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Historical Perspective: The Fed's Latest Rate Cut in Context

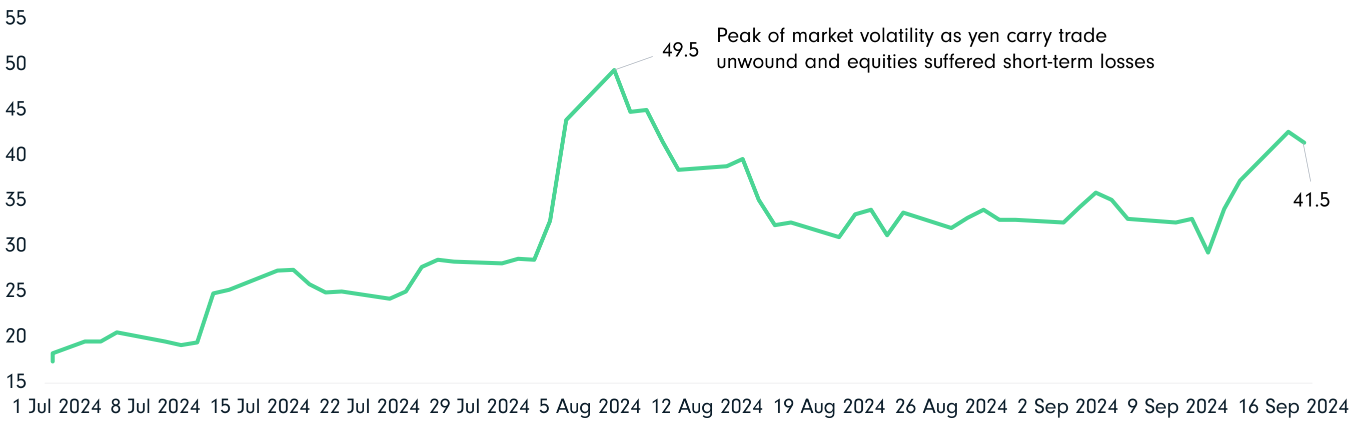
Sep 2024

When was the last time the markets were filled with such uncertainty about what the Fed would do at its next meeting? There have been few surprises since the 2008 global financial crisis thanks to an incredibly transparent Federal Reserve. However, hot and cold economic data has kept markets guessing until the final minute in September 2024. Now that we have our answer (50 basis points), what's next?

As the Federal Reserve embarks on the first easing cycle since the early days of COVID, the discussion has shifted away from the timing of the start of the process to what the path of rates will look like as we move forward. Some argued for an aggressive start, such as Democratic senators like Elizabeth Warren, calling for a 75-basis point cut to start the process, while most expected a more measured approach.

As measured by fed fund futures, the markets priced in a 25-basis point reduction at the September 18 meeting, with a 67% chance of a 50-basis point cut as of the morning of the FOMC meeting. It is important to note that markets have fluctuated wildly over the past month and a half regarding the potential for a 50-basis point reduction at the September meeting, as illustrated in Exhibit 1. Expectations for a more significant initial easing peaked after the market volatility surrounding the Bank of Japan rate hike, less than stellar US jobs report, and subsequent financial market volatility driven by the unwind of the yen carry trade.

Exhibit 1 — Expected Basis Point Cuts at September 2024 FOMC Meeting (bps)



Source: Bloomberg.

