BlackRock.

No time to yield

A case for putting cash to work with bond ETFs

FOR WHOLESALE INVESTORS ONLY – NOT FOR PUBLIC DISTRIBUTION

Key points

1. Australian bond yields are higher today than they were more than 10 years ago. If inflation indicators continue to fall, central banks may proceed to reduce official cash rates.

2. Globally, investors are choosing bonds in record numbers, with 2023 bond ETF inflows at US$333 billion. Australian bond ETF inflows alone reached a new high of nearly $6 billion.

3. Investors are underweight fixed interest, with an average allocation of 19% across the Australian managed funds industry and less than 10% across self-directed funds.

4. We believe investors should consider moving out of cash and into fixed interest exposures because, historically, the market has shown its tendency to price in changes to official cash rates well before they occur.

5. ETFs can be an efficient and cost-effective way for investors to increase their fixed interest allocation.

FOR WHOLESALE INVESTORS ONLY – NOT FOR PUBLIC DISTRIBUTION

MKTGH0724A/S-3754991-2/10

Introduction

The rapid rise in central bank base rates, namely the US Fed Funds rate and Australia's RBA cash rate - which are respectively at their 20-year and 12-year highs[1] - saw a subsequent rise in bond yields that has made fixed interest attractive to investors once again. 2023 set a record for flows into Australia domiciled bond ETFs, with nearly $6 billion of new assets. Globally, bond ETF inflows of US$333 billion surpassed all previous years[2].

Despite the ongoing volatility in economic data and markets, we believe that investors should consider increasing their exposure to fixed interest. Why? Global central banks may be nearing the end of a monetary policy tightening cycle which has in the past made cash an attractive substitute to fixed interest.

As economic growth is crimped due to restrictive cash rates, we believe central banks will increasingly shift their positions and return to less restrictive monetary policy settings. In our view, this policy loosening is not a question of "if" but "when," and investors should look to increase their exposure to fixed interest as markets price in future rate cuts. History tells us that investors can miss out on locking in higher yields, and capital price appreciation, if they wait for a clear, definitive answer on rate cuts[3].

Investors are increasingly taking a more dynamic approach to fixed interest asset allocation in a market regime which has shifted over the past 2 years. We believe bond ETFs are among the most efficient and cost-effective ways to gain exposure to the fixed interest asset class. There is now a wide variety of fixed interest ETFs across the risk spectrum that allow investors to be precise and deliberate when allocating to fixed interest. Depending on their investment objective, investors can target outcomes involving either income, capital protection or diversification.

In this paper, we will discuss the opportunity in fixed interest and why investors may want to consider moving now to capture these decade-high yields, get cash off the sidelines, and employ efficient, precise tools such as bond ETFs in this new market regime.

Authors

Craig Vardy
Head of Australia Fixed Income

Darren Wills
APAC Head of iShares Fixed Income ETFs

Hui Sien Koay
APAC Head of iShares Fixed Income Product Strategy

1 Source: Bloomberg, Federal Reserve Bank of New York (based on the federal funds rate), RBA (based on the Australia RBA cash rate target).

2 Source: BlackRock Global Business Intelligence, as of 30 April 2024. All '$' signs refer to AUD unless otherwise stated.

3 Source: Bloomberg, based on comparing the 5-year Australia Treasury Bond Yield (GTAUD5Y Govt) with the RBA cash rate target (RBATCTR Index) from 1 Jan. 2000 to 30 Apr. 2024.

