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UOB Investment Insights

Thinking Ahead

5 February 2024

Key takeaways

- Economic data suggests investors are too optimistic about early and aggressive rate cuts.
- Other central banks will wait for the Fed to make the first move.
- Diversify your portfolio, lock in current high yields and accumulate quality stocks.

Are investors too optimistic about early and aggressive rate cuts?

At the end of 2023, global financial markets were enthused by the idea of early and aggressive interest rate cuts this year. Are investors too optimistic? Economic data trends would suggest so, and central banks have been actively managing expectations of early and aggressive rate cuts.

Big gap between central bank guidance and market expectations

- The United States Federal Reserve (Fed) held interest rates unchanged on 31 January 2024 for a fourth straight meeting.
- While Fed Chairman Jerome Powell confirmed that rate cuts will be appropriate at some point this year, he emphasised a reduction is unlikely in March.
- The Fed expects to cut interest rates by 75 basis points (bps) this year.
    - Investors are however pricing in 150 bps of rate cuts by the Fed for the whole of this year.
- Most European Central Bank (ECB) officials said it is premature to discuss rate cuts as the fight against inflation is not over, and President Lagarde sees the middle of this year as the likely window for action.
    - Investors are nonetheless expecting the ECB to cut around 150bps by year-end from as early as April.
- The Bank of England (BOE) has stressed that interest rates will need to remain high for sufficiently long in order to cool inflation towards the 2% target.
    - Despite this, investors expect around 110bps of rate cuts for this year.

A stretch to think the Fed will cut rates at nearly every meeting

- The Fed meets eight times a year to set monetary policy, and there are seven meetings left this year when rates can be cut.
- However, the November policy meeting is just two days after the upcoming US elections and the Fed may refrain from policy changes that month.

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- It is unlikely for the Fed to cut rates in the six remaining meetings if the US labour market stays resilient, and if inflation re-accelerates in the short-term.

Economic data does not justify aggressive rate cut expectations

- Developed market (DM) central banks have firmly stated that interest rates will only be cut when they are confident inflation is slowing sustainably to the 2% target.
    - While price pressures are easing, both headline and core inflation remain well above 2% in major economies.
    - The short-term inflation outlook is complicated by ongoing Middle East tensions which have resulted in higher shipping costs that can trigger higher crude oil prices and food prices.
- Historically, aggressive rate cuts only happen when the economy weakens rapidly and faces the risk of a severe recession.
- While the global economy has been slowing over the past year, the slowdown has been orderly, and a deep recession appears unlikely this year.
    - Current economic data does not justify early and aggressive rate cuts.

Other central banks will wait for the Fed to make the first move

- Since geopolitical tensions pose inflation risks and most economies are not yet in recession, other central banks will prioritise stability in their financial systems right now.
- Cutting rates before the Fed could weaken local currencies, leading to capital outflows from domestic financial markets.
- To mitigate this risk, most central banks will wait for the Fed to take the lead in rate cuts.

UOB view

- The Fed will cut interest rates three times this year, 25bps each time in June, 3Q and 4Q.
- We expect other central banks to only cut rates in 2H 2024 after the Fed lowers rates.
- We expect the Bank of Japan (BOJ), which is on a different interest rate path, to end its negative interest rate policy in April and stop yield curve control in June.

Potential financial market volatility

- Financial market volatility is likely as central banks may not deliver the aggressive rate cuts that investors expect.
- Even if central banks start to project more rate cuts ahead, the potential reasons will be a rapidly weakening economy and rising recession risks, which will also increase market volatility.
- Once these expectations are re-aligned, volatility will subside, and risk sentiment will improve.

What you can do

- Build on multi-asset strategies to diversify your portfolio across different asset classes, sectors and regions. They can lower overall portfolio volatility and capture opportunities as they arise.
- Lock in current high yields with bond funds and investment grade bonds during any bond sell-off. While bond markets may see short-term volatility, yields will come down when central banks start to cut interest rates.
- If you are willing and able to take on more risk, accumulate quality growth stocks, including those that pay dividends, during market pullbacks. With steady cash flows and strong balance sheets, quality growth stocks are expected to do better than broader markets. Tap on Asia ex-Japan quality dividend-paying stocks with attractive dividends now for additional income.
- Speak to a UOB Advisor to build a portfolio that meets your investment goals.

Right By You

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