

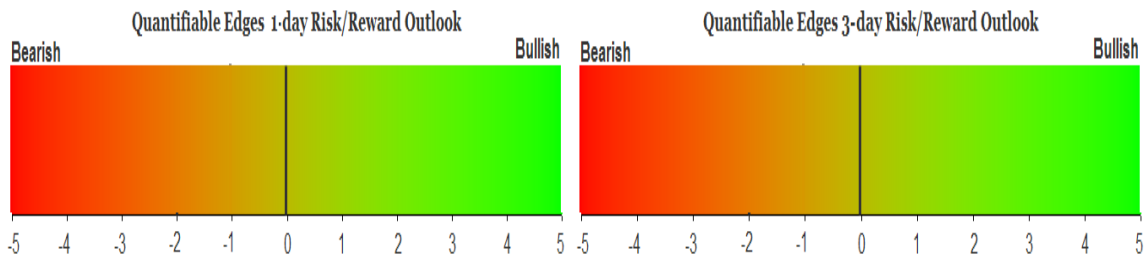
QUANTIFIABLE EDGES SUBSCRIBER LETTER

ASSESSING MARKET ACTION WITH INDICATORS AND HISTORY

July 9, 2018

Volume 11 Issue 130

Market Overview



Signals Overview

Aggregator	CBI Reading
Flat	0

Tonight's Research Points

- 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.
- The SOMA saw a sizable decline last week, but we have entered a 2-week period where I expect to see a reprieve of negative liquidity flows, and we could even see a brief expansion.

Short-term Outlook

The Bottom Line

While the market is now overbought short-term, evidence is still leaning slightly bullish. This leaves me short-term neutral.

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

Study Date	Description	Time span	Bias	Avg Run-up	Avg DrawDn	Avg DrawDn - 1 Std Dev
Active - Short Term						
June 29, 2018	20-low cls. 20-low ID then up	1-7 days	Bullish	2.40%	-1.65%	-3.10%
Active - Long Term						
June 7, 2018	SPX > 50-day Bollinger Band	1-50 days	Bullish	5.00%	-4.10%	-7.80%
May 7, 2018	NASDAQ leading	int term	Bullish			
April 2, 2018	SOMA reduction intensifies to \$30 billion	int term	Bearish			
February 15, 2018	FTD with moderate breadth & volume	int term	Bearish			
January 8, 2018	1st 4 days of year close higher	1-250 days	Bullish	15.90%	-5.70%	-11.10%
April 26, 2016	Golden Cross	int term	Bullish			
July 22, 2013	New High Divergence (Study of Tops)	int term	Bearish			
Dropped Tonight						
July 3, 2018	1% drop then 5 closes within range	1-3 days	Bullish			
June 29, 2018	Higher hi then dn/ Lower lo then up	1-5 days	Bullish	1.80%	-1.15%	-2.30%
June 28, 2018	Outside day dn Bottom 10% 10-day	1-6 days	Bullish			

The Evidence

The reaction to the employment report was (eventually) positive, and the market put in a solid move higher on Friday. The SPX closed up 0.8%, the NASDAQ rose 1.3%, and the Russell 2000 gained 0.9%. Breadth was positive as the NYSE Up Issues % was 74% and the Up Volume % came in at 82%. NYSE volume declined, and remained holiday-week light.

The pattern of strong close / weak close finally broke as Friday saw the 2nd strong close in a row. The rally was accompanied by a sizable drop in the VIX (and even more so for the VXO, which is the old calculation for the VIX). About a year ago, in the 7/10/17 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.

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	-17,127.04	27	15	12	55.56	2,031.92	6,915.44	-3,967.15	-13,784.48	0.51	0.64	-634.33
4	-29,181.03	29	14	15	48.28	1,665.91	4,104.78	-3,500.25	-10,971.63	0.48	0.44	-1,006.24
3	-33,812.52	30	10	20	33.33	1,269.38	2,993.44	-2,325.32	-7,806.29	0.55	0.27	-1,127.08
2	-41,144.44	30	9	21	30.00	946.61	2,466.36	-2,364.95	-9,455.49	0.40	0.17	-1,371.48
1	-18,999.82	30	8	22	26.67	890.80	2,404.65	-1,187.56	-4,400.45	0.75	0.27	-633.33