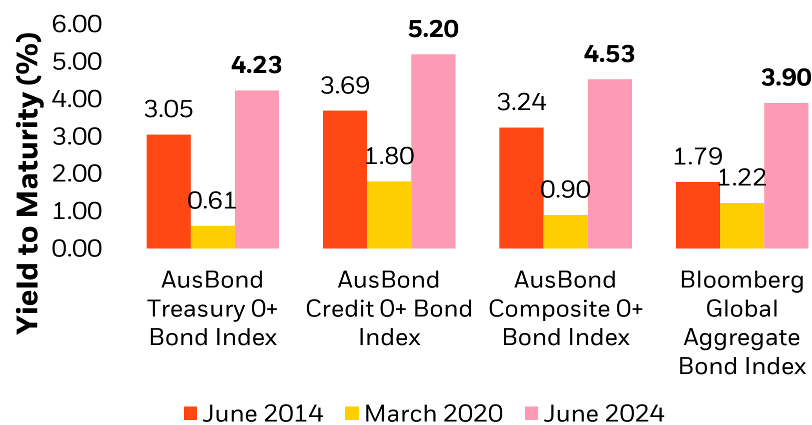
FOR WHOLESALE INVESTORS ONLY – NOT FOR PUBLIC DISTRIBUTION

Seek to capture higher rates

Bond yields are higher today than they were more than 10 years ago, and investors are still able to lock in attractive yield levels. Figure 1 shows yield levels on different indices June 2014 (10 years ago), in March 2020 (at the onset of the COVID-19 pandemic), and in June 2024.

Yields today are at levels not seen in more than a decade.

Figure 1: Yield levels of Australian and global fixed interest exposures (%), 2014-2024

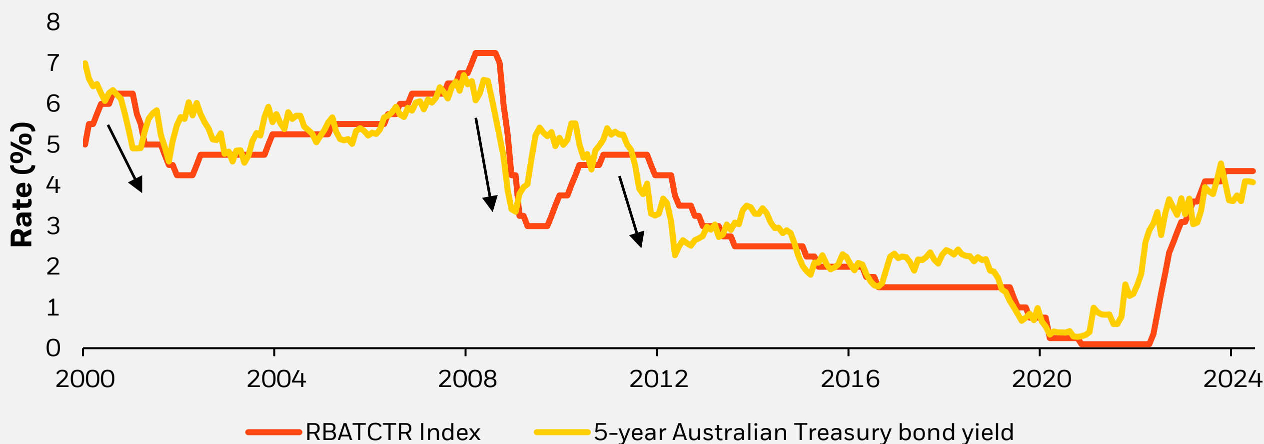


Source: Bloomberg, based on yield to maturity as of 30 June 2024. Index performance does not reflect any management fees, transaction costs or expenses. Indexes are unmanaged and one cannot invest directly in an index. Past performance does not guarantee future results.

Despite the recent uneven and bumpy path back towards the RBA's 2-3% inflation target, the time of elevated cash rates is coming closer to the end. We believe this means investors may want to consider moving out of cash and into fixed interest. Market pricing will continue to ebb and flow around the timing of potential rate cuts, but moderating inflation rates and restrictive monetary policy makes fixed interest a compelling investment opportunity. **Historically, longer term yields have moved ahead of policy shifts** (Figure 2). Investors who are not forward looking could miss the opportunity to capture bond yields at these relatively high levels.

