CIO Office Perspective

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CIO Office

When the Golden Relationship Breaks: Rethinking Diversification in a Changing Stock–Bond World

CIO Office

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For most of the past two decades, investors enjoyed a gift. Stocks and bonds, the twin pillars of traditional portfolios, moved in opposite directions. When equity markets sold off, Treasuries usually rallied. That negative correlation—the "golden parameter" of asset allocation—allowed portfolios to compound with less stress. It gave clients confidence that even in the darkest moments, bonds would cushion the blow.

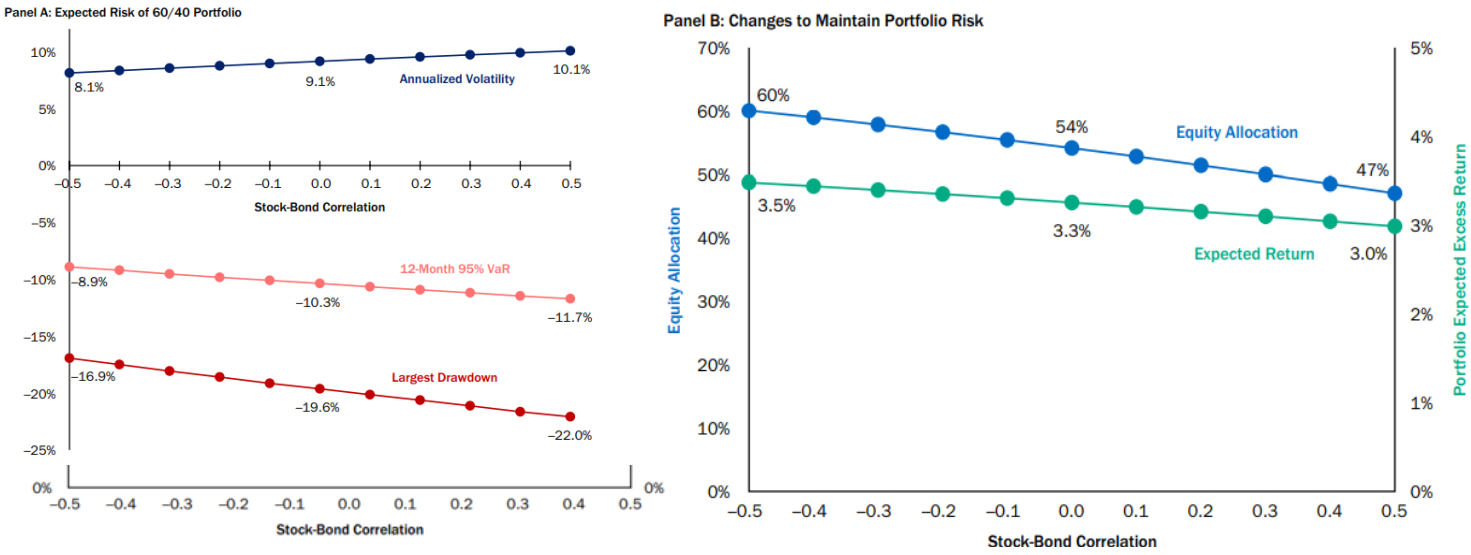
But history warns us this was an anomaly. For much of the 20th century, stocks and bonds often fell together. The 1970s, the inflationary 1980s, even parts of the 1990s—these were decades when the relationship was positive. Bonds did not hedge equities. They amplified risk.

As CIO, I believe we must prepare for the possibility that the comforting patterns of the last 20 years may not repeat. Inflation uncertainty has returned. Policy credibility is under constant scrutiny. And supply-driven shocks—from energy to geopolitics—are more frequent. This shift matters not just to academics, but to every portfolio we manage.

Why Correlation Matters for Real Investors

Correlation is not an abstract statistic. It translates directly into risk and return. A simple exercise shows why.

