

QUANTIFIABLE EDGES SUBSCRIBER LETTER

ASSESSING MARKET ACTION WITH INDICATORS AND HISTORY

January 3, 2012

Volume 5 Issue 1

Market Overview



Signals Overview

Aggregator	Aggressive VIX	Conservative VIX	NDX Trend Timer
Flat	50% Long XIV	Flat	Flat

Tonight's Research Points

- 1st Day of Month seasonality often provides a bullish boost, but not under current circumstances.
- POMO activity over the last week has been negative. Combined with an overbought SPX this has produced a downside edge over the last 3 years.

Short-term Outlook

The Bottom Line

A new POMO-based study has helped turn expectations negative, but the market is now slightly oversold. It's a neutral setup and I am looking to flatten out my positions.

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

Study Date	Description	Time span	Bias	Avg Max Move
Active				
January 3, 2012	Overbought w/out POMO support	1-5 days	Bearish	-2.70%
December 30, 2011	Unfilled gap up inside day. C>200&Opn	1-2 days	Bearish	
December 29, 2011	1% drop after Christmas	1-3 days	Bullish	2.00%
December 28, 2011	5 Days Up > 200 no 50-high	1-10 days	Bullish	2.00%
Active - Long Term				
December 28, 2011	5 Days Up > 200 no 50-high	1-15 days	Bullish	
December 12, 2011	Seasonal strength into year end	thru 1/3	Bullish	
December 5, 2011	POMO scheduled to turn negative	int term	Bearish	
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	FTD on strong breadth/20day high	int term	Bullish	
Dropped Tonight				
December 29, 2011	5 up the close < close 3 days ago	1-2 days	Bullish	1.30%
December 30, 2011	90% Down Vol then 90% Up Vol	1 day	Bearish	

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

The Evidence

Weakness on the last day of the year has occurred consistently since the turn of the century and Friday was no exception. The SPX was positive for much of the day, but a weak afternoon and sharp selling in the last minute put it down on the day and just barely negative for the year. The SPX closed 2010 at 1257.64 and 2011 amazingly finished at 1257.60. On the day the SPX fell 0.4%, the Nasdaq lost 0.3%, and the Russell 2000 dropped 0.5%. Breadth was modestly negative as the NYSE Up Issues % came in at 47% and the Up Volume % was 41%. Total NYSE volume rose just slightly from Thursday's level.

One edge that many traders are aware is that the 1st day of the month tends to be a strong day for the market. Both the long-term trend and short-term overbought/oversold reading have had an impact on this edge. I discussed the long-term trend significance in the blog a couple of months ago. I used the 200ma to define uptrend vs. downtrend. Below is a link to that post:

<http://quantifiableedges.blogspot.com/2011/10/beginning-of-month-effect-in-uptrends.html>

The SPX is just slightly below its 200ma, but the fact that it is not in a clear uptrend certainly dampens the upside edge. The short-term is also worth consideration. Rather than get too fancy here I simply ran a quick study that looked at times the SPX closed down on the last day of the month while trading below the 200ma. Those results are below.

Today is the last trade day of the month. SPX closes lower and below the 200ma.
Buy on close. Sell next day's close. \$100k/trade. 1987 - present.

TradeStation Performance Summary

Collapse ^

All Trades

Total Net Profit	\$1,880.03	Profit Factor	1.07
Gross Profit	\$28,834.74	Gross Loss	(\$26,954.71)
Total Number of Trades	36	Percent Profitable	50.00%
Winning Trades	18	Losing Trades	18
Even Trades	0		
Avg. Trade Net Profit	\$52.22	Ratio Avg. Win:Avg. Loss	1.07
Avg. Winning Trade	\$1,601.93	Avg. Losing Trade	(\$1,497.48)

The bottom line here appears to be that the “1st of the month edge” may not provide much of a spark under current circumstances.

A couple of weeks ago in the 12/20/11 subscriber letter I discussed the short-term impact of POMO buying. The difference in buying a short-term oversold market that the Fed was supporting versus a buying a short-term oversold market when there was little or no Fed support was drastic. This weekend I decided to look at the inverse setup – POMO impact on overbought SPX conditions. Before looking at the new research you may want to review the notes from a couple of weeks ago. I have pasted them below. Beneath the highlighted notes is the new “overbought” research.