Figure 2: Five-year Australian Treasury bond yield compared to RBA cash rate (%), 2000-2024

Historically bond rates have tended to react before the RBA starts to act



Source: Bloomberg, based on comparing the 5-year Australia Treasury Bond Yield (GTAUD5Y Govt) with the RBA cash rate target (RBATCTR Index) from 1 Jan. 2000 to 30 June 2024.

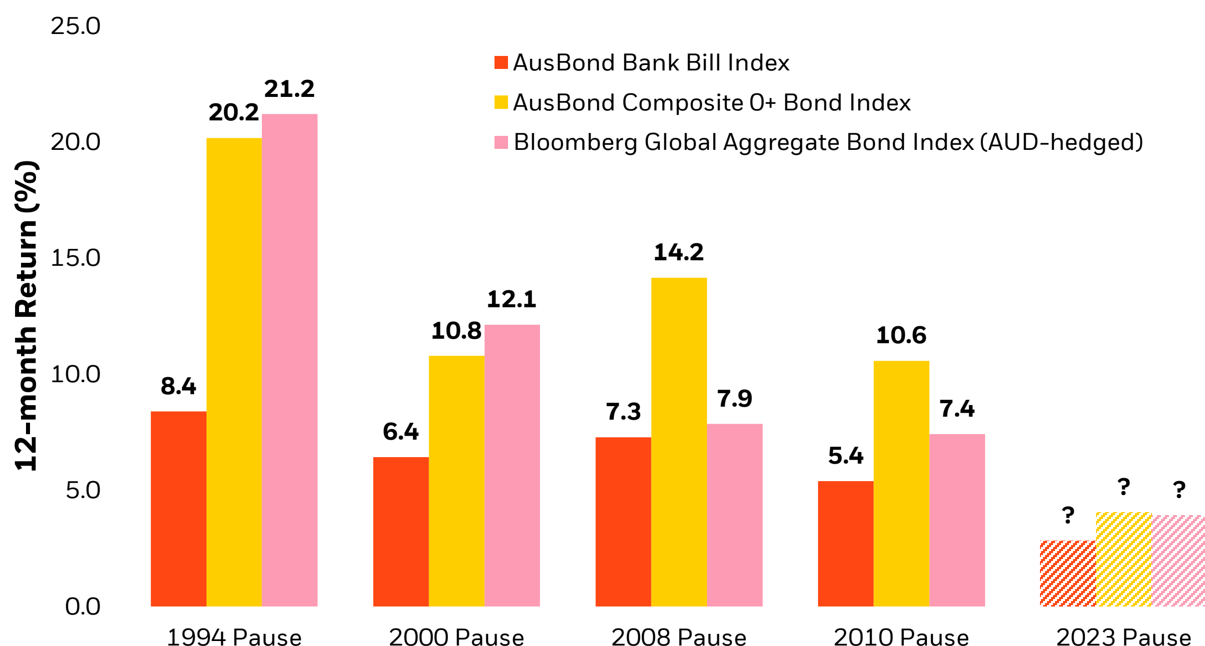
The volatile markets of the past few years have seen investors increase allocations into a less volatile asset – cash. Rising interest rates on the back of the RBA's aggressive rate hikes rewarded investors for holding cash.

Bonds are called fixed interest for a reason. Bonds serve two significant roles in a portfolio: to generate interest income and to provide risk diversification. In the zero/ultra-low cash rate (and bond yield) period from 2015-2022, many investors used cash as a substitute for fixed interest because the risk diversification element of bonds became less relevant. This has served them well during the current tightening cycle. However, over the long-term, cash has not provided the same level of return compared to fixed interest.

Also, by remaining overweight cash investors are now exposed to higher levels of risk in the event equity markets correct. As central banks edge towards a period of less restrictive policy rates, investors risk missing out on the additional return from holding fixed interest assets.

