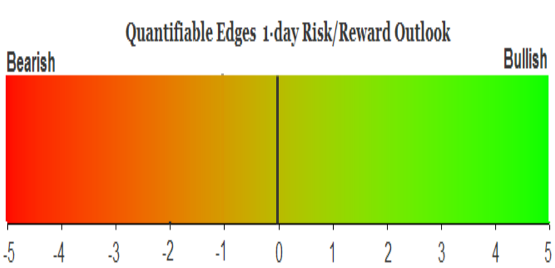
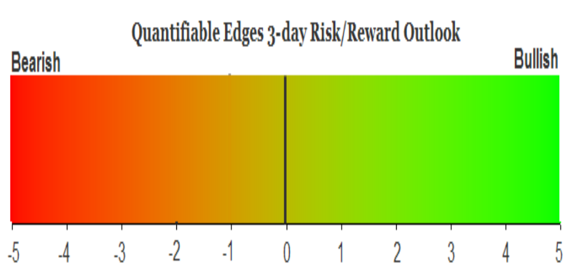
QUANTIFIABLE EDGES SUBSCRIBER LETTER

ASSESSING MARKET ACTION WITH INDICATORS AND HISTORY

December 27, 2010 | Volume 3 Issue 248

Market Overview





Tonight's Research Points

- SPX had its first down day after a persistent move up. Similar occurrences have typically been followed by more upside.
- POMO volume is again hitting a new high – a potentially bullish indication.
- NYSE New Highs are diverging – suggesting *some* caution.
- The Aggregator System is flat.
- The NDX Aggressive Trend Timer is flat.

Short-term Outlook

The Bottom Line

There still appears to be a bullish short-term edge. Despite the slight drop on Thursday the market is still a little overbought.

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 27, 2010	1 day drop after 5 up days.Close>200ma	1-10 days	Bullish	2.20%
December 23, 2010	2 Unfilled up gaps & 50-day high.	1-3 days	Bullish	1.00%
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%
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	
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 2, 2010	***2 90% Up Volume % days in 5 days***	***1-16 days***	***Bullish***	
December 22, 2010	VIX:VXV < 0.85. SPX 50-day high	1 day	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

Thursday was another low-range, holiday light-volume drift day. The only difference was that Thursday was the only day of the week that the market closed lower. Damage was small. The SPX, Nasdaq and Russell al declined about 0.2%. Breadth was a little negative as the NYSE Up Issues % came in at 48% and the Up Volume % was 36%. Total volume was extremely light ahead of the long Christmas weekend.

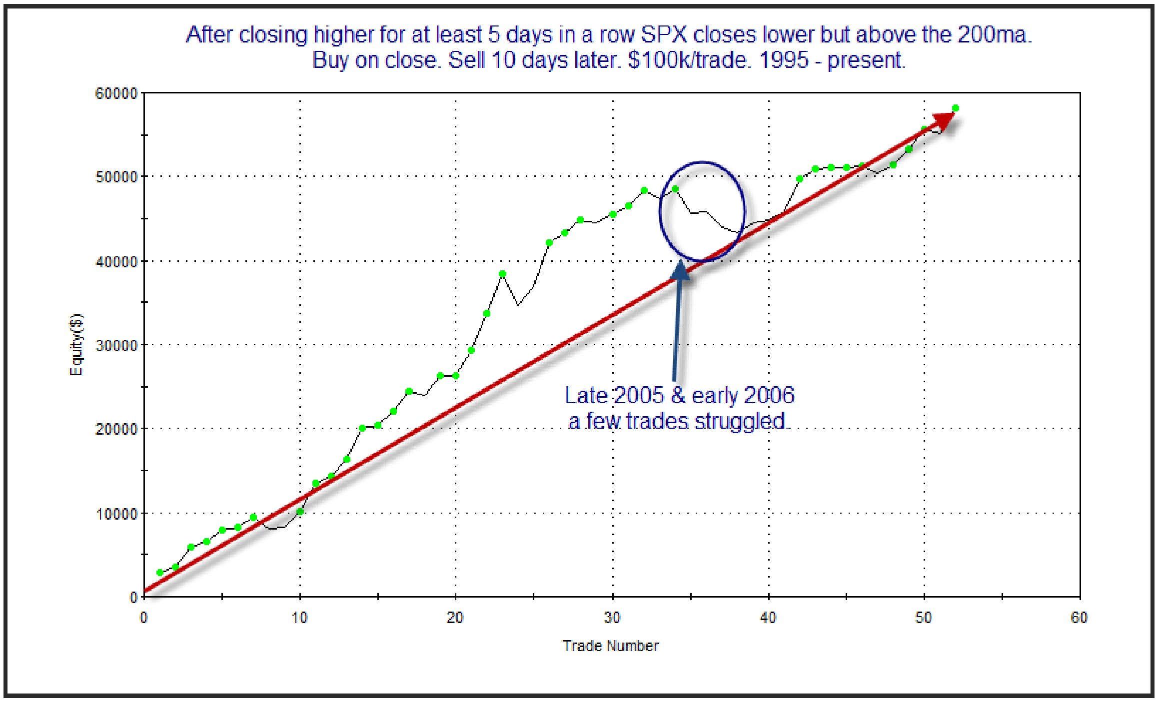
The Quantifinder came up with a few studies that showed little edge under current circumstances. One that was appealing was from the 12/16/10 Subscriber Letter. I've updated it below.

