

# QUANTIFIABLE EDGES SUBSCRIBER LETTER

ASSESSING MARKET ACTION WITH INDICATORS AND HISTORY

December 31, 2012

Volume 5 Issue 249

## Market Overview



## Signals Overview

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

## Tonight's Research Points

- When SPY has left an unfilled gap down and closed poorly after already being positioned in a short-term move lower but a long-term move higher, it has generally led to higher prices over the next several days.
- Strong 1-day selloffs in certain seasonal periods (4<sup>th</sup> Friday of the month or any day between Christmas and New Year's) have typically been followed by a sizable bounce.
- 4+ day pullbacks that experience the worst day of the pullback are normally primed for a bounce.

## Short-term Outlook

### The Bottom Line

Same as the last few days. I am seeing a fair amount of bullish evidence but the market is being held hostage by Fiscal Cliff news. A bounce is overdue and I am positioned to take advantage of it. I may add more if we see additional selling and a higher VIX on Monday.

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

Study Date	Description	Time span	Bias	Avg Max Move
<b>Active</b>				
December 31, 2012	4+ day pullback. Now big drop.	1-5 days	Bullish	2.00%
December 31, 2012	1% drop during strong seasonal time	1-4 days	Bullish	1.70%
December 31, 2012	SPY unfill gap down. Poor close.	1-8 days	Bullish	3.30%
December 27, 2012	VIX 100 high. SPX > 100 low.	1-7 days	Bullish	2.90%
December 27, 2012	SPX down 3 above 200	1-3 days	Bullish	1.30%
December 26, 2012	2 Unfilled Gaps Dn & 5-day low	1-5 days	Bullish	1.80%
December 24, 2012	Opex Week Up 1%-2%	1-5 days	Bearish	
December 21, 2012	Twas 3 Nights Before Christmas	1-8 days	Bullish	
<b>Active - Long Term</b>				
December 24, 2012	Nasdaq Leading SPX	int term	Bullish	
December 12, 2012	5 days up > 200ma & < 50-high	1-15 days	Bullish	2.80%
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>				
December 27, 2012	SPX down 3+. Close in top 25% of range.	1 day	Bullish	

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

**The Evidence**

The market gapped down Friday, never mounted any kind of rally, and then in the last half hour, it fell off “the cliff”. The SPX lost 1.1%, the Nasdaq dropped 0.9%, and the Russell 2000 declined 0.6%. And things worsened further in the futures market after the close. Breadth was negative as the NYSE Up Issues % was 31% and the Up Volume % came in at 18%. Volume was light and lower than Thursday’s level.

Despite the facts that the market has been oversold, we are in a seasonally strong period, and short-term liquidity flows are bullish, market participants are consumed by politics and taxes. The "fiscal cliff" looms and we are seeing a scared selloff as the market worries about implications. We are seeing evidence continue to build suggesting strong probabilities of a sizable bounce. A good number of studies appeared in the Quantifinder Friday evening. I'll go over some of the more compelling and interesting ones below. We need to keep in mind the, that the market is highly reactionary to news right now, and we are in an "abnormal" environment. So while I'm going to show some very strong evidence for the bull case, risks are high and things could still get worse before they get better.

