

QUANTIFIABLE EDGES SUBSCRIBER LETTER

ASSESSING MARKET ACTION WITH INDICATORS AND HISTORY

October 14, 2013

Volume 6 Issue 198

Market Overview



Signals Overview

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

Tonight's Research Points

- October op-ex Monday has been seasonally bullish.
- Columbus Day has been a good day for the market when there is some upside momentum.
- Back to back “strong white candle” days have had bearish 1-day implications.
- When the VIX moves from 10% above the 10ma to 10% below the 10ma in less than a week it has been typically followed by gains.

Short-term Outlook

The Bottom Line

The market is short-term overbought but there is little suggesting a short-side edge. Risks are high due to unusually low POMO flows and political turmoil. I am sidelined and happy to be there for the time being..

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

Study Date	Description	Time span	Bias	Avg Max Move
Active				
October 11, 2013	Up 2nd day. Today > 1.5%. No 10-high	1 day	Bullish	
October 8, 2013	Unfill gap down poor close > 200ma	1-8 days	Bullish	
Active - Long Term				
August 12, 2013	Hindenburg Omen cluster	1-50 days	Bearish	-8.60%
July 22, 2013	New High Divergence (Study of Tops)	int term	Bearish	
June 28, 2013	70% Advancing Issues 3 Days In Row	1-85 days	Bullish	10.60%
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				
October 10, 2013	Bounce < 0.2%	1 day	Bearish	
October 9, 2013	System 1100524	1-7 days	Bullish	
October 10, 2013	Reversal from 20-day low	1-6 days	Bullish	2.10%

