Fundamentally Fixed Income

Views through the Asia-Pacific lens

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After three profoundly abnormal years in global fixed income markets, Rick Rieder and Navin Saigal sift through the politics, geopolitics, and policy, to identify the generational evolutions that are likely to shape the investment landscape for both Asian and Global investors in 2024 and beyond.

'Cause we're living in a ~~material~~ geopolitical world.

Highlights

Generational megatrends are transforming the world, complicating work for asset allocators who face quite a different investment regime.	**The protection and return potential of the risk-free rate is the most enticing in years, and granularity in where to own credits and duration matters.**	**Asian credit leapfrogs global and U.S. corporate bonds, as it boasts the highest yields and most favorable risk metrics such as duration and volatility.**

If Madonna's hit song "Material Girl" from forty years ago were written by an investor in 2024 instead, the hook would likely reflect a world that is less capitalistic and more focused on geopolitics — inspiring the title of our inaugural issue of Fundamentally Fixed Income. Big changes since the 1980s also include the work-from-home model, advancements in artificial intelligence (AI), significant gains in health technology (such as MRNA tech or GLP-1), and the shift in corporate investment focus from capital expenditure (CapEx) to research & development (R&D). These changes are just as important for asset allocation decisions as are the rise of fiscal deficits and coordination of fiscal and monetary policies to support an ageing demographic and the reorientation of supply chains. The common thread between all these changes is the need for financing.

For asset allocators, the challenge of sorting through these generational megatrends is perhaps best embodied by the resultant shift in correlations across asset classes. Bonds have lost some reliability in hedging a portfolio of stocks. The stock-bond correlation has risen to decade highs (north of 80%, see related chart on the next page) after being anchored in negative territory, as scary inflation prints in the past couple of years and huge Treasury supply in late 2023 and early 2024 increasingly intertwined the performance of risky assets and the Treasury market. At the same time, the correlation between U.S. and Asian fixed income has dropped to around 0%, suggesting Asian fixed income is a reasonable diversifier for a global portfolio (see related chart on the next page) just as U.S. duration's hedging efficacy has softened. These trends are likely to moderate from today's extremes. However, portfolios must grapple with fiscal deficits that will continue to pressure up the stock-bond correlation and geopolitically driven desynchronized economic cycles that will pressure down the U.S.-Asia correlation within fixed income.

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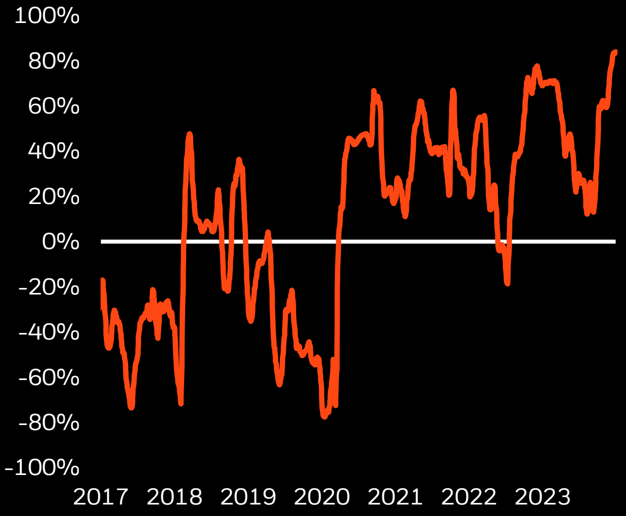
Unprotective bonds in equity selloffs

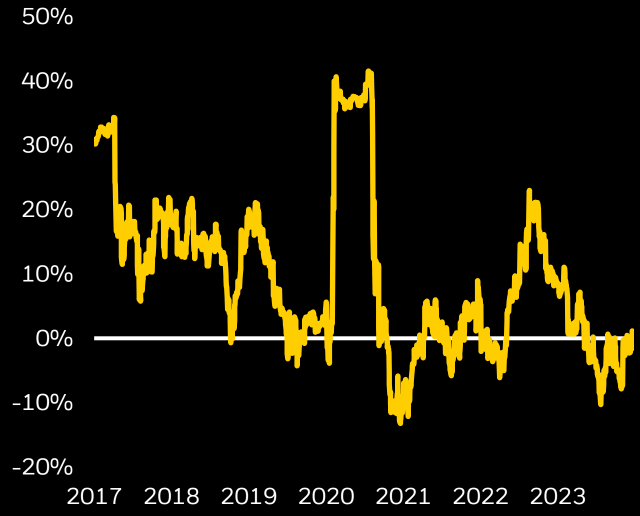
U.S. stock-bond correlation, 2017-2023



Source: Bloomberg and BlackRock, as of 31 December 2023. The chart shows a six-month correlation between equities, represented by the S&P 500, and bonds, represented by the Bloomberg Barclays U.S. Aggregate.

