

QUANTIFIABLE EDGES SUBSCRIBER LETTER

ASSESSING MARKET ACTION WITH INDICATORS AND HISTORY

January 23, 2015

Volume 8 Issue 15

Market Overview



Signals Overview

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

Tonight's Research Points

- When the VIX moves from 10% above the 10ma to 10% below the 10ma in less than a week it has been typically followed by gains.
- The QE Buying Power Swing System triggered a short.

Short-term Outlook

The Bottom Line

Expectations remain slightly bullish, but with the market up 4 days in a row SPX is short-term overbought and not providing favorable reward/risk for bulls. I remain neutral and on the lookout for the next strong edge to emerge.

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
Active - Short Term						
January 23, 2015	VIX 10% up to 10% dn blow ma	1-8 days	Bullish	2.50%	-1.00%	-1.95%
January 21, 2015	SPX up. Breadth poor	1-3 days	Bearish			
January 20, 2015	MLK week bearish	1-4 days	Bearish	-2.00%	1.10%	2.10%
January 20, 2015	Bounce from 20-low	1-6 days	Bullish	2.30%	-1.50%	-2.80%
Active - Long Term						
December 9, 2014	Hindenburg Omens	1-35 days	Bearish			
November 3, 2014	Best 6 Months	6 months	Bullish			
November 3, 2014	Quantitative Easing Ends	int term	Bearish			
July 22, 2013	New High Divergence (Study of Tops)	int term	Bearish			
February 1, 2012	Golden Cross	int term	Bullish			
Dropped Tonight						
January 20, 2015	Higher then Dn. Lower then up.	1-5 days	Bullish	1.90%	-1.20%	-2.50%

The Evidence

The bounce gained more strength on Thursday and the major indices rallied across the board. The SPX gained 1.5%, the NASDAQ rose 1.8%, and the Russell 2000 increased 2.1%. Breadth was solidly positive as the NYSE Up Issues % came in at 78% and the Up Volume % was 82%. Total NYSE volume rose some from Wednesday's level.

After reaching a high of 23.43 last Friday, the VIX closed Thursday at 16.40. The VIX is a measure of expected volatility in the market, and it tends to move up and down counter to the SPX. The Quantifinder study below considered the sharp drop in the VIX over the last few days after a sharp rise the previous few. It was last seen fairly recently in the 12/22/14 subscriber letter. The results are updated.

VIX closes more than 10% below its 10ma after closing more than 10% above it on 1 of the previous 4 days. Buy SPX on close. Sell X days later. \$100k/trade. 1992 - 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	30,713.06	20	16	4	80.00	2,575.93	8,115.80	-2,625.47	-3,412.50	0.98	3.92	1,535.65
9	31,523.05	20	15	5	75.00	2,439.11	8,397.40	-1,012.72	-2,403.36	2.41	7.23	1,576.15
8	34,842.04	20	17	3	85.00	2,197.99	8,076.20	-841.26	-1,733.94	2.61	14.81	1,742.10
7	32,392.29	20	16	4	80.00	2,221.27	7,749.50	-787.03	-1,872.78	2.82	11.29	1,619.61
6	29,516.95	20	15	5	75.00	2,171.08	5,305.30	-609.84	-1,280.71	3.56	10.68	1,475.85
5	27,303.41	20	14	6	70.00	2,209.40	5,361.40	-604.70	-1,159.86	3.65	8.53	1,365.17
4	17,498.37	20	16	4	80.00	1,441.68	4,981.90	-1,392.11	-2,303.32	1.04	4.14	874.92
3	10,102.79	21	14	7	66.67	1,120.42	3,799.40	-797.58	-1,683.22	1.40	2.81	481.09
2	7,873.09	21	12	9	57.14	1,116.07	3,839.00	-613.31	-1,767.90	1.82	2.43	374.91
1	6,740.78	21	13	8	61.90	749.22	2,952.40	-374.88	-1,582.62	2.00	3.25	320.99

All 21 instances closed above the entry price at some point in the next 4 days.

The market condition that would typically accompany such VIX movement is one where you see a strong rebound from a sharp decline during a long-term uptrend, which is what we are currently looking at. Results appear especially strong and consistent between days 4 and 8. Below I have provided the profit curve assuming an 8 day holding period.