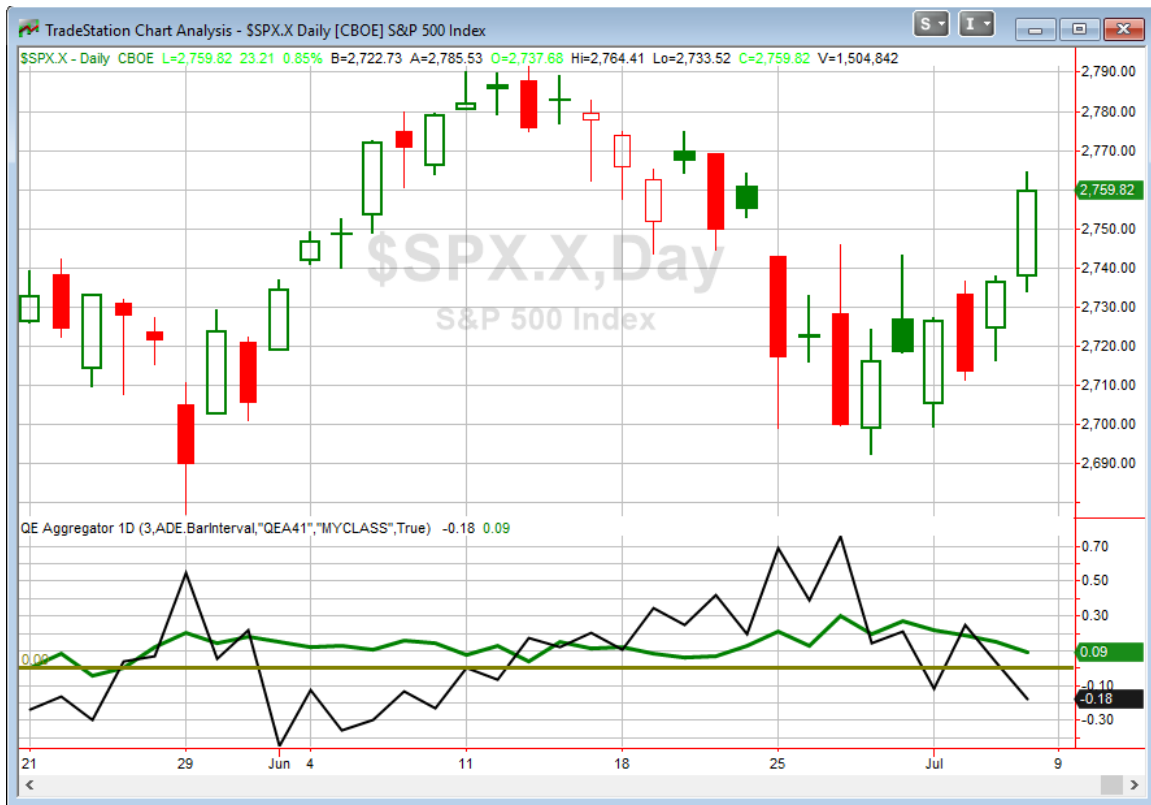
We see here some bearish statistics over the 1-2 day period. There is rarely upside follow-through when fear dissipates that quickly during a downtrend.

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	6,269.88	56	29	27	51.79	1,538.49	5,396.71	-1,420.23	-4,561.65	1.08	1.16	111.96
4	5,489.64	61	34	27	55.74	1,224.20	3,394.72	-1,338.27	-2,927.52	0.91	1.15	89.99
3	7,557.71	63	33	30	52.38	1,233.19	3,276.14	-1,104.59	-3,629.81	1.12	1.23	119.96
2	2,618.52	64	36	28	56.25	998.76	3,075.73	-1,190.61	-5,300.66	0.84	1.08	40.91
1	1,429.07	69	36	33	52.17	782.71	2,842.84	-810.56	-3,724.42	0.97	1.05	20.71

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.

I have updated [the Aggregator chart](#) below.



Without anything new being added tonight, the green Aggregator Line remained above zero. Positive readings mean net expectations from the Active List are for upside over the next few days. Meanwhile the black Differential Line dipped below 0. The negative Differential Line reading means SPX is overbought versus recent expectations. So expectations are positive but SPX is 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 turned flat at the close.

With the current studies on the Active List, expectations are slated to remain bullish on Monday. This could change if compelling new bearish evidence emerges. The Differential Pivot will be 2731.43 on Monday. That is just over 1.0% below Friday's close. So SPX will need to close down at least 1% on Monday in order to flip from being considered overbought to oversold versus recent expectations.