Asian bonds are reasonable diversifiers

Asian-U.S. bond correlation, 2017-2023



Source: Bloomberg and BlackRock, as of 31 December 2023. The chart shows a six-month correlation between the GBI EM Asia U.S. dollar hedged and the Bloomberg Barclays U.S. Aggregate.

We see the great reset in bond yields triggered by inflation fears opening a compelling opportunity for fixed income investors. They can now lock in a diversified portfolio of 6%-7% yields, just as U.S. inflation trends back toward the 2%-3% range. While notably above the Federal Reserve target of 2%, the high end of this range still allows investors to secure a 3%-4% real yield. Before the Covid-19 pandemic, such a result would have required materially increasing a portfolio's volatility (risk).

We believe the current combination of high quality and high carry in such a portfolio offers a substantial buffer against the uncertain Treasury supply and portfolio correlation. Meanwhile, the largest-ever global cash pile has been building.

Triggered by high policy rates, U.S. households alone had stashed about US$18 trillion in cash in their balance sheets last September, Fed data show. A 5.3% cash yield in the U.S. is a strong incentive to keep the cash in money market funds for now, but we see the reinvestment risk ahead of an impending easing cycle as the biggest risk for investors with outsized allocations to cash.

The opportunity to lock in historically elevated nominal and real yields may not last forever. As wise as holding cash was through 2022 and much of 2023, we believe it is time to start deploying that cash before future events, such as a rate-cutting cycle or the U.S. presidential election in November, materially shrink the opportunity set (no pun intended).

The stock-bond correlation (between risk-free and risky assets) has risen to decade highs, while the correlation between U.S. and Asian emerging market bonds hovers around zero.

Charlotte Widjaja
Vice President,
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Three portfolio ideas

1	**Own fixed income on yield.**
2	**Be long duration at the belly of the curve.**
3	**Tap into euro credit.**

Own fixed income on yield.

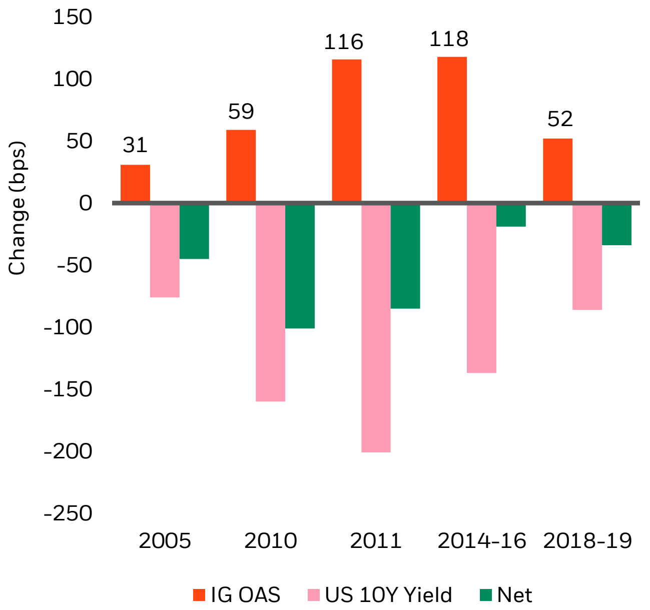
For the first time in over a decade, the protection and return potential in the risk-free rate component of yields is remarkably compelling. Today, the yield in investment grade (IG) and high yield (HY) that comes from the risk-free rate has more than doubled the average of the past ten years. In IG, 83% of the yield is from the risk-free rate compared to the 2010-2019 average of 59%, and in HY, 61% of the yield is from the risk-free rate compared to the past decade average of 28%[1]. Why does this matter?

Spread widenings have historically come along rate rallies, even when rates had much less room to rally than they do now. In the spread widening periods of 2010, 2014-16, and 2018-19, the average spread change across risky assets was 1.0%, and the average rate rally was 1.1% on the U.S. 5-year Treasury and 1.4% on the U.S. 10-year Treasury. In fact, in these periods, the spread change across high-quality credit widened less than 1.0% on average! Thus, the risk-free rate more than compensated for the losses on spread in high-quality assets (see chart). In more pernicious periods, such as the Covid-19 pandemic or the European Sovereign Debt Crisis, the average spread widening in risky assets was 2.3%, and the U.S. 5-year and 10-year Treasuries rallied 2.1% and 2.3% on average, respectively.

