

QUANTIFIABLE EDGES SUBSCRIBER LETTER

ASSESSING MARKET ACTION WITH INDICATORS AND HISTORY

December 1, 2011

Volume 4 Issue 232

Market Overview



Signals Overview

Aggregator	Aggressive VIX	Conservative VIX	NDX Trend Timer
Short	100% short SPY	Flat	Flat

Tonight's Research Points

- Today's strong breadth on the third day higher appears to be an intermediate-term positive.
- The strong volume that accompanied Wednesday's 3% gain is a short-term bullish sign.
- The VXO is now stretched to the downside, suggesting a quick SPX pullback is likely to occur.

Short-term Outlook

The Bottom Line

Net expectations are now moderately negative and the SPX is extremely overbought. I am looking to take on a small short position to take advantage of a possible pullback.

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

Study Date	Description	Time span	Bias	Avg Max Move
Active				
November 29, 2011	2.5% rise from 20-low on 5-hi vol	1-5 days	Bullish	4.20%
November 29, 2011	Aft 20low SPY low > 1% abv yest close.	1-2 days	Bearish	
Active - Long Term				
November 22, 2011	1.75 drops sandwich a lesser one	1-10 days	Bullish	
November 22, 2011	SPX sell off hard, but VIX doesn't spike	1-10 days	Bearish	
November 18, 2011	Triangle breakdown	int term	Bullish	
October 30, 2011	SPX & bond yields hit 50-day highs	1-50 days	Bearish	
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	
Dropped Tonight				
November 29, 2011	99% Up Vol % Rank after 20-day low	1 day	Bearish	

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

The Evidence

Huge up day. Really big. The SPX rose 4.3%, the Nasdaq was up 4.2%, and the Russell 2000 rose 5.9%. Breadth was again off the charts. The NYSE Up Issues % came in at 82% and the Up Volume % was just over 97%. Since 1970 there have only been six instances where the NYSE Up Volume % exceeded 97%. Two of those six occurred this week. The move higher was also accompanied by very strong volume, as the total NYSE volume came in at the highest level in over a month.

There were several studies that took into account the fact that the SPX has now risen for at least three days in a row. Several of those studies indicated that this could create an overbought condition and lead to a pullback. This was basically found to be the case under conditions where 1) the market was not emerging from an intermediate-term low, and 2) the market did not show exceptional breadth. The times where exceptional breadth was shown no such short-term downside edge seem to exist. The study below was last seen in the 8/16/11 subscriber letter. It uses an Up Volume % of at least 90% to demonstrate this concept.

SPX closes higher for at least the 3rd day in a row. The NYSE Up Volume % > 90%. Buy SPX on close. Sell X days later. \$100k/trade. 10/20/87 - 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: Max Winning Trade	All: Max Losing Trade	All: Win/Loss Ratio	All: ProfitFactor	All: Avg Trade
15	43,333.80	18	13	5	72.22	4,168.55	-2,171.47	11,124.12	-5,239.30	1.92	4.99	2,407.43
14	42,075.37	18	16	2	88.89	2,937.15	-2,459.53	8,025.22	-2,533.16	1.19	9.55	2,337.52
13	34,051.50	19	15	4	78.95	2,552.31	-1,058.30	7,484.65	-3,373.70	2.41	9.04	1,792.18
12	32,093.31	19	15	4	78.95	2,548.20	-1,532.42	7,583.70	-2,355.10	1.66	6.24	1,689.12
11	29,374.57	19	12	7	63.16	2,842.28	-676.11	8,671.60	-1,283.04	4.20	7.21	1,546.03
10	29,216.99	19	14	5	73.68	2,729.94	-1,800.43	10,921.96	-2,533.02	1.52	4.25	1,537.74
9	25,604.49	19	14	5	73.68	2,371.00	-1,517.91	8,397.62	-2,298.27	1.56	4.37	1,347.60
8	20,826.00	19	14	5	73.68	2,355.73	-2,430.86	7,394.80	-3,753.26	0.97	2.71	1,096.11
7	24,039.48	19	13	6	68.42	2,492.90	-1,394.69	9,599.94	-2,724.73	1.79	3.87	1,265.24
6	17,806.90	19	12	7	63.16	2,424.31	-1,612.11	5,066.85	-3,497.62	1.50	2.58	937.21
5	11,390.12	19	14	5	73.68	1,903.05	-3,050.52	4,428.90	-6,695.61	0.62	1.75	599.48
4	10,059.40	19	14	5	73.68	1,600.67	-2,470.00	5,800.13	-6,719.68	0.65	1.81	529.44
3	1,625.89	19	12	7	63.16	1,450.11	-2,253.63	3,641.54	-5,298.72	0.64	1.10	85.57
2	4,579.56	19	15	4	78.95	933.72	-2,356.54	4,479.84	-8,004.64	0.40	1.49	241.03
1	5,424.53	19	9	10	47.37	961.74	-323.12	2,860.08	-1,140.30	2.98	2.68	285.50

