

FORGET ROTATION: THINK RISK MITIGATION
ASSESSING RISKS IN FIXED INCOME

FEBRUARY 2013

BLACKROCK®

BLACKROCK
INVESTMENT
INSTITUTE



Russ Koesterich
BlackRock Global
Chief Investment
Strategist



Tom Parker
Deputy Chief
Investment Officer,
BlackRock Model-
Based Fixed Income



Rick Rieder
BlackRock Co-Head
of Americas Fixed
Income



Jeffrey Rosenberg
BlackRock Chief
Investment Strategist
for Fixed Income



Scott Thiel
BlackRock Head of
European and Global
Bonds



Ewen Cameron Watt
Chief Investment
Strategist, BlackRock
Investment Institute

Forget Rotation: Think Risk Mitigation

The era of doomsday investing appears to have run its course, a boon for risk assets. But with muted and regionally disparate economic growth, the foundation for a sustained risk rally looks shaky.

What is certain at this junction? Bond portfolios carry fewer diversification benefits and more risks, we think. More risks than in the past and more risks than many investors realize.

Rather than worry about the bursting of a bond bubble and/or salivate over a massive shift to equities, investors would do well to focus on these hidden risks. In other words: Forget the “Great Rotation”; think risk mitigation.

- ▶ Central banks have flooded the streets with money. As economies recover and financial systems mend, this torrent could turn into a trickle.
- ▶ Investor positioning is extreme and interest rate risk acute. This combination can deliver uncomfortable returns and cause volatility in a “safe” asset class.
- ▶ Money is seeping out of cash and other safe harbors as investors unshackle the chains of nervousness. Fear is down and greed is up.
- ▶ The risk rally is supported by a breakdown in asset correlations and increased risk appetite.
- ▶ Much less certain is a resumption of robust global growth that would push up interest rates materially—and justify rotation.
- ▶ Institutions dominate most bond markets, and their structural bid for yield is likely to slow any rate rises.

Endless rounds of quantitative easing (QE) have bloated central bank balance sheets and kept a lid on interest rates. Policy has moved from fire-fighting and preventing a financial system collapse to fostering credit expansion and spurring growth.

The rapid pace of monetary expansion is likely to slow as it is driving up asset prices and showing signs of stirring up lending. The US Federal Reserve is likely to gently take its foot off the monetary pedal first, as detailed in our annual investment outlook *Slow Turn Ahead?* in December 2012. This is why this publication focuses on US economic conditions. Europe is likely to stay the (ultra-loose) course, whereas Japan is easing.

The big picture: Central banks have taken deflation risks off the table. This makes for a pretty good—but not great—investment landscape. Sustainable global economic growth is needed to upgrade it to “great.”

BLACKROCK INVESTMENT INSTITUTE

The BlackRock Investment Institute leverages the firm’s expertise across asset classes, client groups and regions. The Institute’s goal is to produce information that makes BlackRock’s portfolio managers better investors and helps deliver positive investment results for clients.

EXECUTIVE DIRECTOR
Lee Kempler

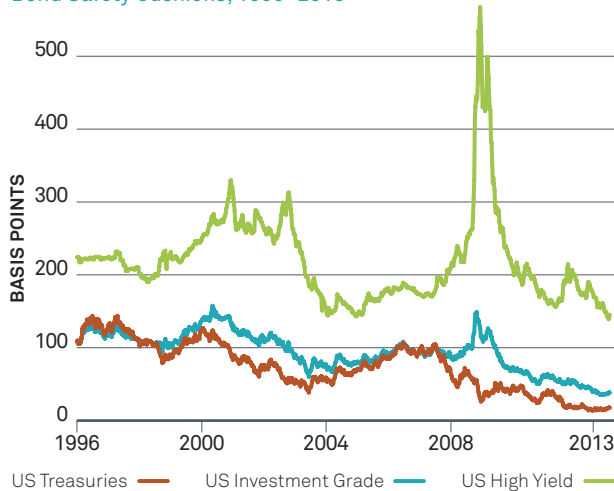
CHIEF STRATEGIST
Ewen Cameron Watt

EXECUTIVE EDITOR
Jack Reerink

The opinions expressed are as of February 2013 and may change as subsequent conditions vary.

LESS SAFETY IN NUMBERS

Bond Safety Cushions, 1996–2013



Sources: Barclays and Bloomberg, February 2013.

