THE ALTERNATIVE WEEKLY BRIEF

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THE POSITIVE EQUITY/BOND RETURN CORRELATION MIGHT NOT GO AWAY IN 2023

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Equity/Bond return correlation spiked in 2022. With stock and bond prices increasingly moving in the same direction, diversification failed to protect diversified allocations. Equity and bond flows also re-correlated, with selling in both segments, in favor of cash and alternatives. Relative implied volatility and risk-premiums reflected investors' higher inflation and rates than growth concerns. Also, the equity/bond return re-correlation was worldwide.

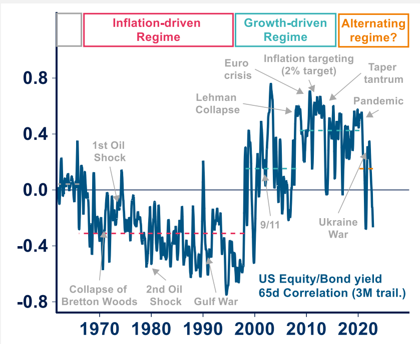
Main drivers of the equity/bond correlation. Building on the abundant literature and our research, we do find that growth and inflation are pivotal variables. When there is more growth uncertainty, return correlation tends to move in opposite directions (the last 20-years 'great moderation', briefly interrupted by the financial crisis). When there's more inflation uncertainty, return correlation tend to be positive (the 'great shocks' of the 70s for instance). Scrutinizing the relative behaviors of stock and bond common return components helps better understand the influences on the overall correlation. Both bond and equity prices derive from their discounted cash flows: *Present Value* $= \Sigma\ [\ \textit{Flows}_t\ /\ (1 + \textit{ST real rates}_t + \textit{inflation}_t + \textit{risk premium}_t)^t\ ]$. We find that the growth and corporate profits backdrop, inflation, and the monetary response are the main correlation movers. Both the pulse and uncertainties around each of these movers matter equally.

Given the multiple factors altering growth, inflation and monetary dynamics, there is no easy answer regarding the outlook of the stock/bond relationship, especially when dynamics at play are looser, typically during mid-cycles. Modelling the equity/bond correlation tends to be more reliable during late, recession and early cycles. The history of equity/bond correlations shows several major regime shifts along with multiple shorter-term trends. They reflect both long-term macro-economic influences and shorter-term market impacts.

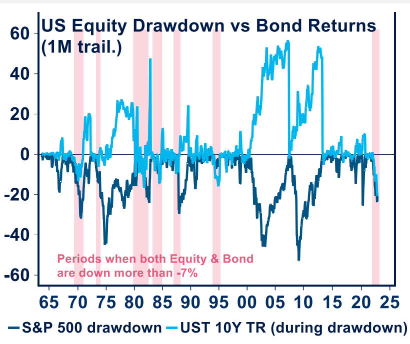
All in all, environments with stable growth, benign inflation and pro-active central banks typically favor negative return correlation. In contrast, when growth weakens, profits fail to outpace the nominal risk-free rate, and when inflation becomes high and sticky, then uncertainty rises, stocks tend to fall while yields tend to rise, which favor positive return correlations.

How could the equity/bond correlation lean next year? In 2022, planets were aligned for a powerful equity/bond return re-correlation. In 2023, such a planet alignment is unlikely to repeat, but the balance of forces still points to a positive correlation, though less than in 2022. Positive correlation factors include growth likely to stay weak and uncertain, inflation to remain above-par. Meaningful changes in both the Fed's balance-sheet and fiscal adjustment tend to support correlation, as well as prospects of shorter economic cycles going forward. The equity/bond correlation also carries an inertia that rarely shifts overnight (partly because inflation fears take time to overcome). Finally, we observe that correlation *[continued p2]*

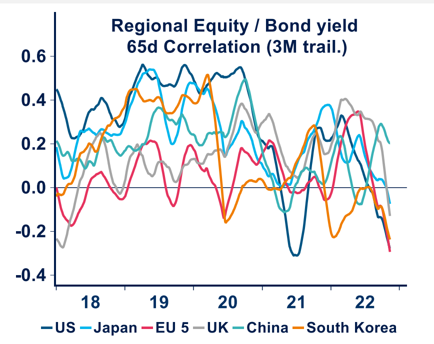
Few Regime shifts, Multiple Short-term Swings



