

# QUANTIFIABLE EDGES SUBSCRIBER LETTER

ASSESSING MARKET ACTION WITH INDICATORS AND HISTORY

December 1, 2014

Volume 7 Issue 227

## Market Overview



## Signals Overview

Aggregator	Aggressive VIX	QE Buy Pwr Swing
Long	100% Long XIV	Short

## Tonight's Research Points

- Relatively strong drops from 50-day highs have consistently been followed by bounces.
- 1<sup>st</sup> day of month has been bullish when the last day of the month has closed poorly.
- The Monday after Thanksgiving has been seasonally bearish.
- Breadth measures continue to diverge as we hit new highs.
- The Fed's SOMA account contracted last week. Continued contraction could make for a difficult market environment.

## *Short-term Outlook*

### *The Bottom Line*

Evidence has flipped to now favor a pullback. I am slightly bearish. But the potential reward appears small and the risk in a counter-trend trade appears too high for me to want to get involved here.

**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>						
December 1, 2014	Monday after Thanksgiving bearish	1 day	Bearish			
December 1, 2014	Weak close to end the month	1 day	Bullish			
December 1, 2014	Big drop from 50-day high	1-4 days	Bullish			
November 28, 2014	Low vol Thanksgiving Wed	1-2 days	Bearish			
<b>Active - Long Term</b>						
November 19, 2014	RSI2 > 99	1-10 days	Bullish			
November 18, 2014	SPX 3-high. Russell dn 3 in row	1-10 days	Bullish			
November 3, 2014	Best 6 Months	6 months	Bullish			
November 3, 2014	Quantitative Easing Ends	int term	Bearish			
October 27, 2014	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			
<b>Dropped Tonight</b>						
November 25, 2014	2 unfilled up gaps and close@ 50-day high	1-3 days	Bullish	0.90%	-0.65%	-1.20%
November 24, 2014	Thanksgiving Week	Wed-Fri	Bullish			
November 24, 2014	1-2% gain opex week	1-4 days	Bearish			

**The Evidence**

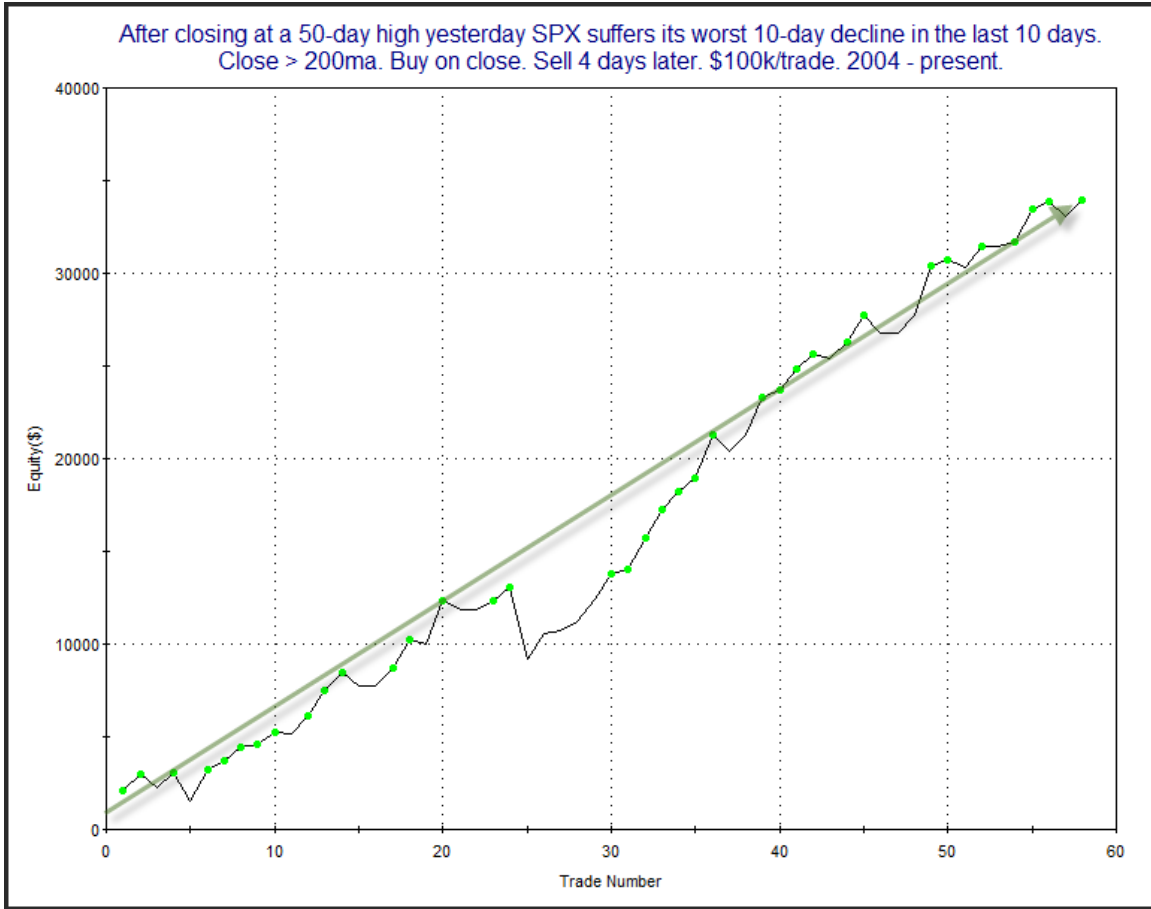
The stock market saw mixed results on Friday. The SPX fell 0.25%, the NASDAQ gained 0.1%, and the Russell 2000 got hit hard with a 1.5% loss. Breadth was negative as the NYSE Up Issues % came in at 39% and the Up Volume % was 31%. Total NYSE volume actually rose from Wednesday's level despite the early close.