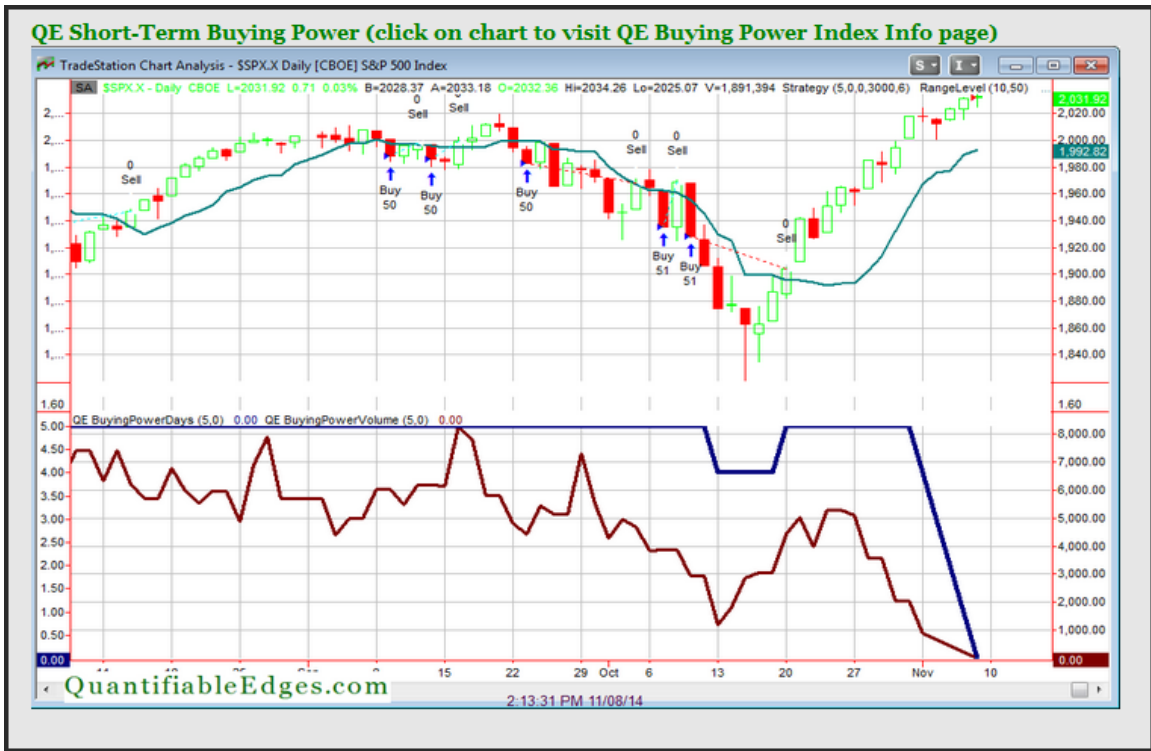


This curve appears very strong and steady, and seems to support the idea of an upside edge. I have included this study on the Active List tonight.

I should also note that the QE Buying Power System triggered a short signal after Thursday's close near the upper part of the recent range. This is the 4th short signal since the Fed ended the most recent QE program at the end of October. I did a detailed write-up of my thoughts in the 11/10/14 letter. My opinion since then has not changed any. So I copied below my notes from that letter.

Perhaps the most interesting chart on the charts page right now is the one that shows the QE Short-Term Buying Power Index. This chart essentially tracks recent Fed activity. For the last 22 months the QE Buying Power Index was locked at either four or five. This meant the QE Short Term Buying Power Swing System was only looking to buy

pullbacks. But with the Fed's QE program now ended, the QE Buying Power Index will now be locked at zero for the foreseeable future. This can be seen in the chart below. So the system is no longer going to be looking to buy pullbacks. Rather, it will be looking to short overbought readings.



With the index now at zero, instead of five, the system is no longer going to be looking to buy pullbacks. Rather, it will be looking to short overbought readings. And on Friday, with SPX at a high, and the Buying Power Index hitting zero, the first short signal in a long time triggered.

The performance table below shows the hypothetical result of having taken all short signals since 2008, and then exiting upon a reversion to the lower half of the recent range. (A short signal simply requires the QE Buying Power Index ≤ 0 and the SPX closes in the top 20% of its 10-day range.)

