

QUANTIFIABLE EDGES SUBSCRIBER LETTER

ASSESSING MARKET ACTION WITH INDICATORS AND HISTORY

May 16, 2012

Volume 5 Issue 94

Market Overview



Signals Overview

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

Tonight's Research Points

- 3 20-day low closes in a row while above the 200ma have suggested an upside edge in the past.
- Intermediate-term lows in HV without highs in price are often followed by a price decline.

Short-term Outlook

The Bottom Line

No change tonight. 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
Active				
May 16, 2012	SPX & TNX hit 50-day highs	1-5 days	Bearish	-2.50%
May 16, 2012	3 20-day lows >200ma	1-4 days	Bullish	2.40%
May 16, 2012	VIX spike to 50-high	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	
Dropped Tonight				
May 15, 2012	Big Drop to 50-low on Monday	1 day	Bullish	

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

The Evidence

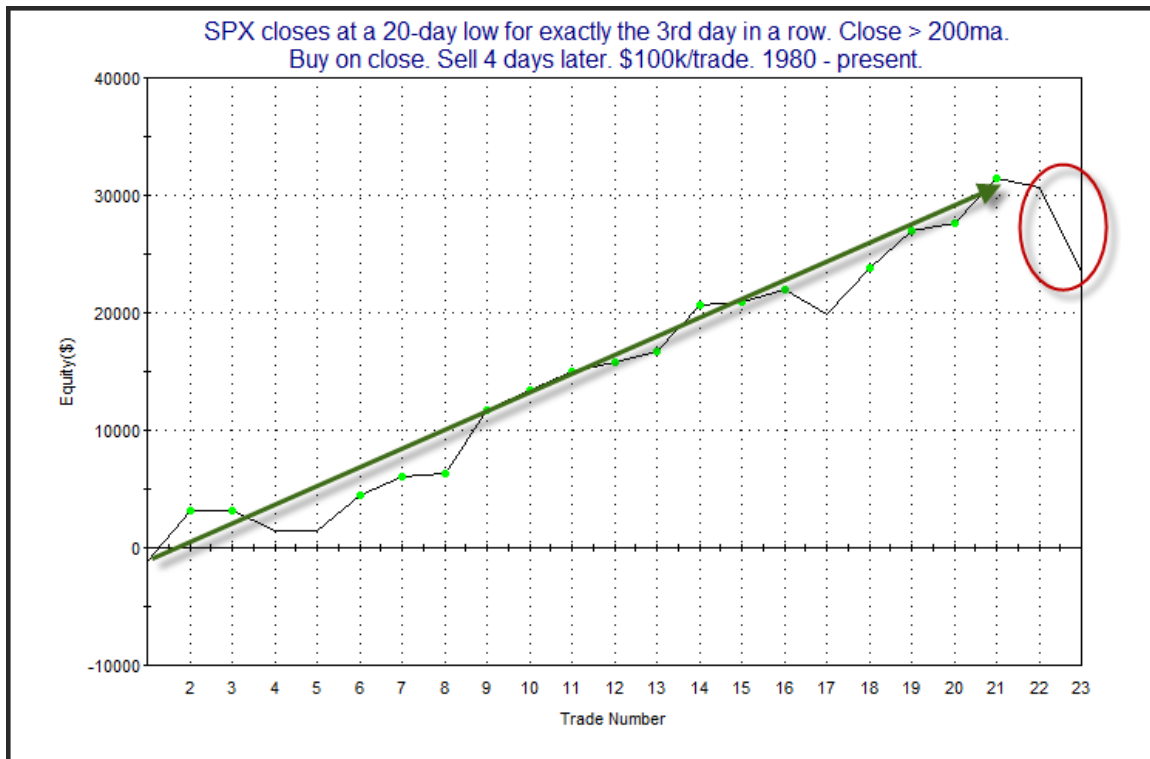
We were oversold and it was Tuesday and still the market couldn't muster a bounce. The major indices again all floundered in the afternoon and finished negative. The SPX finished down 0.6%, the Nasdaq lost 0.3% and the Russell 2000 fell 0.2%. Breadth was again negative as the NYSE Up Issues % came in at 34% and the Up Volume % was 21%. Total NYSE volume rose a bit from Monday's level but did not reach an extreme.

