

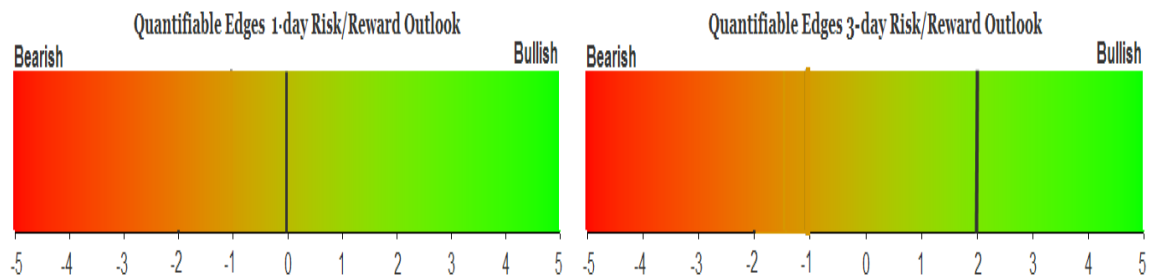
# QUANTIFIABLE EDGES SUBSCRIBER LETTER

ASSESSING MARKET ACTION WITH INDICATORS AND HISTORY

September 2, 2014

Volume 7 Issue 164

## Market Overview



## Signals Overview

| Aggregator | Aggressive VIX | QE Buy Pwr Swing |
|------------|----------------|------------------|
| Long       | 100% Long XIV  | Flat             |

## Tonight's Research Points

- Ending the month at a high has often led to more highs early in the next month.
- 10 days above the 5ma and a new 10-day high suggest the market is due for a brief pullback.
- Labor Day week has often struggled when the market has been strong leading up to it.

## *Short-term Outlook*

### *The Bottom Line*

SPX is not overbought versus expectations and the short-term evidence is still leaning bullish. I believe there is a small upside edge here, but after such an extended move up I'd prefer a bit of a pullback before I start getting long.

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

| Study Date                 | Description                          | Time span | Bias    | Avg Run-up | Avg DrawDn | Avg DrawDn -1 Std Dev |
|----------------------------|--------------------------------------|-----------|---------|------------|------------|-----------------------|
| <b>Active - Short Term</b> |                                      |           |         |            |            |                       |
| September 2, 2014          | End of month at high of month        | 1-5 days  | Bullish | 2.10%      | -1.00%     | -2.30%                |
| September 2, 2014          | 10 days > 5ma & 10-day high          | 1-2 days  | Bearish |            |            |                       |
| September 2, 2014          | Labor Day week after 4-week rise     | 1-4 days  | Bearish | -1.50%     | 1.20%      | 2.20%                 |
| <b>Active - Long Term</b>  |                                      |           |         |            |            |                       |
| August 22, 2014            | 50-low to 50-high in 2 weeks         | 1-17 days | Bullish | 5.40%      | 0.90%      | -1.90%                |
| August 20, 2014            | SPX RSI(2) crosses over 99           | 1-15 days | Bullish | 2.40%      | -1.50%     | -2.90%                |
| June 2, 2014               | NASDAQ leading SPX                   | int term  | Bullish |            |            |                       |
| April 28, 2014             | Sell in May                          | 6 months  | Bearish |            |            |                       |
| December 23, 2013          | QE Tapering                          | int term  | Neutral |            |            |                       |
| July 22, 2013              | New High Divergence (Study of Tops)  | int term  | Bearish |            |            |                       |
| February 1, 2012           | Golden Cross                         | int term  | Bullish |            |            |                       |
| <b>Dropped Tonight</b>     |                                      |           |         |            |            |                       |
| August 4, 2014             | CBI >= 11.                           | 1-20 days | Bullish | 4.00%      |            |                       |
| August 11, 2014            | 4-high after 20-low > 200ma          | 1-19 days | Bullish | 3.80%      | -1.90%     | -4.20%                |
| August 30, 2014            | Fri before Labor Day bullish         | 1 day     | Bullish |            |            |                       |
| August 27, 2014            | 2 unfilled gaps up & a 50-day high   | 1-3 days  | Bullish | 0.90%      | -0.65%     | -1.25%                |
| August 27, 2014            | SPY up but in bottom 10% daily range | 1-3 days  | Bullish | 1.30%      | -0.50%     | -0.90%                |

