

# QUANTIFIABLE EDGES SUBSCRIBER LETTER

ASSESSING MARKET ACTION WITH INDICATORS AND HISTORY

December 30, 2013

Volume 6 Issue 251

## Market Overview



## Signals Overview

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

## Tonight's Research Points

- When an overbought market pulled back as little as it did today, it may not want to pullback at all, and has often continued higher over the next 1 to 2 days.

## *Short-term Outlook*

### *The Bottom Line*

Expectations are somewhat bullish but the market is still a little overbought. I believe with strong seasonality and the trend so strong that we have a decent chance to continue to move higher between now and Thursday. After that – we'll see.

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

Study Date	Description	Time span	Bias	Avg Max Move
<b>Active - Short Term</b>				
December 30, 2013	SPX dn but RSI(2) > 90	1-2 days	Bullish	
December 27, 2013	VXO 15% below 10ma 3 days	1-2 days	Bearish	-1.80%
December 23, 2013	Twas 3 Nights Before Christmas	1-8 days	Bullish	
December 19, 2013	Fed Day closes at 100-day high	1-8 days	Bullish	1.90%
<b>Active - Long Term</b>				
December 23, 2014	QE Tapering	int term	Neutral	
December 19, 2013	20-high on high vol	1-20 days	Bullish	
December 18, 2013	4 Hindenburg Trigger	1 - 35 days	Bearish	-7.00%
December 16, 2013	2nd half December seasonally strong	1-15 days	Bullish	3.60%
December 2, 2013	Nasdaq leading SPX	int term	Bullish	
October 25, 2013	SPX > 50,2 Bollinger Band	1-50 days	Bullish	
October 21, 2013	70% Advancing Issues 3 Days In Row	1-75 days	Bullish	10.60%
July 22, 2013	New High Divergence (Study of Tops)	int term	Bearish	
February 1, 2012	Golden Cross	int term	Bullish	
<b>Dropped Tonight</b>				
April 29, 2013	6 months higher in a row	1-10 month	Bullish	14.30%

