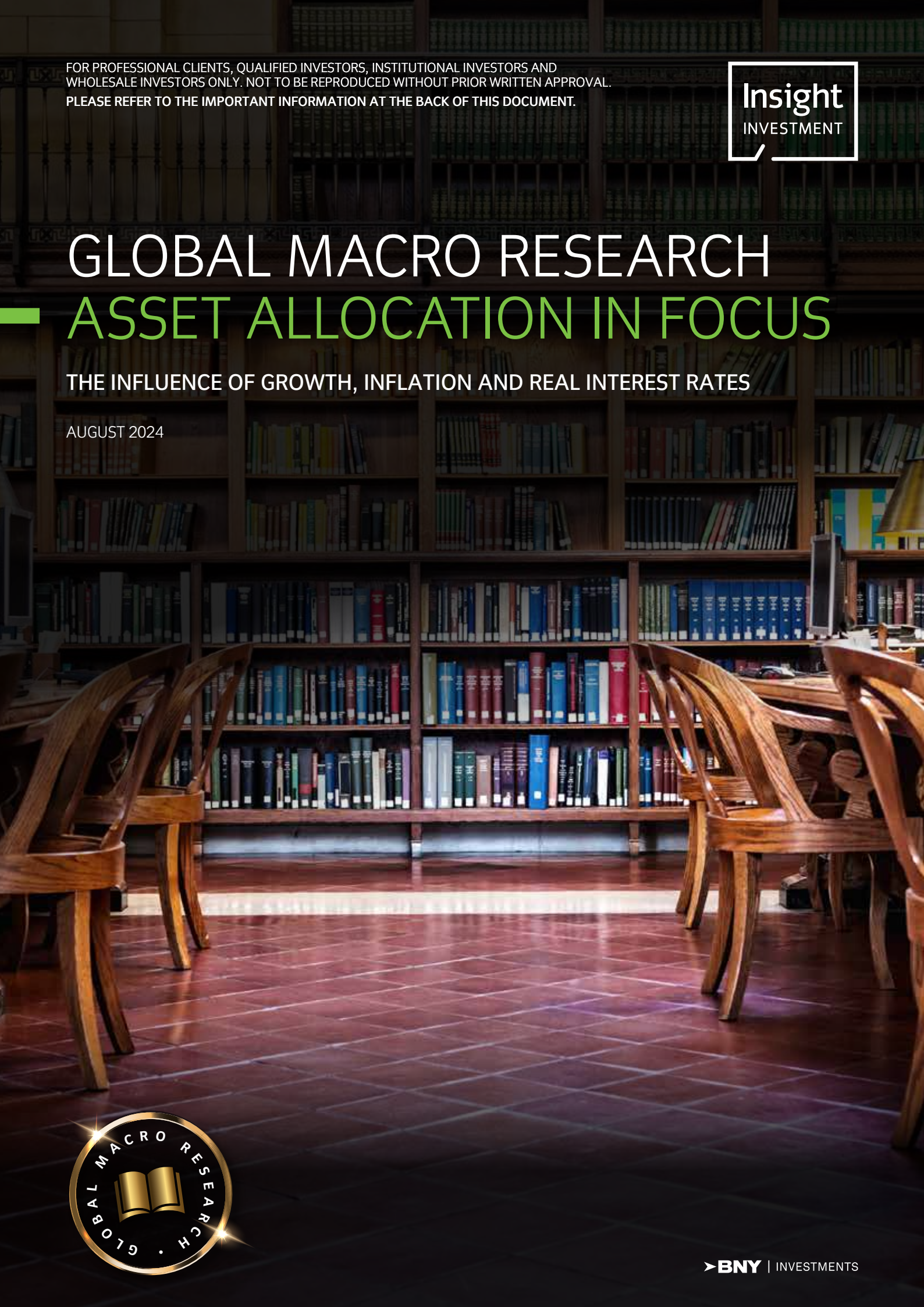
Insight INVESTMENT

GLOBAL MACRO RESEARCH
ASSET ALLOCATION IN FOCUS

THE INFLUENCE OF GROWTH, INFLATION AND REAL INTEREST RATES

AUGUST 2024



BNY | INVESTMENTS

EXECUTIVE SUMMARY

REVISITING OUR ASSET-ALLOCATION FRAMEWORK

- Changes in monetary or financial conditions, and their lagged impact on the rate of growth, are the starting point for our thought process. It then follows that growth dynamics (either periods of excessively strong or unusually weak activity) may have implications for both inflation and/or real interest rates. These interactions are important in understanding economic cycles and these dynamics provide useful insights from an asset-allocation perspective.
- Our growth, inflation and real rate framework allows us to assess how asset class behaviours differ in various states of the world going back over 50 years. The clarity and consistency of our findings suggest that our framework is robust and can provide a solid starting point for making asset-allocation decisions.
- The key drivers of asset-class performance appear stable through time. For equity markets growth is a dominant force, for FX and bonds, real rates matter most. For commodities, inflation is key. The interaction of these forces is also important and can provide signals to the behaviour of a range of alternative investments as well as traditional asset classes.
- Combining growth, inflation and real rates regimes allows us to easily compare prevailing conditions with history and analyse how different asset classes performed over similar periods. Once the prevailing regime is established, our framework can provide important insights into how the regime is likely to evolve, using history as a guide, or whether the unique circumstances of the current environment suggest other periods of history may be more relevant when assessing likely investment performance.

CONTENTS

1 FINANCIAL CONDITIONS THE STARTING POINT FOR OUR ASSET-ALLOCATION FRAMEWORK

The performance of any asset class is driven by a complex set of forces. Some are driven by 'top-down' or macroeconomic influences, and others are shaped by 'bottom-up' or security-specific issues, which collectively drive a market in a specific direction. Other influences can be captured by looking through the lens of factors (sector, style, and many other risk premia). Of course, valuations play a part – especially the price investors (the market) are willing to pay, at any point in time, for the range of attributes that make up an underlying investment. Taken together, this can be a bewildering list of variables to track and analyse. From an asset-allocation standpoint, macroeconomic, or cyclical forces, appear to have a strong influence on returns, and this observation led us to build a simple transparent framework to help us understand how different macro regimes can influence the behaviour of individual asset classes.

FINANCIAL CONDITIONS ARE KEY TO SETTING THE BROADER BACKDROP

The starting point for our analysis stems from a simple economic transmission mechanism that we outline in Figure 1. The idea that monetary or financial conditions lead growth sits at the heart of central bank policy decisions. Historically at least, periods of excessive growth brought with them inflationary pressures and, whilst such pressures have largely been absent in recent years, the post-pandemic inflationary pulse brought that relationship back into sharp focus.

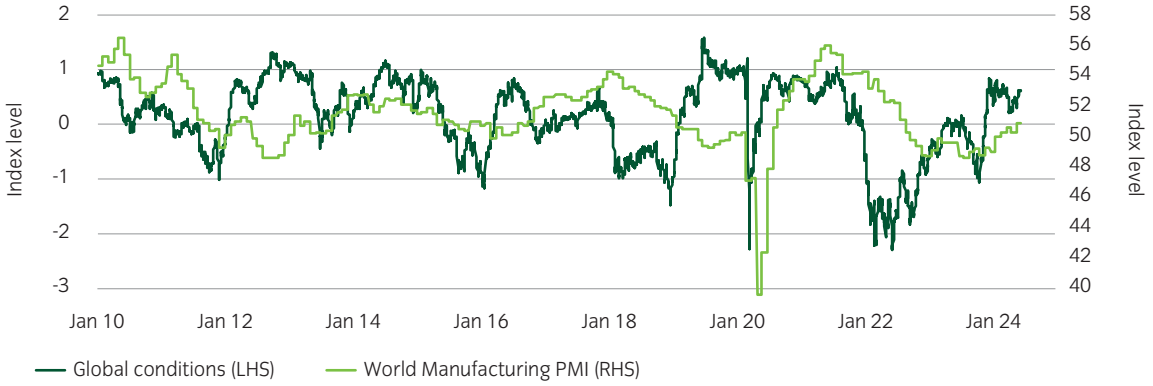
Figure 1: The transmission mechanisms from macroeconomic forces into asset-class behaviours[1]

[1] For illustrative purposes only.

Financial conditions are a way to incorporate a broader range of financial factors

There are many ways to monitor financial conditions in a broader sense. Some of these are 'real-time' indicators factoring a range of variables that are meant to influence the price of funding for the real economy. In our view, they are useful indicators as to whether the overall conditions within an economy are either conducive to, or a headwind for, growth. Our own financial conditions indices are calculated by using interest rates, corporate yields, exchange rates and equity markets across five regions (US, Europe, UK, Japan and Australia), weighted by GDP.

Figure 2: Insight global financial conditions – a good lead indicator of future growth[3]



//

In our view, financial conditions indices are useful indicators as to whether the overall conditions within an economy are either conducive to, or a headwind for, growth.

[2] Source: Insight and Bloomberg. Data to 30 June 2024.

2 ASSET-ALLOCATION FRAMEWORK: GROWTH REGIMES

When assessing growth dynamics, we look at a wide range of indicators, some forward-looking, some co-incident. One of the best sets of timely indicators are the purchasing managers' indices (PMIs) which reflect the health of the manufacturing and service sectors, and we track 38 monthly country and regional releases. The weight that one attaches to different data points is to an extent a matter of judgement. For example, at the time of writing, the gap between services and manufacturing activity is unusually large (due in large part to the unique dynamics of the post-pandemic recovery).

Our historical analysis focuses heavily on manufacturing. Despite its smaller contribution to GDP (manufacturing accounts for only 10% of US GDP) we view it as the most useful from a market perspective. It gives a greater insight into global trade dynamics, is more cyclical and has historically had a closer link with swings in corporate profitability. According to the McKinsey Institute[3] US manufacturing drives 20% of capital investment, 35% of productivity growth, 60% of exports and 70% of business R&D expenditure. Interpreting PMIs is relatively simple, and any data point can be allocated to one of four regimes (see Figure 3).

From a multi-asset perspective, we can use this framework to examine historical asset-price returns and other performance characteristics (for example volatility and drawdowns) across these different regimes since the 1970s. This analysis then serves as a guide to our asset-allocation decisions.

Figure 3: A stylised view of PMI growth regimes[4]

Accelerating PMI > 50 and rising **A**	**Moderating** PMI > 50 but falling **B**
D **Stabilising** PMI < 50 but rising	**C** **Falling** PMI < 50 and falling

A basic guide to purchasing managers' indices (PMIs)

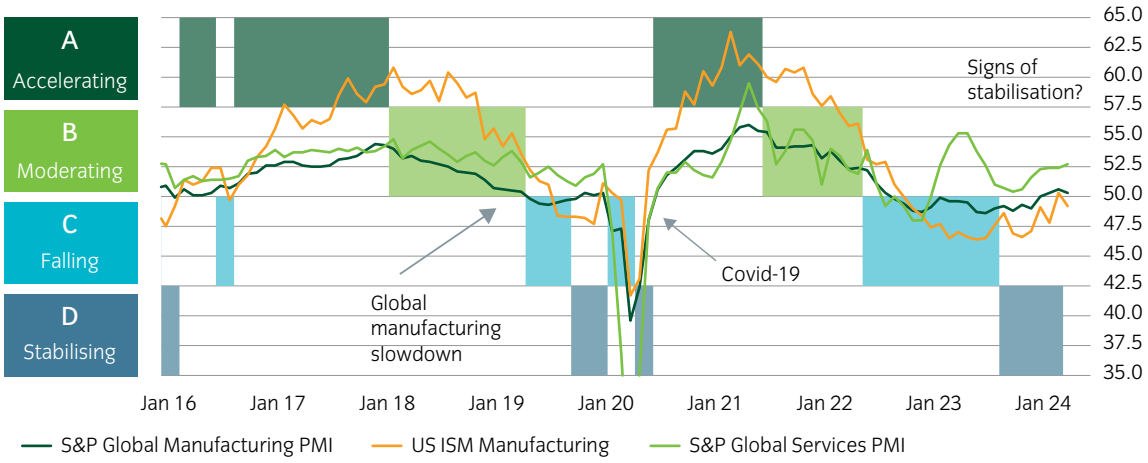
- Each month, a carefully selected group of private sector companies are surveyed on the state of conditions within their industry
- This provides a valuable insight into the underlying trends that companies are experiencing, from the level of new orders to the ease, or difficulty, of finding new employees
- The data is aggregated into an overall score, which can be used to judge the health of the broader economy and whether growth is accelerating or decelerating
- A score above 50 indicates that activity is improving, with a score below 50 indicating contraction

[3] Source: https://www.mckinsey.com/capabilities/operations/our-insights/delivering-the-us-manufacturing-renaissance
[4] For illustrative purposes only.

THE ECONOMIC ENVIRONMENT HAS GENERALLY BEEN POSITIVE SINCE THE GLOBAL FINANCIAL CRISIS

Looking back since the global financial crisis, we have spent more times in 'good' economic environments and less in bad, i.e., we have spent the majority of time in either regime A or B (Accelerating and Moderating), with only short and shallow dips into the sub-50 PMI regimes (C and D) which were often insufficient to tip the US (or other economies) into recession (see Figure 4).

Figure 4: Growth environments since the global financial crisis[5]



On a cross-country basis, few other countries have seen such an impressive cycle as the US. The US economy has spent around 85% of this period in regimes A and B and only 15% in regimes C and D. This performance stands out amongst the 38 countries we follow, which have on average spent 70% in regimes A and B.

Looking at the very long term, the traditional causes of recession (industrial downturns or oil shocks) and policy errors (where interest rates are excessively tightened to cap rising inflation) have largely been absent in recent decades. Instead, recession risk has come via financial transmission mechanisms; for example, inflated stock prices in the late 1990s or the real-estate bubbles which triggered the sub-prime mortgage crisis and ultimately led to the global financial crisis. In 2020, recession came in the form of an exogenous shock – the pandemic. That said, the post-pandemic policy response has arguably put us back into an economic policy-led cycle that we have not seen for multiple decades. By aggressively easing monetary (as well as fiscal) policy into a lock-down, monetary policy has contributed to the burst in demand and the inflationary pulse (clearly, exacerbated by Russia's invasion of Ukraine) which policymakers are now trying to get back under control with the fastest hiking cycle in almost a generation.

