Potential Effects of Fed Rate Cuts on DSE-Listed Companies

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Introduction

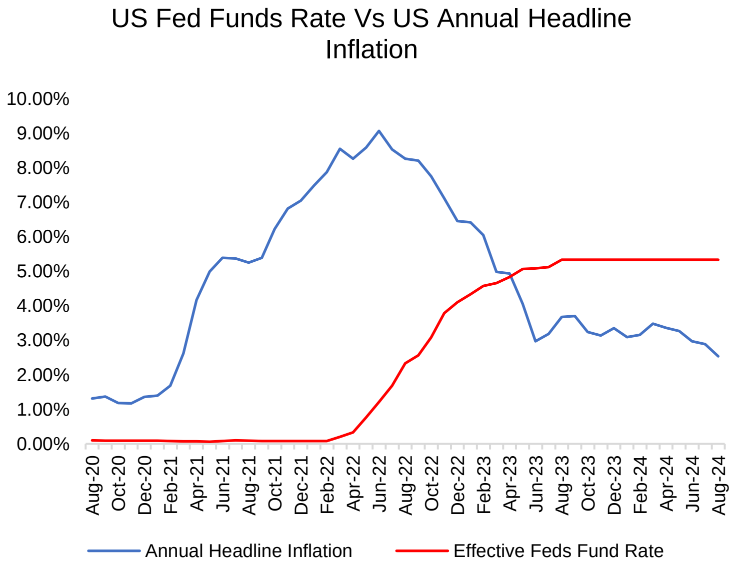
On Wednesday, September 17th, 2024, the Federal Reserve (The Fed) of the United States (basically the US's central bank) cut its interest rates by 50 basis points from the 5.00%—5.25% range to the 4.75%—5.00% range. For context, the Federal Reserve, like any other central bank adopting an interest-based monetary policy (Tanzania included), uses interest rates to control inflation, unemployment, currency stability, employment, and consumer confidence.

How does it work?

To understand how these interest rates affect our economy, we first need to understand how the economy works. The economy is an outcome of four functions: Household Consumption, Business Investment, Government Spending, and Net Exports. Hence, a combination of those components must record a net increment for an economy to grow.

When an economy is expanding (recording incremental growth rates for 2 successive quarters or more), it is usually a result of increased business investment and government spending, which brings about more employment in the country, meaning that more people have more money to spend (which they do, it's consumer confidence). Now, during this period, if it usually happens that the income earned exceeds the number of products produced, that's called inflation.

Lower inflation levels (around 2%—3%) are often tolerable because they result from economic growth. The challenge occurs when inflation exceeds national inflation targets because the negative effects of inflation are higher living standards, a reduction in people's purchasing capabilities, higher rates of wealth erosion, and real economic growth.



Since it's in the Central Bank's best interests to allow for this not to happen, it tends to increase its short-term interest rates; this increment trickles results in an increment of interest returns on bond yields as well as interest rates on deposit accounts and the rates at which banks can borrow from each other and the Central Bank.

These higher costs are then passed on to the businesses and households in the form of higher interest rates on borrowings thus incentivizing people to spend less and save more.

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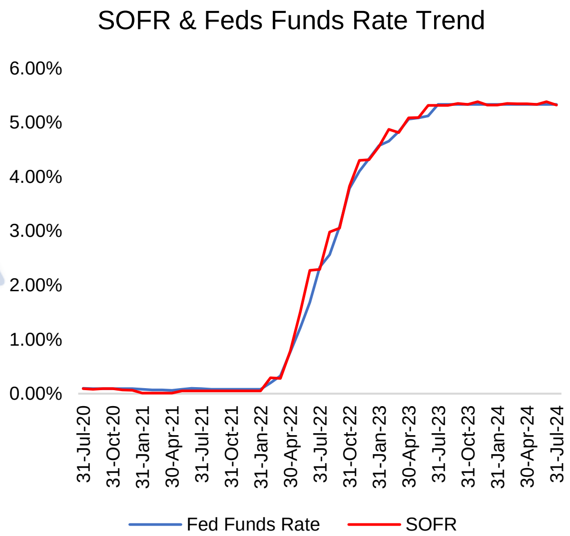
Why did the Fed cut rates?

