MFS® White Paper

November 2025

Declining Rates Favor Low Volatility

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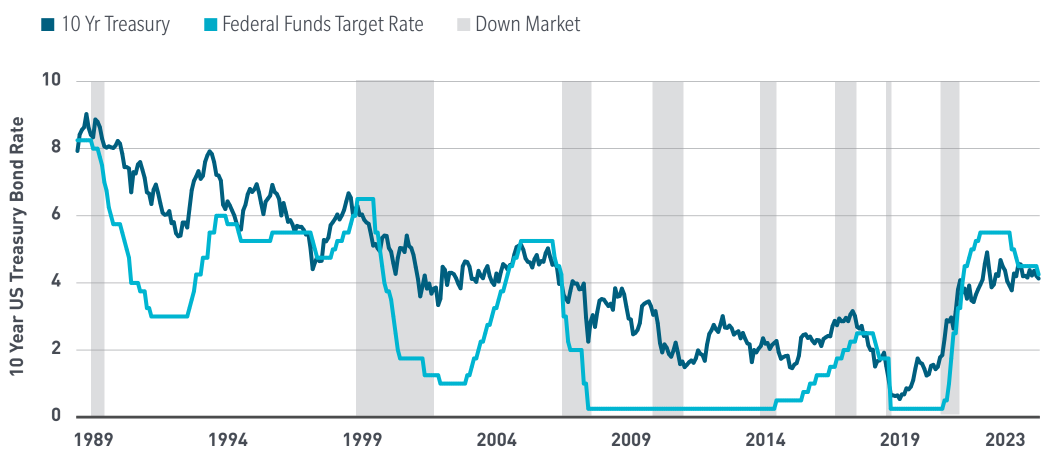
In brief

- 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.

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 continue declining from the current level of 4.0%.

We looked at the path of interest rates since 1990 and identified periods where the market was down (when ACWI was down for consecutive months) to see how down-markets typically correspond to periods of declining rates. As shown in Exhibit 1, shifts in policy and the direction of the US 10-year yield, typically correspond to market underperformance.

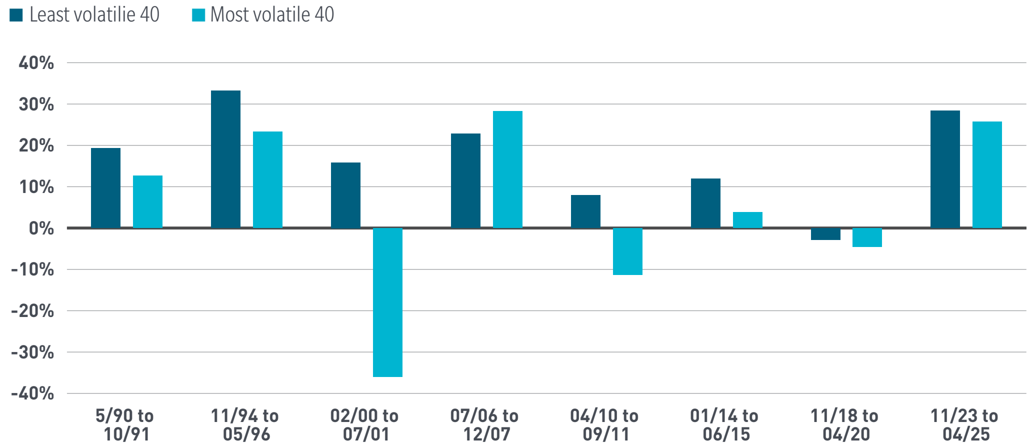
Exhibit 1: Fed policy and the direction of rates since 1990



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.

We also have seen low volatility stocks outperforming in the months following a rate peak in most of the last cycles, as shown in exhibit 2.

