

QUANTIFIABLE EDGES SUBSCRIBER LETTER

ASSESSING MARKET ACTION WITH INDICATORS AND HISTORY

March 3, 2014

Volume 7 Issue 41

Market Overview



Signals Overview

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

Tonight's Research Points

- Turn of the month has not been reliably bullish when the market is already overbought.
- SPX made another new high this past week but the % of stocks making new highs is still diverging badly.
- The "February Barometer" suggests the next 11 months should be good (though I don't have much confidence in it).
- Fed liquidity flows are going to be front-loaded in March.
- Despite tapering, the increase in the Fed's SOMA account has continued at nearly the same pace.

Short-term Outlook

The Bottom Line

Same as the last few days. Still no resolution to the neutral Aggregator. Evidence still points up, but the SPX is overbought. I'm awaiting a pullback to get long or some bearish evidence if I am going to short.

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 28, 2014	SPX low vol breajout	1-5 days	Bullish	
February 25, 2014	SPY breakaway gap	1-5 days	Bullish	1.70%
February 20, 2014	SPX 20-high then close bottom 10% rng	1-8 days	Bullish	2.00%
Active - Long Term				
February 20, 2014	SPX key reversal after 10-high	1-11 days	Bullish	2.30%
December 23, 2013	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	

The Evidence

The market had a bit of a wild ride on Friday, and ended up with mixed numbers. The SPX rose 0.3%, but the Nasdaq fell 0.3% and the Russell 2000 lost 0.4%. Breadth was positive as the NYSE Up Issues % came in at 60% and the Up Volume % was 58%. Total NYSE volume hit the highest level of the week.

The compelling Quantifinder studies that triggered on Friday afternoon were all related to turn of the month seasonality. Typically, the 1st day of the month has been a good one for the bulls when SPX has been in a long-term uptrend. But the current setup shows a bit of a short-term overbought condition, and this has dampened gains. There were a few studies that exemplified this. I'll look back at some of the more intriguing ones. They look at 1) having 3 consecutive up days going into month end, and 2) finishing the last day in the upper half of the daily range.


In the 9/1/11 letter I looked at instances in which SPX had closed higher for 3 days in a row versus instances where it did not heading into a new month. But I did not use a long-term trend filter in those results. Subsequent research has taught me that the 1st of the month has been much more bullish when SPX is above its 200-day moving average than when it has been below it. So I have added the 200ma filter to the below tests. First let's look at time where SPX has not closed up for 3 days.

It is the last trade day of the month. SPX has NOT closed up 3 days in a row. SPX > 200ma. Buy on close. Sell next day's close. \$100k/trade. 1990 - present.

