

QUANTIFIABLE EDGES SUBSCRIBER LETTER

ASSESSING MARKET ACTION WITH INDICATORS AND HISTORY

December 20, 2011

Volume 4 Issue 245

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 consistently weak closes suggest a bounce is likely.
- The strong POMO over the last several days should also help to give the market a boost.
- A Hindenburg Omen triggered on Monday. It is the 1st in a long time. I will continue to watch for confirmation triggers.

Short-term Outlook

The Bottom Line

The Aggregator is still suggesting an upside edge. I took some exposure off the table early on Monday and will look to take that exposure back on Tuesday – but using IWM instead of SPY.

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

Study Date	Description	Time span	Bias	Avg Max Move
Active				
December 20, 2011	5 closes in bottom 50%	1 day	Bullish	
Active - Long Term				
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	
Dropped Tonight				
December 15, 2011	3-day drop < 200ma > 20low. HV low	1-3 days	Bullish	3.00%

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

The Evidence

Strong mornings have meant nothing lately, as the market once again took an afternoon dive. The SPX lost 1.2%, the NASDAQ fell 1.3%, and the Russell 2000 dropped 1.9%. Breadth was extremely negative as the NYSE Up Issues % came in at 22% and the Up Volume % was 9%. Total NYSE volume came in quite a bit lower than Friday.

Regardless of whether the market has closed up or down, SPY has consistently closed near the lower end of its range over the last six days. Below is a list of all the instances where SPY closed in the bottom third of its daily range for at least five days in a row, and their returns over the next two days.

SPY closes in bottom 33% of daily range for at least 5th day in a row. Buy on close. Sell next day's close. \$100k/trade. 1993 - present.				
Date/Time	Signal	Price	% Profit	Run-up Drawdown
07/22/02	Buy	\$82.20	3.07%	\$3,550.72
07/24/02	Sell	\$84.72		(\$5,496.32)
01/05/05	Buy	\$118.01	0.36%	\$1,033.34
01/07/05	Sell	\$118.44		\$0.00
01/25/05	Buy	\$116.88	0.47%	\$743.85
01/27/05	Sell	\$117.43		\$0.00
03/29/05	Buy	\$116.53	1.23%	\$1,655.94
03/31/05	Sell	\$117.96		\$0.00
12/21/05	Buy	\$126.03	0.58%	\$658.19
12/23/05	Sell	\$126.76		\$0.00

These limited results appear to suggest a bullish edge, but are too limited for generating expectations. So to get a better sample size I loosened the range requirement to 50%, but in doing so I also required the close to be below the 200ma. Those results are below.

SPY closes in bottom 50% of daily range for at least 5th day in a row. Close < 200ma. Buy on close. Sell next day's close. \$100k/trade. 1993 - present.			
TradeStation Performance Summary			Collapse ^
All Trades			
Total Net Profit	\$12,811.18	Profit Factor	3.39
Gross Profit	\$18,181.16	Gross Loss	(\$5,369.98)
Total Number of Trades	16	Percent Profitable	81.25%
Winning Trades	13	Losing Trades	3
Even Trades	0		
Avg. Trade Net Profit	\$800.70	Ratio Avg. Win:Avg. Loss	0.78
Avg. Winning Trade	\$1,398.55	Avg. Losing Trade	(\$1,789.99)
Largest Winning Trade	\$5,962.50	Largest Losing Trade	(\$2,736.00)

We see here what appears to be a decent suggestion at an upside edge. Below I have listed all 16 instances.

SPY closes in bottom 50% of daily range for at least 5th day in a row. Close < 200ma.
Buy on close. Sell next day's close. \$100k/trade. 1993 - present.

