

QUANTIFIABLE EDGES SUBSCRIBER LETTER

ASSESSING MARKET ACTION WITH INDICATORS AND HISTORY

October 22, 2018

Volume 11 Issue 204

Market Overview



Signals Overview

Aggregator	CBI Reading
Long	3

Tonight's Research Points

- Characteristics of this 3-day SPX pullback are not suggestive of an edge.
- The gap & reverse pattern in SPY do suggest a bit of an upside edge.
- QT should remain light through Wednesday, and then pick up strongly next week.

Short-term Outlook

The Bottom Line

The market is oversold with plenty of room to bounce. But evidence is light and does not turn fully positive for another day. I am not inclined to get long just yet.

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						
October 22, 2018	SPY Gap Up 0.25% Rise 0.5% Close Down	1-3 days	Bullish	2.50%	-2.20%	-4.95%
October 15, 2018	Inside day low range 3 < 200	1-6 days	Bearish			
Active - Long Term						
October 1, 2018	Quantitative Tightening \$50 billion/mo	int term	Bearish			
September 10, 2018	4+ Hindenburg Omen signals	1-35 days	Bearish	-6.50%	2.50%	4.50%
August 30, 2018	SPX crosses over 50-day Bollinger Band	1-50 days	Bullish	4.90%	-4.10%	-7.80%
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			

The Evidence

Friday was another down day for the market. The SPX lost just 0.04%, but the NASDAQ fell 0.5%, and the Russell declined 1.2%. Breadth was mixed as the NYSE Up Issues % was 49% and the Up Volume % came in at 55%. NYSE volume rose some from Thursday's level, but was not as strong as you often see on opex Friday.

There were a few studies that appeared in the Quantifinder that examined the 3-day pullback for SPX and suggested somewhat bullish implications. But I am not taking those studies into consideration tonight for a couple of reasons. For one, SPY is NOT down 3 days in a row – only 2. It actually closed up slightly on Wednesday while SPX closed down slightly. So it is not really a clear 3-day decline in my view. Additionally, the 3-day decline is now leaving SPX below the 200ma, and the 3-day decline studies that have triggered do not take the long-term trend into account. It is often important to consider it. Below are 2 simple studies that look at buying 3-day pullbacks when above vs below the 200ma.

SPX closes down for the 3rd day in a row and above the 200ma. Buy on close. Sell X days later. \$100k/trade. 1995 - 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
3	95,007.87	214	132	82	61.68	1,319.29	4,895.50	-965.10	-5,306.04	1.37	2.20	443.96
2	67,274.89	214	136	78	63.55	1,054.93	4,424.50	-976.87	-7,559.56	1.08	1.88	314.37
1	42,101.23	214	135	78	63.08	731.10	2,671.02	-725.60	-6,826.40	1.01	1.74	196.73

