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When bonds stop hedging equities: rethinking portfolio diversification

Ludovic Subran
Chief Investment Officer and Chief Economist
ludovic.subran@allianz.com

Nils Bradtke
Senior Investment Strategist
nils.bradtke@allianz.com

Jordi Basco Carrera
Head of Private Markets Investment Strategy
jordi.basco_carrera@allianz.com

In Summary

- **The 60/40 portfolio has quietly stopped working.** The risk-adjusted return investors could reasonably expect from the standard balanced portfolio has fallen to roughly a third of its long-run level, from a Sharpe ratio of 0.47 to just 0.14, as bonds and equities have stopped hedging each other for the first time in a generation. Since mid-2022, the two have moved together rather than apart, with the equity-bond correlation flipping to a positive +0.77, and no comparable episode in the past quarter-century has behaved this way for anywhere near this long.
- **The culprit is policy uncertainty, not only inflation.** The reassuring story that 2022 was a one-off inflation shock and that everything returns to normal once prices settle does not survive contact with the data. Inflation still matters, but it is no longer the master variable. Tariff policy, geopolitical fragmentation and the slow erosion of central bank credibility are now doing the heavy lifting.
- **Gold, private credit and infrastructure are the diversifiers doing the work now.** Where government bonds have failed to catch equity drawdowns since 2022, three asset classes have quietly stepped into their place. Gold has delivered positive risk-adjusted returns in nearly every regime tested and is the closest thing to an all-weather hedge. Private credit is posting its strongest showing on record. Infrastructure has held up across both this cycle and calmer ones before it, a rare cross-regime performer.
- **A regime-robust 'No-Regret' portfolio, built to work across cycles rather than optimized for the current one, roughly doubles the risk-adjusted return of a standard global benchmark.** It delivers a Sharpe ratio of 1.33 against the benchmark's 0.59, compounds an initial dollar to roughly 9x its starting value over two decades against just 5x for the benchmark and cuts the deepest drawdown in the sample from –24.6% to –15.3%. The composition marks a substantial departure from tradition: government bonds are cut from roughly 20% of the benchmark to under 4% and public equities from 43% to 13%, funding materially larger allocations to gold (16%), private credit (29%) and private equity (16%), with a smaller residual position in infrastructure.
- **The historical hedge will return only once policy uncertainty resolves and inflation is fully re-anchored, and rate cuts alone will not do it.** Only two of the five preconditions for a durable return to negative equity-bond correlation are true binding constraints, and neither is something a central bank can deliver on its own. Genuine resolution likely requires a durable Iran settlement and a more stable US trade regime, and both look like multiyear propositions rather than near term fixes. The remaining conditions, on monetary and liquidity settings, equity valuations and the yield curve, follow mechanically once the first two are in place.

How 2022 snapped the 60/40 strategy

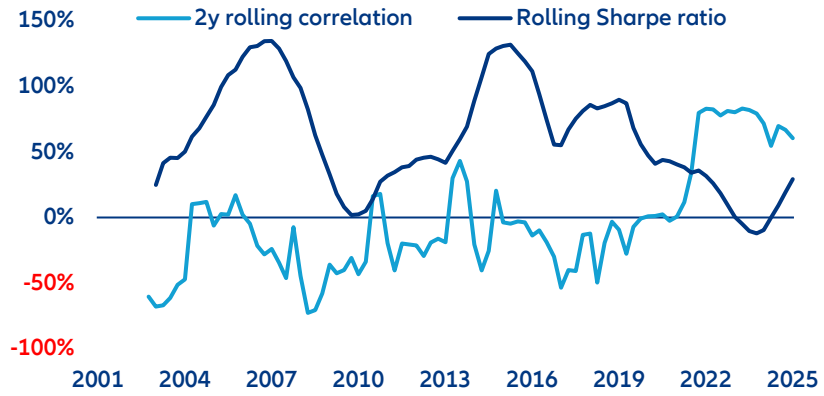
For two decades, the 60/40 portfolio did something rather remarkable: it made the difficult look dull. The formula was straightforward. Sixty cents of every dollar bought equities, which supplied the long-run growth. The other 40 went into government bonds, which stood by, patiently, waiting to catch the fall. When equities dropped, as they periodically did, bonds duly rose. Growth scares brought rate cuts, rate cuts pushed bond prices up and the 40% sleeve absorbed a decent share of the equity pain. Investors could speak, without embarrassment, of a portfolio that returned around 7% a year with the volatility of a mid-cap stock and the drama of an accountancy conference.

But it was a convention, not a law of nature. Yet it held often enough, and for long enough, that the entire architecture of modern retirement finance came to be built on top of it. Liability-matched pension books assumed it. Target-date funds mechanized it. An industry of insurance companies, endowments and family offices arranged themselves around the same quiet promise, that bonds would zig when equities zagged.

Then, in 2022, the convention snapped and the wound is still open. Between the early 2000s and 2021, a 60/40 book delivered a Sharpe ratio of roughly 0.47, a measure of how much excess return a portfolio earns per unit of risk taken (above 0.5 is respectable, above 1.0 enviable). It was unglamorous, but the sort of number pension trustees could take to their boards without flinching. In 2022, the hedge failed at the moment it was most needed. Equities and bonds sold off in unison, and the balanced portfolio delivered its deepest drawdown in a generation. A manager reviewing the year's returns could be forgiven for a moment of vertigo: the diversification premium, dependable for so long that it had ceased to feel like a premium at all, had simply vanished.

Four years on, markets have not forgotten. The Sharpe ratio implied by today's pricing on a 60/40 book sits closer to 0.14, less than a third of its long-run average. Portfolios that had been sold, quite reasonably, as boring have been forced to justify themselves anew (Figure 1).

