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When Bonds Stop Being *Ballast*

U.S. stock–bond correlations have shifted toward negative territory in May 2026 amid renewed inflation pressures and a paused Fed easing cycle, a meaningful risk-state signal that warrants measured portfolio adjustment, not a wholesale risk-off pivot.

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EXECUTIVE SUMMARY

The rolling 52-week stock–yield correlation has shifted back toward negative territory through early 2026, following a positive regime that held from April 2025. Headline CPI reached 3.8% year-over-year in April 2026 (realized), core PCE ran at roughly 4.3% annualized between December 2025 and March 2026 per RSQE May 2026 nowcast/forecast estimates (not finalized BEA data), and the 10-year Treasury yield hit a 52-week high of 4.668% on May 19, 2026. The Federal Reserve has held the federal funds target at 3.50%–3.75% for three consecutive meetings.

Critically, this correlation shift should be read as a **risk-state variable**, an input to scenario analysis, stress testing, and risk budgeting, rather than as a timing signal for equity allocation changes. Historical evidence shows correlation shifts do not reliably precede corrections; the 2022 breakdown itself fully reversed by 2023–25. The appropriate institutional response is incremental and reversible: shorten fixed-income duration, modestly increase real-asset and alternatives exposure, apply defensive tilts within equities, and, most importantly, upgrade stress-testing frameworks to incorporate multi-asset correlation-breakdown scenarios across a range of assumptions (approximately -0.30 to $+0.30$).

01. Empirical Analysis of Historical Correlation Regimes and Disruption Phases

[See Figure 1: Rolling 52-Week Stock–Yield Correlation] A historical analysis of the rolling 52-week correlation between the S&P 500 and the U.S. 10-Year Treasury Yield reveals that these asset classes have tended to cluster in broad macro regimes over long horizons, though these regimes are neither perfectly stable nor cleanly demarcated by observable thresholds.⁸ The episodes described below illustrate how correlation dynamics have interacted with macro shocks at specific historical junctures; they are not offered as evidence that correlation shifts reliably predict imminent equity corrections.³

From the late 1960s through the late 1990s, the stock–yield correlation was predominantly negative.³ High inflation uncertainty during this period drove the negative correlation, as inflation was a persistent drag on both corporate cash flows and bond prices.⁵ Within this negative regime, notable disruptions occurred in 1987 and 1998, as the rolling 52-week correlation temporarily spiked positively.³

The October 1987 disruption coincided with the Black Monday crash, where the S&P 500 fell approximately 20.5% in a single session, the Dow Jones Industrial Average declined 22.6%, driven by rising twin deficits, dollar depreciation, and systemic order imbalances including portfolio

insurance-related selling.¹⁵ During this crash, bond yields fell sharply as the Federal Reserve conducted expansive open market operations to inject liquidity, causing a temporary positive correlation spike.¹⁵

The 1998 disruption occurred during the Asian and Russian financial crises, culminating in the near-collapse of Long-Term Capital Management.¹⁸ Russia's default on its ruble-denominated debt triggered a massive global liquidity shock and a flight to quality.²¹ Investors flooded into liquid on-the-run U.S. Treasuries, driving yields lower while equity prices declined, resulting in a temporary positive shift in the rolling correlation.³

Following the dot-com bubble burst in 2000, the regime shifted into positive territory, where it remained for over two decades.⁸ Inflation during this era was exceptionally low and stable, allowing economic growth to act as the primary driver of asset prices.⁹ Disruptions to this positive regime occurred just before key market peaks.⁸ In 2007, prior to the Global Financial Crisis, subprime mortgage delinquencies began rising, credit card and auto loan defaults soared, and corporate credit spreads widened eight months before the S&P 500 peaked in October 2007.²³ This credit market stress drove bond yields lower while equities remained elevated, pushing the correlation into negative territory.⁸