In both types of selloffs, the risk-free rate has the potential to match or more than offset the entire spread widening move. With the Fed Funds rate at the highest level in nearly 25 years, the potential protection from the risk-free rate is now even more compelling. Bottom line: fixed income assets now offer attractive yields and downside protection, which enables investors to maintain some positive carry even in catastrophic events.

The risk-free rate offers compelling downside protection

Investment grade spreads, 2005-2019



Source: Bloomberg, BlackRock, as of 28 February 2024. This chart shows the trough to peak change in U.S. IG rates during the past five periods of spread widening. IG OAS stands for investment grade option-adjusted spread, the measurement of the spread of a fixed-income security rate and the risk-free rate of return, which is then adjusted to reflect an embedded option.

Be long duration at the belly of the curve.

One main reason to hold fixed income on yield today stems from the value in owning duration. But the notable rate rally coming into 2024 begs the question: is the opportunity in duration now behind? To answer it, we consider today's levels of yields and economic growth relative to their historic "normal" relationship, which we believe will better reflect fixed income markets this year.

Real yields have historically tracked real GDP growth, remaining at or below real GDP growth most often. Between 1970 and 2019, the ratio of real yields to real GDP fluctuated from 0.5x at the 2-year part of the curve to 1.0x at the longer end of the curve.

1. Yield numbers/calculations from Bloomberg, BlackRock, as of 28 February 2024.

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If we apply these ratios to our expectation of 1.5% real GDP growth for 2024, while assuming 2% inflation and some additional term premium to the back end of the curve to reflect the ongoing unprecedented Treasury issuance, we arrive at a more normal upward sloping curve (see related table). The implied nominal rates across the curve based on this analysis are 2.8% (2-year), 3.1% (5-year), 3.5% (10-year) and 4.0% (30-year). These implied levels suggest there is room to run in the front end and belly of the curve, while the back end appears increasingly rich. We would also expect the curve to steepen in response to more balanced growth and inflation levels.

With the front end of the curve still at risk of pricing aggressive Fed cuts and the back end near fair value, we find the most convexity at the belly of the curve, where there is attractive carry and ample room to rally in a cutting cycle. We have a constructive outlook on duration, but in today's market environment, it's crucial to carefully consider where to own the risk-free rate on the yield curve.

Tap into euro credit.

We believe European credit has gained significant appeal given the increase in yield, combined with a drop in net supply and the reduction in duration of the primary market. This presents a more attractive opportunity set than at any point over the past decade.

Euro front-end yields turned negative after the ECB launched the Corporate Sector Purchase Program (CSPP) in March 2016, and remained negative until January 2022. This program allowed the ECB to buy investment grade euro-denominated bonds issued by non-bank corporations based in the euro area. When yields were at the lows in July 2021, 88% of euro front-end IG (1-to-3-year maturities) and 40% of all euro-IG maturities had negative yields. Today, it is possible to own euro front-end IG, U.S. dollar hedged, at a positive 6% yield! The last time yields where this high was in 2006-07, when the size of the euro front-end IG market was under €200bn and held a much larger sector and name concentration. Today, the market is five times bigger (€1trn) with more liquidity, diversification and investable assets[1]. Euro front-end IG credit is also benefitting from high breakevens and positive convexity due to the curve's steepness and hedge effectiveness of the rate component of all-in yields.

From a supply-demand view, we anticipate the net supply this year will remain at historically low levels, with a primary focus on refinancing. The European growth outlook remains uncertain, and we believe merger and acquisition activity will stay subdued with little appetite from corporates to embark on new deals given the increased cost of debt. In addition, we expect reverse Yankees, U.S. companies that issue in euros, to remain tepid as it is now cheaper for them to issue in U.S. dollars given the spread differential.

1. Numbers/calculations from Bloomberg, BlackRock, as of 2 February 2024.

Implied nominal rates

Based on the historical relationship between real GDP and real yields.

	Fed Funds	2Y	5Y	10Y	30Y
1970-2019 median ratio	0.35x	0.52x	0.72x	0.85x	1.02x
Implied real rate at 1.5% real GDP	0.53	0.78	1.08	1.28	1.54
Inflation	2.00	2.00	2.00	2.00	2.00
Additional term premium				0.25	0.50
Implied nominal rate	2.53	2.78	3.08	3.53	4.04
Current nominal rate	5.50	4.69	4.30	4.29	4.42
Implied - current nominal rate	-2.97	-1.91	-1.22	-0.76	-0.38

Source: Bloomberg, BlackRock, as of 28 February 2024. This is not a forecast, but simply a guide for where nominal yields may go in the future under a more "normal" regime.

