Morgan Stanley
INVESTMENT MANAGEMENT

BIG PICTURE
Return of the 60/40

MACRO INSIGHT | Q2 2024

The 60/40 portfolio, defined here as a mix of 60% U.S. equities and 40% U.S. Treasury bonds, saw a rollercoaster ride down 17.5% in 2022 and up 17.2% in 2023.[1] Two hundred years of historical analysis suggests there is an 80% probability of positive returns in the two years following a year of negative returns for both stocks and bonds. We believe mean reversion of returns and diversification benefits make this portfolio a reliable starting point for asset allocation.

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Since 2000, bonds were often an effective hedge against equity-led losses. However, this dynamic dramatically changed in 2022. Both bonds and stocks suffered negative returns, with the 60/40 portfolio declining 17.5%, its worst performance since 1937, and its fourth worst in the last 200 years.

Many market participants, perhaps fueled by the belief that the declines of 2022 would persist (a behavioral misstep known as recency bias), questioned the value of the 60/40 strategy. Our view at the beginning of 2023 was that concerns were overstated. A unique set of circumstances had created the challenging 2022 macro conditions and we predicted the 60/40 strategy would rebound. Indeed in 2023, stocks surged with the S&P gaining 26.3% and U.S. 10-year treasuries up 3.6%. As a result, 60/40 returned 17.2%, far above its historical annual median return of +7.8%.

2022: A Perfect Storm for the 60/40

In 2022, central banks raised interest rates to tame the highest inflation rate in 40 years amid the tightest labor market in 50 years. This was the most aggressive rate-hiking cycle since the Paul Volcker era in the early 1980s. During this period of high inflation and rapidly rising interest rates in 2022, both stocks and bonds suffered declines, contributing to the poor performance of the 60/40 portfolio.

[1] In all cases a 60/40 portfolio refers to 60% U.S. equities/40% U.S. bonds. U.S. equities are represented by the S&P 500 Total Return Index (1926-2023) and the U.S. Market Total Return index (1820-1925), with data provided by Global Financial Data (GFD); U.S. bonds are represented by 10-year U.S. Treasury Total Returns (1820-2023), with data provided by GFD. Index definitions can be found in the disclosure section. The indexes do not include any expenses, fees or sales charges, which would lower performance. The index is unmanaged and should not be considered an investment. It is not possible to invest directly in an index.

As a result, the negative correlation that had existed between the two asset classes over two decades turned positive. However, it is important to note that the negative correlation that persisted since early 2000 was an anomaly. A comprehensive analysis of two centuries of financial data reveals that a positive correlation between stock and bond returns has been more common, occurring in 78% of the years since 1870 (*Display 1*).

Inflation Drives the Correlation Between Stocks and Bonds

Historically, inflation has been the most important driver of the correlation between stocks and bonds. An analysis of 150 years of data reveals that whenever U.S. inflation exceeded 2.4%, there was an increase in the median correlation between stock and bond returns (*Display 2*).

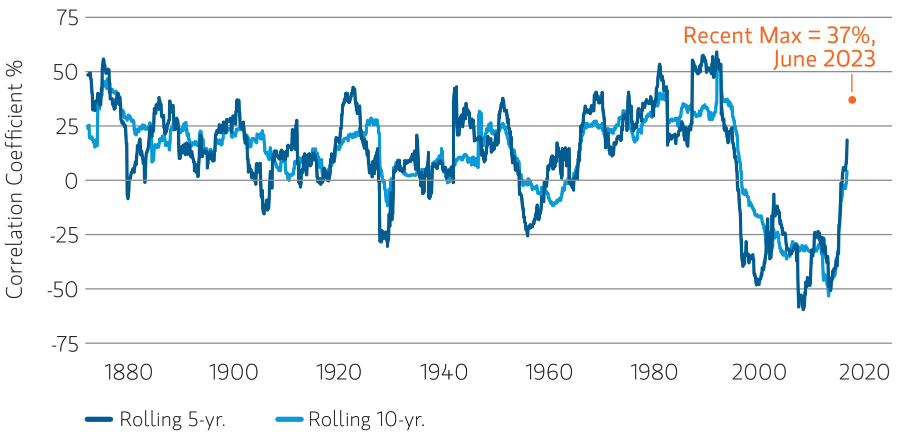
With inflation falling this year, the correlation between stocks and bonds may be lower in 2024 from the very positive levels of 2022, but still higher than the previous 25 years of very negative correlation.

Our findings reveal that an increase in positive correlation between stocks and bonds also leads to higher portfolio volatility. For example, if correlation climbs from -0.5 to +0.5, volatility of a 60/40 portfolio increases from 7.7% to 10.4% (a 35% increase in the baseline volatility level).

