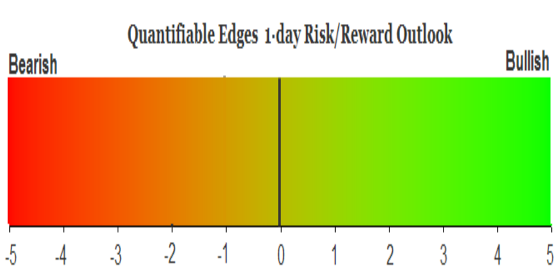
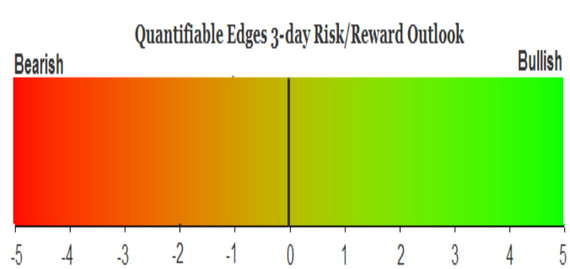
QUANTIFIABLE EDGES SUBSCRIBER LETTER

ASSESSING MARKET ACTION WITH INDICATORS AND HISTORY

December 21, 2010 Volume 3 Issue 245

Market Overview





Tonight's Research Points

- The new high along with a very low VIX:VXV suggests a 1-day downside edge.
- SPX up and VIX up on a Monday also suggests 1-day weakness.
- The Aggregator System is flat.
- The NDX Aggressive Trend Timer is flat.

Short-term Outlook

The Bottom Line

Expectations remain bullish but the SPX is now overbought. I stepped out at the close but will look to get back in on weakness.

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				
December 21, 2010	SPX up. VIX up on Monday. SPX>200	1 day	Bearish	
December 21, 2010	VIX:VXV < 0.85. SPX 50-day high	1 day	Bearish	
December 16, 2010	1 day drop after 5 up days.Close>200ma	1-10 days	Bullish	2.20%
December 15, 2010	100-day high on Fed Day	1-6 days	Bullish	1.70%
December 15, 2010	Gap up reverse down, but still pos twice	1-5 days	Bullish	2.20%
Active - Long Term				
December 16, 2010	2 Hindenburg Signals	1-50 days	Bearish	
December 9, 2010	SPX & TNX 50-day highs	1-50 days	Bearish	
December 6, 2010	SPY 3 lower volume up days	1-19 days	Bearish	
December 2, 2010	2 90% Up Volume % days in 5 days	1-16 days	Bullish	
November 22, 2010	High number of POMO Days recently	int term	Bullish	
October 25, 2010	SPX Golden Cross	int term	Bullish	
September 20, 2010	Nas/SPX RS favors Nasdaq	int term	Bullish	
Dropped Tonight				
December 20, 2010	SPX Up. NYSE vol high 20. Op-ex.	1 day	Bearish	
December 15, 2010	SPY 10 days > 5ma & 10-day high	1-3 days	Bearish	

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

A fairly quiet day ended with the averages mildly higher. The SPX and Nasdaq each gained 0.25% while the Russell 2000 was up 0.4%. Breadth was barely positive as the NYSE Up Issues % came in at 51% and the Up Volume % was 64%. Total volume was very light. It likely will remain so for much of this week and next as many traders take time off.

The Quantifinder identified a large number of studies today that looked at the strong price action on weak volume. This also happened last year during Christmas week. As I did then I shall choose to ignore volume-based studies during the holiday period. The low volume simply doesn't have the same meaning. It is a calendar issue and not a complacency issue.

