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What to Expect When You're Expecting Rate Cuts

After a little over a year of watching how their 525 basis points of interest rate increases has impacted growth and inflation, the Federal Reserve (Fed) finally began its rate cut cycle yesterday. While the economy, financial markets, and your financial plan are driven by more than changes in interest rate policies, policy changes still have important implications for these key inputs into achieving your goals.

Economic Implications

All else being equal, lower interest rates are a stimulus for economic growth via reduced borrowing costs for consumers and businesses. That said, it takes time for that stimulus to flow through to the economy and interest rates will still be restrictive for near-term growth even now that cuts have begun. As such, the start of the rate cut cycle will likely have little immediate impact on the already softening economy.

Financial Market Implications

From a financial market perspective, lower interest rates in a vacuum are a positive for companies as they reduce the cost of borrowing and increase the current value of future profits. In practice, companies do not operate in vacuums, which means the reasons behind the rate cuts matter more for near-term performance.

Past performance is no guarantee of future returns, but historically stocks have performed relatively better when rate cuts are gradual. Gradual rate cut cycles occur when the Fed is not concerned about recession risks, implying underlying economic growth remains positive.

The performance of high-quality bonds (e.g. long-term treasuries), by comparison, improves and is typically more comparable to stock performance. This dynamic has already started to appear.

Over the past six months[1] the Bloomberg Barclays U.S. Aggregate Bond index benchmark for such bonds is up almost 6.5% (vs roughly 8% for global stocks). By comparison, in the three years preceding that period that bond benchmark fell 7% (vs a 21% gain in global stocks).

Ultimately, market performance will depend primarily on when the next recession occurs. Historically, rate cut cycles often begin too late to avert a nearer-term recession. While we hope this time proves the exception rather than the rule, this dynamic leads us to remain defensively allocated in portfolios. In practice this means trying to capture additional market upside to the extent possible while favoring blue-chip U.S. companies, treasuries, and other strategies that historically hold up better in risk-off markets should a recession occur.

Financial Planning Implications

Every financial situation is unique, but one starting point for understanding rate cut implications is having an expectation for how far rates are likely to fall.

[1] Data as of 9/18/24.

Currently, markets have priced in 250 basis points of rate cuts through the end of next year. Our rule of thumb for refinancing mortgages and other types of debt is waiting until rates are 1%-2% lower than where you borrowed. So, while the initial cut is usually too soon to refinance, it is a good time to start gathering the documentation you will need so that you are at the front of the queue when a more appropriate time to refinance arrives.

Lower interest rates also reduce the attractiveness of holding excess cash. For necessary cash (e.g. emergency funds or known upcoming expenses), think about taking advantage of current rate levels before those rates fall to a level that is less competitive versus inflation. Similarly, consider putting excess cash to work in markets, as cash returns tend to lag those of diversified portfolios longer-term.

While Fed cut cycles and the recession risks associated with them are important cyclical milestones, they aren't the only factor that matters – particularly over the long-term. Stay invested and diversified, consider the implications of lower rates on your financial plan outside of financial markets, and contact your Advisor if you have any questions or would like to talk.

Your O'Brien Team

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51 Sawyer Road, Suite 600, Waltham, MA 02453 **P** 617.547.6717 **F** 617.830.0822 **www.obrienwp.com**