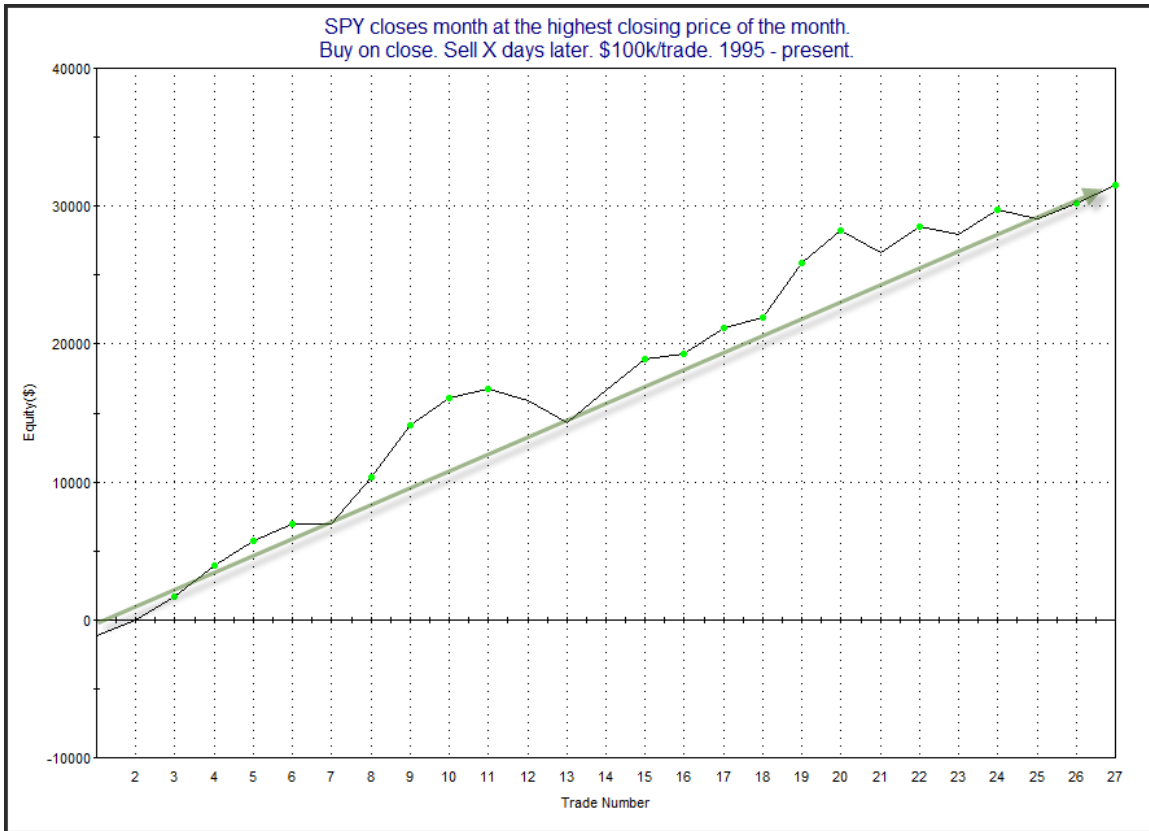
**The Evidence**

The market put in some solid numbers and new highs again on Friday. The SPX finished up 0.3%, the NASDAQ gained 0.5% and the Russell 2000 rose 0.7%. Breadth was strong as the NYSE Up Issues % came in at 70% and the Up Volume % was 71%. Total NYSE volume rose from Thursday's level.

Turn of the month often triggers some seasonal studies. This one examined other times SPY closed at its highest level of the month on the last day of the month. It was last seen in the 6/2/14 letter. Results suggested strong end of month momentum has typically carried through into the following month. I have updated the results below.

| SPY closes month at the highest closing price of the month.<br>Buy on close. Sell X days later. \$100k/trade. 1995 - 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  | 35,455.86       | 27                | 19                  | 8                  | 70.37             | 2,491.49               | 5,238.84               | -1,485.30             | -4,159.04             | 1.68                | 3.98              | 1,313.18       |
| 9   | 34,295.02       | 27                | 18                  | 9                  | 66.67             | 2,449.86               | 4,455.36               | -1,089.16             | -3,178.47             | 2.25                | 4.50              | 1,270.19       |
| 8   | 29,002.57       | 27                | 20                  | 7                  | 74.07             | 2,091.63               | 4,879.68               | -1,832.87             | -2,884.75             | 1.14                | 3.26              | 1,074.17       |
| 7   | 27,430.50       | 27                | 18                  | 9                  | 66.67             | 2,033.26               | 4,366.26               | -1,018.69             | -2,519.04             | 2.00                | 3.99              | 1,015.94       |
| 6   | 31,278.97       | 27                | 19                  | 8                  | 70.37             | 2,095.32               | 6,355.08               | -1,066.51             | -2,024.57             | 1.96                | 4.67              | 1,158.48       |
| 5   | 31,559.96       | 27                | 20                  | 6                  | 74.07             | 1,899.41               | 3,931.92               | -1,071.36             | -1,659.68             | 1.77                | 5.91              | 1,168.89       |
| 4   | 25,671.97       | 27                | 18                  | 9                  | 66.67             | 2,001.16               | 5,394.96               | -1,149.88             | -4,338.40             | 1.74                | 3.48              | 950.81         |
| 3   | 16,083.39       | 27                | 18                  | 9                  | 66.67             | 1,562.41               | 4,105.92               | -1,337.78             | -4,678.40             | 1.17                | 2.34              | 595.68         |
| 2   | 10,886.18       | 27                | 16                  | 11                 | 59.26             | 1,351.34               | 3,954.78               | -975.93               | -4,848.40             | 1.38                | 2.01              | 403.19         |
| 1   | 4,525.25        | 27                | 14                  | 13                 | 51.85             | 869.06                 | 1,850.94               | -587.81               | -1,049.76             | 1.48                | 1.59              | 167.60         |