Historically, when central banks implement a pause in a hiking cycle, bond markets have tended to outperform cash (Figure 3). We believe investors could benefit from getting ahead of potential interest rate cuts.

Figure 3: Bonds vs. cash 12-month returns (%) after last rate hike of each RBA hiking cycle



Source: BlackRock, Bloomberg, as of 30 June 2024. The figures shown related to past performance. 12-month performance shown from the last rate hike of a cycle: 14 Dec 1994, 2 Aug 2000, 5 Mar 2008, 3 Nov 2010, 8 Nov 2023. The 2023 pause period represents returns from 8 November 2023 to 30 June 2024 since it has not yet reached 12 months. Past performance is not a reliable indicator of current or future results. Index returns are for illustrative purposes only. Index performance returns do not reflect any management fees, transaction costs or expenses. Indexes are unmanaged and one cannot invest directly in an index.

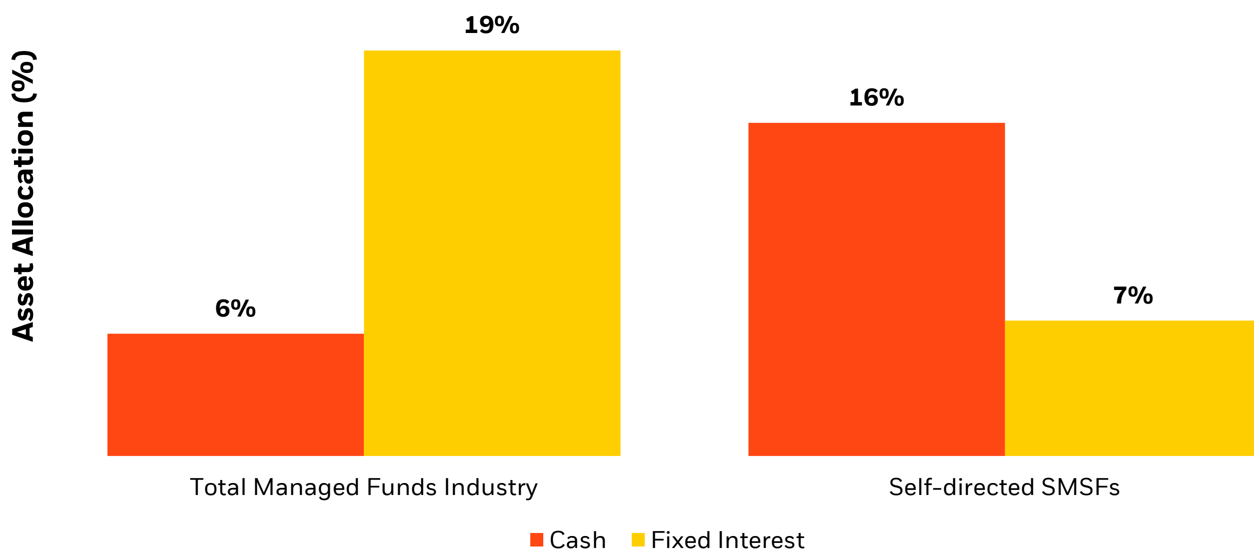
Portfolios have room for bonds. Investors are underweight fixed interest, with the total Australian managed funds industry assets under management (AUM) of more than $3 trillion having an average fixed interest allocation of 19%[4]. Majority of the AUM are in government mandated superannuation schemes.

Yet, zoning into the largest self-directed portion of the industry paints a starker picture. Self-managed superannuation funds (SMSFs), a growing, $908 billion portion of superannuation assets[5], reflect Australia's individual self-directed investment. SMSF investors are leaning towards cash with a 16% allocation, while significantly underweight fixed interest at 7% (Figure 4).

Both asset allocation mixes are far below the "60/40" portfolio allocation often referenced in balanced portfolio discussions. Although the 60/40 allocation itself may not be right for every investor, we believe investors should consider holding more fixed interest than they currently are.

