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A Dovish Federal Reserve: How Monetary Policy will Affect Cryptocurrencies in the Coming Months and What Investors Can Do About It

Implications of a Dovish Federal Reserve

With the Federal Reserve (Fed) meeting in Jackson Hole having concluded, the Fed has, for the first time in more than four years, signaled a dovish stance on interest rates with a larger-than-expected rate cut of 0.5% to bring interest rates down to a range of 4.75%-5%. The 50 basis points rate cut has signaled that inflation is under control with a pivot back to economic growth; it is the first-rate cut since 2020 and the Fed could potentially announce 6-8 more rate cuts by the end of 2025, taking the Federal Funds Rate down to a range of 3.0%-3.5%. Economists are predicting some short-term volatility with probable long-term gains as markets are now just adjusting to the recent rate decision by the Fed. Additionally, the effects of interest rate cuts have a ripple effect through foreign exchange markets, particularly affecting countries that have pegged their currencies to the US dollar. For context, countries peg their currency to the US dollar for stability as it encourages trade from reduced foreign exchange fluctuations. Therefore, countries like Jordan and Lebanon who rely heavily on the US as an oil trading country, would most likely see their currencies depreciate to some degree with the US dollar.

Monetary Policy in the Rest of the World

The impact and effects of the Fed's looser monetary policy will no doubt have a ripple effect across the world. For one, the Fed is often used as the benchmark for central banks across the world. The European Central Bank (ECB) has also this year reduced its policy rate twice, with the most recent 0.25% rate cut only taking place in September. In a similar vein, the Bank of England (BOE), the central bank of the United Kingdom, has announced that it will be pausing rate cuts and maintaining current interest rates at 5%. Evidently, major central banks around the world are starting to adopt a more dovish and "wait and see" approach towards monetary policy as inflation in these respective geographies begins to slow amid global short term volatility. However, economists have cautioned that simultaneous interest rate tightening across different central banks could amplify their effects; it is a tightrope walk between taming inflation and stimulating economic growth as central banks are cognizant that mis-steps in monetary policy could have negative effects that ripple through the global economy. Consequently, the IMF is forecasting global GDP growth to be 3.2% in 2024 and 3.3% in 2025, demonstrating a slight increase from the previously forecasted growth rate of 3%.

How Investors Can Tweak Their Investment Strategy

Changes in the direction of monetary policy always provide a prime opportunity for investors to rebalance their portfolios. For one, investors can continue considering bonds as yields remain attractive in the near term. The outlook for equity markets continue to improve as rate cuts have historically propped-up equity markets, with steady returns in a soft-landing scenario expected to crystallize over a 12-month period in soft-landing scenarios. With growth back in focus, REITs and gold are now back on investors' radars. REITs generally benefit from low interest rate environments due to lower financing costs. Additionally, gold has traditionally offered protection in times of uncertainty which is crucial for investors going forward due to lingering fears of a recession and pre-election jitters in the US.

Implications on Bitcoin Going Forward

Cryptocurrencies could see a resurgence in portfolios of investors as the recent Fed rate cuts could prove to be another significant catalyst for this asset class. As we have discussed in a previous article on the correlation between cryptocurrencies and traditional capital markets, rate cuts and Bitcoin are quite closely connected on several factors.

For one, cryptocurrencies have historically tended to perform better during lower interest rate environments (risk-on environments) as investors are willing to take on riskier assets in search of higher returns. The value proposition for holding bonds which are often regarded as less risky assets consequently become less attractive. Additionally, a weakening US dollar could potentially spur inflation and increase the appeal of holding Bitcoin as a store of value which provides a relative hedge against inflation. Moreover, low interest rate environments often lead to more liquidity in the financial system with ultra low interest rates in 2021 boosting liquidity which contributed to a more than 100% price surge of Bitcoin in 2021 at one point in time. Lastly, favourable geopolitical situations, especially the outcome of the US general elections, coupled with favourable macroeconomic conditions, could be a serious price catalyst for Bitcoin in the coming months through to 2025.