

June 24, 2022 03:12 PM GMT

Cross-Asset Dispatches | Global

AGG+ and CORE+ Optimal Fixed Income Portfolios: June 2022

We refresh our AGG+ and CORE+ fixed income optimal portfolios for June. The move in rates coupled with our macro strategists' revised forecasts for US Treasuries means our optimal portfolios focused on the N12M have pared back exposure in UST, and added in Agency MBS.

Revised UST N12M forecasts drive UW on UST within optimal portfolios: Our macro strategists now see US Treasury 10Y yields rising to around 3.5% at end-2022, with the front end cheapening most from now until 2Q23. These new forecasts form new assumptions for our AGG+ and CORE+ optimal portfolios, and tilt allocation away from US Treasuries.

AGG+ and CORE+ N12M portfolios: Based on our strategists' N12M forecasts, our optimal portfolios maximising total returns subject to vol have a preference for corporates and Agency MBS over US Treasuries, with allocation to the latter swinging from OW last month to UW this month.

AGG+ and CORE+ LR portfolios: Based on the cross-asset team's long-term capital markets assumptions, our optimal portfolios continue to like taking duration and vol exposure in corporate credit (IG and HY), while being underweight in USTs. Allocation for the LR optimal portfolios is little changed from a month ago.

Close to home for fixed income portfolios: Similar to the last AGG+ and CORE+ update, our optimal portfolios have risk profiles close to their benchmarks across semi deviation, max drawdown, etc., suggesting that N12M and long-run expected risk/reward don't justify taking huge bets in vol and duration.

For more on the methodology behind the AGG+ and CORE+ framework, see [Cross-Asset Dispatches: Optimal Fixed Income Portfolios](#), April 24, 2022.

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AGG+ Optimal Portfolios

AGG+ N12M vol target portfolio

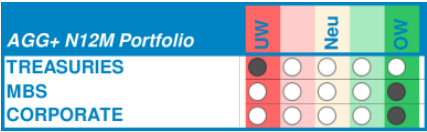
Targeting same volatility as US AGG while maximising N12M expected returns.

Portfolio preference: IG corporates and MBS > Treasuries.

The AGG+ N12M optimal portfolio is UW Treasuries, OW Agency MBS, OW IG corporates. Treasuries swing from OW last month to UW this month, driven by our macro strategy team's [new forecasts](#).

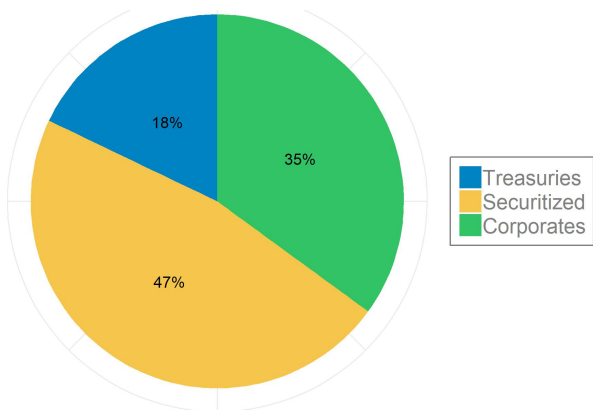
The portfolio has slightly higher duration than the benchmark, driven by an OW in longer-dated IG corporates. AGG+ N12M prefers taking risk in IG 10Y+ instead of US Treasuries. The risk profile of AGG+ N12M is similar to the benchmark across most risk metrics like semi deviation, max drawdown, etc.

