BLACKROCK INVESTMENT INSTITUTE

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Summer of ’69

Jeffrey Rosenberg

Chief Fixed Income Strategist, BlackRock Investment Institute

The persistent flattening of the U.S. yield curve has investors scratching their heads – and searching for historical parallels. One episode that echoes (and inspired this month’s title based on the 1984 Bryan Adams hit): the recession of 1969-70. This was a downturn fueled by overheating – our lead fixed income theme for this year. Back then, late-cycle fiscal stimulus contributed to runaway inflation. The Federal Reserve aggressively raised rates, inverted the yield curve – and a recession followed. What made this episode special was the combination of a recession with a structural rise in inflation expectations, challenging bonds’ ability to cushion against the downturn. What are the lessons for investors today? We seek to answer this timely question.

Highlights

- Bonds go up when stocks go down. Or so investors expect. Yet it is shocks to growth that make this relationship hold. Periodic market “tantrums” since the crisis show that when other concerns – such as inflation – dominate, this may not be the case. Stocks and bonds can both fall at the same time.
- History shows bonds can fail to offset equity losses in periods where inflation fears rise. Today inflationary pressures are far more subdued. What will be the shock that derails the current cycle? One risk: a trade war tightening financial conditions and hitting growth. We believe bonds would cushion portfolios in such a scenario.
- We see no imminent signs of recession, but *how* any recession manifests matters. Short-duration, floating rate, inflation-linked and credit exposures can help offset inflation risk. And we see long duration exposures helping cushion portfolios in a financial shock scenario that hits growth.

Short-end outperformance

The 10-year Treasury yield topped 3% in late April for the first time in four years. Returns on short-maturity Treasuries have outperformed those on the long end this year to date, reinforcing our preference for short- over longer term bonds.

Sector	View	YTD return	Yield	Sector	View	YTD return	Yield
U.S. aggregate	—	-2.34%	3.34%	U.S. municipal bonds	—	-0.83%	2.73%
U.S. government bonds	▼	-2.11%	2.79%	U.S. investment grade	—	-3.46%	3.98%
Short (1-5 years)	▲	-0.88%	2.65%	U.S. high yield	—	-0.06%	6.28%
Intermediate (5-10)	▼	-2.73%	2.92%	Bank loans	—	1.93%	5.65%
Long (10+)	▼	-5.48%	3.09%	Securitized assets	▲	-1.66%	3.50%
U.S. inflation protected	▲	-1.04%	3.05%	Euro credit	▼	-0.39%	0.92%
Agency mortgages	—	-1.77%	3.47%	Emerging markets	—	-4.28%	6.24%
Non-U.S. developed	▼	0.07%	0.89%	Asia fixed income	—	-2.56%	4.85%

▲ Overweight — Neutral ▼ Underweight ↑ Upgrade ↓ Downgrade

Past performance is not a reliable indicator of current or future results. It is not possible to invest directly in an index. Source: Bloomberg, as of May 11, 2018. 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 used are not intended to be indicative of any fund or strategy’s performance.

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Less reliable ballast

Are bonds still a good hedge to stocks? This is among the most frequent questions we have received – especially as stocks have posted negative returns alongside bonds this year. Our answer: yes, but with a caveat.

The conventional wisdom: Bond prices go up when stocks go down. Bonds offer some balance for portfolios with equity exposure. For much of the past 30 years – the bond bull market – bonds have played twin roles for investors: diversification *and* returns. Bonds generated strong returns in their own right, while providing a critical offset to equity risks in times of financial shocks or economic recessions.

The correlation between bond and equity returns has waxed and waned throughout history. For most of the new millennium it has been negative. Yet the relationship has become more unstable in both the U.S. and the eurozone since the end of the global financial crisis. Periodic reversals in the relationship include the "taper tantrum" of 2013, when both equities and bonds sold off in response to Federal Reserve hints about a tapering of its bond purchases. Other examples are the German bund yield spike in 2015 and the more recent equity market sell-off in February. See the *Bonds for ballast* chart. During these episodes, a traditional bond allocation would have exacerbated portfolio risks, rather than providing a buffer. This is a result of the ultra-low interest rate and quantitative easing (QE) policies that have spread low interest rates across the curve. With interest rates finally on an expected path towards normalization, at least in the U.S., bonds may be less reliable as ballast.

The key question: Will bonds still work in the next recession? History provides a guide: it is rare to see negative returns in both stocks and bonds in the same year. Of the 24 years with negative equity returns since 1929, U.S. 10-year Treasuries generated positive returns in all but three. See the chart *Bonds hedge growth, not inflation risks*. Bonds tend to perform well in recessions as they are deflationary, with falling activity and prices (or expectations thereof).

