PORTFOLIO CONSTRUCTION

A Changing Stock-Bond Correlation

Drivers and Implications

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The relationship between stock and bond returns is a fundamental determinant of risk in traditional portfolios. For the first two decades of the 21st century, the stock–bond correlation was consistently negative and investors were largely able to rely on their bond investments for protection when equities sold off. But this was not the case in the previous century, and macroeconomic changes—such as higher inflation uncertainty—could lead to a reappearance of the positive stock–bond correlation of the 1970s, 80s, and 90s. This would have broad implications for investors, either increasing portfolio risk or forcing allocation changes likely to reduce expected returns. This article analyzes the implications for investors of a change in this “golden parameter” and presents a simple macroeconomic model to help understand its drivers, supported by international empirical evidence. Finally, it explores the role of alternatives in making up the potential diversification deficit in a positive stock–bond correlation world.

Key Findings

• Historically, equity and bond markets have exhibited opposite-sign sensitivities to growth news and same-sign sensitivities to inflation news. According to a simple model, the stock–bond correlation thus depends not on the level of inflation, but on the relative volatility of growth and inflation and the correlation between them.

• Empirically, this model explains around 70% of long-term variation in the US stock–bond correlation, with similar results internationally. It is less successful at explaining short-term fluctuations.

• If a sustained rise in inflation uncertainty drives the correlation higher in the present decade, investors can make up the diversification deficit by raising allocations to alternative diversifiers, such as dynamic liquid alternatives and commodities.