THE TIPPING POINT: HOW RATE CUTS AFFECT RISK MANAGED INVESTING

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Key Points

1. Central bank narrative and market positioning anticipates rate cuts
2. Defensive sectors have strong economic and empirical drivers of interest rate sensitivity
3. Rate cutting cycles and economic uncertainty should be beneficial for defensive sectors.
4. Equity markets tend to anticipate bond markets. As such, positioning in defensive strategies before each rate cut is likely superior to waiting for them to arrive.

Overview

The covid crisis prompted a period of close-to-zero interest rates around the world, and an injection of significant monetary and fiscal stimulus. This extensive support, however, proved a doubled-edged sword as while such support was essential, it combined with trade frictions to bring about a sharp surge in inflation. This was initially expected to be transitory but policy makers soon realised that severe action would be required to prevent an inflation/price spiral. Central banks around the world then began a co-ordinated hiking cycle.

Over the subsequent two years, the Fed hiked rates 11 times - the fastest and largest (in terms of magnitude) hiking cycle ever, and others around the world followed suit.

Where do we stand today? If we look at the previous five hiking cycles in the US since 1990, the Fed paused for an average of 10 months between its last hike and its first cut. This time it has been over a year, with the last rate change being on 0.25% increase on 26 July 2023. With the last hike well in the rearview mirror and rate cuts in other markets, including the UK and Europe, understanding the market environment during cutting cycles is now critical.

Our goal is not to nail the exact scope or timing for rate cuts but to extrapolate out the likely path ahead. Historically, the lagged impact of monetary policy has lasted anywhere from 12 months to 24 months before visibly beginning to impact the economy. We are seeing some signs of stress in the labour market and this tends to be a good predictor (albeit early) of policy directionality in the coming months. Paired with central bank communcations, fixed income markets are already beginning to react, pricing in an imminent US cutting cycle.

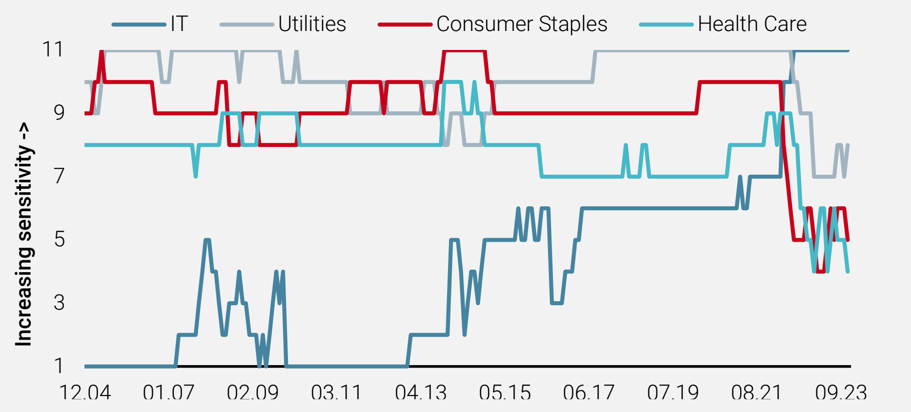
To understand the prospects for risk managed investing, we consider the relationship between interest rates and equity sectors. These reveal both structural and transitory sensitives. These structural sensitivities – combined with the typical macroeconomic context associated with rate cutting cycles – provide dual tailwinds for the risk managed style.

Interest rate sensitivity sectors: structure and sentiment

Before considering the prospects for risk managed investing during a cutting cycle, it is worth spending some time highlighting the historical relationship between sectors and rates. This relationship has both structural and sentiment-driven aspects.

We start by ranking the most interest rate sensitive sectors over the last 20 years. This reveals the extent to which the excess return of a given sector benefits from the movement in bonds.

Figure 1: Excess return sensitivity to interest rates (10Y,US) rank



Source: MSCI, Bloomberg, Unigestion Calculations

Over the greater part of the period – until the most recent hiking cycle – there has been a clear hierarchy of sectors in terms of interest rate sensitivity. In Figure 1 we have highlighted the most significant and persistent, with Utilities, Consumer Staples and Health Care benefiting from falling rates throughout the period. By contrast, we see a rapid increase in sensitivity between IT and interest rates during the most recent hiking cycle.

