

QUANTIFIABLE EDGES SUBSCRIBER LETTER

ASSESSING MARKET ACTION WITH INDICATORS AND HISTORY

August 5, 2013

Volume 6 Issue 149

Market Overview



Signals Overview

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

Tonight's Research Points

- When SPY has closed up just slightly but in the top of the day's range that has suggested a downside tendency the next day.
- The POMO schedule for August is showing less variable flows than other months.
- Bonds are hitting new highs, which has been an intermediate-term negative for stocks, but not when rates have been this low.
- An intermediate-term breadth divergence remains in place.

Short-term Outlook

The Bottom Line

Short-term the market is again overbought, but the studies in total continue to favor more upside. This has the Aggregator chart neutral and me in agreement with it. I'm waiting for a better risk/reward setup to take on my next short-term trade.

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

Study Date	Description	Time span	Bias	Avg Max Move
Active				
August 5, 2013	SPY up < 0.25%. Top 10% daily range	1 day	Bearish	
August 2, 2013	Breakout from short base. Vol lower.	1-5 days	Bullish	1.50%
August 1, 2013	End of Month < 10ma and > 200ma	1-5 days	Bullish	2.20%
Active - Long Term				
July 22, 2013	New High Divergence (Study of Tops)	int term	Bearish	
July 11, 2013	5 up > 200 but < 50-high	1-15 days	Bullish	
June 28, 2013	70% Advancing Issues 3 Days In Row	1-85 days	Bullish	10.60%
June 4, 2013	Hindenburg Omen cluster	1-50 days	Bearish	-8.60%
May 6, 2013	Nasdaq leading SPX	int term	Bullish	
April 29, 2013	6 months higher in a row	1-10 months	Bullish	14.30%
September 17, 2012	QE3	int term	Bullish	
February 1, 2012	Golden Cross	int term	Bullish	
Dropped Tonight				
July 10, 2013	RSI(2) crosses over 99. SPX > 200ma	1-15 days	Bullish	2.40%
April 29, 2013	Sell in May unless Jan-April strong	1-6 months	Bullish	6.80%

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

The Evidence

The market was weak for much of Friday but a strong finish put the major indices in the green. The SPX rose 0.2%, the Nasdaq added on 0.4%, and the Russell 2000 finished up just 0.15 points. Breadth was slightly better than breakeven as the NYSE Up Issues % was just over 50% and the Up Volume % was 51%. Total NYSE volume fell for the 2nd day in a row.

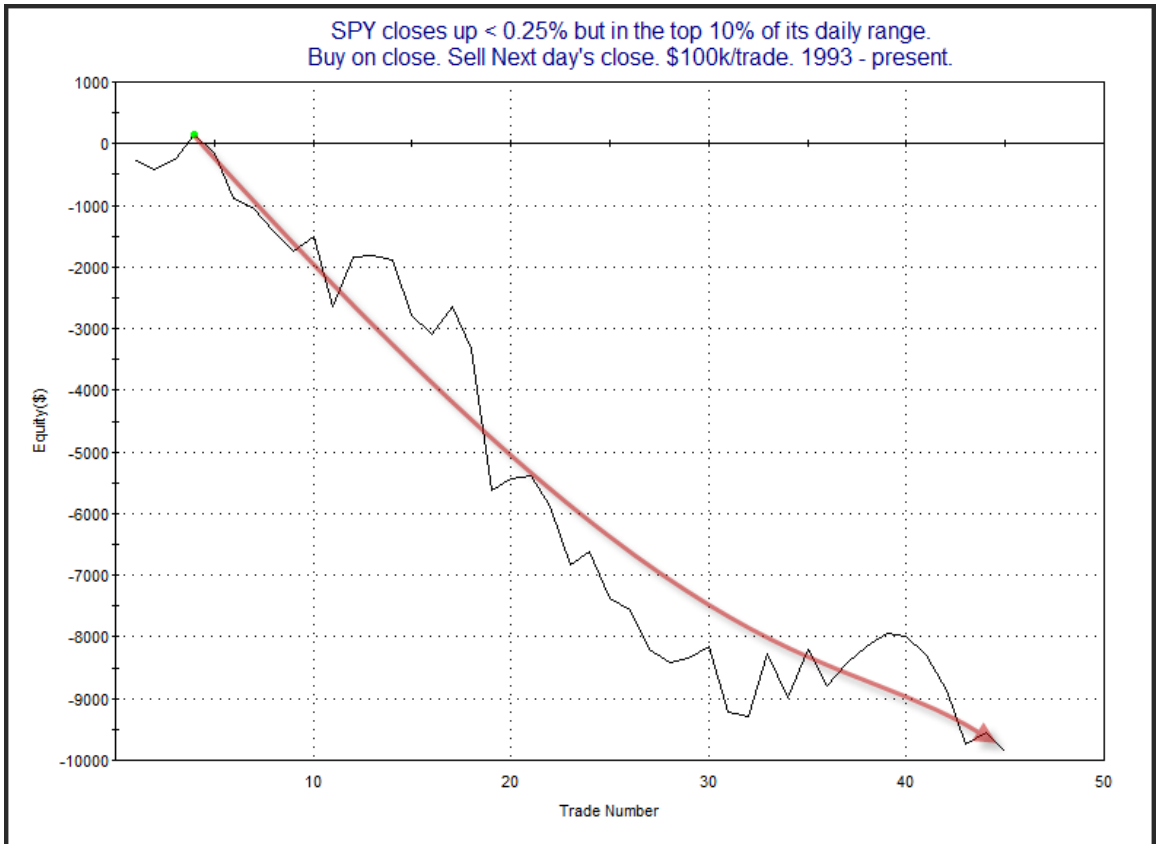
The small gain to another new high saw little of interest emerge from the Quantifinder, but there was one study that was worth some discussion.