With the SPX closing down for the 3rd day in a row, several studies triggered in the Quantifinder. The fact that it also closed at a 20-day low was noted in the Quantifinder as well. I decided to combine the 2 and look at instances where the SPX closed at a 20-day low for 3 days in a row (during a long-term uptrend).

SPX closes at a 20-day low for exactly the 3 rd day in a row. Close > 200ma. Buy on close. Sell X days later. \$100k/trade. 1980 - present.												
X Days	All: Net Profit	All: Total Trades	All: Winning Trades	All: Losing Trades	All: % Profitable	All: Max Winning Trade	All: Max Losing Trade	All: Avg Winning Trade	All: Avg Losing Trade	All: Win/Loss Ratio	All: ProfitFactor	All: Avg Trade
5	21,858.23	23	14	9	60.87	6,229.44	-7,153.30	2,668.46	-1,722.25	1.55	2.41	950.36
4	23,531.51	23	18	5	78.26	5,426.04	-7,100.17	2,028.04	-2,594.65	0.78	2.81	1,023.11
3	23,116.07	23	16	7	69.57	4,371.32	-2,459.38	1,862.50	-954.85	1.95	4.46	1,005.05
2	12,540.39	23	15	8	65.22	4,132.36	-2,943.71	1,393.30	-1,044.90	1.33	2.50	545.23
1	6,849.72	23	13	10	56.52	1,763.36	-1,519.76	925.99	-518.81	1.78	2.32	297.81

20 of 23 instances (87%) closed above the entry price at some point in the next 4 days. Both of the 2011 instances (6/3 and 7/29) failed to bounce.

The stats all look strong, though the fact that the last 2 failed to bounce is disappointing. I decided to look at the profit curves. Below I have posted the one with the 4-day holding strategy.



Up until the last 2 instances the upslope was strong and steady. Two instances is not enough to cause me to abandon a study, and I will include it on the Active List.

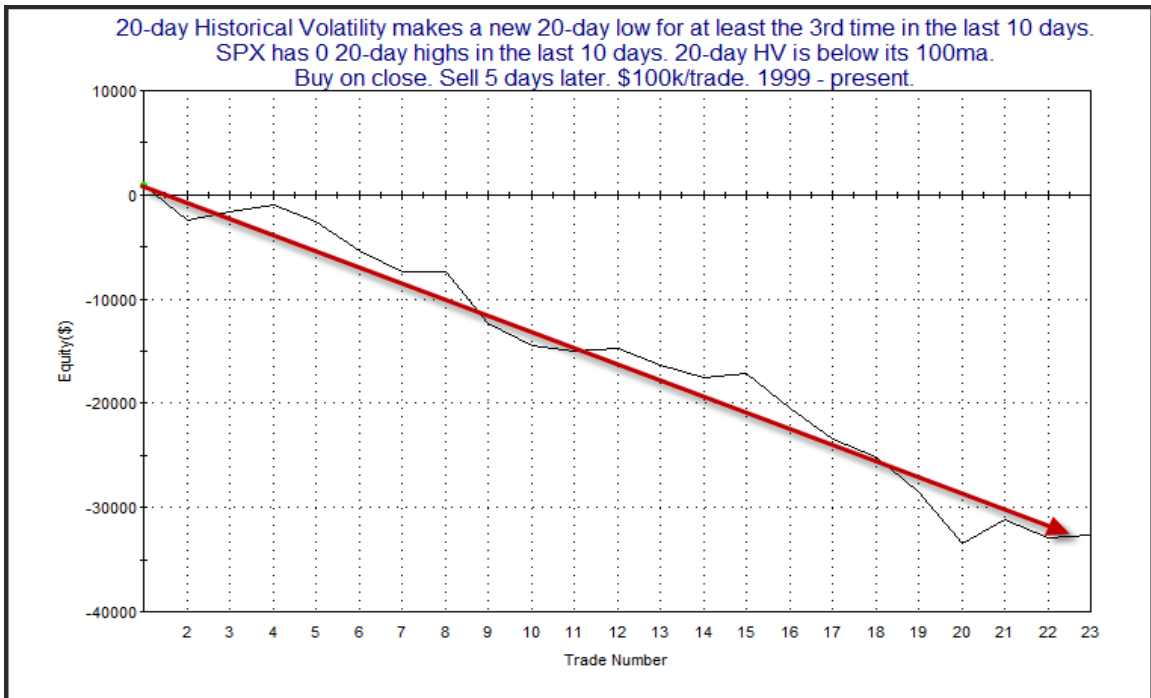
One very interesting aspect of the recent selloff is that is that the move lower has been somewhat slow. We have seen many down days, but no strong signs of panic selling. Since the 1.6% decline on 5/4, the worst day has been Monday's 1.1% selloff. The low CBI is another indication that we are not looking at a washout just yet. Another clue that panic has not taken hold is the very low 20-day HV in SPX. On Tuesday the 20-day HV hit a new 20-day low. It is extremely unusual to have historical volatility so low when implied volatility (as measured by the VIX) is on the rise and posting new 50-day highs. I noted on Twitter Tuesday night that this is only the 7th time that SPX 20-day HV closed at a 20-day low on a day where the VIX closed at a 50-day high. There was no apparent edge when examining those instances. Loosening the requirements to a 20-day high VIX increased the number of instances to 29, but it did not show any more predictability.