The study below was last seen just recently in the 11/20/14 Letter. It looks at relatively large drops from intermediate-term highs. It triggered again on Friday and I have updated all the stats.

After closing at a 50-day high yesterday SPX suffers its worst 10-day decline in the last 10 days. Close > 200ma. Buy on close. Sell X days later. \$100k/trade. 2004 - 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	30,946.49	54	39	15	72.22	1,288.41	3,149.37	-1,286.77	-3,454.00	1.00	2.60	573.08
4	33,975.87	58	42	16	72.41	1,072.57	2,725.38	-692.02	-3,895.76	1.55	4.07	585.79
3	25,025.89	59	43	16	72.88	841.10	2,192.40	-696.35	-1,808.21	1.21	3.25	424.17
2	15,132.60	60	35	25	58.33	816.28	2,437.50	-537.49	-1,777.55	1.52	2.13	252.21
1	6,458.62	60	35	25	58.33	543.62	1,521.72	-502.72	-1,354.59	1.08	1.51	107.64

**55 of 60 instances (92%) closed above the entry price at some point in the next week.**

Over the last 10 years the stats are impressive. And the 3-4 day consistency is strong. Below is a profit curve that assumes a 4-day holding period.



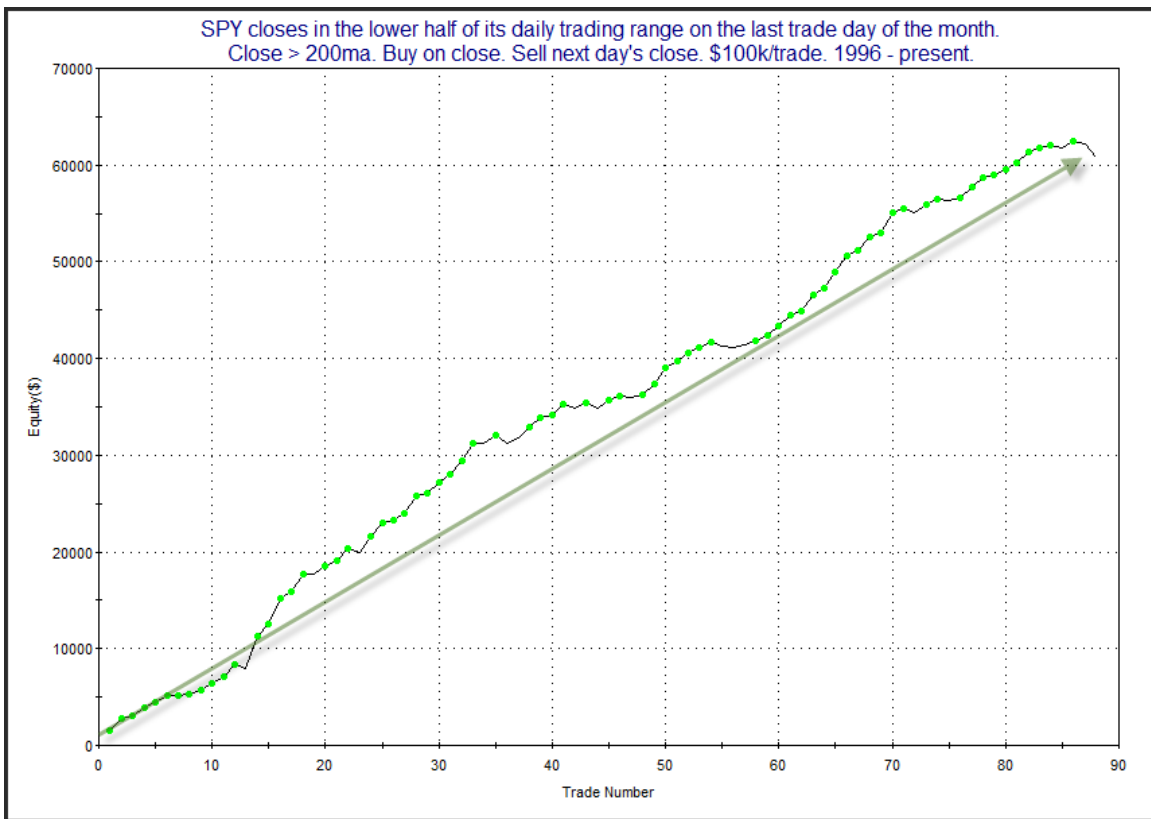
The steady upslope seems to confirm the bullish inclination.

