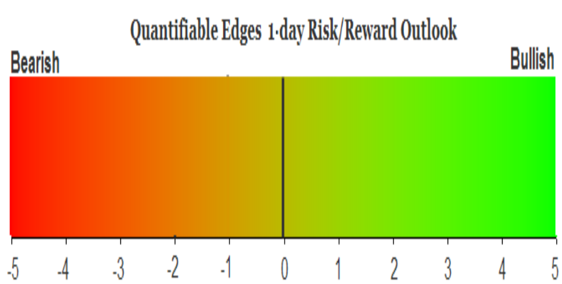
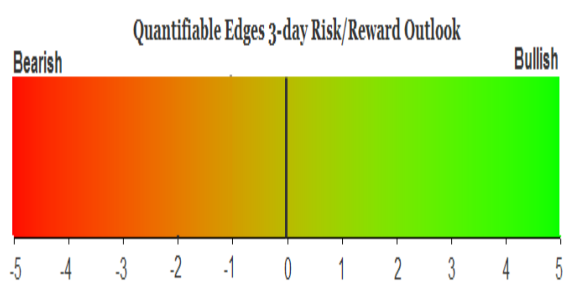
QUANTIFIABLE EDGES SUBSCRIBER LETTER

ASSESSING MARKET ACTION WITH INDICATORS AND HISTORY

August 6, 2012 Volume 5 Issue 150

Market Overview





Signals Overview

Aggregator	Aggressive VIX	QE Buy Pwr Swing	NDX Trend Timer
Flat	50% Long XIV	Flat	Flat

Tonight's Research Points

- A low VIX:VXV at a 50-day high increases short-term risk.
- SPY's large unfilled gap and new high suggest a short-term pullback.
- Friday's strong breadth at a new high suggests positive implications, both short and long-term.
- POMO flows are expected to turn more positive this week and month.

Short-term Outlook
The Bottom Line

Expectations are near flat and the SPX has performed almost exactly in line with them over the last few days. This creates a neutral outlook.

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

Study Date	Description	Time span	Bias	Avg Max Move
Active				
August 6, 2012	SPX 50-day high on 90% up vol	1-5 days	Bullish	
August 6, 2012	VIX:VXV < 0.85. SPX 50-high.	1 day	Bearish	
August 6, 2012	1% unfilled up gap. Close up > 200. 50hi	1-3 days	Bearish	
August 2, 2012	Down 2+ on a Fed Day	1-6 days	Bullish	2.10%
August 2, 2012	Down 3rd day. 3/10 Offset HV very low	1-3 days	Bullish	2.00%
August 1, 2012	Downlast 2 of up month	1-5 days	Bullish	2.00%
Active - Long Term				
July 30, 2012	SPX 50-day high on 90% up vol	1-50 days	Bullish	
July 16, 2012	POMO modestly bullish	int term	Bullish	
June 13, 2012	FTD with modest breadth & vol	int term	Bearish	
February 1, 2012	Golden Cross	int term	Bullish	
Dropped Tonight				
July 30, 2012	SPX 50-day high on 90% up vol	1-5 days	Bullish	
August 3, 2012	***SPX dn 4+. Today is biggest drop.***	***1-5 days***	***Bullish***	***2.00%***

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

The Evidence

Friday the market shot up like a rocket. Gains were strong and broad. The SPX rallied 1.9%, the Nasdaq gained 2.0% and the Russell 2000 rose 2.6%. Breadth was very strong as the NYSE Up Issues % came in at 81% and the Up Volume % was 90%. Total NYSE volume declined from Thursday's level.

