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6 MERIDIAN

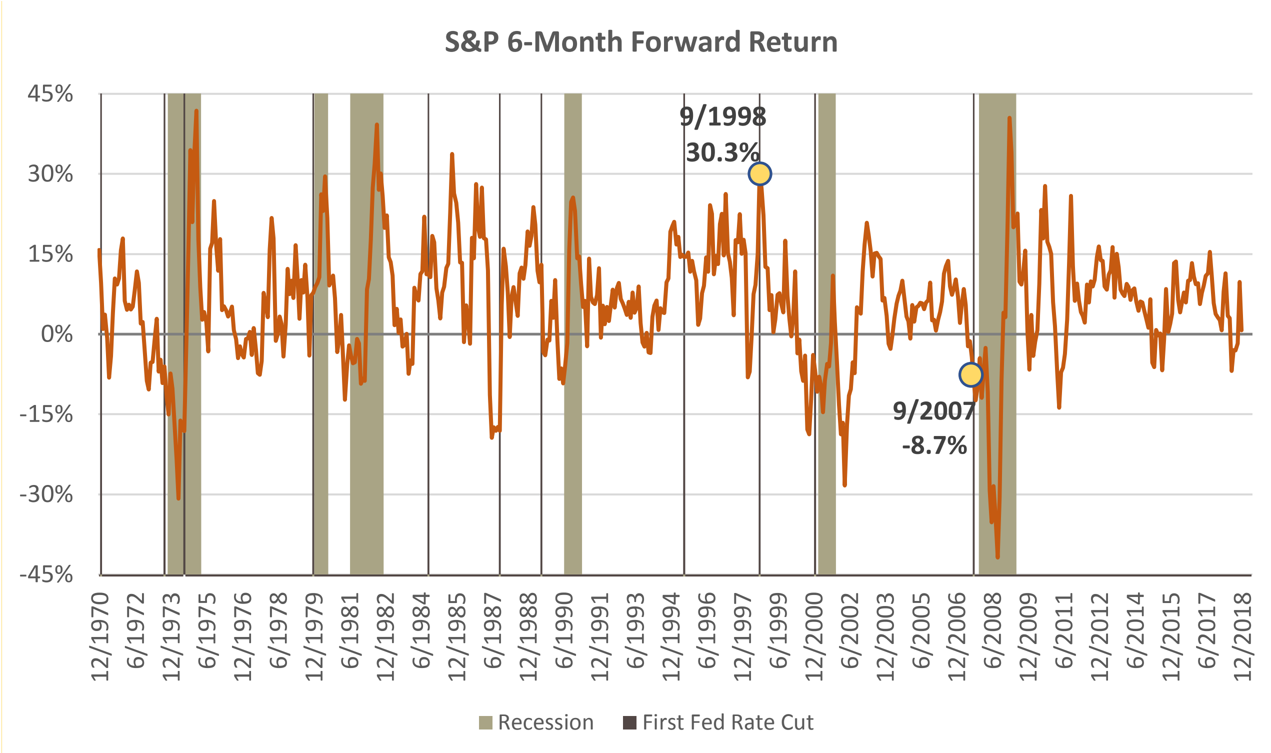
Investment Perspectives – June 2019

There has been a good deal of recent speculation that the Federal Reserve may cut interest rates at some point in the next few months. What might happen when they actually do?

In the past, rates have often been cut in anticipation of or in reaction to a recession. That would be bad news for stocks – the threat of a declining economy hurts earnings expectations and drives down multiples. Historically rate cuts leading into a recession are followed by poor near-term returns. In recent memory we can point to 2001 and 2007 as clear examples.

Date	Fed Cut During Month	S&P 500 Return Next 6 Months	Recession within 6 Months?	Starting P/E	Change in P/E Next 6 Months
Jan-71	-0.75%	9.58%	No	17.4	1.5
Sep-73	-2.00%	(6.05%)	Yes	14.6	(2.5)
Jul-74	-3.75%	(18.14%)	Yes	9.9	(1.9)
Dec-79	-1.50%	7.73%	Yes	7.4	0.1
Oct-84	-1.75%	11.23%	No	10.1	0.6
Oct-87	-0.37%	(18.11%)	No	16.6	(1.6)
Jul-89	-0.63%	12.99%	No	13.7	0.1
Jul-95	-0.25%	14.43%	No	16.6	1.8
Sep-98	-0.25%	30.28%	No	23.2	5.4
Jan-01	-1.00%	(6.70%)	Yes	24.9	(0.9)
Sep-07	-0.50%	(8.72%)	Yes	17.1	(0.3)
July-19	?	?	?	18.9	?

On the other hand, the times when rates were cut but recession did not immediately materialize were generally good for stocks. All else equal, lower rates allow price multiples on stocks to expand as bond yields become less attractive. Growth expectations can also rebound if it becomes clear that recession is not imminent. The starkest example was during 1998, when the Fed cut rates in response to financial pressures from the Asian currency crisis and Russian debt default. Easy money helped propel stocks upward by 30% over the next 6 months and drove P/E multiples into bubble territory.



No two market environments are the same, and one can point to several reasons the market may behave differently now than during past rate cutting cycles. For example, current interest rates and inflation expectations are much lower today than in the above examples. There are also parallels to other time periods such as early 2016, where the Fed didn't cut rates but did pause plans to raise them further in the wake of slower than expected growth. Without expecting a repeat of any one of these scenarios, history still presents a couple lessons. First, Fed action is unlikely to prevent recessions from occurring, especially in the longer term. Second, if rates are cut but recession is not yet approaching then markets could still show considerable upside. While we believe the current economic environment calls for a careful approach to allocation, we would caution against selling in anticipation of, or in response to, a Fed rate cut.

Data Source: Bloomberg; Analysis by 6 Meridian; Data as of 5/31/2019
First Fed Rate Cut defined as the first point where the Federal Reserve lowered the Fed Funds target rate where: a) the rate had not been lowered in the prior nine months and b) the rate had been increased since the last time it had been lowered
Recession as defined by the National Bureau of Economic Research
Returns are measured from the beginning of the month in which the rate cut occurred

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