Notes: The safety cushion represents how many basis points in yield rise would trigger a price decline that would wipe out one year's worth of yield.

DIFFERENT OBJECTIVES

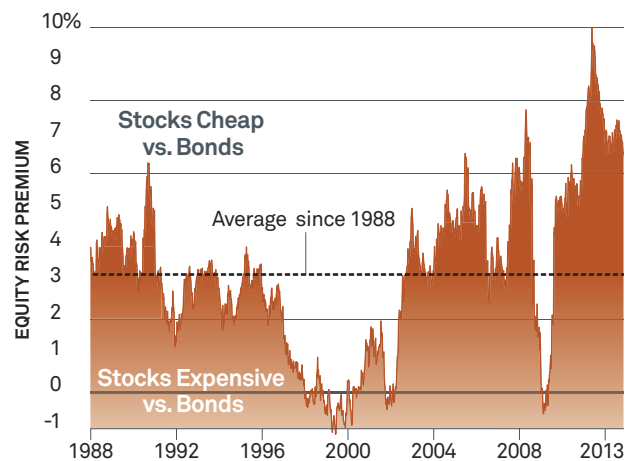
Slowing the pace of bond buying alone could have profound effects on asset prices. Markets often “front-run” events. A smooth withdrawal from QE would be even tougher. Central banks own swaths of fixed income markets. The private sector is bound to only swallow freed-up supply for a price: positive real rates (and the resulting back-up in yields).

In the meantime, most central banks seem ready to stomach some inflation in return for economic growth. Their apparent objective is to boost growth and employment, not to protect fixed income investors.

Fixed income portfolios have become riskier over time. The hunt for yield has compressed spreads on many credit instruments to record lows—in a very short period of time.

A (RELATIVE) BARGAIN?

US Equity Risk Premium, 1988–2013



Sources: Thomson Reuters and Barclays, February 2013.

Note: The equity risk premium is derived from the 12-month forward earnings yield minus the Barclays US Investment Grade index's real yield.

BEDS OF NAILS

Effective duration (bond price sensitivity to changes in interest rates) has been on the rise. Investors are taking progressively more risks in their bond portfolios—for fewer rewards (yield and potential price appreciation).

Ultra-low yields mean safety cushions (to what extent a bond's income offsets a price fall due to a rise in yield) have turned into beds of nails. A mere 17 basis point uptick in the 10-year US Treasury yield, for example, wipes out a year's income. See the left chart above.

