BLACKROCK INVESTMENT INSTITUTE

FIXED INCOME STRATEGY • MARCH 2018

A mighty (tail)wind

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Tax cuts and plans for more government spending are turning past headwinds to U.S. growth into tailwinds (and providing inspiration for this month's title from the 2003 mockumentary). We previewed this dynamic in January with Fuel for (over)heating. One result: The market has now caught up with the median interest rate path projected by Federal Reserve policymakers. We take stock of recent developments and shine a light on rising opportunities at the front end of the curve.

Highlights

- We see short-term U.S. debt offering relatively compelling income, with limited downside risk: Three Fed rate hikes are already priced in for this year, with the first likely this month. Markets could price in one additional quarterly hike after that Fed meeting (making a total of four for 2018), but we see a more rapid pace as unlikely.
- Technical factors such as increasing U.S. Treasury bill issuance – the result of a surging budget deficit – are adding to the factors pulling short-term yields higher. As a result, short-term Treasuries offer positive real yields for the first time since the financial crisis, with income sufficient to offset inflation.
- Higher yields favor short over long maturities in government debt. We like floating rate and inflation-linked securities as buffers against rising rates and inflation, and also see opportunities in 15-year mortgages. We prefer an up-in-quality stance in credit, favoring investment grade over high yield.

Rates rally

Global rates rallied through mid-March, with yields softening partly on signs of some deceleration in economic momentum – and partly on concerns over the impact of rising trade tensions. Fixed income returns rebounded as a result, and duration again has recently played its traditional role of an offset to equity losses.

Bond market summary

Sector	View	YTD return	Yield	Sector	View	YTD return	Yield
U.S. aggregate	—	-1.86%	3.15%	U.S. municipal bonds	—	-1.45%	2.68%
U.S. government bonds	▼	-1.68%	2.58%	U.S. investment grade	—	-2.66%	3.76%
Short (1-5 years)	▲	-0.61%	2.38%	U.S. high yield	—	-0.52%	6.20%
Intermediate (5-10)	▼	-2.07%	2.74%	Bank loans	—	1.37%	5.31%
Long (10+)	▼	-4.86%	3.02%	Securitized assets	▲	-1.35%	3.31%
U.S. inflation protected	▲	-1.43%	2.90%	Euro credit	▼	-0.22%	0.84%
Agency mortgages	—	-1.56%	3.34%	Emerging markets	—	-2.02%	5.74%
Non-U.S. developed	▼	3.43%	0.83%	Asia fixed income	—	-1.40%	4.46%

▲ 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 Mar. 14, 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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Small potatoes

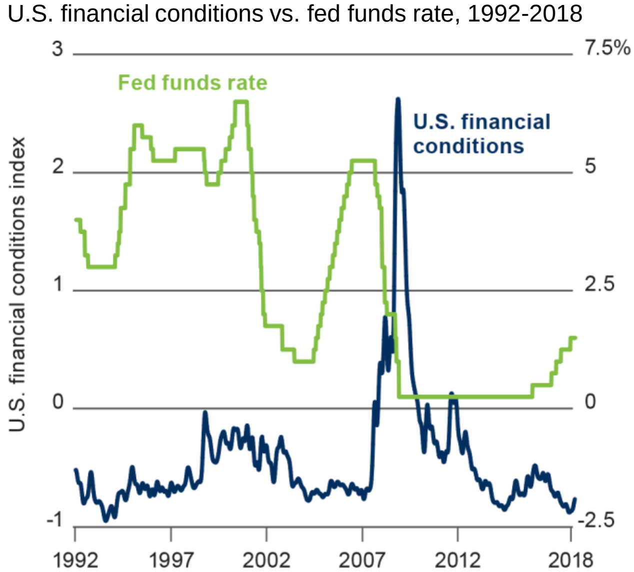
"In many respects, the macro environment today is the mirror image of the environment we confronted a couple of years ago…Strong headwinds sapped the momentum of the recovery and weighed down the path of policy. Today with headwinds shifting to tailwinds, the reverse could hold true."
- Fed Governor Lael Brainard

Debate is heating up about a material shift in U.S. monetary policy. As Fed Governor Brainard's recent speech highlights, it is a story about reversing economic fortunes. Downside risks to the attainment of Fed policy goals are decreasing, while upside risks from "overheating" now threaten higher inflation. The result is a Fed that for the first time post-crisis stands resolute in policy normalization. Contrast this situation with 2016. Back then, the headwinds were falling commodity prices, declining global growth and stresses in emerging markets. The resultant tightening in financial conditions sapped the Fed of its initial confidence in normalizing that year. The end game: only one rate hike by December, versus the four that were initially expected.