Bonds for ballast

Rolling 60-day return correlation, 2013-2018

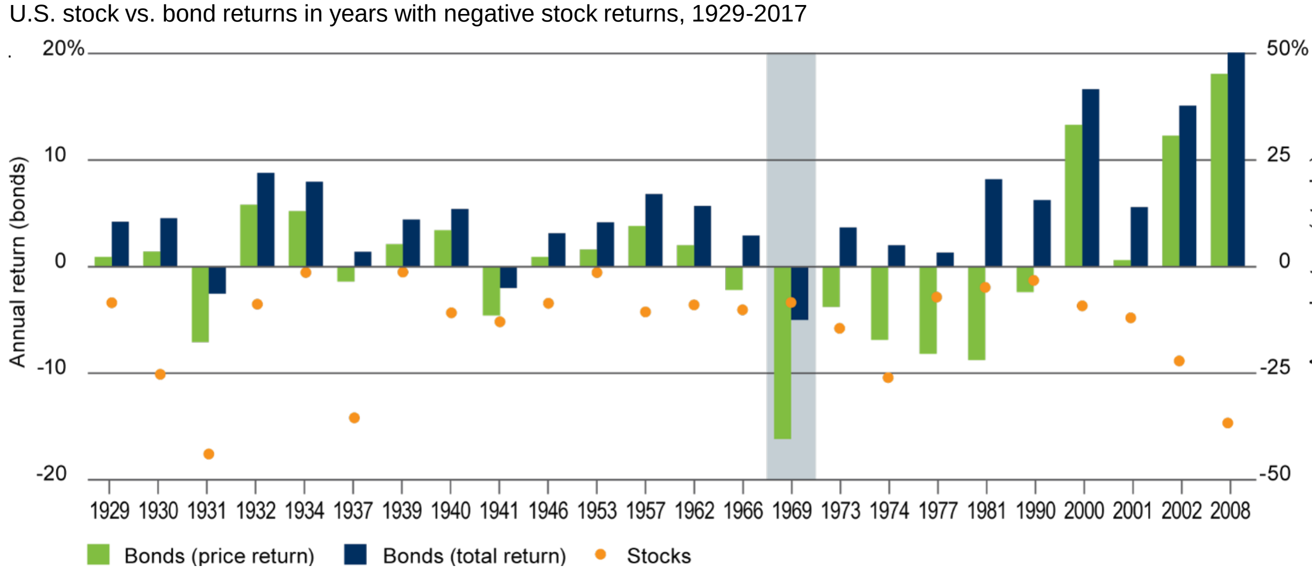
Source: BlackRock Investment Institute, with data from Bloomberg, May 2018. Notes: The chart shows the correlation of daily returns between equities and bonds over a rolling 60-day period. Equity returns are based S&P and Euro Stoxx indexes, while bond returns are based on Bloomberg Barclays U.S. and German government bond indexes.

A history lesson

Two of the three historical exceptions were unique events: Among the causes in 1931 were the collapse of Austrian bank Credit-Anstalt and the currency crisis that forced Britain to abandon the gold standard; in 1941 it was the U.S. entry into World War II. The 1969-70 episode stands out: excessively loose monetary policy coupled with late-cycle fiscal stimulus led to a decade of de-anchored inflation expectations. As growth faltered in 1969, bonds suffered losses even as stocks stumbled. And in the 1970s, bond prices fell in several years of negative equity returns (though high starting yields kept total returns positive). The overall lesson: Bonds are a good offset to stocks when it matters most, *unless* the equity market selloff is triggered by a Fed trying to quell runaway inflation. Put differently, bonds cushion against growth risks but not inflation risks.

Bonds hedge growth, not inflation risks

U.S. stock vs. bond returns in years with negative stock returns, 1929-2017



Past performance is not a reliable indicator of future results. Source: BlackRock Investment Institute, with data from Bloomberg, May 2018. Notes: The price and total return of bonds are based on the annual return of 10-year U.S. Treasury bonds. Stocks are represented by the S&P 500 Index. Price returns are estimated based on the duration of bonds and the movement of the 10-year rate over the year.

Takeaway from 1969

A closer look at the late 1960s reveals some parallels with today's U.S. economic backdrop:

- Inflation was on the rise (albeit much more sharply than today) after a prolonged period of languishing well below the Fed's 2% target.
- The unemployment rate had steadily fallen to long-term lows below the 4% mark.
- The economy was receiving a hefty boost from fiscal stimulus (from President Lyndon Johnson's Great Society programs and Vietnam War spending) – at a time when the cycle was already looking long in the tooth. This parallels the tax cut and spending stimulus currently hitting the U.S. economy, which we see adding as much as one percentage point to growth this year.

