MARKET INSIGHTS

Fed Rate Cuts May Not Be So Bullish For Stocks

MEEDER

Key Takeaways

» With the U.S. inflation rate now below the Federal Funds rate, the Fed's tightening cycle may come to an end this year.

» Investors expect rate cuts before the end of the year, while the Fed anticipates no cuts until 2024.

» Many investors believe the stock market will perform well after the Fed starts cutting interest rates. History tells us this is not necessarily true. Since 1970, more than half of the Fed's first cuts were followed by declines of more than -20% by the S&P 500 Index.

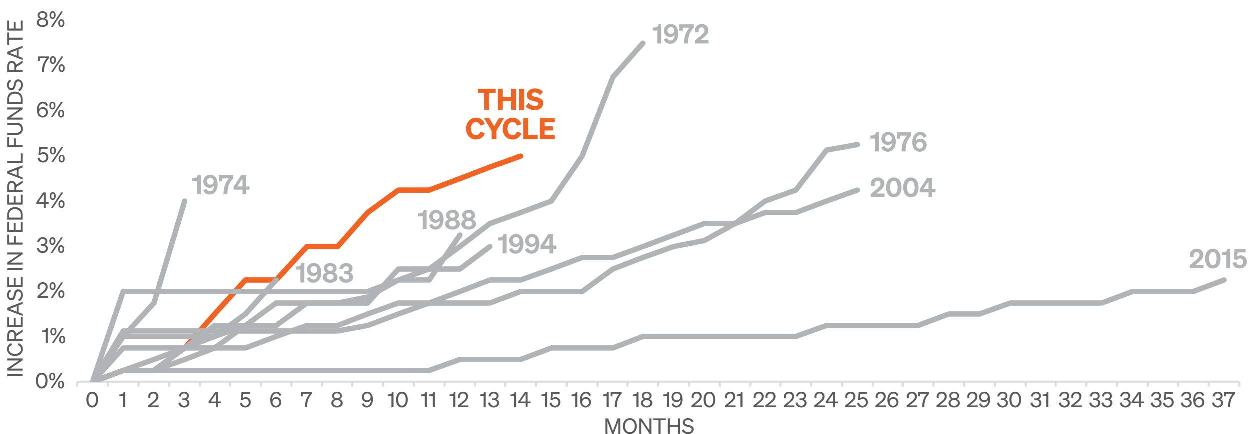
» Soft landings are easier said than done. Historically during recessions, the Fed underestimates the increase in unemployment by 2.5%.

A HISTORIC FED RESPONSE TO A HISTORIC ECONOMIC SHUTDOWN

A myriad of factors contributed to the highest U.S. inflation rate since the early 1980s. The COVID-19 pandemic squeezed the global supply chain, leading to shipping issues, difficulty with inventories, and labor shortages. In addition, food and energy prices soared after Russia invaded Ukraine in 2022. On the monetary policy side, the Fed kept interest rates near 0% while the U.S. government distributed trillions of dollars. The Fed also purchased massive amounts of U.S. debt securities, sending its balance sheet to an unprecedented level of more than 35% of U.S. GDP.

These events caused the Fed to aggressively increase interest rates over the past 14 months. From March 2022 through May 2023, the Fed implemented ten interest rate hikes, taking the Federal Funds rate from near zero to a range of 5.00%-5.25%, making it the second quickest monetary tightening cycle in recent history. (Exhibit 1). Rapidly increasing short-term interest rates created a higher cost of capital, aimed at slowing the U.S. economy and curbing inflation.

