

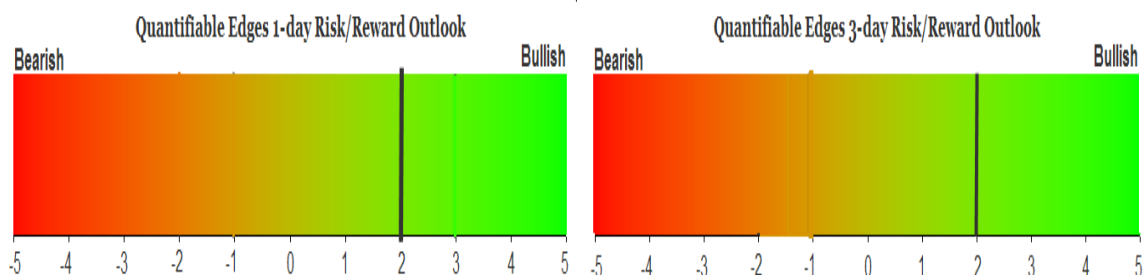
QUANTIFIABLE EDGES SUBSCRIBER LETTER

ASSESSING MARKET ACTION WITH INDICATORS AND HISTORY

May 14, 2012

Volume 5 Issue 92

Market Overview



Signals Overview

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

Tonight's Research Points

- The market has reached extremely rare territory, and in itself that suggests caution.

Short-term Outlook

The Bottom Line

Evidence continues to suggest an upside edge, but conditions are now abnormal. I will look to scale back on my long position.

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

Study Date	Description	Time span	Bias	Avg Max Move
Active				
May 11, 2012	Low Vol Bounce from RSI(2) < 5	1-2 days	Bullish	
May 10, 2012	QE Buying Power Swing System long	1-5 days	Bullish	2.70%
May 9, 2012	20-day low close > 200ma	1-7 days	Bullish	2.00%
Active - Long Term				
May 7, 2012	QQQ 5 lower lows. Today biggest drop.	1-20 days	Bullish	12.30%
March 14, 2012	SPX & TNX hit 50-day highs	1-50 days	Bearish	
March 14, 2012	50-day high on strong breadth	1-50 days	Bullish	8.00%
March 5, 2012	Negative breadth divergences	int term	Bearish	
February 1, 2012	Golden Cross	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

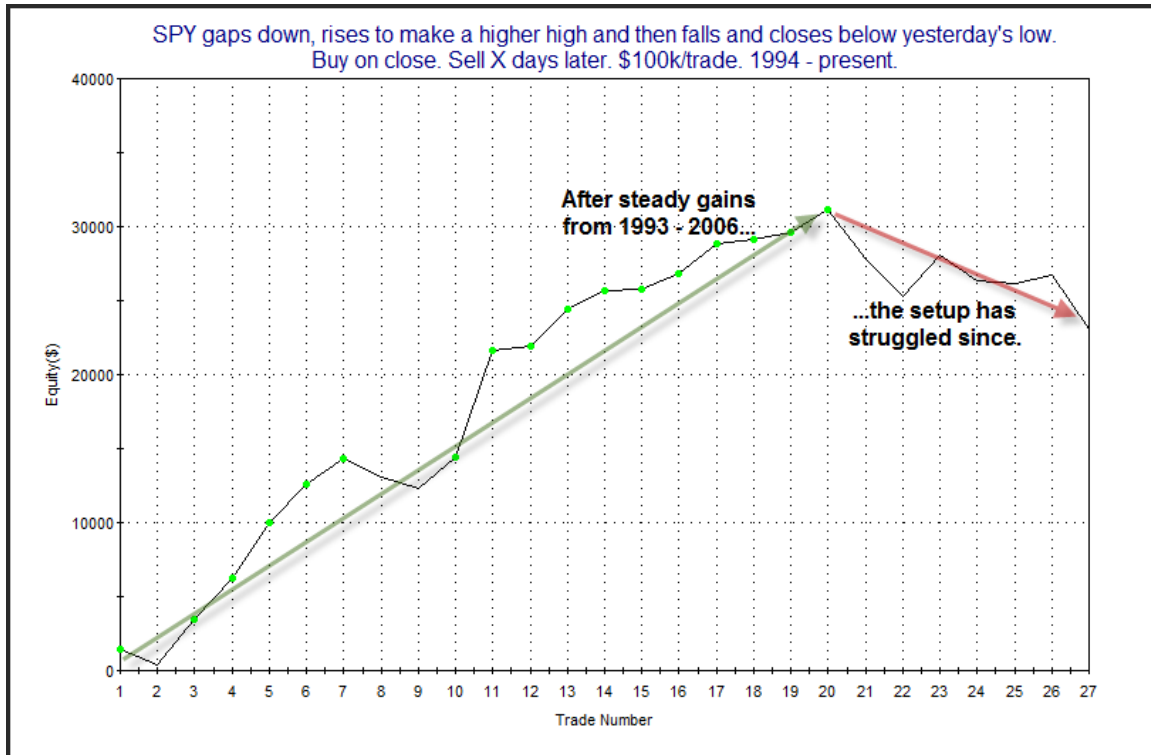
After gapping down to open the day the market rallied strongly – and then fell apart again. The net result was a mixed market. The SPX lost 0.3%, and the Russell 2000 fell 0.2%, but the NASDAQ finished just above breakeven with a 0.01% gain. Breadth was negative as the NYSE Up Issues % came in at 36% and the Up Volume % was 32%. Total NYSE finished just barely above Thursday's level.

