Adaptive Asset Allocation Across Macroeconomic Regimes: A Systematic Solution to the Stock-Bond Correlation Breakdown

Pustak Poudel
pustak@connect.hku.hk

January 2026

1 Abstract

The long-established and widely recognized 60/40 equity–bond portfolio has served as a benchmark for multi-asset investing, mainly predicated on the diversification benefits of the fixed income hedge during equity drawdowns. However, this diversification relies on a stable non-positive Equity vs Bond returns correlation structure that may not persist in all macroeconomic environments. This paper investigates the time-varying nature of the stock–bond correlation structure, demonstrating that it can and has flipped to positive during inflationary ("Stagflationary") regimes, thereby negating the hedging properties of bonds exactly when they are needed most. This paper proposes a dynamic, regime-based allocation framework that classifies the economic environment into four quadrants based on the trends in US Growth and Inflation. By systematically rotating exposure between Equities, Treasuries, and Commodities from 1971 to 2024, our model effectively navigates these correlation breakdowns. The results show that the dynamic strategy, when invested with $1 capital in 1971 generated a terminal wealth of $67.85 at the end of 2024, compared to $37.05 for the static benchmark, delivering an annualized return of 8.6% versus 7.4%. Furthermore, the dynamic approach significantly improved risk-adjusted performance, raising the Sharpe Ratio from 0.32 to 0.49 and reducing the maximum drawdown from -33% to -27%. The annualized returns were higher than the S&P 500's 8.3% (dividends re-invested) with almost half the volatility (8.93% $<$ 17.46%) over the period of 1971–2024. Crucially, the strategy delivered positive risk-adjusted returns during the Stagflationary period of the 1970s and avoided notable stock market plunges afterwards, proving that macro-regime awareness is a critical component of risk management in a post-Great Moderation world.

2 Introduction: The institutional asset allocation benchmark and the inflation trap

2.1 The Status Quo:

If you walk into almost any wealth management office or look at the default setting of a typical pension fund, you will see one dominant strategy: the *60/40 portfolio*. The logic is simple and quite elegant: put 60% of your capital in stocks (for growth) and 40% in bonds (for safety). For nearly four decades, the 60/40 portfolio has served as the bedrock of institutional asset allocation.

But before we start to dismantle this strategy, we need to understand how the status quo came to be—how and why the 60/40 portfolio became the "Holy Grail" of investing. The reason boils down to one powerful assumption: the negative correlation between stock and bond returns.

This assumption is powerful primarily because it rests on robust theoretical foundations. When stock markets fall sharply, it often signals that investors are worried and expect slower economic growth or even a recession. Companies

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may earn less, unemployment could rise, and overall economic activity tends to weaken. During these soft periods, consumers and businesses spend less, aggregate demand drops, and so do prices. This tends to reduce expected future inflation. With lower anticipated inflation, central banks are likely to keep interest rates lower, making existing bonds with higher yields more valuable to investors, since future Treasury rates are expected to be lower.

Rational investors anticipate this economic chain reaction: they sell equities and buy bonds. As we mentioned earlier, the anticipated reduction in future interest rates makes the current yields offered by existing bonds more attractive. During market panics, this flight to safety often creates a self-reinforcing cycle.

For the last two decades, this seesaw relationship between bond returns and stock returns has held up remarkably well. As a result, investors have been led to believe that bonds are the ultimate insurance policy against equity drawdowns.

2.2 The Paradox: When the Hedge Fails

But this raises a critical question: is this negative correlation—which we have seen hold for so long that it has become a widely accepted strategy even among retail investors—a permanent law of financial physics, or is it merely a byproduct of a specific economic environment?

The events of 2022 gave us a painful answer. As inflation spiked to multi-decade highs, central banks were forced to hike interest rates aggressively despite a slowing economy. The result was catastrophic for the passive investor: stocks crashed because of the slowdown, and bonds crashed because of the rate hikes. The seesaw snapped. Both assets fell together.

This episode reveals a crucial correlation trap: bonds are an excellent hedge against *deflationary* shocks (like 2008), but they become fuel on the fire during *inflationary* shocks (like the 1970s or 2022). By holding a static 60/40 portfolio, you are effectively betting that inflation will never be a problem.

2.3 The Solution: A "Weather Station" for the Economy

If the correlation between stocks and bonds is not static, then neither should our portfolio be. We need a way to navigate the changing economic landscape.

In this paper, we propose a dynamic, regime-based asset allocation framework. Instead of blindly holding stocks and bonds, we treat the economy like a weather system. We categorize economic history into four distinct "regimes" based on two simple signals: growth and inflation.

By simply observing the trends in these two major macroeconomic variables, we can rotate our capital into the asset class that thrives in the current weather—stocks for "Goldilocks," bonds for "deflation," and crucially, commodities for "stagflation" and "reflation."

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3 Methodology

3.1 Data Acquisition and Processing

To ensure a robust analysis spanning the inflationary period of the 1970s through the post-pandemic era (1970–2024), this study constructs a proprietary dataset using institutional-grade sources. Standard ETF proxies (e.g., SPY, TLT) were rejected due to their limited history (inception post-1993).

3.1.1 Equity Data

Historical equity returns were sourced from the Center for Research in Security Prices (CRSP). We utilized the S&P 500 Value-Weighted Return (`sprtrn`) rather than the standard price index. This ensures the inclusion of reinvested dividends, which constituted a significant component of total returns during the high-yield regime of the 1970s.

3.1.2 Fixed Income Data

A synthetic 10-Year Treasury Bond portfolio was constructed using daily yields from the Federal Reserve Economic Data (FRED) repository (Ticker: `DGS10`). Price returns were derived using a constant duration approximation (≈ 7 years), calculating the daily capital appreciation or depreciation resulting from yield fluctuations alongside the daily coupon accrual.

3.1.3 Risk-Free Rate

To calculate risk-adjusted metrics (Sharpe Ratio), we utilized the 3-Month Treasury Bill Secondary Market Rate (`DTB3`) from FRED. Annualized yields were geometrically converted to a daily return series to accurately reflect the opportunity cost of capital, particularly during the high-interest rate environment of the 1980s.

3.1.4 Real Assets

The Producer Price Index for All Commodities (`PPIACO`) was selected as the proxy for the inflation-hedge asset class. Monthly index values were forward-filled to create a daily price series, simulating a buy-and-hold exposure to a broad basket of physical commodities.

3.2 Macroeconomic Regime Classification

The core of the strategy relies on classifying the economic environment into four distinct regimes based on the second derivative (acceleration/deceleration) of growth and inflation.

- **Growth Signal**: Proxy variable is Industrial Production (`INDPRO`).

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- **Inflation Signal**: Proxy variable is Consumer Price Index (`CPIAUCSL`).

For both variables, the trend is determined by the 3-month change in the Year-over-Year (YoY) rate. A positive 3-month delta indicates an accelerating trend; a negative delta indicates deceleration. This 3-month lookback period was selected to balance signal responsiveness with noise reduction.

3.3 Dynamic Allocation Strategy

The dynamic portfolio is rebalanced monthly based on the prevailing regime signal. To prevent lookahead bias, the trading signal is lagged by one day relative to the data release. The allocation rules are defined as follows:

1. **Goldilocks** (Growth $\uparrow\uparrow$, Inflation $\downarrow\downarrow$): 100% allocation to Equities.
2. **Reflation** (Growth $\uparrow\uparrow$, Inflation $\uparrow\uparrow$): 100% allocation to Commodities.
3. **Stagflation** (Growth $\downarrow\downarrow$, Inflation $\uparrow\uparrow$): 100% allocation to Commodities.
4. **Deflation** (Growth $\downarrow\downarrow$, Inflation $\downarrow\downarrow$): 100% allocation to Treasuries.

