

QUANTIFIABLE EDGES SUBSCRIBER LETTER

ASSESSING MARKET ACTION WITH INDICATORS AND HISTORY

August 27, 2012

Volume 5 Issue 165

Market Overview



Signals Overview

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

Tonight's Research Points

- The SPY reversal pattern on Friday showed some interesting, but conflicting studies.

Short-term Outlook

The Bottom Line

Expectations have flipped positive, but the quick move from oversold to overbought is keeping me from entering.

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

Study Date	Description	Time span	Bias	Avg Max Move
Active				
August 27, 2012	SPY reverse up from 10-low	1-4 days	Bullish	
August 27, 2012	Mega-outside day up	1 days	Bearish	
August 24, 2012	SPY 1st 5-low in 10 days	1-4 days	Bullish	1.60%
Active - Long Term				
August 22, 2012	Key Dowside Reversal from High	1-12 days	Bullish	
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	
February 1, 2012	Golden Cross	int term	Bullish	
Dropped Tonight				
August 23, 2012	SPX up on bad breadth	1-3 days	Bearish	-1.30%
August 23, 2012	Gap rvs dn then gap reverse up.	1-3 days	Bearish	-1.10%

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

The Evidence

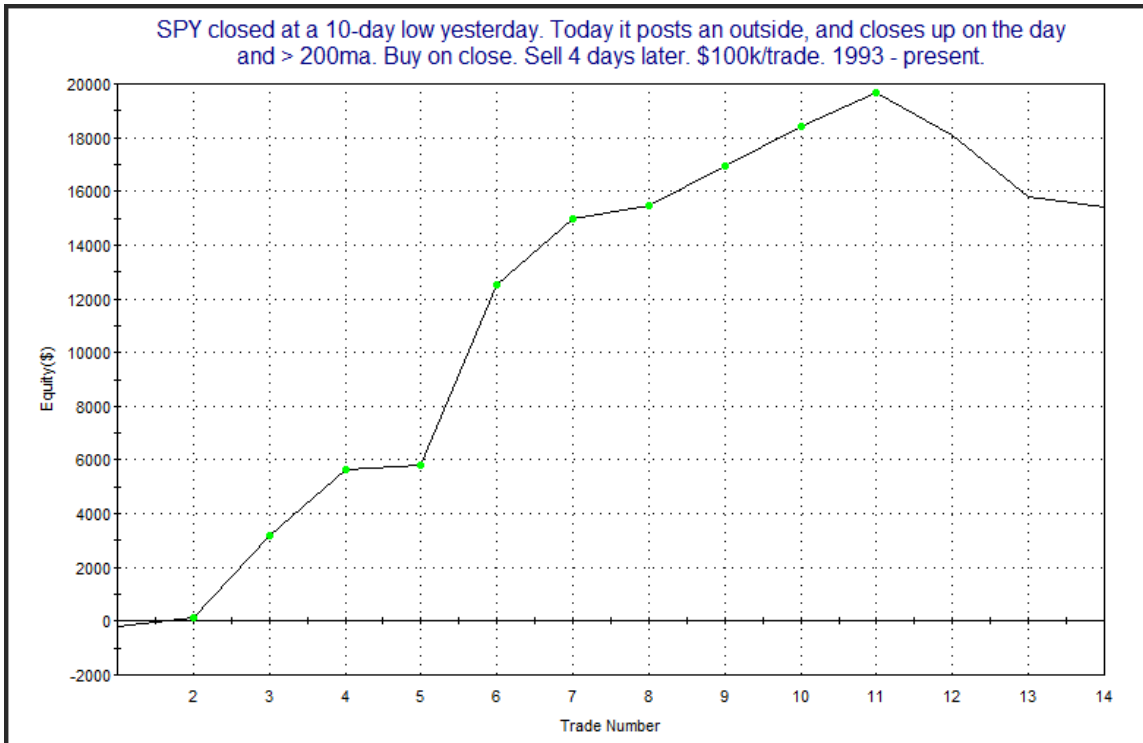
After a weak start to the day, the market rallied from 10am – 4pm and finished with solid gains. The SPX rose 0.7%, the Nasdaq gained 0.5%, and the Russell 2000 rallied 0.4%. Breadth was squarely positive as the NYSE Up Issues % was 64% and Up Volume % came in at 69%. Total NYSE volume dropped to a Friday summer-light level.

