

# QUANTIFIABLE EDGES SUBSCRIBER LETTER

ASSESSING MARKET ACTION WITH INDICATORS AND HISTORY

July 2, 2012

Volume 5 Issue 126

## Market Overview



## Signals Overview

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

## Tonight's Research Points

- Closing the month at a high level is something that has often been followed by further gains the following month.
- The SPX/NASDAQ relative strength indicator is back to favoring the SPX, which is no longer bullish, and now neutral.
- The Fed released the July POMO schedule, and it appears we will experience the largest liquidity inflow in several months.

## Short-term Outlook

### The Bottom Line

Evidence still suggests further upside, but the SPX is now very overbought. Risk/reward at such extended levels is not very good for a short-term trade. I'm standing aside and awaiting a more compelling opportunity.

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

Study Date	Description	Time span	Bias	Avg Max Move
<b>Active</b>				
June 29, 2012	SPY closes month at high	1-5 days	Bullish	2.35%
<b>Active - Long Term</b>				
June 18, 2012	POMO modestly bullish	int term	slight bull	
June 13, 2012	FTD with modest breadth & vol	int term	<b>Bearish</b>	
February 1, 2012	Golden Cross	int term	Bullish	
<b>Dropped Tonight</b>				
<b>June 29, 2012</b>	<b>SPX down. Up Issues &gt; 55%. Close &gt;</b>	<b>1-2 days</b>	<b>Bullish</b>	<b>1.00%</b>
<b>June 28, 2012</b>	<b>Up 2 days but below close 3 ago</b>	<b>1-2 days</b>	<b>Bullish</b>	<b>0.90%</b>
June 25, 2012	Sweet spot bounce from 1.75% drop	1-5 days	Bullish	3.00%
June 25, 2012	Nasdaq leading SPX	int term	Bullish	

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

**The Evidence**

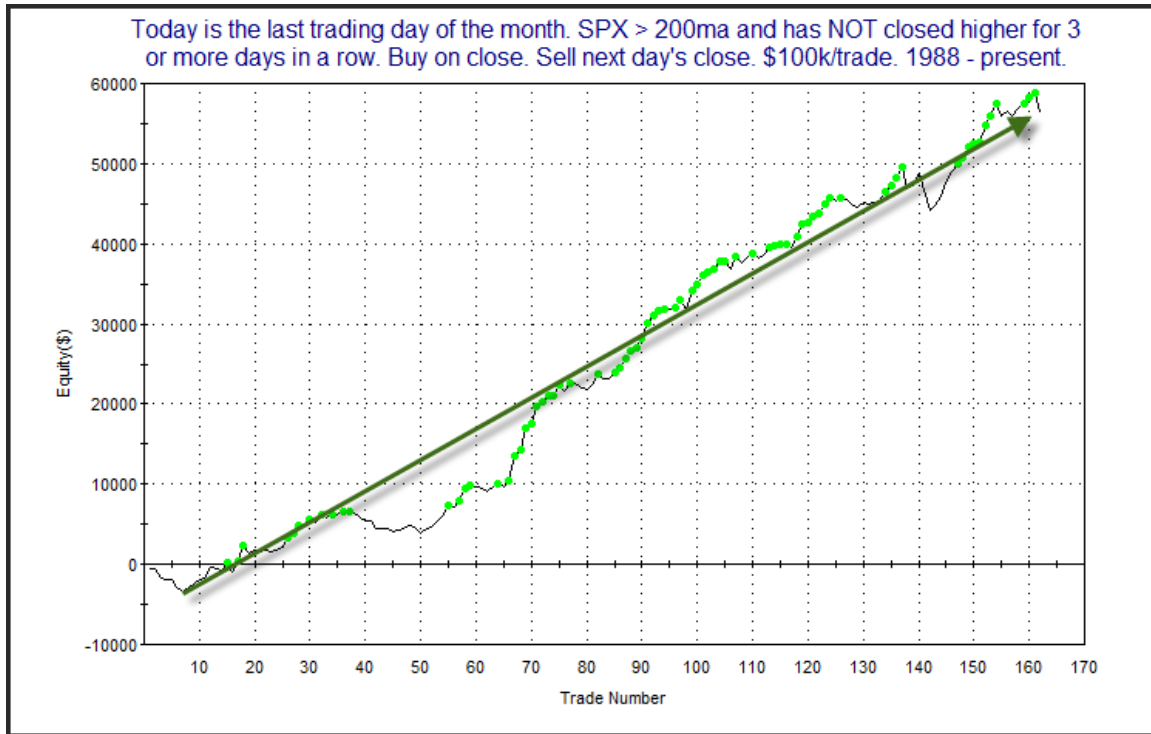
A big gap up was followed by a strong move higher and the market put in strong gains across the board. The SPX gained 2.5%, the Nasdaq rallied 3.0%, and the Russell 2000 closed up 2.9%. Breadth was strongly positive as the NYSE Up Issues % came in at 86% and the Up Volume % was 89%. Total NYSE volume came in at the highest level of the week.

