



With interest rates looking likely to stay above pre-pandemic levels and debt levels elevated, CIO sees a widening dispersion between stronger and weaker creditors. (UBS)

# Diversification vital as inflation falls in 2024

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**US equities and bonds climbed together again last week, marking the seventh consecutive week in which the two major asset classes have moved in lockstep. A 2.5% advance for the S&P 500 left the index almost 15% higher from a recent low point on 27 October.**

Meanwhile, a rally in government bonds pushed the yield on the 10-year US Treasury down around 33 basis points over the past week to 3.9%. The yield is now close to 110 basis points lower since hitting a 16-year peak of 5% in late October.

This twin rally has been a great way for investors to enter the final week of trading before Christmas. However, such periods of positive correlation between equities and bonds can cause some to call into questions the value of (and need for) diversification.

In our view, diversification will remain as important as ever going into 2024.

**The negative correlation between stocks and bonds looks likely to return as inflation falls closer to central bank targets next year.** Quarterly data going back 100 years indicates that the equity-bond correlation tends to be negative when inflation is in a 0–2% range, and positive when inflation is above 5%. During the other periods, when inflation is in the 2–5% range, the equity-bond correlation is generally weak. As the economy slows into 2024, the Federal Reserve is expecting the core personal consumption expenditure measure of inflation to drop to 2.4%, within range of its target. Under such conditions, we would expect diversification to once again start serving its traditional function of lowering portfolio volatility.

**Economic and geopolitical risks have not gone away, adding to the importance of diversification across asset classes and regions.** Politics and geopolitics could play an outsized role on markets in the coming year. The war between Israel and Hamas remains fluid—with the potential to disrupt oil supplies and unsettle markets. The same can be said for the war between Russia and Ukraine. Uncertainty surrounding the US Presidential election also has the potential to cause volatility. And partisan disruptions over the US budget have become more intense. Overall, 2024 will be a record-breaking year for elections. More than two billion voters in 50 countries will be heading for the polls. This could contribute to choppy returns in particular countries, sectors, and industries. This backdrop makes diversification especially helpful.

**Alternative investment classes can also improve risk-adjusted returns in uncertain times.** Market sentiment adjusted frequently during 2023 over the outlook for inflation, growth, and central bank policy—with fears of higher rates for longer giving way to optimism over aggressive easing. Such shifts could well spill over into next year, especially since market expectations for rate cuts continue to run far ahead of the Fed's own projections. As of 18 December, fed funds futures are pricing around 145 basis points of easing next year, versus the median forecast from top Fed policymakers for 75 basis points of US rate cuts.

Against this backdrop, investors can consider adding to allocations of macro hedge funds, which are particularly adroit at capitalizing on changing macroeconomic environments, central bank pivots, and market transitions. We also think a range of alternative credit strategies look set to outperform. With interest rates looking likely to stay above pre-pandemic levels and debt levels elevated, we see a widening dispersion between stronger and weaker creditors. This creates an abundance of opportunities for credit arbitrage funds, enabling managers to make credit choices based on fundamental analysis. Of course, investors need to be willing and able to tolerate lower liquidity and other risks associated with allocating to hedge funds.

So, in our view, this remains an opportune moment for investors to consider the merits of balanced, geographically diversified multi-asset portfolios.

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