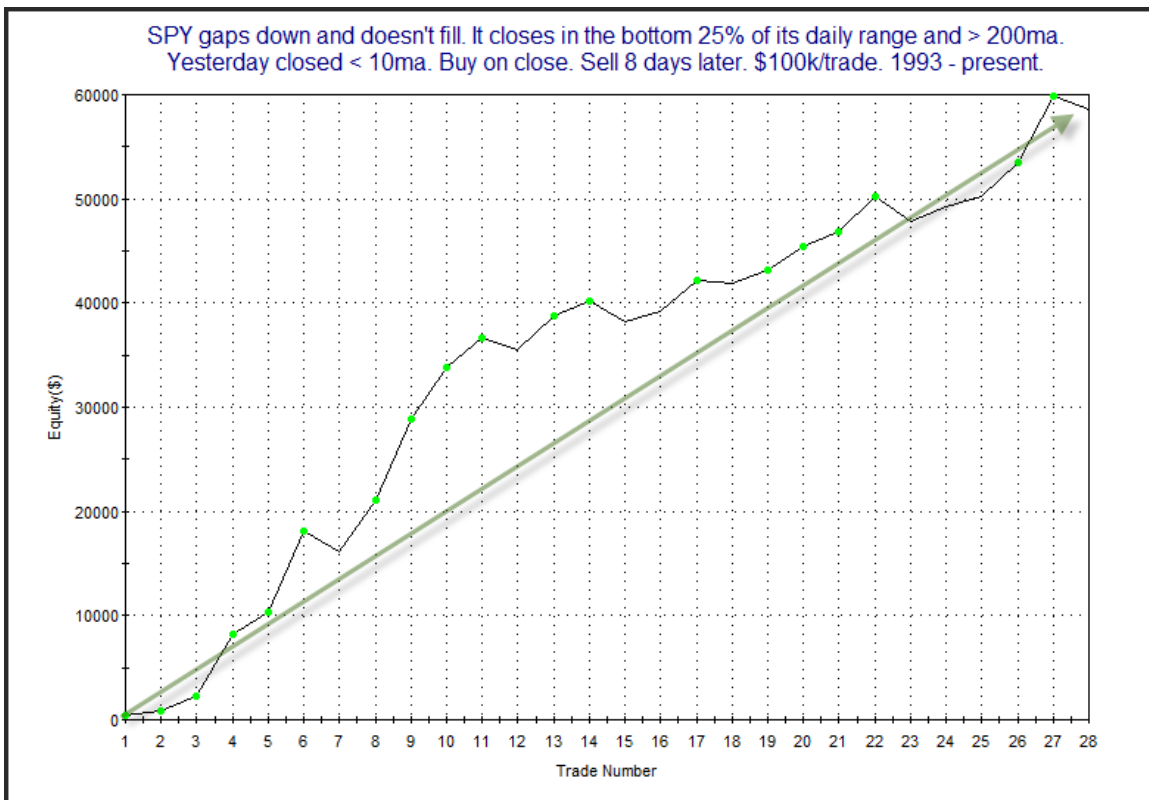
This first study was last seen in the 6/13/11 Subscriber Letter. It looks at unfilled gaps down that close poorly while the market is in a short-term downtrend, but a long-term uptrend. Results are updated.

SPY gaps down and doesn't fill. It closes in the bottom 25% of its daily range and > 200ma.  
 Yesterday closed < 10ma. 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	54,776.09	27	20	7	74.07	3,038.67	9,282.24	-856.77	-1,621.08	3.55	10.13	2,028.74
9	56,940.68	28	22	6	78.57	2,806.29	7,585.77	-799.63	-1,540.26	3.51	12.87	2,033.60
8	58,554.15	28	22	6	78.57	3,067.00	7,858.26	-1,486.65	-2,373.11	2.06	7.56	2,091.22
7	51,500.16	29	22	7	75.86	2,824.84	8,324.13	-1,520.90	-3,146.11	1.86	5.84	1,775.87
6	44,513.75	29	21	8	72.41	2,637.37	7,873.02	-1,358.88	-4,076.73	1.94	5.09	1,534.96
5	38,201.89	29	19	10	65.52	2,608.10	8,239.74	-1,135.20	-3,731.61	2.30	4.37	1,317.31
4	30,878.20	30	20	10	66.67	2,087.84	5,581.02	-1,087.87	-2,342.19	1.92	3.84	1,029.27
3	29,162.63	32	23	9	71.88	1,719.99	5,117.85	-1,155.25	-2,897.57	1.49	3.80	911.33
2	29,592.62	32	26	6	81.25	1,455.97	5,477.88	-1,377.09	-2,657.80	1.06	4.58	924.77
1	21,642.35	32	25	7	78.13	1,037.15	5,764.38	-612.34	-1,269.00	1.69	6.05	676.32

28 of 32 instances (88%) closed above the entry price at some point in the next 3 days.

Results are strong right from the start and look good throughout the first two weeks. Below I have posted the equity curve assuming an 8-day holding strategy.



