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WS Global Chief Investment Office
19 September 2024

Market Watch

US equities favoured after rate cut

Summary

The US Federal Reserve started cutting interest rates for the first time in this cycle as it shifts focus from curbing inflation to supporting growth. It lowered its benchmark Fed funds target rate from a 23-year high of 5.5% by 50bps, slightly exceeding market expectations.

The Fed also projected a total of 100bps and 200bps of rate cuts by end-2024 and end-2025, respectively (vs. 25bps and 125bps cuts projected in June). It cut its growth estimate for 2024, lowered its inflation estimate and raised its unemployment estimates for 2024/25.

The S&P500 index fell 0.3% at close of trading, after scaling an all-time intraday high following the rate cut. The 10-year US government bond yield rose almost 6bps, the broad USD index (DXY) fell 0.3% and gold fell 0.4% from the previous day's closing.

The case to Overweight US equities remains intact. We expect a series of gradual Fed cuts over the next 12 months to help the US economy achieve a soft landing by lowering borrowing costs. Given this backdrop and a strong earnings outlook, we remain overweight the US relative to global equities.

We would use any bounce in US government bond yields towards 4% to lock in an attractive income. Markets are pricing in 200bps of rate cuts by end-2025. A Fed path less aggressive than this would likely lead to such a rebound in bond yields and the USD.

Background

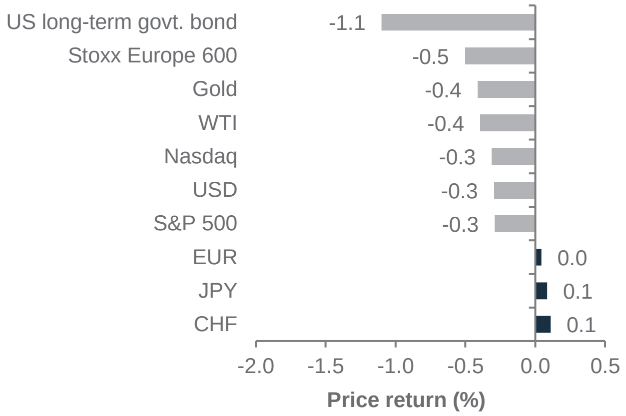
The 50bps rate cut is the largest at the start of a rate easing cycle since 2007. Markets had anticipated an outsized cut ahead of the Fed meeting. This was likely a result of media reports citing unnamed Fed officials favouring a front-loaded series of cuts to make sure the Fed did not fall behind the curve as the economy cooled. Chair Powell said the outsized cut was "a sign of our commitment not to get behind".

The US job market has cooled significantly in recent months. While the economy has generated an average 116,000 net new jobs in the past three months, some leading indicators, such as a rising rate of permanent job losers and falling job openings/hiring rates, have raised the risk of the US unemployment rate rising significantly above its long-run estimate (4.2%).

Falling US inflation has likely helped the Fed gain the confidence to ease policy. US headline and core inflation fell to 2.5% and 3.2% in August, respectively, from a cycle peak of 9.1% and 6.6% in 2022. This sharp decline in inflation means US policy rates had turned excessively restrictive. The Fed's aim is likely to lower rates closer to estimates of neutral (2.9%), thus sustaining the ongoing expansion.

Equities, USD and gold all fell, while bond yields rose on Wednesday following the Fed rate cut decision

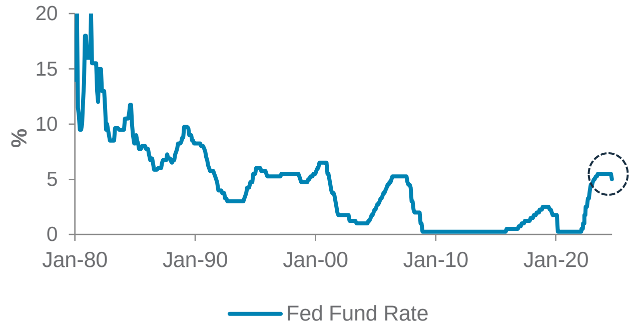
One-day price return following the Fed decision (%)



Source: Bloomberg, Standard Chartered; 18-19 Sep close

The Fed's 50bps rate cut is the largest at the start of a policy easing cycle since 2007

Fed funds target rate (%)



Source: Bloomberg, Standard Chartered

The Fed lowered its rate estimates for end-2024 and end-2025 and cut its growth and inflation estimates

The Fed's September projections vs. its June estimates

	GDP		Unemployment		Core PCE		Rates estimates	
Dates	Old	New	Old	New	Old	New	Old	New
2024	2.1	2.0	4.0	4.4	2.8	2.6	5.1	4.4
2025	2.0	2.0	4.2	4.4	2.3	2.2	4.1	3.4
2026	2.0	2.0	4.1	4.3	2.0	2.0	3.1	2.9
LR*	1.8	1.8	4.2	4.2			2.8	2.9

Source: US Federal Reserve, Standard Chartered

What does this mean for investors?

Fed rate cuts to help achieve a soft-landing. The outlook for various assets significantly depends on whether the US economy achieves an economic soft landing or falls into a recession. Gradual Fed rate cuts are likely to help sustain the consumption-driven US economic expansion by reducing borrowing costs for consumers and businesses. We believe the Fed has ample capacity to cut rates to achieve a soft-landing, given the decline in inflation over the past year.

