CARLYLE

By **Jeff Currie**

January 28, 2025

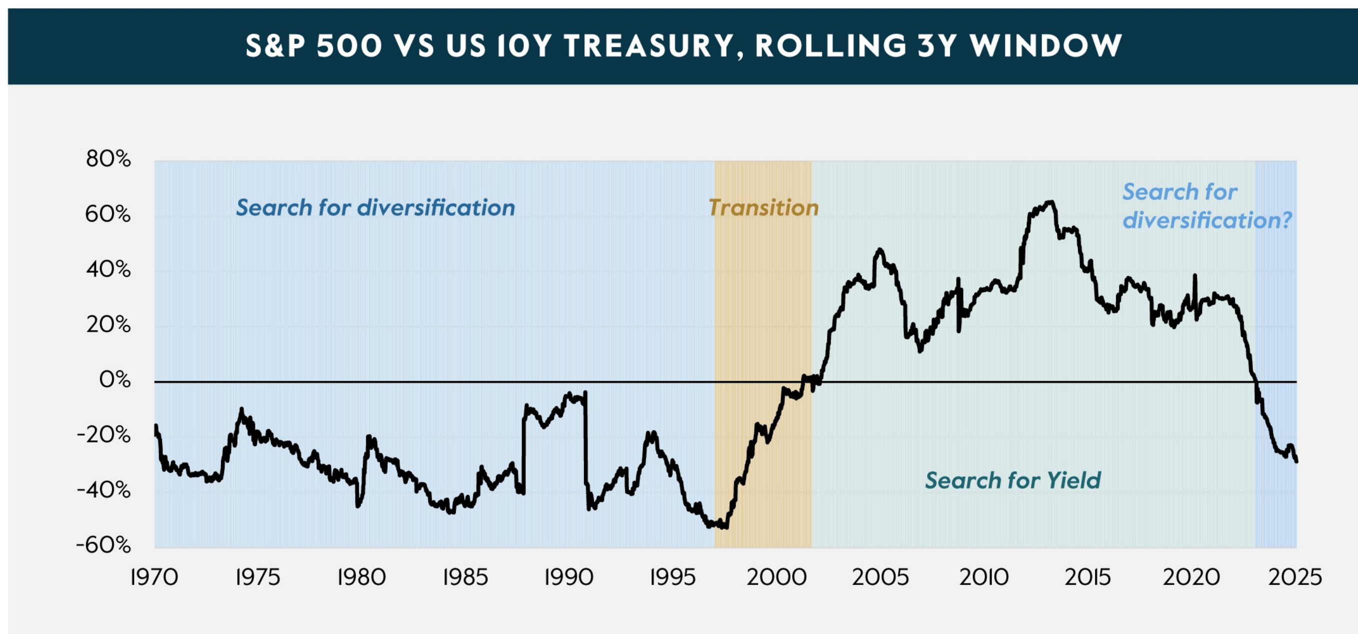
---

*Welcome back to **The Carlyle Compass**, your weekly newsletter that brings together the latest research and market insights from our global team. This week's edition features guest author Jeff Currie, Chief Strategy Officer of Energy Pathways at Carlyle.*

The new "search for diversification"

The search for yield was a defining characteristic of investor behaviour over the past quarter century. It was driven by low interest rates and inflation, excess liquidity and a global savings glut. These conditions have been slowly disappearing over the past 30 months and are expected to substantially and persistently reverse under the new Trump Administration. Best capturing this fundamental shift has been the recent flip and subsequent sharp rise in bond and equity return correlations from negative to strongly positive (Figure 1).

Figure 1: US Stock/Yield Correlation



Source: Carlyle Analysis; Bloomberg, January 2024. There is guarantee that any trends will continue.

