**EUROPE**

# Asset Allocation Framework

03 March 2026
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## Introducing the BBVA 11-stage cycle

### Executive Summary

In this report we are enhancing our existing asset allocation framework to help guide asset allocation decisions. In addition, we use this framework to guide our assets, sectors, factors and QIS risk-premia strategies allocation across different phases of the economic cycle, while considering the prevailing financial conditions. We have built BBVA's dynamic allocation framework using two core tools:

1. The BBVA US Macro Cycle Indicator, which captures both growth and inflation phases. In the post-COVID world, inflation has again become a key part of economic cycle study and cannot be ignored. Hence our six-stage BBVA US Macro Cycle Indicator captures what we believe are the most relevant macro stages in the current environment.
2. Our BBVA US Financial Conditions Index (FCI), which aims to capture the prevailing financial conditions. For example, during the COVID-19 market shock the global economy was in recession for most of 2020, but asset performance during the first half of the year was markedly different from the second half. Defensive leadership during 1H changed to cyclical leadership in 2H.

By overlaying both the US Macro Cycle Indicator and the FCI, we create a more granular eleven-phase approach, designed to capture asset rotation during shifts in growth, inflation and monetary policy.

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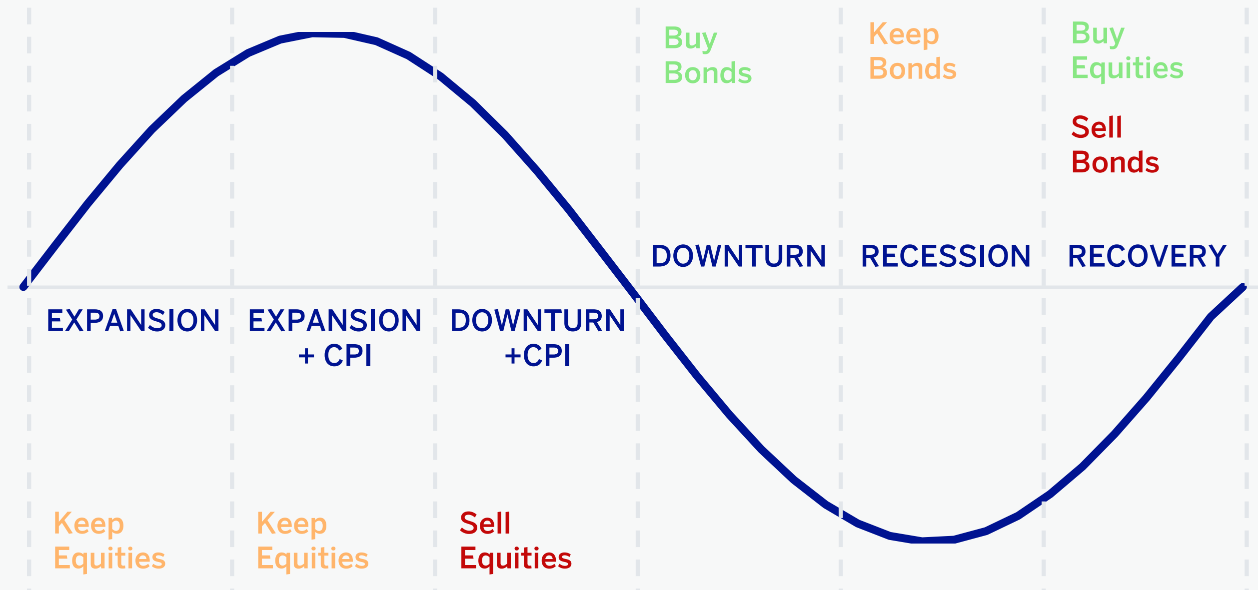
## 1. Introduction

Over the past three years, we have used a six-stage asset cycle model based on our proprietary US leading macro indicator. The BBVA US Macro Cycle Indicator accounts for both growth and inflation phases. In the post-COVID world, inflation has again become a key part of economic cycle study and cannot be ignored. Hence, our six-stage BBVA US Macro Cycle Indicator captures what we consider to be the most relevant macro stages in the current environment.

We believe asset performance is driven by the confluence of different factors, but one of the most relevant is the business cycle. Cyclical fluctuations have a direct impact on asset performance because two of the key determinants of asset prices (earnings growth and discount rates) are a direct function of GDP growth. But given how important inflation has become in the post-COVID world, we have proposed a new six-phase asset cycle vs. the traditional four-phase cycle (see our report, A six-stage asset cycle based on a proprietary leading cyclical/inflation index, 3 February 2023). Our analysis shows that the effect of higher inflation is more noticeable when the strength of the cyclical signal is weaker, notably in the downturn and expansion phases. For this reason, we have also created an inflation acceleration indicator based on moving averages.

**Figure 1**

**BBVA US MACRO CYCLE STAGES**



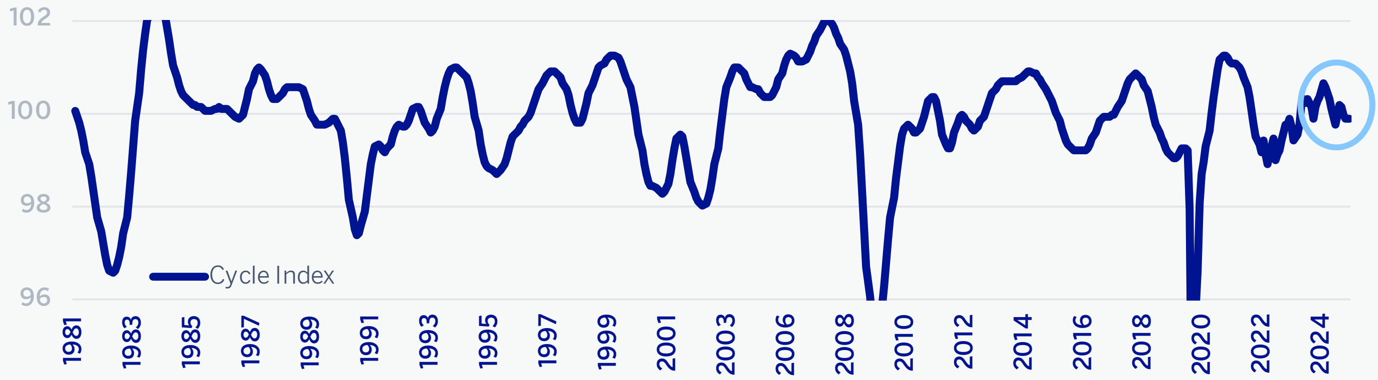

Source: Bloomberg and BBVA Global Markets Strategy

A full business cycle consists of four phases – recovery, expansion, downturn and recession – that seamlessly merge into one another. During the recovery phase, economic indicators such as GDP and industrial production move from negative to positive, supported by easy monetary policy and low inventories. The expansion phase is typically the longest, characterised by healthy profitability, strong credit growth, and a shift toward neutral monetary policy. A downturn occurs when economic activity peaks and growth begins to slow, often accompanied by rising inflation and tighter monetary policy. Lastly, a recession brings a contraction in activity and credit becomes scarce, although easing monetary policy eventually sets the stage for a new recovery. While these stages are traditionally identified using quarterly GDP data, that information often carries a three-month lag that limits its value for investment decisions. Therefore, a synthetic cyclical index can be a valuable tool to identify the current point in the business cycle with greater confidence and timeliness.

Our results indicate that cycle theory based on these six stages is even more profitable and produces superior portfolio returns than the equivalent four-stage strategy. In addition, we have found that the influence of inflation is more aggressive for corporates and high yield bonds than for equities.

**Figure 2**

## BBVA US MACRO CYCLE INDICATOR




Source: Bloomberg and BBVA Global Markets Strategy

Our US Macro Cycle Indicator shows that the US remains resilient. US economic sentiment has softened recently, with concerning jobs data reported towards the end of last year. Further evidence comes from the Atlanta Fed's GDPNow indicator falling to a six-month low (before rebounding in January) and US composite PMIs falling to their lowest since April of last year. That said, Bloomberg consensus for US growth in 2026 is still at 2.4%, despite expectations that consumer spending will slow from 3.5% last year to just 2.2% this year. We expect US growth to remain stable over the course of the year, given the supportive liquidity environment and the prevalence of corporate and government spending rather than consumer demand. In our view, the growth environment could be characterised as mid-cycle, with stable liquidity, credit and labour market conditions. Despite concerns among some market participants that the US economy is entering a late-cycle phase, we do not believe we are there yet.

In conjunction, the BBVA Financial Conditions Index (FCI) aims to capture the prevailing financial conditions (see Introducing BBVA FCI – 16 September 2025). We believe that within each growth/inflation phase, accounting for monetary policy could further enhance investment portfolios by incorporating the prevailing financial conditions. This is because the cycle could be in recession or expansion territory, but central bank actions could shift investor expectations and, consequently, impact asset performance.

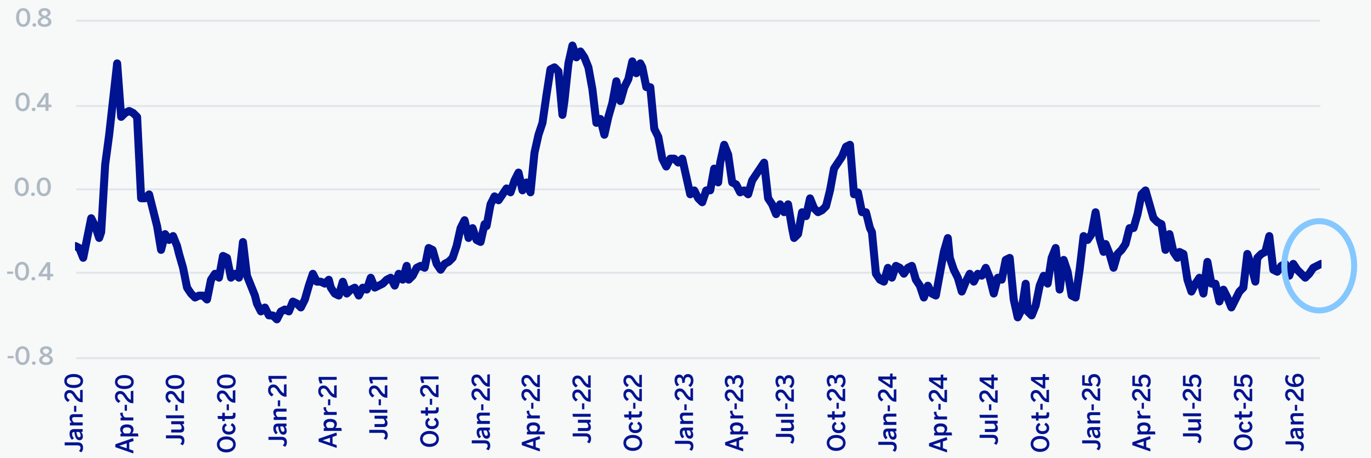
For example, during the COVID-19 market shock the global economy was in recession for most of 2020, but the asset performance during the first half of the year was markedly different from the second half. Defensive leadership during 1H changed to cyclical leadership during 2H. Similarly, when the economy was still not in recession at the start of 2022, Fed tightening drove significant sector rotation over the course of the year.

