EQUITIES

Stock-Bond Correlations

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The correlation between stock market and government bond returns was positive through most of the 1900s, but negative in the early 1930s, the late 1950s, and recently. If the trend is sustained, we believe the shift to a negative correlation should boost government bond valuations owing to bonds' attractive hedging characteristics.

This exploration of sources of stock-bond correlation examines asset class behavior in different economic conditions. Growth and volatility shocks tend to push stocks and bonds in opposite directions, while inflation shocks tend to cause common discount rate variation across asset classes. The latter effect dominated in the variable inflation levels of 1960–1990 and kept stock-bond correlations positive.

As long as inflation rates remain low, low correlations should prevail. Correlations become even more negative during deflationary recessions, equity weakness, and high-volatility flight to quality periods.

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