Market Crash Update: Brace for a Second Market Crash With These Top Tips

Description

Is the worst over? Looking at stock prices lately, one might be inclined to think so.

As investors, we make all sorts of predictions and expectations of future earnings in attempt to place the valuation on a given company before investing. The idea behind analyzing a company is simple based on expected future earnings. In essence, what is the multiple one is willing to pay for those future earnings discounted to today?

Earnings for this year's first quarter has been dismal, as expected. This is due primarily to the COVID-19 related prevention measures. The question now is, how will investors react to potentially two quarters in a row (or three) of terrible results? I will use the earnings results of two of Canada's Big Six banks to highlight potentially extremely bearish narrative.

Companies appear to expect higher losses that investors

Perhaps one of the most surprising elements of this snap back in the stock prices from the March lows we experienced is the broad-based bullish outlook on earnings across the board. Investors seem to be brushing off what many companies are explicitly telling us.

For example, **Canadian Imperial Bank of Commerce** (TSX:CM)(NYSE:CM) saw its net income decline by more than 70% as loan loss provision soared. Across the board, large Canadian banks have raised these provisions to levels which some investors saw as unnecessarily high.

Some viewed this as overly conservative. Others brushed this off as unrealistic. They hold the view that the Canadian economy will lead the G7 in coming out of yet another recession relatively unscathed. These warning signs have not slowed down capital inflows into equities of late.

One of CIBC's peers, **Bank of Nova Scotia,** recently reported a profit beat. This was despite a doubling of loan loss provisions. In addition, this was supplemented by a statement that less than 5%of the bank's loans were likely to be considered high risk to delinquencies as a result of the COVID-19 pandemic. This is a bullish narrative for investors.

Impact of CERB

Personally, I think investors are missing the big picture right now with respect to earnings expectations. The Canadian government CERB program is one of many similar programs launched globally to keep the underwater (and in some cases highly insolvent) public liquid enough to pay bills and continue spending in the short term.

New debt creation once these stimulus measures are lifted is likely to be muted. Canadians banks' earnings are going to be one of the canaries in the coal mine investors need to pay attention to. When borrowing slows as credit quality deteriorates, economic performance will suffer.

I view these recent earnings results by Canada's large financial institutions as overly aggressive. Further, I believe much more pain is likely to be on the horizon, contrary to popular opinion.

If this is true, we will indeed experience another couple rounds of earnings declines broadly. I think investors will be forced to reassess their valuation models. Also, they'll be forced to admit how overvalued most stocks are right now on a fundamental basis.

Stay Foolish, my friends.

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