

Corporate Sector Strength Undergirds the Recovery's Prospects and Serves as a New Benchmark of Value

Fixed Income Market Outlook

Highlights

- ▶ As labor markets slowly improve, and risks to continued monetary policy accommodation rise, the Federal Reserve (Fed) will increasingly be challenged to balance its dual mandate.
- ▶ The continued need for consumer deleveraging, newfound governmental austerity, and eventual rolling back of monetary policy stimulus will all present headwinds to growth, but we look to the corporate sector for possible systemic support.
- ▶ In fact, corporate sector credit characteristics have improved so markedly, a qualitative shift in how the sector should be perceived is taking place, resulting in a potential new standard for valuations.
- ▶ Unlike other market observers, we do not see a high likelihood for a dramatic spike in rates on the horizon, but they should rise gradually, and spread sector assets should continue to perform.

The Challenge of Serving Two Masters: Should the Fed Find More Balance in its Dual Mandate?

As we have pointed out previously, the Fed has recently faced an increased challenge in navigating a monetary policy intended to serve dual mandates; that of price stability and of full employment. Specifically, last month we drew attention to the fact that the economic recovery has not been experienced evenly across the US labor market and consumer base, with lower and middle income workers' fortunes recovering at a decidedly slower pace than those at the higher end of the income spectrum. There are several reasons for this phenomenon, but an important one has been the dramatic risk asset price rally seen over the past two years.

That market recovery, resulting largely from two rounds of Fed quantitative easing and monetary accommodation, created a real "wealth effect" for higher income groups, while low and middle income groups struggled disproportionately with high unemployment levels and recently with rising prices. In fact, total household financial assets have almost retaken their pre-crisis high watermark of nearly \$50 trillion, yet real estate values (where many middle income workers hold a significant portion of their net worth) remain mired in stagnation. Thus, those members of society without significant amounts of investable assets were left behind. Additionally, even after a decade of extended periods of extraordinarily easy Fed monetary policy (including the QE programs), little has been done in the way of enhancing real levels of personal income. That said, we have now seen several months of data that suggest that genuine and broad-based economic improvement is taking place, even in labor markets.

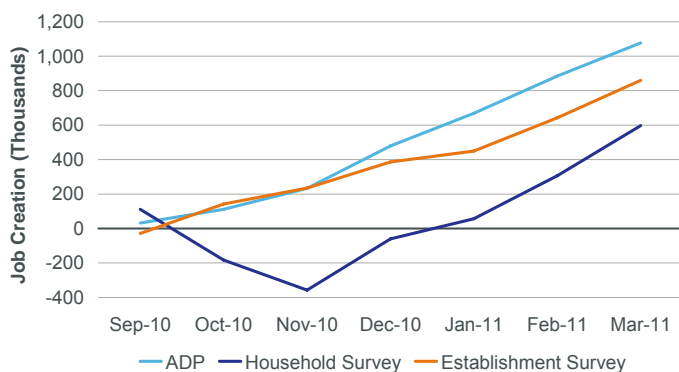
While we have been skeptical of the potential for meaningful job growth, given the many structural headwinds facing labor markets today, near-term economic data (particularly in the manufacturing sector) has been strong and improvement may continue. Regardless of the labor market data source looked to (see Figure 1), we have seen decent gains in cumulative job creation since late 2010, yet the US labor market recovery is still in its early stages. Additionally, Fed Chairman Bernanke has made it abundantly clear that



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monetary policy is set solely with regard to domestic economic considerations, and not with reference to externalities outside the U.S. (such as excess liquidity-inspired inflation produced abroad). The interconnected nature of the global economy today, however, makes such a distinction problematic. Indeed, as we have argued over the past few months, global dynamics of disequilibrium have contributed to the importation of inflation into the developed world from developing countries. As a result, the inflation rate has been edging higher in the U.S., and that rise has been particularly pronounced in the fuel and food segments of CPI, which again heavily impacts low and middle income workers.