The concept of financial conditions has increasingly been in the spotlight since the GFC as a relevant indicator for informed investment decision-making, 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. As a result, central bank benchmark rates were traditionally the key driver of financial conditions. This meant that we didn’t need to monitor much to understand corporate and consumer lending appetite and availability.

Since the GFC, however, we have seen central banks use their balance sheets and public communication to manage policy and thus financial conditions. 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 greater risk-taking. On the other hand, tighter financial conditions have been associated with slower growth and the relative outperformance of bonds vs. equities.

**Figure 3**

**BBVA US FINANCIAL CONDITIONS INDEX** (BBRIFCUS Index)




Source: Bloomberg and BBVA Global Markets Strategy

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 during the course of the year. When combined with further fiscal easing in the US, we could see 2026 as the beginning of a new reflation cycle for the US. This typically tends to be positive for risk assets, particularly in the financial sector.

## 2. BBVA 11-stage cycle

By overlaying both the US Macro Cycle Indicator and the FCI, we create a more granular eleven-phase approach, designed to capture asset rotation during periods of growth, inflation and monetary policy shifts. The table below details the 11 phases of our cycle and how they are defined.

**Figure 4**

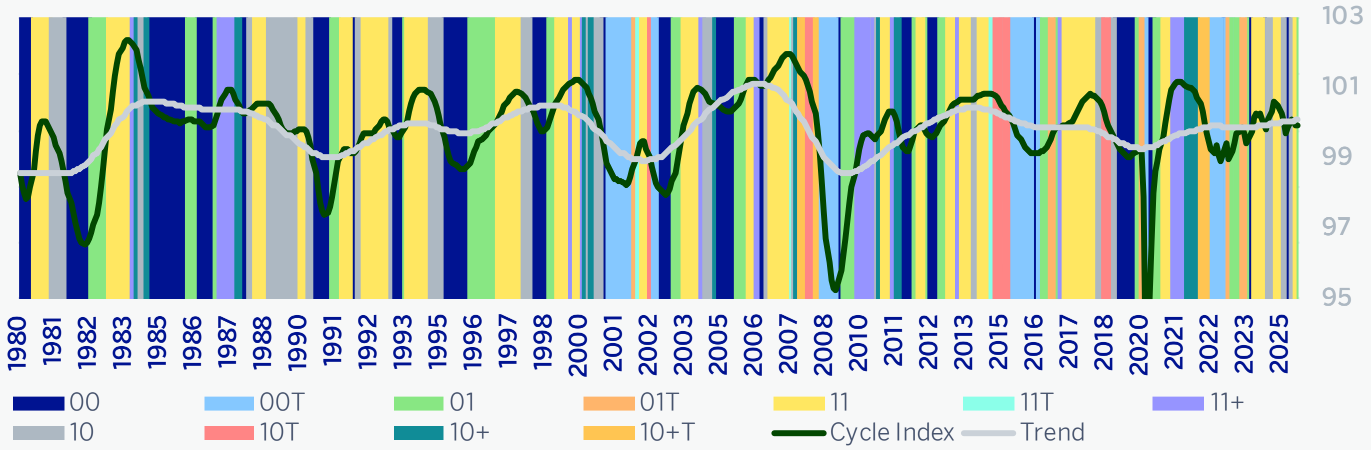
### STAGES: 11 STAGES OF THE BBVA ASSET ALLOCATION FRAMEWORK

| State | vs Trend | Slope | Original state | Inflation | Financial conditions |
|---|---|---|---|---|---|
| 00 | Negative | Negative | Recession | | Neutral |
| 00T | Negative | Negative | Recession | | Tightening |
| 01 | Negative | Positive | Recovery | | Neutral |
| 01T | Negative | Positive | Recovery | | Tightening |
| 11 | Positive | Positive | Expansion | | Neutral |
| 11T | Positive | Positive | Expansion | | Tightening |
| 11+ | Positive | Positive | Expansion | Increasing | Neutral |
| 10 | Positive | Negative | Slow growth | | Neutral |
| 10T | Positive | Negative | Slow growth | | Tightening |
| 10+ | Positive | Negative | Slow growth | Increasing | Neutral |
| 10+T | Positive | Negative | Slow growth | Increasing | Tightening |

Source: Bloomberg and BBVA Global Markets Strategy

**Figure 5**

### STAGES OF MACRO AND FINANCIAL CONDITIONS




Source: Bloomberg and BBVA Global Markets Strategy

We would highly encourage our readers to refer to our launch publications of our US Macro Cycle Indicator (see A six-stage asset cycle based on a proprietary leading cyclical/inflation index, 3 February 2023) and our FCI Indicator (see Introducing BBVA FCI, 16 September 2025) for details of the methodology and variables used. In this publication we will focus on asset performance rotation as we move through cycles. The table below illustrates the time spent during different phases of our 11-stage model since COVID-19. It is notable that the rise in macro volatility since 2024 has increased the frequency of turning points in our model. Our model can, therefore, help investors navigate through an environment of above-average macro volatility. Given our macro expectations that the US is entering a mid-cycle environment, we envisage our model is likely to be more stable going forward, driving sector and factor rotation to remains relatively stable in the near term.

**Figure 6**

## STAGES: THE 11 STAGES OF THE BBVA ASSET ALLOCATION FRAMEWORK (I)

| Start Month | End Month | Signal |
|---|---|---|
| Jul-25 | Jul-25 | Expansion |
| Jun-25 | Jun-25 | Downturn |
| Apr-25 | May-25 | Recession |
| Mar-25 | Mar-25 | Downturn |
| Oct-24 | Feb-25 | Expansion |
| Aug-24 | Sep-24 | Downturn |
| Jul-24 | Jul-24 | Recession |
| Feb-24 | Feb-24 | Expansion |
| Dec-23 | Jan-24 | Recession |
| Nov-23 | Nov-23 | Recovery |
| Sep-23 | Oct-23 | Recovery + Tightening |
| Jun-23 | Aug-23 | Recovery |
| May-23 | May-23 | Recession + Tightening |
| Apr-23 | Apr-23 | Recovery |
| Mar-23 | Mar-23 | Recovery + Tightening |
| Feb-23 | Feb-23 | Recession + Tightening |
| Jan-23 | Jan-23 | Recession |
| Jul-22 | Dec-22 | Recession + Tightening |
| Jun-22 | Jun-22 | Downturn + Tightening + CPI |
| Sep-21 | Feb-22 | Downturn + CPI |
| Mar-21 | Aug-21 | Expansion + CPI |
| Nov-20 | Feb-21 | Expansion |
| Aug-20 | Oct-20 | Recovery |
| May-20 | Jul-20 | Recession |
| Feb-20 | Apr-20 | Recession + Tightening |

Source: Bloomberg and BBVA Global Markets Strategy

# 3. BBVA 11-stage cycle vs. a 4-stage allocation framework

Looking in more detail at how much time has been spent in each stage of our 11-stage cycle, the charts below compare vs. the 1980s and over the past 10 years. It is not surprising to us that most of the time, our model is in the traditional phases of "expansion", "recession", "recovery" and "downturn". Since the 1980s our model has suggested an allocation akin to a traditional 4-phase cycle for 70% of the time vs. 65% for the past 10 years. As such, it is fair to say that more than two-thirds of the time the model doesn't add value to a traditional four-stage allocation model. That said, during the remaining third of the time, the 11-stage approach does add value.

**Figure 7**

**STAGES: TIME SPENT IN THE 11 STAGES SINCE 1980**

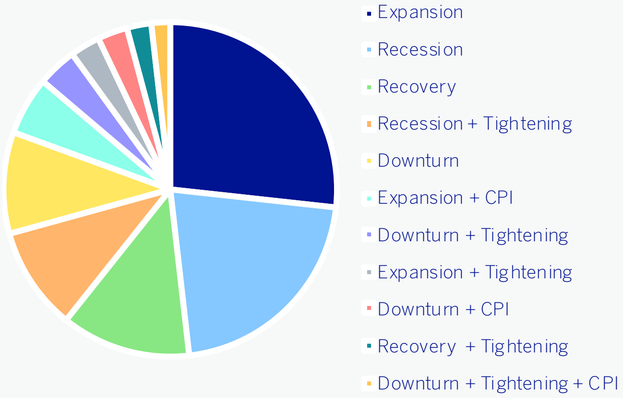
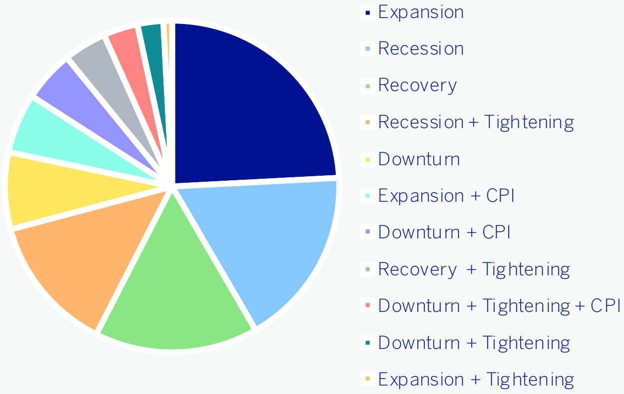



