. 1996 - 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	-10,868.17	45	18	27	40.00	1,530.02	4,290.80	-1,422.54	-3,118.36	1.08	0.72	-241.51
4	-15,817.31	46	19	27	41.30	1,113.20	4,275.84	-1,369.19	-4,306.02	0.81	0.57	-343.85
3	-15,516.17	46	17	29	36.96	973.19	3,000.26	-1,105.53	-3,727.50	0.88	0.52	-337.31
2	-13,216.48	46	18	28	39.13	825.79	2,380.51	-1,002.88	-3,595.20	0.82	0.53	-287.31
1	-10,545.49	46	14	32	30.43	511.66	1,530.15	-553.40	-2,361.45	0.92	0.40	-229.25

The numbers here suggest a downside edge. The equity curve assuming a 3-day holding period is below.



The curve is a little choppy but the downslope has been maintained throughout. This seems to confirm the downside edge.

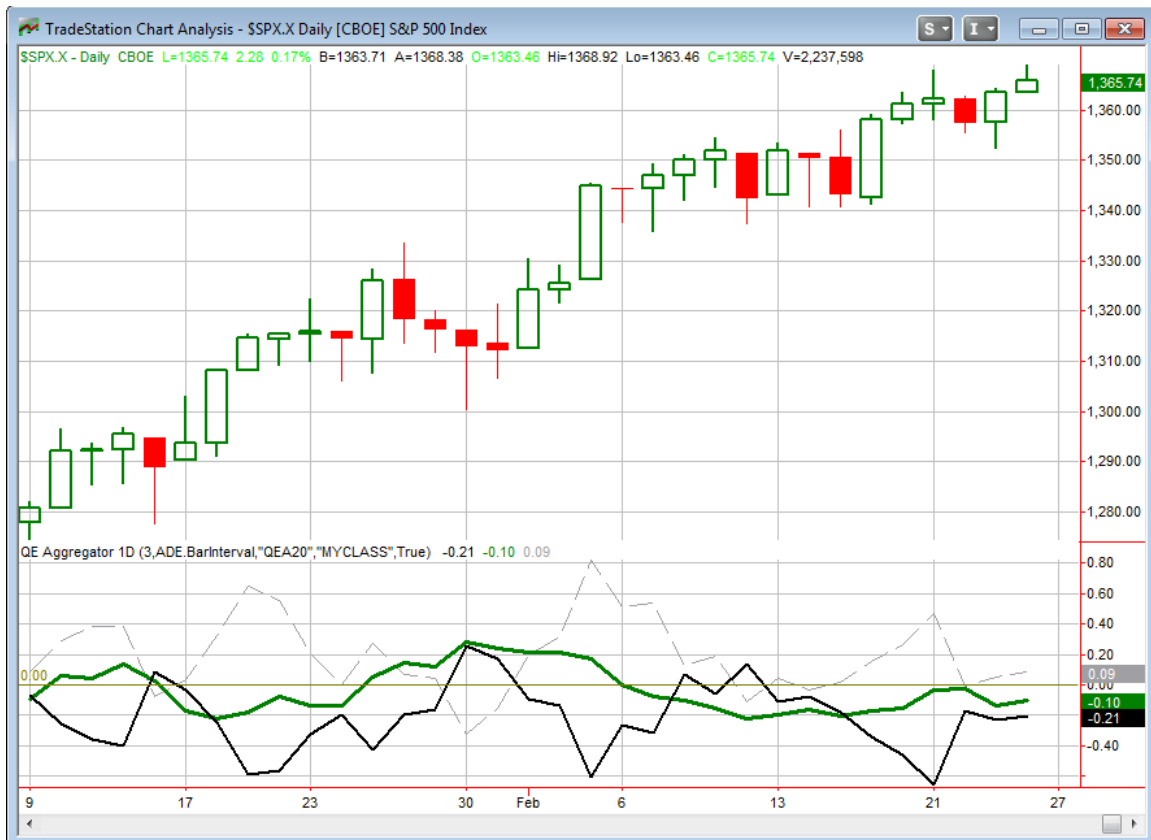
We have seen this next VIX-related study a number of times in the past couple of weeks. It triggered Thursday and again on Friday. I updated the stats once again.

