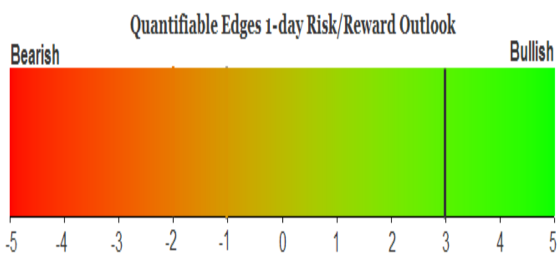
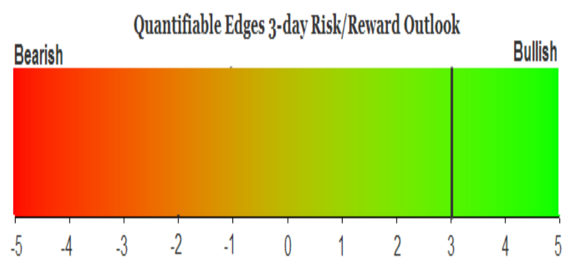
QUANTIFIABLE EDGES SUBSCRIBER LETTER

ASSESSING MARKET ACTION WITH INDICATORS AND HISTORY

December 15, 2011 Volume 4 Issue 242

Market Overview





Signals Overview

Aggregator	Aggressive VIX	Conservative VIX	NDX Trend Timer
Long	100% Long XIV	100% Long XIV	Flat

Tonight's Research Points

- 3-day pullbacks with a low 3/10 Offset HV enjoy a stronger upside edge than 3-day pullbacks with a high 3/10 Offset HV.
- The strong drop on the 3rd day of a pullback under the 200ma but above a 20-day low has most often been followed by a rally in the next few days.

Short-term Outlook

The Bottom Line

The Aggregator is suggesting an upside edge again today. I will look to add more long exposure. I am going to look towards IWM instead of SPY to take advantage of its strong seasonal tendency near year-end.

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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				
December 15, 2011	3-day pullback. < 200 > 20 low HV	1-3 days	Bullish	3.00%
December 14, 2011	Fed Day rise and reversal down	1-3 days	Bullish	
December 14, 2011	Gup up and reverse to a 10-day low	1-2 days	Bullish	
December 14, 2011	33% Up Issues 2 days in a row	1-2 days	Bullish	
December 13, 2011	Unfill gap both ways	1-4 days	Bearish	
December 12, 2011	December Op-Ex Seasonally Strong	1-5 days	Bullish	
Active - Long Term				
December 12, 2011	Seasonal strength into year end	thru 1/2	Bullish	
December 5, 2011	POMO scheduled to turn negative	int term	Bearish	
December 5, 2011	3 20-day VIX lows. No SPY 20-high	1-20 days	Bearish	-7.30%
December 1, 2011	90% up day on at least 3rd day higher	1-14 days	Bullish	
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	

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

The Evidence

Despite being the strongest week of the year historically the market has yet to manage a positive close over the 1st 3 days. On Wednesday the SPX fell another 1.1%, the Nasdaq lost 1.6%, and the Russell 2000 declined 1.4%. Breadth was again weak as the NYSE Up Issues % came in at 28% and the Up Volume % was 21%. Total NYSE declined slightly from Tuesday's level.

Three day pullbacks with certain characteristics will often suggest an upside edge. I'm seeing positives in this pullback.

These first two studies are from the 1/11/11 Subscriber Letter. They look at what happens when a three day pullback occurs in conjunction with a sharp drop in the 3/10 Offset HV indicator.

As a brief review the 3/10 Offset HV compares the current 3-day historical volatility to the historical volatility of the 10 days prior to these three. When very low readings occur that means there has been a sharp contraction in volatility. This often leads to a volatility expansion. It isn't often useful in determining direction. It does suggest that a large move could occur, though. The 0.25 level is one I tend to use. Historically it has reached 0.25 or lower about 9% of the time. The 3 days following such low readings have seen the 3-day HV expand 5.5 times over the next 3 days.

