

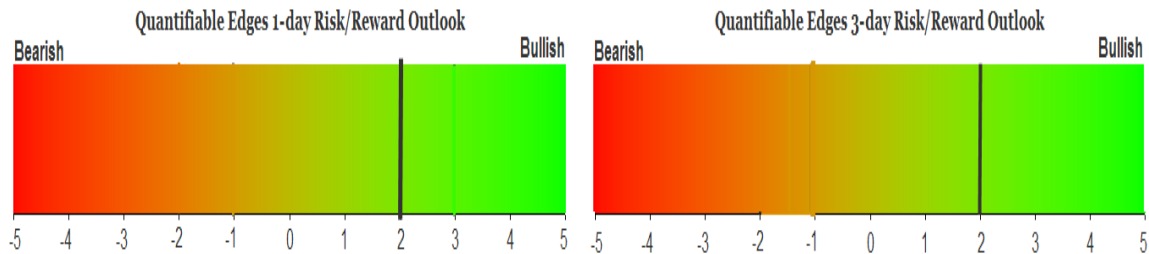
# QUANTIFIABLE EDGES SUBSCRIBER LETTER

ASSESSING MARKET ACTION WITH INDICATORS AND HISTORY

December 21, 2015

Volume 8 Issue 245

## Market Overview



## Signals Overview

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

## Tonight's Research Points

- More strong selling failed to generate much fear as measured by the VIX. This suggests downside risk.
- SPY's gap down and selloff to the low end of its recent range suggests a bounce is likely to occur in the next few days.
- SOMA increased this past week, but the Fed decided to raise rates. Reduced Fed support could mean trouble for the market.

## Short-term Outlook

### The Bottom Line

The market has quickly become short-term oversold, but evidence pointing to a bounce is a little light. I think reward/risk favors near-term upside but I am taking a cautious approach because of the light evidence.

**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 21, 2015	SPX < Bollinger Band. VIX not stretched	1-2 days	Bearish			
December 21, 2015	Gap -n- crap to bottom of 2-week range	1-5 days	Bullish			
December 14, 2015	Opex Week in Decmber next. SP<10ma	1-6 days	Bullish			
December 14, 2015	Fri drop 1.5x 20ATR	1-6 days	Bullish			
<b>Active - Long Term</b>						
December 14, 2015	Santa Rally	thru Jan 2	Bullish			
November 2, 2015	Best 6 months	Nov-Apr	Bullish			
October 26, 2015	NASDAQ leading SPX	int term	Bullish			
September 9, 2015	FTD on mild breadth & volume	int term	Bearish			
November 3, 2014	Quantitative Easing Ends	int term	Bearish			
July 22, 2013	New High Divergence (Study of Tops)	int term	Bearish			

**The Evidence**

Friday was a 2<sup>nd</sup> day in a row of sizable selling. The SPX lost 1.8%, the NASDAQ fell 1.6% and the Russell 2000 declined 1.3%. Breadth was squarely negative as the NYSE Up Issues % came in at 35% and the Up Volume % was 23%. Total NYSE volume came in higher than Thursday's level.

