

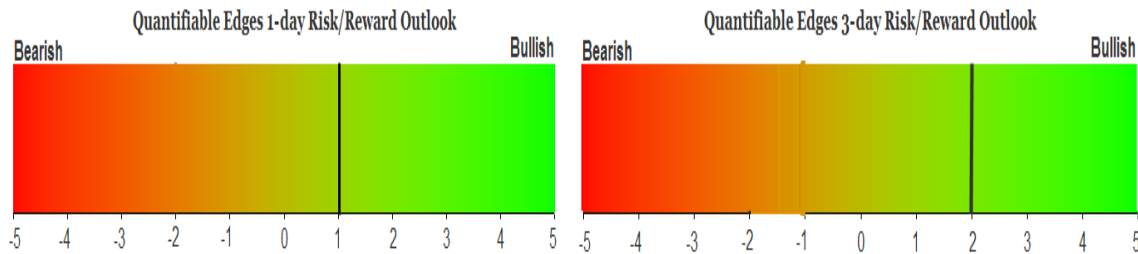
QUANTIFIABLE EDGES SUBSCRIBER LETTER

ASSESSING MARKET ACTION WITH INDICATORS AND HISTORY

March 5, 2012

Volume 5 Issue 43

Market Overview



Signals Overview

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

Tonight's Research Points

- When the 1st Friday of the month has been down during an uptrend, Monday rarely sees follow-through selling.
- Mild drops from 50-day highs on strongly negative breadth have typically been followed by further selling over the next 1-2 days.
- New SPX highs with persistent McClellan Oscillator readings < 0 have been rare. I show the others.

Short-term Outlook

The Bottom Line

The Aggregator shows an upside edge. It appears to be a mild one and potential short-term reward doesn't appear very high. I'm not going to take any index exposure yet, but I will consider alternate long trades.

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

| Study Date | Description | Time span | Bias | Avg Max Move |
|---------------------------|--|--------------|----------------|--------------|
| Active | | | | |
| March 5, 2012 | Down 1st Fri of month. SPX > 200 | 1 day | Bullish | |
| March 5, 2012 | Small drop from 50-high on bad breadth | 1-2 days | Bearish | |
| February 29, 2012 | Russell down 3 days. SPX 3-day high. | 1-6 days | Bullish | 3.95% |
| Active - Long Term | | | | |
| March 5, 2012 | Negative breadth divergences | int term | Bearish | |
| March 1, 2012 | 10-high then outside day down > 200 | 1-12 days | Bullish | 2.70% |
| February 29, 2012 | Russell dn 3 days. SPX 3-day high. | 1-10 days | Bullish | 5.10% |
| February 1, 2012 | Golden Cross | int term | Bullish | |
| January 17, 2012 | Nasdaq leading SPX | int term | Bullish | |
| December 5, 2011 | POMO activity flat to negative | int term | Bearish | |
| Dropped Tonight | | | | |
| March 2, 2012 | SPX 50-high. VIX:VXV < 0.85 | 1 day | Bearish | |