DISPLAY 1

Positive Correlation More the Norm than the Exception

Historical U.S. equity and bond correlation

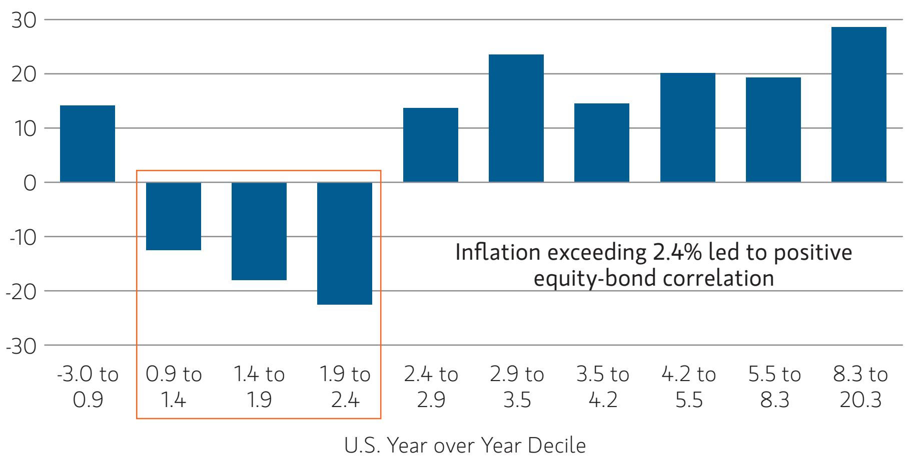


Source: MSIM, Bloomberg, FactSet, Haver. As of December 2023. Recent max value calculated using a 1-year weekly rolling correlation analysis to capture shorter-term movements. U.S. equities are represented by the S&P 500 Total Return Index (1926-2023) and the U.S. Market Total Return index (1820-1925), with data provided by Global Financial Data (GFD); U.S. Bonds are represented by 10-year U.S. Treasury Total Returns (1820-2023), with data provided by GFD. Index definitions can be found in the disclosure section. The indexes do not include any expenses, fees or sales charges, which would lower performance. The index is unmanaged and should not be considered an investment. It is not possible to invest directly in an index.

DISPLAY 2

Inflation Is the Key Driver of Equity-Bond Correlation

Equity and bond total return correlation by inflation decile



Source: MSIM, Bloomberg, FactSet, GFD. Data range from 1873 - December 31, 2023. U.S. equities are represented by the S&P 500 Total Return Index (1926-2023) and the U.S. Market Total Return index (1820-1925), with data provided by Global Financial Data (GFD); U.S. bonds are represented by 10-year U.S. Treasury Total Returns (1820-2023), with data provided by GFD. Index definitions can be found in the disclosure section. The indexes do not include any expenses, fees or sales charges, which would lower performance. The index is unmanaged and should not be considered an investment. It is not possible to invest directly in an index.

Growth and Inflation Drive Stock and Bond Returns

Stock and bond returns are significantly impacted by the interaction between growth and inflation acceleration/deceleration. Using a simple framework measuring median stock and bond returns during real growth and inflation acceleration and deceleration periods since 1946, we can see how the 60/40 portfolio performs under different macroeconomic environments.

The 60/40 portfolio performs best when real growth accelerates and inflation decelerates, as it benefits from higher real earnings growth in stocks, a multiple boost from falling inflation and interest rates, and a rise in bond prices as rates fall. Conversely, the 60/40 portfolio is most challenged in macro conditions characterized by decreasing growth and rising inflation. In this scenario, stocks usually suffer from lower earnings and lower multiples, while the rising inflation can trigger central bank tightening, which pushes up rates, ultimately hurting bonds as well.

Return of the 60/40

The 60/40 portfolio will continue to serve as a solid starting point for strategic asset allocation. It has achieved a compounded annual growth rate of 7.3% over the 200 years' worth of data we analyzed.[2] More importantly, both stocks and bonds experiencing negative returns in the same year occurred in only 16 instances—including 2022—implying only an 8% probability of both stocks and bonds experiencing negative returns in the same year. These are tough odds indeed *(Display 4)*.

After experiencing a dismal year like 2022, it is common for mean reversion to occur. Not only are simultaneous drawdowns in stocks and bonds rare, 81% of the time a 60/40 strategy generates a positive return in the following two years. This event study suggests that both 2023 and 2024 should yield positive returns for the 60/40 portfolio, given our base case

DISPLAY 3

Historically, Equity and 60/40 Portfolios Do Best in Environments of Real Growth Acceleration and Inflation Deceleration

Median 60/40 Portfolio Returns by Macro Regime

60/40 U.S. Equity & Bond Portfolio

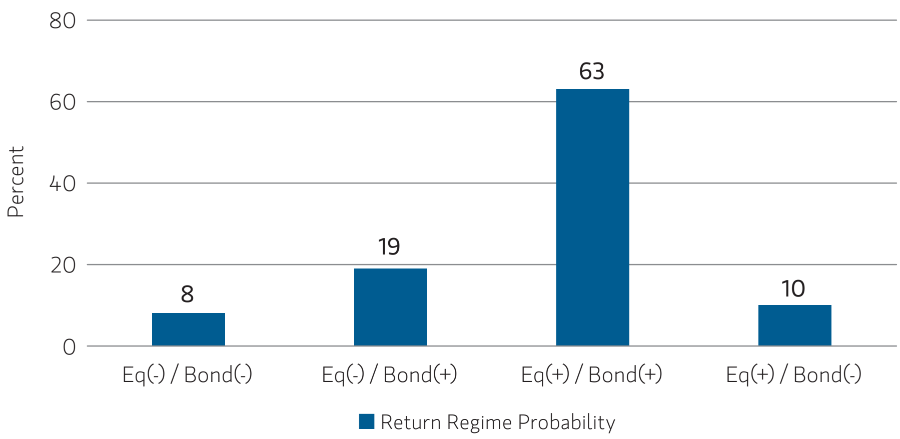
REGIME	REAL GROWTH ACCELERATION	REAL GROWTH DECELERATION
INFLATION ACCELERATION	9.7	5.5
INFLATION DECELERATION	14.9	10.8

