

QUANTIFIABLE EDGES SUBSCRIBER LETTER

ASSESSING MARKET ACTION WITH INDICATORS AND HISTORY

April 27, 2015

Volume 8 Issue 79

Market Overview



Signals Overview

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

Tonight's Research Points

- A SOX decline combined with a strong NDX has often been followed by a market pullback over the last 12 years.
- Breakouts to new 50-day highs often lead to more buying in the short-term. This is especially true when there has been a run-up into the breakout and the breakout occurs on lower volume. Both conditions were present Tuesday.
- The very low 3/10 Offset HV suggests a big move could be coming in the next few days.
- New highs continue to diverge.
- SOMA levels inched up and remain range-bound.

Short-term Outlook

The Bottom Line

Evidence remains mostly bullish, but the market is too overbought for me to consider taking on new exposure.

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						
April 27, 2015	NDX up 1% & SOX down.	1-6 days	Bearish	-3.20%	1.90%	4.10%
April 27, 2015	Breakout, 3up & Low vol.	1-5 days	Bullish	1.90%	-0.90%	-2.00%
April 20, 2015	1% drop on 2:1 negative breadth	1-9 days	Bullish	3.00%	-2.50%	-5.40%
Active - Long Term						
January 26, 2015	NASDAQ leading SPX	int term	Bullish			
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			

The Evidence

Friday was a little mixed but the SPX and NDX both broke out to new highs. The SPX closed up 0.2%, and the NASDAQ rose 0.7%, but the Russell 2000 declined 0.3%. Breadth was barely positive as the NYSE Up Issues % came in at 50.1% and the Up Volume % was 51.2%. Total NYSE volume dropped quite a bit from Thursday's level.

Friday was the 1st time since March 2nd that the SPX closed at a new high. The new high triggered a number of studies in the Quantifinder. I have shown numerous times before that breakouts to new highs show a better chance of following through if they occurring after a decent basing period of at least 1-2 weeks. Some other studies that triggered showed evidence that to some people might seem counter-intuitive. One study showed that breakouts that occurred on declining volume have followed-through much better than breakouts accompanied by rising volume. Another study showed that when the breakout has come after the market had already risen for at least the past 2 days, then it has done a better job of carrying that momentum forward.

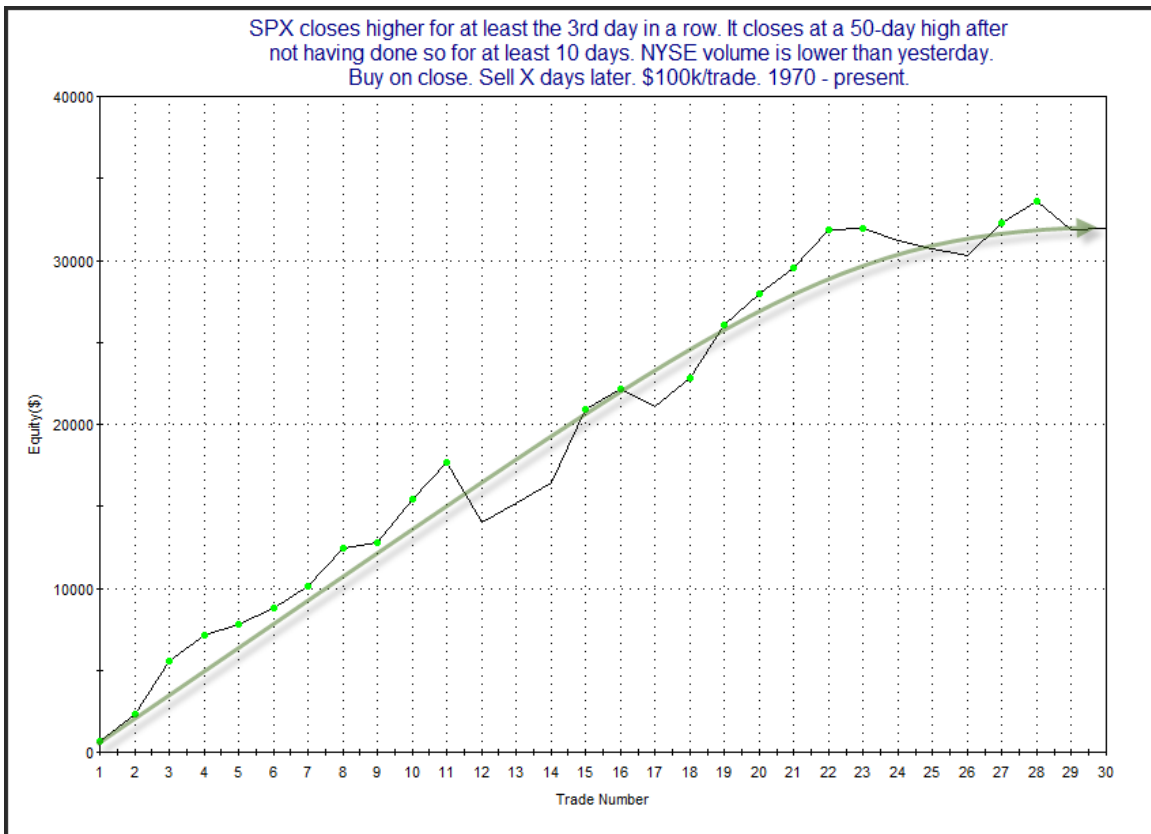
In the 4/2/14 Letter I combined these concepts and published the following study. (All stats are updated.)