Figure 4: Fixed interest vs. cash allocation, total managed funds industry vs SMSFs which are self-directed

Compared to the industry, self-directed investors are significantly underweight fixed interest while favouring cash



Source: Rainmaker Information, as of 31 December 2023. Based on total Australian managed funds industry assets under management; Class 2023 Annual Benchmark Report, as of 30 September 2023. Based on SMSF assets.

4 Source: Rainmaker Information, as of 31 December 2023. Based on total Australian managed funds industry assets under management.

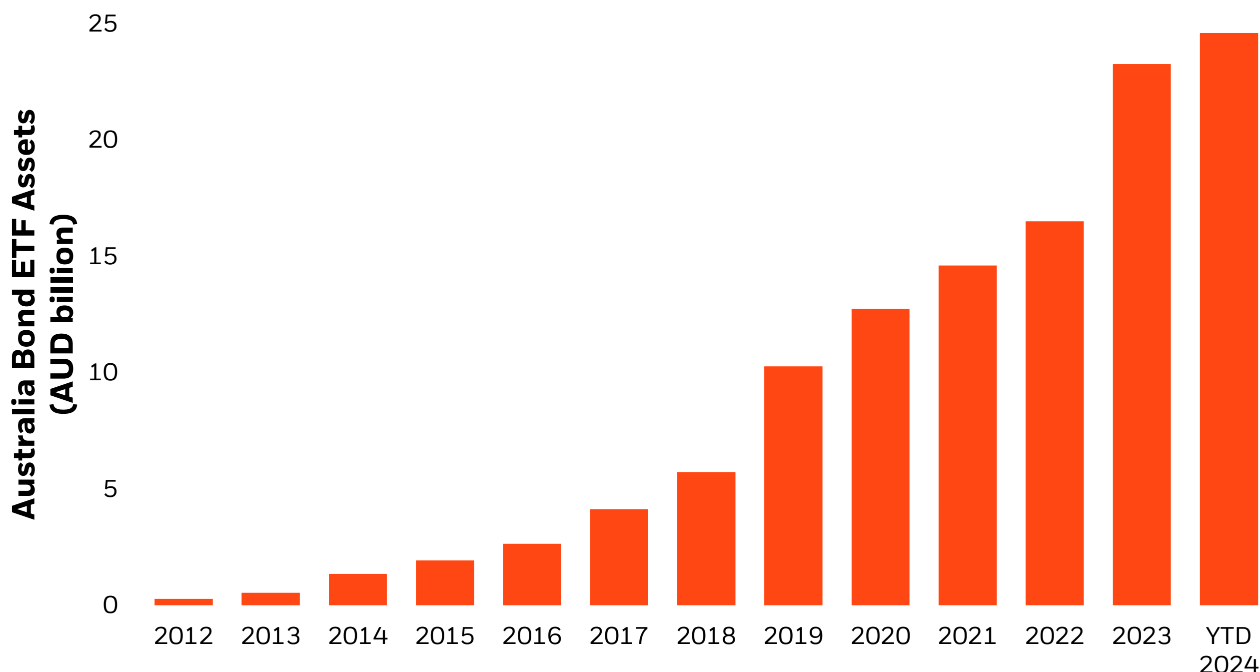
5 Source: Australian Prudential Regulation Authority (APRA), as of 31 December 2023. Based on total assets under management of SMSFs.

Back into bonds, back into ETFs

Bond ETFs are increasingly resonating with investors, with the number of bond ETFs listed in Australia now exceeding 60 and amassing over $23B in assets between them (Figure 5). Globally, assets reached US$2 trillion in assets in July 2023. We believe this market will triple to US$6 trillion by 2030[6] as more investors view ETFs as a convenient way to access the bond market.

