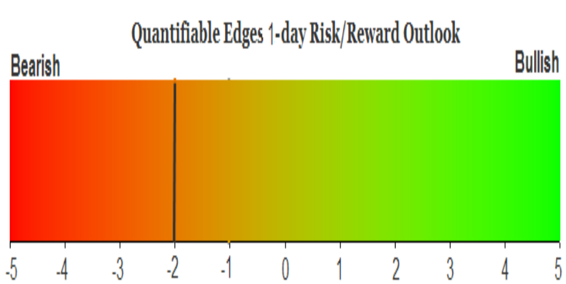
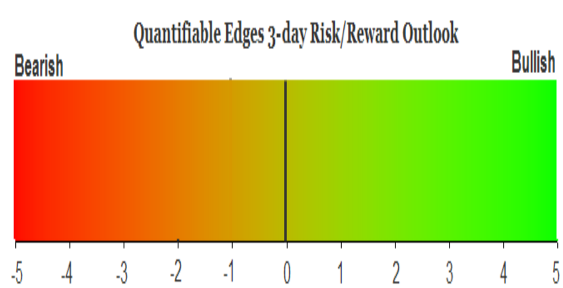
# QUANTIFIABLE EDGES SUBSCRIBER LETTER

ASSESSING MARKET ACTION WITH INDICATORS AND HISTORY

July 21, 2014 Volume 7 Issue 135

## Market Overview




## Signals Overview

| Aggregator | Aggressive VIX | QE Buy Pwr Swing |
|---|---|---|
| Flat | 50% Long XIV | Flat |

## *Tonight's Research Points*

- Unfilled gaps up that fail to make a higher high will often pull back over the next few days.
- The steep drop in VXO may have signaled trouble if the market was in a downtrend, but does not appear concerning during a long-term uptrend.

***Short-term Outlook***
***The Bottom Line***

Friday's rebound was strong and it put SPX back in an overbought condition. Indications for the next few days again are mixed but leaning bullish. Overbought with evidence leaning bullish leaves me neutral for the short-term.



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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 | | | | |
| July 21, 2014 | Unfilled up gap inside day > 200 | 1 day | Bearish | |
| July 18, 2014 | 7 high to 7-low in 1 day | 1-2 days | Bearish | |
| July 17, 2014 | NR7 after high vol WR7 down | 1-5 days | Bullish | 2.20% |
| Active - Long Term | | | | |
| July 9, 2014 | 2 unfilled gaps dn > 200ma | 1-10 days | Bullish | 2.50% |
| June 2, 2014 | NASDAQ leading SPX | int term | Bullish | |
| April 28, 2014 | Sell in May | 6 months | Bearish | |
| December 23, 2013 | QE Tapering | int term | Neutral | |
| July 22, 2013 | New High Divergence (Study of Tops) | int term | Bearish | |
| February 1, 2012 | Golden Cross | int term | Bullish | |
| Dropped Tonight | | | | |
| ***July 18, 2014*** | ***VIX rises > 20% in 1 day*** | ***1 day*** | ***Bullish*** | |
| ***July 18, 2014*** | ***QE Buying Power Long*** | ***1-6 days*** | ***Bullish*** | |

***The Evidence***

Thursday's big down day was almost completely reversed by Friday's rebound. The SPX rose 1.0%, while the NASDAQ and the Russell 2000 each rallied 1.6%. Breadth was strongly positive as the NYSE Up Issues % came in at 82% and the Up Volume % was also 82%. Total NYSE volume was higher on Friday's rally than on Thursday's drop.

The study below was last seen in the 1/15/14 Letter. It looks at days like Friday where the market gaps higher, never fills, and moves higher from open to close without making a higher high. I've updated the results below.

SPY posts an unfilled gap up but a lower high than yesterday. Close > open & close > 200ma. Buy on close. Sell X days later. $100k/trade. 2000 - 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 | -11,561.39 | 41 | 18 | 23 | 43.90 | 1,208.64 | 2,556.33 | -1,448.56 | -3,477.70 | 0.83 | 0.65 | -281.99 |
| 4 | -12,775.91 | 41 | 19 | 22 | 46.34 | 1,042.56 | 1,964.02 | -1,481.12 | -7,544.70 | 0.70 | 0.61 | -311.61 |
| 3 | -11,560.67 | 42 | 18 | 24 | 42.86 | 830.87 | 2,311.02 | -1,104.85 | -6,150.30 | 0.75 | 0.56 | -275.25 |
| 2 | -9,153.71 | 44 | 19 | 25 | 43.18 | 770.72 | 1,859.92 | -951.90 | -2,929.90 | 0.81 | 0.62 | -208.04 |
| 1 | -10,958.89 | 44 | 15 | 28 | 34.09 | 699.15 | 1,600.62 | -765.93 | -2,348.90 | 0.91 | 0.49 | -249.07 |

39 of 44 instances (89%) closed below the entry price at some point in the next week.

