

EUROPE

Introducing BBVA FCI

 16 September 2025
 (10:00 CET)

Executive Summary

In this report, we launch our new BBVA US Financial Conditions Index (FCI). See the appendix for a detailed description of our methodology. During the pre-GFC era, central bank policy was primarily and almost exclusively driven by policy rates. Since the GFC, however, we have seen the central bank use its balance sheet and public communication to manage policy and thus financial conditions. Financial conditions have therefore become a key predictor of financial markets and an important input towards making investment decisions.

In this note, we use our FCI to determine asset allocation between US bonds and equities, MSCI ACWI sectors and BBVA QIS risk premia strategies. We find that using financial conditions as a leading indicator can result in greater alpha than static allocation and even dynamic allocation without the use of the FCI.

According to our model, financial conditions are currently at a level near last decade's lows. Our model suggests a higher equity allocation in portfolios. Across sectors, the current level points to a higher cyclical equity allocation, particularly towards the technology and industrial sectors. Within the risk premia space, the current level points to a higher allocation towards carry strategies, particularly in FX.

Figure 1

FINANCIAL CONDITIONS INDEX (BBRIFCUS Index)



Source: Bloomberg and BBVA Global Markets Strategy

LONDON:

Head of QIS Research

Ankit Kumar, CFA*

ankitkumar.gheedia@bbva.com

+44 747 692 0757

(*) Author(s) of this report

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1. Introduction

The concept of financial conditions has increasingly been in the spotlight since the GFC as a relevant indicator to make informed investment decisions, as it captures multiple channels of transmission from financial variables to the economy. During the pre-GFC era, central bank policy was primarily and almost exclusively driven by policy rates. Central bank benchmark rates have traditionally been the key driver of financial conditions as a result. This meant that we didn't need to monitor a lot to understand corporate and consumer lending appetite and availability.

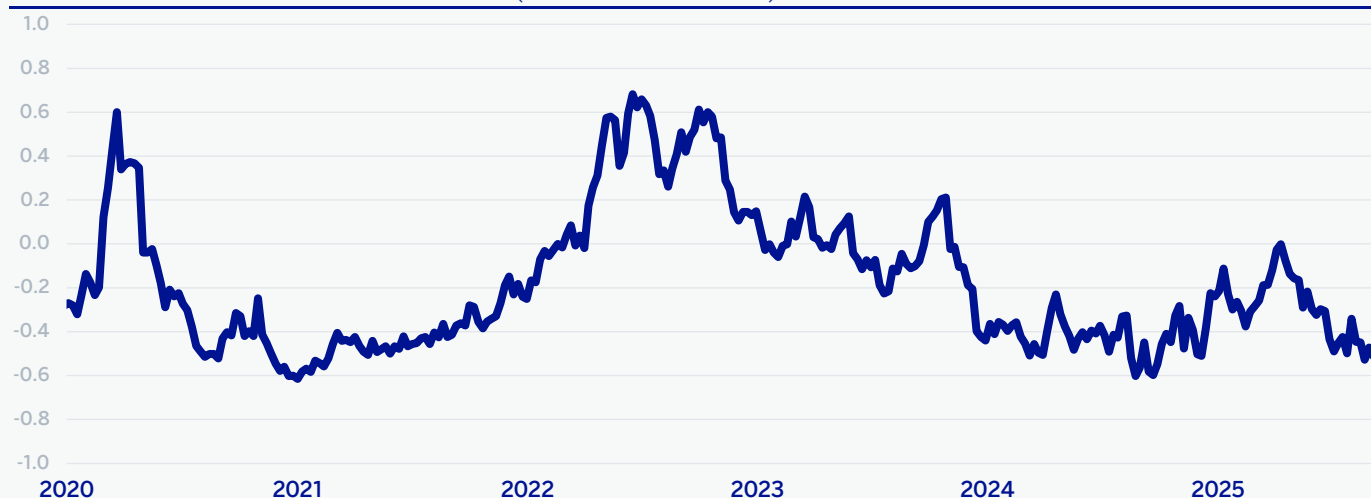
Since the GFC, however, we have seen the central bank use its balance sheet and public communication to manage policy and thus financial conditions. Financial conditions have therefore become a key predictor of inflation expectations, and Powell's latest comments at Jackson Hole led to a substantial easing of financial conditions as the market prepared for imminent rate cuts at the Fed's September meeting. As a result, cycles of financial conditions have been strongly linked to global markets, with periods of loose financial conditions creating an environment for new borrowing, stronger economic activity, higher inflation and more risk-taking. On the other hand, tighter financial conditions have been associated with less growth and the relative outperformance of bonds vs. equities.