The Quantifinder noted the study below, which was last seen in the 7/20/12 subscriber letter. It considers what happens when the SPX is hitting a new 50 day high while the VIX:VXV ratio is very low. For those that are unfamiliar, VIX is a measure of expected 1-month volatility and VXV is a measure of expected 3-month volatility. A very low VIX:VXV ratio suggests that option traders expect to see a rise in volatility in the coming months. Said another way, short-term event risk is perceived as very low right now in comparison to longer-term systematic risk. When the ratio gets especially low it suggests there is a decent chance that short-term risk is being underestimated (complacency is becoming evident in the market). The study below considers the impact of a low ratio at a new market high.

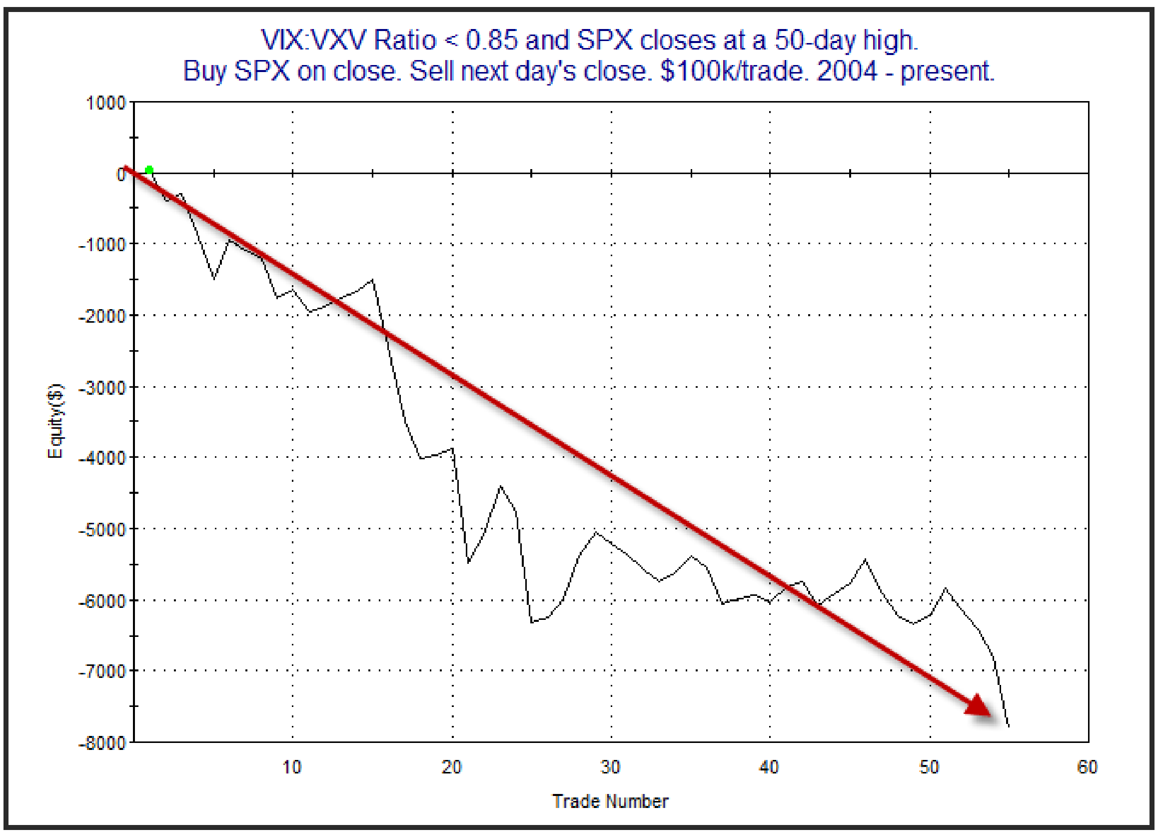
VIX:VXV Ratio < 0.85 and SPX closes at a 50-day high.
Buy SPX on close. Sell next day's close. $100k/trade. 2004 - present.