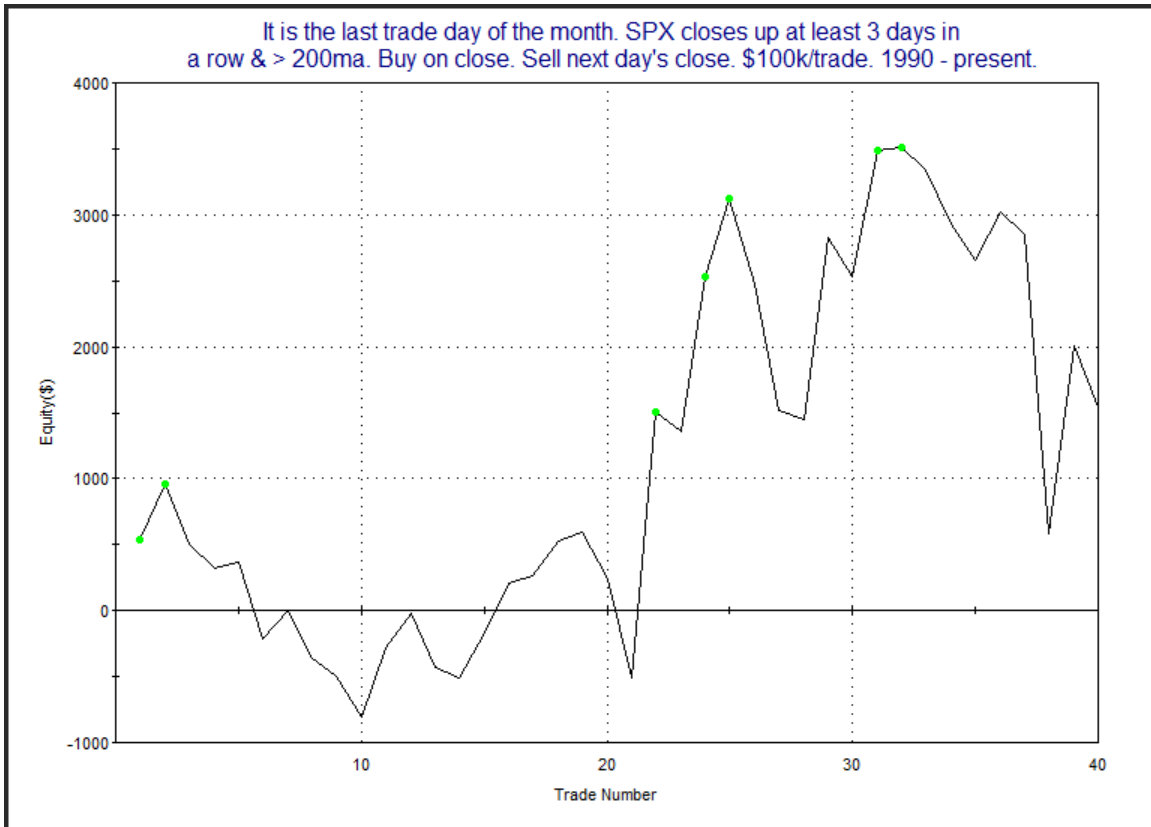
TradeStation Performance Summary Collapse 			
All Trades			
Total Net Profit	\$60,713.42	Profit Factor	2.84
Gross Profit	\$93,747.87	Gross Loss	(\$33,034.45)
Total Number of Trades	169	Percent Profitable	67.46%
Winning Trades	114	Losing Trades	55
Even Trades	0		
Avg. Trade Net Profit	\$359.25	Ratio Avg. Win:Avg. Loss	1.37
Avg. Winning Trade	\$822.35	Avg. Losing Trade	(\$600.63)
Largest Winning Trade	\$3,119.10	Largest Losing Trade	(\$2,617.60)

As you can see, numbers here are strong with over 2/3 of the instances closing higher and winners on average larger than the losers. The average day saw a gain of more than 0.35%.

Now let's look at times like now where there has been a 3-day run.

TradeStation Performance Summary Collapse 			
All Trades			
Total Net Profit	\$1,537.55	Profit Factor	1.16
Gross Profit	\$11,043.30	Gross Loss	(\$9,505.75)
Total Number of Trades	40	Percent Profitable	47.50%
Winning Trades	19	Losing Trades	21
Even Trades	0		
Avg. Trade Net Profit	\$38.44	Ratio Avg. Win:Avg. Loss	1.28
Avg. Winning Trade	\$581.23	Avg. Losing Trade	(\$452.65)
Largest Winning Trade	\$2,015.52	Largest Losing Trade	(\$2,268.10)

Here it appears the edge is gone. Slightly more instances have closed lower, though there has been a small amount of net gains. These numbers don't look tradable. Here is the profit curve.



This does not look any better.

The next study is one from the 7/31/13 letter. It looked at all 1st days of the month and broke them down by whether the previous day closed in the top or bottom half of the daily range. First let's look at times the market closed in the bottom half of its range on the last day of the month.