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			
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)

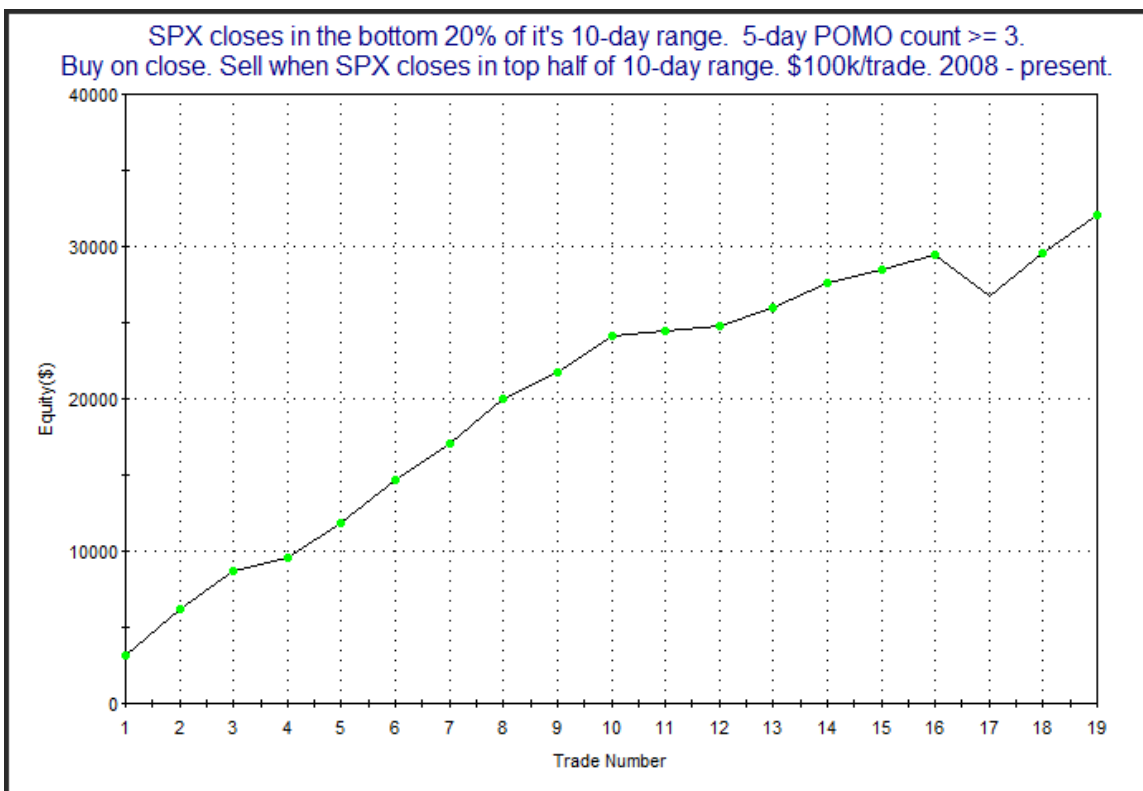
These numbers are not at all impressive unless your goal is to come as close to break-even as you can over a 4-year period. The reason I only go back to 2008 for this test is that prior to 2008 there was no time when the count would have reached as high as 3.

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.

So now let's use the same 5-day lookback and flip the circumstances. Instead of the SPX closing in the bottom 20% of its 10-day range, we'll look for it to close in the top 20% to suggest an overbought condition. I used the same "Day Count" method as described above except now I want to see what happens when there is no support vs. some support. I kept the time frame the same and looked back to the beginning of 2008. This allows to QE1, QE2, and Operation Twist to all be included.

So the system now calls to short any SPX close in the top 20% of its 10-day range and then cover when it drops into the lower half of its then-current 10-day range (again making it a moving target). Here is how that system would have performed if there was ANY net positive POMO stimulus.

SPX closes in the top 20% of its 10-day range. 5-day POMO count > 0. Sell short on close. Cover when SPX closes in the top half of its 10-day range. \$100k/trade. 2008 - present.