Exhibit 1: AGG+ N12M vol target portfolio allocation



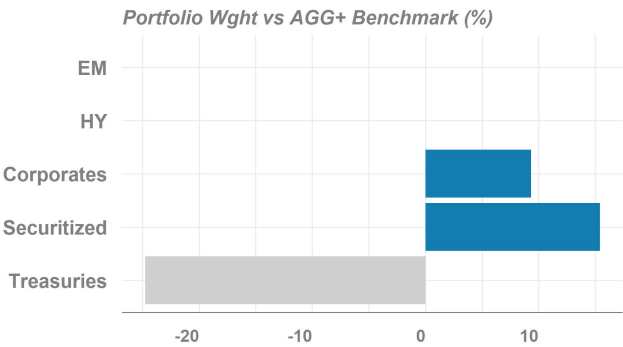
Source: Morgan Stanley Research

Exhibit 2: AGG+ N12M vol target portfolio breakdown by broad asset



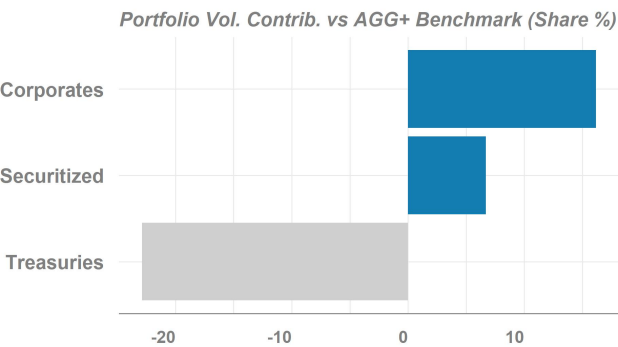
Source: Morgan Stanley Research

Exhibit 3: AGG+ N12M vol target portfolio weight versus benchmark



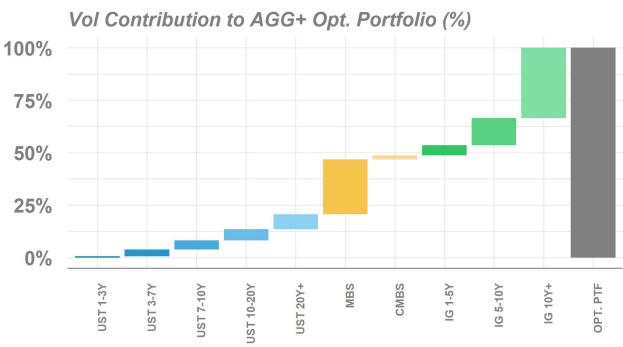
Source: Morgan Stanley Research

Exhibit 4: AGG+ N12M vol target portfolio volatility contribution versus benchmark



Source: Morgan Stanley Research

Exhibit 5: AGG+ N12M vol target portfolio volatility contribution by asset



Source: Morgan Stanley Research

Exhibit 6: Summary statistics for AGG+ N12M vol target portfolio

AGG+ N12M Portfolio

Targeting Same Volatility As AGG While Maximizing N12M Expected Returns

	AGG+ Wght	Bench. Wght	AGG+ Tilt	1M Wght Chg	UW	Neu	OW
US CORE FIXED INCOME	100%	100%					
Treasuries	18%	43%	-25%	-28%			
1-3Y	3%	14%	-11%	-22%			
3-7Y	5%	16%	-11%	1%			
7-10Y	4%	4%	-0%	0%			
10-20Y	3%	3%	+0%	-1%			
20Y+	3%	6%	-3%	-5%			
Securitized	47%	32%	+15%	31%			
MBS	45%	30%	+15%	31%			
CMBS	2%	2%	+0%	0%			
Corporate	35%	26%	+9%	-3%			
1-5Y	10%	9%	+1%	-5%			
5-10Y	10%	7%	+3%	1%			
10Y+	15%	9%	+6%	2%			
					vs Bench		
RISK REWARD	AGG+	Bench	Diff	AGG+ 1M Chg	Higher		
N12M Exp Rtn (%)	3.9	3.5	0.4	3.0			
LR Exp Rtn (%)	4.5	4.2	0.2	0.7			
<i>Risk-free Rtn (%)</i>	<i>2.8</i>	<i>2.8</i>	<i>-</i>	<i>n/a</i>			
XS Rtn (bp)	109	67	42	304			
10Y Vol (%)	3.9	3.9	0.0	0.0			
Exp Sharpe	1.0	0.9	0.1	0.8			
<i>Historical Sharpe</i>	<i>0.5</i>	<i>0.5</i>	<i>0.1</i>	<i>0.0</i>			
Exp Sortino	1.3	1.2	0.1	1.0			
<i>Historical Sortino</i>	<i>0.7</i>	<i>0.6</i>	<i>0.0</i>	<i>0.0</i>			
RISK PROFILE	Riskier						
Downside Deviation	2.8	2.6	0.2	0.0			
Semi Deviation	3.1	2.9	0.2	0.0			
Max Drawdown	12.3	12.2	0.1	-0.1			
Historical VaR	-6.8	-5.7	-1.1	-0.6			
Historical CVaR	-9.8	-9.2	-0.6	-0.4			
PORTFOLIO METRICS	Higher						
YTW	4.1	3.8	0.3	n/a			
OAS	0.8	0.6	0	n/a			
MDur	7.2	6.5	0.7	n/a			
MTY	10.0	8.7	1.3	n/a			
Rtg	AA3	AA2	n/a	n/a			
CORRELATION & BETA	Higher						
Correl. vs AGG+	1.0	1.0	0.0	0.0			
Correl. vs UST 10Y	0.8	0.9	-0.1	0.0			
Beta vs AGG+	1.0	1.0	0.0	0.0			
Beta vs UST 10Y	0.5	0.6	0.0	0.0			

As-Of Date: 2022-06-24

Source: Morgan Stanley Research

AGG+ LR vol target portfolio

Targeting same volatility as US AGG while maximising long-run expected returns.

Portfolio preference: IG corporates and MBS > Treasuries.