Action in SPY triggered some interesting, but opposing, priced-based studies in the Quantifinder.

This first one looked at strong reversals from short-term lows during a long-term uptrend. It was last seen in the 5/26/11 subscriber letter. I have updated the results.

SPY closed at a 10-day low yesterday. Today it posts an outside, and closes up on the day and > 200ma. 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	15,732.98	14	12	2	85.71	2,474.22	8,158.15	-6,978.81	-11,700.18	0.35	2.13	1,123.78
9	17,903.64	14	11	3	78.57	2,389.28	8,043.75	-2,792.82	-4,610.00	0.86	3.14	1,278.83
8	19,961.06	14	10	4	71.43	2,779.88	8,672.95	-1,959.45	-4,268.86	1.42	3.55	1,425.79
7	21,535.84	14	11	3	78.57	2,332.50	9,831.25	-1,373.90	-2,529.25	1.70	6.23	1,538.27
6	21,638.31	14	11	3	78.57	2,320.70	9,187.75	-1,296.48	-1,561.68	1.79	6.56	1,545.59
5	19,116.53	14	11	3	78.57	2,160.26	7,350.20	-1,548.79	-2,353.12	1.39	5.11	1,365.47
4	15,405.22	14	10	4	71.43	1,990.98	6,706.70	-1,126.15	-2,284.36	1.77	4.42	1,100.37
3	10,746.19	14	11	3	78.57	1,529.52	4,561.70	-2,026.16	-3,560.24	0.75	2.77	767.58
2	8,057.83	14	11	3	78.57	1,204.28	5,097.95	-1,729.74	-2,974.32	0.70	2.55	575.56
1	4,790.71	14	5	9	35.71	1,681.43	4,668.95	-401.82	-970.20	4.18	2.32	342.19

Strong reversals of the short-term trend like we saw on Friday often get some follow through over the next week or two. The numbers all look quite strong, although instances are a little low. The equity curve is a little concerning, though.



Whether looking out 4, 5, or 6 days, the last three instances have been down. Three instances isn't enough for me to throw away the study, though with instances already low, it does raise a red flag. I will include it on the active list this time, but I will also keep a careful eye on it going forward.