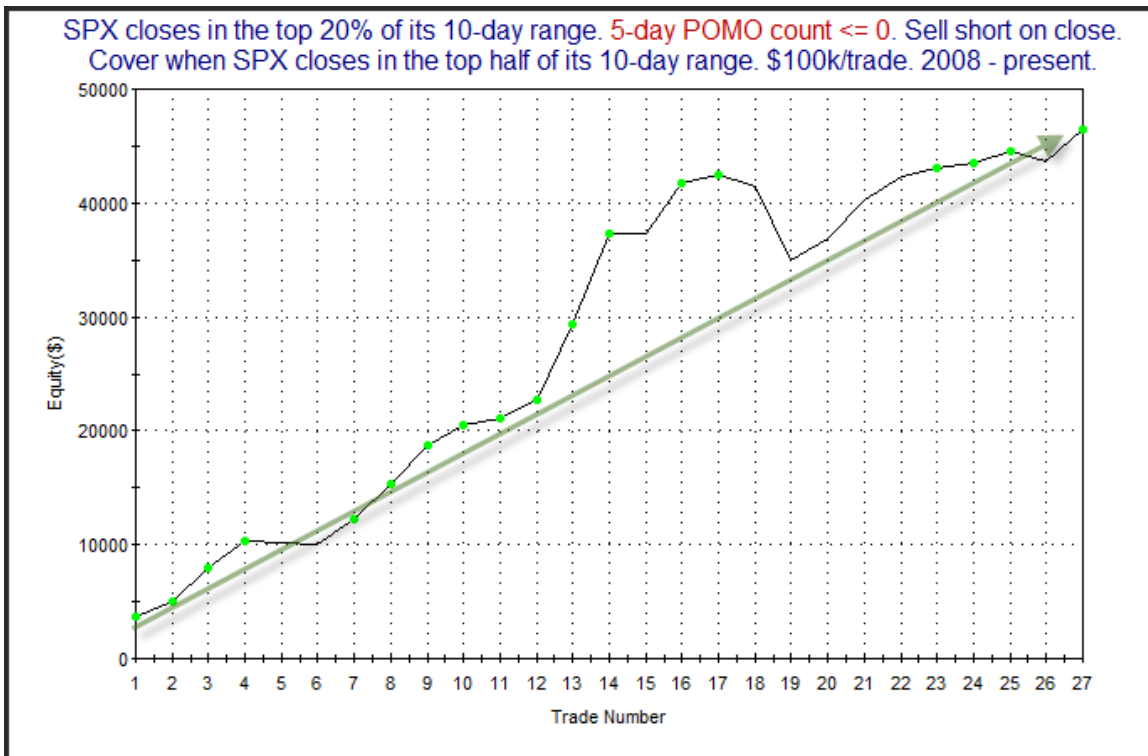
TradeStation Performance Summary Collapse ^			
All Trades			
Total Net Profit	(\$1,038.62)	Profit Factor	0.98
Gross Profit	\$42,901.65	Gross Loss	(\$43,940.27)
Total Number of Trades	34	Percent Profitable	52.94%
Winning Trades	18	Losing Trades	16
Even Trades	0		
Avg. Trade Net Profit	(\$30.55)	Ratio Avg. Win:Avg. Loss	0.87
Avg. Winning Trade	\$2,383.43	Avg. Losing Trade	(\$2,746.27)
Largest Winning Trade	\$5,495.94	Largest Losing Trade	(\$8,850.66)

We see here what is pretty close to a break-even system. Nothing exciting for either bulls or bears. But now let's look at our overbought short-trading system when POMO buying has been absent over the last 5 days.

SPX closes in the top 20% of its 10-day range. 5-day POMO count ≤ 0 . Sell short on close.
 Cover when SPX closes in the top half of its 10-day range. \$100k/trade. 2008 - present.

TradeStation Performance Summary Collapse 			
All Trades			
Total Net Profit	\$46,389.67	Profit Factor	6.16
Gross Profit	\$55,372.10	Gross Loss	(\$8,982.43)
Total Number of Trades	27	Percent Profitable	77.78%
Winning Trades	21	Losing Trades	6
Even Trades	0		
Avg. Trade Net Profit	\$1,718.14	Ratio Avg. Win:Avg. Loss	1.76
Avg. Winning Trade	\$2,636.77	Avg. Losing Trade	(\$1,497.07)
Largest Winning Trade	\$8,004.64	Largest Losing Trade	(\$6,527.26)

The stats here are very impressive. Not quite as consistent as the “buying oversold with POMO support”, but still very strong. The profit factor of 6+ is terrific. And the average profit of over 1.7% is actually slightly better than the long system. In all, this certainly seems worth considering. Below is an equity curve.



