

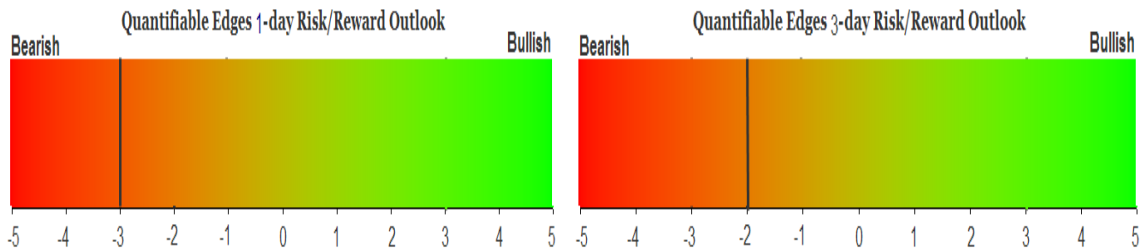
# QUANTIFIABLE EDGES SUBSCRIBER LETTER

ASSESSING MARKET ACTION WITH INDICATORS AND HISTORY

June 30, 2011

Volume 4 Issue 125

## Market Overview



## Signals Overview

Aggregator	Aggressive VIX	Conservative VIX	NDX Trend Timer
Short	100% Short SPY	Flat	Flat

## Tonight's Research Points

- The extremely low VXO is suggesting a market pullback.
- The very low 3/10 offset HV indicates a big move may be on tap.

## Short-term Outlook

### The Bottom Line

The Aggregator has turned bearish for the first time in awhile. I will look to take advantage with a short trade, but will keep the position size small unless more bearish evidence emerges.

## Summary of Recent Active Studies (see Letters from listed dates for details)

Study Date	Description	Time span	Bias	Avg Max Move
<b>Active</b>				
June 30, 2011	VXO 15% under 10ma. SPX > 200ma	1 day	Bearish	
<b>Active - Long Term</b>				
June 22, 2011	FTD with Up Issues % 1-yr Rank > 95%	int term	Bullish	
May 31, 2011	4 Weeks Down. Close > 40ma.	1-10 weeks	Bullish	9.00%
March 22, 2011	3 Days Up Issues % > 70%	8 months	Bullish	19.00%
November 22, 2010	POMO	int term	weakening	
October 25, 2010	SPX Golden Cross	int term	Bullish	

If the avg max move is achieved the study will appear in **bold italic blue** and no longer be active.

## The Evidence

The market put in another day of solid gains. Action was again strong for most of the day and the major indices all finished higher. The SPX gained 0.8%, the Nasdaq added 0.4%, and the Russell 2000 rose 0.3%. Breadth was also strong as the NYSE Up Issues % came in at 69% and the Up Volume % was 80%. Total volume rose for the 1<sup>st</sup> time in the 3-day rally.

There wasn't much today that appeared suggesting a strong directional edge. One indication suggesting the move is getting overdone and is likely to pull back is the extreme stretch in the VXO. It closed nearly 18% below its 10ma. Such rapid drops in the VXO are often followed by a move lower in the SPX. In the 3/24/11 Subscriber Letter I showed a study that examined SPX performance following days when the VXO closed more than 15% below its 10ma while the SPX was trading above its own 200ma. I have updated that study below.

VXO closes over 15% below 10ma. SPX > 200ma. Buy SPX on close. Sell next days close. \$100k/trade. 1988 - present.			
TradeStation Performance Summary			Collapse ^
All Trades			
Total Net Profit	(\$9,221.87)	Profit Factor	0.60
Gross Profit	\$13,928.76	Gross Loss	(\$23,150.63)
Total Number of Trades	65	Percent Profitable	35.38%
Winning Trades	23	Losing Trades	42
Even Trades	0		
Avg. Trade Net Profit	(\$141.87)	Ratio Avg. Win:Avg. Loss	1.10
Avg. Winning Trade	\$605.60	Avg. Losing Trade	(\$551.21)
Largest Winning Trade	\$2,096.10	Largest Losing Trade	(\$2,341.24)

Stats here seem to suggest a decent downside inclination. To get a better idea of how this edge has played out over time I have produced an equity curve below.



The recent rise looks similar to the one between trades 15-20. Other than these 2 periods, the downside edge has been quite consistent. I have elected to include this study on the active list.

Also notable about current conditions is that the 3/10 Offset Historical Volatility Indicator came in at an extremely low 0.21 on Wednesday. I first introduced this indicator 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 numbers indicate there has been an expansion. Anything at or below 0.25 is regarded as extremely low. Often after sharp contractions like this we often see a volatility expansion take place. In August of 2009 I published a study that found this condition created a favorable environment for trading Opening Range Breakouts. A link to that study is below:

[Quantifiable Edges ORBs Study.pdf](#)

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.