There were a few studies related to turn of the month that emerged. Perhaps the most compelling of these was one that was last seen in the 10/1/14 Letter. It broke out stats when SPY closed in the top half of its daily range versus the bottom half, and found that weak closes on the last day of the month led to much better returns on the 1<sup>st</sup> day of the next month. Below are stats for this scenario.

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

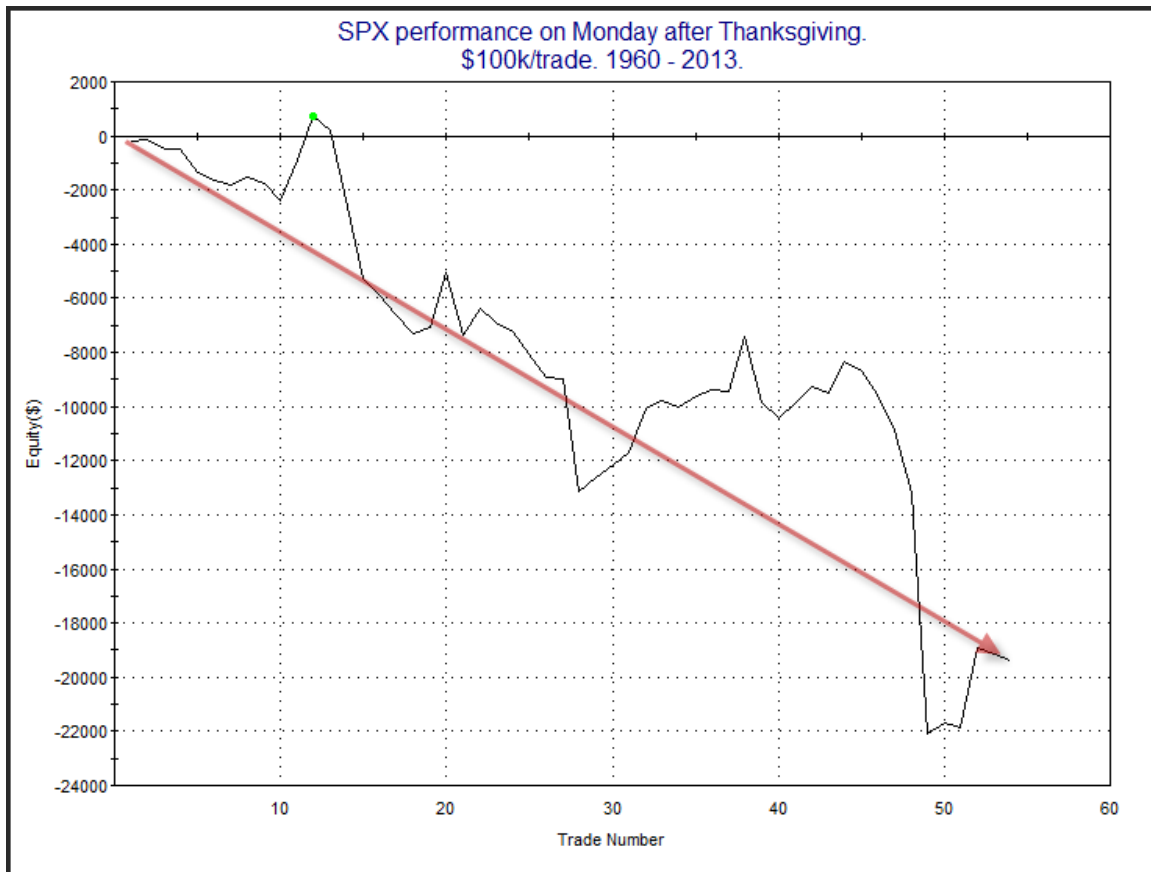
TradeStation Performance Summary <span style="float: right;">Collapse ^</span>			
All Trades			
Total Net Profit	\$60,811.90	Profit Factor	11.60
Gross Profit	\$66,548.40	Gross Loss	(\$5,736.50)
Total Number of Trades	88	Percent Profitable	82.95%
Winning Trades	73	Losing Trades	15
Even Trades	0		
Avg. 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 strong. Gains blow away losses in every category. Gross gains are over 11x the size of gross losses. And the average day posted a gain of 0.7%. That's an impressive number when looking at 88 instances. And the profit curve...



