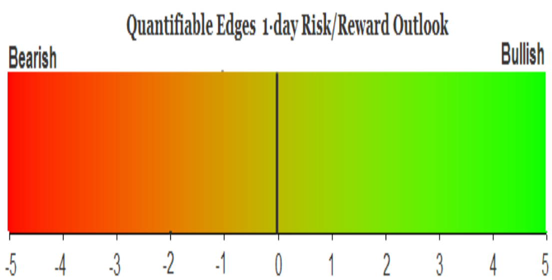
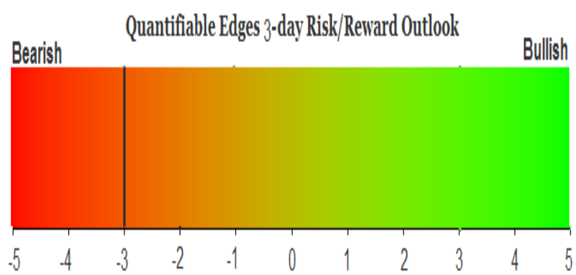
QUANTIFIABLE EDGES SUBSCRIBER LETTER

ASSESSING MARKET ACTION WITH INDICATORS AND HISTORY

August 17, 2012 Volume 5 Issue 159

Market Overview





Signals Overview

Aggregator	Aggressive VIX	QE Buy Pwr Swing	NDX Trend Timer
Short	100% Short SPY	Flat	Flat

Tonight's Research Points

- A low VIX:VXV at a 50-day high increases short-term risk.
- 10 days above the 5ma and a new 10-day high suggest the market is due for a brief pullback.
- High closes on the Thursday prior to opex have routinely been followed by a pullback over the next few days.
- Liquidity no longer appears to be a short-term obstacle for the bears.

Short-term Outlook

The Bottom Line

Several indications are now suggesting a bearish edge. I am looking to take a conservative short position.

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

Study Date	Description	Time span	Bias	Avg Max Move
Active				
August 17, 2012	SPY > 5ma for 10 days. 10-high today.	1-2 days	Bearish	-1.20%
August 17, 2012	SPY high close before OpEx	1-5 days	Bearish	-1.80%
August 17, 2012	VIX:VXV < 0.85. SPX 50-high	1 day	Bearish	
August 16, 2012	SPY 50-high on 20-low vol	1-2 days	Bearish	-1.10%
August 15, 2012	SPY up. VIX up > 6%.	1-3 days	Bullish	1.60%
August 15, 2012	SPY 50-high then 5-day inside range	1-3 days	Bullish	1.10%
August 14, 2012	3/10 Offset HV < 0.3 4th day in row	1-4 days	Bullish	
Active - Long Term				
August 16, 2012	SPY 50-high on 20-low vol	1-10 days	Bearish	
August 15, 2012	SPY 50-high then 5-day inside range	1-10 days	Bullish	
August 10, 2012	SPX & TNX 50-day highs.	1-20 days	Bearish	
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 16, 2012	SPX down 2 then up < 0.2%	1 day	Bearish	

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

The Evidence

The market actually put in a move today, and it was to the upside. The SPX gained 0.7%, the Nasdaq rose 1.0%, and the Russell 2000 rallied 1.1%. Breadth was strongly positive as the NYSE Up Issues % was 71% and Up Volume % both came in at 76%. Volume came in at the highest level in over a week.

