Zacks
INVESTMENT MANAGEMENT

Mitch on the Markets

Portfolio Manager Investing Insights

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Are Bonds No Longer a Good Hedge for Stocks?

The first six months of 2022 were challenging for investors, even those with diversified portfolios of stocks and bonds.

Indeed, one of the most significant ‘issues’ with 2022’s market drawdown has been the atypically tight correlation between stocks and bonds. Consider that in the first six months, an investor with an all-equity portfolio likely performed in-line with someone invested in a 60% stock/40% bond portfolio.[1] In the first four months of the new year, long-term U.S. Treasury bonds were off -18% while the stock market dipped into bear market territory. That’s not supposed to happen.

One of the key benefits of a balanced asset allocation of stocks and bonds is to limit downside volatility during sharp equity market pullbacks, and so far in 2022, bonds have failed to deliver. The breakdown in this relationship between stocks and bonds has some investors wondering if bonds are no longer a reliable hedge for stocks.

But I don’t see the first six months of 2022 as an indication for how the relationship between stocks and bonds will play out moving forward.

Investors should also recognize that throughout history, there have been several periods – sometimes long ones – where bonds and stocks were positively correlated. Those periods also happened to be ones where there was high inflation uncertainty, i.e., the 1970s and 1980s.

For most of history, however, bonds have been effective at mitigating equity market risk, and they have also helped portfolios generate positive returns during periods when equities sold off sharply. During the past 20 years, for instance, there has been a consistently negative correlation between stocks and bonds, with basically the only exception being 2013’s “taper tantrum” when both declined in lockstep.[2]

As readers can see in the table below, long-duration U.S. Treasury bonds have held up remarkably well – and almost always delivered positive performance – during the biggest equity market drawdowns. 2022 is arguably the exception, not the rule.

Period	Cumulative Stock Market Return (S&P 500)	Cumulative Long-Duration US Treasury Bond Return
November 2007 – February 2009	-50.9%	+16.0%
August 2002 – September 2002	-44.7%	+28.5%
December 1972 – September 1974	-42.6%	-6.0%
September 1987 – November 1987	-29.6%	+2.7%
December 1986 – June 1970	-29.3%	-8.0%
January 1962 – June 1962	-22.3%	+4.0%

Source: Morningstar, UBS[3]

Some have argued that an inflation rate of 2.5% is the point at which stocks and bonds flip in correlation from positive to negative or vice versa. During high inflation regimes, bonds suffer as coupon payments become less valuable and as investors demand higher yields, and stocks suffer from lower expected growth rates and cost pressures. High inflation can thus hurt both asset classes.

Expectations for higher-than-average inflation does not mean it's time to abandon bonds in an investment portfolio, however. The fixed income portion of a portfolio can still serve the purpose of generating cash flows and mitigating equity volatility risk, especially when the bonds in a portfolio are actively managed as we do here at Zacks Investment Management.

For the past couple of years, we have held a fairly cautious stance on fixed income as we anticipated rising rates, and with the Fed likely remaining hawkish for the rest of the year, we have decided to keep duration on the shorter end while focusing on higher credit quality bonds. This type of active management is needed, in my view, to navigate the changing market environment but also to ensure a fixed income allocation is serving its purpose.

Bottom Line for Investors

The first six months of 2022 were a rocky stretch, no matter how investors were positioned. Seeing stocks and bonds move in lockstep downward was a break from what we've experienced in the last two decades, when the two asset classes were consistently negative in correlation.

Looking ahead, it is possible that a positive correlation between stocks and bonds could persist in a high inflation regime, which I think argues for the type of active management in fixed income we do here at Zacks Investment Management.

ABOUT MITCH ZACKS

Mitch is the CEO & Senior Portfolio Manager at Zacks Investment Management. Mitch has been featured in various business media including the Chicago Tribune and CNBC. He wrote a weekly column for the Chicago Sun-Times and has published two books on quantitative investment strategies. He has a B.A. in Economics from Yale University and an M.B.A in Analytic Finance from the University of Chicago.

[1] Strategas, June 17, 2022.

