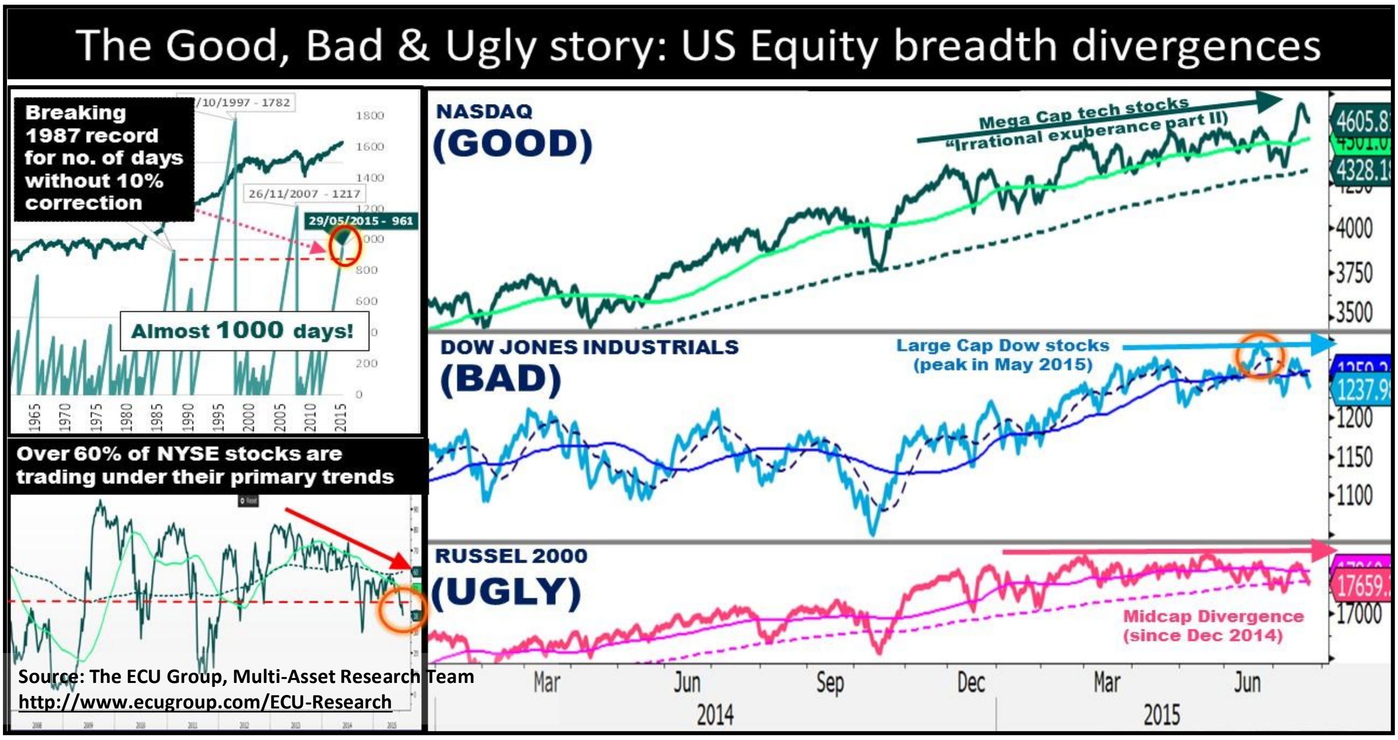
Growing Risk for Equity Market Crash during Q3 Cycle

"Autumn is signalled by the first falling leaf" Japanese proverb

The annual cycles of each year can bring a marked change not only to the weather, but also the surrounding investment landscape. As the temperatures cool again in the fast approaching autumn period, our seasonality analysis suggests a **growing probability for equity markets, notably in the US, to complete its distribution topping phase during the end of August/early September, with a risk of a crash in Q3 this year.** However, we must always remember that market tops are not overnight events, but instead a complex staged process; usually comprised of a peak/distribution pattern, followed by a bearish price dynamic and finally a volatile recuperation phase.

Three likely scenarios exist for the early stages of this particular market top. Each one offers a choice of either a good, bad or ugly technical alert for investors at large. The so-called "good" setup would be **further upside potential, characterised by a euphoric "blow-off" pattern,** which would be driven by the last standing generals (mega-cap stocks) on the battlefield. The NASDAQ is a poster child for this example, while already partying like its 1999, having recently tested its old dotcom peak levels. The parabolic rise is being primarily driven by the last remaining growth-oriented stocks, with runaway trends. This price acceleration is unsustainable in the short-term and masks heightened risks of a "greater fool theory" collapse.

