INDOSUEZ WEALTH MANAGEMENT

CIO PERSPECTIVES

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Time to build all-weather portfolios

After 18 months of elevated interest rates, central banks are beginning to lower their benchmark rates to support continued economic growth. This shift in the macroeconomic landscape may require significant adjustments in asset allocation.

A changing macro landscape

Not long ago, the Federal Reserve (Fed) was focused on a single priority: controlling inflation. When the US Consumer Price Index (CPI) surged above 9% in June 2022, the central bank initiated a tightening cycle, raising interest rates from 0.5% in March 2022 to 5.5% by July 2023.

As inflation has eased, Jerome Powell delivered two key messages at the Jackson Hole Symposium in late August:

- "The time has come for policy to adjust": The Fed is prepared to begin a rate-cutting cycle starting on 18 September as inflation cools.
- "We do not seek or welcome further cooling in labour market conditions": The Fed's focus has shifted to the job market, which is gradually weakening, with US unemployment rising from a low of 3.4% in April 2023 to 4.2% in August.

The Fed is likely to follow other central banks in cutting its benchmark rate to support private investment and economic activity in the US. Despite mixed economic data, we maintain our soft-landing scenario: US GDP remained strong in Q2 2024 at 2.9%, and is expected to reach 2.5% this year, before slowing to 1.8% next year.

In this environment of easing inflation risk, slowing economic growth, and a global rate-cutting cycle, how should investors position their portfolios?

What to expect from Fed's rate cuts?

There is often a misconception about the causal relationship between recessions and rate cuts: while recessions typically lead to rate cuts, a rate cut does not necessarily signal a recession. For instance, the Fed reduced interest rates in 1995, 1998, and 2019 to support the US economy after successfully controlling inflation. In contrast, the circumstances in 1989, 2001, and 2007 were quite different, as the US economy was slowing rapidly, and the Fed had to intervene to mitigate the economic impact of a recession.

Table 1: How did equities and bond yield change 6 months after the previous Fed's rate cuts?

	Peak rate	US 10Y Bond yield	US 2Y Bond yield	10-2Y	Nasdaq	S&P 500	Russell 2000	Large vs. Small caps
02.06.1989	9,75	-61	-76,4	15,4	4,10%	7,95%	-3,01%	10,96%
05.07.1995	6	-50,9	-58,6	7,7	3,70%	12,87%	9,14%	3,73%
28.09.1998	5,5	65,3	55,7	9,6	53,67%	24,04%	8,23%	15,80%
02.01.2001	6,5	47,6	-62,5	110,1	-14,40%	-3,80%	7,23%	-11,04%
17.09.2007	5,25	-113,78	-260,6	146,82	-11,20%	-9,88%	-12,10%	2,22%
30.07.2019	2,5	-47,24	-43,31	-3,93	14,45%	8,64%	4,01%	4,62%
Average	**5,9**	**-26,7**	**-74,3**	**47,6**	**8,4%**	**6,6%**	**2,3%**	**4,4%**

Source: Bloomberg, Indosuez Wealth Management.
Note: Bond yield change in basis points, equities in percentage.

Several key insights can be drawn from past rate cuts, as outlined in Table 1:

- **Bond yields may continue to decline over the medium term**: While US 10-year bond yields have already dropped by more than 100 basis points (bps) since their peak in April, history shows they often continue to fall in the months following an initial rate cut.
- **The yield curve could steepen:** In 5 of the last 6 rate-cut cycles, short-term bond yields declined more sharply than long-term yields. This pattern could repeat, as markets are pricing in 9-10 rate cuts by the end of 2025. Long-term yields, however, may hold steady near current levels if there is no recession and inflation does not fall quickly below 2%.
- **Rate cuts have historically supported equities in the absence of a recession:** US equities performed relatively well following rate cuts in 1989, 1995, 1998, and 2019. Conversely, equities fared poorly during the dot-com bubble and the global financial crisis.
- **Large caps may continue to outperform small caps:** US large caps have historically outperformed, likely due to their growth orientation and sensitivity to interest rates. However, the recent significant underperformance of small caps compared to large caps could limit the extent of large cap outperformance, even after a rate cut.

More volatility ahead

The Q2 2024 earnings season for S&P 500 companies was relatively strong, with 11.5% year-on-year growth. It was encouraging to see that this earnings growth was driven by a broad range of sectors, not just the tech sector, but also more defensive areas like healthcare, utilities, and financials.

However, with a Fed rate cut on the horizon, investors are increasingly shifting their focus from company earnings to macroeconomic data. As investors try to interpret Federal Open Market Committee (FOMC) members' views—who, in turn, are analysing lagging economic indicators—financial markets tend to become more volatile during periods of monetary policy shifts. This volatility was evident during the first weeks of August and September, which saw more market turbulence than usual.

Looking ahead, financial markets, from bonds to equities, should prepare for continued volatility as investors assess the impact of a slowing economy and potential monetary easing on asset prices.

Time to rethink portfolio construction

Investors are now navigating a new macroeconomic and market environment, which may call for portfolio adjustments. While a soft landing remains our base case, there are still many uncertainties, from the extent of the economic slowdown to the pace at which central banks will cut interest rates. As a result, it may be prudent to adopt an all-weather strategy—a portfolio designed to withstand various economic conditions.

Lock-in yield for longer with bonds

Short-term deposits (up to 1 month) and money market funds have been major beneficiaries over the past 18 months, as higher interest rates have driven inflows. However, as central banks, including the Fed, the European Central Bank (ECB), and the Bank of England, begin to cut rates, the yields offered by money market funds are likely to decline accordingly. Bonds, held to maturity and assuming no defaults, can help mitigate reinvestment risk in this environment.

Bonds are macro hedges too

Another positive aspect of bonds is that they are once again becoming an effective macroeconomic hedge. When inflation rises, bond yields tend to increase as central banks raise rates, causing bond prices to fall. In 2022, bonds experienced a significant downturn, failing to provide the usual diversification benefit against equities. However, as inflation eases, bond yields are expected to be more influenced by economic growth prospects, potentially restoring the negative correlation with equities that existed prior to the COVID-19 pandemic.

Stay invested

Since a rate cut does not necessarily signal a recession, it may be premature to reduce overall portfolio risk. The positive takeaway from the Q2 2024 earnings season is the broadening of earnings growth, with many sectors reporting solid results, which could help support equity indices.

Real assets in a lower interest rate environment

Private investments, from Private Equity to real estate, have faced a more difficult environment given much higher interest rates. As most central banks lower their benchmark rates, opportunities will arise to get back into real assets with the potential to reduce portfolio volatility too.

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