AIQ Opening Bell Newsletter

November 2007 Vol. 16 Issue 11

In This Issue

AIQ Opening Bell Newsletter

David Vomund, Publisher
G.R. Barbor, Editor
P.O. Box 7530
Incline Village, NV 89452

The Opening Bell Newsletter is a publication of AIQ Systems P.O. Box 7530 Incline Village, Nevada 89452
E-mail: *openingbell@aiqsystems.com*

Trading Bonds with 'Anti-Bond Index'

How Using Inversely Correlated Measures to Generate Trading Signals Can Be Profitable

By Jay Kaeppel

One of the notions that David Vomund of AIQ has helped to popularize over the years is that switching between non-correlated securities can be quite profitable. I have seized on his work and done a lot of research on the topic over the years. In this article, I will detail a method that I have developed for trading bonds using an index made up of securities that are inversely correlated to bonds.

For the purposes of this system, I created a Group in AIQ that I named "Anti-Bond Index." It contains the securities shown in **Table 1**.

Note that to some degree or another all of the components share an inverse correlation to long-term treasury bonds. **Figure 1** displays a weekly graph of the

Trading Strategist Jay Kaeppel

Anti-Bond Index Group with the iShares Long-Term Treasury Bond ETF (ticker TLT) as an overlay. Just from a simple visual inspection of this graph you can

Table 1. Components of "Anti Bond" Group (ANTI-BOND INDEX)

Index or Fund	What It Is	Correlation to TLT
CRB Commodity Index	Basket of commodities	-44
Fidelity Select Gold	Gold stocks and bullion	-71
Ishares Midcap 400 Growth	Midcap growth stocks	-79
Dow Jones Industrials	30 large-cap stocks	-120
Rydex Strengthening Dollar	Tracks U.S. dollar	-215

observe the tendency for these two market measures to trend in opposite directions. The question then is simply "is there a way to use this tendency to make money?"

I have tested a number of possibilities, but as is often the case the one that I like the best involves an extremely simple measurement. **Figure 2** displays the weekly Anti-Bond Index with a 5-week moving average and a 30-week moving average applied.

Our theory will be that when the 5-week moving average is above the 30-week moving average then this is bad for bonds because it implies that the components that make up the group – which all trade inversely to bonds to one degree or another – are rising. Conversely, when the 5-week moving average is below the 30-week moving average this is good for bonds prices because it implies that the "bond inverse" components are declining on the whole.

The simplest way to use this measure is to take a position in bonds opposite to what is signaled by the Anti-Bond Index. So when the Anti-Bond Index 5-week moving average drops below the 30-week moving average, we will buy bonds (the rationale being that the components that typically move inversely to bonds are trending lower thus suggesting an impending advance in bonds). Conversely, when the Anti-Bond Index 5-week moving average rises above the 30-week moving average we will sell bonds and move to cash.

