How a ‘Fed put’ could leave stock market on path for a ‘late-90s-style meltup’

There’s nothing new under the sun, they say. And that goes for Fed pivots, too. The Federal Reserve’s decision last week to signal a pause in the rate-hike cycle, adopting a wait-and-see approach just six weeks after delivering its fourth rate increase of 2018, took investors by surprise. For one analyst, the move has echoes of the late 1990s, when a nimble Fed led by Alan Greenspan arguably set the table for a final stock-market “meltup” ahead of the bursting of the tech bubble in 2000.

The Fed pivot helped light a fire under a stock market that was already in rebound mode for the new year, with the S&P 500 SPX, +0.07% logging a five-day winning streak in the wake of the Fed meeting before giving back some ground Wednesday and Thursday on continued worries over global growth. Stocks posted a mixed finish Friday, with the S&P 500 and Dow Jones Industrial Average DJIA, -0.25% both posting weekly gains.

For some, the Fed’s move marks likely the end of the tightening cycle, leading them to pencil in a cut as the Fed’s next move as the economy moves toward recession. Stock-market bulls see the move as a temporary pause that will see rate increases eventually resume as the economic expansion regains steam.

Dario Perkins, managing director for global macro at TS Lombard, finds himself in the middle. The Fed could cut rates by the second half of 2019 as exports weaken and the economy begins to feel the delayed, full effects of the previous tightening in financial conditions, he said, in a Thursday note. But he doesn’t expect the U.S. economy to fall into a recession, which means that the Fed could resume hiking rates as the global economy strengthens into 2020.

Nobody likes that sort of “elbow forecast” (down, then up), he acknowledged. But history shows it is hardly unprecedented. In fact, the Fed followed that pattern twice in 1990s, Perkins noted (see charts below).

The first time was in 1995, a year after the Fed caused a lot of carnage in the bond market — that reverberated unpleasantly in emerging markets and elsewhere — with an aggressive round of rate increases that ultimately took interest rates above the level at which they neither boost nor slow the economy. That year, the impact of all that Fed tightening was being felt at home. That led policy makers to reverse course and cut rates three times, in 25 basis-point increments, between July 1995 and January 1996 — a move that simply got rates back to neutral. In March 1997, the Fed shifted back into tightening mode with a quarter-point rate rise.

The problem with that comparison, Perkins acknowledged, is that the Fed had deliberately overtightened by taking fed funds above the neutral rate and then simply brought them back down. Today, Fed policy makers don’t think interest rates are overly restrictive, but they are uncertain about where exactly the neutral rate lies and a sharp slowdown could easily shift their view, he said.

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