

# QUANTIFIABLE EDGES SUBSCRIBER LETTER

ASSESSING MARKET ACTION WITH INDICATORS AND HISTORY

July 25, 2012

Volume 5 Issue 142

## Market Overview



## Signals Overview

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

## Tonight's Research Points

- 3 days down with a low 3/10 Offset HV suggests a downside edge.
- 3 down days from a 50-day high that close < 10ma but above 10-day low also suggest an upside edge.

## Short-term Outlook

### The Bottom Line

The outlook is getting more bullish. I'm looking to buy more on weakness.

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

Study Date	Description	Time span	Bias	Avg Max Move
<b>Active</b>				
July 25, 2012	3 dn from 50-hi. Under 10ma > 10-low	1-4 days	Bullish	1.90%
July 24, 2012	2 unfilled down gaps >200ma. 5 low	1-5 days	Bullish	1.80%
July 23, 2012	Big drop from 50-day high	1-4 days	Bullish	1.20%
<b>Active - Long Term</b>				
July 16, 2012	POMO modestly bullish	int term	Bullish	
June 13, 2012	FTD with modest breadth & vol	int term	Bearish	
February 1, 2012	Golden Cross	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 market fell on Tuesday for the 3<sup>rd</sup> day in a row. The SPX and Nasdaq each lost 0.9%, and the Russell 2000 declined 1.4%. Breadth was squarely negative as the NYSE Up Issues % came in at 26% and the Up Volume % was 22%. Total NYSE volume rose from Monday's level.

The timing of the pullback isn't terribly surprising, coming after a big liquidity withdrawal last week by the Fed. POMO flows have had a strong influence on market prices over the last several years though the timing is not exact. Typically, sizable cumulative flows have shown some influence out about a week. So the strong positive POMO flows we are now seeing could begin to exert themselves anytime in the next several days. Of course prices are dependent on more than just liquidity, but the fact that the QE Buying Power Index is slated to close at 3 for the remainder of the month should be a help for the bulls.

The 3-day pullback attracted a few Quantifinder studies tonight. While a 3-day drop will often lead to an upside edge, they aren't all created equal. Certain standout characteristics that I've identified over the years tend to raise (or lower) the chances of a bounce actually occurring. Based on what I am seeing with this one, the odds appear pretty favorable. Some important aspects of this pullback include: 1) It is occurring during a long-term uptrend. 2) It is coming off an intermediate-term high. 3) The QE Buying Power Index is now three. 4) SPX is below its short-term (10-day) moving average. So I perused the list of studies and elected to review the two below. I felt they best represented the current market conditions.

This first study considers the fact that the 3/10 Offset HV closed at a very low level on Tuesday. It was last seen in the 12/15/11 letter. As a brief review the 3/10 Offset HV compares the current 3-day historical volatility to the historical volatility of the 10 days prior to these three. When very low readings occur that means there has been a sharp contraction in volatility. This often leads to a volatility expansion. It isn't often useful in determining direction. It does suggest that a large move could occur, though. The 0.25 level is one I tend to use. Historically it has reached 0.25 or lower about 9% of the time. The 3 days following such low readings have seen the 3-day HV expand 5.5 times over the next 3 days.

So let's take a look and see how the market has reacted following 3-day pullbacks with low readings vs. those without low readings. First I'll show times when the 3/10 Offset HV is above 0.25.

