Is A Correction Ahead?

So far this year, the major market averages have almost completely ignored the possibility that stock prices can actually move lower. Volatility for the year to date is among the lowest in a long time and short-term pullbacks of any consequence have been nonexistent. For investors, it seems like the best of all worlds, and perhaps it is. But subscribing to that belief would ignore the typical price patterns of the past.

In every year over the latest three decades, substantial interim weakness in stock prices has been the norm, not the exception. Like breathing in and breathing out, it's part of the process. In the aftermath of these events, stock prices have always moved higher, but not always quickly.

Viewing the S&P 500 returns over the last 30 years, it turns out that the average pullback during the course of each year was 15%. Of course, that average includes the 49% plunge of 2008, which some folks may argue overstates the numbers. To reduce the impact of that dive, one can view the median, a still-significant drop of 11%.

For the current year to date, we have yet to see a drop of as much as 3%. That's highly unusual, especially considering the fact that only once between 1987 and 2016 did the interim pullback end up less than 5%. That was in 1995.

Let's also not forget that the third calendar quarter has historically been the weakest of the year. From 1950 to present, the average return during the July to September period has been 0.5%. Not surprisingly, it has also been the season of greatest volatility. So the thought that everything's just fine may be illusory.

No doubt a major driving force behind the upward momentum in stock prices is the continuing improvement in corporate earnings. What's more, interest rates, though up a few notches from the bottom, are still close to the lowest ever. Still, it would be naïve not to remain aware the current market valuation is stretched toward the upper end of normal valuations, which almost certainly increases the likelihood of an interim dip . . . or more.

What could spark a drop? For one thing, the discord within the Washington Beltway continues on the rise despite the reality that one party largely controls all of the major branches of the federal government. Plus, talk of a government shutdown because Congress won't agree to fund a wall at our southern border hasn't helped.

For another, although the tension between North Korea and the rest of the world seemed to ease for a short time, once again the stress level has been raised. Who knows what's next, but most assuredly it won't be good news.

For all of these reasons, I find it increasingly unlikely that this "steady as she goes" market will continue much longer. Whether what looms ahead is a summer thunderstorm or a winter iceberg remains to be seen. Whatever the case, investors would be well advised to keep their eyes fixed on the horizon.