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TRAHAN MACRO RESEARCH

October 24, 2024

The Most Helpful Empirical Tools For The Fed Easing Cycle

Performance	Q3	YTD
The Macro Institute Models		
All Weather Model	+29.5%	+22.5%
Fed Easing Model	+11.0%	+19.3%
QoR Score	+8.9%	+13.6%
Sell Model	+6.7%	+6.1%
Factors		
H/L Volatility	+3.0%	+9.0%
H/L Quality	+2.9%	+7.8%
H/L Momentum	+6.0%	+27.8%
H/L Valuation	-0.6%	-1.03%
Markets		
S&P 500	+5.5%	+21.9%
Russell 2000	+9.2%	+12.1%
U.S. Dollar Index	-4.8%	+1.9%
U.S. 10Yr Yield	-58bps	+15bps

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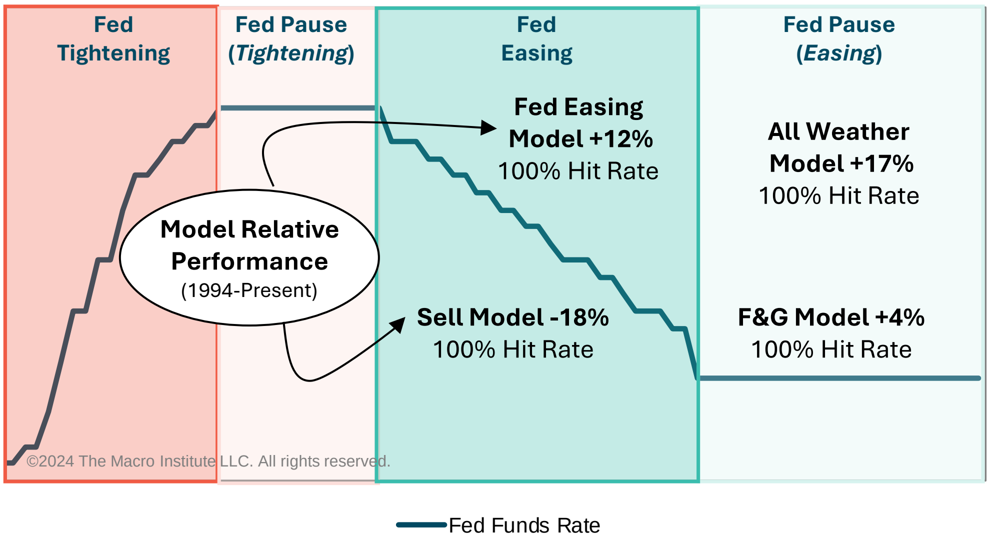
This is perhaps one of the most important statistics for equity investors right now: *the average Fed easing cycle over the last 50 years has lasted about 18 months*! In that context, if we are facing an "average" episode then we are still in the first inning of this thing. This is where the opportunity lies, in our opinion, as there are many repeatable patterns in past Fed easing cycles. At the end of the day, humans make investment decisions and history teaches us that human behavior does not change much from one easing cycle to the next. This helps explain why the "Fed Easing Portfolio" has worked, but it goes well beyond a few factors and sectors.

Performance Of Empirical Models Across Fed Policy Cycles



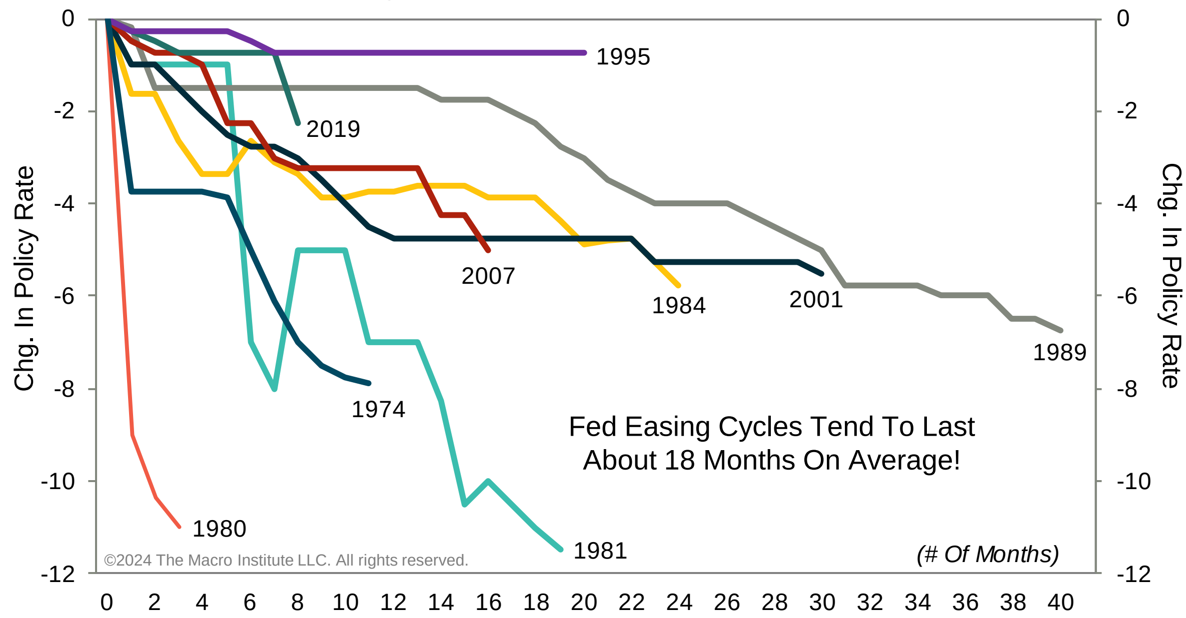
It's not a coincidence that the Healthcare and Consumer Staples sectors have outperformed in each of the last four Fed easing cycles. Now, this doesn't mean that everyone should buy those ETFs blindly, but there is a message from the markets embedded in this statistic – Defensives tend to be in favor as the Fed eases policy. This should not be surprising since the Fed is typically dovish when the economy is losing steam, and that happens to be when Defensives are in favor.