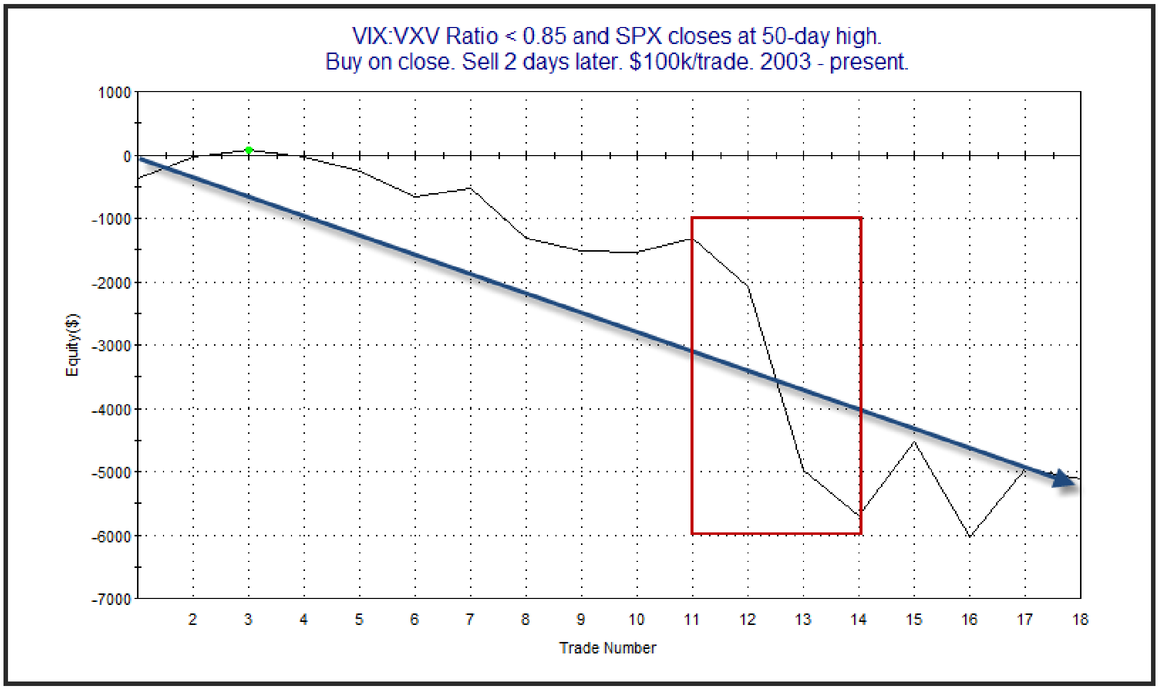
One indicator that did produce some interesting studies was the VIX. The excerpt below is from the 12/17 Letter just a few days ago. I have not updated the stats.

(This study) looked at low VIX:VXV ratios when the market is at a 50-day high. The implication here is that short-term risk is being underestimated and the market is overbought…

