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US stock market ideas for US Federal Reserve rate cuts

WisdomTree Market Insights



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This report covers three major strategies: the WisdomTree US Quality Dividend Growth UCITS ETF (DGRW), the WisdomTree US Quality Growth UCITS ETF (QGRW), and the WisdomTree US Efficient Core UCITS ETF (NTSX). For ease of reference in the text, they will be referred to by their tickers.

One of the questions we’re being asked the most is, “How should investors play the US Federal Reserve (Fed) rate cuts?”. Throughout this piece, we’ll present ideas for the grizzly bears, the ebullient bulls, the undecided and everyone in between.

Let’s start with the rates themselves. Figure 1 shows the distribution of moves in the three-month T-Bill against attendant moves in 10-year T-Note yields, tabulated from 1962 to 2024. The Street anticipates 75 basis points (bps) of Fed rate cuts between now and the Federal Open Market Committee (FOMC) meeting on 18 December. As 2024’s final Fed gathering is about one quarter from now, the table presents quarterly changes in short-term rates, run monthly.

The far-left column is where to focus if you’re on board with the Street’s Fed Funds consensus. In the past, the market saw 45 scenarios (14+18+13 in the northwest corner of the table) where 10-year Treasury rates fell during quarters when short-term rates dropped precipitously. In only 10 instances (8+2 in the table) did T-Note yields rise amid tumbling short rates.

Figure 1: Quarterly interest rate changes, 1962–2024

Number of occurrences	Three-month treasury					
	Yield fell -1.0% or more	Yield fell between -0.5% And -1.0%	Yield fell between 0.0% And -0.5%	Yield rose between 0.0% And 0.5%	Yield rose between 0.5% And 1.0%	Yield rose 1.0% or more
Yield fell -1.0% or more	14	6	4	4	1	0
Yield fell between -0.5% and -1.0%	18	16	39	11	4	0
Yield fell between 0.0% and -0.5%	13	30	90	99	12	1

Yield rose between 0.0% and 0.5%	8	14	71	149	44	13
Yield rose between 0.5% and 1.0%	2	0	18	35	14	14
Yield rose 1.0% or more	0	0	2	7	9	11
Total count	55	66	224	305	84	39

Source: Refinitiv, 31 January 1962– 31 August 2024. The time series is rolling monthly observations of quarterly changes. For example, the first observation is Jan–Apr 1962, then Feb–May 1962, and so on **Historical performance is not an indication of future performance, and any investments may go down in value.**

For readers who believe the bond market will abide, we consulted the 2024 action since bonds turned the 25 April 2024 low in the Bloomberg US Treasury 7–10-year Laddered Index. As bond yields fell, we saw a generalised melt-up across strategies, with the market paying little attention to the Quality spectrum. Our Leveraged 90-60 exposure to US bonds and equities also outperformed the S&P 500 Index as the unusual equity-bond positive correlation, which had been a hindrance to the fund performance in the rather distant past, aided the performance more recently.

