A Periodic Correction

April 15, 2024

A bull market in stocks began in October of 2022 and, by some measures, has set records for longevity. As of the end of March 2024, all three major market indices, the S&P 500, the Dow Jones Industrial Average, and the NASDAQ all experienced record highs. During the first quarter of 2024, several of the lesser-known indices began to catch up. History tells us that strong equity markets precede a strong economy. Today, this relationship was reinforced with a sharp 0.7% increase in retail sales for March, well ahead of the consensus forecast of 0.3%. Ex-Autos, the retail sales were up 1.1%. February retail sales were also revised higher. Additionally, the current GDPNow economic forecast for the first quarter was raised to 2.8% versus a previous estimate of 2.4%! After five quarters of a strong stock market and no signs of the forecasted recession, history tells us that the market needs a breather. A correction is another name for such a rest when we see the general indices decline somewhere between 10-20%. The so-called Magnificent Seven is now the Fantastic Five, as one by one the mega-cap stock leaders fall by the wayside. If we get a correction, growth stocks and companies with poor earnings outlooks will likely suffer the most.

A leading contender for the spoiler of the rally is the surprise increase in interest rates this year. The 10-year government bond, a good indicator of where interest rates are going, has risen from a low of 3.88% to 4.63% at this writing, a gain of 75 basis points! The first quarter market rally seemed to be based on the expectation that inflation would continue downward, and that the Fed would begin to lower the fed funds rate in 25 basis point increments for the balance of this year - perhaps as many as four times. Add in the surprise runup in oil prices and the short-term measures of inflation that turned upward. Commodities' prices, especially gold, moved up along with oil prices. The latter move is good news as a broad increase in commodity prices suggests the economy continues to expand.

Hostilities between Israel and Iran could give impetus to a stock market correction depending on how much further these aggressions expand. Then there is the ongoing war in Ukraine where there appears to be no settlement in sight. On the other hand, what may blunt a serious correction in prices is the prospect of a continued increase in corporate profits. Also, the dollar is hitting highs not seen since late last year, primarily on the back of a weakening Japanese yen. When the dollar strengthens, import prices tend to fall, helping to keep inflation in check.

Even if the economy looks good, why are there stock market corrections? Investors might look at short-term gains and decide to take profits and sit on the sidelines during uncertain times. We tend to believe some investors may keep the decline shallow if corporate earnings come in better than expected. A larger correction could come later in the year when seasonal factors plus volatility surrounding the election become evident.

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