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From the S&P to JSE – how SA can cope with US rate cuts

● *Markets generally respond favourably to cuts, but are not immune to economic crises*

Anton Eser

Market participants worldwide are wondering what the US interest rate cut means for their portfolios.

With history as our guide, we know rate cuts typically signal a shift in economic conditions, but predicting market behaviour is never straightforward. It is, nonetheless, worth exploring the potential effect of the Federal Reserve's rate cut, drawing on historical trends, economic conditions and the broader implications for SA investors.

Looking back at the 14 Fed rate cycles since the Great Depression in 1929, there is a clear trend: the S&P 500 has posted positive returns in the 12 months after the first rate cut 86% of the time. However, it is crucial to note that the two exceptions – during the dot-com bubble and the sub-prime mortgage crisis – were both periods of economic upheaval.

This historical context suggests that while markets generally respond favourably to rate cuts, they are not immune to broader economic crises. Given the current economic environment, characterised by unique conditions such as elevated valuations, geopolitical tensions and the lingering effects of a pandemic, it is challenging to predict whether the market will react similarly this time.

Hedge fund guru Ray Dalio famously quipped that those who live by crystal balls will end up eating shattered glass. And forecasting is not something we like to do at IOX Investments. I prefer to look at

Pithy quip:
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/Reuters



the fundamentals and what valuations are telling us about where the margins of safety can be found.

If we draw parallels to the past, particularly 2000, which also saw high market valuations coupled with the beginnings of a recession, we might be in for a comparable market response over the next 12 to 18 months.

GRADUAL APPROACH

Traditionally, the Fed has taken a gradual approach to raising rates ("taking the stairs up") and a more aggressive stance when cutting them ("taking the elevator down"). However, this cycle has been anything but typical. After a period of rapid rate hikes and now a bigger-than-expected 50 basis point cut, we are on the brink of what is expected to be a more measured approach.

The market had priced in a reduction of about 100 basis points this year, followed by another 100 basis points by the end of 2025. That would bring the Fed funds rate down from about 5.25% before the latest cut to about 3.25%. But in reality, monetary policy changes are

rarely this smooth – more akin to landing a plane in a storm than following a straight line.

A reduction of this magnitude without accompanying economic turbulence would be unprecedented. Our view is, therefore, that while the market expects a soft landing, the path to achieving this remains fraught with challenges.

The potential for a recession in the world's largest economy remains a concern. Historically, there is a lag between the peak in interest rates and the onset of a recession, typically ranging from 18 months to two years. We are now approaching that timeline, and several indicators suggest that a recession in the US is a real possibility within the next six to 12 months.

Warren Buffett's recent shift

THE POTENTIAL FOR A RECESSION IN THE WORLD'S LARGEST ECONOMY REMAINS A CONCERN

towards a more defensive cash position, reducing his stakes in major companies such as Apple and Bank of America, is worth noting. Such moves are often seen as cautionary steps in anticipation of a market downturn. While the exact timing of a recession is impossible to predict, the probability, based on historical trends and market dynamics, is high.

Assuming a recession does not materialise in the next six to 12 months, certain sectors traditionally perform well in a rate-cut environment. Cyclical sectors such as consumer discretionary and industrials have historically benefited from lower interest rates, as have utilities, healthcare, financials and real estate investment trusts.

However, this market environment presents a unique challenge. Unlike in previous cycles, in which tech companies were relatively minor players or speculative ventures with little real cash generation, today's tech giants – the so-called "Magnificent Seven" – have become the dominant forces in the market, exerting much

greater influence.

The big question is whether these tech companies are defensive or cyclical. Historically, companies involved in semiconductors and advertising have shown high sensitivity to economic cycles, but the resilience of today's tech giants remains untested through a full interest rate and recession cycle. This clouds the crystal ball even further.

Given this uncertain environment, SA investors should consider their fixed-income allocations carefully. Historically, bonds – particularly those with longer durations – have performed well after rate cuts. We have seen a strong performance in the local bond market this year, with 10-year yields dropping nearly 200 basis points from their highs in April, resulting in a total return of about 15%.

ROOM FOR GROWTH

Looking ahead, there is still room for growth in the local bond market. The Fed rate cuts could lead to a drop in real rates, which would be bullish for fixed income. From an asset allocation perspective both inflation-linked bonds and nominal government bonds remain attractive options for SA investors, offering favourable valuations and potential for further gains.

In the wake of the Fed's much-anticipated rate cut, global markets are poised for a period of stomach-churning change. While history provides some guidance, the economic environment is unlike any we have seen before, marked by unprecedented challenges and opportunities.

For SA investors this means staying vigilant and bracing for the volatility ahead, being prepared to adapt, and considering a diversified portfolio approach that includes a strong focus on fixed income.

● Eser is chief investment officer at IOX Investments.