

BlackRock

No time to yield

A case for putting cash to work with bond ETFs



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Key points

1

Yields are higher today than they were 20 years ago. If inflation indicators continue to fall, the time of elevated cash rates may be drawing to a close.

2

Investors are choosing bonds in record numbers, with 2023 global bond ETF inflows at \$333 billion.

3

But investors are still significantly underweight to fixed income, with a 22% average allocation, based on global industry assets under management.

4

We believe investors may still want to consider moving back into fixed income because, historically, the market has tended to price in rate actions before they occur.

5

ETFs can be a powerful tool for investors as they recalibrate their fixed income allocations.



Introduction

Interest rates are now at their highest levels since the early 2000s, helping to make bonds more attractive to investors who had been sitting on the sidelines the past couple of years as bonds endured significant volatility.¹ In 2023, global bond ETF inflows rose 25%, hitting a record \$333 billion.² In the fourth quarter alone, global inflows were up 42% over the third quarter.³

Even with ongoing volatility in economic data and bond markets, we believe that investors may still want to consider moving back into fixed income. Why? The signs of market change may be coming into focus: despite the uneven and halting descent in inflation around the world, global central banks may still be nearing the end of a tightening cycle designed to quell the most significant surge in inflation in decades — a cycle that made cash attractive.⁴ A pivot to rate cuts from central banks later in 2024 — and already underway in emerging economies such as Brazil — is still being debated, but current yield levels may portend an opportunity in fixed income.⁵

We continue to believe central banks will ultimately shift their posture and markets will return to an era of less restrictive monetary policy. In our view, policy loosening is still not a question of “if” but “when,” and investors, accordingly, may want to consider moving back to fixed income. History tells us that investors can miss out on locking in higher yields if they wait for a clear, definitive answer on rate cuts.⁶ Instead of trying to time the markets (which is near impossible), investors may consider beginning to move ahead of announced changes in central bank policy rates, and increasing fixed income exposure by putting cash to work with bonds.

1 Source: Federal Reserve Bank of New York; The Federal Open Market Committee (FOMC) federal funds rate was at a target range of 5.25–5.5% in March 2024, with the upper bound at a level not seen since March 2001. **2** Source: BlackRock Global Business Intelligence, as of 31 Dec. 2023. Flows for fixed income ETFs globally totaled \$265 billion in 2022, compared with \$333 billion in 2023. Previous annual record was in 2021 with \$282 billion. **3** Source: BlackRock Global Business Intelligence, as of 31 Dec. 2023. Flows for fixed income ETFs globally in the third quarter of 2023 totaled \$69 billion vs. \$99 billion in the fourth quarter. **4** Source: US Bureau of Labor Statistics, as of 31 Dec. 2023. US annual CPI rose from 0.1% as of 31 May 2020 to a peak of 9.1% as of 30 June 2022. Current rate as of 31 Dec. 2023 is 3.4%. European Central Bank, based on HICP Overall Index, as of 31 Dec. 2023. Euro area inflation rose from -0.3% as of 31 Dec. 2020 to a peak of 10.6% as of 31 Oct. 2022. Current rate as of 31 Dec. 2023 is 2.9%. **5** Source: Bloomberg, Banco Central do Brasil, as of 31 March 2024. First rate cut since June 2020 occurred in August 2023. Subsequent rate cuts have followed with Selic interest rates at 10.75%, as of 31 March 2024 vs. 13.75% in August 2023. **6** Source: Bloomberg, based on comparing the 5-year US Treasury Index (GT5 Govt) with Fed funds rate (FDTR Index) from 1 Jan. 2000 to 29 Feb. 2024. **Past performance does not guarantee future results.**

All '\$' signs refer to USD.

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We expect investors to take a more dynamic approach to asset allocation in this new market regime and leverage all the tools available. We believe bond ETFs are among the most powerful tools within the investor tool kit because they can offer the efficiency and precision needed to navigate this market environment.