SPX closes down for exactly the 3rd day in a row and HV Offset 3/10 Indicator > 0.25. Buy on close. Sell X days later. \$100k/trade. 2000 - 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	41,080.44	111	65	46	58.56	2,975.52	10,849.26	-3,311.49	-16,890.72	0.90	1.27	370.09
9	62,515.50	116	71	45	61.21	2,787.32	12,144.60	-3,008.55	-15,942.36	0.93	1.46	538.93
8	54,186.27	119	73	45	61.34	2,705.52	12,293.93	-3,184.81	-14,092.68	0.85	1.38	455.35
7	57,797.56	124	71	53	57.26	2,681.09	12,277.87	-2,501.13	-9,109.80	1.07	1.44	466.11
6	35,796.47	127	71	56	55.91	2,368.49	10,326.58	-2,363.68	-11,683.62	1.00	1.27	281.86
5	44,031.42	137	71	66	51.82	2,496.51	9,830.18	-2,018.49	-18,000.90	1.24	1.33	321.40
4	43,732.65	145	84	61	57.93	1,947.84	7,119.69	-1,965.35	-17,037.90	0.99	1.36	301.60
3	33,359.56	145	82	63	56.55	1,728.89	7,687.63	-1,720.79	-10,286.10	1.00	1.31	230.07
2	26,977.46	145	84	61	57.93	1,413.83	7,249.63	-1,504.65	-9,270.00	0.94	1.29	186.05
1	34,494.34	145	88	57	60.69	1,087.97	6,901.83	-1,074.51	-3,810.60	1.01	1.56	237.89

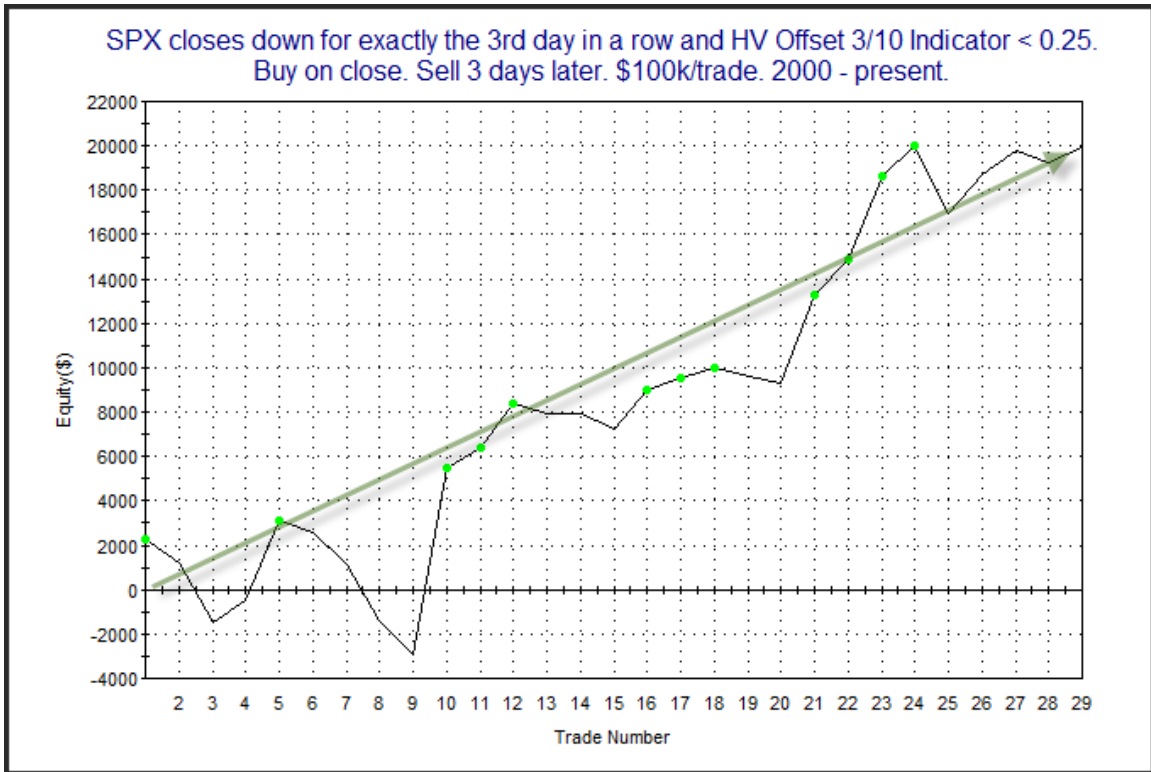
As we knew from past studies there is a mild upside bias after a 3-day pullback. It appears over the last 11 ½ years that the edge has really only lasted 1-day. Returns after the 1<sup>st</sup> day are fairly flat.

