MFS® White Paper

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Declining UK Interest Rates Tend to Signal Positive Relative Performance for Low Volatility

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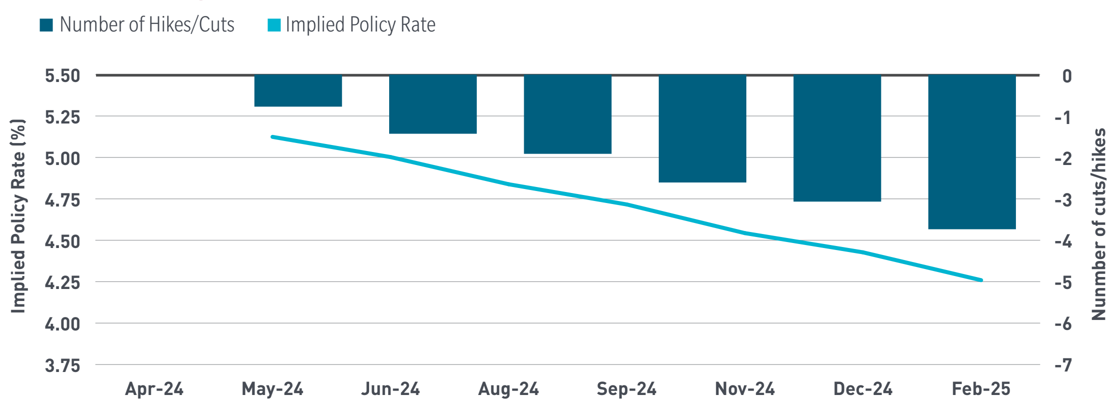
In brief

- **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, favoring low volatility.**
- **In recent decades, higher dividend yields do not suggest a clear relationship 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 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 will perform in a declining rate environment. The market expects the Bank of England's Bank Rate to begin declining in Q1 2024 from the current level of greater than 5% to around 4.3% by 2025.

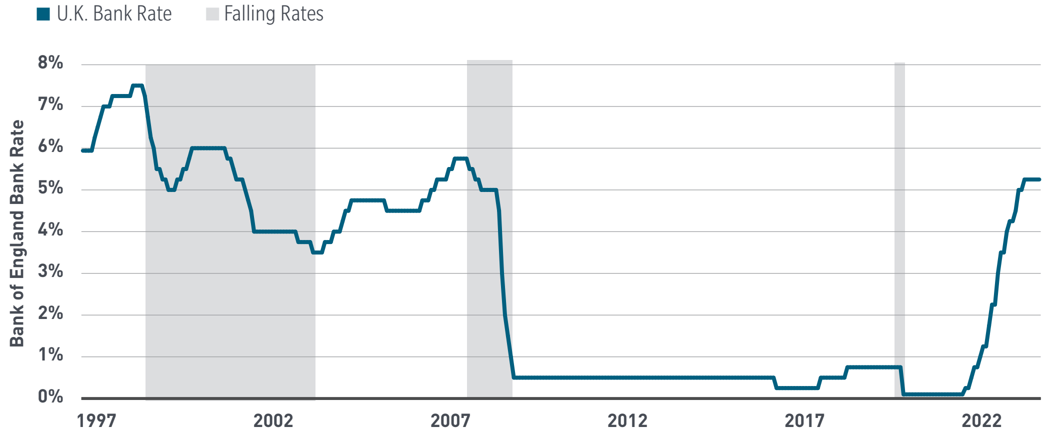
Exhibit 1: Expectations for BOE rate cuts in 2024



Source: Bloomberg. Implied rate is derived from rate cut projections based on pricing of futures contracts on 26 March 2024.

We looked at the path of interest rates since 1997 and identified periods of increasing and decreasing rates based on BOE's action regarding the Bank Rate, as shown in Exhibit 2.

