

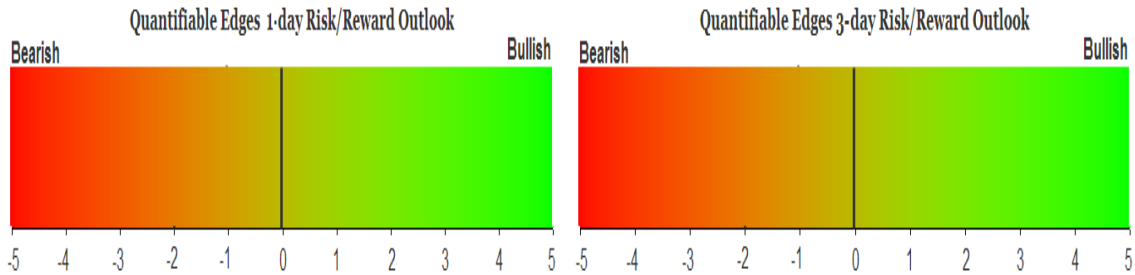
QUANTIFIABLE EDGES SUBSCRIBER LETTER

ASSESSING MARKET ACTION WITH INDICATORS AND HISTORY

October 15, 2012

Volume 5 Issue 199

Market Overview



Signals Overview

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

Tonight's Research Points

- October op-ex Monday has been seasonally bullish.
- Breadth at the September top was not indicative of a major top.
- QE3 liquidity remains strong.

Short-term Outlook

The Bottom Line

Evidence is still suggesting we could see more downside in the next few days. With the market short-term oversold, there isn't a strong edge just yet. If we see another down day on Monday, we will likely see enough bullish evidence to turn expectations positive. In anticipation of that I am on the lookout for a move down on Monday to buy into.

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

Study Date	Description	Time span	Bias	Avg Max Move
Active				
October 15, 2012	October op-ex Monday	1 day	Bullish	
October 12, 2012	High vol bounce after RSI(2)<5.	1-3 days	Bearish	
October 12, 2012	HV low. SPX not high.	1-5 days	Bearish	
Active - Long Term				
October 15, 2012	Breadth not diverging at top	int term	Bullish	
September 17, 2012	QE3	int term	Bullish	
September 17, 2012	SPX and TNX hit 50-day high	1-20 days	Bearish	
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				
October 10, 2012	3 down. Big drop.	1-3 days	Bullish	1.60%

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

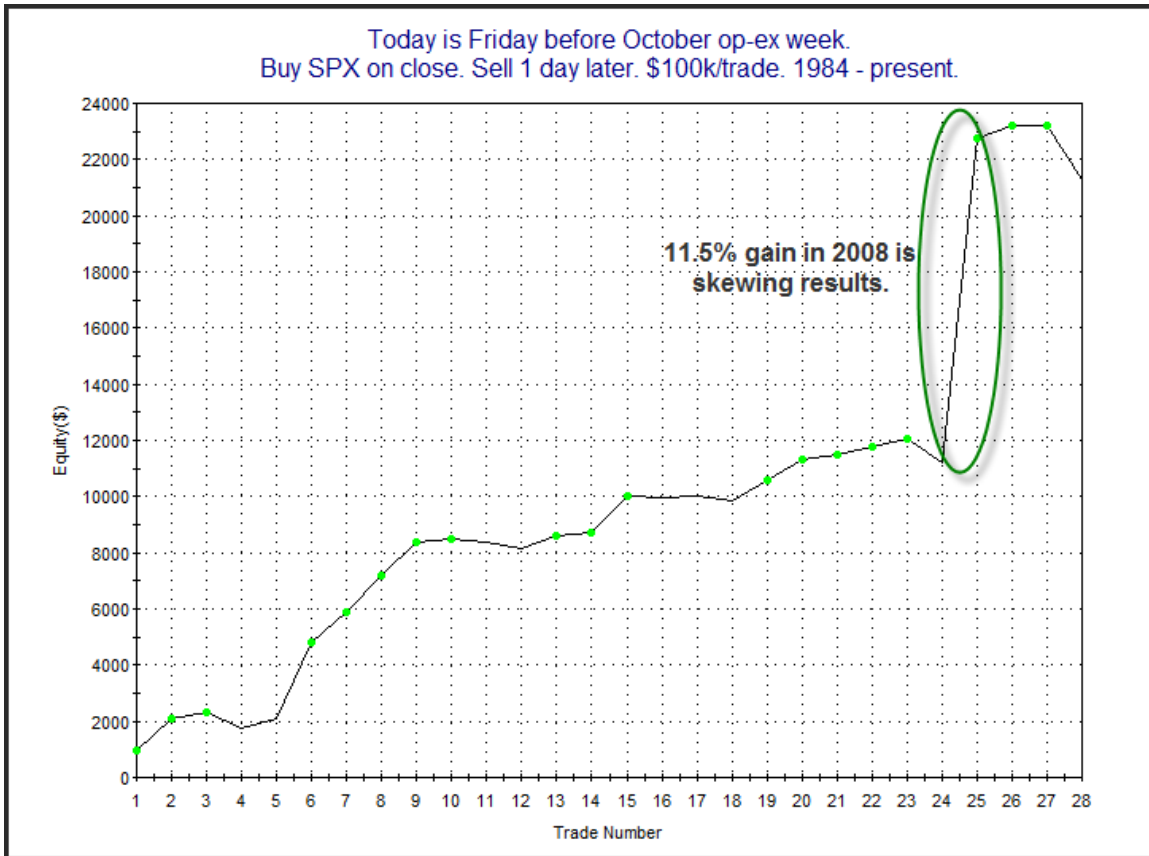
The Evidence

The market started off the morning okay, but hit its high just after 10 AM and had a bad afternoon. In the end the SPX lost 0.3%, the Nasdaq dropped 0.2% and the Russell 2000 declined 0.8%. Breadth was squarely negative as the NYSE Up Issues % was 36% and the Up Volume % came in at 25%. Total NYSE volume fell a little from the level of the last couple days.

