

Shifting Correlations

March 2026

KEY TAKEAWAYS

- We observe the early stages of a reallocation away from US assets as doubts about American exceptionalism progress. This trend should strengthen as US growth slows, and opportunities elsewhere improve.
- Entering 2026, markets looked vulnerable to disruption. Confidence was high despite subdued fundamentals, positioning was stretched, and low cross-asset correlations had created a comfortable risk regime for investors.
- The US/Israel strike on Iran acted as a catalyst for market volatility, yet the shock remained contained partly because investors lacked a clear safe-haven asset.
- Structural concerns about sovereign solvency and post-2022 changes in risk models have weakened bonds' defensive role. The recent sell-off appears driven more by crowded positioning than by a shift in central bank policy.
- Markets increasingly see a limited conflict with Iran as more likely than a catastrophic escalation. Oil prices may remain elevated amid Hormuz tensions.
- Political uncertainty in the US is likely to persist as Trump pursues unconventional policies ahead of the midterms.
- Higher oil prices will have a modest direct impact on the US economy. The larger risk is a loss of confidence that has supported its outperformance, weighing on US assets and the dollar.
- Outside the United States, the global outlook remains relatively constructive. Asia and emerging markets benefit from structural tailwinds and stabilising forces largely absent in the US.

When Stability Breeds Fragility

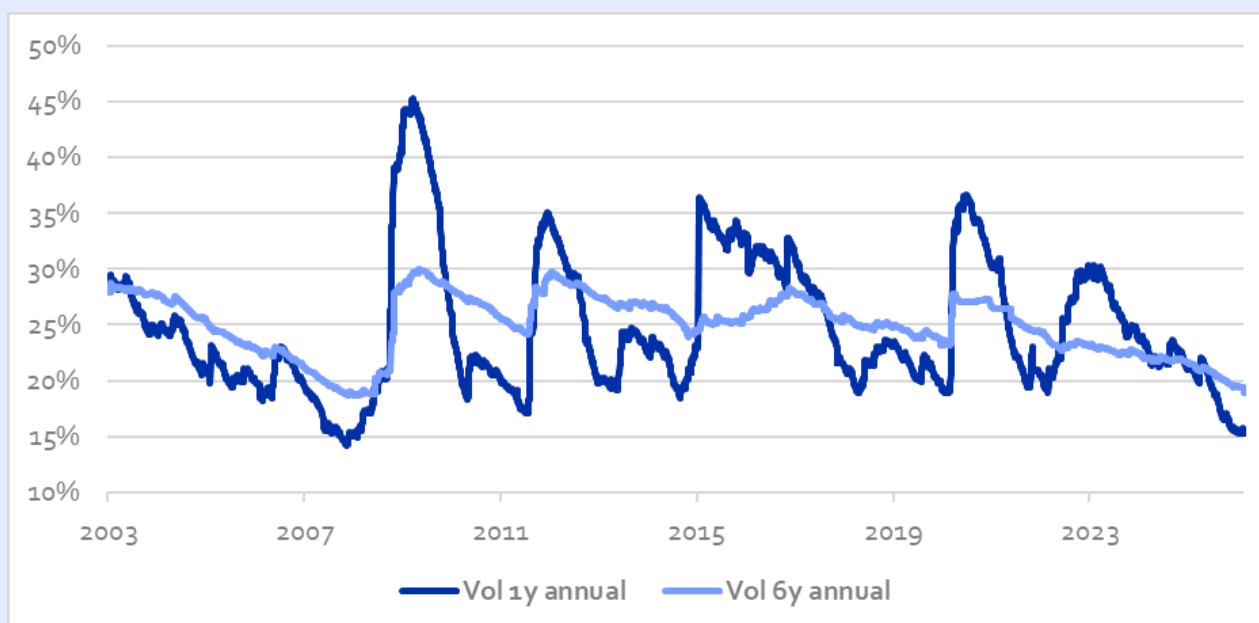
The euphoria that defined US markets last year offered the comforting illusion of stability. Yet beneath the surface, we observed the early stages of capital gradually shifting away from these assets, as investors began to question the persistence of US exceptionalism, despite the American economy hiding its fragilities through the wealth effect and AI capex cycle. We expect this dynamic to persist and strengthen this year, particularly as the spectrum of growth possibilities for the US narrows while more attractive alternatives gradually emerge.

