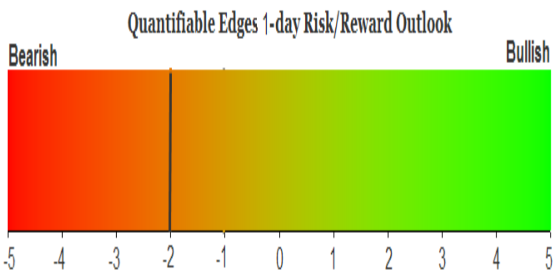
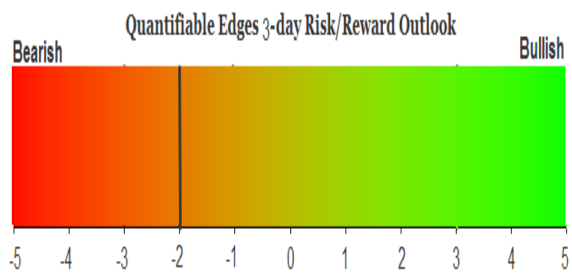
QUANTIFIABLE EDGES SUBSCRIBER LETTER

ASSESSING MARKET ACTION WITH INDICATORS AND HISTORY

January 14, 2013 Volume 6 Issue 9

Market Overview





Signals Overview

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

Tonight's Research Points

- January opex has been weak over the last 14 years.
- A breadth divergence is now in place that could pave the way for a new major top to emerge.

Short-term Outlook

The Bottom Line

The market is now slightly overbought and evidence is tilting down. But with liquidity so strong I am not inclined to try a short.

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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				
January 14, 2013	SPX 50-high. VIX:VXV < 0.85	1 day	Bearish	
January 11, 2013	2 unfilled up gaps. 50-day high	1-3 days	Bullish	
January 9, 2013	2 Unfilled SPY Gaps Dn & 5-low	1-5 days	Bullish	1.90%
January 7, 2013	Up Issue % > 75% 2 of last 3 days	1-6 days	Bullish	
Active - Long Term				
January 14, 2013	Breadth Divergence (from Tops Study)	int term	Bearish	
January 3, 2013	50-day high breakout. 90% up vol	1-25 days	Bullish	
January 3, 2013	SPX & TNX high 50-day highs	1-20 days	Bearish	
December 24, 2012	Nasdaq Leading SPX	int term	Bullish	
September 17, 2012	QE3	int term	Bullish	
February 1, 2012	Golden Cross	int term	Bullish	
Dropped Tonight				
January 3, 2013	VIX high stretch to low stretch	1-8 days	Bullish	
January 11, 2013	***SPX 50-high. VIX:VXV < 0.85***	***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

Action was quiet on Friday and the major indices finished near unchanged. The SPX declined 0.07 points, the Nasdaq gained 0.1%, and the Russell 2000 lost 0.05%. Breadth was a little weak as the NYSE Up Issues % was 48% and the Up Volume % came in at 42%. Volume sank from Thursday's level.

The mixed action on Friday did nothing to inspire compelling price, volume, volatility, or breadth studies to trigger. But the Quantifinder did note that we are now entering a very weak seasonal period. Last year in the 1/17/12 Letter I examined January opex week. I have updated that study below.

Today is Friday before January OpEx.
Buy SPX on close. Sell X days later. $100k/trade. 1999 - 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	-20,330.23	14	3	11	21.43	1,996.05	2,202.87	-2,392.58	-5,768.17	0.83	0.23	-1,452.16
4	-18,272.14	14	4	10	28.57	1,295.39	2,095.20	-2,345.37	-5,262.18	0.55	0.22	-1,305.15
3	-12,212.71	14	4	10	28.57	1,291.99	2,104.46	-1,738.07	-5,295.84	0.74	0.30	-872.34
2	-5,582.18	14	6	8	42.86	538.66	1,497.68	-1,101.77	-2,737.00	0.49	0.37	-398.73
1	-1,353.56	14	7	7	50.00	559.48	1,039.35	-752.85	-2,401.08	0.74	0.74	-96.68

2001 and 2012 were the only years the SPX failed to close below Friday's close at some point during the week. While it is not the case this year, January op-ex week often occurs in conjunction with Martin Luther King Day. Below is the list of 14 January op-ex weeks from the table above with their full week performance results. Note that some of these weeks contained four trading days and some contain five.

January Op-Ex Week SPX Performance. $100k/trade. 1999 - present.				
Date/Time	**Signal**	**Price**	**% Profit**	**Run-up Drawdown**
01/08/99	Buy	$127.75	(2.64%)	$0.00
01/15/99	Sell	$124.38		($5,763.34)
01/14/00	Buy	$146.97	(1.72%)	$20.40
01/21/00	Sell	$144.44		($2,148.80)
01/12/01	Buy	$132.00	1.54%	$3,171.83
01/19/01	Sell	$134.03		($378.50)
01/11/02	Buy	$114.94	(1.56%)	$391.50
01/18/02	Sell	$113.15		($1,974.90)
01/10/03	Buy	$93.06	(2.58%)	$859.20
01/17/03	Sell	$90.66		($3,125.34)
01/09/04	Buy	$112.39	1.64%	$1,706.88
01/16/04	Sell	$114.23		($560.07)
01/14/05	Buy	$118.24	(1.23%)	$1,166.10
01/21/05	Sell	$116.78		($1,343.55)
01/13/06	Buy	$128.68	(2.11%)	$170.94
01/20/06	Sell	$125.97		($2,105.67)
01/12/07	Buy	$143.24	(0.29%)	$153.56
01/19/07	Sell	$142.82		($649.14)
01/11/08	Buy	$140.15	(5.77%)	$1,105.15
01/18/08	Sell	$132.06		($6,452.65)
01/09/09	Buy	$89.09	(4.52%)	$0.00
01/16/09	Sell	$85.06		($8,269.14)
01/08/10	Buy	$114.57	(0.81%)	$497.04
01/15/10	Sell	$113.64		($1,194.64)
01/14/11	Buy	$129.30	(0.72%)	$262.82
01/21/11	Sell	$128.37		($1,677.41)
01/13/12	Buy	$128.84	2.10%	$2,413.36
01/20/12	Sell	$131.54		$0.00
Avg Drawdown: -$2,546 **Avg Run-up: $851** **Max Run-up: $2,700**				

