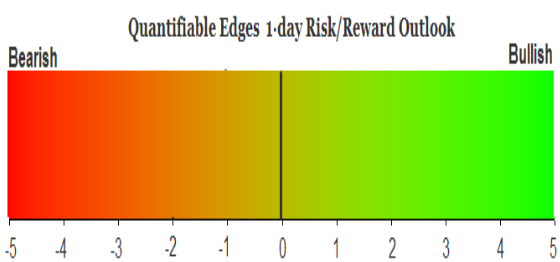
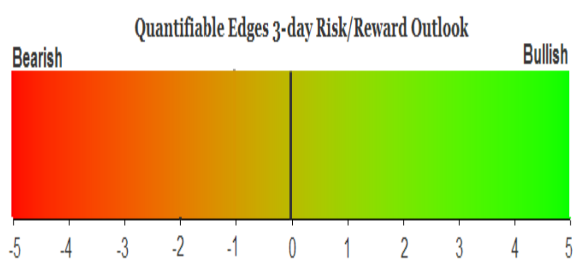
QUANTIFIABLE EDGES SUBSCRIBER LETTER

ASSESSING MARKET ACTION WITH INDICATORS AND HISTORY

July 11, 2011 Volume 4 Issue 131

Market Overview





Signals Overview

Aggregator	Aggressive VIX	Conservative VIX	NDX Trend Timer
Flat	50% Long XIV	Flat	Flat

Tonight's Research Points

- Island tops appear to have bearish short-term potential.
- Large unfilled gaps on employment report days are often followed by more selling.
- Unfilled gaps down on Fridays often bounce on Mondays.
- Very poor breadth and very low volume on the same day is often followed by positive returns.
- QE2 is done and the POMO indicators are dropping.

Short-term Outlook

The Bottom Line

The Aggregator is neutral and I'm mostly sidelined. I'm waiting for a more clearly defined edge and favorable entry point before committing new capital.

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Summary of Recent Active Studies (see Letters from listed dates for details)

Study Date	Description	Time span	Bias	Avg Max Move
Active				
July 11, 2011	Island Top	1-8 days	Bearish	-2.40%
July 11, 2011	Worst breadth & volume in 3 weeks	1-4 days	Bullish	1.90%
July 11, 2011	Unfilled Friday Gap	1 day	Bullish	
July 5, 2011	3 days higher. Up vol % > 90% today.	1-7 days	Bullish	2.90%
July 5, 2011	5 days higher. >200 & < 50-high	1-10 days	Bullish	2.00%
Active - Long Term				
July 5, 2011	POMO over	int term	Bearish	
July 5, 2011	3 days higher. Up vol % > 90% today.	1-20 days	Bullish	5.00%
June 22, 2011	FTD with Up Issues % 1-yr Rank > 95%	int term	Bullish	
May 31, 2011	4 Weeks Down. Close > 40ma.	1-10 weeks	Bullish	9.00%
March 22, 2011	3 Days Up Issues % > 70%	8 months	Bullish	19.00%
October 25, 2010	SPX Golden Cross	int term	Bullish	
Dropped Tonight				
July 8, 2011	***8-day Avg. SPY closing range > 75***	***1-2 days***	***Bearish***	***-1.40%***
July 7, 2011	SPY 10-high on 20-day volume low	1-2 days	Bearish	-1.10%

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

The Evidence

Most of the action on Friday occurred before the open. Thursday’s employment reports looked positive but Friday morning’s numbers came out negative. This caused futures to drop nearly 20 points almost immediately. It also caused a big gap down at the open. After a little of wiggling around throughout the day the market rallied for the last ½ hour and finished near its highs, though those highs were still well below the lows of Thursday. The final numbers saw the SPX down 0.7%, the Nasdaq down 0.5% and the Russell 2000 lost 0.6%. While the losses weren’t terribly large, breadth was bad. The NYSE Up Issues % came in at 30% and the Up Volume % was just 17%. Total NYSE volume came in at the lowest level since the Friday before Memorial Day.