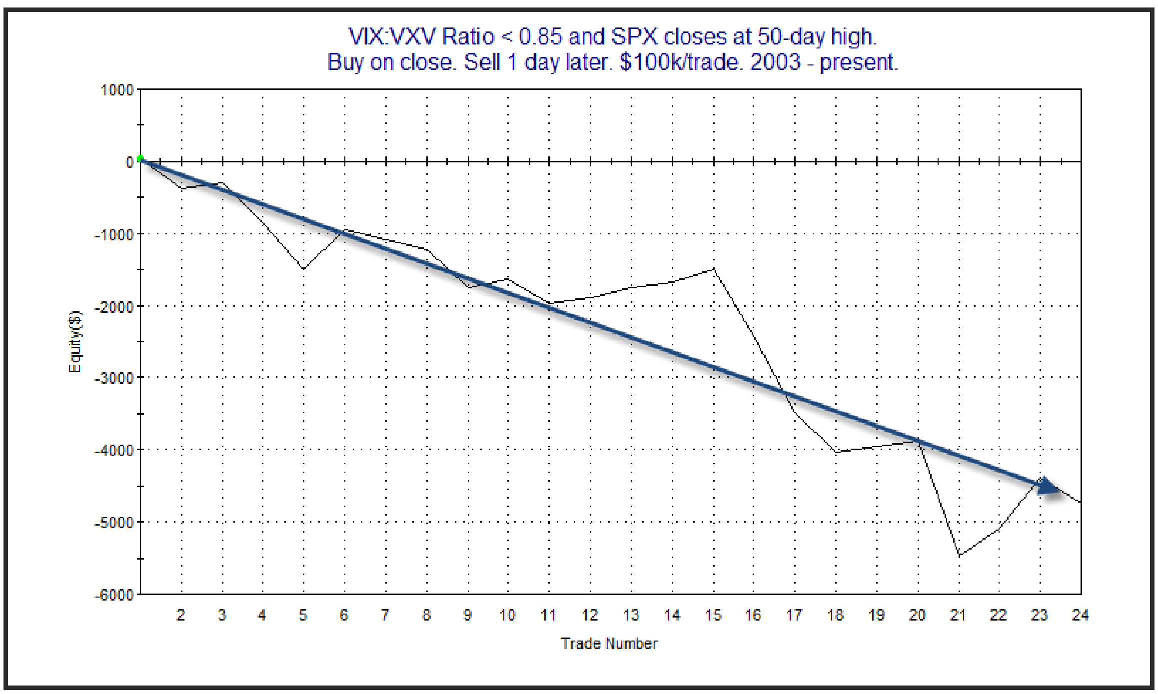
VIX:VXV Ratio < 0.85 and SPX closes at 50-day high.
Buy on close. Sell X days later. $100k/trade. 2003 - present.

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	-4,892.23	15	8	7	53.33	602.03	-1,386.92	0.43	0.50	-326.15
4	-5,938.69	15	6	9	40.00	497.85	-991.76	0.50	0.33	-395.91
3	-4,914.00	17	9	8	52.94	416.51	-1,082.83	0.38	0.43	-289.06
2	-5,117.29	18	6	12	33.33	512.63	-682.76	0.75	0.38	-284.29
1	-4,751.38	24	12	12	50.00	208.97	-604.91	0.35	0.35	-197.97

The results here suggest a downside edge over the next 1-5 days. I ran some equity curves and what I found was interesting. Let's first take a look at the 2-day curve.



The area marked off in red is a series of just 3 trades that comprise almost all of the total losses. Without those 3 trades you are almost looking at a breakeven strategy. This doesn't mean that there isn't a downside edge. It just implies that it doesn't appear steady and reliable. Most of the equity curves looked like this…except the 1-day.



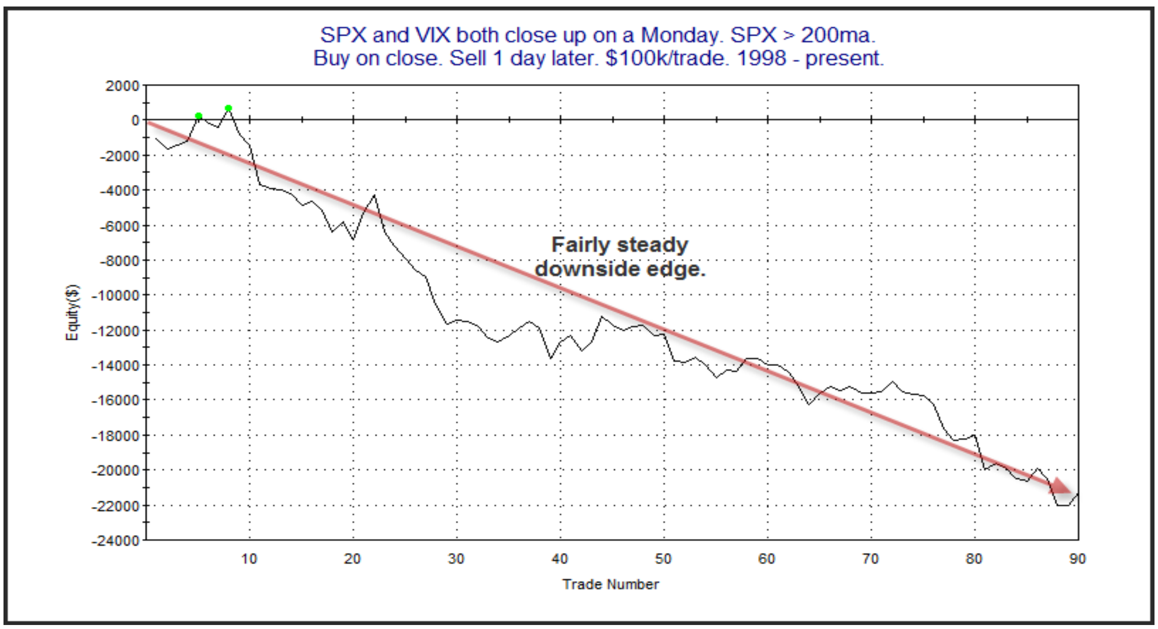
While the average trade didn't lose as much we see what appears to be a much steadier edge. Because of this I'm inclined to only view this study as a 1-day edge for the time being.

