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Factor Returns Around the Fed Pivot

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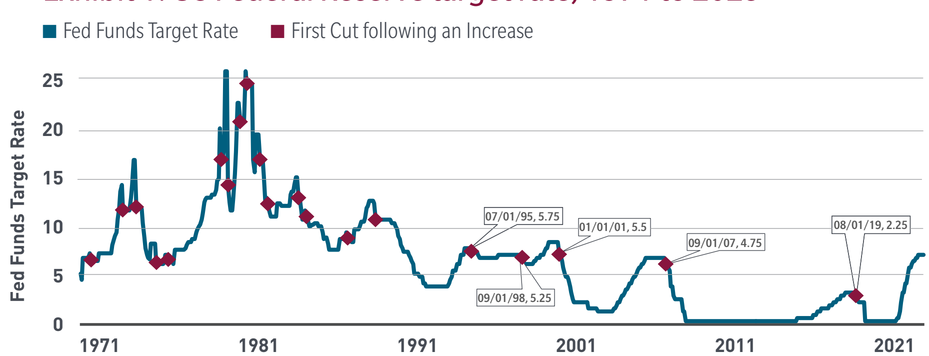
In brief

- Our factor models have worked in both periods leading up to and following the first rate cut after a period of increases.
- Historically, in the year prior to the first cut, price momentum, value, quality and sentiment themes have had positive returns.
- In the year following the first cut, value and sentiment theme returns have tended to decrease while price momentum and quality returns have been comparable to those of the pre-cut period.

As we move further into 2024, the consensus among market participants is that the US Federal Reserve will likely cut the federal funds target rate this year after having been in the rising rate environment that has existed for the past few years. While the timing and magnitude of those cuts may be evolving, we thought it would be useful to understand factor returns in past episodes where the Fed began cutting rates after a period of rate increases.

For our analysis we use the federal funds target rate. We define rate increases as all points when the target rate rose at least 20 basis points. We define decreases as all points where it dropped at least 20 basis points. There are some subtleties regarding the exact timing of the rate changes. For instance, during the 1980s the Fed de-emphasized money supply and began targeting interest rates. We used a threshold of 20 bps to screen out small changes in the target rate occurring in the period before rate targeting began while still including all changes of 25 bps or more in the then-current era. We then identified all initial cuts in the target rate that occurred following a period of increasing rates. There are 20 such instances, highlighted in red on the chart in Exhibit 1 below. We have called out the dates of the last five cuts and the rate in place before the Fed cut.

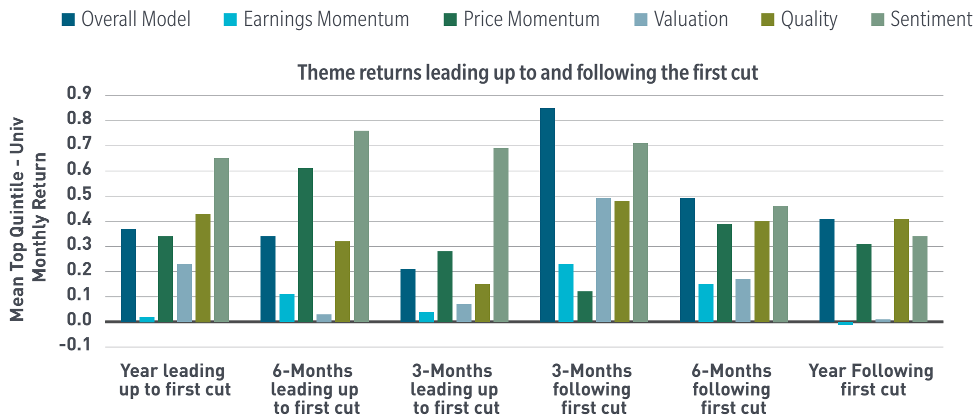
Exhibit 1: US Federal Reserve target rate, 1971 to 2023



FactSet. Methodology for identifying rate changes is taken from the December 2023 Hussman Funds publication, "The Secret Life of Fed Pivots." The Federal Open Market Committee (FOMC) meets eight times a year to determine the federal funds target rate. This rate influences the effective federal funds rate through open market operations or by buying and selling of government bonds.

Using this rate framework, we look at returns of our US stock selection model and its themes — value, quality, earnings momentum, price momentum and sentiment. In Exhibit 2 we show average factor returns from the end of 1994 through year-end 2023. We compare the average monthly top-quintile return versus universe returns over the year leading up to and the year following the past five initial rate cuts noted above.

Exhibit 2: Average monthly returns before and after initial fed funds rate cut



Source: FactSet. Data represents the performance difference between the top quintile stocks versus the universe for the MFS US Large-Cap stock selection model. The US Large Cap universe is the 1000 largest stocks by market cap, drawn from all stocks meeting the following criteria: 1) A member of the S&P 500 or Russell 3000. 2) Has at least two sell-side analyst earnings estimates. The universe is designed to be representative of US Large Cap, liquid stocks. Average factor returns for the periods identified in percent/month.