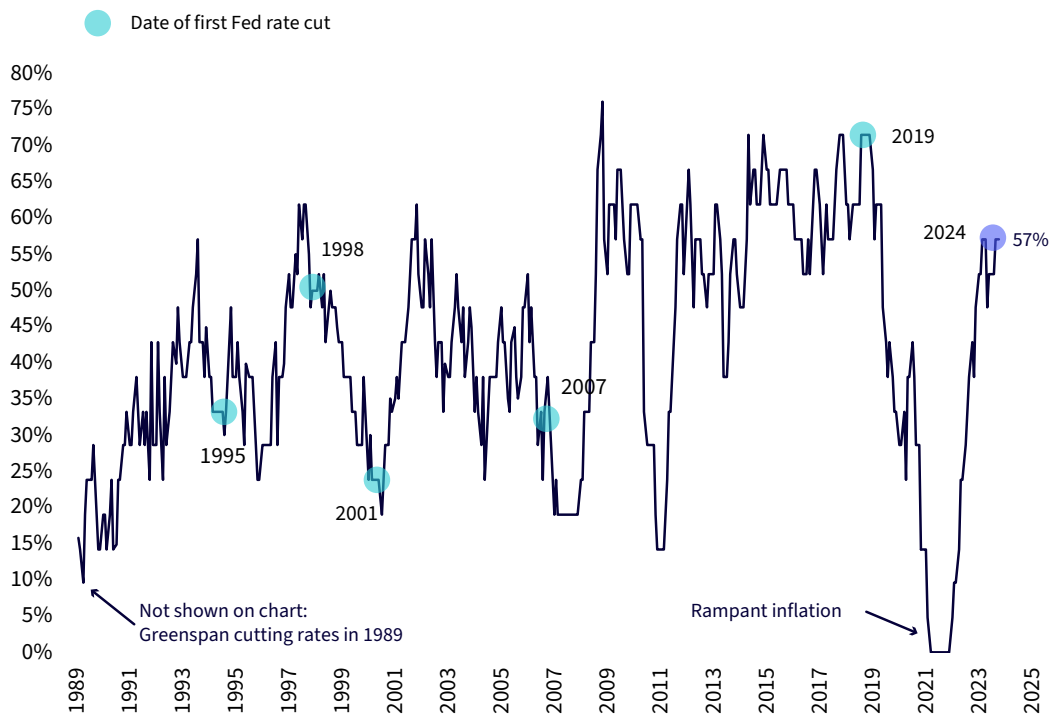
Figure 2: US Equity Funds' returns during fixed income's summer run

Ticker	25/4/2024 - 19/9/2024 Return (%)	Category
I38505 Index	9.7%	Intermediate bonds
QGRW	17.9%	Growth
S&P 500	13.7%	Blend
DGRW	14.1%	Profitable dividend payers
NTSX	16.65%	Equity bond

Source: WisdomTree, Bloomberg as of 19 September 2024. I38505 Index refers to in the Bloomberg US Treasury 7–10-year Laddered Index (TR). Based on Net total returns. **Past performance is no guarantee of future results. You cannot invest directly in a market index. Performance data quoted represents past performance and is no guarantee of future results. Investment return and principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. Current performance may be lower or higher than the performance data quoted.**

As to whether the Fed follows through and meets the consensus, we should ask if inflation is benign enough to justify slashing rates as aggressively as the Street anticipates. Looking into the bowels of the Consumer Price Index (CPI) report, 57% of the subcomponents were at or below the Fed's 2% inflation bogey in July and August (Figure 3). That is higher than when the Fed began cutting rates in 1995, 1998, 2001 and 2007, but not as high as when Powell engaged his first set of rate cuts in 2019.

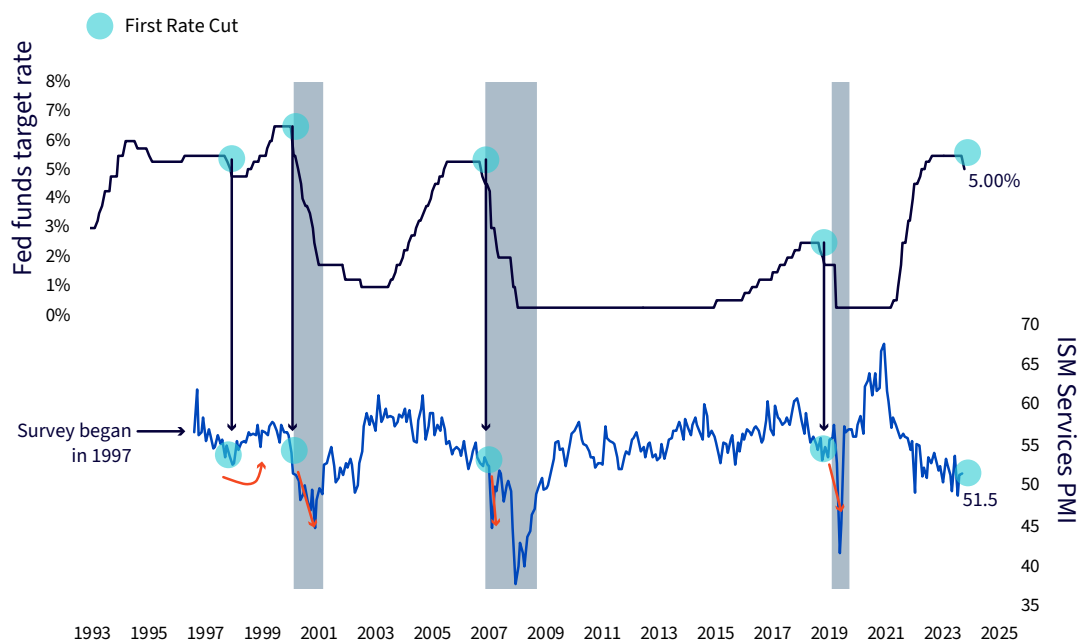
Figure 3: Percentage of CPI components < +2% in last year



