

## What happens now that the Fed rate cuts are here

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— DEVINA MEHRA | SEPTEMBER 22, 2024 / 16:36 IST



The rate cut may give a boost to American corporations which in turn, may boost spending on technology. This may, on the margin, have a positive impact on the demand for Indian IT services companies.

As everyone and their proverbial uncle knows by now, the Federal Reserve ie the US central bank, has cut interest rates by 0.5 percent points or 50 basis points to 4.75-5%. With this, the Fed has joined the other major central banks, including the ECB and the Bank of England, in lowering the interest rates, as the inflation continues to cool off.

The market have had two and a half trading days to digest the news and after closing a bit down on the day of the announcement, the S&P 500 Index has ended the week over 1 percent higher than the Tuesday close

For context, prior to the pandemic the [US Fed](#) rate was 1.5-1.75%. During and post the economic upheaval driven by Covid, it was cut all the way down to 0-0.25%. Then as inflation soared, it went up all the way to 5.25-5.5%.

## Reality vs Expectations

How did the cut compare with what was expected? Most economists expected a cut of 25 basis points and not of 50 basis points.

Also prior to the Fed meeting, the thinking was that if the Fed does cut by 50 basis points, it would indicate that the US economy was in dire states and headed into a recession.

However the Fed Chair Powell manage to convey that the bigger than expected cut was not because of bad economic news but in a sense was combining two cuts in one. He said that if the economic data had be known at the time of the July meeting, maybe they would have cut by 25 basis points then and 25 pieces points now.

## What now?

The real question is what happens from here on. For one it is clear that rates would not be cut all the way down to 0.25%. In fact they will not even been be cut down to 1.75%, where they were prior to the pandemic. The steady state or the neutral rate in Fed rates is expected to be around 3% or a little below that.

The difference is in the expected time to get there. As implied by current bond prices, the market expects this 3% rate to be reached by the end of 2025 but the Fed's own estimate is that it would be done only some 9 months later than that. Basically, the Fed expects to move more slowly than the market expects, even though but everyone agrees on the direction, and on the final target of just a tad below 3%.

However while we are talking of expectations as a particular number, there is a very wide dispersion of 1.75 percentage points even within the FOMC, or the Federal Open Market Committee. The FOMC has 12 members and no single option for the long-term rate gets the vote of more than three members.

The range for the final interest rate target is as large as 2% to 3.75%! Given that the target inflation rate is 2% the range for the target real interest rate is 0% to 1.75% which is indeed very wide.

In any case, all these numbers are amenable to change. Most central bankers, including the Fed, have mostly not paid any attention to what they have said or indicated in the past and are liable to be guided solely by the latest economic numbers.

The Fed itself has gone through many ups and downs in this cycle, starting with saying that inflation is transitory and no action was required and then having to raise at a very rapid pace. Thereafter in the middle of the hiking cycle, the Fed said that it wanted the economy and labor market to slow down but once signs of a slow down came in the labor market, the rates have been cut.

## Inflation, Economy and more

Of course the inflation numbers have been pretty good, showing signs of going towards the target 2% - PCE (Personal Consumption Expenditure) inflation is already at 2.5%, compared to a recent higher of over 7% in 2022.

From hereon as well, since crude prices have slid down, it is likely that goods inflation will drift down further. One of the sticky parts of inflation has been shelter or housing inflation due to some housing shortage. Here, the thinking is that the rate cut may actually help boost housing and therefore bring down shelter inflation.

Since monetary policy is a blunt instrument and also works with an uncertain lag, rates had to be cut before there was visible pain in the economy in terms of an economic slow down.

As for the impact on equity, theoretically a fall in rates is supposed to be positive for equity as this brings down the cost of capital in the economy. However actual observations in the past do not show this to be necessarily the case.

There are several explanations for this including the fact that part of the rate cut is already discounted by the equity markets even before it happens. Also a rate cut may signal a weakening economy which of course equity markets do not like.

In short, as with most macro indicators it is difficult to draw one to one correspondence between what happens to the Fed rate and the direction of the equity markets.

As far as direct impact on earnings of US companies is concerned, interestingly an article in The Economist prior to the rate cut highlighted that borrowing costs for many US corporations may well go up in spite of the cut. This is because when the rates were super low many companies locked in their debt at those low levels of interest rates. As these loans mature, the effective interest rate for several American corporations may paradoxically creep up. This will particularly have a impact on small and medium manufacturing companies.

## The Impact on India

Now we come to the impact on India.

First is on the interest rate cycle here. The Fed rate cut may give some psychological comfort to the RBI for a similar action.

Interestingly even when rates began to go up in 2022, the RBI waited till the Fed rate hike was imminent before raising rates even though most emerging market Central banks had already raised rates 2 to 5 times by then. Therefore it is clear that the RBI watches the Fed for cues.

As for the India macro data, inflation is likely to cool down partly because crude prices are down which impacts the price of many downstream commodities. In addition, due to a good monsoon, food prices have also began to soften. All these give more breathing, and hence cutting, room to the RBI.

Hence a reduction in Indian interest rates may well happen soon or rather than later.

There are a number of speculative articles saying that the rate cut in the US will boost liquidity and hence flows to Emerging Markets in general and India in particular. While this may happen to a greater or lesser extent, it may not have a direct impact on the Indian markets as data has never shown that Foreign Institutional Investors (FII) flows and the market direction in India have anything to do with each other. This was the case even before either the domestic mutual fund corpus or retail participation in the markets had become as high as they are at present.

The rate cut may give a boost to American corporations which in turn, may boost spending on technology. This may, on the margin, have a positive impact on the demand for Indian IT services companies. There has been some slow down in tech spending and the cycle may now be due for an upturn.

Plus unrelated to the interest rate changes in the US, the softening in crude and food commodity prices would also have an overall positive impact on Indian corporate earnings. This together with the rate cut by the RBI may provide an additional boost to Indian equity markets. But as always the question is how much of it is already in the price.

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