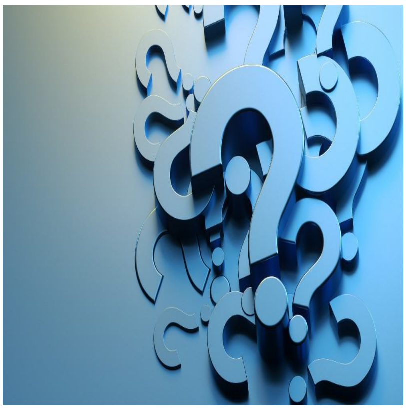

Buffett Indicator: How Much Further Will the TSX Stock Market Crash?

Description

The **S&P/TSX 60 Index**, an index of the 60 largest companies listed on the **Toronto Stock Exchange**, fell 10.6% yesterday. It was the largest single-day stock market crash since 1987, wiping out $298 billion in collective shareholder wealth overnight. The global stock market rout this week is having an impact on everyone, including legendary investor Warren Buffett himself.

Thus far this year the market has been steadily eroding in value. If you'd invested $10,000 in a low cost index fund at the start of 2020, it would be worth only $8,470 today. Such a rapid loss should make even the most passive investors take a closer look to see whether the market sell-off is over or whether the rout has potential to continue.

Here's a look at what Warren Buffett's favourite stock market indicator says about stock valuations and what impact the oil price is likely to have on Canadian investors in 2020.

Buffett indicator for stocks

Warren Buffett once said that the ratio of a country's annual output to the market capitalization of its stock market was the best indicator of valuations. In other words, if the stock market is worth more than gross domestic product (GDP), stocks are overvalued and vice versa.

The indicator was over 100% for years, which could be the reason why Buffett was hoarding so much cash recently.

In Canada, the stock market-to-GDP ratio was as high as 137% before the oil market crash of 2015; it's currently at 105%. That could mean stocks are fairly valued and that investors should consider adding exposure to the **TSX** index in the near term. However, I believe the sudden drop in oil prices complicates this theory.

Oil price

The price of crude oil dropped nearly 30% on Monday, marking its biggest drop since the Gulf War erupted in 1991. That's bad news for Canadian companies and the Canadian dollar.

Oil and gas companies will bear the brunt of this ongoing price war in the global crude oil market. Heavyweights like **Suncor Energy** and **Enbridge** have already lost billions in market value since Monday. Altogether, the energy sector contributes 17.7% of the TSX 60. Also, about 9% of Canada's GDP is derived from crude oil.

In other words, we can expect Canada's GDP to shrink this year if the oil price remains low: a technical recession. This will have a knock-on effect on other businesses. People cut back on spending and the national currency tends to depreciate during recessions, which could mean higher import costs and lower demand for companies like **Dollarama** or **Shopify**.

Investors should probably brace for profit warnings, dividend cuts and perhaps even bankruptcies over the course of this year as corporations adjust to a new reality.

Foolish takeaway

The Buffett indicators measures the ratio of Canada's stock market to its GDP. It's currently at 105% in Canada, which indicates fair value. However, as GDP is expected to fall this year, the market might have to fall even further *to remain* fairly valued.

The stock market crash doesn't appear to be over just yet. Long-term investors should probably wait to buy the dip later. Stay cautious, stay safe, and good luck!

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