4 Empirical Results

4.1 Overall Performance

The primary objective of this study was to determine whether a dynamic, regime-based allocation could outperform the traditional static 60/40 portfolio and also the S&P 500 index (dividends re-invested) over a multi-decade horizon that includes both inflationary and deflationary cycles. To answer this, we must look beyond just the final return; we must examine the path taken to achieve it.

Figure 1 presents the cumulative growth of $1 invested in the Dynamic Strategy, the 60/40 Benchmark, and the standalone asset classes (S&P 500 and 10-Year Treasuries) from April 1971 to December 2024.

The results indicate a significant structural advantage for the regime-based approach. The Dynamic Strategy generated a terminal wealth of $67.85, outperforming the 60/40 Benchmark ($37.05) by a factor of nearly 1.8x. This outperformance was achieved despite the strategy's defensive positioning during the tech boom of the late 1990s, highlighting its ability to capture long-term compounding through capital preservation rather than aggressive risk-taking.

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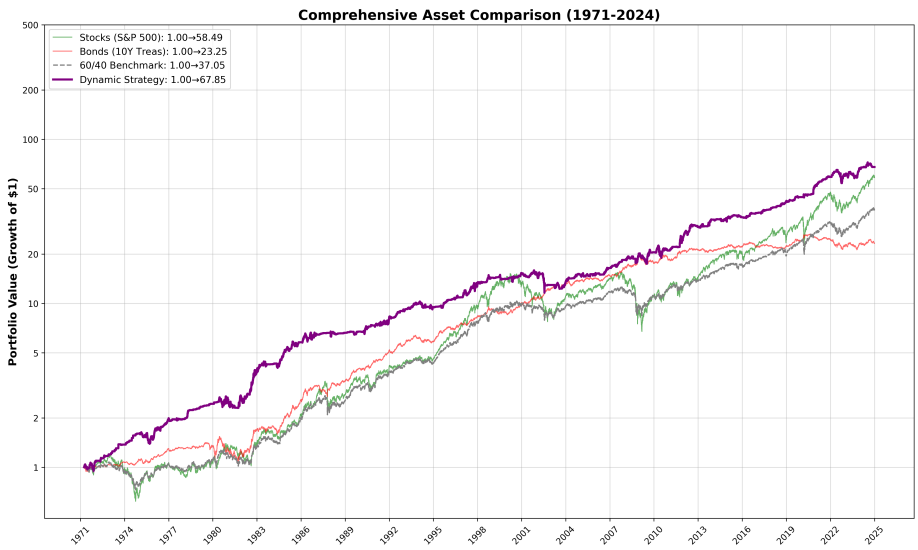

Figure 1: Cumulative growth of $1 invested (1971–2024): Stocks, Bonds, 60/40 benchmark, and Dynamic Strategy.

This visual reveals the distinct "personality" of each strategy:

1. **Equities (Green): The Volatility Trap**
   The S&P 500 demonstrates the classic profile of high-beta exposure. While it enjoyed massive expansions (notably the 1990s and 2010s), it forced investors to endure existential drawdowns in 1974, 2000, and 2008. Although it ended with a respectable $58.49, the path required accepting a massive 56% drawdown.

2. **Bonds (Red): The Failed Hedge**
   This is perhaps the most revealing part of the chart. We often think of bonds as the "safe" asset, yet they experienced a -30% drawdown—a level of risk that contradicts the "safety" expectation of fixed income. The red line ends at the bottom ($23.25), significantly underperforming every other strategy. This confirms that in inflationary regimes (1970s, 2022), bonds are not a hedge; they are a liability.

3. **The 60/40 Benchmark (Gray): The "Compromise"**
   The Gray line sits squarely in the middle, ending at ($37.05). This visualizes the fundamental flaw of static diversification: you get the average of the components. While it dampened the volatility of pure stocks, it was also dragged down by the "dead money" periods of bonds (1970s). It failed to protect capital in 2008 (-33% drawdown) and 2022, proving that simply mixing two asset classes does not guarantee safety.

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4. **The Dynamic Strategy (Purple): Structural Alpha**
   The Dynamic Strategy ends at the highest point ($67.85), beating even the pure equity index. But notice how it achieved this. It did not simply leverage up risk during bull markets. Instead, the outperformance was generated by avoiding the deep, prolonged stagnations that plagued the other assets. By switching to commodities in the 1970s and Treasuries in 2008, it sidestepped the "dead money" periods of the static portfolios.

Overall Performance Metrics (1971–2024)

Table 1: Performance Statistics across asset classes and strategy (1971–2024)

Metric	**Stocks (S&P 500)**	**Bonds (10Y Treasuries)**	**60/40 Bench-mark**	**Dynamic Strategy**
Terminal Wealth	$58.49	$23.25	$37.05	$67.85
Annualized Return	8.32%	6.38%	7.35%	8.64%
Annualized Volatility	17.46%	7.57%	10.73%	8.94%
Max Drawdown	-56.70%	-30.30%	-32.95%	-27.03%
Sharpe Ratio	0.30	0.29	0.32	0.49

Table 1 quantifies this structural advantage. The Dynamic Strategy delivered the highest annualized return (8.64%) with volatility comparable to a bond portfolio (8.94%).

This results in a **Sharpe Ratio of 0.49**, significantly superior to the 0.32 of the 60/40 benchmark. This confirms that the strategy's alpha comes from *efficiency*, not excess risk-taking. We essentially achieved equity-like returns without paying the "volatility tax" usually required to get them. Achieving returns that surpass the S&P 500 while limiting the maximum drawdown to -27%, compared with the S&P 500's more than double drawdown of -56.70%, is indeed a remarkable feat.

But of course, maximum drawdown and volatility metrics alone cannot be considered sufficient to support a definitive claim about safety. It is therefore necessary to examine the full drawdown profile, including the number of drawdowns, average drawdown magnitude, time spent underwater, the duration of recovery periods, and how the drawdowns compare with those of other assets during notable periods in market history.

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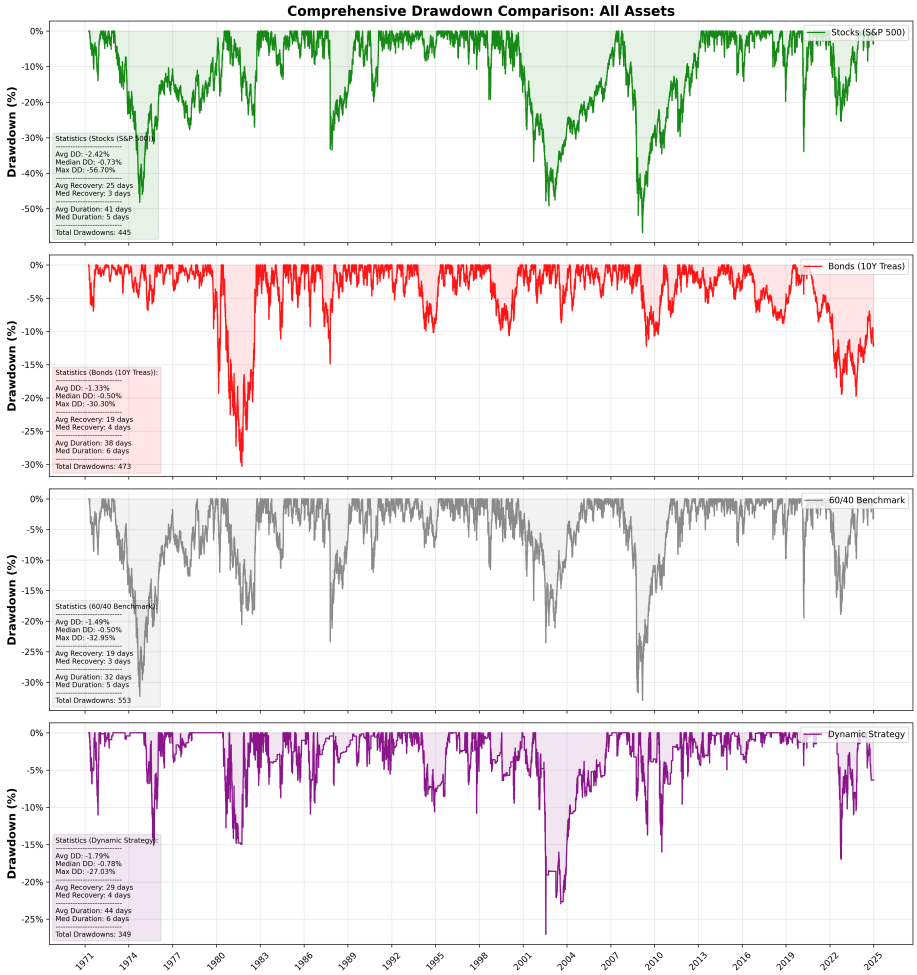

