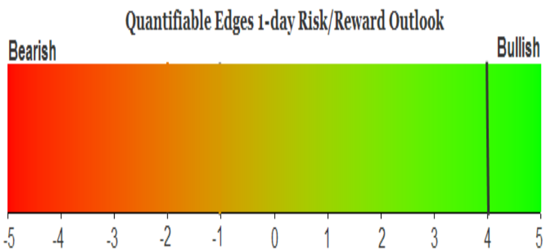
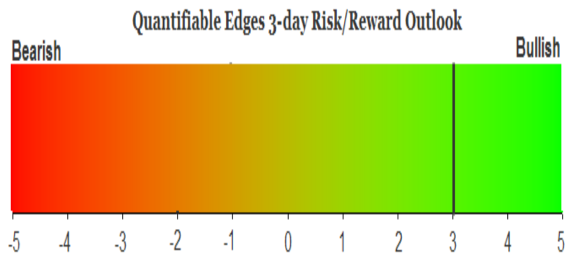
QUANTIFIABLE EDGES SUBSCRIBER LETTER

ASSESSING MARKET ACTION WITH INDICATORS AND HISTORY

September 12, 2011 Volume 4 Issue 175

Market Overview





Signals Overview

Aggregator	Aggressive VIX	Conservative VIX	NDX Trend Timer
Long	100% Long SPY	100% Long SPY	Long

Tonight's Research Points

- Since 1988 big drops on Fridays have consistently been overreactions and led to bounces over the next few days.
- 2 days of very weak breadth during a downtrend have typically been followed by upside.
- The recent outperformance of the Nasdaq vs. the SPX is a potential intermediate-term positive.

Short-term Outlook

The Bottom Line

We've been seeing some quick swings back and forth recently. The market has now flipped to oversold and short-term expectations have gone from negative to positive. This suggests an upside edge. I am establishing a long position in order to take advantage of it.

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

Study Date	Description	Time span	Bias	Avg Max Move
Active				
September 12, 2011	33.3% Up Issues. SPX < 200ma.	1-2 days	Bullish	3.00%
September 12, 2011	SPX down 2.5% on Friday	1-2 days	Bullish	2.70%
Active - Long Term				
September 12, 2011	Nasdaq leading SPX	int term	Bullish	
September 6, 2011	1% drop prior to 3-day US weekend	1-20 days	Bearish	
August 24, 2011	IBD Follow Through Day strong breadth	int term	Bullish	
August 16, 2011	SPY up 3. Vol down 3 days.	1-20 days	Bearish	
July 5, 2011	QE2 Over	int term	Bearish	
March 22, 2011	3 Days Up Issues % > 70%	8 months	Bullish	19.00%
Dropped Tonight				
September 9, 2011	***1% drop doesn't correct 3/4 of yest***	***1 day***	***Bearish***	
September 8, 2011	***Close 4% above yesterday's 1% gao***	***1-2 days***	***Bearish***	
September 6, 2011	***1% drop prior to 3-day US weekend***	***1-4 days***	***Bearish***	***-3.20%***

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

The Evidence

The market got whacked for the 2nd Friday in a row. The SPX lost 2.7%, the NASDAQ fell 2.4%, and the Russell 2000 was down 3.0%. Breadth was extremely negative as the NYSE Up Issues % came in at 15% and the Up Volume % was a scant 3%. Total NYSE volume came in at the highest level in over two weeks.

This was the second Friday in a row that the SPX closed down over 2.5%. Looking back to 1960, this the first time that has happened. There were two instances where the SPX closed down at least 2% on consecutive Fridays. They were on 2/18/00 and 10/4/02. So with another strong decline on Friday a lot of the same studies from last week triggered in the Quantifinder. Perhaps the most obvious is the one that looks for 2.5% declines on Fridays. The excerpt below is from last week's letter.

Prior to the Crash of '87, which occurred on a Monday, the market dropped over 6% on Friday. The Crash of '29 also happened on a Monday. Perhaps these events have played into the psyche of traders when the market is suffering a big drop on a Friday, because since the Crash of '87 big drops on Fridays have shown a substantial tendency to bounce over the next few days.

