MFS® White Paper

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Declining Interest Rates Have Historically Signaled Positive Relative Performance for Global Low Volatility

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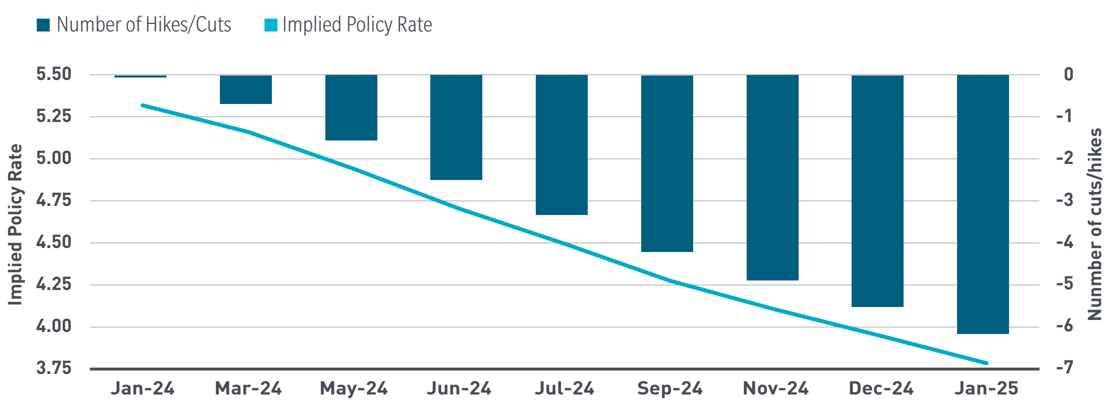
In brief

- Declining interest rates, particularly those that coincide with successive rate cuts, are typical of late economic cycles, when equity markets tend to behave more defensively, therefore favoring low volatility.
- In recent decades, higher dividend yields have not been clearly associated with a declining rate environment.

Capital markets are completing the transition from an environment that has featured quantitative easing, low interest rates and low inflation to one in which Treasury bond yields have reached levels not seen in 20 years. So this may be the time to set expectations for how global low-volatility strategies may perform in a declining rate environment. The market expects the US federal funds target rate to begin declining in Q1 2024 from the current level of greater than 5% to land below 4% by 2025.

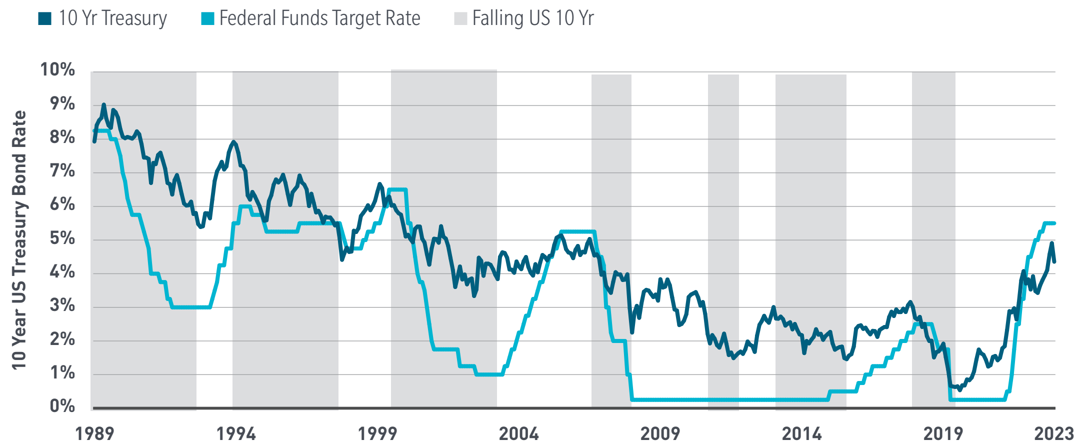
Exhibit 1: Expectations for Fed rate cuts in 2024



Source: Bloomberg. Implied rate is derived from rate cut projections based on pricing of federal funds futures contracts on 9 January 2024.

