

# QUANTIFIABLE EDGES SUBSCRIBER LETTER

ASSESSING MARKET ACTION WITH INDICATORS AND HISTORY

March 18, 2013

Volume 6 Issue 52

## Market Overview



## Signals Overview

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

## Tonight's Research Points

- Unfilled gaps down from intermediate-term high will frequently be followed by more selling.
- VIX futures term structure is becoming very favorable for XIV.
- POMO and AMBS purchases remain strong and the Fed continues to support the market with strong liquidity.

## Short-term Outlook

### The Bottom Line

The Aggregator remains bearish and there is additional evidence that the market could struggle short-term. But we are only slightly overbought on a short-term basis and that could change as early as Monday. I don't love risk/reward for a straight index play, but if the market *does* pull back as the studies suggest, then that could set up a nice opportunity to get long XIV.

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

Study Date	Description	Time span	Bias	Avg Max Move
<b>Active</b>				
March 18, 2013	Unfill gap up then gap dn from 20-hi.	1-7 days	Bearish	-2.20%
March 15, 2013	Top 10% 10-day range. Opex tmrw.	1-5 days	Bearish	-1.80%
March 15, 2013	SPY > 5ma 10 days. Today 10-high	1-2 days	Bearish	-1.10%
March 14, 2013	20 low volume and high close	1-3 days	Bearish	-1.30%
March 13, 2013	Pullback from persistent upmove	1-4 days	Bullish	1.30%
<b>Active - Long Term</b>				
March 13, 2013	5 days up to 50-high, then 1 down	1-10 days	Bullish	2.00%
January 14, 2013	Breadth Divergence (from Tops Study)	int term	Bearish	
September 17, 2012	QE3	int term	Bullish	
February 1, 2012	Golden Cross	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**

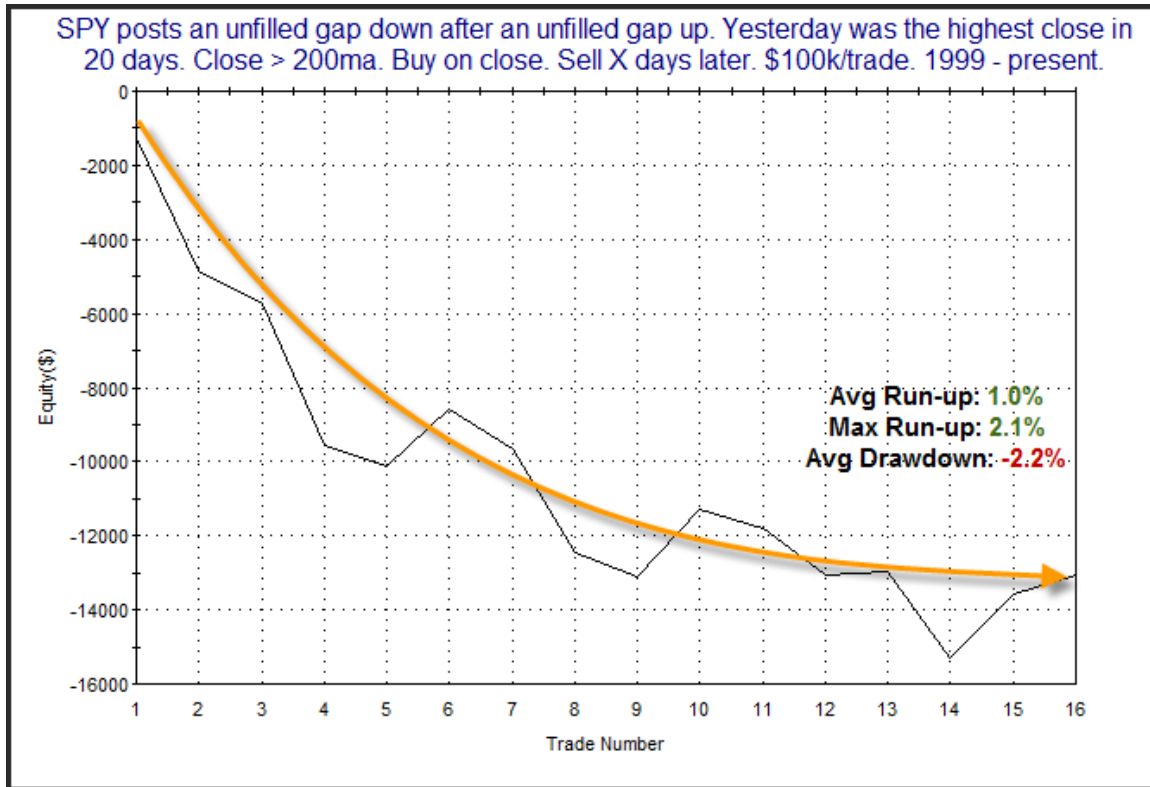
A mild breather was taken on Friday. The SPX declined 0.2%, the Nasdaq lost 0.3%, and the Russell 2000 fell 0.1%. Breadth was slightly negative as the NYSE Up Issues % was 45% and the Up Volume % came in at 44%. Total NYSE volume spiked higher thanks to options expiration.