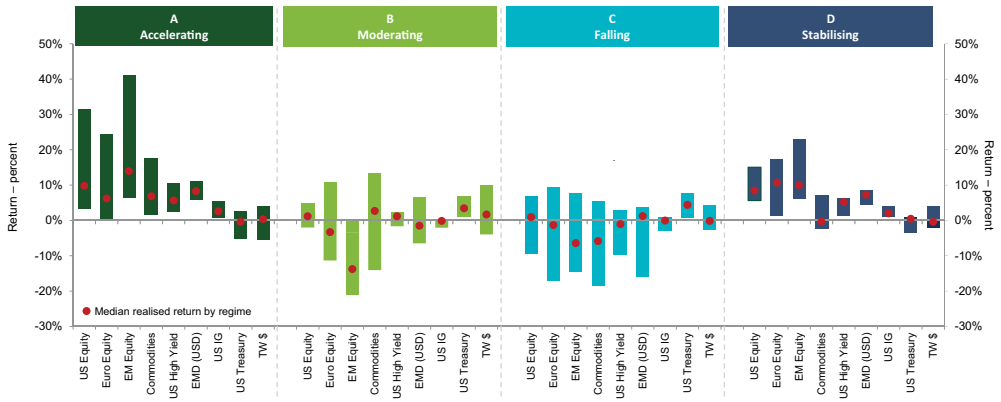
We believe that our growth framework is an effective indicator to assess a wide variety of shocks because, whatever their initial cause, they need to be big enough to have real economic consequences if they are to have significant medium-term asset-allocation implications.

GROWTH IS KEY FOR ASSET PRICES, ESPECIALLY EQUITIES

When we analyse historical data, the sweet spot for risk assets tends to be an Accelerating growth regime (A), when growth is strong and getting stronger. During these times, the correct asset-allocation strategy has been to skew towards pro-cyclical exposures such as equities and away from government bonds which have historically been one of the worst-performing assets when activity is accelerating (see Figure 5). As growth loses momentum and we enter a Moderating growth regime (B), it becomes a more challenging equity environment and the most cyclical assets such as emerging market equities tend to perform poorly. The Falling growth regime (C) is the only one in which average equity market returns have historically been negative but is one in which government bonds tend to perform well. This environment has also been especially poor for commodity prices.

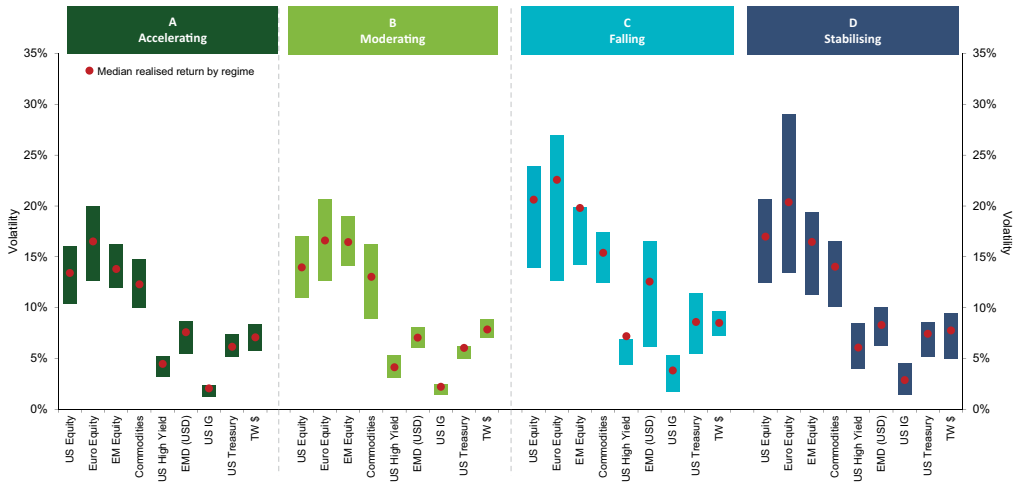
[5] Source: Insight and Bloomberg as at 30 June 2024.

Figure 5: Risk assets perform well when growth is strong and getting stronger[6]



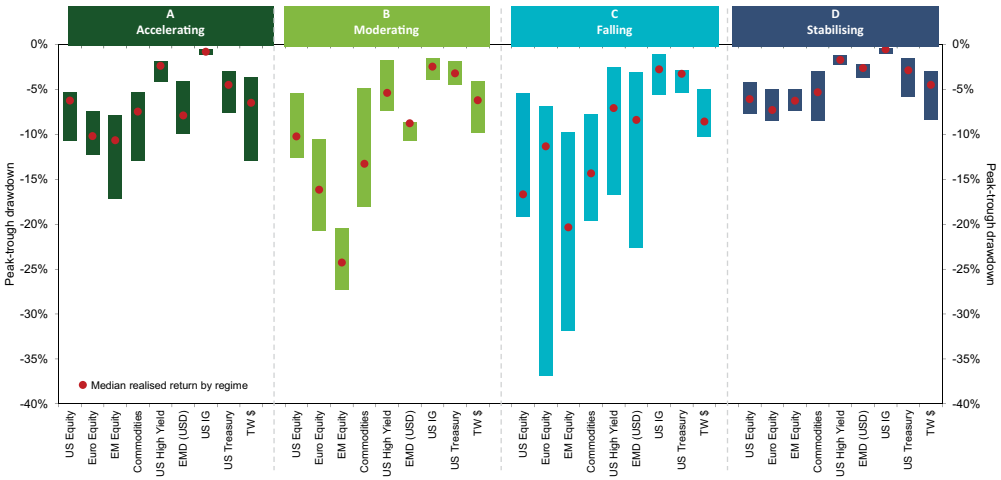
In Moderating growth regimes (B) risk assets have generally experienced slightly higher volatility and a greater chance of meaningful drawdowns than in Accelerating growth regimes (A) – see Figure 6, regimes A and B. However, volatility tends to be much higher when PMIs are sub-50 (regimes C and D).

Figure 6: Volatility increased notably when PMIs are sub-50 (regimes C and D)[7]



Historically, drawdown risks are greatest in a Falling growth regime (C), an environment where the economy and likely earnings are contracting (see Figure 7). For areas that are more leveraged into global growth such as emerging markets, they are also notable in a Moderating growth regime (B).

Figure 7: The Falling growth regime (C) has by far the most extreme peak-to-trough drawdowns historically[8]



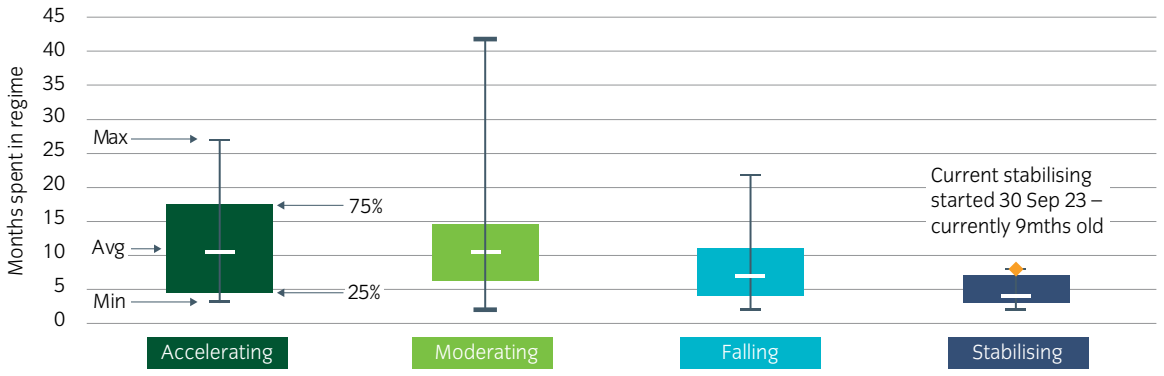
[6, 7, 8] Source: Insight and Bloomberg as at 30 June 2024. Note: Bars show the range of asset returns from 25th to 75th Quartile. Equity and commodity market data is from 1973. Treasury and corporate bond data from 1973. High-yield bond data is from 1986. EM USD and local debt data is from 1993. Trade weighted USD data is from 1973.

ASSESSING CYCLE LONGEVITY

When we analyse the persistence of growth regimes over the longer term, some interesting observations can be made. The regime with the greatest average longevity is regime A, where PMIs are above 50 and growth is accelerating. Once growth starts to moderate, regime B, there is generally a prolonged period where PMIs remain above 50 and, as our analysis has shown, this is not an unattractive environment for some risk assets, although not as attractive as regime A.

By comparison, the length of time typically spent in the sub-50 PMI regimes (C and D) is relatively short. Regime C, where PMIs are below 50 but growth is still falling, is the only regime in which average equity markets returns have historically been negative, and the historical range of drawdowns has been more extreme in regime C than in other regimes. This analysis can provide important context as we assess how regimes are evolving and how best to adapt our asset-allocation decisions in anticipation of a shift to a new regime.

Figure 8: The most persistent regimes are those where PMIs are above 50[9]

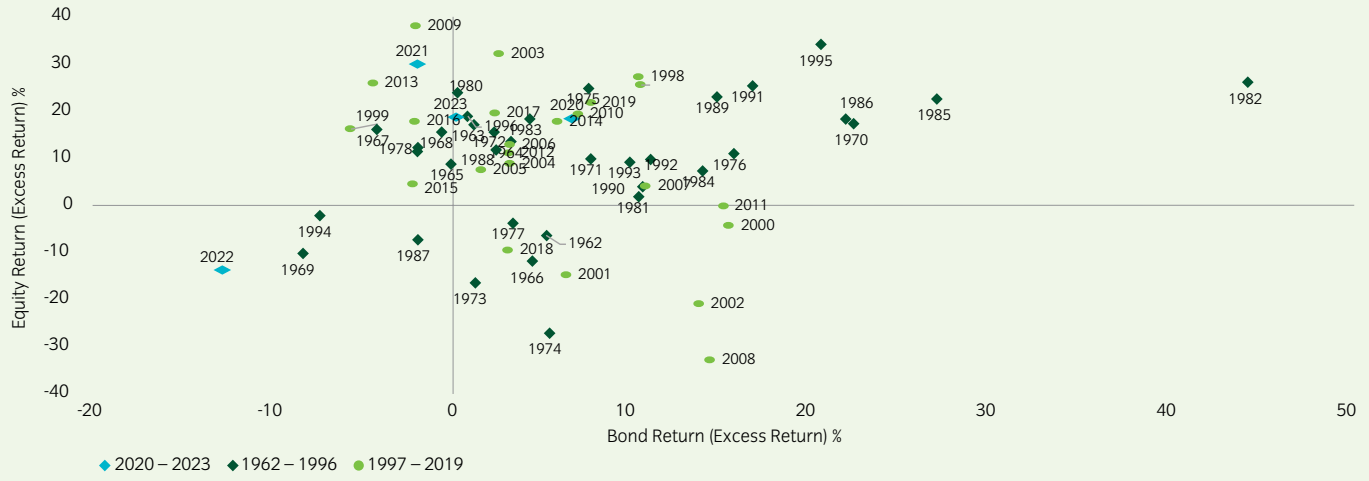


[9] Source: Insight, Bloomberg. Data between December 1976 and June 2024.

CASE STUDY: EQUITY/BOND DIVERSIFICATION

Generally, having some mixture of equities and fixed income makes sense in a growth portfolio but the diversification benefits of doing so are not always as clear as generally assumed. 2022 brought this into sharp focus (as both asset classes performed particularly poorly at the same time), but as Figure 9 shows, equities and bond returns moving in the same direction happens more often than not. The chart shows calendar-year returns split into four quadrants, highlighting when both equity and bond returns have either positive or negative. Over the 62 years covered, equities and bonds posted returns in the opposite direction (equities up/bonds down or equities down/bonds up) only 35% of the time. Of course, holding any two assets, providing they don't have a correlation of one, is diversifying to a point but often there is an assumption that bonds will bail an investor out in periods where equities decline.

Figure 9: Equity and bond return matrix 1962 – 2023[10]



The best period for both equities and bonds came in the 1980s at the beginning of what has been termed the 'great moderation'. From this period – arguably up until the global financial crisis in 2007 – we saw reduced business-cycle volatility attributed in large part to the success of central banks in taming inflation. This gave policymakers the flexibility to respond to growth shocks with stimulative policy, to micro-manage or extend the business cycle. Stocks benefited both from long periods of growth (earnings) and from a falling discount rate as interest rates declined, creating a boom period for equity and bond investors alike.