Figure 2: Drawdown Profile of S&P 500, 10Y Treasury, 60/40 Benchmark, and the Dynamic Strategy

While the S&P 500 suffered catastrophic drawdowns exceeding 56%, and the classic 60/40 benchmark endured declines of nearly 33%, the Dynamic Strategy's worst historical was comparatively shallower at 27.03%. Moreover, it recorded the fewest total drawdown events (349) of any asset class shown, suggesting a noticeably more consistent return profile that minimizes how often the portfolio actually declines. This lower frequency of drawdowns also indicates that the strategy spends a significantly higher percentage of its lifecycle at or near all-time highs compared to any static portfolio.

Although the average drawdown size and average recovery time are slightly larger than those of the benchmark (and comparable to the S&P 500), the fact

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that the total number of drawdowns is lower by over 200 events across a span of more than 50 years—while delivering the highest return—makes the Dynamic Strategy particularly appealing. Crucially, unlike the S&P 500, which is prone to deep and prolonged crashes, the Dynamic Strategy was able to largely sidestep the volatility of two of the most notable crises in modern market history: the COVID-19 crisis and the Global Financial Crisis.

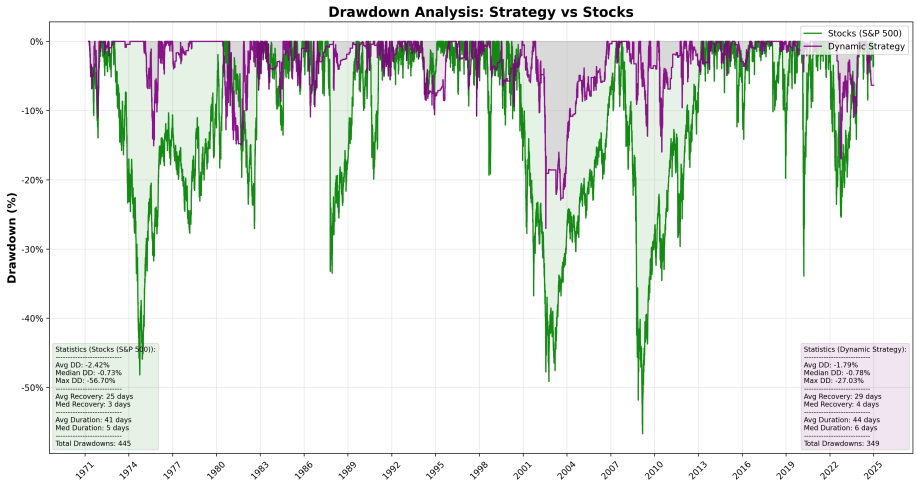

Figure 3: Comparison Between S&P 500 and Dynamic Strategy's Drawdown Curve

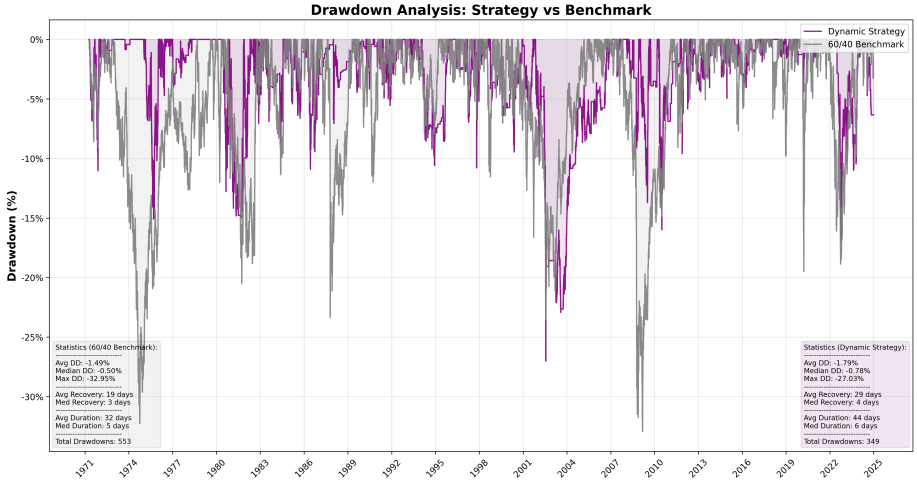

Figure 4: Comparison Between 60/40 Benchmark and Dynamic Strategy's Drawdown Curve

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The contrast between the strategy and the equity portfolio is even more apparent in Figure 3. We can see that the strategy's drawdown was consistently more subdued during virtually every instance of market decline.

Moving to Figure 4, we compare the strategy against the industry standard 60/40 benchmark. The visual story here is one of recurring resilience across widely different market environments. We can see immediately that the grey benchmark line is far more erratic, suffering significantly deeper and more frequent shocks throughout the decades compared to the more composed purple line.

While I note that the strategy did not always decouple—for example, during the inflation shock of 2022 and the dot-com crash, when both lines dipped—the broader historical context reveals a decisive structural advantage. Whether it was the inflationary grind of 1974, the violent, sudden shock of Black Monday in 1987, the systemic credit collapse of 2008, or the global economic shutdown triggered by COVID-19 in 2020, the strategy consistently 'cuts off' the tail risk.

In each of these distinct crises, the 60/40 portfolio—which relies on bonds to hedge stocks—failed to protect capital adequately. In contrast, the Dynamic Strategy was able to largely sidestep the volatility. This visual proof suggests that the strategy's defense mechanism is not specific to one economic cycle, but is robust enough to handle inflation, deflation, and liquidity shocks alike.

It is impractical to provide an exhaustive post-mortem for every major drawdown episode mentioned above—doing so would require a dedicated volume. However, for the sake of completeness, let's briefly examine one of the most distinct cases: Black Monday (1987). The mechanism that protected the portfolio here follows a pattern very similar to the other scenarios.

The strategy's resilience during Black Monday was not due to luck, but stemmed directly from its sensitivity to inflationary trends. While the stock market was caught up in a euphoric rally through mid-1987, the underlying macroeconomic data was already showing a sharp acceleration in CPI (Inflation Delta > 0). As a result, the algorithm classified the environment as a 'Reflation' regime well before the crash. This triggered an automatic rotation out of equities and into commodities. Consequently, when the S&P 500 plunged 22% on October 19, the strategy was already safely positioned in real assets—effectively sidestepping the brutal liquidity crisis that wiped out equity-only portfolios.

