



The Fed Cut the Interest Rate

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Chairman Powell of the Federal Reserve reduced the short-term interest rate by .25%. He did so because the employment numbers were weakening, and the inflation has been under control even though it is still not down to the 2% Fed target (currently 2.90%). The Fed has the difficult task of controlling inflation while trying to maintain full employment (it is called a dual mandate).

The question is what does that mean for investors and, historically, how has the stock market responded to Fed rate cuts?

Historically, the stock market has generally responded positively to Federal Reserve rate cuts over the next 12-24 months, but the precise outcome often depends on the underlying economic context that prompts the cut.

Typical Market Response

- On average, U.S. equities such as the S&P 500 have delivered strong gains in the year after the start of a Fed rate cut cycle, with returns of around 14% reported since 1980.
- The S&P 500 posted positive returns in the 12 months after the first cut in eight out of the last ten cycles, averaging nearly 11%.
- Immediate market response (within one month) is often volatile or flat – the S&P 500 has aver-

aged a slight decline of about 1.3% in the first month after rate cuts since 1970, showing that short-term “sell the news” reactions can occur before trends turn upward.

Context Matters

- **“Normalization” cuts** (when the Fed trims rates to maintain growth while conditions are stable) have historically driven robust multi-year stock gains. For example, the 1995 rate reduction led to a 21% gain in the S&P 500 in the following year.
- **“Emergency” or recession-induced cuts** (when the Fed lowers rates due to crisis or economic deterioration) are associated with weaker or even negative stock returns in the following year—for instance, the 2001-08 rate cut cycles both saw the S&P 500 decline 12% to 22% in the first year afterward.
- If a rate cut is accompanied by clear recession risks, stocks may initially fall or experience turbulence before eventual recovery as the economy stabilizes.



Volatility and Exceptions

- Volatility tends to rise in the months around a Fed rate cut, reflecting investor uncertainty about economic direction and policy effectiveness.
- Market leadership can shift, with rate-sensitive sectors (such as real estate and utilities) often benefiting more, while performance in broader indexes may be muted or sector-dependent.

A Federal Reserve interest rate cut reduces borrowing costs throughout the economy, stimulating spending and investment, which can aid economic growth and generally supports stock prices.

Economic Impact

Lower interest rates make credit less expensive for consumers and businesses, encouraging borrow-

ing for big-ticket purchases, investments, and expansion. This increased activity can help counteract weak economic growth or rising unemployment and create a more robust environment for job creation.

Stock Market Effects

Rate cuts typically boost equity markets as lower rates improve corporate profitability (through reduced financing costs) and make stocks more attractive compared to low-yield bonds. Sectors benefiting most include banking, home construction, consumer goods, and small-cap stocks, with historical cycles often showing stock gains in the months following a rate cut.

In summary, stocks have historically rallied in the year after a Fed rate cut, especially when cuts are not prompted by crisis, but outcomes depend heavily on the economic context at the time.

OUTLOOK

The first three quarters of 2025 have been very positive, producing double digit percentage returns in only nine months. The reasons for this outperformance: strong corporate earnings, inflation remaining under control, favorable tax legislation, rollback of regulations, favorable business environment, and the impact of the tariffs being much milder than anticipated. Another important growth factor has been the phenomenal investment in AI projects (trillions of dollars). The one missing element has been lower interest rates due to the Fed's reluctance (much to President Trump's dismay).

Now the fourth quarter has begun, and the Fed has commenced an interest rate reduction cycle. So, it would seem that "all systems are a go" a phrase used in the early stages of the aerospace industry in the 1960's. But there is a concern, that is the high valuation of stocks after bouncing off the April low without any real correction. We are almost out of the seasonal time of the year where frequently corrections have taken place (mid-August through mid-October). Consequently, a correction may still be coming, or this is one of those times where highly valued stocks become more over-valued. The other possibility is that corporate earnings growth becomes so strong that the valuations are normalized eliminating the need for a correction.

Being concerned about a possible correction does not mean that we are not optimistic regarding the market outlook. All the positive factors mentioned above are still in play and if we do get some kind of pullback, it should set the stage for a bigger rally. To conclude, yes, we may get a correction, but the best advice is to endure, because the recovery is likely to be greater than the pullback. As always, we must add that conditions can change, which could change the outlook.

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