

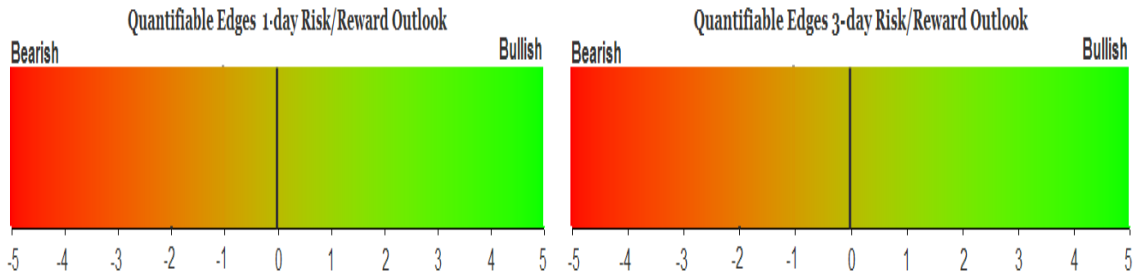
QUANTIFIABLE EDGES SUBSCRIBER LETTER

ASSESSING MARKET ACTION WITH INDICATORS AND HISTORY

May 31, 2012

Volume 5 Issue 104

Market Overview



Signals Overview

Aggregator	Aggressive VIX	QE Buy Pwr Swing	NDX Trend Timer
Flat	50% Long XIV	Flat	Flat

Tonight's Research Points

- 1% drops after FTDs are often followed by more selling the next day. Unfilled gaps down after FTDs have not done poorly, though.
- Unfilled gaps down after unfilled gaps up can have bearish implications - especially when the down day is stronger.

Short-term Outlook

The Bottom Line

The Aggregator is neutral, and so am I. I will not be looking to add exposure until a more compelling edge emerges.

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

Study Date	Description	Time span	Bias
Active			
May 31, 2012	Seasonal strength Thurs-Fri	1-2 day	Bullish
May 31, 2012	Unfilled gap dn after unfilled gap up	1-3 days	Bearish
May 24, 2012	Up 1.5% then flat.	1-5 days	Bearish
Active - Long Term			
May 30, 2012	FTD moderate breadth/weak seasonal	int term	Bearish
May 21, 2012	CBI > 10.	1-20 days	Bullish
May 7, 2012	QQQ 5 lower lows. Today biggest drop.	1-20 days	Bullish
February 1, 2012	Golden Cross	int term	Bullish
December 5, 2011	POMO activity flat to negative	int term	Bearish
Dropped Tonight			
May 25, 2012	Up 3 from 50-low. Today NR7.	1-3 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 buying enthusiasm seen Tuesday was wiped away before the market even opened on Wednesday. SPY gapped down nearly 0.9% and never improved. Selling on Wednesday was stronger than Tuesday's buying for most indices The SPX lost 1.4%, the Nasdaq fell 1.2% and the Russell 2000 suffered a nearly 2.0% loss. Breadth was extremely negative as the NYSE Up Issues % came in at 13% and the Up Volume % was just 7%. Total NYSE volume rose from Tuesday's level.

With selling so strong we of course did see the fairly common "1% drop on bad breadth" study. It is a nonspecific study that will trigger after almost any strong down day and suggests bullish implications. Being that it is so common, I typically only use it when more specific studies are not triggering. One aspect of the current market conditions that is well worth taking into consideration is that Tuesday was a Follow Through Day (FTD). Having a recent FTD in effect is a market condition that I have found useful as a filter in the past. Over the next several days I may continue to incorporate it as a filter. The study below is from the 10/20/11 letter and it looks at large drops immediately following a FTD. Results are updated.

SPX closes down > 1% on the day after a Follow Through Day.
Buy SPX on close. Sell X days later. \$100k/trade. 1971 - present.