<http://www.quantifiableedges.com/members/videos.php>

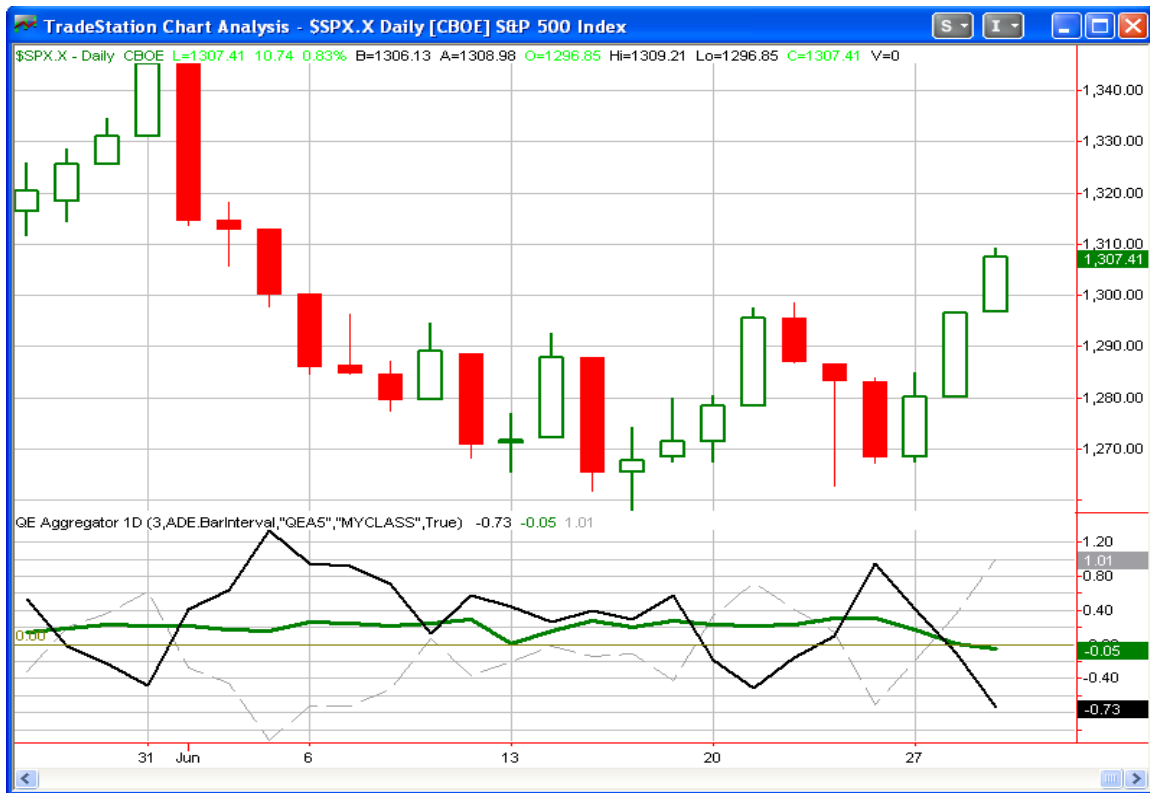
It's important to note that the 3/10 Offset HV indicator predicts volatility, not direction. For direction I look to the Aggregator. The Aggregator is currently bearish. My inclination therefore will be to look to short a breakdown of the opening range if there is a tight consolidation in early trading. This would just be for a possible daytrade and is not something I will be tracking in the subscriber letter as an official trade idea.

Of further note, the 3/10 Offset HV Calculation is available as part of the new "QE Indicators/Functions for Tradestation". Subscribers may download it to include on their own charts. A link to the Indicators page is below, where you may download the User Guide or the Tradestation ELD.

<http://www.quantifiableedges.com/members/qeindicators.php>

***Also, subscribers should note that the original indicators are set to expire on June 30<sup>th</sup>. If you have not uploaded and imported the most recent .eld file at some point in the last few weeks, you must do so Thursday or the indicators will stop working.***

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



The VXO study tonight managed to push the green Aggregator line below 0. Readings below 0 mean net expectations from the active list are for downside over the next few days. Meanwhile, the rally Wednesday caused the Differential Line to drop further below 0. A negative close means the SPX has outperformed expectations over the last few days. So net expectations are negative and the SPX is overbought versus recent expectations. Historically this has suggested a bearish edge. Bearish configurations are visible on the Aggregator chart whenever both lines close below 0. Due to this the Aggregator System changed from flat to short at the close.

