WHEN DIVERSIFICATION "BREAKS DOWN"

Regime Dependence in Stock–Bond Correlations and the Case for Convexity

Lessons from 1973, 1979, 2008, 2020, 2022, and March 2026

Wolfgang Landl, March 2026

Abstract

This paper examines the behaviour of cross-asset correlations across six major market dislocations spanning five decades: the 1973–74 Arab oil embargo, the 1979–80 Iranian Revolution, the 2008 Global Financial Crisis, the 2020 COVID-19 shock, the 2022 inflation shock, and the ongoing 2026 Iran crisis.

We document a consistent pattern: in deflationary crises, the negative stock–bond correlation preserves the diversification properties of the traditional 60/40 portfolio; in energy-driven inflationary crises, this correlation turns positive, materially degrading the effectiveness of conventional balanced construction.

The 2026 episode, while based on a limited 15-trading-day window whose statistical robustness must be interpreted with caution, presents a notable further deterioration: gold – historically the most effective hedge during 1970s stagflationary shocks – has declined alongside equities, likely reflecting a tighter anticipated monetary policy response than in prior energy crises.

We contextualise these findings within the distinction between theoretically optimal and institutionally acceptable portfolio construction, and argue that explicit convexity strategies may represent the most regime-independent mechanism for portfolio protection when traditional correlation assumptions degrade.

1. Introduction

The 60/40 portfolio – 60% equities, 40% bonds – has served as the institutional default for asset allocation for over three decades. Its success rests on a single structural assumption: that the correlation between stock and bond returns is negative, so that bonds provide a natural hedge during equity drawdowns.

This assumption held remarkably well from 2000 to 2021. During the 2008 Global Financial Crisis and the 2020 COVID-19 shock, Treasury bonds rallied precisely as equities collapsed, cushioning balanced portfolios. However, the inflation shock of 2022 – and more acutely, the geopolitical energy shock of March 2026 – has demonstrated that this relationship is regime-dependent, not structural.

This paper makes three contributions. First, we document the correlation shifts across six major crises, showing a clear bifurcation between deflationary episodes (where diversification works) and inflationary episodes (where it fails). Second, we introduce a comparison with the 1973 and 1979 oil shocks, demonstrating that the current episode shares the stagflationary DNA of the 1970s but with a critical divergence in gold's behaviour. Third, drawing on the framework of optimal versus acceptable portfolios (Landl, 2026), we argue that the persistence of the 60/40 model reflects institutional and behavioural constraints rather than analytical conviction.

2. Six Crises, Three Correlation Regimes

We classify the six episodes into three distinct correlation regimes based on the behaviour of the stock–bond relationship ($\rho_{S,B}$) and its implications for balanced portfolio construction.

Table 1: Asset class behaviour across six major crises

	1973–74	1979–80	2008	2020	2022	2026*
Regime	Stagflation	Stagflation	Deflation	Deflation	Inflation	**Stagflation**
S&P 500	–48%	–27%†	–38.5%	–33.9%	–19.4%	–5.4%
Bonds	Sold off	Sold off	Rallied	Rallied	Sold off	Sold off
Gold	+135%	+135%	+5.8%	+24.6%	–0.3%	**–14.9%**
Oil	+300%	+200%	–53.5%	–65%	+6.7%	**+54.8%**
ρ(S,B)	Pos. (≈0.4)	Pos. (≈0.4)	Neg. (≈0.4)	Neg. (≈0.35)	Pos. (≈0.5)	**Pos. (+0.47)**
60/40	**Fails**	**Fails**	**Works**	**Works**	**Fails**	**Fails**

** 15 trading days (27 Feb – 20 Mar 2026). † 1980–82 bear market following the 1979 shock. Sources: Federal Reserve History; Morningstar/CAIA; Bloomberg; Investing.com.*

2.1 Regime A: Deflationary Crises (2008, 2020)

In both the 2008 GFC and the 2020 COVID-19 shock, the dominant driver was a deflationary demand collapse. Central banks responded by cutting rates aggressively, causing bond prices to rally as equities fell. The Bloomberg US Aggregate Bond Index returned +5.2% in 2008 and +7.5% in 2020. Stock–bond correlation was strongly negative ($\rho_{S,B} \approx -0.35$ to -0.40), preserving the 60/40 hedge. Gold performed its traditional safe-haven function. Diversification bent but did not break.

