Trifecta Lens (TL) Score & SQN Case Study

The Trifecta Lens (TL) Score is a composite index that aims to analyze major reversals of current trends and setups within the market on a daily frequency. The TL score is derived via three main categories: Breadth, Liquidity, and Sentiment.

A way to think of this index is as a "health check" for the market as a whole, with each main component a vital organ for optimal market functionality. These components are comprised of individual indicators, listed below:

Breadth
- NYSE New Highs / New Lows Ratio
- Russell 3000 | Percent Advancers
- Russell 3000 | Percentage of Stocks > 50DMA

Liquidity:
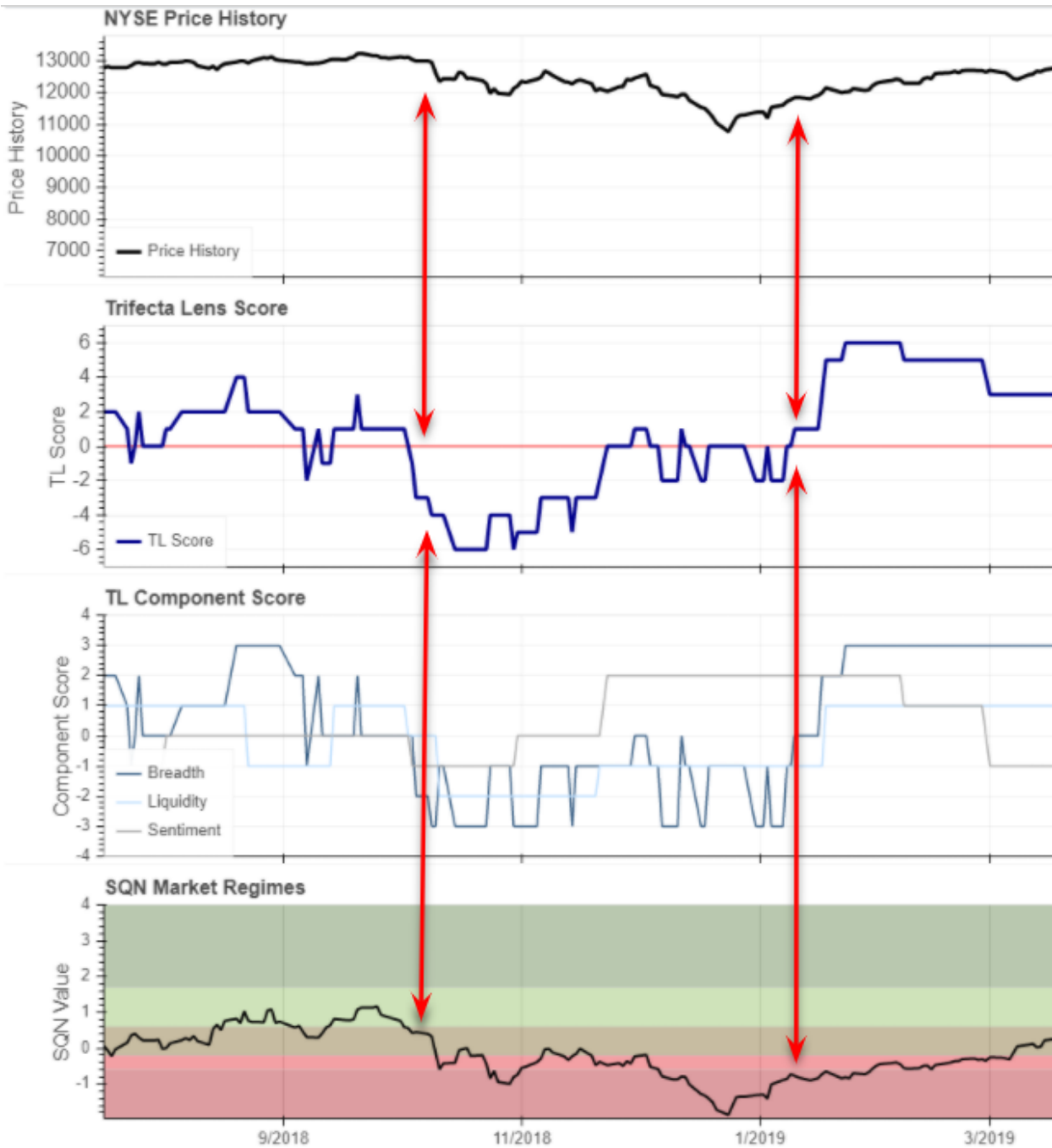- BAA Yield
- LQD/IEF Divergence
- SPX / GT10 Ratio

