FOR PROFESSIONAL CLIENTS AND QUALIFIED INVESTORS ONLY

WHAT WILL THE FUTURE YIELD?

Dealing with divergence, uncertainty and policy surprises in bond markets

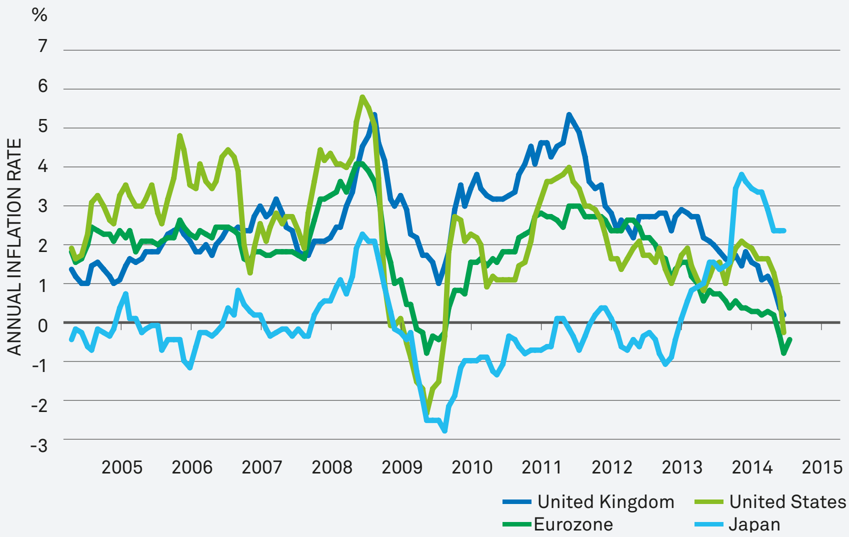
BLACKROCK®

APRIL 2015

When the European Central Bank (ECB) launched its expanded asset purchase programme in January, it became the final major central bank to embark on quantitative easing (QE). The Federal Reserve (Fed), Bank of England (BoE), Bank of Japan (BoJ) and ECB have all now clearly demonstrated that they have both the will and the mandate to deploy a full monetary policy toolkit when circumstances require it. The implementation of such extreme monetary policy measures is important not just for this economic cycle, but also for the next.

In some respects, the actions of the major central banks have had the desired impact, driving investors into riskier assets. The FTSE 100 hit a new all-time high on 24 February 2015 and subsequently broke through the 7,000 level for the first time on 20 March 2015. The DAX hit the 11,000-mark for the first time in its history on 13 February 2015. Even the Nikkei closed at a 15-year high on 23 March 2015. However, despite some positive signals – a surprise on the upside for German Q4 2014 GDP, for instance – the central banks have been less successful at warding off the spectre of deflation[1].

GLOBAL INFLATION RATES (CPI)



Source: Thomson Reuters Datastream, BlackRock Investment Institute 31 March 2015.

Even in countries such as the US and UK, whose economies are growing relatively strongly, inflation remains well below target levels. The additional liquidity injected by QE does not seem to have filtered through to consumers – and spending and prices have not risen as expected – suggesting that monetary policy alone cannot fight off disinflationary pressures. Such thinking has not prevented an ECB-led wall of easing in 2015.

