

Market commentators have devoted much energy over the past year to debating whether it's time to write off the traditional 60/40 approach to investing that broadly allocates 60% of a portfolio to equities and 40% to fixed income. Rather than being drawn into that discussion, Nathan Thooft, Chief Investment Officer, Senior Portfolio Manager, Multi-Asset Solutions Team, believes it's more constructive for investors to focus on understanding the macroeconomic conditions under which the effectiveness of a 60/40 portfolio may be challenged and what this means for portfolio construction going forward.

## Five factors influencing the effectiveness of a 60/40 portfolio

### Key takeaways

- Periods of higher inflation, uncertainty, and lower liquidity can lessen [the diversification benefits](#) of a 60/40 portfolio.
- During periods of monetary expansion, typically driven by accommodative monetary policy, there tends to be a modest positive correlation between stocks and bonds, but we would note that both asset classes' returns are generally positive during these periods noted by our data.
- Elevated market volatility has a modest effect on the potential diversification benefits that a 60/40 approach can offer.

### Measuring the diversification benefits of a 60/40 approach

Typically, an examination of the correlation between equities and bonds would entail comparing monthly changes in the S&P 500 Index with 10-year U.S. Treasury yields, with the goal of observing the relationship between a risky and risk-free asset. A quick look at the relationship reveals that the correlation between the two has been positive over the past couple of decades. This implies that there's been a diversification benefit during this time<sup>1</sup>;

however, 2022's dismal performance across equities and fixed income caused some to question the merits of such a portfolio.

While it's common practice to use the S&P 500 Index and Treasury yields as a proxy to ascertain the correlation between the two asset classes, we don't think that it necessarily reflects an investor's real-world experience: In our view, it's more intuitive to compare an equity index with a comprehensive bond market index. While this approach introduces additional factors into the picture—such as credit risk, which is often excluded from traditional correlation analyses between risky and risk-free assets—we believe it provides a more accurate framework for evaluating the effectiveness of a 60/40 portfolio, which typically holds exposure to a wide range of fixed-income securities that goes well beyond government bonds. Using this approach, we consider the rolling one-year correlation between one-month returns of the S&P 500 Index and the Bloomberg U.S. Aggregate Bond Index.

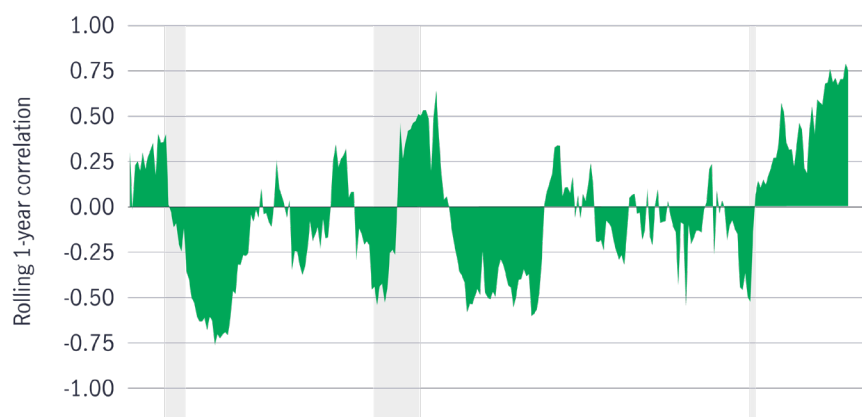
The changing correlation between the two indexes over time highlights that the diversification benefits sought by investors are more pronounced in certain periods than in others. This observation may have important implications for portfolio construction, specifically from a returns and drawdown-management perspective within portfolios.

<sup>1</sup> It's important to note that bond prices are inversely related to yields. As such, a positive correlation between the S&P 500 Index and 10-year U.S.

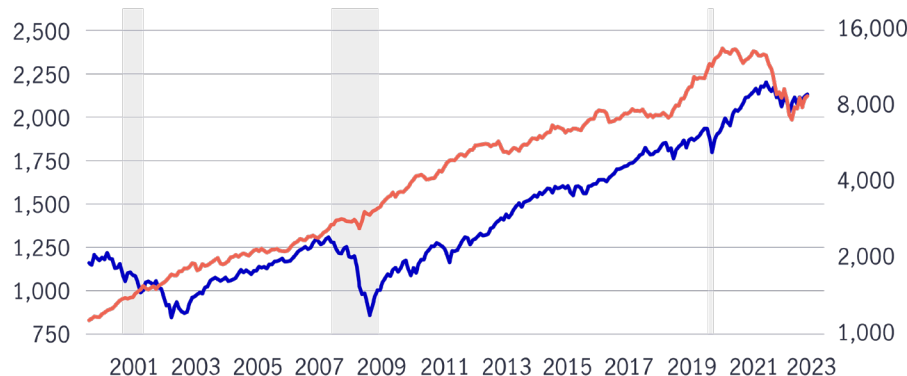
Treasury yields implies negatively correlated returns between the two asset classes, thereby providing a diversification benefit.