As you can see there has been a decided downside tendency over the last 14 years. Despite last year's strong performance the drawdown / run-up stats at the bottom remain especially compelling for the bears. I have therefore included this study on the Short-Term Active List.

I have updated the Aggregator chart below.

The weak seasonal study tonight helped push the green Aggregator line below 0. Negative readings mean net expectations from the Active List are for downside over the next few days. Meanwhile the black Differential Line remained below 0. The negative reading means the SPX is overbought versus recent expectations. So net expectations are negative and the SPX is 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 turn from flat to short at the close.

Based on the current studies, expectations are set to remain bearish on Monday. This could change if compelling bullish evidence emerges. The Differential Pivot will be 1,470.93 on Monday. This is just slightly more than 1 point below Friday's close. So it won't take much of a close lower on Monday in order for the SPX to move back into an oversold state.

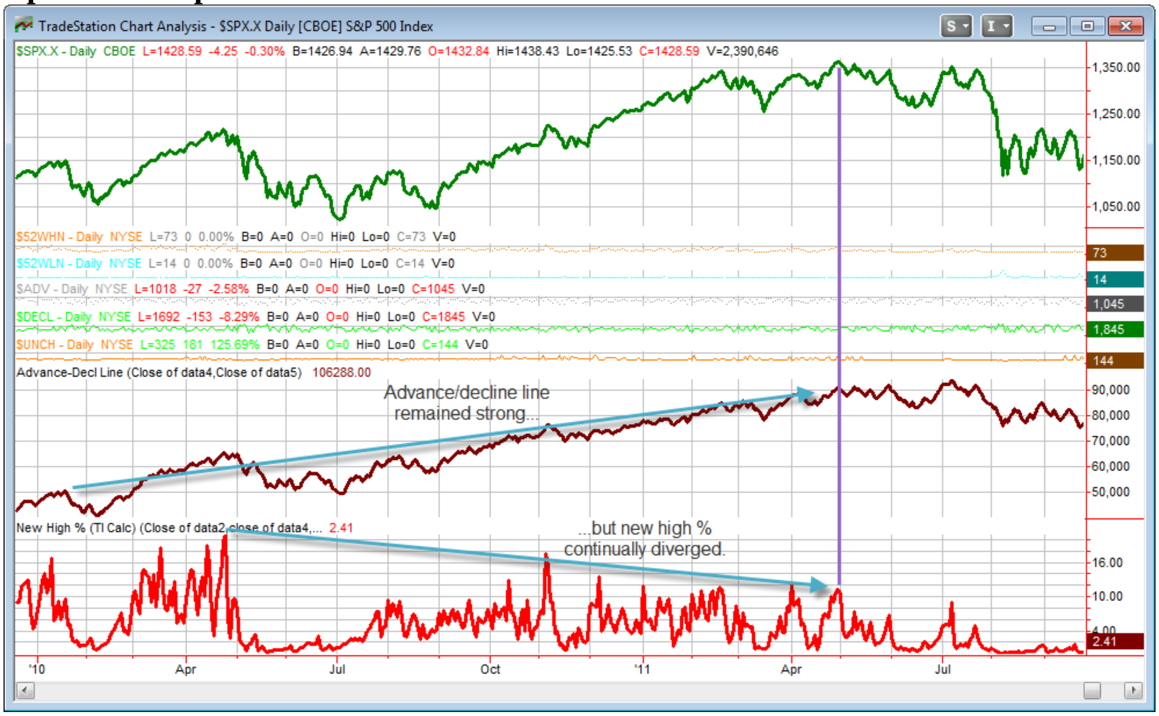
The market is a bit overbought and the weak seasonals are overwhelming the bullish short-term studies that are price-based and nearing expiration. So the net result is a downside edge suggested by the Aggregator. But if the Aggregator is right and the market pulls back much on Monday, then it will no longer be overbought. This means there is little room for shorts to profit. Additionally, the QE Buying Power Index is maxed out at 5. When short-term liquidity has registered this strong over the last 7 years, trying to short overbought conditions has been a fruitless endeavor. So I have no interest in attempting a short trade here. I'll remain sidelined until a more favorable setup avails itself.