SPX closes higher for at least the 3rd day in a row. It closes at a 50-day high after not having done so for at least 10 days. NYSE volume is lower than yesterday.
Buy on close. Sell X days later. \$100k/trade. 1970 - 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	31,924.10	30	24	6	80.00	1,674.38	4,482.50	-1,376.85	-3,693.73	1.22	4.86	1,064.14
4	23,289.96	30	24	6	80.00	1,234.28	4,440.00	-1,055.48	-2,145.44	1.17	4.68	776.33
3	21,035.59	30	21	9	70.00	1,249.65	3,950.00	-578.56	-1,082.79	2.16	5.04	701.19
2	13,225.68	30	22	8	73.33	882.41	2,133.10	-773.43	-1,305.60	1.14	3.14	440.86
1	8,567.32	30	21	8	70.00	556.74	1,384.02	-390.52	-893.32	1.43	3.74	285.58

28 of 30 instances (93%) closed above the entry price at some point in the next week.

Stats here are very impressive, with the average follow-through being over 1% 5 days later. And this is with a setup where the SPX is already extended! The consistency is impressive as well. Below is a look at the profit curve assuming a 5-day holding period.



While the last couple of instances have not done great, the persistent upslope acts as nice confirmation of the upside edge.

To demonstrate the importance of the 3-day rise and the low volume on the breakout, I reversed both of those criteria and re-ran the study.

SPX closes at a 50-day high after not having done so for at least 10 days. It closed down either yesterday or the day before. NYSE volume is higher than yesterday. Buy on close. Sell X days later. \$100k/trade. 1970 - 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	8,265.00	73	35	38	47.95	1,678.68	8,516.82	-1,328.66	-6,088.44	1.26	1.16	113.22
4	-490.24	73	36	37	49.32	1,327.45	6,716.71	-1,304.82	-5,585.56	1.02	0.99	-6.72
3	9,452.45	73	38	35	52.05	1,277.83	6,740.50	-1,117.29	-5,361.06	1.14	1.24	129.49
2	11,265.34	73	40	32	54.79	958.48	4,028.44	-846.06	-4,166.72	1.13	1.42	154.32
1	9,092.35	73	42	31	57.53	564.55	2,731.56	-471.57	-2,722.61	1.20	1.62	124.55

Breakouts under these conditions have seen essentially no edge over the next few days.

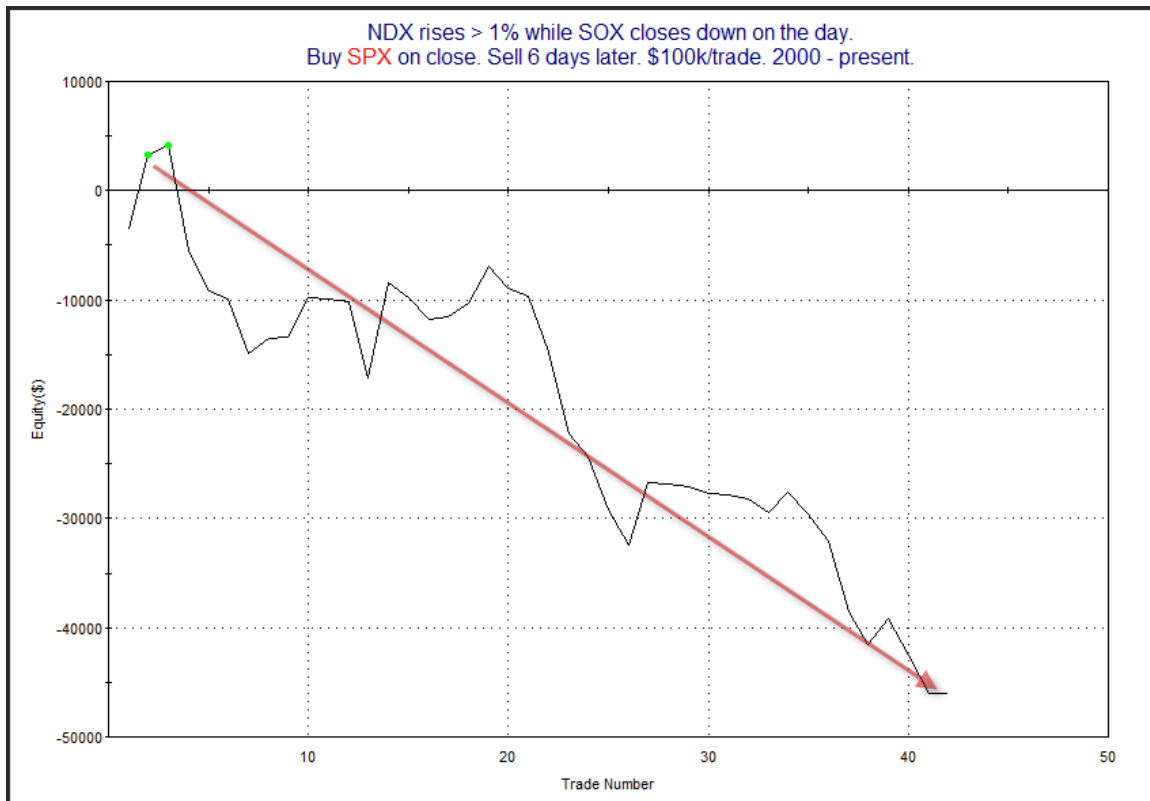
Another interesting aspect of Friday's action was the discrepancy between the NDX and the SOX. While the NDX rose 1.3% on Wednesday, the SOX declined 1.7% - which is very unusual action. It brought about a study last seen just over a year ago in the 4/17/14 Letter, which I have updated below.

