WHAT KEEPS ME UP AT NIGHT?

In short, a rise in the correlation between stocks and bonds right when they both have historically high valuations.

Would it surprise you to learn that stocks and bonds do not always move in opposite directions? Anti-correlation between the two is a recent phenomenon. There have been periods in the past where both stocks and bonds rise and fall together. This type of environment wreaks havoc on people who construct static stock/bond portfolios. They think they’ve achieved diversification. In reality, they have a portfolio that’s acting like one big position.

The graph to the right plots the three-year rolling correlation between the annual returns of stocks (S&P 500) and bonds (long-term Treasuries). When the line is above 0%, that means stocks and bonds were either going up or going down together. This was the case from 1990-2000. When the line is below 0%, that means they were moving in opposite directions. This has been the case since 2000.

Correlation between stocks and bonds isn’t necessarily a bad thing if both asset classes are cheaply valued and have a high probability of offering attractive future returns. This was the case in the early 1990s.

As a quick refresher, my preferred method for estimating future returns from stocks is based off of the average amount investors have allocated to equities in their portfolios. On average, if people have a ton of money in stocks (late 1990s), future returns will be low because there will be little future buying pressure. Who’s left to buy stocks when everybody owns them? On the flip side, if people on average are drastically under-exposed to stocks (early 1990s), that’s historically been a good sign future returns will be high. In the early 1990s, this model correctly predicted a ~18% CAGR for the S&P 500 from 1990 to 2000. Now? Around 2-3% CAGR from 2016 to 2026.
FUTURE RETURNS AND MOVEMENT ALLOCATIONS

Estimating future bond returns is pretty simple. Just take the starting yield. The chart below plots the starting yield of the 5-year Treasury vs. the subsequent 10-year compound annual growth rate of holding a constant maturity portfolio of 5-year Treasuries. The correlation between the two measures is 84%. So you can say the starting yield of bonds is a good predictor of long-term returns. What is the current 5-year yield? 1.3%. What about the 10 year? 1.7%.

So we're looking at 2-3% from stocks and ~1.5% from bonds per year over the next ten years. Paired together with the fact that the correlation between stocks and bonds has been rising, what do you get? A non-diversified portfolio that has a high probability of achieving low long-term returns.

SOURCES AND DISCLOSURES

Average investor equity allocation data is sourced from the St. Louis Federal Reserve's FRED database. Subsequent 10-year CAGR data is calculated based on the returns of the Wilshire 5000. Subsequent returns were simulated and hypothetical and were not realized in a client account. Starting bond yield data is for the 5-year U.S. Treasury and is also sourced from FRED. Subsequent 10-year CAGR bond data is calculated by taking the 10-year compounded growth rate of VFITX, a mutual fund that hold 5-year U.S. Treasuries.

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