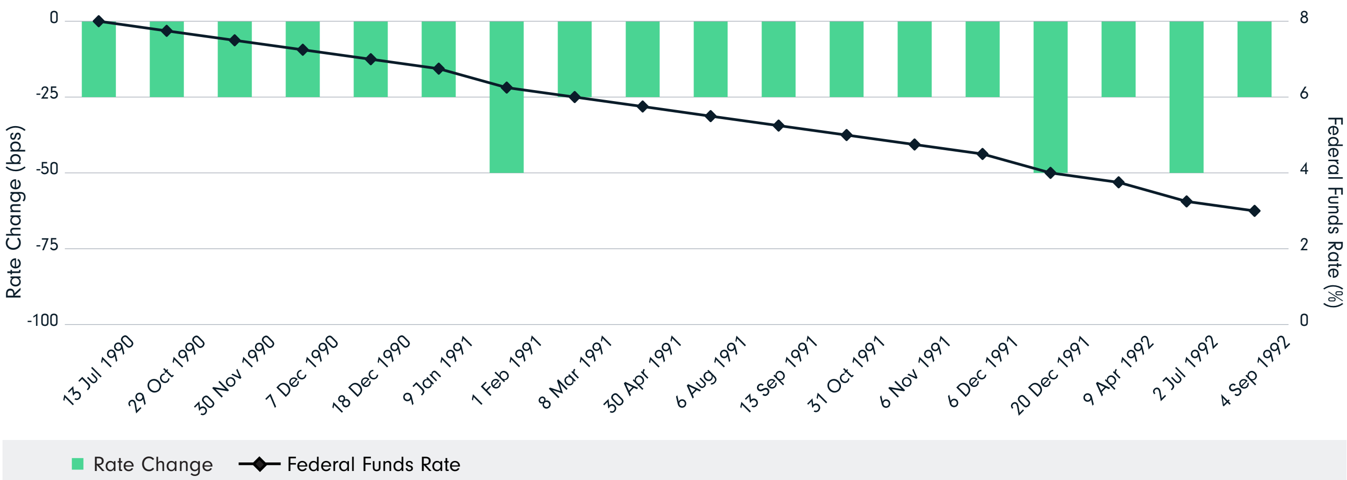
Now that the Federal Reserve has embarked on its easing cycle let's look back at history to see what other easing cycles have looked like, knowing that each one is different based on events in the market at the time.

Gulf War Recession, 1990-1992

The Gulf War recession seems to be the closest comparison to our current environment if we believe we are embarking on a consistent path to lower interest rates executed over a prolonged period.

Iraq invaded neighboring Kuwait on 2 August 1990, and as a result, oil prices doubled from approximately $20 per barrel to $40 per barrel. This significant increase was a critical component of inflation measurement, pushing overall inflation higher and resulting in a drag on consumer spending. The final days of the 1980s Savings and Loan Crisis, combined with a real estate bubble, brought the economy to a standstill, with unemployment climbing from 5.5% to a peak of 7.8%. The Federal Reserve responded by dropping the fed funds rate 525 bps, from 8.25% to 3.00%, over roughly two years (Exhibit 2).

Exhibit 2 — Federal Reserve Meeting Dates and Resulting Rate Changes



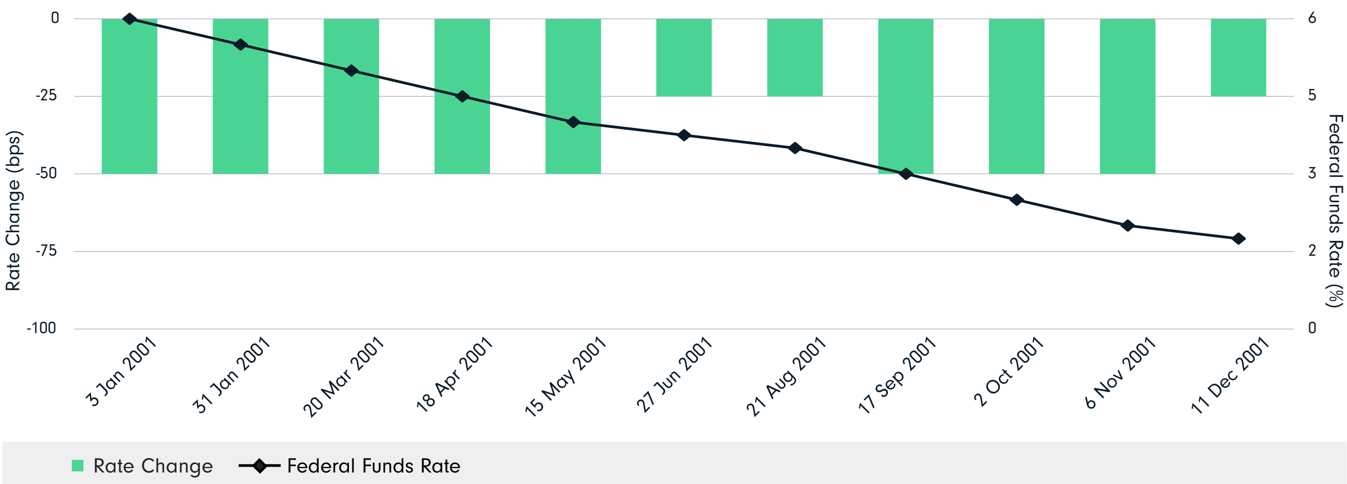
Source: Bloomberg.