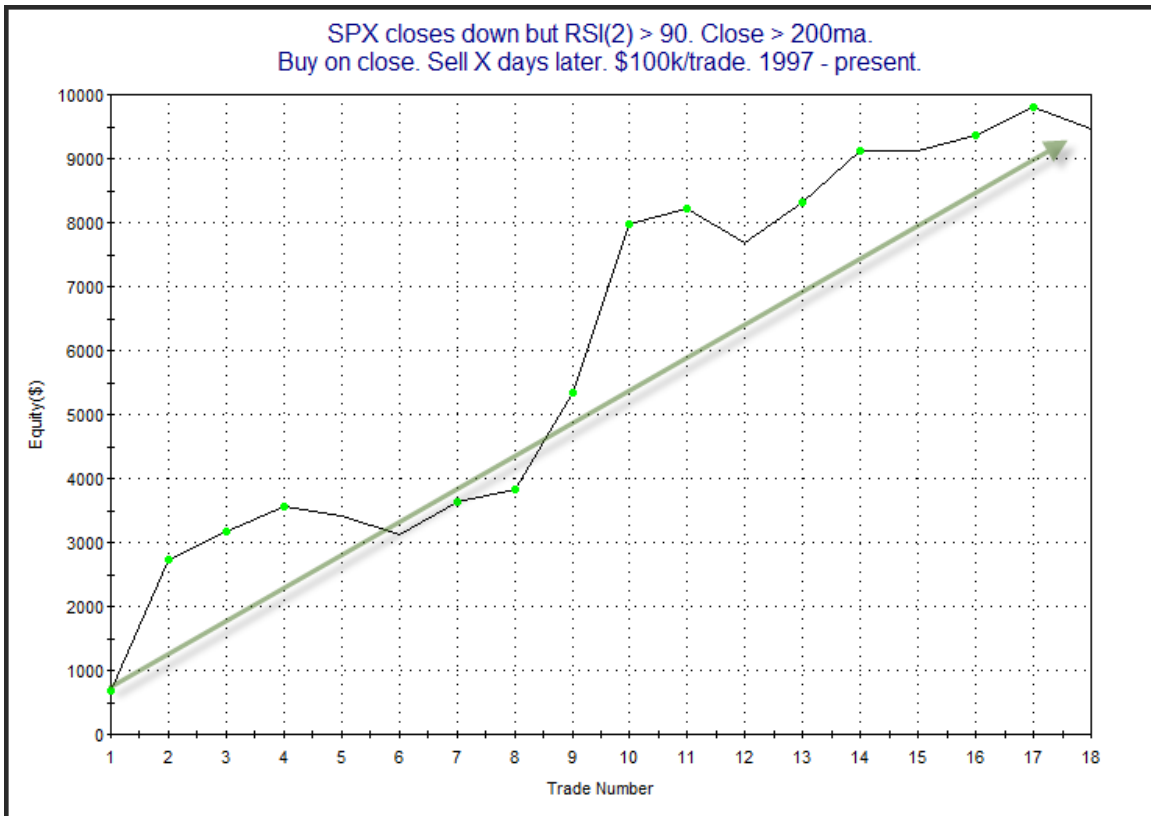
**The Evidence**

The market paused on Friday. The SPX closed down less than 1 point, the NASDAQ fell 0.3% and the Russell 2000 declined 0.1%. Breadth was mixed as the NYSE Up Issues % was 47% and the Up Volume % was 58%. Total NYSE volume was a little above Thursday's level, but still holiday-light.

The recent string of positive closes has some oscillators strongly overbought short-term. With such a small decline on Friday the SPX is still strongly overbought as measured by the 2-day RSI. The 2-day RSI is a very sensitive indicator so it would take a very small decline from a very overbought position in order for it to remain above 90 on a down day. This is what happened on Friday. It therefore triggered the below study from the 8/21/12 letter, which I have updated.

SPX closes down but RSI(2) > 90. Close > 200ma. Buy on close. Sell X days later. \$100k/trade. 1997 - 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	2,918.98	16	6	10	37.50	1,771.65	4,121.28	-771.09	-2,008.73	2.30	1.38	182.44
4	4,725.95	17	9	8	52.94	1,208.11	3,806.46	-768.38	-1,717.70	1.57	1.77	278.00
3	9,935.47	18	11	7	61.11	1,139.00	2,923.44	-370.51	-1,123.50	3.07	4.83	551.97
2	9,468.35	18	13	5	72.22	827.49	2,619.76	-257.80	-525.07	3.21	8.35	526.02
1	4,859.12	18	14	4	77.78	460.67	2,310.88	-397.55	-704.76	1.16	4.06	269.95

The stats here are all appealing over the 1-2 day period. Winning %, win/loss ratio, and profit factor all strongly favor the bulls. Below is a profit curve assuming a 2-day holding period.



Results here are impressive. I have added this study to the Active List.

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



Tonight's study helped the green Aggregator Line to rise strongly 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 still negative. The negative Differential Line reading means the SPX is 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.

