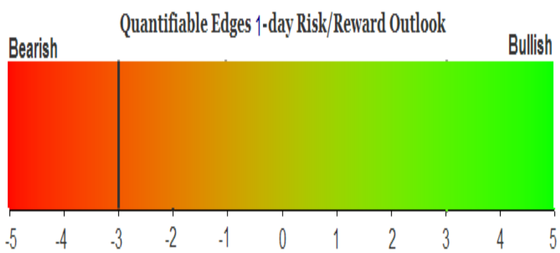
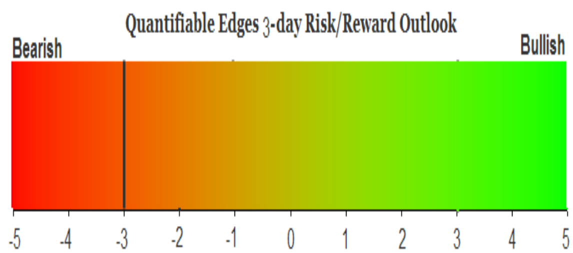
QUANTIFIABLE EDGES SUBSCRIBER LETTER

ASSESSING MARKET ACTION WITH INDICATORS AND HISTORY

October 21, 2011 Volume 4 Issue 204

Market Overview





Signals Overview

Aggregator	Aggressive VIX	Conservative VIX	NDX Trend Timer
Short	100% Long VXX	100% Long VXX	Long

Tonight's Research Points

- The VIX and SPX both closing higher suggests a pullback is likely – even considering the recent FTD.
- The strong underperformance by the SOX could suggest trouble for Friday.

Short-term Outlook

The Bottom Line

The market is back to overbought and we now have more evidence suggesting a short-term drop. I will be looking to get short. But if the market drops as expected, I will also be quick to take profits.

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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				
October 21, 2011	SPX up VIX up. Tues, Wed, Thurs < 200	1-4 days	Bearish	-3.20%
October 19, 2011	Gap dn then 50-day high	1-3 days	Bearish	
October 19, 2011	FTD on strong breadth/20day high	1-3 days	Bullish	
October 18, 2011	Unfilled gap dn after unfilled gap up	1-4 days	Bearish	-4.20%
October 17, 2011	50-day high breakout. Unfilled gap lo vo	1-5 days	Bullish	1.70%
Active - Long Term				
October 19, 2011	50-day high on 90% up vol	1-50 days	Bullish	
October 19, 2011	FTD on strong breadth/20day high	int term	Bullish	
October 17, 2011	50-day low to 50-day high in 10 days	1-20 days	Bullish	
October 11, 2011	2nd 90% up vol in a week	1-14 days	Bullish	
October 7, 2011	90% Up Volume on 3rd day up.	1-14 days	Bullish	
September 12, 2011	Nasdaq leading SPX	int term	Bullish	
March 22, 2011	3 Days Up Issues % > 70%	8 months	Bullish	19.00%
Dropped Tonight				
October 20, 2011	1% drop after FTD	1 day	Bearish	
October 20, 2011	1% drop doesn't erose 3/4 of yest gain	1 day	Bearish	
October 19, 2011	50-day high on 90% up vol	1-2 days	Bullish	

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

The Evidence

Another back and forth day finished mixed on Thursday. The SPX gained 0.5% and the Russell rose 0.3%, but the Nasdaq declined 0.2%. Breadth was moderately positive as the NYSE Up Issues % came in at 60% and the Up Volume % was 66%. Total NYSE volume appears to have dropped slightly from Wednesday despite all the back and forth action.

