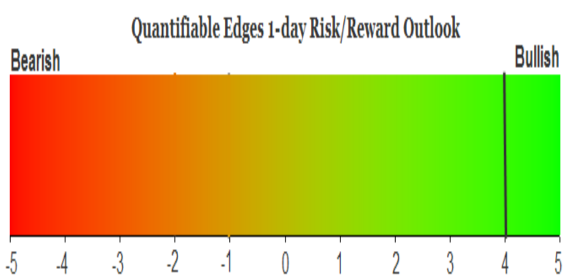
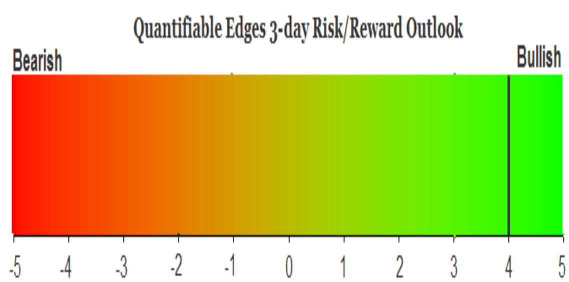
QUANTIFIABLE EDGES SUBSCRIBER LETTER

ASSESSING MARKET ACTION WITH INDICATORS AND HISTORY

January 27, 2014 Volume 7 Issue 17

Market Overview





Signals Overview

Aggregator	Aggressive VIX	QE Buy Pwr Swing
Long	100% Long XIV	Long

Tonight's Research Points

- 2 unfilled down gaps under similar circumstances has commonly been followed by a bounce over the next few days.
- The strong move down through the 50ma is normally good for a 1-day bounce.
- Extreme VIX action suggests short-term bounce.
- Strong moves down on Fridays have led to reliable bounces overt h next several days.
- A big down week in an uptrend has not often led to a long-term selloff.

Short-term Outlook

The Bottom Line

Evidence appears strongly bullish for the next few days. I'm looking to take on some long exposure to take advantage of a bounce.

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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 - Short Term				
January 27, 2014	Strong drop through 50ma	1 day	Bullish	
January 27, 2014	2 unfilled gaps dn > 200ma	1-6 days	Bullish	
January 27, 2014	Friday down 1.5x 20-day ATR	1-6 days	Bullish	
January 27, 2014	VIX 35% over 10ma	1 day	Bullish	
January 14, 2014	1% drop bad breadth	1-9 days	Bullish	3.10%
Active - Long Term				
January 27, 2014	2 unfilled dn gaps & 5-low > 200	1-10 days	Bullish	
December 23, 2014	QE Tapering	int term	Neutral	
December 18, 2013	4 Hindenburg Triggers	1 - 35 days	Bearish	-7.00%
December 2, 2013	Nasdaq leading SPX	int term	Bullish	
October 21, 2013	70% Advancing Issues 3 Days In Row	1-75 days	Bullish	10.60%
July 22, 2013	New High Divergence (Study of Tops)	int term	Bearish	
February 1, 2012	Golden Cross	int term	Bullish	
Dropped Tonight				
January 23, 2014	SPY up 2days but < 3 days ago.	1-2 days	Bullish	
January 21, 2014	MLK week bearish	1-4 days	Bearish	-1.90%

The Evidence

The market had its worst day in a while on Friday, and the selling accelerated into the close. The SPX finished down 2.1%, the Nasdaq lost 2.2% and the Russell 2000 declined 2.4%. Breadth was extremely weak as the NYSE Up Issues % was 15% and the Up Volume % was 8%. Total NYSE volume spiked to the highest level since December.

There were several studies that triggered tonight. I went through the Quantifinder and pulled out the most compelling. The 1st one below was last seen on 6/21/13. It considers the fact that SPX crossed down through the 50ma on strong breadth and volume. The 50ma is a highly-watched line by market technicians, so a strong move through it is often notable. What's interesting is that the 1-day returns are contrarian. Results are updated.

SPX crosses down through the 50ma on 90% downside volume and the highest NYSE volume in 10 days. Buy on close. Sell next day's close. $100k/trade. 10/86 - present.

TradeStation Performance Summary Collapse

All Trades

Total Net Profit	$10,216.18	Profit Factor	32.85
Gross Profit	$10,536.90	Gross Loss	($320.72)
Total Number of Trades	17	Percent Profitable	94.12%
Winning Trades	16	Losing Trades	1
Even Trades	0		
Avg. Trade Net Profit	$600.95	Ratio Avg. Win:Avg. Loss	2.05
Avg. Winning Trade	$658.56	Avg. Losing Trade	($320.72)
Largest Winning Trade	$2,753.79	Largest Losing Trade	($320.72)

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The 16 for 17 record is very impressive. It seems the strong move through the highly watched line will often cause a short-term over-reaction on the part of traders. Here is a look at the individual instances.

SPX crosses down through the 50ma on 90% downside volume and the highest NYSE volume in 10 days. Buy on close. Sell next day's close. $100k/trade. 10/86 - present.				
Date/Time	**Signal**	**Price**	**% Profit**	**Run-up Drawdown**
11/18/86	Buy	$236.77	0.38%	$493.74
11/19/86	Sell	$237.66		($535.94)
04/14/88	Buy	$259.75	0.01%	$241.92
04/15/88	Sell	$259.77		($1,451.52)
10/13/89	Buy	$333.64	2.76%	$2,759.77
10/16/89	Sell	$342.85		($1,949.48)
08/19/91	Buy	$376.46	0.79%	$1,030.85
08/20/91	Sell	$379.42		$0.00
11/15/91	Buy	$382.62	0.68%	$722.97
11/18/91	Sell	$385.23		($767.34)
04/02/93	Buy	$441.39	0.20%	$235.04
04/05/93	Sell	$442.29		($194.36)
01/09/98	Buy	$927.69	1.24%	$1,236.92
01/12/98	Sell	$939.21		($1,590.02)
02/27/07	Buy	$1,399.14	0.55%	$1,189.25
02/28/07	Sell	$1,406.82		($176.79)
07/24/07	Buy	$1,511.04	0.47%	$875.82
07/25/07	Sell	$1,518.09		($482.46)
06/06/08	Buy	$1,360.44	0.10%	$743.87
06/09/08	Sell	$1,361.77		($716.86)
09/04/08	Buy	$1,236.83	0.44%	$648.80
09/05/08	Sell	$1,242.31		($1,568.00)
02/10/09	Buy	$827.16	0.80%	$1,327.20
02/11/09	Sell	$833.74		($583.20)
07/16/10	Buy	$1,064.88	0.60%	$913.26
07/19/10	Sell	$1,071.25		($350.61)
04/18/11	Buy	$1,305.14	0.57%	$574.56
04/19/11	Sell	$1,312.62		($88.92)
07/27/11	Buy	$1,304.89	(0.32%)	$868.68
07/28/11	Sell	$1,300.67		($435.48)
04/10/12	Buy	$1,358.59	0.74%	$1,176.76
04/11/12	Sell	$1,368.71		$0.00
06/20/13	Buy	$1,588.19	0.27%	$682.00
06/21/13	Sell	$1,592.43		($650.38)

