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Interest rate cycles and their impact on asset returns

Global Matters Weekly

5 August 2024

– Charles Thomson — *Head of Portfolio Management*

Interest rates profoundly affect world economies and our personal finances. Monthly mortgage payments, for many their largest single financial commitment, are dependent on either short-term interest rates, set by central banks, or government bond yields (or in bond jargon 'swap' rates, which are closely linked to government bond yields). The recent rise in interest rates has been painful for most mortgage holders. Conversely, savers who for many years had to suffer very low nominal interest rates, below the rate of inflation, now clearly benefit from higher nominal rates and positive real returns.

The financial health of nations is affected by interest rates. In recent years most countries have funded significant budget deficits by issuing government debt, like US Treasuries or UK Gilts. The cost of servicing this debt has increased materially as interest rates have risen, placing a greater burden on government expenditure.

The level of interest rates is impacted my many things. Short term rates can generally be controlled by central banks but longer-term rates, such as 30-year bond yields, are determined by market forces. A dramatic example of market forces was seen in the UK in September 2022 after the infamous Truss budget. Long dated index linked Gilts fell in value by over 50% in the space of three days[1].

Maintaining 'price stability', namely low and stable inflation, is a key objective of central banks and their main tool for achieving this is via interest rates. The enormous bond buying programmes by the Federal Reserve, European Central Bank and the Bank of England, among many other monetary authorities, pushed yields lower by bidding up the prices on their bonds. For many years this appeared to be a win-win situation as low interest rates and large-scale bond purchase programmes, funded by newly created electronic money, didn't appear to cause inflation.

From 2009 until 2022 most countries set interest rates at extraordinarily low levels; in the case of Japan and many European countries rates were negative, allowing governments to borrow for free - effectively being paid to borrow money! This seems inconsistent with economic laws, which require that the 'time value of money' should

"It must be remembered that all interest rate cycles are different, and history is notoriously unreliable in financial forecasting!"

be positive. For readers interested in this I would highly recommend the book 'The Price of Time' by Edward Chancellor.

While there were arguably some positive economic effects from the ultra-low interest regimes, namely, helping governments, corporations and individuals with low debt service costs, importantly, including mortgages, there were also some longer-term negative consequences. Low interest rates almost certainly inflated house prices and other assets creating complex issues such as generational inequality, which enhanced aggravated wealth inequality in societies. Low yields on long bonds also created funding gaps for many of the UK's defined benefit pension schemes, which could potentially have long standing repercussions on the individual schemes and society.

The Covid pandemic and geopolitical troubles caused an unexpected rise in inflation which necessitated abrupt rises in interest rates. This lead to the worst year on record for bond investors in 2022. However, since then inflation has fallen sharply which has allowed central banks to start cutting rates. We are therefore at a turning point in the rate cycle, with major central banks including the European Central Bank and the Bank of Canada having cut interest rates, while the UK and US will surely follow soon.

We have analysed returns for different asset classes before and after the start of an interest rate easing cycle. The good news is that historically, based on many previous interest rate cycles, government bonds, investment grade corporate bonds and equities tend to perform well while other asset classes have underperformed[2]. It must be remembered that all interest rate cycles are different, and history is notoriously unreliable in financial forecasting! Notwithstanding, there are good grounds for optimism in the outlook for equities and high-grade fixed income asset classes over the coming year as interest rates move lower.

Source: [1] Bloomberg L.P., September 2022. [2] Bloomberg L.P., twenty-year history to Dec 2023, data since 1974.

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The **Marketplace**

- Global equities fell 2.1%
- Equities declined globally, while bonds rallied in response to US economic data taking a turn for the worse
- Brent crude fell 5.3% to $76.81 per barrel
- Gold rose 2.3% to $2,443.24 per ounce

Market **Focus**

US

- US equities fell 2.1%
- The Federal Reserve kept interest rates unchanged, with the chair Jerome Powell taking a more dovish tone than in previous meetings
- Labour market data showed headline payrolls increasing 114k month-on-month (vs 175k expected), and a 27k downward revision to June's print
- The unemployment rate rose to 4.3% (vs 4.1% expected), its highest level in three years
- The ADP employment report of private payrolls fell to a 6-month low of 122k in July (vs 150k expected), while the Employment Cost Index fell back to 0.9% in Q2

Europe

- European equities fell 3.1%
- Euro Area GDP grew by 0.3% in Q2 (vs 0.2% expected), which aligns with the Q1 level. This included 0.3% growth in France and an unexpected contraction of 0.1% in Germany
- The Euro Area flash CPI (Consumer Price Index) reading showed the headline rising 2.6% (vs 2.5% expected). The core measure held steady at 2.9% (vs 2.8% expected) for a third consecutive month