Figure 10: Equity and bond returns spilt by quartile – 1980s[11]

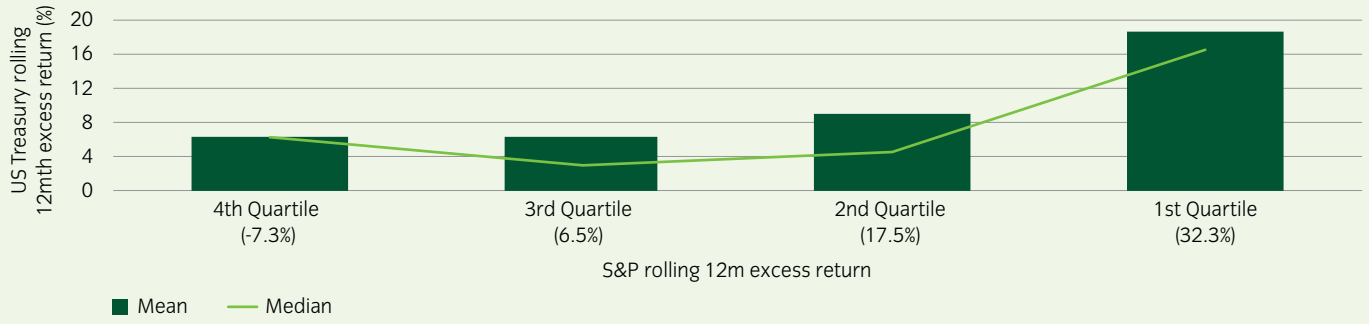


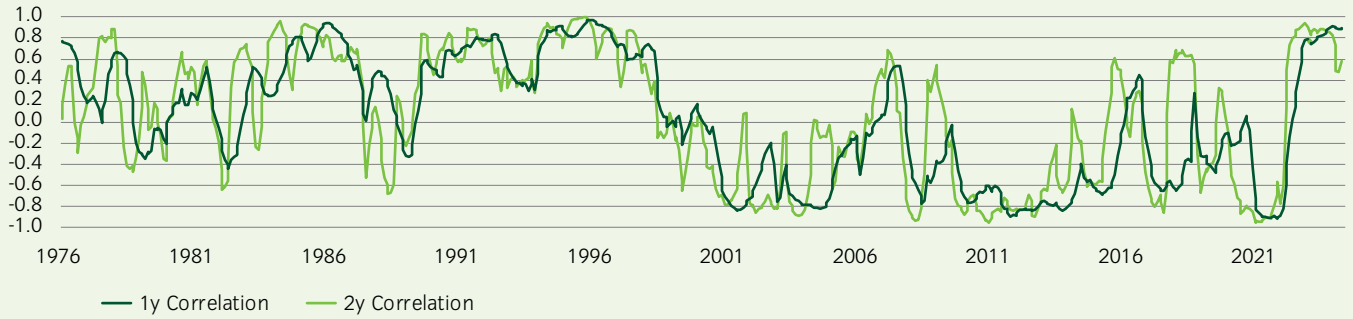
Figure 10 shows bond returns split by quartile and set against the corresponding quartile of equity market returns during the 1980s. Average annualised returns over the decade were in double digits for each asset class (17% for the S&P 500 Index and 12% for the Bloomberg US Treasury Index) but what the chart highlights is that the best bond returns were in the environments where equity returns were also delivering their best (1st quartile) returns. These were good times to be investing.

From a shorter-term perspective, the way in which equities and bonds interact is also critical from an asset-allocation perspective. The correlation between the two is key in assessing the diversification benefits bonds have when paired with risker, higher return, investments. Figure 11 illustrates how this correlation has changed since 1975.

[10] Source: Insight and Bloomberg as at 30 June 2024. Equities: S&P 500 Index. Bonds: Bloomberg US Treasury Index. Calendar-year returns.

[11] Source: Insight and Bloomberg as at 30 June 2024. S&P 500 Index and Bloomberg US Treasury Index.

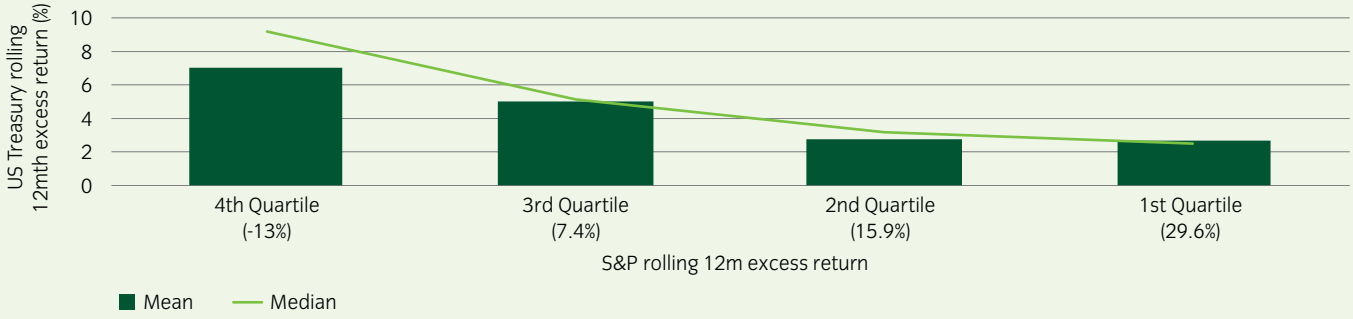
Figure 11: The equity/bond correlation flipped in 1996[12]



Since the late 1990s a negative correlation between equities and bonds has largely held following a period of positive correlation in the 1970s and 1980s (we mentioned earlier that both assets enjoyed positive returns in the 1980s). The reasons are well documented. In a low-inflation world, negative growth shocks put downward pressure on equities, due to lower earnings expectations. If these moves were sufficient in size, they would spur expectations of monetary easing to offset the impending hit to growth. This interaction meant that when equities went down bonds served the role of a hedge within a growth-orientated investment portfolio.

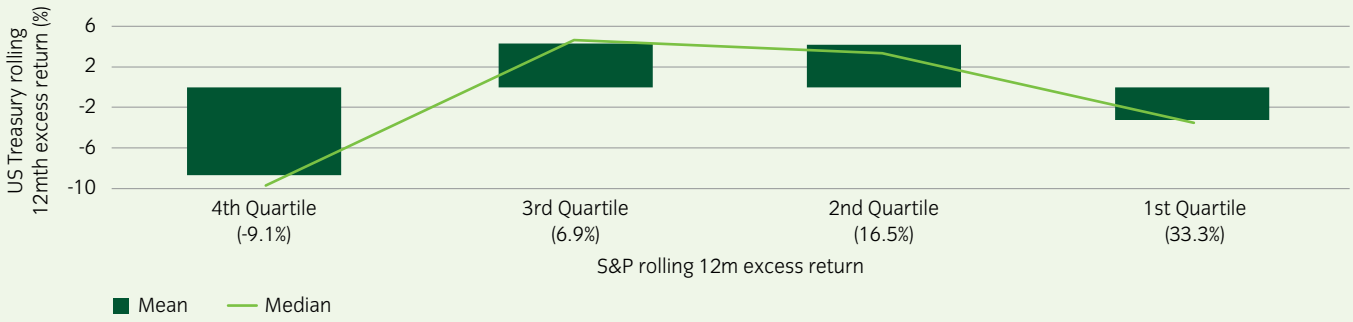
Figure 12 looks at the returns from government bonds broken down by the corresponding performance of the equity market in the periods when the equity/bond correlation was clearly negative (1997 to 2023); over the period, both assets did well (annualised returns of +10% and +2% excess for stocks and bonds respectively). But as the chart shows, by far the best returns for bonds were when they were needed most – when equities were performing worst.

Figure 12: Equity and bond return quartiles (1996 – 2023)[13]



More recently, since around the second half of 2021, this relationship has broken down. High and volatile inflation has dictated the path of monetary policy so, irrespective of the growth environment, bonds have struggled. This has been an environment where expectations for monetary tightening have trended upwards and where high inflation has depressed the value of outstanding debt in nominal terms. Of course, for equity markets, the rising cost of capital and impending impact on growth and earnings has been a negative for returns. Given this, Figure 13 is not a surprise, and it shows the extent to which the worst bond and equity returns occurred at the same time. Indeed, these forces combined to make 2022 the worst on record for a balanced equity/bond portfolio. Whilst it was an extreme case, we have already illustrated that for many periods in decades before the late 1990s, the relationship between equities and bonds was also far less helpful from a diversification standpoint.

Figure 13: Equity & bond return quartiles (2020-2023)[14]



[12, 13, 14] Source: Insight and Bloomberg as at 30 June 2024. Equities: S&P 500 Index. Bonds: Bloomberg US Treasury Index.

3 ASSET-ALLOCATION FRAMEWORK: INFLATION AND REAL RATES REGIMES

Once we have established the growth regime, the next step is to establish the inflation and real rates regimes. The logic goes that growth dynamics (either periods of excessively strong or unusually weak activity) may have implications for both inflation and/or real interest rates. In turn, these dynamics provide useful insights from an asset-allocation perspective.

We consider both current and expected future inflation using consumer price indices and breakeven inflation rates. Our analysis on the relationship between inflation and asset-class price behaviour shows that, much like in our growth framework, both the level and rate of change matter. For example, an environment in which inflation is rising but below central bank targets has historically been very good for equities. However, when inflation is rising, but above central bank targets, this has historically been a bad environment for equities, given the implications for corrective monetary policy to cool inflation down.

For real interest rates, our analysis shows that what really matters is whether they are rising or falling. The level of real interest rates tends to trend over long periods of time and hence the absolute level is less important than the direction of travel. Real yields indicate how cheap or expensive it is for companies to borrow, invest and ultimately grow, and can also be a key indicator of margin pressure as real cost rises may be more difficult to pass onto customers.

Figure 14: A stylised view of inflation/real rates regimes[15]

Inflation and real rate regime		
Inflation rising: above CB target E	Inflation falling: above CB target F	Real rates rising I
H Inflation rising: below CB target	G Inflation falling: below CB target	J Real rates falling

A basic guide to inflation and real rates

- For the current inflation rate we use a country's CPI index. This measures the rate of change in prices for a basket of goods and services that are typically purchased by households.
- For the expected future rate of inflation, we use a country's breakeven inflation rate. This is the rate of inflation at which a country's nominal government bonds would generate the same return as inflation-linked government bonds. This gives us the level of future inflation that markets are currently pricing in.
- Real interest rates are the nominal level of yields adjusted for expected inflation. For the US this is the yield derived from Treasury Inflation-Protected Securities (TIPS) bonds. This gives the real cost of financing for a borrower.

REGIMES WHERE INFLATION IS SLOWING ARE GENERALLY GOOD FOR EQUITIES AND BONDS

When we analyse the historical data, one finding that seems relatively clear is that the best regimes for equities and government bonds are generally those where the pace of inflation is decelerating, regardless of whether inflation is above or below central bank targets (regimes F and G). If real rates are falling as well, this has tended to be especially beneficial for US equity markets.

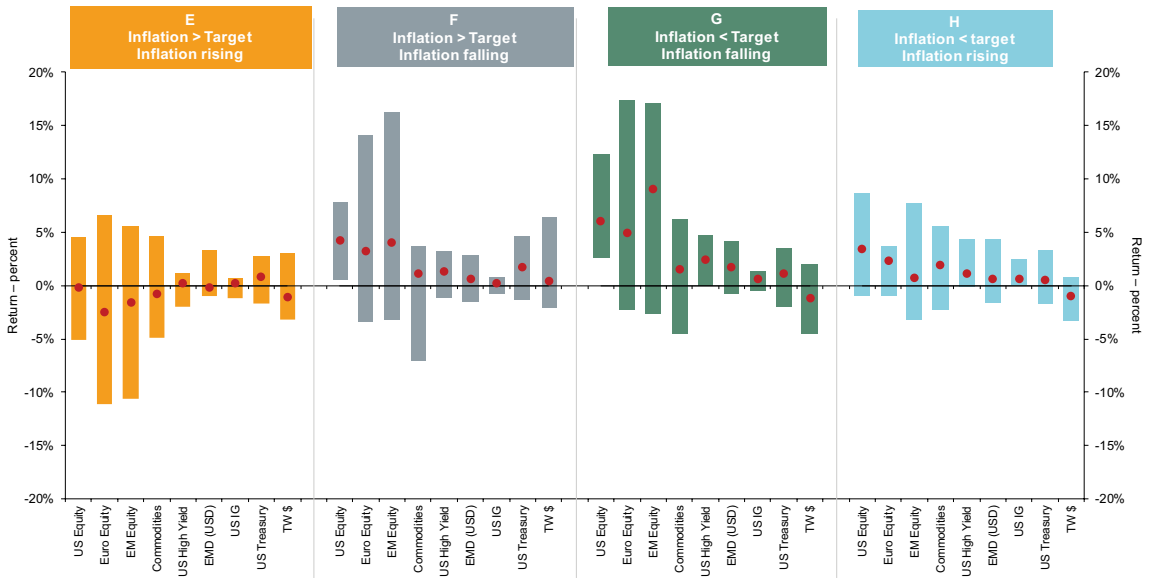
[15] For illustrative purposes only.

Broadly speaking, it is also clear that assets generally perform positively when inflation is below central bank targets, regardless of whether inflation is rising or falling (regimes G and H). The exception to this is the US dollar, which performs poorly in those regimes, but here real rates are key, as the dollar has historically performed far better during environments where real rates are rising than falling.

For commodities, a reflationary regime is optimal, where inflation is rising but still below central bank targets (regime H).

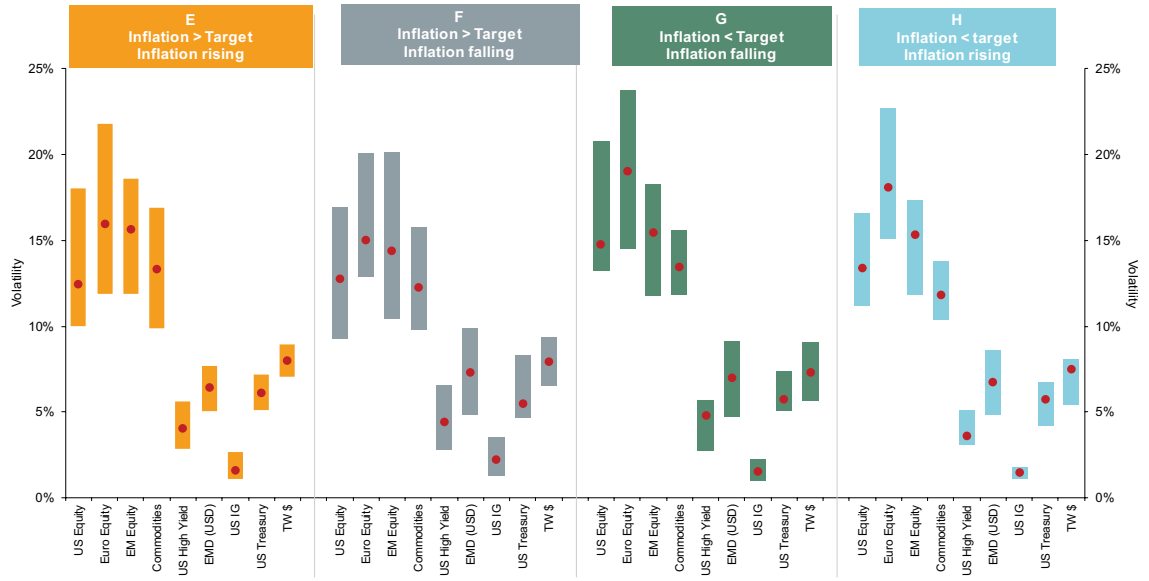
By far the worst regime for broad asset returns is E, where inflation is above target and rising, and this is an environment in which, perhaps unsurprisingly, most assets struggle, including commodities.

