BLACKROCK INVESTMENT INSTITUTE

Normalizing normalization

Jeffrey Rosenberg
Chief Fixed Income Strategist,
BlackRock Investment Institute

The Federal Reserve's rate rise this month marks a departure from the glacial pace of tightening in the past two years. In effect, the Fed looks set to start normalizing its pace of normalization, although we see it ending at a lower peak fed funds rate than in the past. This shift is occurring with little market disruption for now. Yet elevated credit market valuations and low volatility leave little margin for error.

Highlights

- The March rate increase suggests a quicker pace of tightening – even as structural forces such as aging populations point to a shallower tightening path than in the past. Better growth and deft Fed messaging have smoothed the policy shift so far.
- Market expectations for the path of rate rises still trail signals from Fed policymakers. Hawkish Fed rhetoric or unexpectedly strong economic data could lead to overshoots in tightening expectations, causing market turbulence.
- Rising interest rates will likely restore yields on cash and other low-risk assets. This should eventually curb the appetite for higher-yielding, higher-risk fixed income. It could be a rocky transition given lofty valuations in many of these sectors. The Fed appears aware of this risk, and therefore is proceeding cautiously and gradually.

Pricing in higher rates

U.S. Treasury yields jumped ahead of the Fed's March meeting on expectations of more tightening, yet fell on the news. The overall tone has been risk-on, with credit and emerging market (EM) debt spreads grinding tighter amidst signs reflation is taking root. A fall in oil prices reversed part of high yield's gains. See the chart below.

Bond market summary

Sector	View	YTD return	Yield	Sector	View	YTD return	Yield
U.S. aggregate		0.09%	2.71%	U.S. municipal bonds	—	0.48%	2.63%
U.S. government bonds	▼	0.01%	2.00%	U.S. investment grade	▲	0.35%	3.42%
Short (1-5 years)	▼	0.07%	1.58%	U.S. high yield	—	1.54%	6.06%
Intermediate (5-10)	—	0.10%	2.31%	Bank loans	—	1.22%	4.98%
Long (10+)	▼	-0.36%	3.04%	Securitized assets	▲	0.51%	2.79%
U.S. inflation protected	▲	0.43%	2.42%	Euro credit	—	-0.09%	0.93%
Agency mortgages	—	-0.21%	3.00%	Emerging markets	—	2.50%	5.62%
Non-U.S. developed	▼	0.40%	0.83%	Asia fixed income	—	1.50%	4.03%

▲ Overweight — Neutral ▼ Underweight

Source: Bloomberg, as of Mar 15, 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 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. Past performance is no guarantee of future results.

BLACKROCK®

20170322-127656-347354

Fool me once, fool me twice

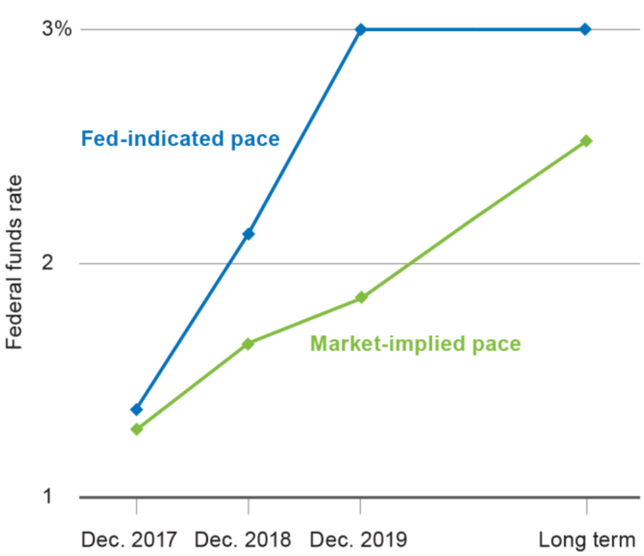
The Fed's March rate rise marks a notable departure from the heretofore glacial pace of U.S. monetary policy normalization. A plunge in commodity prices, the UK's Brexit vote and concerns over a surging dollar frustrated the Fed's planned pace of tightening in 2015 and 2016. In both years, markets were initially expecting four rate increases of 0.25% apiece. The Fed managed to deliver only one hike in both years – at the end-of-year December meeting.