All of the short-term studies that are currently triggering are pointing higher. Despite this, the market has failed to put in any kind of decent bounce over the last few days. While this doesn't necessarily suggest bearish implications, it is becoming concerning. I'll explain why in some detail lower down, but first I thought I would review the one Quantifinder study that appeared bullish.

In the 5/14/10 subscriber letter I examined other instances where SPY gapped down, rallied big, and then rolled back over. Results at that time appeared quite bullish. I updated them and took a closer look tonight.

SPY gaps down, rises to make a higher high and then falls and closes below yesterday's low. Buy on close. Sell X days later. \$100k/trade. 1994 - 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	33,317.88	26	17	9	65.38	3,252.21	7,105.76	-2,441.08	-4,876.80	1.33	2.52	1,281.46
9	27,527.27	26	17	9	65.38	3,004.49	7,063.67	-2,616.57	-7,602.84	1.15	2.17	1,058.74
8	17,437.15	26	17	9	65.38	2,596.97	6,322.49	-2,967.93	-7,042.54	0.88	1.65	670.66
7	12,883.93	26	16	10	61.54	2,606.55	8,658.33	-2,882.08	-7,137.36	0.90	1.45	495.54
6	26,088.31	26	17	9	65.38	2,559.89	7,613.94	-1,936.65	-5,930.56	1.32	2.50	1,003.40
5	14,580.75	27	19	8	70.37	1,927.74	6,086.66	-2,755.80	-7,283.90	0.70	1.66	540.03
4	23,074.38	27	19	8	70.37	1,979.90	7,220.89	-1,817.97	-3,646.26	1.09	2.59	854.61
3	18,295.27	27	19	8	70.37	1,584.40	4,772.75	-1,476.05	-3,094.58	1.07	2.55	677.60
2	8,952.91	27	17	10	62.96	1,305.59	5,087.19	-1,324.21	-2,931.25	0.99	1.68	331.59
1	5,239.74	27	19	8	70.37	877.92	3,649.75	-1,430.09	-3,333.75	0.61	1.46	194.06

Results here still look impressive with a 70% win rate, and a strong average gain and profit factor over the next 1-4 days. Unfortunately, when I examined the equity curves a yellow flag went up. Below is the 4-day equity curve, which was nicely representative of how the others look as well.



We see here that over the first 20 instances, which took place between 1993 and 2006, gains were strong and steady. The seven instances since then have not performed well. This isn't enough to permanently kill the study, but it is enough to convince me to leave it off the active list for now.

As I mentioned above, despite reaching a short-term oversold condition several days ago, the market has failed to mount any kind of substantial bounce. This is highly unusual. I've been showing for the last week that the oversold conditions were pointing to a likely bounce, and several of the short-term studies showed very high win rates. And still we've seen basically nothing. So how unusual is the current situation? I looked at it using several short-term oscillators designed to measure overbought/oversold. I decided to simply use RSI in the examples below. The findings there were as impressive as any.

Friday marked the seventh day in a row in which the 2-period RSI closed below 30. Being a very sensitive indicator, it doesn't take normally much of a bounce to get it back over 30. But it hasn't managed to do this. I looked back at all other instances where the RSI(2) closed below 30 for the seventh day in a row, but was still above the 200ma. Amazingly there have only been two other times since the inception of the SPY in 1993. I listed them below along with their 10-day returns.

