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How the US Equity Market Could Outperform as Inflation and Interest Rates Fall

With the Fed expected to cut rates soon, some stock sectors and styles may benefit right away.

More and more, investors are focusing attention on what the expected fall in inflationary pressures means for the performance of different areas of the equity market. Historically, when US inflation approaches the Federal Reserve's (Fed) 2% target, the momentum style and technology stocks have generally shown stronger performance.

However, it's important to note that this is only one aspect of the overall picture. The fall in inflation provides room for the central bank to cut rates. In fact, a year after the first rate cut by the Fed, US stocks have typically delivered double-digit returns. At the same time, the growth environment matters particularly when recessions lead to a more aggressive rate-easing cycle. With interest rates likely to fall in the coming months, which sectors and styles of the stock market typically do well after the first rate cut?

Insight from sub-adviser Schroders Investment Management

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Key Points

- A year after the first Federal Reserve rate cut, US stocks have typically delivered double-digit returns.
- Most cyclical sectors typically perform poorly in the initial three months after the first rate cut, particularly when the cut occurs during a US recession. Outperformance has historically followed within a year.
- On average, the momentum style has been the best-performing area of the market during past rate-cutting cycles and, to a lesser extent, quality and growth stocks.

After the First Rate Cut, Defensive Sectors Tend to Outperform their Cyclical Peers

For the analysis on sectors, we have grouped them into cyclicals and defensives based on their sensitivity to the overall market. For instance, the cyclical sectors, such as technology, typically outperform even more when the market rises, but also decline more when the market falls.

FIGURE 1 shows that defensive sectors have tended to outperform their cyclical peers following the first rate cut by the Fed. This is especially evident during recessions, which is likely due to investors seeking areas of the market that are most likely to withstand the weaker growth environment and benefit from more aggressive rate cuts.

FIGURE 1: Defensive Sectors Have Outperformed After the First Rate Cut

Annualized Returns vs. Overall Market, 1980 to 2024 (%)

	Time period after the firste rate cut					
	All Periods			Recessions		
Cyclical Sectors	3m	6m	12m	3m	6m	12m
Consumer Discretionary	12.9	5.8	6.2	15.9	9.2	10.4
Energy	-18.7	-9.3	-8.5	-14.1	-9.4	-12.2
Tech	-0.9	-0.8	5.9	-1.7	1.2	6.4
Materials	-3.6	-13.0	-1.3	-1.7	2.4	-18.4
Financials	4.6	6.4	1.3	-0.4	4.2	13.8
Industrials	-2.5	0.2	3.1	0.0	0.0	-6.6
Defensive Sectors						
REITs	11.1	6.3	3.5	28.3	19.7	11.8
Consumer Staples	15.0	3.0	5.5	19.6	5.7	9.1
Utilities	3.8	-1.9	-1.3	9.1	1.9	0.7
Healthcare	7.4	2.4	5.7	10.3	1.9	8.5
Communications Services	18.1	11.5	3.1	15.8	1.2	1.2

As of 7/10/24. **Past performance does not guarantee future results.** Indices are unmanaged and unavailable for direct investment. Performance based on total returns using DataStream sector indices vs. the MSCI USA Index. Annualized returns based on average returns. Recessions occurred in 7 out of the 11 rate-cutting periods from 1980 to 2024. Data Sources: LSEG and Schroders Economic Group.

By contrast, most cyclical sectors typically perform poorly in the initial three months after the first rate cut, particularly when the rate cut occurs during a US recession. But a year after the start of the easing cycle, cyclical sectors have historically delivered stronger returns.

Initially, cyclicals sell off on the back of the rate cut, which may be in response to the weaker growth and inflation backdrop. But, at some point, these areas of the market become attractive as the equity valuations of these stocks become cheaper and investors anticipate the rate cuts boosting economic activity and corporate earnings. That said, both financials and consumer-discretionary sectors have been the exceptions, as they have generally done well even in the initial months after the first cut.

Interestingly, the technology sector has historically underperformed the broader market in the first few months after a rate cut. But its performance has been negatively skewed by the big sell-off during the technology-bubble recession in the early 2000s. Without this period, technology stocks usually achieve positive returns when rates are cut.

Initially, cyclicals sell off on the back of a rate cut, which is likely in response to the weaker growth and inflation backdrop.

How Do Equity Styles Perform During Rate-Cutting Cycles?

The momentum style has, on average, been the best-performing area of the market during past rate-cutting cycles (**FIGURE 2**). These stocks would have been performing very well before the rate-cutting cycle, and we believe the pick-up in investor sentiment following the first cut is only going to boost that performance.