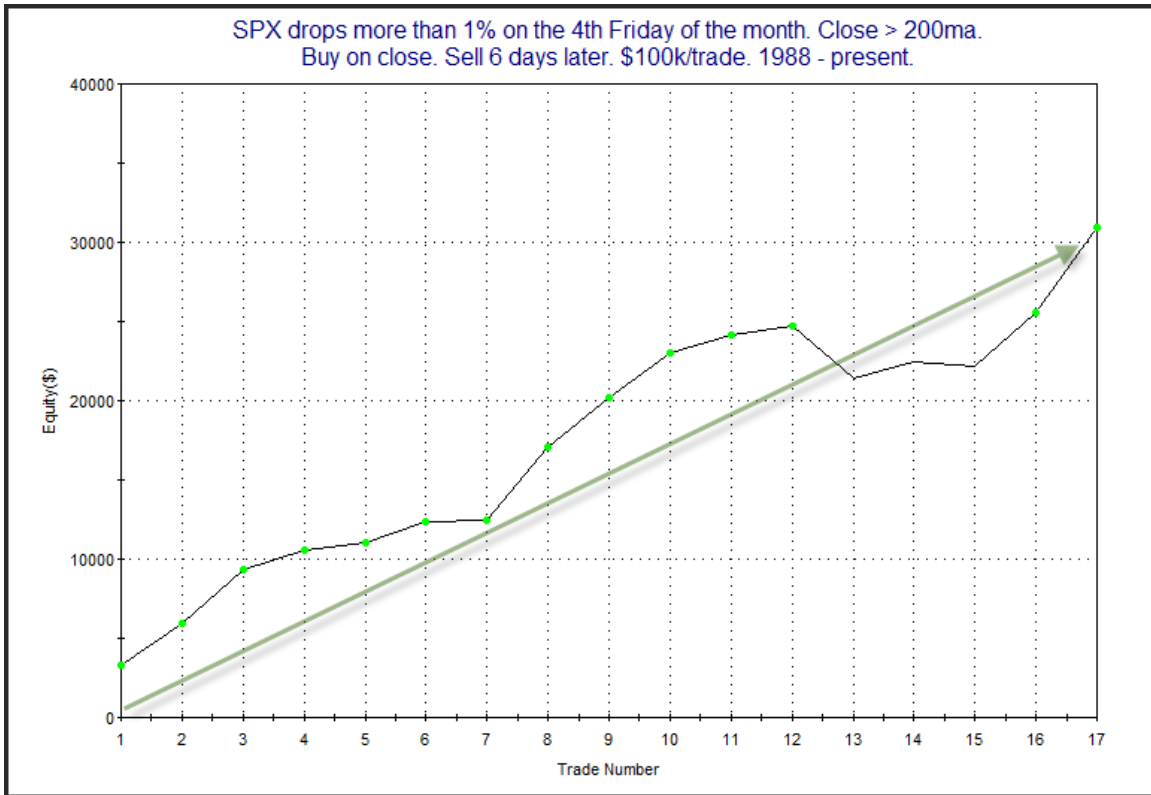
Nothing wrong with this curve. So the unfilled gap down and weak price action on Friday appeared to combine and suggest a bullish edge.

Strong one day selloffs that occur in positive seasonal periods will often see a short-term bounce. This is demonstrated in the next two studies. The first one is from the 6/27/11 subscriber letter. It examines strong selloffs on the fourth Friday of the month. Friday's are prone to strong selloffs near the end of day as we saw this past Friday. The reason this sometimes occurs is that traders do not want to carry risk over a weekend. The stats table below is updated.

SPX drops more than 1% on the 4th Friday of the month. Close > 200ma. Buy on close. Sell X days later. \$100k/trade. 1988 - 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	25,365.69	17	13	4	76.47	2,254.43	4,119.18	-985.48	-2,326.87	2.29	7.43	1,492.10
9	23,362.35	17	12	5	70.59	2,451.54	5,877.30	-1,211.23	-2,607.15	2.02	4.86	1,374.26
8	28,707.71	17	13	4	76.47	2,637.77	6,612.06	-1,395.83	-3,045.20	1.89	6.14	1,688.69
7	32,017.26	17	14	3	82.35	2,629.38	5,956.07	-1,598.01	-3,145.48	1.65	7.68	1,883.37
6	30,951.09	17	15	2	88.24	2,304.21	5,415.54	-1,806.06	-3,378.24	1.28	9.57	1,820.65
5	22,234.50	17	13	4	76.47	2,315.21	5,555.16	-1,965.80	-3,993.72	1.18	3.83	1,307.91
4	16,515.77	17	13	4	76.47	1,639.51	4,731.13	-1,199.46	-2,157.84	1.37	4.44	971.52
3	9,725.74	17	11	6	64.71	1,459.90	3,574.08	-1,055.53	-3,401.24	1.38	2.54	572.10
2	7,943.64	17	11	6	64.71	1,398.04	3,585.76	-1,239.14	-2,061.64	1.13	2.07	467.27
1	4,069.42	17	11	6	64.71	933.24	2,503.90	-1,032.70	-1,922.40	0.90	1.66	239.38

**16 of 17 instances closed above the entry price at some point in the next week.**

Both the consistency and the size of the moves appear to be quite strong. Below is an equity curve showing how the edge has played out over time. It assumes a 6-day hold.