QE Buying Power Swing System Shorts.			
Exit upon reversion through midpoint of 10-day range. \$100k/trade. 2008 - present.			
TradeStation Performance Summary			Collapse ^
All Trades			
Total Net Profit	\$39,637.38	Profit Factor	3.33
Gross Profit	\$56,623.30	Gross Loss	(\$16,985.92)
Total Number of Trades	29	Percent Profitable	75.86%
Winning Trades	22	Losing Trades	7
Even Trades	0		
Avg. Trade Net Profit	\$1,366.81	Ratio Avg. Win:Avg. Loss	1.06
Avg. Winning Trade	\$2,573.79	Avg. Losing Trade	(\$2,426.56)
Largest Winning Trade	\$8,004.64	Largest Losing Trade	(\$8,003.49)

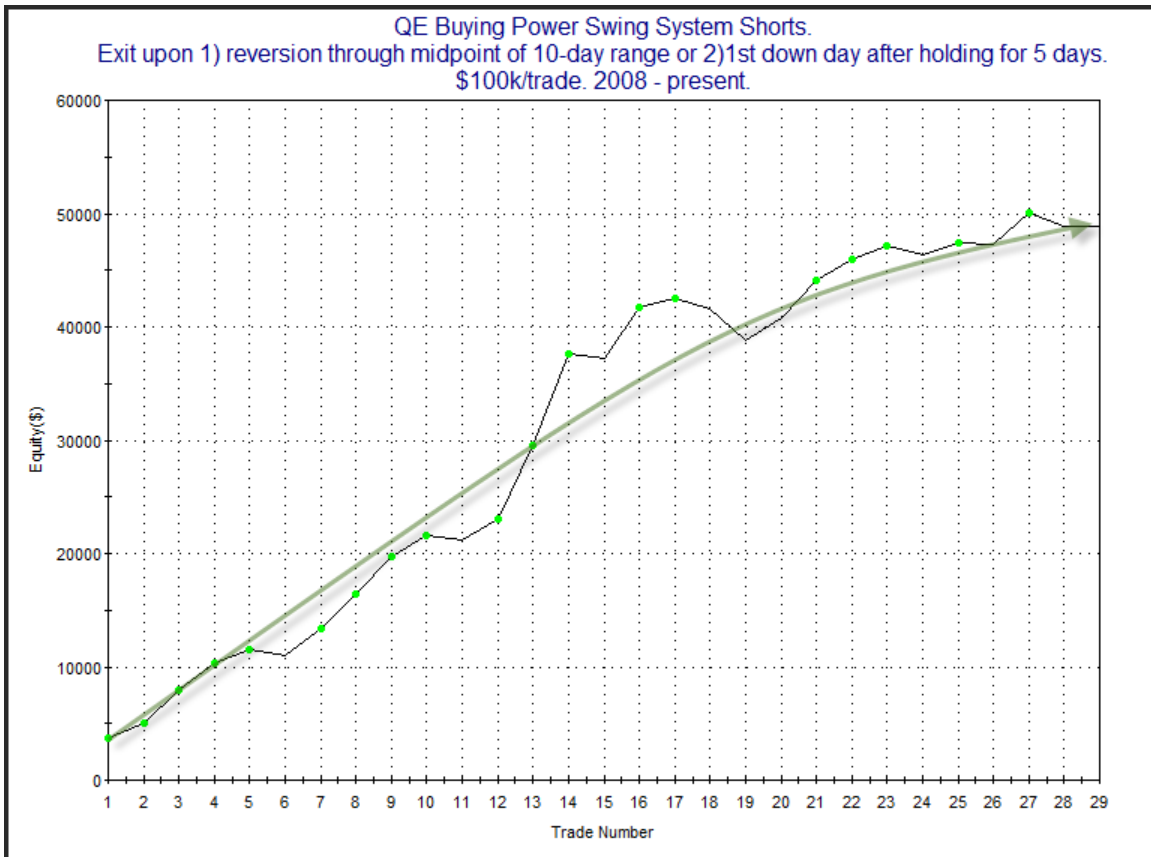
Results here are strong. With short systems there is an adjustment I sometimes make to protect against getting run over by a strong and persistent rally. I do this because the market tends to stay overbought for extended periods more often than it tends to stay oversold for extended periods. For instance, earlier I discussed that since 1997, this is now the 6th time that the market has gone 16 days without closing below its 5ma. Over that same time period it has managed to go 16 days without a close above the 5ma only 1 time. Additionally, lengthy oversold stretches tend to reverse sharply, often helped by short covering, which launches the market quickly higher. (Think about the Quantifiable Edges Catapult System trades for instance.) Overbought reversals are not typically as sharp and violent. So the reversal may not make you back your unrealized losses as easily.