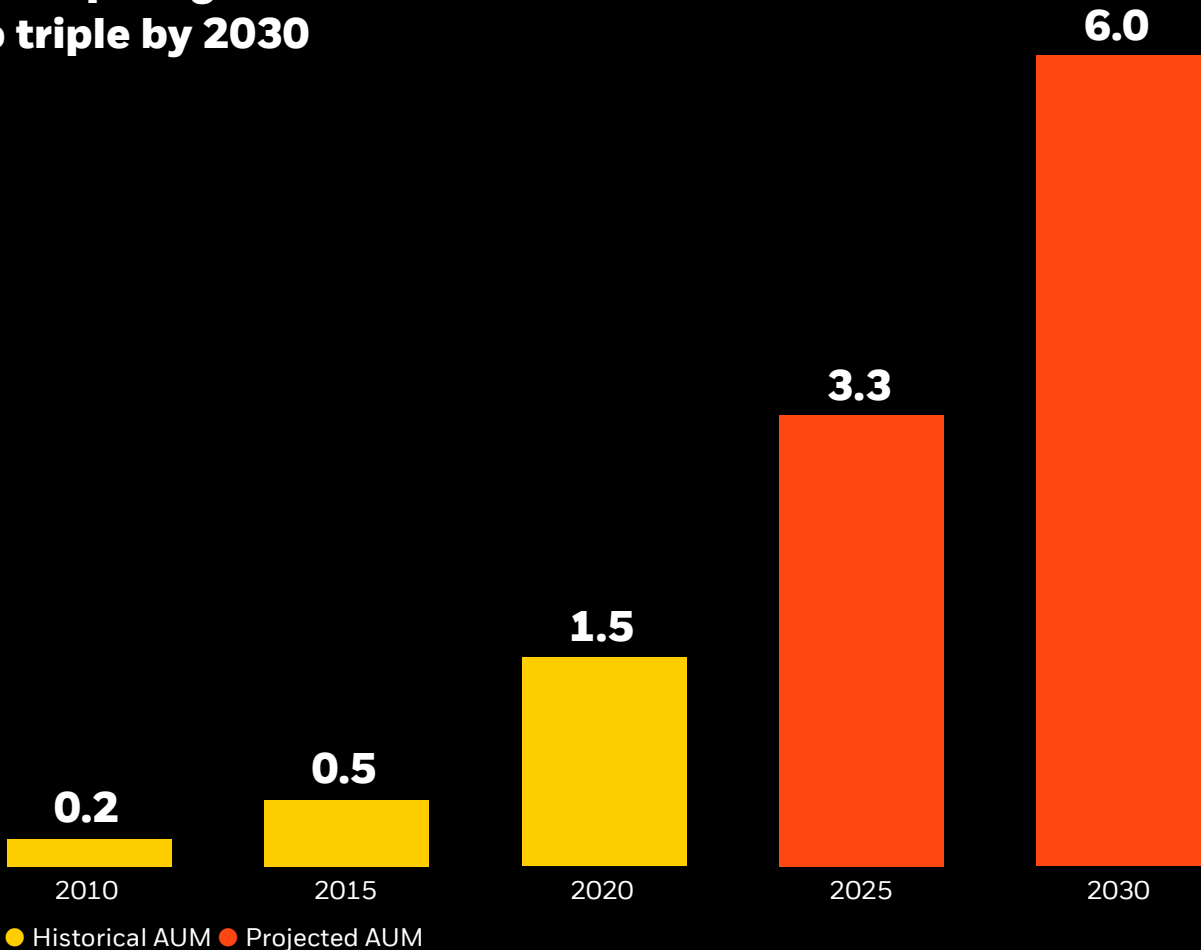
Bond ETFs are increasingly resonating with investors — reaching \$2 trillion in assets in July 2023. We believe this market will triple to \$6 trillion by 2030 as more investors view ETFs as a powerful way to access the bond market (Figure 1).

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

We expect bond
ETFs to triple to
\$6T
by 2030

Figure 1: Actual and projected growth of global bond ETF AUM (USD trillions)

We expect global bond ETF assets to triple by 2030



Source: 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.

