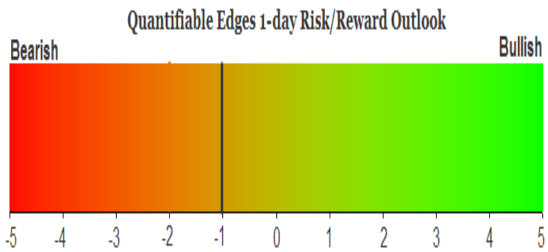
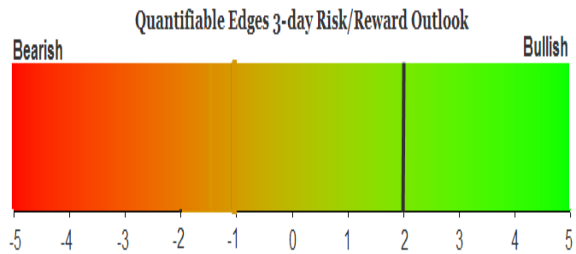
QUANTIFIABLE EDGES SUBSCRIBER LETTER

ASSESSING MARKET ACTION WITH INDICATORS AND HISTORY

February 8, 2010 | Volume 3 Issue 25

Market Overview





Tonight's Research Points

- Oversold bounces not accompanied by solid breadth often lead to short-term weakness.
- The SPX & VIX both up on a Friday has been a bad sign for Monday.
- The CBOE Equity Put/Call Ratio closing 25% above its 200ma shows a mild bullish tendency for the next day.
- The difference between the % of stocks above their 200ma and the % of stocks above their 40ma is currently very large. In the past this has led to intermediate-term upside.
- The Aggregator System remained long despite the predominately bearish studies for Monday.

Short-term Outlook – updated 2/8

The Bottom Line

Friday's reversal and comeback seemed impressive on the surface, but the lack of breadth and the weak final numbers often mean this initial bounce will falter some. Even with the bearish implications suggested by the weak bounce, the net expectation from the active studies remains positive. And with the market still strongly oversold, the outlook for the next few days is for more upside.

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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				
February 8, 2010	SPX bounces on weak breadth	1-2 days	Bearish	-3.50%
February 8, 2010	SPX & VIX up on Friday	1 day	Bearish	
February 8, 2010	Equity Put/call 25% above normal	1 day	Bullish	
February 5, 2010	3% Up Vol	1-2 days	Bullish	3.00%
February 5, 2010	2% Drop 10 low bottom 10% range	1-7 days	Bullish	4.50%
February 3, 2010	75% Up Issue 2 in a row. SPX > 200ma.	1-4 days	Bullish	2.50%
February 1, 2010	Failed Gap Up Bottom 10% Close	1-8 Days	Bullish	4.50%
Active - Long Term				
February 8, 2010	Worden %>200ma - %>40ma > 40	3 - 7 weeks	Bullish	
February 1, 2010	McClellan -60 for 6 days in a row	1-20 days	Bearish	
January 13, 2010	No bearish divergence at high	int. term	Bullish	
Dropped Tonight				
January 29, 2010	Outside day down bottom of range	1-6 days	Bullish	2.40%
December 23, 2009	SPX and TNX hit 50-day high	1-10 weeks	Bearish	

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

The Evidence

Friday saw a huge selloff and reversal in the market. When it was all done the major indices mostly saw slight gains. The SPX finished up 0.3% the Nasdaq rose 0.7% and the Russell 2000 rose 0.6%. While the gains sound nice, breadth was weak and that often doesn't bode well for the market. The NYSE Up Issue % came in at just 43% and the Up Volume % was 55%. Total volume was the highest of 2010.

Several studies related to bounces on weak breadth appeared in the Quantifinder this weekend. This first example looks at the less-than-stellar Up Volume % on Friday. It last appeared in the 11/3/09 Letter. It last appeared in the blog on 6/24/09.

Yesterday SPX drops > 2% and NYSE Up Vol % < 15%. Today SPX closes higher but Up Vol % < 60%. Buy on close. Sell X days later. $100k/trade. 2001 - 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	-22,316.36	20	6	14	30.00	3,495.64	-3,092.16	1.13	0.48	-1,115.82
4	-22,193.29	20	5	15	25.00	3,329.91	-2,589.52	1.29	0.43	-1,109.66
3	-17,583.29	20	5	15	25.00	2,749.57	-2,088.74	1.32	0.44	-879.16
2	-20,153.77	22	8	14	36.36	1,373.39	-2,224.35	0.62	0.35	-916.08
1	-14,333.48	22	7	15	31.82	1,023.68	-1,433.28	0.71	0.33	-651.52

21 of 22 instances (95%) closed below the entry price at some point in the next 3 days. The exception was 11/02/09.

