

QUANTIFIABLE EDGES SUBSCRIBER LETTER

ASSESSING MARKET ACTION WITH INDICATORS AND HISTORY

February 18, 2014

Volume 7 Issue 32

Market Overview



Signals Overview

Aggregator	Aggressive VIX	QE Buy Pwr Swing
Short	100% Short SPY	Flat

Tonight's Research Points

- Low volume on Friday is likely meaningless, since it was pre-holiday.
- The recent pullback could mean the summer will be difficult for the market.
- Weak POMO flows last week could offer the bears a chance this week.

Short-term Outlook

The Bottom Line

The market is still overbought, and expectations remain negative. With POMO flows weak last week, I'm inclined to take a shot at the short side if I can get a favorable fill.

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

Study Date	Description	Time span	Bias	Avg Max Move
Active - Short Term				
February 14, 2014	8-day SPY avg closing range > 75%	1-2 days	Bearish	
February 13, 2014	SPX 5 higher highs. No 20-high.	1-5 days	Bearish	
February 10, 2014	VIX high stretch to low stretch	1-8 days	Bullish	2.70%
Active - Long Term				
December 23, 2014	QE Tapering	int term	Neutral	
December 2, 2013	Nasdaq leading SPX	int term	Bullish	
July 22, 2013	New High Divergence (Study of Tops)	int term	Bearish	
February 1, 2012	Golden Cross	int term	Bullish	
Dropped Tonight				
February 13, 2014	SPX down but RSI(2) > 90	1-2 days	Bullish	
February 12, 2014	SPX up 4 days. 3 > 1%. Close > 200m	1-3 days	Bullish	1.70%
February 13, 2014	VXO 15% downstretch 3 days	1-2 days	Bearish	
February 14, 2014	President's Friday bearish	1 day	Bearish	
January 27, 2014	2 unfilled dn gaps & 5-low > 200	1-10 days	Bullish	

