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Reevaluating reflation

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Global fixed income markets are flashing caution on the reflation trade, with yields halting their late 2016 climb, curves flattening and market-based inflation expectations waning. Yet we believe these market moves mostly reflect a temporary flight to safety in the face of political uncertainties – rather than a breaking down of the underlying reflationary dynamic. We see this dynamic as alive and well, with the global economy moving from acceleration to a phase of sustained growth.

Highlights

- Credit markets – investment grade, emerging market debt and especially high yield – already appear to reflect reflation in their valuations. We believe this implies future total returns will be more modest than in past years, and will be dominated by carry – or the income component – rather than by further spread tightening.
- Risk-on and risk-off episodes are becoming increasingly global, our research suggests. European yields became a key driver of U.S. Treasury yields in the periods around last year's UK Brexit vote and the recent French election, we find. A waning of European political risk could lift global yields in coming months.
- U.S. yields are now more properly reflecting Federal Reserve tightening expectations, we believe, against a backdrop of stable growth and normalizing inflation. Long-term yields may modestly rise under the prospect of an eventual removal of extreme monetary accommodation in the eurozone and Japan.

Risk on in credit markets

U.S. Treasury yields have resumed their climb after following global yields lower ahead of the French election. The overall tone this year has been risk on, with emerging market debt posting strong performance. See the chart below.

Sector	View	YTD return	Yield
U.S. aggregate		1.14%	2.63%
U.S. government bonds	▼	0.80%	1.96%
Short (1-5 years)	▼	0.48%	1.56%
Intermediate (5-10)	—	1.14%	2.21%
Long (10+)	▼	1.41%	2.95%
U.S. inflation protected	▲	0.49%	2.23%
Agency mortgages	—	0.72%	2.92%
Non-U.S. developed	▼	2.81%	0.78%

Sector	View	YTD return	Yield
U.S. municipal bonds	—	2.48%	2.36%
U.S. investment grade	▲	1.92%	3.32%
U.S. high yield	—	3.99%	5.65%
Bank loans	—	1.73%	4.94%
Securitized assets	▲	1.42%	2.71%
Euro credit	▼	0.81%	0.85%
Emerging markets	—	5.36%	5.34%
Asia fixed income	—	3.12%	3.83%

▲ Overweight — Neutral ▼ Underweight

Source: Bloomberg, as of May 10, 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.

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Reflation conflation

Global markets appear to be reflecting skepticism on "reflation trades" predicated on an expansionary economic environment. Positions that have recently come undone include betting on steepening yield curves and inflation expectations (inflation-linked over nominal bonds) – and in equity markets, picking value over growth shares.

A recent pullback in headline consumer price inflation across developed economies has challenged the notion of steady, if unspectacular, increases in inflation from depressed levels. See the green line in the chart below. Yet core inflation in the U.S. – which strips out volatile food and energy prices – appears to be broadening, our analysis suggests, with an increasing share of CPI components clocking gains. Global PMIs (blue line) stand at six-year highs. And our BlackRock GPS, which combines traditional economic indicators with big data signals such as Internet searches, still points to above-trend growth as the global economy transitions from catchup to steady expansion.

Bottom line: We see steady economic growth and inflation extending the lifespan of the reflation theme without the need for further rises in the pace of those measures. Reflation is alive and well according to our definition: rising wages (albeit slowly this cycle) feeding stronger nominal growth, allowing lingering slack from the last recession to be gradually eliminated, stirring higher inflation over time. And to be sure, many financial asset prices still reflect a dominant reflationary view. Equity markets overall are buoyant. Global financials are holding up, despite a recent bout of underperformance. And as we will now discuss, credit markets are looking robust.