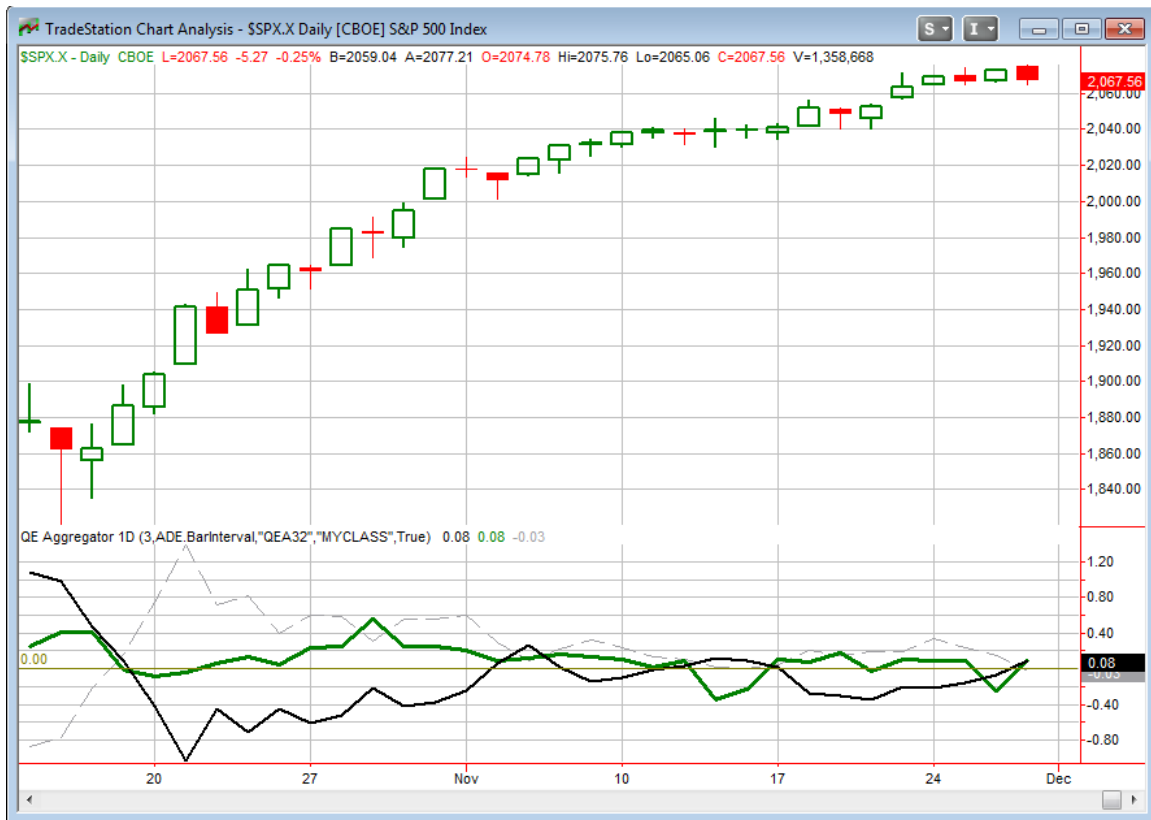
The October instance gave the worst decline of the bunch with a 1.35% loss. But you will be hard pressed to find a long-term profit curve much straighter and more impressive than this one. This setup certainly seems to favor the bulls for Monday.