EXHIBIT 1:
THE FEDERAL FUNDS RATE HAS INCREASED 10 TIMES IN 14 MONTHS

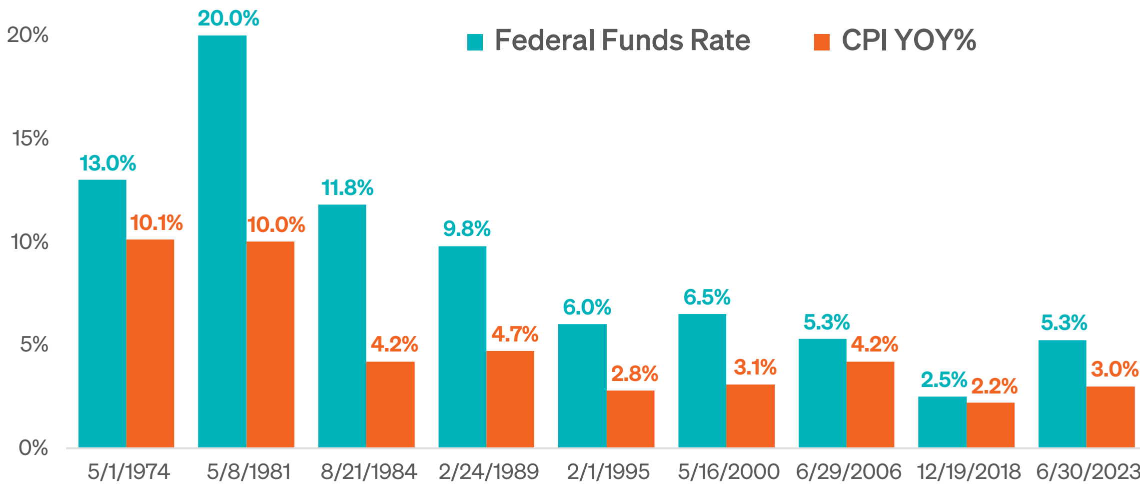


SOURCE: BLOOMBERG, THE BALANCE

FEDERAL FUNDS RATE NOW ABOVE INFLATION RATE

Since 1974, the Fed has not stopped increasing interest rates until the Federal Fund's rate has been above the Consumer Price Index (CPI) annual inflation rate. That level was reached after the Fed's most recent increase in June, when the upper bound of the new Federal Funds rate of 5.25% surpassed the CPI annual inflation rate of 3.0%. This same pattern occurred in each of the past eight tightening cycles before the Fed began cutting interest rates. (Exhibit 2).

EXHIBIT 2:
THE FED HAS NEVER STOPPED INCREASING RATES UNTIL THE ANNUAL CPI GROWTH RATE FELL BELOW THE FEDERAL FUNDS RATE

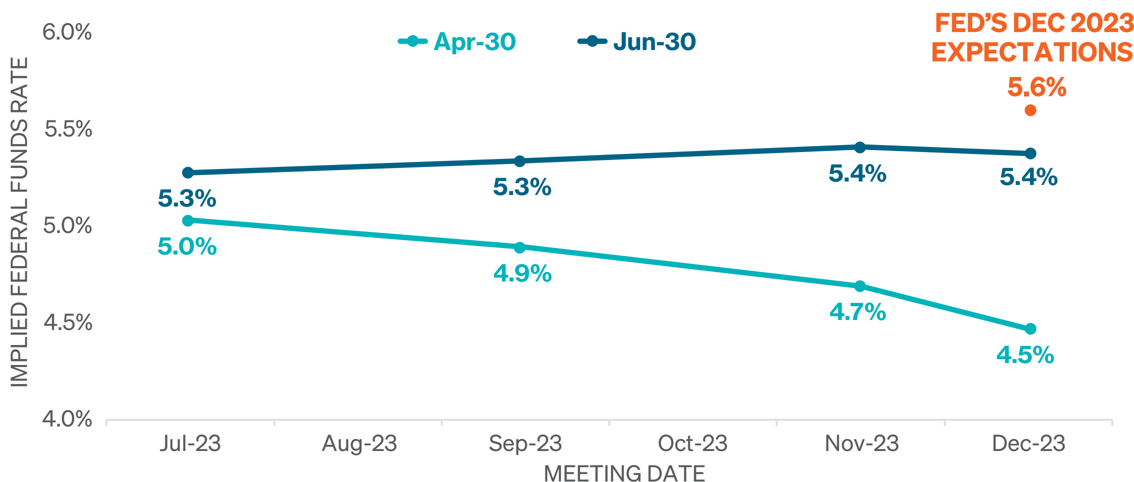


SOURCE: BLOOMBERG

THE FED AND MARKET AT ODDS

At the Fed's June meeting, Chair Jerome Powell announced they were pausing the current target Federal Funds rate of 5.00-5.25%. Surprisingly, the committee increased its Fed Funds rate projection to 5.6% for its December meeting. The green line in Exhibit 3 indicates the market's expectations of the implied Federal Funds rate as of April 30. The blue line shows how significantly those expectations changed after the Fed's June meeting. The orange dot represents the Fed's expectation for the target Federal Funds rate in December 2023. As illustrated, the Fed expects to raise interest rates before year-end, while the market believes that the Fed will cut.

