

# QUANTIFIABLE EDGES SUBSCRIBER LETTER

ASSESSING MARKET ACTION WITH INDICATORS AND HISTORY

November 3, 2014

Volume 7 Issue 208

## Market Overview



## Signals Overview

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

## Tonight's Research Points

- Ending the month at a high has often led to more highs early in the next month.
- SPY's strong (unfilled) gap up, high volume and close below the open appears to be bullish for the next few days.
- We are entering the 3<sup>rd</sup> year of the Presidential Cycle and the Best 6 Months from a seasonal standpoint. That has been a very bullish combination historically.
- The Fed has ended quantitative easing. The market has struggled since 2003 any time the Fed has not been pumping.

## *Short-term Outlook*

### *The Bottom Line*

Same as the last few days. Expectations are bullish but the market is still overbought. I am neutral and waiting for a better setup before jumping back in.

**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>						
November 3, 2014	End of month at high of month	1-5 days	Bullish	2.10%	-1.00%	-2.30%
November 3, 2014	SPY unfill gap 20-high. Close < open.	1-3 days	Bullish	1.15%	-0.50%	-0.90%
October 31, 2014	Gap up reverse. Gap dn reverse 10-high	1-2 days	Bearish			
October 31, 2014	10 days > 5ma. 10-day high	1-2 days	Bearish			
October 22, 2014	FTD low vol strong breadth	1-10 days	Bullish	4.10%	-2.80%	-4.30%
<b>Active - Long Term</b>						
November 3, 2014	Best 6 Months	6 months	Bullish			
November 3, 2014	Quantitative Easing Ends	int term	Bearish			
October 30, 2014	VXO > 15% < 10ma 3 days thn no drop	1-20 days	Bullish	3.50%	-0.70%	-1.30%
October 27, 2014	NASDAQ leading SPX	int term	Bullish			
October 14, 2014	CBI >= 11	1-20 days	Bullish			
October 9, 2014	20-day low then 4-day high	1-19 days	Bullish	2.40%	-1.30%	-2.50%
September 4, 2014	SPX 20-day high. NDX biggest loss in 20	1-50 days	Bullish	6.50%	-2.70%	-5.10%
July 22, 2013	New High Divergence (Study of Tops)	int term	Bearish			
February 1, 2012	Golden Cross	int term	Bullish			
<b>Dropped Tonight</b>						
October 22, 2014	Follow Through Day on Strong Breadth	int term	Bullish			
October 28, 2014	Tues-Fri after 4th Fri in October	1-4 days	Bullish			
April 28, 2014	Sell in May	6 months	Bearish			

