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Victoria Capital Management, Inc.

# Market Musings

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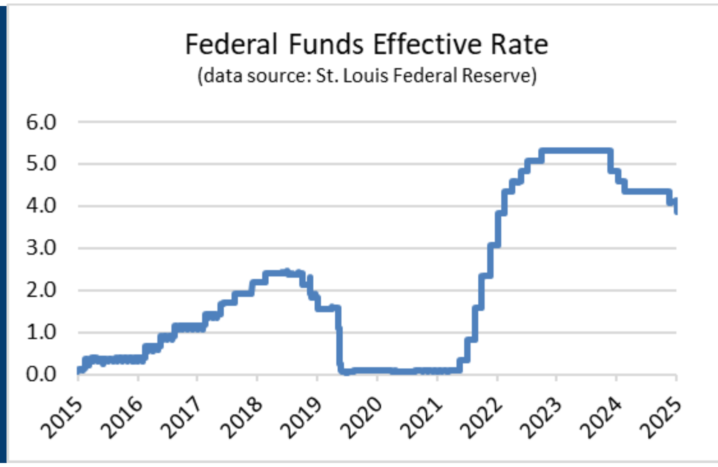
Interest rate levels are a crucial component that affects both the economy and the stock market. The chart tracks changes in the fed funds rate, a rate the Federal Reserve sets that financial markets react to. Equity markets react favorably to declining interest rates, not to rising ones.




## The Impact of Interest Rates on the Stock Market

Last week, the Federal Reserve lowered the fed funds rate by 25 basis points, the second such reduction this year. The Fed is attempting to manage monetary policy to keep inflation low (with a target of 2% annually) while maintaining a low unemployment level. The surprise of this business cycle is that unemployment was relatively unchanged while the Fed was tightening, i.e., raising the fed funds rate to slow down the economy. Perhaps the rise in unemployment is merely lagging behind traditional indicators. One reason is that the onset of AI may be changing the outlook. Several major companies have announced layoffs due to the implementation of AI. Couple that trend with the aggressive reduction in illegal immigrants who are working, and unemployment may rise unexpectedly. If that is the case, we expect to see further rate cuts.

Promises of further rate cuts into 2026 should be good news for equity markets. Historical data indicate that stocks tend to perform well in an environment of declining interest rates, while periods of Fed tightening are generally not favorable for the stock market. The surge in private spending related to AI expansion is likely to keep stocks in an uptrend even though many stocks that don't benefit from AI could languish. The simple reason is that companies directly involved in AI will benefit related industries, such as energy generation. The third-quarter corporate earnings reports show a clear trend of upside earnings surprises among AI companies. The major stock market indices reached new highs last week, and AI-related stocks continued to dominate the market. Perhaps the tariffs are affecting smaller companies, which populate the ever-growing list of new 52-week lows on the New York Stock Exchange.

Soon, the government shutdown will impact economic data and may detract from economic growth. However, the key factor will be Fed policy and the timing of future interest rate reductions. Yet, financial markets remain largely unaffected by adverse economic developments. Our focus is on updated unemployment data and how the Fed is likely to respond. At this juncture, interest rates are likely to contribute to stock market gains.

**"We can draw lessons from the past, but we cannot live in it."**

- Lyndon B. Johnson

***Market Commentary***

October marked another positive month for domestic large-cap equities, with the S&P 500 up by 2%. Both mid- and small-cap stocks were slightly down. Optimism surrounding a potential trade deal between the U.S. and China, along with anticipation of the Fed's recent rate cut, propelled a risk-on reaction throughout the month. This optimism spread to foreign equities with the S&P Pan Asia BMI gaining 3% (27% YTD). Korea and Japan led the way in this region. The broad European benchmark STOXX Europe 600 also edged higher on the back of positive sentiment from easing U.S.–China trade tensions, as did the Latin America STOXX 50. The U.S. dollar exhibited modest strength while gold reached new highs, briefly surpassing $4,200 per ounce.

According to Bespoke, 82% of the first 150 companies reporting earnings during the Q3 earnings season, which unofficially began on October 13, reported stronger-than-expected revenues versus consensus analyst expectations. That's the highest revenue beat rate for this cohort of 150 companies since at least 2001.