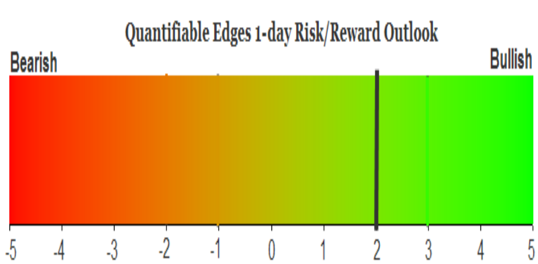
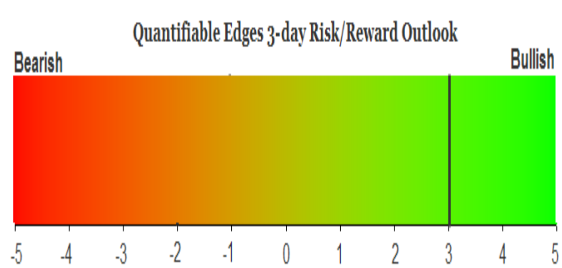
QUANTIFIABLE EDGES SUBSCRIBER LETTER

ASSESSING MARKET ACTION WITH INDICATORS AND HISTORY

June 2, 2010 Volume 3 Issue 104

Market Overview





Tonight's Research Points

- Decliners doubling advancers for the 2nd day in a row while the SPX is under its 200ma has consistently been followed by a bounce.
- The Aggregator System changed to long at the close.
- The NDX Aggressive Trend Timer remained long.

Short-term Outlook – updated 6/2

The Bottom Line

The market is again reaching levels of extreme oversold. It appears an upside edge has re-emerged with the last 2 days of selling.

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				
June 2, 2010	Up Issue % < 33.3 for the 2nd day	1-2 days	Bullish	3.20%
May 28, 2010	2.5% Rise CBI Still Over 5	1-5 days	Bullish	
May 28, 2010	Double 90% Up Vol	1-9 days	Bullish	
May 18, 2010	1% drop on 2:1 neg breadth	1-10 days	Bullish	
Active - Long Term				
June 1, 2010	Nas/S&P Relative Strength favors Nas	int. term	Bullish	
May 25, 2010	Rat Adj McClellan < -60 for 6 in row	1-20 days	Bearish	-5.80%
April 26, 2010	No breadth divergence at new high	int. term	Bullish	
Dropped Tonight				
May 28, 2010	***2.5% Rally on Low Volume***	***1-2 days***	***Bearish***	
June 1, 2010	***Low range inside day***	***1-2 days***	***Bearish***	***-1.70%***

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

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The Evidence

Bearish inclinations won out again on Tuesday as the market endured more hard selling. After initially recovering from a sizable gap down the market tanked in the afternoon. The SPX finished down 1.7% and the Nasdaq dropped 1.5% while the Russell 2000 lost a whopping 3.1%. Breadth was extremely negative with the NYSE Up Issues % coming in at 22% and the Up Volume % at 8%. Total volume rose slightly on the NYSE but declined on the Nasdaq.

A few studies popped up in the Quantifinder this evening. There was really only one that I found compelling enough to include in the Aggregator. The study was last shown in the 1/22/2010 and it looked at times the NYSE Up Issues % was below 33.3% for at least 2 days in a row. In order to avoid several duplicates I adjusted the study slightly tonight to look for *2 and only 2* days with the Up Issues % below 33.3%. The updated results are below.

NYSE Up Issues % closes < 33.3% for exactly the 2nd day in a row. SPX < 200ma.
Buy SPX 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: Avg Losing Trade	All: Win/Loss Ratio	All: ProfitFactor	All: Avg Trade
5	52,844.23	37	28	9	75.68	3,039.06	-3,583.27	0.85	2.64	1,428.22
4	29,367.21	38	23	15	60.53	3,119.32	-2,825.15	1.10	1.69	772.82
3	35,217.62	41	25	16	60.98	3,571.34	-3,379.12	1.06	1.65	858.97
2	46,318.80	41	28	13	68.29	3,005.32	-2,910.02	1.03	2.22	1,129.73
1	42,277.82	41	27	14	65.85	2,197.26	-1,217.73	1.80	3.48	1,031.17

40 of 41 instances (98%) closed above the entry price at some point in the next week.