Looking at the first set of rows in the table, we see that historically, the quarter following an initial rate cut has seen relatively high model returns, with those returns coming mostly from the value, quality and sentiment themes. As we lengthen the look-back and look-ahead windows, we see pre- and post-cut performance come more into line with each other. By the time we are looking out a year after the first cut, model returns are roughly in line with those during the year before it, with model returns in the year following it coming primarily from price momentum, quality and sentiment.

Overall model returns in the year following the first cut are on average slightly higher than in the year preceding it (0.41% vs. 0.37%), even though average theme returns are generally higher in the year preceding it. While this is a little counter-intuitive, it is explained by the fact that theme returns are also more volatile in the year leading up to the first cut, thus lowering the composite model average returns. This shorter-term benefit is reflected in the performance of our sentiment model. Over the long term, this factor theme has generally been a smaller contributor to alpha generation across our Blended Research product suite.

A longer-term view

To look over a longer history, we used the same rate change framework, but in place of our model returns we utilize factors constructed by Kenneth French. Our analysis covers the period from 1971 through 2023 and compares the returns of the cap-weighted top decile to the cap-weighted market for those factors that capture price momentum, valuation and quality of earnings.

As with the previous analysis, we see that in the first few months following a cut, returns to certain valuation factors such as book-to-market, earnings yield, and cash flow yield have been higher than in the period preceding those rate cuts. As we extend the horizon this difference becomes smaller, indicating that there is an initial wave of optimism regarding the prospects for cyclical or financing dependent value stocks that typically reverts.

Unlike what we see from our stock selection models, the Ken French price momentum factor had higher average returns in the period following an initial rate cut. An evaluation of history shows not only that this pattern for the Ken French momentum factor is more pronounced in the period before our model returns begin in 1994, but also that it is true of the Ken French momentum factor through history, while it is not true of the MFS price momentum theme over the last 30-odd years. We believe this difference is due both to the historical window used and factor construction.

Exhibit 3: Average monthly returns for price momentum, valuation and quality 1971 to 2023

Highest — Lowest

Factor Category	Price Momentum	Valuation				Quality	
Factor	12-Month Price Momentum	Book / Market	Earnings / Price	Cash Flow / Price	Dividend Yield	Accruals	Operating Profitability
3-Months Leading up to first cut	0.02	-0.12	-0.18	-0.04	0.81	0.22	0.03
3-Months Following first cut	0.97	1.03	0.29	0.29	0.34	-0.15	0.04
Following - Before	0.95	1.15	0.47	0.33	-0.47	-0.37	0.02
6-Months Leading up to first cut	0.52	0.34	0.32	0.26	0.42	0.40	0.08
6-Months Following first cut	0.73	0.79	0.43	0.31	0.08	0.18	0.01
Following - Before	0.22	0.45	0.10	0.05	-0.35	-0.22	-0.07
Year Leading up to first cut	0.45	0.57	0.38	0.42	0.47	0.12	0.10
Year Following first cut	0.56	0.40	0.40	0.28	-0.08	0.16	0.13
Following - Before	0.11	-0.16	0.02	-0.14	-0.55	0.04	0.04

Source: Calculated from factor returns available at Kenneth R. French's data library. Copyright 2024 Kenneth R. French. Factor returns do not represent actual portfolio returns and ignore transaction costs. Past results are not indicative of future results.

What does it all mean for investors?

Looking at these results, an investor may ask, "If we know the Fed is going to start cutting rates in a few months, would it make sense to reduce exposure to value factors until we see the first rate cut?"

While it is true that on average value factors have had lower average returns in the period before the first cut, there has been some variability in this result depending on the specific historical period. For example, in the months leading up to the initial rate cut of January 2001, value factors tended to do well, whereas in the period leading up to the initial rate cut of September 2007 they performed more in-line with other factors. The findings above would be most helpful for understanding the likely factor dynamics in play around turning points in the interest rate cycle that could in turn help set reasonable expectations for portfolio returns over the near term, yet they are not necessarily significant enough that they could use to time factor exposures. For those investors with a long-term perspective, we believe that a diversified, strategic allocation to factors will be more effective in capturing compelling returns.

Looking ahead

If the coming year plays out as expected and the Fed begins cutting rates, we believe our models will continue having positive returns. We should see the underlying factors driving those returns before and after the cut change. We might also see an initial wave of positive returns to valuation factors, with returns to those factors becoming more muted as time progresses after the initial cut. Returns to price momentum factors may decrease immediately following the initial cut, with reversion to mean levels following it. In the year following the first rate cut, history indicates we should expect to see positive model returns driven primarily by price momentum, quality and sentiment factors.

Representative sample of factors:

Momentum: Change in earnings estimates, 9-to-12-month price momentum, 1-month price reversal

Valuation: Adjusted dividend yield, EV/EBITDA, Price/tangible book, EV/intangible assets, Discount to DCF fair value

Quality: Free cash flow margins, Operating profitability, Accruals, Operating liability leverage, Turnover

Sentiment: Share buybacks, Short interest, Change in leverage, Change in financial report language

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