Exhibit 2: The performance of low volatility stocks following a rate cut

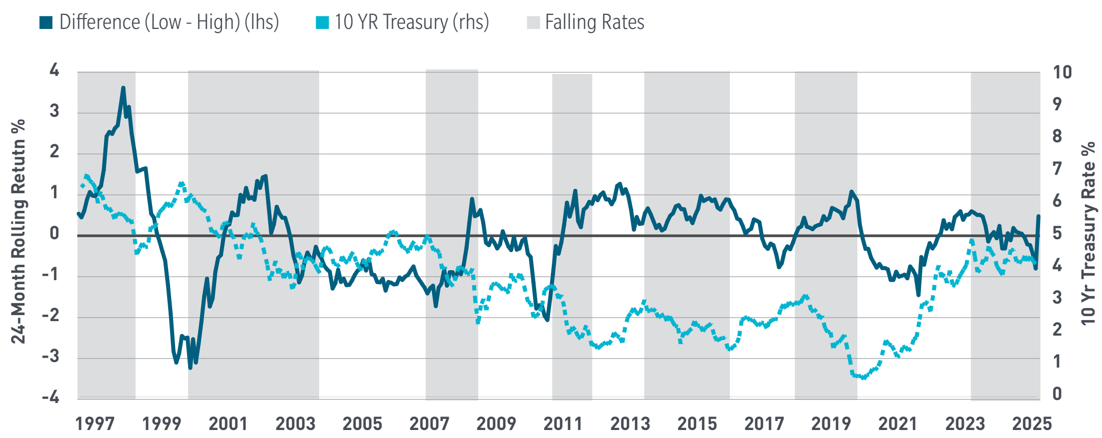


Source: Factset. Monthly data from January 1990 to 30 September 2025. Low-volatility stocks are the stocks within the two lowest- volatility quintiles within the MSCI ACWI. High-volatility stocks are the stocks within the two highest-volatility quintiles with the MSCI ACWI.

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

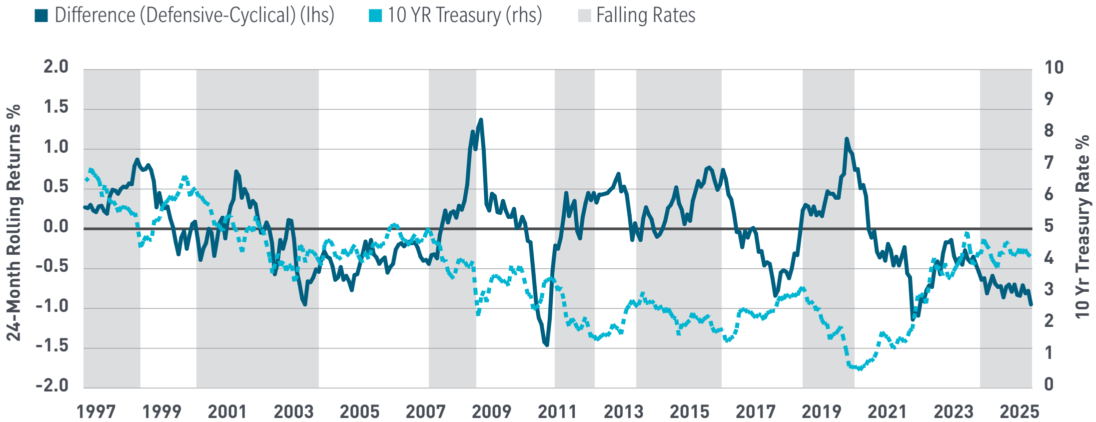
Exhibit 3 below compares the rolling 24-month performance for the lowest-volatility quintiles ("Q1 + Q2") to the highest-volatility quintiles ("Q4 + Q5") of stocks within the MSCI ACWI and it demonstrates the tendency, since 2004, of lower-volatility stocks to outperform as rates decline (darker shaded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

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



Source: FactSet. Monthly data from 31 January 1997 to 30 September 2025. 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: Defensives have tended to outperform when rates decline



Source: FactSet. Monthly data from 31 January 1997 to 30 September 2025. 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.

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.

Conclusion

Our analysis was conducted to address how low-volatility stocks may perform considering the market consensus rate assumptions, which currently anticipate additional rates cuts, and a declining rate environment for 2026. 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.