When inflation begins to cool off, the Central Bank begins lowering interest rates, as leaving the rates higher for too long can disincentivize consumption and investment, leading to what is known as a recession (2 or more consecutive quarters of decelerating economic growth) or even a contraction (negative economic growth). As inflation in the United States continues to decelerate toward the national target of 2% annually, rising unemployment rates, and the need to establish a soft landing (a slowdown in economic growth without causing a recession), the Fed lowered its interest rates. Now, one might ask, why should we be concerned with the Fed's decision? Since the US has established itself as the dominant player in the global financial system, decisions carried out in the US have implications globally. This character applies to the Fed so much that a saying goes, *"When the Fed sneezes, the whole world catches a cold."*

Effects of the rate cut:

1. Lower borrowing costs in international markets.

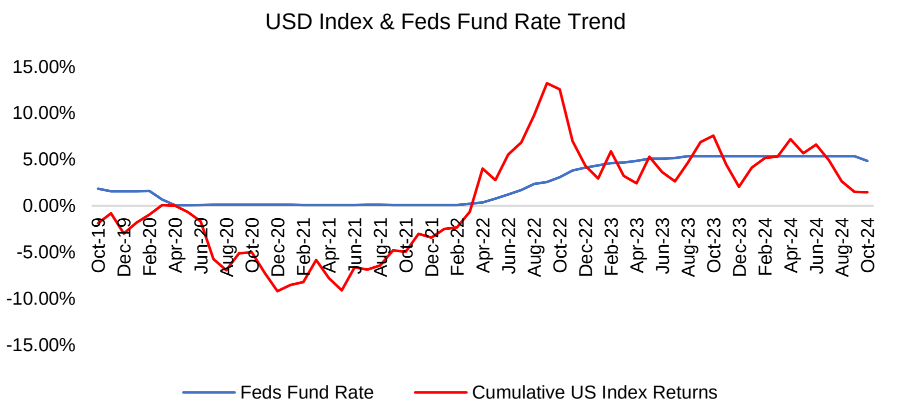
Most international debt taken by governments and the private sector tends to be in US Dollars, with most dollar-denominated debt having a variable interest rate charge where a benchmark rate which has a close correlation with the Feds Fund rate is charged with a fixed interest margin to arrive to the total interest rate. The most notable benchmark rate used includes the Secure Overnight Financing Rate (SOFR), the cost of borrowing cash overnight collateralized by U.S. Treasury securities. Such benchmark rates tend to have a close correlation with the Fed fund rates; this means that during this particular time when the Fed has cut its rates, these benchmark rates also experience a decline, which in turn eases the cost of borrowing for both the private and public sectors.



2. A weakening USD

When the Federal Reserve lowers its interest funds, the borrowing costs for any US-denominated debt begin to fall, as well as the returns generated from holding the USD particularly the yields from US treasury bonds and bills. The fall in returns from one of the safest asset classes in one of the most stable and economically influential countries in the world causes both domestic and foreign capital to look beyond the United States for higher returns which results in the weakening of the US Dollar against other global currencies.

Our analysis of the U.S. dollar index, which measures the value of the U.S. dollar relative to a basket of six major foreign currencies to gauge the dollar's strength on a global scale, has recorded a 0.73 correlation score with the trend Feds Fund rate during the 5-year period between 2019 and 2024. This positive relationship indicates that Fed decisions do have an impact dollar strength.



