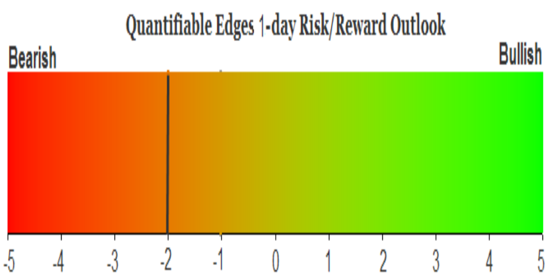
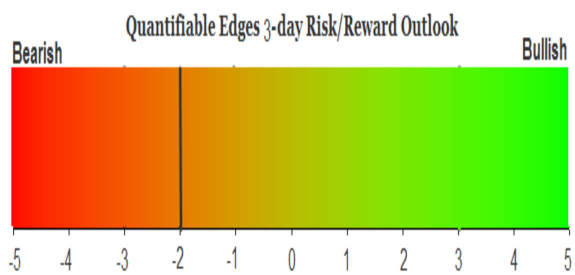
QUANTIFIABLE EDGES SUBSCRIBER LETTER

ASSESSING MARKET ACTION WITH INDICATORS AND HISTORY

August 13, 2012 Volume 5 Issue 155

Market Overview





Signals Overview

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

Tonight's Research Points

- Extremely low NYSE volume at a new high suggests a short-term pullback.
- A low VIX:VXV at a 50-day high increases short-term risk.
- The 3/10 Offset HV is still very low, suggesting a big move could occur soon.
- POMO flows are expected to turn neutral/negative later this week.

Short-term Outlook

The Bottom Line

Evidence is bearish, but it is not overwhelming. I'm willing to take a small short position if I can get a favorable entry. Otherwise, I will continue to remain sidelined.

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

Study Date	Description	Time span	Bias	Avg Max Move
Active				
August 13, 2012	VIX:VXV < 0.85. SPX 50-day high.	1 day	Bearish	
August 10, 2012	SPX 20-high. Vol 20-low.	1-2 days	Bearish	-1.50%
Active - Long Term				
August 10, 2012	SPX & TNX 50-day highs.	1-20 days	Bearish	
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				
August 8, 2012	VIX up &SPX up 2x. SPX 50-high.	1-3 days	Bearish	-1.30%
August 6, 2012	SPX 50-day high on 90% up vol	1-5 days	Bullish	2.50%

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

The Evidence

This market and the studies that have been triggering all week remind me of a first-grade joke. Q: Pete and Repeat sat on a fence. Pete fell off. Who was left? A: Repeat. Q: Pete and Repeat sat on a fence. Pete fell off. Who was left? A: Repeat Q: Pete and Repeat…Friday saw another mild rise in the SPX while the other indices finished mixed. The SPX ended up with a 0.2% gain, the Nasdaq rose 0.1%, and the Russell 2000 fell 0.2%. Breadth was mildly positive as the NYSE Up Issues % came in at 52% and the Up Volume % was 63%. For the second day in a row total NYSE volume was the lightest in over a month.

Most of what I'm going to show today are studies that I've shown at least once already in the past week. So while perhaps the least compelling study, this first one at least hasn't triggered in a while. It looks at days where SPY closes near the very top of its daily range, but still only mildly positive. Basically this suggests it took a strong late day effort to get positive at all. It was last seen in the 1/5/12 subscriber letter, and I have updated the results below.

