

# QUANTIFIABLE EDGES SUBSCRIBER LETTER

ASSESSING MARKET ACTION WITH INDICATORS AND HISTORY

November 12, 2012

Volume 5 Issue 217

## Market Overview



## Signals Overview

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

## Tonight's Research Points

- Very small gains after multiple down days have often been followed by more selling.
- The above is has not necessarily been true when the SPX has closed in the lower portion of its daily range.
- The QE Buying Power Swing System triggered a long signal.

## *Short-term Outlook*

### *The Bottom Line*

Friday's bounce was disappointing. Evidence that emerged as result of it was mixed. But evidence in general still favors a bounce and the market is still extremely oversold. So I am hanging on to my partial long position to try and take advantage of the expected rise over the next few days.

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

Study Date	Description	Time span	Bias	Avg Max Move
<b>Active</b>				
November 12, 2012	QE Buying Power Swing Long	1-7 days	Bullish	3.00%
November 9, 2012	SPX < Bollinger. VIX < 5% stretch	1-2 days	<b>Bearish</b>	
November 9, 2012	33% Up Issue% 2x < 200ma	1-2 days	Bullish	
November 8, 2012	20-low big drop high vol > 200	1-5 days	Bullish	
November 6, 2012	Double big reversal days > 200 < 10	1-4 days	Bullish	1.60%
<b>Active - Long Term</b>				
October 24, 2012	SPY dn 1% and SOX up	1-20 days	Bullish	
October 15, 2012	Breadth not diverging at top	int term	Bullish	
September 17, 2012	QE3	int term	Bullish	
February 1, 2012	Golden Cross	int term	Bullish	
<b>Dropped Tonight</b>				
<b>November 6, 2012</b>	<b>Double big reversal days &gt; 200 &lt; 10</b>	<b>1-4 days</b>	<b>Bullish</b>	<b>1.60%</b>

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

**The Evidence**

The market made an attempt at a strong bounce on Friday, but by the end of the day the numbers were not very impressive. The SPX and RUT each rose under 0.2% while the Nasdaq posted a 0.3% gain. Breadth finished mixed as the NYSE Up Issues % was 47% and the Up Volume % came in at 53%. Total NYSE volume fell for the 2<sup>nd</sup> day in a row.

In the 10/23/12 letter a few weeks ago I looked to see whether there was a substantial difference in performance following a small move down after two down days versus a small move up after two down days. Below I have updated that study.

First let's consider what happens after two down days are followed by a third lower close, but that third close is a drop of less than 0.2%.

SPX declines for the 3rd day in a row. Today's drop is less than 0.2%. Buy on close. Sell X days later. \$100k/trade. 1999 - 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	9,021.99	33	15	18	45.45	2,225.93	5,379.66	-1,353.72	-2,963.52	1.64	1.37	273.39
4	7,965.86	33	17	16	51.52	1,957.16	5,553.52	-1,581.61	-4,672.36	1.24	1.31	241.39
3	-6,661.21	33	18	15	54.55	1,488.32	4,047.64	-2,230.06	-6,686.40	0.67	0.80	-201.85
2	9,371.39	33	21	12	63.64	1,468.86	4,123.60	-1,789.55	-4,296.24	0.82	1.44	283.98
1	9,851.02	33	23	10	69.70	898.22	2,286.08	-1,080.80	-2,452.26	0.83	1.91	298.52

