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The End of QE2: A Structural Market Bid Will Trump Declining Fed Support

Fixed Income Market Outlook

Highlights

- The Federal Reserve's QE2 program supported risk asset prices, aided consumer confidence, and marginally helped labor markets, but as support rolls off we think growth will only be moderate.
- Debates regarding the nature of QE2's effectiveness hold important implications for understanding to what extent the program's scheduled termination is already priced into the market.
- While QE2 has certainly been a massive support to fixed income (and other) assets over the past several months, some dramatic characterizations of market functioning after its end are misguided. In the months and years ahead, it will become evident that a structurally embedded bid for yield should continue to support fixed income sectors even as government accommodation ends.
- Still, the end of QE2 will likely take its toll in the form of added market volatility and reduced liquidity levels, so we think an increasingly prudent stance on risk asset allocations and a focus on sensible carry trades should guide investors.

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Setting the Stage: The End of QE2 and What Comes Next for the Economy

The shorter- and longer-term movement of interest rates, and the volatility and rapidity of any change in rates as the Federal Reserve's most recent quantitative easing program rolls off at the end of June, has been the main focus of much market commentary in recent months, and here we again address the debate ourselves. We have been living through an extraordinary and historic macro cycle that has witnessed rates trend dramatically lower for a multi-decade period, despite taking some meaningful pauses along the way, such as in the middle of the past decade for an increasing leveraging cycle and subsequently higher rates that obviously ended poorly. We believe the question of the hour is where do interest rates move now, and we think the answer lies in how two fundamentally opposing forces- that of the eventual reduction of international monetary policy stimulus, on the one hand; and that of the structural bid for yield, on the other hand- reconcile themselves in the context of financial asset valuations.

Over the past few years this dramatic decline in yield levels has been heavily influenced by the extraordinary rescue measures enacted by the Fed, as well as by shifting economic growth prospects in the wake of the financial crisis that Fed measures were intended to respond to. Therefore, an examination of the current prospects for GDP growth, and its sustainability as governmental stimulus measures are pared back, is key for a better understanding of the pace of policy change and how that change might impact yield levels. When analyzing the trajectory of GDP and its components over the past few quarters, top-line growth has been slow, and this has likely been a disappointment to policy makers given the aggressive stimulus introduced to the economy.

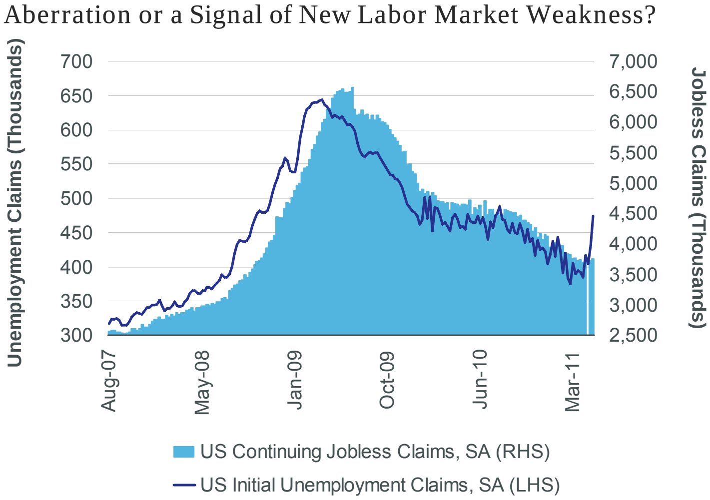
Still, successive quantitative easing programs have generally succeeded in elevating asset prices, which has both helped repair consumer wealth levels damaged during the financial crisis, and consequentially has also aided personal consumption, as the Fed

The views expressed are those of Rick Rieder, Chief Investment Officer of Fixed Income, Fundamental Portfolios as of May 2011 and may change as subsequent conditions vary.

hoped would occur. In fact, with 71% of GDP still driven by personal consumption activity, and real incomes effectively stagnant through this period, this "wealth effect" has been a key driver of the steady post-crisis contribution to growth from the consumer sector. Moreover, while Federal government sector spending is expected to slow with the new tide of fiscal austerity being pursued, given the size of current deficits, it should remain a positive contributor to GDP growth in 2011. It is difficult, however, to envision much help to growth from net exports (despite the tailwind provided from US dollar decline), as elevated commodity prices, and particularly oil, should limit improvements to the trade balance. Finally, as we argued extensively in last month's *Fixed Income Market Outlook*, it is the corporate sector that displays the greatest degree of financial strength currently and it is from this segment of the economy that we expect solid contributions to growth.