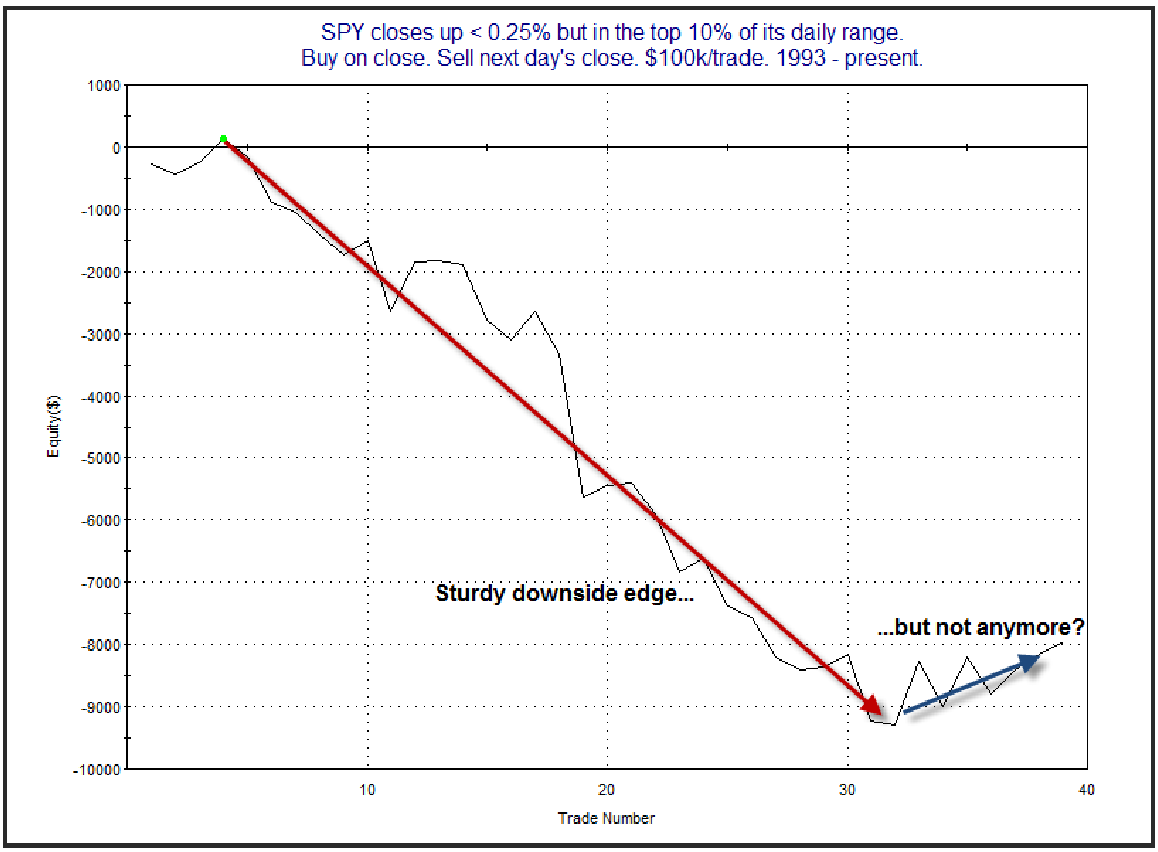
SPY closes up < 0.25% but in the top 10% of its daily range.
Buy on close. Sell next day's close. $100k/trade. 1993 - present.

TradeStation Performance Summary Collapse

All Trades

Total Net Profit	($7,950.97)	Profit Factor	0.41
Gross Profit	$5,448.06	Gross Loss	($13,399.03)
Total Number of Trades	39	Percent Profitable	41.03%
Winning Trades	16	Losing Trades	23
Even Trades	0		
Avg. Trade Net Profit	($203.87)	Ratio Avg. Win:Avg. Loss	0.58
Avg. Winning Trade	$340.50	Avg. Losing Trade	($582.57)
Largest Winning Trade	$1,015.84	Largest Losing Trade	($2,290.72)

As you can see, the stats suggest possible bearish implications. Unfortunately, the equity curve is now telling a little bit different story. Let's take a look at that below.



For many years this setup was commonly followed by moves lower the next day. That hasn't been the case with recent instances. The low point of the equity curve occurred in 2006, and we simply haven't seen the edge play out the same way since. Perhaps this one will come back and the downslope will reassert itself, but for now I've put this study on probation and will not be including it on the short-term active list.