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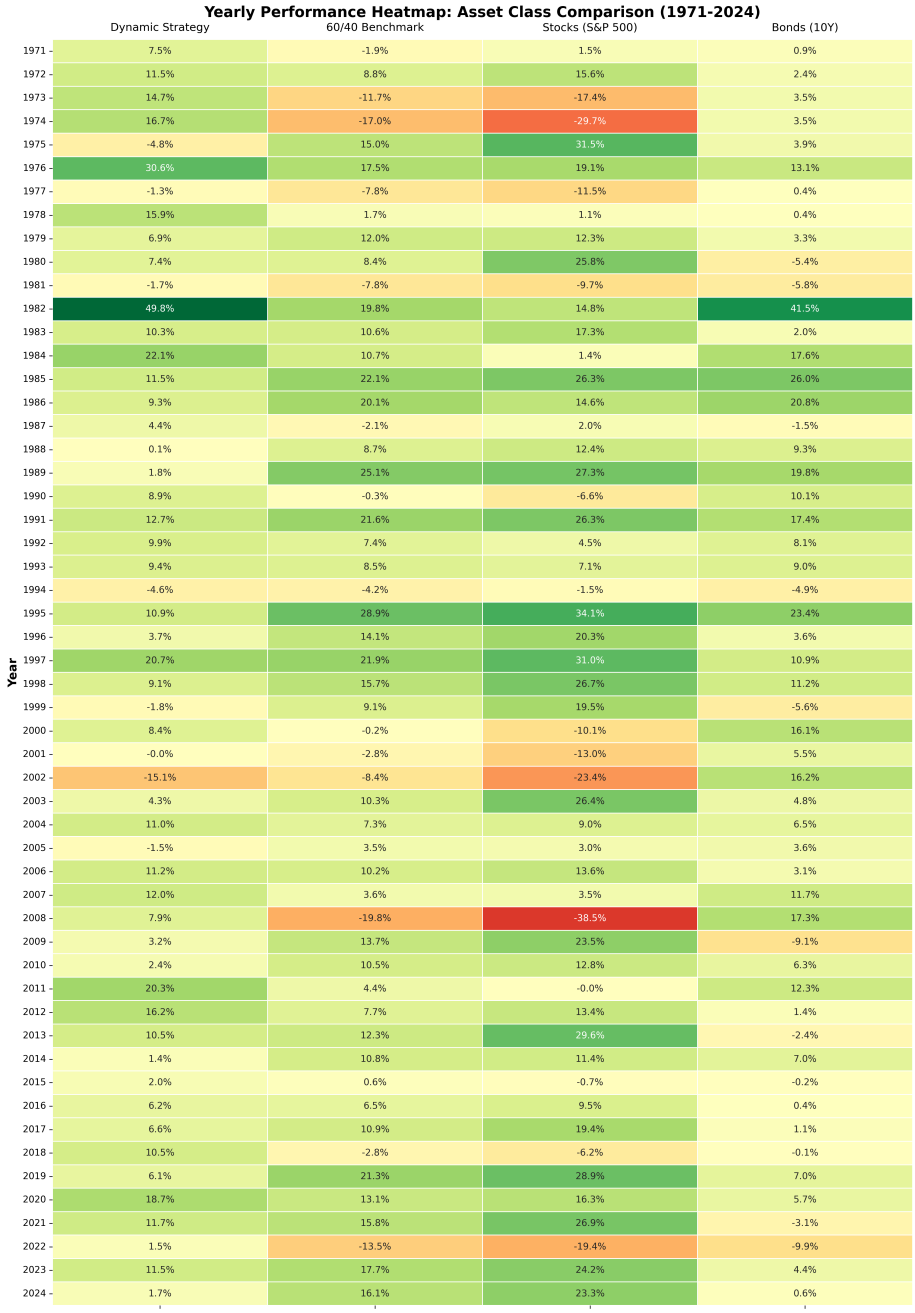

Figure 5: Yearly Returns Heatmap

Figure 5 presents a year-by-year heatmap of performance, which offers perhaps

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the most intuitive visualization of the strategy's value proposition. The visual contrast here is immediate: while the central columns (Stocks and the 60/40 Benchmark) are punctuated by deep blocks of red and orange—representing years of significant capital destruction—the Dynamic Strategy column on the far left remains overwhelmingly green.

This heatmap reinforces the 'winning by not losing' philosophy. If we look specifically at the infamous inflationary period of 1973–1974, the S&P 500 and the 60/40 portfolio are awash in red/orange. In stark contrast, the strategy posted positive double-digit returns in both years. We see this pattern repeat in 2008 and 2022: periods where traditional assets suffered double-digit declines, yet the strategy managed to stay positive.

Of course, there is a trade-off. In years of runaway equity bull markets (like 2013 or 2019), the S&P 500's 'deep green' outperforms the strategy's lighter green. However, the scarcity of red years in the first column demonstrates that the strategy succeeds in smoothing out the compounding curve, delivering positive returns in environments where traditional diversification fails.

4.2 Distributional Analysis

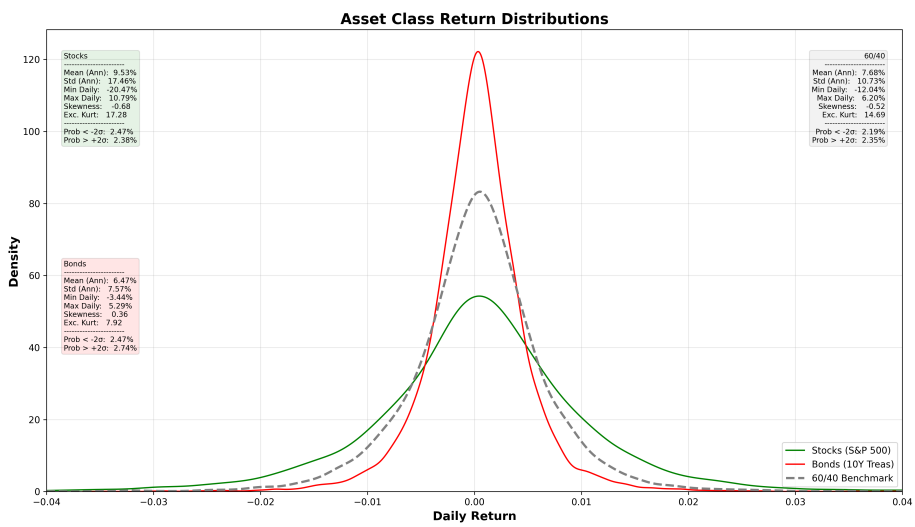

Figure 6: Distribution Plot Comparison Across Assets

After having examined the historical sequence of returns, we now turn to their statistical shape. Figure 6 establishes the baseline behavior of traditional asset classes. We can see clearly that the Equity curve (Green) is relatively flat and wide, illustrating the high variance and 'fat tail' risk inherent in stocks. Even the 60/40 Benchmark (Grey), while an improvement, retains a significant negative

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skew—meaning the distribution leans toward the left, indicating that extreme outliers are usually downside crashes.

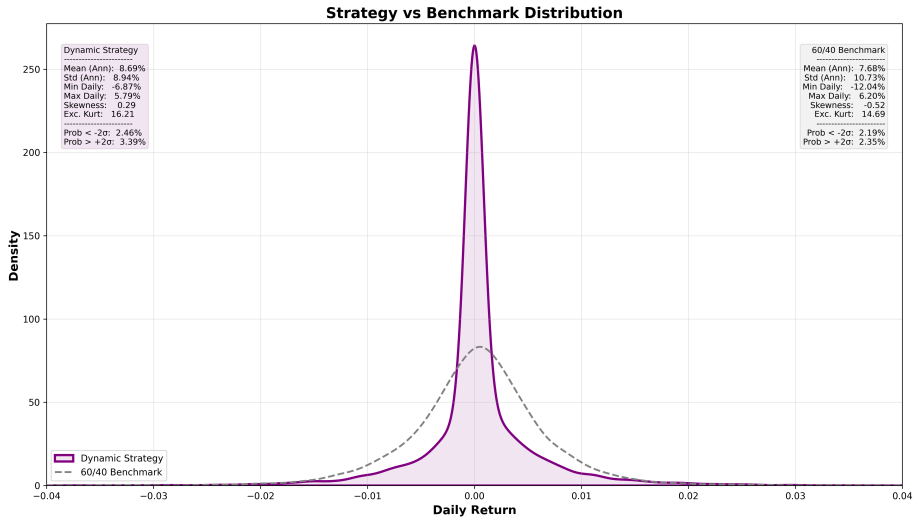

Figure 7: Distribution Plot Comparison of Dynamic Strategy and 60/40 Benchmark

The structural transformation of risk due to the dynamic allocation enabled by the strategy is revealed in Figure 7.