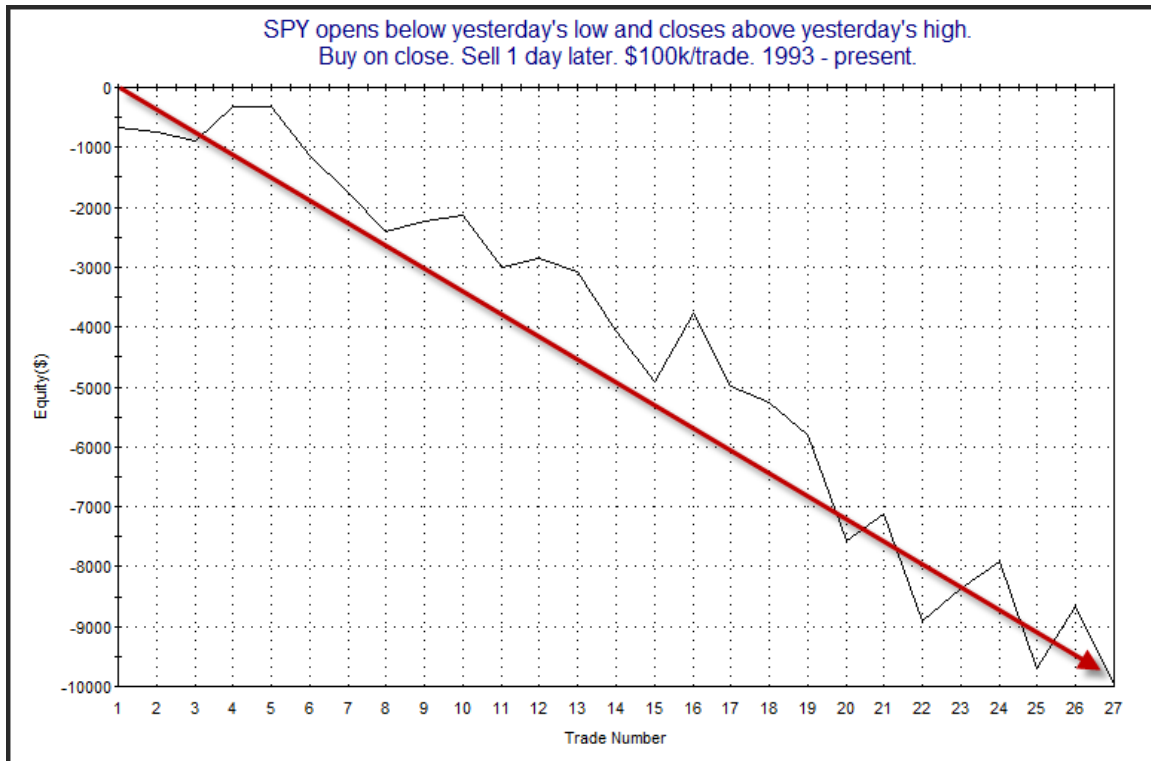
The next study also considered the fact that Friday was an outside day. But it didn't just make a higher high and a lower low. It actually opened below the low of Thursday and closed above the high of Thursday. This is unusual, and in the past it has led to a dip over the next few days. I showed this in the 7/21/10 subscriber letter. This is the first instance since then, and I have updated the stats table below.

SPY opens below yesterday's low and closes above yesterday's high.
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
5	3,488.78	27	14	13	51.85	2,115.71	7,599.20	-2,010.09	-4,991.73	1.05	1.13	129.21
4	-10,564.22	27	12	15	44.44	2,152.24	7,339.60	-2,426.08	-7,084.40	0.89	0.71	-391.27
3	-12,853.19	27	12	15	44.44	1,613.28	5,959.00	-2,147.51	-4,312.93	0.75	0.60	-476.04
2	-13,306.67	27	11	16	40.74	875.16	3,010.00	-1,433.34	-4,314.32	0.61	0.42	-492.84
1	-9,959.40	27	9	17	33.33	510.70	1,147.12	-856.22	-1,784.85	0.60	0.32	-368.87