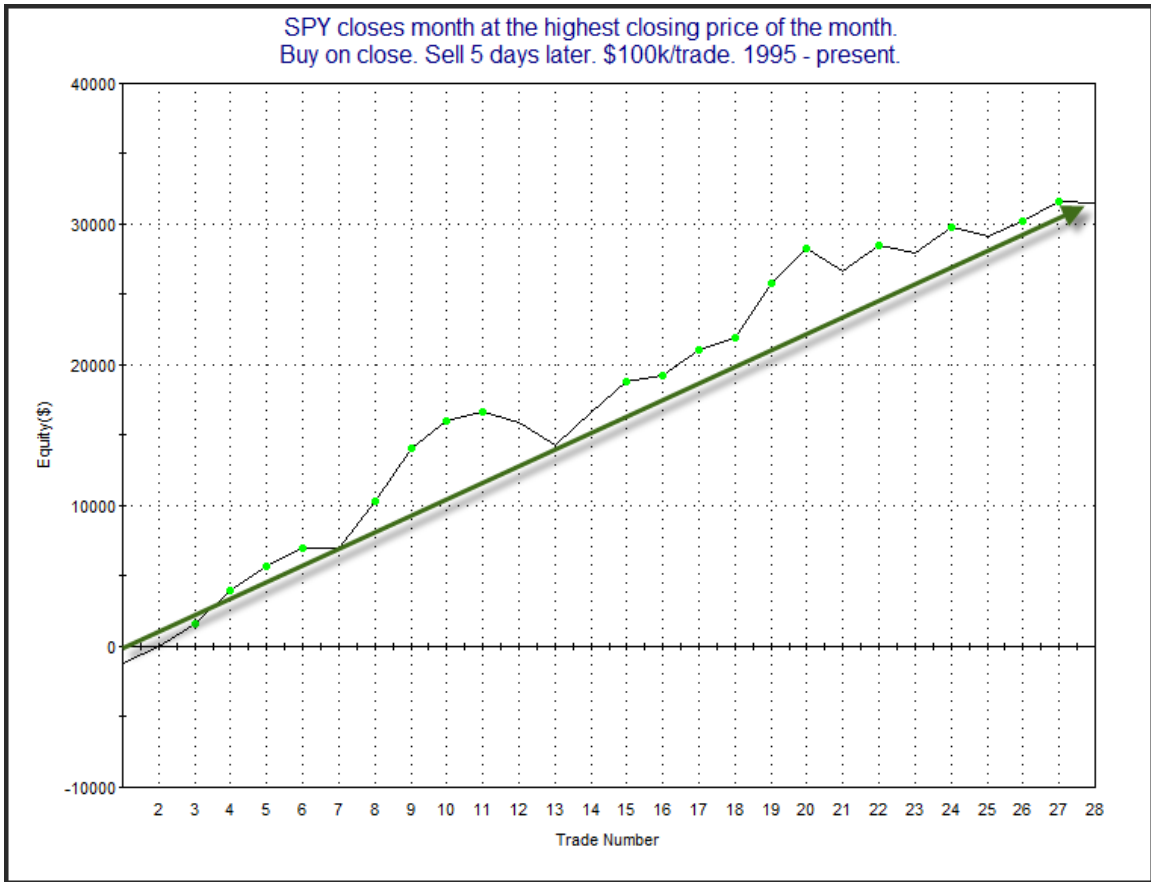
**The Evidence**

Friday was another strong day for the market, leaving some indices at new highs. The SPX rose 1.2%, the NASDAQ gained 1.4% and the Russell 2000 rallied 1.5%. Breadth was positive as the NYSE Up Issues % came in at 76% and the Up Volume % was 81%. Total NYSE volume rose substantially from the levels of the last few days.

Turn of the month often triggers some seasonal studies. The one below examined 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. 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: Profit Factor	All: Avg Trade
5	31,500.20	28	20	7	71.43	1,899.41	3,931.92	-926.85	-1,659.68	2.05	5.86	1,125.01
4	25,871.17	28	19	9	67.86	1,906.32	5,394.96	-1,149.88	-4,338.40	1.66	3.50	923.97
3	15,834.39	28	18	10	64.29	1,562.41	4,105.92	-1,228.90	-4,678.40	1.27	2.29	565.51
2	10,781.60	28	16	12	57.14	1,351.34	3,954.78	-903.32	-4,848.40	1.50	1.99	385.06
1	4,475.45	28	14	14	50.00	869.06	1,850.94	-549.38	-1,049.76	1.58	1.58	159.84

The numbers across the board are quite compelling. 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, also from the 6/2/14 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.

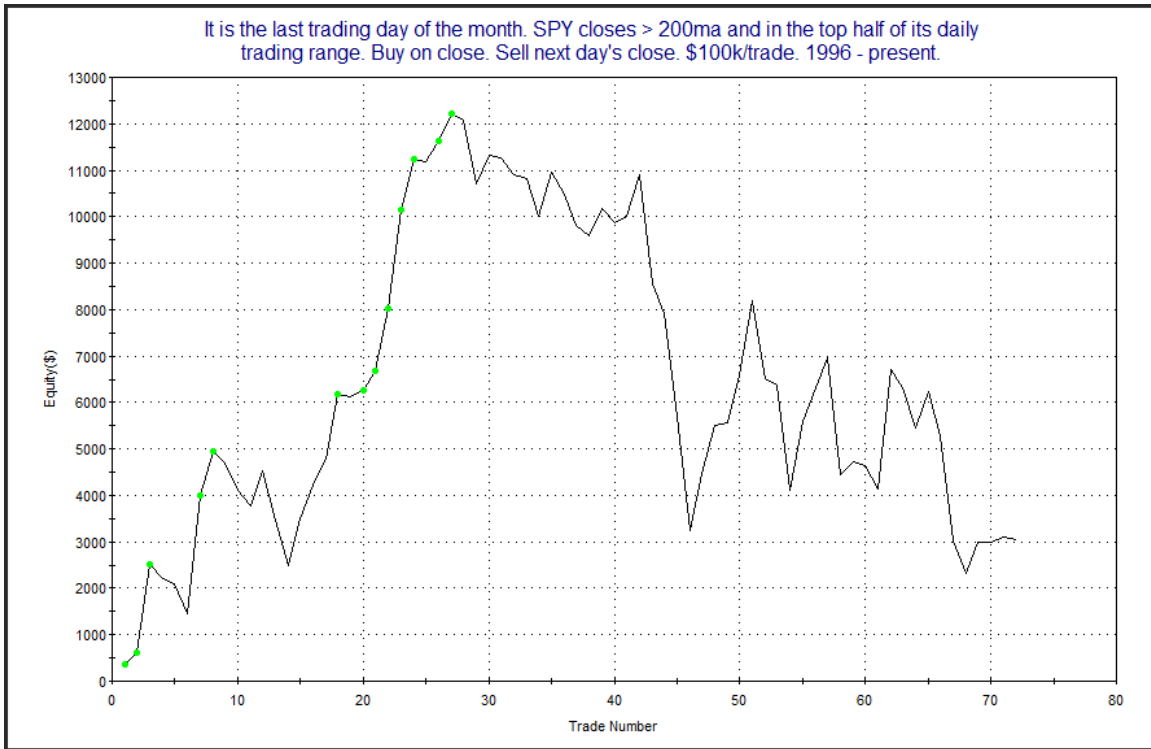
It is the last trading day of the month. SPY closes > 200ma and in the bottom half of its daily trading range. Buy on close. Sell next day's close. \$100k/trade. 1996 - present.

