

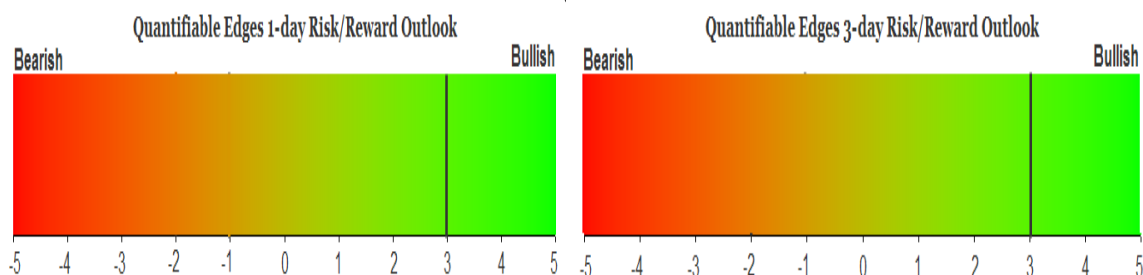
QUANTIFIABLE EDGES SUBSCRIBER LETTER

ASSESSING MARKET ACTION WITH INDICATORS AND HISTORY

August 2, 2012

Volume 5 Issue 148

Market Overview



Signals Overview

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

Tonight's Research Points

- Down 2+ days on a Fed Day has often been followed by a rally.
- 3-day pullbacks with a low 3/10 Offset HV suggest a bullish edge.
- Wednesday's especially weak Russell appears to be a positive.

Short-term Outlook

The Bottom Line

Expectations remain positive and th SPX is no longer overbought. I'm long and may get longer.

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

Study Date	Description	Time span	Bias	Avg Max Move
Active				
August 2, 2012	Down 2+ on a Fed Day	1-6 days	Bullish	
August 2, 2012	Down 3rd day. 3/10 Offset HV very low	1-3 days	Bullish	
August 1, 2012	Downlast 2 of up month	1-5 days	Bullish	2.00%
July 30, 2012	SPY 2 unfilled up gaps & 50 high	1-3 days	Bullish	1.00%
Active - Long Term				
July 30, 2012	SPX 50-day high on 90% up vol	1-50 days	Bullish	
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	
Dropped Tonight				
August 1, 2012	Poor close before a Fed Day	1 day	Bullish	
July 30, 2012	SPX 50-day high on 90% up vol	1-5 days	Bullish	2.60%

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

The Evidence

Wednesday's Fed release was seen as a bit of a disappointment and the market gave back its early gains. Losses hit smallcaps especially hard. The SPX fell 0.3%, the Nasdaq dropped 0.7% and the Russell 2000 declined an outsized 2.0%. Breadth was weak as the NYSE Up Issues % came in at 39% and the Up Volume % was 34%. Total NYSE volume came in at the highest level in over a month.

One positive about the SPX pullback over the last 3 days is that the 3/10 Offset HV Indicator is extremely low. 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. I last did this in the 12/15/11 letter and have updated the studies below. First I'll show times when the 3/10 Offset HV is above 0.25.

SPX closes down for exactly 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 years that the edge has really only lasted 1-day. Returns after the 1st day are fairly flat.