EXHIBIT 3:
THE FED'S EXPECTATIONS DIFFER FROM THE MARKET'S EXPECTATIONS



SOURCE: BLOOMBERG

WHAT TO EXPECT AFTER THE 1ST RATE CUT

Regardless of when the Fed starts cutting rates, the more salient question is how the equity markets will react to the first interest rate cut. One common perception among investors is that the stock market will perform well once the Fed starts cutting interest rates. History tells us this is not necessarily always the case. In fact, over the past nine initial interest rate cuts, more than half of the Fed's first cuts were followed by declines in the S&P 500 Index ranging from -22.6% to -55.5%. The Technology bubble in the early 2000s and the Great Financial Crisis proved to be the worst scenarios, with the Fed cutting interest rates at two different times during the secular bear market of 2000–2009. On the other hand, four of the nine occurrences were followed by minimal weakness and achieved strong 6-month returns. On balance, over the past nine initial interest rate cuts, the S&P 500 Index had an average decline of -20.5% and an average 6-month return of 3.4%. So while the market has experienced both bull markets and bear markets following the first rate cut, history does not indicate that the Fed's accommodative policy will simply carry the market higher.

Valuations matter too. When the market had a decline of at least -20% after the Fed's first cut, the average S&P 500 trailing PE ratio was 18. On the other hand, when the S&P 500 had a decline of less than -10%, the average PE ratio was 11.4. The current P/E ratio of 22 could be another reason to be more cautious once the Fed makes its first cut.

EXHIBIT 4:
STOCK MARKET VALUATION AND PERFORMANCE AFTER THE FED'S 1ST RATE CUT

1ST CUT DATE	S&P 500 P/E RATIO* ON 1ST CUT DATE	MARKET LOW DATE	# OF DAYS	S&P 500 DECLINE TO LOW	6-MONTH RETURN AFTER 1ST CUT
7/1/1974	8.7	10/3/1974	94	-27.6%	-18.2%
4/1/1980	7.1	4/21/1980	20	-2.3%	26.1%
6/1/1981	8.7	8/12/1982	437	-22.6%	-2.0%
10/2/1984	10.0	10/9/1984	7	-1.2%	13.3%
6/5/1989	12.6	10/11/1990	493	-8.3%	10.9%
7/6/1995	16.0	7/19/1995	13	-0.5%	12.6%
1/3/2001	30.1	10/9/2002	644	-42.4%	-7.7%
9/18/2007	19.4	3/9/2009	538	-55.5%	-15.1%
8/1/2019	22.0	3/23/2020	235	-24.2%	10.3%
AVERAGE			**276**	**-20.5%**	**3.4%**

