

Did You Know?



It's Going Down: An Update on Interest Rates

Key Takeaways

- The Fed cut rates by 0.50% in September 2024, with more cuts anticipated through the year and in 2025.
- Historically, we've seen rate cut cycles take a similar path to current expectations. Rates have often fallen quickly once cuts have begun.
- Falling rates have historically benefited intermediate-duration bonds as well as small-value stocks.

In September, the Federal Reserve (Fed) made its first cut to the federal funds rate since March 2020 – a 0.50% reduction. Now, expectations from both the Fed and market participants are for more cuts, and in relatively short order. Recently released Fed estimates project two more 0.25% cuts in the policymakers' last two meetings of the year. They also estimate the fed funds rate to be about 3.4% by the end of 2025. The current target rate is 4.75-5.00%.

As of the market close on September 30, market expectations were slightly more aggressive. Prices on fed futures contracts suggested that the highest probability outcomes are two more cuts in 2024 (total reduction of 0.75% over those two meetings) and cuts in each of the first four meetings of 2025. That would bring the federal funds rate to a target range of 3.00-3.25%. **Figure 1** shows all implied probabilities by target rate range for the next nine Federal Open Market Committee (FOMC) meetings.

Figure 1 | The Market Expects Several More Rate Cuts Ahead

Probability of Federal Funds Rate Target Range by 2024 FOMC Meeting

FOMC MEETING DATE	1.75-2.00%	2.00-2.25%	2.25-2.50%	2.50-2.75%	2.75-3.00%	3.00-3.25%	3.25-3.50%	3.50-3.75%	3.75-4.00%	4.00-4.25%	4.25-4.50%	4.50-4.75%	HIGHEST PROBABILITY ACTION
11/7/24	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	36.70%	63.30%	CUT
12/18/24	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	16.50%	48.60%	34.90%	0.00%	CUT
1/29/25	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	3.60%	23.50%	45.60%	27.20%	0.00%	0.00%	CUT
3/19/25	0.00%	0.00%	0.00%	0.00%	0.40%	5.80%	26.00%	43.60%	24.20%	0.00%	0.00%	0.00%	CUT
5/7/25	0.00%	0.00%	0.00%	0.30%	4.60%	21.40%	39.60%	28.60%	5.50%	0.00%	0.00%	0.00%	CUT
6/18/25	0.00%	0.00%	0.20%	3.10%	15.70%	33.50%	32.30%	13.30%	1.80%	0.00%	0.00%	0.00%	CUT
7/30/25	0.00%	0.10%	1.30%	7.80%	22.40%	33.10%	25.20%	9.00%	1.20%	0.00%	0.00%	0.00%	HOLD
9/17/25	0.00%	0.40%	3.20%	12.10%	25.50%	30.70%	20.40%	6.70%	0.80%	0.00%	0.00%	0.00%	HOLD
10/29/25	0.10%	1.00%	5.00%	14.90%	26.60%	28.60%	17.60%	5.50%	0.60%	0.00%	0.00%	0.00%	HOLD

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The History of Fed Rate Cuts

If these predictions on the path of interest rates feel overzealous, take a look at how the Fed has handled interest rate decisions in the past. In **Figure 2 Panel A**, we share details on each time the Fed has lowered the fed funds rate since 1990. Before that, the Fed didn't target a specific fed funds rate.

We observe nine distinct periods of rate cuts, and it's clear that some have quite different characteristics than others. Four of the nine periods saw the fed funds rate decline by less than 1%. During the other five periods, the average rate change from the first to the last rate cut was more than 3% and, in each case, with a cumulative cut of at least 1% occurring within six months. **Figure 2 Panel B** depicts those five periods showing cumulative rate cuts by month after each cycle began. It's evident that historically when the Fed has cut rates in similar magnitudes to their current projections, it has happened fast.