Given the impact of financial conditions on sentiment, they typically tend to lead the economic cycle. For example, during the Covid-19-related equity market sell-off in March 2020, the best time to buy risk assets was when financial conditions index peaked, according to our data on 20 March 2020. This is despite weak economic data for the months that followed. The most recent reading of our FCI above 0.5x was on 22 October 2022, after which there was another substantial rally in equity markets. We saw financial conditions tighten throughout 2022, making it a tricky environment for risk assets.

In the past 12 months, financial conditions were loose during Q4 2024 and then started tightening at the start of this year. Tightening financial conditions tend to signal to investors to reduce risk allocation or start implementing hedging strategies. Our indicator peaked on 11 April; since then, financial conditions have loosened significantly, driving the risk-on environment. We expect Fed cuts, combined with fiscal easing in the US, to keep financial conditions supportive for risk assets in the near term.

We find that financial conditions tend to lead inflation and the economic cycle by 3-6 months. The current low level of the FCI would hence suggest upside risk to inflation expectations at the start of next year. When combined with further fiscal easing in the US, we could see the start of 2026 as the beginning of a new reflation cycle for the US. This typically tends to be positive for risk asset, particularly in the financial sector.

Figure 2

FINANCIAL CONDITIONS INDEX (BBRIFCUS Index)


Source: Bloomberg and BBVA Global Markets Strategy

Our proprietary FCI methodology offers a simple, robust and timely approach based on a proprietary choice of variables, which is produced weekly. It was created to complete our six-asset cycle phase framework (see our methodological note, Methodology: A six-stage asset cycle based on a proprietary leading cyclical/inflation index, published on 2 February 2023).

It is always important to compare a new series with benchmarks, to justify its creation. To do this, we compare our indicator with well-known and well-used benchmarks like those of the Chicago Fed and Bloomberg. We find that our indicator is more reactive than the Chicago Fed FCI. The latter uses 100+ indicators as an input and is perhaps a good way to track financial conditions from a policy perspective, but as our indicator is more reactive, we believe it is more relevant from a market timing perspective. For example, our indicator began to tighten from mid-December, when US equity markets started going sideways. We believe our indicator gave an early signal of equity markets reaching a peak. On the other hand, the Chicago Fed FCI was still loosening until February this year and only started to tighten in line with the peak in US equities. We believe a narrow-based indicator offers greater predictive power for financial markets.

The most easily accessible FCI series is probably from Bloomberg. The Bloomberg FCI is similarly reactive to ours. We feel that ours gives relevant weightings to bonds, equities and credit markets, which is important for our investment process. The Bloomberg FCI, in contrast, is heavily reliant on the US government bond market without credit components, which we do not believe suits our purpose for asset allocation.

Figure 3

FINANCIAL CONDITIONS INDEX (BBRIFCUS Index)


Source: Bloomberg and BBVA Global Markets Strategy

2. Does it work?

When applied to portfolio decisions, our FCI not only provides better annual returns but also reduced volatility and smaller drawdowns, suggesting the addition of the FCI is a must in any asset allocation. We believe that an investment strategy based on our FCI can help generate substantial portfolio return outperformance vs. traditional benchmarks. A trading strategy based on exploiting the two stages of the FCI has consistently managed to generate far superior risk-adjusted returns than a standard 60/40 portfolio.

Figure 4

INDEX MEMBERS

Sub index	Code	Description	Source
Equity	Above_200MA	S&P members above 200MA	Bloomberg
Equity	SPX_MA24M	Distance to MA24M	Bloomberg
Equity	MV_GDP	Market cap / Gdp	Bloomberg
Equity	FIN_MAIN	Financial sector / Main sector capitalization	Bloomberg
Equity	VIX	Volatility index	Bloomberg
Credit	IG_10Y	Spread Corporate IG vs UST10Y	Bloomberg
Credit	HY_10Y	Spread HY vs UST 10Y	Bloomberg
Credit	HY_IG	Spread HY IG	Bloomberg
Macro	TAYLOR_RULE_SPREAD	Taylor rule	Bloomberg
Macro	US TIPS 10Y	Inflation linked 10Y bonds	Bloomberg
Macro	UST10Y_TERM_PREMIUM	UST10Y tem premium	Bloomberg
Macro	DXY	US Dollar spot index	Bloomberg

Source: Bloomberg and BBVA Global Markets Strategy

Bonds vs. equities: Since 2001 and over the past 10 years, US equities have delivered cumulative returns of 7.3% and 12.6%, respectively. During the same period, our model portfolio delivered returns of 5.5% and 8%, respectively. This is lower in comparison, although our model portfolio has experienced half the volatility at just 8.8% vs. over 17% for equities. And the drawdown of our portfolio has been just 24% vs. 56% for equities since 2001. Using an FCI-based approach, we can achieve better returns over a long timeframe via a reduced volatility profile and smaller drawdowns.

In our model portfolio, we test allocation based on the FCI's weekly levels. While this might seem excessive, the sticky nature of our FCI makes it a viable strategy without high transaction costs. Over the past five years, we have had fewer than three portfolio reshuffles every year and no reshuffle in the past year.