So let's take a look and see how the market has reacted following 3-day pullbacks with low readings vs. those without low readings. First I'll show times when the 3/10 Offset HV is above 0.25.

SPX closes down for exactly the 3rd day in a row and HV Offset 3/10 Indicator > 0.25.
Buy on close. Sell X days later. $100k/trade. 2000 - present.

X Days	All: Net Profit	All: Total Trades	All: Winning Trades	All: Losing Trades	All: % Profitable	All: Avg Winning Trade	All: Max Winning Trade	All: Avg Losing Trade	All: Max Losing Trade	All: Win/Loss Ratio	All: ProfitFactor	All: Avg Trade
10	35,027.80	104	61	43	58.65	2,957.93	10,849.26	-3,381.53	-16,890.72	0.87	1.24	336.81
9	56,377.33	109	66	43	60.55	2,811.67	12,144.60	-3,004.48	-15,942.36	0.94	1.44	517.22
8	44,793.48	112	68	43	60.71	2,705.26	12,293.93	-3,236.37	-14,092.68	0.84	1.32	399.94
7	47,742.48	116	66	50	56.90	2,670.14	12,277.87	-2,569.73	-9,109.80	1.04	1.37	411.57
6	30,254.34	119	66	53	55.46	2,385.86	10,326.58	-2,400.23	-11,683.62	0.99	1.24	254.24
5	37,387.75	129	66	63	51.16	2,521.73	9,830.18	-2,048.35	-18,000.90	1.23	1.29	289.83
4	37,811.84	137	79	58	57.66	1,962.54	7,119.69	-2,021.19	-17,037.90	0.97	1.32	276.00
3	33,173.09	137	78	59	56.93	1,724.20	7,687.63	-1,717.19	-10,286.10	1.00	1.33	242.14
2	28,136.74	137	80	57	58.39	1,424.82	7,249.63	-1,506.12	-9,270.00	0.95	1.33	205.38
1	35,871.34	137	84	53	61.31	1,127.41	6,901.83	-1,110.02	-3,810.60	1.02	1.61	261.83

87% of instances closed above the entry price
at some point in the next week.

As we knew from past studies there is a mild upside bias after a 3-day pullback. It appears over the last 11 years that the edge has really only lasted 1-day. Returns after the 1st day are fairly flat.

Now let's look at times like now where the 3/10 Offset HV is very low.

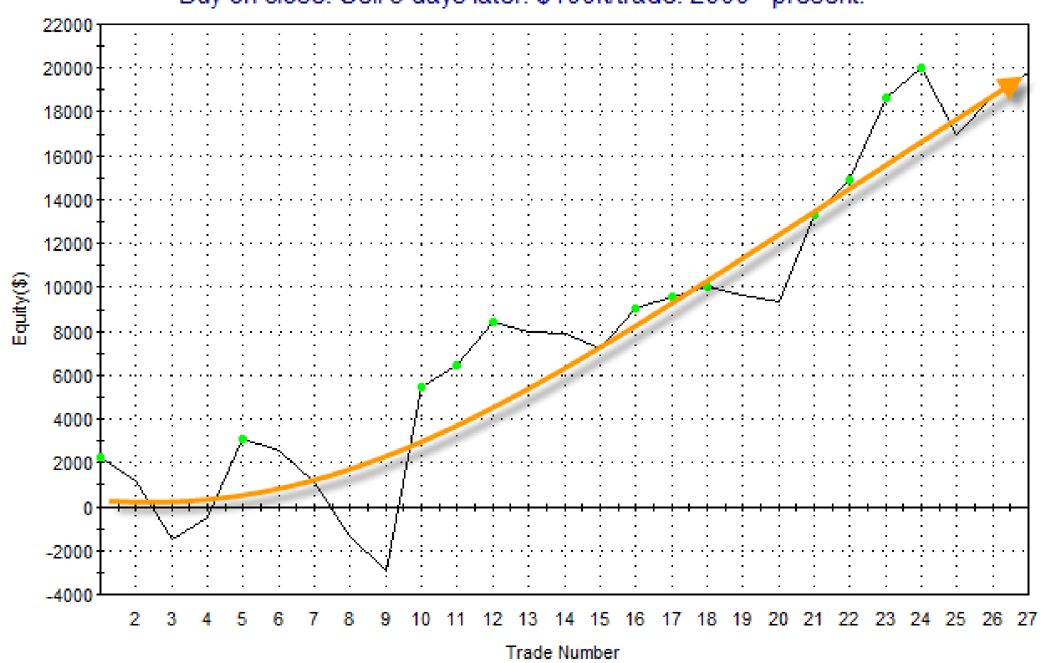
SPX closes down for exactly the 3rd day in a row and HV Offset 3/10 Indicator < 0.25.
Buy on close. Sell X days later. $100k/trade. 2000 - present.