Exhibit 2: BOE policy and the direction of rates since 1997

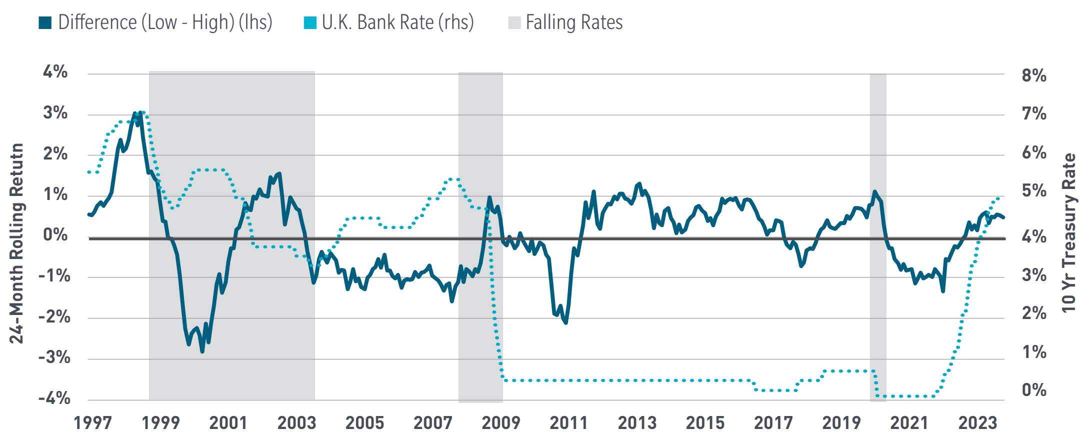


Source: Bloomberg. In the United Kingdom, benchmark interest rate is set by the Monetary Policy Committee (MPC). The Bank of England official interest rate is the repo rate. This repo rate applies to open market operations of the Bank of England.

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 1998, of lower-volatility stocks to outperform as rates decline (darker shaded periods).

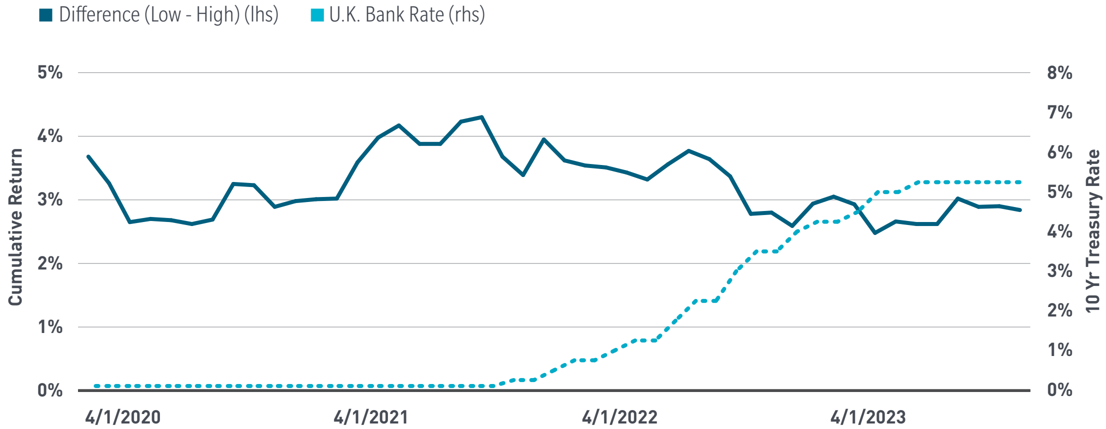
Exhibit 3: Low-volatility stocks tend to outperform high as rates fall



Source: FactSet. Monthly data from 31 January 1997 to 1 January 2024. 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 second half of 2021.

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

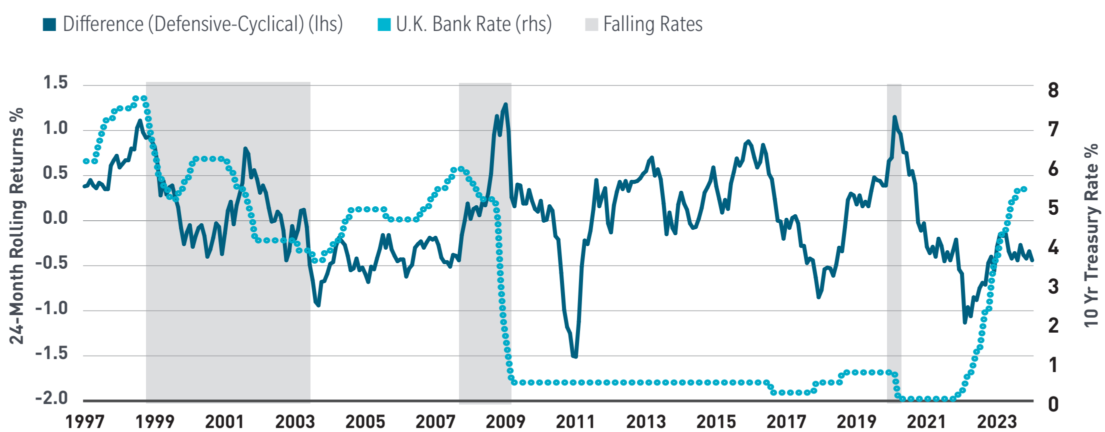


Source: FactSet. Monthly data from 31 January 1997 to 1 January 2024. Low-volatility stocks are the stocks within the two l owest-volatility quintiles within the MSCI ACWI. High-volatility stocks are the stocks within the two highest-volatility quintiles with the MSCI ACWI.

Why has lower volatility historically 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. A historical comparison of rolling 24-month performance suggests that companies with more cyclical exposure tend to underperform during periods of declining rates (darker shaded). The chart shows that this was the case during 1998 to 2003, 2008 to 2009, and 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 1 January 2024. 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.