The study below was last seen in the 9/21/12 subscriber letter. It suggests that when SPY closes strong (in the top 10% of its range) but still only manages a small gain on the day, that the next day has a downside tendency. Stats are updated.

SPY closes up < 0.25% but in the top 10% of its daily range.
 Buy on close. Sell Next day's close. \$100k/trade. 1993 - present.

TradeStation Performance Summary Collapse ^			
All Trades			
Total Net Profit	(\$9,863.69)	Profit Factor	0.36
Gross Profit	\$5,643.09	Gross Loss	(\$15,506.78)
Total Number of Trades	45	Percent Profitable	37.78%
Winning Trades	17	Losing Trades	28
Even Trades	0		
Avg. Trade Net Profit	(\$219.19)	Ratio Avg. Win:Avg. Loss	0.60
Avg. Winning Trade	\$331.95	Avg. Losing Trade	(\$553.81)
Largest Winning Trade	\$1,015.84	Largest Losing Trade	(\$2,290.72)

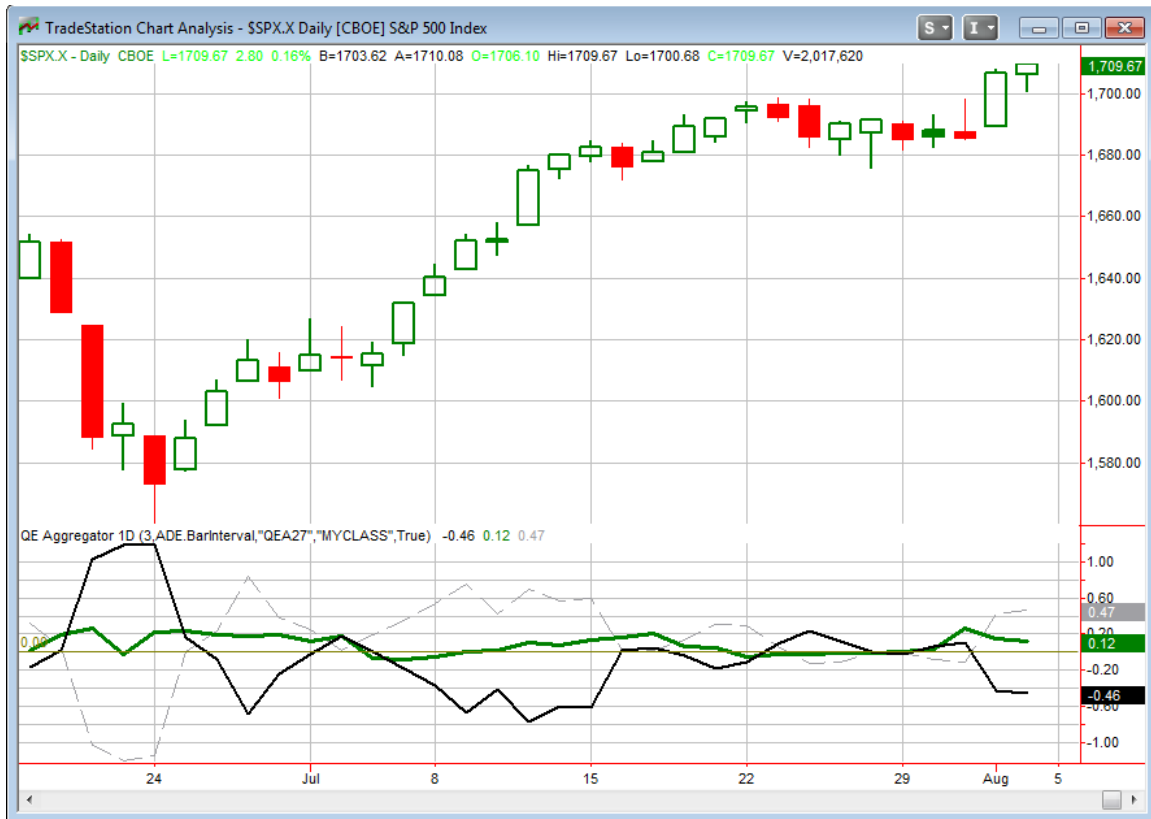
As you can see, there appears to be a bit of a bearish inclination. Below is a profit curve showing how the edge has played out over time.