But there is also a potentially bearish seasonal influence. And that is the fact that Monday is the 1<sup>st</sup> Monday after Thanksgiving. The profit curve below is one I showed in last weekend's letter. I have copied it here again.



While the trend has been down pretty much the entire time, a large portion of the downside move is thanks to a 9% drop in 2008. This suggests a seasonal downside edge does exist, but it is perhaps not as strong as the steepness of the arrow might suggest. So Monday will be interesting, with the bullish “weak close to end the month” bumping up against the bearish “Monday after Thanksgiving”. I’ve included both in the Aggregator calculation.

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



Tonight's studies helped green Aggregator Line rise back 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 rose above 0. The positive Differential Line reading means the SPX is considered oversold versus recent expectations. So expectations are positive and the SPX is oversold. This is considered a bullish configuration. Bullish configurations are visible on the chart whenever both lines close below 0. Therefore the Aggregator signal turned long at the close.

Expectations are set to remain bullish on Monday. Of course this could change if more bearish evidence emerges. The Differential Pivot will be 2072.86 on Monday. This is 0.25% above Friday's close. So SPX will need to close up at least this much in order for SPX to be considered "overbought" versus expectations on Monday.

The Aggregator is back to a bullish configuration. So there appears to be a bit of an upside edge over the next few days. But I remain hesitant to take on new long exposure until a more substantial pullback occurs. It has now been 30 days since SPY closed below its 5-day moving average and 29 days since it closed below its 10ma. Those are both extremely long runs above short-term moving averages. I want to see SPY move down below those lines before getting excited about a short-term long trade. Risk of a move lower at this point is too great, since a pullback is so long overdue.

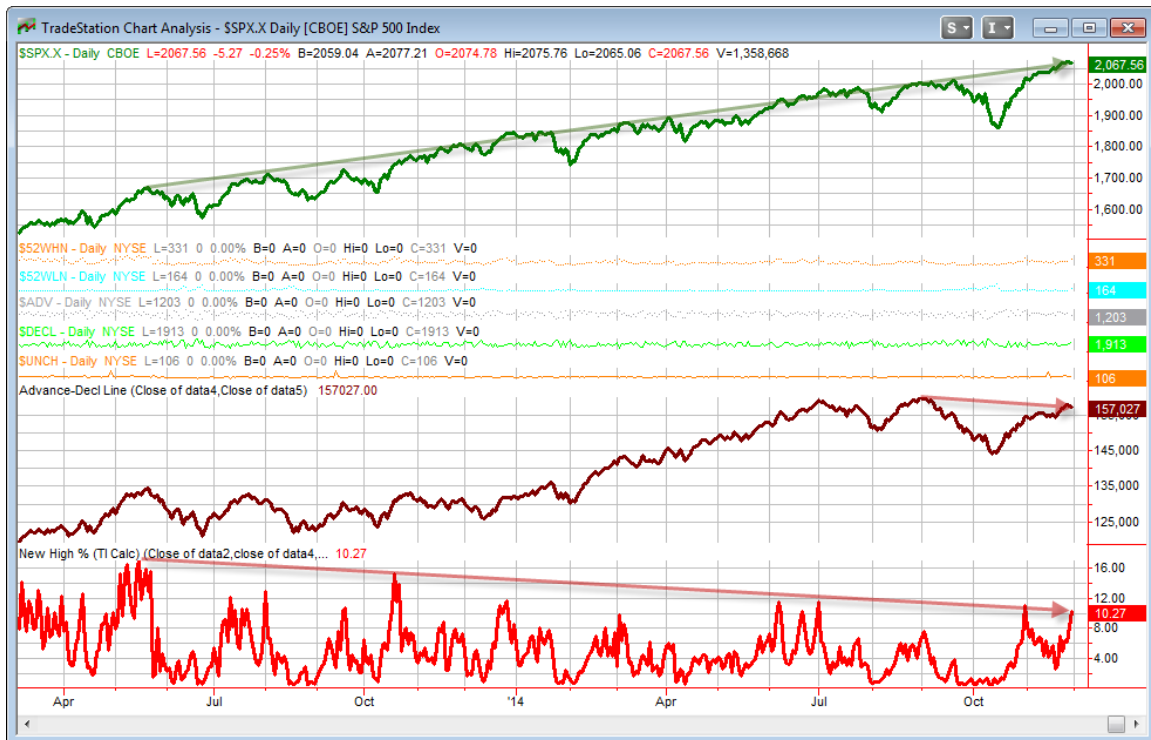
***Intermediate-term Outlook (2 weeks – 2 months) – updated 12/1 – somewhat bullish***

