

QUANTIFIABLE EDGES SUBSCRIBER LETTER

ASSESSING MARKET ACTION WITH INDICATORS AND HISTORY

September 10, 2012

Volume 5 Issue 174

Market Overview



Signals Overview

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

Tonight's Research Points

- Long-term highs reached on the 1st Friday of the month are often followed by a pullback.
- The low VIX:VXV ratio suggests increased risk when at a 50-day high.
- 2 unfilled up gaps and a 50-day high are a short-term positive.
- The SPX %b closed > 115 for the 2nd day in a row – a feat of strength that often begets more strength.
- Short-term POMO flows will be negative the next couple of weeks, which could make it difficult for the market to maintain its upward momentum.

Short-term Outlook

The Bottom Line

Indications are somewhat mixed short-term. Bottom line expectations are for a bit more upside, but the market is now so overbought that risk/reward doesn't appear favorable. I'm flat and awaiting a better opportunity.

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

Study Date	Description	Time span	Bias	Avg Max Move
Active				
September 10, 2012	2 unfilled gap 50-high	1-3 days	Bullish	1.00%
September 10, 2012	%b > 115 2 days	1-5 days	Bullish	1.80%
September 10, 2012	200-high on 1st Friday	1-6 days	Bearish	
September 10, 2012	SPX 50-high. VIX:VXV < 0.85	1 day	Bearish	
September 7, 2012	50-high break strong breadth & vol	1-5 days	Bullish	
September 7, 2012	Breakout with unfilled gap up	1-5 days	Bullish	
September 6, 2012	20-day HV 20-day lows. No20-hi SPX	1-5 days	Bearish	-2.60%
Active - Long Term				
September 10, 2012	POMO liquidity temporarily contracting	int term	Bearish	
September 5, 2012	Russell up 1%. SPX down	1-10 days	Bearish	
August 20, 2012	Nasdaq leading SPX	int term	Bullish	
July 30, 2012	SPX 50-day high on 90% up vol	1-50 days	Bullish	
February 1, 2012	Golden Cross	int term	Bullish	
Dropped Tonight				
September 4, 2012	Post Labor-Day negative seasonality	1-4 days	Bearish	-1.30%
September 4, 2012	Early-month oversold in uptrend	1-5 days	Bullish	2.20%
August 22, 2012	Key Dowside Reversal from High	1-12 days	Bullish	
August 10, 2012	SPX & TNX 50-day highs.	1-20 days	Bearish	

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

The Evidence

A quiet day finished mostly higher and near the highs of the day. The SPX gained 0.4%, the NASDAQ was barely positive with a 0.02% gain, and Russell 2000 rose 0.5%. Breadth was solidly positive as the NYSE Up Issues % was 67% and Up Volume % came in at 72%. Total NYSE volume dipped a little from Thursday's level.

A decent number of studies triggered. Those that I found compelling are all discussed below. There was a good mix of bullish and bearish studies to consider.