TradeStation Performance Summary <span style="float: right;">Collapse ▲</span>			
All Trades			
Total Net Profit	\$60,811.90	Profit Factor	11.60
Gross Profit	\$66,548.40	Gross Loss	(\$5,736.50)
Total Number of Trades	88	Percent Profitable	82.95%
Winning Trades	73	Losing Trades	15
Even Trades	0		
Avg. Trade Net Profit	\$691.04	Ratio Avg. Win:Avg. Loss	2.38
Avg. Winning Trade	\$911.62	Avg. Losing Trade	(\$382.43)
Largest Winning Trade	\$3,295.88	Largest Losing Trade	(\$1,353.69)

The stats here are very, very strong. Gains blow away losses in every category. Gross gains are over 11x the size of gross losses. But SPY closed in the upper half of its range on Friday. So let's look at the implications of that finish.

TradeStation Performance Summary <span style="float: right;">Collapse ▲</span>			
All Trades			
Total Net Profit	\$3,054.79	Profit Factor	1.11
Gross Profit	\$31,951.06	Gross Loss	(\$28,896.27)
Total Number of Trades	72	Percent Profitable	50.00%
Winning Trades	36	Losing Trades	36
Even Trades	0		
Avg. Trade Net Profit	\$42.43	Ratio Avg. Win:Avg. Loss	1.11
Avg. Winning Trade	\$887.53	Avg. Losing Trade	(\$802.67)
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 high close may have set us up for further buying this upcoming week, but not necessarily on Monday.

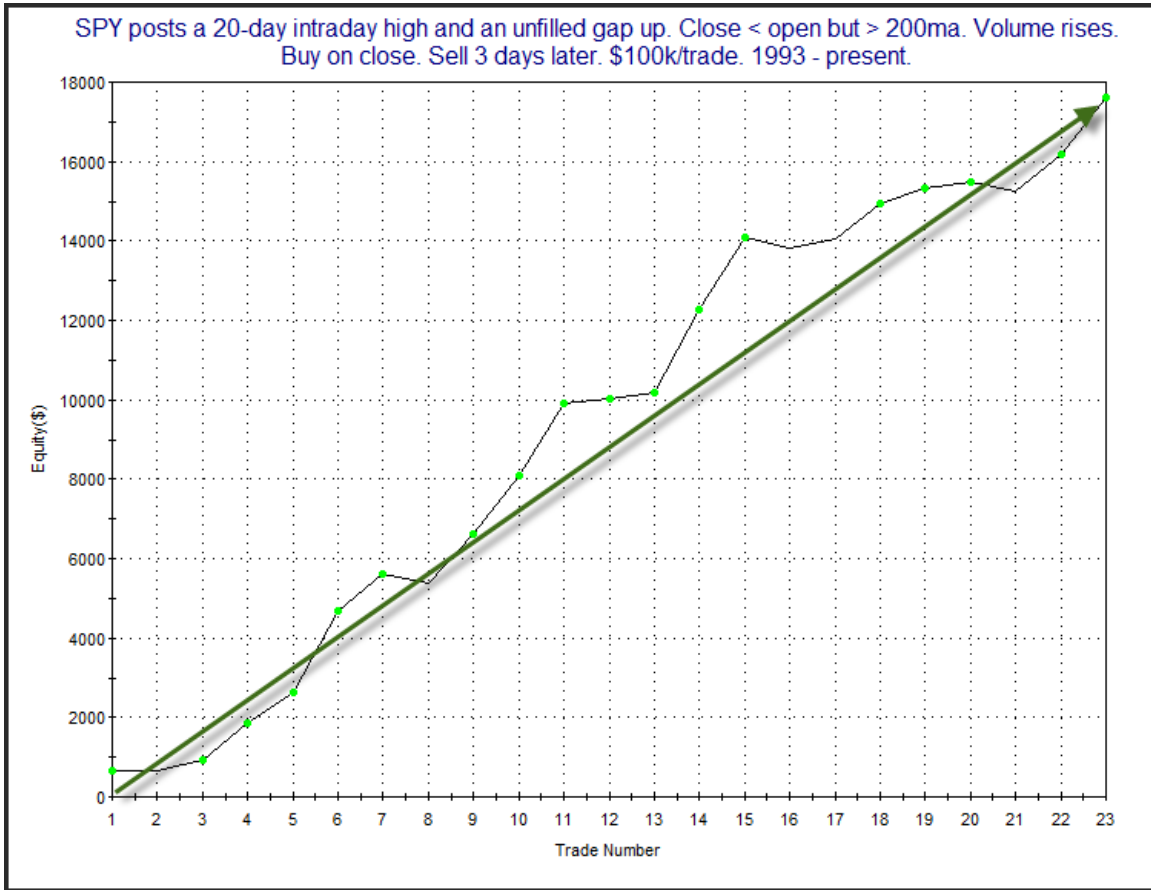
The price and volume action in SPY on Friday triggered a study from the 9/17/13 letter. It considered the fact that while the market opened strong and held its morning gap on rising volume, it failed to add to its morning gains by the end of the day. This failure to add to the gains during the day may sound discouraging, but it has actually been a bullish sign in the past. Below is an updated version of the study.

