

# FIXED INCOME MARKET STRATEGY

3 for 33

## Highlights

- ▶ **Loss of Bond "Ballast."** Bonds go up when stocks go down, right? Not anymore. With YTD returns through September 6th of -3.65% for core fixed income, avoiding an annual loss will require a major shift lower in interest rates, something we do not expect. An annual negative return in 2013 would represent only the third loss over the last 33 years. More importantly, that loss highlights the rapidly changing dynamics for investing in fixed income.
- ▶ **Tapering tantrums.** Despite a disappointing employment report for August, we expect the Fed to announce a modest program of tapering at the conclusion of its September 17-18 FOMC meeting. Increases in rates towards 3% reflect this as well as a Larry Summers nomination, leaving rates vulnerable to decline if either data or the nominee surprises. Nevertheless, recent stronger economic reports undermine our prior year target for the 10-year of 2.5%, and we upgrade that forecast to 2.5%-2.75% for year end.
- ▶ **Back to Schule.** German Federal elections September 22nd cap the surprising bright spot in the global picture of an improving European economic outlook. Adding to the global reasons for rising interest rates in the US, Chinese economic data stabilization removes some downside risks to global growth. Syria and Emerging Market currency crises highlight global risks scenarios that could lead to falling rates.

## So What Do I Do With My Money?™

Rising rates reflect both stronger global economic growth and shifting expectations for both tapering and the next Fed chairman. Significant risks remain and 10-year rates approaching 3% begin to look attractive. The potential to overshoot remains so we'll continue to underweight rate-sensitive segments of fixed income (Treasuries, mortgages and TIPS). Rising rates in August led to underperformance of high yield bonds vs. bank loans. The potential for this to continue in the short run leads us to putting high yield at "neutral" and bank loans to "overweight." Emerging markets continue to be under stress with currency uncertainty in India and Indonesia alongside fears of further global outflows attendant with Fed tapering; we remain neutral regarding an outright recommendation in EM debt. In municipals, higher rates and a steeper curve has restored some value to the broader municipal market with yields their highest since early 2011. However, Puerto Rico bonds finally began to reflect the long deterioration in fundamentals and our longstanding concerns.

\* Yield to Maturity. † Yield to worst. ‡ As of 08/30/2013, Securitized Assets: ABS (MTD -0.21, YTD -1.14, YTM 1.39, Overweight), CMBS (MTD -0.46, YTD -1.36, YTM 2.55, Overweight), Non Agency RMBS (Overweight). § Emerging Market: Hard Currency (MTD -2.56, YTD -9.04, YTM 6.16, Neutral), Local Currency (MTD -4.09, YTD -11.45, YTM 6.92, Neutral), Corporate (MTD -1.22, YTD -4.58, YTM 6.19, Neutral). \*\*Treasuries: 1-3 years (MTD -0.10, YTD 0.08, YTM 0.41, Neutral), 4-10 years (MTD -0.88, YTD -3.76, YTM 1.95, Underweight), 10+ years (MTD -0.75, YTD -10.22, YTM 3.53, Underweight). The respective indexes are listed at the back of this report.

# BLACKROCK®



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## BOND MARKET SUMMARY

Sector	Positioning	8/2013 Total Return (%)	YTD Total Return (%)	9/2013 Yield* (%)
High Yield	Neutral ▼	-0.61	2.71	6.36 <sup>†</sup>
Bank Loans	Overweight ▲	-0.05	3.26	5.14
Securitized Assets <sup>‡</sup>	Overweight —	-0.48	-1.39	2.36
Agency Mortgages	Underweight —	-0.29	-2.38	3.28
Corporates	Neutral —	-0.70	-3.29	3.40
Non-US Dollar	Neutral —	-0.50	-5.05	1.86
Emerging Markets <sup>§</sup>	Neutral —	-2.56	-9.04	6.16
Inflation Protection	Underweight —	-1.46	-8.07	2.27
Treasury/Agency**	Underweight —	-0.49	-2.69	1.36