Figure 15: Returns across historical inflation regimes[16]



Surprisingly, divergences in volatility are more nuanced across inflation regimes, but volatility tends to be slightly lower during periods when inflation is converging with central bank targets in either direction (regimes F and H). In these periods, central banks will generally be returning to a more neutral policy position. For investment grade credit, reflationary environments (regime H) where inflation is below target but rising, have historically been periods where volatility is particularly subdued.

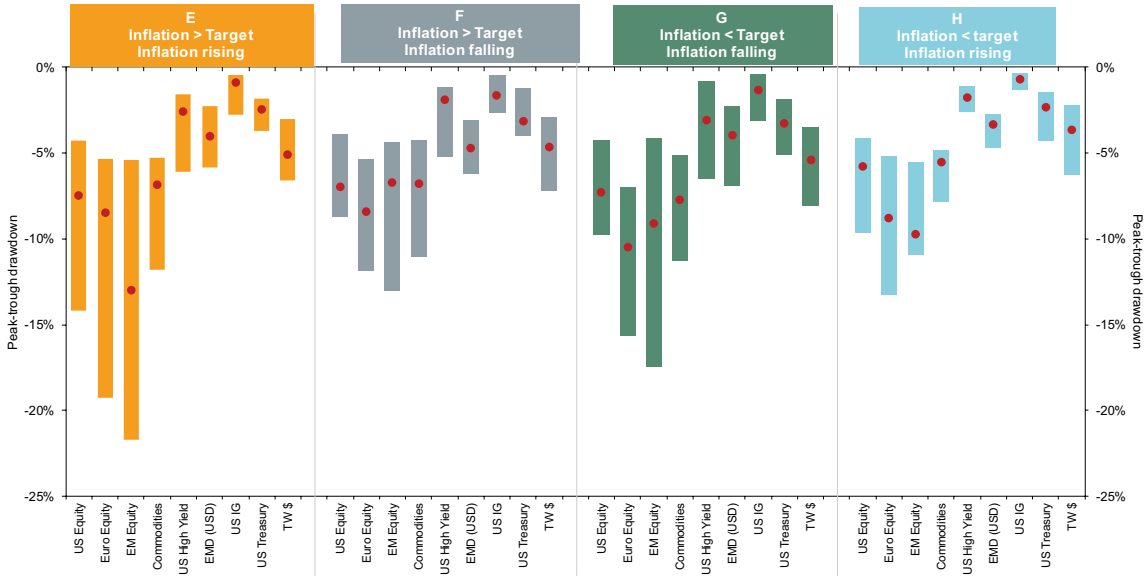
Figure 16: Volatility across historical inflation regimes[17]



[16, 17] Source: Insight, Bloomberg. Data between December 1976 and June 2024.

Perhaps unsurprisingly, for more cyclical assets such as emerging markets, drawdowns have been significantly worse when inflation is above central bank targets but still rising (regime E). This makes sense as it implies an environment where major central banks are likely to react most aggressively to bring inflation back under control, and investors are likely to be returning to core markets in that scenario.

Figure 17: Drawdowns across historical inflation regimes[18]



//

By far the worst regime for broad asset returns is E, where inflation is above target and rising, and this is an environment in which, perhaps unsurprisingly, most assets struggle, including commodities.

[18] Source: Insight, Bloomberg. Data between December 1976 and June 2024.

CASE STUDY: COMMODITIES AS A DIVERSIFIER

Commodities are an asset class with unique characteristics which make them an important building block in multi-asset portfolios. They have two specific attributes:

- Cyclicality: as the inputs to manufacturing, commodities have an natural link to the growth cycle. Energy, agriculture, and particularly industrial metals see increased demand as economies increase their output.
- Inflation protection: history shows that commodities can yield their best returns when inflation is high and rising. While this relationship isn't perfect, it is often when bonds and equities go down in unison and so they can act as a good inflation hedge.

AN ASSET CLASS WITH UNIQUE ATTRIBUTES

Figure 18 illustrates this by showing the correlation of the broad commodity index with inflation and manufacturing activity. The chart also shows that they also exhibit low correlations to the other asset classes that form the building blocks of a multi-asset portfolio. Over the last 96 years the correlation between commodities and equity is only +0.2 while the correlation to government bonds is -0.2. Given this, commodities can be a useful diversifying building block in portfolios. At a static level, the addition of commodities to an equity/bond portfolio can improve real and excess returns, as well as overall risk-adjusted return and average drawdown.

Figure 18: Correlation of commodities to macroeconomic indices and asset returns, 1929 – today[19]

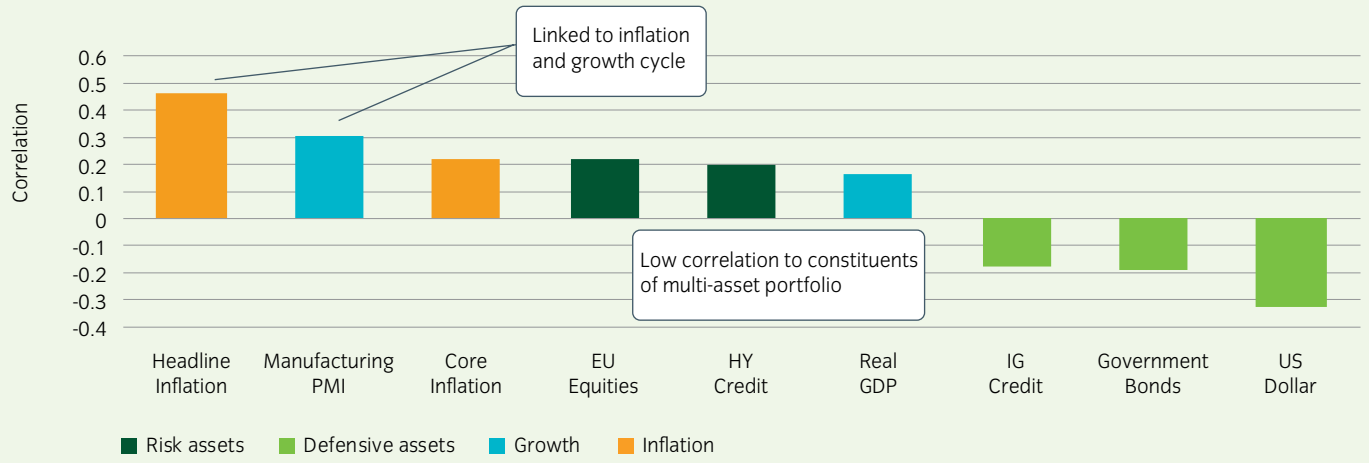


Figure 19 shows the risk and return characteristics of equities, bonds, and commodities against a static 60/40 portfolio and then a portfolio which includes commodities. As we can see, the addition of commodities to a 60/40 portfolio improves both the total and risk-adjusted return of a traditional 60/40 portfolio. The table however also reminds us that commodities, like equity markets, can experience meaningful drawdowns. So, while a static exposure to commodities can be additive to portfolios, potentially large drawdowns can wipe out years of positive gains. To us this argues that commodity exposure needs to be managed dynamically via strategies that aim to capture as much upside as possible while limiting downside in the event of a cycle downturn. The risk-adjusted return of such an approach can be significantly improved, mainly due to the halving in the average and maximum drawdown experience.

Figure 19: Return characteristics of static portfolios, 1929 – today[20]

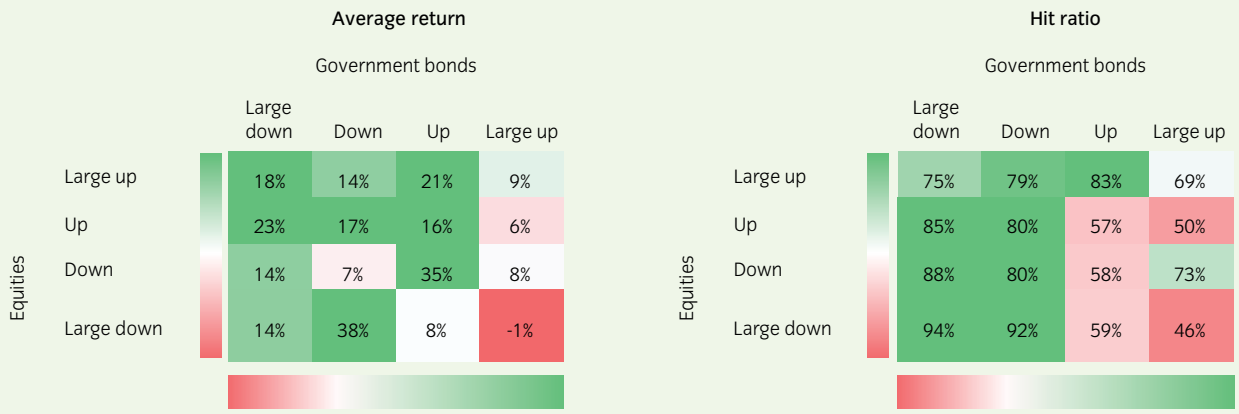
	Equity	Bonds	Commodities	60/40	80% 60/40 20% commodities
Total return	9.4%	4.9%	8.7%	8.1%	8.5%
Real return	6.0%	1.7%	5.3%	4.7%	5.1%
Excess ratio	5.4%	1.1%	4.7%	4.1%	4.5%
Sharpe ratio	**0.29**	**0.18**	**0.28**	**0.35**	**0.42**
Avg drawdown	-15%	-2%	-17%	-6%	-6%
Max drawdown	-86%	-23%	-77%	-66%	-67%
% time spent >10% below high	37%	3%	50%	20%	17%

[19, 20] Source: Insight and Bloomberg as at 30 June 2024.

A FRIEND WHEN YOU NEED ONE MOST

Importantly, commodities have historically provided a good source of positive returns when we need them most – which is when other mainstream assets (equities and bonds) are both selling off. We illustrate this in Figure 20 which shows annual US equity returns on the vertical axis compartmentalised into four sections (large up, up, down, large down) while the same is done for US Treasury returns on the horizonal axis. The corresponding commodities return is shown in the matrix. The cyclical nature of commodities can be seen in that they tend to perform well when equities are also doing well. However, in years where both equities and bonds are performing badly commodity returns really stand out. In simultaneous large down years commodities have an average return of 14% with a positive hit rate (percentage of years where returns are positive) of 94%.

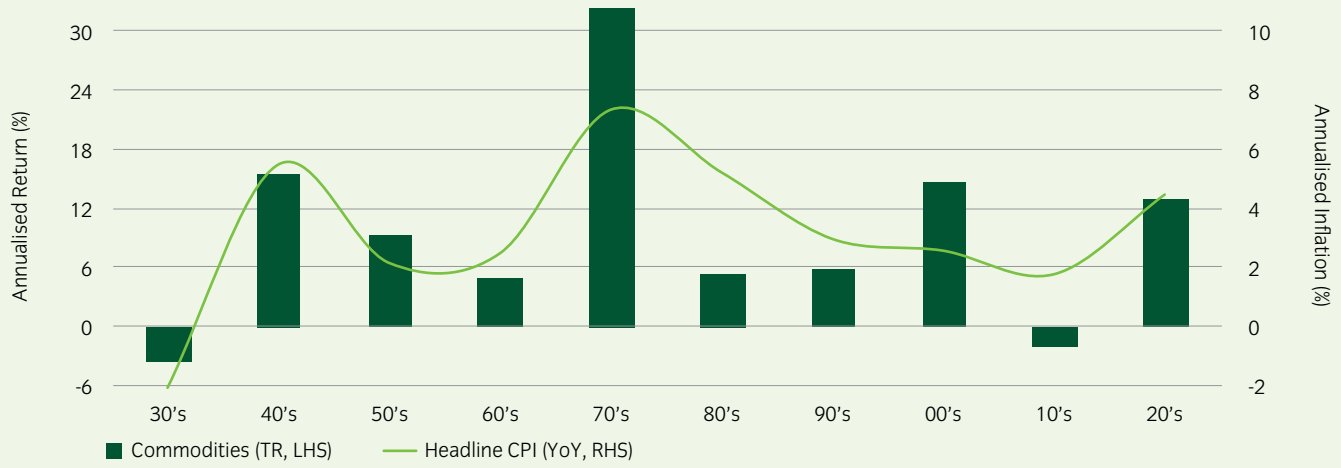
Figure 20: Commodity returns stratified by annual equity and bond returns, 1929 – today[21]



A NATURAL INFLATION HEDGE

The 2020s have so far provided a stark reminder to investors of the significant impact inflation can have on economies, markets, and the value of their portfolios. This decade has already seen an average annualised inflation rate of 5% in the US, versus 1.7% in the 2010s and 2.5% in the 2000s[22]. We know that high inflation is a challenge to both bond and equity markets, but high-inflation environments have historically been associated with positive commodity returns. Indeed, the largest returns from commodities coincide with periods of high inflation (see Figure 21 below). This is of course logical in that some of the underlying components such as energy and agriculture are direct inputs into goods and services costs and hence feed through into inflation.

