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Investing in Alternatives Across Macroeconomic Regimes

June 2024

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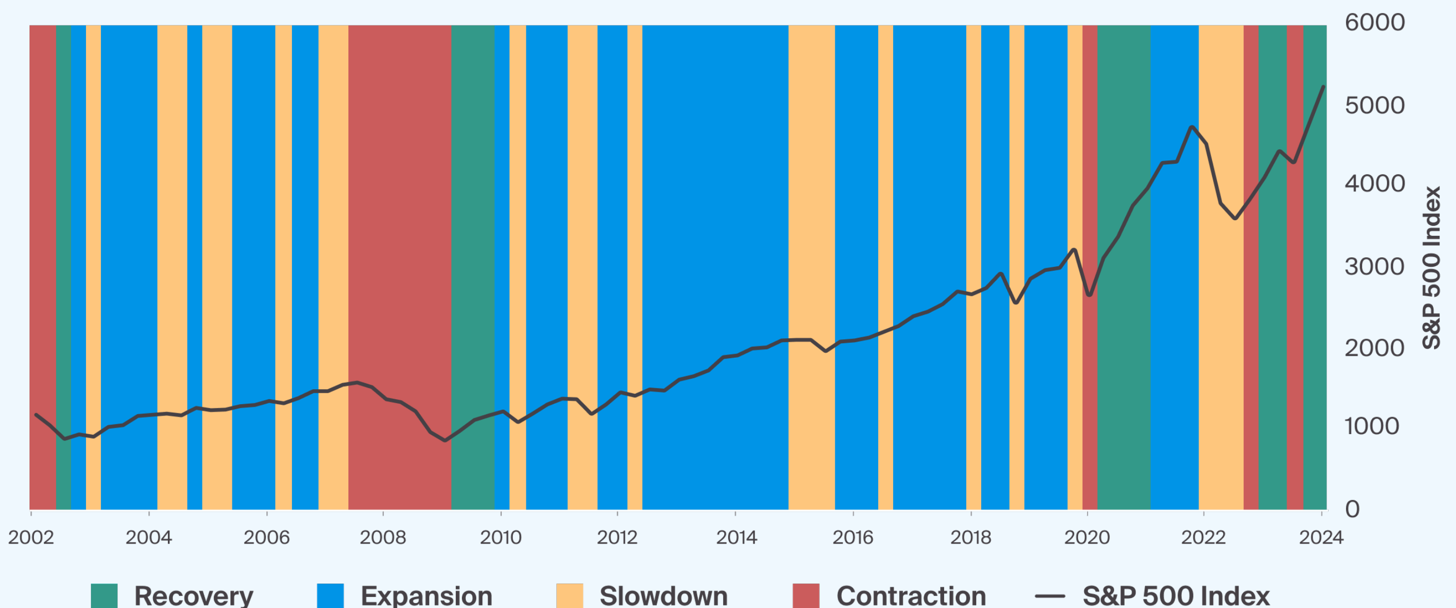
While timing the market is an endeavor that has often resulted in miscues and missed opportunities, understanding how asset classes have performed over time remains a valuable exercise. In this white paper, we present a framework that seeks to classify past market environments into macroeconomic regimes and identify historical patterns of both traditional and alternative asset class returns. In doing so, we hope to help advisors contextualize past performance amid changing macro environments.

The Macro Regimes Over Time

Our framework identifies four primary macroeconomic regimes: Recovery, Expansion, Slowdown, and Contraction. Though these terms are well recognized across our industry, we use them in our framework to describe discrete time periods, using quarterly snapshots of prevailing economic activity and market sentiment. The methodology section at the end of this paper explains the metrics we used to define each regime in more detail.

Exhibit 1: Macroeconomic regimes provide a framework for understanding prevailing economic activity and market sentiment.



Source: Bloomberg, S&P 500 represented by S&P 500 Index; regimes are represented by the framework described in the methodology section, as of Q1 2024.

By combining economic signals and market sentiment, we hope to help advisors better understand past regimes and, critically, the regime that they navigate today. In Exhibit 1, we show these regimes alongside the performance of the S&P 500 to illustrate traditional asset class behavior in the context of each regime, across our period of observation, from Q4 2001 to Q1 2024.

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Historical Asset Class Performance

Throughout this paper, we compare and identify patterns in the historical performance of asset classes across these four regimes. We attempt to answer the following questions by assessing these historical patterns:

1. Which asset classes have performed best (and worst) within a given regime?
2. Which appeared to be a favorable macro environment for each asset class?

To address these two questions, we assess each asset class's "in-regime" returns and "forward" returns, which we define below.

In-Regime Returns

In our analysis, "in-regime" returns represent each asset class's average performance across all quarters during the observation period when macroeconomic conditions matched a specific regime. These returns are annualized for comparison.

Forward Returns

We also calculate "forward" returns to represent the average returns generated if one had invested during any quarter and remained invested for the next five years. For example, the forward return for a fund investment made in Q2 2008 would be the annualized difference between that fund's reported value in Q2 2008 and the value in Q2 2013. The average annualized forward return for the regime type is thus the annualized mean of the forward returns of all the quarters that match the specific regime.

Understanding how an asset class has performed in the years following a specific regime is especially relevant for illiquid asset classes, given general limitations on liquidity. Investing in illiquid asset classes will generally require a long-term, buy-and-hold approach. In this assessment, the five-year forward returns we utilized align with a typical holding period for private equity investments.

We start with an aggregate view of the two sets of returns above, comparing traditional and alternative asset classes across regimes, and discuss some of the major takeaways. In later sections, we describe the characteristics of each regime and the historical in-regime and forward performance alongside each asset class's historical average to better visualize the historical opportunities and challenges of each regime.

Public Markets Performance Across Regimes

In US public markets, equity indices like the S&P 500 and Russell 2000 generated the highest average returns across regimes, with particularly high relative returns in periods of Recovery and Expansion, which was by far the most frequently occurring regime in the observation period. But in periods of Slowdown and Contraction, these asset classes tended to underperform their traditional fixed-income counterparts (Exhibit 2).

Traditional fixed income generated the most consistently positive returns across regimes, with US investment-grade bonds remaining in positive territory across all four regimes. High-yield bonds outperformed US investment-grade bonds in Recovery regimes and experienced limited downside exposure relative to public equities (Exhibit 2). Historically, an allocation to higher-quality fixed income in a Contraction minimized drawdown and added diversification to a portfolio. However, this diversification came at the cost of relatively lower long-term average returns across regimes.

Performance divergence between stocks and bonds may illustrate the low correlation between the two asset classes over the observation period, supporting the longstanding 60/40 approach for portfolio construction. With this approach in place, equities would have driven the bulk of returns during the most frequently occurring Expansion regimes, while fixed income would have supplied more consistent yield while helping to offset the sharp equity losses in Slowdown and Contraction. The negative fixed-income performance that coincided with the equity selloff in recent years also suggests this behavior may not always be reliable.

Exhibit 2: The dispersion in returns in traditional asset classes across regimes is much larger than alternative asset classes.