Date/Time	Signal	Price	% Profit	Run-up Drawdown
06/23/94	Buy	\$45.00	(2.09%)	\$0.00
06/24/94	Sell	\$44.06		(\$2,222.00)
06/24/94	Buy	\$44.06	0.84%	\$1,747.13
06/27/94	Sell	\$44.43		(\$68.07)
10/12/00	Buy	\$133.13	3.33%	\$3,402.03
10/13/00	Sell	\$137.56		(\$187.75)
05/11/01	Buy	\$125.15	0.20%	\$231.71
05/14/01	Sell	\$125.40		(\$551.31)
02/07/02	Buy	\$108.02	1.92%	\$2,525.25
02/08/02	Sell	\$110.09		\$0.00
07/22/02	Buy	\$82.20	(2.74%)	\$1,264.64
07/23/02	Sell	\$79.95		(\$2,979.20)
07/23/02	Buy	\$79.95	5.97%	\$6,462.50
07/24/02	Sell	\$84.72		(\$2,837.50)
01/22/03	Buy	\$88.17	0.61%	\$1,372.14
01/23/03	Sell	\$88.71		(\$249.48)
08/15/07	Buy	\$141.04	0.75%	\$1,347.10
08/16/07	Sell	\$142.10		(\$2,687.11)
06/26/08	Buy	\$128.23	(0.55%)	\$490.77
06/27/08	Sell	\$127.53		(\$927.01)
06/27/08	Buy	\$127.53	0.35%	\$1,081.92
06/30/08	Sell	\$127.98		(\$180.32)
06/30/08	Buy	\$127.98	0.31%	\$382.69
07/01/08	Sell	\$128.38		(\$1,601.05)
12/23/08	Buy	\$86.16	0.58%	\$823.60
12/24/08	Sell	\$86.66		(\$185.60)
03/03/09	Buy	\$70.07	2.37%	\$3,995.60
03/04/09	Sell	\$71.73		\$0.00
06/24/10	Buy	\$107.42	0.42%	\$930.00
06/25/10	Sell	\$107.87		(\$604.50)
08/02/11	Buy	\$125.49	0.54%	\$652.72
08/03/11	Sell	\$126.17		(\$1,560.16)

Results shown here do nothing to diminish the bullish outlook that was suggested above. The boxed returns above are those instances, like the present, where SPY also closed below its open for the last 5 days in a row. They show even more promise. I have decided to include this study on the short-term active list.

On another note, friend and fellow market analyst Tom McClellan of the McClellan Market Report discussed some of his thoughts on POMO in an email group we both belong to today. Tom showed a chart he uses that is very similar to the POMO chart I show in the intermediate-term update section of the letter. But instead of looking back 20 days as I do, Tom only looked back 5 days. He indicated that he has found the 5-day

lookback to be useful in short-term market timing. This was the 2nd time in the last week that someone suggested a short lookback to me. (A subscriber mentioned it last week.) I decided I'd better play around with it since I hadn't in awhile. Below is my note to Tom.

I used a POMO day count for these studies. To do this I assign the following values to each day based on POMO activity: If there was net buying that day's count = 1. If there was no action, then that day = 0. Net selling by the Fed means a negative 1. I use "Days" instead of volume because I have found it useful when looking back over longer periods. POMO activity during QE1 was substantially lower than QE2 and they were both way above any period prior to QE1. A more sophisticated way to measure the POMO activity might be to normalize the volume. Instead I just count days.

So I created a simple system that looks to buy pullbacks and sell when the market bounces. The buy trigger is simply a close for SPX in the bottom 20% of its' 10-day range. The exit signal is a close back in the upper half of the then-current 10-day range (making it a moving target). Let's look and see how this simple system has performed over the last 4 years based on 5-day POMO activity levels. First, let's look at the system when the 5-day POMO count was < 3.

SPX closes in the bottom 20% of it's 10-day range. 5-day POMO count < 3.
Buy on close. Sell when SPX closes in top half of 10-day range. \$100k/trade. 2008 - present.

TradeStation Performance Summary Collapse ^			
All Trades			
Total Net Profit	(\$181.45)	Profit Factor	1.00
Gross Profit	\$53,594.26	Gross Loss	(\$53,775.71)
Total Number of Trades	37	Percent Profitable	62.16%
Winning Trades	23	Losing Trades	14
Even Trades	0		
Avg. Trade Net Profit	(\$4.90)	Ratio Avg. Win:Avg. Loss	0.61
Avg. Winning Trade	\$2,330.19	Avg. Losing Trade	(\$3,841.12)
Largest Winning Trade	\$7,266.36	Largest Losing Trade	(\$10,891.80)