1 Bloomberg, March 2015

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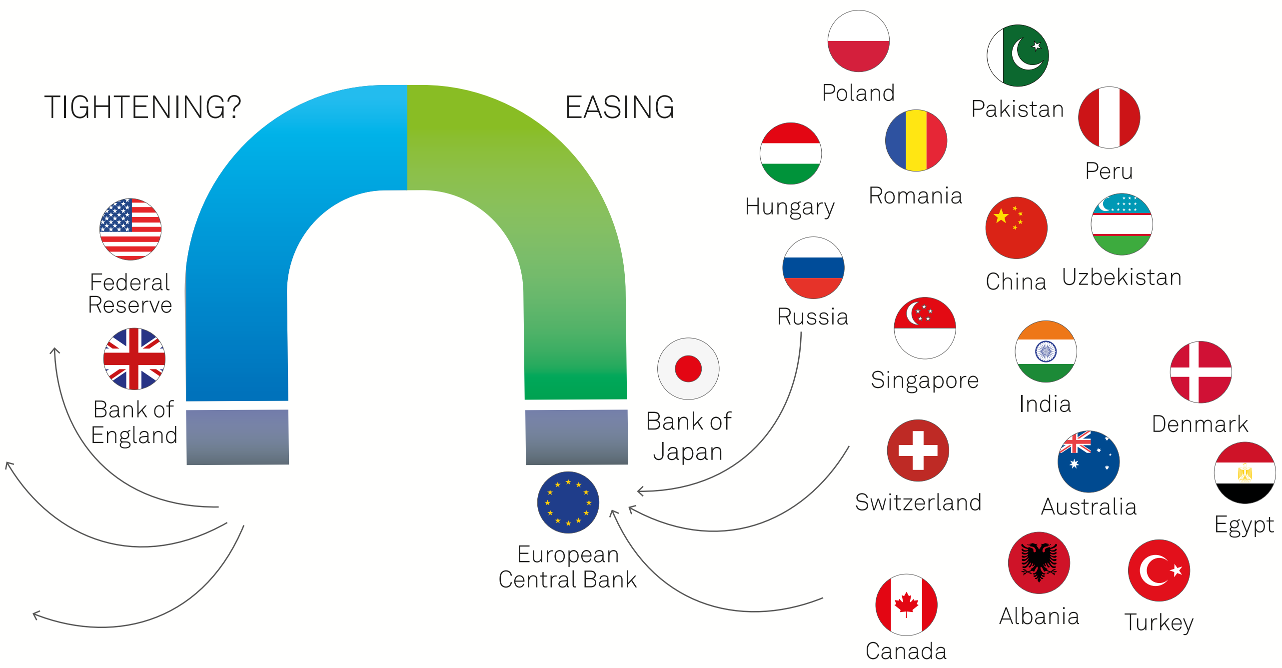
Economic divergence is playing out

While a slowdown in growth is a common global concern, there is clear economic and monetary policy divergence between the developed markets, with the Fed and BoE looking to start normalising rates while the BoJ and ECB have embarked on ambitious QE programmes. Even the Fed and BoE, which until a few months ago looked neck-and-neck in the race to tighten, are increasingly on divergent paths. The dialogue around a first Fed hike has moved on from 'when' (consensus expectations are in June or September) to 'by how much', whereas the market isn't now pricing a first BoE hike until early 2016.

The pressure is for the Fed and the BoE to raise rates ahead of the next economic cycle, thus ensuring they have a full monetary policy toolkit to deploy should they need it. However, despite signs of sustainable economic growth, both are finding it difficult to escape the gravitational pull of low inflation, which hasn't been helped by the deflationary impact of the oil supply shock. Other countries are being sucked in, particularly those export-led nations that suffer from both from weaker global demand and a de facto strengthening of their currency (and thus less competitively-priced exports) when those around them cut rates. The ECB is under even greater pressure to revive growth and inflation before the US transitions through this cycle into its next rate-cutting downturn.

MAGNETIC PULL OF EASING



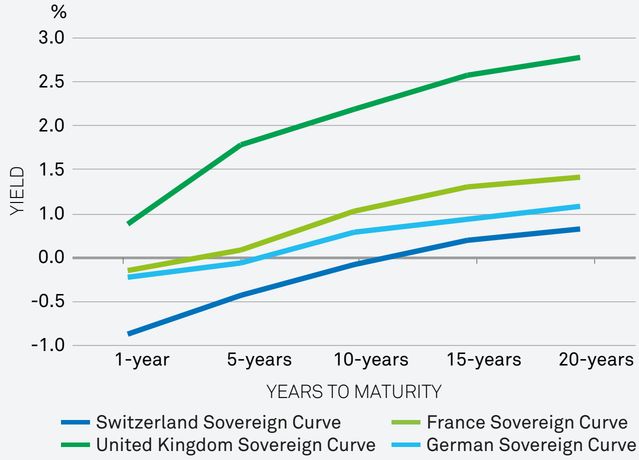
Source: BlackRock, March 2015. Note: for illustrative purposes only.

The reality of negative yields

It is becoming hard to keep track of the number of central banks that have eased in 2015. At the time of writing, it stands at a staggering 20. Unexpected rate cuts and unconventional monetary policy measures have become the norm. So worried are the world's central banks about the downward spiral of deflation (and the relative strength of their currencies) they are pushing further into uncharted territory: negative rates and negative yields are commonplace.