So adjustments that can be employed for short trades would be to either 1) demand less of a pullback to trigger an exit, or 2) give it a few days to revert, and then quickly tighten the exit criteria if it continues to run against you. I prefer #2, since that gives you an opportunity for a more sizable win if you time the entry right. The table below shows results based on giving the reversion X days to work

QE Buying Power Swing System Shorts.
 Exit upon 1) reversion through midpoint of 10-day range or 2) 1st down day after holding for X days.
 \$100k/trade. 2008 - 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	34,670.42	29	21	8	72.41	2,678.15	8,004.64	-2,696.33	-4,186.56	0.99	2.61	1,195.53
9	36,642.20	29	21	8	72.41	2,678.15	8,004.64	-2,449.86	-4,186.56	1.09	2.87	1,263.52
8	42,620.85	29	23	6	79.31	2,470.71	8,004.64	-2,367.60	-4,186.56	1.04	4.00	1,469.68
7	42,608.94	29	22	7	75.86	2,520.37	8,004.64	-1,834.16	-2,852.25	1.37	4.32	1,469.27
6	40,876.53	29	19	10	65.52	2,869.28	8,004.64	-1,363.98	-2,852.25	2.10	4.00	1,409.54
5	48,831.49	29	20	9	68.97	2,786.56	8,004.64	-766.63	-2,776.80	3.63	8.08	1,683.84
4	41,985.68	29	19	10	65.52	2,706.48	8,004.64	-943.75	-2,776.80	2.87	5.45	1,447.78
3	26,656.79	29	19	10	65.52	1,999.74	8,004.64	-1,133.83	-2,044.02	1.76	3.35	919.20
2	26,164.39	29	19	10	65.52	1,930.12	8,004.64	-1,050.78	-2,044.02	1.84	3.49	902.22
1	26,937.66	29	22	7	75.86	1,537.86	8,004.64	-985.03	-1,835.47	1.56	4.91	928.88

Using the time exit adjustment the stats improve nicely between days 4-8. Five days shows the optimal stats here, and a week is typically about right with what I have seen in the past. I often give short systems about 5-6 days to reach their targets before tightening in this manner, so I'll use 5 days here. Below is a look at profit curve assuming the tightening begins on day five.



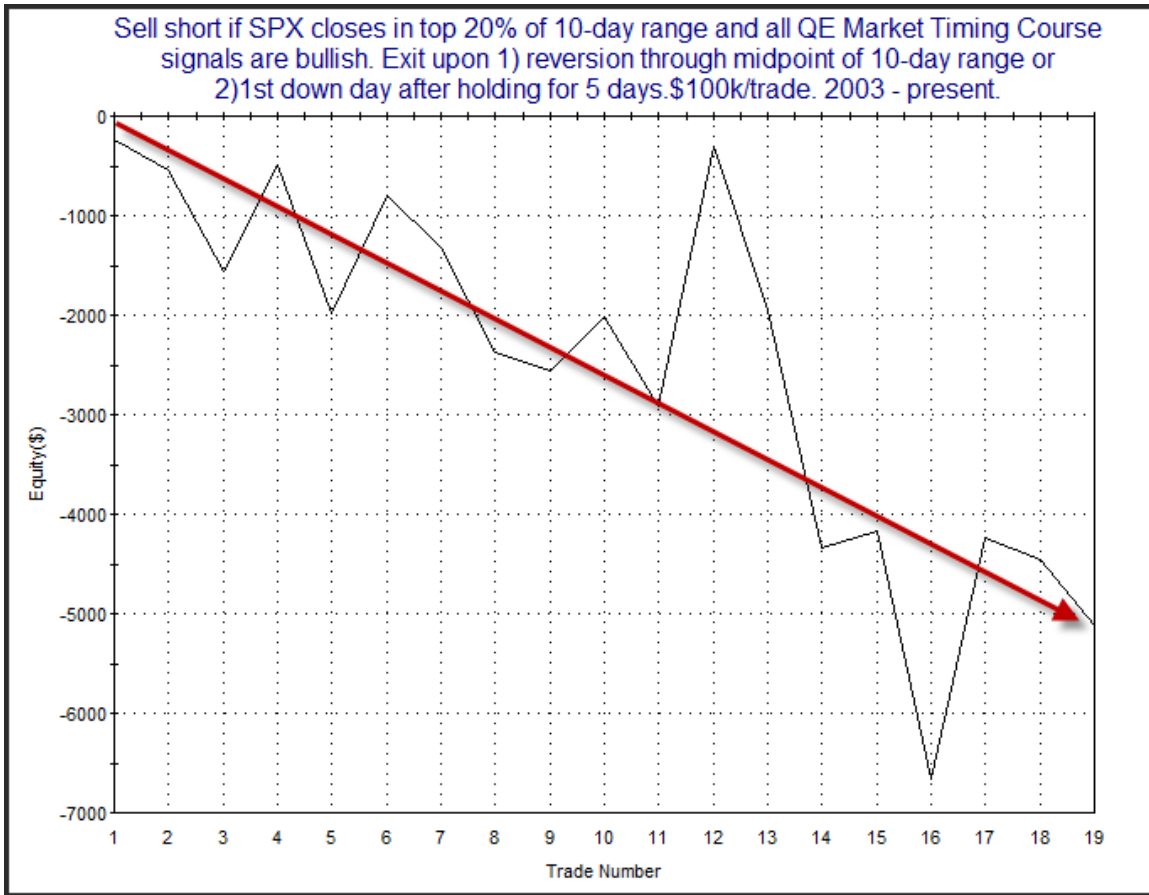
The strong steady upslope serves as a nice confirmation.