TradeStation Performance Summary — Collapse

All Trades

Total Net Profit	($7,799.54)	Profit Factor	0.42
Gross Profit	$5,709.11	Gross Loss	($13,508.65)
Total Number of Trades	55	Percent Profitable	49.09%
Winning Trades	27	Losing Trades	28
Even Trades	0		
Avg. Trade Net Profit	($141.81)	Ratio Avg. Win:Avg. Loss	0.44
Avg. Winning Trade	$211.45	Avg. Losing Trade	($482.45)
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 has certainly been choppy but it managed to maintain a downward trajectory throughout and is again making new lows. For those that are interested in learning more about the VIX:VXV ratio, I would suggest checking out the VIX-based videos on the videos page:

http://www.quantifiableedges.com/members/videos.php

And outside of Quantifiable Edges, another excellent resource on this indicator (and other VIX-related ideas) is the VIX and More blog, written by Bill Luby. Below is a link to his VIX:VXV labeled posts.

http://vixandmore.blogspot.com/search/label/VIX%3AVXV

But the unfilled gap pattern that emerged in the SPY today is one that has been frequently been followed by a pullback over the last 17 years. The study below is from the 10/28/11 subscriber letter. All stats have been updated.

SPY gaps > 1% above yesterday's close and never fills. It makes a 50-day intraday high and closes > open. Close > 200ma. Buy on close. Sell X days later. $100k/trade. 1994 - 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	-6,334.94	12	4	8	33.33	557.13	1,087.82	-1,070.43	-3,183.04	0.52	0.26	-527.91
4	-6,944.73	13	5	8	38.46	613.34	1,497.00	-1,251.43	-3,532.12	0.49	0.31	-534.21
3	-11,212.07	13	3	10	23.08	304.59	438.72	-1,212.59	-5,080.34	0.25	0.08	-862.47
2	-5,167.70	13	6	7	46.15	257.90	505.12	-959.30	-2,357.34	0.27	0.23	-397.52
1	-321.49	13	8	5	61.54	325.64	558.88	-585.32	-1,009.98	0.56	0.89	-24.73

12 of 13 instances (92%) closed below the entry price at some point in the next 3 days.

The number of instances is a bit low, but the consistency is strong enough and the statistics lopsided enough that I think it is still worth taking the study under consideration. Below I have listed all of the instances assuming a 3-day holding period.

SPY gaps > 1% above yesterday's close and never fills. It makes a 50-day intraday high and closes > open. Close > 200ma. Buy on close. Sell 3 days later. $100k/trade. 1994 - present.				
Date/Time	**Signal**	**Price**	**% Profit**	**Run-up Drawdown**
09/13/96	Buy	$68.53	(0.07%)	$919.17
09/18/96	Sell	$68.48		($452.29)
07/03/97	Buy	$92.06	(1.09%)	$477.84
07/09/97	Sell	$91.06		($2,204.58)
02/02/98	Buy	$100.13	0.37%	$1,457.08
02/05/98	Sell	$100.50		($409.18)
01/06/99	Buy	$127.44	(0.71%)	$831.04
01/11/99	Sell	$126.53		($1,740.48)
12/03/99	Buy	$143.84	(2.17%)	$0.00
12/08/99	Sell	$140.72		($2,321.30)
06/01/09	Buy	$94.43	0.11%	$994.52
06/04/09	Sell	$94.53		($1,766.86)
08/03/09	Buy	$100.44	(0.55%)	$577.10
08/06/09	Sell	$99.89		($1,014.90)
08/07/09	Buy	$101.20	(0.40%)	$355.68
08/12/09	Sell	$100.80		($1,719.12)
10/14/09	Buy	$109.31	0.44%	$749.48
10/19/09	Sell	$109.79		($987.12)
11/23/09	Buy	$110.82	(1.23%)	$613.36
11/27/09	Sell	$109.46		($2,282.06)
09/24/10	Buy	$114.82	(0.30%)	$191.40
09/29/10	Sell	$114.47		($1,426.80)
11/04/10	Buy	$122.26	(0.53%)	$563.73
11/09/10	Sell	$121.61		($931.38)
10/27/11	Buy	$128.53	(5.08%)	$248.96
11/01/11	Sell	$122.00		($5,453.78)

So the SPY price pattern appears to suggest it would be unusual for the market to continue to run higher without at least a brief pause here.

