As Risky as US Equity Markets Are, It's Worse in Europe

For months risk levels in European equity markets have been much higher than the already worryingly high levels in the US. Omega Metrics® 10-day risk estimates show a high probability of surpassing last summer's worst 10 day losses in the FTSE 100 and DAX 30 indices. If that happens, the expected drawdowns exceed those experienced in October 2008.

Risk has Exploded in the S&P 500 Index

Omega Metrics® 10-day VaR and ES analysis shows that the 99% risk level has increased by over 32% in the past year. There is a high probability of exceeding the worst 10 day loss in August 2015. If that happens, we should expect a 10 day drawdown of more than 16%, a level last seen in August 2011.

Drawdown Risk is Even Higher in Europe

With the belated realisation that the UK referendum on EU membership could result in a win for the Leave campaign, worries about European equity markets have been increasing. Our measured multi-day risk levels in the FTSE 100 and DAX 30 indices show that they are much riskier than even the very risky US markets.

But this isn't the result of recent UK referendum polls. Equity market risk has been significantly higher than in the US for more than two years and has also been growing explosively.

A Repeat of 2008 for the FTSE 100?

While the S&P 500's worst 10 day loss in August 2015 was just over 10%, the FTSE 100 lost 12.4%.

Our tail fits have given accurate VaR and ES estimates for the FTSE 100 for more than three decades. Using those fits, we can provide realistic estimates of the probability of repeating or exceeding the losses experienced last August. In the case of the FTSE 100, this should be expected once every 217 days. By the time the markets open after the UK referendum, 210 days will have expired since the last one.

It is only prudent to ask what we should expect if the FTSE 100 has a 10 day drawdown of more than 12.4%. The answer is hardly comforting. It's a loss of over 18%, a level last seen in October 2008. That was over 1,900 days ago and the expected frequency of such an event is once in 712 days.

For the DAX 30, the Prospects are Even Worse

Unlike the FTSE 100, which has already fallen (more than once) to the Correction Level of 6,006 we forecast more than two years ago, the DAX 30 still has an outstanding correction of over 25% to reach our predicted level of 7,154.[1]

For the DAX 30 we have accurate VaR and ES estimates going back more than half a century.

Our current tail fit shows that the DAX could exceed its August 2015 10 day loss of 16.9% once every 189 days, so such an event is 'overdue'. The expected loss should this happen is a horrific 36%–which dwarfs even the worst drawdown in 2008. Ominously, the DAX tail is now so fat that a 10 day loss of 36% is something that should be expected once in 8 years!

[1] W. F. Shadwick, *Market Cycles, Risk Measurement and Early Warning of Asset Price Bubbles*, Fields Institute Quantitative Finance Seminar, 29 January 2014. Copies are available from Risk@OmegaAnalysis.com.

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