Another VIX-related study that popped up tonight was last seen in the 11/2/10 Subscriber Letter. It looked at other times the VIX and SPX both closed higher on a Monday. This is more frequent on Mondays since there is a mild tendency for the VIX to rise on Mondays.

SPX and VIX both close up on a Monday. SPX > 200ma.
Buy on close. Sell X days later. $100k/trade. 1998 - present.

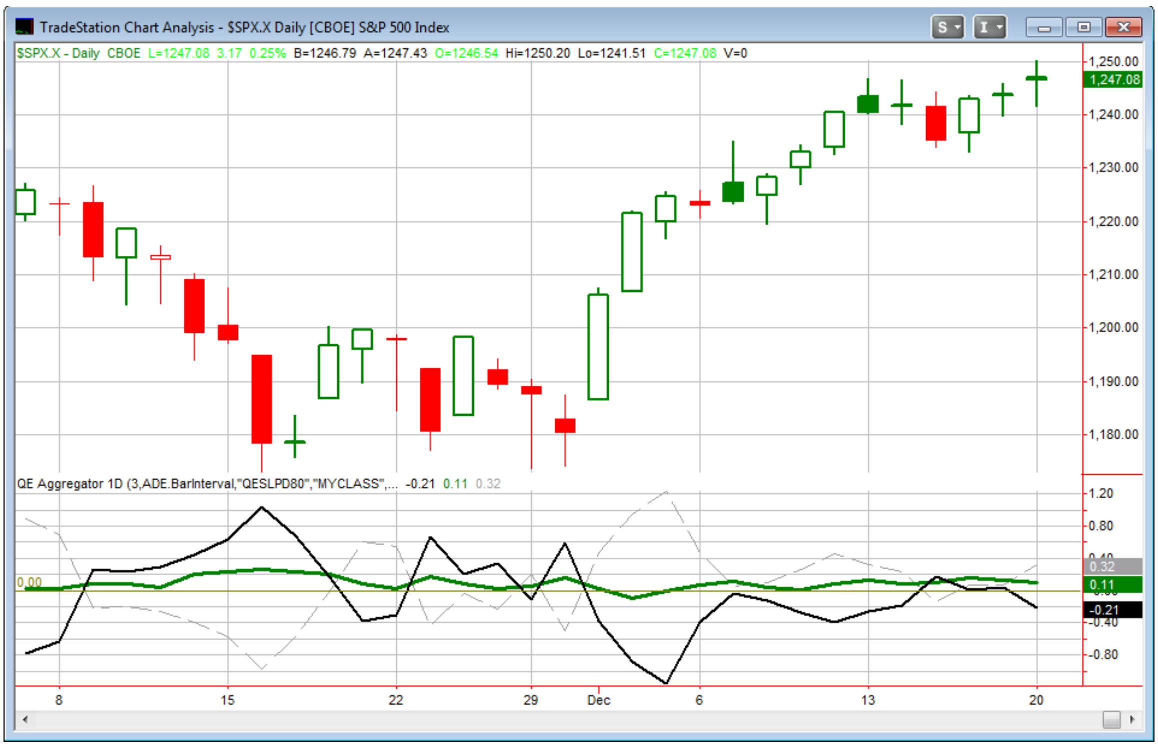
X Days	All: Net Profit	All: Total Trades	All: Winning Trades	All: Losing Trades	All: % Profitable	All: Avg Winning Trade	All: Avg Losing Trade	All: Win/Loss Ratio	All: ProfitFactor	All: Avg Trade
5	-2,013.08	88	45	43	51.14	1,476.08	-1,591.55	0.93	0.97	-22.88
4	-9,715.66	90	42	48	46.67	1,315.99	-1,353.90	0.97	0.85	-107.95
3	-14,704.32	90	41	49	45.56	1,073.71	-1,198.50	0.90	0.75	-163.38
2	-19,442.54	90	38	52	42.22	760.20	-929.42	0.82	0.60	-216.03
1	-21,273.75	90	35	55	38.89	478.09	-691.03	0.69	0.44	-236.38

