

Are Rate Cuts Good for Stock Markets?

Key Takeaways

- A slowing job market raised the hope for interest rate cuts.
- History tells us stocks fare well despite the Fed's poor track record for avoiding a recession.
- Investors should prepare for a bumpier ride as the Fed often cuts rates at precarious times in the economy.

Why Cut Rates?

All eyes are on the Federal Reserve (Fed), which is looking to restart interest rate cuts next week after having been on hold all year due to concerns about tariffs' impact on inflation. Per the 1977 Federal Reserve Act, the Fed has a dual mandate to keep the economy growing in a way that promotes jobs for everyone and maintains inflation at 2%.

Today, the Fed is navigating a period of positive but slowing economic growth, while also battling a stalled job market and higher-than-desired inflation. As of September 10, the markets are pricing in three 0.25% interest rate cuts in 2025 as they expect the Fed to focus on the job market over inflation concerns.

Should Investors Be Worried?

Given that the Fed typically cuts interest rates to stimulate economic activity and avoid a recession, should investors be worried?

History shows us that 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 stock markets.

For stocks, lower interest rates are generally positive as they allow businesses to access cheaper financing for growing their business. Since 1970, looking at cumulative stock returns after the Fed started to cut interest rates, most of the time, stocks have been up one year later. The one-year periods that had double-digit declines coincided with the inflation spiral of the 70's and 80's, 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 for five years after the initial rate cut. No surprise, stocks fared better when a recession was avoided, but the gap in performance is smaller than one would anticipate, even during a recession.

S&P 500 Cumulative Total Return After First Rate Cut				
First Rate Cut	Recession 1 Yr Later	1 Year	3 Year	5 Year
Mar-70	Yes	15%	34%	8%
Oct-71	No	16%	-16%	28%
Oct-73	Yes	-34%	3%	11%
Jul-74	Yes	22%	43%	62%
Oct-75	No	17%	23%	85%
Aug-76	No	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	No	13%	114%	148%
Oct-87	No	19%	40%	99%
Jun-89	No	18%	42%	67%
Jul-95	No	21%	119%	189%
Sep-98	No	16%	2%	1%
Jan-01	Yes	-12%	-14%	1%
Sep-07	Yes	-22%	-21%	8%
Jul-19	Yes	11%	46%	101%
Sep-24	No	?	?	?

Source: FactSet, FRED

Summary

The Fed has a challenging road ahead as it will need to recalibrate its policy to balance economic growth without reigniting inflation. If the Fed can improve its batting average, this time remains to be seen. On the one hand, higher inflation and a weaker job market are weighing on lower-income consumers, a sign of potential economic cracks. On the other hand, the world's largest and most profitable companies are investing record amounts in artificial intelligence technology for future productivity gains, which does not align with an imminent 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.

While the past is no guarantee of the future, lower interest rates generally have been positive for stocks. Of course, the market never moves up in a straight line, and investors should always be prepared for periods of volatility as the Fed often cuts interest rates at precarious times in the economy.

AssetMark, Inc.

1655 Grant Street
10th Floor
Concord, CA 94520-2445
800-664-5345

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