The SQN Indicator & Market Regimes

Knowing how to trade in different Market Regimes is just as important, if not more so, than what to trade. So what is a Market Regime?

A Market Regime is a quantified method of organizing the characteristics of different trading environments. We have five:

- Bull Volatile
- Bull Quiet
- Neutral
- Bear Quiet
- Bear Volatile

Each regime is a measurement of the direction of travel of the underlying asset, Bullish, Bearish, or Neutral.

And further organized by Volatile or Quiet.

This is measured with a tool called the System Quality Number (SQN) that was developed by Van Tharp. The SQN measures the average % change from close to close to the previous 100 days and then square roots it. This is how we quantify bullish or bearish, if the change is positive on average for the past 100 trading days, that's bullish and likewise bearish if negative. Then as the % change increases, it becomes more volatile and decreases that's less volatile. A nice quantified methodology to measure.

This methodology is trailing, so the SQN is a trailing indicator, and that's important to note. The SQN isn't there to be a holy grail super classified highly fragile high win rate indicator that will tell you when to buy the next 24% up move or to short a market meltdown.

Rather it's more like a calendar. If you know that it's January and you are in Montana, you are more likely to need a heavy coat, boots, hat, gloves and you can pretty much be guaranteed you won't need a tank top and flip flops.

The SQN is similar because now we can quantitatively recognize the "season" we are in. Like a Calendar would suggest it's winter and you know you are in Montana, the SQN is saying we are in Bear Volatile regime so let's get the appropriate tools (attire in this analogy).

Let's jump into this week's action.

SQN Indicator on daily S&P 500 Chart

Looking at the S&P 500 index on April 6, 2020, this week's market action is characteristic of the transition between Bear Volatile and Bear Quiet regimes. It gets tricky in here as optimism starts to kick in as we rally from the depths of hell back to where we are now.

Bears are nervous and are covering their shorts or waiting to cover their shorts, bulls who got punched in the throat last month and sold at the first bounce are starting to wonder if they did the right thing and start buying. This is what fuels bear market rallies, the most violent of all rallies.

As you know we aren't here to call bottoms or tops, we let the market regimes guide us. What works in a Bull Quiet regime doesn't work in a lot of other regimes and what worked in Bear Volatile doesn't work as well in a Bear Quiet and vice versa.

We will be running these programs throughout the year, so if you are interested in doing the intense work to become a successful trader, get that course. It's 1/2 off right now!

A Collective member, did some great work on finding a system that performs quite well in a Bear volatile regime. He settled on the ES (S&P 500 Emini) using the Vol Breakout Short only strategy on 60-minute charts, however lower time frames are equally as good.

Here's what he discovered…

What is a Volatility Breakout or VBO for short? This is a setup where the Bollinger Bands are within the Keltner Channel signaling a low volatility regime. One of our beliefs is that volatility moves in cycles from low to high volatility and back again. Therefore, we want to see a price breakout above or below both the Bollinger Bands and Keltner Channels. When that bar closes, we place a buy or sell stop above or below the breakout bar. This is a trend-following strategy so we would expect a lower win rate to the failed volatility breakout (FVBO) system. However, in certain regimes, we see the volatility breakout (VBO) strategy shine. Specifically, the bear volatile regime.