On a positive note, the day's move up to new highs was accompanied by very strong breadth. The study below was last seen just recently in the 7/30/12 subscriber letter. It considered what has transpired after other instances of the SPX making new intermediate-term highs on extremely strong breadth. Results are all up to date.

SPX closes at a 50-day high. NYSE Up Volume % > 90%.
Buy on close. Sell X days later. $100k/trade. 1970 - 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
50	87,196.79	17	16	1	94.12	5,791.93	19,845.80	-5,474.10	-5,474.10	1.06	16.93	5,129.22
45	85,183.93	18	16	2	88.89	5,830.07	17,945.20	-4,048.58	-5,052.36	1.44	11.52	4,732.44
40	83,320.36	19	15	4	78.95	5,989.19	20,950.80	-1,629.39	-2,937.98	3.68	13.78	4,385.28
35	86,607.69	19	16	3	84.21	5,695.52	18,961.80	-1,506.89	-2,194.86	3.78	20.16	4,558.30
30	74,210.36	19	17	2	89.47	4,411.97	11,920.74	-396.52	-418.88	11.13	94.58	3,905.81
25	63,253.95	20	15	5	75.00	4,883.16	12,045.67	-1,998.68	-3,024.54	2.44	7.33	3,162.70
20	56,992.14	21	15	6	71.43	4,843.63	13,393.77	-2,610.37	-6,770.72	1.86	4.64	2,713.91
15	47,797.27	21	16	5	76.19	4,023.58	8,150.48	-3,316.01	-6,277.02	1.21	3.88	2,276.06
10	31,960.92	23	14	9	60.87	3,393.90	10,507.25	-1,728.18	-4,090.24	1.96	3.05	1,389.61
9	27,251.60	23	15	7	65.22	2,955.28	8,413.73	-2,439.66	-5,207.55	1.21	2.60	1,184.85
8	27,269.04	23	15	8	65.22	3,060.64	8,524.75	-2,330.07	-4,082.16	1.31	2.46	1,185.61
7	25,080.10	24	15	9	62.50	2,964.28	6,026.80	-2,153.79	-3,954.60	1.38	2.29	1,045.00
6	25,970.50	24	16	8	66.67	2,333.50	6,819.80	-1,420.68	-4,106.70	1.64	3.29	1,082.10
5	29,569.49	26	20	6	76.92	1,862.44	8,516.82	-1,279.87	-3,295.50	1.46	4.85	1,137.29
4	21,920.40	27	20	7	74.07	1,759.25	6,716.71	-1,894.95	-4,894.50	0.93	2.65	811.87
3	14,844.92	27	17	10	62.96	1,582.39	6,740.50	-1,205.57	-5,105.87	1.31	2.23	549.81
2	16,739.94	27	19	8	70.37	1,160.11	4,028.44	-662.77	-2,409.33	1.75	4.16	620.00
1	10,804.86	28	15	13	53.57	1,047.07	2,755.52	-377.02	-1,255.50	2.78	3.20	385.89