No red flags here.

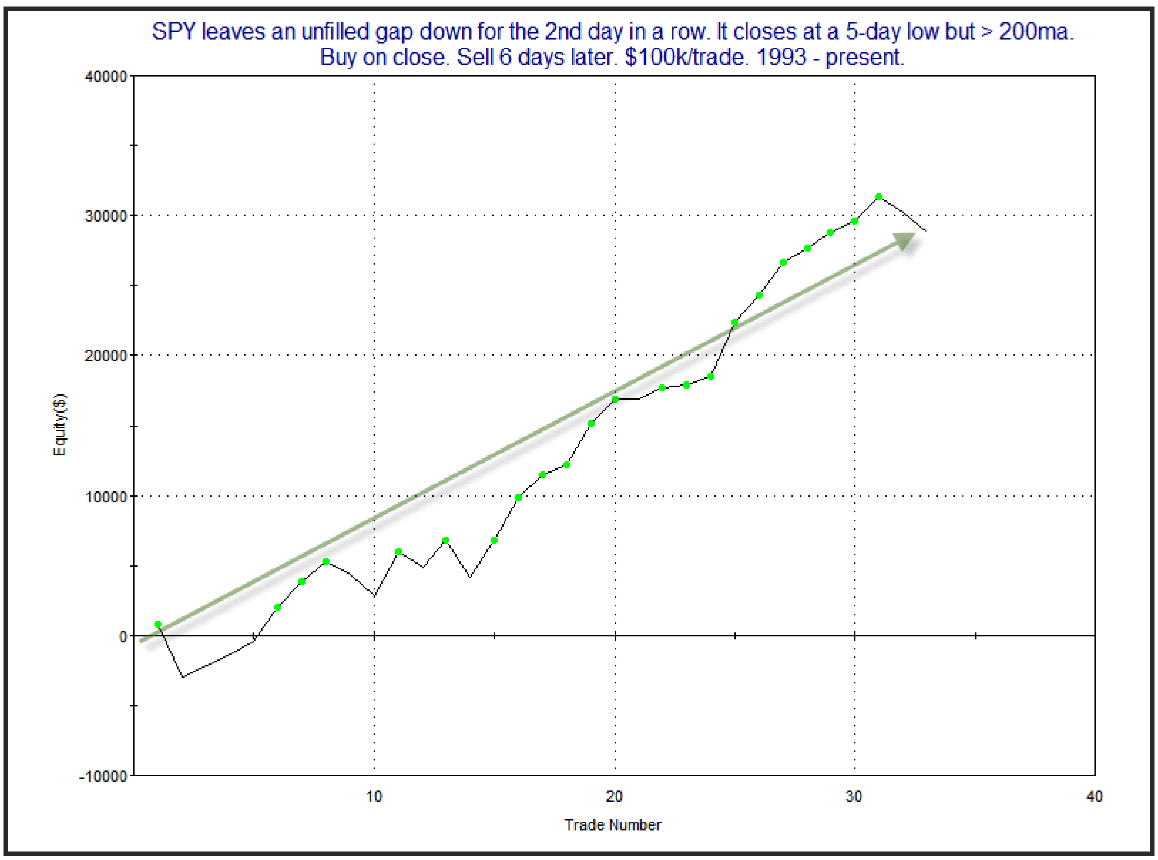
Another notable aspect of the price action over the last 2 days is that both Thursday and Friday SPY posted unfilled gaps down – never reaching breakeven at any point during the day. This helped trigger the study below, which I last featured in the 10/1/13 letter. Results are updated.

SPY leaves an unfilled gap down for the 2nd day in a row. It closes at a 5-day low but > 200ma. Buy on close. Sell X days later. $100k/trade. 1993 - present.