The action didn't generate much new in the Quantifinder. We had a few repeat studies from the last couple of days, so I'll point back to those letters. There was one seasonal study worth noting. As many of you know, option expiration week is often a pretty good week for the market. October is one of those months where it has been especially good over the years. I last showed the table below in the 10/11/10 Subscriber Letter. It examines performance during October op-ex week.

Today is Friday before October op-ex week. Buy SPX on close. Sell X days later. \$100k/trade. 1984 - 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	22,417.68	28	20	8	71.43	2,436.29	7,282.10	-3,288.50	-9,109.98	0.74	1.85	800.63
4	28,239.68	28	19	9	67.86	2,349.15	6,383.20	-1,821.58	-4,169.79	1.29	2.72	1,008.56
3	10,203.77	28	18	10	64.29	1,293.49	2,976.32	-1,307.90	-3,734.78	0.99	1.78	364.42
2	24,709.05	28	19	9	67.86	1,642.62	10,965.69	-722.31	-1,737.36	2.27	4.80	882.47
1	21,296.86	28	21	7	75.00	1,199.91	11,558.43	-557.31	-1,921.32	2.15	6.46	760.60

As you can see, returns have generally been quite good. But much of the upside edge has been thanks to the strong Monday. Below is an equity curve showing Monday's performance over the years.



The strongly oversized gains in 2008 obviously skew the results. But even without 2008 there has been a decent upside tendency. So to generate a more realistic estimate I reran the results excluding 2008.

Today is Friday before October op-ex week.
Buy SPX on close. Sell 1 day later. \$100k/trade. 1984 - present (excluding 2008).

TradeStation Performance Summary Collapse ^			
All Trades			
Total Net Profit	\$9,738.43	Profit Factor	3.50
Gross Profit	\$13,639.60	Gross Loss	(\$3,901.17)
Total Number of Trades	27	Percent Profitable	74.07%
Winning Trades	20	Losing Trades	7
Even Trades	0		
Avg. Trade Net Profit	\$360.68	Ratio Avg. Win:Avg. Loss	1.22
Avg. Winning Trade	\$681.98	Avg. Losing Trade	(\$557.31)
Largest Winning Trade	\$2,753.79	Largest Losing Trade	(\$1,921.32)

Numbers here are still good. The average gain was nearly 0.4%. I included this seasonal study on the active list for tonight.

Over the years, 20-day lows during long-term uptrends have often been buyable for a swing-style profit. The tendency has not been as strong over the last few years and with the QE Buying Power Index at a low level, many pullbacks have struggled over the last several years. I discussed this in detail in Wednesday night's letter. I've provided a link below in case you'd like to read it.

[2012-05-11 QE Subscriber Letter.pdf](#)

The QE Buying Power Index is currently at 2, but it will move up to 3 on Monday afternoon. Without a decent bounce on Monday, this would cause the QE Buying Power Swing System to trigger long, and provide a bit more ammunition for the bulls.

Another study that appeared in the Quantifinder again on Friday was related to the persistently low historical volatility readings we have seen, and the fact that SPX has not been hitting new highs. It is a study that is already active, but if you'd like to review it, below is a link to Thursday night's letter.

[2012-10-12 QE Subscriber Letter.pdf](#)

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



Despite tonight's bullish study the green Aggregator Line is still well below 0. Negative readings mean net expectations from the Active List are for downside over the next few days. Meanwhile the black Differential Line remains positive. This means the SPX is oversold versus recent expectations. So net expectations are bearish but the SPX is already oversold. This is considered a neutral configuration. Neutral configurations are visible on the chart whenever both lines close on opposite sides of 0. This caused the Aggregator system to remain flat at the close. This was indicated as likely on the systems page shortly before the bell.

Based on the current studies, expectations are set to remain negative on Monday. Of course this could easily change if bullish evidence emerges. The Differential Pivot will be 1,438.84 on Monday. This is 0.7% above Friday's close. So it would take a decent sized move up on Monday to move the SPX from oversold to overbought.

