This Time Is Different (Really)

Alternative investments offer options for investors concerned that stock and bond correlations may be shifting from negative to positive.

December 2023

KEY TAKEAWAYS

- Fixed income failed to provide shelter from the stock market correction in the first quarter of 2022.
- Greater market volatility and investor uncertainty may not be short-term phenomena, with growing signs that the negative stock-bond correlation may be turning positive. We may be entering unfamiliar territory for many investors.
- Meeting this challenge will require new ways to access market trends that are less dependent on the direction of the overall market, potentially via alternative strategies such as private credit, relative value arbitrage, private real assets, and structured products.

Four months into 2022, and we appear to have entered an environment that investors allocated exclusively to traditional assets have long feared. The presumed diversification of an asset allocation mix of long-only, publicly traded stocks and bonds may be breaking down.

Whether that stock/bond relationship (which has been negatively correlated for the better part of two decades) has cyclically shifted or structurally changed will be determined over the coming months and years. But with equity valuations still expensive by most historical metrics, interest rates heading higher, and credit spreads still tight, there is certainly an argument to be made that this breakdown reflects the start of a new market paradigm.

The implications of such a structural shift would be significant. If the model 60/40 equity-and-bond allocation can no longer provide the key ingredients of a well constructed portfolio – capital appreciation, downside protection, and portfolio diversification – investors will have to rethink and reshape their portfolios.

HEADS YOU LOSE, TAILS YOU LOSE

As Exhibit 1 highlights, equities and bonds across the spectrum in the United States have moved downward in concert so far this year.

Depending on the composition and balance of risk across an investor's stock and bond investments, a traditional asset-only portfolio is likely down 5% to 7% already this year – and that includes a 10% rebound in equities at the end of the first quarter.

Exhibit 1: No shelter from the stock market rout in traditional assets

U.S. Equity and Fixed Income Year-to-date Performance

	JAN 2022	FEB 2022	MAR 2022	Q1 2022
EQUITY				
Global Equity	-5.6%	-2.5%	2.7%	-5.5%
Large Cap Tech	-8.5%	-4.6%	4.2%	-9.1%
U.S. Small Cap	-9.6%	1.1%	1.2%	-7.5%
FIXED INCOME				
Investment Grade	-3.6%	-2.5%	-2.9%	-8.7%
High Yield	-2.7%	-0.9%	-1.3%	-4.7%
Municipal Bonds	-2.4%	-0.5%	-2.0%	-4.8%

Source: Yahoo Finance. Data for representative ETFs–Global Equity: URTH, Large Cap Tech: QQQ, U.S. Small Cap: IWM, Investment Grade: LQD, High Yield: HYG, Municipal Bonds: MUB. Period to March 31, 2022. For illustrative purposes only. Past performance is not indicative of future results. Future results are not guaranteed.

Appreciating the myriad uncertainties we are currently facing, it seems safe to assume a few things from a market perspective:

a. The risk of a slowing economy, exacerbated by the need to increase rates, presents a fundamental challenge for stocks and bonds.

b. Market dynamics like higher volatility and greater uncertainty, on a company-specific and macroeconomic basis, are likely to remain in focus moving forward.

c. If stocks and bonds remain positively correlated, each leg of the stool that comprises a well constructed portfolio – capital appreciation, wealth preservation, and portfolio diversification – may be weakened.

THIS TIME IT MIGHT BE DIFFERENT, IF NOT UNPRECEDENTED

Like all advisors that allocate client capital in global markets, we are always thinking about historical parallels to help contextualize current market conditions. At the same time, we fear those famously dangerous words that "this time it's different."

Appreciating the recency bias, it is interesting to examine each double-digit drawdown period for global equities dating back to 2000 to assess how bonds performed, in terms of protection and diversification.

Prior to the onset of the COVID pandemic, the average global equity decline during a correction was just over 20% while bonds generated a positive (2.6%) return (see Exhibit 2). However, that relationship did not hold in early 2020 when a 20%-plus fall in global equities was paired with a slight decline in bonds. During the sharp double-digit decline that kicked off 2022, bonds sold off by more than 400 basis points.

So, the key question is whether this is simply anomalous or potentially persistent?

There is certainly historical precedent for stocks and bonds moving in concert. Multiple environmental factors drive the correlation of traditional assets in the United States.[1] Our analysis of the correlation of historical U.S. stock and bond performance highlights the long-term shifts in this relationship (See Exhibit 3).