The position of the green Aggregator line on Wednesday will again depend almost entirely upon what studies emerge. I will be sure to monitor the market action and studies closely during the day. Meanwhile, the Differential Pivot will be 1,289.92. This is about 1.3% below Wednesday's close. So it would take a close above this level along with bearish studies for the short to remain effective, or a close below this level along with bullish evidence emerging to trigger a long.

This is the 1<sup>st</sup> Aggregator short signal that we have seen in a while. I will look to take advantage of it by taking some short exposure on Thursday. I am not inclined to get Aggressive with it. I have found over the years that perhaps the most dangerous time to attempt short trades is typically when a new rally is beginning to emerge. With a Follow-Through Day (FTD) occurring just last week this rally attempt is still fresh. It is much

more typical of a young rally to get overbought and still persist higher than it is for a mature rally to do so. In addition to investors, young rallies are often fueled by traders covering shorts. And what sometimes starts out as disbelief will often turn to chasing the market higher. Therefore, I intend to take just 1 lot at this point in time. To add more exposure it will take some compelling additional evidence. Details in the trade ideas section below.

**Intermediate-term Outlook (2 weeks – 2 months)– updated 6/27 – neutral**

The SPX posted a higher high than last week, a higher low than last week, and a Follow-Through Day in the middle of the week – and still it closed down on the week. In the 2/1/08 blog I looked at possible implications of action immediately after an FTD. I have updated those tests below.

Short-term performance after FTDs that failed to complete successful rallies. \$100k/trade. 1971-present.										
X Days	All: Net Profit	All: Total Trades	All: Winning Trades	All: Losing Trades	All: % Profitable	All: Avg Winning Trade	All: Avg Losing Trade	All: Win/Loss Ratio	All: ProfitFactor	All: Avg Trade
5	-32,145.83	35	15	20	42.86	1,852.06	-2,996.34	0.62	0.46	-918.45
4	-27,660.43	35	14	21	40.00	1,870.00	-2,563.83	0.73	0.49	-790.30
3	-26,864.21	35	15	20	42.86	1,450.39	-2,431.00	0.60	0.45	-767.55
2	-31,610.28	35	13	22	37.14	975.59	-2,013.31	0.48	0.29	-903.15
1	-3,521.06	35	17	18	48.57	591.36	-754.12	0.78	0.74	-100.60

Short-term performance after FTDs that went on to complete successful rallies. \$100k/trade. 1971-present.										
X Days	All: Net Profit	All: Total Trades	All: Winning Trades	All: Losing Trades	All: % Profitable	All: Avg Winning Trade	All: Avg Losing Trade	All: Win/Loss Ratio	All: ProfitFactor	All: Avg Trade
5	71,249.18	39	30	9	76.92	2,833.70	-1,529.10	1.85	6.18	1,826.90
4	61,869.64	39	27	12	69.23	2,846.70	-1,249.28	2.28	5.13	1,586.40
3	57,445.82	39	26	13	66.67	2,744.05	-1,069.20	2.57	5.13	1,472.97
2	55,597.73	39	29	10	74.36	2,260.79	-996.53	2.27	6.58	1,425.58
1	26,842.15	39	22	17	56.41	1,611.25	-506.20	3.18	4.12	688.26

A couple of points here. First, FTDs that went on to successful rallies generally saw additional gains within the 1<sup>st</sup> week after the FTD. Likewise, FTDs that eventually failed tended to suffer losses quickly after the FTD. Another point to consider is that that the success or failure was determined with about 67% reliability within the first week after a FTD. For instance, note there were a combined 45 total trades that were in the black after 5 days. Thirty of them (or 2/3) went on to complete successful rallies. The same ratio