For the considerable sample size and low number of criteria these results are astonishingly consistent. The stat at the bottom of the table is what seems most striking.

The pattern of a large gap down filling and then ultimately closing below the open was examined in the 3/2/09 Letter. It was generally found to be bullish, with larger gaps performing better. I explored the current size gap (0.93% on Tuesday) a little more closely this evening.

SPY gaps down between 0.75% and 1.25%. It fills the gap and then closes below the open. 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	12,334.54	14	8	6	57.14	4,089.99	-3,397.57	1.20	1.61	881.04
4	15,891.68	14	9	5	64.29	3,612.94	-3,324.96	1.09	1.96	1,135.12
3	20,562.09	14	10	4	71.43	2,936.34	-2,200.34	1.33	3.34	1,468.72
2	15,058.29	14	8	6	57.14	3,391.97	-2,012.91	1.69	2.25	1,075.59
1	9,077.36	14	7	7	50.00	3,327.48	-2,030.71	1.64	1.64	648.38

Initial results looked promising. Unfortunately the stats were greatly skewed by 1 large outlier. Below is the list of trades with a 3-day exit strategy.

SPY gaps down between 0.75% and 1.25%. It fills the gap and then closes below the open.Buy on close. Sell 3 days later. $100k/trade. 1994 - present.				
Date/Time	**Signal**	**Price**	**% Profit**	**Run-up DrawDown**
11/12/97	Buy	$90.50	4.73%	$5,310.24
11/17/97	Sell	$94.78		($452.64)
05/02/00	Buy	$144.13	(0.42%)	$0.00
05/05/00	Sell	$143.53		($3,014.55)
09/18/02	Buy	$86.95	(3.78%)	$0.00
09/23/02	Sell	$83.66		($4,899.00)
09/30/02	Buy	$81.79	0.64%	$4,863.56
10/03/02	Sell	$82.31		($391.04)
10/07/02	Buy	$79.13	1.90%	$2,753.34
10/10/02	Sell	$80.63		($2,601.78)
01/27/03	Buy	$85.20	(0.90%)	$2,322.54
01/30/03	Sell	$84.43		($938.40)
11/09/07	Buy	$145.14	1.74%	$2,930.88
11/14/07	Sell	$147.67		($990.72)
03/07/08	Buy	$129.71	1.27%	$3,126.20
03/12/08	Sell	$131.36		($1,632.40)
07/11/08	Buy	$123.85	0.09%	$1,331.55
07/16/08	Sell	$123.96		($3,090.81)
07/31/08	Buy	$126.83	1.21%	$1,363.24
08/05/08	Sell	$128.36		($1,631.16)
08/07/08	Buy	$127.01	1.84%	$3,541.50
08/12/08	Sell	$129.35		($495.81)
10/27/08	Buy	$83.95	14.71%	$15,745.02
10/30/08	Sell	$96.30		$0.00
11/05/08	Buy	$96.19	(3.70%)	$0.00
11/10/08	Sell	$92.63		($6,369.07)
03/24/09	Buy	$80.60	1.25%	$3,348.00
03/27/09	Sell	$81.61		($1,909.60)

As you can see the 10/27/08 instance was far and away larger than anything else. I therefore decided to examine the results without the outlier.

SPY gaps down between 0.75% and 1.25%. It fills the gap and then closes below the open.
Buy on close. Sell X days later. $100k/trade. 1994 - present. Excludes 10/27/08 instance.

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	-3,339.02	13	7	6	53.85	2,435.20	-3,397.57	0.72	0.84	-256.85
4	551.60	13	8	5	61.54	2,147.05	-3,324.96	0.65	1.03	42.43
3	5,853.24	13	9	4	69.23	1,628.29	-2,200.34	0.74	1.67	450.25
2	4,184.46	13	7	6	53.85	2,323.13	-2,012.91	1.15	1.35	321.88
1	-2,606.35	13	6	7	46.15	1,934.78	-2,030.71	0.95	0.82	-200.49

Without the outlier, the results no longer appear compelling. I won't be including this study in the Aggregator.

