# FOCUS · Opportunities for investment and portfolio diversification

Over the last few months an increasing number of people have noted that the correlation, or degree of synchronisation, has increased between the returns on different financial assets (see the enclosed graph). This is incredibly important as it represents a fundamental aspect in building up investment portfolios: it is vital for a portfolio to be able to appropriately diversify its asset allocation in order to match its risk profile to each investor's requirements.

In addition to this importance for investors at an individual level, the degree of correlation between assets is also closely monitored by central banks and the different institutions responsible for safeguarding financial stability such as the IMF and the Bank for International Settlements, as a more positive correlation between the different financial assets also makes economies more vulnerable to adverse sentiment shocks in financial markets.

In recent years, concerns about an increase in this correlation have often been repeated and there is intense debate regarding the factors that lie behind this situation. Over the last few decades, one element that has been fundamental to the stocks/bonds correlation remaining negative (with the result that portfolios can be easily diversified) has been the implementation of appropriate and effective monetary policies which have adjusted interest rates to cushion the impact of any adverse shocks. This has meant that inflation expectations have remained relatively stable for many years and has enabled bonds to act as a safe haven when stocks have gone through corrective episodes. However, central banks have lost some of their credibility in the last few years and doubts are increasing regarding their capacity to control inflation in a world where prices are increasingly affected by global conditions. Additionally, the instruments that can be used by central banks seem to be more limited now that inflation continues to be sluggish in spite of interest rates being at an all-time low.

Another factor to take into account when assessing the possibilities to diversify a portfolio is the globalisation of financial markets. On the one hand, this should give investors access to a wider range of investment opportunities and should therefore make diversification easier. However, the fear is that greater portfolio diversification at an international level results in the price of the different assets being more determined by global factors than by local or idiosyncratic factors.

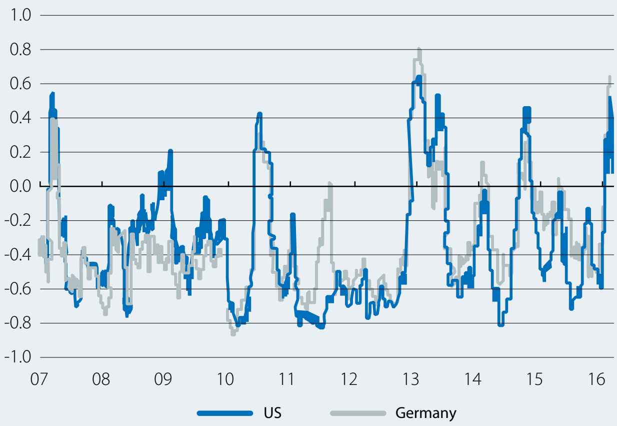
Lastly, another factor that is often put forward as increasing the correlation between assets returns is the application of very similar portfolio management techniques by agents operating in the markets, based on algorithms that generate automatic orders to buy and sell. However, although this does seem to play an important role in some specific cases, resulting in upswings in volatility in certain assets, there is no reliable evidence to suggest, at present, that this is causing any secular increase in the correlation between asset yields.

In the last few quarters concern regarding the financial assets correlation has grown due to the appearance of two forces that may apparently increase this synchronisation. On the one hand, the fact that interest rates now seem to have bottomed out and an upward trend has probably begun (which reduces bond prices) worries investors who believe equity is unlikely to see many gains. Several arguments have been put forward along these lines. In the US, the S&P 500 is at an all-time high while stock market indices in the euro area have been hindered by still sluggish growth and high uncertainty.

Nevertheless, there are also reasons to be optimistic. In particular, the rise in inflation predicted for the next few quarters should boost stock prices. Easier fiscal conditions, especially in the US and UK, will also support cyclical sectors such as those related to consumption or investment in infrastructures. Moreover, the normalisation of interest rates ultimately responds to an improvement in macroeconomic conditions and, if this is the case, sooner or later such improvement should also be reflected in the main stock market indices performing well.

### *Correlation between bonds and equity*

*(Correlation index)*




**Note:** *To calculate the correlation index, the MSCI World Index and 10-year public debt in the US and Germany have been used, respectively. The index shows the evolution of correlations over 3-month windows for weekly returns.*
**Source:** *CaixaBank Research, based on data from Goldman Sachs Investment Research.*