The first few days appear to be a tossup. After that bullish inclinations seem to exert themselves. So while this doesn't appear to provide a strong edge for the very short-term, it does suggest the rally should continue over the next few weeks.

In the 8/16/11 subscriber letter I also ran this test back to 1970. The period from 1970 through October 1987 also showed strong bullish tendencies. They just weren't as prevalent as they've been since the crash of 87.

I should also note that I ran this test several different ways tonight. I wanted to see if it mattered that the market was emerging from a 20-day low but not a 50-day low. I want to see whether Wednesday's big volume might make a difference to these results. No matter how I looked at it the edge did not appear to change substantially. In other words, this baseline test appeared to represent the current situation fairly well.

The above test didn't consider the strength of the move from a % change standpoint. It also didn't consider the fact that volume was so exceptionally strong. These observations were considered in the study below, which was last seen in the 10/28/11 letter. Results are updated.

SPX closes up > 3% on the highest NYSE volume in 10 days. Buy on close. Sell X days later. \$100k/trade. 1960 - 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: Max Winning Trade	All: Max Losing Trade	All: Win/Loss Ratio	All: ProfitFactor	All: Avg Trade
10	53,056.28	26	19	7	73.08	4,205.06	-3,834.26	10,507.25	-8,872.20	1.10	2.98	2,040.63
9	57,179.38	26	18	8	69.23	4,564.48	-3,122.67	11,435.28	-7,579.50	1.46	3.29	2,199.21
8	49,157.39	26	18	8	69.23	4,146.45	-3,184.84	10,693.76	-7,212.15	1.30	2.93	1,890.67
7	42,093.93	26	19	7	73.08	3,720.28	-4,084.49	11,879.20	-8,207.38	0.91	2.47	1,619.00
6	43,438.05	27	18	9	66.67	4,031.27	-3,236.08	9,978.28	-12,127.34	1.25	2.49	1,608.82
5	37,259.24	27	20	7	74.07	3,347.97	-4,242.87	9,334.72	-17,314.65	0.79	2.25	1,379.97
4	34,741.65	27	18	9	66.67	3,688.18	-3,516.17	11,930.04	-11,413.39	1.05	2.10	1,286.73
3	34,780.23	27	15	12	55.56	4,107.28	-2,235.75	10,868.60	-5,686.53	1.84	2.30	1,288.16
2	16,989.35	27	15	12	55.56	2,488.74	-1,695.15	7,112.64	-6,598.86	1.47	1.84	629.24
1	25,909.47	27	17	10	62.96	2,240.54	-1,217.98	9,089.88	-4,142.00	1.84	3.13	959.61

Many traders may find this somewhat surprising that such a strong move has a tendency to carry through rather than to revert. Without the heavy volume this would not be the case. I also showed this in the 10/28/11 subscriber letter. I've copied the results table below from that letter. (Results not updated.)

SPX closes up > 3% on less than the highest NYSE volume in 10 days. Buy on close. Sell X days later. \$100k/trade. 1960 - 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	-29,266.73	47	24	23	51.06	3,672.28	-5,104.41	0.72	0.75	-622.70	
9	-35,064.02	49	24	25	48.98	3,619.98	-4,877.74	0.74	0.71	-715.59	
8	-28,943.58	49	25	24	51.02	2,984.63	-4,314.97	0.69	0.72	-590.69	
7	-51,770.99	51	21	30	41.18	3,659.10	-4,287.07	0.85	0.60	-1,015.12	
6	-30,194.70	52	27	25	51.92	3,243.43	-4,710.70	0.69	0.74	-580.67	
5	-22,741.52	55	32	23	58.18	3,064.28	-5,252.10	0.58	0.81	-413.48	
4	-26,325.27	59	34	25	57.63	2,575.39	-4,555.54	0.57	0.77	-446.19	
3	-22,451.59	60	32	28	53.33	2,106.12	-3,208.83	0.66	0.75	-374.19	
2	-38,329.01	65	33	32	50.77	1,790.83	-3,044.57	0.59	0.61	-589.68	
1	-21,388.45	66	32	34	48.48	1,071.35	-1,637.40	0.65	0.62	-324.07	

The all-green profit columns from the previous test are all red here.

