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How The Stock Market Performs After Federal Reserve Rate Cuts

Last month, the Federal Reserve cut the federal funds rate by 0.5% and that's usually spelled good news for stocks. Data from the past 40 years shows that, after a rate cut, the S&P 500 has usually posted solid gains one year and three years later. But as with most things in the economy, it's not always that simple.

Types of Rate Cuts: Normalization, Panic, and Recession

The Fed doesn't cut rates in a vacuum. Understanding the context of the rate cut— whether it's due to a panic, a recession, or simply the Federal Reserve balancing economic growth and inflation—can help clarify what to expect for stock market performance. Rate cuts happen for one of three reasons:

1. **Normalization**: This type of rate cut happens when the Fed believes that inflation is under control but the economy needs a bit of a boost, often after a period of higher interest rates. It's a way to nudge growth without facing an immediate crisis. In these cases, the stock market has historically performed well following the cuts. For example, after the Fed's rate cuts in 1984, 1989, 1995, and 2019—each a normalization cut—the market saw positive returns one year and three years later.
2. **Recession Cuts**: This type of rate cut occurs when the Fed is trying to prevent a recession or when the economy is already in one. Rate cuts during recessionary periods, like those in 2001 (the Dot-com bust) and 2007 (the Great Recession), have historically been associated with negative stock market returns.
3. **Panic Cuts**: Sometimes, rate cuts are made in response to major events that shake the financial markets. These "panic cuts" often come during times of significant stress, like after the 1987 stock market crash, the Long-Term Capital Management (LTCM) crisis in 1998, or the COVID-19 pandemic in 2020. Historically, even though a crisis has occurred, the stock market posts positive returns over the next few years, as the markets rebound from fear-driven lows. For instance, after the 1987 crash, the S&P 500 gained over 16% in the following year.

Looking Back at 40 Years of Rate Cuts

Here's a look at how the **S&P 500** performed after various types of rate cuts over the last 40 years:

First Rate Cut Types And Subsequent S&P 500 Returns

Date of First Rate Cut	Type of Cut	One-Year Return	Three-Year Return
9/27/84	Normalization	5.98%	81.09%
10/22/87	Panic ('87 Crash)	16.25%	26.07%
6/5/89	Normalization	12.40%	32.84%
7/6/95	Recession	21.17%	114.20%
9/29/98	Panic (LTCM)	22.52%	4.02%
1/3/01	Recession	-12.57%	-14.45%
9/18/07	Recession	-22.07%	-21.00%
7/31/19	Normalization	10.78%	44.16%
3/3/20	Panic (COVID)	28.90%	40.23%

Type of rate cut and subsequent returns. Data from Factset | St. Louis Trust & Family Office

Notably, the data shows that the stock market performed quite well following a normalization cut. After the 1995 cut, for example, the S&P 500 was up 21.17% one year later and over 114% three years later.

But the market's performance wasn't as positive following rate cuts made during recessions. In 2001, after the Fed cut rates in response to the Dot-com bubble, the market dropped by 12.57% in the first year and continued falling over the next three years. The same was true in 2007, when the Fed cut rates just before the Great Recession, and the S&P 500 fell by over 22% in the following year.

Where Are We Now: Normalization or Recessionary Cuts?

So, where do we stand today? The recent rate cut seems to be a normalization cut, with the Fed aiming to give the economy a boost by cutting from historically high rates. The U.S. economy has been resilient, showing strong job numbers and steady consumer spending, suggesting that we're not heading into a recession—at least not yet.

However, it's important to remember that we won't know whether we're in a recession until we look back with hindsight. Economic data can change quickly, and while we may be headed for a "soft landing"—where inflation cools without a significant economic contraction—there's always the possibility that a recession is around the corner. In fact, few people thought we were on the brink of a financial crisis in September 2007, when the Fed made its first rate cut in response to what seemed like an economic slowdown but not a recession. That rate cut ended up beginning a series of cuts that couldn't prevent the Great Recession.

What Can Investors Expect?

If history is any guide, **rate cuts generally support stock market gains**, especially when they are normalization cuts rather than responses to recessionary conditions. But as shown in the past, the timing and the economic backdrop are crucial. We seem to be in a normalization phase, which has historically delivered positive stock market outcomes. However, if the U.S. economy does enter a recession, it could lead to market downturns similar to those in 2001 or 2007.

As investors, it's essential to stay diversified and avoid reacting to short-term market movements. While a rate cut can be a positive signal for the stock market, understanding the broader economic context is key to managing expectations and risks in your portfolio.

Only time will tell whether this recent rate cut will lead to continued stock market gains or if it was a signal of storm clouds on the horizon.