The same dynamic can be found at the factor level as we have shown countless times this year with the Fed easing portfolio. It is simply an amalgamation of five factors that have generated alpha in past easing cycles and that combination happens to be working in recent months as well. In this week's report, we take this analogy further and try to home in on which empirical models tend to work best as the Fed eases policy. There are a few surprises and plenty of great insights for today's backdrop. We hope you find this work as valuable as we did. As always, your feedback is greatly appreciated. Best, Francois

The Opportunity: Fed Easing Cycles Usually Last A Long Time!

The Federal Reserve began its formal easing cycle on September 18th by reducing its target range for the fed funds rate 50bps to 4.75-5.00%. With one month of easing already behind us, history suggests that we can expect this new monetary policy regime to persist through 2025. On average, easing cycles tend to last about 18 months. Below we map nine of the last episodes of policy easing with the change in the official policy rate (percentage points) relative to its cycle peak on the Y-Axis.

Fed Easing Cycles Are Not Typically Short Lived



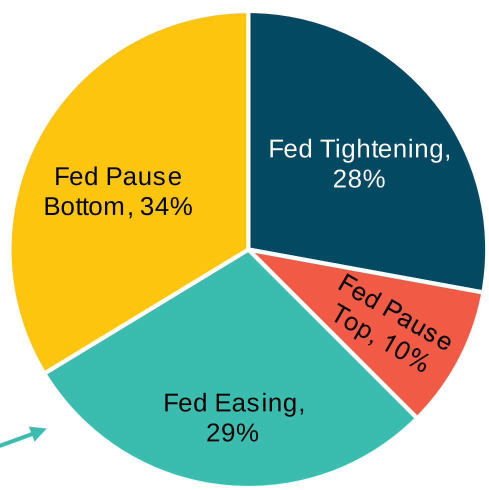
All cycles are different of course and the severity and duration of easing depends on the starting point of both policy and the economy and how the Fed responds to incoming data. (This is a topic for a future report). What we do know is that monetary policy settings tilt more accommodative most of the time. Fed Easing accounts for 29% of Fed phases while the ensuing Fed Pause afterward (at the bottom) comprises another 34%. The point being that we're likely in the earliest innings of a cutting cycle and if history is any measure, we'll be in this regime for the next 12-18 months. What we'll show on the following pages are various investment strategies and quantitative tools for this specific macro environment.

Fed Easing Typically >12Months

Fed Easing Cycles	
Year	**Length**
1981	19 Months
1984	23 Months
1989	39 Months
1995	7 Months
2000	30 Months
2007	16 Months
2019	8 Months

The Fed Easing Cycle tends to be one of the longest lasting of the 4 Fed phases.

Fed Easing Cycles Are Drawn Out



Time Spent In Fed Phases

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Fed Easing Cycles And Their Repeatable Investment Patterns

While it's true that all monetary and economic cycles are different, there are some consistent patterns that help us explain past sector performance and where we will be allocating equity exposure heading in 2025. One thing seems clear: Fed easing cycles result from slowing growth. The Fed lowering its policy rate is typically a lagged response to slower inflation and economic prospects. The easing cycles of the Tech Bubble and GFC had some of these features but were more emergency counter-measures than the 1995 & 2019 cycles. Regardless of causality, Defensive exposure (HC, STA) has consistently generated alpha during past easing cycles.

