The Fed pivots: Lower rates, higher stakes

An analysis of previous rate-cutting cycles and macroeconomic conditions suggests a wide range of potential asset class outcomes in a hard or soft landing.

Brian Hayes, PhD
Quantitative Analyst
Global Asset Allocation

Christopher Luongo, CFA
Institutional Portfolio Manager
Global Asset Allocation

Lance McInerney, CFA
Institutional Portfolio Manager
Global Asset Allocation

Andrew Dierdorf, CFA
Portfolio Manager
Global Asset Allocation

Brett Sumsion, CFA
Portfolio Manager
Global Asset Allocation

Fulcrum Issues is an ongoing series featuring commentary from Fidelity's Target Date investment team. In this series, Fidelity portfolio managers and researchers share insights on current topics of critical importance for multi-asset class investors.

KEY TAKEAWAYS

- Recent trends in inflation, employment, and gross domestic product (GDP) growth support a non-recessionary (soft landing) outcome.
- Forward interest rate curves suggest that investors are expecting rate cuts to be larger than rate cuts in historical non-recessionary environments.
- Equities have outperformed fixed income after the first non-recessionary cut, led by non-U.S. developed markets.
- Fixed income (as measured by the Bloomberg U.S. Aggregate Bond Index) had positive returns in non-recessionary and recessionary rate cuts and outperformed equities when the recession odds approached 60%.
- Commodities have lagged following both recessionary and non-recessionary cuts.

Introduction

Investors are tasked with developing techniques to frame and weigh the range of potential outcomes that could affect asset prices. As we observe a shift in monetary policy, with the U.S. Federal Reserve expected to cut rates by almost 2% in the next 22 months, we are motivated to study historical precedents for rate cuts and the range of potential outcomes for asset returns. We note that the magnitude of rate cuts that investors are expecting suggests debate about whether the Fed is managing a soft landing or is acting in response to an adverse growth scenario. The uncertainty created by a "hard versus soft landing" rate-cut scenario makes it a fulcrum issue for investors.

To address this issue, we studied previous rate-cutting cycles during non-recessionary (soft landing) and recessionary (hard landing) periods and the potential implications for asset prices. We also considered the macroeconomic conditions leading up to prior rate cuts to evaluate the potential for a hard or soft landing.

The results of this study are largely consistent with our portfolios' positioning and where we find relative value today. Our target date fund portfolios are overweight equities with a preference for international markets. We have reduced the portfolios' commodity exposure in favor of fixed income while maintaining duration exposure that is similar to benchmark.

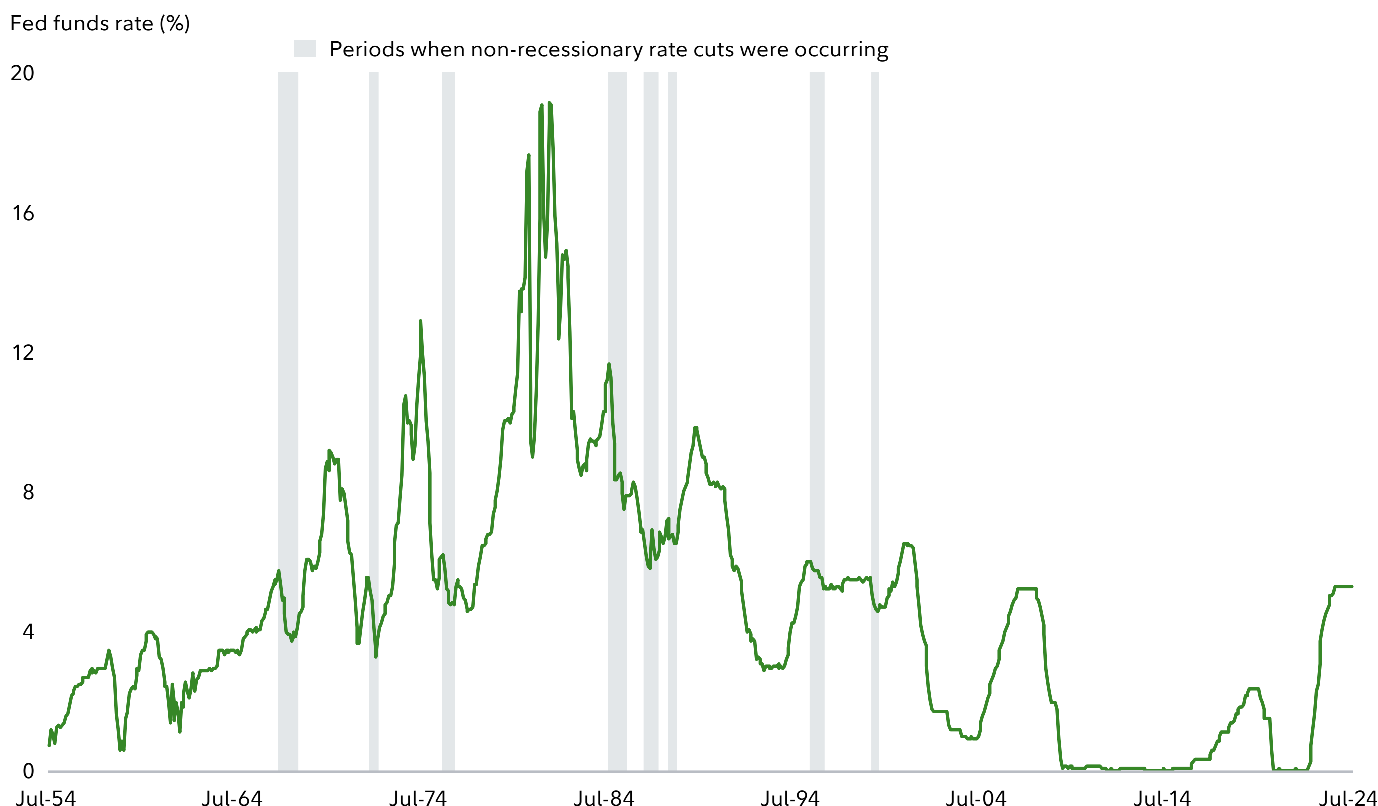
Less is more with non-recessionary rate cuts

