

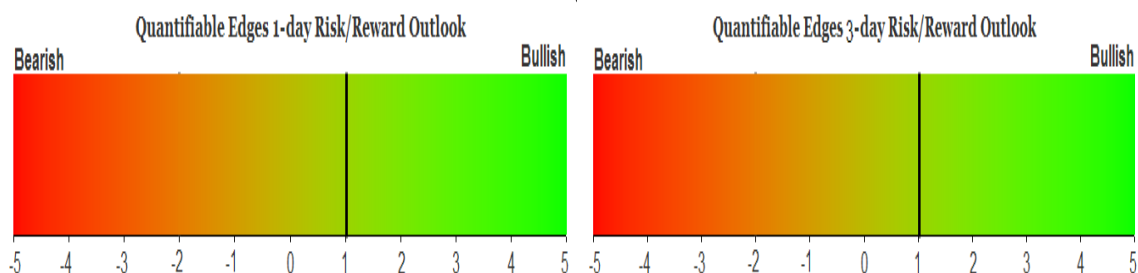
QUANTIFIABLE EDGES SUBSCRIBER LETTER

ASSESSING MARKET ACTION WITH INDICATORS AND HISTORY

July 16, 2012

Volume 5 Issue 135

Market Overview



Signals Overview

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

Tonight's Research Points

- The low-volume bounce from strongly oversold appears to be a positive.
- POMO flows will be strongly negative this week, before turning strongly positive for the rest of the month.

Short-term Outlook

The Bottom Line

Friday's strong rally quickly wore off the oversold condition. There could still be further rallying in the next few days, but risk/reward isn't great. The has me mostly sidelined and waiting for a more favorable entry opportunity.

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

Study Date	Description	Time span	Bias	Avg Max Move
Active				
July 16, 2012	Vol vol bounce from RSI(2)<5.	1-2 days	Bullish	1.30%
July 12, 2012	5 dn. Close > 200ma and > 20-low.	1-3 days	Bullish	1.60%
Active - Long Term				
July 16, 2012	POMO modestly bullish	int term	neutral	
June 13, 2012	FTD with modest breadth & vol	int term	Bearish	
February 1, 2012	Golden Cross	int term	Bullish	
Dropped Tonight				
July 10, 2012	3 down. Tomorrow is Tuesday.	1-4 days	Bullish	3.20%
July 9, 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

The day started off strong and remained strong though the close. Sizable gains were seen across the board. The SPX rallied 1.65%, the Nasdaq gained 1.5% and the Russell 2000 rose 1.4%. Breadth was strongly positive as the NYSE Up Issues % came in at 83% and the Up Volume % was 89%. Total NYSE volume fell quite a bit from Thursday's level.