This curve is also impressive, and quite steady. One reason the fourth Friday of the month may have such strong numbers is that it could also benefit from positive turn of the month seasonality.

Of course, as I have been discussing over the last few days, the time between Christmas and New Year's tends to be a very strong seasonal period. Friday was only the 10th time since 1960 that SPX fell greater than 1% on a day during this week. In the 12/29/11 Subscriber Letter I looked at the other instances. I've updated that research tonight as well.

SPX closes down > 1% on a day between Christmas and New Years. 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
5	14,840.12	9	7	2	77.78	3,002.38	6,111.54	-3,088.27	-4,331.55	0.97	3.40	1,648.90
4	14,313.91	9	7	2	77.78	2,559.50	4,220.59	-1,801.31	-1,950.37	1.42	4.97	1,590.43
3	11,640.76	9	8	1	88.89	1,698.81	3,833.82	-1,949.70	-1,949.70	0.87	6.97	1,293.42
2	8,491.56	9	8	1	88.89	1,128.28	2,027.25	-534.66	-534.66	2.11	16.88	943.51
1	367.51	9	6	3	66.67	678.16	1,592.21	-1,233.81	-2,792.25	0.55	1.10	40.83

All 9 instances closed above the entry price  
on either Day 1 or Day 2.

Over the next 2-5 days there appears to be a nice upside tendency. With all 9 closing up on at least 1 of the next 2 days the reliability appears solid, though on a fairly small sample. Below I have listed all 9 instances.

SPX closes down > 1% on a day between Christmas and New Years. Buy on close. Sell 3 days later. \$100k/trade. 1960 - present.				
Date/Time	Signal	Price	% Profit	Run-up Drawdown
12/29/80	Buy	\$135.02	0.97%	\$1,539.20
01/02/81	Sell	\$136.33		(\$732.60)
12/28/87	Buy	\$245.57	0.61%	\$1,009.36
12/31/87	Sell	\$247.08		(\$529.10)
12/31/96	Buy	\$740.74	0.93%	\$1,696.95
01/06/97	Sell	\$747.65		(\$1,510.65)
12/29/00	Buy	\$1,320.50	0.97%	\$2,230.50
01/04/01	Sell	\$1,333.29		(\$3,441.00)
12/31/01	Buy	\$1,148.08	2.13%	\$2,476.89
01/04/02	Sell	\$1,172.51		(\$1,030.95)
12/27/02	Buy	\$875.40	3.84%	\$3,833.82
01/02/03	Sell	\$909.03		(\$678.30)
12/27/07	Buy	\$1,476.27	(1.97%)	\$786.58
01/02/08	Sell	\$1,447.17		(\$2,291.40)
12/31/09	Buy	\$1,115.10	1.98%	\$2,144.01
01/06/10	Sell	\$1,137.14		\$0.00
12/28/11	Buy	\$1,249.64	2.19%	\$2,798.40
01/03/12	Sell	\$1,277.06		\$0.00

Run-ups weren't always huge but they were consistent. Every instance posted a run-up of at least 0.75% during the next 3 days.

