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A S S E S S I N G M A R K E T A C T I O N W I T H I N D I C A T O R S A N D H I S T O R Y

August 17, 2009 Volume 2 Issue 156

Market Overview

Summary of Recent Active Studies (see http://QuantifiableEdges.blogspot.com or Letters from listed dates for details)

Study Date	Description	Time span	Bias	Avg Max Move
Active				
August 14, 2009	SPX hig close 20. NYSE low vol 20.	1-5 days	Bearish	-1.90%
August 12, 2009	1% Drop & Advances/Decline > 2	1-9 days	Bullish	2.40%
August 11, 2009	SPY low vol 20 while > 10ma	1-5 days	Bearish	-2.10%
August 10, 2009	NDX up 1% Sox Down	1-6 days	Bearish	
August 10, 2009	S&P Up 1% and UUP up 0.5%	1-6 days	Bearish	-5.30%
Active - Long Term				
August 4, 2009	75% Up Issues 2 of 3 Days	1-20 days	Bullish	4.80%
July 14, 2009	VIX:VXV drops below 0.9	2-5 months	Bearish	
Dropped Tonight				
August 14, 2009	***CBOE Equity P/C < 25% of 200ma***	***1 day***	***Bearish***	
August 14, 2009	***2 Days Up In Chop***	***1-4 days***	***Bearish***	

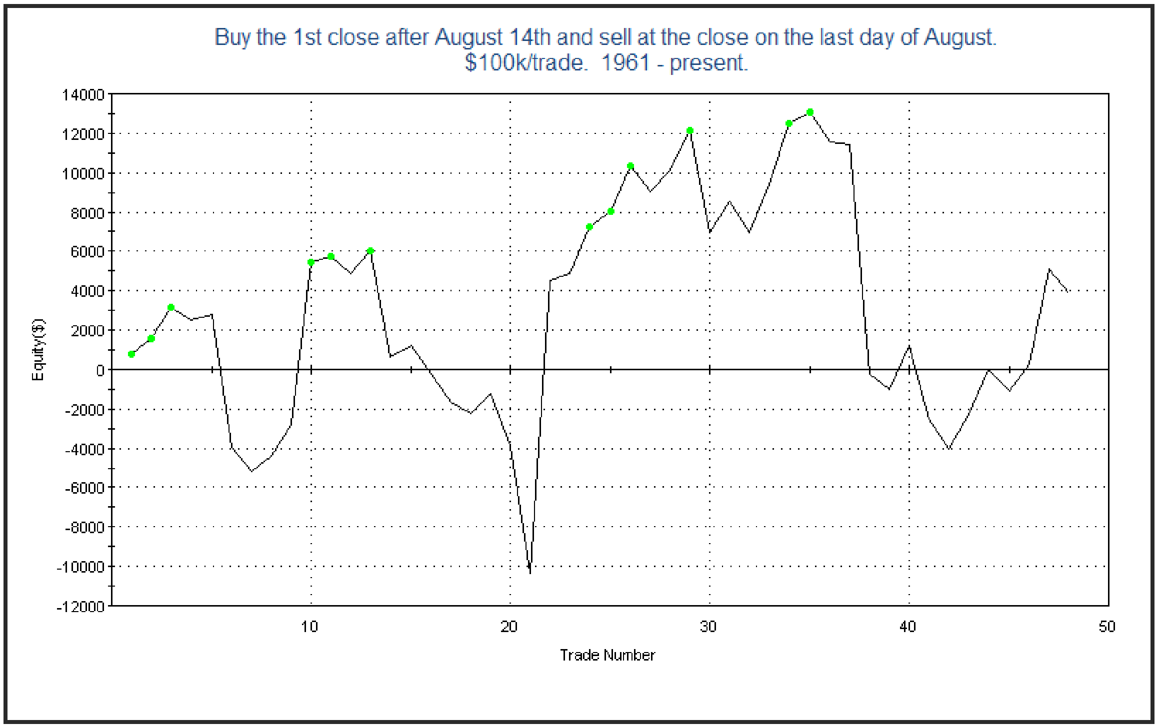
If the avg max move is achieved the study will appear in ***bold italic blue*** and no longer be active. With the reduced market volatility I am no longer requiring a move of Avg max + ½ Std Dev. to reach the target.