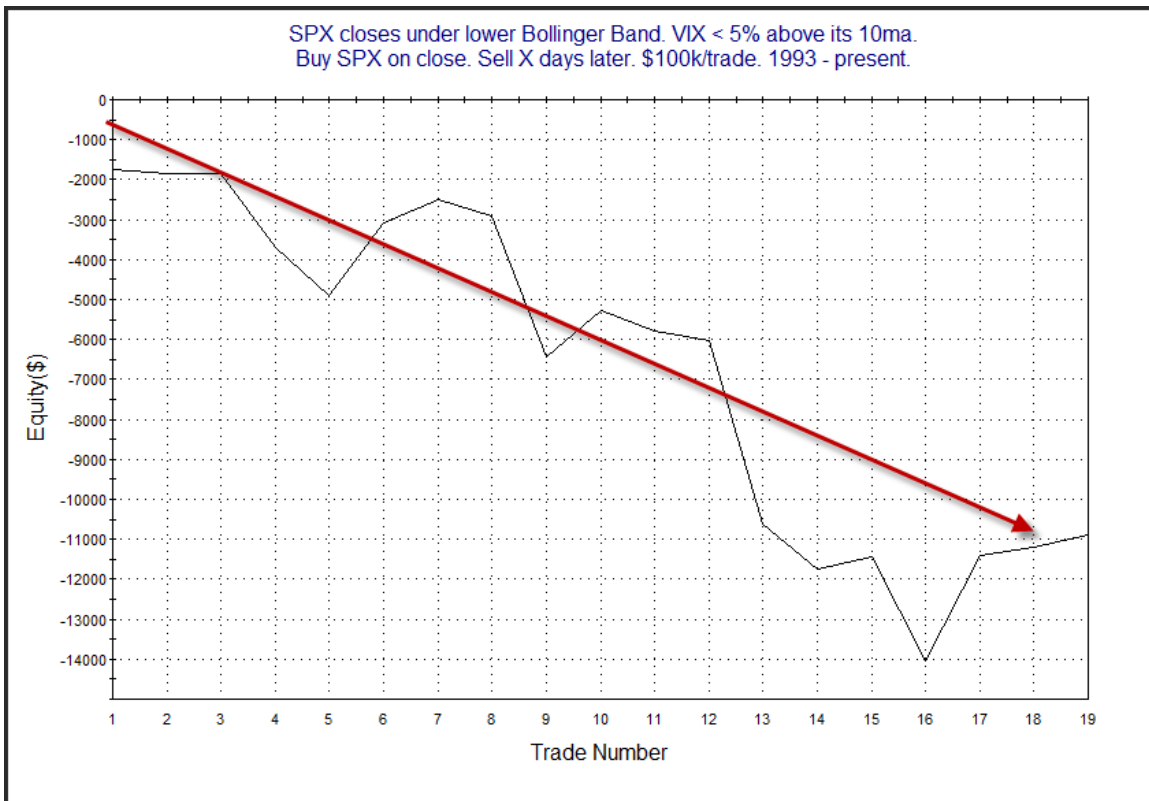
Evidence I examined was somewhat muted for such a strong 2-day selloff. And it was also mixed. After looking at a number of things, there were 2 studies from that Quantifinder that appear worth consideration. One is bearish and the other bullish. Let's first consider the bearish study.

In the 11/15/2012 subscriber letter I looked at other the times where SPX was stretched to the downside, but the VIX was not particularly stretched to the upside. The VIX is a measure of options pricing that can be used to gauge fear among options traders. It commonly trades inverse to the SPX, so when there is a big decline in the market that is often accompanied by a spike in the VIX. The current situation is showing less fear than would often be associated with a selloff like we have seen the last 2 days. The study below examines times like the present.

SPX closes under lower Bollinger Band. VIX < 5% above its 10ma.  
Buy SPX 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	-20,043.21	15	5	10	33.33	3,930.85	7,020.72	-3,969.75	-12,337.92	0.99	0.50	-1,336.21
9	-11,189.87	15	5	10	33.33	3,832.69	6,047.28	-3,035.33	-8,456.96	1.26	0.63	-745.99
8	-13,035.56	15	7	8	46.67	2,432.44	6,752.16	-3,757.83	-10,574.08	0.65	0.57	-869.04
7	-6,978.91	15	7	8	46.67	2,707.65	7,445.52	-3,241.56	-9,999.36	0.84	0.73	-465.26
6	-8,144.34	15	5	10	33.33	2,917.69	5,396.40	-2,273.28	-5,612.80	1.28	0.64	-542.96
5	-12,895.60	15	5	10	33.33	2,025.30	5,396.71	-2,302.21	-4,700.22	0.88	0.44	-859.71
4	-8,117.27	16	6	10	37.50	1,779.98	3,291.12	-1,879.71	-4,256.00	0.95	0.57	-507.33
3	-7,761.66	17	8	9	47.06	1,121.73	2,343.71	-1,859.50	-3,701.20	0.60	0.54	-456.57
2	-10,888.17	19	8	11	42.11	874.69	2,645.36	-1,625.97	-4,558.08	0.54	0.39	-573.06
1	-7,546.83	22	7	15	31.82	855.57	2,842.84	-902.39	-2,205.00	0.95	0.44	-343.04