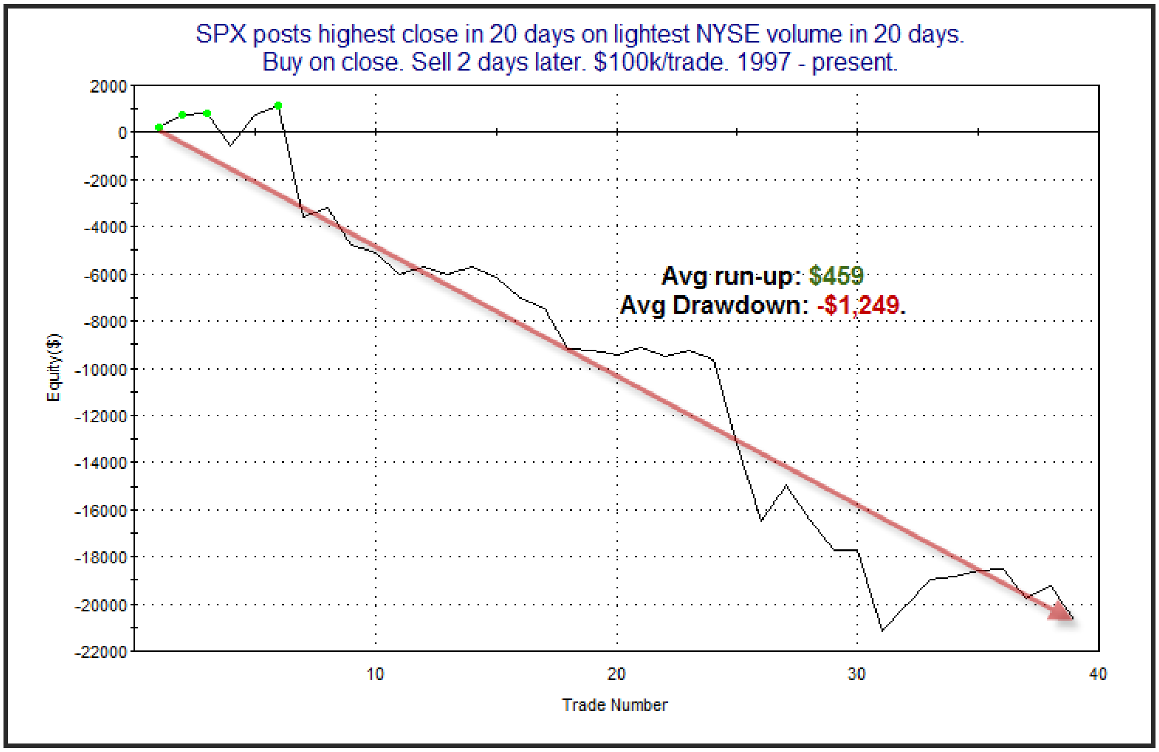
With volume coming in at a 1-month low again on Friday, Thursday night's study that looked at a new price highs on new volume lows again triggered. Below is an excerpt from Thursday night. Stats have NOT been updated.

Such low volume when the market is hitting new highs can often be a sign that the rally is tired and likely to pull back at least briefly. This was shown in several studies that appeared in the Quantifinder. The one below was last seen in the 2/27/12 subscriber letter.

SPX posts highest close in 20 days on lightest NYSE volume in 20 days.
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	-19,443.17	36	15	21	41.67	1,154.56	2,124.32	-1,750.55	-5,584.17	0.66	0.47	-540.09
4	-20,603.82	37	13	24	35.14	971.55	1,831.72	-1,384.75	-4,567.80	0.70	0.38	-556.86
3	-19,778.70	37	13	24	35.14	793.43	1,874.04	-1,253.89	-3,887.84	0.63	0.34	-534.56
2	-20,662.25	39	17	22	43.59	513.69	1,456.36	-1,336.14	-4,748.44	0.38	0.30	-529.80
1	-12,794.72	42	17	25	40.48	284.37	1,111.50	-705.16	-2,378.78	0.40	0.27	-304.64

The stats here appear squarely bearish. Most of the damage is done in the 1st 2 days. I have posted the 2-day equity curve below.



There downslope appears strong, especially considering you're looking at a setup where SPX is in an intermediate-term rally.

Tonight I decided to add a few extra filters to the simple study. I eliminated days where low volume would be expected. These included half days and the week between Christmas and New Year's. I also narrowed the time frame to just show the last 10 years. Those results are below.

SPX posts highest close in 20 days on lightest NYSE volume in 20 days.
Half days are excluded as are the days between Christmas and New Years.
Buy on close. Sell X days later. $100k/trade. 2002 - 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	-9,794.90	23	10	13	43.48	1,059.79	1,998.24	-1,568.67	-4,260.08	0.68	0.52	-425.87
4	-5,883.85	24	9	15	37.50	834.88	1,359.90	-893.19	-4,271.52	0.93	0.56	-245.16
3	-11,974.59	24	9	15	37.50	701.93	1,874.04	-1,219.46	-3,887.84	0.58	0.35	-498.94
2	-12,227.03	25	11	14	44.00	523.22	1,456.36	-1,284.46	-3,595.20	0.41	0.32	-489.08
1	-6,875.91	27	12	15	44.44	282.09	1,111.50	-684.06	-2,361.45	0.41	0.33	-254.66

While the filters definitely make sense, they didn't have a very large impact on the results. Still, it gave me a bit greater comfort that there was at least a mild downside suggestion from this setup.

The study below continues to trigger. I last discussed it a week ago in the 8/6/12 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.

