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Can Bonds Still Hedge Equity Exposure?

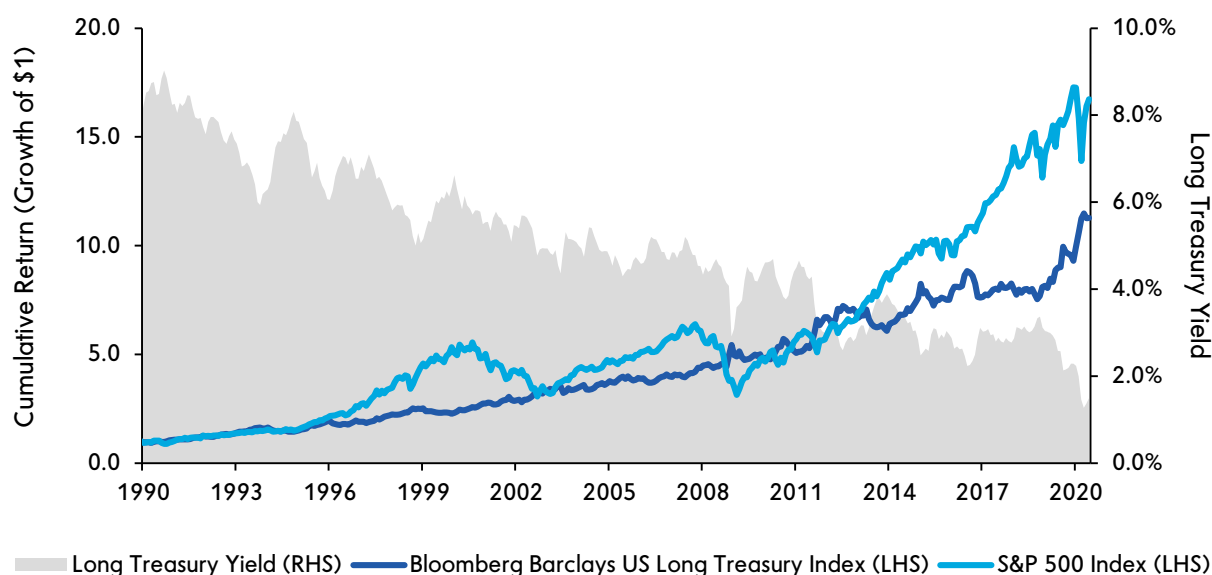
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US Treasuries have been on a 30-year bull run, driving yields to historic lows. This trend has some questioning whether Treasuries will remain a good hedge against stocks. In this paper, we examine the relationship between US stocks and bonds, look beyond the US for guidance, and offer some conclusions about the future relationship.

US stocks have also enjoyed strong returns over the past 30 years as the graph and table below demonstrate.

Cumulative Return

January 1990 - June 2020



Source: Standard and Poor's, Bloomberg.

January 1990 - June 2020	S&P 500® Index	Bloomberg Barclays US Long Treasury Index
Annualized Return	9.68%	8.27%
Standard Deviation	14.57%	10.01%
Average Correlation (S&P 500/BB US Long Treasury Index)	-0.15	