X Days	All: Net Profit	All: Total Trades	All: Winning Trades	All: Losing Trades	All: % Profitable	All: Avg Winning Trade	All: Max Winning Trade	All: Avg Losing Trade	All: Max Losing Trade	All: Win/Loss Ratio	All: ProfitFactor	All: Avg Trade
10	28,282.60	27	18	9	66.67	2,739.29	13,815.90	-2,336.07	-5,143.04	1.17	2.35	1,047.50
9	26,119.11	27	17	10	62.96	2,603.29	11,206.23	-1,813.68	-5,817.60	1.44	2.44	967.37
8	23,983.02	27	17	10	62.96	2,704.61	11,382.35	-2,199.53	-4,624.64	1.23	2.09	888.26
7	14,097.13	27	16	11	59.26	2,493.11	10,117.38	-2,344.79	-5,582.08	1.06	1.55	522.12
6	12,934.73	27	16	11	59.26	2,576.37	5,903.59	-2,571.57	-7,964.16	1.00	1.46	479.06
5	17,081.41	27	17	10	62.96	2,466.49	8,234.80	-2,484.90	-7,032.56	0.99	1.69	632.64
4	11,904.19	27	17	10	62.96	2,122.08	8,810.76	-2,417.12	-7,145.44	0.88	1.49	440.90
3	19,781.21	27	15	12	55.56	2,292.20	8,432.34	-1,216.82	-3,021.92	1.88	2.35	732.64
2	16,870.75	27	15	12	55.56	1,987.72	5,018.23	-1,078.75	-5,271.36	1.84	2.30	624.84
1	8,030.99	27	17	10	62.96	1,067.39	2,971.43	-1,011.47	-4,660.72	1.06	1.79	297.44

24 of 27 instances (89%) closed above the entry price
at some point in the next week.

These numbers appear to be quite a bit better. Both immediately and after a couple of weeks. The reliability of some kind of bounce improves nicely as well. Below is a profit curve assuming a 3-day exit strategy.

SPX closes down for exactly the 3rd day in a row and HV Offset 3/10 Indicator < 0.25.
Buy on close. Sell 3 days later. $100k/trade. 2000 - present.