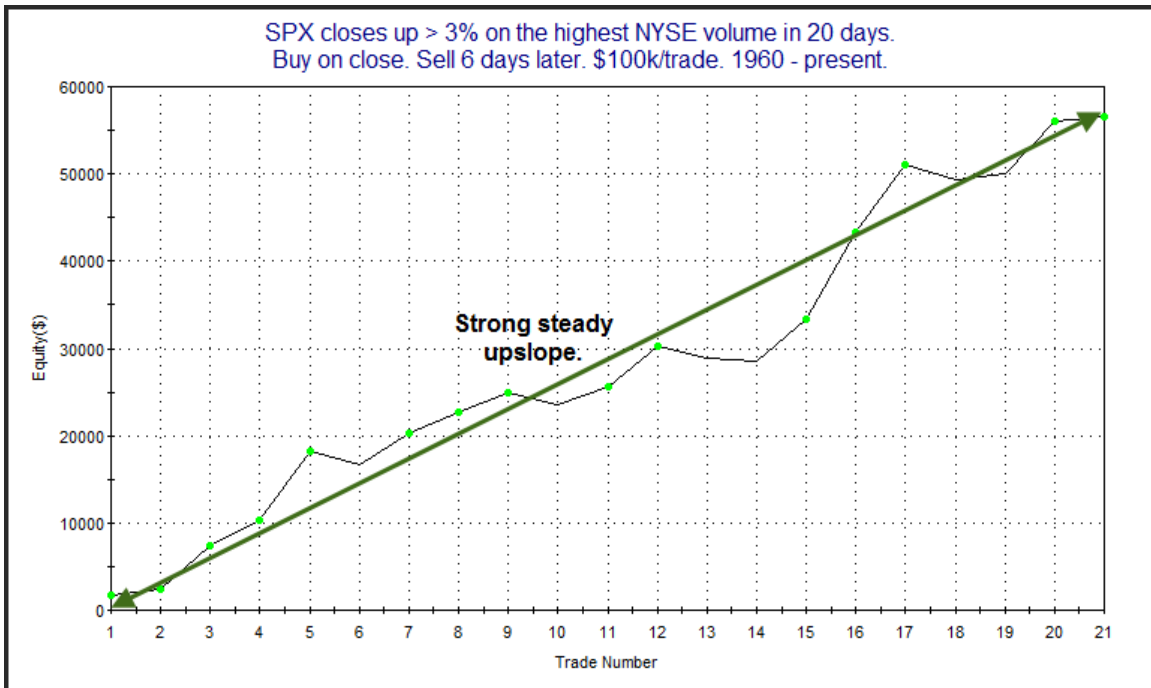
But as I mentioned earlier, volume didn't just come in at a two-week high. It was actually the highest volume in over 20 trading days. When I took the above study and increased the requirements to demand a 20-day high in volume rather than just a 10-day high in volume, I got the below results.