Sector Performance Across History's Fed Easing Cycles

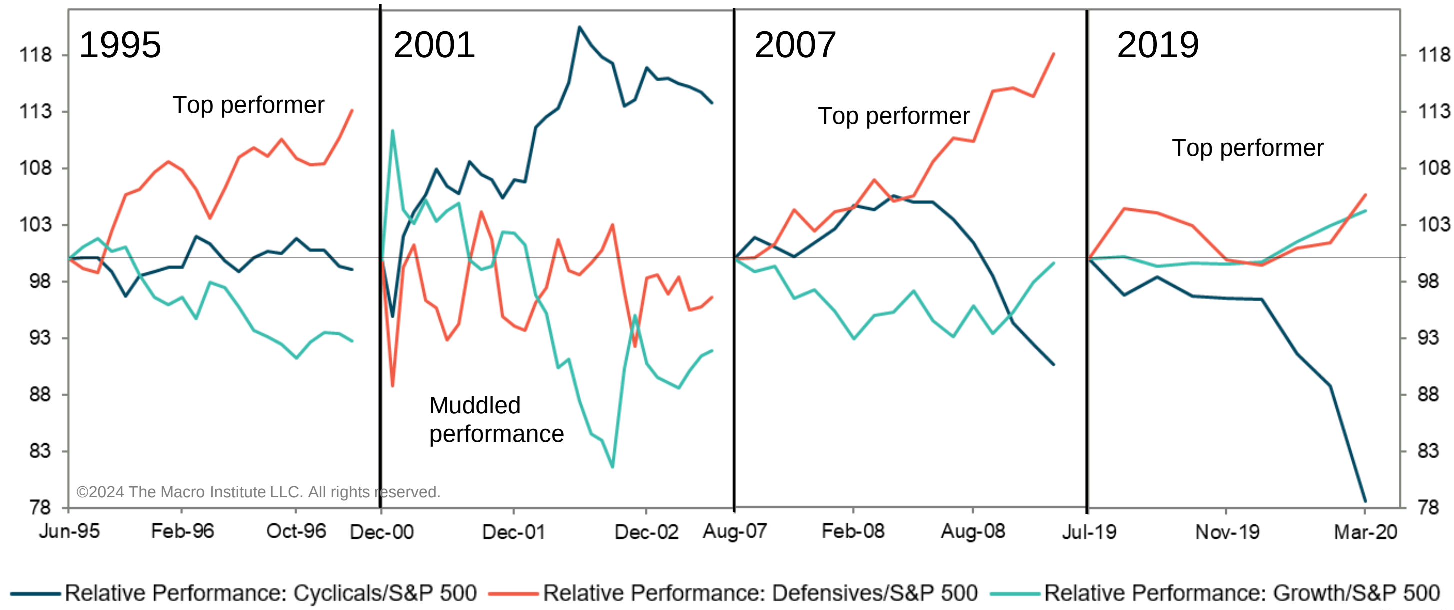
Relative Sector Performance During Fed Easing Cycles

Sector	1995	2001	2007	2019	Average
Energy	-8.6	12.1	7.5	-35.4	-6.10
Financials	32.2	12.1	-22.6	-10.7	2.76
Com. Svcs.	-15.1	-21.8	3.4	1.9	-7.91
Industrials	-2.2	2.8	-3.7	-9.9	-3.22
Materials	-23.8	28.3	-6.4	-8.4	-2.57
Real Estate	N/A	N/A	-12.5	-8.9	-10.70
Health Care	22.2	12.6	16.0	10.4	15.30
Tech	0.3	-25.3	-2.9	13.2	-3.68
Discretionary	-23.2	8.0	-0.7	-4.0	-4.96
Staples	16.8	21.2	25.9	1.9	16.44
Utilities	-29.5	-13.6	13.9	0.9	-7.09

The only sectors to consistently outperform the S&P 500 during every Fed easing cycle since 1990 are Health Care and Consumer Staples.

The red series below is the performance of Defensives relative to the S&P 500 in the last four easing cycles, with three of the four delivering significant returns. In general, factor leadership has been fairly consistent across all four easing cycles – that is more important than sectors at the end of the day. We'd expect secular growth exposure to outperform in a world of declining cyclical growth. We do see Growth faring better in '19 than '95, '01, '07 which could be partially due to Technology's shift toward stability away from cyclicality. In this respect, it pays for investors to look under the hood when thinking about equity leadership and focus on specific sectors.

Equity Leadership Across Fed Easing Cycles … Usually About Defensives



The TMI Fed Easing Model – Alpha Generation As The Fed Eases

The TMI Fed Easing Model has consistently generated outperformance in prior Fed easing cycles. This model is derived from five quantitative factors in three categories that have done well during these particular economic regimes. Across the board, high Profitability was the most consistent factor on the long side for strong relative performance (Op. Margins, ROA, ROIC).