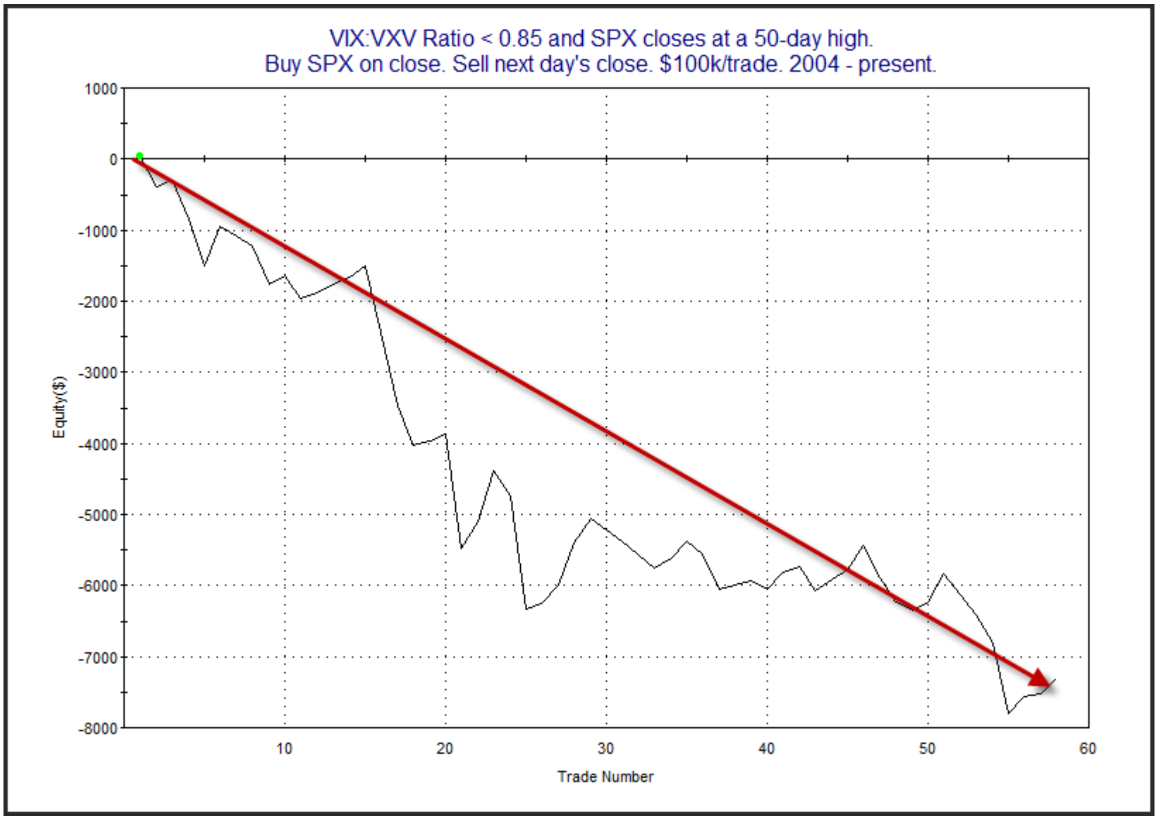
VIX:VXV Ratio < 0.85 and SPX closes at a 50-day high.
Buy SPX on close. Sell next day's close. $100k/trade. 2004 - present.

TradeStation Performance Summary Collapse

All Trades

Total Net Profit	($7,310.35)	Profit Factor	0.46
Gross Profit	$6,198.30	Gross Loss	($13,508.65)
Total Number of Trades	58	Percent Profitable	51.72%
Winning Trades	30	Losing Trades	28
Even Trades	0		
Avg. Trade Net Profit	($126.04)	Ratio Avg. Win:Avg. Loss	0.43
Avg. Winning Trade	$206.61	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 has managed to maintain a downward trajectory throughout. The last few days saw a mild rise in the curve. This is typical on up days. I suspect the next down day may be more sizable.

The SPX 3/10 Offset HV also continues to suggest a big move could be on tap. It closed at a miniscule 0.08 on Friday. Below is an excerpt from Wednesday night's letter that discusses this indicator in detail.

Also notable about current conditions is that the 3/10 Offset Historical Volatility Indicator came in at a very low 0.17 on Wednesday. I first introduced this indicator in July of 2009. *It essentially takes a short 3-day measure of Historical Volatility and compares that to the 10-day measure of 3-days ago. Low readings indicate there has been a contraction in volatility. High readings indicate there has been an expansion. Anything at or below 0.25 is regarded as extremely low. Often after sharp contractions like this we see a volatility expansion take place.*

In August of 2009 I published a study that found this condition created a favorable environment for trading Opening Range Breakouts (ORBs). A link to that study is below:

Quantifiable Edges ORBs Study.pdf

For anyone who is interested in seeing some techniques for actually trading these ORBs, there is a webinar from October 2010 on the subject on the videos page (subscribers only).