Impact of changing correlation on 60/40 portfolio risk and return



NOTES: Hypothetical 60/40 stock–bond portfolio based on assumption of 15% volatility for stocks and 4% volatility for bonds, with 0.3 Sharpe ratio for each asset class. Volatility, VaR, and drawdown estimates are medians from 100,000 10-year simulations with monthly, normally distributed returns. For Panel B, we solve for the weights required to maintain portfolio volatility (assuming -0.5 SBC as the base case) as we increase the stock–bond correlation assumption.

When the stock–bond correlation rises from –0.5 to +0.5, the volatility of a 60/40 portfolio increases by around 20%. Measures of downside risk—Value-at-Risk and drawdown—rise even more, by roughly 30%. To maintain the same level of risk, investors would have to reduce their equity allocation significantly. The cost? Lower expected returns.

This is why correlation is more than a mathematical curiosity. It is the invisible thread holding together the modern diversified portfolio. If that thread frays, we either accept more risk or accept less return. Neither is an easy conversation with clients.

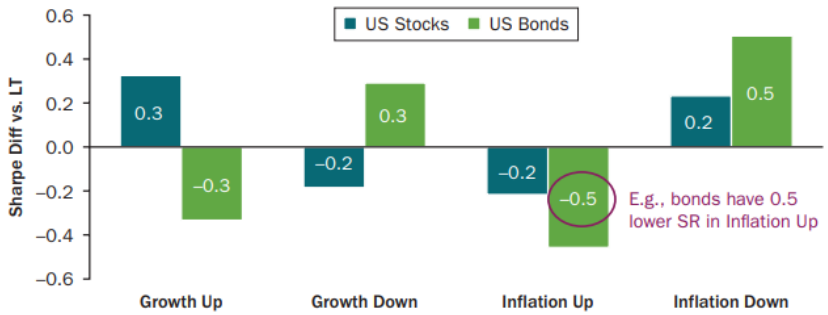
What Actually Drives the Relationship?

It is tempting to think the answer lies in interest-rate levels or inflation itself. But the research shows otherwise. The key is not the **level** of inflation, but the **uncertainty** around inflation relative to growth.

* Growth shocks move equities up and bonds down.
* Inflation shocks push both asset classes down together.

When growth dominates, the correlation is negative. When inflation dominates, the correlation turns positive.

Sharpe ratios of stocks and bonds in different growth/inflation regimes



NOTES: US Stocks are the S&P 500. US Bonds are nominal 10-Year US Treasuries. Each quarterly 12-month period is classified as "up" or "down" by comparing the indicator value to its full sample median. The growth indicator is an average of two normalized series: 1) the Chicago Fed National Activity Index (a monthly composite of 85 indicators of US economic activity) and 2) the surprise in industrial production growth over the past year (difference between realized IP growth and Survey of Professional Forecasters forecast a year earlier). The inflation indicator is also an average of two normalized series: (1) the level of year-on-year inflation and (2) the inflation surprise (difference between realized inflation and Survey of Professional Forecasters forecast a year earlier).

The simple model presented in the study confirms this. Using nearly a century of U.S. data, it finds that about 70% of the long-term variation in stock–bond correlation can be explained by three factors:

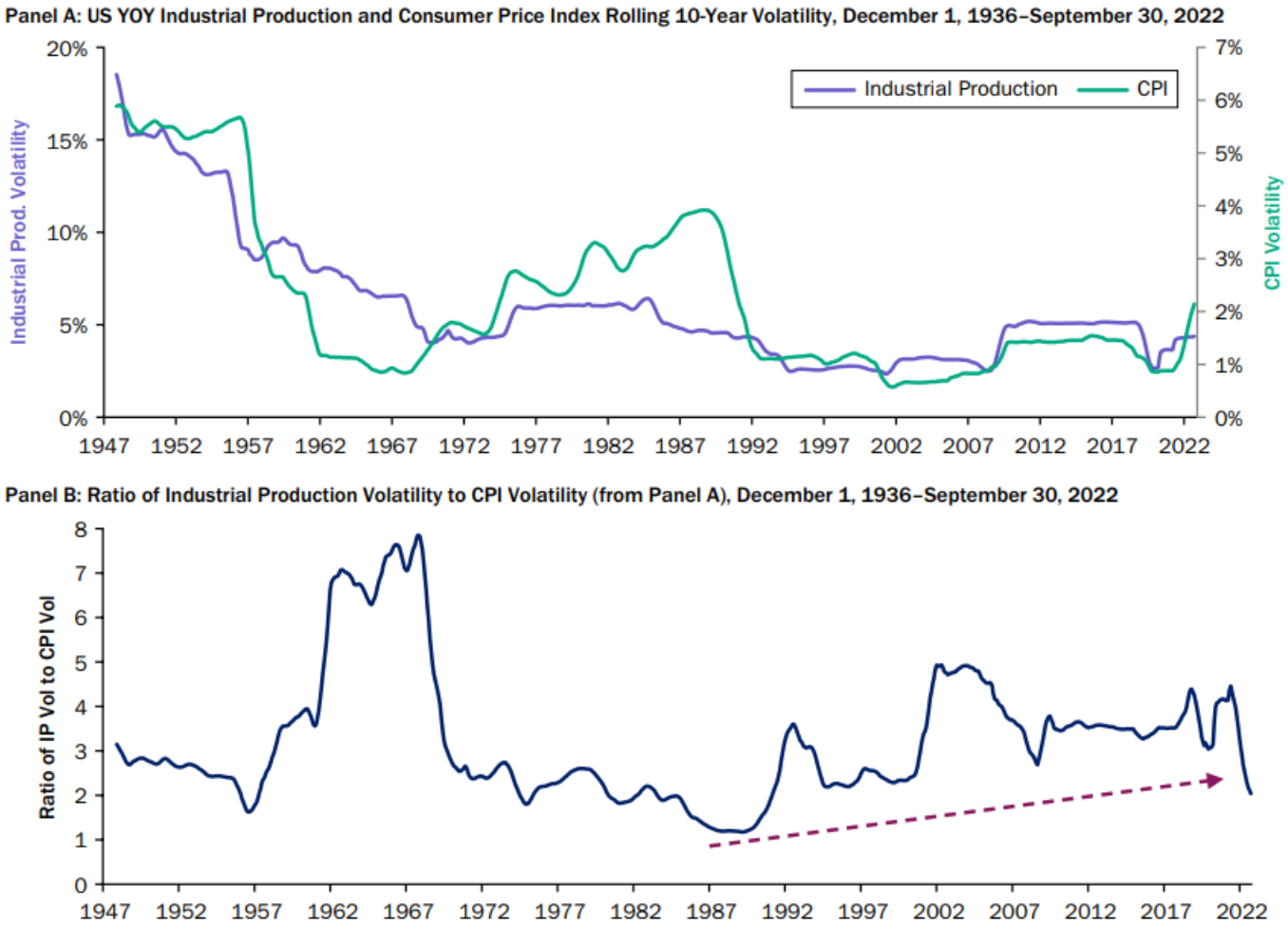
1. Growth volatility
2. Inflation volatility
3. The correlation between growth and inflation

The takeaway is powerful. The correlation is not random. It is a function of macro regimes. In demand-driven economies with anchored inflation expectations, we enjoy negative correlation. In supply-shock economies with unstable inflation, we face positive correlation.

The Return of Inflation Risk

The 2000s and 2010s were defined by stable inflation, globalization, and a world where central banks' credibility was unquestioned. Demand shocks—think the global financial crisis—dominated. That was fertile ground for a negative stock–bond correlation.

The 2020s look different. Supply-side disruptions are everywhere: energy price spikes, pandemic bottlenecks, geopolitical fragmentation. Inflation volatility has risen sharply.



NOTES: US YOY Industrial Production is the 12-month change in Industrial Production. US YOY Consumer Price Index is the 12-month change in the CPI for All Urban Consumers: All Items in US City Average. Panel A is the rolling 10-year realized volatilities of these two series. Panel B is the ratio of the two series in Panel A.

This is the essence of the challenge. When inflation volatility is high relative to growth volatility, the diversification benefit of bonds collapses. This is not speculation—it is what history shows us in the 1970s and early 1980s.

