

QUANTIFIABLE EDGES SUBSCRIBER LETTER

ASSESSING MARKET ACTION WITH INDICATORS AND HISTORY

February 24, 2012

Volume 5 Issue 37

Market Overview



Signals Overview

Aggregator	Aggressive VIX	QE Buy Pwr Swing	NDX Trend Timer
Short	100% Short SPY	Flat	Flat

Tonight's Research Points

- Thursday's gap lower and strong close at new highs sets up a very bearish short-term pattern.
- The low VIX:VXV ratio at a 50-day SPX high suggests downside risk outsizes upside reward for the following day.

Short-term Outlook

The Bottom Line

Evidence still suggests a short-term dip, but the window of opportunity appears small. I'll look for a quick short-side trade.

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

Study Date	Description	Time span	Bias	Avg Max Move
Active				
February 24, 2012	SPX 50-high. VIX:VXV < 0.85.	1 day	Bearish	
February 24, 2012	SPY open < low 2 days ago. Close 50-hi	1-3 days	Bearish	-2.60%
February 22, 2012	SPY gap up close < open & > yest > 200	1-5 days	Bullish	2.10%
February 21, 2012	SPX gains 1%-2% op-ex week. SPX > 200	1-5 days	Bearish	
Active - Long Term				
February 6, 2012	Up Issues % > 75% 2 of 3. 10 high.	1-16 days	Bullish	4.70%
February 1, 2012	Golden Cross	int term	Bullish	
January 31, 2012	SPY 1st close < 10ma in over 25 days	1-20 days	Bullish	4.70%
January 17, 2012	Nasdaq leading SPX	int term	Bullish	
December 5, 2011	POMO activity flat to negative	int term	Bearish	
Dropped Tonight				
February 17, 2012	Top 10% of 10-day range before opex	1-4 days	Bearish	
February 15, 2012	Unfill gap up. 20-high. Unfill gap dn.	1-6 days	Bearish	-1.40%
February 22, 2012	SPX 50-day high. VIX up.	1-2 days	Bearish	

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

The Evidence

Morning weakness failed to follow through and the market quickly bottomed about 20 minutes into the day. It rallied through the afternoon and closed near its high. The SPX gained 0.4%, the Nasdaq rallied 0.8% and the Russell 2000 rose 1.6%. Breadth was solidly positive as the NYSE Up Issues % came in at 71% and the Up Volume % was 68%. Total NYSE volume rose a little from Wednesday's level.

SPY action over the last few days triggered the following study. It is from the 10/19/11 letter. It looks at instances where SPY gaps down below the low of 2 days ago and reverses to new highs. Results are updated.

