

A LOOK AT FEAR AND GREED IN EQUITY MARKETS

How much bad news has already been priced into U.S. shares?

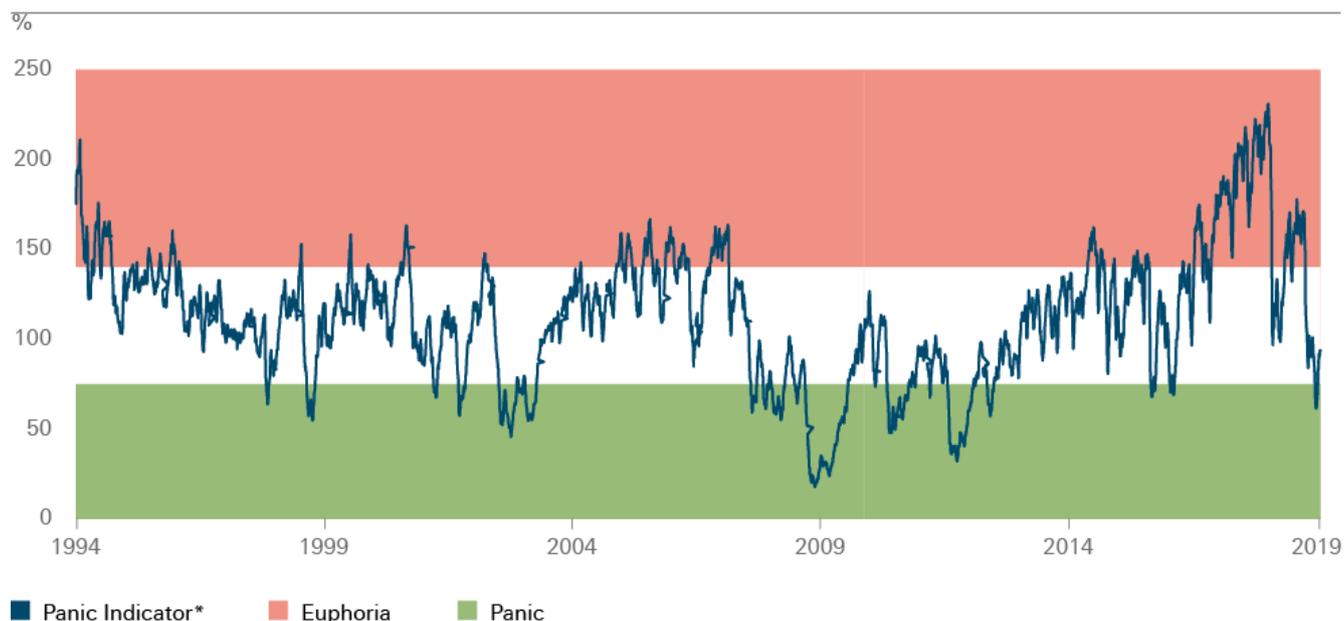
Old hands in markets know that in the long run, doing well has as much to do with disciplining yourself as it does with disciplining any particular insight that you might have. Fear is one of your enemies. When everyone else is panicking, it can often be a good time to pick up assets on the cheap. But instead, it may be tempting to panic and sell. Conversely, it is hard to resist the greed after a good run – it might be tempting to hold onto shares or increase exposure. The snag is that a lot of good news might already have been priced in.

Our Chart of the Week depicts one useful way to think about both dynamics in U.S. markets. Think of it as a value-to-fear ratio (panic indicator). It simply divides the S&P 500 trailing price-to-earnings (P/E) ratio by the volatility index (Vix). The Vix depicts the volatility implied in derivatives markets and is frequently used as a gauge of how fearful – or complacent – U.S. equity markets are of the immediate future. Combining that with how profits are shaping up, can help to gain an interesting perspective on the developments of the past few years.

Starting in February 2016 and throughout 2017, the value-to-fear ratio kept climbing. This largely reflected unusually low levels of volatility, rather than unusually high P/E ratios. The U.S. tax cuts passed in late 2017 gave our panic indicator

one final push, as markets priced in higher earnings expectations. Positioning also played a role – when markets get euphoric, investors tend to pile in one final time on trades that worked well in the past.

In recent years, that meant piling into U.S. stocks, in general, and U.S. technology companies, in particular. That made their fall from grace all the more painful during the turbulent year of 2018. Technical factors reinforced the mood shift in markets. For example, the extremely low volatility levels of 2017 made stocks look less risky than they really were. In 2018, the opposite happened. For the tech-heavy Nasdaq 100 Index, value at risk (VaR) doubled throughout the course of last year, forcing some investors to sell into a falling market. Low liquidity around Christmas made matters worse. These incidents combined implied that the panic indicator fell sharply, before stabilizing again in early 2019. Plainly, a lot of bad news has already been priced in. One way for the panic indicator to rise sharply would be if profits shrink sharply, as it happened in 1994. On that front, we remain optimistic. Lately, company earnings have been mixed, but solid enough to meet more realistic market expectations. Recent market strength might yet have quite a bit further to go before it becomes time to worry.



Source: Bloomberg Finance L.P. as of 1/30/19

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GLOSSARY

CBOE Volatility Index (Vix)

The **CBOE Volatility Index (Vix)** is a trademarked ticker symbol for the Chicago Board Options Exchange Market Volatility Index. It is a popular measure of the volatility of the S&P 500 as implied in the short term option prices on the index.

Derivatives market

The **derivatives market** is the financial market for derivatives.

Liquidity

Liquidity refers to the degree to which an asset or security can be bought or sold in the market without affecting the asset's price and to the ability to convert an asset to cash quickly.

Nasdaq 100 Index

The **Nasdaq 100** is an equity index which contains the 100 biggest common stocks listed on the Nasdaq composite index.

Price-to-earnings (P/E) ratio or multiple

The **price-to-earnings (P/E) ratio** compares a company's current share price to its earnings per share.

S&P 500

The **S&P 500** is an index that includes 500 leading U.S. companies capturing approximately 80% coverage of available U.S. market capitalization.

Technical analysis

Technical analysis is a tool used by capital market participants that want to forecast the development of security prices by detecting patterns in past market data such as prices and volumes.

Value at Risk

Value at Risk (VaR) is a term for a measure of risk. The value of the loss of a particular risk position with a given probability within a given time horizon.

Volatility

Volatility is the degree of variation of a trading-price series over time. It can be used as a measure of an asset's risk.

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