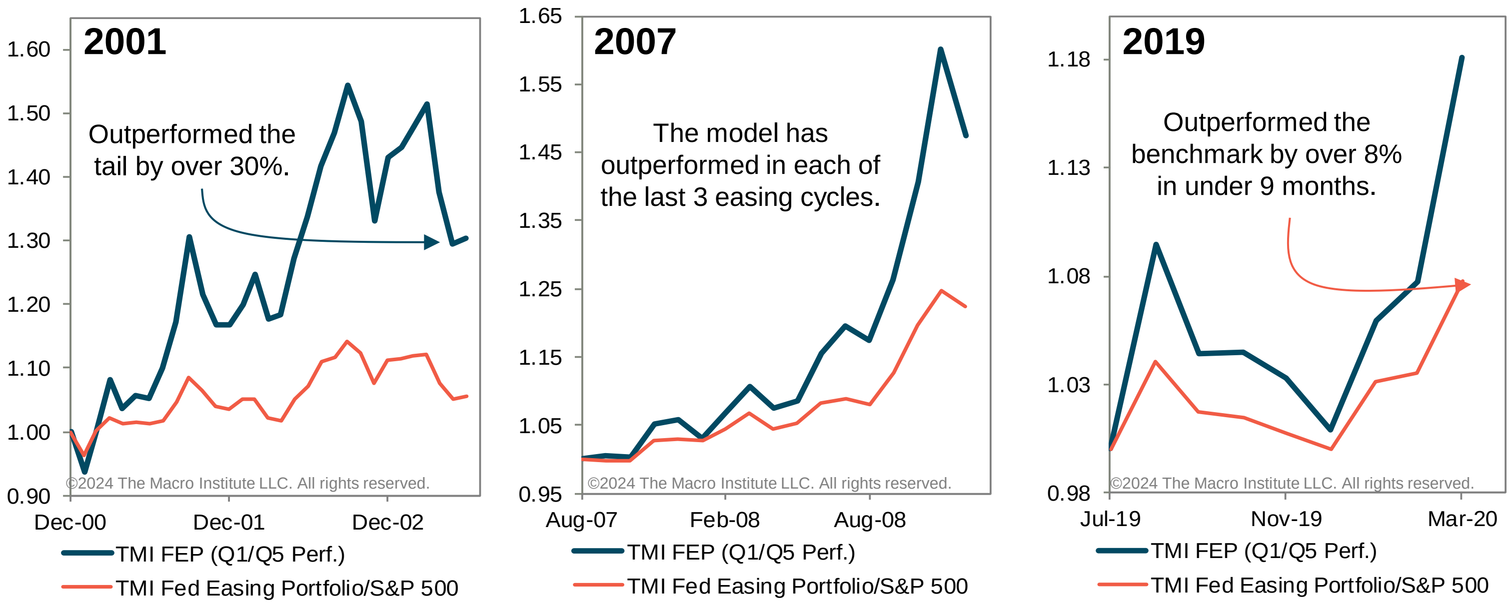
Profitability Is THE Attribute Investors Want To Emphasize

High/Low Relative Performance During Easing	2001	2007	2019	Average	
Operating Margins	**24%**	**36%**	**10%**	**23%**	Profitability
ROA	6%	40%	24%	23%	
CF ROIC	8%	44%	16%	23%	
Gross Margin	21%	20%	11%	18%	
ROE	3%	40%	15%	19%	
ROIC	-2%	49%	23%	23%	21.5%
Degree of Operating Leverage	**5%**	**19%**	**10%**	**12%**	Operating Efficiency
Current Ratio	-19%	-11%	9%	-7%	
Asset Turnover	-5%	5%	13%	4%	
Capital Intensity	6%	-5%	-11%	-4%	
Working Capital	-15%	-11%	6%	-6%	
Inventory Turnover	-23%	7%	3%	-4%	-0.9%
Beta	**-36%**	**-36%**	**-18%**	**-30%**	Risk
Price Target Dispersion	**-12%**	**-31%**	**-9%**	**-17%**	
Capitalization Ratio (Debt/(D+E) Debt to Capital)	**-22%**	**-14%**	**-5%**	**-14%**	
1M Volatility	-29%	-34%	-13%	-25%	
Size	-41%	21%	22%	1%	
Momentum	-40%	29%	27%	5%	-13.4%

Factor performance within the Operating Efficiency category was not consistent but Degrees of Operating Leverage delivered the best results across the last three easing cycles. On the Risk side, the results were very consistent. High/Low Beta, Price Target Dispersion, and Debt all underperformed. This makes sense as we'd expect Risk-Off behavior to dominate during a cutting-cycle.

The Fed Easing Model is essentially **long** High Operating Margin, Degree of Operating Leverage **and short** Beta, Price Target Dispersion, and Debt/Equity (i.e., long the low-end buckets of these factors). In essence, it's a screen of quality-related equity factors. In a world of rising economic uncertainty, we think and can see empirically that best in class businesses tend to catch bids. The beauty of the model is its simplicity and the consistency with which it has outperformed not only the S&P 500 but also the tails (Quintile 1/Quintile 5). Below we show the model's performance over the last three policy easing cycles.

Fed Easing Portfolio (FEP) Across The Cycles … Interestingly Consistent!?!