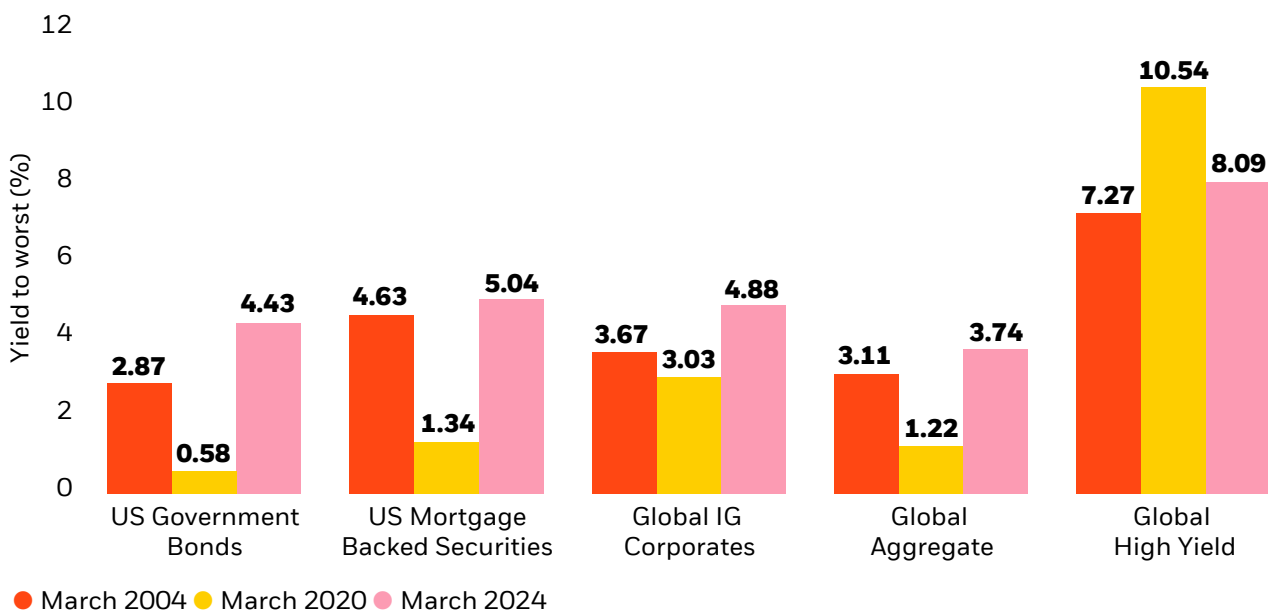
All '\$' signs refer to USD.

Seek to capture higher rates

Promising trends are popping up for investors who are looking past the clouds of uncertainty on timing. **Bond yields are higher today than they were 20 years ago (Figure 2).** Relative to both recent history and even 20 years ago, investors are still able to lock in highly attractive yield levels. Figure 2 shows yield levels on different indices at the end of March in 2004 (before the 2008 financial crisis), 2020 (at the onset of the COVID-19 pandemic), and 2024.

Figure 2: Yield levels of global fixed income exposures (%), 2004-2024

Yields today are at decades-highs



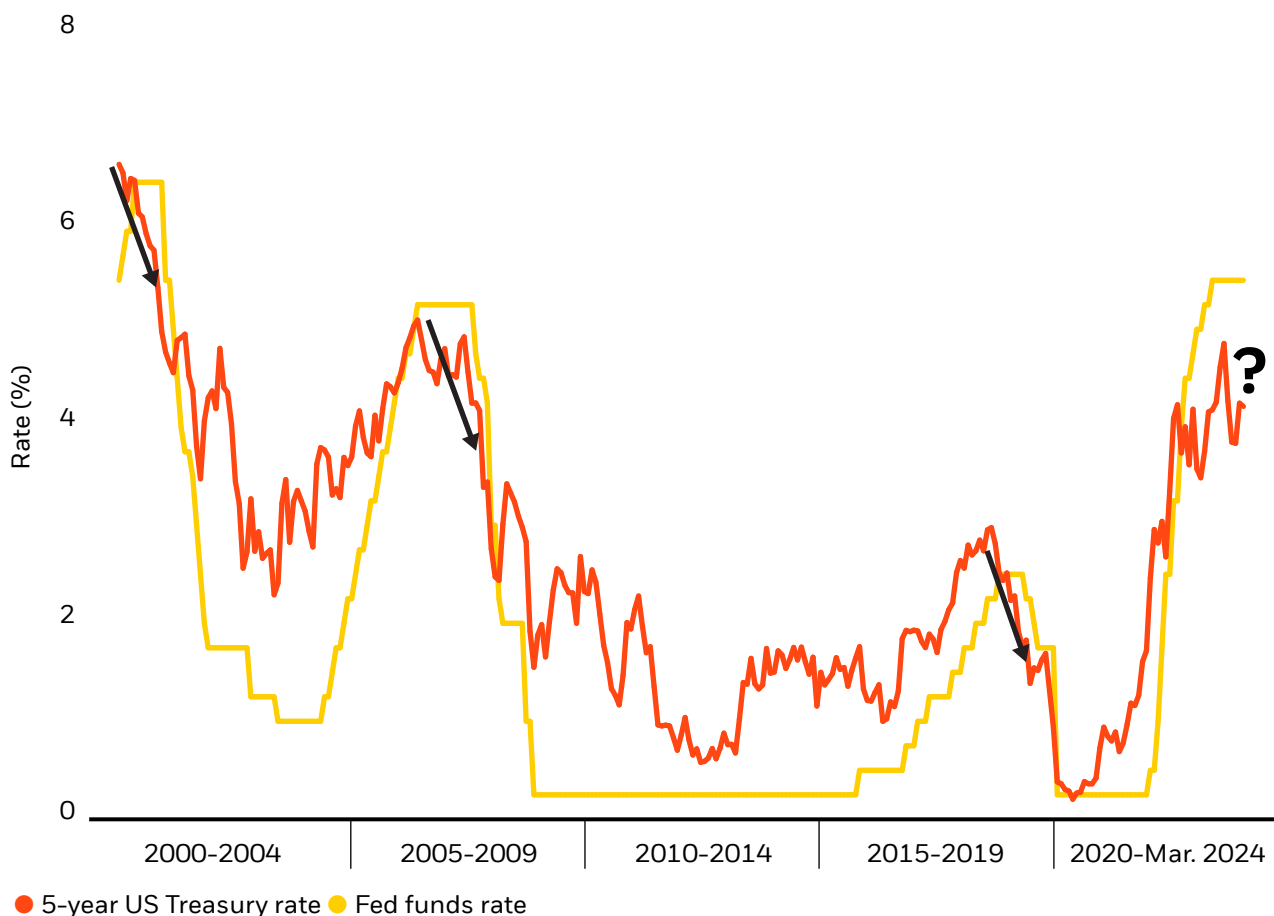
Source: Bloomberg, as of 29 March 2024. Yield to worst as of 31 March 2004, 31 March 2020, and 31 March 2024. US Treasuries: Bloomberg US Treasury Index; US Mortgages: Bloomberg US MBS Index; Global IG Corporates: Bloomberg Global Agg Corporate Index; Global Aggregate: Bloomberg Global Aggregate Index; Global High Yield: Bloomberg Global High Yield Index. **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.**

