QUANTIFIABLE EDGES SUBSCRIBER LETTER

ASSESSING MARKET ACTION WITH INDICATORS AND HISTORY

December 22, 2010 Volume 3 Issue 246

Market Overview

Tonight's Research Points

- The next 5-8 days are very bullish from a seasonal standpoint – especially for smallcap and tech.
- SPX up and VIX up 2 days in a row has consistently been followed by short-term weakness.
- The Aggregator System is flat.
- The NDX Aggressive Trend Timer is flat.

Short-term Outlook

The Bottom Line

Mixed studies are putting expectations just mildly positive. The market is overbought. I'm looking for a pullback to buy into.

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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				
December 22, 2010	VIX up. SPX up & 50-high, twice.	1-3 days	Bearish	-1.50%
December 22, 2010	Twas 3 Nights Before Christmas	1-5 days	Bullish	1.90%
December 22, 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%
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 15, 2010	Gap up reverse down, but still pos twice	1-5 days	Bullish	2.20%
December 21, 2010	SPX up. VIX up on Monday. SPX>200	1 day	Bearish	

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

The Evidence

Tuesday saw the market gap higher in the morning and then slowly creep higher all day. The major indices all closed higher. The SPX gained 0.6%, the Nasdaq was up 0.7% and the Russell 2000 rose 1.0%. Breadth was solidly positive as the NYSE Up Issues % came in at 68% and the Up Volume % was 79%. Total was again holiday-week light.

For the 2nd day in a row several volume-related studies are triggering and for the 2nd day in a row I am going to ignore them. As I mentioned last night, the low volume is due to the holidays and not due to complacency on the part of traders.

What does appear significant and worth reviewing is the fact that the SPX and the VIX both rose for the 2nd day in a row. I last looked at this kind of scenario using a couple of studies in the 10/27/10 Subscriber Letter. I have updated those studies below.

This first one required the VIX and SPX to both be up the last 2 days and for the SPX to close above the 200ma.

SPX and VIX both close higher today and yesterday. SPX closes > 200ma. Buy SPX 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	-826.93	17	11	6	64.71	1,110.90	-2,174.47	0.51	0.94	-48.64
4	-5,268.64	17	8	9	47.06	954.83	-1,434.14	0.67	0.59	-309.92
3	-7,095.88	17	7	10	41.18	735.07	-1,224.14	0.60	0.42	-417.40
2	-6,796.35	17	5	12	29.41	626.71	-827.49	0.76	0.32	-399.79
1	-3,838.22	20	7	13	35.00	246.65	-428.06	0.58	0.31	-191.91
19 of 20 instances (95%) posted a close below the entry price at some point in the next 3 days. 3/10/10 was the lone outlier.										

Over the first 1-3 days there appears to be a substantial downside edge. And with only 1 instance failing to close below the entry price over the next 3 days, consistency is very strong. When I looked closer on 10/27 I found that the lion's share of the losses occurred when the SPX was not only above the 200ma, but it was at a 50-day high. This is shown below.

SPX and VIX both close higher today and yesterday. SPX closes at 50-day high. Buy SPX 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	-3,027.02	12	7	5	58.33	1,240.40	-2,341.97	0.53	0.74	-252.25
4	-6,377.73	12	5	7	41.67	1,091.19	-1,690.52	0.65	0.46	-531.48
3	-8,400.39	12	3	9	25.00	1,043.08	-1,281.07	0.81	0.27	-700.03
2	-5,288.16	12	4	8	33.33	688.12	-1,005.08	0.68	0.34	-440.68
1	-2,030.26	15	5	10	33.33	251.06	-328.56	0.76	0.38	-135.35
All 15 instances posted a close below the entry price at some point in the next 3 days.										

You don't get many bearish studies with 15-0 records that are concentrated during long-term uptrends. These stats are very compelling.