Back in September (around instance 40), it appeared this bearish edge was waning, and I put this study on double-secret probation. But with new lows again being made in the

profit curve, it appears the downside edge has begun to reassert itself. I'm again viewing this as bearish.

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



Tonight's bearish study saw the green Aggregator Line dip a little but it remained in positive territory. Positive readings mean net expectations from the Active List are for upside over the next few days. Meanwhile the black Differential Line remained below zero. The negative Differential Line reading means the SPX is overbought versus recent expectations. So expectations are positive but the SPX is already overbought. 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.

Based on the current active studies expectations are set to remain positive on Monday. Of course this could easily change if new bearish evidence emerges. The Differential Pivot will be 1,690.56 on Monday. That is 1.1% below Friday's close. That is a big drop for 1 day. So it will likely take a multi-day consolidation or pullback in order to move from overbought to oversold.

Strongly overbought with most evidence saying it is likely to go higher is leaving me without a thing to do but wait and watch. Should the market pull back in the next few days there is a good chance I will be looking to buy the dip. But in its extended condition, risk/reward just isn't very favorable. I don't anticipate taking on any new exposure on Monday.

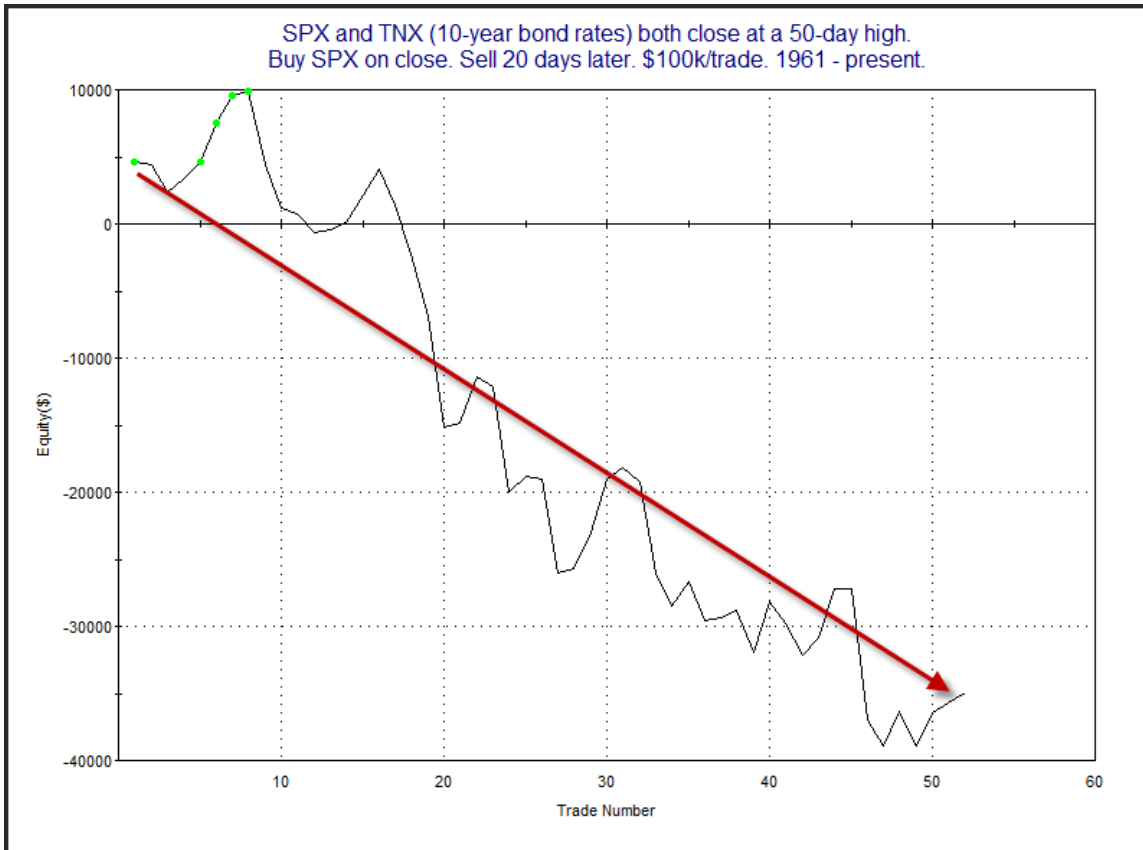
Intermediate-term Outlook (2 weeks – 2 months)– updated 8/5 – somewhat bullish