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

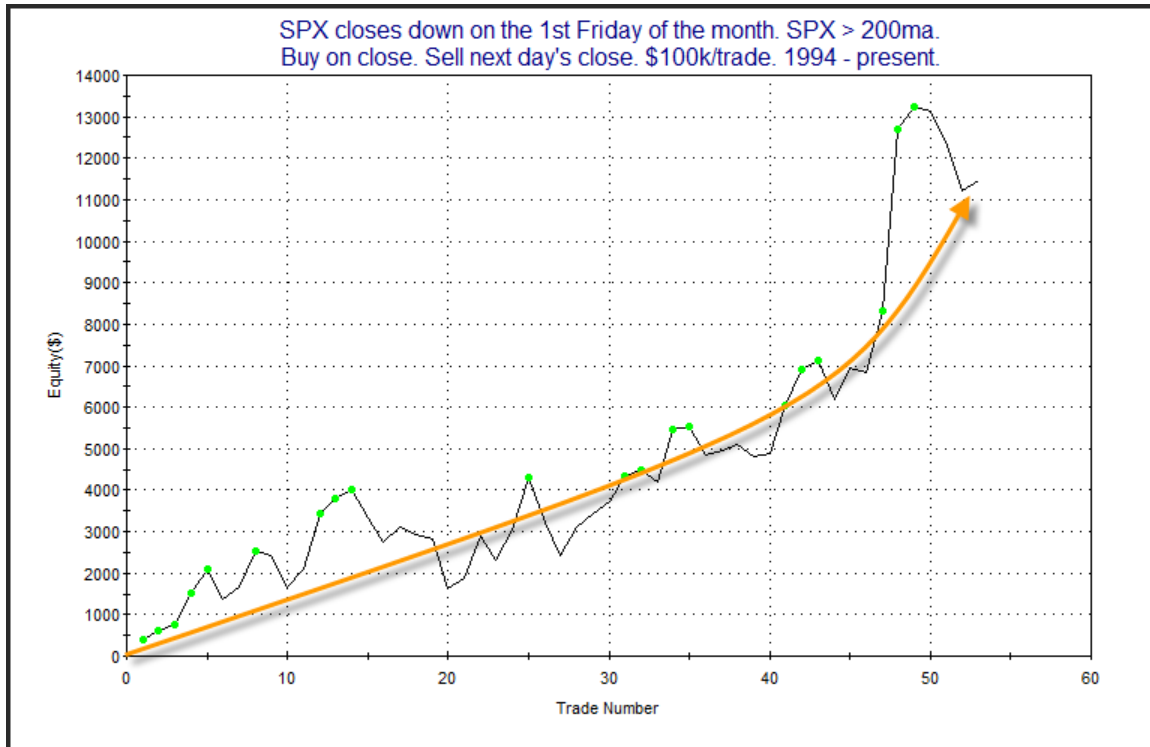
The Evidence

Friday was a fairly quiet day as the major indices pulled back a bit. The SPX lost 0.3%, the Nasdaq declined 0.4%, and the Russell 2000 fared the worst with a 1.6% drop. Breadth was solidly negative as the NYSE Up Issues % came in at 33% and the Up Volume % was 34%. Total NYSE volume fell and came in fairly light.

When the market has declined on the 1st Friday of the month during a long-term uptrend that decline has rarely followed through on Monday. Instead, almost 2/3 of the time Monday saw a bounce. I last showed this in the 6/6/11 letter and have updated the stats below.

| TradeStation Performance Summary Collapse ^ | | | |
|--|-------------|--------------------------|---------------|
| All Trades | | | |
| Total Net Profit | \$11,452.92 | Profit Factor | 2.04 |
| Gross Profit | \$22,507.04 | Gross Loss | (\$11,054.12) |
| Total Number of Trades | 53 | Percent Profitable | 64.15% |
| Winning Trades | 34 | Losing Trades | 19 |
| Even Trades | 0 | | |
| Avg. Trade Net Profit | \$216.09 | Ratio Avg. Win:Avg. Loss | 1.14 |
| Avg. Winning Trade | \$661.97 | Avg. Losing Trade | (\$581.80) |
| Largest Winning Trade | \$4,396.50 | Largest Losing Trade | (\$1,194.83) |

Between the solid winning % and the fact that winners were larger than losers this setup has shown a pretty solid risk/reward. Below is the equity curve.



