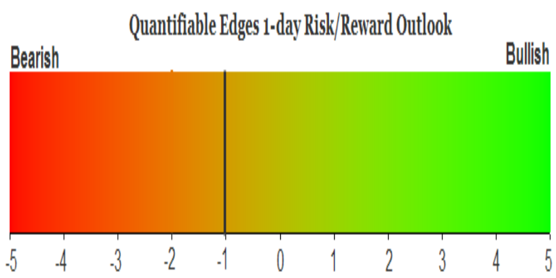
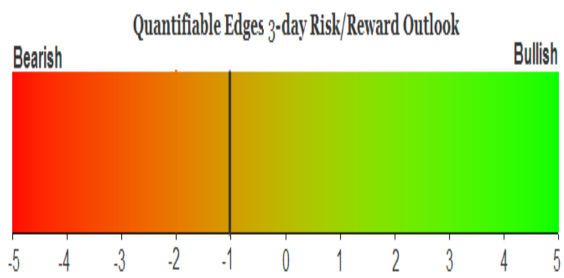
QUANTIFIABLE EDGES SUBSCRIBER LETTER

ASSESSING MARKET ACTION WITH INDICATORS AND HISTORY

January 28, 2013 Volume 6 Issue 18

Market Overview





Signals Overview

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

Tonight's Research Points

- SPY hitting 10-day highs after closing > 5ma for at least 10 straight days suggests extended condition likely to pull back.
- VIX up and SPX up on a Friday has typically been followed by a pullback over the next few days.
- Frequent closes near the top of the daily range can be a sign of over-optimism and an imminent pullback.
- 8 consecutive up days and a 50-day high suggests momentum so strong that it often continues higher over the next several days.

Short-term Outlook
The Bottom Line

As has been the case recently the market is overbought and most evidence is pointing at a likely pullback, including both VIX and SPX price action. But there is now evidence suggesting the momentum has been so strong that we could continue higher. Factor in the strong liquidity that seems to have buoyed this market so far and shorting still appears a dangerous proposition. So I am sidelined an awaiting a pullback in the next few days to possibly buy into.

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

Study Date	Description	Time span	Bias	Avg Max Move
Active				
January 28, 2013	8-day closing range crosses over 75%	1-2 days	Bearish	
January 28, 2013	SPX & VIX up on Friday > 200ma	1-3 days	Bearish	
January 28, 2013	8 days up & 50-day high	1-4 days	Bullish	
January 28, 2013	SPY 10 days > 5ma. 10-high close.	1-2 days	Bearish	-1.20%
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	
September 17, 2012	QE3	int term	Bullish	
February 1, 2012	Golden Cross	int term	Bullish	
Dropped Tonight				
January 24, 2013	VIX up. SPX 50-high. Midweek.	1 day	Bearish	
January 22, 2013	HV low for 4 days. SPX high.	1-4 days	Bullish	
January 22, 2013	MLK week bearish	1-4 days	Bearish	
January 24, 2013	SPY 2 50-day highs on lower volume	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