The AGG+ LR optimal portfolio is OW Agency MBS and IG corporates, and UW Treasuries. The portfolio has added exposure in short-dated IG corporates, and pared some exposure in Agency MBS.

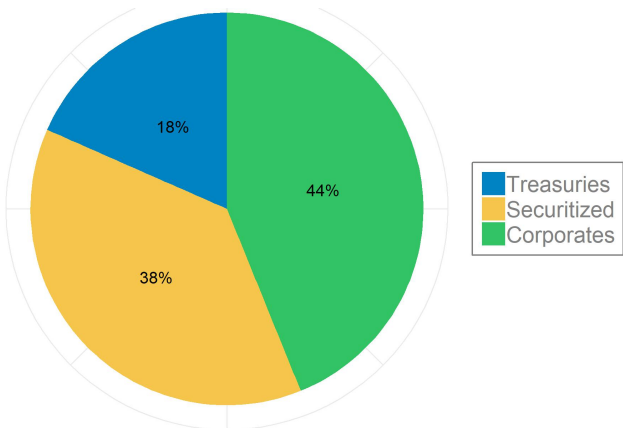
The portfolio has similar duration to the benchmark, mostly via an OW in long-dated IG corporates and UW in long-end US Treasuries. The AGG+ LR portfolio prefers taking vol exposure in IG corporate credit and is underweight vol in UST. The risk profile of the AGG+ LR portfolio is roughly similar to the benchmark across most risk metrics like semi deviation, max drawdown, etc.

Exhibit 7: AGG+ LR vol target portfolio allocation



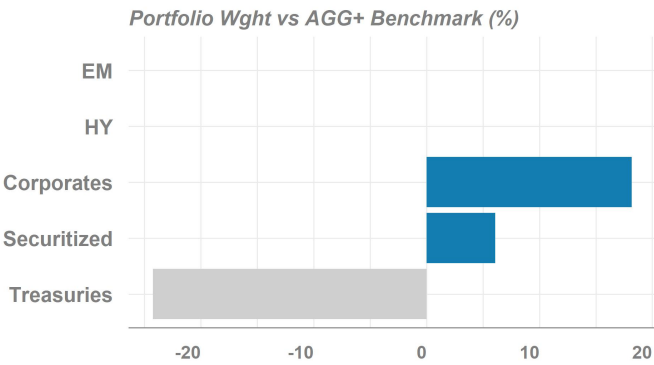
Source: Morgan Stanley Research

Exhibit 8: AGG+ LR vol target portfolio breakdown by broad asset



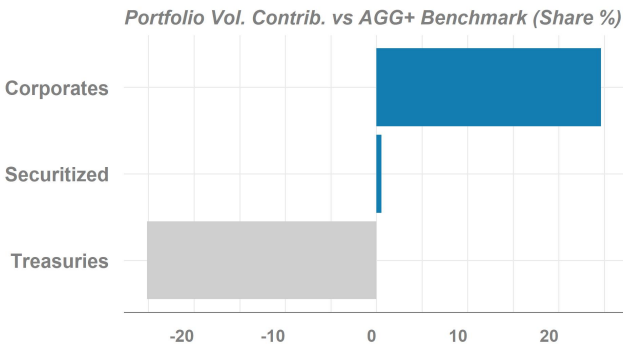
Source: Morgan Stanley Research

Exhibit 9: AGG+ LR vol target portfolio weight versus benchmark



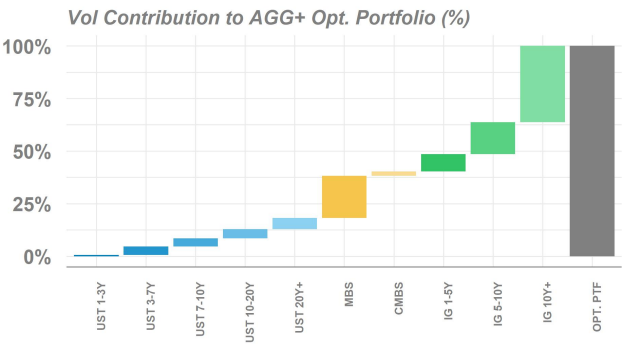
Source: Morgan Stanley Research

Exhibit 10: AGG+ LR vol target portfolio volatility contribution versus benchmark



