MFS® White Paper

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

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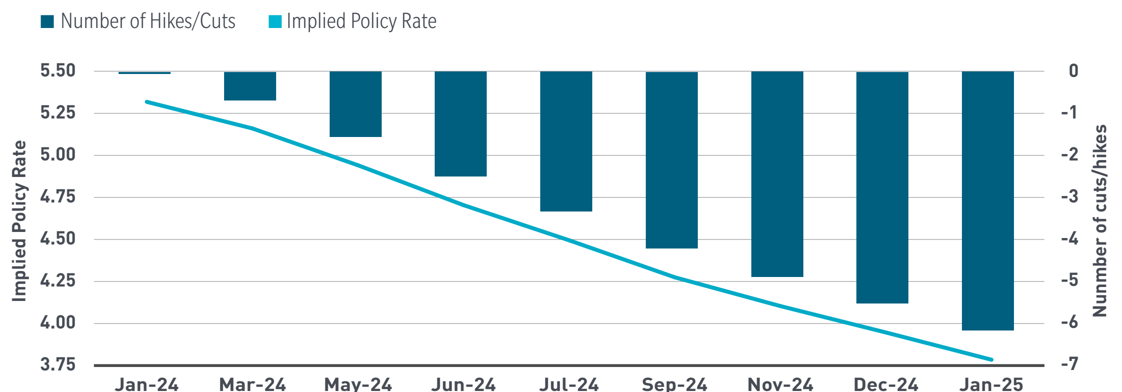
In brief

- 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 do not suggest a clear relationship with a declining rate environment.

As capital markets complete the transition from an environment that featured quantitative easing, low interest rates and low inflation, to one in which treasury bond yields have reached levels we have not seen in 20 years, it may be time to set expectations for how global low volatility strategies may perform in a declining rate environment. Market consensus expects the US federal funds target rate to begin declining in Q1 2024 from the current level of greater than 5% and 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 back at the path of interest rates since 1990 and identified periods of increasing and decreasing rates based on action by the US Federal Reserve regarding the target federal funds rate. The shift in policy historically has aligned very closely with the direction of the US 10-year yield.

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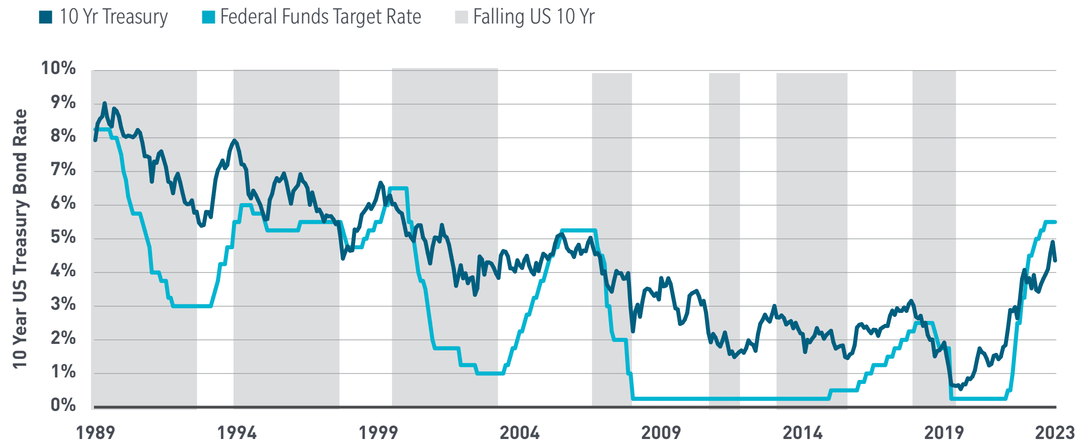
Exhibit 2: Fed policy and the direction of rates since 1990

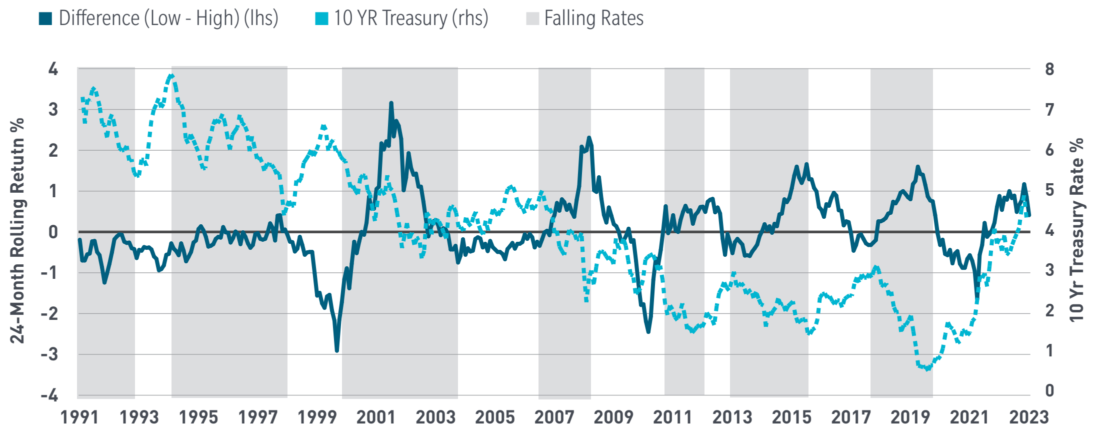


Source: Bloomberg. The Federal Open Market Committee (FOMC) meets eight times a year to determine the federal funds target rate. This rate influences the effective federal funds rate through open market operations or by the buying and selling of government bonds.