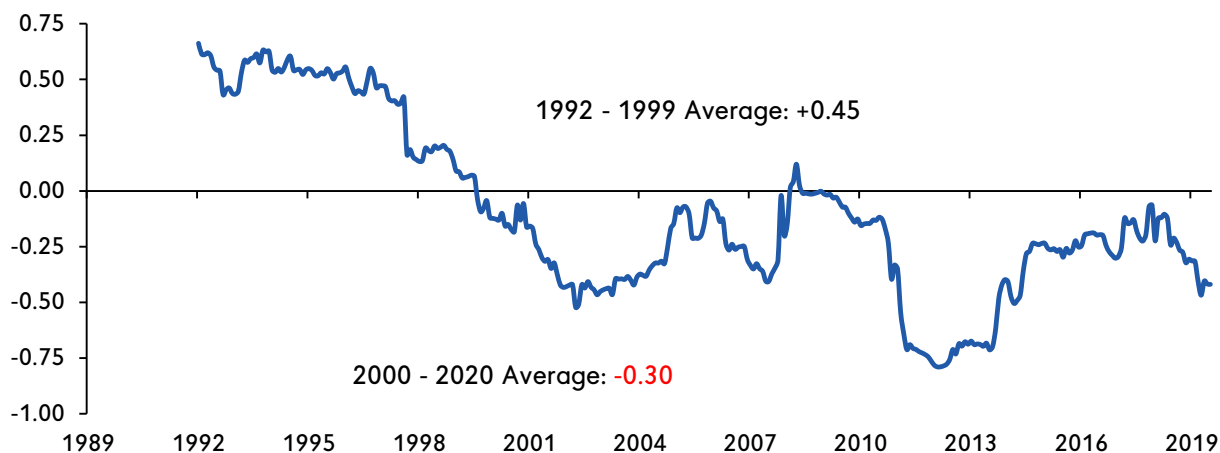
Source: Standard and Poor's, Bloomberg.

Despite similar annualized returns, the average correlation between the S&P 500 and the Bloomberg Barclays US Long Treasury Index was -0.15. That the average correlation was negative implies that Treasuries have been a good hedge against stocks. However, looking only at the long-term average conceals that the relationship is more dynamic.

Observing the correlations on a rolling 3-year basis, for example, reveals that it was not always negative. For the majority of the 1990s, in fact, the stock/bond correlation was persistently positive (+0.45), particularly early in the decade. Since 2000, however, against a backdrop of steady Federal Reserve (Fed) easing and low inflation, the stock/bond correlation turned negative on a rolling 3-year basis, averaging -0.30.

Rolling 3-Year Correlation (S&P 500 vs. Bloomberg Barclays US Long Treasury Index)

January 1990 - June 2020



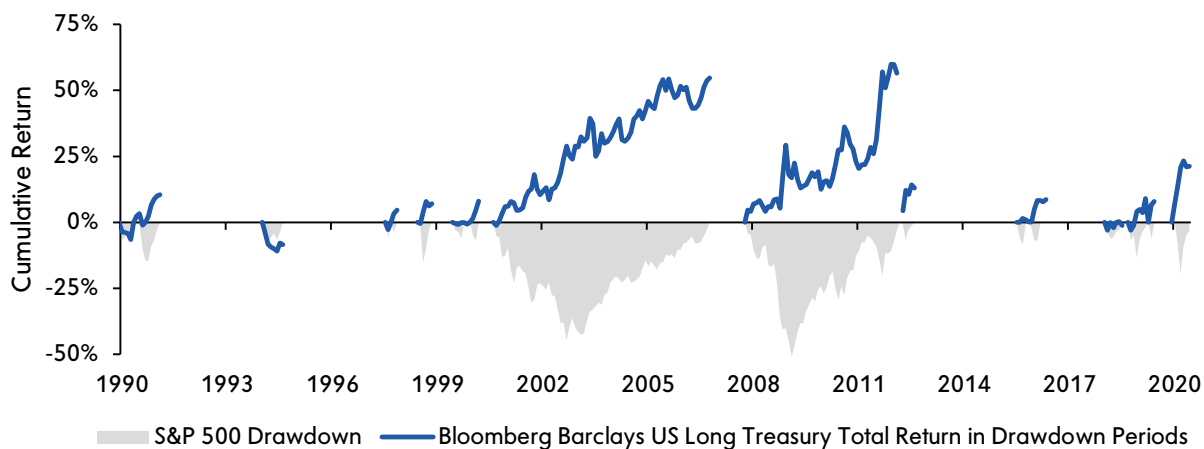
Source: Standard and Poor's, Bloomberg.