Speaking of which, I've updated the Aggregator chart below.

With another bullish study being added and 2 bearish studies leaving the Active List, the green Aggregator line again remained above zero tonight. This shows the net expectations from the active studies is for upside over the next few days. Meanwhile the black Differential line illustrates the SPX has underperformed expectations over the last few days. So we now have positive expectations and a market that is oversold versus expectations. This configuration has historically provided an upside edge. Based on this the Aggregator System changed to long at the close Tuesday.

Looking ahead more bearish studies will need to emerge if the green Aggregator line is going to turn negative tomorrow. With Thursday's big rally exiting the equation, the Differential Pivot is going to jump up to 1,107.10 for Wednesday. This means it would take an SPX close at or above this level in order for the Differential line to turn negative.

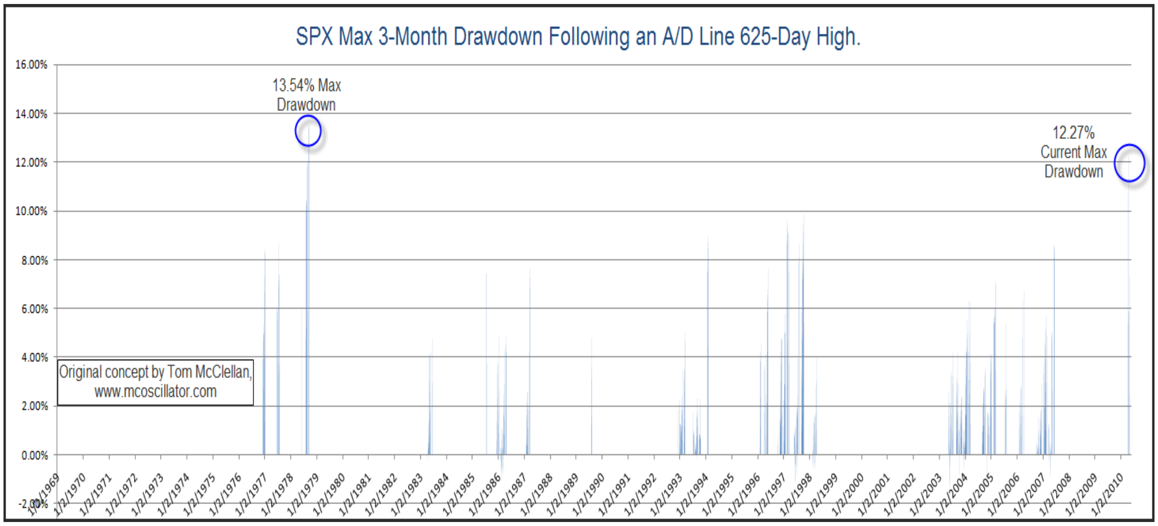
Intermediate-term Outlook (2 weeks – 2 months)– updated 6/1 neutral

Over the past few weeks I've discussed repeatedly my inclination that the current selloff was unlikely to immediately turn into a full-fledged bear market. A primary reason for that was prior to the beginning of the decline about a month ago there had been no deterioration in breadth. I cited some studies done over the last few months that showed every major decline since 1970 has been accompanied by a negative divergence in either the new 52-week high %s or the NYSE Advance/Decline line.

This past week I had the pleasure of interacting with Tom McClellan of McClellan Financial Publications (www.mcoscillator.com). Tom's parents created the McClellelan Oscillator and the McClellan Summation Index many years ago. They remain two of the most widely used breadth measures utilized by analysts to this day. Tom took over writing the McClellan newsletters several years ago and I have followed and admired his work for a number of years myself. Bottom line is you'd be hard pressed to find a family anywhere in the world that knows more about breadth analysis than the McClellans. Tom shared two studies with me that he had done within the last few years. These were related to the breadth work here at Quantifiable Edges that I'd been discussing.