Dot-Com Bubble and 9/11 Terrorist Attacks

The late 1990s saw the emergence of the internet and the dot-com craze. Investors piled into anything and everything that had .com in its title or was tied to the internet in some way, regardless of company fundamentals. The frenzy peaked in March 2000, fueled by online retailers like Pets.com and communications companies like WorldCom and Global Crossing.

Low rates, combined with mainstream access to the internet, fueled the run-up in tech names — similar to the exuberance (irrational or otherwise) driving artificial intelligence investing today. In March 2000, Japan announced a recession, and the markets began to fall apart, putting the markets in crisis and bringing the Fed to the rescue with a reduction in rates (Exhibit 3) to stabilize the economy. The tragic events of September 11 provided additional motivation for the Fed to deliver accommodations through lower rates.

Exhibit 3 — Federal Reserve Meeting Dates and Resulting Rate Changes



Source: Bloomberg.

Housing Crisis and Great Recession, 2007-2008

On the heels of a Fed tightening cycle (with rates increasing from 1.25% to 5.25% from June 2004 to June 2006) meant to cool off a recovering economy from the prior recession, the housing market turned from boom to bust. As the housing crisis worsened, the unemployment rate continued to climb, and the US economy entered the Great Recession in December 2007, which lasted until June 2009.

Home values collapsed, the stock market cratered, and unemployment grew from 5% in December 2007 to its peak of 10% in October 2009. The Fed acted quickly and decisively, bringing the fed funds rate down from 5.25% before the September 2007 meeting to a range of 0.00-0.25% by December 2008. Having exhausted the limit of rate cuts by bringing fed funds to zero (Exhibit 4), the Fed embarked on a new type of policy known as quantitative easing and began buying trillions of dollars of US Treasury bonds and agency mortgage-backed securities.

Exhibit 4 — Federal Reserve Meeting Dates and Resulting Rate Changes

Source: Bloomberg.

Other Rate Cut Periods

Other rate-cut cycles have been short-lived, either for a mid-cycle adjustment or to tackle a specific short-term issue. For example, an adjustment was needed on the heels of the Fed's attack on inflation in 1994 and early 1995. From February 1994 to February 1995, the Federal Reserve raised rates by 2.75% to achieve the ever-elusive soft landing. Fixed income markets didn't appreciate the sudden increase in rates as the Bloomberg US Aggregate Bond Index lost -2.92% in 1994, which at the time was the worst calendar year performance in history and remains the second worst year for the index (second only to 2022's loss of -13.01%).

The Fed began a short-term mid-cycle adjustment to ease monetary conditions. Having started in July 1995 with an initial 25 bps cut (Exhibit 5), the Fed was saddled with 5.6% unemployment six months later and decreased another 50 bps over two meetings in December 1995 and January 1996.

Exhibit 5 — Mid-Cycle Adjustment

Meeting Date	Rate Change (bps)	Fed Funds Rate (%)
6 Jun 1995	-25	5.75
19 Dec 1995	-25	5.50
31 Jan 1996	-25	5.25

Source: Bloomberg.