Figure 1: Cumulative Job Creation since September 2010 - A Comparison of the Three Major Surveys



Source: ADP, Office for National Statistics, Bureau of Labor Statistics, Bloomberg; data as of 31 March 2011

Fed policymakers thus find themselves in something of a double bind, whereby, on the one hand, they seek to retain sufficiently accommodative policy to support labor market recovery and modestly lift inflation expectations, but on the other hand, they cannot allow inflation risks/expectations to become excessive, thereby injuring the broader recovery. This tension has become increasingly evident in the public commentary made by various Fed officials, underscoring the fact that policy direction has become less clear in recent weeks. We think it likely that the time has come to begin backing away from the unprecedented levels of policy stimulus the Fed has introduced in recent years, and despite the uncertainties that exist for a post-QE2 world, it would appear that this will begin to occur after the 30 June 2011 endpoint of the asset purchase program.

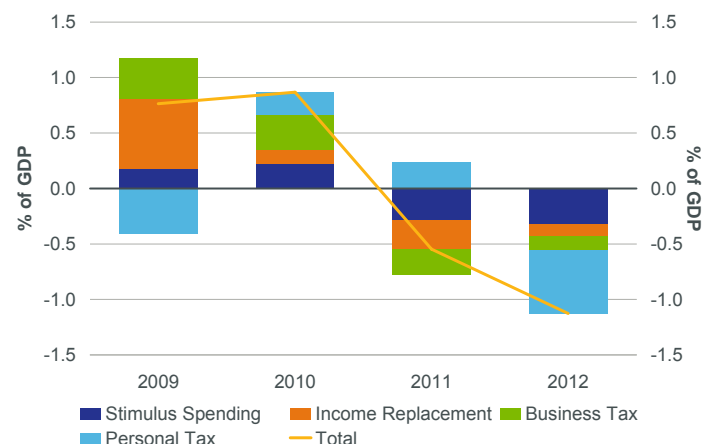
Policy Uncertainty, Deleveraging, and Fiscal Restraint Remain Headwinds: Is the Corporate Sector the Key to the Recovery?

Beyond monetary policy uncertainty, other factors continue to present challenges for a robust recovery of the US economy, such as the continued need for both consumer and governmental sector deleveraging and an increased sense of fiscal prudence at all levels of government. We have long discussed the

deleveraging trends that began in the wake of the financial crisis, which largely remain in place today, and in our view serve to bound growth prospects for years to come. In short, the financial crisis rescue measures of recent years essentially involved a shifting of leverage from corporate and household balance sheets to that of the public sector. The debate now centers on the sustainability of developed market sovereign debt levels. It is vital to understand, however, that this problem was not generated as a result of the financial crisis (although the crisis made it worse and helped bring it to light), but rather it has been building over the past few decades. For example, from 1975 to 2010 total US credit market debt expanded almost twenty-fold while US nominal GDP grew about 7.5 times over that period. While much of this debt growth was centered on increased financial sector leverage and rapidly expanding consumer credit growth, both these sectors have seen net credit contraction over the past two years, and the government sector has instead seen its debt level expand dramatically. We think a system-wide deleveraging needs to continue, as leverage in the economy overall remains dangerously elevated, and bringing it down will enhance private sector confidence and will eventually spur true economic growth.

That said, these trends may take some time to turn and absent a truly exceptional government policy shift, public debt levels will likely continue to rise for the foreseeable future. However, on the fiscal front we are already witnessing significant restraint at all levels of government. Clearly, some of this has been forced on governments struggling under lower tax receipt levels, but even more importantly, since the mid-term elections last November political tides have decidedly turned against increased government spending. Whether or not decreased government spending is economically preferable longer-term is a separate issue, but we think there is compelling evidence suggesting it could present a drag on GDP growth in the years ahead (see Figure 2).

