QUANTIFIABLE EDGES SUBSCRIBER LETTER

ASSESSING MARKET ACTION WITH INDICATORS AND HISTORY

August 20, 2009 Volume 2 Issue 159

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 20, 2009	2 Days Up In Chop	1-4 days	Bearish	
August 20, 2009	Gap < yest low and close > yest high	1-2 days	Bearish	1.60%
August 12, 2009	1% Drop & Advances/Decline > 2	1-9 days	Bullish	2.40%
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 18, 2009	Up Issues % Under 33% 2 days in row	1-2 days	Bullish	2.40%
August 19, 2009	Yest dn 2%. Today strong brdth bad vol	1 day plus	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 8/20 – slightly bearish

A gap down Wednesday morning was quickly bought reversed. The market moved back up near Tuesday's highs before consolidating and then breaking higher around noon for another leg up. The major indices all closed up about 0.7%. Breadth was positive, but not greatly. The NYSE Up Issues % was 60% and the Up Volume % came in at 59%. Volume came in very close to Tuesday's levels.

The large gap down and strong reversal is what stuck out as most significant about today's action. SPY managed to open underneath Tuesday's low and the close above Tuesday's high. This kind of action is fairly rare. Below is a study that shows how days like this were followed in the past:

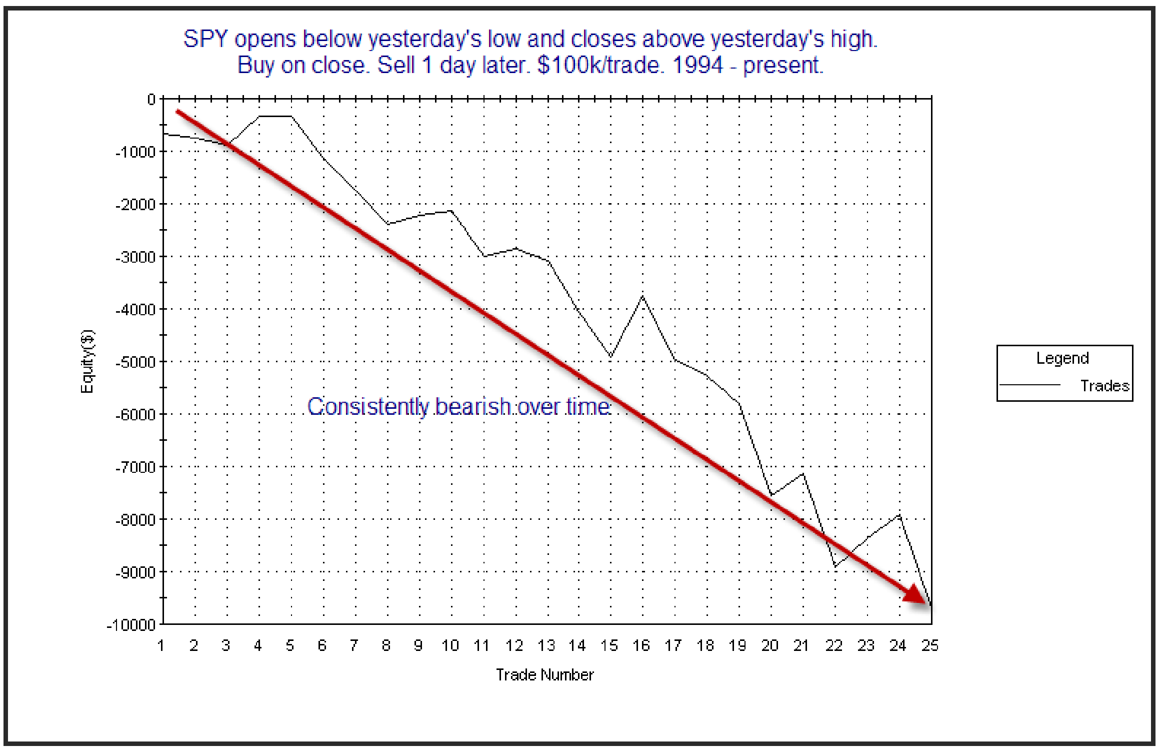
SPY opens below yesterday's low and closes above yesterday's high.
Buy on close. Sell X days later. $100k/trade. 1994 - present.

