There is now a high risk of S&P 500 Index drawdowns much worse than those we saw in February 2018.

Amid tech market sell offs and the biggest shift from Growth to Value since the Lehman meltdown[1] Morgan Stanley's Chief US Equity Strategist has warned that "The selling has just begun. This correction will be the biggest since February"[2]. This comes at a time when the tail of the distribution of 5-day returns in the S&P 500 Index is so fat that a drawdown larger than has been experienced since October 2008 is a real danger.

Risk Control requires realistic estimates of the scale and frequency of loss.

Unlike conventional approaches which treat multi-day returns by applying simplistic formulas to single day estimates, Omega Analysis' risk measurement technology for multi-day returns is based on data samples of those returns.

Our purely data-driven approach provides accurate estimates of 99% Value at Risk (VaR) and Expected Shortfall (ES)—the average VaR breach—for Multi-Day returns in financial markets.

This technology does much more: it allows us to assign realistic probabilities to market losses of any level. For example, last summer[3] we predicted that very large losses in the 'Short VIX' strategy should have been expected within a few months. They materialised in February 2018.

Now the 5-day returns data in the S&P 500 Index shows that risk has gone from an all time low at the end of 2017 to the fattest downside tail ever observed (in a history that goes back to 1885).

The risk of a drawdown worse than the one in February is now very high.

There is no doubt that equity market volatility is back. Many independent analyses from the 'Buffett indicator'[4] to Robert Shiller's CAPE Index indicate that the U.S. equity market is extremely over-valued. Our Unstable Expansion Analysis indicates that it will decline by more than 50% in the next major downturn.

None of these approaches can predict the timing of that collapse, or what event might be the trigger, but the recent tech losses have certainly increased market jitters. Morgan Stanley's Chief U.S. Equity analyst warned this week: "The selling has just begun and this correction will be the biggest since the one we experienced in February."

Our analysis shows that the probability of exceeding the February 2018 losses is alarmingly high. Our tail model shows that a 5-day drawdown in excess of the 8.5% lost 6 months ago should be expected once every 10 months.

The average such loss is almost 16%–the worst 5-day loss since October 2008. If that happens the long expected equity crash may well be the result.

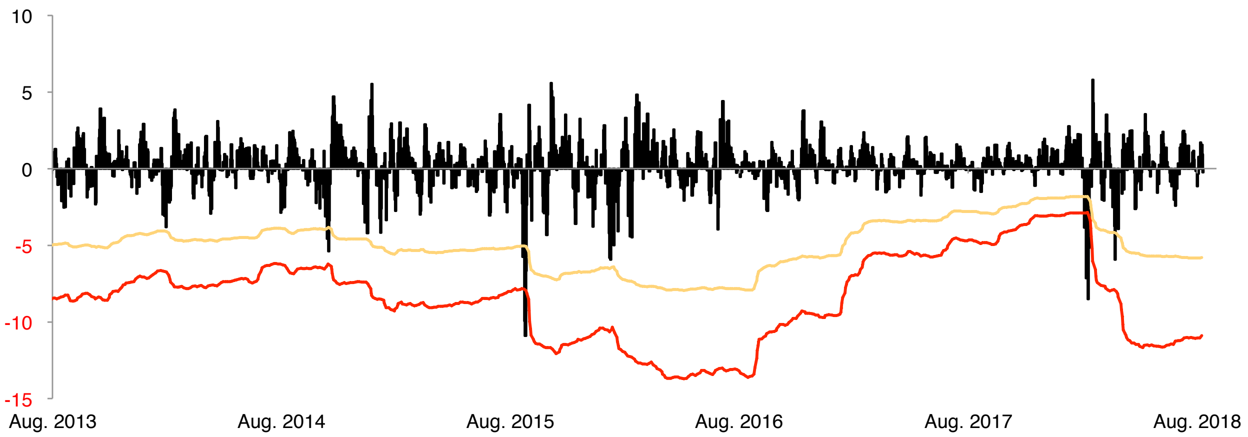

Figure 1. 5-Day Returns in the S&P 500 Index with the 99% Value at Risk (yellow) and Expected Shortfall (red). The ratio of the ES to VaR is a good indicator of the fatness of the tails. It has exploded since February 2018 and the downside tail of 5-Day returns in the S&P 500 Index is fatter than it has ever been before.

[1] https://www.zerohedge.com/news/2018-07-31/43-sigma-event-3-day-move-valuegrowth-biggest-lehman-bankruptcy
[2] https://www.bloomberg.com/news/articles/2018-07-30/correction-worse-than-february-is-building-morgan-stanley-says
[3] What Just Happened Short VIX 14 June 2017 and What Just Happened VIX Again 11 Aug 2017
[4] https://www.msn.com/en-us/money/markets/this-favorite-warren-buffett-metric-tells-us-a-stock-market-crash-could-be-coming/ar-BBL7KZy

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