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

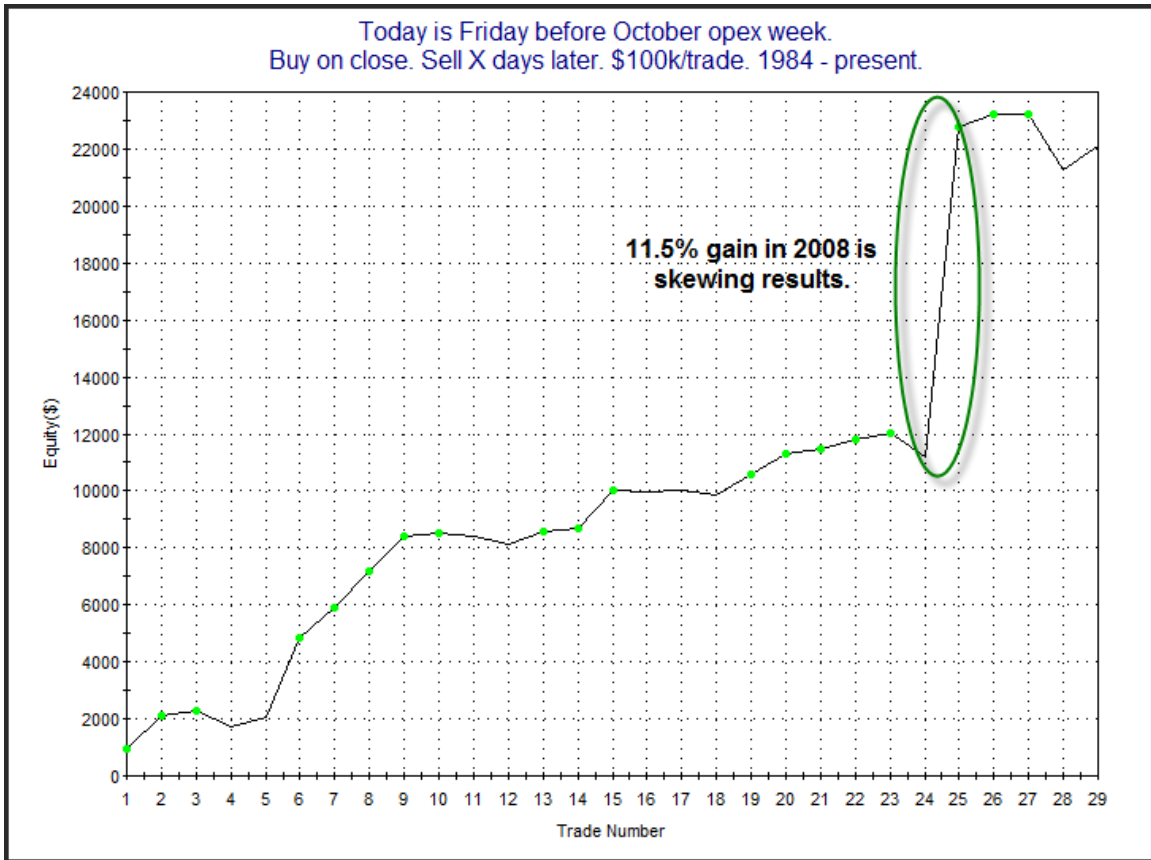
The Evidence

Friday saw another strong move up for the market. The SPX gained 0.6%, the Nasdaq rose 0.8%, and the Russell 2000 rallied 1.4%. Breadth was also positive as the NYSE Up Issues % was 72% and the Up Volume % was 69%. Total NYSE volume came in light ahead of Columbus Day weekend.

There were a couple of seasonal studies worth noting. As many of you know, option expiration week is often a pretty good week for the market. October is one of those months where it has been especially good over the years. I last showed the table below in the 10/15/12 Subscriber Letter. It examines performance during October op-ex week.

Today is Friday before October opex week. Buy on close. Sell X days later. \$100k/trade. 1984 - 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	22,735.08	29	21	8	72.41	2,335.39	7,282.10	-3,288.50	-9,109.98	0.71	1.86	783.97
4	30,223.43	29	20	9	68.97	2,330.88	6,383.20	-1,821.58	-4,169.79	1.28	2.84	1,042.19
3	12,433.85	29	19	10	65.52	1,342.78	2,976.32	-1,307.90	-3,734.78	1.03	1.95	428.75