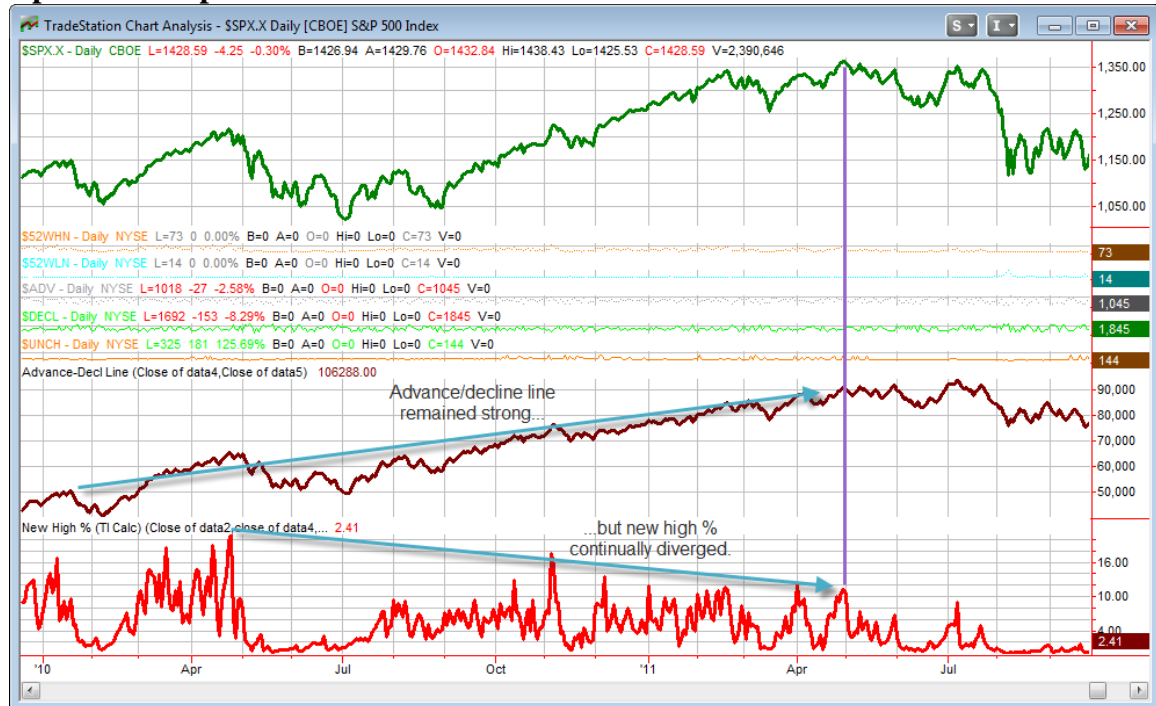
Expectations remain negative, but that would likely change with a down close on Monday thanks to the rise in the QE Buying Power Index. In anticipation of that, I'll be looking to start scaling into a long position on a down close Monday. In fact, if Monday closes up, I'll probably be looking to buy if we head lower in the days following since Buying Power is expected to stay strong at 3 for over a week.

Intermediate-term Outlook (2 weeks – 2 months)– updated 10/15– bullish

This past week was rough, with SPX moving from near new highs all the way down to 20-day lows. From an evidence standpoint, nothing terribly compelling emerged in the form of new studies, which gives me the opportunity to rehash a study of tops.

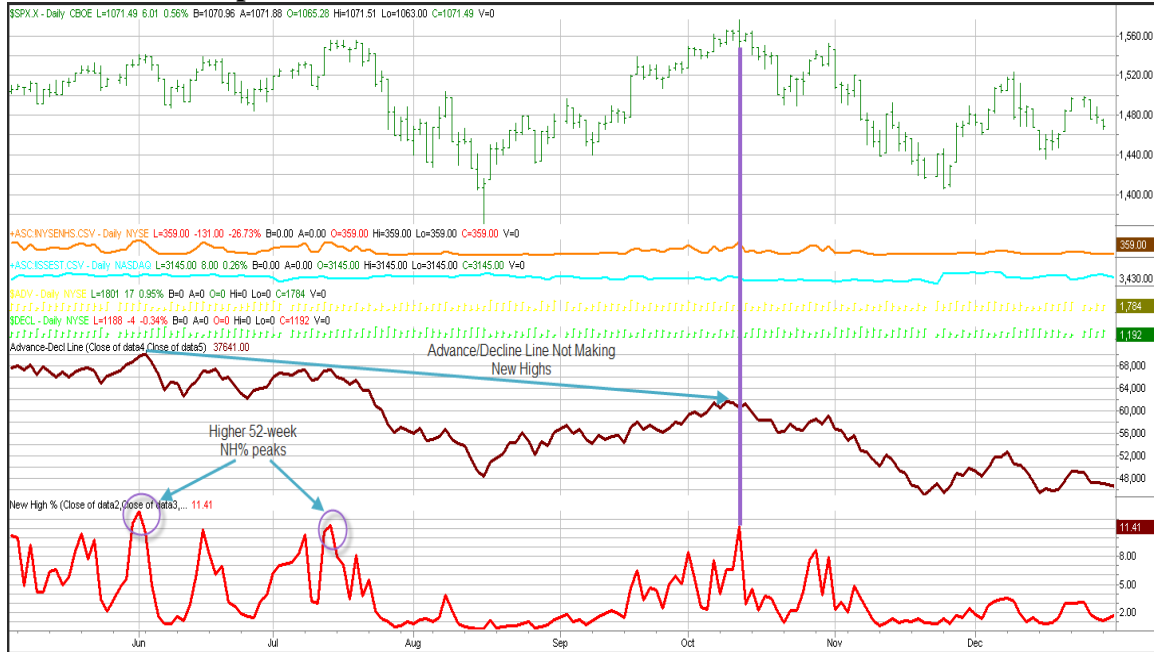
In the 10/12/09 Letter I published a study of the major tops since 1970 and how they had all been accompanied by a breadth divergence. It was inspired by a Lowry’s study on market tops. For those who would like to purchase the Lowry study, it may be obtained here: http://www.lowryreports.com/research_studies.cfm Lowry’s basic finding was that breadth has consistently topped out before the market. They primarily looked at 52-week new highs and the Dow Jones Industrial Average. I used the S&P 500 rather than the DOW. In the charts below the top panel is the S&P 500. The bottom panel is the % of NYSE stocks that are hitting 52-week highs. The panel just above the bottom panel is the NYSE advance/decline line. My breadth data only goes back to 1970, so that’s as far as these charts go. Instances are lower than I’d prefer for a complete study, but you’ll note there is definitely an underlying theme to the instances that do exist. To define a “major top”, I examined all instances of 52-week price highs that were followed by a 20% decline. The 1st chart is the 2011 top.

