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Macroeconomic Factors and the Correlation of Stock and Bond Returns

53 Pages

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Abstract

This paper examines the correlation between stock and bond returns. It first documents that the major trends in stock-bond correlation for G7 countries follow a similar reverting pattern in the past forty years. Next, an asset pricing model is employed to show that the correlation of stock and bond returns can be explained by their common exposure to macroeconomic factors. The link between the stock-bond correlation and macroeconomic factors is examined using three successively more realistic formulations of asset return dynamics. Empirical results indicate that the major trends in stock-bond correlation are determined primarily by uncertainty about expected inflation. Unexpected inflation and the real interest rate are significant to a lesser degree. Forecasting this stock-bond correlation using macroeconomic factors also helps improve investors' asset allocation decisions. One implication of this link between trends in stock-bond correlation and inflation risk is the Murphy's Law of Diversification: Diversification opportunities are least available when they are most needed.

Keywords: Stock-Bond Correlation, Asset Allocation, Macroeconomic Factors**JEL Classification:** G12, G15, E44[Suggested Citation](#) >[Show Contact Information](#) >[Download This Paper \(Delivery.cfm/SSRN_ID363641_code021217590.pdf?abstractid=363641&mirid=1\)](https://papers.ssrn.com/sol3/Delivery.cfm/SSRN_ID363641_code021217590.pdf?abstractid=363641&mirid=1)[Open PDF in Browser \(Delivery.cfm/SSRN_ID363641_code021217590.pdf?abstractid=363641&mirid=1&type=2\)](https://papers.ssrn.com/sol3/Delivery.cfm/SSRN_ID363641_code021217590.pdf?abstractid=363641&mirid=1&type=2)

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