

Analysis on the Impact of the Federal Reserve's Interest Rate Cut Policy on the Herd Behavior in the A-share Market

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Abstract: The monetary policies of the Federal Reserve have a bigger effect on the financial markets of many countries because the decision to lower interest rates often starts a chain reaction. This is particularly true when the Fed decides to decrease interest rates, as this typically sets off a chain reaction. On September 18, 2024, the Federal Reserve announced an interest rate cut, immediately drawing widespread attention. Therefore, the paper aims to explore the impact mechanism of the Fed's interest rate cut policy on the herd behavior in the A-share market, and analyze how it affects the behavior and psychological drivers of investors therein. It adopts the theoretical framework of behavioral finance to explore the changes in the decision-making patterns and herd behavior of investors in the A-share market after the announcement of the interest rate cut by analyzing relevant literature and market transaction data. The results indicate that the Fed's interest rate cut policy prompts investors to exhibit typical herd behavior by influencing market sentiment and expectations, thus exacerbating the herd effect in the A-share market. This behavioral pattern increases market volatility in the short term, leading to irrational fluctuations in asset prices, which in turn increases market risk. In addition, the herd behavior may affect the effective discovery of market prices, resource allocation and exacerbate the instability of financial markets.

Keywords: Federal Reserve's Interest Rate Cut, Herd Behavior, A-Share Market, Market Volatility, Investor behavior

1. Introduction

Against the backdrop of the increasing integrated global financial markets, the Federal Reserve's monetary policy adjustments have become a key factor in the development of global markets. In recent years, behavioral finance research has revealed the importance of "herd behavior" in market volatility, in which investors blindly follow others, affecting market prices and stability. Despite studies on herd behavior, there is still a lack of research on how the Fed's interest rate cut impacts herd behavior in the market, particularly in China's A-share market. In particular, on September 18, 2024, the Federal Reserve announced a 50-basis-point cut in interest rates, which led to significant fluctuations in China's A-share market and attracted widespread attention. Accordingly, this study probes into how the interest rate cut policy of the Federal Reserve triggers the herd behavior in the A-share market by influencing investors' sentiments and expectations, and subsequently amplifies market volatility. Specifically, it dissects the abnormal market behavior in the A-share market on September 19, 2024, and examines how the Federal Reserve's interest rate cut policy instigates the herd behavior among investor groups in the short run and gives rise to market irrational overheating.

The paper aims to investigate the formation mechanism of herd behavior in a specific context by analyzing A-share market transaction data and relevant macroeconomic data, combined with the theoretical framework of behavioral finance. And it is hoped that this study can help understand the relationship between macroeconomic policy changes and market behavior, provide decision-making references for investors, and offer some basis for market behavior analysis by regulators.

2. Relevant Theoretical Basics

2.1. The Definition of Herd Behavior

Herd behavior represents a significant topic in the field of finance, with academic discussions on this phenomenon ongoing since the 1930s. Keynes first introduced the concept of the herd behavior, noting that investors often abandon independent judgment and blindly follow others' decisions, thus leading to collective actions [1]. He argued that investors tend to ignore personal information, rely excessively on group decision-making, and overlook the fundamental value of assets. Though there is no unified definition of herd behavior in academia, studies have explored this phenomenon from various perspectives.

From the vantage point of imitative conduct, the herd effect epitomizes the tendency of investors to mimic others in their decision-making process, rather than relying on individual and independent analysis. Investors habitually base their decisions on the actions of others rather than the intrinsic characteristics of the assets, resulting in collective behavior in the market. In terms of information utilization, the herd behavior manifests itself in investors' overreaction to public information while ignoring the value of private information. Due to the easy access and widespread dissemination of public information such as macroeconomic data or policy changes, investors often make decisions based on the collective response to this information, overlooking any unique insights they may have. Banerjee shows that upon observing the actions of others, an individual may elect to follow suit even if their private information suggests a divergent course of action, under the presumption that the former possess more accurate information, thereby engendering herd behavior [2]. Furthermore, the perspective of behavioral homogeneity further uncovers the consistency aspect within the herd effect, signifying the high degree of uniformity in investors' decision-making and trading activities. And this uniformity is not predicated on rational assessment but is substantially influenced by the conduct of others. Devenow and Welch posited that herd behavior is usually driven by a particular coordination mechanism [3]. For instance, investors arrive at analogous decisions by observing the actions of their peers or market price signals, ultimately culminating in a collective behavior pattern within the market. Thus, the herd effect is not merely an indication of investors' blind following but also a complex result of information asymmetry and behavioral convergence. From information overreaction to individual behavioral coordination, the herd behavior furnishes a crucial theoretical foundation for irrational behavior in the financial market and a multi-faceted analytical framework for comprehending the psychological mechanisms and behavioral patterns of investors during group decision-making.

