

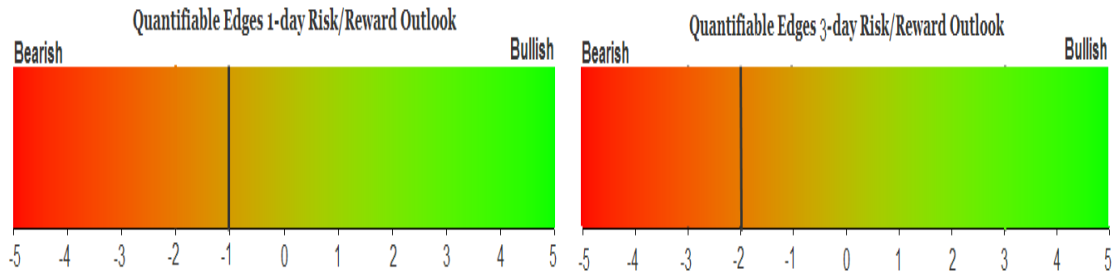
# QUANTIFIABLE EDGES SUBSCRIBER LETTER

ASSESSING MARKET ACTION WITH INDICATORS AND HISTORY

January 22, 2013

Volume 6 Issue 14

## Market Overview



## Signals Overview

Aggregator	Aggressive VIX	QE Buy Pwr Swing	NDX Trend Timer
Short	100% short SPY	Flat	Flat

## Tonight's Research Points

- 50-day highs and a low VIX:VXV ratio mean a big down day could be around the corner.
- The persistently low 3/10 Offset HV near a high price level has led to short-term rallies most often over the years.
- MLK week has been seasonally weak since NYSE began observing the holiday in 1998.
- Consistent closes in the upper part of the daily range are signaling the SPY is overbought and due for a pullback.

## *Short-term Outlook*

### *The Bottom Line*

No change from the last couple of days. Evidence points south and the market is overbought. Ordinarily this would be enough to get me interested in the short side. But with the QE Buying Power Index locked in at the maximum 5 I will remain sidelined.

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

Study Date	Description	Time span	Bias	Avg Max Move
<b>Active</b>				
January 22, 2013	HV low for 4 days. SPX high.	1-4 days	Bullish	
January 22, 2013	VIX:VXV < 0.85. SPX 50-high	1 day	Bearish	
January 22, 2013	SPY closing range consistently high	1-2 days	Bearish	
January 22, 2013	MLK week bearish	1-4 days	Bearish	
January 17, 2013	SPX up. Breadth poor.	1-3 days	Bearish	
<b>Active - Long Term</b>				
January 14, 2013	Breadth Divergence (from Tops Study)	int term	Bearish	
January 3, 2013	50-day high breakout. 90% up vol	1-25 days	Bullish	
January 3, 2013	SPX & TNX high 50-day highs	1-20 days	Bearish	
September 17, 2012	QE3	int term	Bullish	
February 1, 2012	Golden Cross	int term	Bullish	
<b>Dropped Tonight</b>				
December 24, 2012	Nasdaq Leading SPX	int term	Bullish	
January 14, 2013	January Opex Weak	1-5 days	Bearish	
January 18, 2013	SPX 50-day high. VIX up.	1 day	Bearish	