Friday's inability to trade even as high as Thursday's lows in the SPY created an “island" formation on the SPY chart. This is because Thursday's trading occurred completely above both Wednesday’s and Friday’s highs. Island formations can sometimes take longer than three days to form, but the 3-day variety is often the easiest to identify. Candlestick chartists believe an island formation that occurs after a run-up in prices is a bearish sign. Unfortunately, I have found when looking at the major indices, 3-day island formations are extremely rare. SPY has never had a 3-day island formation at a 20-day high. The only other time it posted a 3-day island formation at a 10-day high was 10/16/95. QQQ has *never* posted a 3-day island formation of a 10-day high. So from an index standpoint, we really have nothing to go on that would show just how bearish, if at all, this formation is. So to test it I had to loosen the parameters a bit.

In the 5/12/11 Subscriber Letter I looked at other instances where the SPY posted an unfilled gap down after an unfilled gap up. In that test I simply looked at whether price reached the previous day's close, rather than the previous day's low for the gap down and the previous day’s high for the gap up. I also incorporated a 200ma filter. By adjusting the gap requirement in this way you can see there were a good number of instances. Updated results for this study can be seen in the table below.

SPY posts an unfilled (closing) gap down after an unfilled (closing) gap up. Close > 200ma.
Buy on close. Sell X days later. $100k/trade. 1993 - 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	-3,614.13	50	22	28	44.00	2,292.52	-1,930.35	1.19	0.93	-72.28
9	-12,826.18	50	22	28	44.00	2,109.76	-2,115.75	1.00	0.78	-256.52
8	-14,725.50	50	22	28	44.00	1,894.36	-2,014.34	0.94	0.74	-294.51
7	-13,756.19	50	21	29	42.00	1,988.87	-1,914.57	1.04	0.75	-275.12
6	-15,646.02	51	24	27	47.06	1,509.60	-1,921.35	0.79	0.70	-306.78
5	-16,430.89	53	22	31	41.51	1,527.05	-1,613.74	0.95	0.67	-310.02
4	-11,431.56	54	23	31	42.59	1,355.38	-1,374.37	0.99	0.73	-211.70
3	-27,678.13	56	23	33	41.07	1,134.43	-1,629.40	0.70	0.49	-494.25
2	-20,026.19	57	24	32	42.11	848.23	-1,261.99	0.67	0.50	-351.34
1	250.47	57	29	27	50.88	619.53	-656.14	0.94	1.01	4.39

Results here appear to suggest a short-term bearish edge. This test didn't include a requirement that the market was making an intermediate-term high. This is considered an important factor when evaluating island formations, so I added a 20-day high requirement to this test. Results after doing this can be seen below.

SPY posts an unfilled (closing) gap down after an unfilled (closing) gap up. Yest was the highest close in 20 days. Close > 200ma. Buy on close. Sell X days later. $100k/trade. 1993 - 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	-13,825.22	22	6	16	27.27	1,688.31	-1,497.19	1.13	0.42	-628.42
9	-14,694.90	22	8	14	36.36	1,529.51	-1,923.64	0.80	0.45	-667.95
8	-13,415.23	22	8	14	36.36	1,336.94	-1,722.20	0.78	0.44	-609.78
7	-11,239.56	22	7	15	31.82	1,641.73	-1,515.44	1.08	0.51	-510.89
6	-9,779.35	22	7	15	31.82	1,351.22	-1,282.52	1.05	0.49	-444.52
5	-6,235.84	22	9	13	40.91	1,195.88	-1,307.60	0.91	0.63	-283.45
4	-6,823.45	23	9	14	39.13	1,054.18	-1,165.08	0.90	0.58	-296.67
3	-5,155.34	23	8	15	34.78	1,060.18	-909.12	1.17	0.62	-224.15
2	-4,134.14	24	10	14	41.67	564.52	-698.53	0.81	0.58	-172.26
1	-1,673.97	24	12	12	50.00	561.49	-700.99	0.80	0.80	-69.75

21 of 24 instances (87.5%) closed below the entry price at some point in the next week. All but one did in the next 2 weeks.