Of course HV often makes lows when the market is making new highs and participants are getting complacent. The study below is from the 9/12/11 letter and it looks at repeated instances of 20-day lows in HV without price highs.

**20-day Historical Volatility makes a new 20-day low for at least the 3rd time in the last 10 days.
SPX has 0 20-day highs in the last 10 days. 20-day HV is below its 100ma.
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: Max Winning Trade	All: Max Losing Trade	All: Avg Winning Trade	All: Avg Losing Trade	All: Win/Loss Ratio	All: ProfitFactor	All: Avg Trade
10	-33,366.03	19	8	11	42.11	3,064.50	-9,248.46	1,568.87	-4,174.27	0.38	0.27	-1,756.11
9	-32,492.44	19	6	13	31.58	3,454.95	-5,844.30	1,926.68	-3,388.66	0.57	0.26	-1,710.13
8	-44,515.62	21	6	15	28.57	2,137.74	-7,573.44	1,164.64	-3,433.56	0.34	0.14	-2,119.79
7	-34,303.47	22	7	15	31.82	2,155.50	-5,959.52	982.53	-2,745.41	0.36	0.17	-1,559.25
6	-28,301.56	22	7	15	31.82	2,135.70	-5,678.64	1,154.74	-2,425.65	0.48	0.22	-1,286.43
5	-32,652.11	23	7	16	30.43	2,277.90	-4,943.40	823.24	-2,400.93	0.34	0.15	-1,419.66
4	-18,545.05	25	9	16	36.00	3,291.12	-5,769.55	1,668.98	-2,097.87	0.80	0.45	-741.80
3	-17,814.61	27	9	18	33.33	2,634.92	-4,463.68	1,654.71	-1,817.06	0.91	0.46	-659.80
2	-13,432.83	34	16	18	47.06	2,957.13	-3,551.76	927.52	-1,570.73	0.59	0.52	-395.08
1	-10,094.01	46	20	26	43.48	2,861.10	-3,006.10	977.64	-1,140.26	0.86	0.66	-219.43

The stats all suggest a downside edge. Below is a profit curve using a 5-day exit strategy. This was the most appealing curve.



The downside edge has been steady. This serves as confirmation of the bearish tendency. So we have a mix of studies being added to the Active List tonight.

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



With tonight's studies factored in the green Aggregator line dipped a little but still 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 very 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 Wednesday. Of course this could change if more bearish evidence emerges. Meanwhile, the Differential Pivot will be 1,360.17 on Wednesday. This is 2.2% above Tuesday's close. That means it will

take a very big move on Wednesday 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.

None of this really changes my outlook at all. The market is overdue for a bounce. It appears to hold an upside edge. But it has suggested that for so long that conditions have become abnormal. This means risk is elevated and I have no interest in upping my long allocation under these circumstances (except for new Catapult triggers). A spike in the CBI would likely be needed to get me interested in scaling in further to a long position.