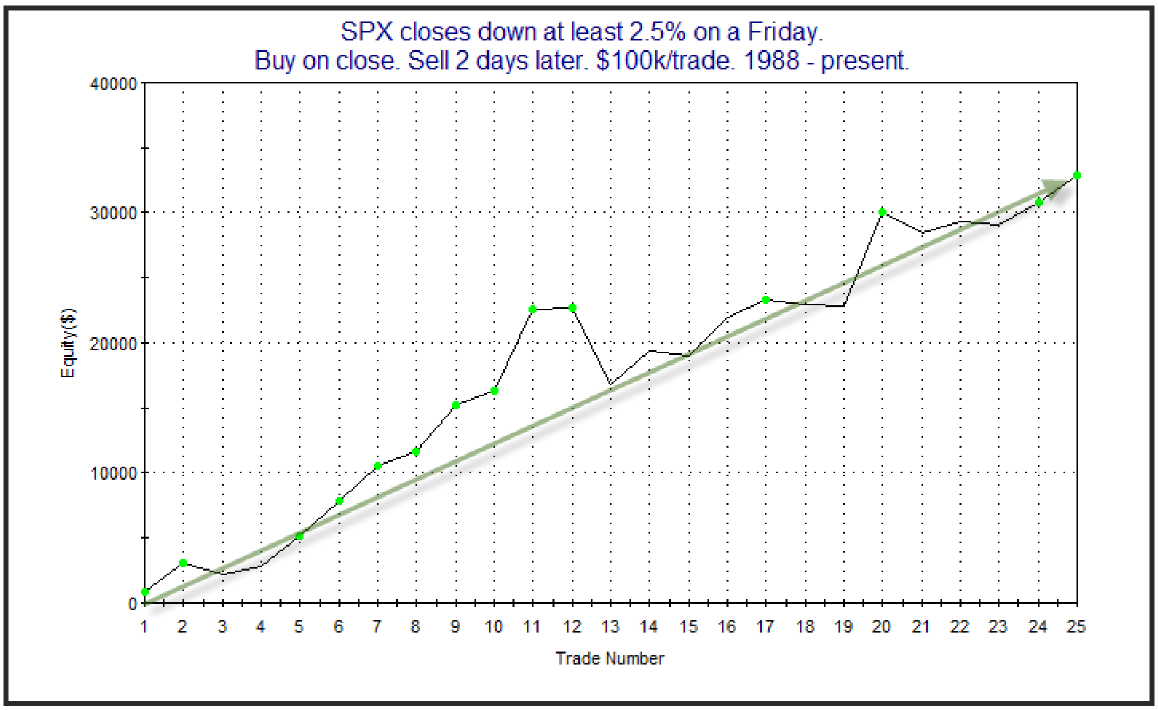
The reason the bounce occurs is because these Friday selloffs tend to be overreactions. Below is the study I showed last week in the 9/6/11 letter. I have updated all the results.

SPX closes down at least 2.5% on a Friday.
Buy on close. Sell X days later. $100k/trade. 1988 - 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	42,175.56	24	18	6	75.00	3,273.67	-2,791.74	1.17	3.52	1,757.32
4	24,345.02	25	16	9	64.00	3,056.60	-2,728.95	1.12	1.99	973.80
3	31,799.92	25	20	5	80.00	2,182.69	-2,370.78	0.92	3.68	1,272.00
2	32,911.78	25	18	7	72.00	2,347.70	-1,335.25	1.76	4.52	1,316.47
1	6,093.45	25	17	8	68.00	1,202.81	-1,794.29	0.67	1.42	243.74

24 of 25 instances (96%) closed above the entry price at some point in the next 5 days. The 11/14/08 instance took 8 days.

These stats appear quite bullish for the short-term. Below is an equity curve that assumes a two day holding period.



The strong upslope here seems to confirm the bullish edge.