But not everything is pointing down tonight. Tuesday's close brings us now to the next extremely strong seasonal period. The last 2 years I have shown the 'Twas 3 Nights Before Christmas studies. They showed up in the Quantifinder Tuesday afternoon and

I'll review them again for the SPX, Russell 2000, and Nasdaq Composite below. First let's look at the SPX.

Buy SPX at close 3 trading sessions before Christmas. Sell X days later.
$100k/trade. 1987 - 2009.

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
10	30,315.29	23	17	6	73.91	2,623.89	-2,381.81	1.10	3.12	1,318.06
9	37,923.90	23	16	7	69.57	3,137.05	-1,752.70	1.79	4.09	1,648.87
8	43,553.68	23	17	6	73.91	2,883.71	-911.58	3.16	8.96	1,893.64
7	33,312.03	23	16	7	69.57	2,458.92	-861.54	2.85	6.52	1,448.35
6	24,129.14	23	15	8	65.22	2,067.67	-860.73	2.40	4.50	1,049.09
5	29,610.06	23	18	5	78.26	1,871.34	-814.81	2.30	8.27	1,287.39
4	20,089.78	23	15	8	65.22	1,755.60	-780.52	2.25	4.22	873.47
3	16,418.40	23	15	8	65.22	1,473.12	-709.81	2.08	3.89	713.84
2	14,829.24	23	17	6	73.91	1,109.47	-671.96	1.65	4.68	644.75
1	9,076.43	23	17	6	73.91	744.45	-596.55	1.25	3.54	394.63

22 of 23 instances (96%) closed above the entry price at some point in the next 5 trading days.

Results continue to look strong. A close above the entry has been a near certainty since 1987. But as I've discussed several times recently, smallcaps rule this time of year. First let's look at the Russell 2000.

Buy Russell 2000 at close 3 trading sessions before Christmas. Sell X days later.
$100k/trade. 1987 - 2009 (full history).

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
10	58,354.52	23	19	4	82.61	3,760.10	-3,271.87	1.15	5.46	2,537.15
9	64,538.83	23	19	4	82.61	3,939.51	-2,577.97	1.53	7.26	2,806.04
8	69,882.26	23	20	3	86.96	3,700.02	-1,372.71	2.70	17.97	3,038.36
7	61,278.12	23	22	1	95.65	2,867.62	-1,809.60	1.58	34.86	2,664.27
6	57,931.59	23	20	3	86.96	3,003.22	-710.91	4.22	28.16	2,518.76
5	49,580.94	23	20	3	86.96	2,562.05	-553.33	4.63	30.87	2,155.69
4	33,810.59	23	19	4	82.61	1,962.16	-867.61	2.26	10.74	1,470.03
3	27,769.84	23	19	4	82.61	1,532.11	-335.06	4.57	21.72	1,207.38
2	22,415.46	23	18	5	78.26	1,378.36	-479.00	2.88	10.36	974.59
1	12,050.27	23	18	5	78.26	797.35	-460.40	1.73	6.23	523.92

All 23 instances (100%) closed above the entry price at some point in the next 4 trading days.

Results are substantially stronger here. And the Russell has never gone without providing an opportunity for a winning trade on a closing basis. Now the Nasdaq.

Buy Nasdaq Composite at close 3 trading sessions before Christmas. Sell X days later. $100k/trade. 1987 - 2009.

