

QUANTIFIABLE EDGES SUBSCRIBER LETTER

ASSESSING MARKET ACTION WITH INDICATORS AND HISTORY

March 13, 2012

Volume 5 Issue 49

Market Overview



Signals Overview

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

Tonight's Research Points

- When the VIX moves from 10% above the 10ma to 10% below the 10ma in less than a week it has been typically followed by gains.
- When the VIX has closed at a 20-day low the day before a Fed Day, those Fed Days have shown no edge.
- The extremely low volume with the SPX closing up and above the 10ma and 200ma has commonly been followed by pullbacks.
- The up close with both the Up Issues % and the Up Volume % < 45% has been a setup that has suggested a short-term downside edge.

Short-term Outlook

The Bottom Line

There seems to be a slight downside edge, but risk/reward is not terrific and it appears the time window is tight. I'm inclined to remain flat the indices and wait for a more favorable opportunity.

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

Study Date	Description	Time span	Bias	Avg Max Move
Active				
March 13, 2012	VIX 10%high to 10% low in < week	1-8 days	Bullish	2.75%
March 13, 2012	SPX up. Up Issues% & Up Vol% < 45%	1-3 days	Bearish	-1.80%
March 13, 2012	SPX up > 10ma > 200ma. Low vol 20.	1-3 days	Bearish	-1.30%
March 12, 2012	3 unfilled up gaps	1-3 days	Bearish	-1.40%
March 12, 2012	March Op-Ex bullish	1-4 days	Bullish	1.70%
March 8, 2012	Unfilled gap from 10-low. Close < 10ma.	1-4 days	Bullish	1.80%
March 8, 2012	McClellan Osc % Rank 4-day sum < 5	1-5 days	Bullish	2.20%
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	

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

The Evidence

Monday was very quiet and the major indices did not move much. The SPX gained a mere 0.02% while the Nasdaq dropped 0.2%, and the Russell 2000 lost 0.3%. Breadth finished negative as the NYSE Up Issues % came in at 44% and the Up Volume % was 40%. Total NYSE volume posted a new low for 2012.

Quiet days like Monday often leave us with very little to discuss, but that wasn't the case tonight. Several studies triggered that were worth taking into consideration. I'll start with a few related to the VIX.

Often leading up to a Fed Day the VIX will rise as traders fret over what the Fed might say or do. Monday was one of those rare occasions where VIX closed at an intermediate-term low on the day before a Fed Day. Below are results of the 16 other times this has occurred.

VIX closes at a 20-day low. Tomorrow is a Fed Day.
Buy SPX on close. Sell Fed Day close. \$100k/trade. 1990 - present.

TradeStation Performance Summary				Collapse ^
All Trades				
Total Net Profit	(\$783.00)	Profit Factor	0.88	
Gross Profit	\$5,604.45	Gross Loss	(\$6,387.45)	
Total Number of Trades	16	Percent Profitable	43.75%	
Winning Trades	7	Losing Trades	9	
Even Trades	0			
Avg. Trade Net Profit	(\$48.94)	Ratio Avg. Win:Avg. Loss	1.13	
Avg. Winning Trade	\$800.64	Avg. Losing Trade	(\$709.72)	
Largest Winning Trade	\$2,077.44	Largest Losing Trade	(\$2,492.10)	

We know Fed Days have provided an upside edge over the years, but in cases like this the edge has not been present.

But there is good news with regards to the sharp drop in the VIX over the last week. The study below was last seen in the 3/23/11 subscriber letter. I adjusted it slightly tonight, only looking back four days instead of five. I did this because while allowing more days provided more instances, those additional instances were basically a breakeven proposition that suggested no edge. The updated study results are below.