UK

- UK equities fell 1.2%
- The Bank of England began the process of easing, cutting the policy rate by 25bps to 5%
- CBI's retail sales volume survey fell to -43 (vs -10 expected)
- The new Labour government made several fiscal announcements, including £5.5bn of savings over 2024-25, and £8.1bn for 2025-26. Chancellor Rachel Reeves also confirmed that the government's first Budget would occur on 30 October

Asia/Rest of The World

- Global emerging market equities fell 1.0%
- Japanese equities fell 6.0%, and Chinese equities fell 0.6%
- In China, the Caixin services PMI (Purchasing Manager Index) climbed to 52.1 (vs 51.5 expected) from 51.2 in June
- In Australia, the trimmed mean for CPI in Q2 increased by 0.8% (vs 1.0% expected). The monthly year-on-year print for June also fell to 3.8%, which is in line with expectations
- Japan's jobless rate dropped to 2.5% in June (vs 2.6% expected) from 2.6% the previous month

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Asset Class/Region	Currency	Currency returns			
		Week ending 2 Aug. 2024	Month to date	YTD 2024	12 months
Developed Market Equities					
United States	USD	-2.1%	-3.2%	12.7%	19.7%
United Kingdom	GBP	-1.2%	-2.2%	8.2%	13.0%
Continental Europe	EUR	-3.1%	-4.0%	5.0%	9.9%
Japan	JPY	-6.0%	-9.2%	8.5%	12.8%
Asia Pacific (ex Japan)	USD	-0.8%	-2.1%	6.4%	7.7%
Australia	AUD	0.3%	-1.8%	6.6%	12.3%
Global	USD	-2.1%	-3.4%	9.8%	16.7%
Emerging markets equities					
Emerging Europe	USD	-3.1%	-2.5%	12.7%	20.5%
Emerging Asia	USD	-0.9%	-2.1%	8.4%	8.3%
Emerging Latin America	USD	-3.2%	-3.3%	-17.6%	-9.5%
BRICs	USD	-0.7%	-1.9%	5.3%	2.7%
China	USD	-0.6%	-2.2%	1.1%	-11.3%
MENA countries	USD	0.3%	-0.5%	-0.4%	0.7%
South Africa	USD	-0.1%	-3.4%	6.3%	9.9%
India	USD	-0.5%	-1.0%	13.9%	26.4%
Global emerging markets	USD	-1.0%	-2.2%	5.5%	6.7%
Bonds					
US Treasuries	USD	2.7%	1.8%	3.2%	6.6%
US Treasuries (inflation protected)	USD	1.4%	0.6%	3.1%	5.8%
US Corporate (investment grade)	USD	2.1%	1.2%	3.7%	9.4%
US High Yield	USD	-0.1%	-0.4%	4.3%	11.4%
UK Gilts	GBP	2.1%	1.1%	0.2%	7.6%
UK Corporate (investment grade)	GBP	1.4%	0.7%	2.6%	11.6%
Euro Government Bonds	EUR	1.3%	0.5%	0.8%	5.9%
Euro Corporate (investment grade)	EUR	0.8%	0.4%	2.6%	7.6%
Euro High Yield	EUR	0.1%	-0.2%	4.3%	10.7%
Global Government Bonds	USD	2.5%	1.6%	0.2%	4.1%
Global Bonds	USD	2.3%	1.5%	1.4%	6.1%
Global Convertible Bonds	USD	-0.7%	-1.1%	-0.4%	2.0%
Emerging Market Bonds	USD	1.2%	0.6%	3.9%	10.2%

Source: Bloomberg. Past performance is not indicative of future returns

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Property					
US Property Securities	USD	1.5%	0.9%	6.2%	11.6%
Australian Property Securities	AUD	1.6%	-1.3%	14.0%	23.6%
Asia Property Securities	USD	-0.6%	-2.7%	-9.0%	-7.9%
Global Property Securities	USD	1.0%	-0.1%	3.4%	10.1%
Currencies					
Euro	USD	0.4%	1.0%	-1.4%	-0.4%
UK Pound Sterling	USD	-0.7%	-0.4%	0.2%	0.5%
Japanese Yen	USD	4.7%	2.5%	-4.1%	-2.5%
Australian Dollar	USD	-0.7%	-0.2%	-4.7%	-0.5%
South African Rand	USD	0.1%	-0.4%	0.0%	1.3%
Swiss Franc	USD	2.7%	2.4%	-2.4%	1.9%
Chinese Yuan	USD	1.1%	0.7%	-1.0%	0.3%
Commodities & Alternatives					
Commodities	USD	-2.0%	-2.5%	0.6%	-2.3%
Agricultural Commodities	USD	-0.8%	-0.3%	-2.9%	-5.7%
Oil	USD	-5.3%	-4.8%	-0.3%	-7.7%
Gold	USD	2.3%	0.7%	18.4%	26.2%

Source: Bloomberg. Past performance is not indicative of future returns

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