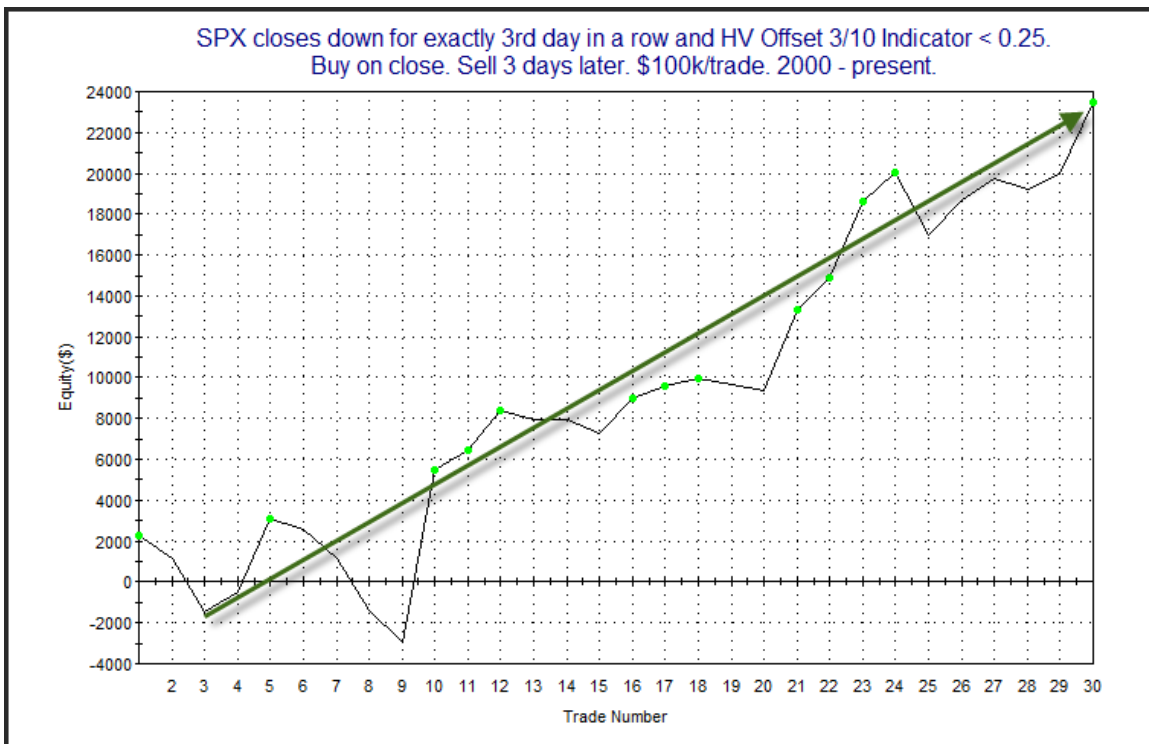
Now let's look at times like now where the 3/10 Offset HV is very low.

**SPX closes down for exactly 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	17,635.55	30	18	12	60.00	2,634.41	5,903.59	-2,481.99	-7,964.16	1.06	1.59	587.85
5	22,362.75	30	19	11	63.33	2,504.26	8,234.80	-2,292.56	-7,032.56	1.09	1.89	745.42
4	17,492.09	30	19	11	63.33	2,208.95	8,810.76	-2,225.27	-7,145.44	0.99	1.71	583.07
3	23,489.63	30	17	13	56.67	2,271.88	8,432.34	-1,164.03	-3,021.92	1.95	2.55	782.99
2	20,229.19	30	18	12	60.00	1,843.01	5,018.23	-1,078.75	-5,271.36	1.71	2.56	674.31
1	8,690.66	30	19	11	63.33	991.39	2,971.43	-922.35	-4,660.72	1.07	1.86	289.69

