What Happens to Stocks After the First Rate Cut?

Key Takeaways

- A slowing job market resurrected recession fears and set the path for interest rate cuts.
- History tells us stocks have fared well despite the Fed's poor track record in avoiding recession.
- After unusually calm markets, investors should prepare for a bumpier ride as the Fed often cuts rates at precarious times in the economy.

The Federal Reserve (Fed) last raised interest rates between 5.25% and 5.5% in July 2023 and has since been on hold. Keeping our economy healthy is at the core of the Fed's responsibilities. The Fed does this through its dual mandate of price stability and maximum employment. Price stability focuses on ensuring inflation remains low and stable, and maximum employment helps the economy grow by keeping as many people employed as possible.

The Fed has held interest rates higher as it aimed to slow the U.S. economy and curb inflation through higher borrowing costs. Progress has been made on this dual mandate. Inflation has fallen, but the economy has also cooled as the number of jobs created is falling and the unemployment rate ticked to 4.3%.

This uptick in unemployment sent markets sharply lower in early August as recession concerns resurfaced. The fear is that the Fed is too late in cutting interest rates. The markets are now pricing interest rate cuts starting September 2023.

With recession fears looming again as the Fed pivots to rate cuts, we look to history to provide some context in this uncertain period.

Stocks After the First Rate Cut

Since 1970, there have been 19 instances of rate cuts. In 11 of 19, the economy experienced a recession within a year of the first rate cut. The Fed has not had a good track record of cutting rates early enough to avoid a recession. However, this has not necessarily spelled doom for markets either.

S&P 500 Cumulative Total Return After First Rate Cut Since 1970

First Rate Cut	Recession 1Yr Later	1Year	3Year	5Year
Mar-70	Yes	15%	34%	8%
Oct-71		16%	-16%	28%
Oct-73	Yes	-34%	3%	11%
Jul-74	Yes	22%	43%	62%
Oct-75		17%	23%	85%
Aug-76		0%	17%	64%
Nov-79	Yes	40%	48%	99%
Apr-80	Yes	41%	86%	132%
Jan-81	Yes	-5%	41%	97%
Jul-81	Yes	-10%	36%	134%
Apr-82	Yes	43%	79%	207%
Sep-84		13%	114%	148%
Oct-87		19%	40%	99%
Jun-89		18%	42%	67%
Jul-95		21%	119%	189%
Sep-98		16%	2%	1%
Jan-01	Yes	-12%	-14%	1%
Sep-07	Yes	-22%	-21%	8%
Jul-19	Yes	11%	46%	-

Source: FactSet, FRED

Most of the time, stocks were up one year later. The double-digit declines in the first year coincided with the inflation spiral in the 1970s and 1980s, the bursting of the dot-com bubble in 2000, and the great financial crisis of 2008. As we span out three years after the first rate cuts, the number of instances of negative returns declines, and it has never been down five years after the initial rate cut.

It's no surprise that stocks fared better when a recession was avoided, but the gap in performance is smaller than one would anticipate even during a recession.

Summary

Today, the economy is in a similar state to a health diagnosis that many middle-aged unfortunates often get, such as pre-diabetic, pre-something, or the other. In this state, you have to adjust your diet and increase your exercise to avoid the dreaded disease, and your current state is not necessarily your final fate. Similarly, the Fed needs to cut rates to reduce costs and curb the slowing job market to avoid a recession.

Even for the skeptics who doubt whether the Fed can engineer a soft landing (i.e., avoiding a recession while keeping inflation in check), history shows that stocks have fared reasonably well post-rate cuts in both scenarios. After a period of unusually calm markets, investors should prepare for greater volatility and remain focused on the bigger picture before making any drastic changes to one's portfolios. After all, the Fed only cuts rates to stave off that pre-illness.

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6878568.1 | 08/2024 | EXP 08/2026