Navigating FOMC Rate Cutting Cycles

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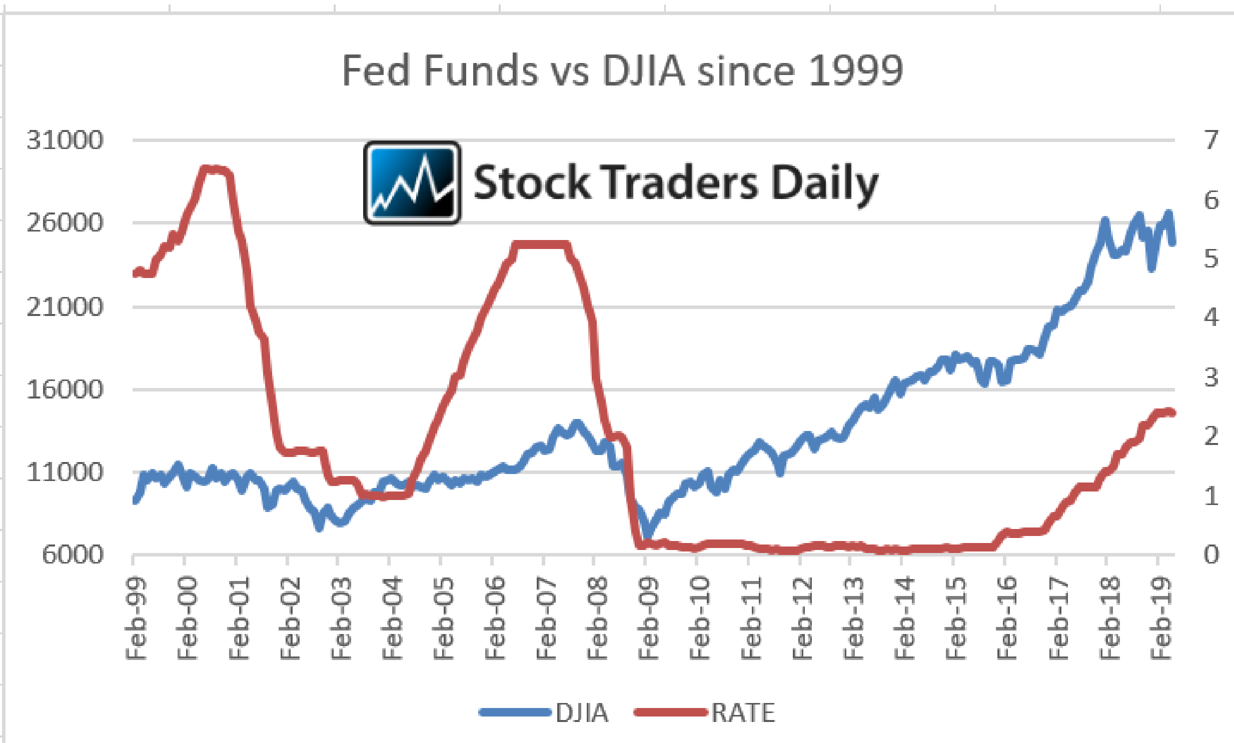
Optimism surrounding a rate cut by the FOMC is unfounded. Historically, when the FOMC cuts interest rates the market performs poorly, and when interest rates increase the market performs well.

We will use the chart below to demonstrate our findings and offer suggestions. The tables included in this report also offer 2 different Models that quantify portfolio performance given this correlation.

The conclusion is that if funds and asset managers protect investments when interest rates are first cut they will realize much lower volatility and an increased probability of material outperformance.



Based on the chart above we can see that over the past 20 years when interest rates were being cut the market fell aggressively. These times were also defined by the unwinding of the Internet Bubble and the Credit Crisis. Significant amounts of volatility existed during these periods.

Therefore, anyone who protected portfolios when interest rates began to be cut avoided significant amounts of volatility during overall market declines.

This is logical, but also counter intuitive to the opinion on the Street when the notion of an interest rate cut is put on the table. Investors seem to always think that interest rate cuts are a good thing for the stock market, but historically, and this was true even before 1999, when interest rates are being cut the stock market tends to decline, sometimes aggressively.

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Not surprisingly, interest rates are cut during times of economic weakness, and equity prices tend to fall during times of weakness, so interest rate cuts and market declines often go hand in hand.

