

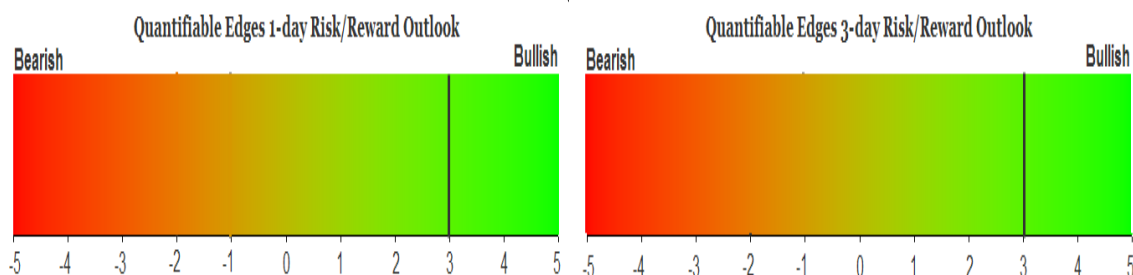
# QUANTIFIABLE EDGES SUBSCRIBER LETTER

ASSESSING MARKET ACTION WITH INDICATORS AND HISTORY

October 22, 2012

Volume 5 Issue 204

## Market Overview



## Signals Overview

Aggregator	Aggressive VIX	QE Buy Pwr Swing	NDX Trend Timer
Long	100% Long XIV	Long	Flat

## Tonight's Research Points

- Oversized drops on Fridays almost always lead to a short-term bounce.
- The QE Buying Power Swing System triggered a long signal.

## Short-term Outlook

### The Bottom Line

Friday's drop moved the market into an oversold condition and also triggered some bullish evidence. I'm looking to start scaling into a long position in anticipation of a bounce.

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

Study Date	Description	Time span	Bias	Avg Max Move
<b>Active</b>				
October 22, 2012	QE Buying Power Swing long	1-7 days	Bullish	3.10%
October 22, 2012	Oversized drop on Friday	1-6 days	Bullish	2.75%
<b>Active - Long Term</b>				
October 19, 2012	SPY key reversal	1-12 days	Bullish	
October 15, 2012	Breadth not diverging at top	int term	Bullish	
September 17, 2012	QE3	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	

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

### *The Evidence*

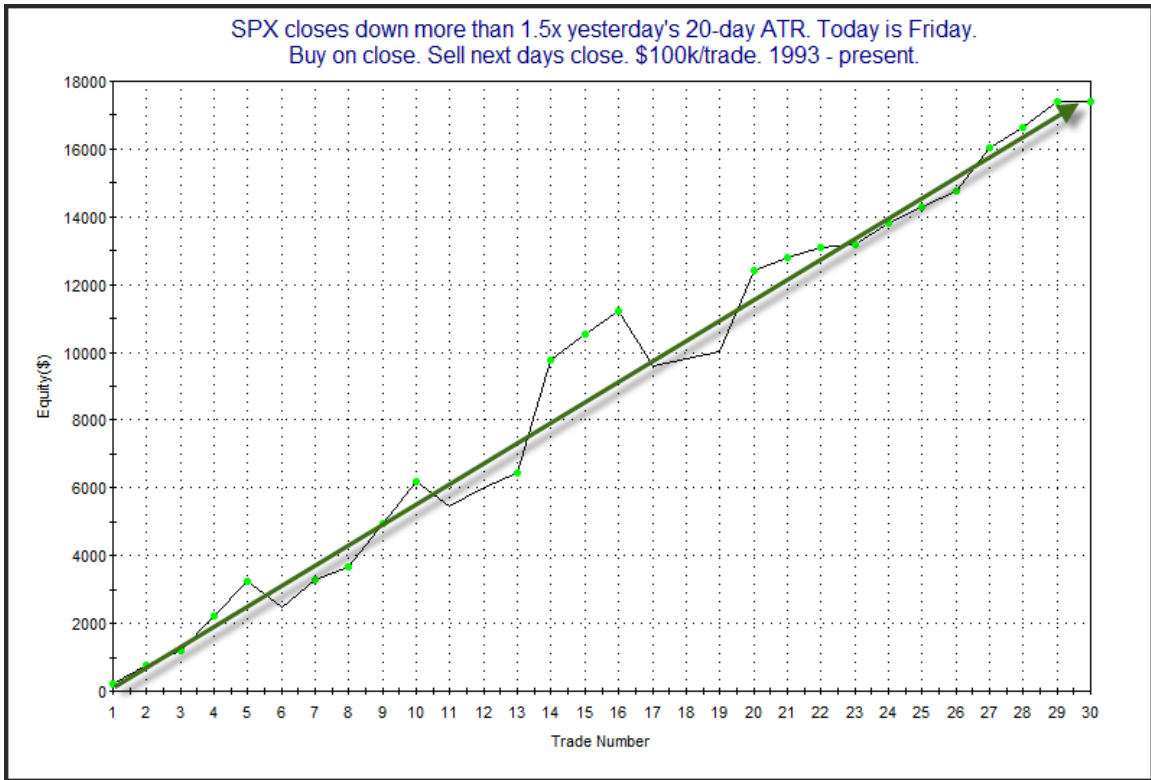
Our bearish studies expired 1 day early as the market took a hard hit on Friday. The SPX lost 1.7%, the Nasdaq declined 2.2% and the Russell 2000 fell 1.9%. Breadth was strongly negative as the NYSE Up Issues % was 22% and the Up Volume % came in at 10%. Total NYSE volume spiked to the highest level in the last month.