NDX rises > 1% while SOX closes down on the day. Buy NDX on close. Sell X days later. \$100k/trade. 2000 - 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	-79,286.99	40	16	24	40.00	4,885.26	18,826.33	-6,560.47	-13,954.56	0.74	0.50	-1,982.17
9	-75,635.95	40	13	27	32.50	5,566.44	22,154.89	-5,481.47	-15,780.45	1.02	0.49	-1,890.90
8	-71,316.46	41	12	29	29.27	6,143.82	30,307.45	-5,001.46	-13,288.50	1.23	0.51	-1,739.43
7	-84,541.97	42	10	32	23.81	7,565.22	31,628.02	-5,006.07	-17,436.00	1.51	0.47	-2,012.90
6	-114,176.09	42	10	32	23.81	6,786.44	23,421.19	-5,688.77	-21,090.48	1.19	0.37	-2,718.48
5	-81,458.63	43	15	28	34.88	4,162.09	12,749.43	-5,138.93	-12,790.08	0.81	0.43	-1,894.39
4	-49,928.05	43	20	23	46.51	3,053.56	11,322.33	-4,826.05	-12,796.24	0.63	0.55	-1,161.12
3	-27,726.57	44	18	26	40.91	4,324.74	15,615.69	-4,060.45	-15,779.50	1.07	0.74	-630.15
2	-5,345.84	46	21	25	45.65	3,418.57	16,624.43	-3,085.43	-9,160.50	1.11	0.93	-116.21
1	-2,972.45	48	22	26	45.83	2,635.69	9,397.52	-2,344.53	-6,256.64	1.12	0.95	-61.93

Six days later 76% of the instances were losers and the average occurrence was nearly a 3% loss. That seems to be a fairly substantial edge. I also updated how the SPX performed while this was all going on.

NDX rises > 1% while SOX closes down on the day. Buy SPX on close. Sell X days later. \$100k/trade. 2000 - 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	-17,851.90	40	17	23	42.50	2,831.05	9,774.70	-2,868.69	-8,478.02	0.99	0.73	-446.30
9	-25,316.68	40	18	22	45.00	2,641.24	9,278.30	-3,311.77	-8,963.07	0.80	0.65	-632.92
8	-32,303.33	41	19	22	46.34	2,220.79	9,165.45	-3,386.29	-7,574.41	0.66	0.57	-787.89
7	-40,771.07	42	19	23	45.24	2,102.23	10,101.57	-3,509.28	-11,391.59	0.60	0.49	-970.74
6	-45,979.25	42	13	29	30.95	2,802.31	8,753.07	-2,841.70	-9,589.14	0.99	0.44	-1,094.74
5	-40,975.55	43	18	25	41.86	1,750.93	6,877.04	-2,899.69	-7,519.22	0.60	0.43	-952.92
4	-25,646.02	43	21	22	48.84	1,659.24	5,068.10	-2,749.55	-11,917.40	0.60	0.58	-596.42
3	-12,846.35	44	20	24	45.45	1,888.68	6,877.26	-2,109.17	-9,480.90	0.90	0.75	-291.96
2	-6,846.36	46	20	26	43.48	1,602.90	5,842.98	-1,496.32	-6,411.90	1.07	0.82	-148.83
1	3,378.73	48	24	24	50.00	1,271.61	5,396.04	-1,130.83	-2,692.80	1.12	1.12	70.39

The pullbacks haven't been quite as reliable or as strong as the NDX but there still appears to be a decent downside edge. Below is an equity curve that assumes a 6-day holding period.



While choppy, it has persisted lower and continues to make new lows. Overall, this study appears worthy of consideration.

Another factor that traders may want to consider is the fact that the 3/10 Offset HV indicator closed at just 0.23 on Friday. This suggests a volatility expansion is likely to occur in the next few days. I discussed this indicator a couple of weeks ago when we had another low reading. Below I have copied that commentary:

I first introduced the 3/10 Offset HV in July of 2009. It essentially takes a short 3-day measure of Historical Volatility and compares that to the 10-day measure of 3-days ago. Low readings indicate there has been a contraction in volatility. High readings indicate there has been an expansion. Anything at or below 0.25 is regarded as extremely low. Often after very low numbers like this we see a volatility expansion take place...

In the July 2009 study I found on average when the 3/10 Offset HV falls below 0.25, then the 3-day Historical Volatility reading 3 days later is about 5.5 times higher than on the trigger day. I decided to examine the 6 years since then and found that HV over this time period increased on average 4.75x over the next 3 days. This is below the historical average but still implies a sharp volatility expansion is likely.

In August of 2009 I published a study that found this condition created a favorable environment for trading Opening Range Breakouts (ORBs). A link to that study is below:

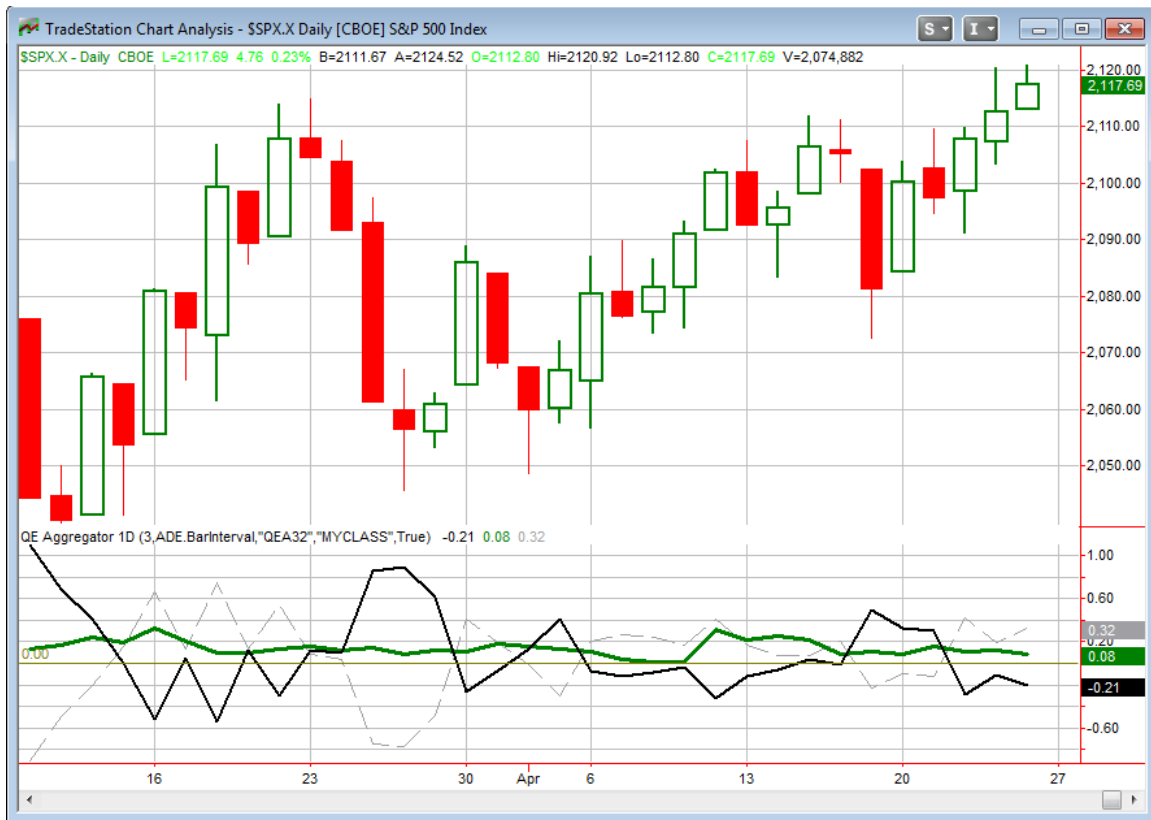
Quantifiable Edges ORBs Study

For anyone who is interested in seeing some techniques for actually trading these ORBs, there is a webinar from October 2010 on the subject on the videos page (subscribers only).

Daytrading ORBs using the 3/10 Offset HV as a filter

It's important to note that the 3/10 Offset HV indicator predicts volatility, not direction. For direction I look to the Aggregator. Of course tonight the Aggregator is neutral. The low 3/10 Offset HV implies that a move in either direction could be exaggerated and increases risk (and possible reward).

So we are seeing bullish evidence, bearish evidence, and evidence suggesting whatever way things break, it could be a sharp move. It is times like this when the picture is not entirely clear that I find the Aggregator most useful. I have updated the [Aggregator](#) chart below.



The green Aggregator Line tonight 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 remained 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 positive on Monday. Of course that could change if additional bearish evidence emerges. The Differential Pivot will be 2115.38 on Monday. That is just 0.1% below Friday's close. So SPX will flip from "overbought" to "oversold" versus recent expectations on just about any down close on Monday.

There is a bit too much conflict and the market is a little too extended for me to get excited about the long side just yet here. And the increased risk suggested by the low 3/10 Offset HV makes possible trades less appealing. A decline in the next couple of days that is also accompanied by short-term bullish evidence could get me to start building a long index position. But I am not quite there yet, and will instead wait for a higher probability setup to emerge before taking on new exposure.

