The Role of Fixed Income in Equity Market Downturns

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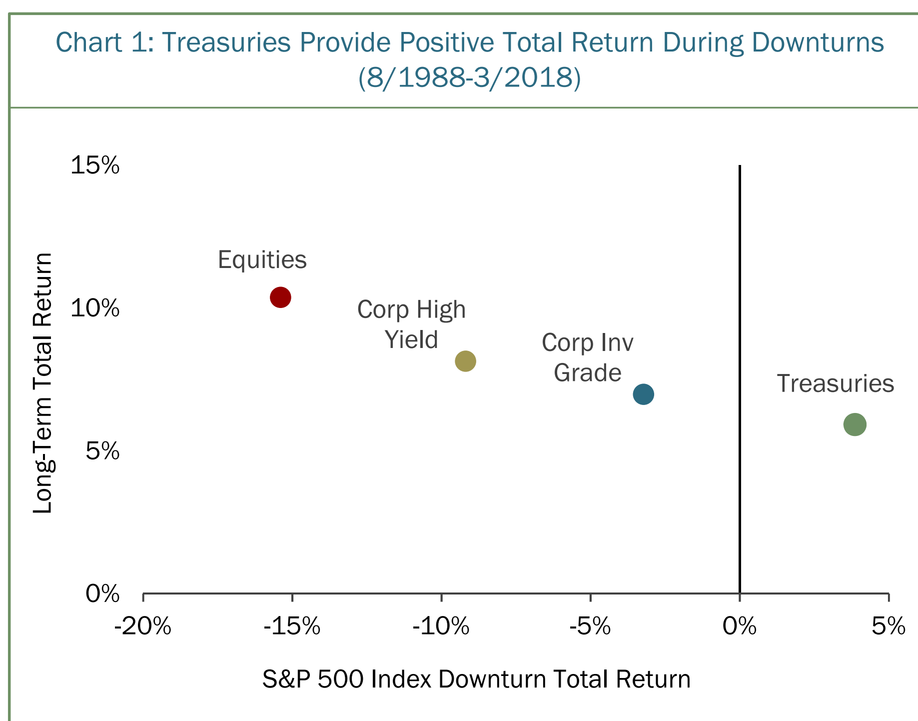
Today's financial markets are characterized by low interest rates, low quality spreads, unprecedented levels of debt, record levels for leverage, above average P/Es, and one of the longest economic expansions in U.S. history. But just as stock market optimism seemed limitless through 2017, with equity markets continuously hitting new highs and volatility at historically low levels, a pullback in equity markets has made investors reevaluate the risks to which they are exposed. It is times like these when the role of fixed income – to provide principal preservation, income, and risk reduction through diversification – cannot be overemphasized.

A market regime analysis demonstrates what specific traits are most valuable from a bond portfolio in today's financial landscape. Within a multi-asset framework, high quality bonds, most specifically U.S. Treasuries, offer the most attractive correlation characteristics versus equity exposures. This is due to the flight-to-quality during equity sell-off periods.

Examining the most dominant exposures in a multi-asset portfolio (equity, credit, and sovereign rates), demonstrates a strong positive relationship between equities and credit, but a weak correlation between U.S. equities and Treasuries. From this analysis, one can deduce that if a portfolio has significant equity exposure and concern exists about the level of valuations in the equity market and credit spreads, then a bond portfolio emphasizing U.S. Treasuries and only the highest quality corporate bonds is most appropriate to mitigate equity risk. Chart 1 shows that among U.S. Treasuries, corporate investment grade, corporate high yield, and equities, the riskier asset-types that required a higher return over the long-run (y-axis) performed poorly in equity market downturns (x-axis). Furthermore, Treasuries, what has been historically considered a "safe haven" asset, was the only asset class with positive returns over both the long-term and during equity market downturns.

Chart 1: Treasuries Provide Positive Total Return During Downturns (8/1988-3/2018)



Source: Morningstar and Barclays. Long-Term Total Return is annualized. S&P Index Downturn Total Return is average cumulative return during an approximately -10% or worse negative total return of the S&P 500 Index over consecutive month-ends. Equities = S&P 500 Index, Corp High Yield = BBgBarc U.S. Corporate High Yield Index, Corp Inv Grade = BBgBarc U.S. Corporate Investment Grade Index, Treasuries = BBgBarc U.S. Aggregate Bond Treasury Index.

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Table 1 further details this particular set of circumstances and how these primary exposures have historically behaved. This scenario includes instances when the S&P 500 Index dropped by approximately 10% or more in a single month or in consecutive months. During the last 30 years, this has occurred on 14 occasions. Beginning in August 1988, the S&P 500 Index declined during these periods by an average of -15.39%, with a range of -9.20% to -29.65%. In 13 of these 14 periods examined, the total return for the U.S. Treasury Index was positive, with an average total return for all periods of 3.87%. The excess returns (relative to duration-equivalent Treasuries) for investment grade corporate bonds were negative in 12 of 14 periods, with an average excess return across periods of -3.22%. The effect is even more dramatic when comparing high yield corporate bonds, which produced an average excess return of -9.19%. As a result, the correlation of equities to Treasuries was -0.23, equities to investment grade corporates was 0.72, and equities to high yield corporates was 0.76.

Table 1: Market Regime Analysis—Treasuries Negatively Correlated to Higher Risk Assets (8/1988-3/2018)

Period	Monthly Ranges	S&P 500 Total Returns	U.S. Treasury Total Returns	U.S. Corporate Investment Grade Excess Returns	U.S. Corporate High Yield Excess Returns
1	6/90 – 10/90	-14.69%	4.05%	-1.98%	-11.82%
2	7/98 – 8/98	-15.37%	2.88%	-2.87%	-7.98%
3	9/00 – 11/00	-13.12%	3.13%	-1.64%	-11.27%
4	2/01 – 3/01	-14.88%	1.53%	-0.28%	-2.89%
5	6/01 – 9/01	-16.75%	6.07%	-1.98%	-12.51%
6	4/02 – 7/02	-20.15%	6.99%	-4.96%	-16.81%
7	9/02	-10.87%	2.70%	-0.87%	-3.87%
8	12/02 – 2/03	-9.72%	4.05%	1.44%	2.26%
9	11/07 – 3/08	-13.83%	7.72%	-7.49%	-12.41%
10	6/08 – 7/08	-9.20%	1.21%	-2.76%	-5.29%
11	9/08 – 11/08	-29.65%	5.83%	-15.76%	-34.04%
12	1/09 – 2/09	-18.18%	-3.43%	2.29%	4.64%
13	5/10 – 6/10	-12.80%	3.60%	-2.68%	-5.19%
14	5/11 – 9/11	-16.26%	7.78%	-5.58%	-11.49%
	AVERAGE	-15.39%	3.87%	-3.22%	-9.19%
Conditional Correlations vs. S&P 500 Index			-0.23	0.72	0.76

Source: Morningstar and Barclays. Conditional correlations run for downturn periods only.

As evidenced by the aforementioned market regime analysis, it can be concluded that a bond portfolio which is biased toward U.S Treasuries should provide significant diversification benefits in an equity market downturn, as a “safe haven” asset in hard times.

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