**Figure 8**

**STAGES: TIME SPENT IN THE 11 STAGES, LAST 10 YEARS**



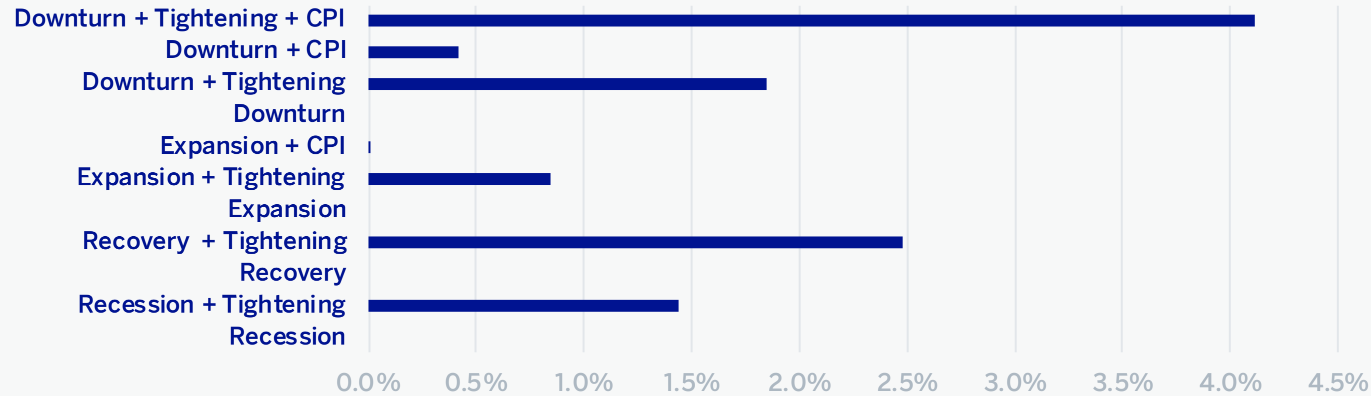

Source: Bloomberg and BBVA Global Markets Strategy

To demonstrate this concept further, in the chart below we look at the average Alpha generated by modifying allocation during the non-traditional phases of our 11-stage model to match the 4-stage model. In each of the seven additional stages we find additional Alpha from changing allocation vs. a traditional 4-stage approach. The best performance comes during a downturn. Generally, the best equity returns come during the beginning of a downturn or during recovery. However, our study shows that a downturn accompanied by high inflation and tight monetary policy tends to drive the worst returns. This is in line with central banks hiking rates to control inflation and often results in a recession. The year 2022 was a good example of a downturn combined with high inflation and tight monetary policy, which resulted in a double-digit correction in equity markets.

Therefore, adjusting asset allocation in response to inflation and monetary policy can help improve the Alpha of a portfolio. We have found that the least value is added during a phase of expansion combined with high inflation. This again makes sense, as generally expansion phases are accompanied by a rebound in inflation, hence our model delivers similar returns to a traditional 4-stage expansion phase. That said, when monetary policy is tight during an expansion phase, our model adds greater value as asset allocation needs to be adjusted to account for a tighter monetary policy stance.

Figure 9

**ALPHA GENERATED DURING OUR 11-STAGE CYCLE MODEL VS. TRADITIONAL 4-STAGE MODEL**




Source: Bloomberg and BBVA Global Markets Strategy

In the next section, we dive into the details of the modifications of each of the four stages of the economic cycle and discuss how we adjust allocation to incorporate the inflation and monetary policy outlooks.

## 3.1. Recession

A **recession** is a phase of the business cycle in which overall economic activity contracts, reflected in broad declines in output, income, employment and spending. Real gross domestic product (GDP) typically falls, business profits shrink, and both consumers and firms cut back on spending. As demand weakens, credit conditions often tighten as banks become more cautious, making loans harder to obtain for households and companies. This scarcity of credit further dampens investment and consumption. Falling demand leads firms to scale back production and reduce inventories; unsold stockpiles gradually diminish as companies draw down existing inventories to meet orders rather than produce new goods, even though sales remain weak. This destocking process can deepen the downturn before the economy reaches its trough.

Policymakers typically respond to recessions by **easing monetary policy –** lowering interest rates and expanding the money supply – to stimulate borrowing and spending. Fiscal measures, such as increased government spending or tax cuts, are used to support demand. Over time, as confidence slowly returns, consumption and investment pick up, inventories stabilise, and output begins to grow again, setting the stage for **economic recovery**, the phase in which national income and employment rebound toward pre-recession levels.

In a typical recession, **safer assets outperform riskier ones** as investors seek stability. Government bonds deliver strong positive returns as demand for high-quality, low-risk securities rises and yields fall, while investment-grade corporate bonds also perform reasonably well, albeit with some credit risk. High-yield bonds show modest positive performance as markets anticipate recovery, and cash or cash equivalents earn small gains as central banks cut interest rates. Equities perform modestly positive, particularly if the downturn has already been partially priced in by markets or if the economy is near its trough.

When a recession occurs alongside **tight monetary policy,** the pattern changes significantly. Higher interest rates and reduced liquidity tend to dampen returns across assets, especially equities and high-yield bonds, which see negative returns as credit spreads widen. Government bonds still deliver the best returns despite rising yields. Cash becomes relatively more attractive with higher short-term rates, and equities deliver the worst returns as higher interest rates weigh on valuations amid already weak earnings. This highlights how the policy environment can meaningfully alter asset-class performance during recessions.

**Sector performance** in a recession also varies with financial conditions. In a recession, defensive sectors such as Consumer Staples and Health Care tend to hold up as investors seek stability, while cyclical sectors such as Industrials and Energy underperform. Information Technology delivers positive returns irrespective of financial conditions. Under tight financial conditions, defensive sectors outperform more clearly, while cyclical and rate-sensitive sectors such as Financials, Energy and Industrials show wider declines as higher rates and tight credit suppress investment and earnings.

**Figure 10**

### ASSET PERFORMANCE DURING RECESSION

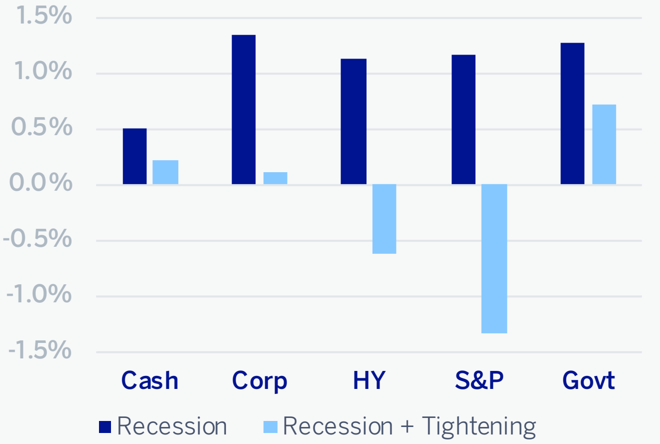
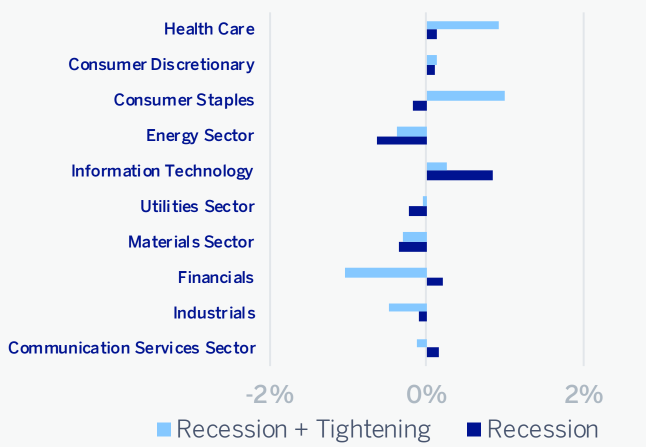



**Figure 11**

### SECTOR RELATIVE PERF. DURING RECESSION




Source: Bloomberg and BBVA Global Markets Strategy

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**Factor allocations** also shift with market conditions. During a recession with loose financial conditions, investors allocate more toward **Value**, along with moderate exposure to Growth, Quality and Financial Health, as cheaper stocks historically perform better ahead of a turnaround. When financial conditions are tight, the emphasis shifts toward **defensive and quality-oriented factors**, with Growth, Financial Health and Quality receiving greater emphasis, while Value exposure declines. This reflects a cautious stance, prioritising stability and strong balance sheets amid tighter credit.

**Quantitative investment strategies** reflect similar patterns. In a typical recession, carry-oriented strategies such as LatAm Carry, Credit Carry and Global Carry tend to deliver positive returns, benefiting from stable or declining interest rates and improving risk sentiment. Trend-based strategies also show modest positive results as markets adjust. However, when recession occurs with tight monetary policy, carry strategy performance turns decisively negative as higher rates and tighter credit reduce carry benefits. In contrast, trend and macro-oriented strategies tend to show stronger positive returns as they capture directional moves driven by policy shifts and rate expectations.

Figure 12
## QIS PERFORMANCE DURING RECESSION

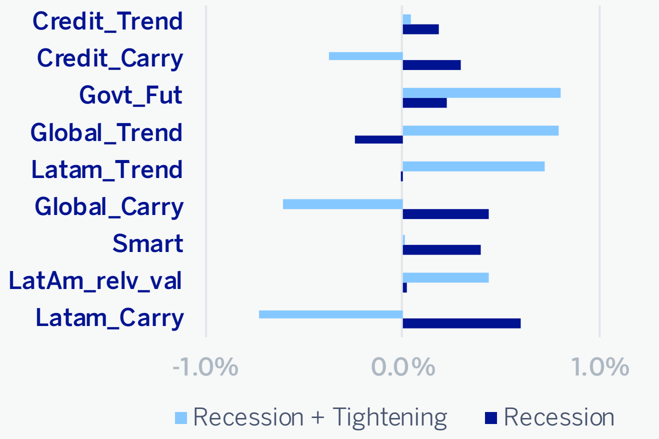
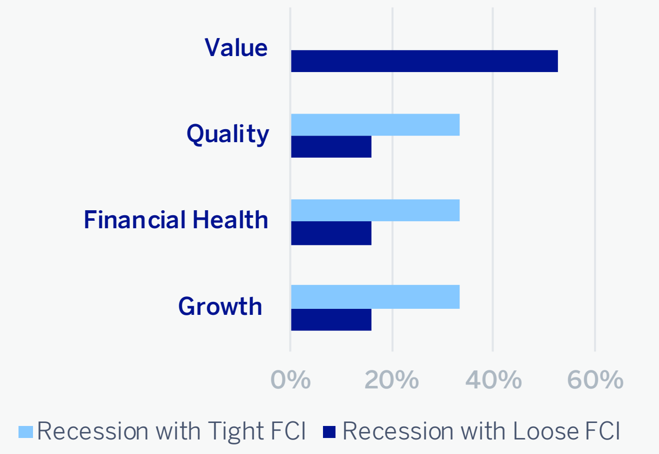



Figure 13
## FACTOR ALLOCATION DURING RECESSION




Source: Bloomberg and BBVA Global Markets Strategy

## 3.2. Recovery

The **recovery phase** begins once the economy moves past the lowest point of a downturn and key indicators start to improve. Measures such as real GDP, industrial production, employment and income shift from contraction towards expansion, signalling that economic activity is regaining strength. As confidence returns, consumers increase spending and businesses ramp up production, driving significant sales growth. Inventories, which were previously drawn down to match weak demand, begin to rebuild as firms anticipate future orders. At the same time, credit conditions become more favourable: banks and lenders are more willing to extend loans, and easy monetary policy – characterised by low interest rates and abundant liquidity – supports borrowing, investment and faster profit growth across sectors. These forces create a self-reinforcing cycle of expanding demand, rising output and improving financial conditions that define the early stages of recovery.