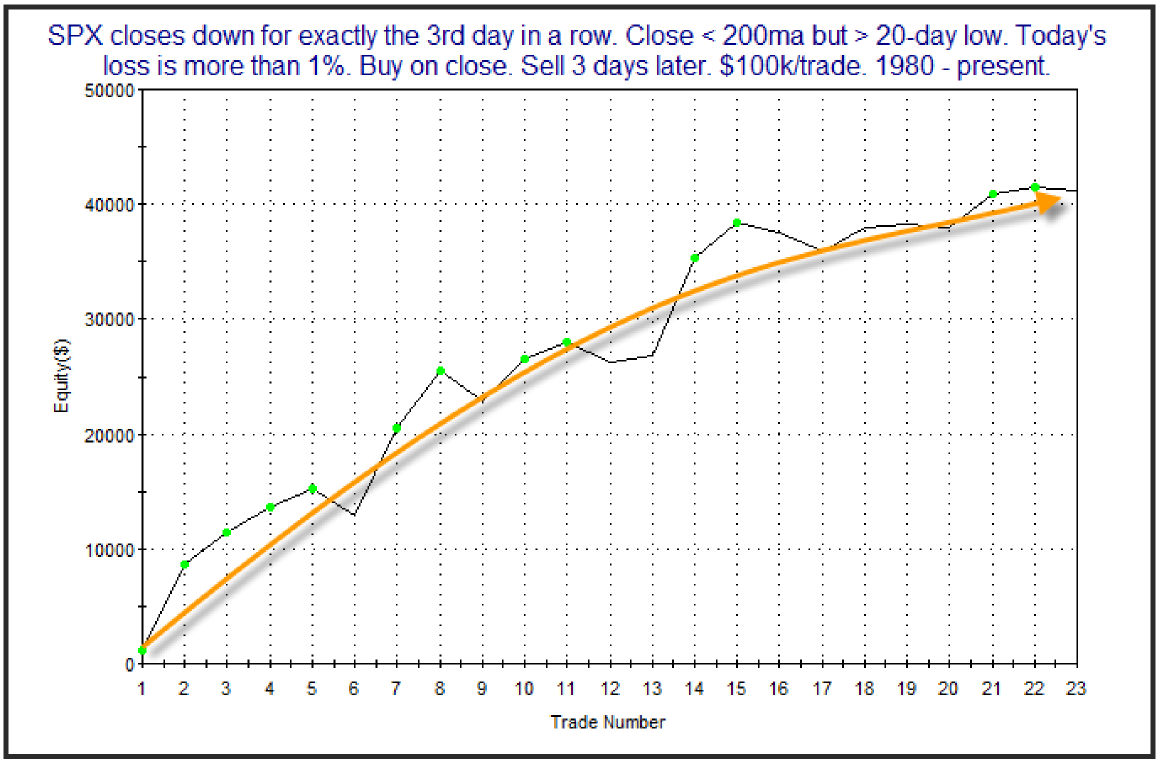
The strong upslope appears to confirm the stats table.

There were some other studies in the Quantifinder tonight that looked at things like 1) the sizable drop, and 2) the position of the market being above a 20-day low but < 200ma. So I combined a few of these and concocted the below study.

SPX closes down for exactly the 3rd day in a row. Close < 200ma but > 20-day low. Today's loss is more than 1%. Buy on close. Sell X days later. $100k/trade. 1980 - present.

X Days	All: Net Profit	All: Total Trades	All: Winning Trades	All: Losing Trades	All: % Profitable	All: Avg Winning Trade	All: Max Winning Trade	All: Avg Losing Trade	All: Max Losing Trade	All: Win/Loss Ratio	All: ProfitFactor	All: Avg Trade
10	55,924.54	22	16	6	72.73	4,347.20	13,815.90	-2,271.78	-4,560.60	1.91	5.10	2,542.02
9	53,009.96	22	15	7	68.18	4,361.27	12,019.45	-1,772.72	-5,068.80	2.46	5.27	2,409.54
8	50,548.18	22	15	6	68.18	4,569.56	12,293.93	-2,999.21	-6,288.70	1.52	3.81	2,297.64
7	39,238.13	22	16	6	72.73	3,574.91	12,277.87	-2,993.42	-6,115.59	1.19	3.18	1,783.55
6	34,775.05	23	16	7	69.57	3,780.89	10,326.58	-3,674.16	-11,683.62	1.03	2.35	1,511.96
5	40,482.74	23	16	7	69.57	3,941.86	12,331.51	-3,226.71	-5,973.00	1.22	2.79	1,760.12
4	44,685.56	23	17	6	73.91	3,716.34	10,588.68	-3,082.02	-5,638.06	1.21	3.42	1,942.85
3	41,144.03	23	16	7	69.57	3,186.35	8,432.34	-1,405.37	-2,616.64	2.27	5.18	1,788.87
2	23,469.94	23	13	10	56.52	2,727.81	7,249.63	-1,199.16	-2,936.78	2.27	2.96	1,020.43
1	18,155.89	23	16	7	69.57	1,620.26	6,901.83	-1,109.74	-3,162.00	1.46	3.34	789.39

Results here appear even stronger than the low Offset HV study. Below is the 3-day profit curve.



