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What impact will interest rate cuts have on income investors? The March 2024 Quarterly Market Update

By Perpetual Wealth Management

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The March 2024 Perpetual Private Quarterly Market Update (QMU) addresses a pressing question for income-focused investors: how will potential interest rate cuts impact their portfolios?

You can watch the video above, download our full report, or read our concise review below.

Please note: except where otherwise noted or quoted, the views in this article are those of Perpetual Private's Investment Research Team.

Download the report

A brighter outlook for income generation

The past decade has been tough for income-focused investors. Ultra-low interest rates squeezed yields on fixed income, forcing many to chase riskier assets to maintain their income streams.

However, the outlook for income generation from clients' fixed income portfolios is now more promising. While central banks like the Reserve Bank of Australia are shifting towards a more neutral monetary policy stance, with potential rate cuts on the horizon, these cuts are likely to be delayed and slower than the market currently anticipates. Here's why this shift may be positive for income investors:

- **The power of starting yields:** Unlike the zero-interest rate policy (ZIRP) environment of the pandemic, current yields offer a stronger foundation. Even with potential rate cuts, the higher starting point translates into inherently better income generation from fixed-income investments.
- **Beyond economic growth:** Bonds can deliver returns even in moderate growth environments, as evidenced by 2023's performance. This alleviates concerns about slowing economic activity and its impact on income generation.
- **A soft landing for rates:** The combination of higher starting yields and the prospect of a central bank "soft landing" (avoiding recession) paints a more favourable picture for income investors. In a soft-landing scenario, rate cuts would likely be fewer and slower than currently expected, meaning fixed income portfolio yields won't plummet back to pandemic lows.

Looking ahead: A gradual improvement

We began to see official interest rates rise in 2022, and the income-to-capital ratio is shifting back towards historical norms. However, tax rules and market structures created a lag between higher rates and improved income for investors. Over time, rising income levels are expected to flow through portfolios, benefiting investors, with the worst likely behind us.

March Quarter 2024: What happened?

Markets continued their ascent in the first quarter of 2024. Positive sentiment fuelled by steady economic growth, the easing of inflation, and the potential for central bank rate cuts propelled asset values higher. Indeed, the chances of a rare soft-landing continue to grow and the confidence this is generating is becoming self-fulfilling.

Equity market rally broadens

The rally that began last November continued into Q1 2024, with the MSCI All Country World Index rising 13.2%[1] and the S&P/ASX 300 gaining 5.4%[2] . A positive combination of economic factors and ever-growing enthusiasm towards Artificial Intelligence (AI) propelled stocks higher. Pleasingly, many major global stock indices reached new highs with stocks outside the US "Magnificent 7" (large-cap tech companies) contributing more meaningfully to the upswing.

Fixed income navigates higher yields

Fixed income faced a slower start. Bond returns were subdued as yields rose on disappointing inflation data and investors pushed back expectations for central bank rate cuts, anticipating a potential "higher for longer" interest rate environment. At the time of writing, the bond market is now expecting less than 0.75% in cuts from the US Federal Reserve[3] in 2024, which is quite different than the 1.5% priced in at the start of the year. Similarly, in Australia, bond markets have scaled back their expectations from nearly three cuts starting in June, to only one rate cut late this year.

Australia's resilient households

The RBA remains data-dependent, emphasising the need for further inflation control before considering rate cuts. Their latest assessment highlights the resilience of Australian households and businesses. Low unemployment and wage growth have bolstered household finances, even with adjustments to spending habits. However, a sharp rise in unemployment could threaten this resilience.

Entering Q2, we find ourselves in a favourable environment, mirroring the mid-1990s soft landing. Nevertheless, historically high valuations and bullish sentiment still raise concerns. Even with a positive outlook, close monitoring of macro and microeconomic risks is crucial.

Geopolitics: A Simmering Backdrop

Despite the visceral nature of conflict and war grabbing our attention, geopolitical events rarely have a lasting impact on investment returns. This paradox of market resilience can be attributed to several factors.

Why markets remain buoyant

Perhaps most importantly, the potential for major disruptions from these geopolitical flashpoints hasn't materialised (yet). While the tensions and conflict persist, they haven't escalated to a level that significantly disrupts global trade or financial flows. Additionally, institutions like the United Nations, the European Union, and NATO, despite their limitations, appear to be functioning as a buffer against widespread conflict. Beneath the surface tensions, a modicum of rationality seems to be prevailing in international relations.

Geopolitical risks and investment decisions

Understanding geopolitical risks is one thing, but translating those views into investment decisions is challenging. Financial markets can take years to price in a particular geopolitical event, making it difficult to hedge a portfolio specifically against geopolitical risks.

Long-term focus is key

Whilst major geopolitical events can have a negative short-term impact, especially in commodity markets, history suggests markets tend to recover over the long term. For example, even significant events like World War 1, World War 2, and 9/11 were accompanied by short-term market downturns of 10% or more but were followed by rebounds exceeding 15%[4] just a year later.

Attempting to predict the precise impact of a geopolitical event on asset prices is difficult, and in most cases minimal. However, as with all potential investment risks, we will continue to be vigilant in monitoring these and other conflicts for any indication of significant escalation that might impact portfolio characteristics over the medium-to-long term.

The bottom line

The recent rally in markets reflects positive fundamentals, and indeed, the chances of a rare soft landing continue to grow. However, it is not the only possible outcome. It is a plain truth that most hard landings first must travel through soft landing territory. While the current environment is encouraging, vigilance is crucial, and the potential for negative news shouldn't be ignored.

Perpetual Private's Quarterly Market Update for March 2024 provides a comprehensive overview of the changing investment landscape, including the outlook for shares, fixed income, real estate, currency, and alternatives.

[Download the report]

[1] FactSet. Returns are net of fees and are in AUD (unhedged)

[2] FactSet. Returns are net of fees and are in AUD

[3] *CME Group – Fed Watch Tool - https://www.cmegroup.com/markets/interest-rates/cme-fedwatch-tool.html*

[4] *FactSet. Calculated using S&P 500 returns (USD)*