MSCI ACWI sector allocation: Since 2001 and over the past 10 years, global equities have delivered cumulative returns of 5.7% and 9.2%, respectively. During the same period, our model portfolio has delivered returns of 8.4% and 12.6%, respectively. Given 100% allocation to equities, the volatility of the portfolio has been similar to the benchmark at 16%, but better returns have meant a better Sharpe ratio for our allocation strategy.

QIS risk premia allocation: Since 2001 and over the past 10 years, a portfolio of 60% US equities and 40% US bonds has delivered cumulative returns of 5% and 7.25%, respectively. During the same period, our model portfolio has delivered returns of 5.4% and 5.8%, respectively. This is lower in comparison, although our model portfolio has experienced a third of the volatility at just 3.5% vs. over 10% for the 60/40 portfolio. And the drawdown of our portfolio has been just 5% vs. 35% for the 60/40 portfolio since 2001.

The Sharpe ratio of our FCI-based QIS portfolio has been an impressive 1.5x since 2001 and 1.7x over the past 10 years vs. just 0.6x for the 60/40 index. An equal-weighted QIS portfolio also delivers a Sharpe ratio of 1.6x over a longer time frame with lower volatility and lower cumulative returns.

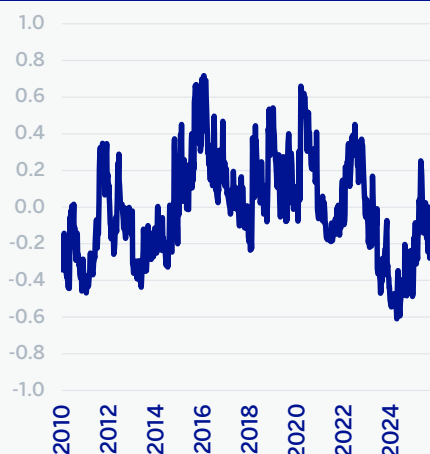
3. What is it telling us?

Our FCI is a composite of the financial conditions driving equities, credit and US macro. Currently, long-end bond yields have proven to be stubbornly high with still abundant fiscal support to the economy, particularly in the US. Higher rates would suggest tighter financial conditions, everything else equal. However, our macro component of financial conditions is pointing to neutral conditions. The higher term premium and real rates components are offsetting the easing currently provided by a weak USD.

The credit component of our FCI is near its record lows. This is driven by the credit spread compression we have observed since April this year. More recently, we have also observed a slew of corporate issuance given the compression in corporate spreads. This supports the conclusion of our credit component, which sees the environment as supportive for corporate borrowing.

Finally, the equity component of our FCI is also loose but not near record lows. Equities have rebounded sharply off the April lows, but the rally has been concentrated in a handful of AI stocks. A broadening of the equity rally will drive a much looser equity component of financial conditions, according to our methodology.

Combining the three, our model is still pointing towards loose financial conditions in the near term. Current levels are near last decade's lows, which supports a higher equity allocation in portfolios. Across sectors, the current level of financial conditions points to a higher cyclical equity allocation. Within the risk premia space, the current level of financial conditions points to a higher allocation towards carry strategies, particularly in FX.

Figure 5**EQUITY – FCI**

Source: Bloomberg and BBVA Global Markets Strategy

Figure 6**CREDIT – FCI**

Source: Bloomberg and BBVA Global Markets Strategy

Figure 7**MACRO – FCI**

Source: Bloomberg and BBVA Global Markets Strategy

4. Using financial conditions to predict markets

For global market performance, we expect financial conditions to become an important driver of medium-term forward returns beyond just knee-jerk reactions from published headlines.