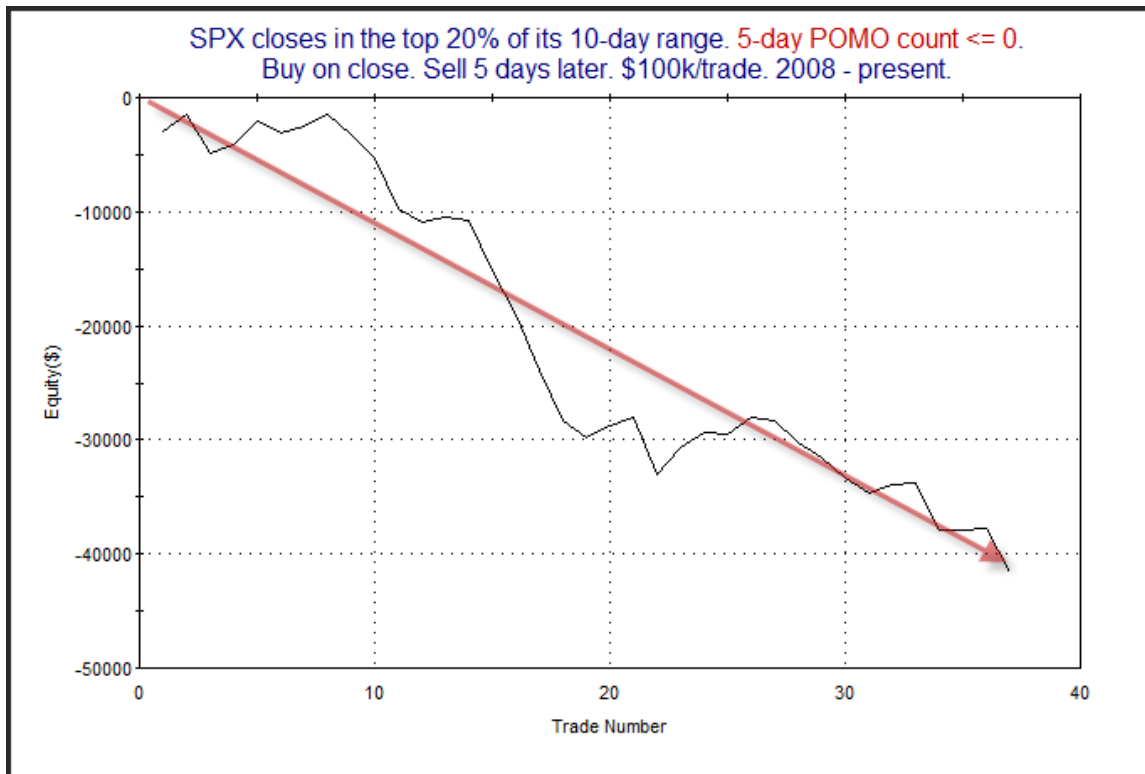
A solid equity curve that does not raise any red flags in my eyes. I should not that the average winning trade took about 5 days before it closed out, but the average losing trade

took 18 days. So the impact should be looked at short-term. If the signal gets much older than 5 days then I would tend to ignore it. That likely means that POMO buying has entered the equation and is helping to push the market higher.

Below I looked at it one more way. Rather than treating it as a “system”, I treated it as a “study” and looked out over the next several days. (Note I am “buying” here instead of selling short. I always “buy” for the studies so that bearish ones show up red and negative and bullish ones show up green and positive. It makes it less confusing to always be able to see it this way.)

