Signs of a Market Correction

The stock market rally has been going on for five and a half years. The S&P 500 bottomed out at 683 on March 6 of 2009. This was the end of the market fall and the start of the second worst recession in 75 years. And, like in the days after the 2009 Stock Market Crash the market has steadily recovered. Due to wise actions of the US Federal Reserve in keeping banks afloat and credit flowing there has not been another Great Depression. Those who invested in a basket of US stocks mirroring the S&P 500 have seen their investment triple in value as the S&P 500 has set a new record in rising above 2000. A pair of pertinent questions are just how long market rallies last and what are the signs of a market correction? Is this a matter of sound**fundamental analysis** or reading the tea leaves of market sentiment with technical trading tools? Our belief is that the signs of a market correction can be found in both fundamental and technical factors.

Projected Return on Invested Capital versus Reading Minds

Long term investors expect a reliable return on investment. They want to stay ahead of inflation and make a few percent as well. **Dividend stocks** that pay a good return and pay year after year are a good idea. In our article **Basics of Successful Investing II** we refer to the Graham formula for calculating intrinsic stock value. The point of fundamental analysis is to tell you if a stock is underpriced or overpriced for the long term. The problem is that markets often run up even after the so-called fundamentals no longer support stock prices. Every investor and every stock trader has his or her expectation as to how high the market will go and what signs of a market correction will tell them when to sell. Many use stock options to hedge risk. They purchase puts on stocks that may have gone too high in order to lock in a price at which to sell. These folks usually believe that the market will go at least a little higher and they do not want to lose out by selling too soon. To a degree reading signs of a market correction is a bit like reading minds.

Practical Aspects

Although we say that this market rally has lasted since 2009 there was a more than ten percent downward correction from July to August of 2011. That makes the subsequent rally three years old. IN the 1990s the market went up for seven years before in corrected, or shall we say crashed with an S&P 500 that fell from 1500 to 835. In Basics of Successful Investing I we note that three basics of successful investing are sound fundamental analysis, appropriate risk management and patience in waiting for investment opportunities. When the market keeps going up too many investors become impatient, looking for more and more profits. They forget risk management. An old piece of investing advice is that you do not have a profit until you take a profit. If you have done well with a volatile stock there is nothing wrong with taking a little profit, paying long term capital gains and holding on to cash until the market offers great deals again. Prior to the burst of the dot com bubble several well-known investors stated that they were essentially cashing out of the stock market because it made no sense. These folks were able to re-invest an very attractive prices a year or so later.

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