LPL RESEARCH

WEEKLY MARKET COMMENTARY

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STOCKS AND FED RATE CUTS

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KEY TAKEAWAYS

Stocks have benefited recently from increasing hopes of a Fed rate cut, although investors probably won't get one this week.

Stocks' historical performance after initial Fed rate cuts has been mostly positive, but it has been greatly dependent on the business cycle.

We prefer to see the market stand on its own and take more direction from generally solid fundamentals of economic growth and corporate profits.

A potential rate cut may give stocks a lift. Stocks have benefited recently from increasing hopes of a Federal Reserve (Fed) rate cut, pulling the S&P 500 Index back to within 2% of its record high set on April 30, as of June 14. On June 4 Fed Chair Jay Powell signaled a possible cut by saying "we will act as appropriate to sustain the expansion," and since then, as of Friday, June 14, 2019, the S&P 500 is up 5.4%. The central bank's verbal pivot, partly an acknowledgement that they must be ready to offset trade tensions, has pushed the odds of a rate cut in July from roughly 60% to 86%, based on the fed fund futures market. So what might a cut mean for stocks?

WILL THE FED CUT?

It's been a while since we've talked about rate cuts. After last cutting rates in 2008, the Fed started hiking rates in 2015 and has raised them a total of nine times since then. Now, amid the longest economic expansion ever recorded in U.S. history, the bond market is aggressively pricing in not one but two rate cuts this year.

Although the bond market may be overdoing it by pricing in two cuts this year, the latest growth and inflation data, along with U.S.-China trade tensions, provide cover for the Fed to lower rates this summer. In particular, the May jobs report was soft, inflation is below the Fed's target and falling, and headlines suggest that a trade breakthrough at the G-20 in Japan at the end of June has become increasingly difficult to achieve.

Bottom line, we don't believe that current economic conditions justify a Fed rate cut this week, but we will probably get a signal from Powell that a cut is likely coming in July (we now see a July cut as more likely than not). Fed policy is too tight for a prolonged trade war, while the bond market is forcing the Fed's hand to an extent, amid slowing growth and depressed interest rates globally.

WHAT MIGHT A CUT MEAN FOR STOCKS?

As we wrote in last week's *Weekly Economic Commentary*, if the Fed cuts rates in June or July, we would view it as a course correction and not a precursor to an imminent recession. However, the last two starts to easing cycles (a cut in rates after a series of hikes) in January 2001 and September 2007 immediately preceded recessions. Those business cycles were about to end (tech bubble and financial crisis), and Fed policy was clearly too tight heading into those recessions. Where we are in the business cycle matters a lot.

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Looking further back in history, however, reveals a more encouraging picture that is consistent with a midcycle pause. As you can see in Figure 1, after the five initial rate cuts before 2001 (1984, 1987, 1989, 1995, and 1998), the S&P 500 rose an average of 11.1% and 15.8% over the subsequent 6 and 12 months, respectively. We think these cases provide better comparisons to today's environment.

Even including the poor stock market performance after the 2001 and 2007 cycles, the average S&P 500 gains over subsequent 6 and 12 months were a respectable 4.5% and 5.8%.

Wall Street's favorite analogy for this environment might be the 1995 "insurance cut," when the Fed cut rates by 25 basis points (0.25%) twice that year. At that point, the expansion was four years old, growth was solid, and the stock market was doing well. After the Fed's first cut in July 1995, the expansion lasted almost six years longer. One could draw a parallel between the Mexican peso crisis in 1994 and today's trade tensions, although the relatively stronger economy and early-stage internet boom are among the key differences to consider.

The rate cut in 1998 offers another promising analogy to today's Fed environment. The U.S. economy was late in the cycle in a very long expansion then—as we probably are now (though hopefully not quite as late)—and the economic cycle and bull market lasted a couple of more years after the 1998 initial cut. We had crises then too, notably the collapse of hedge fund Long Term Capital Management, and problems internationally, in particular the Asian currency and Russian debt crises. But again, the lack of euphoria—dot-com or otherwise—offers a stark contrast.