Source: Morgan Stanley Research

Exhibit 11: AGG+ LR vol target portfolio volatility contribution by asset



Source: Morgan Stanley Research

Exhibit 12: Summary statistics for AGG+ LR vol target portfolio

AGG+ LR Portfolio

Targeting Same Volatility As AGG While Maximizing LR Expected Returns

	AGG+ Wght	Bench. Wght	AGG+ Tilt	1M Wght Chg	UW	Neu	OW
US CORE FIXED INCOME	100%	100%					
Treasuries	18%	43%	-24%	2%			
1-3Y	4%	14%	-11%	1%			
3-7Y	7%	16%	-9%	-1%			
7-10Y	3%	4%	-1%	0%			
10-20Y	3%	3%	-0%	1%			
20Y+	2%	6%	-3%	0%			
Securitized	38%	32%	+6%	-7%			
MBS	35%	30%	+6%	-7%			
CMBS	3%	2%	+0%	0%			
Corporate	44%	26%	+18%	5%			
1-5Y	16%	9%	+7%	6%			
5-10Y	12%	7%	+5%	0%			
10Y+	16%	9%	+6%	0%			
					vs Bench		
RISK REWARD	AGG+	Bench	Diff	AGG+ 1M Chg	Higher		
N12M Exp Rtn (%)	3.9	3.5	0.4	3.2			
LR Exp Rtn (%)	4.5	4.2	0.3	0.5			
<i>Risk-free Rtn (%)</i>	2.8	2.8	-	n/a			
XS Rtn (bp)	105	67	37	325			
10Y Vol (%)	3.9	3.9	0.0	0.0			
Exp Sharpe	1.0	0.9	0.1	0.8			
<i>Historical Sharpe</i>	0.5	0.5	0.1	0.0			
Exp Sortino	1.3	1.2	0.0	1.1			
<i>Historical Sortino</i>	0.7	0.6	0.1	0.0			
RISK PROFILE	Riskier						
Downside Deviation	2.8	2.6	0.2	0.0			
Semi Deviation	3.1	2.9	0.2	0.0			
Max Drawdown	12.1	12.2	-0.1	-0.3			
Historical VaR	-6.9	-5.7	-1.2	0.0			
Historical CVaR	-10.0	-9.2	-0.8	0.1			
PORTFOLIO METRICS	Higher						
YTW	4.1	3.8	0.3	n/a			
OAS	0.9	0.6	0	n/a			
MDur	6.9	6.5	0.4	n/a			
MTY	9.6	8.7	0.9	n/a			
Rtg	AA3	AA2	n/a	n/a			
CORRELATION & BETA	Higher						
Correl. vs AGG+	1.0	1.0	0.0	0.0			
Correl. vs UST 10Y	0.8	0.9	-0.1	0.0			
Beta vs AGG+	1.0	1.0	0.0	0.0			
Beta vs UST 10Y	0.5	0.6	0.0	0.0			

As-Of Date: 2022-06-24

Source: Morgan Stanley Research

CORE+ Optimal Portfolios

CORE+ N12M vol target portfolio

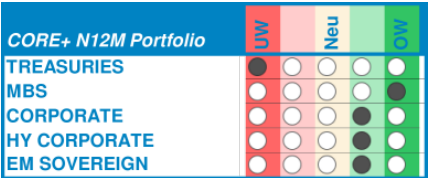
Targeting same volatility as CORE+ benchmark while maximising N12M expected returns.

Portfolio preference: Agency MBS > IG and HY corporates and EM sovereigns > Treasuries.

The CORE+ N12M optimal portfolio is UW US Treasuries, OW MBS, OW IG corporates, OW HY corporates, OW EM sovereigns. Treasuries swing from OW last month to UW this month, driven by our macro strategy team's [new forecasts](#).

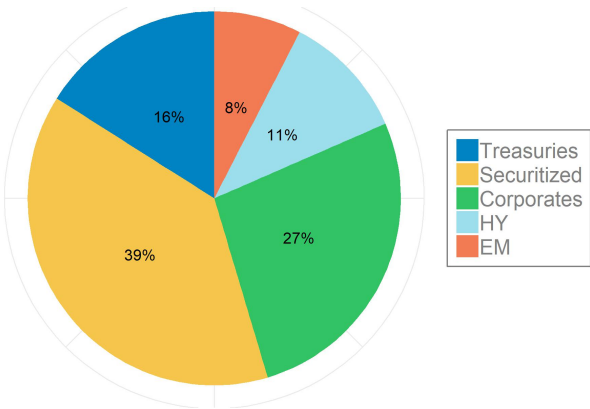
The portfolio has similar duration to the benchmark. For portfolio volatility CORE+ N12M prefers taking risk in IG, HY and EM. The risk profile of CORE+ N12M is similar to the CORE+ benchmark across most risk metrics like semi deviation, max drawdown, etc.

