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Do we still play the old sneezing game with the US?

In the central banks' arsenal lie various tools that enable it to shape the contours of the economy and often, change the course of a country's economic success. One of these tools is interest rates.

During economic duress, when countries are witnessing a slowdown, central banks often respond by cutting interest rates and increasing liquidity to stimulate growth. This strategy is aimed at lowering borrowing costs, encouraging spending, and mitigating the impact of factors causing economic slowdown. However, even though these measures help to stabilise markets and promote recovery, they also raise concerns of potential inflationary pressure. Thus, when an economy starts witnessing elevated inflation, the central bank raises rates to curtail spending and stop the heating up of the economy. Changes in rates have widespread ramifications on cost of borrowing, capital investments, consumption, and growth. Hence, rate action by central banks is one of the key elements that market participants have on their radar.

Signals from across the pond

On September 18, 2024, the U.S. Federal Reserve announced a significant cut in the federal funds rate by 50 basis points. This decision marked the first reduction in borrowing costs since March 2020 and was driven by signs of easing inflation and a slowdown in the labour market. The markets expect another 50bps rate cut by the end of 2024 and a cumulative 100bps cut in 2025. At this juncture, where few more rate cuts are expected, let us try to understand whether this change in regime will have any significant impact on India.

Since July 1994, the Fed has made 53 rate cuts with the biggest rate cut being 475 bps in 2001. Historically, the Fed has announced 25 bps rate cuts 58% of the times and 50 bps almost 34% of the times.

Exhibit 1: Historical Fed rate cut/hike quantum count

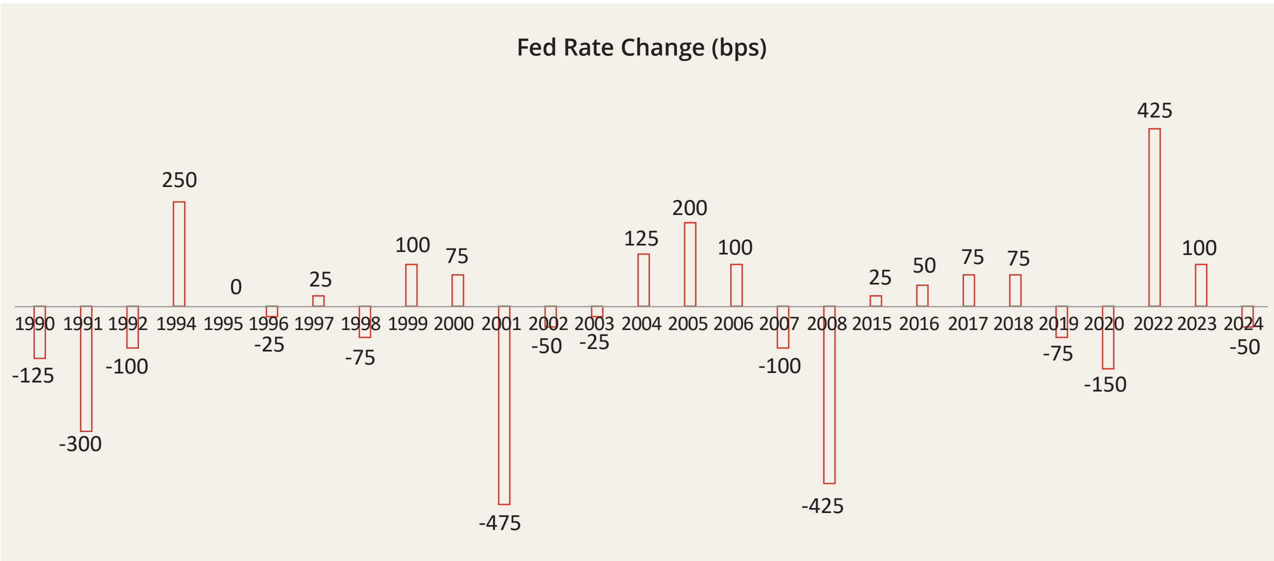
Rate Cuts (bps)	No. of times	%
-25	31	58%
-50	18	34%
-75	2	4%
-100	2	4%
Total	**53**	**100%**