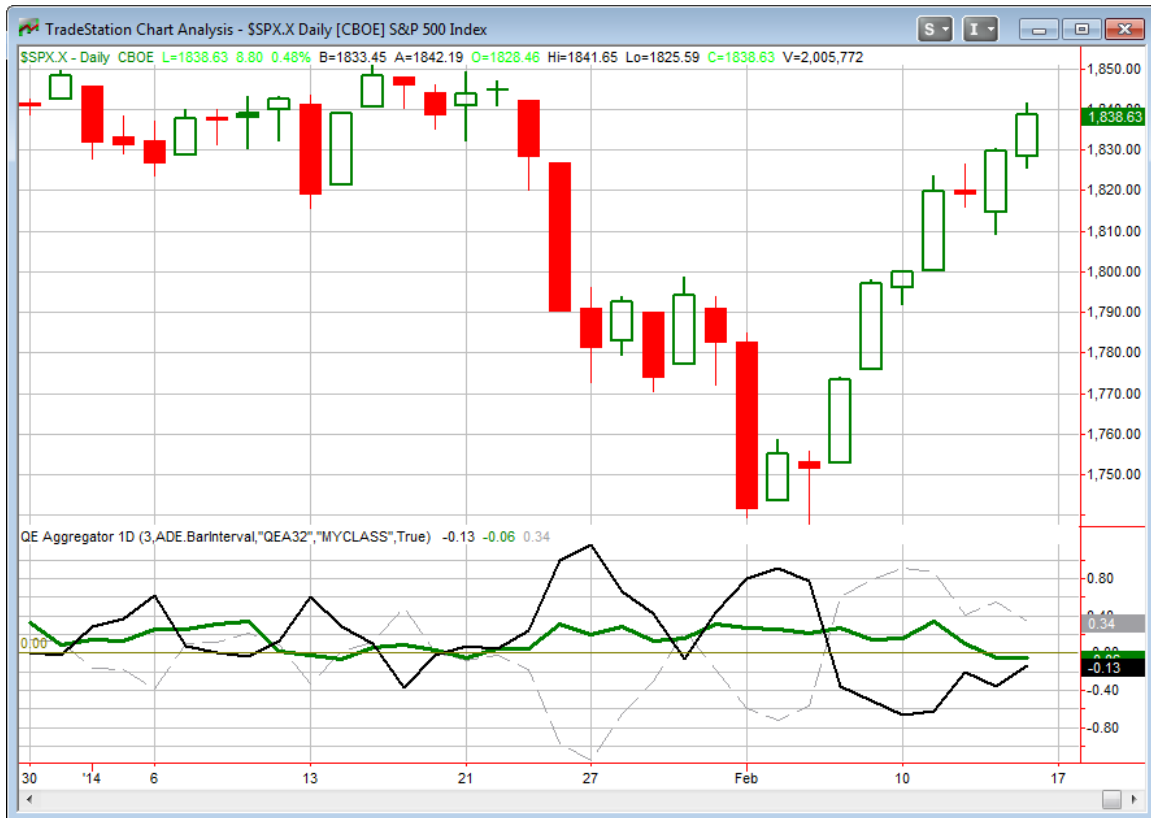
The Evidence

Friday was the 1st day in a while that our studies suggested downside was more likely than upside. But those bearish inclinations were squashed as the bulls continued their charge. SPX rallied 0.5%, the Nasdaq gained 0.1%, and the Russell 2000 also rose 0.1%. Breadth was positive as the NYSE Up Issues % came in at 66% and the Up Volume % was 64%. Total NYSE volume sank to the lowest level so far in February.

The low volume combined with the rising prices triggered quite a number of studies in the Quantifinder. But I do not believe low volume studies are worth considering in this situation. Low volume / high price studies typically suggest that there is complacency among traders, or perhaps that the market has reached equilibrium and is at a tipping point. But low volume just prior to a long weekend is typical. It cannot be viewed as complacency. It is simply a matter of fewer traders working because several decided to get a jump on the long weekend. So in cases like this I simply ignore the volume studies, and I will need to do that again tonight.

That does not leave me with a lot to discuss tonight from a short-term perspective, but that is not terribly unusual when there has been a grind higher. Several of the short-term studies fell off the Active List tonight, and we are left with just 2 bearish and 1 bullish studies currently remaining.

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



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

Based on the current open studies, expectations are slated to remain negative on Tuesday. Of course this could easily change if new bullish evidence emerges. The Differential Pivot will be 1830.04 on Tuesday. That is about 0.5% below Friday's close. SPX will need to close lower by at least this much if it is going to move from overbought to oversold versus expectations.

So there appears to be a mild downside edge. The market is certainly short-term overbought as well. I was somewhat undecided on whether to look to take advantage of this apparent short-side edge. I have not taken any shorts since the end of 2012 because the QE Buying Power Index (Fed liquidity) has been so strong, and my research showed that such strong liquidity was very difficult to short against. And while the "days" indicator is still maxed out at "5", the volume indicator is very low. (I'll discuss this

more in the intermediate-term section down below.) So if there was ever a time to dip my foot back in to the short side, this might be it. Therefore, if I can get a favorable entry on Tuesday, I will take a small SPY short position.

Intermediate-term Outlook (2 weeks – 2 months) – updated 2/18 – neutral

SPX put in a strong move up this past week and is now back within 1% of a new all-time high. And the Nasdaq 100 made a new multi-year high. So we certainly cannot count the bull dead yet. From an intermediate-term standpoint, there was nothing both significant and of immediate importance, but there have been some things occur that I thought were worth noting.

First, the study below was from Wednesday night’s letter. It looked at other instances in which the VXO was strongly oversold for 3 days in a row. A strongly oversold VXO suggests that fear has quickly exited the market. As you can see, short-term indications were bearish.

VXO closes over 15% below its 10ma for exactly the 3rd day in a row. Buy SPX on close. Sell X days later. \$100k/trade. 1987 - 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	-24,902.76	24	12	12	50.00	799.12	2,073.06	-2,874.35	-10,448.88	0.28	0.28	-1,037.62
4	-18,864.38	24	12	12	50.00	799.60	2,331.45	-2,371.64	-5,673.45	0.34	0.34	-786.02
3	-14,629.49	24	11	13	45.83	983.38	1,904.75	-1,957.43	-8,395.18	0.50	0.43	-609.56
2	-16,589.97	24	6	18	25.00	924.84	1,737.55	-1,229.95	-5,164.42	0.75	0.25	-691.25
1	-15,932.65	24	6	18	25.00	651.62	1,990.25	-1,102.35	-4,980.56	0.59	0.20	-663.86

Just 4 instances failed to close below the entry price on either day 1 or day 2. All 4 continued higher and did not post a close below the entry price any time in the next month. The 4 instances took place on 7/18/94, 10/19/98, 10/2/01 & 10/18/13.