New York Fed president Bill Dudley called this year's February stock market correction "small potatoes." This implies a much larger financial shock would be needed to dislodge the Fed from its normalization path, given tailwinds such as U.S. fiscal stimulus. Various measures of "financial conditions" make clear why the correction appears small potatoes to policymakers. See the *Easy money* chart. The tightening in financial conditions barely registers relative to the big easing in conditions seen in recent years, even as the Fed has been steadily raising rates. This highlights why we expect ongoing Fed normalization in 2018. And it suggests the strike price of the famed "central bank put" may have moved well out of the money: Investors face greater financial market risks today. Why? With the economy above potential, it will take a much bigger tightening of financial conditions for the Fed to come to the rescue of markets.

Easy money

U.S. financial conditions vs. fed funds rate, 1992-2018



Source: BlackRock Investment Institute, with data from Bloomberg, March 2018. Notes: U.S. financial conditions are represented by the Chicago Fed's National Financial Conditions Index (NFCI). Positive values of the NFCI indicate tighter-than-average financial conditions; negative values indicate looser conditions.

Playing catchup

Market vs. Fed outlook for Fed funds rate, 2015-2018

Source: BlackRock Investment Institute, with data from JP Morgan, March 2018. Notes: The chart shows the 12-month forward market-implied fed funds rate (using overnight index swaps) versus the 12-month forward path (interpolated) based on the Fed's median forecast in its Statement of Economic Projections.

Long on the short end

One clear result of shifting from headwinds to tailwinds? Market participants' confidence that the Fed will make good on its normalization plans. In most of the post-crisis normalization period, the bond market significantly discounted Fed expectations for the pace of normalization, as shown in the "dots plot" of the Fed's Statement of Economic Projections. See the *Playing catchup* chart.

The market has now caught up with the Fed's view, with rising short-term interest rates reflecting greater confidence in the Fed's normalization path. This, too, is a material change. Bond markets were very skeptical of Fed normalization signals for much of the post-crisis period. And for good reason. 2017 was the only year the Fed delivered on its promised pace of normalization. The current economic tailwinds suggest the central bank is poised to extend that recent track record. This comes along with the potential scenario – in our view a likely one – of adding one additional hike in 2018 to the Fed's projected path. This would make for quarterly rate rises without a pause. Three hikes were reflected in short-term interest rates as of mid-March.

We believe it will likely take some time for any economic overheating to challenge the central bank's gradual pace of normalization. We see inflation returning to the Fed's target, with the possibility of a temporary overshoot. But at least for 2018, we see little chance of the Fed increasing rates beyond a quarterly pace of 25-basis-point rate hikes.

Combined with what is already priced into front-end yields, this makes for attractive risk vs. reward. It means an investment perceived as "risk-free" has become compelling: limited downside risk and positive after-inflation yields. A two-year Treasury yield now well above the core inflation rate restores a viable and perceived safe investment option that has been missing since the crisis. This is another big shift in the investment landscape.

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Getting technical

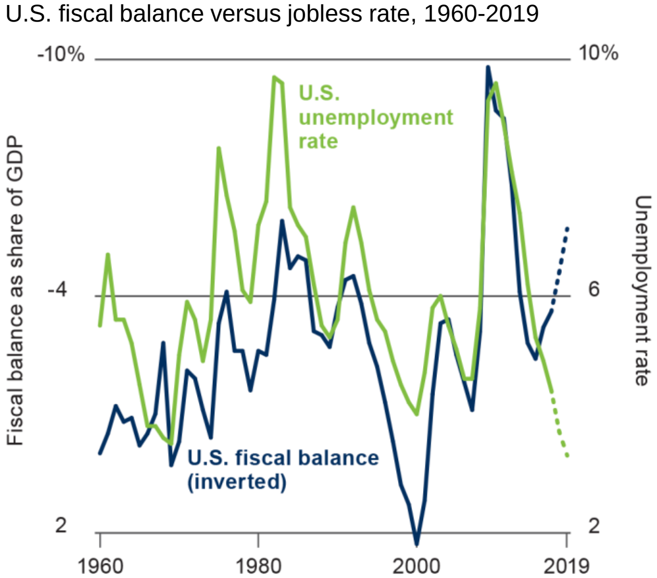
Technical factors such as issuance trends are also making the short end look more attractive. Lost revenues from tax cuts, twinned with greater government spending, mean more borrowing to fund deficits. We project the U.S. deficit to hit 5.7% of GDP by 2019, the highest since 1960, outside of the 2008 crisis aftermath. The deficit spike comes even as the jobless rate drops to multi-decade lows – an unprecedented disconnect. See the *Diverging paths* chart. Treasury bill and bond issuance are ramping up at a time when the Fed is reducing its reinvestment of maturing bond holdings. We estimate net bill issuance to the tune of roughly $500 billion in 2018, far beyond levels seen in recent years. The result: a need for greater private-sector financing of federal deficits.