SPX closes up > 3% on the highest NYSE volume in 20 days.
Buy on close. Sell X days later. \$100k/trade. 1960 - 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: Max Winning Trade	All: Max Losing Trade	All: Win/Loss Ratio	All: ProfitFactor	All: Avg Trade
10	70,836.57	21	18	3	85.71	4,458.56	-3,139.18	13,599.08	-7,562.86	1.42	8.52	3,373.17
9	74,968.52	21	17	4	80.95	4,724.50	-1,337.01	11,435.28	-3,726.90	3.53	15.02	3,569.93
8	61,986.65	21	17	4	80.95	4,095.79	-1,910.44	10,693.76	-3,292.30	2.14	9.11	2,951.75
7	59,395.20	21	18	3	85.71	3,969.77	-4,020.25	11,879.20	-8,207.38	0.99	5.92	2,828.34
6	56,585.54	21	16	5	76.19	3,936.27	-1,278.94	9,978.28	-1,660.50	3.08	9.85	2,694.55
5	51,254.86	21	18	3	85.71	3,115.86	-1,610.19	9,334.72	-2,534.50	1.94	11.61	2,440.71
4	42,377.06	21	15	6	71.43	3,828.25	-2,507.79	11,930.04	-3,869.74	1.53	3.82	2,017.96
3	40,461.07	21	13	8	61.90	4,091.37	-1,590.85	10,868.60	-3,820.62	2.57	4.18	1,926.72
2	23,506.93	21	13	8	61.90	2,489.66	-1,107.34	7,112.64	-3,630.44	2.25	3.65	1,119.38
1	30,361.94	21	14	7	66.67	2,536.97	-736.51	9,089.88	-1,516.06	3.44	6.89	1,445.81

20 of 21 instances (95%) closed above the entry price at some point in the next week. The only failure triggered on 1/3/2001.

Not too many trades were filtered out, and the results of the remaining were even stronger. The equity curves across the board all looked good. I found the 6-day holding period to be especially attractive.

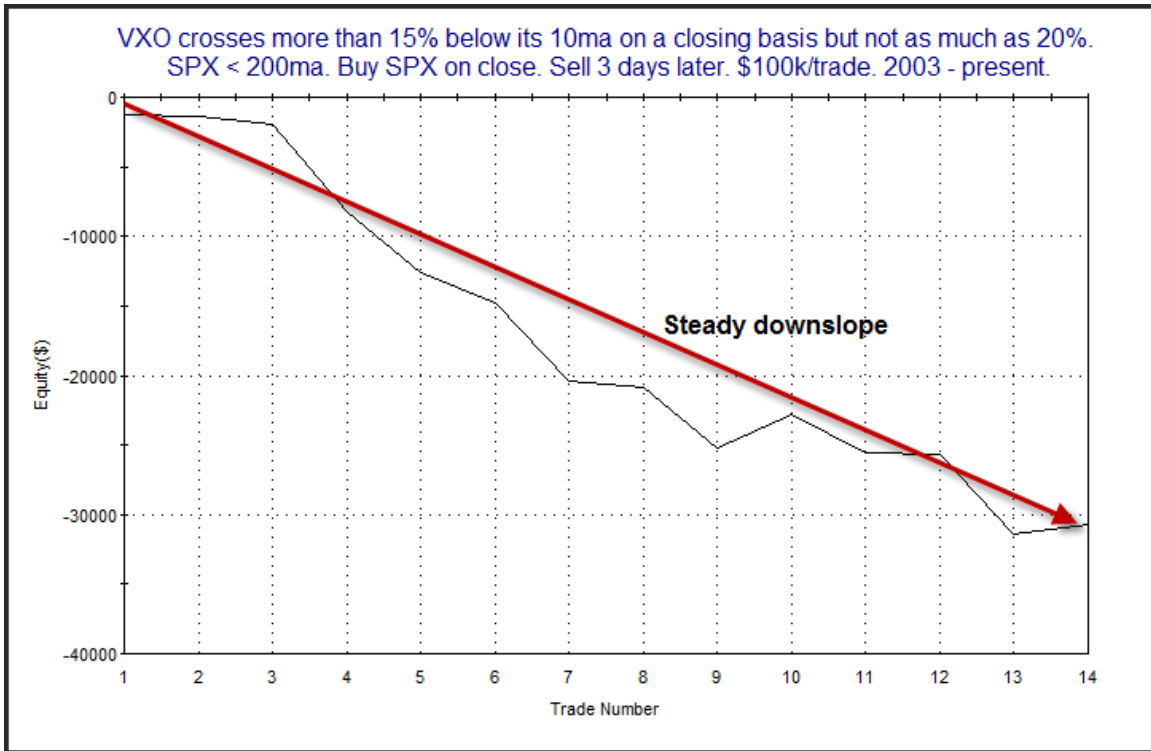


Everything with this study looks good to me.