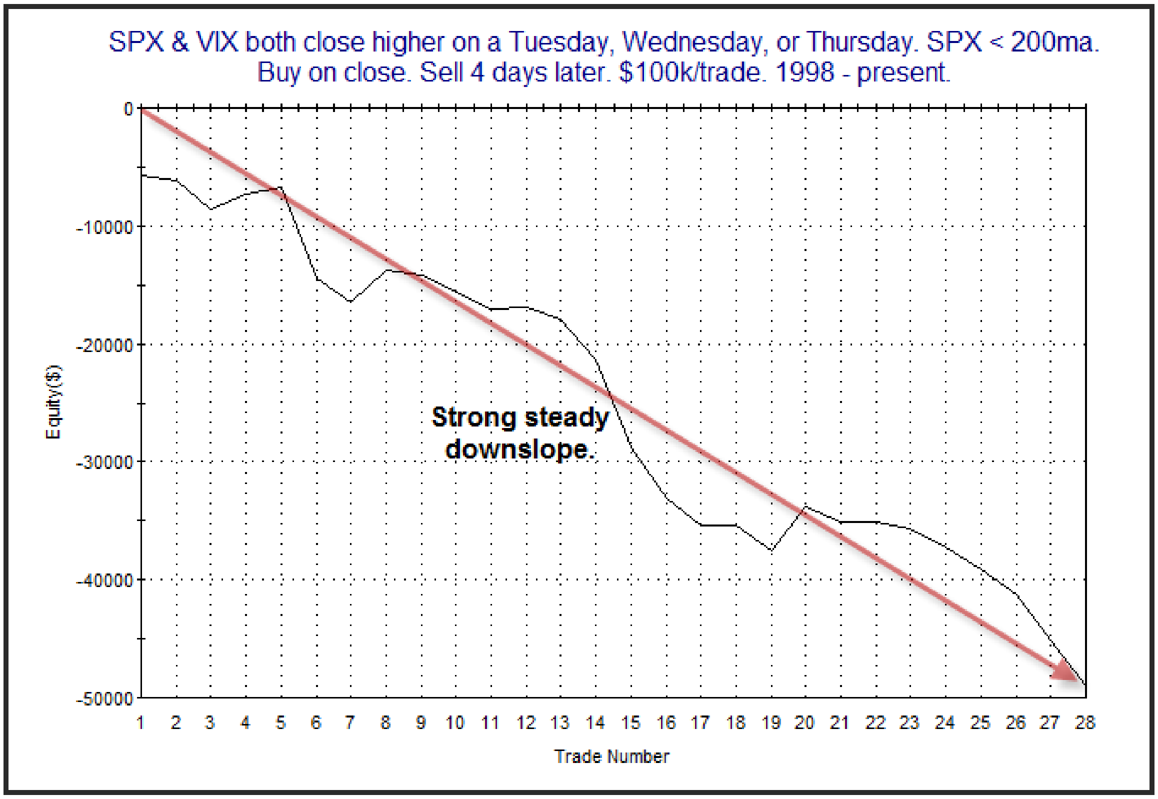
One notable observation from today was that while the SPX closed higher the VIX did as well. This is somewhat unusual since they tend to move in opposite directions. In the past I have found that when they both rise on the same day that often precedes a market pullback. Because the VIX has a natural tendency to decline on Fridays and rise on Mondays I normally separate out those days vs. mid-week when conducting VIX related studies. The study below therefore looks at all occurrences since 1998 where the VIX and SPX both rose on a Tuesday, Wednesday, or Thursday. I last showed this study in the 7/14/2010 subscriber letter. I have updated the results below.

SPX & VIX both close higher on a Tuesday, Wednesday, or Thursday. SPX < 200ma.
Buy 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	-30,009.99	27	9	18	33.33	1,380.04	-2,357.24	0.59	0.29	-1,111.48
4	-49,048.29	28	7	21	25.00	1,214.18	-2,740.36	0.44	0.15	-1,751.72
3	-35,628.09	28	8	20	28.57	1,251.28	-2,281.92	0.55	0.22	-1,272.43
2	-27,255.56	29	9	20	31.03	1,404.65	-1,994.87	0.70	0.32	-939.85
1	-9,578.87	30	14	16	46.67	1,023.66	-1,494.38	0.69	0.60	-319.30

27 of 30 instances (90%) closed below the entry price at some point in the next week.

The numbers all strongly suggest a bearish edge over the next 1-4 days. Let's take a look at the equity curve.



The curve seems to confirm what the numbers were suggesting.

Last night I talked in detail about how we were in the early stages of a possible intermediate-term rally. The Follow Through Day (FTD) Tuesday was the first since the market bottomed a couple of weeks ago. I discussed how early-stage rallies are different than other periods and that it is well worth taking this into consideration when conducting studies. So let's take a look and see how this VIX/SPX study would look if we require a FTD to have recently occurred. Does the bearish edge hold up in the face of a possible emerging rally?