In late 2015 and into early 2016, a collapse in global oil prices, which fell below \$30 per barrel in January 2016, coupled with growth concerns in China and the conclusion of the Fed's QE program (which had ended in October 2014), triggered a sharp global equity sell-off.²⁴ High-yield energy-sector bond defaults spiked, prompting a flight to safe-haven sovereign bonds that drove yields lower and briefly pushed the rolling correlation negative.²⁴

The positive regime collapsed in 2022 as post-pandemic supply chain disruptions, massive fiscal stimulus, and geopolitical conflicts drove inflation to a peak of 9.1%.⁵ The Fed's aggressive rate hike cycle drove the 10-year yield sharply higher, causing equities and bonds to fall in tandem in what was the first simultaneous annual loss for both asset classes in more than four decades.⁶

KEY EMPIRICAL COUNTERPOINT, THE 2023–25 RECOVERY

The 2022 correlation breakdown did not prove permanent. As the Fed's tightening cycle crested and inflation moderated through 2023 and into 2024–25, the stock–bond return correlation turned negative again and 60/40 portfolios recovered substantially, delivering meaningful positive returns. This recovery is a critical counterpoint to any claim that bond diversification was permanently broken by 2022. It underscores that even structural-looking correlation shifts can reverse as the macro regime evolves, and that declaring a definitive end to the negative stock–bond return correlation regime after a single inflationary episode overstates the evidence.

Note: Correlation regime changes have limited demonstrated value as stand-alone tactical timing tools for equity markets. Some correlation shifts have coincided with the onset of bear markets (2007); others occurred during episodes that resolved without severe drawdowns (2015) or were precipitated by shock events largely independent of the macro correlation backdrop (1987). The academically appropriate application in institutional portfolio management is as a *risk-state variable*, a measure of how portfolio volatility and diversification properties are evolving, not as a reliable signal for short-term equity allocation changes.

Historical Correlation Regime Table

PERIOD / DISRUPTION	PRIMARY STANCE P(S,Y)	DISRUPTION VECTOR	KEY MACRO & GEOPOLITICAL TRIGGERS	EQUITY & PORTFOLIO IMPACT	MONETARY POLICY CONTEXT
1970s– 1990s Regime	Negative ($\rho < 0$)	Persistent regime	Supply-side energy shocks, soaring oil prices, structural stagflation ⁵	Long-term valuation compression, frequent cyclical recessions ⁹	Highly hawkish Fed fighting entrenched price pressures ⁵
1987 Disruption	Negative ($\rho < 0$)	Shifted positive	Rising twin deficits, dollar depreciation, program trading glitches ¹⁵	Black Monday; S&P 500 declined ~20.5% in a single session ¹⁵	Fed intervened with immediate liquidity support and credit easing ¹⁵
1998 Disruption	Negative ($\rho < 0$)	Shifted positive	Russian ruble devaluation, EM contagion, near- collapse of LTCM ¹⁸	Intraday equity sell- offs and extreme credit spread widening ¹⁹	NY Fed brokered private consortium rescue; Fed cut rates aggressively ¹⁸
2000–2022 Regime	Positive ($\rho > 0$)	Persistent regime	Secular stagnation, low stable inflation, dominant demand-side shocks ⁹	Prolonged equity bull markets; highly resilient asset valuations ⁹	Highly accommodative policy, ZIRP, and Quantitative Easing ¹¹

