

QUANTIFIABLE EDGES SUBSCRIBER LETTER

ASSESSING MARKET ACTION WITH INDICATORS AND HISTORY

September 17, 2012

Volume 5 Issue 179

Market Overview



Signals Overview

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

Tonight's Research Points

- SPX up and VIX up on Fridays has been short-term bearish in the past.
- Continued highs on increasing volume is a short-term positive.
- Bond rates hitting a new high along with stocks has often led to intermediate-term trouble for stocks.
- QE3 is here.

Short-term Outlook

The Bottom Line

The market is very overbought but it is still hinting that more upside could come. Shorting appears dangerous, especially with QE3 now in effect. I'm flat and awaiting a pullback.

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

Study Date	Description	Time span	Bias	Avg Max Move
Active				
September 17, 2012	3up 3 volume up. 50-day high	1-2 days	Bullish	
September 17, 2012	VIX up SPX up Fri	1-3 days	Bearish	
September 14, 2012	20-high on 20-high vol	1-3 days	Bullish	
September 14, 2012	100 day high on Fed Day	1-8 days	Bullish	1.90%
September 10, 2012	200-high on 1st Friday	1-6 days	Bearish	
Active - Long Term				
September 17, 2012	QE3	int term	Bullish	
September 17, 2012	SPX and TNX hit 50-day high	1-20 days	Bearish	
September 11, 2012	Key Reversal from high	1-12 days	Bullish	
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 10, 2012	%b > 115 2 days	1-5 days	Bullish	1.80%
September 5, 2012	Russell up 1%. SPX down	1-10 days	Bearish	

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

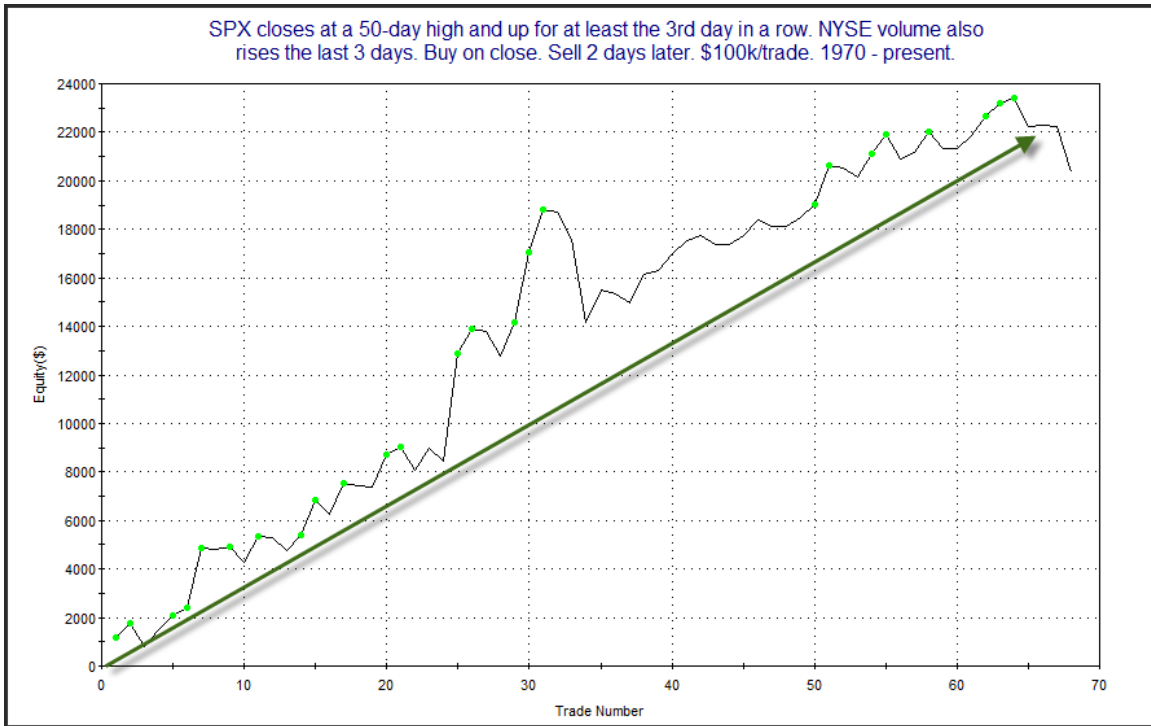
The Evidence

The QE3 announcement rally continued on Friday. The SPX rose 0.4%, the NASDAQ rallied 0.9%, and the Russell 2000 gained 1.0%. Breadth was strongly positive as the NYSE Up Issues % was 67% and Up Volume % came in at 73%. Total NYSE volume again came in at the highest level since early August.