2	26,525.82	29	20	9	68.97	1,651.33	10,965.69	-722.31	-1,737.36	2.29	5.08	914.68
1	22,093.12	29	22	7	75.86	1,181.56	11,558.43	-557.31	-1,921.32	2.12	6.66	761.83

As you can see, returns have generally been quite good. But much of the upside edge has been thanks to the strong Monday. Below is an equity curve showing Monday's performance over the years.




The strongly oversized gains in 2008 obviously skew the results. But even without 2008 there has been a decent upside tendency. So to generate a more realistic estimate I reran the results excluding 2008.

Today is Friday before October opex week.
Buy on close. Sell next day's close. \$100k/trade. 1984 - present. (Excluding 2008)

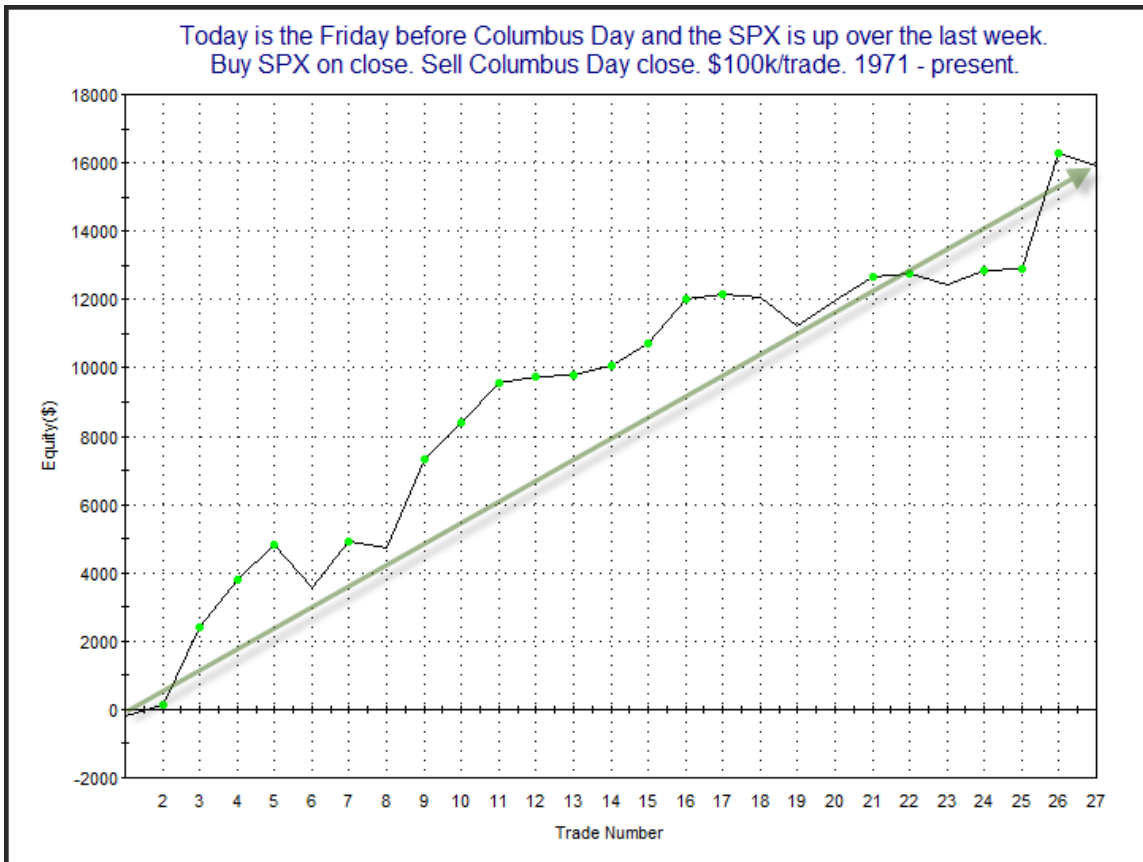
TradeStation Performance Summary Collapse ^			
All Trades			
Total Net Profit	\$10,534.69	Profit Factor	3.70
Gross Profit	\$14,435.86	Gross Loss	(\$3,901.17)
Total Number of Trades	28	Percent Profitable	75.00%
Winning Trades	21	Losing Trades	7
Even Trades	0		
Avg. Trade Net Profit	\$376.24	Ratio Avg. Win:Avg. Loss	1.23
Avg. Winning Trade	\$687.42	Avg. Losing Trade	(\$557.31)
Largest Winning Trade	\$2,753.79	Largest Losing Trade	(\$1,921.32)