April 2011 Top



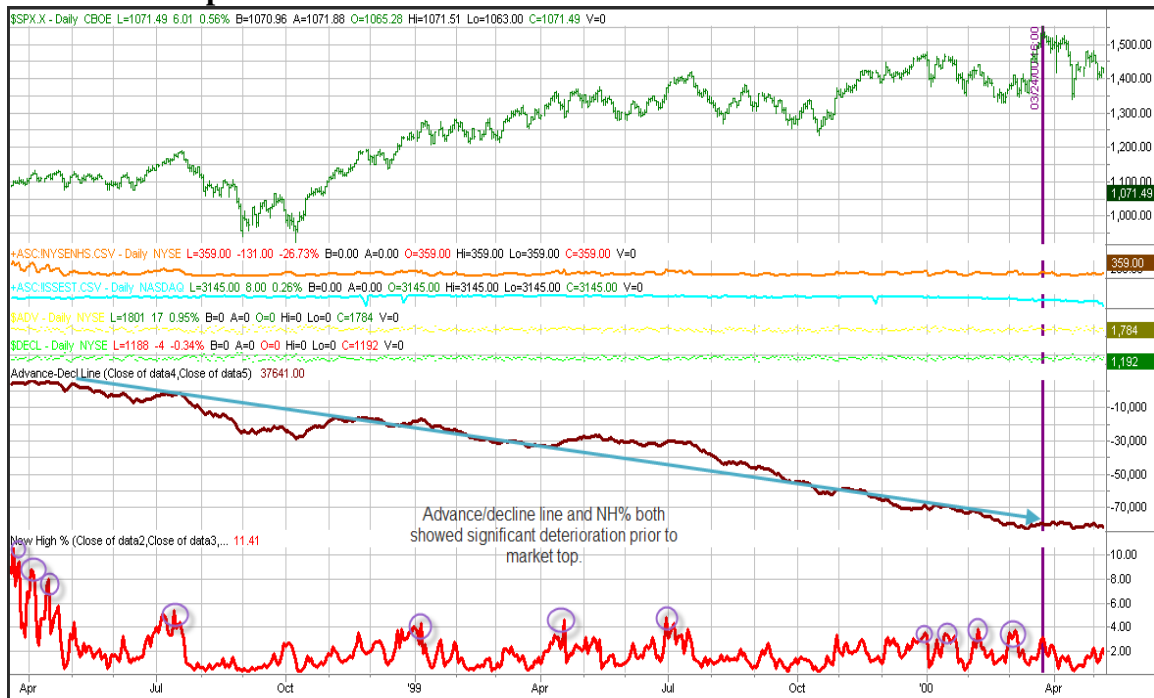
Many traders may not have realized that the market underwent a 20% correction during 2011. It did. And though advance/decline did not diverge, new highs did. This was one of only two instances where the a/d line managed to make a new high.

October 2007 Top



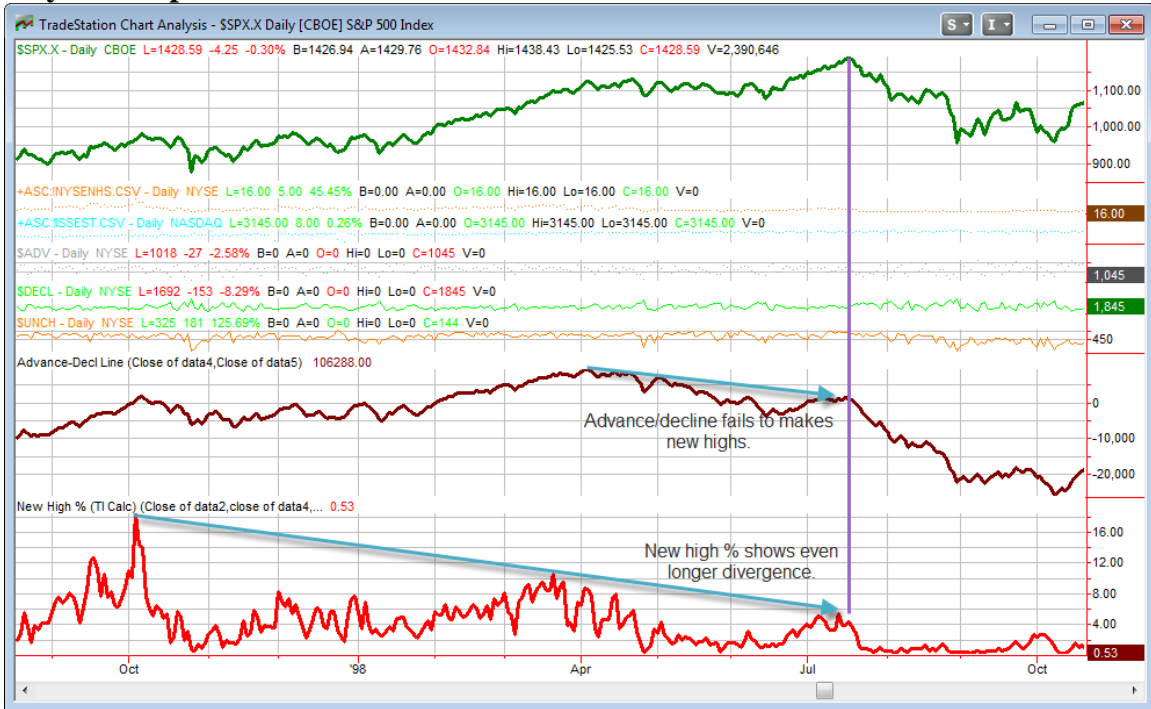
What I note above is a deteriorating a/d line and new highs that are failing to reach prior levels. Next is the 2000 top.