**27 of 30 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.

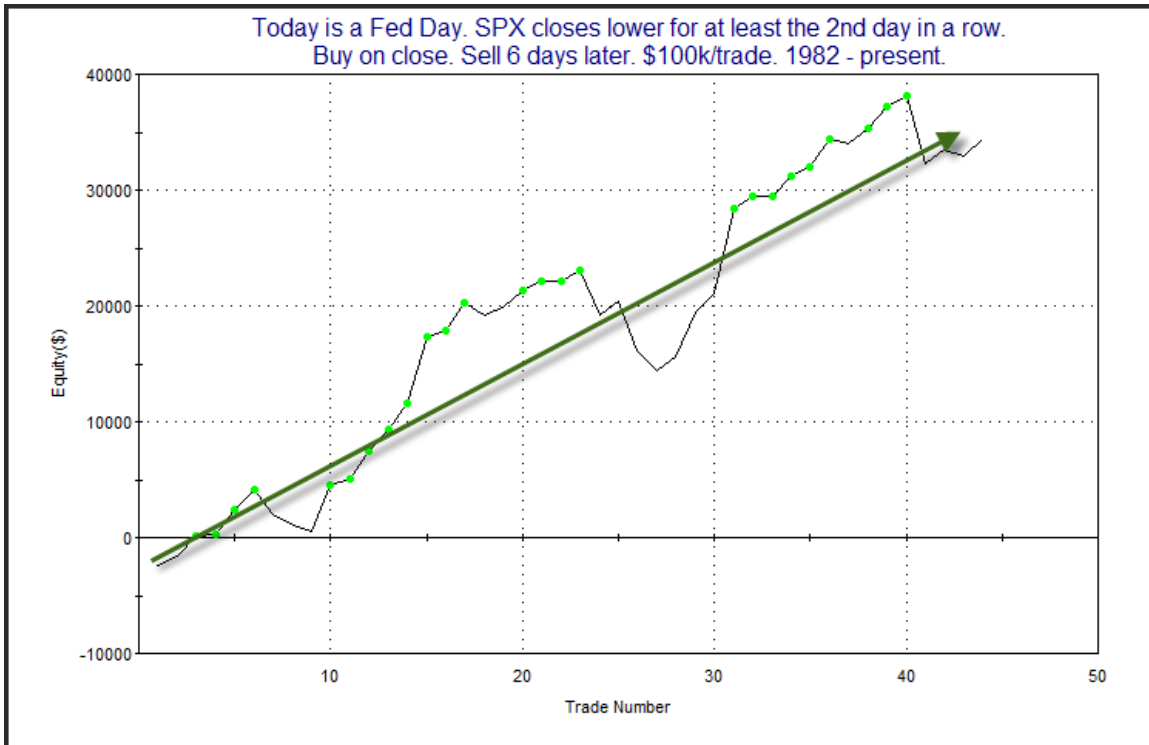


The strong upslope appears to confirm the stats table.

Last night I showed a couple of studies related to the fact that Wednesday was a Fed Day. They suggested a possible bullish edge, which didn't play out. Still, the mild drop wasn't too damaging and it did bring about this study, which was last seen in the 6/24/10 letter.

Today is a Fed Day. SPX closes lower for at least the 2nd day in a row. Buy on close. Sell X days later. \$100k/trade. 1982 - 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	43,627.88	44	30	14	68.18	2,522.27	9,012.33	-2,288.58	-5,334.70	1.10	2.36	991.54
9	36,175.95	44	32	12	72.73	2,233.41	8,967.96	-2,941.09	-5,671.36	0.76	2.03	822.18
8	29,518.56	44	33	11	75.00	2,000.64	8,456.40	-3,318.42	-6,514.96	0.60	1.81	670.88
7	32,709.70	44	34	10	77.27	1,791.62	8,869.37	-2,820.55	-6,757.80	0.64	2.16	743.40
6	34,388.68	44	33	11	75.00	1,760.18	7,361.95	-2,154.31	-5,884.97	0.82	2.45	781.56
5	28,755.25	44	31	13	70.45	1,650.33	6,013.86	-1,723.45	-5,581.03	0.96	2.28	653.53
4	16,335.23	44	26	18	59.09	1,551.95	7,513.37	-1,334.19	-4,622.80	1.16	1.68	371.26
3	11,145.14	44	25	19	56.82	1,183.44	5,035.28	-970.57	-2,737.00	1.22	1.60	253.30
2	15,292.68	44	28	16	63.64	1,152.78	5,202.52	-1,061.57	-2,942.24	1.09	1.90	347.56
1	9,771.32	44	28	16	63.64	937.39	4,001.33	-1,029.72	-3,162.00	0.91	1.59	222.08

When Fed Days fail to rally, you normally see a rally shortly after. This is even truer when the day before the Fed Day was also down as it was on Tuesday. And for those who are curious, below is a profit curve assuming a 6-day exit strategy.



While it has been a bit choppy recently there certainly appears to be an upside edge.

Smallcap action has been poor lately. Typically you would like to see smallcaps offering upside leadership during a rally. They certainly have not been doing that. Today's smallcap underperformance was quite outsized and I decided to look at other pullback scenarios where the RUT underperformed so badly. I devised the following study.

