

The Deflationary Impact of Inflationary Forces: Or, Why The Back Half of 2011 May Be More of a Wild Ride

Fixed Income Market Outlook

Highlights

- ▶ Economic data has continued to disappoint in recent months, however we think the recovery should persist.
- ▶ Still, the commodity price spikes witnessed in recent months present a danger to a recovery in consumer spending and the recovery more generally.
- ▶ This economic climate, and the uncertainty surrounding the end of QE2, should create added volatility for markets and will likely constrain liquidity for some asset classes.
- ▶ Nevertheless, disruptions of this kind present opportunities for patient investors who can take advantage of tumultuous markets to provide a bid at advantageous levels.

The Economic Recovery Faces Considerable Headwinds, Yet Modest Growth Should Persist

Significant structural headwinds are on display in various data series (such as those representing labor and housing markets), and the recovery can at best be characterized as sub-par. That said, we also think the economic recovery will likely avoid a “double dip” recession, as continued monetary policy support should keep short-term rates pegged at historic lows and longer-term rates should also remain at reasonably low levels for some time. Still, while some of the data has been very weak, we would argue that there is potential for the corporate sector to reinvigorate the recovery through capital expenditures. To take the lead in supporting the recovery, corporations require an environment exhibiting less economic and political uncertainty, which has clearly been inhibiting growth. Moreover, since much of the pre-crisis boom was driven by systemic debt growth and the build-out of capacity to support that growth, which we do not think is coming back, the economy will not be aided by mean reversion in credit creation, as some have hoped for.

Beyond the high unemployment rate, the sluggishness exhibited by labor markets is expressed in the recent spike in, and stubbornly high level of, weekly unemployment claims data. In fact, weekly claims remained roughly 50k higher in May than when at trough levels around the turn of the year, and unlike the April spike in this data series, the most recent elevated readings appear to be free of seasonal or one-off adjustments that cloud results. Additionally, we have also seen downward revisions to previous payroll estimates; while average hours worked by employees has remained stable and hourly earnings have edged higher. Also, small businesses, which are one of the main engines of job creation comprising roughly two-thirds of total hiring activity and virtually all the net new job creation, have not shown much of a willingness to take on added employees.

Overall, the labor market data has continued to look quite weak for this point in an economic recovery. As we have discussed extensively before, these stresses are not shared evenly across the demographic spectrum, but rather have resulted in a bifurcated consumer base and economic recovery. In fact, when looking at the most recent data, the unemployment levels suffered by younger workers as well as by those workers with lower levels of education are dramatically higher than the levels of older and more highly



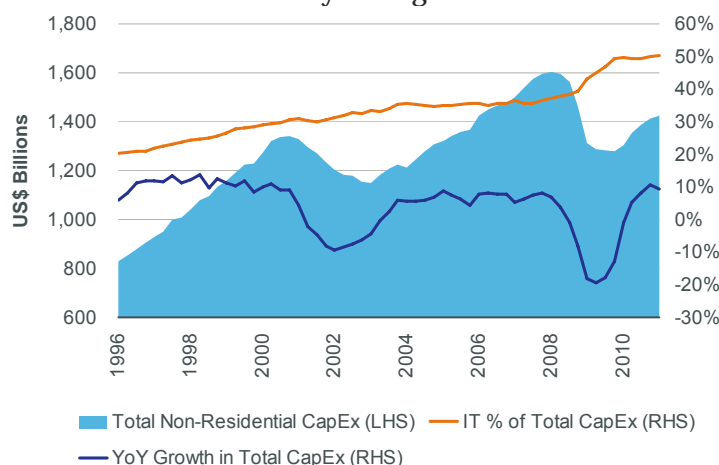
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educated worker cohorts. Moreover, improvement has not meaningfully come to lower- and middle-income workers through monetary policy-inspired asset price appreciation, as workers in these demographic groups tend to have relatively low levels of financial assets, and housing (where much of their net worth has historically been stored) has remained mired in stagnation.

