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Investors May Want to Curb Their Enthusiasm on Interest-Rate Cuts -- Interview

By Alice Uribe

SYDNEY--Investors betting that interest-rate cuts in 2024 will boost stock valuations by easing company debt burdens and unlocking household spending may want to curb their enthusiasm.

Hugh Selby-Smith, co-chief investment officer of Melbourne-based Talaria Capital, said lower interest rates are typically accompanied by a fall in corporate profitability. That adds to uncertainty around the outlook for Australia's benchmark S&P/ASX 200 index, which has rebounded about 11% since hitting a low in late October.

"Be careful what you wish for," Selby-Smith said in an interview.

Last week, new projections showed that Federal Reserve officials expect three interest-rate cuts next year. Fed Chairman Jerome Powell helped ignite a market rally when he said the central bank is aware of the risk to the economy of leaving rates too high as inflation falls.

Officials have since tried to squelch speculation of a March cut. For the past year and a half, markets have often reflected bets on a faster decline in inflation and more rate cuts than the Fed has signaled.

The Fed isn't alone in turning more dovish. Earlier this month, the European Central Bank cut its inflation forecasts for next year, a sign it expects price growth to be tamed soon, and said it will accelerate its exit from a pandemic stimulus program.

The shift is increasingly making an outlier of the Reserve Bank of Australia, which in the minutes this week continued to send hawkish signals to money markets, keeping the door open to a further increase in the official cash rate next year if its concerns about rising services inflation and strong domestic demand aren't alleviated.

Selby-Smith cautioned that some companies could face issues with refinancing their debt, even as rates come down. That helps to shape strategy for its Talaria Global Equity Fund, which manages around 2 billion Australian dollars (US\$1.35 billion).

"Just be very wary of leverage. It's the absolute level of debt that we would highlight to people," he said.

Also, if the market rally loses steam after interest rates peak, investors may find they have overpaid for stocks in industries such as consumer durables and technology, Selby-Smith said.

Talaria, which tends to hold stocks for an average of three and a half years, continues to find more attractive investments outside the U.S. Japanese assets make up 17% of the global fund's portfolio, up from a much smaller allocation five years ago.

"We continue to disproportionately find new ideas to debate in the team in Japan, relative to other regions," Selby-Smith said.

Corporate policy changes pushed by Japan's stock exchange, an endorsement from Warren Buffett and relatively low valuations have helped the country's stocks become one of the best-performing markets worldwide this year.

The global fund, which returned around 15.7% over the 12 months through June, has sold its stock in Asahi Group, but it retains a shareholding in Secom, Japan's largest protective and electronic security solutions provider, and KDDI, the second-largest telecom company in Japan.

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Japan is one of the few places in the world where "it's been priced for deflation for a very long period of time, so a little bit of inflation is a positive dynamic," Selby-Smith said.

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