Sentiment:
- Put/Call 10DMA Ratio
- SPX Z-Score
- AAII Bulls - Bear (%)

Those nine indicators are then filtered through thresholds, and assigned a resultant value of +1 or -1. The scores are added together and a TL score emerges; ranging from -9 (extremely bearish) to +9 (extremely bullish). We believe that showcasing the power of this index is best displayed via a few examples. We also invite you to check this out for yourself, and bookmark the page. The TL index updates overnight once all data is in for the previous trading day.
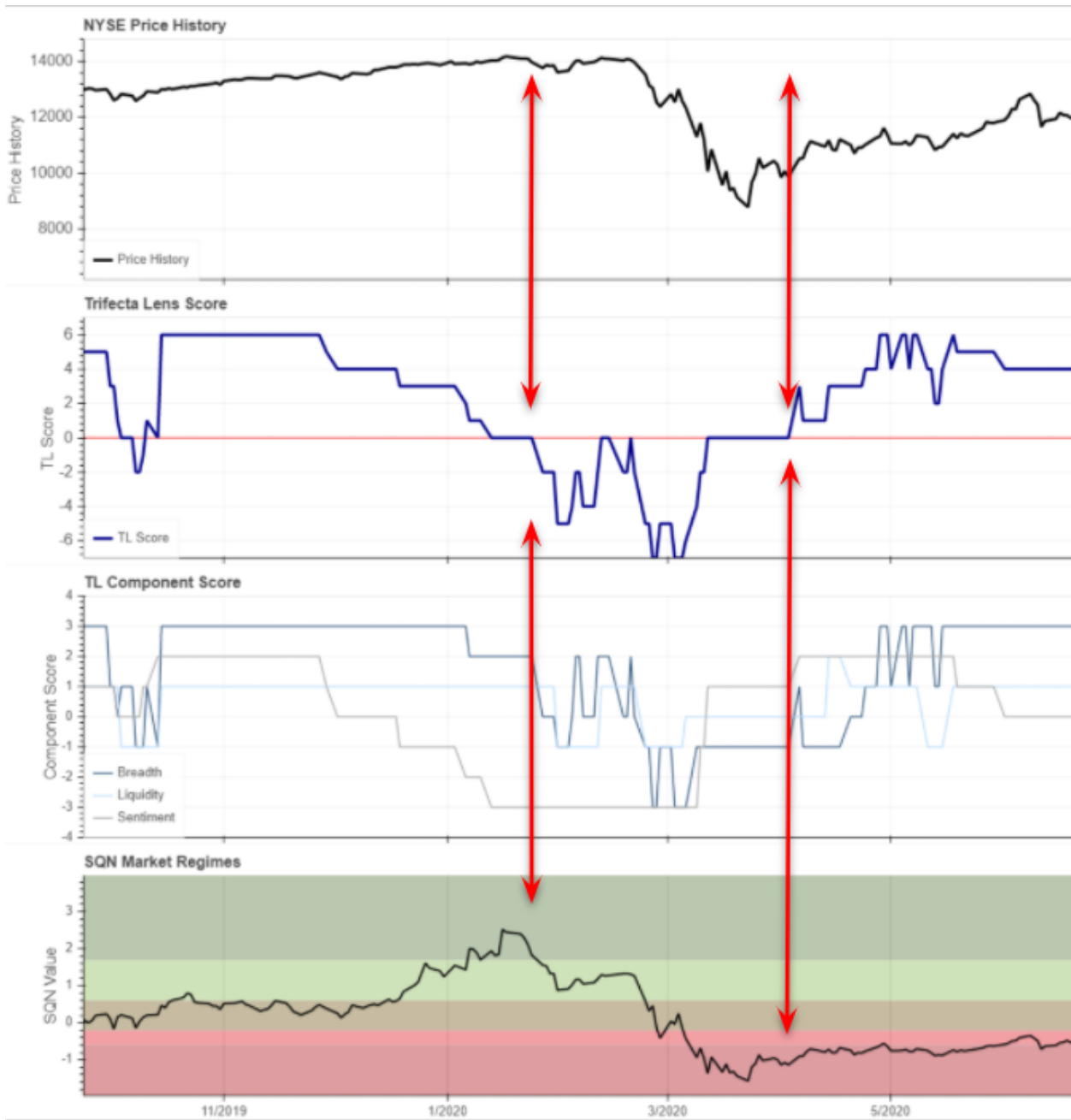
TL Score Examples:

We'll start with "Vol-pacalypse", which occurred in late 2018 into early 2019. Note how breadth and liquidity were slightly negative at the start of this period, and then dipped strongly negative at the start of the period. Think about it like this. If two of your main organs are malfunctioning, are you healthy? No. Same with the market. Note that the TL score flashed these "sick" signals ~45 days before the relative bottom in late 2018. The TL score signaled the "all clear" shortly after, rising above zero; preceding the gradual upward trend that was to come for the next several months.

Furthermore, now zoom from late 2019 into early 2020. Note how sentiment gradually turns negative starting in December of 2019, followed by breadth shortly after. Also, note that major indexes were in a bull-volatile regime. So, we have:

- Bull volatile regime
- Two major "organs" of the market are declining in health.

All we need is a catalyst event, and we got one; creating the perfect storm. Note how our TL index dipped to zero, and then did not emerge positive until after the relative bottom, and then never looked back.

SQN Indicator

Another tool we use to check market health is known as the SQN indicator. If the TL score is an assessment of the market's major organs, then the SQN indicator can be thought of as the thermometer. Research by Van Tharp and other prominent figures shows that the market behaves in distinct regimes:

1. Bear Volatile
2. Bear Quiet
3. Neutral
4. Bull Quiet

5. Bull Volatile

Each market regime is categorized by the magnitude of the SQN score. The SQN derives itself from close price action, so it's a "first derivative" product and does not introduce external metrics like some of the other popular indexes.

Explaining the Regimes

Allow us to continue with our health analogies when describing the main characteristics of each regime.

Bear Volatile: This regime is observed at, and near the relative bottom of the correction both before and after. In this state, the market is in need of rescue, its core temperature needs to be raised externally, as it cannot accomplish this itself. It is in a hypothermic state, and confidence of a recovery in the short term along with sentiment is low/bearish.
- Governments will come out of the woodwork to attempt to establish support over a short timeframe.
- Price action is often erratic; if you are to initiate positions, do so with trailing stops, independent of whatever side of a trade you take.
- Favor the short side of the trade.

Bear Quiet: This regime is observed above the relative bottom of a major correction or long-term downtrend. While not as foreboding as a bear volatile market, there are several mannerisms to take note of:
- Light chop is often observed in this regime; price action often retests relative highs and lows, attempting to find support.
- Government support is rare in this regime.
- Currency plays are often as viable as equities regarding position initiation.
- Favor the long side of the trade, however, be wary regarding overextension, as mean reversion wins out more often than not.

Neutral: This regime shares similar characteristics as a bear quiet, however, the chop is often greater in magnitude, and mean reversion is very prevalent. This is the market to "buy dips and short rips".
- This is by far the best performing market in terms of win rate.
- If a trade is largely profitable, take those profits!
- Mean reversion is your adversary.
- This regime often can go on for a long time, and sideways movement will likely be observed.
- This is an especially favorable market for a high number of trades to be placed; currency plays may contain up to 5% risk if conviction is high.

Bull Quiet: This is where the market is not running in a fashion which is too cold or too hot. Several distinguishing characteristics can be observed:

- Buy the dips and add to positions at 1-2% risk.
- This is where the headlines are the most "doomsday-ish", however, the market seems to ignore the doom and gloom and continues its ascension.
- Favor the long side of a trade, unless you have strong conviction otherwise. If the market moves high and volume starts to trade sideways, the top may be in.
- However, more often than not, a dip is just enough to fake out participants and continue an uptrend.

