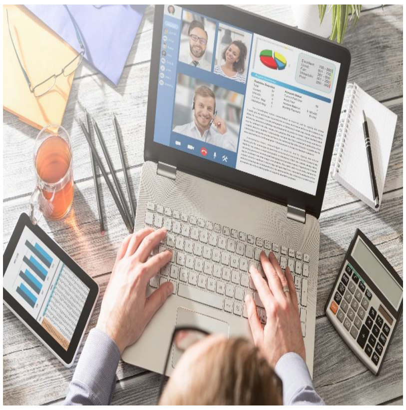

Market Crash 2.0: Don’t Make These Mistakes Warns Buffett

Description

There were many firsts for Canadians this year. For the first time, there was a nationwide lockdown, double-digit unemployment rate, generous cash benefits, and economic slowdown. Despite an economic crisis, the stock market rallied riding on the tech bulls. This was a rally that even Warren Buffett feared to jump into. The famous Buffett Indicator showed that the stocks were overvalued, warning of a market crash 2.0.

How correct are Buffett indicator’s warnings?

The Buffett indicator measures market capitalization to gross domestic product (GDP). A ratio of over 100% indicates the stocks are overvalued. His indicator proved right in the 2000 dot.com bubble and the 2009 financial crisis. But is it right for the pandemic crisis?

The Buffett indicator has been above 100% since 2014 and has been rising ever since. The indicator just hit a peak of 160% in December as the pandemic accelerated the stock rally to unprecedented levels. This shows that the Buffett indicator may not be the right measure to predict the market. But it does helps you take a calculated risk and avoid making expensive mistakes where your portfolio could go negative.

Buffett warns against making two mistakes

The COVID-19 pandemic accelerated the adoption of technology, pushing tech stocks to sky-high valuations. The rally was fuelled by the money the government injected into the economy through the fiscal stimulus package. The rally will end and when the stimulus money dries up.

Some analysts and investors warned about the formation of a tech bubble. Even if you disagree with these analysts, there is no harm in staying cautious. Buffett warns against making the two biggest mistakes that could leave you in negative if there is another market crash.

Don’t buy growth stocks at their pandemic peak

Don’t make the mistake of investing in stocks like **Shopify** (TSX:SHOP)(NYSE:SHOP) and **Kinaxis** (TSX:KXS) at their all-time highs. These stocks were the biggest beneficiaries of the pandemic, rallying 195% and 132% from April to September 1. However, their rally faded as the economy reopened, and the government replaced Canada Emergency Response Benefit (CERB) with Canada Recovery Benefit (CRB).

Investors had valued Shopify and Kinaxis stocks for the next eight to 10 years. Those who purchased these stocks at the end of August have made losses on their purchases. These stocks are down 9% and 18%, respectively, from their September highs. These stocks have strong fundamentals and significant growth potential, but their high valuations have limited their upside. It will take them a year or two to surpass their pandemic highs.

If you want to buy these stocks, wait for a market correction. Shopify’s ($1,200-$1,450) and Kinaxis’s ($180-$210) stock price rally has become rangebound. Buy these stocks when they fall below the lower end of the range. That way, you will have upside potential.

Buffett generally doesn’t invest much in tech stocks or stocks that have a high valuation. He invests in stocks that have low value and significant potential to grow in the next 10 years. As the above tech stocks didn’t meet the value criteria, he did not invest in them. Rather, he invested in the Initial Public Offering (IPO) of cloud-based data warehousing platform **Snowflake** in September. In three months, he gained over US$1.28 billion on his US$735 million investment.

Don’t miss good dividend stocks at their pandemic bottom

A market crash is like a gold mine of value stocks. Many energy stocks lost significant value in the pandemic crisis as oil demand plunged. But Buffett has lived in a world where oil price always recovers. He played his biggest pandemic bet of US$8 billion by acquiring **Dominion Energy’s** natural gas transmission business.

You can play a similar bet with **Enbridge** (TSX:ENB)(NYSE:ENB), which lost 35% value during the pandemic as oil demand dipped to an all-time low. Oil companies reported losses and even cut dividends, but Enbridge did not. Hence the dip in stock price inflated its dividend yield above 8%. As the economy showed signs of recovery, the stock surged 22% from its pandemic low.

Foolish takeaway

If there is another market crash, Enbridge’s dividend will remain stable, and tech stock will rally to their pandemic peaks.

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