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

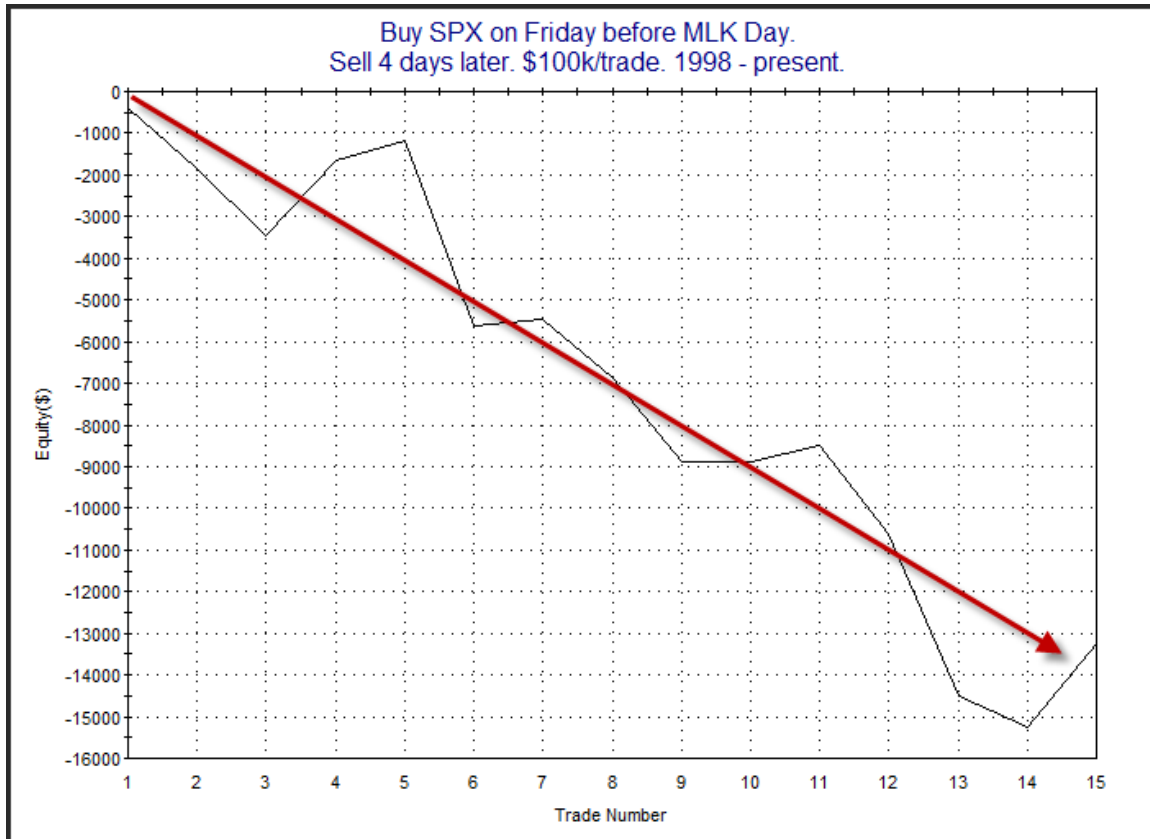
**The Evidence**

Friday looked weak for a while, but a strong move at the end of the day left the major indices mixed. The SPX and Russell 2000 each gained 0.3% while the Nasdaq just missed breaking even with a 0.04% decline. Breadth was solidly positive as the NYSE Up Issues % was 64% and the Up Volume % also came in at 64%. Volume spiked up, largely thanks to options expiration.

Martin Luther King Jr. Day is on Monday. The NYSE has only observed MLK Day as a holiday since 1998. But over that 15 year period the market has not done well during MLK week. I discussed this last year in the 1/17/12 Letter. I've updated that study below.

Buy SPX on Friday before MLK Day. Sell X days later. \$100k/trade. 1998 - 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
4	-13,242.88	15	5	10	33.33	976.59	2,024.33	-1,812.58	-4,441.80	0.54	0.27	-882.86
3	-3,094.08	15	6	9	40.00	1,183.88	2,206.50	-1,133.04	-2,646.54	1.04	0.70	-206.27
2	247.89	15	9	6	60.00	692.63	1,459.15	-997.63	-2,576.20	0.69	1.04	16.53
1	-3,995.92	15	8	7	53.33	722.22	1,776.32	-1,396.24	-5,253.30	0.52	0.59	-266.39

Numbers here are poor – especially Friday. Below is an equity curve showing how the full (4-day) week has played out over time.



