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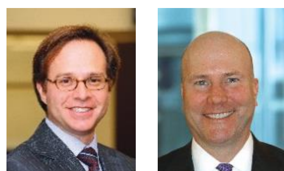
FIXED INCOME STRATEGY • JUNE 2017

Crossing the river by feeling the stones



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A huge post-crisis expansion of the Federal Reserve balance sheet – via purchases of U.S. Treasuries and mortgages – pushed interest rates lower and lower. A looming unwinding of this balance sheet, which could start later this year, should put this process in reverse as the central bank lets its holdings run off. The Fed will try to avoid a market tantrum through clear signaling of its process, yet risks remain.

Highlights

- The evolution of the U.S. economy toward the Fed's goals – full employment and stable inflation – implies a greater urgency in normalizing policy. This policy will soon include not just interest rate increases, but also balance sheet "runoff." The Fed may provide some details on how it will proceed at its June meeting.
- We expect the Fed to move cautiously in its unwinding process – akin to crossing a river by feeling the stones – but the market consequences are harder to predict. Any lack of clarity over the pace and end game of the Fed's unwinding has the potential to unnerve markets as debate heats up in the coming weeks and months.
- Our base case is for modestly rising U.S. rates, with strong global appetite for income helping limit any yield spikes. We are underweight U.S. Treasuries and neutral on mortgages, which we see as offering little cushion against the risk of hiccups in the Fed's normalization process. We prefer up-in-quality credit.

Softening yields

U.S. Treasury yields reached year-to-date lows this month, led by the 10-year, on falling inflation and fading fiscal policy hopes. This has richened valuations in the belly of the curve versus the long end, leading to a small update to our tactical curve views with a relative preference for long bonds. The overall tone is risk on, and spreads remain tight with emerging market debt performing strongly. See the table below.

Bond market summary

Sector	View	YTD return	Yield
U.S. aggregate	—	2.52%	2.47%
U.S. government bonds	▼	2.15%	1.81%
Short (1-5 years)	▼	0.95%	1.47%
Intermediate (5-10)	▼ ↓	2.85%	1.98%
Long (10+)	— ↑	5.45%	2.75%
U.S. inflation protected	▲	1.74%	2.14%
Agency mortgages	—	1.85%	2.72%
Non-U.S. developed	▼	6.88%	0.72%

Sector	View	YTD return	Yield
U.S. municipal bonds	—	4.25%	2.10%
U.S. investment grade	▲	3.70%	3.15%
U.S. high yield	—	4.98%	5.50%
Bank loans	—	2.04%	5.00%
Securitized assets	▲	2.48%	2.55%
Euro credit	▼	1.33%	0.79%
Emerging markets	—	7.00%	5.18%
Asia fixed income	—	4.02%	3.71%

▲ Overweight — Neutral ▼ Underweight ↑ Upgrade ↓ Downgrade

Source: Bloomberg, as of June 8, 2017. Notes: Performance and yields are represented by the S&P Leveraged Loan Index (bank loans); J.P Morgan EMBI Global Diversified Index (EM hard-currency debt), J.P. Morgan Asia Credit Index (Asia fixed income), and the respective Barclays Bloomberg indexes for the remaining sectors. Yields are yield to maturity, except 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 for illustrative purposes only. They are not indicative of any fund or strategy's performance. It is not possible to invest directly in an index. Past performance is no guarantee of future results.