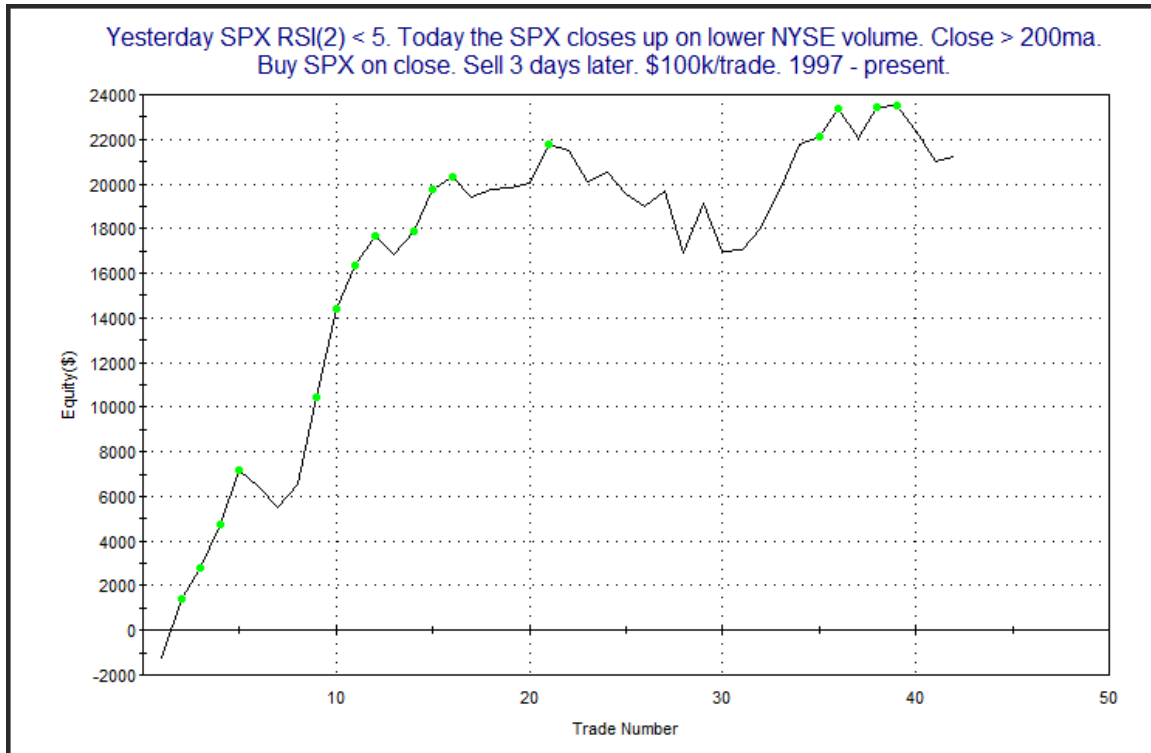
Friday was an incredibly strong reversal after such a persistent selloff. In fact it made up for the last 4 days, which were all losers. Looking back to 1961, I was only able to find 4 other instances where the SPX made up for 4 consecutive down days in just 1 day while the SPX was above the 200ma. Results over the next couple of days were mixed, but when looking out 2 weeks, it was interesting to see that all 4 instances were trading lower. I'm not going to try and draw any meaning from just 4 instances but the dates for those that are interested were 2/15/62, 5/26/81, 12/17/92, and 9/28/00. It's happened 6 times while the SPX was below its 200ma, and oddly 4 of those 6 were higher 2 weeks later, which seems to be further warning that we shouldn't try and imply much from those 4 instances.

The study below was last seen in the 5/11/12 letter. It considered bounces from strongly oversold short-term conditions and filtered based on the relative volume of the first day of the bounce. The study suggested that low volume bounces provide more favorable odds. I have updated the results.