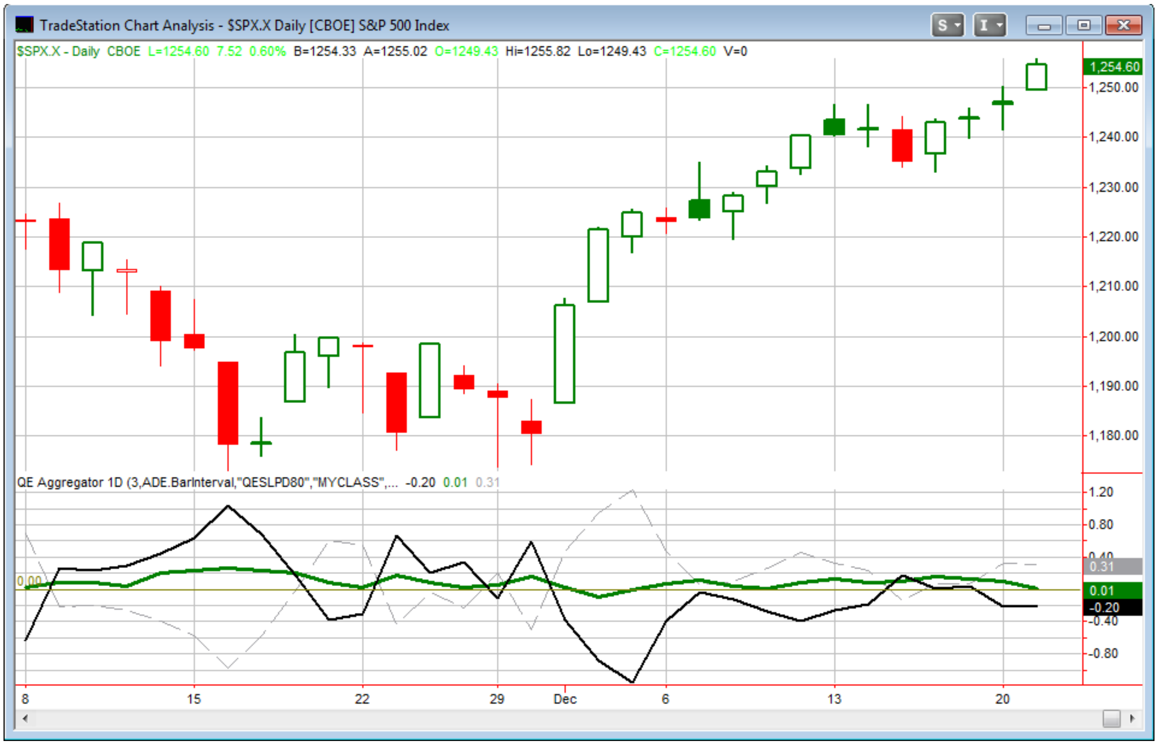
X Days	All: Net Profit	All: Total Trades	All: Winning Trades	All: Losing Trades	All: % Profitable	All: Avg Winning Trade	All: Avg Losing Trade	All: Win/Loss Ratio	All: ProfitFactor	All: Avg Trade
10	67,011.59	23	19	4	82.61	4,161.08	-3,012.24	1.38	6.56	2,913.55
9	74,322.36	23	19	4	82.61	4,365.00	-2,153.16	2.03	9.63	3,231.41
8	80,892.66	23	21	2	91.30	3,980.43	-1,348.19	2.95	31.00	3,517.07
7	49,201.65	23	17	6	73.91	3,229.98	-951.34	3.40	9.62	2,139.20
6	46,234.74	23	20	3	86.96	2,495.46	-1,224.83	2.04	13.58	2,010.21
5	45,397.04	23	18	5	78.26	2,674.89	-550.21	4.86	17.50	1,973.78
4	33,901.21	23	18	5	78.26	2,077.98	-700.50	2.97	10.68	1,473.97
3	28,854.69	23	18	5	78.26	1,757.92	-557.57	3.15	11.35	1,254.55
2	26,008.50	23	19	4	82.61	1,566.44	-938.49	1.67	7.93	1,130.80
1	13,547.22	23	19	4	82.61	887.78	-830.16	1.07	5.08	589.01

Since Nasdaq inception in 1971 the only year that the Nasdaq failed to close above the entry at some point within 5 days was 1986.

Over the last 23 years these are the strongest numbers of all. And only once since the inception of the Nasdaq did it go without some kind of move up in the following week.

