

Monetary Policy in Focus: Anticipating Rate Cuts and Their Impacts

What Rate Cuts Really Mean for Investors

🕒 By Nico Tschanz, Head of Wealth Management at Dexbridge Capital

Dear Reader,

The Fed is expected to deliver its first interest rate cut this year. For global markets – and especially the GCC, where currencies are pegged to the U.S. dollar – such a move has immediate consequences. But what does a rate cut actually mean? Is it good news for markets, or a warning sign of weakness?

In this Mid-Month Insight, we start by explaining the role of central banks and the tools they use, before turning to the mechanics of rate cuts, their impact on different asset classes, and the risks investors should keep in mind. Finally, we explain why this Fed decision matters today, not only for the U.S. economy, but for portfolios everywhere.

The Role and Objectives of Central Banks

Central banks are the stewards of modern economies. Their roles are unique:

- Issuer of currency: the sole authority to create legal tender, ensuring trust in money
- Banker to the government: managing public debt and holding government accounts
- Bankers' bank: providing reserves and settlement services to commercial banks
- Lender of last resort: supplying emergency liquidity to stabilize the system in crises
- Conductor of monetary policy: using policy tools to guide interest rates and credit conditions

For the U.S. Federal Reserve, these objectives are captured in its “dual mandate”: maximum employment and stable prices. In practice, it means balancing the fight against inflation with the need to sustain growth and jobs. Other central banks – including those in the GCC – share similar goals, even if they operate under different structures.

The Tools of Monetary Policy

How do central banks pursue these objectives? They rely on a few key levers: **Open Market Operations (OMO)**: Buying or selling government securities to influence the supply of money in the banking system. Bond purchases add liquidity and lower interest rates, while sales withdraw liquidity and raise them. **Policy Rates**: The benchmark short-term interest rate (in the U.S., the federal funds rate) that guides borrowing costs throughout the economy. Raising it tightens financial conditions, while lowering it makes credit cheaper. **Reserve Requirements**: The share of deposits banks must hold as reserves. Lowering requirements frees up funds to lend, while raising them restricts credit creation. Through these tools, central banks influence the cost of borrowing, the availability of credit, and ultimately inflation, employment, and growth.

Why Central Banks Cut Rates

Rate cuts aim to stimulate slowing economies by lowering borrowing costs and boosting spending and investment. They can also act as insurance against shocks, supporting confidence. The Fed is expected to cut this week as inflation has eased and the labor market weakens. Cuts can be proactive (like 1995, 2019) to extend growth, or reactive (2001, 2007) when recession is already underway – a crucial distinction for investors.

How Rate Cuts Affect Markets

The immediate effect of a rate cut is to lower interest rates across the financial system. The ripple effects extend to every major asset class:

Bonds:

Bond prices and interest rates move inversely. The value of a bond is the present value of its future cash flows:

$$PV = \sum \frac{C}{(1+r)^t} + \frac{F}{(1+r)^T}$$

where C is the coupon, r the discount rate, F the face value, and T the maturity. When r falls, those future payments are worth more today, so the bond's price rises. This effect is strongest for long-duration bonds, since they have more future payments to be revalued. A one percent drop in yields can generate a double-digit price gain for a 30-year bond, while a 1-year bill barely moves. In easing cycles, investors often extend duration to benefit from this price sensitivity. Corporate bonds also gain when benchmark rates fall, though high-yield bonds are more sensitive to whether the cut reflects economic strength or weakness. Emerging market bonds, including many in the GCC, can benefit from Fed cuts as global investors seek higher yields abroad.

Equities

Stocks usually welcome lower rates. Cheaper credit reduces financing costs, while lower discount rates make future earnings more valuable. Growth companies, whose cash flows lie further in the future, often benefit most. Interest-sensitive sectors such as housing and autos also gain from cheaper loans. However, the context matters. Equities typically perform well after "insurance" cuts that prolong an expansion, but poorly if cuts are responding to recession. In other words: the reason behind the cut determines how sustainable the stock rally will be.

Inflation-Protected Bonds (TIPS)

TIPS are bonds whose principal value is adjusted for inflation, which means they protect investors' purchasing power. They gain value when real interest rates fall and act as a hedge against unexpected inflation, making them different from regular bonds with a fixed return.

The Risks of Rate Cuts

When central banks cut interest rates, it's often a signal that the economy is already in trouble. Cuts in both 2001 and 2007 came as the economy was heading into a recession and a financial crisis, respectively. These actions can help cushion a downturn, but they can't necessarily stop it. Therefore, for investors, the crucial factor is whether the rate cut is a proactive move to prevent a future slowdown or a reactive one responding to an existing problem.

Why This Matters Today

Rate cuts can mark a significant policy turning point following years of tight monetary conditions. These shifts often reshape market trends, creating both opportunities and uncertainty. For the GCC, which has dollar pegged currencies, local borrowing costs will fall as well, easing conditions for households, companies, and governments. The impact, however, depends on the reason for the move: if it reflects confidence that inflation is contained, markets may rally; if it signals a deeper weakness, volatility could follow. For investors, the message is clear: Cuts are not a cure all, but a signal of where the cycle stands and a reminder to stay informed and balanced.

In the end, it's not the cut itself, but the reason behind it that will define the path ahead and is important for investors to understand.

Warm Regards,

Nico