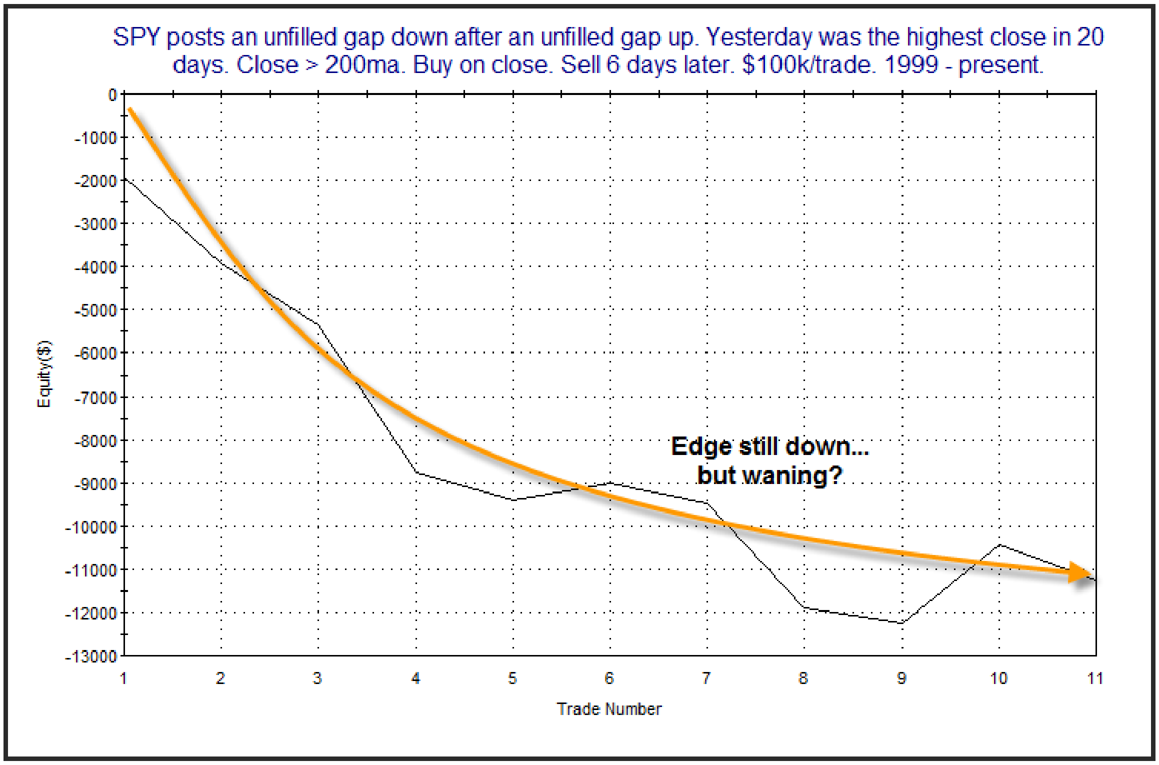
Factoring in the intermediate-term high appears to lengthen the short-term edge. Rather than maxing out after three days, bearish inclinations appeared to persist for up to 2 weeks. I did notice when examining results in more detail that the downside edge wasn't easily apparent prior to 1999. So I reran the above test just looking at the period from 1999-present.

SPY posts an unfilled gap down after an unfilled gap up. Yesterday was the highest close in 20 days. Close > 200ma. Buy on close. Sell X days later. $100k/trade. 1999 - 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	-15,649.39	11	1	10	9.09	1,937.52	-1,758.69	1.10	0.11	-1,422.67
9	-18,736.23	11	1	10	9.09	2,070.90	-2,080.71	1.00	0.10	-1,703.29
8	-13,211.48	11	2	9	18.18	1,248.08	-1,745.29	0.72	0.16	-1,201.04
7	-11,800.82	11	2	9	18.18	1,685.09	-1,685.67	1.00	0.22	-1,072.80
6	-11,258.16	11	2	9	18.18	1,079.35	-1,490.76	0.72	0.16	-1,023.47
5	-7,251.76	11	3	8	27.27	763.50	-1,192.78	0.64	0.24	-659.25
4	-6,410.67	11	5	6	45.45	556.59	-1,532.27	0.36	0.30	-582.79
3	-4,265.80	11	4	7	36.36	488.04	-888.28	0.55	0.31	-387.80
2	-3,433.09	12	4	8	33.33	285.95	-572.11	0.50	0.25	-286.09
1	120.70	12	6	6	50.00	523.00	-502.89	1.04	1.04	10.06

All 12 instances closed below the entry price at some point in the next week.

These results appear to be the most bearish of all. They are a little bit misleading though. If you look at the equity curve below, which uses a 6-day exit strategy, you'll see that the downside inclinations appeared much stronger with the early instances. This is not just a case with a 6-day exit, but rather across the entire spectrum of results.



