SOUTHERN ROCK CAPITAL

Wishing upon a cut

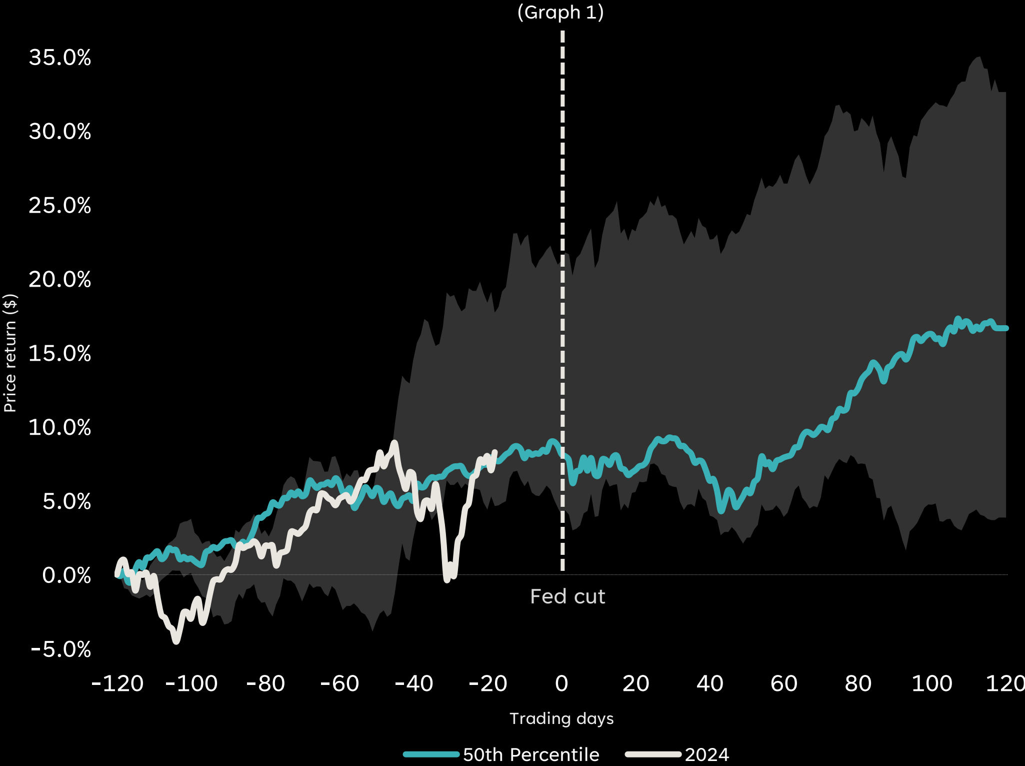
Global interest rates have been elevated for nearly two years, leaving homebuyers, investors, and businesses alike feeling uneasy. It's as if everyone is standing outside at night, gazing up at the sky, and instead of wishing upon a star, they're wishing upon a rate cut.

Recent economic data indicates that while inflation was the main story of 2023, growth is now the primary concern. At the much-anticipated Jackson Hole Summit, Jerome Powell expressed confidence that inflation would eventually return to 2%. Notably, the word "gradual" was absent from his speech, suggesting that the Fed might not rule out a larger-than-expected rate cut, potentially even a 50 basis points cut before the year's end.

While the prospect of lower rates is appealing, it's important to consider why a significant cut might be on the table. The Fed aims to land the economic plane gently, avoiding a recession. This pause allows the economy to absorb the full impact of the 18-month monetary policy rollercoaster. Rate hikes can take up to two years to influence economic activity, with the latest cycle proving resilient due to factors like a stronger consumer base and fixed-rate mortgages in the US.

However, soft landings are as rare as unicorns. Since 1960, the Fed has embarked on 12 tightening cycles, with only four ending without a crash: 1960-1966, 1982-1984, 1994-1995, and 2015-2018. These smooth descents shared three common threads: no inflation spike, a modest pace of Fed tightening, and easing bank lending standards—none of which seem present this time around. Currently, the economic environment lacks these favourable conditions. Inflation has been more persistent, the pace of rate hikes has been relatively aggressive, and lending standards have tightened. Despite this, market sentiment remains cautiously optimistic about the possibility of a soft landing.

Assuming we are on a glide path to normality without an imminent deep recession, what does this mean for investors? We conducted an in-depth analysis of four significant market events to understand how the stock market typically behaves leading up to and following the first rate cut. Graph 1 illustrates the 120 days preceding the rate cut leading into a soft landing and the subsequent 120 days. Historically, when the Federal Reserve successfully navigates the economic landscape, equity returns trend upwards. On average, markets appreciate by approximately 9% in the lead-up to the cut, and this upward trend continues in the following 120 trading days, albeit with greater variability, averaging another 9% increase. It's interesting to note that the anticipated 2024 rate cut seems to align with a market expecting a rate cut with a soft landing.