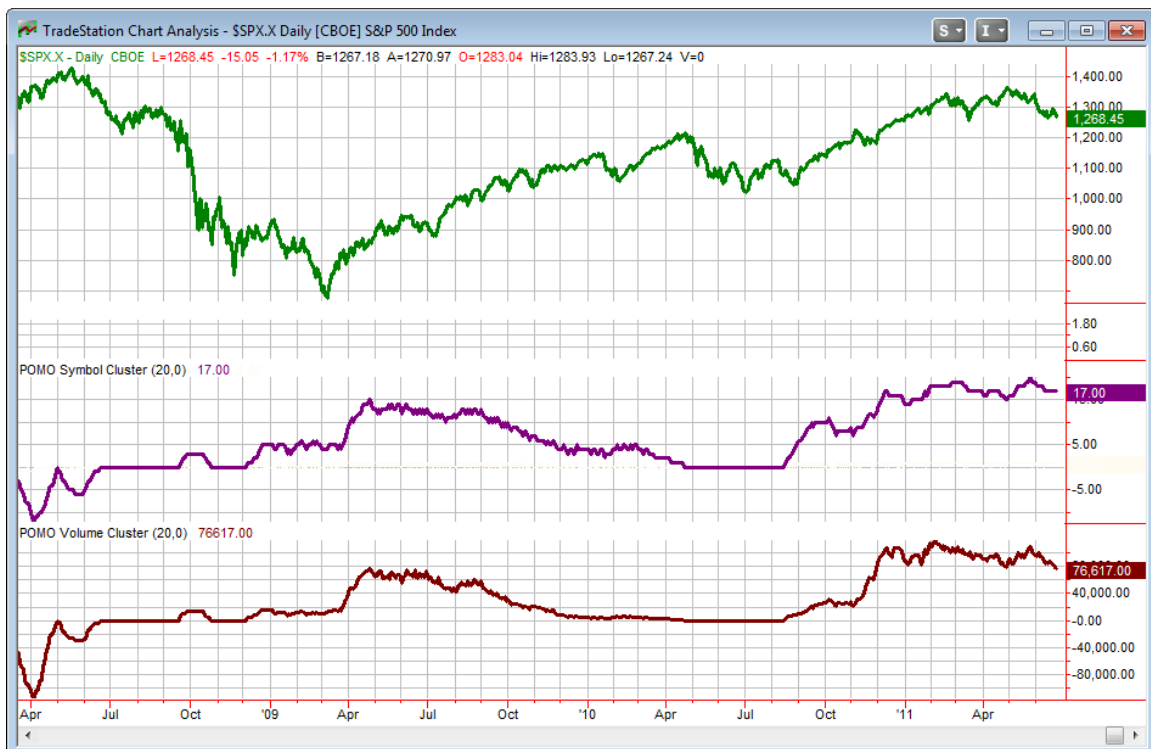
applies for the losers. There were 29 losers after 5 days. Twenty of them ended up with failed rallies and the other 9 were successful.

For the current setup to show a winner over the 5-day period, Monday and Tuesday will need to produce strong upside results.

I've been updating the POMO chart most weekends in the letter. For those who may not recall below is a brief refresher on POMO. Beneath that I have updated our POMO indicator chart.

*POMO stands for Permanent Open Market Operations and it is how the Fed goes into the open market to buy securities. 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 POMO indicators). The top pane is the S&P 500. The middle pane is the rolling number of days in the last 20 that have been POMO days. The bottom pane is the total amount of money infused into the system over the previous 20 days. Information on acquiring the data and constructing the chart can be found in the January 3<sup>rd</sup> POMO presentation linked below. (Not available for trial users.)*

<http://www.quantifiableedges.com/members/pomo.php>



My POMO interpretation remains similar to the last 2 weeks.

Both the POMO Days and POMO Volume indicators remain at fairly high levels. Still, they are beginning to trend lower. The current schedule calls for steady but decreased buying until the end of the month, but after that there will be little in the way of Fed stimulus. Starting July 1 we will see these indicators begin to head back towards the 0 line. There are 2 small days of buying currently scheduled in July which is associated with the reinvestment of principal payments rather than the \$600billion of QE2 money. The past few times POMO stimulus was halted, it took the market about a month after the halt until prices began to decline.

For those that would like to view the current schedule I have provided a link below.

[http://www.newyorkfed.org/markets/tot\\_operation\\_schedule.html](http://www.newyorkfed.org/markets/tot_operation_schedule.html)

Intermediate-term studies are moderately bullish but we remain in the midst of a correction. Tuesday's FTD appears in jeopardy. It will need to right itself quickly if a rally is to emerge. A short-term bounce does appear likely, but unless it comes quickly and with substantial force the market will be looking for a lower bottom than the 6/16 low. My outlook remains neutral for now. This means I will approach both longs and shorts with some caution but am willing to bet either way should short-term evidence suggest an edge.

### **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 [system triggers 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.*

***SPY – short 1/4 index share at \$130.72 limit.** Based on the short-term outlook above. Cancel order if it doesn't fill in the 1<sup>st</sup> half-hour. **If filled and the SPY closes down on Thursday I will exit this trade at the close.***

### **Current Open Trade Ideas**

Symbol	Entry Date	Entry Price	Current Price	% Gain/Loss	Stop	Notes
XIV	6/13/2011	\$17.04	\$17.18	0.83%		<b>sold on open</b>

*XIV was sold at the open as per last night's instructions.*

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