Figure 21: Commodities versus inflation by decade[23]

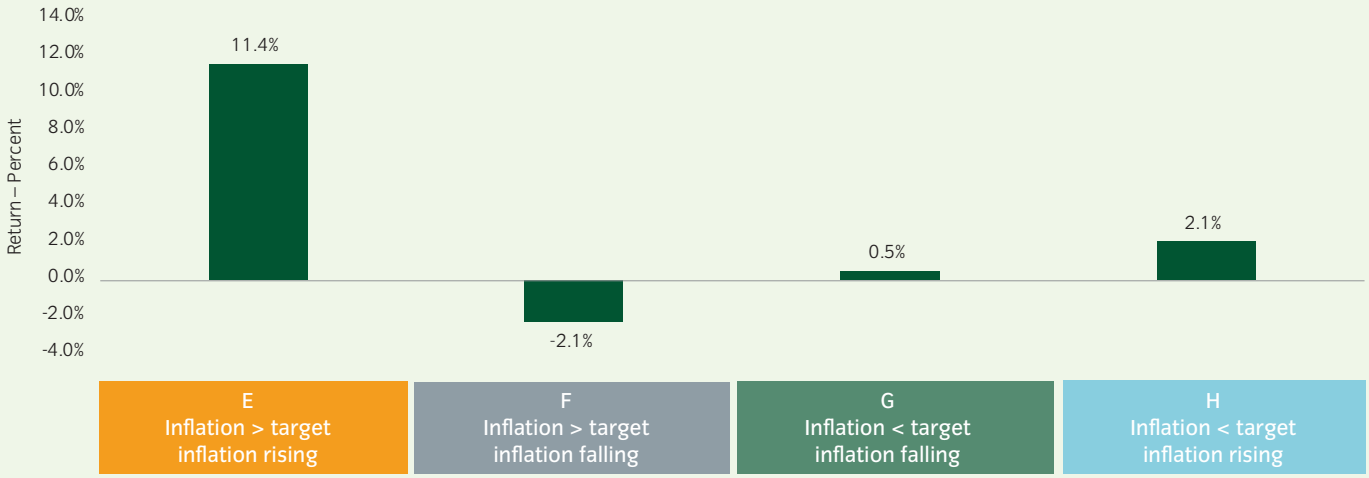


[21] Source: Insight and Bloomberg as at 30 June 2024.
[22] Source: Bloomberg - US CPI to end May 2024.
[23] Source: Insight and Bloomberg as at 30 June 2024.

REGIMES IN FOCUS

This longer-term perspective is useful but how do commodities fit into our regime framework? Both from a growth and inflation perspective commodities behave as you might expect. As we can see in Figure 22, we see positive returns when inflation is rising (either below or above target) but the largest potential returns come when inflation is both above target and rising (such as we saw in 2021/2022).

Figure 22: Mean commodity return by Insight inflation regime, 1972 – today[24]



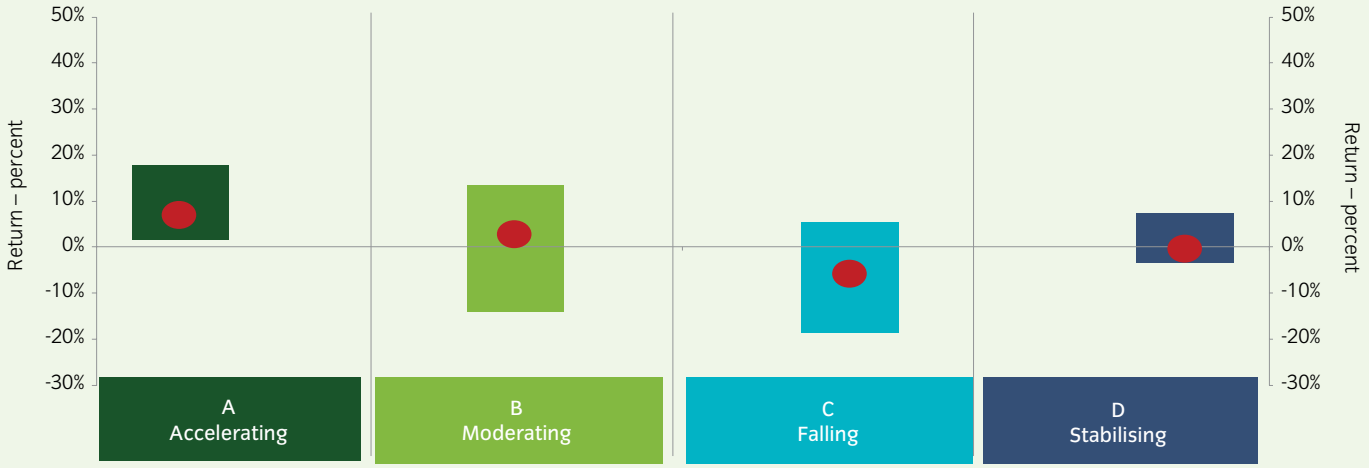
Similarly, commodities exhibit a strong relationship to the growth cycle. As growth increases, demand in the economy for energy, agriculture, and particularly industrial metals, increases. Conversely, commodity returns are particularly sensitive to recessions (see Figure 23), which typically occur as the cycle moves from moderating to falling.

Figure 23: Commodity return by recession, 1929 – today[25]

	Non-recession	Recession
Average annualised return	13%	-3%

Indeed, what we find when we look through the lens of our regime framework (Figure 24) is that the most consistent returns occur in the Accelerating phase, while the outsized returns in Moderating are usually associated with late-cycle high inflation.

Figure 24: Commodity return by Insight growth regime, 1972 – today[26]

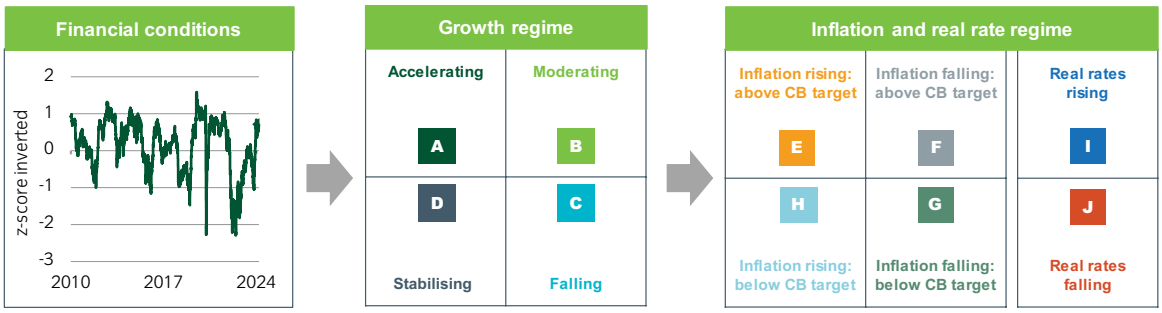


[24] Source: Insight, Bloomberg. Data between December 1976 and June 2024.
[25] Source: Insight, Bloomberg. Data between 1929 and June 2024.
[26] Source: Insight, Bloomberg. Data between December 1976 and June 2024.

4 ASSET-ALLOCATION FRAMEWORK: BRINGING EVERYTHING TOGETHER

Viewed within the context of broader financial conditions, the combined growth, inflation and real rates regimes allow us to categorise the prevailing investment environment, and to view the outlook for asset price performance within a historical context. Once the current environment is established, we are able to utilise both our macro-economic models, and our fundamental understanding of the particular forces at play at the time, to understand how a given environment is most likely to evolve going forward. We can then compare our most likely scenarios to the historical patterns, or regime sequences, that we have witnessed in the past. This allows us to use our rich data set to provide insights into how we believe different asset classes should be expected to perform, allowing us to adapt our asset allocation to best take advantage of the prevailing and likely future environments.

Figure 25: A clear framework for our assessment of the macro environment[27]



SINGLE ASSET CLASS EXAMPLE OF A COMBINED REGIME FRAMEWORK

Let us illustrate how this framework looks when assessing the prospect for a single asset class – (US) equity. At the time of writing, we have spent the majority of the year so far in an environment best described as:

- Stabilising growth (D)
- Inflation is coming down (albeit bumpily) – but remains above central bank targets (F)
- Real rates have been edging lower with some volatility (J)

In Figure 26, we rank the performance of US equity in the various combinations of these regimes. The first three columns show different combinations of growth, inflation and real interest rates. We then show the average excess return, Sharpe ratio, drawdown and 'hit rate' (percentage of time we recorded a positive return) for each. To the right, these regimes are ranked according to their combined behaviours. What this ranking shows clearly is the historical dominance of the growth factor for US equities. The best environments for equity performance have been when growth is stabilising or accelerating while the worst environments have been when growth is moderating or falling. Similar return profiles can be built for a broad range of asset classes. It is notable that DFJ is an environment that has historically been one in which equity markets have performed particularly well.

[27] For illustrative purposes only.

Figure 26: Equity market regime ranking[28]

Growth Regime	Inflation Regime	Real Rate Regime	Combined Regime	Excess Return	Sharpe	Drawdown (3rd quartile)	Hit Ratio	Return Ranking 40%	Sharpe Ranking 20%	Drawdown (3rd quartile) Ranking 20%	Hit Ratio Ranking 20%	Weighted Ranking	Time Spent In Regime	Regime count
Stabilising	Inflation > Target & Falling	Real Rates Falling	DFJ	6.9%	2.6	-6%	83%	2	2	6	4	3.20	2%	6.0
Accelerating	Inflation > Target & Falling	Real Rates Falling	AFJ	4.1%	3.1	-2%	83%	8	1	1	4	4.40	2%	6.0
Accelerating	Inflation < Target & Falling	Real Rates Rising	AGI	6.3%	2.0	-6%	78%	4	3	3	9	4.60	4%	9.0
Stabilising	Inflation > Target & Falling	Real Rates Rising	DFI	5.7%	1.8	-6%	86%	6	4	4	3	4.60	3%	7.0
Stabilising	Inflation < Target & Falling	Real Rates Falling	DGJ	9.6%	1.5	-12%	100%	1	6	19	1	5.60	2%	4.0
Accelerating	Inflation < Target & Falling	Real Rates Falling	AGJ	5.8%	1.0	-8%	100%	5	10	15	1	7.20	4%	6.0
Accelerating	Inflation < Target & Rising	Real Rates Rising	AHI	4.0%	1.6	-4%	69%	9	5	2	12	7.40	5%	13.0
Accelerating	Inflation < Target & Rising	Real Rates Falling	AHJ	6.3%	1.2	-9%	67%	3	8	16	13	8.60	4%	6.0
Moderating	Inflation > Target & Falling	Real Rates Falling	BFJ	3.8%	1.3	-6%	80%	10	7	8	8	8.60	4%	10.0
Falling	Inflation < Target & Falling	Real Rates Falling	CGJ	4.1%	0.8	-10%	83%	7	12	17	4	9.40	2%	6.0
Accelerating	Inflation > Target & Rising	Real Rates Rising	AEI	2.9%	1.0	-7%	82%	11	11	13	7	10.60	5%	11.0
Accelerating	Inflation > Target & Falling	Real Rates Rising	AFI	2.7%	1.0	-6%	62%	13	9	7	16	11.60	6%	13.0
Falling	Inflation > Target & Falling	Real Rates Falling	CFJ	2.8%	0.7	-8%	75%	12	13	14	10	12.20	5%	12.0
Moderating	Inflation < Target & Falling	Real Rates Falling	BGJ	2.2%	0.7	-6%	56%	14	14	5	18	13.00	4%	9.0
Accelerating	Inflation > Target & Rising	Real Rates Falling	AEJ	0.0%	0.0	-6%	75%	16	16	9	10	13.40	4%	8.0
Moderating	Inflation < Target & Falling	Real Rates Rising	BGI	1.1%	0.4	-7%	67%	15	15	10	13	13.60	2%	6.0
Moderating	Inflation > Target & Falling	Real Rates Rising	BFI	-0.3%	-0.1	-7%	67%	17	17	11	13	15.00	4%	9.0
Moderating	Inflation > Target & Rising	Real Rates Rising	BEI	-1.5%	-0.4	-7%	62%	20	20	12	16	17.60	6%	13.0
Moderating	Inflation > Target & Rising	Real Rates Falling	BEJ	-0.9%	-0.1	-11%	53%	19	18	18	19	18.60	11%	15.0
Falling	Inflation > Target & Rising	Real Rates Falling	CEJ	-0.8%	-0.2	-14%	53%	18	19	21	19	19.00	6%	15.0
Falling	Inflation < Target & Rising	Real Rates Falling	CHJ	-4.3%	-0.9	-18%	33%	21	21	23	21	21.40	3%	6.0
Falling	Inflation > Target & Rising	Real Rates Rising	CEI	-4.9%	-1.4	-13%	0%	22	23	20	23	22.00	2%	6.0
Falling	Inflation > Target & Falling	Real Rates Rising	CFI	-6.1%	-1.3	-14%	11%	23	22	22	22	22.40	4%	9.0

Potential future regimes:

1. (AFJ) – Growth is accelerating, inflation is above target, but falling and real rates are falling appears the most likely next regime

Historically, we would expect a move from a Stabilising growth regime into an Accelerating one – absent an exogenous shock. But this cycle is unique and the length of time we have spent in a recovery phase is already above average. Too tight policy for too long could trip economies into a deeper downturn but it is that very balance of risks that is guiding central banks to ease policy should inflation trends allow. The easing of central bank policy should be sufficient to reignite economic growth and, although we saw an uptick in real rates in April which spooked markets for a period, more recently the path of real rates has been benign. This type of environment has historically been one in which US equity markets have made solid gains.