The numbers across the board are quite compelling. And while most of the edge is realized week one, there even appears to be some follow through into week two. Below is an equity curve showing results assuming a 5-day holding period.



The steady upslope supports the bullish hypothesis suggested by the stats table.

But the next study, from the 3/3/14 letter throws a little cold water on day 1. It looked at all 1<sup>st</sup> 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 trading range. Buy on close. Sell next day's close. \$100k/trade. 1996 - present.

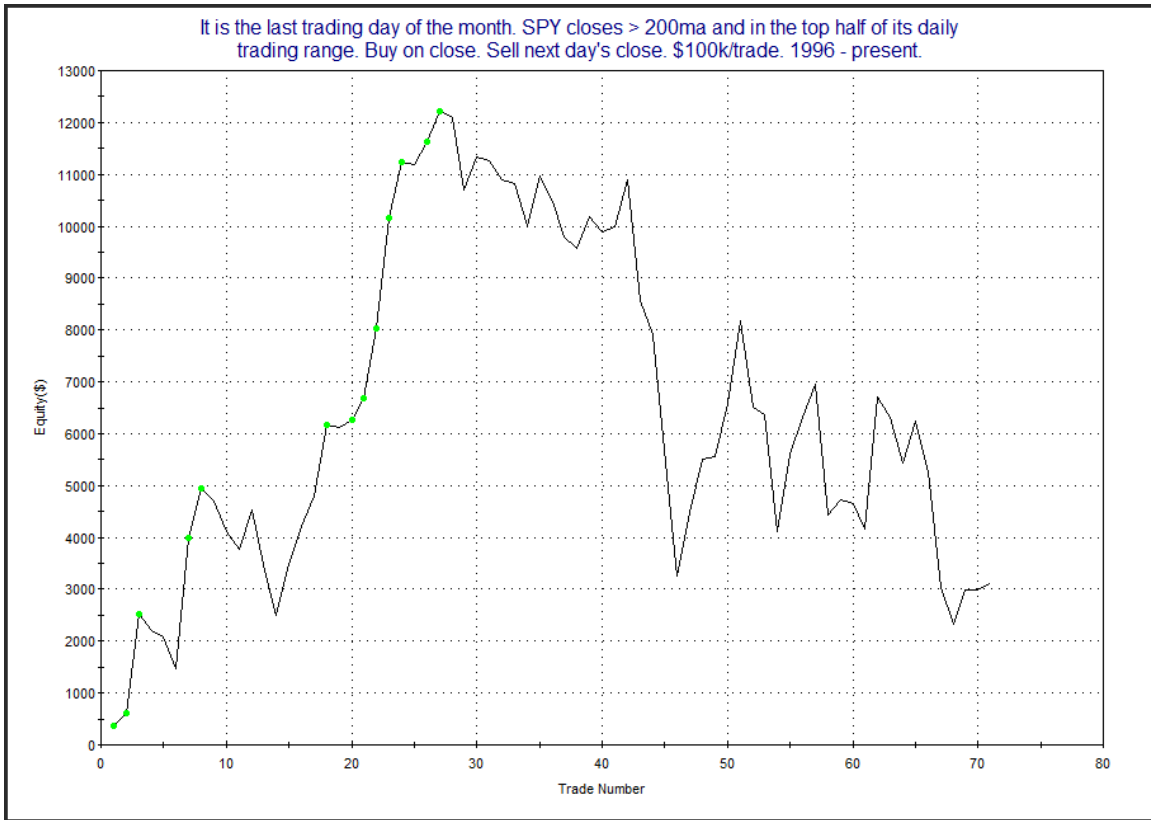
| TradeStation Performance Summary <span style="float: right;">Collapse ^</span> |             |                          |              |
|--|-------------|--------------------------|--------------|
| All Trades   |             |                          |              |
| Total Net Profit   | \$62,165.59 | Profit Factor            | 15.18        |
| Gross Profit   | \$66,548.40 | Gross Loss               | (\$4,382.81) |
| Total Number of Trades   | 87          | Percent Profitable       | 83.91%       |
| Winning Trades   | 73          | Losing Trades            | 14           |
| Even Trades  | 0           |                          |              |
| Avg. Trade Net Profit  | \$714.55    | Ratio Avg. Win:Avg. Loss | 2.91         |
| Avg. Winning Trade   | \$911.62    | Avg. Losing Trade        | (\$313.06)   |
| 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 87 instances. But SPY closed in the upper half of its range on Friday. So let's look at the implications of that finish.