Costly Diversification with Bonds in 2022



Worldwide Equity/Bond Re-correlation



Sources: Bloomberg, Macrobond, Amundi Institute

Performance: Widening Merger Spreads on Tighter Financial Conditions

Amundi UCITS Peer Group Performance

	Last week*	MTD	YTD
Global Amundi UCITS Peer Group	0.2%	0.2%	-1.8%
L/S Equity Directional	0.5%	0.9%	-8.0%
L/S Equity Market Neutral	0.9%	0.1%	1.1%
Event-Driven: Merger Arbitrage	-1.2%	-1.2%	-1.5%
Event-Driven: Special Situations	1.3%	1.3%	-9.0%
L/S Credit	0.2%	0.2%	-5.3%
Global Macro	0.7%	0.7%	-3.5%
CTAs	0.3%	0.3%	17.4%
Risk Premia	0.3%	0.3%	5.3%
MSCI World	-2.1%	-1.6%	-22.4%
Bloomberg Barclays Global Aggr. Bond	-0.7%	-0.4%	-12.8%

*Last Week: Oct 28 to Nov 4. YTD and MTD until Nov 4. Source: Amundi Institute

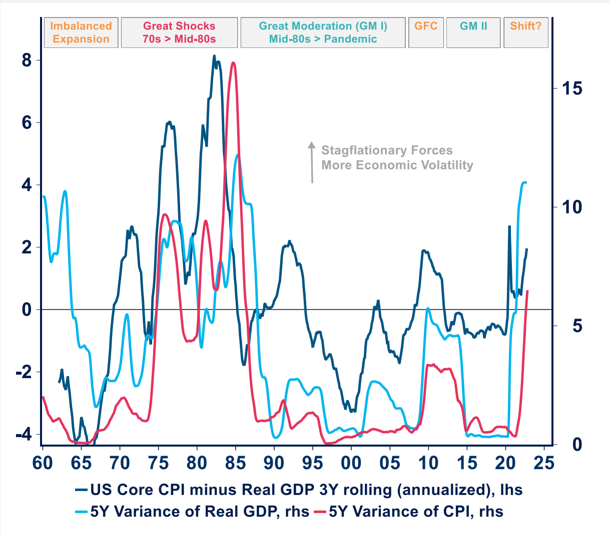
US equities underperformed ahead of the US midterm elections and after the Fed confirmed its hawkish stance and a fourth 75bps rate hike. In contrast, Chinese equities staged an impressive rally on rumors authorities could loosen their zero-Covid policy.

Hedge fund performance was positive. L/S Equity strategies benefitted from a global rally of value stocks. Global Macro continued to benefit from rising short-term US interest rates.

Merger arbitrage lagged this week, weakened by the rise of merger spreads, in sympathy with rising US yields. Tighter financial conditions and more deal funding concerns also resulted in spread widening.

The Positive Equity/Bond Return Correlation might not go away in 2023 *[continued from p1]*

Stagflation forces coincided with higher Macro Volatility



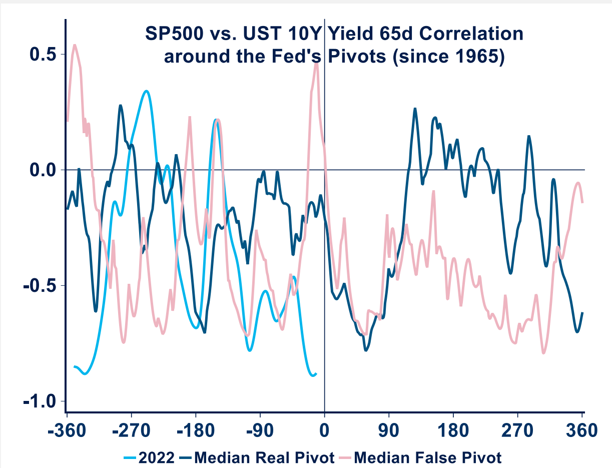
Source: Bloomberg, Amundi Institute

tends to stay positive ahead and well after the Fed's pivots. In contrast, the following factors tend to play the other way round: a peak in target rates and in inflation prints. A possible stock rally when the Fed pivots could depress the equity risk premium. The case of a sharper recession than expected and intensifying deflation fears could also shift the focus to growth instead of inflation, resulting in a negative correlation.