Numbers here are still good. The average gain was nearly 0.4%. I included this seasonal study on the active list for tonight.

While the stock market is open on Monday, banks, schools, government offices, and the bond market are closed. In past years with the bond market closed, the stock market has done quite well on Columbus Day. Of course the most famous Columbus Day rally was in 2008 when the market gained over 11% after having crashed the week before. Last year in the 10/8/12 subscriber letter I showed that positive momentum leading up to Columbus Day has generally led to a positive Columbus Day. Columbus Day has been celebrated on the 2nd Monday of October since 1971. Below is an updated version of last year's study.

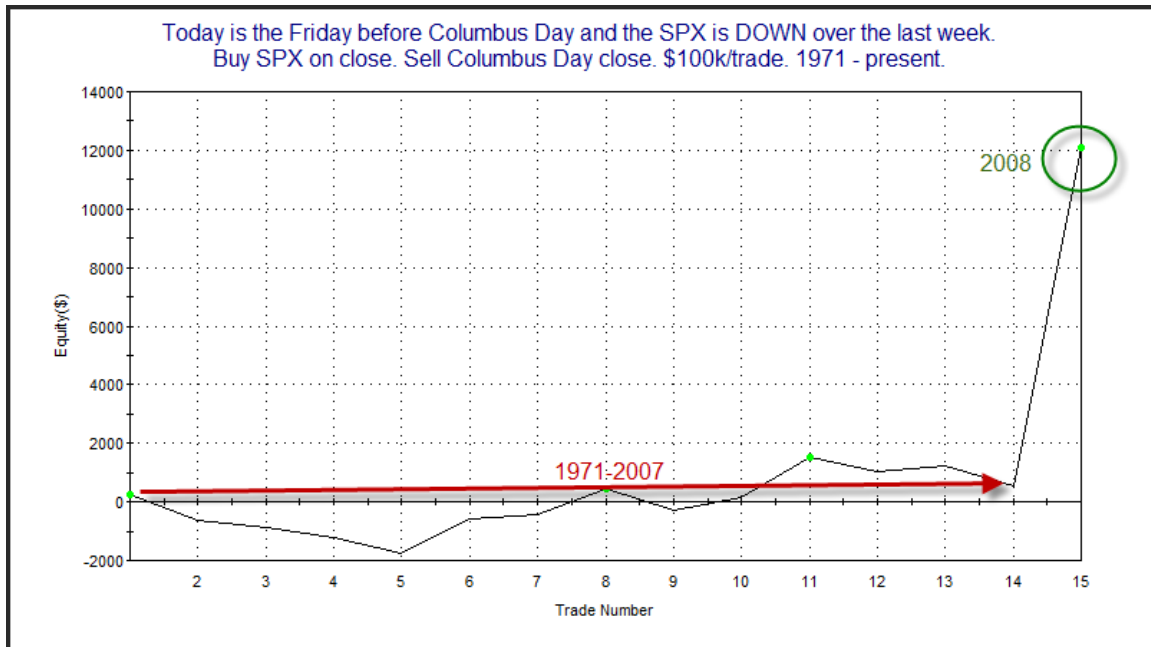
TradeStation Performance Summary Collapse 			
All Trades			
Total Net Profit	\$15,932.31	Profit Factor	5.99
Gross Profit	\$19,126.42	Gross Loss	(\$3,194.11)
Total Number of Trades	27	Percent Profitable	74.07%
Winning Trades	20	Losing Trades	7
Even Trades	0		
Avg. Trade Net Profit	\$590.09	Ratio Avg. Win:Avg. Loss	2.10
Avg. Winning Trade	\$956.32	Avg. Losing Trade	(\$456.30)
Largest Winning Trade	\$3,390.98	Largest Losing Trade	(\$1,248.22)
<p>23 of 27 instances (85%) closed above the entry price at some point in the next 3 days. The 4 that didn't were 1979, 1981, 1999 and 2012. All 4 saw steep drawdowns the next week. The drawdowns respectively reached levels of 8.0%, 2.8%, 7.7%, and 2.4%.</p>			

