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How will consumers react to weaker and volatile stock prices? Regardless of stock ownership, consumers may conclude that while they still anticipate continued economic growth, the more volatile stock market increased their sense of uncertainty about future economic prospects, causing consumers to increase their precautionary savings. In addition, among stock owners, weaker and volatile stock prices could directly diminish the impact of household wealth on consumption. It is more likely that the alternative hypothesis of a very minor and temporary impact on personal consumption will prevail. The already low savings rate means that robust consumer spending has become more reliant on expanding jobs, wage growth, and on increases in after-tax incomes due to the tax reform legislation. Higher costs of household energy due to an unusually cold winter is likely to temporarily shift spending away from discretionary purchases. While monetary policy must tighten in the face of heightened fiscal stimulus, it would still be advisable to err on the side of smaller and more gradual rate hikes to foster a robust pace of economic growth rather than a pattern of rate hikes that diminish the pace of growth in incomes and jobs. Unlike past inflationary episodes, the marketplace behavior of consumers will act to limit rather than to accelerate inflation.

The Black Mondays of October 17, 1987, August 24, 2015, and February 5, 2018 represent three sharp declines in stock prices as well as increases in market volatility. The 2018 decline set an all-time record, with the Dow falling 1,175 points, twice the two prior point declines (508 in 1987 and 588 in 2015). In terms of percentage declines, however, 1987 was by far the largest, as the Dow declined by 22.6%—an equivalent decline in the Dow on February 5, 2018 would have totaled 5,768 points! The one-day fall in 2018 was nonetheless a substantial 4.6%, somewhat above the 2015 loss of 3.6%. If the 1987 decline was justly referred to a "Black Monday," the subsequent declines may only merit a "Gray Monday" designation.

None of the three declines were due to a sudden weakness in the domestic economy. Indeed, consumers were quite optimistic in the months leading up to each decline. The Sentiment Index averaged 92.1 from the start of 1987 until October, 94.6 from the start of 2015 until August, and 96.7 from the start of 2017 to January 2018. The immediate reaction was for the Sentiment Index to fall by 10.1 points following the 1987 crash, and to fall by 9.1 points following the 2015 crash. Consumers' initial reaction to the 2018 plunge will be known next Friday with the release of the preliminary February data. Importantly, following the 1987 and 2015 episodes, consumers quickly concluded that whatever the reasons for the panic on Wall Street, job and incomes prospect were unchanged on Main Street. Nonetheless, the steep plunge in equity prices in 1987 did cause the growth rate in real personal consumption to dip to just below 1% in the 4th quarter of 1987, and then to immediately jump by 7% in the following quarter. The much smaller 2015 stock decline had little noticable impact on the quarterly path of spending in late 2015. It can be expected that the spending impact from the 2018 stock plunge will be similarly small.

How will decreased household wealth influence spending? Needless to say, the market value of stock market holdings are not evenly distributed across the population. The largest stock portfolios (including mutual funds and retirement accounts) are held by upper income and older households. Stock ownership is quite common among upper income households, although the value of their holdings differs substantially by income level. Among household with incomes in the top third of the income distribution, 90% held stock with a median market value of $255 thousand in 2017; among households in the top fifth of the income distribution, 91% held stock with a median value of $305 thousand, and among those with incomes in the top tenth of the income distribution, 92% held stock with a median value of $483 thousand in 2017. Just as rebalancing consumption with saving goals may have been responsible for the recent very low savings rates given the higher than expected appreciation in stock values, the savings rate in the months ahead is likely to be increased if the current weakness in stock prices persists.

The dominant hypothesis for plunging stock prices is that a strong labor market would prompt higher inflation and require much higher interest rates. Consumers do not share this apprehension about rapidly rising inflation and accelerated increases in interest rates. To be sure, the vast majority of consumers expect interest rates to increase moderately during the year ahead, but consumers also anticipate that the pace of economic growth will remain robust, with unemployment continuing to inch downward. Although the year-ahead expected inflation rate has inched upward in the past few months, it has repeatedly displayed a similar pattern of small increases followed by subsequent declines in the past few years. Moreover, year-ahead inflation expectations remain well anchored as consumers anticipate small declines over the next few years to be consistent with their long term inflation expectations. Just as important, consumers reactions to higher market prices and interest rates will cause postponement rather than prompt advance buying to avoid those increases. A decade of low inflation and interest rates has caused consumers to adopt lower postponement thresholds for interest rates and prices. These thresholds reflect consumers' experiences and are revised slowly over time. Several decades ago, this made so-called "inflationary psychology" difficult to dispel; that same resistance will now make the transition to "normal" slower and more difficult to attain.