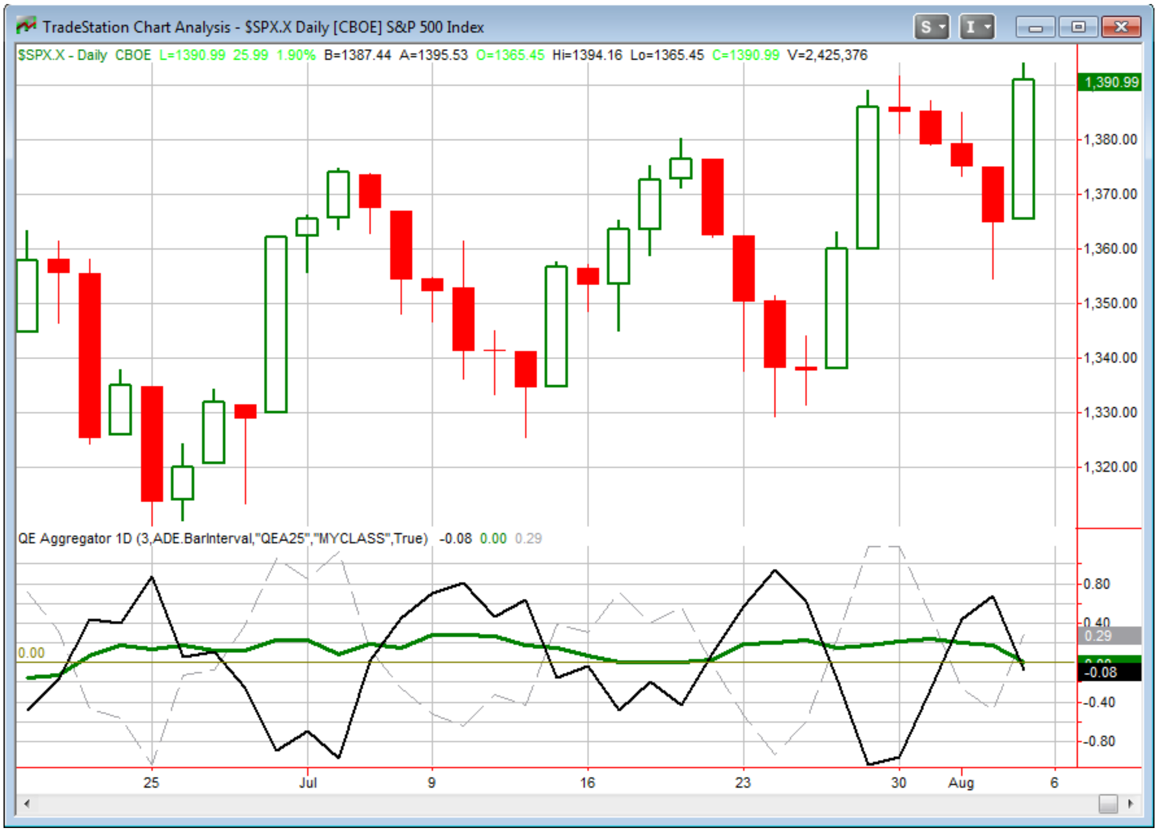
92% of instances posted a close above the entry price at some point in the next week. All within 8 trading days.

Implications appeared to be strongly positive both short and long-term. Below again is the list of instances assuming a 50-day exit criteria, which I have copied from the 7/30 letter.

