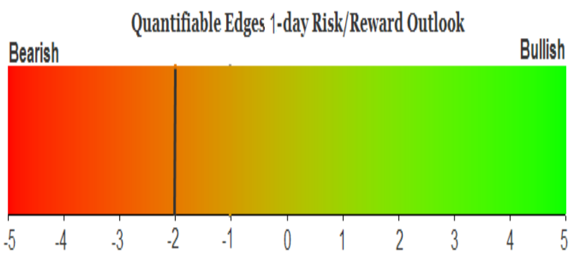
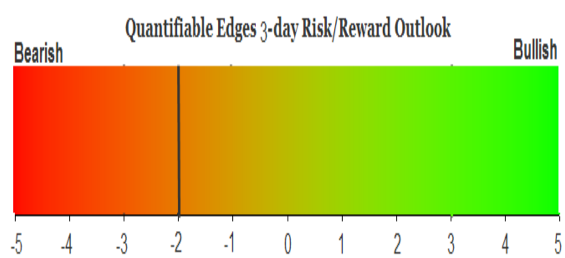
QUANTIFIABLE EDGES SUBSCRIBER LETTER

ASSESSING MARKET ACTION WITH INDICATORS AND HISTORY

January 6, 2012 Volume 5 Issue 4

Market Overview





Signals Overview

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

Tonight's Research Points

- Gaps down below the low of 2 days ago that reverse to close at 20-day highs have consistently been followed by selling over the next 1-4 days.

Short-term Outlook
The Bottom Line

The market remains overbought and expectations have turned negative. I am looking to exit my XIV and take some short exposure in SPY.

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

Study Date	Description	Time span	Bias	Avg Max Move
Active				
January 6, 2012	SPY gap dn then reverse to 20-high	1-3 days	Bearish	-2.25%
January 4, 2012	SPY strong day but weak finish	1-3 days	Bullish	
January 4, 2012	2 of 3 days Up Issue %>75. 10-high.	1-6 days	Bullish	2.50%
January 3, 2012	Overbought w/out POMO suppport	1-5 days	Bearish	-2.70%
December 28, 2011	5 Days Up > 200 no 50-high	1-10 days	Bullish	2.00%
Active - Long Term				
January 4, 2012	2 of 3 days Up Issue %>75. 10-high.	1-18 days	Bullish	
December 28, 2011	5 Days Up > 200 no 50-high	1-15 days	Bullish	
December 5, 2011	POMO activity flat to negative	int term	Bearish	
October 30, 2011	SPX & bond yields hit 50-day highs	1-50 days	Bearish	
October 19, 2011	FTD on strong breadth/20day high	int term	Bullish	
Dropped Tonight				
January 5, 2012	SPY up < 0.25%. Close in top 10%.	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

For the 2nd day in a row bears tried to take the market lower. And for the 2nd day in a row they couldn't maintain their downward momentum much past 10am EST. After that it was up or sideways for the rest of the day. In the end the SPX gained 0.3%, the Nasdaq was up 0.8% and the Russell 2000 rose 0.7%. Breadth was moderately positive as the NYSE Up Issues % came in at 60% and the Up Volume % was 58%. Total NYSE volume hit its highest level in a few weeks.

The gap down and reversal to a new 20-day high triggered a study last seen in the 1/6/11 subscriber letter. I have updated results for that study below.

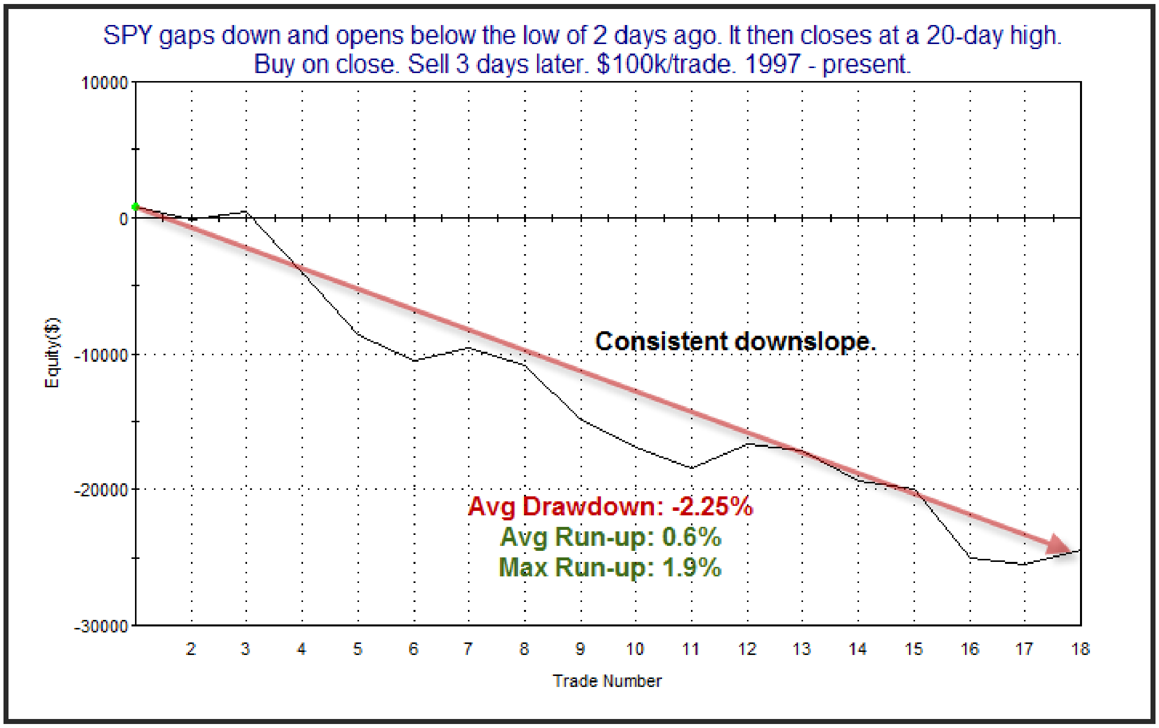
SPY gaps down and opens below the low of 2 days ago. It then closes at a 20-day high.
Buy on close. Sell X days later. $100k/trade. 1997 - present.

