RESS CAPITAL

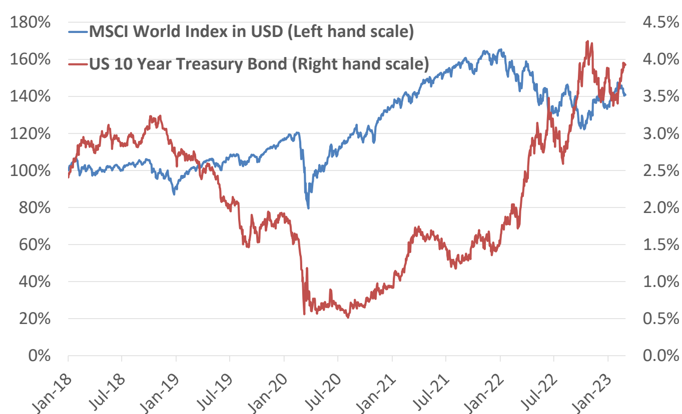
MARKET INSIGHT ON CHANGES IN ASSET CLASS CORRELATION

The change in monetary policy by central banks has greatly affected the conditions for successful asset allocation. In this Market Insight we make the case that this should call for further diversification into assets uncorrelated to macroeconomic events.

EXECUTIVE SUMMARY

- **Since the spring of 2022, the correlation between global equities and sovereign debt has moved from negative into positive territory**
- **This limits investors' possibilities to hedge their equity allocations with fixed income investments**
- **The new pattern of correlation makes the case for investors to increase their allocation to assets with returns that are uncorrelated to liquid equity and bond markets**

BOND YIELDS AND EQUITY MARKETS



Source: MSCI and US Treasury

As can be seen from the graph above, we have witnessed a dramatic shift in the level of bond yields in the last two years. The US 10-year bond yield has increased by approximately 300 basis points, and we have seen similar movements in other markets. It is now possible for an investor to expect a medium-term positive return from an investment in US government bonds. This is clearly positive, since the fixed income part of a balanced equity/bond portfolio now can contribute to the return of the total portfolio, not only reduce the risk.

Behind the pickup in global bond yields lies to a large extent increasing short-term interest rates following monetary policy tightening by central banks.

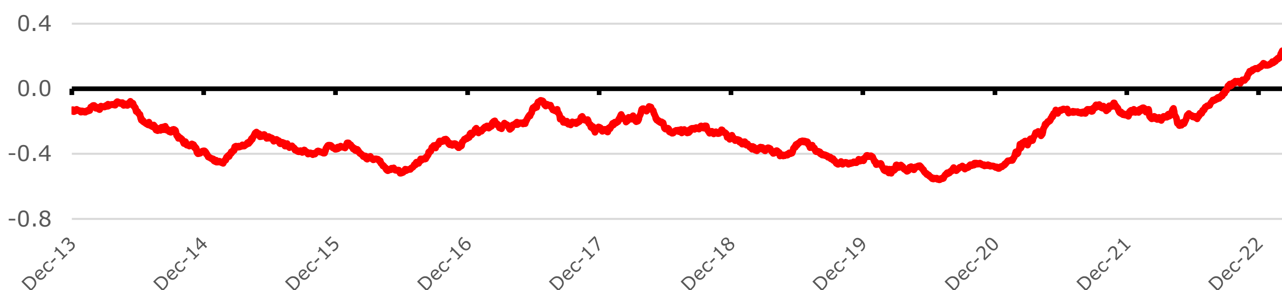
PARADIGM SHIFT IN CORRELATION

Unfortunately, the new monetary stance by central banks has resulted in a situation where the correlation in returns between the two major asset classes equities and fixed income has shifted from negative to positive. This is a result of a new pattern of reaction to inflation and economic activity data in the following ways:

- Strong economic data and/or high inflation data is viewed as an indication that monetary policy is too loose, and higher interest rates are expected. Therefore, both equity and bond markets react negatively, resulting in a positive correlation.
- Weak economic data and/or unexpectedly low inflation, decreases the risk of tighter central bank policy, leading to a positive reaction in both equity and bond markets. Thus, once again a positive correlation between bonds and equity returns.