SPX closes at a 50-day high. NYSE Up Volume % > 90%. Buy on close. Sell 50 days later. $100k/trade. 1970 - present.				
Date/Time	**Signal**	**Price**	**% Profit**	**Run-up Drawdown**
11/30/70	Buy	$87.20	11.69%	$11,815.26
02/10/71	Sell	$97.39		$0.00
01/27/75	Buy	$75.37	9.91%	$14,108.64
04/09/75	Sell	$82.84		$0.00
01/05/76	Buy	$92.58	9.01%	$10,281.60
03/16/76	Sell	$100.92		$0.00
04/14/78	Buy	$92.91	1.82%	$9,597.92
06/26/78	Sell	$94.60		($172.16)
08/02/78	Buy	$102.91	1.91%	$4,990.94
10/12/78	Sell	$104.88		($2,184.75)
08/20/82	Buy	$113.02	19.86%	$27,722.24
11/01/82	Sell	$135.47		($928.20)
11/03/82	Buy	$142.86	2.65%	$4,347.78
01/14/83	Sell	$146.64		($7,535.22)
08/02/84	Buy	$157.99	3.91%	$7,362.80
10/12/84	Sell	$164.17		$0.00
01/04/88	Buy	$255.94	3.98%	$5,779.80
03/15/88	Sell	$266.12		($6,154.20)
05/12/89	Buy	$313.84	6.38%	$7,488.90
07/25/89	Sell	$333.87		$0.00
05/11/90	Buy	$352.00	1.08%	$5,049.52
07/24/90	Sell	$355.79		($542.44)
02/11/91	Buy	$368.58	3.85%	$6,146.28
04/24/91	Sell	$382.76		($1,734.40)
05/04/09	Buy	$907.24	2.80%	$5,388.90
07/15/09	Sell	$932.68		($4,171.20)
08/03/09	Buy	$1,002.63	7.04%	$7,674.48
10/13/09	Sell	$1,073.19		($2,387.88)
08/02/10	Buy	$1,125.86	3.90%	$4,111.36
10/12/10	Sell	$1,169.77		($7,582.08)
10/18/11	Buy	$1,225.38	3.07%	$5,449.68
12/29/11	Sell	$1,263.02		($5,404.32)
03/13/12	Buy	$1,395.96	(5.52%)	$1,875.82
05/23/12	Sell	$1,318.86		($7,382.58)

The last 50-day instance disappointed but still the results appear outstanding across the board.

Overall we are seeing a real mix of studies from the last few days. The strong breadth is a positive, but with the very-low VIX:VXV ratio and the unusual gap action in SPY there is a risk of a short-term pullback. Of course my favorite tool to help sort out mixed signals is the Aggregator, and I have updated the Aggregator chart below.



With tonight's studies factored in the green Aggregator Line finished almost exactly at 0, but just a tiny fraction above it. Positive readings mean net expectations from the Active List are for upside over the next few days. Meanwhile the big gains on Friday pushed the black Differential Line to just barely below 0. This means the SPX is marginally overbought versus recent expectations. So net expectations are neutral/bullish and the SPX is minimally overbought. It doesn't get any more neutral than this. Neutral configurations are visible on the chart whenever both lines close on opposite sides of 0. In this case they are also almost exactly at 0. This caused the Aggregator System to change from long to flat at the close. This was indicated in an afternoon update to subscribers and also on the Systems page shortly before the bell.

