

The Recovery Remains Fragile and Risk Assets Should be Approached Cautiously

As we approach the middle of 2011, we thought it an apt time to revisit our macroeconomic regime framework (first discussed in November 2010 and then reprised in January 2011), particularly since economic data in the U.S. has worsened over the past several weeks. As a reminder, our regime framework is divided into four macro phases: pre-recession, recession (early and late), recovery, and expansion (early, middle, and late). When we first wrote, just prior to the Federal Reserve's announcement of its QE2 asset purchase program, we argued that the preponderance of evidence suggested that the economy had entered into a pre-recessionary regime (with some signals instead pointing to a mid-recovery slowdown). By the beginning of 2011, it appeared as if both QE2 and tax cut stimulus had allowed the recovery to continue, avoiding a genuine "double-dip" recession, and indeed our economic regime indicators were beginning to move from recovery to expansion, but these gains have all but fallen away since April.



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Headwinds to Recovery

At mid 2011, we think significant structural headwinds are on display in various data series (such as those representing labor markets), and the recovery can at best be characterized as sluggish (and largely jobless, not unlike the 1993 and 2003 recoveries), and at worst our indicator is close to signaling a return to the pre-recession regime and it may well arrive there by month-end. For instance, the four week moving average of initial jobless claims data has been trending upward, breaking its downward trajectory largely in place since March 2009, and residing now around the 425k level (see Figure 1). Additionally, the unemployment rate increased between March and May (to 9.1%) and the change in Nonfarm Payrolls data released on June 3rd surprised significantly lower, rising only 54k.

Figure 1: Initial jobless claims reversing its downward trajectory



Source: Bloomberg, Department of Labor; data through 27 May 2011

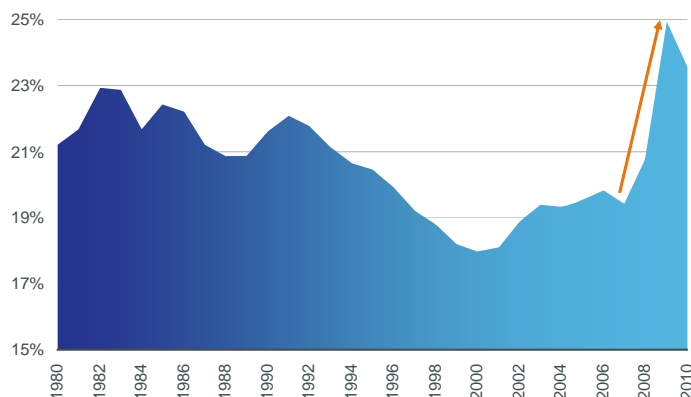
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In addition to the weak claims and payroll data, a number of leading indicators have moved to a level that supports a significant growth slowdown. Consumer confidence, small business confidence, three-month LEI, CFNAI, and ISM New Orders have all moved from levels consistent with the last two recoveries to levels consistent with the pre-recession regime in the last two months. In addition, the leading indicators that are still consistent with continued recovery, credit spreads, the yield curve, and ECRI, are moving in the wrong direction. While Japanese related supply disruptions explain some of the deterioration in these indicators, it is not the pre-dominate factor.

Additionally, while we argued in November that both governmental monetary and fiscal stimulus were needed to avoid a slowdown in the recovery, and indeed this appeared to help, the impact from these factors has seemingly waned. In fact, contrary to average recessions/recoveries, government spending has been a detractor from GDP the past two quarters, which is very unusual at this point in the cycle. Moreover, as government budgets are pared back at all levels, the sector has also recently weighed on labor markets via job cuts, a headwind to growth that may remain for some time. Interestingly, while government spending as a proportion of GDP rose through the financial crisis and subsequent recession, this was partly because the government kept spending growth more or less constant while spending/income from other sectors collapsed in 2008 (see Figure 2). The actual capital spent has kept with the trend rate since 2001. With the political winds shifting toward greater levels of fiscal restraint, there may well be social limits (as well as economic ones) to what further government spending and stimulus can accomplish.