That said, the transitioning of the economy from a heavily government-supported framework to one in which we see truly organic economic growth also has to involve considerable support from the consumer, a segment of the economy still facing serious headwinds. In particular, while we have seen labor markets exhibiting signs of improvement, the recent spike up in initial claims for unemployment (see Figure 1) is unsettling. Also, both actual changes in average weekly earnings and expectations for wage inflation remain flat, muting hopes for much of an increase in disposable incomes to spur consumption, which is vital given the consumers' lack of ability to take on much leverage at this point. Taken altogether, we think these various factors should result in very moderate GDP growth (near 2% to 3%), and with continued stress on labor markets, we think the Fed will likely keep policy rates low for awhile yet, while it allows QE2 to roll off with little prospect for any further quantitative easing.

Figure 1: Weekly Claims Data - Are Spiking Claims an Aberration or a Signal of New Labor Market Weakness?



Source: Bloomberg; data as of 29 April 2011

The Impact of QE2 and the "Stock versus Flow" Debate

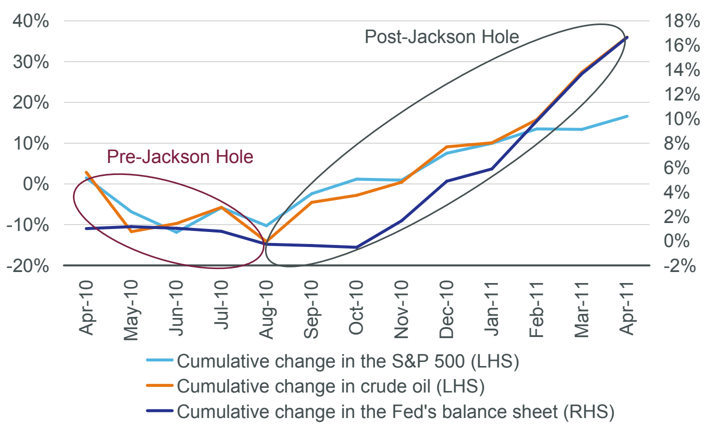
In its attempt to jump-start economic growth, the Fed has not only maintained historically low rate levels with its target rate, but it has also engaged in two rounds of large scale asset purchases, commonly referred to as quantitative easing, in an attempt to introduce liquidity into the financial system and support asset prices of all kinds. While in many ways we think these efforts have clearly been successful, as witnessed by a two year risk asset rally, we have recently begun to argue that the externalities that have begun to emerge from the policy (such as a weaker dollar, higher commodity prices, as well as the higher realized and expected inflation levels that stem from these price gains), may have started to become counterproductive.

As mentioned, the massive addition of liquidity to the financial system has clearly had a beneficial impact on asset prices, but due to the bifurcated nature of our economy and consumer sector (which we have discussed extensively in the past) this positive effect has not accrued to economic actors evenly. This is particularly the case for lower and middle income segments of the population that have not fully participated in asset price reinflation, largely due to a relative lack of financial assets held, as well as the fact that the housing sector, where much of the middle classes' net worth resides, remains mired in stagnation. Moreover, the durability of asset price gains is an open question, and some investors expect to see market declines in the back half of the year (our view will be touched on shortly). In the end though, we think it is reasonable to assume that long-term policy goals should include not only an appreciation of financial assets, but also a depreciation of hard assets (or, modest increases relative to changes in personal income). The former goal would lead to wealth creation while the latter would enhance or maintain purchasing power, but the reality is that over the past decade the exact opposite has occurred. We think it is time for the Fed to begin backing away from the unprecedented levels of policy stimulus it has introduced in recent years, but as QE2 approaches its scheduled conclusion, the impact this will have on asset prices and the economy becomes vital to understand.

