Regime-Based Asset Allocation:
A Practitioner’s Guide to Late-Cycle, Pre-Recessionary Investing

By Bruce Stewart, CAIA®, CIMA®
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A PRACTITIONER’S GUIDE TO LATE-CYCLE, PRE-RECESSIONARY INVESTING

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Editor’s note: This article is a follow-up to the Investments & Wealth Monitor article, “Introduction to Regime-Based Asset Allocation” (Stewart 2020). The author has updated and tailored the article to today’s macroeconomic environment.

According to the International Monetary Fund, tentative signs in early 2023 that the world economy could achieve a “soft landing” have receded amid stubbornly high inflation and recent financial sector turmoil. Although inflation has declined as central banks have raised interest rates, underlying price pressures remain sticky and labor markets remain tight in several economies. Side effects from the rapid rise in interest rates are becoming apparent as banking sector vulnerabilities have come into focus and fears of contagion have risen across the broader financial sector, including non-bank financial institutions.

Meanwhile, on Wall Street, there is broad consensus that the United States likely will endure an economic slowdown starting in late 2023, as the Fed’s rapid rate hikes from March 2022 through May 2023 fully impact the economy. There is, however, a significant divergence of opinion regarding what is to come during the following quarters.

According to the Fed, a best-case scenario has the United States making a soft landing, with low growth rates continuing through mid-2024 when growth could reaccelerate. However, a downside scenario could have the United States enter a prolonged recession lasting through 2024 and even into 2025. As most professional investors are aware, economic regime change is a constant condition that advisors should consider leaning into rather than shying away from under the guise of staying the course or managing an all-weather portfolio. A healthy balance between emotional discipline and regime awareness may add significant value—especially with the list of economic unknowns lengthening.

CORE TENETS OF REGIME-BASED ASSET ALLOCATION

Most studies concede that the majority of portfolio returns come from asset allocation.1 History also has shown us that it’s the economy, not the markets, that ultimately drives returns over the extended term. Regime-based asset allocation (RBAA, see sidebar) is grounded in the premise that asset classes will perform differently when affected by various economic scenarios referred to as regimes. As an example, investment-grade bond returns are

DEFINITION OF REGIME-BASED ASSET ALLOCATION*

Regime-based asset allocation (RBAA) is a strategy used by investors to adjust portfolios based on the prevailing economic or market conditions, i.e., regimes. Portfolio managers allocate investments across different asset classes based on the expected performance under different market conditions.

The core premise behind RBAA is that distinct asset classes perform differently under different market regimes that last between six months and up to four years. This is not a form of tactical asset allocation whereby short-duration sector, style, or market-cap bets are made where portfolio turnover is excessive, e.g., risk assets tend to perform well during times of economic expansion but risk-off assets tend to perform better during recessions.

To implement this strategy, portfolio managers typically identify several market regimes and assign specific asset allocation weights to each regime. For example, an investor might allocate a larger portion of a portfolio to small-cap equities during the first half of a bullish market regime and shift to more defensive assets such as short-duration bonds during the early stage of a bearish market regime.

RBAA requires careful analysis of economic and market indicators, as well as a deep understanding of how different asset classes behave under different market conditions. Although RBAA is not infallible, evidence suggests that broad moves as described can limit some of the downside that all-weather portfolios present.

inversely correlated to interest-rate changes. Commodity prices often will be driven by expectations that prices will rise when inflation expectations increase and fall as inflation ebbs.

Asset class behavior also can vary significantly over shifting economic scenarios. For example, business cycles tend to impact cyclical and noncyclical companies in markedly different ways, primarily due to sensitivities of consumers and producers to economic growth. Yet, although asset class performance certainly varies with changing conditions, traditional asset allocation approaches make no effort to adapt to such shifts. Instead, traditional approaches seek to develop static all-weather portfolios that optimize efficiency across a range of economic scenarios.

Different economic regimes produce significant impacts on various asset returns and risks, albeit to varying degrees. Dynamically rebalanced asset classes have an objective of increasing returns while reducing risk. A formal RBAA strategy could therefore be an option for investors seeking to manage a portfolio across multiple business cycles.

The business cycle represents the collective fluctuations in economic activity that play a crucial role in determining asset performance over the medium term. Historical evidence suggests that changes in key economic indicators can serve as reliable markers for identifying the distinct phases of the economic cycle: early, mid, late, and recession.

RBAA seeks to identify these business phases, providing a structured framework for making asset allocation decisions based on the likelihood of asset outperformance or underperformance.

RBAA comprises²:

**Active risk management.** RBAA involves adapting portfolio allocations to different market conditions. By allocating assets based on expected performance during different regimes, investors potentially can reduce portfolio volatility and minimize downside risk exposure during unfavorable market conditions. Example: reducing growth equity into fixed income as interest rates rise when inflation expectations increase.