Exhibit 13: CORE+ N12M vol target portfolio allocation



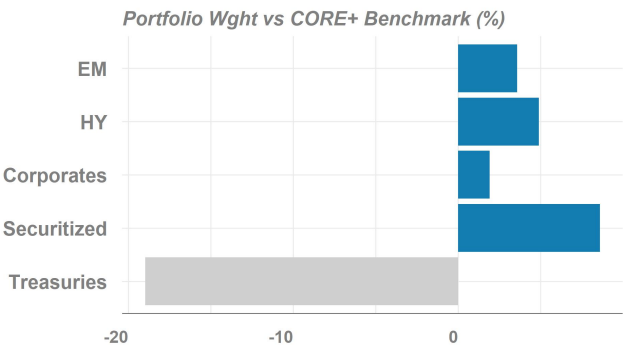
Source: Morgan Stanley Research

Exhibit 14: CORE+ N12M vol target portfolio breakdown by broad asset



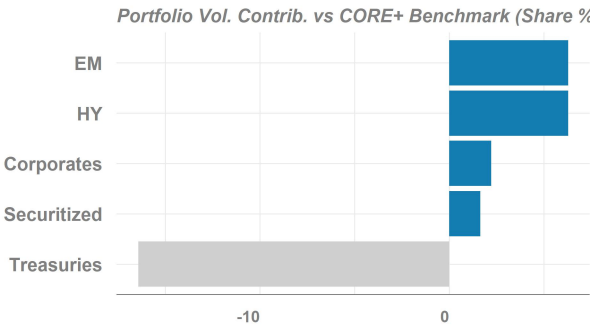
Source: Morgan Stanley Research

Exhibit 15: CORE+ N12M vol target portfolio weight versus benchmark



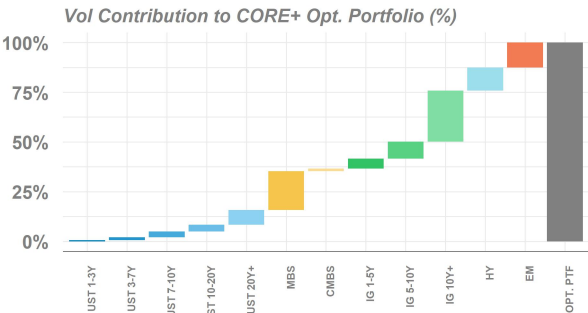
Source: Morgan Stanley Research

Exhibit 16: CORE+ N12M vol target portfolio volatility contribution versus benchmark



Source: Morgan Stanley Research

Exhibit 17: CORE+ N12M vol target portfolio volatility contribution by asset



Source: Morgan Stanley Research

Exhibit 18: Summary statistics for CORE+ N12M vol target portfolio

CORE+ N12M Portfolio

Targeting Same Volatility As 'Core USD Fixed Income' While Maximizing N12M Expected Returns

	CORE+ Wght	Bench. Wght	CORE+ Tilt	1M Wght Chg	UW	Neu	OW
US CORE FIXED INCOME	100%	100%					
Treasuries	16%	35%	-19%	-19%			
1-3Y	5%	12%	-7%	-14%			
3-7Y	3%	13%	-10%	-2%			
7-10Y	3%	3%	-0%	1%			
10-20Y	2%	2%	+0%	0%			
20Y+	3%	5%	-2%	-3%			
Securitized	39%	30%	+9%	24%			
MBS	37%	28%	+9%	25%			
CMBS	2%	2%	-0%	-1%			
Corporate	27%	25%	+2%	-6%			
1-5Y	10%	9%	+1%	-4%			
5-10Y	6%	7%	-1%	-2%			
10Y+	11%	9%	+2%	0%			
OTHER FIXED INCOME	18%	10%	+8%				
HY Corporate	11%	6%	+5%	1%			
EM Sovereign	8%	4%	+4%	0%			
RISK REWARD					CORE+ 1M vs Bench		
	CORE+	Bench	Diff	Chg	Higher		
N12M Exp Rtn (%)	5.2	4.3	0.9	3.4			
LR Exp Rtn (%)	5.0	4.6	0.4	0.6			
Risk-free Rtn (%)	2.8	2.8	-	n/a			
XS Rtn (bp)	240	149	91	337			
10Y Vol (%)	3.9	3.9	0.0	0.0			
Exp Sharpe	1.3	1.1	0.2	0.9			
Historical Sharpe	0.6	0.5	0.1	0.0			
Exp Sortino	1.6	1.4	0.2	1.1			
Historical Sortino	0.8	0.7	0.1	n/a			
RISK PROFILE					Riskier		
Downside Deviation	2.9	2.7	0.2	n/a			
Semi Deviation	3.2	3.0	0.2	n/a			
Max Drawdown	11.5	11.5	0.0	0.3			
Historical VaR	-7.2	-6.8	-0.5	-0.2			
Historical CVaR	-10.5	-9.5	-1.0	-0.1			
PORTFOLIO METRICS					Higher		
YTW	4.8	4.3	0.5	n/a			
OAS	1.5	1.0	1	n/a			
MDur	6.8	6.5	0.3	n/a			
MTY	9.7	8.9	0.8	n/a			
Rtg	A1	AA3	n/a	n/a			
CORRELATION & BETA					Higher		
Correl. vs CORE+	1.0	1.0	0.0	0.0			
Correl. vs UST 10Y	0.7	0.8	-0.1	0.0			
Beta vs CORE+	1.0	1.0	0.0	0.0			
Beta vs UST 10Y	0.4	0.5	-0.1	0.0			

As-Of Date: 2022-06-24

Source: Morgan Stanley Research

CORE+ LR vol target portfolio

Targeting same volatility as CORE+ benchmark while maximising long-run expected returns.