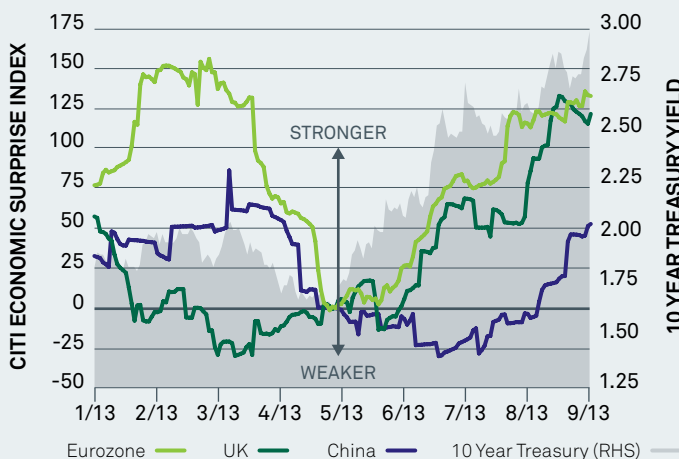
## REFERENCE INDICES (AUGUST)

Sector	8/2013 Total Return (%)	YTD Total Return (%)	9/2013 Yield <sup>†</sup> (%)
Barclays US Aggregate	-0.51	-2.81	2.48
Barclays Municipal Bond	-1.43	-4.92	3.35 <sup>†</sup>

## Back to Schule

German Federal elections September 22nd cap a surprising bright spot in the global picture of an improving European economic outlook for this month. While Merkel is widely expected to prevail, the ruling coalition dynamics that result will dictate the pace of European policy changes to follow. Adding to the global reasons for rising interest rates in the US, Chinese economic data stabilization removes some downside risks to global growth. Figure 1 below highlights the rising rate of economic growth in Europe, the UK and China. Note the correlation to generally rising interest rates in the US over this time period.

**FIGURE 1: GLOBAL GROWTH EXCEEDING EXPECTATIONS**



Source: Citigroup. Indices normalized to zero at May 1st, 2013.

Syrian and emerging market currency uncertainties, however, highlight global risks to the outlook that potentially lead to falling rates in the US. Further out, fiscal policy uncertainty in the US still looms with the debt ceiling and fiscal year budgeting battles yet to unfold. But for September, the focus for US investors remains the Fed and near-term US economic performance.

## Tapering Tantrums

Will the Fed taper in September? And will financial markets respond as they did back in June in what we now call the “taper tantrum?” Absent some surprisingly weak economic data between now and then – or more likely absent a significant increase in financial market uncertainty – we expect the Fed to begin reducing its pace of purchases of securities and to announce this change at the conclusion of its September 17-18 two-day meeting. Crucially for investors, a likely September start to tapering is the consensus expectation; hence, it is already priced in.

This is the crux of why we answer “no” to the second question. Conditions were different in late May when the Fed started to signal a shift in policy. The Fed’s statements, combined with its downgrading of the risks facing the economy and its above-consensus economic forecasts, all served to surprise the markets.

Looking forward, a repeat of the “taper tantrum” appears unlikely. Because financial markets now expect the Fed to announce tapering removes this as a likely source for financial market uncertainty – at least to the degree we saw back in June.

We can expect uncertainty in September and October from noise around the debt ceiling and the upcoming nomination of the next Fed Chairman. In the backdrop of these policy events is the continued recovery of the US economy, a heavy fall calendar for new debt issuance and the “data driven” decision process that guides the Fed’s pace of tapering, which despite the Fed’s open communication policy, has not been clarified yet. This is due to (as highlighted in the July FOMC minutes) “reasoning that earlier inclusion might trigger an unintended tightening of financial conditions.”<sup>1</sup>

## Tapering and the rate outlook

What does tapering mean for interest rates? The Fed’s comments back in May and subsequent reaction not only changed expectations for when QE would end they also changed expectations for how long the Fed would maintain its zero-interest-rate policy. That speculation exacerbated the breadth of global financial market uncertainty because the exit from zero interest rates holds much greater significance for broader financial markets than does the purchases of Treasury and mortgage bonds.

Bernanke has taken pains to disabuse the market of the interpretation that Fed-controlled policy rates are set to jump any time soon. Furthermore, by this point he has convinced everyone both that the Fed will continue to maintain a zero interest-rate policy and that this decision is separate from the decision to taper. Some of the rise in rates in August can be attributed to re-pricing these Fed expectations under a new, and presumably more hawkish, Chairman in the form of Larry Summers.

The broader issue affecting the rate outlook remains the performance of the economy and even more importantly the Fed’s assessment of that performance. Market expectations stand high for a second half economic rebound, and the Fed appears to share that view. Recent economic data as highlighted in Figure 1 globally and in the US (not shown) support this view. Notably, part of those improvements reflects surprisingly strong purchasing manager survey data.