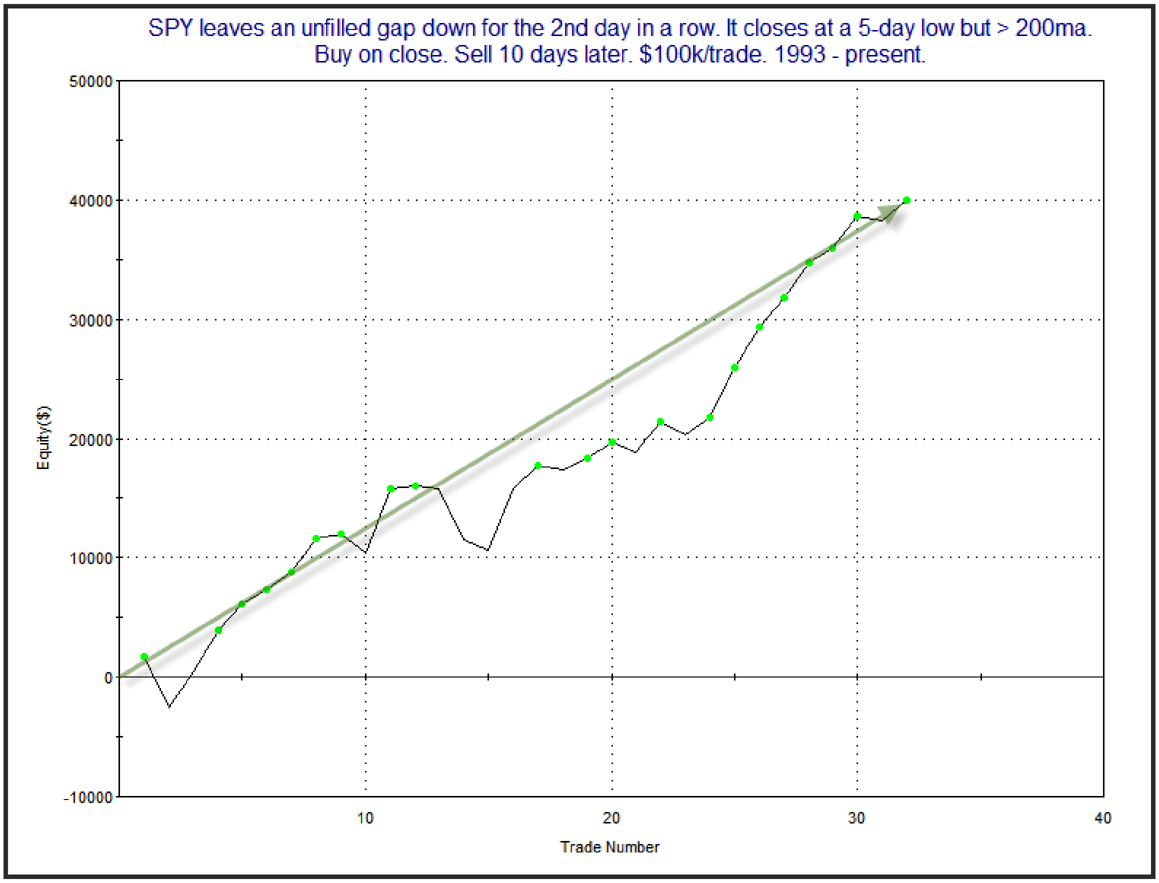
X Days	All: Net Profit	All: Total Trades	All: Winning Trades	All: Losing Trades	All: % Profitable	All: Avg Winning Trade	All: Max Winning Trade	All: Avg Losing Trade	All: Max Losing Trade	All: Win/Loss Ratio	All: ProfitFactor	All: Avg Trade
10	40,021.20	32	23	9	71.88	2,344.12	5,325.39	-1,543.73	-4,353.36	1.52	3.88	1,250.66
9	37,884.10	33	27	6	81.82	2,032.36	4,882.41	-2,831.61	-6,273.96	0.72	3.23	1,148.00
8	33,082.79	33	24	8	72.73	2,040.90	4,574.25	-1,987.36	-4,801.50	1.03	3.08	1,002.51
7	21,935.49	33	23	9	69.70	1,926.68	4,429.74	-2,486.45	-5,057.58	0.77	1.98	664.71
6	28,753.01	33	25	8	75.76	1,645.19	3,828.72	-1,547.09	-3,734.50	1.06	3.32	871.30
5	28,006.43	33	24	9	72.73	1,533.13	3,940.02	-976.53	-2,465.95	1.57	4.19	848.68
4	22,041.82	33	25	8	75.76	1,205.60	4,388.28	-1,012.26	-1,920.60	1.19	3.72	667.93
3	12,986.00	33	20	13	60.61	1,098.56	3,325.14	-691.17	-1,645.38	1.59	2.45	393.52
2	7,200.44	33	19	14	57.58	957.07	2,948.14	-784.56	-2,436.12	1.22	1.66	218.20
1	4,067.39	34	20	14	58.82	724.07	1,974.15	-743.85	-1,849.26	0.97	1.39	119.63

Only 1 instance failed to close above the entry price at some point in the next 6 days. It triggered on 9/14/99.

The numbers appear to suggest s strong tendency for a bounce in the next few days. Below is the profit curve assuming a 6-day holding period.



The steady upward slope acts as confirmation of the bullish edge. Since the 10-day numbers were also I strong I ran a profit curve for that as well.



This is also very strong, and it has compelled me to also include this study on the intermediate-term Active List.

