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They Move in Mysterious Ways – Stocks vs. Bonds

It's all right to be confused about the relationship between stocks and bonds. The correlation can shift depending on inflation and growth regimes.

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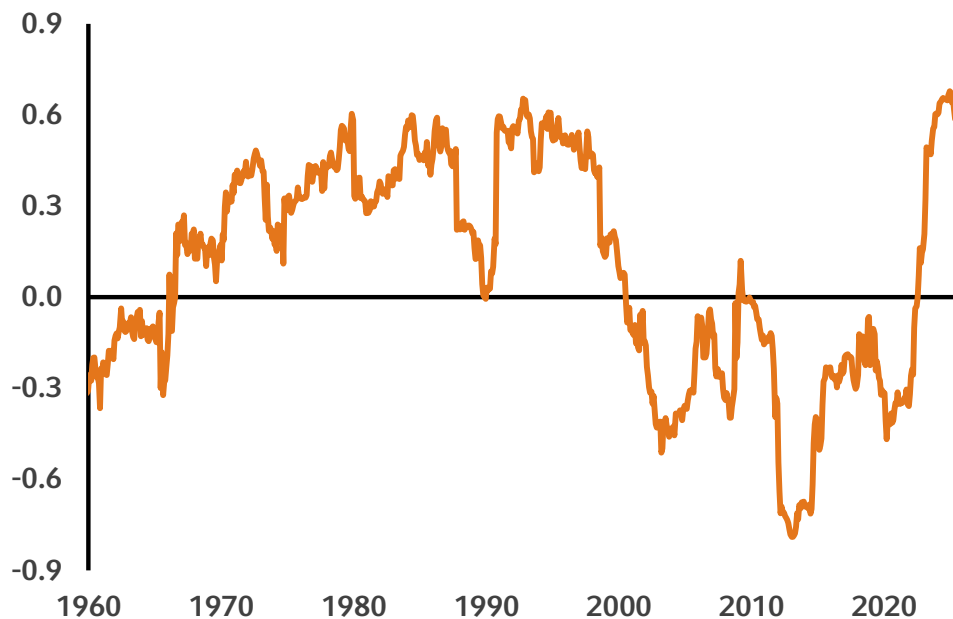
Stocks and bonds move in opposite directions—until they don't.

During the 2022 stock market downturn, bonds also took it on the chin, challenging long-held assumptions about the negative correlation between the two. While this surprised many investors, a broader look to history reveals these breakdowns are not novel. We had simply enjoyed a quarter-century of relative calm.

Not Your Father's Stock-Bond Relationship

Since the 1960s, the U.S. stock-bond correlation has been positive more often than not.

U.S. stock-bond correlation, 3-year rolling average



Source: Russell Investments, Ibbotson Associates, LSEG Datastream. Monthly returns on the S&P 500 Index and Bloomberg Long-Term U.S. Treasury Index.

It's Complicated

The correlation between stocks and bonds is largely shaped by inflation, monetary policy and the degree of macroeconomic shocks. In low and stable inflation environments, macroeconomic shocks are the biggest driver. Stocks fall on weak growth, while bonds rally on rate cuts, leading to negative correlations. However, in inflationary or stagflationary periods, both asset classes may decline together, pushing correlations positive.

At low inflation levels (below 2%), stock-bond correlations are strongly negative across all growth scenarios. In this environment, inflation is not a major concern, and growth is the primary driver of stock prices. Weak growth leads to falling stock prices due to lower expected cash flows, while bond prices rise as rate cut expectations increase—resulting in a negative correlation.

Correlation Conversation

The correlation between stocks and bonds flips from negative to positive as growth and inflation rise.