Portfolio preference: IG corporates > HY corporates and EM sovereigns > Agency MBS > Treasuries.

The CORE+ LR optimal portfolio is UW UST, EW MBS, OW IG corporates, OW HY corporates, OW EM sovereigns. Portfolio has added exposure in IG corporates, and pared some exposure in Agency MBS.

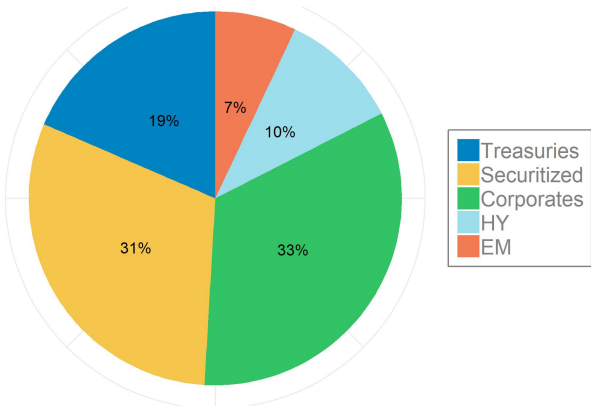
The portfolio has similar duration as the benchmark. For portfolio volatility the CORE+ LR portfolio prefers taking vol exposure in long-end IG corporates, HY corporates and EM sovereigns. The risk profile of the CORE+ LR portfolio is similar to the CORE+ benchmark across most risk metrics like semi deviation, max drawdown, etc.

Exhibit 19: CORE+ LR vol target portfolio allocation

CORE+ LR Portfolio	UW	Neu	OW
TREASURIES	●	○	○
MBS	●	○	○
CORPORATE	○	○	○
HY CORPORATE	○	○	○
EM SOVEREIGN	○	○	○

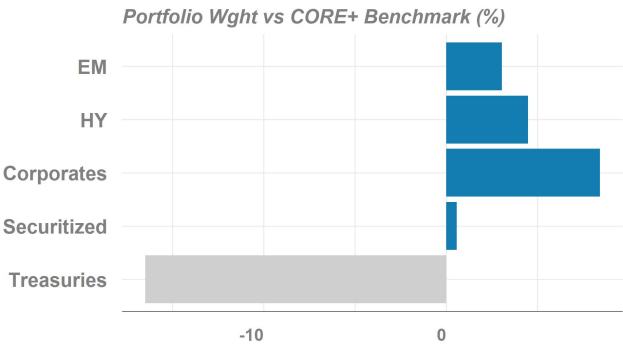
Source: Morgan Stanley Research

Exhibit 20: CORE+ LR vol target portfolio breakdown by broad asset



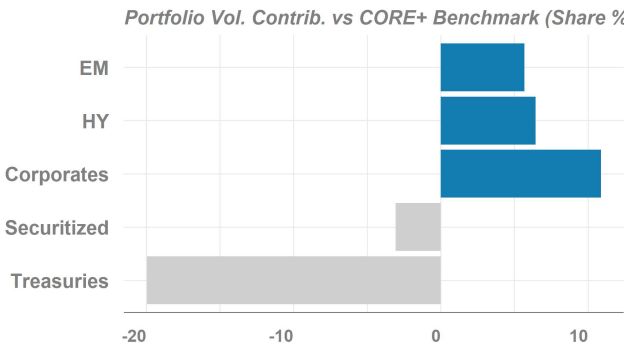
Source: Morgan Stanley Research

Exhibit 21: CORE+ LR vol target portfolio weight versus benchmark



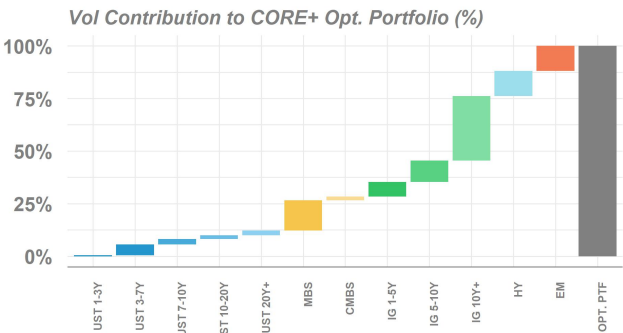
Source: Morgan Stanley Research

Exhibit 22: CORE+ LR vol target portfolio volatility contribution versus benchmark