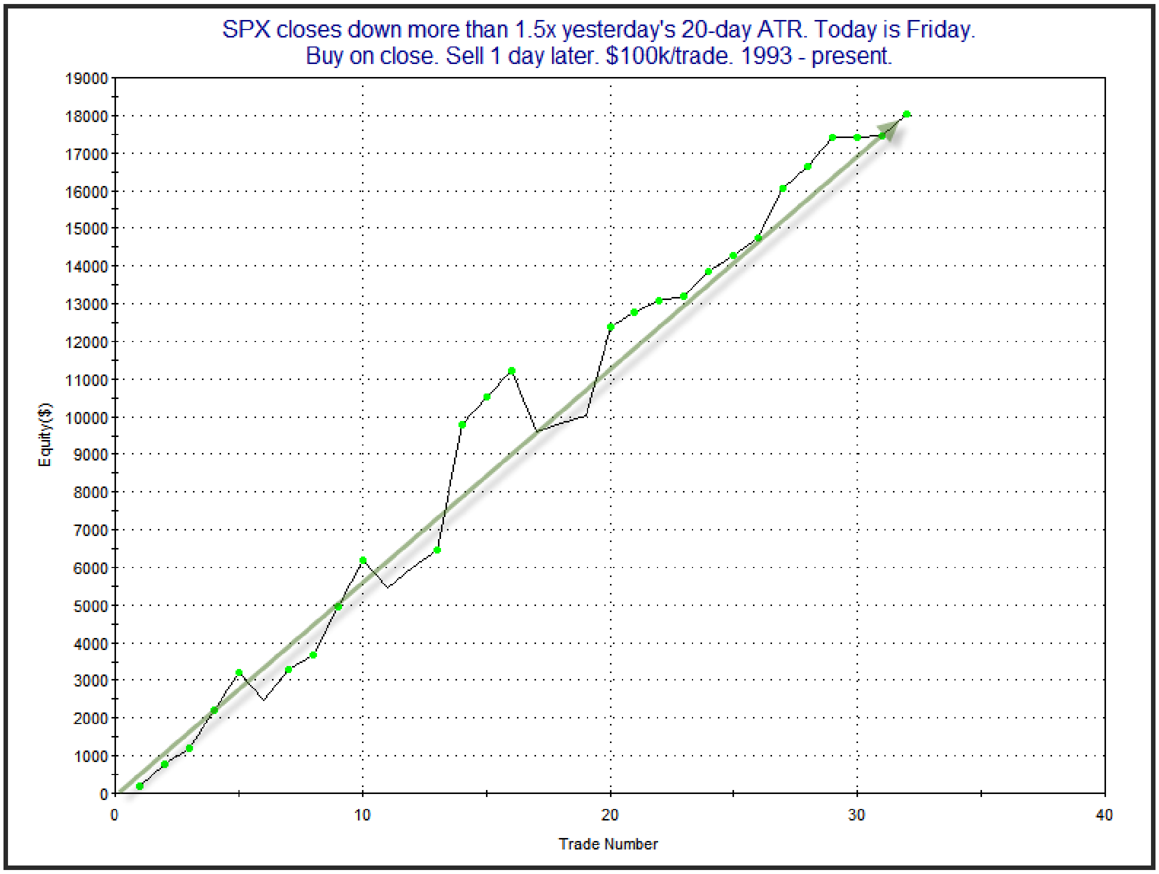
Another very compelling study that appeared in the Quantifinder examined large drops on Fridays. Both the Crash of '29 and the Crash of '87 happened on Monday. The Crash of '87 is still remembered by many traders that are active today. There was a strong selloff on Friday and then all hell broke loose on Monday. But since then strong Friday selloffs have commonly been followed by bounces on Mondays. Perhaps this is due to the fact that fear of a crash causes what might otherwise be an ordinary selloff to become exaggerated and overdone on Fridays. Or perhaps it is just that people don't want to hold over the weekend. Whatever the reason, the tendency to bounce has been very strong. The study below looks at strong drops on Fridays and was last discussed in the 6/3/13 subscriber letter.

SPX closes down more than 1.5x yesterday's 20-day ATR. Today is Friday.
Buy on close. Sell X days later. $100k/trade. 1993 - present.

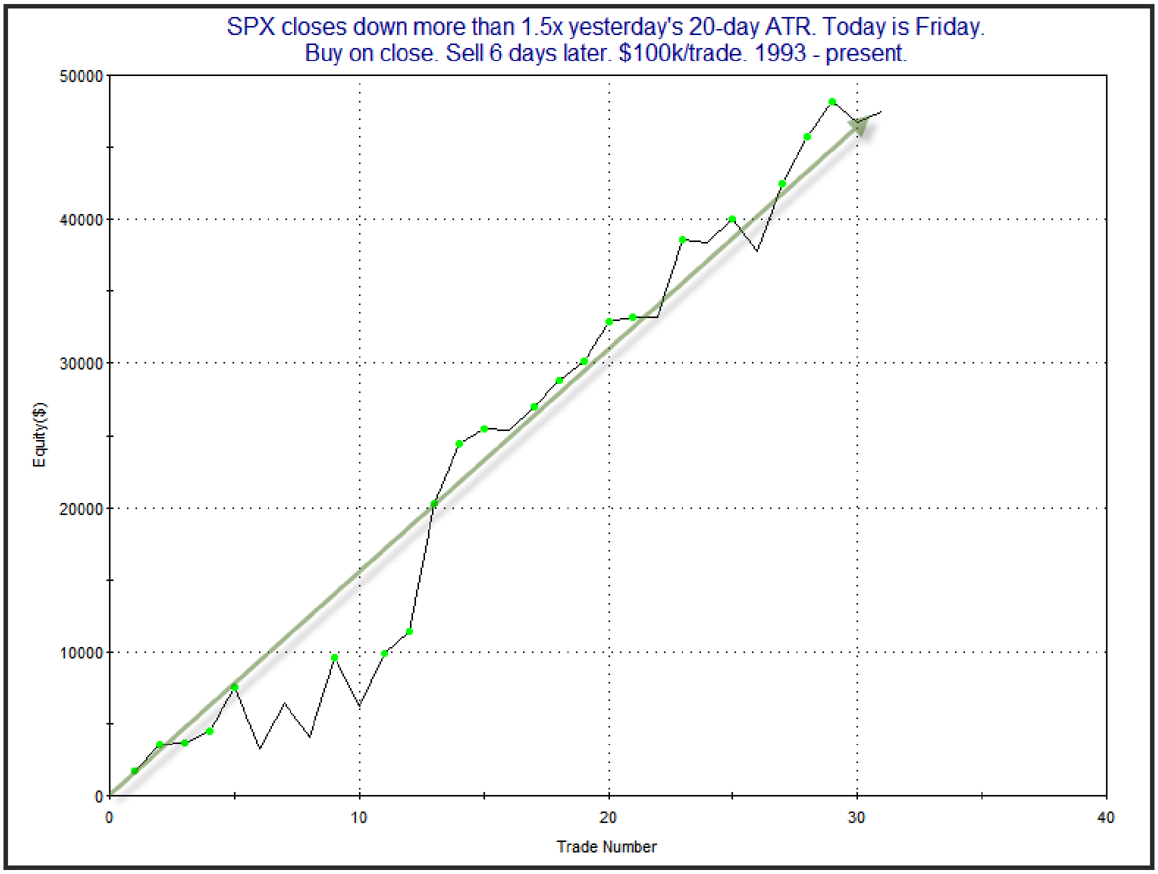
X Days	All: Net Profit	All: Total Trades	All: Winning Trades	All: Losing Trades	All: % Profitable	All: Avg Winning Trade	All: Max Winning Trade	All: Avg Losing Trade	All: Max Losing Trade	All: Win/Loss Ratio	All: ProfitFactor	All: Avg Trade
10	29,641.63	31	19	12	61.29	3,138.76	9,241.60	-2,499.57	-6,049.40	1.26	1.99	956.18
9	33,080.03	31	20	11	64.52	2,866.11	7,602.40	-2,203.83	-5,483.80	1.30	2.36	1,067.10
8	40,457.82	31	21	10	67.74	2,820.21	7,949.70	-1,876.66	-3,550.72	1.50	3.16	1,305.09
7	40,268.76	31	20	11	64.52	2,943.80	7,662.81	-1,691.57	-4,599.52	1.74	3.16	1,298.99
6	47,454.51	31	23	8	74.19	2,667.20	8,870.96	-1,736.40	-4,202.80	1.54	4.42	1,530.79
5	32,826.59	32	23	9	71.88	2,248.38	5,393.97	-2,098.46	-6,368.04	1.07	2.74	1,025.83
4	23,060.42	32	21	11	65.63	1,933.22	5,731.96	-1,594.30	-4,917.36	1.21	2.31	720.64
3	25,257.34	32	21	11	65.63	1,830.80	5,215.85	-1,199.04	-3,492.36	1.53	2.91	789.29
2	21,208.79	32	22	10	68.75	1,452.56	6,245.15	-1,074.74	-4,320.06	1.35	2.97	662.77
1	18,049.59	32	29	3	90.63	729.09	3,322.23	-1,031.38	-1,614.72	0.71	6.83	564.05