Annualized In-Regime Asset Class Returns

Average Annualized Return

60%
50%
40%
30%
20%
10%
0%
-10%
-20%
-30%

12.0%
9.8%
8.9%
6.0%
9.6%
10.7%
9.3%
11.5%
7.9%
3.6%

Private Equity
Private Debt
Real Estate
Hedge Funds
Infrastructure
S&P 500
MSCI World
Russell 2000
HY Index
US Agg

Alternative Investments
Traditional Investments

Recovery
Expansion
Slowdown
Contraction
Long-Term Average Return

Source: Preqin, Private Equity, Private Debt, Real Estate, and Infrastructure represented by respective Preqin Quarterly Index returns; HFR, Hedge Funds represented by the HFRI Fund Weighted Composite Index; Bloomberg, S&P 500 represented by the S&P 500 Index, MSCI World represented by the MSCI World Index, Russell 2000 represented by the Russell 2000 Index, HY Index represented by the Bloomberg US Corporate HY Index, US Agg represented by the Bloomberg US Agg Index; Nominal in-regime average annualized returns calculated by averaging the quarterly performance of indices during the regime in which they reside, Q4 2001 – Q4 2023, as of Q4 2023.

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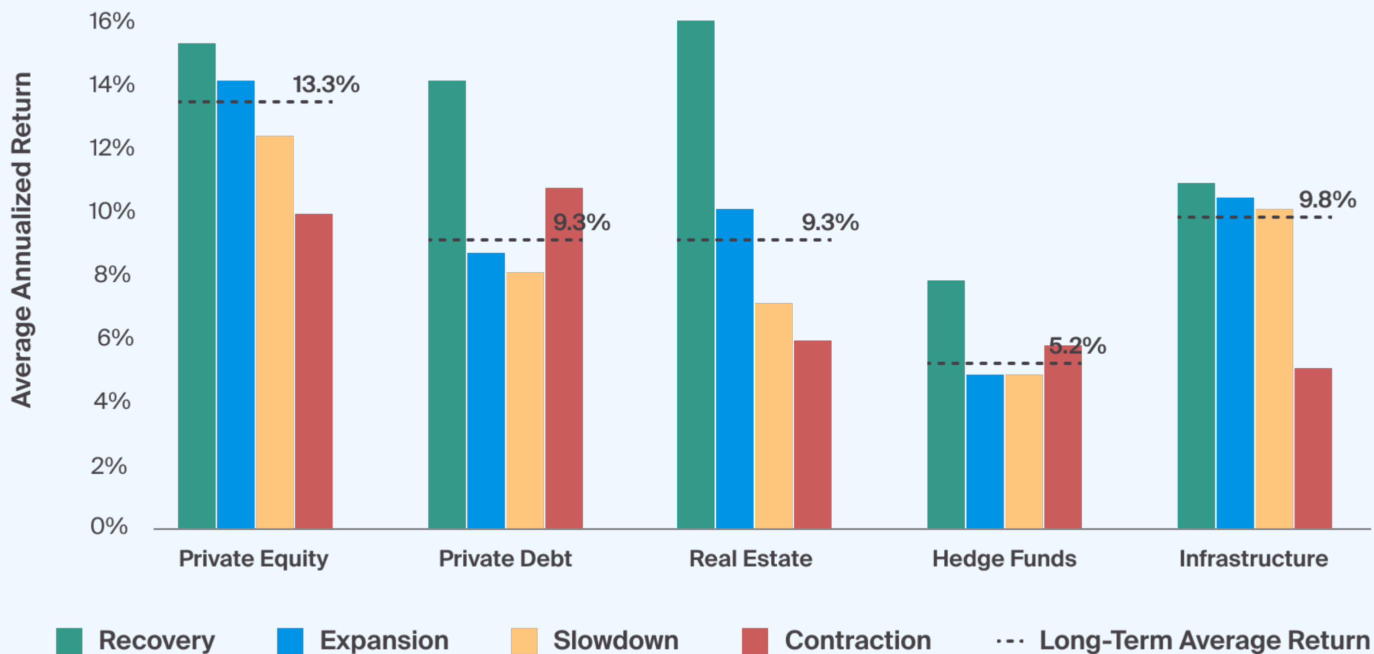
Alternative Investment Performance Across Regimes

In Exhibit 2 above, we also compare the performance of major alternative asset classes—private equity, private debt, real estate, hedge funds, and infrastructure—with traditional asset classes across regimes. When comparing performance by regime, we first observed the dispersion between each asset class's returns in their best and worst regime environments. Below, we depict forward returns on a five-year time horizon to better gauge how each performed in the years following a given regime (Exhibit 3). Note that the private markets returns we used here are based on the Preqin Quarterly Index and are calculated net of fees.

In the last 22 years, alternative asset classes had higher long-term average returns than traditional asset class equivalents with tighter return spreads across regimes. The S&P 500, for example, generated an annualized average return of -26.5% during Contraction regimes, while returning an average annualized +36.8% in Recovery regimes—a dispersion of 63.3 percentage points. Private equity, in comparison, returned -10.7% and +19.5% in those respective periods, exhibiting a meaningfully smaller dispersion of 30.2 percentage points (Exhibit 2).

Exhibit 3: Investors who deployed into Recovery regimes, which had the highest average forward return, may have been rewarded.



Source: Preqin, Private Equity, Private Debt, Real Estate, and Infrastructure represented by respective Preqin Quarterly Index returns; HFR, Hedge Funds represented by the HFRI Fund Weighted Composite Index; Average annualized nominal forward returns calculated through the five years following an indication of an economic regime; observation period between Q4 2001 – Q4 2023, as of Q4 2023.

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Private Equity

Private equity historically generated the highest average return compared to all other asset classes. The asset class saw its worst performance during Contraction regimes, following a pattern similar to public equities (Exhibit 2). Unlike public equity, however, private equity did generate, on average, a positive return in Slowdown regimes. This difference may reflect the nature of private equity's valuation-based pricing. By contrast, public equity markets have historically reacted much faster and more dramatically to regime changes with far more frequent sentiment-based repricing.

The best quarters to deploy capital into private equity appeared to be within Recovery regimes (Exhibit 3). During those periods, managers likely could invest at depressed valuations. They may have also taken advantage of better exit environments, given the return to risk-on environments in the Expansion regimes that followed.

Private Debt

Private debt had the second-highest average returns across regimes in our observation period (Exhibits 2 and 3). Private debt, on average, experienced smaller drawdowns in Contraction regimes compared to private equity and private real estate. During Expansion and Recovery periods, private debt generated its highest returns—potentially due to more conservative underwriting in the preceding regimes and improving company fundamentals amid Recovery, limiting loan losses.

Private debt appeared to perform best on a forward-return basis following Recovery and Contraction regimes (Exhibit 3). Contraction environments likely delivered more opportunistic managers a greater opportunity set due to market dislocations. Direct lenders, in particular, could lend to businesses with strong fundamentals but potentially more depressed valuations with meaningful downside protection given the senior position of private debt in the capital stack.

Real Estate

Real estate exhibited the greatest cyclicality in regimes relative to other alternative asset classes. Real estate delivered among the highest returns in Expansion and Slowdown regimes, but the lowest returns in Recovery and Contraction. This may be due to real estate's sensitivity to interest rates and economic growth, but the outsized impact of the global financial crisis (GFC) on this observation period and real estate's central role in that crisis should be noted. The nature of real estate's contractual cash-flow-driven returns and its correlation with inflation likely drove its outperformance in Slowdown regimes relative to other alternative asset classes.