A debate between market commentators, policy makers, and academics has unfolded over whether the influence of quantitative easing is primarily a function of the overall size of the Fed's balance sheet (the "stock" position) or a matter of changes to that balance sheet size (the "flow" perspective). During Fed Chairman Bernanke's recent press conference, he asserted that once QE2 is completed, accumulated monetary accommodation (at near $2.8 trillion) would nevertheless remain in full force since the size of the Fed's balance sheet would remain constant with coupon and maturity reinvestment. Thus, Bernanke argued, while accommodation will no longer be expanding, the Fed would remain more stimulative than at any time in history by virtue of its large and stable balance sheet, a classic argument for the importance of the stock of debt held. Ultimately, this argument would imply that the end of QE2 is already priced into the market, and indeed that it has been since the announcement was made of the size of the Fed's asset purchases in early November of last year.

In contrast, some empirical data on the relationship between the cumulative change in the Fed's balance sheet relative to the cumulative changes in certain asset prices, both before and after the first hints of QE2 at Bernanke's Jackson Hole, Wyoming, speech, argues for the importance of the flow perspective (see Figure 2). Still, regardless of the position one takes with regard to which aspect of quantitative easing produced its ultimate effectiveness (and it may be some combination of both), the fact remains that the US Treasury’s debt stock must continue to grow at an unprecedented pace just as the Fed stops growing its balance sheet; does this not constitute a de facto tightening?

Figure 2: The Fed's Balance Sheet and its Correlation with Asset Prices in the Aftermath of QE1



Source: JP Morgan; data as of 30 April 2011

A Structural Bid for Yield Represents a Profound Technical Tailwind

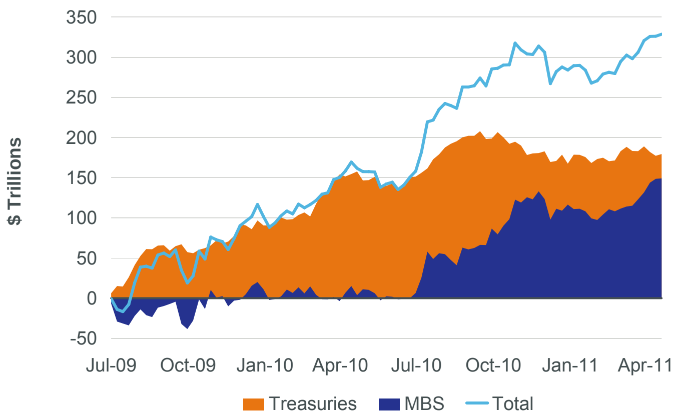
As QE2 comes to an end, and as other sources of Fed accommodation roll off in the coming months and years, this profound foundation of support for market liquidity and asset prices will either need to be supplanted, or yields and prices will have to reset to conform to the market's new reality. For instance, as we ask above, and as others have speculated on, should not the end of QE2 cause a rise in Treasury rates? We would suggest the tentative answer is: not as dramatically or as rapidly as many people seem to think. Moreover, the impact of this incredible market support goes well beyond the mere purchasing of Treasury debt, as the massive growth in global reserves that has followed on from QE has created a compounding effect which has buoyed all financial assets. Therefore, another vital question with the end of QE2 is how risk assets will behave. Ultimately, we think there are key, long-term, structural supports for fixed income assets that will provide an important source of technical demand in the years ahead, mitigating the disruptive rise in rates envisioned by some.

One pillar of this structural demand for yielding assets is demographic change. While it is well known that the "Baby Boom" generation now beginning to enter retirement will require stability and income from their investment portfolios, which ultimately will bolster demand for yielding assets, we think the implications on the landscape of asset purchases in the years ahead is largely underappreciated. We are now at the beginning of a period of just over a dozen years when the annual birth rate 65 years ago was spiking dramatically. As these individuals draw near to their retirement age, they will require a significant asset reallocation not only in any personal accounts, but also in institutional accounts run on their behalf (such as pension funds) toward fixed income assets.

Moreover, this demand technical is not merely theoretical; a comparable dynamic existed in the United Kingdom, but with roughly a five-year lead, and the result has been impressive. From 2000 to 2010 pension assets in the U.K. have shot up more than 80% (compared to a 50% rise in the U.S. and a 44% jump in Japan over the same period) to $2.28 trillion, as institutions prepared for the demographic shift and bolstered portfolios buffeted from a decade of market shocks. One of the impacts this change has had on the U.K. bond market is to effectively support a bid for long-dated government bonds, allowing the government to term out its debt so as to improve the maturity profile overall. Additionally, over this same decade, the average percentage of assets in U.K. pension funds that were devoted to a fixed income allocation rose markedly from 15% in 2000 to 35% in 2010 (mostly at the expense of equities), again underscoring the need for yield in the context of an aging population. In the years to come, we think this dynamic may begin to exhibit itself to a greater extent in the U.S. as well.