The housing sectors' long list of woes are well known, as home sales remain weak despite the extraordinary price declines witnessed in recent years as well as near record lows in mortgage rates. Elsewhere, we have estimated that the nearly two million unit housing stock overhang will take nearly seven years to work off before we might see meaningful home price appreciation beyond the rate of inflation. The sluggish labor market and tighter credit conditions have resulted in a decline in household formations, weighing on demand for housing, which has contributed to the excess housing inventory. In fact, relative to the pre-crisis trend in household formation, we now see an approximate 3.6 million fewer households than otherwise would be the case had the pre-crisis trend not been disrupted. The upshot for consumption is that unlike prior to the crisis when housing equity was often utilized to fuel excess purchases, this process has come to a halt and a multi-year consumer deleveraging trend has begun.

Finally, while it is clear that spending from both the consumer and governmental sectors will be constrained for some time, as these segments of the economy reduce leverage levels, the corporate sector appears to be in fantastic financial shape and holds the potential to sustain and improve the recovery. Corporations can both utilize the massive cash balances on their balance sheets (the largest aggregate levels in history) for capital expenditures, as well as draw on unutilized borrowing potential (commercial and industrial loan levels could grow substantially for this purpose). Current capital expenditure spending is close to where it was 11 years ago (see Figure 1),

Figure 1: Total US Non-Residential Investment is close to where it was 11 years ago



Source: Bureau of Labor Statistics, Federal Reserve, CapIQ; data through 1 March 2011

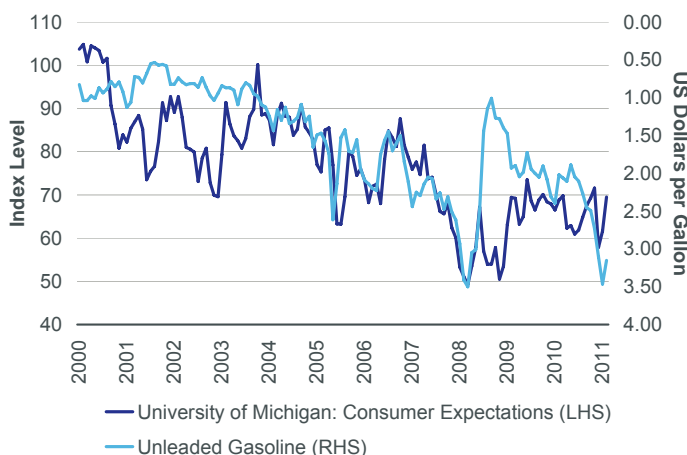
and businesses have increasingly spent their marginal capex dollars on information technology and processing software and equipment, which improves productivity but does not help much in the way of employment (it can, in fact, delay hiring plans for companies). Thus, the US economy very much needs a material increase in manufacturing capex, which could bolster the declines recently seen in ISM Manufacturing Index numbers and continue to support what has been an unexpected, but quite encouraging, resurgence in the manufacturing sector.

The Deflationary Impact of Inflationary Forces in the Current Economic Climate

As commodity prices have spiked across the board over the past several months the U.S. consumer has raised its expectations of future inflation, current realized inflation increased somewhat, and consumer spending (particularly in lower- to middle-income groups) has remained under pressure, which is why we think certain aspects of inflation can have a deflationary impact on the economy. This dynamic has hampered economic growth prospects for the entire economy, forcing net disposable income down, reducing potential consumption, compressing some corporations' margins, dulling corporate confidence, and consequently hampering the potential for wage growth and labor market recovery.

Consumer expectations indices in the US closely tracked the prices that auto drivers paid at the pump (see Figure 2), such that as gasoline prices increased, consumer expectations for the economy's performance declined. Additionally, according to some data, bearish investor sentiment increases along with gasoline prices, suggesting that this phenomenon holds implications both for consumer spending and for financial asset demand dynamics. Moreover, roughly parallel to the recent spike in commodity prices, we have seen a significant downward

Figure 2: Consumer Expectations are inversely related to Gasoline Prices



Source: Bloomberg, University of Michigan and Thomson Reuters, Energy Information Administration; data through 31 May 2011

trend in the Citigroup Economic Surprise Index, with the implication that on average recent economic data has been dramatically lagging consensus estimates. Indeed, this index last touched its recent lows during the heights of the financial crisis in 2008, and its decline over the past three months has been the largest in the history of the series, illustrating a profound disconnect between analyst expectations and announced data.