Figure 1: When bonds stopped catching the fall (%)



Sources: LSEG Datastream, Allianz Research

At this point the industry has, predictably, split into two camps. The optimists take a relatively benign view. 2022 was an inflation shock and inflation shocks have always played havoc with the correlation between bonds and equities. Once inflation settles, and provided the world manages to avoid a second, 1970s-style episode, the old negative correlation should quietly reassert itself, as ordinary growth shocks reclaim the driver's seat. On this reading, patience is the only strategy required. The pessimists point to something rather harder to unwind. Fiscal and monetary policy have become, if not fused, then uncomfortably entangled. Geopolitical fragmentation is running at levels not seen since the end of the cold war. And central bank credibility, that intangible asset which underwrote so much of the previous cycle, has been slowly, publicly, corroded. On this view, the positive correlation can persist long after inflation itself has been tamed, because what has changed is not the price level but the framework around it.

In this paper we apply both theories to post-2022 data and find that the pessimists have the better of it, though with an important wrinkle. The dominant force behind today's positive correlation is not the monthly inflation print, awaited each month with such nervous attention on Wall Street, but policy uncertainty itself. Inflation still matters, of course. It shows up in the regression, alongside tighter liquidity, a flatter yield curve and stretched equity valuations, as a genuine driver of correlation. It is simply not the master variable. The implication is uncomfortable, particularly for those who have spent the past two years waiting for a single, clean catalyst. A first rate cut, however loudly cheered, will not on its own restore the hedge. Policy uncertainty is the binding constraint, and the bar for its removal is a good deal higher than markets are currently pricing. Investors counting on a return to the old regime may find themselves counting for some time.

Where are we in the cycle?

Five regimes, not one endless cycle. The temptation, when confronted with the current mess, is to reach for the nearest historical analogue and declare it a rerun of the 1970s. This is almost always a mistake. Instead of assuming the past 25 years amount to a single continuous cycle, we sifted the macro data into five distinct regimes, each with its own equity-bond correlation and, if one is honest, its own personality. The first, which we call liquidity and rates normalization, ran from 2001 to 2008 and produced the workhorse negative correlation of -0.38, not spectacular, but exactly the diversification investors had learned to expect. (Correlation runs from minus one, a perfect mirror image, through zero, no relationship at all, to plus one, perfect lockstep; the more negative the number, the more reliably bonds cushion equity losses.) Crisis and deleveraging, the label for the acute shocks of 2008-09 and 2020, was brief but violent, and pushed the correlation to -0.69, the strongest hedge in the entire sample; when the world briefly ended, in other words, bonds worked harder than ever. Post-crisis reflation, the recovery years of 2009 to 2012, offered a more modest -0.19, with wide credit spreads and a steep yield curve. Then came the long risk on expansion of 2012 to 2022, a decade in which valuations rose, volatility slept and correlations grew lazy, flattening the hedge to -0.12.

And then, in May 2022, the arrangement changed. Today's regime is the odd one out. Elevated rates, stubborn inflation, high policy uncertainty and a compressed yield curve have combined to push the equity-bond correlation to a +0.77, a figure without precedent anywhere in the past 25 years.

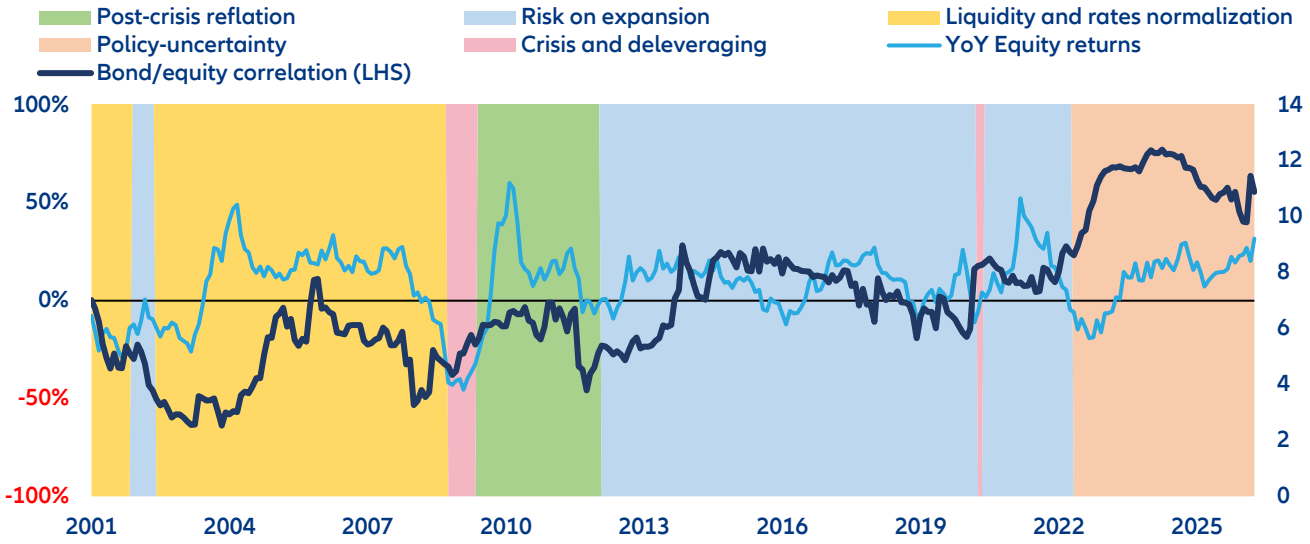
Overlay the five regimes onto realized equity returns and the rolling bond-equity correlation and a familiar picture emerges: The hedge holds through every "normal" regime and breaks only when inflation becomes the dominant shock. Through the dot-com bust and the subsequent recovery of 2003 to 2007, the correlation stays firmly negative, touching -60% even as equity returns swing from -40% to +40%. Rates and the shape of the curve did most of the work. The Fed entered 2001 with the funds rate still at 6.5%, cut aggressively through the dot-com bust to 1.75% by year-end and, because short rates fell faster than long ones, watched the curve steepen sharply even as growth expectations collapsed. That combination, elevated starting rates giving the Fed room to cut and a yield curve that could steepen on cue, is precisely the mechanism that lets bonds rally when equities sell off. It is, in other words, a textbook illustration of why bonds do their job as shock absorber at exactly the moment equities need them to.