Bull Volatile: This is when the market runs a bit hot and may develop a "fever"; fever reducers (by way of corrections) are common. This is when you must take profits; the risk is greater than the reward! Be very risk-averse here (max risk of 1%, maybe 2% if very confident).

- Remember the doom and gloom headlines of Bull Quiet?
- This is where the negative sentiment actually starts to take effect and could tip the scale to the downside.
- It is very important to note that without first rising into a bull volatile regime, the top is not in.
- Any dips here could kick a bull volatile back into a bull quiet, hence restarting the ascension process.

Where can I view SQN data?

We've developed a dashboard where you can view the current market regime for major equities, indexes, currencies, and some cryptocurrencies. On page top, you will find a table of these tickers along with attendant regime statistics. Check it out at: https://dashboard.macro-ops.com/sqn_ret.php?ticker=DIA

For example, we see that XME is in a bull quiet regime. It first entered into its current bull quiet regime on the 18th of March and has been in the bull quiet regime for 85 days. It's returned almost 18%. Moving further across the columns, historical returns across certain time periods have been computed, so an operator can check how the current market regime is performing relative to the past.

Ticker	Current Regime	Date of Regime Entry	Days Elapsed in Regime	Current Regime Return [%]	5D Avg. Returns [%]	10D Avg. Returns [%]	15D Avg. Returns [%]	20D Avg. Returns [%]	40D Avg. Returns [%]	60D Avg. Returns [%]
XME	Bull Quiet	03/18/2021	85	17.75	2.09	1.74	2.54	3.12	12.16	35.79
CLA	Bull Quiet	04/16/2021	56	12.2	1.53	1.79	0.72	3.24	0.47	6.49
MMEA	Neutral	05/19/2021	23	4.35	-0.84	-0.18	0.43	0.87	4.4	N/A
XLE	Bull Quiet	05/18/2021	24	3.54	1.39	1.7	2.35	2.16	2.27	4.08
SMH	Neutral	04/30/2021	42	3.26	0.05	1.83	3.65	5.02	12.03	N/A
SPY	Bull Quiet	04/20/2021	52	2.84	0.65	0.58	1.21	1.97	5.12	0.65
MSCI	Bull Quiet	06/09/2021	2	2.78	0.84	1.57	2.72	4.32	10.07	11.57
IBB	Neutral	06/07/2021	4	2.27	0.46	0.32	1.23	2.92	7.65	14.27
XLU	Neutral	06/08/2021	3	1.77	0.17	0.69	1.49	2.48	5.21	N/A
NYA	Bull Quiet	05/11/2021	31	1.69	0.51	1.07	1.61	1.69	4.08	8
XLK	Bull Quiet	06/09/2021	2	1.19	0.89	1.4	2.12	3.05	6.04	6.64
AUDUSD	Neutral	03/28/2021	75	0.96	0.01	0.31	0.83	0.53	1.53	N/A
XLV	Bull Quiet	06/09/2021	2	0.86	0.65	0.81	1.67	1.69	2.41	2.51
UKX	Bull Quiet	06/10/2021	1	0.65	0.56	1.06	1.3	2.19	4.27	7.59
DIA	Bull Quiet	05/11/2021	31	0.56	0.57	0.89	1.41	1.82	5.03	5.55
CCMP	Bull Quiet	05/11/2021	31	0.56	0.57	0.89	1.41	1.82	5.03	5.55
MXNUSD	Neutral	05/13/2021	29	0.36	-0.01	0.11	0.17	0.35	2.17	7.13
RTY	Neutral	06/09/2021	2	0.2	0.29	0.51	0.57	0.91	8.52	8.43
XLY	Neutral	05/28/2021	14	0.14	0.2	0.41	1.02	1.82	6.78	N/A
XLP	Bull Quiet	05/17/2021	25	0.11	0.57	0.57	1.01	1.21	2.61	1.67

Additionally, an operator can inspect the current regime's performance graphically. We note below that the current bull-quiet regime for XME has performed as expected, but lasted longer than any other bull-quiet regime in the past (second half of the figure)

XME Average Cumulative Return Per Regime [%]