One study that provided some fairly compelling results examined SPY performance after posting an unfilled gap down from a high level immediately after an unfilled gap up. It was last shown in the 2/5/13 Subscriber Letter. Stats are updated.

SPY posts an unfilled gap down after an unfilled gap up. Yesterday was the highest close in 20 days. Close > 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
10	-11,078.32	16	5	11	31.25	1,627.24	2,478.28	-1,746.77	-3,349.00	0.93	0.42	-692.39
9	-15,435.60	16	5	11	31.25	1,451.58	2,070.90	-2,063.05	-4,281.25	0.70	0.32	-964.73
8	-11,874.98	16	5	11	31.25	1,312.95	1,846.26	-1,676.34	-6,802.05	0.78	0.36	-742.19
7	-13,059.34	16	5	11	31.25	1,140.72	1,818.18	-1,705.72	-3,808.60	0.67	0.30	-816.21
6	-12,426.94	17	6	11	35.29	934.59	1,790.10	-1,639.50	-3,425.00	0.57	0.31	-731.00
5	-6,847.56	17	7	10	41.18	779.03	1,649.70	-1,230.08	-4,404.92	0.63	0.44	-402.80
4	-8,067.29	17	7	10	41.18	748.37	1,509.68	-1,330.59	-3,746.95	0.56	0.39	-474.55
3	-5,209.00	17	7	10	41.18	639.78	948.56	-968.74	-2,017.28	0.66	0.46	-306.41
2	-3,061.81	18	8	10	44.44	471.79	1,082.16	-683.61	-2,232.00	0.69	0.55	-170.10
1	-1,580.41	18	8	10	44.44	549.91	1,008.68	-597.97	-1,807.92	0.92	0.74	-87.80