The most substantial study that appeared in the Quantifinder examined large drops on Fridays. Both the Crash of '29 and the Crash of '87 happened on Monday. The Crash of '87 is still remembered by many traders that are active today. There was a strong selloff on Friday and then all hell broke loose on Monday. But since then strong Friday selloffs have commonly been followed by bounces on Mondays. Perhaps this is due to the fact that fear of a crash causes what might otherwise be an ordinary selloff to become exaggerated and overdone on Fridays. Or perhaps it is just that people don't want to hold over the weekend. Whatever the reason, the tendency to bounce has been very strong. The study below looks at strong drops on Fridays and was last discussed in the 1/31/11 subscriber letter.

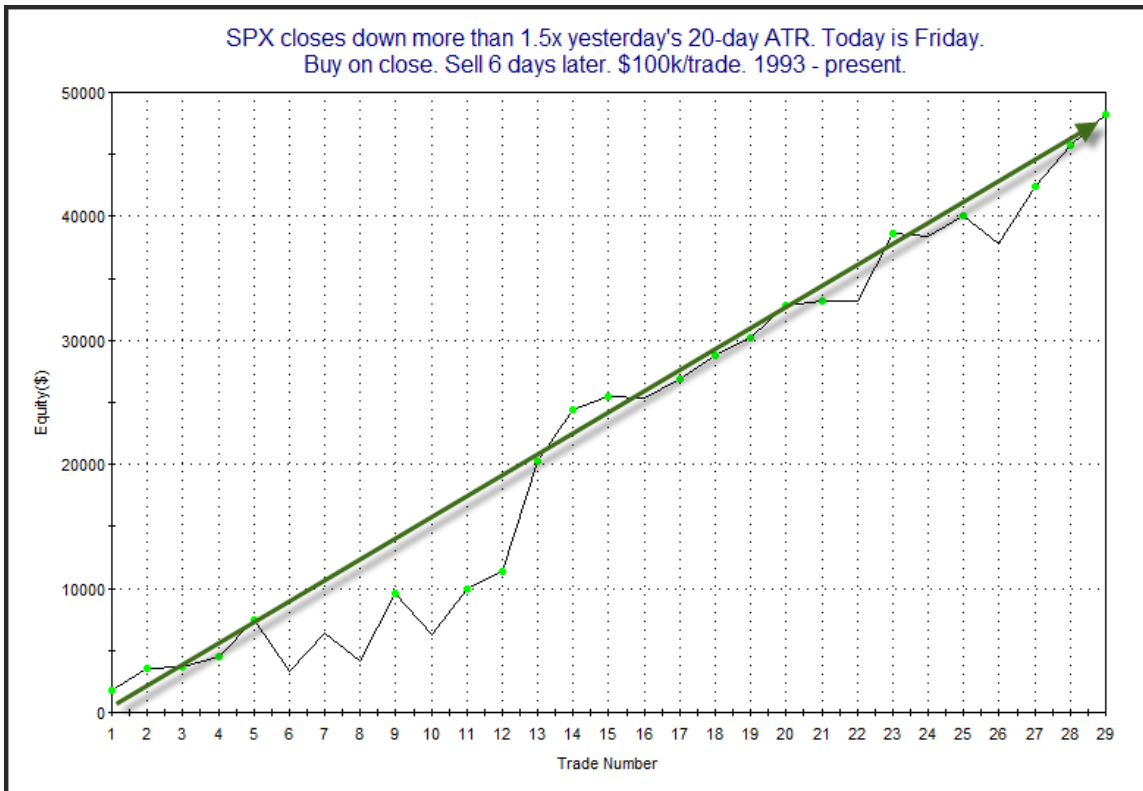
SPX closes down more than 1.5x yesterday's 20-day ATR. Today is Friday. Buy on close. Sell X days later. \$100k/trade. 1993 - present.												
X Days	All: Net Profit	All: Total Trades	All: Winning Trades	All: Losing Trades	All: % Profitable	All: Avg Winning Trade	All: Max Winning Trade	All: Avg Losing Trade	All: Max Losing Trade	All: Win/Loss Ratio	All: ProfitFactor	All: Avg Trade
10	30,217.44	29	19	10	65.52	3,138.76	9,241.60	-2,941.91	-6,049.40	1.07	2.03	1,041.98