Source: Refinitiv, BLS, as of August 2024, using 19 to 21 of the largest line items in the CPI report, depending on inception date. **Historical performance is not an indication of future performance, and any investments may go down in value.**

For the pessimistically inclined reader, here is a grizzly chart. With manufacturing struggling, the market’s economic soft landing thesis rests on the ISM Services PMI keeping its head above water. Historically, Fed rate cuts have given no such assurance, at least as far as the three 21st-century cycles are concerned (Figure 4).

Figure 4: Fed Funds vs. ISM Services PMI



Source: Refinitiv, ISM, as of August 2024. The current Fed Funds Rate is the upper bound of a 4.75%–5.00% range, as of 20/9/2024
Historical performance is not an indication of future performance, and any investments may go down in value.

For the bearish reader, it may be of interest to see which mandates held up during the ugly 2022 action, when the market declined 24.3% from 3 January to 12 October (Figure 5). DGRW, the all-weather dividend fund composed of profitable dividend-paying companies, really shined in that period. That is because it watched in futility in 2021 as its dividend screens largely ignored stay-at-home stocks, COVID-19 themes and the like. When the floor dropped out from underneath that stuff in 2022, DGRW outperformed the S&P 500 by about 700 bps.

Figure 5: Funds during the 2022 bear market

Ticker	3/1/2022–12/10/2022 return (%)	Category
QGRW	Wasn't launched yet	Growth
NTSX	Wasn't launched yet	Equity bond
DGRW	-17.2%	Profitable Dividend Payers
S&P 500	-24.3%	Blend

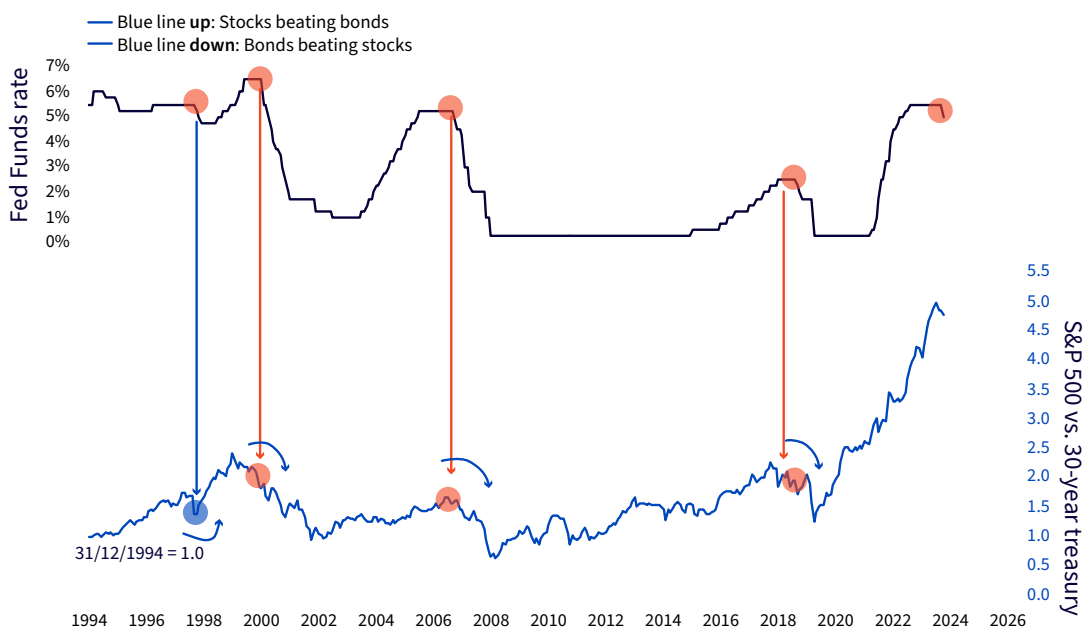
Source: WisdomTree, Bloomberg. **Past performance is no guarantee of future results. You cannot invest directly in a market index. Performance data quoted represents past performance and is no guarantee of future results. Investment return and principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. Current performance may be lower or higher than the performance data quoted.**