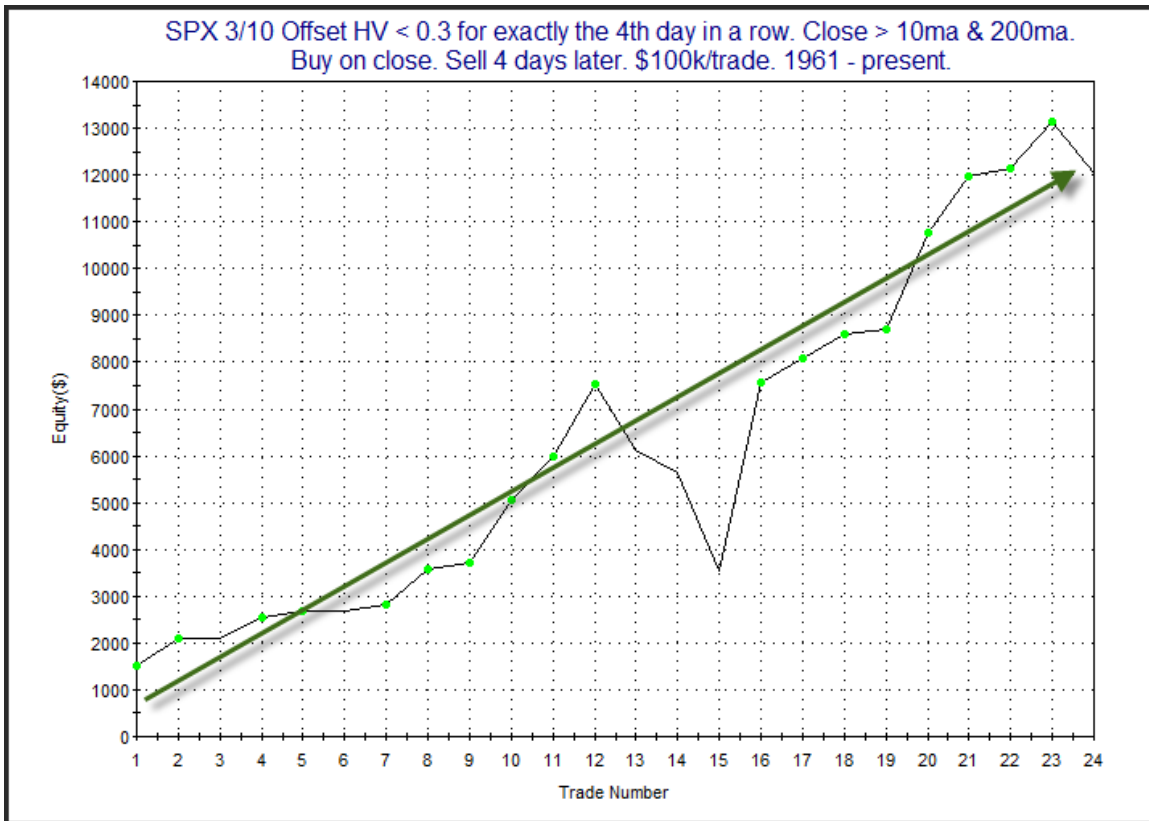
Bottom line from a seasonality standpoint is that MLK week has exhibited a bearish tendency over the last 15 years. The bearish tendency appears strong enough to consider including it on the Active List and as part of the Aggregator calculation.

The 3/10 Offset HV indicator for SPX has shown very low readings over the last few days. Historically a very low reading has commonly been followed by an expansion in volatility. I've discussed this indicator and this tendency in the Subscriber Letter many times over the years. Traders that would like to learn more about it may check out the Quantifiable Edges ORBs study on [the downloads page](#).

It's very rare to see low 3/10 Offset HV readings occur for 4 days in a row. I did study similar conditions in the 9/25/12 Subscriber Letter. I have updated that study below.