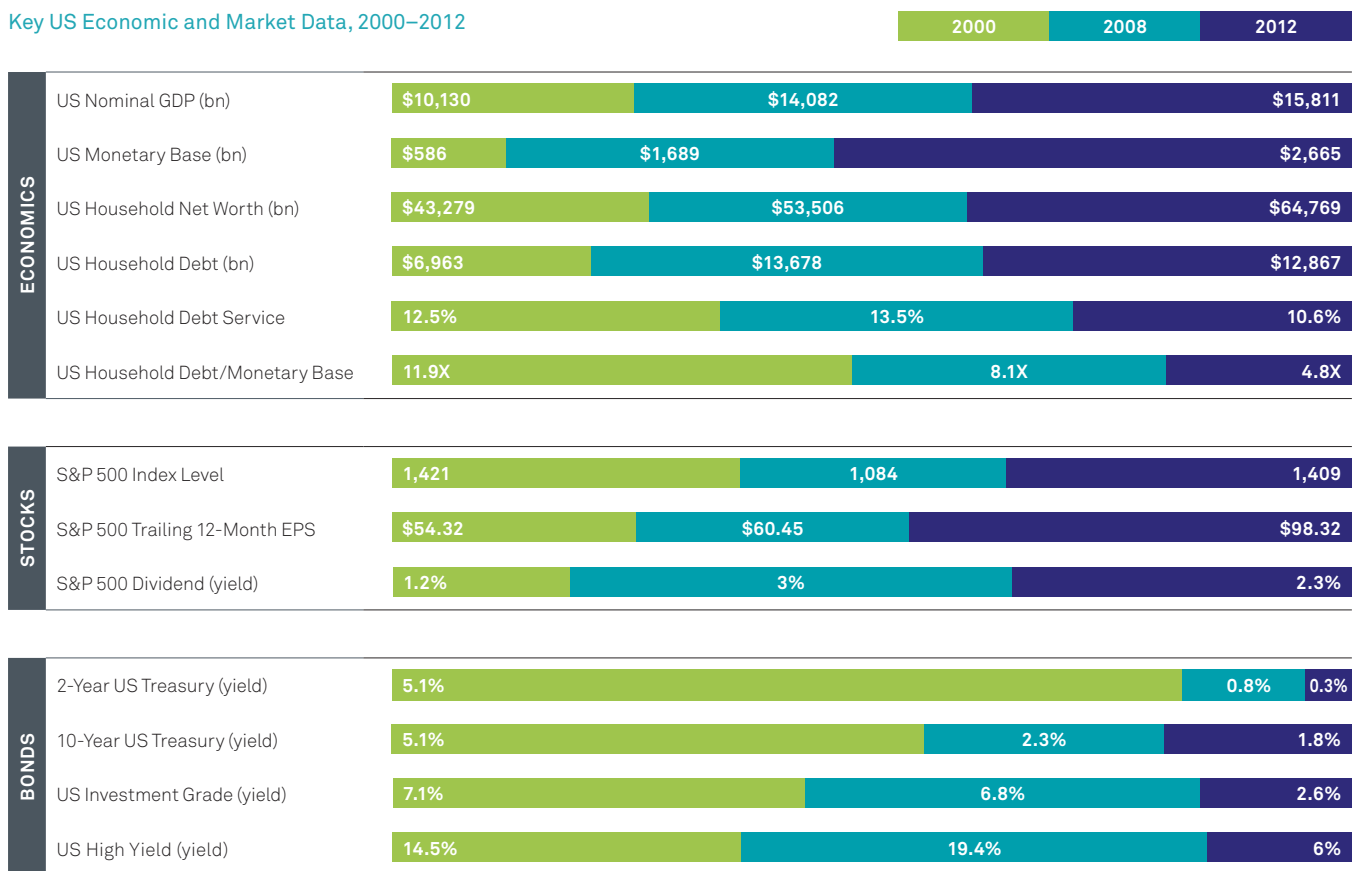
US equities look relatively cheap, given rock-bottom bond yields. See the right chart above. They are not screaming buys. Earnings have increased—but values have jumped hitting bottom in March 2009. See the table on the next page.

SO WHAT DO I DO WITH MY MONEY?™

- ▶ **Uncover Risks:** Recognize hidden risks in bond portfolios and consider diverging from fixed income benchmarks—or even abandoning them.
- ▶ **Go Short:** Shorten duration and emphasize higher-yielding credit over “safe” government bonds. Cash = negative return.
- ▶ **Change Gears:** Markets tend to overshoot. Be ready to take advantage by rotating duration, credit sectors or asset classes.
- ▶ **Focus on Income:** Do not count on capital gains in bond sectors that have had a great run such as US municipal bonds. Buy them for income.
- ▶ **Quality Bargains:** The hunt for yield has boosted not-so-great income assets. Climb up the quality ladder for a small loss in yield.
- ▶ **Buy Insurance:** Volatility in most assets is very low, so options to protect against downside risks or participate in upside opportunities are cheap.
- ▶ **(Bond) Pickers Welcome:** Correlations between asset classes are breaking down. This puts a premium on security selection.
- ▶ **Neutral Bliss:** Reduce market exposure by buying favored assets and simultaneously selling short similar but less desirable securities.

CHANGE IS IN THE AIR

Key US Economic and Market Data, 2000–2012



Sources: Bloomberg, Thomson Reuters and Barclays.

Notes: S&P 500 values are the average for the last six months of each year. Remaining data as of year end.

TRIGGER HAPPY

In their search for income, many investors have pushed themselves to hold higher-yielding—but riskier—fixed income assets than they would ideally like. These “conviction-less” trades could easily reverse as many investors have their finger on the (sell) trigger.

Similarly, some retail investors may have bought bond funds in the belief (or hope) they are money market funds with better yields. They are not. Just check the levels of key bond indices in the past 12 years. See the table above.

Once monthly statements start showing losses, these investors may reconsider. Returns will start to matter, so cash becomes a less viable option.

This increases the risks of overshoots—and opportunities to exploit them. These opportunities may be temporary: Bonds can move lightning fast.

Bottom Line: Flexibility and readiness are crucial for fixed income investors in this environment.