Recovery regimes appeared to have been the best time to allocate to real estate, which outperformed other alternative asset classes on a forward return basis during our observation period (Exhibit 3). The lower, more attractive valuations available in the period after the GFC, in particular, likely drove that outperformance alongside the improving economic conditions and a recovering real estate market in the years that followed.

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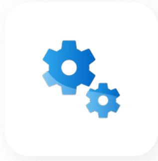

Hedge Funds

Hedge funds generated their highest returns during periods of Expansion and Recovery (Exhibit 2). In fact, hedge funds performed better than any other asset classes during Recovery regimes. Hedge funds often perform their best in periods of dislocation, when they can generate alpha through differentiated opportunity sets. In periods of Slowdown, hedge funds may not be able to find these opportunities, and in Expansion, their performance can likely be attributed to public market beta, as the monetary environment is generally looser, more stable, and supportive of broad growth. During Contraction regimes, hedge funds had one of the lowest drawdowns behind infrastructure, indicating their defensive nature when added to portfolios (Exhibit 2). Hedge funds also had a differentiated return profile from that of public equities, as drawdowns in periods of Contraction and Slowdown were much smaller.

The relatively lower dispersion of results across regimes could also explain why hedge fund forward returns were lower than other alternative asset classes. These strategies are typically not meant to be deployed based on a specific entry point; returns are rather attributable to opportunities that arise periodically and as traders within the fund identify them.

Infrastructure

Private infrastructure was the most consistently performing alternative asset class across regimes (Exhibit 2 and 3). During periods of Expansion and Slowdown, private infrastructure generated its highest return. Recovery appeared to be the best regime to invest into infrastructure, as the periods of Expansion that followed may have supported broader investment into infrastructure assets that were less attractive in other periods of dislocation. Infrastructure, specifically, may have performed in this way due to a number of factors inherent to the asset class. First, private infrastructure tends to have lower correlation to other asset classes. Additionally, the contractual nature of its cash flows can provide a hedge against inflation.

Exploring the Macro Regimes

Below, we will walk through the economic cycle from Recovery to Contraction and discuss the performance of alternative asset classes within each regime and after.

It must be noted that neither in-regime nor forward returns are indicative of future results nor should advisors use only them to identify an entry point. These graphs should not be interpreted in isolation; the entire picture is necessary, and while asset class performance is averaged to characterize behavior in a particular regime, returns have differed across time given the market environment.

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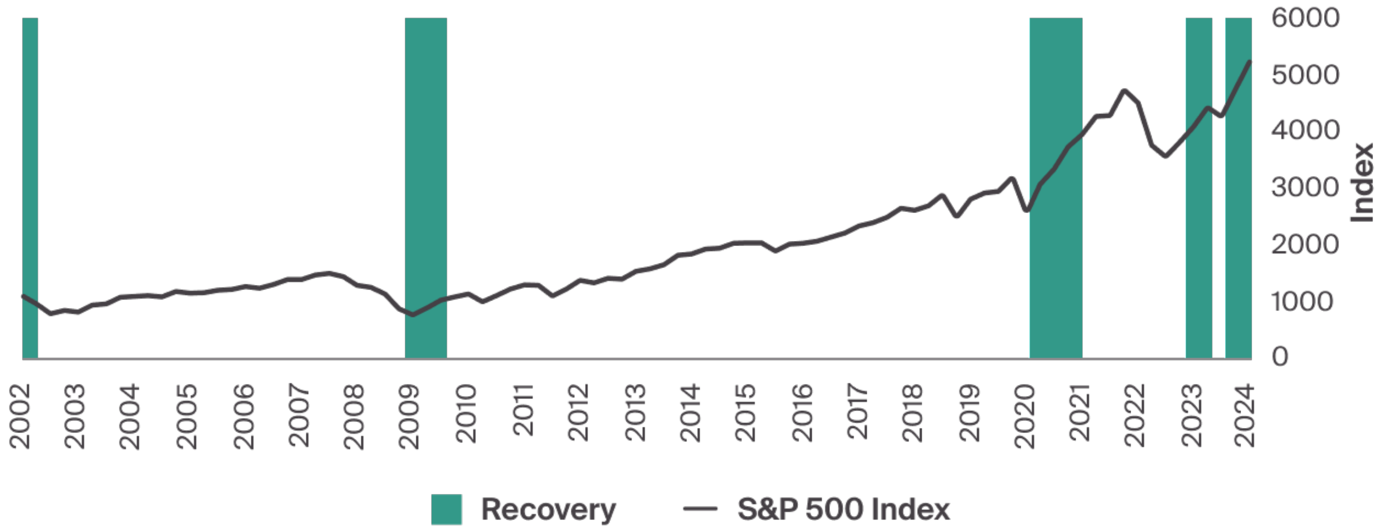
Recovery

Exhibit 4: Recovery periods were characterized by rapidly rising economic conditions and rapidly growing risk appetite.



Source: Bloomberg, S&P 500 index represented by S&P 500 Index; regimes are represented by the framework described in the methodology section, as of Q1 2024.

We begin the economic cycle with Recovery, which occurred during 14% of the quarters in our observation period and lasted on average 2.2 quarters.

Because Recovery tends to follow Contraction regimes, business activity typically rebounds rapidly from its Contraction lows. Interest rates, in most cases, begin to decline as central banks, believing inflation is mostly under control, are eager to improve employment and business activity. Employment begins to flourish; jobless claims, still high from the prior regime, begin to fall quickly, tightening the labor market. Consumer sentiment is low but rising. These periods are also characterized by investors broadly shifting risk back into portfolios as risk appetite is typically very high and rises rapidly during this regime.

Characteristics of Recovery

	Nominal Level	Trend
Business Activity	Low	Rapidly Rising
Monetary Conditions	Tight	Loosening
Labor Market Conditions	Loose	Rapidly Tightening
Consumer Confidence	Low	Rising
Risk Appetite	Very High	Rapidly Rising