Obviously the last 2 days did not play out as they commonly have in the past. Which brings me to the note at the bottom of the study. This is now just the 5th time in 25 instances where SPX did not close lower on either of the next 2 days. In all 4 previous cases, SPX went at least a month without closing down below the trigger day low. This hints that the big drop in fear could act as a springboard and that the market rally could get further legs. Of course we are looking at a very low number of instances. The intermediate-term results are 4-0 so far, but that is not enough instances to base any decision on. Still, while not statistically significant, I thought it was interesting and perhaps worth pointing out.

The recent drop in the SPX was over 6% from high to low. While that does not seem very big, it is enough to put us to the bearish side of the Quantifiable Edges “Sell in May” study.

“Sell in May and go away” is based on the idea that the period of May – October has not done very well over time. Most of the market’s gains over the years have come during the November – April period.

So in the 4/29/13 letter I decided to look at this time period and filter it by whether the market has suffered a pullback at any point leading up to the end of April. To define “pullback” I started with a clean slate every year on January 1. The high of Jan 1 was the high for the year as of that date. Each time a new high was made I would measure pullback from the highest high to-date. I broke “Sell in May” down by years the SPX had a 5% pullback before May versus years it did not. Three-quarters of the time we have seen a 5% pullback. Let’s first look at times where there had been a pullback at some point before May.

<p>It is the last day of April. SPX has pulled back > 5% at some point this year. Buy on close. Sell close on last day of October. \$100k/trade. 1961 - present.</p>			
TradeStation Performance Summary			Collapse ^
All Trades			
Total Net Profit	(\$18,423.45)	Profit Factor	0.89
Gross Profit	\$144,585.97	Gross Loss	(\$163,009.42)
Total Number of Trades	39	Percent Profitable	56.41%
Winning Trades	22	Losing Trades	17
Even Trades	0		
Avg. Trade Net Profit	(\$472.40)	Ratio Avg. Win:Avg. Loss	0.69
Avg. Winning Trade	\$6,572.09	Avg. Losing Trade	(\$9,588.79)
Largest Winning Trade	\$19,918.60	Largest Losing Trade	(\$30,011.76)
<p>Avg Run-up: 8.1% Avg Drawdown: -10.6%</p>			
<p>15 of 39 years saw a drawdown of at least 10%, and 7 of them finished with a loss of greater than 10%.</p>			

Of the 39 years where this was the case, 15 of them saw the market drop more than 10% from its April closing price during the next 6 months. And 7 of them were more than 10% lower at the close of October. There were slightly more winning years than losing ones, but the losers were quite a bit bigger and the market has suffered substantial net losses during the May – October period for these 39 years. This year SPX will be faced with this scenario entering May.

Now let's look at times where the market has been strong through April and it has not experienced a 5% pullback at any point.

It is the last day of April. SPX has not pulled back > 5% from high of year so far this year.
Buy on close. Sell close on last day of October. \$100k/trade. 1961 - present.

TradeStation Performance Summary Collapse ^			
All Trades			
Total Net Profit	\$61,393.81	Profit Factor	7.48
Gross Profit	\$70,861.38	Gross Loss	(\$9,467.57)
Total Number of Trades	14	Percent Profitable	85.71%
Winning Trades	12	Losing Trades	2
Even Trades	0		
Avg. Trade Net Profit	\$4,385.27	Ratio Avg. Win:Avg. Loss	1.25
Avg. Winning Trade	\$5,905.12	Avg. Losing Trade	(\$4,733.78)
Largest Winning Trade	\$12,957.26	Largest Losing Trade	(\$9,350.64)

These stats look a LOT different. Twelve of fourteen years the market closed higher. And the profit factor was nearly 7.5! Let's take a closer look at the instances to learn a little more.

It is the last day of April. SPX has not pulled back > 5% from high of year so far this year.
Buy on close. Sell close on last day of October. \$100k/trade. 1961 - present.