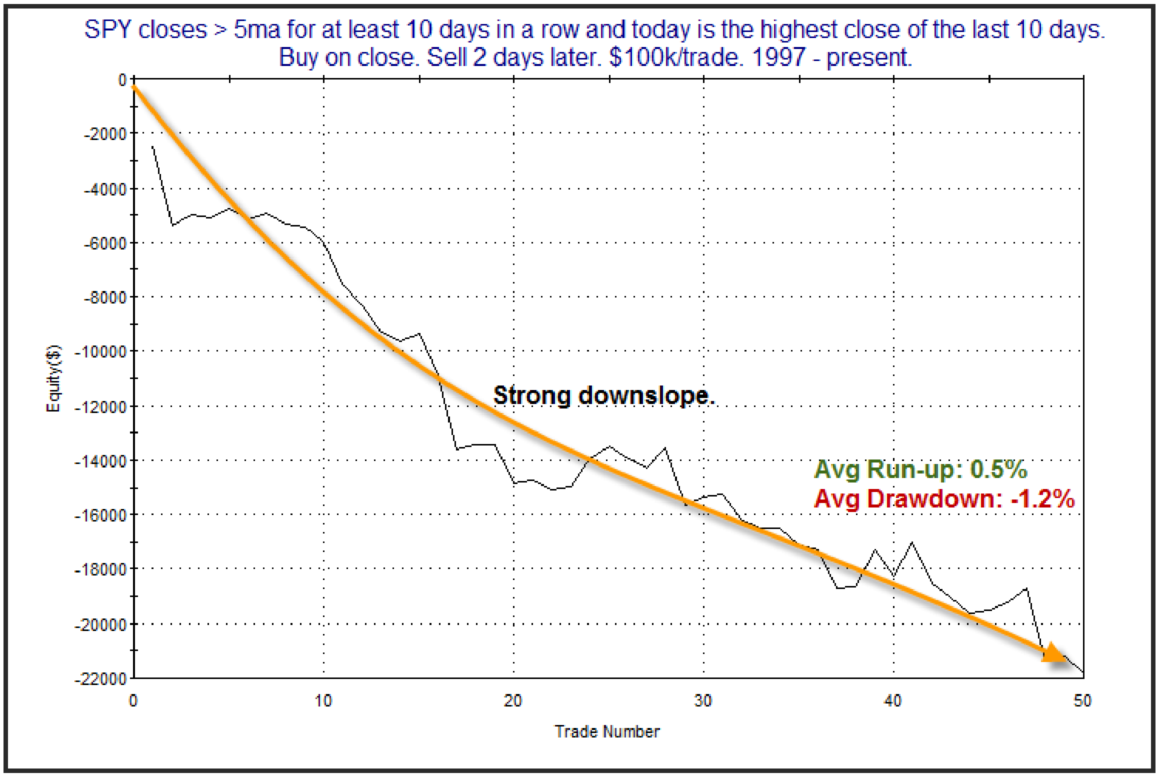
Despite the sideways consolidation the last several days, SPY has now gone a full two weeks without closing below its 5ma. That's an unusually long period of time to hold above such a short-term moving average. The study below was last seen in the 4/7/11 subscriber letter. It looked at other instances in which the market had traded above the 5ma for so long and was now closing at a 10-day high. All results are updated.

SPY closes > 5ma for at least 10 days in a row and today is the highest close of the last 10 days.
Buy 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
5	-10,351.28	36	20	16	55.56	752.39	2,516.52	-1,587.44	-4,014.40	0.47	0.59	-287.54
4	-16,473.08	38	16	22	42.11	644.93	1,428.90	-1,217.81	-3,723.20	0.53	0.39	-433.50
3	-19,567.74	45	15	30	33.33	635.50	1,294.25	-970.01	-3,235.65	0.66	0.33	-434.84
2	-21,829.58	50	20	29	40.00	397.34	1,392.65	-1,026.77	-2,870.40	0.39	0.27	-436.59
1	-21,309.31	71	28	43	39.44	307.87	1,134.24	-696.04	-2,817.32	0.44	0.29	-300.13

90% of instances closed below the entry price
at some point in the next week.

In the past this setup has almost always been followed by a short-term pullback. The downside edge doesn't last long, though. It seems to pretty much play itself out over the first 2 days. Below is an equity curve showing how the edge has evolved over time. It uses a 2-day exit strategy.



The strong downslope seems to confirm the bearish edge.

The study below continues to trigger. I last discussed it a just a few days ago in the 8/13/12 subscriber letter. It considers what happens when the SPX is hitting a new 50 day high while the VIX:VXV ratio is very low. For those that are unfamiliar, VIX is a measure of expected 1-month volatility and VXV is a measure of expected 3-month volatility. A very low VIX:VXV ratio suggests that option traders expect to see a rise in volatility in the coming months. Said another way, short-term event risk is perceived as very low right now in comparison to longer-term systematic risk. When the ratio gets especially low it suggests there is a decent chance that short-term risk is being underestimated. The study below considers the impact of a low ratio at a new market high.