Correlations do not tell the whole story, however. What is interesting and perhaps most important for equity investors, long Treasuries rallied during periods of equity market turmoil (graph below). The only exception was the so-called “bond massacre” of 1994. In each period, except 1994, where the S&P fell more than 5%, long Treasuries rallied. Moreover, this rally occurred irrespective of whether the rolling 3-year correlation was positive or negative, or whether bond yields were high or low.

February 1994 to June 1994 was the only period in which Treasuries failed to protect against an equity drawdown. In March of 1994, the equity drawdown bottomed at -6.96% and took five months to recover. Long Treasuries fell in concert with stocks. 30-year Treasury yields jumped 200 basis points between February 1994 and October 1994, equivalent to a drawdown of -11.70%. The market blamed an over-eager Fed for raising interest rates prematurely and unpredictably during this period.

S&P 500 Drawdowns Greater Than 5%

January 1990 - June 2020



Source: Standard and Poor's, Bloomberg.

Long Treasury Yield

January 1990 - June 2020



Source: Bloomberg.

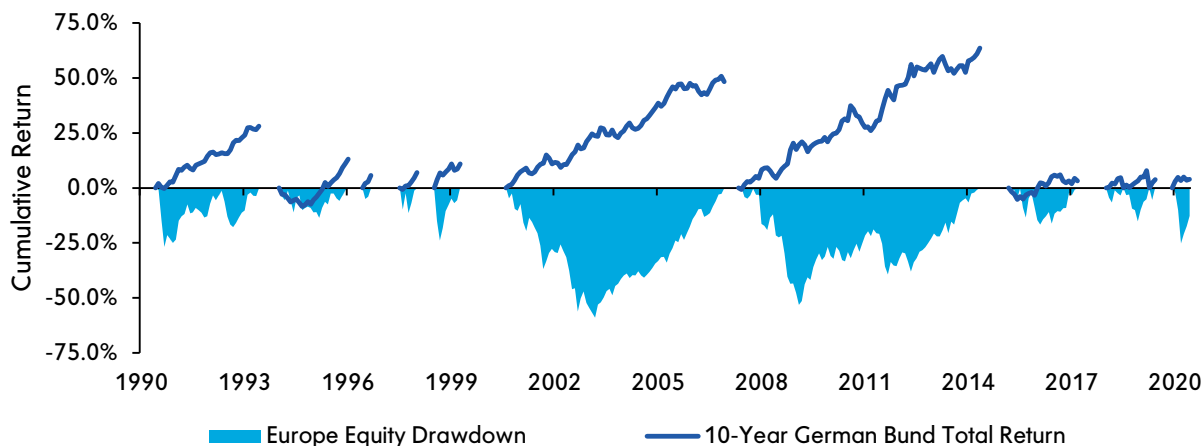
During the two most prolonged and deepest periods of equity turmoil, the tech bubble (2002) and Global Financial Crisis (2008), one can easily see that US Treasuries rallied strongly not only from peak to trough, but also continued their upward trajectory even as equities recovered. More recently, despite low yields, long Treasuries have provided valuable and useful diversification benefits to equity investors.

Of course, the past is the past. What about the future? Will bonds still protect now that rates are low and approach a zero-rate bound? While we cannot predict what happens, we can draw some comparisons by looking at other markets. While rates have compressed notably here in the US, they have been at “rock bottom” levels in Europe for some time. Europe offers a useful glimpse of what may occur in the US.

A similar analysis of European equities and German bunds paints a remarkably similar picture to the US. In fact, every period in which European equities fell by more than 5%, German bunds rallied. What is especially noteworthy is that even over the past five years—a period marked by zero or negative bund yields—the diversification benefit prevailed. Not surprisingly, the magnitude of the bond returns was lower in the more recent yield environment, but directionally, investors were protected.