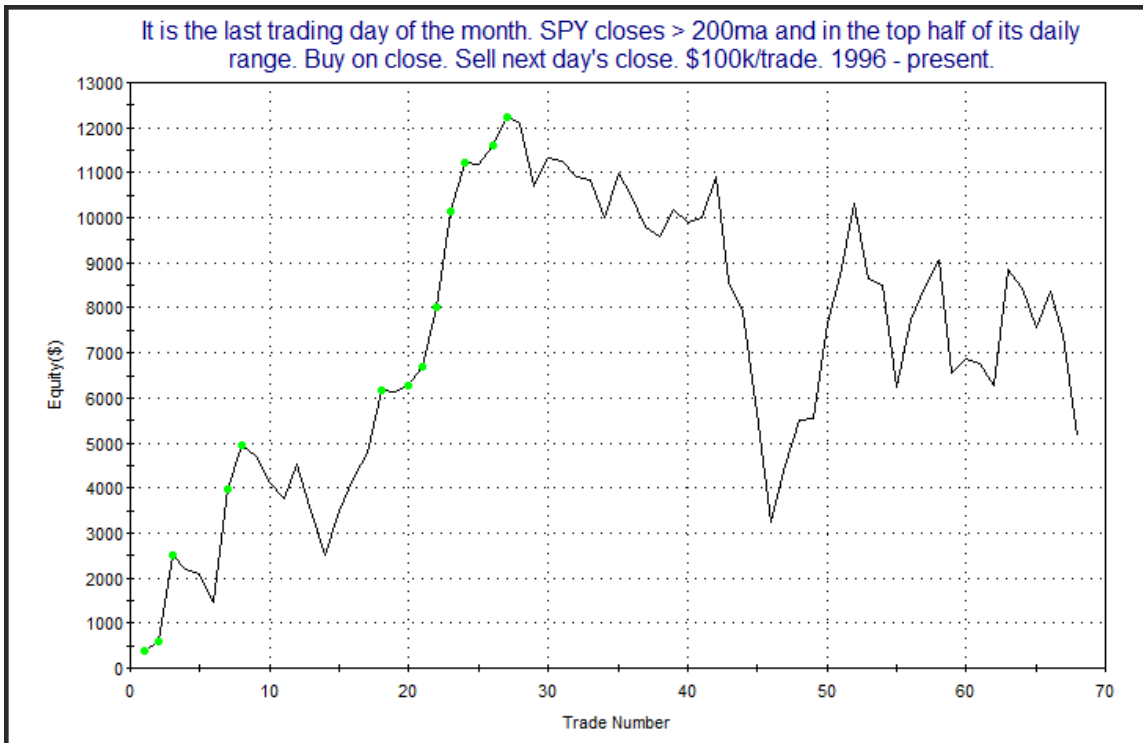
It is the last trading day of the month. SPY closes > 200ma and in the bottom half of its daily range. Buy on close. Sell next day's close. \$100k/trade. 1996 - present.

TradeStation Performance Summary			
All Trades			
Total Net Profit	\$59,678.16	Profit Factor	15.63
Gross Profit	\$63,755.94	Gross Loss	(\$4,077.78)
Total Number of Trades	84	Percent Profitable	84.52%
Winning Trades	71	Losing Trades	13
Even Trades	0		
Avg. Trade Net Profit	\$710.45	Ratio Avg. Win:Avg. Loss	2.86
Avg. Winning Trade	\$897.97	Avg. Losing Trade	(\$313.68)
Largest Winning Trade	\$3,295.88	Largest Losing Trade	(\$885.28)

The stats here are phenomenal. Gains absolutely blow away losses in every category. Gross gains are over 15x the size of gross losses. And the average win is actually bigger than the largest loss. That's an incredible stat when you are looking at a sample size of 84 instances. But SPY closed in the upper half of its range on Saturday. So let's look at the implications of that finish.

TradeStation Performance Summary			
All Trades			
Total Net Profit	\$5,149.68	Profit Factor	1.18
Gross Profit	\$33,293.99	Gross Loss	(\$28,144.31)
Total Number of Trades	68	Percent Profitable	50.00%
Winning Trades	34	Losing Trades	34
Even Trades	0		
Avg. Trade Net Profit	\$75.73	Ratio Avg. Win:Avg. Loss	1.18
Avg. Winning Trade	\$979.23	Avg. Losing Trade	(\$827.77)
Largest Winning Trade	\$2,562.30	Largest Losing Trade	(\$2,515.60)