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
5	-2,548.69	25	12	13	48.00	1,965.20	-2,010.09	0.98	0.90	-101.95
4	-16,600.90	25	10	15	40.00	1,979.03	-2,426.08	0.82	0.54	-664.04
3	-17,630.72	25	10	15	40.00	1,458.19	-2,147.51	0.68	0.45	-705.23
2	-17,219.25	25	9	16	36.00	634.91	-1,433.34	0.44	0.25	-688.77
1	-9,690.79	25	8	16	32.00	445.79	-828.57	0.54	0.27	-387.63

23 of 25 (92%) of instances closed below the trigger day close at some point in the next 3 days.

These results seem to suggest a bearish edge for the next few days.

Looking just at the next day's performance I charted the profit curve. Those results are below:



What I see here is a fairly steady decline. It doesn't appear the edge has significantly strengthened or weakened lately. The consistency adds another layer of confidence when considering the bearish results.

Also notable Wednesday was that it was the 2nd up close in a row. As most subscribers were likely aware this triggered our "2 Days Up In Chop" strategy. Below I have updated results for that strategy.

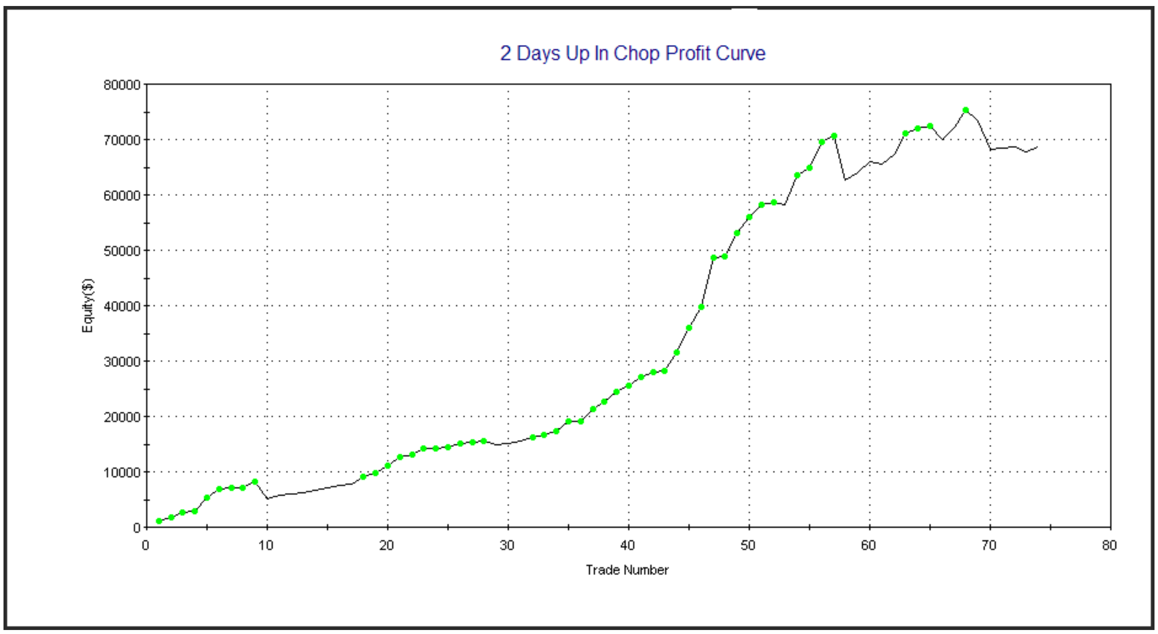
SPY closes up 2 days in a row. Short on close. Cover 1st profitable close up to 4 days later. Cover after 4 days regardless of profitability. $100k/trade. 6/1/2007 - present.