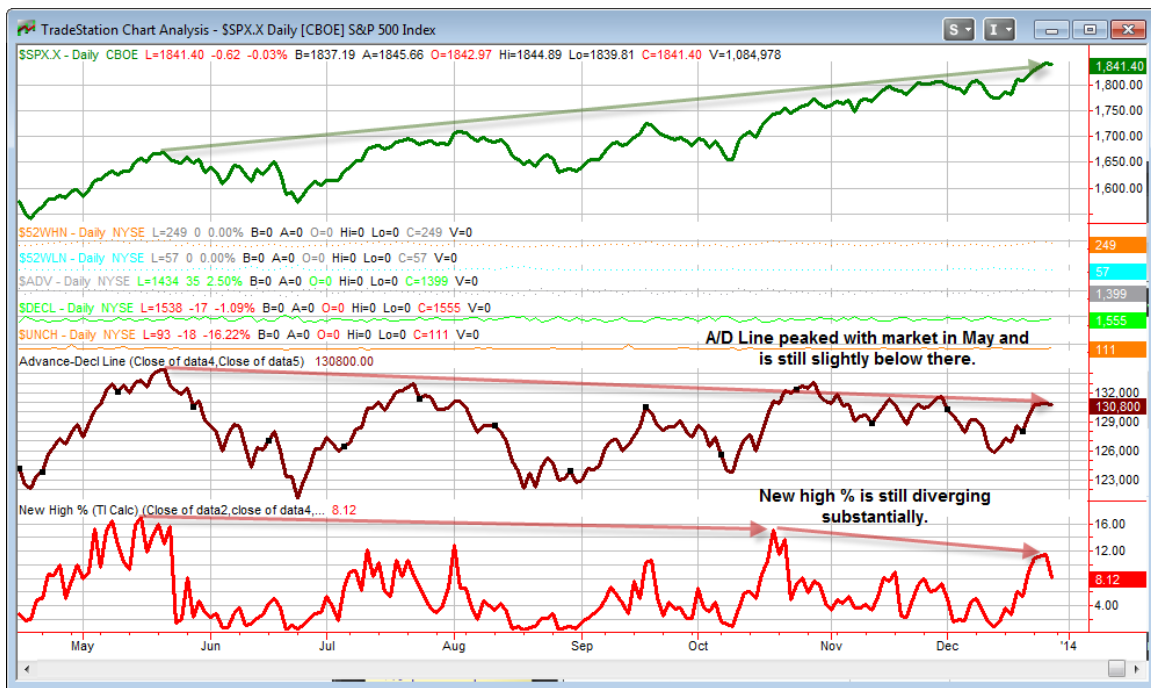
With the current active studies, expectations are set to remain bullish on Monday. This could change if more bearish evidence emerges. The Differential Pivot will be 1841.06 on Monday. That is less than 1 point below Friday's close. So SPX will move from overbought to oversold on just about any down close.

One small down day is not enough to get me interested in a long trade, despite the bullish studies. But another down day Monday could set us up for a quick end-of-year bounce. So I will look to take a small position if the SPY closes down much on Monday.

**Intermediate-term Outlook (2 weeks – 2 months) – updated 12/30 – bullish**

The market put in some nice gains this week, and is just off the all-time highs posted on Thursday. The uptrend is currently alive and strong.

But even with the continued rally, the Study of Tops indicators remain highly divergent. This can be seen on the chart below, which I copied from the QE charts page.