We looked at the path of interest rates since 1990 and identified periods of increasing and decreasing rates based on US Federal Reserve action regarding the target federal funds rate. As shown in Exhibit 2, shifts in policy have historically corresponded with the direction of the US 10-year yield.

Exhibit 2: Fed policy and the direction of rates since 1990

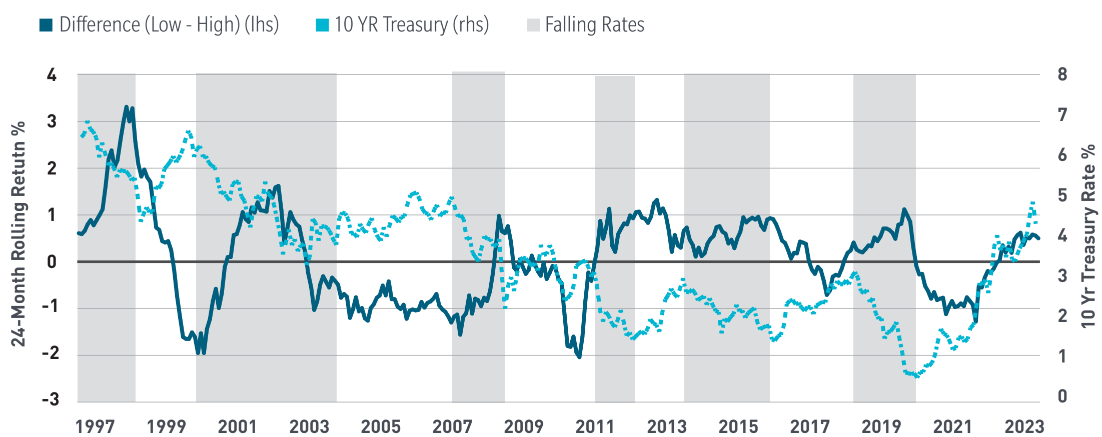


Source: Bloomberg. The Federal Open Market Committee (FOMC) meets eight times a year to determine the federal funds target rate. This rate influences the effective federal funds rate through open market operations or by the buying and selling of government bonds.

How have low-volatility stocks behaved in recent declining rate environments?

Exhibit 3 below compares the rolling 24-month performance for the lowest-volatility quintiles ("Q1 + Q2") to the highest-volatility quintiles ("Q4 + Q5") of stocks within the MSCI ACWI and it demonstrates the tendency, since 2004, of lower-volatility stocks to outperform as rates decline (darker shaded periods).

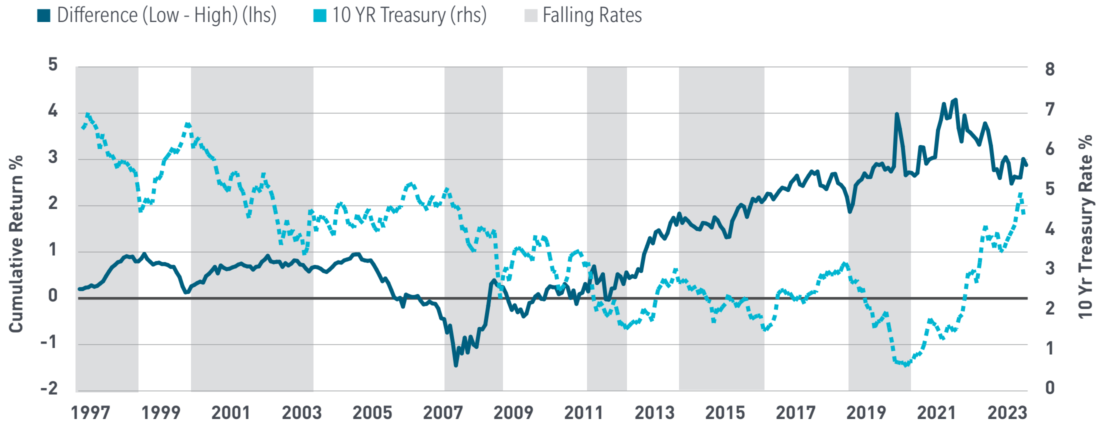
Exhibit 3: Low-volatility stocks tend to outperform high as rates fall