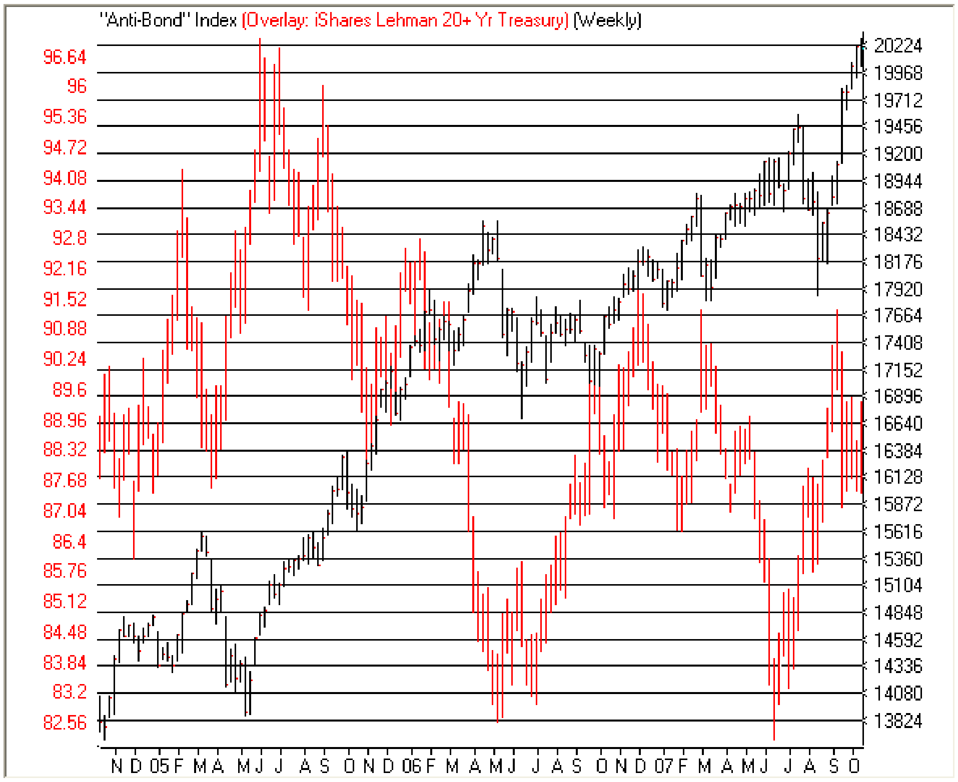

Figure 1. Weekly chart of Anti-Bond Index group (black) versus iShares Long-Term Treasury ETF, symbol TLT, (red).

Figure 2. Weekly chart of Anti-Bond Index group (black) with 5-week and 30-week moving averages.

The buy and sell signals generated by this simple method versus TLT appear in **Table 2**. Most of the completed buy signals have shown a profit. Likewise, the sell signals would have allowed a bond trader to miss the –13.1% decline in long bonds between 5/16/03 and 5/7/04, and the –12.9% decline between 6/24/05 and 6/16/06. **Figure 3** displays the buy and sell signals versus TLT.

Another way to maximize the profitability of this method is to consider leveraged bond funds. For example, Profunds fund family offers the U.S. Government Plus fund, which attempts to mirror the long-term treasury bond times 125%. Thus, if your timing is correct, you can increase your gains (with the obvious caveat that if your timing is wrong you will lose more than if you bought a non-leveraged fund). The ticker symbol for Profunds U.S. Governments Plus fund is GVPIX.

Now let's assume that a trader buys GVPIX when the Anti-Bond Index 5/30 crossover method gives a buy signal and moves to cash (earning a nominal rate of 1% per year in this test) when the Anti-Bond Index 5/30 crossover method gives a sell signal. **Figure 4** displays the total percentage return achieved using this strategy since July of 2002.

Summary

As with any type of market indicator there is certainly no guarantee that the buy and sell signals generated by the simple moving average crossover method that I have described will always result in profitable trades. Still, the idea here is not so much to promote the system or the idea that people should rush out and start trading bonds. Rather, the primary idea here is to promote the concept of using low or inversely correlated measures to generate trading signals for a given security.

Jay Kaeppel, a trading strategist with Optionetics, Inc., writes a weekly column titled "KAEPPEL'S CORNER" at www.optionetics.com. A former Commodity Trading Advisor (CTA), he is the author of the bestselling "The Four Biggest Mistakes in Option Trading" as well as "The Four Biggest Mistakes in Futures Trading" and "The Option Trader's Guide to Probability, Volatility and Timing."

Table 2. Buy and Sell Signals versus TLT

BuyDate	SellDate	TLTBuy Price	TLTSell Price	% +(-)
7/26/02	11/29/02	82.51	85.24	+3.3
3/14/03	5/16/03	88.88	93.40	+5.1
5/7/04	10/1/04	81.13	87.58	+8.0
4/22/05	6/24/05	91.74	96.65	+5.4
6/16/06	11/3/06	84.19	88.79	+5.5
8/24/07	9/21/07	88.31	88.14	(-0.2)

