

# QUANTIFIABLE EDGES SUBSCRIBER LETTER

ASSESSING MARKET ACTION WITH INDICATORS AND HISTORY

January 24, 2012

Volume 5 Issue 15

## Market Overview



## Signals Overview

| Aggregator | Aggressive VIX | QE Buy Pwr Swing | NDX Trend Timer |
|------------|----------------|------------------|-----------------|
| Short      | 100% Short SPY | Flat             | Long            |

## Tonight's Research Points

- SPX at a 50-day while the VIX:VXV ratio is very low has suggest higher risk than potential reward the following day.
- SPX at a 50-day high and VIX up today is typically followed by 1-2 days of weakness.

## Short-term Outlook

### The Bottom Line

I have a small amount of short exposure that I am holding. I'll take some profits on a weak close tomorrow. I am not inclined to add to the position right now.

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


| Study Date                | Description                           | Time span | Bias    | Avg Max Move |
|---------------------------|---------------------------------------|-----------|---------|--------------|
| <b>Active</b>             |                                       |           |         |              |
| January 24, 2012          | SPX 50-high. VIX up.                  | 1-2 days  | Bearish |              |
| January 23, 2012          | Up 3. 50-high. Vol up at least 3.     | 1-4 days  | Bullish |              |
| January 23, 2012          | SPX up 1%-2% op-ex week               | 1-4 days  | Bearish |              |
| January 23, 2012          | SPX 50-high. VIX:VXV < 0.85           | 1 day     | Bearish |              |
| January 20, 2012          | Op-ex Thursday closes near high       | 1-4 days  | Bearish | -1.60%       |
| <b>Active - Long Term</b> |                                       |           |         |              |
| January 17, 2012          | Nasdaq leading SPX                    | int term  | Bullish |              |
| December 5, 2011          | POMO activity flat to negative        | int term  | Bearish |              |
| October 19, 2011          | FTD on strong breadth/20day high      | int term  | Bullish |              |
| <b>Dropped Tonight</b>    |                                       |           |         |              |
| January 23, 2012          | SPX up < 0.25% in top 10% daily range | 1 day     | Bearish |              |

