THE ANGLE

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Fresh perspectives on the market outlook.

STOCKS, BONDS AND THE TRUMP FACTOR

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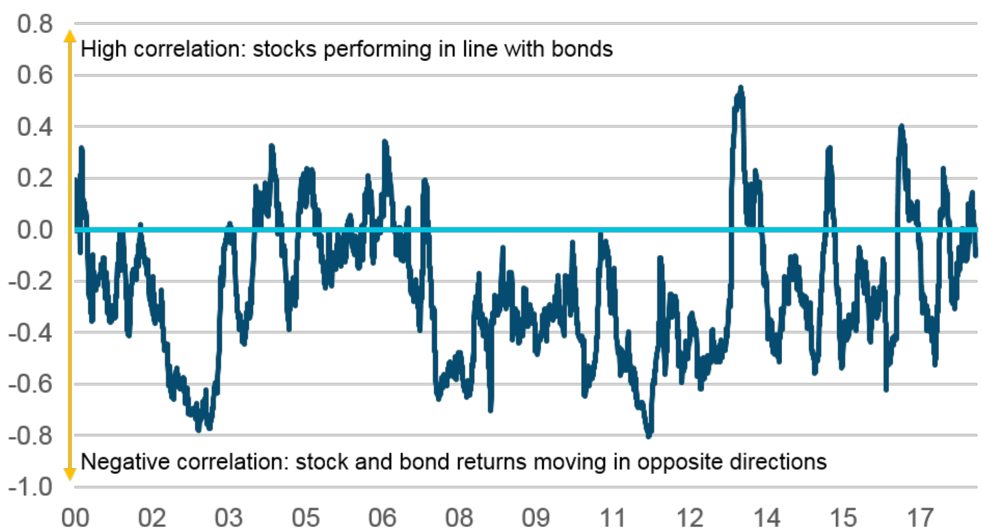
KEY POINTS

- Traditionally investors have assumed that stocks and bonds are not highly correlated in their performance, tending to move in opposite directions. In reality, this is not always the case.
- At times, this means that simply combining stocks with government or other high-quality bonds may not actually offer much benefit of diversification in your clients' portfolios.
- Today, however, as the market's attention turns from inflation fears to concern about Trump's trade wars, we may see the traditional pattern coming back. This in turn may affect how you advise your clients in terms of portfolio construction.

CORRELATION OF STOCKS VS. BONDS



12-week rolling correlation between MSCI World index (stocks) and Bloomberg Barclays Global Aggregate Index (bonds) from 23 August 2000 to 5 April 2018. Source: Bloomberg. Used with permission of Bloomberg Finance L.P.delink

Investors used to take it for granted that stocks and bonds tended to move in opposite directions. Combining them in your clients' portfolios offered a good way to diversify, because when stock markets were falling bond values tended to rise and vice versa. In recent years, however, this relationship has sometimes broken down. Now, interestingly, we may see US President Donald Trump's experiments in trade warfare restore the negative correlation—at least temporarily.

The chart shows the correlation between global stocks and global investment-grade bonds (a mix of government and corporate bonds). A correlation of -1 would mean a perfect inverse relationship, +1 would mean they behaved in exactly the same way, and a correlation of 0 would mean no relationship—that they moved in a random way relative to each other. The chart reveals that historically equities and bonds have often been in a state of negative correlation, but that relationship has become more unstable in recent years.

WHEN STOCKS AND BONDS DIVERGE

Equities commonly perform well when market participants believe the economy will expand. This environment can weigh heavily on government bonds as investors expect inflation and interest rates to rise. When the market expects the economy to slow, equities generally do badly. This can give a boost to bonds as inflation and interest rates would eventually begin to fall. It can get even better during flights-to-quality, when panicked investors dump risk assets and embrace the safety of high-quality government bonds, bidding their prices upward and pushing their yields down. So, in the past, government bonds normally helped to diversify away equity risk. They offered a type of insurance for equity risk, but instead of paying for this insurance, investors collected coupon income.

WHEN THE NEGATIVE CORRELATION BREAKS DOWN

Of late, rising inflation has emerged as a major risk for financial markets, potentially pushing central banks to raise rates at a faster pace than expected. Investors fret that this could not only derail equities, but also create an unfriendly environment for government bonds. When equities and bonds fall together, the correlation between them turns positive and government bonds lose their traditional role as diversifiers of equity risk.

TRUMP'S TRADE WARS

In the last few weeks, however, the major risk for financial markets has shifted away from inflation and US rate hikes to global trade wars. The Trump administration has slapped new tariffs on imports into the US, prompting fears of retaliation by China. Global trade wars might slow down the global, synchronised economic expansion. Under this scenario, equities might suffer, while government bonds should fare well. The correlation between these two asset classes could turn negative again, which offers a potential opportunity for multi-asset investors to add value for client portfolios.

THE BOTTOM LINE

We have seen some evidence of negative correlation making a comeback. Equity markets have been losing ground recently, while 10-year government bond yields have eased. Blending equities and government bonds has become constructive again. However, government bond yields remain quite low (about 2.8% in the US, 1.4% in the UK and only 0.5% in Germany, as of 12 April), which means they may not have much room to add value in price terms. Low yields also imply that, when purchasing the "insurance" of government bonds, the coupon payment investors collect cannot match that of a decade ago. Historically low yields also limit the room for yields to fall (and price to rise) and the risk of rising rates and falling bond prices still exists.

Nevertheless, you may wish to consider how this changing environment may impact upon the portfolios you construct for your clients as you seek to help them achieve their financial goals.

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