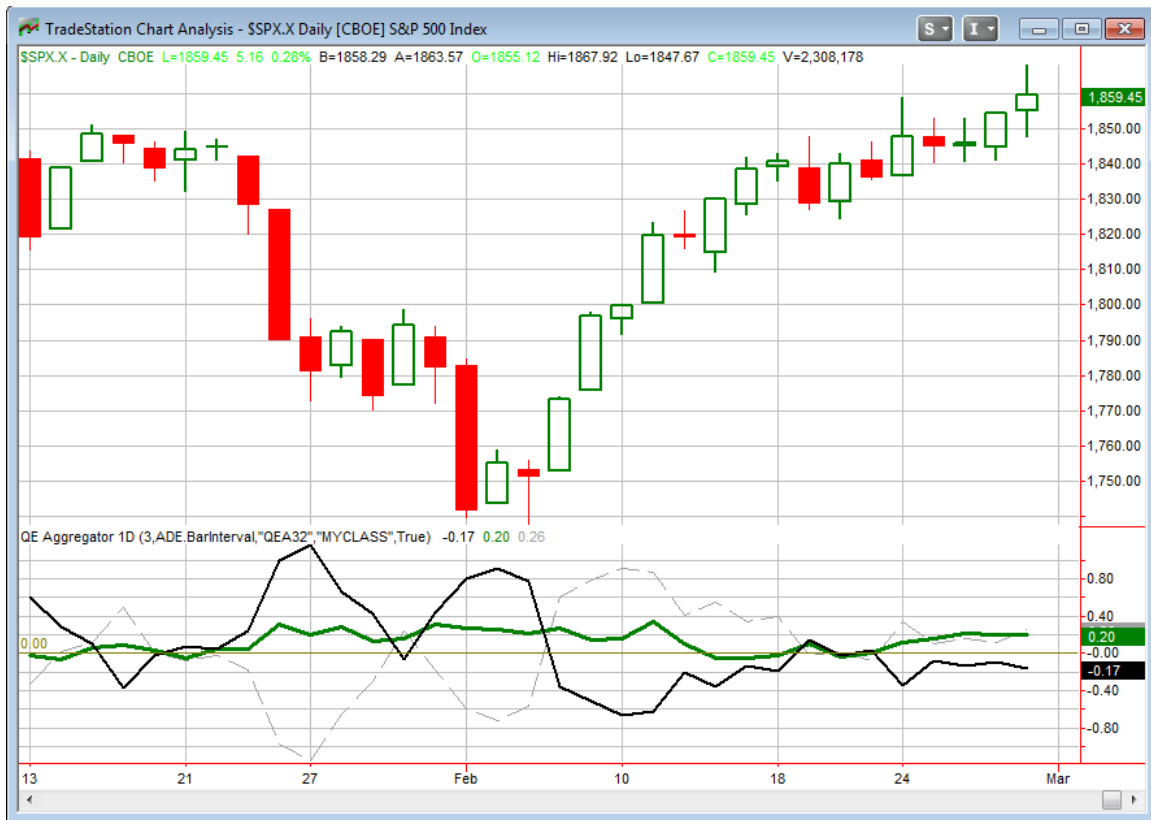
Similar to the 3-day up study, we see here the upside edge nearly completely wiped away. Here is a picture of the profit curve.



This paints an even bleaker picture.

So I am not viewing the turn of the month as a particularly strong setup this time. This leaves us without anything new to add to the short-term Active List tonight.

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



Without anything new being added the green Aggregator Line tonight moved sideways and remained 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 below 0. 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. Therefore the Aggregator signal remained flat.

Based on the current open studies, expectations are slated to remain positive on Monday. Of course this could change if new bearish evidence emerges. The Differential Pivot will be 1853.90 on Monday. That is 0.3% below Friday's close. So it won't take too much of a decline on Monday to move SPX from overbought to oversold.

The short-term outlook has been the same for the last few days. Evidence continues to point higher but the market is quite overbought. So I still don't like risk/reward. I plan to remain patient until a substantial edge with favorable risk/reward emerges.

Intermediate-term Outlook (2 weeks – 2 months) – updated 3/3 – slightly bullish

The SPX put in solid gains this week and closed on Friday at a new all-time high. So the bull remains in force and momentum is to the upside.

In the 2/3 Letter I examined the “January Barometer”. Below is a partial excerpt.

The January Barometer is a fairly famous study from the Stock Traders Almanac. It says that “as goes January, so goes the year”. In other words, a positive January will typically lead to a positive year, while a negative January can be a warning. So, as I did in the 2/2/09 letter, let’s look at how the SPX has done for the remaining 11 months of the year based on how January performed.

SPX finishes January positive. Buy close of month. Sell on close end of December. \$100k/trade. 1961- present.			
TradeStation Performance Summary			Collapse ^
All Trades			
Total Net Profit	\$343,785.59	Profit Factor	8.46
Gross Profit	\$389,846.70	Gross Loss	(\$46,061.11)
Total Number of Trades	33	Percent Profitable	84.85%
Winning Trades	28	Losing Trades	5
Even Trades	0		
Avg. Trade Net Profit	\$10,417.75	Ratio Avg. Win:Avg. Loss	1.51
Avg. Winning Trade	\$13,923.10	Avg. Losing Trade	(\$9,212.22)
Largest Winning Trade	\$30,848.12	Largest Losing Trade	(\$15,908.89)

The numbers show that in years that January has done well, the rest of the year has typically fared well also.