The Quantifinder identified a mix of moderately compelling studies. The one below was last seen in the 1/23/12 letter. I have updated the results.

SPX closes at a 50-day high and up for at least the 3rd day in a row. NYSE volume also rises the last 3 days. Buy on close. Sell X days later. \$100k/trade. 1970 - 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: Profit Factor	All: Avg Trade
5	22,547.26	69	42	27	60.87	1,263.50	4,765.28	-1,130.36	-3,827.55	1.12	1.74	326.77
4	9,137.04	69	41	28	59.42	1,006.81	6,138.16	-1,147.94	-3,898.65	0.88	1.28	132.42
3	16,187.34	69	44	25	63.77	893.92	4,376.64	-925.80	-4,388.45	0.97	1.70	234.60
2	19,140.29	69	41	28	59.42	905.86	4,399.92	-642.86	-3,412.80	1.41	2.06	277.40
1	5,885.28	79	44	35	55.70	520.24	2,755.52	-485.87	-1,602.28	1.07	1.35	74.50

The stats suggest a modest upside edge over the next couple of days. Below is a profit curve.



The last few instances have struggled but the edge has been steady enough prior to that so that I won't panic just yet. I still think it is worth giving this study some consideration.

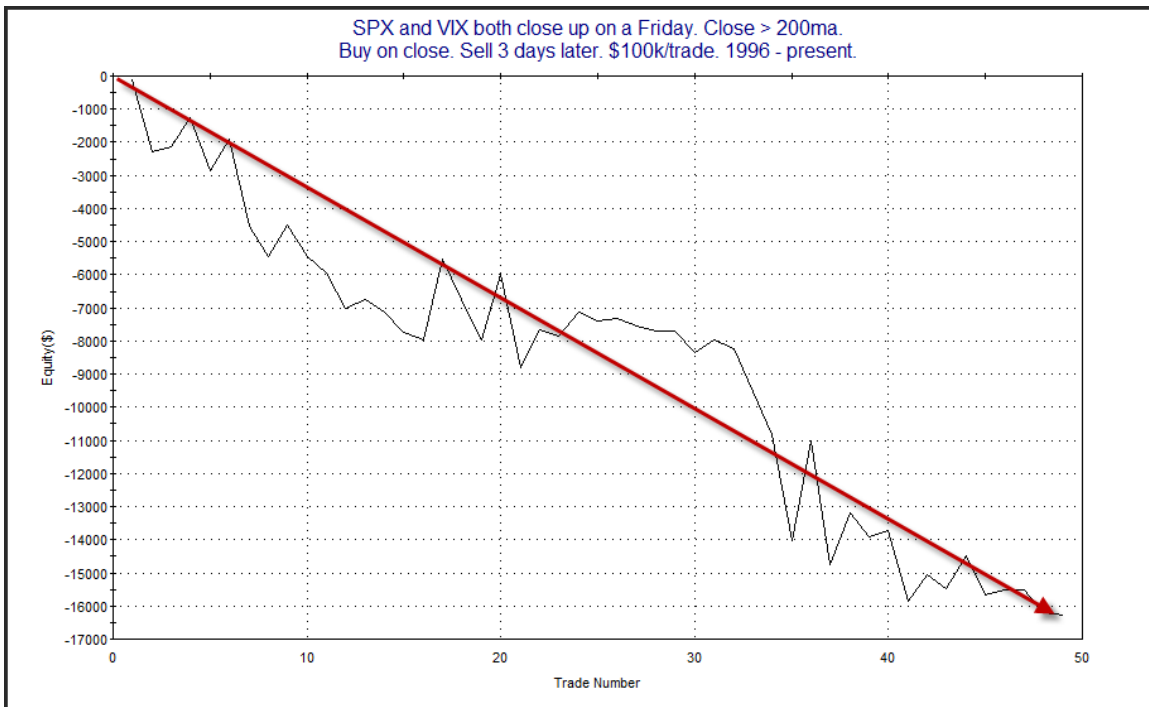
Even with the SPX rising, the VIX managed to close up a bit. The VIX will typically trade in a direction opposite the SPX, so it is unusual that they both close higher. On Fridays, the VIX has a natural tendency to dip in the afternoon, so it is *most* unusual to see them both close higher on Friday. The study below was last seen in 4/30/12 subscriber letter. It examines other instances of the VIX and SPX both closing higher on a Friday while the SPX is in an uptrending market. All stats are updated.