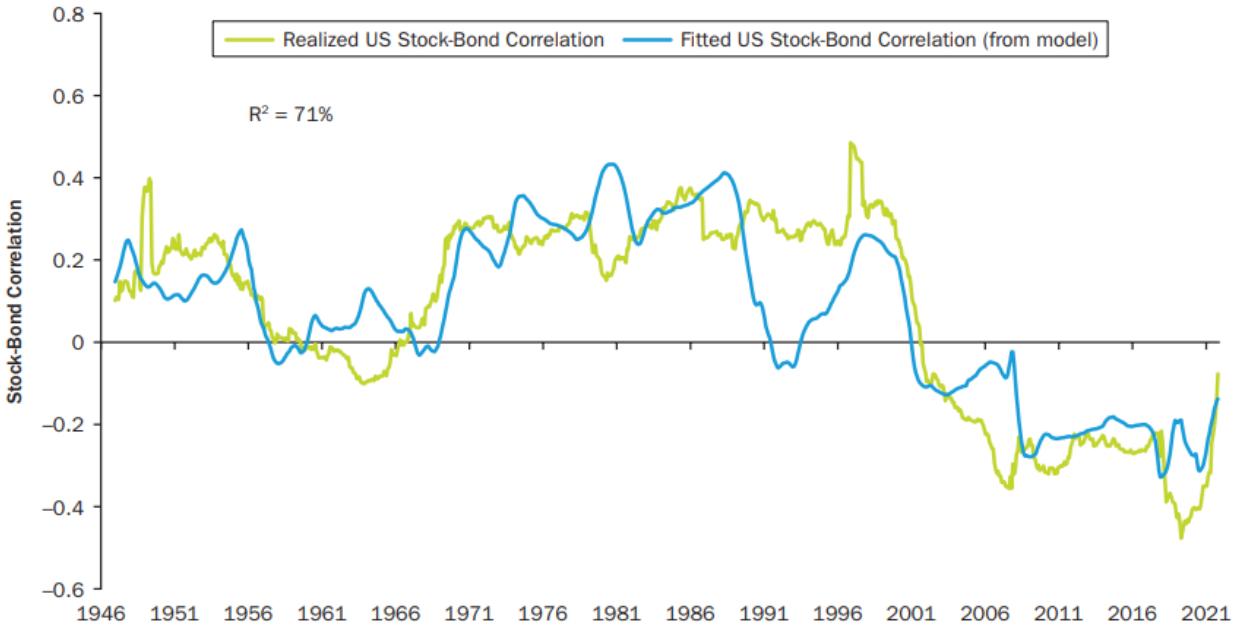
As CIO, my base case is not an immediate return to those decades. Central banks have stronger frameworks today. Inflation expectations remain broadly anchored. But the risk is no longer theoretical. Investors must price it in.

A Global Phenomenon, Not Just American

Skeptics might ask: is this only about U.S. markets? The answer is no. The study tested the model across Germany, Japan, the UK, France, and Italy. The findings were remarkably consistent.

International comparisons of fitted vs realized correlations

Visually Testing the Model: Forecast and Realized US Stock–Bond Correlation, Rolling 10-Year, December 1, 1936–September 30, 2022



NOTES: US stocks are the S&P 500. US bonds are nominal 10-Year US Treasuries. For the regressions, the series being analyzed is the rolling 10-year stock–bond correlation. Growth (IP) is the 12-month change in industrial production. Inflation (CPI) is the 12-month change in the CPI. Growth risk is the rolling 10-year volatility of Growth. Inflation risk is the rolling 10-year volatility of Inflation. Growth–inflation correlation is the rolling 10-year correlation between growth and inflation. The fitted correlation uses the regression betas/alpha from Exhibit 5.

The model explained between 50% and 85% of long-term correlation variation across markets. Germany showed the strongest fit. Italy was an outlier, where sovereign credit risk added another layer of complexity.

For global private bank clients, this message is critical. The diversification challenge is not solved by simply moving portfolios abroad. The structural drivers—growth shocks vs inflation shocks—are universal.