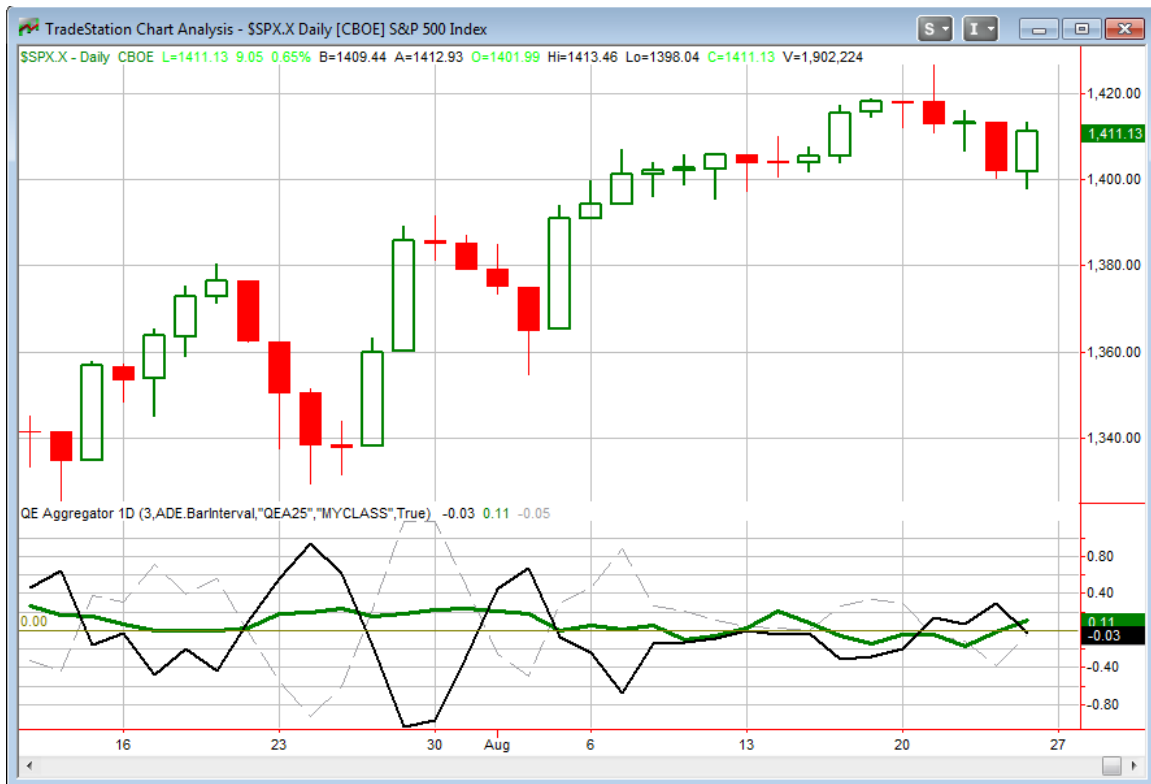
24 of 27 instances (89%) closed below the entry price at some point in the next 3 days.

Stats here still look strongly negative over the first 1-2 days. Most of the downside is actually realized on day one, and that timeframe had the most compelling profit curve as well. I have produced that curve below.



That looks like a pretty straight shot lower. This curve appears to confirm the downside edge suggested by the stats table.

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



With 2 bearish studies expiring and tonight's studies now factored in, the green Aggregator Line rose above 0. Positive readings mean net expectations from the Active List are for upside over the next few days. Meanwhile the black Differential Line reversed and dropped down below zero. This means the SPX is still now overbought versus recent expectations. So net expectations are bullish but the SPX is already overbought. This is considered a neutral configuration. Neutral configurations are visible on the chart whenever both lines close on opposite sides of 0. This led the Aggregator to remain flat. This was indicated as likely on the systems page shortly before the bell.

Based on the current studies, expectations are scheduled to remain positive on Monday. Of course this could change if bearish studies arise. The Differential Pivot will be 1409.74 on Friday. This is about 0.1% below Friday's close. So it will take a close lower of at least this much in order to move the SPX out of overbought territory and flip the Differential Line.

I was hoping for another down day to allow me to buy into the selloff early this week when the QE Buying Power Index will be turning bullish again. The market never seems to care what I (or anyone else) hope for, though. So, aside from my Catapult positions, I was not able to gain from Friday's bounce. There is no point in chasing now. A much more prudent move for my next swing-entry is to wait for the market to align itself in a high-probability setup. So I will again wait.