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

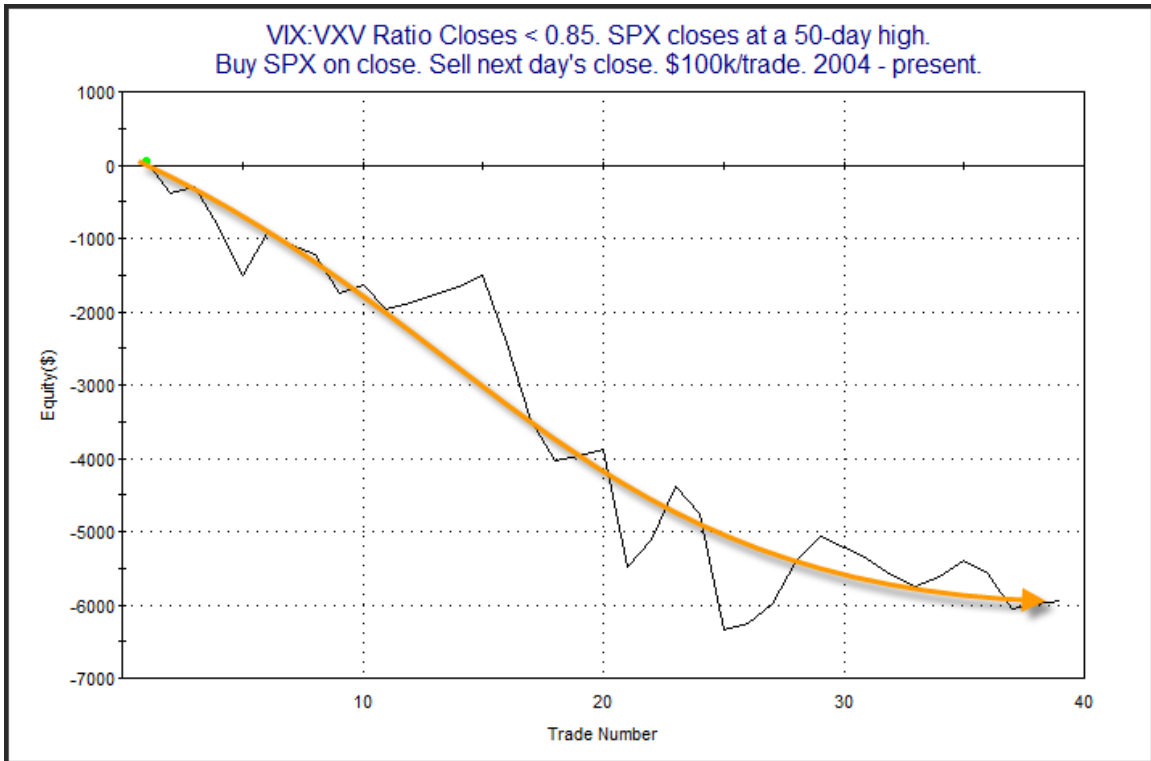
## The Evidence

Yawn. It was another nothing day on Monday with the major averages trading tight ranges and closing near breakeven. The SPX was up 0.1% while the Nasdaq dropped 0.1% and the Russell 2000 lost 0.2%. Breadth finished mildly positive as the NYSE Up Issues % came in at 58% and the Up Volume % was 57%. Total NYSE volume came in at the lowest level in over a week.

One study identified by the Quantifinder has now triggered for the 3<sup>rd</sup> day in a row. It examined instances of the SPX closing at a 50-day high while the VIX:VXV ratio was below 0.85. It showed a moderate 1-day downside edge. I have updated the results again below.

| VIX:VXV Ratio Closes < 0.85. SPX closes at a 50-day high.<br>Buy SPX on close. Sell next day's close. \$100k/trade. 2004 - present. |              |                          |  |
|---|--------------|--------------------------|--|
| TradeStation Performance Summary  |              |                          | Collapse  |
| All Trades  |              |                          |  |
| Total Net Profit  | (\$5,940.96) | Profit Factor            | 0.42   |
| Gross Profit  | \$4,260.49   | Gross Loss               | (\$10,201.45)  |
| Total Number of Trades  | 39           | Percent Profitable       | 51.28%   |
| Winning Trades  | 20           | Losing Trades            | 19   |
| Even Trades   | 0            |                          |  |
| Avg. Trade Net Profit   | (\$152.33)   | Ratio Avg. Win:Avg. Loss | 0.40   |
| Avg. Winning Trade  | \$213.02     | Avg. Losing Trade        | (\$536.92)   |
| Largest Winning Trade   | \$708.05     | Largest Losing Trade     | (\$1,602.28)   |

The odds are 50/50 but the losers have been more than twice the size of the winners. This suggests the complacency we are seeing at these high levels is more likely to lead to a big down day than be followed by a big up day. To see how the edge has played out over time I have posted the profit curve below.



The equity curve seems to have flattened out a bit lately. I noted that I was going to keep an eye on this one, and I will continue to do so. For now I find it compelling enough to keep under consideration.

Another VIX-based study that trigged on Monday also suggests bearish implications. When the SPX and VIX both close higher on the same day it often suggests a short-term downside edge. It is more common on Mondays than any other day because the VIX has a tendency to rise on Mondays. I looked at this setup in conjunction with a 50-day high in the 1/19/11 letter. I have updated the results below.