2.2 Regime B: Inflationary Rate Shock (2022)

When US CPI surged to 9.1% in 2022, both stocks and bonds fell simultaneously for the first time since 1977. The S&P 500 declined –19.4% while the Bloomberg Aggregate fell –13.0%. Stock–bond correlation turned positive ($\rho_{S,B} \approx +0.50$). As State Street (2025) documented, equities and bonds declined simultaneously for 14 consecutive months. The diversification assumption was not merely weakened – it was inverted.

2.3 Regime C: Stagflationary Energy Shocks (1973, 1979, 2026)

The 1973–74 Arab embargo quadrupled oil prices, triggering a –48% equity decline and simultaneous bond selloff as yields rose from 6% to 8%. The 1979–80 Iranian Revolution tripled oil prices and pushed inflation to 14.5%. In both episodes, stocks and bonds fell together ($\rho_{S,B} > 0$) and the 60/40 portfolio offered no protection.

Gold, however, surged +135% in each episode – functioning as an effective hedge because real interest rates remained deeply negative under the accommodative monetary policy of Fed Chairman Arthur Burns. The 60/40 failed, but investors with gold exposure were partially protected.

The March 2026 Iran strikes repeat the stagflationary template: Brent Oil +54.8%, S&P 500 –5.4%, MSCI World –6.9%, bonds selling off (+43bp in yields). A critical caveat: the 2026 data covers only 15 trading days. Correlation estimates over such short horizons are statistically noisy, with wide confidence intervals, and should not alone be taken as evidence of a structural regime shift. However, we include the 2026 window not as standalone proof, but as the latest data point within a pattern documented across five prior episodes spanning fifty years. The direction and magnitude of the correlation shifts are consistent with the established stagflationary template.

Within this caveat, a notable divergence from the 1970s is emerging in gold. Gold has declined –14.9% in the crisis window, which contrasts sharply with its +135% rallies during the 1973–74 and 1979–80 shocks. The explanation is not that gold has "failed" as an asset class – gold's long-run hedging properties are well documented, and it is common for gold to lag in the initial phase of a crisis before recovering (as it did in late 2008). Rather, the divergence reflects the **real rate channel:** in the 1970s, the Fed under Arthur Burns was behind the curve, real rates were deeply negative, and gold surged as the primary beneficiary of monetary accommodation. In 2026, yields are rising faster than inflation expectations, pricing a tighter Fed stance – more Volcker than Burns. Whether this persists as the crisis develops remains to be seen, but the early signal is that gold's sensitivity to real rates is currently dominating its safe-haven function.

Table 2: Correlation shifts during the 2026 crisis window

Asset Pair	YTD ρ	Crisis ρ	Δρ	Signal
S&P 500 / US 10Y Yield	–0.13	**–0.47**	**–0.34**	**60/40 failure**
S&P 500 / Brent Oil	–0.20	**–0.36**	–0.16	**Stagflation**
Gold / S&P 500	+0.29	**+0.48**	+0.19	**No hedge value**
MSCI World / Brent Oil	–0.32	**–0.57**	–0.25	**Global contagion**
Bitcoin / S&P 500	+0.58	**+0.63**	+0.05	**Risk proxy**

Source: Investing.com. Daily return correlations (Pearson's r). YTD: 2 Jan – 20 Mar 2026 (n=53). Crisis: 27 Feb – 20 Mar 2026 (n=15). Note: correlation estimates over 15 observations carry wide confidence intervals and should be interpreted as directional indicators, not precise point estimates. Bitcoin/S&P correlation is included for completeness but confirms the already widely established consensus that Bitcoin behaves as a high-beta risk proxy, not a diversifier.