The dynamics described above have resulted in a precarious balancing act for the US consumer. Several headwinds are present to the drivers of consumption, and it is likely that commodity inflation crowds out other spending, resulting in a zero sum game, especially as wages and wealth changes remain modest. Thus, we think markets are now pricing in the economic impact from higher commodity prices (primarily fuel) as actually deflationary in nature. With many cyclical and structural/secular elements that factor into consumer spending showing negative trends (high unemployment, a negative wealth effect from housing asset depreciation, and the need for continued consumer deleveraging, among others), a significant change in price for required commodities, such as gasoline, can have an outsized impact on consumer spending power and perception, particularly at low- and middle-income segments of the population. Also, while true consumer spending represents only about two-thirds of the consumption portion of GDP, this is still a vitally important factor to overall economic growth.

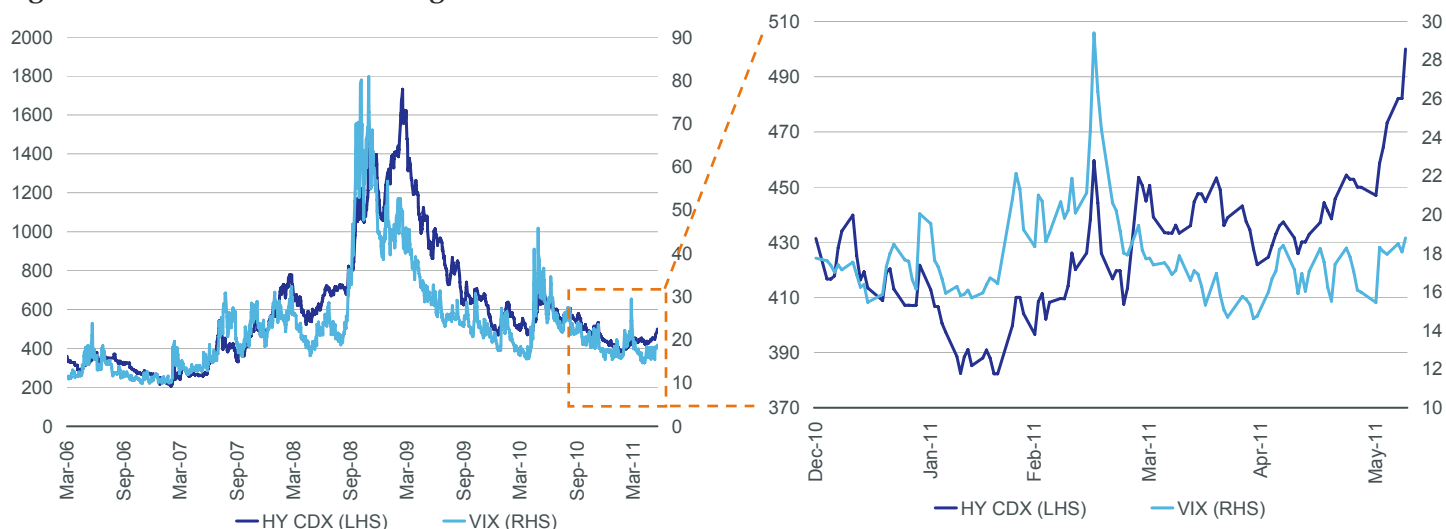
With consumer spending constrained by the factors above, we have argued that economic growth levels will remain capped, yet positive, and that further corporate capital expenditures are required to improve recovery prospects. We think that the corporate sector is due for a significant capex spending cycle, and that some of the factors that have impacted corporate confidence and impeded the recovery are transitory, raising the prospect that this spending could eventually occur.

Rising Volatility, Declining Liquidity: The Economic Backdrop and The End of QE2

What does this economic backdrop, when combined with the June 30 end of the Federal Reserve's QE2 asset purchase program, mean for markets? Ultimately, we think the end of QE2 in the US, as well as the tightening of credit and money supply growth in several key emerging markets nations (such as China and India) will test market resilience, which has benefitted greatly from monetary policy-induced liquidity provision in recent years. The importance of this liquidity provision for both the financial markets and the recovery of the underlying economy should not be understated, and we think increased market volatility and more limited liquidity in certain asset classes will likely be the end result.