The TMI Sell Model: Avoiding Portfolio Torpedoes As The Fed Eases

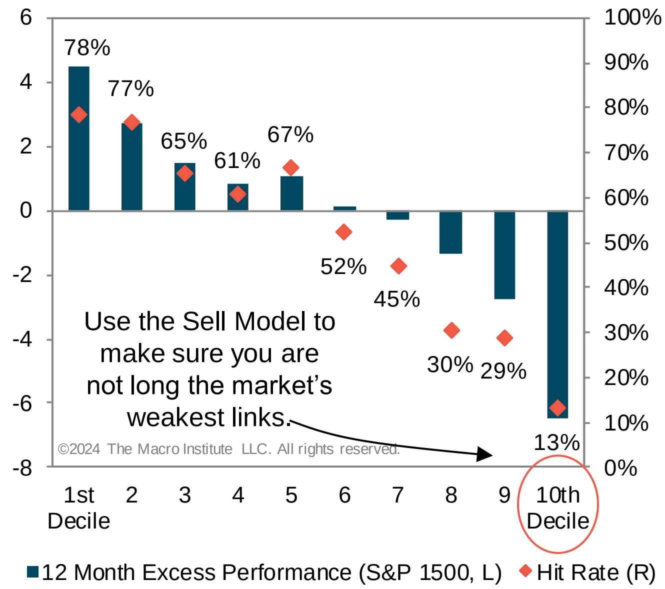
The TMI Sell Model can be deployed across all monetary policy backdrops, not just Fed easing. At the same time, an economic backdrop marked by Fed easing is not exactly conducive to low-quality, highly indebted, "red flag" businesses which sometimes work well under the right circumstances (think 2021!). Without cyclical tailwinds, it's more important to screen for potential portfolio torpedoes. The seven factor Sell Model can also be used as a tool to identify short candidates. The 10th decile of the S&P 1500 represents the sell/short recommendations of the Sell Model. This cohort of companies, on average, generated -7% of relative performance and outperformed the index only 13% of the time.

Breaking Down The TMI Sell Model

Valuation	Start with valuation and look for unattractively valued (expensive) stocks.
Manipulation	Screen for companies that are potentially manipulating earnings.
Risk	"Red flags" in operations and sales volatility.
Sentiment	Identify stocks with poor investor and analyst sentiment.
Governance	Score firms based on how they use equity and the stability of the firm.
Operating Efficacy	Screen for firms that are not earning an economic profit or generating cash.
Profitability	Look for firms in which both levered and unlevered profitability is low.

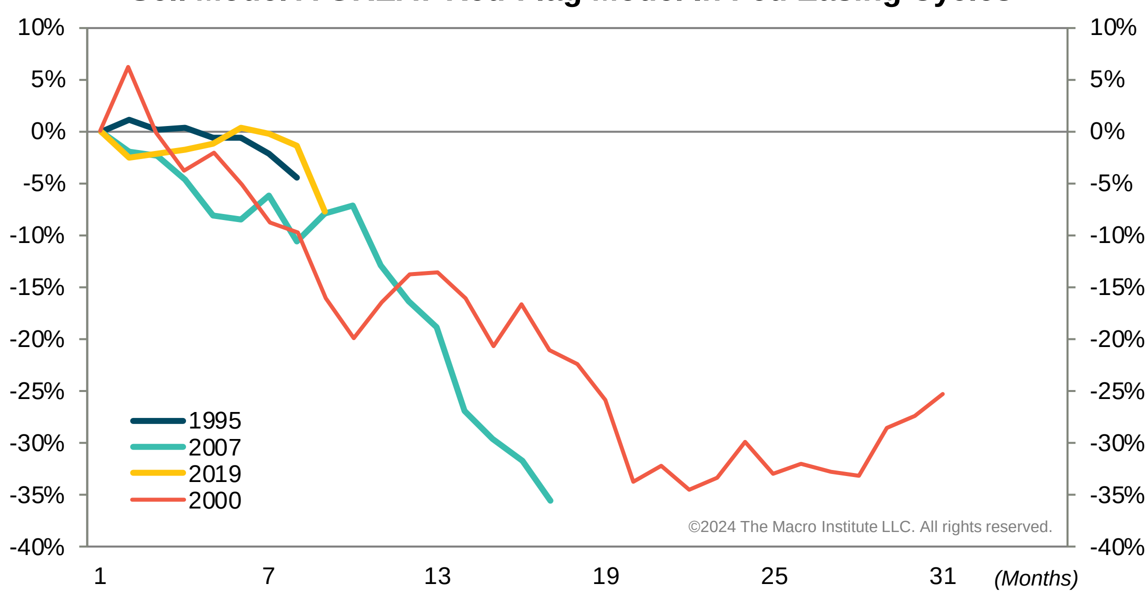
*Factors are modified for Financials stocks

About As Monotonic As It Gets



So how has the Sell Model performed during past easing cycles? Remarkably well. The model's 10th decile of stocks underperformed the overall Index in each of the last four easing cycles. These are stocks with significant debt, poor profitability to service that debt, governance-related red flags, and exuberant valuations and sentiment.