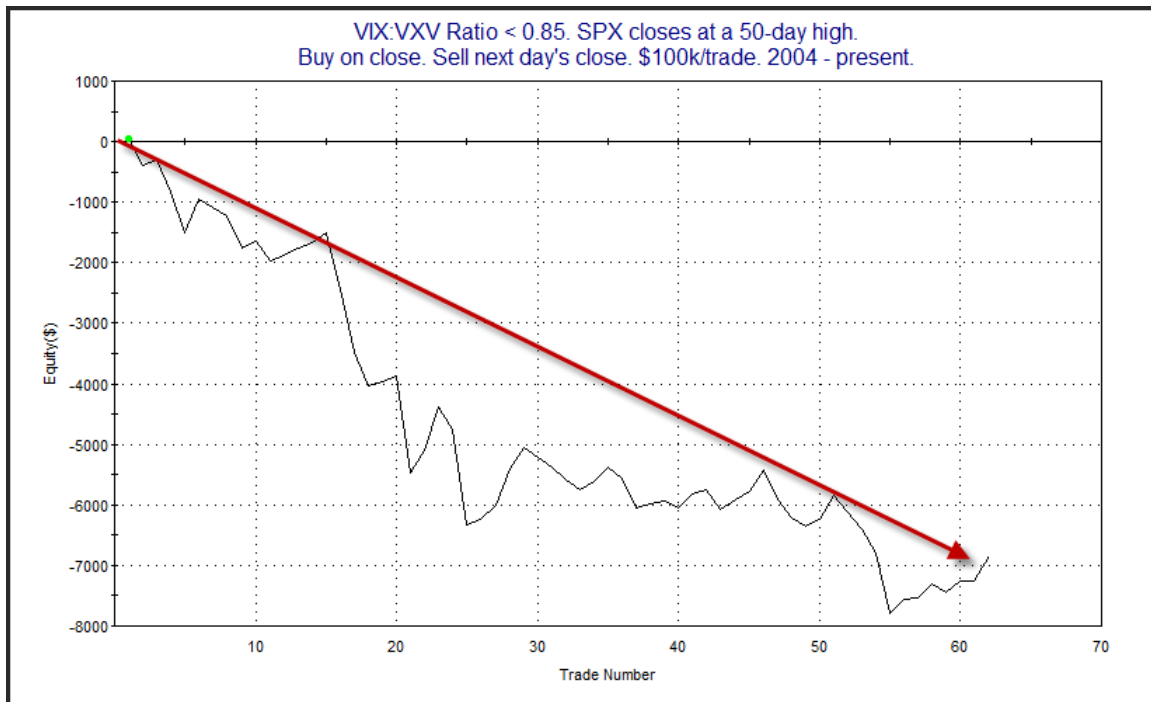
The first study to consider is the VIX:VXV study from Thursday night's letter. I have copied the commentary below and updated the stats.

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 a 50-day high.
Buy on close. Sell next day's close. \$100k/trade. 2004 - present.

TradeStation Performance Summary Collapse ^			
All Trades			
Total Net Profit	(\$6,851.71)	Profit Factor	0.50
Gross Profit	\$6,784.00	Gross Loss	(\$13,635.71)
Total Number of Trades	62	Percent Profitable	51.61%
Winning Trades	32	Losing Trades	30
Even Trades	0		
Avg. Trade Net Profit	(\$110.51)	Ratio Avg. Win:Avg. Loss	0.47
Avg. Winning Trade	\$212.00	Avg. Losing Trade	(\$454.52)
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.