What drives the sensitivity of Utilities, Consumer Staples and Health Care? Considering more closely their business models, we can see they share three key dynamics: capital intensity; long-date revenues; and moderately cyclical demand. Each of these builds a clear bridge to interest rates:

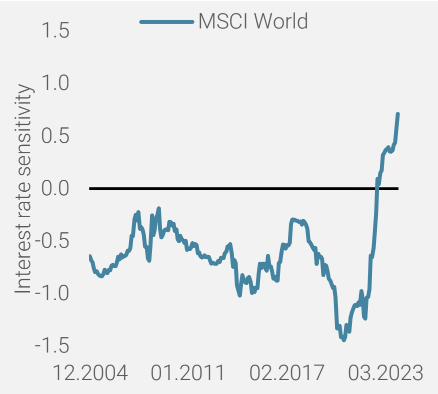
- capital intensity requires borrowing and a payback period;
- long-dated revenues mean the discounted values are sensitive to change in long-term rates;
- moderately cyclical demand reduces earnings uncertainty, making cash-flows more bond like without the volatility of the risk premium associated with growth companies.

The case for IT is broadly weaker. While we have seen elements of the IT sector become more utility-like in nature – for example, cloud computing services – it hardly dominates the economic sensitivity of the sector overall.

Sentiment and the dynamic market relationship with rates

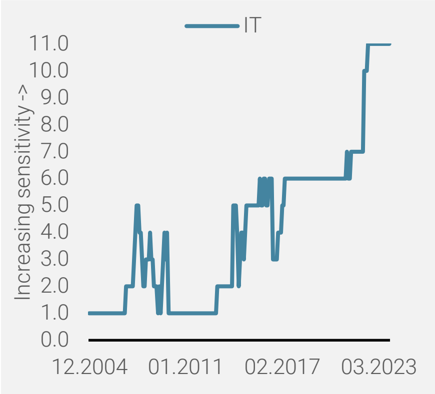
If the changing sensitivity is not structural, then perhaps it is sentiment. In Figure 2 we show the long-term relationship between the overall market and interest rates.

Figure 2: Sensitivity to bond prices (10Y, US)



Source: MSCI, Bloomberg, Unigestion Calculations

Figure 3: Excess return sensitivity to interest rates (10Y, US) rank



Source: MSCI, Bloomberg, Unigestion Calculation

Historically, falling bond prices would typically be supportive for markets and indeed the latest hiking cycle has seen markets rise. Following the final hike of 2023, this relationship has inverted. This change in relationship is reflected in the increasing IT sensitivity noted earlier. It will be a familiar pattern for those following the market day-to-day in recent months. Macroeconomic releases that indicate the Fed will consider cutting receive positive reactions from the market; the anticipation of a rate cut drives sentiment, rather than the actual consequences or context of that rate cut on the economy.

From rate sensitivity to defensiveness

Focusing on the sectors with a structural sensitivity to interest rates, we can see they share another characteristic outside their economic drivers: defensive performance. Using a simple definition of a defensive sector – outperforming during downturns on a regular basis – we see the hit rates of these three sectors are very high.

	>0%	>5%	>10%
Utilities	100%	83%	67%
Consumer Staples	100%	83%	50%
Health Care	83%	83%	50%

Table 1 : defensive hit rate by outperformance (columns) for a sample of sectors

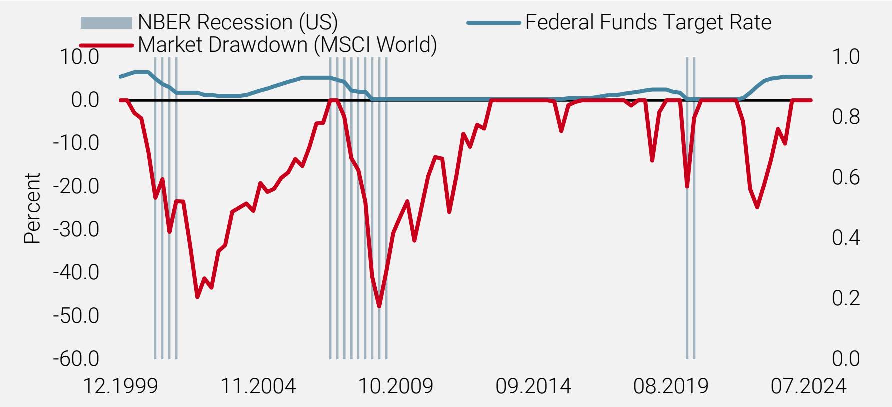
Scenario analysis:
cutting because you have to, versus managing a soft landing

In the US at least, expectations of interest rates cuts have broadly been taken as a potential positive catalyst for equity markets – fuel for an already healthy fire. We see evidence for this in equity market valuations, especially in large caps.