Sectors and Styles: Not All Equities Behave the Same

While the broad equity market drives most of the conversation, there are important nuances beneath the surface.

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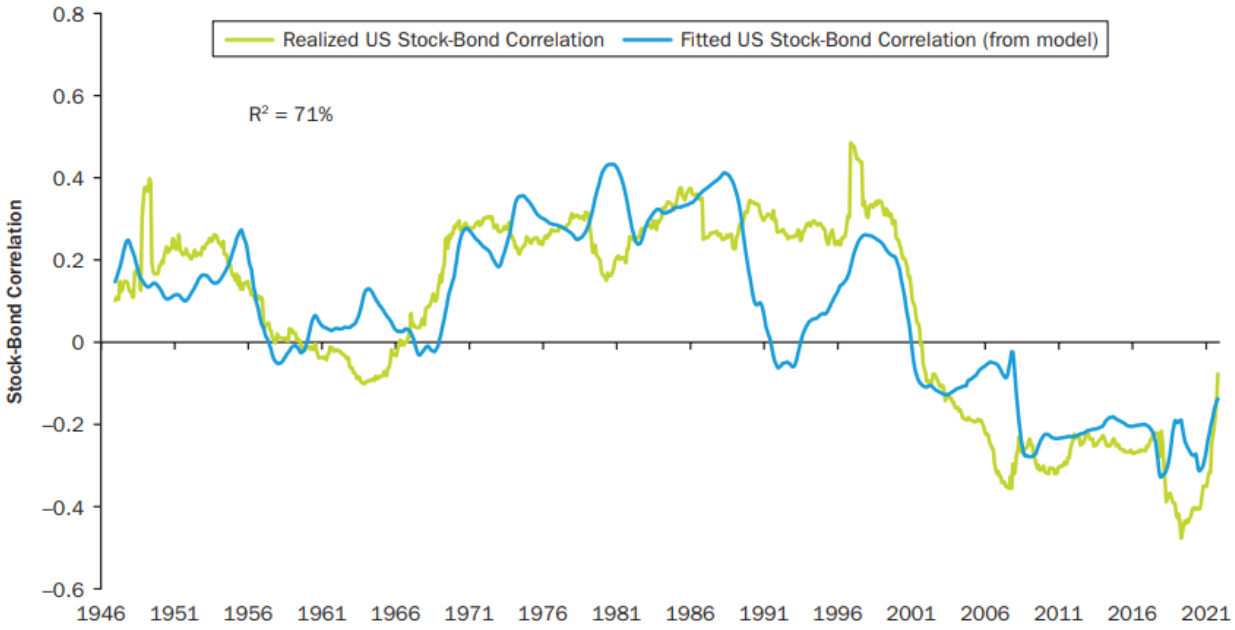

