INTEREST RATES AND MARKET VOLATILITY

Commentary by Patrick Catania

The stock market slide of the middle of May has clearly been difficult for investors, as markets have turned sharply lower amid uncertainty over the path of inflation, economic growth and how aggressively the Fed (Federal Reserve Board) may need to tighten interest rates.

There are well-established precedents to the financial market's reaction to fluctuating interest rates. Our current interest rate picture is somewhat unusual, given the length of time rates have been declining, and the degree of the decline to near zero percent. It is logical to assume that the wrench thrown into the works by the two years plus COVID pandemic has clearly accentuated the impact. Record numbers of business closures have resulted from the lack of physical traffic to most establishments.

The rapid and significant increase in the money supply because of government stimulus packages has fueled consumer demand enough to trigger a Federal Reserve interest rate response. More than $5 trillion dollars were distributed by the federal government to families, businesses, local governments, and health care facilities. Now, consumer demand is shifting back to a pre-COVID level, which, while still growing, is doing so at a slower pace than at the height of fiscal and monetary stimulus. Additionally, spending habits are shifting back to services and away from goods. The return to a more measured pace of growth has been uncomfortable for some and downright painful for areas of the market and economy that had benefitted from COVID-related trends.

According to the U S Bureau of Economic Analysis (BEA) consumer spending remained strong during the month of April, with retail sales up 0.9 percent overall. Meanwhile, the March figure was revised up from 0.5 percent to 1.4 percent by the BEA. While consumer demand remains strong, supply challenges that have fueled some of the recent inflation are showing signs of receding.

Over the years, economic data shows that increasing interest rates slows the flow of funds, thus bringing down spending. Less spending puts pressure on prices for goods which in turn brings down the rate of inflation. This scenario is exactly the opposite of what happens when the FED lowers rates, as they have done for years since the housing bubble burst in 2008.

The impact of higher interest rates on financial markets is to slow down spending as money becomes more expensive. This impacts stock prices directly because as spending slows so does growth of profits, which impacts the value of company shares.

We have had these cycles for as long as financial market records have been kept. Historically, the long-term investor has continued to do well as these market declines allow for additional acquisitions and cost averaging. As the cycle reverses, the investor remains well positioned to benefit on the upside. This is the time to lean on your financial plan. Good planning anticipates market downturns like this. It anticipates recessions. Staying invested through downturns is what positions investors to participate in the growth that has historically followed. I do not think there is any reason to believe this time will be any different.