Evidence is currently underwhelming. There is only one active short-term study, and nothing new based on Friday's action. And with the market now overbought, reward/risk does not appear terribly favorable for longs or shorts. As I will discuss further in the intermediate-term section below, I do not expect SOMA flows to be providing a headwind this week (measured Thurs-Wed based on Fed reporting). And bulls seem to have taken advantage of the lack of headwind in the first 2 days of this week. Since we are now overbought, that buying may or may not continue, but I am not seeing compelling evidence

suggesting this is a favorable entry point for a short. After taking profits on Friday afternoon, I am now completely out of my latest index trade. I intend to remain sidelined until the next favorable trading opportunity arises.

Intermediate-term Outlook (2 weeks – 2 months) – updated 7/9– neutral

Combo #1	Combo #2	Combo #3
Flat	Long	Long

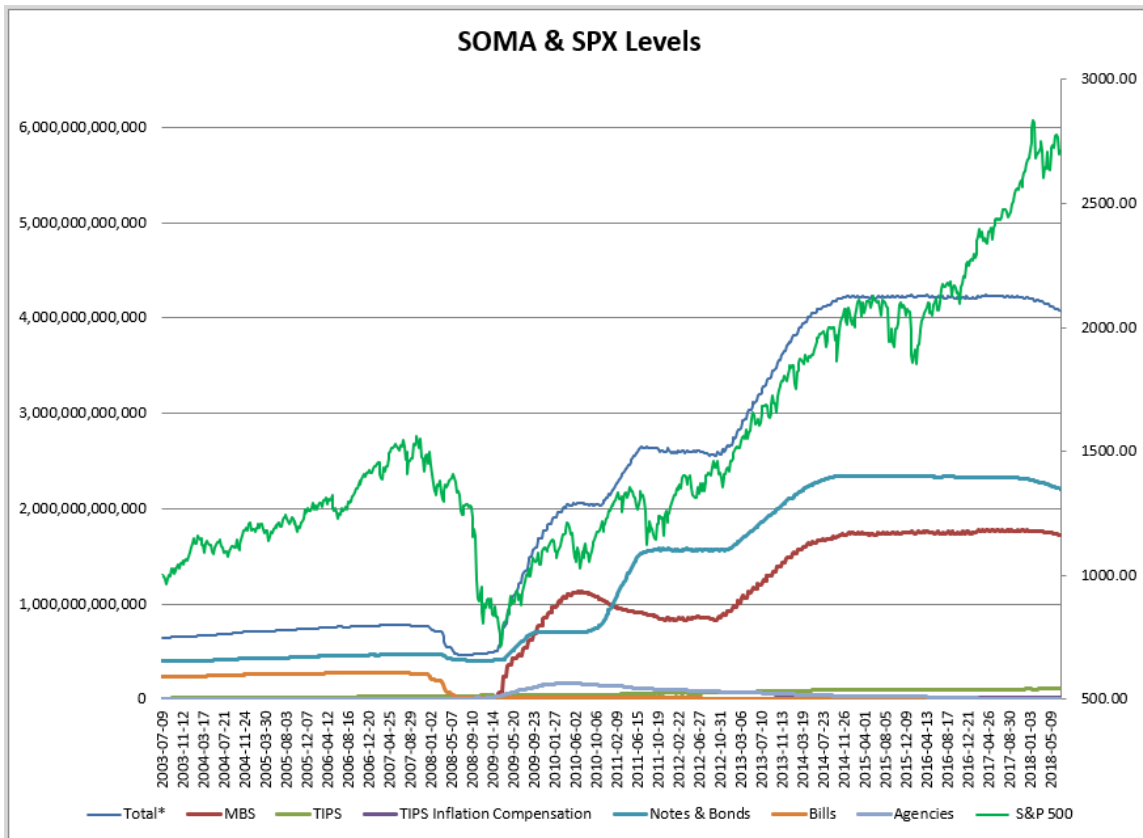
Above is the status of the different Combination Signals from the Quantifiable Edges Market Timing Course. Signals are long-term in nature. All 3 can be either flat or long. None of them look to short. More information on these signals can be found in the [Quantifiable Edges Market Timing Course](#), 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 12/31/71 – 3/7/14 in [Lesson 11, Course Downloads](#). (You must go through the course first in order to access the Downloads.) This week there were no changes to the Combo Systems. *There were no changes to the Combo Systems this week as #1 remained “flat” and #2 and #3 remained “long”.*

Thanks to the last 2 days, the shortened holiday week was a good one for the market. The SPX rose 1.5%, while the NASDAQ managed a 2.4% gain and the Russell 2000 rallied 3.1%. The SPX remains range-bound and still not far above its 200ma. But the NASDAQ and Russell are again nearing new all-time highs. Despite the strong moves the last 2 days, there were no new studies with intermediate-term implications.

