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COMMENTARY

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Market Correction Coming? Plan Ahead

- Given strong 2020 market returns and rising headwinds, a market correction is possible.
- Market corrections are a normal part of investing and can be used as an opportunity.
- Being prepared before and during a market correction is very important.

When the overall economy is doing well, companies sell more goods and services, corporate earnings increase, and investors buy the shares of these companies. Unprecedented fiscal and monetary stimulus that supported a sharp economic recovery in the latter half of 2020 helps to explain the very strong investor sentiment that has powered the nearly 60 percent stock market rally off of the March 2020 lows. As markets rise and valuations expand, investor optimism may be pricing in perfection, increasing the likelihood of a market correction. As we note in our 2021 Market Outlook, we believe the economic recovery will remain uneven in the near-term.

There are many indicators, in our opinion, that suggest a near-term market correction is possible. These include high overall stock market valuations, market sentiment that is too bullish (the S&P 500 currently trades about 15% above its 200-day moving average and the latest Investors Intelligence sentiment survey, a contrarian indicator, shows the widest spread between bulls and bears since Jan 2018), recent signs that economic data is starting to slow, increasing COVID-19-related restrictions, and uncertainty around vaccine distribution. Investors have been very optimistic since the last market correction (September 2020) and some of these concerns could easily reverse market sentiment.

While a market correction is possible, keep in mind that they are not as alarming as the name suggests. In general, a market correction is a stock market decline that is more than 10 percent from highs. Though we anticipate a possible correction, in the imminent future, we do not foresee another bear market where stocks fall 20 percent or more from their highs. Significant fiscal and monetary stimulus should offer near-term downside protection. A correction can turn into a bear market when investor worries increase and lead to a broader and deeper market selloff. Historically, there are many reasons that have caused market corrections:

Earnings disappointment. When a company misses its earnings expectations or reduces its earnings projections, investors may be disappointed and could sell the shares of that company. If enough investors sell many companies, it becomes a correction.

Non-stock market factors. Like we have seen when our economy has shown signs of heading toward a recession, a non-market, or economic factor, could cause a correction. Using the earlier analogy, a downshift in expected economic growth could affect the ability of companies to sell goods or services. If investors begin to anticipate weakening economic growth, they may sell shares in advance of the actual weak economy coming to fruition.

Momentum breaks down. Some investors tend to follow stock trading patterns and have identified trends that they feel indicate an impending correction. If enough feel that way, it can become a self-fulfilling prophecy. For example, we have seen that when the S&P 500 trades at least 11% above its 200-day moving average, the index has had a correction or, at the minimum, traded sideways.

Profit-taking. There is an adage: "trees don't grow to the sky." Sometimes, a stock has performed so well that investors become concerned that future appreciation is priced in and they sell shares. This is classic profit-taking.

If a market correction does occur, some tips on what to do in a market correction are as follows:

Review your holdings. Look for new potential opportunities to buy equities. Stocks that may have been too expensive before, may be more attractively priced. Because a correction tends to hit the entire stock market, in some cases, you can upgrade your stocks to better quality ones.

Utilize active money managers. Active money managers tend to buy equities based on their research (as opposed to an index manager that buys all stocks at index weights). During a market correction or a volatile market, an active manager should be able to use their investment resources to find better potential opportunities.

Take a deep breath. According to Ned Davis Research, a market correction occurs on average about every 167 trading days (about every eight months). Market corrections are a normal part of the stock market. They have happened in the past and they will be a part of the future. Consider this, according to J.P. Morgan Asset Management, the S&P 500 has been positive in 30 of the past 40 years but the average intra-year loss in this index is -13.8%. This suggests that the stock market is positively biased and market corrections are a normal part of the stock market.

Market corrections are a normal part of investing and there are steps that you can take to possibly mitigate the negative effects. Even before a market correction, you should review your financial plan to make sure that you are not too aggressive or too conservative in your investment portfolio. The ability to maintain a long-term investment plan is most important and having a financial professional review your time horizon, risk tolerance, and liquidity needs is important.

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A diversified portfolio does not assure a profit or protect against loss in a declining market.

The S&P 500 is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.