SPX closes in the top 20% of its 10-day range. 5-day POMO count <= 0. Buy on close. Sell X days later. \$100k/trade. 2008 - 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	-38,049.23	29	13	16	44.83	1,662.68	4,220.38	-3,729.00	-9,832.38	0.45	0.36	-1,312.04
9	-30,490.20	29	13	16	44.83	1,735.47	3,619.63	-3,315.71	-9,422.42	0.52	0.43	-1,051.39
8	-42,021.10	29	11	18	37.93	1,572.00	3,849.08	-3,295.17	-11,994.35	0.48	0.29	-1,449.00
7	-32,584.17	30	13	17	43.33	1,349.05	2,929.29	-2,948.35	-7,189.40	0.46	0.35	-1,086.14
6	-35,320.28	33	12	21	36.36	998.50	2,799.05	-2,252.49	-6,584.78	0.44	0.25	-1,070.31
5	-41,638.41	37	15	22	40.54	938.47	2,386.98	-2,532.52	-4,932.90	0.37	0.25	-1,125.36
4	-39,771.21	42	17	25	40.48	1,110.38	2,044.02	-2,345.91	-6,578.61	0.47	0.32	-946.93
3	-27,717.15	48	19	29	39.58	1,046.70	4,441.44	-1,641.53	-4,353.44	0.64	0.42	-577.44
2	-41,248.21	61	27	34	44.26	767.37	3,811.00	-1,822.57	-9,986.13	0.42	0.33	-676.20
1	-43,564.74	99	44	55	44.44	575.06	4,063.35	-1,252.14	-8,883.33	0.46	0.37	-440.05

Statistics here remain impressive you’d think they would. Below is a profit curve assuming a 5-day hold.

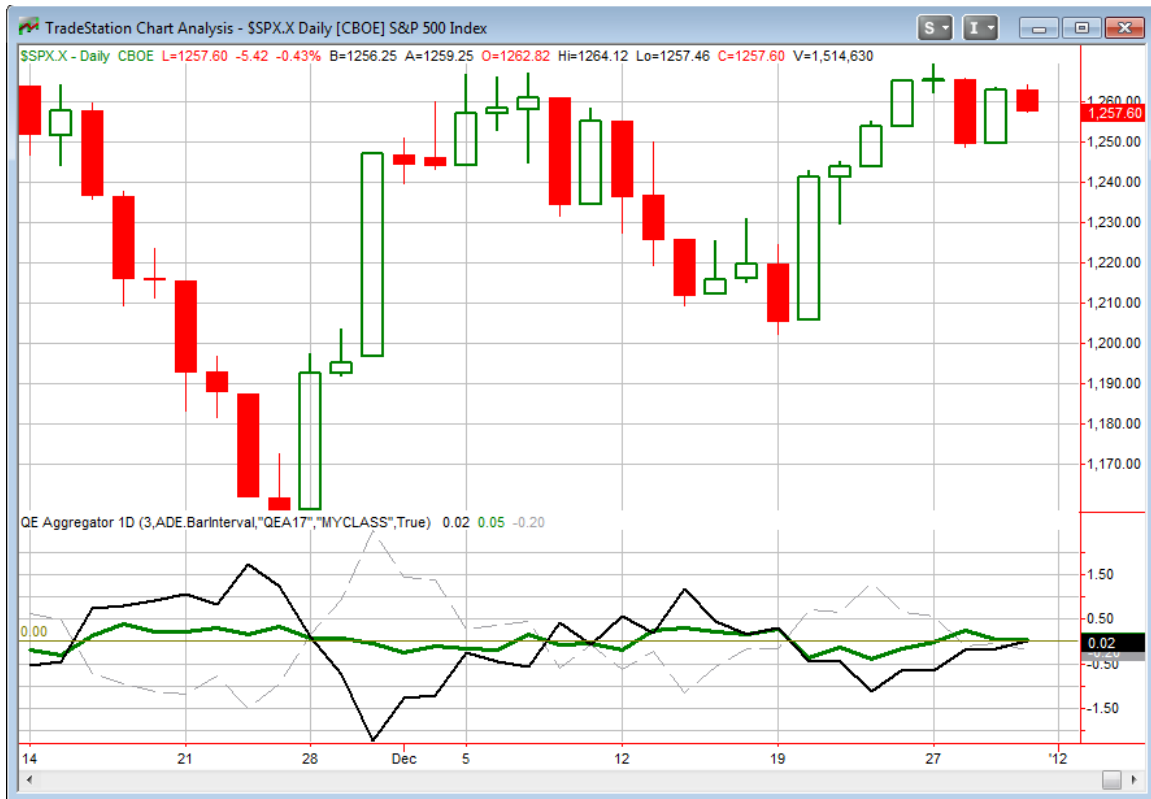


Still impressive. This setup did trigger on Friday and I have added it to the Short-term Active List.