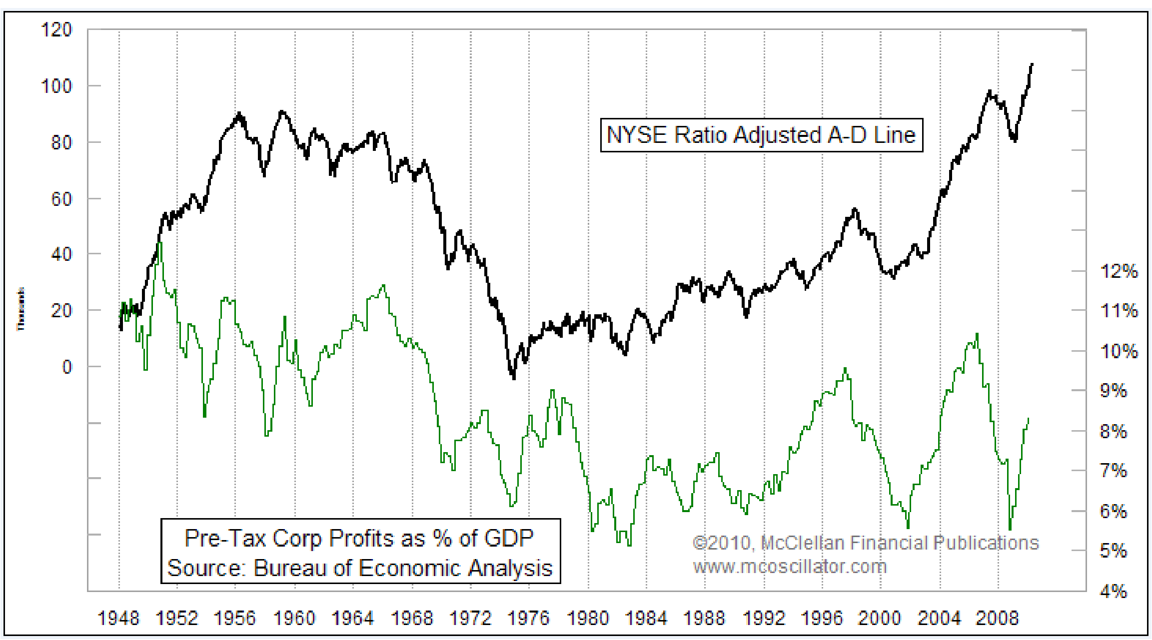
The 1st study Tom shared with me looked at market risk when the A/D line was making new highs. In Tom's study he took any time the Advance/Decline line made a 3-year high and then looked forward 3 months to see what the max drawdown was in the SPX. The study had not been updated for a few years. Additionally, we did not manage to make a 3-year high in the A/D line last month. We DID make a 2 ½ year high though. So I re-ran the study using Tradestation data (which should be very similar) and used a requirement of a 2 ½ year high instead of 3 years.

Note: A full year typically contains about 252 trading days. For purposes of this test I rounded that down to 250 and multiplied by 2.5 to get 625 trading days. To estimate 3 months I used a 63-day period. Also note that the flat spots on the chart are times when the high A/D condition is not met.



As you can see above, since 1970 there has only been one instance that saw a larger drawdown over the following 3 months than we've already seen this past month. Other corrections were generally capped at between an 8% - 10% decline. This doesn't mean we can't drop precipitously from here. The market has demonstrated several times in the past few years that it is completely capable of breaking records. It does show that we've reached an area where risk has pretty much maxed out in the past under similar conditions – at least temporarily. And as Tom put it, the study *"is good enough to illustrate the philosophical point that strong breadth is a good thing."*

Tom also shared a 2nd Advance/Decline study with me that showed the A/D Line was a good predictor of corporate profits. Improving corporate profits generally mean an improving economy.



From Tom:

A couple of points worth noting: This is not a predictive relationship. It merely shows that both stock market performance and corporate profits are dependent on something else, i.e. liquidity. And it is a coincident relationship, although it does not seem that way because of the lag in the reporting of profits. The point here is that if you say that you are going to wait until you see profits improve before you decide to jump back into the market, then you are going to miss the move. Profits as a % of GDP look the best at the end of the bull market, not at the beginning. So watching profits to determine what stock prices are going to do is backwards. Prices are going to tell you the important information before the accountants can, and it is the behavior of the broad list of issues that has the most important information about what the economy is going to do.

