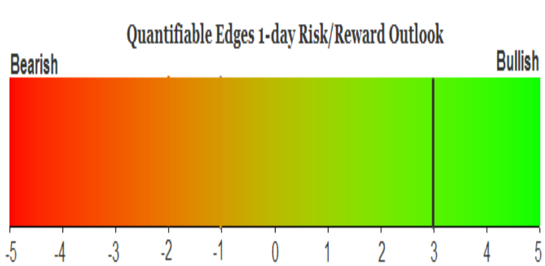
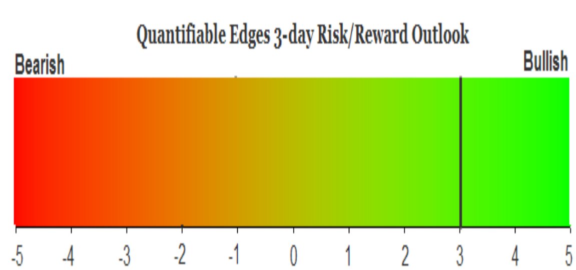
QUANTIFIABLE EDGES SUBSCRIBER LETTER

ASSESSING MARKET ACTION WITH INDICATORS AND HISTORY

June 28, 2010 Volume 3 Issue 122

Market Overview





Tonight's Research Points

- 5 lower lows sets up a possible move higher.
- The Aggregator System remained long.
- The NDX Aggressive Trend Timer remained long.

Short-term Outlook – updated 6/28
The Bottom Line
A minor bounce occurred on Friday. It still appears we have further to go.

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 26, 2010	5 Lower Lows	1-3 days	Bullish	2.00%
June 25, 2010	2 90% Down Days in 1 week	1-5 days	Bullish	4.70%
June 24, 2010	Fed Day / slowing from 20-hi pullbacks	1-6 days	Bullish	2.00%
June 23, 2010	1% drop and bad breadth	1-8 days	Bullish	1.90%
June 16, 2010	2nd 90% up day	1-10 days	Bullish	5.40%
Active - Long Term				
June 21, 2010	Nas/SPX Relative Strength favors Nas	int. term	Bullish	
April 26, 2010	No breadth divergence at new high	int. term	Bullish	

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

Friday was a bit of a mixed day and unusual day. After a fair amount of intraday choppiness the SPX and Nasdaq both closed up about 0.3%. Friday was the annual Russell rebalancing day. Thanks in part to rebalancing games by institutions the Russell 2000 rose a whopping 1.9% and exchange volume spiked. Breadth was also quite strong as the NYSE Up Issues % came in at 73% and the Up Volume % was 69%. The Russell rebalancing had a sizable effect on market internals, so I'm not inclined to worry much about breadth and volume stats from Friday.

Friday marked the 5th consecutive lower low for the SPX. In the May 19th 2009 Subscriber Letter I did a detailed analysis of how the market performs following 5 lower lows. I found that the returns following this setup were largely dependent on the intermediate-term position of the market. Rather than show the whole study here I've attached it at the bottom of the report as an Appendix. Below is a stats table showing the "current" situation. While I re-ran the stats today, they haven't changed since those in the report in 2009 since this is the 1st occurrence we've seen since then.

SPX make s5 consecutive lower lows. The highest high of the last 6 days < the highest high of the last 50 days. Today is NOT a 50-day low. Buy on close. Sell X days later. $100k/trade. 1978 - 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	14,476.86	57	31	26	54.39	2,279.90	-2,161.54	1.05	1.26	253.98
4	11,534.88	57	34	23	59.65	1,736.25	-2,065.12	0.84	1.24	202.37
3	25,924.81	57	35	22	61.40	1,648.96	-1,444.94	1.14	1.82	454.82
2	24,379.25	57	38	19	66.67	1,191.81	-1,100.50	1.08	2.17	427.71
1	16,705.00	57	36	21	63.16	885.57	-722.64	1.23	2.10	293.07

So the suggestion is a somewhat mild upside edge over the next 3 days. I also looked at whether an up or down close on the last day mattered. It didn't appear to make a substantial difference. Another similar test I ran was in looking at a series low lower lows and lower highs with an up close as happened on Friday. Basically, short-term results there were similar to the results I show in the study above.

I have updated the Aggregator chart below.