Visually, the most striking feature is the massive central spike in the Dynamic Strategy's distribution. This extreme 'peakedness' illustrates that the strategy spends the vast majority of its time producing small, stable returns clustered tightly around the mean, effectively eliminating the daily 'noise' seen in the flatter, wider profile of the 60/40 benchmark. However, because the visual lines at the far extremes of the distribution become microscopic to the naked eye, we must rely on the calculated metrics to truly understand the crash risk. The statistics box reveals that while the benchmark has suffered a single-day collapse of over -12%, the Dynamic Strategy effectively halved that risk, capping its worst daily loss at roughly -6.8%.

This shift in risk is best summarized by the Skewness metric. The benchmark exhibits a negative skew, confirming the old market adage that traditional portfolios tend to crash faster than they rise. The Dynamic Strategy flips this dynamic entirely, producing a positive skew. This indicates a fundamental change in the return geometry: structurally, the strategy is now mathematically more prone to 'upside surprises' than sudden downside shocks.

Now, to rigorously test the assumption of 'normality' in these returns, Figures 8 and 9 present Q-Q (Quantile-Quantile) plots. In these charts, if the data were

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perfectly normally distributed, the colored dots would align perfectly along the straight black diagonal line. Deviations from this line reveal where the hidden risks lie.

Figure 8: Q-Q Plot for S&P 500 Daily Returns and 10Y Treasury Daily Returns

The S&P 500 (Green) provides a textbook example of why standard risk models created based on the assumption of the daily returns following a normal distribution often fail during crises. Primarily, we need to notice the dramatic 'breakaway' in the bottom-left corner, where the dots fall significantly below the black trendline. This visually confirms that extreme negative events occur far more frequently and with greater severity than a normal distribution predicts, proving that the equity market possesses dangerous 'fat tails' that standard models simply cannot capture.

Crucially, the Bond market (Red) is not immune to this phenomenon either. While often viewed as the safe anchor of a portfolio, the Q-Q plot reveals that Treasuries also exhibit significant non-normality. We can see the red dots soaring well above the trendline in the top right quadrant, capturing the massive 'flight-to-safety' rallies where bond prices spike during equity panics. Conversely, the deviation below the line on the left confirms that bonds also face specific tail risks, likely driven by sudden inflation shocks or rate hikes. This demonstrates that even the defensive component of a traditional 60/40 portfolio is statistically unpredictable, swinging wildly away from 'normal' expectations in both directions.

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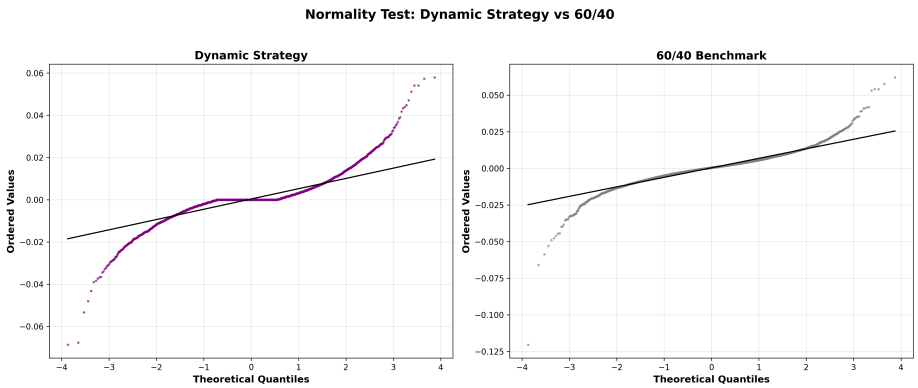

Figure 9: Q-Q Plot for Dynamic Strategy Daily Returns and 60/40 Portfolio Daily Returns

The structural advantage of the Dynamic Strategy becomes immediately clear when we compare its Q-Q plot against the 60/40 Benchmark in Figure 9. While the benchmark (Grey) attempts to dilute the risk of equities, we can see that it fails to eliminate the core statistical flaw: the dots in the bottom-left corner still break away significantly below the trendline. This confirms that even a diversified 60/40 portfolio retains the dangerous 'fat tail' characteristics of the stock market, leaving investors exposed to crashes that are far more severe than a normal distribution would predict.

In stark contrast, the Dynamic Strategy (Purple) reveals a completely different statistical geometry. To understand the magnitude of this difference, we must first look at the scale of the Y-axis. While the benchmark requires a scale extending down past -12% to capture its crashes, the Dynamic Strategy is entirely contained within a much tighter risk corridor, bottoming out around -6%. This means that although the purple dots do deviate from the black line, they do so within a range of volatility that is mathematically far safer.

Furthermore, the distinct 'S-shape' of the purple curve—flat in the middle and curving upward at the top right—visually confirms the positive skewness we noted earlier. The strategy spends the majority of its time producing stable returns clustered near the mean, and when it does break away from 'normality,' it tends to deviate to the upside. In essence, while the benchmark's non-normality represents hidden danger, the strategy's non-normality represents structural stability and upside potential.

4.3 Regime Attribution: The Source of Alpha

To understand the source of the strategy's outperformance, we move from a linear historical analysis to a Regime Attribution Analysis.

As we know, financial markets do not move in a straight line; they cycle through

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distinct economic environments. By isolating specific days where macro conditions met the criteria for Goldilocks, Reflation, Stagflation, or Deflation, we can grade our Dynamic Strategy's behavior conditional on the state of the economy. This 'stitched' analysis reveals whether the mechanism is truly adapting its behavior or simply riding a single favorable trend.

4.3.1 Goldilocks Regime

Table 2: Conditional Performance Analysis: Goldilocks Regime
(Rising Growth, Falling Inflation)

Portfolio	**Return (Ann)**	**Volatility**	**Sharpe**	**Sortino**	**Max DD**
Dynamic	16.15%	14.83%	0.80	1.13	-28.64%
60/40	10.31%	9.35%	0.65	0.92	-17.63%
Stocks	16.80%	14.93%	0.84	1.19	-28.23%
Bonds	6.40%	7.55%	0.29	0.40	-19.29%

The *Goldilocks regime*—characterized by rising growth and falling inflation—is historically the most favorable environment for risk assets. The primary criticism of most dynamic or "hedged" strategies is that they tend to lag during these bullish periods, acting as a drag on the portfolio.

The data, however, dispels this concern. As shown in the table, the Dynamic Strategy delivers an annualized return of 16.15% during Goldilocks periods, nearly matching the S&P 500's 16.80% and significantly outperforming the 60/40 benchmark (10.31%).

This high "capture ratio" confirms that the switching mechanism is sufficiently sensitive to growth signals. When the macro data gives the "all clear," the strategy effectively rotates into equities, participating fully in the upside. Unlike a permanent hedge that bleeds money during bull markets, this strategy proves it can act as a pure growth vehicle when the sun is shining.

4.3.2 Reflation Regime

Table 3: Conditional Performance Analysis: Reflation Regime
(Rising Growth, Rising Inflation)

Portfolio	**Return (Ann)**	**Volatility**	**Sharpe**	**Sortino**	**Max DD**
Dynamic	4.96%	3.08%	0.37	0.21	-1.48%
60/40	1.60%	10.92%	-0.20	-0.24	-25.37%
Stocks	1.84%	17.83%	-0.11	-0.13	-36.73%
Bonds	2.36%	7.02%	-0.21	-0.28	-17.22%

The value proposition of the strategy becomes evident as we transition to the *Reflation* regime. This environment, characterized by accelerating growth alongside rising inflationary pressure, often acts as a headwind for traditional financial assets.