Intermediate-term Outlook (2 weeks – 2 months)– updated 8/27– bullish

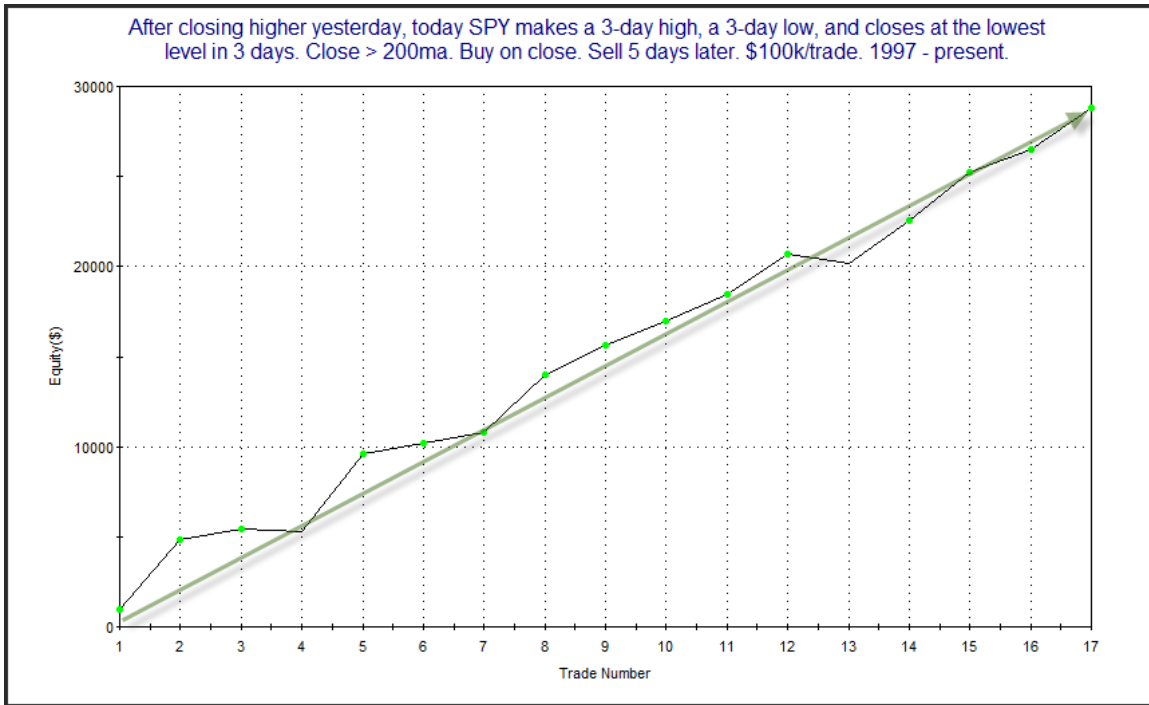
After 6 weeks of gains the SPX finally suffered a down week. But it did manage to make a new rally high before reversing down. And while the new rally high sounds like the big news, it was actually the reversal off that high that gave us the best bit of intermediate-term evidence this past week. The excerpt below is from the 8/22 letter. It examines day like Tuesday were such reversals from highs have taken place.

When price makes a new high as it did Tuesday, and then reverses down to form an outside day and closes negative, that is considered a "key reversal". I looked at reversals like this in number of times in the past. For the very short-term there rarely appears to be a substantial edge. Often test results will show churn or very mildly bearish numbers. But when you look out 1 to 2 weeks what you often see is that the uptrend most of the time will reassert itself. Let's look at two studies from the Quantifinder that exemplify this.

The study below was last shown in the 3/2/11 subscriber letter. It looks for the reversal day to engulf both of the last two days, close at a three day low, and still be above the 200ma. All results are updated.

After closing higher yesterday, today SPY makes a 3-day high, a 3-day low, and closes at the lowest level in 3 days. Close > 200ma. 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
10	33,233.85	16	13	3	81.25	2,781.55	6,438.74	-975.43	-1,808.31	2.85	12.36	2,077.12
9	34,135.41	17	14	3	82.35	2,741.31	6,845.74	-1,414.30	-3,430.00	1.94	9.05	2,007.97
8	25,379.32	17	12	4	70.59	2,815.44	5,456.88	-2,101.49	-7,031.50	1.34	4.02	1,492.90
7	30,363.94	17	12	5	70.59	2,960.42	6,365.48	-1,032.21	-1,635.06	2.87	6.88	1,786.11
6	30,903.62	17	14	3	82.35	2,316.29	5,193.32	-508.15	-645.78	4.56	21.27	1,817.86
5	28,802.22	17	15	2	88.24	1,959.93	4,273.50	-298.33	-489.14	6.57	49.27	1,694.25
4	16,130.80	17	12	5	70.59	1,782.14	4,533.98	-1,050.98	-2,123.52	1.70	4.07	948.87
3	3,212.40	17	10	7	58.82	1,851.97	3,903.34	-2,186.75	-5,283.03	0.85	1.21	188.96
2	3,366.13	17	10	7	58.82	1,524.77	3,244.78	-1,697.36	-3,737.28	0.90	1.28	198.01
1	-170.76	17	11	6	64.71	673.38	2,359.84	-1,262.99	-3,909.03	0.53	0.98	-10.04

After the first three days or so, there appears to be a strong and consistent upside edge. Below is a profit curve that assumes a 5-day holding period.