Short-term Outlook (1-5 days) – updated 8/17 – neutral

We were looking for a move down Thursday night and we got it on Friday. Hopefully some of you were a bit more aggressive than me and were able to take advantage of it. A late rally made the numbers a bit better than they looked for most of the day but still the S&P dropped nearly 1%, the Nasdaq over 1% and the Russell 2000 almost 2%. Breadth was weak. The NYSE Up Issues % came in at 27.5% and the Up Volume % at 20%. Total volume rose. When the market drops on high volume that is sometimes referred to as a “distribution day”. In the intermediate-term section I’ll discuss the use of tracking distribution days for purposes of identifying market tops.

From a short-term perspective I’m not seeing a lot that would provide a significant edge at this point. The S&P is now right back in the middle of its recent range between 992 and 1018. Mid-range is not my preferred place to take trades from. I’d rather be dealing on the outer edges in order to generate a more favorable risk/reward ratio.

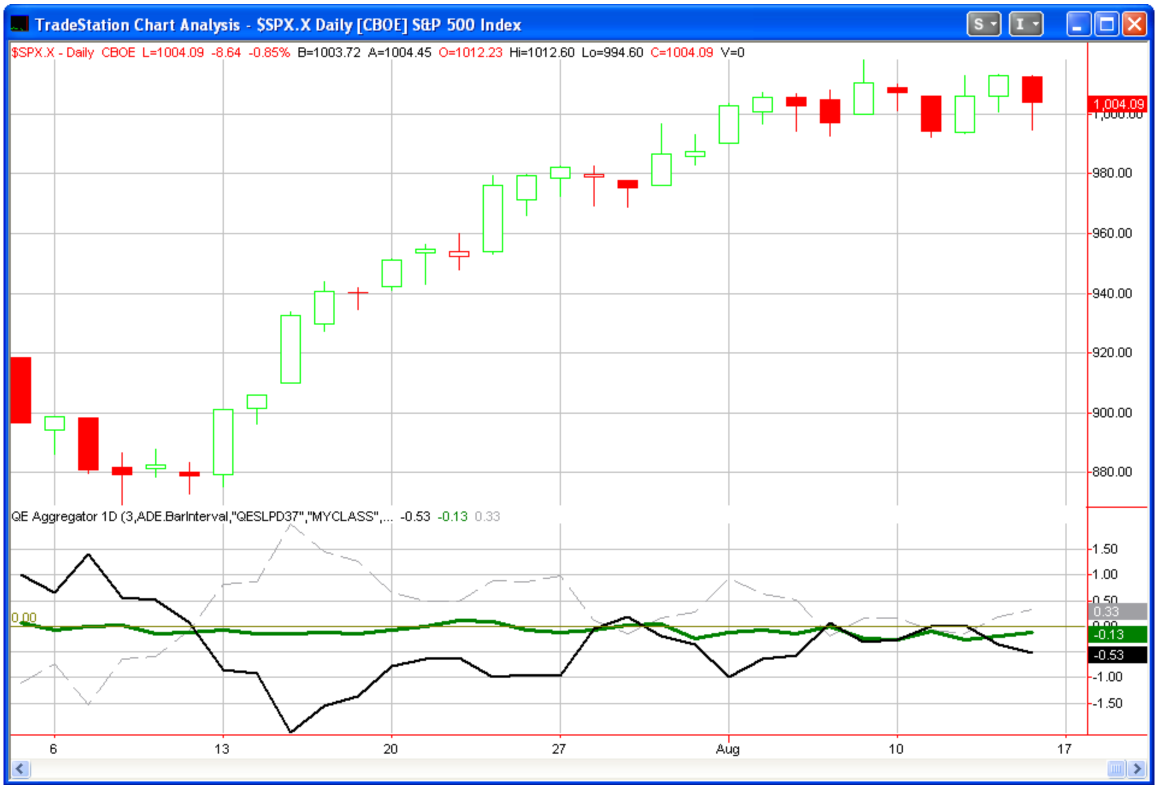
As we enter the last 2 weeks of August one thing that traders can expect is that there will be a droppoff in volume (and perhaps volatility as well). Late August is a notoriously slow time of year for the stock market as many traders take vacations. Does the droppoff in volume suggest a trading edge for the next 2 weeks? I looked at past Augusts to see their performance over the last half of the month.