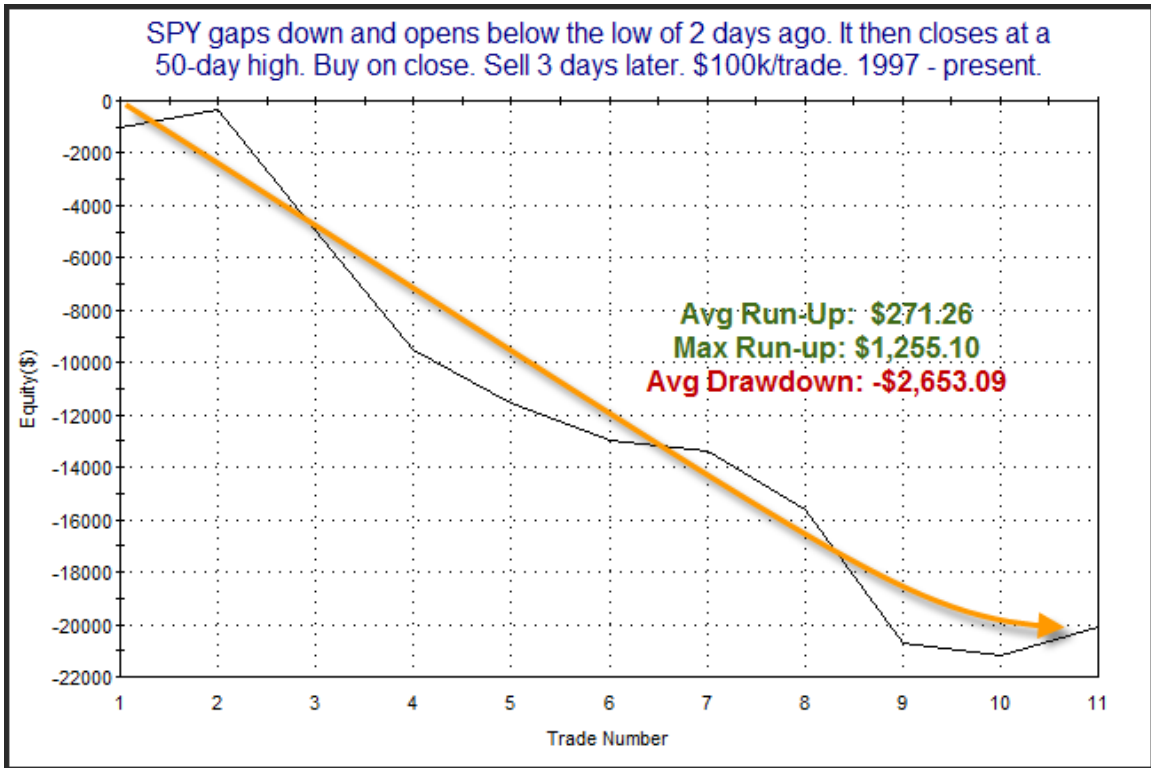
SPY gaps down and opens below the low of 2 days ago. It then closes at a 50-day high. Buy on close. Sell X days later. \$100k/trade. 1997 - present.												
X Days	All: Net Profit	All: Total Trades	All: Winning Trades	All: Losing Trades	All: % Profitable	All: Avg Winning Trade	All: Max Winning Trade	All: Avg Losing Trade	All: Max Losing Trade	All: Win/Loss Ratio	All: ProfitFactor	All: Avg Trade
5	-15,464.08	11	4	7	36.36	674.78	1,289.20	-2,594.74	-4,996.75	0.26	0.15	-1,405.83
4	-16,222.65	11	1	10	9.09	2,371.65	2,371.65	-1,859.43	-4,597.01	1.28	0.13	-1,474.79
3	-20,080.66	11	2	9	18.18	890.91	1,132.85	-2,429.16	-5,083.65	0.37	0.08	-1,825.51
2	-14,315.67	11	1	10	9.09	444.50	444.50	-1,476.02	-2,919.84	0.30	0.03	-1,301.42
1	-11,413.16	11	0	11	0.00	0.00	0.00	-1,037.56	-1,935.36	0.00	0.00	-1,037.56

While more instances would be nice, the 11-0 record and powerful returns strongly suggest a downside edge. Below I have listed all instances along with their 1-day holding period stats.

SPY gaps down and opens below the low of 2 days ago. It then closes at a 50-day high. Buy on close. Sell 1 day later. \$100k/trade. 1997 - present.				
Date/Time	Signal	Price	% Profit	Run-up Drawdown
05/30/97	Buy	\$85.28	(0.62%)	\$257.84
06/02/97	Sell	\$84.75		(\$656.32)
04/17/98	Buy	\$112.38	(0.06%)	\$160.02
04/20/98	Sell	\$112.31		(\$444.50)
03/18/99	Buy	\$132.25	(1.94%)	\$287.28
03/19/99	Sell	\$129.69		(\$1,935.36)
01/19/00	Buy	\$147.00	(1.53%)	\$0.00
01/20/00	Sell	\$144.75		(\$2,169.20)
01/26/04	Buy	\$115.87	(1.03%)	\$0.00
01/27/04	Sell	\$114.68		(\$1,052.86)
10/06/04	Buy	\$114.62	(1.02%)	\$0.00
10/07/04	Sell	\$113.45		(\$1,098.72)
05/09/07	Buy	\$151.16	(1.05%)	\$0.00
05/10/07	Sell	\$149.58		(\$1,249.29)
05/06/08	Buy	\$142.05	(1.78%)	\$0.00
05/07/08	Sell	\$139.52		(\$2,052.76)
01/19/10	Buy	\$115.06	(1.02%)	\$0.00
01/20/10	Sell	\$113.89		(\$1,807.52)
01/05/11	Buy	\$127.64	(0.20%)	\$148.77
01/06/11	Sell	\$127.39		(\$493.29)
10/18/11	Buy	\$122.58	(1.18%)	\$407.50
10/19/11	Sell	\$121.13		(\$1,524.05)