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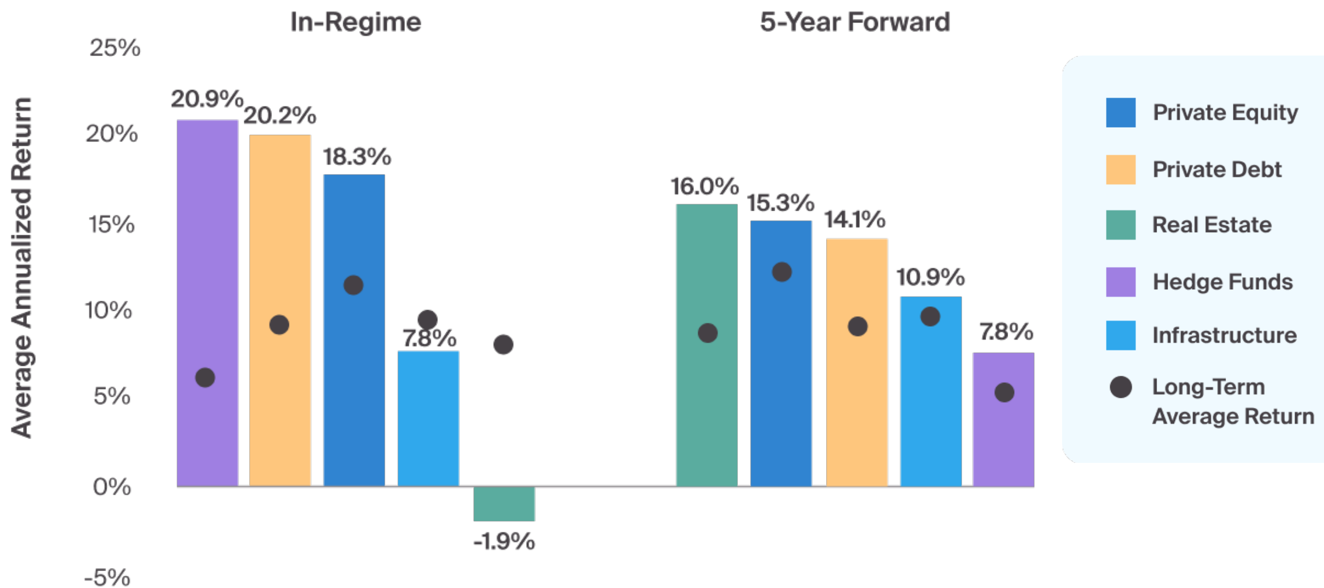
Recovery

Exhibit 5: During Recovery, hedge funds outperformed while deployment across most asset classes appeared more attractive than in other regimes.



Source: Preqin, Private Equity, Private Debt, Real Estate, and Infrastructure represented by respective Preqin Quarterly Index returns; HFR, Hedge Funds represented by the HFRI Fund Weighted Composite Index; Average annualized forward returns calculated through the five years following an indication of an economic regime; Average annualized in-regime returns calculated by averaging the quarterly performance of indices during the regime; observation period between Q4 2001 – Q4 2023, as of Q4 2023.

In-Regime

Within Recovery, we saw the greatest relative outperformance from hedge funds and private debt compared to their long-term historical averages (Exhibit 5). As noted previously, hedge funds are better equipped to adjust their portfolios' positioning quickly, increasing market exposure and capturing alpha in periods of rapid repricing or valuation rebounds. Meanwhile, higher-risk strategies in private debt may have done relatively well in these Recovery regimes given the market's budding risk appetite and the prospect of greater business activity in the quarters that followed. Despite this shift back to a "risk-on" and loosening monetary environment, average real estate returns were negative. Given the real estate market's central role in the GFC, its slow Recovery post-GFC likely weighed negatively on its average return given the length of the observation period.

Forward

Capital deployment in periods of Recovery has historically produced above-average results, as most asset classes outperformed their respective historical averages (Exhibit 5). Private real estate, private equity, and private debt outperformed long-term averages during this time, likely because capital could be deployed when asset valuations were still relatively depressed despite rapidly improving fundamentals. Deploying into a Recovery regime allows GPs to put capital to work in periods that are generally followed by higher business activity, looser monetary conditions, and very tight labor markets, which can drive returns.

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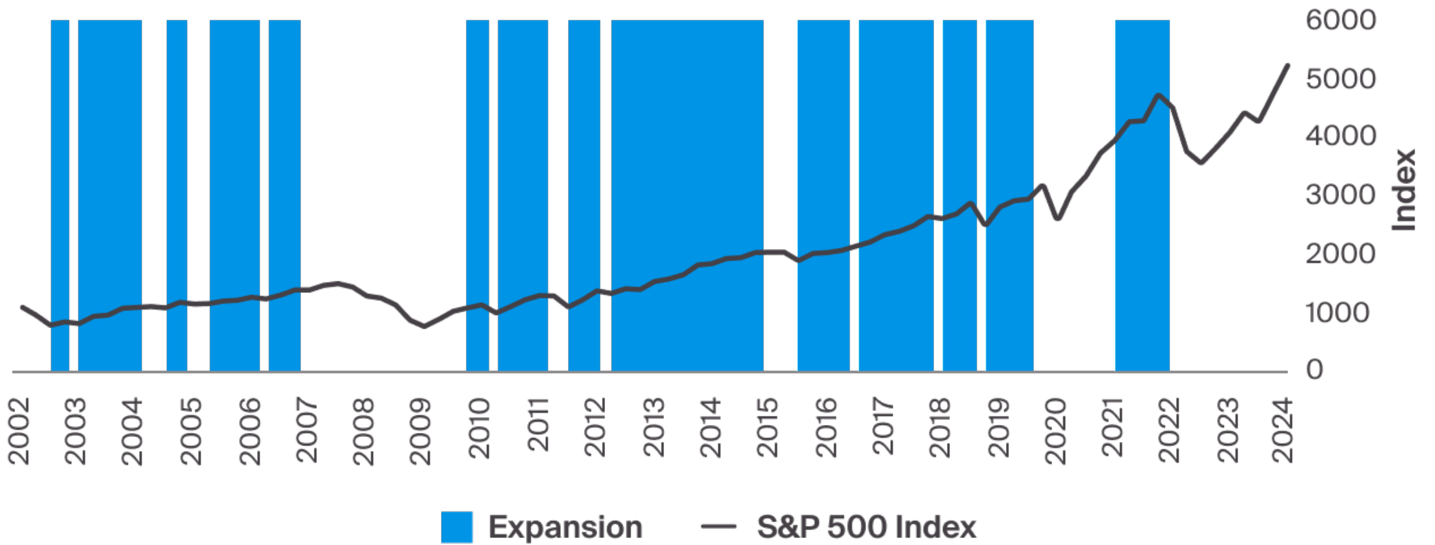
Expansion

Exhibit 6: Expansion periods were characterized by broad economic growth, with risk appetite moderating.



Source: Bloomberg, S&P 500 index represented by S&P 500 Index; regimes are represented by the framework described in the methodology section, as of Q1 2024.

Expansion regimes, which characterized 48% of the quarters covered and lasted an average of 3.1 quarters, were often punctuated by Slowdown regimes before re-entering Expansion—especially in the zero-interest-rate policy (ZIRP) period that followed the GFC.

Expansion is characterized by broad and steady growth driven by strong business activity. Often, very loose monetary conditions support this growth. Inflation gradually begins to climb back up, which is combatted by the gradual tightening of monetary conditions, usually towards the end of the regime. Consumer confidence tends to rise most meaningfully, and investors become comfortable with riskier investments as valuations rise and the economy expands.

