

# QUANTIFIABLE EDGES SUBSCRIBER LETTER

ASSESSING MARKET ACTION WITH INDICATORS AND HISTORY

May 15, 2012

Volume 5 Issue 93

## Market Overview



## Signals Overview

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

## Tonight's Research Points

- Strong selloffs to new lows on Monday's are often followed by a Turnaround Tuesday.

## Short-term Outlook

### The Bottom Line

Evidence continues to point north, but conditions remain abnormal. I am partially long and intend to remain conservatively positioned.

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

Study Date	Description	Time span	Bias	Avg Max Move
<b>Active</b>				
May 15, 2012	Big Drop to 50-low on Monday	1 day	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%
<b>Active - Long Term</b>				
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	
<b>Dropped Tonight</b>				
May 11, 2012	Low Vol Bounce from RSI(2) < 5	1-2 days	Bullish	

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

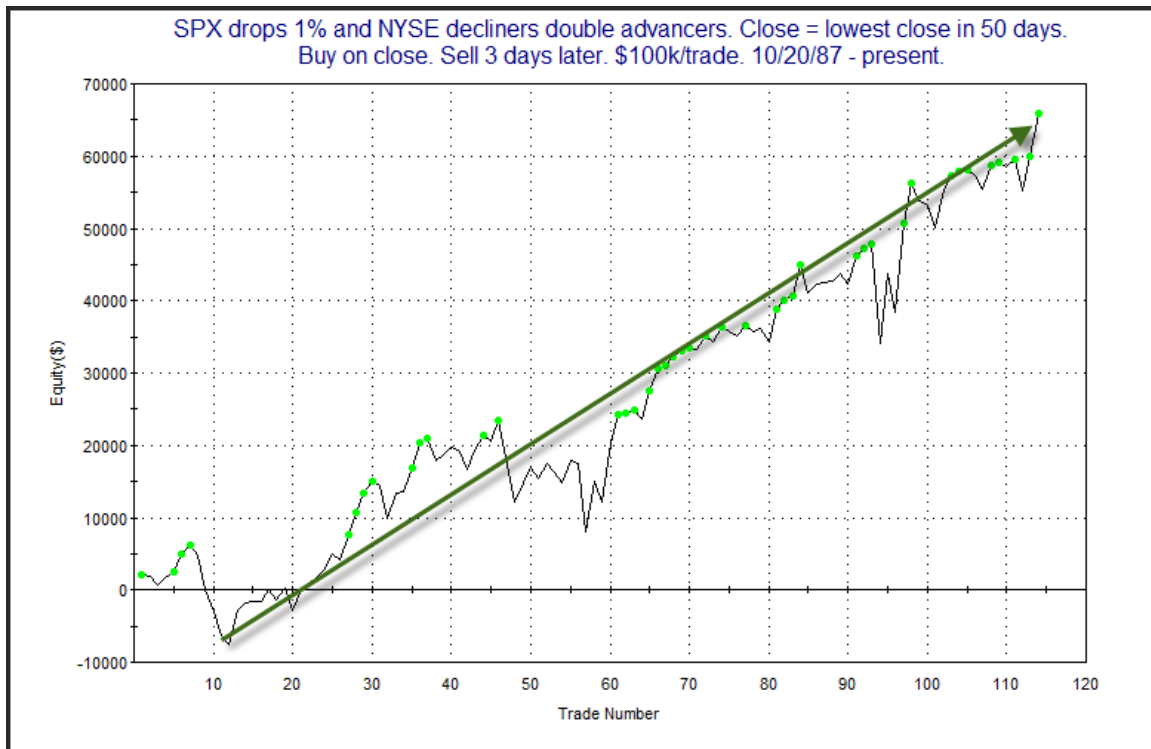
## *The Evidence*

The market opened poorly, tried to bounce, and failed. The SPX and NASDAQ each finished down 1.1%, while the Russell 2000 fell 1.4%. Breadth was very strongly negative as the NYSE Up Issues % came in at 15% and the Up Volume % was 12%. Total NYSE volume was just barely above Friday's level despite the strong selloff.

Strong drops on bad breath will often suggest a washout and an upside edge. A few studies in the Quantifinder pointed towards this. One that I have used repeatedly over the years looks for drops of at least 1% with decliners at least doubling advancers. I have found in the past that the upside edge suggested by this pattern has been stronger when the market is not also making a 50-day low. The last time I looked at it in conjunction with a 50-day low was in the 6/13/11 subscriber letter. I took a closer look tonight and also updated the stats table.

SPX drops 1% and NYSE decliners double advancers. Close = lowest close in 50 days. Buy on close. Sell X days later. \$100k/trade. 10/20/87 - 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	63,958.77	92	51	41	55.43	3,010.08	11,371.92	-2,184.28	-8,127.00	1.38	1.71	695.20
4	6,294.27	101	55	46	54.46	2,214.68	6,249.63	-2,511.15	-14,820.98	0.88	1.05	62.32
3	65,947.62	114	72	42	63.16	2,371.21	12,304.89	-2,494.75	-13,815.18	0.95	1.63	578.49
2	40,481.79	129	72	57	55.81	2,103.23	8,484.76	-1,946.51	-8,657.72	1.08	1.36	313.81
1	38,062.70	153	89	64	58.17	1,580.81	10,716.03	-1,603.59	-7,577.02	0.99	1.37	248.78

While the edge is more mild than we might see without the 50-day low, the study does appear to suggest a moderate upside edge. Below is a profit curve covering the 3-day exit strategy.