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The performance divergence here is striking. While the 60/40 benchmark and the S&P 500 effectively stalled—delivering annualized returns of just 1.6% and 1.8% respectively—the Dynamic Strategy generated a steady 4.96% return.

This outperformance is a direct result of the algorithm's asset selection. During Reflation, the strategy rotates explicitly into Commodities. Since commodities naturally benefit from rising demand and pricing power, the portfolio is able to generate positive returns with extremely low volatility (3.08%) even while the broader stock market churns directionless with high volatility (17.83%). This regime highlights the benefit of leaving the financial economy (Stocks/Bonds) for the real economy (Commodities) when inflation begins to bite.

4.3.3 Stagflation Regime

Table 4: Conditional Performance Analysis: Stagflation Regime
(Falling Growth, Rising Inflation)

Portfolio	**Return (Ann)**	**Volatility**	**Sharpe**	**Sortino**	**Max DD**
Dynamic	3.26%	4.01%	-0.36	-0.08	-9.81%
60/40	4.81%	9.80%	0.01	0.02	-32.82%
Stocks	2.40%	16.21%	-0.14	-0.19	-50.11%
Bonds	6.35%	6.82%	0.24	0.35	-11.66%

The *Stagflation* regime—defined by slowing growth and rising inflation—represents the most hostile environment for a traditional portfolio. Historically, this is where the correlation between stocks and bonds breaks down, and where "buy and hold" investors suffer their deepest losses.

The table illustrates the devastation in the equity market: the S&P 500 suffered an annualized maximum drawdown of -50.11% during these periods. The 60/40 benchmark provided little shelter, losing nearly -33% as bonds failed to offset equity losses due to high inflation.

In stark contrast, the Dynamic Strategy limited its maximum drawdown to just -9.81%. While the annualized return was modest (3.26%), the primary objective in this regime is survival. By maintaining its allocation to Commodities (which act as a hedge against the inflation component of stagflation), the strategy avoided the catastrophic capital destruction seen in equities. This ability to "tread water" while the market collapses is mathematically the most valuable driver of long-term compounding, as it avoids the deep hole from which other strategies must spend years recovering.

4.3.4 Deflation Regime

Finally, we examine the *Deflation* regime—typically associated with economic recessions and market panics (such as the 2008 crash or the COVID-19 onset). In these periods, growth collapses and investors flee to safety.

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Table 5: Conditional Performance Analysis: Deflation Regime
(Falling Growth, Falling Inflation)

Portfolio	**Return (Ann)**	**Volatility**	**Sharpe**	**Sortino**	**Max DD**
Dynamic	10.27%	8.65%	0.70	1.02	-15.18%
60/40	13.17%	12.40%	0.72	0.96	-24.81%
Stocks	16.23%	20.11%	0.60	0.77	-45.09%
Bonds	10.15%	8.62%	0.68	1.00	-15.18%

The statistics confirm that the strategy operates exactly as designed. Notice the near-perfect alignment between the Dynamic Strategy and Bonds: they share an almost identical annualized return ($\sim 10.2\%$) and volatility ($\sim 8.6\%$). This confirms that the algorithm successfully identifies the deflationary signal and rotates the entire portfolio into Treasury Bonds.

While the S&P 500 remains volatile and dangerous in this regime (suffering a massive -45.09% maximum drawdown), the strategy serves as a safe haven. It is worth noting that the 60/40 benchmark actually posts a higher return here (13.17%), but it comes at the cost of a significantly deeper drawdown (-24.81%) due to its persistent equity exposure. By switching excl usively to bonds, the Dynamic Strategy prioritizes capital preservation, ensuring that the portfolio remains intact to redeploy capital when the cycle eventually turns back to Reflation or Goldilocks.

5 Discussion

The preceding sections have established the statistical superiority of the Dynamic Strategy through historical backtesting, drawdown analysis, and distributional testing. We have observed that the strategy not only delivers higher risk-adjusted returns but does so by structurally truncating the 'left tail' risk that plagues traditional portfolios.

However, empirical results alone are insufficient without a robust theoretical understanding of why the performance divergence occurred. In this section, we move from observation to explanation. We first deconstruct the mechanical failure of the 60/40 benchmark by analyzing the changing relationship between stocks and bonds. We then address the practical viability of the strategy by examining turnover and implementation costs, ensuring that the theoretical alpha is preservable in a real-world trading environment. Subsequently, we investigate the underlying drivers of the dynamic strategy's most pronounced drawdowns. Such post-mortem analysis of failure often lays the most fertile ground for meaningful progress beyond an initial, foundational model.

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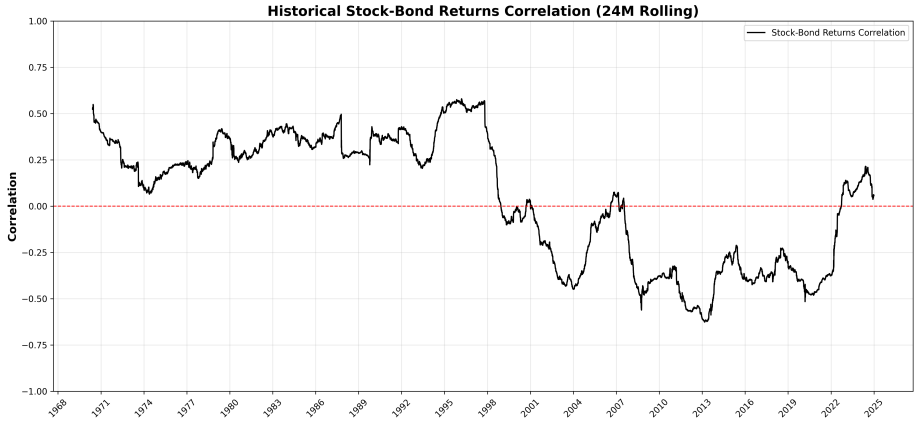

Figure 10: Historical Stock (S&P 500) Returns vs Bond (10Y Treas) Returns Correlation

5.1 The Correlation Mechanism and the Collapse of the Diversification Benefit

To understand why the 60/40 benchmark failed to protect capital in 2022 (and in the 1970s), we examine the rolling correlation between stock and bond returns. Figure 10 displays this relationship using a 24-month rolling window. The red dashed line represents zero correlation; the area below this line defines the *safe zone*, where bonds act as an effective hedge for equities, while the area above defines the *danger zone*, where diversification breaks down.

The chart reveals a stark historical truth: the negative correlation regime of the last two decades (2000–2021) was an anomaly rather than the rule. During this "Golden Era" of central bank moderation, the black correlation line remained persistently below zero. As a result, when equities experienced sharp drawdowns (e.g., 2008 and 2020), bonds reliably rallied, creating the impression that a static 60/40 portfolio constituted a robust risk-management framework.

In contrast, the left side of the chart (1970–1995) and the far right (2022–present) tell a very different story. During inflationary regimes, the stock–bond correlation turns positive. Throughout the 1970s and 1980s, the black line hovered well above zero, and it has again spiked sharply positive in the post-COVID period. In such environments, the foundational premise of the 60/40 portfolio collapses because both stocks and bonds decline simultaneously.

This visual evidence supports the central hypothesis of this report: a static allocation is only viable in a deflationary or stable-growth world. In regimes dominated by inflationary shocks (Reflation or Stagflation), the stock–bond correlation becomes positive, rendering bonds ineffective as an equity hedge. The Dynamic Strategy succeeds precisely because it is not structurally constrained

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to hold both assets when they move in tandem. Instead, it escapes the correlation trap by rotating into a different asset class (Commodities) that thrives in inflationary environments.

We must also consider the institutional anchor that made the 'Golden Era' of negative correlation possible: Central Bank Independence (CBI).