So we have two strongly suggestive sides to the story tonight. We have a seasonality setup saying the market almost always goes up from here and VIX-related studies showing how the market almost always declines under these conditions. It can be tricky measuring such combative influences and it's something I generally leave up to the Aggregator.

I have updated the Aggregator chart below.



The VIX studies have caused the green Aggregator line to drop a bit. Still it managed to close just above 0. The positive value indicates the net expectation from the Active Studies over the next few days is for a slight move higher. But the black Differential line remains 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 remained flat at the close.

The green Aggregator line is set up to stay positive again tomorrow. This could change if strong bearish evidence emerges. Meanwhile the Differential Pivot will be 1,248.57. Any close at or below this level will turn the Differential line back to positive. This would require about a 0.5% drop from Tuesday's close.

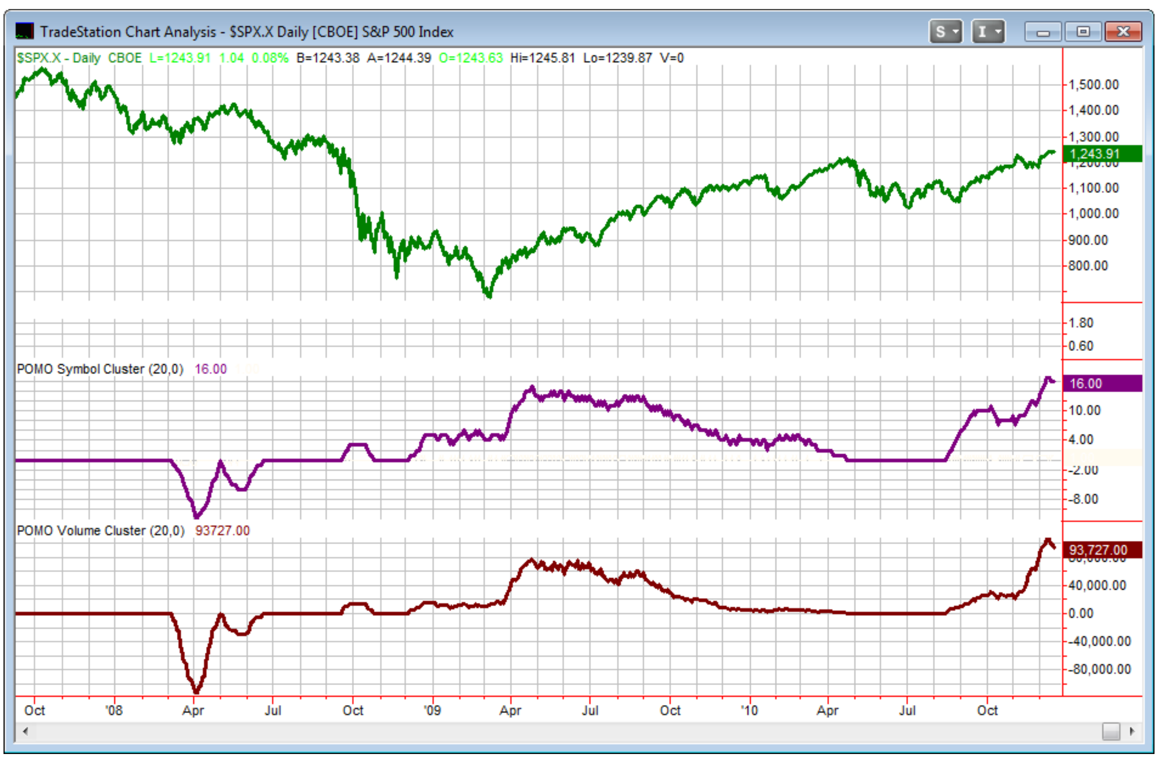
So the net result of all the Active Studies is a very slight edge to the bulls as far as expectations go. Of course the overbought nature of the market is keeping me sidelined for now. Should the VIX studies manage to win out over the next day or two it could set up a nice long entry. With the expectations likely to remain bullish this is what I'm hoping for. I'll look to start scaling long should we get a decent pullback tomorrow. And I'll be looking at smallcaps since they have a strong seasonal advantage.

