UC SANTA BARBARA

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# Taking Stock

The stock market's precipitous drop Monday, Feb. 5 — 1,175 points when the closing bell rang — represents the largest single-day point decline in history. The proximate cause: a dawning fear of higher interest rates.

So said Benjamin Cohen, the Louis G. Lancaster Professor of International Political Economy at UC Santa Barbara. "When interest rates rise, stocks become correspondingly less attractive," he explained. "Borrowing becomes more expensive, and, of course, there is the possibility that higher interest rates will choke off spending by corporations and consumers."

The fear has been building up for some time, Cohen continued, with the Federal Reserve's promise to raise interest rates. "But it was the jobs report last Friday, which showed that wages may now finally be starting to turn up, that became the coup de grace," he said. "The tax cut may have added some fuel to an already strong economy, but everyone knows that higher wages were already long overdue even without the tax cut. Higher wages eventually mean more inflation, and more inflation means higher interest rates."

Already economies around the world have begun to react to the U.S. stock market. Japan's Nikkei stock average lost more than 6 percent Monday — following 2.5 percent the previous day — and Hong Kong's Hang Seng dropped nearly 4 percent. Markets in Australia, Korea and China also took a dive. "Why?" Cohen asked rhetorically. "Because the U.S. is still roughly one-quarter of the world economy and a big market for the exports of others. Trouble here means less revenue there."

So what action, if any, can the government take on the market's behalf? Not much. "There is no material way that the Federal government can intervene to affect the market directly," said Cohen. "All it can do is try to sustain confidence by talking up 'fundamentals' — stressing the continued growth of employment, the low unemployment rates and the hoped-for positive effects of the tax cut and the administration's policy of deregulation.

"The rise of the market — dating back to 2009 — reflected two things: high corporate earnings (the inverse, in part, of stagnant wages) and the reasonably good health of the U.S. economy as compared with Europe or Japan," Cohen went on. "I have no doubt that the administration's policies — deregulation, tax cuts — contributed significantly to the market's rise in the last year by boosting profit prospects. But the drop in the last week was due to economics, not politics."

What the market holds in the coming weeks is, according to Cohen, anyone's guess. "Today's drop could be a brief pullback, or it could be the start of a serious bear market — who knows," he said. "One thing is certain. Prior to this week, the market was at historic highs — using the conventional metric of price-earnings ratios — matching the highs reached just before the stock market crashes of 1929 and 2000."

"If I had to guess, I would say that a correction was long overdue," he went on. "You never know when you're in a bubble, but my guess is that after all this is over, commentators will agree that the last years were a classic bubble, feeding unrealistically on its own optimism."

And just how worried should any of us be about losing our proverbial shirts in a market slide? That depends on how big the correction will be and how long it will last. "Younger people should hold tight and hope to ride out the storm, even if it takes not months but years," Cohen said. "It's people who have fewer years to go who will be impacted the most. That's why the usual advice for older investors is to shift into fixed-income investments and cash equivalents as we age."

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## About UC Santa Barbara

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collaboration that is responsive to the needs of our multicultural and global society. All of this takes place within a living and learning environment like no other, as we draw inspiration from the beauty and resources of our extraordinary location at the edge of the Pacific Ocean.