9	33,836.38	29	19	10	65.52	2,998.91	7,602.40	-2,314.29	-5,483.80	1.30	2.46	1,166.77
8	42,879.55	29	21	8	72.41	2,820.21	7,949.70	-2,043.11	-3,550.72	1.38	3.62	1,478.61
7	40,936.37	29	20	9	68.97	2,943.80	7,662.81	-1,993.30	-4,599.52	1.48	3.28	1,411.60
6	48,169.31	29	22	7	75.86	2,754.97	8,870.96	-1,777.16	-4,202.80	1.55	4.87	1,661.01
5	33,521.80	30	22	8	73.33	2,315.53	5,393.97	-2,177.48	-6,368.04	1.06	2.92	1,117.39
4	24,954.58	30	21	9	70.00	1,933.22	5,731.96	-1,738.12	-4,917.36	1.11	2.60	831.82
3	28,275.94	30	21	9	70.00	1,830.80	5,215.85	-1,130.10	-3,492.36	1.62	3.78	942.53
2	22,555.27	30	21	9	70.00	1,519.87	6,245.15	-1,040.21	-4,320.06	1.46	3.41	751.84
1	17,416.33	30	27	3	90.00	759.65	3,322.23	-1,031.38	-1,614.72	0.74	6.63	580.54

**2 of the 3 instances that didn't bounce on Monday kept dropping and failed to post a close above the entry price at all in the next 2 weeks. They were 7/5/96 and 7/31/98.**

The numbers here are all very impressive and suggest a strong bullish bias. I decided tonight to look at the 1-day and 6-day returns in a little more detail. First, below is the profit curve for a 1-day holding period.



The Monday inclination has been strong, and I see no red flags here. For the 6-day I also produced a profit curve.