**Active diversification.** RBAA encourages diversification across different asset classes and sectors. By diversifying across various regimes, investors potentially can benefit from different investment opportunities and reduce the concentration risk associated with specific market conditions. Example: rotating from low–earnings high–beta growth into high cash–flow dividend–paying value.

**Performance optimization.** By dynamically allocating assets based on market regimes, RBAA aims to optimize portfolio performance. It seeks to capture positive returns during favorable regimes and minimize losses during unfavorable regimes, potentially enhancing overall portfolio performance over the long term. Example: reducing an allocation to small caps while increasing one to large caps with global reach.

**Flexibility and adaptability.** RBAA provides the flexibility to adjust portfolio allocations as market conditions change. It allows investors to respond to shifts in economic indicators and adjust their portfolios accordingly, taking advantage of opportunities or protecting against potential risks. Example: converting a portion of the portfolio to liquid alternatives—commodities, multi–strategy bonds, or options strategies—to reduce correlations but maintain liquidity.

**Active management approach.** RBAA involves an active management approach where investors continuously monitor economic indicators and make strategic adjustments to portfolio allocations. This active approach can provide a more responsive and adaptive investment strategy compared with passive, static allocation approaches. Example: acting when necessary, but not simply to act.

The RBAA framework begins with the premise that long–term historical averages provide reasonable baselines for portfolio allocations. However, over shorter time horizons—30 years or less—asset price fluctuations are driven by a confluence of various short–, intermediate–, and long–term factors that might cause performance to deviate significantly from historical averages. For this reason, incorporating a framework that analyzes underlying factors and trends among the following three temporal segments can be an effective asset allocation approach: tactical (1–12 months), business cycle (1–10 years), and secular (10–30 years). An asset performance driven by a combination of various short–, intermediate–, and long–term factors is shown in figure 1.
Over the intermediate term, asset performance generally is driven by cyclical factors tied to the state of the economy, including corporate earnings, interest rates, and inflation. The business cycle, which encompasses the cyclical fluctuations in an economy over a few years, can therefore be a critical determinant of asset market returns and the relative performance of various asset classes.

Every business cycle is unique, but patterns have emerged over time. Fluctuations in the business cycle essentially are distinct changes in the rate of growth in economic activity, in particular changes in three key cycles: the corporate profit cycle, the credit cycle, and the inventory cycle—as well as changes in monetary and fiscal policy. Although unforeseen macroeconomic events or shocks can disrupt a trend, key indicators historically have provided a reliable guide for recognizing the different phases of an economic cycle (see figure 2).

**Early-cycle phase (~ 1-year duration).** Generally, the early-cycle phase starts with a sharp recovery from recession, marked by an inflection from negative to growth in economic activity, e.g., gross domestic product and industrial production, then an accelerating growth rate. Credit conditions stop tightening amid easing monetary policy, creating a healthy environment for rapid margin expansion and profit growth. Business inventories begin low, with sales growth driving demand against fewer goods in the system. Historically, the early phase of the business cycle has produced the most robust stock performance on an absolute basis, with elevated upside volatility accompanying those gains.

**Mid-cycle phase (~ 4 years).** The mid-cycle is characterized by a positive but more moderate rate of growth than the early-cycle phase. Economic activity gathers momentum, credit growth becomes strong, and profitability is healthy against an accommodative, though increasingly neutral, monetary policy backdrop. Inventories and sales growth, reaching equilibrium relative to each other. Mid-cycle tends to be significantly longer than any other phase of the business cycle. As the economy moves beyond its initial stage of recovery and growth rates moderate during the mid-cycle, the leadership of economically sensitive assets typically has tapered. On an absolute basis, stock market performance has tended to be strong, though not as robust as in the early-cycle phase, while bonds and cash have continued to post lower returns than equities in the mid-cycle. This phase also is when most stock market corrections have taken place, with increased frequency of downside volatility—if not heightened amplitude of it, being more widespread.

**Late-cycle phase (~ 1.5 years).** The late-cycle phase often coincides with peak economic activity, implying that the rate of growth remains positive but slows. A typical late-cycle phase may be characterized as an overheating stage for the economy when capacity becomes constrained, which leads to rising inflationary pressures. Although rates of inflation are not always high, rising inflationary pressures and a tight labor market tend to crimp profit margins and lead to tighter monetary policy. As the recovery matures, inflationary pressures build, monetary policy becomes restrictive, and investors start to shift away from economically sensitive areas. On an absolute basis, average stock performance is roughly in line with cash.
Rising inflation that typically accompanies this cycle phase tends to weigh on the performance of longer-duration bonds, which lags the absolute returns of shorter-duration cash. In addition to economic indicators, the news cycle can drive more broadly elevated volatility during this phase.