I still believe the island formation we saw over the last few days suggests short-term bearish inclinations. But with the low number of instances and waning intensity I elected to generate estimates using the data from the '93-present results table.

I should note that unfilled gaps down that occur on Fridays have had a tendency to be followed by a positive Monday over the last 14 years. This is something I last showed in the 5/23/11 Subscriber Letter. The results below are updated.

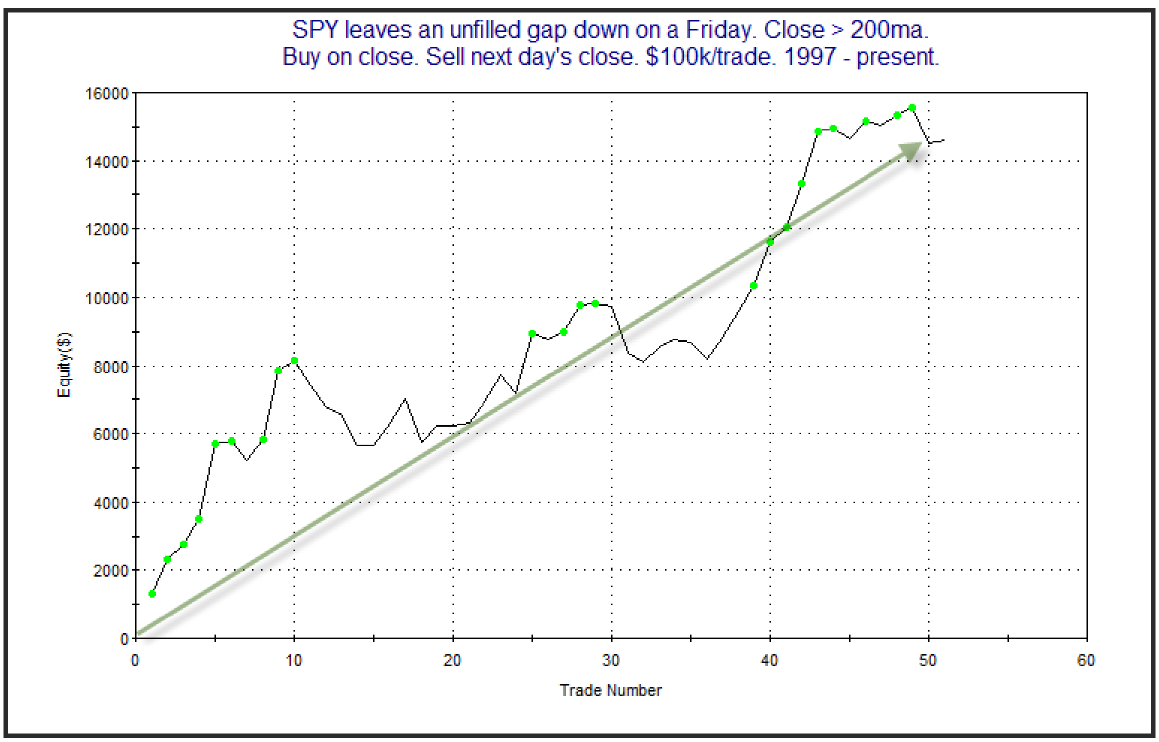
SPY leaves an unfilled gap down on a Friday. Close > 200ma.
Buy on close. Sell next day's close. $100k/trade. 1997 - present.

TradeStation Performance Summary Collapse

All Trades

Total Net Profit	$14,601.04	Profit Factor	2.65
Gross Profit	$23,443.29	Gross Loss	($8,842.25)
Total Number of Trades	51	Percent Profitable	66.67%
Winning Trades	34	Losing Trades	16
Even Trades	1		
Avg. Trade Net Profit	$286.29	Ratio Avg. Win:Avg. Loss	1.25
Avg. Winning Trade	$689.51	Avg. Losing Trade	($552.64)
Largest Winning Trade	$2,196.55	Largest Losing Trade	($1,374.16)

Across the board the stats seem to suggest an upside edge for Monday. Possible bullish impact from unfilled gaps down on Fridays did not extend beyond one day. The chart below shows how the 1-day edge has played out over time.