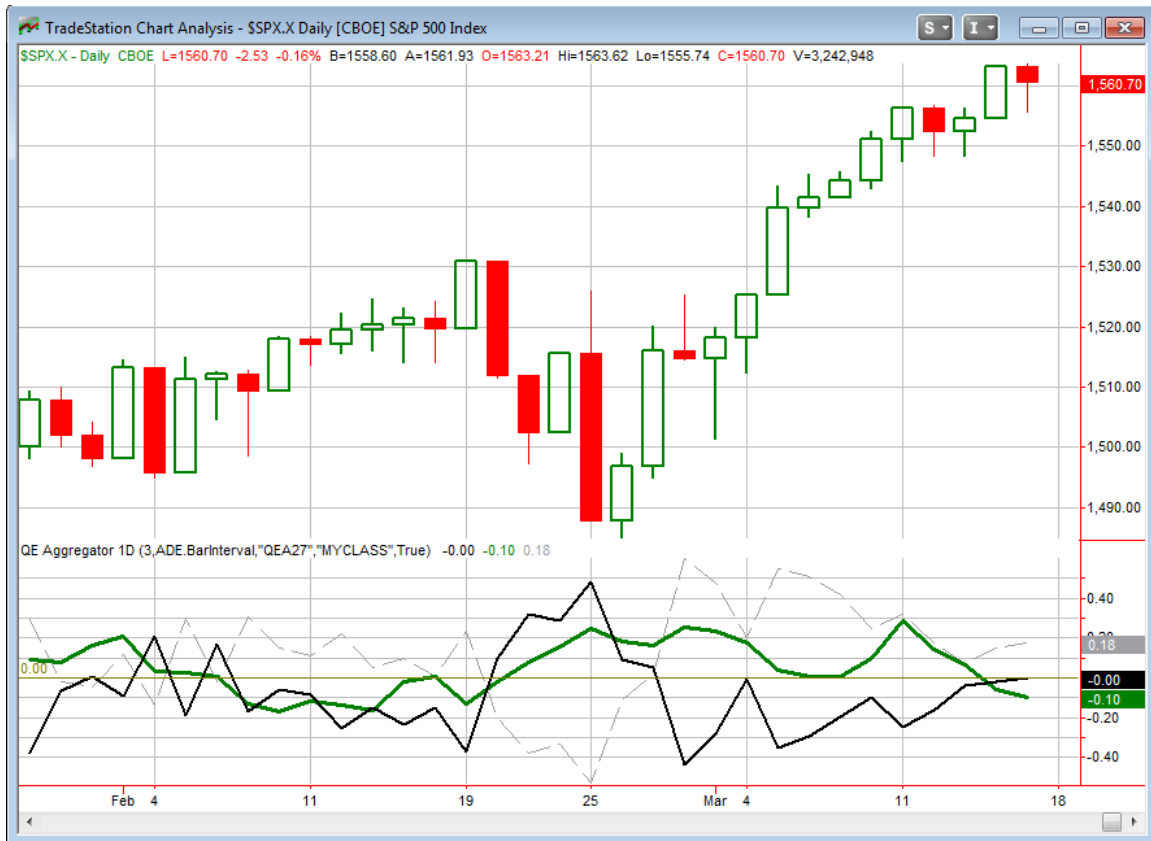
**2/5/13 was the only instance where SPY did not post a close below the entry point in the next 5 days.**

Instances are a bit low, but the consistency is very strong. Below is a profit curve assuming a 7-day holding period.



The curve here has flattened out a bit so I am now keeping a close eye on this one. The risk/reward stats noted on the right hand side are compelling though. I find it impressive whenever the Avg Drawdown exceeds the Max Run-up. Without anything else notable triggering on Friday I decided this one was worth inclusion on the Short-term Active List.

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



Tonight's bearish study helped keep the green Aggregator Line below zero. Negative readings mean net expectations from the Active List are for downside over the next few days. Meanwhile the black Differential Line remains just a hair below 0. The negative reading means the SPX is overbought versus recent expectations. So expectations are bearish and the SPX is overbought. 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 at the close.

Based on the current short-term studies, expectations are set to remain bearish on Monday. Of course this could change if compelling bullish evidence emerges. The Differential Pivot will be *slightly inverted* at 1,562.18 on Monday. This is just 0.1% *above* Friday's close. An inverted pivot means the Differential Line would cross 0 if SPX closes flat. In this case, in order to remain overbought, SPX is going to need to close up 0.1%.

I've held firm in not wanting to short this market that is so fueled by liquidity. (More on that in the intermediate-term section below when I review the POMO indicators.) I still have no interest in shorting, especially with an inverted pivot, which basically would limit the opportunity to profit to just 1 day. But I am seeing potential opportunity outside of SPX.