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.



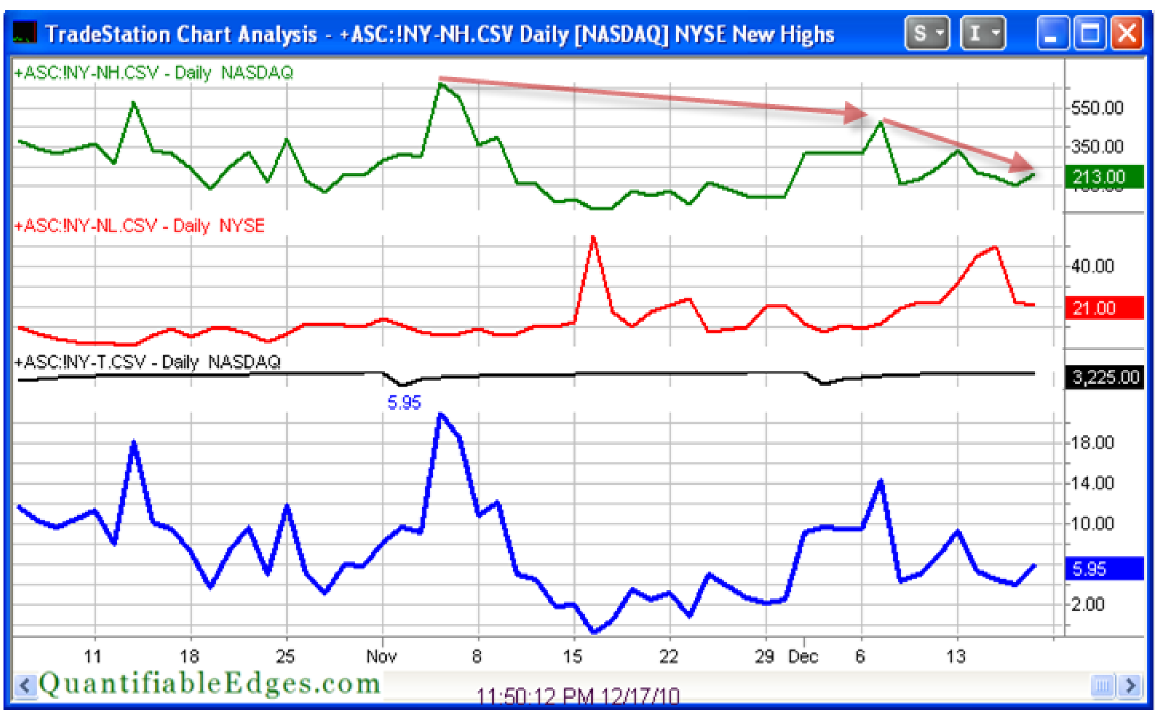
POMO volume and activity levels have pulled back a bit from last week but are still well above even the highest 1-month levels of 2009. I expect this will continue to act as a bullish influence on the market.

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.

<u>Catapult and Capitulative Breadth Statistics</u>

Catapult & CBI Presentation Link

Open Catapult Triggers

AXP – 1/3 @ $42.50 limit (not filled)

Catapult for ETF's Trades

None

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

<u>Additional New Trade Ideas</u>

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.

IWM – IF SPX closes < 1,248.58 then buy 1/4 index position in IWM @ $79.19 LIMIT ON CLOSE. Based on the short-term outlook above. The entry calls for a down close in IWM and an SPX close below the Differential pivot.

With the move up in AXP on Tuesday I am going to cancel the order there for now. Should it remain an active Catapult and pull back I will consider entry at that time.

<u>Current Open Trade Ideas</u>

None.

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