SPY RSI(2) < 30 for exactly 7th day in a row. Close > 200ma. Buy on close. Sell 10 days later. \$100k/trade. 1993 - present.				
Date/Time	Signal	Price	% Profit	Run-up Drawdown
06/18/96	Buy	\$66.34	1.67%	\$2,049.52
07/02/96	Sell	\$67.45		(\$256.19)
03/23/05	Buy	\$117.00	1.91%	\$1,930.04
04/07/05	Sell	\$119.24		(\$640.50)

They both went up, but that really doesn't tell me anything other than the fact that such a failure to bounce is incredibly unusual.

But what's really unusual is that the bounce has failed to arrive following the extremely-low sub-5 reading on 5/4/12. I looked at other times the SPY was above the 200ma and after registering a sub-5 RSI(2) it failed to get above 30 for 5 straight days. This is the 1st time ever. It has managed to do it 3 times when the SPY was below its 200ma, and I have listed those below.

5 days ago SPY RSI(2) < 5. It has not closed above 30 since. Buy on close. Sell 10 days later. \$100k/trade. 1993 - present.				
Date/Time	Signal	Price	% Profit	Run-up Drawdown
04/04/94	Buy	\$43.91	0.91%	\$2,777.94
04/18/94	Sell	\$44.31		\$0.00
06/30/10	Buy	\$103.22	6.26%	\$6,650.16
07/15/10	Sell	\$109.68		(\$2,023.12)
08/03/11	Buy	\$126.17	(5.15%)	\$0.00
08/17/11	Sell	\$119.67		(\$12,592.80)

The bottom line is that we are in uncharted territory. Quantitative analysis is great at helping us to identify high-percentage situations. Those are times when you often want to bet big. But when we go beyond “oversold and likely to bounce” to “oversold and acting in a way never seen before”, it suggests caution to me. The fact that the CBI has still only managed to reach “1” despite the oversold condition is also suggestive of caution. I’ve been moderately long, and I aim to keep some long exposure, but I am now interested in lightening up and taking risk off the table until we get back to a high-percentage situation.

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



The green Aggregator line barely budged today and remains positive. Readings above 0 mean net expectations from the Active List are for upside over the next few days. Meanwhile the black Differential Line is also above zero. This means the SPX is short-term oversold versus expectations. So net expectations are bullish and the SPX is oversold versus recent expectations. This is considered a bullish configuration. Bullish configurations are visible on the chart whenever both lines close above 0. This meant the Aggregator System remained long at the close. This was indicated as likely on the systems page shortly before the bell.

Based on the current studies, expectations will remain positive on Monday. Of course this could change if strong bearish evidence emerges. Meanwhile, the Differential Pivot will be 1,361.92 on Monday. This is 0.6% above Friday's close. So it would take a rise of at least this much to move the SPX from oversold to overbought, causing the Differential line to drop below 0.

As I discussed earlier, there still appears to be an upside edge. But conditions are now abnormal, and that suggests extra caution may be warranted. I currently have a ½ size long index position and I will look to lower my exposure to ¼ on Monday if we even get a moderate intraday bounce.

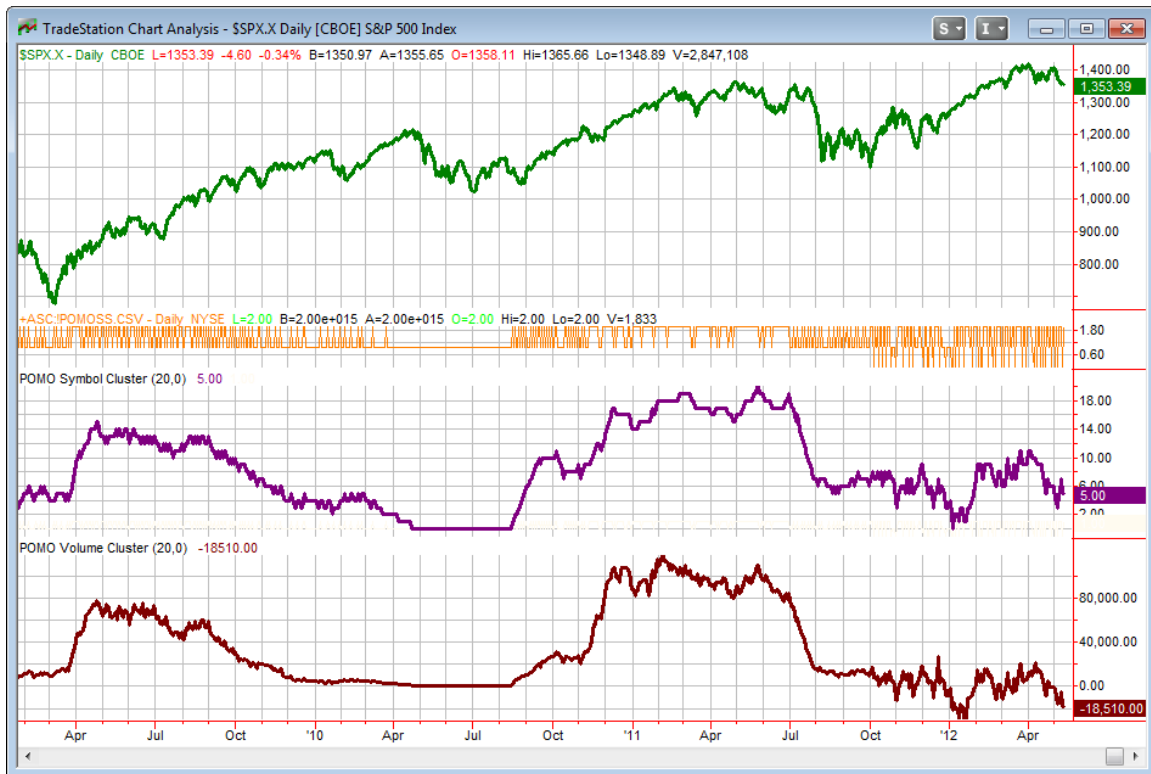
Intermediate-term Outlook (2 weeks – 2 months)– updated 5/14 – neutral

