

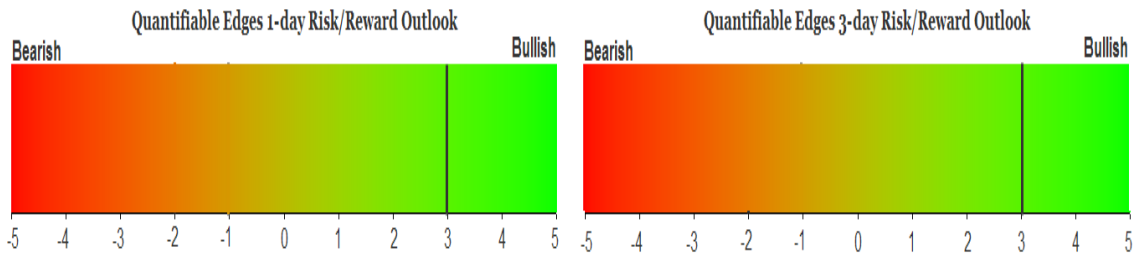
# QUANTIFIABLE EDGES SUBSCRIBER LETTER

ASSESSING MARKET ACTION WITH INDICATORS AND HISTORY

December 16, 2011

Volume 4 Issue 243

## Market Overview



## Signals Overview

| Aggregator | Aggressive VIX | Conservative VIX | NDX Trend Timer |
|------------|----------------|------------------|-----------------|
| Long       | 100% Long XIV  | 100% Long XIV    | Flat            |

## Tonight's Research Points

- The Russell 2000 has historically performed strongly from Dec 15<sup>th</sup> through the 1<sup>st</sup> trading day in Jan.

## *Short-term Outlook*

### *The Bottom Line*

The Aggregator is still suggesting an upside edge again. I have a fair amount of long exposure in anticipation of further gains. I have no intention of buying more immediately.

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

| Study Date                | Description                           | Time span | Bias    | Avg Max Move |
|---------------------------|---------------------------------------|-----------|---------|--------------|
| <b>Active</b>             |                                       |           |         |              |
| December 15, 2011         | 3-day pullback. < 200 > 20 low HV     | 1-3 days  | Bullish | 3.00%        |
| December 14, 2011         | Fed Day rise and reversal down        | 1-3 days  | Bullish |              |
| December 13, 2011         | Unfill gap both ways                  | 1-4 days  | Bearish |              |
| December 12, 2011         | December Op-Ex Seasonally Strong      | 1-5 days  | Bullish |              |
| <b>Active - Long Term</b> |                                       |           |         |              |
| December 12, 2011         | Seasonal strength into year end       | thru 1/2  | Bullish |              |
| December 5, 2011          | POMO scheduled to turn negative       | int term  | Bearish |              |
| December 5, 2011          | 3 20-day VIX lows. No SPY 20-high     | 1-20 days | Bearish | -7.30%       |
| December 1, 2011          | 90% up day on at least 3rd day higher | 1-14 days | Bullish |              |
| November 18, 2011         | Triangle breakdown                    | int term  | Bullish |              |
| October 30, 2011          | SPX & bond yields hit 50-day highs    | 1-50 days | Bearish |              |
| October 19, 2011          | 50-day high on 90% up vol             | 1-50 days | Bullish |              |
| October 19, 2011          | FTD on strong breadth/20day high      | int term  | Bullish |              |
| <b>Dropped Tonight</b>    |                                       |           |         |              |
| December 14, 2011         | Gup up and reverse to a 10-day low    | 1-2 days  | Bullish |              |
| December 14, 2011         | 33% Up Issues 2 days in a row         | 1-2 days  | Bullish |              |

