

How will the market react when the Fed cuts interest rates?

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All eyes on September

Market-watchers widely anticipate the Federal Reserve to start cutting rates at its meeting in September.

The 1995-1996 playbook

I explore the market's reaction to the beginning of the Fed easing cycle in 1995 and some important differences between then and now.

Fed expectations

I expect the Fed will cut only 25 basis points, but I anticipate that would only be the start of what is likely to be a very significant easing cycle.

In recent weeks, it's become clear to me that the US is very likely to avoid recession and the US Federal Reserve (Fed) is very likely to begin cutting rates, and so my thoughts have increasingly turned to the 1994-1995 tightening cycle. I think we could all categorize it as a success story because it did not end in recession. While history doesn't usually repeat itself, it often rhymes, so I'm hopeful there are lessons to be learned by studying what happened to markets as the Fed began to cut rates in 1995.

First, I think it's important to establish the timeline¹:

- Between February 1994 and February 1995, the Fed hiked rates 300 basis points.
- In July 1995, the Fed began to ease, but cut rates only 75 basis points from July through January 1996 and then held rates at those levels for more than a year.

So what happened to markets in the first six months once the Fed began to ease on July 6, 1995? From July 6, 1995, to Jan. 5, 1996:

- **Stocks rose.** The S&P 500 gained 11.32% in the six months after the Fed began easing.²
- **Large caps outperformed.** In terms of capitalization, small caps modestly underperformed large caps during that six-month period. The Russell 2000 Index rose 9.05% while the Russell 1000 Index returned 11.46%.²
- **Value outperformed.** In terms of styles, for the six months after the Fed began to ease rates, the value style modestly outperformed the growth style; the Russell 3000 Value Index rose 12.0% while the Russell 3000 Growth rose 10.48%.² This was true in the large-cap space as well; during that six-month period, the Russell 1000 Growth rose 10.66% (price return) and the Russell 1000 Value rose 12.31%.²
- **Health care was the top sector.** In terms of sector performance in the first six months of the Fed's 1995 easing cycle, health care was the best performing sector, returning 26.06% during the period.² A number of sectors – including energy, industrials, financials, utilities and consumer staples – all posted double-digit returns for that period. However, consumer discretionary posted an anemic gain of 2.91%, the materials sector was essentially flat, and the tech sector posted a loss.²
- **International stocks underperformed.** Both European and UK equities posted solid gains but modestly underperformed US stocks. The Stoxx 600 rose 10.05% and the FTSE 100 gained 9.33% during the six-month period.² However, emerging markets equities experienced worse performance, posting a modest loss for the period – although that was due to some country-specific issues such as the Mexican peso crisis.
- **Bonds posted gains.** The Bloomberg US Aggregate Total Return Index rose 5.28% and the Bloomberg High Yield Total Return Index rose 6.02% in the six months after the Fed began easing.²

- **Real estate performed well.** The FTSE NAREIT Index rose 6.89% during this six-month period.²
- **The US dollar strengthened.** The US Dollar Index began strengthening in the summer of 1995 as the Fed began to cut. This may seem surprising, but it followed a large decline for the dollar earlier in the year as a result of the Mexican peso crisis. The strengthening that began later in the year likely reflected a normalization once the crisis began to resolve.

What happened in the subsequent six months?

In general, returns were more muted in the subsequent six-month period (from Jan. 5, 1996, through July 5, 1996). The S&P 500 posted a gain, but it was a more tepid 6.6%.² Small-caps posted more modest gains as well, as did international stocks.² Bonds were also weaker. Growth outperformed value during this period, with the tech sector posting the biggest return (as represented by the S&P 500's tech sector return of 15.10%).² My sense is that 75 basis points in rate cuts provided limited fuel for risk assets to move higher.

Unemployment and inflation are in a different place today than in 1995

It's important to note that the 1994-95 tightening cycle was considered "preemptive." In other words, inflation was relatively low but the Fed was worried that inflation would rise significantly because of a tightening labor market. As then-Fed Chair Alan Greenspan explained in 1997 Congressional testimony, "In recognition of the lag in monetary policy's impact on economic activity, a preemptive response to the potential for building inflationary pressures was made an important feature of policy. As a consequence, this approach elevated forecasting to an even more prominent place in policy deliberations."³

When the Fed began to tighten in February 1994, unemployment was at 6.5%; it had fallen to 5.4% by February 1995 when the Fed stopped tightening, suggesting there was a significant lag to monetary policy – something Alan Greenspan noted.⁴ Unemployment was at 5.7% when the Fed started to ease in July 1995.³ When easing ended in January 1996, it had actually moved slightly higher, to 5.8%, again illustrating lagged effects.⁴

The 2022-2023 tightening cycle was far from preemptive – I would describe it as reactive and just plain late. Inflation had risen dramatically but had initially been dismissed as transitory before the Fed finally began to tighten in March 2022. But because of the nature of the post-COVID labor market, unemployment was significantly lower (it was 3.6% in March 2022)⁴ and, also owing to COVID policies, fiscal stimulus was abundant. In addition, many US consumers were sitting on homes they had already financed or re-financed with low long-term fixed rate mortgages, so they were more insulated from the impact of aggressive tightening.

