January 31, 2023

MONTHLY UPDATE

January Market Review

- Financial markets started 2023 in risk-on mode. Market participants continue to wager that monetary policy will ease before the end of the year and have – so far – ignored Fed statements that say otherwise.
- After slowing in the fourth quarter of 2022, the US economy has stabilized and shows signs of re-acceleration. Notably, the labor market remains historically tight. The US added 443k jobs in January and unemployment fell to 4.4%.
- International economic and earnings growth has started to re-accelerate. Warm weather in Europe has erased concerns about energy supplies this winter.
- Global equities appreciated 7.2%. International equities, small cap, and growth equities led. Domestic equities, quality, and large cap value trailed.
- Fixed income produced outsized returns, as well as interest rates, fell and credit spreads contracted.

Despite the encouraging start to the year, we continue to believe that we are late-cycle, not early cycle. Our portfolio positioning reflects this viewpoint.

Is the 60/40 Portfolio Dead?

Last year was unusually bad for the ubiquitous 60/40 stock/bond portfolio. A portfolio consisting of 60% global equities and 40% US taxable bonds returned about -16% for the year. In isolation, a negative portfolio return shouldn't be overly disconcerting as 60/40 portfolios have experienced negative calendar year returns in 26 of the last 97 years. More troublesome was that stocks and bonds were both negative on the year. Since 1926 there have only been three calendar years in which stocks and bonds both produced negative returns: 1931, 1969, and 2022.

Due to 2022's poor performance, it has become popular at investment conferences and within financial media to question whether the ubiquitous 60/40 stock/bond portfolio has outlived its usefulness. The question usually refers to anemic prospective returns, but there are two reasons a 60/40 portfolio might no longer be adequate:

1. Return expectations have declined to unacceptable levels, and
2. Stocks and bonds have become positively correlated to the extent that they no longer provide diversification.

Will 60/40 portfolios produce reasonable returns?

Our answer to this question is an unequivocal yes, but we would have answered differently at the end of 2021. Our 2023 Capital Market Assumptions (Fig. 1), estimated returns over one full market cycle, imply a 7.8% return on a 60/40 portfolio, up from only 4.7% at the start of 2022. Anemic prospective returns in traditional assets were one reason we developed a private lending and real asset strategy at the beginning of 2021.

Why are we more optimistic about the traditional 60/40 today? Interest rates, credit spreads, and the equity risk premium all expanded in 2022, resulting in a long-term return outlook that's as good as it has been since before the financial crisis. From a return standpoint, the 60/40 portfolio remains very much alive.

Fig 1. 2023 Capital Markets Assumptions

Asset Class	Equilibrium Estimated Return	Estimated Volatility	Sharpe Ratio
Cash and Fixed Income			
US Cash	2.5%	0.3%	-
US Taxable Bonds	4.8%	3.1%	0.7
US Treasuries	4.3%	3.6%	0.5
US Agency Debt	4.9%	2.1%	1.2
US Corporate IG	5.6%	5.2%	0.6
US Corporate HY	7.2%	6.5%	0.7
Municipal Bonds	3.0%	3.7%	0.1
Municipal High Yield	5.6%	6.6%	0.5
Public Equity			
Global Equity	9.8%	13.3%	0.5
United States	9.4%	13.5%	0.5
International Developed	10.0%	14.1%	0.5
Emerging Market	11.0%	16.0%	0.5
Non-traditional			
Absolute Return	7.6%	3.4%	1.5
Diversified Private Lending	8.0%	4.1%	1.3
Private Equity	12.1%	13.3%	0.7
Other			
Inflation (CPI)	2.5%		

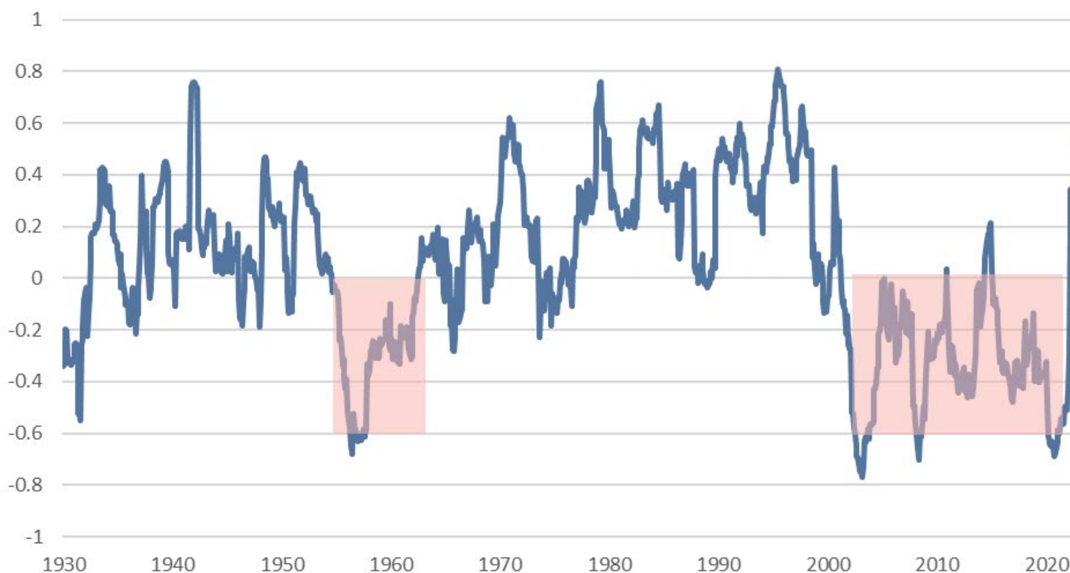
Source: Mill Creek.

Do stocks and bonds still provide sufficient diversification?

The evidence for this answer is less certain. Correlation is a statistical measure of the relationship between two things. If two investments are positively correlated, they tend to rise and fall together. If they are negatively correlated, they tend to offset each other – one rises when the other falls. Part of the premise of a 60/40 portfolio is that the stocks and bonds will be negatively correlated during stress events — your bonds will do well when your stocks fall.

Stock/bond correlations were unusually mostly negative between 2000 and 2019, leading to good diversification and downside protection for 60/40 portfolios (Fig. 2). In the broader historical context, however, that period is an outlier. Absent a decade of low and stable inflation in the 1950s, stock/bond correlations were generally positive before 2000.

Fig. 2: Rolling 2-year equity/bond correlation



Source: Bloomberg, Morningstar, Mill Creek.

Why were stock/bond correlations unusually low between 2000 and 2020? It can mostly be attributed to a one-sided reaction function from the Federal Reserve. The Fed has a dual mandate — full employment and low inflation — but fighting inflation wasn't on their radar for the last 20 years. Persistently low inflation allowed the Fed to focus on employment, which meant that anytime there was a shock to the economic system, the Fed could loosen policy by lowering interest rates. Declining interest rates were supportive of bond prices even when equities were falling, leading to a negative correlation between stocks and bonds. The Fed did not

benefit from persistently low inflation prior to 1999 and it's unclear whether they will have it going forward from here.

If equities and bonds are more highly correlated, 60/40 portfolios will be more volatile and prone to larger drawdowns. In this respect, the 60/40 isn't dead, but it has developed chronic arthritis. The Fed won't be able to push back on economic and market declines at the same pace they did between 2000 and 2019 until all of the inflation has been rehabbed out of the system.

QUICK LINKS

- House View Summary
- The Labor Market Remains Very Tight
- Why Corporate Borrowers Remain Well-Positioned
- Fowl Play

This week's contributor: Michael Crook, CAIA

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