Even squinting hard I fail to see an edge here.

Two studies came off the active list at the top of the Letter tonight. They were the Equity put/call study and the "2 days up on chop" system. Nothing was added.

The Aggregator chart is updated below.



The green Aggregator line below 0 means there is a net negative expectation from the active studies over the next few days. The black Differential line below 0 illustrates the market has outperformed expectation over the last 3 days. Normally both lines below 0 would suggest a bearish edge. In this case all is not quite as bearish as it may seem. First of all the market already dropped on Friday following the rash of bearish studies Thursday night. Second, with Wednesday's performance about to be dropped from the Differential calculation and 3 bearish studies set to expire tomorrow, both lines are currently scheduled to move back to around neutral by tomorrow afternoon.

So we have a bit of a tossup and we're in the middle of a trading range. Not a place I'm looking to initiate index positions from.

Intermediate-term Outlook (2 weeks – 2 months)– updated 8/17 – neutral

One sign of a potential top that some traders monitor is distribution days. It was popularized by Investors Business Daily. The essential idea is that when the market falls on increasing volume that suggests institutions are selling stock. When clusters of distribution days occur, it is a topping signal. Below are some quotes from an IBD column published on August 4th that discusses distribution.

"What you're looking for is distribution. If one or more of the major indexes (the NYSE composite, the Nasdaq, the S&P 500 or Dow industrials) falls more than 0.2% in higher volume than in the prior session, that's a distribution day.

Distribution means the big money — mutual funds, investment banks and other institutional investors — is dumping shares.

That's bad news for the little guy, because institutions make up roughly three-fourths of the market and chart its direction.

IBD studies show that when you get a series of three to five distribution days over a few weeks during an uptrend, that's a red flag."

"Identifying distribution days is crucial: If you don't, you might have the wrong take on the market's direction. Then you'll be wrong about every move you make. That's a nice recipe for financial agony…Once distribution days pile up, it's wise to scale back your portfolio. Ease off margin, and get rid of any laggard stocks first. Raise cash and move entirely off stocks if necessary."

So the bottom line is that if the market rallying, and you see a cluster of distribution days occur within a fairly short time period, you should begin selling stocks. The market is likely heading for a tumble. Let's take a quantified look at it.

First, before I show test results I will say that clusters of distribution days do often occur near market tops – so they got that part right. But are they predictive of a top and should they be used for purposes of early identification?

I actually devised this test 4 years ago when I wrote an article for TradingMarkets about distribution days. To test the concept I looked for the following criteria:

1) The S&P closes above the 200-day moving average (remember – we're looking for a top.)

2) Sometime within the last 12 days the S&P closed within 1% of its 200-day high. (Again, confirming we are near a top.)

3) Over the last 12 days there have been at least 4 distribution days.

Looking for 4 distribution days within 12 trading days was the criteria I used in the original test based on information at that time. It still seems like a good number according to the above article that suggests "*a series of three to five distribution days over a few weeks during an uptrend, that's a red flag."*

So if you wanted to use this red flag as a short signal, how would you do looking out over the next 1, 2, and 3 month periods?

Short S&P on close of 4th distribution day within last 12 if it is above its 200ma and has come within 1% of its 200day high in the last 12 days.
Cover X days later. $100k/trade. 1980- present.