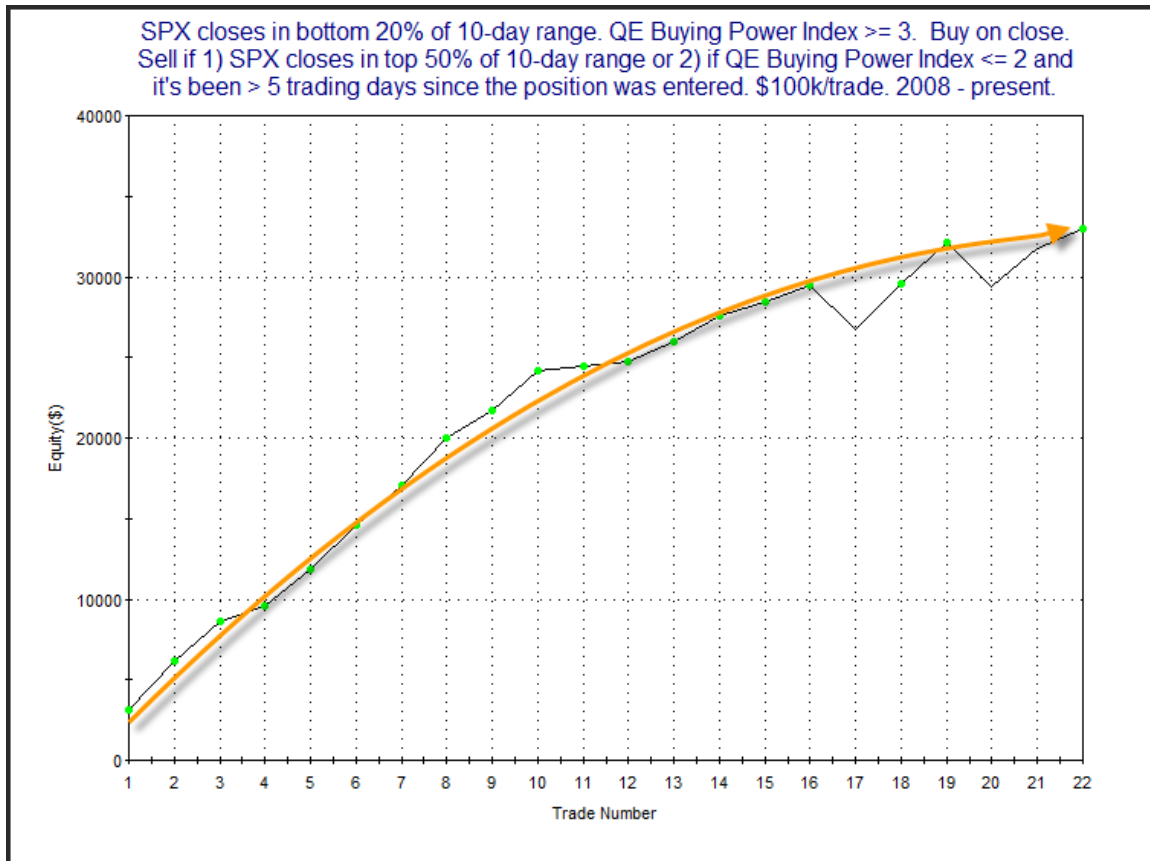
Here too the results remain impressive. This certainly seems to be a study worth taking under consideration.

Another positive is that a QE Buying Power Swing System long signal triggered on Friday. This little system looks to go long on pullbacks when short-term liquidity has been strong. It requires a reading of three or higher for the QE Buying Power Index and a close in the bottom 20% of the 10-day range. There have been many readings of 3 or higher over the last several months and all throughout the year, but they've generally come when they were "supposed" to come. In other words, when POMO flows were weak or negative. This has been pretty eye-opening since the required pullback is fairly mild and common. The results table below shows the performance of long entries using this simple system since 2008.

SPX closes in bottom 20% of 10-day range. QE Buying Power Index  $\geq 3$ . Buy on close.  
 Sell if 1) SPX closes in top 50% of 10-day range or 2) if QE Buying Power Index  $\leq 2$  and  
 it's been  $> 5$  trading days since the position was entered. \$100k/trade. 2008 - present.

TradeStation Performance Summary			Collapse 
<b>All Trades</b>			
Total Net Profit	\$32,960.31	Profit Factor	7.07
Gross Profit	\$38,394.23	Gross Loss	(\$5,433.92)
Total Number of Trades	22	Percent Profitable	90.91%
Winning Trades	20	Losing Trades	2
Even Trades	0		
Avg. Trade Net Profit	\$1,498.20	Ratio Avg. Win:Avg. Loss	0.71
Avg. Winning Trade	\$1,919.71	Avg. Losing Trade	(\$2,716.96)
Largest Winning Trade	\$3,160.20	Largest Losing Trade	(\$2,750.44)

The numbers here are all very strongly in favor of a bounce. Below is an equity curve.



There have been a couple of recent losers, but the curve remains impressive nonetheless. I also looked at it simply with a time-based exit. Those stats are below.