Then came 2008. The global financial crisis was, above all, a credit and volatility episode. Those two forces dominated all other drivers, sentiment and growth expectations collapsed to sample lows and the recovery of 2009 and 2010 was a sharp, V-shaped affair driven by quantitative easing, which briefly, and unusually, pushed both equities and correlation higher together. What followed was the decade-long stabilization regime of 2011 to 2020, in which correlation settled into a shallow, range-bound negative-to-neutral band and equity returns unfolded in the calmer, low-rate manner that came to define the era. The Covid-19 shock of 2020 was narrow and sharp, marked by the highest readings in the sample for monetary and liquidity conditions as central banks intervened at unprecedented scale. It, too, resolved quickly.

The regime that breaks this pattern is defined by policy, not growth, and that is precisely why we do not expect it to resolve on its own. Since 2022, the correlation between bonds and equities has decoupled from its historical negative range and climbed into the 60% to 80% band, even as equity returns themselves have been comparatively muted. Unlike 2001, the Fed entered this shock with rates near zero, and there was, therefore, no room to cut when inflation and growth diverged. Instead, consumer price inflation and commodity inflation reached their highest levels in the sample, the dollar strengthened, equity valuations sold off, and hiking rather than cutting pushed bonds and equities in the same direction.

By 2024, the character of the shock had rotated. Inflation itself cooled, but policy uncertainty and interest rate levels took over as the elevated forces, while monetary and liquidity conditions sank to sample lows. Tariff policy and geopolitical shocks now sustain the same positive-correlation dynamic that inflation started. This, more than anything, is why the current regime should be treated as structurally different, not merely a noisier version of the stabilization years that preceded it (Figure 2).

Figure 2: A quarter-century in five acts (%)



Sources: LSEG Datastream, Allianz Research; Note: 2y correlation

The current regime is structurally different, not simply unusually long. Three features set it apart from every prior episode. The first is duration and consistency, every single quarter since May 2022 has fallen into this regime, and the average correlation has stayed stubbornly above +0.40 throughout. There is no precedent in the sample for that kind of persistence. The second is the identity of the dominant signal. It is not merely inflation, as many assumed at the outset, but policy uncertainty specifically. Our Economic Policy Uncertainty index, expressed as a z-score (that is, in standard deviations away from its long-run average, so that +1 means one standard deviation above trend and anything above +2 is unusually high), sits at +1.7 as of May 2026. It has been elevated since 2024, and briefly touched a remarkable +5.4 on "Liberation Day". The third, most awkward of the three is that this regime has never ended. Every quarter since May 2022 has remained inside it, with no observed exit anywhere in the historical record.

There are two plausible exits from here, and one rather less likely one. A transition into the risk on expansion regime, in which policy uncertainty resolves and liquidity conditions ease, is one credible route; a transition into the liquidity-normalization regime, in which rates settle into a predictable path and broad liquidity returns to the system, is the other. Both are structurally consistent with the way prior regimes have unwound. A direct jump into an acute crisis regime is also possible, though far less probable, and historically brief. Those episodes have, on average, lasted only around five months before resolving into something calmer.

What is driving the change in correlation? An anatomy of a broken hedge

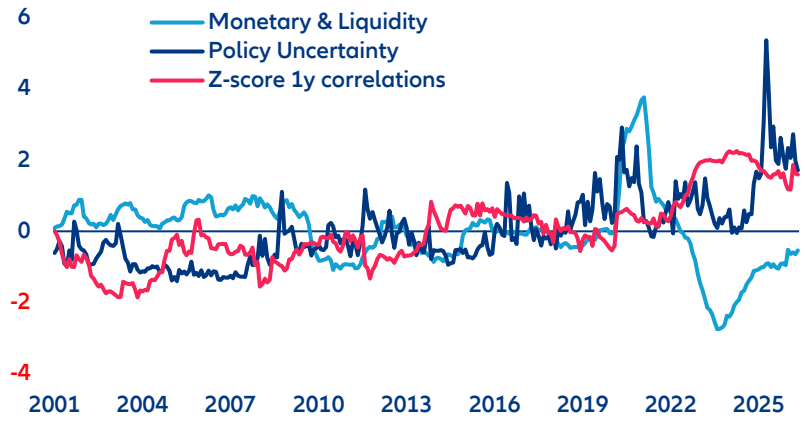
Policy uncertainty is the biggest driver, but inflation matters too. To work out which macro forces have actually been moving the equity-bond correlation, we regressed 25 years of rolling correlation data against five candidate factors. The results are unambiguous. Roughly two-thirds of the variation in correlation can be traced to those five drivers, and all five clear the usual statistical thresholds comfortably. Policy uncertainty emerges as the dominant force, pushing correlation firmly into positive territory whenever it rises. Monetary and liquidity conditions carry an almost identical, but opposite, effect, looser conditions restore the traditional hedge, tighter ones destroy it. Equity valuations turn out to matter more than most would guess. A stretched market pushes correlation up, a calmer one pulls it back down. A steeper yield curve, the mark of a "normal" rate environment, works quietly on the negative side. And inflation, contrary to those hoping the story is a pure policy-uncertainty morality play, also pushes correlation up in its own right, an effect that has been especially pronounced since 2022.