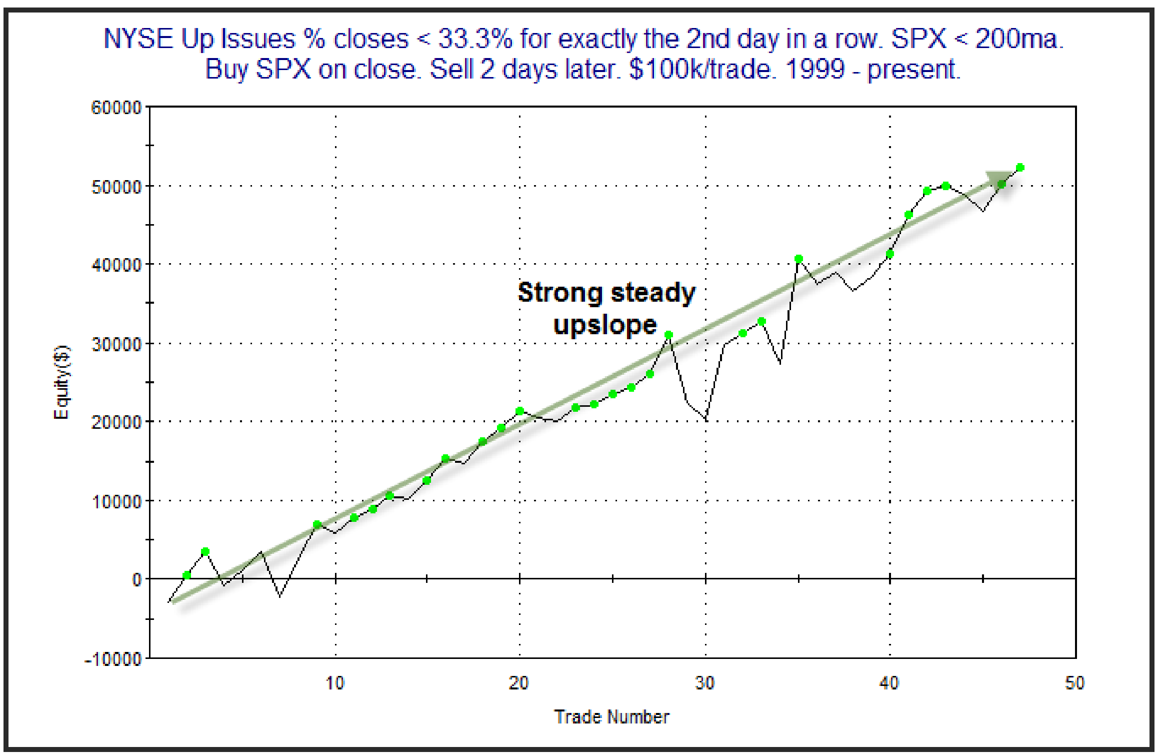
Another study that was also shown in the 9/6/11 subscriber letter looked at what occurs after two strong days of selling. Rather than considering price, this study examined breadth. It also specifically filtered to only include instances below the 200ma. I have updated that study below as well.

NYSE Up Issues % closes < 33.3% for exactly the 2nd day in a row. SPX < 200ma.
Buy SPX 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
5	55,494.71	41	30	11	73.17	3,008.71	-3,160.61	0.95	2.60	1,353.53
4	32,633.05	43	26	17	60.47	3,042.77	-2,734.06	1.11	1.70	758.91
3	36,513.20	47	28	19	59.57	3,520.17	-3,265.88	1.08	1.59	776.88
2	52,193.51	47	32	15	68.09	2,911.95	-2,732.59	1.07	2.27	1,110.50
1	38,063.62	47	30	17	63.83	2,100.68	-1,468.05	1.43	2.53	809.86

45 of 47 instances (96%) closed above the entry price at some point in the next week. 46 of 47 did so within 6 trading days.

For the considerable sample size and low number of criteria the results are astonishingly consistent. The stat at the bottom of the table is what seems most striking. Below is an equity curve using a 2-day exit.



As I mentioned last week I especially like this study because it has produced such consistently positive returns in a downtrending environment. That's fairly unusual to see.

There was one bearish study that appeared in the Quantifinder. It was from the 8/24/10 subscriber letter and it looked at times where the 20-day Historical Volatility of the SPX was consistently hitting new 20-day lows while the price of the SPX was failing to make 20-day highs. The idea behind the study was that the low HV could be an indication of complacency. The current drop in the 20-day HV seems to have nothing to do with complacency, but rather the fact that the wild moves from 20-days ago are falling out of the equation. So while that setup triggered, it doesn't seem to represent what I was trying to capture with that original study. Therefore, tonight I filtered it by looking for times the 20-day HV was above or below its own 100-day moving average. This helps to break out times like now where the HV is falling but still relatively high compared to the last 5 months.