X Days	All: Net Profit	All: Total Trades	All: Winning Trades	All: Losing Trades	All: % Profitable	All: Avg Winning Trade	All: Avg Losing Trade	All: Win/Loss Ratio	All: ProfitFactor	All: Avg Trade
60	-111,222.35	37	10	27	27.03	4,277.81	-5,703.72	0.75	0.28	-3,006.01
40	-89,499.34	42	15	27	35.71	2,944.62	-4,950.69	0.59	0.33	-2,130.94
20	-53,091.36	49	18	31	36.73	2,930.37	-3,414.13	0.86	0.50	-1,083.50

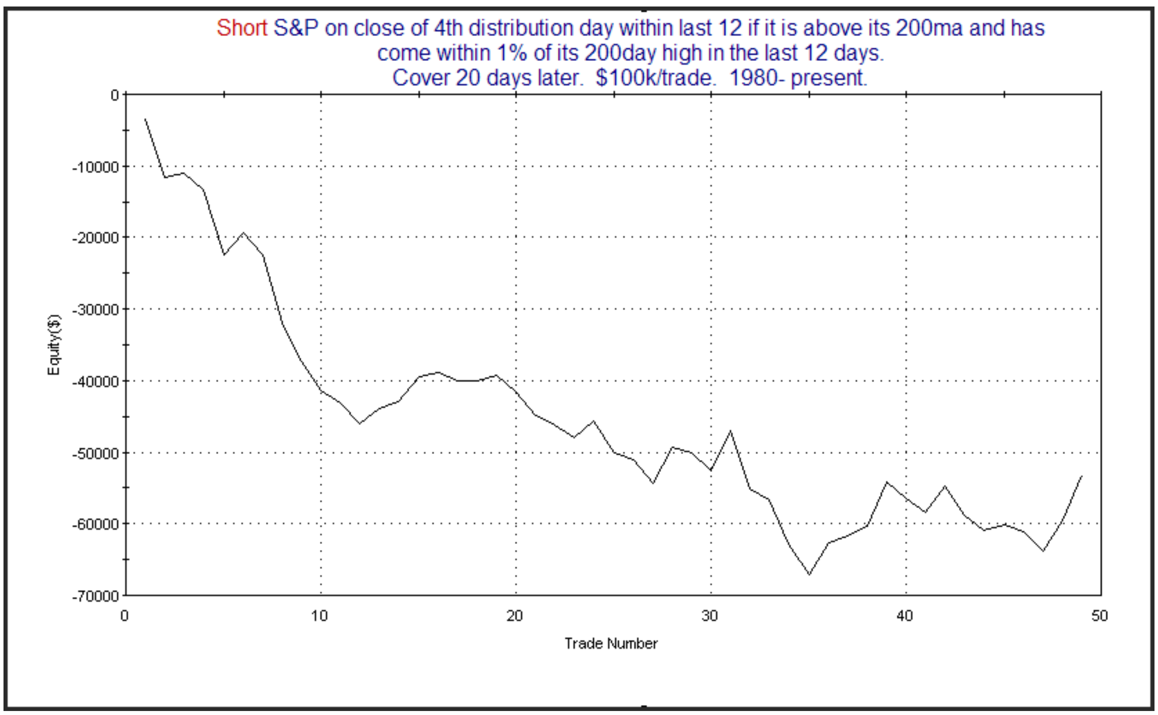
Needless to say these results are horrible. It appears that following a bout of distribution is NOT a good time to be selling. What if we flip the study on its head and instead BUY after such instances when distribution day counters are unloading positions?

Buy S&P on close of 4th distribution day within last 12 if it is above its 200ma and has come within 1% of its 200day high in the last 12 days.
Sell X days later. $100k/trade. 1980- present.

X Days	All: Net Profit	All: Total Trades	All: Winning Trades	All: Losing Trades	All: % Profitable	All: Avg Winning Trade	All: Avg Losing Trade	All: Win/Loss Ratio	All: ProfitFactor	All: Avg Trade
60	111,222.35	37	27	10	72.97	5,703.72	-4,277.81	1.33	3.60	3,006.01
40	89,499.34	42	27	15	64.29	4,950.69	-2,944.62	1.68	3.03	2,130.94
20	53,091.36	49	31	18	63.27	3,414.13	-2,930.37	1.17	2.01	1,083.50

Not the most explosive results I've ever posted in term of average trade, but a decent edge nonetheless. Wins are bigger than losses and the winning percentage is pretty good. This makes for decent looking profit factors (gross gains / gross losses = profit factor).