The May SPX high was accompanied by new highs in both the A/D Line and the New High %, and that provided us some confidence that the next price top prior to a major decline was unlikely to occur until at least July. This held true and the market has continued higher, but the New High % and A/D Line have failed to keep up.

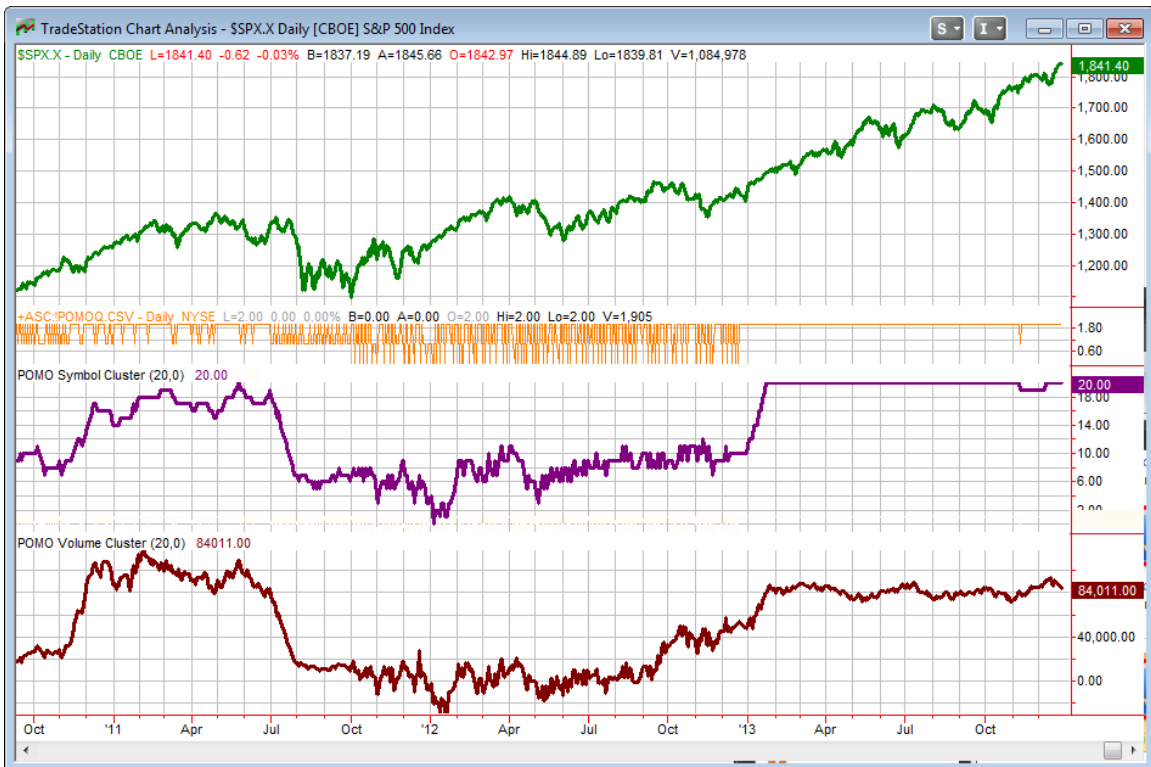
This opens up the possibility of a major top being put in. Note I said possibility, not probability. It needs to be understood that while the narrowing of New Highs and/or the turn down in the Advance/Decline Line has been a prerequisite for a top to take place, these breadth conditions have not been very useful in timing the tops. Often such divergences have persisted for many months, or even years. I therefore view these breadth divergences as possible warning signs – not as timing signals. The current divergence is about 7 months old. It hasn't mattered yet, but if it persists, then it will matter at some point.