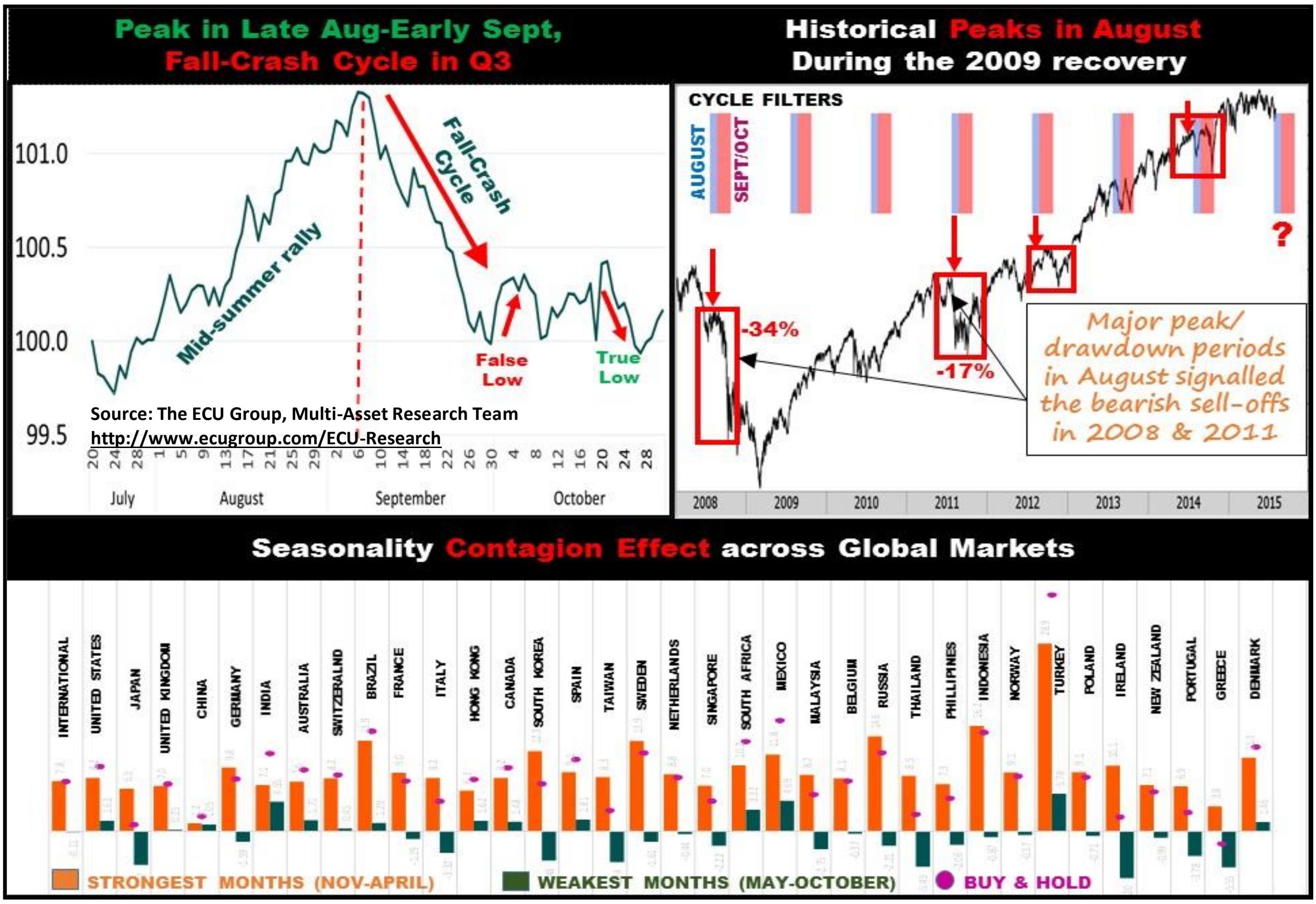
Another topping scenario could be **a failed new high, pressured by an exhausted market.** This would be very bad for leveraged investors that get trapped into a false upswing, only to realize the weight of the market reverses against them. Both the Dow Jones Industrial or/and S&P500 could be likely candidates here, having yielded flat year-to-date performances. The last and ugliest of scenarios would be **an outright and violent sell-off, especially on already fragile markets.** Strong divergences have been in place for some time across the broad-based stock indices, such as the Russell 3000 and the NYSE, which already have **more than half of their stock constituents underwater, beneath their 200-day average.** Closer to home, here in the UK, the FTSE100 is also vulnerable, trading under its long-term average, while undergoing a massive distribution phase from Y2K, beneath the psychological 7000 glass ceiling.



All topping scenarios, or a synchronized mix of the three, would **lead us into the bearish stage of the larger decennial cycle which is expected during 2016-17**. This is what makes this time so very different, also given the historically overextended nature of the market. At six-and-a-half years old, the resulting bear skew will likely be much stronger this time around. Indeed, to quote an adapted market maxim **"the stronger the market trend, the harder the price fall".**

Ultimately, this peak out in seasonality, not only **marks the end of the shorter-term mid-summer-rally, but also the rather muted, but expected, outperformance of the fifth year of the decade.** Mr. Market should now lead us into the well-known "Autumn (Q3) Fall-Crash cycle" that traditionally unfolds between September and October. The chart below illustrates the shape of this seasonal pattern, which is based on the average performance of over 100 years of back-tested price data on the Dow Jones Industrial Average.

These results tell us the **largest price fall can be expected in September, followed by a volatile rise/whipsaw, then another fall in October,** which traditionally marks the final capitulation "true low" in the market. This is in-line with Robin Griffiths' signature Roadmap cycle schema of *"a price fall, followed by a rise and then the rest of the fall".*



During the latest cyclical recovery since 2009, there have several peak/drawdown periods in August. The largest one occurred beforehand, on **8th August 2008, which marked one of the final major peaks of the Global Financial Crisis, triggering a drop of -34%.** The second largest was an extended drawdown timing window into **early August 2011, with a net fall of -17%,** which triggered a week earlier on 22nd July. Historically, one of the most infamous seasonal anniversaries of this kind was the **peak of the 25th August 1987,** and we all know how that ended. Here, we should also be alerted to the fact that the US equity market (and a few others) have **already broken the pre-1987 crash record of number of days without a simple 10% correction.** This tactical countertrend measure has now **overrun by more than 1000 days.**

Finally, it is also worth noting these annual seasonal cycles are not limited to the US market, or even the western hemisphere, as is often perceived. Closer examination shows that **world markets are impacted by this seasonality contagion effect,** not least, through the negative psychological feedback of profits being wiped out. It should come as no surprise that when the Wall Street Bear starts its stampede, investors from around the world will be able to be feel the herded exit out of the stadium doors.

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