March 2000 top



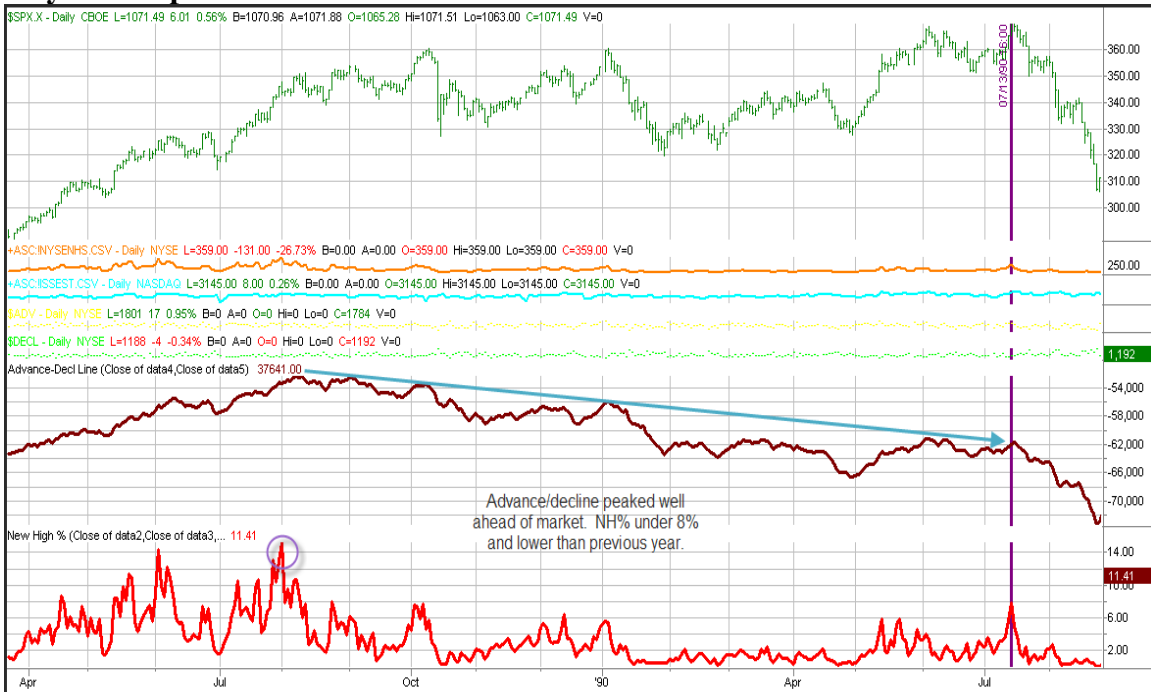
This market was thinning for years before topping. A rather extreme case here. Next is July of 1998.

July 1998 top



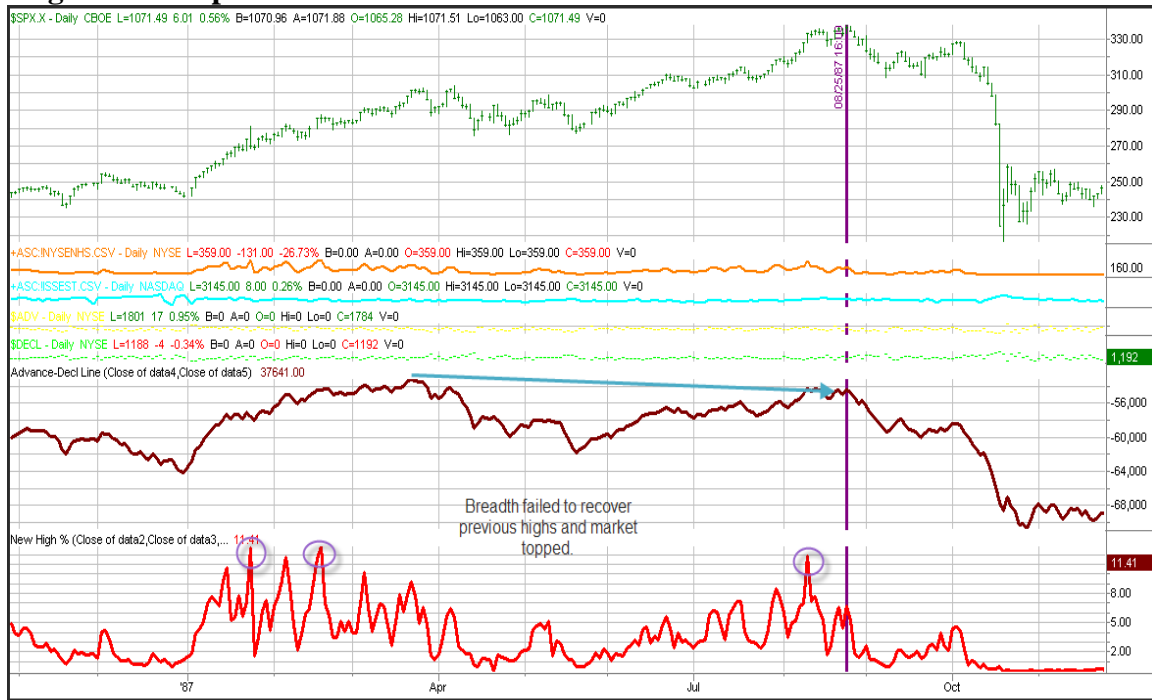
Note that this top was not shown in the original study, because the down move that followed was not long-term. It was deep, though, so I added it tonight. Again we see diverging breadth for both the A/D line and the new high%. Now July of 1990.