Intermediate-term Outlook (2 weeks – 2 months) – updated 4/27– somewhat bullish

Combo #1	Combo #2	Combo #3
Long	Long	Long

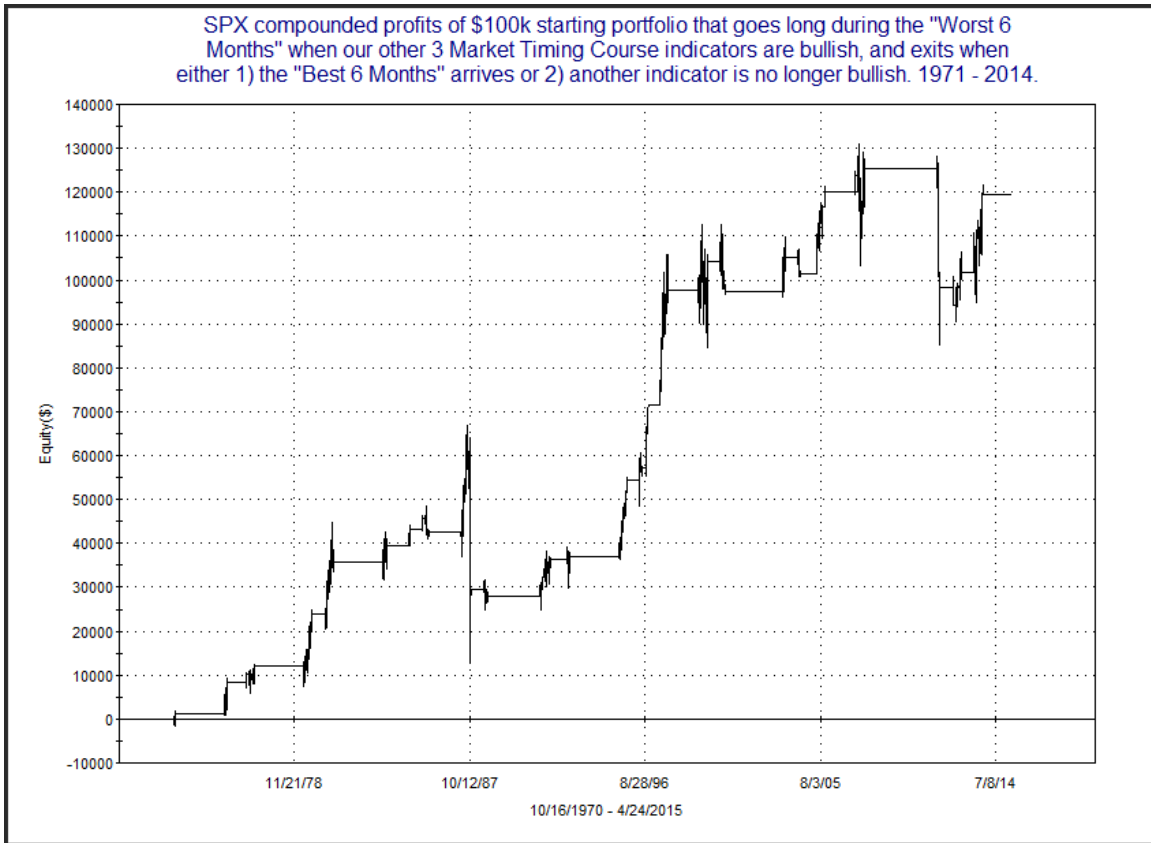
Above is the status of the different Combination Signals from the Quantifiable Edges Market Timing Course. Signals are long-term in nature. All 3 can be either flat or long. None of them look to short. More information on these signals can be found in the [Quantifiable Edges Market Timing Course](#), 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.)

With SPX and the NASDAQ both closing at new highs on Friday there is no doubt the uptrend remains in place. Traders need to continue to respect the trend.

Of course seasonality will change some on Friday as we move from the “Best 6 Months” (Nov – April) to the “Worst 6 Months” (May – Oct). For detailed information on how the market has performed during the Best vs Worst 6 month periods please check out the Market Timing Course. The bottom line is that since 1960 the market has made very little headway during the Worst 6 Months, and nearly all of its gains during the Best 6 Months.

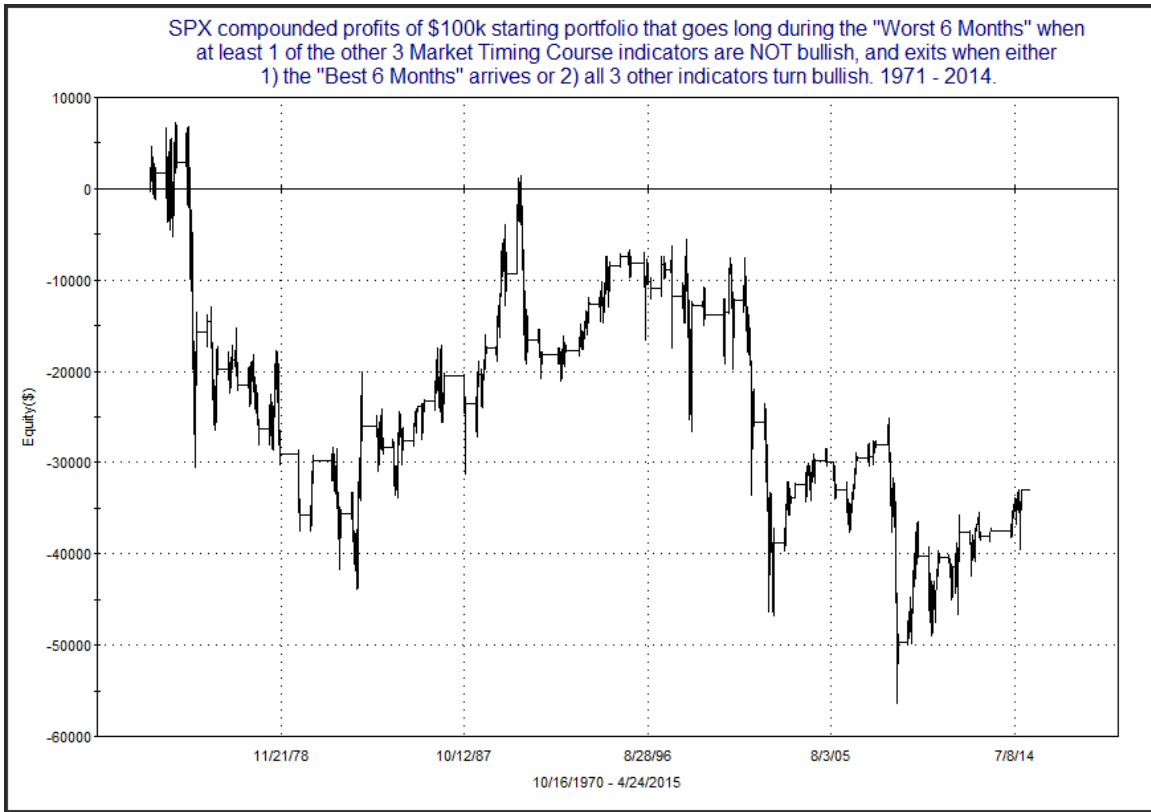
But while the Worst 6 Months is nearly upon us, our other 3 Market Timing Course indicators are all bullish. So let’s examine Worst 6 Months returns when this has been the case.

The profit curve below shows compounded profits in a \$100k starting portfolio during the Worst 6 Months when our other indicators were all bullish as they are now. It goes back to 1971.