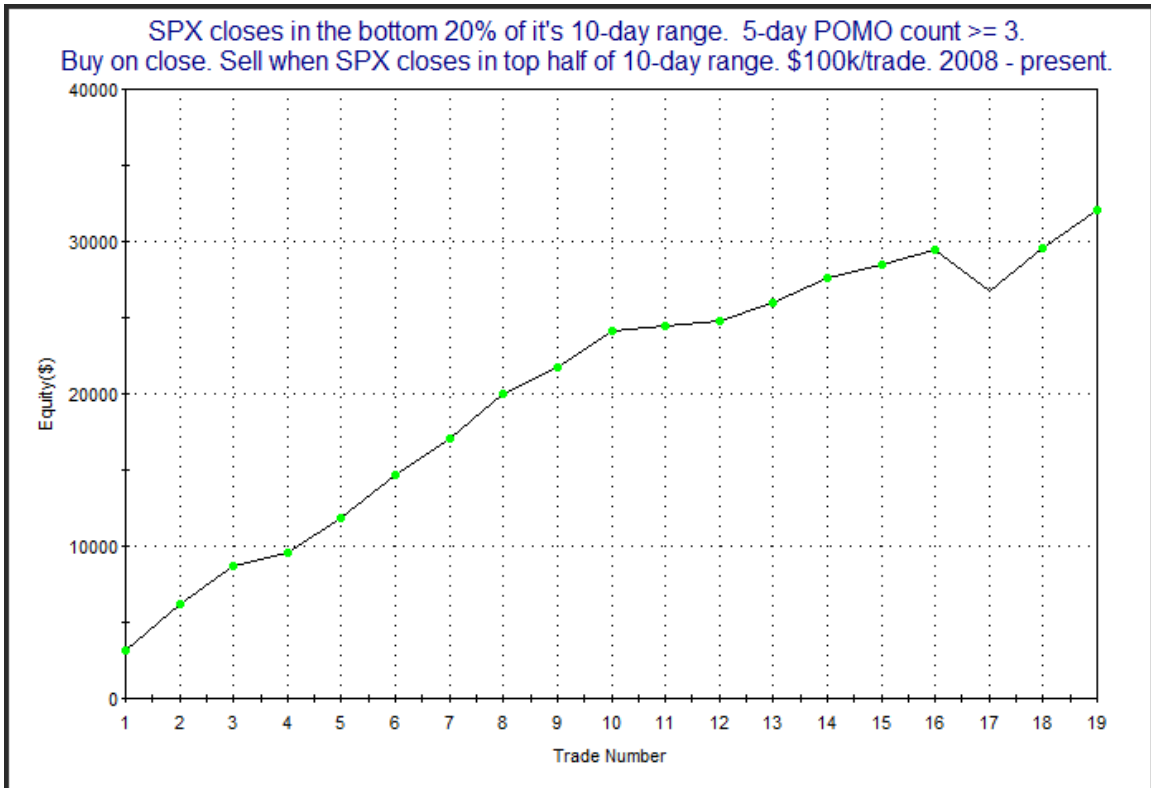
These numbers are not at all impressive unless your goal is to come as close to break-even as you can over a 4-year period. The reason I only go back to 2008 for this test is that prior to 2008 there was no time when the count would have reached as high as 3.

But now let's look at the same setup when the 5-day POMO count is ≥ 3 . This could be accomplished with 3 days of buying in the last 5, or perhaps 4 days of buying and 1 of selling.

SPX closes in the bottom 20% of it's 10-day range. 5-day POMO count ≥ 3 .
Buy on close. Sell when SPX closes in top half of 10-day range. \$100k/trade. 2008 - present.

TradeStation Performance Summary			
All Trades			
Total Net Profit	\$32,107.12	Profit Factor	12.67
Gross Profit	\$34,857.56	Gross Loss	(\$2,750.44)
Total Number of Trades	19	Percent Profitable	94.74%
Winning Trades	18	Losing Trades	1
Even Trades	0		
Avg. Trade Net Profit	\$1,689.85	Ratio Avg. Win:Avg. Loss	0.70
Avg. Winning Trade	\$1,936.53	Avg. Losing Trade	(\$2,750.44)
Largest Winning Trade	\$3,160.20	Largest Losing Trade	(\$2,750.44)

Huge difference. The sample size isn't great, but you can't get results much better than this. Below is an equity curve.



Nice line there. The point here should be obvious. You are much better off buying pullbacks when the Fed has your back. A “low” price and an inflow of money into the system has been a nice combination and provided a decent edge over the last 4 years.