2 of the 3 instances that didn't bounce on Monday kept dropping and failed to post a close above the entry price at all in the next 2 weeks. They were 7/5/96 and 7/31/98.

The numbers here are all very impressive and suggest a strong bullish bias. I decided to look at the 1-day and 6-day returns in a little more detail. First, below is the profit curve for a 1-day holding period.



The Monday inclination has been strong, and I see no red flags here. For the 6-day I also produced a profit curve.



Here too the results remain impressive. This certainly seems to be a study worth taking under consideration.

The price drops were very large, but what also stuck out to me was the massive spike in the VIX. It rose 31.7% on Friday. This triggered a number of VIX-related studies in the Quantifinder. The one below is the one that I found most compelling. It was last seen in the 8/5/11 subscriber letter.

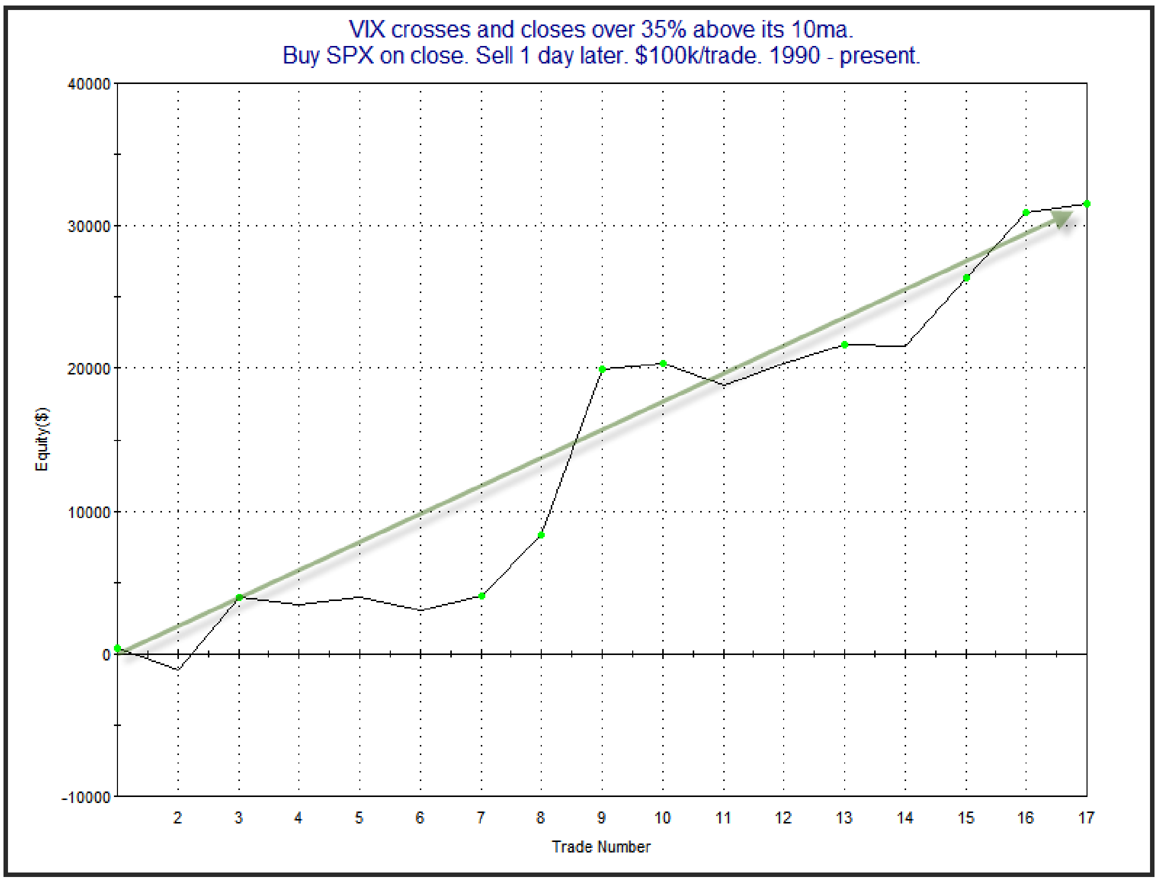
VIX crosses and closes over 35% above its 10ma.
Buy SPX on close. Sell 1 day later. $100k/trade. 1990 - present.