PERIOD / DISRUPTION	PRIMARY STANCE P(S,Y)	DISRUPTION VECTOR	KEY MACRO & GEOPOLITICAL TRIGGERS	EQUITY & PORTFOLIO IMPACT	MONETARY POLICY CONTEXT
2007 Disruption	Positive ($\rho > 0$)	Shifted negative	Subprime defaults, banking liquidity strains, widening credit spreads ²³	S&P 500 peaked Oct 2007, preceding a 54% global equity drawdown ²⁹	Fed transitioned to emergency rate cuts and balance sheet expansion ³
2015–16 Disruption	Positive ($\rho > 0$)	Shifted negative	Oil below \$30/ bbl (Jan 2016), China growth concerns, post- QE anxiety ²⁴	Major global equity corrections; high-yield energy- sector bond downdrafts ²⁴	First Fed rate hike in ~a decade (Dec 2015); volatility briefly paused cycle ²⁴
2022 Regime Shift	Negative ($\rho < 0$)	Regime shift	Post-pandemic supply disruptions, fiscal stimulus, war in Ukraine ⁵	Steep equity bear market; first simultaneous stock & bond annual losses since 1977 ⁶	Aggressive Fed hiking cycle; FFR raised >500 basis points ⁵
Apr 2025 – Early 2026	Positive ($\rho > 0$)	Regime restabilization	Inflation moderation, steady corporate earnings, resumed Fed rate cuts ³¹	Equities hit record highs; balanced portfolios performed well ³¹	Fed implemented consecutive rate cuts to close out 2025 ³¹
May 2026 Shift	Negative ($\rho < 0$)	Rapid negative shift	Middle East conflict, energy price shocks, core PCE reacceleration ³⁴	Equity market corrections; VIX exceeded 30 ⁷	Fed halted rate cuts; FFR held at 3.50%– 3.75% ³¹

02. Macroeconomic Catalysts of the May 2026 Regime Reversal

After holding a positive regime stance since April 2025, the rolling 52-week correlation between stock prices and bond yields has shifted back toward negative territory through early 2026.⁸ This shift is associated with a renewed inflationary impulse weighing on both asset classes. Headline CPI inflation reached 3.8% year-over-year in April 2026 (realized data), driven in part by an oil price shock associated with escalating Middle East tensions.³⁴

According to the University of Michigan's RSQE May 2026 U.S. Economic Forecast, core PCE is estimated to have run at an annualized pace of roughly 4.3% between December 2025 and March 2026, a nowcast/forecast figure rather than finalized BEA data, reflecting the delayed pass-through of tariffs imposed in April 2025, tighter labor supply, and an expansionary fiscal stance with the deficit near 6–7% of GDP.³⁴

In response to these price pressures, the FOMC halted its rate-cutting cycle, holding the federal funds target range at 3.50%–3.75% for three consecutive meetings as of May 2026, and signaling that further cuts are unlikely before year-end.³¹ The 10-year Treasury yield reached a 52-week high of 4.668% on May 19, 2026, before settling to 4.569% on May 20, 2026 (both realized market data).³³ The sustained elevation of yields has been a meaningful headwind for equity valuations, contributing to the correlation shift described in this note.⁵

Institutional Forecast Comparison, Year-End 2026

The table below compares competing institutional forecasts, highlighting consensus and discrepancies regarding GDP growth, core inflation, interest rates, and equity targets.

FORECAST METRIC	TRANSAMERICA YEAR-END 2026 ³²	RBC YEAR-END 2026 ³⁹	VANGUARD YEAR-END 2026 ³⁵
Real GDP Growth	2.00%	2.20%	2.30%
Core Inflation Rate	2.90% (PCE) / 3.10% (CPI)	>3.00% (Core CPI/PCE)	2.80% (PCE)
Federal Funds Rate (Target)	3.00%–3.25%	3.50%–3.75%	3.40% (midpoint)
10-Year Treasury Yield	3.75%	4.55%	4.40% (Bloomberg Agg est.)
S&P 500 Target	7,400	EPS \$310 (P/E 21.3×)	Market weight allocation focus

FORECAST METRIC	TRANSAMERICA YEAR-END 2026 ³²	RBC YEAR-END 2026 ³⁹	VANGUARD YEAR-END 2026 ³⁵
Unemployment Rate	N/A	4.60% (projected)	4.60%

Note: The variance across these forecasts reflects materially different assumptions about inflation persistence and the pace of policy normalization. Transamerica's projection anticipates a soft landing in which rate cuts resume and drive the 10-year yield back toward 3.75% by year-end. RBC and Vanguard project a more challenging environment in which inflation remains above target. RBC's 4.55% year-end yield projection is broadly consistent with current market levels, implying limited relief from duration headwinds for the remainder of 2026. These are published institutional forecasts, not Icarus Asia estimates, and are subject to revision.