TradeStation Performance Summary				Collapse ^
All Trades				
Total Net Profit	(\$14,880.09)	Profit Factor		0.06
Gross Profit	\$975.68	Gross Loss		(\$15,855.77)
Total Number of Trades	11	Percent Profitable		27.27%
Winning Trades	3	Losing Trades		8
Even Trades	0			
Avg. Trade Net Profit	(\$1,352.74)	Ratio Avg. Win:Avg. Loss		0.16
Avg. Winning Trade	\$325.23	Avg. Losing Trade		(\$1,981.97)
Largest Winning Trade	\$451.82	Largest Losing Trade		(\$4,302.72)

The last instance showed a small gain the next day, but the stats are still heavily skewed in favor of the bears. Especially impressive is the fact that the average of the 8 down days was over 4x as large as the biggest up day. That is a risk/reward scenario that strongly suggests a 1-day downside edge.

But I also looked tonight at other times SPY left an unfilled gap down on the day following a FTD. The unfilled gap is another way in which Wednesday's weakness was exhibited. Those results are below.

SPY leaves an unfilled gap down on the day after a Follow Through Day.
Buy SPY 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	6,335.68	5	4	1	80.00	3,274.79	4,515.28	-6,763.50	-6,763.50	0.48	1.94	1,267.14
4	8,448.34	5	4	1	80.00	3,262.28	4,867.12	-4,600.80	-4,600.80	0.71	2.84	1,689.67
3	6,264.82	5	4	1	80.00	2,722.48	3,093.26	-4,625.10	-4,625.10	0.59	2.35	1,252.96
2	4,665.83	5	4	1	80.00	1,842.81	2,953.72	-2,705.40	-2,705.40	0.68	2.72	933.17
1	-1,992.27	5	3	2	60.00	1,035.78	1,572.50	-2,549.80	-4,276.80	0.41	0.61	-398.45

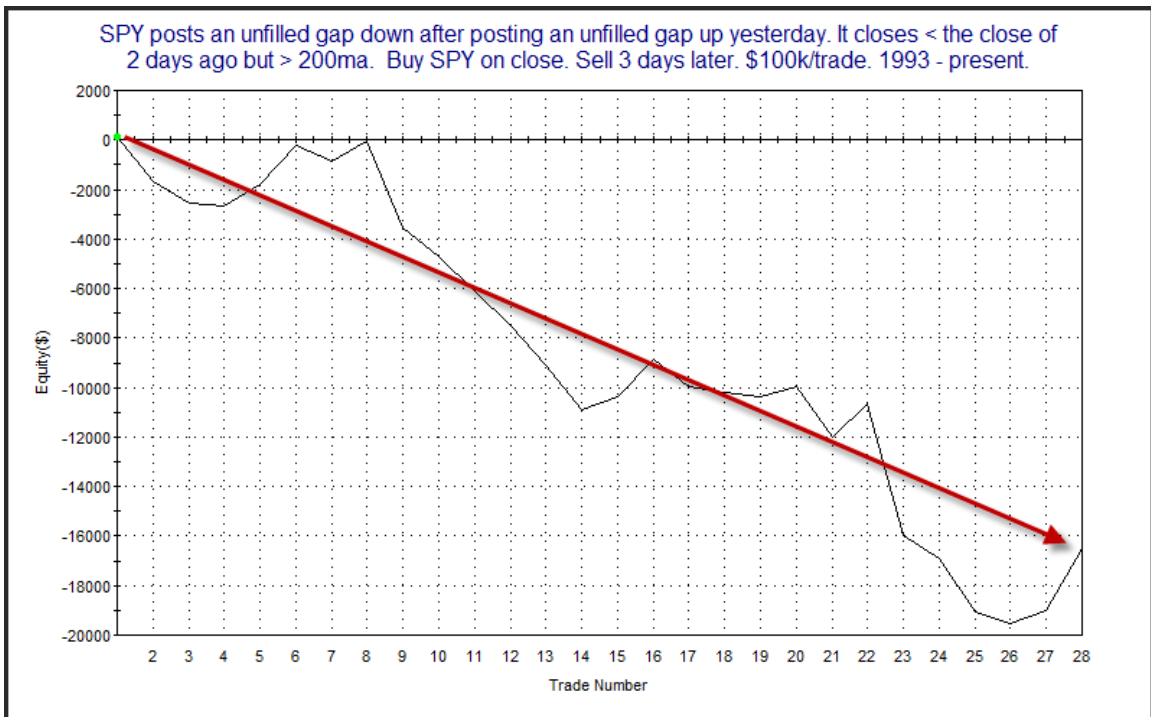
There have only been 5 instances since SPY began trading in 1993. That is too few to generate any meaningful expectations from. But with the results strongly bullish-so-far, it does cast doubt on the implications of Wednesday's weakness.