TradeStation Performance Summary Collapse

All Trades

Total Net Profit	$31,565.98	Profit Factor	7.82
Gross Profit	$36,193.65	Gross Loss	($4,627.67)
Total Number of Trades	17	Percent Profitable	70.59%
Winning Trades	12	Losing Trades	5
Even Trades	0		
Avg. Trade Net Profit	$1,856.82	Ratio Avg. Win:Avg. Loss	3.26
Avg. Winning Trade	$3,016.14	Avg. Losing Trade	($925.53)
Largest Winning Trade	$11,558.43	Largest Losing Trade	($1,532.16)

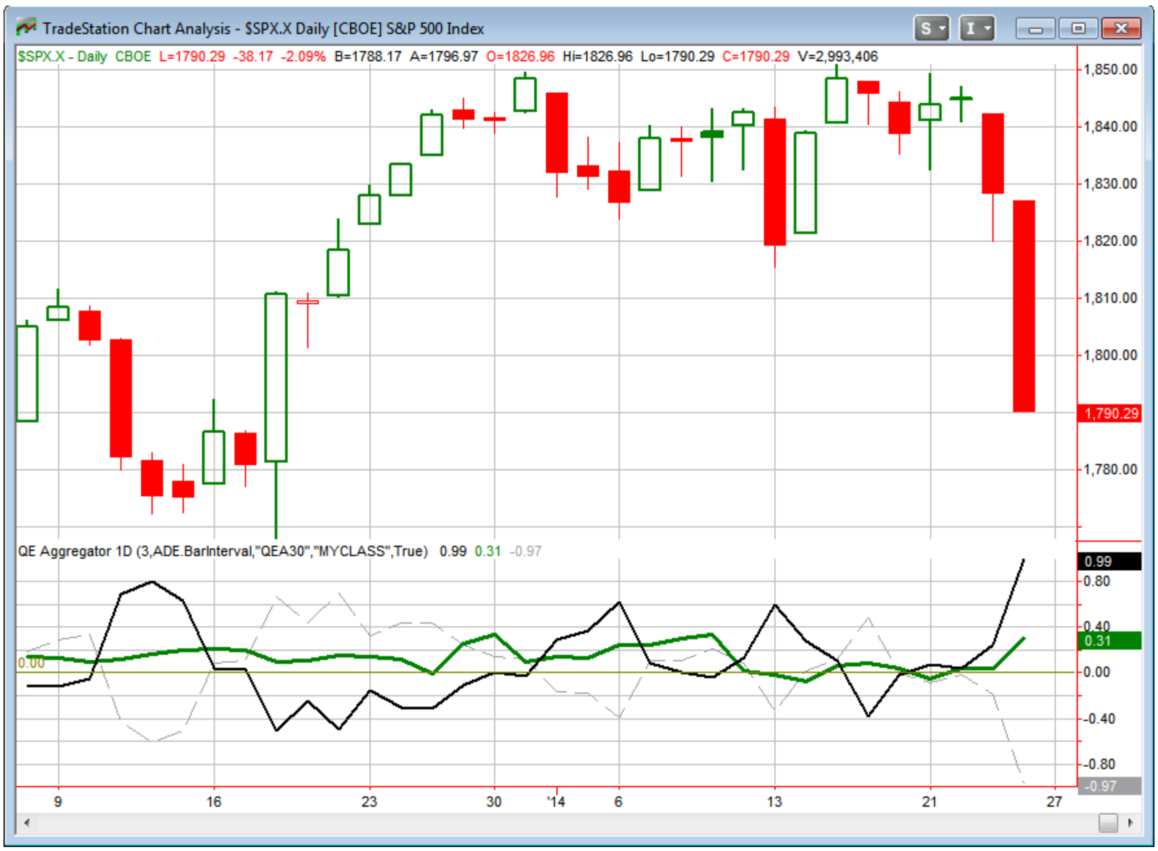
A close this far above the 10ma is rare. It has frequently meant a market bounce the next day. Follow through after the initial bounce has been unreliable, though. Below is a profit curve.



The curve is fairly impressive also. This study seems worth consideration.

So there is quite a bit to add to the short-term Active List. But it is all pointing up. So the changes in the Aggregator chart should be no surprise.

I have updated the Aggregator chart below.



Tonight's bullish studies helped the green Aggregator Line move strongly above 0. Positive readings mean net expectations from the Active List are for upside over the next few days. Meanwhile the strong selloff caused the black Differential Line to take a big jump up. The positive Differential Line reading means the SPX is oversold versus recent expectations. So expectations are positive and the SPX is strongly oversold. This is considered a bullish configuration. Bullish configurations are visible on the chart whenever both lines close above 0. This caused the Aggregator signal to remain long.

With everything short-term pointing up, expectations are slated to remain positive on Monday. This is unlikely to change without extremely compelling bearish evidence emerging. The Differential Pivot will be 1843.97 on Monday. That is 3.0% above Friday's close. The chances of that happening on Monday are extremely remote. For the SPX to move from oversold it overbought it will likely take a multi-day rally or consolidation.

While the Aggregator has been mildly positive the last couple of nights, I did not find the evidence compelling enough to take on any exposure. The evidence certainly strengthened on Friday. And the market is now oversold to the point that a bounce could be sizable. If the market fails to bounce on Monday, I expect to see even more bullish evidence emerge based on both the 3-day pullback and the Turnaround Tuesday possibility. So it is now time for me to start taking on some long exposure. I will look to scale up to ½ full pretty quickly here with the evidence so favorable. I won't get completely full right away though.

The one indicator that is glaringly bland is the CBI. The big drop the past few days has failed to trigger any Catapults. Continued strong selling will change that. Over the years during times of extreme selling I have found the CBI to be one of my most reliable bounce indicators. I'll be keeping a close eye on it as usual.

Intermediate-term Outlook (2 weeks – 2 months) – updated 1/27 – somewhat bullish
The SPX lost 2.8% this week. It was the worst week since June, and most of the damage was done on Friday. The seasonal weakness we anticipated with Martin Luther King, Jr. week played out, but we are not yet seeing strong evidence that a major correction upon us. (Though certainly there is that possibility.)

