End of the rate cycle

Following a period of the highest interest rates seen since 2001, during which central banks globally sought to tame inflation, major economic regions have now started to cut interest rates. This shift marks the start of a new monetary policy cycle that is set to significantly influence global financial markets. Particular attention is on the US, the world's economic engine, which has entered this cycle later than others but with a more assertive approach. Investors are now faced with the challenge of determining how to position themselves tactically in this shifting environment.

Fed rate cuts and their consequences

Historically, the Fed has typically lowered interest rates in response to economic challenges, often coinciding with recessions. In fact, eight out of the last twelve periods of rate cuts have been linked to a recession, such as those in 1990, 2001 and 2008, all marked by global economic downturns.

The early 1990s saw a relatively mild recession, while in 2001, the burst of the dot-com bubble triggered a prolonged bear market lasting two difficult years. The recession of 2008, meanwhile, was exacerbated by the global financial crisis. On average, stock markets have declined by about 10% in the six months following rate cuts during recession periods (see Fig. 1, red line).

However, when interest rate cuts were implemented in a soft-landing environment, they fostered growth and boosted the value of risk-sensitive assets such as equities. For instance, rate cuts in 1995 and 1998 helped stabilize the labour market and avert an economic downturn. As a result, markets saw an average gain of 10% in the following six months (Fig. 1, green line).

In these cases, the Fed's rate cuts were not a reaction to a specific crisis but rather aimed at bringing interest rates down to a more neutral level. Conversely, rate cuts made in response to concerns about slowing growth (Fig. 1, yellow line) led to economic recovery, with equities gaining approximately 20% within six months.

Current Fed policy

The US interest rate easing cycle started with a significant 50 basis point cut – a move typically reserved for economic emergencies. However, the current environment shows little indication of a crisis: the USA is experiencing near full employment, stable consumer spending and rising real wages. This suggests that the Fed is acting pre-emptively to mitigate potential risks rather than responding to an immediate economic downturn. To maintain a balance between its dual objectives – price stability and full employment – the Fed is aiming for interest rates that are neutral rather than restrictive in terms of monetary policy. The Fed itself has indicated that the neutral interest rate is 2.8%, meaning it currently lags more than 2.0% behind the yield curve.
In the six months leading up to the first interest rate cut of an easing cycle, US stock markets have typically recorded modest gains of around 3% in non-recessionary periods. Since March 2024, equity prices have, however, risen by as much as 10%. This is signalling that much of the optimism surrounding interest rate cuts may already be reflected in current equity valuations – that said, there is also considerable AI enthusiasm in the market, further contributing to the upward momentum.

Conclusion

The key question then is whether the Fed can successfully achieve a soft landing. Since predicting a recession with certainty is impossible, this question remains unanswered for now. If the USA were to enter a recession, stock markets would likely experience short-term price declines. However, for long-term investors, such a downturn could present a favourable opportunity to enter the market at lower valuations.

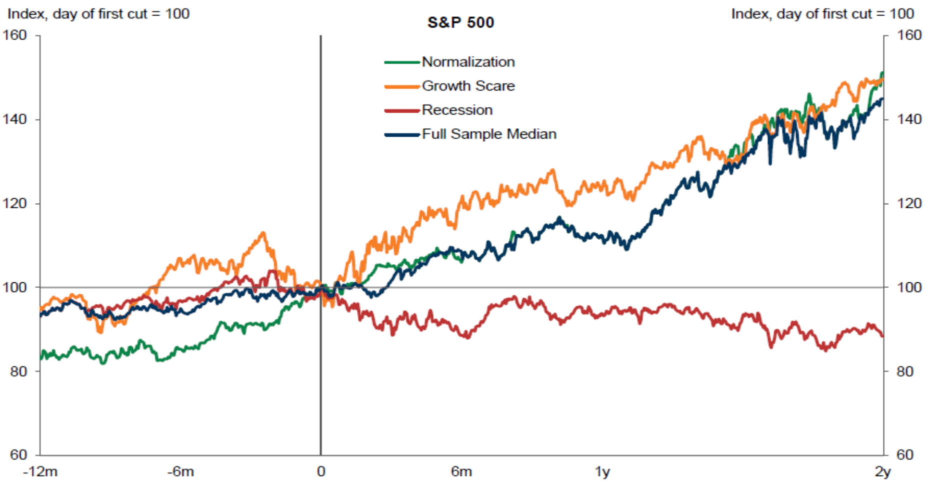

Fig. 1: Equity returns before and after interest rate cuts *Source: Goldman Sachs Global Investment Research*

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