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FIXED INCOME STRATEGY • FEBRUARY 2019

Bonds are back

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Bonds are making a comeback. They have become a viable source of income, in our view, amid higher U.S. interest rates, a slowing but growing U.S. economy and a pause in the Federal Reserve's tightening cycle. We also like government bonds as portfolio shock absorbers as the risk of late-cycle volatility in the equity market grows. Our key points for fixed income are:

- **Themes**: A Fed on hold gives comfort to investors looking to move out of cash and money market funds in search of greater income – via longer-duration bonds and credit. Negative bond/equity correlations have returned and are likely here to stay, offering a powerful diversification tool in balancing risk and reward in portfolios.
- **Central banks**: We expect the Fed to avoid raising rates until the second half, after it pledged a more patient and data-dependent stance on policy. Is this a pause or peak of the Fed's tightening cycle? It depends on economic data in coming months, in particular inflation readings. We expect the European Central Bank to stay put on rates this year, and see its forward guidance as a focus for markets.
- **Growth and inflation**: We see U.S. growth slowing as the economic cycle moves into the late stage. Ongoing monetary policy support is vital to Europe's economy, we believe, while fiscal stimulus provides some cushion. We see China's economy regaining its footing in the first half on policy easing, putting a floor under the synchronized slowdown in emerging market growth. We see inflation below target in Europe and Japan, while price pressures in the U.S. look contained.
- **Risks**: We view the probability of a U.S. recession as low for 2019, though the odds are set to rise materially thereafter, as detailed in our 2019 Global investment outlook. Other risks include European fragmentation and an intensification of U.S.-China trade disputes. Read our analyses on these and other key risks on our BlackRock geopolitical risk dashboard.

Bond market summary

Rates	YTD total return	Yield	Credit	YTD total return	Yield
U.S. government bonds	0.44%	2.61%	U.S. investment grade	2.65%	3.91%
Short (1-5 years)	0.27%	2.52%	U.S. high yield	5.41%	6.74%
Intermediate (5-10 years)	0.47%	2.58%	Bank loans	3.21%	6.84%
Long (10+ years)	0.95%	2.96%	Securitized assets	1.15%	3.31%
U.S. inflation protected	1.25%	2.82%	Euro investment grade	0.96%	0.69%
Agency mortgages	0.68%	3.34%	Euro high yield	2.93%	4.82%
U.S. municipal bonds	1.05%	2.55%	Emerging markets	4.55%	6.27%
Global rates ex-U.S.	0.29%	0.85%	Asia fixed income	2.44%	4.78%

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 Feb. 15, 2019. 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 Bloomberg Barclays indexes for the remaining sectors. Yields are yields to worst, except U.S. bank loans (yield to maturity) and emerging markets (blended yield). Performance is measured in total returns and in U.S. dollars, except for the euro credit categories (euros). Indexes used are not intended to be indicative of any fund or strategy's performance.

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Fixed income views

Our views are from a U.S. dollar perspective over a three-month horizon. Views and comments are from a fixed income-only perspective, and may differ from whole-portfolio tactical views on fixed income in our Global weekly commentary. For example, we overweight U.S. credit and emerging market debt from a fixed income perspective because of their income potential. Yet we are neutral on these asset classes in a multi-asset context, where we prefer to take economic risk in equities.

Rates	View	Notes
U.S. government bonds	▲	We see modestly soft economic news, positive fixed income flows and a first-half pause in Fed rate hikes as supportive. The impact of Fed balance sheet reduction should be muted. The front end has the most appealing risk-adjusted income, but we favor going out on the curve on any material backup in yields. A negative correlation with risk assets makes Treasuries attractive portfolio diversifiers.
U.S. inflation protected	▲	The Fed has confirmed its intent to be patient with its next rate move and may let inflation temporarily breach its 2% target. Along with a slowing but growing economy, we believe this makes inflation-protected securities an attractive alternative to nominal bonds.
U.S. agency mortgages	▼	Current coupon mortgages look fully valued after strong performance in risk-adjusted terms. We see light overseas demand for the asset class in the short run, supporting our underweight.
U.S. municipal bonds	—	We prefer long-intermediate maturities for their attractive carry amid a steeper yield curve. We see supply-demand dynamics supporting the asset class in the near term as we expect new issuance to lag the total amount of debt that is called, refunded or matures.
Global rates ex-U.S.	▼	We steer away from most euro peripheral debt amid rising political risks, slowing economic momentum and fewer policy levers to counter any downturn. We see a no-deal Brexit as unlikely, but expect a bumpy road. We favor the British pound and underweight UK gilts in the medium term as a result.

Credit and other	View	Notes
U.S. investment grade	▲	Solid fundamentals are supportive, but late-cycle economic concerns pose a risk to valuations. We favor BBB-rated bonds and emphasize credit selection.
U.S. high yield	▲	We see generally healthy fundamentals, supportive supply-demand and reasonable valuations, and prefer bonds over loans. We like the asset class for its income potential.
U.S. bank loans	▼	Ample supply and reduced demand for floating-rate products dampen the outlook for bank loans. We see opportunities to separate the wheat from the chaff after a surge in issuance in the past few years.
U.S. securitized assets	▲	We like securitized assets for their income potential and stability. Credit selection is key, however, because of the diversity between and within the asset class' subsectors.
Euro investment grade	—	We are overall cautious on euro investment grade credit — but see attractive relative value and income potential in the BBB segment. Yields appear low on first glance but compare favorably when hedged back to the U.S. dollar, mainly because of interest rate differentials between the eurozone and U.S.
Euro high yield	—	We are neutral on European high yield but note significantly wider credit spreads versus equivalent U.S. peers. We like the relatively high yields for their income potential.
Emerging market debt	▲	Valuations are attractive despite the recent rally, and limited issuance in recent months is supportive. A pause in U.S. monetary policy tightening and U.S. dollar strength remove a key drag on performance. Clear risks include deteriorating U.S.-China relations and slower global growth.
Asia fixed income	▲	Easing U.S.-China trade tensions would increase the appeal of the Chinese yuan. A focus on quality is prudent in credit. We favor investment grade in India, China and parts of the Middle East, and high yield in Indonesia and in Chinese real estate.

▲ Overweight — Neutral ▼ Underweight

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