But there was a study with an ample number of instances that looked at strong moves higher that quickly reversed during long-term uptrends. In the 5/12/11 letter I looked at instances during uptrends where an unfilled gap up was followed by an unfilled gap down, and the down day was stronger than the up day. I have updated that study below.

SPY posts an unfilled gap down after posting an unfilled gap up yesterday. It closes < the close of 2 days ago but > 200ma. Buy SPY 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	-5,662.16	26	10	16	38.46	1,475.70	3,445.05	-1,276.20	-3,791.20	1.16	0.72	-217.78
4	-3,299.12	26	11	15	42.31	1,377.38	3,174.85	-1,230.02	-4,926.08	1.12	0.82	-126.89
3	-16,523.74	28	10	18	35.71	1,018.98	2,463.47	-1,484.08	-5,321.00	0.69	0.38	-590.13
2	-13,765.29	28	10	17	35.71	822.35	1,754.40	-1,293.46	-3,893.00	0.64	0.37	-491.62
1	13.76	28	14	13	50.00	479.02	1,325.15	-514.81	-1,564.50	0.93	1.00	0.49

The results table seems to point to a 2-3 day downside edge. So below I ran a 3-day equity curve.



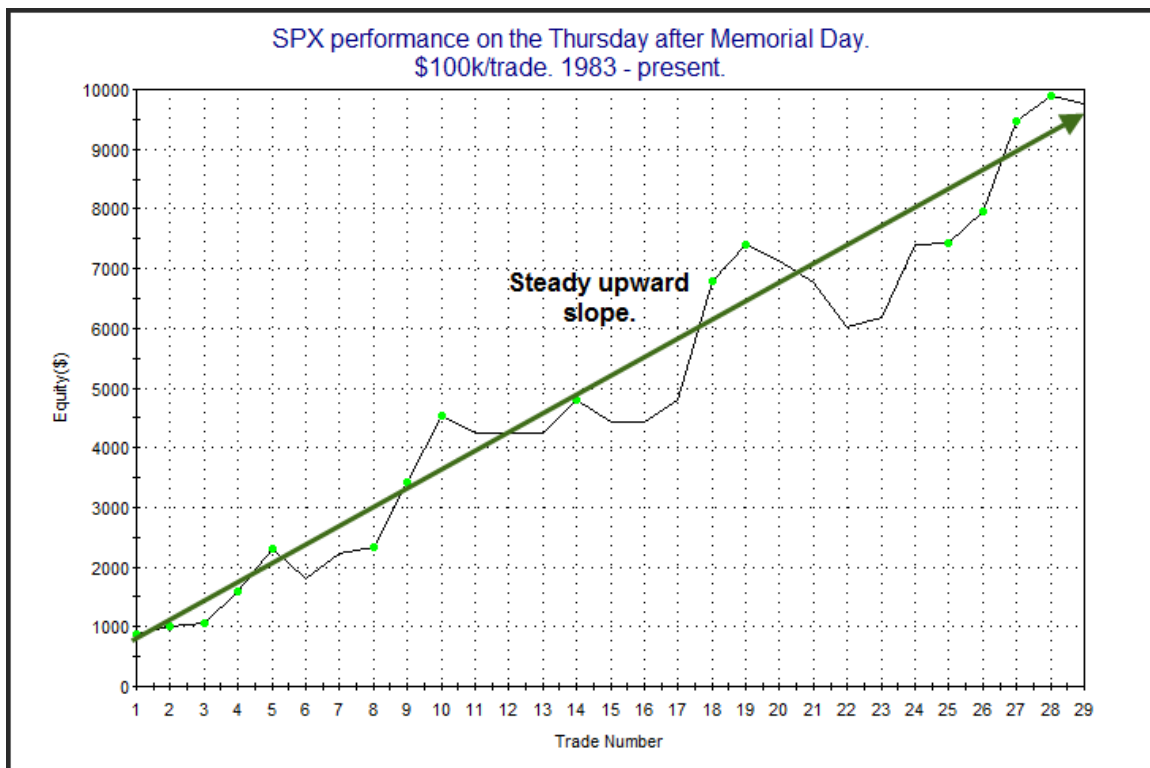
It is definitely choppy, and the last couple of instances have been up, but the general slope has been, and still appears to be, down.