Soft landing cuts: 01/01/1966, 02/10/1984, 05/07/1995, 30/07/2019
Source: FactSet, Yahoo Finance

How does factor strategies behave

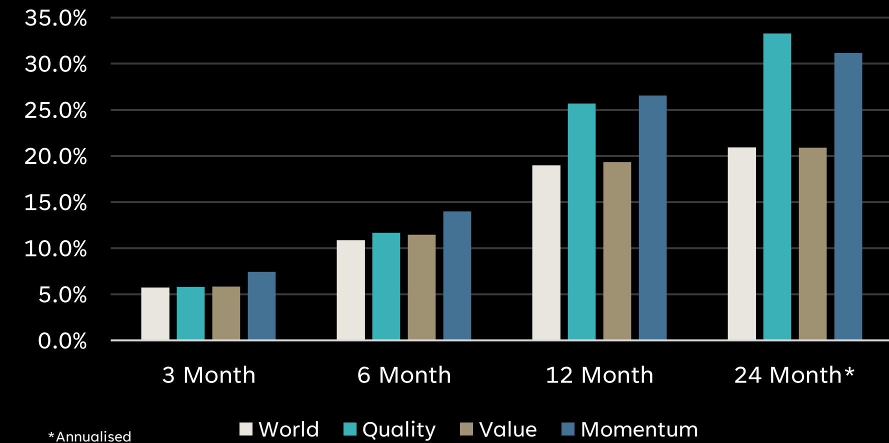
Aligned with our core philosophy, we explored factor returns and their typical behaviour when the Fed cuts rates in a soft-landing scenario. Utilizing the MSCI World factor indices data from 1985, we analysed the 3-, 6-, 12-, and 24-month return profiles, as shown in Graph 2. Notably, Quality and Momentum factors stand out. While it might seem that all factor strategies rise concurrently, there remains a diversification benefit in holding various factors within your portfolio. Examining the correlation between excess returns (Table 1) reveals statistical variations among these upward pathways, suggesting that investors can benefit from embracing multiple strategies.

It would have been easier to study the times the Fed failed to achieve a soft landing, as there is a larger dataset to analyse. The bear case for this cycle is prevalent in the news, creating more sensation. Between the potential for a Chinese invasion of Taiwan, the increasing U.S. budget deficit, the largest Yen carry-trade unwind, or historically high equity multiples, there are plenty of bear cases to consider. Absent a significant catalyst, the economy may well continue on a moderate growth trajectory, steering clear of any severe contraction.

Morgan Housel, a financial writer, often emphasizes that good things generally take time to develop, while bad events tend to occur suddenly. This perspective aligns with the idea that positive outcomes, such as building wealth or achieving personal goals, require patience; consistent effort; and time. On the other hand, negative events, like market crashes or personal setbacks, can happen abruptly and without much warning.

Housel's insights remind us to stay patient and persistent in our long-term endeavours, while also being prepared for unexpected challenges. It's a valuable mindset for investors and anyone navigating the ups and downs of life.

"bears sound clever but bulls make money'"



Factor strategies excess return correlation

(Table 1)

	Quality	Value	Momentum
Quality	1.00	0.06	0.14
Value	0.06	1.00	-0.21
Momentum	0.14	-0.21	1.00

Source: FactSet

Any reference to regions/ countries/ sectors/ stocks/ securities is for illustrative purposes only and not a recommendation to buy or sell any financial instruments or adopt a specific investment strategy. The views and opinions contained herein are those of the individuals to whom they are attributed and may not necessarily represent views expressed or reflected in other Southern Rock Capital Limited communications, strategies or funds. The information and opinions contained in this document are provided in good faith and are based on sources believed to be reliable. However, Southern Rock Capital Limited does not provide any guarantee regarding the accuracy or completeness of the information or opinions expressed herein. Southern Rock Capital Limited will not be held liable for any claims, damages, losses, or expenses incurred directly or indirectly by investors or their financial advisors as a result of reliance on the information contained in this document. It is important to note that Southern Rock Capital Limited does not serve as the investor's financial advisor and has not conducted a financial needs analysis. Therefore, investors and financial advisors should carefully evaluate whether the information provided in this document is appropriate for the investor's objectives, financial situation, and specific needs. Any guidance offered may have limitations in terms of suitability. Investors should be aware that no assurances of investment performance or capital protection can be inferred from the information provided in this document. It is advisable for investors to exercise caution and conduct their own research before making any investment decisions.

Southern Rock Capital Limited is authorised and regulated by the Mauritius Financial Services Commission.