I've circled some of the more impressive stats here. With 74% of trades profitable and winners twice the size of losers risk/reward has been very favorable. Below is the profit curve.



The slope is clearly up. It certainly appears Columbus Day with upside momentum appears to provide a solid seasonal edge.

What about times without positive momentum? Below is an equity curve showing results of that setup.



As I mentioned above, 2008 was a huge outlier. Take away that one year and Columbus Day showed basically no edge whatsoever when the prior week was down.

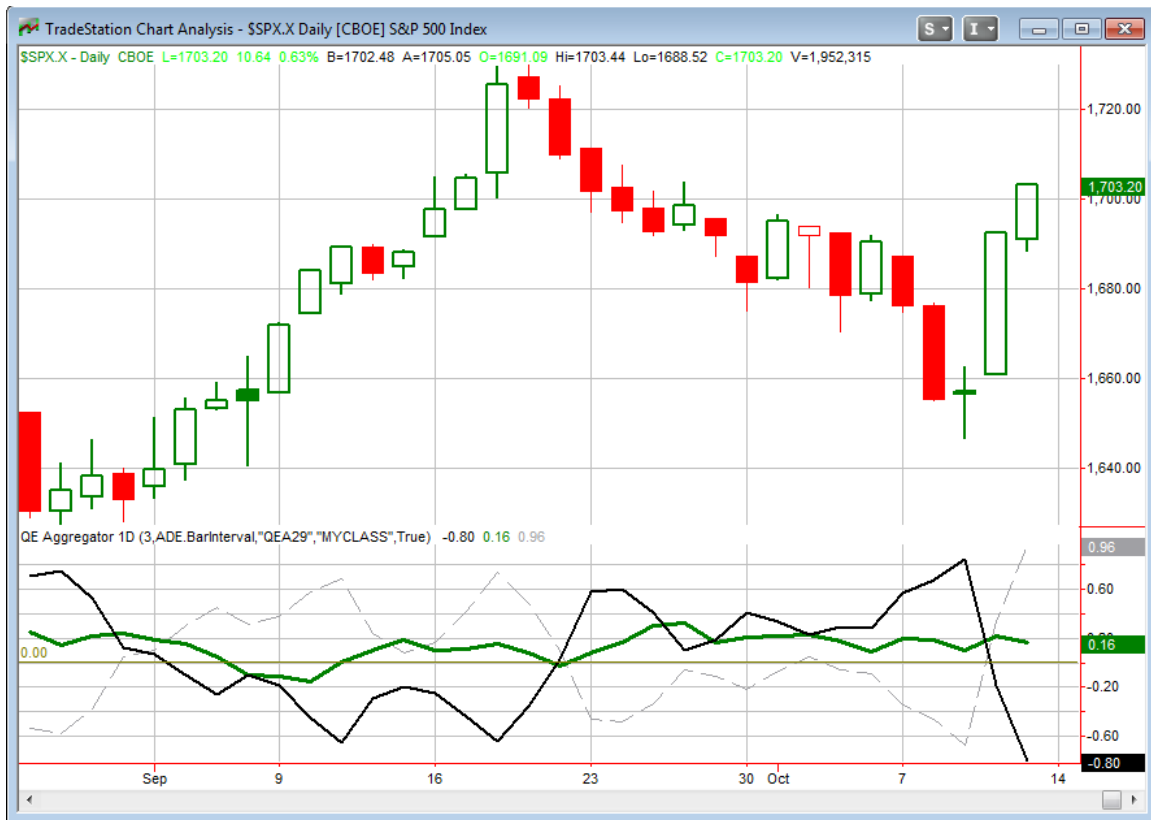
When a market opens near its low and closes near its high it is considered a sign of strength. On a classic candle chart it is seen as a white candle with very small or no wicks. Not only did we see this formation occur in the SPY on Friday, but we also saw it Thursday. So what happens after you get back to back days that are so strong that they manage to open in the bottom 10% of the day's range and close in the top 10%? I examined this on 9/3/10 and re-checked the list tonight. Looking back to the inception of the SPY I only found 5 other instances. I've listed them all below along with their next-day returns.