While it may have lost a little oomph lately the curve is still nicely upsloping.

In all, I would say the current 2-day pullback contains characteristics similar to other pullbacks that quickly bounced. I believe the above studies are indicative of an upside edge.

I have updated the Aggregator chart below.

With tonight's studies taken into account the green Aggregator Line remained strongly positive. Readings above 0 mean net expectations from the Active List are for upside over the next few days. Meanwhile, the black Differential Line is now well above 0. A positive Differential reading means the SPX has underperformed expectations over the last few days. So net expectations are bullish and the SPX is oversold versus recent expectations. Historically, this setup has provided an upside edge. It can be seen on the chart whenever both lines close above zero. This caused the Aggregator System to remain long.

The expectations of the short-term active studies are currently set up to close positive again on Thursday. Of course this could change if bearish evidence emerges. The Differential Pivot will be at 1,232.45 on Thursday. This is over 1.7% above Wednesday's close. So the SPX will need to rally at least this much in order for the Differential Line to fall below 0. Without a strong move up Thursday it appears likely the long signal will remain active for another day.

Overall there appears to be a solid upside edge at this point. I am partially long and will look to continue to scale in on Thursday. I won't be using SPY though. Instead I will look to take some exposure in IWM. After Thursday IWM should have a seasonal advantage over SPY, and I'll be looking to take advantage of this edge. I discussed this in the 12/12/11 letter a few days ago. Below is an excerpt.

In past years I discussed the January Effect, which is a tendency that I believe was first published in the Stock Traders Almanac. It suggests that from mid-December through January smallcap stocks tend to outperform largecaps. My research in 2008 looked back to 1988 and used the Russell 2000 versus the SPX. I found that the bulk of this tendency was realized in the end of December and the 1st day of January. I measured from the 15th of December (or the 1st trading day afterwards if the 15th was a weekend) through the 1st trading day in January. In 2008, 2009, and 2010 this edge played out quite strongly with the Russell outperforming the SPX by 4.4%, 3.3% and 3.3%. So the edge certainly has not waned in recent years. Since 1988 we have now seen the Russell outperform 18 of 23 years, or 78% of the time. But not only have there been substantially more winning years, but the average win has doubled the average loss. The average winning year saw the Russell outperform by 2.14% while the average losing year saw the SPX outperform by 1.03%. There have been gross gains of 38.46% in the 18 winning years and gross losses of 5.15% in the 5 losing years. So gains have outsized losses by nearly 7.5 to 1. And the only losing year to post a loss of greater than 1% was 1991 when the SPX outperformed the Russell by 2.82%. In all, the Russell has outperformed the SPX over the last 23 years by an average of 1.5% during this 2+ week period.