*Trailing 12-month Price to Earnings Ratio

SOURCE: STRATEGAS, BLOOMBERG

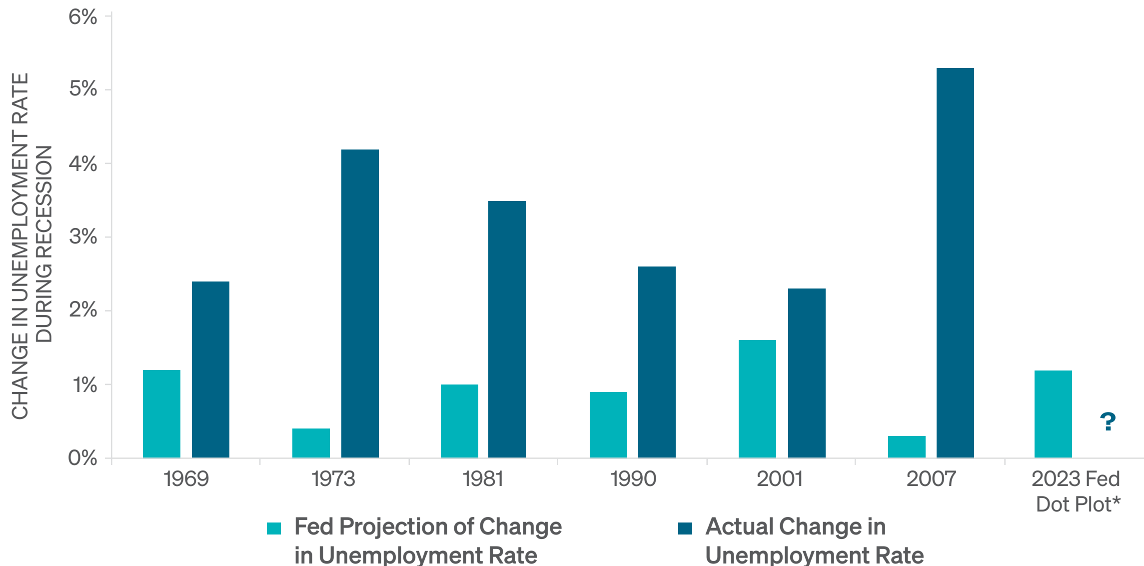
THE FED HISTORICALLY UNDERESTIMATES ITS IMPACT ON UNEMPLOYMENT

One reason the Fed's first cut has not always been the best predictor of equity returns is that higher interest rates have a lasting and more pronounced impact on the economy. During this recent inflationary cycle, the Fed has remained focused on tightening monetary policy, while understanding that this will slow economic growth.

As of June 2023 the current unemployment rate is 3.6%. According to the Fed's dot plot, the FOMC anticipates unemployment will rise to 4.5% during this period of economic slowing. As shown in Exhibit 5, since 1969, the Fed has consistently **underestimated** the increase in unemployment during recessions **by an average of 2.5% each cycle.** If the Fed's average underestimation holds true, that means that the unemployment rate would rise to 7% during this period of economic slowing.

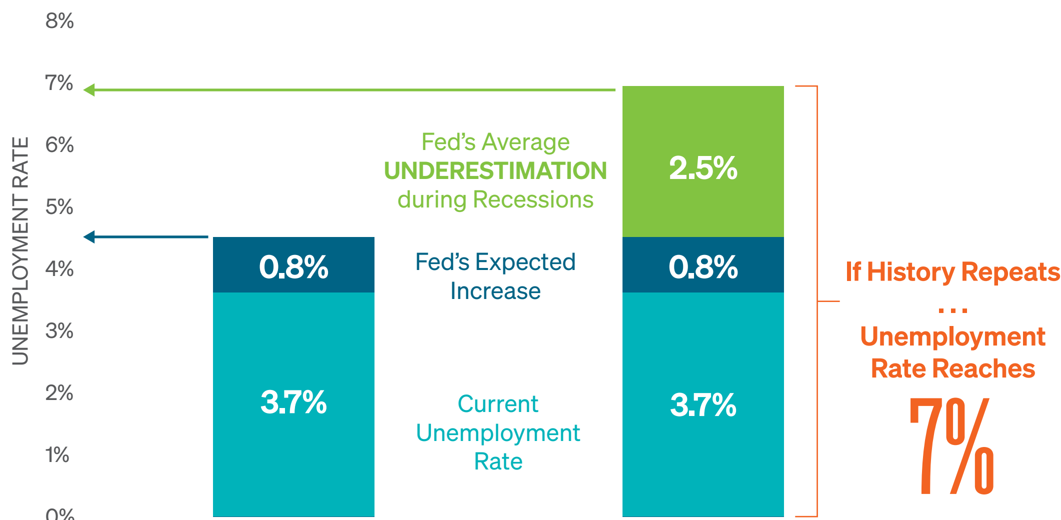
As the famous quote often attributed to Mark Twain states, "History doesn't repeat itself, but it often rhymes."

EXHIBIT 5:
THE FED HISTORICALLY UNDERESTIMATES THE INCREASE IN UNEMPLOYMENT RATE BY 2.5%



SOURCE: CLEARBRIDGE

EXHIBIT 6
IF HISTORY REPEATS



SOURCE: BLOOMBERG, CLEARBRIDGE

6125 Memorial Drive, Dublin, Ohio 43017 | 1.866.633.3371 | meederinvestment.com

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