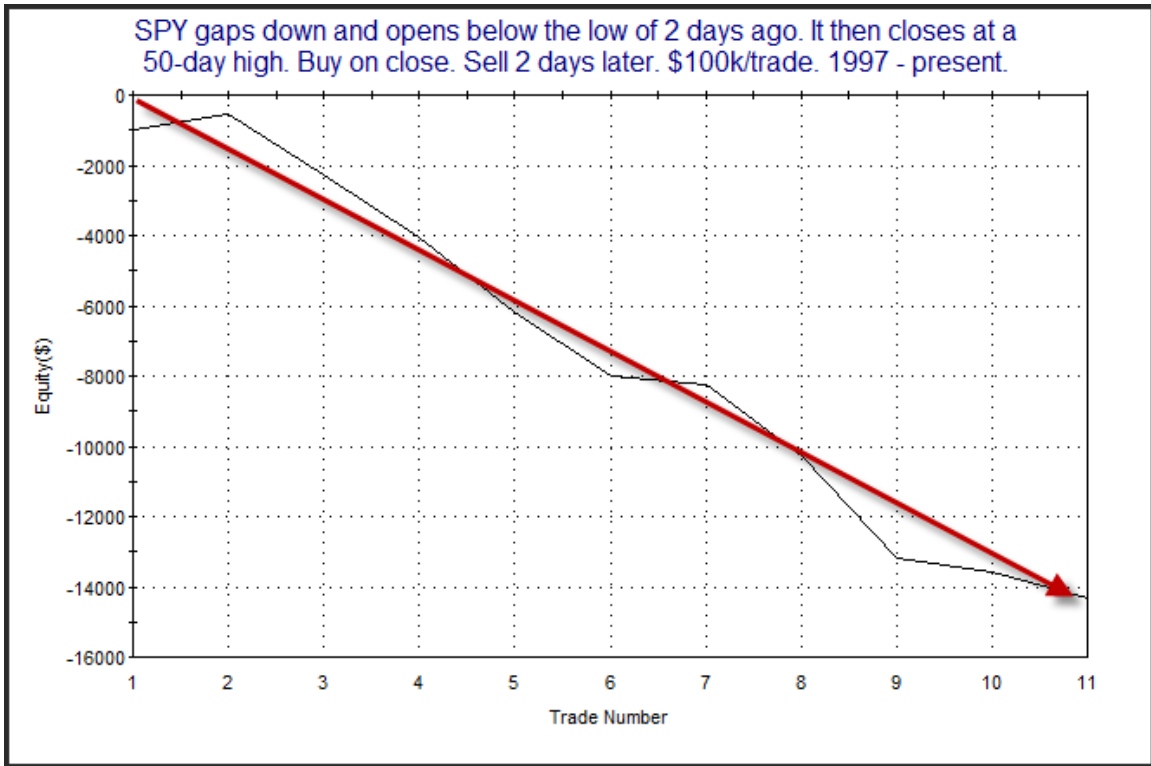
Note that 6 of the 11 instances saw no run-up at all the next day. This means an unfilled gap down occurred. Also note that the largest run-up of the remaining 5 instances was just \$407.50 (0.4%). Every instance saw a larger drawdown than this. Risk/reward has therefore been heavily skewed to the downside.