**Recession phase (~ 9 months)**. The recession phase features a contraction in economic activity. Corporate profits decline and credit is scarce, monetary policy becomes more accommodative, and despite low sales levels, inventories gradually fall as companies reduce production to set up for the next recovery. The recession phase historically has been the shortest, lasting nine months on average from 1950 to 2020. As economic growth stalls and contracts, assets that are more economically sensitive fall out of favor—especially long-duration equities—and assets that are defensively oriented take their place. The stock market traditionally has performed poorly, with cash playing a defensive role and the falling interest-rate environment acting as a tailwind for bonds. Performance patterns relative to the strategic allocation have been significantly different in recessions than in the other three phases, most notably in the high frequency of outperformance for bonds and the opposite for stocks. Cash positions also enjoy their best performance relative to the balanced benchmark, albeit with only moderate hit rates. This phase of the business cycle tends to favor a high conviction in more defensive allocations.

**Recession sub-phases**

Conceptually, it is important to understand that a recessionary regime also is composed broadly of four sub-phases:

- **Early-recession phase**. During the early-recession phase, defensive sectors such as utilities, consumer staples, and health care tend to perform relatively well. These sectors typically provide essential products and services that consumers need, regardless of economic conditions.

- **Mid-recession phase**. In the mid-recession phase, cyclical sectors such as technology, consumer discretionary, and industrials might perform well as the economy begins to recover. These long-view, or long-duration, sectors are sensitive to changes in economic activity and might benefit as consumer spending and business investment return.

- **Late-recession phase**. During the late-recession phase, defensive sectors might continue to perform well as investors seek safety amid continued economic uncertainty. Additionally, value-oriented sectors such as energy and financials might outperform others as investors target undervalued assets.

**Recovery phase**. During the recovery phase, sectors that benefit from a growing economy, such as technology, consumer discretionary, and industrials, often outperform well. Additionally, sectors that were hit hard during the recession, such as real estate and financials, might recover as economic conditions improve.

As shown in Figure 3, economically sensitive stocks have tended to perform well in the early- and mid-cycle phases, bonds generally have delivered during the recessionary phase, and performance has been mixed during the late-cycle phase.

**RBAA TODAY: LATE-CYCLE INVESTING**

The saying goes that it’s a recession when your neighbor gets laid off, but when you get laid off it’s a depression. But what is it called when both you and your neighbor are working but worrying about possible layoffs, rising prices, and volatile stock markets? The answer is the late phase of the business cycle.

During Q1 of 2023, the U.S. economy transitioned into the late phase of the business cycle, with most of the characteristics now firmly entrenched. Nominal wage growth has reached historic highs, but high inflation has resulted in negative real wage growth, negatively impacting consumer confidence and income expectations. Although inflation is expected to moderate, it is anticipated to remain higher than in previous decades. Although the near-term risks of a recession are moderate, the economy might move through this late-cycle phase faster than in previous cycles.

During this late cycle, stock prices have (broadly) continued rising, albeit with increased volatility, and corporate earnings remain (mostly) on target—although there is softening at the edges. The timing of an eventual recession is
uncertain, however, due to the significant role played by Federal Reserve policies and government stimulus spending in the current cycle compared to previous ones, so this transition period may be different.

**TRANSLATING FROM LATE-CYCLE TO EARLY RECESSION**

Given the characteristics of the late cycle, it is prudent to review investment portfolios and ensure preparedness for an eventual downturn and the subsequent early-cycle recovery, both of which can present attractive investment opportunities.\(^5\)

If portfolio rebalancing is necessary, it can be helpful to examine the historical patterns of late cycles and recessions. It is crucial, though, to exercise caution when making portfolio adjustments during the late cycle, because markets during this phase tend to be historically volatile, and there is a possibility that a downturn could end the cycle prematurely.

Although each business cycle is unique, U.S. stocks historically have risen during the late cycle, averaging an annualized return of around 6 percent. However, market leadership often changes during this phase. In the past, rising inflation and interest rates have prompted investors to shift away from stocks of companies producing discretionary consumer goods, high-value consumables, and real estate. On the other hand, producers of energy, materials, consumer staples, and utilities have performed well.

In terms of asset performance (see figure 4), equities tend to outperform strongly in the early cycle, while stocks, bonds, and cash deliver more comparable returns in the late cycle. During a recession, stocks typically underperform. Information technology and consumer discretionary stocks have lagged during the late cycle due to inflationary pressures impacting corporate profits and capital spending, as well as investor preference for less economically sensitive areas.