SPY posts a 20-day intraday high and an unfilled gap up. Close < open but > 200ma. Volume rises.  
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
10	25,538.21	21	13	8	61.90	2,581.06	3,751.11	-1,001.95	-2,117.20	2.58	4.19	1,216.11
9	19,066.71	21	15	6	71.43	1,711.14	3,384.84	-1,100.05	-1,837.44	1.56	3.89	907.94
8	17,635.93	21	14	6	66.67	1,716.75	3,352.48	-1,066.43	-1,581.20	1.61	3.76	839.81
7	17,156.66	21	13	8	61.90	1,895.95	3,310.89	-936.33	-1,451.12	2.02	3.29	816.98
6	17,979.71	21	14	7	66.67	1,755.29	3,008.79	-942.06	-2,000.96	1.86	3.73	856.18
5	14,305.35	22	12	10	54.55	1,569.55	3,754.17	-452.92	-1,879.20	3.47	4.16	650.24
4	16,097.25	22	18	4	81.82	971.08	3,436.02	-345.53	-628.68	2.81	12.65	731.69
3	17,616.90	23	19	3	82.61	965.12	2,056.39	-240.14	-252.60	4.02	25.45	765.95
2	12,432.08	24	17	7	70.83	896.07	1,998.70	-400.16	-926.12	2.24	5.44	518.00
1	8,229.75	24	19	5	79.17	506.32	1,708.92	-278.07	-479.96	1.82	6.92	342.91

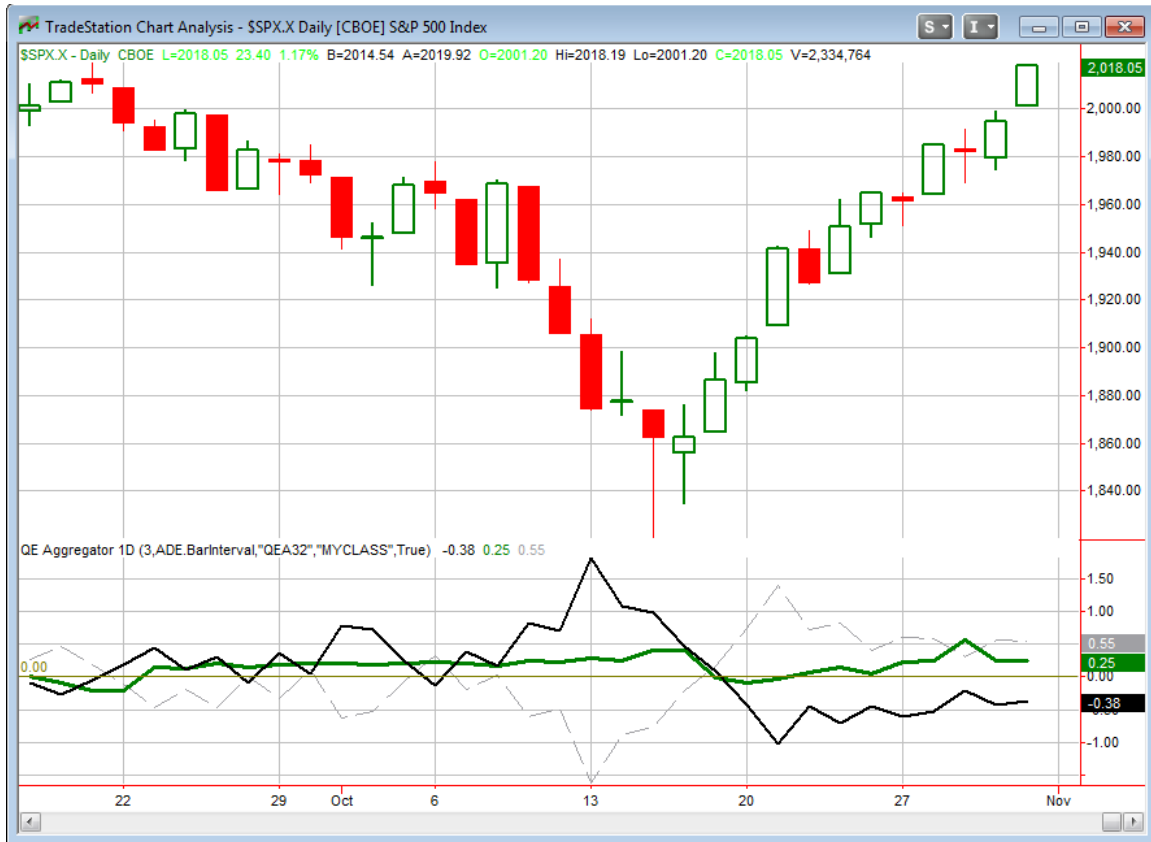
23 of 24 (96%) instances closed above the entry price at some point in the next 3 days.