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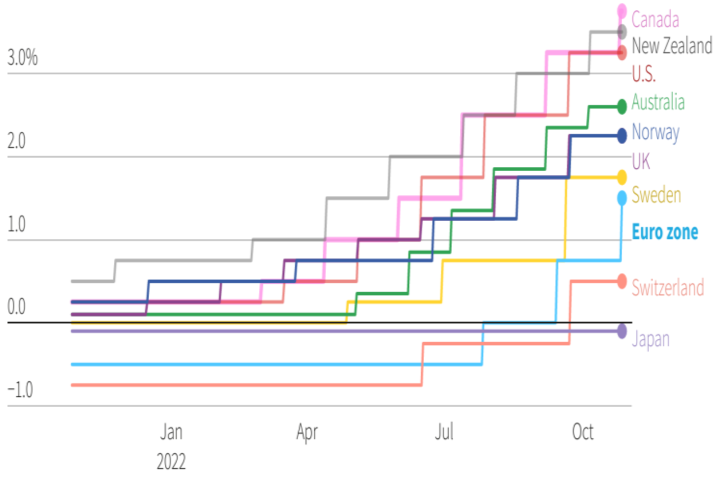
Effects of the rate cut:

3. Other Central Banks following suit

There tends to be a positive correlation between the movement in Federal Funds rates and the central bank rates of other countries, as most central banks worldwide opt for a ‘wait and see’ approach. This is often done to protect individual economies from adversities such as capital flight, currency depreciation, dwindling foreign currency reserves, higher loan defaults, and rising inflation stemming from the rise in import prices; thus, a falling federal funds rate is likely to result in falling Central Bank rates from other countries in the world.



Source: Refinitiv Datastream | Reuters, Oct. 27, 2022 | By Vincent Flasseur

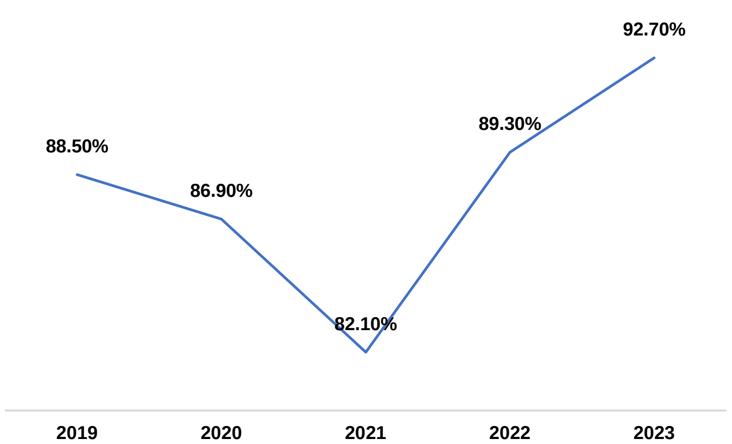
Rate cut implications on publicly listed companies in the DSE

1. The Banking Sector

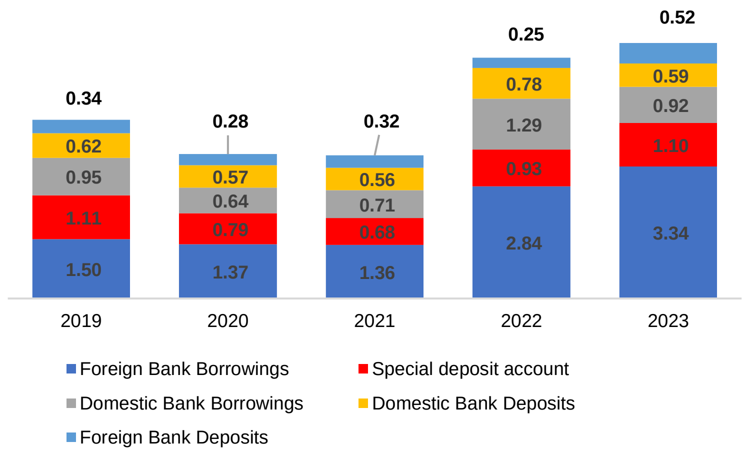
The banking sector has been on a bull run over the past five years, recording record-breaking profits year over year and maximizing shareholder value with our listed blue-chip banks, which happen to be our largest banks, CRDB and NMB, spearheading this growth. CRDB and NMB are commercial banks, meaning their primary business model rotates around mobilizing deposits, disbursing loans to customers and other banks, and investing in government bonds.