3-year rolling U.S. stock-bond correlation scenarios¹

		Long-Term Growth						
		0.5%	1.0%	1.5%	2.0%	2.5%	3.0%	3.5%
Long-Term Inflation	0.5%	-0.96	-0.97	-0.97	-0.98	-0.98	-0.98	-0.99
	1.0%	-0.90	-0.91	-0.93	-0.94	-0.95	-0.95	-0.96
	1.5%	-0.75	-0.78	-0.81	-0.84	-0.86	-0.88	-0.90
	2.0%	-0.44	-0.50	-0.56	-0.61	-0.66	-0.71	-0.74
	2.5%	0.03	-0.05	-0.13	-0.21	-0.29	-0.36	-0.43
	3.0%	0.49	0.42	0.35	0.28	0.20	0.12	0.04
	3.5%	0.66	0.61	0.56	0.50	0.44	0.37	0.30

Source: Russell Investments, FRED, Datastream

As inflation rises above 2%, correlations become less negative and eventually turn positive. In periods of weaker growth, stock prices are impacted by both lower earnings expectations and higher rates. But at higher inflation levels, the U.S. Federal Reserve (Fed) has less room to cut rates and therefore bond yields don’t fall by much, if at all. As a result, bond prices no longer offset stock losses. Inflation dominates, and diversification erodes.

Balancing Act

Higher growth tends to reduce the stock-bond correlation. For a given level of inflation, stronger growth directly boosts expected corporate earnings, supporting equity prices. At the same time, the interest rate outlook—shaped by the Fed’s dual mandate—responds to both growth and inflation. So even if inflation is stable, stronger growth can still push yields higher, putting downward pressure on both stocks and bonds. However, when growth is strong enough, the earnings boost can partially offset the valuation drag from rising rates, muting the correlation between the two asset classes.

When both inflation and growth are elevated, a tug-of-war emerges. Inflation drives stock-bond correlations higher by weighing on both asset classes, while growth can still lift equity prices through stronger fundamentals. This delicate balance helps explain why understanding both inflation and growth dynamics is critical when evaluating shifts in stock-bond correlation.

¹The scenario analysis is based on forecasts from a simple two factor regression model that regresses 3-year rolling stock-bond correlations on 5-year expected inflation from the DKW model (Kim, Don, Cait Walsh, and Min Wei (2019)) and long-term growth using 10-year rolling year-over-year U.S. industrial production growth.

Driving Forces

Inflation and the growth outlook are shaped by both cyclical and structural drivers.

Cyclical Inflation

After surging to its highest level in 40 years, core inflation has moderated mostly back to the Fed's 2% target. But tariffs present significant near-term risks to the outlook.