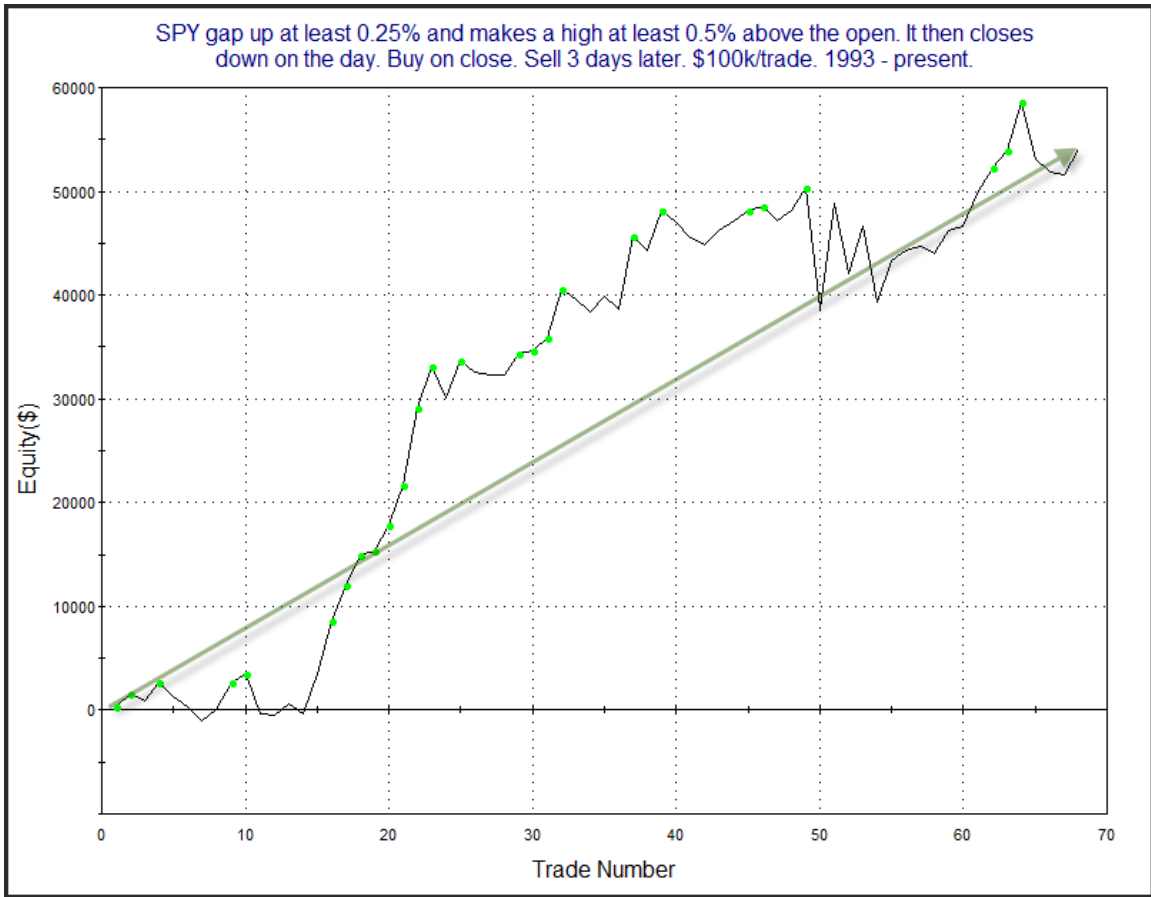
SPX closes down for the 3rd day in a row and below the 200ma. Buy on close. Sell X days later. \$100k/trade. 1995 - present.												
X Days	All: Net Profit	All: Total Trades	All: Winning Trades	All: Losing Trades	All: % Profitable	All: Avg Winning Trade	All: Max Winning Trade	All: Avg Losing Trade	All: Max Losing Trade	All: Win/Loss Ratio	All: ProfitFactor	All: Avg Trade
3	12,000.23	108	55	53	50.93	2,262.06	8,432.34	-2,121.00	-10,286.10	1.07	1.11	111.11
2	10,564.44	108	55	53	50.93	1,895.37	7,249.63	-1,767.57	-9,270.00	1.07	1.11	97.82
1	16,249.60	108	60	48	55.56	1,340.29	6,901.83	-1,336.83	-6,760.90	1.00	1.25	150.46

As you can see, the instances above the 200ma have offered a more substantial upside edge. Below the 200 it has generally been a coin-toss. This is something we will need to keep in mind as SPX continues to decide whether it wants to renew the uptrend, or whether this is going to turn into a more substantial downtrend.

The pattern constructed by the SPY on Tuesday is one that has suggested a bullish tendency in the past. And while the study does not include a long-term trend filter, when I added one I did not find a strong change in the results. So I am much more comfortable giving it some consideration. It was last seen in the 1/14/15 subscriber letter. I have updated the results.