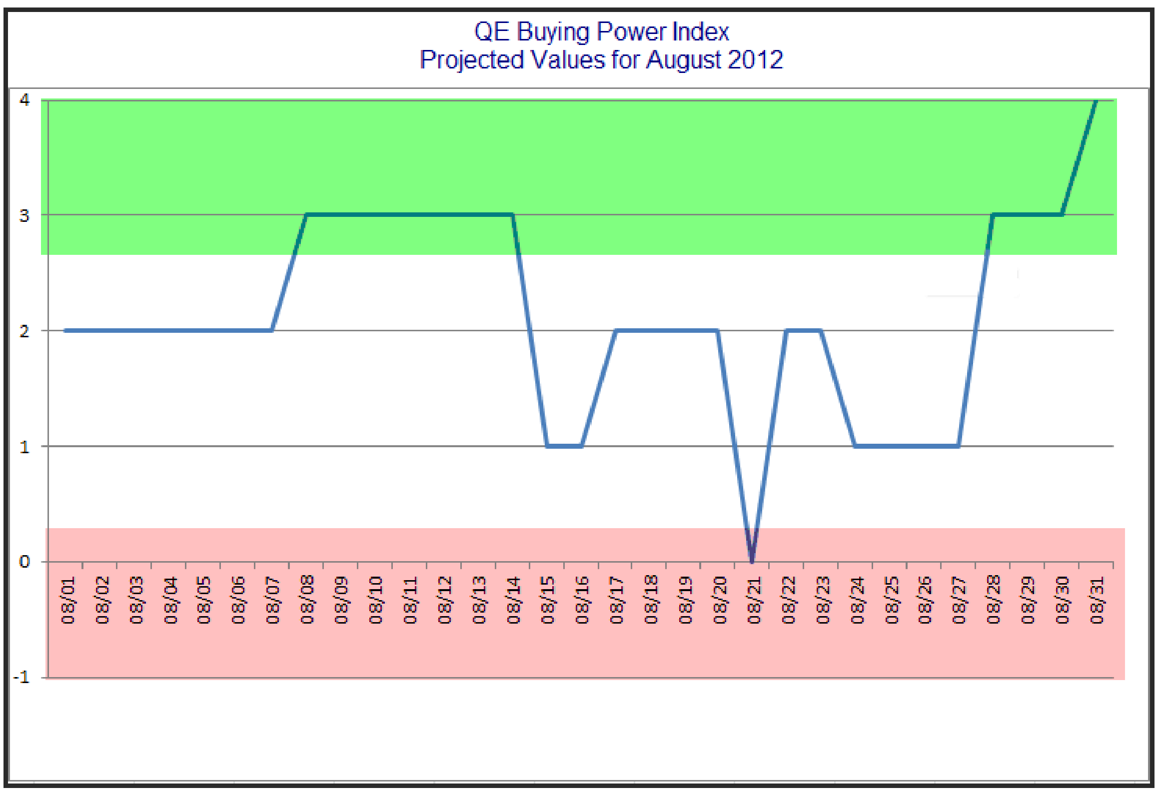
Based on the current studies, expectations are slated to remain bullish on Monday. Of course that could change if more bearish evidence emerges. The Differential Pivot will be 1,383.95 on Monday. This is 0.5% below Friday's close. So it would take a drop of at least this much on Monday for the SPX to move back into oversold territory and the Differential Line to close above 0.

As I said, the Aggregator couldn't get any more neutral. And with the mix of studies and the VIX:VXV study suggesting elevated short-term risk, it seems like a good time to stand aside for a day or two. I am now flat and intend to exercise a little patience until a more compelling setup emerges.

Intermediate-term Outlook (2 weeks – 2 months)– updated 8/6– bullish

Even though Monday-Thursday all declined, Friday's strong move up left the SPX higher on the week. It marked the 4th week in a row that the SPX posted a gain. The move up off the June lows has persisted and we continue to inch closer to the April highs.

The Fed released its POMO schedule for August at 2pm on Tuesday. The net result of the buying and selling is an anticipated liquidity infusion of about $6 billion. This is the same as July. Prior to July there had been more mild infusions of $1-$2 billion/month since Operation Twist began last October. Using the August schedule I have produced the projected QE Buying Power Index for August. A copy can be found below.



We have a few notable periods here. Over the 1st week flows are anticipated to be neutral. Then for a week from 8/8 – 8/14 the Index will have a bullish "3" reading. Pullbacks during this time could provide nice buying opportunities. After the 14th the next couple of weeks are neutral/negative. The 0 reading on 8/21 suggests it might be a good day to short if the market is overbought at that time. The last notable period is the final 4 days of the month – all of which show bullish readings.