With nothing but bullish studies still, the green Aggregator line remains well above 0. This represents higher net expectation from the Active Studies over the next few days. Meanwhile the black Differential line illustrates the SPX has substantially underperformed expectations over the last few days. So we have positive expectations and a market that is oversold versus recent expectations. This set has historically provided a bullish edge. The Aggregator configuration is considered bullish whenever both lines are above 0. Based on this the Aggregator System is again long.

Looking ahead the green Aggregator line is set up to remain positive tomorrow. Of course some strong bearish evidence could change that outlook. Meanwhile the Differential pivot will be 1,097.85 tomorrow. This means it would take an SPX close at or above this level in order for the black Differential line to turn negative. Without a decent move higher the Aggregator System will likely remain bullish.

Intermediate-term Outlook (2 weeks – 2 months)– updated 6/28 - slightly bullish

After attempting to break out of a double bottom formation 2 weeks ago, the SPX got smacked right back down into the middle of that double bottom pattern this past week. On the week it lost over 3.5% and likely has put a quite a scare into traders that bought the breakout. We did see overall fear spike a bit this week with sentiment measures like the VIX and the CBOE Equity put/call ratios rising from complacent to mildly overdone levels.

I also got some notes about the fact that some intermediate and long term moving averages were starting to cross downward and that this was a potential bad sign. For instance on Friday the 40ma crossed and closed beneath the 200ma. Since 1960 when the 40ma has been below the 200ma the market has done slightly worse than breakeven. The performance has been pretty typical of what you see on the "short" side of a long-term moving average crossover system. For the 40/200 since 1961 there have been 25 down crosses. If you shorted every one and then covered or went long when the averages crossed again you would have made a profit 8 times and lost money 17 times. Obviously slightly better than breakeven short-side results were primarily due to a few sizable bear markets. During these times the winning short trades made up for all the instances where the market chopped lower and then rose again. The last signal which lasted from 12/13/07 to 6/18/09 was good for over a 38% gain on the short side. This actually accounts for nearly 30% of all short-side gains over the last 50 years.

I'm not a big fan of trading a moving average crossover system like this. I do think it could do a decent job of keeping someone out of the market if a massive bear market is about to begin. But bear markets create their own kind of opportunities – many of which occur in a short, or swing-style time frame. So if a bear market does occur after this cross it should be viewed opportunistically rather than with great trepidation.

Personally, I still think the market is unlikely to fall into a protracted bear market at this point. We've seen fear and volatility levels hit areas that are capable of launching bull markets several times over the last month and a half. A number of breadth studies have also suggested the intermediate-term outlook favors the upside. I believe the market still has an attempt at new highs in it. And with the short-term outlook so full of bullish studies the move back up could begin at any moment.

Some upside confirmation would be helpful. A move higher in the next few days could mark a higher low on the SPX chart. Additional confirmation could come in the form of the SPX sticking above its 200ma and 50ma and making a few higher highs. So I don't want to get carried away just yet, but I'm leaning slightly towards the long side.

Catapult and Capitulative Breadth Statistics
Catapult & CBI Presentation Link

Open Catapult Triggers
LOW – 1/3 position @ $21.76
AMZN – 1/3 position @$118.33
NEW
RTN – 1/3 position @$50.38 limit
MSFT – 1/3 position @ $24.53 limit
MON – 1/3 position @ $48.27 limit

Catapult for ETF's Trades
None

Broad Market Large Cap CBI – 5 (LOW, AMZN, RTN. MSFT, MON)

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.

RTN – 1/3 position @$50.38 limit
MSFT – 1/3 position @ $24.53 limit
MON – 1/3 position @ $48.27 limit

All 3 of these are based on the Catapult System. For a 30-minute presentation on the system, use the Catapult & CBI Presentation Link. Note that Catapult system code is NOT fully revealed.

I considered adding the 4th and final lot to the SPY trade but decided to hold off a day on that and just go with the new Aggregator signals.

