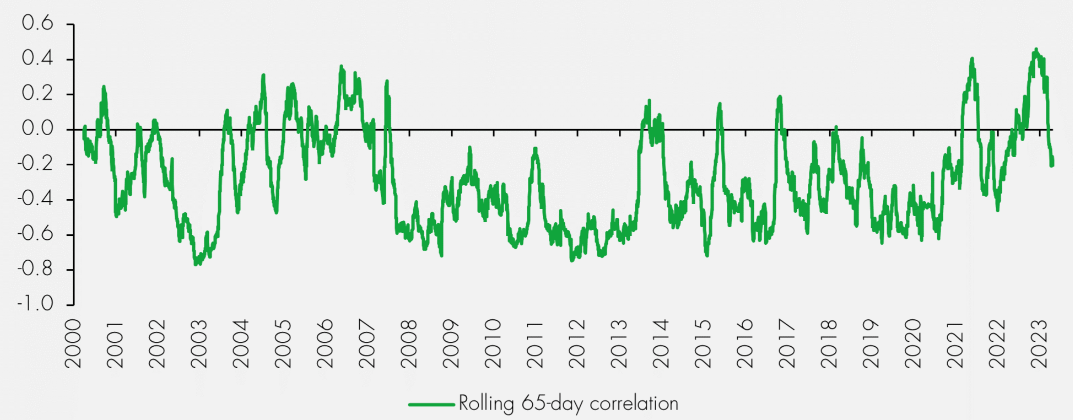
Are bonds back as a diversification tool?

The diversification benefits of bonds appear to be returning after disappearing in the market turmoil of 2022. Bonds are traditionally seen as a key diversifier versus equities because their investment returns are expected to be negatively correlated. But this broke down in 2022 as sharply rising interest rates impacted both asset classes.

In its latest quarterly strategy, the Liontrust Global Fixed Income team notes: *"With the markets' collective thoughts turning from the inflationary problems of 2022 to the impending economic slowdown later in 2023, we have seen one relationship pleasingly reassert itself. Namely, the correlation between high quality sovereign bond returns and those on riskier assets has become negative again."*

Rolling 3 months (daily returns) correlation of S&P 500 and US Treasury returns



Source: Bloomberg, Liontrust, 28.04.23

This is important because owning low or negatively correlated assets is a fundamental principle of diversification, a strategy that – when applied effectively – should reduce expected portfolio volatility without negatively affecting expected investment returns.

Although the correlation of bonds and equities has shifted over time, it is often assumed that a negative correlation is the 'normal' relationship suggested by investment theory.

Equities and bonds are usually expected to perform very differently at various points in the economic cycle.

During periods of economic growth, shares in companies might perform well due to rises in profits and investor risk appetite. As the economy heats up, demand for goods and services is likely to push up prices, causing inflation and prompting central banks to raise interest rates to cool things. Rising interest rates would usually imply rising bond yields and falling bond prices through a relationship known as duration.

As economic activity moderates or contracts, this relationship should reverse; shares may perform poorly as companies find it tougher to generate profits growth and as investors look to shift into lower-risk asset classes. A cooling economy would usually lead to interest rate cuts from central banks, which would imply falling bond yields and rising bond prices.

Historically, the correlation of bonds and equities has gone through periods of conforming to the negative relationship described above but it has also been positive at times.

There are several possible reasons why a negative relationship might not hold. The nature of central banks' monetary policy is one.

If, rather than responding countercyclically to the normal economic cycle (i.e. hiking rates as economic growth and inflation rises, before cutting as they decline), policy was instead responding to unique shocks to the economy, then the negative relationship can break down.

For example, the chart above shows that the decade following the 2008/9 global financial crisis was typically characterised by negative equity/bond correlation broken by episodes of zero or positive correlation. These episodes may be explained by the ultra-low interest rates and huge bond-buying quantitative easing programmes unleashed by key central banks at the time.

Investors during this period may remember bouts in which equities and bonds responded as a homogenous group of risk assets to the provision of each tranche of monetary stimulus – all rising together in response to more cheap money in the economy.

More recently, the chart shows two large spikes of positive correlation in 2021 and 2022. This corresponds to the inflationary supply-side shocks provided by post-Covid lockdown bottlenecks and the Ukraine conflict respectively.

As central banks belatedly accepted that these events were leading to persistent rather than transitory inflation, they started to raise interest rates. Because this inflation stemmed from supply disruption rather than high, cyclical demand, it corresponded to poor returns for both bonds and equities – bond yields rose and prices fell as interest rates went up; equities were weighed down by tighter monetary policy and higher discount rates at a time when economic activity was still disrupted by recovery from Covid and the Ukraine conflict.

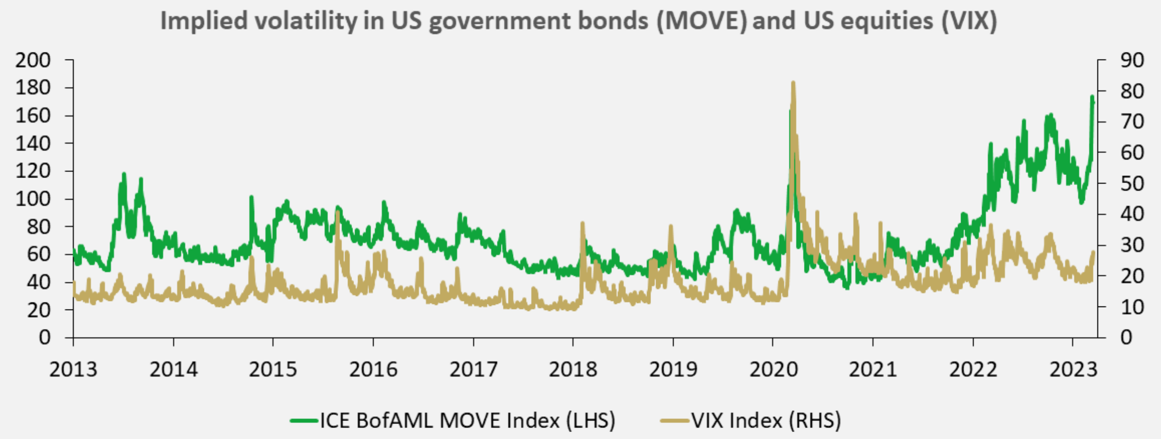
This meant that diversification benefits did not apply that strongly in 2022, and a number of well-diversified multi-asset portfolios will have suffered negative returns as both bonds and equities slid.

The return of a negative correlation is therefore likely to be welcomed by multi-asset investors.

It is also a potential boon for our Global Fixed Income team, which notes that bond market volatility has recently been much higher than equity volatility – suggesting that valuation dispersion and active management opportunities may be greater. As fund manager Phil Milburn says: "This points towards greater dislocations having occurred in bond market pricing, which we view as a buying opportunity for duration exposure."

For more information, see an article by Donald Phillips from the same investment team: "Why bond market volatility is good for strategic investors"

Bond market volatility decoupled from equity markets last year



Bloomberg, Liontrust as at 15.03.23

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