The market remains in a strong uptrend, as evidenced by the new all-times high reached on Friday in the S&P 500. But intermediate-term evidence remains mixed. First I want to show a study from Thursday night's subscriber letter. Then I will break it down a bit further tonight. It examines bond rates in relation to stock prices.

10-year bond rates hit new highs on Thursday along with the SPX. Occurrences like this were last discussed in the 1/3/13 Subscriber Letter. I have updated the study from that letter below.

SPX and TNX (10-year bond rates) both close at a 50-day high. Buy SPX 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
50	-32,306.32	40	19	21	47.50	3,513.00	9,293.13	-4,716.83	-11,866.50	0.74	0.67	-807.66
45	-23,710.24	42	19	23	45.24	4,112.47	8,170.47	-4,428.14	-11,540.20	0.93	0.77	-564.53
40	-9,868.18	44	22	22	50.00	3,829.82	7,101.51	-4,278.38	-10,971.10	0.90	0.90	-224.28
35	-22,088.51	46	22	24	47.83	3,171.43	9,093.59	-3,827.50	-9,558.36	0.83	0.76	-480.18
30	-9,752.80	47	20	27	42.55	3,523.20	8,122.50	-2,970.99	-6,689.55	1.19	0.88	-207.51
25	-1,027.33	49	22	27	44.90	2,988.04	7,845.48	-2,472.75	-6,261.07	1.21	0.98	-20.97
20	-34,924.24	52	27	25	51.92	1,757.74	4,616.92	-3,295.33	-9,695.84	0.53	0.58	-671.62
15	-23,751.97	52	28	24	53.85	1,653.18	3,500.32	-2,918.38	-9,608.60	0.57	0.66	-456.77
10	-7,735.51	58	34	24	58.62	1,265.10	3,263.44	-2,114.53	-8,683.66	0.60	0.85	-133.37
5	-5,010.27	76	41	35	53.95	989.45	5,231.46	-1,302.22	-6,088.44	0.76	0.89	-65.92

Generally it seems that higher interest rates have often made bonds an attractive investment. This may have lead people to forsake stocks in favor of lower risk returns with improved yield. Implications of this study appear to be longer-term in nature. To help visualize how this edge has played out over time I have pasted below an equity curve using a 20-day exit strategy.



Obviously there have been some struggles recently. At the suggestion of a reader, I decided to break this study down a little further. While high bond rates might convince people to forsake stocks, is 2.6% really enough? I looked at a number of different levels over the weekend and have broken it down into 3 categories below: 1) TNX > 8%, 2) TNX >4% but <8%, and 3) TNX < 4%. Let's look at the results tables of these 3 categories.