SPY opens in bottom 10% of daily range and closes in top 10% of daily range for the 2nd day in a row. Buy on close. Sell next day close. \$100k/trade. 1993 - present.

Date/Time	Signal	Price	% Profit	Run-up DrawDown
06/19/95	Buy	\$54.58	(0.24%)	\$73.28
06/20/95	Sell	\$54.45		(\$329.76)
02/01/96	Buy	\$63.92	(0.42%)	\$172.04
02/02/96	Sell	\$63.65		(\$656.88)
06/18/02	Buy	\$104.97	(2.33%)	\$0.00
06/19/02	Sell	\$102.52		(\$2,598.96)
11/21/02	Buy	\$94.09	(0.71%)	\$191.16
11/22/02	Sell	\$93.42		(\$870.84)
11/28/08	Buy	\$90.09	(8.86%)	\$0.00
12/01/08	Sell	\$82.11		(\$9,135.30)

The most obvious observation is that all 5 instances declined the next day. But what really stands out to me is the “Run-up” column. If you look there you will note that none of the 5 instances managed an intraday gain of even 0.2%. Meanwhile they all suffered intraday drawdowns of at least 0.3%, and 4 of the 5 were greater than 0.6%.

So with just a few very-short-term studies to add tonight, I have updated the [Aggregator](#) chart below.



With tonight's studies factored in the green Aggregator Line is still above 0. Positive readings mean net expectations from the Active List are for upside over the next few days. Meanwhile the rally caused the black Differential Line to dive even further below 0. The negative Differential Line reading means the SPX is strongly overbought versus recent expectations. So expectations are positive but the SPX is 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 signal to turn flat at the close.

Based on the current active studies, expectations are slated to remain positive again on Monday. Of course this could change if new bearish evidence emerges. The Differential Pivot will be 1,663.59 on Monday. That is a whopping 2.3% below Friday's close. It's unlikely we'll see that accomplished on Monday. More likely it will require a multi-day selloff or consolidation to work off the overbought condition.

While we are now strongly overbought versus short-term expectations, there is simply not a compelling reason to attempt a short. I took off all of my long positions on Friday and will wait for the next compelling edge to emerge before putting the money back to work.

Intermediate-term Outlook (2 weeks – 2 months) – updated 10/14 – somewhat bullish

After some strong selling early in the week the market bounced back in a big way the last few days. From an intermediate-term perspective that action did trigger a study at Friday’s close.

It considered the sharp drop in the VIX over the last couple of days after a sharp rise the previous few. The study below was from the 1/3/13 subscriber letter. The results are updated.