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.

TradeStation Performance Summary			
All Trades			
Total Net Profit	(\$5,905.01)	Profit Factor	0.44
Gross Profit	\$4,731.34	Gross Loss	(\$10,636.35)
Total Number of Trades	44	Percent Profitable	52.27%
Winning Trades	23	Losing Trades	21
Even Trades	0		
Avg. Trade Net Profit	(\$134.20)	Ratio Avg. Win:Avg. Loss	0.41
Avg. Winning Trade	\$205.71	Avg. Losing Trade	(\$506.49)
Largest Winning Trade	\$708.05	Largest Losing Trade	(\$1,602.28)

Despite the even odds, the potential for a big loser has far outweighed the potential for a big winner. I did not include this study on the Active List tonight simply because I didn't see a point in doubling up on the VIX-based studies.

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



Volume and VIX action helped keep the green Aggregator line in 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 is also squarely 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 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 Monday. Of course this could change if more bullish evidence emerges. Meanwhile, the Differential Pivot will be 1,354.69 on Monday. This is about 0.8% below Friday's close. That wouldn't be a very large selloff, but amazingly it would be bigger than any other 1-day drop in 2012.

We have a good mix of studies suggesting there will likely be a selloff in the next couple of days. The studies look at a diverse number of indications, such as volume, VIX, price action and seasonality. But most of them expire on either Monday or Tuesday. The QE Buying Power Index (and especially the QE Buying Power Volume Index) are also weak for the next 2 days. So probabilities are all pointing to a quick dip. But getting that dip could very easily set up a long trade as early as Tuesday's close, when the QE Buying Power Index will move back up to a strong +3 reading. So the window of opportunity for a short trade appears tight, but evidence is fairly impressive.

I have a small short position at the moment. I am not looking to up it substantially since it this is a counter-trend (and counter intermediate-term outlook) trade. But if the market gaps up large and offers a "gift" open, then I will add 1 more lot to my short position.

Intermediate-term Outlook (2 weeks – 2 months)– updated 2/27 – bullish

The uptrend continued this past week as the market rolled right over some short-term bearish studies and continued to make new highs. There wasn't much that triggered from an intermediate-term standpoint, but it appears a tough market to bet against.

Several people have pointed out the waning breadth that has accompanied the move up lately. One way this breadth divergence can easily be seen is by looking at the McClellan Oscillator, which has closed below 0 for 8 straight days despite the SPX posting new rally highs. This is an unusual situation and one that has only been seen 12 times since