With inflation indicators generally still falling (albeit haltingly and unevenly, depending on the region), the time of elevated cash rates may ultimately be coming to an end. We believe this means investors may want to consider moving back to fixed income. The market will continue to debate the timing of rate cuts, but few would debate that cuts will eventually come if inflation continues to moderate and

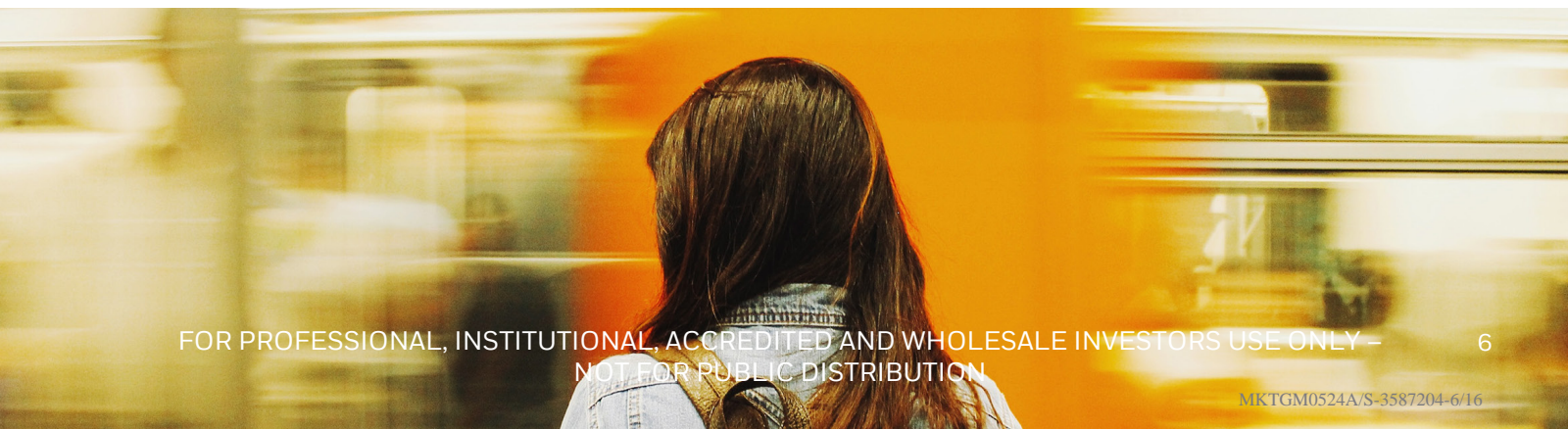
policy becomes ever more restrictive as a result. **Historically, longer term yields have moved ahead of policy shifts (Figure 3).** Investors who wait for a definitive answer may miss the opportunity to capture yields at these levels. And while history may not repeat, volatile data in inflation and economic activity have kept yields elevated even as central banks continue to signal that rate cuts are still under consideration, providing a potentially attractive entry point for investors.