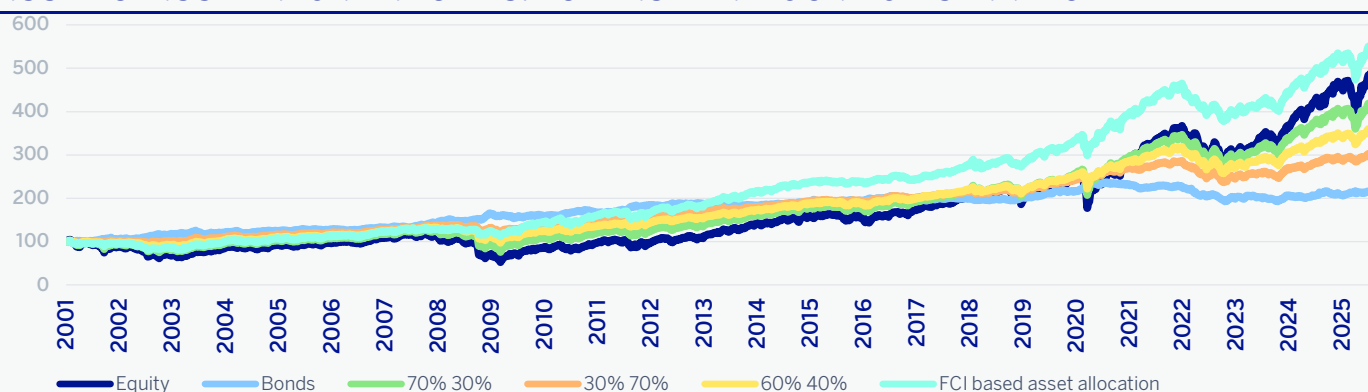
4.1. Asset allocation approach

To test our hypotheses, we allocate 30% to equities (US equities) and 70% to bonds (US 10Y) when our FCI is in a tightening phase and 70% to equities and 30% to bonds during looser times. Over the past 25 years, we find that this simplistic model even outperforms a 100% allocation to equities. Given the strong performance of equity markets over the last 25 years, our conservative approach outperforms our expectations.

Since 2001 and over the past 10 years, US equities have delivered cumulative returns of 7.3% and 12.6%, respectively. During the same period, our model portfolio delivered returns of 5.5% and 8%, respectively. This is lower in comparison, although our model portfolio has experienced half the volatility at just 8.8% vs. over 17% for equities. And the drawdown of our portfolio has been just 24% vs. 56% for equities since 2001. Moreover, the drawdown in the past 10 years has been just 16% for our model portfolio vs. 31.5% for equities. Using an FCI-based approach, we can achieve better returns over a long timeframe via a reduced volatility profile and smaller drawdowns.

Figure 8

ASSET CLASS PERFORMANCE VS. FCI-BASED ALLOCATION STRATEGY



Source: Bloomberg and BBVA Global Markets Strategy

Figure 9

1-WEEK FORWARD RETURNS ANNUALISED

	Equity	Bonds	70-30	70-30	30-70	FCI based asset allocation
P75	111.1%	27.6%	70.9%	28.5%	45.4%	57.1%
Average	8.4%	3.3%	6.8%	4.8%	5.8%	7.7%
Median	15.1%	4.4%	11.4%	6.5%	8.7%	9.7%
P25	-41.0%	-15.2%	-29.7%	-14.4%	-20.9%	-23.0%

*Since 05/01/2001. Source: Bloomberg and BBVA Global Markets Strategy

Figure 10

PORTFOLIO STATISTICS (annualised)

Returns	S&P	60/40	FCI based asset allocation
All	7.29%	5.03%	5.46%
10Y	12.62%	7.25%	7.98%
5Y	13.01%	6.40%	8.30%
1Y	14.77%	8.72%	9.41%
Historical volatility			FCI based asset allocation
All	17.60%	10.35%	8.93%
10Y	17.33%	10.52%	8.78%
5Y	16.80%	10.49%	8.85%
1Y	18.19%	10.73%	10.92%
Maximun Drawdown 1Y rolling			FCI based asset allocation
All	-52.06%	-35.01%	-23.98%
10Y	-31.81%	-21.39%	-15.95%
5Y	-24.82%	-21.39%	-11.78%
1Y	-17.02%	-9.84%	-10.43%
Sharpe ratio (RF=0)			FCI based asset allocation
All	0.41	0.49	0.61
10Y	0.73	0.69	0.91
5Y	0.77	0.61	0.94
1Y	0.81	0.81	0.86

Source: Bloomberg and BBVA Global Markets Strategy

In our model portfolio, we test allocation based on the FCI's weekly levels. While this might seem excessive, the sticky nature of our FCI makes it a viable strategy without high transaction costs. Figure 11 summarises the change in allocation over time. Over the past five years, we have had fewer than three portfolio reshuffles every year and no reshuffle in the past year.