Exhibit 2: Recent data shows historical equity-bond correlation may be shifting

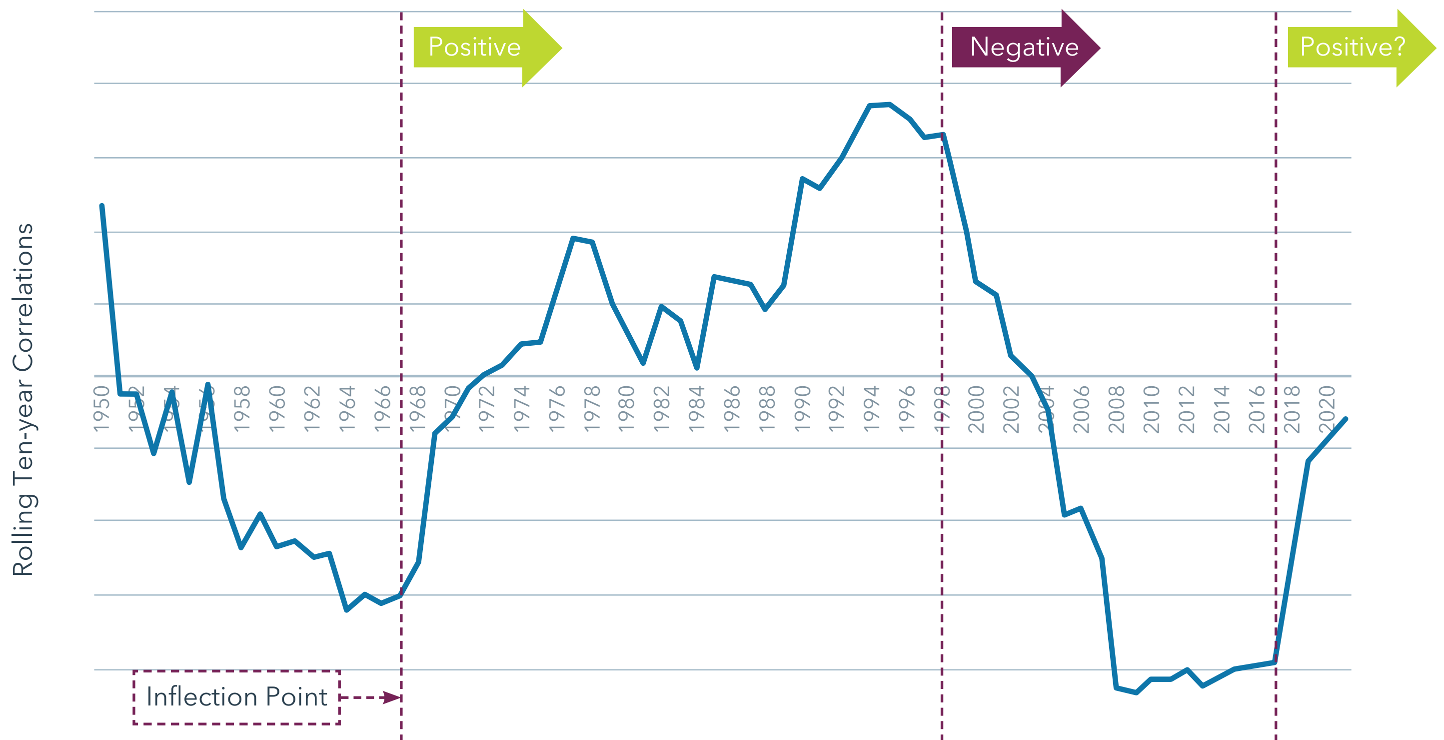
Global Equity and Bond Performance During Stock Market Corrections

START	END	MSCI WORLD	BLOOMBERG GLOBAL AGGREGATE BOND INDEX
Sep 00	Nov 00	-12.6%	1.2%
Feb 01	Sep 01	-24.9%	3.5%
Apr 02	Sep 02	-25.8%	12.9%
Nov 07	Feb 09	-44.2%	0.5%
May 10	Jun 10	-12.7%	0.1%
May 11	Sep 11	-19.6%	1.0%
Jun 15	Sep 15	-10.6%	0.4%
Oct 18	Dec 18	-13.4%	1.2%
Sep 00	Dec 18	-20.5%	2.6%
Jan 20	Mar 20	-21.1%	-0.3%
Jan 22	Mar 22*	-13.3%	-4.2%

*Source: Yahoo Finance. *For the period December 31, 2021, to market trough on March 8, 2022. For illustrative purposes only. Past performance is not indicative of future results. Future results are not guaranteed.*

Exhibit 3: Stock and bond correlation paradigms have shifted over time

Ten-year Correlations Between U.S. Stock and Bond Performance Since 1950



Source: Stern School of Business, New York University. As of January 2022. Annual data. Stocks represented by S&P 500, bonds by U.S. Treasury Bonds. For illustrative purposes only. Past performance is not indicative of future results. Future results are not guaranteed.