[2] UBS, https://www.ubs.com/global/en/asset-management/global-sovereign-markets/overview/stock-bond-correlation.html

[3] UBS, https://www.ubs.com/global/en/asset-management/global-sovereign-markets/overview/stock-bond-correlation.html

IN FOCUS THIS WEEK

- **Rise in electricity prices**
- **Wages and spending up in the U.S.**
- **Growth within the private sector**
- **EU countries prepare for the future of natural gas**

Hotter Temperatures, Higher Air Conditioning Bills

It's the summer season, which almost certainly means a heat wave is heading your way sometime in the next couple of months. What many readers may not know is that a higher air conditioning bill is likely coming, too. In the U.S., electricity prices rose 12% over the past year, and signs point to even more increases ahead. One of the key drivers behind higher prices for A/C this summer is the war in Ukraine, which has sent natural gas prices soaring. About 40% of electricity generation in the U.S. comes from natural gas. According to a study by the National Energy Assistance Directors Association, the average American family can expect $540 in electric bills between June and August, which marks an increase of $90 from just a year ago. That's a slightly higher than 15% increase in a year's time, which also comes at a time when just about every other good and service costs more.[1]

Wages and Spending are Up in the U.S., But There's a Catch

A historically tight labor market may offer some respite to higher electricity bills and higher prices at the pump and the grocery store. Just about any American who wants a job can find one, and wages have also been on the rise. In the last year, wages have grown at a year-over-year pace of 4% each month. But it's also true that over the same period, inflation has exceeded 4% in each month – meaning that there has not been a month with "real" year-over-year wage growth. The same catch applies to consumer spending – Americans are doling out more for goods and services in the economy, but they are consuming less than they did a year ago. Again, the culprit here is inflation. In a more recent example, gas prices are up 60% but sales at gas stations are up 50%, signaling that Americans are driving less. There has been one exception in the spending category, however – restaurants. Spending in June at restaurants is up 14%, but prices were only up 8%.[2]

The Private Sector Has Now Recovered All Jobs Lost in the Pandemic

The saving grace of the U.S. economy has arguably been – and continues to be – the jobs market. The private sector in particular has seen impressive and sustained growth in employment. Now, just over two years following the pandemic, all of the 21 million jobs that were lost have been recovered. The biggest growth within the private sector has been in transportation and warehousing jobs, which is directly tied to consumers shifting purchases to goods online. The same goes for manufacturing, construction, and retail, all of which have benefited from the shift in spending from services to goods.[3]

Europe Worries That Russia is Poised to Cut Off Natural Gas

European countries are getting nervous. This week, the Nord Stream pipeline that carries gas from Russia to Germany closed for annual maintenance, but Germany and other European countries are worried that Russia won't turn it back on once the maintenance is complete. Such a move by Russia would deal a major blow to European economies, which rely heavily on Russian gas that arrives via Nord Stream. Should Russia decide to pump less natural gas or turn off the pipeline permanently, it could have cascading consequences across the EU. Natural gas is used in German factories to make raw materials, plastics, and other chemicals critical to its manufacturing infrastructure. EU leaders and in particular German leaders are preparing for this possibility. Plans are being put in place to prepare for rationing into the fall and winter, which seems almost certain to put additional upward pressure on prices and strains on supply chains. If Germany experiences a recession as a result, the effects could be felt across Europe and globally.[4]

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[1] Wall Street Journal. July 18, 2022. https://www.wsj.com/articles/inflation-will-crank-up-your-air-conditioner-bill-this-summer-11655055762?mod=djemRTE_h

[2] Wall Street Journal. July 17, 2022. https://www.wsj.com/articles/inflation-has-outpaced-wage-growth-now-its-cutting-into-spending-11658050200?mod=djemRTE_h

[3] Wall Street Journal. July 16, 2022. https://www.wsj.com/articles/all-jobs-businesses-cut-in-pandemic-are-back-but-not-where-they-were-lost-11657972801?mod=djemRTE_h

[4] Wall Street Journal. July 18, 2022. https://www.wsj.com/articles/europe-fears-widespread-economic-fallout-if-russian-gas-outage-drags-on-11658136780?mod=djemRTE_h

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