Figure 11

NUMBER OF TRANSACTIONS USING FCI-BASED ALLOCATION SIGNAL

	Number of transactions/ Year
All	1.79
10Y	2.70
5Y	2.80
1Y	0.00

*Since 05/01/2001. Source: Bloomberg and BBVA Global Markets Strategy

4.2. Sector allocation approach

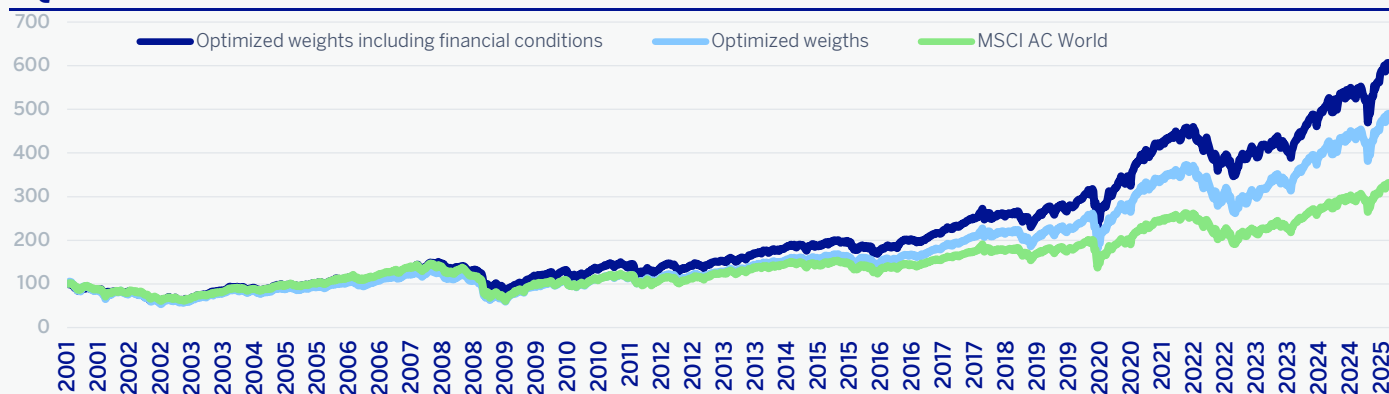
Similar to the above, we also test a sector allocation strategy. We floor each sector's weight to 5% and cap it at 40%. With this approach, we find that the FCI-based sector allocation approach outperforms the MSCI ACWI index substantially over the past 25 years. Furthermore, we test this strategy with similar sector weighting constraints but without the use of the FCI and still see that using the FCI adds additional alpha to sector allocation strategies.

Our FCI-based allocation strategy gives us input into preferred sectors during times of easing and tight financial conditions. In the current environment of loose financial conditions, our model suggests a high allocation to the tech sector, followed by industrials. If we see financial conditions tighten, our allocation model will advocate a higher allocation to defensive sectors like healthcare and consumer staples. The cyclical rally we have observed since April this year could still have legs, given that our FCI is still in the easing category.

Since 2001 and over the past 10 years, equities have delivered cumulative returns of 5.7% and 9.2%, respectively. During the same period, our model portfolio has delivered returns of 8.4% and 12.6%, respectively. Given 100% allocation to equities, the volatility of the portfolio has been similar to the benchmark at 16%, but better returns have meant a better Sharpe ratio for our allocation strategy. The drawdown of our portfolio has, similarly, been only marginally lower at 43.6% vs. 56% for the MSCI ACWI index. Using the FCI-based approach, we can achieve better returns over a long timeframe with a smaller drawdown. This could be further improved by allocation to cash or bonds during the tightening phase, as evidenced above.

Figure 12

EQUITY SECTOR ALLOCATION PERFORMANCE WITH AND WITHOUT FCI



*Since 01/05/2001. Source: Bloomberg and BBVA Global Markets Strategy

Figure 13

ALLOCATION WEIGHT

	Comm. Services Sector	Industrials	Financials	Materials Sector	Utilities Sector	Information Technology	Energy Sector	Consumer Staples	Consumer Discretionary	Health Care
All	5%	5%	5%	5%	5%	40%	5%	5%	20%	5%
Loosening	5%	20%	5%	5%	5%	40%	5%	5%	5%	5%
Tightening	5%	5%	5%	5%	5%	5%	5%	20%	5%	40%

Source: Bloomberg and BBVA Global Markets Strategy

Figure 14

1-WEEK FORWARD RETURNS ANNUALISED

	Weekly excess return annualized	Comm. Services Sector	Industrials	Financials	Materials Sector	Utilities Sector	Information Technology	Energy Sector	Consumer Staples	Consumer Discretionary	Health Care	FCI based asset allocation
Loosening	P75	7.0%	8.5%	13.7%	32.5%	-5.2%	33.7%	36.2%	-11.8%	15.3%	-2.6%	6.9%
	Average	-3.6%	2.1%	0.6%	1.8%	-2.6%	3.9%	-0.2%	-2.6%	1.0%	-3.3%	1.5%
	Median	-6.0%	1.8%	-0.9%	-1.2%	-4.4%	2.2%	1.0%	-5.8%	-1.0%	-6.6%	2.5%
Tightening	P25	-11.9%	-5.7%	-14.9%	-16.1%	0.9%	-13.1%	-25.9%	10.7%	-10.3%	-2.4%	-3.1%
	P75	9.2%	3.5%	8.4%	23.6%	-14.5%	46.5%	40.9%	-19.3%	15.5%	-9.1%	-13.3%
	Average	-0.1%	-2.3%	-6.9%	-0.7%	-1.1%	5.6%	-0.9%	5.9%	2.6%	9.7%	4.8%
	Median	-0.7%	-5.4%	1.3%	4.5%	-12.7%	-7.1%	4.1%	9.5%	1.0%	11.2%	9.4%
	P25	-8.8%	-6.0%	-22.6%	-22.8%	11.5%	-36.8%	-26.9%	36.0%	-21.8%	20.6%	25.0%