Source: Morgan Stanley Research

Exhibit 23: CORE+ LR vol target portfolio volatility contribution by asset



Source: Morgan Stanley Research

Exhibit 24: Summary statistics for CORE+ LR vol target portfolio

CORE+ LR Portfolio

Targeting Same Volatility As 'Core USD Fixed Income' While Maximizing LR Expected Returns

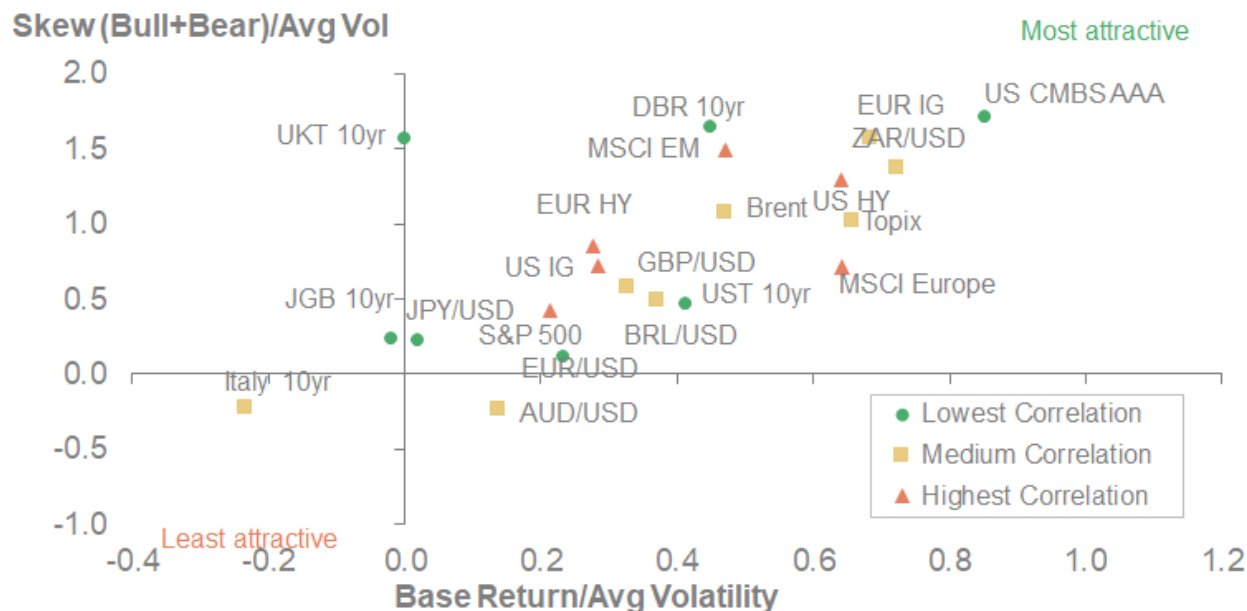
	CORE+ Wght	Bench. Wght	CORE+ Tilt	1M Wght Chg	UW	Neu	OW
US CORE FIXED INCOME	100%	100%					
Treasuries	19%	35%	-16%	0%			
1-3Y	3%	12%	-9%	0%			
3-7Y	10%	13%	-3%	1%			
7-10Y	3%	3%	-0%	1%			
10-20Y	1%	2%	-1%	-1%			
20Y+	1%	5%	-4%	-2%			
Securitized	31%	30%	+1%	-3%			
MBS	28%	28%	+0%	-3%			
CMBS	2%	2%	+0%	0%			
Corporate	33%	25%	+8%	4%			
1-5Y	13%	9%	+4%	2%			
5-10Y	8%	7%	+1%	0%			
10Y+	13%	9%	+4%	2%			
OTHER FIXED INCOME	18%	10%	+8%	-1%			
HY Corporate	10%	6%	+4%	-1%			
EM Sovereign	7%	4%	+3%	0%			
RISK REWARD					CORE+ 1M vs Bench		
	CORE+	Bench	Diff	Chg	Higher		
N12M Exp Rtn (%)	5.1	4.3	0.8	3.4			
LR Exp Rtn (%)	5.0	4.6	0.4	0.5			
Risk-free Rtn (%)	2.8	2.8	-	n/a			
XS Rtn (bp)	224	149	76	341			
10Y Vol (%)	3.9	3.9	0.0	0.0			
Exp Sharpe	1.3	1.2	0.1	0.9			
Historical Sharpe	0.6	0.5	0.1	0.0			
Exp Sortino	1.6	1.4	0.1	1.1			
Historical Sortino	0.8	0.7	0.1	0.0			
RISK PROFILE					Riskier		
Downside Deviation	2.9	2.7	0.2	0.0			
Semi Deviation	3.2	3.0	0.2	0.0			
Max Drawdown	11.4	11.5	-0.1	n/a			
Historical VaR	-6.9	-6.8	-0.2	0.1			
Historical CVaR	-10.6	-9.5	-1.1	-0.1			
PORTFOLIO METRICS					Higher		
YTW	4.8	4.3	0.5	n/a			
OAS	1.6	1.0	1	n/a			
MDur	6.5	6.5	0.0	n/a			
MTY	9.2	8.9	0.3	n/a			
Rtg	A2	AA3	n/a	n/a			
CORRELATION & BETA					Higher		
Correl. vs CORE+	1.0	1.0	0.0	0.0			
Correl. vs UST 10Y	0.6	0.8	-0.2	0.0			
Beta vs CORE+	1.0	1.0	0.0	0.0			
Beta vs UST 10Y	0.4	0.5	-0.1	0.0			