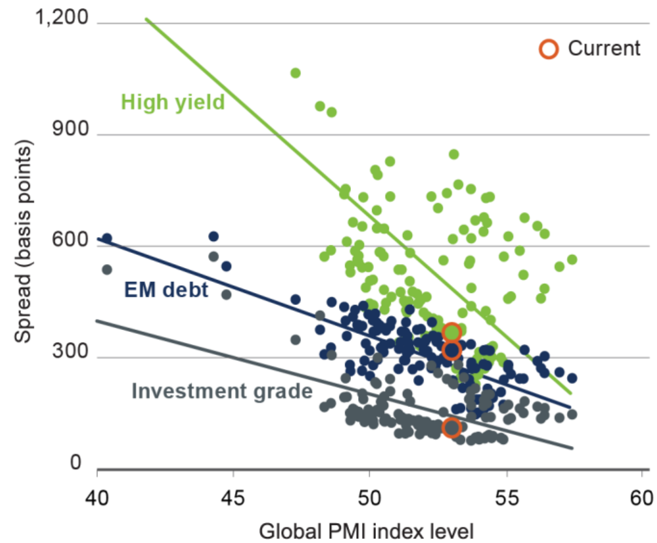
Return of reflation

Global inflation vs. manufacturing PMI, 2007-2017

Sources: BlackRock Investment Institute and IMF, May 2017. Notes: Inflation is measured as year-over-year growth in a weighed average of the consumer price index (CPI) in 40 advanced economies as defined by the IMF. The global manufacturing purchasing managers' index (PMI) is a weighted average of readings from China, U.S., Germany, India, Japan and Brazil.

Pricing in reflation

Global PMIs versus credit spreads, 2006-2017



Sources: BlackRock Investment Institute, Bloomberg. May 2017. Notes: The global manufacturing PMI is a weighted average of readings from China, U.S., Germany, India, Japan and Brazil. U.S. investment-grade, U.S. high-yield and emerging-market hard-currency debt spreads are represented by the Bloomberg Barclays U.S. Corporate Bond, U.S. Corporate High Yield indexes, and the JPMorgan Emerging Market Bond Index. Each dot is a monthly observation. The current level of the credit spreads and global PMIs are as of the end of April 2017. The diagonal lines indicate linear regressions for each sector based on the 2006-2017 period.

Credit conundrum

What are the credit markets telling us about reflation? Credit spreads today look to be roughly where you would expect based on their historical relationship with global PMI levels, our analysis shows. See the chart above. Investment grade and emerging market debt spreads are right in line with the historical trend line since 2006.

High yield bond spreads are a little tighter than they should be according to the analysis. This highlights rich valuations, which contribute to our "up-in-quality" preference in credit. It implies today's strong PMI levels are already priced in, with future returns in credit likely to be more muted than in the recent past. Returns will likely come mostly from income, not from further spread tightening, we believe.

The divergence between sovereign debt and credit market's pricing of reflation is on the surface a bit of a conundrum. One possible explanation is that when market uncertainty increases, investors have two choices as to how to reduce risk in their portfolios. They can sell risky assets such as credit, or buy less risky assets such as government bonds, adding a buffer to their portfolios.

Investors tend to choose the latter of these two options, since government bonds are a much more liquid asset class than credit, with lower transaction costs. U.S. Treasuries are also regarded as the ultimate hedge against geopolitical risks. Jitters around the recent French election – not fears that reflation is dead – likely lie behind the recent flows into U.S. Treasuries, we believe.

Who's leading?

Global fixed income markets are becoming increasingly interdependent. The U.S. has often led moves in global bond yields, such as in the "taper tantrum" of 2013 when then Fed Chairman Ben Bernanke sparked a global bond rout by signaling the beginning of the end of quantitative easing. Similarly, U.S. Treasuries led the big collapse in global yields of 2014, which was accompanied by a commodity price crunch and the reemergence of deflation fears. See the blue shaded areas in the chart below, which show periods when the U.S. was driving global bond market moves.

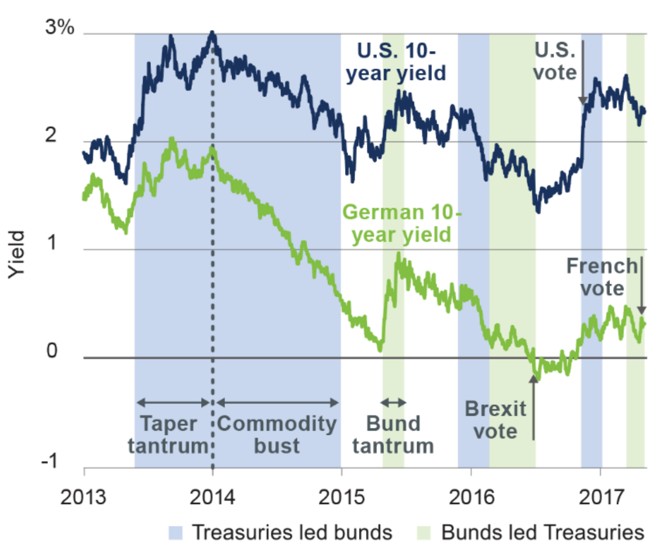
Yet our research suggests the causality sometimes runs the other way, with global developments leading the U.S. Ultra loose monetary policies in Japan and the eurozone have exerted a gravitational pull on yields worldwide. And U.S. Treasury yields followed German bund yields lower in the period around the 2016 Brexit vote, with a similar pattern playing out in the run-up to the recent French election. See the green shaded areas in the chart. Overall, the correlation between major bond markets has risen sharply, as detailed in Waking up to reflation of January 2017.