Source: MSIM, Bloomberg, FactSet. Data range for all regimes from 1946 through November 29, 2023. U.S. equities are represented by the S&P 500 Total Return Index (1946-2023) with data provided by Global Financial Data (GFD); U.S. bonds are represented by 10-year U.S. Treasury Total Returns (1946-2023), with data provided by GFD. Index definitions can be found in the disclosure section. Index definitions can be found in the disclosure section. The indexes do not include any expenses, fees or sales charges, which would lower performance. The index is unmanaged and should not be considered an investment. It is not possible to invest directly in an index.

DISPLAY 4

Low Odds of Weak Returns for Both Equities and Bonds in the Same Year

Probability of Positive/Negative Equity and Bond Returns



Source: MSIM, Bloomberg, FactSet. As of December 31, 2023. Equities are represented by the S&P 500, bonds by the U.S. 10-year Treasury. Index definitions can be found in the disclosure section. The indexes do not include any expenses, fees or sales charges, which would lower performance. The index is unmanaged and should not be considered an investment. It is not possible to invest directly in an index.

[2] MSIM, Bloomberg, FactSet, Haver, Global Financial Data. Data range from 1820 to September 30, 2023.

scenario of moderately decelerating growth and falling inflation over the next 12 months (*Display 5*). The 60/40 already delivered a +17.2% return in 2023.

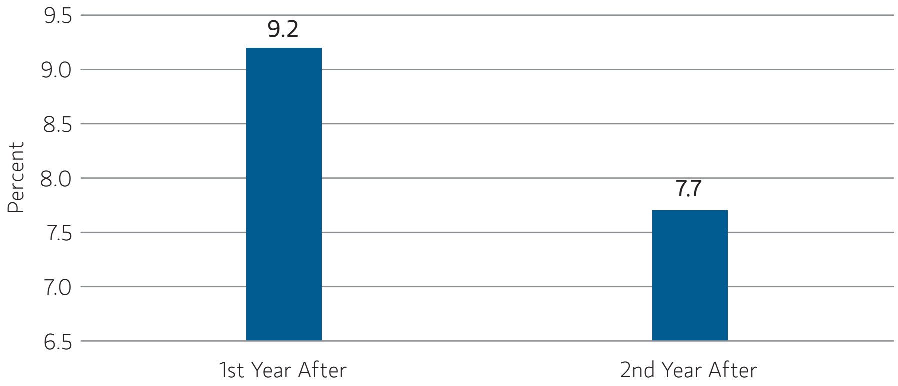
There is also the question of whether the traditional diversification rationale for a 60/40 strategy is still valid. What will the correlation of stocks and bonds look like in 2024? Our view is that overall correlation between stocks and bonds could be lower than what we saw in 2022, but still higher than it was the previous 25 years, given we have reset to a higher inflation rate.

There is a diversification rationale as well. In the event of a recession, bonds can serve as a hedge. Historical data from the National Bureau of Economic Research shows that in 88% of the 34 U.S. recessions going as far back as 1854, nominal bond returns were positive, with a median return of +6.3%.

DISPLAY 5

Returns of 60/40 Seen Improving in the Two Years Following Sharply Negative Returns for Both Equities and Bonds

60/40 median returns in year 1 and year 2 post a year when both are negative. ***Past performance is no guarantee of future results.***



Source: MSIM, Bloomberg, FactSet, Haver. As of December 31, 2023. Data is based on historical trends and is subject to change. The information is not intended to predict the future performance of any specific investment or Morgan Stanley product.

Summary

Over the last few decades investors in stocks and bonds have enjoyed the benefits of structurally declining yields, leading to rising valuations and beneficial diversification. While the post-2000 trend of a negative correlation between stocks and bonds deviates from history, it is important to recognize that this relationship is strongly influenced by inflationary factors. We believe that a decline in inflation in 2024 will lead to lower correlation between stocks and bonds, increasing the diversification benefits and lowering downside risk. In addition, our analysis of second-year returns following a year when both asset classes yielded negative returns, like in 2022, indicates a likelihood of positive returns for this combination in 2024. We believe this broader contextual analysis, drawing on 200 years of data, provides a valuable roadmap for investors to consider the benefits of a 60/40 portfolio. Despite some skepticism following the challenges of 2022, we believe a 60/40 strategy remains relevant.

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The **S&P 500® Index** measures the performance of the large cap segment of the U.S. equities market, covering approximately 75% of the U.S. equities market. The Index includes 500 leading companies in leading industries of the U.S. economy.

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