I've discussed many times in the past that the first trading day of the month has been seasonally bullish. This has especially been true for the SPX when it has been in an uptrend. In the 4/2/12 subscriber letter I looked at other instances where the market was above the 200ma and had not closed up for at least three consecutive days. I have updated that study below

Today is the last trading day of the month. SPX > 200ma and has NOT closed higher for 3 or more days in a row. Buy on close. Sell next day's close. \$100k/trade. 1988 - present.

TradeStation Performance Summary				Collapse ^
All Trades				
Total Net Profit	\$56,366.49	Profit Factor	2.80	
Gross Profit	\$87,701.28	Gross Loss	(\$31,334.79)	
Total Number of Trades	162	Percent Profitable	67.28%	
Winning Trades	109	Losing Trades	53	
Even Trades	0			
Avg. Trade Net Profit	\$347.94	Ratio Avg. Win:Avg. Loss	1.36	
Avg. Winning Trade	\$804.60	Avg. Losing Trade	(\$591.22)	
Largest Winning Trade	\$3,119.10	Largest Losing Trade	(\$2,617.60)	

Results here appear quite strong. Below is an equity curve that shows how the edge has played out over time.



The steady upslope appears to confirm the bullish edge.

But with a 2.5% gain today I had some concern that Monday's seasonal strength may have come a bit early. I looked back to 1988 to find other times when the SPX was above its 200ma and closed greater than 2% higher on the last day of the month. Unfortunately, there were only two instances. Not that we can derive much from just two instances, but they did both close higher. So I lowered the requirement down to 1.25% and reran the study. There were 10 instances that qualified and they are all listed below.

Today is the last trading day of the month. SPX close up > 1.25% today and > 200ma. Buy on close. Sell next day's close. \$100k/trade. 1988 - present.

Date/Time	Signal	Price	% Profit	Run-up Drawdown
07/29/88	Buy	\$272.02	0.07%	\$286.26
08/01/88	Sell	\$272.20		(\$300.94)
10/31/89	Buy	\$340.36	0.24%	\$401.41
11/01/89	Sell	\$341.19		(\$167.01)
05/31/95	Buy	\$533.41	0.01%	\$149.60
06/01/95	Sell	\$533.49		(\$628.32)
04/30/98	Buy	\$1,111.75	0.83%	\$825.03
05/01/98	Sell	\$1,121.02		\$0.00
05/28/99	Buy	\$1,301.82	(0.58%)	\$1.52
06/01/99	Sell	\$1,294.26		(\$1,545.08)
06/30/99	Buy	\$1,372.86	0.59%	\$715.68
07/01/99	Sell	\$1,380.96		(\$871.20)
10/29/99	Buy	\$1,362.93	(0.65%)	\$324.12
11/01/99	Sell	\$1,354.12		(\$643.13)
01/31/00	Buy	\$1,394.46	1.06%	\$1,280.13
02/01/00	Sell	\$1,409.28		(\$465.05)
02/29/00	Buy	\$1,366.42	0.93%	\$1,243.92
03/01/00	Sell	\$1,379.19		\$0.00
05/30/03	Buy	\$963.59	0.35%	\$1,598.56
06/02/03	Sell	\$967.00		\$0.00

This seems to suggest that Friday's strong move up may not take away from Monday's chance to move higher.