Equity curves don't get much straighter than this. It appears to be a nice confirmation of the bullish suggestion by the stats table.

The other key reversal study required a 10 day high, but it only needed to engulf the last one day. It was last seen in the 3/1/12 letter. All results are updated.

After closing at a 10-day high, SPY posts an outside day with a down close. Close > 200ma. 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
12	60,249.89	43	35	8	81.40	2,349.26	8,494.78	-2,746.79	-8,389.36	0.86	3.74	1,401.16
11	53,622.79	43	35	8	81.40	2,102.76	6,726.11	-2,496.74	-9,630.04	0.84	3.68	1,247.04
10	44,256.85	44	34	9	77.27	1,833.08	5,990.24	-2,007.56	-5,992.40	0.91	3.45	1,005.84
9	37,485.95	45	32	13	71.11	1,865.26	5,267.28	-1,707.88	-5,764.17	1.09	2.69	833.02
8	42,087.42	46	31	15	67.39	2,047.03	7,603.99	-1,424.71	-4,587.23	1.44	2.97	914.94
7	34,970.54	47	30	17	63.83	1,973.60	7,694.36	-1,425.74	-4,962.72	1.38	2.44	744.05
6	33,602.99	48	32	16	66.67	1,762.42	5,189.82	-1,424.65	-4,591.36	1.24	2.47	700.06
5	25,085.36	52	33	19	63.46	1,441.81	4,428.81	-1,183.91	-4,346.17	1.22	2.12	482.41
4	4,980.85	52	27	25	51.92	1,412.52	3,915.78	-1,326.29	-4,228.43	1.07	1.15	95.79
3	-7,494.00	52	25	27	48.08	1,133.44	2,930.57	-1,327.04	-5,283.03	0.85	0.79	-144.12
2	-9,615.71	53	23	30	43.40	888.77	2,361.64	-1,001.91	-3,737.28	0.89	0.68	-181.43
1	-6,382.30	53	27	26	50.94	572.32	1,601.91	-839.80	-3,909.03	0.68	0.71	-120.42

The story here is very much the same. After about three days of choppiness the upside edge appears to exert itself in a consistent way.

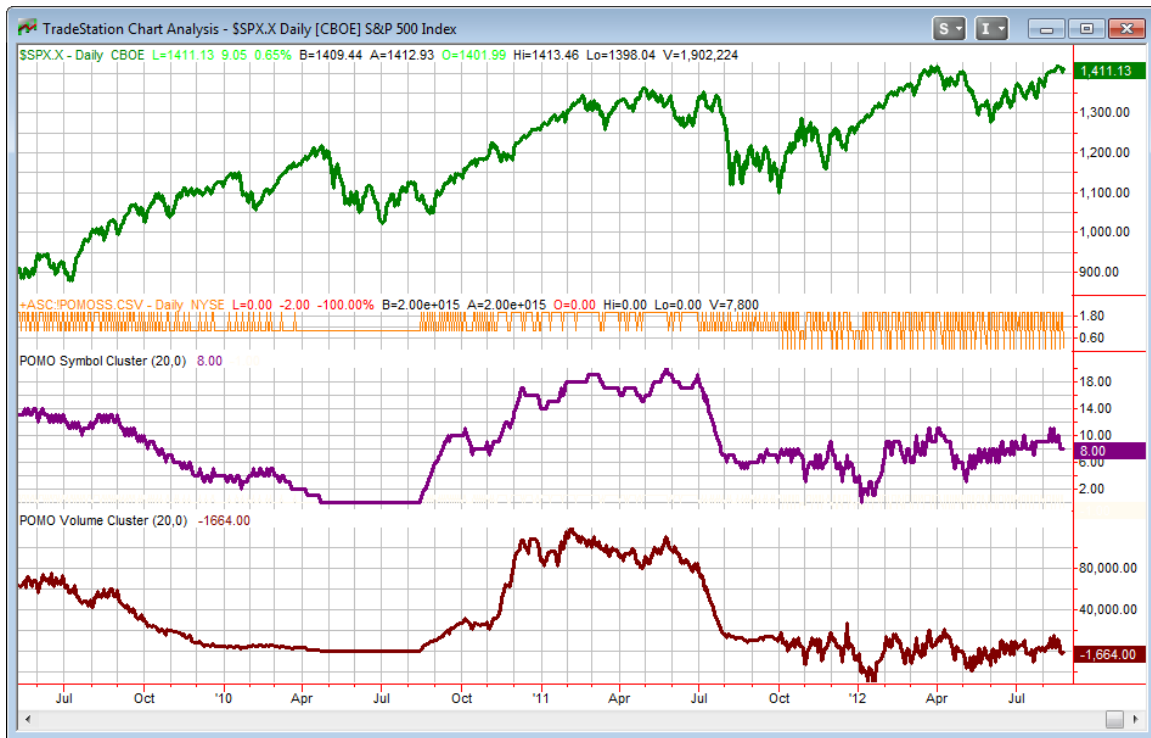
So while tonight's studies don't seem to have much of an implication on the next 1-3 days, they do suggest that an end to the intermediate-term rally has likely not occurred. I have therefore included the key reversal study on the intermediate-term active list.