In many recoveries, this acceleration in economic activity can be relatively sharp. With low borrowing costs and greater access to credit, businesses invest in growth and production capacity, while households increase consumption, including durable goods. Improving corporate earnings and stronger financial fundamentals help restore investor confidence, contributing to rising asset prices and broader market participation. Over time, sustained improvements in employment and income further strengthen demand, pushing the economy towards more robust expansion. Recovery reflects the transition from a period of contraction and defensive positioning to one of rising activity, optimism and renewed economic momentum.

In a typical recovery, **risk assets outperform** as growth rebounds and confidence returns. Equities tend to show the strongest gains, reflecting renewed earnings growth and stronger investor appetite for risk. High-yield and corporate bonds also deliver solid returns as credit spreads tighten and credit conditions improve. Cash earns modest positive returns, while government bonds generate smaller gains as yields remain relatively low in the early stages of recovery. This pattern reflects broadening risk-taking, with investors moving up the risk spectrum to capture growth, and fixed-income markets benefiting from improved fundamentals and lower default risk.

When recovery occurs under **tight monetary policy**, the dynamics change. If central banks keep interest rates elevated or withdraw liquidity to guard against inflation as growth picks up, higher financing costs can dampen asset returns. In this scenario, equities deliver negative returns as tighter financial conditions weigh on valuations and capital expenditure intentions. Corporate and high-yield credit returns are slightly negative as higher rates and restricted lending widen spreads and reduce the attractiveness of risk-taking. Government bonds underperform corporate bonds during the recovery phase irrespective of financial conditions, on the back of prevailing yield differentials and lower room for spread widening from already wide levels following a recession.

**Sector performance** during recovery also depends on financial conditions. In a normal recovery, economically sensitive and growth-oriented sectors such as Information Technology, Consumer Discretionary and Industrials tend to lead as demand strengthens and corporate activity picks up. Defensive sectors such as Consumer Staples and Health Care typically lag following their relative strength during recessions. Under tight financial conditions, higher interest rates and constrained lending temper cyclical sector gains. Information Technology and Communication Services still perform relatively well but with more muted returns, while consumer-oriented sectors such as Consumer Discretionary show weaker recoveries. In this environment, defensive sectors underperform their normal-recovery profiles, and Financials lag as tight credit compresses lending volumes and profit margins. Overall, tighter conditions dampen cyclical leadership but continue to support quality-growth exposures.

**Figure 14**

## ASSET PERFORMANCE DURING RECOVERY

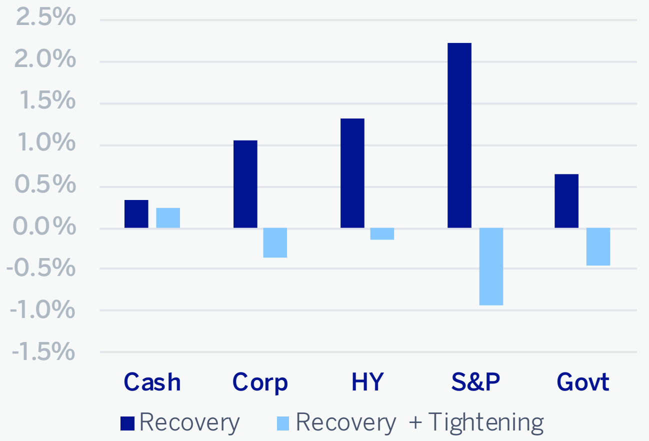
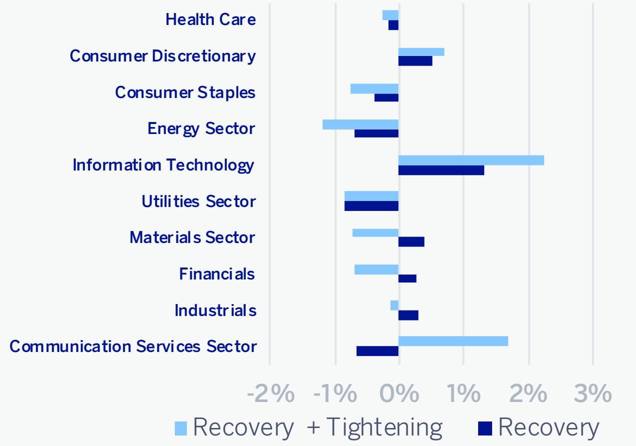



**Figure 15**

## SECTOR RELATIVE PERF. DURING RECOVERY




Source: Bloomberg and BBVA Global Markets Strategy

**Factor allocations** also adjust with conditions. In a normal recovery with loose financial conditions, investors balance stability and upside capture, with Value often attracting significant allocation, reflecting interest in undervalued stocks as fundamentals improve, while Quality and Financial Health also receive meaningful exposure. When recovery occurs with tight financial conditions, emphasis shifts to defensive strength, with Financial Health becoming the dominant factor, Quality remaining important, and Value being deemphasised as tighter conditions limit re-rating of undervalued names.

**Quantitative investment strategies** display distinct patterns in recovery. In a normal recovery, improving markets and risk sentiment support both carry-oriented approaches such as Global FX Carry, Latam FX Carry and Credit Carry, as well as trend strategies such as LatAm Trend and Global Trend, which benefit from sustained directional moves. Under tight financial conditions, FX carry strategies tend to turn negative as investor risk appetite becomes subdued. Nevertheless, the Credit Carry strategy still tends to perform well as credit spreads remain wide during this period, with limited room for further widening following a recession.

Figure 16
**QIS PERFORMANCE DURING RECOVERY**

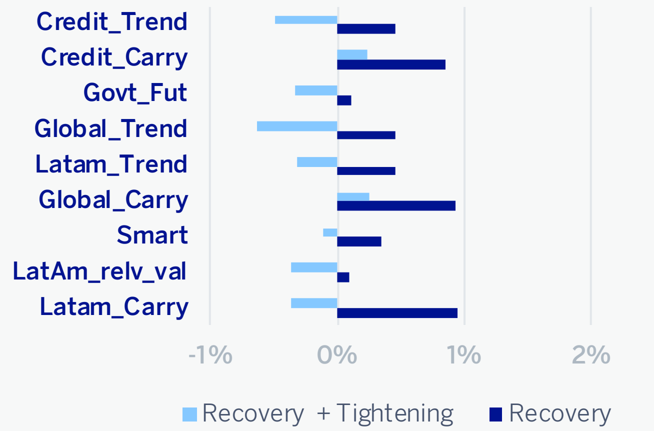
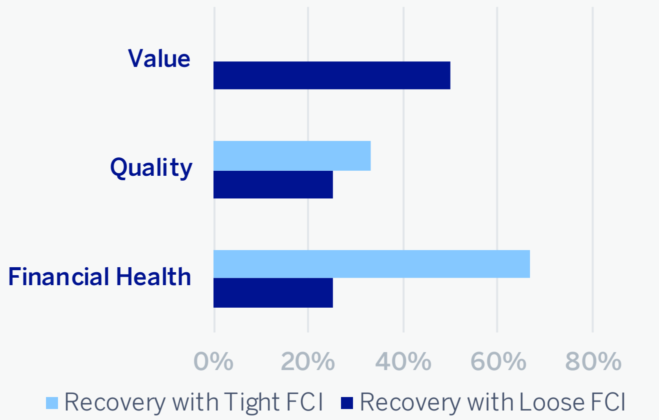



Figure 17
**FACTOR ALLOCATION DURING RECOVERY**




Source: Bloomberg and BBVA Global Markets Strategy

## 3.3. Expansion

The **expansion phase** is typically the longest part of the business cycle, characterised by sustained moderate growth following recovery. During expansion, economic activity continues to strengthen: output, employment, incomes and consumer spending all rise at a steady pace. Business confidence improves, investment increases, and firms build inventories to support rising demand. Unlike the early stages of recovery – when growth emerges from a trough – expansion reflects a broader and more entrenched strengthening of economic fundamentals. Our models show that the US economy is currently in the expansion phase.

Credit growth is generally robust as lenders become more willing to extend loans, and borrowers increase investment and consumption. Healthy profitability across sectors supports corporate spending on capacity, research and development, and hiring. Monetary policy usually shifts towards a **neutral stance** during expansion, withdrawing some of the extraordinary support used during recession and recovery but stopping short of restrictive settings. This neutral environment – where interest rates are neither strongly stimulative nor contractionary – helps sustain moderate growth without overheating the economy. Coupled with solid labour markets and rising household incomes, these conditions foster durable demand, normalised credit flows and stable financial conditions.

**Risk assets perform well** in a typical expansion. Equities tend to deliver strong returns as corporate earnings grow and investor confidence rises. Corporate and high-yield credit markets also perform solidly as credit spreads tighten and default risk declines. Cash returns remain modest, reflecting stable short-term rates. Government bonds continue to produce positive returns, though often smaller than those from risk assets. This overall pattern reflects broadening risk appetite, with investors increasingly allocating to assets that benefit from sustained economic momentum and improving fundamentals.

When **inflation picks up and monetary policy tightens** during expansion, the asset return profile shifts. Higher interest rates and reduced liquidity dampen equity performance, as elevated financing costs weigh on valuations and capital spending. Corporate credit returns generally weaken, with tighter lending conditions widening spreads and reducing risk-taking, and high-yield credit even delivers negative returns. In this environment, government bonds can deliver relatively stronger returns as investors anticipate slower growth or an eventual downturn due to restrictive policy. Expansionary periods with **high inflation but loose financial policy** are generally favourable for risky assets, though fixed-income returns tend to lag because equity earnings often provide a hedge against inflation, whereas fixed coupons do not.