## Measuring the stock-bond correlation

■ S&P 500 Index vs. Bloomberg U.S. Aggregate Bond Index



■ S&P 500 Total Return Index    ■ Bloomberg U.S. Aggregate Bond Total Return Index



Source: Macrobond, Manulife Investment Management, as of 9 May 2023. Bloomberg U.S. Aggregate Bond Total Return Index: left-hand side. S&P 500 Total Return Index: right-hand side. The grey areas represent recessions. It is not possible to invest directly in an index.

Given the changing relationships, our key aim is to identify periods—and the macroeconomic forces—that have a role in altering the strength of the correlation between stock and bond prices. Having a better sense of *when* these dynamics could come into play can potentially make a material difference to returns: This enables active asset allocators to look beyond stocks and bonds in their search for diversification benefits *ahead* of time.

### Identifying periods of rising correlations between stocks and bonds: examining five factors

To enhance our understanding of how an active, flexible approach to portfolio management can complement a traditional 60/40 portfolio, we examine five factors to identify periods that could influence the correlation between stocks and bonds. In our review, we assess all periods from 1989 through April 2023 to understand the influence of these five factors.

#### 1 Inflation

According to our analysis, headline inflation data has shown to have the highest positive correlation to the stock-bond relationship. The relationship becomes more pronounced when we use core measures (i.e., inflation excluding food and energy) for both the Consumer Price Index (CPI) and the Personal Consumption Expenditure deflator. Our research shows that the correlation between core inflation and the stock-bond relationship is around 0.50. The equivalent reading for headline inflation was slightly lower, at about 0.40. Put differently, this suggests that the 60/40 approach is likely to be less effective in periods in which prices are rising.

There are two additional notable observations: First, when inflation is below 3%, the correlation between stocks and bonds can have a range of outcomes, with a negative correlation becoming more observable when the year-over-year rise in price increases stay *below* 1%. Second, when inflation rises above the 3% level, the correlation between the two asset classes almost always turns positive. We

believe this shift in correlation can be attributed to monetary tightening that typically occurs with higher inflation.

## 2 Liquidity

We found that there was a moderately negative correlation (roughly  $-0.35$ ) between money supply growth (using  $M2^2$ ) and the stock-bond relationship; however, the correlation turns slightly less negative when we take inflation into account (i.e., using  $M2$  less  $CPI$ ). This means that as money supply moderates, the correlation with the stock-bond relationship strengthens.

## 3 Uncertainty

Using the Global Supply Chain Pressure Index as a proxy, we examined the stock-bond relationship with strains in the global supply network, revealing a correlation of approximately  $0.45$ . We found that when the index exceeds 1, the correlation between stocks and bonds tends to be more positive, therefore, implying that the 60/40 approach to portfolio construction may not perform as well in times in which global supply networks are stressed.