The stats here all point strongly to the bulls for the short-term. Below is a profit curve.



The strong, steady upslope appears to confirm the bullish edge.

So we have a few new studies to consider for tonight. I have updated the [Aggregator](#) chart below.



With tonight's studies taken into account the green Aggregator Line again stayed 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 stayed flat at the close.

Based on the current active studies, expectations are slated to remain bullish on Monday. Of course that could change if more bearish evidence emerges. The Differential Pivot will be 2002.75 on Monday. That is 0.8% below Friday's close. So for SPX to move from overbought to oversold on Monday it is going to need to close down at least 0.8%.

From a short-term trading perspective there really is not much for me to do but exercise some patience. Bullish expectations but an overbought market does not provide a great reward/risk profile. I'm waiting for either a pullback to enter long or for bearish evidence to emerge and allow for a short-side opportunity.

***Intermediate-term Outlook (2 weeks – 2 months) – updated 11/3 – somewhat bullish***

Combo #1	Combo #2	Combo #3
Long	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 12/31/71 – 3/7/14 in [Lesson 11, Course Downloads](#). (You must go through the course first in order to access the Downloads.)

Combo #1 turned bullish this week thanks to the improved seasonal outlook. As of Friday's close, we saw 2 substantial improvements in the seasonal outlook. For one, the market move from its "Worst 6 Months", being May – October into its "Best 6 Months", being November – April.

Secondly, the market shifted into the 3<sup>rd</sup> year of the Presidential cycle. As a refresher, we measure the Presidential Cycle years from November – October rather than January – December. That allows the cycle years to better match up with the elections, which take place in early November. The 3<sup>rd</sup> year of the Presidential Cycle has been a strong one.

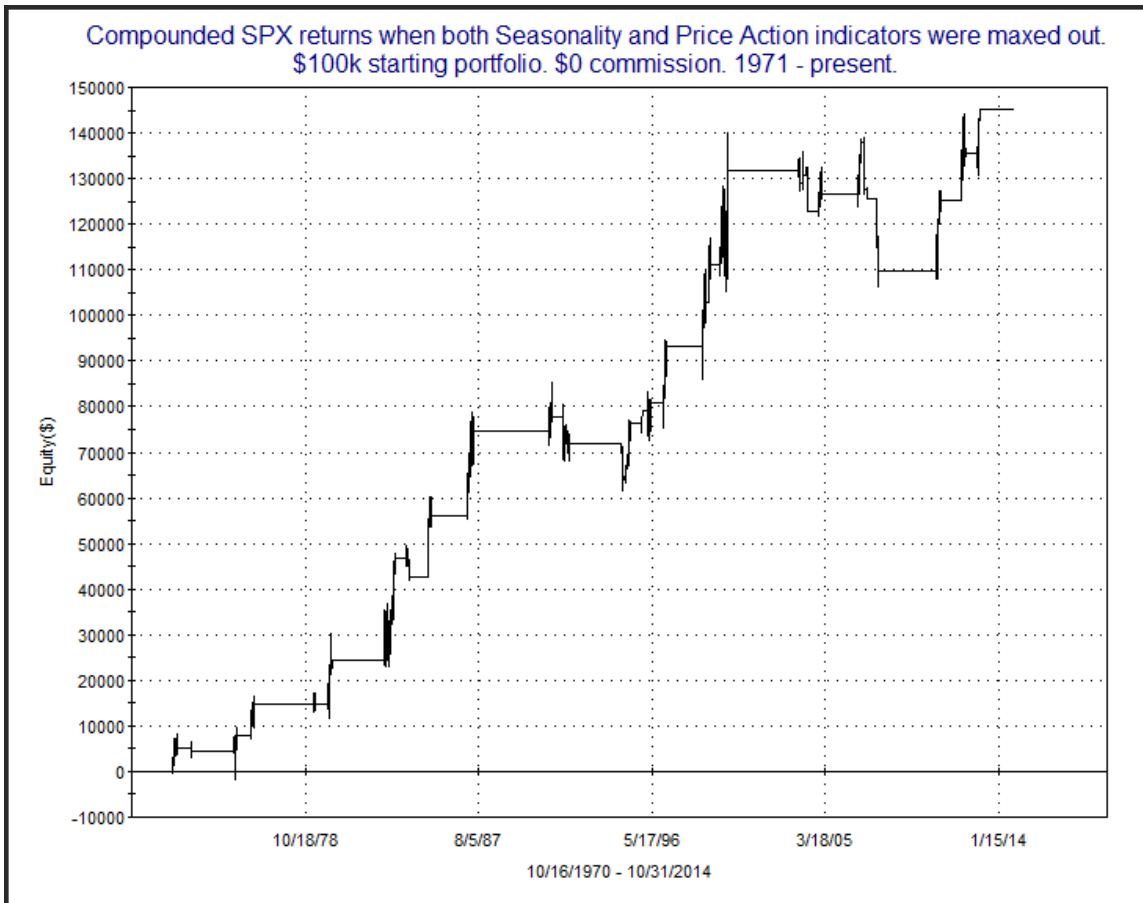
When the Best 6 Months and the 3<sup>rd</sup> Year of the Presidential Cycle have been active at the same time, the results since 1960 have been outstanding. In the table below I have listed out each instance.