This VIX study also appears to suggest a 1-day edge. Below is the equity curve so you can see how it has played out over time.



For a bearish study above the 200ma the edge shown here has been pretty consistent. I've included this among the active studies.

I have updated the Aggregator chart below.



We see a change in the configuration tonight. The green Aggregator line remains well above 0. The positive value indicates the net expectation from the Active Studies over the next few days is for a move higher. But the black Differential line has now dipped below 0. The negative value means the SPX has outperformed expectations over the last few days. So net expectations are for more upside but the SPX is already overbought. This is considered a neutral configuration. It can be seen on the Aggregator chart whenever both lines are on opposite sides of 0. Due to this the Aggregator System turned flat at the close.

The green Aggregator line is set up to remain positive again tomorrow. This is unlikely to change but it could if strong bearish evidence emerges. Meanwhile the Differential Pivot will be 1,247.14. This is almost exactly at Monday's closing level. So any down close will leave the SPX underperforming and the Differential line positive and any up close will leave the SPX overbought and the Differential line negative.

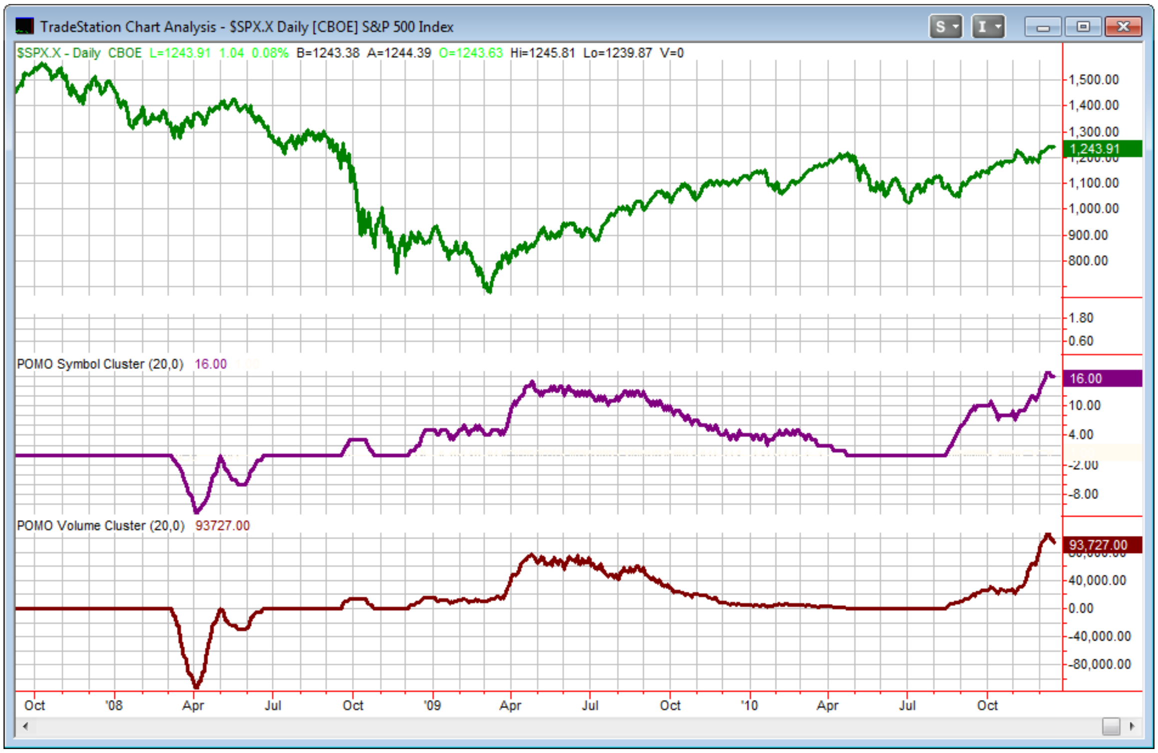
I took off my partial index position at the close on Monday. A catapult setup did trigger though. I track all Catapults in the letter. It can be found in the trade ideas section below. I will also look to re-establish the index position should the SPX close down tomorrow. Details in the trade ideas section.