Numbers here appear to favor the bears. Below is a profit curve using a 2-day holding period.

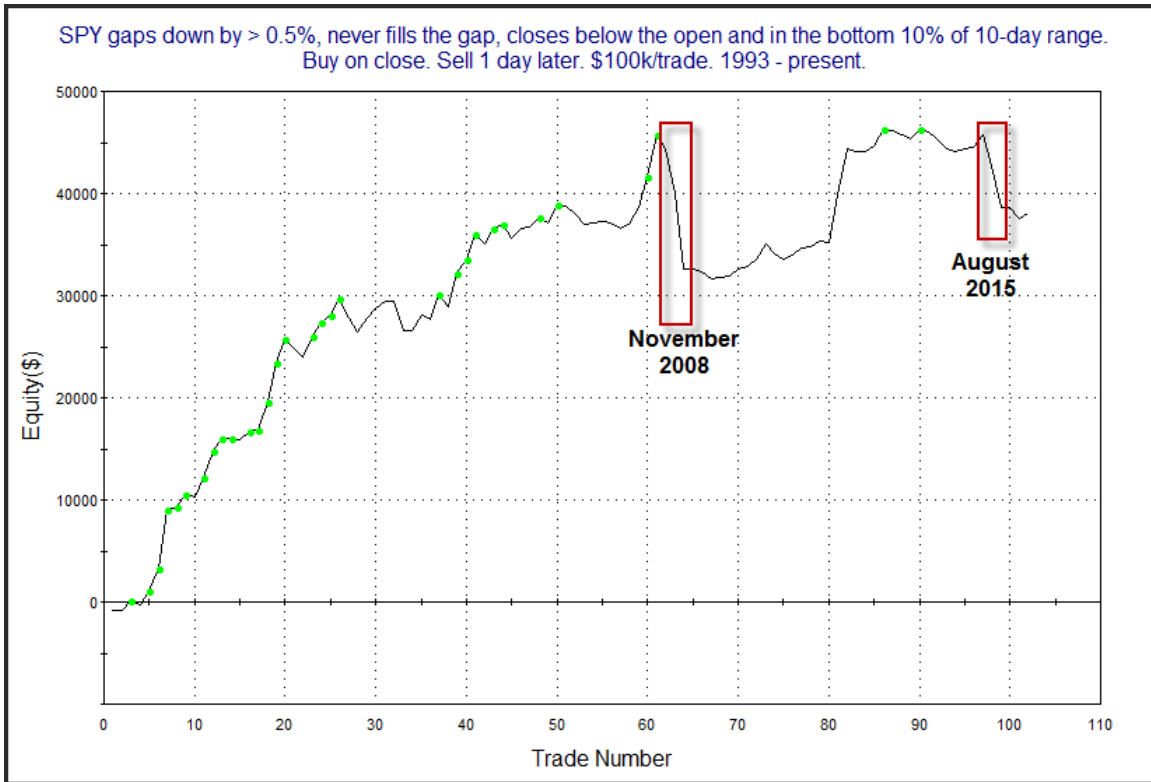


The last 3 instances have not played out as many of the others, but I think it is too early to give up on this study. The overall downslope appears to be in place. I have therefore included this study on the Active List.