Figure 3: Five-year US Treasury rate compared to Fed funds rate (%), 2000-2024

Historically certain bond rates have tended to fall before the Fed starts to cut



Source: Bloomberg, from 1 Jan. 2000 to 31 March 2024. Price returns based on monthly data comparing the 5-year US Treasury Index (GT5 Govt) with Fed funds rate (FDTR Index).





From history, we also know that when central banks implement pauses, bond markets have tended to do well as Figure 4 below illustrates. We believe investors could benefit from getting ahead of potential interest rate cuts.

Figure 4: Bonds vs. cash 12-month returns (%) after last rate hike of each Fed hiking cycle

Bonds have historically delivered the strongest performance during the “hold” period



Source: BlackRock, Bloomberg as of 31 March 2024. Reference to Bloomberg US Treasury Bill 1-3 Months Index (LD12TRUU) as a proxy for cash, Bloomberg US Aggregate Bond Index (LBUSTRUU), and Bloomberg Global Aggregate Bond Index (USD hedged) (LEGATRUH). The figures shown relate to past performance. 12-month performance shown from the last rate hike of a cycle: 1 Feb. 1995, 25 March 1997, 16 May 2000, 29 June 2006, 19 Dec. 2018, 27 July 2023. The 2023 pause period represents returns from 27 July 2023 to 31 March 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.**

Time to get off the sidelines?

The volatile markets of the past few years caused many investors to, understandably, move money into a less volatile asset – cash. Rising interest rates on the back of the Fed’s aggressive rate hikes in 2022 and 2023 rewarded investors for holding cash – with yields in US Treasury Bills now hovering near 5.25%.⁷ Over \$1 trillion poured into money market funds globally in 2023, and the amount of cash held worldwide in money market funds sat at \$9.2 trillion through year-end, up 19% from 2022.⁸

Bonds are called fixed income for a reason. Historically bonds have served a significant role in portfolios: to generate income and provide portfolio diversification. While cash has provided income temporarily during this tightening cycle, over the long-term, cash has not provided the same level of potential ballast and portfolio diversification against riskier assets such as equities. In typical, upward-sloping yield curve environments, where short-term bonds yield less than longer-term bonds, longer-dated instruments can provide more income to a portfolio. Figure 5 highlights how quickly cash yields can fall, by looking at the 2001-2002 rate cut cycle, money market fund 12-month returns fell from 5.8% in March 2001 to 2.6% by March 2002 and down to 1.8% by July 2002.

7 Source: Bloomberg, based on Bloomberg Barclays US Treasury Bill Index, as of 29 Feb. 2024. **8** Source: Simfund for US money market funds Broadridge for non-US money market funds, both as of 31 Dec. 2023; Total funds for 2023 using all sources were \$9.283 trillion, while total funds for 2022 were \$7.747 trillion. All '\$' signs refer to USD.