XIV could be an opportune short-term buy soon, especially if the Aggregator is correct and the SPX declines on Monday. There are a number of presentations available on the Videos page of the website that look at trading VIX-based ETFs. I'd recommend subscribers check them out if this subject interests them. As a brief overview:

- XIV & VXX are ETNs that look to change price along with VIX futures. VXX trades in the direction of the VIX (or more specifically – VIX futures), while XIV trades inversely to it. From here out to keep the conversation simple, I will only refer to XIV (since that is where I am seeing opportunity currently).
- XIV's price is impacted by 2 factors: 1) Movement of VIX futures each day, and 2) The spread between the 1<sup>st</sup> and 2<sup>nd</sup> month futures.
- The spread between the futures is important because XIV seeks to maintain a constant maturity. So each day the portfolio is rolled. This means that 1/30<sup>th</sup> of XIV's futures holding are changed each day. 2<sup>nd</sup> month futures are shorted, and front month futures are covered.
- The larger the spread between the 2 months the more positive the impact on XIV – it is essentially buying low and selling high when 2<sup>nd</sup> month futures are priced high above the 1<sup>st</sup> month (also known as contango).

So right now we have strong contango in the VIX futures. I often use <http://vixcentral.com/> to track it. What you see there is interesting. The VIX is currently 11.30. Front month futures will settle on Wednesday of this upcoming week. They are currently at 12.50. Between now and Wednesday, these numbers will need to collide. So either the VIX spikes 10% to reach the futures, or the futures will need to decline to match the VIX. April futures are at 14.65, which is 17.2% above March. So while March must get down to match cash VIX by Wednesday, the 17.2% roll is also strongly favoring XIV.

Of course the VIX tends to trade opposite SPX most days. So if SPX drops as the Aggregator expects on Monday, that should lead to a rise in the VIX (which VIX futures traders also seem to expect). We already know that drop will cause SPX to no longer be “short-term overbought” as defined by the Differential Line.

So with strong contango, a market no longer overbought, and possible bullish studies emerging after a 2<sup>nd</sup> day of selling in an uptrend, XIV would seem to offer favorable risk/reward. I'll be looking to take on a partial XIV position if it closes down much on Monday. I would add to it if SPX studies do become more bullish and the Aggregator triggers long. I could hold this position for either a very quick trade, or if contango remains strong and bearish evidence subsides, I could remain long for an intermediate-term hold.

**Intermediate-term Outlook (2 weeks – 2 months)– updated 3/18 – bullish**

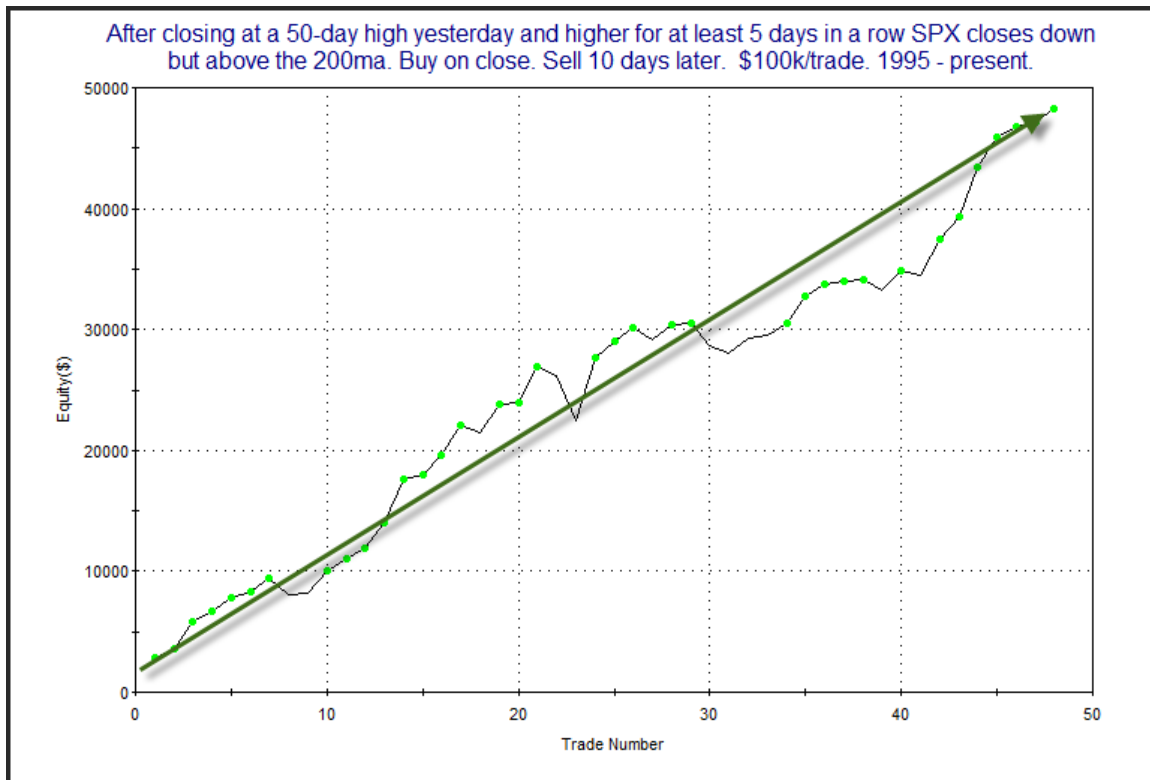
With the SPX hitting new highs again this week there is no doubt that the uptrend remains intact. And I am not compelled to fight it. From a studies standpoint, there was one that had intermediate-term implications.

