ECONOMIC VIEWPOINT

Stocks and Bonds: Parting Ways

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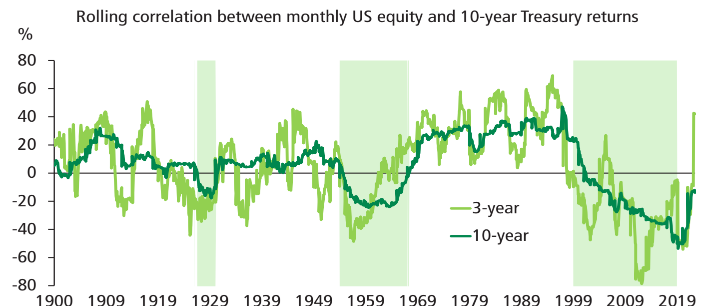
Summary
Over the past year, the positive correlation between stocks and bonds has been a source of pain for many cross-asset investors. A negative stock–bond correlation ultimately rests on price stability, and we expect central bankers will eventually achieve that. Of course, given the recent bout of high inflation and emerging secular trends, returning inflation to 2% could take some time and prices may be more volatile moving forward. That means the stock–bond correlation is unlikely to return to the deeply negative range it was in between 2000 and 2020. Investors may, therefore, need to look to other asset classes to diversify their portfolio risks—at least until there are clearer signs that inflation has been truly tamed.

Over the past year, the positive stock–bond correlation has been a headache for cross-asset investors. Since the turn of the millennium until the pandemic, investors had benefited from a reliably negative correlation between stocks and bonds. But what should have been a hedge against falling equity prices has turned into a conduit for further pain for investors. The correlation between the asset classes is now clearly positive. Looking back over a long time horizon, we find that the deeply negative stock–bond correlation of the early 2000s was more of an exception than a rule (graph 1). Although there were other periods of sustained negative correlation between stocks and bonds, most of the time the two asset classes either traded in the same direction or had no correlation.

The anomaly that began at the turn of the millennium can likely be chalked up to a significant decline in inflation volatility. The main drivers of cross-asset returns are growth and inflation. Stocks and bonds respond in opposite directions to growth outcomes, but tend to trade in the same direction with respect to inflation shocks (graph 2).

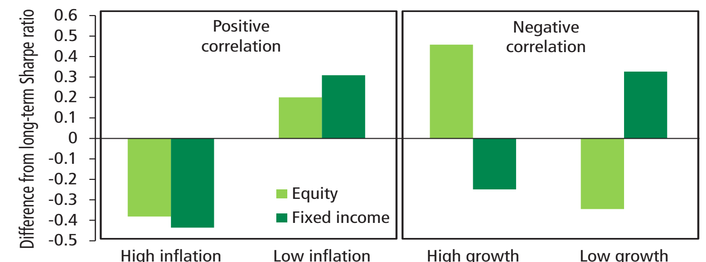
The widespread adoption of inflation targeting during the 1990s helped quell inflationary pressures and pushed growth into the driver's seat for asset returns. That jumpstarted the negative stock–bond correlation that many investors have taken for granted until recently. The late 1920s and mid-1950s also offered periods of persistently negative stock–bond correlations which came alongside very low inflation (averaging below the 20th percentile). It's easy to see that the Achilles heel of a pure

GRAPH 1
Stock–Bond Correlations Were Deeply Negative throughout Most of the 2000s, but That Was More of an Exception than a Rule



Sources: Robert Shiller and Desjardins Capital Markets

GRAPH 2
Stocks and Bonds Respond Similarly to Inflation, but Move in Opposite Directions to Growth Shocks



Sources: Bloomberg and Desjardins Capital Markets

NOTE TO READERS: The letters k, M and B are used in texts and tables to refer to thousands, millions and billions respectively.
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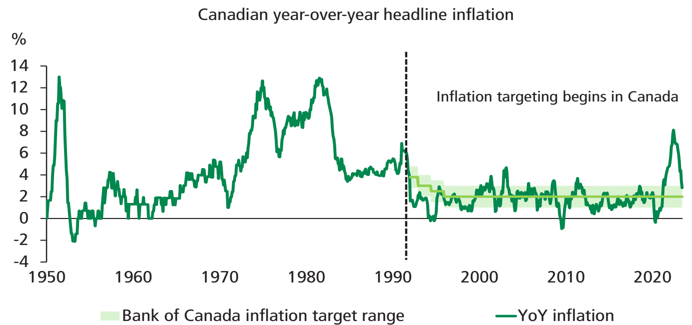
stock–bond portfolio is high inflation. That's what drove steep losses in fixed income and a steady grind lower in equities last year.

Now that the pandemic is over, inflation appears to be driving asset returns once again, and there are legitimate concerns that it will continue to do so. Secular factors such as the green transition and the preference for onshoring or friend-shoring critical production are expected to put upward pressure on inflation. The negative stock–bond correlation ultimately rests on price stability and low inflation risk premia. So, at the least, it's not clear that the stock–bond correlation will take a linear path back to its pre-pandemic form.

That said, we expect that price stability will eventually be achieved. While the pandemic represented a major failure in inflation targeting, central bank mandates remain focused on returning inflation to 2%. Policymakers were very successful using their tools to achieve price stability pre-pandemic (graph 3). Of course, given the recent bout of high inflation and the emerging secular trends mentioned above, returning inflation to 2% could take some time and prices may be more volatile moving forward. That means the stock–bond correlation is unlikely to return to the deeply negative range it was in between 2000 and 2020. Rather, we expect it could settle into the range similar to the one we saw in the 1920s or 1950s. Investors may, therefore, need to look to other asset classes to diversify their portfolio risks, particularly in the near-term—at least until there are clearer signs that inflation has truly been tamed.

GRAPH 3
Inflation Targeting Has Resulted in Relatively More Stable and Predictable Inflation



Sources: Statistics Canada, Bank of Canada and Desjardins Capital Markets