SPX closes in bottom 20% of 10-day range. QE Buying Power Index >= 3. Buy on close. Sell X days later. \$100k/trade. 2008 - 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	45,559.09	19	15	4	78.95	3,740.23	8,311.15	-2,636.09	-5,452.11	1.42	5.32	2,397.85
9	38,406.34	19	14	5	73.68	3,455.41	7,921.30	-1,993.87	-3,325.86	1.73	4.85	2,021.39
8	35,008.10	20	14	6	70.00	3,231.28	8,227.10	-1,704.97	-2,925.72	1.90	4.42	1,750.41
7	37,743.40	21	16	5	76.19	2,973.07	7,393.35	-1,965.13	-4,333.28	1.51	4.84	1,797.30
6	27,353.20	23	13	10	56.52	3,199.66	7,893.60	-1,424.23	-3,629.56	2.25	2.92	1,189.27
5	30,411.00	26	17	9	65.38	2,555.53	6,257.44	-1,448.12	-2,659.24	1.76	3.33	1,169.65
4	20,537.07	26	17	9	65.38	2,114.64	5,281.05	-1,712.42	-4,672.36	1.23	2.33	789.89
3	23,993.76	29	22	7	75.86	1,615.97	6,051.15	-1,651.09	-4,416.52	0.98	3.08	827.37
2	21,340.87	32	24	8	75.00	1,255.56	3,018.23	-1,099.06	-2,264.02	1.14	3.43	666.90
1	14,580.81	45	28	17	62.22	853.25	3,031.79	-547.66	-1,858.94	1.56	2.57	324.02

No matter how you slice it, there seems to be a decent upside edge.

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



Tonight's studies allowed the green Aggregator line to shoot up above 0. Positive readings mean net expectations from the Active List are for upside over the next few days. Meanwhile the black Differential Line also spiked higher and is now positive. This means the SPX is oversold versus recent expectations. So net expectations are bullish and the SPX is oversold. This is considered a bullish configuration. Bullish configurations are visible on the chart whenever both lines close above 0. This caused the Aggregator system to turn long the close.

We are still not looking at a lot of studies. Inclinations would remain bullish if nothing else emerges on Monday, but new studies will have a strong influence on expectations over the next few days. The Differential Pivot will be 1,453.23 on Monday. This is 1.4% above Friday's close. That would be a pretty sizable rally. The more likely scenario would be either a multi-day bounce or consolidation.

The pullback is only 2 days old and could certainly worsen, but a bounce appears likely. I'll start scaling in so that I may take advantage of the bounce. And with a (bullish) Fed Day scheduled on Wednesday, I'll likely scale in Aggressively on Tuesday if we continue to sell off.

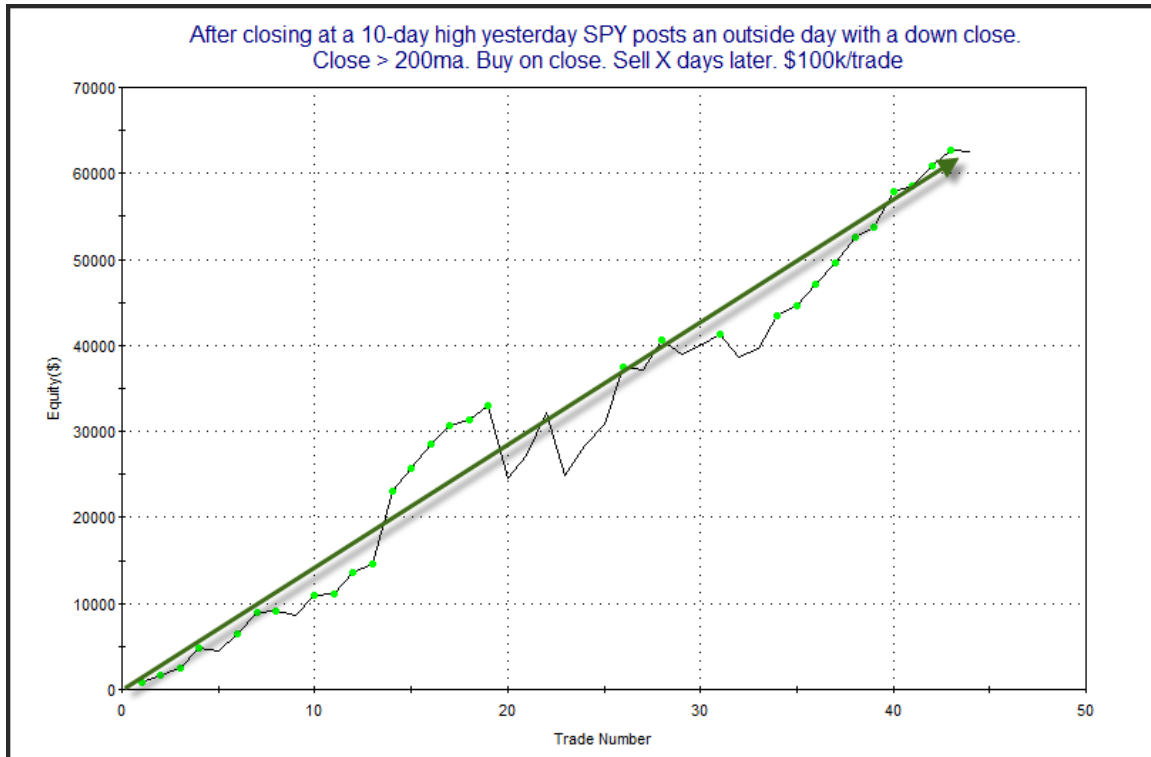
**Intermediate-term Outlook (2 weeks – 2 months)– updated 10/22– bullish**