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

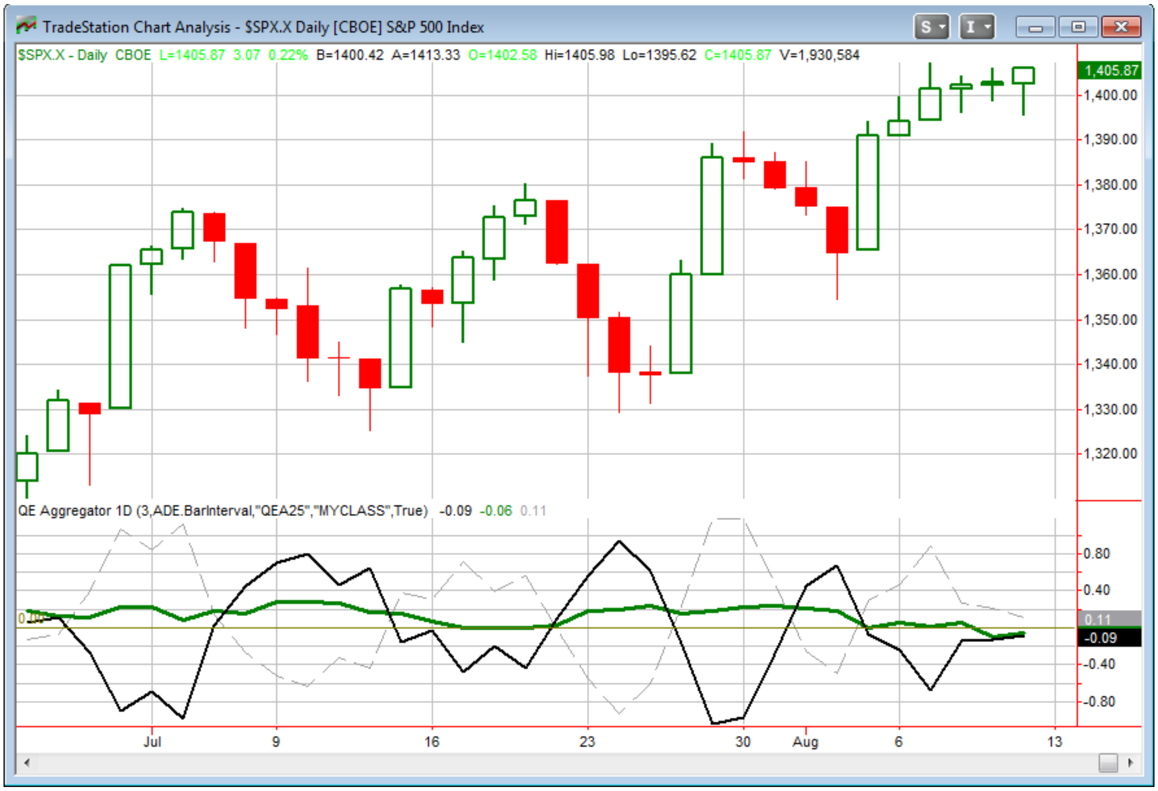
It's important to note that the 3/10 Offset HV indicator predicts volatility, not direction. For direction I look to the Aggregator. The Aggregator is currently neutral. Under these circumstances I could consider ORB trades in either direction. This would just be for a possible daytrade and is not something I will be tracking in the subscriber letter as an official trade idea. But even if you don't have any interest in attempting a daytrade, the low 3/10 Offset HV is worth noting. Because a volatility expansion (in either direction) is now likely, that means risk is elevated in open swing trade positions.

Of further note, the 3/10 Offset HV Calculation is available as part of the "QE Indicators/Functions for Tradestation". Subscribers may download it to include on their own charts. A link to the Indicators page is below, where you may download the User Guide or the Tradestation ELD.

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

In looking at the short-term active studies list, you'll note that while bearish studies are somewhat moderate, bullish ones are now nonexistent.

I have updated the Aggregator chart below.



Current evidence has left the green Aggregator Line down below 0. Negative readings mean net expectations from the Active List are for downside over the next few days. Meanwhile the black Differential Line is also still a small amount below 0. This means the SPX is mildly overbought versus recent expectations. So net expectations are bearish and the SPX is a little overbought. 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 a little before the bell.