There were some brief but sizable dips along the way. Still, the equity curve persisted upwards and is again making new highs.

Another Quantifinder study looked at the tendency of Turnaround Days to occur on Tuesday's. I examined this tendency back in January of 2009. A link to the blog post is below.

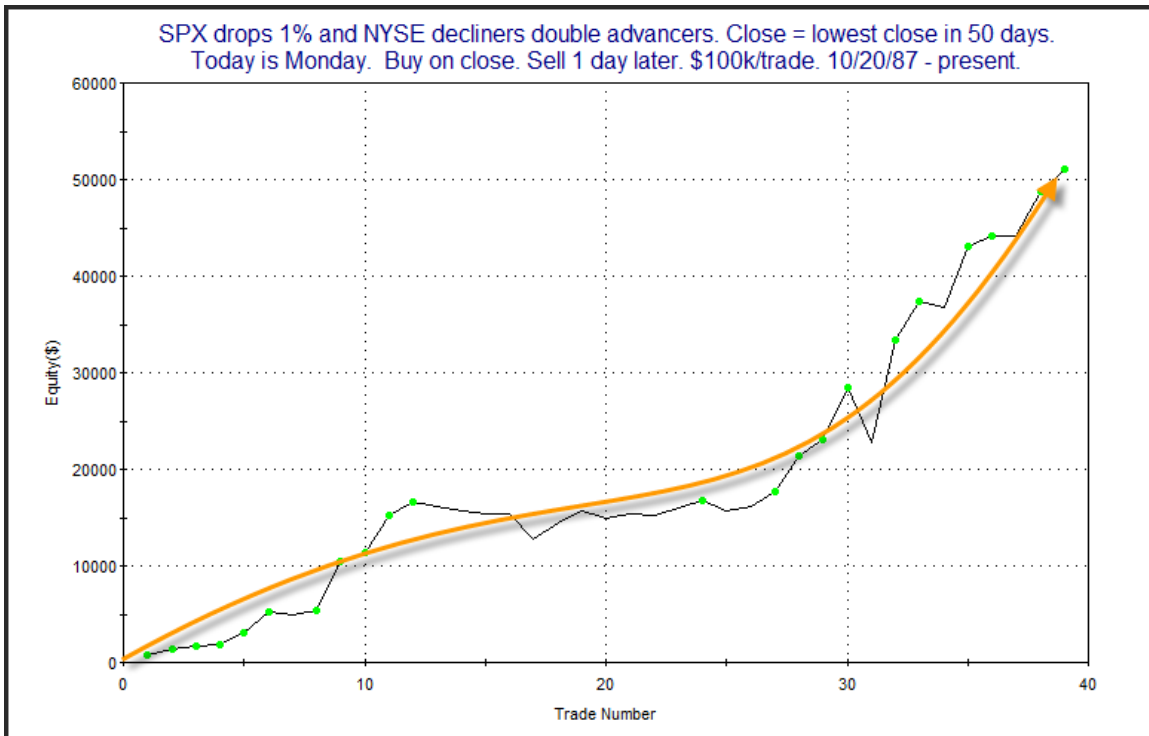
<http://quantifiableedges.blogspot.com/2009/01/turnaround-tuesdays.html>

Tonight I decided to see what might happen to the first study if I also required the setup to occur on a Monday. Those results are below.

SPX drops 1% and NYSE decliners double advancers. Close = lowest close in 50 days.  
Today is Monday. Buy on close. Sell X days later. \$100k/trade. 10/20/87 - 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	77,078.54	38	25	13	65.79	4,224.64	13,733.46	-2,195.19	-5,696.34	1.92	3.70	2,028.38
4	51,595.81	39	29	10	74.36	2,957.20	14,020.11	-3,416.30	-14,820.98	0.87	2.51	1,322.97
3	52,784.48	39	29	10	74.36	2,796.25	12,304.89	-2,830.68	-13,815.18	0.99	2.86	1,353.45
2	48,000.92	39	26	13	66.67	2,582.81	9,496.89	-1,473.24	-6,763.30	1.75	3.51	1,230.79
1	51,046.41	39	28	11	71.79	2,273.27	10,716.03	-1,145.93	-5,702.04	1.98	5.05	1,308.88

Results are very strong across the board, but most of the edge is realized on day one. Below is a profit curve using a 1-day exit strategy.



While it is not the straightest line I have ever shown, performance appears to be even stronger in recent instances, which is a positive.

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



Tonight's study helped the green Aggregator line to rise further into positive territory. 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 far 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 Tuesday. Of course this could change if strong bearish evidence emerges. Meanwhile, the Differential Pivot will be 1,364.55 on Tuesday. This is nearly 2% above Monday's close. That means it will take a very big move on Tuesday to flip the differential line into negative territory. A 1-day rally of this magnitude is unlikely. A more likely scenario would be a multi-day rise or consolidation that would work off the oversold condition.

