Here’s What Causes a Market Crash

### Description

The stock market is difficult to understand and can do some surprising and unpredictable things. When there is a market crash, it may seem like nothing makes sense, as often there is a lot of irrational selling of stocks for no real reason.



The stock market is important, though. It gives savers and investors the ability to buy numerous business and grow their capital.

It also present major risks to people who don’t know what they are doing or who neglect well-known investing rules, such as doing thorough due diligence or portfolio diversification.

For those who do understand it and know how to use it to their advantage, the market can do wonderful things. And as technology improves and more products are introduced, the opportunities continue to grow.

One of the toughest things to comprehend about the market is how it can crash so quickly and what causes it.

Markets will almost always crash at a much faster pace than they appreciate, posing major risks to investors who aren’t aware of potential danger.

Here is what you need to know about market crashes.

## Forward expectations

The stock market is naturally forward looking. This is because investors try to predict and guess the future then buy or sell stocks according to their market views.

Because the market is forward looking, major news tends to move markets, even if the effects are stilla long way away. That is precisely what we have seen for the last month of trading. The market istrying to predict what it thinks will happen to companies as the world fights the coronavirus.

## Lower valuation multiples

When it has been established that the economy is slowing and valuations on all stocks are coming down, metrics that are used to give stocks a multiple get reduced to price in the higher risk that is present.

The higher the risk level of the business, the more the valuation metrics will come down. This includes not only industry operations and economics, but also economic strength in a company’s operating region.

## Emotion

The last thing that drives stock market crashes is emotion. It’s also the reason why markets crash so much faster than they rise.

Every time stocks are sold off, fear is present. Depending on the severity of the sell-off, different levels of fear exist.



## Air Canada

For example, a stock like **Air Canada** (TSX:AC) (TSX:AC.B), which may be one of the most affected stocks on the TSX, has fallen by roughly 75% since the beginning of this market crash, for all three of the reasons listed above.

Analysts expect it to have reduced revenue and earnings this year, and that alone, at the same multiples, would drive the stock down. This is a result of forward expectations.

But because the level of revenue and earnings are so difficult to predict, and the situation could end up being much worse, analyst target prices include a reduced multiple.

So, now the lower multiple, along with the lower earnings expectations combine to reduce the stock’s target price even further.

While all this is happening though, fear is taking over in the markets, driving the stock down to oversold levels. Eventually, the company will become undervalued when looking at it from a risk-to-reward perspective. And for those investors who are willing to buy the stock at these undervalued levels, the rewards could be massive.

Looking at four analysts who posted their target price since the beginning of March, Air Canada currently has an average price target of $39. That's 188% upside from its $13.50 price at the time of writing.

## Bottom line

Air Canada is the perfect example of a stock that is oversold out of fear. Of course, there is risk that is present, but, at a certain point, when markets crash, stocks get so cheap that the risk is easily worth the reward.

Identifying companies like Air Canada that have become extremely undervalued, then buying them and waiting for a long-run recovery is the number one strategy to getting rich.

After all, if in just a few short years, everything will be back to normal, and Air Canada will get back to its high of $52 — that's almost a 300% return.

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