Historical trends suggest a US soft-landing driven by Fed rate cuts is likely to be positive for US equities over a 12-month period following the start of rate cuts (e.g., the soft-landings of 1987, 1995 and 1998). Meanwhile, the US 10-year government bond yield and the US dollar typically rise in the 12 months after the Fed starts cutting rates in a soft-landing scenario.

We stay overweight US equities within a broadly diversified asset allocation. Fed rate cuts are likely to lower borrowing costs for businesses, helping boost investment. US corporate balance sheets remain robust and the corporate earnings growth outlook remains strong. This is particularly so in growth sectors such as technology, where rising demand for generative artificial intelligence-related equipment and software is driving structural growth. Lower interest rates also help support valuations of long-term growth sector equities.

US bond yields and the USD could see a near-term bounce. Aggressive market pricing for Fed rate cuts going into the Fed meeting means US government bond yields and the US dollar are likely to bounce in the near-term after the Fed projected a more gradual path of interest rate cuts relative to market expectations. Heading into the meeting, markets were pricing almost 120bps of rate cuts by end-2024 and a total 242bps of cuts by end-2025. Instead, the Fed's updated projections show it plans to deliver a total of only 100bps and 200bps of cuts by end-2024 and end-2025, respectively.

Look for opportunity to lock-in bond yields. A Fed path less aggressive than this would likely lead to such a rebound in bond yields. We would use any bounce in US yields, especially in the 10-year bond, towards 4% to lock-in attractive income over a longer term.

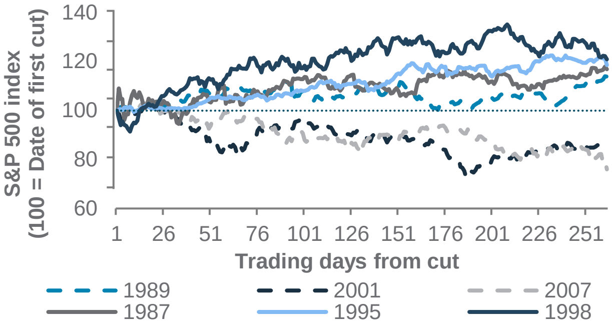
Rangebound USD. We see little scope for a significant move in the broad-based USD. Already aggressive market pricing for Fed rate cuts limits room for further near-term downside as the Fed embarks on rate cuts. Meanwhile, any USD upside is likely to be limited in the near-term unless the ECB turns more aggressive in its rate cuts.

Downside risk in USD/JPY. There is risk of further downside in USD/JPY, though, as expectations of further Fed rate cuts contrast with prospects of further rate hikes by the BoJ. Although the BoJ is likely to hold rates this week, we expect it to hike further in the coming months as it counters inflation pressures from rising wages. Divergent monetary policies mean US and Japan rates are likely to move closer to each other, raising the risk of lower USD/JPY.

Risks to the outlook: Fed rate cuts do not guarantee an economic soft-landing. The risk is that the Fed is behind the curve and rate cuts are too late and the pace of cuts too slow to prevent a sharper downturn in the economy (e.g., the recessions of 1990, 2001 and 2007). In such an event (to which we assign a low probability at this stage), bonds and gold typically outperform, while equities decline sharply. The USD's performance has been mixed in this scenario: in the 2001 recession, the USD rose after the start of Fed rate cuts, while in the recessions that followed 1989 and 2007 rate cuts, the USD fell.

US stocks have historically benefitted from Fed rate cuts that resulted in an economic soft-landing

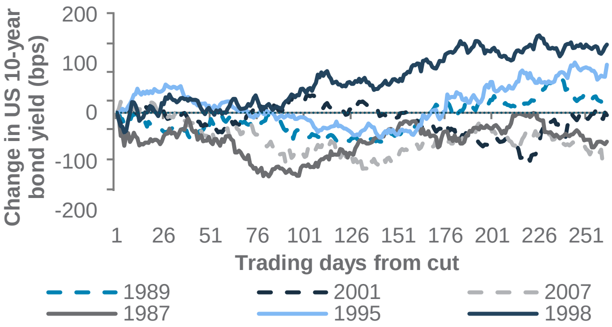
S&P500 index 12m trend after past Fed rate cuts



Source: Bloomberg, Standard Chartered;
Note: Fed rate cuts starting in 1987, 1995 and 1998 resulted in economic soft-landings, while cuts in 1989, 2001 and 2007 failed to prevent recessions

US bond yields have historically risen in the 12 months following the start of Fed rate cuts in the event of an economic soft-landing (e.g., 1995, 1998)

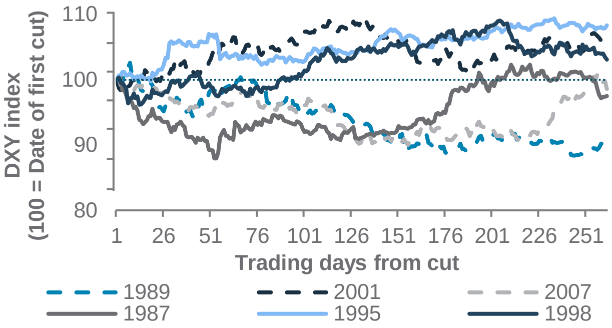
US 10-year yield 12m trend after past Fed rate cuts



Source: Bloomberg, Standard Chartered

The USD has typically gained in the 12 months after the start of Fed rate cuts that resulted in a soft landing

USD index (DXY) 12m trend after past Fed rate cuts



Source: Bloomberg, Standard Chartered

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