SPX and TNX (10-yr bond rates) both close at 50-day high. TNX > 8%.
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
50	-18,679.68	5	1	4	20.00	7,272.00	7,272.00	-6,487.92	-11,866.50	1.12	0.28	-3,735.94
45	-17,852.06	5	1	4	20.00	6,795.28	6,795.28	-6,161.83	-11,444.58	1.10	0.28	-3,570.41
40	-16,771.07	5	2	3	40.00	3,657.50	6,552.88	-8,028.69	-10,011.81	0.46	0.30	-3,354.21
35	-15,463.43	5	1	4	20.00	3,967.20	3,967.20	-4,857.66	-7,869.54	0.82	0.20	-3,092.69
30	-7,091.92	5	2	3	40.00	5,114.22	5,478.24	-5,773.45	-5,977.20	0.89	0.59	-1,418.38
25	-842.23	5	3	2	60.00	1,102.07	1,656.40	-2,074.22	-4,122.06	0.53	0.80	-168.45
20	-11,191.98	6	2	4	33.33	2,316.75	3,455.64	-3,956.37	-7,875.46	0.59	0.29	-1,865.33
15	-9,377.11	6	3	3	50.00	2,013.18	3,111.12	-5,138.89	-9,608.60	0.39	0.39	-1,562.85
10	-8,264.31	7	3	4	42.86	1,551.19	2,267.82	-3,229.47	-8,683.66	0.48	0.36	-1,180.62
5	-2,881.18	9	5	4	55.56	1,296.40	2,350.08	-2,340.80	-6,088.44	0.55	0.69	-320.13

The setup has not triggered too many times when interest rates were in this high range. But though the number of instances was small, they certainly suggest a downside edge.

SPX and TNX (10-yr bond rates) both close at 50-day high. TNX > 4% and < 8%. 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
50	-16,401.97	26	12	14	46.15	2,841.60	6,279.56	-3,607.23	-11,625.02	0.79	0.68	-630.84
45	-6,693.35	27	13	14	48.15	3,276.27	7,306.64	-3,520.35	-9,611.02	0.93	0.86	-247.90
40	3,383.58	28	14	14	50.00	3,380.96	7,101.51	-3,139.28	-8,514.98	1.08	1.08	120.84
35	-2,976.96	30	15	15	50.00	2,954.60	9,093.59	-3,153.07	-6,282.36	0.94	0.94	-99.23
30	-11,105.13	31	13	18	41.94	2,593.84	6,661.35	-2,490.28	-6,689.55	1.04	0.75	-358.23
25	-6,578.56	32	14	18	43.75	2,628.45	6,420.31	-2,409.82	-6,261.07	1.09	0.85	-205.58
20	-20,241.48	32	18	14	56.25	1,390.27	3,945.72	-3,233.31	-8,308.32	0.43	0.55	-632.55
15	-21,776.48	32	16	16	50.00	1,238.14	3,500.32	-2,599.17	-6,046.56	0.48	0.48	-680.52
10	-6,742.86	35	21	14	60.00	1,101.79	3,263.44	-2,134.32	-3,951.68	0.52	0.77	-192.65
5	-10,913.26	48	24	24	50.00	810.50	2,191.63	-1,265.22	-5,333.58	0.64	0.64	-227.36