When bond and equity returns were negatively correlated, as they mostly were from 2001 to 2023 (-0.29), diversification was not a priority since a 60/40 portfolio was naturally hedged (when bond yields went down equity yields went up). Instead, the prevailing low yields made a search for yield the priority. With structurally higher rates reversing asset return correlations, we believe this suggests that a "search for diversification" will likely replace a "search for yield" as a new defining investor paradigm in the coming decade,

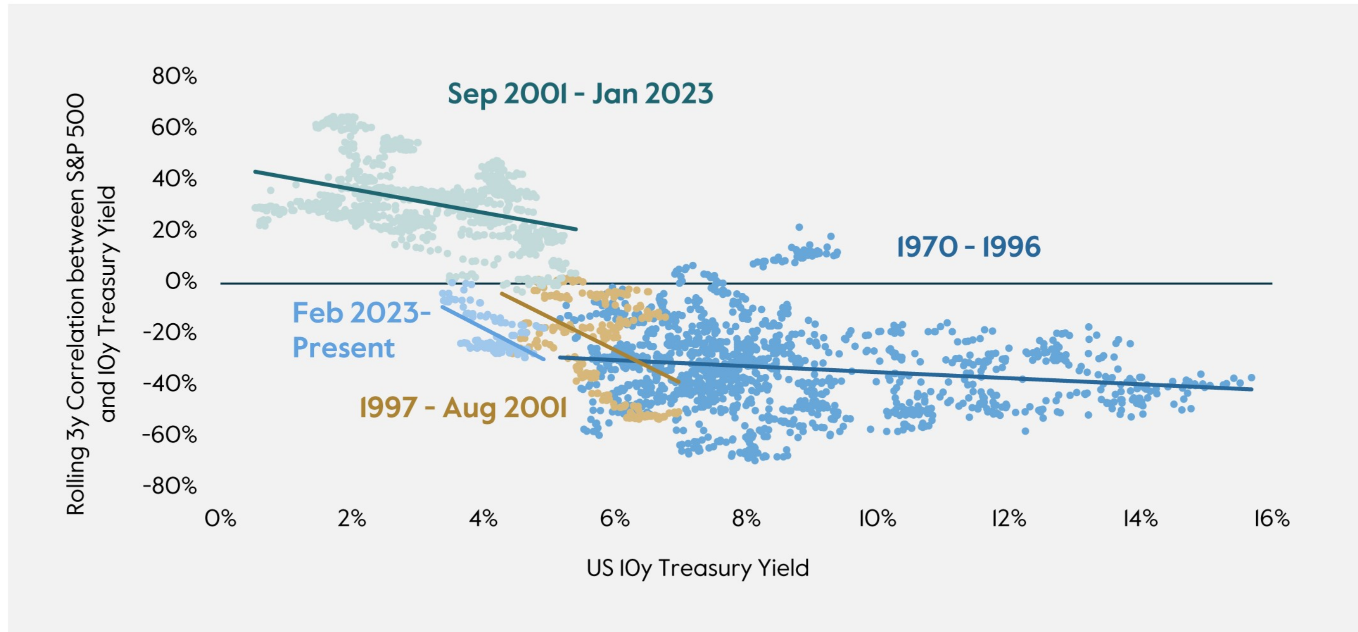
creating an era more similar to 1968 to 2000 when bond and equity returns were positively correlated (+0.34).

We believe the key to diversification is to identify spot assets correlated to inflation and structurally higher rates which most real assets are. (For example, illiquid real assets in natural resources, real estate, and infrastructure, as well as liquid alternatives like managed futures in rates and commodities.) While this structural shift is slowly being priced into macro markets, investors have not fully embraced this new paradigm and may not until both equity and bond returns are simultaneously negative like they were briefly in 2022 and early 2023.