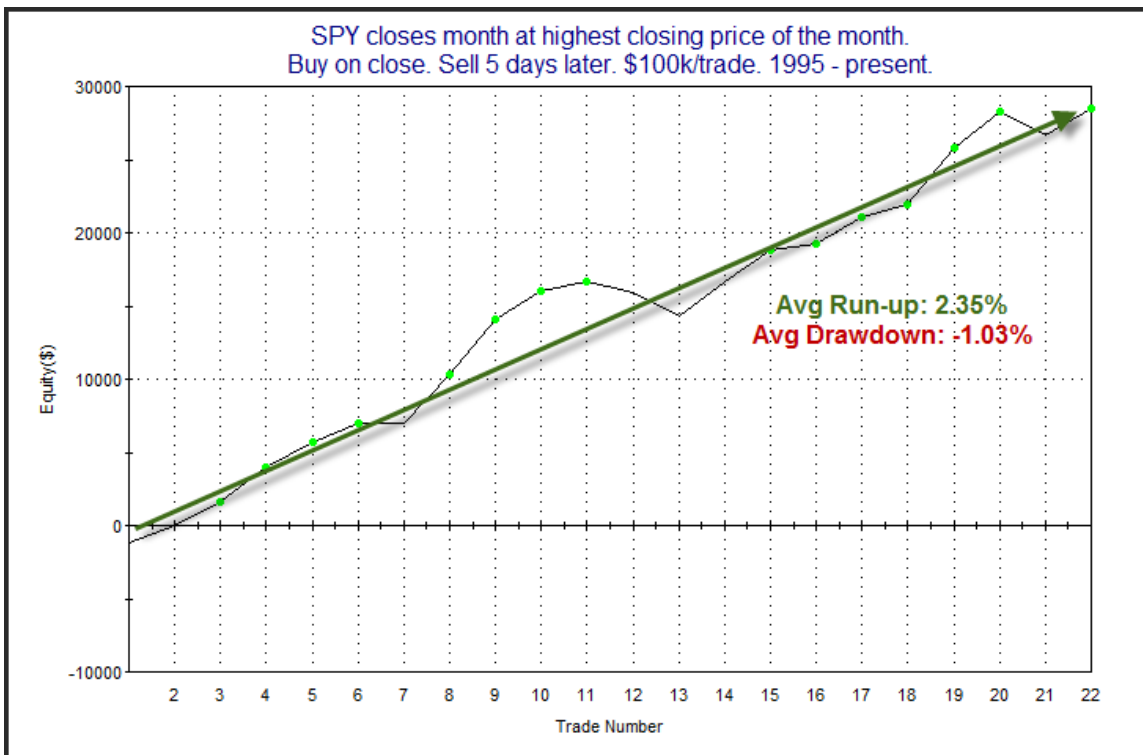
In the 7/1/11 subscriber letter I showed a study that examined other times SPY closed at its highest level of the month on the last day of the month. Results of that study suggested the strong end of month momentum has typically carry through into the following month. I have updated that study below.

SPY closes month at highest closing price of the month.  
Buy on close. Sell X days later. \$100k/trade. 1995 - 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	32,612.15	22	17	5	77.27	2,536.05	5,238.84	-2,100.14	-4,159.04	1.21	4.11	1,482.37
9	32,836.86	22	16	6	72.73	2,577.23	4,455.36	-1,399.79	-3,178.47	1.84	4.91	1,492.58
8	28,506.09	22	17	5	77.27	2,223.93	4,879.68	-1,860.13	-2,884.75	1.20	4.06	1,295.73
7	25,132.41	22	15	7	68.18	2,171.94	4,366.26	-1,063.82	-2,519.04	2.04	4.37	1,142.38
6	28,489.98	22	16	6	72.73	2,188.46	6,355.08	-1,087.56	-2,024.57	2.01	5.37	1,295.00
5	28,483.00	22	17	4	77.27	1,982.69	3,931.92	-1,305.67	-1,659.68	1.52	6.45	1,294.68
4	21,653.56	22	15	7	68.18	2,184.68	5,394.96	-1,588.08	-6,208.40	1.38	2.95	984.25
3	14,732.78	22	14	8	63.64	1,822.31	4,105.92	-1,347.44	-4,678.40	1.35	2.37	669.67
2	10,135.79	22	12	10	54.55	1,657.65	3,954.78	-975.60	-4,848.40	1.70	2.04	460.72
1	6,646.48	22	12	10	54.55	979.33	1,850.94	-510.54	-1,049.76	1.92	2.30	302.11

