

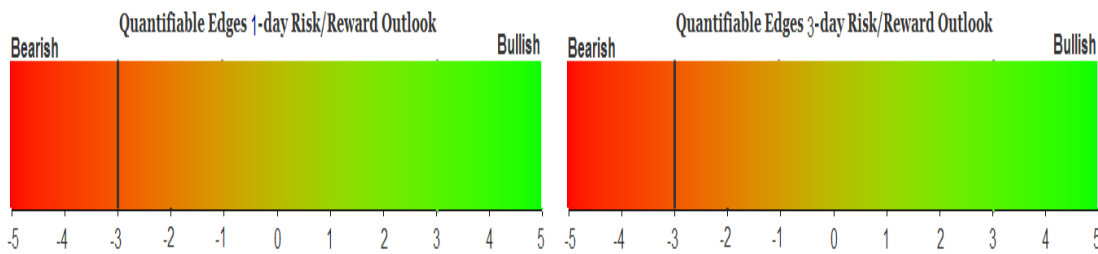
QUANTIFIABLE EDGES SUBSCRIBER LETTER

ASSESSING MARKET ACTION WITH INDICATORS AND HISTORY

December 27, 2011

Volume 4 Issue 249

Market Overview



Signals Overview

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

Tonight's Research Points

- Though overbought, this time of year overbought can easily become more overbought.
- The POMO schedule is slated for net selling for the 2nd week in a row.

Short-term Outlook

The Bottom Line

I'm looking for a bit of a pullback in the next few days and have a small short position to try and take advantage of it.

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

Study Date	Description	Time span	Bias	Avg Max Move
Active				
December 23, 2011	3 up < 200ma. No 50-low.	1-3 days	Bearish	-2.80%
December 22, 2011	Twas 3 nights before Christmas	1-5 days	Bullish	
December 22, 2011	Low VXO, no highSPY	1-4 days	Bearish	
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%
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	

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

The Evidence

Friday was a gap up followed by a slow grind higher. The SPX gained 0.9%, the Nasdaq rose 0.7% and the Russell 2000 rallied 0.3%. Breadth was solidly positive as the NYSE Up Issues % came in at 68% and the Up Volume % was 79%. Total NYSE Volume was extremely light as many traders (including me) took off early.

Light volume can often be a sign of complacency and when the market is making new short-term highs on very light volume it is often followed by a pullback. This can be seen with many of the studies that triggered in the Quantifinder. But Friday's light volume was not likely due to complacency. Rather it was due to the holiday weekend coming up. So as I indicated I would do over the last few days I am ignoring all those volume-related studies.

Volatility studies and price action have been suggesting the market is overdone a bit and likely to pullback. But we are in a strong seasonal period and the good holiday vibes have seemed to have a positive effect on market prices. It is not unusual for overbought markets to continue higher this time of year. This is demonstrated in the study below.

Today is the last trading day before Christmas. SPX closes up for at least the 3rd day in a row. Buy on close. Sell X days later. \$100k/trade. 1960 - 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	9,193.56	13	10	3	76.92	1,365.55	4,482.50	-1,487.33	-3,252.48	0.92	3.06	707.20
4	6,465.59	13	8	5	61.54	1,420.67	4,440.00	-979.96	-1,858.56	1.45	2.32	497.35
3	7,938.17	13	9	4	69.23	1,141.19	3,950.00	-583.13	-1,185.36	1.96	4.40	610.63
2	4,977.90	13	9	4	69.23	799.88	1,839.29	-555.24	-1,331.88	1.44	3.24	382.92
1	5,090.53	13	8	4	61.54	840.04	1,751.75	-407.45	-945.36	2.06	4.12	391.58

As you can see, the short-term overbought condition sees the market continue higher more often than not. This study could even be considered borderline bullish based on the stats alone. But below is a list of all the instances.

Today is the last trading day before Christmas. SPX closes up for at least the 3rd day in a row. Buy on close. Sell 3 days later. \$100k/trade. 1960 - present.

