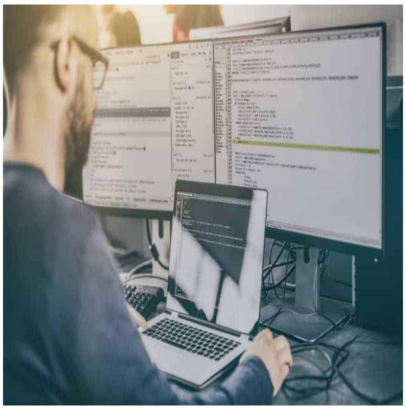

Is the Current Stock Market Rally Sustainable?

Description

The stock market crashed in March, as the outbreak of the COVID-19 pandemic created panic among investors. The **TSX Composite Index** hit bottom on March 23, falling 34% from the start of the year. At that time, there were around 1,300 COVID-19 cases and fewer than 20 deaths in Canada. However, the index recovered over the next three months, even though the number of new cases continued to increase and crossed 100,000, with over 8,400 deaths.

The stock market rallied, even when Canada's GDP contracted 11%, and the unemployment rate rose to 13% in April. The TSX Composite Index rose 37% from its March 23 low but is still down 10% year to date. The stock market is not reflecting the state of the economy. Moreover, its rally is incomplete, as investors are fearful of a second market crash.

This state of uncertainty and optimism leaves a question of whether the current stock market rally is sustainable. But before this, it is crucial to understand the reason behind the stock market crash and recovery.

Why did the stock market crash in March?

A stock market crash comes when speculation goes out of control, and stock valuation is inflated beyond the fundamentals. Uncertainty fuels speculation, as investors are unable to make informed decisions. They react instead of responding. In March, when Canada announced the pandemic-driven lockdown, there was a lot of uncertainty around public health and safety. Everyone, from investors to consumers to businesses, panicked. The stock market has been in its longest bull run from 2009 to 2020, which had stretched the valuation of stocks. The out-of-control speculation around the pandemic and stretched stock valuations in the last 11 years sent the stock market down 30%.

The way market dynamic works, the stock valuation is corrected periodically. The stock market falls 10% every one to two years, and 20% every five to seven years. But it is rare for the stock market to fall 30% and above. The market witnessed such a decline in the 2008 financial crisis. It took the market six years to return to the pre-crisis level.

At the start of the year, stocks like that of **Air Canada** (TSX:AC) and **CGI Group** were trading at their all-time highs, which stretched their valuations beyond their fundamentals. Both companies have high leverage and lower profit. The market sell-off sent the stocks down 60% and 20%, respectively.

Why did the stock market rally in the April-June period?

However, the TSX Composite Index rallied from April onward, even though the economy contracted, as the government injected money into the economy. The Canada Revenue Agency (CRA) started providing $2,000 monthly payment to citizens who lost their jobs due to the pandemic. The government also launched Canada Emergency Wage Subsidy to protect jobs. The central bank lowered interest rates, REITs deferred rent payments, and banks deferred mortgage and loan payments. These stimulus payments revived optimism and stabilized the economy.

Is the current rally sustainable?

The government is funding the stimulus payment with taxpayers' money, and it will last until the economy reopens in June. However, the government extended the stimulus package until August, as the unemployment rate increased and companies struggled to return to business. But these exemptions and stimulus packages are not sustainable.

The current stock market rally has priced in expectation that a cure or vaccine for coronavirus will be found in the next 12 months and life will start returning to normal this fall or early next year. Many companies have taken loans and cut jobs to have sufficient cash to stay afloat until the end of the year.

Another stock market crash is inevitable if the recovery takes longer than expected. Individuals and companies would default on their rent and loan, thereby putting banks under pressure. Many companies will go bankrupt, and new companies will replace them. This entire economic revival will take at least three to five years.

Air Canada stock rose 50% from its March 23rd fall, as the company increased its liquidity by $3 billion. The investors have priced in expectation that the air travel will begin this fall. The stock will see another sell-off if international travel demand takes longer to recover, and the company defaults on payments.

Another stock market crash is inevitable. Don't rush to buy stocks just because they are cheap. Invest in stocks that are fundamentally strong and can withstand a recession.

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