Intermediate-term Outlook (2 weeks – 2 months)– updated 1/14– bullish

SPX made a new multi-year closing high on Thursday (but is still just a bit below the September intraday high). So it appears the uptrend is still in effect. Nothing new triggered this week from a studies standpoint, but there is a divergence right now in the % of NYSE stocks making new highs versus what we saw in September. This led me to update the "Quantifiable Edges Study of Tops". I have added this study to the downloads page on the members site. I have also pasted it below:

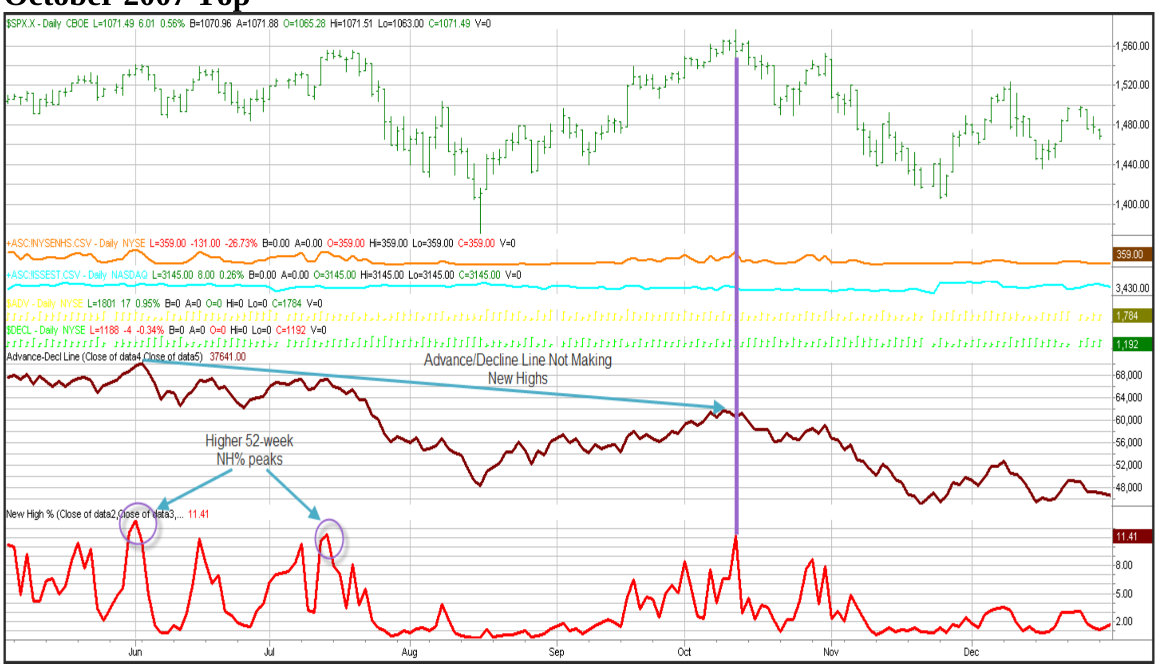
I first published a study of tops in the 10/12/09 Subscriber Letter. It was inspired by a Lowry's study from 2006 which can be found here. Lowry's basic finding was that breadth has consistently topped out before the market. They primarily looked at 52-week new highs and the Dow Jones Industrial Average. I used the S&P 500 rather than the DOW. In the charts below the top panel is the S&P 500. The bottom panel is the % of NYSE stocks that are hitting 52-week highs. The panel just above the bottom panel is the NYSE advance/decline line. My breadth data only goes back to 1970, so that's as far as these charts go. Instances are lower than I'd prefer for a complete study, but you'll note there is definitely an underlying theme to the instances that do exist. To define a "major top", I examined all instances of 52-week price highs that were followed by a 20% decline. The 1st chart is the 2011 top.

April 2011 Top



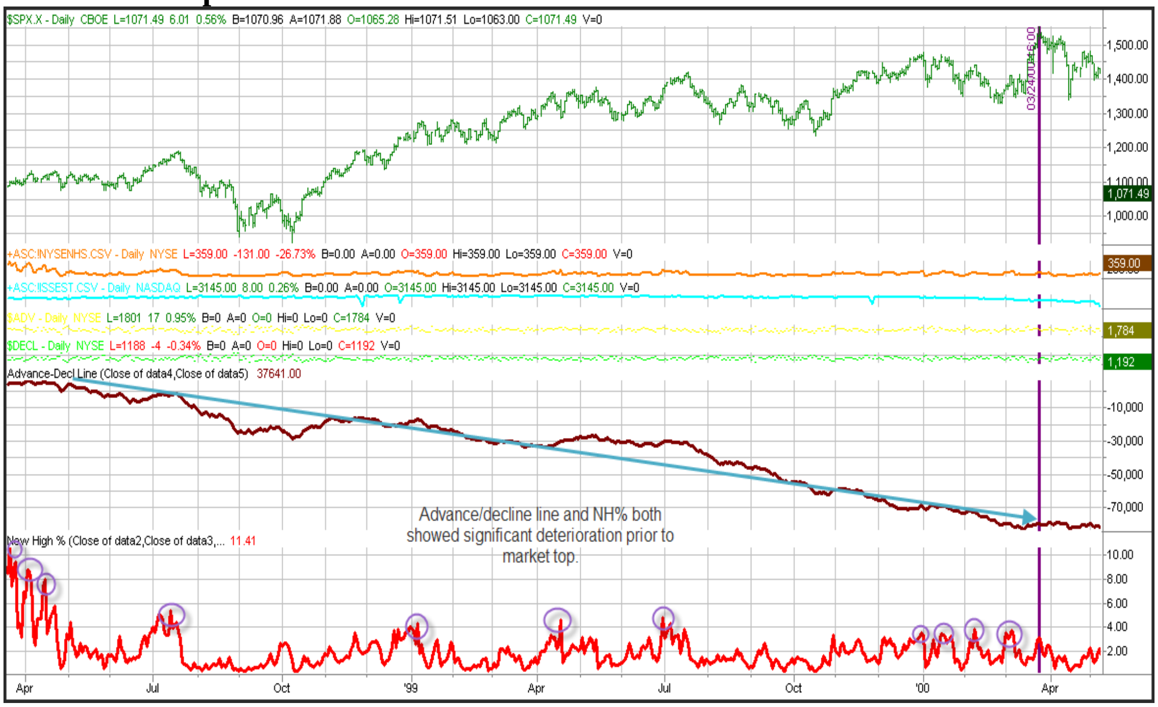
Many traders may not have realized that the market underwent a 20% correction during 2011. It did. And though advance/decline did not diverge, new highs did. This was one of only two instances where the a/d line managed to make a new high.