Conversely, when interest rates increase it is because economic conditions are getting better, and the stock market often acts favorably when conditions improve. The chart pattern above shows steady increases during times when interest rates were increasing, supporting this point as well.

Therefore, investors who protect portfolios when interest rates are being cut and who expose portfolios to the market when interest rates are going up avoid substantial amounts of volatility and experience a much steadier overall performance.

This does not imply outperformance yet; there is a tradeoff.

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Model 1:

In the table below we have calculated performance based on acting along with FOMC decisions as described above. The actionable times correlate to when the FOMC made their first decisions to cut interest rates or increase interest rates respectively. We assume that portfolios are neutralized against all market risk when interest rates are first being cut, and portfolios are then again exposed to the market when interest rates are first increased, starting with the first cut or raise respectively.

As mentioned, in Model 1 volatility levels are significantly reduced, with a tradeoff. Portfolios who subject themselves to the volatility have outperformed those portfolios that remove the volatility in this model by 7% over time.

Therefore, the question for your portfolio is would you prefer lower volatility and a 7% lower rate of return, or greater volatility and same as market returns?

A better question, further addressed below, is would you prefer to remove market exposure before markets fall and avoid volatility, and then buy at what would be long-term market troughs instead? This is possible too given the FOMC Rate cycles offered above, but with one more hurdle to cross; we'll discuss that next.

Result from acting after the first FOMC decision to cut or raise during a cycle:

Model 1: Acting When the FOMC Acts

Action	Date	DJIA	Net	Model 1	% Diff
Rate Hike	Feb-99	9307	0		
Rate cut	Jan-01	10887	1581	1581	
Rate hike	Jul-04	10140	-748		
Rate cut	Sep-07	13896	3756	3756	
Rate hike	Feb-16	16517	2621		
Today	Jun-19	26618	10102	10102	
Net		17311		15439	
Diff				-1872	-7.03%

The right hand column of the table above shows us that the net gain from a portfolio that was neutralizing itself when interest rates were cut and exposing itself when interest rates were increasing achieved a gain that was roughly 7% lower than the market itself during this same time frame.

During that time this portfolio also avoided the declines associated with the collapse of the Internet Bubble and the Credit Crisis, making it a great option for investors who want to reduce volatility, but there's also something here for more aggressive portfolios who want to maximize returns.

A Variation of this model can be used to achieve outperformance too.

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Model 2:

One way is obviously to use the short side of the market, but in Model 2 below we will stick with the long side only. With shorts, if the market declines aggressively when the FOMC is cutting interest rates, then shorting the market when the FOMC is cutting interest rates can be extremely profitable.

The catch with shorting the market is that decisions need to be made about when to cover those short positions too. According to the chart above the best time to cover short positions that were established when interest rates began to be cut is when the rate cuts stop.

For clarification, rate cuts can stop well before interest rates start to increase. Therefore, the end of a rate cutting cycle often requires an additional level of understanding.

However, for funds and investors who are capable of identifying the end of a rate cutting cycle, not only would that be the best time to cover short positions, but when the FOMC stops cutting interest rates it has also historically been the best time to buy. That is where Model 2 presents its added value.

Where Model 1 above suggests a 7% under performance without the volatility, a model that exposes the portfolio to market conditions when rate cuts stop rather than when rate hikes begin outperforms the market by 31.73%.

Model 2: Buy When Rates Cuts Stop					
Action	**Date**	**DJIA**	**Net**	**Model 1**	**% Diff**
Rate Hike	Feb-99	9307	0		
Rate cut	Jan-01	10887	1581	1581	
Cuts Stop	Sep-03	9275.06	-1612		
Rate cut	Sep-07	13896	4621	4621	
Rate hike	Feb-09	7062.93	-6833		
Today	Jun-19	26618	19555	19555	
Net		17311		25757	
Diff				8446	31.73%

Ultimately, the decision of the FOMC to cut rates has been proven to be a negative indicator for the stock market until such time as the FOMC stops cutting rates. The notion in layman circles and in the media is often that interest rate cuts will benefit the stock market, but that is not what history tells us.

History tells us we can use these FOMC cycles to navigate the market, but when interest rates are being cut markets are likely to fall, so the mindset should actually be the opposite of what the masses seem to think. Isn't that almost always the case 😉.

Companies: GS, MS, JPM, BLK, WFC, BAC, C, PRU, UBS

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