Challenging diversification. The equity/bond correlation is a crucial input for allocation decisions. Positive correlations over the last 20 years until the pandemic were goldilocks for diversification. The relationship might be more unstable and trickier to forecast going forward. Beyond stocks and bonds, surging cross-asset correlations are rising co-movements risk. This is calling for more sustainable diversification options.

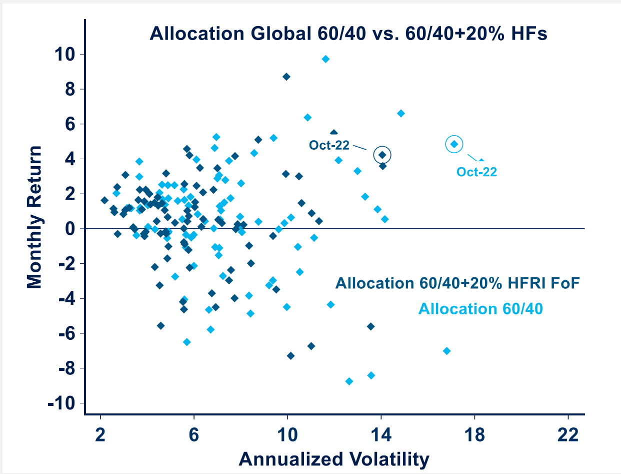
Hedge Funds are appealing alternative to bonds, given their low volatility, market beta, and sensitivity to duration. While getting extra-returns from their long cash profile, their improving alpha prospects could become a high-value asset, amid more modest growth and traditional asset returns.

Equity/Bond Return Correlation stays Positive well after Pivots



Source: Bloomberg, Macrobond, Amundi Institute

Appealing Hedge Funds Diversification in Global Allocations



Source: Bloomberg, Macrobond, Amundi Institute

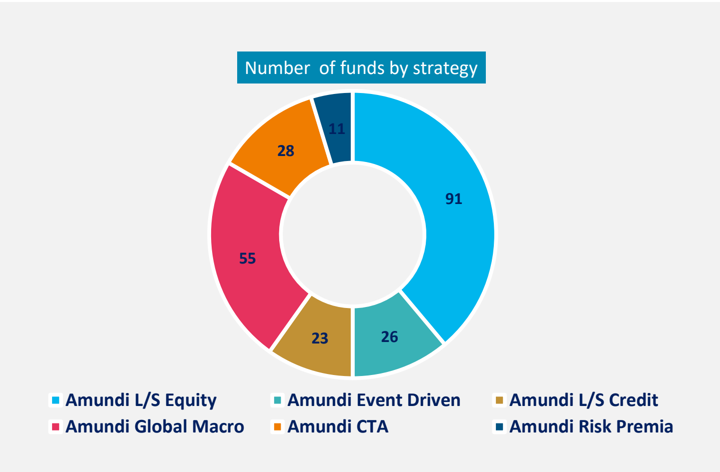
METHODOLOGICAL APPENDIX

The information contained in this report on the performance of hedge funds is based on publicly available information. The universe of underlying funds is relatively stable but varies depending on the criteria of inclusion presented below. It is based on an unbiased selection from our hedge fund analyst team.

Performance is calculated on a weekly basis, as of end-of-week, using an arithmetic average (equally weighted average).

Regarding share classes used in these peer groups, we selected the primary share class as referenced in Bloomberg. Non-USD share classes are hedged in USD based on hedging costs available on Bloomberg.

Amundi Hedge Fund Peer Groups: number of funds by strategy



- 234 strategies across the main categories in the industry
- USD 154 billion of assets under management
- As of November 2022

Criteria of inclusion

The criteria of inclusion are fourfold:

- Only UCITS strategies are included
- Assessment by Amundi’s Hedge Fund selection team based on funds’ materials or manager interaction
- Strategies included must have assets under management of at least USD 50 million
- Strategies included must display at least a one-year track record

PUBLICATION FREQUENCY

This report will be published every two weeks.

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