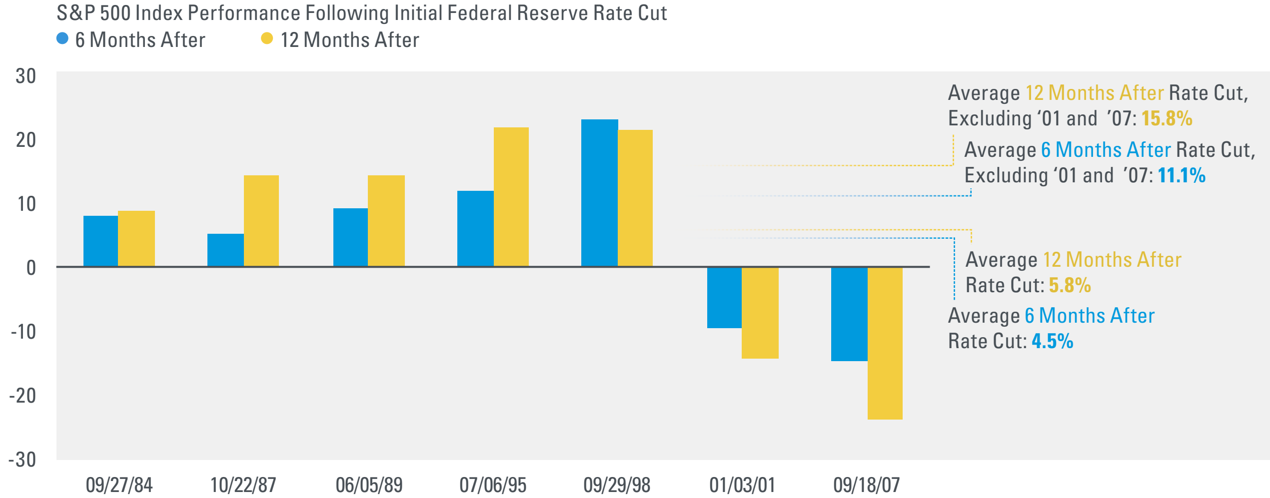
We could also make a reasonable comparison to the waves of quantitative easing in the years following the financial crisis and the pausing of the Fed's rate hike campaign in 2016. Stocks responded positively to more stimulus then as they have so far in this cycle.

CONCLUSION

Slower growth, tariffs, ongoing trade tensions, low inflation, and bond market positioning have given the Fed cover for a rate cut. Taking some of the upward pressure off the U.S. dollar provides additional incentive. We don't think the Fed will cut rates this week, but a July cut is a strong possibility. We expect stocks to applaud an eventual cut

1 INITIAL FED RATE CUT NOT NECESSARILY A SELL SIGNAL

S&P 500 Index Performance Following Initial Federal Reserve Rate Cut



Source: LPL Research, Bloomberg, Federal Reserve 06/14/19

All indexes are unmanaged and cannot be invested into directly. Past performance is no guarantee of future results.

and break out to new highs later this year. Trade disputes could throw a wrench in that plan, but we continue to believe that additional economic pain experienced by both the United States and China will bring the two sides together to strike some sort of a deal this summer. We think it will be the same story with Europe and Japan if we get auto tariffs.

Stocks' historical performance after initial Fed rate cuts has been mostly positive, but it has been greatly dependent on the business cycle.

Our belief that this cycle has more left in it supports comparisons to the initial rate cuts in the mid- and late-1990s rather than the cuts in 2001 and 2007.

We prefer to see the market stand on its own and take more direction from the fundamentals of economic growth and corporate profits. We think fundamentals generally look good here, which we discuss in detail in our *Midyear Outlook 2019* slated for release one week from today. Until we get clarity on trade, we'll gladly take the help. ■

MIDYEAR OUTLOOK 2019

LPL Research *Midyear Outlook 2019* containing our updated insights on the economy and markets for the second half of 2019 will be released June 24. As a result, we will not distribute a separate *Weekly Market Commentary* or *Weekly Economic Commentary* that Monday. We will resume distribution of the stand-alone commentaries Monday, July 1.

IMPORTANT DISCLOSURES

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