SPX closes down for at least the 3rd day in a row. RUT loses > 1.5% more than SPX today.
Buy SPX on close. Sell X days later. \$100k/trade. 1988 - present.

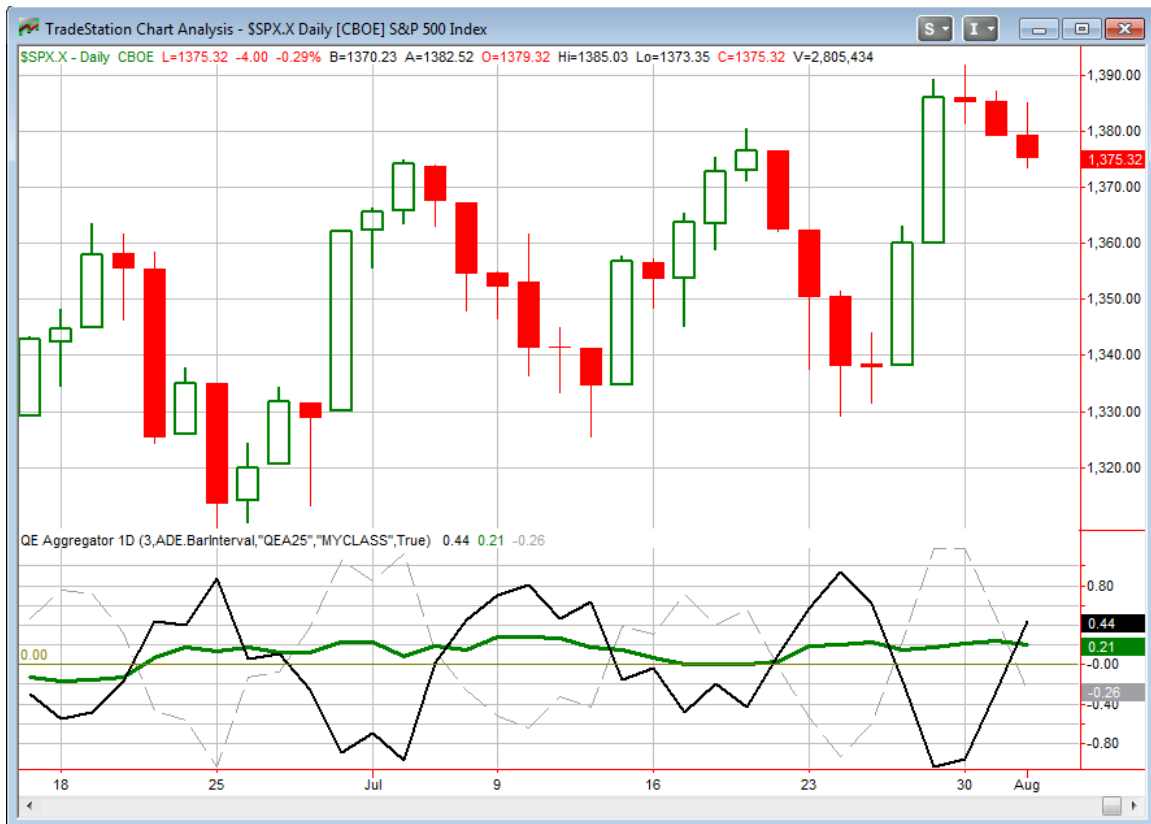
X Days	All: Net Profit	All: Total Trades	All: Winning Trades	All: Losing Trades	All: % Profitable	All: Avg Winning Trade	All: Max Winning Trade	All: Avg Losing Trade	All: Max Losing Trade	All: Win/Loss Ratio	All: ProfitFactor	All: Avg Trade
10	20,012.04	6	6	0	100.00	3,335.34	10,217.60	0.00	0.00	100.00	100.00	3,335.34
9	16,059.92	6	5	1	83.33	3,273.53	9,604.75	-307.74	-307.74	10.64	53.19	2,676.65
8	20,297.06	6	6	0	100.00	3,382.84	9,445.10	0.00	0.00	100.00	100.00	3,382.84
7	22,111.93	6	6	0	100.00	3,685.32	8,827.10	0.00	0.00	100.00	100.00	3,685.32
6	21,013.70	6	6	0	100.00	3,502.28	7,910.40	0.00	0.00	100.00	100.00	3,502.28
5	16,480.89	6	5	1	83.33	3,298.80	7,567.67	-13.13	-13.13	251.24	1,256.21	2,746.82
4	12,734.28	6	6	0	100.00	2,122.38	5,282.15	0.00	0.00	100.00	100.00	2,122.38
3	13,345.82	6	6	0	100.00	2,224.30	4,733.02	0.00	0.00	100.00	100.00	2,224.30
2	2,184.51	6	3	3	50.00	1,069.92	1,693.26	-341.75	-611.80	3.13	3.13	364.09
1	12,201.38	7	6	1	85.71	2,226.69	4,723.23	-1,158.75	-1,158.75	1.92	11.53	1,743.05