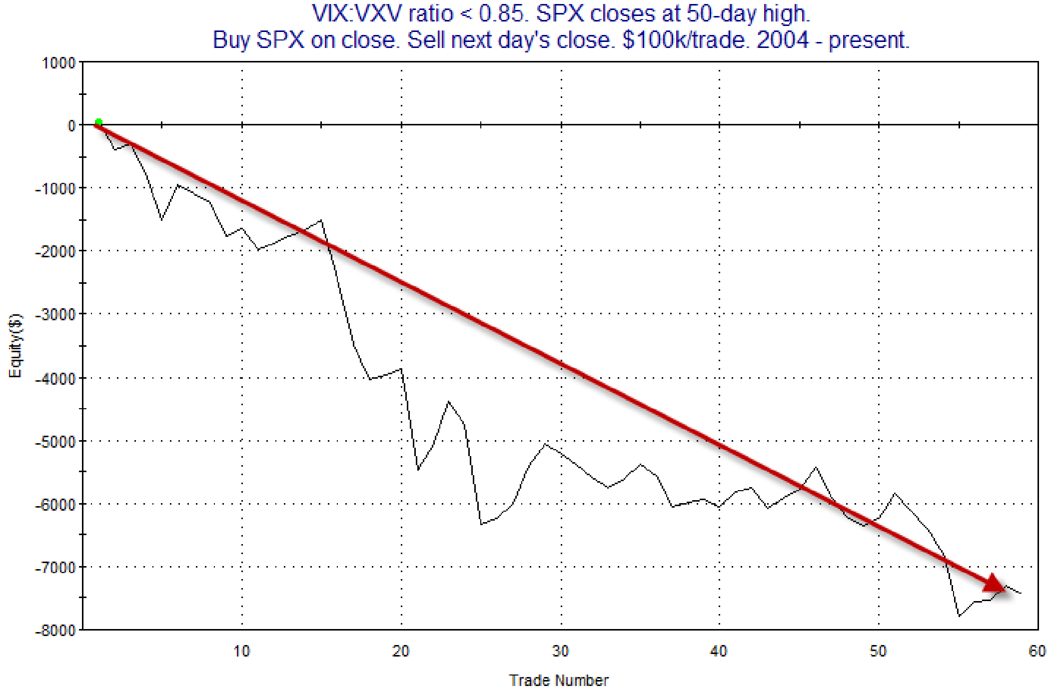
VIX:VXV ratio < 0.85. SPX closes at 50-day high.
Buy SPX on close. Sell next day's close. $100k/trade. 2004 - present.

TradeStation Performance Summary Collapse

All Trades

Total Net Profit	($7,435.31)	Profit Factor	0.45
Gross Profit	$6,198.30	Gross Loss	($13,633.61)
Total Number of Trades	59	Percent Profitable	50.85%
Winning Trades	30	Losing Trades	29
Even Trades	0		
Avg. Trade Net Profit	($126.02)	Ratio Avg. Win:Avg. Loss	0.44
Avg. Winning Trade	$206.61	Avg. Losing Trade	($470.12)
Largest Winning Trade	$708.05	Largest Losing Trade	($1,602.28)

The odds are 50/50 but the losers have been more than twice the size of the winners. This suggests the complacency we are seeing at these high levels is more likely to lead to a big down day than be followed by a big up day. To see how the edge has played out over time I have posted the profit curve below.



