Warning to Investors: “COVID-Proof” Stocks Are Getting Too Expensive!

Description

In recent months, investors have been showing a keen interest in stocks perceived to be immune to the financial effects of COVID-19. The pandemic has ravaged vulnerable industries like airlines and hotels, while hitting the broader economy through unemployment and lower retail sales. In this environment, most industries are getting hit hard. Accordingly, investors have piled in to equities seen as “immune” to the contagion.

This strategy makes sense in theory. If COVID-19 lockdowns are going to damage the economy, it’s logical to invest in companies that are less exposed to the damage. These include tech stocks and “essential service” companies. So far, investors have done well with tech stocks and, to a lesser extent, with essential service stocks like **Costco.**

The problem now is that a lot of these “COVID-proof” stocks are getting too expensive. With bond yields low and travel/retail companies still in shambles, investors have piled into stocks that are perceived as being safe. While the underlying companies are, in many cases, great, the stocks’ valuations have gotten unrealistic. We can illustrate this by looking at two generally excellent companies whose stock prices are getting steep.

CN Railway

Canadian National Railway (TSX:CNR)(NYSE:CNI) is a great company by any standard. It has an edge in long distance North American freight transportation, backed by its huge three-coast network. It has grown its earnings considerably over the past decade and typically generates high returns on equity.

In the first quarter, which saw one month of COVID-19 lockdowns, CNR grew its earnings by 31%. In the second quarter, adjusted earnings fell 27% and revenue fell 19%. The earnings number was a slight beat, exceeding analyst expectations by 2%, but revenue missed. The brightest spot in the report was free cash flow, which grew to $1 billion from $495 million.

The markets apparently took these results well, as CNR rallied the day after they were released.

However, it's a bit odd to see a stock race to all-time-highs after a 27% earnings decline. To be sure, the company did better than many others — particularly airlines and energy companies — in the first half of 2020. But its recent results don't suggest that it's worth more now than it was before COVID-19 began. Perhaps CNR's recent gains are a product of investors rushing into stocks that at least aren't *losing* money. Either way, it has gotten expensive. As a CNR shareholder myself, I'd wait for a dip before buying more of it.

Cargojet

Cargojet (TSX:CJT) is another good company that has gotten expensive in the aftermath of COVID-19. It's a cargo airline that has grown thanks to its relationship with the e-commerce industry. E-commerce is seeing incredible growth, and CJT ships a lot of e-com packages. That helped contribute to a solid Q1 earnings beat.

There's no doubt that CJT is a great company. The problem is that Wall Street is well aware of that fact and has bid it up to more than 200 times earnings. That's an extremely high P/E ratio for an airline, even one that grew adjusted earnings by 24.5% in its most recent quarter.

Foolish takeaway

There's a lot of hype these days about "COVID-proof" stocks that can survive the current headwinds. It's rational to think that way. The problem is that most stocks that have benefited from this thinking have gotten too expensive. The two stocks mentioned in this article are great examples. The underlying companies are great, but you might want to see cheaper prices before buying.

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