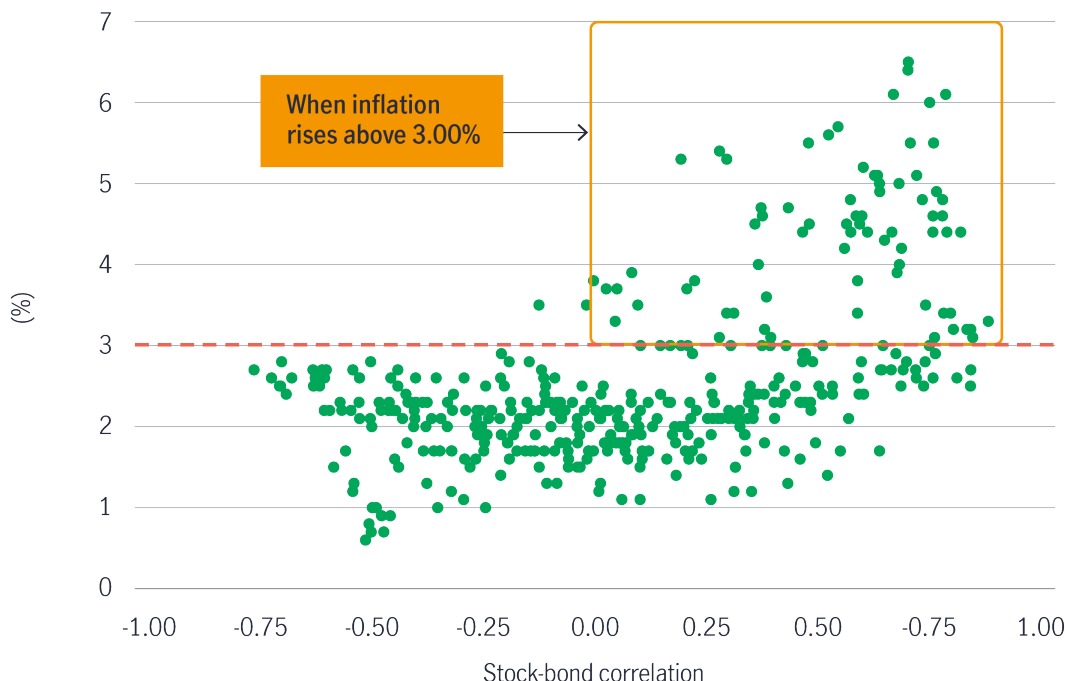
## 4 Growth

When examining the relationship between economic growth and the stock-bond relationship, we uncovered a more modest positive association between them. Interestingly, we found that indicators measuring manufacturing production showed a slightly stronger relationship to—and effect on—the stock-bond correlation relative to broader growth indicators such as GDP. This finding is encouraging as it may suggest that during periods of weaker growth, if equities underperform, fixed-income assets are likely to offer some level of support aligned to a traditional 60/40 approach. Furthermore, we observed that the correlation strengthened to some extent when we excluded most recent data captured during the onset of the COVID-19 pandemic.

## 5 Volatility

In order to examine the impact of volatility on the stock-bond relationship, we used two different measures<sup>3</sup>. The findings yielded somewhat unexpected results by suggesting that the correlation between equity and bond market volatility and the

### CPI, excluding food and energy, YoY vs. stock-bond correlation



Federal Reserve, U.S. Bureau of Labor Statistics, U.S. Bureau of Economic Analysis, American Association of Individual Investors, Macrobond, Manulife Investment Management, as of 9 May 2023. CPI refers to the Consumer Price Index (CPI), which tracks the average change of prices over time by urban consumers for a market basket of goods and services. It is not possible to invest directly in an index. YoY refers to year over year.

<sup>2</sup> M2 is a measure of the money supply that includes cash, checking deposits, savings deposits, money market securities, mutual funds, and other time deposits. M2 is widely used as an indicator of the money available for spending and investment in the economy.

<sup>3</sup> For equities, we used the Cboe Volatility Index, and we used the ICE BofA U.S. Bond MOVE Index to test bond market volatility.

stock-bond relationship may be weak. That said, we think it's important to consider the influence that the pandemic had on these correlations; prior to the pandemic, the correlation between stocks and bonds and volatility was a little higher, at 0.25, relative to now. This may suggest that the market response to the emergence of COVID-19, and subsequent government policy actions taken to support the economy, could have distorted the data, making it more difficult to decipher the more recent correlation between market volatility and the stock-bond relationship.

## **The path forward**

The analyses yielded intriguing results and provided valuable insight into factors that can potentially compromise the effectiveness of a traditional 60/40 approach to asset allocation. Our study showed that the efficacy of the 60/40 portfolio can be diminished during periods of higher inflation, particularly when inflation surpasses 3%. The same occurs during periods of deteriorating liquidity, and—somewhat counterintuitively—in times of sudden and massive liquidity injection, typically occurring in periods of monetary policy stimulus.

Encouragingly, the expected relationship between stocks and bonds asserts itself during periods of economic slowdown. In these cases, fixed-income assets are able to resume their traditional role as a diversification tool as equities underperform. Meanwhile, high bond and equity volatility exhibited minimal impact on stock-bond correlations.

Naturally, these findings raise an important question: Which asset types can offer diversification when the stock-bond correlation turns positive? In our view, a logical response could involve widening the investment universe to consider allocating to alternative investments. For example, real assets tend to have a lower correlation to a traditional 60/40 portfolio and, as such, are a viable diversifier. Ultimately, the strategic use of the right tools at the right time is of utmost importance.

## Disclaimer

Investing involves risks, including the potential loss of principal. Financial markets are volatile and can fluctuate significantly in response to company, industry, political, regulatory, market, or economic developments. These risks are magnified for investments made in emerging markets. Currency risk is the risk that fluctuations in exchange rates may adversely affect the value of a portfolio's investments.