After closing higher for at least 5 days in a row SPX closes lower but above the 200ma.
Buy on close. Sell X days later. $100k/trade. 1995 - 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
10	58,147.58	52	42	10	80.77	1,709.37	-1,364.60	1.25	5.26	1,118.22
9	58,887.59	57	47	10	82.46	1,623.84	-1,743.29	0.93	4.38	1,033.12
8	50,953.53	58	40	18	68.97	1,866.54	-1,317.11	1.42	3.15	878.51
7	39,631.19	59	40	19	67.80	1,619.03	-1,322.63	1.22	2.58	671.72
6	39,782.39	62	42	20	67.74	1,542.09	-1,249.26	1.23	2.59	641.65
5	31,833.36	62	41	21	66.13	1,284.72	-992.39	1.29	2.53	513.44
4	29,330.41	62	39	23	62.90	1,253.23	-849.81	1.47	2.50	473.07
3	13,771.25	62	37	25	59.68	1,012.39	-947.49	1.07	1.58	222.12
2	7,957.46	62	37	25	59.68	842.92	-929.23	0.91	1.34	128.35
1	4,225.42	62	37	24	59.68	532.57	-644.98	0.83	1.27	68.15

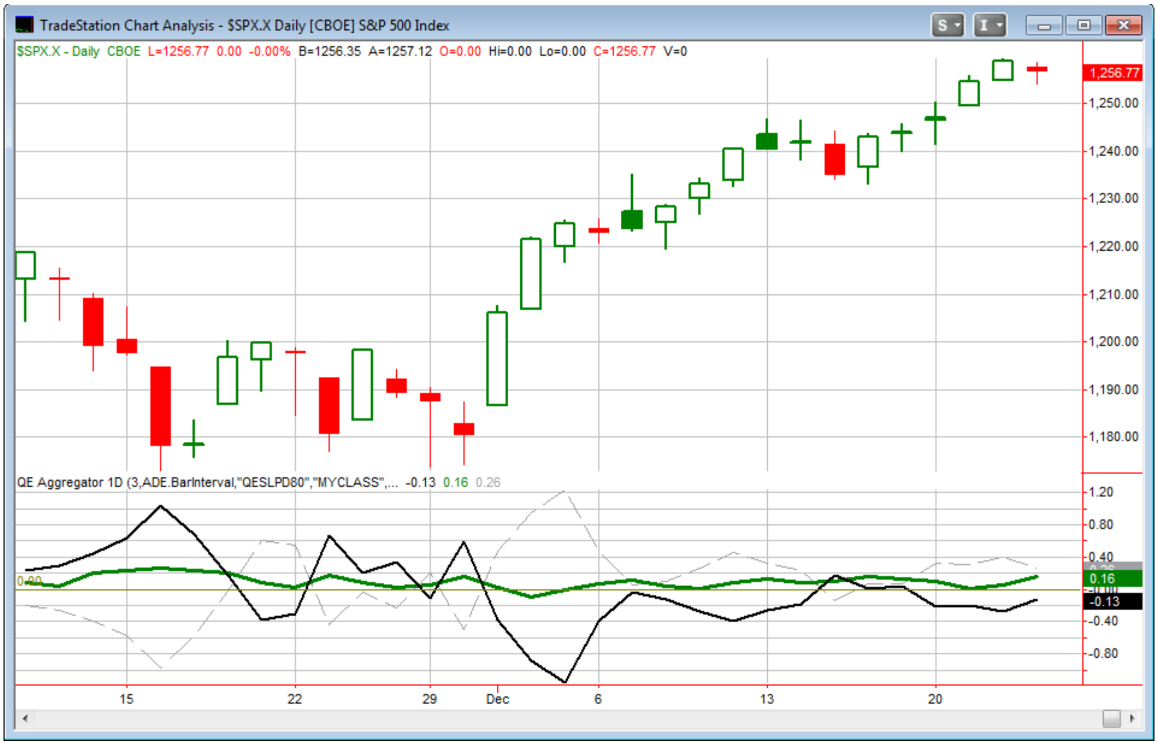
54 of 62 instances (87%) close above the entry price at some point in the next week.