SPX & VIX both close higher on a Tuesday, Wednesday, or Thursday. SPX < 200ma. There was a FTD within the last 5 days. 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	-8,647.71	6	2	4	33.33	488.18	-2,406.01	0.20	0.10	-1,441.28
4	-17,171.41	6	0	6	0.00	0.00	-2,861.90	0.00	0.00	-2,861.90
3	-15,631.44	6	1	5	16.67	223.20	-3,170.93	0.07	0.01	-2,605.24
2	-11,448.89	7	2	5	28.57	86.75	-2,324.48	0.04	0.01	-1,635.56
1	-6,598.78	7	2	5	28.57	644.67	-1,577.62	0.41	0.16	-942.68

Instances are low as you would presume. Not only does the downside edge hold up, but the bearish consistency and size of the pullbacks is considerably more impressive than the larger sample set. Below I have listed the 6 instances along with their 4-day results.

SPX & VIX both close higher on a Tuesday, Wednesday, or Thursday.
SPX < 200ma. There was a FTD within the last 5 days.
Buy SPX on close. Sell 4 days later. $100k/trade. 1998 - present.

Date/Time	Signal	Price	% Profit	Run-up Drawdown
10/21/98	Buy	$1,069.90	(0.43%)	$1,501.95
10/27/98	Sell	$1,065.35		($785.85)
03/08/01	Buy	$1,264.76	(7.75%)	$0.00
03/14/01	Sell	$1,166.71		($8,643.39)
10/03/01	Buy	$1,072.28	(1.45%)	$1,101.12
10/09/01	Sell	$1,056.75		($1,746.54)
07/23/08	Buy	$1,282.10	(1.47%)	$86.24
07/29/08	Sell	$1,263.19		($3,674.44)
07/13/10	Buy	$1,095.34	(2.20%)	$340.34
07/19/10	Sell	$1,071.25		($3,114.93)
08/30/11	Buy	$1,212.92	(3.93%)	$1,458.78
09/06/11	Sell	$1,165.24		($5,968.78)

Avg Run-Up: 0.75%% Avg Drawdown: -3.99%

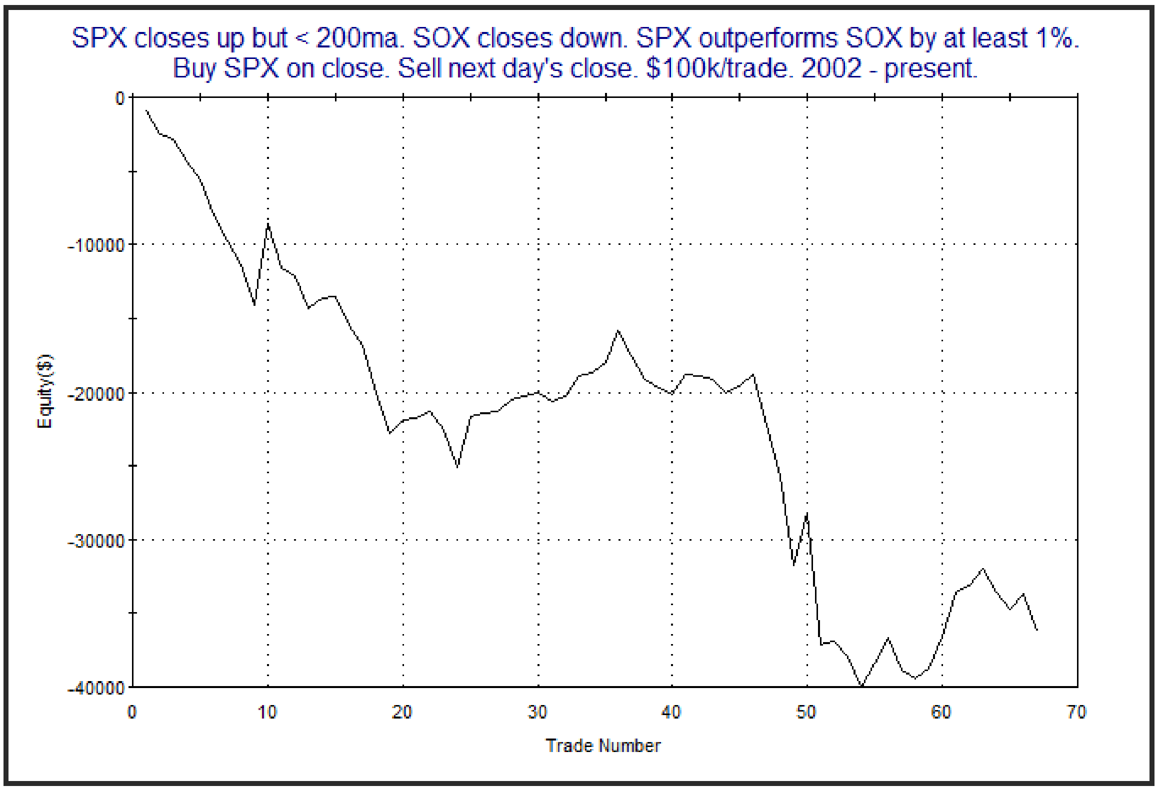
Risk/reward heavily favors the bears here as the average drawdown is over 5x the average run-up and over 2.5x the largest run-up. In all, the rise in the VIX and SPX on Thursday seems to strongly suggest we'll see a pullback soon.