On February 25, Germany auctioned off five-year government bonds at a negative yield for the first time in history, following a similar move by Finland a few weeks earlier. The five-year yields of Finnish, Dutch and Austrian bonds are now all negative, as are those issued by the European Financial Stability Facility. Further along the maturity curve, the 10-year yields of Ireland, Slovakia, France, Belgium, Austria, the Netherlands, Finland and Germany are all below 1%. Outside the eurozone, Denmark and Switzerland also have negative five-year yields. UK 5-year treasuries are at less than 1%, with UK 10-year bonds at below 2%. JPMorgan estimates that the universe of negative-yielding European bonds now totals $2tn, an increase from $20bn in less than a year.

GOVERNMENT BOND YIELD CURVES



Source: Bloomberg, March 2015.

Even in the corporate world, yields have turned negative: Nestle's €500m bond maturing in October 2016 slipped below zero in January. US companies, attracted by the potential for low borrowing costs, are flocking to European debt capital markets to raise funds, taking advantage of yield-starved investors. The world has been turned upside down[2].

ACCEPTING A GUARANTEED LOSS

Why would any investor accept negative rates – a guaranteed loss? Some may be cautious about the economic outlook, prepared to accept a loss for downside protection. Some may be anticipating sustained deflation: a negative nominal yield could still deliver a positive yield in inflation-adjusted terms. Others may be attempting to second-guess central banks: if you were holding Swiss bonds before the Swiss National Bank removed its minimum exchange rate floor against the euro, you would have made significant currency gains. There could be similar relative value trades to be made in the future.

For many institutional investors, regulation means there is no option: they have to hold high-quality liquid assets. In Europe, the ECB's QE programme is not helping matters, scooping up many of these assets and driving yields still lower. Combined with regulatory pressure on the amount of inventory that dealers can hold, such wide-scale purchase programmes across the globe have created an asset-supply problem. Illiquidity exasperates bouts of volatility brought about by central bank surprises.

2 Bloomberg, March 2015

Policy and uncertainty reign supreme

Central bank monetary policy looks set to remain the key driver of fixed income markets for years to come, but it is becoming increasingly difficult to anticipate the banks' actions. For instance, even though ECB QE was widely-anticipated, the scope and scale of the programme surprised – and it's worth remembering that as recently as November 2014 the talk was of the legal and political impediments that might prevent the ECB from undertaking QE.

What is certain is that global yields are going to stay low for a long time. This is not news for investors. However, the reality of negative yields and the omnipresence of central bank bond buyers may be fundamentally shifting the way we need to think about fixed income. Are investors worried about the theoretical loss in holding a bond to maturity if they know there will always be someone there to buy it? How can investors protect themselves against uncertainty in a world that was once thought of as a safe haven?

Fixed income markets are beset with uncertainty and the potential for volatility shocks. We know interest rates will start to rise but we don't know when, how fast or how high they'll reach. All this is likely to create challenges for fixed income investors, particularly traditional long-only benchmarked strategies that are already struggling to generate meaningful returns in the low-rate environment.

> "Finding yield in this environment requires investing more broadly across countries and regions... going deeper into capital structures and allocating more broadly to non-conventional fixed income products..."

Beating today's bond challenges

One way of navigating today's fixed income markets is to be flexible. With no guarantees about how and when central banks will act, investors need to be alert enough to pick up any signals and agile enough to respond quickly and appropriately to developments as they occur. However, a flexible fixed income strategy alone may not bring the returns investors require if all the bonds they buy offer negative or very low yields. And, as already shown, a large chunk of the conventional bond universe currently falls into this category.

> "The reality of negative yields and the omnipresence of central bank bond buyers may be fundamentally shifting the way we need to think about fixed income."

Finding yield in this environment requires investing more broadly across countries and regions, for example incorporating more of Asia and the emerging markets. It also means going deeper into capital structures and allocating more broadly to non-conventional fixed income products such as high yield, infrastructure, real estate and private market debt. In other words, it means adopting an approach that is unconstrained by traditional benchmarks as well as being flexible. As economies in Europe continue to recover, the US strengthens further and emerging markets increasingly diverge, the monetary and even fiscal policies of governments in these countries will spur interest rate differentials around the world. To benefit from this, investors need to adopt a global fixed income strategy that enables them to identify opportunities where and when they arise, but also utilises appropriate research analytics and risk management techniques to help them understand how the individual components of a bond portfolio react against each other.