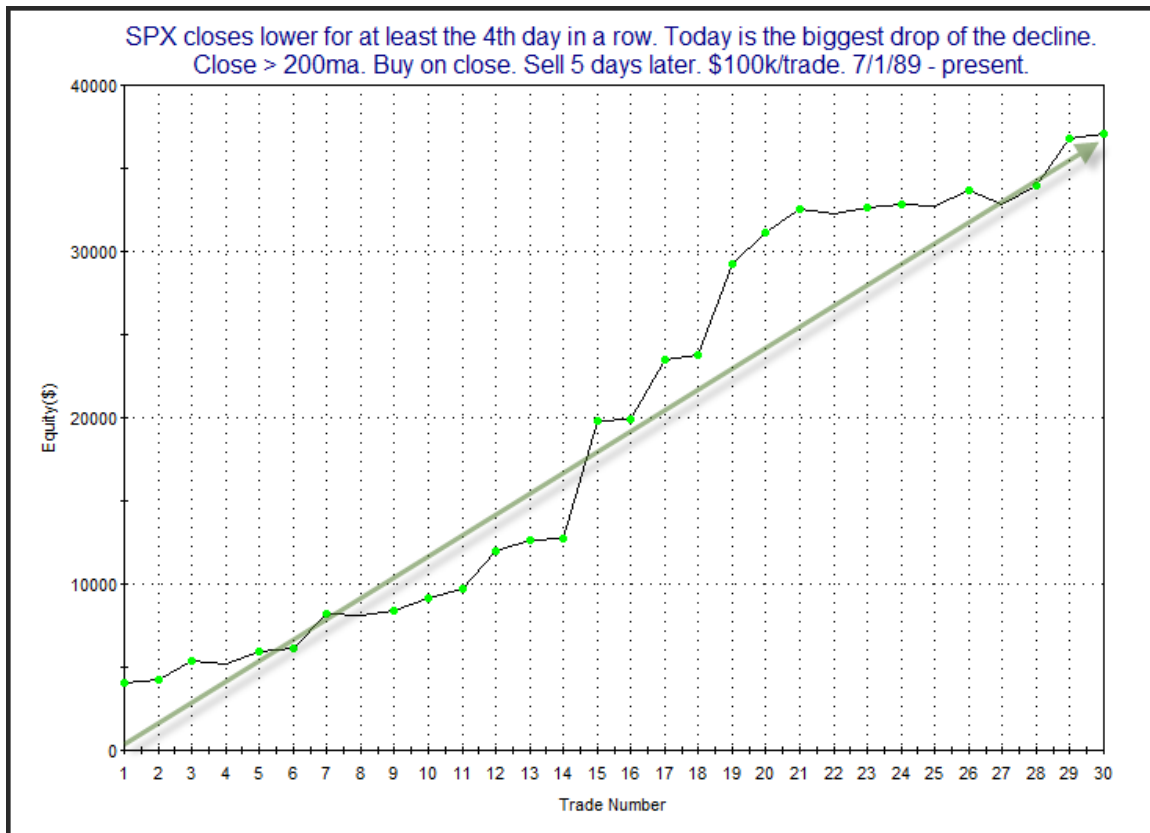
Perhaps the most compelling price-based study came from the 9/26/12 Subscriber Letter. It looks at multi-day moves lower that have accelerated.

SPX closes lower for at least the 4th day in a row. Today is the biggest drop of the decline.  
Close > 200ma. Buy on close. Sell X days later. \$100k/trade. 7/1/89 - 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	37,047.31	30	25	5	83.33	1,547.72	7,070.28	-329.15	-909.36	4.70	23.51	1,234.91
4	29,585.32	30	23	7	76.67	1,545.12	5,187.49	-850.34	-1,776.42	1.82	5.97	986.18
3	30,242.73	30	23	7	76.67	1,473.11	5,339.18	-519.83	-849.87	2.83	9.31	1,008.09
2	25,769.49	31	23	8	74.19	1,349.58	4,809.66	-658.85	-1,343.84	2.05	5.89	831.27
1	16,864.06	34	23	11	67.65	1,023.38	5,117.46	-606.71	-1,699.92	1.69	3.53	496.00

**100% of instances closed above the entry price  
at some point in the next 6 days.**

These results appear extremely compelling. The consistency is very strong. Of course the market is always capable of doing things it hasn't before. We've seen plenty evidence of that over the last 5 years. So although this condition has led to a bounce in every instance evaluated over the test period, it's no sure thing. In fact just before the period shown there were 2 trades that were losers. Still, the evidence appears strong enough to suggest a bullish inclination. This is further confirmed by the equity curve below.



The curve has been a little choppy when looking strictly at the 5-day holding period. But it has maintained an upward trajectory throughout and the setup has effectively called short-term bounces.