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

***The Evidence***

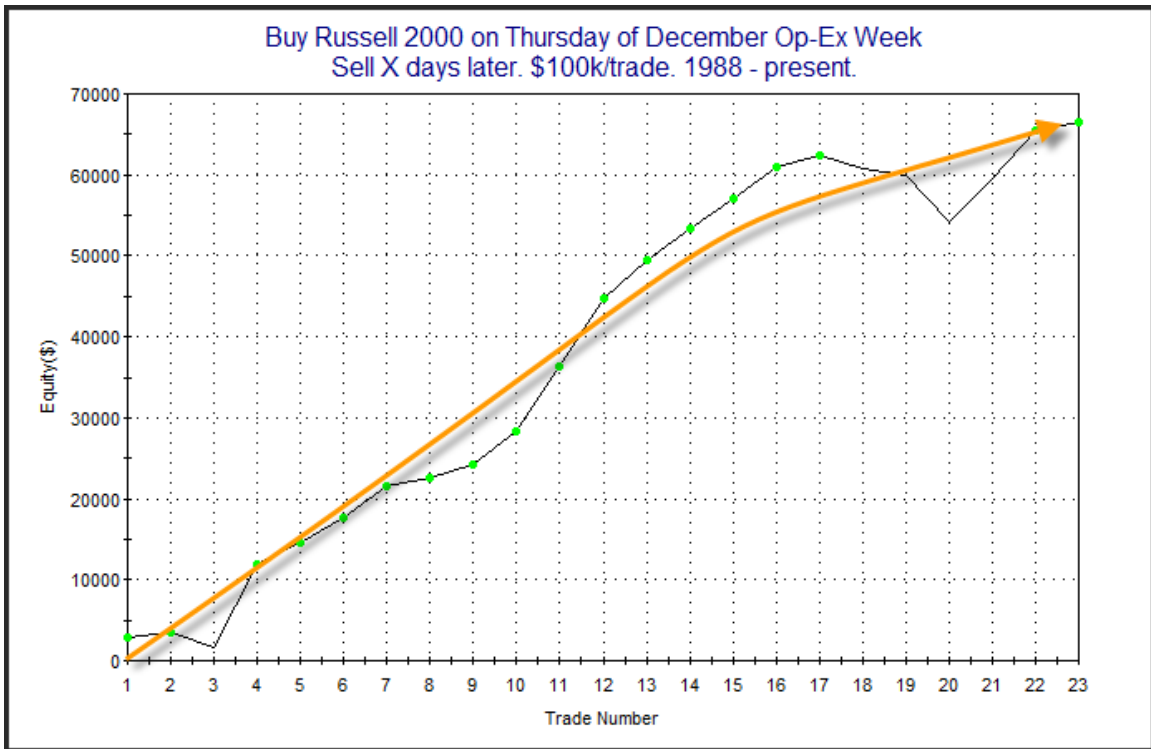
The day started strong but never gained any momentum. In the end the major indices finished mostly higher. The SPX closed up 0.3%, the Nasdaq was up 0.1%, and the Russell 2000 rose 1.1%. Breadth was tilted positive as the NYSE Up Issues % came in at 62% and the Up Volume % was 63%. Total NYSE volume came in lower than the last couple of days.

The mild bounce inspired very little from a testing standpoint. If the market was more stretched to the downside Wednesday the relatively weak bounce Thursday would likely have generated some bearish studies. But with only a moderate downside stretch in place, Thursday's action doesn't seem to be providing a significant edge. One study that is now kicking in is the Russell 2000 study that suggested bullish seasonality over the next 2 weeks. I showed it in the 12/12/11 letter a few days ago and have simply copied it below.

*I also ran a study that looked at buying the Russell on op-ex Thursday and holding for up to 2 weeks. This was shown in the 12/13/10 Letter and I have updated it below.*