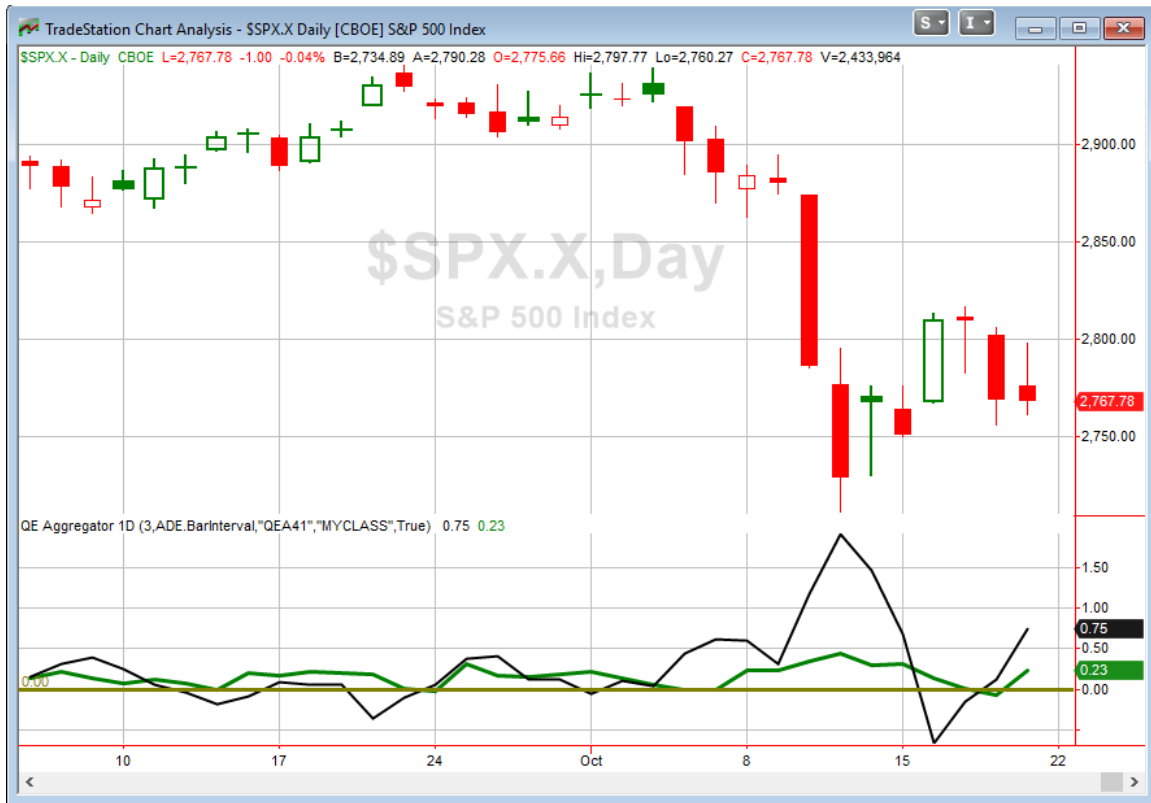
SPY gap up at least 0.25% and makes a high at least 0.5% above the open. It then closes down on the day. Buy on close. Sell X days later. \$100k/trade. 1993 - present.												
X Days	All: Net Profit	All: Total Trades	All: Winning Trades	All: Losing Trades	All: % Profitable	All: Avg Winning Trade	All: Max Winning Trade	All: Avg Losing Trade	All: Max Losing Trade	All: Win/Loss Ratio	All: ProfitFactor	All: Avg Trade
5	41,902.57	64	42	22	65.63	2,804.77	13,737.50	-3,449.89	-19,787.04	0.81	1.55	654.73
4	46,368.90	66	38	28	57.58	2,868.39	12,275.00	-2,236.78	-17,793.84	1.28	1.74	702.56
3	54,064.86	68	42	26	61.76	2,623.57	10,083.30	-2,158.66	-11,623.98	1.22	1.96	795.07
2	48,099.02	70	45	25	64.29	2,257.60	11,736.30	-2,139.72	-9,340.86	1.06	1.90	687.13
1	4,836.77	71	43	28	60.56	1,316.78	5,962.50	-1,849.45	-9,839.83	0.71	1.09	68.12

Results here seem to show a bit of an upside edge. Below is a look at the 3-day profit curve.



The curve is certainly choppy, but it does make its way from lower left to upper right, and seems to offer some confirmation of the upside edge suggested by the numbers. I have included this study on the Active List tonight.

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



With today's study considered, the green Aggregator Line rose back above zero. Positive readings mean net expectations are for upside over the next few days. Meanwhile the black Differential Line is still above 0. The positive Differential Line reading means SPX is oversold versus recent expectations. So expectations are positive and SPX is oversold. This is considered a bullish configuration. Bullish configurations are visible on the chart whenever both lines close above zero. Therefore, the Aggregator signal turned long at the close.