19 of 22 instances (86%) closed above the entry price at some point in the next week.

We see here that the edge goes beyond just the first trading day of the month. The numbers across the board are quite compelling. And while most of the edge is realized week one, there even appears to be some follow through into week two. Below is an equity curve showing results assuming a 5-day holding period.



The steady upslope supports the bullish hypothesis suggested by the stats table.

While the market was rallying strongly, VXO took a dive. In doing so it triggered a seemingly bearish study from the 2/25/09 subscriber letter. That study suggested that VXO drops of 15%+ provided a downside SPX edge over the next few days. But there was no trend filter associated with that study. Tonight I examined performance both above and below the 200ma. First let's look at times like now when the SPX is above the 200ma. A

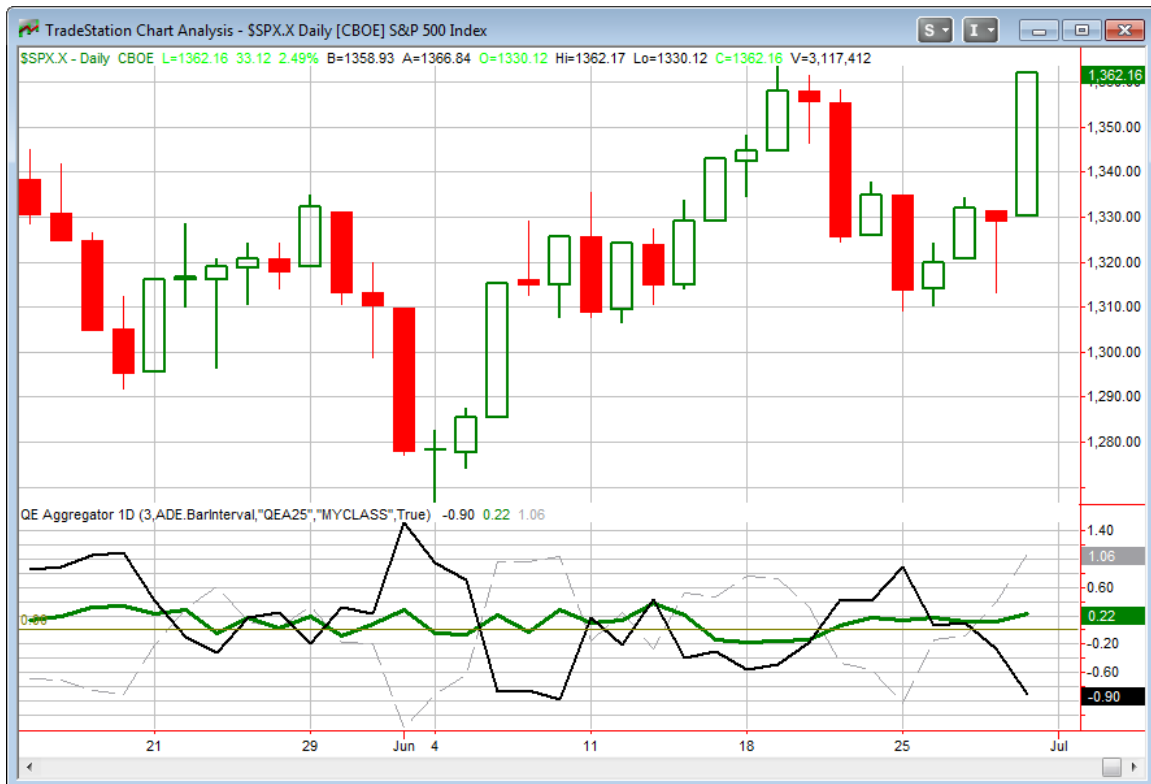
VXO closes down over 15%. SPX > 200ma. Buy SPX on close. Sell X days later. \$100k/trade. 1988 - present.												
X Days	All: Net Profit	All: Total Trades	All: Winning Trades	All: Losing Trades	All: % Profitable	All: Avg Winning Trade	All: Max Winning Trade	All: Avg Losing Trade	All: Max Losing Trade	All: Win/Loss Ratio	All: ProfitFactor	All: Avg Trade
5	-2,739.10	21	9	12	42.86	1,887.24	5,261.10	-1,643.68	-4,903.50	1.15	0.86	-130.43
4	-1,534.43	22	10	12	45.45	1,088.16	2,395.28	-1,034.67	-3,781.59	1.05	0.88	-69.75
3	-2,950.35	22	9	13	40.91	979.83	2,172.60	-905.30	-2,538.22	1.08	0.75	-134.11
2	-3,710.05	22	11	11	50.00	979.51	2,472.46	-1,316.79	-2,913.46	0.74	0.74	-168.64
1	840.63	22	9	13	40.91	942.81	2,463.70	-588.05	-2,447.08	1.60	1.11	38.21