Wondering whether such poor weeks will often signal the beginning of a deep decline I decided to look at other instances where SPX suffered its worst week in at least 20 weeks, but still closed above its 40-week moving average.

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SPX suffers worst % weekly decline in at least 20 weeks. It closes above the 40-week ma. Buy on close. Sell X weeks later. $100k/trade. 1980 - present.												
X Weeks	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
20	199,819.74	34	30	4	88.24	7,740.31	21,845.70	-8,097.41	-22,871.95	0.96	7.17	5,877.05
19	190,530.09	34	29	5	85.29	8,185.62	25,095.15	-9,370.55	-25,513.25	0.87	5.07	5,603.83
18	171,993.25	35	28	7	80.00	7,865.15	22,026.60	-6,890.13	-24,387.80	1.14	4.57	4,914.09
17	167,551.33	35	27	8	77.14	7,822.59	26,445.15	-5,457.34	-22,881.10	1.43	4.84	4,787.18
16	168,330.68	36	28	8	77.78	7,840.88	28,281.15	-6,401.75	-23,753.40	1.22	4.29	4,675.85
15	141,411.25	37	27	10	72.97	7,265.16	27,153.90	-5,474.82	-27,974.60	1.33	3.58	3,821.93
14	133,494.66	38	31	7	81.58	6,427.07	23,982.75	-9,392.07	-31,454.65	0.68	3.03	3,513.02
13	147,566.78	38	30	8	78.95	6,783.44	24,166.35	-6,992.05	-26,446.55	0.97	3.64	3,883.34
12	141,959.09	38	28	10	73.68	7,026.22	24,201.45	-5,477.51	-25,937.20	1.28	3.59	3,735.77
11	130,465.30	39	27	12	69.23	6,942.97	20,201.40	-4,749.58	-24,830.05	1.46	3.29	3,345.26
10	132,312.71	40	28	12	70.00	6,943.43	21,741.75	-5,175.28	-23,372.15	1.34	3.13	3,307.82
9	111,589.75	41	31	10	75.61	5,419.46	21,008.70	-5,641.34	-22,954.30	0.96	2.98	2,721.70
8	84,283.16	43	31	12	72.09	5,049.13	16,248.60	-6,019.98	-24,040.10	0.84	2.17	1,960.07
7	94,059.11	43	30	13	69.77	4,775.14	14,935.05	-3,784.24	-13,526.75	1.26	2.91	2,187.42
6	62,509.26	44	33	11	75.00	3,941.44	14,766.30	-6,141.65	-22,171.47	0.64	1.93	1,420.66
5	64,115.61	45	31	14	68.89	3,903.16	12,433.50	-4,063.03	-21,006.24	0.96	2.13	1,424.79
4	35,761.68	45	28	17	62.22	3,346.35	11,763.90	-3,408.00	-19,471.86	0.98	1.62	794.70
3	15,514.93	46	27	19	58.70	2,953.65	10,168.20	-3,380.72	-19,032.09	0.87	1.24	337.28
2	-10,715.05	49	20	29	40.82	2,850.91	5,982.53	-2,335.63	-20,174.85	1.22	0.84	-218.67
1	16,572.02	50	30	20	60.00	2,036.04	6,312.15	-2,225.46	-9,109.98	0.91	1.37	331.44

The worst of the numbers here is 2 weeks out, and the best of them is 20-weeks out. The shorter-time frame equity curves are all pretty choppy. My short-term take-away is that these parameters are not necessarily predictive. There is no need to over-react to 1 bad week. We will need more evidence to form a strong opinion.

The 20-week results do suggest that when a really bad week occurs during an uptrend it rarely leads to a long-term decline. I have shown the equity curve below. The big glaring exception was 1987.

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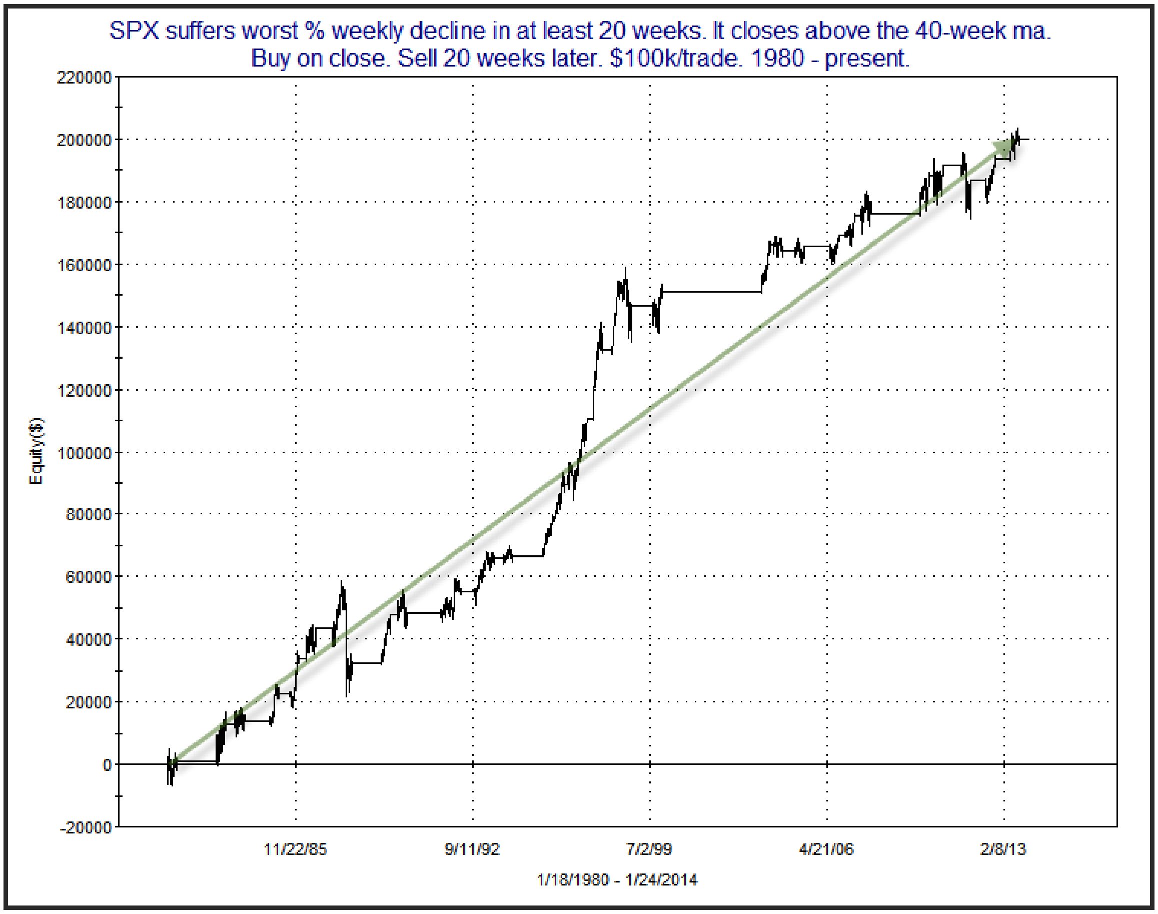