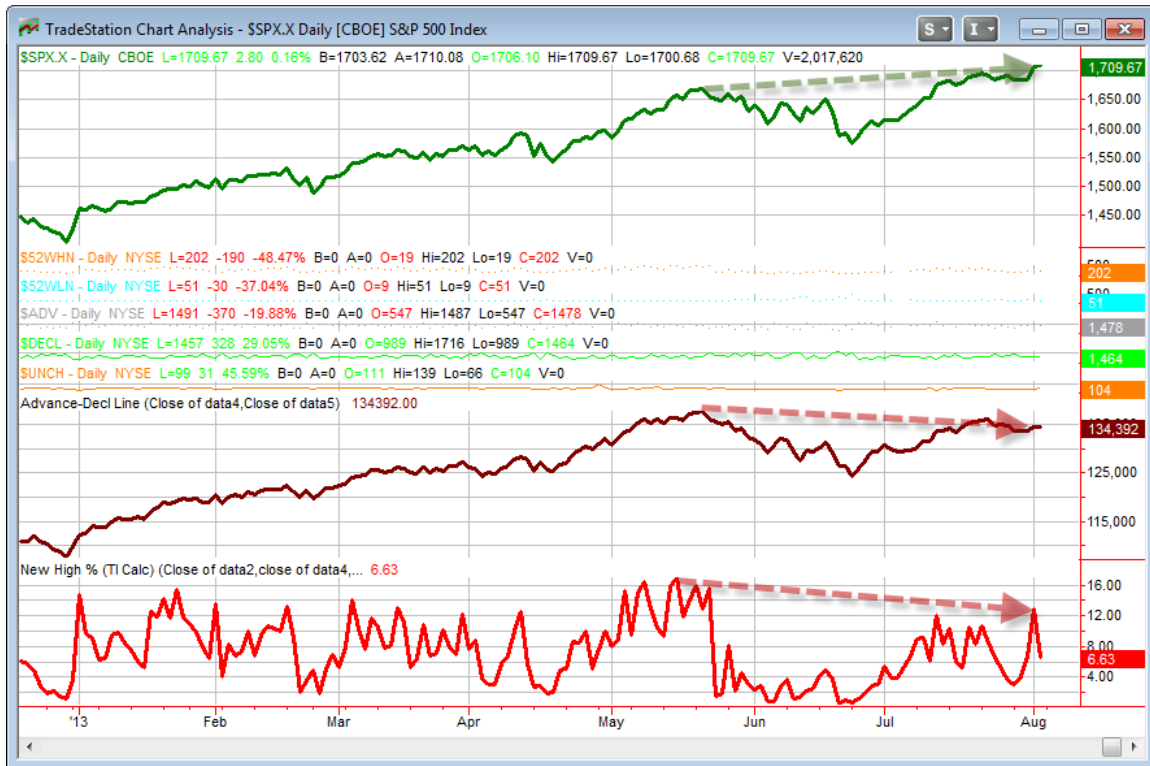
Numbers here show 50/50 odds, but high apparent risk. But what about times like now when interest rates are below 4%?

SPX and TNX (10-yr bond rates) both close at 50-day high. TNX < 4%. 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
50	4,150.00	10	7	3	70.00	3,821.49	9,293.13	-7,533.48	-11,060.70	0.51	1.18	415.00
45	2,180.88	11	6	5	54.55	5,015.97	8,170.47	-5,582.98	-11,540.20	0.90	1.08	198.26
40	4,879.49	12	7	5	58.33	4,423.97	6,689.79	-5,217.66	-10,971.10	0.85	1.19	406.62
35	-1,318.45	12	7	5	58.33	3,402.13	5,351.43	-5,026.67	-9,558.36	0.68	0.95	-109.87
30	9,572.90	12	6	6	50.00	4,607.40	8,122.50	-3,011.91	-5,629.40	1.53	1.53	797.74
25	7,652.35	13	6	7	46.15	4,481.88	7,845.48	-2,748.41	-5,793.90	1.63	1.40	588.64
20	-1,479.44	15	8	7	53.33	2,476.50	4,616.92	-3,041.64	-9,695.84	0.81	0.93	-98.63
15	8,038.30	15	10	5	66.67	2,107.59	3,400.62	-2,607.53	-5,281.98	0.81	1.62	535.89
10	6,729.76	16	10	6	62.50	1,468.02	2,475.36	-1,325.07	-3,456.53	1.11	1.85	420.61
5	8,419.19	19	12	7	63.16	1,189.05	5,231.46	-835.62	-1,804.88	1.42	2.44	443.12

With interest rates under 4% this setup has not provided the same bearish inclinations as when interest rates have been higher. Based on this I am inclined to change this study going forward so that it filters out instances like now when interest rates are below 4%.

The past few weeks I have discussed the bearish divergence we are seeing in two breadth indicators – the Advance/Decline Line and the % of NYSE stocks hitting new highs. In the Quantifiable Edges Study of Tops (always available on the Downloads page for subscribers) I went through every major top since 1970. For purposes of that study I defined a “major top” as any top that was followed by a decline of at least 20%. I found that in every case, there was a divergence in the % of NYSE issues hitting new 52 week

highs, and that the divergence was in effect for at least 2 months before any market top. The % of NYSE stocks making new highs peaked on May 15 at a level of 16.96%. August 1st it reached its highest level since May, but it was just 12.82%. So the divergence is here more than 2 months after the New High % reading of 16.96% in May. This can be seen in the chart below, which is similar to those shown in the Study of Tops.