*Since 05/01/2001. Source: Bloomberg and BBVA Global Markets Strategy

Figure 15

PORTFOLIO STATISTICS (annualised)

Returns	MSCI AC World	FCI based asset allocation
All	5.72%	8.44%
10Y	9.16%	12.60%
5Y	10.25%	11.82%
1Y	14.91%	15.91%

Historical volatility

All	17.16%	16.34%
10Y	16.09%	15.77%
5Y	15.31%	15.38%
1Y	15.37%	17.09%

Maximun Drawdown 1Y rolling

All	-55.81%	-43.64%
10Y	-31.54%	-28.55%
5Y	-27.08%	-24.59%
1Y	-13.57%	-14.96%

Sharpe ratio (RF=0)

All	0.33	0.52
10Y	0.57	0.80
5Y	0.67	0.77
1Y	0.97	0.93

*Since 10/08/2001. Source: Bloomberg and BBVA Global Markets Strategy

4.3. QIS indexes

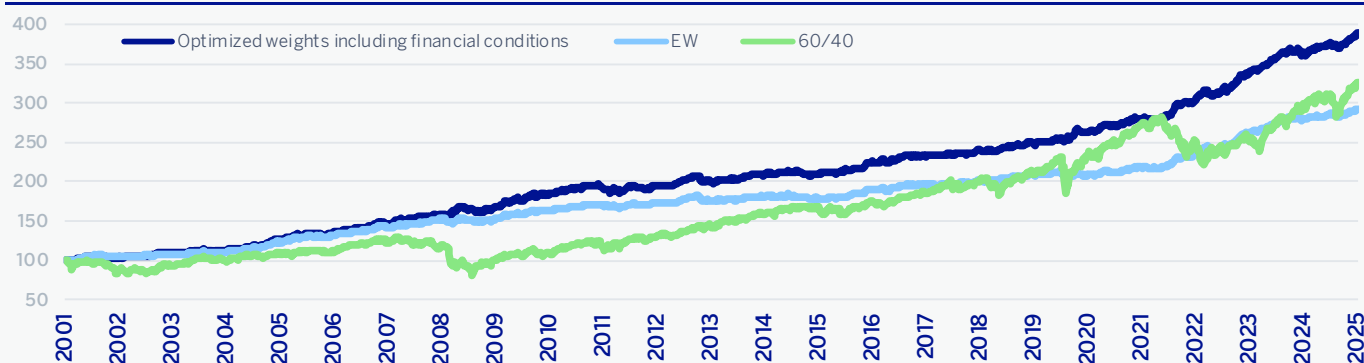
Finally, we use the FCI to allocate towards risk premia strategies. Unlike in our sector model, we limit the allocation freedom to allow a maximum allocation of just 20%. We find that using this approach, we beat the performance of an equally weighted QIS portfolio. This shows that using a dynamic rather than static approach to allocation to QIS strategies could be far superior. Furthermore, we find that our allocation strategy outperforms equities over the long run with much lower volatility and limited drawdown.

Since 2001 and over the past 10 years, a portfolio of 60% US equities and 40% US bonds has delivered cumulative returns of 5% and 7.25%, respectively. During the same period, our model portfolio has delivered returns of 5.4% and 5.8%, respectively. This is lower in comparison, although our model portfolio has experienced a third of the volatility at just 3.5% vs. over 10% for the 60/40 portfolio. And the drawdown of our portfolio has been just 5% vs. 35% for the 60/40 portfolio since 2001. Moreover, the drawdown in the past 10 years has been just 3% for our model QIS portfolio vs. 21.4% for 60/40. Using the FCI-based approach, we can achieve better returns over a long timeframe via a reduced volatility profile and smaller drawdowns.

The Sharpe ratio of our FCI-based QIS portfolio has been an impressive 1.5x since 2001 and 1.7x over the past 10 years vs. just 0.6x for the 60/40 index. An equal-weighted QIS portfolio also delivers a Sharpe ratio of 1.6x over a longer time frame with lower volatility and lower cumulative returns.

Figure 16

QIS ALLOCATION PERFORMANCE WITH AND WITHOUT FCI



Source: Bloomberg and BBVA Global Markets Strategy

Figure 17

ALLOCATION WEIGHTS

	BBVA FX LatAm Carry USD Index	BBVA FX LatAm Relative Value USD Index	BBVA SMT USD Index	BBVA FX Global Carry USD Index	BBVA FX LatAm Macro Trend USD Index	BBVA FX Global Macro Trend USD Index	BBVA G II Government Bond Futures Trend USD Index	BBVA Credit Carry USD Index
EW	12.5%	12.5%	12.5%	12.5%	12.5%	12.5%	12.5%	12.5%
Loosening	20.0%	5.0%	20.0%	20.0%	5.0%	5.0%	5.0%	20.0%
Tightening	5.0%	5.0%	20.0%	5.0%	20.0%	20.0%	20.0%	5.0%