Implications here appear somewhat bearish, with most of the damage occurring on day 1. Below is a profit curve that shows how the downside edge has played out over time.



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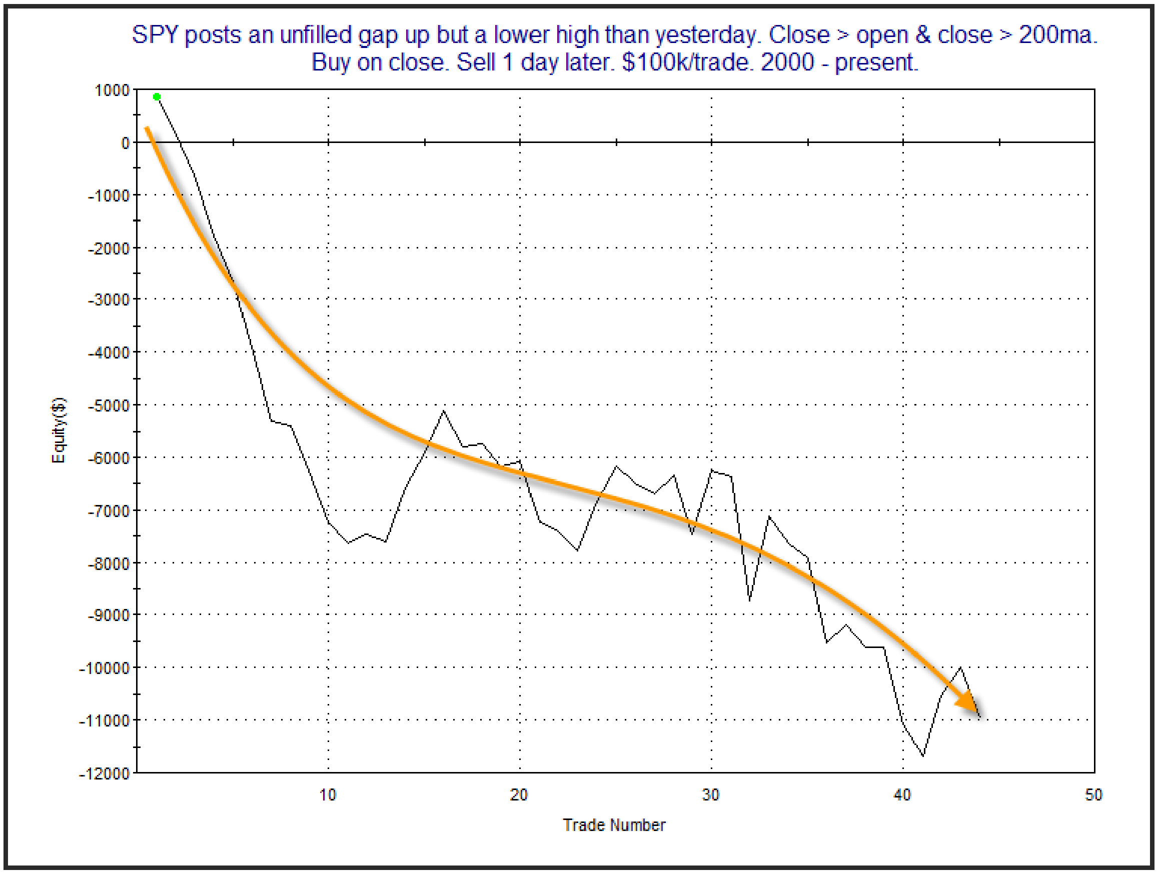


This is not an ideal profit curve but it still appears to suggest a downside edge. I felt it was worth giving this study consideration once again.

The rally was accompanied by a very large drop in the VIX (and VXO, which is the old calculation for the VIX). Back in the 4/22/13 subscriber letter I noted that big drops in the VXO have had much different connotations depending on whether SPX is in a long-term uptrend or downtrend (as defined by its proximity to the 200ma). I decided to review those studies, which require a 15% 1-day VXO drop, in tonight's letter.