SPX and VIX both close up on a Friday. Close > 200ma.
Buy on close. Sell X days later. \$100k/trade. 1996 - 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	-14,855.56	48	19	29	39.58	1,464.44	4,290.80	-1,471.72	-3,118.36	1.00	0.65	-309.49
4	-16,772.15	49	20	29	40.82	1,088.02	4,275.84	-1,328.71	-4,306.02	0.82	0.56	-342.29
3	-16,260.80	49	17	32	34.69	973.19	3,000.26	-1,025.16	-3,727.50	0.95	0.50	-331.85
2	-12,232.90	49	21	28	42.86	754.66	2,380.51	-1,002.88	-3,595.20	0.75	0.56	-249.65
1	-10,067.29	49	16	33	32.65	501.77	1,530.15	-548.35	-2,361.45	0.92	0.44	-205.45

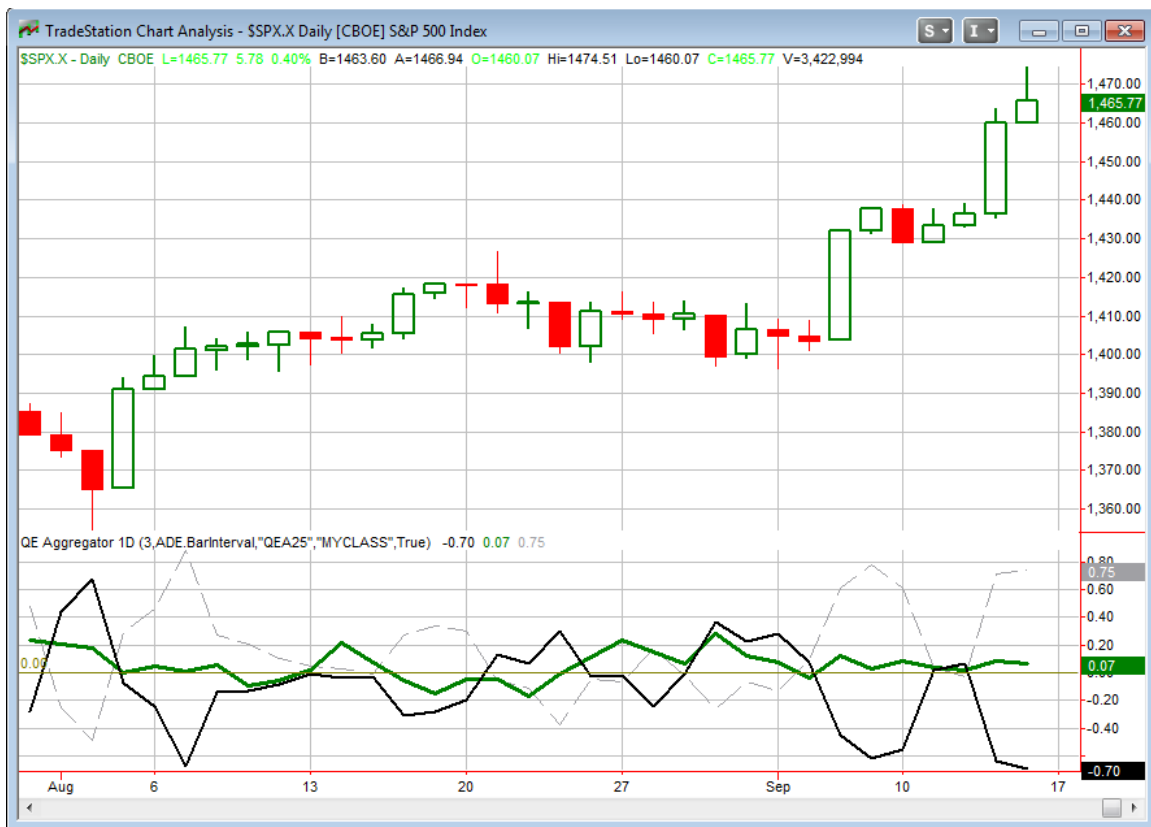
46 of 49 instances (94%) closed below the entry price at some point in the next week.