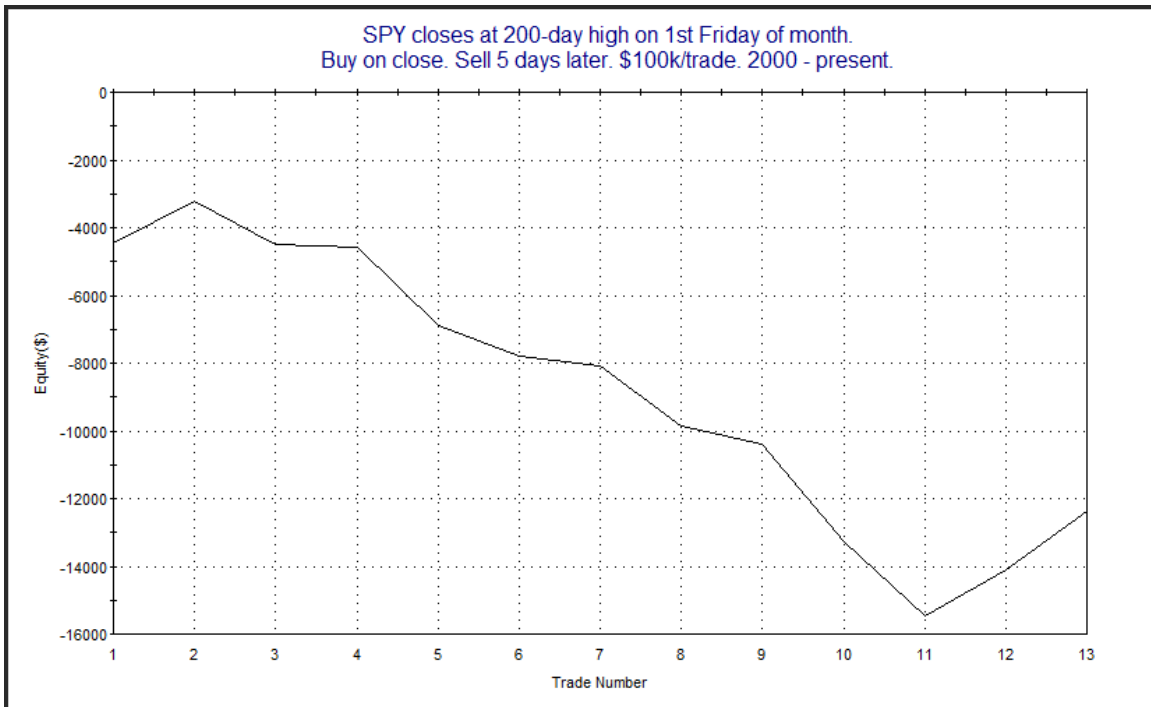
The equity curve has certainly been choppy but it has managed to maintain a downward trajectory throughout.

Another study with potentially bearish implications is the one below, which last appeared in the 2/7/11 subscriber letter. It is a seasonality-based study that shows early month rallies to new highs will often take a mid-month breather. All stats are updated.

**SPY closes at 200-day high on 1st Friday of month.
Buy on close. Sell X day 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	-12,889.95	13	6	7	46.15	1,225.02	2,575.56	-2,891.44	-4,569.88	0.42	0.36	-991.53
9	-10,786.46	13	5	8	38.46	1,221.97	2,362.20	-2,112.04	-4,757.74	0.58	0.36	-829.73
8	-12,368.06	13	5	8	38.46	1,030.18	2,057.40	-2,189.87	-4,275.18	0.47	0.29	-951.39
7	-15,918.18	13	3	10	23.08	1,125.22	1,447.14	-1,929.38	-3,942.81	0.58	0.17	-1,224.48
6	-12,360.29	13	3	10	23.08	1,443.49	1,737.36	-1,669.08	-4,449.62	0.86	0.26	-950.79
5	-8,144.31	13	5	8	38.46	913.42	1,493.52	-1,588.93	-3,264.20	0.57	0.36	-626.49
4	-9,273.23	13	6	7	46.15	480.59	891.54	-1,736.68	-4,518.34	0.28	0.24	-713.33
3	-4,772.56	13	7	6	53.85	363.15	853.44	-1,219.10	-3,264.20	0.30	0.35	-367.12
2	-3,207.10	13	5	8	38.46	394.87	1,082.04	-647.68	-1,614.92	0.61	0.38	-246.70
1	-1,526.82	13	6	7	46.15	165.14	624.84	-359.67	-1,219.78	0.46	0.39	-117.45

Not a lot of instances, but fairly compelling stats anyway. Below is an equity curve that assumes a 6-day holding period.