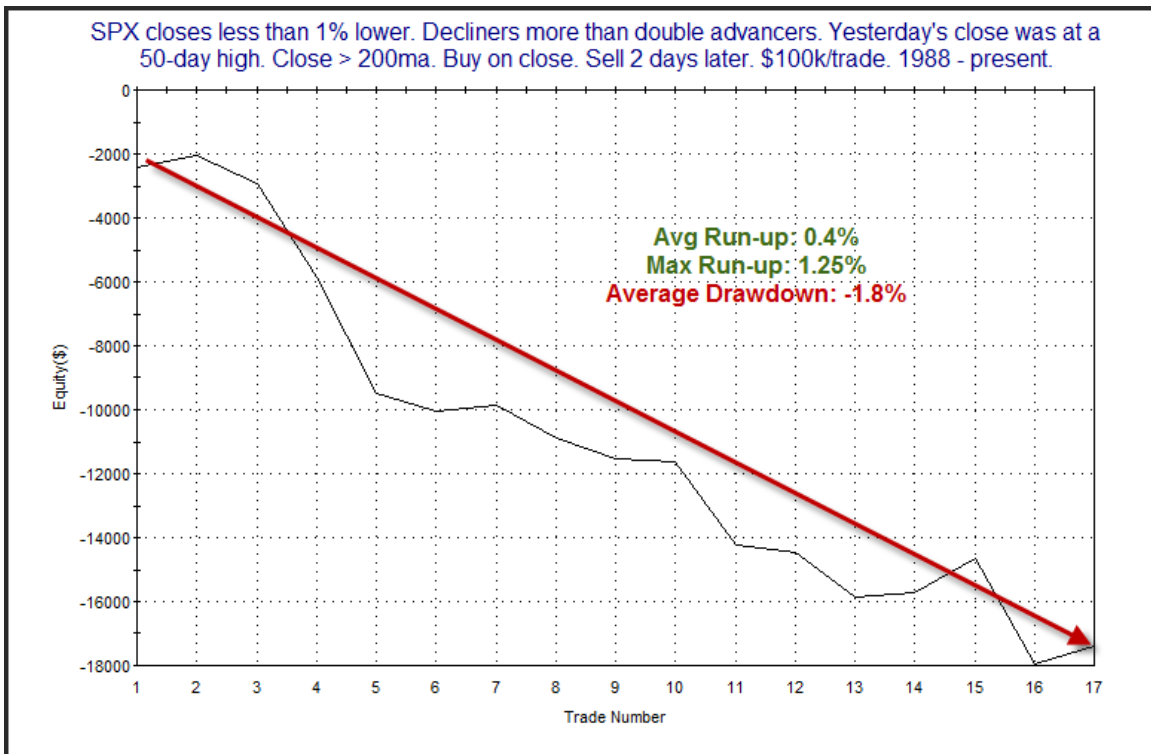
While there was one outsized instance to the upside, the continual upslope provides some confirmation of a bullish edge. What is a little different about Friday's instance is that it did not accompany an employment report. The employment report is typically released on the 1st Friday of the month. This month it is being released on the 2nd Friday. So I filtered the above results to see other instances where the setup occurred with an employment report. Stats were fairly similar, though there were only 7 instances. Five ended up posting gains on Monday. I decided since they weren't substantially different that I would include the study on the Active List.

Another study identified by the Quantifinder considered what happens after relatively mild drops from high levels are accompanied by very weak breadth. It was last seen just a few weeks ago in the 2/13/12 subscriber letter and has been updated below.

SPX closes less than 1% lower. Decliners more than double advancers. Yesterday's close was at a 50-day high. Close > 200ma. Buy on close. 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 |
|--------|-----------------|-------------------|---------------------|--------------------|-------------------|------------------------|------------------------|-----------------------|-----------------------|---------------------|-------------------|----------------|
| 5 | -4,517.06 | 17 | 10 | 7 | 58.82 | 792.10 | 2,181.96 | -1,776.87 | -2,538.28 | 0.45 | 0.64 | -265.71 |
| 4 | -10,045.79 | 17 | 7 | 10 | 41.18 | 766.61 | 1,232.88 | -1,541.20 | -3,709.52 | 0.50 | 0.35 | -590.93 |
| 3 | -16,293.69 | 17 | 5 | 12 | 29.41 | 283.01 | 568.80 | -1,475.73 | -3,721.09 | 0.19 | 0.08 | -958.45 |
| 2 | -17,387.63 | 17 | 5 | 12 | 29.41 | 467.29 | 1,077.12 | -1,643.67 | -3,611.48 | 0.28 | 0.12 | -1,022.80 |
| 1 | -14,272.61 | 17 | 5 | 12 | 29.41 | 550.25 | 832.48 | -1,418.65 | -3,794.40 | 0.39 | 0.16 | -839.57 |

