Is Your Asset Allocation Working? Volatility is Rewriting the Correlation Playbook

In higher-volatility regimes, diversification is not assumed, it is validated.

This week's volatility spike has an obvious catalyst: rising geopolitical tension in the Middle East and the renewed uncertainty that comes with it. However, the more important development has been happening in the background. The Cboe Volatility Index (VIX) has been quietly moving higher since late December, and this week's jump simply made the shift hard to ignore.

When volatility re-rates higher, the math of diversification changes. A 60/40 equity-fixed income allocation seeks to temper swings: stocks drive long-term growth while bonds often offset part of that volatility. However, correlations drift, traditional 60/40 can become inconsistent, and portfolios that rely on static assumptions can behave very differently than expected. The headline may change, but the portfolio question stays the same: is your diversification strategy working right now?

Regime Scorecard

The goal is not to forecast next week's move. It is to identify whether current signals potentially point to a contained volatility reset or stress that could start to spread.

Signal	Where it stands	What it tends to mean
Volatility	Elevated and rising since late Dec (VIX in low 20s)	More regime switching and higher correlation risk
Diversification gap	S&P 500 vs 10Y Treasury 3M correlation about +0.12 (should be negative in a typical risk-off regime)	A standard 60/40 Allocation has been less reliable, and can add risk on some down days
Rates backdrop	Real yields have eased recently	Falling real yields tend to make bonds behave more like ballast
Breadth	Short-term participation softer than long-term (~60% above 50DMA vs ~65% above 200DMA)	Cooling momentum, longer-term trend still largely intact
Credit	Stress at the margin (CCC widening faster than HY)	Early warning sign to monitor for spreading stress

1) Volatility has Shifted Higher, and That Changes Behavior Across Markets

VIX closed at 21.44 on 03/02/2026 after trading as low as the mid-teens earlier this year and reaching the mid-20s this week amongst Middle East related unease. Even if volatility fades from the peak, a higher baseline may lead to producing larger day-to-day swings and quicker rotation in market leadership. That is when portfolio construction matters more than headlines.

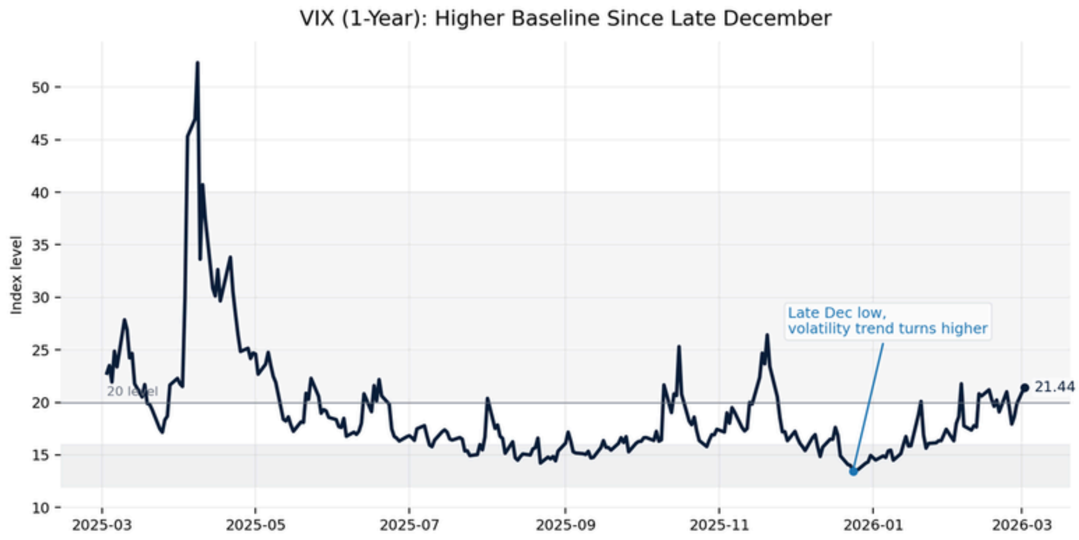

Chart 1. VIX, 1-year
Source: Cboe Global Markets, daily VIX history as of March 2, 2026.

2) The Diversification Test: Stocks and Bonds Are Not Moving Like They Used To

When volatility rises, diversification becomes something you measure, not something you assume. A simple way to track whether duration is providing offset is to look at the rolling relationship between the S&P 500 and intermediate Treasury total returns.