With the current active studies, expectations are slated to remain bullish on Monday. This could change if new bearish evidence emerges. The Differential Pivot will be 2820.96 on Monday. That is 1.9% above Friday's close. Therefore, SPX would need to close up 1.9% on Monday to flip from oversold to overbought versus recent expectations. That is a big number and unlikely to happen in 1 day. A more likely scenario for working off the oversold condition would be a multi-day bounce or consolidation.

While the Aggregator is bullish it is worth looking at the risk/reward readings at the top of the letter. You'll note that the 1-day is actually neutral. This is because 1-day expectations are slightly negative. The Aggregator looks at 3-day expectations, and they are positive. But the 1-day does not suggest an upside edge. The 3-day expectations are based on a limited amount of bullish evidence. So we appear to have a somewhat weak bullish Aggregator signal, that really does not suggest much of a strong edge until after

Monday. With the intermediate-term still not supportive of a bullish outlook, I am not inclined to take an aggressive position. So I will wait to see how Monday plays out and what new evidence emerges before considering possible new index positions for Tuesday.

Intermediate-term Outlook (2 weeks – 2 months) – updated 10/22– neutral

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

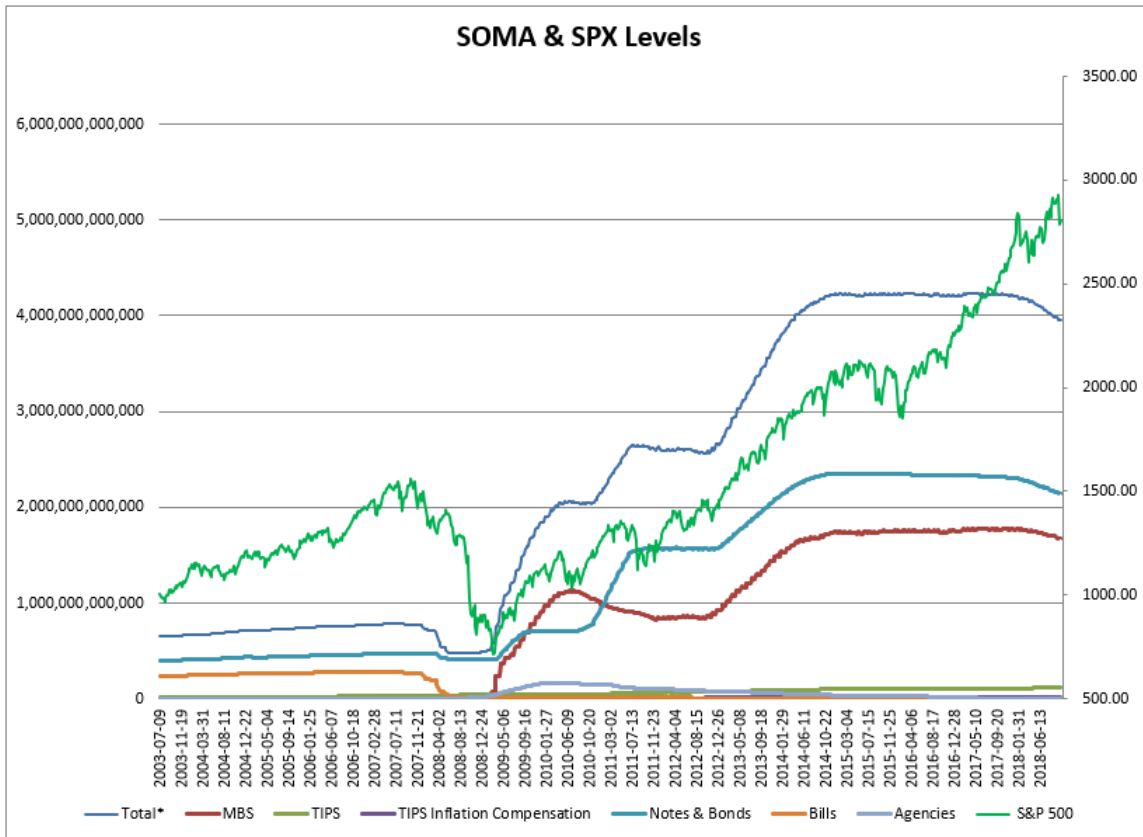
Above is the status of the different Combination Signals from the Quantifiable Edges Market Timing Course. Signals are long-term in nature. All 3 can be either flat or long. None of them look to short. More information on these signals can be found in the [Quantifiable Edges Market Timing Course](#), 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 the Combo Systems all remained “Flat”.*