Intermediate-term Outlook (2 weeks – 2 months)– updated 12/20 – bullish turning neutral

There are still bullish indications and bullish studies active, but I am beginning to see more cracks in the bull case. Let look at some of the positives first.

I've been updating the POMO chart each week in the Letter. For those who may not recall below is a brief refresher on POMO. Beneath that I have updated our POMO indicator chart.

POMO stands for Permanent Open Market Operations and it is how the Fed goes into the open market to buy securities. The net effect of this buying is an influx of cash into the system. It appears a portion of that cash makes its way to the stock market and works as a bullish influence. A "POMO Day" is simply a day where these operations take place… The chart below (shows a couple of POMO indicators). The top pane is the S&P 500. The middle pane is the rolling number of days in the last 20 that have been POMO days. The bottom pane is the total amount of money infused into the system over the previous 20 days.



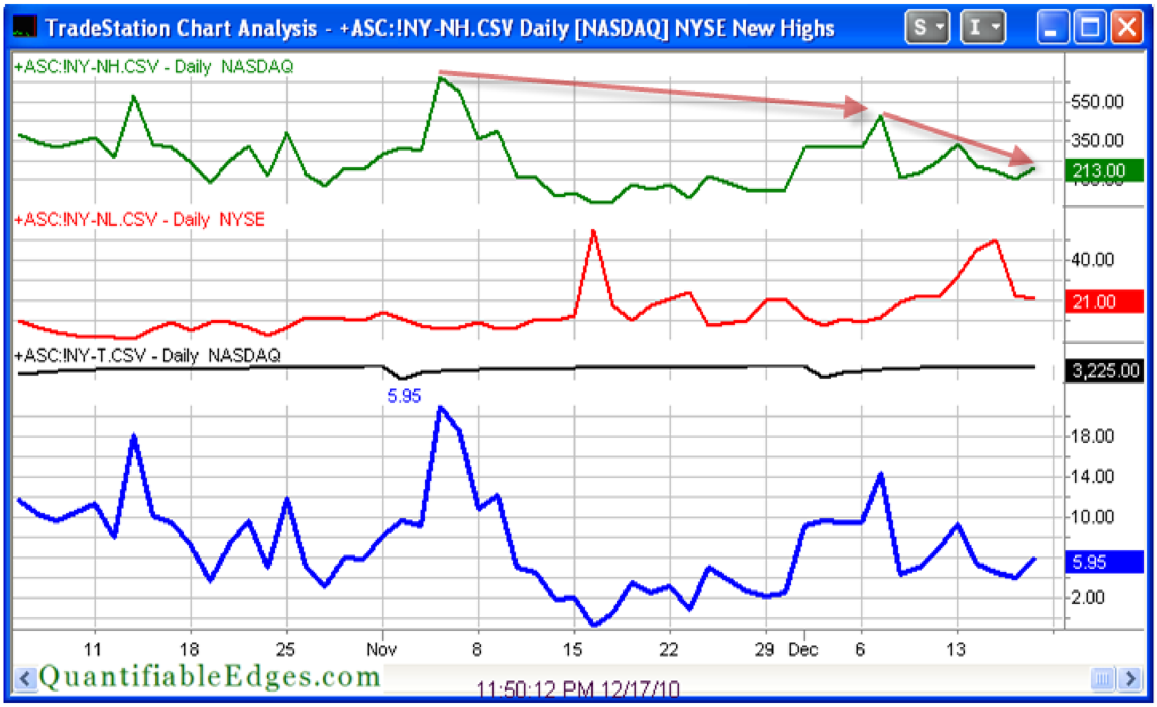
POMO volume and activity levels have pulled back a bit from last week but are still well above even the highest 1-month levels of 2009. I expect this will continue to act as a bullish influence on the market.