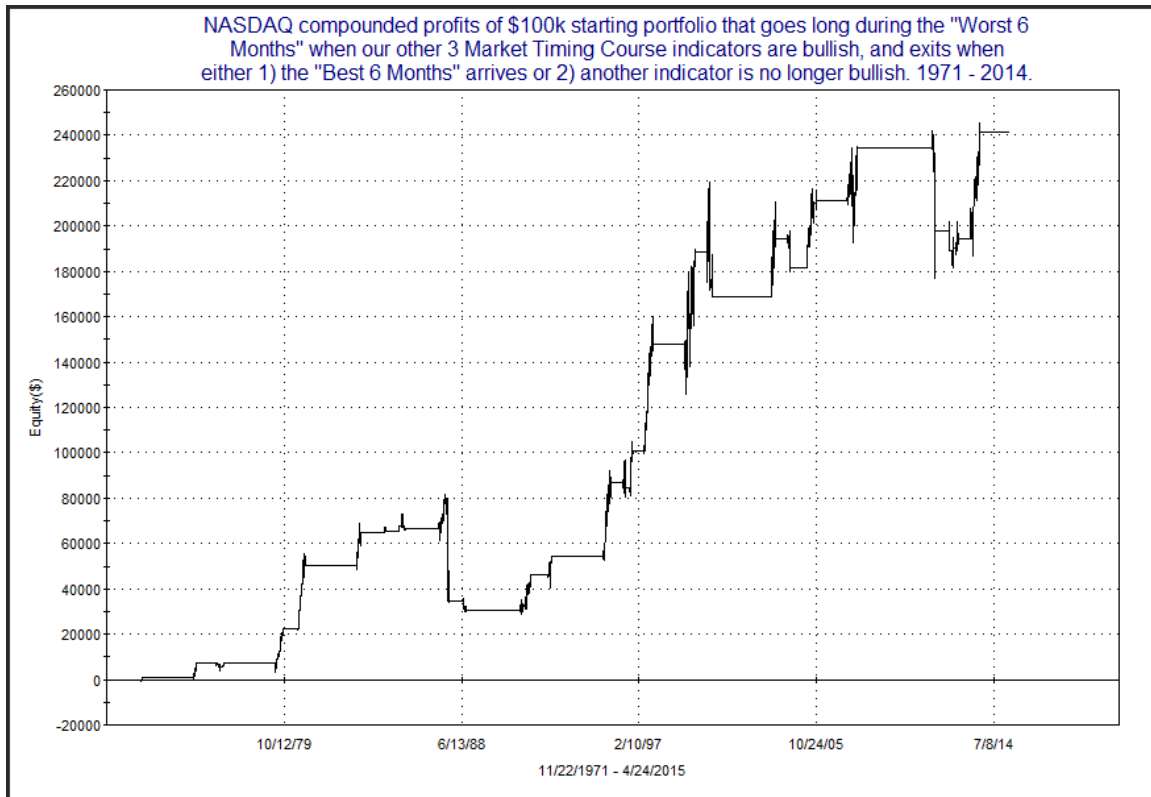
As you can see, the “Worst 6 Months” under these circumstances has actually fared quite well, with over \$120k in profits and a choppy, but persistently upward moving profit curve. (Of course this strategy is for evaluation only. Staying in cash during the “Best 6 Months” regardless of market conditions would be silly, since the “Best 6 Months” have done substantially better.)

For comparison, and to prep ourselves in the case that we see any indicator changes, let’s now look at how the Worst 6 Months has performed when it did NOT have the other 3 Market Timing Course indicators all pointing bullish.



In this case a \$100k portfolio would now be down to about \$67k – a pretty terrible return over 43 years.

Of course one of our Market Timing Course indicators is our NASDAQ/SPX Relative Strength Indicator, which looks for a leading NASDAQ. If instead of going long SPX during the Worst 6 Months with everything else positive as shown earlier, let's look at NASDAQ returns under this scenario.