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

| TradeStation Performance Summary <span style="float: right;">Collapse ^</span> |             |                          |               |
|--|-------------|--------------------------|---------------|
| All Trades   |             |                          |               |
| Total Net Profit   | \$3,104.59  | Profit Factor            | 1.11          |
| Gross Profit   | \$31,951.06 | Gross Loss               | (\$28,846.47) |
| Total Number of Trades   | 71          | Percent Profitable       | 50.70%        |
| Winning Trades   | 36          | Losing Trades            | 35            |
| Even Trades  | 0           |                          |               |
| Avg. Trade Net Profit  | \$43.73     | Ratio Avg. Win:Avg. Loss | 1.08          |
| Avg. Winning Trade   | \$887.53    | Avg. Losing Trade        | (\$824.18)    |
| Largest Winning Trade  | \$2,562.30  | Largest Losing Trade     | (\$2,515.60)  |

We see here the upside edge nearly completely wiped away. Here is a picture of the profit curve.



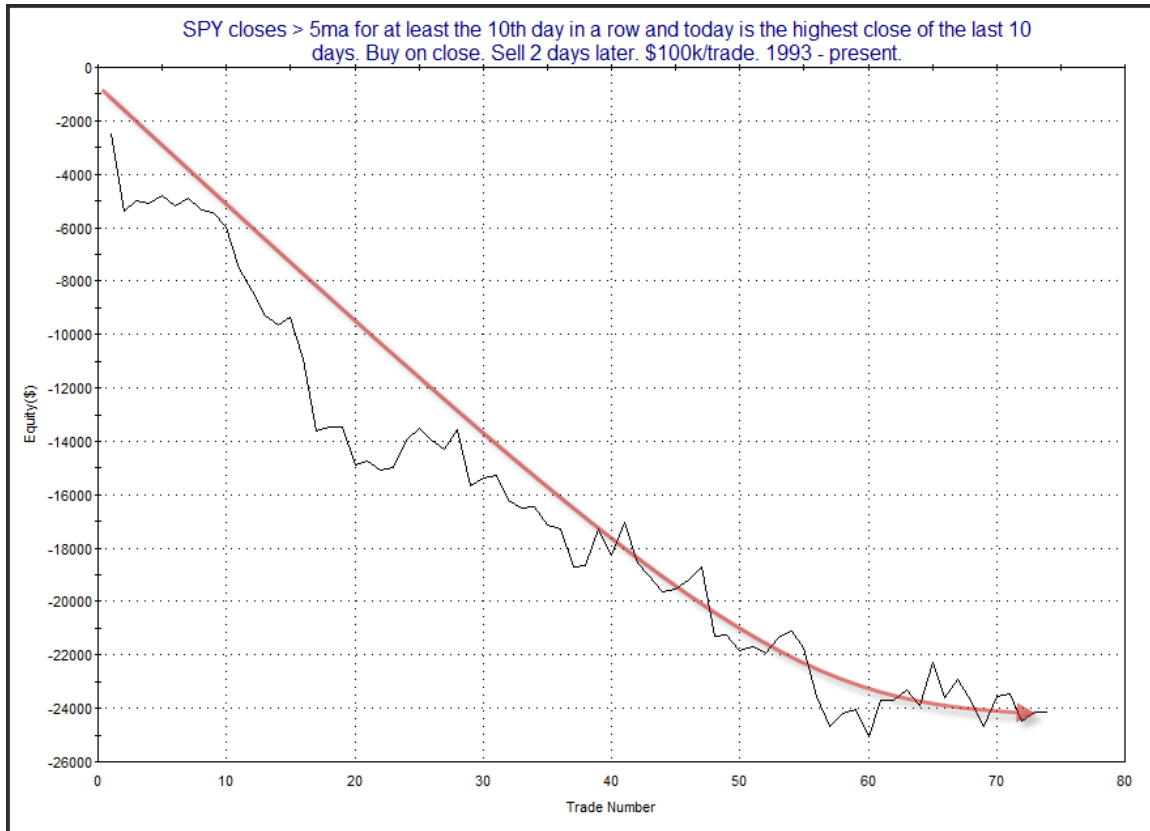
This paints an even bleaker picture. So it appears Friday's action may have set us up for further buying this upcoming week, but not necessarily on Tuesday.

SPY has now gone 16 days without closing below its 5ma. The study below was last seen just a few days ago in the 8/26/14 subscriber letter. It looks at other instances in which the market traded above the 5ma for at least 2 weeks and closed at a 10-day high. It triggered again and I have updated the results.