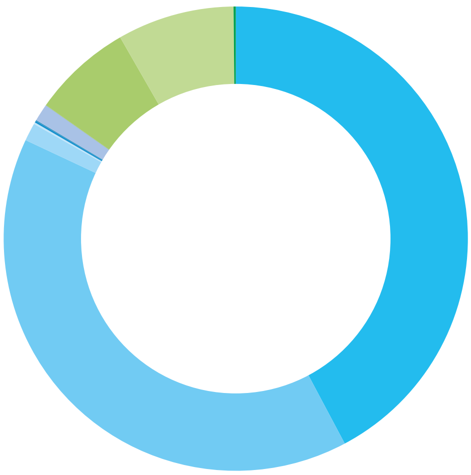
Be unconstrained

Adopting an unconstrained approach to fixed income means moving away from benchmark-constrained approaches. While there is nothing inherently wrong with using benchmarks, strategies that are tethered too closely to them can become too concentrated and lacking in flexibility. Traditional core bond strategies, for example, have for years tended to be heavily benchmarked to a market index such as the Barclays Global Aggregate Bond Index (the 'Agg'), which has become increasingly-dominated by interest rate-sensitive government and government-related issues (80% of the index's risk is concentrated in duration – the sensitivity of bond prices to interest rates). In 2013 the Agg lost 2.15% after posting an average annual return of 8.9% between 1981 and 2012. It then rebounded again last year. The difficulty of 'calling' the market with any precision during periods like this means that traditional bond strategies are ill-equipped to deliver the outcomes expected of them, which is why increasing numbers of investors are turning to flexible, unconstrained approaches.

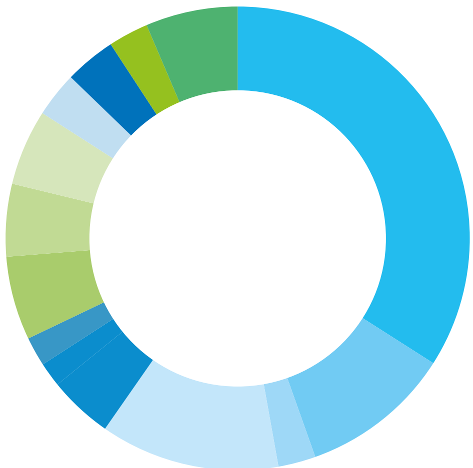
The extent to which a fixed income portfolio can move away from the benchmark will depend on the constraints under which the investor is operating. As noted above, many institutional investors face liability-matching responsibilities that prevent them from abandoning the benchmark entirely. But even for these investors, there remains considerable scope to reduce their reliance on the benchmark and 'free up' more of their portfolio to allocate to unconstrained strategies that are benchmark-agnostic, and seek to limit interest rate risk while adding alpha through diversification and access to a broader opportunity set. Unconstrained fixed income strategies can also eliminate interest rate risk by maintaining shorter (or even negative) duration than core bond funds – an important advantage when rates start to rise.

A flexible, unconstrained approach to fixed income can be enhanced by combining top-down and bottom-up decision-making, and employing both fundamental and quantitative investment strategies. However, it is not a simple strategy to implement and requires a great deal of trust in the investment manager. This is not a move that all investors could make in one step, which is why many are partially-adopting more flexible approaches while using beta tactically to 'fine-tune' their portfolio to achieve specific objectives. However, as the markets continue to remind us, bond portfolios tethered to a benchmark are ill-suited to a climate of persistently-low yields and increasingly unpredictable central banks. In such an environment, becoming more flexible and responding to change as it occurs while simultaneously moving away from the benchmark towards a broader mix of fixed income strategies could substantially increase your chances of achieving your portfolio objectives.

RISK ALLOCATION FOR BARCLAYS GLOBAL AGGREGATE BOND INDEX (EUR HEDGED)



RISK ALLOCATION FOR HYPOTHETICAL DIVERSIFIED FIXED INCOME PORTFOLIO



Duration	6.50
Yield*	1.62%
Risk	192bps

Duration	1.36
Yield*	2.02%
Risk	167bps

*Yield to Worst. All data as of 31 December 2014
Source: BlackRock Solutions (BRS) Ex-ante value-at-risk. (1 standard deviation) based on the BRS Portfolio Risk model average contribution to risk.

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*AUM as at 31 December 2014. † Source: Pensions & Investments as at 31 December 2013.

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