The Method in the Markets’ Madness

Predicting stock-price moves is usually a mug’s game—but beneath this year’s wild gyrations is an underlying logic.

By [James Surowiecki](https://www.theatlantic.com/author/james-surowiecki/)

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The stock market was down sharply on Wednesday this week. It was up sharply on Thursday. And it will surprise no one if it ends up or down sharply today, the final trading day of the year. That’s because, though the market will finish the year [down almost 20 percent](https://www.washingtonpost.com/business/interactive/2022/stock-market-sp500-down-this-year/) (per the S&P 500 index), stocks have not taken a steady downward path to get there. Instead, they’ve been on an extraordinarily bumpy ride, oscillating between bouts of optimism and gloom, regularly adding or erasing trillions of dollars of market capitalization in a matter of weeks.

Take what the S&P 500 has done since the beginning of June. First, it fell about 10 percent in a couple of weeks, then it rose [18 percent over the next two months](https://www.reuters.com/markets/europe/futures-up-easing-price-pressures-set-wall-st-weekly-gains-2022-08-12/). Then it fell sharply again, 16 percent in little more than a month, but clambered back up by about 15 percent by the beginning of December, before finally falling a relatively mild 6 percent or so by the month’s end. There were no earthshaking economic developments over that stretch of time. Yet Goldman Sachs [now judges](https://www.forbes.com.au/news/investing/us-economy-enters-stronger-downturn/) that 2022 will go down as the sixth-most-volatile year since 1929.

Trying to explain stock-market moves is usually a mug’s game. But there is an underlying logic to the combination of a steep decline coupled with lots of ups and downs that we’ve seen this year. The decline was the result of a meaningful shift in economic fundamentals, most notably interest rates—which have [risen steadily all year](https://www.theatlantic.com/ideas/archive/2022/12/us-economy-recession-unemployment-inflation-interest-rates/672379/)—and the prospects for corporate profit growth.

As interest rates rise, less risky assets—such as U.S. Treasuries—become more attractive, and riskier ones, like stocks, less so. That’s especially true given that the Federal Reserve, which for years kept interest rates at historic lows, is now committed to [hiking them](https://www.washingtonpost.com/business/2022/12/14/fed-rate-hike-december/), and keeping them high, until inflation is dead and gone. That, in turn, has significantly increased the chances that the U.S. economy will end up in a recession next year. And recessions are generally bad for corporate profits.

The companies hardest hit by this general repricing of stocks have been, not surprisingly, companies that had been trading at relatively lofty valuations, meaning that their stocks were priced as if the future was going to be irrevocably bright. That’s why the tech-dominated Nasdaq index is down roughly 34 percent on the year—and former highfliers such as [Tesla](https://www.cnn.com/2022/12/29/business/tesla-stock/index.html) and [Amazon](https://www.cnbc.com/2022/12/29/amazon-shed-half-its-value-in-2022-as-tech-stocks-got-crushed.html) are down far more than that—while the broader-based Dow Jones Industrial Average is down only [9 percent](https://www.barrons.com/market-data/indexes/djia).

But if fundamentals explain a lot of the market’s overall drop, why all the turbulence? Well, the stock market is a kind of prediction machine, and, as Yogi Berra supposedly said, “It’s tough to make predictions, especially about the future.” They’re especially hard to make at the moment, when so much about what’s going to happen next year is genuinely uncertain.

There are geopolitical concerns: most obviously, the [war in Ukraine](https://www.theatlantic.com/category/russias-invasion-ukraine/); and what’s going to happen to China as it emerges from its [zero-COVID policy](https://www.theatlantic.com/ideas/archive/2022/12/china-zero-covid-strategy-authoritarianism-america/672418/). There are domestic challenges, too: Will Republicans in Congress [refuse to raise the U.S. debt limit](https://www.bloomberg.com/news/articles/2022-12-07/biden-risks-2023-standoff-on-debt-as-gop-digs-in-democrats-wait) later in 2023, throwing everything into chaos? But above all is the question of how central bankers’ attempts to squash inflation are going to affect the global economy, and the U.S. economy in particular.

At the moment, after all, the U.S. economy looks pretty good. Unemployment is still low, at [3.7 percent](https://www.bls.gov/opub/ted/2022/unemployment-rate-3-7-percent-in-november-2022.htm#:~:text=The%20unemployment%20rate%20was%20unchanged,to%203.7%20percent%20since%20March.) as of November. Job growth is [continuing](https://www.bls.gov/news.release/pdf/empsit.pdf), but isn’t so strong as to panic the Fed into more drastic action on interest rates. Household finances are still relatively buoyant. Companies’ balance sheets are generally strong. Profit margins *are* falling, but they’re falling from unusual highs.

Still, the Fed wants inflation down, for obvious reasons: Maintaining price stability is part of its mandate, and it doesn’t want high prices to feed on themselves. So investors aren’t just trying to forecast *whether* there will be a recession. They’re trying to forecast *how deep* that as-yet-hypothetical recession will be, what will happen to inflation, how much pain the Fed will be willing to inflict on the economy, and how all of this will affect corporate profits.

This uncertainty represents a pretty dramatic shift from the recent years in which interest rates and inflation were reliably low, and corporate profits reliably high (so much so that even the pandemic turned out to be mostly a blip from investors’ perspective). The impact of the uncertainty is magnified in the stock market because, despite the cliché about investors having very short time horizons, the reality is that individual stock prices typically reflect how the market thinks a given company will perform for many years to come. And because small changes in the present can compound into big changes in the future, small shifts in investors’ assumptions about corporate-profit growth or long-term interest rates can have a big effect on stock prices.

To look at the stock market’s performance this year and conclude that we’re definitely headed for a sustained economic downturn would therefore be a mistake. After all, the economist Paul Samuelson’s famous 1966 saying that the stock market had predicted nine of the previous five recessions was backed up by a [2016 CNBC study](https://www.cnbc.com/2016/02/04/can-the-markets-predict-recessions-what-we-found-out.html), which found that in the postwar era, of 13 bear markets—usually defined as a sustained period of a 20 percent market decline—only seven were followed within 12 months by actual recessions.

Instead, a reasonable assumption might be that there’s a better-than-even chance of a recession in the next year. Beyond that, though, the market’s Magic 8 Ball is saying, “Reply hazy, try again later.”

[James Surowiecki](https://www.theatlantic.com/author/james-surowiecki/) is the author of [*The Wisdom of Crowds*](https://bookshop.org/a/12476/9780385721707) and blogs at [Medium](https://surowiecki.medium.com/).