

Navigating the Diversifiers' Dilemma

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One of the most significant developments in financial markets since the pandemic has been the shift in the correlation between bonds and equities from negative to positive. This followed a 20-year period during which the correlation was consistently negative. In simple terms, bonds lost their diversification benefits as they moved in tandem with equities.

The primary reason for this was the return of inflation. The drivers of which were: the pandemic disrupting the supply of goods and services, government spending increasing substantially to support households and businesses, the Federal Reserve facilitating this spending by expanding their balance sheet and holding interest rates at low levels.

Around the time of the bursting of the Dot-Com bubble in 2000, the correlation between bonds and equities turned decisively negative. While equity weakness made bonds more attractive as a safe haven, two other factors played an important role. Firstly, a shift in monetary policy towards price stability and inflation targeting, with a target around 2%. This helped reduce the tail risk of very high inflation and this anchoring boosted the appeal of bonds as a diversifier.

Secondly, China joining the World Trade Organisation led to hundreds of millions of low wage and productive workers entering the global labour force. This integration heralded a period of accelerated integration and was a profoundly disinflationary force on the global economy. This again increased the attractiveness of bonds in investment portfolios.

In the period prior to the pandemic, the primary risk to economies and equities was deflation. This backdrop was conducive to a negative bond-equity correlation, which made for a golden age of portfolios comprising of 60% equities and 40% bonds.

This was a different world to the period between the mid-1960s and late 1990s, where bonds and equities were on average positively correlated. This was a time when the main risk to business cycles and equities was inflation.

The 60s saw the Great Society initiatives in the US such as the introduction of Medicare, Medicaid, and increased welfare spending. This, along with the spending on the Vietnam war, increased the budget deficit, which proved inflationary. The 1970s then saw two major oil price shocks and the end of the Bretton Woods monetary system, which compounded inflationary pressure. The inflation rate then fell in the 1980s, but strong growth and the memories of the 70s meant investors didn't trust the bond market to offset equity risk.

Understanding past cycles highlights the importance of understanding different investment regimes, as this helps determine the most attractive asset allocation. The past four years contains some similarities with the late 60s and the 70s.



However, bonds did perform very well in the recent equity sell-off in early August. This raises the important question of whether we have reverted to the pre-pandemic regime where bonds again have attractive diversification benefits.

The reason bonds rallied as equities fell was the shift in focus from inflation to economic growth. More specifically, whether the US labour market was about to crack and tip the economy into recession.

Oil prices remain an important factor. Commodities worked especially well to offset equity risk in 2022 when the Russia-Ukraine war broke out. Manufacturing companies are large consumers of energy and saw input costs go up which hit profitability. This is why commodities can work well as diversifiers. Although, when the risks are on the demand side rather than supply, oil and industrial commodities tend to move in tandem with equities.

Gold has been a good diversifier as the negative relation with real yields has broken down. Geopolitics and more specifically the sanctions placed on Russia's foreign exchange reserves help explain why. While US investors have less incentive to own gold in a higher real rate environment, foreign central banks have different economic priorities. This has increased the attractiveness of gold as a reserve asset and it has been incredibly strong.

Recently, commodities have been mixed as diversifiers. Middle East tensions have been hanging over the oil price, but strong US production and weak growth in China have seen the oil price fall. Lower gas/petrol prices help to support the consumer, so in the event of another oil price shock, commodity exposure would help offset equity weakness. Speculative positioning in gold looks a little stretched, but it is structurally very well supported.

The economic outlook is finely balanced. The key question is whether interest rate cuts have come in time to stop a negative feedback loop taking hold in the US labour market. While recession concerns suggest bonds will work as a hedge, the market is already pricing in an aggressive rate cut cycle, which limits the ability for further capital gains unless growth weakens substantially.

The pandemic heralded a regime change in markets due to the return of inflation, but in the short-term, recession risks dominate the outlook. These contrasting forces present a dilemma for investors. Rather than try to forecast short term correlations, it's better to focus on the medium term and build a diversified portfolio that is resilient to different types of risk.

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