Given the debate on soft versus hard landing, we split prior rate cut cycles into recessionary and non-recessionary groups. We define a soft landing as a period when the Fed cuts rates absent a recession.[1] Our criteria resulted in eight non-recessionary rate-cut periods since the federal funds rate began in 1954, as shown in Exhibit 1.

Non-recessionary rate cuts have been relatively brief in length, with a median duration of 7.5 months,[2] and relatively modest, with a median cumulative rate cut of 1.15%. In contrast, in the recessionary rate cut periods, the federal funds rate declined by a median amount of 2.21%. Given the 5.33% fed funds rate as

EXHIBIT 1: Non-recessionary rate-cut periods (soft landings)

Periods with Fed cuts in absence of recession



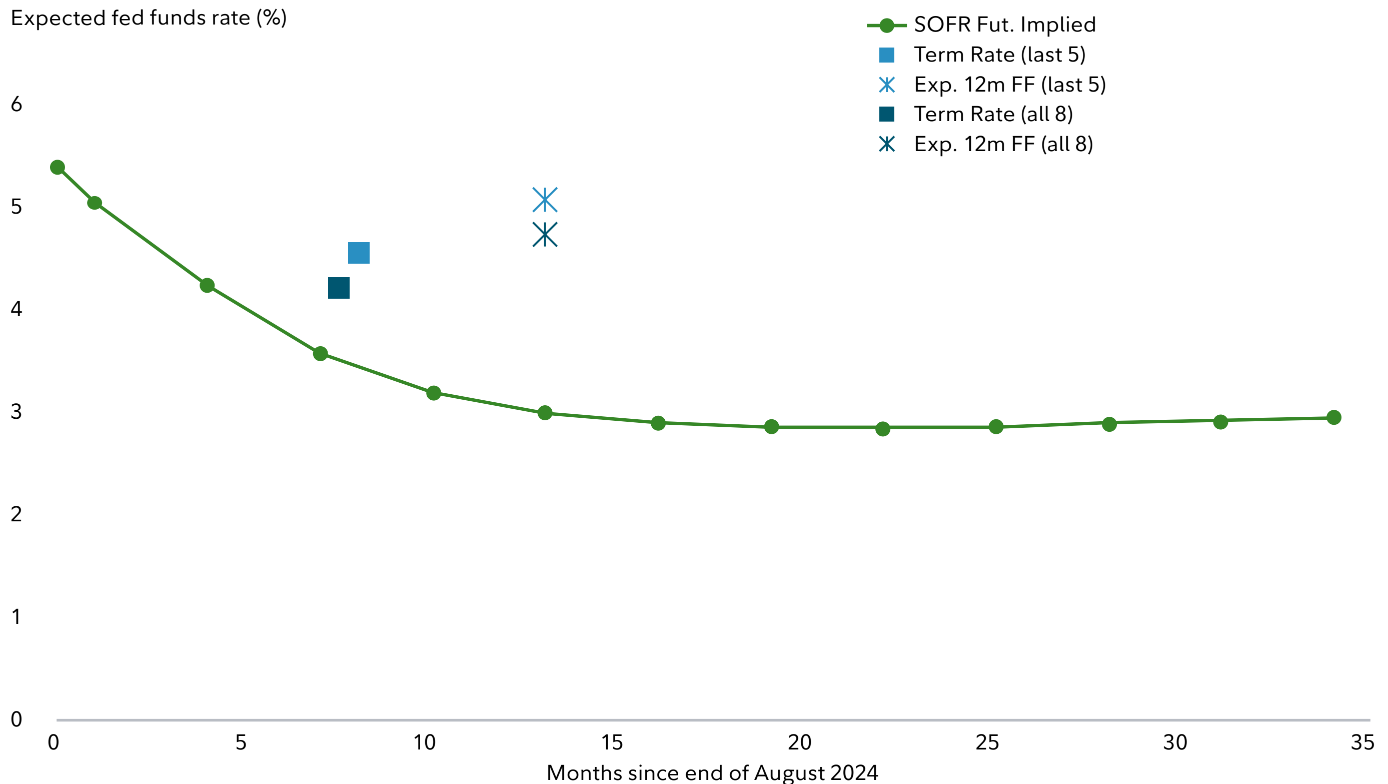
Sources: Bloomberg Finance L.P., Fidelity Investments, as of August 31, 2024.