Date/Time	Signal	Price	% Profit	Run-up Drawdown
12/24/70	Buy	\$90.61	1.83%	\$1,830.98
12/30/70	Sell	\$92.27		\$0.00
12/23/76	Buy	\$104.84	1.43%	\$1,839.29
12/29/76	Sell	\$106.34		\$0.00
12/23/77	Buy	\$94.69	0.26%	\$264.00
12/29/77	Sell	\$94.94		\$0.00
12/22/78	Buy	\$96.30	(0.03%)	\$1,640.04
12/28/78	Sell	\$96.27		(\$498.24)
12/23/82	Buy	\$139.72	1.09%	\$2,438.15
12/29/82	Sell	\$141.24		(\$414.70)
12/22/89	Buy	\$347.41	0.94%	\$935.62
12/28/89	Sell	\$350.66		(\$252.56)
12/24/91	Buy	\$399.33	3.96%	\$3,950.00
12/30/91	Sell	\$415.13		(\$5.00)
12/23/94	Buy	\$460.45	0.16%	\$494.76
12/29/94	Sell	\$461.17		(\$314.65)
12/23/99	Buy	\$1,458.34	0.35%	\$620.84
12/29/99	Sell	\$1,463.46		(\$510.68)
12/23/04	Buy	\$1,210.13	0.27%	\$331.28
12/29/04	Sell	\$1,213.45		(\$427.22)
12/23/05	Buy	\$1,268.66	(1.12%)	\$247.26
12/29/05	Sell	\$1,254.42		(\$1,129.44)
12/24/07	Buy	\$1,496.45	(1.20%)	\$158.40
12/28/07	Sell	\$1,478.49		(\$1,633.50)
12/24/09	Buy	\$1,126.48	(0.01%)	\$343.20
12/30/09	Sell	\$1,126.42		(\$399.52)

While the great majority led to positive price action the last 3 have turned out negative, and the last time the market even saw a run-up of as much as 0.7% during the next 3 days was 1991. So I am not inclined to look at this as a bullish study. But it certainly leaves open the possibility that we could see a continued drift higher despite the bearish volatility and price studies that are currently on the board.

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



The green Aggregator line is still solidly negative. Readings below 0 mean net expectations from the Active List are for downside over the next few days. Meanwhile, the black Differential Line is also well below 0. A negative Differential reading means the SPX has outperformed expectations over the last few days. So net expectations are bearish and the SPX is overbought versus recent expectations. Historically, this setup has provided a downside edge. It can be seen on the chart whenever both lines close below zero. This caused the Aggregator System to remain short at the close. This was indicated on the Systems page.

Based on the current active studies, expectations are set to remain negative on Tuesday. Of course new bullish evidence could emerge that would change this. The Differential Pivot will be 1,240.51 on Tuesday. This is almost 2% below Friday's close. It's unlikely we'll see a decline that large in just one day. More likely is that we will need to see a multi-day pullback or consolidation in order to work off the overbought condition and flip the Differential back to positive.

Coming in to Friday I had a hedged position on with a long QQQ and a short SPY. I sold the QQQ portion on Friday at the close and am now looking for the SPY to pull back in the next few days, allowing me a more favorable place to cover.

Intermediate-term Outlook (2 weeks – 2 months)– updated 12/27 – somewhat bullish

Santa delivered with a 4-day rally into Christmas. In the process it took the SPX back above its 200ma and near the early December highs. It is now less than 3% below its October highs and is up slightly for 2011.