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Yield scarcity

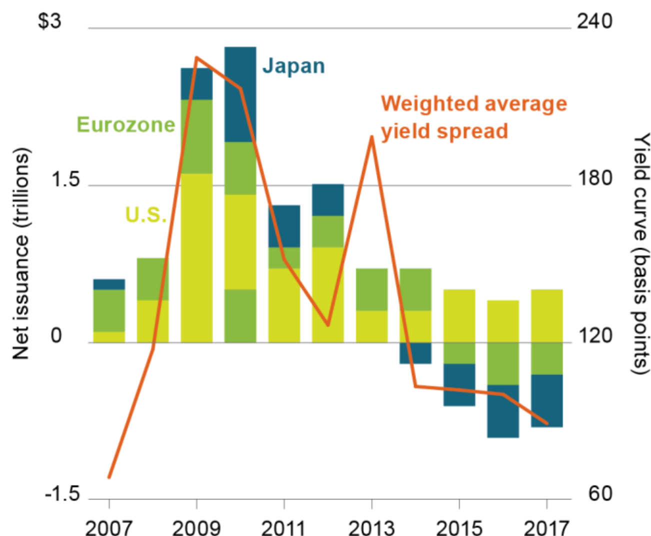
The unconventional monetary policy toolkit of central banks – zero or negative interest rates coupled with asset purchases – has had two consequences for investors. First, it has reduced the amount of risk-free bonds in circulation, exacerbating a scarcity of "safe assets." Second, it has compressed the term premium that compensates investors for accepting the risk of holding longer term debt. Today's U.S. 10-year Treasury yield, for example, sits around one percentage point lower than it otherwise would as a result of the cumulative effect of the Fed's quantitative easing (QE), an April 2017 study by the Fed suggests. Driving longer term yields lower was a key objective of QE: The Fed's "Maturity Extension Program," initiated in September 2011, removed any doubt by explicitly shifting the Fed's purchases out of short-maturity bonds and into longer maturities to further accomplish this task.

This is a global story. The European Central Bank (ECB), Bank of Japan (BoJ) and Bank of England have pursued similar policies, with similar results. Central bank purchases decreased the amount of government bond issuance available for private investors in the U.S., and all but eliminated it in Europe and Asia. Net issuance in Japan this year is set to be negative for a fourth straight year – and for a third straight year in the eurozone. Term premiums have collapsed in response, with a big compression in the average spread between 10-year and two-year yields across G3 nations. See the *Who stole my term premium?* chart. This has had a ripple effect across bond markets, pushing investors into riskier sectors such as credit or emerging market debt – via the so-called portfolio rebalance channel.

What happens when this process goes into reverse? This depends on the pace of the Fed's balance sheet unwind, and on how deftly the policy shift is communicated.

Who stole my term premium?

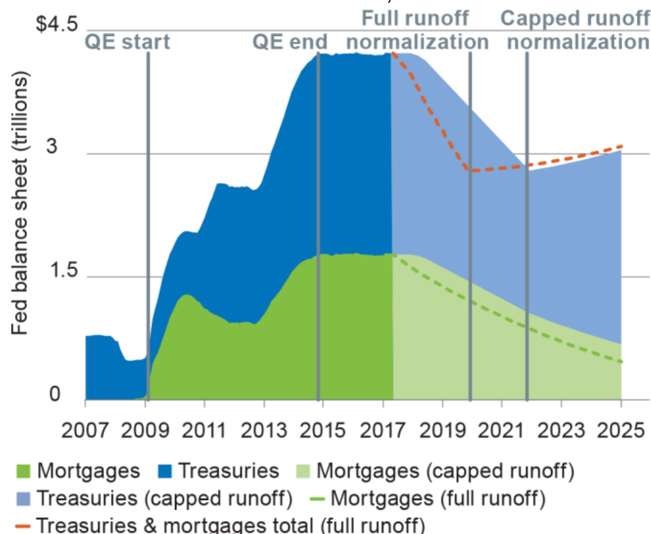
G3 net debt issuance ex central bank purchases, 2007-2017



Sources: BlackRock Investment Institute and Morgan Stanley, June 2017. Notes: The bars show net government bond issuance for the U.S., eurozone and Japan, net of central bank purchases via quantitative easing programs. The weighted average spread is the average difference between 10-year and two-year yields in the three regions, weighted by nominal GDP. The figures for 2017 are estimates.