As I pointed out earlier the gap down on Friday occurred in reaction to the release of the employment report. The employment report is typically released on the first Friday of the month, though in some cases such as this month it occurs on a different day. I have occasionally been asked about seasonalities surrounding employment days. In the past I ran studies that looked at the first Friday of the month as a substitute for programming in the actual employment report day. This weekend I spent a good amount of time going through the BLS website and programming in all the employment days from 1993-present. I used 1993 as my start date because that is the year SPY began trading. Some of the more interesting employment-day related studies I have looked at over the years have incorporated gaps and gaps aren't accurately reflected in the cash indices. Therefore SPY is my normal security of choice when examining market gaps. Employment day seasonalities aren't typically as pronounced as Fed Day seasonalities, but they can be worth examining on occasion. Therefore I have decided I will incorporate the employment day code into the QE Tradestation Indicators & Functions code in the near future for subscribers that would care to explore employment days further on their own.

I looked at Friday's action a few different ways with regards to employment days. I found it was only the 10th time that the SPY has gapped down over 1% and failed to fill that opening gap. While I didn't find the results significant, below I have listed the other 9 instances along with their 1-day returns.

Today is an employment day. SPY gaps down over 1% and fails to close the gap intraday. Buy on close. Sell next day's close. $100k/trade. 1993 - present.

Date/Time	Signal	Price	% Profit	Run-up Drawdown
03/08/96	Buy	$63.50	1.15%	$1,306.42
03/11/96	Sell	$64.23		($676.82)
07/05/96	Buy	$65.58	(0.41%)	$624.84
07/08/96	Sell	$65.31		($685.80)
12/06/96	Buy	$74.31	1.44%	$1,492.95
12/09/96	Sell	$75.38		$0.00
11/07/97	Buy	$92.94	(0.60%)	$967.50
11/10/97	Sell	$92.38		($1,010.50)
09/07/07	Buy	$146.07	(0.19%)	$444.60
09/10/07	Sell	$145.79		($1,190.16)
01/04/08	Buy	$141.31	(0.08%)	$650.44
01/07/08	Sell	$141.19		($855.47)
07/02/09	Buy	$89.81	(0.01%)	$133.56
07/06/09	Sell	$89.80		($1,279.95)
06/04/10	Buy	$106.82	(1.25%)	$739.44
06/07/10	Sell	$105.49		($1,319.76)
06/03/11	Buy	$130.42	(1.06%)	$0.00
06/06/11	Sell	$129.04		($1,187.30)

These results seem to imply a mild inclination towards further selling the next day. Another way that I looked at employment day gaps was by using a 200ma filter and eliminating the 1% size requirement. Overall the results of doing this didn't suggest much. I did find it interesting though that there have been three instances since the March 2009 bottom and all three instances were followed by further declines ranging from 2.4% to 4.3% during the course of the following week. Those three instances occurred on 7/2/09, 8/6/10, and 6/3/11.

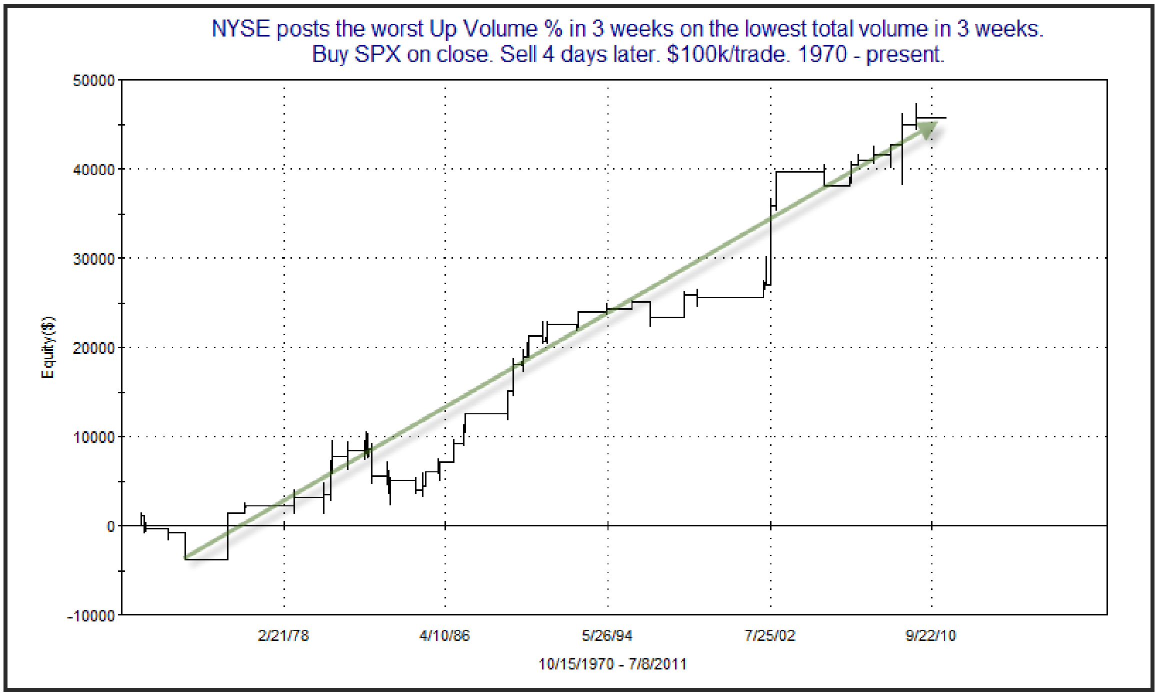
I don't believe either of these employment day studies is worth heavy consideration. My main take away is that the reaction to the employment report is not necessarily an overreaction. As the employment day results showed there does not appear to be an inclination for an immediate reversal. In fact, downside follow-through may be more likely.