03. Strategic Asset Allocation and Portfolio Construction Under Correlation Stress

The rolling stock–yield correlation is a useful input within multi-factor risk models, functioning as a risk-state variable that reflects how portfolio diversification properties and overall volatility are evolving.⁸ Its recent shift toward negative territory in 2026, following a period of positive stance since April 2025, is an important signal for portfolio risk budgeting and scenario analysis, though it should be read alongside other macro indicators rather than in isolation.⁸

The tariff shock of April 2025 and renewed trade tensions in early 2026 were associated with episodes in which U.S. equities, long-duration Treasuries, and the dollar all came under simultaneous pressure, what MSCI has termed "Triple-Red" conditions in its stress-testing framework.³⁷ MSCI's scenario analysis, calibrated to historical analogues, estimates that a diversified multi-asset portfolio could sustain double-digit losses under such a stress scenario; these are modelled scenario outputs, not documented realized 60/40 portfolio performance for any specific two-week window.³⁷

Separately, theoretical and empirical research by Acharya and Laarits (NYU Stern) provides a framework for understanding how tariff uncertainty and policy risk may erode the safe-haven premium in long-duration Treasuries, thereby reducing their effectiveness as equity hedges when both channels are simultaneously activated.⁴¹ These analyses are best used as frameworks for stress-scenario design rather than as ex-post descriptions of realized 2025–2026 market outcomes.

Quantifying Regime Sensitivity: 60/40 Volatility Under Correlation Stress

Historical calibrations from FAJ and AQR research suggest that the annualized volatility of a standard 60/40 portfolio averaged roughly 8.4% during the broadly negative stock–bond return correlation environment of 2000–2021 (average correlation $\approx -7\%$), compared with roughly 10.5% during positive-correlation periods of the 1970s–1990s.² These figures are historical calibrations based on specific sample periods and assumptions about asset-class volatilities; they are not universal constants and will differ depending on the estimation window and index construction.²

Under a simplified risk-parity-style calculation, holding all other inputs constant, an investor targeting a constant portfolio volatility level would need to reduce equity exposure by approximately 25 percentage points to absorb the higher portfolio variance associated with a positive stock–bond return correlation, with freed capital reallocated to assets with lower or negative cross-correlation.² An illustrative example of such a calculation might yield a 35/45/20 framework, with the 20% representing a diversified real-asset and liquid-alternatives sleeve, this split is one possible output under specific assumed inputs and is *not a model portfolio recommendation*. In practice, a rigorous institutional SAA process would re-estimate volatilities, correlations, and expected returns under current conditions and solve for optimal weights subject to liability, regulatory, and client-specific

constraints; the outcome may differ materially from this stylized illustration. This is a specific output based on the provided inputs; an institutional optimization process will yield different weights based on bespoke client mandates. Critically, because correlations are themselves time-varying and estimation-uncertain, robust portfolio design requires stress-testing across a range of assumptions rather than calibrating to a single point estimate, the stress-testing recommendation in Section 4 specifies an appropriate range.²