Another plus for the bulls is that the trend is obviously up. Momentum is positive as we hit a new closing high again on Friday.

The SPX/Nasdaq Relative Strength Weekly indicator as shown on the charts page is still favoring the Nasdaq. Since 1971 the SPX has made close to 100% of its gains when the Nasdaq has been leading. The Nasdaq lead is shrinking though and it is just barely outpacing the SPX at this point. The NDX Aggressive Trend Timer System which I show signals for on the systems page uses a similar relative strength method. It has turned flat and will not be going long at all this upcoming week.

The SPX is overbought by numerous measures. I discussed the overbought nature in last week's intermediate-term section. Bottom line is that it used to be a positive for the market up until the 80's. Since then it has not shown a significant edge either way.

Breadth is a bit of a concern. Below is the NYSE Net New Highs chart from the website. You'll note the new highs have making lower peaks since November. (And November's new highs were below April's new highs.)



We see a breadth divergence in place. And this isn't the only one. A breadth divergence is typically necessary for a top to occur, but a top doesn't have to occur just because there is a breadth divergence. Using divergences like this as timing tool is dangerous because such divergences can persist for many months and even up to 2 years before the major indices succumb. It does raise a yellow flag though. And though I am not a huge fan of the Hindenburg signal it is also suggesting a breadth warning.

Bond rates pulled back a bit on Friday but they are still a concern. The December 9th study that looked at other instances where SPX and TNX (10-yr rates) both hit new highs suggests bearish implications out over 2 months.

In fact from a studies standpoint the recent intermediate-term studies have all been bearish. Meanwhile the bullish intermediate-term studies have all been slowly expiring. Seasonality is expected to remain strong for the next 2 weeks but after that seasonal influences will go away as well.

So I still think there should be some more upside, but the closer we get to January the less clear the picture is for me. I'll continue to search for intermediate-term indications, but as of now my bullish outlook is beginning to fade.

Catapult and Capitulative Breadth Statistics

Catapult & CBI Presentation Link

Open Catapult Triggers

AXP – 1/3 @ $42.50 limit

Catapult for ETF's Trades

None

***Broad Market Large Cap CBI* – 1 (AXP)**

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.

AXP – buy 1/3 position @ $42.50 limit. This is a Catapult trade. Catapults have performed very well but have had significant volatility. If you haven't traded them before or would like a refresher I'd encourage you check out the *Catapult & CBI Presentation.*

SPY – buy 1/4 position @ $124.59 LIMIT ON CLOSE. Based on the short-term outlook above I'll be looking to go long on a pullback.

Current Open Trade Ideas

Symbol	Entry Date	Entry Price	Current Price	% Gain/Loss	Stop	Notes
SPY(1/4)	12/15/2010	$124.10	$125.25	0.93%		dividend adjusted price

SPY was exited on the close.