So most of what we've looked at so far has suggested Friday's price action may carry a short-term downside edge. Not all is gloom and doom though. Price action aside the combination of very low volume and very weak breadth triggered a study from the 8/26/08 blog with seemingly bullish inclinations. I have updated that study below.

NYSE posts the worst Up Volume % in 3 weeks on the lowest total volume in 3 weeks.
Buy SPX on close. Sell X days later. $100k/trade. 1970 - present.

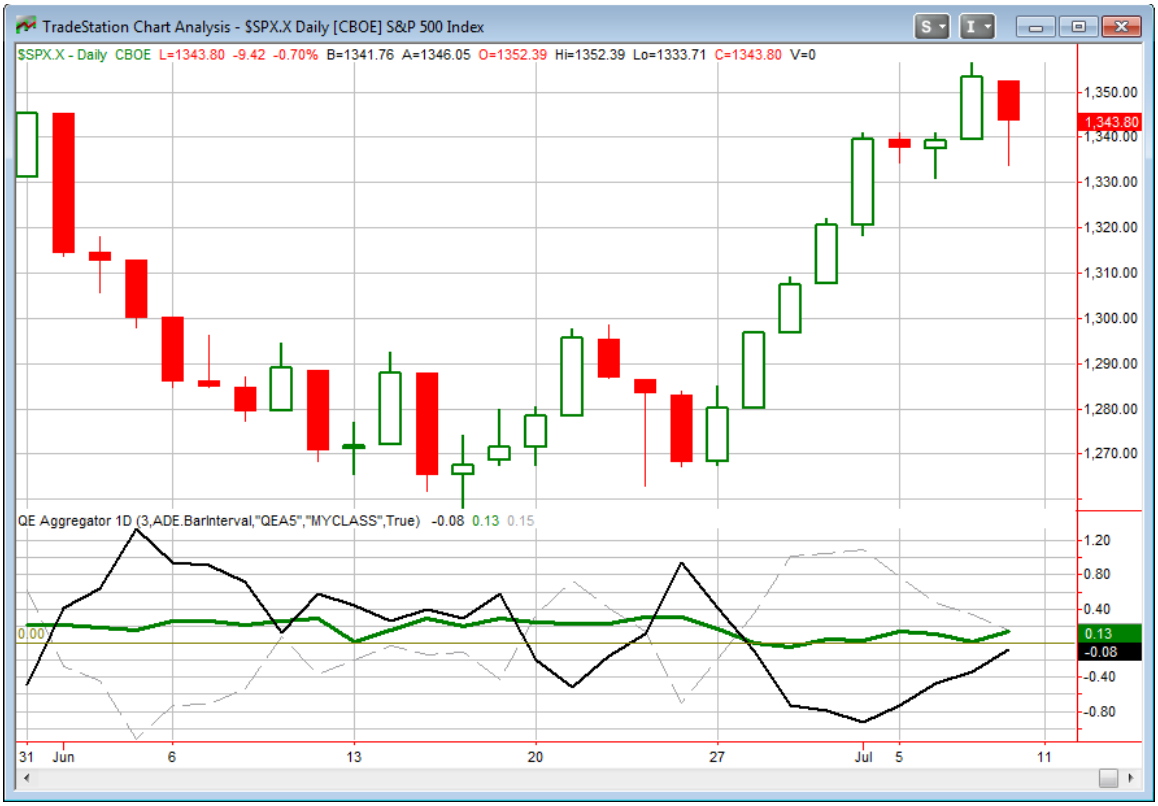
X Days	All: Net Profit	All: Total Trades	All: Winning Trades	All: Losing Trades	All: % Profitable	All: Avg Winning Trade	All: Avg Losing Trade	All: Win/Loss Ratio	All: ProfitFactor	All: Avg Trade
10	55,669.96	47	33	14	70.21	2,683.27	-2,348.43	1.14	2.69	1,184.47
9	58,166.50	47	31	16	65.96	2,784.66	-1,759.87	1.58	3.07	1,237.59
8	49,584.16	47	32	15	68.09	2,446.18	-1,912.92	1.28	2.73	1,054.98
7	43,139.59	47	27	20	57.45	2,502.43	-1,221.31	2.05	2.77	917.86
6	40,061.78	47	32	15	68.09	1,896.93	-1,376.01	1.38	2.94	852.38
5	41,238.52	47	32	15	68.09	1,862.64	-1,224.39	1.52	3.25	877.42
4	45,647.90	47	35	12	74.47	1,756.80	-1,320.00	1.33	3.88	971.23
3	36,642.86	47	32	15	68.09	1,653.31	-1,084.20	1.52	3.25	779.64
2	22,793.77	47	30	17	63.83	1,336.22	-1,017.23	1.31	2.32	484.97
1	7,923.65	47	29	18	61.70	737.23	-747.56	0.99	1.59	168.59