Rate Hikes (bps)	No. of times	%
25	40	78%
50	6	12%
75	5	10%
Total	**51**	**100%**

(Since July'94 upto Sep'24)

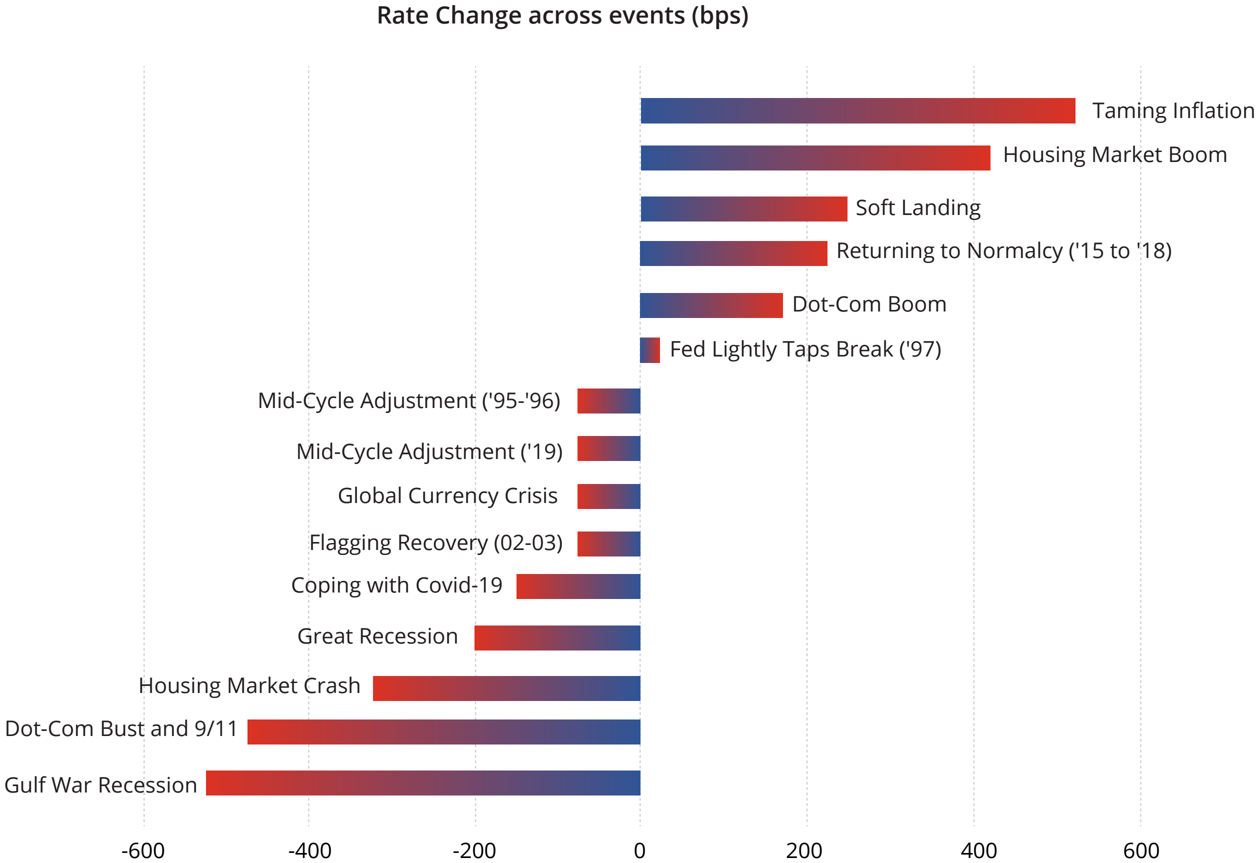
Source: https://www.forbes.com/advisor/investing/fed-funds-rate-history/

Exhibit 2: Year wise Fed Rate announcements



Source: https://www.forbes.com/advisor/investing/fed-funds-rate-history/

Exhibit 3: Fed rate changes across Market Cycles



Source: https://www.forbes.com/advisor/investing/fed-funds-rate-history/

As the latest Fed cut has been of 50 bps let's analyse what followed the previous 17 times the Fed had announced a 50bps rate cuts. The table below indicates the quantum of rate cut that followed the 50-bps cut.