It's not the highest percentage play over the first few days, but once you look out 9-10 days it appears very consistent. I believe the reason for this is based on an idea I've demonstrated a number of times before: persistent moves higher rarely end abruptly. You are more likely to see either a continuation of the move or at least some chop before a substantial decline. Below is an equity curve using a 10-day exit.



Aside from the brief drawdown I've circled above performance has been quite steady. I've included this study on the Active List.

I have updated the Aggregator chart below.



Tonight's bullish study helped to lift the green Aggregator line a little higher above 0. The positive value indicates the net expectation from the Active Studies over the next few days is for a move higher. Meanwhile 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. A neutral configuration occurs whenever both lines are on opposite sides of 0. Due to this the Aggregator System remained flat at the close.

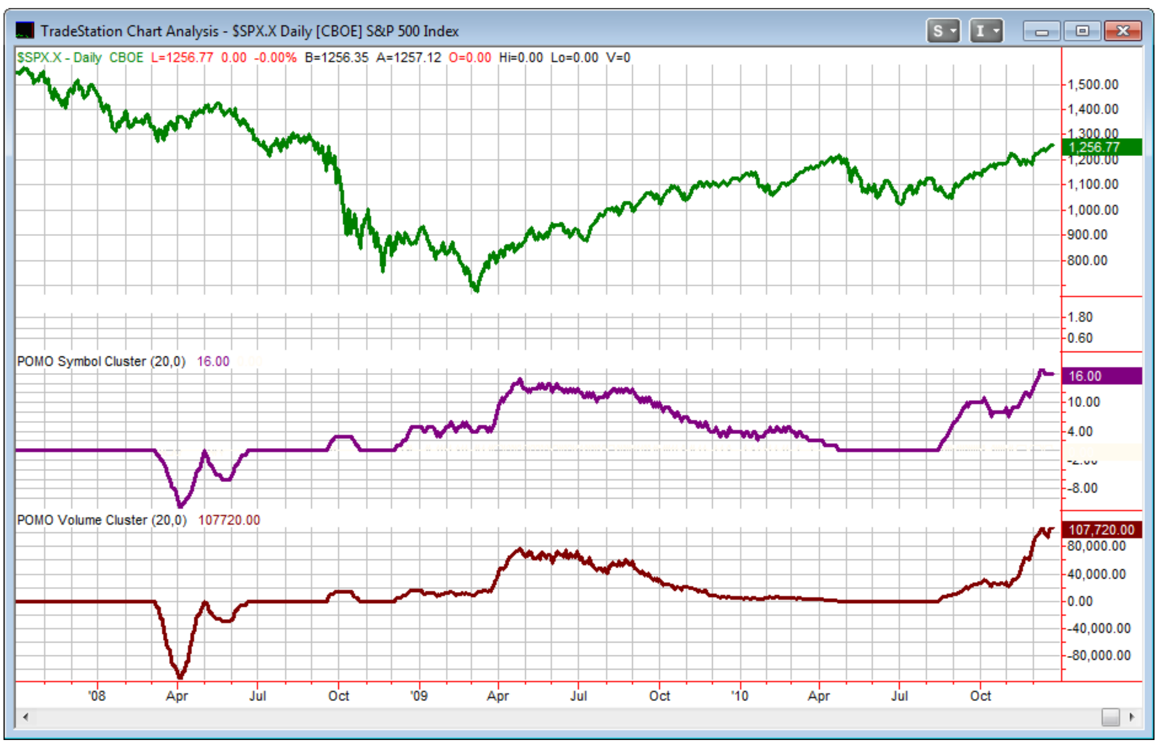
The green Aggregator line is set up to stay positive again tomorrow. This could change if strong bearish evidence emerges. Meanwhile the Differential Pivot will be 1,257.63. This is about 1 point above Thursday's close. So the SPX will again be considered "underperforming" unless it closes at least a point higher on Monday. A flat or down close would see the Differential line turn positive and would probably trigger a long Aggregator System signal.