The U.S. tax system overhaul also has created incentives for companies to repatriate overseas cash currently held in short-term instruments. Anticipation of these fund outflows is contributing to rising yields on shorter maturities. Money market funds have generally maintained a defensive posture on duration as the Fed normalizes policy. They may also be building liquidity ahead of expected repatriation-driven redemptions. This has led to market expectations of a widening in the spread between LIBOR and overnight index swap (OIS) rates, a gauge of stress in U.S. dollar funding. This indicates a pullback in demand for short-term paper by money funds. Yields on such paper have risen more than underlying Treasury yields. A shrinking of excess reserves in the banking system as the Fed normalizes policy is also pressuring funding rates, with three-month LIBOR-OIS spreads surpassing the peaks seen around U.S. money market reforms in 2016.

Our bottom line: Today's funding pressures are similarly technical in nature, with rising short-term rates providing investment opportunities. We see no concern about the broader health of the financial system, as was the case in mid-2011, when the European banking crisis led to sharp, upward pressure on funding rates.

Diverging paths

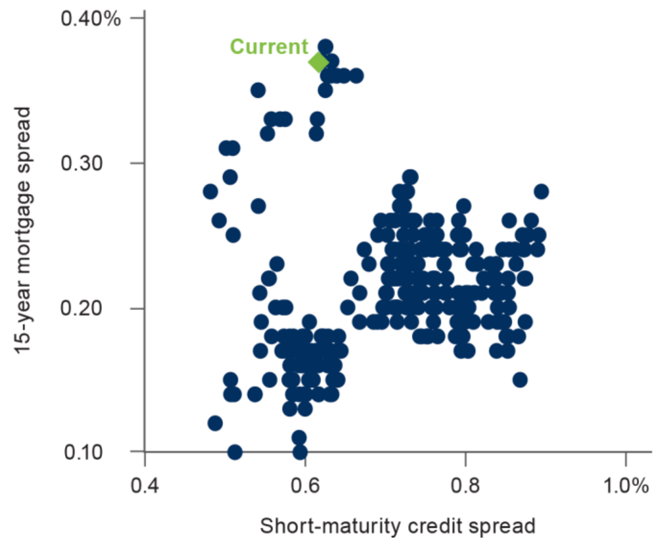
U.S. fiscal balance versus jobless rate, 1960-2019



Source: BlackRock Investment Institute, with data from Congressional Budget Office and Bloomberg, March 2018. Notes: Fiscal deficits are based on CBO estimates. The dotted lines represent BlackRock estimates through 2019.

Relative value

U.S. mortgage vs. IG credit spread, 2017-2018



Source: BlackRock Investment Institute, with data from Bloomberg Barclays, March 2018. Notes: The chart shows the historical relationship between short-maturity credit spreads and 15-year U.S. mortgage spreads. Each dot represents a daily observation, starting in January 2017. The mortgage spread is a BlackRock estimate based on the option-adjusted spread of the current coupon on the 15-year mortgage. The credit spread is based on the spread of the Bloomberg Barclays 1-3 year Corporate Index.

Back in the game

Mortgage-backed securities (MBS) are another hunting ground for short-end opportunities. This includes 15-year maturities, perhaps an unlikely target for investors seeking to limit their duration risk. But these mortgages have interest rate sensitivity closer to that of a five-year Treasury instrument. Yields on these securities have significantly improved since the start of the year, on the heels of rising interest rates.

Mortgages are also trading at more attractive valuations relative to investment grade corporate debt. The 15-year mortgage spread is unusually wide relative to credit spreads today, based on the relationship between the two since 2017. See the green triangle in the *Relative value* chart.

In addition, reduced agency MBS issuance could support the value of these securities. We find the share of 15-year MBS issuance tends to shrink as the Treasury curve flattens. Why? As the Treasury curve flattens, so goes the mortgage curve -- the rate differences across fixed-rate mortgages of different terms. This reduces the relative reward for borrowers who can afford the higher monthly payments of a shorter-term mortgage. The overall result: compelling valuations in 15-year MBS relative to their 30-year counterparts in a period of declining issuance.

Bottom line: We believe the short end offers relatively compelling income along with a healthy buffer against the prospects of further increases in yields. This marks a major shift away from the post-crisis era of near-zero yields on such instruments. Traditionally "safe" and liquid assets can now better compete for investor capital. And investors now have a viable alternative to cash, with yields finally above inflation levels.

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