What the new rate-cutting cycle means for asset classes

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Investment Management
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Key takeaways

- Central banks' decisions are reshaping the financial landscape
- The monetary policy shift is supporting high-yield bonds and equities
- Opportunities are arising for investors taking advantage of shifts in the yield curve and market volatility
- Maintaining a well-diversified portfolio regardless of market conditions remains key as investors need to brace for volatility
- Gold reached all-time highs, driven by an accommodative Federal Reserve

Several central banks have begun a new chapter in monetary policy: by initiating the first round of rate cuts, they signalled the end of their battle against inflation. In September, the Federal Reserve initiated its first rate decreases since March 2020, with a sharp 0.5% reduction. This aligns with the European Central Bank and Bank of England which lowered their rates by 0.25% in August and in June, respectively. The Swiss National Bank has similarly implemented three 0.25% cuts since March. As monetary policy is easing globally – with exceptions in Australia, Japan, and Norway –, investors are now assessing the implications of this new cycle for their portfolios. What does this wave of rate cuts mean for various asset classes?

Equities: set to benefit from declining rates

With the broad impact of lower rates on the economy and purchasing power, interest rate cuts act as a supportive catalyst for both businesses and consumers.

In a low-interest-rate environment, consumers are more inclined to purchase goods that typically require financing, such as homes, automobiles and appliances. This boost in consumer demand trickles up to corporations, reigniting manufacturing activity and contributing to a new virtuous cycle for the overall economy. Equities of companies tied to these consumer goods or related manufacturing sectors (e.g. home builders, construction materials, industrial parts) are often the first to experience a reacceleration in growth, fuelling investor interest in these cyclical areas of the market.

On the corporate side, a favourable rate environment boosts business investments and improves debt profiles by reducing the cost of borrowing. Companies are encouraged to increase borrowing for capital expenditure. Lower rates also trim financing costs for expansions or acquisitions, potentially leading to higher growth rates and earnings forecasts. Sectors with high levels of debt, such as real estate and utilities, are particularly sensitive to interest rate fluctuations, benefiting from lower rates in terms of both earnings and balance sheet health. Known as “bond proxies”, these sectors often exhibit an inverse relationship between interest rates and share price performance: as rates fall, share prices rise.

Equity valuations also benefit from a lower rate environment, as the present value of future earnings are calculated using a discount rate. Lower interest rates reduce the discount rate, which, in turn, increases the present value of projected cash flows and thus the theoretical value of shares. This is most beneficial for “growth-oriented” companies (notably those in the technology sector). While lower interest rates are generally beneficial for many sectors, there are offsetting factors for banks and insurance companies. Better economic growth should drive increased loan volumes and capital market activity, but this may be offset by lower profit margins which tend to contract in an easing cycle.

Fixed income: high-yield and emerging market bonds to outperform

Widely seen as the return of the so-called "Fed put", the shift in US monetary policy suggests that the Federal Reserve is keen to support markets if economic conditions worsen. This environment favours the riskier fixed-income segments, such as high-yield and emerging market debt, which typically benefit from tighter credit spreads as investors seek higher returns in a low-rate environment.

Typically, a Fed rate cut reduces yields and boosts bond prices due to their inverse relationship, particularly for Treasury bills with maturities under one year. However, the current landscape is more complex. Despite the 0.5% rate cut, yields on longer-term Treasuries, such as 5- and 10-year notes, have risen, reflecting market expectations of economic resilience and future inflationary pressures.

As the current inverted yield curve steepens, a return to a positive slope is evident. Our expectation is for short-term rates, like the 2-year Treasury, to remain stable, while longer-term bond yields should climb towards mid-4%. If this were to happen, it would create an entry point for investors with a focus on longer-duration assets.

Fixed-income instruments linked to short-term rates, such as floating-rate notes and senior loans, see yield declines as the Secured Overnight Financing Rate (SOFR, LIBOR's replacement) falls alongside the Fed funds rate.

Structured products: enhanced valuations and opportunities arise

The interest rate component plays a key role in structured products, driving returns alongside optional components linked to assets, such as equities, indices, commodities, currencies, or even other rates.

For investors holding structured products in their portfolios, a decrease in interest rates generally enhances the valuation of these investment solutions on the secondary market. However, the extent of this impact depends largely on a product's remaining maturity, with longer-maturity instruments seeing greater valuation increases compared with those closer to maturity.

Equity-linked products, such as yield-enhancement instruments like reverse convertibles, are likely to see a resurgence in demand. They generally become more attractive as rates decline, benefiting from a widening equity risk premium relative to the risk-free rate, as in a low-to-negative-rate environment. In addition, the recent volatility in equity markets could further support their appeal, as heightened fluctuations tend to enhance the pricing of options embedded in structured products. Products linked to fixed income, such as credit-linked notes (CLNs) or solutions capitalising on a steepening yield curve, should also become more appealing, as they are likely to offer higher yields than traditional bonds in a low-rate environment.