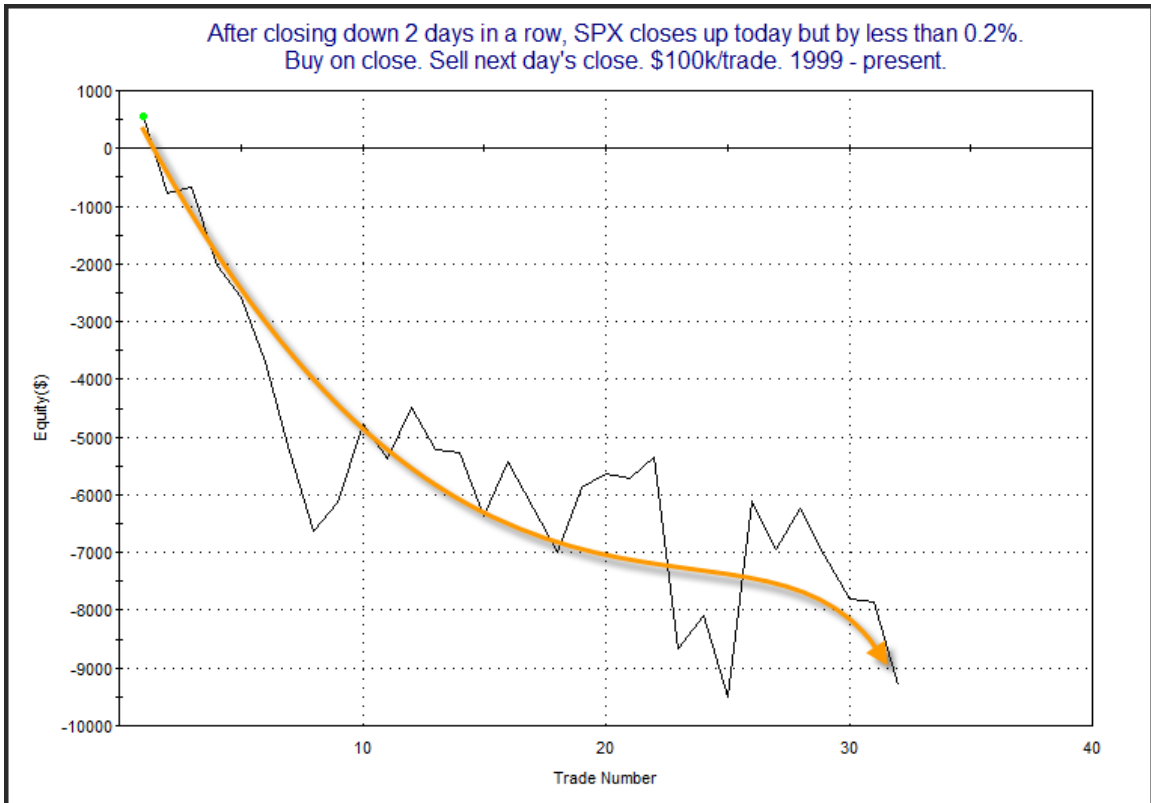
Results here are a bit mixed, but at least day one appears to suggest a bit of an upside edge.

Now let's look at times like the present where two down days were followed by an up day, but that up day rose less than 0.2%.

After closing down 2 days in a row, SPX closes up today but by less than 0.2%.  
Buy on close. Sell X days later. \$100k/trade. 1999 - 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	5,814.43	32	16	16	50.00	2,254.86	7,590.88	-1,891.46	-5,506.23	1.19	1.19	181.70
4	-10,305.42	32	14	18	43.75	1,717.35	4,662.24	-1,908.24	-7,588.98	0.90	0.70	-322.04
3	-10,230.39	32	13	19	40.63	1,569.86	3,939.79	-1,612.56	-5,685.45	0.97	0.67	-319.70
2	-5,031.72	32	13	19	40.63	1,423.32	4,732.64	-1,238.67	-3,197.70	1.15	0.79	-157.24
1	-9,290.66	32	12	20	37.50	894.58	3,390.64	-1,001.28	-3,325.38	0.89	0.54	-290.33

As you can see, results here suggest a small down day is substantially different than a small up day. While not overwhelming, the edge in this case would appear to be for more downside, most of which is realized on day one. Lastly, I decided to show a profit curve assuming a 1-day holding period.



I don't love this curve, but I suppose it is good enough to merit some small consideration. Normally I would include it on the Active List, but tonight I also looked at Friday's action in a little different way.

In the past when I ran the above studies, it was often following a reversal where the market traded low much of the day and then squeezed into positive territory in the end. But Friday it was up big and then closed weak. So I concocted the below setup that adds a filter where the SPX must close in the bottom 1/3 of its daily range.