One other study triggered in the Quantifinder tonight. It was last shown in the 8/2/10 letter and looked at the relative weakness in the SOX versus the SPX on Thursday. I took another look at that study tonight.

SPX closes up but < 200ma. SOX closes down. SPX outperforms SOX by at least 1%.
Buy SPX on close. Sell X days later. $100k/trade. 2002 - 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	-7,702.77	54	27	27	50.00	3,107.05	-3,392.34	0.92	0.92	-142.64
4	-7,678.56	55	27	28	49.09	2,608.08	-2,789.17	0.94	0.90	-139.61
3	-26,284.18	60	28	32	46.67	2,336.27	-2,865.62	0.82	0.71	-438.07
2	-36,511.60	66	29	37	43.94	1,859.07	-2,443.91	0.76	0.60	-553.21
1	-36,184.65	67	30	37	44.78	1,188.22	-1,941.38	0.61	0.50	-540.07

I shortened the lookback period to 2002. When examining the equity curve it appeared there was little edge prior to this date. In doing this I noticed that the edge was really just a 1-day phenomenon. Below is the equity curve.



While generally downsloping it is a little more inconsistent than I would prefer. I decided not to include it on the Active List tonight, but will keep an eye on it moving forward.

I have updated the Aggregator chart below.

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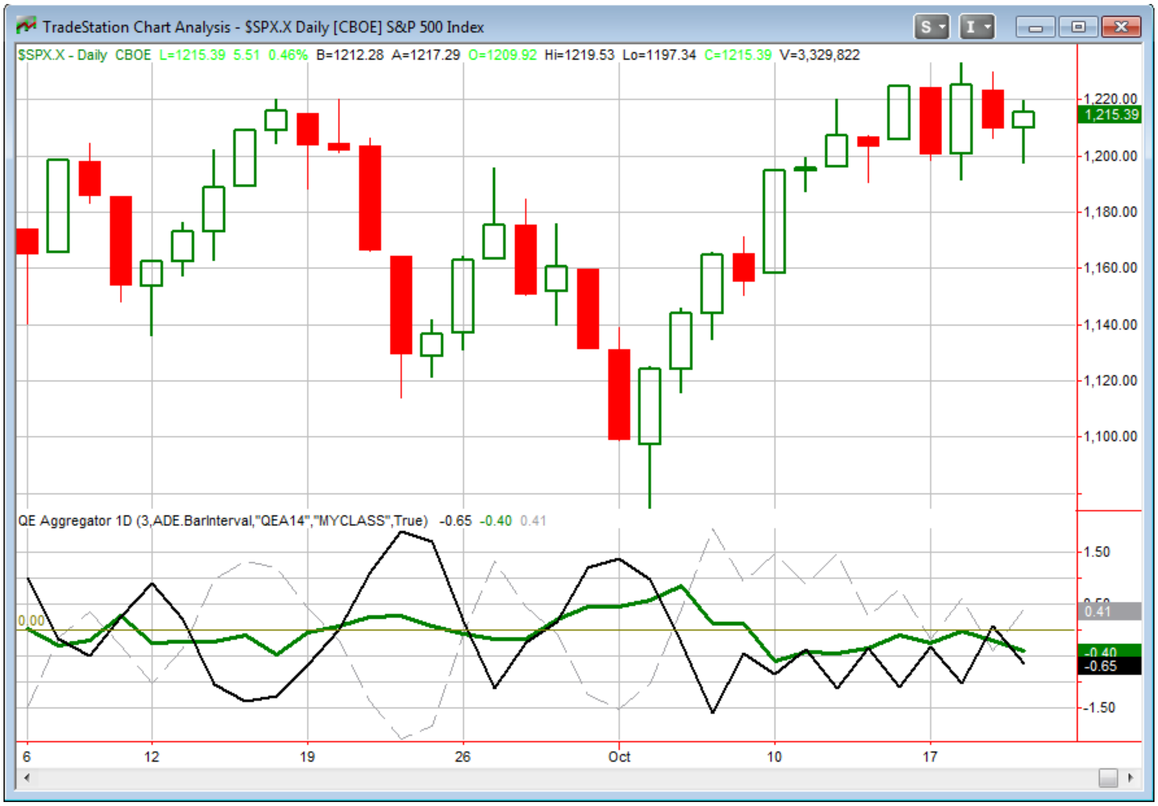