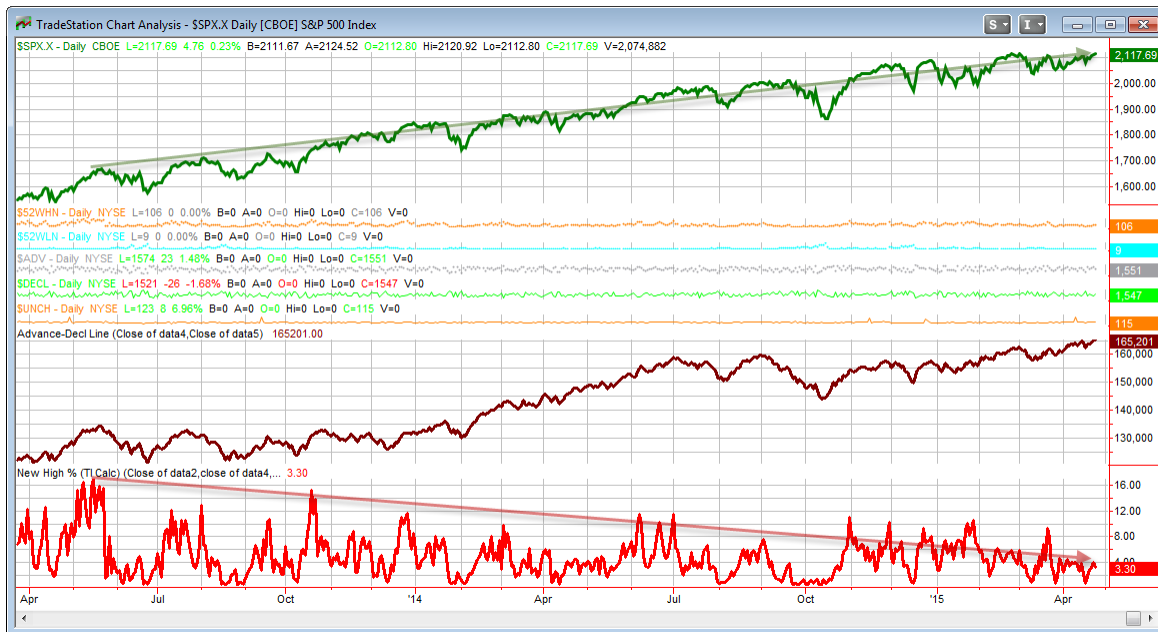


Profits here are even more impressive. The NASDAQ would have gained about twice as much as the SPX over the same time period.

One other potential positive to the current Worst 6 Months is that the SPX has been in a persistent uptrend leading up to it. Last year in the 4/29/14 letter I showed that years where SPX has avoided a 5% pullback prior to May it has performed MUCH better during the Worst 6 Months than years in which there had been a 5% pullback. So far this year, we have not yet seen a 5% pullback. If that holds true until Thursday, then this study could add further bullish confirmation. I will update that study next weekend once we know for sure whether there has been a 5% pullback or not.

The bottom line for this upcoming "Worst 6 Months" period is that it does not appear to look very dire, and with the trend in place and the NASDAQ leading, further gains appear more likely than a large decline.

On the downside, while new highs were reached for SPX the number of new stocks making new highs continued to diverge badly. This can be seen on the chart below, which is similar to the one found on the QE charts page.



Not only is the New High % diverging, it is still very far below the May 2013 level, and it seems to be getting progressively worse as this rally continues. As I discussed in the Study of Tops (available for Gold & Silver subscribers on the special reports downloads page) the divergent New High % is a condition that has preceded every major SPX decline since 1970.

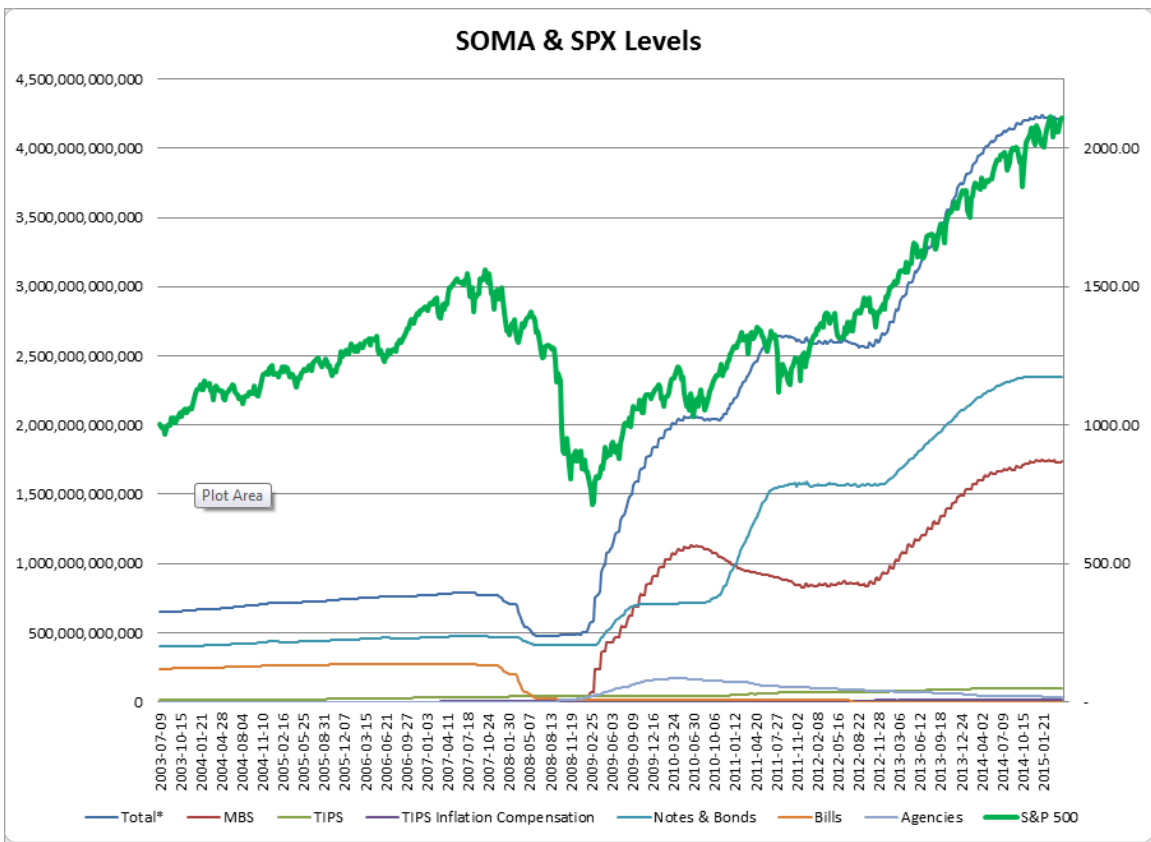
This opens up the possibility of a major top being put in. Note I said possibility, not probability. It needs to be understood that while the narrowing of New Highs and/or the turn down in the Advance/Decline Line has been a prerequisite for a top to take place, these breadth conditions have not been very useful in timing the tops. Often such divergences have persisted for many months, or even years (as in this case). I therefore view these breadth divergences as possible warning signs – not as timing signals. The current divergence is now nearly 2 years 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 most recent temporary top in March.