I showed a couple of nights ago in the 3/13/ letter that persistent upmoves are unlikely to abruptly end. This was demonstrated by the study below, which I have copied from that letter.

After closing at a 50-day high yesterday and higher for at least 5 days in a row SPX closes down but above the 200ma. Buy on close. Sell X days later. \$100k/trade. 1995 - 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	48,273.60	48	39	9	81.25	1,523.59	5,131.35	-1,238.51	-3,672.90	1.23	5.33	1,005.70
9	48,708.93	51	42	9	82.35	1,497.39	5,023.20	-1,575.73	-4,151.40	0.95	4.43	955.08
8	40,697.88	52	35	17	67.31	1,724.66	4,878.08	-1,156.77	-4,874.10	1.49	3.07	782.65
7	33,184.16	53	35	18	66.04	1,552.67	3,874.76	-1,175.52	-3,912.48	1.32	2.57	626.12
6	32,730.70	55	36	19	65.45	1,448.71	4,307.20	-1,022.26	-3,637.71	1.42	2.69	595.10
5	24,457.58	55	34	21	61.82	1,236.19	4,252.50	-836.80	-2,466.75	1.48	2.39	444.68
4	25,102.31	55	34	21	61.82	1,232.19	3,843.00	-799.63	-3,003.39	1.54	2.49	456.41
3	13,823.61	55	34	21	61.82	920.48	2,472.85	-832.03	-1,992.34	1.11	1.79	251.34
2	14,265.04	55	37	18	67.27	795.70	2,437.50	-843.10	-2,614.95	0.94	1.94	259.36
1	8,736.46	55	34	20	61.82	570.12	1,751.19	-532.39	-1,744.10	1.07	1.82	158.84