1970. But it does not tell us much about short or intermediate-term odds. The study below demonstrates this.

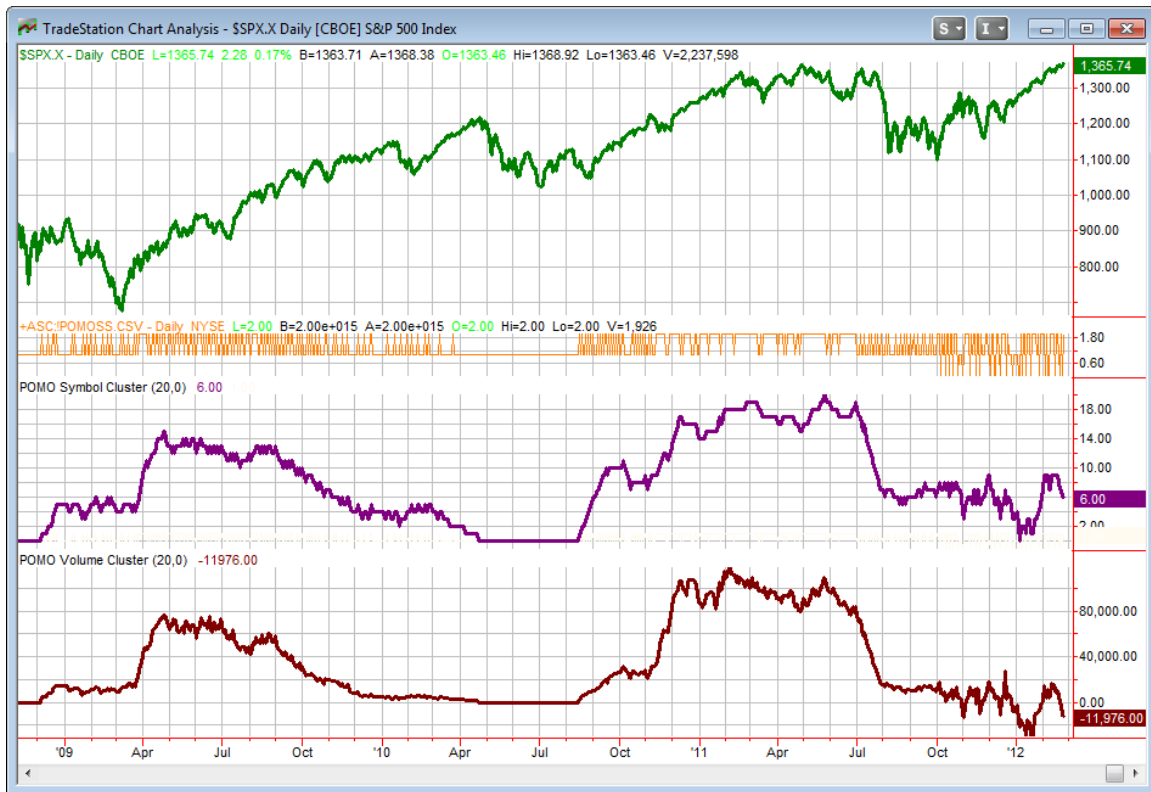
McClellan Oscillator closes below 0 for the 8th day in a row. SPX closes at a 100-day high. Buy SPX on close. Sell X days later. \$100k/trade. 1970 - present.												
X Days	All: Net Profit	All: Total Trades	All: Winning Trades	All: Losing Trades	All: % Profitable	All: Avg Winning Trade	All: Max Winning Trade	All: Avg Losing Trade	All: Max Losing Trade	All: Win/Loss Ratio	All: ProfitFactor	All: Avg Trade
40	1,662.50	11	7	4	63.64	2,969.07	7,015.56	-4,780.24	-13,828.80	0.62	1.09	151.14
35	2,544.44	11	6	5	54.55	3,110.58	5,036.76	-3,223.81	-13,416.00	0.96	1.16	231.31
30	-988.09	11	5	6	45.45	3,414.11	6,505.60	-3,009.78	-12,014.20	1.13	0.95	-89.83
25	-470.28	11	5	6	45.45	3,401.65	5,496.32	-2,913.09	-9,331.00	1.17	0.97	-42.75
20	-1,617.90	11	7	4	63.64	1,617.62	3,437.40	-3,235.31	-8,066.80	0.50	0.87	-147.08
15	7,578.54	11	6	5	54.55	2,742.81	4,065.50	-1,775.67	-2,244.60	1.54	1.85	688.96
10	10,948.86	11	7	4	63.64	2,047.23	3,757.93	-845.43	-1,670.56	2.42	4.24	995.35
5	2,502.54	12	6	6	50.00	1,448.78	3,126.97	-1,031.69	-3,049.12	1.40	1.40	208.54

Results here did not surprise me. I have studied negative breadth divergences quite a bit. A breadth divergence has typically been a prerequisite for a top. In other words, you are very unlikely to see a rally roll over and suffer a major decline without first seeing a breadth divergence. But breadth divergences can persist for extended periods of time, sometimes for years, before the market may ultimately roll over. When a market is rallying and a divergence is present that does not interest me terribly, because it is a poor timing tool. You can't pick a top by stating a divergence is occurring. But when a market is rallying and there is NOT a divergence – that is something I pay attention to. Because that strongly suggests the rally has further to go before a major decline will occur. For my money, that is more useful information.