However, new capital-protected products may lose some appeal if long-term rates decrease, as they become less attractive to investors compared with previous quarters. This is because the cost of providing capital guarantees rises when rates decline. Still, long-term rates remain elevated, offering an opportunity to lock in higher returns. For instance, the current 3-year USD swap rate is still 1.50% above the decade-long average, continuing to make it a compelling case for capital-protected solutions in today's market.

Gold: all-time highs thanks to a dovish fed

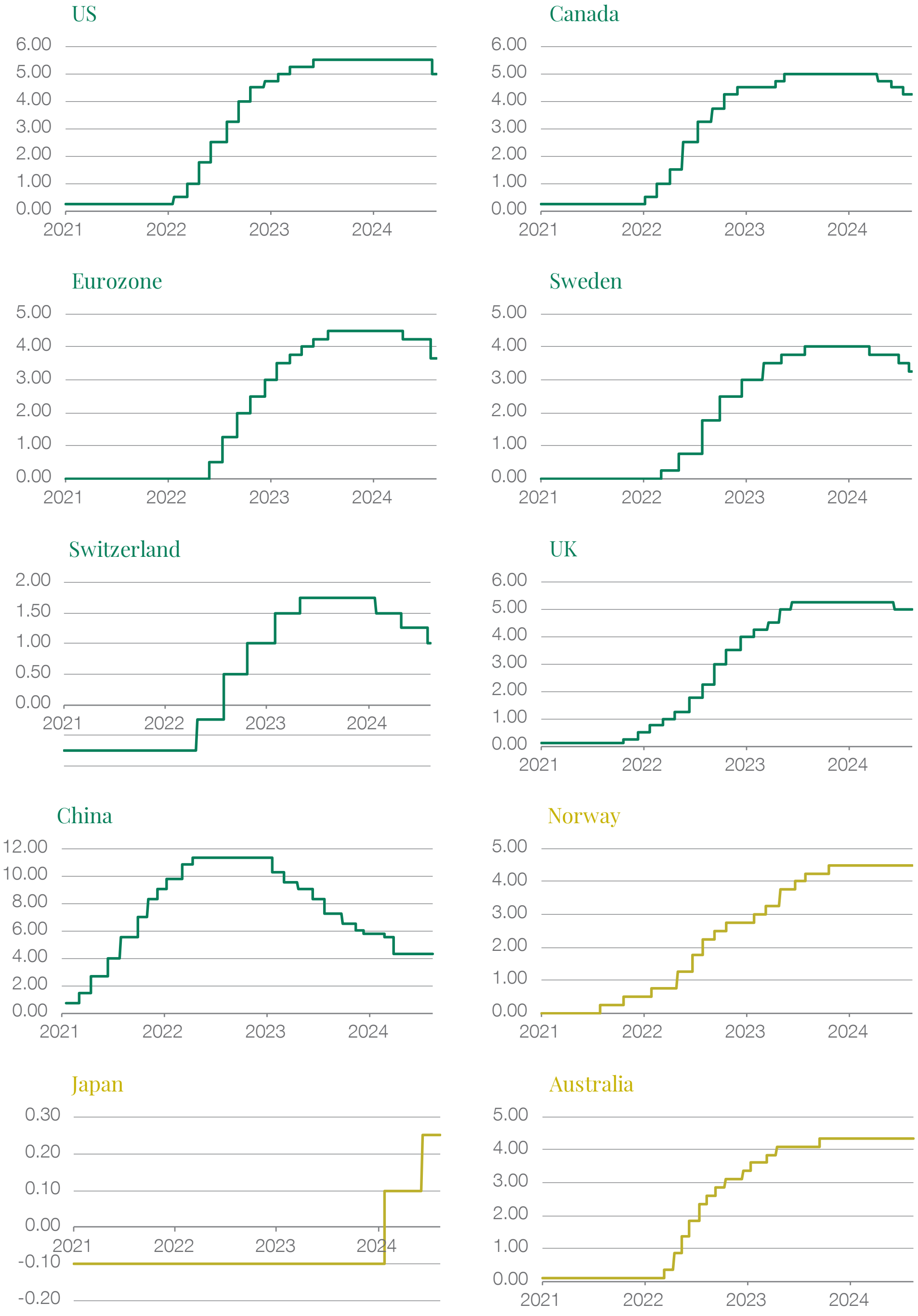
In September, gold surged to record highs, buoyed by the Federal Reserve's larger-than-expected rate cut and the Federal reserve's dovish commentary on further easing. This shift in monetary policy provides a tailwind for non-yielding assets like gold. Meanwhile, rate cuts from other central banks might amplify this momentum effect.

From a portfolio perspective, asset allocation is heavily influenced by interest rate levels. Low rates generally diminish the appeal of fixed income and cash savings, as they offer lower yields, shifting preferences towards equities and high-yield bonds, which can deliver superior returns provided investors are willing to accept higher risk profiles. However, regardless of market conditions, portfolio diversification remains essential.

EVOLUTION OF POLICY RATES BY MAIN CENTRAL BANKS

While the Federal Reserve reduced its policy rate by 50 basis points, the Bank of England maintained its interest rate at 5% on 19 September.

Below is a summary of recent policy rate adjustments by central banks overseeing the world's 10 most traded currencies



Source: Bloomberg Finance LP

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