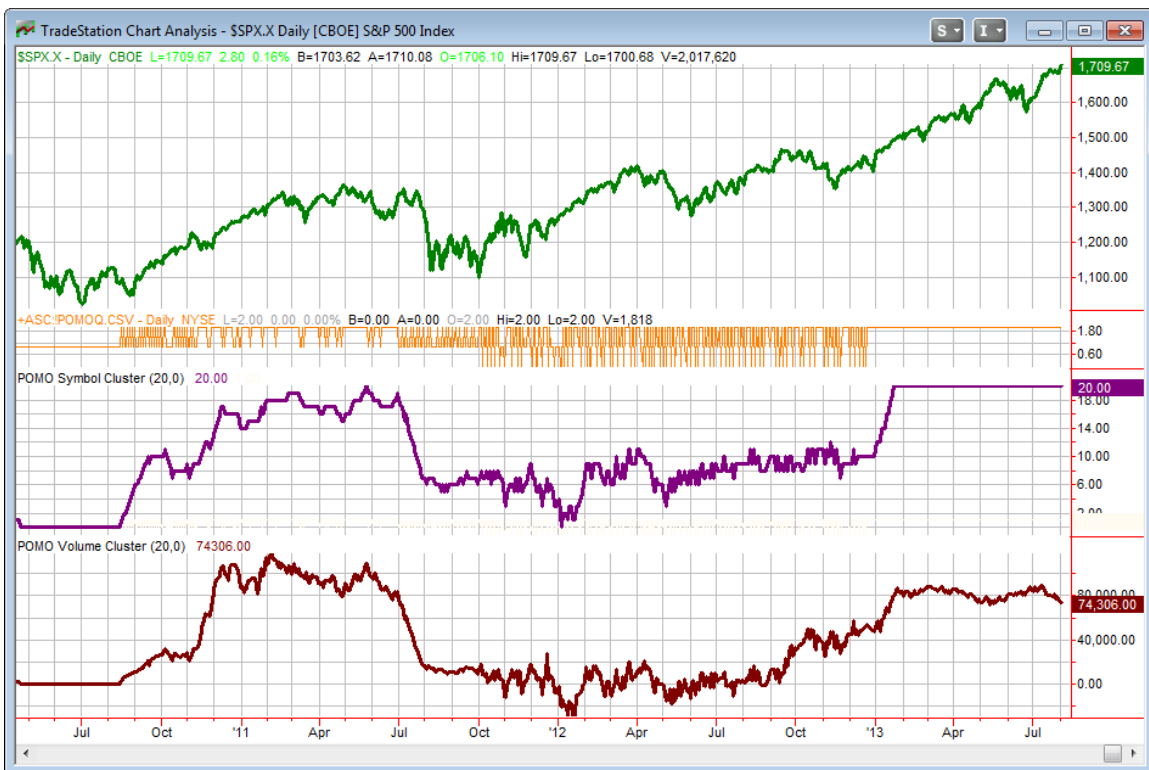


The indicator on the bottom is the NYSE % of stocks making new 52-week highs. The divergence there is clear. The maroon indicator above that, which is also in a divergence, is the Advance/Decline Line. It is important to keep in mind that these divergences can persist for months, and even years, before the market eventually begins its major decline. They are not a good timing device. But they are something to be aware of, and they provide a condition from which the market is capable of beginning a major decline. Without a divergence in place, we could feel comfortable (as we did in May) that the next major decline was highly unlikely to begin for at least a couple of months. I'll continue to watch this indicator closely going forward.

I update the intermediate-term POMO/QE 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