July 1990 top



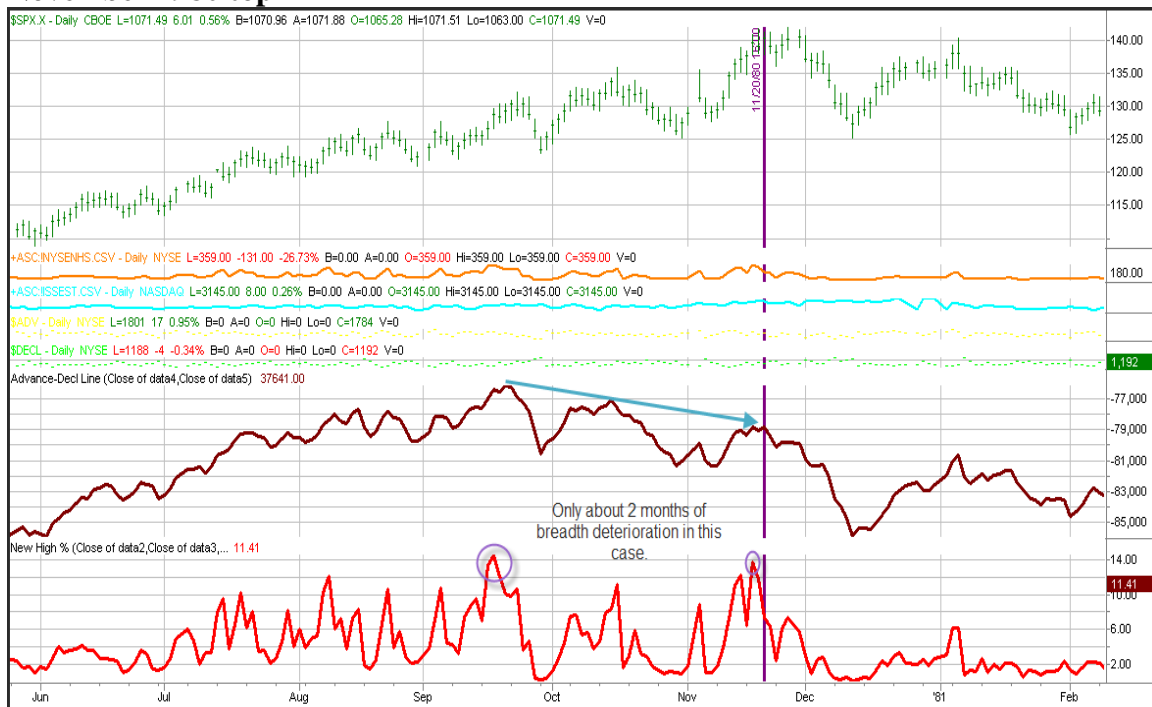
More of the same here. A muted NH % accompanied by a declining a/d line. Now for 1987.

August 1987 top



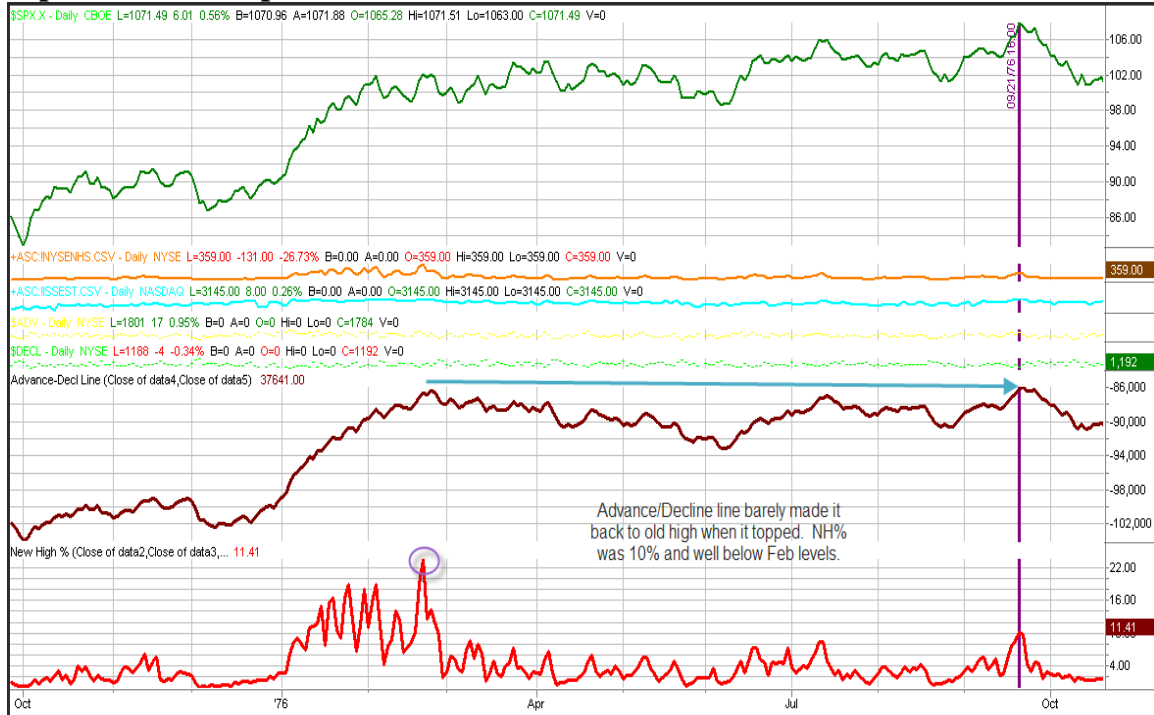
Here again we see a rising market that is accompanied by worsening breadth. Now for November of 1980.