The unfilled gap down, further selling, and close near the bottom of the 2-week range for SPY did trigger the study below, from the 11/12/08 letter

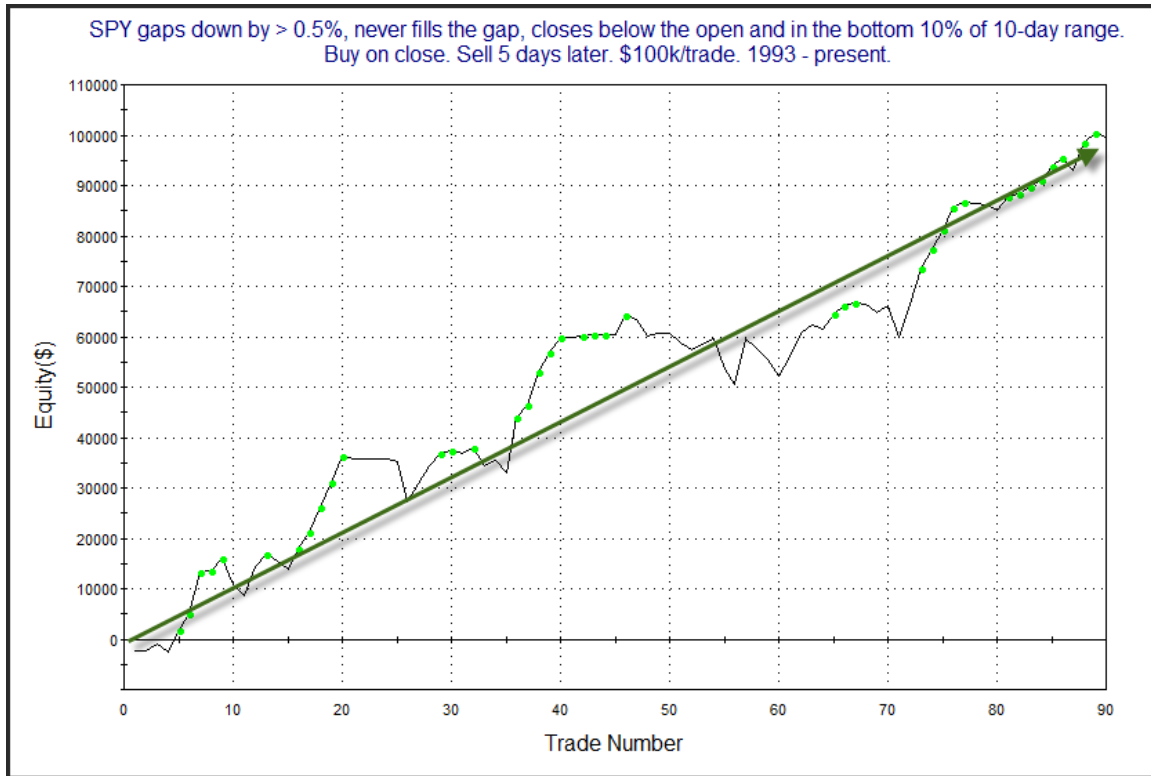
SPY gaps down by > 0.5%, never fills the gap, closes below the open and in the bottom 10% of 10-day range. Buy on close. Sell X days later. 1993 - present.												
X Days	All: Net Profit	All: Total Trades	All: Winning Trades	All: Losing Trades	All: % Profitable	All: Avg Winning Trade	All: Max Winning Trade	All: Avg Losing Trade	All: Max Losing Trade	All: Win/Loss Ratio	All: ProfitFactor	All: Avg Trade
5	99,516.56	90	54	35	60.00	3,106.13	10,816.00	-1,948.98	-7,955.64	1.59	2.46	1,105.74
4	67,287.20	91	52	39	57.14	2,876.47	13,568.00	-2,109.98	-10,531.08	1.36	1.82	739.42
3	45,888.76	97	58	39	59.79	2,294.43	8,358.40	-2,235.59	-10,567.08	1.03	1.53	473.08
2	50,393.60	101	61	39	60.40	2,046.53	7,756.80	-1,908.84	-7,761.78	1.07	1.68	498.95
1	38,045.67	102	62	40	60.78	1,327.63	5,764.38	-1,106.69	-7,417.30	1.20	1.86	373.00

Numbers here suggest a bullish edge. I decided to highlight a couple of the profit curves as well. Here is the 1-day profit curve.