As I typically do each week, I have updated our Fed SOMA charts below. Below is a description for those who are new to these charts or who may want a refresher.

SOMA stands for System Open Market Account. It is the account at the Fed that contains all of its bond purchase holdings. We have tracked Fed purchases for several years, and as is evident in the charts below, the stock market has consistently reacted positively when the Fed has been buying securities in the open market and increasing the size of its account. When the account has declined, the market has struggled. The obvious takeaway has been “don’t fight the Fed”. As far as intermediate-term indicators go, this has been as good as anything in recent years.

In October 2017 the Fed began reducing the size of the SOMA by not reinvesting some maturities in MBS and treasuries. That program is expected to continue for the next few years. Below are long and short-term views of SOMA and SPX. First, the long-term view (back to 2003).



The table below is from the Fed’s website and shows the changes this past week.

« As of 06/27/2018

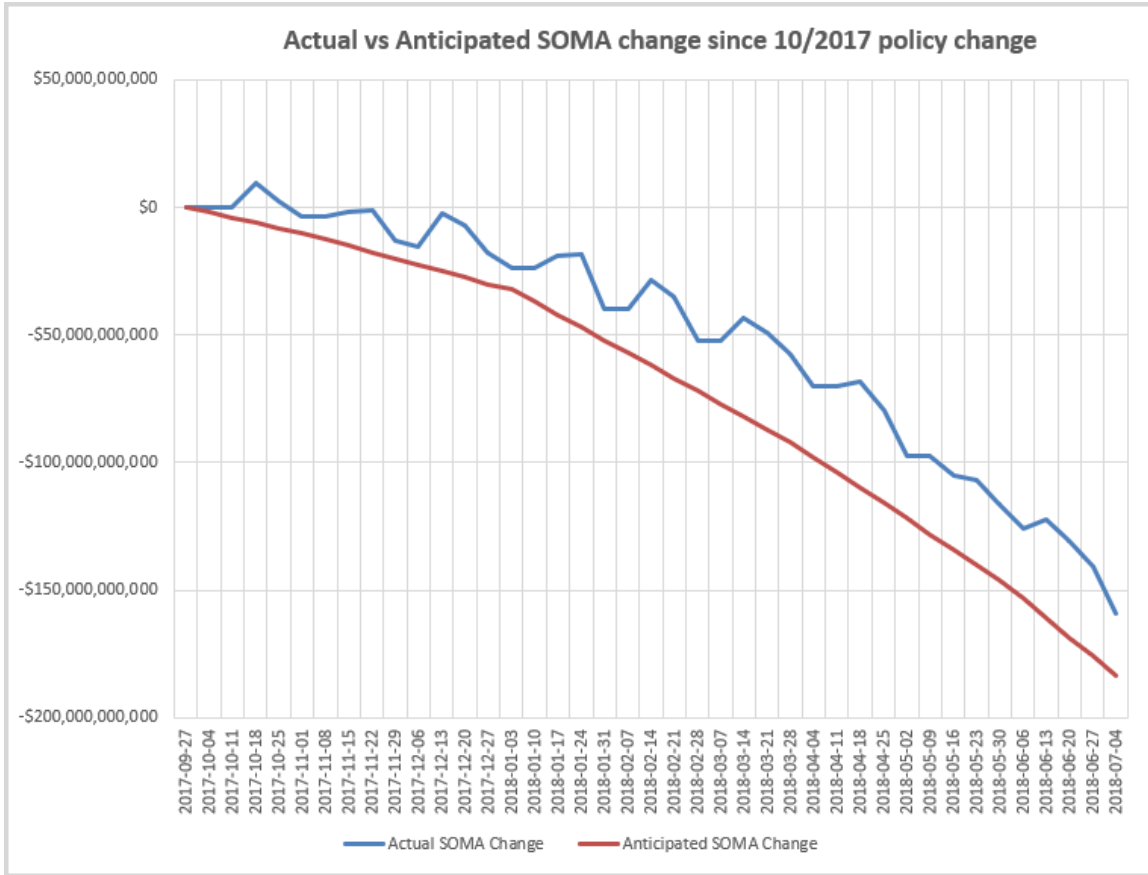
**SECURITIES HOLDINGS AS OF
July 4, 2018**