Of course January closed down, and the forward 11-month implications for that were basically neutral. When I ran that test I also looked at other months. What I found was that a strong February actually predicted a strong next 11 months better than any other month. Below are the February results.

SPX finishes February positive. Buy close of month.
 Sell on close at the end of January. \$100k/trade. 1961 - present.

TradeStation Performance Summary Collapse ^			
All Trades			
Total Net Profit	\$299,842.12	Profit Factor	13.35
Gross Profit	\$324,125.46	Gross Loss	(\$24,283.34)
Total Number of Trades	28	Percent Profitable	85.71%
Winning Trades	24	Losing Trades	4
Even Trades	0		
Avg. Trade Net Profit	\$10,708.65	Ratio Avg. Win:Avg. Loss	2.22
Avg. Winning Trade	\$13,505.23	Avg. Losing Trade	(\$6,070.84)
Largest Winning Trade	\$30,469.15	Largest Losing Trade	(\$9,519.12)

The numbers here aren't massively better than January, but if you like using a month as a "barometer", February appears to be your best bet. And the edge has been even stronger since 1988. Below is the list of instances over the more recent time period.

SPX finishes February positive. Buy close of month.
Sell on close at the end of January. \$100k/trade. 1961 - present.

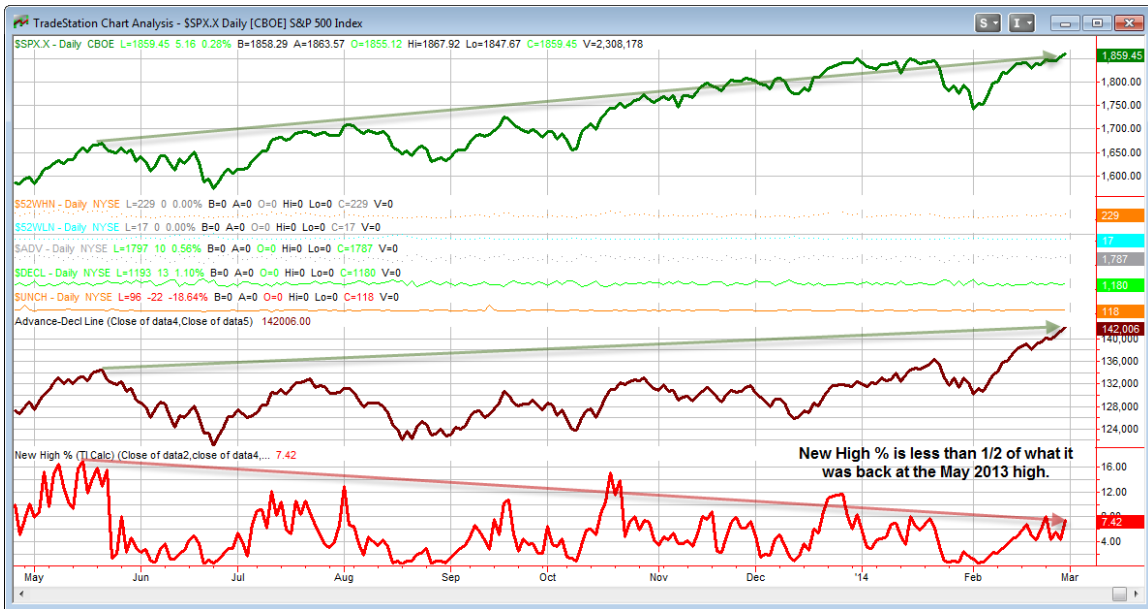
Date/Time	Signal	Price	% Profit
02/29/88	Buy	\$267.82	11.07%
01/31/89	Sell	\$297.46	
02/28/91	Buy	\$367.07	11.36%
01/31/92	Sell	\$408.78	
02/28/92	Buy	\$412.69	6.32%
01/29/93	Sell	\$438.78	
02/26/93	Buy	\$443.37	8.62%
01/31/94	Sell	\$481.61	
02/28/95	Buy	\$487.38	30.50%
01/31/96	Sell	\$636.01	
02/29/96	Buy	\$640.43	22.76%
01/31/97	Sell	\$786.16	
02/28/97	Buy	\$790.82	23.96%
01/30/98	Sell	\$980.28	
02/27/98	Buy	\$1,049.34	21.95%
01/29/99	Sell	\$1,279.64	
02/27/04	Buy	\$1,144.94	3.17%
01/31/05	Sell	\$1,181.26	
02/28/05	Buy	\$1,203.60	6.35%
01/31/06	Sell	\$1,280.08	
02/28/06	Buy	\$1,280.66	12.30%
01/31/07	Sell	\$1,438.24	
02/26/10	Buy	\$1,104.49	16.44%
01/31/11	Sell	\$1,286.12	
02/28/11	Buy	\$1,327.22	(1.12%)
01/31/12	Sell	\$1,312.40	
02/29/12	Buy	\$1,365.68	9.70%
01/31/13	Sell	\$1,498.11	
02/28/13	Buy	\$1,514.68	17.69%
01/31/14	Sell	\$1,782.59	