VIX closes more than 10% below its 10ma after closing more than 10% above it one of the previous 4 days. SPX > 200ma. Buy SPX on close. Sell X days later. \$100k/trade. 1992 - 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	20,364.18	13	10	3	76.92	2,760.01	8,115.80	-2,411.98	-3,412.50	1.14	3.81	1,566.48
9	22,670.01	13	9	4	69.23	2,814.47	8,397.40	-665.05	-2,173.08	4.23	9.52	1,743.85
8	24,836.55	13	11	2	84.62	2,432.98	8,076.20	-963.09	-1,733.94	2.53	13.89	1,910.50
7	22,441.32	13	10	3	76.92	2,502.54	7,749.50	-861.37	-1,872.78	2.91	9.68	1,726.26
6	18,531.52	13	8	5	61.54	2,697.59	5,305.30	-609.84	-1,280.71	4.42	7.08	1,425.50
5	17,022.54	13	9	4	69.23	2,275.41	5,361.40	-864.04	-1,159.86	2.63	5.93	1,309.43
4	8,555.40	13	10	3	76.92	1,376.55	4,981.90	-1,736.69	-2,303.32	0.79	2.64	658.11
3	3,209.51	14	8	6	57.14	1,094.56	3,799.40	-924.50	-1,683.22	1.18	1.58	229.25
2	3,218.58	14	6	8	42.86	1,406.71	3,839.00	-652.71	-1,767.90	2.16	1.62	229.90
1	3,416.62	14	7	7	50.00	886.89	2,952.40	-398.80	-1,582.62	2.22	2.22	244.04

All 14 instances posted a close above the entry price at some point in the next 4 days.

The market condition that would typically accompany such VIX movement is one where you see a strong rebound from a sharp decline during a long-term uptrend. Results

over the first 2-3 days are somewhat sketchy, but once you get out beyond that they become more consistent and more powerful. Below I have listed all 13 instances with an eight day holding period.

