



CIO continues to see value in holding a well-diversified portfolio, including allocations to alternatives for those willing and able to manage inherent risks. (UBS)

Markets get set for Fed rate cuts

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The US dollar has fallen back toward its recent low and gold prices hit a fresh record high as investors once more dialed up the chances of a 50-basis-point interest rate cut by the Federal Reserve at this week's policy meeting.

The DXY index, which measures the greenback against six major trading partners, has fallen by around 5% since June, while gold is trading near a new all-time high above USD 2,585 an ounce. The precious metal benefits from lower US rates, as they lower the opportunity cost of holding the non-yielding asset.

The moves come despite a higher-than-expected reading for the US producer price index (PPI) for August released on Thursday, and a monthly core consumer inflation (CPI) gauge that rose by the most in four months. The latest weekly initial jobless claims also held steady, below the July peak. Instead, markets appeared to be swayed by media reports that suggest the Fed's decision—between a 25- or 50-basis-point rate cut this week—may be a closer call for policymakers than previously thought. According to CME FedWatch data, the probability of the Fed starting its easing cycle with a cut of 50 basis points rose to 59% by the end of last week, up from just 14% earlier in the week following the publication of August's CPI data.

In our view, overall inflation data have been good enough to allow the Fed to start cutting rates this week amid a softening labor market, but do not give officials a reason to cut aggressively. Data for retail sales and industrial production due Tuesday could potentially influence the Fed's decision, with weak results likely to trigger a 50-basis-point cut.

But just as Fed Chair Jerome Powell pointed out last month at the Jackson Hole Symposium, while the timing and pace of rate cuts will depend on incoming data and the balance of risks, “the direction of travel is clear.” In our base case scenario of a soft landing, we see room for 100 basis points of interest rate reductions this year, and another 100 basis points in 2025.

This means that recent trends in the US dollar and gold may continue, as markets anticipate a shift to a lower-rate environment.

The US dollar should weaken further in the coming months as Fed cuts gather pace. In addition to imminent policy easing by the US central bank, the growing US federal deficit is likely to be a headwind for the greenback over the longer term. With several top central banks likely to cut rates less aggressively than the Fed, we expect the US dollar to stay under pressure as yield differentials narrow. Investors should reduce or hedge their USD holdings, and consider selling the currency's upside potential for yield pickup versus the Swiss franc, the Australian dollar, the British pound, or the euro.

Gold's rally has further to run. Gold has gained over 24% this year, and we continue to see higher prices driven by increased investment demand. According to the official gold exchange-traded fund (ETF) data published by the World Gold Council, physically backed gold ETFs grew in August to mark the fourth consecutive month of inflows. Total holdings have rebounded to nearly 3,182 metric tons, the highest since the start of the year. With upcoming Fed cuts reducing the opportunity cost of holding the non-interest-bearing asset, we expect gold prices to hit USD 2,700/oz by June next year. We also believe gold's hedging properties make it an attractive proposition from a portfolio perspective amid macro and geopolitical uncertainties.

Returns on cash are likely to dwindle from here. Relative to cash, we think the risk-return profile is attractive for investment grade bonds, diversified fixed income portfolios, and quality equities with high and sustainable dividends as central banks advance the global easing cycle. In our view, excess cash and money market holdings should be redeployed, and we recommend quality bond ladders and structured investment strategies to manage near-term liquidity needs.

So while investors should brace for volatility as the Fed approaches a regime change, we see ways they can stay invested and position for lower interest rates. We continue to see value in holding a well-diversified portfolio, including allocations to alternatives for those willing and able to manage inherent risks.

Main contributor: Mark Haefele

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