The Fed’s questionable image

Though rate cuts ease the cost of capital on business ventures, the Fed has a reputation for arriving too late to alleviate the pain from each cycle’s systemic bust-up, be it Dot-Com, Lehman, etc.

Four policy easing cycles ago, former Fed Chair Alan Greenspan managed to avoid a potential cataclysm when he started cutting rates in 1998. The hedge fund Long Term Capital Management was blowing up, threatening systemic risk due to its severe leverage. Rate cuts lubricated the system’s gears, perpetuating the market’s bull run, which had been in fast and furious mode since the end of the Gulf War at the beginning of that decade. The S&P 500 made its peak in August 2000. Figure 6 shows the S&P 500 trouncing long-term bonds after Greenspan’s 1998 rate cuts.

Figure 6: Stocks relative to 30-year treasuries



Source: Refinitiv, as of 20 September 2024. **Past performance is no guarantee of future results. You cannot invest directly in a market index.**

However, one had no such luck in the three cycles after that. Greenspan’s next attempt at a magic trick commenced in the opening days of January 2001. It didn’t work. The bear market that started in 2000 would persist until October 2002. The next policy easing was former Fed Chair Ben Bernanke’s attempt to stem severe losses in the 2007–2009 panic. That didn’t work either. Finally, we will never know the alternate history of 2019–2020, where lockdowns never happened. The market tanked from February to March 2020, just months after Jay Powell’s 2019 rate cuts.

We’ve never been sure how to treat 2020 in the context of Powell’s 2019 actions, but the fact is that the Fed cut rates, and the stock market tanked a little while afterwards. Therefore, we must mark it as three in a row.

Sectors

The historic record for sector rotation is mixed. Since the Ford administration, there have been eleven identifiable “first rate cut” dates (Figure 7). In eight of those, Consumer Discretionary and Health Care beat the broad market over the subsequent 12 months.

Of the poor performers, Telecom has a notoriously awful track record after the Fed’s first cut. However, that sector deserves two asterisks. Firstly, it was part of the notorious “TMT” bubble – Tech, Media, and Telecom – at the turn of the century, so maybe we should draw a line through both the post-1998 mania and the 2001 collapse.

The second asterisk is the evolution of that sector itself. In 2018, Standard & Poor’s added social media and gaming companies to the old Telecom basket, renaming it ‘Communication Services’. Now, the sector is a hodgepodge of phone companies, video games and dopamine spikes. Keep that in mind as you review the historical record.