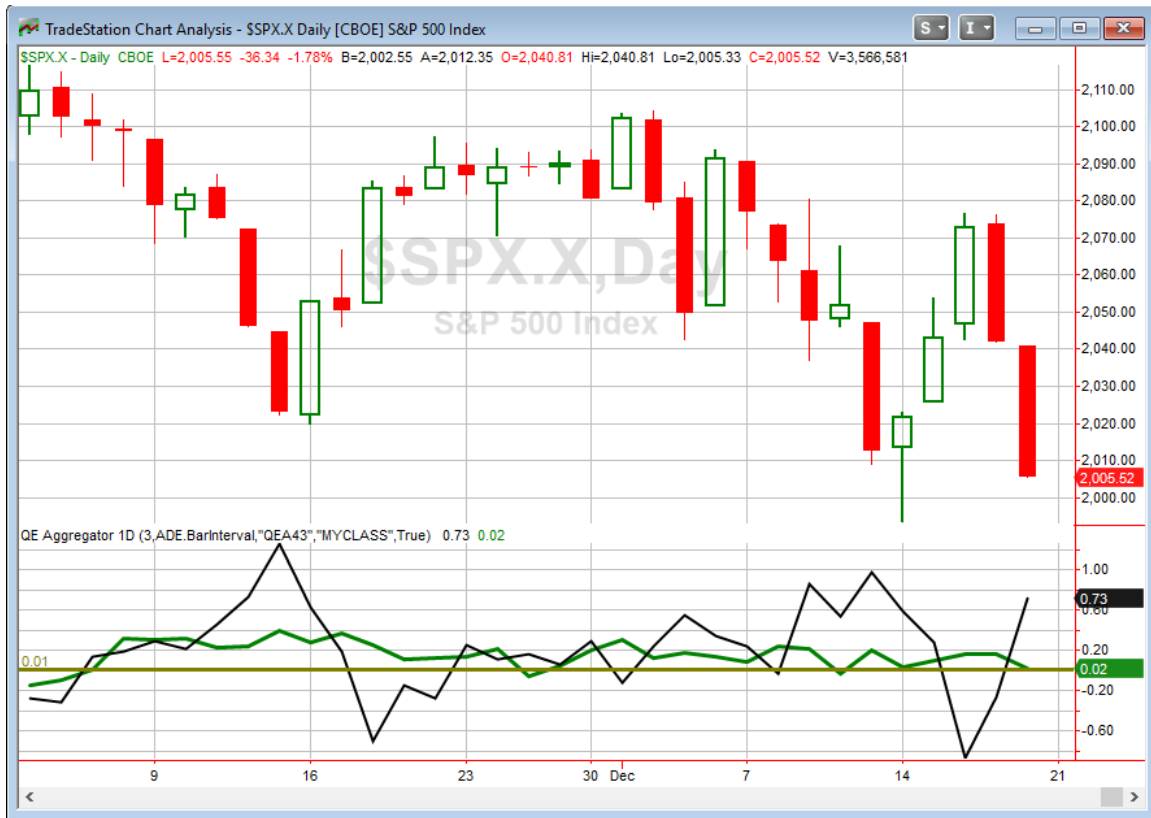
The curve here has been quite choppy over the last several years. When I looked closely I found that there were 2 periods that saw some big back-to-back losses and caused the sharp swoons I noted above. They were in November of 2008 and August of 2015. Without

those few trades the curve would not look bad at all. In fact, when examining the 5-day curve, I did not find nearly the same issue. Below is a look at that.