TradeStation Performance Summary Collapse

All Trades

Total Net Profit	$68,646.91	Profit Factor	3.95
Gross Profit	$91,947.45	Gross Loss	($23,300.54)
Total Number of Trades	74	Percent Profitable	87.84%
Winning Trades	65	Losing Trades	9
Even Trades	0		
Avg. Trade Net Profit	$927.66	Ratio Avg. Win:Avg. Loss	0.55
Avg. Winning Trade	$1,414.58	Avg. Losing Trade	($2,588.95)
Largest Winning Trade	$8,783.02	Largest Losing Trade	($7,832.88)

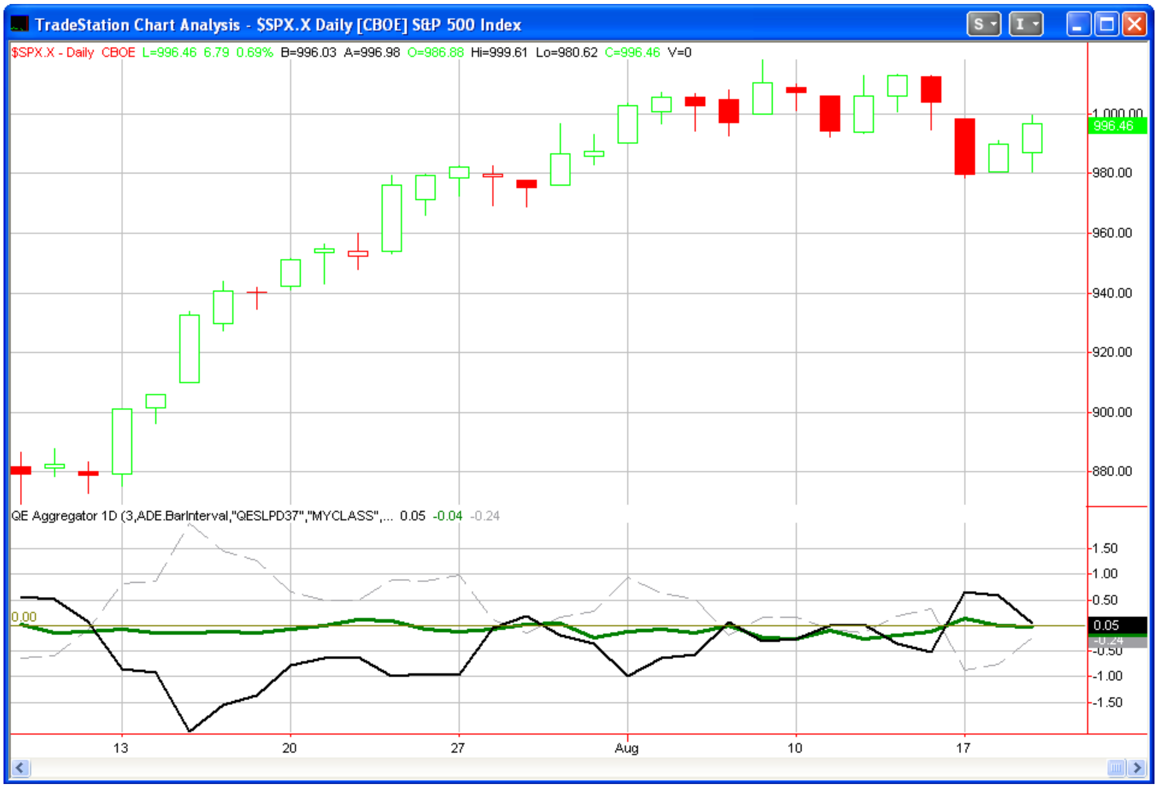
At first blush the results look fantastic. The profit curve below shows that since the March lows the system has leveled off substantially.



While the edge has not been nearly as strong during the recent rally, my indicators still suggest there should be a downward edge here.

On a side note, I recently mentioned that I would be releasing new tools and research in the short-term. Unfortunately, sometimes new ideas beget additional ideas. So what I was about to release could be even more intriguing with a bit more research – hence the delay. Hopefully in the next 2 weeks I'll have some new tools to share with subscribers that will allow you to take advantage of systems like this one even better.

The Aggregator chart is updated below. (Note charting issues forced me to draw in the values tonight. This has happened on occasion. I expect all will be well tomorrow.)



Tonight brought about a few more bearish studies. With a few bullish studies on the board, the green Aggregator line is only mildly bearish. It's reading -0.04, which estimates an average return of -0.04% over the next 3 days. Tomorrow's estimate is -0.06%, which is a bit stronger, but still tame. Meanwhile the black Differential line is just a hair above 0, which means the SPX has barely underperformed expectations over the last 3 days. These are basically neutral readings, though I am slightly more bearish than the Aggregator chart suggests.