SPX Performance during Nov - April during the 3rd year of the Presidential Cycle.  
\$100k trade. 1960 - 2013.

Date/Time	Signal	Price	% Profit	Run-up Drawdown
10/31/62	Buy	\$56.52	23.50%	\$24,164.54
04/30/63	Sell	\$69.80		(\$1,096.78)
10/31/66	Buy	\$80.20	17.22%	\$18,154.22
04/28/67	Sell	\$94.01		(\$1,632.26)
10/30/70	Buy	\$83.25	24.86%	\$26,842.35
04/30/71	Sell	\$103.95		(\$1,225.02)
10/31/74	Buy	\$73.90	18.13%	\$20,146.17
04/30/75	Sell	\$87.30		(\$13,218.81)
10/31/78	Buy	\$93.14	9.24%	\$11,588.40
04/30/79	Sell	\$101.75		(\$1,470.01)
10/29/82	Buy	\$133.71	22.96%	\$23,657.49
04/29/83	Sell	\$164.41		(\$1,217.61)
10/31/86	Buy	\$243.97	18.19%	\$24,405.03
04/30/87	Sell	\$288.36		(\$3,464.23)
10/31/90	Buy	\$304.00	23.47%	\$28,621.28
04/30/91	Sell	\$375.35		(\$783.92)
10/31/94	Buy	\$472.35	8.97%	\$9,060.34
04/28/95	Sell	\$514.71		(\$6,218.17)
10/30/98	Buy	\$1,098.65	21.53%	\$24,844.82
04/30/99	Sell	\$1,335.18		\$0.00
10/31/02	Buy	\$885.77	3.52%	\$7,677.60
04/30/03	Sell	\$916.92		(\$10,849.44)
10/31/06	Buy	\$1,377.94	7.58%	\$8,645.76
04/30/07	Sell	\$1,482.37		(\$1,221.12)
10/29/10	Buy	\$1,183.26	15.24%	\$15,229.20
04/29/11	Sell	\$1,363.61		(\$861.84)

All 13 instances since 1960 have shown gains. Of course there have been drawdowns along the way. The 1974-75 period saw SPX pull back 13.2% from its October closing price before rebounding and finishing April 18.1% above the October closing price. And in 2002-03 there was a 10.85% drawdown from the October close before finishing April 3.5% above it. But overall the stats have been incredibly lopsided. The average 6-month period saw a net gain of 16.5%. The average run-up (from the October close) was 18.7% and the average drawdown just 3.3%. Long-term seasonality does not get any better.

And with the Nasdaq leading and the Golden Cross in effect, we have both long-term Price Action based indicators from the Market Timing Course active as well. Below is a chart of hypothetical performance in a \$100k portfolio that goes long SPX when both Seasonality and Price Action are both maxed out.



2007 saw the worst drawdown here. But the edge has seemed strong. And long-term results would have been even stronger using the Nasdaq. Traders that would like to learn more about the performance of different combinations and possible long-term approaches to utilizing them are encouraged to review the Quantifiable Edges Market Timing Course (free with all annual subscriptions).

It was the 2<sup>nd</sup> strong week for the SPX, which posted a gain of 2.7%. And while it is still a little less than 2 points away from a new intraday high, it did post a new closing high on Friday afternoon. The Nasdaq easily posted new long-term highs (both intraday and closing). So there is little doubt that the uptrend remains in place.

With new highs being made, the Follow Through Day that we discussed in some detail last week is now considered “successful”. Its objective has been reached very quickly, so it will no longer be appearing as a bullish indicator on the intermediate-term list.

There was a new intermediate-term study that made its way to the Active List this week. The following excerpt is from the 10/30 letter.