VIX closes more than 10% below its 10ma after closing more than 10% above it one of the previous 4 days. SPX > 200ma. Buy SPX on close. Sell X days later. \$100k/trade. 1992 - 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	24,328.70	15	12	3	80.00	2,630.39	8,115.80	-2,411.98	-3,412.50	1.09	4.36	1,621.91
9	25,218.01	15	11	4	73.33	2,534.38	8,397.40	-665.05	-2,173.08	3.81	10.48	1,681.20
8	26,959.91	15	13	2	86.67	2,222.01	8,076.20	-963.09	-1,733.94	2.31	15.00	1,797.33
7	25,385.76	15	12	3	80.00	2,330.82	7,749.50	-861.37	-1,872.78	2.71	10.82	1,692.38
6	21,670.08	15	10	5	66.67	2,471.93	5,305.30	-609.84	-1,280.71	4.05	8.11	1,444.67
5	19,710.86	15	10	5	66.67	2,326.22	5,361.40	-710.27	-1,159.86	3.28	6.55	1,314.06
4	10,578.80	15	11	4	73.33	1,467.93	4,981.90	-1,392.11	-2,303.32	1.05	2.90	705.25
3	5,442.19	16	9	7	56.25	1,225.03	3,799.40	-797.58	-1,683.22	1.54	1.97	340.14
2	5,163.66	16	8	8	50.00	1,298.17	3,839.00	-652.71	-1,767.90	1.99	1.99	322.73
1	4,999.86	16	8	8	50.00	999.86	2,952.40	-374.88	-1,582.62	2.67	2.67	312.49

All 16 instances posted a close above the entry price at some point in the next 4 days.

The market condition that would typically accompany such VIX movement is one where you see a strong rebound from a sharp decline during a long-term uptrend, which is what we are currently looking at. Results over the first 2-3 days are somewhat sketchy, but once you get out beyond that they become more consistent and more powerful. Below I have listed all 13 instances with an eight day holding period.

VIX closes more than 10% below its 10ma after closing more than 10% above it one of the previous 4 days. SPX > 200ma.
Buy SPX on close. Sell X days later. \$100k/trade. 1992 - present.

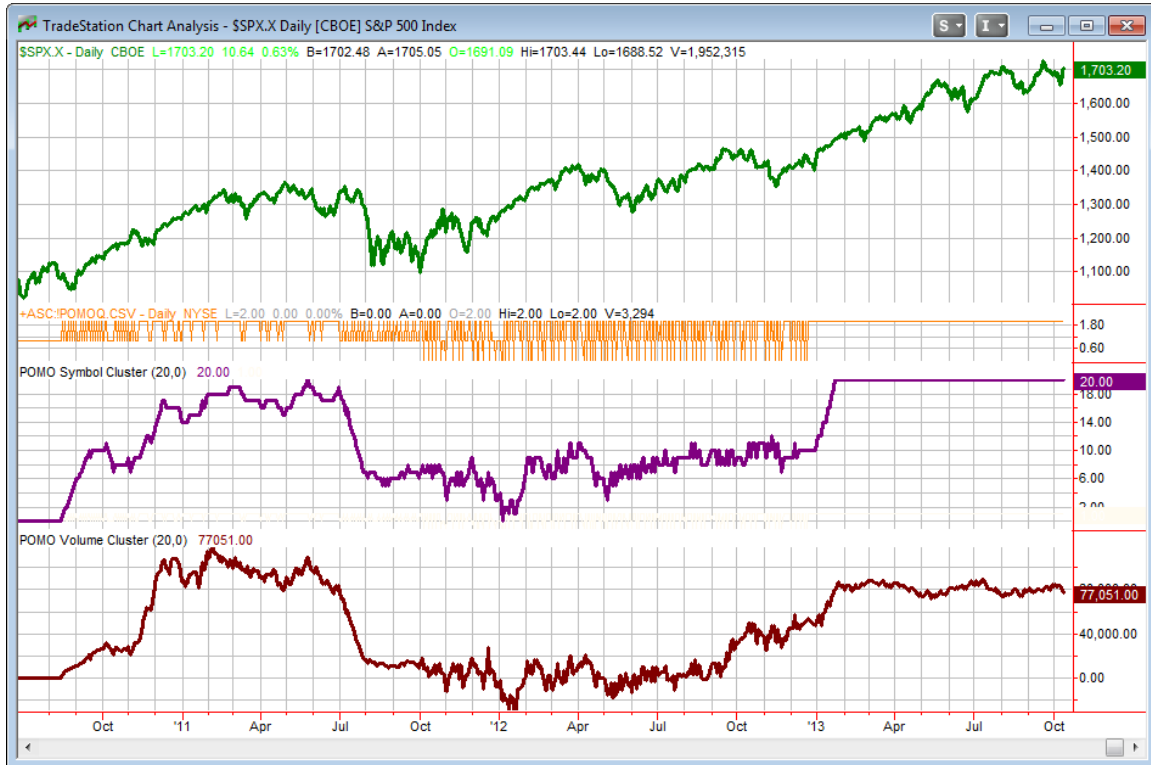
Date/Time	Signal	Price	% Profit	Run-up Drawdown
06/23/92	Buy	\$404.04	2.43%	\$2,880.02
07/06/92	Sell	\$413.84		(\$521.17)
07/26/96	Buy	\$635.89	4.44%	\$4,509.04
08/07/96	Sell	\$664.15		(\$1,047.19)
05/01/98	Buy	\$1,121.02	(0.19%)	\$845.50
05/13/98	Sell	\$1,118.86		(\$2,357.61)
01/07/00	Buy	\$1,441.47	0.28%	\$2,175.57
01/20/00	Sell	\$1,445.57		(\$992.91)
03/26/04	Buy	\$1,108.02	2.93%	\$3,829.50
04/07/04	Sell	\$1,140.48		\$0.00
05/26/06	Buy	\$1,280.16	(1.74%)	\$820.56
06/08/06	Sell	\$1,257.93		(\$3,508.44)
09/13/06	Buy	\$1,318.07	0.63%	\$846.00
09/25/06	Sell	\$1,326.37		(\$534.75)
03/09/07	Buy	\$1,402.85	2.29%	\$2,479.32
03/21/07	Sell	\$1,435.04		(\$2,759.77)
08/22/07	Buy	\$1,464.07	1.73%	\$2,198.44
09/04/07	Sell	\$1,489.42		(\$2,180.08)
07/14/09	Buy	\$905.84	8.11%	\$8,134.50
07/24/09	Sell	\$979.26		\$0.00
11/09/09	Buy	\$1,093.08	0.17%	\$1,875.51
11/19/09	Sell	\$1,094.90		(\$744.38)
12/03/10	Buy	\$1,224.71	0.86%	\$1,783.62
12/15/10	Sell	\$1,235.23		(\$422.01)
03/22/11	Buy	\$1,293.77	2.99%	\$3,394.16
04/01/11	Sell	\$1,332.41		(\$748.44)
03/12/12	Buy	\$1,371.09	1.58%	\$3,089.52
03/22/12	Sell	\$1,392.78		\$0.00
01/02/13	Buy	\$1,462.42	0.56%	\$702.44
01/14/13	Sell	\$1,470.68		(\$733.04)