Historically, however, they have typically acted in the opposite fashion – with central banks being regarded as seeking to revive an economy that has been pushed into slowdown. Indeed, if history is to repeat, central banks tend to cut rates when they have to and not when they choose to.

While lower rates can be a boon for growth (given the impact on the discount rate) vs value, this impact can be lagged and the transmission effect is far weaker than for defensive sectors.

Figure 4: Cutting cycle timing compared with recession and market drawdowns



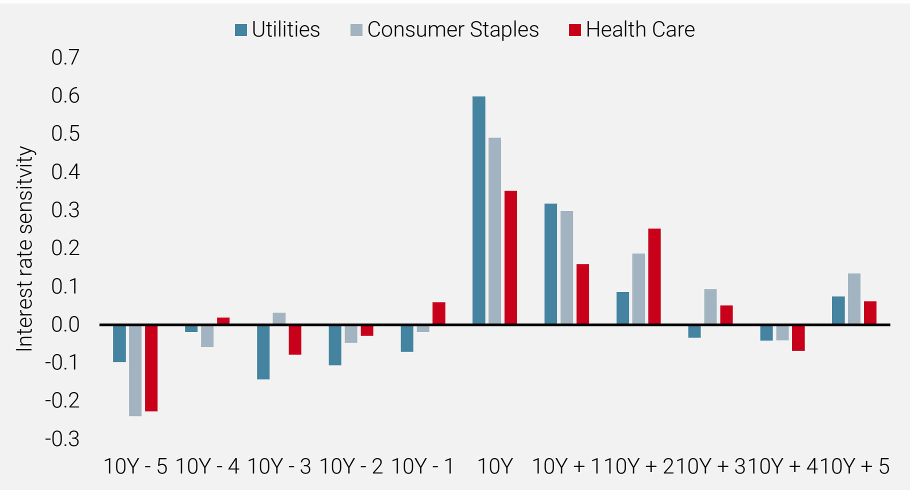
Source: MSCI, Bloomberg, Unigestion Calculations

There are two potential supporting factors for defensive sectors on a relative basis: the context in which central banks tend to cut (economic weakness) and the strong linkage between the economics of defensive sectors and interest rates. These effects are clearly additive: underlying fundamental drivers that give rise to interest rate sensitivity should dominate in a cutting environment that reflects economic slowdown.

Who moves first?

Equity markets are understood to be a discounting mechanism for future expected movements. We see this in the relationship between defensive sectors and interest rates. Figure 5 shows the sensitivity of defensive sectors to current ('10Y') future ('10Y + x') and past ('10 Y – x') interest rates moves.

Figure 5: Past, Current and Future excess return sensitivity to interest rate moves (10Y, US)



Source: MSCI, Bloomberg, Unigestion Calculations

While the strongest relationship is coincident, outperformance of the defensive sectors anticipates movements in interest rates up to a quarter ahead of the actual movement. It is thus beneficial to be positioned for a souring in the economic environment and associated interest rate cuts.

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Conclusion

- Central bank narrative and market positioning anticipates rate cuts even as inflation remains sticky above target
- Defensive sectors have strong economic and empirical drivers of interest rate sensitivity, while other sectors, notably IT, exhibit only transitory sensitivity. As interest rates leave the formation of market sentiment, we expect structural factors to dominate.
- Absent the global economy 'threading the needle' between taming inflation and economic growth, rate cutting cycles and economic uncertainty should be beneficial for defensive sectors. The strength of this tailwind will be dictated by wider macroeconomic strength or weakness.
- Equity markets tend to anticipate bond markets. As such, positioning in defensive strategies before rate cuts is likely superior to waiting for them to arrive.

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