Of course the QE Buying Power Index Swing System does not consider seasonality or long-term trend. As exhibited by the QE Market Timing Indicators as shown in the intermediate-term section below, both seasonality and trend are strong right now. So I wondered how a short selling approach similar to the QE Buying Power Swing System would have worked if we ignored the Buying Power Index and substituted fully bullish seasonality and price action indicators from the QE Market Timing Course. Since 2008 there have only been seven instances. So I ran the test back to 2003. Those results are below.

Sell short if SPX closes in top 20% of 10-day range and all QE Market Timing Course signals are bullish. Exit upon 1) reversion through midpoint of 10-day range or 2) 1st down day after holding for 5 days. \$100k/trade. 2003 - present.

TradeStation Performance Summary Collapse ^			
All Trades			
Total Net Profit	(\$5,113.84)	Profit Factor	0.61
Gross Profit	\$8,018.08	Gross Loss	(\$13,131.92)
Total Number of Trades	19	Percent Profitable	31.58%
Winning Trades	6	Losing Trades	13
Even Trades	0		
Avg. Trade Net Profit	(\$269.15)	Ratio Avg. Win:Avg. Loss	1.32
Avg. Winning Trade	\$1,336.35	Avg. Losing Trade	(\$1,010.15)
Largest Winning Trade	\$2,617.60	Largest Losing Trade	(\$2,494.80)

As you can see, trying to short an overbought market with seasonality and trend strongly against you would have been a losing approach over the last 11 years. Let's take a look at the profit curve to see how it has played out.



This seems to confirm the difficulty in trying to short strongly trending markets during strongly bullish seasonal periods.

This leaves us with a bit of a conundrum. Will the weak liquidity win out, or will trend and seasonality prevail? If liquidity does begin to exert its influence here, then it will probably not take long for one, or both, of the price action indicators to come out of their bullish posture.