One aspect of this short-term POMO analysis that I really like is that you can easily anticipate the POMO count, since the Fed posts it to their website in advance.

The last time I held a POMO-dedicated webinar for subscribers was about 1 year ago. I think it would be worth reviewing how I create the POMO indicators and taking a deeper look at these short-term systems. So I will plan on hosting (and recording) another POMO webinar in a couple of weeks. I think tracking the short-term POMO counts that I used in the systems above is worthwhile, and **I would ask subscribers, between now and the webinar, to consider how they may want that information delivered and to please provide me with suggestions.**

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



Before conducting the short-term POMO research it appeared the green Aggregator line was going to close positive. In fact it dipped down and closed slightly negative. (I sometimes have trouble producing the Aggregator chart in Tradestation on holidays. Since I didn't make the chart on Sunday, it does not appear to be updating properly on Monday. So while it may look like a positive Aggregator, you'll have to trust me that it isn't and the chart will look better tomorrow.) Readings below 0 mean net expectations from the Active List are for downside over the next few days. Meanwhile, the black Differential Line inched up just above 0. A positive Differential reading means the SPX has underperformed expectations over the last few days. So net expectations are bearish but the SPX is oversold versus recent expectations. This is considered a neutral configuration. Neutral configurations are visible on the chart whenever both lines close on opposite sides of 0. This caused the Aggregator System to remain flat at the close. With the POMO research all-new I did not anticipate this and thought we would have a long-signal from the Aggregator on Friday. So I bought some at the bell and will look to correct that on Tuesday.

Based on the current active studies (primarily POMO), expectations are scheduled to remain negative on Tuesday. Of course this could change if strong bullish evidence emerges. The Differential Pivot will be inverted at 1,250.79 on Tuesday. This is 0.5% below Friday's close. This means that unless the SPX sells off at least this much the

black Differential line will flip to negative and the SPX will turn from “oversold” to “overbought” versus recent expectations.

I’m neutral at this point. The strong move up that concluded Tuesday put the market at a level of “overbought” that it will normally continue to ride higher from. But this weekend’s research suggests overbought with neutral or negative POMO provides an edge to the bears. So it will be interesting to see how it plays out over the next few days. And I’m sure the market will give us some more evidence to consider. At this point it seems that a move higher on Tuesday could trigger a short, but that’s no guarantee. I suspect a little patience will provide a bit more clarity.

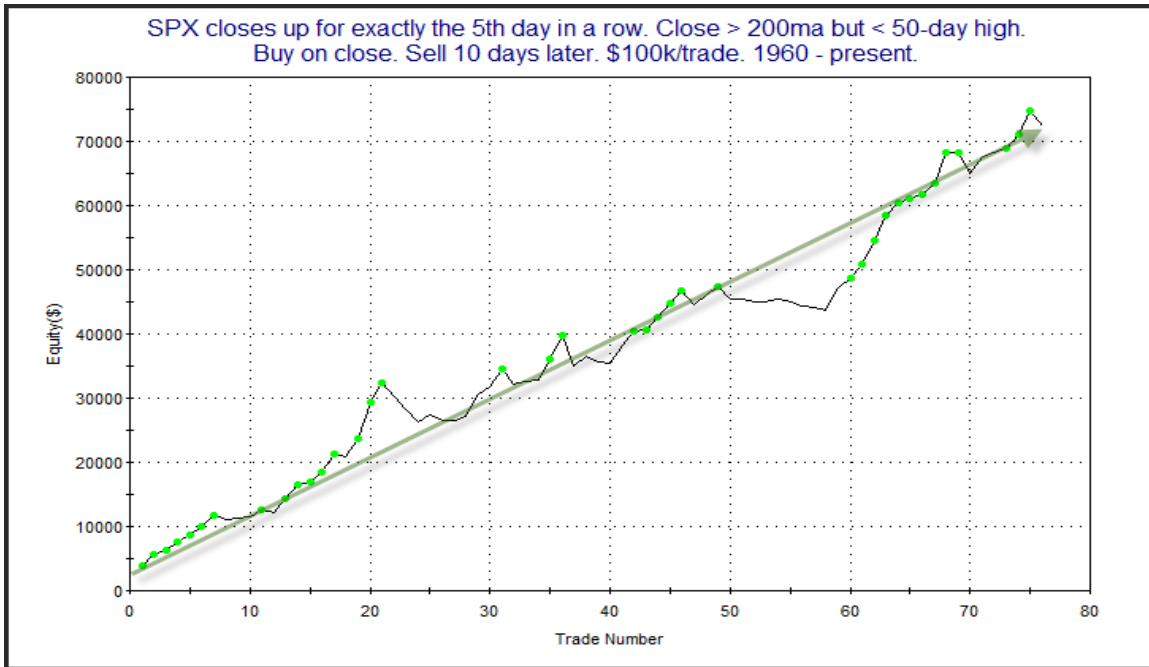
Intermediate-term Outlook (2 weeks – 2 months)– updated 1/3 – neutral