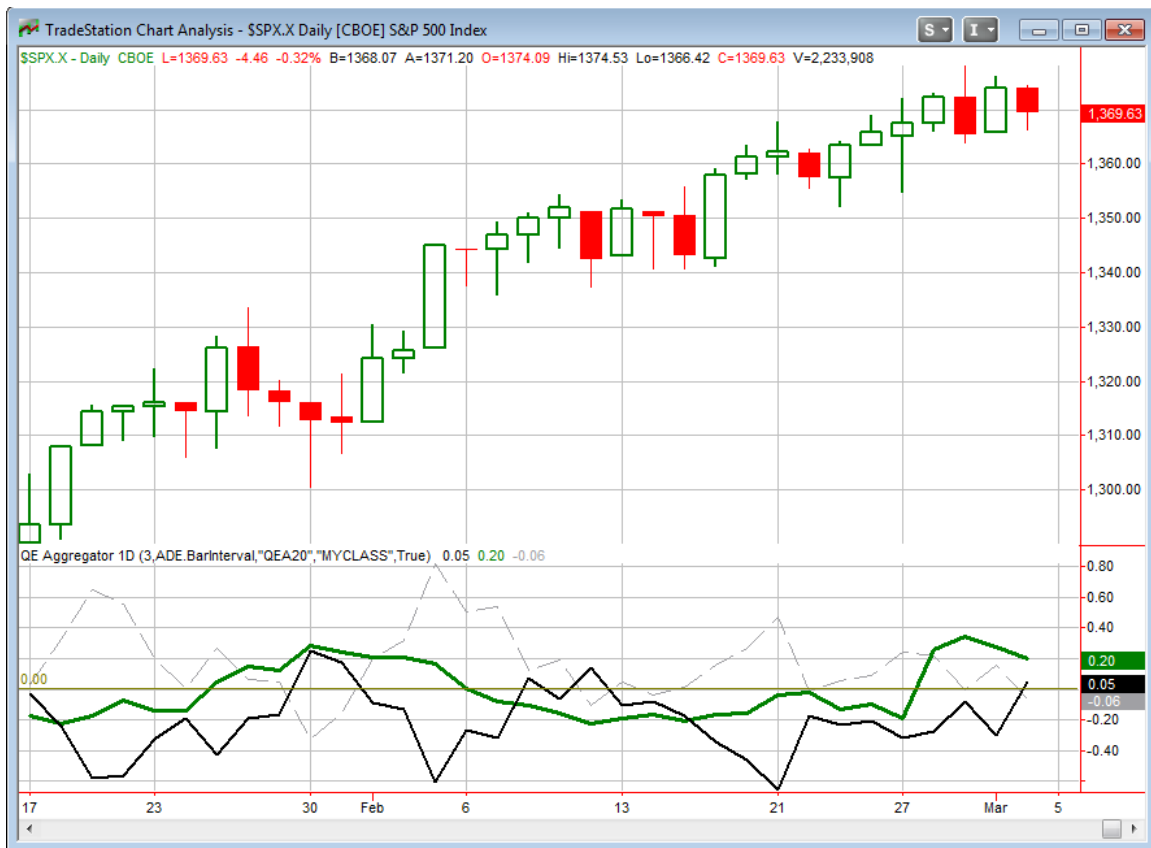
The implication here is that when the SPX is coming off a high level and it holds up relatively well despite broad selling, it will often have further to drop. The strong selling in the Russell 2000 could spill over into the large caps. There's a chance they could even play catch-up to the downside. The good news for bulls here is that the bearish inclinations have only lasted a couple of days. In addition to the edges suggested by the "% profitable" and the "avg trade" columns, the win:loss ratio is also strongly skewed. Risks appears to far outweigh reward. Below is a profit curve using a two day exit strategy.



We see here a fairly steady downmove. While instances are a little bit low this study appears well worthy of consideration. The stats shown on the chart are especially impressive, with downside risks swamping upside reward as the results table seemed to imply.

Of course we also have a study on the Active List from a few days ago that looked at short-term smallcap underperformance with the SPX posting short-term highs that suggested bullish implications. This casts some doubt on the meaning of recent action, but as I most often do, I decided to let the Aggregator sort it out.

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



The green Aggregator line is still quite positive. Readings above 0 mean net expectations from the Active List are for upside over the next few days. Meanwhile, the black Differential Line rose 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. This is considered a bullish

configuration. Bullish configurations are visible on the chart whenever both lines close above 0. This caused the Aggregator System to change from flat to long at the close. This was indicated on the Systems page before the bell.