of the end of August 2024, a soft-landing scenario would imply a terminal fed funds rate of 4.2%. By contrast, the Secured Overnight Financing Rate[3] (SOFR) futures implied fed funds rate is expected to fall to around 3% in the next 22 months and remain near that level. In Exhibit 2, we show the SOFR curve as of the end of August 2024; the dark-blue square represents the soft-landing terminal rate based on the cuts we saw historically in prior non-recessionary rate-cut periods.

In prior non-recessionary rate-cut periods, at the time of the first rate cut (for example, Sep. 30, 2025), the expected fed funds rate one year hence is a median of 4.7%, as represented by the dark-blue star in Exhibit 2, further diverging from the SOFR curve. While SOFR represents a range of views – some expecting a soft landing, others anticipating a recession – even investors expecting a soft landing may be disappointed in the total cuts that occur if a soft landing materializes.[4]

EXHIBIT 2: Rate cut expectations from SOFR futures and prior non-recessionary rate-cut cycles

Fed funds rate expected evolution



Sources: Bloomberg Finance L.P., Fidelity Investments, as of August 30, 2024.

Macro analogues for the current rate cycle

With investors weighing the potential for the Federal Reserve to achieve a soft landing, we are interested in studying how the macro backdrop today compared to prior non-recessionary rate cuts. We analyzed a number of macro variables in the six months leading up to prior non-recessionary rate-cut scenarios (Exhibit 3). Given the dispersion in the absolute values of the macro variables we assessed, we normalized them for comparison purposes to range between 0 and 1. We then compared the evolution of these macro variables during January–July 2024 with their scaled values six months prior to past rate-cut periods (Exhibit 3).[5]

Compared with lead-ins to prior non-recessionary cut periods, 2024 has had:

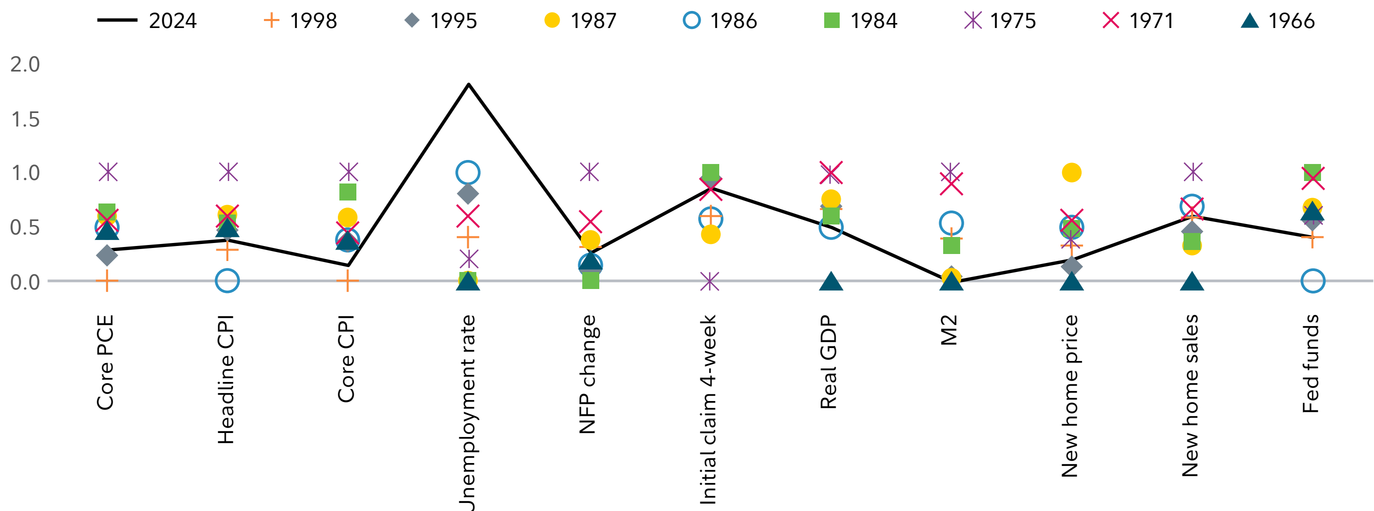
- lower inflation (first three columns)
- weaker employment data evolution (higher unemployment rate change, lower average payroll changes, and higher initial claims)
- comparable GDP growth
- lower M2 growth[6]
- median new home price growth; comparable new home sales growth
- lower fed funds rate change