3. The Optimal vs. Acceptable Portfolio Problem

If the evidence against unconditional 60/40 construction is so clear – documented not only in 2022 and 2026 but across five decades of energy shocks – why does the model persist? The answer lies in the distinction between *theoretically optimal* and *institutionally acceptable* portfolios.

Modern portfolio theory (Markowitz, 1952) frames construction as an optimisation problem. In practice, however, institutional portfolios are shaped by benchmark tracking, career risk, governance constraints, and behavioural biases. A regime-aware portfolio – for example, 35% equities, 20% short-duration bonds, 20% commodities, 10% gold, 10% cash, and 5% convexity strategies – delivers superior risk-adjusted returns over the full 1990–2026 period (~800% total return vs. ~650% for 60/40, with similar volatility of ~10.5% and lower drawdowns of ~–20% vs. ~–30%).

Yet the regime-aware portfolio underperforms during prolonged equity bull markets (2009–2019), generating tracking error and peer-group deviation that most institutional allocators cannot tolerate. The result is a systematic preference for strategies that are *acceptable to hold* over those that are *optimal to own*. As Ilmanen (2011) and Dalio (2013) have argued, the behavioural cost of maintaining contrarian positioning through extended periods of underperformance exceeds the analytical conviction of most investment committees.

This is the core paradox: the very conditions that make hedging cheapest and most effective (low volatility, complacent markets) are those in which it is hardest to justify. And the conditions that expose the failure of the 60/40 model (inflationary shocks, rising correlations) are precisely those in which repositioning is most expensive and least practical.

4. The Exhaustion of Traditional Hedges and the Case for Convexity

4.1 What investors typically reach for – and why it fails in inflationary regimes

When diversification disappoints, institutional investors instinctively turn to a familiar set of alternatives. Each has merit in specific conditions, but none provides reliable protection across the full range of inflationary and stagflationary regimes documented in Section 2.

Increase bond duration or quality. In deflationary crises (2008, 2020), extending duration into Treasuries works precisely because falling yields push bond prices higher. In inflationary regimes (1973, 1979, 2022, 2026), this is the worst possible trade: rising yields destroy bond capital. The Bloomberg US Aggregate lost –13% in 2022, and long-duration Treasuries fared far worse. Duration is not a hedge – it is a bet on falling rates.

Add gold. Gold is widely regarded as the canonical inflation hedge, and its +135% surges during both 1970s oil shocks support this reputation. However, as Section 2.3 demonstrates, gold's effectiveness depends critically on the real rate environment. When the central bank is behind the curve (Burns, 1973–78), real rates are negative and gold thrives. When the central bank tightens into the shock (Volcker, 1980–82; the current market expectation in 2026), rising real rates overwhelm safe-haven demand. Gold is a conditional hedge, not an unconditional one.

Rotate into commodities. Commodity exposure (Gorton & Rouwenhorst, 2006; Erb & Harvey, 2006) can provide positive returns during energy shocks, as oil's +54.8% move in March 2026 illustrates. But commodity allocation introduces its own problems: high volatility, roll costs in futures-based implementations, and the fact that commodity returns are unpredictable outside of the shock itself. Commodities are a source of return in stagflation, not a source of portfolio protection – they do not cushion equity drawdowns, they simply happen to be going up at the same time.

Raise cash. Cash preserves nominal capital but erodes purchasing power when inflation is elevated. During the 1973–82 stagflation period, short-term Treasury bills roughly kept pace with inflation, netting approximately 0% in real terms (WealthGen Advisors, 2025). Cash is a defensive measure, not a source of positive real returns during the very periods when portfolios need them most.

The common thread is that each of these alternatives is *regime-conditional.* Bonds work in deflation. Gold works when real rates are negative. Commodities provide returns but not protection. Cash preserves capital but not purchasing power. No traditional asset class offers *unconditional* hedging across all regimes. This is the gap that convexity strategies are designed to fill.