I've been looking for a pullback to get long the last several days. I'll put a small order out there again for Monday's close should the market close lower.

Intermediate-term Outlook (2 weeks – 2 months)– updated 12/27 – slightly bullish
Intermediate-term indications are becoming more mixed, but the market is continuing to grind higher.

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.



20-day POMO volume hit a new high again at the end of this week and the number of days remains extremely high. I expect this will continue to act as a bullish influence on the market.

Over the last several weeks I have also been noting the divergence in the number of 52-week highs while the market indices are making new highs. I've mentioned that divergences like this are not great timing tools but they do raise a yellow flag. This week I thought I'd take a more detailed look at why I've been saying that.

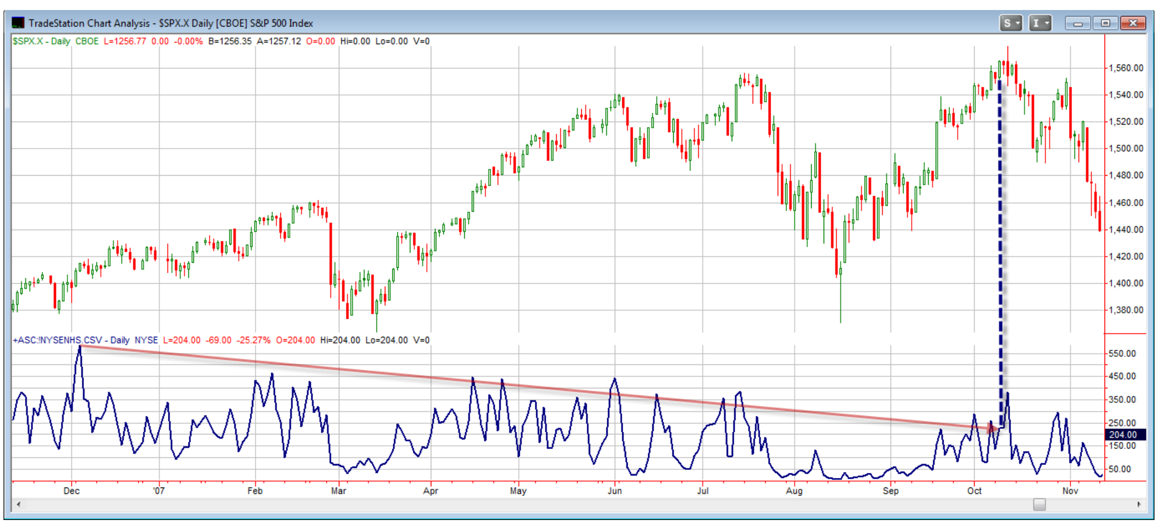
You may read some articles over the next few weeks or months that will claim such a divergence will inevitably lead to a large market decline. "Proof" might even be offered by showing you times where the market has tanked after such divergences have taken place.