First let's consider what has followed when the large VXO drop has occurred during a long-term downtrend.



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| VXO closes down over 15%. SPX < 200ma. Buy SPX on close. Sell X days later. $100k/trade. 1988 - 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 | -17,347.66 | 22 | 11 | 11 | 50.00 | 2,554.44 | 6,915.44 | -4,131.50 | -13,784.48 | 0.62 | 0.62 | -788.53 |
| 4 | -25,727.59 | 24 | 13 | 11 | 54.17 | 1,704.02 | 4,104.78 | -4,352.71 | -10,971.63 | 0.39 | 0.46 | -1,071.98 |
| 3 | -36,219.02 | 25 | 7 | 18 | 28.00 | 1,278.37 | 2,993.44 | -2,509.31 | -7,806.29 | 0.51 | 0.20 | -1,448.76 |
| 2 | -41,080.73 | 25 | 7 | 18 | 28.00 | 757.24 | 1,439.48 | -2,576.74 | -9,455.49 | 0.29 | 0.11 | -1,643.23 |
| 1 | -21,140.11 | 25 | 4 | 21 | 16.00 | 858.88 | 1,311.50 | -1,170.27 | -4,400.45 | 0.73 | 0.14 | -845.60 |

We see here some very bearish statistics over the 1-2 day period. There is rarely upside follow-through when fear dissipates that quickly during a downtrend.

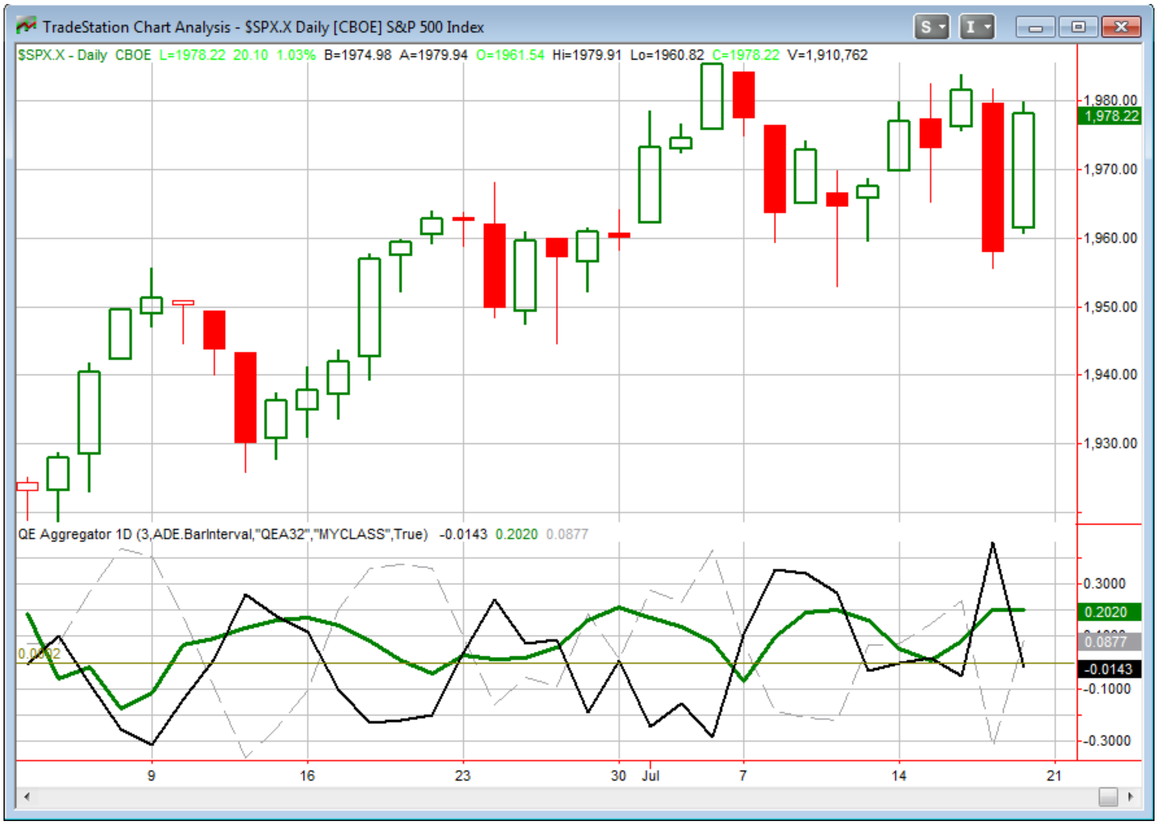
But now let's consider times like the present where SPX is in an uptrend.