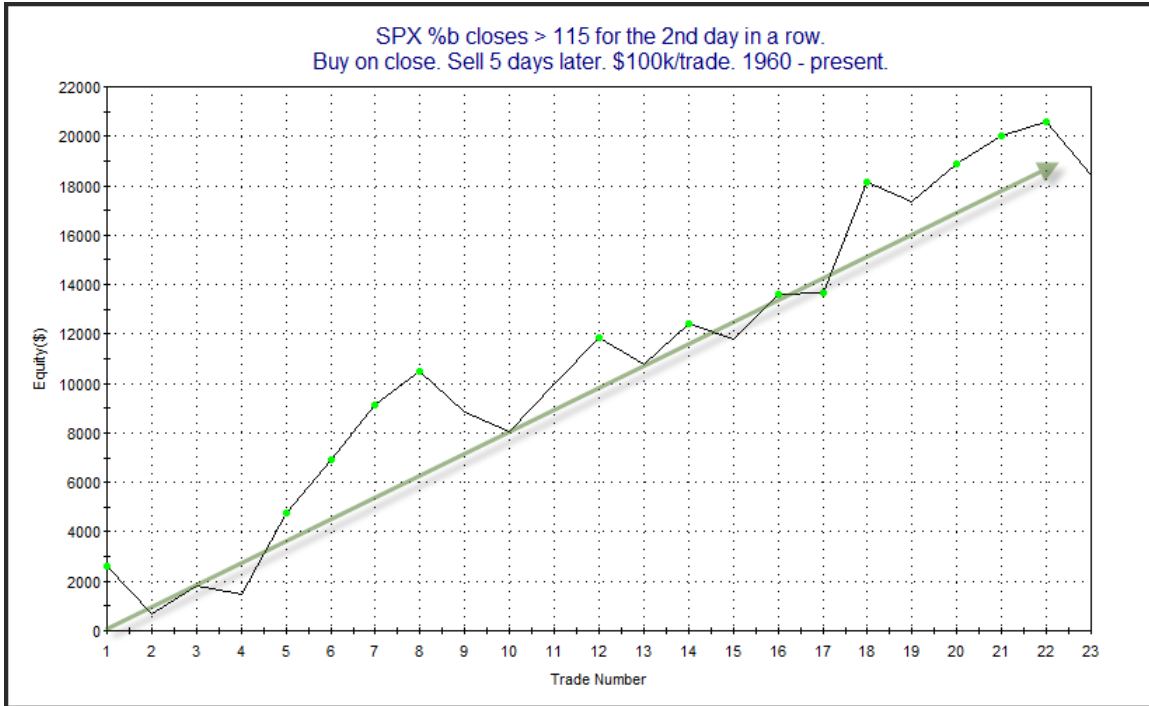


Curve is a little choppy, and the last two instances have gone against the norm, so it bears watching, but the edge still seems strong enough to keep under consideration.

Last night we saw several studies trigger that suggested Thursday's breakout was strong enough that it was likely to see some short-term follow through. The continued strength on Friday also appears to be a positive. Short-term strength is often followed by short-term weakness, but when that short-term strength is extremely impressive, then it tends to beget more strength. This is demonstrated in both of the studies below. The first one is from the 11/8/10 Subscriber Letter. It examines strong moves above the upper Bollinger Band. It requires not only a move above the upper band but substantially above it. Using the %b calculation the required reading is 115. All stats are updated.

SPX %b closes > 115 for the 2nd day in a row. Buy on close. Sell X days later. \$100k/trade. 1960 - 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	30,200.49	23	15	8	65.22	3,146.46	5,936.14	-2,124.54	-4,247.60	1.48	2.78	1,313.06
9	25,397.05	23	16	7	69.57	2,734.00	6,104.00	-2,621.00	-4,418.40	1.04	2.38	1,104.22
8	17,026.53	23	15	8	65.22	2,345.83	6,233.71	-2,270.12	-3,942.40	1.03	1.94	740.28
7	16,879.58	23	15	8	65.22	2,308.78	4,655.00	-2,219.02	-6,521.20	1.04	1.95	733.89
6	24,706.54	23	15	8	65.22	2,366.47	5,002.50	-1,348.82	-2,526.48	1.75	3.29	1,074.20
5	18,442.51	23	15	8	65.22	1,853.76	4,482.50	-1,170.49	-2,157.84	1.58	2.97	801.85
4	15,491.57	23	14	9	60.87	1,635.71	4,440.00	-823.15	-2,057.55	1.99	3.09	673.55
3	10,809.94	23	14	9	60.87	1,227.09	4,318.58	-707.70	-1,703.46	1.73	2.70	470.00
2	6,960.46	23	16	7	69.57	824.43	2,586.57	-890.06	-1,529.34	0.93	2.12	302.63
1	5,069.40	23	15	8	65.22	569.27	2,609.46	-433.70	-1,358.70	1.31	2.46	220.41

