Stock Market Crash Round 2: Is it Happening or What?

Description

In recent weeks, there's been a lot of talk about the possibility of a renewed stock market crash. Big money managers have been saying they think another dip is coming, while investors have continued piling money into the markets. To say we've been getting mixed signals would be putting it mildly. While economic fundamentals show high unemployment and declining consumer spending, stocks are behaving as if they've got their sights on the moon.

What's really going on here?

Typically, bearish stock markets accompany economic downturns. When unemployment is high, people spend less money, so naturally, stocks should fall when the economy is weak. Additionally, this particular downturn has been caused by the forced closure of many businesses. So, it's no surprise that stocks fell initially. Why are they recovering so quickly? A lot of people think the answer is, "for no good reason at all."

I wouldn't be so sure. If we look at history, we see that stocks have a tendency to behave as a "leading indicator," peaking or bottoming before the underlying economy. Viewed in that light, we could read the current stock market as the product of bets on a speedy recovery.

I'll explore that in just a minute. First, though, let's take a look at the case that we *will* see another stock market crash in the year ahead.

Signs pointing to another stock market crash

The biggest indicator that another stock market crash is coming is the fact that stocks were already pricey before the COVID-19 market crash, and now their earnings are lower. According to *MacroTrends.net*, the S&P 500 had a P/E ratio of 23.5 in December 2019. That's higher than it had been for most of the 2010-2020 bull market. It's not a stratospherically high P/E ratio, but it's pretty high.

At current price levels, stocks are likely more expensive than they were last December. We can't compute a P/E ratio for the S&P 500 in Q1 just yet, because not all of the constituent companies have released earnings.

However, we do know that Q1 has been a weak earnings season. Companies like **Air Canada** (TSX:AC) have posted billion-dollar losses while seeing their revenue decline for the first time in years. Once all of these companies have reported their earnings, trailing P/E ratios will be higher than they are now. As a result, we'll have a market that looks overpriced.

Signs indicating otherwise

With all that said, there are plenty of signs pointing to stocks *not* tanking any time soon. One of those would be history. In the early months of the Spanish Flu pandemic of 1917/1918, stocks fell, just like we saw in March. However, they recovered quickly. By October of 1918, the worst month of that pandemic, stocks had recovered completely. Basically, the markets priced in the losses early and priced in the recovery early, too.

We can see in 2020 that the COVID-19 recovery is moving along. States and provinces are already beginning to re-open, and airlines like Air Canada plan to be flying internationally again by winter. There's no *guarantee* that those plans will bear fruit, but things are looking optimistic right now. A second wave of COVID-19 could easily disrupt everything. That's a given. But if the curve has indeed been flattened, then we could expect the economy to recover very soon.

Of course, some specific stocks will fare poorly from here on. To return to Air Canada, that company's management is not expecting to reach 2019 revenue levels again for a *full three years*. It's the same story for AC's Canadian competitors and U.S. equivalents. For at least another year or so, you'll want to stay away from the airlines. But the markets as a whole could be set for further gains.

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