After closing down 2 days in a row, SPX closes up today but by less than 0.2%. It also closes in the bottom 1/3 of its daily range. Buy on close. Sell X days later. \$100k/trade. 1999 - 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	13,516.14	8	5	3	62.50	3,421.16	7,590.88	-1,196.55	-1,947.00	2.86	4.77	1,689.52
4	7,060.78	8	5	3	62.50	2,243.88	4,662.24	-1,386.21	-2,161.38	1.62	2.70	882.60
3	3,963.92	8	5	3	62.50	1,847.26	3,535.07	-1,757.46	-2,037.00	1.05	1.75	495.49
2	3,799.56	8	3	5	37.50	2,924.58	4,732.64	-994.84	-1,832.70	2.94	1.76	474.95
1	1,312.35	8	4	4	50.00	1,304.91	3,390.64	-976.82	-1,405.00	1.34	1.34	164.04

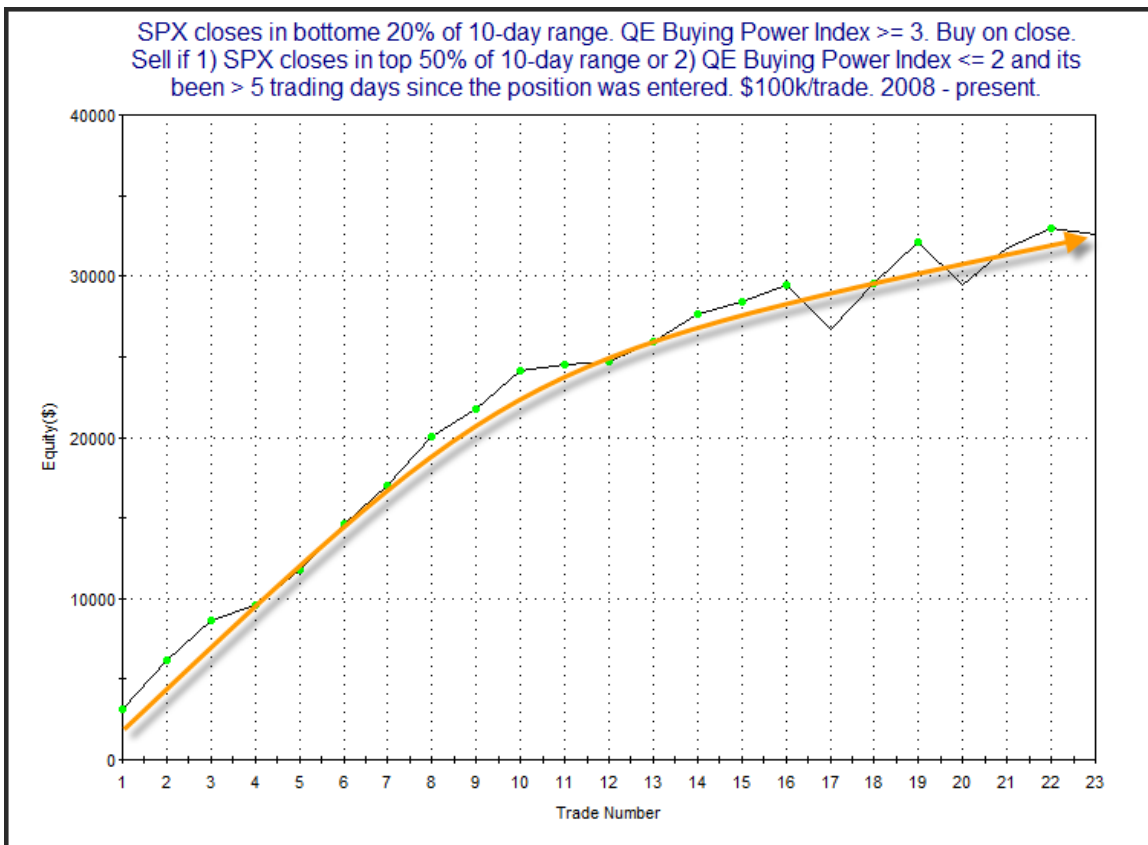
Results here no longer appear bearish. The number of trades is low and the breakeven win rate means the results are not significant. But to me they are good enough to call the original study into question today, and negate my desire to include it on the Active List.

One 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) QE Buying Power Index  $\leq 2$  and its  
 been  $> 5$  trading days since the position was entered. \$100k/trade. 2008 - present.

TradeStation Performance Summary				Collapse $\wedge$
<b>All Trades</b>				
Total Net Profit	\$32,629.11	Profit Factor	6.66	
Gross Profit	\$38,394.23	Gross Loss	(\$5,765.12)	
Total Number of Trades	23	Percent Profitable	86.96%	
Winning Trades	20	Losing Trades	3	
Even Trades	0			
Avg. Trade Net Profit	\$1,418.66	Ratio Avg. Win:Avg. Loss	1.00	
Avg. Winning Trade	\$1,919.71	Avg. Losing Trade	(\$1,921.71)	
<a href="#">Largest Winning Trade</a>	\$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.