Is this a new phenomenon? Did distribution day counting formerly work and in recent years it has failed? That might explain why IBD has discussed it for so long. Sadly, no. Below is the equity curve for the 1st test above using a 20-day holding period.



While the results have been helped out by some horrible bear markets in the last decade, it's never been a winning concept.

So why preach it? Well, it's rare that you'll get a top without a bout of distribution days. Therefore, when a top actually does occur, the service or person who talks about their importance can point to the top and say "See, the distribution days signaled it. You would've been fine if you'd just used this tool."

This is somewhat similar to the perception that has been created with regards to follow through days for calling market bottoms. They occur there, but they are not predictive and are pretty much a worthless tool. For detail on follow through days, you may refer to the series I wrote last year. The primary difference here is that while follow through days are generally worthless, counting distribution days to try and identify tops is worse than that – it's hazardous.

The bottom line reality of distribution days is that when the market endures a pullback after an extended uptrend, it's often a buying opportunity and NOT a time to sell.

Of course there are still reasons to be cautious here. The VIX:VXV ratio has slipped back below 0.9. This indicator which worked so well in the past has been, at best, extremely early this time.

The Nasdaq continues to lag, which has been a condition under which the market has struggled to rally in the past.

On the positive side there is still a breadth thrust signal on the board from the studies list. After such strong breadth moves in July it would be a positive for the market to see the 10-day ema of the advance-decline line remain above 49% or 50% on this pullback. That will be something I'll be keeping an eye on in the days to come.

In general the story remains much the same as last week. Things are a bit overdone after a big run-up. There are some signs that the market could roll over. At this point the pullback has not provided any substantial evidence that a new leg down is beginning. I believe it will at some point though. I still believe we are in a 30'd style environment where selloffs and rallies will both be more exaggerated than people are used to.

Catapult and Capitulative Breadth Statistics

(Catapult Presentation Part 1) (Catapult Presentation Part 2)

Open Catapult Triggers

New

SLE – 1/3 @ $9.48 limit (filled @ $9.45)

SLE – 1/3 @ $9.45 limit (I'll look to enter a bit lower)

Catapult for ETF's Trades

None

Broad Market Large Cap CBI –2(SLE-2)

Sector CBI Breakdown (% of stocks with active catapult triggers within each sector.)

Index	**ETF**	**CBI %**		**Index**	**ETF**	**CBI %**
DJ US Broker Dealers	IAI	0.00		DJ US Energy	IYE	1.00
DJ US Insurance Index	IAK	0.00		DJ US Financial	IYF	0.00
DJ US Regional Banks	IAT	0.00		DJ US Financial Services	IYG	0.00
DJ US Utilities	IDU	2.70		DJ US Healthcare	IYH	0.00
DJ US Oil&Gas Expl & Prod	IEO	0.00		DJ US Industrial Sector	IYJ	0.00
DJ US Oil Equip & Svcs	IEZ	0.00		DJ US Consumer Goods	IYK	2.13
DJ US Pharmaceuticals	IHE	2.86		DJ US Basic Materials	IYM	0.00
DJ US Healthcare Providers	IHF	0.00		DJ US Real Estate	IYR	0.00
DJ US Medical Devices	IHI	0.00		DJ US Transportation	IYT	0.00
DJ US Aerospace & Defense	ITA	0.00		DJ US Technology Sector	IYW	0.54
DJ US Home Construction	ITB	0.00		DJ US Telecommunications	IYZ	9.09
DJ US Consumer Svcs	IYC	0.00		Nasdaq 100	QQQQ	2.00

Some telecom stocks have been beaten up lately.

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.

SLE – *buy @ 9.35 limit.* SLE bounced as it approached its 200ma on Friday. I'll look to buy the 2nd lot (of 3 max) tomorrow if it heads back down to retest that area.

Active Trades Table

Symbol	**Entry Date**	**Entry Price**	**Current Pr**	**% Gain/Lo**	**Stop**	**Notes**
SLE(1/3)	8/14/2009	$9.45	$9.45	0.00%		Catapult bt on close