Over
\$1T
poured into money
market funds
globally in 2023



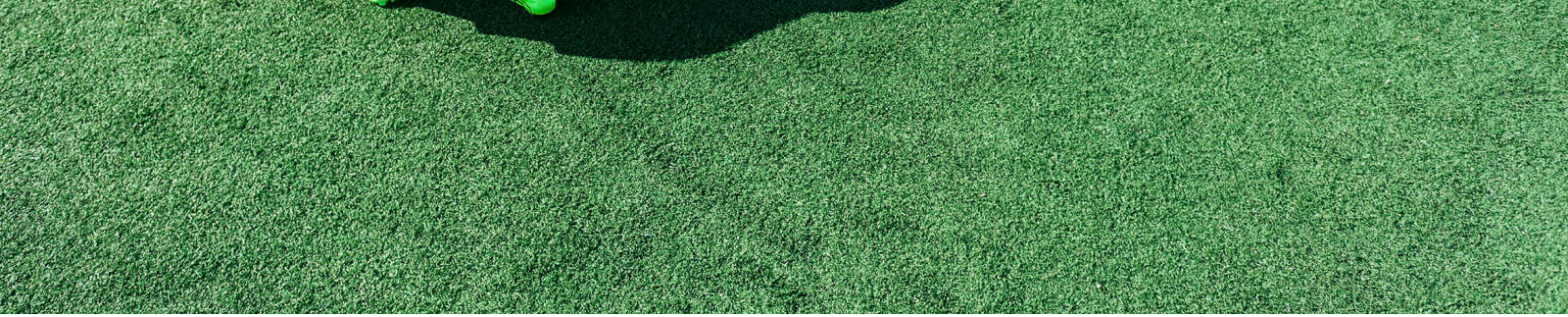
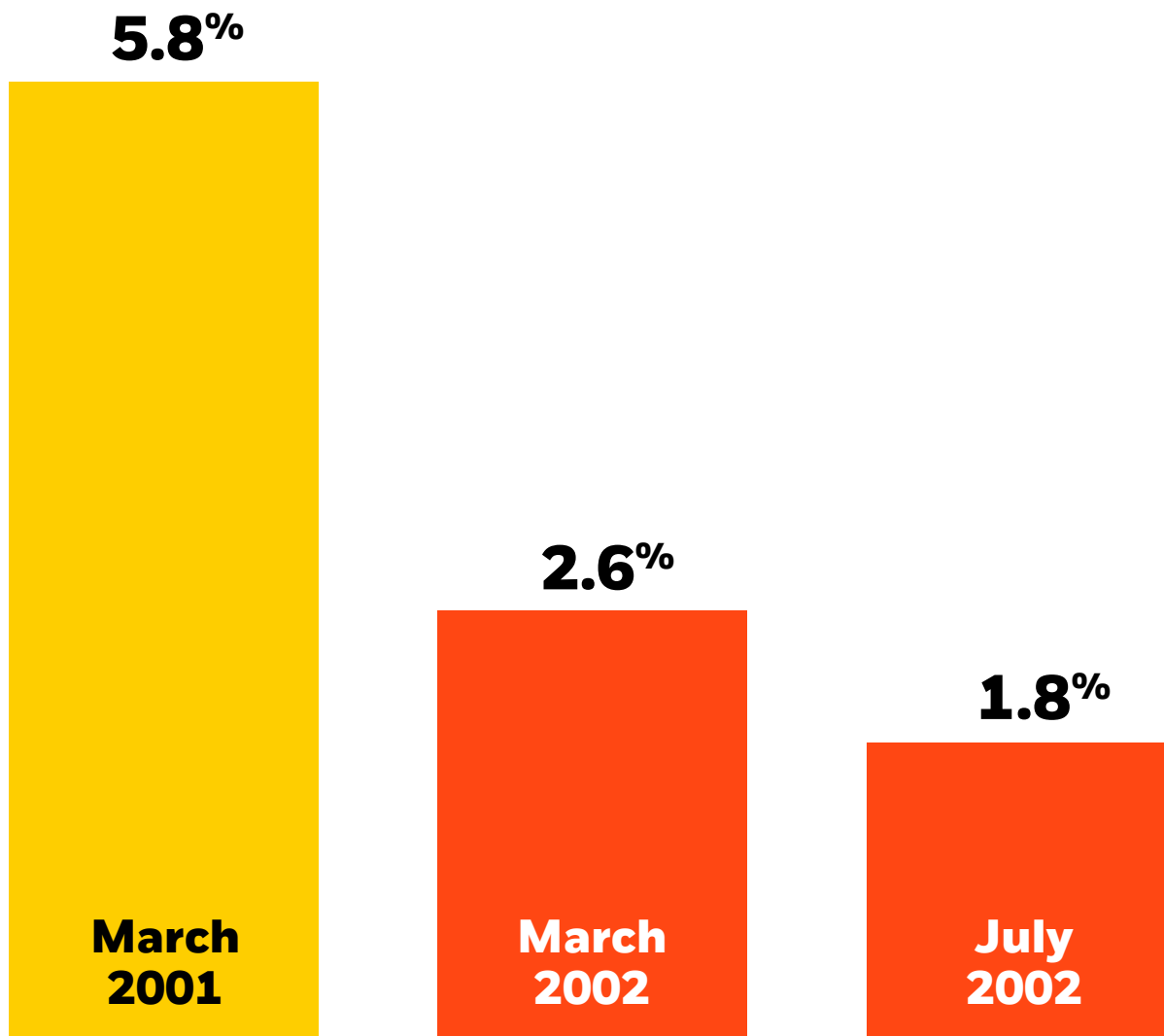


Figure 5: Money market fund average annualised returns (%), 2001-2002

Historically money market returns have fallen rapidly when the Fed pivots to rate cuts