PRISONER’S DILEMMA

Investors and policymakers share a prisoner’s dilemma of sorts. Both parties want the economy to recover and both are scared of the financial consequences of a yield back-up. Yet when one moves first, the other could be walloped.

Do not expect a “great yield rise” anytime soon, however. For one, the global hunt for yield is intense. This means marginally higher rates draw plenty of hungry buyers.

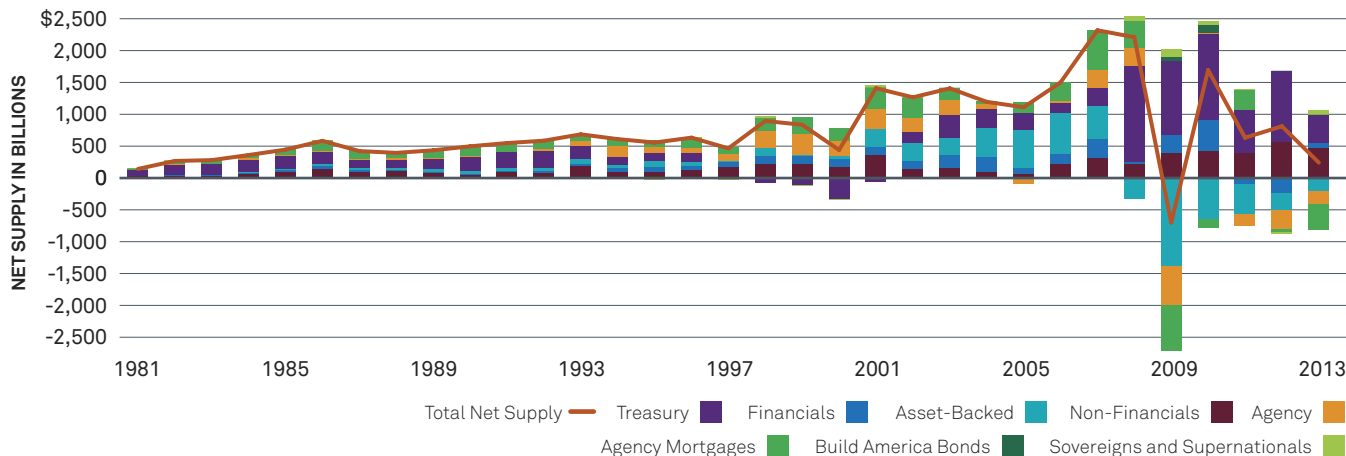
Net supply of fixed income is muted due to central banks’ buying in bulk. See the chart at the top of the next page.

Interest rates are also capped by a self-correcting mechanism: Central banks are likely to quickly revert to loose monetary policies if they sense the economy cannot stomach higher rates. They mostly worry about crushing a nascent recovery, not about a graceful exit from QE.

The developed world’s heavily indebted governments cannot stomach higher yields either, we think, and would push back against any material rises.

IN SHORT SUPPLY

Net Supply of US Fixed Income, 1981–2013



Source: Credit Suisse, February 2013.

Notes: All figures are net of US Federal Reserve and Treasury purchases. 2013 and some 2012 data are estimated.

FORGIVE AND FORGET

Markets had a lot to worry about in 2012: An ugly eurozone breakup. The US “fiscal cliff” plunges the nation into recession. China’s economic growth takes a big hit.

These risks have subsided this year—for now. Once people get out of the shackles of nervousness, things start to move quickly.

Investors also have become more forgiving about types of collateral they are willing to own, resulting in upticks in beaten-down “risky” assets, sudden jolts to “safe” assets and record valuations for income assets. Consider:

- ▶ The slow but sure upswing in US housing prices.
- ▶ Record-low spreads, including in US high yield.

SAFE TO COME OUT?

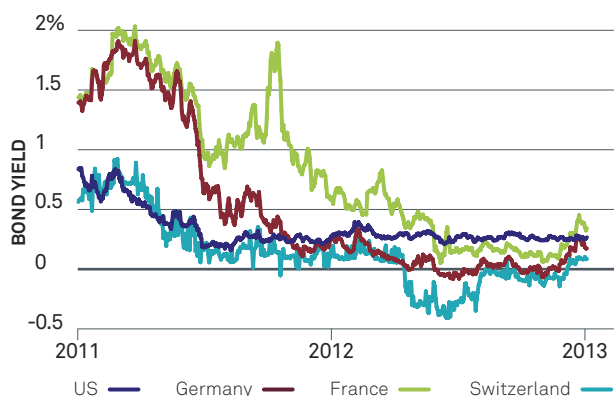
We are witnessing the unwinding of safe-harbor trades, rather than the bursting of a big bond bubble. “It is safe to come out of the bomb shelter,” is the sentiment. Investors are starting to contemplate how to earn returns in the next five years, rather than worry about how to preserve capital in the next six months.