Now let's look at times like now where the 3/10 Offset HV is very low.

SPX closes down for exactly the 3rd day in a row and HV Offset 3/10 Indicator < 0.25. Buy on close. Sell X days later. \$100k/trade. 2000 - 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	30,136.58	29	19	10	65.52	2,816.08	13,815.90	-2,336.90	-5,143.04	1.21	2.29	1,039.19
9	28,104.94	29	18	11	62.07	2,630.95	11,206.23	-1,750.20	-5,817.60	1.50	2.46	969.14
8	25,924.57	29	18	11	62.07	2,798.58	11,382.35	-2,222.71	-4,624.64	1.26	2.06	893.95
7	15,311.96	29	17	12	58.62	2,604.57	10,117.38	-2,413.81	-5,582.08	1.08	1.53	528.00
6	14,896.81	29	17	12	58.62	2,628.28	5,903.59	-2,481.99	-7,964.16	1.06	1.50	513.68
5	19,328.01	29	18	11	62.07	2,474.79	8,234.80	-2,292.56	-7,032.56	1.08	1.77	666.48
4	14,014.83	29	18	11	62.07	2,138.49	8,810.76	-2,225.27	-7,145.44	0.96	1.57	483.27
3	19,962.79	29	16	13	55.17	2,193.45	8,432.34	-1,164.03	-3,021.92	1.88	2.32	688.37
2	18,622.65	29	17	12	58.62	1,856.92	5,018.23	-1,078.75	-5,271.36	1.72	2.44	642.16
1	8,721.74	29	19	10	65.52	991.39	2,971.43	-1,011.47	-4,660.72	0.98	1.86	300.75

**26 of 29 instances (90%) closed above the entry price  
at some point in the next week.**

These numbers appear to be quite a bit better. Both immediately and after a couple of weeks. The reliability of some kind of bounce improves nicely as well. Below is a profit curve assuming a 3-day exit strategy.



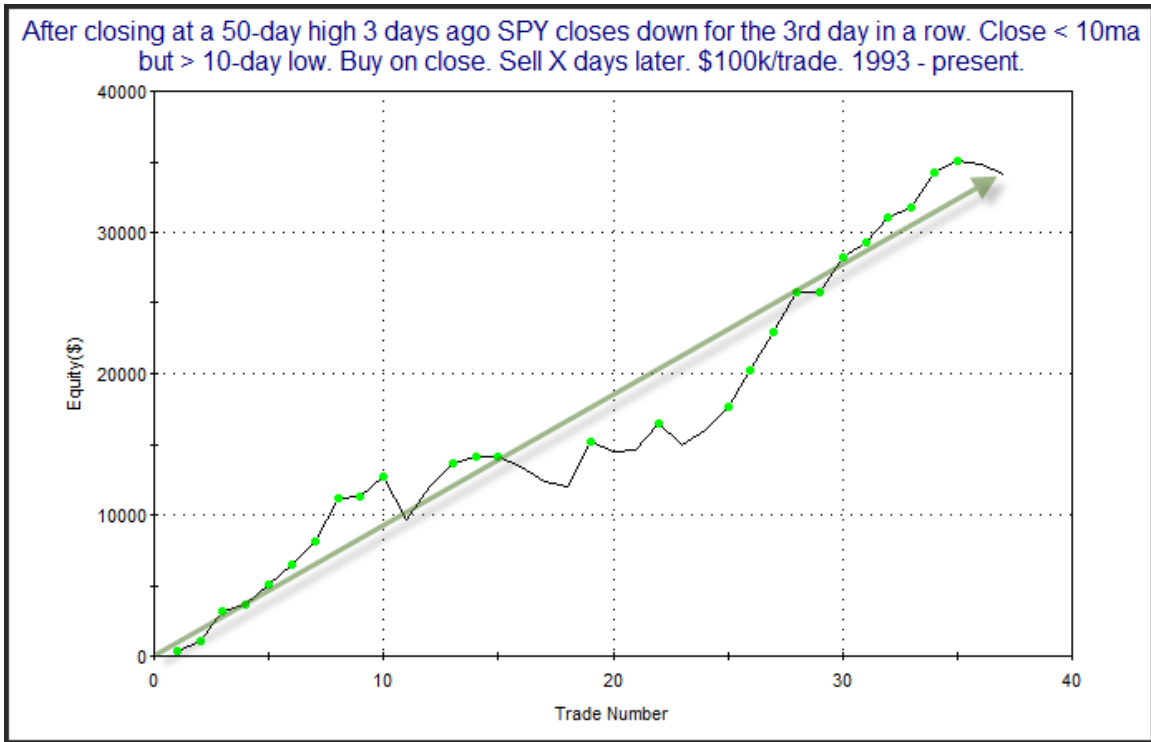
The strong upslope appears to confirm the stats table.