SPX 3/10 Offset HV < 0.3 for exactly the 4th day in a row. Close > 10ma & 200ma. Buy 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
5	12,795.37	24	18	6	75.00	1,153.68	3,131.52	-1,328.48	-3,082.28	0.87	2.61	533.14
4	12,054.23	24	19	4	79.17	901.60	4,018.24	-1,269.06	-2,088.32	0.71	3.37	502.26
3	6,154.82	24	15	9	62.50	864.00	3,405.76	-756.14	-2,168.64	1.14	1.90	256.45
2	1,763.76	24	15	9	62.50	504.74	2,681.92	-645.26	-1,602.76	0.78	1.30	73.49
1	1,554.79	24	15	9	62.50	335.18	1,187.84	-385.87	-1,040.40	0.87	1.45	64.78

With the market trading above both its 10ma and 200ma such consistently low 3/10 Offset HV readings have been followed by an upside expansion very often. Below is a profit curve of all the instances using a 4-day exit strategy.



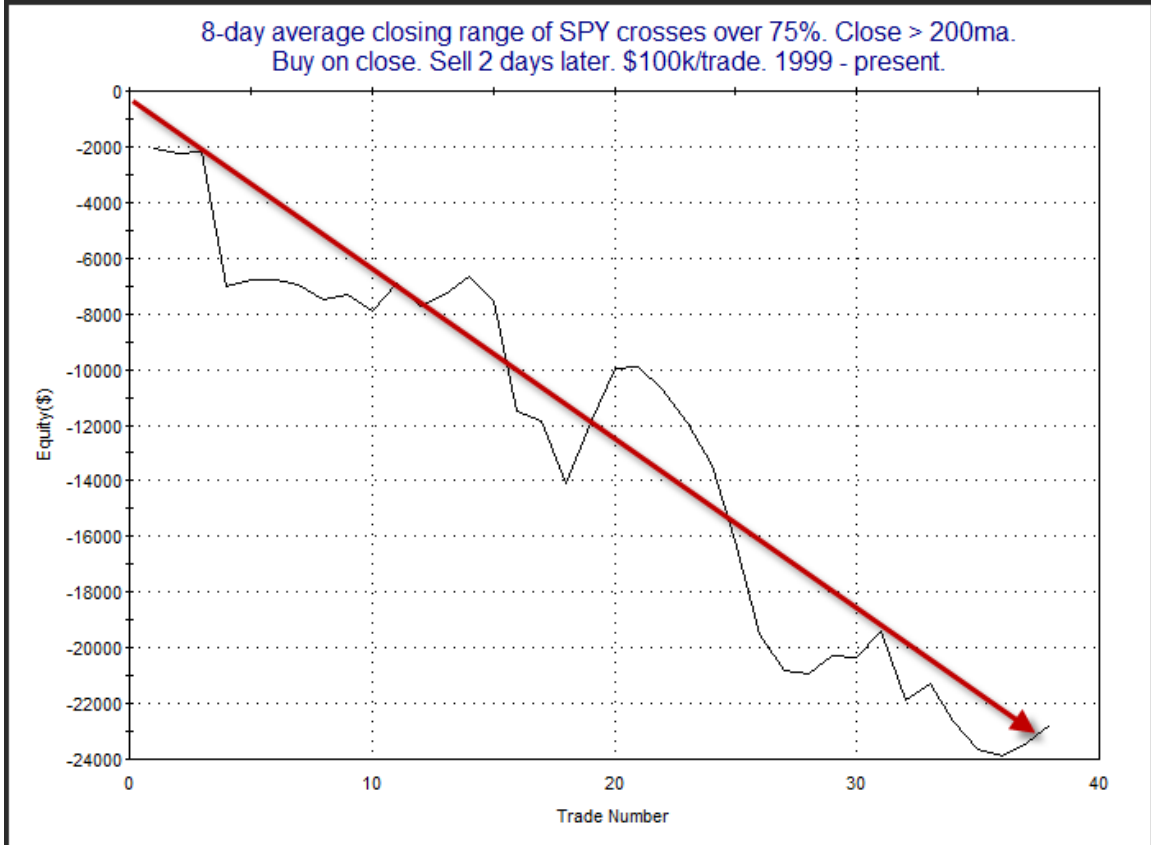
This study has shown strong upside consistency. Oddly, it went from 1996 – 2009 without any instances. But since the beginning of 2010 this marks the 5<sup>th</sup> instance. I decided to include it among the active studies.