Bond ETFs have revolutionised the way investors access fixed interest exposure. Investors may now buy and sell portfolios of thousands of bonds through ETFs with a single click, accessing much of the fixed interest market that was previously only available to larger investors at high cost. These exposures run the gamut of liquid sovereigns to emerging markets across duration, sector, and credit quality, helping provide investors with a robust and highly efficient toolkit for portfolio construction.

Figure 5: Growth of Australian bond ETF assets



Source: BlackRock Global Business Intelligence, as of 30 June 2024.

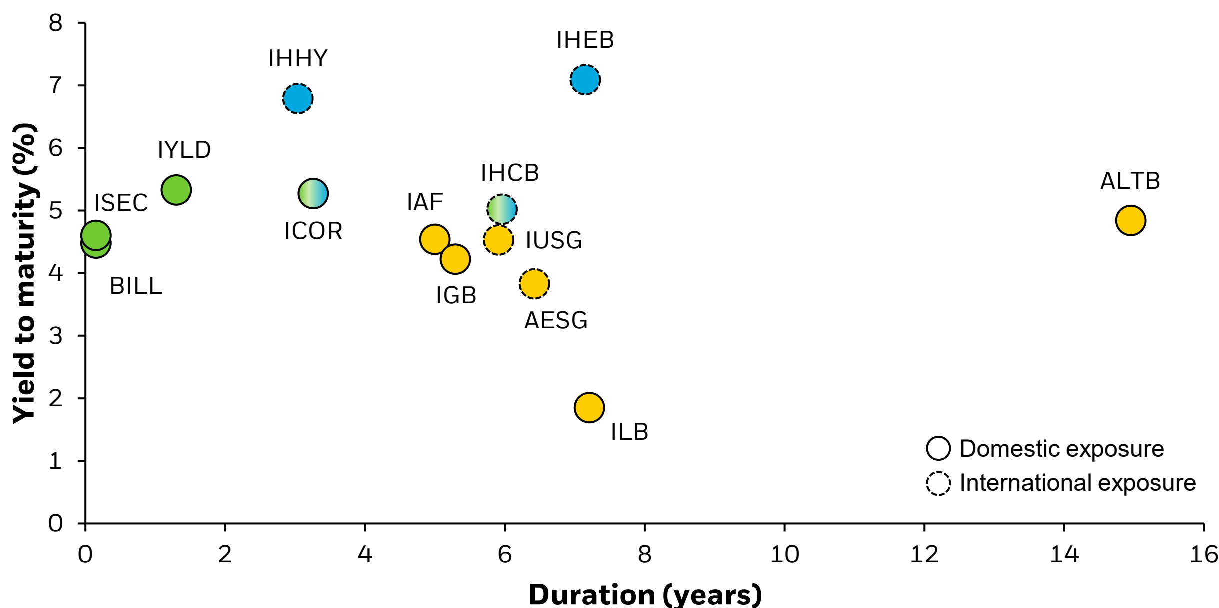
6 From proprietary research. BlackRock projections as of 31 March 2024. Subject to change. The figures are for illustrative purposes only and there is no guarantee the projections will come to pass.