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.)

The quiet holiday week had very little impact on the intermediate-term outlook. New highs were reached again in multiple indices, but no new studies emerged with intermediate-term implications. Obviously with new highs intact, the uptrend remains squarely in place. So the bulls certainly have trend on their side.

Despite the new highs this week, the number of stocks hitting new 52-week highs again came in quite low. This keeps the divergence in place that we have noted for over a year and a half 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 very 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.

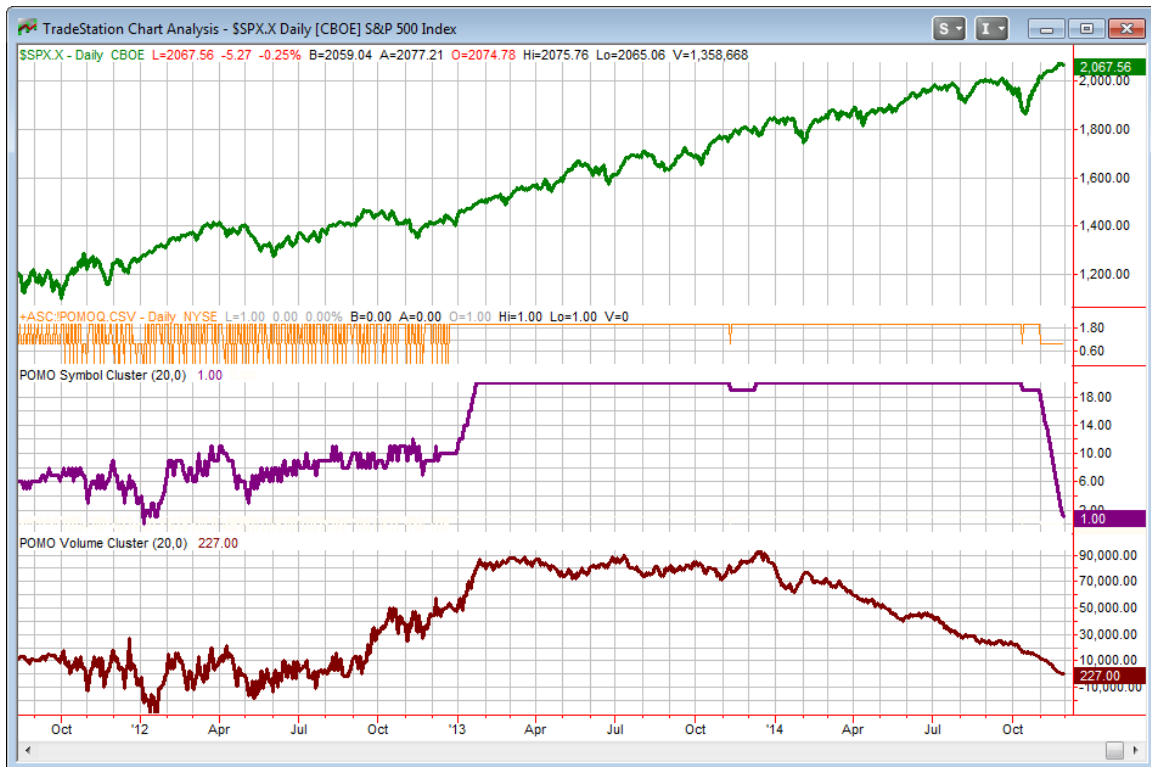
This opens up the possibility of a major top being put in. Note I said possibility, not probability. It needs to be understood that while the narrowing of New Highs and/or the turn down in the Advance/Decline Line has been a prerequisite for a top to take place, these breadth conditions have not been 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 18 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 2013 level, or even levels we saw at the end of October.