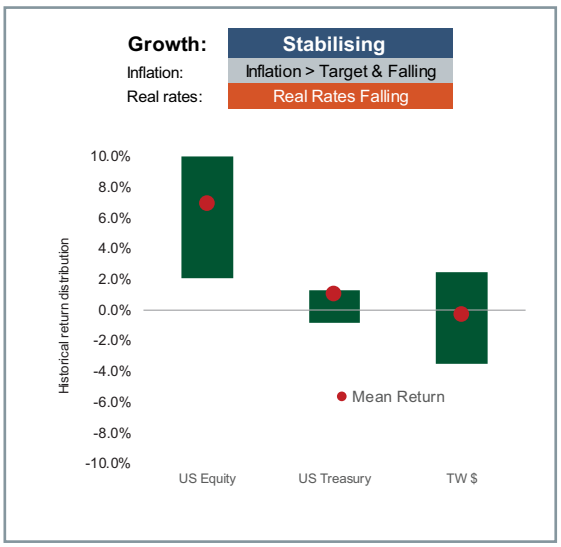
2. (CFJ) – Growth is falling, inflation is above target, but falling and real rates are falling is a possible scenario

Our data set goes back to the 1970s and we have 29 observations of a Stabilising (D) growth environment. In 69% of those cases, the economic journey moved from Stabilising to Accelerating (A), which would be consistent with an upswing or the start of a new cycle. Around 31% of the time we have seen growth dynamics regress from Stabilising back into Falling (C) growth periods. Some of these 'false dawns' were in the early 1980s when inflation was uncomfortably high and the parallels with today suggest that the likelihood of such a reversal is far higher than the odds inferred by history. Although this environment has not historically been as beneficial for equity markets as DFJ or AFJ, it is still one in which equities have generally continued to trend upwards.

[28] Source: Insight, Bloomberg. Data between December 1976 and June 2023.

Figure 27: Regime pathway – two very different risk scenarios remain possible[29]

We have spent most of the recent year in a 'stabilising' growth regime with 'falling' inflation, historically a very positive backdrop for equity returns



But where we might get to is more nuanced….

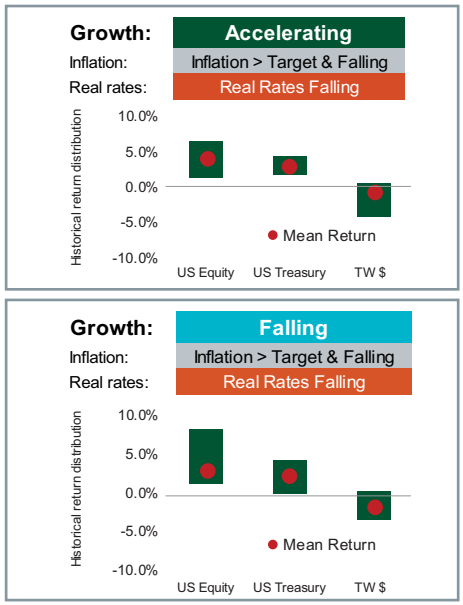


Figure 28: A shift to AFJ would still be positive for equities[30]

Growth Regime	Inflation Regime	Real Rate Regime	Combined Regime	Excess Return	Sharpe	Drawdown (3rd quartile)	Hit Ratio	Return Ranking 40%	Sharpe Ranking 20%	Drawdown (3rd quartile) Ranking 20%	Hit Ratio Ranking 20%	Weighted Ranking	Time Spent In Regime	Regime count
Stabilising	Inflation > Target & Falling	Real Rates Falling	DFJ	6.9%	2.6	-6%	83%	2	2	6	4	3.20	2%	6.0
Accelerating	Inflation > Target & Falling	Real Rates Falling	AFJ	4.1%	3.1	-2%	83%	8	1	1	4	4.40	2%	6.0
Accelerating	Inflation < Target & Falling	Real Rates Rising	AGI	6.3%	2.0	-6%	78%	4	3	3	9	4.60	4%	9.0
Stabilising	Inflation > Target & Falling	Real Rates Rising	DFI	5.7%	1.8	-6%	86%	6	4	4	3	4.60	3%	7.0
Stabilising	Inflation < Target & Falling	Real Rates Falling	DGJ	9.6%	1.5	-12%	100%	1	6	19	1	5.60	2%	4.0
Accelerating	Inflation < Target & Falling	Real Rates Falling	AGJ	5.8%	1.0	-8%	100%	5	10	15	1	7.20	4%	6.0
Accelerating	Inflation < Target & Rising	Real Rates Rising	AHI	4.0%	1.6	-4%	69%	9	5	2	12	7.40	5%	13.0
Accelerating	Inflation < Target & Rising	Real Rates Falling	AHJ	6.3%	1.2	-9%	67%	3	8	16	13	8.60	4%	6.0
Moderating	Inflation > Target & Falling	Real Rates Falling	BFJ	3.8%	1.3	-6%	80%	10	7	8	8	8.60	4%	10.0
Falling	Inflation < Target & Falling	Real Rates Falling	CGJ	4.1%	0.8	-10%	83%	7	12	17	4	9.40	2%	6.0
Accelerating	Inflation > Target & Rising	Real Rates Rising	AEI	2.9%	1.0	-7%	82%	11	11	13	7	10.60	5%	11.0
Accelerating	Inflation > Target & Falling	Real Rates Rising	AFI	2.7%	1.0	-6%	62%	13	9	7	16	11.60	6%	13.0
Falling	Inflation > Target & Falling	Real Rates Falling	CFJ	2.8%	0.7	-8%	75%	12	13	14	10	12.20	5%	12.0
Moderating	Inflation < Target & Falling	Real Rates Falling	BGJ	2.2%	0.7	-6%	56%	14	14	5	18	13.00	4%	9.0
Accelerating	Inflation > Target & Rising	Real Rates Falling	AEJ	0.0%	0.0	-6%	75%	16	16	9	10	13.40	4%	8.0
Moderating	Inflation < Target & Falling	Real Rates Rising	BGI	1.1%	0.4	-7%	67%	15	15	10	13	13.60	2%	6.0
Moderating	Inflation > Target & Falling	Real Rates Rising	BFI	-0.3%	-0.1	-7%	67%	17	17	11	13	15.00	4%	9.0
Moderating	Inflation > Target & Rising	Real Rates Rising	BEI	-1.5%	-0.4	-7%	62%	20	20	12	16	17.60	6%	13.0
Moderating	Inflation > Target & Rising	Real Rates Falling	BEJ	-0.9%	-0.1	-11%	53%	19	18	18	19	18.60	11%	15.0
Falling	Inflation > Target & Rising	Real Rates Falling	CEJ	-0.8%	-0.2	-14%	53%	18	19	21	19	19.00	6%	15.0
Falling	Inflation < Target & Rising	Real Rates Falling	CHJ	-4.3%	-0.9	-18%	33%	21	21	23	21	21.40	3%	6.0
Falling	Inflation > Target & Rising	Real Rates Rising	CEI	-4.9%	-1.4	-13%	0%	22	23	20	23	22.00	2%	6.0
Falling	Inflation > Target & Falling	Real Rates Rising	CFI	-6.1%	-1.3	-14%	11%	23	22	22	22	22.40	4%	9.0

In a scenario where we shift regimes from DFJ to either AFJ or CFJ this has historically been a better environment for bond returns, and in fact regime AFJ has historically been one of the best regimes for fixed income performance. In fact the performance of bond markets in this regime has been only marginally lower than the return on equities.

[29] For illustrative purposes only.
[30] Source: Insight, Bloomberg. Data between December 1976 and June 2024.

Figure 29: The next regime could be a better environment for fixed income[31]

Growth Regime	Inflation Regime	Real Rate Regime	Combined Regime	Excess Return	Sharpe	Drawdown (3rd quartile)	Hit Ratio	Return Ranking 40%	Sharpe Ranking 20%	Drawdown (3rd quartile) Ranking 20%	Hit Ratio Ranking 20%	Weighted Ranking	Time Spent In Regime	Regime count
Accelerating	Inflation > Target & Falling	Real Rates Falling	AFJ	3.1%	2.5	-1%	100%	2	1	1	1	1.40	2%	6.0
Falling	Inflation < Target & Rising	Real Rates Falling	CHJ	3.1%	2.4	-2%	83%	1	2	6	3	2.60	3%	6.0
Falling	Inflation < Target & Falling	Real Rates Falling	CGJ	2.4%	2.0	-4%	100%	4	3	18	1	6.00	2%	6.0
Falling	Inflation > Target & Falling	Real Rates Falling	CFJ	2.3%	1.1	-2%	75%	5	7	9	6	6.40	5%	12.0
Moderating	Inflation > Target & Falling	Real Rates Falling	BFJ	2.2%	1.7	-2%	70%	7	4	7	9	6.80	4%	10.0
Moderating	Inflation < Target & Falling	Real Rates Falling	BGJ	1.5%	1.3	-2%	78%	10	5	4	5	6.80	4%	9.0
Accelerating	Inflation < Target & Falling	Real Rates Falling	AGJ	2.8%	1.0	-3%	83%	3	10	16	3	7.00	4%	6.0
Accelerating	Inflation < Target & Rising	Real Rates Falling	AHJ	2.0%	1.2	-2%	67%	9	6	8	10	8.40	4%	6.0
Moderating	Inflation > Target & Rising	Real Rates Falling	BEJ	2.3%	1.1	-2%	60%	6	8	10	13	8.60	11%	15.0
Falling	Inflation > Target & Rising	Real Rates Falling	CEJ	2.2%	1.0	-3%	73%	8	9	13	8	9.20	6%	15.0
Stabilising	Inflation > Target & Falling	Real Rates Falling	DFJ	1.0%	0.7	-1%	67%	12	11	2	10	9.40	2%	6.0
Accelerating	Inflation > Target & Rising	Real Rates Falling	AEJ	1.2%	0.7	-3%	75%	11	12	12	6	10.40	4%	8.0
Moderating	Inflation < Target & Falling	Real Rates Rising	BGI	0.6%	0.6	-2%	67%	13	13	5	10	10.80	2%	6.0
Stabilising	Inflation > Target & Falling	Real Rates Rising	DFI	-0.1%	-0.1	-1%	57%	14	14	3	14	11.80	3%	7.0
Moderating	Inflation > Target & Rising	Real Rates Rising	BEI	-1.3%	-1.0	-3%	45%	16	18	15	17	16.40	6%	11.0
Stabilising	Inflation < Target & Falling	Real Rates Falling	DGJ	-1.4%	-0.7	-5%	50%	17	15	20	15	16.80	2%	4.0
Accelerating	Inflation < Target & Falling	Real Rates Rising	AGI	-1.2%	-0.8	-6%	44%	15	16	22	18	17.20	4%	9.0
Accelerating	Inflation > Target & Falling	Real Rates Rising	AFI	-1.4%	-1.0	-3%	17%	18	20	14	23	18.60	6%	12.0
Accelerating	Inflation > Target & Rising	Real Rates Rising	AEI	-1.8%	-1.3	-3%	30%	20	23	11	20	18.80	5%	10.0
Accelerating	Inflation < Target & Rising	Real Rates Rising	AHI	-1.4%	-1.2	-5%	38%	19	21	21	19	19.80	5%	13.0
Falling	Inflation > Target & Rising	Real Rates Rising	CEI	-2.2%	-0.9	-7%	50%	23	17	23	15	20.20	2%	6.0
Falling	Inflation > Target & Falling	Real Rates Rising	CFI	-1.9%	-1.0	-5%	22%	21	19	19	22	20.40	4%	9.0
Moderating	Inflation > Target & Falling	Real Rates Rising	BFI	-2.0%	-1.2	-4%	29%	22	22	17	21	20.80	4%	7.0

For those with greater flexibility, currency markets can also offer interesting opportunities. A shift to regime AFJ has historically been associated with greater directionality in currency markets, with the trade-weighted US dollar generally moving lower (see Figure 30), which can provide additional ways to add alpha or seek diversification for those that have the flexibility to access currency-based strategies.

Figure 30: In currency markets, a regime shift could suggest dollar weakness ahead[32]

Growth Regime	Inflation Regime	Real Rate Regime	Combined Regime	Excess Return	Sharpe	Drawdown (3rd quartile)	Hit Ratio	Return Ranking 40%	Sharpe Ranking 20%	Drawdown (3rd quartile) Ranking 20%	Hit Ratio Ranking 20%	Weighted Ranking	Time Spent In Regime	Regime count
Moderating	Inflation > Target & Falling	Real Rates Rising	BFI	2.9%	2.0	-3%	56%	1	1	2	7	2.40	4%	9.0
Accelerating	Inflation > Target & Falling	Real Rates Rising	AFI	2.7%	1.8	-3%	77%	3	2	4	2	2.80	6%	13.0
Falling	Inflation > Target & Rising	Real Rates Rising	CEI	2.7%	1.5	-5%	67%	2	3	9	3	3.80	2%	6.0
Stabilising	Inflation > Target & Falling	Real Rates Rising	DFI	1.3%	0.8	-3%	86%	5	5	5	1	4.20	3%	7.0
Moderating	Inflation < Target & Falling	Real Rates Rising	BGI	1.2%	0.8	-3%	67%	6	6	1	3	4.40	2%	6.0
Falling	Inflation > Target & Falling	Real Rates Rising	CFI	2.4%	1.0	-7%	67%	4	4	18	3	6.60	4%	9.0
Moderating	Inflation > Target & Rising	Real Rates Rising	BEI	0.5%	0.3	-3%	54%	9	9	3	10	8.00	6%	13.0
Moderating	Inflation > Target & Falling	Real Rates Falling	BFJ	0.7%	0.4	-4%	50%	7	8	6	12	8.00	4%	10.0
Moderating	Inflation < Target & Falling	Real Rates Falling	BGJ	0.6%	0.4	-5%	56%	8	7	12	7	8.40	4%	9.0
Accelerating	Inflation < Target & Rising	Real Rates Rising	AHI	0.3%	0.2	-5%	54%	10	10	13	10	10.60	5%	13.0
Stabilising	Inflation > Target & Falling	Real Rates Falling	DFJ	-0.3%	-0.2	-5%	50%	11	12	8	12	10.80	2%	6.0
Accelerating	Inflation > Target & Rising	Real Rates Rising	AEI	-0.7%	-0.4	-5%	55%	14	15	7	9	11.80	5%	11.0
Falling	Inflation < Target & Falling	Real Rates Falling	CGJ	-0.5%	-0.4	-7%	67%	13	13	17	3	11.80	2%	6.0
Accelerating	Inflation > Target & Rising	Real Rates Falling	AEJ	-0.7%	-0.4	-5%	50%	16	16	10	12	14.00	4%	8.0
Moderating	Inflation > Target & Rising	Real Rates Falling	BEJ	-0.4%	-0.1	-9%	47%	12	11	21	16	14.40	11%	15.0
Falling	Inflation > Target & Rising	Real Rates Falling	CEJ	-0.7%	-0.4	-5%	33%	15	14	15	17	15.20	6%	15.0
Accelerating	Inflation > Target & Falling	Real Rates Falling	AFJ	-0.8%	-0.7	-5%	50%	17	18	14	12	15.60	2%	6.0
Falling	Inflation < Target & Rising	Real Rates Falling	CHJ	-1.3%	-0.9	-5%	17%	18	19	11	21	17.40	3%	6.0
Accelerating	Inflation < Target & Falling	Real Rates Falling	AGJ	-1.6%	-0.5	-12%	33%	19	17	23	17	19.00	4%	6.0
Falling	Inflation > Target & Falling	Real Rates Falling	CFJ	-1.8%	-1.0	-7%	33%	20	20	19	17	19.20	5%	12.0
Accelerating	Inflation < Target & Falling	Real Rates Rising	AGI	-2.2%	-1.3	-5%	33%	21	22	16	17	19.40	4%	9.0
Accelerating	Inflation < Target & Rising	Real Rates Falling	AHJ	-3.8%	-1.7	-8%	17%	23	23	20	21	22.00	4%	6.0
Stabilising	Inflation < Target & Falling	Real Rates Falling	DGJ	-2.6%	-1.2	-9%	0%	22	21	22	23	22.00	2%	4.0

[31, 32] Source: Insight, Bloomberg. Data between December 1976 and June 2024. US Treasury and trade-weighted US dollar.