That inflation still matters is a corrective to the pure policy uncertainty story. The two forces have moved together, often, over the past two decades. In 2008 and 2020, the monetary and liquidity indicator surged to nearly 3.8 standard deviations above its long-run average, and correlation briefly flipped positive alongside extreme easing. In 2021, correlation turned positive ahead of the inflation shock itself. The two then rose together as consumer prices climbed, with CPI reaching 3.9 standard deviations above trend in 2022 while correlation's z-score ran up to a peak near 2. The post-2021 regime, in other words, was inflation-driven before it became uncertainty-driven.

The character of the shock rotated after that. In 2022, monetary and liquidity conditions collapsed to almost 2.8 standard deviations below trend as the Fed hiked, yet correlation stayed elevated: growth was no longer the master shock, inflation had taken over. Inflation then receded faster than correlation, which anchored near 1.5 to 2 through 2024 and 2025 as policy uncertainty stepped in as the marginal driver, consistent with the tariff-driven uncertainty of the second Trump administration. The sharpest reading in the sample, policy uncertainty touching 5.4 in early 2025, captures the “Liberation Day” shock. Uncertainty then remained stubbornly high through the escalation to "major combat operations" in the February 2026 Iran conflict, a longer and more consequential episode than the brief Israel-Iran strikes of June 2025 (which had only pushed Brent crude from around USD65 to the low USD80s before subsiding). All of it feeds the same inflation-and-uncertainty channel that has kept bonds and equities correlated near their sample highs.

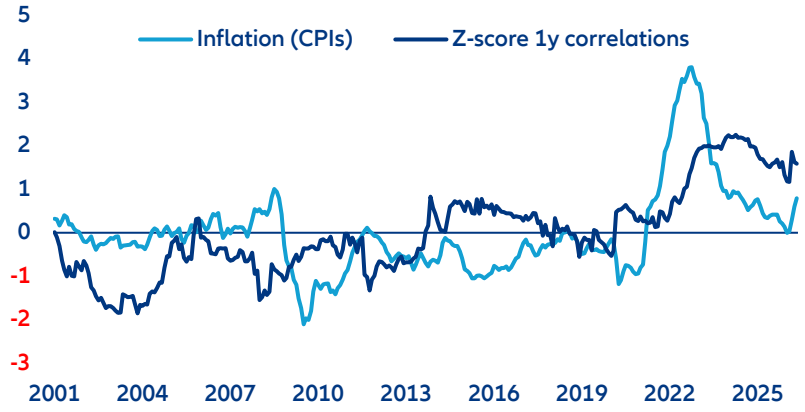
The model, reassuringly, still works. Its predictions match reality most closely when one or two forces dominate the regime, and most poorly when short, sharp shocks temporarily overwhelm the underlying macro drivers. The fit is at its best during the 2001 to 2008 and 2022 to 2026 windows, precisely when a small number of factors have been doing most of the driving, rates and the yield curve in the early 2000s, and policy uncertainty and monetary policy together from 2022 onwards. It tracks worst around the 2009 to 2010 rebound and the 2020 Covid-19 dip, when actual correlation overshot the model in both directions faster than macro variables could move. Those, unsurprisingly, are precisely the moments when positioning, liquidity dislocations and forced deleveraging drive realized co-movement independent of the fundamentals the model measures. The gap widens for a while, then both series converge again. Feeding May 2026 inputs into the model produces a predicted correlation reading of 1.05 standard deviations above the long-run average, against an actual reading of 1.59. Policy uncertainty is the largest contributor at +0.62, with equity valuations, monetary and liquidity conditions and inflation each contributing between +0.11 and +0.14, and a re-steepening yield curve chipping in a marginal +0.04. The gap of +0.54 between prediction and reality is larger than in prior months, consistent with a degree of regime persistence the underlying factors alone do not capture. The correlation has become, in effect, self-reinforcing. Portfolio managers have already cut their duration exposure in response to it, and their reduced participation keeps realized co-movement elevated even as the underlying drivers ease a fraction (Figure 3 and 4).

Figure 3: Where the correlation comes from (Z-scores)



Sources: LSEG Datastream, Allianz Research

Figure 4: The model, put to the test (Z-scores)



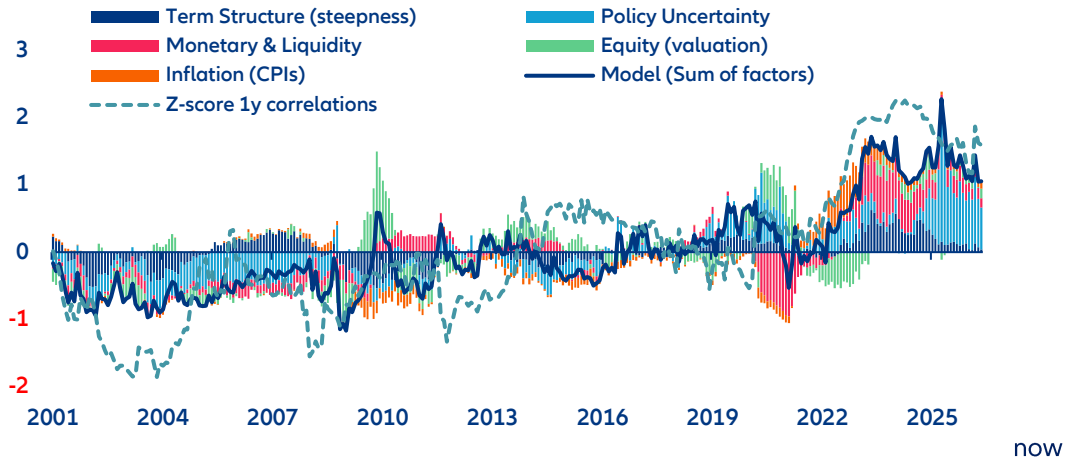
Sources: LSEG Datastream, Allianz Research

What has to happen before the hedge normalizes? A durable return to negative bond-equity correlation requires five conditions to line up. The good news is that only two of them are genuine constraints. The other three are largely endogenous to a normal easing cycle and should follow, mechanically, once it is underway.