Many investors are adopting a we-won't-be-fooled again stance, and markets still underprice the odds of more Fed rate hikes compared with the median path illustrated in the Fed's statement of economic projections. Overnight indexed swap (OIS) rates – a gauge of interest rate expectations – recently showed an expectations gap of nearly 100 basis points for 2019. See the *Fed rate dichotomy* chart. Yet even the Fed points to a terminal fed funds rate of just 3%, well below peaks seen in previous cycles. This mirrors structural forces such as sluggish growth and a greying population.

The Fed's ability to raise rates without disturbing markets reflects confidence that global growth has become less reliant on monetary stimulus. Improving global growth prospects could narrow interest-rate differentials between the U.S. and other countries. We see this constraining the dollar's rise and limiting the hit to global financial conditions from Fed hikes. The risk: Market expectations of monetary tightening rapidly catch up to those of the Fed – or even overshoot them. Hawkish rhetoric from the central bank or expectations of large tax cuts boosting growth could be catalysts for such a repricing. The prospect of a turnover in most of the Fed's board over the coming couple of years – including the chair and vice chair – adds to the uncertainty.

Fed rate dichotomy

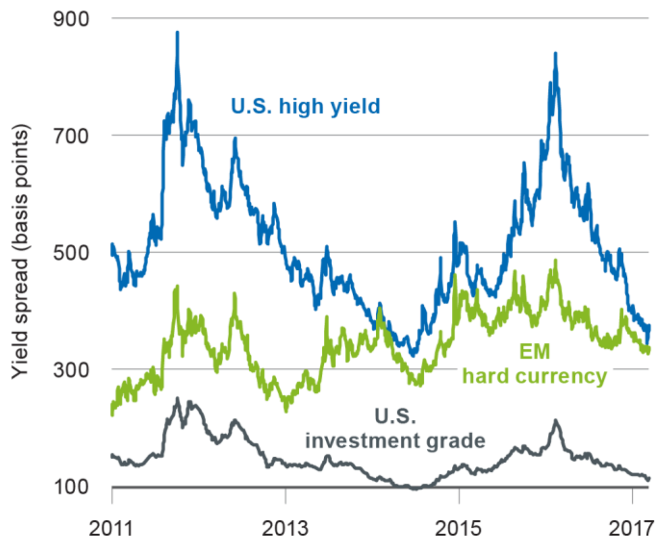
Policy makers vs. market expectations, 2017 to long term



Sources: BlackRock Investment Institute and Bloomberg, March 2017. Notes: The chart shows the market's projection and the Fed's outlook for the fed funds rate. The market outlook is based on overnight indexed swap rates, while the Fed's is the median projections from policymakers in the Federal Open Market Committee.

Valuations signal "risk-on"

Bond spreads, 2011-2017



Sources: BlackRock Investment, Bloomberg and JP Morgan, March 2017. Notes: Yield spreads are versus U.S. Treasuries. U.S. investment-grade used the Bloomberg Barclays U.S. Corporate Bond Index; high-yield debt spreads are based on the Bloomberg Barclays U.S. Corporate High Yield index. The EM hard-currency debt spread is based on the JPMorgan Emerging Market Bond Index.

Third time's a charm

Are markets right to doubt the Fed for a third year? We think they may be underappreciating an evolution of the policy-setting Federal Open Market Committee's (FOMC) stance. The Fed's policy toolkit has more tools to combat inflation than deflation. This asymmetry led the central bank to err on the side of caution in recent years: better to let the economy run a little hot until excess capacity had been worked off and deflationary fears vanquished. Yet today, the Fed's preferred inflation measure – the personal consumption expenditures (PCE) index –shows the fastest pace of price increases in more than four years, and is heading toward the central bank's target against a backdrop of robust jobs growth. The FOMC described its inflation goals as "symmetric" in its March statement, as a reminder to expect deviations both above and below its 2% inflation target.