With the additional bearish evidence the green Aggregator line remained in negative territory. Readings below 0 mean net expectations from the Active List are for downside over the next few days. Meanwhile, after a brief rise above it, the black Differential Line flipped back below 0. A negative Differential reading means the SPX has outperformed expectations over the last few days. So net expectations are negative and the SPX is overbought versus recent expectations. Historically this combination has provided a downside edge. Bearish configurations are visible on the chart whenever both lines close below 0. Due to this the Aggregator System turned from flat to short at the close.

With the current studies on the board the green Aggregator Line is scheduled to close negative again on Friday. Of course new bullish evidence emerging on Friday could turn the Aggregator positive. Meanwhile, the Differential Pivot is once again inverted and will be at 1,220.43 on Friday - about 0.4% ***above*** Thursday's close. In order to prevent the Differential Line from turning back to positive and the SPX from being considered "oversold", the SPX will need to close above the 1,220.43 pivot level.

The inverted pivots the last couple of nights are largely a function of the choppy market conditions. The SPX has reversed direction 6 days in a row now, and several of those moves were large. If this continues we will likely see a few more inverted pivots in the coming days.

So I am again short-term bearish and I will be looking to take some exposure on Friday. I will look to put on up to a ½ size position but it is unlikely I will continue to scale in over the next few days. As this rally looks stronger and stronger it becomes something I am less enthusiastic to battle. Still, we have ample evidence suggesting a pullback - perhaps a sharp one - is in order. And tonight's study was even checked to see if the bearish edge held true during possible emerging rally conditions. It did. So I will be looking to get short Friday. If it works it will be a quick exit, though. I will exit the trade on any SPX close below the Differential Pivot (even if it is a small loss). Details are in the trade ideas section below.

Intermediate-term Outlook (2 weeks – 2 months)– updated 10/17 – neutral

This past week certainly changed things in a hurry. As noted above we have moved from 50-day lows to 50-day highs and also above the consolidation of the last 2 months.