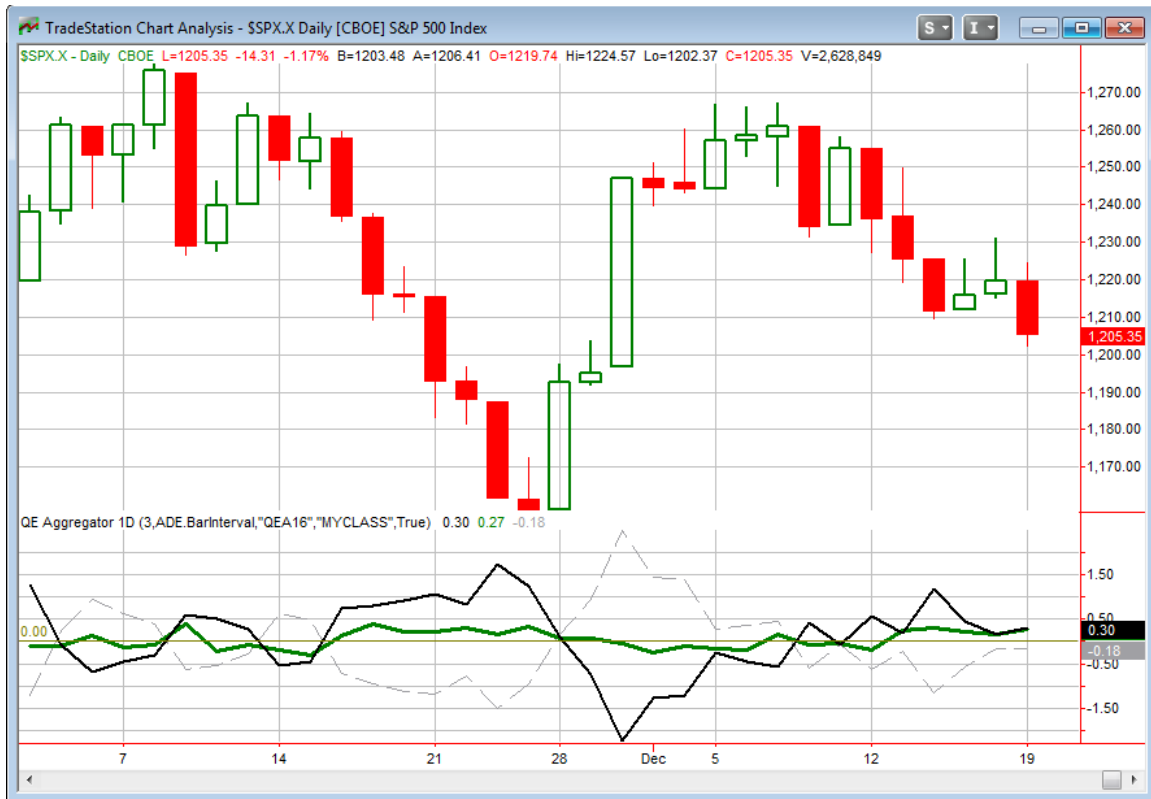
None of this is optimized. The parameters are the 1st ones I chose, so I am sure if someone was looking to build a trading system they could come up with something better. It should demonstrate the point, though and certainly supports the idea that a 5-day lookback can provide a nice indication of short-term market direction.

One thing I neglected to mention was that the 5-day POMO Day Count is scheduled to reach 3 on Tuesday.

There was one notable bearish observation from the Quantifinder. It noted that Monday's action qualified it for a Hindenburg omen. Hindenburg omens are relatively well known signals that suggest the market has become split and a possible intermediate-term selloff could follow. Most people follow that they feel that a cluster of 2 to 3 within a 30-day period is necessary to generate a reliable signal. Monday was the first trigger since December of 2010. If we get more triggers I'll be happy to go into detail about the signal. Personally, I have found it to be generally unimpressive. For those that would like to learn more about Hindenburg omens I have included a link below to the 12/15/2010 subscriber letter. Gold subscribers that also use Tradestation and would like to study Hindenburgs on their own may download the Hindenburg strategy code off the downloads page on the members site.

[2010-12-15 QE Subscriber Letter.pdf](#)

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 still 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 short-term expectations remain bullish but highly in doubt since the number of short-term studies is extremely low. If new bearish evidence emerges, expectations could quickly turn. So studies that emerge over the next few days will go a long way towards determining short-term expectations. The Differential Pivot will be 1,225.05 on Tuesday. This is 1.6% above Monday's close. It will take a close higher of at least this much for the Differential Line to fall below 0 on Tuesday.

So there appears to be a decent upside edge. If we could go a few days without bad news out of Europe then those expectations might be realized. I took a conservative approach with the SPY position in last night's letter and was stopped out just above breakeven on Monday morning. With prices now quite a bit lower, I will look to put that capital back

to work. Instead of SPY I will use IWM, though. IWM dropped harder on Monday, so it is a bit more oversold. Also, it has a strong seasonal tendency to outperform SPX near the end of the year. Details are in the trade ideas section near the bottom of the letter.

