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What Makes a Stock a Bargain?

As equity prices drop, it's important to remember that valuation alone doesn't make a true bargain. Improving investor sentiment is also crucial.

A drop in price doesn't necessarily make a stock a good bargain. Whether a stock is an attractive buy depends on many aspects of performance. This commentary focuses on valuation and investor sentiment, because they are two of the most prominent and observable dimensions of performance, and they interact with each other in important ways.

Price changes certainly play a role in assessing value, but value is determined by comparing changes in price with changes in stock fundamentals. (Falling prices due to weakening fundamentals do not indicate good value.) It's also critical to compare a stock's value with that of other stocks (and not just with its own history).

Even when these comparisons suggest that a stock is genuinely undervalued, that doesn't mean that it's ripe for investment. Improving investor sentiment is an important signal that a stock's price is likely to realize its true value over time.¹

This is why the Active Quantitative Equity (AQE) team's segment preferences have been quite stable over the last few months, despite equity-market declines. Our headline forecasts and our most preferred and least preferred segments have remained unchanged, although the drivers of those preferences have shifted in a few cases. Here is what has happened in our most preferred segments in the developed-market universe:

- **Technology Hardware, Semiconductors, and Banks** have experienced both declining sentiment and improving value (particularly Banks in regions where our overall forecasts have improved). In Banks, valuations have improved so much that our overall forecast has improved, despite falling sentiment.
- **Telecommunications** have seen improving overall forecasts, driven by improving sentiment, even though the segment is looking a bit expensive.
- **Energy, Pharmaceuticals, Health Care Equipment, and Insurance** are all unchanged in their attractiveness.

For our least preferred segments across the developed-market universe, most of our forecasts are unchanged:

- **Capital Goods** has declined even further in our eyes, mainly due to our sentiment and catalyst signals weakening further, from an already low base.

- **Software** is still expensive, despite looking cheaper on our measures than at the start of the year; it remains one of our least preferred segments.
- Other segments that remain least preferred (i.e., with reasonably unchanged signal preferences) include **Real Estate, Retailing, and Household Products**.
- We have seen a small improvement in the forecast return for **Transport** and **Consumer Services** (both with improving sentiment) and **Media** (a slight improvement in quality), so we are watching these segments.

The biggest changes in our forecasts have occurred in segments that are neither most preferred nor least preferred, i.e., **Autos, Consumer Durables, and Diversified Financials**. Each of these segments has seen deep losses over the last few months, and much worse investor sentiment — which has led to a deterioration in our overall forecasts for these segments.

Bottom Line

A large drop in price doesn't necessarily make a stock look more compelling from AQE's perspective. Even if a stock is looking more attractive on relative valuation, investor sentiment needs to be positive for us to see it as attractive overall. This powerful combination of valuation and sentiment helps us to recognize when an undervalued stock is likely to realize its true value over time.

AQE Sector Preference Summary

Changes in Value, Sentiment, and Overall Forecast, by Segment, Over the Past Three Months As of May 10, 2022.

	Value	Sentiment	Forecast
Most Preferred			
Banks	^	v	^
Energy		^	
Health Care Equipment			
Insurance			
Pharmaceuticals			
Semiconductors	^	v	
Technology Hardware	^	v	v
Telecommunications	v	^	^
Least Preferred			
Capital Goods			v
Consumer Services		^	^
Household Products			
Media			^
Real Estate			
Retailing			
Software	^		
Transport		^	^

Source: State Street Global Advisors.

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Endnote

- 1 It's worth noting that value and sentiment tend to move in opposite directions when price moves are extreme. Deep price drops (generating lower valuations) are often caused by falling sentiment, while improving sentiment can lead to much higher prices (and higher valuations).

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