This past week saw some substantial selling. The SPX rose less than 0.1%, the NASDAQ dropped 0.6% and the Russell 2000 fell 0.3% on the week. All 3 indices also closed below their 200ma. There were not any new studies that triggered this week 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 10/10/2018

DOMESTIC SECURITIES HOLDINGS AS OF
October 17, 2018

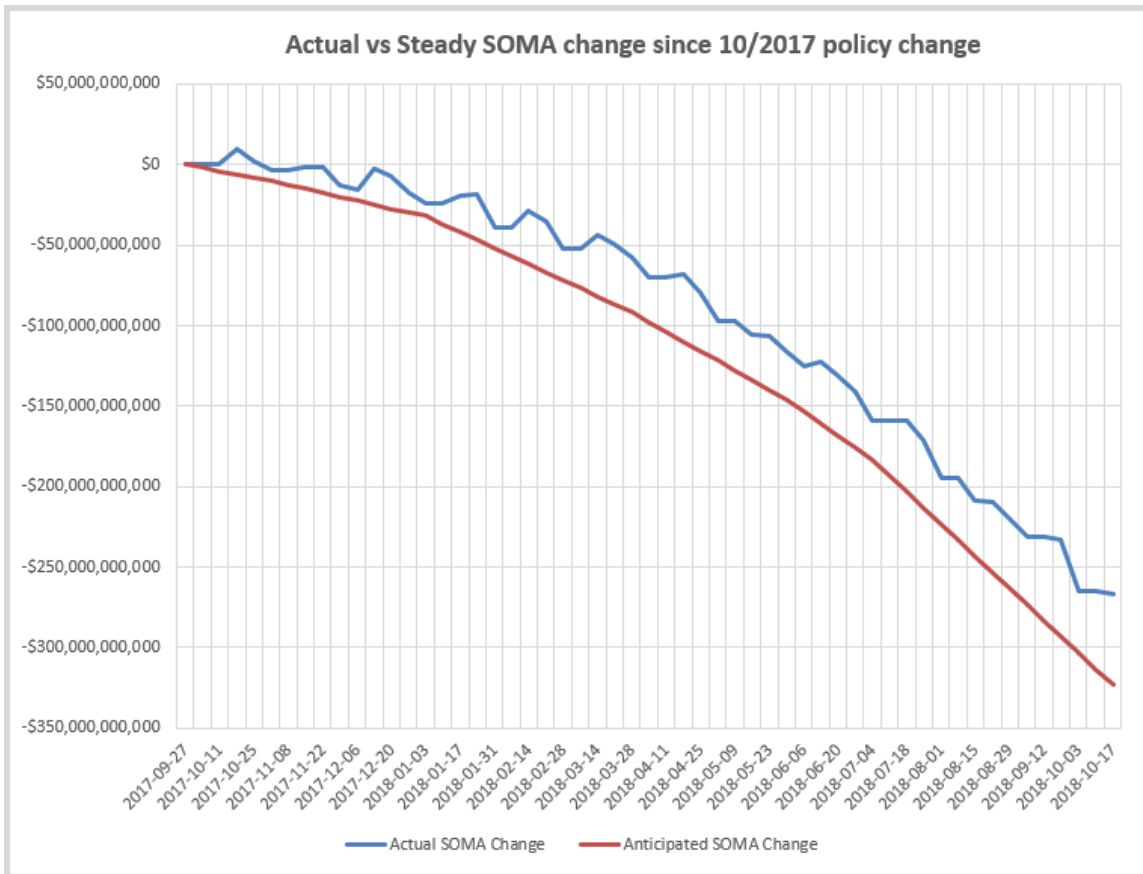
Summary T-Bills T-Notes and T-Bonds FRN TIPS Agencies