| VXO closes down over 15%. SPX > 200ma. Buy SPX on close. Sell X days later. $100k/trade. 1988 - 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 | 10,282.57 | 31 | 17 | 14 | 54.84 | 1,821.86 | 5,396.71 | -1,477.79 | -4,561.65 | 1.23 | 1.50 | 331.70 |
| 4 | 9,605.41 | 33 | 20 | 13 | 60.61 | 1,238.81 | 2,499.00 | -1,166.98 | -2,356.90 | 1.06 | 1.63 | 291.07 |
| 3 | 10,324.22 | 34 | 20 | 14 | 58.82 | 1,129.14 | 2,819.60 | -875.62 | -2,321.70 | 1.29 | 1.84 | 303.65 |
| 2 | 7,851.16 | 34 | 21 | 13 | 61.76 | 982.57 | 2,322.60 | -983.30 | -2,076.48 | 1.00 | 1.61 | 230.92 |
| 1 | 5,956.15 | 35 | 19 | 16 | 54.29 | 850.92 | 2,842.84 | -638.20 | -2,176.20 | 1.33 | 1.58 | 170.18 |

Here there is no hint of a short-term bearish inclination. In fact the setup has shown slight gains for each of the time periods measured. I don't think the numbers are strong enough to consider this a bullish setup, but it certainly is not bearish.

In addition to the bearish study being added tonight, we have two bullish studies expiring from the Active List. The QE Buying Power System signal only lasted one day, so that study has been taken off quicker than usual.

I have updated the Aggregator chart below.




Even with tonight's bearish study and with a couple of bullish studies expiring, the green Aggregator Line remained strongly above 0. Positive readings mean net expectations from the Active List are for upside over the next few days. Meanwhile the black Differential Line dropped sharply and closed just below 0. The negative Differential Line reading means the SPX is now overbought versus recent expectations. So expectations are positive but the SPX is slightly overbought. This is considered a neutral configuration. Neutral configurations are visible on the chart whenever both lines close on opposite sides of 0. Therefore the Aggregator signal quickly turned from long back to flat at the close.

Based on the current active studies, expectations are set to remain positive on Monday. Of course this could change if more bearish evidence emerges. The Differential Pivot will be *inverted at* 1984.07 on Monday. That is 0.3% *above* Friday's close. An inverted pivot means that the Differential Line will cross through 0 if SPX closes flat. In this case SPX is going to need to close up at least 0.3% in order to remain overbought. Otherwise it will be considered oversold versus expectations.

Thursday's studies played out perfectly and the result was a strong rebound Friday. Unfortunately, my trade idea from Thursday night's letter was not able to benefit because the market gapped higher and never filled the opening gap. You'll note that the 1-day risk/reward at the top of the letter is leaning bearish. That simply looks at expectations



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for Monday. But looking out over the next 3 days, gains are expected. This leaves the Aggregator neutral even while Monday suggests a downside edge. I generally don't trade off the 1-day edge for the purpose of tracking trade ideas here in the letter. It is more for daytraders or those who are quite agile with their accounts. But it is still worth noting. And if it plays out with some downside on Monday, there is seems to be a pretty good chance that the Aggregator could turn bullish at that point. So I am neutral but ready to pounce if opportunity avails itself.

***Intermediate-term Outlook (2 weeks – 2 months) – updated 7/21 – slightly bullish***

**Quantifiable Edges Market Timing Course Combo Signals Overview**

| Combo #1 | Combo #2 | Combo #3 |
|---|---|---|
| Flat | Long | Long |

Above is the status of the different Combination Signals from the Quantifiable Edges Market Timing Course. Signals are long-term in nature. All 3 can be either flat or long. None of them look to short. More information on these signals can be found in the Quantifiable Edges Market Timing Course, which is included with all annual subscriptions. Detailed descriptions of these combination approaches can be found in Lesson 8. Subscribers may also download detailed hypothetical historical performance reports covering 1/1/71 – 3/7/14 in Lesson 11, Course Downloads. (You must go through the course first in order to access the Downloads.)

SPX posted an inside week but finished about ½% above last week's close. It is very close to new all-time highs once again. The uptrend appears to be intact. There were no studies of intermediate-term consequence that emerged this past week.