The hard ones first. Policy uncertainty must recede, and inflation must remain on a credible disinflation path. Neither is something a central bank can deliver on its own, which is why we do not expect the hedge to return simply because the Fed or the ECB begin cutting. Policy uncertainty today is anchored by an unresolved geopolitical and trade backdrop, with the Iran conflict's ceasefire collapsing again in July 2026 and tariff policy still being litigated through the courts and alternative executive authorities. Genuine resolution likely requires a durable Iran settlement and a more stable US trade regime, and both look like multi-year propositions rather than near-term fixes. Inflation, for its part, has retraced most of its 2022 surge, but tariff pass-through and Gulf-driven energy volatility keep the disinflation path only partially secured.

The remaining three conditions should follow of their own accord. Monetary and liquidity conditions will loosen as the new Fed leadership under Kevin Warsh, who was expected at his May 2026 installation to lean toward easier policy but has so far held a more neutral stance, continues to cut rates. Equity valuations, a channel of similar size to policy uncertainty and liquidity in the updated regression, are likely to moderate as the AI capital-spending cycle cools or broadens into green-transition and infrastructure investment rather than through an outright shock. And the yield curve should steepen as a natural consequence of rates normalizing once the first four conditions are in train. Investors waiting on the first cut, in short, are waiting on the wrong thing (Figure 5).

Figure 5: The road back to a working hedge (Z-scores)



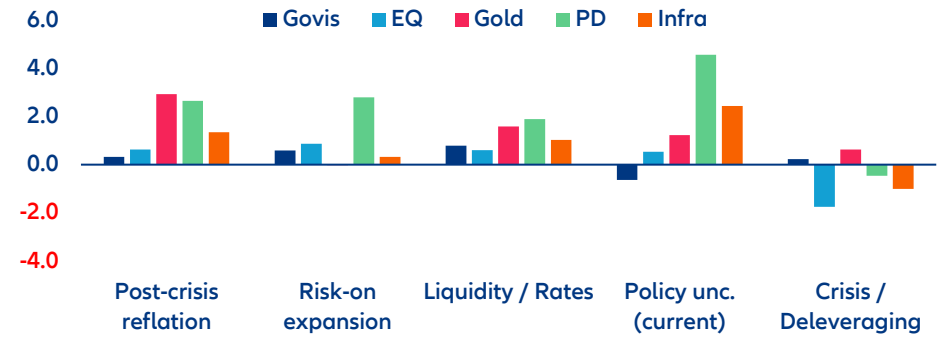
Sources: LSEG Datastream, Allianz Research

What are the implications for portfolio construction?

Some asset classes are earning their keep. In the current regime, the 15 asset classes we track are being sorted rather ruthlessly. Government bonds, agencies, investment-grade credit and inflation-linked bonds have all posted negative risk-adjusted returns in Regime 4 (the current policy-uncertainty and inflation regime, running since May 2022), the direct consequence of losing the very negative correlation that once made them portfolio anchors. Government bonds alone have swung from a positive Sharpe ratio in every other regime (between +0.22 and +0.78) to -0.64 in the current one. Public equities have held up, more or less, but without the tailwind of a hedge behind them: a modest +0.54, well short of their strongest showing during the risk-on expansion of the 2010s (+0.86) but nowhere near the collapse they suffered in the crisis and deleveraging regime (-1.75).

Three asset classes stand out as the genuine diversifiers of this cycle. Gold has delivered a positive Sharpe ratio in nearly every regime we tested, including the current one at +1.22, and its finest hour came in the post-crisis reflation of 2009 to 2012, at +2.92. It is the closest thing to an all-weather hedge in the dataset. Private credit has produced its best risk-adjusted performance of any regime in this one, at +4.55, quietly stepping in as a source of income where traditional fixed income has been failing. Infrastructure, meanwhile, has been the standout real asset, reaching +2.43 in the current regime while also holding up in calmer, more traditional regimes such as liquidity and rates normalization (+1.03) and post-crisis reflation (+1.34). It is one of the very few exposures with strong performance across both the current regime and the more typical ones that came before: a genuinely cross-regime diversifier rather than a regime-specific bet.

Figure 6: Where risk pays and where it doesn't (Sharpe Ratio (rf=2%, annualized))



Sources: LSEG Datastream, MSCI, Allianz Research

In the face of unexpected regime shifts, it makes sense to plan for the transition, not just the present. Regime 4 has a perfect track record, in our sample, of persisting rather than resolving. The more useful planning question, then, is not whether it will eventually end but what should change once it does. The two structurally plausible exits both point in the same direction. As policy uncertainty fades and liquidity normalizes, government bonds and investment-grade credit should regain a meaningful share of their traditional hedging role, while the current outperformers – private credit, infrastructure and gold – would see their relative advantage compress back toward more typical historical levels. That argues for holding today's tilts with conviction, but not permanently.