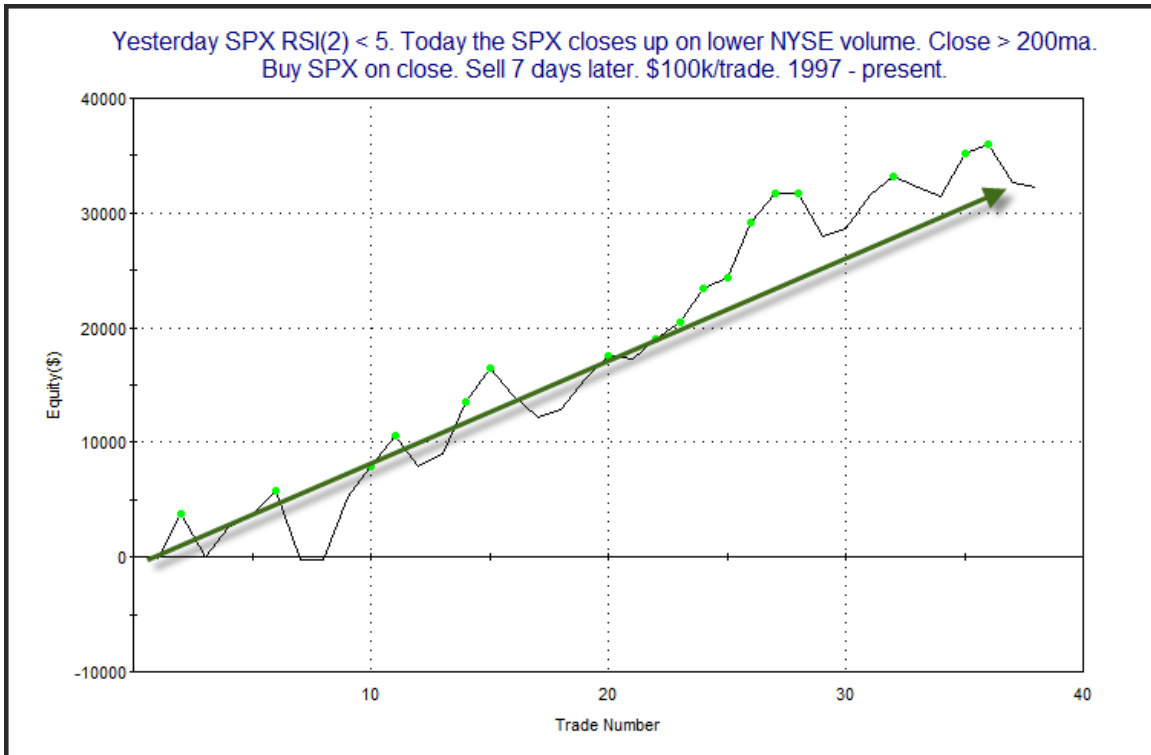
Yesterday SPX RSI(2) < 5. Today the SPX closes up on lower NYSE volume. Close > 200ma. Buy SPX on close. Sell X days later. \$100k/trade. 1997 - present.												
X Days	All: Net Profit	All: Total Trades	All: Winning Trades	All: Losing Trades	All: % Profitable	All: Avg Winning Trade	All: Max Winning Trade	All: Avg Losing Trade	All: Max Losing Trade	All: Win/Loss Ratio	All: ProfitFactor	All: Avg Trade
10	18,589.43	37	18	19	48.65	3,285.31	6,440.94	-2,134.01	-7,402.88	1.54	1.46	502.42
9	23,149.83	38	24	14	63.16	2,604.46	6,371.46	-2,811.23	-6,195.44	0.93	1.59	609.21
8	13,342.93	38	24	14	63.16	2,250.91	6,486.48	-2,905.63	-7,580.04	0.77	1.33	351.13
7	32,257.69	38	25	13	65.79	2,339.56	5,418.09	-2,017.79	-5,975.16	1.16	2.23	848.89
6	29,200.44	39	25	14	64.10	2,092.58	5,668.38	-1,651.00	-3,510.00	1.27	2.26	748.73
5	26,795.65	39	23	16	58.97	2,325.69	5,396.71	-1,668.45	-8,178.56	1.39	2.00	687.07
4	24,860.49	41	25	16	60.98	1,869.91	4,223.34	-1,367.95	-2,736.28	1.37	2.14	606.35
3	15,479.61	42	24	18	57.14	1,461.86	4,457.43	-1,089.17	-3,490.90	1.34	1.79	368.56
2	21,210.19	42	28	14	66.67	1,347.21	4,001.40	-1,179.41	-2,735.64	1.14	2.28	505.00
1	14,095.57	42	27	15	64.29	943.26	2,842.84	-758.16	-2,782.56	1.24	2.24	335.61

87% of instances closed above the entry price at some point in the next week.

The numbers here are all fairly attractive. The 2-day and 7-day results appear to be especially appealing. Below are profit curves for both those time frames. First I will show the 2-day holding period.



This one has bounced around a bit lately. That is a little disconcerting, but not so much to make me throw out the study. I also wanted to look at the 7-day results.



This curve is more appealing. It did not seem to suffer the same struggles that the 2-day holding period experienced.

The volume is an interesting filter here. Many readers may be wondering whether it really matters. The test below looks at the exact same scenario, except rather than requiring volume come in lower, it requires it to come in higher.

