

Emerging market pause



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We maintain our long-term positive view on emerging market (EM) debt as it is a key beneficiary of global reflation, but are calling a pause: Spreads are now tighter than before the U.S. election and policy risks abound. As a result, we are lowering our EM debt view to “neutral” in the short run. Conversely, the underperformance of agency mortgage-backed securities leads us to believe they deserve a fresh look.

Highlights

- The rally in EM debt has pushed the extra yield investors demand over U.S. Treasuries down to a level that we believe merits a neutral stance in the short term – especially considering uncertainty over U.S. trade, tax and currency policies.
- Global reflation underpins our long-term positive EM debt view. A rising U.S. dollar and threats to global trade pose challenges. We therefore favor hard-currency debt and advocate selectivity as we see greater divergence of returns between EMs.
- We have upgraded our outlook on agency mortgage-backed securities after a drop in valuations. We stay “neutral” for now amid market concerns over the timing of the Federal Reserve’s rate increases and any moves to unwind its balance sheet.

Trump trade tribulations

Markets have zigzagged this year as the “Trump trade” (higher interest rates, a stronger U.S. dollar and rising cyclical stocks) appeared to lose its potency in January – only to make a tentative comeback this month. Fed Chair Janet Yellen’s semi-annual congressional testimony also led rates higher by reigniting market expectations for an interest rate increase as soon as March. We expect volatility to ebb and flow this year as U.S. fiscal policy uncertainty and monetary policy dominate the bond market outlook, as detailed in [Make America grow again](#) of January 2017.

Bond market summary

Sector	View	YTD return	Yield	Sector	View	YTD return	Yield
U.S. aggregate		0.31%	2.63%	U.S. municipal bonds	—	0.59%	2.56%
U.S. government bonds	▼	0.22%	1.92%	U.S. investment grade	▲	0.58%	3.36%
Short (1-5 years)	▼	0.18%	1.48%	U.S. high yield	—	2.20%	5.74%
Intermediate (5-10)	—	0.23%	2.25%	Bank loans	—	0.75%	5.11%
Long (10+)	▼	0.38%	2.99%	Securitized assets	▲	0.58%	2.72%
U.S. inflation protected	▲	0.69%	2.43%	Euro credit	—	-0.01%	0.90%
Agency mortgages	○	0.06%	2.90%	Emerging markets	○	2.63%	5.53%
Non-U.S. developed	▼	1.30%	0.81%	Asia fixed income	—	1.73%	3.92%

▲ Overweight — Neutral ▼ Underweight ○ Changed view

Source: Bloomberg, as of Feb 16, 2017. Notes: Performance and yields for bank loans are represented by the S&P Leveraged Loan Index; for emerging markets by the J.P. Morgan EMBI Global Diversified Index, for Asia fixed income by the J.P. Morgan Asia Credit Index, and for the other sectors by the appropriate Bloomberg Barclays indexes. Yields are yield to maturity, except for U.S. high yield and municipal bonds (yield to worst). Performance is measured in total returns and in U.S. dollars, except for Euro credit (euros). Our TIPS view reflects relative performance vs. nominal U.S. Treasuries. Indexes are unmanaged and used for illustrative purposes only. They are not intended to be indicative of any fund or strategy’s performance. It is not possible to invest directly in an index.

A round trip in EM debt

EM debt's rout immediately after the U.S. election reflected surging market expectations for higher interest rates in anticipation of fiscal stimulus under incoming President Donald Trump. A related development was a rally in the dollar fed by congressional proposals such as a "border adjustment" that would effectively subject imports to a 20% tax. These developments – as well as the risk of Trump's "America First" agenda potentially leading to a trade war – weighed on the outlook for EM assets.