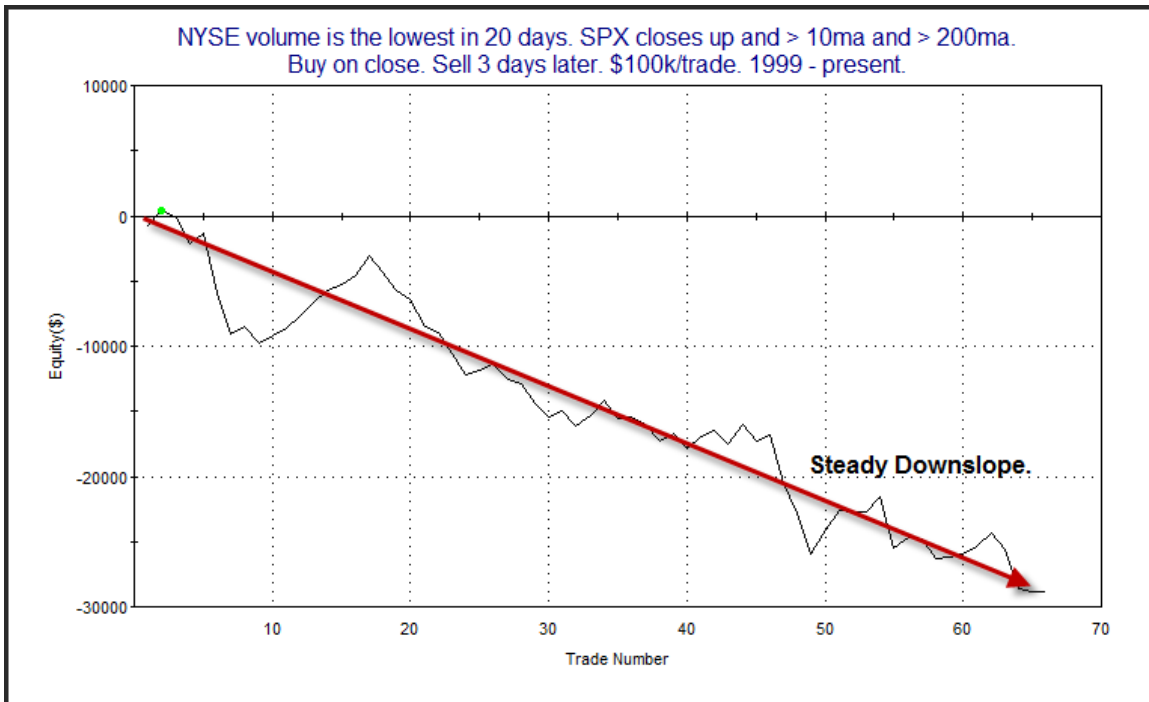
VIX closes more than 10% below its 10ma after closing more than 10% above it one of the previous 4 days. SPX > 200ma. Buy SPX on close. Sell 8 days later. \$100k/trade. 1992 - present.				
Date/Time	Signal	Price	% Profit	Run-up Drawdown
06/23/92	Buy	\$404.04	2.43%	\$2,880.02
07/06/92	Sell	\$413.84		(\$521.17)
07/26/96	Buy	\$635.89	4.44%	\$4,509.04
08/07/96	Sell	\$664.15		(\$1,047.19)
05/01/98	Buy	\$1,121.02	(0.19%)	\$845.50
05/13/98	Sell	\$1,118.86		(\$2,357.61)
01/07/00	Buy	\$1,441.47	0.28%	\$2,175.57
01/20/00	Sell	\$1,445.57		(\$992.91)
03/26/04	Buy	\$1,108.02	2.93%	\$3,829.50
04/07/04	Sell	\$1,140.48		\$0.00
05/26/06	Buy	\$1,280.16	(1.74%)	\$820.56
06/08/06	Sell	\$1,257.93		(\$3,508.44)
09/13/06	Buy	\$1,318.07	0.63%	\$846.00
09/25/06	Sell	\$1,326.37		(\$534.75)
03/09/07	Buy	\$1,402.85	2.29%	\$2,479.32
03/21/07	Sell	\$1,435.04		(\$2,759.77)
08/22/07	Buy	\$1,464.07	1.73%	\$2,198.44
09/04/07	Sell	\$1,489.42		(\$2,180.08)
07/14/09	Buy	\$905.84	8.11%	\$8,134.50
07/24/09	Sell	\$979.26		\$0.00
11/09/09	Buy	\$1,093.08	0.17%	\$1,875.51
11/19/09	Sell	\$1,094.90		(\$744.38)
12/03/10	Buy	\$1,224.71	0.86%	\$1,783.62
12/15/10	Sell	\$1,235.23		(\$422.01)
03/22/11	Buy	\$1,293.77	2.99%	\$3,394.16
04/01/11	Sell	\$1,332.41		(\$748.44)

I don't see anything alarming here. These results appear to confirm the upside edge.

But not all studies tonight suggested an upside edge. The rapid reduction in perceived risk by option traders may be a good thing, but Monday's low volume, and poor breadth statistics appear to suggest a downside edge. First let's consider the low volume. The study below was last seen in the 4/26/11 Subscriber Letter. All results are updated.

NYSE volume is the lowest in 20 days. SPX closes up and > 10ma and > 200ma. Buy 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	-24,618.97	62	31	31	50.00	1,191.92	2,927.68	-1,986.08	-10,421.45	0.60	0.60	-397.08
4	-21,930.33	64	31	33	48.44	849.33	1,909.60	-1,462.41	-4,929.60	0.58	0.55	-342.66
3	-28,818.02	66	30	36	45.45	787.60	1,874.04	-1,456.84	-4,565.52	0.54	0.45	-436.64
2	-22,249.35	68	28	40	41.18	627.05	1,532.44	-995.17	-3,595.20	0.63	0.44	-327.20
1	-10,306.08	74	36	38	48.65	441.69	1,439.62	-689.65	-2,361.45	0.64	0.61	-139.27

Based on these results there appears to be a moderate downside edge suggested by the setup. To confirm the downside edge, I examined the profit curve assuming a 3-day holding period.