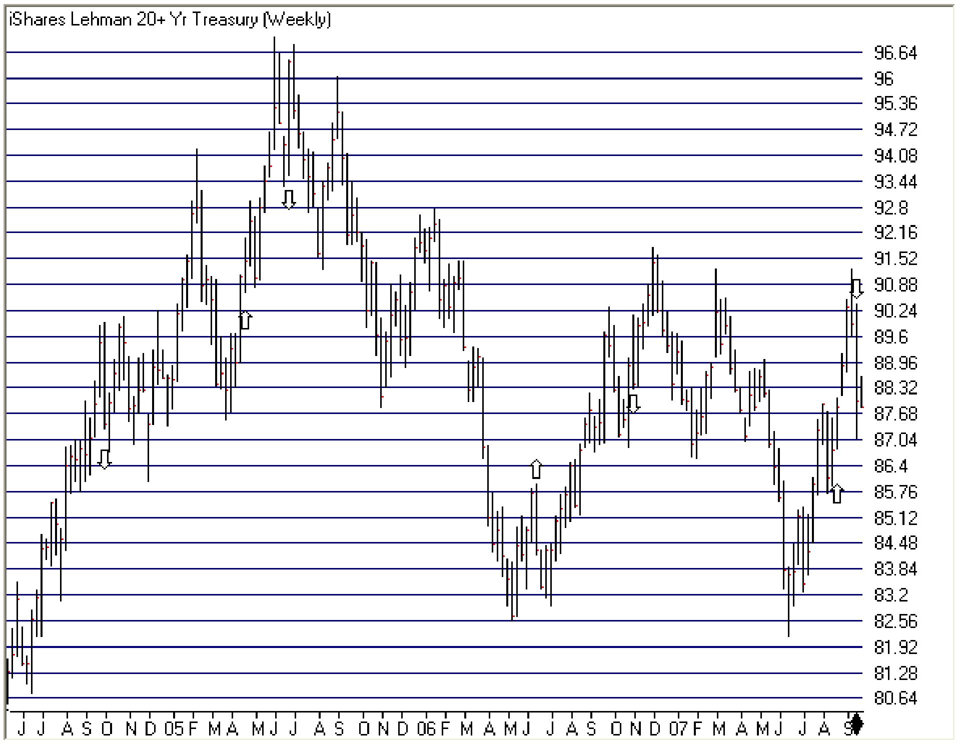

Figure 3. Chart of TLT with Buy and Sell Signals generated by Anti-Bond Index crossovers.

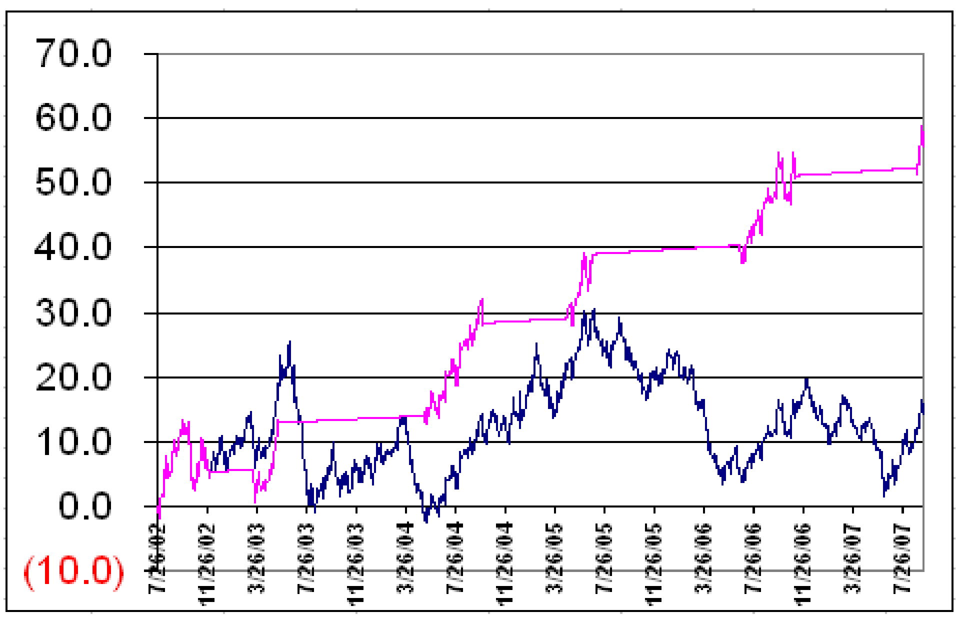

Figure 4. Graph of % Return from trading GVPIX Govt bond ETF for Anti-Bond Index System (purple line) versus buy-and-hold (blue line).