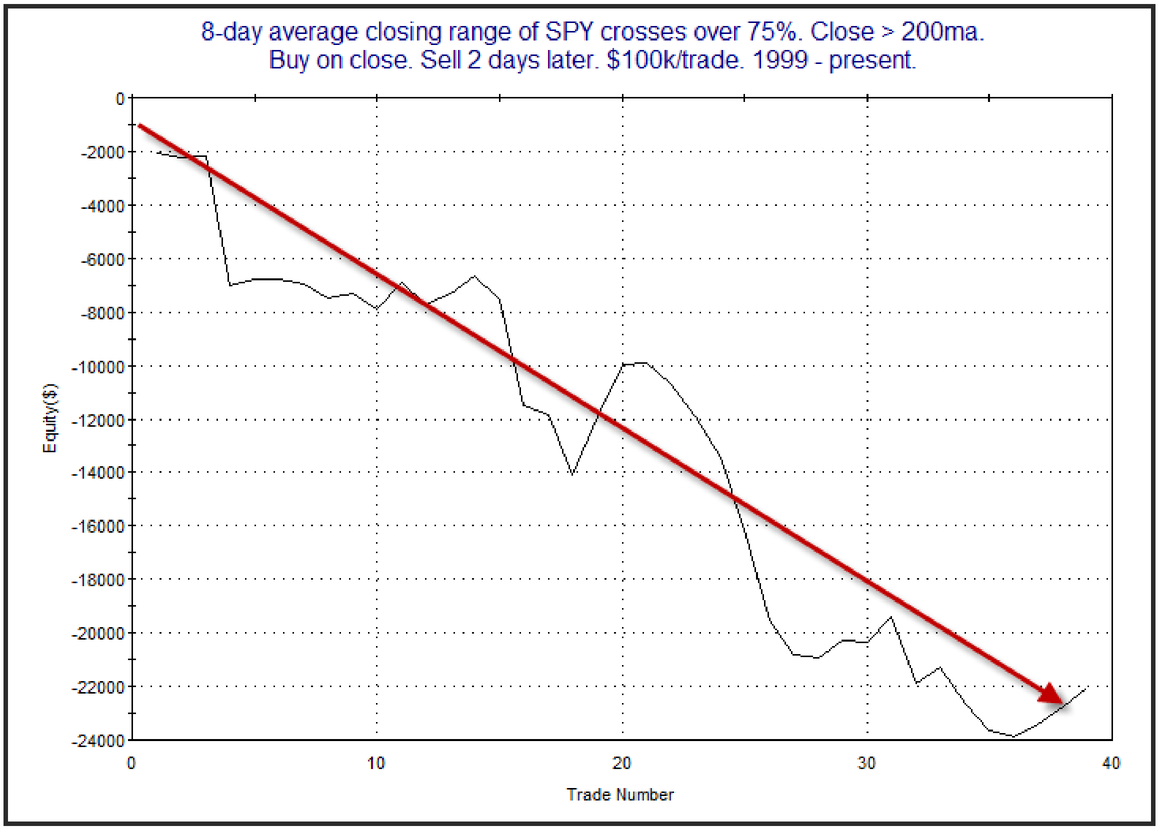
Friday was another up day for the market. The SPX was rose 0.5%, and the Nasdaq and Russell 2000 rallied 0.6%. Breadth was squarely positive as the NYSE Up Issues % was 62% and the Up Volume % came in at 72%. Total NYSE volume dipped just a little from Thursday's level.

SPY finished right near the top of its daily range again on Friday. When the market consistently closes near the high of the day it suggests optimism on the part of traders. This end-of-day optimism is again at a level that suggests it is overdone and there is a good chance of a pullback. The study below was seen just a couple of days ago in the 1/16/13 letter and has triggered again. Stats are updated.

8-day average closing range of SPY crosses over 75%. Close > 200ma.
Buy 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	-24,401.52	33	16	17	48.48	930.33	2,426.72	-2,310.98	-4,637.61	0.40	0.38	-739.44
4	-20,663.53	33	14	19	42.42	1,026.33	2,907.88	-1,843.79	-4,807.86	0.56	0.41	-626.17
3	-19,977.61	35	14	21	40.00	827.68	2,604.54	-1,503.10	-3,618.23	0.55	0.37	-570.79
2	-22,066.68	39	15	24	38.46	718.64	2,186.14	-1,368.59	-4,848.40	0.53	0.33	-565.81
1	-9,050.27	39	17	22	43.59	352.28	1,029.30	-683.59	-2,738.12	0.52	0.40	-232.06

While the downside edge appears to remain in place for a full week, most of the edge has been realized over the 1st 2-3 days. Below is an equity curve showing how the edge has played out using a 2-day exit strategy.



The strong downslope appears to confirm the bearish edge, even with the action of the last few instances.