Statistics aren't overwhelming, but there still quite impressive considering the fact that the market is already overbought. Below is an equity curve that assumes a 5-day holding period.



The curve is a little choppy, but still appears strong enough to confirm the upside edge suggested by the stats table.

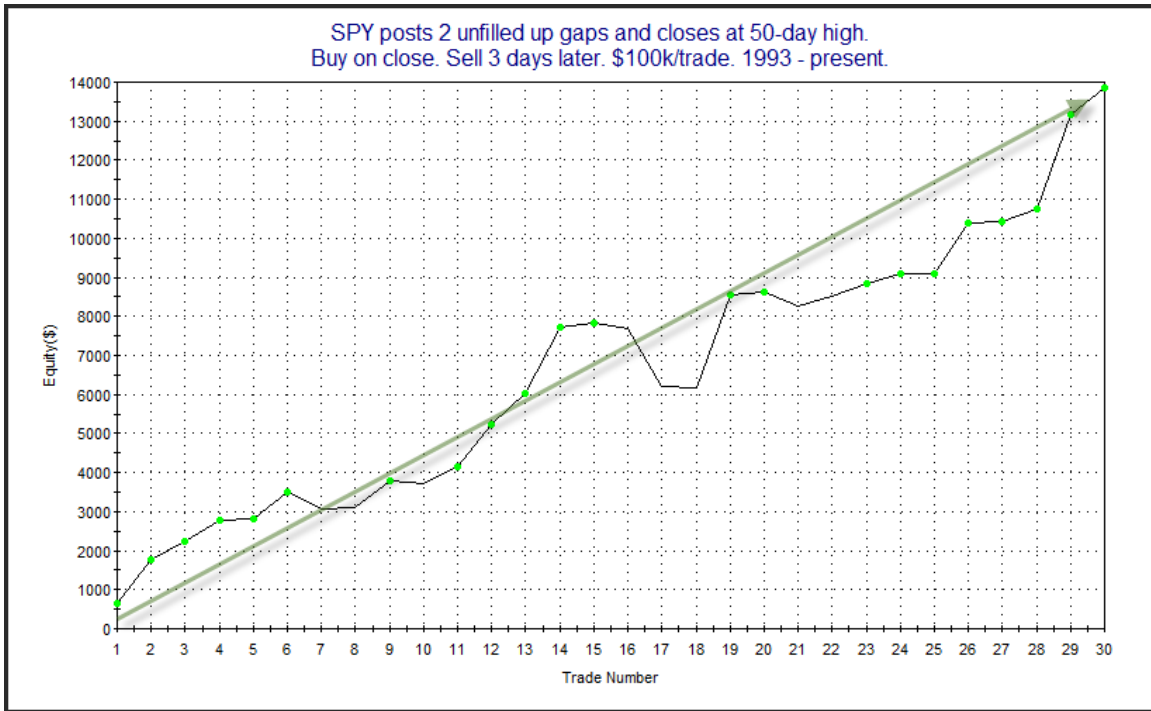
This next study was last seen in the 10/25/11 Subscriber Letter. It looks at other times the market has posted two consecutive unfilled up-gaps and closed at a 50-day high. The unfilled up-gaps are considered a sign of strength. All stats are updated.