Portfolio Dynamics Across Correlation Regimes

PORTFOLIO AND ASSET METRICS	GROWTH-DOMINATED REGIMES (TYPICALLY LOWER, MORE STABLE INFLATION)	INFLATION-DOMINATED REGIMES (HIGHER AND MORE VOLATILE INFLATION)
Asset Class Dynamics	Stocks and bond yields move together; stock returns and bond returns are negatively correlated. ⁵	Stocks and bond yields move in opposite directions; stock returns and bond returns are positively correlated. ⁹
Typical 60/40 Volatility	Low volatility, averaging approximately 8.4% p.a. historically. ²	Elevated volatility, rising to 10.5% or higher. ²
Diversification Mechanism	Strong diversification; bond gains offset equity losses during growth shocks. ⁵	Diversification breakdown; stocks and bonds decline simultaneously during inflation shocks. ⁵
SAA Impact	Supports full equity exposure; standard 60/40 weights remain broadly efficient. ²	A simplified risk-parity calculation suggests ~25pp equity reduction may be warranted to hold volatility constant; freed capital toward real assets and liquid alternatives, not additional long duration. ² Full institutional SAA process would re-estimate all inputs.
Role of Government Bonds	Active diversifier and safe-haven ballast. ⁶	Muted total return prospects; long-duration bonds drag and fail to hedge equity risk. ³⁹ Short-duration Treasuries retain safe-asset properties and should be favoured within the fixed-income sleeve. ³²

PORTFOLIO AND ASSET METRICS	GROWTH-DOMINATED REGIMES (TYPICALLY LOWER, MORE STABLE INFLATION)	INFLATION-DOMINATED REGIMES (HIGHER AND MORE VOLATILE INFLATION)
Alternative Asset Requirements	Low urgency; traditional asset classes provide sufficient risk-adjusted returns. ¹¹	High urgency; requires allocations to gold, commodities, and dynamic liquid alternatives capable of generating positive returns in a rising-inflation, high-volatility environment. ¹²

This correlation regime change has material implications for strategic portfolio design.² When traditional stock–bond diversification fails, financial institutions that rely on historical correlation models risk underestimating their downside exposure.⁴² Volatility spikes can feed into sell-off dynamics, worsening investors' funding constraints, triggering margin calls, and forcing deleveraging across both equity and fixed-income portfolios.⁴²

Diversifier Candidates and Associated Considerations

Dynamic Liquid Alternatives and Trend-Following Strategies

Academic evidence, including research from AQR and the broader managed-futures literature, suggests these strategies have historically provided meaningful diversification when both stocks and bonds come under simultaneous pressure.¹² Investors should, however, carefully account for model and implementation risk, capacity constraints at institutionally meaningful position sizes, fee drag, and the tendency of these strategies to underperform during choppy, mean-reverting markets when no sustained trend is present.

Commodities and Gold

Broad commodity indices and gold have historically acted as partial inflation hedges and geopolitical shock absorbers, with gold in particular showing some evidence of negative correlation to nominal bond returns during inflationary episodes.¹² Implementation costs, roll yield dynamics in commodity futures, the commodity cycle's own regime-dependence, and the fact that both assets can suffer significant drawdowns during deflationary or growth-shock-driven risk-off episodes should be factored into allocation sizing and entry-point judgement.

Short-Duration Sovereign Debt

Within the fixed-income sleeve, rotating toward the 1–3 year Treasury segment reduces mark-to-market sensitivity to rising long-end yields while preserving liquidity and the safe-asset properties that long-duration bonds currently lack.³² This is most appropriately understood as a risk-reduction measure within the existing bond allocation, not a substitute for genuine portfolio diversification against equity drawdown risk.

04. Strategic Portfolio Allocation and Risk Management Framework

The recent shift of the stock–yield correlation toward negative territory in 2026 is a meaningful risk-management signal that warrants a measured portfolio response, but it should be interpreted as one indicator among several, not as standalone evidence of an imminent severe market correction.⁸ The macro backdrop, persistent inflation, a paused Fed easing cycle, and elevated geopolitical uncertainty, creates a more challenging environment for traditional balanced portfolios than the 2000–2021 low-inflation era.³¹ However, as both the IMF and Vanguard have noted, the stock–bond relationship has been structurally unstable since 2020, oscillating between positive and negative return correlations as the macro regime evolved.^{42,5} Robust institutional portfolio design should therefore be architected to function across a range of correlation environments rather than anchoring to any single regime. The adjustments below are framed as incremental, scenario-robust risk-management steps, not a prescribed wholesale reallocation.