Current Open Trade Ideas

Symbol	Entry Date	Entry Price	Current Price	% Gain/Loss	Stop	Notes
SPY	6/23/2010	$109.57	$107.87	-1.55%		Aggregator
LOW	6/23/2010	$21.71	$21.33	-1.75%		Catapult
SPY	6/24/2010	$108.69	$107.87	-0.75%		Aggregator
SPY	6/25/2010	$107.42	$107.87	0.42%		Aggregator
AMZN	6/25/2010	$118.14	$121.00	2.42%		Catapult

Appendix – Five Lower Lows Study from 5/18/2009 Letter

Friday also marked the 5th day in a row that the S&P 500 made a lower low. Five lower lows is often cited as a pattern with an upside bias, but it is actually largely dependent on where the pattern takes place. I'll illustrate this a few different ways. First I'll break it out in a way that I originally did in the May 12, 2008 Letter – by times it was coming off a 50-day high and times it wasn't. First let's look at times it wasn't:

S&P 500 makes 5 consecutive lower lows. The highest high of the last 6 days < the highest high of the last 50 days.										
Buy on close. Sell X days later. $100k/trade. 1978-present.										
X%	Net Profit	Trades	Wins	Losses	% Wins	Avg Win	Avg Loss	W/L Ratio	Profit Factor	Avg Trade
20	$127,273.89	77	52	25	67.53	$4,945.67	($5,196.03)	0.95	1.98	$1,652.91
15	$80,761.85	78	49	28	62.82	$3,982.75	($4,085.46)	0.97	1.71	$1,035.41
10	$54,640.46	81	47	34	58.02	$3,619.14	($3,395.85)	1.07	1.47	$674.57
9	$61,143.65	83	49	34	59.04	$3,350.43	($3,030.21)	1.11	1.59	$736.67
8	$61,871.65	83	48	35	57.83	$3,492.04	($3,021.32)	1.16	1.59	$745.44
7	$52,820.74	85	50	35	58.82	$3,092.58	($2,908.80)	1.06	1.52	$621.42
6	$28,094.98	87	53	34	60.92	$2,506.91	($3,081.51)	0.81	1.27	$322.93
5	$35,419.85	87	49	38	56.32	$2,508.31	($2,302.29)	1.09	1.40	$407.12
4	$50,879.49	87	54	33	62.07	$2,328.14	($2,267.88)	1.03	1.68	$584.82
3	$65,921.65	87	53	34	60.92	$2,146.18	($1,406.65)	1.53	2.38	$757.72
2	$53,863.79	87	57	30	65.52	$1,669.24	($1,376.10)	1.21	2.30	$619.12
1	$46,534.66	87	55	32	63.22	$1,369.30	($899.28)	1.52	2.62	$534.88

The potential upside bias I mentioned above is evident here. It's also quite consistent over the period of 1-day to 4 weeks.

Now I'll show times when the market is coming off an intermediate-term high.

S&P 500 makes 5 consecutive lower lows. The highest high of the last 6 days = the highest high of the last 50 days.										
Buy on close. Sell X days later. $100k/trade. 1978-present.										
X%	Net Profit	Trades	Wins	Losses	% Wins	Avg Win	Avg Loss	W/L Ratio	Profit Factor	Avg Trade
20	($5,425.35)	24	9	15	37.50	$3,350.68	($2,372.10)	1.41	0.85	($226.06)
15	($7,369.13)	24	9	15	37.50	$3,313.50	($2,479.38)	1.34	0.80	($307.05)
10	($22,212.05)	24	5	19	20.83	$1,794.25	($1,641.23)	1.09	0.29	($925.50)
9	($15,595.29)	24	10	14	41.67	$1,051.54	($1,865.05)	0.56	0.40	($649.80)
8	($15,418.19)	24	9	15	37.50	$1,090.18	($1,681.98)	0.65	0.39	($642.42)
7	($4,330.81)	24	13	11	54.17	$1,115.34	($1,711.83)	0.65	0.77	($180.45)
6	($603.04)	24	13	11	54.17	$1,027.90	($1,269.61)	0.81	0.96	($25.13)
5	($4,844.85)	24	10	14	41.67	$1,461.94	($1,390.30)	1.05	0.75	($201.87)
4	$1,265.24	24	11	13	45.83	$1,406.48	($1,092.77)	1.29	1.09	$52.72
3	($2,459.76)	24	12	12	50.00	$934.05	($1,139.03)	0.82	0.82	($102.49)
2	($1,145.02)	24	11	13	45.83	$952.44	($893.99)	1.07	0.90	($47.71)
1	($399.64)	24	12	12	50.00	$626.65	($659.95)	0.95	0.95	($16.65)

The difference here is striking. The downside bias is quite strong over the next 2 weeks. After 10 days only 5 of 24 (21%) instances were trading higher. In fact there was only 1 instance of the 24 that didn't post a lower close at some point over the next two weeks. Even looking out as far as 4 weeks there is a surprising downside bias.