The 1998 easing cycle (Exhibit 6) represents a unique situation compared to other easing cycles, as the main culprit driving the economic uncertainty pushing the Fed to take action was from abroad. The first card to fall in the currency house of cards was in Thailand in 1997, and then it pushed its way into the rest of Asia and Latin America. This international crisis bled into Russia in late 1998, pushing massive hedge fund Long-Term Capital Management (LTCM) into crisis and then to the brink of bankruptcy, forcing major financial firms to step in and bail them out.

Exhibit 6 — Currency Crisis/Long-Term Capital Management

Meeting Date	Rate Change (bps)	Fed Funds Rate (%)
29 Sep 1998	-25	5.25
15 Oct 1998	-25	5.00
17 Nov 1998	-25	4.75

Source: Bloomberg.

After the September 11 attacks, the world was a different place. The US was embroiled in the occupation of Afghanistan, while high energy prices due to the conflict were hitting consumers hard. The Fed was worried that the economic recovery was stalling out as consumer confidence hit a nine-year low and sales and production were weakening. Having essentially paused its easing cycle from 2001, the Fed delivered 50 bps of easing in late 2002 (Exhibit 7) to reinvigorate the economy, citing "greater uncertainty" and "geopolitical risks." An additional 25 basis points followed this reduction in mid-June.

Exhibit 7 — Slow Recovery, Low Inflation

Meeting Date	Rate Change (bps)	Fed Funds Rate (%)
6 Nov 2022	-50	1.25
25 Jun 2003	-25	1.00

Source: Bloomberg.

What began as a mid-cycle adjustment to tackle economic uncertainty brought about by trade wars between the US and China in late 2019 quickly accelerated in early 2020 as the COVID pandemic shut down the global economy. Much like in 2008, the Fed ran out of string on rate cuts, pulling them back to zero (Exhibit 8). It re-engaged in quantitative easing, but at a faster pace, and used other measures to help keep the economy afloat. The unemployment rate jumped from 4.4% in March 2020 to 14.8% in April 2020 and didn't move below 5% until September 2021.

Exhibit 8 — Trade Wars/COVID-19

Meeting Date	Rate Change (bps)	Fed Funds Target Range (%)
1 Aug 2019	-25	2.00 to 2.25
19 Sep 2019	-25	1.75 to 2.00
31 Oct 2019	-25	1.50 to 1.75
3 Mar 2020	-50	1.00 to 1.25
16 Mar 2020	-100	0.00 to 0.25

Source: Bloomberg.

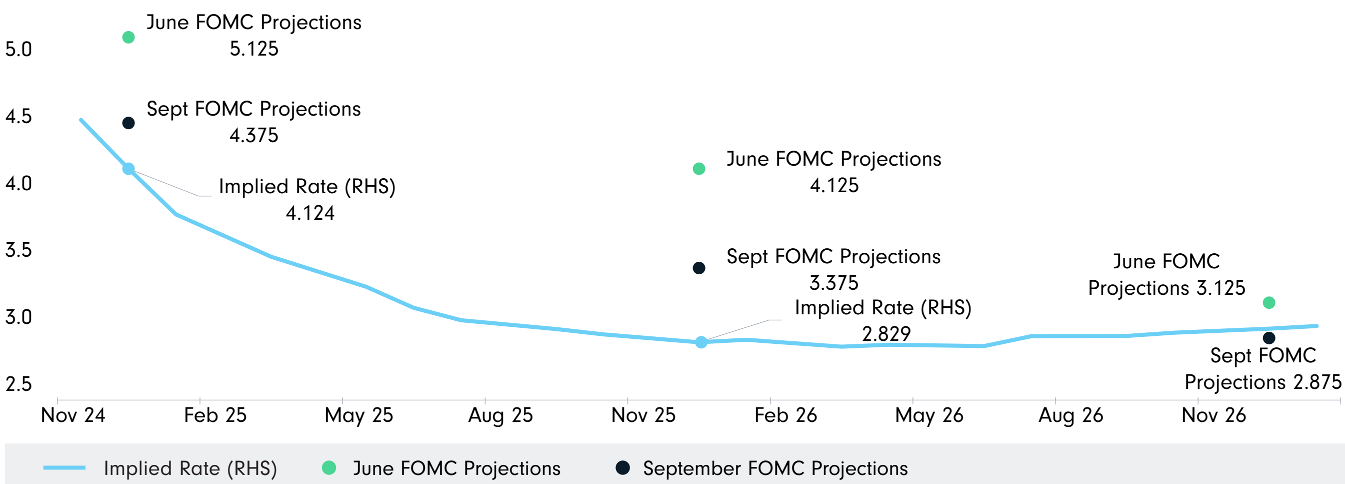
Where Do We Go From Here?