Right now, that relationship is near zero over the last three months (-0.06) and modestly negative over the last six months (-0.12). In other words, the traditional offset from Treasuries has been present, but not consistently strong. The shorter window is doing more of the work lately: the 20-day correlation is -0.52, which suggests Treasuries have recently behaved more like ballast as volatility picked up.

The takeaway is straightforward. When correlation is negative, Treasuries tend to diversify equity risk. When it drifts toward zero or positive, the diversification benefit becomes more episodic.

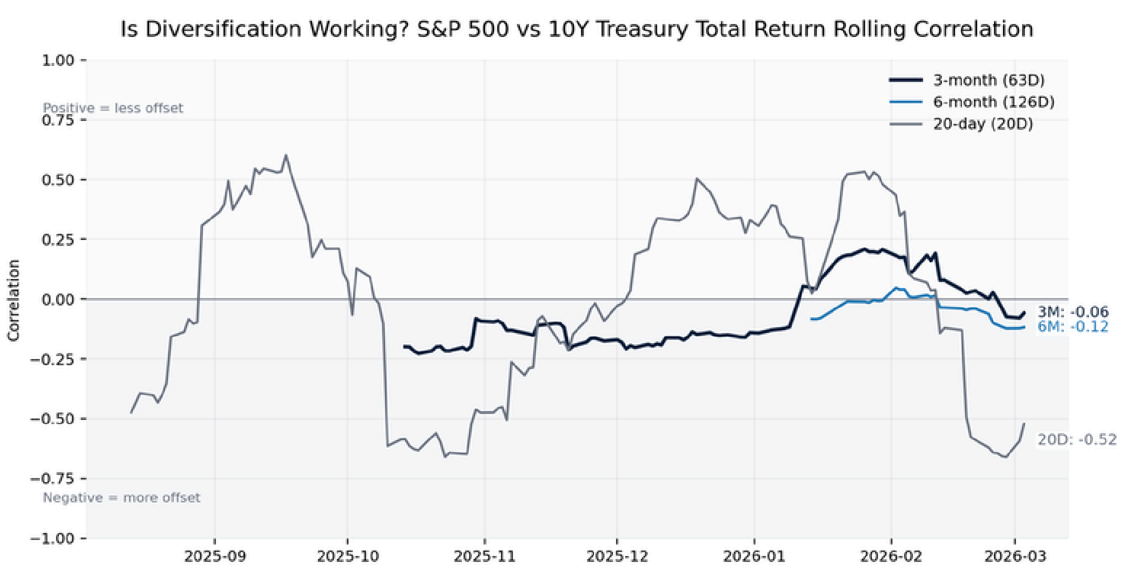

Chart 2. S&P500 vs US 10Y Treasury rolling correlation (20-day, 3-month, and 6-month)
Source: Yahoo Finance, daily adjusted close for SPY and TLT as of March 3, 2026.

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3) Oil and Inflation Expectations: Watch What is Driving Yields

With oil prices rising, many investors are focused on inflation expectations. The most practical way to keep that discussion grounded is to decompose the 10-year yield into real yields and inflation compensation. In the past month of data, the 10-year nominal yield fell about 29 bps to 3.97% (as of 02/27/2026), while the 10-year real yield fell about 18 bps to 1.72%. Ten-year breakevens have been around 2.29% (as of 03/02/2026), slightly lower than a month earlier.

This does not dismiss the inflation narrative. Energy shocks often push near-term inflation fears first, and the question is whether that bleeds into longer-run pricing. For portfolio construction, the takeaway is simpler: When real yields (inflation-adjusted Treasury yields, e.g., TIPS) fall, bonds have often provided better diversification, cushioning part of equity declines. If real yields (TIPS yields) start rising again alongside higher or more uncertain inflation, that diversification can weaken.