The strong steady upslope here offers some confirmation of the upside edge suggested by the numbers. I have also included this study on the Active List.

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



With the studies above included the green Aggregator Line only barely held above zero. Positive readings mean net expectations from the Active List are for upside over the next few days. Meanwhile the black Differential Line shot up far above zero. The positive Differential Line reading means SPX is oversold versus recent expectations. So expectations are modestly positive and SPX is short-term 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.

Based on the current studies, evidence is set to remain positive on Monday. This could change if more bearish evidence emerges. The Differential Pivot will be 2077.57 on Monday. That is a whopping 3.6% above Friday's close. The chances of SPX closing up 3.6% on Monday are extremely low. A more likely scenario to work off the oversold condition would be a multi-day rally or consolidation.

Despite the strong selling, bullish evidence is pretty weak. Still, with a bounce more likely than further selling, and plenty of room to the upside (high potential reward), it seems worth considering beginning to scale into a long position on Monday. With evidence weak so far, I have decided I will demand a strongly favorable fill. And since we are in a time of year where the Russell 2000 tends to outperform SPX, I will look to trade IWM rather than SPY.

**Intermediate-term Outlook (2 weeks – 2 months) – updated 12/21 –slightly 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.) *There were no changes this week and the combo systems are all still positive.*

It was a big negative turnaround for the market this past week. After 3 days higher Monday – Wednesday, the market gave back those gains and more over the last 2 days. Of course the big news on the street this past week, and the source of much of the volatility was that the Fed raised rates for the 1<sup>st</sup> time in 11 years. Since 1990 there have only been 4 other cycles of rate hikes. In Wednesday night’s letter I decided to measure SPX performance from the start of those cycles. I found that one month later the stock market was trading lower every time. But one year later it was higher every time. Individual returns (based on \$100k/trade) can be found in the table below.

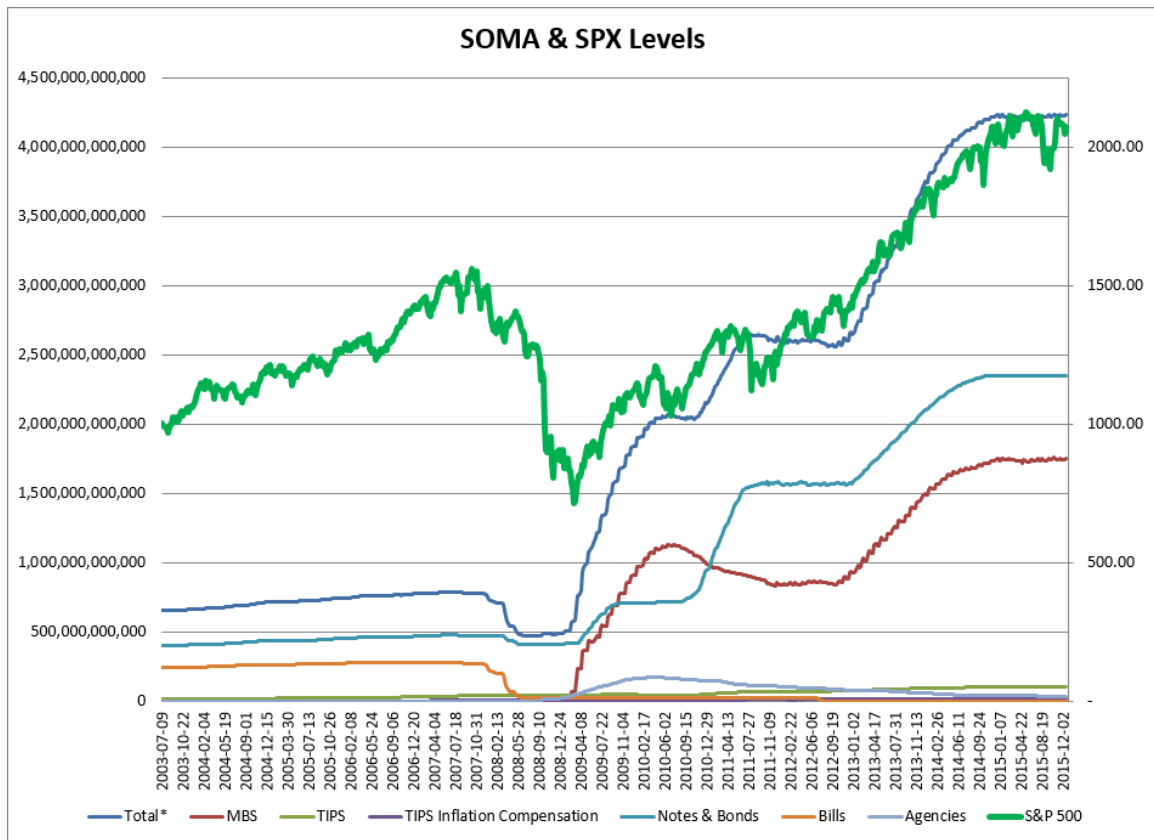
Rate Hike Cycle Begins	After One Month (21 trading days)		After One Year (252 trading days)	
Date/Time	% Profit	Run-up Drawdown	% Profit	Run-up Drawdown
2/4/1994	-0.84%	\$1,127.84 (\$2,573.68)	2.41%	\$2,573.68 (\$7,197.40)
3/25/1997	-2.27%	\$733.32 (\$6,996.78)	39.66%	\$40,824.00 (\$6,996.78)
6/30/1999	-3.22%	\$3,404.16 (\$3,194.64)	5.97%	\$12,960.72 (\$10,022.40)
6/30/2004	-3.42%	\$3.48 (\$5,392.26)	5.18%	\$7,686.45 (\$6,963.48)