That said, entering 2026 we did not expect this transition to unfold without disruption given prevailing market conditions. This view rested on the convergence of three warning signals that had been steadily aligning since last year and which defined the market’s starting point prior to the outbreak of

the conflict in Iran:

- **Investors entered 2026 heavily positioned for a “Goldilocks” outcome:** While enthusiasm for AI-related stocks had cooled somewhat, investors rotated into other market segments, supported by a benign macro narrative: resilient consumption, manageable tariff impacts, solid corporate balance sheets, expectations of a more accommodative Fed, and prospects of additional fiscal support in 2026. The prevailing view among investors and analysts was that the US macro backdrop remains sound, and even more so for the rest of the world. While their assessment may eventually prove correct, its highly consensual nature left little margin of error for markets.
- **Risk metrics were exceptionally supportive, arguably more than investors realised:**

Strategy applied to H2O Allegro since 16/03/2011: Annualised volatility estimates using historical risk matrices



Source: H2O AM, as of January 2026

As shown by the annualised volatility of our global fixed income fund, H2O Allegro FCP, calculated using available risk matrices since 2003, cross-asset correlations had fallen to such levels that overall volatility metrics entered 2026 close to their historical lows. These readings were comparable to those observed in 2007, a period similarly characterised by unusually low and complacent covariances.

The first measure (1-year annualised volatility) relies on a short-term covariance matrix and can be viewed as a proxy for the risk frameworks typically adopted by more speculative investors. The second measure (6-year annualised volatility) captures a longer time horizon and incorporates an exponentially weighted methodology, under which older observations are effectively halved every two years, thereby placing greater emphasis on recent data. This approach serves as a proxy for the risk models generally employed by active managers and institutional investors.

The convergence of these two indicators toward exceptionally low risk readings across different investor cohorts fostered a shared sense of complacency. The resulting perception of stability encouraged higher leverage, which in turn eroded the robustness of the overall financial structure.

In today's increasingly mechanised markets, portfolio construction is heavily influenced by risk models. With cross-asset correlations unusually low, incremental positions contribute little to measured portfolio risk, mechanically allowing investors to increase leverage, for instance allocating 10% to an asset rather than 5% under more normalised correlation regimes. During periods of market stress, as much as 70–80% of total market variance can be explained by the behaviour of these risk models. As a result, the build-up in positioning was driven as much by risk dynamics as by investment allocation decisions.

- Positioning was elevated across the board:** risk appetite was not just confined to US equities. Crowded positioning had extended to European, Asian and emerging market equities, as well as to carry trades and other risk-oriented strategies. Investors were broadly long risk at levels approaching historical extremes.

We perceived the near-term environment as increasingly vulnerable to an unwinding of crowded consensus positioning, given the alignment of these three intertwined market dynamics. In such a context, the precise trigger for a correction becomes secondary. When positioning is stretched and correlations are low, even a modest catalyst can prompt a market adjustment.

The early 2018 episode illustrates this dynamic: growth was solid and investor confidence high, yet a stronger-than-expected US wage growth release was sufficient to spark a sharp equity sell-off due to firmer inflation concerns. The issue was less the data itself than the market's positioning. The longer this environment persists, the more leverage builds beneath the surface. As exposure increases, the threshold for disruption declines, meaning a relatively small shock can have an outsized impact.

Markets Without Shelter

Given current market developments, the US/Israel decision to strike Iran on February 28th has proven to be a catalyst broadly consistent with our initial intuition. Yet the ensuing volatility shock remained relatively contained. This partly reflects the absence of a clear safe-haven asset into which investors could rotate to offset losses on active positions. Consequently, the mechanical selling pressure typically affecting risk assets during periods of market stress proved more limited.