As you can see, there appears to be a decent downside edge suggested by this study. That edge primarily plays out over the first three days. Below is an equity curve showing how the edge has evolved assuming that 3-day holding period.



Considering the fact that the study utilizes a long-term uptrend filter, the persistent downslope is quite impressive. The last instance once again put the equity curve at new lows.

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



The green Aggregator Line is again 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 still strongly below zero. This means the SPX is overbought versus recent expectations. So net expectations are bullish but the SPX is 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 at the close, as was indicated as likely on the systems page before the bell.

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 1,438.05 on Monday. So it would take a close at or below this level in order to turn the SPX back to oversold. That would be a 1.9% decline, which is a large 1-day drop. A more likely scenario would be a multi-day drop or consolidation to work off the overbought condition.

I'm not inclined to take on new exposure with the market so overbought. I intend to wait until the next strongly favorable opportunity avails itself.

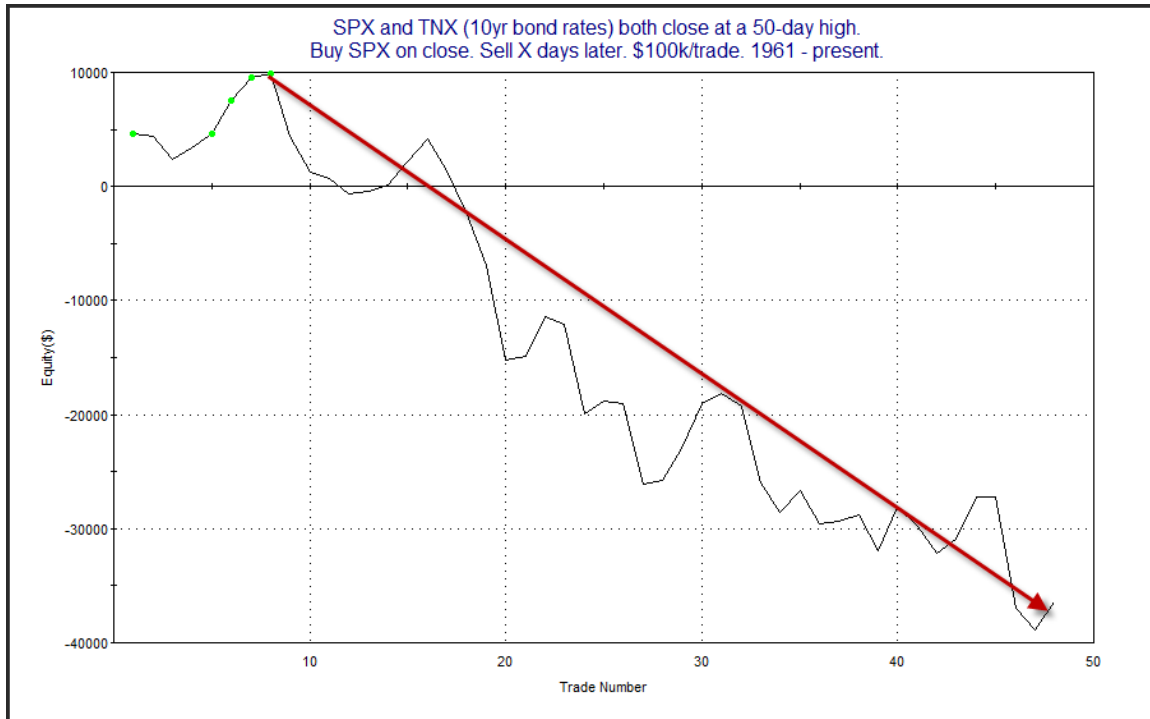
Intermediate-term Outlook (2 weeks – 2 months)– updated 9/17– bullish