Based on the current evidence, expectations are scheduled to remain positive on Monday. Of course this could change if bearish evidence emerges. Meanwhile, the Differential Pivot will be 1,371.27 on Monday. This is just 0.1% above Friday's close. So the SPX would move from oversold to overbought with just about any up close.

The Differential Pivot being so close by suggests the size of the opportunity to profit here is not very big. And while the Aggregator is bullish, it is based on a small number of conflicting studies. It is not the kind of strong evidence that would give me great confidence in a large position. So between the limited opportunity size and the questionable evidence I am not inclined to get long index shares just yet.

I may look to get long XIV, the inverse VIX short-term ETF. XIV is currently benefitting from very steep contango in the VIX futures market. On Friday the March VIX futures closed at \$20.40 and the April at \$23.69. That is a very large spread. Since the fund rolls futures on a daily basis in order to maintain a consistent duration it is now covering March futures for nearly 14% less than it is shorting the April futures. If such conditions were to persist for a whole month and the futures prices remained steady, XIV would gain nearly 14%. That is a very large cushion to help even if the direction of the futures goes against you. I have been waiting for a long Aggregator signal in order to take some XIV exposure. Because even with the strong edge that contango is providing, VIX futures are incredibly volatile and a strong move down in the market could send VIX futures prices rocketing. But the combination of a bullish market edge (both short and intermediate-term) and strong contango makes XIV very tempting. So I'll be looking to take some small exposure there if we get a dip on Monday.

Note: Those who wish to learn more about the contango effects on XIV should watch any one of the 3 VIX-based ETF / XIV videos on the videos page.

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

Intermediate-term Outlook (2 weeks – 2 months)– updated 3/5 – moderately bullish

The SPX managed to surpass its 2011 highs this past week as the steady ascent continued. A few studies with intermediate-term significance also triggered

The study below from the 2/29/12 letter considered results following instances where SPY posted an outside day with a down close immediately following a short-term closing high during an uptrend. Results were interesting in that the outside day often lead to a small amount of additional selling over the next few days, but rarely did this “reversal signal” ever actually mark an intermediate-term high.

| After closing at a 10-day high SPY posts an outside day with a down close. Close > 200ma. Buy on close. Sell X days later. \$100k/trade. 1993 - 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 |
| 12 | 57,858.78 | 42 | 34 | 8 | 80.95 | 2,348.03 | 8,494.78 | -2,746.79 | -8,389.36 | 0.85 | 3.63 | 1,377.59 |
| 11 | 50,925.49 | 42 | 34 | 8 | 80.95 | 2,085.28 | 6,726.11 | -2,496.74 | -9,630.04 | 0.84 | 3.55 | 1,212.51 |
| 10 | 42,150.04 | 43 | 33 | 9 | 76.74 | 1,824.79 | 5,990.24 | -2,007.56 | -5,992.40 | 0.91 | 3.33 | 980.23 |
| 9 | 35,269.79 | 44 | 31 | 13 | 70.45 | 1,853.94 | 5,267.28 | -1,707.88 | -5,764.17 | 1.09 | 2.59 | 801.59 |
| 8 | 41,679.18 | 45 | 30 | 15 | 66.67 | 2,101.66 | 7,603.99 | -1,424.71 | -4,587.23 | 1.48 | 2.95 | 926.20 |
| 7 | 34,569.60 | 46 | 29 | 17 | 63.04 | 2,027.83 | 7,694.36 | -1,425.74 | -4,962.72 | 1.42 | 2.43 | 751.51 |
| 6 | 33,588.41 | 47 | 31 | 16 | 65.96 | 1,818.80 | 5,189.82 | -1,424.65 | -4,591.36 | 1.28 | 2.47 | 714.65 |
| 5 | 26,054.93 | 51 | 33 | 18 | 64.71 | 1,441.81 | 4,428.81 | -1,195.82 | -4,346.17 | 1.21 | 2.21 | 510.88 |
| 4 | 6,635.68 | 51 | 27 | 24 | 52.94 | 1,412.52 | 3,915.78 | -1,312.60 | -4,228.43 | 1.08 | 1.21 | 130.11 |
| 3 | -7,297.17 | 51 | 25 | 26 | 49.02 | 1,133.44 | 2,930.57 | -1,370.51 | -5,283.03 | 0.83 | 0.80 | -143.08 |
| 2 | -9,827.12 | 52 | 22 | 30 | 42.31 | 919.56 | 2,361.64 | -1,001.91 | -3,737.28 | 0.92 | 0.67 | -188.98 |
| 1 | -6,899.89 | 52 | 26 | 26 | 50.00 | 574.42 | 1,601.91 | -839.80 | -3,909.03 | 0.68 | 0.68 | -132.69 |

