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Despite selling, stocks' recovery looks on track

By Adam Shell
USA TODAY

NEW YORK -- Despite a burst of selling late in September, blue-chip stock indexes posted their second consecutive quarter of gains, and the Nasdaq composite posted its fourth consecutive winning quarter.

After hitting highs for the year on Sept. 18, the three major U.S. stock indexes have given back 4% to 6.4%. Investors sitting on sizable gains have turned defensive and are booking profits amid concerns that stocks have run up too far and are ripe for a fall.

The recent selling may signal the start of a stock market correction, notes Bob Doll, chief investment officer of Merrill Lynch Investment Managers. "A 5% to 10% correction would be normal," he says. "Perhaps this is it." But it's too early to tell how severe or lengthy the drop will be, other experts say.

For now, at least, the stock market's longer-term recovery remains on track. The Nasdaq, led by tech stocks, posted a 10.1% gain in the third quarter, despite being up almost 18% at one point in the July, August and September period. The Dow Jones industrial average rose 3.2% in the quarter, and the Standard & Poor's 500 gained 2.2%.

The Nasdaq has put together its longest string of quarterly gains since the bull market ended, MarketHistory.com says. The third quarter also marked the first time in more than four years that all three indexes posted back-to-back up quarters, a sign of broad market strength.

The steady rise of stock prices, which began last October and has gained momentum the past six months after a brief war-related pause, puts Wall Street on track for its first winning year since 1999. This year, the Nasdaq has soared 33.8%, the Dow is up 11.2%, and the S&P 500 has rallied 13.2%.

Driving the rally: rising corporate profits and growing signs that the economic recovery is gaining traction. If the market advance is to continue in the final three months of the year and beyond, these positive trends must persist, says Richard Nash, chief market strategist for Victory Capital Management.

Stock gains have been instrumental in soothing investors' psychological wounds. "Our clients are telling us that they are comfortable with increasing their stock weightings," says Elizabeth Newberry, managing director at Carret & Co. "There is again a sense that the market can go up."

Still, there's no shortage of potential obstacles. Selling intensified Tuesday on a sharp drop in consumer confidence, a profit warning from former tech darling Sun Microsystems and a slowdown in growth at Midwest businesses.

Stocks have also been under pressure due to softness in the U.S. dollar, a development that could make U.S.-based assets less attractive to foreigners. OPEC's decision last week to slash oil production, which has pushed oil prices higher, is sparking worries that it could choke off the economic recovery.

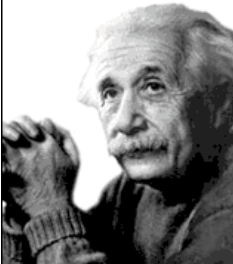
Other potential obstacles include rising bond yields and worries that consumers will cut back on spending now that the wave of mortgage refinancings that helped bolster their cash flow is fading.

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