The higher inflation and interest rates characteristic of the late cycle historically have affected longer-duration bonds negatively, but they also present opportunities for income-seeking bond investors. Cash historically has outperformed bonds during the late cycle, with money market investments and certificates of deposit benefiting from higher rates.

Commodities such as oil, wheat, iron ore, and copper traditionally have been favored by investors during the late cycle. These commodities historically have shown price increases in line with inflation and ongoing demand, providing diversification from increasingly volatile stocks. However, trade wars, the COVID-19 pandemic, and rising geopolitical tensions have disrupted the historical relationships between commodity prices and the business cycle.

Although commodities still can serve as diversifiers during the late cycle, investors should be aware of the potential for underperformance as the cycle transitions into a recession. Utilizing commodity exchange-traded funds, mutual funds, or multi-asset strategies can help capture the benefits of commodity exposure while managing risk.

Understanding what lies beyond the late cycle is crucial, because it typically concludes with a recession. Although recessions generally are the shortest phase of the business cycle, stocks have experienced an average annual loss of 15 percent.

In most recessions, investment-grade corporate and government bonds have outperformed stocks and cash, benefiting from falling interest rates that commonly are observed during economic downturns.

History demonstrates that the late cycle often has delivered positive returns for stock and bond investors; however, it is not a phase for the faint-hearted. Increasingly gloomy economic indicators and headlines, along with the casual use of the term “recession,” may challenge even the most disciplined investors and instill anxiety about the future. Nevertheless, it is crucial to acknowledge the lessons of history, which indicate that recessions usually are short-lived and followed by an improvement in economic conditions.

**OTHER CONSIDERATIONS**

Successful regime investing is predicated on modeling the relationships between asset returns and economic performance drivers. Research shows that it is important to model relationships that are both dependent and nonlinear.\(^6\) Modeling such relationships is complex for both conceptual and practical reasons. For example, a simple scatter plot of S&P 500 returns and U.S. real...
gloss domestic product growth may not reveal much of a relationship at first, at least not a clearly linear one. But advanced nonlinear statistical techniques can help to identify and define the relationship. As prospects for economic growth improve, equity prices tend to rally. Beyond a certain threshold, however, the relationship begins to break down.

Of course, asset class and factor performance can be driven by more than just growth rates and other macroeconomic fundamentals. Financial markets can reflect extreme optimism or pessimism—as expressed in their valuations—over long periods of time, rather than pure economic fundamentals. In such cases, regime-based frameworks may prove inadequate for the purposes of developing robust and resilient portfolios. It might also be that the framework works but it is not evident until a future historical analysis has sufficient data points to function.

Successfully developing and executing an RBAA strategy does not require perfect forecasting skills. But even imperfect foresight is not necessarily easy to achieve.

Good economic foresight, systematically implemented in an RBAA framework, can add value. Good foresight would be defined as forecasting the direction of economic changes without attempting to predict magnitude. The former is much more important in determining the success of dynamic regime response. The more inaccurate the economic foresight, the lower the value added by the framework, as measured by the information coefficient. Developing even imperfect economic foresight is no small accomplishment.

Even with perfect economic foresight—the correct forecasting of the direction as well as the magnitude of economic changes—asset class response can be extremely difficult to capture. This is particularly true when the economy and financial markets experience new paradigms relative to history. In such circumstances, the relationship between economic factors and financial markets can change quickly, leading to potential underperformance of a regime-based approach relative to a static asset allocation model.

Of course, taxes and administrative effort are salient factors that may limit the ability of a portfolio manager to implement RBAA. Actively minimizing tax liability via tax-loss harvesting during RBAA rebalancing is a prudent tactic.

CONCLUSION
Every business cycle is different, and so are the relative performance patterns among asset categories. However, by using a disciplined business cycle approach to portfolio construction, it is possible to identify key phases in the economy’s natural ebb and flow and allocate accordingly. These signals can provide the potential to generate incremental excess returns over the intermediate term. When successfully incorporated into an asset allocation framework, analyzing underlying factors and trends across various time horizons provides useful information that not doing so disallows.

RBAA is differentiated in that it is data-driven and may not always follow standard capital-based asset allocation rules. It also doesn’t depend on the age, risk appetite, investment horizon, or diversification of the investor. The availability of new data prompts portfolio managers to look at rebalancing their portfolios. At a minimum, RBAA allows a portfolio manager to better assess total risk across all four moments of a return distribution by understanding how growth and inflation may affect specific asset prices. Relative to a static, all-weather portfolio, RBAA can contribute positively to the overall portfolio management process. Constructing an RBAA strategy, in conjunction with other traditional tools, could be a productive approach to maintaining a disciplined, unemotional approach to portfolio management.

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ENDNOTES
2. See Lim (2017) and Sheikh and Sun (2012).
5. See endnote 3.
7. See endnote 4.

REFERENCES