Stocks at Record Highs: Is a Correction Coming?

Description

The past year and a half has witnessed an unprecedented rally in stocks. Ever since the COVID-19 stock market correction, stocks have been rising, setting numerous new highs in 2020 and 2021.

Today, stocks are near record highs. The TSX is only 1.1% down from its highest level ever, and it's the same story for the major U.S. indexes. The NASDAQ has sharply rebounded from its September selloff and is now only 0.6% off from record highs. The Dow, meanwhile, is more or less at its all-time high right now.

This all leads naturally to this question: *Is a correction coming?*

Normally, we see a correction in stocks every few years. Technically there was a correction — a bear market, in fact — in March 2020, but it was over extremely quickly. If we exclude that sharp but brief correction, stocks have been rallying for 11 years. That's by far the longest bull market in history. And it would tend to suggest that a new correction is coming. In this article, I will explore the case for that happening, and then go over some reasons why it might not after all.

Why a correction might be coming

The biggest reason to believe a correction might be coming is the fact that some stocks — particularly tech stocks — are getting very expensive. Traditional value stocks are actually pretty modestly valued these days. Banks, in particular, are very cheap. But tech stocks on the whole are getting pricey. That's a problem because they now have heavy weighting in the biggest stock indexes.

Take **Shopify** (TSX:SHOP)(NYSE:SHOP) for example. It's by far the biggest company in Canada by market cap and therefore has heavy weighting in the TSX Composite and the TSX 60. It's also an extremely expensive stock. Trading at 44 times sales, 73 times GAAP earnings, and 200 times adjusted earnings, it's expensive as heck. Sure, the company cranked out four consecutive quarters with earnings growth above 90%. But the most recent quarter already showed deceleration and more is expected going forward.

If Shopify falls, then the TSX falls with it. It's a guaranteed byproduct of the stock's heavy weighting in the index. So, this is a major risk for investors to watch out for.

Why it might not

Despite all the concerns with tech stock valuations, there are many reasons to think that a correction is *not* coming.

One of those is valuation.

We are current in the midst of third-quarter report season, and most companies are reporting solid earnings growth. Yet the markets are having a lukewarm response. As a result, market P/E ratios are starting to come down. For example, the S&P 500's P/E ratio recently came down from 35 to 28. Previously, that 35 P/E ratio was a major point of concern, but with the multiple contraction we've seen, it's not so much a concern anymore.

So, are we going to see a correction?

It's hard to say, but my bet is we probably won't be seeing a major one anytime soon. Yes, some individual stocks are very pricey, but the markets as a whole are getting cheaper relative to earnings. Perhaps a sudden interest rate hike would cause some damage, but for the most part, I'm optimistic.

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