The No-Regret portfolio we define is built to perform across regimes, not just this one. A brief word on how we got there. The optimization blends three ingredients in a way that deliberately avoids over-relying on any single one. It starts from a market-capitalization-style prior allocation, which anchors the portfolio to the actual composition of investable capital in the world. It then nudges those weights using the return signal implied by market pricing itself, a standard technique known as Black-Litterman, which avoids the notorious instability of feeding raw historical averages straight into an optimizer. And it adds a modest tilt from a machine-learning model trained on each asset's own momentum and drawdown history. Diversification, turnover and tail-risk penalties are built into the objective directly and the final result is stress-tested by resampling across thousands of simulated histories rather than optimized against a single historical path. The final weights, in short, are not simply the one combination that happened to work best in hindsight.

The portfolio calculations are a mathematical exercise rather than a bespoke recommendation for any individual investor. As discussed, the optimizer does embed a series of modeling choices we set directly rather than resulting from historical return data alone. However, it does not account for market depth, transaction costs, asset manager fees, taxes or an investor's specific liquidity needs or mandate constraints. We assume a risk-tolerant, unbiased and unrestricted investor purely relying on mathematical concepts, which is rarely the case in practice.

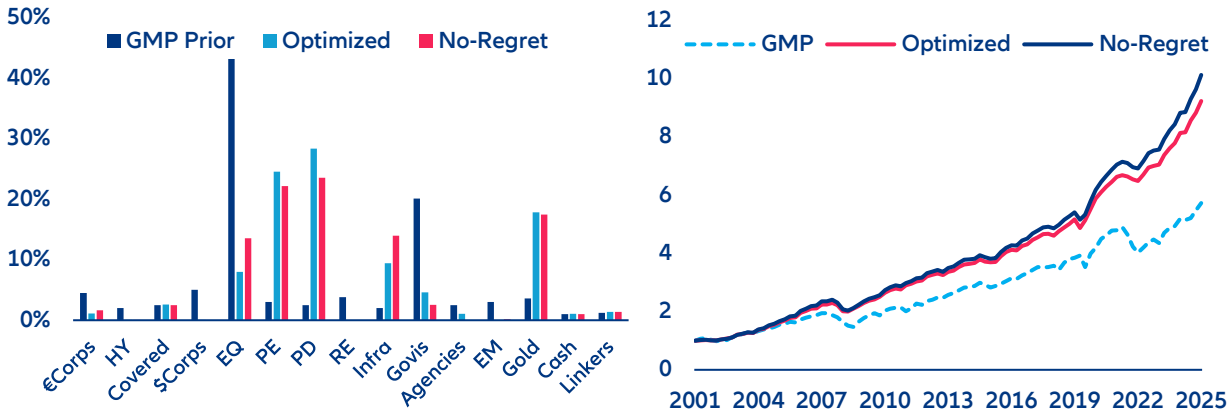
As such, the output should be read as an analytical starting point rather than an end point: a way to stress-test conventional allocations and surface where the mathematics disagrees with convention, with the actual translation into an investable portfolio left to an investment professional who can weigh it against real-world constraints.

On a full-sample, risk-adjusted basis, the No-Regret portfolio outperforms both a traditional benchmark and a portfolio optimized purely for the current regime. Optimizing a portfolio for the current regime works beautifully if the regime persists indefinitely, and rather less well the moment it does not. Instead, we constructed a blended No-Regret portfolio, using an equal-weighted average of all five regime correlations, with the current regime given double weight to reflect its higher-for-longer persistence. The blended equity-bond correlation embedded in the construction comes to +0.037, essentially neutral, against -0.032 using the full-sample quarterly correlation and +0.77 using the current regime alone. The result is a portfolio anchored around private markets and gold, with a reduced equity allocation and a small residual government bond position kept specifically as insurance for the eventual regime transition.

The shift away from the Global Market Portfolio (GMP) prior, which is roughly the market-capitalization-weighted mix of all investable assets globally and serves as the optimizer's neutral starting point, is large, consistent across methodologies and has paid off for two decades, not just recently. Private debt rises from a 2.5% prior weight to 28.5% in the No-Regret allocation, private equity from 3.0% to 15.9% and gold from 3.6% to 16.0%, while government bonds fall from 20.1% to just 3.6% and equities are cut from 43.2% to 12.6%. Reassuringly, an alternative construction built directly on the unconditional full-sample correlations rather than the regime blend lands in a broadly similar place on most positions. The tilt toward private markets and gold, in other words, does not appear to be an artefact of regime-weighting choices, it holds up even without leaning on the current regime at all.

The payoff has been persistent, not a recent flourish. Both the optimized and No-Regret portfolios compound from 1.0 to roughly 9x over the sample, clearly separating from the GMP benchmark's roughly 5x outcome by the mid-2010s and holding that gap through both the 2020 and 2022 drawdowns, consistent with Sharpe ratios of 1.35 and 1.33 against the benchmark's 0.59.

Figure 7: Two decades of compounding (allocation weights – left , cumulative NAV – right)



Sources: LSEG Datastream, MSCI, Allianz Research

On that basis, the No-Regret portfolio posts the second-highest Sharpe ratio of any portfolio we tested (1.33), behind only the full-sample optimized portfolio (1.35), which has the significant benefit of hindsight, and comfortably ahead of the Global Market Portfolio benchmark (0.59). Its maximum drawdown, at minus 15.3%, is meaningfully shallower than the benchmark's minus 24.6%, and notably better than a portfolio built purely around current-regime assumptions (minus 18.9%). That last portfolio, despite looking attractive on paper today, offers the weakest downside protection of the group once tested across the full cycle.

Table 1: Risk-adjusted performance across portfolio constructions

Portfolio	Sharpe ratio	Annualized return	Max drawdown
Global Market Portfolio (GMP)	0.59	7.1%	–24.6%
Optimized for current regime (R4)	1.07	10.0%	–18.9%
Full-sample optimized	1.35	9.61%	–12.9%
No-Regret portfolio	1.33	9.9%	–15.3%

Sharpe ratio uses rf = 2%. Figures based on quarterly data, 2001–2025 (97 observations).