For the past three decades, the market assumed that the Federal Reserve would prioritize inflation control over short-term political goals. This credibility allowed bonds to act as a hedge; when growth slowed, the market anticipated rate cuts without fearing runaway inflation. However, this structural anchor is currently under threat. The rising trend of 'Fiscal Dominance'—where monetary policy is increasingly pressured to accommodate government spending—undermines this dynamic.

Recent challenges to institutional norms, exemplified by overt political pressure on the Federal Reserve during the Trump administration and continued fiscal expansionism, introduce a new risk premium. If the market perceives that the Central Bank has lost the political autonomy to fight inflation, inflation expectations become unanchored. In such a regime, bonds lose their deflationary protective characteristics and instead trade in tandem with risky assets—effectively locking in the positive correlation structure we see emerging on the far right of Figure 10.

5.2 Implementation Viability: Turnover and Friction Analysis

A common critique of active strategies is that theoretical alpha is often consumed by transaction costs ("churn"). To validate the real-world viability of this model, we analyzed the turnover profile.

Table 6: Turnover and Trading Friction Analysis (1971–2024)

Metric	**Value**
Total Trading Years (252 days)	50.90
Total Asset Switches	193
Average Switches per Year	3.79
Assumed Cost per Trade	0.10%
Annual Friction Drag	0.3792%
Gross CAGR (No Transaction Costs)	8.64%
Net CAGR (After Costs)	8.26%

The results, presented in the turnover report, reveal a highly efficient mechanism. The strategy averages just 3.79 asset switches per year. This low turnover rate confirms that the algorithm is not a high-frequency trading system chasing daily noise; rather, it tracks persistent macroeconomic cycles which evolve over months and quarters.

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Efficiency of the Signal

It is worth noting a structural efficiency in the design: the strategy does not necessarily trade every time the regime changes. For instance, a shift from *Reflation* to *Stagflation* alters the economic label, but the asset allocation (Commodities) remains the same. This *signal overlap* naturally suppresses unnecessary turnover, allowing the portfolio to ride long trends without incurring transaction costs during minor macro jitters.

The Cost of Business

To model a conservative "real-world" scenario, we applied a friction cost of 10 basis points (0.10%) per switch—a prudent estimate given the high liquidity of the underlying asset classes. Even with this penalty, the Annual Friction Drag is limited to approximately 0.38%, resulting in a Net CAGR of 8.26%.

This net performance highlights the strategy's exceptional efficiency.

- **Vs. The Benchmark:** It significantly outperforms the 60/40 portfolio (Net 8.26% vs 7.35%) while carrying roughly half the historical drawdown risk.
- **Vs. Equities:** Perhaps most impressively, the strategy effectively **matches** the total return of the S&P 500 (Net 8.26% vs 8.32%). However, it achieves this parity with drastically lower volatility (8.9% vs 17.5%) and without subjecting the investor to the catastrophic near -50% drawdowns inherent in pure equity investing.

In conclusion, the Dynamic Strategy delivers **equity returns** with **bond-like stability**. The fact that this is achievable with low turnover and minimal friction drag confirms that the strategy is robust, tradeable, and scalable, rather than being just a theoretical artifact of a frictionless backtest.

5.3 Limitations and Robustness

While the backtest demonstrates significant structural alpha, we must acknowledge some key limitations to assess the strategy's practical implementation:

Signal Lag and Data Revisions The model relies on macroeconomic data (CPI and Industrial Production) which is subject to reporting lags and subsequent revisions. In a real-time trading environment, preliminary data releases may be noisier, potentially leading to false signals or "whipsaws" that are smoothed out in the historical record. Future implementation would benefit from testing against "vintage" (unrevised) data to quantify this discrepancy.

Concentration Risk and Career Risk To isolate the "pure" signal of each asset class, this model utilizes a binary (100% allocation) switching mechanism. In an institutional context, such extreme concentration is often impractical due to tracking error constraints and internal risk limits. A volatility-

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targeted implementation or a "tilt" approach—using these regime signals to overweight/underweight asset classes relative to a strategic benchmark rather than exiting them entirely—would likely offer a more palatable path for deployment.

5.4 Case Studies: Signal Divergence

While the aggregated performance metrics validate the long-term efficacy of the Dynamic Strategy, relying solely on multi-decade averages can often times obscure the specific mechanical risks inherent in the model. To truly understand the strategy's robustness, we must conduct a forensic examination of the periods where it faltered. We are essentially trying to detail the mechanisms that precipitated some of the notable drawdowns faced by the dynamic strategy.

2002 Drawdown Inspection

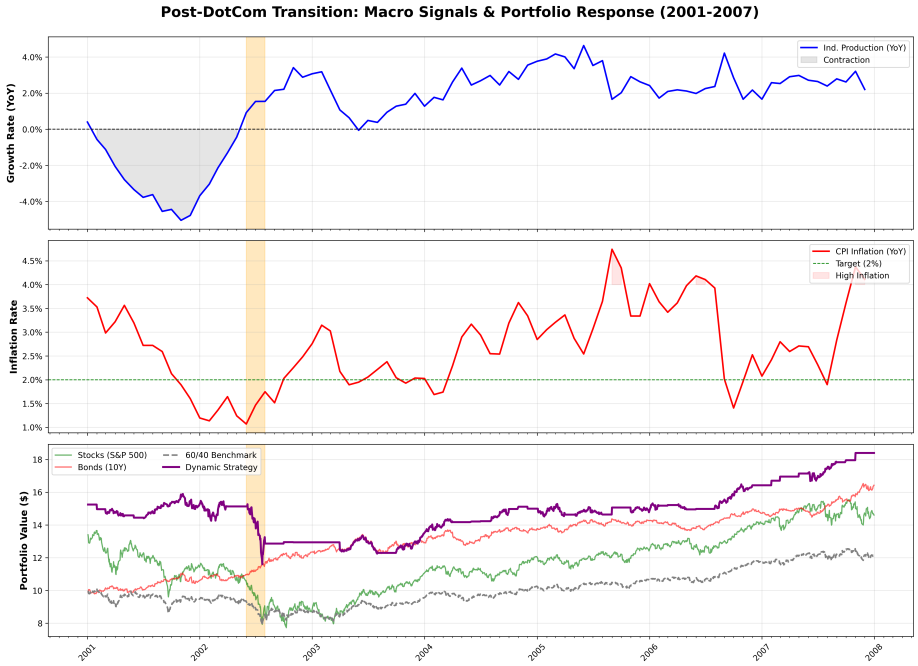

Figure 11: Performance and macro-regime inspection during the 2001–2007 period *(highlighting the significant 2002 drawdown of the dynamic strategy)*

In Figure 11, we are trying to provide a granular view of the disconnect between economic recovery and consequent market action. As illustrated in the top panel, the US economy began to exit recession in early 2002, with Industrial Production aggressively accelerating. Simultaneously, the inflation signal exposes a subtle vulnerability inherent in rule-based systems.

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In June 2002, our 3-month lookback mechanism correctly identified a downward trend in CPI. However, strictly following this mathematical slope ignored the broader context: inflation had already fallen to nearly 1%, significantly below the Federal Reserve's target. In such an environment, the probability of the trend continuing downward is statistically negligible due to the natural mean-reverting properties of monetary policy.

While a human discretionary trader might recognize that inflation cannot stay below target indefinitely, the algorithm blindly extrapolated the downtrend, locking in a 'Disinflationary' signal just as the cycle was bottoming. This edge case highlights a potential avenue for model improvement: incorporating mean-reversion thresholds or 'floor/ceiling' logic to prevent the model from betting on the continuation of trends that have already reached their logical extremes.

Coming to the drawdown in 2002, during that time, although the 'Real Economy' was recovering (as shown by the top panel in the figure), the 'Financial Economy' was still purging the extreme valuation excesses of the Dot-Com bubble, exacerbated by the WorldCom accounting scandal. The algorithm effectively bought into the Goldilocks signal which unfortunately forced the investor to endure the wash-out of the bear market. This informs us that even though macro regimes tend to drive long-term returns, short term structural deleveraging can sometimes completely override positive fundamental signals.

