

FI in a New Era: A Dynamic Approach

Heightened Volatility Is Here To Stay

For decades, low and moderate inflation has been the norm, a backdrop that beckoned an era of declining interest rates and attractive asset class returns. However, the past few years have shaken this paradigm: in the aftermath of COVID, we have seen unexpected vulnerabilities in global supply chains and markets have realized that forceful fiscal and monetary policy can inflame inflation and exacerbate volatility in financial markets. The rapid ascent in policy rates, the fastest campaign since the 1980s (Figure 1), has exposed economic weak links including some financial institutions and sectors that were dependent on lower rates.

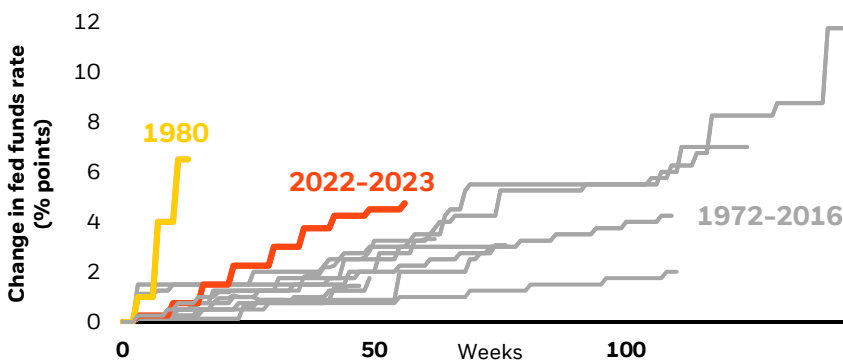
In our view, this heightened backdrop of volatility is not a temporary spike; rather, it is a new regime characterized by financial markets waking up to risks that were once considered dormant. Markets are repricing the capacity for inflation to spike in response to supply and demand shocks, and investors recognize the unusual uncertainty in the range of decisions that policymakers may take. Looking ahead, we think inflation will likely cool from here, but a combination of geopolitical risks, tight labor markets and lingering productivity challenges in some segments could keep inflation elevated over the medium term.

New Opportunities, New Risks

While this heightened volatility has meant steep losses including a 10% drawdown in the Bloomberg US Aggregate Index since the start of 2022, it has also brought massive opportunity. Fixed income yields* have moved meaningfully higher over the past year as Federal Reserve rate hikes have pushed up risk-free rates. The higher level of the risk-free rate means that in an asymmetric growth shock, bonds may act as a hedge or diversifier in portfolios that have riskier allocations, given there could be considerable room for rates to rally if the Fed pivots and eases. This means that the menu of investment options seeking to reach a target yield has greatly expanded and investors may reach that target, without potentially having to reach aggressively into higher risk products.

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Figure 1: Fed rate hiking cycles, 1972-2022



Source: BlackRock Investment Institute, with data from Refinitiv Datastream, March 2023. Notes: The chart shows previous and current Federal Reserve rate hike cycles. **Indexed are unmanaged and one cannot invest directly in an index.** Past Performance is not a reliable indicator of future results. *The yield on the Bloomberg US Aggregate Index moved up from 2.91% in March 31st, 2022 to 4.36% in March 31st, 2023.

Key Takeaways

- We believe markets will remain volatile and dispersion elevated in a new regime characterized by policy uncertainty
- This new era necessitates a flexible approach that seek to optimize the potential for returns across the global fixed income market while effectively seeking to manage risks
- A flexible approach may be able to dynamically adjust duration and credit positioning in seeking to capture potential dispersion-driven opportunities as they arise
- A keen focus on risk management by maintaining a diversified* set of exposures can serve in seeking to create the potential of a more stable and durable return stream

* Diversification and risk management do not assure a profit and may not protect against loss of principal



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Fixed income: no free lunch

While valuations are attractive, we don't think investors can passively sit in fixed income seeking to reap potential returns in an environment where volatility shocks could be more prevalent than in the past. And while elevated yields may mean that fixed income looks attractive, with the curve so inverted, there could be a negative term premium in longer-term bonds. Thus, unlike the '80s and '90s where the starting point of elevated terms premiums set off decades of attractive fixed income returns as rates compressed, the starting point today is quite different.

We see dispersion increasing across the capital structure as tightening credit conditions and the higher for longer interest rate environment could create more distinct separations between winners and losers. Looking ahead, we believe won't see the kind of "beta" yield compression that drove attractive fixed income returns since the 1980s. Rather, returns going forward may be more influenced by active strategies such as tactical positioning shifts, security selection and leaning into opportunistic carry and potential income.

