Why Are TSX Stocks Rallying Despite the Economic Collapse?

Description

The early months of the COVID-19 pandemic saw an economic downturn unlike anything in recent memory. The U.S. second quarter GDP decline of 33% was worse than any in the great recession, and Canada's numbers are expected to be similar.

In the midst of all this, **TSX** stocks have actually been rallying. Not only have they walked off most of their COVID-19 losses, but they're even approaching all-time-highs. In the midst of all the economic devastation we've been seeing, many people have been questioning whether the stock market gains are justified. With GDP tanking and unemployment at record highs, it's hard to see why stocks are worth more than before.

To be sure, not all economic indicators have been bad. In June, Canada gained nearly one million jobs, while the U.S. gained four and a half million. However, these gains still don't take us back to pre-COVID unemployment levels, raising the question of how long the economic recovery will really take.

Winners and losers becoming more obvious over time

When comparing the stock market to gross domestic product (GDP), you have to keep one thing in mind:

The stock market is based on *future expectations*, not *today's conditions.* Investors make bets on where companies are going to be tomorrow, not where they are today. As a result, the stock market serves as a leading indicator, moving before the underlying economy does.

So the stock market action we've been seeing lately isn't necessarily irrational. Most of the gains have been driven by sectors like tech that stand to recover quicker than others. In the second quarter, **Shopify Inc** (TSX:SHOP)(NYSE:SHOP) posted its best results ever, with 97% year-over-year revenue growth and positive GAAP earnings.

A company like that doesn't need to worry about being out of business long term because of COVID-19. So there's no reason for its stock not to rise. Long-term unemployment could hit its sales somewhat, but it clearly won't be "out for the count" like, say, **Air Canada.**

"COVID-proof stocks" getting expensive

However, are some reasons to tread carefully in today's market. One of the big ones is that stocks perceived as being COVID-proof are now getting extremely expensive. Last week, the world's largest tech companies released their earnings, and they almost all soared to all-time highs after the news was released.

Shopify was one of the stocks that benefitted from the jump. While Shopify is actually cheaper relative to earnings now, thanks to its Q2 blowout, many tech stocks are getting pricier than ever before.

In fact, even some companies that got hit by COVID-19 are getting pricey. For example, one of my favourite stocks, **CN Railway**, now trades at $130 at writing–a price I find hard to justify given its iffy Q2 performance. I'm still holding it because I think it has solid long-term prospects, but I wouldn't buy more at today's prices.

Foolish takeaway

In 2020, we're seeing a remarkable divergence between the stock market and the underlying economy. On the one hand, the economy is shrinking; on the other, stocks are rallying to all-time highs.

To an extent, this is a product of stocks' tendency to behave as leading indicators. Nevertheless, this is a market where you'd be wise to tread carefully.

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