Sell Model A GREAT Red-Flag Model In Fed Easing Cycles

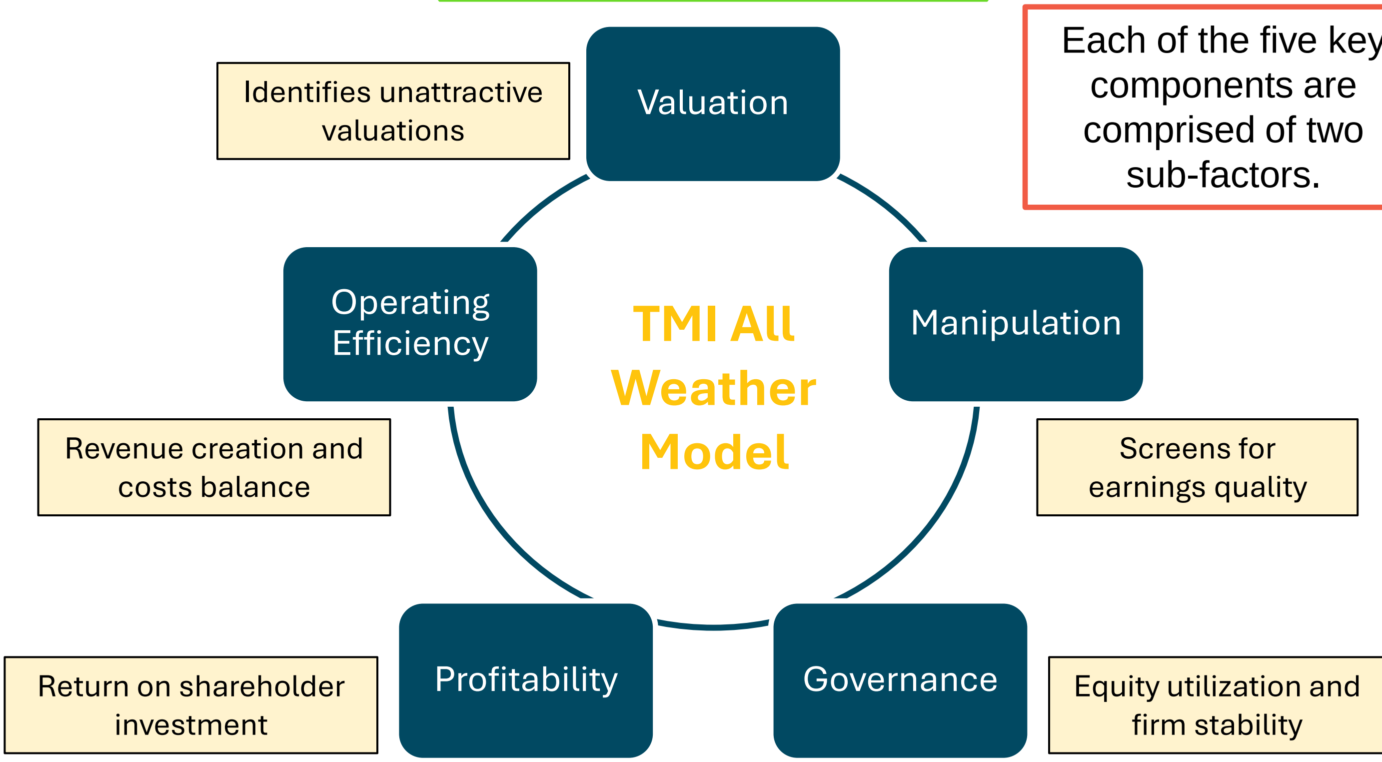


Relative Performance During Fed Easing: Sell Model/S&P 500

The TMI All Weather Model – Emphasize This During Easing Pause

The TMI All Weather Model is our favorite stock selection model to identify potential BUY candidates. The model is business cycle agnostic. In other words, the factors and their weights do not vary based on the economic backdrop. The model incorporates a blend of factors that tend to outperform when economic prospects are improving as well as factors that outperform when LEIs are losing steam.

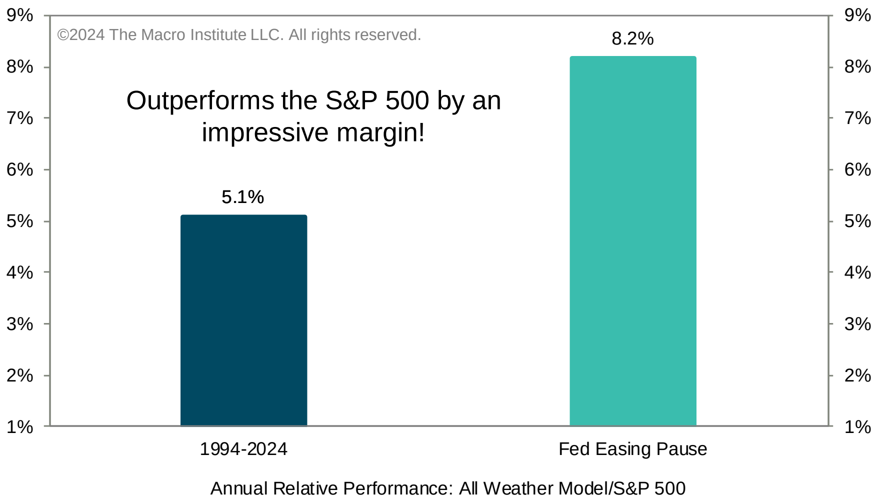
TMI All Weather Model Construction



Each of the five key components are comprised of two sub-factors.