Characteristics of Expansion

	Nominal Level	Trend
Business Activity	Very High	Rising
Monetary Conditions	Very Loose	Tightening
Labor Market Conditions	Very Tight	Tightening
Consumer Confidence	High	Rapidly Rising
Risk Appetite	High	Rising

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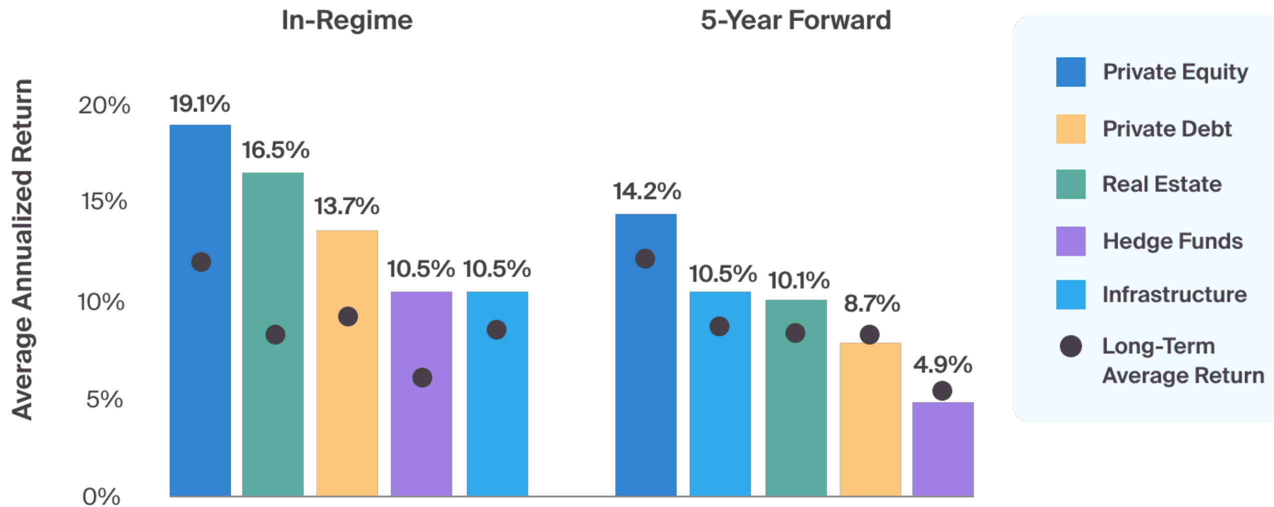
Expansion

Exhibit 7: During Expansion, private equity generated the highest return, but all asset classes outperformed their long-term average.



Source: Preqin, Private Equity, Private Debt, Real Estate, and Infrastructure represented by respective Preqin Quarterly Index returns; HFR, Hedge Funds represented by the HFRI Fund Weighted Composite Index; Average annualized forward returns calculated through the five years following an indication of an economic regime, in-regime average annualized returns calculated by averaging the quarterly performance of indices in the regime in which they reside; observation period between Q4 2001 – Q4 2023, as of Q4 2023.

In-Regime

Expansion regimes produced higher-than-average returns across all alternative asset classes (Exhibit 7). Risk assets benefited from confident investors, typically loose monetary conditions, and businesses and consumers fueling steady economic growth.

Forward

Expansion periods have offered investors relatively attractive entry points into private equity, infrastructure, and real estate (Exhibit 7). Despite the relatively higher valuations that may characterize Expansion regimes given broad risk-on sentiment, the length of Expansion regimes, punctuated by brief Slowdowns, meant that investing in Expansions, historically, still provided sufficient time for longer-term investments to grow and be harvested in positive macro conditions. Private equity, infrastructure, and real estate benefited to different degrees as the tailwinds of economic growth and positive risk sentiment lasted for many quarters. Private debt slightly underperformed its long-term average forward return perhaps due to more competitive terms and looser underwriting in this risk-on environment.

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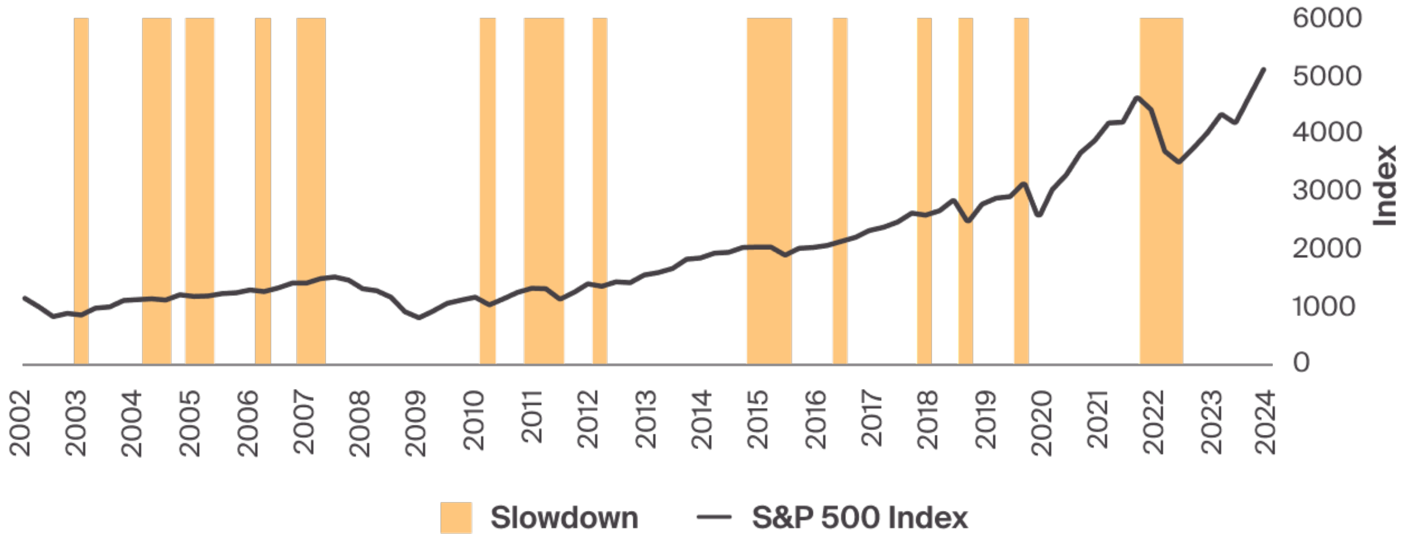
Slowdown

Exhibit 8: Slowdown periods were characterized by slowing economic indicators and falling risk appetite.



Source: Bloomberg, S&P 500 index represented by S&P 500 Index; regimes are represented by the framework described in the methodology section, as of Q1 2024.

Following Expansion, we enter the Slowdown regime, which occurred in 24% of the quarters we observed and lasted 1.6 quarters on average (Exhibit 1). Most instances of Slowdown in our observation period were followed by a reversion to Expansion, but importantly, in three out of 14 instances, they were followed by a Contraction regime.

During a Slowdown, businesses tend to begin scaling back their activity; monetary conditions start looser but rapidly tighten in most cases to combat rising inflation. The labor market is generally at its tightest compared to other regimes and continues to tighten, while consumer sentiment reaches its peak but starts descending. In this environment, risk appetite begins to wane as investors reconcile the diminishing economic conditions, and economic growth begins to slow.