One trend that has helped: Investors will do almost anything to avoid negative nominal yields. This has brought short-term rates back into (nominally) positive territory while investor sentiment appears more upbeat. See the charts below.

The newfound investor courage will be tested: Political risk in Europe lurks. US growth could disappoint. China’s corporate bond market could implode.

HONEY, I SHRUNK THE YIELD

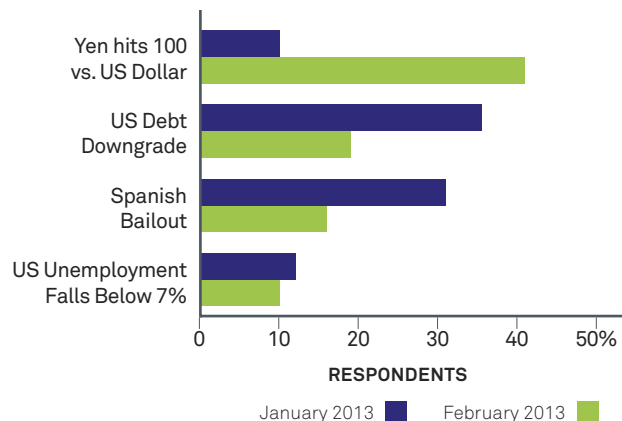
2-Year Bond Yields, 2011–2013



Source: Thomson Reuters, February 2013.

WHAT’S NEXT?