October 2007 Top



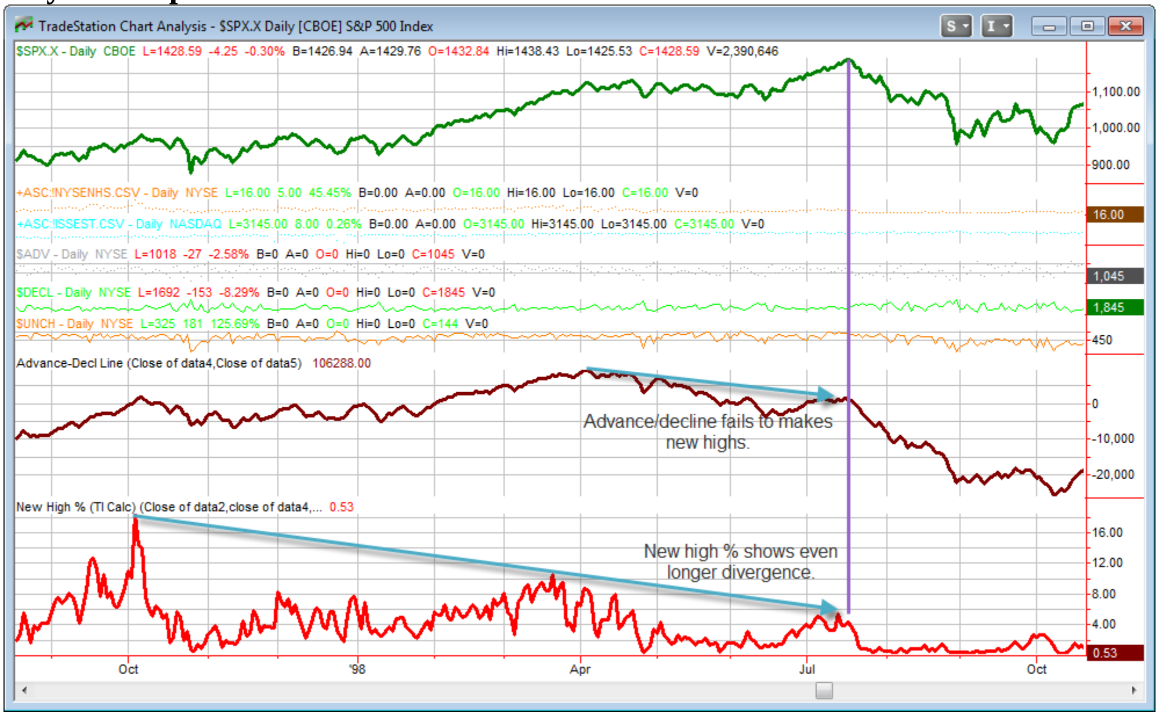
What I note above is a deteriorating a/d line and new highs that are failing to reach prior levels. Next is the 2000 top.

March 2000 top



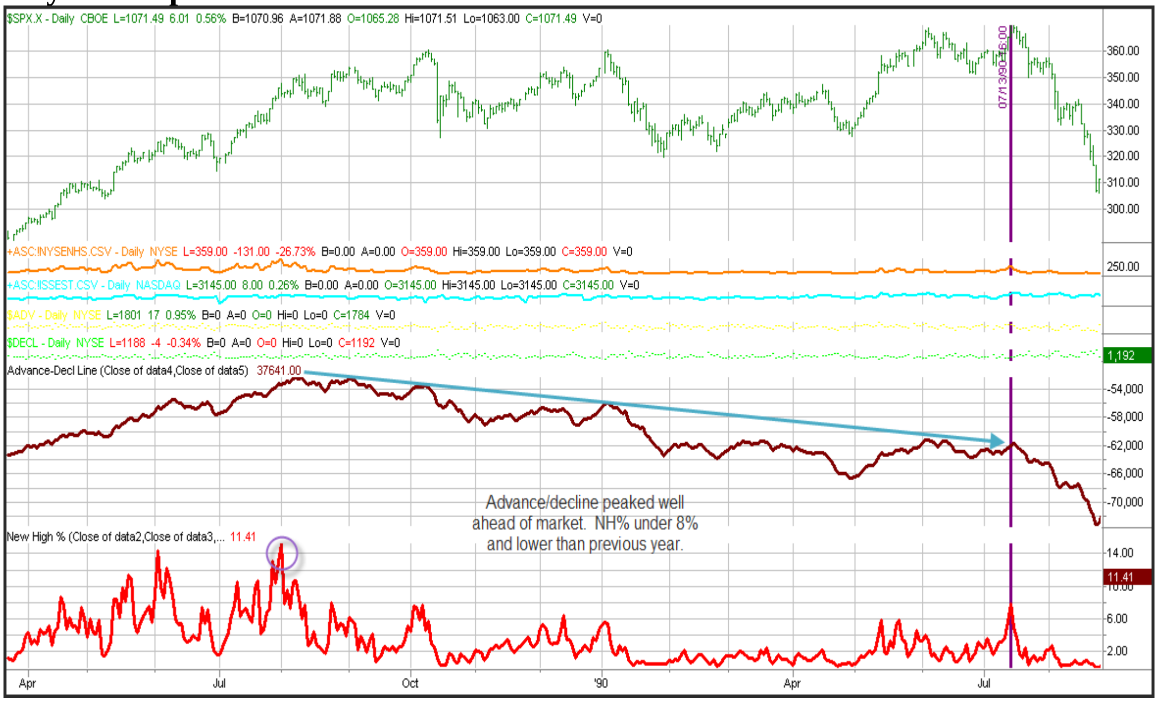
This market was thinning for years before topping. A rather extreme case here. Next is July of 1998.