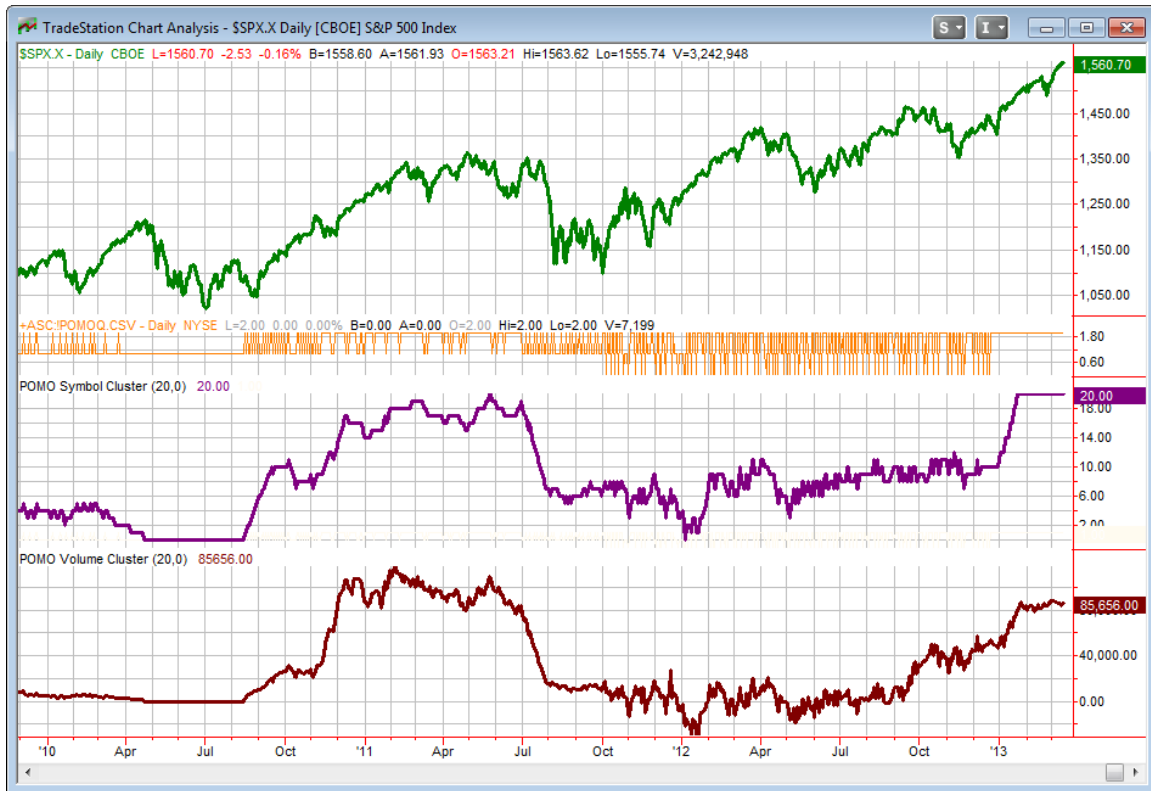
We see here a decent edge that becomes stronger and more consistent as you look out over the next several days. The 9-10 day time frame shows exceptional stats. Here is a look at the 10-day profit curve.



The strong upslope appears to confirm the bullish edge and this study was added to the intermediate-term outlook Tuesday night.

I update the intermediate-term POMO/QE chart each week. For those not familiar, below is a brief description.

*POMO stands for Permanent Open Market Operations and it is how the Fed has gone into the open market to buy securities over the last several years. 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 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. Since the Sept 13, 2012 QE3 announcement the POMO numbers are also adjusted to reflected the Fed's new approach of buying AMBS securities. Therefore, prior to that date the indicators just look at POMO, since that date it is a combination of POMO and AMBS flows.*



The POMO/AMBS volume indicator is again near post-QE2 highs. And the days indicator is *still* maxed out at 20, which was a rarity even during QE2. We estimate net inflows this past week to have been about \$22.8 billion. That is a strong week. Numbers like this normally provide a nice bullish wind at the market's back in the following days.

This upcoming week is also expected to see strong liquidity again. Between POMO and AMBS we should see about a \$19.5 billion inflow. The liquidity environment continues to be one that is favorable for the bulls.

Overall, intermediate-term evidence is mixed but leaning positive. On the negative side, bond action has not been favorable and the breadth divergence from the Study of Tops (available on the members download page) remains in place. But liquidity and momentum are both positive and they have trumped all in recent years. It still appears this rally may have further to go. I'll continue to favor the long side.

## **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.*

***XIV – buy ½ position @ \$23.00 LIMIT ON CLOSE.** Based on the discussion in the short-term outlook above, I'll look to take a position in XIV if it closes at \$23.00 or lower.*

## **Current Open Trade Ideas**

*None*

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