On The Mark

NWM NOLAN WEALTH MANAGEMENT
WEALTH MANAGEMENT SOLUTIONS

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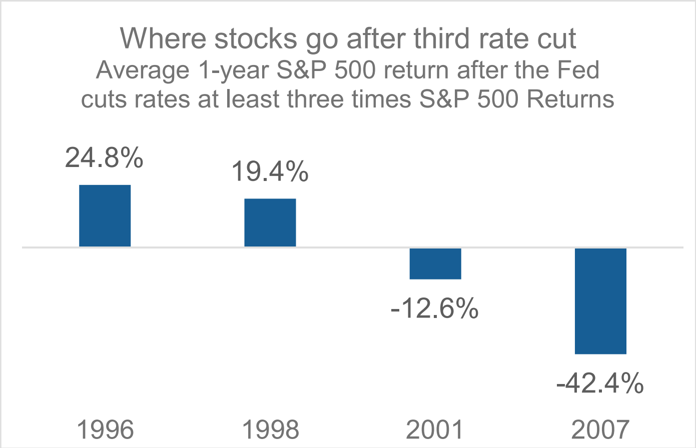
Fed Rate Cuts: Three strikes or third time's the charm?

Key Takeaways

- The Federal Reserve (Fed) cut rates for the third time this year.
- Historically, three rate cuts have been the sweet spot for stocks.
- The Fed rate cuts have improved investor sentiment and "un-inverted" the yield curve, quieting fears of an imminent recession.

The Fed cut interest rates for the third time this year and—more importantly—signaled that it would pause before additional rate cuts. Historical data shows when the Fed cuts rates just three times, it's been good for stocks. However, if it needed to continue with additional cuts because the economy was already slipping into a recession, stocks perform poorly.



Source: CNBC, Kensho

In the last 25 years, there have been four times when the Fed cut interest rates at least three consecutive times[1]. At first glance, the data appears mixed, but a closer look paints a clearer picture. In 2001 and 2007, stocks fell as three rate cuts were simply not enough and the economy was already heading into a recession. However, in 1996 and 1998, when the Fed was done after three cuts, it was the sweet spot. It lifted the economy and allowed stocks to rise further. Today resembles the 90's. The Fed confirmed the economy is performing well and the cuts are a mid-cycle adjustment rather than an effort to rescue the economy from a recession. Finally, the Fed started its rate cuts in 2001 and 2007 with 50 basis points[2], unlike the latest 25-basis point "insurance" cut, likely indicating it was more worried in 2001 and 2007 than it is today.

For bonds, on the other hand, research by Ned Davis shows that when the Fed stopped cutting rates after three times, 10-year Treasury yields were substantially higher[3], leading to lower bond returns. Bond yields and prices move in opposite direction. In addition, the dreaded yield curve inversion, an indicator for predicting recessions, has returned to normal[4], meaning shorter-dated benchmark Treasuries yield less than longer-dated ones. The yield curve has become normal as a result of the rate cuts. That's a clear difference from the last time the yield curve inverted in 2006, and the Fed rate cuts were too late to correct the inversion.

In conclusion, the Fed's three rate cuts have provided the US economy a better chance to fight the risks of global slowdown.

[1] CNBC.com, When the Fed cuts rates three times
[2] FederalReserve.gov/monetarypolicy/openmarket.htm
[3] Ned Davis Research
[4] Wall Street Journal

Brian A. Nolan, CLTC
Nolan Wealth Management, LLC
4454 Main Street, PO Box 505
Kingston, NJ 08528-0505

Tel. – Main: 609-920-0321
Toll Free: 877-NOLANWM (877-665-2696)
Fax: 609-651-8209
Email: bnolan@nolanwealth.com
Website: www.nolanwealth.com

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