Market Crash Alert: How the Cannabis Bubble Affects All Stocks

Description

Investors that have lost their shirts with various Canadian cannabis stocks over the past year can attest the pain of a bubble and stock prices. Valuations are now at levels that, by some metrics, are at all-time highs. Therefore, investors ought to be more cautious with making large investments in any company right now. In this article, I'm going to discuss some of the lessons learned from the cannabis bubble, which we saw pop recently.

Earnings matter

The "growth-at-any-price" investment mandate of so many momentum investors in 2018 and 2019 led to valuation increases. In hindsight, these increases were absurd for cannabis stocks. Expectations of revenue growth and eventual profitability in a year or two (this year or next) determined stock prices rather than fundamentals.

Cannabis producers were scrambling to acquire production capacity at any cost. They had no regard for profitability at the time. There was a marked shift in investor sentiment related to the weaker-than-expected revenue growth. This was ultimately tied to demand that did not materialize. Subsequently, stock prices plummeted. As many investors have seen, some cannabis producers have seen stock price declines north of 90% from their peaks.

The overall stock market today is by no means as irresponsibly priced as the cannabis sector was 18 months ago. That said, some of the same concerns of growth expectations being way too bullish and demand failing to materialize are real.

The rebound in demand for almost any good right now that is being priced into the stock market is, in my opinion, unrealistic. Investors should pay attention to the structural economic issues that are likely to influence earnings when making assessments of the value of any company.

Cost cutting is not bullish

As we have seen with one of Canada's largest cannabis producers, **Canopy Growth**, cost cutting has become the name of the game in the cannabis sector. Instead of adding production capacity, companies like Canopy have been shuttering plants and laying off workers. Their goal is to widen margins and produce cash flow and profitability sooner.

The sharp fall out of expected demand has created an environment in which survival has become the primary goal of management teams across the sector. Even these management teams have seen significant turnover of late.

I expect we'll see similar measures take hold in a swath of sectors in the coming quarters. Consumer and corporate demand for goods and services will flatline or decline. This potential spiral, similar to the one experienced in the cannabis sector, would be structural.

This means monetary and fiscal stimulus measures would likely not have the desired impact investors today are banking on. A reduction in the efficacy of government intervention in the economy is not in any way priced into the stock market right now. Lowering interest rates to below zero, for example, is unlikely to persuade a company to hire back thousands of laid-off employees. However, you couldn't tell that by watching how stocks react to stimulus news.

Stay Foolish, my friends.

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