Using 10-year rolling correlations, we show that a market paradigm of negative stock-bond correlation has (or had) only been in place since early this millennium, and previously for around 20 years from 1950. These two distinct periods share several traits, including low and stable risk-free interest rates, combined with low and stable inflation.[2]

By contrast, for roughly three decades up to around the turn of the millennium, stocks and bonds generally moved in the same direction. During this period, the U.S. economy exhibited the inverse conditions, principally high and variable risk-free rates and high and variable inflation, though there were other economic and policy drivers.

Should the start of this year prove to be a leading indicator for market conditions, rather than a passing phase – and it is too early to be certain which of these it is – it becomes quickly evident that what worked well over the last two decades will not necessarily work moving forward. Stocks and bonds may not alone be able to fulfill the key portfolio goals of return generation, capital protection, and diversification.

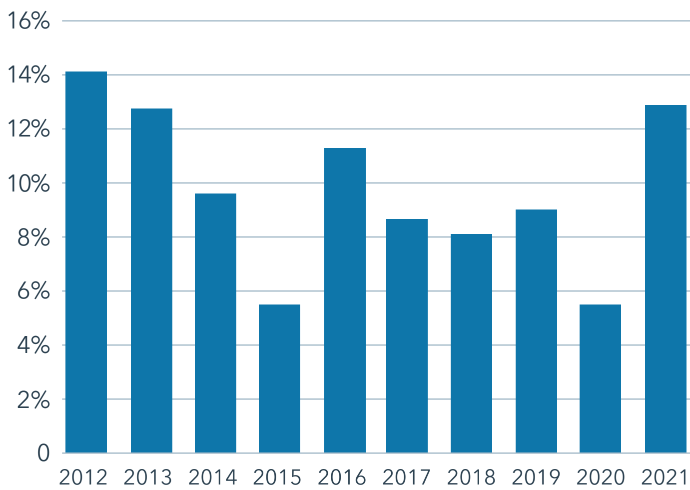
TIME TO BROADEN THE TOOLKIT?

If this truly is indicative of a new market paradigm, we are entering uncharted territory for many advisors. A new mindset and a new set of tools will be required to adequately handle a higher volatility market regime. Finding ways to not just manage but actively exploit these new market trends via alternatives will likely become increasingly important to meeting clients' long-term goals.

This may include certain "non-directional" fixed income strategies, such as relative value arbitrage, that are less dependent upon the trajectory of the overall bond market but are instead focused on exploiting its inefficiencies. We also see opportunities to diversify fixed income allocations with private credit, private real assets, and structured products.

Exhibit 4: Direct lending offers stable returns and diversification versus bonds

Annual total returns, 2012 to 2021 (%)



Quarterly return correlations, Q4 2004 to Q4 2021

Leveraged Loans	0.81
U.S. High-Yield Corporate Loans	0.75
S&P 500	0.70
Private Real Estate	0.36
U.S. Investment-Grade Corporate Loans	0.20
U.S. Municipal Bonds	0.11
Farmland	-0.01
3-Month Treasury Bills	-0.06
Timberland	-0.10
U.S. Aggregate Bonds	-0.29
U.S. Treasuries	-0.62

Sources: Guggenheim, Bloomberg, Cliffwater, as of March 21, 2022. For illustrative purposes only. Past performance is not indicative of future results. Future results are not guaranteed. Annual returns from Guggenheim. Correlations based on quarterly total returns data. From Bloomberg–Private Real Estate: NCREIF Property Index, Farmland: NCREIF Farmland Index, Timberland: NCREIF Timberland Index, U.S. Aggregate Bond: Bloomberg U.S. Aggregate Bond Index, U.S. Treasuries: Bloomberg U.S. Treasury Index, U.S. IG Corporates: Bloomberg U.S. Corporate Bond Index, U.S HY Corporates: Bloomberg U.S. Corporate High Yield Bond Index, U.S. Municipal Bonds: Bloomberg Municipal Bond Index Total Return Index, Leveraged Loans: Value Unhedged USD Credit Suisse Leveraged Loan Total Return, 3-Month Treasury Bills: FTSE "Citi" 3 Month Treas Bill Local Currency, S&P 500: S&P 500 Index. From Cliffwater–Direct Lending: Cliffwater Direct Lending Index.