Let's first look at times like now where the HV was at 20-day lows but still above its 100-day average.

20-day Historical Volatility makes a new 20-day low for at least the 3rd time in the last 10 days.
SPX has 0 20-day highs in the last 10 days. 20-day HV is above its 100ma.
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	-378.35	7	4	3	57.14	3,264.36	-4,478.60	0.73	0.97	-54.05
9	-602.96	7	4	3	57.14	3,152.08	-4,403.76	0.72	0.95	-86.14
8	6,343.26	7	4	3	57.14	3,211.54	-2,167.64	1.48	1.98	906.18
7	9,198.22	7	4	3	57.14	3,607.41	-1,743.81	2.07	2.76	1,314.03
6	10,908.39	8	5	3	62.50	2,589.42	-679.58	3.81	6.35	1,363.55
5	9,766.56	8	5	3	62.50	2,837.59	-1,473.79	1.93	3.21	1,220.82
4	9,591.98	8	5	3	62.50	2,742.09	-1,372.83	2.00	3.33	1,199.00
3	4,494.38	10	6	4	60.00	1,993.83	-1,867.15	1.07	1.60	449.44
2	5,347.02	10	6	4	60.00	2,204.73	-1,970.34	1.12	1.68	534.70
1	5,735.16	12	9	3	75.00	1,315.48	-2,034.71	0.65	1.94	477.93

The edge here isn't strong but the results over the 1st 1-7 days appear more bullish than bearish. Now let's look at times where the 20-day HV was below its 100-day moving average.

20-day Historical Volatility makes a new 20-day low for at least the 3rd time in the last 10 days.
SPX has 0 20-day highs in the last 10 days. 20-day HV is below its 100ma.
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	-35,475.33	18	7	11	38.89	1,491.66	-4,174.27	0.36	0.23	-1,970.85
9	-34,373.43	18	5	13	27.78	1,935.82	-3,388.66	0.57	0.22	-1,909.63
8	-46,653.36	20	5	15	25.00	970.02	-3,433.56	0.28	0.09	-2,332.67
7	-36,144.17	21	6	15	28.57	839.50	-2,745.41	0.31	0.12	-1,721.15
6	-30,123.30	21	6	15	28.57	1,043.58	-2,425.65	0.43	0.17	-1,434.44
5	-32,936.51	22	6	16	27.27	913.05	-2,400.93	0.38	0.14	-1,497.11
4	-19,257.63	24	8	16	33.33	1,788.54	-2,097.87	0.85	0.43	-802.40
3	-17,470.17	26	9	17	34.62	1,654.71	-1,903.68	0.87	0.46	-671.93
2	-14,335.80	33	15	18	45.45	929.16	-1,570.73	0.59	0.49	-434.42
1	-10,996.98	44	18	26	40.91	1,036.10	-1,140.26	0.91	0.63	-249.93

Here's where the bearish inclination from the original study came from. It appears this extra filter is worth considering. It also appears the falling HV should be of no concern to traders right now.

I have updated the Aggregator chart below.

The strong move down and bullish studies led to a complete flip of the Aggregator chart. The green Aggregator line moved back into positive territory. Levels above 0 mean net expectations from the Active List are for upside over the next few days. Meanwhile, the Differential Line also flipped back above 0. A positive Differential reading means the SPX has underperformed expectations over the last few days. So net expectations are positive and the SPX is oversold versus recent expectations. This is considered a bullish configuration. Bullish configurations can be seen on the chart whenever both lines close above 0. Due to this the Aggregator System changed from short to long at the close.