July 1998 top



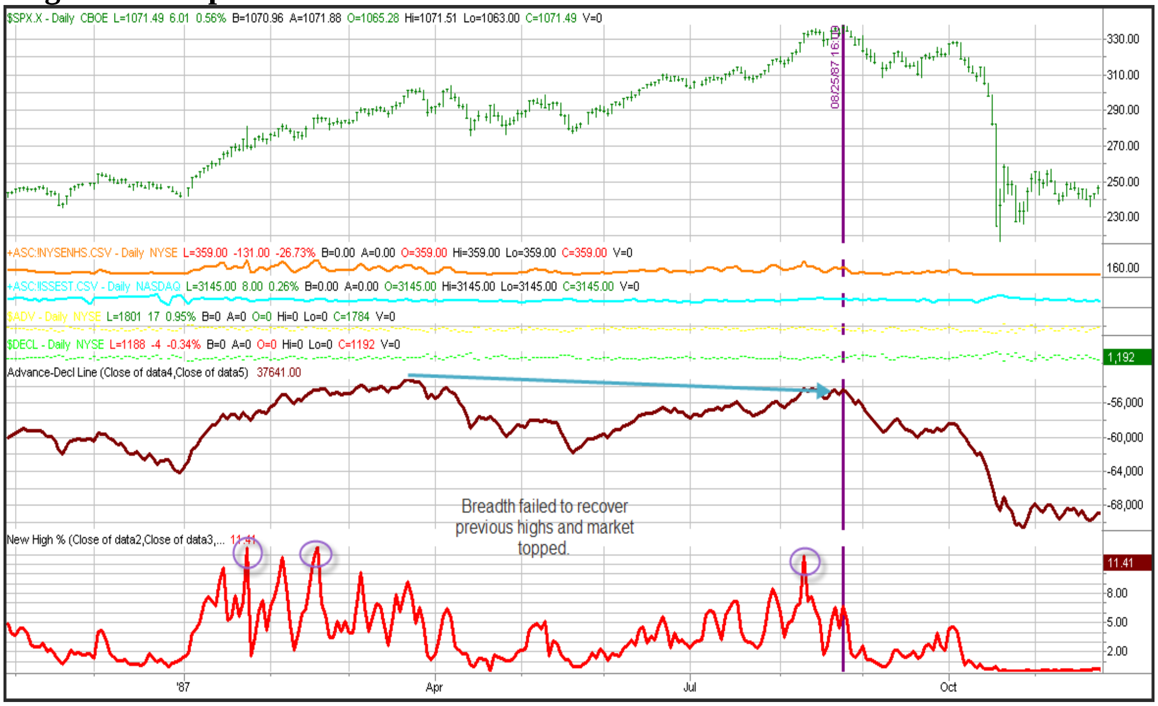
Though this top did not lead to a long-term decline and a bottom was reached in a few months the selloff did reach the 20% threshold. So it did qualify for the sample. Again we see diverging breadth for both the A/D line and the new high%. Now July of 1990.