When the Fed is on hold following a rate-cutting cycle, the All Weather Model tends to perform well,, which is best explained by the inconsistency of factor leadership in this backdrop. Defensives, for example, are usually leaders in the early innings of a pause and become laggards as LEIs accelerate later. The AWM does not take an explicit stance on factor leadership. The strong performance below reflects the macro agnostic nature of the model. In essence, the model sidesteps large whipsaws and as a result mitigates severe drawdowns.

The TMI AWM Boasts An Impressive Track Record



Performance During Fed Easing Pause

Year	Relative Performance
1998	+2.4%
2003	+9.8%
2008	+39.8%
2020	+17.7%

The TMI F&G Model – Another Tool For An Easing Pause

The TMI F&G Model is a macro-agnostic tool for transitions in market leadership (Growth & Value). It's also a way to isolate stock-picking from macro influences altogether. In theory, this is similar to our All-Weather Model. The F&G Model is based on studies by Piotroski and Mohanram, who identified various financial statement-based metrics that generated outperformance in the Value and Growth universes, respectively. Both original models include several factors not listed here – some are highly effective, some are less applicable.

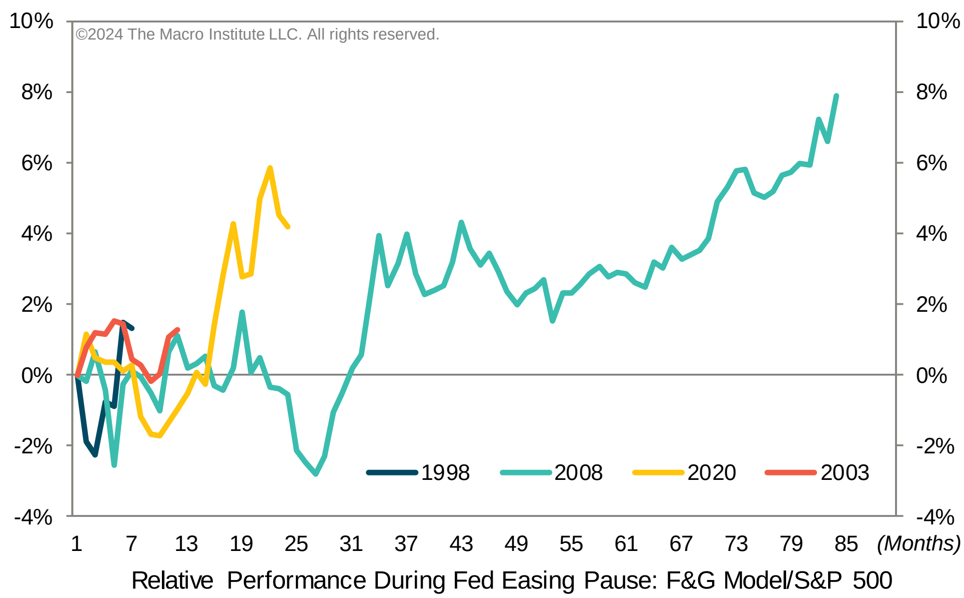
The F&G Score: A Macro-Agnostic Stock-Picking Model

TMI F&G Score Model	Factor	Category
F-Score Factors	CFROA > 0	Profitability
	CFROA > ROA	Profitability
	Share Decrease	Leverage/Liquidity
G-Score Factors	CFROA > Industry	Profitability
	CF Op > Net Income	Profitability
	R&D > Industry	Consistency
	Adv. Expense > Industry	Consistency

There are four Profitability factors in the TMI F&G Model.

The model includes the most effective stock-picking factors from both the F-Score and G-Score models. Like the All Weather Model, the performance of the F&G is not tied directly to equity leadership in a given phase. As we stated earlier, leadership can change rapidly during a Fed pause. Through the G-Score components, the model screens for attributes of Growth companies (Risk-Off phase), and through the F-Score components, it seeks Value characteristics (Risk-On phase). During Fed pauses, relative performance has been inconsistent in the first few months, but it tends to do better after 6-12 months.