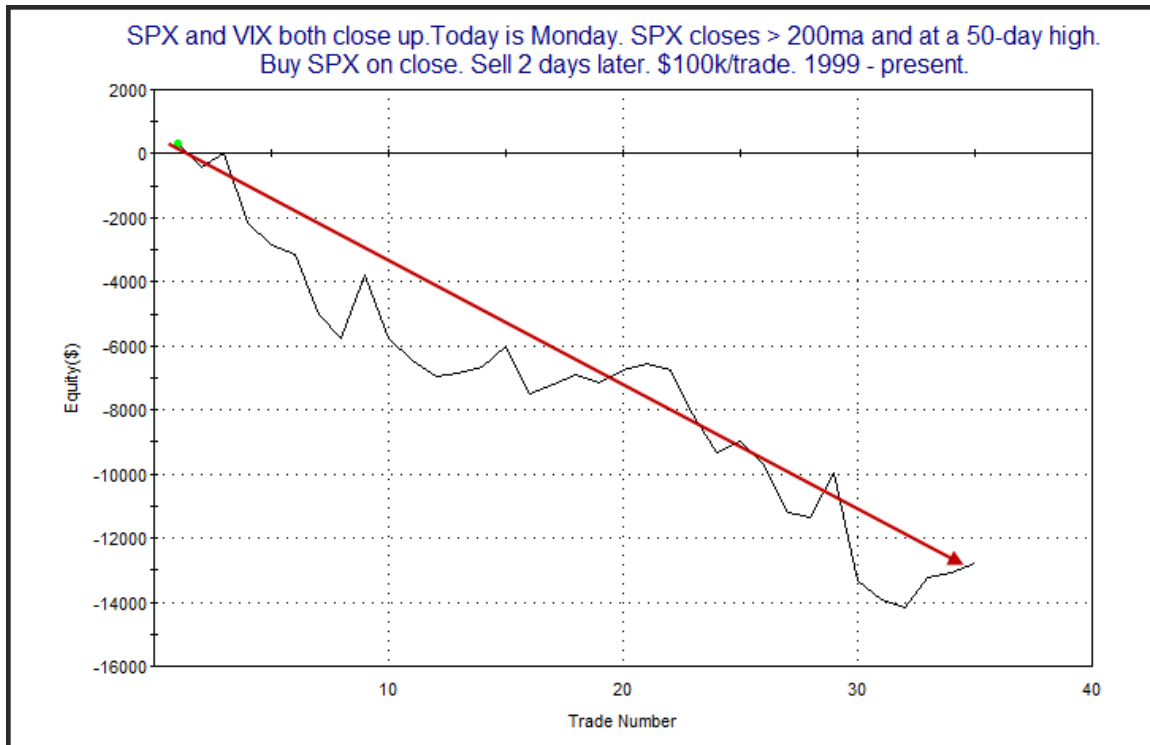
SPX and VIX both close up. Today is Monday. SPX closes > 200ma and at a 50-day high.  
Buy SPX on close. Sell X days later. \$100k/trade. 1999 - present.

| 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      | -8,392.78       | 34                | 15                  | 19                 | 44.12             | 1,255.08               | 3,260.25               | -1,432.58             | -5,048.68             | 0.88                | 0.69              | -246.85        |
| 4      | -6,547.29       | 35                | 15                  | 20                 | 42.86             | 1,115.14               | 2,953.65               | -1,163.72             | -4,271.52             | 0.96                | 0.72              | -187.07        |
| 3      | -6,775.53       | 35                | 14                  | 21                 | 40.00             | 975.37                 | 2,641.80               | -972.89               | -3,887.84             | 1.00                | 0.67              | -193.59        |
| 2      | -12,787.06      | 35                | 15                  | 20                 | 42.86             | 525.43                 | 1,981.72               | -1,033.43             | -3,372.16             | 0.51                | 0.38              | -365.34        |
| 1      | -7,154.36       | 35                | 11                  | 24                 | 31.43             | 301.09                 | 769.70                 | -436.10               | -1,580.04             | 0.69                | 0.32              | -204.41        |

The stats table seems suggests 1-2 days of possible weakness. Below are equity curves for both. First a 1-day hold.



This curve is fairly steady. Now let's look at the 2-day holding period.