Instances are very low, which makes it difficult to generate meaningful expectations. But results could not be any more bullish. Below is the list of instances assuming a 3-day holding period.

SPX closes down for at least the 3rd day in a row. RUT loses > 1.5% more than SPX today. Buy SPX on close. Sell X days later. \$100k/trade. 1988 - present.				
Date/Time	Signal	Price	% Profit	Run-up Drawdown
10/07/98	Buy	\$970.70	2.78%	\$4,120.00
10/12/98	Sell	\$997.70		(\$4,882.20)
06/12/00	Buy	\$1,446.00	2.25%	\$2,595.78
06/15/00	Sell	\$1,478.60		(\$249.78)
07/17/03	Buy	\$981.73	0.65%	\$1,264.52
07/22/03	Sell	\$988.11		(\$616.10)
05/13/09	Buy	\$883.92	2.92%	\$2,947.04
05/18/09	Sell	\$909.71		(\$562.74)
10/28/09	Buy	\$1,042.63	0.02%	\$2,299.00
11/02/09	Sell	\$1,042.88		(\$1,258.75)
08/08/11	Buy	\$1,119.46	4.75%	\$5,947.87
08/11/11	Sell	\$1,172.64		(\$1,594.88)

Four of the six instances registered 2%+ gains over the next 3 days. Though somewhat compelling the low instances did keep me from including this study on the Active list tonight. I did include the other 2 studies though.

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



With tonight's studies factored in the green Aggregator Line remained squarely above 0. Positive readings mean net expectations from the Active List are for upside over the next few days. Meanwhile the black Differential Line shot back above 0. This means the SPX is now oversold versus recent expectations. So net expectations are bullish and the SPX is short-term oversold. This is considered a bullish configuration. Bullish configurations are visible on the chart whenever both lines close above 0. This meant the Aggregator System turned from flat to long at the close.

Based on the current studies, expectations are slated to remain bullish on Thursday. Of course that could change if bearish evidence emerges. The Differential Pivot will be 1,392.77 on Thursday. This is nearly 1.3% above Wednesday's close. It would take a strong rally Thursday to accomplish this.

As I indicated I would do in last night's letter, I began scaling long on Wednesday. As anticipated the Aggregator became bullish and I now believe there is a short-term upside edge. But with the QE Buying Power Index no longer bullish and the CBI at zero I'd rather scale in slowly here. So I'll only look to add to my position on Thursday if SPX closes down a substantial amount. Details are in the Trade Ideas section at the bottom of the letter.

Intermediate-term Outlook (2 weeks – 2 months)– updated 7/30 – bullish

The intermediate-term outlook was last updated in the 7/30 letter. Link below:

[2012-07-30 QE Subscriber Letter.pdf](#)

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 ¼ size index position at \$136.00 LIMIT ON CLOSE. Based on the short-term outlook above I'll scale in further on a big drop.

Current Open Trade Ideas

Symbol	Entry Date	Entry Price	Current Price	% Gain/Loss	Stop	Notes
SPY	8/1/2012	\$137.59	\$137.59	0.00%		Aggregator

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