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*



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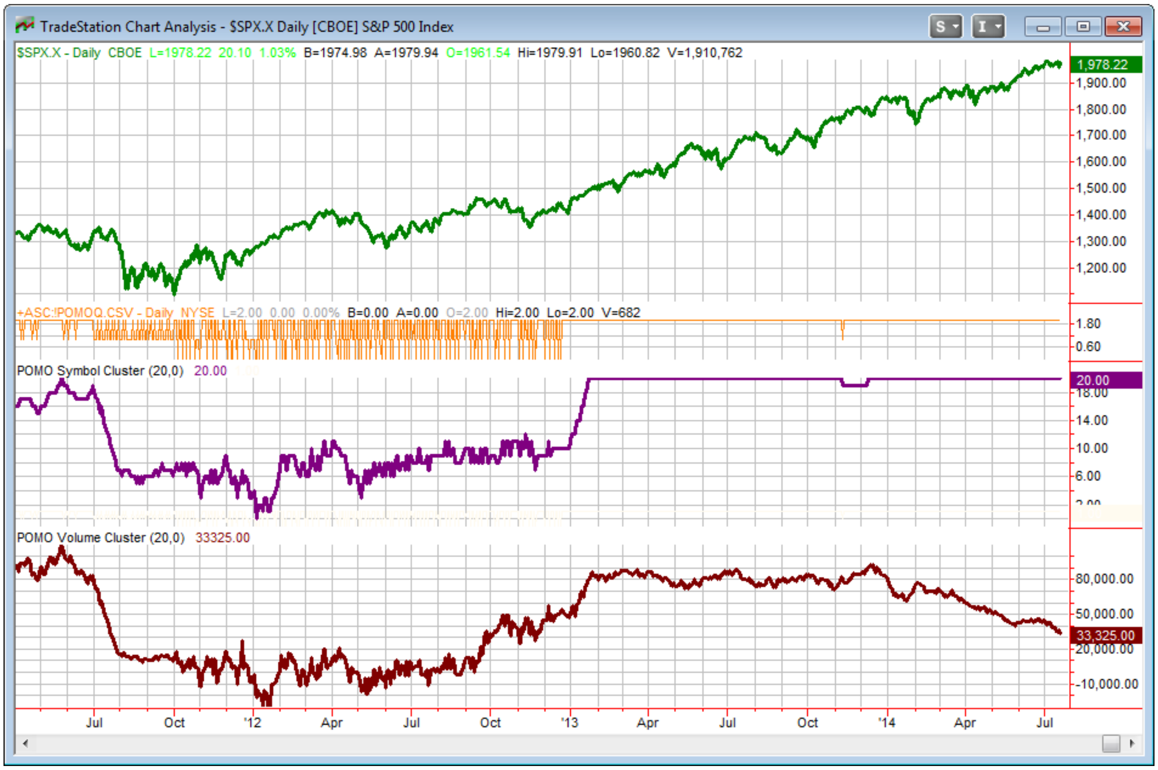
*reflected the Fed's new approach of buying AMBS securities. Therefore, prior to that date the indicators just look at POMO, since that date it is a combination of POMO and AMBS flows.*




The POMO/AMBS days indicator is still riding along at 20, where it spent most of 2013 and 2014 so far. The volume indicator is continuing to head lower since purchase amounts were again tapered starting July 1. We estimate net inflows this past week to have been about $6.7 billion. That is quite low compared to the last year and a half. It is also a little low for July. It could serve to dampen further rallying in the next few days.

This upcoming week is expected to see substantially larger inflows. We should see Fed buying of nearly $9.7 billion. This could provide a wind at the market's back towards the end of the week and into the following week.

While the reduced flows have not had a negative impact up to this point, I am still of the opinion that the market is likely to struggle sometime between here and when they hit 0, or at the very least, shortly after they hit 0. This has effectively been the case at least back until 2003 when the Fed began publishing its POMO flows. The next Fed meeting is set to conclude on July 30th. It is at that time where will find out if August and September will see an even further reduction in stimulus levels.

The leading NASDAQ is still providing a plus, and the uptrend appears intact. The study from the 7/9 letter is also bullish. So the bulls have some things in their favor. The bears are still banking on the shrinking New High % divergence and the weak seasonality (and at some point in the next few months the lack of Fed stimulus.) I am keeping my outlook at slightly bullish again this week. I will use some caution on both sides of the market, but will continue to favor longs over shorts.

## 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.*

**None tonight.**

## Current Open Trade Ideas

*None*