Stephen Gough
Managing Director,
Head of Asian Credit
Singapore

Why Asian bonds look particularly compelling

1	**There is an attractive backdrop of high growth and low inflation.**
2	**Asian U.S. dollar credit provides duration exposure to the favored part of the curve.**
3	**The strong and uncorrelated onshore China credit performance is likely to continue.**

The evolving landscape in global investing begs a crucial question: where should investors allocate their money? Fixed income assets are currently sought after for their ability to lock in high yields, and the segment offering the most competitive yields at lower risk levels is naturally the center of attention. Asian credit emerges as a compelling option compared to global and U.S. corporate bonds, as it boasts the highest yields and most favorable risk metrics such as duration and volatility (see related chart below).

Asian credit offers two additional benefits. First, the bulk of exposure to the intermediate part of the curve optimizes its potential to benefit from the bull steepening related to rate cuts. Second, the lowest exposure to the longer end of the curve, relative to global market yardsticks, gives Asian credit more insulation from increases in term premium (see related chart on the right).

We believe the combination of increased yield, risk mitigation, and diversification benefits constitute a good base for Asian credit in a world largely driven by geopolitics. We see a favorable economic backdrop amid a desynchronized economic cycle. Asia's more stable inflation and robust growth expectations relative to developed markets act as tailwinds for Asian credit and the sovereign-linked assets that make up more than 20% of the universe.

We also see Asian-IG credit fundamentals remaining stable, led by state-owned enterprises (SOE) ownership, strong balance sheets, and easy access to funding at attractive rates. This segment drives Asian credit returns. We see negative net supply continuing through 2024, which, combined with the local bias of a predominantly Asian investor base, should further support stability in Asian credit.

And the winner is...

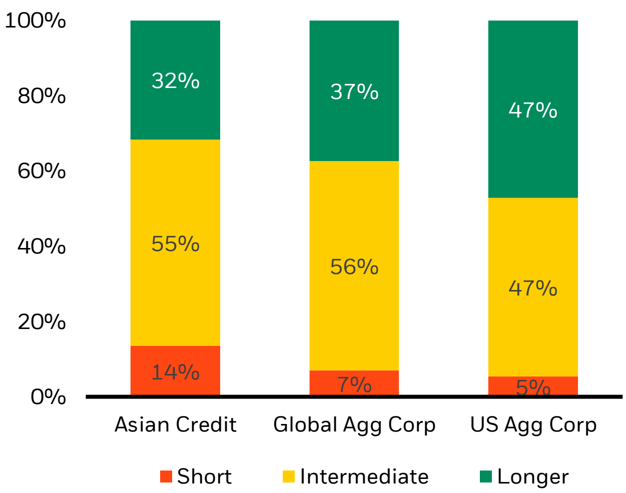
Yield and risk metrics in broad markets

	Asian Credit	Global Agg Corp.	U.S. Agg Corp.
Portfolio yield (%)	6.0	4.8	5.2
Duration (years)	4.4	6.0	7.0
3-year monthly volatility (ann.)	6.5	7.7	9.3
Yield / Volatility	0.9	0.6	0.6

Source: BlackRock and Bloomberg, as of 31 January 2024. Asia Credit represented by JACI Index. Global Agg Corp. represented by BBG Global Agg Corp. Total Return USD-hedged; US Agg Corp. represented by BBG U.S. Corporate Bond Index.

Composition matters

Duration distribution across maturities/markets



Source: BlackRock and Bloomberg, as of 31 January 2024. Asia Credit represented by JACI Index. Global Agg Corp. represented by BBG Global Agg Corp. Total Return USD-hedged; U.S. Agg Corp. represented by BBG U.S. Corporate Bond Index. . Indices are unmanaged and one cannot invest directly in an index.