Figure 2: The Turn Toward Fiscal Restraint has Begun - Discretionary Change in Federal Taxes & Spending



Source: GS Global and ECS Research; data as of 4 April 2011

With headwinds to economic growth resulting from the need to continue deleveraging, from restrained government spending, and perhaps most importantly, from the eventual rolling back of central bank monetary accommodation, where should we look to for possible systemic support? The answer in our view must reside in the corporate sector, which has profoundly strengthened its financial position over the past few years. For instance, the net debt/equity ratio of S&P 500 companies (ex-financials) has dropped precipitously over the past decade from more than 90% around January 2000 to less than 45% today. Moreover, even firms that reside in the below investment grade credit ratings range currently operate with leverage levels close to historical lows. When this is combined with recent debt refinancings and solid cash flow characteristics, the result has been very low levels of high yield company defaults. Additionally, momentum in the changes to credit ratings has shifted in the favor of corporations, with ratings upgrade to downgrade ratios improving dramatically over the past year. In a fascinating turn of events, the corporate sector is thriving in an environment where the economy overall is not. We think that corporate strength (and resilience to possible stresses) has to now transition to become the system-wide economic driver for a truly organic economic recovery to take hold.

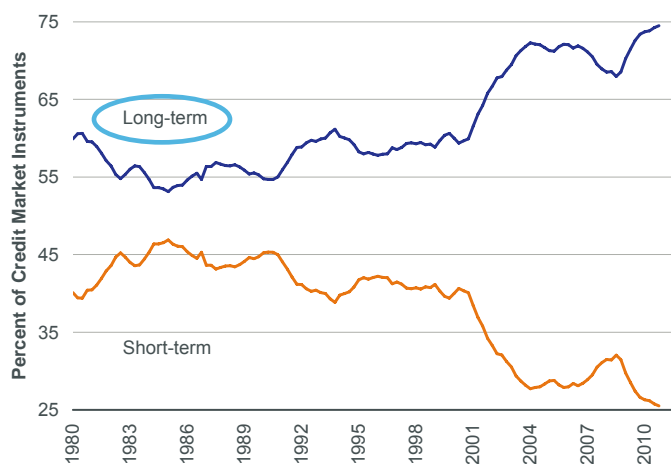
The Corporate Sector Assumption of the Mantle of Leadership: Reconsidering the Risk-Free Rate

As we have argued, we think the economy is at an inflection point around which private sector demand could replace public sector stimulus as the main driver of growth. The ability for capital expenditure investment exists in the corporate sector, as the ratio of companies' liquid assets relative to total assets is near a 50-year high (for non-financial firms), but the real question

involves a willingness to spend. Moreover, should business confidence improve over the short- to medium-term, perceived economic stability would eventually lead to demand for credit and further investment. As it stands, total bank credit began declining in November 2010. We expect this trend to continue unless corporate leaders gain the confidence required to borrow and invest in an effort to improve firm returns on equity. Historically, when the Fed was successful in increasing long-term inflation expectations, it led to an increase in the velocity of money. In this cycle, however, the velocity of money has not risen appreciably yet, in part due to the uncertainty created by the previously discussed bifurcations in the economy as well as the shifting regulatory environment for banks.

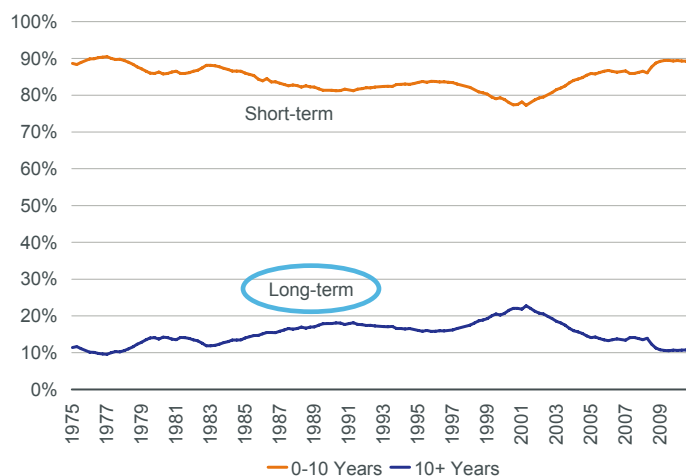
We believe the potential for corporate sector leadership is tremendous. We think the credit characteristics seen in the sector today signify a qualitative shift in how this segment of the credit markets should be perceived. Not only have overall leverage levels been brought down, but perhaps even more importantly, the term structure of corporate sector debt is much more favorable than that of government debt (see Figures 3 and 4). This raises the question of whether sovereign debt, long thought the "risk-free rate" upon which virtually all other asset valuation determinations would begin, is beginning to cede the role of the risk-free rate to other regions of the debt markets, and to the corporate sector in particular. We believe that this is already beginning to take place and that corporate benchmarks are increasingly being viewed as a "risk-free(r) rate" upon which valuation can be better judged. (An extensive discussion of BlackRock's views on the shifting character of sovereign debt markets can be found in the following paper: *Sovereign Bonds: Reassessing The Risk-Free Rate* on www.blackrock.com).

