FirstCitizensWealth™

Making Sense

February 5, 2025

Yield in a Time of Rate Cuts

An important – and at times perplexing – pattern over the last few months is the surge in longer-term yields despite the Federal Reserve lowering interest rates by 100 basis points. Rate cuts often pull longer-term yields lower, but now the opposite has happened. What explains this paradox?

When the Fed cuts rates, it is typically in response to a growth scare or financial market stress. But when the speedbump doesn't turn into a full economic recession, history shows us that yields do end up higher rather than lower after the Fed cuts rates.

Three months ago, we asked, "The Fed Cut Rates. Why Are Bond Yields Higher?" and offered four thoughts. First, while the Fed directs short-term rates, it does not control longer-term rates like the 10-year Treasury yield. Second, markets are pricing fewer rate cuts after the Fed's 100 basis point easing in late 2024. Third, investors are increasingly concerned about mounting government debt. Fourth, markets could be adapting to structurally higher inflation and nominal growth.

We would offer an additional consideration: what is driving the decision to cut rates in the first place? Historically, yields have responded differently when the Fed cuts rates preemptively (as an adjustment) rather than when the Fed responds too late (in a recession). Now with hindsight and economic data from the second half of 2024 in hand, it is clear the economy was nowhere close to being in recession in 2024. Therefore, we would place the 2024 rate cuts along with other non-recessionary easing cycles over the last 40 years in 1989, 1995, 1998, and 2019.

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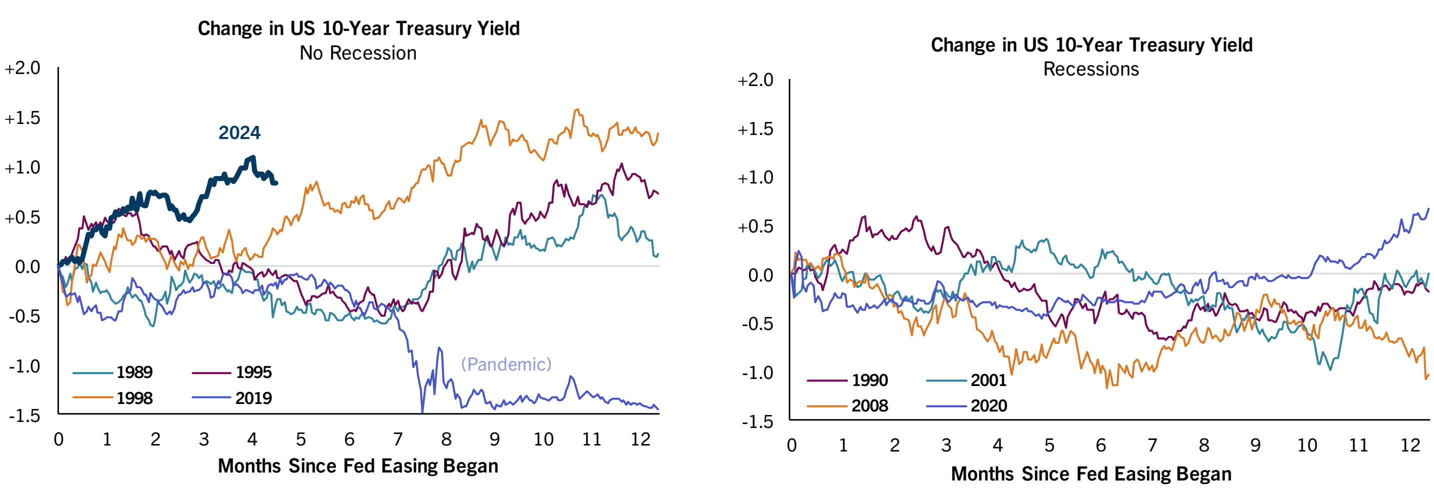
Exhibit 1: 10-Year Treasury Yields Have Risen in Past Non-Recessionary Easing Cycles



Source: Bloomberg

In each of these instances, the Federal Reserve lowered interest rates as a calibrated adjustment mid-cycle rather than a full-blown response to economic recession.

- 1989: The Federal Reserve cut interest rates to support slowing economic growth and financial stress stemming from the savings and loan crisis. A recession did follow in 1990 after oil prices surged due to Iraq's invasion of Kuwait, leading the Fed to wage a forceful easing campaign in 1990 and 1991.

- 1995: Amid slowing growth and softening inflation, the Federal Reserve lowered interest rates modestly in what is now viewed as a successful "mid-cycle adjustment."

- 1998: Financial distress stemming from foreign markets and the collapse of a large US hedge fund led the Federal Reserve to cut rates to ease financial conditions.

- 2019: A few years after raising rates parked at zero since the Global Financial Crisis, the Federal Reserve lowered rates modestly, judging that its policy was overly restrictive given low consumer price inflation and the slowdown in global growth.

- *2024: After raising rates at the fastest pace in decades, the Federal Reserve lowered interest rates by 100 basis points to a less restrictive stance, attempting to balance the risks around its dual inflation and employment mandates.*

Although it is still early, the rate cuts of late 2024 do seem to fit squarely in this category of mid-cycle adjustments rather than recession-driven rate cuts. Policymakers were concerned about labor market risks and believed inflation was on a steady path back toward the 2% target. Within a few months, policymakers announced they are content leaving policy modestly restrictive.

Lower long-term interest rates can deliver relief and pro-growth stimulus to both households and businesses. But given the recent spate of better-than-expected data, it is becoming clearer that higher rates today might be the tradeoff for a stronger economy. We often remind our clients that at 4.5% the 10-year Treasury is elevated compared to the decade following the Global Financial Crisis, but today's yield is moderate compared to longer-term history. **Markets and the economy have absorbed higher yields fairly well since the surge in rates since 2022 and certainly better than economists and forecasters expected. We will gladly take good market and economic news even if it means yields are moderately higher for now.**

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