There was one more Catapult that triggered tonight and I have listed it in the CBI section and the Trade Ideas section further down.

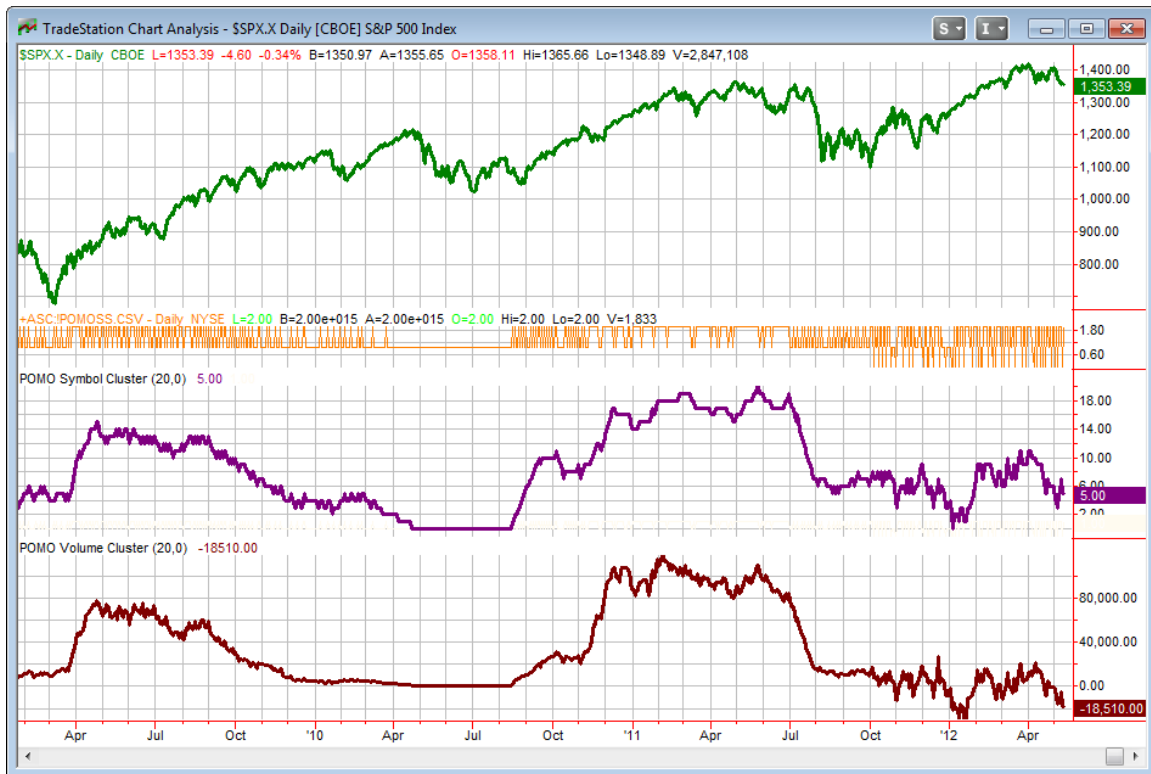
Intermediate-term Outlook (2 weeks – 2 months)– updated 5/14 – neutral

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)

CAT – 1/3 @ \$93.61 (bought @ limit)

New

CAT – 1/3 @ \$92.68 (buy @ limit)

Catapult for ETF's Trades

None

Broad Market Large Cap CBI – 3/2 (HD, CAT-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.

CAT – buy 1/3 Catapult position @ \$92.68 limit. - This is based on the catapult signal listed above in the Catapult & CBI section. It is the 2nd of possibly 3 lots.

Current Open Trade Ideas

Symbol	Entry Date	Entry Price	Current Price	% Gain/Loss	Stop	Notes
QQQ(1/4)	5/7/2012	\$64.31	\$63.37	-1.46%		Aggregator
SPY(1/4)	5/9/2012	\$135.74	\$133.34	-1.77%		Aggregator
CAT(1/3)	5/15/2012	\$93.61	\$92.68	-0.99%		Catapult

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