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IAS PORTFOLIO INSIGHTS

THE FOUNDATION OF A BALANCED PORTFOLIO MAY BE SHIFTING – HERE'S WHAT TO LOOK FOR

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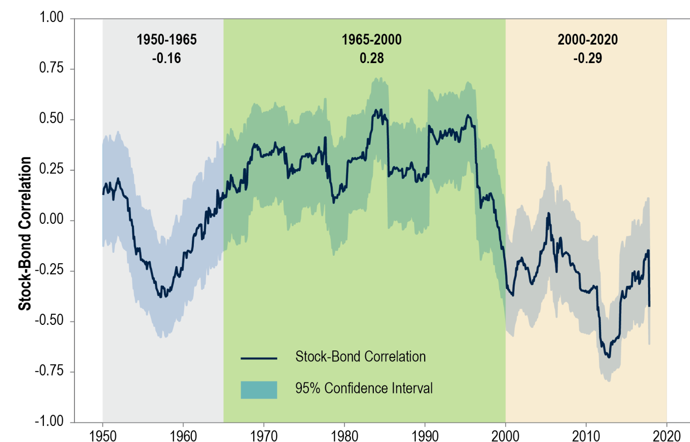
Bonds have long been an important ingredient in a diversified portfolio, reliably hedging riskier assets: when stock returns go down, bond returns go up (and vice versa). But what would happen if stocks and bonds moved in concert — as they did for more than 30y up until the turn of the 21st century? In that case, everything from the traditional 60/40 portfolio to risk parity strategies would need to change, with bonds no longer cushioning equity swings. All else equal, investors would face a tough choice between targeting the same level of portfolio return with greater risk or reducing exposure to riskier assets but sacrificing returns.



Note: Stock-bond correlation is based on 1m total returns and calculated over a 5y centered window. Source: DataStream, FRED, NBER, Robert J. Shiller online data and PGIM IAS. For illustrative purposes only.

Are we near a stock-bond correlation tipping point? Over the last 12m, correlation has moved to positive, perhaps suggesting a regime change. However, this is a short period of time and on a year-to-year basis correlation can fluctuate. While today's economic landscape differs from the 1960s and 1970s, the last time that stock-bond correlation was persistently positive, we should not be lulled into a false sense of security. With deficits on the rise, Fed objectives seemingly in flux, and strengthening incentives for policy coordination, monetary and fiscal policy may be evolving to support positive stock-bond correlation. What should investors be looking for? A close study of monetary and fiscal policy over the past 70y finds that positive correlation is determined by policy and its effects on rate volatility, the co-movement of stock and bond risk premia, and the co-movement of economic growth and rates.

Investors should be mindful of three possible scenarios for stock-bond correlation:

The economy overheats; Fed accommodates. How much stimulus is too much? Could the Fed keep rates low even as inflation climbs?

With deficits rising and Fed objectives in flux, US policy may be evolving in ways that support a shift to positive stock-bond correlation

Would the Fed willingly dilute its hard-won inflation-fighting credibility? Greater Fed accommodation would likely lead to greater rate volatility, higher stock and bond risk premia, and a shift to a negative correlation between economic growth and rates as the Fed spurs growth, rather than reacting to it. These are the hallmarks of the positive stock-bond correlation regime of 1965-2000 when volatility in the 3m yield was two to three times higher than today, stock and bond risk premia trended higher, and growth and interest rates were negatively correlated.

Fed and fiscal policy align. In the US, fiscal and monetary policy are usually independent, but with interest rates still at multi-decade lows, the Fed slow to raise rates, and the debt-to-GDP ratio climbing, the preconditions for policy coordination are visible. In this scenario, a fiscal expansion pushes up rates and crowds out investment, restricting the capital stock and limiting long-term growth. As the fiscal burden grows, incentives for the Fed to be more accommodative of fiscal considerations could grow, too.

It is equally hard to imagine US fiscal and monetary policy independence eroding. Yet, looking back at 1965-2000, we find signs that less sustainable fiscal policy and more discretionary monetary policy supported positive stock-bond correlation. Looking forward, given the large fiscal stimulus and the Fed's inclination to maintain low rates, the possibility of greater policy coordination seems higher now than the recent past, with clear implications for stock-bond correlation and portfolio construction.

Inflation stays dormant; Fed stays independent.
Fears of inflation and a loss of policy independence could be overblown—the future may well look like the recent past. If inflationary pressures fade, the Fed's commitment to low policy rates would not jeopardize its inflation-fighting credibility. Low rates would be a reaction to economic slack, not a shift of Fed priorities. Or, if inflationary trends persist, the Fed could respond in a manner consistent with past policymaking.

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