The few 2024 outliers in the exhibit below have explanations that we view as logical and unique to this cycle. The recent rise in unemployment is concerning, but our research suggests that we are seeing signs of slower hiring rather than outright layoffs, which would be a harbinger of a coming recession. The low M2 growth is also unique to this cycle. We believe that aggregate liquidity is normalizing after outsized M2 growth during the pandemic period. In fact, M2 growth is running above its long-term trend and could continue to be supportive of economic growth.

Using this data for both non-recessionary and recessionary rate cut cycles, we compared each period to the present to analyze which appeared most

EXHIBIT 3: Comparison of 2024 with macro variable lead-ins to prior non-recessionary cuts

6-month macro lead-in to non-recessionary cuts



Sources: Bloomberg Finance L.P., Fidelity Investments, as of July 31, 2024. The PCE Price Index excluding food and energy is also known as the core PCE price index. Core CPI is an aggregate of prices paid by urban consumers for a typical basket of goods, excluding food and energy. NFP stands for non-farm payrolls.

closely related to today. Exhibit 4 illustrates that the 1995 soft landing period bears the closest resemblance to the economic conditions of 2024.

The main differences in fundamental indicators between 2024 and 1995 (the best historical fit) included lower CPI growth today; higher unemployment rate change today, with higher nonfarm payroll growth and lower initial claims; similar GDP and money supply growth (both are low compared to other periods) and new home sales and price growth.

In addition, the next closest periods were:

- The mild recession of 2001, which was one of the shortest recessions lasting only eight months and among the lowest peak-to-trough declines in GDP, while consumer spending fell modestly.
- The aftermath of the Long-Term Capital Management (LTCM) experience in 1998, when the Fed cut rates to stabilize the financial system. The event led to a sharp and relatively short decline in the equity market.

From our perspective, the dynamics of the economy in each of these scenarios supports the view that a soft landing is a plausible outcome today. While outside of the scope of the analysis and paper, our macroeconomic business cycle research also indicates that the U.S. economic expansion remains resilient and continues to normalize.

EXHIBIT 4: Distance of 16 prior rate-cut period lead-ins to 2024 (lower = closer to 2024)

Macro lead-ins to rate cuts

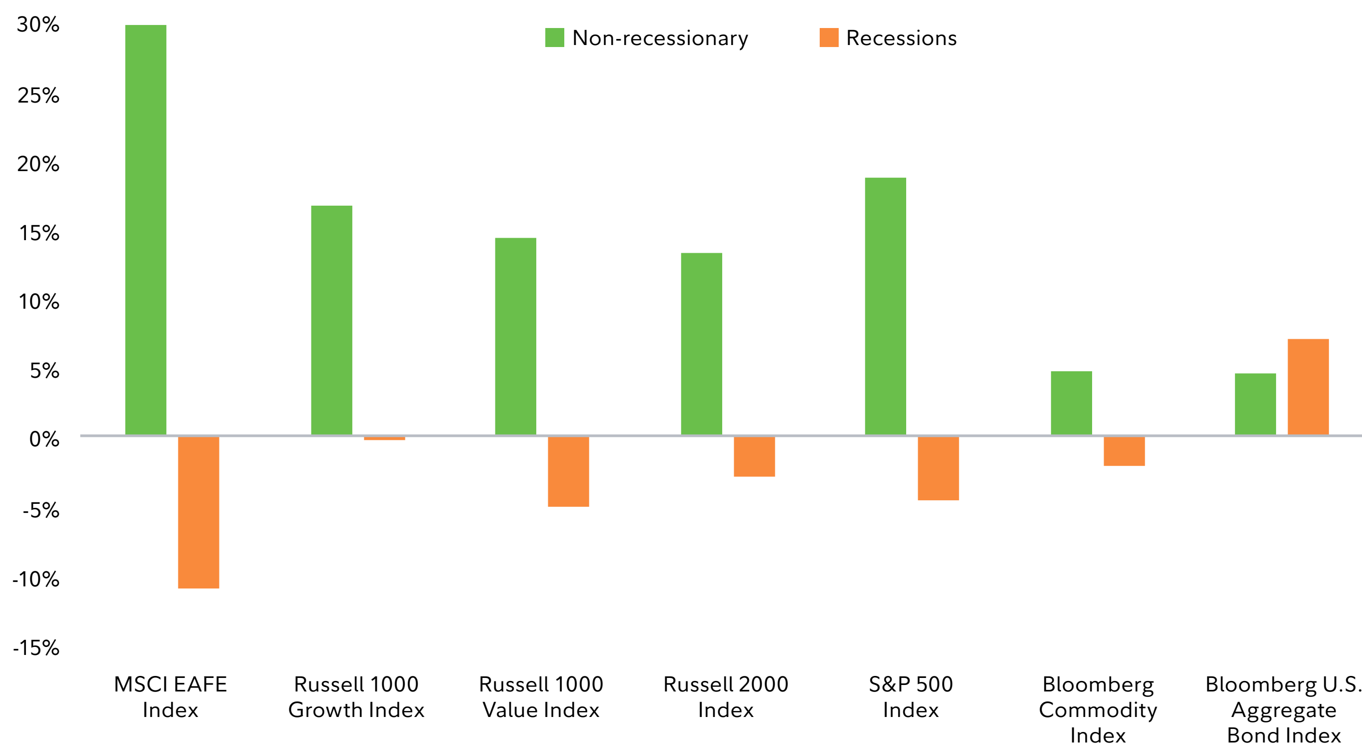
Sources: Bloomberg Finance L.P., Fidelity Investments, as of July 31, 2024.