By raising rates three months after the December 2016 hike, the central bank introduces the prospect of a more "normal" pace of rate rises, albeit one that is likely less rapid than in the past. Fed policymakers have been pointing to a gradual path of two more rate rises in 2017 – likely at the longer meetings that include a media conference. Markets look in line with this view, although some see three more hikes.

This shift has occurred with little market disruption. Volatility across asset classes – including equities, credit, currencies and interest rates – stands near year-to-date lows. And yield spreads have tightened significantly, whether it be in U.S. high yield, hard currency emerging market (EM) debt or U.S. investment grade bonds. These elevated valuations may be a sign of market complacency. There is a much thinner yield cushion against the risk of rising interest rates then in the recent past. See the *Valuations signal "risk-on"* chart.

Regime shift

Normalizing U.S. interest rates signals the gradual fading of a regime that encouraged investors to reach for yield – and take on more risk. The Fed's purchases of Treasuries and agency mortgage-backed securities (MBS) depressed yields in these asset classes, pushing investors into riskier corporate and EM debt to meet their return targets.

The Fed's holdings of Treasuries and agency MBS approached 20% of the amount outstanding five years after the financial crisis, roughly quadrupling its ownership share. At the same time, the holdings of corporate debt by mutual funds and pension funds rose to about 15% each. See the *Crowded out of safety* chart.

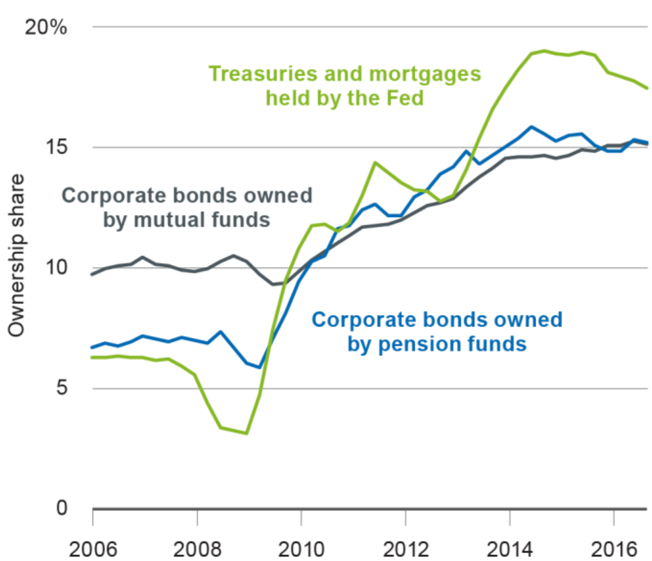
Effectively, the long period of zero interest rates, combined with a "lower-for-longer" consensus, led to investors reaching for yield.

We illustrate this concept through a thought experiment: Imagine an investor seeking to meet a 5% income target with fixed income investments such as cash, core fixed income (lower-risk bonds such as U.S. Treasuries and agency MBS), credit and higher-yielding sectors such as EM debt. The investor would need to adjust the asset mix over time to generate sufficient income. In 2006, it would have been possible to meet the target with lower-risk allocations of around 90% cash, with the remainder in U.S. core fixed income and high yield, our analysis shows.

By 2012, the investment landscape had morphed into low-growth, low-yield world. The investor would have needed to have 80% in high yield and EM bonds, with the rest in core fixed income to hit the target. This would have led to a big spike in risk. See the *Risk round trip* chart.

