Mitch on the Markets

Why Investors Panicking Should Make You Bullish

By Mitch Zacks
Portfolio Manager

Investors are getting increasingly edgy and bearish as stock market volatility continues apace, which is actually having the opposite effect on me – *it's making me more bullish*. In this week's column I'll explain why I feel that way, but first I'll unpack some of the sentiment indicators 'flashing pessimism.'

You can find evidence of investor bearishness/skepticism in many places. Watching the news for one! However, there are also a few sentiment indicators available to give us a good idea of sentiment in the marketplace.

One such gauge comes from The American Association of Individual Investors (AAII). Late last week, they said that bearish sentiment – which is measured as the expectation that stock prices will fall over the next six months – soared 18.4% to 48.9% in just a week's time. The AAII noted that 48.9% is the highest bearish reading since April 2013, and it also marks the 10th straight week that bearish sentiment has been above the historical average.

Similarly, the AAII said that bullish sentiment – which is measured as the expectation that prices will rise over the next six months – fell 17% to 20.9%, its lowest level since May 2016.[1]

Over the last few weeks, investors appear to be responding to the negative sentiment by shifting away from equities and 'running for the exits,' so to speak. According to Lipper, weekly outflows of US-based stock funds hit a record in the week of December 10, and it follows that bonds have outperformed stocks by 8.24% in the 20 trading days leading up to December 18. On a relative basis, this is close to the weakest performance for stocks relative to bonds over the past two years.[2] And as if you didn't need any more evidence of bearish sentiment, I've got one more – investors have been buying puts and selling calls at some of the highest levels seen in two years.

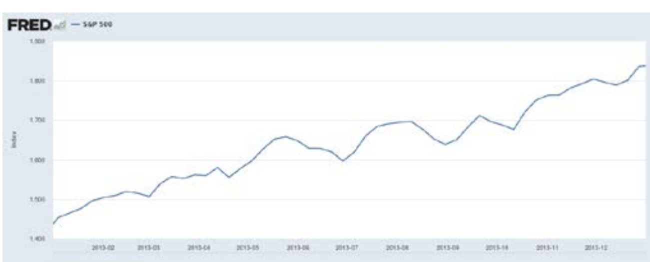
Why This Investor Behavior Makes Me More Bullish

It is fairly obvious that today, pessimism is unusually high and optimism is unusually low. There aren't a whole lot of investors asking what they should buy today, as the conversation is more geared towards whether it's time to sell or go defensive in portfolios.

However, remember the adage that investors should be "fearful when others are greedy and greedy when others are fearful"?[3] I believe that it still applies today! In my view, the current investment environment has all of the classic marks of a correction – a short-term, emotionally-driven pullback with a characteristic disconnect: fear and worry running high with economic fundamentals remaining reasonably strong. That disconnect is precisely what I think we're seeing today.

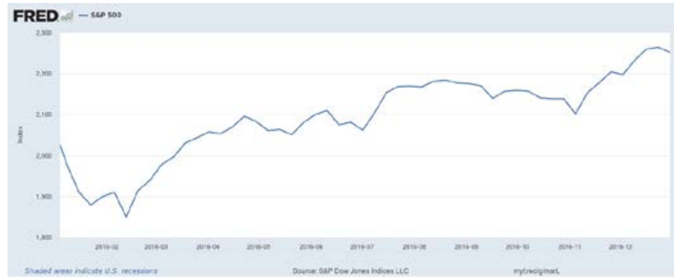
Historical data suggests that bearish investor sentiment is not a good indicator for bearish future returns. Earlier I noted that the last time investors were this bearish was back in April 2013, but take a look at what the S&P 500 did in that year:

As Investors Got More Fearful, Stocks Continued Climbing



Source: Federal Reserve Bank of St. Louis

We saw a similar outcome in 2016. When bullish sentiment in that year dipped to levels as low as we're seeing today, stocks still managed to track higher:



Source: Federal Reserve Bank of St. Louis

Bottom Line for Investors

It's been a difficult few weeks for stock investors, and I empathize with the difficulty of remaining patient as the ups and downs – but mostly the downs – grip the market.

But I believe this volatility has the classic markings of a short-term, emotionally-driven correction, and in such situations historically it has been beneficial to remain calm and focused on the long-term. As the AAII also notes, instances of extreme investor pessimism *have been followed by higher-than-median 6- and 12-month returns for the S&P 500*. Going forward, I think patience will be rewarded once again.

About Mitch Zacks

Mitch is a Portfolio Manager at Zacks Investment Management. Mitch has been featured in various business media including the Chicago Tribune and CNBC. He wrote a weekly column for the Chicago Sun-Times and has published two books on quantitative investment strategies. He has a B.A. in Economics from Yale University and an M.B.A in Analytic Finance from the University of Chicago.

[1] MarketWatch, December 14, 2018. https://www.marketwatch.com/story/stock-investors-havent-been-this-bearish-in-more-than-5-12-years-survey-2018-12-14?siteid=bnbh
[2] CNN Business, December 18, 2018. https://money.cnn.com/data/fear-and-greed/
[3] CNBC, June 30, 2017. https://www.cnbc.com/2017/06/30/buffetts-big-bank-score-proves-be-greedy-when-others-are-fearful.html

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