If the market continues higher and the New High % and A/D Line rally to new highs as well, then that would suggest the market is unlikely to reach a major price top for at least another 2 months. I'll continue to keep an eye on these indicators. For now they remain

highly divergent. So the rally is occurring with fewer and fewer stocks participating. And from this point it will take a bit of work to get the New High % back to the May level.

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.*

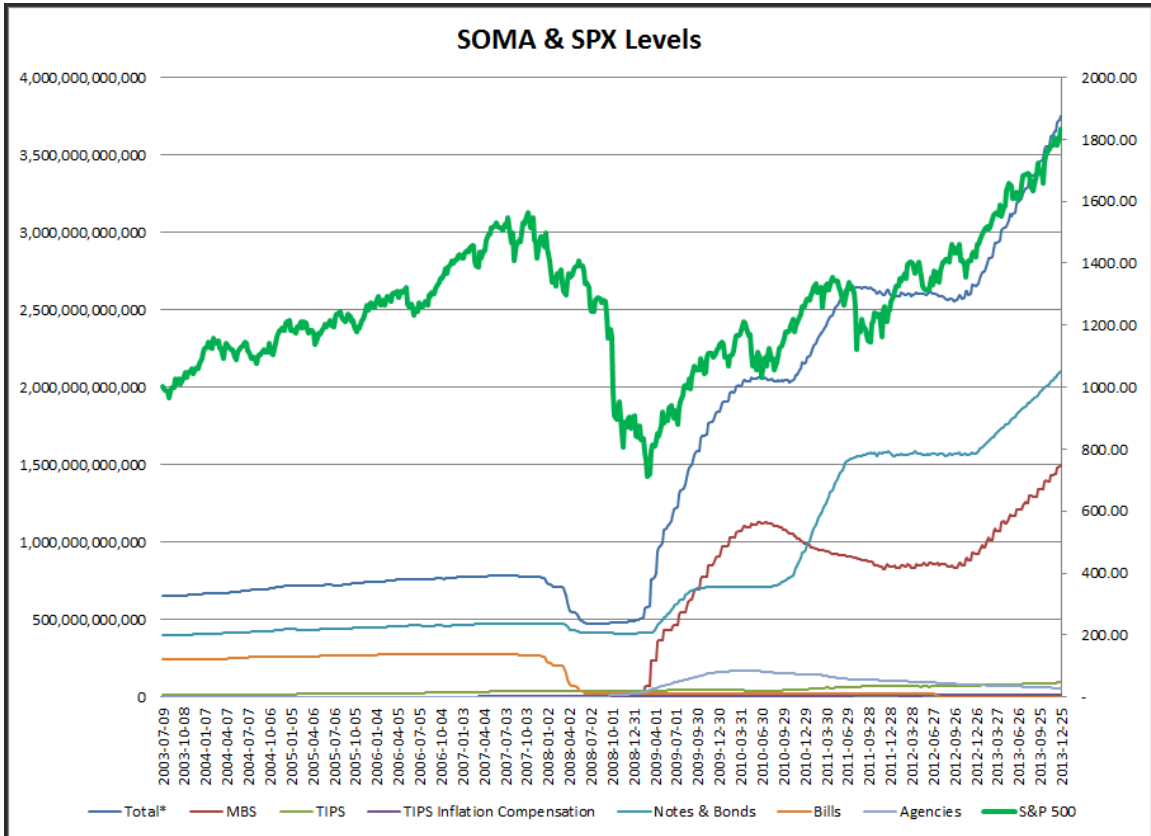


The POMO/AMBS volume indicator is still well within its range of the last year. The days indicator is again at 20 where it has spent most of 2013. High days readings like this were a rarity during past QE implementations, but have been the norm so far this year. We estimate net inflows this past week to have been about \$9.2 billion, by far the smallest number for 2013. This is not likely to provide much fuel for the coming week.

And this upcoming week will likely be light as well. Monday and Tuesday there is no POMO buying scheduled. Wednesday there is no buying at all since the markets are closed. And Thursday and Friday is so far unknown, since the January schedule is set to be released Tuesday afternoon.

The January schedule will be especially interesting, since it will be the first month of reduced Fed buying. The Fed has stated that they plan to taper from the \$85 billion/month that persisted throughout 2013 down to \$75 billion / month starting in January. This is still a substantial amount of stimulus, but it is less than the market has become accustomed to. So the reaction will be interesting.

Perhaps the only chart intermediate-term traders may have needed over the last 11 years is the one below that shows the Fed's System Open Market Account (SOMA) balances along with the SPX.



The SOMA is the account that holds all of the bond purchases the Fed makes to stimulate the economy. As you can see, any time the account balance has been rising the SPX has fared well. And any time total SOMA has declined, SPX has struggled. With \$75 billion/month of buying scheduled we should still see SOMA increase, although, at a lower rate than during the past year. As the amount of tapering increases (and Fed buying decreases) we'll continue to see the blue SOMA line turn flatter. At some point here I believe a sideways (or perhaps even mildly up) slope will lead to stock market troubles.

As I said last week, (and may reiterate again next week) I believe we are going to encounter some more substantial corrections in 2014 as liquidity shrinks. Traders and investors are going to need to stay much more on their toes. 2013 was a year where intermediate-term traders would have had an easier time than those who use a swing-trading approach. I suspect that will flip in 2014.

I am remaining bullish through Thursday. Next weekend I will likely scale back to a less bullish stance. I may turn neutral in the near future if the reduced liquidity appears to have a negative effect on the market. Trend, momentum, and volume studies still favor more upside, and the Nasdaq is in a leading position, which is a good thing. But the Hindenburg Omen signals discussed last week provide a warning sign, and the breadth divergences noted by the [QE Study of Tops indicators](#) remain in place. Liquidity remains perhaps the top market influence in my book, and that is no longer strongly bullish. I'm currently viewing it as either slightly bullish or neutral, and the more the Fed tapers the more neutral/negative liquidity will become. So like I said, I am "bullish" through Thursday, then "somewhat bullish" for Friday. And of course next weekend I will reevaluate again.

### **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 @ \$183.35 LIMIT ON CLOSE.** Based on the short-term outlook above, I'll look to scale into some SPY for a short-term trade if it closes down at least \$0.50.

### **Current Open Trade Ideas**

Symbol	Entry Date	Entry Price	Current Price	% Gain/Loss	Stop	Notes
APC(1/3)	12/11/2013	\$85.26	\$79.40	-6.87%		sell on open
APC(1/3)	12/12/2013	\$83.74	\$79.40	-5.18%		sell on open
APC(1/3)	12/16/2013	\$78.30	\$79.40	1.40%		sell on open

*APC hit its exit target on Friday and will be closed out at the open on Monday.*

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