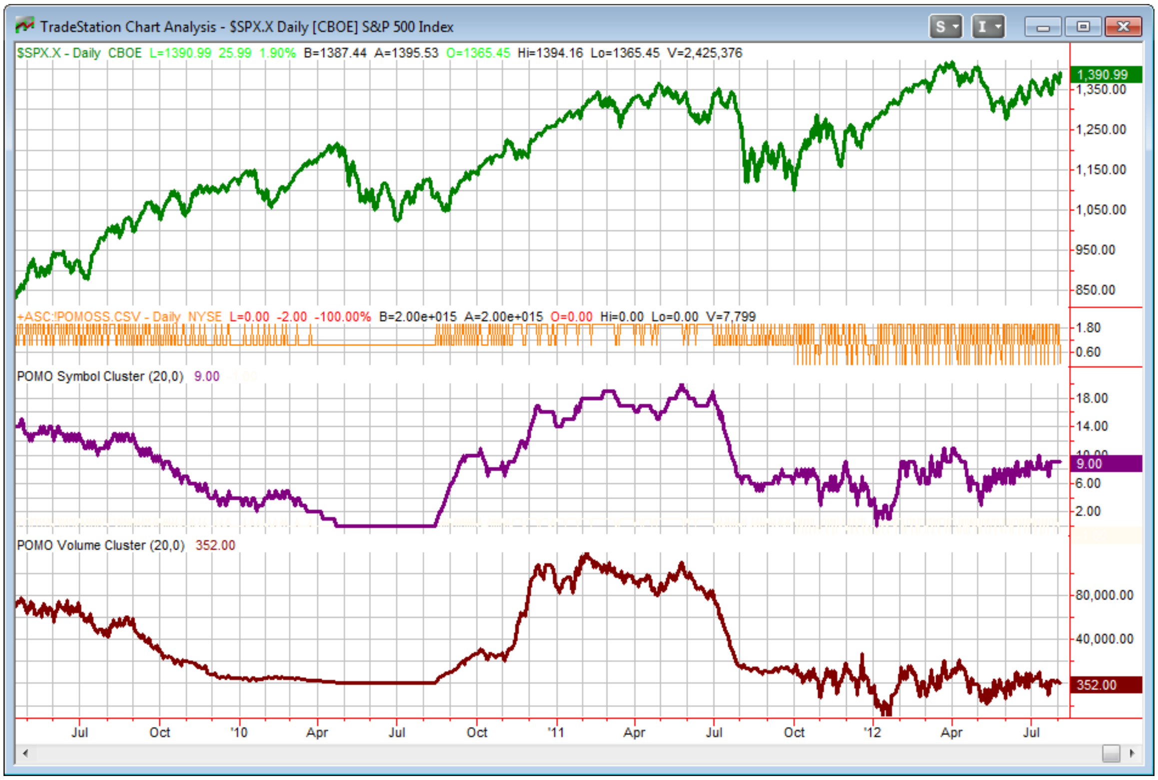
This chart may be seen anytime during the month at the QE Buying Power Index information page on Quantifiable Edges (link below).

http://www.quantifiableedges.com/members/qebuyingpower.php

I've been updating the intermediate-term POMO chart most weekends in the letter. For those who may not recall below is a brief refresher on it. Beneath that is the 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 past week saw 3 days of POMO buying and one day of selling. The net result of this was a very mild $0.6 billion liquidity inflow. This left the intermediate-term indicators near the middle of their recent range.

This upcoming week flows are expected to be considerably stronger. Buying is scheduled for Monday-Thursday before a sell day on Friday. The net result is expected to be about a $5 billion POMO inflow. As I noted earlier the QE Buying Power Index is expected to hit “3” on Wednesday and stay there for a week. If the short-term bearish studies do exert their influence in the next few days then it could set up a nice buying opportunity with inflows we are about to see.

Intermediate-term evidence remains a little mixed, but the repeat strong breadth breakout study is encouraging. POMO also appears to be a positive, with August set to be a relatively strong month for liquidity flows. The trend also appears to favor the bullish case. So as has been the case over the last several weeks I am still more willing to buy oversold than I am to short overbought.

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.

None tonight. The systems triggers page came up with a rare "none" when looking at the setups across the 600 or so stocks and ETFs it tracks. This serves as further confirmation of the neutral short-term outlook.

Current Open Trade Ideas

Symbol	Entry Date	Entry Price	Current Price	% Gain/Loss	Stop	Notes
SPY	*8/1/2012*	*$137.59*	*$139.35*	*1.28%*		*sold on close*

SPY was sold at the close as I indicated would occur in the intraday update sent to gold subscribers at 3:06pm EST on Friday.