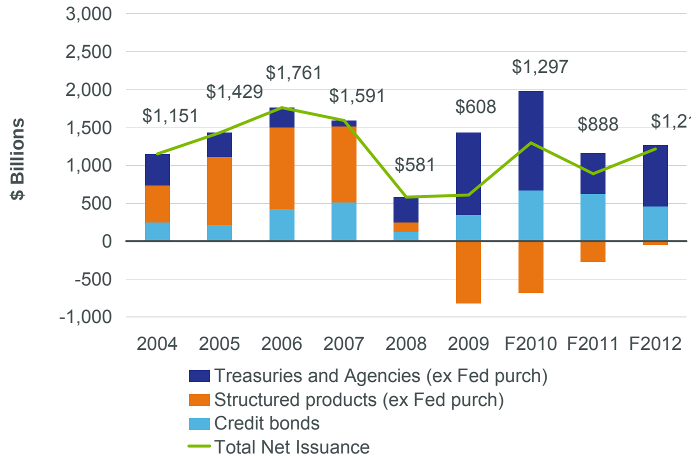
The institutional bid for fixed income assets in the U.S. is likely to remain strong and increase over time, while simultaneously supply will remain constrained. For example, in the period ahead we estimate that the demand for interest rate and credit spread duration from insurance companies and pension funds alone will likely outpace available supply, keeping prices supported and yields relatively stable. Insurance companies (both life and property and casualty combined) have more than $600 billion in asset requirements over the next year as they continue to put to work net investment income earned in 2010, as well as reinvest nearly $400 billion in maturing bonds. Moreover, fixed income supply (and its sector diversity) has diminished considerably since the pre-crisis peak, and we expect total fixed income supply to remain moderate (see Figure 3) even as demand remains strong. Finally, another source of considerable, and likely increasing, demand for high-quality fixed income assets (such as Treasuries and Agency MBS) are banking institutions. Banks have already stepped up purchases of these securities (see Figure 4) in the wake of the financial crisis, and we expect

Figure 3: Cumulative Change in Commercial Bank Holding of Treasuries and Agencies Since July 2009



Source: Deutsche Bank, data through 27 April 2011

Figure 4: Total Supply of Fixed Income is Moderating and the Diversity is Diminishing



Source: Bloomberg; data through 6 April 2011

the implementation of banking regulatory changes in the years ahead will only increase the demand for these assets. (An extensive discussion of BlackRock's views on the shifting landscape of bank regulation and capital requirements can be found in the following paper: *A Regulatory Roadmap Is Not Banking Territory* at www.blackrock.com).

Investing in a Period of Uncertainty and Volatility

What are the investment implications we can take from the macro dynamics described above? While we do not foresee a dramatic spike up in Treasury yields at the end of QE2, Treasury yields have come down considerably in recent weeks, so it would not surprise us if yields had bottomed and may drift slowly higher toward year end (perhaps topping around the 3.75% region on the ten-year). That said, a perhaps more pertinent question involves the reaction of risk assets to the end of QE2. We think the end of QE2 will likely result in added volatility and reduced liquidity in many risk asset markets. Additionally, we are nearing a time of the year when market volatility (as measured by the VIX Index) has historically been seasonally elevated, so the end of QE may well exacerbate market swings. Thus, we are willing to hold some duration in our portfolios, as the traditional flight-to-quality asset (Treasuries) should perform reasonably well during periods of elevated volatility and market uncertainty.

Still, echoing our main theme from last month, we like credit assets (both selected high yield and investment grade bonds in the short- to medium-term maturity range) and think corporations are poised to lead the economy forward in the year ahead. Also, while there may well be some interest rate volatility in the months ahead, credit spreads continue to be amazingly stable, again underscoring the highly favorable fundamental and technical positioning of credit assets. Also, in securitized credit (including parts of CMBS and ABS) generally improving fundamentals should allow selected issues to perform well. Finally, given the historic rally in risk assets over the past couple years, we think investors should move beyond thinking in terms of price return and should focus more on carry, which has been a historic driver of returns and should be our most valuable tool in the second half of the year.

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