Shorten Fixed-Income Duration as an Incremental Risk-Reduction Step

With inflation running above the Fed's 2% target and rate cuts delayed (as of May 2026), the risk-adjusted case for long-duration fixed-income exposure is weaker than in recent years.³⁴ Rotating toward the 1–3 year segment of the Treasury curve is a reversible risk-reduction measure that preserves liquidity and safe-asset properties; investors should monitor the inflation trajectory and be prepared to extend duration if the macro environment shifts.³²

Modestly Increase Allocations to Real Assets and Evidence-Based Alternatives

Incrementally raising allocations to gold, broad commodities, and liquid alternative strategies with a demonstrated track record of positive performance in stagflationary environments can reduce the sensitivity of portfolio risk to a prolonged positive stock–bond return correlation.¹² Sizing decisions should reflect liquidity constraints, realistic implementation costs, the time-varying nature of these strategies' own performance, and uncertainty about the specific macro path that will unfold.

Apply Quality and Defensive Tilts Within Equities

Emphasizing high-quality, cash-generative equities and defensively oriented sectors (health care, consumer staples, regulated utilities) can reduce the equity sleeve's sensitivity to rising discount rates and margin compression without requiring a dramatic overall reduction in equity exposure.³⁹ This tilt should be calibrated against valuation and the risk of underperforming if the macro scenario proves more benign than assumed.

Substantially Upgrade Stress Testing and Scenario Analysis

The most critical near-term risk-management action is ensuring that portfolio stress tests incorporate multi-asset correlation-breakdown scenarios, including conditions in which equities, long-duration Treasuries, and the dollar fall simultaneously, across a range of correlation assumptions, from approximately -0.30 to $+0.30$.³⁷ Models calibrated exclusively on the 2000–2021 negative stock–bond correlation environment will systematically underestimate portfolio risk under the current macro backdrop and should be recalibrated accordingly.⁴²

Addendum. Open Questions, Monitoring Points

The following questions are flagged for ongoing monitoring as the macro environment evolves. This section is intended to be updated as new data becomes available and should be read alongside the analytical framework in Sections 1–4 rather than as standalone conclusions.

OPEN QUESTIONS FOR ONGOING REVIEW

01 Alternatives Sleeve Liquidity Under Stress

In a higher-volatility environment, rebalancing demands and potential margin calls can arise precisely when alternatives allocations are most needed. How does the liquidity profile of each alternatives sub-sleeve hold up under a simultaneous equity drawdown and volatility spike? Mandate explicit liquidity tiering, distinguish between daily-liquid trend funds, monthly-redemption commodity funds, and quarterly-lock managed-futures vehicles, before scaling alternatives exposure.

02 Fan Charts and Probability-Weighted Scenario Framing

The note's correlation range (-0.30 to $+0.30$) and the 35/45/20 illustrative weights are point-in-time scenario outputs. For Investment Committee presentations, explicit fan charts for the inflation path and probability-weighted scenario distributions would reinforce the epistemic humility in the framework and prevent any single scenario from anchoring committee deliberations. Consider developing three scenario branches: soft landing (correlation reverts negative), stagflation persistence (correlation stays positive), and growth shock (correlation rapidly negative in risk-off flight).

03 Implementation Asymmetry: Duration vs. Alternatives

Shortening duration is operationally straightforward and immediately reversible. Scaling alternatives exposure is not: it requires manager selection, due diligence, capacity analysis, fee negotiation, and onboarding lead times that may span 3–9 months. This implementation asymmetry means the alternatives build-out should begin before the correlation signal is fully confirmed, not after. Track the pipeline of manager approvals as a leading indicator of implementation progress.

04 Growth Surprise Risk, The Scenario That Reverses the Trade

A positive growth surprise, stronger-than-expected labor market data, a resolution of trade tensions, or a faster-than-expected disinflation, could quickly restore the negative stock–bond return correlation and make defensive tilts and shortened duration a drag on performance. The monitoring triggers for unwinding incremental adjustments should be defined explicitly: at what CPI trajectory, yield level, or Fed

communication shift would the risk-management case for this posture weaken materially?