A fairly volatile week saw the SPX test the upper and lower boundaries of its 1-month range. It is now near its lower boundary. On the studies front, 1 new study with possible intermediate-term implications emerged on Thursday night. I have copied my comments from Thursday night’s letter below.

*In the 3/1/12 subscriber letter I examined the study below. It considered results following instances where SPY posted an outside day with a down close immediately following a short-term closing high during an uptrend. Results were interesting in that the outside day often lead to a small amount of additional selling over the next few days, but rarely did this “reversal signal” ever actually mark an intermediate-term high. I have updated the results table below.*

After closing at a 10-day high yesterday SPY posts an outside day with a down close. Close > 200ma. Buy on close. Sell X days later. \$100k/trade												
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	62,609.46	44	36	8	81.82	2,334.34	8,494.78	-2,678.33	-8,389.36	0.87	3.92	1,422.94
11	54,378.76	44	36	8	81.82	2,065.35	6,726.11	-2,496.74	-9,630.04	0.83	3.72	1,235.88
10	45,557.05	45	34	10	75.56	1,869.42	5,990.24	-1,800.31	-5,992.40	1.04	3.53	1,012.38
9	37,886.75	46	32	14	69.57	1,883.75	5,267.28	-1,599.51	-5,764.17	1.18	2.69	823.63
8	43,918.50	47	32	15	68.09	2,052.67	7,603.99	-1,451.12	-4,587.23	1.41	3.02	934.44
7	39,096.89	48	31	17	64.58	1,981.56	7,694.36	-1,313.61	-4,962.72	1.51	2.75	814.52
6	36,237.08	49	33	16	67.35	1,774.61	5,189.82	-1,395.31	-4,591.36	1.27	2.62	739.53
5	26,523.17	53	33	20	62.26	1,493.07	4,428.81	-1,137.41	-4,346.17	1.31	2.17	500.44
4	7,208.85	53	27	26	50.94	1,500.78	3,915.78	-1,281.24	-4,228.43	1.17	1.22	136.02
3	-243.54	53	26	27	49.06	1,172.30	2,930.57	-1,137.90	-3,561.68	1.03	0.99	-4.60
2	-6,041.45	54	24	30	44.44	877.26	2,361.64	-903.19	-2,698.50	0.97	0.78	-111.88
1	-2,152.57	54	29	25	53.70	543.90	1,601.91	-717.03	-2,183.72	0.76	0.88	-39.86