Figure 3: Corporations Protect Themselves from Future Fed Tightening - Nonfinancial Corporations



Source: US Treasury; data as of 31 December 2010

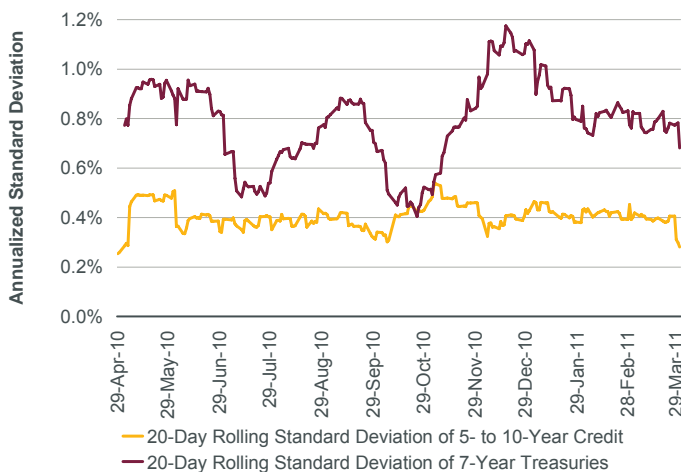
Figure 4: Treasury's Funding Structure Looks Less Risk-Free Than Corporates - Marketable US Treasury Debt (excluding TIPS)



Source: US Treasury; data as of 28 February 2011

Another reason this transition increasingly makes sense is due to volatility differentials between Treasury and corporate yield curves (see Figure 5). Over the past year Treasury yields have exhibited considerably higher levels of standard deviation than those of corporates, and are likely to continue doing so as long as Fed policy holds its distorting effect this markets. In a sense, recent Fed policy has held a profoundly distorting effect on all asset markets, but investment-grade credit: with lower leverage levels, lower yield volatility, a more favorable funding structure, greater financial flexibility, and less of a direct policy impact, is looking like a proxy to consider when evaluating fixed income assets today.

Figure 5: Average Volatility of Treasuries vs. Corporates



Source: Barclays Capital Live; data as of 31 March 2011

Rates Risk and Investment Implications

While we do not foresee a dramatic spike in rates on the horizon, it is likely that we will see gradually higher rate levels in the months ahead. As we described last month, we expect a slow grinding higher of yield levels and we would not be surprised to see the ten-year Treasury yield near 4% at year end. If rates were to move significantly higher, alongside inflation or otherwise, this could present a significant challenge to the strength of the underlying economy. That said, we have considerably greater confidence that investment grade corporate issuers, and even some high yield firms, will prove resilient. In fact, we estimate the EBITDA/interest coverage ratio for firms included in the S&P 500 Index in 2010 at 12.2 times. Even if corporate rates rose 200 basis points, that interest coverage ratio would still be 8.7 times (not that far off the 9.1 times average of the past 20 years). We question the ability of other segments of the economy (such as the government and consumer sectors) to withstand correspondingly higher rates as well as the corporate sector appears to be able to at this time.

Even as monetary and fiscal policy slowly shifts from being a tremendous tailwind to risk assets, we think favorable supply/demand technicals and a persistent global demand for yield will continue to support selected spread assets. We think that investors can generate solid results from certain spread sector asset classes with decent embedded yields, particularly at the shorter end of the yield curve. We also think increasing liquidity in portfolios makes sense at this time and take into consideration the price that we pay for this liquidity off a newly adapted "risk-free" rate centered on the corporate curve.

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. Investments in non-investment-grade debt securities ("high yield" or "junk" bonds) may be subject to greater market fluctuations and risk of default or loss of income and principal than securities in higher rating categories. Index performance is shown for illustrative purposes only. You cannot invest directly in an index.

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