Despite the small loss on the last instance, the curve remains impressive. 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	45,227.89	20	15	5	75.00	3,740.23	8,311.15	-2,175.11	-5,452.11	1.72	5.16	2,261.39
9	37,307.17	20	14	6	70.00	3,455.41	7,921.30	-1,844.76	-3,325.86	1.87	4.37	1,865.36
8	33,697.79	21	14	7	66.67	3,231.28	8,227.10	-1,648.59	-2,925.72	1.96	3.92	1,604.66
7	37,357.00	22	16	6	72.73	2,973.07	7,393.35	-1,702.01	-4,333.28	1.75	4.66	1,698.05
6	23,476.63	25	13	12	52.00	3,199.66	7,893.60	-1,509.91	-3,629.56	2.12	2.30	939.07
5	30,096.25	28	18	10	64.29	2,477.53	6,257.44	-1,449.93	-2,659.24	1.71	3.08	1,074.87
4	16,659.69	29	18	11	62.07	2,001.94	5,281.05	-1,761.39	-4,672.36	1.14	1.86	574.47
3	22,903.10	32	24	8	75.00	1,506.13	6,051.15	-1,655.50	-4,416.52	0.91	2.73	715.72
2	22,267.45	36	27	9	75.00	1,201.68	3,018.23	-1,130.89	-2,264.02	1.06	3.19	618.54
1	16,156.59	51	33	18	64.71	773.90	3,031.79	-521.24	-1,858.94	1.48	2.72	316.80

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

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



The green Aggregator line is still well above 0. Positive readings mean net expectations from the Active List are for upside over the next few days. Meanwhile the black Differential Line is as high as it has been in months. This means the SPX is strongly oversold versus recent expectations. So net expectations are bullish and the SPX is very 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 remain long at the close.

Based on the current studies, expectations are set to remain bullish again on Monday. Of course this could easily change if more bearish evidence emerges. The Differential Pivot will be 1,400.86 on Monday. This is 1.5% above Friday's close. That's a bit of a tall order for 1 day. Most likely it is going to take a multi-day rally or consolidation to work off this oversold condition.

The weak bounce was somewhat disappointing. And it did nothing to instill confidence in a rise over the next few days. But bullish evidence is still stronger than bearish. And with the SPX extremely oversold it still appears the long-side is a decent bet. I have a fair amount of exposure already, so I won't look to increase it any further on Monday. Instead I'll re-evaluate as the week moves on to see when it make sense to adjust my positions.

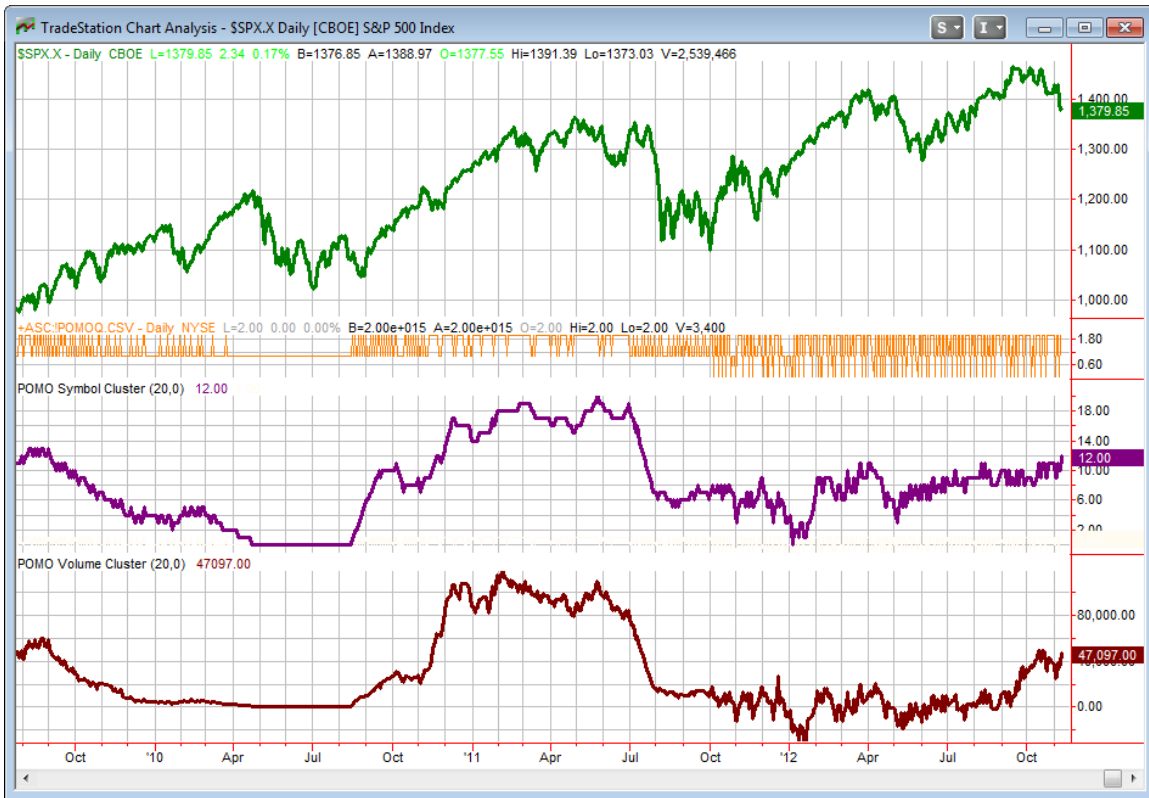
***Intermediate-term Outlook (2 weeks – 2 months)– updated 11/12– bullish***