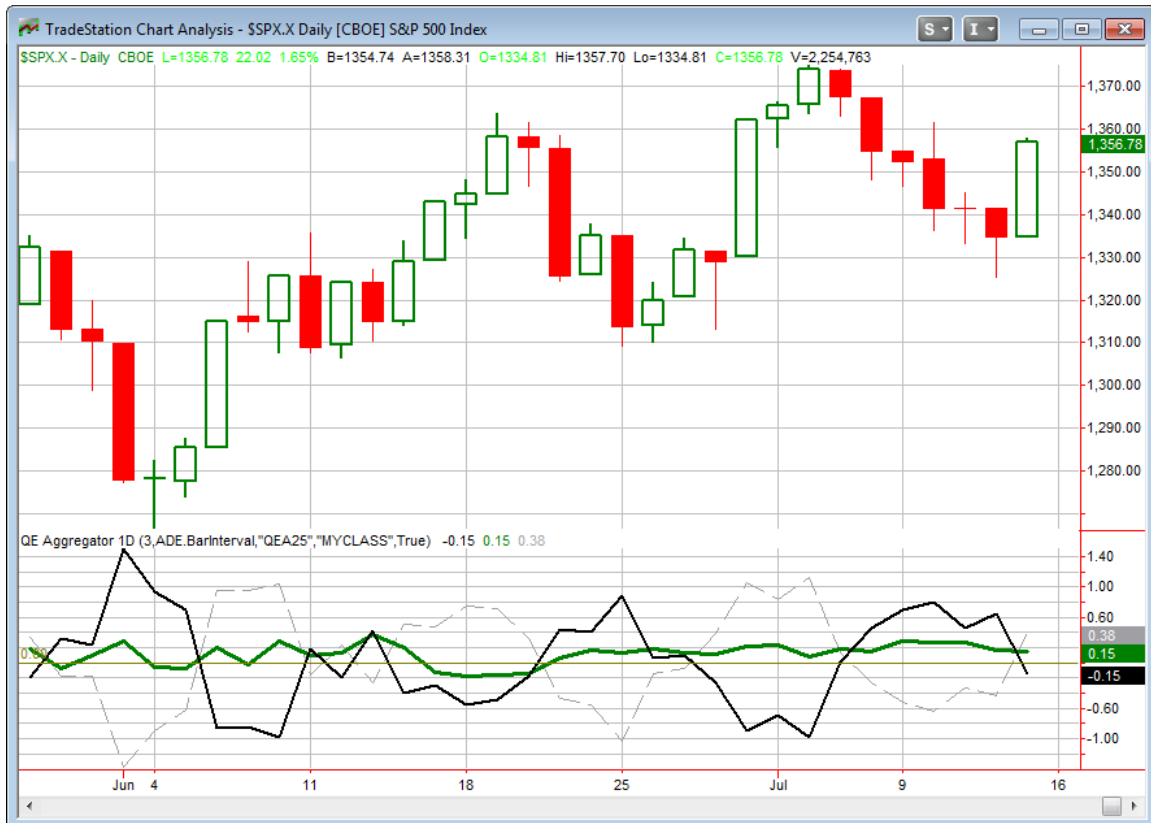
Yesterday SPX RSI(2) < 5. Today the SPX closes up on **higher** NYSE volume. Close > 200ma.
Buy SPX on close. Sell X days later. \$100k/trade. 1997 - present.

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	-2,071.07	19	9	10	47.37	3,532.25	-2,969.64	1,342.26	-1,415.14	0.95	0.85	-109.00
4	-4,197.57	20	11	9	55.00	2,587.95	-2,541.13	929.63	-1,602.61	0.58	0.71	-209.88
3	-10,722.45	20	6	14	30.00	3,939.79	-2,517.13	1,234.45	-1,294.94	0.95	0.41	-536.12
2	-8,343.62	20	8	12	40.00	2,794.56	-1,962.36	705.60	-1,165.70	0.61	0.40	-417.18
1	-6,590.57	20	8	12	40.00	761.76	-1,774.60	347.28	-780.74	0.44	0.30	-329.53

As you can see, the change in volume appears to have a dramatic impact on the results. It would seem that the low volume bounces may suggest that people need convincing and

are not rushing back in. But over the next few days, their willingness to commit capital and desire not let the bounce get too far away from them helps to propel it further.