Source: Bloomberg and BBVA Global Markets Strategy

Figure 18

1-WEEK FORWARD RETURNS ANNUALISED

	Annualised weekly excess return	BBVA FX LatAm Carry USD Index	BBVA FX LatAm Relative Value USD Index	BBVA SMT USD Index	BBVA FX Global Carry USD Index	BBVA FX LatAm Macro Trend USD Index	BBVA FX Global Macro Trend USD Index	BBVA G II Government Bond Futures Trend USD Index	BBVA Credit Carry USD Index	Optimised	Optimized including financial conditions index
Loosening	P75	-2.1%	-22.1%	-23.2%	-5.6%	-24.4%	-20.1%	-18.5%	-18.3%	-22.9%	-18.9%
	Average	-1.2%	-3.2%	-3.0%	-0.2%	-4.9%	-5.1%	-3.6%	-0.7%	-3.0%	-2.2%
	Median	-3.2%	-7.3%	-4.8%	-0.9%	-7.9%	-6.9%	-7.1%	-6.3%	-5.2%	-4.9%
Tightening	P25	-1.9%	14.8%	20.6%	4.0%	16.8%	11.5%	11.1%	15.3%	18.6%	16.3%
	P75	-5.3%	-27.0%	-35.6%	-14.3%	-25.6%	-20.5%	-21.0%	-29.0%	-32.9%	-31.3%
	Average	4.8%	3.4%	5.2%	6.2%	8.9%	9.8%	8.6%	3.8%	6.3%	7.4%
	Median	3.1%	-1.4%	-0.9%	7.5%	1.0%	1.4%	3.9%	-0.3%	1.3%	0.8%
	P25	13.6%	41.8%	54.5%	24.5%	36.7%	28.3%	35.1%	45.4%	53.8%	52.5%

*Since 10/08/2001. Source: Bloomberg and BBVA Global Markets Strategy

Figure 19

PORTFOLIO STATISTICS (annualised)

Returns	EW QiS	60/40	FCI based asset allocation
All	4.58%	5.03%	5.43%
10Y	5.10%	7.25%	5.80%
5Y	7.06%	6.40%	7.71%
1Y	4.88%	8.72%	7.01%
Historical volatility			
All	2.86%	10.35%	3.62%
10Y	2.76%	10.52%	3.36%
5Y	2.97%	10.49%	3.34%
1Y	1.78%	10.73%	2.79%
Maximun Drawdown 1Y rolling			
All	-4.19%	-35.01%	-5.18%
10Y	-3.66%	-21.39%	-3.05%
5Y	-2.60%	-21.39%	-2.43%
1Y	-1.48%	-9.84%	-2.43%
Sharpe ratio (RF=0)			
All	1.60	0.49	1.50
10Y	1.85	0.69	1.73
5Y	2.37	0.61	2.31
1Y	2.74	0.81	2.51

*Since 10/08/2001. Source: Bloomberg and BBVA Global Markets Strategy

APPENDIX:

Financial Conditions Index (FCI): composition and methodology

Members

Above_200MA (percentage of members above 200DMA):

This metric represents the percentage of stocks within a given index that are trading above their 200-day moving average (200DMA). The 200DMA is a long-term trend indicator, and a higher percentage suggests bullish market sentiment, indicating that a majority of stocks are in an upward trend.

SPX_MA24M (distance to 24MMA):

This measures the distance between the current price of the S&P 500 index (SPX) and its 24-month moving average (24MMA). The 24MMA smooths out price data over two years to identify long-term trends. A positive distance indicates the index is trading above its long-term average, suggesting a bullish trend, while a negative distance indicates a bearish trend.

MV_GDP (market capitalisation as a percentage of GDP):

This ratio compares the total market capitalisation of a country's publicly traded companies to its gross domestic product (GDP). It is often referred to as the Buffett Indicator. A high ratio may indicate an overvalued market relative to the economy, while a low ratio may suggest undervaluation.

FIN_MAIN (financial markets capitalisation as a percentage of total market capitalisation):

This metric shows the proportion of the total market capitalisation that is accounted for by financial markets. It highlights the dominance or significance of financial institutions and markets within the broader economy.

VIX (CBOE Volatility Index):

The VIX, also known as the "Fear Index," measures the market's expectations for volatility over the next 30 days based on S&P 500 index options. A higher VIX value indicates higher expected volatility and greater market uncertainty, while a lower VIX suggests calmer market conditions.

IG_10Y (spread between US corporate investment-grade yield and UST10Y):

This spread represents the difference in yields between US investment-grade corporate bonds and 10-year US Treasury bonds (UST10Y). It reflects the additional risk premium investors demand for holding corporate bonds over risk-free government bonds.