Bullish tendencies appeared to persist for at least a couple of weeks, though much of the upside edge is realized within the first four days. You may notice that there is no long-term trend filter associated with the study. I did look at that and found that instances above and below the 200ma produced very similar results. To see how the edge has played out over time I have included the equity curve below. It assumes a 4-day holding period.



So price action generally appears to be warning of a further pullback but the volume/breath combination suggests the rally may reassert itself without too much pain.

I have updated the Aggregator chart below.



With 2 bearish studies dropping off the Active List and a mix of studies being added the green Aggregator line rose a little further above 0. Readings above 0 mean net expectations from the Active List are for upside over the next few days. Meanwhile, the Differential Line remains slightly below 0. A negative Differential reading means the SPX has outperformed expectations over the last few days. In this case it is just mild outperformance. So net expectations are positive but the SPX is still moderately overbought versus recent expectations. This is considered a neutral configuration. Neutral configurations are visible on the Aggregator chart whenever both lines close on opposite sides of 0. Due to this the Aggregator System remained flat at the close.

The green Aggregator line is again set to close above 0 on Monday. Of course that could change if compelling bearish evidence emerges. Meanwhile, the Differential Pivot will be 1,342.73. This is only 1 point below Friday's close. So for the Differential Line to flip back to positive on Monday it would require the SPX to close only about 1 point lower.

Thursday it appeared the market was in runaway mode and that the April highs were destined to be taken out in fairly short order. I still think that is a possibility, though Friday's island formation has helped cast a little doubt. If the bearish edges are to take hold, then they will likely do so fairly shortly. Hopefully action the next few days will help to provide some clarity and perhaps some favorable entry points. I'm mostly sidelined at the moment and not inclined to rush into new positions. Risk/reward just isn't where I require for putting large amounts of capital at risk. So I'll take it one day at a time and wait until a short-term edge becomes more apparent.