Much bigger rate cuts are expected today

My conclusion is that economic conditions were different back in 1995, with unemployment higher relative to today and a less resilient consumer. So while tightening was more aggressive in the most recent Fed cycle – hiking rates by 525 basis points in 2022-2023 versus 300 basis points in 1994-1995 – the economy has appeared more capable of withstanding the pressure. Also, rate cut expectations are very different today — there is an expectation of about 200 basis points in cuts in the next year,⁵ which would likely provide a far more powerful boost to risk assets in coming months than the tepid 75 basis points in cuts provided by the Fed from July 1995 through January 1996. Given this environment, markets are likely to discount an economic re-acceleration late in 2024 or early 2025, which I would anticipate resulting in strong performance from risk assets; more specifically, I would expect at least modest cyclical and small-cap outperformance. I would also anticipate a weakening US dollar, which could provide a tailwind to international equities. And I would expect gains from fixed income, especially high yield and municipal bonds, and real estate investment trusts (REITs).

Having said that, we must recognize that every monetary policy and economic environment is different, and thus every market environment is different. I wouldn't be surprised to see significant market volatility and even some sell-offs in coming weeks – especially leading up to the Fed's September meeting and again leading up to the November presidential election, but also in response to weak economic data since "bad news" is no longer "good news" but just plain old "bad news."

Looking ahead

We will be getting a number of country Purchasing Managers' Indexes this week as well as the US Job Openings and Labor Turnover Survey Report, which is helpful in gauging the tightness of the labor market. I am personally a big fan of the Federal Reserve Beige Book, which I always make sure to read since it usually provides some valuable insights. The Bank of Canada meets this week, and I am hopeful it will cut again, which should further increase the Fed's comfort level with starting to ease.

The most watched data release this week is likely to be Friday's US jobs report, and markets are already showing signs of nervousness about it. The most important metric in the report will be wage growth, and I anticipate it will be relatively modest. However, I can't stress enough that whatever the report is, it should not derail the Fed from a rate cut in September. I expect the Fed will cut only 25 basis points, but I anticipate that would only be the start of what is likely to be a very significant easing cycle. And if the 1995-1996 easing playbook is a guide, I believe it's likely to set up a positive climate for risk assets in coming months.

Dates to watch

Date	Event	What it tells us
Sept. 3	US Manufacturing Purchasing Managers' Index	Indicates the economic health of the manufacturing sector.
	US ISM Manufacturing Purchasing Managers' Index	Indicates the economic health of the manufacturing sector.
	Canada Manufacturing Purchasing Managers' Index	Indicates the economic health of the manufacturing sector.
	China Caixin Services Purchasing Managers' Index	Indicates the economic health of the services sector.
Sept. 4	Eurozone Services Purchasing Managers' Index	Indicates the economic health of the services sector.
	UK Services Purchasing Managers' Index	Indicates the economic health of the services sector.
	Eurozone Producer Price Index	Measures the change in prices paid to producers of goods and services
	Brazil Industrial Production	Indicates the economic health of the industrial sector.
	Bank of Canada Monetary Policy Decision	Reveals the latest decision on the path of interest rates.
	US Job Openings and Labor Turnover Survey Report	Gathers data related to job openings, hires, and separations.
	Korea Gross Domestic Product	Measures a region's economic activity
	US Federal Reserve Beige Book	Summarizes anecdotal information on current economic conditions in each of the Fed's 12 districts.
Sept. 5	Eurozone Retail Sales	Indicates the health of the retail sector.
	US Services Purchasing Managers' Index	Indicates the economic health of the services sector.
	US ISM Non-Manufacturing Purchasing Managers' Index	Indicates the economic health of the services sector.
	Japan Household Spending	Indicates the health of the housing market.
Sept. 6	US Employment Situation Report	Indicates the health of the job market.
	Eurozone Employment	Indicates the health of the job market.
	Eurozone Gross Domestic Product	Measures a region's economic activity
	Canada Jobs Report	Indicates the health of the job market.