So price action and seasonality are providing some very compelling bullish evidence. But sentiment isn't quite at the point where it appears everyone has thrown in the towel and the market is destined to reverse. There are two indicators I look at that I'll use to demonstrate this point. The first is the VIX. Movement in the VIX over the last several days has been strong. And Friday's jump higher was as strong as we've seen in some time. It actually left the VIX between 20%-25% above its 10-day moving average. That is a fairly impressive stretch, but stretches of this magnitude have sometimes marked the beginning of the panic selloff rather than the end of one. I demonstrated this with a couple of studies in the 5/5/10 Subscriber Letter. Let's take a fresh look at them.

This first one looks at instances where the VIX crossed more than 25% above its 10-day moving average. That's higher than we are at right now.

VIX crosses over 25% above its 10ma on a closing basis. SPX > 200ma. Buy SPX on close. Sell X days later. \$100k/trade. 1990 - 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	20,411.20	19	11	8	57.89	2,591.62	7,070.28	-1,012.08	-1,759.84	2.56	3.52	1,074.27
4	27,444.26	19	14	5	73.68	2,271.79	4,690.50	-872.16	-1,776.42	2.60	7.29	1,444.43
3	20,882.31	19	16	3	84.21	1,465.20	3,940.55	-853.62	-1,067.49	1.72	9.15	1,099.07
2	21,504.71	19	14	5	73.68	1,697.79	4,809.66	-452.86	-835.20	3.75	10.50	1,131.83
1	15,803.32	19	16	3	84.21	1,162.37	5,117.46	-931.53	-1,519.76	1.25	6.65	831.75

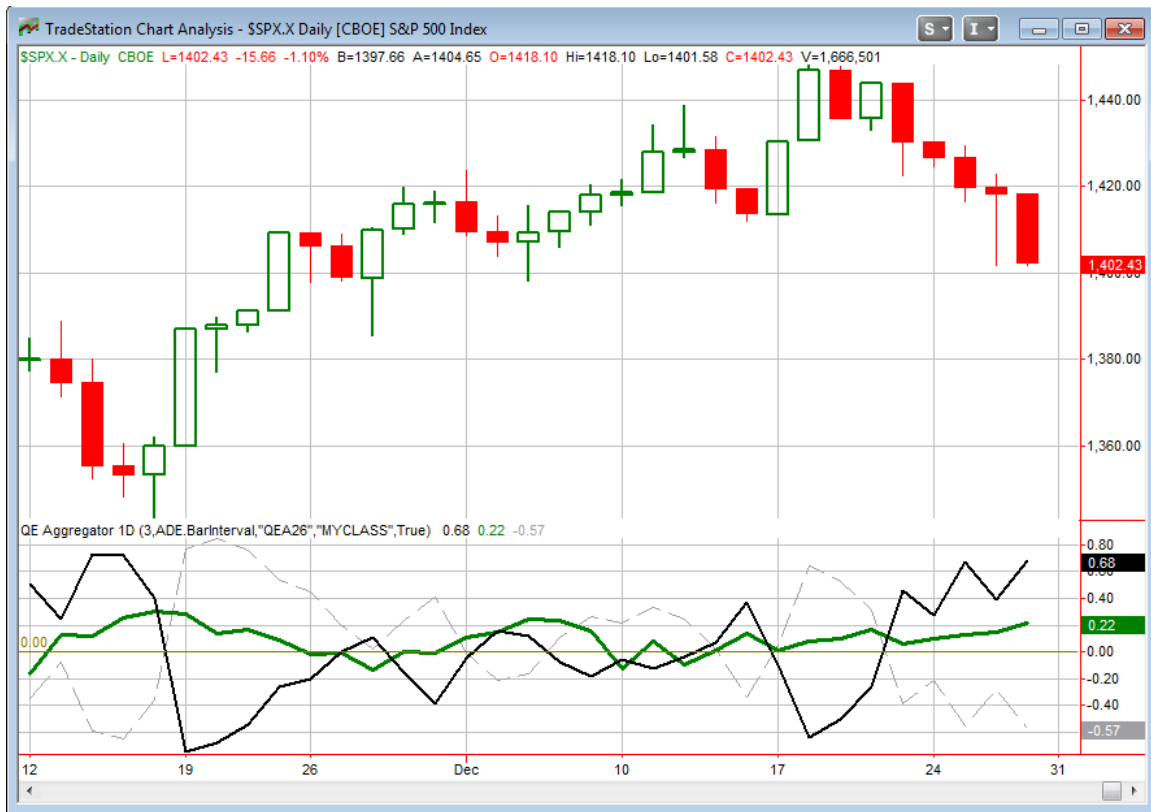
Results here were strongly suggestive of a short-term bounce. Sellers were often exhausted at this point. But what of those times when the VIX was more than 20% above its 10-day moving average, but not more than 25% above it?

