Cetera® Investment Management

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Commentary

Hawkish Rate Cut Sends Markets Lower

- The has Fed signaled less rates cuts in 2025.
- Both bond and equity markets sold off on the possibility of higher borrowing costs.
- With high valuations, diversification is even more prudent.

Investors reacted negatively to the Federal Open Market Committee's (FOMC's) December meeting, although much of the meeting's conclusions were widely anticipated. The Dow Jones Industrial Average dropped for the 10th consecutive day, the longest such streak since 1974. Wednesday, the S&P 500 lost nearly 3%, the Dow was down around 1% and the small cap Russell 2000 index was down over 4%.

The FOMC cut the Fed Funds rate by 0.25% to a target range of 4.25 to 4.50%. While not all economists and market strategists agreed with this cut, it was largely a foregone conclusion. Investors expected a hawkish rate cut: Fed would cut rates by 0.25% and signal fewer rate cuts in 2025. That is exactly what happened.

The committee publishes their future estimates for key economic data in their quarterly economic projections dubbed the "dot plot." The median projection for the Fed Funds rate by the end of 2025 rose from 3.4% to 3.9%. This would imply the Fed would only cut rates by 0.5% in 2025 rather than 1%, which was projected in September.

However, investors had already been anticipating less cuts than what the Fed expected in September as evidenced in both Fed Funds futures probabilities and the 2-year Treasury yield, which can be seen as where bond investors think the Fed Funds rate will be one year from now. After the Fed meeting, both the Fed Futures markets and bond markets priced in even fewer cuts. Markets could now be expecting no rate cuts in 2025. Bond prices move inversely to bond yields, so bond indexes fell as yields rose.

The Fed went from foe to friend in 2024, but in our 2025 annual outlook we predicted the Fed would not be as good of a friend as investors expected. While the Fed still cut rates this month, we already have indications that the Fed will not be as supportive in 2025. This is not all bad news though. The Fed would be a better friend if the economy was faltering. But it isn't.

We also predicted economic data would moderate, but not fade away. The Fed's dot plot shows the committee's economic growth projections for 2024 and 2025 both rose. The U.S. economy may be a bright spot in the global economy next year. With economic growth comes inflation and therefore inflation estimates also rose, but it is still moderating from high levels. Inflation is expected to be 2.5% next year, while the unemployment rate is only anticipated to rise to 4.3%. So, inflation is a bit higher than the Fed would like, but the labor market is strong, and economic growth is better than most of the world. With that backdrop, the Fed may not feel the need to cut rates much more.

Valuations in equity markets have been very high. Stocks have been trading at high prices relative to their earnings. This can cause volatility. Additionally, indexes like the S&P 500 are very concentrated with the top ten stocks comprising over 35% of the index. When these stocks do well, the index does well, but that can change. That's why we have been emphasizing diversification and investing in other asset classes with better valuations like international and small cap. Small cap stocks did not do well today, but being diversified across asset classes can reduce risk and may provide better long-term returns.

It is important to stay focused on your own long-term financial goals and avoid getting caught up in the market enthusiasm or trying to call the next bear market. As always, please consult your financial professional for guidance during these times.

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A diversified portfolio does not assure a profit or protect against loss in a declining market.

Glossary

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