HY_10Y (spread between US high-yield spread and UST10Y):

This spread measures the difference in yields between US high-yield (junk) bonds and the 10-year US Treasury bonds. It indicates the risk premium for investing in lower-rated, higher-risk corporate bonds compared to safer government bonds.

HY_IG (spread between US corporate investment grade yield and US high yield):

This spread compares the yields of US high-yield bonds to investment-grade corporate bonds. It provides insight into the relative risk and return expectations between higher-risk and lower-risk corporate debt.

TAYLOR_RULE_SPREAD (Taylor rule spread):

The Taylor rule spread is derived from the Taylor rule, which prescribes the optimal federal funds rate based on the inflation rate and the output gap. The spread indicates the difference between the actual federal funds rate and the rate suggested by the Taylor rule, providing insight into the stance of monetary policy.

US_TIPS_10Y (US 10-year TIPS):

Treasury Inflation-Protected Securities (TIPS) are a type of US Treasury bond designed to help investors protect against inflation. The principal value of TIPS increases with inflation and decreases with deflation, as measured by the Consumer Price Index (CPI). The interest payments on TIPS are calculated based on the adjusted principal, so they vary with inflation. TIPS are issued with maturities of 5, 10 and 30 years. The 10-year TIPS, specifically, provides a fixed interest rate over its 10-year term, with the principal adjusted for inflation. At maturity, investors receive the adjusted principal or the original principal, whichever is greater.

UST_10Y_TERM_PREMIUM (US 10-year term premium):

The 10-year term premium refers to the extra yield that investors require for holding a 10-year Treasury bond instead of a series of shorter-term bonds. This premium compensates investors for the risks associated with holding a longer-term bond, such as interest rate changes and inflation. The term premium is not directly observable and must be estimated using financial and macroeconomic models. It reflects the difference between the yield on a long-term bond and the expected path of short-term interest rates over the bond's maturity.

DXY (DXY Index):

The US Dollar Index (USDIX) is a measure of the value of the USD relative to a basket of six foreign currencies. These currencies are the euro (EUR), Japanese yen (JPY), British pound (GBP), Canadian dollar (CAD), Swedish krona (SEK), and Swiss franc (CHF). The index was established by the US Federal Reserve in 1973 after the dissolution of the Bretton Woods Agreement and is now maintained by ICE Data Indices, a subsidiary of the Intercontinental Exchange (ICE). The index has a base value of 100, and its value fluctuates based on the exchange rates of the included currencies.

Methodology

Retrieve the time series:

Collect weekly data points for each time series relevant to your analysis. Ensure the data is accurate and consistent.

Calculate the 5-year rolling Z-Score:

Compute the rolling Z-Score using a 5-year window. For each week, calculate the mean and standard deviation of the data points within that window, then determine the Z-Score as:

$$Z = \frac{X - \mu}{\sigma}$$

where X is the data point, μ is the mean, and σ is the standard deviation.

Remove outliers:

Identify outliers by determining the 95th and 5th percentiles of the Z-Score distribution. Replace values above the 95th percentile with the 95th percentile value and values below the 5th percentile with the 5th percentile value. This process reduces the impact of extreme values on the analysis.

Apply the correct sign:

Adjust the sign of each time series based on the context or predefined criteria. This step ensures that the data aligns with the expected direction of influence.

Rescale the time series:

Normalise the time series to a common scale, ranging between -3 and 3. This standardisation facilitates comparison and aggregation across different time series.

Calculate the equally weighted sectoral indexes:

Group the time series into relevant sectors (e.g., equity, credit, macro) and calculate the equally weighted index for each sector. This involves averaging the rescaled time series within each sector.

1. Equity is the equally weighted average of Above_200MA, SPX_MA24M, MV_GDP, FIN_MAIN and VIX
2. Credit is the equally weighted average of IG_10Y, HY_10Y and HY_IG
3. Macro is the equally weighted average of TAYLOR_RULE_SPREAD, US_TIPS_10Y, UST_10Y_TERM_PREMIUM and DXY

Calculate the composite index:

Combine the sectoral indexes to create a composite index using the specified weights:

$$\text{Composite Index} = \frac{1}{4} \text{Equity} + \frac{1}{4} \text{Credit} + \frac{1}{2} \text{Macro}$$

Rescale the final index:

Centre the index at the 70th percentile. Values above 0 indicate tightening financial conditions, while values below 0 indicate neutral or loosening conditions. For positive values, rescale between 0 and 1, and for negative values, rescale between -1 and 0. This final step ensures the index is easy to interpret and compare over time.



Corporate &
Investment Banking

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Markets Strategy

Director of Global Markets Strategy

Ana Munera

ana.munera@bbva.com

+34 91 374 36 72

Global Risk Premia Strategy

Head of QIS Research

Ankit Kumar, CFA

ankitkumar.gheedia@bbva.com

+44 747 692 0757

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