As you can see, 2011 was the only recent loser, with 14 of 15 leading to gains over the next 11 months.

This is not a study I plan to rely on for establishing a market bias. I view this more as an academic exercise. A few reasons for this: 1) I don't like the way the test was developed. I did not start with a reasonable premise and test it. I data-mined to find the best month. This approach does not give me confidence in the results. Some month is bound to be best, and it could be nothing more than random noise. 2) I see no reason that February's results should be predictive of the next 11 months. You could argue that momentum at this time of year may carry through nicely, but I think that is a poor explanation. I suspect this study is only slightly better than the Super Bowl indicator or the Sports Illustrated Swimsuit Cover indicator.

But there are some intermediate-term indications to remain aware of.

The bad news is that the NYSE New High % continues to diverge, as it has since July. This can be seen on the chart below, which I copied from the QE charts page.



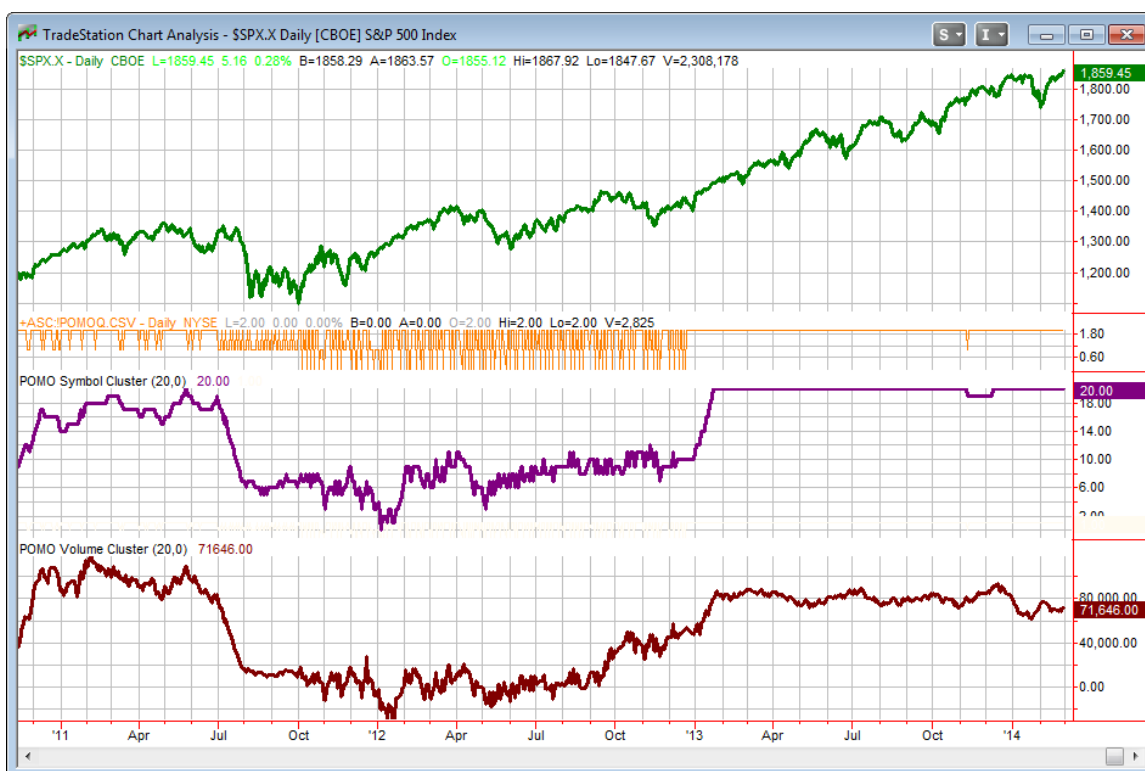
In fact, not only is the New High % diverging, it posted a number that was less than 50% of the May level. That is a substantial difference. And as I discussed in the Study of Tops and have reiterated here a number of times, the divergent New High % is a condition that has preceded every major SPX decline since 1970.