But not every study suggested good news. While breadth, price action, and volume all seem to support a further rally over the next few days and weeks, action in the VXO is flashing a warning sign. The strong move up in the SPX was mirrored by a strong move down in VXO. Sharp drops in VXO are often followed by drops in SPX over the next few days. The study below is from the 8/24/11 letter. Results have been updated.

VXO crosses more than 15% below its 10ma on a closing basis but not as much as 20%. SPX < 200ma. Buy SPX on close. Sell X days later. \$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: Max Winning Trade	All: Max Losing Trade	All: Win/Loss Ratio	All: ProfitFactor	All: Avg Trade
10	-6,252.75	11	6	5	54.55	3,196.29	-5,086.09	5,243.84	-11,901.65	0.63	0.75	-568.43
9	-9,028.35	11	5	6	45.45	2,560.59	-3,638.55	4,431.84	-9,580.03	0.70	0.59	-820.76
8	-5,511.02	11	6	5	54.55	1,853.32	-3,326.19	4,919.04	-5,666.03	0.56	0.67	-501.00
7	-13,049.83	11	5	6	45.45	1,475.05	-3,404.18	2,466.24	-11,742.00	0.43	0.36	-1,186.35
6	-18,651.23	11	3	8	27.27	1,444.30	-2,873.02	2,530.67	-6,937.05	0.50	0.19	-1,695.57
5	-18,653.10	11	3	8	27.27	1,500.00	-2,894.14	2,439.39	-4,850.27	0.52	0.19	-1,695.74
4	-10,424.06	12	3	9	25.00	1,745.14	-1,739.94	2,464.27	-4,056.12	1.00	0.33	-868.67
3	-30,721.10	14	2	12	14.29	1,530.64	-2,815.20	2,333.37	-6,326.26	0.54	0.09	-2,194.36
2	-29,041.50	14	4	10	28.57	700.46	-3,184.33	1,025.88	-8,004.64	0.22	0.09	-2,074.39
1	-5,811.32	14	6	8	42.86	1,166.29	-1,601.13	4,063.35	-4,418.09	0.73	0.55	-415.09

Not evident in the above table is that the average drawdown was over 3.3% , which is around 3.5x the size of the 0.9% average run-up. Meanwhile the maximum run-up was about 4.4%. I have posted below the profit curve assuming a three day holding period.



Overall, the sharp drop in the VXO over the last few days appears to suggest a substantial short-term downside edge.

I have updated the [Aggregator](#) chart below.



The bearish VIX study exerted enough downside influence that caused the green Aggregator Line to drop slightly into negative territory. Readings below 0 mean net expectations from the Active List are for downside over the next few days. Meanwhile, the black Differential Line continued its dive and is now extremely negative. A negative Differential reading means the SPX has outperformed expectations over the last few days. So net expectations are modestly bearish and the SPX is extremely overbought versus recent expectations. Historically this configuration has provided a downside edge. Bearish configurations can be seen on the chart whenever both lines close below 0. This all caused the Aggregator System to turn from flat to short at the close. This was posted to the Systems page shortly before the bell, and confirmed after the bell once the study numbers were crunched.

The short-term active studies are currently set up to remain net negative on Wednesday. Of course this could change if bullish evidence emerges. With the low number of studies currently active, expectations will be largely dependent on action over the next few days. The Differential Pivot will be 1,197.02 on Thursday. This is 4% below Wednesday's close. So it would take a drop of at least this much in order to move the Differential Line back into positive territory. That is highly unlikely to happen in 1 day. So it will probably take a multi-day pullback or consolidation to wear off the overbought condition.

So with my short-term outlook now bearish I will look to take on a small short position. I will not be trading this aggressively. I am seeing several indications that the market could continue to power higher over the next several days and weeks. Momentum is also very strong right now. Still, with the market as overbought as it is, potential reward on the downside versus short-term upside risk appears very favorable. Only agile traders should consider attempting a short at this point.

The VIX:VXV ratio and the futures term structure have moved considerably in favor of XIV in the last few days as contango has steepened. Though I am looking to take SPY short on Thursday, I have no intention of exiting my XIV position just yet. I still believe it has room to appreciate over the next several weeks and do not want to get shaken out and miss the ride up. The SPY short and XIV long trades will hedge each other to some degree for the time being.