Now let's look in more detail at the 3-day holding period.



The last instance saw a sizable rise on Day 3, which led it to close higher. Even so, the stats are strongly in favor of the bears. The average drawdown is almost 10 times the size of the average run-up and over twice the size of the max run-up.

I also found the 2-day curve interesting.



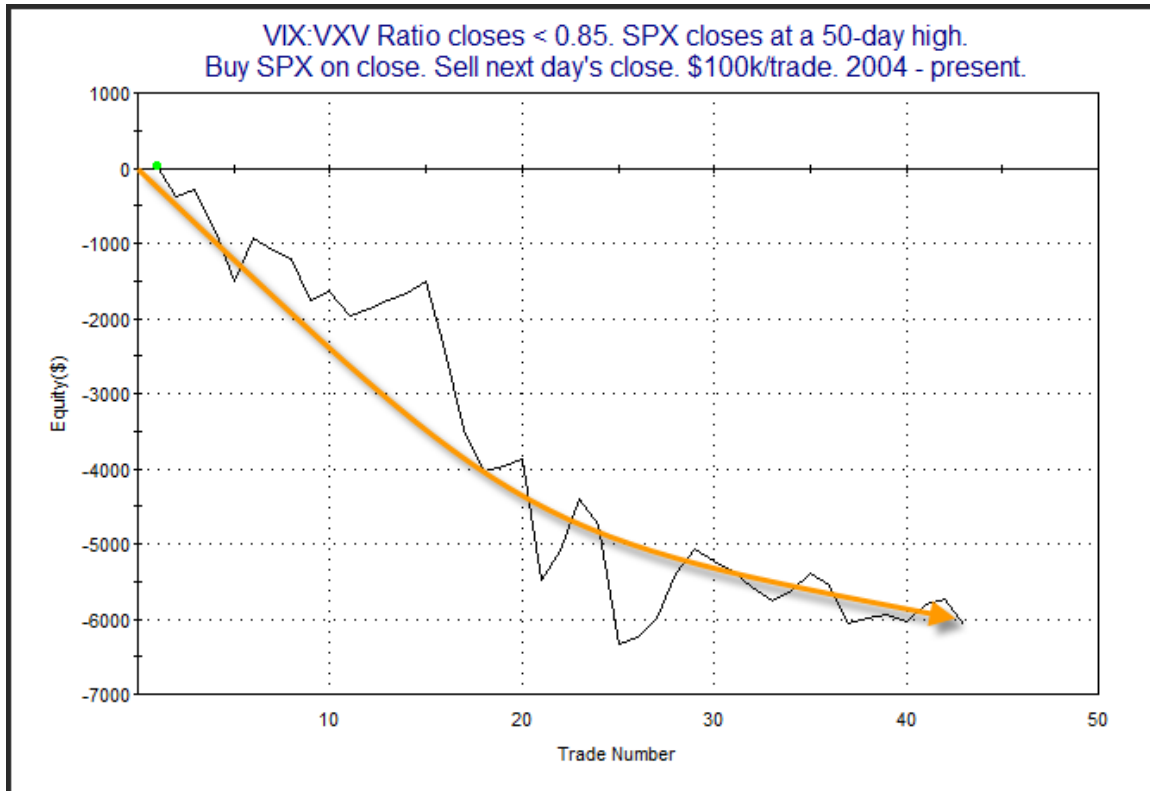
It is nearly a straight shot lower in the 2-day time frame, suggesting strong consistency.

And once again the study below triggered, which we saw a few times last week. It looks at instances of the SPX closing at a 50-day high while the VIX:VXV ratio was below 0.85. I have updated the results again below (but kept the comments the same).

VIX:VXV Ratio closes < 0.85. SPX closes at a 50-day high.
Buy SPX on close. Sell next day's close. \$100k/trade. 2004 - present.