**Sector performance** in expansion also varies with financial conditions. In an expansion with loose financial conditions, economically sensitive and growth-oriented sectors – such as Energy, Information Technology and Financials – often outperform defensive, low-Beta sectors such as Health Care and Consumer Staples. Technology frequently shows strong gains driven by robust earnings and sustained investment in innovation, while Energy benefits as demand rises with overall economic activity. Sector dispersion is generally moderate, as most industries benefit from stable expansion.

When expansion occurs under **tight financial conditions or high inflation**, sector performance diverges more sharply. Information Technology still leads on quality earnings growth, while Energy benefits from inflationary pricing dynamics. Defensive sectors such as Health Care and Consumer Staples underperform, as higher rates and slower growth weigh on longer-duration cash flows. Industrials tend to perform relatively well in environments combining high inflation and favourable credit conditions, as capital expenditure demand remains strong. Consumer Discretionary also performs well when consumer credit remains accessible despite inflationary pressures.

**Figure 18**

## ASSET PERFORMANCE DURING EXPANSION

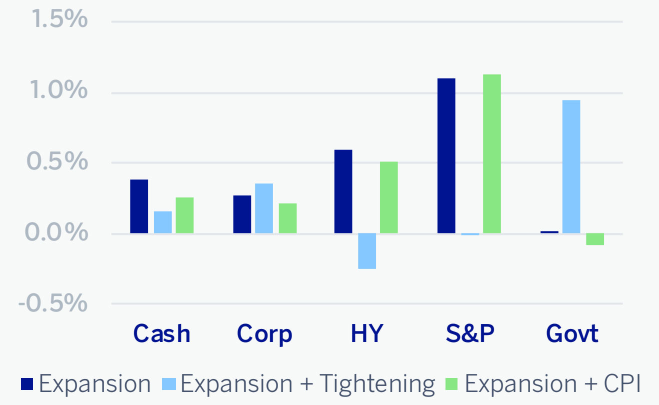
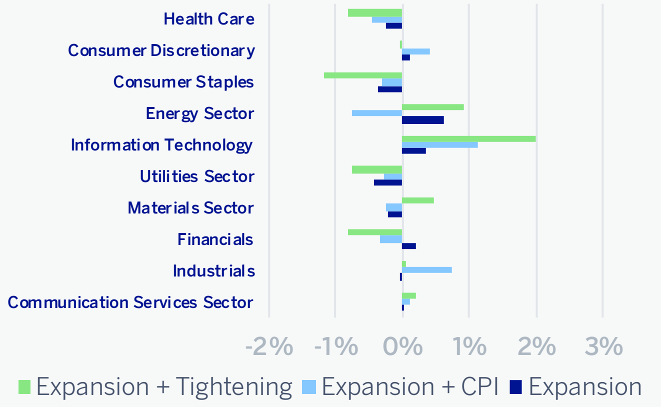



**Figure 19**

## SECTOR RELATIVE PERF. DURING EXPANSION




Source: Bloomberg and BBVA Global Markets Strategy

**Factor performance** during expansion varies with the financial conditions. In a typical expansion with loose conditions, investors focus on factors that balance stability and upside potential: **Growth**, **Quality** and **Financial Health** receive strong allocations, while **Value** often plays a smaller role after its strong performance during recovery. When expansion coincides with tight financial conditions or high inflation, the factor mix may shift toward **Value and Quality**, as investors become wary that higher rates will compress valuations for defensive stocks.

**Figure 20**

## QIS PERFORMANCE DURING EXPANSION

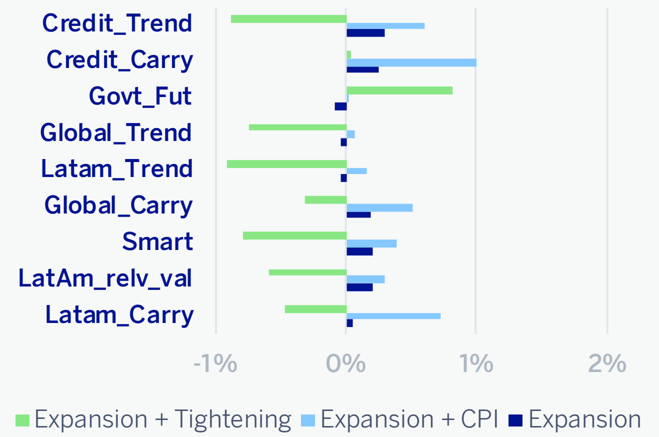
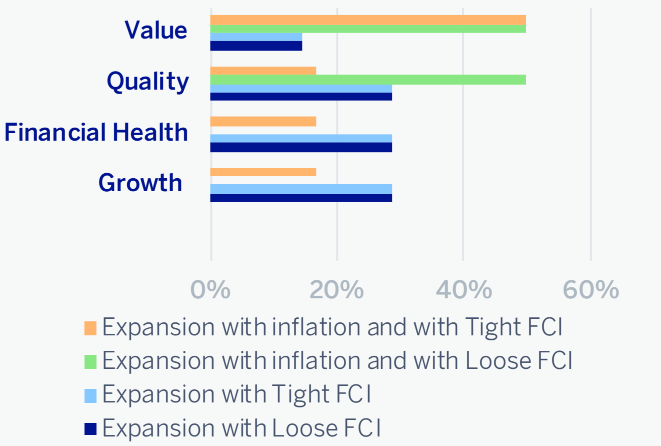



**Figure 21**

## FACTOR ALLOCATION DURING EXPANSION




Source: Bloomberg and BBVA Global Markets Strategy

**Quantitative investment strategies** reflect broader market conditions. In a normal expansion, strategies that benefit from rising markets and risk appetite tend to perform well. Carry-oriented strategies – such as Global FX Carry and Credit Carry – deliver strong returns as favourable yield differentials persist, while trend-based approaches capture sustained directional moves across markets. Other systematic signals, such as Credit Trend and Smart strategies, contribute positively as momentum builds. Higher inflation can accentuate dispersion across economies and asset prices, often enhancing opportunities for carry strategies. However, under tight financial conditions, carry strategies tend to underperform due to higher funding costs and tighter credit, while trend and macro-oriented strategies become relatively more prominent, capturing persistent market and policy-driven price dynamics. Government futures and other defensive trend exposures also hold up better as markets adjust to tighter conditions and potential signs of slowing growth.

## 3.4. Downturn

The **downturn phase** typically begins after the economy reaches its peak and growth starts to slow. While output, employment and spending may initially remain positive, the pace of expansion decelerates as capacity constraints, weakening demand and rising costs increasingly weigh on businesses and households. Profit margins come under pressure from rising wages and higher input costs, particularly if inflation accelerates. A tight labour market – with low unemployment and rising compensation – adds further cost pressures, reducing profit growth and tempering hiring and investment. As firms adjust to slowing growth and shrinking margins, overall economic confidence weakens and momentum fades, laying the groundwork for a broader slowdown.

Rising inflation during a downturn often prompts monetary authorities to shift towards restraint. When inflation persists above target, central banks tighten policy by raising interest rates or withdrawing liquidity to slow demand and contain price growth. Higher borrowing costs for households and businesses further reduce consumption, investment, and credit growth. These forces collectively slow economic activity, erode corporate profitability and increase the likelihood that output will eventually contract, potentially tipping the economy into a full recession if conditions continue to deteriorate.

In this environment, most **risk assets weaken relative to expansion**. Equity returns are typically lower, reflecting fading earnings expectations and heightened risk aversion. In downturns accompanied by rising inflation, performance deteriorates further as concerns about stagflation grow. In such cases, corporate bonds can perform relatively better than equities, since default rates remain contained and investors seek income amid weakening profits. However, when downturns coincide with **tight financial conditions**, asset performance generally deteriorates more sharply. Equities often suffer deeper losses as higher financing costs and margin compression amplify downside risk. Credit assets weaken further as spreads widen and risk premia rise, with high-yield credit particularly sensitive to tightening conditions. In these environments, **government bonds tend to be the best-performing asset class**, benefiting from safe-haven demand, while **cash becomes more attractive** due to higher short-term rates.

**Sector performance** during a downturn also shifts as conditions tighten. During a typical downturn, economically sensitive sectors such as Information Technology and Communication Services may still outperform relative to other cyclicals, while consumer-oriented sectors like Consumer Discretionary and Consumer Staples tend to underperform. However, when the downturn is accompanied by tight financial conditions, the sector landscape shifts in favour of defensives: Health Care and Consumer Staples outperform as investors favour stability, while Communication Services is often the worst hit due to sensitivity to higher inflation and financing costs. The Energy sector tends to outperform when downturns are accompanied by elevated inflation, benefiting from pricing dynamics even amid slowing growth. In contrast, Technology tends to underperform when financial conditions tighten, unlike in other phases when it can lead irrespective of conditions. Consumer Discretionary consistently shows weakness during downturn periods, while the performance of Financials and Industrials generally mirrors the broader market direction.

