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The stock market is freaking out because of the end of free money. It all has to do with something called ‘the Fed put’

BY [**WILL DANIEL**](https://archive.ph/o/CIlYd/https://fortune.com/author/will-daniel/)May 10, 2022 9:11 PM UTC

Sign up for the [*Fortune Features*](https://archive.ph/o/CIlYd/https://mynewsletters.fortune.com/fortune-features) email list so you don’t miss our biggest features, exclusive interviews, and investigations.You might have noticed some turbulence in the stock market recently.It took a while to sink in after last week, but investors had a full freakout from Friday through Monday when they realized just how serious the Federal Reserve is about fighting inflation.As a result, stocks have posted their worst start to the year since 1939, with the S&P; 500 falling over 16%.What changed?In short, last week was the end of the “[free money](https://archive.ph/o/CIlYd/https://fortune.com/2021/08/31/us-economy-risk-treasury-low-interest-rates/)” era of central banking. Since the beginning of the pandemic, the Fed had supported markets with ultra-accommodative monetary policy in the form of near-zero interest rates and [quantitative easing (QE)](https://archive.ph/o/CIlYd/https://fortune.com/2019/11/13/what-is-quantitative-easing-qe-federal-reserve-rates/). Stocks thrived under these loose monetary policies. As long as the central bank was injecting liquidity into the economy as an emergency lending measure, the safety net was laid out for investors chasing all kinds of risk assets.But starting in March, when the Fed raised its benchmark interest rate for the first time since 2018 to tackle inflation, that all changed. The move, which was followed by another [half-point rate hike](https://archive.ph/o/CIlYd/https://fortune.com/2022/05/04/financial-advisors-on-what-to-do-with-money-after-fed-rate-hike/) on Wednesday, signaled the end of the free money era.Markets are now experiencing what Wall Street watchers call a “[regime change](https://archive.ph/o/CIlYd/https://www.hartfordfunds.com/insights/market-perspectives/nanette-abuhoff-jacobson/the-latest-market-sell-off-regime-change-in-the-making.html),” and understanding how far stocks might fall as a result requires understanding how markets price in a lack of Fed support moving forward.

The regimes they are-a-changin'

Stretching back to the Great Financial Crisis of 2008, the Fed has kept the cost of borrowing low, allowing consumers to invest in homes, cars, and their education without the burden of high-interest payments. This made sense when inflation and wage growth were low, as consumer spending needed encouragement from wherever possible.Now, though, with unemployment rates near pre-pandemic lows and inflation surging beyond even historically high wages, the central bank has shifted tactics, raising interest rates and signaling its intention to trim its balance sheet to the tune of billions of dollars each month. The regime change has left markets effectively on their own and led risk assets, including stocks and cryptocurrencies, to crater as investors grapple with the new norm. It’s also left many wondering whether the era of the so-called “Fed put” is over.For decades, the way the Fed enacted policy was like a [put option contract](https://archive.ph/o/CIlYd/https://www.investopedia.com/terms/p/putoption.asp), stepping in to prevent disaster when markets experienced serious turbulence by cutting interest rates and “printing money” through QE.Fed officials argue that significant market drops could set off a debt cascade, destabilizing banks and the financial system as a whole, so they must act when times are tough to restore market order.This policy led investors to understand that the Fed would come to the rescue if stocks fell.

But under a new, more hawkish regime, many are wondering if that’s still the case.If stocks continue to drop, will the Fed slash rates and reinstate QE to spur growth? Or will the markets be left to fend for themselves?

The Fed put

The idea that the Fed will come to stocks’ aid in a downturn began under Fed chair Alan Greenspan. What is now the “Fed put” was once the “Greenspan put,” a term coined after the 1987 stock market crash, when Greenspan lowered interest rates to help companies recover, setting a precedent that the Fed would step in during uncertain times.It was a monumental shift in policy from the era of Paul Volcker, who served as Fed chair from 1979 to 1987. Volcker is widely credited with having reigned in the inflation of the 1970s and 80s through the use of hawkish monetary policies.However, his policies were also part of the cause of the 1980–1982 recession, and they led to large Federal budget deficits as the cost of borrowing soared amid the Reagan Administration’s tax cuts and record military spending.Greenspan, on the other hand, ushered in an era of more dovish monetary policy, lowering interest rates on several occasions when stocks fell, including after the dot-com bubble burst in 2001. And every Fed chair since Greenspan has followed suit, using interest rate cuts as a way to improve investor sentiment and catalyze investment when stocks fall. Fed chair Ben Bernanke, who served between 2006 to 2014, went even further after the housing bubble burst in 2008, famously slashing interest rates and instituting the first round of QE ever seen in the U.S. to help the country weather the economic storm.Ever since, when stocks experienced serious downturns, investors have looked to the Fed for support, but that era may now be over, as inflation pushes the central bank towards a new, more hawkish approach.

A new normal for stocks

If the Fed put does come to an end, the current business cycle will likely be very different from previous ones, especially for stocks, Deutsche Bank’s head of thematic research and credit strategy Jim Reid says.“Many themes will be different going forward to what we've been accustomed to,” Reid wrote in a Monday note. “One such theme is the relentless march of U.S. equities. The last decade was noticeable for record long periods without a correction, a don't fight the Fed mentality, and a buy the dip narrative.”Reid noted that last week marked the first time the S&P; 500 has fallen for five consecutive weeks since June 2011, ending the longest run without five consecutive down weeks since relevant data first began being tracked in 1928.“In the 83 years between 1928 and 2011, we had 61 runs of five or more weekly declines in a row, so one every year and a third on average,” Reid wrote. “So the last decade has very much been the exception rather than the norm.”Martin Zweig, a renowned investor and analyst who was well known for calling the 1987 market crash, coined the phrase “don’t fight the Fed” decades ago. And for years, investors used the phrase as a mantra that signified the importance of staying invested while the Fed was behind markets, acting as a safety net from downturns. Now, “don’t fight the Fed” may have a new meaning.As Zweig wrote in his book “Winning on Wall Street”: “Indeed, the monetary climate—primarily the trend in interest rates and Federal Reserve policy—is the dominant factor in determining the stock market’s major direction. Generally, a rising trend in rates is bearish for stocks; a falling trend is bullish.”As long as the Fed left interest rates historically low and pumped billions of dollars into the economy each month through QE, it made sense to stay invested in risk assets. As Zweig describes, falling interest rates reduce stocks’ competition from other investments, including Treasury Bills, money market funds, and certificates of deposit. “So, as interest rates drop, investors tend to bid prices higher, partly on the expectation of better earnings,” Zweig wrote.Now, with the Fed raising rates and ending QE, it’s a whole new era, one that might not be as kind to risk assets.But investors still can’t fight the Fed. It’s just the central bank is no longer pushing them toward high-flying tech stocks and cryptocurrencies. Instead, it’s making other, perhaps less risky, assets look more favorable. Assets that typically perform during rising-rate environments, like short-term government bonds and value and dividend stocks, may outperform in this new era. Don’t fight it.