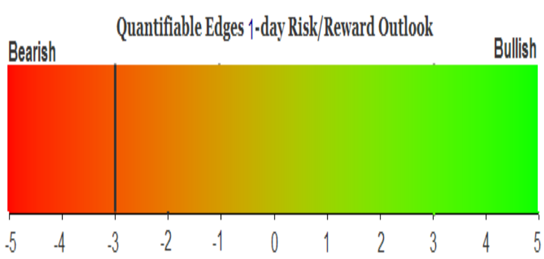
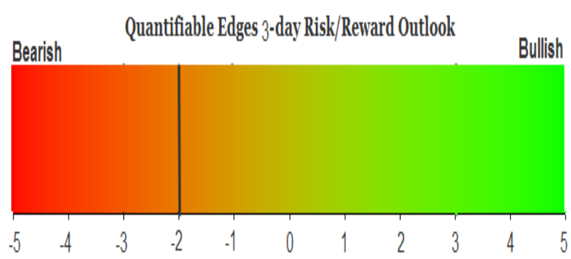
QUANTIFIABLE EDGES SUBSCRIBER LETTER

ASSESSING MARKET ACTION WITH INDICATORS AND HISTORY

January 6, 2011 Volume 4 Issue 4

Market Overview





Tonight's Research Points

- The spy pattern of a gap below the low of two days ago and then a reversal to close at a 50 day high suggests bearish implications.
- The low VIX: VXV ratio with the SPX at a high level suggests elevated risk.
- The Aggregator System is short.
- The NDX Aggressive Trend Timer is flat.

Short-term Outlook

The Bottom Line

The outlook is has quickly switched to bearish, and I am looking to take advantage of it.

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				
January 6, 2011	SPY gap below 2 ago low then 50-high	1-3 days	Bearish	-3.00%
January 6, 2011	VIX:VXV < 0.85 & SPX 50-day high	1 day	Bearish	
January 5, 2011	SPX down from high. RUT dn 1% more.	1-3 days	Bullish	3.00%
January 3, 2011	SPX down last 2 days of up quarter	1-8 days	Bullish	2.90%
December 27, 2010	1 day drop after 5 up days.Close>200ma	1-10 days	Bullish	2.20%
Active - Long Term				
January 4, 2011	SPX up 1st day of year	1-13 days	Bearish	
January 3, 2011	SPX down last 2 days of up quarter	1-15 days	Bullish	
December 30, 2010	SPX closes > 10ma every day of month	1 month	Bullish	
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	
Dropped Tonight				
December 30, 2010	2 Days of gap, reverse but positive close	1-5 days	Bullish	2.20%

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

The Evidence

After gapping down to start the day the market rallied right from the opening bell, and never suffered much of a pullback, finishing near its highs. The SPX gained 0.5%, the NASDAQ gained 0.8%, and the Russell 2000 rose 1.2%. Breadth was positive, but not in a very big way. The NYSE Up Issues % finished at 58% and the Up Volume % was 70%. Total NYSE volume dipped to the lowest level of the week.

Some interesting studies appeared in the Quantifinder tonight that looked at the gap-down and reverse-up to a new high pattern that has appeared in the SPY. They were last shown in the 4/9/10 Subscriber Letter. Results have not changed since the pattern did not trigger in April, and has not triggered since last January. They are shown again below, but with a bit more detail than I showed in April.

SPY gaps down and closes below the low of 2 days ago. It then closes at a 50-day high.
Buy on close. Sell X days later. $100k/trade. 1997 - 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	-16,583.15	9	2	7	22.22	790.02	-2,594.74	0.30	0.09	-1,842.57
4	-18,429.87	9	0	9	0.00	0.00	-2,047.76	0.00	0.00	-2,047.76
3	-20,696.73	9	1	8	11.11	648.97	-2,668.21	0.24	0.03	-2,299.64
2	-13,174.37	9	1	8	11.11	444.50	-1,702.36	0.26	0.03	-1,463.82
1	-10,035.66	9	0	9	0.00	0.00	-1,115.07	0.00	0.00	-1,115.07

Results here are strongly suggestive of a downside edge. All 9 instances closed lower off of their 50-day high the very next day, and by an average amount of more than 1%. Three and four days out the average trade showed losses of over 2%. Such sizable and consistent downside results are rarely found when the market is hitting an intermediate-term high. Instances are a bit low, though, so I decided to take a look at them in more detail below.