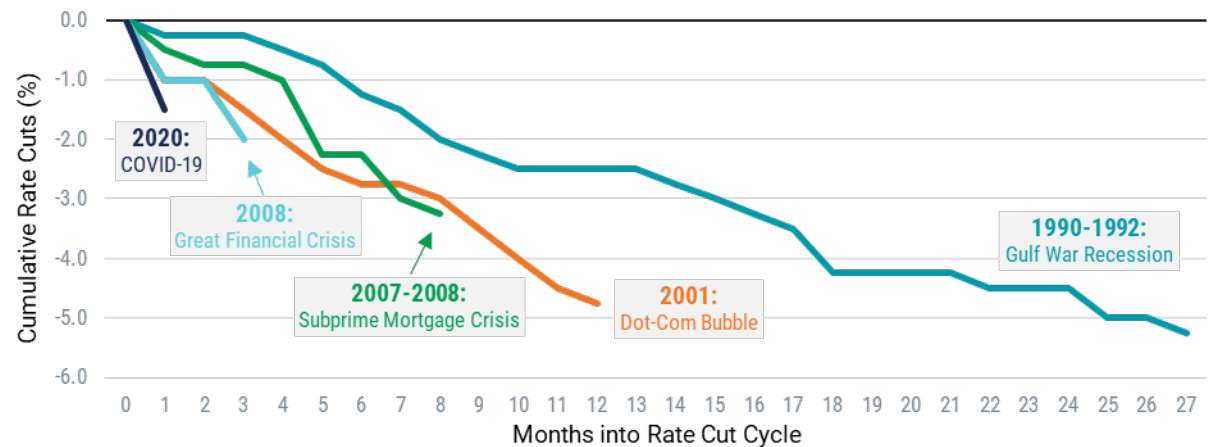
Figure 2 | History of Fed Funds Rate Cuts Since 1990

Panel A | All Historical Rate Cut Cycles

Period	Starting Fed Funds Rate	Ending Fed Funds Rate	# of Rate Cuts	Size of First Rate Cut	# of Months to Cut 1%
July 1990 - September 1992	8.25%	3.00%	18	0.25%	6
July 1995 - January 1996	6.00%	5.25%	3	0.25%	-
September 1998 - November 1998	5.50%	4.75%	3	0.25%	-
January 2001 - December 2001	6.25%	1.75%	11	0.50%*	1
November 2002 - June 2003	1.75%	1.00%	2	0.50%	-
September 2007 - April 2008	5.25%	2.00%	7	0.50%	4
October 2008 - December 2008	2.00%	0.00%	3	0.50%*	1
August 2019 - October 2019	2.25%	1.50%	3	0.25%	-
March 2020	1.50%	0.00%	2	0.50%*	1

*Multiple rate cuts occurred in the first month of the cycle via emergency FOMC meetings. The figure shown reflects only the first rate-cut decision.

Panel B | Past Rate Cut Cycles When the Fed Funds Rate Fell by 1% or More





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The Impact of Bond Duration During Falling-Rate Environments

For many investors, the question now is what these expected rate cuts could mean for their portfolios. With more than \$5 trillion currently in government money market funds, a more specific question is what impact will duration have during a period of declining interest rates.

With money market funds, the attraction of late has been yields generally around 5% without much concern for price sensitivity to changes in interest rates given the amortized cost structure of money market funds that allows them to maintain a typically constant \$1 price. That also means that as rates on short-term bonds come down (money market funds are required to maintain a weighted average maturity of 60 days or less), overall yield for money market funds should decline (in particular in the presence of new cash flows diluting existing yields) without any potential benefit from price appreciation.