Figure 22

## ASSET PERFORMANCE DURING DOWNTURN

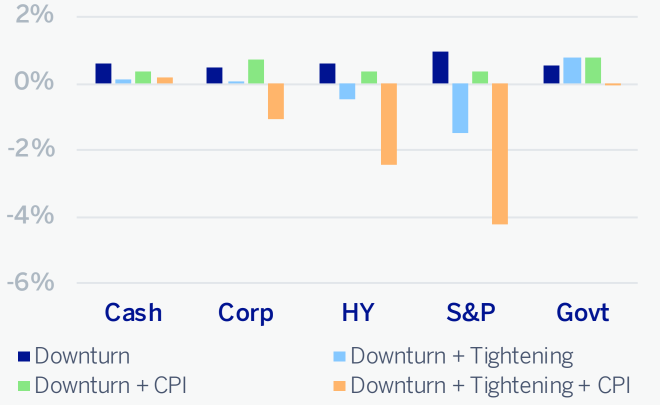
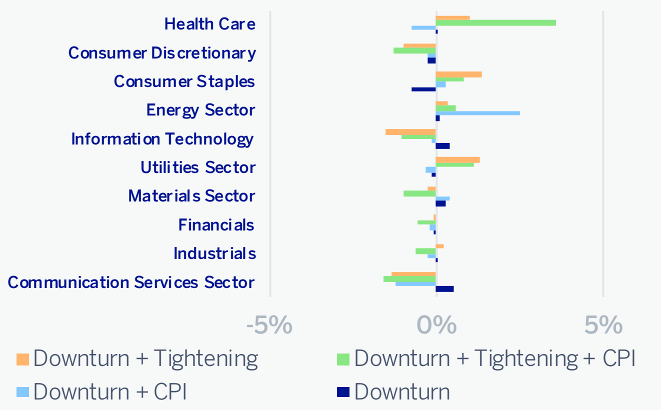



Figure 23

## SECTOR RELATIVE PERF. DURING DOWNTURN




Source: Bloomberg and BBVA Global Markets Strategy

**Factor preferences** also shift as risk aversion rises and growth expectations fade. Under relatively loose financial conditions, **Financial Health** tends to dominate allocations, as investors prioritise firms with strong balance sheets capable of withstanding slower growth and more volatile credit conditions. *Value* and *Quality* receive moderate exposure, reflecting searches for relative bargains and resilient earnings, while *Growth* plays a smaller role amid slowing expansion. When financial conditions are tight, emphasis on **Financial Health** remains strong, and *Quality* becomes even more important as investors seek predictable earnings and durable cash flows in a constrained environment. In downturns featuring both **high inflation and tight financial conditions**, *Momentum* rises in importance, capturing persistent market moves driven by policy signals and heightened volatility. Across scenarios, defensive characteristics – whether through balance sheet resilience, earnings stability, or persistent trend signals – tend to receive greater weight than traditional growth factors, reflecting the broader shift toward risk mitigation as economic conditions deteriorate.

**Systematic strategies** also exhibit distinct patterns in downturns. In a downturn with relatively loose financial conditions, **carry-oriented strategies** such as Global Carry, LatAm Carry and Credit Carry can still produce modest positive returns, as yield differentials remain moderately attractive and markets are not fully risk-off. *Government futures* and other defensive trend exposures contribute positively, while pure trend strategies such as Global Trend and Credit Trend tend to deliver muted returns due to limited strong directional price moves. When downturns are accompanied by **tight financial conditions or elevated inflation**, carry strategies tend to underperform, as higher funding costs and constrained credit reduce both their appeal and profitability. In contrast, **trend and macro-oriented strategies** such as Global Trend and Credit Trend become relatively stronger, capturing clearer policy-driven directional shifts in prices and yields amid heightened uncertainty. Government futures and other defensive trend exposures also tend to hold up better as markets adjust to tighter conditions and investors seek shelter from downside risks.

Figure 24
## QIS PERFORMANCE DURING DOWNTURN

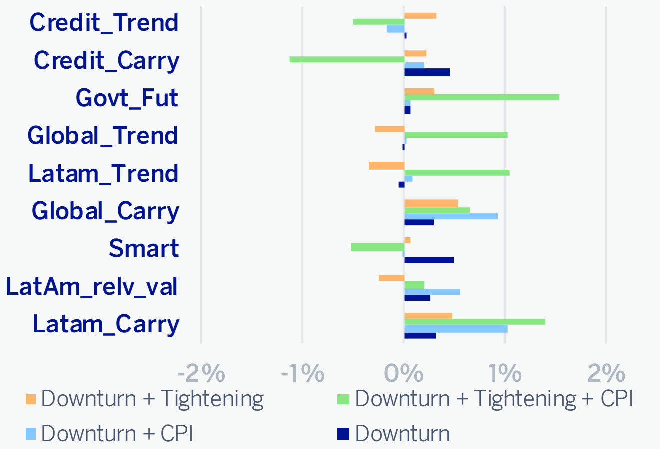
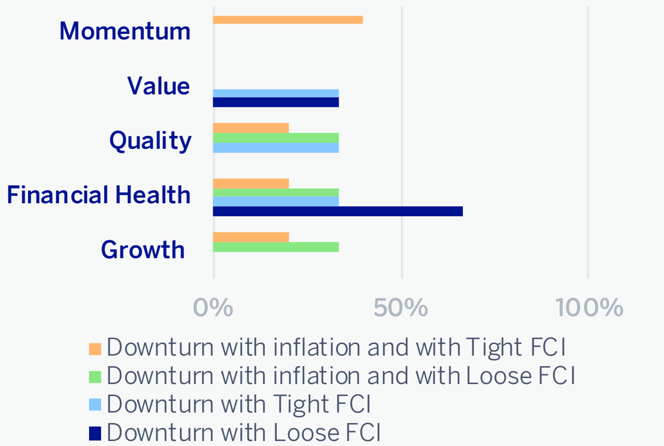



Figure 25
## FACTOR ALLOCATION DURING DOWNTURN




Source: Bloomberg and BBVA Global Markets Strategy

# 4. Dynamic Asset Allocation

In the current market environment, many argue that the traditional 60/40 portfolio - allocating 60% to equities and 40% to bonds - no longer works as reliably as it once did because the conditions that historically supported its diversification benefit have changed. For decades, a core assumption of the 60/40 approach was that bonds would act as a hedge when stocks fell (i.e., stocks and bonds exhibited a negative correlation), smoothing portfolio losses and reducing volatility. However, in recent years rising inflation and higher interest rates have weakened this relationship - both stocks and bonds fell together during the inflation shock of 2022, producing one of the worst performances for a classic 60/40 mix in decades.

The change stems largely from higher interest rate volatility and shifting macro dynamics, which have increased the correlation between equities and fixed income and reduced the cushion that bonds traditionally provided. As a result, 60/40 returns have declined while volatility has increased compared with the “old regime” of low rates and stable inflation, placing the portfolio “under strain” and challenging its role as a balanced strategy. Because this traditional split now offers less effective diversification - particularly during periods of inflationary pressure and tight monetary policy - we believe we need to reconsider portfolio design and consider a dynamic asset allocation approach.

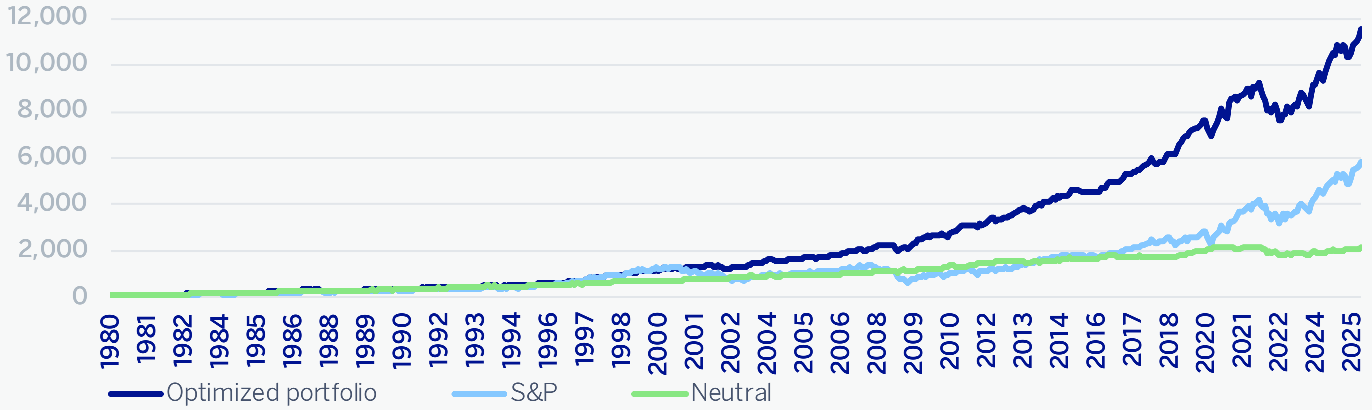
**Dynamic asset allocation** is an investment approach that actively adjusts portfolio exposures in response to changing economic conditions, market signals, and risk factors rather than maintaining a static mix of assets. Under this framework, allocations to equities, fixed income, credit, cash, and alternative exposures shift systematically or tactically as indicators such as growth momentum, inflation expectations, interest-rate outlook, and financial conditions evolve through the business cycle. For example, during periods of strengthening growth and accommodative policy, dynamic allocation may increase exposure to risk assets such as equities and high-yield credit, while in phases marked by slowing growth or tightening financial conditions, it may tilt more toward defensives such as government bonds, high-quality factors, or cash equivalents. By responding to both macroeconomic cues and market valuations, dynamic asset allocation aims to capture upside participation during favourable regimes and reduce risk exposure in adverse environments, seeking to improve long-term risk-adjusted returns and to better navigate the transitions between cyclical phases.

In this note we demonstrate the strength of the dynamic asset allocation using our 11-stage cycle approach. This approach adjusts investor portfolios as growth momentum, inflation expectations, interest-rate outlook, and financial conditions evolve through the business cycle. In this section we use the results above to create portfolios using our 11-stage cycle approach. We back test our strategy since 1995 for asset allocations between bonds (government bonds, high yield and investment grade bonds), equities and cash, and sector allocation using MSCI level 1 sector classification, since 2005 for BBVA QIS strategy portfolio allocation and finally since 2006 for equity factor allocation approach. In all instances our strategy generates a substantial uplift in Sharpe ratios when compared to benchmarks.

## 4.1. Asset Allocation – Bonds, Equities and Cash

Dynamic asset allocation adapts portfolio weights in response to evolving economic and financial regimes rather than maintaining a fixed mix like 60/40. The table below highlights the recommended allocations across key asset classes (Cash, Corporate bonds, High Yield, Equities/S&P, Government bonds) in different stages of an 11-phase framework - from Recession, Recovery, Expansion, Downturn, and combinations with prevailing financial conditions and inflation outlook. This regime-based approach adjusts exposures to reflect the prevailing risk and return environment: for example, increasing investment grade corporate bond exposure in recessionary regimes when spreads are attractive, overweighting government bonds when safe-havens are needed, or shifting into equities more aggressively in expansion and recovery. By contrast, a static 60/40 portfolio holds the same risk mix regardless of where the economy sits in the cycle, leaving it exposed to significant drawdowns when conditions shift abruptly or when the traditional negative correlation between stocks and bonds breaks down.