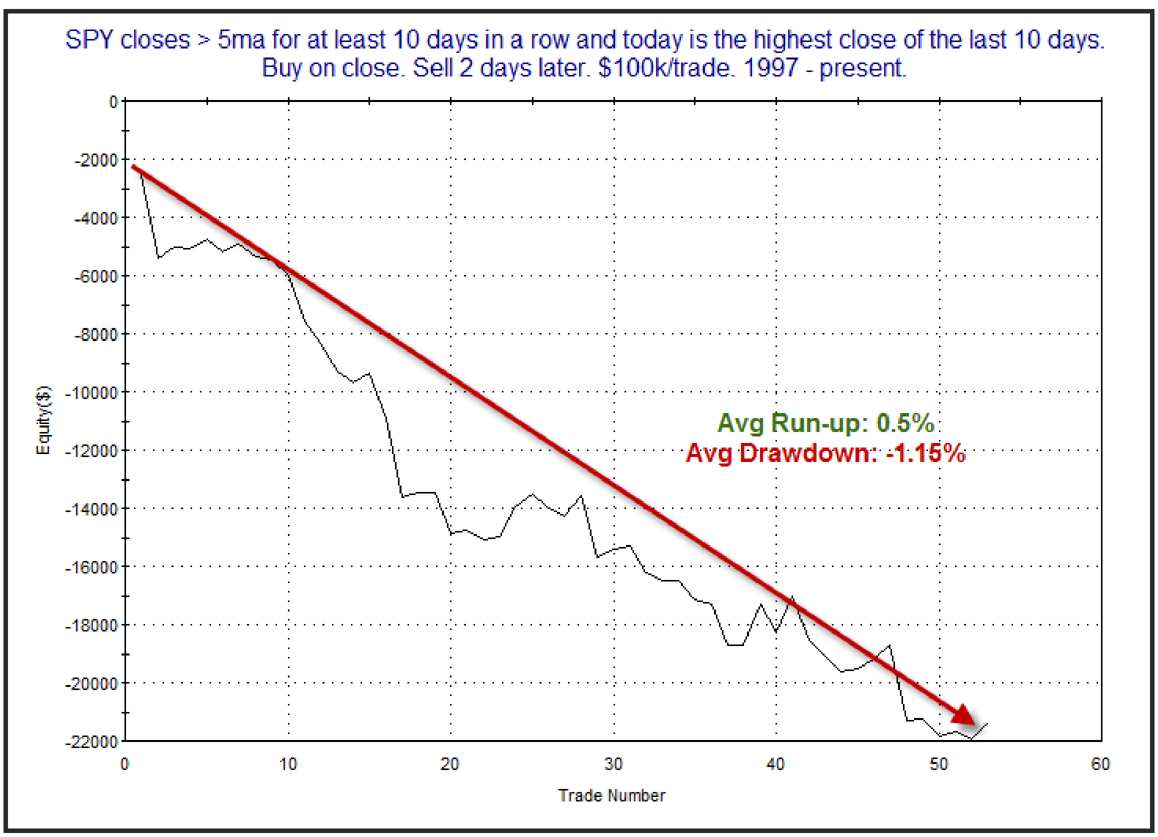
This next study I also showed yesterday in the subscriber letter. It looked at other instances in which the market had traded above the 5ma for so long and was now closing at a 10-day high. All results are updated.

SPY closes > 5ma for at least 10 days in a row and today is the highest close of the last 10 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	-11,287.60	37	20	17	54.05	752.39	2,516.52	-1,549.14	-4,014.40	0.49	0.57	-305.07
4	-16,592.76	39	16	23	41.03	644.93	1,428.90	-1,170.07	-3,723.20	0.55	0.38	-425.46
3	-19,729.66	46	15	31	32.61	635.50	1,294.25	-943.94	-3,235.65	0.67	0.33	-428.91
2	-21,360.17	53	22	30	41.51	394.38	1,392.65	-1,001.22	-2,870.40	0.39	0.29	-403.02
1	-20,882.09	76	32	44	42.11	292.19	1,134.24	-687.09	-2,817.32	0.43	0.31	-274.76

90% of instances closed below the entry price at some point in the next week.

In the past this setup has almost always been followed by a short-term pullback. The downside edge doesn't last long, though. It seems to pretty much play itself out over the first 2 days. Below is an equity curve showing how the edge has evolved over time. It uses a 2-day exit strategy.



The strong downslope seems to confirm the bearish edge.