July 1990 top



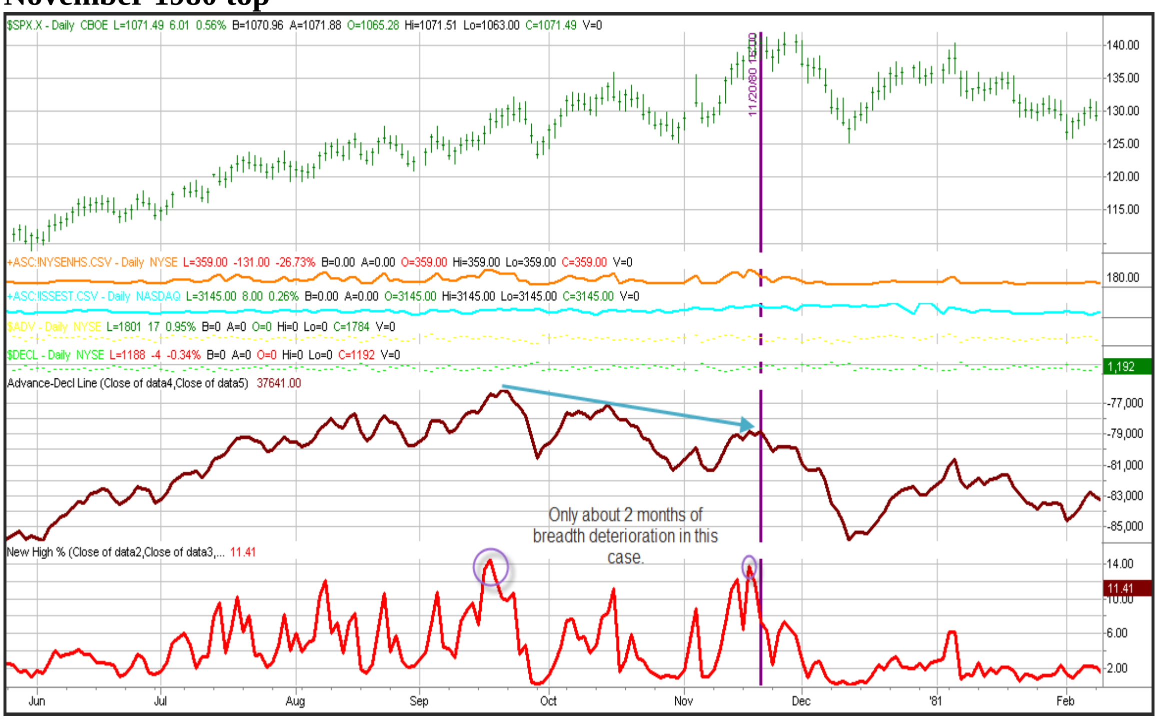
More of the same here. A muted NH % accompanied by a declining a/d line. Now for 1987.

August 1987 top



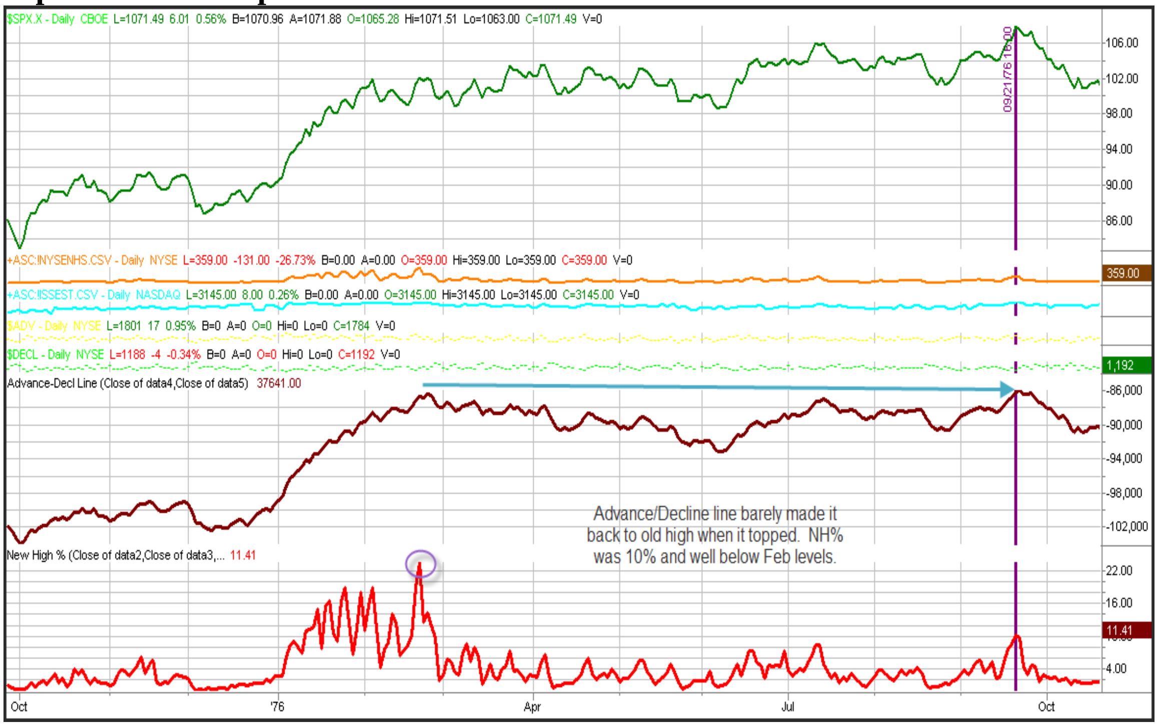
Here again we see a rising market that is accompanied by worsening breadth. Now for November of 1980.