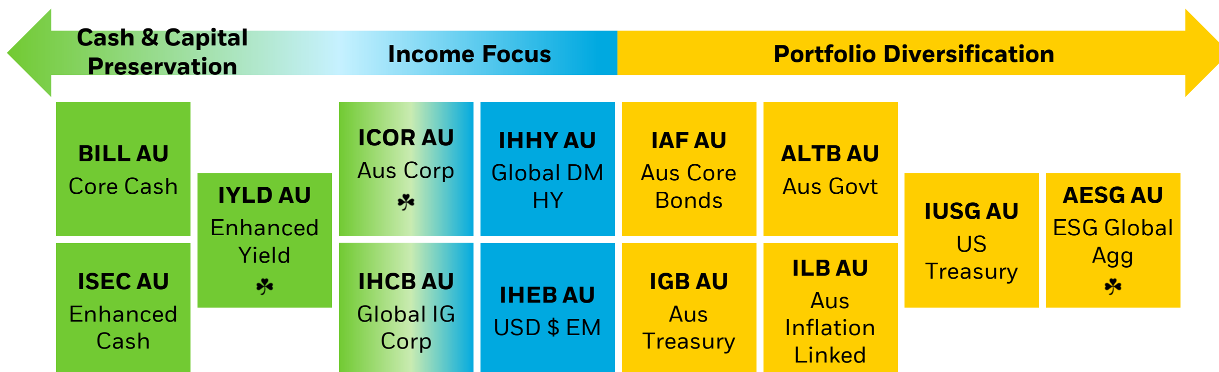
FOR WHOLESALE INVESTORS ONLY – NOT FOR PUBLIC DISTRIBUTION

Investors can also benefit from continued bond ETF innovation offering even more granular exposures which can be blended into highly customisable portfolios. The breadth of the bond ETF toolkit provides increasing flexibility to suit almost any investor's income/return risk profile (Figure 6).

Figure 6: Breadth of the iShares fixed interest toolkit

Bond ETFs offer increasingly greater flexibility for investors





Source: BlackRock, as of 30 June 2024. ✤ denotes Screened/Sustainable offering. Mentioning of iShares Fund does not construe as any investment advices or recommendations. Please refer to the iShares Fund prospectus for more details, including the risk disclosure.

This information is for illustration purposes only. It should not be relied upon by the reader as investment advice or recommendation regarding the iShares funds. This includes ASX-listed ETFs and index mutual fund domiciled in Australia

FOR WHOLESALE INVESTORS ONLY – NOT FOR PUBLIC DISTRIBUTION

Fixed interest has once again returned as a key ingredient in a well-diversified portfolio. Low-cost bond ETFs provide an effective means to transition from cash into fixed interest. In the table below, we explore potential scenarios for stepping out of cash into fixed interest exposures.

Scenario	Potential ETFs for consideration
Scenario 1: The RBA is forced to hike again In this scenario where inflation persists at a high level, the RBA may have to hike the cash rate. Investors should own **minimal or ultra-short duration exposures** (0-1 year), which help insulate investors from rising interest rate, while providing attractive yields compared to cash deposits in the bank.	**BILL** **iShares Core Cash ETF** **ISEC** **iShares Enhanced Cash ETF**
Scenario 2: The RBA keeps rates unchanged The status quo continues in this scenario, and the RBA keeps the cash rate unchanged for longer. Investors should own **short duration exposures where yield (including credit spread) per unit duration is highest today,** allowing investors to move out of cash without stepping too far, while riding out the pause by harvesting more attractive income.	**IYLD** **iShares Yield Plus ETF**
Scenario 3: The RBA achieves a soft landing In this 'goldilocks' scenario, inflation continues to fall, and the RBA starts to gradually cut the cash rate. Investors could consider adding **high quality bonds with both duration and spread duration** which offer income from a yield pick up above treasury, and potential capital price appreciation as interest rates fall. Additionally, for investors seeking **higher income**, high yield corporate bonds could become more attractive.	**ICOR** **iShares Core Corporate Bond ETF** **IHHY** **iShares Global High Yield Bond (AUD Hedged) ETF**
Scenario 4: The RBA is forced to cut rates as recession fears grow In this hard landing scenario, both growth and inflation falls, leading to a sudden decrease in the cash rate. For portfolio ballast, investors can consider allocating to **treasury and government exposures** to help cushion risk asset exposures (equities and credit) and to provide additional risk diversification. ***Maximum return contribution for your duration?*** *Consider precise, long duration exposures that can increase duration contribution in portfolios for the least amount of capital.*	**IGB** **iShares Treasury ETF** **IUSG** **iShares U.S. Treasury Bond (AUD Hedged) ETF** **ALTB** ***iShares 15+ Year Australian Government Bond ETF***

This information is for illustration purposes only. It should not be relied upon by the reader as investment advice or recommendation regarding the iShares funds.
This includes ASX-listed ETFs and index mutual fund domiciled in Australia.