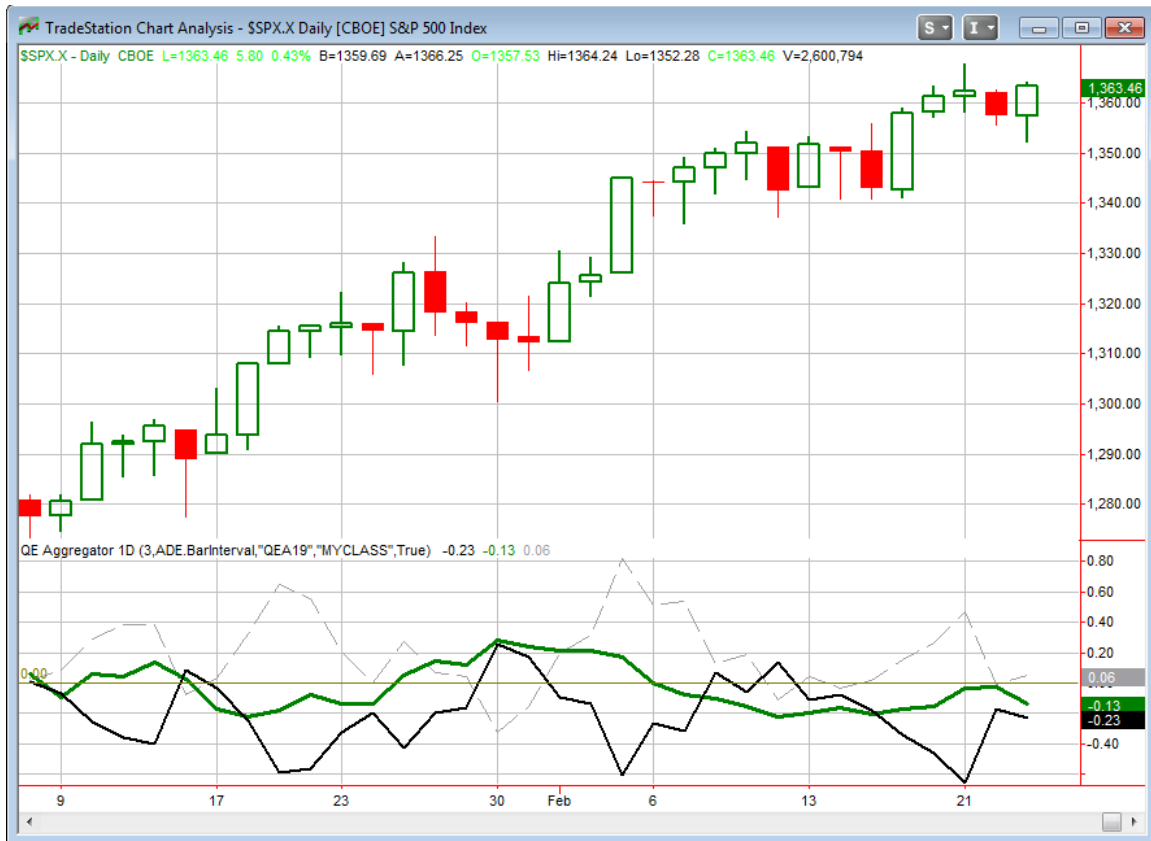
TradeStation Performance Summary Collapse ^			
All Trades			
Total Net Profit	(\$6,071.45)	Profit Factor	0.43
Gross Profit	\$4,564.90	Gross Loss	(\$10,636.35)
Total Number of Trades	43	Percent Profitable	51.16%
Winning Trades	22	Losing Trades	21
Even Trades	0		
Avg. Trade Net Profit	(\$141.20)	Ratio Avg. Win:Avg. Loss	0.41
Avg. Winning Trade	\$207.50	Avg. Losing Trade	(\$506.49)
Largest Winning Trade	\$708.05	Largest Losing Trade	(\$1,602.28)

The odds are 50/50 but the losers have been more than twice the size of the winners. This suggests the complacency we are seeing at these high levels is more likely to lead to a big down day than be followed by a big up day. To see how the edge has played out over time I have posted the profit curve below.