The market came in to the week extremely oversold and failed to alleviate that condition. It closed Friday at the lowest level in over 2 months, and it is going to take some work to re-establish the uptrend and make new highs.

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 4 days of POMO buying and 1 day of selling this past week, but the net result was a moderate \$1 billion liquidity injection. The intermediate-term POMO indicators dropped further and are now at the lowest levels in months. Liquidity measures topped out in early April along with the market. Since then we've seen negative POMO flows and negative stock returns. This should not surprise anyone.

The correlation between POMO flows and market returns has been strong since 2005 when POMO data first became available. The 1st period where it got strongly out of whack was from December through February. At the time we noted that while POMO was negative, the Fed was aggressively increasing liquidity through swap transactions with European banks. It appeared that this may have provided stimulus for the rally. This stimulus has been unwinding over the last couple of months, and with POMO negative since early April the stock market has struggled.

This upcoming week the Fed is scheduled for 3 days of buying and 1 day of selling. This should net out to near a \$3 billion inflow. The short-term QE Buying Power Index is at 3 right now (and the QE Buying Power swing system is long). Three or higher is considered bullish, while 0 or below is considered bearish. On Tuesday it will dip to 1 before reaching 0 on Wednesday and then finish Thursday and Friday at 2. All this means is that short-term flows are expected to have a positive market influence for the next couple of days, but beyond that things will again become sketchy. The swing system long signal will expire on Thursday if the market fails to bounce before then.

More details on the QE Buying Power Index and swing system, including the full May projections, are available to subscribers on the QE Buying Power Index page, which can be linked to below:

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

Intermediate-term evidence continues to remain mixed. Weak POMO readings, weak net new highs, new 40-day lows, and possible negative impacts from rising interest rates are all possible concerns. On the bullish side the long-term trend, the breadth thrust in March, and last week's overdone QQQ study are all worth considering. I remain neutral. I'm not seeing compelling enough evidence to produce strong a conviction about the intermediate-term either way. I will continue to play both the long and the short side fairly conservatively.

Catapult and Capitulative Breadth Statistics

Catapult & CBI Presentation Link

Open Catapult Triggers

HD -1/3 @ \$50.11 (not filled and now temporarily off the table)

Catapult for ETF's Trades

None

Broad Market Large Cap CBI – 1(HD)

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. (I have shelved HD for the time being due to my “abnormal conditions” concerns.)

Current Open Trade Ideas

Symbol	Entry Date	Entry Price	Current Price	% Gain/Loss	Stop	Notes
QQQ(1/4)	5/7/2012	\$64.31	\$64.18	-0.20%		Aggregator
SPY(1/4)	5/9/2012	\$135.74	\$135.61	-0.10%		sell @ \$136.00 limit

SPY has reached \$136.00 easily over the last few days, but has bounced around that number several times. If it gets there on Monday, I will sell it. I'll hold on to the QQQ lot for now. Since I am only looking to maintain a small position at this point, I decided I might as well hold on to the more volatile of the two. Of course traders should make their own decisions.

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