The past week was choppy with the market finishing a bit lower. The pullback after Tuesday’s high came in the wake of a strong move higher. It was the strength of that move that provided perhaps the strongest bit of evidence this past week for the intermediate-term. The excerpt below is copied from the short-term section of the December 28th letter.

When the market begins to get overbought it will often suggest a pullback is likely. When overbought gets powered through then odds will sometimes shift from a pullback to a continuation of that move. Below is a study that demonstrates this concept. It was last seen in the 7/5/11 subscriber letter.

SPX closes up for exactly the 5th day in a row. Close > 200ma but < 50-day high. 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
15	104,930.23	74	50	24	67.57	2,832.66	8,288.00	-1,529.28	-4,879.10	1.85	3.86	1,417.98
14	92,032.17	74	49	25	66.22	2,674.44	8,272.60	-1,560.61	-4,738.50	1.71	3.36	1,243.68
13	92,569.87	74	54	20	72.97	2,427.12	6,401.50	-1,924.72	-3,773.44	1.26	3.40	1,250.94
12	85,027.39	75	54	21	72.00	2,250.42	5,925.50	-1,737.88	-3,661.77	1.29	3.33	1,133.70
11	70,534.74	76	51	25	67.11	2,100.41	6,110.00	-1,463.44	-4,887.00	1.44	2.93	928.09
10	72,291.50	76	54	22	71.05	1,875.36	5,675.25	-1,317.19	-4,684.28	1.42	3.49	951.20
9	67,664.64	76	50	26	65.79	1,953.37	5,228.75	-1,153.99	-4,910.55	1.69	3.26	890.32
8	61,276.58	77	53	24	68.83	1,662.97	5,146.50	-1,119.20	-3,376.64	1.49	3.28	795.80
7	53,640.44	77	50	27	64.94	1,682.33	5,698.75	-1,128.74	-3,500.70	1.49	2.76	696.63
6	45,295.84	77	54	23	70.13	1,413.79	5,134.75	-1,349.94	-3,359.36	1.05	2.46	588.26
5	37,465.03	77	53	24	68.83	1,245.30	4,476.75	-1,189.00	-3,716.53	1.05	2.31	486.56
4	27,481.43	77	51	26	66.23	1,061.07	3,983.25	-1,024.35	-3,494.78	1.04	2.03	356.90
3	26,404.71	77	51	26	66.23	1,021.40	2,796.50	-987.95	-3,359.36	1.03	2.03	342.92
2	13,427.23	77	50	27	64.94	773.77	2,479.25	-935.60	-3,748.50	0.83	1.53	174.38
1	8,507.43	77	48	29	62.34	517.98	2,211.54	-563.98	-2,193.72	0.92	1.52	110.49

These results appear to suggest a pretty consistent upside edge over the next 1-3 weeks. Below is an equity curve using the highlighted 10-day hold that shows how this edge has played out over time.