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 9 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 % rallies 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 it. For now it remains highly divergent. So the rally is occurring with fewer and fewer stocks making new highs. And from this point it will likely take quite a bit of work to get the New High % back to the May level.

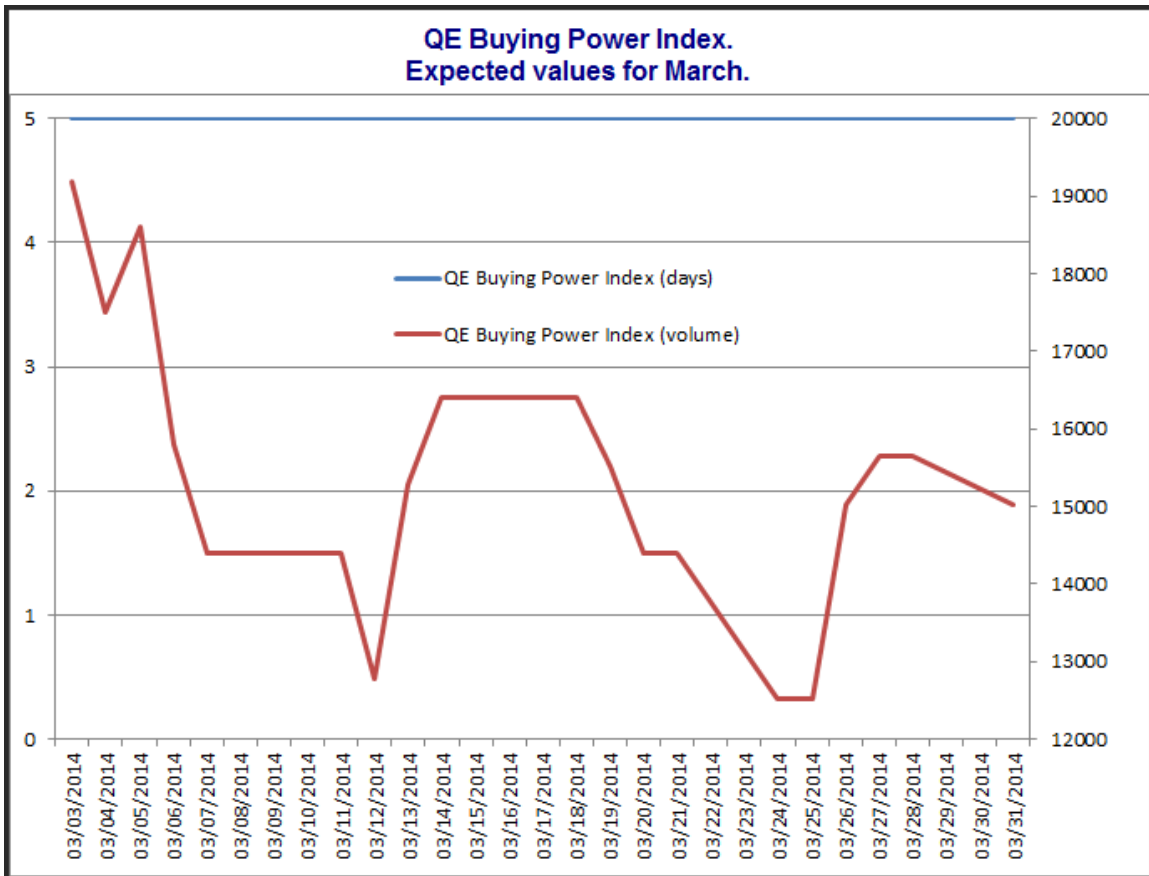
I update the intermediate-term POMO/QE chart each week. For those not familiar, below is a brief description.

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.