2.2. The Characteristics of Herd Behavior

The characteristics of herd behavior include blindness, follow-the-crowd behavior, contagiousness, and short duration, which reveal the impact of irrational factors on investment decisions and market fluctuations.

Blindness is a core characteristic of herd behavior, manifesting as investors lacking independent judgment and blindly following the actions of others. This behavior stems from excessive reliance on others' decisions, the impact of fund managers and market opinions, or an inherent tendency to conform. Bikhchandani et al. noted that investors may mimic others' decisions because they believe

others may possess crucial investment insights or due to incentive systems, particularly when fund managers face performance evaluations [4]. The inherent conformist tendencies of individuals may also lead them to ignore their own information and blindly follow group behavior.

Follow-the-crowd behavior is another prominent characteristic of herd behavior, where investors change their originally independent decisions under the influence of others' actions. Specifically, investors may discard their original investment plans and follow the trend when observing others buying a particular stock, or decide to sell when seeing others sell, ignoring their own independent information and analysis. Bikhchandani et al. held that the follow-the-crowd behavior arises from investors' perception of others' actions in the decision-making process [4]. When individuals notice that others have chosen a particular investment approach, they adjust their decisions to align with the group's behavior.

Contagiousness refers to the transmissibility of the herd behavior, where individual actions can trigger widespread bandwagon effects. Bikhchandani et al. discovered that investors may imitate others' investment decisions without independent judgment, thereby forming collective behavior. For example, market volatility and uncertainty might increase if a small number of bullish investors rush into an emerging market, leading other investors to reevaluate their positions and join them.

Moreover, short duration is another crucial trait of herd behavior, exhibited as the occurrence of herd behavior usually being rapid and short-lived, especially when information varies or market sentiment fluctuates. When faced with market emergencies or fresh knowledge, investors may quickly change their investing strategy, escalating short-term market swings. Bikhchandani et al. mentioned that investors' decisions are often founded on experience amassing or new information refreshing [4]. When investors realize their mistakes, they may change their investment habit and even cause group behavior to change. This reverse herding will increase market instability.

2.3. The Causes of Herd Behavior

The emergence of herd behavior is influenced by multiple psychological theories, particularly social identity theory, information cascade theory, and herd instinct, which explain the decision-making process of investors within group behavior. Investors' collective action via social identification and information transmission fuels the A-share market's irrational surge following the Federal Reserve reduced interest rates.

The social identity theory explains how individuals drive investment decisions through a sense of belonging. In the financial market, investors align themselves with specific groups based on factors such as investment philosophy and risk appetite. When the A-share market rises due to the Federal Reserve's interest rate cut, investors may categorize themselves as a "bullish A-share" group and follow their decisions in the market frenzy. This behavior stems from investors' need to seek social identity and self-validation. Hewstone and Greenland noted that an individual's identity is defined by the social group to which he or she belongs, and that investors gain social identity by imitating the investment patterns of successful groups [5].

The information cascade theory further analyzes the causes of group behavior, which posits that in the case of information asymmetry, individuals do not have access to private information about others and can only speculate on decisions based on the behavior of others. When an investor sees an early market participant making a profit, subsequent investors will make decisions based on this behavior, resulting in a follow-the-leader effect. Bikhchandani et al. stated that investors speculate on private information based on the decisions of others, leading to the creation of group behavior [4]. In the context of the Federal Reserve's interest rate cuts, early investors' conduct affects later investors' decisions, neglecting personal information and analysis, aggravating the herd effect.

In addition, the herd instinct plays a crucial role in herd behavior. Asch's conformity experiment shows that individuals are prone to making decisions that contradict their own judgment under group

pressure [6]. In financial markets, especially in the A-share market, investors often struggle to make rational decisions due to their limited professional experience. Despite their fears of being shunned or losing money, people follow the trend when others buy a stock or fund. Bikhchandani et al. held that the herd instinct intensifies irrational exuberance and increases market volatility [4].

3. The Herding Effect of the Federal Reserve's Interest Rate Cuts on the A-Share Market

3.1. The Interest Rate Cuts and Market Reactions

The Federal Reserve's decision to cut interest rates is closely tied to the market's response. The rate cut is a measure to address changes in the U.S. economic situation, significantly impacting global financial markets, particularly the A-share market. On September 18, 2024, the Federal Reserve announced a 50 basis point reduction in the benchmark interest rate to a range of 4.75%-5.00%, marking the first rate cut since March 2020, mirroring the alleviation of inflationary pressures and the sluggishness of the labor market in the US.