November 1980 top



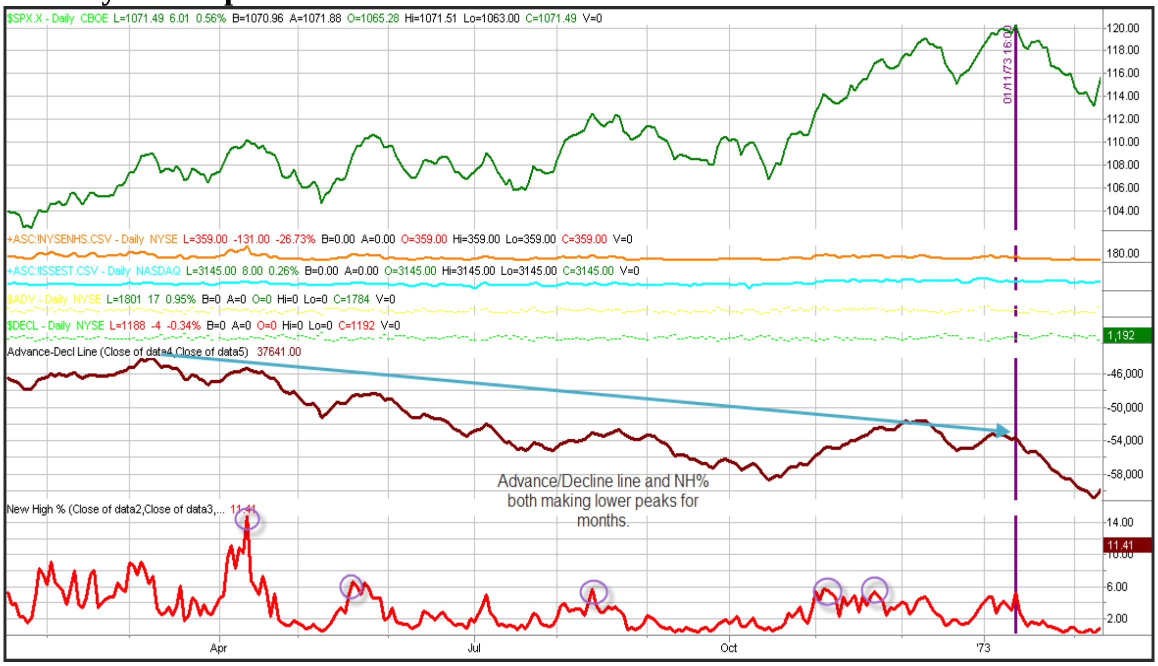
This one is less extreme than some of the others. The breadth decline only occurred over the course of a couple of months before the market topped out. This is the shortest amount of time in from which breadth peaked ahead of price. Most other instances breadth has peaked much longer before price peaked. Here's September 1976.

September 1976 top



This actually just missed the "major top" definition, as it declined "only" 19.5% before bottoming. I included it anyway. This was the 2nd instance where the a/d line managed to make a new high. It wasn't by much. It didn't last long. It also wasn't confirmed by the NH %. Lastly let's look at January 1973:

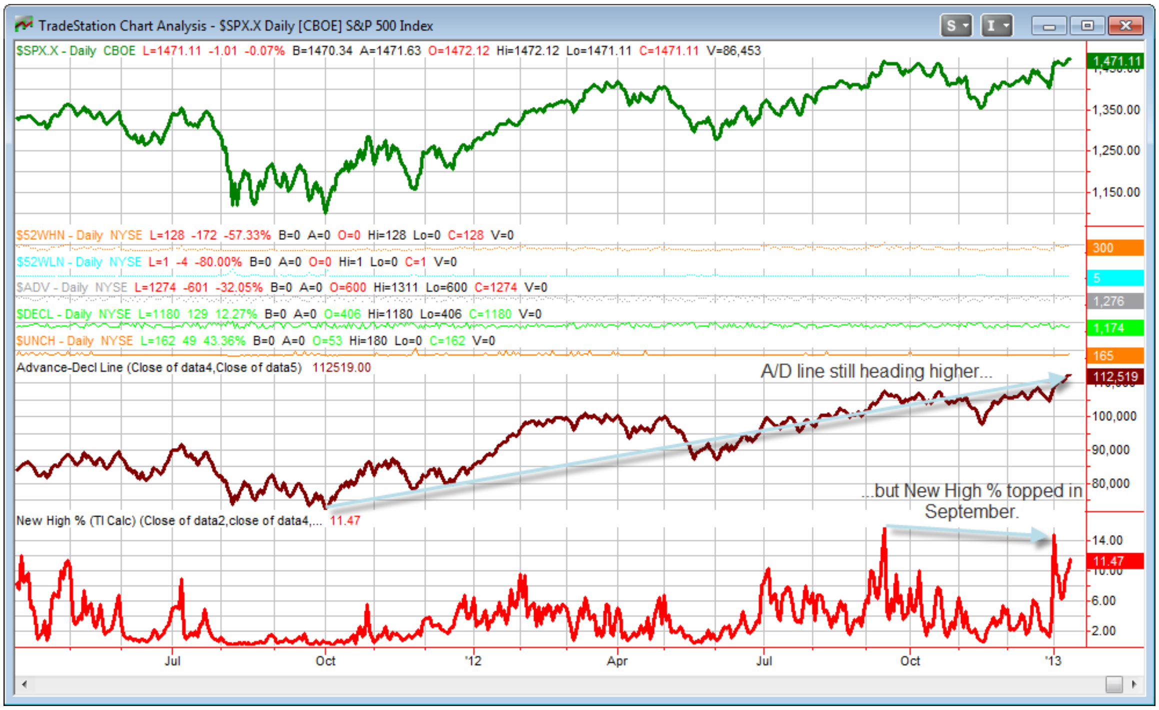
January 1973 top



More of the same here. A weakening a/d line and consistently lower peaks in the 52-week NH%.

So every major price top in the last 43 years has been preceded by some kind of breadth divergence. In every case breadth, either as measured by A/D line, or NH%, or both, has topped out at least 2 months before the final price high was made. Let's now take a look at the current chart to see what that may be saying.