SPY finished right near the top of its daily range again on Friday. When the market consistently closes near the high of the day it suggests optimism on the part of traders. This end-of-day optimism is again at a level that suggests it is overdone and there is a good chance of a pullback. The study below was seen just a couple of days ago in the 1/16/13 letter and has triggered again. Stats are updated.

**8-day average closing range of SPY crosses over 75%. Close > 200ma.  
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	-25,963.22	32	15	17	46.88	888.23	2,426.72	-2,310.98	-4,637.61	0.38	0.34	-811.35
4	-22,062.27	32	13	19	40.63	997.68	2,907.88	-1,843.79	-4,807.86	0.54	0.37	-689.45
3	-20,705.53	34	13	21	38.24	835.35	2,604.54	-1,503.10	-3,618.23	0.56	0.34	-608.99
2	-22,767.64	38	14	24	36.84	719.90	2,186.14	-1,368.59	-4,848.40	0.53	0.31	-599.15
1	-9,589.47	38	16	22	42.11	340.59	1,029.30	-683.59	-2,738.12	0.50	0.36	-252.35

While the downside edge appears to remain in place for a full week, most of the edge has been realized over the 1st 2-3 days. Below is an equity curve showing how the edge has played out using a 2-day exit strategy.

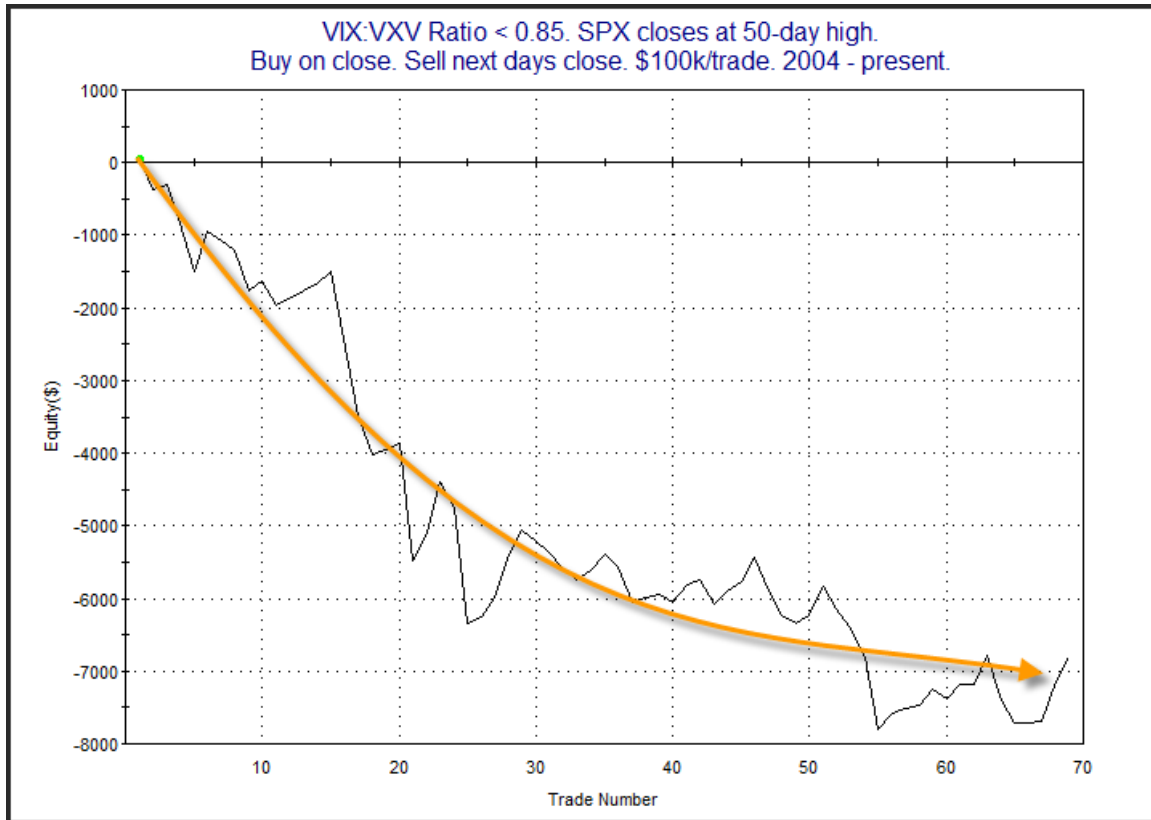


The strong downslope again appears to confirm the bearish edge.