I ran some studies examining other times there were divergences of similar magnitude to the current one. I laid out the parameters as follows:

1) The SPX must make a high today that is at least 3% higher than the last time the number of NYSE New Highs made a 200-day high.
2) The number of NYSE New Highs today must be less than 40% of the previous NYSE New Highs number. It won't look back for more than a year.

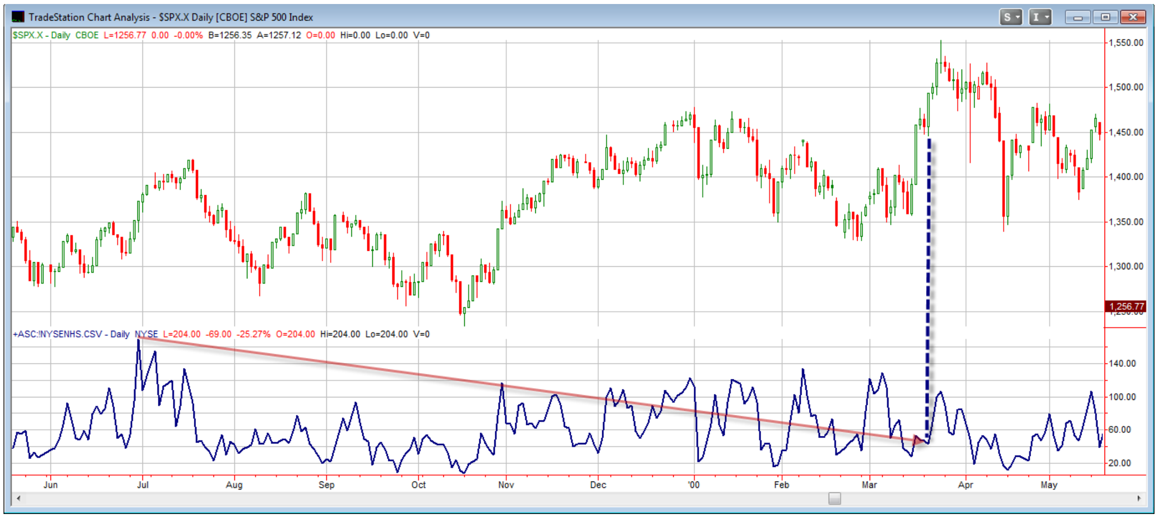
This setup would have triggered on Wednesday. Let's first look at some that bearish prognosticators could point to as "proof".

Here is the 2007 instance:



This almost exactly called the 2007 top.

Here is an instance from 2000:



Again we see another big market top occur within a few days of such a significant divergence.

But what if we look at all the results in a results table? This table goes back to 1970.

QE NHs lag on rally: daysin	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
100	42,098.95	25	13	12	52.00	9,843.85	-7,155.93	1.38	1.49	1,683.96
90	16,672.65	26	13	13	50.00	8,553.26	-7,270.75	1.18	1.18	641.26
80	26,350.72	26	15	11	57.69	6,432.79	-6,376.46	1.01	1.38	1,013.49
70	24,643.25	27	15	12	55.56	6,716.09	-6,341.51	1.06	1.32	912.71
60	32,266.23	28	16	12	57.14	5,544.12	-4,703.31	1.18	1.57	1,152.37
50	35,717.49	31	17	14	54.84	5,704.29	-4,375.38	1.30	1.58	1,152.18
40	41,638.42	35	19	16	54.29	5,087.74	-3,439.29	1.48	1.76	1,189.67
30	1,076.55	38	23	15	60.53	3,160.66	-4,774.58	0.66	1.02	28.33
20	9,460.70	46	28	18	60.87	2,951.98	-4,066.38	0.73	1.13	205.67
10	4,309.88	55	31	24	56.36	1,760.57	-2,094.50	0.84	1.09	78.36

There's a fair amount of overlap as you move out from 10 to 100 days, but you are generally looking at a 50-50 proposition and very slight net gains. No edge is suggested. Below is a list of recent instances going back to 1983. This assumes the 50-day exit.

