Why is the Market Going Down?

Presented by Christopher Phelps

The big question on everyone's mind is, why is the market going down? The answer, in short, is interest rates. Interest rates are up. When rates go up, stocks tend to go down. And this takes us to the next question: why are interest rates up—and will they continue to rise?

New View from the Fed

In the short term, the answer seems to be yes. Last Friday, Fed Chair Jerome Powell spoke at the annual Jackson Hole central banking forum. His prepared remarks reinforced the Fed's current view that restrictive monetary policy will need to be in place for some time in order to combat inflation before we start to see easing policy and lower rates.

In other words, Powell was quite clear that the Fed intends to get inflation under control and that it will keep hiking rates, even as the economy moves into a recession. This is new.

Before last week's speech, markets were pricing rate hikes through March of next year, but then rate cuts shortly thereafter. After Friday's speech, though, markets are now expecting those rate cuts to be delayed until at least the second half of 2023. Markets were counting on limited rate increases and quick rate cuts. The speech was clear, however, that the increases will be larger, and the cuts more delayed, than anyone expected.

That's why rates have risen. The rate on the 10-year U.S. Treasury note rose from about 2.6 percent at the start of the month to over 3.1 percent as of this writing. That is a big jump, especially over a short time period, which has hit the stock market hard for several reasons.

The Market Reaction

First, higher rates pressure valuations for equities, especially for stocks that have recently outperformed and have high valuations on a historical basis. In addition, the tighter policy and higher rates are designed to slow economic activity to combat inflation, which could negatively impact earnings growth. Lower valuations and lower earnings mean stocks drop, as we just saw. This isn't the first time (even the first time this year) that we have seen this reaction.

Just as with earlier this year, that initial market reaction doesn't necessarily hold over time. While we should expect more volatility, there is a real possibility the Fed will end up hiking less, and cutting sooner, than Powell's speech seemed to suggest. With inflation showing signs of peaking and with growth slowing, the economy is already responding to higher rates—meaning that fewer hikes in the future may be necessary. When the data changes, so will expectations, and the market will react then as well.

The Real Message

That is the real message of the Powell speech and the market reaction: expectations rule the market, and those expectations can change quickly with new data. Given current expectations, that new data is now more likely to be positive for markets than negative.

Notably, we have seen interest rates bouncing around between 2.5 percent and 3.5 percent over the past six months or so. As noted, that is a large range and reflects the uncertainty around where inflation is going, what the Fed is likely to do, whether we are in or headed for a recession, and so forth. Depending on the data releases, markets push rates up or down, and then back again. Most recently, the Fed has been hawkish, which drove rates up through June. But with growing economic weakness, markets drove rates back down through early August on the expectation that a recession would force the Fed to cut rates. Now we are starting that cycle all over again with the hawkish Fed. So, rates are likely to rise through the end of the year, but that will, over time, have the effect of slowing the economy and raising expectations of rate cuts—and we will be back to square one.

What Does This All Mean?

In the short term, it likely means higher rates and more pressure on the stock market. But in the medium term, rates will likely come down again. For the stock market, the fact that those higher rates are now expected should limit the damage going forward and increase the chance of a bounce when expectations change.

So, to go back to where we started, will the market keep going down? Possibly, for a while. But, overall, this is a normal cycle of policy and reaction, rather than something worse.

Keep calm and carry on.

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