The information provided does not take into account the suitability, investment objectives, financial situation, or particular needs of any specific person. You should consider the suitability of any type of investment for your circumstances and, if necessary, seek professional advice.

This material is intended for the exclusive use of recipients in jurisdictions who are allowed to receive the material under their applicable law. The opinions expressed are those of the author(s) and are subject to change without notice. Our investment teams may hold different views and make different investment decisions. These opinions may not necessarily reflect the views of Manulife Investment Management or its affiliates. The information and/or analysis contained in this material has been compiled or arrived at from sources believed to be reliable, but Manulife Investment Management does not make any representation as to their accuracy, correctness, usefulness, or completeness and does not accept liability for any loss arising from the use of the information and/or analysis contained. The information in this material may contain projections or other forward-looking statements regarding future events, targets, management discipline, or other expectations, and is only current as of the date indicated. The information in this document, including statements concerning financial market trends, are based on current market conditions, which will fluctuate and may be superseded by subsequent market events or for other reasons. Manulife Investment Management disclaims any responsibility to update such information.

Neither Manulife Investment Management or its affiliates, nor any of their directors, officers or employees shall assume any liability or responsibility for any direct or indirect loss or damage or any other consequence of any person acting or not acting in reliance on the information contained here. All overviews and commentary are intended to be general in nature and for current interest. While helpful, these overviews are no substitute for professional tax, investment or legal advice. Clients should seek professional advice for their particular situation. Neither Manulife, Manulife Investment Management, nor any of their affiliates or representatives is providing tax, investment or legal advice. This material was prepared solely for informational purposes, does not constitute a recommendation, professional advice, an offer or an invitation by or on behalf of Manulife Investment Management to any person to buy or sell any security or adopt any investment strategy, and is no indication of trading intent in any fund or account managed by Manulife Investment Management. No investment strategy or risk management technique can guarantee returns or eliminate risk in any market environment. Diversification or asset allocation does not guarantee a profit or protect against the risk of loss in any market. Unless otherwise specified, all data is sourced from Manulife Investment Management. Past performance does not guarantee future results.

## Manulife Investment Management

Manulife Investment Management is the global wealth and asset management segment of Manulife Financial Corporation. We draw on more than a century of financial stewardship to partner with clients across our institutional, retail, and retirement businesses globally. Our specialist approach to money management includes the highly differentiated strategies of our fixed-income, specialized equity, multi-asset solutions, and private markets teams—along with access to specialized, unaffiliated asset managers from around the world through our multimanager model.

This material has not been reviewed by, is not registered with any securities or other regulatory authority, and may, where appropriate, be distributed by the following Manulife entities in their respective

jurisdictions. Additional information about Manulife Investment Management may be found at [manulifeim.com/institutional](http://manulifeim.com/institutional)

**Australia:** Manulife Investment Management Timberland and Agriculture (Australasia) Pty Ltd, Manulife Investment Management (Hong Kong) Limited. **Canada:** Manulife Investment Management Limited, Manulife Investment Management Distributors Inc., Manulife Investment Management (North America) Limited, Manulife Investment Management Private Markets (Canada) Corp. **Mainland China:** Manulife Overseas Investment Fund Management (Shanghai) Limited Company. **European Economic Area** Manulife Investment Management (Ireland) Ltd. which is authorised and regulated by the Central Bank of Ireland. **Hong Kong:** Manulife Investment Management (Hong Kong) Limited. **Indonesia:** PT Manulife Aset Manajemen Indonesia. **Japan:** Manulife Investment Management (Japan) Limited. **Malaysia:** Manulife Investment Management (M) Berhad 200801033087 (834424-U) **Philippines:** Manulife Investment Management and Trust Corporation. **Singapore:** Manulife Investment Management (Singapore) Pte. Ltd. (Company Registration No. 200709952G) **South Korea:** Manulife Investment Management (Hong Kong) Limited. **Switzerland:** Manulife IM (Switzerland) LLC. **Taiwan:** Manulife Investment Management (Taiwan) Co. Ltd. **United Kingdom:** Manulife Investment Management (Europe) Ltd. which is authorised and regulated by the Financial Conduct Authority **United States:** John Hancock Investment Management LLC, Manulife Investment Management (US) LLC, Manulife Investment Management Private Markets (US) LLC and Manulife Investment Management Timberland and Agriculture Inc. **Vietnam:** Manulife Investment Fund Management (Vietnam) Company Limited.

Manulife, Manulife Investment Management, Stylized M Design, and Manulife Investment Management & Stylized M Design are trademarks of The Manufacturers Life Insurance Company and are used by it, and by its affiliates under license.