Finally, another recent repeat is the one from 2 nights ago in the 1/17/13 letter where we examined the low VIX:VXV ratio. It considers what happens when the SPX is hitting a new 50 day high while the VIX:VXV ratio is very low. For those that are unfamiliar, VIX is a measure of expected 1-month volatility and VXV is a measure of expected 3-month volatility. A very low VIX:VXV ratio suggests that option traders expect to see a rise in volatility in the coming months. Said another way, short-term event risk is perceived as very low right now in comparison to longer-term systematic risk. When the ratio gets especially low it suggests there is a decent chance that short-term risk is being underestimated. The study below considers the impact of a low ratio at a new market high.

VIX:VXV Ratio < 0.85. SPX closes at 50-day high. Buy on close. Sell next days close. \$100k/trade. 2004 - present.			
TradeStation Performance Summary			Collapse ^
All Trades			
Total Net Profit	(\$6,802.15)	Profit Factor	0.53
Gross Profit	\$7,759.65	Gross Loss	(\$14,561.80)
Total Number of Trades	69	Percent Profitable	52.17%
Winning Trades	36	Losing Trades	33
Even Trades	0		
Avg. Trade Net Profit	(\$98.58)	Ratio Avg. Win:Avg. Loss	0.49
Avg. Winning Trade	\$215.55	Avg. Losing Trade	(\$441.27)
Largest Winning Trade	\$708.05	Largest Losing Trade	(\$1,602.28)

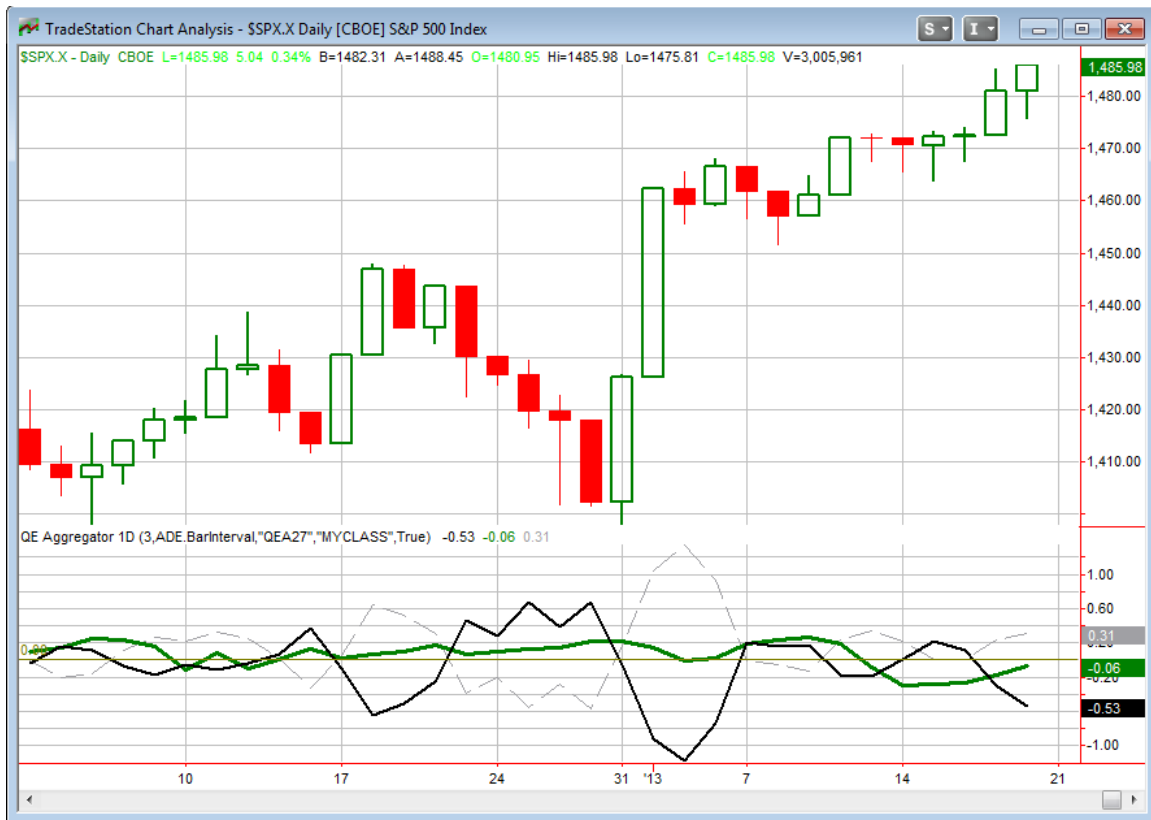
The odds are 50/50 but the losers have been more than twice the size of the winners. This suggests the complacency we are seeing at these high levels is more likely to lead to a big down day than be followed by a big up day. To see how the edge has played out over time I have posted the profit curve below.