THE "RECORRELATION" TOOLKIT

1. Private credit

Traditional fixed income is suffering under the quadruple threat of rising rates, higher inflation, low bond yields, and tight credit spreads, creating significant problems for advisors dealing with the "40" in a standard stock/bond portfolio allocation. The first quarter of 2022 highlighted this dilemma, with investment grade bonds down over 8% to start the year.[3]

Private credit provides exposure to floating-rate securities, often secured and senior in the capital structure, with stable total returns, attractive yields, and defensive attributes to help protect against defaults.[4] Additionally, private debt can also provide diversification benefits, offering further value in client portfolios. Direct lending, for example, which is dominated by private, non-bank lenders,[5] has been negatively correlated to the aggregate bond index for nearly two decades (see Exhibit 4).[6]

2. Relative value arbitrage

Relative value arbitrage seeks to take advantage of the fundamental or statistical relationship between different securities and, unlike long-only stocks and bonds, greater uncertainty and rising volatility creates non-correlated, return-generating opportunities.[7] Absent volatility, asset prices tend to be highly correlated, and the arbitrage spread is narrow. Greater volatility causes those spreads to trade in a wider band, providing more opportunities to find value in market mispricing and inefficiencies, and thereby offering a tailwind to strategies like merger, convertible bond, and equity arbitrage, along with fixed income relative value and volatility trading.

Further, the exponential increase in new equity, credit, and convertible bond issuance,[8] and record merger volumes,[9] provide fertile conditions for relative value arbitrage, which takes long and short positions in securities to offer capital appreciation opportunities with downside protection.

3. Real assets

Investments in private real estate, timber, farmland, and global commodities can offer compelling yields,[10] diversification, and exposure to potential long volatility strategies, complementing the traditional long-only portfolio construct.

Core real estate, for example, offers stable, predictable income through long-term contracts that generate regular cash yield for investors.[11] Timberland investments also provide income,[12] with returns that are basically uncorrelated to either stocks or bonds.[13] The energy and mining sectors are direct beneficiaries of commodity price inflation,[14] and therefore may serve as defensive allocations when rates rise and many traditional assets decline, as both stocks and bonds did in the first quarter.

4. Structured products

Structured products are designed to offer both capital protection and yield enhancement. Capital protected instruments come in two forms: market-linked notes, which are a type of bond with a senior but unsecured credit profile, and FDIC-insured certificates of deposit.

In both instances, the notes provide investors with the opportunity to benefit from the performance of an underlying reference asset, while protecting capital at maturity from a decline in the asset's value. Yield enhancement instruments allow investors to benefit from rangebound (i.e., relatively flat) markets by combining conditional downside protection down to a pre-set barrier level, along with partial upside participation via a fixed coupon that typically offers a higher yield than the standard interest rate market. If, however, the reference asset's price declines beyond the established barrier level, the investor is fully exposed to the negative performance of the underlying asset, just as they would be with a direct investment.

As ever, appropriate investment selection depends entirely on an investor's goals and risk and illiquidity tolerance, among many other factors. But for advisors concerned that the shift in stock-bond correlations may reflect a new market reality – particularly in the context of a volatile macroeconomic environment and heightened geopolitical risks – alternatives seem likely to become increasingly necessary components of a portfolio that meets clients' financial goals.

END NOTES

1. Source: PGIM, "US Stock–Bond Correlation: What Are the Macroeconomic Drivers?", May 2021.
2. Source: Ibid.
3. Source: Yahoo Finance.
4. Source: Oaktree Capital, "Direct Lending: Benefits, Risks and Opportunities", May 13, 2021.
5. Source: Ibid.
6. Based on quarterly total returns data from Bloomberg U.S. Aggregate Bond Index and Cliffwater Direct Lending Index over period from Q4 2004 to Q4 2021. Source: Bloomberg, Cliffwater, as of March 21, 2022. For illustrative purposes only. Past performance is not indicative of future results. Future results are not guaranteed.
7. Source: BarclayHedge, "Understanding Relative-Value Arbitrage", February 1, 2012.
8. Source: Equity—Stock Analysis, "IPO Statistics", as of April 8, 2022. Credit—Moody's, "Corporate Bond Issuance Set to Moderate", January 20, 2022. Convertible bonds—Schroders, "Outlook 2022: Global convertible bonds", August 12, 2021.
9. Source: Reuters, "Global M&A volumes hit record high in 2021, breach $5 trillion for first time," December 31, 2021.
10. Source: Russell Investments, "Real assets: Looking for income in all the right places?", October 22, 2020.
11. Source: Russell Investments, "Real assets: Looking for income in all the right places?", October 22, 2020.
12. Source: Nuveen, "Investing in Timberland," 2022.
13. Timberland had a correlation of 0.03 to the U.S. Aggregate Bond Index, and a correlation of -0.10 to the S&P 500 from Q4 2004 to Q4 2021, based on quarterly total returns data. Source: Bloomberg, as of March 21, 2022. For illustrative purposes only. Past performance is not indicative of future results. Future results are not guaranteed. Timberland: NCREIF Timberland Index, U.S. Aggregate Bond: Bloomberg U.S. Aggregate Bond Index, S&P 500: S&P 500 Index.
14. Source: VanEck, "Inflation Heat Keeps Resources Warm", January 21, 2022.

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