05 The 35/45/20 as Thought Experiment, Not Committee Anchor

The illustrative 35/45/20 split is one output of a simplified risk-parity calculation under fixed inputs. A full institutional SAA optimization, re-estimating correlations, volatilities, and expected returns; incorporating liability structure, regulatory constraints, and client mandates, will generally produce different weights. Avoid allowing this stylized illustration to anchor Investment Committee discussions; use it only to illustrate the magnitude of adjustment implied by the volatility arithmetic, then proceed to a full optimization process.

06 Systemic Risk and Tail Liquidity

In a scenario where both equities and long-duration bonds come under simultaneous pressure (Triple-Red), the funding demands from margin calls and collateral posting can exceed initial estimates. Stress-test liquidity reserves against a scenario in which the alternatives sleeve itself requires additional margin, the fixed-income sleeve marks down, and equity redemptions accelerate simultaneously. The question is not whether the portfolio can absorb the P&L; it is whether it can remain fully invested through the drawdown without forced selling.

Appendix A. Theoretical Modeling, Technical Supplement

TECHNICAL SUPPLEMENT · METHODOLOGY

Theoretical Modeling of the Stock–Bond Yield Covariance

For readers interested in the mathematical foundations, the following derivations trace the analytical basis for each claim made in the main note. The supplement is self-contained and can be read independently of the body text. All equations use stationary variables, stock log-returns and first-differenced yields, to avoid the spurious-correlation problems that arise when correlations are computed directly on non-stationary price and yield levels.

I. NOTATION AND STATIONARITY

Asset price levels and interest rate levels are non-stationary and exhibit unit roots. To avoid spurious correlation, we work with stationary transformations throughout. Define the stock log-return $r_{S,t} = \Delta \ln S_t$ and the change in yield ΔY_t . The stock–yield correlation, denoted $\rho_{S,\Delta Y}$, is then defined on these stationary series:

$$r_{S,t} = \Delta \ln S_t$$

$$\rho_{S,\Delta Y} = \text{Corr}(r_S, \Delta Y) = \frac{\text{Cov}(r_S, \Delta Y)}{\sigma_{r_S} \sigma_{\Delta Y}}$$

II. DURATION IDENTITY AND SIGN RELATIONSHIP

The return of a government bond, $R_{B,t}$, is inversely proportional to its yield change, approximated through modified duration D :

$$R_{B,t} \approx -D \Delta Y_t$$

Therefore, the stock–bond return correlation ρ_{S,R_B} follows directly from the linearity of covariance and the fact that D is a positive scalar:

$$\rho_{S,R_B} = \text{Corr}(r_S, -D \cdot \Delta Y_t) = -\text{Corr}(r_S, \Delta Y_t) = -\rho_{S,\Delta Y}$$

This identity demonstrates that a positive stock–yield correlation ($\rho_{S,\Delta Y} > 0$) translates to a *negative* stock–bond return correlation ($\rho_{S,R_B} < 0$).⁴ This negative return correlation provides the traditional diversification “ballast” for balanced portfolios. Conversely, a negative stock–yield correlation ($\rho_{S,\Delta Y} < 0$) implies a *positive* stock–bond return correlation ($\rho_{S,R_B} > 0$), meaning both asset classes decline in tandem, stripping bonds of their hedging capabilities.⁵