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>



There were 2 days of buying and 2 days of selling this week by the Fed, but the selling was much larger as the net came to over \$13 billion in selling. This caused the POMO indicators to dive, including 20-day volume levels below 0.

This upcoming week there is POMO buying scheduled for Monday, Tuesday, and Wednesday. On Wednesday around 2pm the schedule for March will be released. Traders may use the link below after that time to see the new schedule. I will be sure to post the anticipated QE Buying Power Index to the [QE Buying Power Index](#) page after the schedule is released.

http://www.newyorkfed.org/markets/tot_operation_schedule.html

It is somewhat surprising to see how well the market has performed without substantial intermediate-term POMO support over the last couple of months. Between the non-support for POMO and the waning breadth we seem to have some warnings. A couple of the bullish intermediate-term studies will be expiring this week as well. After that has happened I will consider moving the intermediate-term outlook to neutral (or “slightly bullish”). With the trend still intact I’m currently favoring the bullish side more willing to trade aggressively long than short.

Catapult and Capitulative Breadth Statistics

[Catapult & CBI Presentation Link](#)

Open Catapult Triggers

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

GILD– 1/3 position @ \$44.69 limit (\$44.21 fill)

GILD –1/3 position @ \$44.53 limit (\$44.53 fill)

Catapult for ETF’s Trades

None

Broad Market Large Cap CBI – 3/1(GILD-3)

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 – short 1/4 index position @ \$137.93 limit ON OPEN. If not filled in open, cancel order. This is \$1 above Friday’s close. Based on the short-term outlook above. I am not looking to build a big position in this counter-trend position, but will take some additional short exposure if it gaps up large.

Current Open Trade Ideas

Symbol	Entry Date	Entry Price	Current Price	% Gain/Loss	Stop	Notes
FCX(1/3)	2/16/2012	\$42.17	\$44.24	4.91%		hit intraday stop
GILD(1/3)	2/21/2012	\$46.50	\$45.26	-2.67%		Catapult
GILD(1/3)	2/22/2012	\$44.21	\$45.26	2.38%		Catapult
GILD(1/3)	2/23/2012	\$44.53	\$45.26	1.64%		Catapult
SPY(1/4)(s)	2/24/2012	\$136.93	\$136.93	0.00%		Aggregator

After FCX hit its intraday target I sent out an update to gold subscribers indicating that rather than waiting for the “standard” exit on Monday’s open, I would place an intraday stop at \$44.24, in case of a reversal. This stop was hit in the afternoon as FCX reversed and closed poorly.

GILD

GILD is still not close to hitting its exit trigger. It will probably need to close up a little over \$1 on Monday in order to get there. In a move I would rarely do with a Catapult trade, I am considering closing part of this position out early. I am considering this for a few reasons. First, though it met all the criteria for a Catapult, it doesn’t appear as a typical Catapult on the chart. This is largely due to the big gap down that led to the trigger. This huge gap down has also made the standard exit target a bit more difficult to reach. So I am not entirely comfortable maintaining a large position in an atypical Catapult setup that has already seen a 2-day bounce and is still a long way from its exit target.

When I developed the Catapult Exit Designer (available to subscribers on the Downloads page) I showed one “alternate” exit strategy that would have produced similar (though slightly lower) results compared to the standard exits. That strategy called for an exit following a close > the 5ma (or an intraday move > 1% above the 5ma). For this to be accomplished on Monday it would only take a close > \$44.91 or an intraday target of around \$45.36. So there is a big disparity between the standard exit and the “alternate” exit.

With all this in mind I will look to exit 1/3 of the GILD position on Monday. Of course if I am to exit it early I would like to get a good fill. So I will use a limit order equal to Friday’s close of \$45.26. If hit, I will put a stop on the remaining 2 lots at \$43.74 - just under the 2/22 swing low.

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