SPY closes > 5ma for at least the 10th day in a row and today is the highest close of the last 10 days. Buy on close. Sell X days later. \$100k/trade. 1993 - 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      | -12,339.49      | 48                | 26                  | 22                 | 54.17             | 714.77                 | 2,516.52               | -1,405.62             | -4,014.40             | 0.51                | 0.60              | -257.07        |
| 4      | -18,146.10      | 53                | 22                  | 31                 | 41.51             | 685.68                 | 1,428.90               | -1,071.97             | -3,723.20             | 0.64                | 0.45              | -342.38        |
| 3      | -18,193.87      | 62                | 26                  | 36                 | 41.94             | 643.19                 | 1,790.80               | -969.91               | -3,235.65             | 0.66                | 0.48              | -293.45        |
| 2      | -24,117.66      | 74                | 34                  | 39                 | 45.95             | 449.52                 | 1,608.38               | -1,010.29             | -2,870.40             | 0.44                | 0.39              | -325.91        |
| 1      | -21,420.65      | 105               | 46                  | 59                 | 43.81             | 328.44                 | 1,361.25               | -619.13               | -2,817.32             | 0.53                | 0.41              | -204.01        |

In the past this setup has commonly been followed by a short-term pullback. The downside edge doesn't last long, though. This too seems to pretty much play itself out over the first 2 days. Below is an equity curve showing how the edge has evolved over time. It uses a 2-day exit strategy.

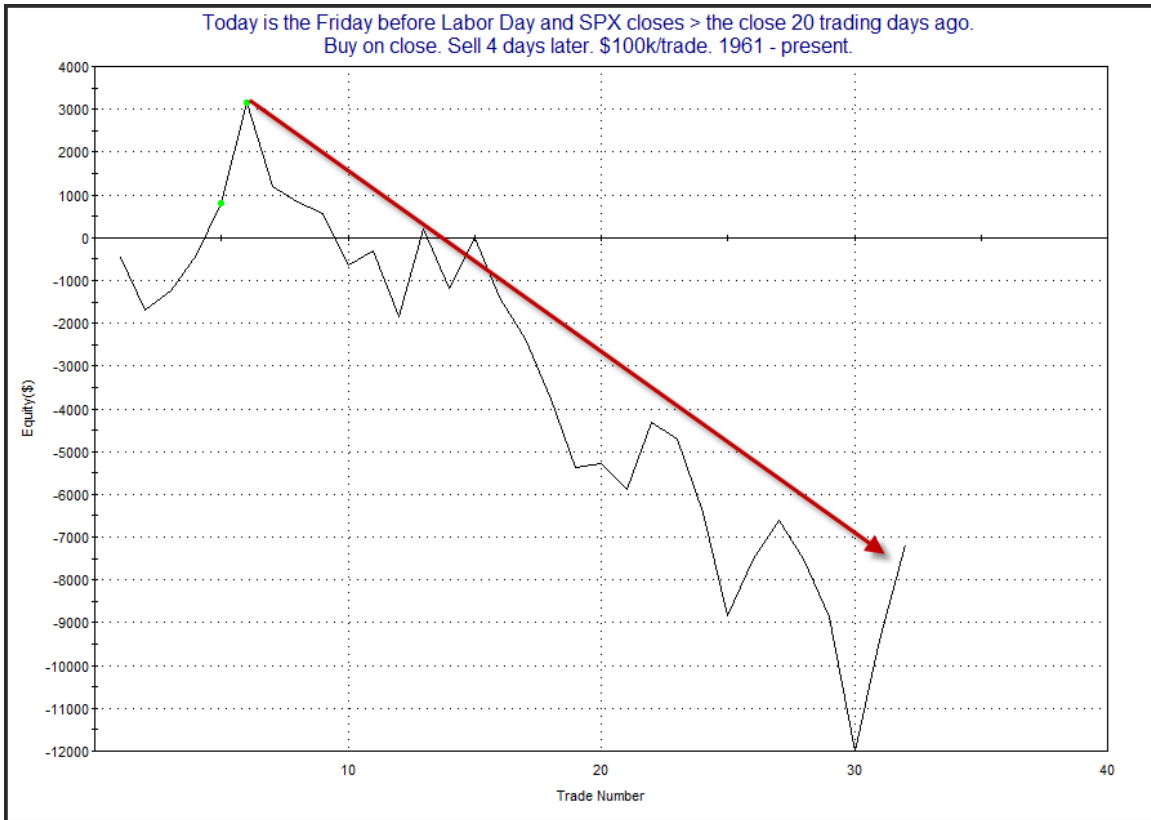


The line may be flattening out a bit here, but I think it is too soon to throw away this study. It has generally headed from upper left to lower right for a long time and certainly appears worthy of consideration. I have added this study to the Active List tonight. I will note further that 16 days above the 5ma is exceptionally long and has only been matched 4 other times. The longest any streak has lasted was 19 days. That occurred 3 times. Those streaks ended on 2/23/98, 1/8/04, and 7/23/13. None made it to 20 days.