The equity curve has certainly been choppy but it has managed to maintain a downward trajectory throughout. Of course the last few instances have not played out, but I plan to stick with it a while longer.

So we have 1 bullish study being added to the Active List today, but 3 more bearish ones. The weight of the evidence continues to favor a pullback. But it has for over a week now and yet the market continues to power higher. I believe this is a strong testament to the power of liquidity. As I have detailed lately and will discuss further below the Fed has really been pumping in January. Large liquidity flows are capable of bulldozing typical historic market tendencies. Knowing this I have avoided the temptation to try and short. I will continue to resist that temptation until we see a change in Fed action.

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



The green Aggregator line remained below 0 tonight. Negative readings mean net expectations from the Active List are for downside over the next few days. Meanwhile the black Differential Line is also below 0. The negative reading means the SPX is overbought versus recent expectations. This is considered a bearish configuration. Bearish configurations are visible on the chart whenever both lines close below 0. This caused the Aggregator system to remain short at the close.

Based on the current active studies expectations are set to remain bearish on Tuesday. This could change if compelling bullish evidence emerges. The Differential Pivot will be 1,459.82 on Tuesday. This is nearly 1.8% below Friday's close. It's unlikely we will see a selloff of that magnitude on Tuesday. A more likely scenario to work off the overbought condition would be a multi-day pullback or consolidation.

As I discussed above, evidence is clearly bearish but with QE3 flooding the system with liquidity the market is powering through overbought conditions and bearish tendencies and chugging higher. A pullback does seem likely to occur soon. And MLK week would be an appropriate time to have one since it is typically weak. Still, I have no intention to fight the Fed on this one. At some point I will be wrong about not being short, but I don't like current risk/reward. (From the "reward" side, pullbacks are often shallower when there are large liquidity inflows, so even if my timing is good, there may not be much to

make on the short side.) I am flat and would prefer to wait for a pullback to buy into than to try and pick a top.