Intermediate-term Outlook (2 weeks – 2 months)– updated 11/28 – moderately bullish

Selling intensified this past week despite the bullish seasonality. The triangle breakdown from about a week and a half ago shows no sign of being a “false” breakdown (as 70% of them are) and instead is very close to the 1,150 projection target already. The move up, which was so strong in October, will soon be in jeopardy of failing unless the market can get its act together soon.

A couple of studies with intermediate-term consequences triggered this past week. Both appeared in the 11/22 letter and I have copied both of their results tables below. The 1st one was bullish. It looked at instances where drops of 1.75% or more surrounded a smaller SPX decline.

**SPX closes down > 1.75% today and 2 days ago. Yesterday it was down but < 1.75%.
Buy on close. Sell X days later. \$100k/trade. 1961 - 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	69,714.98	20	17	3	85.00	4,958.12	-4,857.67	1.02	5.78	3,485.75
9	57,843.58	20	15	5	75.00	5,003.34	-3,441.29	1.45	4.36	2,892.18
8	55,882.82	20	15	5	75.00	4,838.73	-3,339.62	1.45	4.35	2,794.14
7	48,627.22	20	16	4	80.00	4,441.95	-5,610.98	0.79	3.17	2,431.36
6	51,365.59	20	16	4	80.00	3,933.71	-2,893.46	1.36	5.44	2,568.28
5	57,064.27	20	15	5	75.00	4,344.18	-1,619.70	2.68	8.05	2,853.21
4	40,353.37	20	18	2	90.00	3,089.24	-7,626.43	0.41	3.65	2,017.67
3	35,545.85	21	18	3	85.71	3,063.90	-6,534.80	0.47	2.81	1,692.66
2	28,025.00	21	15	6	71.43	2,585.03	-1,791.74	1.44	3.61	1,334.52
1	16,728.82	21	14	7	66.67	2,023.24	-1,656.65	1.22	2.44	796.61

The only instance that failed to close above the entry price at some point in the next 4 days triggered on 10/6/08.

The short-term is not playing out well for this study but it still could provide an intermediate-term influence.

The 2nd study considered the lackadaisical VIX that accompanied the strong selling. In contrast to the 1st study this one suggested bearish implications.

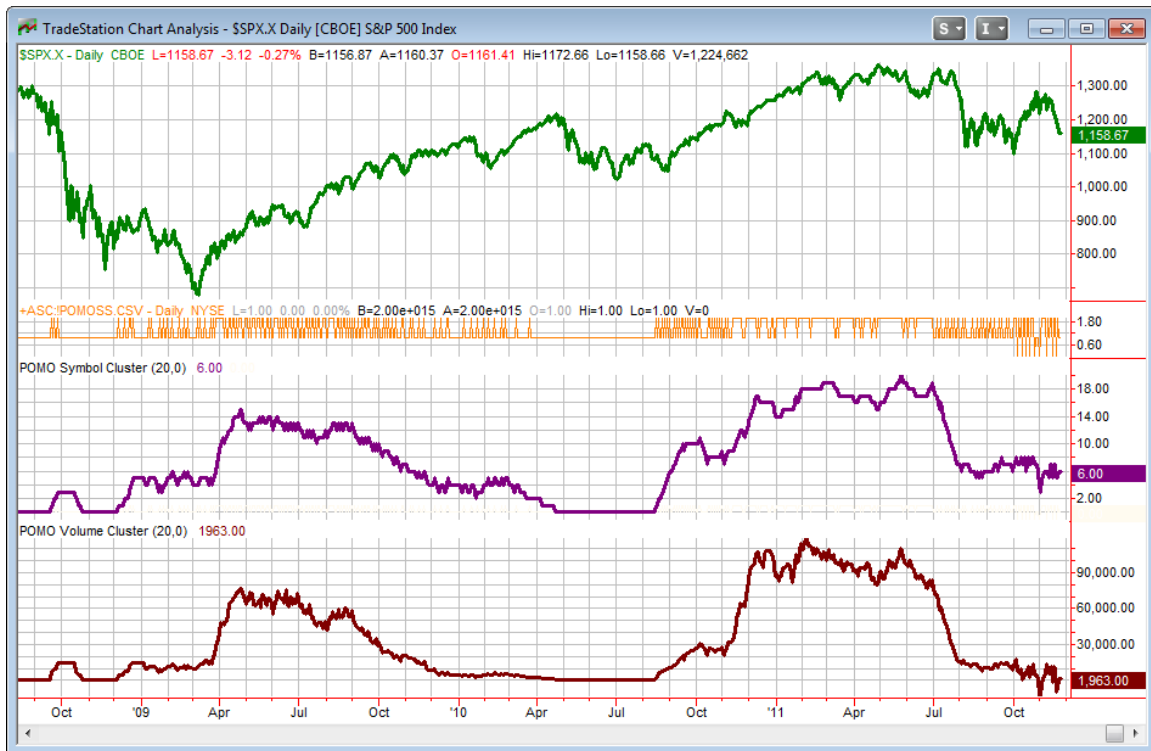
SPX closes under lower Bollinger Band. VIX closes < 5% above its 10ma. Buy on close. Sell X days later. \$100k/trade. 1993 - present.										
X Days	All: Net Profit	All: Total Trades	All: Winning Trades	All: Losing Trades	All: % Profitable	All: Avg Winning Trade	All: Avg Losing Trade	All: Win/Loss Ratio	All: ProfitFactor	All: Avg Trade
10	-27,756.96	13	3	10	23.08	3,980.17	-3,969.75	1.00	0.30	-2,135.15
9	-17,483.61	13	3	10	23.08	4,289.90	-3,035.33	1.41	0.42	-1,344.89
8	-18,035.78	13	5	8	38.46	2,405.37	-3,757.83	0.64	0.40	-1,387.37
7	-11,937.07	13	5	8	38.46	2,799.08	-3,241.56	0.86	0.54	-918.24
6	-11,355.32	13	4	9	30.77	2,527.03	-2,384.83	1.06	0.47	-873.49
5	-11,337.35	13	4	9	30.77	2,485.77	-2,364.49	1.05	0.47	-872.10
4	-8,856.23	13	5	8	38.46	1,663.96	-2,147.00	0.78	0.48	-681.25
3	-6,991.57	14	7	7	50.00	954.52	-1,953.31	0.49	0.49	-499.40
2	-11,444.51	15	5	10	33.33	770.48	-1,529.69	0.50	0.25	-762.97
1	-4,673.56	17	6	11	35.29	970.08	-954.01	1.02	0.55	-274.92