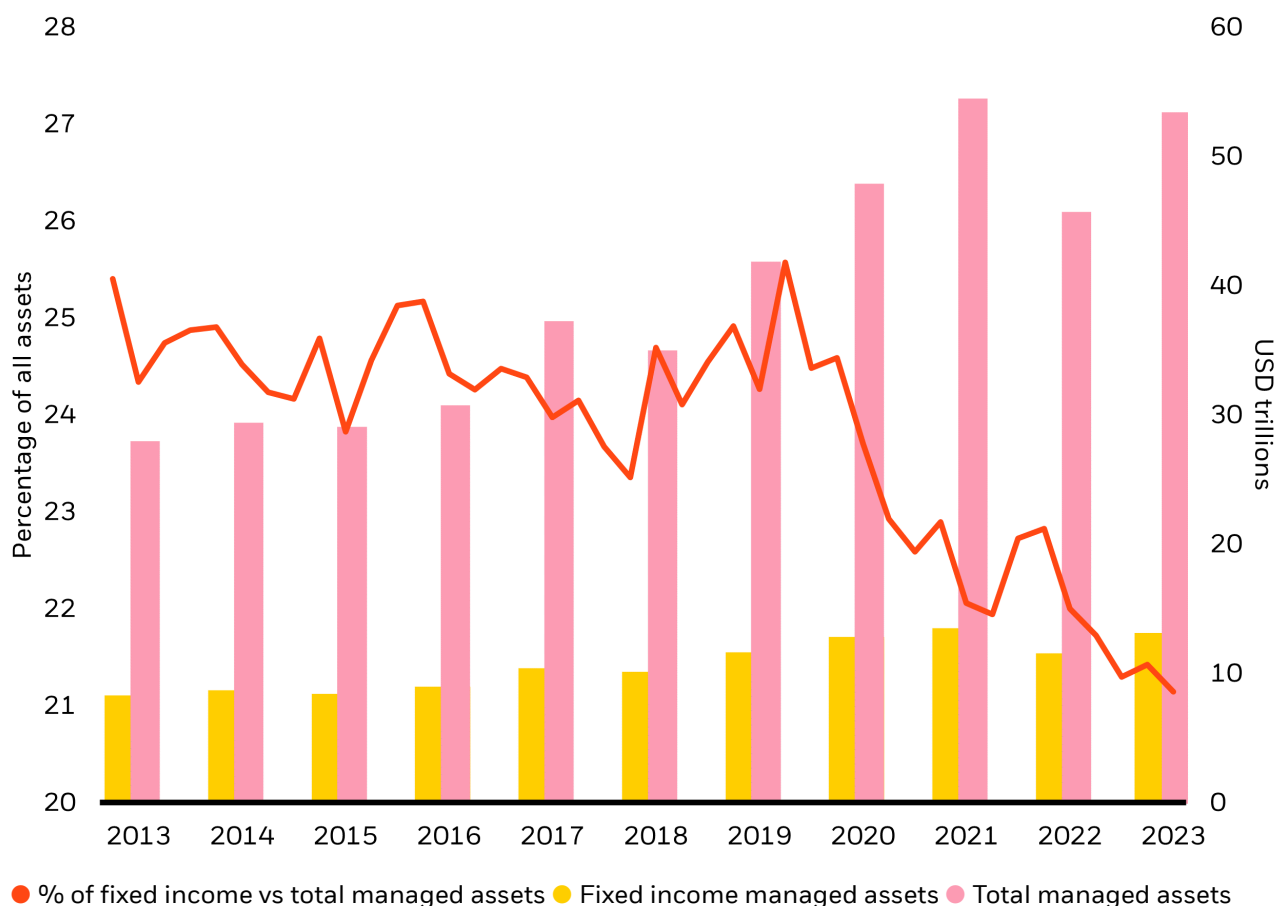
● Money market returns before rate cuts ● Money market returns following rate cuts

Source: Morningstar, as of 31 March 2024. Money market fund returns represented by the Morningstar Prime Money Market Fund Category from March 2001 to July 2002. Average annualised return is the average annual rate of return over a given period. **Past performance does not guarantee or indicate future results.**

Portfolios have room for bonds. Many investors are still significantly underweight to fixed income, with a 21% average fixed income allocation, based on global industry assets under management (Figure 6). The allocation has fallen from 26% at the start of March 2020, as the COVID-19 pandemic began, and it is 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 on average may want to consider holding more fixed income than they currently do depending on factors like the investors themselves, their goals, and their tolerance for risk.

Figure 6: Global fixed income assets as percentage of total industry assets, 2013-2023 (%)

Percentage of bond fund assets reach lowest levels in the past decade



Source: Simfund for US Mutual Funds, Broadridge for non-US Mutual Funds, GBI iShares for Global ETFs, all as at 31 Jan. 2024. Broadridge Money in Motion for Global Institutional and Hedge Fund Research (HFR) for Global Hedge Funds, as at 31 Dec. 2023. Closed ended funds excluded.