<sup>1</sup> Federal Reserve “Minutes of the Federal Open Market Committee”, July 30–31, 2013.

However, as the August employment report highlighted (and the employment component of these purchasing manager surveys also highlight) the expected improvements in production have not led to expected improvements in hiring. And absent hiring and income growth, the most important catalyst for economic growth – consumption – remains constrained.

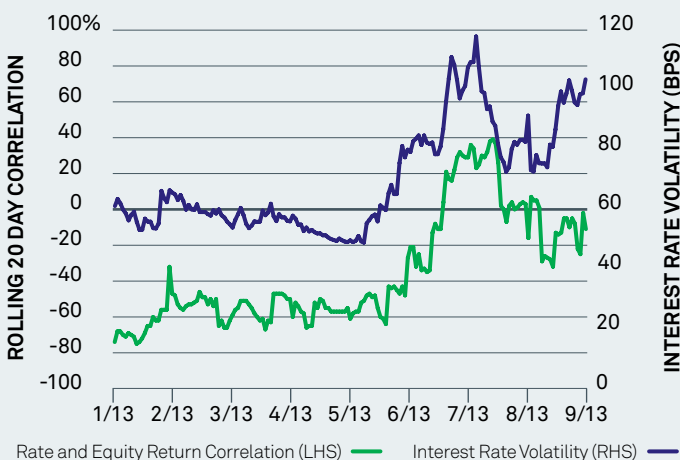
Meeting or exceeding these 2nd half growth expectations likely keeps rates on an upward trajectory. Disappointment, however, means that rates would fall. Increases in interest rates reflect tapering expectations and an improving picture of global growth inconsistent with zero interest rate policy around the world. In longer-maturity interest rates, these shifting expectations appear more fairly priced with rates approaching 3.0%.

Ultimately, our view remains more cautious on the outlook for the US economy. And as rates approach the 3% level, those rates begin to look attractive in areas of fixed income that we have long avoided. As rates may end up overshooting in the near term, we'll continue with those underweight recommendations for now (in Treasuries, mortgages and TIPS). Our year-end forecast of 2.50% with a wider range to 2.75%, acknowledges the better economic data in August and suggests tactically positioning fixed income portfolios for lower rates remains a future strategy to consider for the remainder of the year.

### The Loss of Bond “Ballast”

The losses in fixed income for the months of May, June and August were some of the most severe in recent experience. Notably, losses in these recent periods in fixed income occurred as stock prices fell, breaking from the historic relationship expected between bonds and stocks in which they move in

**FIGURE 2: CORRELATION SHIFT CORRESPONDS TO RATE UNCERTAINTY**



Source: BAML MOVE Index, Barclays, Bloomberg.

opposite directions, what I call "ballast." That reversal in correlation began after the Fed rattled markets with its surprise taper announcement. Figure 2 highlights this shift and how it has occurred alongside rising uncertainty over the direction of interest rates (measured as the anticipated volatility of interest rates over the next 1 month).

The two week selloff in mid-August was comparable to the severity of losses in May and June and kept investors on guard for additional aftershocks from the tapering announcement. Those occurred in the first week of September with the 10-year Treasury rate briefly hitting 3.0%: through September 6th, the Barclays US Aggregate Index (the “Agg” is the most common benchmark index for taxable intermediate fixed income investments), stood at -3.65% YTD losing 86 bps in the first week of September.

### Scenarios for Fixed Income Returns

As we look to the remaining part of the year, the bond market declines of August and May/June provide us with guide posts for determining the potential damage additional rate increases could inflict from here. We created a simple scenario analysis to show how the Agg might perform through the end of the year.

Figure 3 highlights our scenario analysis of potential returns for the remainder of the year under a scenario of declining, stable and rising interest rates. Under the rising rate scenario we highlight an additional scenario labeled “No Ballast.” Under this scenario of rising interest rates, stocks and bonds decline together representing a break from the past traditional relationship. The projected bond losses here are higher as credit sensitive sectors of the bond portfolio perform worse when stock prices are falling. Arguably the much greater significance of such a scenario is the impact across the entire portfolio (i.e. not just the bond portfolio) from such a shift in correlations between stocks and bonds.