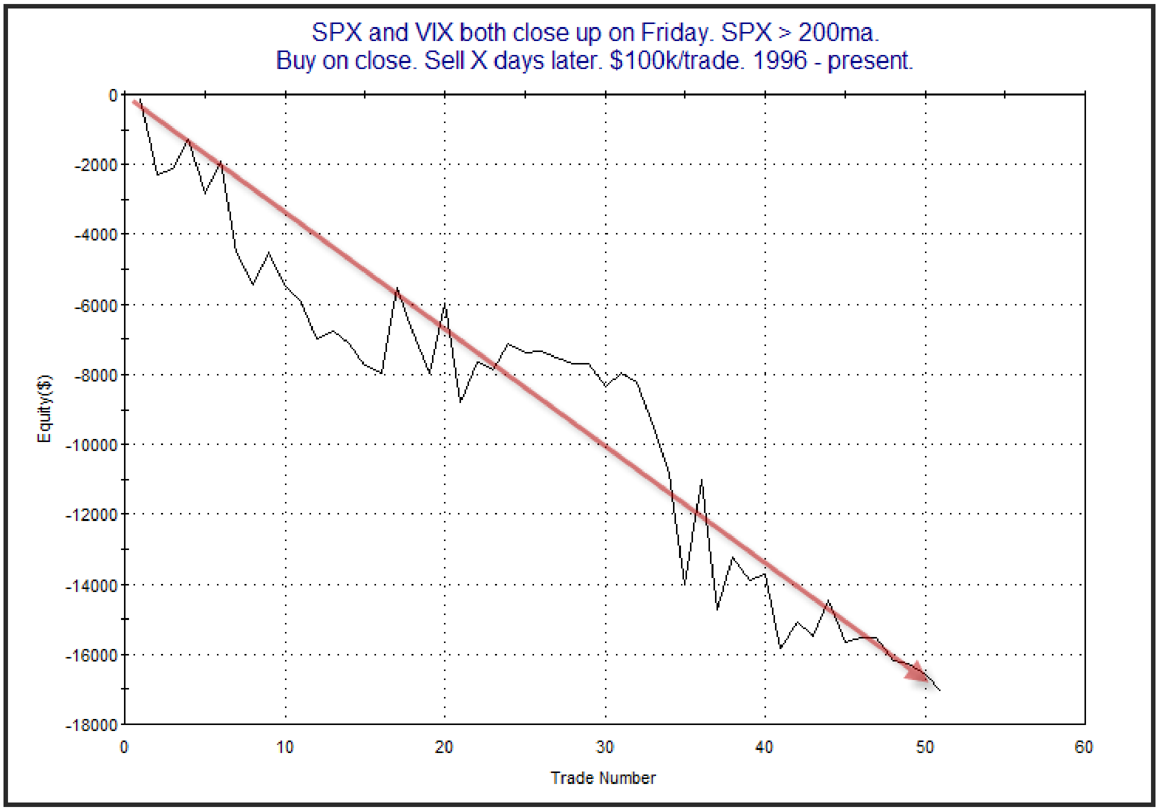
Even with the SPX rising, the VIX managed to close up a bit. The VIX will typically trade in a direction opposite the SPX, so it is unusual that they both close higher. On Fridays, the VIX has a natural tendency to dip in the afternoon, so it is *most* unusual to see them both close higher on Friday. The study below was last seen in 12/3/12 subscriber letter. It examines other instances of the VIX and SPX both closing higher on a Friday while the SPX is in an uptrending market. All stats are updated.

SPX and VIX both close up on Friday. SPX > 200ma.
Buy on close. Sell X days later. $100k/trade. 1996 - 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	-15,105.42	50	20	30	40.00	1,397.83	4,290.80	-1,435.40	-3,118.36	0.97	0.65	-302.11
4	-17,303.63	51	20	31	39.22	1,088.02	4,275.84	-1,260.13	-4,306.02	0.86	0.56	-339.29
3	-17,064.76	51	17	34	33.33	973.19	3,000.26	-988.50	-3,727.50	0.98	0.49	-334.60
2	-13,310.60	51	21	30	41.18	754.66	2,380.51	-971.95	-3,595.20	0.78	0.54	-260.99
1	-10,849.13	51	16	35	31.37	501.77	1,530.15	-539.36	-2,361.45	0.93	0.43	-212.73

48 of 51 instances (94%) closed below the entry price at some point in the next week.

As you can see, there appears to be a decent downside edge suggested by this study. That edge primarily plays out over the first three days. Below is an equity curve showing how the edge has evolved assuming that 3-day holding period.



Considering the fact that the study utilizes a long-term uptrend filter, the persistent downslope is quite impressive. The last instance once again put the equity curve at new lows.