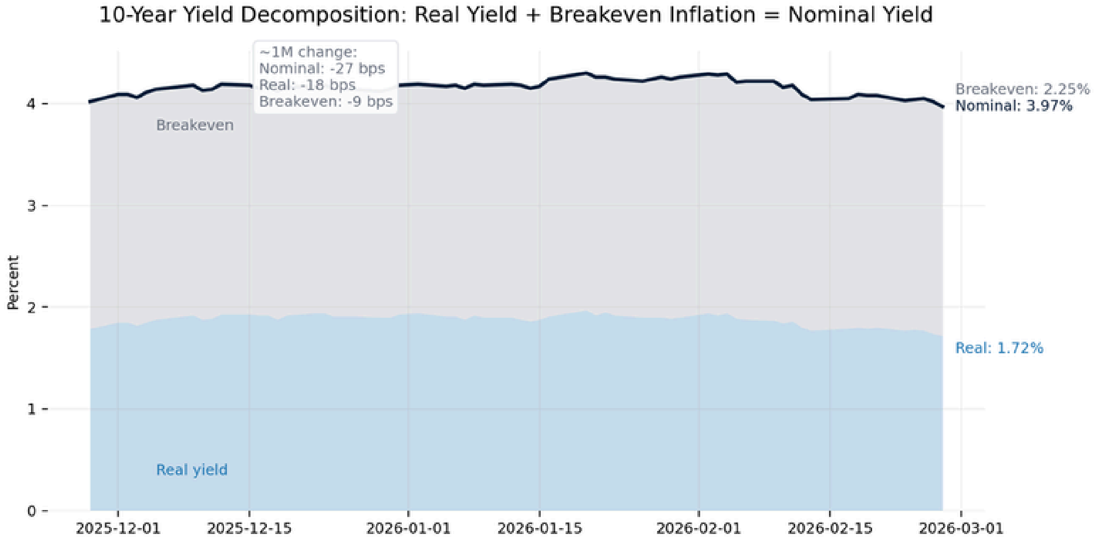

Chart 3. 10-year yield decomposition (real yield + breakeven inflation)

Source: Federal Reserve Economic Data (FRED). DGS10 and DFII10 as of February 27, 2026; T10YIE as of March 2, 2026.

4) Stress Check: What Credit is Pricing

Credit canary: is stress spreading at the margin?

Equities can pull back for many reasons. Credit often helps distinguish a healthy reset from stress that is spreading. Broad spreads are widening, but they are not flashing systemic stress. As of 03/02/2026, High yield bonds are offering 3.03% in extra yield over Treasuries, while investment grade bonds are around 0.85%, both modestly wider over the last month. The more telling signal is that CCC rated bonds, the most distressed, highest-default-risk slice of high yield, show spreads around 9.45%, up materially over the month.

This is why CCC spreads are worth watching. When the lowest-quality tier reprices faster than the broader market, it is often an early sign that investors are demanding more yield than the rest of the market for weak balance sheets and refinancing risk. If CCC spreads stabilize or begin to narrow, it suggests stress is contained. If they continue widening, it reasons for more caution around risk and liquidity.

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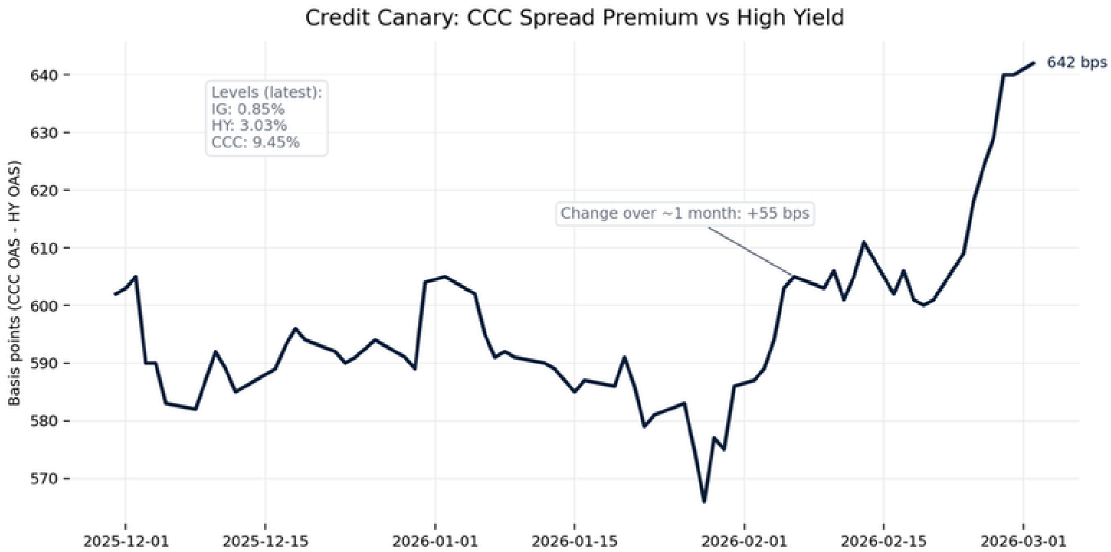

Chart 4. Credit canary - CCC spread premium vs high yield
Source: Federal Reserve Economic Data (FRED), ICE BofA OAS series as of March 2, 2026.