Figure 7: Total return, 12m after first Fed rate cut

Date of first rate cut of the cycle	US total market	Financials	Industrials	Technology	Basic Materials	Consumer Discretionary	Consumer Staples	Energy	Health Care	Telecom	Utilities	Real Estate
19/11/74	38.5%	27.6%	40.8%	29.5%	47.2%	53.6%	49.1%	30.2%	31.4%	21.0%	42.4%	102.6%
15/5/80	25.9%	30.9%	39.1%	25.2%	34.3%	31.2%	21.1%	21.3%	27.6%	20.4%	7.4%	57.3%
17/11/81	27.3%	28.4%	30.1%	55.8%	19.2%	53.4%	39.3%	-10.6%	34.7%	14.1%	23.2%	50.7%
15/7/82	53.9%	79.9%	60.9%	90.0%	68.4%	67.3%	36.6%	43.9%	35.1%	35.1%	31.9%	101.9%
10/10/84	18.3%	34.1%	14.3%	1.3%	16.9%	14.7%	26.6%	10.5%	29.8%	23.6%	22.7%	29.5%
13/7/90	12.3%	16.5%	2.8%	-3.6%	13.6%	9.6%	21.1%	4.9%	24.1%	2.5%	12.2%	-6.0%
6/7/95	23.1%	25.2%	28.9%	14.2%	7.6%	16.7%	31.3%	27.6%	32.9%	20.4%	14.3%	22.6%
29/9/98	22.1%	8.6%	41.6%	73.8%	6.4%	26.4%	-4.7%	11.6%	-0.8%	41.0%	-2.6%	-8.0%
3/1/01	-11.5%	-8.7%	-9.8%	-29.2%	4.1%	-1.1%	0.1%	-8.1%	-5.6%	-20.5%	-20.3%	9.4%
18/9/07	-17.0%	-32.7%	-18.0%	-18.8%	-7.9%	-12.9%	-0.6%	-11.4%	-8.0%	-30.1%	-13.2%	-9.6%
1/8/19	13.6%	-11.5%	3.5%	44.3%	7.6%	23.9%	6.3%	-36.4%	22.0%	13.6%	1.2%	-3.4%
Median	22.1%	25.2%	28.9%	25.2%	13.6%	23.9%	21.1%	10.5%	27.6%	20.4%	12.2%	22.6%
Average	18.8%	18.0%	21.3%	25.7%	19.8%	25.7%	20.6%	7.6%	20.3%	12.8%	10.8%	31.5%
% Time sector outperformed		64%	64%	36%	55%	73%	64%	27%	73%	27%	27%	64%

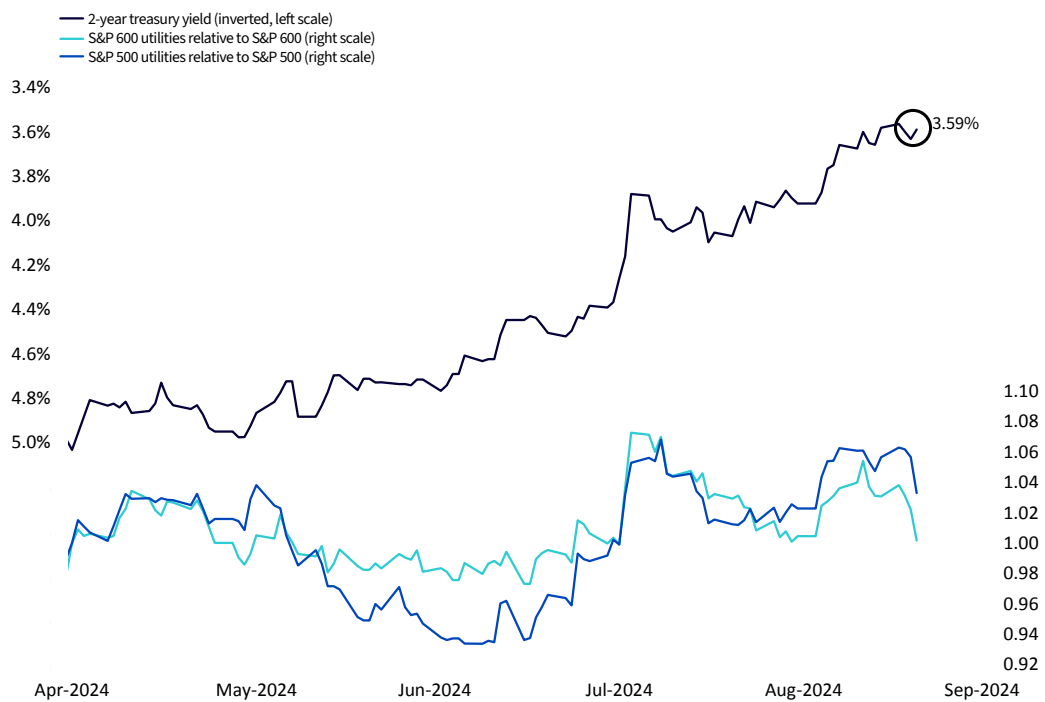
Source: Refinitiv, using Datastream total return aggregates, 31 December 1973 to 30 August 2024. **Historical performance is not an indication of future performance, and any investments may go down in value.**

