U.S. Equity Market Performance Following the First Fed Funds Rate Cut

September 2024

After two and a half years of battling elevated inflation with aggressive monetary policy tightening measures, the Federal Reserve (Fed) finally reduced the federal funds target rate range (fed funds rate) by 50 basis points during its September 2024 meeting. With recent inflation indicators seemingly within the Fed's comfort zone, coupled with an increasing emphasis on supporting the labor market, we believe it's highly likely that additional rate cuts are forthcoming.

The charts below examine U.S. large-cap (Russell Top 200® Index), mid-cap (Russell Midcap® Index), and small-cap (Russell 2000® Index) equity market performance in 6-month, 12-month, and 24-month periods after the first fed funds rate cut within a monetary policy easing cycle, as defined by at least two fed funds rate cuts before the next rate hike.

Since monetary policy tools and communication methods used by the Fed have evolved over time, periods after 1994 (which marked a new approach in fed funds rate transparency) are most indicative of how the Fed currently operates and disseminates monetary policy. However, data going back to 1983 is used in this analysis as the post-1983 era represents a period in which inflation bottomed and remained range-bound after an extended period of relatively extreme movements in inflation and interest rates in the late 1970s and early 1980s. As such, it's important to note that delays in monetary policy change communication prior to 1994 led to less definitive fed funds rate cut start dates during the 1983-1993 period. To overcome this challenge, data from David E. Lindsey's *A Modern History of FOMC Communication: 1975-2002* was used to define monetary policy change dates from 1983-1989.

		6-Month Return (%) After Communication Date		
Fed Funds Rate Reduction Communication Date	**U.S. Recession Within 24 Months of Communication Date?**	**Russell Top 200® Index**	**Russell Midcap® Index**	**Russell 2000® Index**
10.02.1984	No	10.76	13.95	11.59
12.17.1985	No	23.87	26.47	20.51
10.23.1987	No	-19.19	-13.20	15.61
06.06.1989	Yes	10.53	5.40	-1.58
07.06.1995	No	15.91	10.38	10.46
09.29.1998	No	25.76	14.49	7.64
01.03.2001	Yes	-4.74	2.36	8.49
09.18.2007	Yes	-12.18	-13.59	-15.61
07.31.2019	Yes	11.17	6.16	4.72
Average Return		6.88	5.83	6.87
Best Return		25.76	26.47	20.51
Worst Return		-19.19	-13.59	-15.61
# Positive Returns		6	7	7
# Negative Returns		3	2	2
Average Positive Return		16.33	11.32	11.29
Average Negative Return		-12.03	-13.39	-8.60
Average Return - Recession Within 24 Months		1.20	0.09	-1.00
Average Return - No Recession Within 24 Months		11.42	10.42	13.16

Source: Federal Reserve Bank of St. Louis, A Modern History of FOMC Communication 1975-2002, Morningstar Direct. Charts are for illustrative purposes only. The views expressed represent the opinions of Sterling Capital Management. Any type of investing involves risk and there are no guarantees that these methods will be successful.

U.S. Equity Market Performance Following the First Fed Funds Rate Cut

September 2024

		12-Month Return (%) After Communication Date		
Fed Funds Rate Reduction Communication Date	U.S. Recession Within 24 Months of Communication Date?	Russell Top 200® Index	Russell Midcap® Index	Russell 2000® Index
10.02.1984	No	14.67	16.32	11.02
12.17.1985	No	26.32	26.27	7.71
10.23.1987	No	-13.12	-7.76	22.29
06.06.1989	Yes	17.77	7.61	0.68
07.06.1995	No	24.85	19.51	20.90
09.29.1998	No	26.08	15.51	15.23
01.03.2001	Yes	-11.22	-1.64	6.86
09.18.2007	Yes	-20.52	-17.98	-11.63
07.31.2019	Yes	13.55	1.10	-4.31
Average Return		8.71	6.55	7.64
Best Return		26.32	26.27	22.29
Worst Return		-20.52	-17.98	-11.63
# Positive Returns		6	6	7
# Negative Returns		3	3	2
Average Positive Return		20.54	14.39	12.10
Average Negative Return		-14.95	-9.13	-7.97
Average Return - Recession Within 24 Months		-0.10	-2.73	-2.10
Average Return - No Recession Within 24 Months		15.76	13.97	15.43

		24-Month Return (%) After Communication Date		
Fed Funds Rate Reduction Communication Date	U.S. Recession Within 24 Months of Communication Date?	Russell Top 200® Index	Russell Midcap® Index	Russell 2000® Index
10.02.1984	No	22.52	24.84	16.39
12.17.1985	No	9.73	6.37	-3.00
10.23.1987	No	7.79	9.11	20.19
06.06.1989	Yes	14.88	9.78	3.83
07.06.1995	No	34.29	23.97	19.74
09.29.1998	No	20.58	24.17	20.76
01.03.2001	Yes	-16.47	-7.81	-6.56
09.18.2007	Yes	-13.08	-11.36	-9.55
07.31.2019	Yes	25.00	20.06	19.98
Average Return		11.69	11.01	9.09
Best Return		34.29	24.84	20.76
Worst Return		-16.47	-11.36	-9.55
# Positive Returns		7	7	6
# Negative Returns		2	2	3
Average Positive Return		19.25	16.90	16.82
Average Negative Return		-14.77	-9.59	-6.37
Average Return - Recession Within 24 Months		2.58	2.67	1.92
Average Return - No Recession Within 24 Months		18.98	17.69	14.82

Source: Federal Reserve Bank of St. Louis, A Modern History of FOMC Communication 1975-2002, Morningstar Direct. Charts are for illustrative purposes only. The views expressed represent the opinions of Sterling Capital Management. Any type of investing involves risk and there are no guarantees that these methods will be successful.