Characteristics of Slowdown

	Nominal Level	Trend
Business Activity	High	Rapidly Falling
Monetary Conditions	Loose	Rapidly Tightening
Labor Market Conditions	Very Tight	Flat
Consumer Confidence	Very High	Falling
Risk Appetite	Low	Falling

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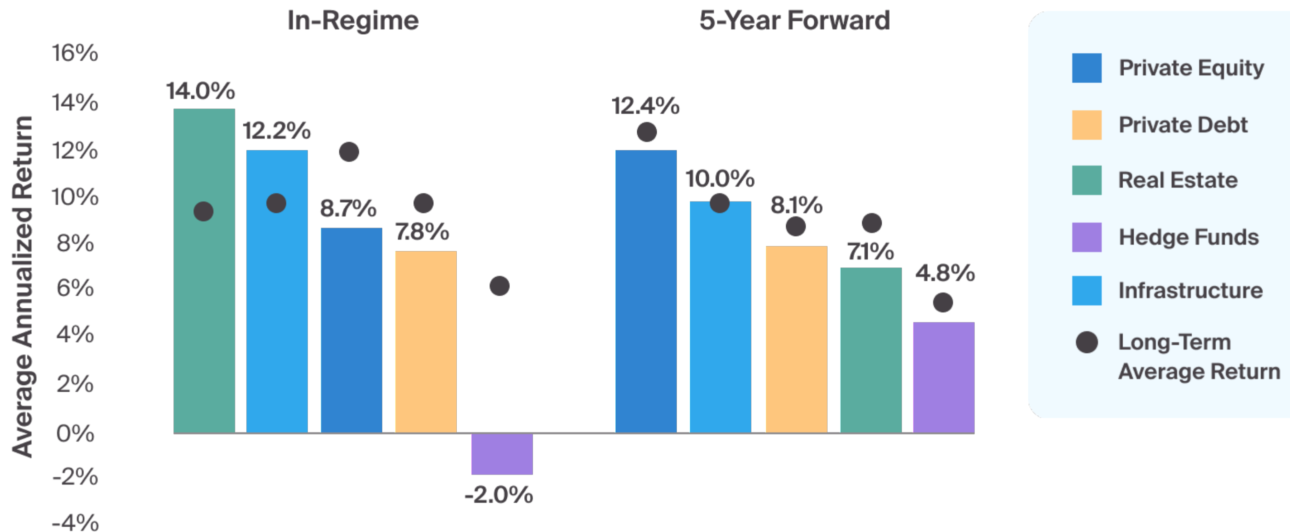
Slowdown

Exhibit 9: During a Slowdown, real assets generally outperform, and while deploying to private equity has outperformed relative to other asset classes, infrastructure was the only asset class to surpass its long-term average returns.

Performance During Recovery: Average In-Regime and Forward Returns



Source: Preqin, Private Equity, Private Debt, Real Estate, and Infrastructure represented by respective Preqin Quarterly Index returns; HFR, Hedge Funds represented by the HFRI Fund Weighted Composite Index; Average annualized forward returns calculated through the five years following an indication of an economic regime, in-regime average annualized returns calculated by averaging the quarterly performance of indices in the regime in which they reside; observation period between Q4 2001 – Q4 2023, as of Q4 2023.

In-Regime

During Slowdown, private real estate and infrastructure outperformed all other alternative asset classes and were the only two that outperformed their average return. As the economic cycle of Expansion began to cool, real asset classes continued to generate income through contractual leases and hold their value despite slowing economic growth; private equity and private debt began to pull back.

Forward

Broadly, Slowdowns were a less-than-optimal environment to deploy capital, though private infrastructure's forward returns slightly exceeded its long-term average returns. While the majority of Slowdowns were followed by a reversion to Expansion, these environments also, at times, preceded a Contraction, which was challenging to risk assets from both a valuation and fundamentals perspective.

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A Historical Perspective: The Global Financial Crisis

Slowdown (Q3 2007 – Q4 2007)

Subprime Mortgage Industry Collapse

In Q1 2007, US home sales declined, triggering a collapse of the US subprime mortgage industry—more than 25 subprime lending firms went bankrupt, and the Dow Jones Industrial Average plummeted.

The subprime crisis stretched into the broader financial sector, with Bear Stearns filing for bankruptcy, and went global, prompting central banks to inject liquidity into major economies.

Contraction (Q1 2008 – Q2 2009)

Financial Services Sector Implodes

Panic spread across Wall Street, with the September 2008 Lehman Brothers' collapse. The US government rescued AIG with an $85 billion plan, and the Department of the Treasury launched the Troubled Asset Relief Program to stabilize markets.

Investor trust vanished from the financial system, with the consumer sentiment, as measured by the Consumer Confidence Index, dropping to 25, the lowest level since 1967, when the measure was created.

In late 2009, the Fed started purchasing troubled assets, a move that became known as quantitative easing, or QE, and the Treasury Department cracked down on banks with stress tests. US unemployment started to rise.

Recovery (Q3 2009 – Q2 2010)

Consumer Spending Bounces, Oil Prices Rise

US economic indicators, such as consumer spending, started to rise in the second half of 2009, while unemployment persisted. Oil prices reached a new high on the back of a weak dollar and strong company results in the US. The Fed suggested that the worst of the recession was in the rearview mirror.

Expansion (Q3 2010 – Q4 2010)

Low Interest Rates, Quantitative Easing Jumpstarts US Economy

The Fed scooped up troubled assets in QE2, which took place in 2010, along with near-zero interest rates, helping to keep inflation below 2% from mid-2010 until March 2011.

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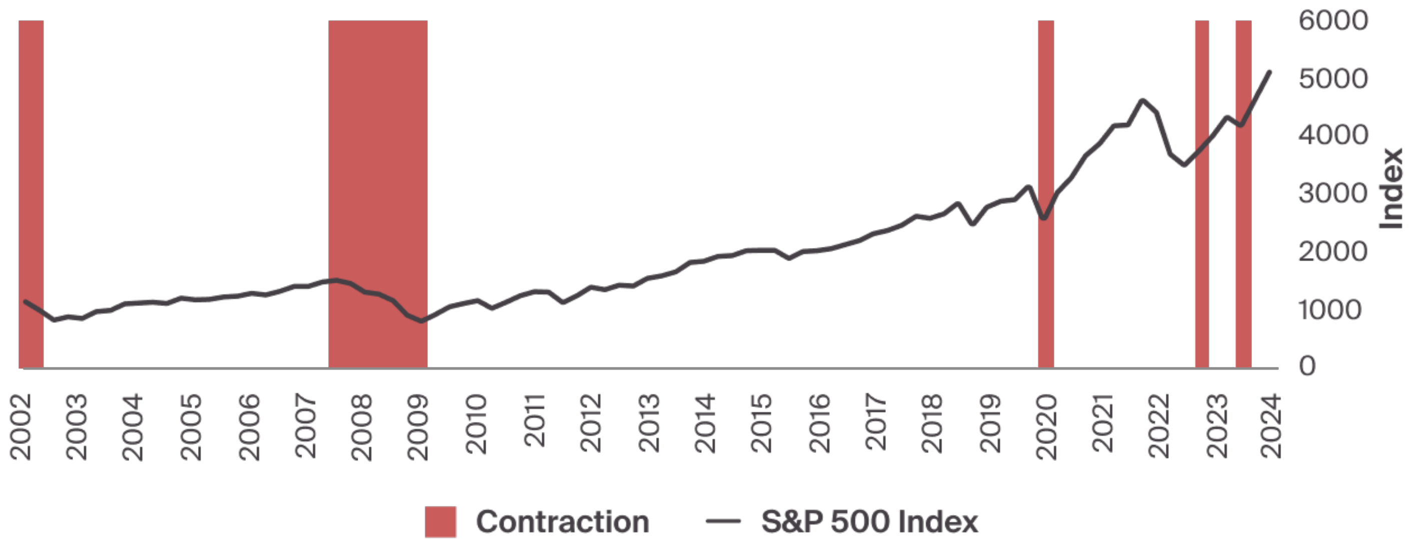
Contraction

Exhibit 10: Contraction periods were characterized by broad economic decay and a muted appetite for risk.