So the Aggregator continues to suggest an upside edge, and new evidence implies Tuesday is a good candidate for a bounce to begin. But as I discussed last night, market conditions are currently abnormal. The market has been strongly oversold and failed to bounce for an extended period of time - far longer than is typical. This suggests the

market contains more risk than usual. Therefore taking aggressive position sizes could be dangerous. I currently have a one half size long index position. And despite the fact that we have more bullish evidence after Monday's selloff, I am not looking to continue to scale in. In fact, if the market rallies strongly on Tuesday I will look to take some of my position off the table.

One other note is that a new Catapult signal triggered today. This moves the CBI up from 1 to 2 - still a neutral reading. I will look to enter this new Catapult position. In examining the current state of individual stocks among the S&P 100 I find it unlikely that further selling over the next few days would cause a large spike in the CBI (to 10 or higher). With abnormal market conditions, a low CBI reading, and a neutral intermediate-term outlook, the chance of me adding more long index exposure is low. We would almost certainly need to see changes in at least one of these areas.

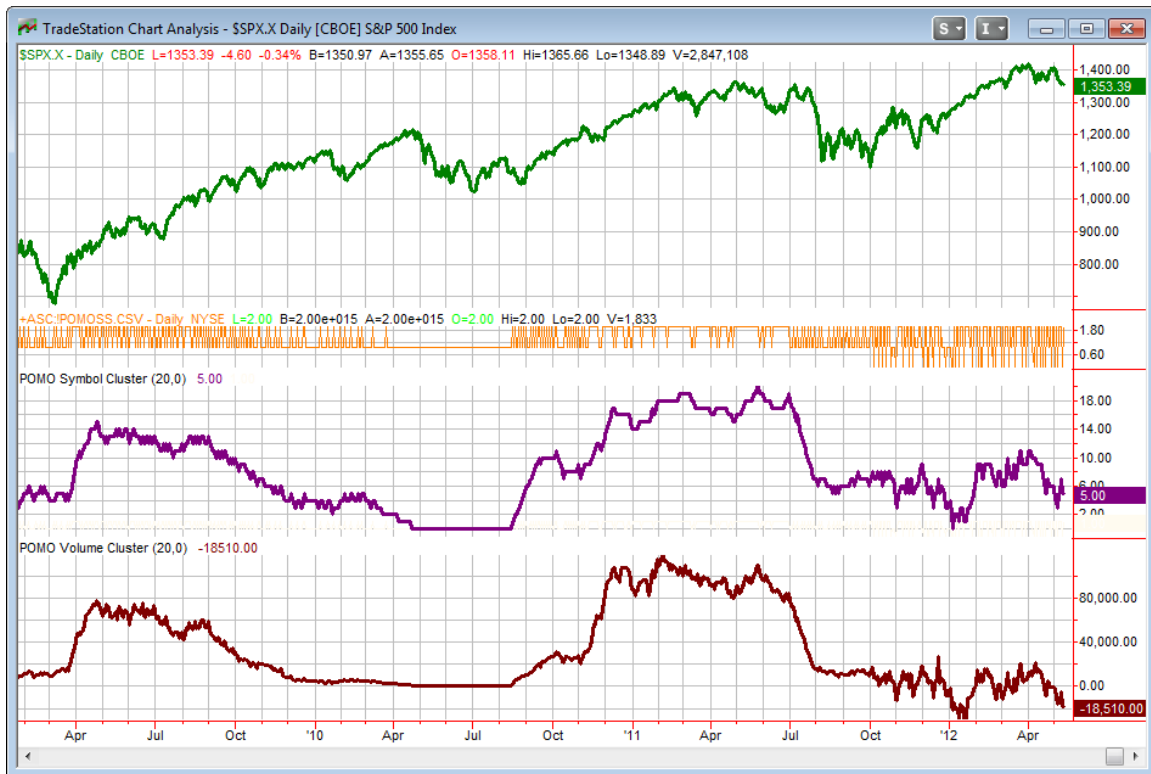
***Intermediate-term Outlook (2 weeks – 2 months)– updated 5/14 – neutral***

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 3<sup>rd</sup> 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 1<sup>st</sup> 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)*

***New***

*CAT – 1/3 @ \$93.61 (buy @ limit)*

#### ***Catapult for ETF's Trades***

*None*

***Broad Market Large Cap CBI – 2 (HD, CAT)***

### **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.*

**CAT – buy 1/3 Catapult position @ \$93.61 limit.** - This is based on the catapult signal listed above in the Catapult & CBI section.

### **Current Open Trade Ideas**

Symbol	Entry Date	Entry Price	Current Price	% Gain/Loss	Stop	Notes
QQQ(1/4)	5/7/2012	\$64.31	\$63.58	-1.14%		Aggregator
SPY(1/4)	5/9/2012	\$135.74	\$134.11	-1.20%		sell @ \$136.00 limit

*Though a fill is now less likely I decided to leave the sell @ \$136.00 order out there for another day.*

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