With the QE3 excitement the uptrend remained firmly intact and the market closed Friday at multi-year highs. So the trend is clearly up, and as I will discuss below, the Fed is now strongly accommodative. But there was a bearish sign that triggered on Friday and I'll first show that.

It noted the fact that 10-year bond rates hit new highs on Friday along with the SPX. It was last seen in the 8/10/12 subscriber letter and has been updated below.

SPX and TNX (10yr bond rates) both close at a 50-day high. Buy SPX on close. Sell X days later. \$100k/trade. 1961 - 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
50	-41,147.05	38	17	21	44.74	3,406.25	9,293.13	-4,716.83	-11,866.50	0.72	0.58	-1,082.82
45	-36,862.77	39	16	23	41.03	4,061.53	8,170.47	-4,428.14	-11,540.20	0.92	0.64	-945.20
40	-22,032.92	41	19	22	46.34	3,794.28	7,101.51	-4,278.38	-10,971.10	0.89	0.77	-537.39
35	-31,109.04	43	19	24	44.19	3,197.42	9,093.59	-3,827.50	-9,558.36	0.84	0.66	-723.47
30	-19,312.69	44	17	27	38.64	3,582.60	8,122.50	-2,970.99	-6,689.55	1.21	0.76	-438.92
25	-3,661.40	46	20	26	43.48	3,044.37	7,845.48	-2,482.64	-6,261.07	1.23	0.94	-79.60
20	-36,377.86	48	24	24	50.00	1,811.55	4,616.92	-3,327.29	-9,695.84	0.54	0.54	-757.87
15	-28,136.94	48	25	23	52.08	1,663.00	3,500.32	-3,030.96	-9,608.60	0.55	0.60	-586.19
10	-7,709.20	53	31	22	58.49	1,321.47	3,263.44	-2,212.49	-8,683.66	0.60	0.84	-145.46
5	-4,966.06	70	38	32	54.29	1,025.53	5,231.46	-1,373.01	-6,088.44	0.75	0.89	-70.94

Generally it seems that higher interest rates have often made bonds an attractive investment. This may have lead people to forsake stocks in favor of lower risk returns with improved yield. Implications of this study appear to be longer-term in nature. To help visualize how this edge has played out over time I have pasted below an equity curve using a 20-day exit strategy.



Despite the recent instance showing a slight gain, the downside edge appears squarely intact.

Of course the big news this past week was the QE3 announcement. The Fed is about to embark on another aggressive liquidity infusion. But this time they are not going to buy treasury securities, but instead agency mortgage backed securities. Based on the reactions since 2005 of all liquidity infusions and withdrawals, this new round of liquidity expansion would seem to have a strong positive impact on the stock market. We may need to track it a little differently, though.

So far I have not found any daily data on QE3 purchases. With this being the case, I may only be able to chart these flows on a weekly or monthly basis. I did find the following note, indicating the daily schedule may be released in the near future. [From the Fed's website:](#)

How much will the Desk purchase each month in agency MBS associated with the reinvestment program and how will this be communicated?