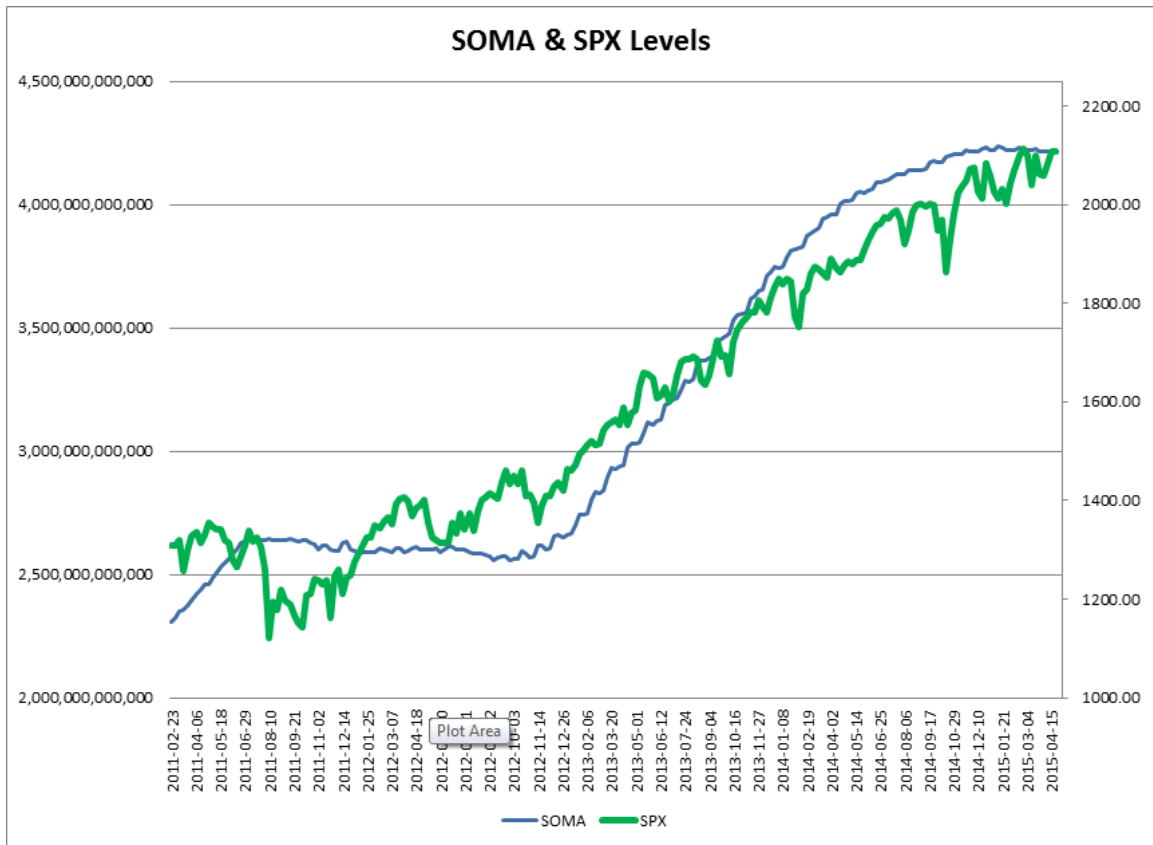
As I do each week, I have updated our Fed SOMA charts below. Below is a description for those who are new to these charts or who may want a refresher.

SOMA stands for System Open Market Account. It is the account at the Fed that contains all of its bond purchase holdings. We have tracked Fed purchases for several years, and as is evident in the charts below, the stock market has consistently reacted positively when the Fed has been buying securities in the open market and increasing the size of its account. When the account has declined, the market has struggled. The obvious takeaway has been “don’t fight the Fed”. As far as intermediate-term indicators go, this has been as good as anything in recent years.

While the Fed is not making new QE purchases any longer, it is continuing to reinvest maturities. Therefore, the total assets in their System Open Market Account (SOMA) has not begun to dive like the old Quantifiable Edges POMO indicators did. Below are long and short-term views of SOMA and SPX. First, the long-term view (back to 2003).



And now the zoomed-in view (2011 – present).



SOMA again saw another mild increase this week. That changed really nothing in my SOMA analysis. SOMA has basically chopped sideways over the last couple of months. The high came on January 14th, and changes since then have been minimal. But still the SOMA line has not rolled over. Of course, in looking at the 1st chart you'll note that even flat SOMA readings have led to difficult markets over the last several years. Since quantitative easing ended in October the market has seen much choppier action. There have been strong swings over the last several months. The market has not made much progress but the rally is still intact. Perhaps flat SOMA is enough to sustain the market for now. I doubt a steadily declining SOMA would support a positive market environment. Fed policy changes and SOMA activity remain an important market influence. Therefore, as I have been doing, I will continue to keep a close eye on Fed action and SOMA levels.

Overall, evidence still seems to favor the bulls. The flat SOMA and the continually floundering number of stocks hitting new highs may eventually set the stage for a correction. But the uptrend remains strong and the Market Timing Course indicators are all predominantly favorable, even with the Worst 6 Months approaching.

Therefore I am keeping the intermediate-term outlook at “somewhat bullish” as it has been for some time now. I remain more inclined to take on long positions than short ones, but will take either if short-term evidence is compelling enough.

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)	3/9/2015	\$32.25	\$41.92	29.98%	\$32.69	Aggressive VIX

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