The strongest edges here appear to be the bullish ones that look out a couple of weeks.

The March 1st letter included another study with bullish intermediate-term implications. It looked at the pullback in the Russell as a “stealth” pullback because it was occurring with the SPX making new highs. Over the last 13 years there have been 10 similar instances and they all led to higher prices over the next couple of weeks. The results table from that study is copied below.

Russell 2000 closes down for at least the 3rd day in a row while the SPX closes at a 3-day high.
Buy SPX on close. Sell X days later. \$100k/trade. 11/98 - present.

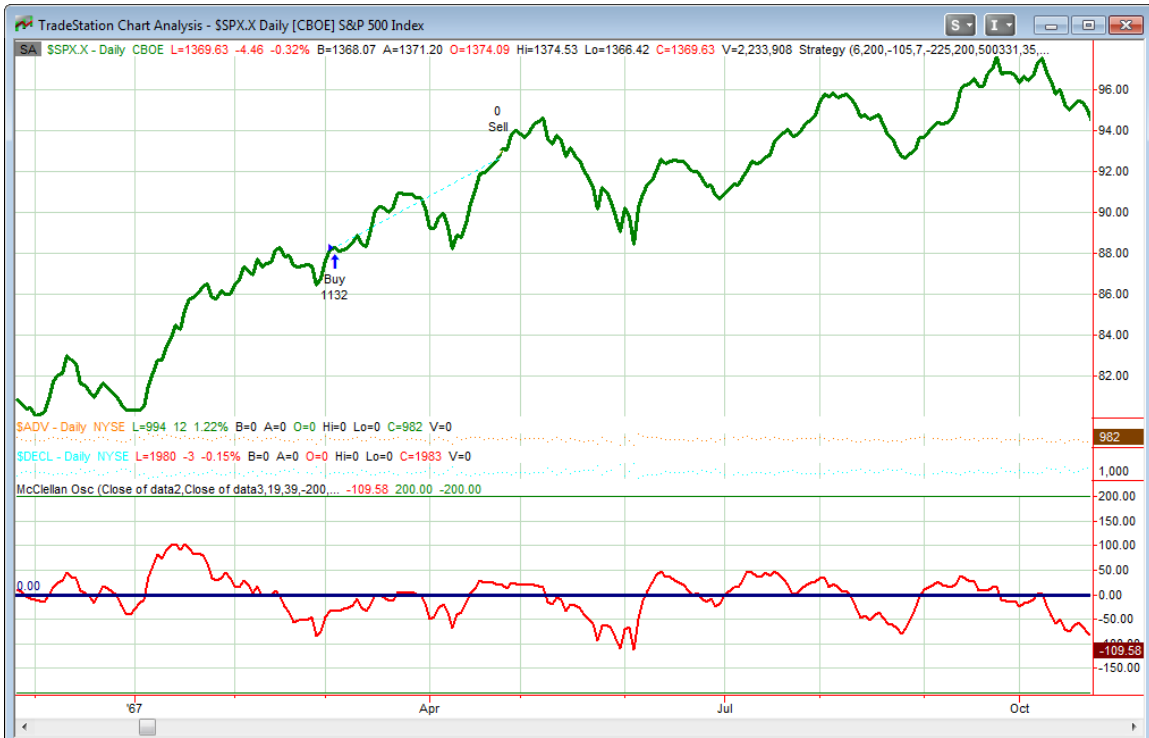
| X Days | All: Net Profit | All: Total Trades | All: Winning Trades | All: Losing Trades | All: % Profitable | All: Avg Winning Trade | All: Max Winning Trade | All: Avg Losing Trade | All: Max Losing Trade | All: Win/Loss Ratio | All: ProfitFactor | All: Avg Trade |
|--------|-----------------|-------------------|---------------------|--------------------|-------------------|------------------------|------------------------|-----------------------|-----------------------|---------------------|-------------------|----------------|
| 10 | 42,214.48 | 10 | 10 | 0 | 100.00 | 4,221.45 | 10,577.93 | 0.00 | 0.00 | 100.00 | 100.00 | 4,221.45 |
| 9 | 37,299.07 | 10 | 10 | 0 | 100.00 | 3,729.91 | 8,209.02 | 0.00 | 0.00 | 100.00 | 100.00 | 3,729.91 |
| 8 | 33,383.52 | 10 | 10 | 0 | 100.00 | 3,338.35 | 9,347.15 | 0.00 | 0.00 | 100.00 | 100.00 | 3,338.35 |
| 7 | 35,117.30 | 10 | 8 | 2 | 80.00 | 4,462.30 | 9,614.11 | -290.54 | -424.84 | 15.36 | 61.43 | 3,511.73 |
| 6 | 33,307.36 | 10 | 9 | 1 | 90.00 | 3,750.81 | 9,598.49 | -449.92 | -449.92 | 8.34 | 75.03 | 3,330.74 |
| 5 | 27,307.82 | 10 | 9 | 1 | 90.00 | 3,094.18 | 7,700.66 | -539.77 | -539.77 | 5.73 | 51.59 | 2,730.78 |
| 4 | 25,520.40 | 10 | 9 | 1 | 90.00 | 2,945.86 | 7,217.86 | -992.31 | -992.31 | 2.97 | 26.72 | 2,552.04 |
| 3 | 18,918.91 | 10 | 9 | 1 | 90.00 | 2,200.68 | 4,839.33 | -887.22 | -887.22 | 2.48 | 22.32 | 1,891.89 |
| 2 | 17,613.04 | 10 | 8 | 2 | 80.00 | 2,261.00 | 5,134.01 | -237.48 | -434.97 | 9.52 | 38.08 | 1,761.30 |
| 1 | 10,873.20 | 11 | 8 | 3 | 72.73 | 1,526.88 | 4,708.01 | -447.28 | -764.46 | 3.41 | 9.10 | 988.47 |