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

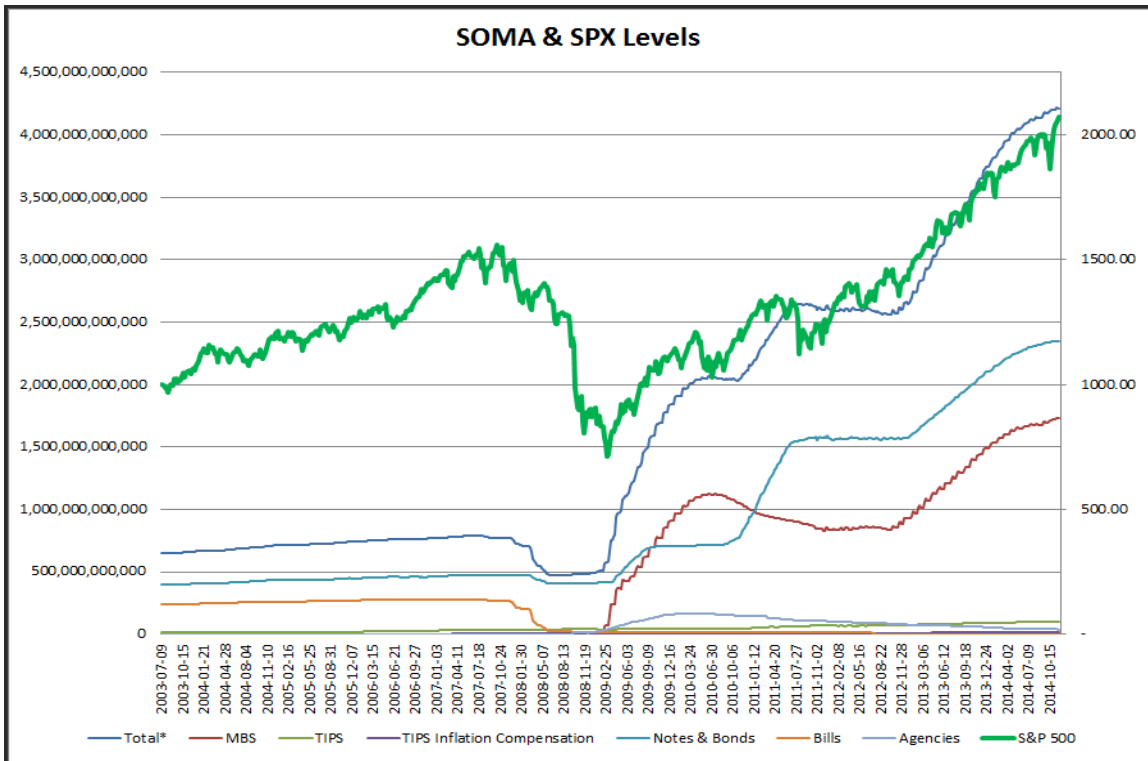
*POMO stands for Permanent Open Market Operations and it is how the Fed has gone into the open market to buy securities over the last several years. The net effect of this buying is an influx of cash into the system. It appears a portion of that cash makes its way to the stock market and works as a bullish 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 at 1 and Monday it will reach zero. The volume indicator is locked in a similar decline.

The lack of new purchases did lead the Fed's System Open Market Account (SOMA) to shrink a little this week. The last few weeks it has oscillated back and forth. The Fed is continuing to reinvest maturities, so the Total Assets line has not begun a rapid decline like the QE POMO indicators. And with the reinvestment there still appears to have been some liquidity support. I have updated the SOMA chart again below.



The market has continually struggled over the years whenever the SOMA has not been increasing. So I am continuing to watch the Total Assets line closely to see whether it begins to roll over and head south, or whether reinvestments can keep it afloat a while longer.

The story remains largely the same from last week. Strong seasonality and strong trend and price action indications are butting heads with a potential liquidity issue and overextended market. Additionally, the potential for a major decline still exists based on the Quantifiable Edges Study of Tops indicators.

I am still somewhat bullish overall. Despite the danger signs (liquidity, and Study of Tops breadth indicators), there is no sign of a letup with the rally. For now I will remain more willing to take on longs than shorts for my short-term trades. With the majority of intermediate-term indications 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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