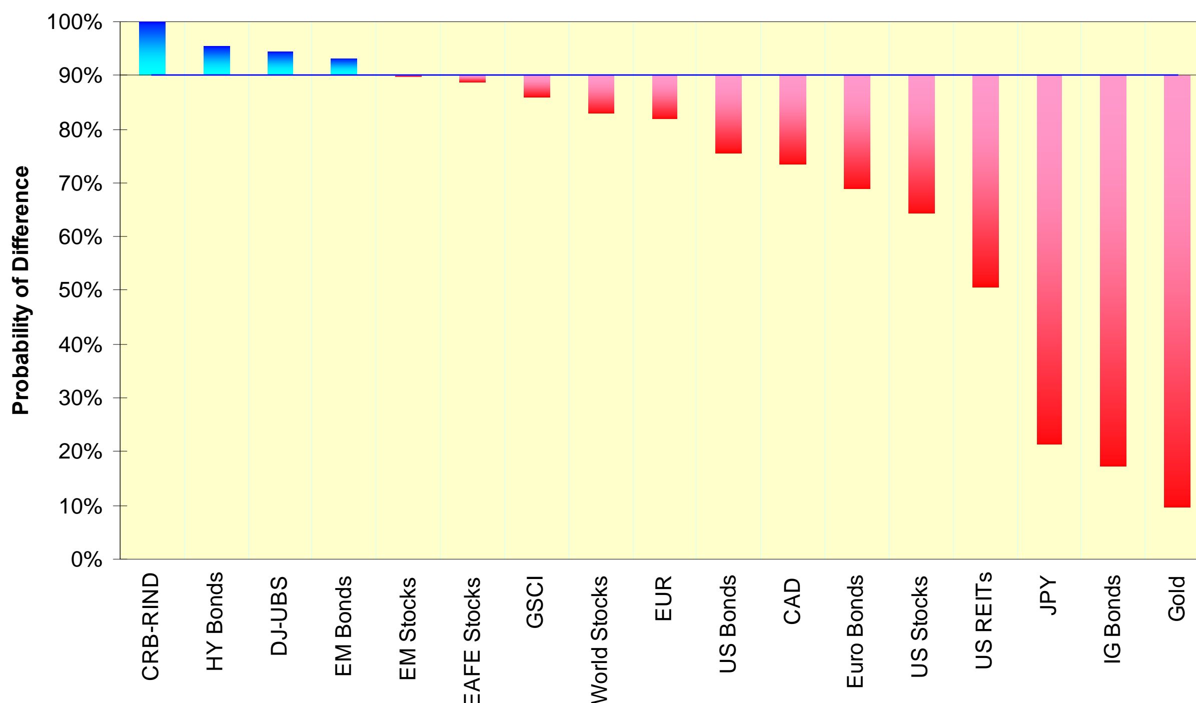
The End Of Lockstep Correlation

You may have seen it; I did. The "it" in question was an e-mail parodying an Occupy Wall Street protester with the image of a young banker holding a sign saying, "End market correlation." Most of us would second that sentiment after months of seemingly everything rising and falling together in what has been described, accurately, as the risk-on/risk-off trade.

The general principle has been that during times of crisis, correlations of returns move toward unity, either +1.00 or -1.00. However, that principle is being eroded even though it still seems as if we are moving in lockstep across markets. Let's use the MSCI World index in USD terms as the basis of comparison for other key market indices; all correlations referred to below were calculated over rolling three-month periods.

Here are a few highlights from the analysis. The MSCI Emerging Market index has made a series of lower highs in correlation since September 2010. U.S. investment-grade corporate bonds, which had been moving toward a correlation of -1.00 along with Treasuries and the Pan-European Sovereign bond index, diverged in August (see "Dissecting Credit Spreads"). Correlations for both U.S. high-yield and emerging market bonds, which had been declining rapidly from strongly positive levels since May 2010, started to reverse higher and began acting more like equities this June. Within the world of currencies, the excess carry return on the yen has crossed the line from negative to positive correlations twice this year and the excess carry returns for both the euro and the Canadian dollar are both more than 75% correlated to the MSCI World index after being below 40% in March.

The differentiation process has been going on longer than realized commonly and has not been a function of this year's break from the highs at the start of May. This can be illustrated by comparing the average returns over two periods, the one extending from Bernanke's Jackson Hole speech on August 27, 2010 through the May 2, 2011 high and the period thereafter across a range of assets. The chart below depicts the probabilities the two periods are in fact different. I highlight the break at a 90% confidence level.



Only four indices, the CRB industrial materials index, U.S. high-yield bonds, the Dow Jones-UBS commodity index and emerging market bonds, had statistically different returns at the 90% confidence level after global equities

decided to head south for the summer. Some markets, including gold, the Japanese yen and investment-grade bonds, were unfazed by the downturn in global equities.

It has been easy, too easy, for many professional managers to lament high levels of market correlation, hence the OWS parody making the rounds. That era is drawing to a close. From now on, the general risk-on/risk-off approach will diminish in importance.