

Looking Beyond the Fear: An Analysis of Sharp Selloffs

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- COVID-19's spread and containment efforts have forced market prices to recalibrate sharply as expectations about different industries and the overall economy have shifted at a breakneck pace.
- This fallout—while new and uncomfortable—represents a tiny part of the market's forward-looking focus.
- Sharp selloffs provide an opportunity to own investments at inexpensive levels under historical conditions that should inspire confidence.

What do stock-market prices tell us? Lately, they've been telling us that investors are afraid. They also suggest that stocks are beginning to look like a bargain.

Putting a Price on Stocks: What's it Worth Today?

Academics characterize stock markets as forward-looking discounting mechanisms. More simply stated, this means that, as a collective group, investors use all available information about the future in an effort to put a value on a company.

This exercise—in which forward-looking expectations produce a current price—is known as discounted earnings analysis. It's based on the idea that we can determine the current value of a future payment or income stream by “discounting” it backward through time at a pre-determined rate. Scaled up from individual companies to the market level, pricing should reflect all available information about the future earnings potential of the market, serving as a partial proxy for the economy.

Rapid Repricing Resembles Panic

Armed with this understanding of how new information gets factored into prices, we can sympathize with the

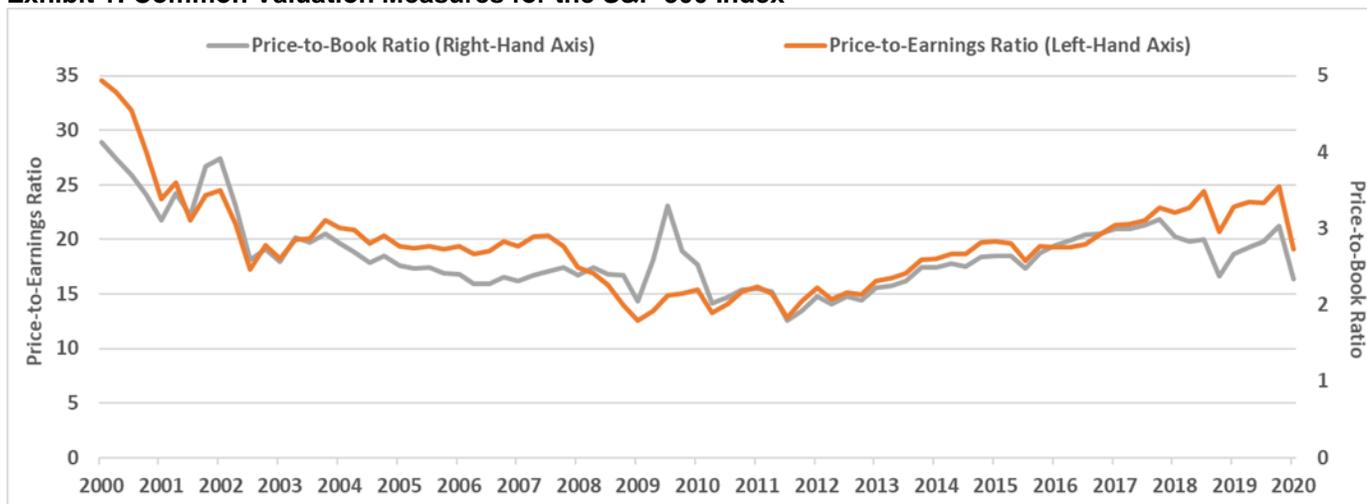
challenge presented by a quickly evolving (or deteriorating) environment. The onslaught of developments presented by COVID-19's spread and a simultaneous collapse in oil prices has forced financial markets to recalibrate prices sharply as expectations about different industries and the overall economy shift at a breakneck pace.

What's it Worth in the Future?

One way to think about the market's forward-looking focus is with well-known metrics like the price-to-earnings (P/E) or price-to-book (P/B) ratios. The S&P 500 Index had a forward P/E ratio of about 15 on March 25, 2020, meaning that investors must pay a price equal to 15 times the estimated annual earnings of its constituent companies to buy them. That's the next 60 quarters of earnings.

There's some reassurance in the fact that a COVID-19-containment-induced earnings recession is generally only expected to last a couple quarters or so. If market prices are based on the next 60 quarters, then this fallout—while new and uncomfortable—represents a tiny part of the market's forward-looking focus.

Exhibit 1: Common Valuation Measures for the S&P 500 Index



Through March 25, 2020. P/E ratio uses 12-month trailing earnings and P/B ratio uses latest quarter's values. Source: Bloomberg

Not Quite a Silver Lining

A couple quarters of poor earnings are not going to create permanent damage for a well-designed long-term investment strategy. But we understand that it's also not going to make investors feel better about the value of their accounts today.

The aforementioned ratios are fundamental measures used to help determine the underlying value of a stock, index or market. They tell us whether an investment is cheap or expensive according to a given measure. They don't, however, make any claim about the future direction of prices over any specific time frame.

Technical measures, on the other hand, track the price of a stock, index or market as a standalone measure. Technicals use historical prices and patterns to help develop forward-looking expectations about price direction.

Sharp selloffs can produce what market technicians describe as "oversold" levels. We can use the 200-day simple moving average (that is, a stock's average price over the last 200 days) as a measure of whether the math suggests that it's oversold, or has fallen too far, too fast.

If we look at the price of each constituent stock in the S&P 500 Index relative to its own 200-day moving average, we can estimate the extent to which U.S. stocks are oversold.

Exhibit 2 shows the historical track record 6 and 12 months after the date when 90% of S&P 500 Index constituents first pierced their respective 200-day moving averages on the way down. This study goes back to the Crash of 1987 and the latest 90% trigger took place on March 12, 2020.

We can see that the S&P 500 Index was positive six months later in every case except the Global Financial Crisis from 2008 to 2009. Looking out 12 months from the 90% threshold, however, shows positive performance in every case.

SEI's View

While past performance is no guarantee of future results, we think the math contains an important message for investors. All of the available information right now has compelled investors to push stock prices to their cheapest valuations in years (four years according to the P/E ratio and eight years according to the P/B ratio).

Furthermore, as the oversold indicator suggests, these types of technical conditions have historically preceded positive turnarounds.

While math and logic don't always look correct over short time frames, sharp selloffs provide investors with an opportunity to own stocks at inexpensive levels under historical conditions that should inspire confidence. Looking beyond the fear with a critical eye will enable investors to see the opportunity that's beginning to take shape.

Exhibit 2: Historical Evidence Shows that Oversold Conditions Are Typically Followed by Positive Turnarounds

| Date of 90% Threshold Breach | S&P 500 Stock Price Change 6 Months Later (%) | S&P 500 Stock Price Change 12 Months Later (%) |
|-------------------------------------|--|---|
| 10/19/1987 | 14.0 | 24.3 |
| 8/23/1990 | 18.2 | 28.4 |
| 7/19/2002 | 3.6 | 16.6 |
| 10/7/2008 | -13.8 | 7.0 |
| 8/8/2011 | 20.8 | 25.3 |
| 12/24/2018 | 28.2 | 37.0 |
| Average % Change | 11.8 | 23.1 |
| Median % Change | 16.1 | 24.8 |
| 3/12/2020 | ??? | ??? |

Average and median calculated using the 6- and 12-month performance for each of the 10/19/1987-12/24/2018 data points.
Source: Ned Davis Research, SEI

Important Information

There are risks involved with investing, including possible loss of principal.

Index returns are for illustrative purposes only and do not represent actual investment performance. Index returns do not reflect any management fees, transaction costs or expenses. Indexes are unmanaged and one cannot invest directly in an index. Past performance does not guarantee future results.

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