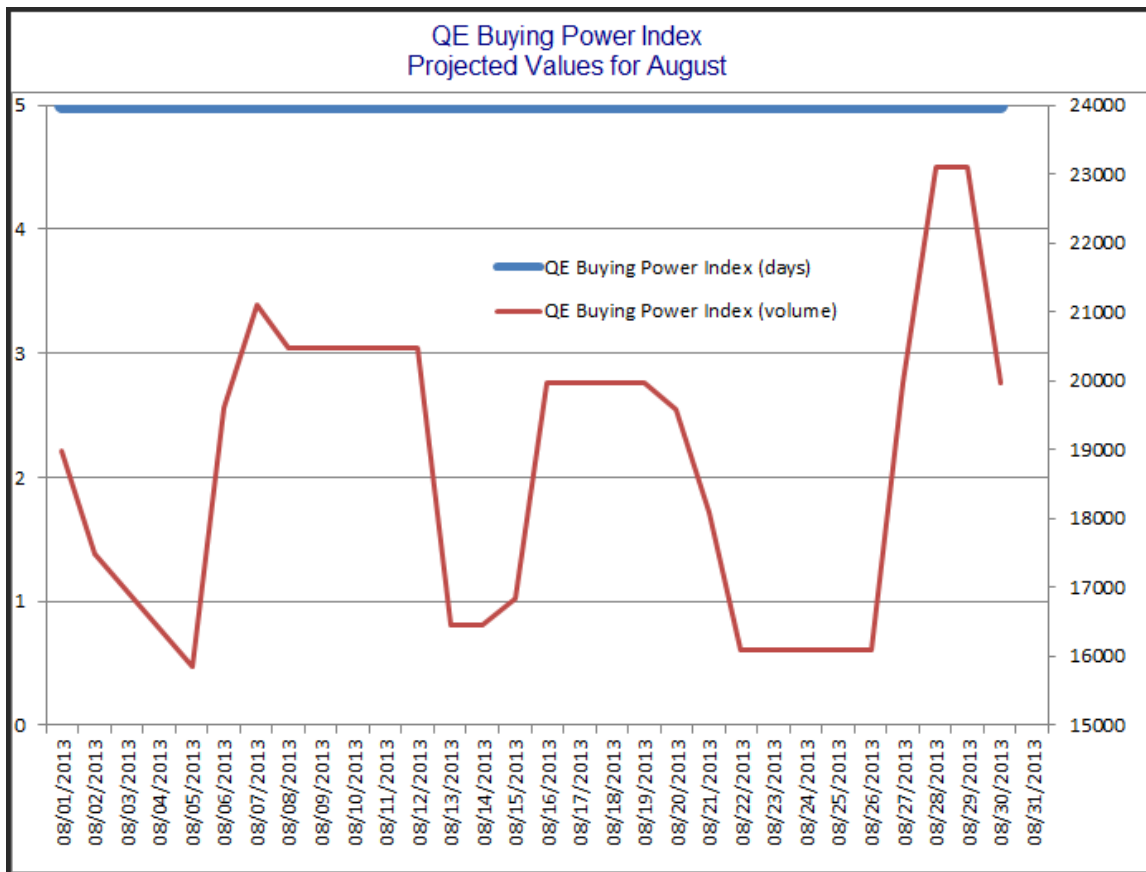
way to the stock market and works as a bullish influence. A “POMO Day” is simply a day where these operations take place. The chart below shows a couple of indicators. The top pane is the S&P 500. The middle (purple) pane is the net rolling number of days in the last 20 that have been POMO days. In other 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 remains in its 2013 range, though now near the lower end of that range. The days indicator is *still* maxed out at 20, which was a rarity during past QE implementations, but has been the norm so far this year. We estimate net inflows this past week to have been about \$17.5 billion, which is moderate number compared to others in 2013.

This upcoming week is expected to see stronger flows, in the neighborhood of \$20.5 billion. That is a solid amount and has been a number that has provided a nice wind at the market’s back all year.

On Wednesday the Fed announced its buying schedule for August. There were no real surprises. The last few months have seen schedules totaling about \$85 billion between POMO and AMBS. August is schedule to see purchases of \$86 billion, with the extra \$1 billion there to make up for a shortfall in July. To see how these flows will occur during the month I created the QE Buying Power Index (days and volume) Projected Values Chart for August.



Other than a couple of days near the very end of the month, there appears to be very little variability likely in August. There will be a little bit of an extended period at a relatively low level between August 22nd and 26th or so. So those periods may be worth watching.

The overall intermediate-term outlook is still leaning bullish. The breadth divergences we are now seeing along with the Hindenburg Omens from early June are providing some bearish evidence. But the majority of the other studies, including those related to trend, momentum, and liquidity, all point higher. We did see a couple of intermediate-term studies expire this week. This included our bullish “Sell in May study”, which reached its 6-month target already. I’m on the lookout for any evidence that would change (or confirm) my somewhat bullish stance. But for now, I still believe it is appropriate. I will continue to look to the long side for most of my trades until my outlook worsen.

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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