COVID-19: Stocks to Avoid Before a 2nd Wave

Description

The coronavirus crisis has wreaked havoc on an otherwise healthy world economy in the first half of the year. With fears mounting over a potential second wave that could spark another round of reopening rollbacks and shutdowns, investors should be ready for panic to grip the markets once again. Unlike back in the dark depths of early March, though, the U.S. Federal Reserve (the Fed) is standing by with an arsenal of monetary tools that can be implemented should the selling get out of hand again.

"The Fed has our backs" is not a sound investment thesis

That's not to say the Fed will prevent a slow and steady fall into bear market territory, though. While we're unlikely to suffer a steep +30% market crash in a matter of weeks, one should have a backup plan in case the market grinds lower into year-end. Bear markets can be prolonged and painful, much like this pandemic. Should we be in for a slow and steady decline and not a vicious market crash that sees the averages making record point falls on the daily, one shouldn't expect the Fed to hold an emergency meeting to limit the damage done to the equity markets.

A healthy balance sheet and ample liquidity are a must amid COVID-19

Until a safe and effective vaccine is widely available, one should expect choppy market waters to persist, with COVID-hit industries standing to take a brunt of the damage once again. If you're looking to prepare for a potential second wave of COVID-19 cases, I'd urge you to analyze a firm's balance sheet to ensure sufficient financial flexibility not only to avoid the risk of insolvency amid a worsening of this crisis, but to steer clear of longer-lasting damage to the fundamentals in the form of business erosion.

Limited financial flexibility could cause a firm to pull the brakes on long-term growth initiatives, and that could stunt a firm's growth for years after this pandemic concludes. After you've spotted a firm with a decent balance sheet, you should also analyze the resilience of the said firm's operating cash flow stream and how it will hold up during this pandemic and the recessionary (or depressionary) environment that could last years longer.

Resilient operating cash flow streams are also highly desirable

A good liquidity position is desirable, but if the firm is burning cash at an alarming rate, the liquidity position could erode, and insolvency could become inevitable if this crisis drags on longer than most folks expect. **Air Canada** is an example of a liquid firm with a severely pressured operating cash flow stream that's unlikely to recover in the "new normal sustainably." You can raise as much liquidity as you want, but if operating cash flows aren't at (near) normalized levels, it may be uneconomical to stay in business over the long term. **Cineplex** is another example of a company with a decent balance sheet but a crippled operating cash flow stream that's unlikely to bounce back as long as the insidious coronavirus is still out there.

The Foolish bottom line on investing in the COVID-19 pandemic

If you seek to limit your damages for the next leg of this sell-off, I'd urge you to have a strong preference for liquid firms with resilient (enough) operating cash flows in the face of this pandemic and the recession it'll leave behind. While upside may be massive for firms under financial distress, I'd urge prudent investors to steer clear of such names, unless they understand the risks and have a portfolio that's otherwise well diversified to the risks brought forth by COVID-19.

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