SPY posts 2 unfilled up gaps and closes at 50-day 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	9,952.30	30	22	8	73.33	906.08	1,927.68	-1,247.69	-4,508.40	0.73	2.00	331.74
4	15,740.19	30	25	5	83.33	899.18	2,475.56	-1,347.89	-2,720.25	0.67	3.34	524.67
3	13,872.78	30	24	6	80.00	682.49	2,419.84	-417.82	-1,509.60	1.63	6.53	462.43
2	7,279.27	30	22	7	73.33	517.78	1,858.87	-587.41	-947.24	0.88	2.77	242.64
1	-1,070.31	35	19	16	54.29	305.11	980.49	-429.21	-1,942.24	0.71	0.84	-30.58

33 of 35 instances (94%) closed above the entry price at some point in the next week.

The size of the follow-through isn't terribly large, but it has been very, very consistent that some follow through was achieved in the next few days. Below is the 3-day profit curve.



The curve here is strong, and fairly steady. This study seems well worth consideration, and I have included on the Active List.

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



With tonight's studies factored in the green Aggregator Line moved down closer to zero, but still held above it. Positive readings mean net expectations from the Active List are for upside over the next few days. Meanwhile the black Differential Line took a dive further below zero. This means the SPX is overbought versus recent expectations. So net expectations are bullish but the SPX is already strongly overbought. This is considered a neutral configuration. Neutral configurations are visible on the chart whenever both lines close on opposite sides of 0. This lead the Aggregator to remain flat at the close. This was indicated as likely on the systems page.

Based on the current open studies, expectations are scheduled to remain positive on Monday. Of course this could change if more bearish evidence emerges. The Differential Pivot will be 1,405.04 on Monday. This is a whopping 2.3% below Friday's close. It would take a close lower of at least this much in order to push the SPX into oversold territory. That's a tall order for a one day drop. A more likely scenario would be a multi-day pullback or consolidation to move SPX out of overbought territory.

So the studies suggest the strong move up over the last couple of days could be a positive, and there may be more upside to come. But the market is so overbought at this point that risk is elevated. I prefer a much more favorable risk/reward ratio before putting new

capital to work. So I'll stay sidelined here and wait for either a pullback, or compelling bearish evidence to emerge.

Intermediate-term Outlook (2 weeks – 2 months)– updated 9/10– slightly bullish

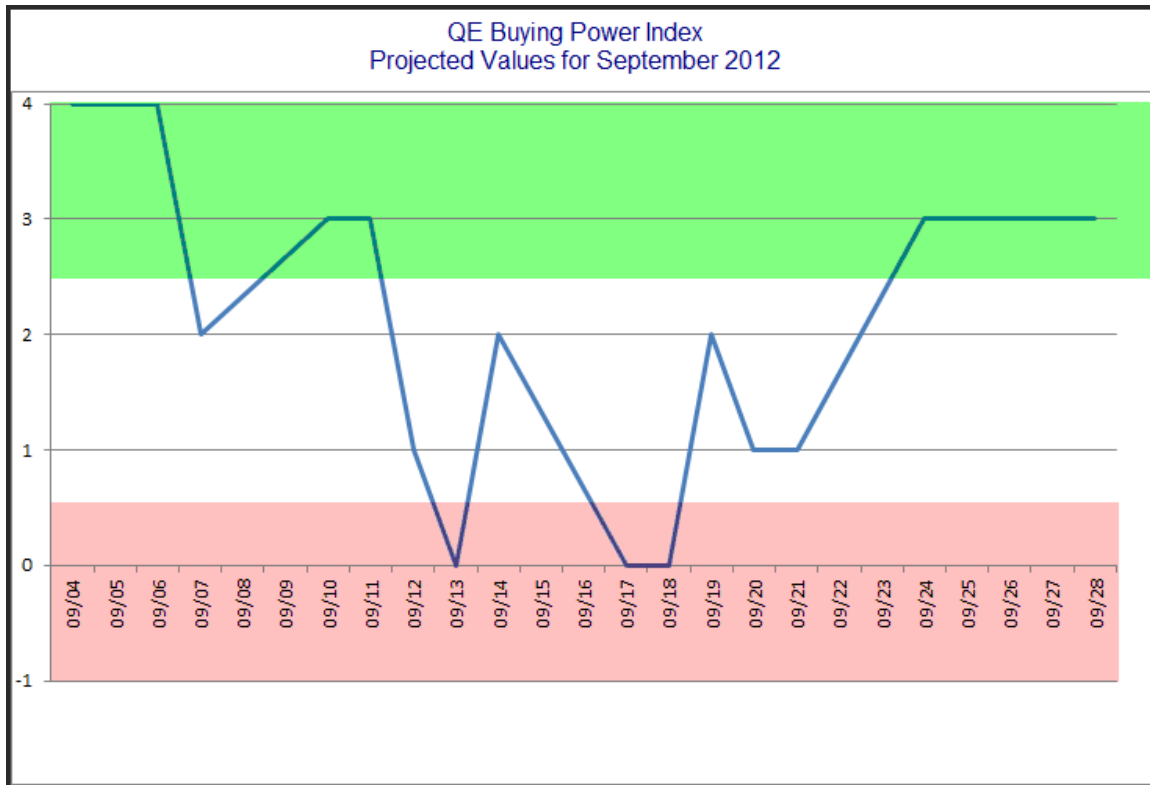
In case there was any doubt whether the uptrend remained intact, the SPX closed Thursday and Friday at the highest level in years. So if you want to be intermediate-term bearish, you've got a trend to fight.