Understanding the Liquidity-Growth Trade off

In the very long run, bond and equity returns likely have a zero correlation, which is sufficient to make the 60/40 portfolio work as conceived by Markowitz in his Modern Portfolio Theory; however, the reality is that bond and equity return correlations go through decade-long regimes of positive and negative correlations (Figure 2) with the ultimate driver of the correlation regime being the level of interest rates. Nonetheless, data since 1925 suggest that the need for diversification and a positive correlation in bond and equity returns seems to be the more prevalent state of the world where expected economic growth, not instant liquidity availability, drives investment decisions.

Figure 2: US Stock/Yield Correlation Vs Yield



Source: Carlyle Analysis; Bloomberg, January 2024. There is guarantee that any trends will continue.

In the low interest rate, high liquidity dominated environment of 2001 to 2023, the investment decision was how much to allocate simultaneously to both bonds and equities as there was very little trade-off between debt and equity at zero to negative interest rates. The question was simply how much to leverage to apply to each investment. This surge in levered liquidity, in turn, created a positive correlation in bond and equity prices which is negative correlation in yields, which gave investors a natural hedge and the confidence to lever even more, reinforcing the liquidity and positive correlations in asset returns.

In contrast, higher interest rates force choices between debt and equity and discourage leverage, which in turn, reduce asset correlations and the natural hedge which further reduces leverage and liquidity. Yes, M2 is going up faster than nominal US GDP growth today, but that doesn't mean liquidity is doing the same as the ability to lever that M2 is declining as asset correlations reverse and interest rates remain high.

In higher interest rate environments like 1968 to 2000, investors had constraints on their liquidity position and had to make an allocation decision between debt and equity. Higher interest rates created real trade-offs in the decision of debt versus equity with the allocation decision based upon their views around expected economic growth. When

economic growth was expected to accelerate, investors sold bonds, and bought equities, which created a positive correlation in bond and equity yields. The key is that in the 1968 to 2000 environment with interest rates above the long-term nominal growth rate of 5%, the investors liquidity position was constrained, making expected growth the primary driver of allocation decisions, not liquidity.

The Rise of the Risk-On, Risk-Off Investing Paradigm

This all changed following September 11, 2001, when the Fed slashed interest rates by 200 basis points below 2% and injected $100 billion of liquidity into global markets to keep financial markets functioning while Wall Street was shut. Then on September 17, 2001, the World Trade Organization successfully concluded negotiations on China's terms of membership, paving the way to full membership before the end of 2001. The United States likely sped this process up to secure China's vote in the United Nations security council on September 28, 2001 to pass UN resolutions that set the stage to use force.

In the course of two weeks, all of the factors driving a "search for yield" environment were put into place: low interest rates, excess liquidity and with China in the WTO—low inflation and an impending savings glut. While this transition actually began in fits and starts in 1997 with the Asian Financial Crisis, and then the Russian Debt Crisis in 1998, by January 2002 macro markets were pricing the new regime, and the bond and equity return correlations were firmly in the new self-diversifying "search for yield" regime. As interest rates continued to decline across the curve, leverage rose accordingly which lifted constraints on liquidity making it the most important driver in asset allocation decisions. This created a negative correlation in bond/equity returns which made the need for diversification in a 60/40 portfolio redundant and thus the focused shifted to a search for yield.