The equity curve seems to have flattened out a bit lately. I noted last time that I was going to keep an eye on this one, and I will continue to do so. For now I find it compelling enough to keep under consideration.

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



The strongly bearish studies tonight caused the green Aggregator line to dip further 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 is still squarely below 0. A negative Differential reading means the SPX has outperformed expectations over the last few days. So net expectations are slightly bearish and the SPX is overbought versus recent expectations. This is considered a bearish configuration. Bearish configurations are visible on the chart whenever both lines close below 0. This caused the Aggregator System to remain short at the close. This was indicated on the Systems page before the bell.

Based on the current evidence, expectations are scheduled to remain negative on Friday – but not very. Of course this could change if more bullish evidence emerges. Meanwhile, the Differential Pivot will be 1,357.28 on Friday. This is about 0.5% below Thursday’s close. So a half-decent sized selloff on Friday would cause the SPX to move into oversold territory. Like last night it appears action on Friday could lead to a long, short, or flat Aggregator signal. I’ll be keeping a close eye on the Quantifinder and the market throughout the day.

I took small profits on my short SPY trade idea this morning. At the time it appeared likely that expectations were going to turn positive and I would be exiting at the end of

the day anyway. But with the new SPY high the bearish studies above emerged and kept expectations bearish. So I am again looking at what appears to be a downside edge. But like last night it appears the window of opportunity may be small since the QE Buying Power Index is set to rise into bullish territory on Tuesday. If I can get a favorable entry I will take it. Details are in the Trade Ideas section at the bottom of the letter.

Because the windows of opportunity can be small, counter-trend trading will often require agility. It can be quick ins and outs for limited profits. Every once in a while, you'll catch a big one though. This is because counter-trend moves are not only quick, but they are also often sharp when compared to moves in the direction of the trend. It is for this reason that I am willing to consider taking small stabs in what appear to be quick trades like this one.

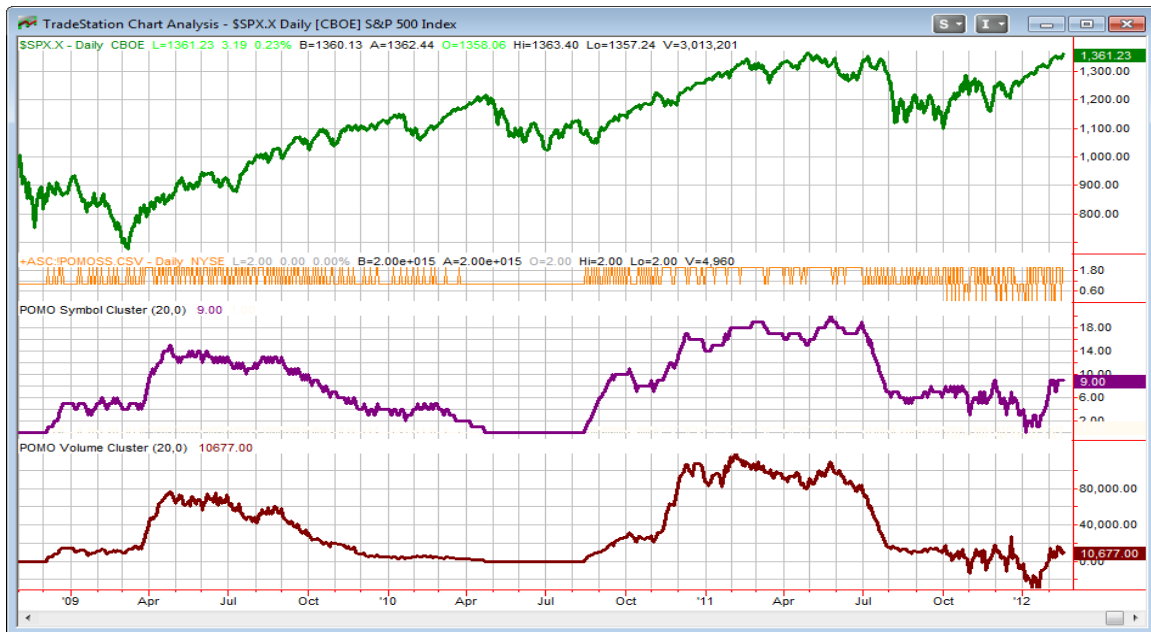
Intermediate-term Outlook (2 weeks – 2 months)– updated 2/21 – bullish