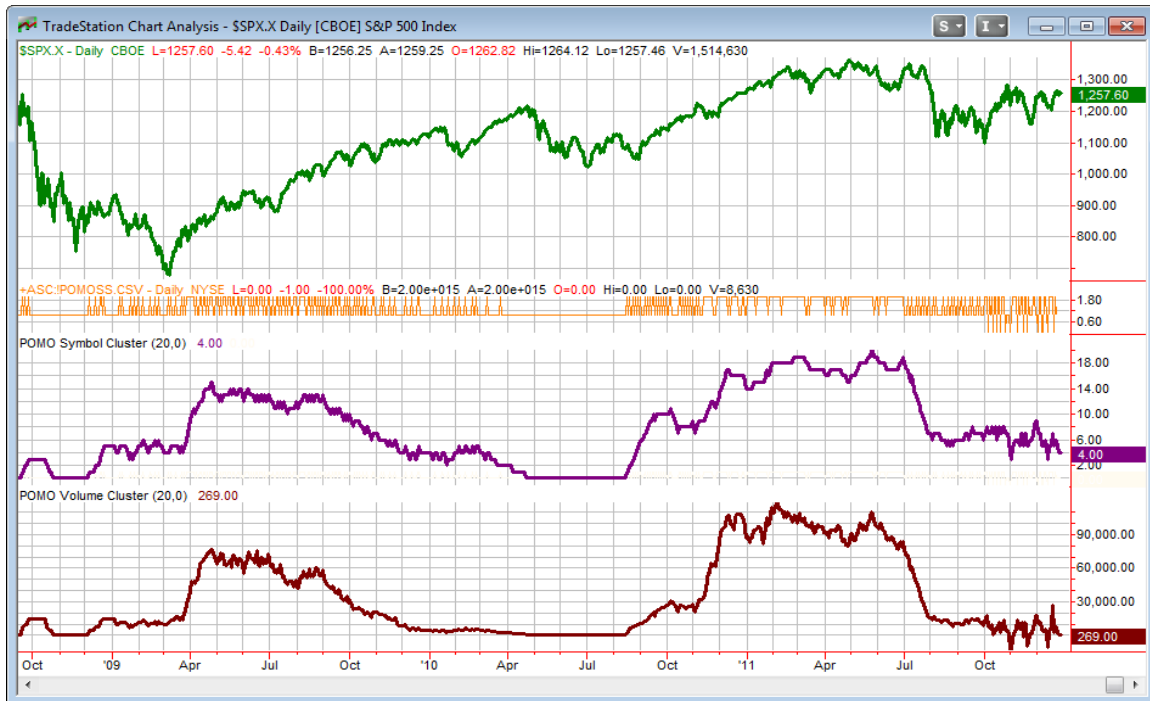
This appears to be quite a consistent curve and makes the study even more compelling. I have also added it to the intermediate-term list since the bullish impact appears to persist for up to 3 weeks.

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 \$8.6 billion from the system with sales stronger than purchases. This is the 2nd week in a row of net selling. The net volume over the last 20 days is now just \$269 million injected, which is hardly anything.

The new operations schedule was just released and the Fed doesn't appear likely to be lending any substantial support to the market this month either. The net purchases in January are expected to net to about \$1 billion. And the start to the month is not terribly good. This week there is selling scheduled on Wednesday and Thursday before we finally see some POMO buying on Friday.

The intermediate-term is somewhat mixed. We are still seeing a mix of bullish and bearish studies. POMO remains bad, but momentum has provided some hope for the bulls. Some upside follow-through would go a long way for providing me bullish confidence. At this point I've decided to scale back my outlook to "neutral". Of course this could change as action unfolds and new studies emerge. From a trading perspective my outlook simply means I will be playing longs and shorts with equal (slightly reduced) aggressiveness.

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	\$6.51	32.59%	\$5.29	may exit if Agg "short"
SPY(1/4)	11/30/2012	\$125.50	\$125.50	0.00%		entered on close - now exit

SPY will be sold at the open. I entered it anticipating a close at this level would trigger a long signal. In fact the new evidence presented this weekend kept the long from occurring, so I will exit this position at the open.

XIV may be nearing its exit point. Contango is favorable, but much weaker than it was a couple of weeks ago. The intermediate-term outlook is now neutral. If the short-term outlook turns bearish then I'll be running out of reasons to hold on to this. I am not putting this in as an "on close" order in case new evidence emerges or something changes that I am not able to evaluate properly during the day. But if the Aggregator triggers a short signal in the next few days I will likely take my profits in XIV the next morning.

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