Overall it appears Wednesday's weak response to Tuesday's strong move higher is a short-term negative.

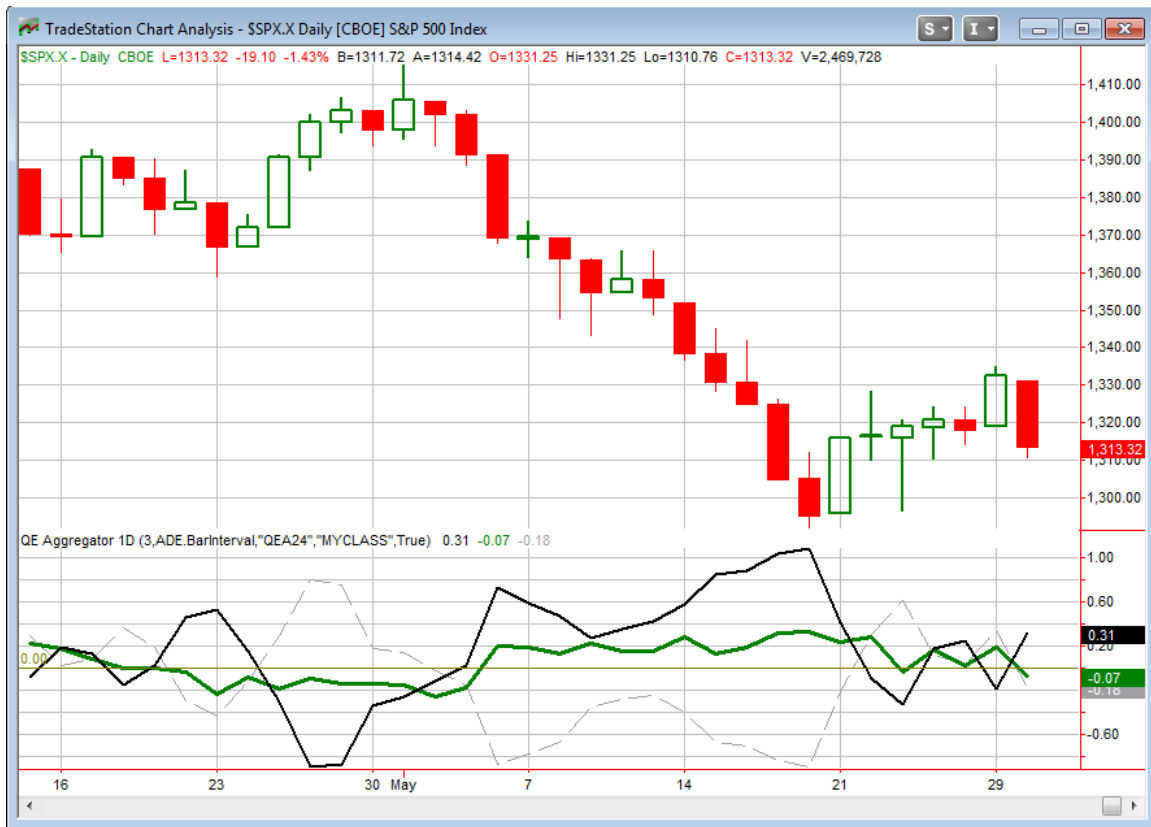
And short-term action could go a long way in determining the rally's potential for success or failure. Generally speaking, instances where the market has been down 5 days after the FTD have led to failed rallies about 2/3 of the time. And when the market closed up from the FTD 5 days later, that led to successful rallies about 2/3 of the time. I documented this in the blog on 2/1/2008. I intend to update these numbers this weekend. Below is a link to that blog post:

<http://quantifiableedges.blogspot.com/2008/02/short-term-implications-of-follow.html>

Lastly, I have simply copied that chart below from Sunday night's letter as a reminder of Thursday's bullish seasonal tendency.



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



Tonight's research helped cause the green Aggregator line to turn negative. Readings below 0 mean net expectations from the Active List are for downside over the next few days. Meanwhile the black Differential Line shot back above 0. This means the SPX is short-term oversold versus expectations. So net expectations are bearish but the SPX is now oversold versus recent expectations. This is considered a neutral configuration. Neutral configurations are visible on the chart whenever both lines close on opposite sides of 0. This meant the Aggregator System remained flat at the close. This was reflected on the systems page before the bell.

Based on the current studies, expectations are set to remain negative on Thursday. Of course this could change if bullish evidence emerges. Meanwhile, the Differential Pivot will be 1,319.58 on Thursday. This is 0.5% above Wednesday's close. Therefore the SPX would need to close up at least this much in order to turn the differential line back negative.

So despite the strong selling the Aggregator remains neutral. And so do I. Normally such strong down days will trigger studies suggesting a short-term bounce. But since the down day is a reversal of an attempt to break higher, suggestions instead point to high risk of

more downside. Bottom line is that while the market is now oversold, it does not appear to be a high-probability buying opportunity just yet.

I do still have some long exposure in the trade ideas section below. I feel as though I managed it poorly. Most of the time I am very good about getting out of my positions when I feel there is no longer a substantial edge in my favor. But I failed to get out at Tuesday's close, and Wednesday's unfilled gap down stuck me in a bad place. Since I am neutral at this point, I am not going to be stubborn and try and hold a position for an extended period, but I also see no need to panic out. So I decided to use a stop to manage the position. Details are in the Trade Ideas section near the bottom of the letter.

Intermediate-term Outlook (2 weeks – 2 months)– updated 5/29 – slightly bullish

The intermediate-term outlook was last updated in the 5/29 letter. There is a link below:

[2012-05-29 QE Subscriber Letter.pdf](#)

Catapult and Capitulative Breadth Statistics

[Catapult & CBI Presentation Link](#)

Open Catapult Triggers

JPM – 1/3 @ \$32.51 (not filled and not currently looking for a fill)

Catapult for ETF's Trades

None

Broad Market Large Cap CBI – 1 (JPM)

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.

Current Open Trade Ideas

Symbol	Entry Date	Entry Price	Current Price	% Gain/Loss	Stop	Notes
QQQ(1/4)	5/7/2012	\$64.31	\$62.33	-3.08%	\$61.58	<i>stop below Wed low</i>

I placed a stop a little below Wednesday's low for QQQ. No need to let it hurt me bad if selling intensifies. If not hit I may give it a chance to bounce a little before selling. I will examine the Quantifinder during the day on Thursday and use that information in my decision to hold or exit.

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