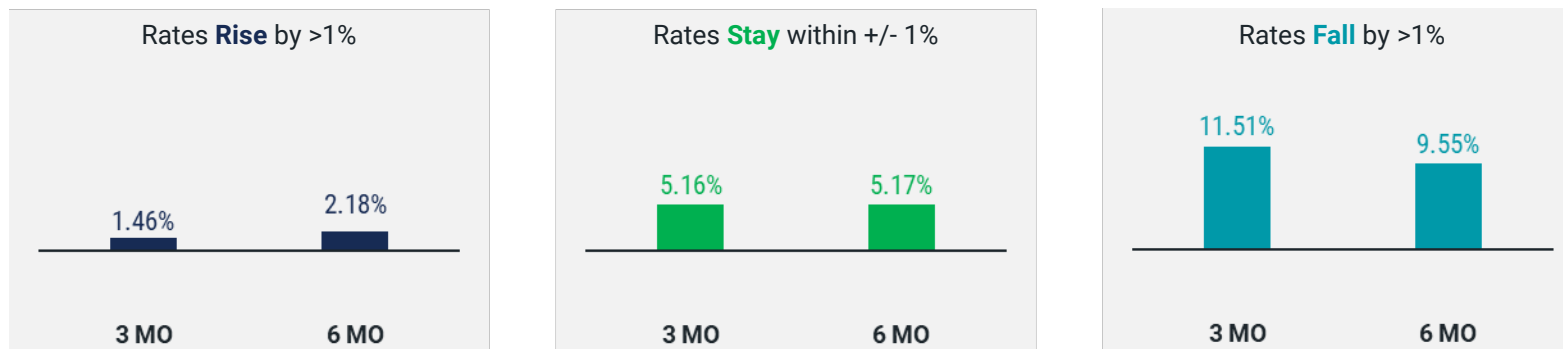
Bond prices tend to go up as yields go down, but money market investors don't receive this benefit due to the amortized cost structure and short duration of the underlying securities.

We examined how intermediate core bonds have performed in past interest rate environments, using the Bloomberg U.S. Aggregate Bond Index since its inception in 1986. Given the current expectations for fairly quick rate declines, we've computed the analysis over short time horizons: three months and six months.

The results are shown in **Figure 3**, which includes annualized average returns for the index for each time horizon during periods when rates rose by more than 1%, when rates were relatively stable and stayed within plus-or-minus 1%, and when rates fell by more than 1%. We find that historically, intermediate core bonds have delivered significantly higher annualized average returns when rates fall quickly versus in more stable or fast-rising interest rate environments.

Figure 3 | Intermediate Core Bonds Have Delivered Higher Returns When Rates Fall Quickly

Bloomberg U.S. Aggregate Bond Index Annualized Average Return During Different Rate Environments



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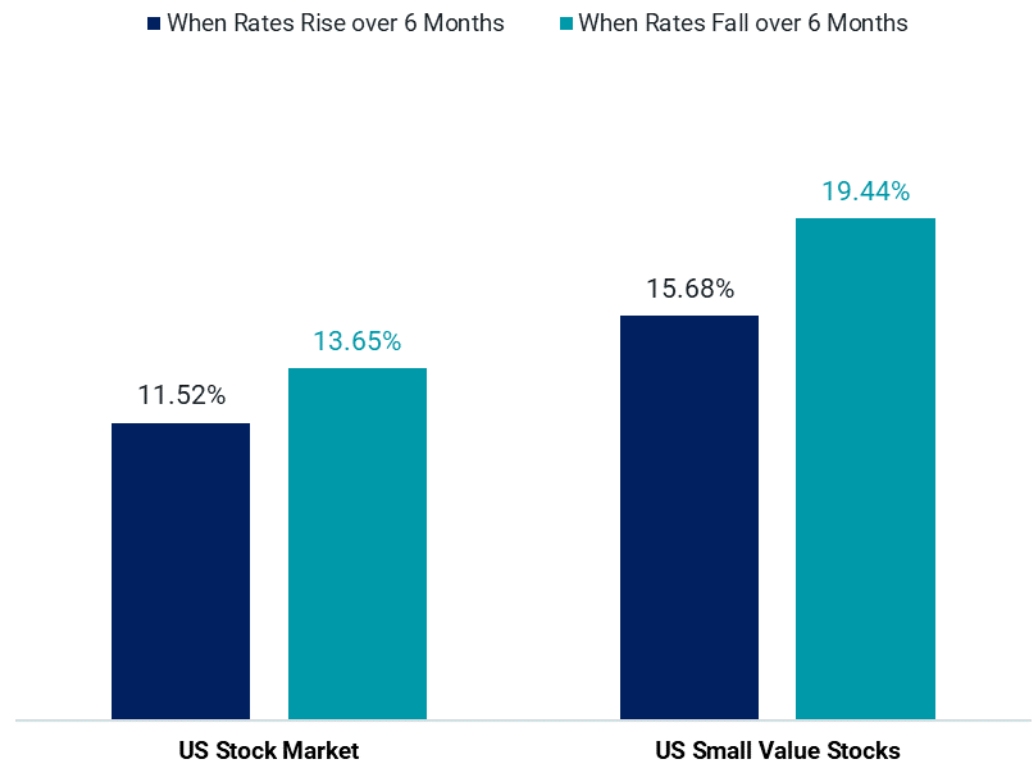
How Stocks Have Performed When Rates Fall

