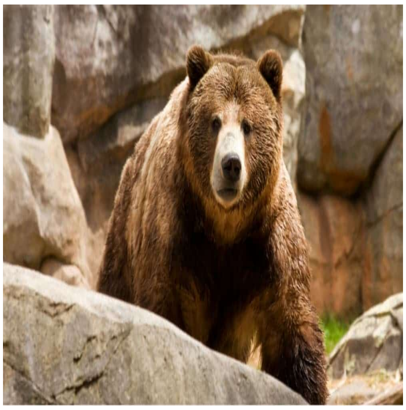

3 Reasons We Could See Another Bear Market in 2020

Description

A 20% decline in stock prices is technically considered a bear market. By that definition, the TSX Index entered a bear market by mid-March. However, stock prices have rapidly recovered since then. In fact, if you'd invested in the index by late March, your investment would be worth 32% more by now.

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It's fair to say investor sentiment has recovered since the height of the crisis. The economy is slowly opening up, and technology companies seem to be performing better than ever before. However, there are plenty of risks on the horizon. In fact, I believe we could see another 20% drawdown before the end of 2020. Here's why.

Stocks are overvalued

There are numerous ways to measure stock valuations, but they all hinge on one key element: earning power. The **S&P/TSX Composite Index** was expected to generate $960 per unit in earnings this year. The index now trades at $14,885, which implies a price-to-earnings (P/E) ratio of 15.5.

A P/E ratio of 15.5 seems fairly reasonable. However, the $960 in earnings were estimated *before* the COVID-19 outbreak. Now, of course, we know many Canadian firms will see their earnings decline substantially. In fact, National Bank estimated the earnings per unit could drop to $692 by the end of the year. That implies a P/E ratio of 21.5.

In other words, the Canadian stock market is overvalued. The market would have to decline substantially, perhaps enter another bear market, to adjust to fair value.

Delayed distress

The Canadian government's stimulus measures have prevented economic chaos this year. Monthly payments to unemployed Canadians, tax relief for small businesses, and mortgage payment deferrals by major banks have all helped mitigate economic misery ever since the outbreak.

However, these much-needed stimulus packages are temporary. Eventually, the government will run out of stimulus checks, and banks will collect the mortgage payments owed to them. If unemployment stays as high as it is now, we could be heading for a “stimulus cliff.”

When consumers struggle financially, businesses experience a decline in sales. This is ultimately reflected in the stock market’s earnings — yet another reason to expect a bear market.

Risk of a second wave

Perhaps the most overlooked risk investors face is a resurgence in COVID-19 cases and a renewed lockdown later in the year. South Korea had to suspend its economy earlier this month after a fresh outbreak of COVID-19 at a nightclub. More recently, China put 100 million people in a northeastern province back under lockdown after cases climbed. Singapore and Japan have had to deal with resurgence as well.

Experts believe a second wave of the pandemic could be much more severe than the first one. If this is the case, even pessimistic forecasts of TSX earnings could be overstated. Any sign of a second wave could plunge stocks into another bear market.

Bottom line

The stock market has surged since the peak of the COVID-19 pandemic. However, stock prices now seem overvalued and could be at risk of correction. The prospect of a second wave and a “default cliff” for the Canadian economy could trigger another bear market before the end of the year. Investors should probably tread carefully.

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