**Figure 26**
STRATEGY PERFORMANCE




Source: Bloomberg and BBVA Global Markets Strategy

The table below highlights the performance edge of a dynamically allocated strategy over both the S&P 500 and a traditional 60/40 across multiple horizons. Over the full history (“All”), the dynamic strategy produces higher annualised returns (≈10.78 %) compared with the S&P (≈9.05 %) and 60/40 (≈6.83 %), with lower historical volatility than equities and a markedly higher Sharpe ratio (~1.39 vs. ~0.61 for S&P and ~0.63 for 60/40). Over the last 10 years, the strategy again outperforms the 60/40 both in returns (~9.79 % vs. ~6.18 %) and in risk-adjusted terms, and it continues to show superior risk-adjusted performance over 5-year and 1-year horizons. These outcomes illustrate a key benefit of dynamic allocation - improving risk-adjusted returns by reducing drawdowns during adverse regimes and capturing upside in favourable ones.

The strength of the 11-phase approach lies in its ability to rotate exposures based on macro and financial conditions, rather than passively allocating. During recessions or downturns with tight monetary conditions, the approach moves toward government bonds and cash to preserve capital; in recoveries and expansions with loose conditions, it increases exposure to equities and credit. This flexibility allows the dynamic strategy to adapt to shifts in monetary policy, inflation, credit spreads, and growth momentum, capturing different risk premia depending on the regime. The result is a strategy that seeks better downside protection when markets are stressed and increased participation when markets advance, which is reflected in both higher net returns and a more attractive Sharpe profile compared with a traditional 60/40 portfolio.

Figure 27

PORTFOLIO STATISTICS

| Returns | S&P 500 | 60/40 | Strategy |
|---|---|---|---|
| All | 9.05% | 6.83% | 10.78% |
| 10Y | 12.65% | 6.18% | 9.79% |
| 5Y | 6.58% | 2.31% | 4.14% |
| 1Y | 13.54% | 5.71% | 11.52% |
| **Historical Volatility** | | | |
| All | 14.93% | 10.79% | 7.78% |
| 10Y | 14.74% | 10.07% | 7.08% |
| 5Y | 14.89% | 10.30% | 6.96% |
| 1Y | 11.57% | 9.30% | 7.96% |
| **Sharpe ratio (RF=0)** | | | |
| All | 0.61 | 0.63 | 1.39 |
| 10Y | 0.86 | 0.61 | 1.38 |
| 5Y | 0.44 | 0.22 | 0.60 |
| 1Y | 1.17 | 0.61 | 1.45 |

Source: Bloomberg and BBVA Global Markets Strategy

## 4.2. Sector Allocation – MSCI US Level 1 sector

We repeat the exercise to create a **dynamic sector allocation framework** that adapts sector weights in response to the economic and financial phase of the cycle, rather than market-cap based weighting in most liquid indices. The sector allocation heatmap below shows how exposures shift dramatically across the 11 identified regimes - ranging from recession phases (with or without tightening), through recovery and expansion and downturn with overlay of financial conditions and inflationary environments. For example, in phases aligned with **expansion and strong growth**, sectors like **Information Technology** receive significantly higher weights (e.g., 55%), reflecting their tendency to lead when macro conditions improve. Conversely, in recessionary or tight environments, allocations tilt away from cyclicals and toward more stable or defensive exposures (e.g., balanced, low-Beta sectors or underweights across most sectors), reflecting changing risk premiums and sector performance patterns. This dynamic repositioning allows portfolios to be positioned pro-cyclically when growth and earnings prospects are strong, and more defensively positioned when downside risks rise.

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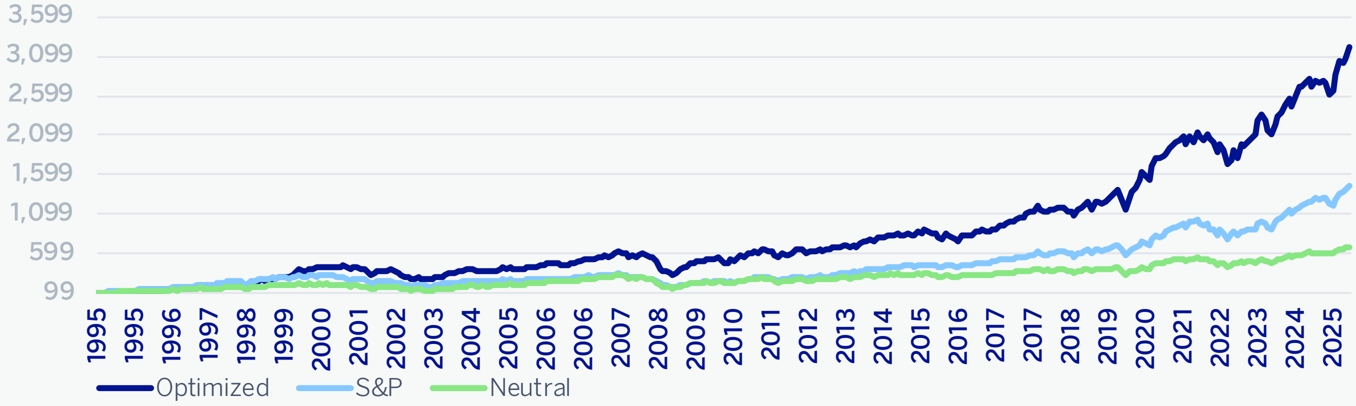
Figure 28

## STRATEGY PERFORMANCE




Source: Bloomberg and BBVA Global Markets Strategy

The performance comparison table underscores the **risk-adjusted benefit of such a dynamic strategy** versus a static benchmark like the S&P 500. Over long-term horizons ("All" and 10-year), the dynamic sector strategy delivers **higher annualised returns** (e.g., 12.03% and 14.81% for strategy vs. 9.05% and 12.65% for S&P 500) while maintaining volatility similar to or only slightly above the benchmark. More importantly, the dynamic strategy shows consistently **higher Sharpe ratios** across multiple periods (e.g., ~0.93 vs. ~0.86 over 10 years; ~1.85 vs. ~1.17 over one year), indicating that it generates **better risk-adjusted returns** than a static broad market exposure. This result reflects the strategy's ability to reduce exposure to weaker sectors and increase allocation to prevailing outperformers through varying regimes, thereby mitigating drawdowns by reducing market Beta during unfavourable phases and capturing upside during favourable ones.

By aligning sector weights with macro conditions, the 11-phase dynamic approach captures the **differential performance patterns of sectors across regimes** - growth sectors during expansions, steadier defensive sectors during stress, and tactical shifts during inflationary or tightening episodes. This leads to both **enhanced return potential and improved volatility management** compared with a one-size-fits-all static approach. In effect, dynamic sector allocation seeks to harness the evolving economic cycle rather than passively ride through it, offering a compelling framework for investors seeking more adaptive exposure through varying market environments.

Figure 29

## PORTFOLIO STATISTICS

| Returns | S&P 500 | Strategy |
|---|---|---|
| All | 9.05% | 12.03% |
| 10Y | 12.65% | 14.81% |
| 5Y | 6.58% | 8.22% |
| 1Y | 13.54% | 23.73% |
| **Historical Volatility** | | |
| All | 14.93% | 15.21% |
| 10Y | 14.74% | 15.91% |
| 5Y | 14.89% | 15.30% |
| 1Y | 11.57% | 12.84% |
| **Sharpe ratio (RF=0)** | | |
| All | 0.61 | 0.79 |
| 10Y | 0.86 | 0.93 |
| 5Y | 0.44 | 0.54 |
| 1Y | 1.17 | 1.85 |

Source: Bloomberg and BBVA Global Markets Strategy

## 4.3. Factor Allocation – BBVA Equity Factors

We follow a slightly modified methodology for factor allocation, as our factor allocation methodology begins with factor scoring at the individual stock level across the US equity benchmark. Each stock is evaluated using multiple fundamental and market-based metrics, with scores computed and normalised both cross-sectionally (across sectors and the overall market) and historically for each stock. This ensures consistent, comparable factor information that adjusts for sector dynamics and stock-specific histories.

**Growth Score** is based on historical and forward expected growth across key fundamentals, including sales, EBITDA, EBIT, EPS, and various margin measures (EBITDA, EBIT, free cash flow). Appropriate alternative metrics are used for financial sector stocks. All metrics are normalised using Z-scores across sectors and the market.

**Financial Health Score** measures balance sheet strength using ratios such as quick ratio, current ratio, interest coverage, net debt relative to cash flow, debt-to-equity, and debt-to-assets. Financial sector stocks have tailored metrics as needed. Scores are normalised based on each stock's data history and cross-sectionally by sector and market.

**Quality Score** captures profitability and operational efficiency using return on assets, return on equity (RoE), return on capital employed (RoCE), return on invested capital (RoIC), and margin metrics, supplemented by free float. Like other factors, scores are Z-score normalised over time and across the market and sectors with adjustments for financials.

**Valuation Score** reflects relative cheapness and income characteristics using valuation multiples and yields, including price/earnings, dividend yield, price-to-book, free cash flow yield, and EV/EBITDA. Metrics are adapted for financials where appropriate and normalised in the same disciplined manner.

**Momentum Score** is based on 12-month price performance. This market signal is also normalised using historical and cross-sectional Z-scores, preserving consistency with the fundamental factors.

To incorporate macroeconomic context, we compute our proprietary BBVA US Macro Cycle Index and BBVA US Financial Condition Index, which together inform the prevailing regime in the 11-phase economic cycle framework.