Last year in the 9/3/13 letter I showed that Labor Day week performance has often been poor when the market has rallied over the month (20 trading days) leading up to it. Below is a look at Labor Day week performance when the previous 4-week period has seen gains.

| Today is the Friday before Labor Day and SPX closes > the close 20 trading days ago.<br>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 |
| 4  | -7,188.21       | 32                | 13                  | 19                 | 40.63             | 1,315.32               | 2,580.34               | -1,278.28             | -3,113.11             | 1.03                | 0.70              | -224.63        |
| 3  | -4,777.06       | 32                | 17                  | 15                 | 53.13             | 1,042.93               | 2,718.52               | -1,500.45             | -4,024.28             | 0.70                | 0.79              | -149.28        |
| 2  | -5,743.59       | 32                | 13                  | 18                 | 40.63             | 1,055.30               | 3,047.41               | -1,081.25             | -2,678.02             | 0.98                | 0.70              | -179.49        |
| 1  | -4,207.11       | 32                | 17                  | 15                 | 53.13             | 631.48                 | 1,745.28               | -996.15               | -4,147.45             | 0.63                | 0.72              | -131.47        |

This shows the poor performance record when there has been a rise in the market. Below is a look at the profit curve using a 4-day exit strategy.



Definitely choppy. And the last couple of instances have seen gains during the week of Labor Day. But the overall downslope and evidence still has me including this, as I think it is worth some consideration. (A strongly bullish performance this year could change my mind for the future, though.)

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



With the new studies being added tonight the green Aggregator Line managed to hold slightly above 0. Positive readings mean net expectations from the Active List are for upside over the next few days. Meanwhile the black Differential Line also held just above 0. The positive Differential Line reading means the SPX is oversold versus recent expectations. So expectations are positive and the SPX is now oversold. This is considered a bullish configuration. Bullish configurations are visible on the chart whenever both lines close above 0. Therefore the Aggregator signal turned long at the close.

Expectations are set to remain positive on Tuesday. Of course this could easily change if bearish new studies emerge. The Differential Pivot will be 2006.77 on Tuesday. That is 0.2% above Friday's close. So for SPX to move from oversold to overbought it is going to need to close up at least 0.1%.

It's quite unusual for SPX to be "oversold" while at a new all-time high. But that simply means that over the last few days it has not risen quite as much as expected based on the studies we had active. There still appears to be a bit of an upside edge. But with the market having gone so long without a pullback, and also at new highs, risk appears elevated. I'd prefer to see a bit of a pullback before taking on new long positions.

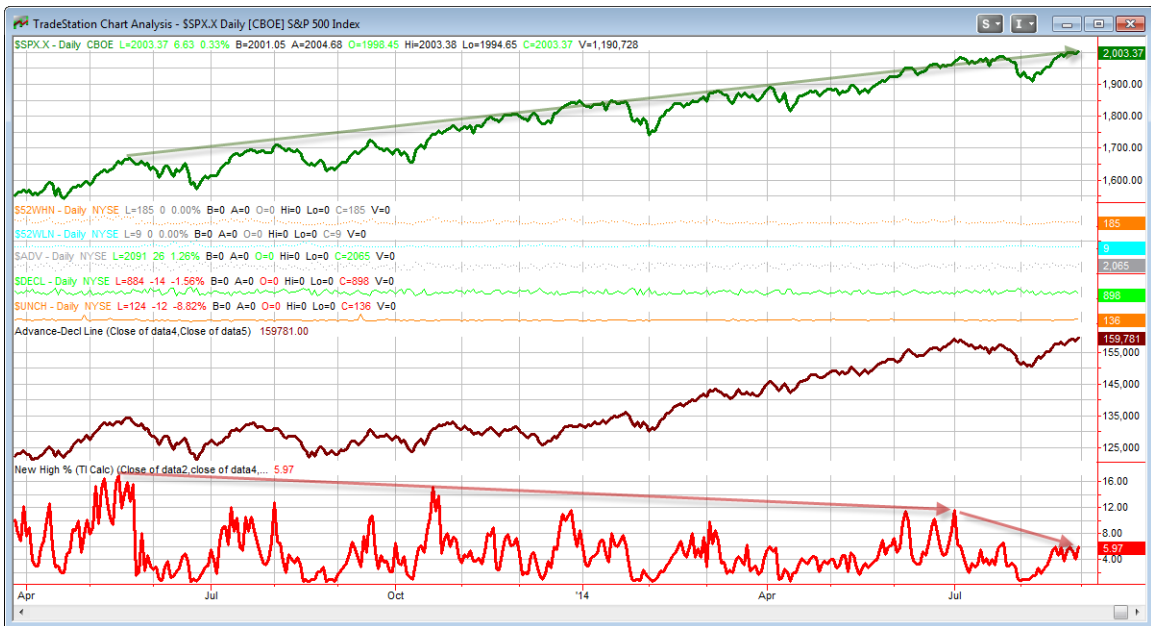
**Intermediate-term Outlook (2 weeks – 2 months) – updated 9/2– slightly bullish**

| Combo #1 | Combo #2 | Combo #3 |
|----------|----------|----------|
| Flat     | Long     | Long     |