Exhibit 9 illustrates the market's expectation for future rates based on fed fund futures along with the projections for the June and September Dot Plots from the FOMC. The shift from the Federal Reserve at the September 18 meeting brings its long-term expectations in line with the markets, targeting 2.875% for the neutral point for this rate cycle.

The Fed's expectations compressed across all periods, dropping 75 basis points for year-end 2024 and 2025 and 25 basis points for year-end 2026. The main difference between the Fed and the market is velocity: How quickly will the Fed move to bring rates down to neutral? The market believes a more accelerated approach has begun, while the Fed continues to expect a measured pace as we advance after this significant move to start the cycle.

While the Fed and markets are in sync over the longer term (year-end 2026 shows FOMC 2.875% and fed fund futures 2.90%), there is still a disconnect over the shorter term, with the FOMC targeting 4.375% by year-end 2024 and 3.375% by year-end 2025 compared to the markets' pricing in 4.08% and 2.91%, respectively.

Exhibit 9 — Federal Reserve Meeting Dates and Resulting Rate Changes (%)



Source: Bloomberg.

Financial Market Performance During Easing Cycles

Total Return (%)	Time Period	S&P 500	Bloomberg Aggregate	Bloomberg US Corporate	Bloomberg Treasury	Bloomberg Securitized
Gulf War	13 Jul 1990 to 4 Sep 1992	9.62	13.42	14.31	12.80	N/A*
Mid-Cycle Adjustment	6 Jun 1995 to 31 Jan 1996	20.53	6.80	7.68	6.82	N/A*
Currency / LTCM	29 Sep 1998 to 17 Nov 1998	8.81	-0.40	-0.95	-0.53	1.08
Dot Com / 9/11	3 Jan 2001 to 11 Dec 2001	-14.60	7.60	9.14	6.04	8.79
Housing / Global Financial Crisis	18 Sep 2007 to 16 Dec 2008	-31.99	5.67	-4.59	14.01	5.01
Trade Wars / COVID-19	1 Aug 2019 to 16 Mar 2020	-18.17	4.87	1.00	8.76	3.07

Source: Bloomberg. *The inception date for the Bloomberg US Securitized Index is 1 Jan 1997.

S&P 500 Index measures the performance of 500 large companies in the US.

Bloomberg US Aggregate Bond Index measures the performance of investment grade, fixed-rate taxable bond market and includes government and corporate bonds, agency mortgage-backed, asset-backed and commercial mortgage-backed securities (agency and non-agency). **Bloomberg US Corporate Index** measures the performance of the US investment grade fixed-rate taxable corporate bond market. **Bloomberg Treasury Bond Index** measures US dollar-denominated, fixed-rate, nominal debt issued by the US Treasury. **Bloomberg US Securitized Index** measures the performance of the securitized sector of the Bloomberg US Aggregate Bond Index. The indexes are unmanaged, include net reinvested dividends, do not reflect fees or expenses (which would lower the return) and are not available for direct investment. Index data source: Bloomberg Index Services Limited. See diamond-hill.com/disclosures for a full copy of the disclaimer.