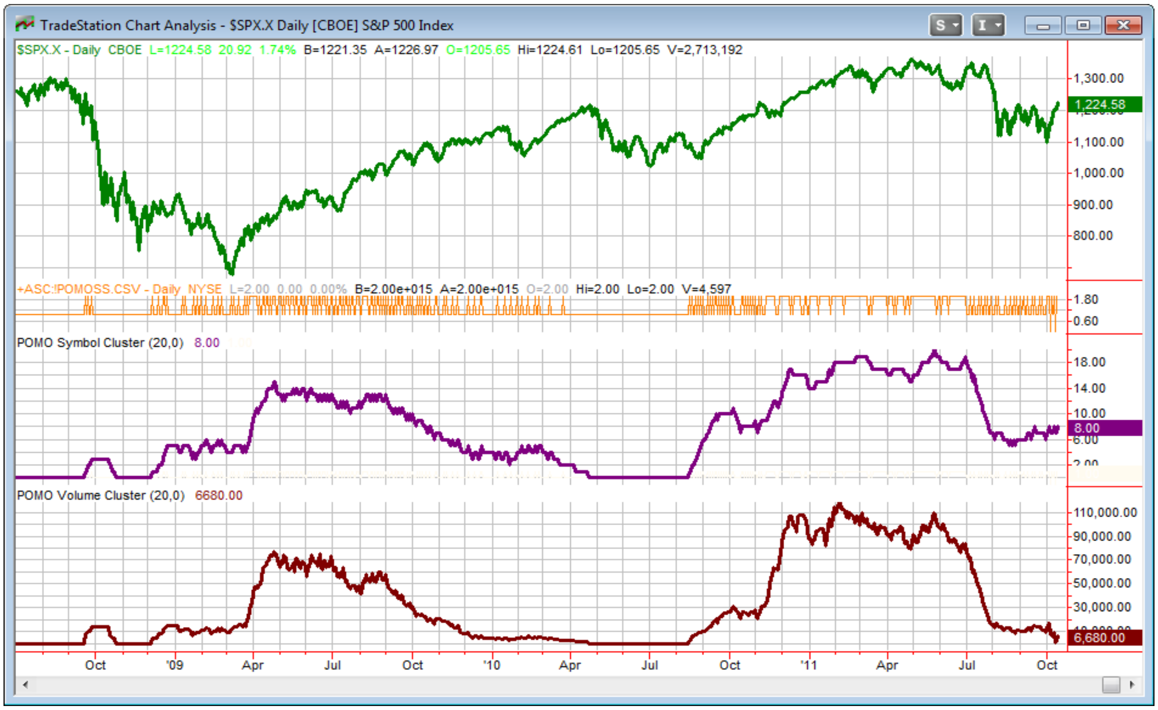
From an intermediate-term perspective, one of the more amazing things I've notice about this rally is that it has come without any 1% Follow Through Day (FTD) on rising volume. Investors' Business Daily first published and popularized the concept of the Follow Through Day (FTD). Though they have changed the definition slightly over the years, I have found their original definition to be useful in several studies. My tests go back to 1971, which was the inception of the Nasdaq, and also as far as some of my volume data goes. Since that time there has never been a rally that has taken the SPX from a drawdown of at least 8% to a new 50-day high that was not inclusive of a FTD – until Friday.

This puts this rally in uncharted territory, which is always a little bit of an uncomfortable place for me. A FTD could still occur, and just because we have had a strong 9-day rally does not mean a bull market has already been missed. But a primary purpose of the FTD concept is to help in identifying market bottoms. If we are already at a 50-day high, then I would say this is one case where the FTD concept has failed us.

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



The market began its rally almost exactly when Operation Twist began. This could be coincidental, and seems odd since the net amount of the buying has been reduced versus previous buying. This is because we have seen increased buying on the long end largely offset by selling short-dated securities. Perhaps the focus on purchasing longer-dated securities has somehow helped. It is difficult to draw any solid conclusions yet. At this point I can say we are seeing a new rally occur in conjunction with new Fed action. I may not be smart enough to fully explain "why", but I am smart enough to know I shouldn't dismiss it, especially after observing the impact QE1 and QE2 had on the market.

I'm somewhat neutral at this point. I'll trade in either direction with similar aggressiveness. As we've seen the last couple of weeks, things can change quickly. I suspect the quick move from a 50-day low to a 50-day high may turn out to be a bullish intermediate-term sign as it has in the past. Still, I'd prefer to see some volume behind the move, and I want to see the VIX and VXO exhibit more normal behavior. If some of these things can occur this upcoming week, then I may turn outright bullish.

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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1st SPY lot – short ¼ index position @ $121.66 LIMIT. If not filled by 11am EST, then cancel order. Based on short-term outlook above. This 1st lot I will look to enter at a price at or better than Thursday's close.

2nd SPY lot – short ¼ index position @ $122.88 LIMIT ON OPEN. If not filled on open, cancel order and look to short AT THE CLOSE UNDER THE FOLLOWING 2 CONDITIONS 1) If filled on the 1st lot from above, SPY is at least $0.50 above that entry, and 2) SPX closes above the Differential Pivot of 1,220.43. Based on short-term outlook above. The "short on open" order here assumes a gap up > 1%. Otherwise, I'm waiting for the close to put the 2nd lot on.

I will exit any open SPY positions at the close on an SPX close <= 1,220.43.

Current Open Trade Ideas

None.

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