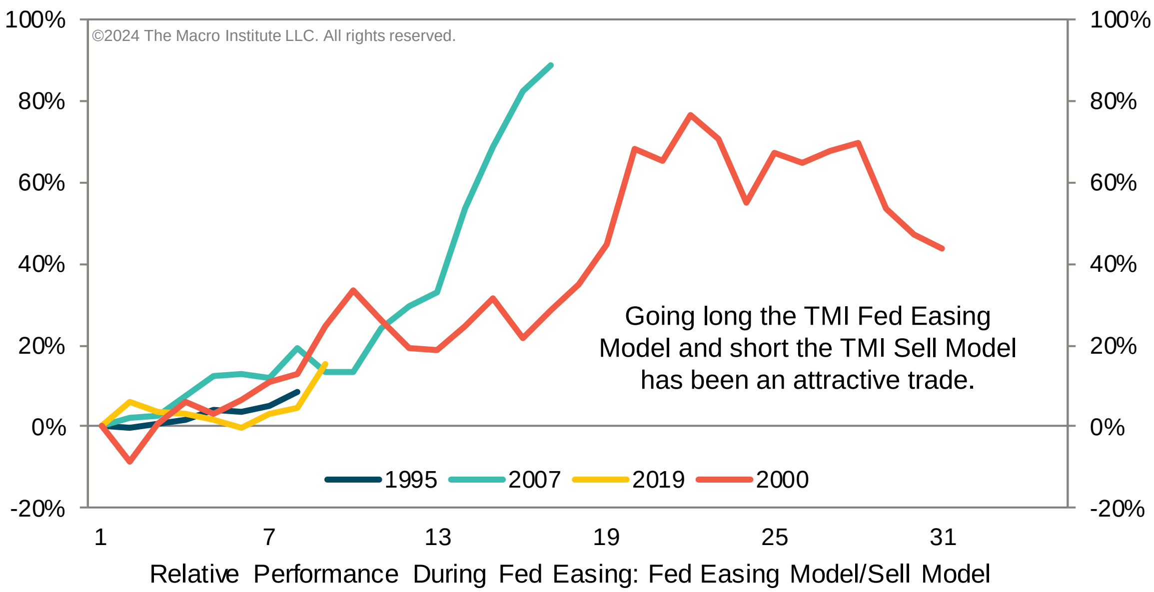
F&G Model Has Worked During Fed Pauses



Long TMI Fed Easing Model & Short TMI Sell Model

The performance below is essentially a long/short strategy of the TMI Fed Easing Model and the TMI Sell Model over the last four easing cycles. Conceptually, we're attempting to amplify returns by owning factors that address quality, such as high Profitability and low Risk, against factors that seek out portfolio torpedoes. Unlike our macro-agnostic tools like the All-Weather and F&G Models, this strategy is an explicit bet on a macro environment where Quality metrics are rewarded and Risk is punished. It's geared toward investors that can stomach risk, but returns have been strong.

Combining Models To Maximize Performance



The TMR Fed Easing Portfolio has outperformed the Sell Model by 44% on average over the last four Fed easing cycles.

The full screen for the TMI Fed Easing Portfolio is available for the S&P 500 as well as other indices. Simply email quant@trahanmacroresearch.com for the full list. Again, this is a simple screen of 5 factors that has systematically generated alpha in prior easing cycles. The TMI Sell Model has also proven to be quite effective at identifying underperformers, like all the models we offer this can be applied to any universe.

A Sample Stock Listing Of The Fed Easing Models

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Universe: S&P 500
TMR Models - Easing Phase

Lower Values Rank Better In All Categories
Sell Model = 10

Ticker	Name	Fed Easing Model	All Weather Model	F&G Model	Sell Model	Price	Market Cap	Sector	Industry
GIS	General Mills, Inc.	1	1	1	1	$ 69.08	38350.4	Consumer Staples	Food Products
LVS	Las Vegas Sands Corp.	1	1	1	6	$ 51.75	38110.3	Consumer Discretionary	Hotels Restaurants & Leisure
DOW	Dow, Inc.	1	1	2	6	$ 52.07	36497.0	Materials	Chemicals
GILD	Gilead Sciences, Inc.	1	1	2	2	$ 88.16	109758.5	Health Care	Biotechnology
DUK	Duke Energy Corporation	1	1	3	2	$ 119.88	92571.5	Utilities	Electric Utilities
HOLX	Hologic, Inc.	1	1	3	4	$ 81.58	18948.7	Health Care	Health Care Equipment & Supplies
WEC	WEC Energy Group Inc	1	1	3	1	$ 98.69	31193.9	Utilities	Multi-Utilities
CI	Cigna Group	1	1	4	1	$ 317.46	88745.6	Health Care	Health Care Providers & Services
T	AT&T Inc.	1	[illegible]	5	4	$ [illegible]	[illegible]	Communication Services	Diversified Telecommunication Services
VICI	VICI Properties Inc	1	1	5	10	$ 32.77	34315.9	Real Estate	[illegible]

For complete list, different benchmark, or monthly model updates:
Email quant@trahanmacroresearch.com or visit trahanmacroresearch.com/screens

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