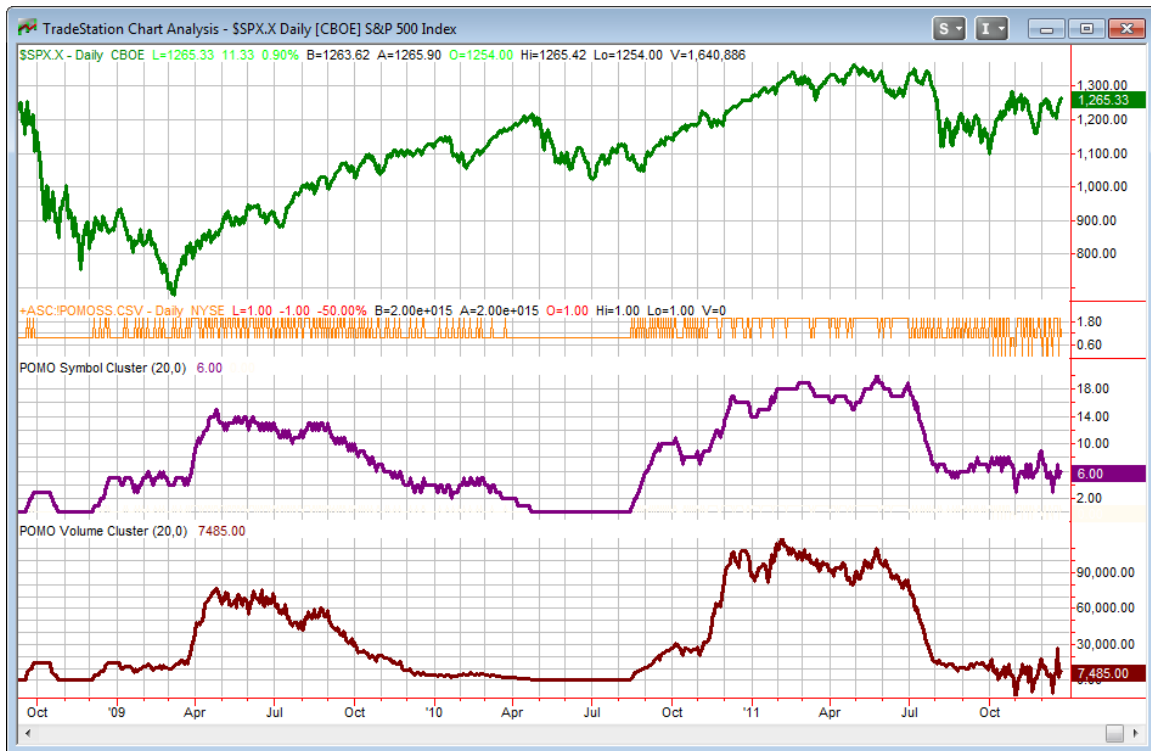
From a studies standpoint there wasn't anything new this week that triggered with long-term implications. The Triangle Breakdown study from November that predicted a move up to 1,267 before trading down as low as 1,150 is now within 2 points of fulfilling that prediction. It was a close call on the ride down as it got pretty close to 1,150 after the initial breakdown in late November.

This is the last week of strong seasonality and we will soon see several of the intermediate-term studies come off the board – both bullish and bearish. The only 2 with much of a shelf-life at this point are the bullish Follow Through Day study from the October FTD and the bearish POMO indications based on recent Fed activity.

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 *withdrew* a net \$4.8 billion from the system with sales stronger than purchases. The net volume over the last 20 days is now \$7.5 billion injected, which is in the middle of its recent range.

The bad news is that this upcoming week there are no purchases scheduled but there is an estimated \$8 – \$8.75 billion of scheduled sales, which in effect will pull more liquidity from the system.

The intermediate-term is somewhat mixed. We are still seeing a mix of bullish and bearish studies. POMO is looking worse, but seasonality may allow the momentum to carry the market up for another week. I'm still just slightly bullish but anticipate turning neutral after this week. Of course this could change as action unfolds and new studies emerge. From a trading perspective my outlook simply means I will be playing shorts a bit more conservatively than longs.

