A key part of our investing process at Macro Ops is identifying the market regime we're in. We do that with our SQN Indicator.

The SQN Indicator

The SQN indicator can be thought of as a market thermometer. Research by Van Tharp and other prominent figures shows that the market behaves in distinct 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.

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)

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

Let’s start with 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 created an MO SQN indicator with TradingView and Bloomberg.

You can find it in TV by searching “Macro Ops SQN” within the indicators section. And if you’re a BBG terminal user, shoot me a DM in slack or send me an email with your BBG handle and I’ll provide you access.

In the next email we’ll take a look at some strategies based on the SQN.

Your Macro Operator,

Alex

P.S: If you have questions on any of this, or if you want to skip ahead, **check out our FAQ here.**