Should You Be Worried About the Recent Stock Market Correction?

Description

On February 2, U.S. stock markets began to plunge, followed by the **S&P/TSX Composite Index** and then by markets all around the world. This global equity sell-off fueled the fear of seeing the entire economy sink into a recession, like the one we had in 2008.

Now that the dust has settled and that markets are up again, let's try to understand what happened.

Concerns about inflation and rising interest rates

A job report released on February 2 showed that unemployment is historically low. With more jobs open than people available to fill them, companies are raising wages to retain existing employees and attract new ones. They will eventually have to pass those raises on to customers by rising prices, thus creating inflation. The Fed combats inflation by raising interest rates.

The Fed raised interest rates three times last year and is planning to raise them three times again this year, but at a slow pace. The next rate hike is expected for March. But with inflation rising faster than expected, investors are concerned that the Fed will raise rates faster and more often than planned.

This has fueled widespread concerns that markets were stretched after a sharp rise in the past year, which pushed many indexes to record highs. Stock market analysts warned that the stock market might be a bubble, and that a correction could be coming soon. Many stocks were overvalued, and a pullback would make them cheaper and more attractive, especially if the underlying companies are healthy.

Some also question the possible role of computer-driven algorithmic trading in the sharp declines or even the ramifications of the rise and fall in the value of cryptocurrencies such as Bitcoin.

On Valentine's Day, data was released that showed cored inflation posted its biggest gain in a year in January, stoking fears of faster-than-expected increases in interest rates. Data also showed an unexpected decline in retail sales, suggesting the U.S. economy may not be as strong as we thought. Markets fell at the beginning of the day, but then went up.

Rising interest rates make stocks less attractive

Rising interest rates increase the cost of borrowing. Therefore, companies pay more interest on their debt, which reduces their profits and brings down their share price.

In past years, bond yields have been very low. Investors seeking a decent return preferred to invest in stocks. But bond yields have risen in recent weeks. As bond yields start to rise, investors have been selling stocks to invest in bonds because they are a safer investment.

Utilities, telecom, and REIT stocks are particularly impacted by rising bond yields. **BCE Inc.** (TSX:BCE)(NYSE:BCE) and **Hydro One Ltd.** (TSX:H), while having high dividend yields of 5.1% and 4.2%, respectively, are less attractive to investors when they can find bonds offering similar yields. Since BCE and Hydro One carry high amounts of debt, rising interest rates will increase their borrowing costs and thus negatively impact their earnings. Therefore, investors will generally prefer to invest in less-risky investments like bonds.

Fear was overdone

As you can see, the global sell-off was caused by panic driven by concerns of faster-than-anticipated rate hikes.

The fundamentals of the global economy and corporate earnings growth remain strong, so the pessimism was exaggerated.

We haven’t seen a bear market yet, as it would take a drop of more than 20% in indexes. A drop of 10% is a correction. There could be other market corrections coming, but that doesn’t mean a bear market will follow.

If there are other declines like the one we had at the beginning of the month, there are hopes that they won’t last long given that global economic growth has accelerated and that the financial system has become more solid since the financial crisis. So, there is no reason to panic and sell all your stocks at this point.

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1. NYSE:BCE (BCE Inc.)
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