Date/Time	Signal	Price	% Profit	Run-up Drawdown
04/28/61	Buy	\$65.31	5.07%	\$5,067.61
10/31/61	Sell	\$68.62		(\$1,377.90)
04/30/63	Buy	\$69.80	6.03%	\$6,701.76
10/31/63	Sell	\$74.01		(\$2,720.80)
04/30/64	Buy	\$79.46	6.80%	\$7,271.24
10/30/64	Sell	\$84.86		(\$1,031.56)
04/30/65	Buy	\$89.11	3.71%	\$3,814.80
10/29/65	Sell	\$92.42		(\$8,426.22)
04/28/67	Buy	\$94.01	(0.12%)	\$3,805.54
10/31/67	Sell	\$93.90		(\$5,931.54)
04/30/71	Buy	\$103.95	(9.35%)	\$0.00
10/29/71	Sell	\$94.23		(\$10,024.04)
04/28/72	Buy	\$107.67	3.63%	\$4,528.64
10/31/72	Sell	\$111.58		(\$2,719.04)
04/30/76	Buy	\$101.64	1.24%	\$6,084.77
10/29/76	Sell	\$102.90		(\$2,958.83)
04/30/85	Buy	\$179.83	5.56%	\$9,029.44
10/31/85	Sell	\$189.82		(\$850.68)
04/28/89	Buy	\$309.63	9.92%	\$16,357.60
10/31/89	Sell	\$340.36		(\$1,793.54)
04/28/95	Buy	\$514.71	12.98%	\$14,734.30
10/31/95	Sell	\$581.50		(\$325.92)
04/28/06	Buy	\$1,310.62	5.14%	\$5,991.08
10/31/06	Sell	\$1,377.94		(\$6,941.08)
04/30/12	Buy	\$1,397.91	1.02%	\$5,438.60
10/31/12	Sell	\$1,412.16		(\$9,313.07)
04/30/13	Buy	\$1,597.57	9.95%	\$11,014.30
10/31/13	Sell	\$1,756.54		(\$2,308.88)
Avg Run-up: 7.1% Avg Drawdown: -4.1%				

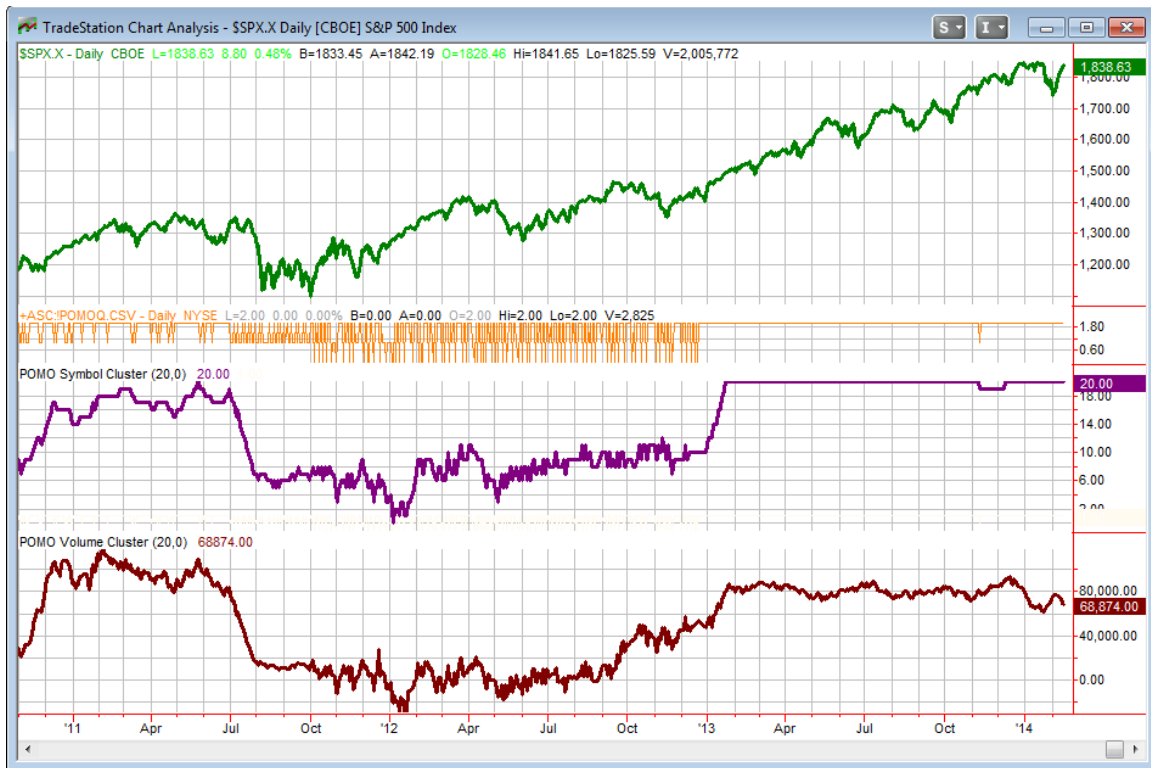
We see here that 1 of the 2 losses was only a decline of 0.1%. In other words, 1971 was the only bad year of the bunch. And even 1971 closed with a loss of less than 10%. In fact its max drawdown was almost exactly 10%, and NO other year saw a 10% drawdown. When May has come without a 5% pullback appears like 2013 that has been a good thing. Lastly, I also updated the table below from last year.