Asset class performance following initial rate cuts

Market performance following an initial rate cut depends on whether the time period is associated with a recession. We computed 12-month forward performance for equities, fixed income, and commodities in the eight non-recessionary rate cuts as well as the eight recession rate cuts.[7] Assuming a September 2024 rate cut, this horizon corresponds with Sep. 30, 2024 to Sep. 30, 2025. The difference in 12-month returns following rate cuts for recessionary and non-recessionary periods is shown in Exhibit 5.

EXHIBIT 5: 12-month returns following rate cuts for recessionary and non-recessionary periods

12-month median returns post-initial rate cut



Sources: Bloomberg Finance L.P., Fidelity Investments, as of August 31, 2024.

Key takeaways for non-recessionary rate-cut periods:

- The MSCI EAFE Index[8] was the best performer with a 30% median return; it was also consistent with positive returns in all but one period. S&P 500 returns were positive in all eight periods with a median return of 18.6%.
- The Russell 1000 Growth Index outperformed the Russell 1000 Value Index; however, both trailed the S&P 500. Meanwhile, the returns on the Russell 2000 Index of small cap stocks lagged those of S&P 500.
- The returns on the Bloomberg Commodity Index and the Bloomberg U.S. Aggregate Bond Index of fixed income were well below those of equity markets.[9] A combination of rising U.S. Treasury yields and inconsistent Baa-rated credit spread tightening has resulted in only modest total returns for credit investors in non-recessionary periods.

These results illuminate the consistent themes in non-recessionary rate-cutting cycles and lend support to our views and portfolio positioning. The start of this rate-cutting cycle could serve as the catalyst for repricing international equity higher relative to U.S. equity. This position remains a high-conviction view in our portfolios. International equity has faced dual headwinds of weak foreign exchange rates and slow earnings per share (EPS) growth relative to the United States. A U.S. soft landing and moderating U.S. growth may place international equity markets in the favorable position of stronger currencies (compared with the U.S. dollar) and stronger relative EPS growth. A non-recessionary rate cycle for the United States would make this the likely path.

The data highlights the challenge that commodities face in previous rate-cutting cycles. We have chosen to reduce commodity exposure in favor of bonds. Portfolios reflect a neutral duration position, which may provide ballast to the overall portfolio in the event that a soft landing is not achieved.

Key takeaways for recessionary rate-cut periods:

- Median equity returns are negative, with the MSCI EAFE lagging the S&P 500.
- Growth outperformed value and delivered a higher median return than the S&P 500. The Russell 2000 Index of small cap stocks outperformed the S&P 500, likely due to its higher sensitivity to the stimulative effects of rate cuts.
- Returns on the Bloomberg Commodity Index tended to be negative following recessionary cuts, even with periods of stagflation included.
- Bloomberg U.S. Aggregate Bond Index returns were positive, with a higher median return than in non-recessionary periods.