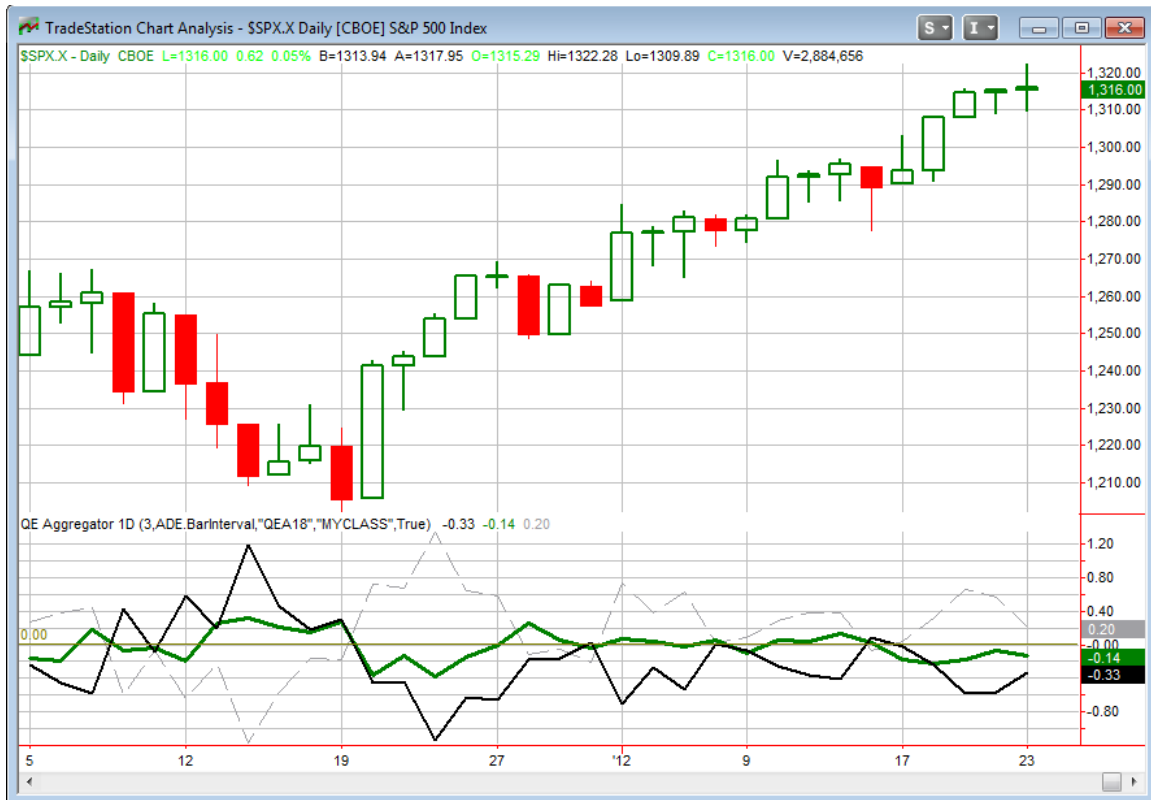
Here again we see a fairly consistent downslope. The curves act as confirmation of the bearish inclination.

The market is overbought and the VIX is suggesting a pullback from a few different angles. And while there is no good news tonight, it is fairly probable that we will see some bullish edges emerge tomorrow.

The reason Tuesday may trigger bullish edges is that Wednesday is a Fed Day. As I have documented many times over, and written in detail about in “The Quantifiable Edges Guide to Fed Days”, Fed Days typically carry a bullish inclination. A big factor in determining the strength (or weakness) of this inclination is the market’s action on the day before. The stronger the day before finishes, the weaker the edge, and vice-versa. So if Tuesday finishes near the bottom of its range, there will be some pretty strong 1-day edges likely setting up for Wednesday. Another factor to consider is the position of the market. If the SPX closes up again on Tuesday, it will be again be closing at an intermediate-term high. Fed Days that immediately follow an intermediate-term high have not shown strong upside tendency. One thing to keep in mind if you are looking to play a Fed Day edge is that the bullish inclinations are strongest between the close of the

day before up until the actual announcement. After the announcement is made, returns become much more random.

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



Bearish studies remain in control and the green Aggregator line still resides in negative territory. 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 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. This is considered a bearish configuration. Bearish configurations are visible on the chart whenever both lines close below 0. This caused the Aggregator System to remain short. This was indicated as likely on the systems page before the close.

Based on the current active studies, expectations are scheduled to remain negative on Tuesday. Of course this could change if more bullish evidence emerges. The

Differential Pivot will be 1,306.94 on Tuesday. This is 0.7% below Monday's close. So it will take a drop of at least this much in order for the Differential Line to turn positive.

I'm still holding some small short positions. My outlook remains negative and I will look to hold them for now. I am not looking to add to them at this time. In addition to the Fed Day on Wednesday and the possible bullish implications of that, Tuesday night is also the State of the Union address, which could be a market mover. This remains an environment where I am not inclined to get aggressive on the short side.