However, in recent years, we have seen that as our economy continues to expand, the demand for credit by the private sector has exceeded the banking sector's ability to mobilize deposits; as a result, such banks have opted for the increased use of wholesale funds (large sums of money raised by banks from other financial institutions to issue loans) such as borrowings in their funding mix to meet this growing demand however at the expense on the margins they generate from their interest-bearing assets.

Banking Sector Loan to Deposit Ratio

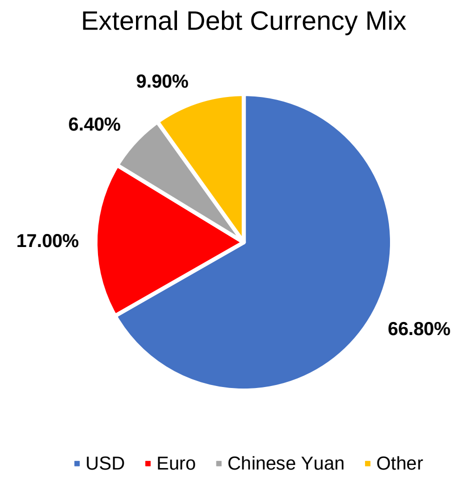


Wholesale Funding Breakdown in Trillions TZS



Rate cut implications on publicly listed companies in the DSE

Looking at the composition of wholesale funds, we see that foreign bank borrowing has been the largest component of the wholesale funds raised by commercial banks, averaging 41.65% of the total during the 5-year period between 2019 and 2023. It was also the fastest-growing component, growing at a C.A.G.R of 22.16% during the same period. With 66.8% of our external debt in USD, according to the Aug 2024 Monthly Economic Review, Banks with external debt in USD and quoted with SOFR rates are likely to see an alleviation in the interest expense they have to pay as the SOFR falls in line with the Feds fund rate, this alleviation will likely bring about relief in the bank's costs of funds and help our banks record higher net interest margins on their interest-bearing assets.

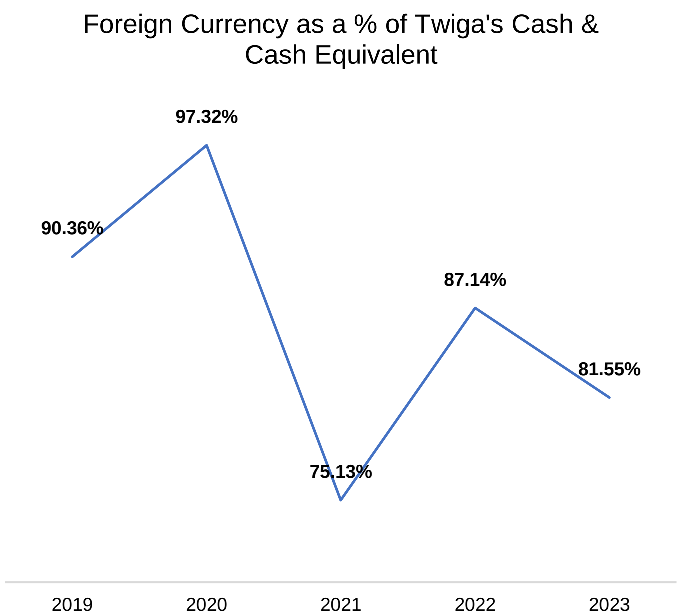


Additionally, as inflation globally continues to cool, and with the Tanzanian inflation rate consistently below national targets, the Central Bank could be prompted to lower its rates from the current 6%. This reduction would automatically translate to lower overnight borrowing costs in the interbank cash market, further reducing borrowing costs for the banks and allowing them to experience a cooldown in their cost of funds.