Thus, a very different reaction pattern than the one observed before 2021, when a major concern of investors was deflation. In the deflationary era, higher inflation was seen as a sign that corporations had some pricing power, benefitting equity investors.

CORRELATION* - 6M ROLLING BETWEEN MSCI WORLD AND US TREASURY BOND INDEX



*Calculated by Resscapital using Kendall rank correlation

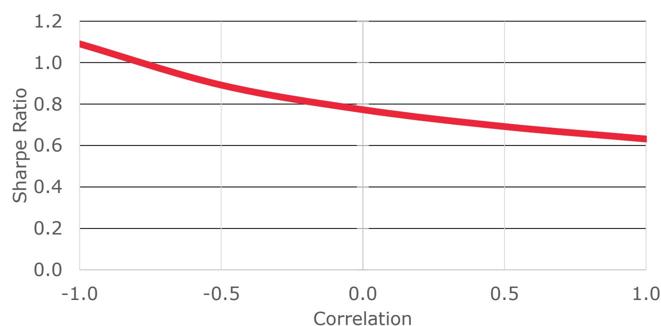
Source: MSCI and Bloomberg

The new correlation pattern can be seen in the graph above. The solid red line shows the six-month rolling correlation between daily equity and bond returns from 2013 to 2023. In the period 2013 to 2021 the correlation between the two asset classes was mainly negative. This changed in the beginning of 2022 when central banks started to impose a tighter monetary policy. Currently, the correlation between the two asset classes seems to have stabilized at a positive level.

Our view is that financial markets will have a tendency to behave as described above, until central banks firmly have shown that inflation in the medium term will be close to the target levels defined in their policy objectives.

THE EFFECT ON PORTFOLIO RETURNS

If financial markets are in a situation with positive correlation between equities and bonds, this will have negative effects on the risk-adjusted returns for equity/bond portfolios. The graph below illustrates how the risk-adjusted return, measured with a Sharpe ratio**, is depending on the correlation between the two asset classes. If the correlation moves from minus 0.5 to plus 0.5 the risk-adjusted return falls by more than 20%. In the graph, the expected return for equities is assumed 8% p.a. and for bonds 4% p.a. Volatilities for the two asset classes are expected to be 15% and 4%, respectively.



** Sharpe ratio is calculated as expected return divided by the volatility

THE IMPORTANCE OF UNCORRELATED RETURNS

The fact that financial markets are now in a different macro-economic environment has major consequences for investors. The risk for setbacks for equity returns has increased markedly when central banks are actively trying to slow down economic activity. Furthermore, the fixed income markets face two major risks. Firstly, the risk of higher interest rates that can potentially lead to capital losses if bond yields rise further. Secondly, that falling economic activity leads to higher bankruptcy risks, which causes credit spreads to widen. These two risks in combination with the fact that the correlation between the two major asset classes has now turned positive, makes the case for investors to increase their allocation to assets that are uncorrelated to the business cycle and decoupled from equity and fixed income markets.

THE CASE FOR INVESTING IN LIFE INSURANCE POLICIES

Ress Capital has, since it begun investing in US life insurance policies in 2011, only observed minor changes in expected gross returns for US life insurance policies. Our internal data indicates exceptionally low correlation between the performance of our fund, Ress Life Investments relative to equity and bond returns and changes in the inflation rate. The major explanation to this is that the dominant risk driving the returns for life insurance policies is longevity risk, which is fundamentally uncorrelated to other financial risks.

CONCLUSION

In the current macro-economic environment where inflation control by central banks is a major concern for investors, the expected risk-adjusted return for a balanced portfolio is at risk. This is partly explained by the positive correlation between equity and bond returns. To compensate for this deterioration, investors can increase the allocation to assets which are fundamentally uncorrelated, and one strong candidate would be US life insurance policies.

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