VIX crosses over 20% above its 10ma on a closing basis but does NOT close > 25% above 10ma . SPX > 200ma. Buy SPX on close. Sell X days later. \$100k/trade. 1990 - 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	9,112.87	21	14	7	66.67	1,695.35	3,317.04	-2,088.85	-7,153.30	0.81	1.62	433.95
4	-2,750.32	21	13	8	61.90	1,281.51	3,172.16	-2,426.25	-7,100.17	0.53	0.86	-130.97
3	-9,686.35	24	14	10	58.33	862.98	2,319.32	-2,176.81	-5,331.20	0.40	0.56	-403.60
2	1,361.91	24	14	10	58.33	1,089.20	2,184.84	-1,388.68	-3,863.25	0.78	1.10	56.75
1	2,769.04	24	14	10	58.33	760.14	2,230.60	-787.29	-2,200.08	0.97	1.35	115.38

There were more moves higher than there were moves lower over the next few days, but the losers have been steep. In fact, much steeper than the previous test. So risks are elevated, and as I said earlier, it appears things could still get worse before they get better.

I also find it very interesting that the Quantifiable Edges CBI is still stuck at zero. While the market has undergone a good amount of selling over the last several days, individual stocks are not showing signs of capitulation. Further, there are very few S&P 100 stocks that even appear as though would be capable of triggering Catapult signals in the next few days. So I do not expect to see a significant rise in the CBI for at least several days.

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



Tonight's studies pushed the green Aggregator line to its highest level in a while. Positive readings mean net expectations from the Active List are for upside over the next few days. Meanwhile the black Differential Line is at its highest level since mid-November. The positive reading means the SPX is oversold versus recent expectations. So net expectations are positive and the SPX is strongly 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 on Monday. This is unlikely to change unless very strong bearish evidence emerges. The Differential Pivot will be 1,423.69 on Monday. This is 1.5% above Friday's close. So it would take a close higher of at least this much in order to move the differential line back below zero, signaling an SPX move from oversold to overbought.

My outlook tonight is largely the same as it was the last 2. The market remains oversold, seasonality remains bullish, and liquidity as measured by the QE Buying Power Index also remains bullish. We have a lot of evidence suggesting a good chance of a bounce. Still, the market is emotional and news-driven right now. I'm not ready to take on a full index position, but if Monday leads to more selling and a higher VIX (at least 23) then I will take on a 3<sup>rd</sup> lot. The 4<sup>th</sup> lot may be reserved for a CBI spike.