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September 2024

Key Takeaways:

- **U.S. Equities Have Historically Generated Positive Returns after the First Fed Funds Rate Cut**
  - On average, returns for large caps, mid caps, and small caps are positive in the 6-month, 12-month, and 24-month periods after the first rate cut in a rate cut cycle.
  - Average returns during periods in which the U.S. economy did not experience a recession within 24 months of the first fed funds rate cut are higher than returns in periods in which a recession occurred within 24 months.
  - However, average returns in the 24-month period following the first fed funds rate cut in which a recession occurred within 24 months of first fed funds rate cut are positive for all three market segments. In addition, average returns for all three segments are only slightly negative in the 12-month period following the first rate cut.
- **Large Caps Have Historically Outperformed After the First Fed Funds Rate Cut**
  - Average returns for large caps over the 6-month, 12-month, and 24-month periods after the first fed funds rate cut outperformed mid caps and small caps.
  - This outperformance was primarily driven by returns in which 6-month, 12-month, and 24-month periods were positive after the first rate cut.
  - Large-cap outperformance is somewhat surprising in our opinion, especially in positive periods, as small caps generally have higher levels of floating rate debt when compared to large caps. All else equal, this dynamic may provide a larger tailwind for small caps as interest expense and/or cost of capital typically falls at a faster pace when compared to large caps.
- **Small Caps Have Historically Been a Source of Downside Protection During Easing Cycles**
  - Small caps had the best “worst” return in the 12-month and 24-month periods and had the lowest average negative return across all time frames.
  - This is somewhat counterintuitive given that small caps have historically had a higher risk profile when compared to large caps and mid caps and can be more sensitive to a slowdown in economic growth.
  - However, small caps had the lowest average return during the 6-month and 24-month periods in which a recession occurred within 24 months of the first fed funds rate cut.
  - In our view, small-cap outperformance in down periods supports the case for diversification, especially as many investors could be questioning the rationale for maintaining a diversified portfolio after U.S. large caps have outperformed other market segments for over a decade.

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September 2024

- **“Stick to Your Plan” Regardless of Fed Monetary Policy**
  - Perhaps the most important takeaway, in our view, is the initiation of a fed funds rate easing cycle is not a compelling reason to make drastic changes to strategic asset allocation positioning.
  - The data in the previous tables suggests that equities, on average, have historically produced positive results in the short-to-intermediate term periods following the initial fed funds rate cut in an easing cycle. While recessions have occurred shortly after the Fed begins reducing the fed funds rate, it’s difficult to predict the onset, duration, and severity of future recessions. Moreover, equities can produce positive results during recessions. Engaging in marketing timing (i.e., not staying fully invested) could potentially lead to missing out on positive returns.
  - Finally, elevated volatility caused by changes in monetary policy may provide opportunities to take advantage of market dislocations by implementing risk-measured tactical asset allocation changes.

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Important Information

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Brandon W. Carl, CFA®, Executive Director, joined BB&T Asset Management in 2001 and Sterling Capital Management through merger in 2010. He has investment experience since 2001. Brandon is a portfolio manager on Sterling's Advisory Solutions team with a focus on equity. Previously, he graduated from the BB&T Leadership Development Program and was an equity analyst covering the healthcare and consumer staples sectors for BB&T Asset Management. Brandon received his B.S. in Finance and Management from the University of South Carolina. He holds the Chartered Financial Analyst® designation.

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The **fed funds rate** is the interest rate that depository institutions (such as banks and credit unions) charge other depository institutions for overnight lending of capital from their reserve balances on an uncollateralized basis.

A Note on Indices: The volatility of an index varies greatly. All indices are unmanaged and investments cannot be made directly in an index.

The Russell Top 200® Index is an index of the largest 200 companies in the Russell 3000 index. It is commonly used as a benchmark index for U.S.-based ultra large-cap (mega-cap) stocks with the average member commanding a market capitalization of upwards of $200 billion.

The Russell Midcap® Index measures the performance of the mid-cap segment of the U.S. equity universe. The Russell Midcap® Index is a subset of the Russell 1000® Index. It includes approximately 800 of the smallest securities based on a combination of their market cap and current index membership. The Russell Midcap® Index represents approximately 31% of the total market capitalization of the Russell 1000® companies. The Russell Midcap® Index is constructed to provide a comprehensive and unbiased barometer for the mid-cap segment. The index is completely reconstituted annually to ensure larger stocks do not distort the performance and characteristics of the true mid-cap opportunity set.

The Russell 2000® Index measures the performance of the small-cap segment of the U.S. equity universe. The Russell 2000® Index is a subset of the Russell 3000® Index representing approximately 10% of the total market capitalization of that index. It includes approximately 2,000 of the smallest securities based on a combination of their market cap and current index membership. The Russell 2000® is constructed to provide a comprehensive and unbiased small-cap barometer and is completely reconstituted annually to ensure larger stocks do not distort the performance and characteristics of the true small-cap opportunity set.

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