This would seem to hint strongly that a bearish edge exits for the next few days. In the 11/3 letter I also looked at the results when the condition took place while the SPX was above its 200ma.

Yesterday SPX drops > 2% and NYSE Up Vol % < 15%. Today SPX closes higher but Up Vol % < 60%. Close > 200ma. Buy on close. Sell X days later. $100k/trade. 2001 - 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	-2,133.21	6	2	4	33.33	2,513.82	-1,790.21	1.40	0.70	-355.54
4	-9,054.51	6	1	5	16.67	2,509.90	-2,312.88	1.09	0.22	-1,509.09
3	-8,801.75	6	1	5	16.67	2,256.25	-2,211.60	1.02	0.20	-1,466.96
2	-4,109.43	6	3	3	50.00	369.89	-1,739.70	0.21	0.21	-684.91
1	-2,564.11	6	2	4	33.33	181.15	-731.60	0.25	0.12	-427.35

There aren't enough instances here to put a lot of faith in the results, but there is no hint that the results of the first test are compromised by the fact the market is in a long-term uptrend.

The Up Issues % was even lower than the Up Volume %, so I also decided to run a study based on that. In this case I lowered the requirement for the previous days % drop in order to get a decent number of instances.

Yesterday SPX drops > 1.5%. Today SPX closes higher but Up Issue % < 45%. 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: Avg Losing Trade	All: Win/Loss Ratio	All: ProfitFactor	All: Avg Trade
5	-20,458.58	19	4	15	21.05	5,348.99	-2,790.30	1.92	0.51	-1,076.77
4	-22,294.19	19	3	16	15.79	4,755.78	-2,285.10	2.08	0.39	-1,173.38
3	-25,302.48	19	4	15	21.05	3,714.15	-2,677.27	1.39	0.37	-1,331.71
2	-32,693.20	19	5	14	26.32	2,133.90	-3,097.33	0.69	0.25	-1,720.69
1	-25,790.75	19	3	16	15.79	2,457.05	-2,072.62	1.19	0.22	-1,357.41

18 of 19 instances (95%) closed below their entry price at some point in the next 3 days.

Results here are consistent with the previous weak bounce studies. In this case the downside edge basically maxes out in the 1st two days.

Another bearish study identified by the Quantifinder looked at times the VIX rose along with the S&P 500. In the 8/3/09 Letter I broke this type of action down by day of the week. Fridays had a low number of instances but the most bearish implications. I've updated those study results below.

SPX and VIX both close up. Today is Friday.
Buy on close. Sel X days later. $100k/trade. 1998 - 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	-16,643.97	37	16	21	43.24	1,695.03	-2,084.02	0.81	0.62	-449.84
4	-24,173.33	37	14	23	37.84	1,655.31	-2,058.59	0.80	0.49	-653.33
3	-19,378.04	37	13	24	35.14	1,514.39	-1,627.71	0.93	0.50	-523.73
2	-21,481.22	37	10	27	27.03	1,339.55	-1,291.73	1.04	0.38	-580.57
1	-29,215.67	37	10	27	27.03	579.14	-1,296.56	0.45	0.17	-789.61

32 of 37 instances (86.5%) closed below the entry price within the next 2 days.

This is another study that suggests Monday may be a down day.

Another measure that was showing notable readings the last 2 days was the CBOE Equity Put/Call Ratio. Put/call ratios have changed quite a bit over time so whenever I use them I always normalize by measuring against a long-term moving average. On Friday the CBOE Equity Put/Call ratio closed more than 25% above its 200-day moving average. It appeared when I examined such stretches that there was an upside edge apparent. The upside edge only lasted for one day, though – which is consistent with the 1-day downside edge we've seen in the past when the ratio is 25% below the 200ma. Below are some statistics from this study.

CBOE Equity Put/Call ratio closes more than 25% above its 200ma.
Buy SPX on close. Sell next day's close. $100k/trade. 2004 - present.

TradeStation Performance Summary — Collapse

All Trades

Total Net Profit	$36,411.12	Profit Factor	1.77
Gross Profit	$83,617.63	Gross Loss	($47,206.51)
Total Number of Trades	95	Percent Profitable	61.05%
Winning Trades	58	Losing Trades	37
Even Trades	0		
Avg. Trade Net Profit	$383.27	Ratio Avg. Win:Avg. Loss	1.13
Avg. Winning Trade	$1,441.68	Avg. Losing Trade	($1,275.85)
Largest Winning Trade	$11,558.43	Largest Losing Trade	($6,659.22)
Largest Winner as % of Gross Profit	13.82%	Largest Loser as % of Gross Loss	14.11%

Based on these results the upside edge appears to be substantial. I did decide to also filter this test based on the 200ma of the SPX as well.