Market Breadth: Is Volatility Spreading?

Market breadth is best used as a guide rather than a verdict. After the initial pullback, fewer stocks are holding above their 50-day average than their 200-day average, which is consistent with short-term momentum cooling while the longer-term trend is still largely intact. The escalation scenario is when the 200-day measure starts following the 50-day measure lower.

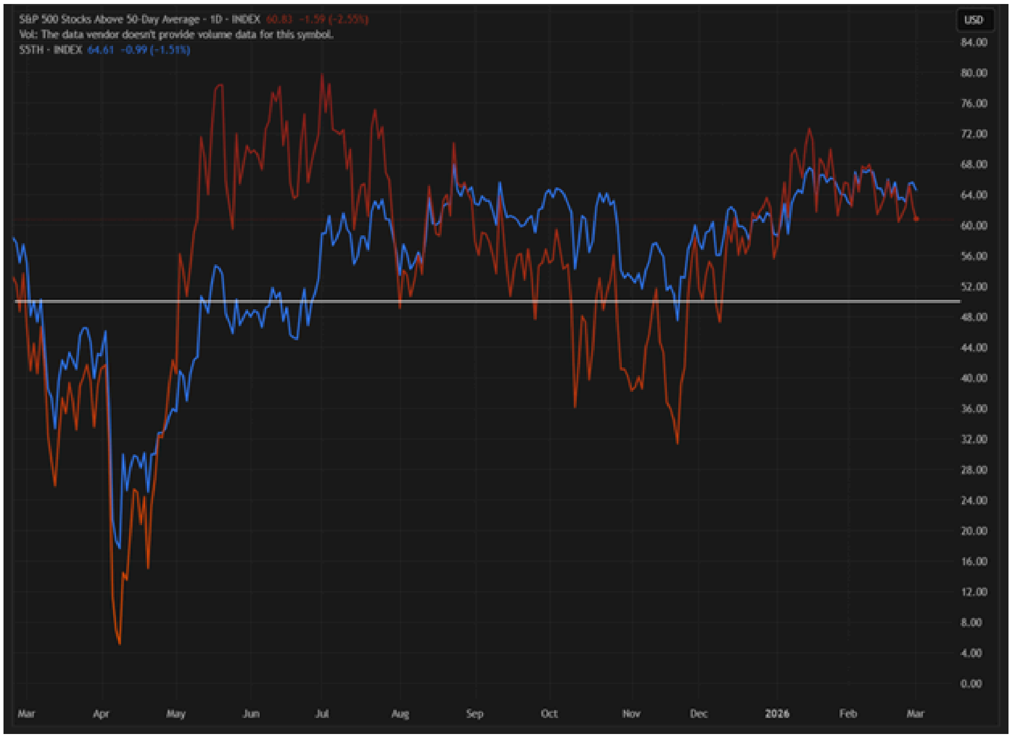

Chart 5. Market Breadth - share of S&P 500 stocks above 50-day and 200-day moving averages
Source: TradingView (INDEX: S5FI and INDEX: S5TH) as of March 3, 2026.

Disclosures on next page

Considerations: A Strategy For Validating Diversification

A higher-volatility market regime does not require dramatic changes, but clearer signposts can help. A simple approach:

- **Validate the allocation you have, do not assume it:** monitor whether bonds are cushioning equity weakness and whether stock-bond correlation is staying negative.
- **Use real yields as a lead indicator:** if 10-year TIPS yields start rising again, expect bonds to be a less dependable counterbalance to volatility and plan risk budgets accordingly.
- **Watch the canary:** CCC repricing faster than broad high yield is a reason to favor quality and liquidity. Stabilization and continued narrowing of spreads in CCC are signs that stress is being contained.

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