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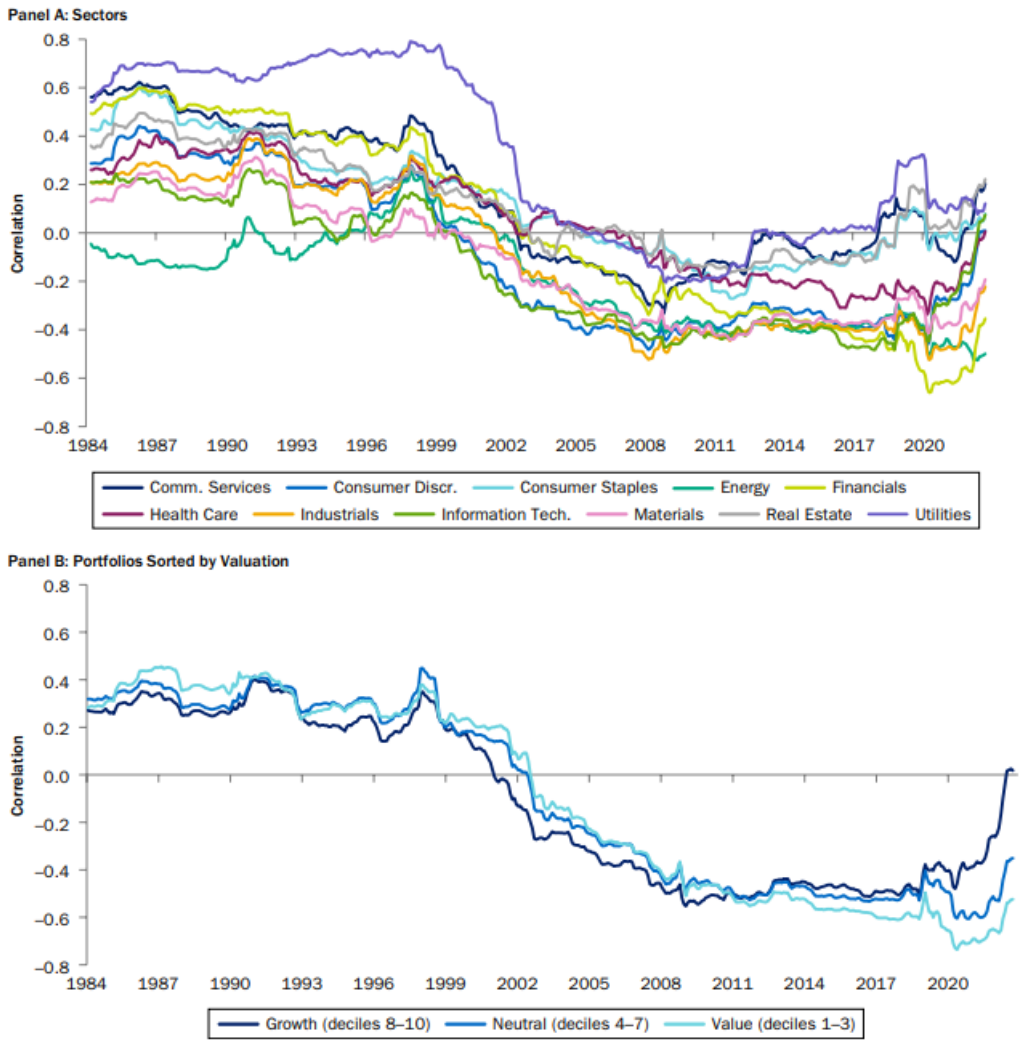
Sector and value vs growth correlations to bonds

Rolling 10-Year Bond Correlations for US Equity Market Sectors, March 1, 1974–September 30, 2022



NOTES: Rolling 10-year series based on overlapping three-month returns at monthly frequency. Valuation portfolios are sorted on book-to-price, from the Ken French data library (https://mba.tuck.dartmouth.edu/pages/faculty/ken.french/data_library.html).

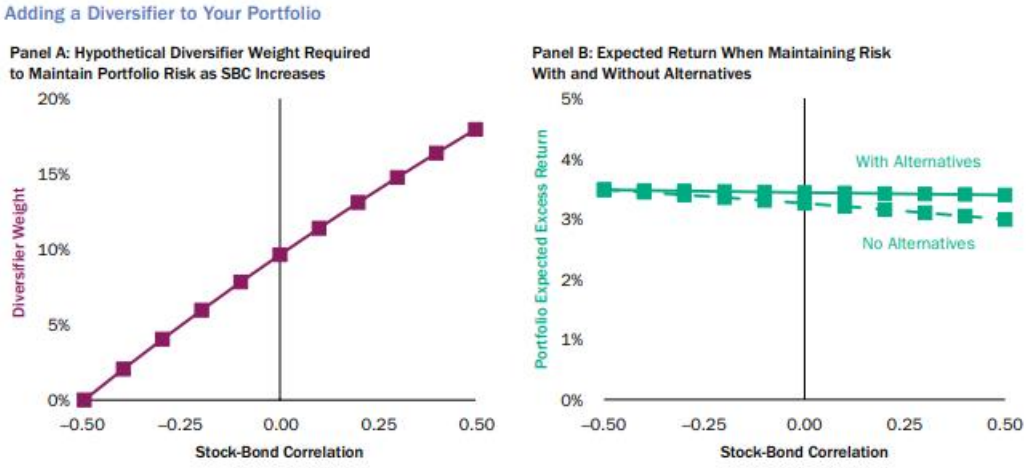
* Utilities and staples—with their bond-like cash flows—tend to move more in line with bonds.
* Energy and industrials—more resilient to inflation—tend to be negatively correlated.
* Style factors also shift. At times, growth stocks have behaved more like long-duration assets, showing stronger correlation with bonds.