These results don't appear to suggest any kind of an edge. Now let's look at results and below the 200ma.

VXO closes down over 15%. SPX < 200ma. Buy SPX on close. Sell X days later. \$100k/trade. 1988 - 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	-23,997.14	17	7	9	41.18	2,820.34	7,088.90	-4,859.94	-15,038.32	0.58	0.45	-1,411.60
4	-33,165.36	19	10	9	52.63	1,655.41	4,221.36	-5,524.38	-11,911.24	0.30	0.33	-1,745.55
3	-34,361.15	19	6	13	31.58	1,074.79	3,272.62	-3,139.22	-7,473.88	0.34	0.16	-1,808.48
2	-39,296.49	19	4	15	21.05	1,366.38	2,707.64	-2,984.13	-11,171.38	0.46	0.12	-2,068.24
1	-17,959.68	19	4	14	21.05	870.28	1,407.12	-1,531.49	-4,416.69	0.57	0.16	-945.25

Based on this it would seem that the entire downside edge has been realized when SPX has been trading below its 200ma. Needless to say, the study did not make the active list.

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



There is only one study left on the short-term active list, and it is the one from above that looks at month's closing at a high level. So it is no surprise that the green Aggregator line remained positive tonight. Readings above 0 mean net expectations from the Active List are for upside over the next few days. Meanwhile the black Differential Line dove down well below zero. This means the SPX is short-term overbought versus expectations. So net expectations are moderately bullish but the SPX is strongly overbought 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.

Based on the current active studies, expectations are set to remain positive Monday. But with only the one short-term study active, expectations will be largely dependent on new studies that emerge. Meanwhile, the Differential Pivot will be 1,337.10 on Monday. That is over 1.8% below Friday's close. So it would take a close at or below this level to flip the Differential line and move the SPX back to short-term oversold. That sized drop is unlikely to occur in one day. A more likely scenario is that we see a multi-day pullback or consolidation to alleviate the overbought condition.

So evidence is still pointing higher. But after Friday's move, the market is so strongly overbought that it is in a dangerous place to attempt a short-term trade. I'm going to remain flat and await a more compelling opportunity before putting capital at risk.