A temporary lifting of European political risk in the wake of the pro-business Emmanuel Macron's election victory could reverse some of the recent dynamic, sending global yields higher. A strong U.S. unemployment report for April has added to this tone, reinforcing expectations that the Fed will likely raise rates again in June.

China is also playing a central role in global markets. Its credit-fueled stimulus from 2015 helped pave the way for a rebound in depressed commodity prices. This impacts how the reflation thesis is playing out in emerging markets.

Bonded to bunds

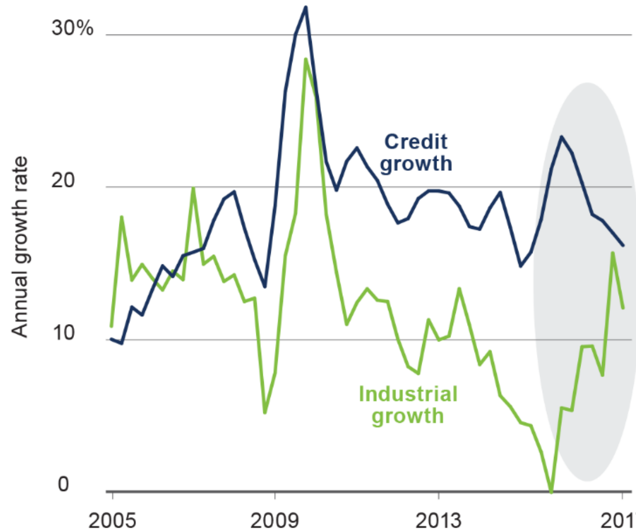
U.S. vs. German 10-year yields, 2013-2017



Sources: BlackRock Investment Institute and Bloomberg, May 2017. Notes: The blue shaded areas highlight periods in which changes in U.S. Treasury yields tended to lead changes in German 10-year bunds by a day, according to a Granger causality analysis of daily yield movements. The green shaded areas indicate the relationship ran in the opposite direction (bunds led Treasuries).

Addicted to credit

China credit vs. industrial growth, 2005-2017



Sources: BlackRock Investment Institute, Bloomberg, Emerging Advisors Group and Citigroup, May 2017. Notes: Credit growth combines outstanding bankers' acceptances and entrusted and trust loans with claims of depository institutions in the domestic economy based on People's Bank of China surveys. Industrial growth is based on CItigroup's Li Keqiang Index of railroad cargo volume, electricity consumption and bank lending, named after China's premier.

Reflation – EM style

China's industrial growth tends to follow credit stimulus. The rebound in 2016 followed an earlier large credit expansion, which is now notably tapering. See the shaded area in the chart. This has implications for Chinese growth and industrial commodities that rely on China's property and infrastructure spending for the bulk of their demand.

What could go wrong? Accidents can happen when liquidity is tightened in economies heavily reliant on credit. This might explain why, in our observation, U.S. equity market volatility (the VIX) has tended to rise in periods of slowing Chinese credit growth. Yet the VIX is trading near multi-decade lows – a possible sign of complacency.

Reflation for EM as a whole depends partly on stability in commodity prices. The recovery in commodity prices from the 2014-2016 slump helped stabilize EM current account deficits and reduce pressure on currencies and inflation. This gave EM central banks leeway to relax monetary policy, allowing countries such as Brazil and Russia to cut rates. This supports our positive view on EM local debt and is part of the reason for our EM equities overweight.

Our bottom line: We see stable global growth and inflation helping the Fed make good on its promise to Normalize normalization. Global developed bond yields appear vulnerable to further increases as French political risk fades, leaving improving fundamentals as a longer run driver for eventual global policy normalization. We remain overweight U.S credit for its income potential, but prefer investment grade debt given elevated credit market valuations. We are underweight European credit and sovereign debt amid tight spreads and improving growth.

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