Figure 2: U.S. federal government spending as a percentage of GDP (annual)



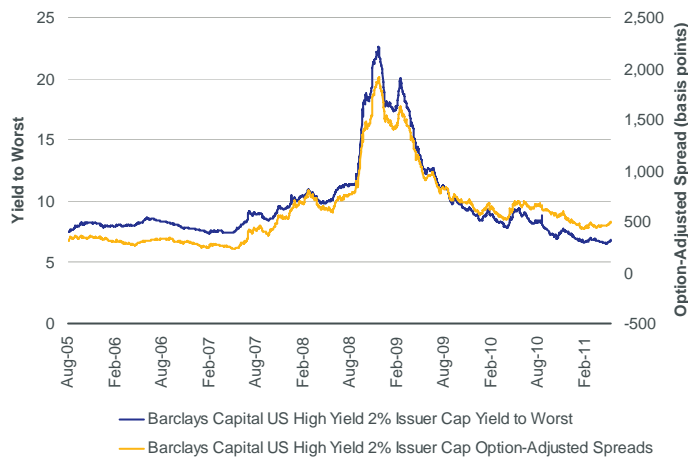
Source: Bloomberg, US Treasury, US Bureau of Economic Analysis; data through 31 December 2010

The Impact of the Economic Backdrop on Risk Assets, Particularly High Yield

In this cycle high yield should be relatively immune to a mere economic slowdown, as slower growth would continue the demand driver of low Fed target rates for a longer period. Additionally Fed balance sheet maintenance underpins the extreme upward slope to the yield curve, a positive for this market. In fact, key holdouts from a slip into the pre-recession regime framework are the yield curve slope and the very low implied high yield default rates. These factors are important because the primary differences between pre-recessionary regimes that turn into genuine recessions, rather than merely growth slowdowns, are those two indicators turning negative. Fed action and fiscal stimulus have essentially turned around a significant growth slowdown as long as these indicators remain positive. Still, significant risks do remain for the high yield market, since in our view QE2 and the near-zero interest rate policy have created excess demand for high yield assets and therefore the largest near-term risk would be a reversal of these factors resulting in capital flight from the sector. Perhaps counter-intuitively, the factors that could slow down the economy (while avoiding outright recession) could be beneficial to the high yield outlook, and a policy reversal stemming from economic recovery might be detrimental to it.

Finally, beyond the possible withdrawal of technical market support, another concern we have about the high yield market is that we are already seeing many signs of late-cycle (negative) behavior in the market. For instance, we have witnessed falling underwriting standards (such as payment-in-kind toggle provisions) and a rapidly diminishing quality differential in the new issue marketplace. Further, yields reside near all time lows; spreads are approaching their tightest quartile, and forward implied default rates are near all time lows (see Figure 3). Some of these factors are certainly the signs of corporate sector strength (as many companies are generating solid cash flows, have responsibly termed out their debt, and have improved efficiencies in recent years). However, technicals in credit can turn on a dime, making it difficult to get out of trades should demand dissipate or fundamentals deteriorate. Therefore we think great attention must be paid to valuation, careful credit screening, and liquidity considerations.

Figure 3: High yield yields are near all-time lows and spreads are approaching their tightest quartile



Source: BlackRock, Bloomberg; data through 3 June 2011

The Corporate Sector is Key to Recovery

With government budgets under stress, the consumer sector still struggling with job losses, and with no housing recovery in sight, the recovery has been almost entirely led by corporate sector

spending, hiring, and export growth. This has been the result of one of the strongest profit recoveries in history, but there are signs of profit momentum slowing, margin pressure, and slowing global growth, which are the most likely causes of the turn in initial claims mentioned previously. Thus, we think the corporate sector is vital to sustaining the recovery, and should it falter a significant reduction in growth will become more likely.

A second growth slowdown during a recovery would be historically unique for the U.S., but not to Japan, as Japan in the past has had anemic growth-on and growth-off recoveries that alternated every few quarters. In the end, it may well be that growth expectations are just too unrealistic. Prior to the recession, most estimates of U.S. potential growth were in the 2.25% to 2.50% range, but research by Harvard University professor Kenneth Rogoff has shown that post-financial crisis growth often gets a 1% haircut that lasts for a significant period. If applicable in this case, this would leave U.S. post-recession potential growth at 1.25% to 1.50%. The unusually strong business recovery has allowed the economy to grow faster than this (at a 2.8% rate for the seven recovery quarters thus far), but the question remains as to whether this growth is sustainable, and whether this time really is different.

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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