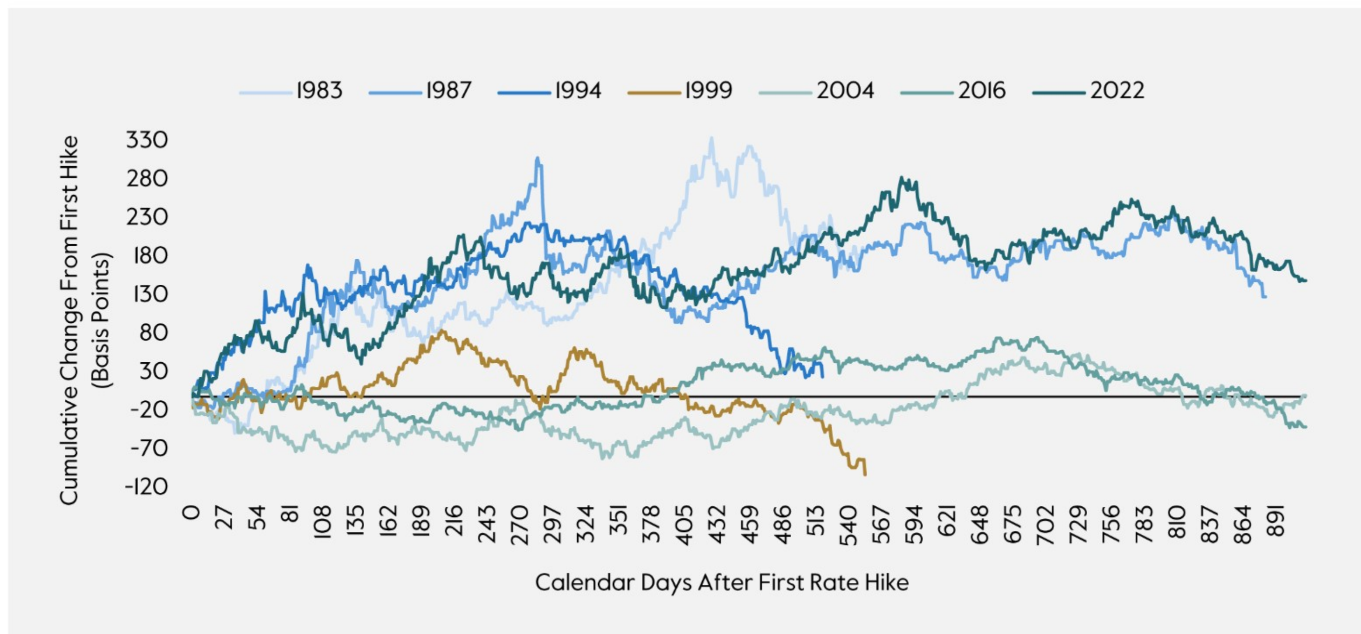
By 2004 markets started using the "risk-on" and "risk-off" language to refer to buying both bonds and equities, or risk assets more broadly, based upon perceived liquidity. Leverage drove liquidity until 2008 when the GFC led to policies that restricted leverage. But in response to the crisis, policy makers just replaced the leveraged liquidity with more base money supply liquidity that had a lower velocity, so the search for yield continued and accelerated with zero to negative yields. While this environment faded somewhat during the 2016-2019 rate hiking cycle, it was essentially uninterrupted from 2001 to 2022 and resurfaced in late 2023-early 2024 over rate cut excitement. Higher rates after 2023,

however, discouraged leveraged liquidity and forced investors to make real economic choices.

The "Search for Yield" Exit in 2024/25 Mirrored the Entry in 2004/05

While it is easy to the tell the history ex post, it wasn't clear until around 2005 that financial markets were in a new paradigm. Similar to today, with Fed officials calling the recent rise in 10-year yields "alarming" following a 100bp Fed Funds Rate cut, in 2005 then Fed Chair Alan Greenspan called the exact opposite dynamic a "conundrum" when 450bp of Fed Fund Rate hikes led to a record decline in the 10-year yield. Importantly, the 2004-2006 rate hiking cycle was the first cycle following the 2001-2003 easing cycle that started the "search for yield" paradigm (Figure 3). Not surprising, this easing cycle was the first since the 2022-2023 rate hiking cycle that started this new regime of higher rates driven by stubbornly higher inflation.

Figure 3: Cumulative Change in 10Y Treasury Yields After the Fed Starts Hiking Rates



Source: Carlyle Analysis; Federal Reserve Board of Governors, Bloomberg, January 2025. There is no guarantee any trends will continue.