The other poorly performing sector is Utilities, which only outperformed in the 12 months after the first cut in three of the 11 cycles.

Of note for this cycle: many investors are treating Utilities as a backdoor play on artificial intelligence (AI) due to data centres’ electricity gobbling. That makes it a bit of a special situation in this cycle.

Earlier this summer, Utilities’ relative performance appeared tied at the hip with interest rates. That was especially true after the release of the June CPI report in mid-July, an event that catalysed a major dump in 2-year Treasury rates and a furious rally. However, recent action has witnessed the sector underperforming. For investors looking for a relationship between interest rates and this historically rate-sensitive sector, it’s simply not there at the moment.

Figure 8: Utilities’ relative performance stopped tracking interest rates



Source: Refinitiv, as of 28 August 2024. Past performance is no guarantee of future results. You cannot invest directly in a market index.

Figure 9 can serve as a guide for readers with strong sector views. We added an extra line in the table for the dividend-and-growth combo: 2/3 DGRW with 1/3 QGRW. This mix makes sense for investors who do not want to have huge sector biases.

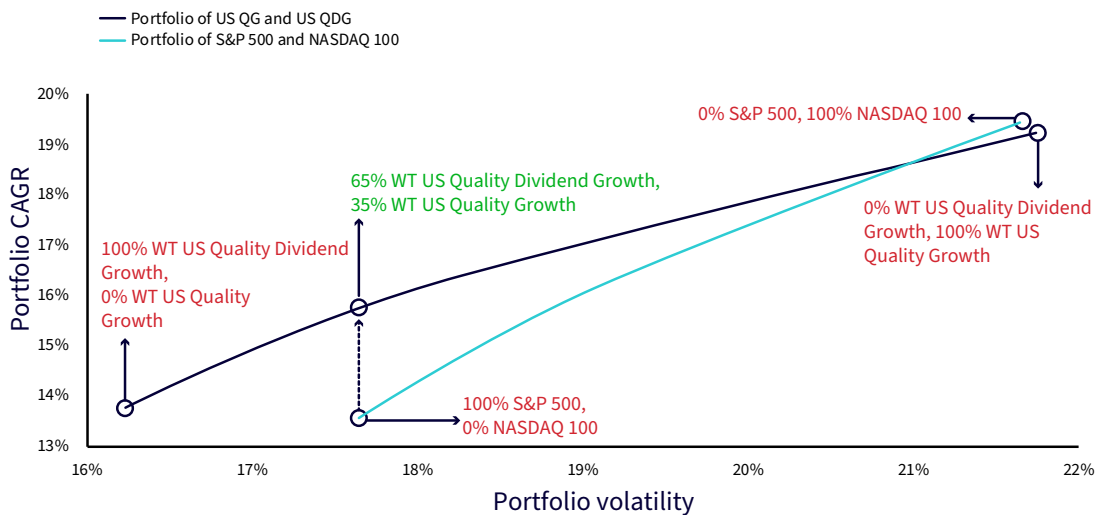
Figure 9: WisdomTree sector weights

Ticker	Financials	Industrials	Technology	Basic Materials	Consumer Discretionary	Consumer Staples	Energy	Health Care	Communication Services*	Utilities	Real Estate
DGRW	12.9%	9.4%	29.8%	2.3%	10.1%	11.4%	0.7%	17.6%	5.4%	0.1%	0.3%
QGRW	6.3%	1.6%	55.0%	0.1%	14.3%	0.3%	0.2%	6.5%	15.8%	0.0%	0.0%
2/3 DGRW + 1/3 QGRW	10.7%	6.8%	38.2%	1.6%	11.5%	7.7%	0.5%	13.9%	8.9%	0.1%	0.2%
S&P 500	13.1%	8.4%	31.4%	2.3%	10.0%	5.8%	3.7%	11.9%	8.9%	2.4%	2.3%

Source: WisdomTree, as of 31/8/2024.

Shining additional light on the 2/3 DGRW + 1/3 QGRW combination, we ran an efficient frontier analysis showing the potential superiority of the combination compared to traditional benchmarks like the S&P 500 and the NASDAQ 100. The common denominator of Quality ensures that the risk-adjusted performance is superior and less prone to large drawdowns. It is worth noting that the combination of DGRW and QGRW resulted in more than 150 bps more returns than the S&P 500 for the same volatility as the S&P 500. This might be a way to go for investors not looking to make strong sector bets.

Figure 10: Efficient frontier of the WisdomTree US Quality Growth and WisdomTree US Quality Dividend Growth versus S&P 500 and NASDAQ 100



Source: WisdomTree, Factset, Bloomberg. Based on backtested data from 30 April 2013 to 30 June 2023. Historical performance is not an indication of future performance, and any investments may go down in value.