Every instance posted at least 1 close above the entry price at some point in the next week.

While these studies were providing bullish evidence, we still saw breadth weaken and I am seeing more and more people suggest this is an ominous sign. As I discussed last week, breadth divergences are a prerequisite for a strong market correction, but they are not a very good timing tool. They can persist for months and even years before the large cap indices finally roll over. And sometimes divergences will resolve themselves before the market does manage to suffer a large decline.

The current breadth situation is fairly extreme, though, and somewhat interesting. I noted last week that SPX had hit a new high after the McClellan Oscillator had closed below 0 for 8 straight days – a fairly unusual occurrence. On Thursday of this week that streak was at 12 days and the SPX was again closing at a new high. There have only been 5 other instances of this occurring in the SPX since 1966. You really don't want to try and draw many conclusions from just 5 instances, but I thought the setup was interesting enough that I provided charts of each of them below. The “buy” arrow occurs when the setup triggers. The “sell” date for each is 35 trading days later.

1967:



1980:



1989:



1997:



1998:

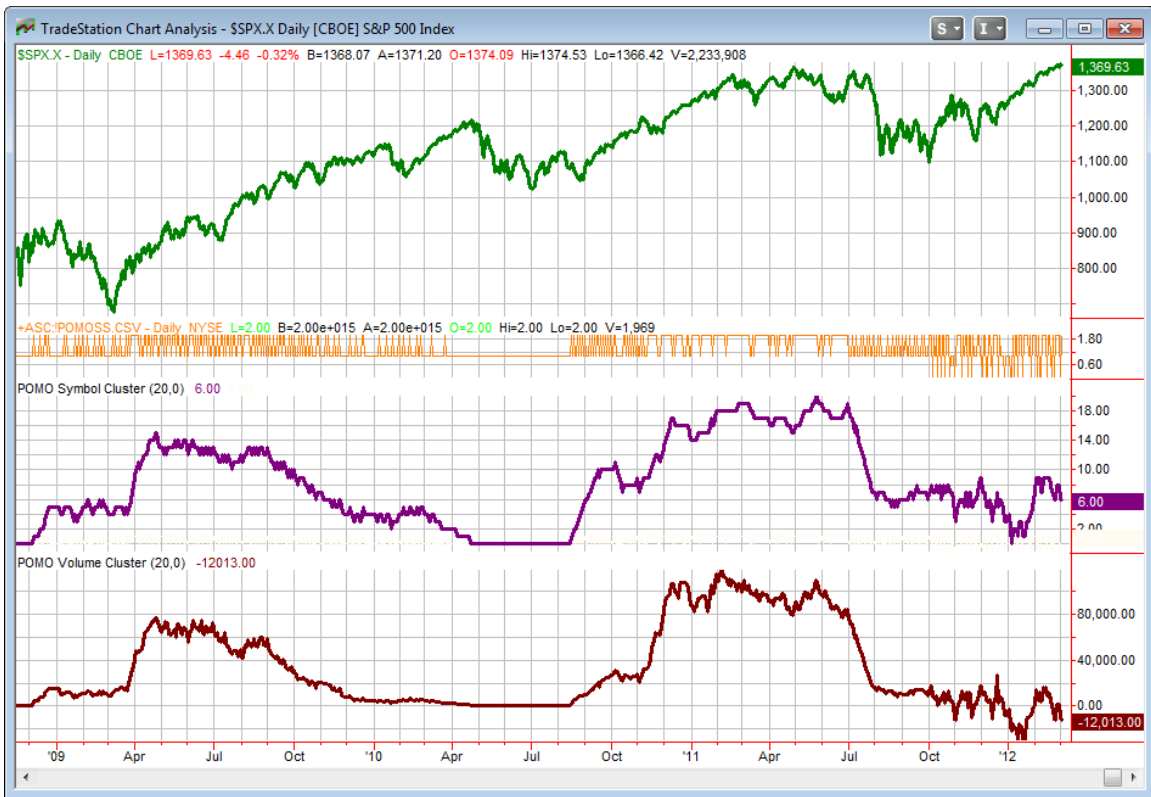


So 4 of the 5 instances did see a pullback over the next few weeks. That isn't enough evidence to suggest a probability, but it is enough to keep me open to the possibility of a coming correction.

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>



There were 4 days of buying and 1 day of selling this week by the Fed, which amounted to about \$5 billion of POMO inflows. The intermediate-term POMO indicators were largely unaffected, since a similar week came off the back of the calculations.