The fact that this was the first down week in seven weeks was no surprise since we pegged this past week as a possible trouble-spot back at the end of July when the POMO schedule was released. Short-term POMO flows have seemed to lead the market up and down with strong consistency this year. In fact, for those looking to take advantage of the QE Buying Power Swing System it has been a bit too consistent. That system looks for price to get stretched against a strong POMO flow in the opposite direction. Since prices have followed POMO flows so closely, we haven't seen any such misalignment in a while. Hence, few trading opportunities.

I've updated the intermediate-term POMO chart each weekend in the letter. For those who may not recall below is a brief refresher on it. Beneath that is the 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>



This past week saw 3 days of POMO buying and 2 days of selling. With the selling days larger the net result was a \$7.5 billion liquidity contraction. The intermediate-term indicators both dipped to low levels. But no more selling is scheduled in August.

This upcoming week is scheduled to see buying Monday-Thursday. Friday will be a rare day off for the POMO desk ahead of the long weekend. The net amount of the buying is expected to be a whopping \$13.1 billion. Liquidity flows that strong should act as a positive influence for some of this week and into the following week.

Of course flows after Friday are still a mystery. The mystery will be solved Friday afternoon around 2 PM EST. The link below shows the current schedule, and after that time it will show the September schedule.

http://www.newyorkfed.org/markets/tot_operation_schedule.html

While there still could be some additional selling in the next few days, it appears the evidence for a rally continuation is fairly strong at present. The uptrend is firmly intact. Momentum is positive, the Nasdaq is in a leading position, and there are a few pattern-based setups with bullish intermediate-term implications as well. Volume and bond rates continue to provide warnings, but most evidence points higher over the next few weeks. Therefore, I have moved back to a bullish stance, and I anticipate trading more aggressively from the long side than the short side.

Catapult and Capitulative Breadth Statistics

[Catapult & CBI Presentation Link](#)

Open Catapult Triggers

ETR – 1/3 @ \$69.04 (bought at limit)

MRK – 1/3 @ \$42.91 (bought @ limit)

ETR – 1/3 @ \$68.65 (bought @ limit)

Catapult for ETF's Trades

None

Broad Market Large Cap CBI – 3/2(ETR-2, MRK)

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
ETR(1/3)	8/22/2012	\$69.04	\$68.73	-0.45%		Catapult
ETR(1/3)	8/23/2012	\$68.65	\$68.73	0.12%		Catapult
MRK(1/3)	8/23/2012	\$42.90	\$43.12	0.51%		Catapult

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