Source: Bloomberg, S&P 500 index represented by S&P 500 Index; regimes are represented by the framework described in the methodology section, as of Q1 2024.

Contraction occurred in 13% of the quarters in our observation period and lasted 2.4 quarters on average (Exhibit 1).

Contraction regimes are marked by rapid economic deceleration, with business activity decreasing to its lowest point in the cycle. Interest rates usually peak but start to drop rapidly as economic activity retracts and inflation comes down. Jobless claims typically reach their apex within the cycle, and the labor market loosens, contributing to a pullback in consumer sentiment. Risk appetite falls as investors seek safe-haven assets in an attempt to safeguard assets from drawdown.

Characteristics of Contraction

	Nominal Level	Trend
Business Activity	Very Low	Falling
Monetary Conditions	Very Tight	Rapidly Tightening
Labor Market Conditions	Very Loose	Rapidly Loosening
Consumer Confidence	Very Low	Rapidly Falling
Risk Appetite	Very Low	Rapidly Falling

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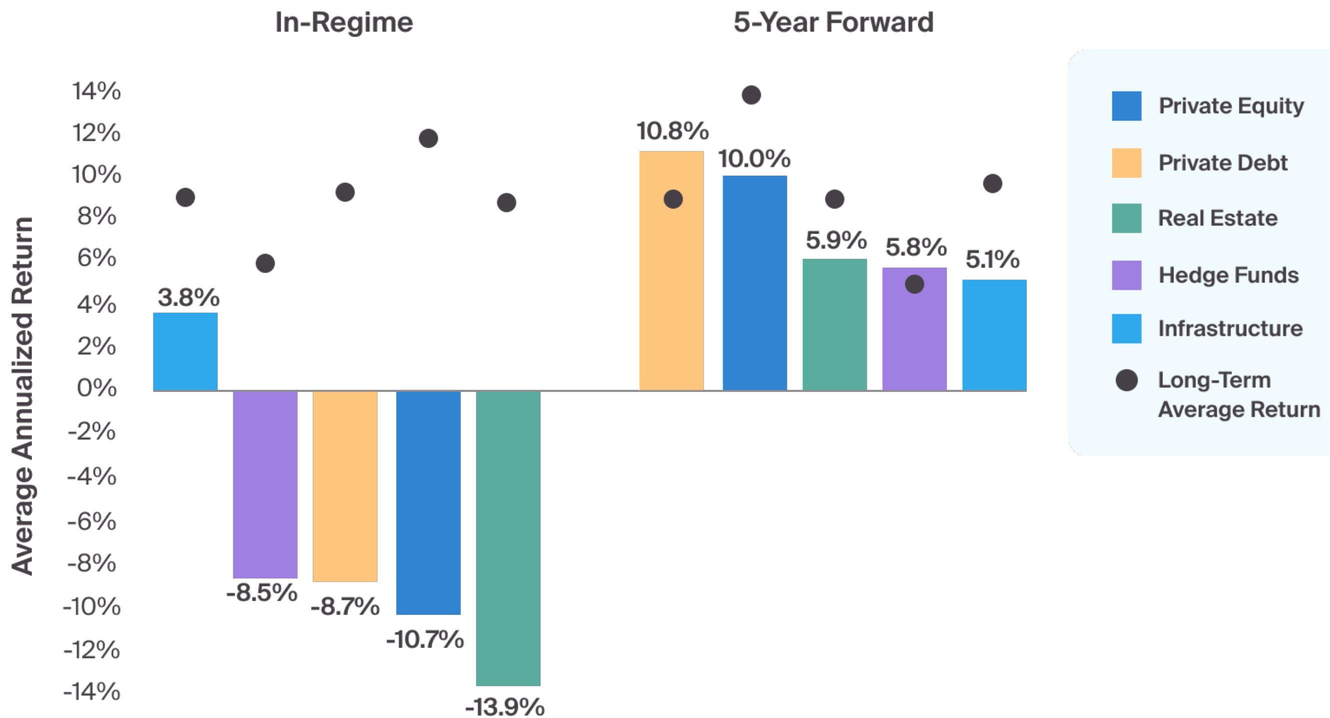
Contraction

Exhibit 11: During Contraction, all asset classes underperformed their long-term average; infrastructure remained resilient while forward returns for private debt shined.



Source: Preqin, Private Equity, Private Debt, Real Estate, and Infrastructure represented by respective Preqin Quarterly Index returns; HFR, Hedge Funds represented by the HFRI Fund Weighted Composite Index; Average annualized forward returns calculated through the five years following an indication of an economic regime; in-regime average annualized returns calculated through averaging the quarterly performance of indices in the regime in which they reside; observation period between Q4 2001 – Q4 2023, as of Q4 2023.

In-Regime

In periods of Contraction, all asset classes underperformed their long-term historical averages, but the greatest resilience was seen from infrastructure—the only alternative asset class to deliver positive returns. Infrastructure appeared to buck Contraction due to the nature of its assets, the demand for which is often inelastic given their importance to the basic functioning of society. Infrastructure managers can also generally reprice their costs based on inflation and changes in rates. The performance of private equity fell, as risk assets sold off and market sentiment eroded traditional exit venues for these funds. Real estate declined more than other alternative investments, likely as a result of the outsized impact of the GFC—which was inherently a real-estate-driven crisis. It may also have reflected the sell-off of real estate assets that tend to be highly sensitive to economic conditions.

Forward

Returns following this period varied. Private debt was the only asset class for which the forward returns overtook its historical return. In this case, lenders may have been able to demand better terms on loans when other sources of credit pulled back. Opportunistic and distressed debt-focused managers also had greater opportunities in Contraction due to dislocation in the stressed and distressed environment that typically characterizes this regime.