Backtest Notes

1) 12/13/2007–3/6/2009

2) We only took Short VBO Trades

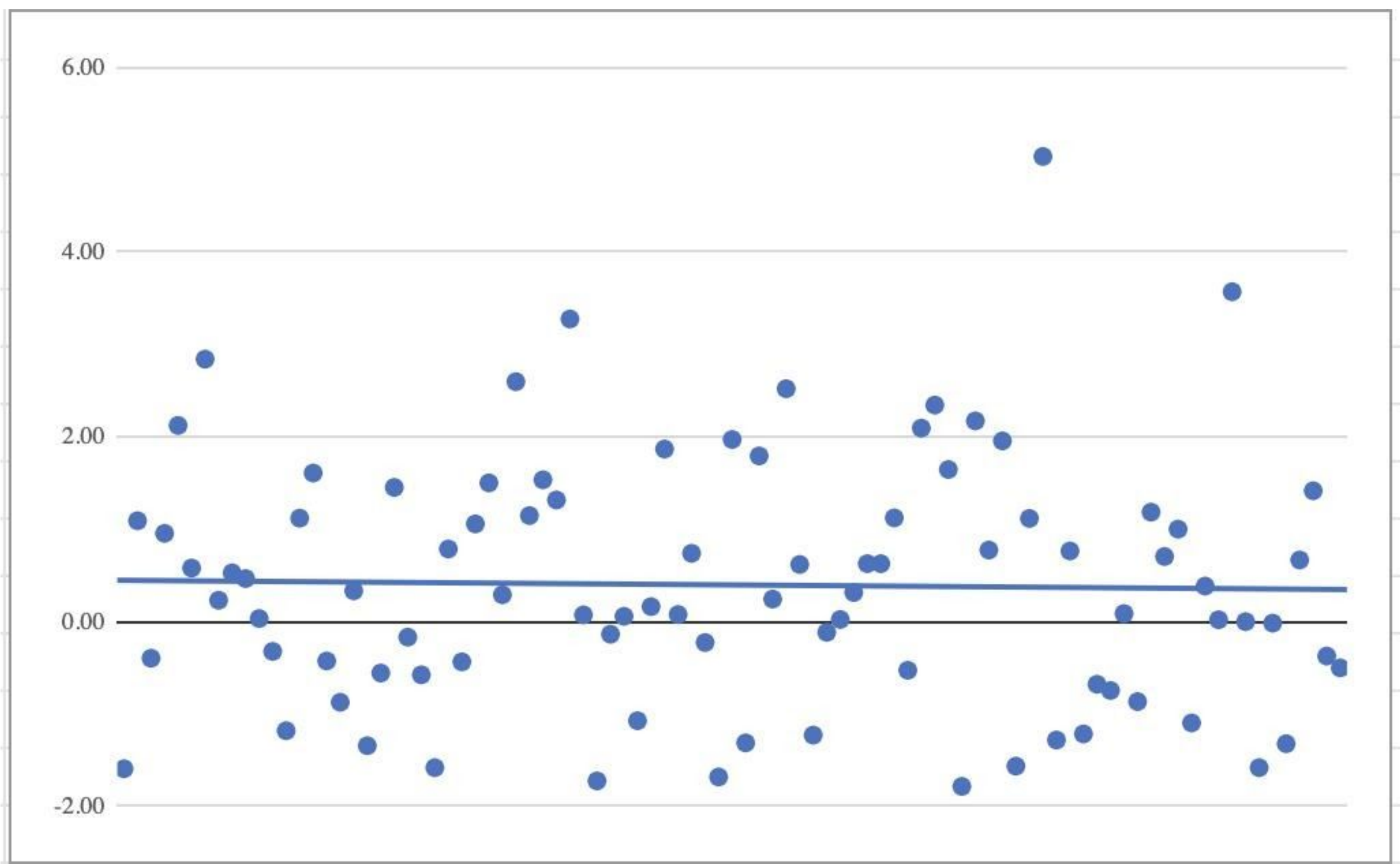
3) All stops were based on the bar close