The primary driver behind the rate cut is the continuous decline in U.S. inflation. In August 2024, the U.S. Consumer Price Index (CPI) showed a 2.5% year-on-year increase, a decrease from the previous month, marking a five-month consecutive decline and reaching the lowest level since 2021. Global crude oil prices fell below \$70 per barrel, further easing inflationary pressures. Although inflation remains above the Federal Reserve's 2% target, the notable moderation laid the foundation for a shift in monetary policy [7]. Besides, the weakness in the U.S. labor market contributed to the decision. Despite a rebound in non-farm payroll data, the weakness in the manufacturing and goods production sectors reflects a lack of growth momentum in the U.S. economy. The Federal Reserve stimulates economic growth through rate cuts, particularly to support the ailing manufacturing and service sectors, in an effort to stabilize the employment market [8].

Another reason for the rate cut is the frailty of the U.S. manufacturing sector and insufficient consumer demand. The Manufacturing PMI index has remained in contraction territory for several months, signaling challenges to U.S. economic growth. Meanwhile, the consumer savings rate has dropped. Though household spending remains high, the long-term high-interest-rate environment limits economic recovery. As such, the Fed has boosted consumption and investment by cutting interest rates to promote economic recovery [8]. After the rate cut news was released, the A-share market experienced pronounced oscillations. The stock market embarked on a new uptrend, offering numerous opportunities for investors but creating the risk of irrational overheating. Herd behavior was significantly manifested in this context, with many investors blindly following the trend and ignoring their individual decision-making, which exacerbated market volatility and bubble risks. As more investors rushed in, the irrational behavior in the A-share market became more pronounced, and the market faced a potential risk of collapse.

3.2. The Specific Manifestation of Herd Behavior: The September 18, 2024 Interest Rate Cut

The Fed's interest rate cut policy had a significant impact on the short-term volatility of the A-share market, triggering a substantial inflow of international capital, which drove a rapid market rally. On September 19, 2024, under the influence of the Fed's interest rate cut, the A-share market generally rose, with the major stock indices all rising and market turnover increasing significantly, showing a recovery in market sentiment. This reflects the features of herd behavior in the following ways:

The blindness of herd behavior was strikingly obvious during this A-share market upswing. The Fed's interest rate cut policy brought about short-term profit-making opportunities in the market, drawing in a substantial number of investors, particularly the young investor cohort, to pour into the stock market. These investors often based their decisions on market performance and the actions of others, overlooking fundamental stock valuations and long-term value. It led to excessive market

optimism. Follow-the-crowd behavior also contributed to market fluctuations. Under the impact of the interest rate cut, many investors, observing others buying stocks and driving up prices, began to imitate these behaviors and abandon their independent judgments. Based on Social Identity Theory, investors seek identification within the group, believing that the group's behavior is correct, and reducing decision-making uncertainty by mimicking others [5]. This further contributed to market over-prosperity. In addition, the contagiousness is reflected in this rally. Investors' buying behavior spreads rapidly like a contagion, creating a widespread herd effect. The information cascade theory states that investors rely on others' decisions due to information asymmetry, which leads to rapid propagation of investment decisions and exacerbates irrational exuberance in the market [4]. The short duration is also characterized by market volatility. Many investors lack long-term investment strategies and often adjust their decisions frequently in short-term fluctuations. The stock market rose after the Fed cut interest rates, making it easier for investors to make short-term choices and increasing market volatility and bubbles. This indicates that herd behavior stems from short-term reactions to market information rather than rational expectations.

3.3. Investor Behavior Insights

The study of investor behavior helps to understand how individuals formulate decisions and group behavior impacts market manifestations in a specific market context. Under the impact of the Fed's interest rate cut policy, the A-share market has risen sharply, and changes in investor behavior have driven irrational overheating in the market.