This next study utilizes a few of the observations I noted earlier. It was last shown in the 4/9/12 Letter. I have updated the stats table below.

After closing at a 50-day high 3 days ago SPY closes down for the 3rd day in a row. Close < 10ma  
but > 10-day low. Buy on close. Sell X days later. \$100k/trade. 1993 - present.

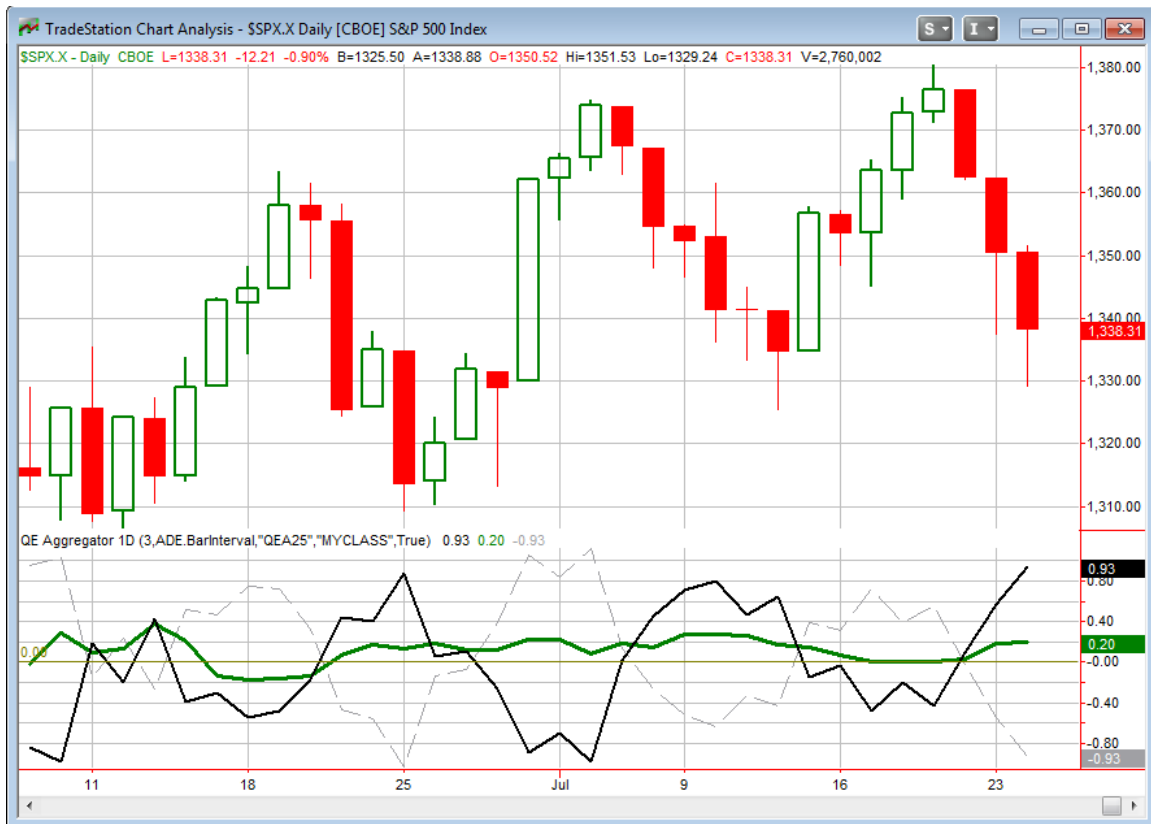
X Days	All: Net Profit	All: Total Trades	All: Winning Trades	All: Losing Trades	All: % Profitable	All: Avg Winning Trade	All: Max Winning Trade	All: Avg Losing Trade	All: Max Losing Trade	All: Win/Loss Ratio	All: ProfitFactor	All: Avg Trade
10	47,295.09	36	26	10	72.22	2,564.10	7,242.70	-1,937.15	-6,933.13	1.32	3.44	1,313.75
9	37,509.86	36	27	9	75.00	2,284.06	6,322.56	-2,684.43	-8,192.92	0.85	2.55	1,041.94
8	43,384.04	36	28	8	77.78	2,182.09	6,358.08	-2,214.30	-4,499.25	0.99	3.45	1,205.11
7	39,673.55	36	27	9	75.00	2,107.12	6,322.56	-1,913.18	-4,354.31	1.10	3.30	1,102.04
6	40,245.47	36	27	9	75.00	2,001.51	5,375.36	-1,532.82	-2,140.14	1.31	3.92	1,117.93
5	30,365.04	37	26	11	70.27	1,701.39	3,522.94	-1,261.00	-3,453.71	1.35	3.19	820.68
4	34,121.72	37	29	8	78.38	1,468.12	3,178.14	-1,056.73	-3,076.63	1.39	5.04	922.21
3	20,756.06	37	25	12	67.57	1,352.56	2,873.85	-1,088.16	-2,027.68	1.24	2.59	560.97
2	10,635.77	37	25	12	67.57	1,029.71	2,332.48	-1,258.92	-2,781.35	0.82	1.70	287.45
1	6,788.25	37	22	15	59.46	872.60	2,060.16	-827.26	-2,031.09	1.05	1.55	183.47

