Twitter Thread by The_Chartist ■



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Correlation between bonds and equities? ■■

Asset Allocation

Japan offers asset allocators one simple lesson – forget everything you think you know about the nature of the relationship between bonds and equities. The arrival of deflation wreaks havoc upon prior relationships.

Too many investors have grown up only experiencing bull market conditions, and disinflationary bull market conditions at that. There is a lost generation of analysts because they spent so long preparing rather than analysing income statements, let alone balance sheets. Similarly, there is a lost generation of asset allocators who have only experienced bonds driving equities.

We have written many times before that this supposed relationship between bonds and equities is an illusory correlation. It results from equity investors trying to have their cake and eat it. Think of it this way, prices should be determined by discounted cash flow models. Such valuation models will have inflation factored into both their numerator and denominator; that is to say, cash flows projections will be in nominal terms, and the discount rate will be in nominal terms. Hence inflation should cancel out to leave the resulting value in "real terms".

However, investors have been willing to drop their discount rates as bond yields declined owing to low inflation. Of course, as inflation declines so should cash flow projections in nominal terms. But investors haven't done this, resulting in seriously overvalued equities, and an illusory correlation between nominal bonds and equities!

Figure 39.23 shows the relationship between bond and equity returns in Japan. We have overlaid inflation on the chart, and it is no coincidence that the correlation drops negative at the same time that deflation arrives on quite a permanent basis.

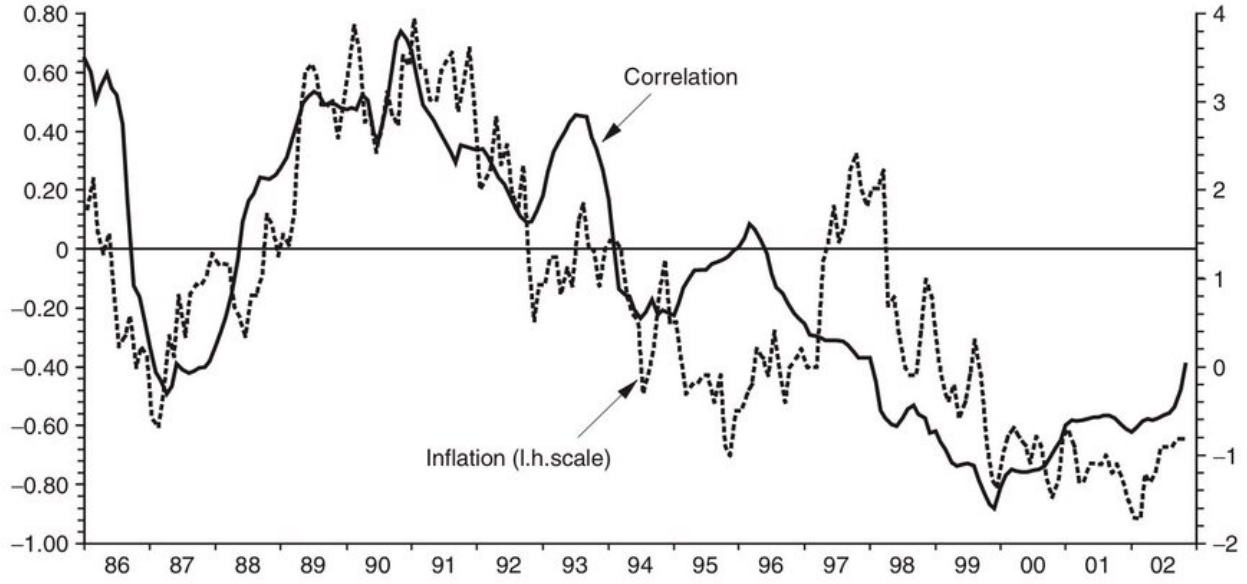

Figure 39.23 Japanese bond/equity return correlation and inflation.
Source: Thomson Financial Datastream.