Date/Time	Signal	Price	% Profit	Run-up DrawDown
10/10/83	Buy	$172.64	(6.16%)	$138.96
12/20/83	Sell	$162.00		($6,971.16)
11/11/85	Buy	$197.28	3.53%	$8,748.74
01/23/86	Sell	$204.25		($202.40)
05/28/86	Buy	$246.63	(3.89%)	$2,656.80
08/07/86	Sell	$237.03		($5,961.60)
08/27/86	Buy	$253.30	(2.94%)	$327.02
11/06/86	Sell	$245.86		($9,936.68)
12/03/86	Buy	$253.85	10.18%	$11,165.13
02/13/87	Sell	$279.69		($4,943.94)
06/16/87	Buy	$304.76	9.78%	$10,863.36
08/26/87	Sell	$334.57		($731.44)
10/09/89	Buy	$359.80	(4.82%)	$174.51
12/19/89	Sell	$342.45		($9,052.36)
01/03/90	Buy	$358.76	(5.77%)	$0.00
03/15/90	Sell	$338.07		($10,822.54)
05/29/90	Buy	$360.64	(6.18%)	$2,531.78
08/08/90	Sell	$338.35		($7,875.11)
11/27/92	Buy	$430.15	3.53%	$4,614.48
02/09/93	Sell	$445.33		($760.96)
12/29/93	Buy	$470.58	(1.42%)	$2,601.24
03/10/94	Sell	$463.90		($2,736.92)
09/21/95	Buy	$582.99	4.11%	$4,394.70
12/01/95	Sell	$606.98		($1,956.24)
09/20/96	Buy	$687.01	10.12%	$10,890.95
12/02/96	Sell	$756.53		($870.00)
05/15/97	Buy	$841.88	11.23%	$12,244.86
07/28/97	Sell	$936.45		($1,825.46)
02/03/98	Buy	$1,005.99	10.16%	$12,474.00
04/16/98	Sell	$1,108.17		($649.44)
04/22/98	Buy	$1,130.50	1.41%	$1,589.28
07/02/98	Sell	$1,146.45		($4,937.68)
07/02/98	Buy	$1,146.45	(10.18%)	$3,839.31
09/14/98	Sell	$1,029.70		($17,961.15)
02/24/99	Buy	$1,253.41	6.27%	$9,342.54
05/06/99	Sell	$1,332.05		($2,953.02)
03/21/00	Buy	$1,493.82	(3.01%)	$3,897.30
06/01/00	Sell	$1,448.80		($10,191.72)
12/14/05	Buy	$1,272.74	0.62%	$1,936.74
02/28/06	Sell	$1,280.66		($2,106.00)
03/14/06	Buy	$1,297.48	(3.00%)	$2,249.94
05/24/06	Sell	$1,258.57		($4,014.78)
05/15/07	Buy	$1,501.19	(1.23%)	$3,610.86
07/26/07	Sell	$1,482.66		($2,368.74)
10/09/07	Buy	$1,565.15	(7.17%)	$689.22
12/19/07	Sell	$1,452.99		($10,020.15)

You can see much of the rally during the late 90s occurred on narrowing breadth. Divergences such as the one we are seeing can last for close to 2 years before becoming a problem. Bottom line is that it's not encouraging to see new highs contracting, and if it doesn't correct itself it may eventually lead to a market correction, but it is a poor timing tool and not a sign of impending doom.

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

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 continues to shrink though and it is just barely outpacing the SPX at this point.

Bond rates 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.

Intermediate-term studies lately have begun to turn bearish. We have one more week of strong seasonality and then the market will no longer have that wind at its back.

Of course the final arbiter is price. Until price starts to roll over it is highly unlikely I will turn outright bearish. For now I'll lean slightly to the bull side. I'm certainly open to trading both sides of the market here, though.

Catapult and Capitulative Breadth Statistics

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)**

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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.

SPY – buy @ $125.59 LIMIT ON CLOSE. Based on short-term outlook above.

Current Open Trade Ideas

None.