MARKET SIGHT*LINES*

Will Rate Cuts Be Enough to Sustain the Bull Market, or Is a Bear Market Inevitable?

By Michael O'Keeffe, *Chief Investment Officer*

My team and I focus on the long term, developing 20-year+ market forecasts, identifying long-term investment themes we expect to drive economies and markets, and buying individual stocks we plan to hold for 7-10 years. But as we meet with clients, we are often asked: Will we have a recession? Will we experience a correction or a bear market? The long-term investor knows that the answer to both questions is "yes." People are really asking, when we will have a recession or a correction/bear market, and how deep will it be? In this Sight|Lines, we consider if Federal Reserve (Fed) rate cuts likely starting next week will be enough to prevent a recession and sustain the bull market, or whether a recession or a bear market is on the near-term horizon.

THE TAKEAWAY:
FED CUTS WILL HELP THE ECONOMY … MARKETS NOT SO MUCH

Despite a stronger-than-expected economy in the first half, the Fed will likely begin to cut rates next week given cooler inflation, weaker recent economic data, and a softer job market. While this may result in a "soft landing" for the economy, the potential for negative markets remains high. In summary:

- Monthly inflation hovers near the Fed's 2% target, giving officials room to cut rates.
- Fed officials have signaled their intention to do so starting next week.
- Investors expect a cut next week and many more over the next year or so.
- While investors sometimes celebrate Fed rate cuts as expansionary for the economy and markets, these upcoming moves seem more focused on mitigating economic challenges.
- Stretched valuations are a headwind to a continued, strong bull market.
- Investors worry that the hype around optimism for artificial intelligence is overdone.
- Other external events could serve as a catalyst for a market downturn.

IN-DEPTH: FED RATE CUTS WILL LIKELY EXTEND THE ECONOMIC CYCLE, BUT WEAKER MARKETS ARE QUITE POSSIBLE

Despite a strong economy in the first half, the Fed will likely begin cutting rates next week. While this may result in a "soft landing" for the economy, the potential for negative markets remains high. Going deeper:

- Fed officials have room to cut rates, as monthly inflation hovers near the Fed's 2% target:
  - The consumer price index (CPI) monthly increase has averaged 0.17% over the last six months.
  - The producer price index (PPI) monthly increase has averaged 0.15% over that period.
  - These figures compare to 0.17%, the monthly equivalent of the Fed's 2% target.
- Fed officials have been signaling their intention to cut rates next week:
  - Fed Chair Jerome Powell said, "The time has come for policy to adjust."
  - Vice Chair and New York Fed President John Williams offered, "…it is now appropriate to dial down the degree of restrictiveness in the stance of policy by reducing the target range for the federal funds rate."
  - Investors expect cuts to begin next week and many more over the next year:
    - Fed funds futures are pricing in a 0.25% cut next week.
    - Futures are also pricing in a cut at six out of seven meetings that follow.
    - These cuts would total 2.5% through September 2025.
- While investors sometimes consider Fed rate cuts as expansionary, these upcoming moves seem more focused on mitigating economic impact:
  - The consensus 2025 forecast for U.S. GDP is 1.7%, below trend growth.
  - Despite expected rate cuts, Bloomberg still assigns a 30% probability of a recession next year.
- Stretched valuations lessen the chances of a continued, strong bull market.
  - The S&P 500 P/E ratio of 25.3 is 19% higher than the 10-year average of 21.2.
- Investors worry that the hype around optimism for artificial intelligence is overdone.
  - While the Bloomberg Magnificent Seven Index was up 51.1% from 12/31/2023 – 7/10/2024, this index is down 10.5% since July 10.
  - Notably, Nvidia, which posted a total cumulative return of 824% from 12/31/2022 – 7/10/2024, has fallen 13.3% since then.
- An unexpected "external event" can trigger a market downturn. Possibilities include:
  - A sizable cybersecurity event that shakes confidence in our infrastructure.
  - A credit crisis as higher rates further affect borrowers' ability to service debt.
  - A tight U.S. election that spurs violence from supporters of the losing party.
  - A military escalation in one of the many geopolitical hotspots around the world.

CONCLUSION

Long-term investors know that a recession and a bear market in the future are inevitable, so shorter-term economic and market analysis often gauges the risk of a downturn in the near term. The Fed rate cuts anticipated to start next week may well guide our economy to a soft landing, but the chance of an extended, strong bull market is unlikely.

Michael P. O'Keeffe, CFA
Chief Investment Officer
michael.okeeffe@stifel.com
www.stifelinsights.com

Stifel, Nicolaus & Company, Incorporated | Member SIPC & NYSE | www.stifel.com 0924.7011532.1