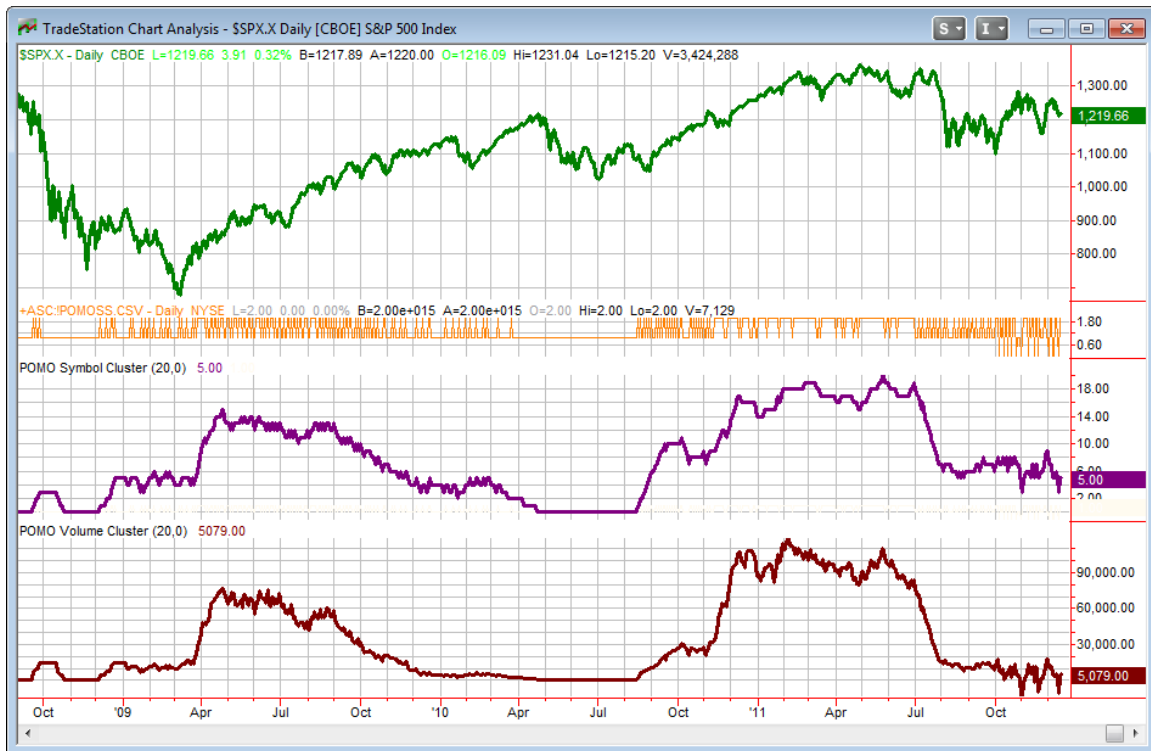
Intermediate-term Outlook (2 weeks – 2 months)– updated 12/19 – somewhat bullish

For only the 2nd time in the last 28 years the SPX failed to post a close during December op-ex week that was above the close of the previous week. Minimal damage was done, but it was still a little disconcerting to see the market fail to deliver during such a seasonally strong period. As I mentioned in the short-term outlook above, the next seasonally strong period is about to begin on Wednesday's close.

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 3rd POMO presentation linked below. (Not available for trial users.)

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



This week the Fed added a net \$4.8 billion to the system with purchases a bit stronger than sales. The net volume over the last 20 days is now \$5.1 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.

IWM – buy ¼ index position @ \$71.11 limit. Based on the short-term outlook above. The entry price here is a little above Monday's close in case it gaps up and doesn't quite close the gap.

Current Open Trade Ideas

Symbol	Entry Date	Entry Price	Current Price	% Gain/Loss	Stop	Notes
XIV(1/2)	11/21/2011	\$4.91	\$6.11	24.44%	\$5.29	looking to hold a while
SPY(1/4)	12/14/2011	\$122.56	\$122.64	0.07%		stopped out (div adj price)
IWM(1/4)	12/15/2011	\$71.04	\$71.01	-0.04%		Aggregator/Seasonal

SPY was sold at around 10:05 after it broke the low of the 1st half-hour as discussed in last night's letter and also sent to gold subscribers via intraday update this morning.

Despite the selloff, our XIV position actually rose Monday. The strong contango appears to be working for us nicely. If the market can get going in our direction this position might really take off. I have raised the stop a little to protect some gains. It is still very, very loose.

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