Notes

¹Source for all historical information about the level of US interest rates: US Federal Reserve as of Sept. 3, 2024

²Source: Bloomberg, L.P., as of Sept. 3, 2024

³Source: Alan Greenspan, Congressional testimony, January 1997

⁴Source: US Bureau of Labor Statistics, as of Aug. 31, 2024

⁵Source: CME Group Fed Watch Tool, as of Sept. 3, 2024

Important information

All investing involves risk, including the risk of loss.

Past performance does not guarantee future results.

An investor cannot invest directly in an index.

This does not constitute a recommendation of any investment strategy or product for a particular investor. Investors should consult a financial professional before making any investment decisions.

In general, stock values fluctuate, sometimes widely, in response to activities specific to the company as well as general market, economic and political conditions.

Stocks of small and mid-sized companies tend to be more vulnerable to adverse developments, may be more volatile, and may be illiquid or restricted as to resale.

The profitability of businesses in the financial services sector depends on the availability and cost of money and may fluctuate significantly in response to changes in government regulation, interest rates and general economic conditions. These businesses often operate with substantial financial leverage.

Businesses in the energy sector may be adversely affected by foreign, federal or state regulations governing energy production, distribution and sale as well as supply-and-demand for energy resources. Short-term volatility in energy prices may cause share price fluctuations.

A value style of investing is subject to the risk that the valuations never improve or that the returns will trail other styles of investing or the overall stock markets.

Growth stocks tend to be more sensitive to changes in their earnings and can be more volatile.

The health care industry is subject to risks relating to government regulation, obsolescence caused by scientific advances and technological innovations.

The risks of investing in securities of foreign issuers, including emerging market issuers, can include fluctuations in foreign currencies, political and economic instability, and foreign taxation issues.

Fixed-income investments are subject to credit risk of the issuer and the effects of changing interest rates. Interest rate risk refers to the risk that bond prices generally fall as interest rates rise and vice versa. An issuer may be unable to meet interest and/or principal payments, thereby causing its instruments to decrease in value and lowering the issuer's credit rating.

Junk bonds involve a greater risk of default or price changes due to changes in the issuer's credit quality. The values of junk bonds fluctuate more than those of high quality bonds and can decline significantly over short time periods.

Municipal securities are subject to the risk that legislative or economic conditions could affect an issuer's ability to make payments of principal and/ or interest.

Investments in real estate related instruments may be affected by economic, legal, or environmental factors that affect property values, rents or occupancies of real estate. Real estate companies, including REITs or similar structures, tend to be small and mid-cap companies and their shares may be more volatile and less liquid.

Tightening monetary policy includes actions by a central bank to curb inflation.

A basis point is one-hundredth of a percentage point.

The S&P 500® Index is an unmanaged index considered representative of the US stock market.

The Russell 1000® Index, a trademark/service mark of the Frank Russell Co.®, is an unmanaged index considered representative of large-cap stocks.

The Russell 1000® Growth Index, a trademark/service mark of the Frank Russell Co.®, is an unmanaged index considered representative of large-cap growth stocks.

The Russell 1000® Value Index, a trademark/service mark of the Frank Russell Co.®, is an unmanaged index considered representative of large-cap value stocks.

The Russell 2000® Index, a trademark/service mark of the Frank Russell Co.®, is an unmanaged index considered representative of small-cap stocks.

The Russell 3000® Value Index, a trademark/service mark of the Frank Russell Co.®, is an unmanaged index considered representative of the US value stocks.

The Russell 3000® Growth Index, a trademark/service mark of the Frank Russell Co.®, is an unmanaged index considered representative of the US stock market.

The STOXX® Europe 600 Index represents large-, mid-, and small-capitalization companies across 17 countries of the European region.

The FTSE 100 Index includes the 100 largest companies in terms of capitalization listed on the London Stock Exchange.

The Bloomberg US Aggregate Total Return Bond Index is an unmanaged index considered representative of the US investment grade, fixed-rate bond market.

The Bloomberg High Yield Total Return Bond Index covers the universe of fixed-rate, non-investment grade debt.

The FTSE NAREIT Index is an unmanaged index considered representative of US REITs.

The US Dollar Index measures the value of the US dollar relative to the majority of its most significant trading partners.

Purchasing Managers' Indexes (PMI) are based on monthly surveys of companies worldwide and gauge business conditions within the manufacturing and services sectors.

The Federal Reserve Beige Book is a summary of anecdotal information on current economic conditions in each of the Fed's 12 districts.

A real estate investment trust (REIT) is a company that owns (and typically operates) income-producing real estate or real estate-related assets.

The opinions referenced above are those of the author as of **September 3, 2024**. These comments should not be construed as recommendations, but as an illustration of broader themes. Forward-looking statements are not guarantees of future results. They involve risks, uncertainties and assumptions; there can be no assurance that actual results will not differ materially from expectations.