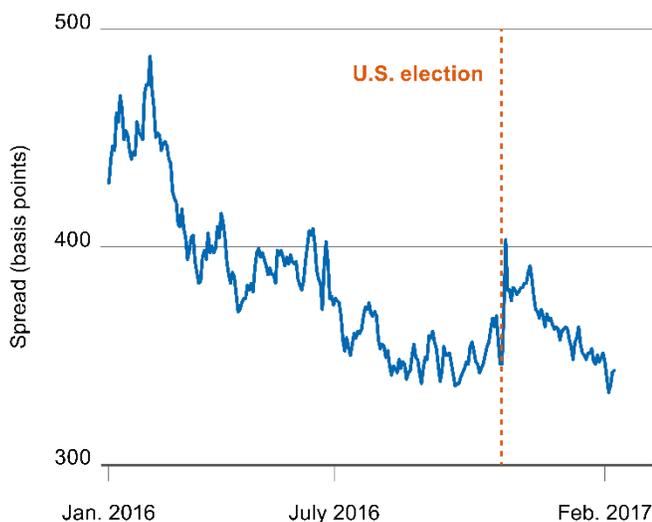
Things turned around at the start of the new year. The biggest trigger was a sobering assessment of both the likelihood and timing of any U.S. fiscal reform. The reversal in the dollar was a clear example of these developments, and helped support EM assets. And a powerful driver in the background was reflation taking root around the world, as detailed in our [Global Macro Outlook](#) of January 2017. An upswing in China's economic activity featured prominently in the unfolding reflation story, pushing up valuations of debt and equities of commodity-exporting nations.

The resulting rally has compressed EM hard-currency spreads to levels that prevailed before the U.S. vote. See the chart below. Local-currency yields (not shown in the chart), too, have fallen versus global yields, and many EM currencies have rallied against the dollar.

Our bottom line: The surge in EM valuations comes at a time when we believe the dollar could resume its upswing and U.S. policy uncertainty is high. As a result, we have lowered our EM debt view to "neutral" in the short term.

Fading Trump effect

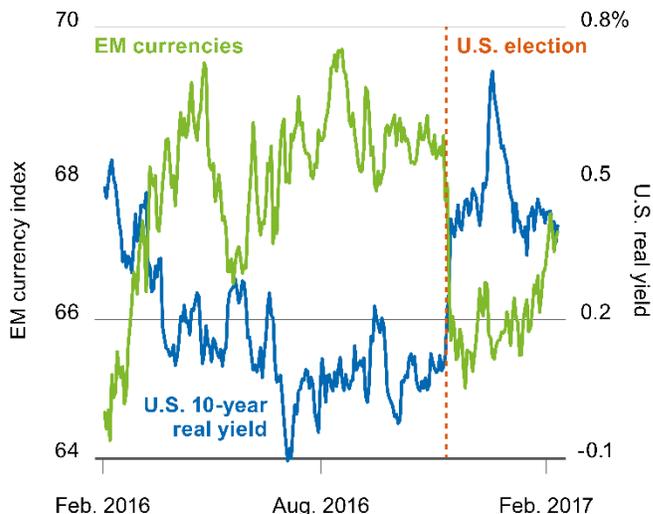
EM hard-currency spread, 2016-2017



Sources: BlackRock Investment Institute, Bloomberg and J.P. Morgan, February 2017. Note: The spread measures the yield differential between the J.P. Morgan Emerging Market Bond Index and U.S. Treasuries.

Mirror image

EM currencies vs. U.S. 10-year real yield, 2016-2017



Sources: BlackRock Investment Institute, Bloomberg and J.P. Morgan, February 2017. Notes: EM currencies are based on the J.P. Morgan Emerging Market Currency Index. The real (inflation-adjusted) yield is represented by 10-year Treasury Inflation-Protected Securities (TIPS).

The role of real rates

Why is EM debt so sensitive to changes in U.S. fiscal and monetary policy? The answer partially lies in how these policies affect U.S. interest rates and the dollar.

Trump's election victory fueled expectations that fiscal expansion could take over from monetary policy as a driver of economic growth. For example, tax cuts could stimulate consumption, infrastructure spending could boost investment, and regulatory rollbacks could lift market and business sentiment.

The Fed's highly accommodative policy of near-zero interest rates and large purchases of financial assets (quantitative easing) long kept a cap on inflation-adjusted interest rates, also called "real" rates. A surge in real rates following the election reflected expectations for a less accommodative monetary policy. Associated with that was a decline in the value of EM currencies, relative to a strengthening dollar.

When the real rate of return of holding dollars rises, so does the value of the currency. This, in turn, reduces the value of bonds held in foreign currencies when translated back into dollars. The chart above highlights the opposing relationship between U.S. real interest rates (the blue line) and the value of EM currencies (green). When real rates rise, EM currencies have historically fallen, and vice versa.

The reversal in investor sentiment toward U.S. fiscal policy triggered a decline in real U.S. rates from mid-December highs and a corresponding resurgence of EM currencies, as the chart shows. We believe currency risks remain, so we prefer hard-currency EM debt over the local variety. We also favor short duration as part of our more cautious stance.