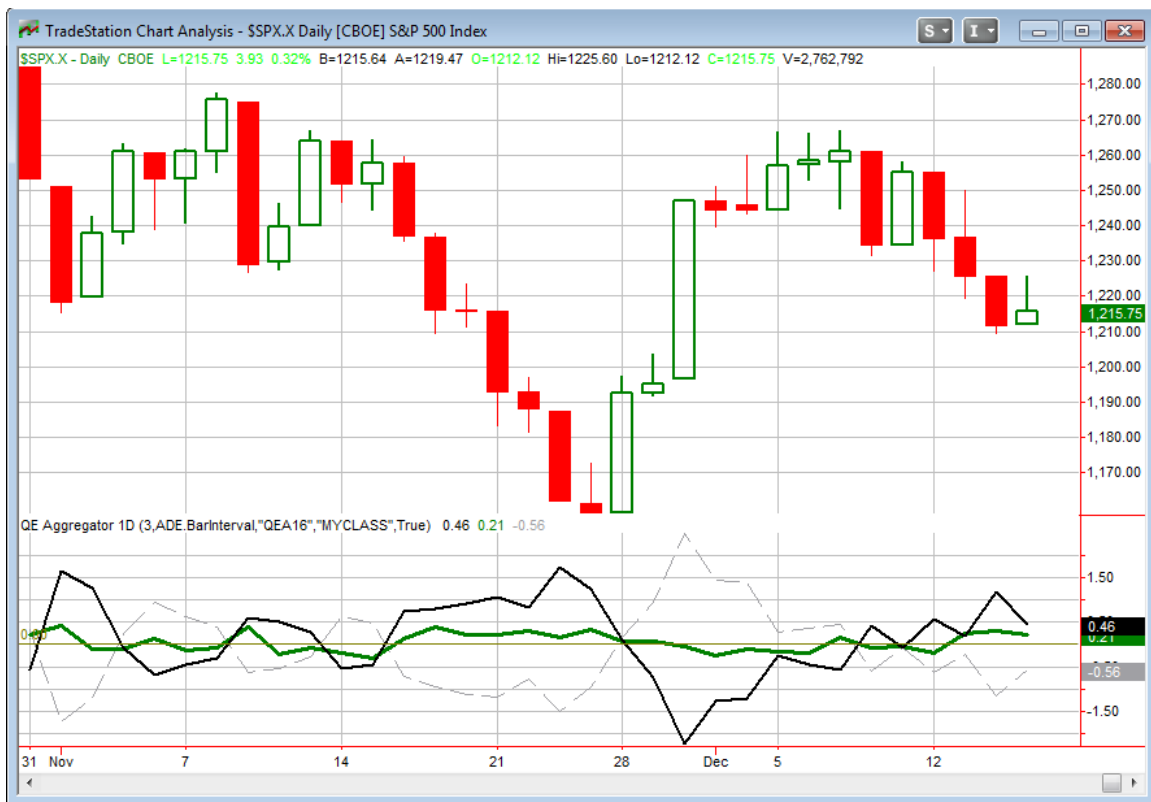
| Buy Russell 2000 on Thursday of December Op-Ex Week<br>Sell X days later. \$100k/trade. 1988 - present. |                 |                   |                     |                    |                   |                        |                        |                       |                       |                     |                   |                |
|---|-----------------|-------------------|---------------------|--------------------|-------------------|------------------------|------------------------|-----------------------|-----------------------|---------------------|-------------------|----------------|
| 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  | 66,446.39       | 23                | 19                  | 4                  | 82.61             | 4,028.05               | 10,279.71              | -2,521.64             | -5,643.30             | 1.60                | 7.59              | 2,888.97       |
| 9   | 60,292.78       | 23                | 19                  | 4                  | 82.61             | 3,591.26               | 9,009.63               | -1,985.28             | -5,973.50             | 1.81                | 8.59              | 2,621.43       |
| 8   | 52,072.32       | 23                | 19                  | 4                  | 82.61             | 2,985.32               | 7,115.85               | -1,162.20             | -2,948.40             | 2.57                | 12.20             | 2,264.01       |
| 7   | 40,047.05       | 23                | 18                  | 5                  | 78.26             | 2,499.05               | 7,790.58               | -987.18               | -1,809.60             | 2.53                | 9.11              | 1,741.18       |
| 6   | 30,905.11       | 23                | 17                  | 6                  | 73.91             | 2,182.63               | 6,599.88               | -1,033.28             | -2,720.64             | 2.11                | 5.98              | 1,343.70       |
| 5   | 22,286.62       | 23                | 16                  | 7                  | 69.57             | 1,891.74               | 4,892.25               | -1,140.18             | -3,194.64             | 1.66                | 3.79              | 968.98         |
| 4   | 15,774.28       | 23                | 15                  | 8                  | 65.22             | 1,810.43               | 4,413.75               | -1,422.77             | -3,892.32             | 1.27                | 2.39              | 685.84         |
| 3   | 13,126.29       | 23                | 14                  | 9                  | 60.87             | 1,739.15               | 3,814.20               | -1,246.88             | -2,650.68             | 1.39                | 2.17              | 570.71         |
| 2   | 7,942.34        | 23                | 14                  | 9                  | 60.87             | 1,308.99               | 3,495.70               | -1,153.72             | -2,810.39             | 1.13                | 1.76              | 345.32         |
| 1   | 9,021.28        | 23                | 13                  | 10                 | 56.52             | 899.08                 | 2,299.70               | -266.68               | -816.48               | 3.37                | 4.38              | 392.23         |

Stats are very, very strong. Looking at the max loss column, though you can see it has not been without risk. Below is an equity curve using the 10-day exit strategy.