Security Type	Total (in Thousands)
US Treasury Bills (T-Bills)	100,000.0
US Treasury Notes and Bonds (Notes/Bonds)	2,138,443,137.2
US Treasury Floating Rate Notes (FRN)	18,152,012.4
US Treasury Inflation-Protected Securities (TIPS)*	115,578,709.4
Federal Agency Securities**	2,409,000.0
Agency Mortgage-Backed Securities***	1,680,109,056.1
Total SOMA Holdings	3,954,791,915.1
Change From Prior Week	-1,669,186.5

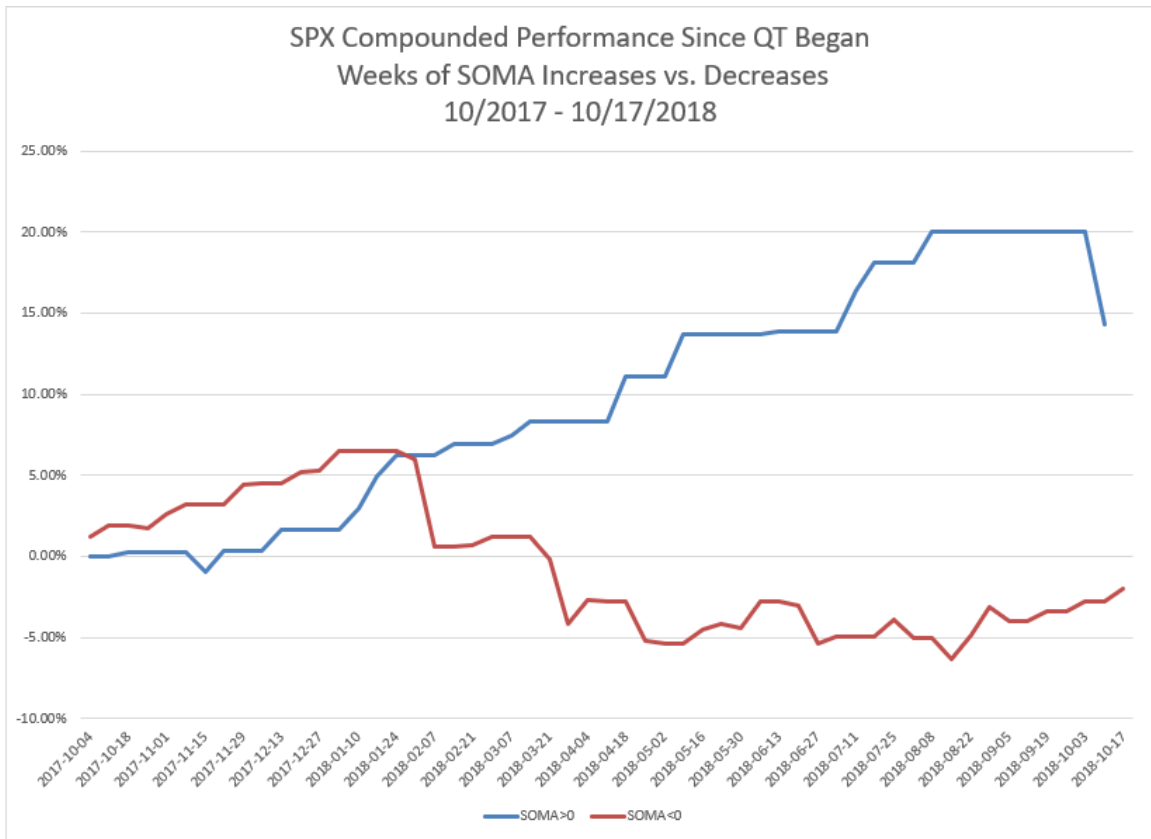
*Does not reflect inflation compensation of 21,970,673.2
 **Fannie Mae, Freddie Mac and Federal Home Loan Bank
 ***Guaranteed by Fannie Mae, Freddie Mac, and Ginnie Mae. Current face value of the securities, which is the remaining principal balance of the securities.