Under these circumstances, it appears bounces have been both reliable and powerful. Below is a look at the profit curve assuming a 4-day exit technique.



The curve appears to provide confirmation of the bullish tendency suggested by the stats table.

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



With tonight's study factored in the green Aggregator Line again climbed and is now well above zero. Positive readings mean net expectations from the Active List are for upside over the next few days. Meanwhile the black Differential Line is now further above 0 than it has been in a long time. This means the SPX is very oversold versus expectations. So net expectations are bullish and the SPX is strongly 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.

Based on the current studies, expectations are slated to remain bullish on Wednesday. Of course that could change if bearish evidence emerges. The Differential Pivot will be 1,362.73 on Wednesday. This is 1.8% above Tuesday's close. It's pretty unlikely we'll see the SPX make up that much ground in 1 day. A more likely scenario would be a multi-day rally or consolidation to work off the oversold condition.

We are seeing more evidence emerge suggesting a bounce. One indicator that is not signaling an oversold condition just yet is the CBI, which is still at 0. I won't get fully invested unless we get a spike in the CBI, but with the QE Buying Power Index strong and the studies we've seen the last few nights squarely bullish, it appears worth taking on

some long exposure. I am already partially long, and will consider scaling in to a 2<sup>nd</sup> lot if I can get a favorable entry on Wednesday – either with a big gap down at the open or a weak close. Details are in the Trade Ideas section below.

