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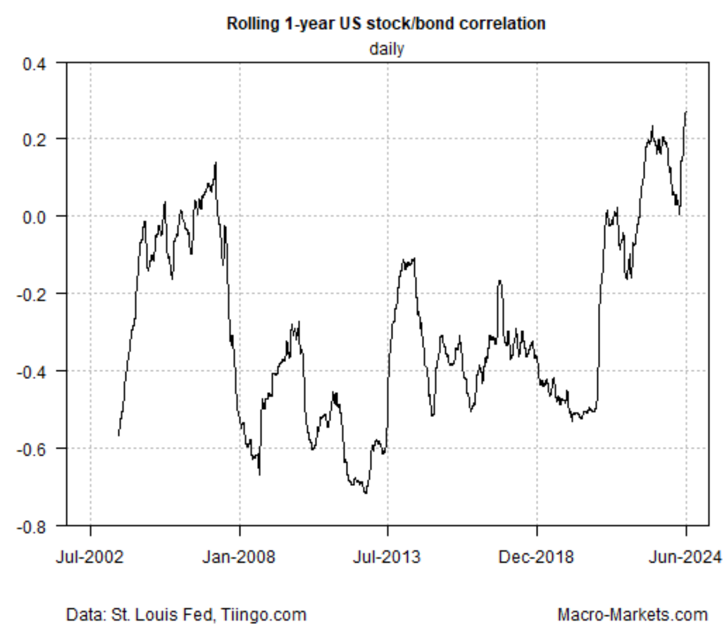
Unusually High US Stock-Bond Correlation Implies Rising Odds For Mean Reversion

Key Points:

- *The rolling 1-year correlation for daily returns for U.S. stocks vs. U.S. Treasuries has risen to the highest level in several decades.*
- *History suggests that the correlation between equities and fixed-income securities is cyclical and so the current elevated readings imply that stock and bond market trends will continue to shift to relatively independent paths.*
- *A return to lower/negative stock-bond correlations suggests a revival in diversification benefits related to owning both asset classes.*

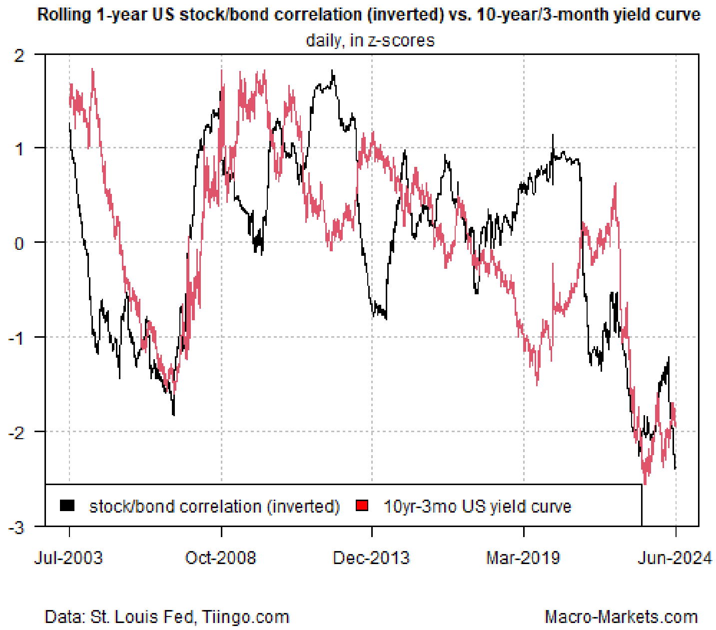


The cornerstone of asset allocation theory rests on the view that owning multiple asset classes enhances diversification, which is widely prized by investors as a risk-management tool. At the core of this strategy is the historical record that highlights complimentary performance results for stocks and bonds – if one market is weak, the other tends to be strong, if only in relative terms. But recent history has upended this view as the correlation between the two markets has increased sharply over the past few years.

As shown in the chart at left, the rolling 1-year return correlation between US shares (proxied by SPDR S&P 500 ETF (SPY)) and US Treasuries (iShares 7-10 Year Treasury Bond ETF (IEF)) has jumped to nearly 0.3 – well above peaks in recent history. (Note: correlations range from 1.0, which is perfect positive correlation, to -1.0, which is perfect negative correlation. Zero equates with no correlation, i.e., random behavior.)

A key reason for the unusual rise in correlation is the aggressive shift in monetary policy by the Federal Reserve over the past two years. The central bank's interest-rate tightening cycle that started in early 2022 has been the fastest round of hikes since the early 1980s. In turn, the unusually swift policy change has dulled the diversification properties of a stock/bond portfolio. This abnormal profile was especially conspicuous in 2022, when stocks and bonds suffered hefty losses at the same time.

To be fair, stock and bond correlations periodically align. But it's reasonable to wonder if relatively extreme correlations of late are set to return to the common historical range and post lower/negative readings when monetary policy begins to normalize. For some context, consider the second chart below, which compares the inverted stock/bond correlation with the 10-year/3-month Treasury yield curve (both time series are shown in z-scores to allow for easier visual comparison).



The yield curve can be thought of as a proxy for monetary/macro conditions. Normally, the curve is upward sloping – yields rise in line with maturities in order to compensate investors with time and duration risk. The curve has been inverted since late-2022, but the degree of inversion has been fading in recent months, which suggests that the market is anticipating that policy will soon start to normalize. In other words, the market seems to be expecting that long yields will fall, short yields will rise, or some combination of the two.

Timing, of course, is uncertain. Nonetheless, history suggests the relatively high positive correlation between stocks and bonds will peak (if it hasn't already) and return to "normal" levels. Under that scenario, diversification/risk-management benefits will strengthen. When will this change unfold? The changing shape of the yield curve will likely provide a clue. As the curve moves closer to un-inverting, the odds will favor a revival in stock-bond diversification benefits.