

THE FED DECISION & MARKET REACTION

LEARNING OBJECTIVES

Distinguish a policy decision from a policy surprise; connect interest rates, expected cash flows, and risk premiums to equity values; and explain why two stock indexes can respond differently to the same announcement.

MARKET 1 | FED DECISION

What change in the federal funds target range will the selected scheduled FOMC meeting announce?

Security	Change in basis points
Larger cut	Less than -25
Cut up to 25 bp	$-25 \leq \text{change} < 0$
No change	0
Rise up to 25 bp	$0 < \text{change} \leq +25$
Larger increase	More than +25

Settlement: Federal Reserve FOMC statement. Change = new target-range upper bound minus the upper bound immediately before the announcement, in basis points (100 bp = 1 percentage point).

Boundary rule: Exactly -25 bp belongs to cut up to 25 bp; exactly +25 bp belongs to rise up to 25 bp. The five intervals cover all possible numerical changes.

MARKETS 2 & 3 | EQUITY RETURNS

Two separate markets: **Dow Jones Industrial Average (^DJI)** and **Nasdaq Composite (^IXIC)**. What return will each index record?

Security in each market	Return R
Positive reaction	$R > +r\%$
Within the band	$-r\% \leq R \leq +r\%$
Negative reaction	$R < -r\%$

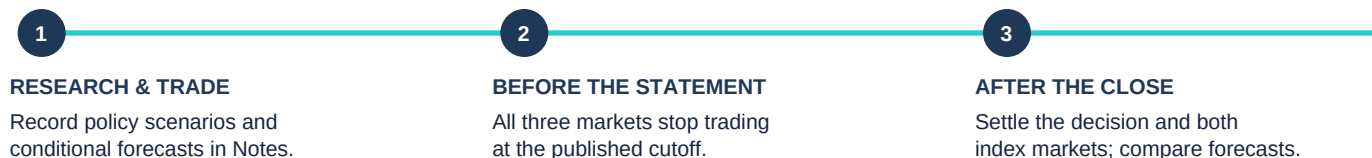
$R = 100 \times (\text{Close_after} / \text{Close_before} - 1)$.

Use Yahoo Finance index **Close**: the last regular-session close before the announcement and the first regular-session close after it. These are index returns, not ETF returns.

Suggested classroom threshold: $r = 0.5\%$ for both indexes. Fix it before trading. Use unrounded calculated returns for settlement; exact boundaries fall in the middle band.

This daily window includes other news and, normally, the Fed press conference. It measures the event-day response, not an isolated causal effect.

CASE TIMELINE



YOUR TASK

Build one coherent view across all three markets. In Notes, explain how each possible Fed decision could change the outlook for interest rates, earnings, and risk. Then translate those scenarios into probabilities and trading decisions. Use the worksheet on page 2.

BEFORE TRADING: Your professor specifies the meeting, release time and time zone, cutoff, threshold, and payout. **Proposed payout:** 100 market-cash units for each winning security; 0 for the others in that market.

SETTLEMENT RECORD: Retain the dated Fed statement and both dated index closes. Use the selected scheduled meeting only. If the target-range format changes or a required index close is unavailable, defer settlement for instructor review.

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1. START WITH WHAT IS ALREADY EXPECTED

Before trading, record the current target range, your probability of each policy outcome, and a dated source for market expectations (for example, federal funds futures). Explain what would be surprising. A 25 bp rise can be expected; the statement or projected path of future rates may contain the important news.

2. CONNECT EACH POLICY SCENARIO TO BOTH INDEXES

Complete this framework in **Notes**. Returns are your conditional point estimates for the settlement window. Include a plausible range and explain the expected Nasdaq-minus-Dow return difference.

Policy scenario	Probability	Dow return	Nasdaq return	Reason / key risk
Cut >25 bp				
Cut up to 25 bp				
No change				
Rise up to 25 bp				
Rise >25 bp				

For each scenario, assign probabilities to **negative / within-band / positive** returns for each index. Each conditional set sums to 100%; policy probabilities also sum to 100%. Consider different guidance even when the current rate decision is the same.

Consistency check: Overall probability of an index outcome = sum across policy scenarios of [scenario probability x probability of that index outcome given the scenario].

Illustration only: If a rise has 60% probability and a hold 40%, and Nasdaq has a 30% / 60% chance of a positive return in those scenarios, its overall chance is $0.60 \times 0.30 + 0.40 \times 0.60 = 42\%$.

3. EXPLAIN THE FINANCIAL CHANNELS

Discount rates: How might the expected future rate path affect the present value of cash flows?

Cash flows: Does the announcement signal stronger demand, weaker growth, or persistent inflation?

Risk premiums: Does uncertainty change the extra return investors require to hold equities?

Index composition: Which sectors and large constituents drive each index? The Dow is price-weighted; the Nasdaq Composite is market-cap-weighted. A simple "rates up, tech down" rule is insufficient.

4. DEBRIEF | SAME DECISION, DIFFERENT RETURNS

On September 16, 2026, the Fed raised its target range by 25 bp to 3.75%-4.00%. Reported daily returns were about **-1.21% for the Dow** and **-0.01% for the Nasdaq Composite**. With $r = 0.5\%$, these fall in the negative and within-band outcomes. Treat this as a discussion example, not proof of a single cause.

Compare your prior forecasts with the decision, guidance, Treasury-yield moves, and index constituents. Which explanation fits the evidence? What evidence would contradict it? Assess the quality of your reasoning separately from trading profit; one realized outcome does not establish forecast calibration.

Sources: [Fed statement, Sept. 16, 2026](#); [AP daily index results](#); [Fed research on stock-market channels](#).

Settlement sources: [FOMC statements](#); Yahoo Finance historical Close for [^DJI](#) and [^IXIC](#).