TFSA Investors: How Bad Could the Stock Market Crash Get?

Description

The **S&P/TSX Composite Index** lost 280 points yesterday, one of the sharpest declines this year. It's losing points today as well. Canada's stock market isn't alone in this wealth destruction — stocks fell around the world as investors grappled with the long-term economic impacts of the ongoing Coronavirus crisis.

You've probably noticed the sell-off in your Tax-Free Savings Account; this impacts everyone.

Despite yesterday's loss, the TSX Index is still up 2.7% year to date. Over the past 12 months, the market has gained roughly 9.4%. With that in mind, investors may want to ask themselves if yesterday's crash is just a bump in the road for a robust bull market or a signal of an incoming bear market.

To determine that, here's a closer look at the fundamentals.

Stock market to GDP ratio

Warren Buffett's favourite method of measuring valuations is to compare the total market capitalization of a country's stock market to its economic output.

In other words, when the stock market's total capitalization exceeds the annual gross domestic product, stocks are broadly overvalued and exposed to a correction.

In Canada, the market-to-GDP ratio currently stands at 139.5%, according to Siblis Research, which could mean that the market is overvalued by at least a third.

Earnings growth

Stock market valuations are based on the combined earning power of Canadian corporations. If earnings are robust and steadily expanding, investors shouldn't be too concerned about an imminent crash.

Unfortunately, corporate earnings appear to be declining this year; 80% of the TSX listed companies that have reported earnings have seen their growth rate decline to the lowest level since 2015, according to BNN Bloomberg.

However, the **TSX 60 index** is currently trading near an all-time high and doesn't reflect this slowdown in corporate earnings.

In fact, the stock market's aggregate price-to-earnings ratio is 17.6, which is higher than the market's long-term average.

Coronavirus impact

The Ontario Chamber of Commerce says the economic impact of coronavirus has been minimal so far, but could be fully reflected in the next few months.

It's worth noting that China, the world's largest producer and consumer of finished goods, is currently on extensive lockdown.

Several Canadian companies, such as **Dollarama**, rely on Chinese factories for their cost-effective products. Meanwhile, companies like **Air Canada** could be impacted by the downturn in international travel and **Canada Goose** could bear the brunt of lower demand for luxury goods.

Even oil and software stocks could be impacted by China's sudden shutdown. If earnings in 2020 are likely to be lower than expected, the market could be even more overvalued than it appears at the moment.

Bottom line

There are several red flags that seem to be indicating that the Canadian stock market is overvalued. If the market cap-to-GDP ratio or PE ratio revert to their long-term averages or corporate earnings drop because of the coronavirus pandemic, the stock market could lose 20% or more of its value and enter a technical bear market.

Your pessimism is probably justified right now. Your best bet is to buy some excellent stocks when their valuations look attractive, bet on gold funds to protect capital, or simply wait for the storm to pass.

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