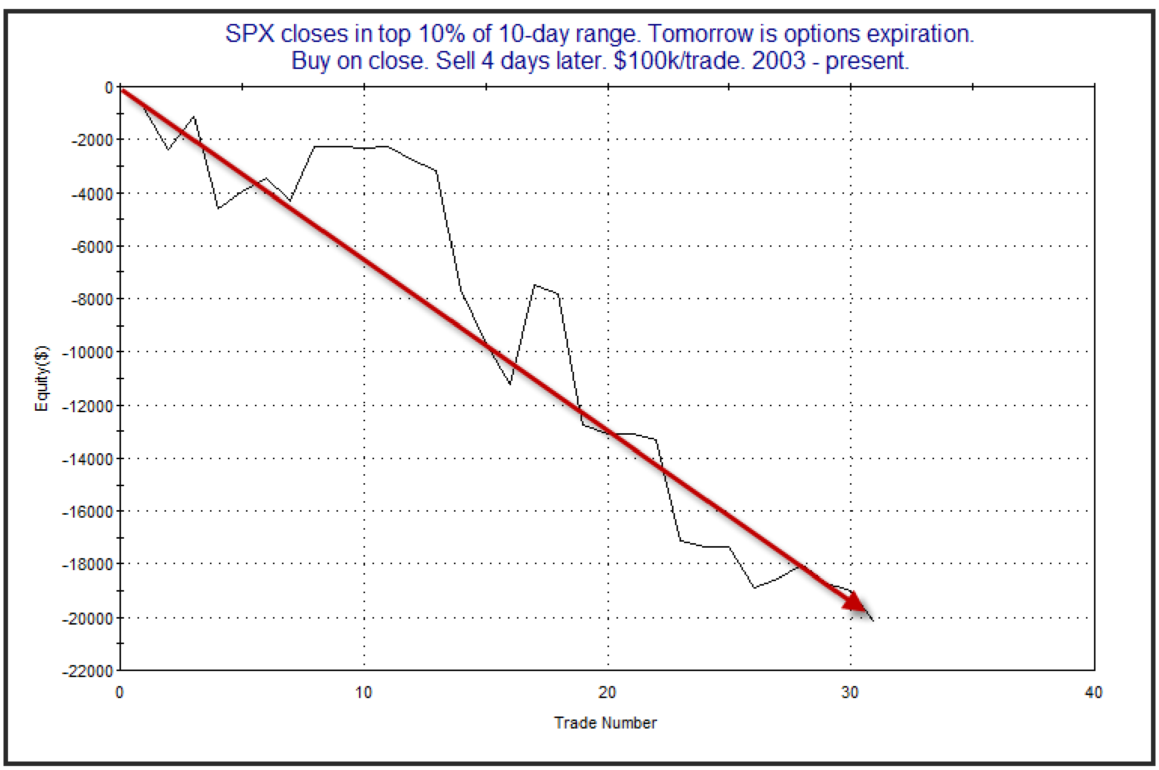
The equity curve has certainly been choppy but it has managed to maintain a downward trajectory throughout.

The study below was last seen in the 7/20/12 subscriber letter. It looks at other times the market closed at a high level just before options expiration. It generally has been a bad time for an overbought market.

SPX closes in top 10% of 10-day range. Tomorrow is options expiration.
Buy on close. Sell X days later. $100k/trade. 2003 - present.