Relative to a typical diversified benchmark, the resulting No-Regret mix makes three deliberate trade-offs: less public equity, materially less government bond duration and a substantially larger allocation to gold and private markets, particularly private credit and infrastructure. The optimizer switches public for private counterparts: Private equity offers higher returns with lower volatility than public equity; private debt carries slightly more volatility than government bonds but far higher returns. None of these tilts is extreme or all-in. They represent a rebalancing of emphasis toward the exposures that have actually protected portfolios through this cycle, without abandoning the assets that will matter again once the regime eventually turns.

The No-Regret allocation looks private. The optimizer overweight private markets and gold for a straightforward reason. These exposures combine higher risk-adjusted returns with genuinely low correlation to a standard 60/40 book, which is precisely the combination a mean-variance optimizer is built to chase. The diversification case is visible in the data. US private equity, private debt, and infrastructure move through distinctly different cycles rather than in lockstep: private equity's mid-cycle strength around 2016 to 2019 arrives as infrastructure is flat or negative, infrastructure's sharp 2016 and 2022 spikes come while private debt is subdued and the four series only really converge during the 2008 to 2009 and 2020 shocks, when almost everything sells off together.

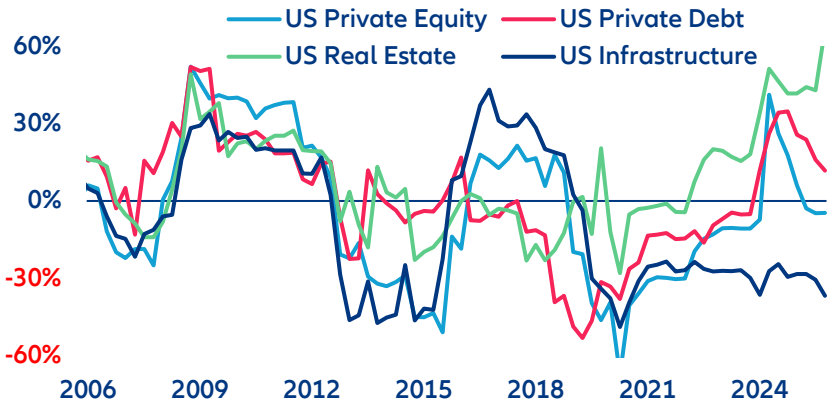
Table 2: Recommended allocation versus a typical diversified benchmark

Asset class	GMP (typical mix)	No-Regret (recommended)	Difference
Public equities	43.2%	12.6%	–30.6pp
Private equity	3.0%	15.9%	+12.9pp
Private credit	2.5%	28.5%	+26.0pp
Infrastructure	2.0%	13.5%	+11.5pp
Government bonds	20.1%	3.6%	–16.5pp
Gold	3.6%	16%	+12.4pp

GMP reflects a market-capitalization-weighted global benchmark spanning public and private asset classes. Figures are illustrative allocations, not personalized investment advice.

That pattern of usually uncorrelated, occasionally-jointly-stressed returns is precisely what shows up in the regime-level Sharpe ratios. Private debt posts its best risk-adjusted performance of any regime in the current one (+4.55). Infrastructure holds up across the current and calmer regimes alike (+2.43 today, and between +1.03 and +1.34 in earlier non-crisis eras). Gold, meanwhile, is positive in nearly every regime we tested. Higher Sharpe plus low correlation to the traditional stock-bond mix is, in a word, what the optimizer is rewarding when it reallocates away from equities and government bonds and into these exposures.

Figure 8: Private assets, dancing to their own beat (three-year rolling correlation of private assets with 60/40 portfolio)