For us as allocators, this reinforces the importance of sector and factor diversification, not just headline equity/bond splits.

Alternatives: The Third Allocation

If stocks and bonds can no longer be counted on to hedge each other, the solution is not despair. It is to embrace a "third allocation"—assets or strategies that diversify both simultaneously.

Impact of adding an alternative diversifier to maintain portfolio risk/return



NOTES: We assume a 0.3 Sharpe ratio for stocks, bonds, and alternatives. We assume 15% volatility for stocks, 4% volatility for bonds, and 10% volatility for alternatives, with alternatives zero-correlated to stocks and bonds. As we increase the SBC assumption, we hold everything else equal but solve for the alternatives capital weight that results in a portfolio with the same volatility as the 60/40 portfolio with SBC = –0.5, keeping the ratio of stocks to bonds fixed at 60:40. In Panel B, the solid line is expected excess return with alternatives, and the dotted line is without.

The research highlights several candidates:

*** Commodities:** historically low correlation to both stocks and bonds, with strong positive sensitivity to inflation shocks. A broad commodity basket provides more robust inflation protection than any single sector.
*** Liquid alternatives:** such as long–short equity, risk premia strategies, and macro/CTA funds. Many of these are market neutral or thrive on volatility, making them strong diversifiers in inflationary regimes.
*** Private markets:** private equity and credit may dampen mark-to-market volatility, but they carry the same underlying economic exposures as public markets. Their role is more about smoothing than true diversification.

As CIO, I view commodities and systematic alternatives as the more effective diversifiers for this challenge. They should play a larger role in portfolios designed for the next decade.

The Good Luck vs Good Policy Debate

One of the most fascinating debates is whether the negative correlation of the 2000s and 2010s was a product of “good luck” or “good policy.”

*** Good luck:** The global economy was dominated by demand shocks, which naturally create a positive link between growth and inflation. That supported negative correlation.
*** Good policy:** Central banks, from Volcker onwards, built credibility in fighting inflation. Inflation expectations became anchored, reducing volatility and reinforcing diversification.

The truth is likely a mix of both. But as recent years remind us, luck is not a strategy. Investors cannot assume the past regime will return.

What This Means for Client Portfolios

For private banking clients, the implications are concrete:

1. Diversification is not free. The 60/40 portfolio that worked so well may deliver lower returns with higher volatility if correlation shifts.
2. Risk must be monitored. We should actively track stock–bond correlation, inflation volatility, and growth–inflation interactions as leading indicators.
3. Alternatives matter more. From commodities to systematic strategies, these exposures may no longer be optional—they are essential.
4. Scenario planning is critical. We must stress-test portfolios not just for returns, but for correlation shocks. What happens if stocks and bonds sell off together for three consecutive years?

This is the type of conversation we need to have with families, entrepreneurs, and institutional clients alike.

Conclusion: The CIO’s Responsibility in a World of Uncertainty

The beauty of the negative stock–bond correlation was its simplicity. It allowed us to build robust portfolios with two building blocks. That era may be ending.

The coming decade is unlikely to provide the same free hedge. Inflation uncertainty is the swing factor, and it is rising. If we do return to a world of positive correlation, portfolios will need more than bonds to balance risk. They will need commodities, liquid alternatives, and a more thoughtful approach to sector and style exposures.

This is not a counsel of despair. It is a call for preparation. As CIO, my role is to ensure portfolios are not anchored in yesterday’s assumptions, but ready for tomorrow’s shocks. We cannot control correlation. But we can control how we prepare for it.
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Appendix

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