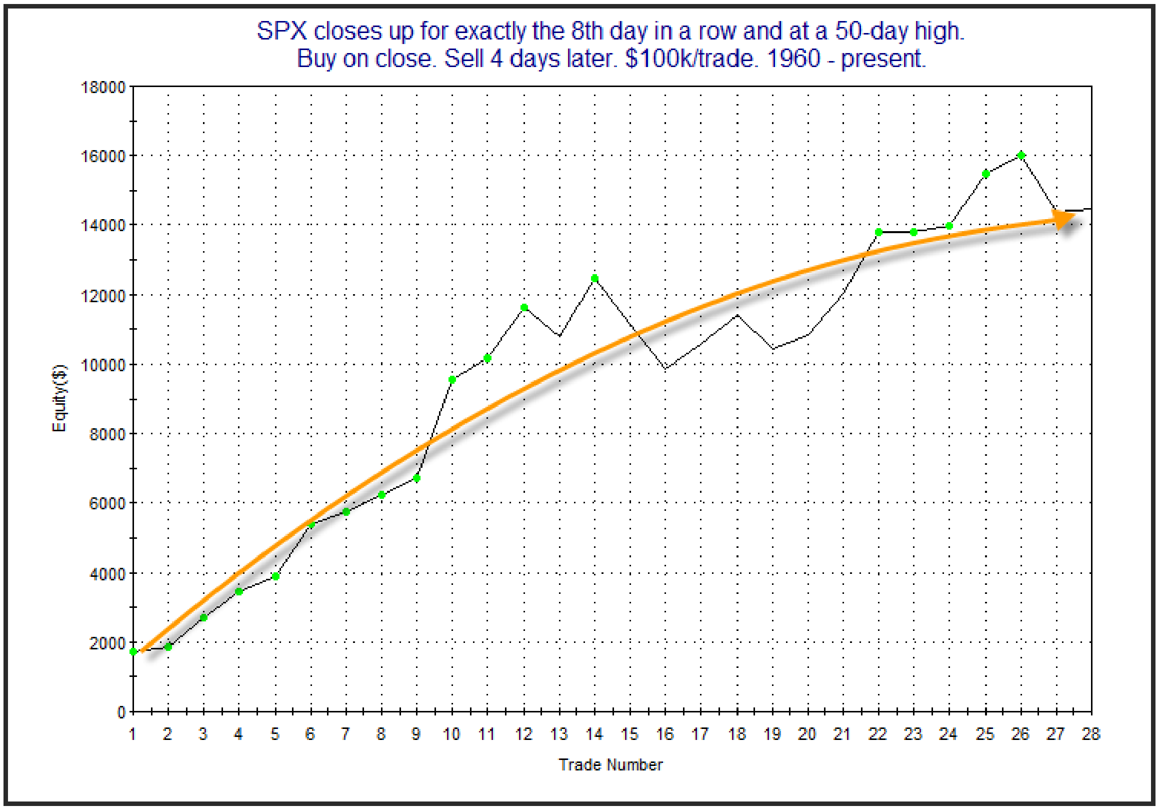
Most of the time overbought conditions suggest a pullback. But there are occasions when overbought becomes so overbought that it suggests momentum will continue to carry the market higher. The study below suggests we may be in a situation like this.

SPX closes up for exactly the 8th day in a row and at a 50-day high.
Buy on close. Sell X days later. $100k/trade. 1960 - 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	10,093.58	28	17	11	60.71	1,195.90	2,331.00	-930.62	-2,562.72	1.29	1.99	360.49
4	14,461.37	28	23	5	82.14	892.99	2,823.21	-1,215.50	-1,653.85	0.73	3.38	516.48
3	11,879.76	28	19	9	67.86	763.10	2,274.57	-291.02	-875.91	2.62	5.54	424.28
2	6,586.85	28	18	10	64.29	578.87	1,634.49	-383.29	-1,020.39	1.51	2.72	235.24
1	2,684.14	28	19	9	67.86	381.12	1,191.36	-506.36	-1,088.70	0.75	1.59	95.86

26 of 28 instances (93%) closed above the entry price at some point in the next week. The 2 that failed triggered on 5/26/72 and 4/17/75.