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Risks and Considerations

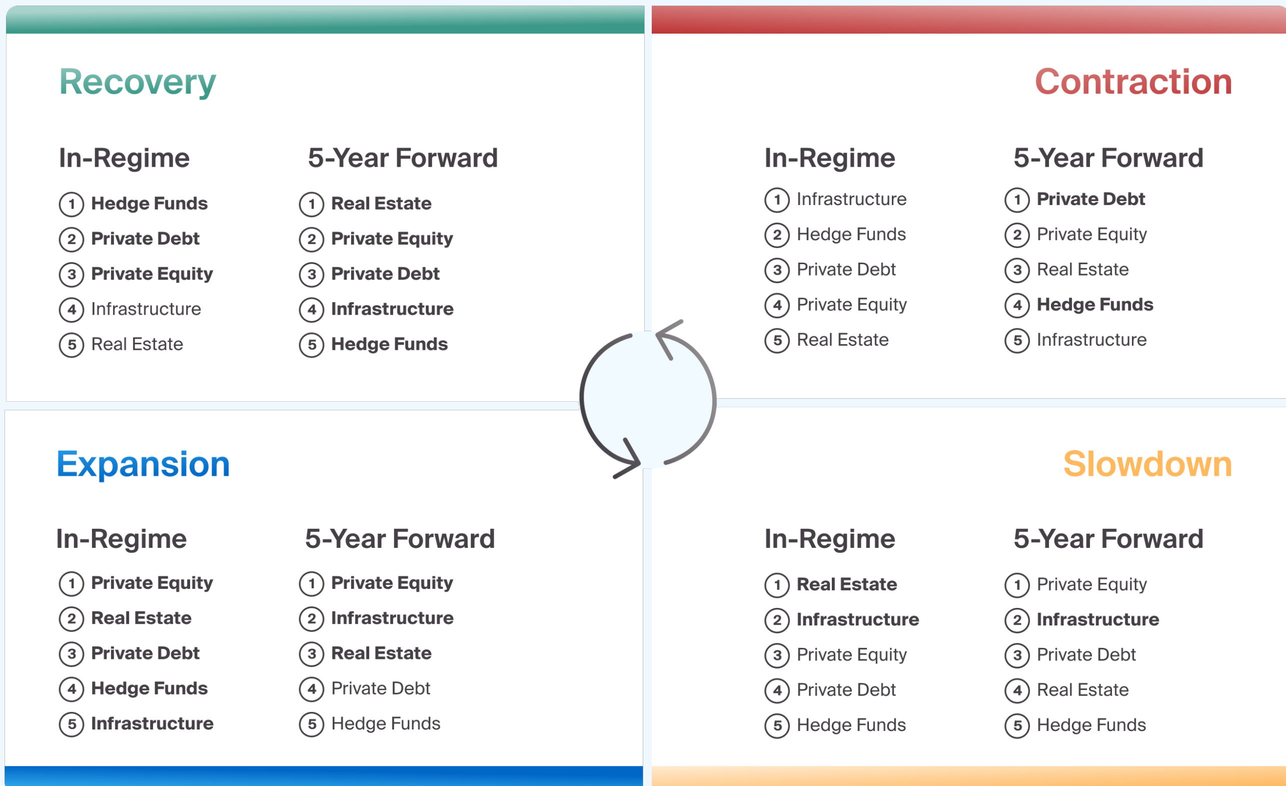
Advisors may be exposed to significant risks when allocating portions of their portfolios to alternative asset classes. Though alternatives seemed to experience relatively less performance dispersion across the historical regimes in this analysis, the performance dispersion across these types of funds appeared higher than that across traditional funds. Funds in these alternative asset classes may also have limited liquidity at both the fund and asset level. Alternative fund managers may also employ tactics that are inherently riskier than those available to traditional fund managers, such as greater use of leverage or short selling.

It's also worth noting that it is not possible to invest in any of the broad asset class indices used in this analysis, and therefore, the experience of an advisor who invests in individual strategies may have been quite different from the results shown here.

In Summary

Below, we summarize our findings, with a box for each regime. Alternative asset classes that performed above their historical average within regimes are bolded and ranked higher. The same ranking is used for asset classes with above-historical-average forward returns.

Exhibit 12: According to long-term average outperformance, while periods of Expansion broadly generated the highest returns, Recovery periods had relatively higher forward returns.



Source: For illustrative purposes. Asset classes are ranked based on the highest average annualized in-regime and forward returns.

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Historical returns do not indicate future results; however, we can use these insights to better inform how and why certain asset classes may perform the way they do across economic regimes.

Alternative asset classes, by nature, require a long-term investing approach and take time to generate returns. Thus, investing into attractive regimes is important, but not imperative, as these strategies generally deploy capital into underlying assets over a period of three to five years, on average. Vintage diversification, or building toward strategic long-term allocations over time, may be more important when aiming to minimize risk.

As we see here, alternative asset classes historically experienced much less dispersion of returns across regimes compared to traditional asset classes. Advisors may look to these strategies to complement their more traditional allocations, seeking additional value through diversification, alternative income, enhanced returns, and capital preservation.

Methodology

Markets are inherently cyclical, influenced by myriad economic and psychological factors. Our Regime Framework consolidates the plethora of signals available to financial advisors and segments the market timeline into distinct regimes, each characterized by unique economic conditions and investor behaviors. This segmentation allows for a more nuanced understanding of asset class performance across different phases of the economic cycle.

We name our regimes in line with typical economic, business, and credit cycles: Recovery, Expansion, Slowdown, and Contraction. However, assuming asset classes have significant but varying sensitivity to both macroeconomic and market sentiment factors, we expand upon the classic definitions. By integrating sentiment analysis with economic indicators, our Regime Framework captures both the rational economic outlook and the often irrational psychological influences that drive market movements.

Our observation period in this paper, from Q4 2001 to Q4 2023, was determined by the inception dates and the most recent data points of the indices used to proxy asset class returns.

Signals of Economic Environment and Market Sentiment

To classify each time period into distinct economic environments, or regimes, we rely on a suite of metrics to signal future economic activity. Leading indicators, such as manufacturing orders, consumer confidence, and monetary conditions, provide early warnings of economic expansions or contractions. The signal that represents the economic environment in our framework is the annual positive or negative change in an index of economic variables like the ones listed above. A positive signal indicates improving economic conditions while a negative signal indicates worsening economic conditions. To leverage this index as a forward-looking indicator, our calibration of the economic environment was done on a forward basis, meaning that the value of the index in a given quarter accounts for the economic environment of the quarter prior.

We also used a measure of market sentiment to determine regimes. Such a metric aims to capture the collective mood and outlook of market participants and is influenced by factors such as news, investor behavior, and market trends. Here we use this measure to gauge the risk appetite of market participants and their expectations for future market performance. We define changes in the measurement of market sentiment using the intersection of short-term and long-term risk-adjusted returns of public markets.

We calculated changes in market sentiment using two distinct signals, the daily four-month trailing Sharpe of a broad equity market index and the daily one-year trailing Sharpe of the same broad equity market index. In practice, as a shorter-term signal surpasses the level of a longer-term signal, this indicates a sustained positive change, the same goes for a negative change. A reading of the four-month signal above the one-year signal indicates market sentiment is above trend and risk appetite is growing. By contrast, when the four-month signal is lower, market sentiment is declining.

The combination of these two indicators allows us to determine the macroeconomic regime in a given quarter. Below we depict the regime outputs and their underlying makeup of economic environment and market sentiment.

Determining the Regime

Expansion regimes are defined by both positive economic conditions and positive market sentiment signals in a given quarter.

Slowdown regimes are defined by mixed signals between economic conditions and market sentiment and preceded by a Contraction regime or another Slowdown regime.

Contraction regimes are defined by both negative economic conditions and negative market sentiment signals in a given quarter.

Recovery regimes are defined by mixed signals between economic conditions and market sentiment and preceded by an Expansion regime or another Recovery regime.

Defining Recovery and Slowdown regime as “mixed” signals between economic conditions and market sentiment assumes that investors may at times incorrectly anticipate economic conditions. In addition, this methodology codifies the intuition that regimes are sequential in nature. However, regimes may revert to a previous phase in the regime cycle. For example, a Recovery regime may be followed by a reversion to a Contraction regime if both economic conditions and market sentiment signals are negative in that subsequent quarter. Given regimes are measured at a quarterly interval and the aforementioned definitions of regimes, it is plausible that Recovery or Slowdown regimes may be “skipped” if signals flip from synchronously positive to synchronously negative, or vice versa. There are, however, no cases of this in the observable period.

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