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
5	-17,053.46	18	7	11	38.89	1,016.37	2,022.02	-2,197.10	-4,996.75	0.46	0.29	-947.41
4	-22,445.87	18	4	14	22.22	1,391.72	2,371.65	-2,000.91	-4,597.01	0.70	0.20	-1,246.99
3	-24,416.73	18	5	13	27.78	1,057.59	1,679.13	-2,284.98	-5,083.65	0.46	0.18	-1,356.48
2	-15,928.12	18	4	14	22.22	743.91	1,409.64	-1,350.27	-2,919.84	0.55	0.16	-884.90
1	-10,634.84	18	3	15	16.67	789.65	1,034.48	-866.92	-1,935.36	0.91	0.18	-590.82

17 of 18 instances (94%) posted a close above the entry price at some point in the next 4 days.

Results here all appear to suggest a short-term bearish tendency. The stats are especially impressive considering the SPY is making 20-day highs.

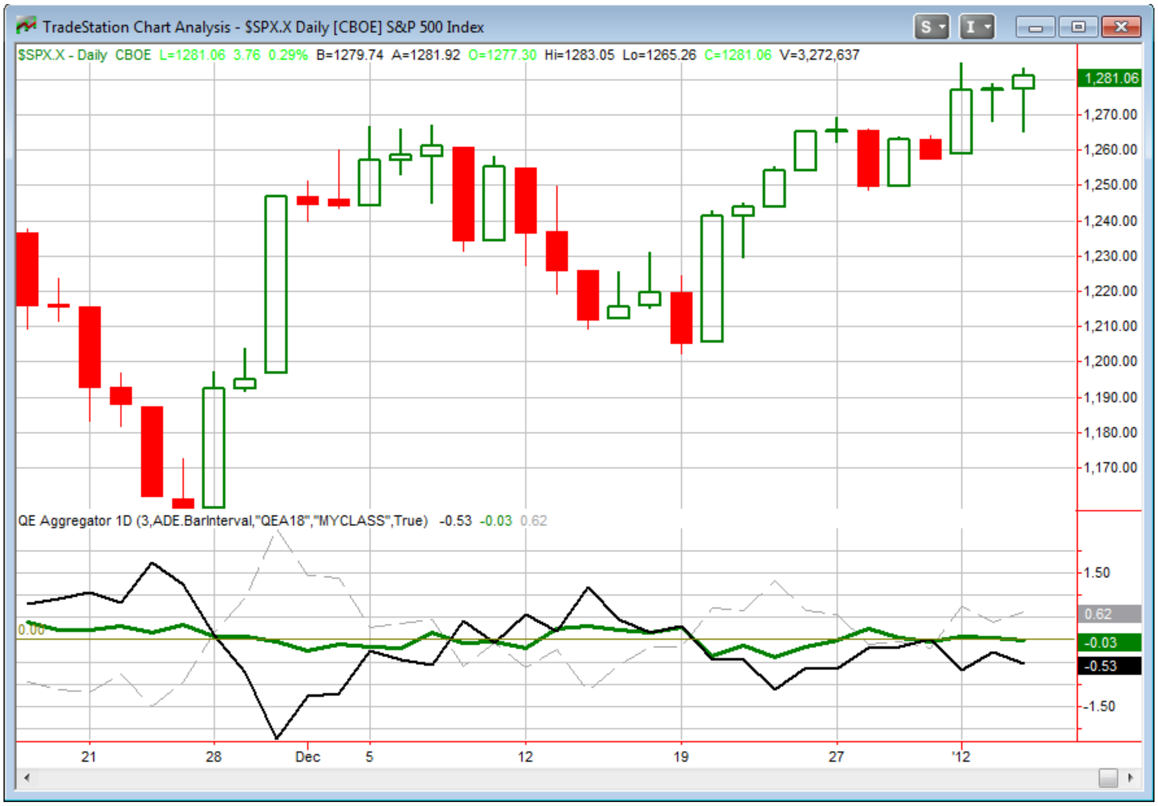
Below is a profit curve to see how the edge has played out over the last several years.