5 LOOKING BEYOND TRADITIONAL ASSET CLASSES INCREASES THE POTENTIAL FOR DIVERSIFICATION AND RETURNS

To be able to position for all possible environments, we believe that a multi-asset strategy must take a flexible approach that gives access to both traditional assets and alternative assets. The ability to access such a broad opportunity set offers different ways to add diversification at a time when traditional sources of diversification may prove less reliable than in the past and our asset-allocation framework can be just as applicable to these alternative strategies.

To illustrate this, we can compare a range of alternative assets across two of the regimes in our growth framework (see Figure 31). These include alternative assets (convertible bonds, fallen angels and dividend futures), alternative alpha trades (commodity carry and quantitative currency returns, also known as QCR) as well as alternative hedges (equity dispersion and equity quality long/short). Although higher government bond yields have once again increased their attractiveness as a diversifying asset, alternative strategies such as relative value or defensive currency trades can offer ways to enhance diversification. **In environments where both bond and equity markets may generate negative returns, we believe multi-asset strategies need all available tools to mitigate against downside risks.**

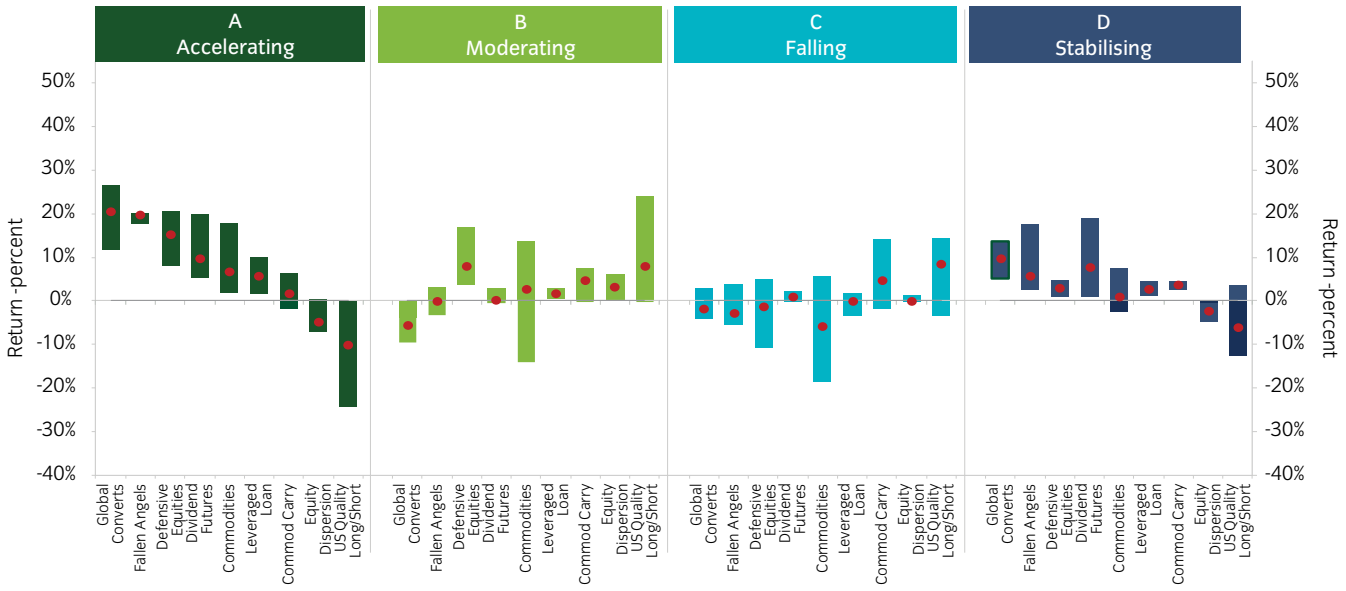
While the regime framework was primarily built as an asset-allocation tool for traditional assets, we have also found it a useful tool when allocating between alternative assets. For example, Figure 32 shows the performance characteristics of equity dispersion across all growth, inflation and real rate regimes. What is striking is how the economic environments which tend to be the worst for equities that we discussed earlier, are actually some of the best for equity dispersion, highlighting its appeal as a hedge. Figure 33 applies the same analysis to a commodity carry strategy (explained below). What is notable here is that there is no clear pattern, either from a growth or inflation perspective for the environments this strategy has historically performed poorly or well. This highlights its attraction as a potentially more alpha-generative strategy, less dependent on broad market direction, where a risk-based framework for allocation would be more appropriate.

COMMODITY CARRY STRATEGIES EXPLAINED

Commodities markets cover a large spectrum of raw materials (including energy, metals and agriculture) that investors can trade through futures contracts. Generally, the price at which futures contracts are traded will be higher (known as contango) or lower than prevailing spot prices (known as backwardation).

The shape of the futures is mainly dependent upon the fundamental supply and demand dynamics of the underlying markets, the levels of inventories and the costs of storage and delivery of the physical assets. Commodity carry strategies are designed to harvest the yield available from the futures curve, without relying on the direction of movements in spot price.

Figure 31: Alternative strategies across growth regimes[33]



[33] Source: Insight, Bloomberg. Data between December 1976 and June 2024.

Figure 32: Equity dispersion characteristics across the combined regimes[34]

Growth Regime	Inflation Regime	Real Rate Regime	Combined Regime	Excess Return	Sharpe	Drawdown (3rd quartile)	Hit Ratio	Return Ranking 40%	Sharpe Ranking 20%	Drawdown (3rd quartile) Ranking 20%	Hit Ratio Ranking 20%	Weighted Ranking	Time Spent In Regime	Regime count
Falling	Inflation > Target & Falling	Real Rates Rising	CFI	9.4%	2.7	-2%	38%	1	1	8	5	3.20	4%	3.0
Falling	Inflation > Target & Rising	Real Rates Rising	CEI	3.4%	2.2	-1%	17%	2	2	6	10	4.40	2%	2.0
Moderating	Inflation > Target & Rising	Real Rates Rising	BEI	2.4%	1.3	-2%	15%	4	4	7	12	6.20	6%	3.0
Moderating	Inflation < Target & Falling	Real Rates Rising	BGI	2.2%	1.4	-4%	50%	6	3	16	1	6.40	2%	3.0
Falling	Inflation < Target & Rising	Real Rates Falling	CHJ	1.3%	0.6	-3%	50%	7	7	13	1	7.00	3%	4.0
Moderating	Inflation < Target & Rising	Real Rates Rising	BHI	2.3%	0.7	-5%	50%	5	6	19	1	7.20	1%	2.0
Falling	Inflation < Target & Rising	Real Rates Rising	CHI	0.4%	0.4	-2%	50%	10	9	9	1	7.80	1%	1.0
Falling	Inflation > Target & Falling	Real Rates Falling	CFJ	0.6%	0.5	0%	8%	8	8	3	13	8.00	4%	1.0
Falling	Inflation < Target & Falling	Real Rates Falling	CGJ	2.4%	0.9	-8%	17%	3	5	21	10	8.40	2%	4.0
Accelerating	Inflation < Target & Falling	Real Rates Rising	AGI	0.5%	0.3	-2%	33%	9	10	10	6	8.80	4%	4.0
Accelerating	Inflation < Target & Rising	Real Rates Rising	AHI	0.0%	0.0	-3%	23%	12	12	14	8	11.60	5%	7.0
Moderating	Inflation < Target & Falling	Real Rates Falling	BGJ	0.2%	0.2	-4%	22%	11	11	18	9	12.00	4%	3.0
Moderating	Inflation > Target & Rising	Real Rates Falling	BEJ	-0.5%	-0.1	-2%	7%	13	13	12	14	13.00	11%	2.0
Moderating	Inflation < Target & Rising	Real Rates Falling	BHJ	-0.6%	-0.8	-1%	0%	14	19	4	15	13.20	1%	1.0
Accelerating	Inflation > Target & Rising	Real Rates Falling	AEJ	-0.7%	-0.5	-1%	0%	16	15	5	15	13.40	4%	2.0
Moderating	Inflation > Target & Falling	Real Rates Rising	BFI	-1.0%	-0.8	0%	0%	17	18	1	15	13.60	5%	1.0
Moderating	Inflation > Target & Falling	Real Rates Falling	BFJ	-1.2%	-0.7	0%	0%	19	16	1	15	14.00	5%	1.0
Accelerating	Inflation < Target & Falling	Real Rates Falling	AGJ	-0.6%	-0.3	-4%	0%	15	14	15	15	14.80	4%	2.0
Accelerating	Inflation < Target & Rising	Real Rates Falling	AHJ	-2.0%	-1.0	-5%	33%	20	21	20	6	17.40	4%	5.0
Stabilising	Inflation < Target & Rising	Real Rates Falling	DHJ	-1.0%	-0.9	-4%	0%	18	20	17	15	17.60	1%	2.0
Accelerating	Inflation > Target & Rising	Real Rates Rising	AEI	-3.6%	-2.3	-2%	0%	22	22	11	15	18.40	6%	2.0
Stabilising	Inflation < Target & Falling	Real Rates Falling	DGJ	-2.2%	-0.8	-9%	0%	21	17	22	15	19.20	2%	3.0

Figure 33: Commodity carry return characteristics across the combined regimes[35]

Growth Regime	Inflation Regime	Real Rate Regime	Combined Regime	Excess Return	Sharpe	Drawdown (3rd quartile)	Hit Ratio	Return Ranking 40%	Sharpe Ranking 20%	Drawdown (3rd quartile) Ranking 20%	Hit Ratio Ranking 20%	Weighted Ranking	Time Spent In Regime	Regime count
Stabilising	Inflation < Target & Falling	Real Rates Rising	DGI	4.6%	2.7	0%	100%	5	5	1	1	3.40	0%	1.0
Moderating	Inflation > Target & Falling	Real Rates Falling	BFJ	6.2%	4.4	0%	40%	2	2	1	14	4.20	5%	4.0
Moderating	Inflation > Target & Falling	Real Rates Rising	BFI	11.6%	6.3	0%	11%	1	1	1	23	5.40	5%	2.0
Stabilising	Inflation < Target & Rising	Real Rates Falling	DHJ	3.3%	2.9	-1%	100%	6	4	10	1	5.40	1%	2.0
Moderating	Inflation > Target & Rising	Real Rates Falling	BEJ	4.7%	1.8	-1%	47%	4	8	8	13	7.40	11%	7.0
Falling	Inflation > Target & Falling	Real Rates Rising	CFI	6.0%	3.0	-2%	38%	3	3	12	16	7.40	4%	3.0
Falling	Inflation < Target & Falling	Real Rates Falling	CGJ	3.2%	2.2	-5%	67%	7	6	23	5	9.60	2%	6.0
Falling	Inflation < Target & Rising	Real Rates Rising	CHI	2.4%	2.0	-2%	50%	9	7	15	9	9.80	1%	2.0
Falling	Inflation < Target & Rising	Real Rates Falling	CHJ	1.6%	1.0	-2%	67%	12	10	13	5	10.40	3%	6.0
Falling	Inflation > Target & Rising	Real Rates Rising	CEI	2.5%	1.8	-1%	17%	8	9	7	21	10.60	2%	2.0
Falling	Inflation > Target & Rising	Real Rates Falling	CEJ	1.9%	1.0	0%	20%	11	11	1	20	10.80	6%	5.0
Moderating	Inflation < Target & Rising	Real Rates Rising	BHI	1.2%	0.9	-2%	100%	17	12	11	1	11.60	1%	2.0
Stabilising	Inflation < Target & Falling	Real Rates Falling	DGJ	2.0%	0.8	-4%	75%	10	15	20	4	11.80	2%	4.0
Moderating	Inflation < Target & Falling	Real Rates Falling	BGJ	1.5%	0.9	-4%	56%	13	13	19	7	13.00	4%	8.0
Accelerating	Inflation > Target & Rising	Real Rates Rising	AEI	1.2%	0.7	0%	36%	15	16	4	17	13.40	6%	4.0
Accelerating	Inflation > Target & Rising	Real Rates Falling	AEJ	1.2%	0.8	-1%	13%	16	14	6	22	14.80	4%	2.0
Accelerating	Inflation < Target & Rising	Real Rates Falling	AHJ	1.3%	0.6	-5%	50%	14	17	21	9	15.00	4%	6.0
Accelerating	Inflation < Target & Falling	Real Rates Rising	AGI	0.7%	0.5	-2%	56%	19	18	14	7	15.40	4%	6.0
Accelerating	Inflation < Target & Falling	Real Rates Falling	AGJ	0.8%	0.3	-3%	50%	18	19	16	9	16.00	4%	4.0
Moderating	Inflation > Target & Rising	Real Rates Rising	BEI	0.1%	0.0	-1%	38%	21	21	9	15	17.40	6%	8.0
Falling	Inflation > Target & Falling	Real Rates Falling	CFJ	-0.7%	-0.3	-1%	25%	22	22	5	19	18.00	4%	5.0
Moderating	Inflation < Target & Falling	Real Rates Rising	BGI	0.4%	0.2	-5%	50%	20	20	22	9	18.20	2%	5.0

[34, 35] Source: Insight, Bloomberg. Data between December 1976 and June 2024.