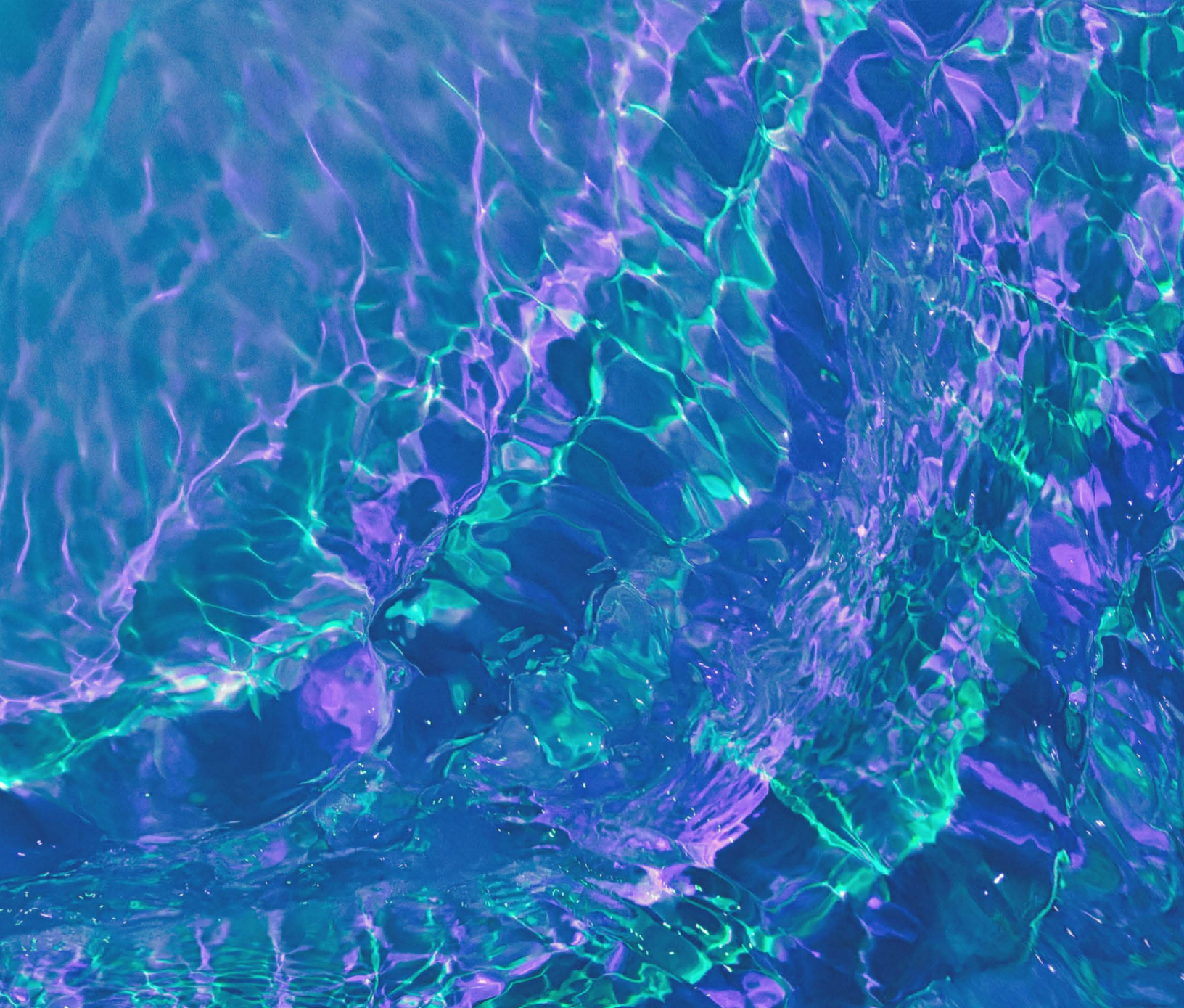
- **Core goods inflation** moderated back to pre-pandemic norms in 2024. But risks for this category are extremely high given the potential for tariffs to provide a one-time boost to the price of imported products.
- **Housing inflation** is high but moderating. A further moderation seems very likely.
- **Inflation for core services ex-housing** has also moderated with the rebalancing of the labor market. We expect this progress to hold.

Other important watchpoints:

- **Fiscal Policy**
The "One Big Beautiful Bill"—currently under consideration by the Senate— extends tax relief for households but looks unlikely to provide a large boost to aggregate demand and inflation.
- **Energy Policy**
Crude oil prices are near their lowest levels since 2021. Decreasing prices help lower inflation.

Structural inflation

- **Inflation Target**
The Fed could potentially raise its inflation target above 2% in the future. This isn't under consideration for their strategic review in 2025, but could be revisited in at some point.
- **Trade and Supply Chains**
Disinflationary impacts from "cheapest-to-deliver" global production models may fade if the deglobalization theme gains traction.
- **Energy Transition**
A more aggressive energy transition could be re-established in the U.S. in 2028 or beyond. This could lift the inflation rate by nearly 1% for five years.
- **Wars and Military Spend**
Elevated geopolitical uncertainty could lead to increased military spending, particularly in Europe. What happens in Europe could have a ripple effect on U.S. yields.
- **Debt Sustainability and Rates**
The U.S. is on an unsustainable fiscal trajectory. The bond market has begun to price more fiscal risk into long-term Treasuries. We do not expect a crisis in the near-term.
- **Online Shopping**
Online shopping continues to gain market share in the U.S., increasing consumer access to low-cost, at-scale retailers. This disinflation force is likely to persist.
- **Artificial Intelligence**
AI could lead to rapid labor productivity gains, sparking a disinflationary trend.
- **Demographics**
An aging population, weaker population growth and weaker aggregate demand could drive additional disinflation in the U.S. economy.



Deepening the Bench

Ultimately, stock-bond correlations are driven by long-term growth and inflation expectations. When inflation and long-term growth prospects are high, the diversification potential of bonds diminishes as correlations turn positive. We're in a period characterized by large economic, political and technological change that could widen the range of plausible inflation outcomes in the years ahead.

In these environments, we believe investors should consider incorporating alternative diversifiers into their portfolio. Because these assets are less sensitive to inflation, they can boost a portfolio's resilience when stocks and bonds are both in decline.

Questions?



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