The steady downslope is pretty impressive considering the setup includes a long-term uptrend filter. This study appears worthy of inclusion on the Active List.

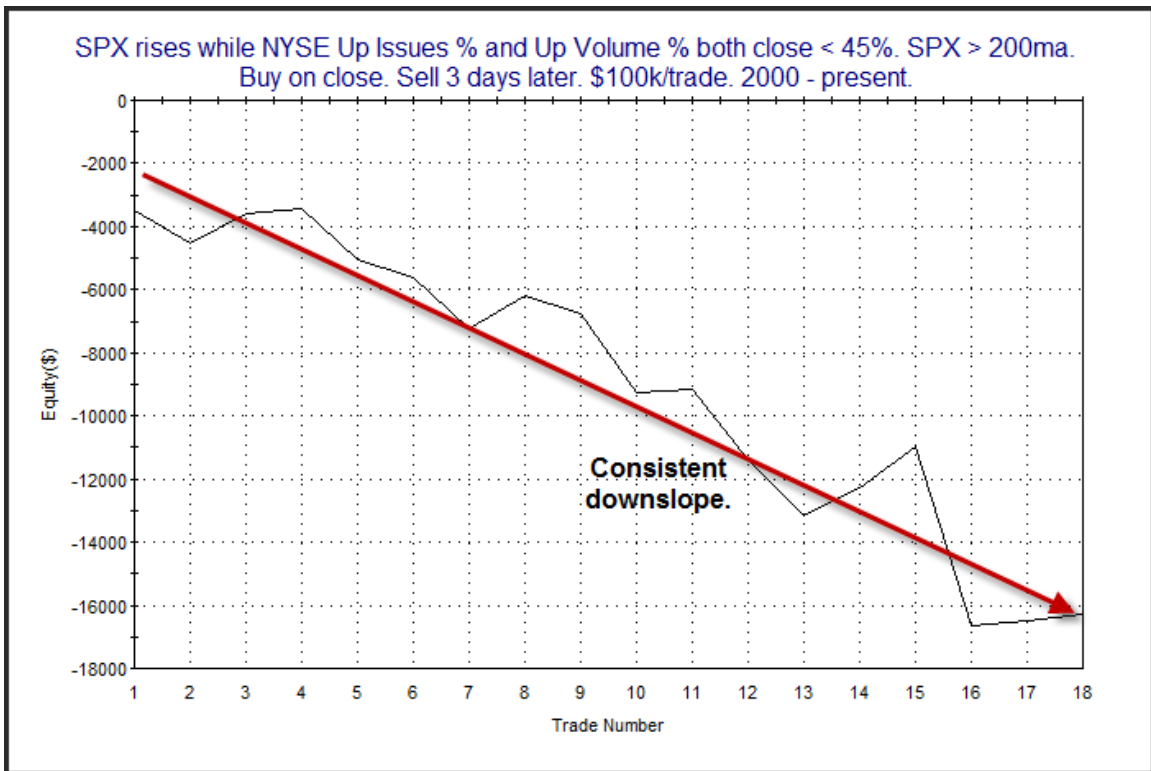
Another study with bearish implications considered the fact that breadth was quite poor. It was last shown in the 12/15/10 Subscriber Letter. I again updated the results below.

SPX rises while NYSE Up Issues % and Up Volume % both close < 45%. SPX > 200ma.
Buy on close. Sell X days later. \$100k/trade. 2000 - 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	-7,346.35	18	9	9	50.00	1,227.71	2,828.00	-2,043.97	-5,506.23	0.60	0.60	-408.13
4	-14,577.66	18	8	10	44.44	817.03	1,430.00	-2,111.39	-4,284.75	0.39	0.31	-809.87
3	-16,305.41	18	8	10	44.44	602.90	1,317.52	-2,112.86	-5,685.45	0.29	0.23	-905.86
2	-8,513.88	18	8	10	44.44	659.99	1,705.61	-1,379.38	-2,848.17	0.48	0.38	-472.99
1	-6,922.04	18	6	12	33.33	596.38	1,130.49	-875.03	-2,079.70	0.68	0.34	-384.56

15 of 18 instances (83%) closed below the entry price at some point in the next week.