What I also found is that the 5 lower lows pattern provides most of its upside edge when it is a potentially exhaustive situation. Below I illustrate this by looking at times the 5th lower low also coincided with a 50-day low.

S&P 500 makes 5 consecutive lower lows and today is the lowest low of the last 50 days.										
Buy on close. Sell X days later. $100k/trade. 1978-present.										
X%	Net Profit	Trades	Wins	Losses	% Wins	Avg Win	Avg Loss	W/L Ratio	Profit Factor	Avg Trade
20	$104,473.83	29	21	8	72.41	$6,170.08	($3,137.24)	1.97	5.16	$3,602.55
19	$116,403.77	30	24	6	80.00	$5,841.51	($3,965.43)	1.47	5.89	$3,880.13
15	$74,791.62	30	21	9	70.00	$4,903.92	($3,132.30)	1.57	3.65	$2,493.05
10	$50,412.53	30	18	12	60.00	$4,713.87	($2,869.77)	1.64	2.46	$1,680.42
9	$57,349.29	30	20	10	66.67	$3,987.05	($2,239.17)	1.78	3.56	$1,911.64
8	$51,181.77	30	18	12	60.00	$4,429.46	($2,379.04)	1.86	2.79	$1,706.06
7	$49,855.64	30	19	11	63.33	$3,904.30	($2,211.46)	1.77	3.05	$1,661.85
6	$34,759.58	30	19	11	63.33	$3,347.82	($2,622.63)	1.28	2.20	$1,158.65
5	$20,942.99	30	18	12	60.00	$2,901.67	($2,607.25)	1.11	1.67	$698.10
4	$39,344.61	30	20	10	66.67	$3,334.35	($2,734.23)	1.22	2.44	$1,311.49
3	$39,996.84	30	18	12	60.00	$3,113.01	($1,336.45)	2.33	3.49	$1,333.23
2	$29,484.54	30	19	11	63.33	$2,624.12	($1,852.16)	1.42	2.45	$982.82
1	$29,829.66	30	19	11	63.33	$2,285.85	($1,236.51)	1.85	3.19	$994.32

Here we see an extremely strong upside edge. Whether looking at winning %, profit factor, w/l ratio, or average trade, all the stats over the entire time period strongly favor the bulls. The edge is so strong in fact, that without a 50-day low, I wouldn't consider it a tradable advantage at all. Below is another table that shows the 5 lower lows pattern when there is neither a 50-day high nor low associated with it.

S&P 500 makes 5 consecutive lower lows. The highest high of the last 6 days < the highest high of the last 50 days.										
Today is NOT a 50-day low. Buy on close. Sell X days later. $100k/trade. 1978-present.										
X%	Net Profit	Trades	Wins	Losses	% Wins	Avg Win	Avg Loss	W/L Ratio	Profit Factor	Avg Trade
20	$13,715.48	52	32	20	61.54	$4,069.35	($5,825.19)	0.70	1.12	$263.76
15	$13,393.77	53	31	21	58.49	$3,521.73	($4,560.95)	0.77	1.14	$252.71
10	$9,125.34	53	30	23	56.60	$3,038.45	($3,566.44)	0.85	1.11	$172.18
9	$10,785.05	55	30	25	54.55	$3,080.47	($3,265.17)	0.94	1.13	$196.09
8	$16,216.76	55	31	24	56.36	$3,038.60	($3,249.16)	0.94	1.21	$294.85
7	$139.39	57	31	26	54.39	$2,595.07	($3,088.76)	0.84	1.00	$2.45
6	($6,664.60)	57	34	23	59.65	$2,037.00	($3,300.98)	0.62	0.91	($116.92)
5	$14,476.86	57	31	26	54.39	$2,279.90	($2,161.54)	1.05	1.26	$253.98
4	$11,534.88	57	34	23	59.65	$1,736.25	($2,065.12)	0.84	1.24	$202.37
3	$25,924.81	57	35	22	61.40	$1,648.96	($1,444.94)	1.14	1.82	$454.82
2	$24,379.25	57	38	19	66.67	$1,191.81	($1,100.50)	1.08	2.17	$427.71
1	$16,705.00	57	36	21	63.16	$885.57	($722.64)	1.23	2.10	$293.07

Here you can see there is a bit of an upside edge that lasts for only 3 days. After day three there are actually mildly negative expectations up to 4 weeks out. As you can see, the pattern is largely dependent on market positioning, and it is important to consider the bigger picture when evaluating the pattern.