The current short-term studies will all expire on Monday, so expectations will be largely dependent upon what new studies emerge. If we again close at a new high it is likely the VIX:VXV study will again trigger and suggest a short side edge. The Differential Pivot will be 1,403.79 on Monday. This is only 0.15% below Friday's close. So just about any down close would cause the SPX to move from overbought to oversold versus expectations.

The last few days I have cited short-term POMO flows as a reason for being hesitant to short. Today I thought I would examine the impact of short-term POMO flows as measured by the QE Buying Power Index in a little more detail. I decided to run tests back to the March 2009 bear market bottom and see what has followed overbought readings using different QE Buying Power Index measures. The index is currently at 3 and is expected to close there on Monday and Tuesday as well. First let's look at how overbought readings have fared when the index has been at a bullish 3 or higher like it is currently.

SPX closes in top 20% of 10-day range. QE Buying Power Index is bullish (3 or higher).
Buy on close. Sell X days later. $100k/trade. 3/9/09 - 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
3	1,764.30	76	43	33	56.58	1,052.84	3,830.40	-1,318.42	-4,848.17	0.80	1.04	23.21
2	4,440.66	100	59	41	59.00	789.40	2,969.64	-1,027.66	-3,234.00	0.77	1.11	44.41
1	6,231.99	163	88	75	53.99	590.52	3,358.36	-609.78	-4,241.94	0.97	1.14	38.23

Since the market is already overbought, the implications of the high POMO reading aren't terribly bullish. They are net positive, but still very close to neutral. Next let us look at a similar setup but with a neutral index reading of 1-2.

SPX closes in top 20% of 10-day range. QE Buying Power Index is neutral (1-2).
Buy on close. Sell X days later. $100k/trade. 3/9/09 - 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
3	-9,319.32	70	39	31	55.71	1,002.89	3,641.54	-1,562.33	-5,105.87	0.64	0.81	-133.13
2	-98.57	91	51	40	56.04	818.52	5,340.72	-1,046.08	-3,683.44	0.78	1.00	-1.08
1	-250.47	140	80	60	57.14	580.94	3,198.36	-778.76	-2,447.06	0.75	0.99	-1.79

Results here are almost dead neutral over the first two days. It's not necessarily a strong set up for a short but it also isn't something you want to be buying into. I would consider shorting into a situation like this if additional evidence (like volume or VIX readings) suggested a downside edge. Now let's look at the setup when the index reading has been zero or lower.

SPX closes in top 20% of 10-day range. QE Buying Power Index is bearish (0 or lower).
Buy on close. Sell X days later. $100k/trade. 3/9/09 - 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
3	-6,398.11	30	16	14	53.33	821.42	1,835.47	-1,395.77	-3,721.09	0.59	0.67	-213.27
2	-1,864.58	37	21	16	56.76	705.14	1,941.94	-1,042.04	-4,712.40	0.68	0.89	-50.39
1	-6,762.81	63	34	29	53.97	470.72	1,537.34	-785.07	-3,415.50	0.60	0.70	-107.35

As you probably suspected, when POMO flows have been neutral or negative and the market is overbought, short-term expectations turn negative. This appears to be a favorable situation to take advantage of short opportunities with confirming bearish evidence.

So the aggregator is suggesting a downside edge but the strong POMO reading is a valid concern. If I can get a favorable entry price I may attempt short on Monday or Tuesday but it will only be with a ¼ position and I will not increase it until at least Wednesday's close when the QE Buying Power Index is slated to drop out of bullish territory.