4.2 What convexity is and why it is structurally different

Convexity, in the portfolio context, refers to strategies with a **non-linear, asymmetric payoff profile:** small, bounded costs in normal markets and outsized gains during dislocations. The most common instruments are long out-of-the-money put options on equity indices, long calls on the VIX, long variance swaps, and actively managed long-volatility funds that combine these instruments with disciplined timing and execution.

The critical distinction from the hedges discussed above is that convexity strategies do not depend on any specific macroeconomic outcome. Bonds require falling rates. Gold requires negative real rates. Commodities require supply shocks. Convexity requires only one thing: **a large move in any direction.** Because the payoff is tied to the magnitude of market dislocation rather than its cause or direction, convex strategies are structurally indifferent to whether the crisis is deflationary (2008, 2020), inflationary (2022), or stagflationary (1973, 1979, 2026).

As Pflueger (2023) demonstrates, when supply-shock-driven inflation is present, bonds' betas turn positive and their hedging properties collapse. Convexity strategies are not subject to this regime dependency. Their effectiveness is a function of volatility itself, not of the correlation structure between asset classes.

4.3 The practical constraint: cost and implementation

If convexity is so attractive in theory, why isn't it universally adopted? The answer connects directly to the optimal-versus-acceptable framework of Section 3. Passive convexity strategies – systematically rolling out-of-the-money puts on a fixed schedule – are expensive. Equity markets rise on average, and volatility is typically priced at a premium. An investor buying protection continuously pays a compounding cost (the "bleed") that can erode several percentage points of annual return over a full cycle. This is the primary reason institutional allocators resist the strategy.

However, the distinction between passive and active convexity is decisive. Active approaches – which adjust timing, strike selection, and carry profile based on the volatility surface and market microstructure – can substantially reduce or eliminate the bleed. The key insight is that convexity is not a product but a **trading discipline:** its economic value depends entirely on the skill and price discipline of the implementation.

MSCI Research (2026) calibrated a stress test to the 1973–74 period showing that a global diversified portfolio would lose approximately 13% in a sustained stagflationary episode. Allocating 2–5% of portfolio assets to well-implemented convex strategies can substantially offset this loss – not by predicting the regime, but by constructing a payoff that is indifferent to it. The cost of this allocation, when actively managed, need not exceed the insurance premium that investors already implicitly pay through drawdown exposure in unhedged portfolios.

5. Conclusion

The empirical record across six episodes spanning five decades yields three conclusions:

First, the stock–bond correlation is regime-dependent, not structural. In deflationary crises, bonds hedge equities. In inflationary and stagflationary crises, they do not. The negative correlation of 2000–2021 was, in the context of 150 years of data, the anomaly – not the norm. Diversification does not "break" in absolute terms – dispersion across asset classes, regions, and sectors persists – but the specific stock–bond hedge that underpins balanced portfolio construction degrades materially in inflationary regimes.

Second, the early evidence from March 2026, while based on a limited sample that must be interpreted with appropriate caution, suggests a potentially more adverse environment than prior stagflationary crises for conventional portfolios. Unlike the 1970s, gold has not yet provided a hedge – likely reflecting anticipated monetary tightening rather than a permanent failure of gold's properties. Whether this persists will depend on the Fed's actual policy response and the evolution of real interest rates. Nonetheless, the pattern of simultaneous equity, bond, and gold weakness has few historical precedents.

Third, the persistence of the 60/40 model despite its documented failures reflects institutional and behavioural constraints rather than analytical optimality. The distinction between optimal and acceptable portfolios explains why most allocators remain structurally underhedged.

For institutional investors, the implication is clear. Convexity is not a tactical overlay – it is a *structural portfolio consideration* for any allocation that seeks resilience across regimes. The question is not whether diversification works in general – it does – but whether the specific diversification embedded in the 60/40 model can be relied upon when the macroeconomic regime shifts from disinflation to stagflation. The evidence of five decades suggests it cannot.

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