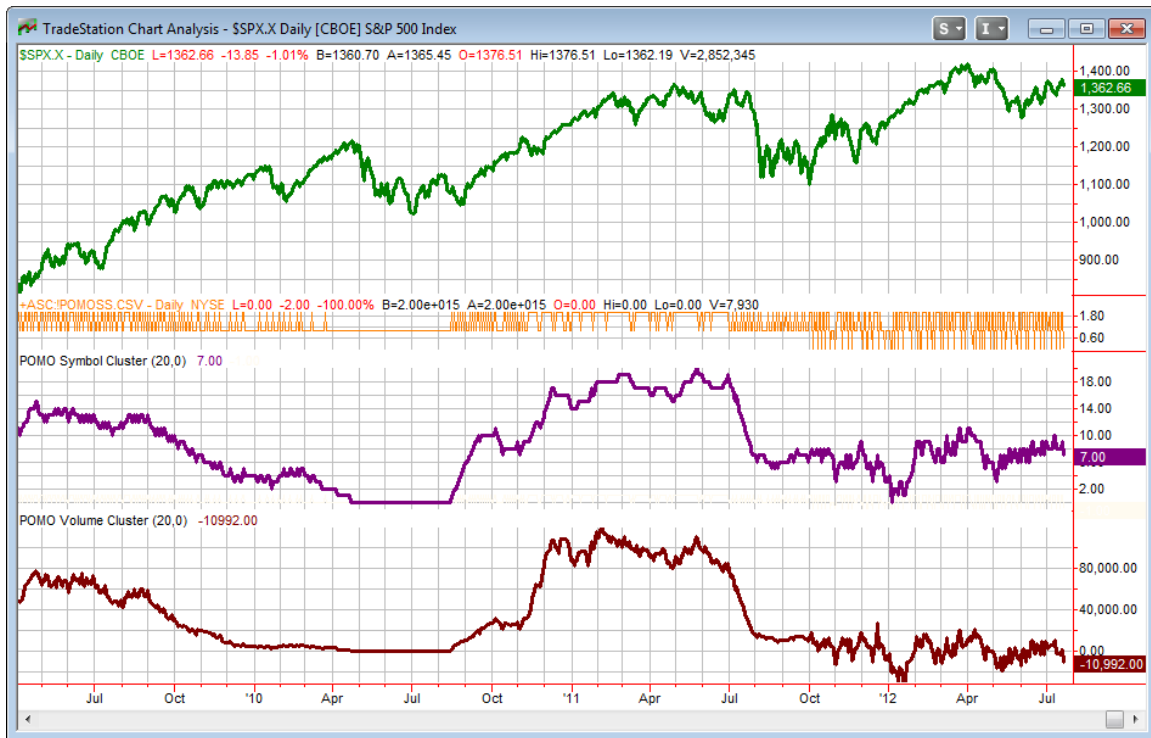
***Intermediate-term Outlook (2 weeks – 2 months)– updated 7/16 – slightly bullish***

Back and forth trading this week left the market up a mild 0.4%. Making a new 50 day high was somewhat encouraging, but strong upside evidence and momentum are still lacking.

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>



As expected there were three days of POMO buying and two days of selling this past week. But the net outflows were larger than expected and amounted to \$7.5 billion. This left the intermediate-term indicators at their lowest points in quite a while, so it's not surprising to see that the market has made little progress over the last four weeks.

But from here through the end of the month POMO flows are expected to improve dramatically. There is only one selling day scheduled during the next seven trading days, with the rest all scheduled to see liquidity inflows. The net result of this buying is estimated to be about a \$12 billion inflow. The impact of this inflow is anticipated to be felt near the end of the month and the beginning of August.

Intermediate-term evidence remains mixed. I am feeling just slightly more bullish this week since we are now beyond last week's bout of POMO selling. Of course liquidity flows don't typically have an immediate impact and selling we saw this past week could continue to exert itself for several more days before the positive influence of the upcoming inflows takes over. While choppy, the trend also appears to favor the bullish case. So as has been the case recently, 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.

**SPY – buy 1/4 index position @ \$133.25 LIMIT ON OPEN. If NOT filled on open, cancel order and look to enter this lot ON CLOSE if SPX closes <= 1,336.40.** This is based on the short-term outlook above. I am looking to get long a 2<sup>nd</sup> lot of SPY.

## Current Open Trade Ideas

Symbol	Entry Date	Entry Price	Current Price	% Gain/Loss	Stop	Notes
SPY(1/4)	7/23/2012	\$135.09	\$133.93	-0.86%		Aggregator

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