Above is the status of the different Combination Signals from the Quantifiable Edges Market Timing Course. Signals are long-term in nature. All 3 can be either flat or long. None of them look to short. More information on these signals can be found in the [Quantifiable Edges Market Timing Course](#), which is included with all annual subscriptions. Detailed descriptions of these combination approaches can be found in [Lesson 8](#). Subscribers may also download detailed hypothetical historical performance reports covering 1/1/71 – 3/7/14 in [Lesson 11, Course Downloads](#). (You must go through the course first in order to access the Downloads.)

Another week of gains was put in as the SPX rose and again made new all-time highs. But with trading mostly quiet, no new intermediate-term studies emerged. But that doesn't mean there is nothing to discuss.

For one, despite the new highs this week, the number of stocks hitting new 52-week highs came in very low. This keeps the divergence in place that we have noted for over a year now. This can be seen on the chart below, which is similar to the one found on the QE charts page.



In fact, not only is the New High % diverging, it is still extremely far below the May 2013 level. And as I discussed in the Study of Tops ([available for Gold & Silver subscribers on the special reports downloads page](#)) and have reiterated here a number of

times, the divergent New High % is a condition that has preceded every major SPX decline since 1970.

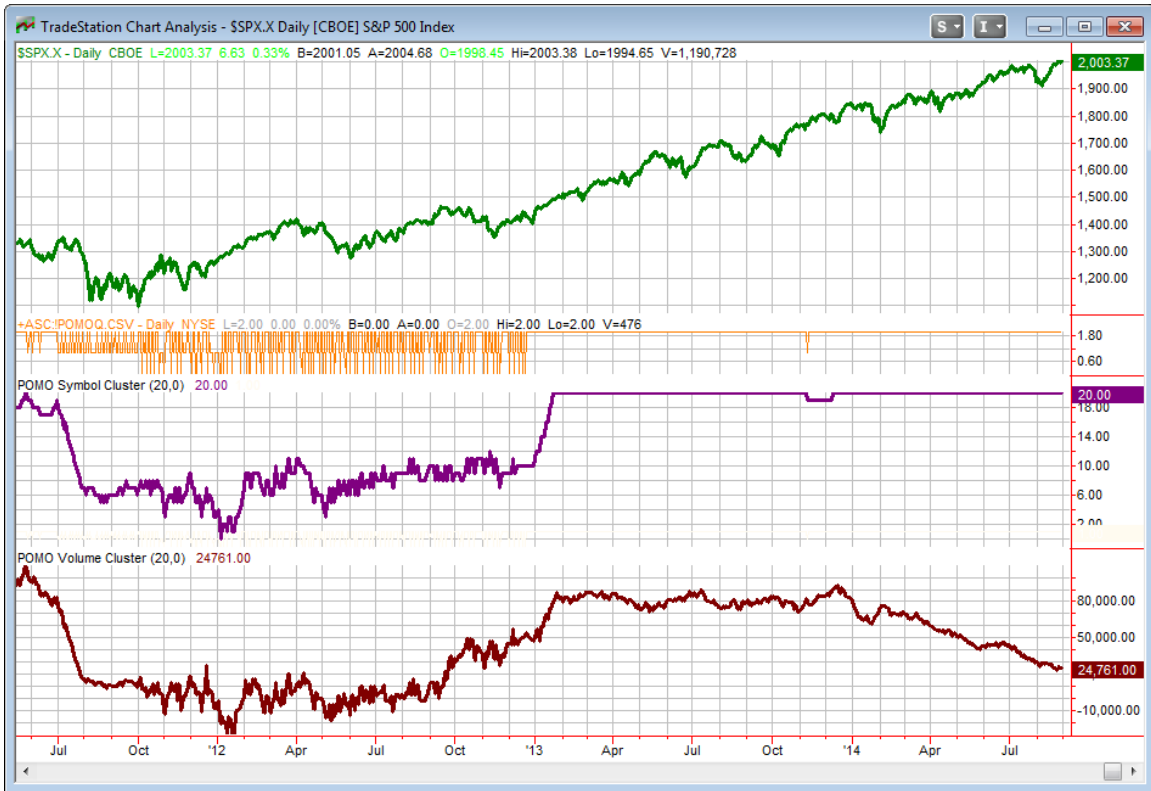
This opens up the possibility of a major top being put in. Note I said possibility, not probability. It needs to be understood that while the narrowing of New Highs and/or the turn down in the Advance/Decline Line has been a prerequisite for a top to take place, these breadth conditions have not been 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 over a year 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 2013 level, or even levels we saw earlier this summer.