However, a weakening USD and other major currencies whose central banks have opted to cut rates could slow down the depreciation of the TZS against such currencies, which could, in turn, slow down the magnified foreign exchange income that may have been earned as a result of holding these currencies and selling them at higher prices in the future.

2. The Manufacturing Sector

A weakening USD means that the TZS could either strengthen against the USD or depreciate much slower than during periods of higher interest rates. In either scenario, companies such as Vodacom, Tanzania Breweries Ltd, and Tanzania Cigarette Company are likely to experience a slowdown in foreign exchange translation and transaction losses as a result of having foreign-denominated trade payables and or importing the necessary components to allow for production. On the other hand, outliers like Twiga Cement, which benefited from the high-interest rate environment, as the company went on to record foreign currency gains because a significant proportion of its cash and cash equivalents remained in stable foreign currencies, might record weaker foreign currency gains in the future following a weakened dollar.



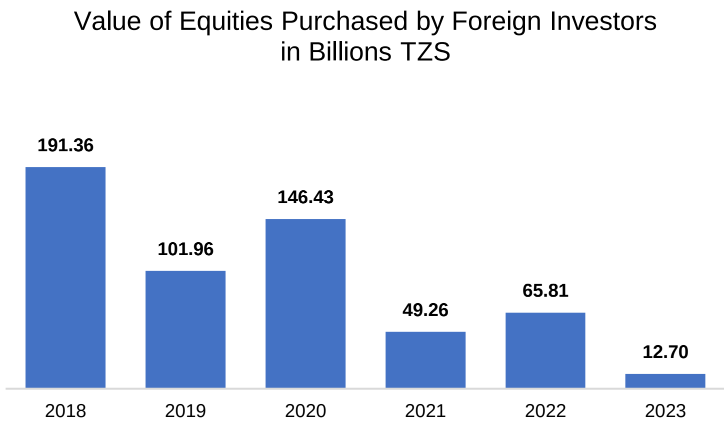
3. The Dar es Salaam Stock Exchange

With a weakening USD, cooling inflation, and better macroeconomic prospects ahead, retail and institutional investors worldwide could feel justified in investing in other riskier markets to attract greater returns.

Rate cut implications on publicly listed companies in the DSE

3. The Dar es Salaam Stock Exchange (Cont.)

The Dar es Salaam Stock Exchange could be a potential recipient of foreign capital, given that its domestically listed companies are performing better from a fundamental perspective, providing prospects for higher returns. This resilience could attract foreign investors into the market, bringing about increased turnover from the equities and increased market capitalization, resulting in higher listing and transaction fees for DSE.



4. Swissport Tanzania

Swissport Tanzania's main revenue segments stem from cargo handling of goods and passengers passing through its airline customers. These airline clients often pay in USD for Swissport's services. When Fed rates were high, the TZS weakened in value compared to the dollar, meaning that Swissport earned more in TZS for every USD it received as revenue from its customers. Now, with the Fed initiating a rate cut cycle, that could see the USD weaken in value and could, in effect, slow the pace at which the TZS was weakening against the USD, resulting in less incremental revenues from a depreciating shilling. For the company to continue sustaining higher growth, it would have to rely more on improving its revenue streams and operational efficiency.

Conclusive Remarks

While rate cuts do positively affect companies with foreign liabilities and those likely to attract foreign inflows of funds, it's worth noting that the effects tend to lag and happen over time rather than overnight. Furthermore, the effects will likely be more pronounced, provided that the Fed continues cutting rates. Since it holds its meeting every 6 or so weeks, the US economy would have to continue to display signs of a cooling economy well into 2025 to convince the Fed to pursue a cycle of rate cuts.

From an equity investment standpoint, assessing foreign currency risks and mitigation strategies remains necessary in assessing whether companies are worth investing in since, during times of uncertainty and volatility in the foreign exchange markets, companies with exposure to foreign currency dealings will continue to become seriously tested.

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