Wednesday afternoon the Fed released its operations schedule for March. I used that schedule to produce projected values for the QE Buying Power Index over the course of the month. This can be seen in the graphic below.

So we saw some positive studies this past week that imply another couple of weeks of strength. Additionally the Nasdaq continues to lead and the uptrend is undeniable. But breadth is waning, POMO is providing very little in the way of intermediate-term support, and the trend, while strong, is long in the tooth. With all this in mind I have decided to dial back the optimism a little bit. I will still favor long positions versus shorts, but perhaps without the same fervor as I would have had over the past few weeks. So I have moved the outlook from “bullish” to “moderately bullish”.

Catapult and Capitulative Breadth Statistics

[Catapult & CBI Presentation Link](#)

Open Catapult Triggers

New

CAT – buy 1/3 position @ \$112.49 limit

Catapult for ETF's Trades

None

Broad Market Large Cap CBI – 1(CAT)

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.

CAT – buy 1/3 position @ \$112.49 limit. This is a Catapult trade.

XIV – buy 1/2 position @ \$9.00 limit ON CLOSE if SPX also closes down. This is based on the short-term outlook above. The combination of a bullish Aggregator and strong VIX futures contango make this trade appealing. Since XIV can be very volatile it is likely that if filled, I will scale out of this position in parts even though it is already a small position. This will allow me to take some profits off the table if they materialize while still letting a portion of the trade run in a seemingly positive environment.

Current Open Trade Ideas

None.

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