7 out of 17 times (which comes to 41%) there have been 25bps and 50 bps rate cuts

75 bps and 100 bps were announced only 1/17 (6%) and 2/17 times (12%), respectively

Exhibit 4: Digging deeper into the quantum of Fed rate cuts following a 50-bps cut

Rate Cut Following 50 bps cut	No. of times	%
-25	7	41%
-50	7	41%
-75	1	6%
-100	2	12%

Source: https://www.forbes.com/advisor/investing/fed-funds-rate-history/

How have Indian markets reacted?

Post the first 50 bps rate cut, on an average, it is observed that directionally, the NIFTY 50 remained positive across time periods (Refer to the table below).

Exhibit 5: Performance of NIFTY50 after every 50-bps rate cut by the Fed in the past

Quantum of cut following 50 bps cut	1 Day	1 Week	1 Month	3 Month	6 Month	1 Year
01-02-1991	3.25%	4.29%	17.16%	19.96%	53.79%	99.03%
20-12-1991	1.85%	1.52%	12.18%	64.83%	57.68%	31.26%
02-07-1992	-4.55%	-4.55%	-10.27%	9.62%	-11.05%	-22.74%
03-01-2001	1.27%	1.39%	6.78%	-11.00%	-14.75%	-19.94%
31-01-2001	-0.91%	0.79%	-4.76%	-17.97%	-22.62%	-21.26%
20-03-2001	3.09%	-0.82%	-2.26%	-7.91%	-21.46%	-0.10%
18-04-2001	3.72%	4.20%	6.29%	-0.03%	-12.69%	3.91%
15-05-2001	0.51%	2.40%	-2.84%	-7.19%	-12.33%	-2.52%
17-09-2001	3.20%	-2.07%	13.07%	24.72%	34.11%	14.84%
02-10-2001	-1.15%	0.49%	9.22%	16.37%	24.11%	7.29%
06-11-2001	-1.44%	0.21%	10.83%	7.49%	9.49%	-5.04%
06-11-2002	-0.17%	-0.86%	11.17%	9.61%	-1.76%	61.69%
18-09-2007	4.09%	6.41%	17.70%	27.07%	4.39%	-6.99%
30-01-2008	-0.58%	5.73%	1.08%	0.54%	-16.17%	-48.17%
08-10-2008	-6.65%	-0.65%	-15.39%	-11.41%	-7.32%	44.68%
29-10-2008	6.99%	12.86%	2.15%	2.75%	28.66%	85.28%
03-03-2020	-0.46%	-2.78%	-26.98%	-13.07%	3.05%	28.54%
18-09-2024	0.15%	2.21%	-	-	-	-
Average	0.68%	1.71%	2.66%	6.73%	5.60%	14.69%
Average(excluding COVID)	0.75%	1.97%	4.51%	7.97%	5.76%	13.83%

Data from Ace MF

The below table shows the average returns generated by NIFTY 50 depending on the quantum of rate cut that followed the initial 50bps rate cut:

Exhibit 6: Avg. NIFTY 50 Returns Post-Second Rate Cut by Cut Size

Quantum of cut following 50 bps cut	NIFTY 50 Returns % (Post-Rate Cuts)					
	1 Day	1 Week	1 Month	3 Month	6 Month	1 Year
-25 bps	0.01%	0.17%	-1.62%	-6.63%	5.26%	11.38%
-50 bps	1.54%	2.88%	2.66%	-0.93%	-0.98%	9.65%
-75 bps	0.90%	0.90%	9.38%	0.87%	-6.72%	-40.01%
-100 bps	-0.94%	-1.87%	-6.49%	-0.13%	37.67%	66.61%

Data from Ace MF

Amongst the factors that influence the Fed decision, one of the most important is the CPI inflation in the US. Let’s look at the average CPI inflation that existed in the economy at the time when such rate cuts were made.

