

Will falling stock markets lead to a recession?

<https://www.taxresearch.org.uk/Blog/2024/08/06/will-falling-stock-markets-lead-to-a-recession/>

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In this first video of the day, I argue that around the world, stock market values are falling as widespread selling of shares takes place. Irrational investors are dumping shares they only recently drove to record high valuations. Is this a timely adjustment, or the sign of a recession to come? It's hard to tell - but the signs aren't good, especially for a new government that says it is dependent on growth.

<https://www.youtube.com/watch?v=c-Kz1oXimH0>

The audio version of this video is here:

https://www.podbean.com/player-v2/?i=w7kwf-168fc64-pb&from=pb6admin&share=1&download=1&rtl=0&fonts=Arial&skin=1b1b1b&font-color=&logo_link=episode_page&btn-skin=ff6d00

The transcript is:

As I record this, stock markets are falling heavily around the world. Japan has seen the biggest falls, but there isn't a market in Europe which hasn't seen a fall during the course of Monday, and the US stock market is looking particularly vulnerable, whichever version of that stock market you're looking at.

In particular, the VIX, which is the volatility index of fear in US stock markets, indicating the likelihood that panicked trades will take place, is currently running at its highest level since 2020, when the COVID pandemic broke out. In other words, for reasons that aren't completely apparent to anyone, fear is gripping financial markets.

In part it's because Japan saw a significant increase in the local interest rate from the Bank of Japan last week, which has unsettled that particular market.

In part it's because American tech companies are not delivering results which are justifying the billions of pounds, dollars, yen, and everything else that they're pouring across the world into investment in AI.

In part it's because the US Fed is not indicating when or if it will definitely cut the US interest rate again, and it appears that it is far too late to react to market conditions because US employment data is looking particularly vulnerable now, with the number of new jobs that are expected to be created month in month out in the US economy falling heavily.

In part, it's because, well, most people realize that interest rates have been too high for far too long and the chance of recession as a consequence of those rates being so high for so long is now very high.

Are we going to have a recession? I don't know. Let's be clear. Economics does not provide us with a crystal ball.

We might just have a stock exchange blip on our hands, appropriately bringing down some of the excess values that I think exist inside stock markets anyway, and therefore this is just a timely readjustment.

It could be no more than that, but it could somehow feel like something bigger than that. It feels as if the bubble created after COVID ended, which felt wholly artificial from the outset, is being burst.

The bubble has been ridiculous.

After COVID, there was no good reason to believe that the economy would grow significantly.

And whilst most economies have done better than the UK's economy, no one has done particularly well.

At the same time, there's been the threat of war in Ukraine throughout this period, but clearly in the Middle East now as well.

And there's been instability between the US and China.

And if Trump gets back into office, the prospects for global trade insecurity are enormous.

Add to that the threat from global warming, which either is or is not believed by those who trade on world financial markets, but in either case is a cause of further instability,

and you end up with a situation where you have to ask the question, why on earth are shares trading at their highest-level price in many of the world's financial markets?

I can find no rational explanation. So, it's entirely possible that this bubble, created by and large by interest rates simply being too large and therefore the price of bonds being too low and therefore money being forced into stock markets - that's my belief - if that's the case then this money that's been forced into stock markets is now going to leave because they realize that stock markets have been over inflated as a result.

Now, the reaction of governments could be, and central banks could be, to reduce the official interest rates in many countries around the world. Starting with the US, maybe, but followed closely by the Bank of England, the ECB, the European Central Bank, the Bank of Japan, and so on. So, although the Bank of Japan has just raised rates, I wouldn't be surprised if that is a short-term position, and there might be a change.

Again, I'm guessing. I stress, no one knows. But if that happens, the price of bonds will rise because bonds are always, in value terms, worth an inverse of the interest rate, and therefore money will pour out of stock markets into bonds and we'll get a market adjustment.

Is that bad? In some senses, in the long term, no.

In the short term, yes, it definitely is. Why is that problematic? Because falling stock markets tend to create a situation where there is a lack of confidence in the business environment. And that is what leads to recession. It's as simple and straightforward as that.

This may not be the start of a recession, I stress, but it has the feelings of instability around it that created problems when previous major stock market downturns took place.

1987 began with a bit of a crash, and the market in Japan did worse over this weekend and early on Monday than it did in 1987 in proportionate terms.

The European markets haven't done that badly, thankfully, as yet, because I don't like instability. I think transitional change is much better, but the US markets are looking highly volatile.

If we do get a crash, the consequences are significant, not least for the UK, because Rachel Reeves will not be seeing the growth on which she's built all her promises to the UK if we get a stock market crash because that will knock on into a real loss of growth impetus inside the real economy itself.

Therefore, this matters. So, watch the markets with care. We may be in for troubled times ahead.