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



Tonight's studies didn't change the green Aggregator line much as it is still squarely positive. Readings above 0 mean net expectations from the Active List are for upside over the next few days. But the big rally caused the black Differential Line to drop sharply and fall below 0. This means the SPX is overbought versus expectations. So net expectations are bullish but the SPX is 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 changed from long to flat at the close. This was indicated as likely on the systems page before the bell.

Based on the current active studies, expectations are set to remain positive again on Monday. Of course this could change if bearish evidence emerges. Meanwhile, the Differential Pivot will be 1,352.26 on Monday. This is just 0.3% below Friday's close. So it won't take much of a pullback to quickly wear off the overbought condition..

So I am mostly neutral short-term. I do have a short-volatility trade on (long XIV), and I may hold on to that a little longer, since it is nicely profitable and contango is acting strongly in its favor. To enter new long positions would require a pullback.

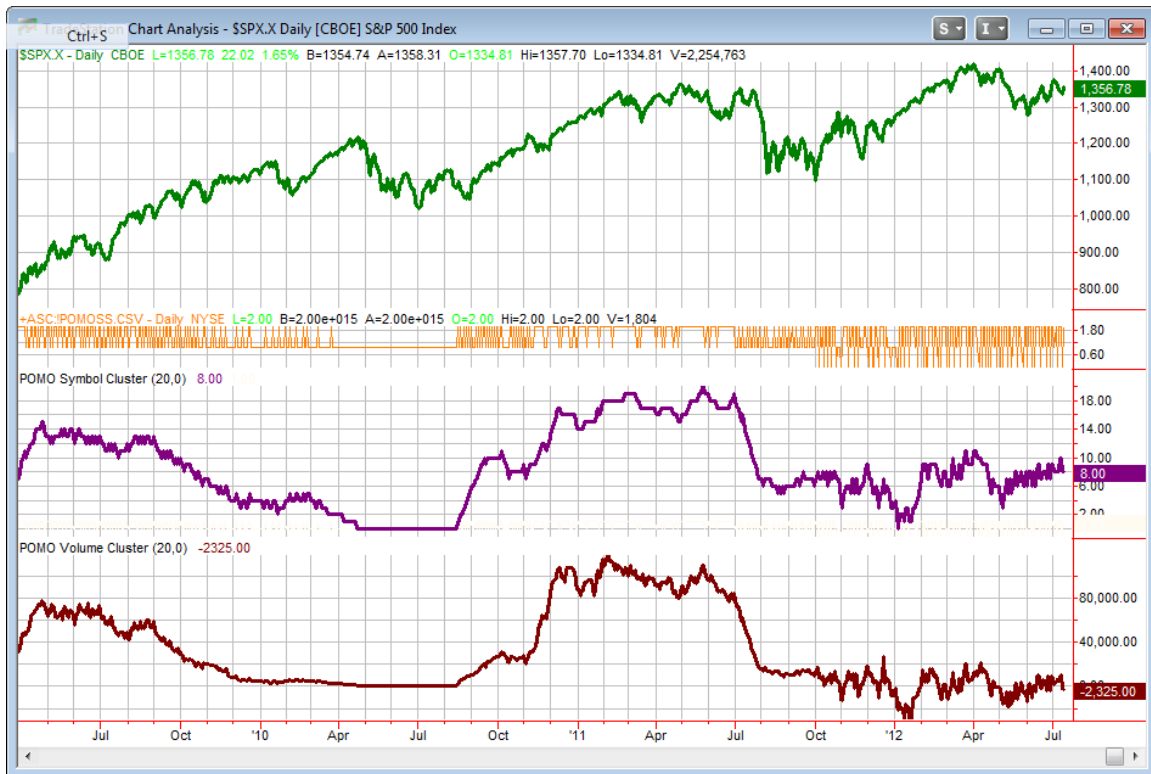
Intermediate-term Outlook (2 weeks – 2 months)– updated 7/16 – slightly bullish

After suffering losses Monday – Thursday, Friday’s action actually left the SPX with a mild gain for the week. After bottoming in early June, the market has been doing a lot of chopping around. This marked the 4th week in a row that the SPX reversed course.

