HSBC technical analyst Murray Gunn issued a ‘red alert’ this week over the possibility of very large losses in US equity markets if the Dow Jones Industrial Average falls below the critical level of 17,992 or the S&P 500 Index falls below 2,116.

According to our tail models, there is a significant probability of single day losses that would breach those critical levels. But the probability of a 10-day drawdown large enough to do the job is now so high that we should expect such an event more than twice a month.

It’s not just the chart pattern that’s reminiscent of October 1987. Tails are even fatter than they were then. A repeat of 19 October 1987 now looks like a 1 day in 25 year event.

Gunn’s Red Alert

Murray Gunn’s red alert over a combination of Elliot wave analysis and the ‘head and shoulders’ patterns in the Dow Jones Industrial Average (DJI) and the S&P 500 Index was widely quoted this week.

He cited the levels of 17,992 for the DJI and 2,116 for the S&P 500 Index as the ones below which a very large sell off could occur. He also pointed out that a similar head and shoulders pattern appeared in early October 1987.

Three Red Flags from Omega Analysis

Omega Analysis also has red alerts on both indices, based on entirely different criteria. Our risk measurement technology reveals predictable Risk Cycles which are leading indicators of market booms and busts.

Unstable Expansions–unsustainable asset price increases–emerge during market booms. They provide real-time Correction Levels that are predictions of the extent to which markets must fall in the subsequent downturn.

U.S. markets went into Unstable Expansion in 2013 and their Correction Levels provide a large red warning flag. We expect the DJI to fall below 12,000 and the S&P 500 Index to drop below 1,250.

Our Downturn Indicator signalled the end of the U.S. and global equity market boom over a year ago, another red flag.

Finally, as has happened prior to all of the major corrections in the past, there is a dramatic increase in daily and multi-day risk levels, all of which are now flagged red.

What are the odds of Gunn’s Levels being Breached?

The high point on the current shoulder occurred for both indices on September 22nd. The percentage losses from those highs that would bring the indices to Gunn’s critical level are 2.2% for the DJI and 2.8% for the S&P 500 Index.

Our tail models provide a reliable means of estimating the likelihood of such losses either in a single day or as multi-day drawdowns.

For both indices the expected frequency of a single day loss that takes them to the critical level is quite high. In the DJI such a loss should be expected once every 50 days. The larger drop required in the S&P 500 Index is a 1 in 75 day event.

The likelihood rises dramatically for multi-day returns. A 10-day loss large enough to breach the critical levels should be expected more than twice a month in both indices. We shouldn’t have to wait long to see if that triggers major losses.

The Risk of a Repeat of October 1987 is Uncomfortably High.

Omega Metrics® daily VaR and Expected Shortfall levels have risen inexorably over the past two years. The tails of the S&P 500 Index and the DJI are much fatter than they were in 2014.

In 2014, the 19 October 1987 loss of 20.4% would have been expected only once in more than 200 years. In June of this year, our tail fit to the S&P 500 Index said that it was a 1 day in 30 year event.

As of September 2016, twenty nine years after the worst loss in market history, the expected frequency of a repeat is an ominous 1 day in 25 years.

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