Omega Analysis

Navigating through the 1929 Crash with Omega Metrics® Indicators

The Omega Metrics® suite of 'statistical macro' indicators was originally designed for a major commercial bank's market intelligence analysis and to inform a G7 Central Bank's policy decisions. Here's what they would have shown for the Dow Jones Index (DJI) had they been available prior to the 1929 Crash.

Unstable Expansion Modes: You would have seen an Unstable Expansion emerge in Q3 of 1924, indicating that an asset price bubble was forming. You would have been tracking the increasing gap between the DJI and its Correction Level (green).

During this period the DJI was a 'buy' as you expected the price to be bid up. It would have been an even stronger 'buy' during Green periods in the Trend Alerts. But in both cases it also required a hedge against the eventual correction you'd also be expecting, especially as that gap grew to extreme levels in 1928 and 1929.

Risk Warnings: While there had been no major downturns recently, tails of returns distributions at time horizons from daily out to 20-day were very fat. There was a high probability of losses that would wipe out investors who were geared 10 times on margin.

The last major 20-Day drawdown was in June 1921 and at the end of August 1929 you would have been warned that there was a 1 time in 7 month chance of exceeding that loss. And that the average such breach would be 24% — worse than what had happened in the Panic of 1907 and in fact a larger loss than had *ever* been recorded in the U.S. stock market. Two months later, the market crashed. In the 20 days that began on Black Monday, the average breach of the June 1921 loss was 28%.

Market Trend Alerts: The first major downturn, in October 1929, came while the Trend Alert was still Green. Even after the initial shock losses, the DJI was still far above the Correction Level. By mid November the Trend Alert turned to Red during what turned out to be a 'dead cat bounce'. This made the DJI a short until either it reached the Correction Level, or an Unstable Contraction emerged.

Unstable Contraction Modes: The latter is exactly what happened in Q3 1931. The DJI continued to be a short until the Unstable Contraction ended with the market reaching its Correction Level (red) in Q2 1933.

The Rebound Signal: This was the signal that the DJI was finally a strong 'buy' again. The market Trend Alert was Green and the bounce back overheated again producing an Unstable Expansion in Q2 1936. This was killed off by repeated Fed interventions and reached its Correction Level in September 1937, and so on…

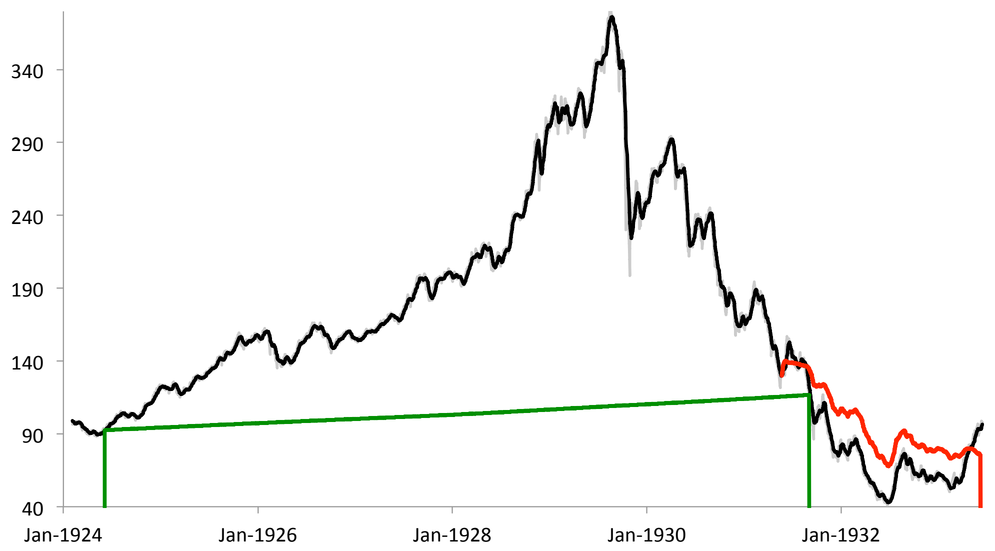

Figure 1. The DJI (grey) and smoothed DJI (black) with the Correction Levels for the Unstable Expansion (green) which began in Q3 of 1924 and the Unstable Contraction (red) which appeared in Q3 1931. From the October 1929 crash to the rebound signal when the Index reached the Correction Level for the Unstable Contraction took 42 months.

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