Source: FactSet. Monthly data from 31 January 1997 to 30 November 2023. Low-volatility stocks are the stocks within the two lowest- volatility quintiles within the MSCI ACWI. High-volatility stocks are the stocks within the two highest-volatility quintiles with the MSCI ACWI. Shaded areas indicate declining 10-year treasury rates.

Exhibit 4 shows us that despite the relative strength of low-volatility stocks during 2022, high volatility has sharply outperformed since the latter half of 2020.

Exhibit 4: High-volatility stocks have outperformed in recent years

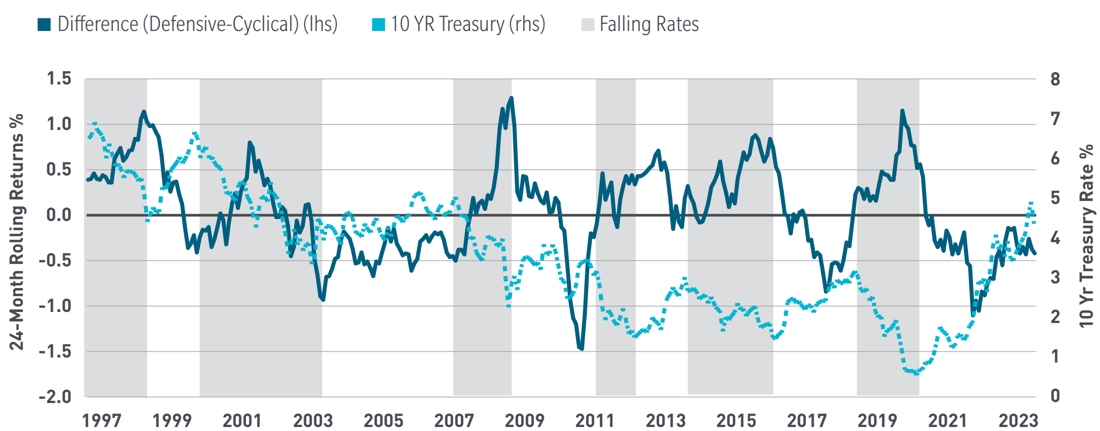


Source: FactSet. Monthly data from 31 January 1997 to 30 November 2023. Low-volatility stocks are the stocks within the two lowest volatility quintiles within the MSCI ACWI. High-volatility stocks are the two highest-volatility quintiles with the MSCI ACWI. Shaded areas indicate declining 10-year treasury rates.

Why has lower volatility outperformed during declining rate environments?

Cyclical sectors such as retailing, autos, housing, and materials tend to experience relative weakness after rates reach their cyclical peaks and economic growth slows. Comparing rolling 24-month performance, history suggests that companies with more cyclical exposure tend to underperform during periods of declining rates. This was the case from 2008 to 2009, from 2012 to 2013, from 2015 to 2016 and from 2019 to 2020. During periods of rising rates from 2004 to 2023, cyclical sectors outperformed defensives.

Exhibit 5: Defensives have tended to outperform when rates decline



Source: FactSet. Monthly data from 31 January 1997 to 30 November 2023. Cyclical sectors within the MSCI ACWI include energy, financials and materials. Defensive sectors include consumer Staples, health care and utilities. Shaded areas indicate declining 10-year Treasury rates.

Conclusion

Our analysis was conducted to address how low-volatility stocks may perform considering the market consensus rate assumptions, which currently anticipate rates cuts, and a declining rate environment for 2024. In this environment, recent cycles suggest that low-volatility stocks have typically outperformed higher-volatility stocks and going forward may provide diversification to portfolios with exposure to higher-volatility and cyclical stocks.