Cutting Through the Noise

By: Jay Skaalen, CFA, CFP®

July 2024

As the Federal Reserve prepares to cut interest rates, we take a look at the wide range of implications across all asset classes.

It may seem hard to believe given the seemingly endless flow of headlines of late, but the second half of 2024 may prove to be one of the more interesting periods for financial markets in recent memory. In November, the U.S. will hold a presidential election, all but ensuring a period of heightened volatility and uncertainty. Concurrently, it is likely that we will see the U.S. Federal Reserve (Fed) begin cutting interest rates, marking the formal end to the sharpest rate hiking cycle in U.S. history. Whether we like it or not, this likely means we will be inundated with election news over the next several months. As such, we'll focus this article on the implications of the Fed's anticipated rate cuts and what it may mean for your portfolio. As it stands today, consensus believes that by the time you are reading our October Wealth Report, the Fed will have begun lowering the Federal Funds rate — the benchmark rate it controls to help govern the economy. While forecasts can, and likely will, shift prior to year-end, markets are suggesting the Fed will cut rates twice during the back-half of the year. With this in mind, it is worth exploring the implications of declining rates for various asset classes. In this article, we will look at the past 30 years of rate-cutting cycles, assess what has transpired historically, and highlight anything that may be different this time around.

As a caveat applicable to all asset classes, performance following a rate cut has historically hinged on the "character" of the rate cut. What does this mean? To dramatically over-simplify, rate cuts can generally fall into "insurance" rate cuts or "recessionary" rate cuts. Insurance rate cuts are preemptive measures taken during periods of economic stability to safeguard against future risks. Recessionary cuts are typically in response to excessive financial stress and/or a notably weaker economic environment. Actions taken by the Fed in 1995 and 1998 are examples of insurance cuts, while cuts in 2001 and 2008 are examples of recessionary cuts. At the moment, barring an unforeseen decline in the health of the U.S. economy, rate cuts delivered in the second half of this year would be viewed as insurance cuts. U.S. GDP grew a slow, but steady, 1.6% in the first quarter this year and expectations are calling for growth to come in around 2% for the full year. As such, the Fed is contemplating cutting interest rates to help prevent growth from decelerating – but at the moment is not dealing with a sickly economy. That said, the longer they wait, the more they risk it becoming one. This distinction between insurance and recessionary cuts has historically been associated with meaningful differences in performance. As you could expect, performance following insurance rate cuts has been stronger than performance following recessionary rate cuts. Assuming no material changes in the health of the underlying economy, this could bode well for cross-asset class performance following upcoming rate cuts.

Cutting Through the Noise

U.S. Equities

Historically, U.S. equities have been one of the more volatile asset classes following rate cuts. The largest decline (note: all performance referenced is measured as 12 months following the initial rate cut) occurred in 2007-2008 when the S&P 500 fell by 20.6%. The largest gain occurred in 1998-1999, when the S&P 500 rose by 20.9%. Looking back over the last five interest rate cutting cycles, the average performance for the S&P 500 has been +3%. That said, when you focus on periods where the Fed was deploying insurance cuts, the average historical performance is much better, up over 16% on average. What does this mean for U.S. equities in the upcoming cycle? As mentioned previously, all signs currently point towards upcoming rate cuts more closely resembling insurance cuts, a potentially encouraging sign of things to come. The market will still need to navigate several issues that could present headwinds including: elevated overall valuations, lingering concerns around inflation and ongoing geopolitical spats. There are also factors that could be more supportive of solid performance including broader market participation, solid earnings growth and more attractive valuations outside of the so-called “Magnificent 7”, which have largely carried market performance through the first half of 2024.

Foreign Equities

Foreign equity performance has loosely mirrored U.S. equity performance following interest rate cuts by the Fed, with one notable exception being 2019-2020. With the technology sector outperforming during the initial months following the Covid outbreak, the tech-heavy S&P 500 saw an outsized benefit vs. foreign equities, which fell by a modest 1% vs. the 10% gain seen in the S&P 500. Aside from this period, foreign equities (as measured by the MSCI All Country World Index Ex-USA) have also experienced strong returns during periods following insurance cuts (+20%), and worse returns during recessionary cuts (-21%). While it has been more common historically for other major central banks to take their cues from the U.S. Federal Reserve, several Central Banks, namely the European Central Bank and the Bank of Canada, have already begun cutting rates. As global fixed income yields decline, this may spur additional capital to flow from fixed income into foreign equities. Additionally, should we see more resilient economic data in the U.S. and a continuation of softer economic data abroad, we may see foreign Central Banks continue leading the way during this cutting cycle. If so, this may provide incremental support to more rate-sensitive cyclical assets to which foreign equity markets have more exposure. Lastly, while foreign equities are confronting several of the same headwinds as U.S. equities, specifically elevated inflation and geopolitical flare-ups, it is not dealing with elevated overall valuations. Broader foreign equity indices are hovering around historical averages and all-time lows relative to U.S. indices.