Bottom Line

Last night I mentioned the oversold nature of the market provided poor risk/reward for a short trade and I wasn't particularly interested. The market is no longer oversold as it was yesterday and the outlook is still for downside. Tonight's studies were both bearish and both suggest a pretty good chance of a lower close in the next 1-3 days. The market isn't yet overbought and is basically trading mid-range here, so risk/reward is still a little low. If you believe the studies then it's really just a matter of how aggressive you want to be. Aggressive traders could look to take on a small amount of short exposure here. Those who prefer a more clear edge could give it another day in hopes that the market becomes more overbought and provides some additional indications of downside. I plan to split the difference and will look to take a partial position should the market show strength during the day tomorrow. Details in the trade ideas section below.

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

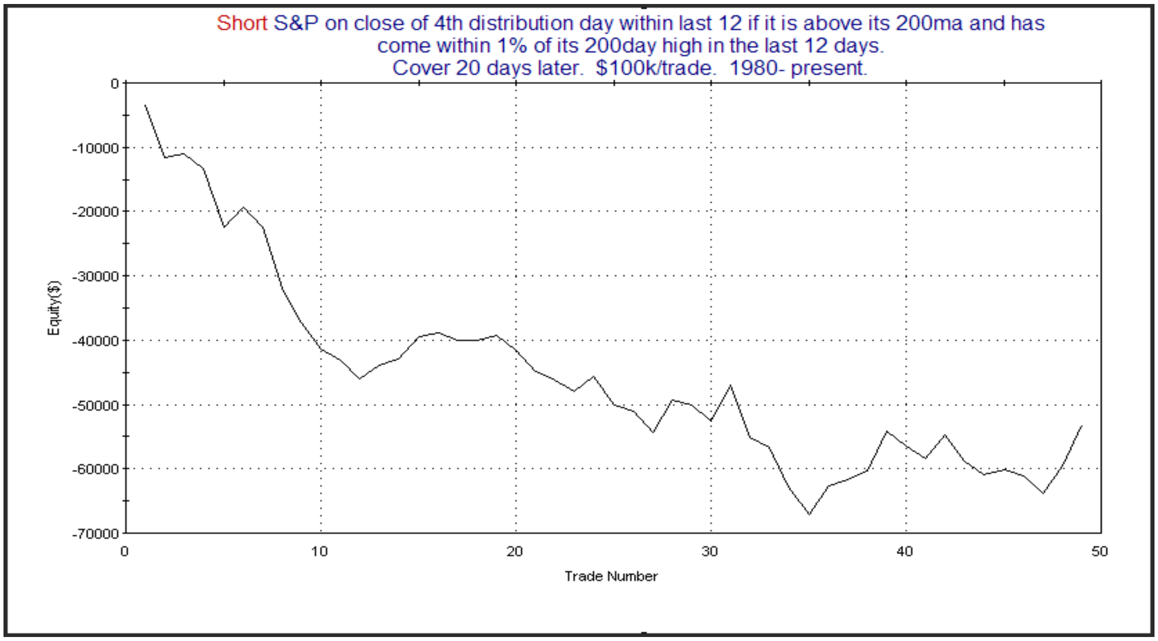
Needless to say these results are horrible. It appears that following a bout of distribution is NOT a good time to be selling. What if we flip the study on its head and instead BUY after such instances when distribution day counters are unloading positions?

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 (filled @ $9.35)

SLE – 1/3 @ $9.20 limit(not filled)

Catapult for ETF's Trades

None

Broad Market Large Cap CBI –3(SLE-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.

SPY – *short ¼ index position under ONE of the following circumstances 1) SPY opens at $100.50 or higher. 2) SPY trades up to $100.75.* Based on short-term market outlook above I am looking to take a small amount of exposure should the market show some strength tomorrow.

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
SLE(1/3)	8/14/2009	$9.35	$9.45	1.07%		Catapult

If SLE should trade as high as $9.60 during the day tomorrow I will place a stop on the whole position at $9.45 to protect against a reversal.