Adding to our analysis on interest rate changes, we calculated the performance of U.S. stocks (total market and small-cap value) since 1976. Now that we are presenting multiple asset classes, we narrow the scenarios to when rates rise and fall over six-month periods for simplicity.

In **Figure 4**, we show that whether rates have risen or fallen over six-month periods, both the total market and small value stocks have delivered strong positive returns. Perhaps more interesting is the spread in average returns between small-value stocks and the total market during the different environments.

The difference in average small value and total market returns when rates rise during the sample period is 4.2%. When rates have fallen, the outperformance for small-value stocks over the market rises to 5.8%. So, while low-priced stocks don't outperform the market every month or even every year, periods of falling rates have historically been favorable for value investors.

Figure 4 | Lower-Priced Stocks Have Historically Fared Well in Falling-Rate Environments
Annualized Average Returns





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The Bottom Line

While nothing is ever guaranteed with respect to the path of interest rates, the expectations are clear and largely aligned between the Fed and the market that the fed funds rate is currently well above the so-called "neutral rate" and should decline going forward.

Moreover, the Fed's expected pace of rate cuts is now even faster than what we observed earlier in the year. The data tells us that historically, in quickly falling rate environments, extending duration beyond cash or money market funds has, on average, led to better outcomes for investor portfolios. And, as we believe is true every day, considering valuations within equity allocations is expected to benefit investors, but historically that benefit has been more impactful when rates are going down.

Endnotes

Duration: Measures how long it takes, in years, for an investor to be repaid a bond's price by the bond's total cash flows. It is also a measure of a bond's interest rate sensitivity. The longer the duration, the more sensitive a bond is to interest rate shifts.

Federal Funds Rate (Fed Funds Rate): An overnight interest rate banks charge each other for loans. More specifically, it's the interest rate charged by banks with excess reserves at a Federal Reserve district bank to banks needing overnight loans to meet reserve requirements.

Fed Futures Contract: An agreement to buy or sell a specific amount of a commodity or financial instrument at a particular price on a stipulated future date, based on the federal funds rate. Futures contracts are typically used as a hedging/risk management tool in portfolio management.

Federal Reserve (Fed): The Fed is the U.S. central bank, responsible for monetary policies affecting the U.S. financial system and the economy.

FOMC (Federal Open Market Committee): The committee that sets interest rate and credit policies for the Federal Reserve System, the U.S. central bank. The committee decides whether to increase or decrease interest rates through open-market operations of buying or selling government securities.

Yield: For bonds and other fixed-income securities, yield is a rate of return on those securities. There are several types of yields and yield calculations. "Yield to maturity" is a common calculation for fixed-income securities, which takes into account total annual interest payments, the purchase price, the redemption value, and the amount of time remaining until maturity.