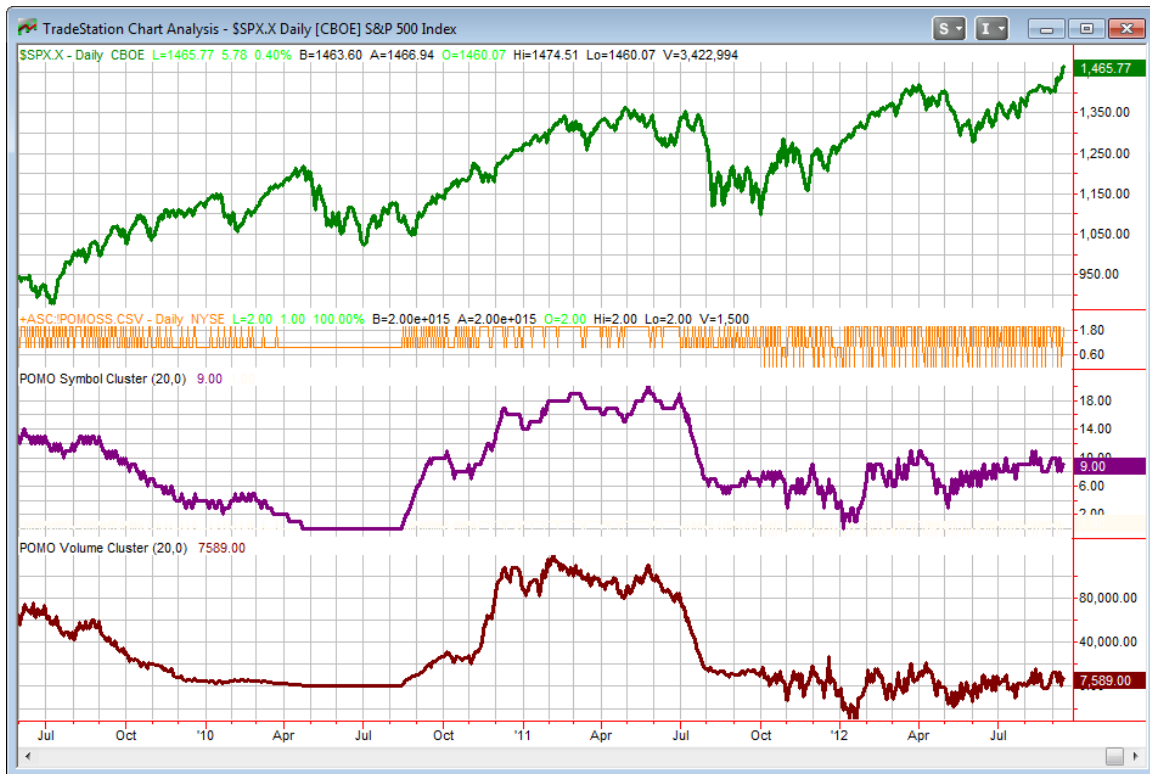
On or around the eighth business day of each month, the Desk will publish a tentative amount of reinvestment-related purchases expected to take place between the middle of the current month and the middle of the following month. This amount will be approximately equal to the amount of principal payments from agency debt and agency

MBS expected to be received over that period, adjusted for any variations from prior periods. Adjustments for any deviation between anticipated and actual agency MBS purchases over a given monthly period will be made by modifying the following month's agency MBS purchases. For example, if actual agency MBS purchases were \$1 billion smaller (larger) than previously announced, the Desk would increase (decrease) the following month's anticipated agency MBS purchases by \$1 billion.

My initial inclination is that the POMO indicators, including the QE Buying Power Index, will need to be adjusted to combine the treasury and ambs purchase and sale data. It may take some time before all of the necessary data is available. So for this week, I will again post our intermediate-term POMO chart. 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>



As far as POMO action this past week there was a \$3 billion outflow. This had a small negative impact on the intermediate-term indicator. Of course as I mentioned above it is going to be necessary to begin incorporating the QE3 agency MBS transactions into this data in upcoming weeks. There is further POMO outflows expected this upcoming week, but no telling just yet how much of that will be offset by QE3 and what the net will be.

Like I mentioned above, it is difficult to imagine QE3 will be bad for the stock market. (I'm not as confident about its impact on the economy.) I expect increased liquidity in the system will work its way into the market and support prices. But since they will be trading different amounts and in a different way, judging the actual affect is impossible. I will say this, if the market begins to falter badly while QE3 is in effect, then watch out below.

For now I expect the bulls to be in charge. I will certainly favor long positions over short ones for the immediate future. The uptrend is firmly intact. Momentum is positive, the Nasdaq is in a leading position, and now there is another massive stimulus package that is starting. The bond rate study from tonight is really the only intermediate-term negative on my radar. My focus for now will be buying pullbacks.

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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