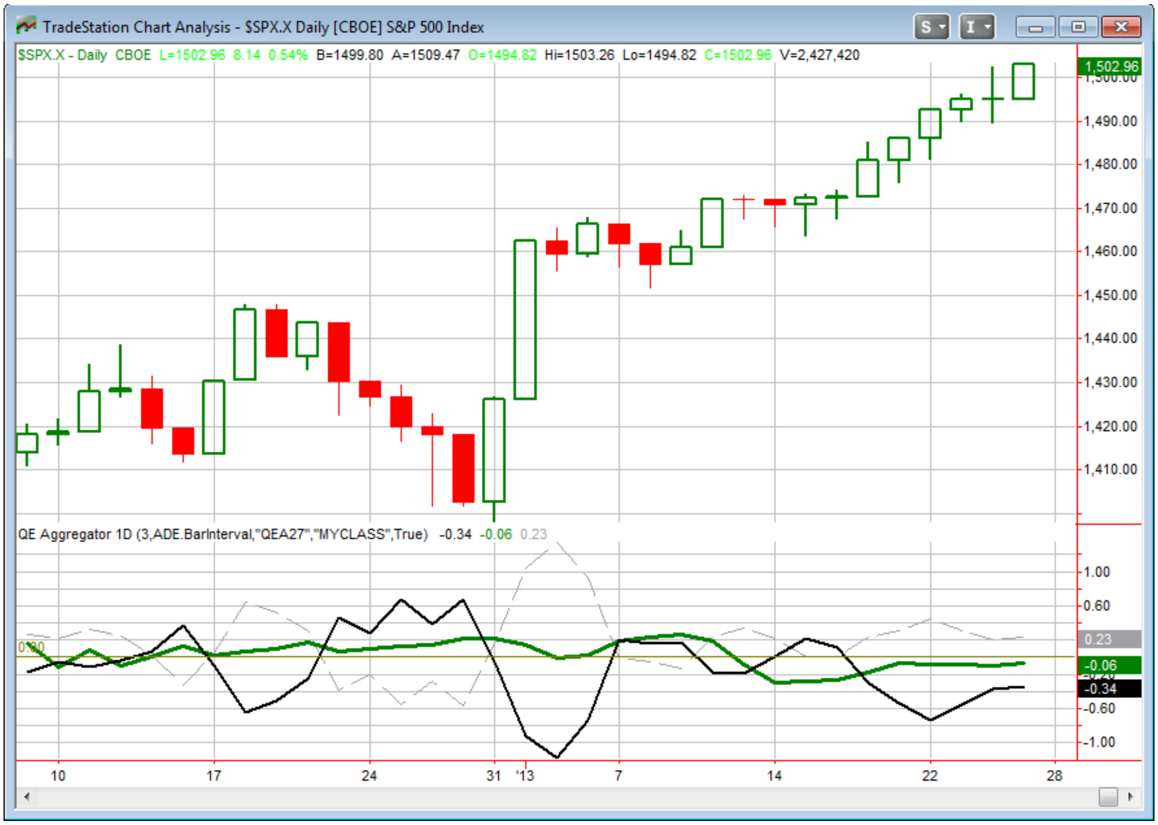
The net numbers are not all that powerful from an average trade standpoint, but the consistency is very impressive. This makes sense as it would be difficult to spark a big move up when the market is already so overbought. Below is an equity curve that assumes a 4-day holding period.



Perhaps not quite as strong as it once appeared but the slope certainly remains up, and the results appear steady enough to include this study on the active list.

So short-term evidence is mixed. While most studies are saying we are overbought to the point we would normally see a pullback, the last study suggests we may even be beyond that and the strength could continue.

I have updated the Aggregator chart below.



The Aggregator formation changed very little once again. The green Aggregator line remained 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 below 0. The negative reading means 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.

Largely thanks to the "8 higher closes and a 50-day high" study, expectations are set to turn very slightly bullish on Monday. This could easily change if additional bearish evidence emerges. The Differential Pivot will be 1,491.41 on Monday. This is 0.8% below Friday's close. So it will take a decline of at least this much on Monday in order for the SPX to move from overbought to oversold.

While some might characterize the recent rally as a "boring grind higher", I've found it very interesting. The one thing that seemed to hint the market was capable of such a move is the QE Buying Power Index, which has been locked in at a maximum "5" all month. A market flush with liquidity is generally a tough one to short, even when overbought. It is the QE Buying Power Index that has kept me sidelined rather than short. So while I have not been able to participate in the melt-up the last week or so, I am very pleased not to have been run over by it either.

The prospect of expectations turning bullish on Monday is interesting. It means that after 8 days up in a row, we could see a long signal trigger with just 1 down day of 0.8% of more. I don't anticipate taking on any exposure on Monday, but if we get a couple of days down here I'll almost certainly start scaling into a long position.