Past peak

Fed balance sheet runoff scenarios, 2007-2025



Sources: BlackRock Investment Institute, Bloomberg, the Federal Reserve, June 2017. Notes: Mortgages includes agency debt. Balance sheet runoff scenarios are based on the scenarios presented in Federal Reserve Bank of New York (FRBNY) analysis (April 2017) and a speech by Fed Governor Jerome Powell (June 1, 2017). The full runoff scenario assumes no reinvestment until the FRBNY balance sheet normalization at $2.8 trillion. Runoff is based on the current schedule of Treasury maturities and BlackRock estimates of MBS prepayments. We assume net Treasury purchases of $17 billion per month to keep pace with liability growth after normalization is reached.

"Gradual and predictable"

The Fed's focus on normalizing both interest rates – and now its balance sheet – reflect confidence in the economy moving toward its goals of full employment and stable prices. Normalizing the balance sheet means the Fed would stop reinvesting proceeds from maturing bonds (or mortgage prepayments), allowing its holdings of Treasuries and mortgage securities to gradually run off over time.

The Fed has promised a "gradual and predictable" process; the balance sheet reduction would essentially be put on autopilot. This is aimed at preventing a repeat of the 2013 "taper tantrum" bond market sell-off, when markets first contemplated the end of an ever-increasing balance sheet. The Fed has discussed preannouncing a schedule of gradually increasing caps on the dollar value of bonds that would be allowed to run off each month. The caps would moderate the pace of wind-down. See the *Past peak* chart, which presents two scenarios based on a recent analysis by the Federal Reserve Bank of New York (FRBNY) and a speech by Fed Governor Jerome Powell.

A capped runoff scenario points to "normalization" by perhaps as early as mid-to-late 2021, as the chart shows. This would leave the Fed with a balance sheet of roughly $3 trillion, far higher than the pre-crisis size of less than $900 billion. The "normal" size of the balance sheet today is likely much higher than in the past - partly due to increases in currency outstanding and other elements of the Feds liabilities. Critically, monetary policy today functions with much higher levels of reserves than pre-crisis. This contributes to the need for larger Fed balance sheets.

More issuance = higher rates

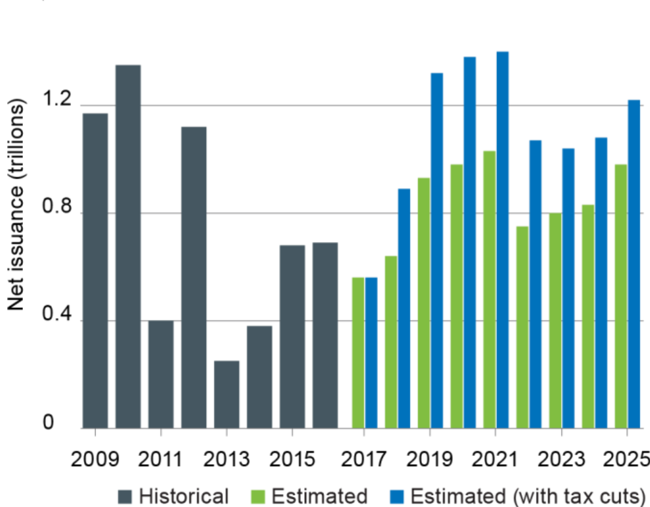
Gauging the market impact of balance sheet normalization is critical to the market outlook. The size of this effect is uncertain, but the direction of travel would appear to be a longer-run rise in the term premium. This is a reversal of the portfolio rebalance effect that helped drive yields lower under QE. The issue: This is the first time the Fed has ever used asset reductions as a tightening (or normalizing) tool. This makes it difficult to gauge the potential impact. The signaling effect that was so potent when the Fed launched and extended QE could be equally powerful on the way out. Also, the Fed has not detailed the size of the balance sheet it considers appropriate. Any lack of clarity about the central bank's end game could increase market anxiety.

The chart below illustrates one way of looking at the potential impact by showing "net net Treasury issuance" – (gross issuance less redemptions, less Fed purchases under QE). Fed purchases reduce net Treasury supply. But "net net" supply is set to rise steadily as both the Fed shrinks its balance sheet and deficits expand (based on Congressional Budget Office projections). Increased supply might result over time in steeper yield curves, although the U.S. Treasury could opt to issue more short-term bills as an offset. Alternatively, a desire to lock in today's lower rates by issuing ultra-long 50-year bonds could have the opposite effect, contributing to a further steepening of the curve.