We Believe This is the Start of a New "Search for Diversification"

Paradigm

The key question to ask is, are we going back to the low-interest rate environment that characterized 2001-2023 or 1954-1967? We believe not, which should keep bond and equity return correlations positive as Exhibit 3 suggests. Two years of “high” real rates have done nothing to dent economic activity, which continues to grow at rates close to 2x what most forecasters believed was the economy’s potential in 2021. The Trump Administration’s policies are directly targeting the dynamics that created the search for yield environment to begin with—mainly globalization. Without robust trade with China there cannot be a savings glut nor recycling of dollars into US treasuries that characterized the previous decades. Second, the reduction of US imports must shift the US growth/liquidity mix to favour growth through higher levels of domestic investment. And third, the Administration’s goal to weaken the dollar could force Europe and Asia to finally focus on increasing domestic consumption as a weaker dollar will give them room to stimulate. All of which favours growth, inflation and structurally higher interest rates, which are the key factors for a new “search for diversification” paradigm.

For Diversification, Focus on Spot Assets and the Level of Activity, Not the Growth Rate

Most bonds and equities, private or public, are financial assets. Their values are driven by expectations of future activity, not current activity. In other words, financial assets are anticipatory assets that depend upon future growth rates. In contrast, real assets are spot assets and depend upon the level of activity today. To see this, let’s take an infrastructure project like a toll road where the spot tolls are paid to the investor as a dividend each quarter. Now assume that inflation surges and the Fed starts to hike rates, this will clearly slow expectations on future growth rates, but it is unlikely to take the growth rates negative, just slow them.

This will cause financial valuations to fall due to a decline in the growth rate, but it will only slow the rise in spot valuations as the number of cars on the toll road will still rise but at a slower rate. If the number of cars was already causing pricing pressure, even a slower *growth* rate that increases the *current* level of cars on the road will be a positive to spot valuations even as financial valuations fall. This is why we suggest looking at spot-related assets

that often exhibit lower or negative correlations with financial assets, especially during inflationary or high-interest-rate environments when financial assets, particularly bonds, may struggle, making them valuable for diversification.

JEFF CURRIE

Chief Strategy Officer of Energy Pathways

This material is provided for educational purposes only. Nothing herein constitutes investment advice or recommendations and should not be relied upon as a basis for making an investment decision. It does not constitute a personal recommendation or take into account the particular investment objectives, financial situations, or needs of individual investors.

Economic and market views and forecasts reflect our judgment as of the date of this presentation and are subject to change without notice. In particular, forecasts are estimated, based on assumptions, and may change materially as economic and market conditions change. Carlyle has no obligation to provide updates or changes to these forecasts. Certain information contained herein has been obtained from sources prepared by other parties, which in certain cases have not been updated through the date hereof. While such information is believed to be reliable for the purpose used herein, Carlyle and its affiliates assume no responsibility for the accuracy, completeness or fairness of such information.

Past events and trends do not imply, predict or guarantee, and are not necessarily indicative of, future events or results. This material should not be construed as an offer to sell or the solicitation of an offer to buy any security, and we are not soliciting any action based on this material. If any such offer is made, it will only be by means of an offering memorandum or prospectus, which would contain material information including certain risks of investing including, but not limited to, loss of all or a significant portion of the investment due to leveraging, short-selling, or other speculative practices, lack of liquidity and volatility of returns.

Recipients should bear in mind that past performance does not predict future returns and there can be no assurance that an investment in a Carlyle fund will achieve comparable results. The views expressed in this commentary are the personal views of certain Carlyle personnel and do not necessarily reflect the views of Carlyle. Investment concepts mentioned in this commentary may be unsuitable for investors depending on their specific investment objectives and financial position; each recipient is encouraged to discuss such concepts with its own legal, accounting and tax advisors to determine suitability. Tax considerations, margin requirements, commissions and other transaction costs may significantly affect the economic consequences of any transaction.

In connection with our business, Carlyle may collect and process your personal data. For further information regarding how we use this data, please see our online privacy notice at https://www.carlyle.com/privacy-notice.