In anticipation of these volatility and liquidity issues, and due to surprisingly weak economic data, renewed sovereign debt fears in Europe, and policy uncertainty in the US, we have witnessed a decrease in investment conviction as the second quarter unfolded. Fears over these uncertainties resulted in anemic daily volumes on the NYSE through the second quarter, as well as a modest rise in realized equity volatility, as measured by the VIX Index, in a pattern reminiscent of the troubled summer of 2010. Further, while we have argued that technical factors are highly supportive of fixed income asset prices over a longer time horizon, there is little doubt that governmental attempts to dispose of assets taken on during the height of the financial crisis have also added to the uncertainty and volatility of the marketplace. In the non-agency mortgage space, for instance, the Maiden Lane auctions have contributed some short-term supply to the market, and the Treasury has been selling off its MBS portfolio as well. These factors are clearly pressuring fixed income returns, especially in risk assets, where excess returns versus comparable Treasuries are in some sectors not much above flat for the year.

Figure 3: Correlation between High Yield CDX and VIX Index has declined



The added volatility, which we expect could intensify and continue for some time, combined with market uncertainty, has caused some tangible market aberrations. For example, the correlation between high yield spreads and implied equity volatility has declined (see Figure 3), which we argue is due to the credit markets anticipating a tougher liquidity and higher volatility paradigm with QE2 ending.

Buying Opportunities Exist As a Structural Bid for Fixed Income Assets Remains

In the end, many of the fixed income sectors that have suffered poor performance over the past few months (largely due to the liquidity/volatility dynamic discussed previously) are still in fundamentally solid shape. The end of QE2, government asset dispositions, and the heated political rhetoric over the debt ceiling have resulted in some of these disappointing results, however this also has opened some interesting buying opportunities, particularly from a yield/carry perspective.

As a result, on a near-term tactical basis, investors would do well to consider Agency MBS and secure ABS positions to maintain portfolio liquidity and as a source of high-quality spread allowing for the capture of roll-down return, given continued yield curve steepness. At the same time, riskier sectors, such as CMBS, present solid longer-term opportunities for selective purchase from distressed sellers in the current "risk off" trading climate.

Also, while investors need to be cautious in this environment, as they will witness added volatility, long-term opportunities can be found in high yield credit sectors as well, as spreads have widened although many corporations have improved fundamentals, have termed out debt, and default rates remain near historic lows. Also, in the near-term we have continued to witness a strong bid for Treasuries, surprising many market observers who expected rates to march higher by mid-year. We think Treasuries will continue to see some solid support from various buyer bases, as we discussed last month, however as market volatility is reduced and some of the sources of market uncertainty abate, yields should back up moderately.

Finally, as we have argued for some time, a structural market bid will continue to broadly support fixed income asset markets, and will place an upside cap on rates movements. There are highly favorable technical factors supporting demand for fixed income assets in the US, and indeed in much of the developed world, while at the same time the need to deleverage in these countries will present a profound imbalance between the need for yielding assets and its supply (see Figure 4). Natural market demand from institutional investors (insurance companies and pension funds), as well as what we have termed captive capital practices, or "financial repression," in the banking sector, will combine with the requirements of individuals in an aging population to provide a strong bid for bonds for some time to come.

Figure 4: Fixed Income Sector Net Issuance Levels in Decline

	Treasuries	US Agencies	Agency MBS	IG Non-Fin Corps	IG Financial Corps	HY Corporates	ABS	Build America Bonds	Total
2000	(314)	234	200	166	129	16	129	-	560
2001	16	304	339	278	131	69	137	-	1,273
2002	237	220	327	52	129	116	148	-	1,229
2003	370	249	185	124	201	28	123	-	1,280
2004	369	74	41	108	240	(33)	306	-	1,105
2005	222	(85)	164	25	107	30	298	-	763
2006	157	18	293	218	164	(2)	593	-	1,440
2007	194	272	623	299	292	12	246	-	1,939
2008	1,257	304	497	165	52	40	(342)	-	1,973
2009	1,447	(475)	415	290	266	92	(477)	48	1,605
2010	1,580	17	(59)	247	232	219	(424)	117	1,929
2011	1,255	(158)	24	332	35	60	(326)	-	1,222
2012	1,050	(160)	59	255	50	65	(266)	-	1,053
2013	765	(141)	59	260	80	80	(187)	-	916

Source: JP Morgan; data as of June 2011

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.

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