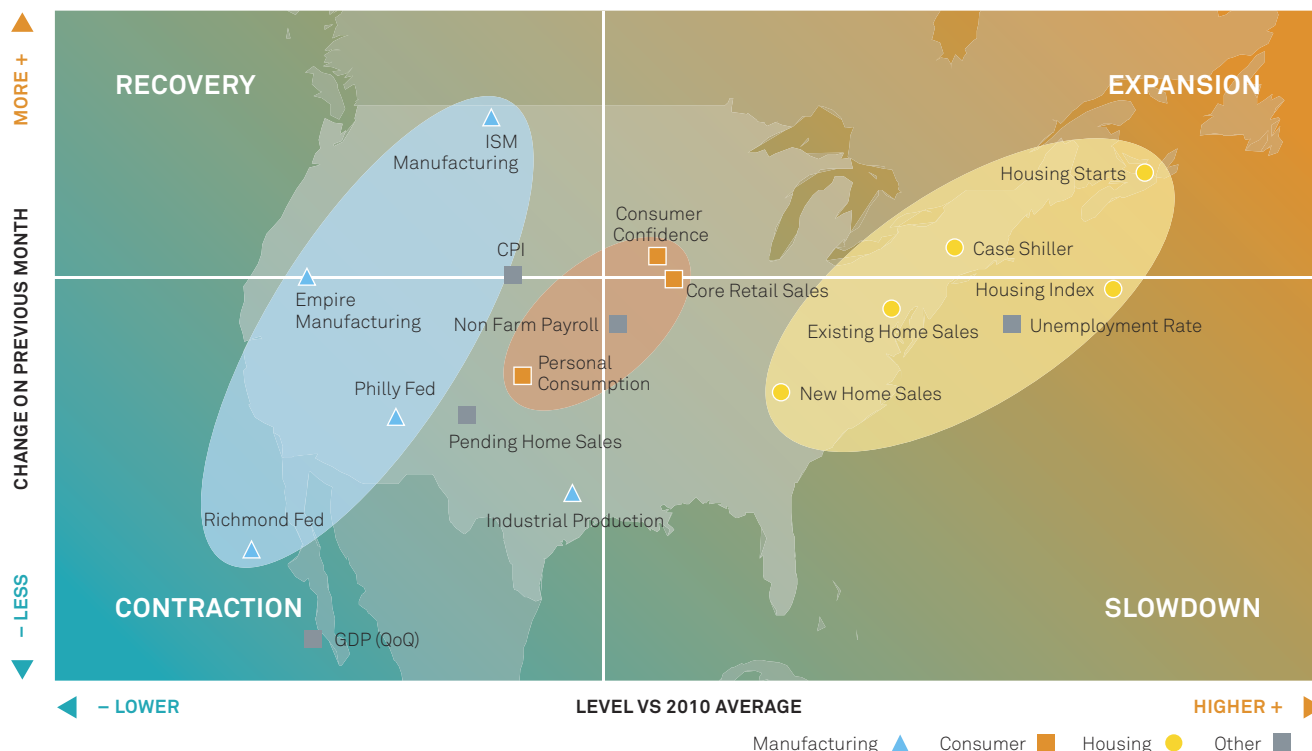
Fund Manager Perceptions, February 2013



Source: Bank of America Merrill Lynch Global Fund Manager Survey, February 2013.
Note: Fund Manager Survey responses to question: “What will happen first?”

A NATION DIVIDED

Key US Economic Data , February 2013



Sources: Bloomberg and BlackRock.

Note: Z-scores for each data series are calculated vs. the post-2010 average. Data series ended December 31, 2012 and January 31, 2013.

US CONUNDRUM

Global growth is far from pre-crisis levels. Europe's economy is permanently teetering on the edge of recession. China's growth rate has perked up but other big emerging markets such as Brazil look to be stuck in low gear.

The US economy, which has been putting along at 2%, is a big swing factor. It is also a bit of a conundrum. Key economic data are not aligned. Manufacturing is weak, consumer spending is holding up (for now) and housing is gaining strength. See the map above.

Washington's Band-Aid deal to avoid the "fiscal cliff" is slowly working its way through the economy. New taxes on the wealthy and a hike in payroll taxes for all risk hurting consumer spending—which has been a bright spot. It is nothing like Greek or Irish austerity, but it is austerity all the same. We have long warned of complacency about the impact of this fiscal headwind.

The cliff deal's limited scope means more uncertainty. Fights are brewing over spending cuts and raising the statutory debt limit. For details, see BlackRock's *US Fiscal Cliff Deal: A Stopgap, Not a Solution* of January 2013 and our post-US election *Now for the Hard Part* of November 2012.

SUNNY SIDE UP

On the plus side, rising housing prices may boost consumer confidence and spending. The housing turnaround, flagged in *In the Home Stretch? The US Housing Market Recovery* in June 2012, is for real. Its psychological and economic impact cannot be overstated.

Another booster is an abundance of cheap energy thanks to increased exploitation of shale gas and oil, as detailed in *US Shale Boom: A Case of Temporary Indigestion* in July 2012. The boom's effects may not move the economic needle much yet, but are likely to be profound over time.

The fiscal deal takes away some uncertainty that kept businesses from investing (or gave them an excuse to hoard cash). For now, manufacturing data remains weakish.

Money multipliers, long immune to ever greater amounts of money pumped into the financial system, appear to have reawakened. For example, the *Center for Financial Stability* recently showed its broad money measure rose 7% in December—the biggest increase since 2008. It predicts the Fed will hit its goal of reducing unemployment to 6.5% much sooner than markets expect (sometime in 2015).

JUBILANT ... AND INCONSOLABLE

For much of the post-crisis years, markets and assets moved in lockstep on the latest batch of economic data or central bank pronouncements. Jubilant one day, inconsolable the next. Many investors did not have the stomach for these big risk-on/risk-off moves, and only a few managed to make real money.

This has changed in the past six months. Correlations between assets are currently just below the post-crisis average. There are also signs of increased risk appetite, with volatile assets performing better than others. See the chart on the right.

Markets look to inch toward the chart's sweet spot in the left top corner: few correlations and many rewards for risk. At the same time, the speed of change has been slowing and volatility has stayed down. All this bodes well for stock or bond pickers who were sidelined for much of the post-crisis years.

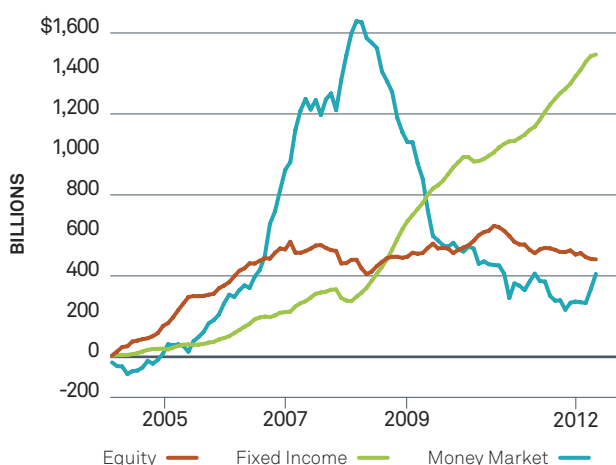
To be sure, we are far from the early 2000s, when correlations were much lower and volatile assets performed well.