Also, the A-D Line has zoomed up to a new all-time high, while the corporate profits line is still just getting back to the middle of the range for recent years. This is not unusual. The A-D Line is unbounded, whereas corporate profits have a natural range that they will stay in. When things get bad, the Fed works to boost liquidity. When things get too good in terms of profits, the Fed responds and Congress also thinks of new ways to skim off more of those profits for purposes that it likes. So the correlation is not about levels, but about directions and slopes.

If you'd like to see a bit more on this study you may find additional comments from Tom at:
http://www.mcoscillator.com/learning_center/weekly_chart/ad_line_has_the_story_on_corporate_profits/

A few other quick intermediate-term observations to note tonight. First the Nasdaq/SPX Relative Strength indicator has flipped again showing the Nasdaq is leading. This has generally been a bullish indication for the market.

Second, intermediate-term traders will no doubt be watching for a Follow Through Day in the coming days. I'd encourage you to review the Quantifiable Edges posts associated with follow-though days before one actually occurs.

So my outlook remains neutral. I am at the ready to turn bullish though should we see additional follow-through or other confirmation of upside.

Catapult and Capitulative Breadth Statistics

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

Open Catapult Triggers

MON - 1/3 position @ $64.73 limit (filled @ $62.60)
MON – 1/3 position @ $62.25 limit (filled @ $60.74)
MON – 1/3 position @ $55.54 limit (filled @ $54.79)
EXC – 1/3 position @ $40.59 limit (filled @ $40.11)
EXC – 1/3 @ $39.31 limit
CSCO – 1/3 @ $23.31 limit
MSFT – 1/3 @ $27.11 limit
QCOM – 1/3 @ $35.59 limit
MSFT– 1/3 position @ $26.84 limit
ORCL– 1/3 position @ $22.16 limit
DELL – 1/3 position @ $13.35 limit
MSFT – final 1/3 @ $26.27
EXC – final 1/3 @ $38.06 limit (no fill)
GILD – 1/3 @ $34.82 limit (no fill)
JNJ – 1/3 position @ $58.30 limit

Catapult for ETF's Trades

none

Broad Market Large Cap CBI – 14 (MON-3, EXC-3, CSCO, MSFT-3, QCOM, DELL,GILD, JNJ)

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.

EXC – buy final 1/3 position @ $36.75 limit. Looking to enter this unfilled Catapult trade as it is now hitting new lows.

SPY – *buy ¼ index position @ $105.75 limit ON CLOSE.* If not for already holding 2 lots I'd be a bit more aggressively buying here. Between the high CBI and the double 90% up days I felt it was worth a shot at getting a little more than the Aggregator suggested. At this point that is looking like a bad decision. I could have been out and now getting back in to at least 1 of those lots. As is I want to see a close tomorrow near the lower end of the recent range in order to buy.

Active Trades Table

Symbol	Entry Date	Entry Price	Current Price	% Gain/Loss	Stop	Notes
MON(1/3)	4/29/2010	$62.60	$48.77	-22.09%		Catapult
MON(1/3)	5/5/2010	$60.74	$48.77	-19.71%		Catapult
MON(1/3)	5/14/2010	$54.79	$48.77	-10.99%		Catapult
SPY(1/4)	5/19/2010	$111.76	$107.53	-3.78%		Aggregator
SPY(1/4)	5/21/2010	$105.91	$107.53	1.53%		Aggregator
EXC(1/3)	5/20/2010	$40.11	$37.65	-6.13%		Catapult
EXC(1/3)	5/21/2010	$38.50	$37.65	-2.21%		Catapult
CSCO(1/3)	5/21/2010	$22.67	$23.00	1.46%		Catapult
MSFT(1/3)	5/21/2010	$26.63	$25.89	-2.78%		Catapult
QCOM(1/3)	5/21/2010	$35.10	$35.07	-0.09%		Catapult
MSFT(1/3)	5/24/2010	$26.84	$25.89	-3.54%		Catapult
DELL(1/3)	5/25/2010	$13.05	$13.09	0.31%		Catapult
MSFT(1/3)	5/25/2010	$25.65	$25.89	0.94%		Catapult
JNJ(1/3)	6/1/2010	$58.21	$58.76	0.94%		Catapult