European Equity Drawdowns Greater Than 5%

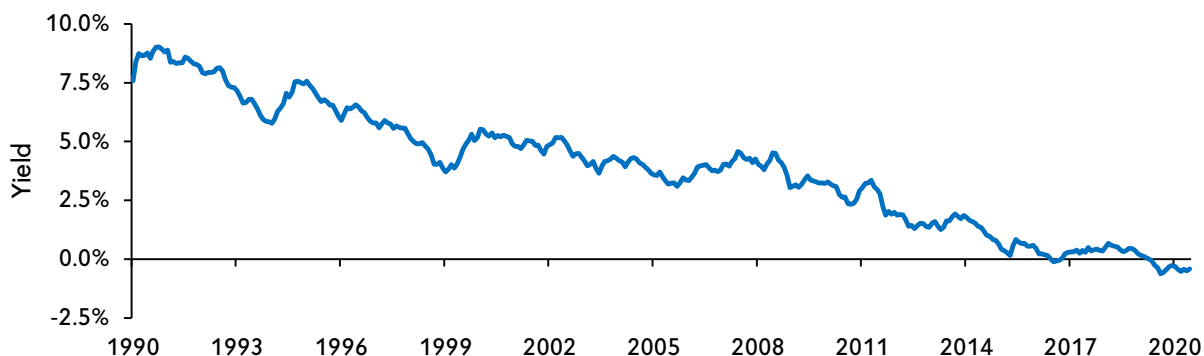
January 1990 - June 2020



Source: Bloomberg.

10-Year German Bund Yield

January 1990 - June 2020



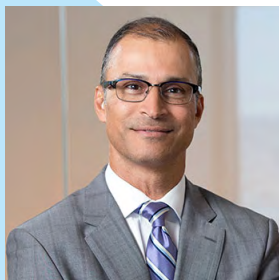
Source: Bloomberg.

Concluding Thoughts

Currently, the stock/bond correlation in the US remains firmly negative, indicating that bonds remain an attractive hedge against stocks. The low yield environment may affect this relationship, but the evidence in other markets, such as Germany, suggests that even in the presence of low yields, the hedge can still be effective. In fact, one school of thought attributes the negative correlation, in part, to the effectiveness of central bank inflation targeting.

Apart from long Treasuries, another potential equity hedge is cash. Why are investors not turning to cash? We believe there are several possible reasons. First, the most obvious reason is that cash offers virtually no yield. Next, the correlation between stocks and cash is basically zero. As noted, the current stock/bond correlation is negative, making bonds more likely to provide protection. Lastly, while not often mentioned, instruments with a longer duration not only offer a better hedge to stocks (which can be thought of as the ultimate long-duration instrument), they also provide the potential to collect additional premium from the roll-down return. As long as the yield curve remains upward sloping, the “roll-down” return is an additional benefit to owning long Treasuries. Finally, cash has historically been a good hedge of inflation while long-term nominal bonds have not. However, a very low and predictable inflationary environment should reduce the risk of holding longer-maturity (long duration) bonds.

During equity drawdowns, long US Treasuries have served as an efficient and effective hedge. While lower yields make long Treasuries less attractive from a term premium and income perspective, during an equity turmoil these appear to be less of a concern as investors tend to seek safety and liquidity. In our view, they also provide positive return during the equity drawdown (peak to recovery). We believe long US Treasuries should continue to act as a reasonable and effective hedge to US stocks, especially if the Fed and other central bankers remain dovish and the negative equity/bond correlation persists.

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Syed is a global investment strategist. He is responsible for articulating the firm's index, multi-asset and multi-factor strategies to clients and prospects, as well as participating in the refinement of current strategies and the development of new strategies. He works closely with sales and client service staff worldwide with an eye toward bringing innovative product solutions to client portfolios.

Prior to joining the firm in 2015, he was a client portfolio manager at American Century Investments, focused on active equity and multi-asset strategies. Previously, he worked as an investment strategist at BlackRock, primarily focused on active equity. Past roles include director of client service and portfolio management at AXA Rosenberg, portfolio manager at Innovest Capital Management, consultant at Barra, and programmer/analyst at Vestek Systems. Syed has been in the investment industry since 1987.

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Disclosure

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