Unstable Contractions–anti-bubbles of panic selling–can lead to uncontrollable price declines, as they did in the case of many large European and U.S. banks in the Financial Crisis of 2007-2009. In that period, some of the biggest disasters for shareholders occurred when two banks, both in Unstable Contraction, were allowed or 'encouraged' to merge.

This week, a merger of Banca Popolare di Milano and Banco Popolare to create Italy's third largest bank was announced. Both banks have been in Unstable Contraction since the second Quarter of 2016. The Banca d'Italia and the ECB approved the merger.

In August, Commerzbank and Deutsche Bank discussed a merger when both banks were in Unstable Contraction. Are we about to see a repeat of the most egregious management and regulatory errors of 2007-2009?

## Unstable Contractions: Anti-bubble Indicators

Just as Unstable Expansions–unsustainable asset price increases–emerge during market booms, market busts can produce Unstable Contractions. These are leading indicators of anti-bubbles of panic selling.

During the Financial Crisis of 2007-2009, most large European and U.S. banks went into Unstable Contraction as their prices declined precipitously from their 2007 peaks. Some, like Barclays, Goldman Sachs and Morgan Stanley, survived by securing additional capital, on very attractive terms to investors. Others suffered devastating losses in share value after merging with another bank that was also in Unstable Contraction.

The technology to observe the Unstable Contraction danger signals was only developed after the crisis. If it had been in place at the time, it would have provided bright red warning flags for investors and for regulators.

## Disastrous Mergers

RBS was in Unstable Contraction when it got approval from regulators and shareholders for its doomed purchase of ABN Amro. HBOS and Lloyds Bank were *both* in Unstable Contraction when, with Gordon Brown's 'encouragement', they completed an emergency merger. Commerzbank was in Unstable Contraction when it purchased Dresdner Bank from Allianz (itself in Unstable Contraction at the time). Bank of America and Merrill Lynch were *both* in Unstable Contraction when Bank of America bought Merrill Lynch.

Each of these deals was followed by a disaster for shareholders as panic selling continued. But that is precisely what should have been expected if only the red flag had been visible.

From the point of view of a trader, an anti-bubble is something to sell just as a bubble is something to buy, and he has an exit strategy in either case.[1]

Bank investors are unwittingly buying the anti-bubble, just as they did in 2008. A merger of two banks in Unstable Contraction is like one drowning man clinging to another in hope of salvation when what they both need is a lifeguard.

## A Repeat of 2008?

In August of this year, Commerzbank and Deutsche Bank were reported to have been in merger discussions. Both banks were in Unstable Contraction at the time.

The Banca d'Italia and the European Central Bank, as well as the shareholders, have approved the creation of Italy's third largest bank through a merger of Banca Popolare di Milano and Banco Popolare. These banks have lost 75% and 55% of their share value respectively since the beginning of the year. Both of them have been in Unstable Contraction since Q2 2016. According to our tail model, a 5 day drawdown of at least 25% should be expected at least once every two months at current risk levels.

There is every chance that the most egregious errors of 2008 are about to be repeated in the European bank sector. The technology needed to identify the warning signs was only developed after those mistakes had been made. We can use it to avoid repeating them.

That technology has produced clear warning signals–Central Banks should heed them.

[1] In 2008, Allianz got it right. But in early 2001 Allianz was in Unstable Contraction when it purchased Dresdner Bank as the tech bubble was bursting. Its shares have never recovered from that error.

Omega Analysis

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