JIM BAIRD
CPA, CFP®, CIMA®
Partner
Chief Investment Officer

TRICIA NEWCOMB
CIMA®
Associate
Senior Strategy Analyst

ERIC DAHLBERG
CFA
Associate
Senior Equity Analyst

PAUL OLMSTED
CIMA®
Associate
Senior Fixed Income Analyst

Would a rate cut foreshadow poor performance in the stock market?

While a potential rate cut later this year may make some investors nervous, equity markets often perform well in the 12 months following an initial rate cut.

If the Federal Reserve cuts interest rates in the near term — potentially as early as this month — it would mark the quickest shift from a hiking cycle to a cutting cycle in its history. The Fed had been in rate hiking mode since the end of 2015 until early this year, when it signaled that a slowdown in growth and weaker economic data was compelling enough to shift to a neutral stance and slow the unwinding of their balance sheet.

Historically, a rate cut hasn't always indicated a recession looming in the near term. In fact, since 1971, there have been 12 instances in which the Fed has made an initial cut after making at least one rate hike, but in more than half of those cases, no recession followed in the ensuing year.

The chart above illustrates when a rate cut wasn't followed by a near-term recession, equities saw an average return of just over 19% in the next 12 months. Even in cases when a recession followed, returns on average were essentially flat one year later, but with a very wide range of actual returns (-24% to +30%).

The bottom line is that a rate cut isn't necessarily a bad omen for equities. As we discuss in our accompanying piece, easy financial conditions and a Fed willing to cut rates could help create a soft landing and avoid a recession in the near term.

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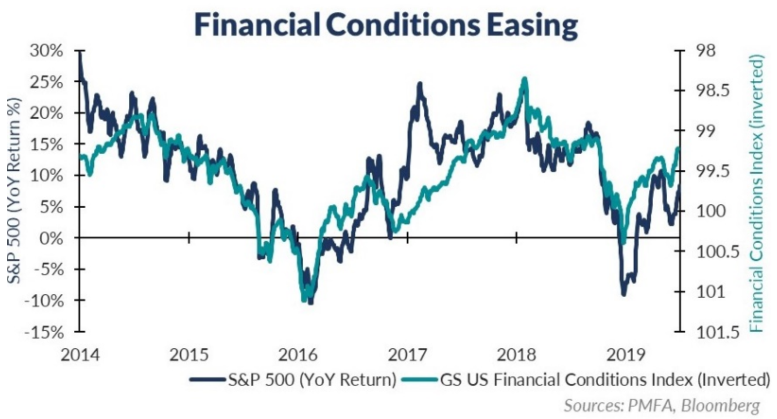
Could easy financial conditions help to moderate an economic slowdown?

Despite weaker prints on recent economic indicators, a cut from the Fed may provide a cushion for a softer landing.



Recent mixed economic data has stoked concerns among investors that growth is slowing and that recession risk has risen. As a result, the latest comments by the Fed have been noteworthy, as policymakers have indicated they may be willing to ease conditions by cutting interest rates if incoming data remains sluggish.

Even without a cut, financial conditions have already become more accommodative in recent months, as credit spreads and interest rates have broadly fallen. With financial conditions loosening, the environment could be (and typically has been) increasingly positive for risk assets, including equities. Additionally, if the Fed were to cut rates, conditions could be perceived as even more attractive, so long as economic data doesn't materially deteriorate. Historically, stocks have done well as financial conditions eased. Recently, financial markets have started to price in that potential, which also creates a potential risk should the Fed ultimately not deliver a rate reduction as expected.

The bottom line is that if economic data continues to disappoint, the probability of a Fed rate cut will remain high. Easy financial conditions combined with a willingness by the Fed to trim rates, if appropriate, could provide additional "insurance" to create a soft landing for the economy, extending the current expansion.