Recession probability-weighted expected returns

While we believe the data support a non-recessionary outcome, this outcome is uncertain and not assured in our view. Investors discount outcomes considering probabilities and magnitudes for potential paths. We applied recession probabilities to the historical asset

class returns to refine our view of the potential range of outcomes. This approach allows us to see how the sensitivities in portfolio positioning are relative to changes in recession outlook. In Exhibit 6, below, we show weighted expected asset returns compared with recession probability. The main takeaways are:

- For recession probabilities of 58% or less, all equity asset classes outperformed the Bloomberg U.S. Aggregate Bond Index and commodities, with the MSCI EAFE Index the best performer.
- Commodities underperformed in the majority of recessionary scenarios, reflecting sensitivities to growth in the economy.
- The Bloomberg U.S. Aggregate Bond Index outperformed all asset classes when recession probabilities exceed 60% as the stability of cash flows from fixed income assets relative to riskier assets is often sought out by investors.

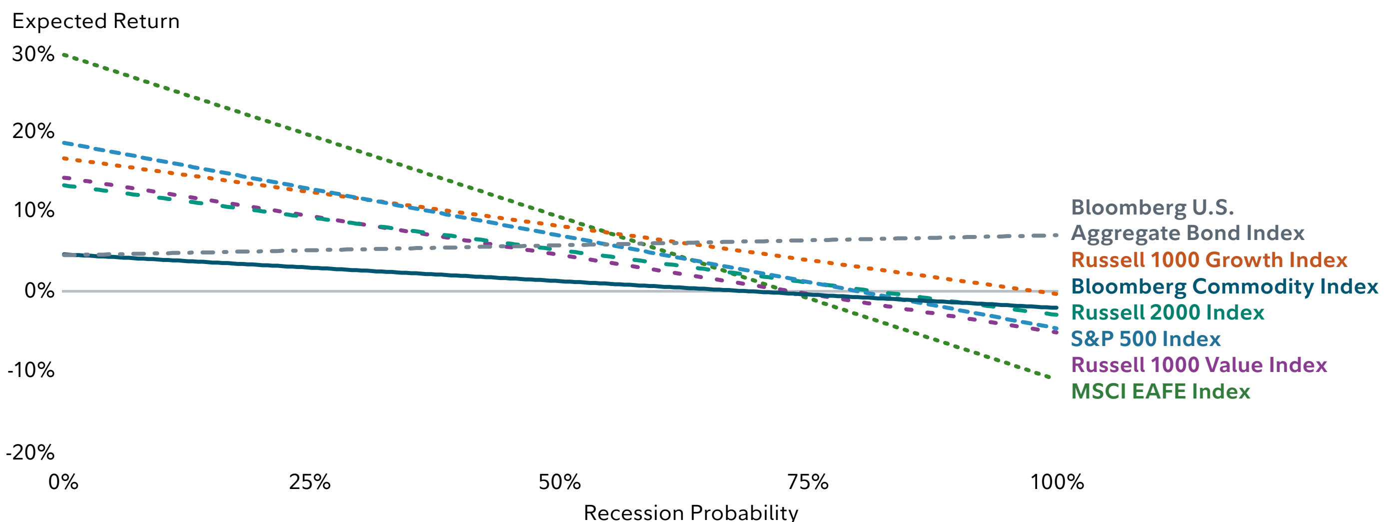
This research suggests that an overweight to the MSCI EAFE Index is the best way to position in a soft-landing scenario, in our view. In fact, the recession probabilities implied by our business cycle modeling are lower than 58% with the economy straddling mid- and late-cycle. If a hard landing (greater than a 60% chance) becomes the most likely scenario, the Bloomberg U.S. Aggregate Bond Index is likely to be the best-performing asset class based on historical experience.

Conclusion

The effect on future asset class returns could be meaningful depending on whether we are entering a recessionary or non-recessionary rate-cutting cycle.

While soft landings and non-recessionary rate cycles are rare, they have happened historically, and the payoffs have rewarded a handful of asset classes within a multi-asset class universe. The results of this analysis increase our conviction in our portfolio's current positioning. Our research and portfolio management teams will remain focused on these developments in the months ahead and will continue to position our portfolios accordingly.

EXHIBIT 6: Recession probability-weighted expected asset returns (based on medians of all eight periods)



Sources: Bloomberg Finance L.P., Fidelity Investments, as of August 31, 2024.

Endnotes

[1] We required at least 75 basis points in total rate cuts and no National Bureau of Economic Research (NBER) recession during or within six months of either the beginning or end of the rate cuts.

[2] Due to small samples and fat-tailed distributions, we focus on median returns rather than means.

[3] Federal Reserve Bank of New York. The Secured Overnight Financing Rate (SOFR) is a broad measure of the cost of borrowing cash overnight collateralized by Treasury securities. https://www.newyorkfed.org/markets/reference-rates/sofr

[4] Assuming the 3% SOFR terminal rate is a linear combination of our soft-landing terminal rate and a recession-based terminal rate implies a 35% chance that the fed funds rate is at the zero lower bound in 13 months, or a 44% chance that it is back to 1%, both seemingly non-consensus.