Summary		T-Bills	T-Notes and T-Bonds	FRN	TIPS	Agencies
Security Type	Total (in Thousands)					
US Treasury Bills (T-Bills)						
US Treasury Notes and Bonds (Notes/Bonds)	2,206,344,406.1					
US Treasury Floating Rate Notes (FRN)	17,816,385.9					
US Treasury Inflation-Protected Securities (TIPS)*	114,860,063.8					
Federal Agency Securities**	2,409,000.0					
Agency Mortgage-Backed Securities***	1,721,272,186.2					
Total SOMA Holdings	4,062,702,042.0					
Change From Prior Week	-17,999,001.3					

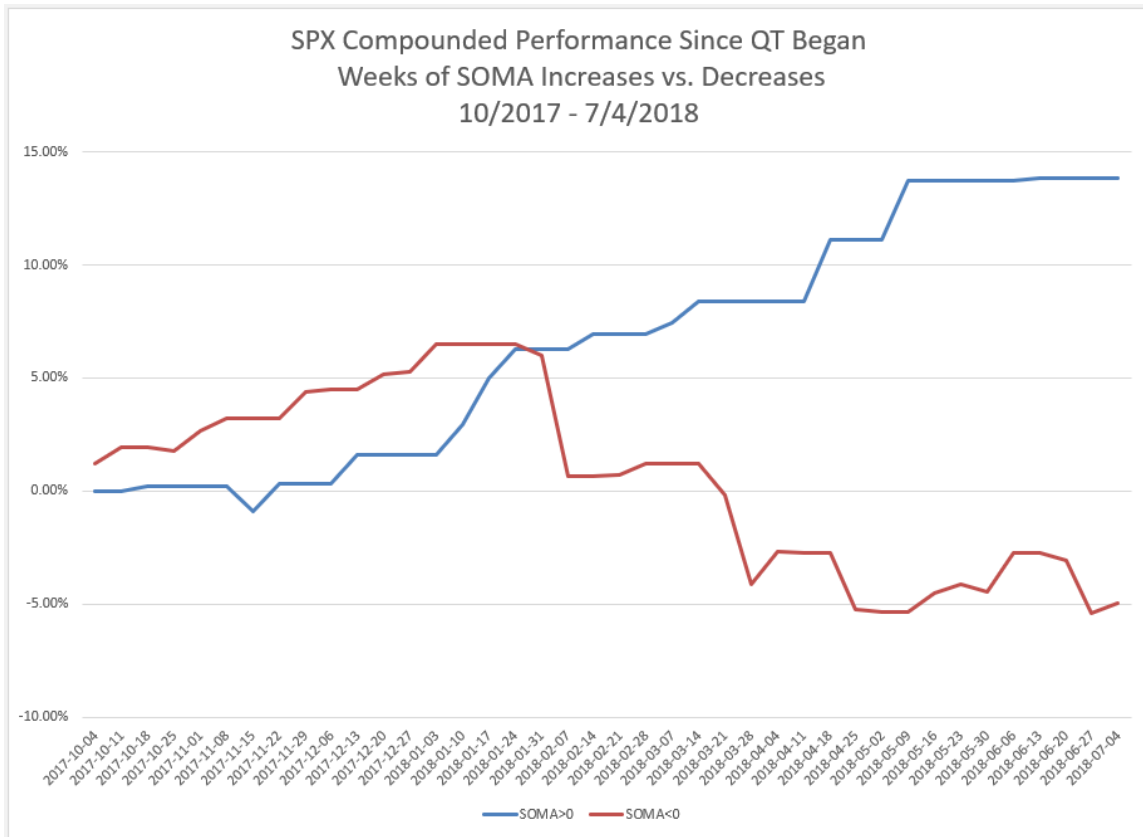
*Does not reflect inflation compensation of 21,355,739.9
 **Fannie Mae, Freddie Mac and Federal Home Loan Bank
 ***Guaranteed by Fannie Mae, Freddie Mac, and Ginnie Mae. Current face value of the securities, which is the remaining principal balance of the securities.

Data posted on 07/05/2018 4:30pm.

And now a zoomed-in view since October comparing expected reductions to actual.