The market has rotated the last 7 weeks. It has basically been 1) sizable down week, follow by 2) small up week. So if the pattern holds true then we are due for a small up week this week. Of course I am not counting on this little pattern. Instead I will look to the evidence we have seen build up over the last several weeks. Though action was volatile this past week, no new studies emerged with intermediate-term implications

I 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 moved back up this week and is now at the high end of its expected QE3 range. While higher than Operation Twist, it should remain below the levels of QE1 and QE2. We estimate there was a net inflow of about \$17 billion this past week.

While the stock market is open all week, the bond market is closed for Veterans Day on Monday. Net buying is scheduled for Tuesday, Thursday and Friday, while Wednesday is set to see a net outflow. In total this upcoming week is expected to see a net inflow of about \$12 billion.

Liquidity has increased in the last 2 months with the advent of QE3, but so far it has not had the same kind of bullish impact that QE1 and QE2 did. I've been concerned about the size of QE3 from a market standpoint. It is a smaller infusion compared to QE1 and QE2 and it is sloshing around in a bigger pool. So it's not surprising that the impact has not been as bullish. But you would still expect it to have some kind of bullish impact. If

the market decline worsens and we really get into a sizable correction, then the failure of QE3 could have the opposite impact and we could see a massive selloff and panic out of stocks. The view of traders could become “they are trying to prop up the market and still it is falling”. And that would likely cause quite a bit more selling, which could lead to either a massive repricing and washout, or (more likely) an expansion of QE3.

This pullback has been deeper than I expected, but at this point I still believe the market is more likely to head higher over the next few weeks than it is to head lower. Despite the fact that we are making new 50-day lows, the bulls seem to have a decent amount of evidence on their side. As shown on the intermediate-term active list, bulls have an existing uptrend, strong liquidity, and price patterns on their side. Breadth is also suggesting we should see higher highs ahead. Evidence can swing at any time, but I continue to favor the long side.

### **Catapult and Capitulative Breadth Statistics**

*[Catapult & CBI Presentation Link](#)*

#### ***Open Catapult Triggers***

*ALL – 1/3 @ \$38.56 (bought @ limit)*

*T – 1/3 @ \$33.20 (bought at limit)*

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

*None*

***Broad Market Large Cap CBI – 2(ALL, T)***

### **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**

<b>Symbol</b>	<b>Entry Date</b>	<b>Entry Price</b>	<b>Current Price</b>	<b>% Gain/Loss</b>	<b>Stop</b>	<b>Notes</b>
SPY(1/4)	10/22/2012	\$143.15	\$138.16	-3.49%		Aggregator
ALL(1/3)	11/5/2012	\$38.21	\$38.73	1.36%		Catapult
SPY(1/4)	11/8/2012	\$139.70	\$138.16	-1.10%		Aggregator
T(1/3)	11/9/2012	\$33.02	\$33.54	1.57%		Catapult

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