***Intermediate-term Outlook (2 weeks – 2 months)– updated 7/2 – slightly bullish***

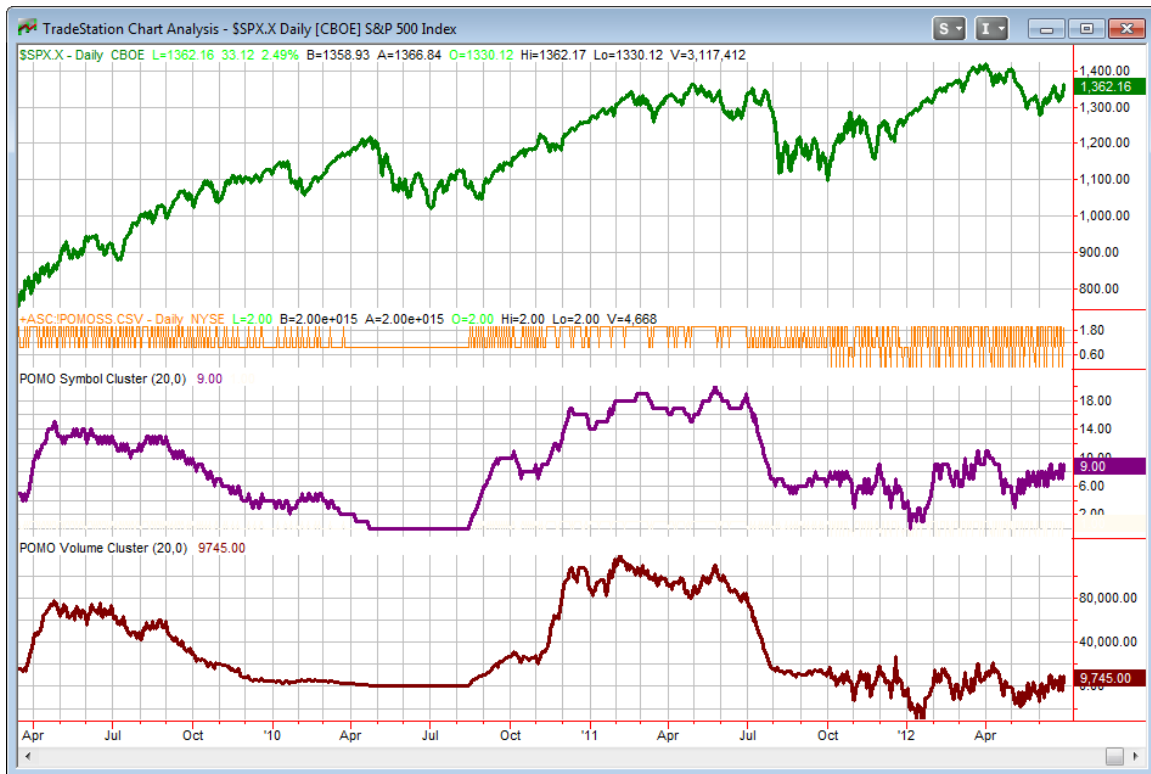
It was a back and forth week for the market that ultimately ended with a solid game. The market put in at least a short-term low about four weeks ago and has been working on a rally since. There are a couple of notable intermediate-term indicators to discuss below.

For the 2<sup>nd</sup> week in a row the Nasdaq/SPX relative strength model flipped its signal. This time it swung back to where the SPX is leading. Since the inception of the Nasdaq, the SPX has gained 1,408 points when then Nasdaq was in leading position and has lost ground when the SPX is leading. The indicator has been less consistent over the last few years, but I would still prefer to see a leading Nasdaq. More information on the indicator may be found [in this old blog post](#). Any subscriber who wants to download the model may do so on [the Downloads page](#). The data in the Excel version has not been updated in a while, but the calculations are all there.