Data posted on 10/18/2018 4:30pm.

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



The Fed's SOMA this past week (Wednesday to Wednesday) saw a decline of about \$1.7 billion. I've been indicating that the change would likely be small, but I felt there was a better chance of a small rise than the small decline we see here. Meanwhile, the SPX rose a modest 0.8% during this week ending Wednesday 10/17. The "Actual vs Steady" chart shows that the decline in the SOMA balance this past week was very small with the QT rate being \$50 billion / month. While it was not the case this past week, the market has typically encountered difficulty during SOMA contractions, 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 QT began of being long SPX during SOMA expansion weeks vs SOMA contraction weeks. It is updated from last week.



The red “contraction week” strategy profit line this past week saw a moderate increase, as the SPX gained about 0.8%. That is quite strong for a contraction week during the Fed’s Quantitative Tightening (QT) program. Meanwhile, the blue “expansion week” strategy profit line has performed substantially better, despite the big drop the last week. Since last October the blue “expansion week” strategy would have posted a 14.3% gain while the red “contraction week” strategy would have lost 2.8%. So how might the next few weeks of QT play out? Let’s first look at the T-Note and T-Bond Maturity Table below, from the Fed’s website.

« As of 10/03/2018

DOMESTIC SECURITIES HOLDINGS AS OF
October 10, 2018

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
10/31/18	912828T83	0.750	1,571,797.0	5.70%		
10/31/18	912828WD8	1.250	3,542,000.0	10.12%		
10/31/18	912828RP7	1.750	17,812,617.0	59.17%		
11/15/18	912810EB0	9.000	3,842,000.0	53.55%		
11/15/18	912828M64	1.250	122,282.3	0.51%		
11/15/18	912828JR2	3.750	30,339,856.6	52.90%		
11/30/18	912828U40	1.000	2,767,228.7	9.62%		
11/30/18	912828A34	1.250	5,652,000.0	16.15%		
11/30/18	912828RT9	1.375	16,496,968.3	54.42%		

We see here that there are no treasuries set to mature until the last day of the month. So any QT between now and then will be due to AMBS securities rolling off the books. Compared to treasuries, AMBS flows are a little more difficult to anticipate. This is 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/ambs-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.

There has only been one other week since QT began that ended on the 24th, and that was January. That month saw a small increase in the SOMA. July, April, and last October all saw weeks end on the 25th, and they all posted good-sized declines. Meanwhile, the week ending May 23rd saw a small decline. So there is a chance that the SOMA could rise a little this week, but with the sample size being only 1, and the nearby week-ends all closing higher, that seems less than probable. The following week will end on the 31st, and will include the large treasury maturity. So that week will see a substantial amount of QT.

The intermediate-term outlook is basically unchanged from last week. Intermediate-term bullish evidence is light. There is still the momentum study from the end of August suggesting further gains. And the Golden Cross formation is still in effect. Another upcoming positive is that seasonality will improve when we enter November as that begins both the “Best 6 Months”, and bullish 3rd year of the Presidential Cycle. But right now the concerns remain much the same. Quantitative Tightening has caused some chaos and it continues to build. And the split market conditions we identified in September seem to be having an impact as the market decline is pretty much right on schedule with them. I again will keep my intermediate-term outlook neutral. I am willing to take trades in either direction, but will not be very aggressive for short-term trades until a better-defined intermediate-term edge is backing the short-term edges.

Catapult and Capitulative Breadth Statistics

[Catapult & CBI Presentation Link](#)

OpenCatapult Triggers

LOW @ \$110.78 (bought @ limit)

LOW @ \$109.74 (bought @ limit)

LOW @ \$106.29 (bought @ limit)

Broad Market Large Cap CBI – 3(LOW-3)

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
LOW(1/3)	10/5/2018	\$110.64	\$99.59	-9.99%		Catapult
LOW(1/3)	10/8/2018	\$109.52	\$99.59	-9.07%		Catapult
DHR(1/3)	10/9/2018	\$105.61	\$101.20	-4.18%		<i>sold on open</i>
LOW(1/3)	10/11/2018	\$106.29	\$99.59	-6.30%		Catapult

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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