November 1980 top



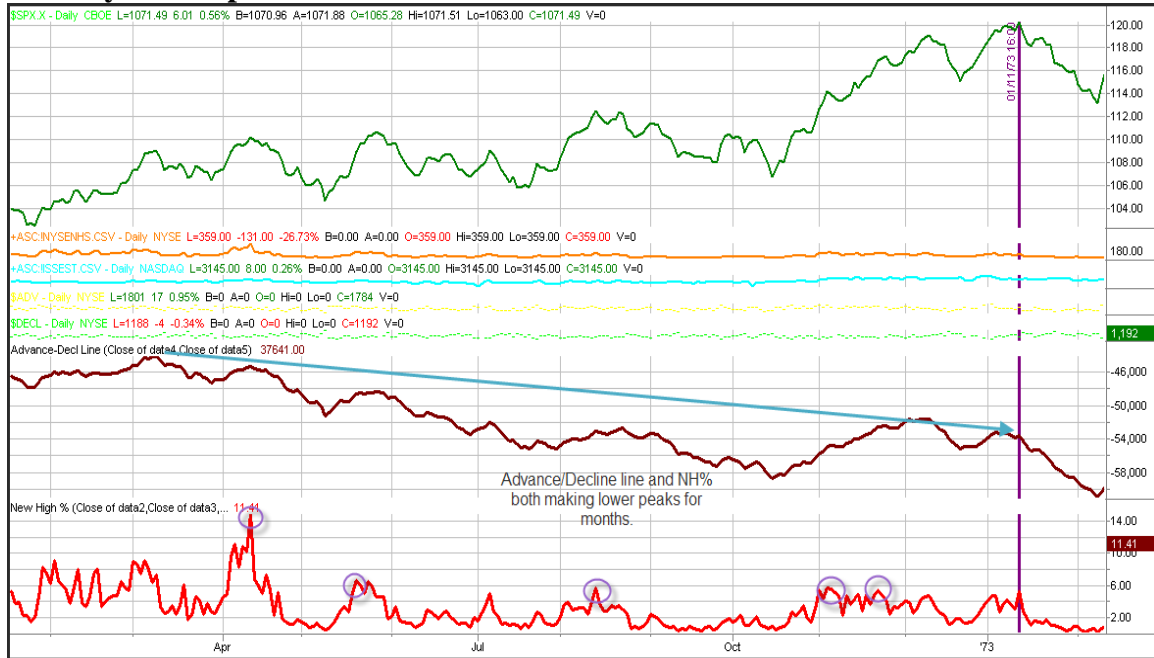
This one is less extreme than some of the others. The breadth decline only occurred over the course of a couple of months before the market topped. Here's September 1976.

September 1976 top



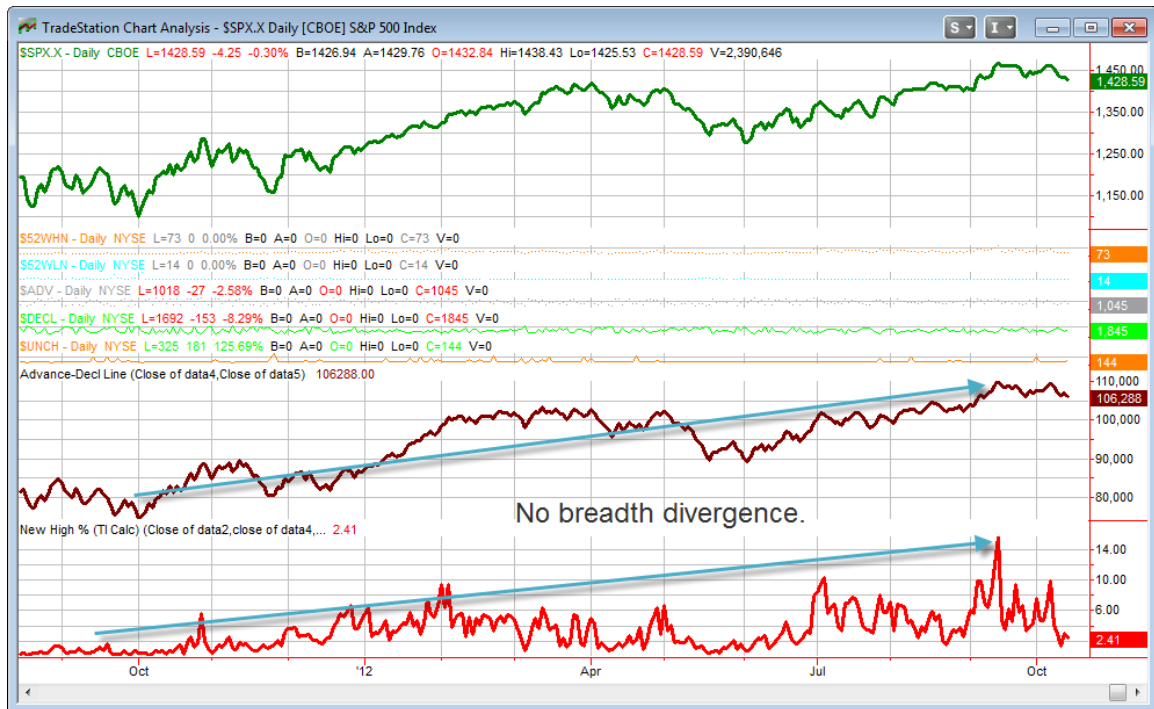
This actually just missed the “major top” definition, as it declined “only” 19.5% before bottoming. I included it anyway. This was the 2nd instance where the a/d line managed to make a new high. It wasn’t by much. It didn’t last long. It also wasn’t confirmed by the NH %. Lastly let’s look at January 1973:

January 1973 top



More of the same here. A weakening a/d line and consistently lower peaks in the 52-week NH%.