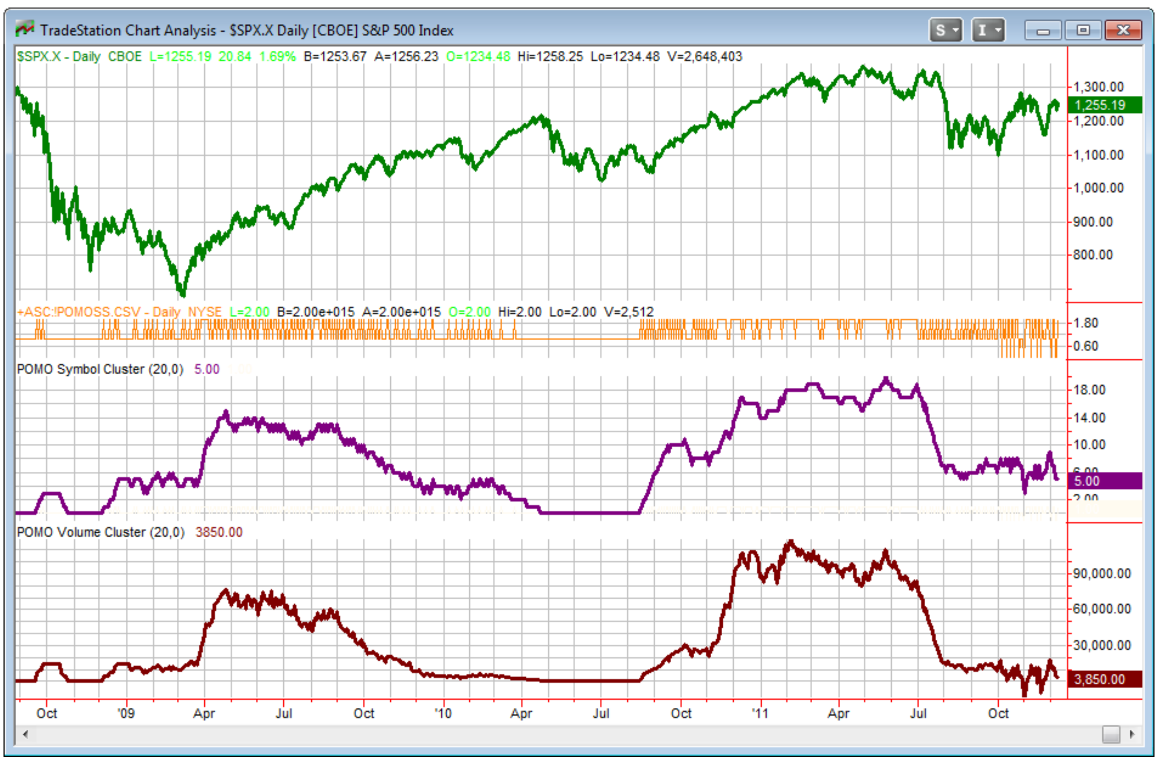
Intermediate-term Outlook (2 weeks – 2 months)– updated 12/12 – somewhat bullish

More gains this past week have the market testing the 200ma. The next stop would be the October highs. Aside from the seasonal studies shown in the short-term section above there wasn't anything that triggered from an intermediate-term standpoint this past week.

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 added a net $6.3 billion to the system with purchases quite a bit stronger than sales. The net volume over the last 20 days is now $3.6 billion injected, which is in the middle of its recent range.

The bad news is that the December POMO schedule worsens in the next several weeks and outflows are expected.

The intermediate-term is somewhat mixed. The intermediate-term active studies list is showing a fair amount of both bullish and bearish indications. With seasonality strong over the next few weeks I am inclined to give a slight edge to the bulls. Of course this could change as things evolve this week.

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.

IWM buy ¼ index position @ $71.04 limit. Based on short-term outlook above.

Current Open Trade Ideas

Symbol	Entry Date	Entry Price	Current Price	% Gain/Loss	Stop	Notes
XIV(1/2)	11/21/2011	$4.91	$5.81	18.33%	$4.99	looking to hold a while
SPY(1/4)	12/14/2011	$122.56	$121.74	-0.67%		bought on open

The XIV position has held up remarkable well despite the market pullback the last few days. While SPX has declined 3.5% over the last 3 days our XIV position is only down 0.7%. There are a number of contributing factors. With holiday trading just around the corner the VIX appears resigned to decline. Additionally, contango is exceptionally strong right now, which is helping out XIV by at least a couple of cents each day. Unless there is a big shift in the futures term structure it appears the contango should remain steep until at least VIX futures expiration next Wednesday. If the market continues to slide and we get a sharp drop in XIV in the next few days, I very well may look to add another lot of it.