As-Of Date: 2022-06-24

Source: Morgan Stanley Research

Asset Class Forecasts and Risk/Reward

Global asset classes – expected 12-month return vs. risk



Source: Morgan Stanley Research. Note: 'Expected returns' based on MS Strategy 12m forecasts and current market prices. Correlation is six-month relative to global equities (MSCI ACWI). Credit returns are excess returns.

Exhibit 25: Morgan Stanley forecasts

	As of Jun 23, 2022	Q2 2023 Forecast			Q2 2023 Return Forecast			Average	Base Case
		Bear	Base	Bull	Bear	Base	Bull	Volatility	Return/Risk
Equities									
S&P 500	3,796	3,350	3,900	4,450	-10%	4.4%	19%	21%	0.21
MSCI Europe	1,619	1,340	1,760	2,000	-14%	12.4%	27%	19%	0.64
Topix	1,852	1,620	2,050	2,370	-10%	13.3%	31%	20%	0.66
MSCI EM	995	890	1,060	1,340	-8%	9.5%	38%	20%	0.47
FX									
USD/JPY	135	125	130	133	-2%	0.2%	4%	10%	0.02
EUR/USD	1.05	1.03	1.10	1.14	-5%	1.9%	6%	8%	0.23
GBP/USD	1.23	1.20	1.28	1.33	-3%	3.6%	8%	10%	0.37
AUD/USD	0.69	0.63	0.70	0.73	-9%	1.5%	6%	11%	0.14
USD/INR	78.3	72.0	74.3	79.0	2%	8.4%	12%	6%	1.30
USD/ZAR	16.0	14.5	14.8	15.3	8%	11.5%	14%	16%	0.72
USD/BRL	5.24	5.20	5.40	5.70	1%	5.9%	10%	18%	0.33
Rates (% percent)									
UST 10yr	3.09	4.00	3.05	2.50	-5%	3.2%	8%	8%	0.41
DBR 10yr	1.43	1.75	1.25	0.20	-1%	3.3%	13%	7%	0.45
UKT 10yr	2.31	2.10	2.25	1.65	4%	3.8%	8%	8%	
JGB 10yr	0.23	0.45	0.30	0.05	-1%	-0.1%	2%	3%	-0.02
Credit (bps)									
US IG	149	175	150	115	0%	1.5%	4%	5%	0.28
US HY	525	625	490	340	-1%	6.0%	13%	9%	0.64
EUR IG	108	115	95	65	1%	1.7%	3%	2%	0.69
EUR HY	479	650	550	350	-3%	2.0%	9%	7%	0.28
EM Sovs	510	525	410	350	4%	12.4%	17%	7%	1.68
US Agency MBS	51	60	35	25	0%	1.4%	2%	2%	0.89
Commodities									
Brent	110	75	110	150	-19%	19.3%	63%	41%	0.47
Copper	3.8	3.4	4.0	4.9	-13%	3.1%	29%	25%	0.12
Gold	1,842	1,530	1,700	2,040	-19%	-9.8%	8%	17%	-0.58

Source: Markit iBoxx, MSCI, Bloomberg, The Yield Book, Morgan Stanley Research forecasts. Note: Returns are total returns, except for credit, where we forecast excess returns versus government bonds. Commodity returns are calculated relative to futures to account for carry. All currency returns are shown as XXXUSD return. Volatility is shown as the average of 1y implied vol (where available) and 10y realised vol.

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STOCK RATING CATEGORY	COVERAGE UNIVERSE		INVESTMENT BANKING CLIENTS (IBC)			OTHER MATERIAL INVESTMENT SERVICES CLIENTS (MISC)	
	COUNT	% OF TOTAL	COUNT	% OF TOTAL IBC	% OF RATING CATEGORY	COUNT	% OF TOTAL OTHER MSC
Overweight/Buy	1398	39%	344	44%	25%	599	39%
Equal-weight/Hold	1576	45%	354	45%	22%	721	47%
Not-Rated/Hold	1	0%	1	0%	100%	0	0%
Underweight/Sell	565	16%	86	11%	15%	211	14%
TOTAL	3,540		785			1531	

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