Fixed Income

Of all primary asset classes, fixed income has been the steadiest following the beginning of the Fed’s cutting cycle. Demonstrating its outsized benefits, fixed income has logged positive returns in each of the past five rate cut cycles, averaging just over 5% return in the 12 months following the start of the cycle. More importantly, the asset class has performed best during more trying economic conditions (like 2001-20002 and 2007-2008) when the Fed was forced to cut more aggressively to stave off further economic damage. In looking at the upcoming cycle, there are a few attributes that could be tailwinds going forward. For one, we are coming off a

period that saw the highest inflation since the early 1980s. As a result of this, the Fed hiked interest rates 11 times over a short period of time, only 16 months. This compares to the historical average of 9 rate hikes over 18 months. The byproduct of these actions could result in a longer easing cycle if we see a more gradual normalization of inflation. It could also result in a more aggressive rate-cutting cycle if we begin to see material signs of economic stress. Both situations have the potential to help turn the tide for this asset class which has seen relatively muted returns in recent years. Regardless, considering the relatively elevated level of rates today, the ongoing easing of inflation concerns and the Federal Reserve on the precipice of a rate-cutting cycle, we feel more encouraged about this asset class than we have in some time.

Natural Resources

Natural resources is an asset class that has performed well in prior rate-cutting cycles for a variety of reasons. First, commodities are often priced in U.S. dollars around the world. As the Fed lowers rates, it can decrease the value of the dollar relative to other currencies making them increasingly attractive to foreign buyers. Second, rate cuts are intended to stimulate economic growth, which can lead to increased demand for commodities, thereby supporting prices. Finally, should the U.S. economy remain more resilient, it is likely there will be lingering fears of resurgent inflation. As investors look for ways to hedge against the risk of inflation, commodities stand to be among the primary beneficiaries.

Real Estate

Real estate is one of the asset classes most influenced by prevailing interest rates. Prices and activity within both residential and commercial sectors are closely tied to changes in rates. As a result of this, performance tends to improve as rates decline, with the overall benefit more pronounced further along in the rate-cutting cycle as compared to other asset classes. Over the past five cycles, real estate has averaged around a 1% decline following the start of rate cuts. However, like U.S. and foreign equities, performance was better when the Fed was

providing insurance cuts. During these years, the asset class (as measured by the FTSE NAREIT All REIT Index) was up roughly 7% on average. Sub-classes within real estate like homebuilders can perform well after the Fed starts lowering rates, as can certain pockets of REITS, like industrials, which are more linked to economic output. With activity in the sector having been subdued in recent years due to abnormally high rates, it's possible that this cycle may spur a more dramatic increase in activity, which could provide fundamental support and help performance.

In summary, while challenges like inflation and geopolitical tensions persist, the upcoming actions from the Fed stand to have meaningful impacts across your portfolio. The second half of 2024 will offer both challenges and opportunities. Our team is confident we will successfully navigate this cycle, like we have cycles in the past, by focusing on our discipline that has served us well for many decades. By understanding historical precedents and the nuanced impacts of different types of rate cuts, we have positioned our portfolios well to endure a wide range of economic outcomes. We appreciate the trust you place in our team here at Osborne Partners.

The opinions expressed herein are strictly those of Osborne Partners Capital Management, LLC as of the date of the material and is subject to change without notice. None of the data presented herein constitutes a recommendation or solicitation to invest in any particular investment strategy and should not be relied upon in making an investment decision. There is no guarantee that the investment strategies presented herein will work under all market conditions and investors should evaluate their ability to invest for the long-term. Each investor should select asset classes for investment based on his/her own goals, time horizon and risk tolerance. The information contained in this report is for information purposes only and should not be deemed investment advice. Although information has been obtained from and is based upon sources Osborne Partners Capital Management, LLC believes to be reliable, we do not guarantee its accuracy and the information may be incomplete or condensed. Past performance is not indicative of future results. Inherent in any investment is the possibility of loss. Osborne Partners Capital Management, LLC does not provide tax or legal advice. Please consult with your tax and legal advisors regarding your personal circumstances. Certified Financial Planner Board of Standards Inc. owns the certification marks CFP®, CERTIFIED FINANCIAL PLANNER™ and federally registered CFP (with flame design) in the U.S., which it awards to individuals who successfully complete CFP Board's initial and ongoing certification requirements.