Of course it is dangerous to draw conclusions from just 4 instances, but I thought it was interesting and somewhat noteworthy nonetheless.

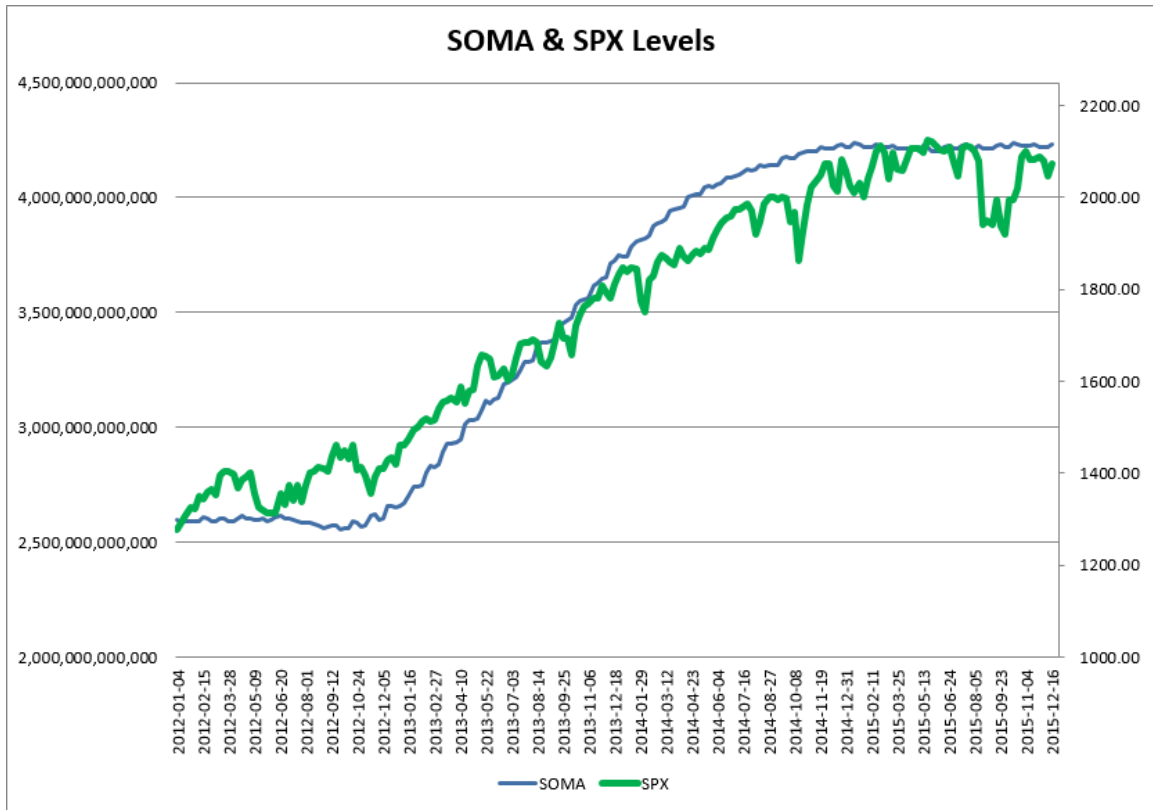
As I do each week, I have updated our Fed SOMA charts below. Below is a description for those who are new to these charts or who may want a refresher.