And we have sort of been here before: The start of 2011 looked very similar. Correlations were similar—but risk appetite was greater. That year did not end well for risk assets.

On the plus side, the signs are much better than at the start of last year. So we cannot dismiss current trends as the typical “January effect” of rising stocks in the beginning of the year.

FOLLOW THE MONEY

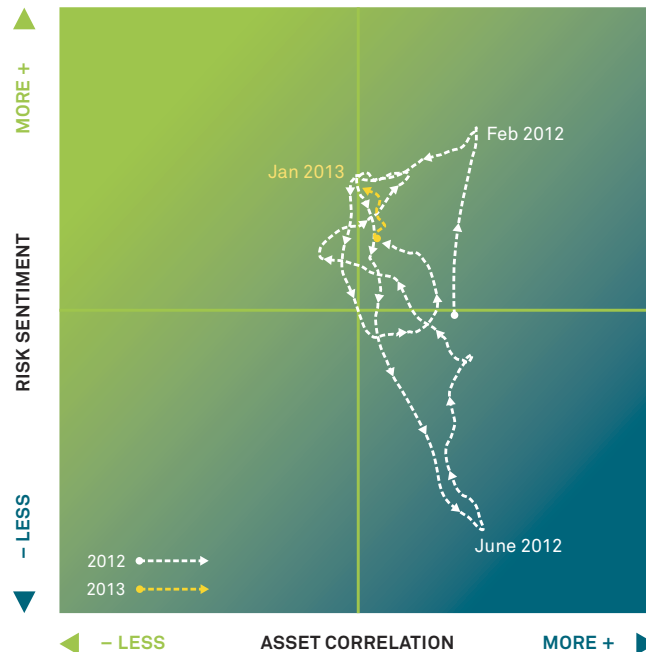
Cumulative Flows Into US Mutual Funds and ETPs, 2005–2012



Sources: Investment Company Institute (ICI) and BlackRock, December 31, 2012. Notes: Combines cumulative flows into actively managed US funds (ICI data) and into exchange traded products (ETPs; BlackRock data) in the period 2005 through 2012. ICI cumulative flows were \$1,273 billion for fixed income, \$410 billion for money market and -\$189 billion for equities. ETP flows were \$671 billion for equities and \$221 billion for fixed income in the period. Money market funds make up a minuscule percentage of ETP fixed income flows.

TO A BETTER PLACE?

Asset Correlations and Risk Appetite, 2012–2013



Source: BlackRock. Data from January 31, 2012 through February 5, 2013. Notes: Based on correlations between 14 asset classes. Risk sentiment measures performance of more volatile assets. Time series is a smoothed 20-day average.

SCARRED BY THE PAST

The Great Rotation story often has a chapter that could be called reversion to the mean. It relates how investors for years fled equities and stormed into bonds. The Great Rotation would be a massive shift *back* into equities, from bonds.

We suggest investors skip this chapter. US fund flows show it has major holes. The big story has been a \$1.2 trillion outflow from US money market funds since risk assets hit bottom in early 2009. US bond funds attracted \$1.2 trillion over this period whereas equities were essentially flat. See the chart on the left.

Investors have stuck with bonds in recent history. Yield spikes triggered some outflows from rate-sensitive sectors such as US Treasury exchange traded funds, as detailed in *Behind the Bond Boom* in January 2013. The impact on credit sectors has been next to nothing—so far.

Institutions dominate most fixed income markets. Their structural bid for yield will likely mitigate any back-up in rates—even if retail investors throw in the towel.

Investor psychology is important. A “lost decade” for stocks with two crashes may have soured many on equities. Other investors may have come to believe bonds always rise. Bottom line: It takes a long time to shape and change investor behaviors.

Why BlackRock

As the world's largest investment manager, we believe it's our responsibility to help investors of all sizes succeed in the New World of Investing. We were built to provide the global market insight, breadth of capabilities, unbiased investment advice and deep risk management expertise these times require.