This past week saw the market post some solid gains and hit new highs. With new highs being reached on Friday the trend clearly remains up. And though the market looks susceptible to a short-term pullback there still appears to be ample evidence suggesting more upside over the intermediate-term. No new intermediate-term studies emerged in the last few days. The Active List here remains populated with studies seen in previous weeks.

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>



POMO numbers were strong this past week. There were 4 days of buying and 1 day of selling and the net over the week was about \$5 billion in buying. This kept the POMO indicators fairly flat as a similar week fell off the back end of the equations.

Thus upcoming week is expected to see strong POMO selling. There are 2 small buying days and 2 large selling days schedule that will result in a net sale of over \$14 billion in securities. This could have a negative short-term impact on the market. While the QE Buying Power Index is scheduled to post moderate values of “+1” all week, the strong selling days will actually mean negative volume. If there is an opportune time for the market to pull back with all the bearish studies already on board, this upcoming week would seem to be it.

So the intermediate-term still appears to be looking up. The SPX is in rally mode. We are still seeing studies related to momentum, trend, breadth, and Nasdaq leadership all point higher. Therefore, my outlook remains bullish. From a trading standpoint this simply means I will take a more aggressive approach with longs than with shorts.

Catapult and Capitulative Breadth Statistics

[*Catapult & CBI Presentation Link*](#)

Open Catapult Triggers

FCX – 1/3 position @ \$42.40 limit (\$42.17 fill)

GILD– 1/3 position @ \$47.00 limit (\$46.50 fill)

GILD– 1/3 position @ \$44.69 limit (\$44.21 fill)

GILD –1/3 position @ \$44.53 limit (\$44.53 fill)

Catapult for ETF's Trades

None

Broad Market Large Cap CBI – 4/2(FCX, GILD-3)

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 @ \$136.63 limit. If not filled in the first 15 minutes of trading – cancel order and place as a LIMIT ON CLOSE order (at same \$136.63 limit) as long as the “short” signal is confirmed on the systems page before the bell.. Based on the short-term outlook above I am looking for some selling on Friday. Since the edge appears sketchy after day 1 and I don't want to fight intraday momentum, I have no interest in taking a mid-day entry. I will therefore take this one very early or not until the close. ***If filled in the morning I will cover the SPY position on an SPX close <= the Differential Pivot of 1,357.28.***

Current Open Trade Ideas

Symbol	Entry Date	Entry Price	Current Price	% Gain/Loss	Stop	Notes
FCX(1/3)	2/16/2012	\$42.17	\$43.78	3.82%	\$42.25	Catapult
SPY(1/4)(s)	2/17/2012	\$136.52	\$136.06	0.34%		stopped out intraday
GILD(1/3)	2/21/2012	\$46.50	\$45.15	-2.90%		Catapult
GILD(1/3)	2/22/2012	\$44.21	\$45.15	2.13%		Catapult
GILD(1/3)	2/23/2012	\$44.53	\$45.15	1.39%		Catapult

SPY was stopped out at \$136.06 intraday. Gold subscribers were sent an intraday update around 10:25 alerting them that the stop was being lowered. The stop was hit around 10:45.

We have a small cluster of Catapult triggers now. Traders are encouraged to review the Catapult & CBI presentation available on the videos page, and the Catapult Exit Designer package available on the members downloads page for more Catapult info.

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