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 selling day was again substantially larger than the buying days, so the net result was a moderate \$1.8 billion liquidity infusion. Activity that fell off the back-end of the intermediate-term (20-day) lookback was stronger, so this past week actually saw a sizable drop in the intermediate-term POMO volume indicator. Over the last 20 days there have actually been net outflows of \$2.325 billion. Perhaps this partially explains the difficulty the market has had in getting this rally going.

This upcoming week is scheduled to be the worst one in a while. We are set to see 3 moderate days of POMO buying and 2 large days of selling. The net result is an anticipated outflow of about \$6.5 billion, which could make for some difficult trading in the next week or two for the market.

The good news is that starting next week and lasting through the end of the month we are set to see strong inflows. From the 23rd to the 31st we will see 6 buying days and only 1 selling day. The net result will be about a \$12 billion inflow. The impact of this should be felt soon after, perhaps starting near the end of July and lasting into early August.

Breadth has been pretty good in the last few weeks. On 7/3 the McClellan Oscillator hit its highest level in over a year. And the NYSE advance/decline line is only about 2000 points below its 1-year high. So I am keeping an eye on breadth-based studies that would

hint at increased chances of success for this rally. Unfortunately I have not come up with anything terribly compelling to date.

One way I like to define environments like the current one is to say that it is in a “burgeoning rally”. The definition of a burgeoning rally is that the market has made a Follow Through Day (FTD), is currently above the close of the FTD close, but has not yet been deemed a “successful” rally based on the Quantifiable Edges FTD study. I found 27 instances in which the McClellan Oscillator hit a new 1-year high during a burgeoning rally. Seventeen of them resulted in successful rallies and the other 10 failed. That’s not a great win rate, especially since the losers were larger on average. There have been 13 times that the NYSE advance/decline line made a new 1-year high during a burgeoning rally (which it has not yet done). Seven turned into successful rallies and 6 ended as losers.

Intermediate-term evidence remains mixed. While I have listed the outlook above as “slightly bullish”, I am really neutral. The reason I did not list it as neutral is that neutral implies I am as willing to short as I am to enter long trades. With the QE Buying Power Index scheduled to close in neutral (1-2) or bullish (3+) territory from now through the end of the month, I won’t have a strong inclination to short, and will only do so very conservatively. So I am still more willing to buy oversold than I am to short overbought.

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

Symbol	Entry Date	Entry Price	Current Price	% Gain/Loss	Stop	Notes
SPY(1/4)	7/6/2012	\$135.49	\$135.75	0.19%		<i>sold on close</i>
SPY(1/4)	7/10/2012	\$135.32	\$135.75	0.32%		<i>sold on close</i>
XIV(1/2)	7/11/2012	\$11.64	\$12.60	8.25%	\$11.70	Aggressive VIX

I sent an intraday update to all gold subscribers Friday afternoon indicating I would exit the SPY lots on the close, so both of those were closed out.

I considered closing out XIV as well but kept it open for the following reasons. 1) The Aggressive VIX system still calls for a 50% long position thanks to the strong contango still present in the VIX futures term-structure. 2) It will only require a mild pullback in order to turn the Aggregator bullish and the Aggressive VIX system back to 100% long.

So I will hold XIV for now, but don't see a point in taking a loss on it if it reverses. Therefore I have placed a stop just above breakeven. If bearish evidence emerges in the next few days and the Aggregator signals short, then I will most likely take quick profits on this position.

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