CBOE Equity Put/Call ratio closes more than 25% above its 200ma. SPX > 200ma.
Buy SPX on close. Sell next day's close. $100k/trade. 2004 - present.

TradeStation Performance Summary

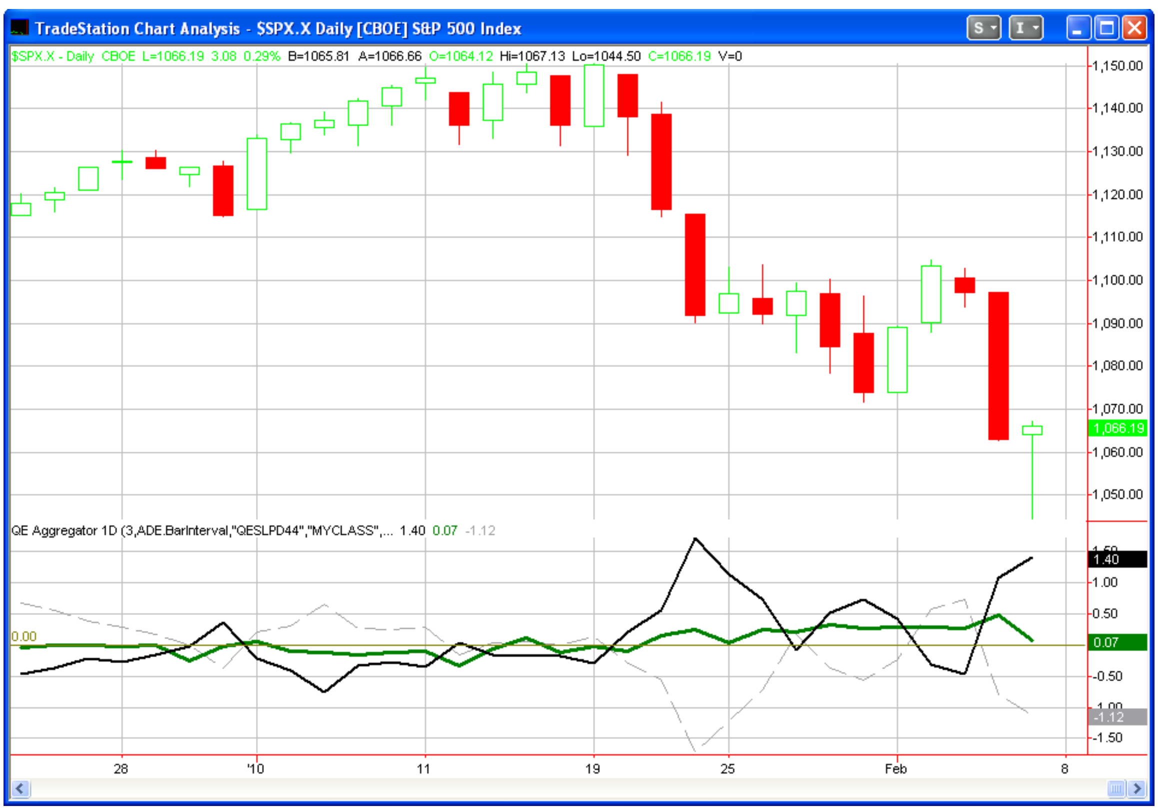
All Trades

Total Net Profit	$5,154.45	Profit Factor	1.70
Gross Profit	$12,483.98	Gross Loss	($7,329.53)
Total Number of Trades	34	Percent Profitable	73.53%
Winning Trades	25	Losing Trades	9
Even Trades	0		
Avg. Trade Net Profit	$151.60	Ratio Avg. Win:Avg. Loss	0.61
Avg. Winning Trade	$499.36	Avg. Losing Trade	($814.39)
Largest Winning Trade	$1,532.88	Largest Losing Trade	($1,765.61)
Largest Winner as % of Gross Profit	12.28%	Largest Loser as % of Gross Loss	24.09%

What I found is that the % profitable increases quite a bit, but with dampened volatility above the 200ma, the average profit is not nearly as substantial.

Lastly, I also examined reversal bars like we saw on Friday a number of different ways. I looked for large tails and new lows being hit followed by strong reversals and positive closes. I simply didn't find anything compelling along these lines.

I have updated the Aggregator chart below.



First I should note there was slight error in the Aggregator calculation Friday. The green Aggregator line should've read 0.48. I've corrected it in the above chart.