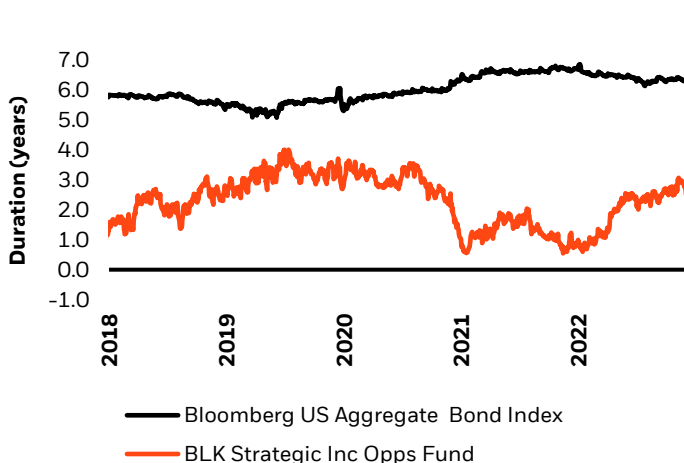
Why unconstrained?

Against this backdrop of heightened volatility in the current market, a flexible approach and positioning across the full investment landscape may tend to be more efficient over time than allocating to each sub sector individually. Additionally, flexible strategies may alleviate the need to adjust fixed income allocations in seeking to keep up with changing market dynamics, while striving to operate within the risk budget of many traditional fixed income portfolios.

Unconstrained fixed income such as the BlackRock Strategic Income Opportunities Fund (SIO) can leverage a broader toolkit, may allow investors striving to capture the potential higher yields, while seeking to keep risks contained. Unconstrained strategies may flex up and down duration and weightings across sectors geographies and capital structures seeking to position opportunistically or defensively in ways unavailable to benchmark-oriented strategies.

As the following two case studies show, the flexibility of SIO's unconstrained approach has allowed the team to adjust duration and spread sector allocations to align with changing macroeconomic and financial market conditions.

Figure 2: SIO has dynamically adjusted duration to take advantage of the interest rate regime



Source: BlackRock, as of April 19th, 2023. An index is unmanaged and one cannot invest directly in an index.

Case study 1: Actively rotating duration

A fitting example of this flexibility in action is the shifting duration stance of SIO in the past few years. Through 2021 and mid-2022, SIO maintained fund duration very low on the view that interest rates could move higher (Figure 2). With no reference benchmark or duration constraints, the team was able to maintain a highly defensive duration position under the flexible unconstrained framework. This limited duration exposure proved to be a critical performance driver, as rates moved dramatically higher through 2022 with the Fed hiking rates from the zero lower bound.

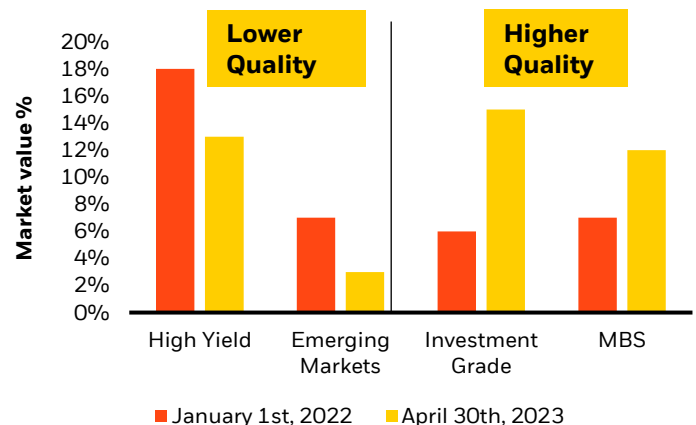
However, as growth began to slow and inflation stabilized in mid-2022, SIO shifted to gradually adding duration. Fund duration has continued to trend up, and hit 3 years as of 31 March 2023, reflecting the team's view that duration is beginning to look more attractive as the Fed reaches the latter stages of the hiking cycle. A benchmark-constrained strategy tethered to duration guideposts may not necessarily have the flexibility of SIO to shift duration exposure and risk profile to reflect changing economic regimes.

Case study 2: Flexible management of spread assets

Given the unconstrained nature of SIO, the Fund can adapt sub-sector exposures to align with the team's market outlook. Since the beginning of 2022, we rotated up-in-quality (Figure 3) on the view that the Federal Reserve is likely to hike rates expeditiously and push terminal rates to a fairly restrictive level, weighing on potential growth.

To minimize the impact of potential spread widening, we gradually trimmed our high yield allocation by a third and cut half of the fund's exposure to emerging markets hard currency debt. We also vetted our banking exposure and less liquid securitized holdings in late 2022 to remove holdings vulnerable to tightening lending standards. For example, we more than doubled our exposure to investment grade credit and markedly increased our agency mortgage allocation in the first half of 2023 as part of a valuation play

Figure 3: SIO has engaged in an up-in-quality rotation to increase portfolio resiliency in the new regime



Source: BlackRock, as of April 30th, 2023. MBS = Mortgage Backed Securities. Any reference herein to any security and/or a particular issuer shall not constitute a recommendation to buy or sell, offer to buy, offer to sell, or a solicitation of an offer to buy or sell any such securities issued by such issuer.

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Fixed income risks include interest-rate and credit risk. Typically, when interest rates rise, there is a corresponding decline in bond values. Credit risk refers to the possibility that the bond issuer will not be able to make principal and interest payments. Learn more about how consistent investment performance and low fees are critical to achieving your fixed income goals in today's environment.

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