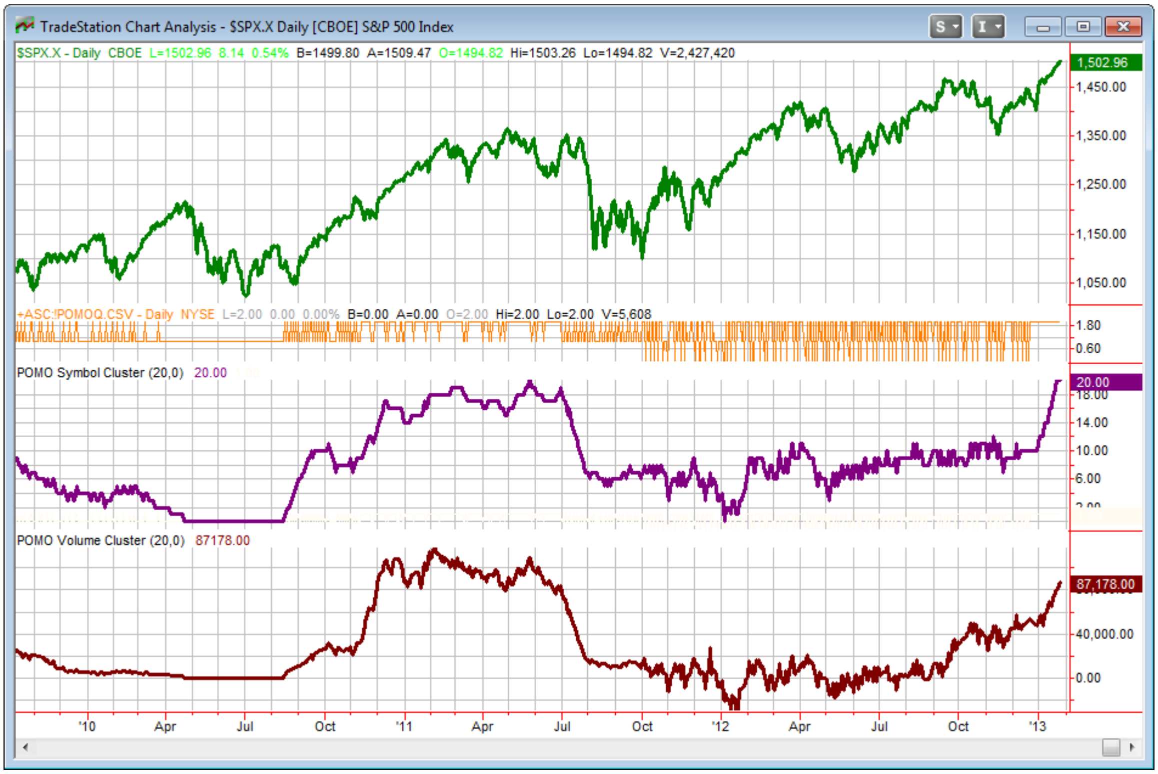
Intermediate-term Outlook (2 weeks – 2 months)– updated 1/28– bullish

The SPX made new intraday and closing highs every day this past week. It has been a persistent grind higher, fueled by a combination of momentum and Fed-pumped liquidity. The studies that triggered this week were primarily short-term in nature. While the market is strongly overbought short-term, we aren't seeing strong indications of an intermediate-term decline just yet.

Since I updated the study of tops a few weeks ago I have been keeping a close eye on the number of new highs being made on the NYSE. While the SPX has been making new highs, and is now well above the mid-September high, the numbers of individual issues hitting new highs remains in a divergence. Thursday it neared a higher number when it posted 475 new highs, but that was still below the 483 on September 14th. So the divergence remains in place for now, leaving open the possibility that a top could form leading to a major decline. A further expansion of new highs would greatly reduce the possibility of that happening in the next couple of months.

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 again hitting post-QE2 highs. Same goes for the days indicator, which is now maxed out at 20, which was a rarity even during QE2. We estimate net inflows this past week to have been around $17.5 billion. That is a 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 – at least through Thursday. Between POMO and AMBS we should see about a $14 billion inflow between Monday and Thursday. 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.

Beyond Thursday we don't have great visibility yet. Friday is the 1st day of February and the Fed will release its February POMO and AMBS buying intentions on Thursday afternoon. This will allow us to anticipate next month's liquidity flows and produce the QE Buying Power Index for February.

As usual, the Fed will post the new POMO schedule on the following web page:

http://www.newyorkfed.org/markets/tot_operation_schedule.html

February's scheduled AMBS purchase amount will be published to this web page:

http://www.newyorkfed.org/markets/ambs/ambs_schedule.html

I'll be sure to discuss February's liquidity outlook in detail next weekend.

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 an active bond study is also warning of some intermediate-term downside. But the 1/3/13 breadth thrust study is bullish, liquidity is very strong, 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