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

The chart below compares rolling 24-month performance for the lowest volatility quintiles ("Q1 + Q2") to highest volatility ("Q4 + Q5") of stocks within the Russell 1000® Index and it demonstrates the tendency since 2004 for lower volatility stocks to outperform as rates decline (darker shaded periods).

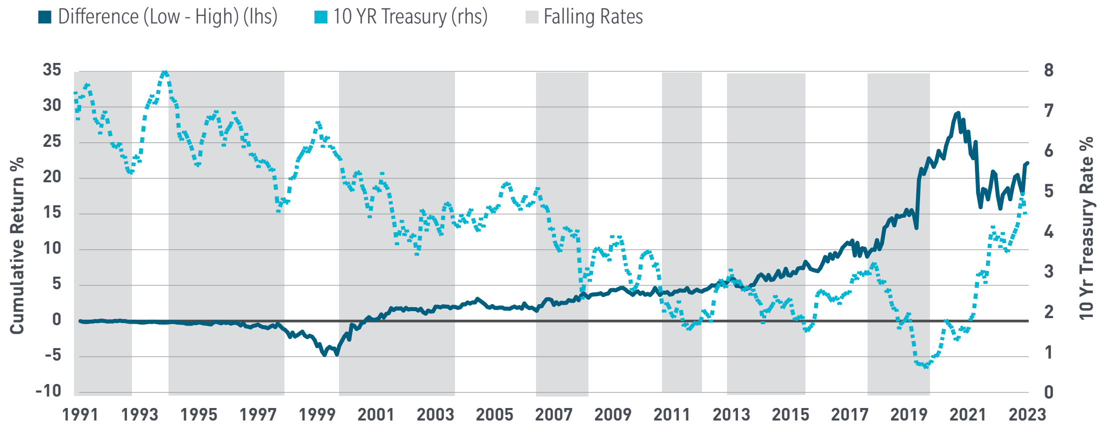
Exhibit 3: Low-volatility stocks tend to outperform high as rates fall



Source: Factset. Monthly data from 29 November 1991 to 30 November 2023. Low volatility stocks are the stocks within the two lowest volatility quintiles within the Russell 1000® Index. High volatility stocks are the two highest volatility quintiles with the Russell 1000® Index. 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

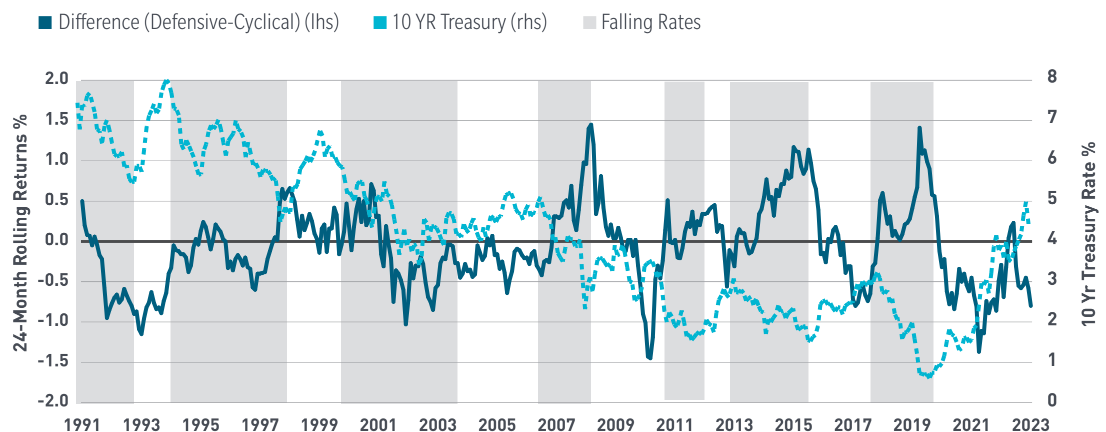


Source: Factset. Monthly data from 29 November 1991 to 30 November 2023. Low volatility stocks are the stocks within the two lowest volatility quintiles within the Russell 1000® Index. High volatility stocks are the two highest volatility quintiles with the Russell 1000® Index. Shaded areas indicate 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. The chart shows that this was the case during 2008 to 2009, 2012 to 2013, 2015 to 2016 and 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 29 November 1991 to 30 November 2023. Cyclical sectors within the Russell 1000® Index 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 rate cuts, and a declining rate environment for 2024. For 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.

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