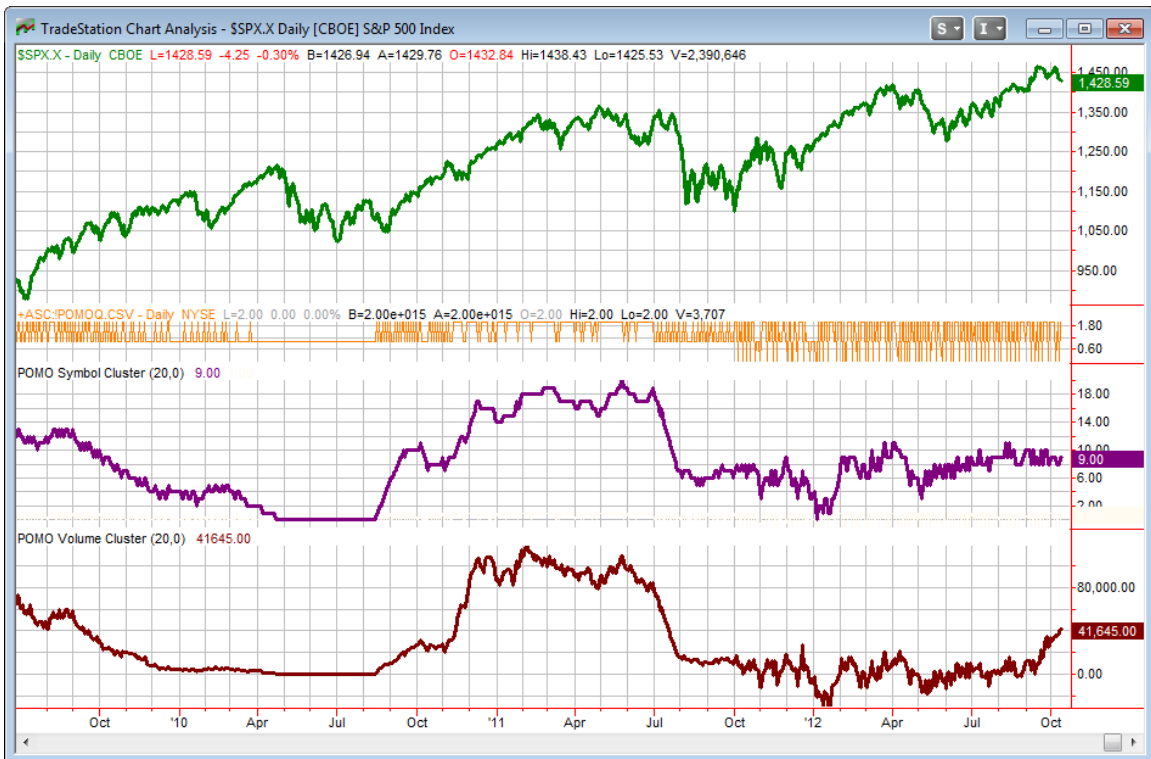
So every major top in the last 43 years has been preceded by some kind of breadth divergence. Let's take a look at the current chart and consider what breadth may be saying about the September "top".



September's SPX high was accompanied by new highs for both of our breadth measures. With no divergence in place, it would seem unlikely that the market is set up for a major decline. New highs in the months ahead appear more likely based on our intermediate-term breadth indicators.

I always update the intermediate-term POMO/QE3 chart each week. For those not familiar, below is a brief description.

POMO stands for Permanent Open Market Operations and it is how the Fed has gone into the open market to buy securities over the last several years. 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 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. Since the Sept 13, 2012 QE3 announcement the POMO numbers are also adjusted to reflected the Fed's new approach of buying AMBS securities. Therefore, prior to that date the indicators just look at POMO, since that date it is a combination of POMO and AMBS flows.



The POMO/AMBS volume indicator is nearing a level where it will likely settle in for a while now that QE3 is in gear. This will be higher than Operation Twist, but below the levels of QE1 and QE2. Total liquidity flows this week resulted in a relatively mild \$4.5 billion estimated inflow.

This upcoming week we expect to see net inflows every day except Wednesday. This should result in a total net inflow of about \$12.5 billion, which is a little above an average expected QE3 week.

Bulls have an existing uptrend and strong liquidity on their side. And as we saw, breadth is suggesting we should see higher highs ahead. The bears seem to have much less pointing in their favor. I continue to have more interest in long-side opportunities than in short-side opportunities.

Catapult and Capitulative Breadth Statistics

[Catapult & CBI Presentation Link](#)

Open Catapult Triggers

New

CVS – (\$47.06 close) – buy 1/3 position @ \$47.06 limit

INTC - (\$21.46 close) – buy 1/3 position @ \$21.46 limit

VZ - (\$44.62 close) – buy 1/3 position @ \$44.62 limit

Catapult for ETF's Trades

None

Broad Market Large Cap CBI – 3(CVS, INTC, VZ)

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.

CVS – buy 1/3 Catapult position @ \$47.06 limit

INTC - buy 1/3 Catapult position @ \$21.46 limit

VZ - buy 1/3 Catapult position @ \$44.62 limit

All 3 trade ideas above are from the Catapult section.

Those unfamiliar with the catapult trades are encouraged to review the Catapult and CBI video, which can be found on the videos page. There is also a perma-link near the top of the catapult section above. Additional and more recent information can also be found in the "Catapult Exit Designer" presentation and tools, which are available for subscribers on the downloads page. Bottom line with the Catapults is that while they have performed quite well as a whole over time, they can be very volatile and I rarely trade them with stops, so position sizing is critical for managing risk.

SPY – buy 1/4 index position at \$142.88 LIMIT ON CLOSE – Based on the short-term outlook above. I'll look to begin scaling in if we close lower Monday and likely trigger a QE Buying Power Swing System long signal.

Current Open Trade Ideas

Symbol	Entry Date	Entry Price	Current Price	% Gain/Loss	Stop	Notes
SPY(1/4)	10/9/2012	\$144.20	\$143.46	-0.51%		<i>sold on open</i>

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