Forbes

The Fed Rates And Your Investments: What We Learn From History

Paul Daneshrad Forbes Councils Member
Forbes Finance Council COUNCIL POST| Membership (Fee-Based)
Oct 26, 2023,07:00am EDT

Paul Daneshrad is the founder & CEO of StarPoint Properties, a well-respected real estate investment and development firm.

Getty

The debate raging in the financial commentariat over when and how much the Federal Reserve will cut interest rates is enough to make bewildered investors sympathize with Harry Truman. The 33rd president once groused, “Give me a one-handed economist. All my economists say, ‘on the one hand ...’ then ‘but on the other ...’”

Fortunately, it is possible to look back at historical rate-cutting cycles and glean some insight into what the next one holds in store.

Inflation Concerns In The Last Three Cycles

The Dot-Com Cycle

In May of 1999, worried that the dot-com boom would fuel inflation, the Fed began raising rates from 4.74%. It stopped a little over a year later at around 6.50% as the dot-com stock bubble began bursting. About six months later, it began cutting again as the economy slid into recession, reducing rates sharply until mid-2003, by which time it had cut all the way down to 1.00%.

The Great Recession

The inflationary pressure caused by the 2000s housing boom was the next cause for the Fed to hike. It brought its benchmark from 1.00% in May 2004 up to 5.25% in August 2006. Unfortunately, in June 2007 the housing market was beginning to crash, triggering the massive Great Recession, which forced the Fed to cut rates to 0.25% by the end of 2008.

2015 Normalization

The Fed kept rates near zero until late 2015 when economic conditions allowed it to attempt to return to a “natural” rate—the process called “normalization.” The natural rate is the one that allows for economic growth without inflation. By the end of 2018, it had raised the rate by 2 percentage points, to 2.25%, where it paused, having brought nascent inflationary pressures under control.

The normalization gave it the ability to cut rates by half a percent by 2020 in response to worries about economic growth. Then the Covid crisis hit, and the Fed slashed rates back to 0.25%.

The Current Cycle

he Fed’s massive monetary stimulus combined with fiscal policy moves like stimulus payments and loans caused inflation to careen out of control, hitting a 40-year high of over 9% in 2022. This caused the Fed to raise the Fed Funds rate to where it is today.

How Rate Changes Have Affected The Economy

In all three of the previous crisis-related cycles (excluding the 2015 normalization), the Fed followed the strategy often derisively called “The Greenspan Put.” This is the Fed’s willingness to bail out investors by lowering rates when markets crash, first used by former Chairman Alan Greenspan.

The Fed slashed rates in all three cycles in response to market declines, and this resulted in rebounds, some of which provided extraordinary returns for investors:

• It took six years for the S&P 500 to regain its previous high after both the 2000 dot-com crash and the 2008 Great Recession, and it took about half a year after the 2020 Covid crash.

• From the time the Fed cut until its next high, the S&P 500 rose 66% after the dot-com crash, 294% after the Great Recession crash and 66% after the Covid crash.

Discounting the Covid situation as uniquely affected by the exogenous variable of the pandemic, stock market investors can assume that stock market investors in a crash could have to wait about six years from the time the Fed cuts the Fed Funds rate to recoup their losses—and real estate investors may have to wait even longer.

Looking Ahead: When May The Fed Start Cutting?

The big question, then, is when is it likely that the Fed will cut rates? Every analyst on Wall Street has a view, and they differ widely. For example, Goldman Sachs, in a recent report by Jan Hatzius and his colleagues, called for cuts to begin in the second quarter of next year and proceed in quarter-point increments until the rate reaches 3%-3.25%.

What To Consider

Bear in mind that in this cycle, the past is not the prologue. All of the Fed's rate cycles since the late 1990s, except for the short attempt at normalization in 2015, were driven by downturns and rebounds in markets (dot-com stocks, the Great Recession and the Covid crisis). Today's cycle is designed to deal with inflation concerns, which have not driven policy since the early 1980s. The Fed's Greenspan Put strategy no longer works in this environment, and that has markets on edge.

With so much uncertainty in the market, and everyone on a hair trigger, it's best to consider focusing on risk management. Whatever asset class you favor, you may want to consider investments that demonstrated low volatility during past cycles. This also means we need to be patient and today might not be the best time to invest. History suggests that markets can take an awfully long time to recover from shocks, but it also suggests that long-term investors can see outsized gains if they stay the course.

LINK TO ORIGINAL ARTICLE HERE