Exhibit 7: Average CPI Inflation in US at the time of every 50-bps cut

Rate Cut Following 50 bps cut	Average CPI in US before the 50-bps cut		
	3 Months Avg. CPI	6 Months Avg. CPI	12 Months Avg. CPI
-25	3.1%	3.2%	3.3%
-50	3.4%	3.5%	3.5%
-75	4.3%	3.5%	3.1%
-100	4.7%	4.8%	4.4%
Current	**3.2%**	**3.1%**	**2.8%**

Source: https://fred.stlouisfed.org

*Note: the average CPI has been calculated from the month in which the 50bps cut was announced and the dates preceding the 50bps rate cut.

If we were to predict the next fed rate cut based on the table above, we can conclude that a 25-bps cut is what the Fed may end up announcing considering the average CPI for 3mths/6mths/12mths is much closer to what the CPI was in the last few cycles when 25 bps cut was announced.

The 100-bps rate cut was announced to tackle the sudden lock downs due to the Covid19 pandemic. This was a tail event, and might not be relevant in the current context.

Since 1990, there have been only 5 instances in the past where the rate cut cycle began with a 50bps cut. These events were:

- **2001** The Dot Com Bust
- **2002** Flagging Recovery
- **2007** Housing Market Crash
- **2008** Financial Crisis
- **2020** The Covid-19 pandemic

The average CPI Inflation in the preceding 12-months was 2.74%. As of Sep'24 the average CPI inflation in the US was 3.19%, slightly higher than what it has been in the past. Below, we chalk out the average time taken by the Fed to announce the next rate cut after the initial 50bps rate cut:

Exhibit 8: Average Time for Fed to Announce Next Rate Cut After 50bps Cut

Rate Cut Following 50 bps cut	No. of times	%
-25	7	41%
-50	7	41%
-75	1	6%
-100	2	12%

Source: https://www.forbes.com/advisor/investing/fed-funds-rate-history/

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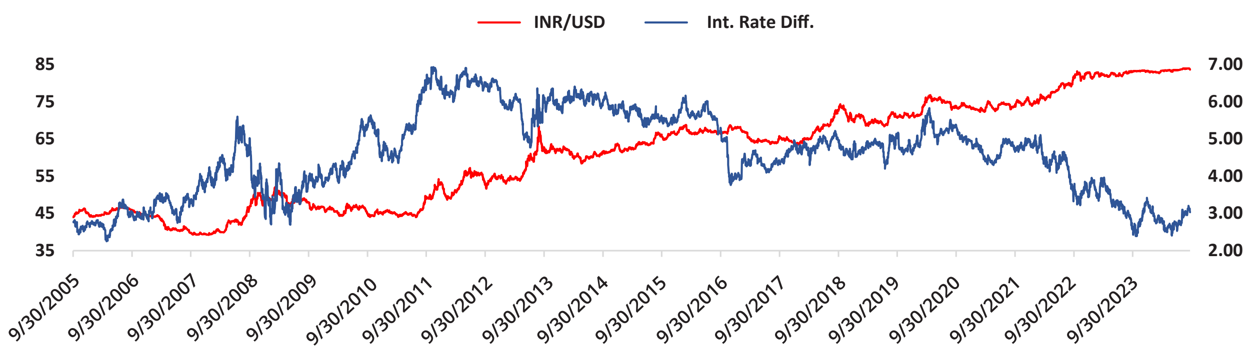
Impact on yields

Inarguably, a change in benchmark interest rates will have an impact on yields. This can have significant ramifications for global markets as well since investors are fairly mobile in their search for higher yield.

To understand this phenomenon, we plotted the interest rate differential between the Indian 10 Year G-sec yield and US 10 Year G-sec yield. Ideally the Interest Rate Differential and INR/USD rate should be negatively correlated but one should note that there are multiple factors at play that affect the currency so the trend is not as evident as it should be.