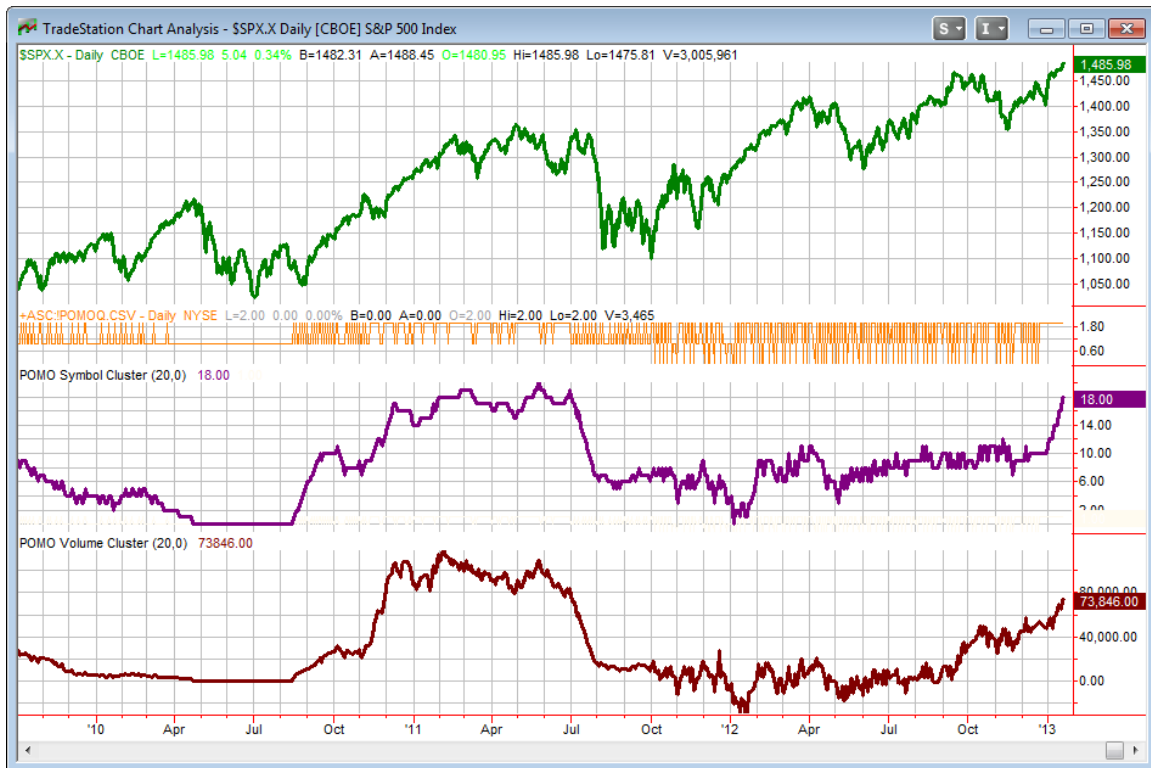
***Intermediate-term Outlook (2 weeks – 2 months)– updated 1/22– bullish***

The market put in a strong week with the Russell 2000 and the SPX both hitting multi-year highs. So it appears the uptrend is still in effect. Nothing new triggered this week from a studies standpoint, but that does not mean nothing notable occurred.

The SPX new high came as the NYSE advance/decline was also making new highs. That is a good sign. But the % of stocks hitting a new 52-week high has not yet expanded to the level seen on January 3<sup>rd</sup> or in September. Last week I republished the “Quantifiable Edges Study of Tops”, which can be found on [the downloads page](#) of the members section of the site. In the study of tops I noted that either the a/d line or the % of new highs has seen a divergence before every major top since 1970. Sometimes these divergences lasted for years so they did not act as a useful timing device, but without a divergence we could have greater confidence that the rally is likely to continue without a major correction. I’m continuing to watch the New High % (which can be found on the charts page). If it breaks above previous levels, it will be like the groundhog seeing its shadow on Feb 2<sup>nd</sup> and predicting 6 more weeks of winter. But in this case it will suggest a continued uptrend rather than an extended cold spell.

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 continues to rise and is now as high as it has been since QE2. Same goes for the days indicator. We estimate net inflows this past week to have been around \$18 billion. That is a 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 is also expected to see strong liquidity inflows (as is the rest of the month). Between POMO and AMBS we should see about a \$17 billion inflow in the shortened 4-day week. So for now it appears we will have a strong liquidity wind at the markets back. Over the last 7-8 years the market has flourished under such conditions.

Overall there still appears to be decent technical evidence that higher prices are likely over the next several weeks. We do have a breadth divergence to be aware of, and an active bond study is also warning of some intermediate-term downside. But the 1/3/13 breadth thrust study is bullish, overall liquidity is very strong, and the market is making new highs. So it appears this rally should have further to go. I'll continue to favor the long side.

## **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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