In 2005, 2006, and 2007 the Russell saw declines, but it got right back on track the last 3 years.

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



The green Aggregator Line remained solidly positive. Readings above 0 mean net expectations from the Active List are for upside over the next few days. Meanwhile, the black Differential Line is also squarely above 0. A positive Differential reading means the SPX has underperformed expectations over the last few days. So net expectations are bullish and the SPX is oversold versus recent expectations. Historically, this setup has provided an upside edge. It can be seen on the chart whenever both lines close above zero. This caused the Aggregator System to remain long at the close. This was indicated on the Systems page shortly before the bell.

The expectations of the short-term active studies are currently set up to close positive again on Friday. Most of them are expiring though, so this could easily change if new bearish evidence emerges. The Differential Pivot will be at 1,225.94 on Friday. This is over 0.8% above Thursday's close. Therefore the SPX will need to rally at least this much in order for the Differential Line to fall below 0.

So there still appears to be an upside edge. I now have a decent long position and am looking to take advantage of the upside. My long exposure, as shown in the Trade Ideas

section below is a mix of SPY, IWM, and XIV. Below I will lay out a brief overview of how I intend to handle each position.

*The SPY position* is really just a pure Aggregator trade. As I typically do I will look to close this out when the Aggregator is no longer on a buy signal. This could be as early as Friday afternoon.

*IWM* was entered on an Aggregator-style pullback. The reason I went with IWM over SPY is that between now and the 1<sup>st</sup> trading day in January smallcaps have exhibited a strong history of outperformance. This was shown in the 12/12/11 letter (and again last night). The Russell 2000 study above also demonstrates the Russell's strongly bullish seasonality over the next couple of weeks. Between the strong seasonality and my bullish-tilted intermediate-term outlook I believe it is worth trying to get a little more out of this position. Rather than exit when the Aggregator is no longer on a long signal, I will likely wait for at least one of 3 things to happen. 1) IWM moves to strongly overbought (a 10-day high close for instance). 2) The Aggregator System triggers short. 3) 2011 comes to an end. Any of these 3 scenarios would probably lead me to exit IWM. Additionally, I may begin to trail a stop to protect profits if the Aggregator signal comes off.

*XIV* was entered in late November based on a few premises. The market was pulling back and the Aggregator was on a long signal, suggesting an opportune time for entry. Also, the futures term structure moved from backwardation to contango when futures rolled in November. Because of how XIV operates a contango environment provides a nice wind to its back.

As a quick example and to understand why I have been more willing to stick with this position than I normally am a SPY trade, let's consider the current VIX futures prices (as of the 4:15 close on Thursday December 15<sup>th</sup>).

December VIX futures - \$26.35

January VIX futures - \$28.90

February VIX futures - \$30.15

XIV aims to maintain a 30-day average maturity to the futures contracts it owns. As an *inverse* VIX ETN it holds them short. To maintain the 30-day maturity it effectively needs to cover 1/30<sup>th</sup> of its front month (currently December) position and roll it by shorting the 2<sup>nd</sup> month (currently January). This means it is buying (covering) futures at \$26.35 and selling them (short) at \$28.90. The wider the spread between the front and 2<sup>nd</sup> month the better this deal is. Right now it is a \$2.55 difference (or 9.7%). That is sizable. When December futures settle next Wednesday then the front month will be January and the 2<sup>nd</sup> month will be February. The spread there is also in contango (Feb is priced higher than Jan). The difference isn't quite as large, though. It is currently \$1.25 (or 4.3%). As long as the contango effect is sizable and my intermediate-term outlook is positive, I may look to maintain XIV. If either of these things changes, or if we get a very strong spike in XIV, I may look to exit (at least temporarily). I will also begin to trail my stop higher in this one as it stair steps up. With its extreme volatility I believe a stop can be useful, but I also believe it needs to be very loose. So I'll be trailing it slowly while also looking for an opportune time to take profits on a strong spike or change in market conditions.