[5] For example, in Exhibit 3, 1986 had the lowest headline CPI growth (set to zero), while 1975 had the highest growth (set to 1), with other periods in between, and the black curve for 2024 toward the bottom of the interval.

[6] Federal Reserve. M2 consists of M1 plus (1) small-denomination time deposits (time deposits in amounts of less than $100,000) less individual retirement account (IRA) and Keogh balances at depository institutions; and (2) balances in retail money market funds (MMFs) less IRA and Keogh balances at MMFs.

[7] Returns for Russell indexes and Bloomberg U.S. Aggregate Bond Index are only available in the last 5 non-recessionary cuts and last 6 recessionary cuts; results are similar if we restrict all indexes to the last 5 periods, though equity and commodity returns are weaker excluding the stagflationary periods.

[8] The MSCI EAFE Index is designed to represent the performance of large and mid cap securities across 21 developed markets, including countries in Europe, Australasia, and the Far East, excluding the U.S. and Canada.

[9] The Bloomberg U.S. Aggregate Bond Index is a broad-based flagship benchmark that measures the investment-grade, U.S. dollar-denominated, fixed-rate taxable bond market. The index includes Treasuries, government-related and corporate securities, mortgage-backed securities (agency fixed-rate pass-throughs), asset-backed securities, and collateralized mortgage-backed securities (agency and non-agency).

Authors

Brian Hayes, PhD
Quantitative Analyst, Global Asset Allocation

Brian Hayes is a quantitative analyst in the Global Asset Allocation (GAA) group at Fidelity Investments. In this role, Dr. Hayes performs research supporting GAA's Target Date products while supporting the active allocation process and external thought leadership efforts. He joined Fidelity in 2021.

Christopher Luongo, CFA
Institutional Portfolio Manager,
Global Asset Allocation

Christopher Luongo is an institutional portfolio manager for Institutional Portfolio Management team, at Fidelity Institutional®. Mr. Luongo, whose focus is on target date capabilities, also assists portfolio managers and their CIOs in ensuring portfolios are managed in accordance with client expectations. Mr. Luongo joined Fidelity in 2006.

Lance McInerney, CFA
Institutional Portfolio Manager,
Global Asset Allocation

Lance McInerney is an institutional portfolio manager for Global Asset Allocation on the Institutional Portfolio Management team at Fidelity Institutional®. With a focus is on target date capabilities, he helps portfolio managers, and their CIOs ensure portfolios are managed in accordance with client expectations. He joined Fidelity in 2005.

Andrew Dierdorf, CFA
Portfolio Manager, Global Asset Allocation

Andrew Dierdorf is a portfolio manager in the Global Asset Allocation (GAA) group at Fidelity Investments. In this role, Mr. Dierdorf co-manages Fidelity's target date strategies, including Fidelity-managed 529 plans and Canadian target date funds. He joined Fidelity in 2004.

Brett Sumsion, CFA
Portfolio Manager, Global Asset Allocation

Brett Sumsion is a portfolio manager in the Global Asset Allocation (GAA) group at Fidelity Investments. In this role, Mr. Sumsion co-manages Fidelity's target date strategies, including Fidelity-managed 529 plans and Canadian target date funds. He joined Fidelity in 2014

Fidelity Thought Leadership Vice President Shanthy Nambiar provided editorial direction for this article.

Information provided in, and presentation of, this document are for informational and educational purposes only and are not a recommendation to take any particular action, or any action at all, nor an offer or solicitation to buy or sell any securities or services presented. It is not investment advice. Fidelity does not provide legal or tax advice.

Before making any investment decisions, you should consult with your own professional advisers and take into account all of the particular facts and circumstances of your individual situation. Fidelity and its representatives may have a conflict of interest in the products or services mentioned in these materials because they have a financial interest in them, and receive compensation, directly or indirectly, in connection with the management, distribution, and/or servicing of these products or services, including Fidelity funds, certain third-party funds and products, and certain investment services.

Fidelity does not provide tax or legal advice. Employee benefit plans may wish to consult with their ERISA counsel regarding the evaluation of investment or investment courses of action that incorporate non-pecuniary factors.

Investing involves risk, including risk of loss. Past performance is no guarantee of future results.

Diversification and asset allocation do not ensure a profit or guarantee against loss.

It is not possible to invest directly in an index. All market indices are unmanaged.

Investment decisions should be based on an individual's own goals, time horizon, and tolerance for risk.