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.*

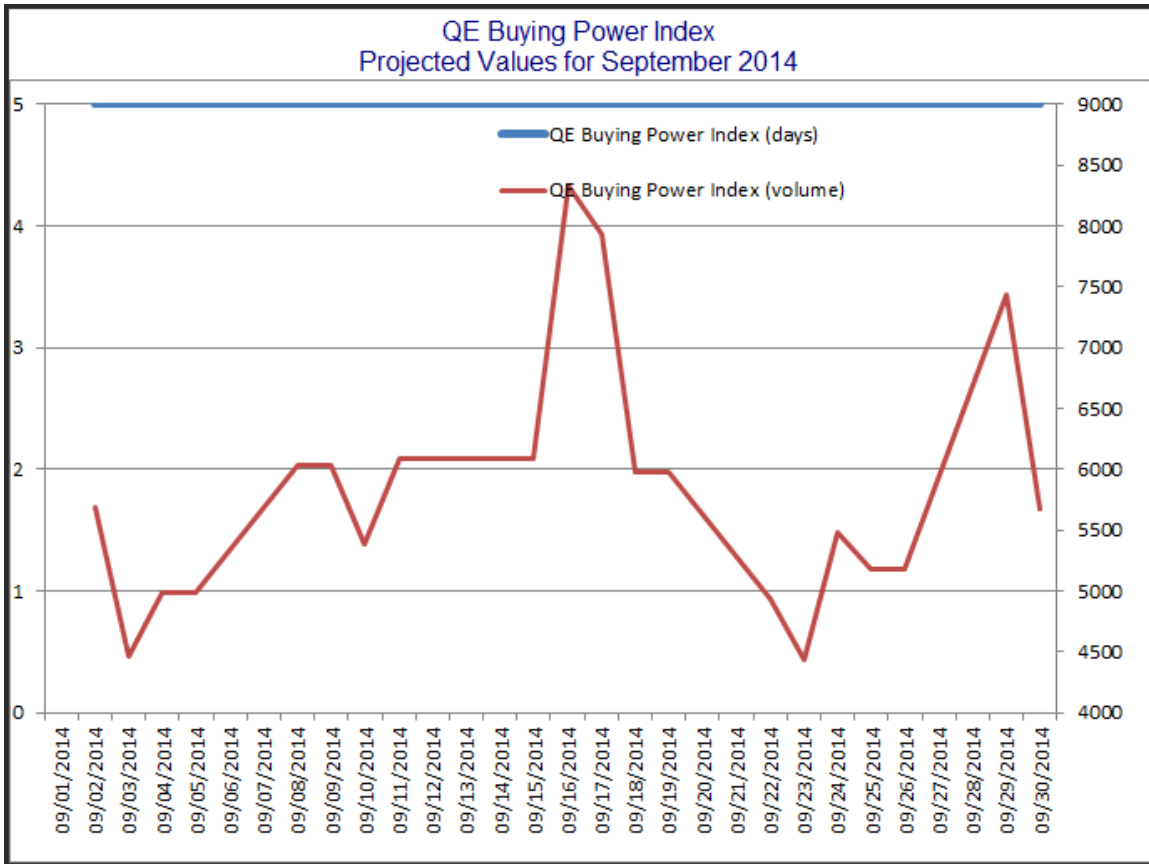
*The top pane is the S&P 500. The middle (purple) pane is the net rolling number of days in the last 20 that have been POMO days. In other words, a day the Fed buys on the market will add +1 while a day of selling will count as -1. The bottom pane is the total amount of money infused into (or taken out 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 and 2014 so far. The volume indicator is continuing to head lower since purchase amounts continue to be tapered. We estimate net inflows this past week to have been about \$5.7 billion. That is a little lower than last week and again near the low end of levels we have seen in recent months.

Buying levels this week are expected to be an extremely low \$4.5 billion. While it is a shortened week, this is still very low. If the bears are going to take an opportunity to sell down the market a bit, this could be a good time coming up.

With the Fed posting their September buying schedule on Friday, I have produced the projected values for September below (and to the QE Buying Power Index Page).



As you can see, the lowest values of the month are on 9/3 and 9/23. The days following these low-volume POMO flow periods would be the most opportune times for bears to gain an advantage from a liquidity standpoint. So late this upcoming week or early next week I would not be surprised if we saw a bit of a pullback.

Overall, the total evidence still seems to be leaning bullish. The leading NASDAQ is still providing a plus. The market is still above long-term moving averages, and momentum studies look bullish. So the bulls have some things in their favor. The bears are still banking on the shrinking New High % divergence and the weak seasonality (and at some point in the next few months the lack of Fed stimulus.) No change for me again this week. I am keeping my outlook at slightly bullish, and I will use some caution on both sides of the market, but will continue to favor longs over shorts.

## **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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