Bottom line with this study is that short-term the bad week does not seem to mean much, and long-term the trend has most often re-asserted itself.

I update the intermediate-term POMO/QE 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.

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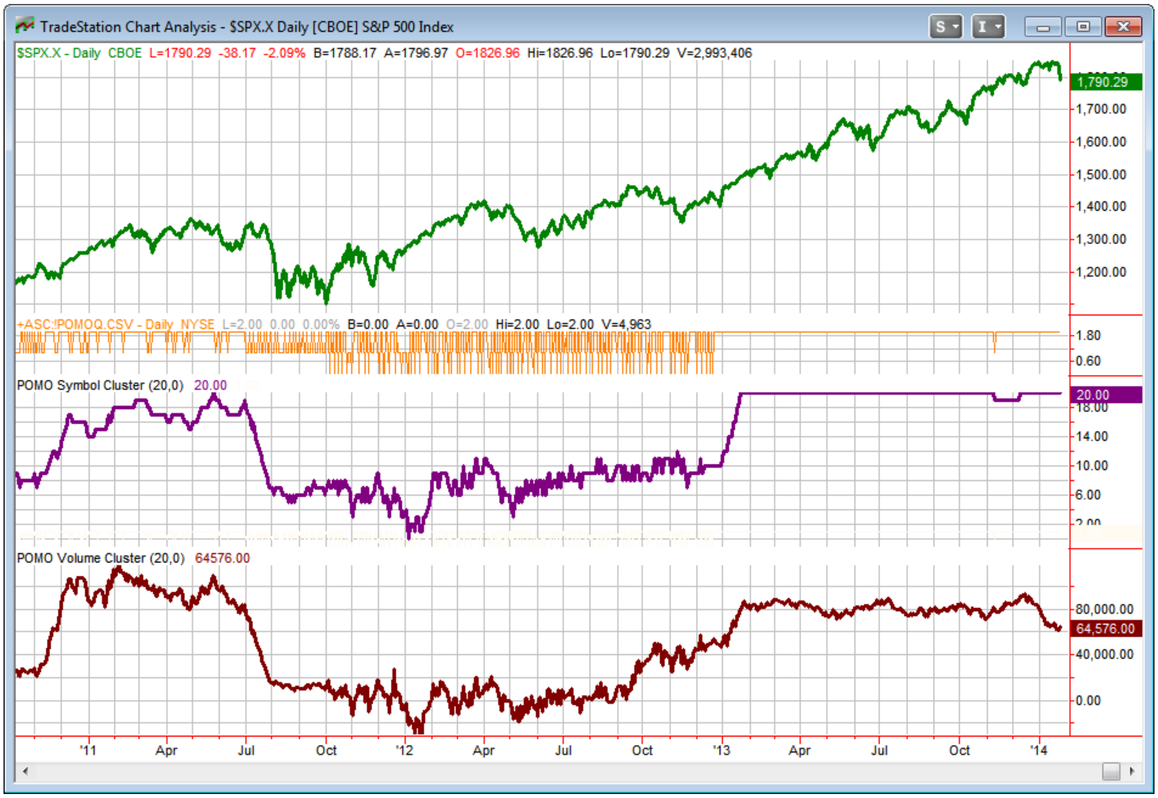

The POMO/AMBS days indicator is still riding along at 20, where it spent most of 2013. The volume indicator is starting to flatten out at its new, reduced level. We estimate net inflows this past week to have been about $15.5 billion, which is a decent amount for a 4-day week.

This upcoming week there is about $17.7 billion of inflows expected. This is about average for the current pace of $75 billion/month. But this is going to be a big news week with regards to the Fed.

First, we have a Fed meeting that will wrap up on Wednesday. We will find out then whether there will be further tapering or whether they will hold the inflows steady at $75 billion for a while longer.

The 2nd bit of news will come out Friday when the AMBS and POMO schedules for February will be released. This will allow me to create the QE Buying Power Index projections for Feb. I'm sure the Fed will provide us plenty to consider next weekend.

Despite the big drop this week, my intermediate-term bias is still somewhat bullish. As we saw in the study above, over-reacting to a bad week in an uptrend is often a mistake. The breadth thrust from October, the leading Nasdaq, and the continued uptrend all favor the bulls. But the bears can point to the narrowing of new highs – both with the QE

Study of Tops New High % indicator, and the Hindenburg Omen signals from December, as potential warning signs. Liquidity is likely still somewhat positive, but less so than before. Overall, I continue to lean bullish, but not strongly so. I will still favor longs over shorts. I will need very compelling evidence to consider a short position, and I will be a bit more discerning with long entries than if I was outright bullish.

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 numbered systems 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 – buy ¼ index position @ $178.89 LIMIT. Based on the short-term outlook above, I will take on my first piece if I can get in at a level equal to (or below) Friday's close.

SPY – buy ¼ index position @ $178.88 LIMIT ON CLOSE. A close down of any amount will lead me to take on a 2nd lot as well.

Current Open Trade Ideas

None.

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