Current Market



The SPX is now posting closing highs above those that were seen in September. (But we need another 2+ points before new intraday highs are achieved.) At this point the A/D line looks strong. The potential red flag is with the New High %. It posted a 15.73% reading in September, 14.75% on January 2nd, and is well below there right now.

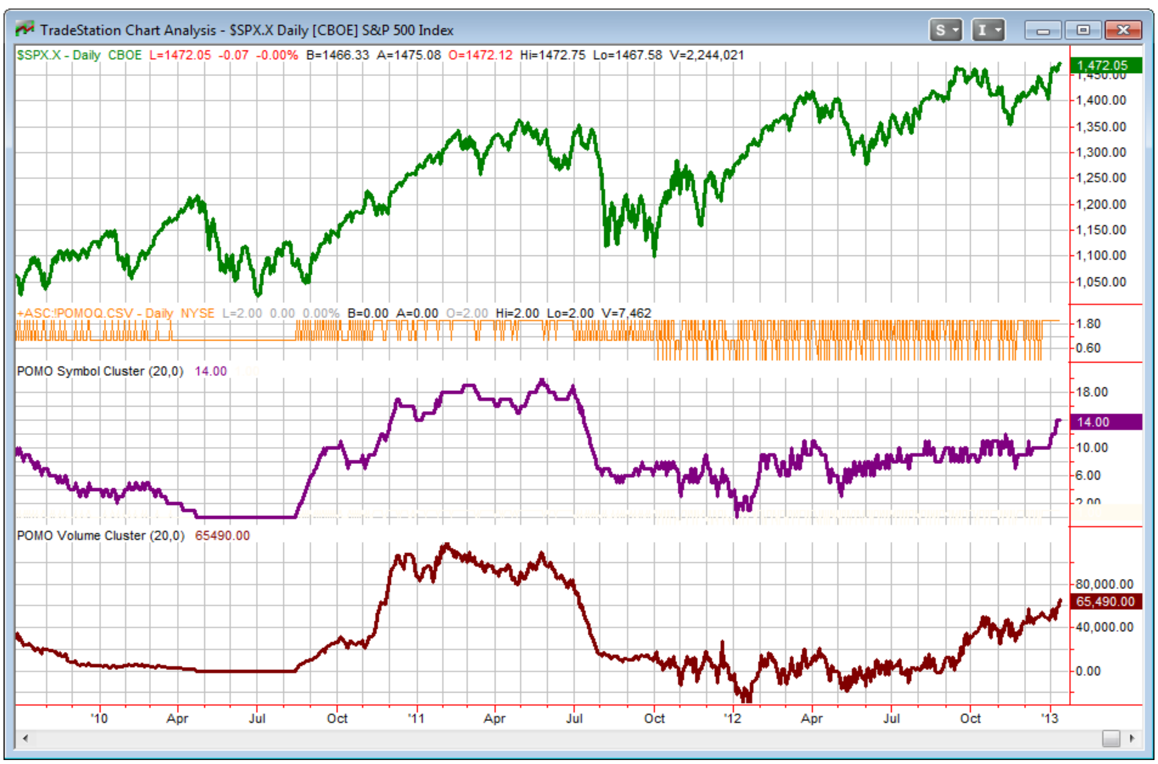
So by one of our measures breadth topped more than 2 months ago. This opens up the possibility of a major top being put in. Note I said *possibility*, not *probability*. It needs to be understood that while the narrowing of New Highs and/or the turn down in the Advance/Decline Line has been a prerequisite for a top to take place, these breadth conditions have not been very useful in timing the tops. Often such divergences have persisted for many months, or even years. I therefore view these breadth divergences as possible warning signs – not as timing signals.

If the market continues higher and New High % registers a day above 15.73%, then that would suggest the market is unlikely to reach a major price top for at least another 2 months. I'll be keeping an eye on the New High % in the upcoming weeks and months. Quantifiable Edges subscribers that would like to monitor this indicator may find it on the charts page.

http://www.quantifiableedges.com/members/charts.php#NYSE_Net_New_Highs

I update the intermediate-term POMO/QE3 chart each week. For those not familiar, below is a brief description.

POMO stands for Permanent Open Market Operations and it is how the Fed has gone into the open market to buy securities over the last several years. 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 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. Since the Sept 13, 2012 QE3 announcement the POMO numbers are also adjusted to reflected the Fed's new approach of buying AMBS securities. Therefore, prior to that date the indicators just look at POMO, since that date it is a combination of POMO and AMBS flows.



The POMO/AMBS volume indicator continues to rise and is now as high as it has been since QE2. We estimate net inflows this past week to have been around $25 billion. That is a very high number and enough that it would normally provide a nice bullish wind at the market's back in the following days.

This upcoming week is also expected to see strong liquidity inflows (as is the rest of the month). Between POMO and AMBS we should see about an $18 billion inflow this week. So for now it appears we will have a strong liquidity wind at the markets back. Over the last 7-8 years the market has flourished under such conditions.

Overall there still appears to be decent technical evidence that higher prices are likely over the next several weeks. We do have a breadth divergence to be aware of, and the bond study from last week is also warning of some intermediate-term downside. But the 1/3/11 breadth thrust study is bullish, overall liquidity is very strong, the Nasdaq continues to lead, and the market is making new highs. So it appears this rally should have further to go. I'll continue to favor the long side.

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.

Current Open Trade Ideas

None