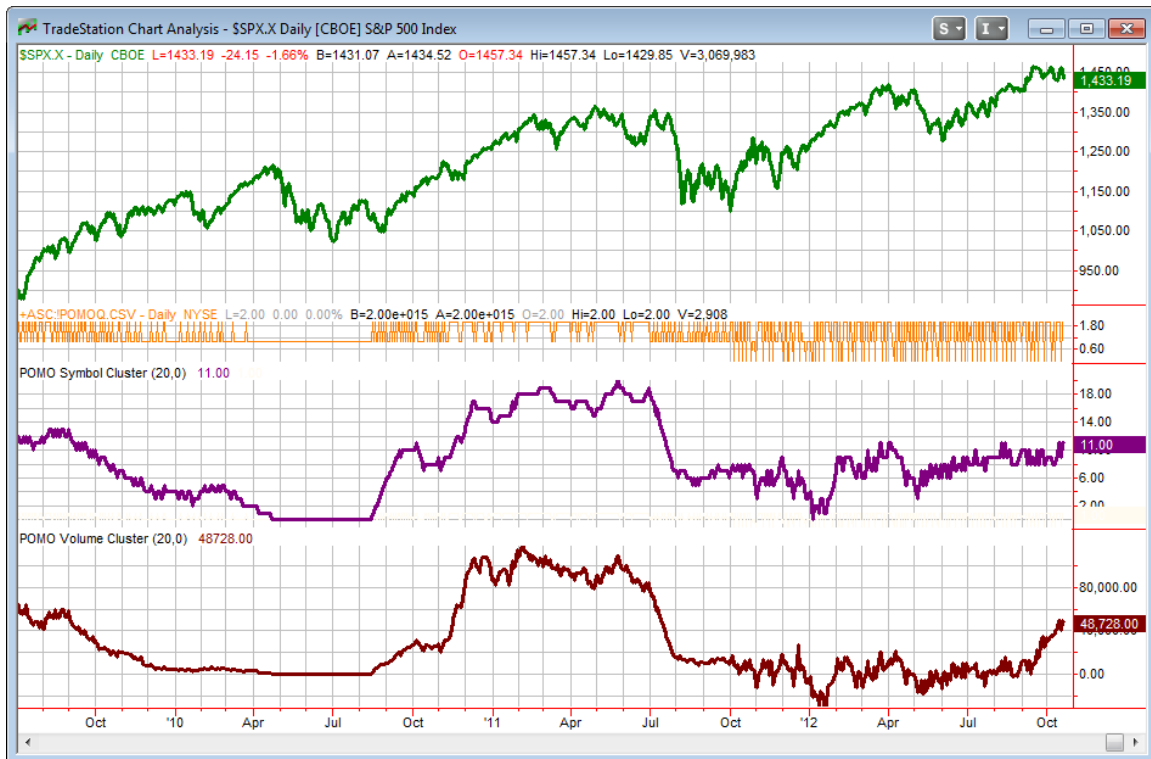
*In looking at the equity curves, the consistent edges were the ones that look out a couple of weeks. Below is an equity curve assuming a 12-day exit strategy.*



*The curve here is very appealing. I am not going to include this study on the short-term active list, but I have placed it on the intermediate-term list.*

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 very strong \$14.5 billion estimated inflow.

This upcoming week we expect to see net inflows every day except Tuesday. This should result in a total net inflow of about \$10 billion.

Bulls have an existing uptrend and strong liquidity on their side. Breadth is suggesting we should see higher highs ahead. And the SPY reversal on Thursday also favors the bulls. 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**

CVS – (\$47.06 close) – bought 1/3 position

CVS – (\$47.07 close) – bought 1/3 position

CVS – (\$46.90 close) – bought 1/3 position

### **Catapult for ETF's Trades**

None

### **Broad Market Large Cap CBI – 3(CVS-3)**

## 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 – buy 1/4 index position @ \$143.39 LIMIT.** Based on short-term outlook above, I am looking to begin scaling in to a long position.

## Current Open Trade Ideas

Symbol	Entry Date	Entry Price	Current Price	% Gain/Loss	Stop	Notes
CVS(1/3)	10/15/2012	\$47.06	\$46.20	-1.83%		Catapult
<b>VZ(1/3)</b>	<b>10/15/2012</b>	<b>\$44.48</b>	<b>\$46.02</b>	<b>3.46%</b>		<b>sold on open</b>
CVS(1/3)	10/16/2012	\$47.07	\$46.20	-1.85%		Catapult
<b>VZ(1/3)</b>	<b>10/16/2012</b>	<b>\$44.50</b>	<b>\$46.02</b>	<b>3.42%</b>		<b>sold on open</b>
CVS(1/3)	10/17/2012	\$46.90	\$46.20	-1.49%		Catapult

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