Finally, we want to ensure there is a pure play for the reader who is ‘on’ the Magnificent Seven¹ and is long and strong on the AI theme. Of the three funds in this report, QGRW is the most “NASDAQ-y” of the funds (Figure 11). As a strategy based on fundamentals like quality and growth, it will follow the sectors/section of the market generating the highest growth and tilt towards that, making it futureproof to when the market starts favouring the non-Magnificent Seven stocks.

1 The Magnificent Seven are a group of high-performing companies in the US stock market: Alphabet, Amazon, Apple, Meta Platforms, Microsoft, NVIDIA, and Tesla.

Figure 11: Performance since the launch of QGRW Index (WTQGRWUN)

Ticker	30/11/23 – 30/9/24 (%)	Category
QGRW (proxied by WTQGRWUN Index)	33.1%	Growth
S&P 500	27.2%	Blend
DGRW	26.0%	Profitable Dividend Payers
NTSX	27.3%	Equity-Bond

Source: WisdomTree. Based on Net total returns. **Past performance is no guarantee of future results. You cannot invest directly in a market index. Performance data quoted represents past performance and is no guarantee of future results. Investment return and principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. Current performance may be lower or higher than the performance data quoted.**

Conclusion

In summary, it looks like the market wants to reward stocks of all stripes, as was the case in a couple of the 1990s rate-cutting cycles. However, the cycles of this century have a poor track record for stock market performance in the months (and sometimes years) after the Fed's first set of cuts. In other words, the Fed waited too long in 2001, 2007, and 2019, so we respect the argument that maybe they made the same mistake this time around too.

A DGRW-QGRW may be an opportune approach, as the former has developed a reputation for downside resilience that could pay off if it turns out the Fed has, in fact, made that mistake. QGRW has been our big winner in the post-2022 bull market, stacked as it is with Magnificent Seven members. Combining the two makes for a mix that scores highly on profitability metrics, which we suspect will be of utmost importance if the market catches an adverse economic surprise.

Investors who want asset class diversification to equities could look at NTSX. With a diversified 1.5X levered 90-60 exposure to equities and bonds, one could reap the benefits of hedging equities without losing exposure to equities. In a scenario where equities continue to do well (our bullish case), investors would generate most of the upside. Still, on the flip side, if equities don't do well (our bearish scenario), the fixed income exposure could help hedge equity returns and provide some protection on the downside.

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