Intermediate-term Outlook (2 weeks – 2 months)– updated 8/13– slightly bullish

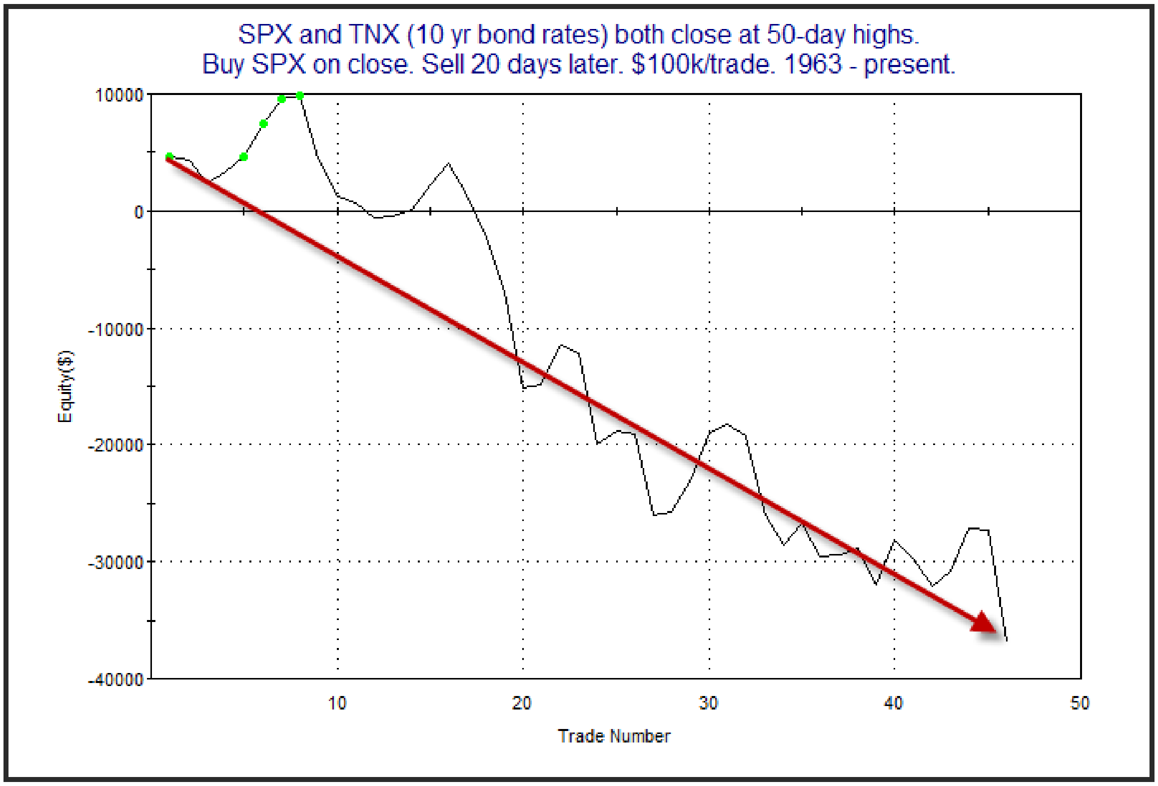
The SPX closed higher every single day this week. It seemed to do so 1 inch at a time though. The move up off the June lows has persisted and we continue to inch closer to the April highs.

One study that triggered Thursday with intermediate-term implications is the one below. I have copied the results and comments from Thursday night's letter.

SPX and TNX (10-yr bond rates) both close at 50-day highs.
Buy SPX on close. Sell X days later. $100k/trade. 1963 - 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	-41,147.05	38	17	21	44.74	3,406.25	9,293.13	-4,716.83	-11,866.50	0.72	0.58	-1,082.82
45	-36,862.77	39	16	23	41.03	4,061.53	8,170.47	-4,428.14	-11,540.20	0.92	0.64	-945.20
40	-22,032.92	41	19	22	46.34	3,794.28	7,101.51	-4,278.38	-10,971.10	0.89	0.77	-537.39
35	-31,109.04	43	19	24	44.19	3,197.42	9,093.59	-3,827.50	-9,558.36	0.84	0.66	-723.47
30	-19,312.69	44	17	27	38.64	3,582.60	8,122.50	-2,970.99	-6,689.55	1.21	0.76	-438.92
25	-8,132.27	45	19	26	42.22	2,969.29	7,845.48	-2,482.64	-6,261.07	1.20	0.87	-180.72
20	-38,871.38	47	23	24	48.94	1,781.90	4,616.92	-3,327.29	-9,695.84	0.54	0.51	-827.05
15	-27,901.22	47	25	22	53.19	1,663.00	3,500.32	-3,158.01	-9,608.60	0.53	0.60	-593.64
10	-7,658.08	52	31	21	59.62	1,321.47	3,263.44	-2,315.41	-8,683.66	0.57	0.84	-147.27
5	-4,928.37	68	37	31	54.41	1,028.86	5,231.46	-1,386.98	-6,088.44	0.74	0.89	-72.48

Generally it seems that higher interest rates have often made bonds an attractive investment. This may have lead people to forsake stocks in favor of lower risk returns with improved yield. Implications of this study appear to be longer-term in nature. To help visualize how this edge has played out over time I have pasted below an equity curve using a 20-day exit strategy.