Conclusion

After a profoundly challenging period in the bond market brought on by global inflation and resulting aggressive central bank tightening, we believe that there is a compelling case for moving off the cash sidelines and back into fixed interest for the long-term. While yields may continue to oscillate with changing economic conditions, they remain at attractive levels not seen in decades and therefore now provide investors with an opportunity to rebalance and reduce risk in portfolios for the future. The granularity, efficiency, and versatility of bond ETFs make them an effective tool for fortifying portfolios with fixed interest exposure.

Contributors

Darryl Yee
Sarah Kendell

Important Information

Issued by BlackRock Investment Management (Australia) Limited ABN 13 006 165 975, AFSL 230 523 (BIMAL) for the exclusive use of the recipient, who warrants by receipt of this material that they are a wholesale client as defined under the Australian Corporations Act 2001 (Cth).

This material provides general advice only and does not take into account your individual objectives, financial situation, needs or circumstances. Before making any investment decision, you should assess whether the material is appropriate for you and obtain financial advice tailored to you having regard to your individual objectives, financial situation, needs and circumstances. Refer to BIMAL's Financial Services Guide on its website for more information. This material is not a financial product recommendation or an offer or solicitation with respect to the purchase or sale of any financial product in any jurisdiction.

Information provided is for illustrative and informational purposes and is subject to change. It has not been approved by any regulator.

This material is not intended for distribution to, or use by, any person or entity in any jurisdiction or country where such distribution or use would be contrary to local law or regulation. BIMAL is a part of the global BlackRock Group which comprises of financial product issuers and investment managers around the world. BIMAL is the issuer of financial products and acts as an investment manager in Australia.

BIMAL is the responsible entity and issuer of units in the Australian domiciled managed investment schemes referred to in this material, including the Australian domiciled iShares ETFs. Any potential investor should consider the latest product disclosure statement (PDS) before deciding whether to acquire, or continue to hold, an investment in any BlackRock fund. BlackRock has also issued a target market determination (TMD) that describes the class of consumers that comprises the target market for each BlackRock fund and matters relevant to their distribution and review. The PDS and the TMD can be obtained by contacting the BIMAL Client Services Centre on 1300 366 100. In some instances the PDS and the TMD are also available on the BIMAL website at www.blackrock.com/au. An iShares ETF is not sponsored, endorsed, issued, sold or promoted by the provider of the index which a particular iShares ETF seeks to track. No index provider makes any representation regarding the advisability of investing in the iShares ETFs. Further information on the index providers can be found in the BIMAL website terms and conditions at www.blackrock.com/au.

BIMAL, its officers, employees and agents believe that the information in this material and the sources on which it is based (which may be sourced from third parties) are correct as at the date of publication. While every care has been taken in the preparation of this material, no warranty of accuracy or reliability is given and no responsibility for the information is accepted by BIMAL, its officers, employees or agents. Except where contrary to law, BIMAL excludes all liability for this information.

Any investment is subject to investment risk, including delays on the payment of withdrawal proceeds and the loss of income or the principal invested. While any forecasts, estimates and opinions in this material are made on a reasonable basis, actual future results and operations may differ materially from the forecasts, estimates and opinions set out in this material. No guarantee as to the repayment of capital or the performance of any product or rate of return referred to in this material is made by BIMAL or any entity in the BlackRock group of companies.

No part of this material may be reproduced or distributed in any manner without the prior written permission of BIMAL.

© 2024 BlackRock, Inc. or its affiliates. All Rights Reserved. **iSHARES** and **BLACKROCK** are trademarks of BlackRock, Inc., or its affiliates. All other marks are the property of their respective owners.

BlackRock.

MKTGH0724A/S-3754991-10/10