The Fed's SOMA this past week (Wednesday to Wednesday) saw a decrease of \$18 billion, which is exactly the amount I anticipated in last week's letter. The decline was entirely due to treasuries maturing off the books. The "Actual vs Anticipated" chart simply shows that the drop is somewhat steep compared to a typical week. While the SOMA was contracting, the SPX managed to post a gain of 0.5%. While large SOMA drops have often been accompanied by market declines, the moderate rise is not terribly surprising, since the week before the SPX had lost 2.5%. This left it stretched downward, so a mild reversion would be expected, even with a liquidity-induced headwind. Typically, the market has struggled during SOMA contraction weeks, and flourished when the SOMA has seen expansions. I discuss this in detail in the Fed-Based Quantifiable Edges for Stock Market Trading Research Paper. This next chart shows compounded results since Quantitative Tightening (QT) began in October 2017 of being long SPX during SOMA expansion weeks vs SOMA contraction weeks. It is updated from last week.



Expansion weeks have been positive on a fairly consistent basis. Reduction weeks have been choppy and net losers. The mild bounce back this past week does not make the red line any more appealing in my eyes. So what can we expect the SOMA to do over the next few weeks?

Summary T-Bills T-Notes and T-Bonds FRN TIPS Agencies						
Maturity Date	CUSIP	Coupon (%)	Par Value (in Thousands)	% of Total Outstanding ¹	Change in Par from Prior Week ²	Change in Par from Prior Year ²
7/31/18	912828S68	0.750	1,815,682.0	6.53%		
7/31/18	912828VQ0	1.375	6,270,000.0	17.91%		
7/31/18	912828QY9	2.250	20,376,532.0	68.23%		
8/15/18	912828K82	1.000	482,460.4	1.97%		
8/15/18	912828JH4	4.000	22,586,630.9	61.37%		
8/31/18	912828C3	0.750	1,778,095.1	6.40%		
8/31/18	912828RE2	1.500	19,153,976.1	29.52%		
9/30/18	912828T42	0.750	1,584,917.7	5.75%		
9/30/18	912828RH5	1.375	17,421,863.6	26.84%		

As you can see in the table above, there are no more treasuries set to mature until the end of July. This means that any reductions in the SOMA between now and then will be seen in the AMBS section of the portfolio. AMBS flows are a little more difficult to anticipate, because 1) amounts may vary depending on loan pre-payments, and 2) there is a lag of 1-3 months to settle. For those interested in details, AMBS policies and procedures are described in more detail at the Fed's website: <https://www.newyorkfed.org/markets/ambst-treasury-faq>. I have found that examining past months will often provide clues as to the flows we can anticipate during similar periods of the current month. Looking at recent past weeks that ended on the 10th or 11th of the month, they all saw very little change. This includes October (down less than 0.01%), January (up less than 0.01%), and April (down less than 0.01%).

And if we look out to the next week, the outlook appears even better. Weeks ending on the 17th or 18th recently have all seen *expansions* in the SOMA. October 2017 the SOMA rose 0.23%, in January it rose 0.11%, and in April it gained 0.04%.

Fed policy should continue to act as a headwind in the months to come. And that headwind just increased to a rate of \$40 billion/month. But the next week and a half could see a bit of a reprieve for the bulls. It will be interesting to see if they can take advantage, because liquidity tightening could make things a lot tougher towards the end of July.

My overall outlook is little changed this week. The long-term trend is with the bulls and there are some active studies showing that. And the continued NASDAQ outperformance along with SPX Golden Cross formation has led to solid gains in the past. But Quantitative Tightening is a substantial bearish force, and long-term seasonal cycles like the "Best 6 Months" and the Presidential Cycle are currently unfavorable. I am keeping my outlook neutral. That means I am willing to take short-term trades in either direction, though I will be a bit more conservative with entries for both longs and shorts. I still believe there could be more volatility this summer, though we may have a short reprieve for the next couple of weeks. Overall, the shrinking SOMA leaves the market more prone to liquidity events, and the negative seasonality also leaves the door open for the bears. I will continue to monitor the market closely in search of new and compelling evidence. For the time being, I remain wary of betting too aggressively in either direction.

Catapult and Capitulative Breadth Statistics

[Catapult & CBI Presentation Link](#)

OpenCatapult Triggers

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

Symbol	Entry Date	Entry Price	Current Price	% Gain/Loss	Stop	Notes
SPY(1/4)	6/21/2018	\$274.24	\$275.42	0.43%		<i>sold on close</i>
LOW(1/3)	7/5/2018	\$94.87	\$96.14	1.34%		<i>sell on open</i>

A complete list of Quantifiable Edges trade idea results since the inception of the letter in 2008 [can be found here](#).

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