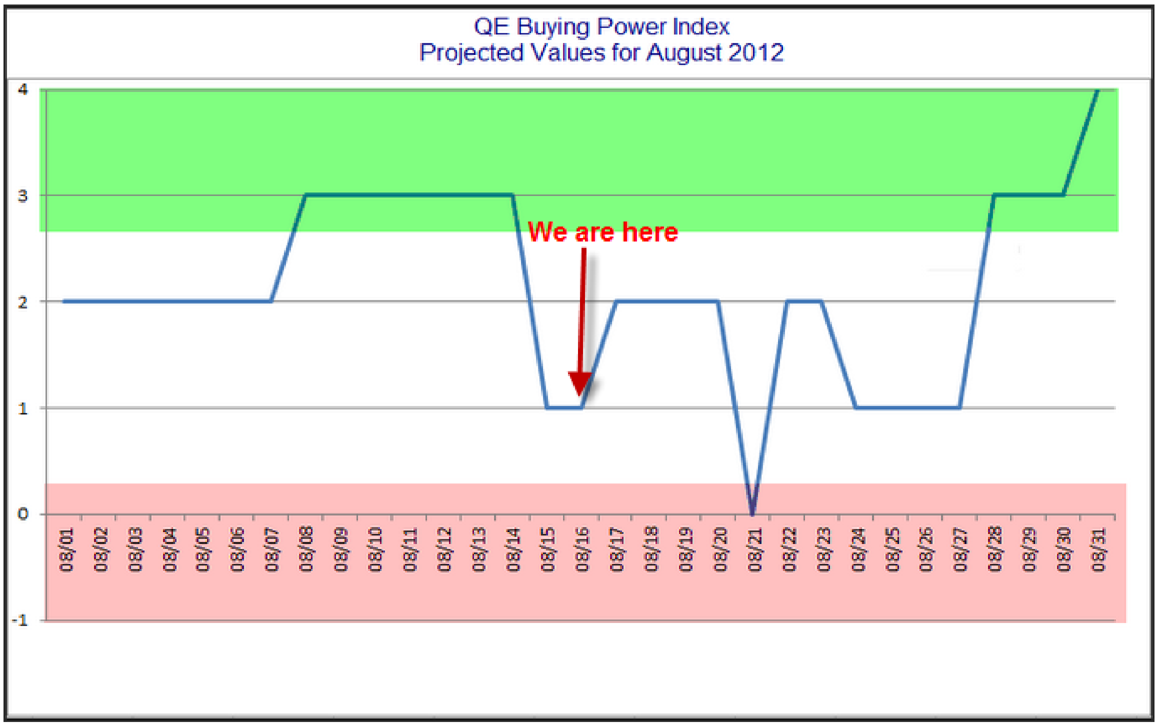
X Days	All: Net Profit	All: Total Trades	All: Winning Trades	All: Losing Trades	All: % Profitable	All: Avg Winning Trade	All: Max Winning Trade	All: Avg Losing Trade	All: Max Losing Trade	All: Win/Loss Ratio	All: ProfitFactor	All: Avg Trade
5	-18,970.07	30	10	20	33.33	920.01	3,768.30	-1,408.51	-4,932.90	0.65	0.33	-632.34
4	-16,019.68	30	12	18	40.00	803.95	1,994.25	-1,425.95	-2,899.20	0.56	0.38	-533.99
3	-7,217.15	30	16	14	53.33	641.91	2,166.00	-1,249.12	-2,828.70	0.51	0.59	-240.57
2	-7,901.23	30	18	12	60.00	473.98	1,588.40	-1,369.41	-3,784.65	0.35	0.52	-263.37
1	-2,632.39	30	17	13	56.67	382.51	2,286.84	-702.69	-2,875.60	0.54	0.71	-87.75

The numbers here are fairly compelling. To confirm the downside edge, I also produced a profit curve. The profit curve is based on a 5-day holding strategy.



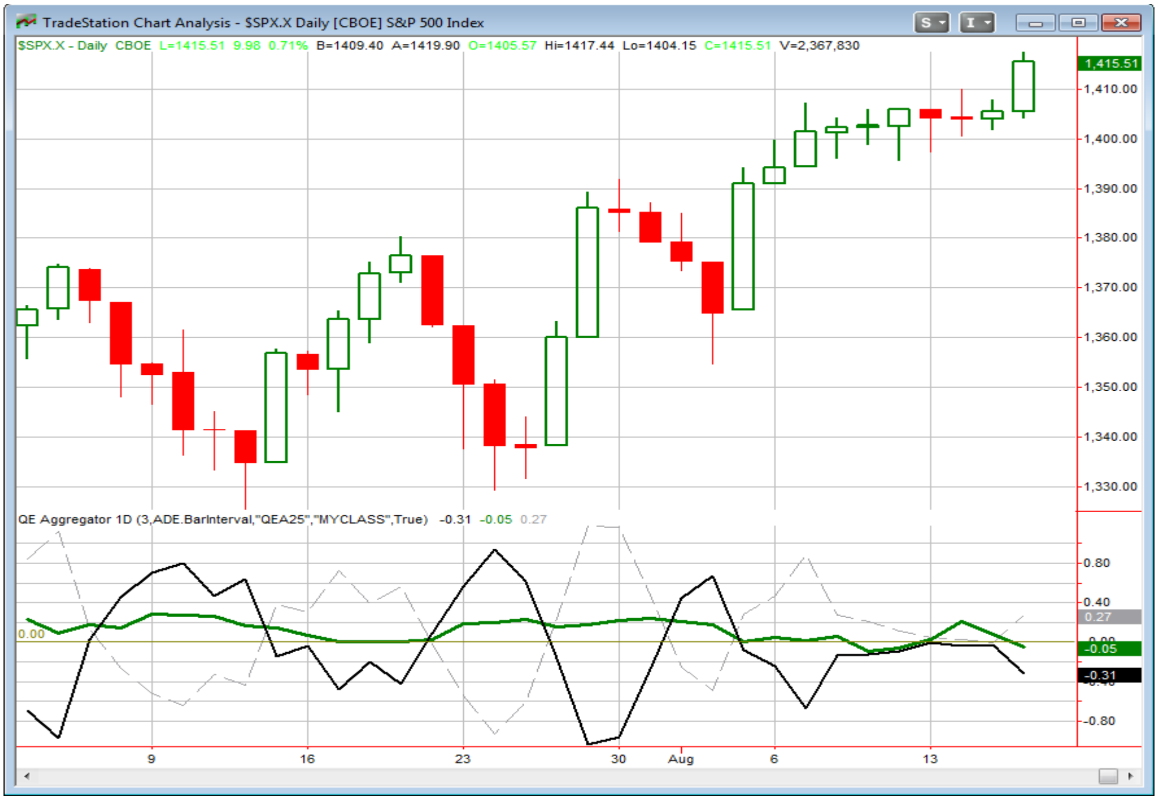
The curve would seem to confirm the downside edge and suggests we are entering a period of possible seasonal weakness.

