3 Signs the Stock Market Could Correct

Description

Stock market pullbacks are notoriously difficult to predict. In fact, there's a small cottage industry devoted to predicting a crash every year, which means they eventually get it right.

I prefer to be cautiously optimistic in general but like to keep an eye on any indicators of trouble. Recently, three such indicators seem to have surfaced. Here are some of the signs that could indicate a stock market pullback is imminent.

Rising interest rates

Interest rates are crucial for stocks. The valuation of a company hinges on the rate of return you could get for taking absolutely no risk. Over the past year, the rate of return on risk-free assets such as government bonds has been remarkably low. This is why it made sense to put money in stocks that offer dividends as high as 6% or growth as high as 30%.

However, interest rates are now climbing. The yield on a five-year government bond has jumped from 0.366% to 1.566% in just one year. Experts believe this trend could continue in 2022. If lending money to the government (which is risk-free) delivers a 2% return, a company with no profits or even 5% growth looks less attractive because of its associated risk.

Rising interest rates are usually a trigger for a stock market correction.

Economic weakness

Dark clouds are looming over the Canadian economy, which makes stocks even less attractive. Inflation, for instance, is running at an 18-year high. Meanwhile, the pace of job growth has slowed down. This is reflected in recent earnings reports that have disappointed investors.

If the economy stagnates or dips in 2022, stocks that pay 6% dividend today may have to cut back. Meanwhile, loss-making growth stocks that delivered double-digit capital gains could plunge.

The Buffett Indicator

Rising interest rates and a slowing economy would have had less impact if stocks were undervalued. Unfortunately, that’s not the case. The stock market is trading at a historically rich valuation right now. The ratio of stock market valuation to Gross Domestic Product (GDP), sometimes called the Buffett Indicator, is currently at 183%!

In other words, the market is on the verge of a classic bubble.

What can investors do?

Retreating from the stock market doesn’t seem like a good option, despite the red flags. Instead, the best strategy could be to seek out undervalued stocks that are somewhat detached from the economy.

Fortis (TSX:FTS)(NYSE:FTS) is an excellent example. The utility giant expects revenue to remain stable, even in economic downturns. For instance, people didn’t stop paying their hydro bills in 2020 when the pandemic erupted.

Since future revenue and cash flows are so predictable, Fortis can easily offer expanding dividend payouts. In fact, the company has boosted its dividend every year for 47 years and expects to do so for the foreseeable future, too.

Currently trading at 21 times earnings per share with a 3.9% dividend yield, Fortis is the ultimate safe haven for investors worried about a stock market pullback.

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