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.)*

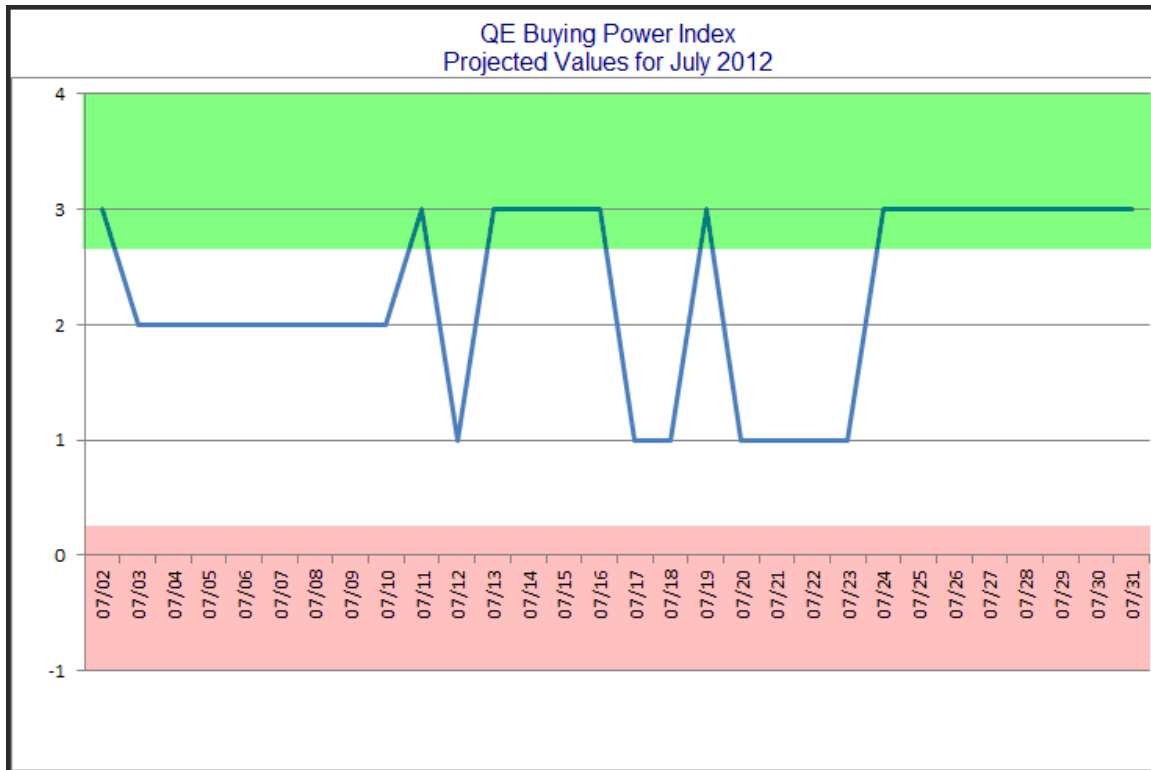
<http://www.quantifiableedges.com/members/pomo.php>



There were 3 days of POMO buying and 2 days of selling this past week. The selling days were much larger though and the net result was a fairly large \$5.7 billion outflow. With an even worse week coming off the back end of the equations, the intermediate-term POMO indicators actually rose slightly and remain near the upper end of the range for the last 2 months.

This upcoming week is scheduled to see further outflows of about \$750 million. There are to be 2 moderate days of buying and 1 large selling day.

The Fed released its POMO schedule for July on Friday, and it was interesting. The net result of July's buying and selling is set to be about a \$6 billion liquidity infusion. This will be the largest monthly infusion since Operation Twist began. Previous months have typically seen infusions of \$1-\$2 billion. Using the July schedule I have generated the projected QE Buying Power Index chart for July. I have copied it below.



It also can be seen anytime (through the end of July) at the QE Buying Power Index Information page on Quantifiable Edges (link below).

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

In looking at the chart the key takeaways are that 1) the Index will spend a good portion of the month in bullish (3+) territory, and 2) it will not move down into bearish territory ( $\leq 0$ ) at any point during the month. This all suggests July could be a dangerous month for shorts, and that pullbacks could provide some nice buying opportunities.

Intermediate-term evidence remains mixed with a bullish tilt. Bullish evidence comes from POMO flows and momentum studies. FTD inclinations initially appeared bearish but the fact that the market has continued to move higher since the FTD is encouraging. I am still moderately favoring the bull case.

## **Catapult and Capitulative Breadth Statistics**

*[Catapult & CBI Presentation Link](#)*

### ***Open Catapult Triggers***

*None*

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

*None*

### ***Broad Market Large Cap CBI – 0***

## **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**

*None*

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