Additionally, our short-term liquidity measure, the QE Buying Power Index, is no longer in bullish territory and is not scheduled to get there for another week and a half. Below I have pasted the August projected value chart, which I copied from the QE Buying Power Index information page.



Readings of zero or lower are needed to trigger a Buying Power short signal. If the market fails to correct and is still overbought on Tuesday, we will see the first short signal in quite a while.

I have updated the Aggregator chart below.



Bearish evidence increased tonight and the green Aggregator Line dipped down below 0. Negative readings mean net expectations from the Active List are for downside over the next few days. Meanwhile the black Differential Line is still below 0. This means the SPX is overbought versus recent expectations. So net expectations are bearish and the SPX is overbought. This is considered a bearish configuration. Bearish configurations are visible on the chart whenever both lines close below 0. This lead the Aggregator signal to switch from neutral to short on Thursday's close. This was indicated as likely on the systems page before the bell.

Based on the current studies expectations will remain negative on Friday. This could change if strong bullish evidence emerges. The Differential Pivot will be 1,406.32 on Friday. This is about 0.6% below Thursday's close. So a close below this level would move the SPX from overbought to oversold and flip the Differential Line.

After several nights of seeing little-to-no edge, it finally appears that some pieces are falling together here. We are seeing short side evidence from a number of angles. Seasonality, complacency, liquidity flows, underpricing of short-term risk and the volume issues I discussed last night all suggest we should see a pullback in the next few days. I'm not going to go overboard here though. While we are seeing a good amount of evidence suggest a pullback, the fact remains momentum is to the upside. This is a counter-trend trade and it needs to be managed as such. So I will look to initiate a small position on Friday. For me to add to this position any time before Tuesday's close (and the scheduled QE Buying Power Index reading of the zero) would take additional confirming evidence along with a more favorable entry point at the very least. Details on my approach for initiating Friday's lot are in the Trade Ideas section below.

Intermediate-term Outlook (2 weeks – 2 months)– updated 8/13– slightly bullish

The intermediate-term outlook was last updated in the 8/13 letter. A link is below:

2012-08-13 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 – short ¼ index position @ $142.00 LIMIT. Based on the short-term outlook above, I will look to begin scaling in to a short trade.

Current Open Trade Ideas

None.

This report has been prepared by Hanna Capital Management, LLC and is provided for information purposes only. Under no circumstances is it to be used or considered as an offer to sell, or a solicitation of any offer to buy securities. While information contained herein is believed to be accurate at the time of publication, we make no representation as to the accuracy or completeness of any data, studies, or opinions expressed and it should not be relied upon as such. Robert Hanna, Hanna Capital Management, LLC or clients of Hanna Capital Management, LLC may have positions or other interests in securities (including derivatives) directly or indirectly which are the subject of this report. This report is provided solely for the information of Hanna Capital Management, LLC clients and prospects who are expected to make their own investment decisions without reliance upon this report. Neither Hanna Capital Management, LLC nor any officer or employee of Hanna Capital Management, LLC accepts any liability whatsoever for any direct or consequential loss arising from any use of this report or its contents. This report may not be reproduced, distributed or published by any recipient for any purpose without the prior express consent of Hanna Capital Management, LLC.

Copyright © 2012 Hanna Capital Management, LLC.