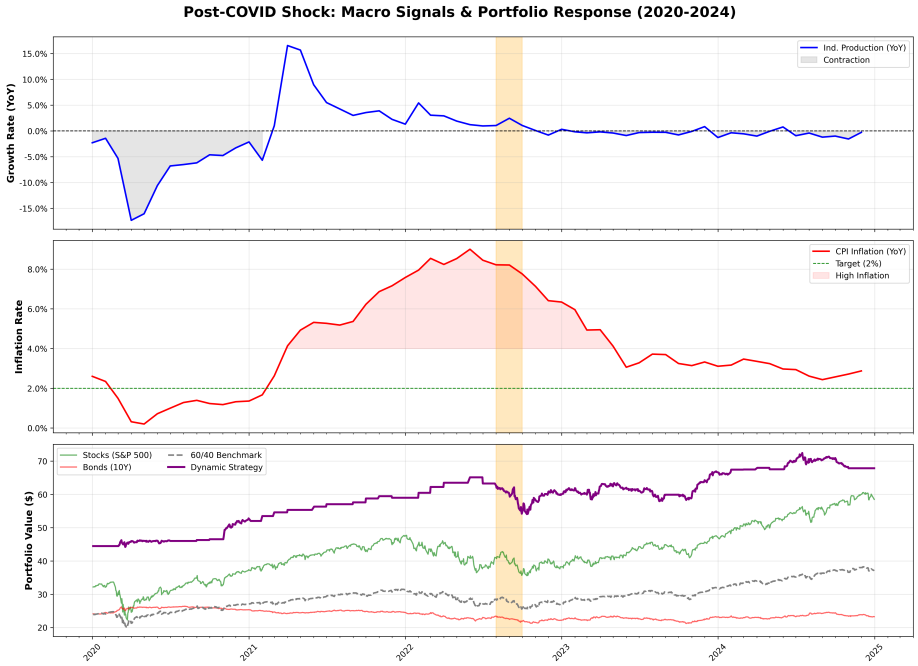

Figure 12: Performance and macro-regime inspection during the 2020–2024 period *(highlighting the significant 2022 drawdown of the dynamic strategy)*

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2022 Drawdown Inspection Similar to Figure 11, Figure 12 illustrates the mechanics of a drawdown, with the late-2022 period highlighted in orange. At the start of the shaded zone, the model detected slowing growth and inflation momentum, triggering a Deflation signal. Consequently, it rotated 100% into 10-Year Treasuries.

However, instead of acting as a safe haven, bonds sold off as the Federal Reserve signaled a 'higher for longer' policy stance to combat inflation. Just like in the previous case, understanding the broader context could have prevented this allocation. With absolute inflation near 8%, the central bank was structurally forced to keep rates high regardless of the slowing growth trend. Had the model been sophisticated enough to incorporate this absolute level constraint, it might have rejected the Bond signal—perhaps defaulting to Cash (T-Bills) as the only viable defensive asset in a regime where both stocks and bonds are falling.

The drawdown was compounded in the subsequent month by a classic signal whipsaw. A transient uptick in Industrial Production ('The Blip') combined with slowing CPI triggered a shift into Goldilocks (Equities). As the chart illustrates, this growth signal proved to be statistical noise rather than a durable trend change; the slow downward trajectory resumed shortly after.

But, it is important to acknowledge that these specific types of whipsaws are an inherent characteristic of a systematic trend-following endeavor. Without the benefit of hindsight, distinguishing between a true trend reversal and temporary data noise in real-time remains the central challenge for any rule-based strategy.

6 Conclusion

The central premise of this research was to challenge the reliance on static asset allocation in an era of regime instability. For decades, the 60/40 portfolio has served as the default solution for risk management, predicated on the assumption that bonds will always hedge stocks. However, our analysis of the rolling correlation structure (Figure 10) demonstrates that this relationship is historically fragile, breaking down precisely when protection is needed most—during periods of inflationary stress.

The Dynamic Regime Strategy proposed in this report offers a robust alternative. By abandoning static weights in favor of a macro-sensing mechanism, the strategy transforms the "weather" of the economy—Growth and Inflation trends—into actionable signals. The results of this 54-year backtest are definitive: the strategy effectively matches the long-term total return of the S&P 500 (Net CAGR 8.26% vs. 8.32%) while carrying the volatility profile of a bond portfolio.

This asymmetry is the strategy's defining characteristic. Through the "lost decade" of the 1970s, the shock of Black Monday in 1987, and the systemic collapse of 2008, the mechanism proved its ability to decouple from equity risk.

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While our forensic analysis of the 2002 and 2022 drawdowns highlights the inherent vulnerability of trend-following during periods of signal divergence—specifically when macro trends conflict with absolute valuation or inflation levels—the aggregate performance confirms the strategy's structural resilience. It achieved this not through predictive clairvoyance, but through structural adaptability—rotating into Commodities during Stagflation and Treasuries during Deflation. Statistical analysis confirms this shift, showing a transformation from the "negative skew" (crash-prone) profile of the benchmark to a "positive skew" (stable) profile.

Looking forward, the case for dynamic allocation is strengthening. As the global economy faces the headwinds of fiscal dominance and unanchored inflation expectations, the negative correlation between stocks and bonds can no longer be guaranteed. Neither can we guarantee the "free lunch" of diversification. The data suggests that the only way to preserve capital without sacrificing growth is to evolve from a portfolio that holds everything to a portfolio that knows what to hold and when to hold it. The Dynamic Strategy provides the blueprint for that evolution.

7 Future Research/Further Improvements

Beyond the ideas mentioned in section 5.4, here are some other potential improvements:

- **Vintage Data and Nowcasting**
  The current backtest relies on final, revised macroeconomic data. A critical next step is to re-evaluate the signal efficacy using 'vintage' or 'point-in-time' data—using only the preliminary GDP and CPI numbers available to investors on the specific trading date. Furthermore, integrating modern 'Nowcasting' techniques (using high-frequency alternative data to predict monthly CPI prints before they are released) could significantly reduce the signal lag identified in Section 5.3, potentially improving entry and exit timing.

- **Continuous Weighting vs. Binary Switching**
  Our model currently employs a binary 'On/Off' switch (e.g., 100% Equities or 0%). Future iterations should explore continuous weighting functions. Rather than exiting an asset class entirely, the algorithm could adjust weights dynamically based on the magnitude of the macro trend (e.g., a 'Z-score' approach). For instance, a mild inflation signal might trigger a 20% tilt toward commodities, while an extreme inflation shock triggers a massive rotation. This would reduce turnover and tracking error.

- **Volatility Targeting (Leverage)**
  One of the most striking findings is that the Dynamic Strategy achieves equity-like returns with bond-like volatility ($\sim$8.9%). This suggests the

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strategy is 'capital efficient' but under-risked relative to an equity mandate. Future research could explore applying Volatility Targeting (e.g., leveraging the portfolio to target a constant 12% or 15% volatility). Theoretically, since the Sharpe Ratio is high (0.49), applying leverage to normalized volatility could generate significantly higher absolute returns than the S&P 500 without exceeding its risk budget.

- **Granularity within Inflation Hedges**
  Currently, the model uses a broad Commodities basket (PPI) as the sole hedge for Reflation and Stagflation. However, different inflationary regimes favor different assets. For example, 'Reflation' (Growth + Inflation) typically favors Industrial Metals and Energy, while 'Stagflation' (Slowing Growth + Inflation) historically favors Gold and TIPS (Treasury Inflation-Protected Securities). Decomposing the 'Commodity' bucket into these granular sub-components could further optimize the strategy's precision during inflationary stress.

Access to the entire backtesting engine is provided in the GitHub repository, the link to which is posted alongside this PDF. Further discussions and feedback are welcome!

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