seed investments

Global Equity and Bond Correlations

As part of Seed's multi management process, we perform monthly asset class valuations using our in-house quantitative models. The output of these models guides our tactical asset allocation decisions, where we under- or overweight certain asset classes in the short term, compared to our longer-term target weights.

Although we have established models for the main asset classes on both the local and global side, the Seed team also looks at some additional measures that either support or challenge our main models. Today we investigate the correlations between global equities and global bonds, using a dataset stretching back to 1985 and two well-known proxies, the S&P 500 and the Bloomberg US Treasury index.

At the start of 2023, many headlines stated that "the 60/40 portfolio is dead" referring to the popular global portfolio mix of 60% equities and 40% bonds. This followed after this blend produced -15.8% for the 2022 calendar year, with both equities and bonds in the red indicating a potential positive correlation trend. Since inception of this bond index in 1985, only the 2008 global financial crisis produced a worse return at -19.7%. The great news is that this portfolio has recovered well and produced 16.7% last year - well above the average of 9.8% - thanks to a booming S&P 500.

The chart below shows a sharp increase in the rolling 1-year correlation between the two asset classes since 2020, and investors believed this trend is responsible for the 2022 setback. Some investors are also concerned that this increase in correlations could continue, and will reduce the usefulness of global balanced portfolios.

Chart 1: S&P 500 & Bloomberg US Treasury 1Y Rolling Correlation

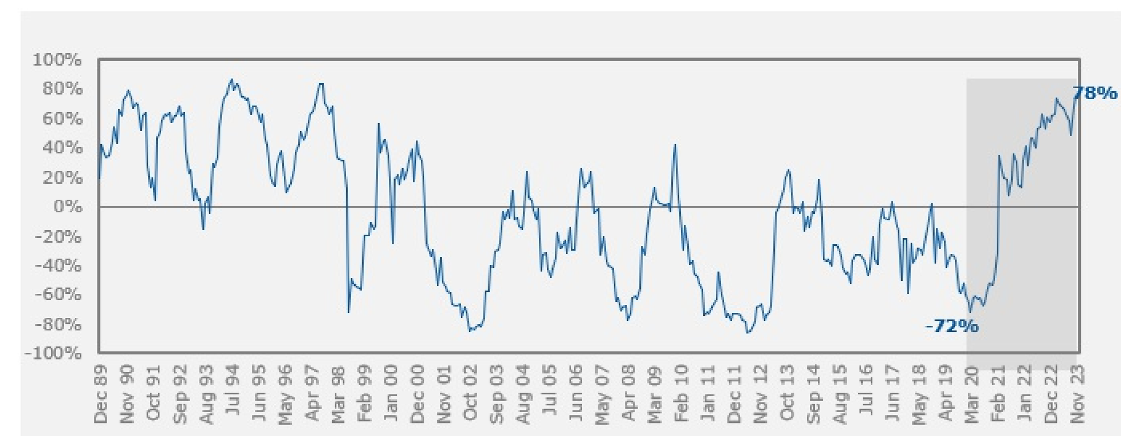

Chart Source/s: Seed Investments (2024)

When examining the annual correlations and underlying asset class performances since 1985, there is no definite link between the correlations and performances. In other words, high correlations do not necessarily mean low returns for the blended portfolio. Indeed, the synergy between bonds and equities have worked well in many high correlation years in the past.

The chart below shows the annual calendar year returns from equities and bonds, as well as the monthly correlation for the year. The years are not displayed in chronological order, but rather sorted into 4 different environments:

Chart 2: Annual Calendar Year Returns From Equities & Bonds

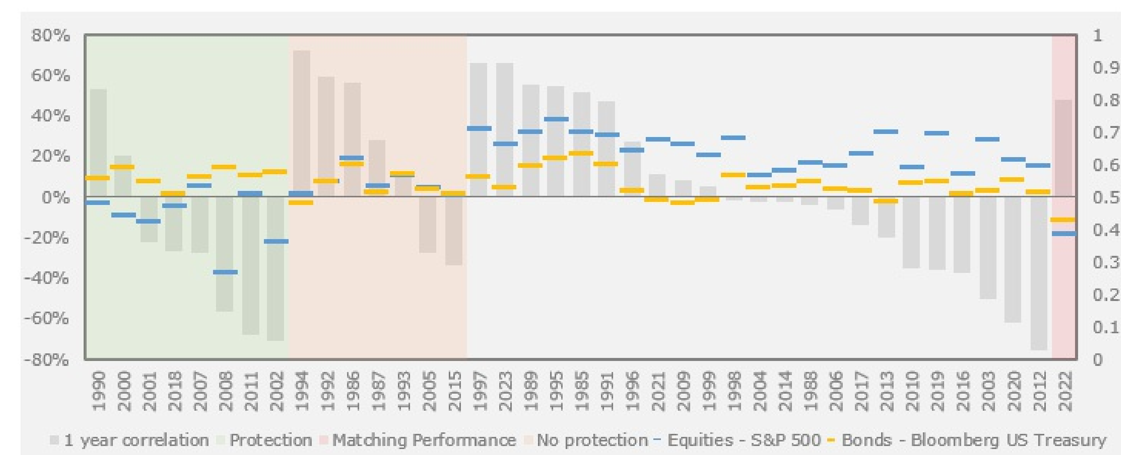

Chart Source/s: Seed Investments (2024)

1. Protection – Bonds provided protection when equity returns are negative, or very low in the case of 2007 and 2011.
2. Matching Performance – Equities and bonds provided very similar returns, so neither asset class really detracted from the overall 60/40 portfolio performance.
3. Normal Environment – Years in which bonds underperformed equities, but crucially did so at lower risk to reduce the overall portfolio volatility.
4. No Protection – Only one year (2022) when bonds provided no protection to offset negative equity performance.

Overall, the bond allocation has shielded the 60/40 portfolio in 8 years, worked as intended by reducing volatility in 30 years, and only 'failed' outright in a single year. All of this in low and high correlation environments ranging from -76% to +72%.

At Seed, we know that asset classes do not change their characteristics and that the complimentary attributes of equities and bonds extend beyond the need for low or negative correlations. But the fact remains - high correlations really hurt when both asset classes are going down!

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For any questions or assistance please feel welcome to reach out to our Investment team on investmentteam@seedinvestments.co.za

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