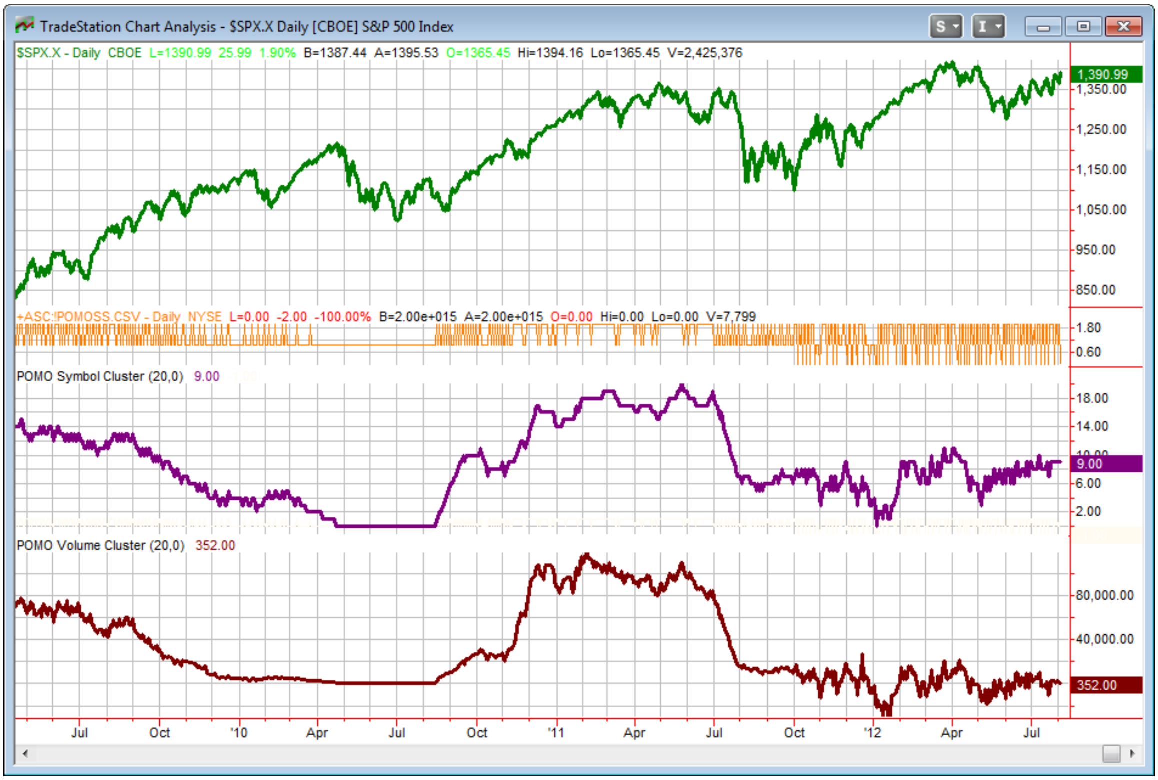


The most recent instance saw the curve hit new lows and kept the downslope squarely intact. I've included this study on the intermediate-term active list.

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 4 days of POMO buying and one day of selling. The net result of this was a $4.6 billion liquidity inflow. The intermediate-term indicators didn't change much and are still near the middle of their recent range.

This upcoming week flows are expected to be more moderate. Buying is scheduled for Monday, Tuesday, and Thursday. Wednesday is scheduled for selling, and Friday is a rare off-day for Fed POMO trading. The net result is expected to be about a $1 billion inflow.

The week of the 20th - 24th is expected to see sizable outflows Before POMO buying kicks in strongly again the last week in August. I mentioned in the short-term outlook above that the QE Buying Power Index is scheduled to close at 3 on both Monday and Tuesday. But from the 15th through the 27th readings will be between 0-2. So if the bears are going to put a scare into the market, an opportune time to do so when they won't be fighting strong liquidity inflows would be between August 16 and August 28. I'm viewing this window as a danger zone. If we are at a low area as we approach the 28th, that could set up the next strong buying opportunity.

Intermediate-term evidence weakened a bit this week even as the market closed higher every single day. Bond rates are a possible concern and liquidity will be for the next couple of weeks. The trend is obviously still up and we've seen some evidence to support a move higher in the last few weeks. I considered moving to outright neutral, but have a hard time doing that when the SPX is sitting right at an intermediate-term high. So I have scaled back the intermediate-term outlook from "bullish" to "slightly bullish". And while I am not yet willing to trade the short side as aggressively as the long side, I'm not far from it.

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 – sell short ¼ index position @ $141.00 LIMIT ON OPEN. If not filled on open, the order will be cancelled and then placed as a LIMIT ON CLOSE order. This is based on the short-term outlook above. I'm only willing to go short right now if I can get a "favorable" entry.

Current Open Trade Ideas

None.