*One bit of possible bullish news is related to a study I showed in Monday night's letter. There I examined times the VXO (old VIX measurement) was stretched more than 15% below its 10ma for 3 days in a row. Below I have copied the results table I shared in that letter.*

VXO closes 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	-22,094.34	26	14	12	53.85	885.56	2,073.06	-2,874.35	-10,448.88	0.31	0.36	-849.78
4	-16,449.11	26	14	12	53.85	857.89	2,331.45	-2,371.64	-5,673.45	0.36	0.42	-632.66
3	-11,864.54	26	13	13	50.00	1,044.78	1,904.75	-1,957.43	-8,395.18	0.53	0.53	-456.33
2	-14,190.45	26	8	18	30.77	993.57	1,737.55	-1,229.95	-5,164.42	0.81	0.36	-545.79
1	-14,511.19	26	8	18	30.77	666.40	1,990.25	-1,102.35	-4,980.56	0.60	0.27	-558.12

**Just 6 instances failed to closed below the entry price on either Day 1 or Day 2. All 6 continued higher and did not post a close below the entry price at any time in the next month. The 6 instances triggered on 7/18/94, 10/19/98, 10/2/01, 10/18/13, 2/12/14 & 8/15/14.**

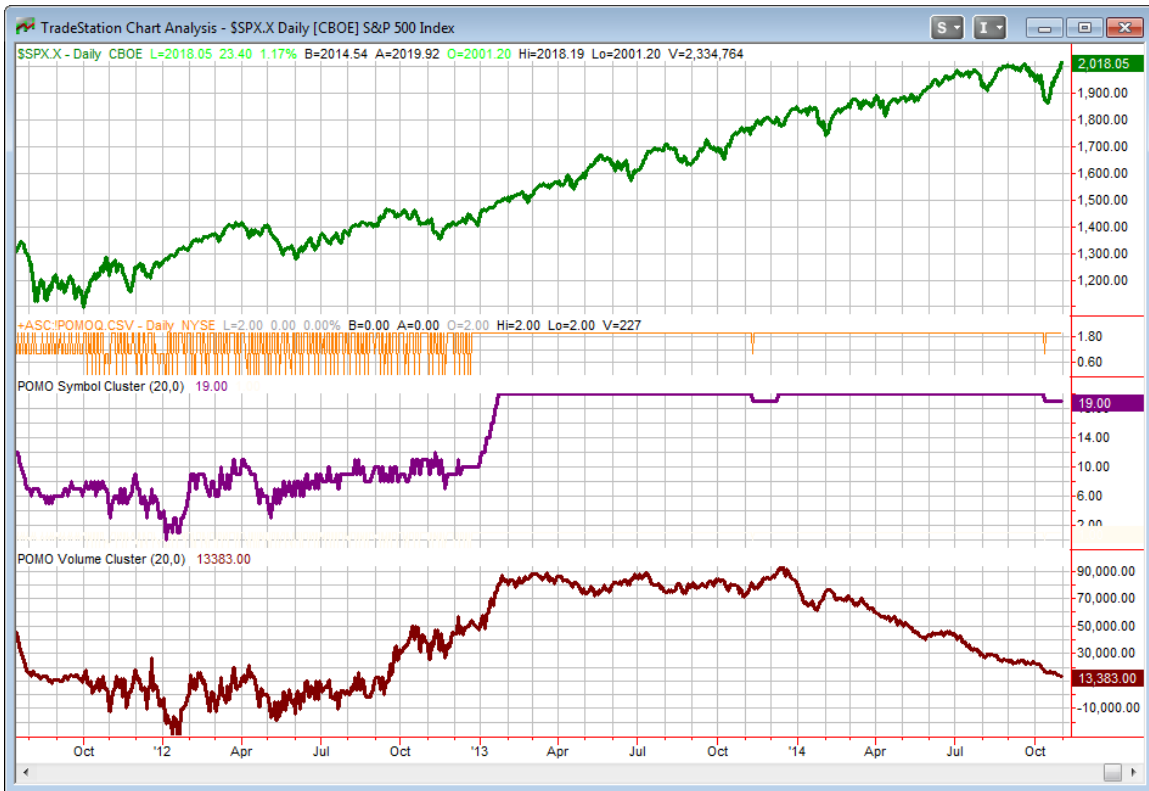
*While the overall results appear bearish, the note at the bottom is what is coming into play now. This is just the 7<sup>th</sup> time the market did not pull back over the next 1-2 days. The other 6 have all led to a continued move higher. And 20 days out from this point the average of gain of the 6 instances was an additional rise of 2.5%. That is a small sample size, so I would not put too much faith in it. But it's at least notable – so I have noted it.*

So seasonality, trend, and price action all seem to be bullish at the moment. But easy Fed liquidity is over, and that is a bearish indication. 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.*