Exhibit 9: How INR/USD Currency reacts to the Interest Rate Differential



Source: INR/USD data - https://www.rbi.org.in | 10-Year Gsec Yields for US & India - Bloomberg | Dissecting NIFTY 50 wala section: Nifty 50 data from Ace MF

Summary of the correlation between the two across time periods

Period	Correlation
2005 - 2011	-0.02
2011 - 2013	0.33
2014 - 2017	-0.50
2018 - 2024	-0.80

Like we pointed out earlier, the trend (correlation) is not very evident between the two from 2005 to 2017. However, if you look at the period from 2018 to 2024, the correlation stands at -0.8 indicating that they have a high negative correlation.

Dissecting NIFTY 50 performance across previous market cycles

Market Cycle	Total Rate change (bps)	First Rate Cut	Last Rate Cut	Return % (after first cut of the market cycle)						Return % (after last cut of the market cycle)				
				1 Day	1 Week	1 Month	3 Month	6 Month	1 Year	1 Week	1 Month	3 Month	6 Month	1 Year
Gulf War Recession	-525	7/13/1990	9/4/1992	-2.83%	2.11%	12.49%	51.60%	8.49%	40.47%	1.28%	5.53%	-14.88%	-16.42%	-10.69%
Mid-Cycle Adjustment ('95-'96)	-75	7/6/1995	1/31/1996	0.79%	4.03%	6.52%	10.18%	-3.46%	20.30%	9.85%	17.80%	31.35%	21.87%	16.20%
Global Currency Crisis	-75	9/29/1998	11/17/1998	-0.38%	-6.90%	-8.38%	-3.14%	14.62%	55.47%	-2.12%	-3.46%	10.99%	35.51%	59.72%
Dot-Com Bust and 9/11	-475	1/3/2001	12/11/2001	1.27%	-0.31%	6.78%	-11.00%	-14.75%	-19.94%	-2.51%	-1.08%	5.19%	-5.53%	-3.64%
Flagging Recovery (02-03)	-75	11/6/2002	6/25/2003	-0.17%	0.04%	11.17%	9.61%	-1.76%	61.69%	2.45%	5.07%	20.02%	61.67%	34.75%
Housing Market Crash	-325	9/18/2007	4/30/2008	4.09%	8.64%	17.70%	27.07%	4.39%	-6.99%	-0.59%	-5.73%	-18.89%	-51.14%	-32.62%
Great Recession	-200	10/8/2008	12/16/2008	-6.65%	-4.99%	-15.39%	-11.41%	-7.32%	44.68%	-2.40%	-10.03%	-8.70%	50.68%	68.24%
Mid-Cycle Adjustment ('19)	-75	8/1/2019	10/31/2019	0.16%	0.48%	0.39%	7.87%	9.80%	1.95%	1.13%	1.50%	2.12%	-21.02%	0.45%
Coping with Covid-19	-150	3/3/2020	3/16/2020	-0.46%	-7.54%	-26.98%	-13.07%	3.05%	28.54%	-17.26%	-2.96%	8.43%	24.65%	64.99%
				-0.46%	-0.49%	0.48%	7.52%	1.45%	25.13%	-1.13%	0.74%	3.96%	11.14%	21.93%

Nifty 50 Data from Ace MF

Observations

Across the 9 market cycles, NIFTY 50 generated positive returns 7 out of 9 times from a 1-year perspective post the first rate cut.

NIFTY 50 generated positive returns 6 out of 9 times from a 1-year perspective post the last rate cut

The average 1 Yr. return generated by NIFTY50 was upwards of ~20%

If we look at a shorter period, on a 6-months basis, Nifty generated positive returns in only 5 out of the 9 cycles

Nifty generated an average return of just ~1.4% in the period post the first rate cut and an average return of ~11% after the final rate cut, on a 6-month basis.

The Indian market is currently navigating a complex landscape influenced by various factors, including high valuations, global macroeconomic conditions, ongoing geopolitical tensions, and events unfolding in China. We find ourselves in an unprecedented situation, characterized by two active conflicts and persistently elevated market valuations. Recent shifts in investor sentiment have been triggered by China's stimulus measures aimed at revitalizing its economy, while many countries continue to grapple with high inflation. With such global turbulence, it will be intriguing to observe how these dynamics evolve and impact the markets moving forward.