4) 20-Day EMA Trailing Stop

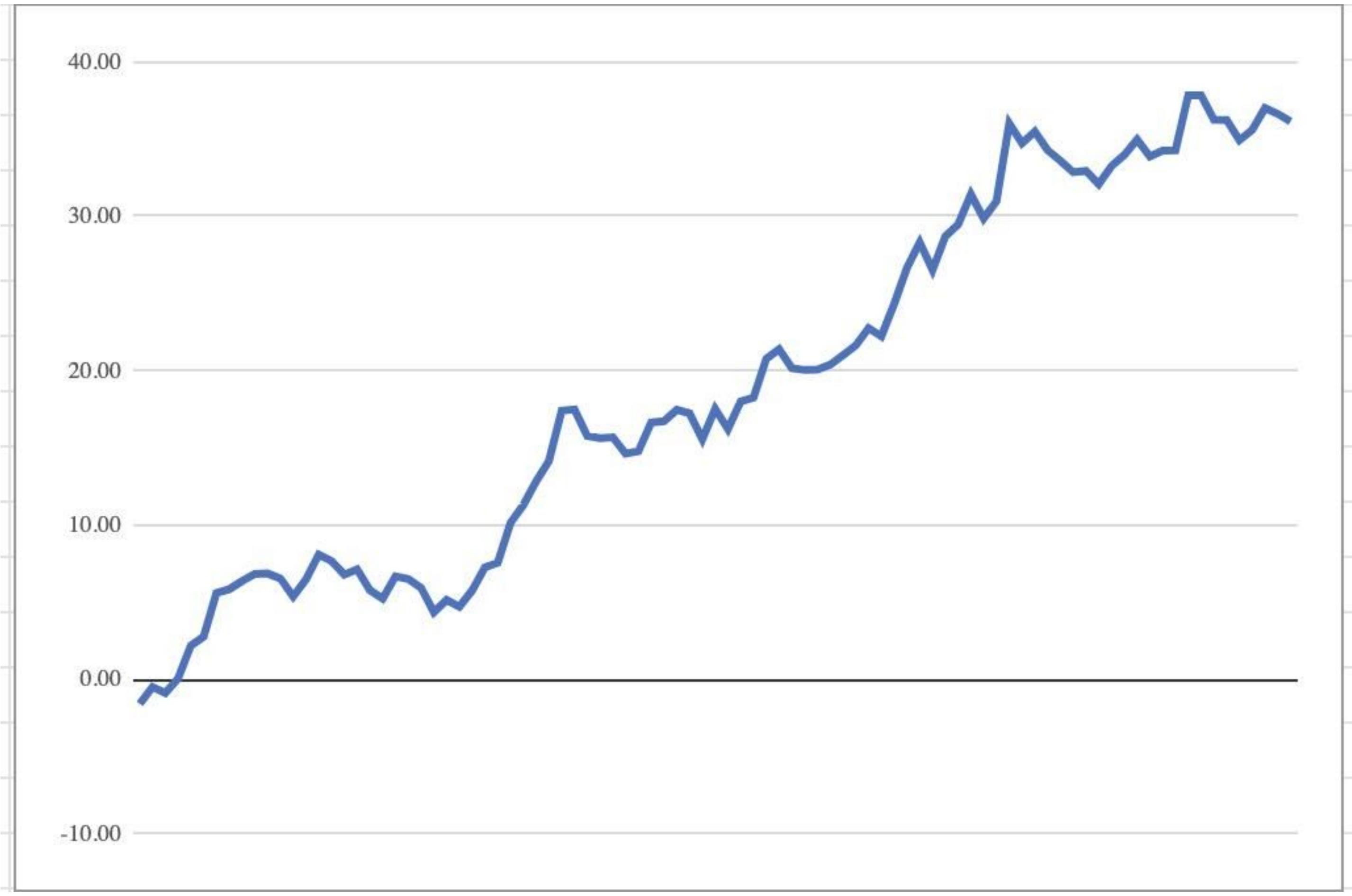
5) All trades were entered between 7 am and 4 pm EST

The first thing to note is that this strategy provides a fair number of opportunities. This is important because we want the law of large numbers to work in our favor. The more opportunities we see the greater chance we meet the expectancy of the back tested data.

The next thing I want to draw attention to is the win rate; 61.5%!!! For trend-following systems, this is unheard of. Good trend-following systems win just about 40% of the time. This should ring massive church bells in everyone's head… market regimes matter to strategy selection.



Finally, this system has a positive skew. That just means we make more money on winning trades than we lose on losing trades. This provides robustness to the VBO strategy and is an important factor in its profitability.



This report was written in early 2019