In particular, the usual flight-to-quality into government bonds failed to materialise. The erosion of bonds' traditional role as portfolio stabilisers, one they fulfilled for nearly three decades, can be traced to two structural developments. First, the gradual deterioration in the solvency profile of safe-haven issuers, led by the United States, a dynamic likely to intensify as defence spending rises. Second, the sharp volatility experienced by the asset class in 2022, when central banks swiftly raised rates following the resurgence of inflation and the invasion of Ukraine. As a consequence, risk models no longer advocate adding duration to mitigate portfolio risk during periods of heightened uncertainty and price volatility.

However, bonds did more than simply fail to protect, they came under significant selling pressure. While higher oil prices are clearly negative for fixed income given their stagflation implications, the scale of the sell-off bears the hallmarks of a positioning-driven adjustment. Hedge funds appear to have reduced stretched duration exposures, temporarily pushing market prices away from underlying fundamentals, an instance in which the "dog" (the market) briefly runs ahead of the "walker" (the fundamentals) – [see our 2024 note](#).

Following the sell-off, which triggered a bear-flattening of yield curves, short-term government debt was repriced to levels consistent with investors anticipating rate hikes this year. Such repricing implies a policy reaction function that prioritises inflation risks over growth concerns, an assumption that runs counter to historical central bank behaviour. In practice, policymakers are unlikely to contemplate hikes as their next move, nor materially delay easing solely because of

higher oil prices. Instead, they are more likely to look through the initial supply shock while assessing any potential recessionary impact.

Welcome the Positioning Reset

Given the difficulty of timing such events, and the improvements made to our risk management model after the Covid crisis, our approach since the start of the year has been to gradually reduce overall portfolio risk while the barrel (i.e., investor confidence, positioning and low correlations) continued to fill. This ensured portfolio resilience while retaining sufficient dry powder to benefit from a potential market repricing and risk conditions normalisation.

The longer investment horizon embedded in our process typically precludes us from making aggressive portfolio adjustments during market developments that appear disconnected from fundamentals, as is currently the case. On the contrary, we view episodes of positioning-driven liquidation positively, as they help transition asset pricing back toward macro-driven considerations. We used this technical repricing phase to reinforce our exposure to short-term German sovereign debt.

Should another phase of conflict escalation unfold, we expect our portfolio hedges (i.e, the long duration, yield-curve steepeners, and long JPY position) to offer protection, particularly given the now-cleansed positioning environment.

A More Limited Scenario

The catastrophic escalation scenario appears to be losing traction as markets reassess geopolitical risks in light of Trump's shifting rhetoric. A prolonged military intervention, such as deploying ground forces or pursuing regime change in Iran, would likely prove politically costly, particularly in a midterm election year. Logistical constraints would also make a sustained conflict difficult to maintain for the US, given the need to resupply forces from distant bases. Moreover, the nuclear option, despite representing Trump's most asymmetric lever, remains outside the current set of plausible scenarios. Instead, a more limited pattern, reminiscent of the 12-day conflict in June 2025, when Israel and the US launched a surprise strike on Iranian military and nuclear facilities, appears more likely if the

administration opts to declare strategic success and withdraw forces.

That said, the risk of higher-for-longer energy prices cannot be fully dismissed, particularly as long as tensions persist around the Strait of Hormuz. Disruptive actions, such as the deployment of sea mines, could still be used to deter passage. From a financial market perspective, however, the key variable is often the rate of change in oil prices rather than the level itself. Historically, markets tend to react more strongly to sudden price spikes than to gradual increases to new highs. In other words, even a worsening supply shock may have a limited market impact if oil prices rise in a contained and orderly fashion. In such a scenario, markets could gradually stabilise in the absence of further negative surprises, even if energy prices remain elevated and geopolitical tensions unresolved.

Elevated Risk, Limited Buffers

Markets are not immune to further disruption this year. Although 2025 was marked by significant policy shifts following President Trump's return to office, particularly on tariffs and immigration, these moves had largely been signalled during the campaign and were therefore, to a certain extent, already priced in by markets. Indeed, tariff increases ultimately proved only marginally higher than investors had anticipated at the end of 2024. By contrast, much like the objectives behind the administration's new offensive in the Middle East, Trump's agenda for 2026 remains far less certain. His administration will likely seek to inflate the economy through additional interventions in an attempt to regain political momentum ahead of the midterms. With conventional policy levers increasingly exhausted, the probability of more unconventional or disruptive measures is rising. Investors are progressively recognising that Trump governs as a risk-taker, as seen in the recent actions in Venezuela and now Iran. As long as bold moves appear to succeed, he is likely to double down and broaden the scope of disruptive policies.