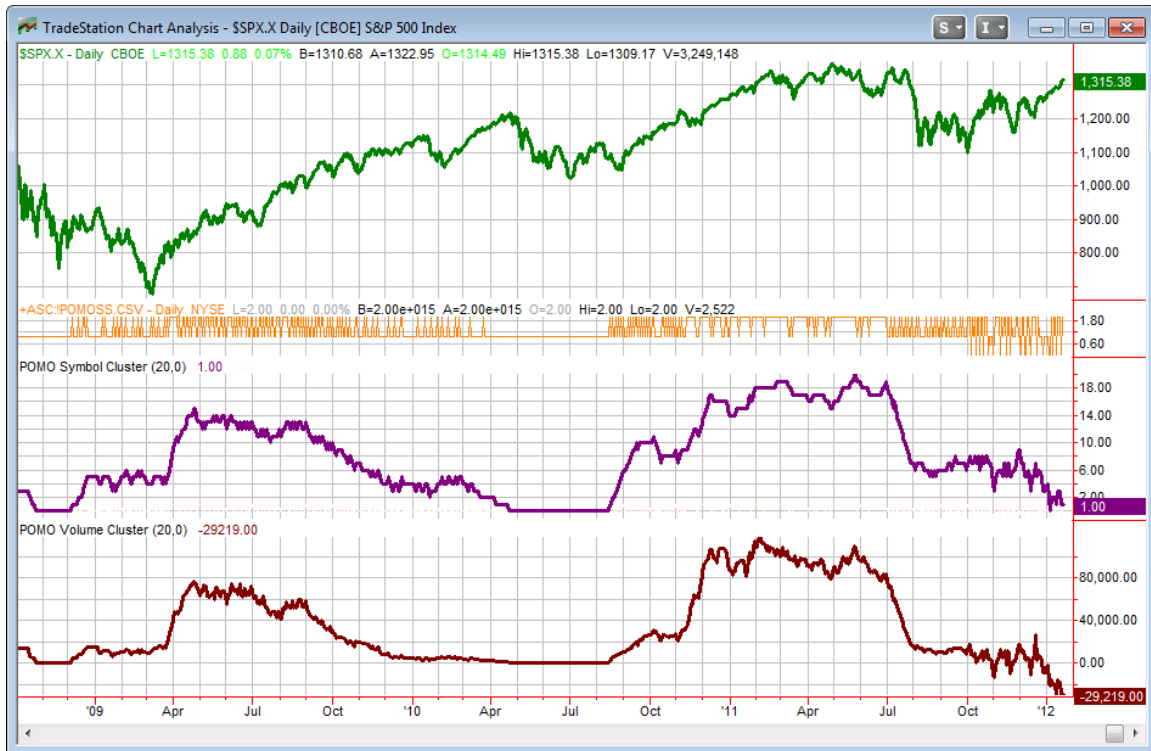
***Intermediate-term Outlook (2 weeks – 2 months)– updated 1/23 – bullish***

The SPX again hit new rally highs this week as it posted a rare all-up op-ex week. Despite overbought readings and bearish short-term studies the long-term trend and momentum pushed forward. Both continue to look good.

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>



For the first time in five weeks POMO numbers showed net gains. The fed added about \$5.9 billion to the system. But because an even bigger week came off the back end of our POMO indicator calculations, we are still seeing strongly negative net volume over the last 20 days. This should flip this upcoming week as several negative and neutral days will be falling out of the calculation and several positive days are scheduled.

The negative POMO numbers are running out of time to exhibit a bearish impact on the market. If the market can continue to rally despite all the negative readings we've seen in the last few weeks then that could be a very bullish sign. It has been several years since the market has managed to rally strongly without the aid of liquidity inflows from the Fed. The rest of January is slated to see primarily POMO buying, and that could aid in helping the market continue to rally higher over the next few weeks.

So the intermediate-term still appears to be looking up. The SPX again made new rally highs. The Nasdaq is still in a leadership position, and there also appears to be strong upside momentum with a POMO tailwind just begun. So my outlook remains bullish. From a trading standpoint this simply means I will take a more aggressive approach with longs than with shorts.

## **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>  |
|---------------|-------------------|--------------------|----------------------|--------------------|-------------|---------------|
| SPY(1/4)(s)   | 1/19/2012         | \$131.22           | \$131.54             | -0.24%             |             | Aggregator    |
| DIA(s)        | 1/23/2012         | \$126.96           | \$126.81             | 0.12%              |             | System -80514 |
|               |                   |                    |                      |                    |             |               |

*I will cover my SPY if SPX closes  $\leq$  1,306.94 (the Differential Pivot).*

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