This one played out short-term, and it could continue to exert some influence.

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 (purple) pane is the net rolling number of days in the last 20 that have been POMO days. In other words, a day the Fed buys on the market will add +1 while a day of selling will count as -1. The bottom pane is the total amount of money infused into (or taken out of) 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>



This week the Fed withdrew a net \$9.6 billion from the system with sales swamping purchases. As you can see the net volume over the last 20 days is now just \$1.9 billion injected, and earlier this week that number actually dipped into negative territory for the 2nd time in recent weeks.

The next operations schedule is set to be released on Wednesday the 30th, so we will see then how December shapes up for liquidity support (or resistance) from the Fed. Currently there is buying scheduled for Monday and Tuesday, and then selling on Wednesday. The schedule suggests Wednesday's selling will likely exceed the buying total of Monday and Tuesday.

There was a strong thrust in the market that began at basically the same time as Operation Twist. Perhaps that was initial excitement over the Fed's new plan. As it became clear that Operation Twist would not provide the kind of liquidity support that QE1 and QE2 did the market seems to have floundered.

The intermediate-term is somewhat mixed. I'm still optimistic that the strong breadth and price thrusts that accompanied the rally in October were not false signals. It is unusual to see such early strength quickly dissipate and lead to another leg down for the market. Although seasonalities have not played out well recently, December is typically a strong month for the market. I'm inclined to maintain a bullish posture at this point, though I have reduced the strength of my outlook some.

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 @ \$125.00 limit. I considered a more conservative entry or perhaps looking to enter at the close rather than during the day, but with the market so overbought even a "moderate" pullback could provide a few % in profits. With that in mind I am looking to get in near Wednesday's closing price.

Current Open Trade Ideas

Symbol	Entry Date	Entry Price	Current Price	% Gain/Loss	Stop	Notes
<i>XIV(1/2)</i>	<i>11/17/2011</i>	<i>\$5.21</i>	<i>\$5.58</i>	<i>7.10%</i>		<i>sold on open</i>
XIV(1/2)	11/21/2011	\$4.91	\$5.71	16.29%		looking to hold a while

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