The Resources You Need for a New World of Investing

Investing with BlackRock gives you access to every asset class, geography and investment style, as well as extensive market intelligence and risk analysis, to help build the dynamic, diverse portfolios these times require.

The Best Thinking You Need to Uncover Opportunity

With deep roots in all corners of the globe, our 100 investment teams in 30 countries share their best thinking to translate local insight into actionable ideas that strive to deliver better, more consistent returns over time.

The Risk Management You Need to Invest with Clarity

With more than 1,000 risk professionals and premier risk management technology, BlackRock digs deep into the data to understand the risk that has to be managed for the returns our clients need and bring clarity to the most daunting financial situations.

BlackRock. Investing for a New World.

This paper is part of a series prepared by the BlackRock Investment Institute and is not intended to be relied upon as a forecast, research or investment advice, and is not a recommendation, offer or solicitation to buy or sell any securities or to adopt any investment strategy. The opinions expressed are as of February 2013 and may change as subsequent conditions vary. The information and opinions contained in this paper are derived from proprietary and nonproprietary sources deemed by BlackRock to be reliable, are not necessarily all-inclusive and are not guaranteed as to accuracy. As such, no warranty of accuracy or reliability is given and no responsibility arising in any other way for errors and omissions (including responsibility to any person by reason of negligence) is accepted by BlackRock, its officers, employees or agents. This paper may contain "forward-looking" information that is not purely historical in nature. Such information may include, among other things, projections and forecasts. There is no guarantee that any forecasts made will come to pass. Reliance upon information in this paper is at the sole discretion of the reader.

For distribution in EMEA for Professional Investors only, or "professional clients", as such term may apply in relevant jurisdictions.

Issued in Australia and New Zealand by BlackRock Investment Management (Australia) Limited ABN 13 006165975. This document contains general information only and is not intended to represent general or specific investment or professional advice. The information does not take into account any individual's financial circumstances or goals. An assessment should be made as to whether the information is appropriate in individual circumstances and consideration should be given to talking to a financial or other professional adviser before making an investment decision. In New Zealand, this information is provided for registered financial service providers only. To the extent the provision of this information represents the provision of a financial adviser service, it is provided for wholesale clients only. In Singapore, this is issued by BlackRock (Singapore) Limited (Co. registration no. 200010143N). In Hong Kong, this document is issued by BlackRock (Hong Kong) Limited and has not been reviewed by the Securities and Futures Commission of Hong Kong. In Canada, this material is intended for permitted clients only.

In Latin America this material is intended for Institutional and Professional Clients only. This material is solely for educational purposes and does not constitute an offer or a solicitation to sell or a solicitation of an offer to buy any shares of any fund (nor shall any such shares be offered or sold to any person) in any jurisdiction within Latin America in which an offer, solicitation, purchase or sale would be unlawful under the securities law of that jurisdiction. If any funds are mentioned or inferred to in this material, it is possible that they have not been registered with the securities regulator of Brazil, Chile, Colombia, Mexico and Peru or any other securities regulator in any Latin American country and thus might not be publicly offered within any such country. The securities regulators of such countries have not confirmed the accuracy of any information contained herein. No information discussed herein can be provided to the general public in Latin America.

The information provided here is neither tax nor legal advice. Investors should speak to their tax professional for specific information regarding their tax situation. Investment involves risk. The two main risks related to fixed income investing are interest rate risk and credit risk. Typically, when interest rates rise, there is a corresponding decline in the market value of bonds. Credit risk refers to the possibility that the issuer of the bond will not be able to make principal and interest payments. International investing involves risks, including risks related to foreign currency, limited liquidity, less government regulation, and the possibility of substantial volatility due to adverse political, economic or other developments. These risks are often heightened for investments in emerging/developing markets or smaller capital markets.

FOR MORE INFORMATION: www.blackrock.com

©2013 BlackRock, Inc. All Rights Reserved. **BLACKROCK**, **BLACKROCK SOLUTIONS**, **iSHARES** and **SO WHAT DO I DO WITH MY MONEY** are registered and unregistered trademarks of BlackRock, Inc. or its subsidiaries in the United States and elsewhere. All other trademarks are those of their respective owners.

Not FDIC Insured • May Lose Value • No Bank Guarantee

AC6510-0213