I don't see anything alarming here. These results appear to confirm the upside edge. But since the first 1-3 days are a tossup, I simply placed this study on the intermediate-term list rather than the short-term list.

I update the intermediate-term POMO/QE chart each week. For those not familiar, below is a brief description.

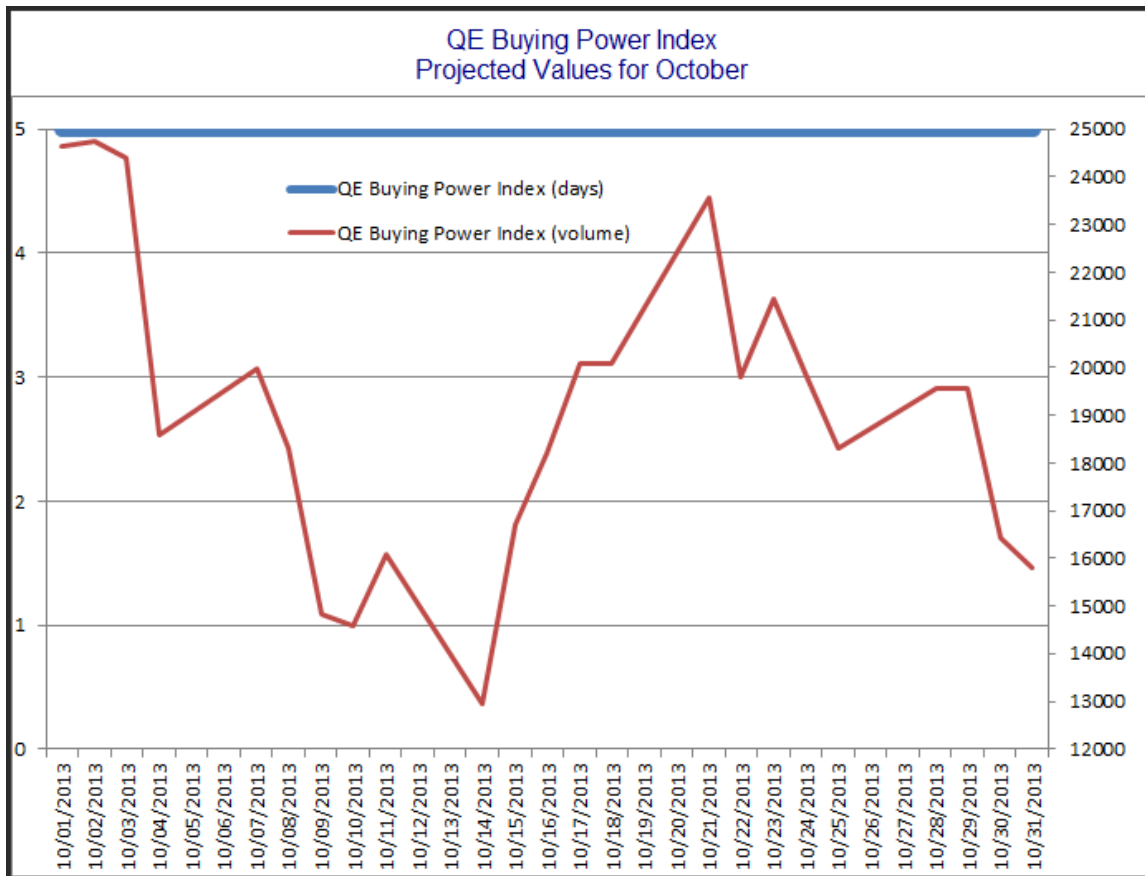
POMO stands for Permanent Open Market Operations and it is how the Fed has gone into the open market to buy securities over the last several years. The net effect of this buying is an influx of cash into the system. It appears a portion of that cash makes its way to the stock market and works as a bullish 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 is down near the low end of its 2013 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 \$16.2 billion, which is quite low for what we have seen in 2013.

Expected flows for this upcoming week are expected to be about \$20 billion. This is more typical of 2013 flows. But there is typically a few day delay in the impact of these liquidity flows. Below is another peek at the QE Buying Power expectations chart for October.



I noted last week that the liquidity flows were fairly high and if the market could get over the negative political news that they could help provide an extra boost on a rebound. That happened. But on Monday the liquidity flows will reach their lowest level in quite a while. So they simply will not be providing the kind of impact they have throughout this year. Therefore, towards the later part of this week and into the following week, it could be an opportunity for the bears to gain some ground. A little extra caution may be warranted during this period.

The overall intermediate-term outlook remains somewhat bullish. Liquidity flows are a bit light now, but they are expected to rise again soon. The breadth divergences noted by the QE Study of Tops continue to be a problem and suggest the market could undergo a major decline. Political risks remain elevated as the government is unable to complete a budget or debt ceiling agreement. But the trend remains up, the Nasdaq is still leading, and the sharp VIX reversal I noted earlier is provided additional hope over the next couple of weeks. This upcoming week I will likely be a bit cautious on both the long and the short side. Patience may be necessary to navigate the current market.

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

Symbol	Entry Date	Entry Price	Current Price	% Gain/Loss	Stop	Notes
<i>SPY (1/4)</i>	<i>9/24/2013</i>	<i>\$169.90</i>	<i>\$169.00</i>	<i>-0.53%</i>		<i>sold at limit</i>
<i>SPY (1/4)</i>	<i>9/25/2013</i>	<i>\$169.53</i>	<i>\$169.00</i>	<i>-0.31%</i>		<i>sold at limit</i>
<i>EMC</i>	<i>10/4/2013</i>	<i>\$25.16</i>	<i>\$25.30</i>	<i>0.56%</i>		<i>sold on close</i>
<i>SPY (1/4)</i>	<i>10/8/2013</i>	<i>\$165.48</i>	<i>\$169.00</i>	<i>2.13%</i>		<i>sold at limit</i>
<i>TGT(1/3)</i>	<i>10/9/2013</i>	<i>\$62.13</i>	<i>\$63.14</i>	<i>1.63%</i>		<i>sold on open</i>

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