Crowded out of safety

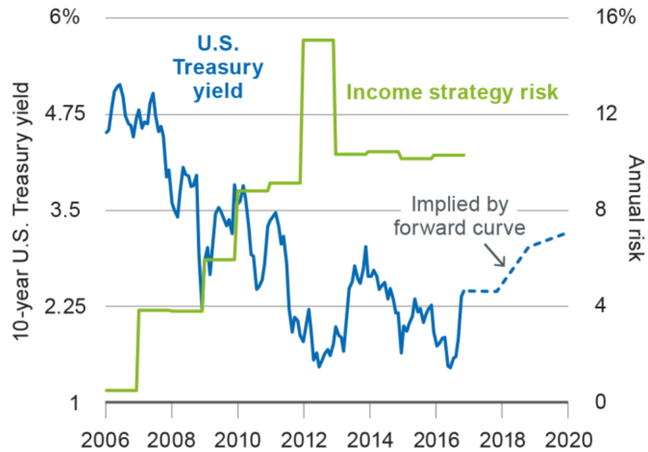
Fund holdings vs. Fed's balance sheet, 2005-2015



Sources: BlackRock Investment Institute, Bloomberg and U.S. Federal Reserve, March 2017. Note: The ownership shares are percentages of debt outstanding, based on Fed data.

Risk round trip

Yield vs. risk of 5% income strategy, 2006-2020



Sources: BlackRock Investment Institute, Bloomberg and JP Morgan, March 2017. Notes: The blue line shows the annual value at risk at year end for an hypothetical fixed income strategy with a 5% target yield. The strategy aims to minimize risk while rebalancing allocations annually between the following: the Bloomberg Barclays U.S. Aggregate, U.S. High Yield, and U.S. Treasury Bills: 1-3 Months Indexes; and the J.P. Morgan EMBI Global Diversified and GBI-EM Global Diversified Indexes. The future U.S. 10-year yield assumptions are based on forward interest rates. The chart is based upon a hypothetical strategy and does not represent actual performance. Allocation decisions were not made under actual market conditions and cannot completely account for the impact of financial risk in actual portfolio management.

Embracing the transition

As rates head higher, we should see a welcome respite from this environment. We believe the prospect of rising yields on cash and government debt means investors could hit income targets while taking less risk.

The challenge for investors will be to manage the transition as the Fed tightens policy. The central bank's caution in only gradually raising rates partly is rooted in wanting to avoid a market selloff such as the "taper tantrum" in 2013 that followed then Fed Chair Ben Bernanke's signaling the beginning of the end of quantitative easing (QE). It also reflects structural reasons such as high debt levels, which constrain the global economy's ability to weather rises in rates.

The Fed has thus far appeared more comfortable tightening via interest rate rises, rather than by signaling an intention to start unwinding its QE-bloated balance sheet by halting the reinvestment of maturing security holdings. The difficulty for bond markets is that a rise in the relative attractiveness of risk-free assets comes just at a time when the pricing of risky debt appears so rich.

To be sure, any spikes in U.S. yields are likely to be suppressed by income investors fleeing still rock-bottom interest rates in other markets such as Europe and Japan. Yet the next stages in this tightening cycle may become more volatile for financial markets. This underpins our defensive views on credit and advice that investors be selective. We generally favor up-in-quality exposures and investment-grade bonds due to elevated valuations.

BlackRock Investment Institute

The ***BlackRock Investment Institute*** (BII) provides connectivity between BlackRock's portfolio managers, originates economic and markets research, develops actionable views for clients, and publishes investment insights. Our goals are to help our portfolio managers become even better investors and to produce thought-provoking investment content for clients and policymakers.

BLACKROCK VICE CHAIRMAN
Philipp Hildebrand

HEAD OF ECONOMIC AND MARKETS RESEARCH
Jean Boivin

GLOBAL CHIEF INVESTMENT STRATEGIST
Richard Turnill

EXECUTIVE EDITOR
Jack Reerink

BLACKROCK®

20170322-127656-347354