It is the last day of April. SPX has not pulled back > 5% from high of year so far this year. 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
240	131,410.10	13	12	1	92.31	11,072.08	31,936.64	-1,454.84	-1,454.84	7.61	91.33	10,108.47
220	113,898.15	13	11	2	84.62	11,083.76	31,536.32	-4,011.59	-6,048.47	2.76	15.20	8,761.40
200	124,723.65	14	12	2	85.71	10,810.18	28,469.50	-2,499.26	-4,113.81	4.33	25.95	8,908.83
180	113,863.02	14	13	1	92.86	8,800.13	16,511.34	-538.72	-538.72	16.34	212.36	8,133.07
160	108,877.51	14	13	1	92.86	8,686.73	19,828.74	-4,050.02	-4,050.02	2.14	27.88	7,776.97
140	73,326.06	14	11	3	78.57	7,844.14	15,374.50	-4,319.82	-10,678.20	1.82	6.66	5,237.58
120	59,908.65	14	13	1	92.86	5,222.56	14,109.62	-7,984.60	-7,984.60	0.65	8.50	4,279.19
100	57,540.05	14	13	1	92.86	4,831.68	13,979.64	-5,271.76	-5,271.76	0.92	11.91	4,110.00
80	34,232.13	14	9	5	64.29	4,654.17	10,159.10	-1,531.08	-3,415.10	3.04	5.47	2,445.15
60	14,713.80	14	7	7	50.00	5,217.08	8,999.66	-3,115.10	-5,935.54	1.67	1.67	1,050.99
40	-7,554.78	14	6	8	42.86	3,580.41	5,707.48	-3,629.66	-8,426.22	0.99	0.74	-539.63
20	2,477.60	14	8	6	57.14	2,378.55	4,359.04	-2,758.47	-4,649.79	0.86	1.15	176.97

The 1st 3-4 months (20-80 days) you seen pretty breakeven numbers, but once you get out further than that, gains have been strong and consistent, with 1971 being the lone fly in the ointment.

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 days indicator is still riding along at 20, where it spent most of 2013. The volume indicator dipped some this past week, and will be continuing to move at this lower level for a while. We estimate net inflows this past week to have been about \$13 billion. This is the lowest number in quite some time and the lowest expected for February. So the bulls currently do not have a strong short-term liquidity backdrop in which to press their gains further.

This upcoming week there are only 4 trading days, but there is about \$15 billion of inflows expected. So the liquidity backdrop should be improving as the week moves on and we get into next week. If the bears are going to make some noise, early this week could be an opportune time to do so.

On the whole, the outlook remains muddled. The leading Nasdaq remains a positive, as does the Golden Cross formation. But liquidity is no longer clearly bullish, and the NYSE New High % reading from the Study of Tops has been negatively diverging for some time. The VIX study above hints at a possible rally continuation, and the “Sell in May” study suggests it could be a tough summer (but we don’t need to worry about that yet). So I am keeping my eyes and options open. I am willing to trade both sides of the market, though neither with great aggressiveness since I no longer have strong intermediate-term conviction.

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 [numbered systems 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 – Sell Short ¼ index position at \$184.40 LIMIT ON OPEN – if not filled on open, cancel order and then Short \$184.10 LIMIT ON CLOSE AS LONG AS SPX DOES NOT CLOSE ABOVE 1848.38 (which would mean a breakout to a new high). This is based on the short-term outlook above. If I can short into a gap-up open or if I can short an up close Tuesday (that is not a breakout), then I will look to take advantage of the bearish indications we are seeing.

Current Open Trade Ideas

None

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