**FIGURE 3: YEAR END SCENARIO ANALYSIS**  
Projections for US Aggregate Bond Returns

Stock/Bond Relationship	Traditional (“Ballast”)			Break from Past (“No Ballast”)
Interest Rate Environment	DECLINING -50 bps 10 yr to 2.50%	STABLE +0 bps 10 yr to 3.00%	RISING +50 bps 10 yr to 3.50%	RISING +50 bps 10 yr to 3.50%
September–December	2.86%	0.75%	-1.28%	-2.17%
Full Year 2013	-0.79%	-2.90%	-4.93%	-5.82%

Source: BlackRock. As of 9/6/2013.

Note: “Ballast” indicates scenarios with historical long run correlations between rates and risky assets such as stocks and corporate bonds. “No Ballast” indicates scenarios where higher rates are associated with falling stock prices and rising risks of default.

Can fixed income recover its losses this year and end in the black? With weak US economic data that lead to higher expectations for Fed accommodation (or global political or economic uncertainty that leads to a flight to quality), 10 year interest rates would need to decline about 75 basis points (or to 2.25% from 3.0%) to break even. In our outlook, that is not likely to happen.

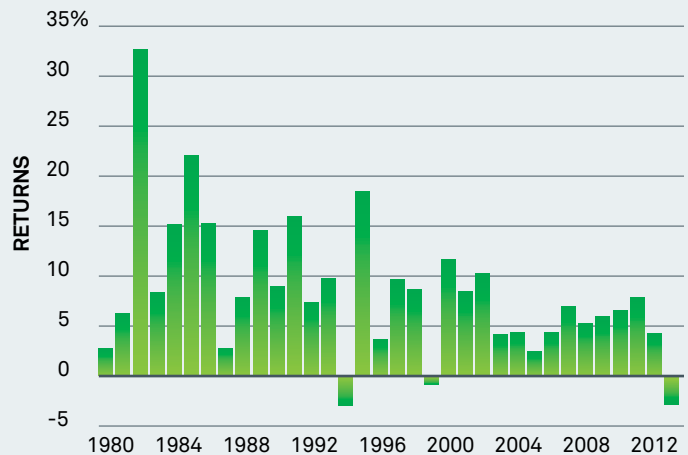
Our view remains somewhat more cautious on the strength of the recovery fueling rising rates. For the remainder of the year, investors can expect to recoup some losses from coupon income (as highlighted under the “Stable” scenario) and even some potential for further modest gains under our year end rate forecasts. However, absent more significant declines in interest rates that remain outside of our forecasts, investors should expect negative returns from core fixed income in 2013.

### A Rare Loss

The potential for a yearly loss to “core” fixed income represents a rare occurrence. Figure 4 at right highlights annual returns to the Agg over the past 30 years. An annual loss would represent only the third annual negative return to core fixed income since 1980. The loss validates our longer-run themes on fixed income that we have discussed for some time. The problem with today’s fixed income universe is traditional fixed income strategies are overly reliant on falling interest rates and exposures to government-related

securities for their returns. Such strategies made sense when those two features supported returns; now they detract. A period of continued “normalization” of interest rates (recalling the Fed defines its longer-run “normal” rate for the short end of the yield curve at 4 to 4.5%) suggests more losses in terms of annual returns to come in the future from traditional “core” fixed income investing.

**FIGURE 4: SINCE 1980, ONLY 2 YEARS OF NEGATIVE RETURNS IN FIXED INCOME**



Source: Barclays

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The sector performance and yields listed are represented by, respectively: Barclays US High Yield Index, S&P Leveraged Loan Index, Barclays US Securitized Ex-MBS Index, Barclays US Mortgage Backed Securities Index, Barclays US Corporate Investment Grade Index, Barclays Global Aggregate ex-USD Index, JP Morgan EMBI Global Diversified Index, Barclays US Inflation Protected Securities Index and Barclays US Treasury Index. The reference indices are represented by the Barclays US Aggregate and the Barclays Municipal Bond Index.

**Investment involves risk.** The two main risks related to fixed income investing are interest rate risk and credit risk. Typically, when interest rates rise, there is a corresponding decline in the market value of bonds. Credit risk refers to the possibility that the issuer of the bond will not be able to make principal and interest payments. Investments in non-investment-grade debt securities (“high yield” or “junk” bonds) may be subject to greater market fluctuations and risk of default or loss of income and principal than securities in higher rating categories. International investing involves additional risks, including risks related to foreign currency, limited liquidity, less government regulation and the possibility of substantial volatility due to adverse political, economic or other developments. These risks are magnified for investments in emerging/developing markets or smaller capital markets. Index performance is shown for illustrative purposes only. You cannot invest directly in an index.

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