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

Symbol	Entry Date	Entry Price	Current Price	% Gain/Loss	Stop	Notes
XIV(1/2)	11/21/2011	\$4.91	\$6.69	36.25%	\$5.29	may take profits before Jan
SPY(1/4)(S)	12/22/2011	\$124.63	\$126.39	-1.41%		Aggregator
QQQ(1/4)	12/22/2011	\$55.22	\$56.08	1.56%		<i>sold on close</i>

QQQ was sold at the close as instructed in last night's letter.

XIV has pulled back a bit the last couple of days. I have had a few questions about this action so I thought I would share those questions, my answers, and some additional thoughts.

Question 1

A couple of technical analysts say the VIX - volatility Index has retraced all the way to the critical long term support at 21 and is flashing a major buy signal.

In addition, one posits a long term target at 47 and a stop at 19.5.

Would you agree, and if so, would you sell the XIV - a great call, by the way - here nearing \$7, or do you think there's enough cantango still left to play the trade a bit longer?

My answer: I say there is no such thing as support or resistance on the VIX. Technical analysis tools are not useful in determining VIX moves.

Support and resistance work because stocks/indices saw buyers & sellers at certain levels before. VIX is just a measure of volatility. There is no memory. There are no people

that “missed the boat” last time it was at 21. If the VIX goes up it is because traders are perceiving increased risk in the market.

So...I’m conflicted many ways about whether to take profits here. End of month/year are a consideration for record keeping. The fact that the market is grinding up the last 2 days but XIV has struggled is not something I like. If the market pulls back (as I expect) in the next few days then XIV might get whacked a bit here. On the other hand, if the market continues higher over the next several weeks, the XIV should benefit – and contango will help too.

Question 2

Rob – Up 60 on the Dow and starting to see VXX break out. Could it be contango starting to unwind?

My answer: Contango is still helping XIV. Rise in Jan & Feb futures despite lower VIX is hurting XIV.

Additional thoughts

That last question was via twitter so my answer needed to be short. I’ll expound upon it a bit more now. The VIX closed Friday at 20.43, which was down 0.43, or 2%. But while this was going on January VIX futures rose to 25.70, and February rose to 26.40. XIV is based on VIX futures, so the rise in the futures is what caused the decline in XIV over the last 2 days. The futures action shows that VIX futures traders are expecting VIX to rise quite a bit between now and January expiration. Let’s consider a few implications of this structure:

- 1) The VIX and Jan VIX futures are going to be on a collision course over the next 3 and ½ weeks. Futures expire on Jan 17th. So either the VIX is going to need to rise (as futures traders currently expect), or expectations (and futures prices) are going to need to come down. Even a moderate rise in the VIX is going to see futures drop over this time period. That should help XIV. VIX prices will somewhat mirror market movement. An up market should help greatly and would likely see the VIX fall a bit further (causing a more sizable drop in the futures). A sideways market might see the VIX remain near current levels. To get a move up in the VIX from 20.43 to 25.70 (current futures price) it would probably take a decent selloff. That’s possible, but I don’t believe probable at the moment.
- 2) The \$0.70 difference in Jan and Feb futures means contango is somewhat mild compared to recent levels. $\$0.70 / \$25.70 = 2.7\%$. That is the current amount of monthly positive roll that contango is providing. A week and a half ago it was close to 10%. So the benefit is not nearly as strong at the moment, but it is still a benefit.

As I said, I expect a bit of an SPX pullback in the next few days. I'll also be closely watching intermediate-term evidence. If we get strong bullish intermediate-term indications then I'll be inclined to try and hold XIV longer. Bearish intermediate-term indications will have me looking to take profits. Perhaps I should have taken profits a few days ago when XIV was extended, but doing so would have been betting on a sizable SPX decline. I wasn't prepared to do that during the strong seasonal period, and I am not quite ready yet. There is certainly nothing wrong with taking profits at this point, but I still believe there is more to be had over the next few weeks, so I am sticking with the XIV position for now and reserving the right to change my mind.

I am not sure any of this helps at all since XIV can be a confusing security to trade and there is a lot to consider. But hopefully some of you are finding it informative, if not helpful.

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