But there are some hints that the uptrend could struggle in the next couple of weeks. One such hint came from a setup that triggered on Tuesday. I showed the possible 10-day implications in the 9/6 letter. I have copied the stats table below.

SPX closes down but <i>not</i> at a 20-day low. RUT closes up over 1%. Buy SPX 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	-28,461.52	15	1	14	6.67	7,654.42	7,654.42	-2,579.71	-8,323.53	2.97	0.21	-1,897.43
9	-23,344.94	16	2	14	12.50	3,812.88	7,455.14	-2,212.19	-4,873.44	1.72	0.25	-1,459.06
8	-21,838.48	16	3	13	18.75	2,730.97	5,503.70	-2,310.11	-6,458.64	1.18	0.27	-1,364.91
7	-17,539.79	16	5	11	31.25	1,750.68	5,689.82	-2,390.29	-6,585.48	0.73	0.33	-1,096.24
6	-18,137.16	16	7	9	43.75	1,523.01	5,523.44	-3,199.80	-9,589.14	0.48	0.37	-1,133.57
5	1,086.20	16	8	8	50.00	2,121.26	5,379.66	-1,985.49	-4,012.80	1.07	1.07	67.89
4	10,076.25	17	8	9	47.06	3,667.66	8,095.62	-2,140.56	-4,174.20	1.71	1.52	592.72
3	3,626.10	20	11	9	55.00	1,489.26	4,047.64	-1,417.30	-2,635.20	1.05	1.28	181.31
2	782.45	20	13	7	65.00	1,065.17	4,136.62	-1,866.40	-4,296.24	0.57	1.06	39.12
1	12,299.85	21	14	7	66.67	1,251.04	2,568.00	-744.95	-2,722.05	1.68	3.36	585.71

Looking out over the next couple of weeks there has been a strong downward tendency. This may be worth keeping in mind over the next week and a half or so.

Also of some concern over the next couple of weeks will be the liquidity contraction suggested by the POMO schedule. Below again this week is the QE Buying Power Index.



While it is scheduled to close at 3 on Monday and Tuesday, by Thursday it will be at 0, which could trigger a short signal for the QE Buying Power Swing System if the SPX is at or near its highs at that point. And POMO selling is expected to dominate through the 20th of September. After that we will see another liquidity infusion at the end of the month. More details can be found in last week's update or on the Fed's posted schedule using the link below.

