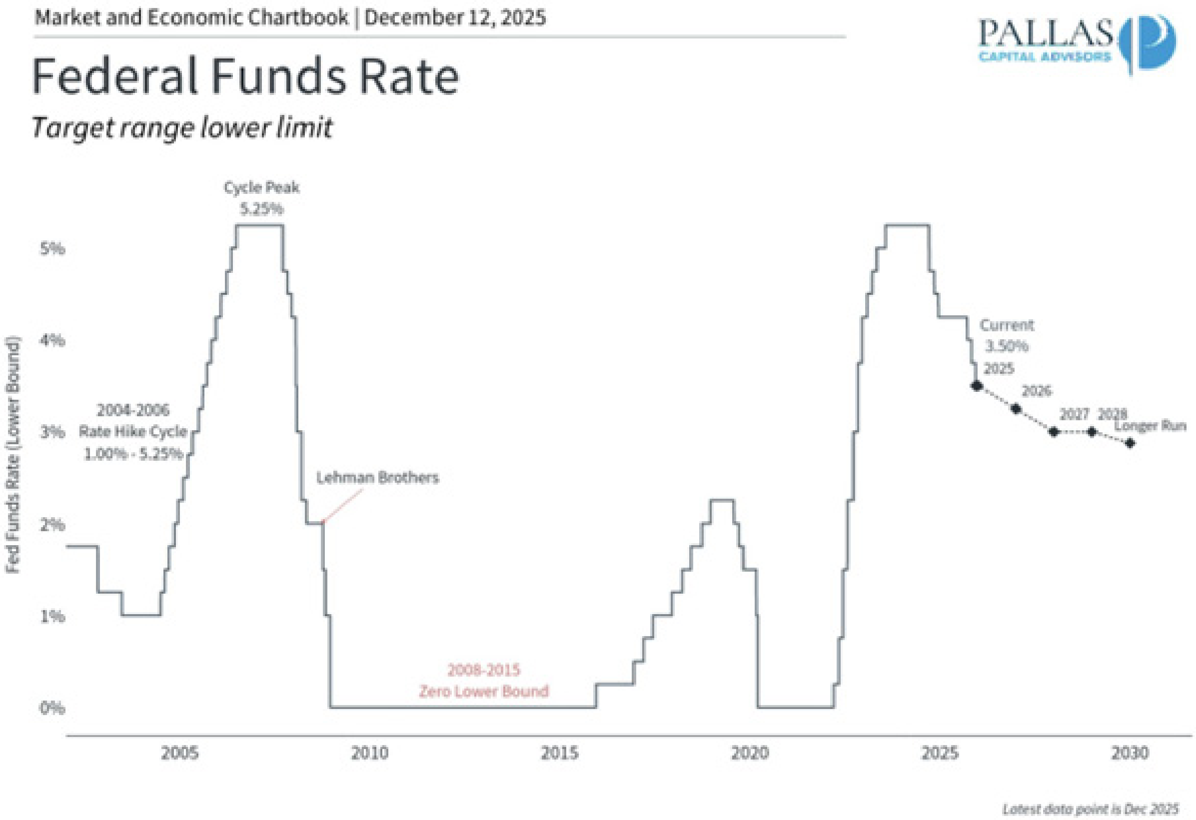
Markets Got the Expected Rate Cut Turning Attention to Business Fundamentals

This past week, the Federal Reserve lowered the benchmark federal funds rate by 25 basis points to a range of 3.50% to 3.75%, marking the third consecutive monthly cut. As the Fed rate has come down, equity markets have climbed higher, supported by strong earnings growth and able to look past concerns about artificial intelligence (AI) capital spending, uncertainty surrounding tariffs, and the protracted government shutdown. However, the easy rate cuts are likely behind us. Fed Chair Powell noted following the announcement that future cuts may be on pause for a while. Looking ahead, only one 25-basis-point rate cut is now expected in each of 2026 and 2027.



With less support from Fed rate cuts, equity markets will be more dependent upon company fundamentals, which overall look favorable with economic growth, government stimulus, and broadening out of investment beyond AI expected in 2026. However, a generally positive backdrop for business fundamentals is not without risk, and the longer-term bond market has been acting in a contrary manner.

While short-term rates have followed the Fed funds rate lower, the opposite has happened with the important longer-term benchmark, the 10-year Treasury, which has seen yields move up to their upper range since the Fed commenced rate cuts in September. The key concerns for long-term rates remaining higher are the large U.S. federal budget deficits and mounting U.S. debt, including debt being raised to fund AI infrastructure buildout. In addition, inflation remains above the Fed's 2.0% target as government stimulus and policy uncertainty extend into 2026. The risk to market fundamentals is that higher long-term rates tend to have a dampening impact on economic growth as borrowing costs rise and put pressure on valuation multiples.

In summary, while the latest Fed rate cut was welcomed by the market, the slowing pace of projected rate cuts and rising long-term interest rates raise the bar for business fundamentals to support market returns as we enter 2026.