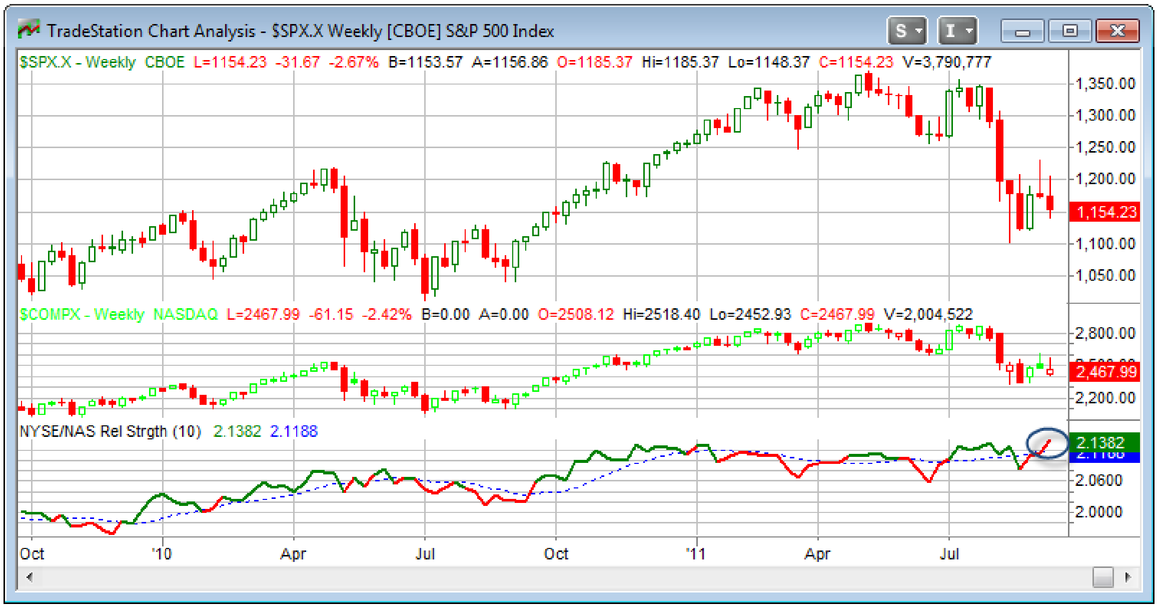
There's only two short-term studies on the board and they are both bullish and they both expire after Tuesday. The low number of studies and their short duration means that expectations over the next few days will be largely dependent upon market action and what new studies emerge. Meanwhile, the Differential Pivot will be 1,193.85 on Monday. This is 3.5% above Friday's close. It's unlikely the market will manage gains that large on Monday. A more likely scenario is a multi-day rally.

I covered the remainder of my short position at the close on Friday and am now looking to add long exposure. Based on the studies there appears to be a decent upside edge. The market has been in turmoil, though. There are a few levels of possible technical support nearby. The swing lows around 1140 and 1120 could provide support. Also, the August lows near 1100 aren't far off. Should these levels be broken it could lead to another cascade south. I'm not inclined to get too long too quickly here. I'll be taking small shots at the long side, and only increasing to a more aggressive position size if evidence becomes overwhelming. I'll also be keeping a close eye on the CBI. At this point it is still 0. It likely won't spike unless we start taking out a few levels of support.

Intermediate-term Outlook (2 weeks – 2 months)– updated 9/12 – slightly bearish

The losses Thursday and Friday were steep, and likely a great disappointment to the bulls that rushed into the market between Tuesday's open and Wednesday's close. From a studies standpoint there wasn't much that appeared this week with intermediate-term consequences.

One potential positive for the bulls is that the Nasdaq is now outperforming the SPX. Below is the SPX/Nasdaq Weekly Relative Strength chart from the charts page.



I've circled the reading at the bottom of the chart. It is now appearing in green rather than red, indicating the line color is about to change because the Nasdaq has now taken over the lead from the SPX. This is important because since near the end of 1971 (which is the 1st possible new signal after the inception of the Nasdaq) the SPX generated over 100% of its positive performance when the Nasdaq has been leading. Over that time the SPX has gained 1,268.41 points when the Nasdaq has been in the lead. Since the SPX only sits at 1,154.23 today you can easily see how important a leading Nasdaq has been over the last 40 years. More details on this indicator can be found in the blog posts below.

http://quantifiableedges.blogspot.com/2009/05/simple-powerful-timing-indicator.html

http://quantifiableedges.blogspot.com/2009/06/tweaking-nasdaqs-leadlag-model.html