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

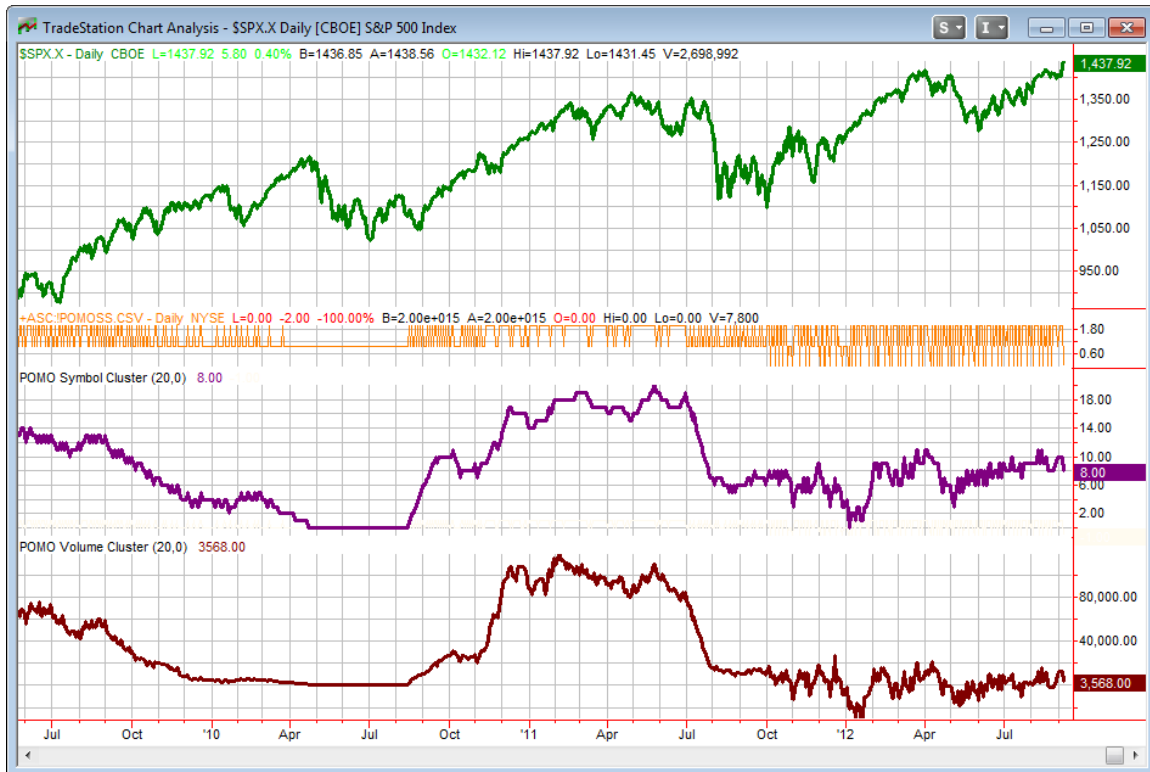
For more details on the QE Buying Power Index chart and swing system subscribers may visit the [QE Buying Power Index Information page](#).

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 1 day of selling. The net result was a \$5.2 billion liquidity infusion. Though fairly strong, this only left the intermediate-term indicators near the middle of their recent range.

This upcoming week is scheduled to see very mild buying on Monday, Tuesday, and Friday. There will be strong selling on Wednesday and no activity on Thursday. The net of this activity is expected to be about a \$2.75 billion outflow.

We had 2 intermediate-term studies expire this week. The bears can point to upcoming short-term POMO flows and the Russell/SPX divergence study shown above. The bulls can look to a few positives. The uptrend is firmly intact. Momentum is positive, the Nasdaq is in a leading position, and we had another 50-day high on 90% up volume confirming the one that was already in effect since July. I'm generally bullish but wary

we may hit a brief rough patch in the next couple of weeks. So I am scaling back my outlook from “bullish” to “slightly bullish” at least until this little period passes.

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

None

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