The dramatic fluctuation in market sentiment played a key role in driving investor behavior. The market sentiment swiftly turned optimistic due to the Fed's interest rate cut, with major A-share indices rising and trading volumes increasing significantly on September 18. This sentiment-driven decision-making shows that investors tend to overreact to short-term upward trends, overlooking potential risks. Based on sentiment-driven theory, collective sentiment not only affects short-term decisions but can also lead to market price volatility, further amplifying herd behavior [9]. The herd phenomenon is particularly significant after the interest rate cut. The rapid rise of the market not only stems from individual decisions, but is also the result of collective behavior. During the rise, investors tend to follow others, especially the influx of new investors. According to social identity theory, investors seek a sense of belonging in the market and believe that emulating others' behavior will gain them group acceptance. This conformity led to further market expansion, intensifying the herd effect. Also, information asymmetry played an important role in this process. The information cascade theory held that investors rely on the decisions of others to speculate on market movements in the absence of private information [4]. The Fed's interest rate cut policy acted as a key signal in the market, on which initial investors based their decisions, and subsequent investors confirmed their decisions by observing the market and the behavior of others, further exacerbating irrational overheating in the market. And overreaction and short-term decision-making exacerbated market volatility. Rapid market reaction followed the interest rate cut, and investors' irrational exuberance hastened the stock market's ascent, which is unfounded by fundamentals. In addition, investors lacked a long-term investing outlook and were overly reactive to short-term market fluctuations because of their susceptibility to such changes.

4. Measures to Address the Herd Behavior

4.1. Investor Education

In addressing market fluctuations and avoiding herd behavior, investors should cultivate the ability to make rational judgments and think independently. In particular, investors should formulate an investment strategy that is in line with their own circumstances based on their personal investment

style, risk appetite and tolerance, and avoid blindly following others. Assessing the situation rationally and making calm decisions are crucial when dealing with short-term changes in the market or external policy variables. Investors should adhere to long-term investment goals, resist the temptation of short-term gains, and maintain a clear investment philosophy to avoid making irrational decisions driven by collective sentiment. Also, investors should overcome the psychology of comparison and avoid changing their decisions at will when they see others making profits, which may lead to frequent trading and unnecessary losses. Rational analysis of individual stock fundamentals, market valuations, and other factors should be used to avoid making hasty decisions. And avoiding herd behavior requires focusing on long-term consistent returns rather than short-term swings. To improve investment decision-making skill, investors should increase their financial knowledge and expertise, as well as improve investment methods and risk management through ongoing learning and practice. At the same time, the establishment of a reasonable risk control framework, such as stop-loss and take-profit settings, and reasonable diversification of investments can effectively avoid herd behavior and reduce risk.

4.2. Market Mechanism Improvement

To reduce the negative effects of herd behavior on the market, information disclosure oversight and trade restrictions must be improved to improve market rationality and transparency. Strengthening the supervision of information disclosure by listed companies is crucial to reducing information asymmetry. Investors can make informed judgments by enhancing disclosure quality, transparency, and timeliness and ensuring corporations give accurate, comprehensive, and quick information. This reduces the risk of herd behavior caused by information gaps or misinterpretation, thus minimizing the occurrence of irrational market fluctuations. And refining the market trading system is equally critical in curbing herd behavior. By enforcing strict trading regulations, the legitimate rights and interests of investors can be effectively safeguarded, while preventing disruptive actions such as excessive speculation, malicious manipulation, and misleading conduct. Strengthened oversight and crackdowns on market manipulation, especially during moments of increased market volatility, help to ensure fairness and stability. Optimizing the market trading mechanism helps to reduce irrational investment behavior and promote the healthy development of the market, while minimizing the impact of herd behavior on market stability.

5. Conclusion

The influence of the Federal Reserve's interest rate cut policy on the herd behavior in the A-share market is remarkably conspicuous. It has especially instigated intense market gyrations in the short run and spurred the generation of herding behavior. This study probes into this phenomenon from diverse viewpoints, encompassing the backdrop of the Fed's interest rate cut, the responses of the global stock market, and the reaction of the A-share market to this policy. It further dissects the specific manifestation of herding behavior in the A-share market and its fundamental psychological underpinnings. The results reveal the intrinsic link between macroeconomic policies and micro market behaviors, and discuss how to mitigate the adverse consequences of herd behavior through investor education and improving market mechanisms, thereby promoting healthier and more efficient market operations. Understanding the formation mechanism of herd behavior and its impact on the market will help investors make more rational decisions and help market decision makers formulate more effective policies to prevent and mitigate violent market oscillations and ensure the stable development of the financial market. Nevertheless, the study mainly focuses on the psychological foundations of herd behavior, without fully considering the comprehensive effects of social, cultural, and economic factors. Moreover, the research is centered on the A-share market,

leaving the applicability and differences in other markets yet to be verified. Future research could adopt a more holistic perspective, exploring the causes of herd behavior through multidimensional factors while expanding the scope to include diverse markets and participant perspectives.

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