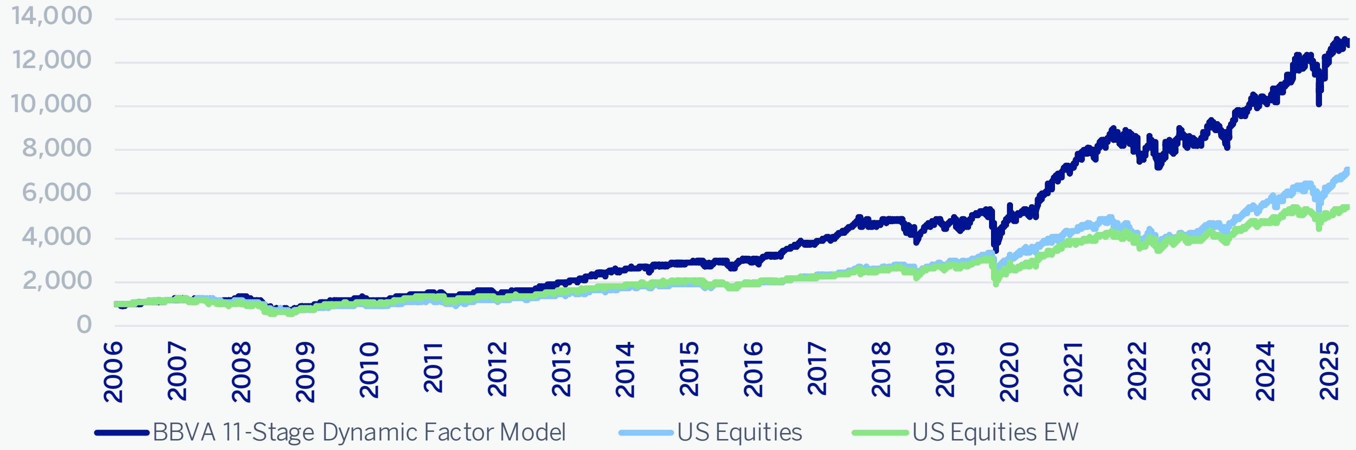
Each stock’s overall score is then calculated by combining its factor scores with regime-specific factor weights. These factor weights are derived from the historical performance of the factors across the eleven phases and remain static to preserve out-of-sample robustness.

For portfolio construction, we select the top 100 stocks by combined score in a given regime and build an equally weighted basket, ensuring diversified exposure to the most attractive factor and fundamental characteristics for the current and anticipated cycle phase.

The 11-stage cycle approach explicitly adjusts factor emphasis based on growth momentum, credit conditions, inflation pressures, and monetary policy. For example, during **recessionary regimes with loose financial conditions**, the **Value** tends to receive a heavier weight (≈52.6 %), reflecting evidence that cheaper valuations outperform as markets anticipate mean reversion. In contrast, when recession coincides with **tight financial conditions**, the emphasis shifts towards **Growth, Financial Health, and Quality** (each ≈33.3 %), as investors prioritise firms with stronger balance sheets and resilient earnings during a more constrained environment. During **downturns with loose conditions**, **Financial Health** becomes very prominent (≈66.7 %), underscoring the defensive nature of quality balance sheets when markets are stressed but liquidity remains relatively accessible. Across expansionary regimes with or without tightening or inflation, allocations to **Value** or **Quality** often rise, while pure **Growth** plays meaningful roles depending on the tracking environment.

Figure 30

## STRATEGY PERFORMANCE




Source: Bloomberg and BBVA Global Markets Strategy

Figure 31

## OPTIMISED WEIGHTS

| | | Growth | Financial Health | Quality | Value | Momentum |
|---|---|---|---|---|---|---|
| Recovery with Loose FCI | 1L | 0.0% | 25.0% | 25.0% | 50.0% | 0.0% |
| Recovery with Tight FCI | 1T | 0.0% | 66.7% | 33.3% | 0.0% | 0.0% |
| Recession with Loose FCI | 2L | 15.8% | 15.8% | 15.8% | 52.6% | 0.0% |
| Recession with Tight FCI | 2T | 33.3% | 33.3% | 33.3% | 0.0% | 0.0% |
| Downturn with Loose FCI | 3L | 0.0% | 66.7% | 0.0% | 33.3% | 0.0% |
| Downturn with Tight FCI | 3T | 0.0% | 33.3% | 33.3% | 33.3% | 0.0% |
| Downturn with inflation and with Loose FC | 5L | 33.3% | 33.3% | 33.3% | 0.0% | 0.0% |
| Downturn with inflation and with Tight FCI | 5T | 20.0% | 20.0% | 20.0% | 0.0% | 40.0% |
| Expansion with Loose FCI | 4L | 28.6% | 28.6% | 28.6% | 14.3% | 0.0% |
| Expansion with Tight FCI | 4T | 28.6% | 28.6% | 28.6% | 14.3% | 0.0% |
| Expansion with inflation and with Loose FC | 6L | 0.0% | 0.0% | 50.0% | 50.0% | 0.0% |
| Expansion with inflation and with Tight FCI | 6T | 16.7% | 16.7% | 16.7% | 50.0% | 0.0% |

Source: Bloomberg and BBVA Global Markets Strategy

These results reflect the core advantage of dynamic factor allocation: by shifting exposures in line with cyclical signals - emphasising Value and downside buffers in recessions, prioritising Quality and Financial Health amid stress, and capturing upside through Value and Quality in expansions - the strategy captures **diversified sources of return** while mitigating extended drawdowns. The improved Sharpe ratio and reduced drawdown statistics further suggest that this regime-aware factor approach delivers **better risk-adjusted performance than static factor mixes or traditional equity benchmarks**, particularly in periods of tightening, inflation pressures, and shifting financial conditions that static models struggle to navigate.

Figure 32
**PORTFOLIO STATISTICS**

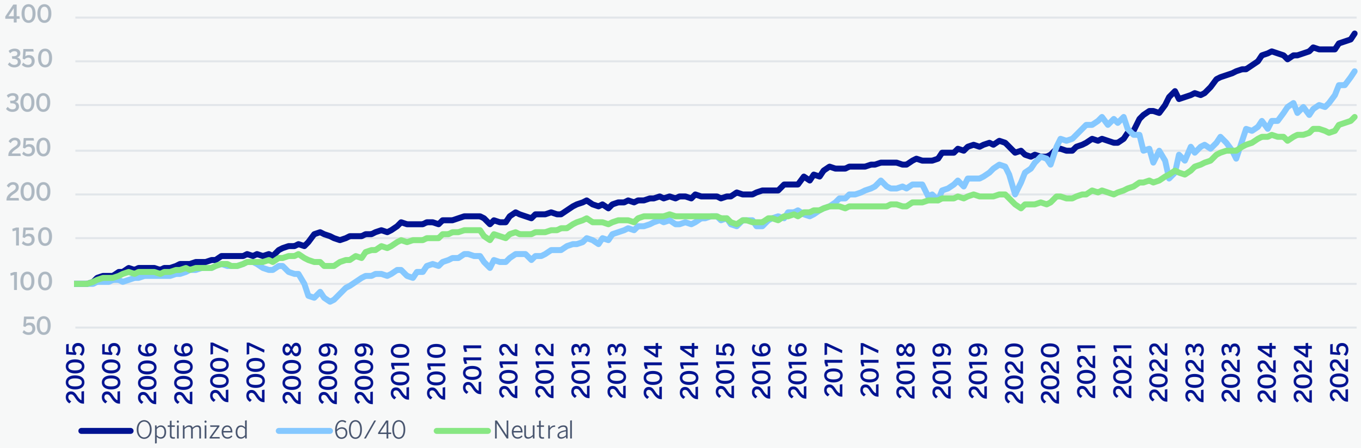
| Key Statistics | BBVA 11-Stage Dynamic Factor Model | US Equities | US Equities EW |
|---|---|---|---|
| **Cumulative Return** | 1196% | 612% | 446% |
| **Annualised Return** | 14.2% | 10.7% | 9.2% |
| **Standard Deviation** | 21.4% | 19.7% | 20.9% |
| **Sharpe Ratio** | 0.66 | 0.54 | 0.44 |
| **Downside Deviation** | 17.2% | 16.4% | 17.4% |
| **Sortino Ratio** | 0.82 | 0.65 | 0.53 |
| **Maximum Drawdown** | -52.6% | -55.1% | -58.4% |
| **Skewness** | - 0.12 | - 0.20 | - 0.25 |
| **Excess Kurtosis** | 10.8 | 12.7 | 11.7 |
| **Dividend Yield*** | | 1.29% | 1.29% |

Source: Bloomberg and BBVA Global Markets Strategy

## 4.4. QIS Strategy Allocation – BBVA Risk Premia offering

The QIS (Quantitative Investment Strategy) framework uses **regime-dependent systematic exposures** - such as FX Carry, Global Macro Trend, Government Bond Trend, and other risk premia indices - to allocate differently across market environments like recession, recovery, expansion, and downturn (as shown below). Instead of a fixed allocation, the strategy increases exposure to styles that historically perform best in the current macro regime (e.g., carry or trend signals), and reduces exposure as and when risk premia are expected to underperform. This dynamic weighting allows the strategy to tilt into assets and signals that capture prevailing market drivers (risk appetite, rate cycles, volatility regimes) while mitigating exposure during weaker regimes.

Figure 33
**STRATEGY PERFORMANCE**




Source: Bloomberg and BBVA Global Markets Strategy

The performance comparison (shown below) shows that this **dynamic QIS approach materially outperforms a static 60/40 portfolio** across multiple horizons. Over the full history ("All"), the QIS strategy delivers **similar annualised returns (~6.3 % vs. ~6.83 %)** with a substantially lower volatility and, as a result, a significantly **higher Sharpe ratio (~1.37 vs. ~0.63)**, indicating superior risk-adjusted performance. It also shows **lower volatility** and **better downside protection** than a 60/40 portfolio, over shorter horizons such as one, five and 10 years, where the Sharpe ratio advantage is particularly pronounced (~1.89 vs. ~0.61 over 10Y). These results suggest that systematic, rules-based adaptation to macro and market dynamics leads to both **improved returns and more efficient risk exposure** relative to a static equity-bond blend.

This performance edge reflects a broader limitation of traditional 60/40 portfolios: bonds no longer reliably hedge equities in all market regimes, particularly when inflation and interest rates rise, weakening the negative correlation that historically supported diversification. In contrast, QIS strategies **adjust exposures across a broader set of risk premia and signals**, offering more diversified and adaptive return sources that help navigate shifting economic cycles and market stresses in a way static allocations cannot.

Figure 34

## PORTFOLIO STATISTICS

| Returns | 60/40 | Strategy |
|---|---|---|
| All | 6.83% | 6.30% |
| 10Y | 6.18% | 9.46% |
| 5Y | 2.31% | 4.98% |
| 1Y | 5.71% | 16.54% |
| **Historical Volatility** | | |
| All | 10.79% | 4.58% |
| 10Y | 10.07% | 5.01% |
| 5Y | 10.30% | 4.70% |
| 1Y | 9.30% | 2.60% |
| **Sharpe ratio (RF=0)** | | |
| All | 0.63 | 1.37 |
| 10Y | 0.61 | 1.89 |
| 5Y | 0.22 | 1.06 |
| 1Y | 0.61 | 6.35 |

Source: Bloomberg and BBVA Global Markets Strategy

Corporate &
Investment Banking

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