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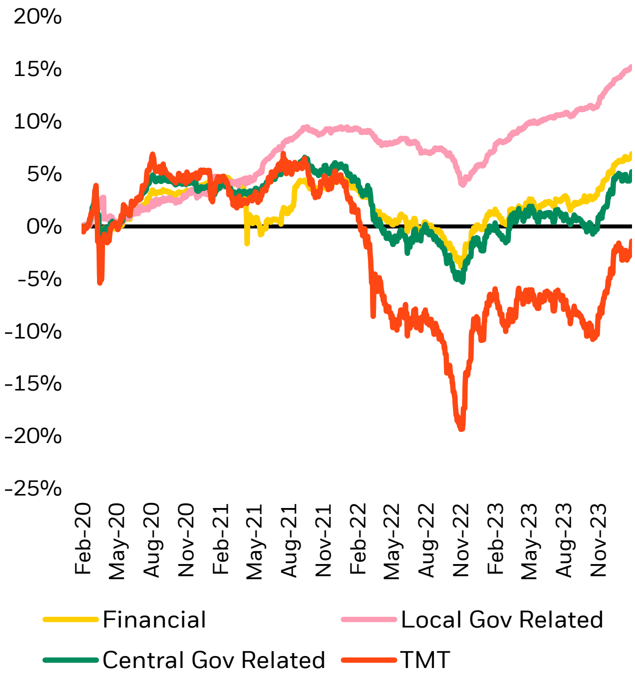
Active on China

We see opportunities in China credit, especially in ex-property sectors that have been resilient and where we anticipate minimal fallen angel risk – a credit-rating downgrade to below investment grade. Deleveraging in the property sector has transformed China's U.S. dollar credit market (represented by the JACI China Index) into a higher-quality market. Investment grade credits accounted for more than 90% of the market in February 2024, up from 78% in June 2021.

Such compositional shift partially explains the diverging performance between China's equity market and its U.S. dollar-credit market over the 12-month period ended February 2024. China's U.S. dollar credit positive 2.7% return contrasts sharply with a negative 17.0% return in China's equities. However, differentiating beyond credit quality is increasingly critical as the strong dispersion of returns by sector suggests (see related chart below).

Significant dispersion

China U.S. dollar-credit returns, 2020-2023

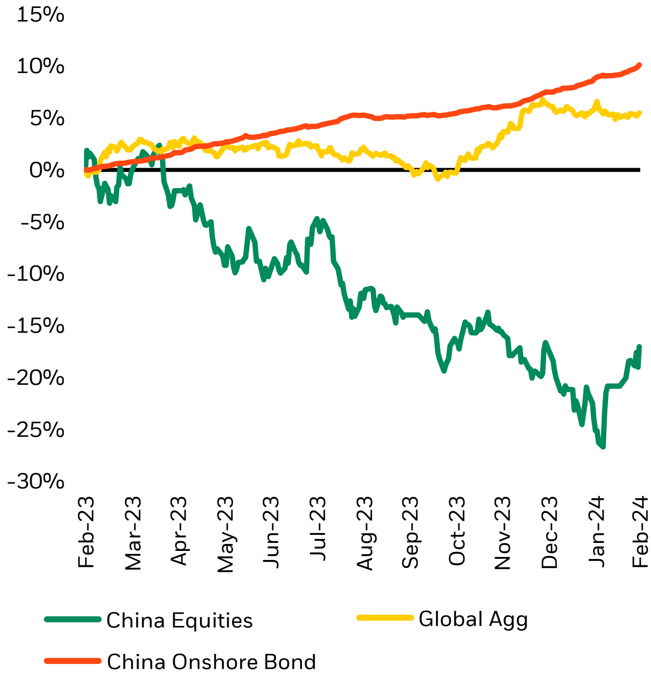


Source: BlackRock, as of 31 January 2024. China U.S. dollar credit represented by JACI China Total Return Index, broken down by internal sector breakdowns. TMT stands for technology, media and telecom.

Lastly, we see opportunities in China's onshore CNY bonds, which returned 10.1% over the 12-month period ended February 2024, almost twice the 5.5% return of the Global Agg and a sharp contrast to the -17% return in China equities over the comparable period (see chart below). This underscores these bonds role as effective diversifiers. Indeed, CNY bonds have had a very low beta (less than 0.1, based on 5-year monthly returns) to both the Global Agg and China equities.

Stable diversifier

Equity and bond returns, 2023-2024



Source: Bloomberg, as of 29 February 2024. China Onshore Bond represented by the Bloomberg China Agg Total Return Index U.S. dollar hedged. Global Agg represented by the BBG Global Agg Index U.S. dollar hedged. China equities represented by the MSCI China A Onshore Net Return Index U.S. dollar. Indices are unmanaged and one cannot invest directly in an index.

Closing on another song reference, symbolizing the shift from materialistic to geopolitical overtones, astute asset allocators could think of 2024 as "What a Wonderful World." We believe those riding the opportunities in fixed income, especially in Asian credit, have a good chance to be properly rewarded.

China's U.S. dollar credit market is now offering a higher quality profile.

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