More information on contango and backwardation effects on XIV and VXX can be found in the VIX-based ETF presentations on the videos page. I also strongly recommend Bill Luby's work over at <http://vixandmore.blogspot.com/>

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

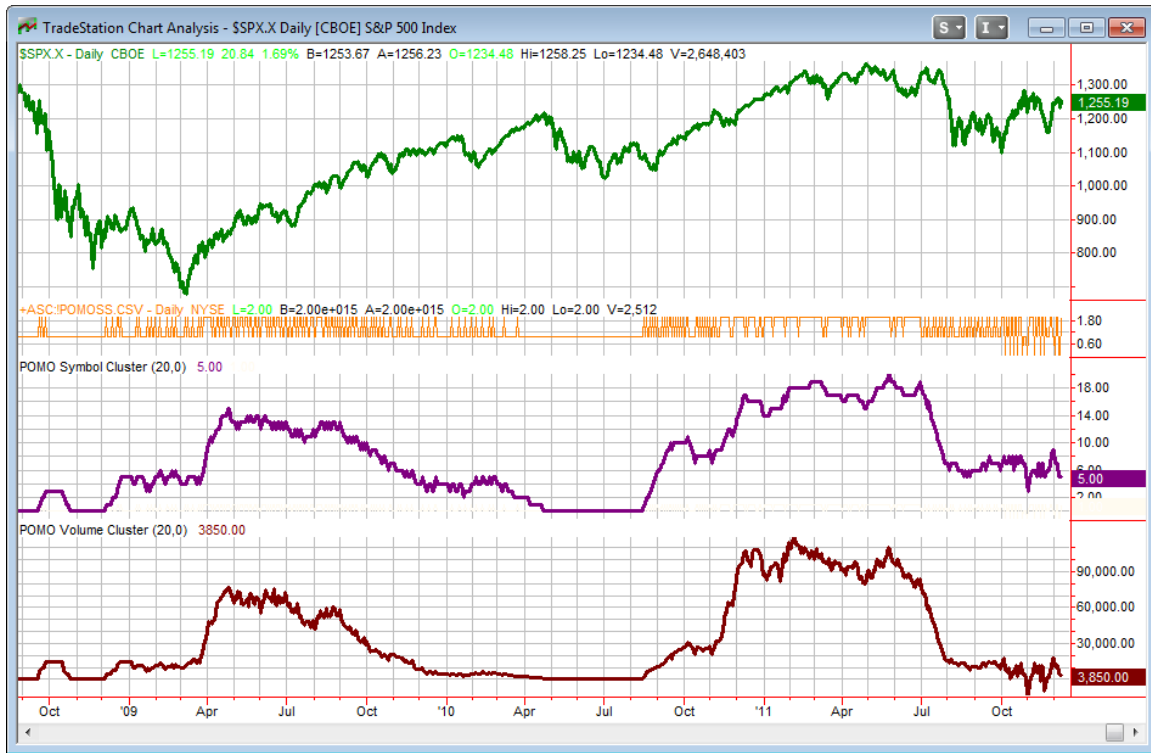
More gains this past week have the market testing the 200ma. The next stop would be the October highs. Aside from the seasonal studies shown in the short-term section above there wasn't anything that triggered from an intermediate-term standpoint this past week.

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 (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. 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>



This week the Fed added a net \$6.3 billion to the system with purchases quite a bit stronger than sales. The net volume over the last 20 days is now \$3.6 billion injected, which is in the middle of its recent range.

The bad news is that the December POMO schedule worsens in the next several weeks and outflows are expected.

The intermediate-term is somewhat mixed. The intermediate-term active studies list is showing a fair amount of both bullish and bearish indications. With seasonality strong over the next few weeks I am inclined to give a slight edge to the bulls. Of course this could change as things evolve this week.

## **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.*

*[None tonight.](#)*

## **Current Open Trade Ideas**

| <b>Symbol</b> | <b>Entry Date</b> | <b>Entry Price</b> | <b>Current Price</b> | <b>% Gain/Loss</b> | <b>Stop</b> | <b>Notes</b>                 |
|---------------|-------------------|--------------------|----------------------|--------------------|-------------|------------------------------|
| XIV(1/2)      | 11/21/2011        | \$4.91             | \$6.01               | 22.40%             | \$4.99      | looking to hold a while      |
| SPY(1/4)      | 12/14/2011        | \$122.56           | \$122.18             | -0.31%             |             | sell on SPX close > 1,225.93 |
| IWM(1/4)      | 12/15/2011        | \$71.04            | \$71.70              | 0.93%              |             | bought at limit              |
|               |                   |                    |                      |                    |             |                              |
|               |                   |                    |                      |                    |             |                              |

*I will look to sell SPY on an SPX close > 1,225.93.*

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