SPY gaps down and closes below the low of 2 days ago. It then closes at a 50-day high. Buy on close. Sell X days later. $100k/trade. 1997 - present.				
Date/Time	**Signal**	**Price**	**% Profit**	**Run-up DrawDown**
05/30/97	Buy	$85.28	(0.60%)	$257.84
06/05/97	Sell	$84.77		($1,406.40)
04/17/98	Buy	$112.38	(0.36%)	$942.34
04/23/98	Sell	$111.97		($560.07)
03/18/99	Buy	$132.25	(4.04%)	$287.28
03/24/99	Sell	$126.91		($5,004.72)
01/19/00	Buy	$147.00	(3.44%)	$0.00
01/25/00	Sell	$141.94		($5,440.00)
01/26/04	Buy	$115.87	(2.06%)	$0.00
01/30/04	Sell	$113.48		($2,856.53)
10/06/04	Buy	$114.62	(1.82%)	$0.00
10/12/04	Sell	$112.53		($2,336.96)
05/09/07	Buy	$151.16	(0.39%)	$330.50
05/15/07	Sell	$150.57		($1,249.29)
05/06/08	Buy	$142.05	(1.12%)	$0.00
05/12/08	Sell	$140.46		($2,530.80)
01/19/10	Buy	$115.06	(4.60%)	$0.00
01/25/10	Sell	$109.77		($5,187.93)
Avg Run-up: $202		Avg Drawdown: $2,953		

What really sticks out when looking at the individual occurrences is the run-up versus the drawdown. I can't recall another study with statistics in this column being so lopsided. The max drawdown is more than 5 1/2 times the size of the max run-up. In fact, the *average* drawdown was more than 3 times the size of the max run-up. And when you compare the average drawdown to the average run-up, you're looking at a 15:1 ratio!

With the low number of instances, I decided to also run the study again and loosen the new-high requirement from 50 days to 20 days.

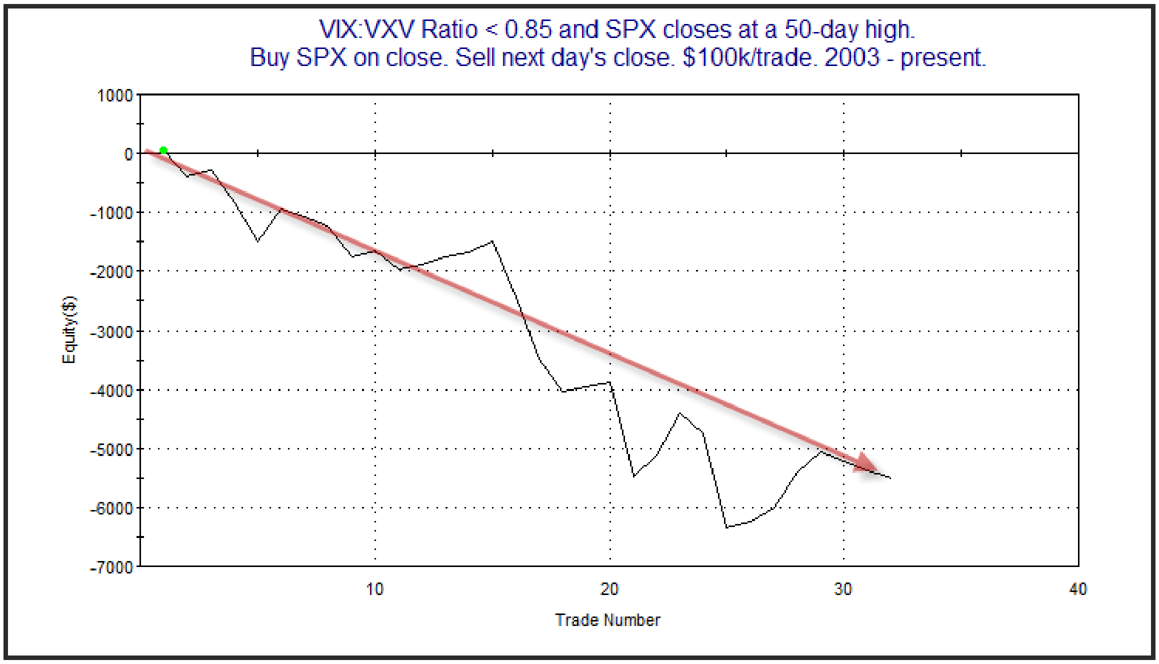
SPY gaps down and closes below the low of 2 days ago. It then closes at a 20-day high. Buy on close. Sell X days later. $100k/trade. 1997 - present.										
X Days	All: Net Profit	All: Total Trades	All: Winning Trades	All: Losing Trades	All: % Profitable	All: Avg Winning Trade	All: Avg Losing Trade	All: Win/Loss Ratio	All: ProfitFactor	All: Avg Trade
5	-18,172.53	16	5	11	31.25	1,199.11	-2,197.10	0.55	0.25	-1,135.78
4	-24,653.09	16	3	13	18.75	1,065.08	-2,142.18	0.50	0.11	-1,540.82
3	-25,032.80	16	4	12	25.00	1,038.78	-2,432.33	0.43	0.14	-1,564.55
2	-14,786.82	16	4	12	25.00	743.91	-1,480.21	0.50	0.17	-924.18
1	-9,257.34	16	3	13	18.75	789.65	-894.33	0.88	0.20	-578.58
15 of 16 instances (94%) closed below the entry price at some point in the next 4 days.										