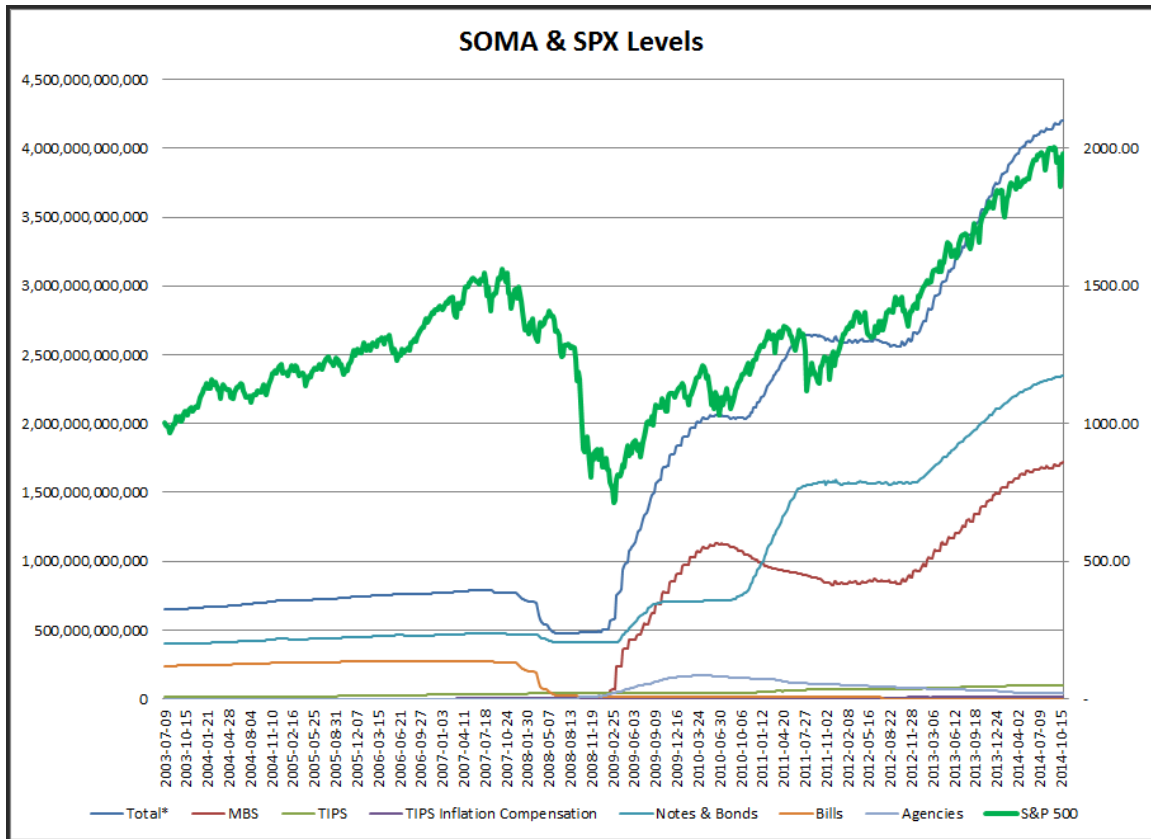
*The top pane is the S&P 500. The middle (purple) pane is the net rolling number of days in the last 20 that have been POMO days. In other words, a day the Fed buys on the market will add +1 while a day of selling will count as -1. The bottom pane is the total amount of money infused into (or taken out 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 now 19. It has held in the 19-20 area since the beginning of 2013. But it is about to head into a steady decline towards 0 now since the Fed announced the end of their quantitative easing program on Wednesday. The volume indicator is also anticipated to decline towards 0. We estimate net inflows this past week to have been about \$2.1 billion. That is a low number for what we have seen the last couple of years, but it is significantly above the \$0 that is expected going forward.

The POMO/QE indicator chart above is going to level off over the next month. So from a charting perspective it is going to become less interesting. But it is not the only way to examine the Fed's action. While new bond purchases are not in the works, they will still be re-investing money that comes from matured bonds. So the SOMA (System Open Market Account) total account holdings may remain firm. The chart below is one that I have shown numerous times over the years. It looks at SPX levels along with SOMA size. SOMA is the account where all of the Fed purchases are held. Since 2003 (as far back as data is available) the market has struggled any time the SOMA has not been increasing.



I intend to begin watching this chart more closely. It could easily be argued that this has been the most influential intermediate-term factor of market strength and weakness over the last decade. A turn down (or perhaps even a flattening out) of the blue “Total” line could be a bad sign for the market. And with QE now over, I anticipate it will flatten out and eventually begin to decline.

In ending the QE program the Fed’s timing here is very interesting. Because as I discussed above, the market is entering a very bullish seasonal period. Perhaps the Fed understands this and is counting on the strong seasonality to aid the market after their stimulus has been taken away. Whether the timing was intentional or not doesn’t really matter. What we are left with is strong seasonality and strong trend and price action indications butting heads with a potential liquidity issue. Not only is the Fed stimulus being turned off, but the potential for a major decline still exists based on the Quantifiable Edges Study of Tops indicators.

At this point I am inclined to remain somewhat bullish on the market. There are some real danger signs out there (most notably the end of QE), so I will pay close attention to see if price action or seasonality weaken. I will also remain cognizant of any other long-term indications that might support the bearish case. But for now I will remain more willing to take on longs than shorts for my short-term trades. With the majority of what I am seeing still bullish, I feel long trades have a better reward/risk outlook.

### **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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