



PORTFOLIO CONSTRUCTION

A Changing Stock-Bond Correlation

Q1 2023

An earlier version of this article was published as the Q2 2022 Alternative Thinking

The relationship between stock and bond returns is a fundamental determinant of risk in traditional portfolios. For the first two decades of the 21st century, the stock–bond correlation was consistently negative and investors were largely able to rely on their bond investments for protection when equities sold off. But this was not the case in the previous century, and macroeconomic changes—such as higher inflation uncertainty—could lead to a reappearance of the positive stock–bond correlation of the 1970s, 80s, and 90s. This would have broad implications for investors, either increasing portfolio risk or forcing allocation changes likely to reduce expected returns. This article analyzes the implications for investors of a change in this “golden parameter” and presents a simple macroeconomic model to help understand its drivers, supported by international empirical evidence. Finally, it explores the role of alternatives in making up the potential diversification deficit in a positive stock–bond correlation world.

Key Findings

- Historically, equity and bond markets have exhibited opposite-sign sensitivities to growth news and same-sign sensitivities to inflation news. According to a simple model, the stock–bond correlation thus depends not on the level of inflation, but on the relative volatility of growth and inflation and the correlation between them.
- Empirically, this model explains around 70% of long-term variation in the US stock–bond correlation, with similar results internationally. It is less successful at explaining short-term fluctuations.
- If a sustained rise in inflation uncertainty drives the correlation higher in the present decade, investors can make up the diversification deficit by raising allocations to alternative diversifiers, such as dynamic liquid alternatives and commodities.

This document is not intended to, and does not relate specifically to any investment strategy or product that AQR offers. It is being provided merely to provide a framework to assist in the implementation of an investor's own analysis and an investor's own view on the topic discussed herein.

This document has been provided to you solely for information purposes and does not constitute an offer or solicitation of an offer or any advice or recommendation to purchase any securities or other financial instruments and may not be construed as such. The factual information set forth herein has been obtained or derived from sources believed by the author and AQR Capital Management, LLC (“AQR”) to be reliable but it is not necessarily all-inclusive and is not guaranteed as to its accuracy and is not to be regarded as a representation or warranty, express or implied, as to the information's accuracy or completeness, nor should the attached information serve as the basis of any investment decision. This document is not to be reproduced or redistributed to any other person. The information set forth herein has been provided to you as secondary information and should not be the primary source for any investment or allocation decision. Past performance is not a guarantee of future performance. Diversification does not eliminate the risk of experiencing investment losses.

This material is not research and should not be treated as research. This paper does not represent valuation judgments with respect to any financial instrument, issuer, security or sector that may be described or referenced herein and does not represent a formal or official view of AQR. The views expressed reflect the current views as of the date hereof and neither the author nor AQR undertakes to advise you of any changes in the views expressed herein.

The information contained herein is only as current as of the date indicated, and may be superseded by subsequent market events or for other reasons. Charts and graphs provided herein are for illustrative purposes only. The information in this presentation has been developed internally and/or obtained from sources believed to be reliable; however, neither

AQR nor the author guarantees the accuracy, adequacy or completeness of such information. Nothing contained herein constitutes investment, legal, tax or other advice nor is it to be relied on in making an investment or other decision. There can be no assurance that an investment strategy will be successful. Historic market trends are not reliable indicators of actual future market behavior or future performance of any particular investment which may differ materially, and should not be relied upon as such. Diversification does not eliminate the risk of experiencing investment losses.

The information in this paper may contain projections or other forward-looking statements regarding future events, targets, forecasts or expectations regarding the strategies described herein, and is only current as of the date indicated. There is no assurance that such events or targets will be achieved, and may be significantly different from that shown here. The information in this document, including statements concerning financial market trends, is based on current market conditions, which will fluctuate and may be superseded by subsequent market events or for other reasons.