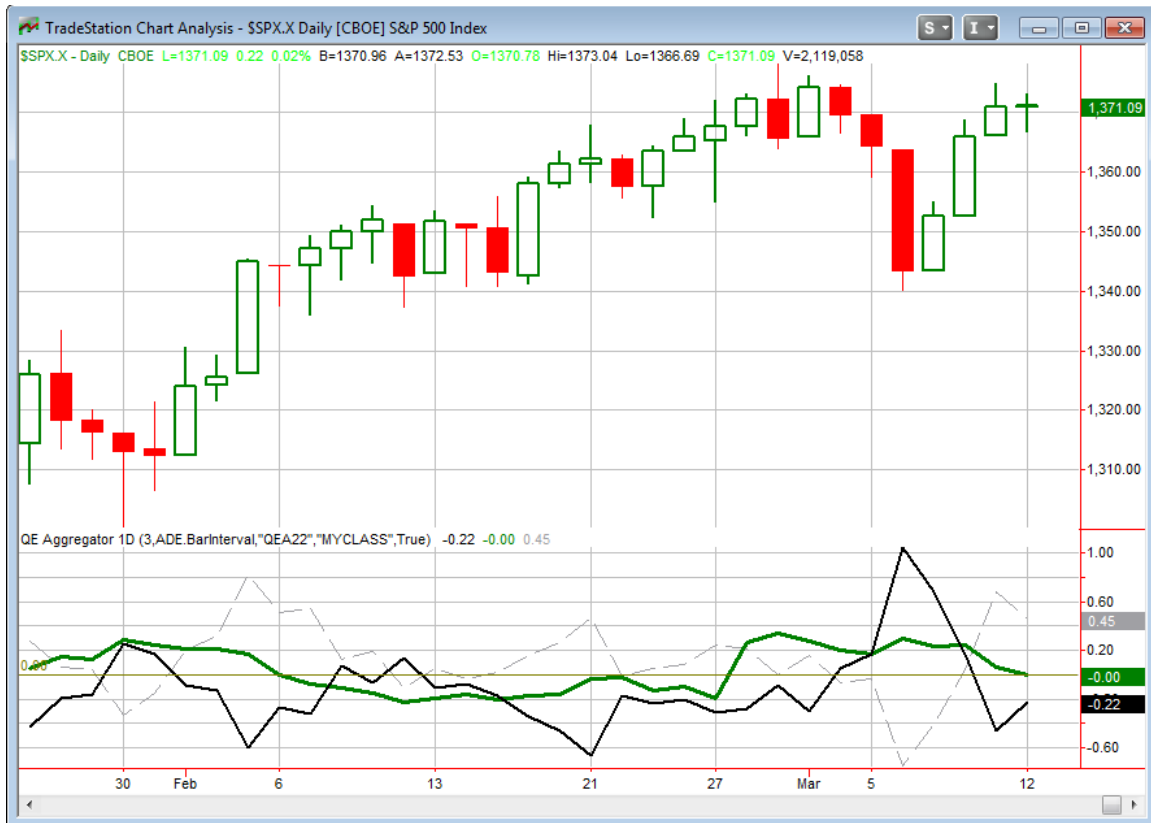
The average trade is quite negative over the first three days, but the % profitable is barely above breakeven for the shorts. I decided it would be best to take a look at the profit curve.



The downslope is amazingly consistent considering the down trades only barely outnumber the up ones. This shows that the losers have consistently outsized the winners.