Generally, among asset classes stocks are more volatile than bonds or short-term instruments and can decline significantly in response to adverse issuer, political, regulatory, market, or economic developments. Although the bond market is also volatile, lower-quality debt securities including leveraged loans generally offer higher yields compared to investment-grade securities, but also involve greater risk of default or price changes. Foreign markets can be more volatile than U.S. markets due to increased risks of adverse issuer, political, market or economic developments, all of which are magnified in emerging markets.

Case studies and examples of investment research are shown for illustrative purposes only and are not representative of current holdings invested in by Fidelity Investments. Such examples should not be construed as recommendations or investment advice. The statements and opinions are subject to change at any time, based on market and other conditions.

Third parties mentioned are an independent entity and not affiliated with Fidelity Investments. Third-party trademarks and service marks are the property of their respective owners. All other trademarks and service marks are the property of FMR LLC or an affiliated company.

Fidelity Investments® provides investment products through Fidelity Distributors Company LLC; clearing, custody, or other brokerage services through National Financial Services LLC or Fidelity Brokerage Services LLC (Members NYSE, SIPC); and institutional advisory services through Fidelity Institutional Wealth Adviser LLC.

Personal and workplace investment products are provided by Fidelity Brokerage Services LLC, Member NYSE, SIPC.

Institutional asset management is provided by FIAM LLC and Fidelity Institutional Asset Management Trust Company.

© 2024 FMR LLC. All rights reserved.

1166814.2.0

For institutional use only.

This is original content from Fidelity Investments in the U.S. No recipient is authorized to pass this communication on to any other person whatsoever or reproduce it by any means without the prior written consent of Fidelity.

This document is used by Fidelity Investments Canada ULC ("FIC") and is not meant to endorse or sponsor any specific Fidelity product or service. FIC investment funds are advised by our investment division, Fidelity Canada Investment Management, or sub-advised by a variety of companies, such as Fidelity Management & Research Company LLC, FIAM LLC, FIL Limited, Geode Capital Management LLC and State Street Global Advisors Ltd. Mutual funds, ETFs and other investment products and services that are sponsored by FIC are only qualified for sale in the provinces and territories of Canada.

These materials may contain statements that are "forward-looking statements," which are based on certain assumptions of future events. Forward-looking statements are based on information available on the date hereof, and Fidelity Investments Canada ULC ("FIC") does not assume any duty to update any forward-looking statement. Actual events may differ from those assumed by FIC when developing forward-looking statements. There can be no assurance that forward-looking statements, including any projected returns, will materialize or that actual market conditions and/or performance results will not be materially different or worse than those presented.

Information provided in this document is for informational and educational purposes only. To the extent any investment information in this material is deemed to be a recommendation, it is not meant to be impartial investment advice or advice in a fiduciary capacity and is not intended to be used as a primary basis for you or your client's investment decisions. Fidelity and its representatives may have a conflict of interest in the products or services mentioned in this material because they have a financial interest in them, and receive compensation, directly or indirectly, in connection with the management, distribution, and/or servicing of these products or services, including Fidelity funds, certain third-party funds and products, and certain investment services.

Information presented herein is for discussion and illustrative purposes only and is not a recommendation or an offer or solicitation to buy or sell any securities. Views expressed are as of 10/15/24, based on the information available at that time, and may change based on market and other conditions. Unless otherwise noted, the opinions provided are those of the authors and not necessarily those of Fidelity Investments or its affiliates. Fidelity does not assume any duty to update any of the information. • Investment decisions should be based on an individual's own goals, time horizon, and tolerance for risk. Nothing in this content should be considered to be legal or tax advice, and you are encouraged to consult your own lawyer, accountant, or other advisor before making any financial decision. • In general, the bond market is volatile, and fixed income securities carry interest rate risk. (As interest rates rise, bond prices usually fall, and vice versa. This effect is usually more pronounced for longer-term securities.) • Fixed income securities carry inflation, credit, and default risks for both issuers and counterparties.

Investing involves risk, including risk of loss.

Past performance is no guarantee of future results. An investment may be risky and may not be suitable for an investor's goals, objectives and risk tolerance. Investors should be aware that an investment's value may be volatile and any investment involves the risk that you may lose money. Performance results for individual accounts will differ from performance results for composites and representative accounts due to factors such as portfolio size, account objectives and restrictions, and factors specific to a particular investment structure.

Diversification and asset allocation do not ensure a profit or guarantee against loss.

Third party trademarks and service marks are the property of their respective owners. All other trademarks and service marks are the property of Fidelity Investments Canada ULC or its affiliated companies. FIC does not provide legal or tax advice and we encourage you to consult your own lawyer, accountant or other advisor before making an investment.

Portions © 2024. FMR LLC. All rights reserved. Used with permission.

U.S.: 1.9918208.100 CAN: Compliance ID FCI 2120409 10/24

FIDELITY CANADA INSTITUTIONAL™