The downslope is nicely consistent, which serves to act as confirmation of the stats table. Aside from the other information, I have also included run-up/drawdown stats. With the average drawdown greater than the MAX run-up and over 3.5 times the size of the average run-up, risk/reward seems to strongly favor the bears.

So the bullish studies from Tuesday night's letter that showed Tuesday's strong action was likely to see some follow through have worked out so far, though with somewhat muted upward movement. But the overbought / weak POMO activity setup has yet to exert influence and tonight's SPY reversal study is tilting the scales in favor of the bears.

I have updated the Aggregator chart below.



Tonight's bearish study helped the green Aggregator Line turn negative. Readings below 0 mean net expectations from the Active List are for downside over the next few days. Meanwhile, the black Differential Line held firm below 0. A negative Differential reading means the SPX has outperformed expectations over the last few days. So net expectations are now bearish and the SPX remains overbought versus recent expectations. Historically this configuration has provided a short-term downside edge. Bearish configurations are visible on the chart whenever both lines close below 0. This caused the Aggregator System to turn short at the close. This was indicated on the systems page before the bell.

Based on the current active studies, expectations are scheduled to turn back to positive on Friday. Of course this could change if more bearish evidence emerges. The Differential Pivot will be 1,278.07 on Friday. This is less than 0.25% below Thursday's close. So it won't take much of a selloff to flip the Differential positive, and without new bearish evidence expectations will likely turn positive. This means the "short" signal tonight could easily flip to a "long" signal tomorrow night.

While the market is overbought it really doesn't look too stretched on a chart. It is still below the high of 2 days ago. The last 2 days appear to be more of a consolidation than a stretch higher. The SPX is also only about 10 points below its late-October high. A break to a new 50-day high could get some attention and gather momentum. So if the studies are wrong and the SPX fails to drop over the next few days, there is a decent chance they will be very wrong rather than just a little wrong. I still think it is worth taking a shot with some short exposure here, but risk is a little elevated and I am not going to get aggressive at this point.

The other thing to keep in mind is that the bearish edge may only last 1 day. With this in mind I will use a limit order for entry as I normally do, but I will cancel the order if not filled early on in the day. Also, if I do get a fill and the market does the expected and moves lower, then I will look to take quick profits at the close.

And if you're monitoring the trades in the Trade Ideas section below, note that I am placing a rare stop on the Catapult and I am looking to exit the XIV trade which I have held for close to a month and a half. Details further down.

Intermediate-term Outlook (2 weeks – 2 months)– updated 1/3 – neutral
The intermediate-term outlook was lat updated in the 1/3/12 letter. I may be accessed using the link below:

2012-01-03 QE Subscriber Letter.pdf

Catapult and Capitulative Breadth Statistics
Catapult & CBI Presentation Link
Open Catapult Triggers
MO – bought 1/3 @ $28.40 limit

Catapult for ETF's Trades
None.

***Broad Market Large Cap CBI* – 1 (MO)**

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 @ $128.04. If not filled in the first 30 minutes of trading, cancel order. This is based on my short-term outlook above. Since I'll be looking for a quick exit on this one I don't want to be caught shorting into an afternoon reversal and rally if I'm not already filled early in the day. ***If filled, then I will cover this position on any SPX close <= the Differential Pivot of 1,278.07.***

Current Open Trade Ideas

Symbol	Entry Date	Entry Price	Current Price	% Gain/Loss	Stop	Notes
XIV(1/2)	11/21/2011	$4.91	$7.15	45.62%	$6.25	*sell @ $7.08 limit*
MO(1/3)	1/5/2012	$28.40	$28.83	1.51%	$28.09	Catapult

In December I held on to the XIV position through several days where the Aggregator was showing a short signal. At that time contango was very strong and XIV was earning quite a bit of premium rolling futures. It was also a strong seasonal play with December VIX levels typically very low. And thirdly, my intermediate-term market outlook was a bit rosier. Those factors have weakened substantially and are no longer enough to support an XIV position through a short Aggregator signal. So I will look to take profits here. I put it in as a limit price about 1% below Thursday's close. In case of a gap down this will give us a better chance of a fill. If this isn't filled early on then I may adjust the limit lower of move the stop strongly higher. I do still feel XIV has a good chance to rally over the next few weeks. Its edge just isn't that sharp right now. I will certainly keep an eye out for the next favorable entry opportunity, and may even re-enter in the next few days if it pulls back and bullish evidence increases.

MO – I rarely use stops on Catapults. My testing has not found a way to incorporate them that improved results. Still, with MO bouncing today at a level with multiple layers of support, I think a stop is a good choice. Wednesday's swing low is barely above the swing low on December 5th. Also right in this area is the 50-day moving average. So this obvious support level could hold prices up. But if it is broken a lot of people will notice, and it could cause prices to cascade lower in another leg down. I don't want to sit through that so I'll place a stop at $28.09, which is just below the 12/5/11 low.