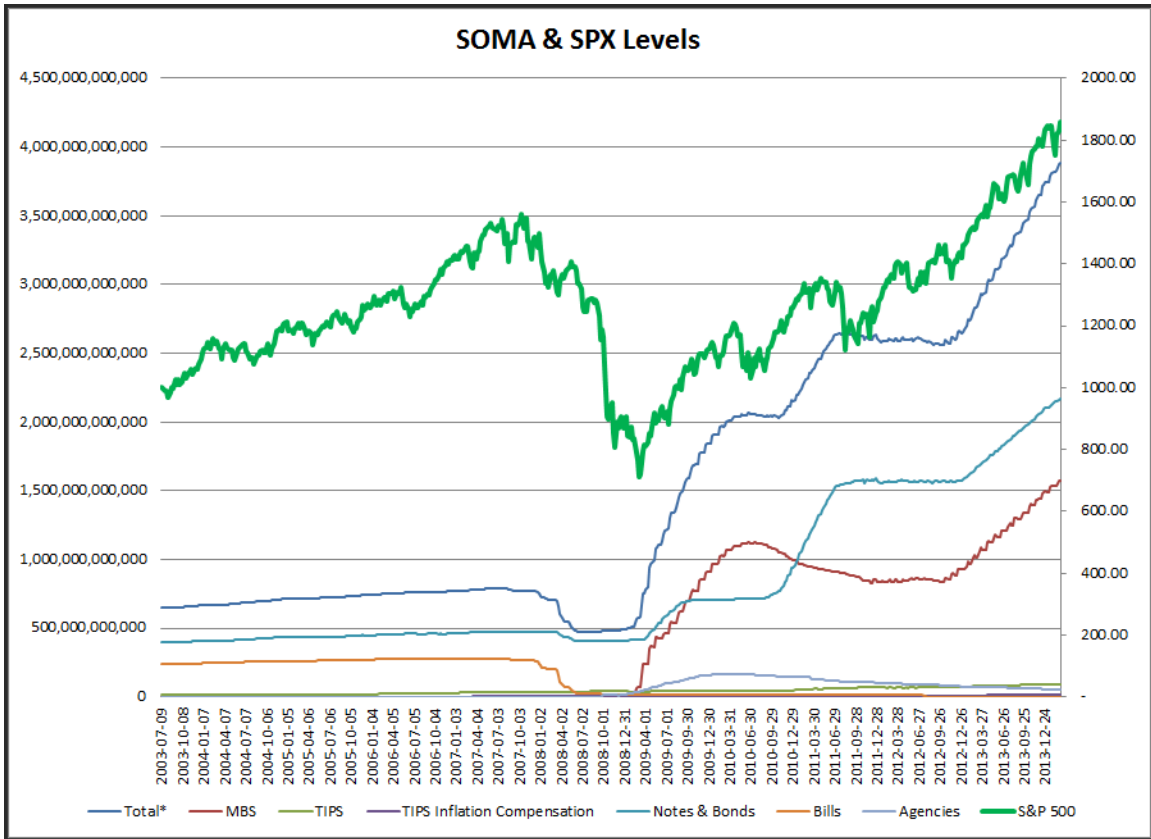
The POMO/AMBS days indicator is still riding along at 20, where it spent most of 2013. The volume indicator is now bumping along at its lowered level. We estimate net inflows this past week to have been about \$19.4 billion. This is a pretty sizable amount, and as you’ll see below, higher than we are likely to see for most of March.

On Friday the Fed released their buying schedule for March. I used it to generate the projected QE Buying Power levels for the month. This chart can also be seen on the [QE Buying Power Index Information page](#) on the website.



Liquidity is strong at the moment, and that should continue for the next week or so, but after this week, we are going to see an extended period of relatively low liquidity infusions. The next Fed meeting is set to conclude on March 19th, and we will find out at that time if they intend to taper further or whether they will hold firm at the current level of \$65 billion/month.

The chart below is one I have shown a number of times in the past. It shows the Fed's System Open Market Account (SOMA). SOMA is the account where all of the purchases the Fed does are held. SPX movement has been highly correlated with increases and decreases in this account over the years. The chart goes back to 2003, because that is as far back as the data is available on the Fed's website.



What's interesting here is that although the Fed has begun tapering the amounts, this has had almost no discernible impact on the slope of the SOMA total holdings (blue line). As long as this line is heading higher at (or near) this rate, liquidity will have to be looked at as at least somewhat positive.

On the whole, the outlook remains a bit muddled. The leading Nasdaq remains a positive, as does the Golden Cross formation. Liquidity appears bullish, but not the level we saw in 2013. On the bearish side the NYSE New High % reading from the Study of Tops has been negatively diverging for some time. I remain willing to trade both sides of the market, but I will probably favor the long side a bit more than shorts for the time being.

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.

None tonight.

Current Open Trade Ideas

None

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