The Fed Cut Rates and There is No Recession?

The Fed is growing the money supply and that will help the U.S. economy

Since 2015, the Federal Reserve has raised short-term interest rates nine times, including in December 2018, but all that rate-raising came to an end in the summer of 2019.

On Wednesday, July 31st at 2 pm EST, the Fed cut interest rates by 25 basis points – the first time investors have seen a rate cut since the start of the last recession, more than a full decade ago.

It's the end of an era of monetary tightening by the Fed and Fed-watchers anticipate that more rate cuts might be on the horizon for the remainder of 2019. But it does beg the question: why now?

It's an especially important question because the last time the Fed cut rates, it was in 2008, when the Fed dropped rates to basically zero to deal with the financial crisis. And at the time, unemployment was north of 7%, on its way to 10% in 2009, and GDP was -0.1%, on its way to -2.5% the following year.

Today, unemployment is at a 50-year low (3.7%) and GDP is slowing, but still healthily above 2%.

The Fed's Reasoning

The logic behind the Fed's decision is simple: there are a few macro-data points that suggest it's better to act now to protect the U.S. economy and by cutting rates, the Fed can grow the supply of money, which has been growing too slowly for the past few years.

Increasing the supply of money will encourage consumers to spend more – and consumer spending accounts for more than 2/3 of our GDP. In addition, cutting rates would weaken the U.S. dollar, making (in theory) U.S. exports more attractive to foreign buyers.

And while the Fed might not say this, undoubtedly they see headwinds to the U.S. economy – U.S./China trade issues, that Brexit mess, softening manufacturing data here and abroad, and slower corporate earnings.

Investors Should Relax

We all knew that one day, the Federal Reserve's recent run of rate hikes would end and that provokes a lot of investor anxiety. Fortunately, those fears are overblown.

Oddly, the media seems to think that once the Fed sets out to change course it will do so with a damn-the-torpedoes approach, ignoring all sorts of dislocations in the prices of securities and bringing the economy to a grinding halt.

This is evident by the market reaction to Fed news. Anything that pushes forward the starting date, like soft data or a dovish statement from a Fed official, sends the market up. Strong data or hawkish comments, however slight, send the market down. The media's obsessive focus on Fed policy makes this worse.

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Here is the thing about the Fed: rate hikes and rate cuts are almost always gradual and predictable, as the Fed itself has committed to do in writing. But the market still reacts nonetheless.

The concern that interest rates could rise a lot stems from past Fed moves. The market remembers 2004 when the fed funds rate soared from 1% to 5.25%. And 10 years before that, in 1994, it climbed from 3% to 6%. And before that, in 1987, from 5.75% to 9.75%. This suggests that the Fed does not fool around when it changes policy.

Monsters are not Real

A change in Fed policy is a monster under the bed keeping investors awake at night: scary, but not real.

No doubt, there are always reasons to worry. But investors who think their main threat today is U.S. monetary policy are looking in the wrong place.

Here is another thing that might help you sleep better at night:

- Over the past 35 years, the Fed has started rate-cutting cycles five other times when there was no recession – in 1984, 1987, 1989, 1995 and 1998.
- During the six months after the first rate cut, the S&P 500 rose an average of 11%.
- Twelve months after each of those initial rate cuts, the S&P 500 rose an average of 15.8%.

While past performance is never a guarantee of future results, the Fed is no monster.

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