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US investors are smiling again!

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Last week Tuesday March 9, share prices in the United States had a steep fall.

They fell so much that gains made in the New Year during the last 10 weeks were wiped out in a single day.

Why?

The fears were that since the US economy has begun to recover, the US Federal Reserve (the Fed) would apply the brakes sooner than the originally announced likely date, June; and raise its benchmark interest rate known as the Fed funds rate from its current, historically lowest rate of all times: zero to 0.25 percent, since 2008. In fact, if it were to increase, it would be the first time since 2006 when the Fed started reducing the rate to rock bottom.

The US Fed Reserve's policy committee was scheduled to meet this week on March 18 and 19 and the rate increase was imminent. The rate increase fears gripped the stock market a week in advance.

Should good news create panic?

The US economy has finally come out of the unemployment pit. Jobs are on the rise: 200,000 each month for the last 13 straight months. Nearly, three million new jobs have been created. Unemployment rate is down to 5.5 percent from 10 percent at the height of the financial crisis in 2009.

Stock market ups and downs are often irrational. True, fears of all kinds affect expectations, which influence investment. Actual or a threat of a terrorist attack or earthquake or any natural disaster legitimately causes fears of bad impact on economy. It is the future expectations that matter most.

And, there are economic reasons as well.

First, in any economy, advanced country or a developing economy like Fiji, increase in interest rate affects consumers and businesses. It increases the cost of credit: higher borrowing costs reduces consumer spending on durables; and decreases investment in capital goods for expansion.

In regard to bonds, a rise in interest rate lowers the present value of all the sum of future cash flows. If the expected return, which is the total of coupon rate of payment and possible capital loss if sold immediately, is likely to be much lower and even negative, the bonds cease to be a good investment. The longer the remaining period of maturity and the shorter the holding period, the higher is the net loss. So bonds become less attractive. So too are stocks.

The method of valuing a firm is similar. We have to calculate the sum of expected future cash streams from the company discounted to reach the present value. The company's stock price is determined by dividing it by the number of shares. The price varies since there would be different kinds of expectations about the company's performance in a new environment. If the company has already been heavily indebted thanks to a low interest environment, the debt servicing costs with variable interest rates would rise; and the estimated future cash flows will be much less. The stock prices have to fall.

Nobody likes falling stock prices.

Fearing further fall, stock holders tend to adopt the dreaded herd behavior. If all of them would get rid of their holdings at the same time, it will be a disaster: Share prices will have steeper fall.

There is another aspect: capital inflows. An increase in interest rate signifying the return of US economy to recovery mode would attract capital inflows, which would strengthen US dollar. That would hurt US exports. The overseas based US companies would be sending profits less in terms of dollars, as they get converted at the new exchange rate.

The Fed decision

As I write this on Thursday, the news is just in.

The Fed would not increase the interest rate in the near future, certainly not in April meeting. As the forecasts of growth and inflation have been revised down, the Fed says there is no urgency.

Though jobs have increased, good jobs have not; and inflation is still low. Until there is improvement in labour market and inflation is up, no rise in interest rate. But, it will be coming!

Investors are smiling: only for some months. They have to review their holdings: good and bad stocks; and junk and sound bonds. Selling and buying are brisk. In late trading on Thursday, Standard & Poor's 500 stock- index was up by more than one percent.

An American author, William Feather wrote long time ago:

"One of the funny things about the stock market is that every time one person buys, another sells, and both think they are astute".

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