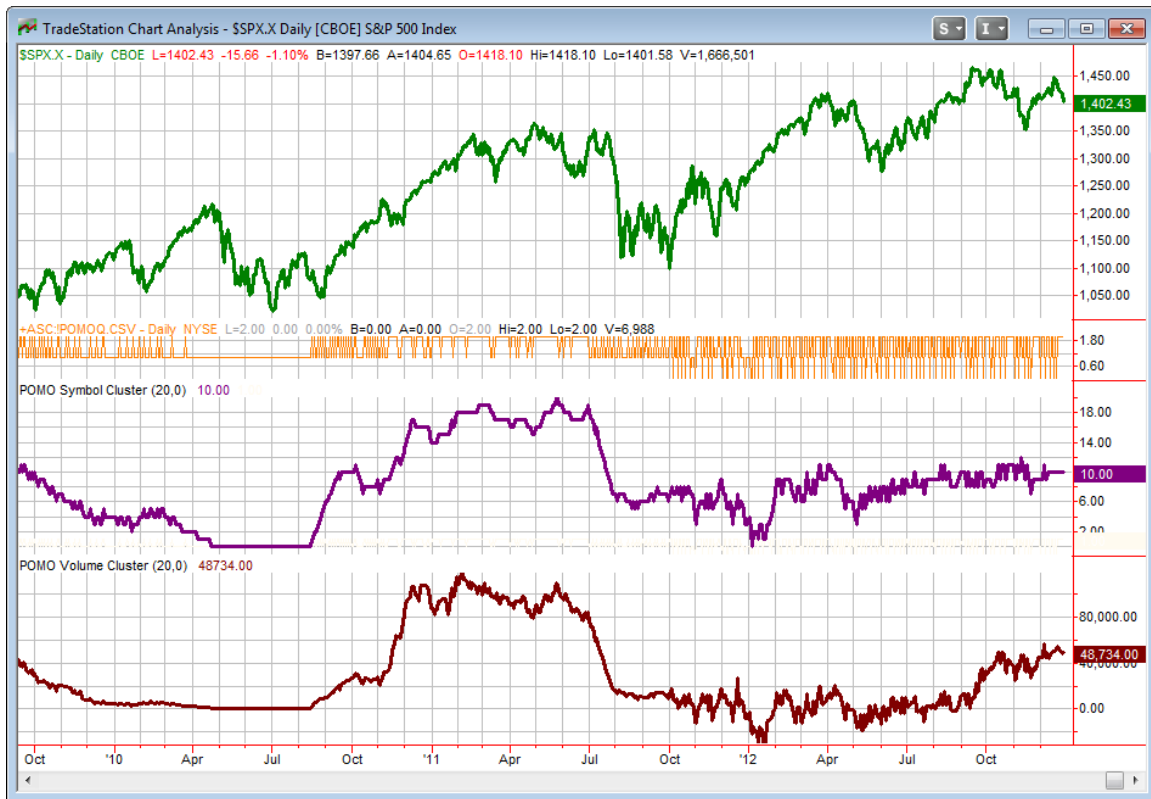
***Intermediate-term Outlook (2 weeks – 2 months)– updated 12/31– bullish***

It was a bad week for the bulls, with the market declining every day. The SPX went from being just a hair away from 20-day highs to being at 20-day lows.

Despite the pullback, we did not have any new studies with strong intermediate-term (10 days and beyond) implications emerge. So my intermediate-term outlook really has not changed much.

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 is again in the upper end of its expected QE3 range. While higher than Operation Twist, levels still remain below those of QE1 and QE2. And at this point it appears the lower amount of liquidity infusion is struggling to have as strong of an impact. We estimate net inflows this past week to have been around \$17.6 billion. That is a very high number and enough that it would normally provide a nice bullish wind at the market's back in the following days.

This upcoming week will be interesting. Monday there is no POMO activity scheduled but there will likely be some AMBS buying. Both the POMO schedule and AMBS amounts for January are set to be released on Monday.

The POMO schedule can be found at the following link any time after 1pm EST on Monday.

[http://www.newyorkfed.org/markets/tot\\_operation\\_schedule.html](http://www.newyorkfed.org/markets/tot_operation_schedule.html)

The AMBS amount is set to be announced at 2pm, and can be found at the following link at that time:

[http://www.newyorkfed.org/markets/ambs/ambs\\_schedule.html](http://www.newyorkfed.org/markets/ambs/ambs_schedule.html)

Overall there still appears to be decent technical evidence that higher prices are likely over the next several weeks. Breadth has provided bullish clues. Liquidity is also anticipated to remain strong. Price studies and Nasdaq leadership are also pointing higher. Of course even with all this bullish influence we still have the Fiscal Cliff. It currently appears to be weighing heavy on the market and there is a chance some real panic selling could ensue. I'll continue to favor the long side, but will keep a close eye on new studies to see if technically bearish clues are emerging.

### **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.*

***SPY – buy ¼ index position if VIX closes  $\geq$  23 and SPY closes  $\leq$  \$140.00.** Based on the short-term outlook above. A VIX move to over 25% above the 10ma and a further oversold SPY would lead me to take on a 3<sup>rd</sup> lot.*

### **Current Open Trade Ideas**

Symbol	Entry Date	Entry Price	Current Price	% Gain/Loss	Stop	Notes
SPY(1/4)	12/24/2012	\$142.48	\$140.03	-1.72%		Aggregator
SPY(1/4)	12/24/2012	\$142.35	\$140.03	-1.63%		Aggregator

*As I discussed in the [Overnight Edges](#) trading room on Thursday, the only year SPY failed to gap up over New Years was New Years 1996. With that in mind, I will not look to sell regardless of where we close, but may exit some or all of my SPY on Wednesday's open if SPY moves strongly higher on Monday.*

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