FIGURE 2: Momentum Style Has Outperformed After the Fed Begins to Cut Rates

Annualized Returns vs. Overall Market, 1980 to 2024 (%)

	Time period after the first rate cut					
	All Periods			Recessions		
Equity Styles	3m	6m	12m	3m	6m	12m
Momentum	3.7	1.7	3.5	0.6	-1.4	2.7
Quality	0.1	1.1	1.4	-1.1	1.1	1.3
Growth	-1.5	1.1	2.4	-3.7	0.0	2.4
Value	1.0	-1.8	-2.8	4.0	-0.1	-2.7
Small	0.3	-2.4	-1.4	6.9	6.1	2.7
Minimum Volatility	-1.7	-1.1	-1.9	4.4	1.5	1.0

As of 7/10/24. **Past performance does not guarantee future results.** Indices are unmanaged and unavailable for direct investment. Performance based on total returns using MSCI style indices vs. MSCI USA Index. For small caps, S&P SmallCap 600 Index is used for analysis. Anualized returns based on average returns. Recessions occurs in 7 out of the 11 rate cutting periods from 1980 to 2024. See last page for factor definitions. See back page for index definitions. Sources: LSEG and Schroders Economic Group.

To a slightly lesser extent, quality and growth stocks have historically generated positive returns during rate-cutting cycles. This is consistent with our previous analysis on these equity styles performing well in a low inflationary environment. Growth, quality, and momentum stocks perform worse when the rate-easing cycle occurs in recessions. This might be because investors rotate into the more defensive areas of the market, such as the minimum-volatility style.

Even small caps tend do well after the first rate cut during recessions. It may be that small caps benefit from the more aggressive rate cutting that occurs in recessions. However, it's worth bearing in mind that our analysis is dependent on the time horizon. For example, analysis of small caps back to the 1920s shows that they have historically outperformed the market a year after the first rate cut (**FIGURE 3**).

FIGURE 3: Performance of Small Cap vs. Overall Market During Rate-Cutting Cycles

Date of First Cut	Small vs. Large Cap Performance (%)
9/30/1929*	-19.1
12/31/1931*	3.1
3/31/1933*	155.6
11/30/1953*	-5.0
10/31/1957*	16.3
5/31/1960*	9.4
11/30/1966	46.6
2/28/1970*	-10.4
9/30/1971	-11.5
9/30/1973*	4.9
7/31/1974*	20.0
4/20/1980*	45.7
1/31/1981*	10.6
7/31/1981*	0.7
4/20/1982*	19.0
8/31/1984	-6.8
5/31/1989	-20.3
6/30/1995	4.2
9/30/1998	-5.3
12/31/2000*	34.1
7/31/2007*	-2.3
7/31/2019*	-24.8
Average: All Periods	**12.0**
Average: No Recession	**1.2**
Average: Recession	**16.1**

As of 1/30/24. * Recession occurred within 12 months. Data Sources: CFA Institute Stocks, Bonds, Bills, and Inflation (SBBI) database, Federal Reserve Economic Data (FRED)/Federal Reserve Bank of St. Louis, and Schroders Economics and Strategy Group.

But since the mid-1980s, small caps have historically underperformed the broader market after the first rate cut (this is the starting period of our analysis). The difference is likely due to changes in the composition of sectors in the small-cap universe, which has increased its share of financial and real-estate companies but reduced its exposure of technology and consumer-discretionary sectors. That said, the sector exposures of equity styles are dynamic, and the past investment playbook does not guarantee future performance.

Conclusion

Given our baseline view of no recession in the US and the anticipated rate cut by the Fed in September, momentum, growth, and quality stocks may outperform. This finding is consistent with our analysis of these equity styles within a low inflationary backdrop. At the same time, defensive sectors compared to their cyclical peers may also benefit in an environment where rates are being cut.

Talk to your financial professional to help you build a diversified equity portfolio that's right for you.

Factor Definitions: Momentum—Stocks that have outperformed in the past tend to exhibit strong returns going forward. A momentum strategy is grounded in relative returns from three months to a one-year time frame. Quality: Defined by low debt, stable earnings, and consistent asset growth. Investors can identify quality stocks by using common financial metrics such as return to equity, debt to equity, and earnings variability. Growth—An investment style and strategy focused on increasing an investor's capital. Growth investors typically invest in growth stocks, i.e., young or small companies whose earnings are expected to increase at an above-average rate compared to their industry sector or the overall market. Value—Aims to capture excess returns from stocks that have low prices relative to their fundamental value. This is commonly tracked by price to book, price to earnings, dividends, and free cash flow. Size—Historically, portfolios consisting of small-cap stocks exhibit greater returns than portfolios with just large-cap stocks. Investors can capture size by looking at the market capitalization of a stock. Volatility—Research suggests that stocks with low volatility earn greater risk-adjusted returns than highly volatile assets. Measuring standard deviation from a one- to three-year time frame is a common method of capturing volatility.

Index Definitions: MSCI USA Index is designed to measure the performance of the large- and mid-cap segments of the US market. With 601 constituents, the index covers approximately 85% of the free-float-adjusted market capitalization in the US. S&P Small Cap 600 Index seeks to measure the small-cap segment of the US equity market. The index is designed to track companies that meet specific inclusion criteria to ensure that they are liquid and financially viable.

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