In the mid-1960s, the Fed shifted from inflation-creating to inflation-fighting mode quickly, as shown in the *Mad (money) men* chart, contributing to the market downturn. Under such a scenario, bonds were able to provide a hedge to equities eventually, but only after the Fed had sufficiently snuffed out inflation. Unfortunately for investors at the time, inflation kept climbing and peaked only in the mid-1970s. Further policy errors throughout the 1970s contributed to the dreadful experience with stocks, bonds and inflation.

This lesson from history is clear, yet it is unfamiliar to the modern era. The past 30 years – a disinflationary period – has few examples to show how bonds perform in an overheating economy in which the Fed inverts the curve in a bid to cool inflationary pressures.

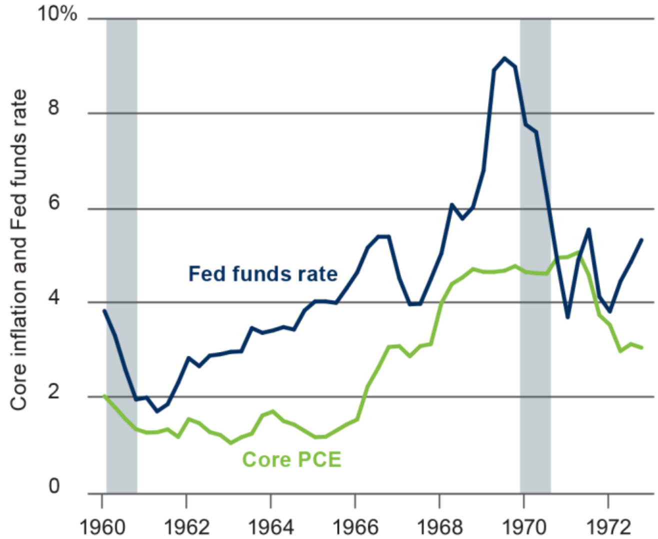
How does a cycle end? Either it overheats with high inflation, or a financial shock causes a recession through the financial conditions channel. More recent cycles belong to the latter category. A financial shock is deflationary – falling markets and collapses in confidence, spending, investment and hiring. The central bank then cuts rates, sending inflation expectations lower and bond prices up.

Bonds are typically a good shock absorber under this scenario. They can lower portfolio volatility, by providing lower risk than equity. This includes corporate credit, securitized assets and emerging market bonds. Bonds can also provide a buffer against risks by providing returns greater than those offered by cash-like instruments. For example, the recent rises in short-term rates have restored the value of short-duration strategies, which now offer positive after-inflation yields in the U.S.

Today's lower rates suggest the Fed has less ammunition than in the past. But former Fed Chair Janet Yellen argued in her 2016 Jackson Hole speech that the Fed still had plenty of tools to fight the next recession. We believe the current Fed leadership likely shares this view. The implication: In a recession, we could see a large monetary easing with potential for a return to zero or even negative rates – and even a possible reboot of QE. The use of these unconventional policy tools would once again lower rates – and should boost the value of bonds.

Mad (money) men

Inflation vs. Fed funds rates, 1960-1972



Source: BlackRock Investment Institute based on data from Bloomberg, May 2018. Notes: Core PCE refers to the Fed's favored inflation gauge: U.S. Personal Consumption Expenditures. Shaded areas represent recessions.

Growth versus inflation shock

The recent flattening of the yield curve has alarmed many investors. They see it as a potential sign that we are headed to an overheating economy with rising inflation and a Fed that's ready to push rates up aggressively – a potential trigger for exiting the equity market. But a flatter curve was the intention and result of the Fed's QE program. It may therefore be a less reliable indicator than in the past. And inflation risks are much less apparent today. Our BlackRock Inflation GPS points to only a modest rise in U.S. inflation. And it sees inflation stuck well below target in Japan and the eurozone.

Technological innovation, globalization and aging populations all suggest a lower likelihood of inflation rising sharply enough to prompt the Fed to invert the yield curve. Rather, today's backdrop looks all too much like cycles of the recent past: a reliance on loose financial conditions creates vulnerabilities to financial shocks. We do not see any imminent warning signs of recession, as detailed in BlackRock's Q2 investment outlook. This underpins our overall preference for equities over bonds. The greatest near-term risk that we see: a trade war that could tighten financial conditions and undermine global growth. Financial stability concerns may well manifest long before inflation risks do in this cycle. We believe this should make bonds a source of ballast when you need it most.

Bottom line: for investors unsure of the path toward an eventual recession, having a foot in both camps may work best as the cycle matures. For an inflation shock, short-duration, floating rate, inflation linked and credit exposures can act as offsets. For a growth shock, some long duration strategies either in core fixed income or municipal bonds (for U.S. investors) can serve as a hedge. Non-dollar-based investors may consider U.S. duration with the added benefit of dollar exposure. We see both duration and the dollar benefiting in a flight to quality.

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