Fundamental matters

Our long-term view on EM assets is positive. Key is improvement in our outlook for developed market growth. Our [BlackRock GPS](#), which incorporates big data signals to provide a handle on the economic growth outlook, shows consensus growth forecasts are still too cautious. These improving fundamentals should eventually boost EM growth.

Traditional measures of EM economic activity have lagged behind a rebound in developed markets, as the chart below shows. We see EM activity recovering; our proprietary EM growth tracker in January clocked the fastest pace of growth since 2011. One driver beyond developed market growth is a rebound in China's economic activity. The country appears to have stabilized economic growth, leading to a surge in commodity prices that many EM economies depend on. This has addressed market concerns over Chinese debt growth, capital outflows and a potential currency devaluation – and has made us turn positive on China's economy for this year.

We do worry about long-term stability risks because China has partly turned to its tried-and-true method of credit growth to stabilize the economy. We also see rising risks of temporary credit crunches as increases in domestic interest rates appear to signal monetary tightening. These long-term concerns are offset by our view that many EM economies have already partly adjusted to slower Chinese economic growth and a stronger dollar: Currencies have fallen, current account balances have improved and signs of an uptick in economic activity abound. We see returns between EM countries diverging, and favor commodity exporters as we believe they stand to benefit most from global reflation.

EM activity to catch up

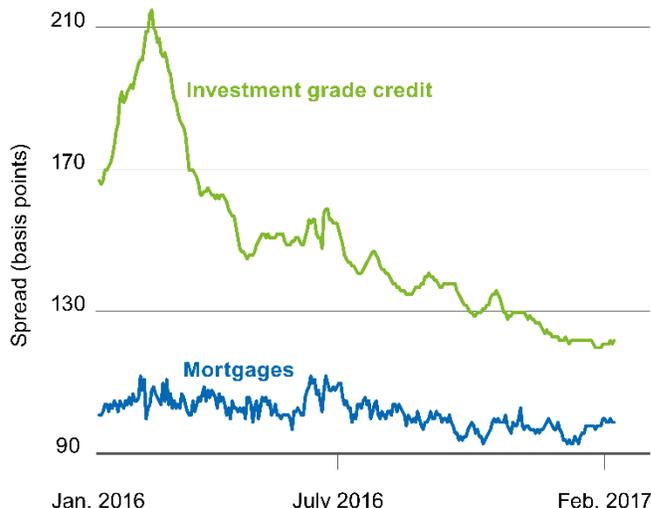
Developed and EM PMIs, 2014-2017



Sources: BlackRock Investment Institute and Markit, February 2017. Notes: Data are based on Markit Economics' Purchasing Managers' Index (PMI) surveys. An index reading above 50 indicates growth in manufacturing activity; a reading below 50 indicates a decrease.

Narrowing mortgage gap

U.S. mortgage and corporate spreads, 2016-2017



Sources: BlackRock Investment Institute and Bloomberg, February 2017. Notes: The mortgage spread is calculated by BlackRock's mortgage investment team based on the difference between the current coupon on the Fannie Mae 30-year mortgage and a weighted average yield of Treasury securities based on the coupon's exposure to the Treasury yield curve. The investment grade credit spread is represented by the Bloomberg Barclays U.S. Corporate Bond Index.

Reappraising mortgages

We are upgrading our outlook on U.S. agency mortgage backed securities (MBS) to "neutral" this month. Valuations now better reflect the risks of rising rates, in our view, as well as the uncertainty surrounding the Fed's intentions for MBS securities held on its balance sheet. The latter got another airing during Yellen's semi-annual monetary policy report to Congress. Yellen highlighted both a desire to return the balance sheet to hold only Treasuries over time (a negative for MBS) as well as a preference to stop reinvesting proceeds from maturing securities rather than actively looking to sell them (a positive for MBS). These longer-term concerns, coupled with only modest widening in spreads this year, temper our enthusiasm for MBS and prevent us from advocating an overweight position.

We see an opportunity in MBS to add income while decreasing credit risk against a backdrop of ever-tighter corporate bond spreads. The chart above reflects the narrowing valuation gap between the higher-quality mortgages and comparatively lower-quality corporate debt. We also see mortgages as having other advantages over corporate credit: They lack company-specific risks and have historically been more liquid. To be sure, we still favor credit in a rising-rate environment as higher yields can help cushion price falls. The rapid compression in corporate bond spreads, however, dulls our enthusiasm and highlights our current preference for quality over yield.

Our bottom line: We believe agency MBS represent an attractive tactical opportunity to move up in credit quality while maintaining income.

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