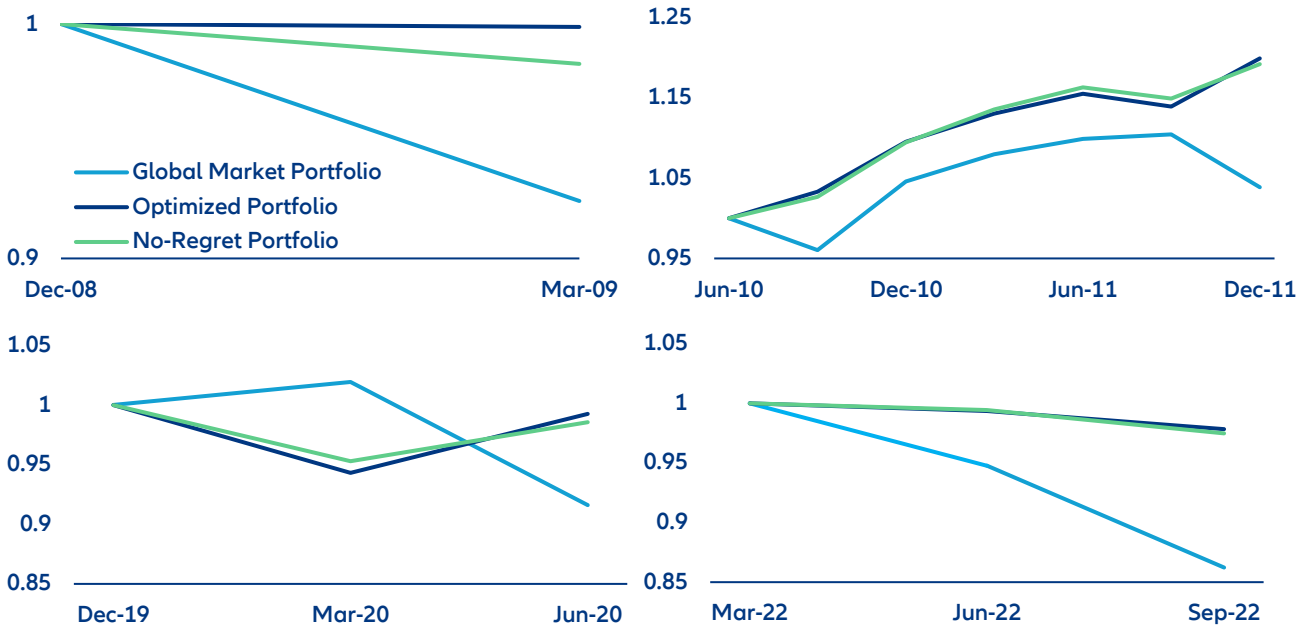
Sources: MSCI, Allianz Research

One important caveat. The shift into private assets is only appropriate for investors with genuine capacity to bear illiquidity risk. Private markets cannot be rebalanced or exited on short notice the way public equities and government bonds can. The allocation therefore assumes a long investment horizon, limited near-term liquidity needs and a governance structure able to tolerate multi-year lock-ups and unpredictable capital calls. Where that capacity is absent, the same diversification logic points to a smaller private-markets tilt, funded from public equity rather than from the liquid fixed income that may still be needed for near-term cash flow.

The cost of choosing robustness over point-optimality is small and well worth paying. The fully-optimized, full-sample portfolio edges out the No-Regret construction on both Sharpe ratio (1.35 versus 1.33) and drawdown (minus 12.9% versus minus 15.3%). But it does so only by implicitly assuming that the benign full-sample correlation structure persists, which is precisely the assumption this paper's diagnosis calls into question. Giving up 0.02 of Sharpe and roughly two additional points of drawdown, in exchange for a portfolio that is not quietly betting on the current regime never ending, is an easy trade.

The crisis-period behavior makes the case for that insurance plain. In the global financial crisis, the No-Regret portfolio held its NAV within two points of the fully-optimized one, while the Global Market Portfolio benchmark lost roughly 8%. In the 2022 rate shock, the one crisis actually built on the current regime itself, both No-Regret and the optimised construction held up far better than the benchmark, even as the portfolio built purely for today's regime actually gained ground. That last outcome is a useful reminder: the regime-specific optimum wins only if the regime in question is the one that actually materializes.

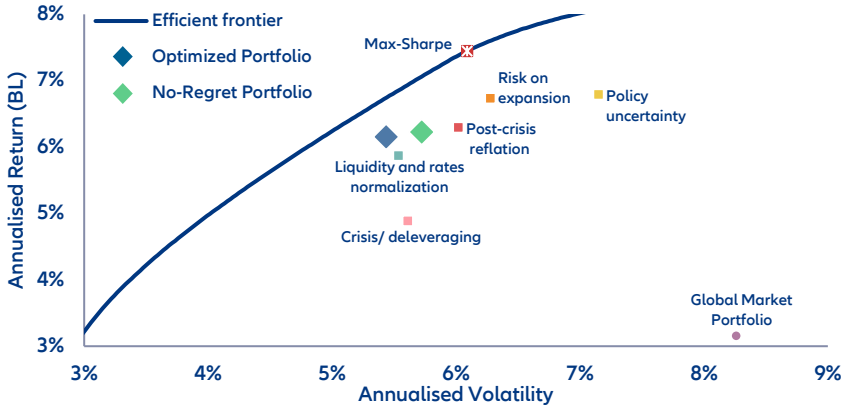
Figure 9: How each portfolio held up when it mattered (return rebased to 1)



Sources: LSEG Datastream, MSCI, Allianz Research

The Monte Carlo frontier confirms this is not a free lunch dressed up as one. No-Regret sits close to the efficient frontier with a Sharpe of 0.74, just behind the fully-optimized point (0.76) and ahead of every single-regime-optimal portfolio except Regime 2's risk-on construction (0.75), including the Regime 4-specific optimum (0.67 Sharpe, though R4 does carry the highest raw return among the regime portfolios, reflecting a bet on today's regime persisting). It sits well clear of the Global Market Portfolio benchmark (0.14). The frontier's true mathematical ceiling sits higher still, at a maximum Sharpe of 0.89, but only by concentrating nearly 70% of the portfolio in private debt alone, with gold, private equity and infrastructure making up almost all of the remainder and ten of the fifteen asset classes receiving no allocation at all. That portfolio is a mathematical artefact, not something any real mandate would hold. Taken together, the evidence says the No-Regret portfolio gives up only a modest amount of Sharpe (both against the fully-optimized point and against the true theoretical ceiling) in exchange for a portfolio that is actually diversified, and for materially better protection against downside risk and the one scenario this whole paper is built around: the current regime eventually ending.

Figure 10: Robustness, for a sliver of Sharpe



Sharpe ratios on this chart use Black-Litterman-blended (BL) returns, a shrinkage-adjusted version of historical averages. This is why the same portfolios (e.g. GMP, No-Regret) show different Sharpe ratios here than in Table 1.

Sources: LSEG Datastream, MSCI, Allianz Research

These assessments are, as always, subject to the disclaimer provided below.

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The statements contained herein may include prospects, statements of future expectations and other forward-looking statements that are based on management's current views and assumptions and involve known and unknown risks and uncertainties. Actual results, performance or events may differ materially from those expressed
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(v) persistency levels, (vi) particularly in the banking business, the extent of credit defaults, (vii) interest rate levels, (viii) currency exchange rates including the EUR/USD exchange rate, (ix) changes in laws and regulations, including tax regulations, (x) the impact of acquisitions, including related integration issues, and reorganization measures,
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