*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 (2012 – present).



While the headlines suggested a tightening, the Fed increased the SOMA this week by the largest amount since mid-October. It also spiked total SOMA value up to near that high level achieved in mid-October. Flat or declining SOMA readings over the last few years have led to market struggles. But a rising SOMA has consistently led to gains. It will be interesting to how the SOMA changes in the coming weeks. Will the Fed look to offset rising rates with increased SOMA liquidity? Or will the tightening policy hit the SOMA as well. It is notable that SOMA values are reported each Wednesday, so the tightening policy had not yet been established when this past week's buying occurred. Of course I will continue to keep a close eye to see if the SOMA goes on to new highs (bullish) or whether it reverses and starts heading lower with new policies in place (bearish).

Intermediate-term indications remain split. Intermediate-term seasonality remains strongly favorable and the NASDAQ is still leading, so the Market Timing Course indicators are mostly bullish. Also, the SPX is very close to triggering a Golden Cross if it can manage a rally in the next few days. (More on that in the Market Timing Course also.) The bears can still point to the FTD study from a while back, the questionable Fed support, and the old breadth divergence study. None of these appear strongly bearish on their own. Overall, I still think evidence tilts moderately in favor of the bulls. For now I remain slightly bullish. I will be marginally more aggressive with long trades than shorts, but I am willing to trade both sides of the market if good short-term setups emerge.

## Catapult and Capitulative Breadth Statistics

[Catapult & CBI Presentation Link](#)

### **Open Catapult Triggers**

KMI – 1/3 @ \$16.82 (bought @ limit)

KMI – 1/3 @ \$16.42 (bought @ limit)

KMI – 1/3 @ \$15.72 (not filled – cancel for now)

### **Broad Market Large Cap CBI – 3(KMI)**

### 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.

**IWM – buy ¼ index position @ \$111.00 LIMIT ON OPEN. If not filled on the open, cancel the order and look to buy @ \$111.47 LIMIT ON CLOSE.** Based on the short-term section above I will look to take advantage of the apparent upside edge in the market. But with evidence a little light I will only be look to buy into a gap down of at least \$0.48 or a down close. I do not want to buy into an intraday selloff in case it turns ugly as we have seen the last 2 days.

### Current Open Trade Ideas

Symbol	Entry Date	Entry Price	Current Price	% Gain/Loss	Stop	Notes
KMI(1/3)	12/7/2015	\$15.66	\$15.14	-3.32%		Catapult
KMI(1/3)	12/8/2015	\$15.29	\$15.14	-0.98%		Catapult

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