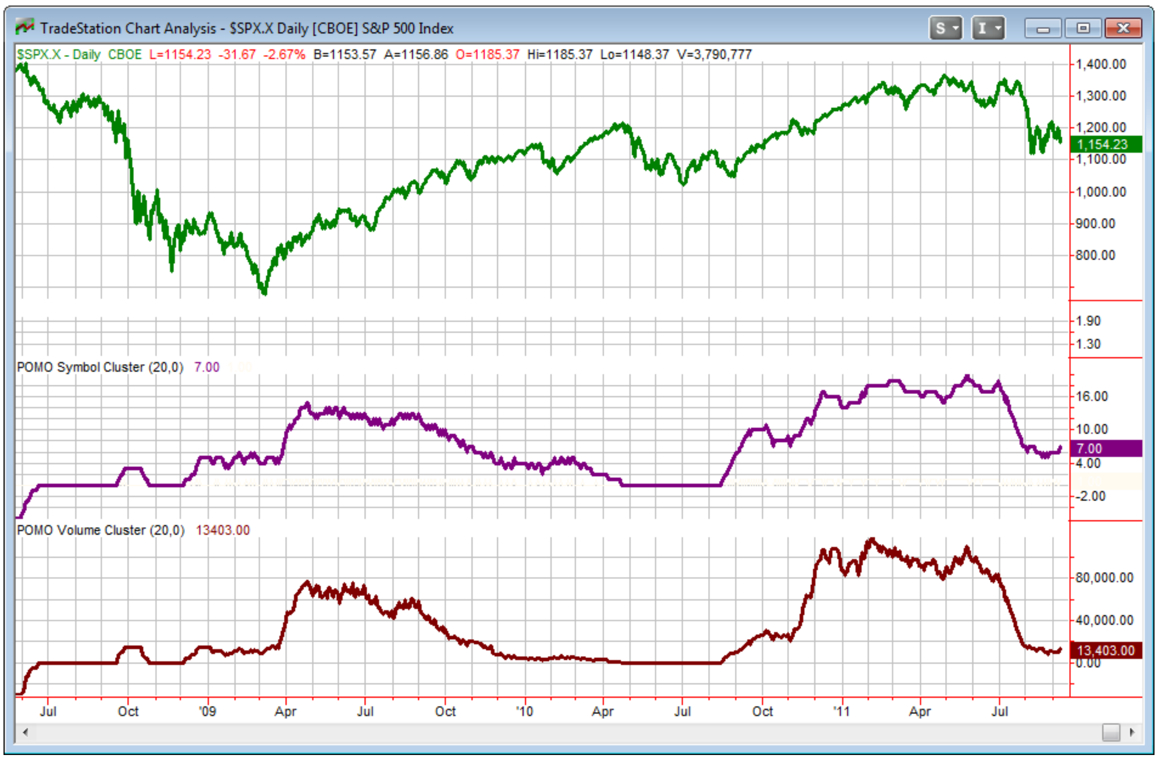
Additionally, for those subscribers that are interested in exploring this indicator more on their own, they may download the model in either Excel or Tradestation format from the downloads page of the members site at any time.

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

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



POMO indicators remain relatively low. After spending the last few weeks at levels quite a bit below the Fed's published schedule, purchases over the last month are extremely close to the $14billion number shown on the Fed's website. Stimulus still remains well below the levels that helped propel the market higher during QE1 and QE2. We keep waiting for the market to prove it can rally without substantial stimulus. So far it has not managed to do so.

While indicators remain mixed, I'm still inclined to slightly favor the short side. Bearish studies are associated with volume, liquidity (POMO), and seasonality. Bulls may find hope in the August FTD study, the breadth study from several months back, and now the leading position of the Nasdaq. Though I'm not wed to either direction I remain inclined to play the short side a little more aggressively and take a more conservative approach to longs.

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.

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SPY – buy ¼ index position @ $115.92 limit. Based on short-term outlook above.

Current Open Trade Ideas

Symbol	Entry Date	Entry Price	Current Price	% Gain/Loss	Stop	Notes
SPY(1/4)(s)	*9/8/2011*	*$120.29*	*$116.80*	*2.90%*		*exited 1/2 open & 1/2 close*

Half of the SPY position was covered on the open as mentioned in last night's letter and the other half was covered at the close per the intraday update sent to gold subscribers around 3:30pm EST on Friday.