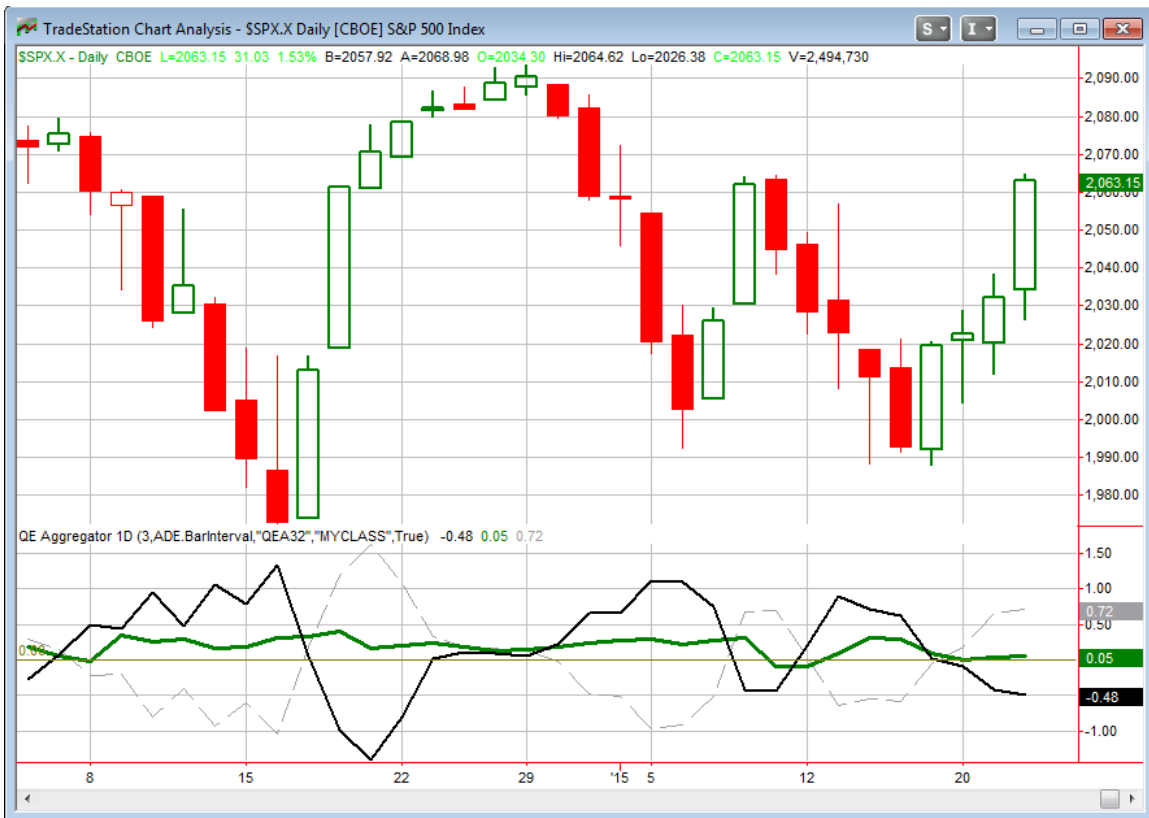
I intend to watch this closely. For the time being, I am not including the QE Buying Power short signals in the Aggregator calculation. That will quickly change if it appears to be fruitful in this environment.

Since I wrote this the 3 QE Buying Power short signals that triggered resulted in 1 loser and 2 winners if you did not use a time-based tightening. Using the tightening method

would have led to 2 losers and just 1 winner. I am still inclined to keep a close eye, but not yet include QE Buying Power System shorts in the Aggregator.

So tonight we have the one VIX-based study making it onto the Short-Term Active List.

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



Once again the green Aggregator Line held a little above 0. Positive readings mean net expectations from the Active List are for upside over the next few days. Meanwhile, the black Differential Line again fell a little further 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 set to remain bullish on Friday. That could change if more bearish evidence emerges. The Differential Pivot will be 2029.83 on Friday. That is a distant 1.6% below Thursday's close. In order for SPX to move from

overbought to oversold versus expectations on Friday it will need to close down at least this much. That's pretty unlikely considering the size of the move that would be needed. A more likely scenario for working off the overbought condition would be a multi-day decline or consolidation.

After the last 4 days the market is clearly short-term overbought by a number of measures. This increases short-term risk for long positions. But evidence is still favoring continued upside rather than a high-probability pullback. Because of this, shorting is also high-risk. I see no reason to put new index capital at work right here. I will instead continue to observe and be prepared for the next adequately favorable reward/risk opportunity to emerge.

Intermediate-term Outlook (2 weeks – 2 months) – updated 1/20 – somewhat bullish

The intermediate-term outlook was last updated in the 1/20 Letter. It can be found in the most recent weekly letter on the website.

<http://quantifiableedges.com/current-weekly-letter/>

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

Symbol	Entry Date	Entry Price	Current Price	% Gain/Loss	Stop	Notes
XIV(1/2)	12/11/2014	\$34.03	\$30.66	-9.90%		Aggressive VIX

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