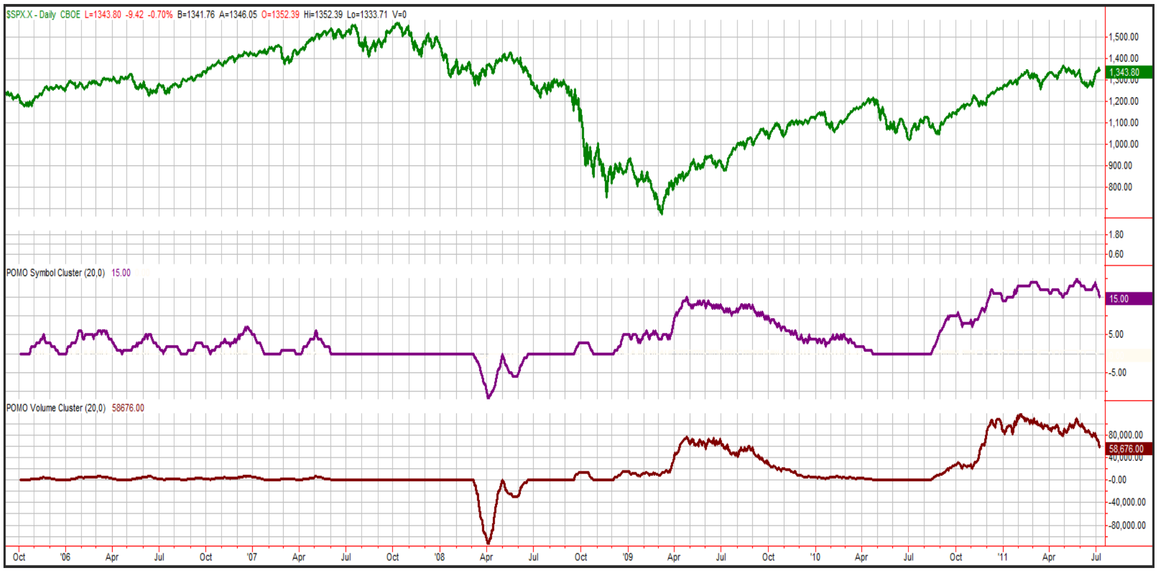
Intermediate-term Outlook (2 weeks – 2 months)– updated 7/11 – mildly bullish

Even with Friday's move lower the major indices managed to post gains for the week and are all nearing their spring highs. Not a lot changed from last week on the intermediate-term front. With QE2 now over the most significant change to the intermediate-term indicators may the rapid decline that has begun with the POMO indicators.

I've been updating the POMO chart most weekends 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. Information on acquiring the data and constructing the chart can be found in the January 3rd POMO presentation linked below. (Not available for trial users.)

http://www.quantifiableedges.com/members/pomo.php



There was just one day of buying this past week. There is also currently one day scheduled for this upcoming week. POMO activity is currently limited to buying associated with principal payments expected to be received from prior purchases. Compared to what the market had become accustomed to, this is likely to me a miniscule number that will serve to provide little to no stimulus. The next operations schedule is set to be released on Wednesday at 2pm, so we will see just how much of this buying is likely to take place over the next month. When available the schedule will be posted to the Fed's website and you may view it using the link below:

http://www.newyorkfed.org/markets/tot_operation_schedule.html

The POMO chart is a little harder to read this week because I elected to show the long-term view rather than the typical shorter-term one. I did this so you might better see the struggles the market has endured during those periods when POMO activity was flat or negative. I last posted a chart like this on the blog about a month and a half ago. If you'd like to view that chart you may use the link below. On it I showed periods with net Fed buying in green, inactivity in white, and net selling in red.

http://2.bp.blogspot.com/-jPZivVMTH-4/TdbKqBMMEHI/AAAAAAAAByg/EKR4MFO4nBg/s1600/2011-05-20.png

The absence of POMO buying is my biggest intermediate-term concern at the moment. Over the last six years POMO activity has seemed to have a larger influence on market performance than anything else I can point to. POMO buying has consistently occurred in conjunction with market rallies. Meanwhile times without buying the market has struggled mightily and been prone to severe corrections. The market has been in bull-market mode for the better part of 2 years now. But in looking at the POMO chart you can see that it hasn't managed to rally without stimulus since 2005 when the Fed data begins. Can the market extend this already long bull run with minimal or no stimulus? I have my doubts. Other instances did provide about a 1-month "grace period" before the market began to suffer, so perhaps we'll get through July before the market begins to feel the effects.

There are still a number of intermediate-term market positives that can be pointed to. Several of these I went over in some detail last week. The Intermediate-Term Active list at the top of the letter shows there is still a high-probability Follow-Through Day signal active, the Nasdaq is leading the SPX, breadth has issued bullish intermediate-term signals, and price action has as well. The combination of evidence is enough to keep me favoring the bull side for the time being. POMO is a large concern though, and it could be a ticking time-bomb that goes off later this summer if not sooner.

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.

No new trade ideas tonight.

Current Open Trade Ideas

None