Market Review

Big One-Day Drops! Yet Averages Only Modestly Lower

The market turned volatile with big one-day drops including the 367 Dow point dive on October 19, and another 360-point drop on November 1. While those days got investors' attention, market averages were only modestly lower since October 1.

There were a few triggers for the sell-offs. First, earnings reports from multi-nationals were less than upbeat about the outlook. Those were supposed to benefit from the falling dollar and solid growth overseas. So much for fundamental analysis!

The main trigger, however, was the ongoing worry that the credit and sub-prime problems are even more serious than we thought. All banks and large brokerage firms have been writing down the value of certain mortgages and loans on their books. Merrill Lynch and Citibank were the most aggressive lenders in the riskiest areas, so their stocks suffered the most.

On several occasions, the S&P 500 has fallen to 1490 only to rebound. This level acted as resistance in August and September and is now acting as support in October and November. As long as the S&P 500 is above this level it is hard to make a bearish case.

The Nasdaq is outperforming the S&P 500. The Nasdaq Composite leaped to a new yearly high on October 31. Stronger still is the Nasdaq 100, an index of the largest stocks on the Nasdaq. Year-to-date through November 1, this index is up an amazing 25%.

From October 1 through November 1, the best performing sectors were Biotechnology, Utilities, Precious Metals, Energy, and Technology. These sectors all gained about 4%.

The worst performing sector was Banking, losing 12% of its value. Semiconductors fell 8%, Financial Services fell 7%, and Defense & Aerospace fell 5%.

STOCK DATA MAINTENANCE

The following table shows stock splits and other changes:

Stock	Ticker	Split	Approx. Date
Met-Pro Corp.	MPR	4:3	11/02/07
Idexx Labs	IDXX	2:1	11/06/07
Rollins Inc.	ROL	3:2	11/13/07
Gorman Rupp	GRC	5:4	11/16/07
Graham Corp.	GHM	5:4	12/03/07

Trading Suspended:
Archstone-Smith Trust (ASN), Avaya (AV), Biomet (BMET), First Data (FDC), Gateway (GTW), Hilton Hotels (HLT), Topps Co. (TOPP), TXU Corp. (TXU)

Name Changes:
American Real Estate Partners (ACP) to Icahn Enterprises LP (IEP)
BPZ Energy (BZP) to BPZ Resources (BZP)
Innovo Group (INNO) to Joe's Jeans (JOEZ)
Input/Output (IO) to ION Geoghysical (IO)
Wireless Facilities (WFII) to Kratos Defense & Security Solutions (KTOS)

S&P 500 Changes

Changes to the S&P 500 Index and Industry Groups:

Tesoro Energy (TSO) replaces Maxim Integrated Products (MXIM). TSO is added to the Oil & Gas Refining & Marketing (OIL&GASR) group.

Teradata Information (TDC) replaces NCR (NCR). TDC is added to the Technology Computer Hardware (COMPUTEH) group.

Expedia (EXPE) replaces Solectron (SLR). EXPE is added to theConsumer Discretionary Internet Retail (RETAILIN) group.

Noble Energy (NBL) replaces Archstone-Smith (ASN). NBL is added to the Oil & Gas Exploration & Production (OILEXPLO) group.

NYSE Euronext (NYX) replaces Hilton Hotels (HLT). NYX is added to the Specialty Finance (FINANSPC) group.

Titanium Metals (TIE) replaces Bausch & Lomb (BOL). TIE is added to the Metals and Mining (METALSMI) group.

Expeditors Int'l (EXPD) replaces TXU (TXU). EXPD is added to the Air Freight & Logistics (AIRFREIG) group.

InterContinental Exchange (ICE) replaces First Data (FDC). ICE is added to the Specialized Finance (FINANSPC) group.