Despite the predominance of bearish studies related to Friday's action, they weren't quite enough to swing the green Aggregator line into negative territory. In an unusual situation the estimates for Monday are actually negative while Tuesday and Wednesday are positive. The 1 and 3-day risk/reward thermometers at the top of the letter reflect this difference. Of course the Aggregator looks at estimates over the next 3 days so that is why we have a positive value there. The black Differential is about as extended as it has been in a long time. Both lines above zero mean we have bullish expectations and the SPX has underperformed expectations over the last few days. This configuration has historically provided a bullish edge and the Aggregator system remains long.

Looking ahead to tomorrow it is again unlikely that either line will approach negative territory. The green Aggregator line is positioned to rise further on Monday without some strongly bearish studies. The pivot number for the black Differential line is a whopping 1,105.24. It would take quite a rally for the SPX to close at that level. It's probably going to take at least a couple of days to trigger a change in the Aggregator System at this point.

Intermediate-term Outlook (2 weeks – 2 months)– updated 2/8 –slightly bullish

Two useful breadth statistics that are tracked by Worden Bros. are the % of Stocks Trading Above the 200ma (T2107) and the % of Stocks Trading Above the 40ma (T2108). At the current time the difference between these two readings is very large. 72% of stocks remain above their 200ma, but only 24% stocks are above their 40ma. The only other time since 1986 when Worden Bros. began tracking these statistics that the difference has been this large was late October / early November of 2009. To get such a large difference between the readings you would need to have a strong pullback occur in a strong uptrend. I was curious to see whether such a strong pullback was likely to derail the long-term uptrend and lead to further selling. To get a better sense I lowered the required difference between the 2 to 40. Below are those results.

Worden Bros T2107 (% stocks > 200ma) minus T2108 (% stocks > 40ma) crosses over 40. Buy SPX on close. Sell X days later. $100k/trade. 1986 - 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
35	21,475.58	4	4	0	100.00	5,368.90	0.00	100.00	100.00
30	23,219.60	4	4	0	100.00	5,804.90	0.00	100.00	100.00
25	21,741.08	4	4	0	100.00	5,435.27	0.00	100.00	100.00
20	20,572.12	5	5	0	100.00	4,114.42	0.00	100.00	100.00
15	19,107.91	5	5	0	100.00	3,821.58	0.00	100.00	100.00

The 5 dates shown for the 20-days out test are: 10/27/97, 3/11/04, 3/2/07, 10/27/09, and 11/27/09.

In general returns were positive from day 1. From a long-term perspective, such sharp pullbacks have been followed by additional buying. Any uptrend strong enough that such a large number of stocks were trading above their 200ma that the difference could be as large as 40 simply didn't fall apart when a strong selloff occurred. The 2004 instance saw a retest of the highs before the market underwent a lengthy but shallow selloff. The other instances all rallied through their old highs and kept rising. Instances are definitely low but results couldn't be any more bullish.

While we are now way above a difference of 35, I also ran that to get a few more instances.

Worden Bros T2107 (% stocks > 200ma) minus T2108 (% stocks > 40ma) crosses over 35. Buy SPX on close. Sell X days later. $100k/trade. 1986 - 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
35	23,068.19	10	9	1	90.00	5,402.87	-25,557.66	0.21	1.90	2,306.82
30	22,283.78	10	9	1	90.00	5,187.10	-24,400.14	0.21	1.91	2,228.38
25	33,480.55	10	8	2	80.00	4,272.10	-348.13	12.27	49.09	3,348.06
20	24,726.47	10	9	1	90.00	2,876.02	-1,157.70	2.48	22.36	2,472.65
15	35,452.69	12	11	1	91.67	3,320.18	-1,069.30	3.11	34.16	2,954.39

This seems to confirm the previous findings and suggests the current breadth differential is indicative of not a market about to fall apart, but rather a market that is likely to resume its uptrend.

<u>Catapult and Capitulative Breadth Statistics</u>
(Catapult Presentation Part 1) *(Catapult Presentation Part 2)*
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.

VXX short @ $34.00 limit. If not filled during day then short at $32.75 limit on close. – I believe fear got overdone a bit on Friday. If we again approach Friday's highs again then I will look to go short VXX. I will also look to short it on any close higher. We're expecting a bounce here and that should also come with reduced volatility and fear. In the 2/1/10 letter I wrote in detail about the virtues of using VXX as a short in situations like this.

Active Trades Table

Symbol	Entry Date	Entry Price	Current Price	% Gain/Loss	Stop	Notes
SPY	2/5/2010	$106.56	$106.66	0.09%		bought on open
SPY	2/5/2010	$106.44	$106.66	0.21%		bought @ limit