III. ASSET PRICING FOUNDATIONS

Stocks are priced as the present value of expected future dividend cash flows under the dividend discount framework:

$$S_t = \sum_{k=1}^{\infty} \frac{\mathbb{E}_t[D_{t+k}]}{(1 + R_e)^k}$$

where S_t is the stock price, $\mathbb{E}_t[D_{t+k}]$ is the expected dividend at period N , and R_e is the equity cost of capital. When inflation rises and erodes real earnings or compresses multiples, R_e increases while expected dividends may stagnate, driving equities lower. Nominal government bonds are priced as:

$$P_{B,t} = \sum_{k=1}^N \frac{C_k}{(1 + Y_t)^k} + \frac{F}{(1 + Y_t)^N}$$

where $P_{B,t}$ is the bond price, C_k is the coupon in period k , F is the face value, Y_t is the yield to maturity, and N is the number of periods to maturity. When inflation expectations push Y_t higher, $P_{B,t}$ falls. If equity valuations fall simultaneously, both asset classes post negative returns, producing the positive stock–bond return correlation characteristic of inflationary regimes.⁵

IV. REGIME LOGIC, WHY THE SIGN SHIFTS

When growth shocks dominate, conditions most commonly associated with low and stable inflation, a positive stock–yield correlation tends to prevail. Strong activity raises earnings expectations (equities up) while lifting real rates and policy expectations (yields up, bond prices down). These opposite-sign return sensitivities produce $\rho_{S,R_B} < 0$, providing portfolio diversification benefits.⁵

When inflation shocks dominate, stock–yield correlations tend to turn negative ($\rho_{S,\Delta Y} < 0$), implying $\rho_{S,R_B} > 0$ and eroding diversification.^{5,9} Positive inflation surprises compress equity valuations through higher discount rates while simultaneously pushing bond yields higher, creating same-sign return sensitivities across asset classes.

V. ACHARYA & LAARITS YIELD AND RETURN DECOMPOSITIONS

Acharya and Laarits (2023) decompose the nominal Treasury yield into three structural components, isolating the contribution of each to bond returns:

$$\text{Yield}_{t,n} = \text{Frictionless}_{t,n} + \text{CDS}_{t,n} - \text{Convenience}_{t,n}$$

The frictionless rate captures the risk-free component; the CDS spread captures sovereign credit risk; the convenience yield enters with a negative sign because a higher convenience yield drives nominal yields *lower*, reflecting the safety premium investors accept in exchange for holding liquid Treasuries. The corresponding return decompositions follow directly from the duration approximation applied to each component:

$$R_{t,n}^{\text{Yield}} = -n \cdot \Delta \text{Yield}_{t,n}$$

$$R_{t,n}^{\text{Frictionless}} = -n \cdot \Delta \text{Frictionless}_{t,n}$$

$$R_{t,n}^{\text{CDS}} = -n \cdot \Delta \text{CDS}_{t,n}$$

$$R_{t,n}^{\text{Convenience}} = +n \cdot \Delta \text{Convenience}_{t,n}$$

Note the sign on the convenience return: an increase in the convenience yield ($\Delta \text{Convenience}_{t,n} > 0$) causes nominal yields to fall, producing *positive* bond returns for the holder. This framework allows the stock–bond correlation to be decomposed into growth, credit, and safety-premium channels, providing a structural foundation for the regime analysis in Section 1.

Note: All equations use stationary transformations. The Acharya & Laarits decomposition is derived from “Decomposing the Yield Curve,” Viral V. Acharya and Tomas Laarits, *Journal of*

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APPENDIX B, ANALYST NOTE

Authors	Icarus Asia Research Team
Report Date	May 2026
Analytical Framework	Rolling 52-week stock–yield correlation analysis; FAJ/AQR correlation regime calibration; MSCI Triple-Red stress scenario framework; RSQE nowcast integration; simplified risk-parity volatility arithmetic.
Key Assumptions	Historical volatility calibrations (8.4% / 10.5%) are sample-period-specific, not forward estimates. The 35/45/20 illustrative allocation is a stylized risk-parity output, not a model portfolio recommendation. The –0.30 to +0.30 correlation stress range is derived from observed historical extremes in cited academic literature.
Data Vintage	Realized macro data as of May 20–21, 2026. Institutional forecasts as of respective publication dates (Q1–Q2 2026). RSQE May 2026 U.S. Economic Forecast (nowcast, not finalized BEA data).

LEGAL & COMPLIANCE DISCLOSURES

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