Stats here continue to impress. No matter how I look at it, the evidence clearly suggests a short-term bearish edge.

The low VIX:VXV Ratio with the SPX again at a 50-day high once again triggered the study below, which I just recently showed in the 12/30/10 letter. I have updated it once again tonight.

VIX:VXV Ratio < 0.85 and SPX closes at a 50-day high. Buy SPX on close. Sell next day's close. $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	-2,378.17	18	11	7	61.11	666.39	-1,386.92	0.48	0.76	-132.12
4	-3,900.57	19	9	10	47.37	573.57	-906.27	0.63	0.57	-205.29
3	-3,162.03	21	12	9	57.14	489.53	-1,004.04	0.49	0.65	-150.57
2	-4,294.99	24	9	15	37.50	524.36	-600.95	0.87	0.52	-178.96
1	-5,501.95	32	16	16	50.00	236.31	-580.18	0.41	0.41	-171.94

The numbers aren't overwhelming but they do seem to suggest caution. Most of the downside edge is exhausted in the first day or two. Below is an equity curve using a one-day exit strategy.



While the edge hasn't played out as well recently, it still seems to suggest a bearish inclination.

I have updated the Aggregator chart below.

Tonight's strongly bearish studies caused an unusually sharp drop in the green Aggregator line. It is now well below zero. The negative value indicates the net expectation from the Active Studies over the next few days is for a move lower. Meanwhile the black Differential line is still below 0. The negative value means the SPX has outperformed expectations over the last few days. So net expectations are for downside and the SPX is overbought. This is considered a bearish configuration. Bearish configurations occur whenever both lines are below 0. Due to this the Aggregator System changed to short at the close.

The green Aggregator line tomorrow is set up to remain below 0. Of course this could change if enough bullish evidence emerges. Meanwhile the Differential Pivot will rise to 1280.75. This is about 0.3% above Wednesday's close. So the Differential line will move back above zero and the SPX will be considered "underperforming" expectations unless it manages to close at least as high as the stated 1280.75 level.

The short-term outlook is therefore bearish, but without a continued move higher this outlook is unlikely to persist. I will be looking to take advantage of a move lower in the next day or two.

Intermediate-term Outlook (2 weeks – 2 months)– updated 1/3 – neutral to slightly bullish

The intermediate-term outlook has not changed. If you'd like to see it you may use the link below to view the 1/3/11 Letter.

2011-01-03 QE Subscriber Letter.pdf

Catapult and Capitulative Breadth Statistics

Catapult & CBI Presentation Link

Open Catapult Triggers

none

Catapult for ETF's Trades

None

***Broad Market Large Cap CBI* – 0**

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 – short ¼ index position @ $127.60 LIMIT. If not filled in the first half-hour, then cancel order. Based on short-term outlook above. With the differential pivot so high, I want to avoid shorting into a late day rebound since the short signal would be likely to come off at the close.

SPY – short ¼ index position @ $128.00 LIMIT ON OPEN. If not filled at the open, cancel order. Should the market gap higher I will look to take advantage of the higher selling price and enter another lot short. Incidentally after writing this order for the second lot I decided to check the gap guides on Scott Andrews' Master the Gap site. They seemed to support the idea that a gap higher would be likely to reverse as gap probabilities and profit factors both appeared relatively strong for someone looking to fade an up gap with a downside gap fill target.

If the market closes at or below $127.60 I will cover all open SPY lots on the close. Also there is a possibility I will send out intraday updates tomorrow with stop prices if the market seems to be working its way lower.

Traders who would rather go for a multi-day trade could consider one of the stocks or ETF's triggering system -80514 on the triggers page.

Current Open Trade Ideas

None.