A key risk we see is deficit-financed tax cuts. This could increase the U.S. Treasury's issuance needs, as the *More issuance ahead* chart shows, and would likely lead to rising inflation expectations. This could lead the Fed to increase its pace of rate hikes, and even consider unwinding its balance sheet more rapidly. The result might be a more rapid snapback in interest rates and term premiums, with a rapid steepening of yield curves.

More issuance ahead

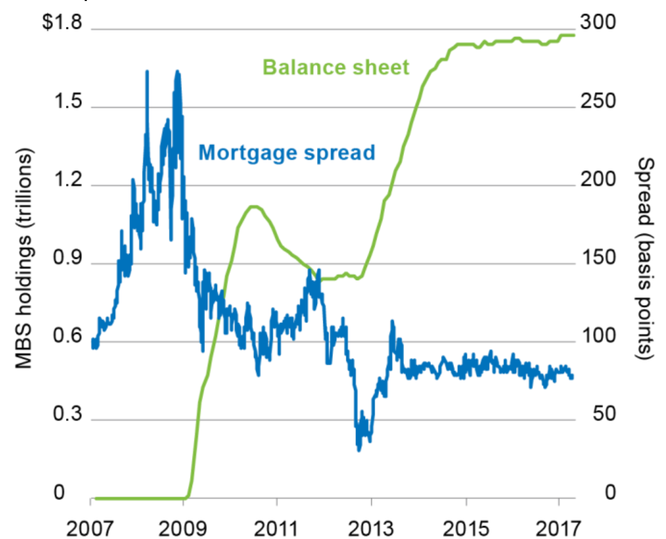
U.S. Treasury net issuance ex Fed purchases, 2009-2025



Sources: BlackRock Investment Institute and Bloomberg, May 2017. The estimated debt issuance figures are based on the Congressional Budget Office baseline projections. The tax cut scenario is based on the same CBO figures and analysis by the Tax Policy Center (September 2016) of the House Republican tax plan.

Good for homeowners

MBS spreads vs. MBS on Fed balance sheet, 2007-2017



Sources: BlackRock Investment Institute and Bloomberg, June 2017. Notes: The mortgage spread is calculated by BlackRock's mortgage 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.

Little margin for error

No discussion on the Fed's balance sheet would be complete without looking at the impact of the central bank's credit easing policy of purchasing mortgage backed securities (MBS). Housing was at the core of the financial crisis. To curb this crisis, the Fed bought some $1.8 trillion in mortgages. MBS yield spreads to Treasuries – a proxy for home borrowing costs – have slumped back to precrisis levels in line with the expansion in the Fed's holdings, as the *Good for homeowners* chart shows. We believe this has diminished their traditional attractiveness as an alternative to Treasuries that provides similar default-free risks but with higher income.

A normalization of the Fed balance sheet would likely involve eliminating most of the central bank's MBS holdings over time. MBS valuations today reflect anticipation that this process will go smoothly – as well as benign expectations that rates will rise only gradually. These expectations are not limited to MBS – credit spreads as well stand at or close to post-crisis tights. This leaves little margin for error, we believe, and is reflected in our up-in-quality credit views and neutral stance on MBS.

Our bottom line: We expect modestly higher interest rates, even as the Fed moves toward normalizing its balance sheet. Any lack of clarity on the Fed's end game could lead to volatility spikes, but we see a dampening of inflation pressures and global forces helping limit yield rises for now. The ECB, and especially the BoJ, are behind the Fed in considering unwinding in their own balance sheets. Plenty of excess savings looking for a home – and relatively higher U.S. yields – should keep global demand for U.S. bonds high. We keep an underweight stance on U.S. government debt overall, and prefer higher-quality credit in today's environment.

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