So there are two new bearish studies and one new bullish study being included on the active list tonight.

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



The green Aggregator line dipped to just barely below zero. This can't be seen well on the chart but the reading is -0.003. Readings below 0 mean net expectations from the Active List are for downside over the next few days. Meanwhile, the black Differential Line held firm 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 change from flat to short at the close. This was indicated on the Systems page before the bell.

Based on the current studies, expectations are scheduled to flip back to positive on Tuesday. This could change if additional bearish evidence emerges. Meanwhile, the Differential Pivot will be *inverted* at 1,376.50 on Tuesday. This is 0.4% *above* Monday's close. An inverted pivot means the Differential Line will cross zero if the SPX closes

flat. In this case the SPX would need to rise at least 0.4% in order to keep the Differential Line negative. Any down close or slight up close will mean a positive value to Tuesday's Differential Line.

Between the inverted pivot, the extremely mild negative Aggregator reading, and the fact that Tuesday is a Fed Day this is not a short signal that I am interested in pursuing. There's substantial risk, limited reward, and a tight time window. Therefore I will simply wait to see what tomorrow brings before taking on new exposure. If the Aggregator signal is correct and the market does drop on Tuesday, then there is a good chance we will see a long signal Tuesday afternoon.

Intermediate-term Outlook (2 weeks – 2 months)– updated 3/12 – moderately bullish

The intermediate-term outlook was last updated in the 3/12 letter. Use the link below if you wish to review it.

[2012-03-12 QE Subscriber Letter.pdf](#)

Catapult and Capitulative Breadth Statistics

Catapult & CBI Presentation Link

Open Catapult Triggers

CAT – buy 1/3 position @ \$112.49 limit (filled at \$111.55)

CAT – buy 1/3 position @ \$110.09 limit (filled at \$106.57)

CAT – buy 1/3 position @ \$105.93 limit (not filled)

Catapult for ETF's Trades

None

Broad Market Large Cap CBI – 3/1(CAT-3)

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.

No new trade ideas tonight.

Current Open Trade Ideas

Symbol	Entry Date	Entry Price	Current Price	% Gain/Loss	Stop	Notes
CAT(1/3)	3/5/2012	\$111.55	\$108.94	-2.34%		Catapult
CAT(1/3)	3/6/2012	\$106.57	\$108.94	2.22%		Catapult
XIV(1/2)	3/6/2012	\$8.48	\$9.70	14.39%		Aggressive VIX

CAT – A down day on Monday put CAT a bit further from an exit target. It will take a strong rally Tuesday or a multi-day move to reach and exit.

XIV – Contango remains extremely steep. This is greatly helping our XIV position since second month futures are being shorted at a much higher price than front month futures are being covered. This allows for a nice profit to be made on the daily roll. The trade has also benefited greatly from the sharp drop in the VIX over the last few days. I mentioned last night that I intend to hold this position for a while. I had a few people ask me what I meant by "a while". That is a little difficult to answer, but I can say what I like about the trade currently and what would convince me to exit it. Obviously the contango is currently a great help. If the market dives and the VIX spikes it is probable that the contango will be greatly reduced, making the position less attractive. At this point, a strong move down in the VIX is not necessary to make money in this position. Choppy, sideways, or even a slight up move in the VIX should allow XIV to continue to prosper. The intermediate-term outlook is somewhat bullish, the long-term trend is up, and while the aggregator is slightly negative tonight that is not expected to continue. So for me to want out of this trade I will need to see at least one of the following: 1) compelling evidence of a probable short-term market pullback (a strong Aggregator short signal), 2) an unwinding of the steep contango, or 3) a bearish change in my intermediate-term outlook. Until at least one of these occurs I will try and ride the position. As far as how long "a while" may be, any of the above could change on a dime. So it may just be a day or two, or it could be over a month like our last X IV trade from late November until early January.

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