CONCLUSION

Absent a crystal ball, we don't know exactly how the macroeconomic landscape will unfold in the years ahead. It seems fair to assume that inflation and interest rates will not return to pre-pandemic levels any time soon. That period was an abnormal one, and it followed the extended period of unconventional policy support in the wake of the global financial crisis. Trends in globalisation seem less disinflationary while geopolitical risks seem elevated on multiple fronts. Such forces may make it harder for policymakers to adjust monetary policy to fine-tune the global economy and this may translate into more fluctuations both in terms of growth and inflation which makes relying on a stable equity/bond correlation harder.

We believe there are several ways in which asset allocators will need to adapt to deal with this new investment landscape:

1. **Greater diversification.** This alone is unlikely to be enough to create good investment outcomes but we can start by ensuring that we have at our disposal a range of building blocks, that will help us when others are being challenged.
2. **A robust framework for asset allocation.** We need a framework that helps us understand the particular environments in which certain investments are likely to do well and poorly and then have the conviction to dynamically asset allocate in a manner consistent with that road map. The regime framework discussed in this note aims to be a cyclical framework to help guide asset-allocation decisions.
3. **Tools to build asymmetry into a portfolio's return profile.** Dynamic asset allocation, specifically actively moving to asset or investments that are likely to do well in the prevailing macro environment, and away from those where the current economic forces are a headwind, is a start. Adding a layer of asymmetry – essentially creating option-like pay-out profiles via more fluid risk or momentum-based indicators – can provide an extra element of systematic rigour to work alongside a fundamental regime-based approach.

APPENDIX: THE IMPORTANCE OF RECESSIONS TO EQUITY BEAR MARKETS

Our analysis on the interaction of economic data with asset-class behaviour across history shows us that periods of strong or weak growth are significantly influential for equity markets. This is unsurprising; the intrinsic relationship between economic growth, corporate profitability and share prices is clear. However, it is worth noting just how pronounced these linkages are, particularly in more extreme periods of economic contraction where equity downside risks are dominant. To demonstrate this, we can analyse the various bear markets[36] that have occurred for the S&P 500 Index over the past 100 years. We have split these into three categories: normal bear markets (declines of -20% to -30%), large bear markets (declines of -30% to -50%) and mega bear markets (declines of more than -50%). Once defined, we can then look at the growth indicators across those periods (see Figure 34).

Figure 34: Historical US economic environment during S&P 500 Index bear markets[37]

	Bear market characteristics			Growth environment		
Dates	Drawdown	Length (months)	Realised Vol. (High 22d)	Earnings Decline (Nominal)	Real GDP Decline (peak to trough)	ISM Manufacturing Fall (Pts.)
Normal Bear Markets						
Jun 46 to Apr 48	-28%	22	43	-29%	-13.0%	
Aug 56 to Oct 57	-22%	15	24	-22%	-3.7%	-12.4
Dec 61 to Jun 62	-27%	6	37	-12%	-1.6%	-12.0
Feb 66 to Oct 66	-22%	9	20	-5%	0%	-8.0
Nov 80 to Aug 82	-27%	21	20	-5%	-2.6%	-22.7
Jul 90 to Oct 90	-20%	4	25	-37%	0%	-2.1
Average	**-24%**	**13**	**28**	**-18%**	**-3.5%**	**-11.4**
Big Bear Markets						
Jan 73 to Oct 74	-48%	22	35	-15%	-3.2%	-25.9
Nov 68 to May 70	-36%	19	32	-13%	-0.6%	-13.1
Aug 87 to Dec 87	-34%	5	92	-13%	0%	-1.9
Mar 00 to Oct 02	-49%	31	46	-54%	-0.4%	-14.1
Feb 20 to Mar 20	-32%	1	86	-33%	-19.2%	-9.6
Average	**-40%**	**16**	**58**	**-26%**	**-4.7%**	**-12.9**
Mega Bear Markets						
Sep 29 to Jun 32	-86%	33	101	-75%	-27.0%	
Mar 37 to Apr 42	-60%	62	56	-49%	-18.0%	
Oct 07 to Mar 09	-57%	18	88	-92%	-5.1%	-18.3
Average	**-68%**	**38**	**82**	**-72%**	**-16.7%**	**-18.3**
2022 Bear Market	**-25%**	**9**	**34**	**-2.5%**	**0%**	**-15.0**

Key observation: A key observation is that each and every bear market has been historically associated with a growth decline, most notably in earnings and the ISM manufacturing, with the size of the bear market tending to reflect the severity of the growth decline.

Implication: As an asset allocator, a timely understanding of when the growth backdrop is deteriorating should always be a key component of an investment framework.

It is notable how unique the pandemic-driven bear market was in terms of the rapidity of the market drawdown and scale of recession. Each period in history has its own unique facets, but the link between big drawdowns in stock markets and growth holds, even if the causality can work both ways.

It is also interesting to note that the bear market seen in 2022 has not yet coincided with a material corporate earnings decline. This is in striking contrast to the 16 point fall in the ISM Manufacturing Index and a historic precedent. This highlights the unique nature of the post-pandemic growth environment. The strength of consumer balance sheets combined with a surge in re-opening demand, has allowed companies to raise prices without materially hurting volumes, helping maintain corporate profitability despite a huge tightening in financial conditions and sharp manufacturing decline.

[36] A bear market is defined as a peak-to-trough decline of more than 20%.
[37] Source: Insight, Bloomberg. Data between December 1976 and June 2024.

IMPORTANT INFORMATION

RISK DISCLOSURES

Past performance is not indicative of future results. Investment in any strategy involves a risk of loss which may partly be due to exchange rate fluctuations.

The performance results shown, whether net or gross of investment management fees, reflect the reinvestment of dividends and/or income and other earnings. Any gross of fees performance does not include fees and charges and these can have a material detrimental effect on the performance of an investment.

Any target performance aims are not a guarantee, may not be achieved and a capital loss may occur. Funds which have a higher performance aim generally take more risk to achieve this and so have a greater potential for the returns to be significantly different than expected.

Portfolio holdings are subject to change, for information only and are not investment recommendations.

ASSOCIATED INVESTMENT RISKS

Multi-asset

Derivatives may be used to generate returns as well as to reduce costs and/or the overall risk of the portfolio. Using derivatives can involve a higher level of risk. A small movement in the price of an underlying investment may result in a disproportionately large movement in the price of the derivative investment.

Investments in bonds are affected by interest rates and inflation trends which may affect the value of the portfolio.

The investment manager may invest in instruments which can be difficult to sell when markets are stressed.

Property assets are inherently less liquid and more difficult to sell than other assets. The valuation of physical property is a matter of the valuer's judgement rather than fact.

While efforts will be made to eliminate potential inequalities between shareholders in a pooled fund through the performance fee calculation methodology, there may be occasions where a shareholder may pay a performance fee for which they have not received a commensurate benefit.

CONTRIBUTORS

Matthew Merritt
Head of Multi-Asset Strategy Group

Steve Waddington
Co-Deputy Head
Multi-Asset Strategy Group

Michael Ford
Co-Deputy Head
Multi-Asset Strategy Group

Zacharias Bobolakis
Senior Portfolio Manager
Multi-Asset Strategy Group

Jonathan Crone
Portfolio Manager
Multi-Asset Strategy Group

Jenny Pham
Portfolio Manager
Multi-Asset Strategy Group

Shantanu Tandon
Portfolio Manager
Multi-Asset Strategy Group

Stephanie Chan
Portfolio Manager
Multi-Asset Strategy Group

Christopher Broadley
Portfolio Manager
Multi-Asset Strategy Group

Vladimir Sovetkin
Portfolio Manager and Quantitative Strategist
Multi-Asset Strategy Group

Andy Burgess
Investment Specialist
Multi-Asset Strategy Group

Kristin Qi
Portfolio Analyst
Multi-Asset Strategy Group

FIND OUT MORE

Institutional Business Development
businessdevelopment@insightinvestment.com

European Business Development
europe@insightinvestment.com

Consultant Relationship Management
consultantrelations@insightinvestment.com

company/insight-investment

www.insightinvestment.com

IMPORTANT INFORMATION

Material in this publication is for general information only. This material is not intended to be relied upon as a forecast, research or investment advice, and is not a recommendation, offer or solicitation to buy or sell any securities or to adopt any investment strategy. This document must not be used for the purpose of an offer or solicitation in any jurisdiction or in any circumstances in which such offer or solicitation is unlawful or otherwise not permitted. This document should not be duplicated, amended or forwarded to a third party without consent from Insight Investment.

This material may contain 'forward looking' information that is not purely historical in nature. Such information may include, among other things, projections and forecasts. Forecasts are not guarantees.

Past performance is not indicative of future results.

Investment in any strategy involves a risk of loss which may partly be due to exchange rate fluctuations.

Index returns are for illustrative purposes only and are used in the context of our macro-economic models and analysis only. Returns cannot be linked to any fund or investment strategy and results do not represent or infer any links to actual fund or strategy performance. Index performance returns do not reflect any management fees, transaction costs or expenses. Indices are unmanaged and one cannot invest directly in an index.

Insight does not provide tax or legal advice to its clients and all investors are strongly urged to seek professional advice regarding any potential strategy or investment.

References to future returns are not promises or even estimates of actual returns a client portfolio may achieve. Assumptions, opinions and estimates are provided for illustrative purposes only. They should not be relied upon as recommendations to buy or sell securities. Forecasts of financial market trends that are based on current market conditions constitute our judgment and are subject to change without notice.

The information and opinions are derived from proprietary and non-proprietary sources deemed by Insight Investment to be reliable, are not necessarily all-inclusive and are not guaranteed as to accuracy. As such, no warranty of accuracy or reliability is given and no responsibility arising in any other way for errors and omissions (including responsibility to any person by reason of negligence) is accepted by Insight Investment, its officers, employees or agents. Reliance upon information in this material is at the sole discretion of the reader.

Telephone conversations may be recorded in accordance with applicable laws.

For clients and prospects of Insight Investment Management (Global) Limited: Issued by Insight Investment Management (Global) Limited. Registered in England and Wales. Registered office 160 Queen Victoria Street, London EC4V 4LA; registered number 00827982.

For clients and prospects of Insight Investment Funds Management Limited: Issued by Insight Investment Funds Management Limited. Registered in England and Wales. Registered office 160 Queen Victoria Street, London EC4V 4LA; registered number 01835691.

For clients and prospects of Insight Investment Management (Europe) Limited: Issued by Insight Investment Management (Europe) Limited. Registered office Riverside Two, 43-49 Sir John Rogerson's Quay, Dublin, D02 KV60. Registered in Ireland. Registered number 581405. Insight Investment Management (Europe) Limited is regulated by the Central Bank of Ireland. CBI reference number C154503.

For clients and prospects of Insight Investment International Limited: Issued by Insight Investment International Limited. Registered in England and Wales. Registered office 160 Queen Victoria Street, London EC4V 4LA; registered number 03169281.

Insight Investment Management (Global) Limited, Insight Investment Funds Management Limited and Insight Investment International Limited are authorised and regulated by the Financial Conduct Authority in the UK. Investment Management (Global) Limited and Insight Investment International Limited may operate in certain European countries in accordance with local regulatory requirements.

For clients and prospects based in Singapore: This material is for Institutional Investors only. This documentation has not been registered as a prospectus with the Monetary Authority of Singapore. Accordingly, it and any other document or material in connection with the offer or sale, or invitation for subscription or purchase, of Shares may not be circulated or distributed, nor may Shares be offered or sold, or be made the subject of an invitation for subscription or purchase, whether directly or indirectly, to persons in Singapore other than (i) to an institutional investor pursuant to Section 304 of the Securities and Futures Act, Chapter 289 of Singapore (the 'SFA') or (ii) otherwise pursuant to, and in accordance with the conditions of, any other applicable provision of the SFA.

For clients and prospects based in Australia and New Zealand: This material is for wholesale investors only (as defined under the Corporations Act in Australia or under the Financial Markets Conduct Act in New Zealand) and is not intended for distribution to, nor should it be relied upon by, retail investors.

Both Insight Investment Management (Global) Limited and Insight Investment International Limited are exempt from the requirement to hold an Australian financial services licence under the Corporations Act 2001 in respect of the financial services; and both are authorised and regulated by the Financial Conduct Authority (FCA) under UK laws, which differ from Australian laws. If this document is used or distributed in Australia, it is issued by Insight Investment Australia Pty Ltd (ABN 69 076 812 381, AFS License No. 230541) located at Level 2, 1-7 Bligh Street, Sydney, NSW 2000.

For clients and prospects of Insight North America LLC: Insight North America LLC is a registered investment adviser under the Investment Advisers Act of 1940 and regulated by the US Securities and Exchange Commission. INA is part of 'Insight' or 'Insight Investment', the corporate brand for certain asset management companies operated by Insight Investment Management Limited including, among others, Insight Investment Management (Global) Limited, Insight Investment International Limited and Insight Investment Management (Europe) Limited (IIMEL).

16100-06-24