Yet the underlying macroeconomic trajectory remains broadly unchanged. The US economy still appears to be slowing toward potential growth after a period of above-trend expansion. However, we view the country's risk profile as materially higher than in 2025. This reflects not only the possibility that President Trump continues to stress-test the boundaries of an already fragile system,

but also the limited availability of macroeconomic stabilisers at this stage of the cycle:

- **Household savings rates have fallen back below their long-term average (~3.5%),** leaving consumers with limited buffers after sustaining spending through 2025, including absorbing tariff-related costs.
- With the federal funds rate at 3.5%, **monetary policy offers limited scope to cushion a downturn.** Even if the Federal Reserve were to prioritise labour market conditions over inflation, price dynamics may in turn constrain its capacity to pivot decisively towards a more dovish stance.
- **Among other undelivered promises and following the Supreme Court's decision to cancel the tariffs, the government's retreat from its campaign pledge to meaningfully reduce the fiscal deficit has reignited concerns over debt sustainability, with bond markets now clearly penalising continued fiscal slippage.** As observed throughout 2025, attempts to pursue expansionary fiscal policy despite widening deficits have increasingly triggered investor pushback, reflected in a repricing of the bond term premium, the additional compensation demanded for holding longer-dated maturities. This dynamic weakens policy transmission, as any fiscal decision is now liable to be immediately sanctioned by the market through a sharp steepening of the yield curve, thereby constraining credit conditions for long-term borrowers.

At an estimated growth impact of around -0.2% to -0.3% , the direct effect of higher oil prices on the US economy remains relatively limited. The greater risk lies less in the price at the pump than in the broader vulnerability of a system that is gradually losing the support from confidence. While the US economy is still operating above trend, much of its recent outperformance has been confidence-driven, its "outgrowth engine." A negative shock to sentiment could therefore leave it materially exposed. Liquidity risks in private markets, the absence of meaningful equity gains since Q4 2025 amid fading optimism on AI model developers, and now the emergence of a new war in the Middle East could together trigger a negative growth feedback loop as confidence erodes.

On the geopolitical front, the US is increasingly testing the limits of its global partnerships, first commercially through tariffs, and now geopolitically through the threat or use of force. As a result, allies are reassessing the depth of their ties with Washington, albeit at different speeds across regions. While Asia remains more cautious given its mercantile approach, confidence in the US is also fading. More broadly, the world appears to be moving away from the long-standing "all-America" framework that has underpinned global trade and security. This shift will likely unfold gradually, but each additional strain on alliances adds incremental pressure on the long-term appeal of the dollar and US assets.

The Global Cycle Has Other Engines

Outside the United States, where the macroeconomic narrative remains skewed to the downside, we maintain a constructive view on the global growth backdrop. While the energy shock represents a direct blow for European and Asian economies, these regions are not devoid of the stabilising forces that appear increasingly absent in the US economy when confronted with shocks of this nature.

Asia in particular continues to benefit from the positive tailwinds that have underscored the region's strength since last year. Chief among them is its central role in supplying the hardware required for the global AI development race. In addition, Japan's structural improvement, having seemingly exited deflation for good, is now translating into a broad-based and self-sustaining expansion (see our latest [podcast](#)). Starting from such a strong cyclical base, the current shock is unlikely to materially derail the region's positive trajectory.

The same applies to emerging market assets. While these markets have recently come under increased selling pressure, albeit far less acute than during past crises, largely a consequence of their popularity as investors sought diversification away from US equities and the AI theme, their fundamental appeal remains intact. Their reduced dependence on foreign capital and continued improvement in trade balances and capital accounts justify the privileged role they retain within our asset allocation.



To find out more, visit our [website](#) or listen to our podcast by scanning the QR code

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