How to get back into bonds

Harnessing the power of bond ETFs

For investors considering bonds again, how could they implement their fixed income allocation?

1

Utilise a bond investing toolkit. There are many ways to invest in fixed income including: individual bonds themselves, mutual funds, closed-end funds, separately managed accounts, and bond ETFs. An investor's specific circumstances, including investment objectives, holding period, tax position, and investing platform (e.g., brokerage account vs. retirement account), can help determine the ultimate choice of exposure.

2

Adopt a portfolio mindset. The new yield landscape means that there are now many opportunities in fixed income for investors to pursue. In an effort to build durable, resilient portfolios, investors are now able to use low-cost index exposures at the core, while employing active strategies to seek enhanced returns. For example, index bond ETFs are liquid, transparent, and efficient, making them good building blocks for the core of a portfolio. At the same time, active bond ETFs can augment this portfolio by providing the potential for enhanced return and diversification of opportunities.



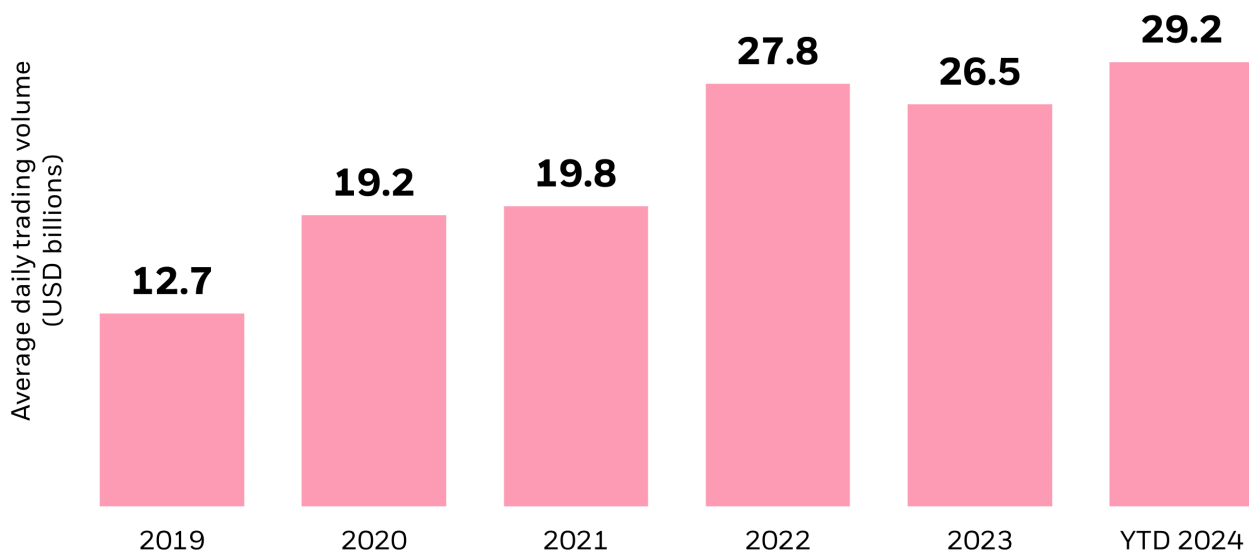


Why bond ETFs can be a good fit for the new market regime

We believe bond ETFs will be a tool of choice for investors as they recalibrate their fixed income allocations and implement whole portfolio solutions using index and active strategies. As bond ETFs have grown in assets and liquidity (Figure 7), they have become increasingly integrated into the fixed income marketplace and have helped catalyse an evolution in bond market structure. Advances in electronic trading and algorithmic pricing of individual bonds have helped improve transparency and liquidity in underlying bond markets. Even more importantly, bond ETFs have revolutionised the way investors access fixed income exposure. Investors may now buy and sell portfolios of thousands of bonds through ETFs with a single click, often for just pennies in trading costs.⁹ 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 7: US and UCITS bond ETF average daily trading volumes (USD billions), 2019–2024

Bond ETF trading volumes have grown at a rate of 20% since 2019



Source: big xyt, Bloomberg, as of 29 March 2024. Based on average daily trading volumes of all US (40 Act) and UCITS bond ETFs. The compound annual growth rate from 2019–2023 was 20%. Past performance is not a reliable indicator of current or future result.

⁹ Source: Bloomberg. Average bid/ask spreads over the past 30 days (as of from 29 Feb 2024) of the 25 largest bond ETFs by assets under management were 0.01%.

Investors can benefit from bond ETF innovation. With over 2,300 bond ETFs globally, investors today have more choices and tools than ever.¹⁰ Newer bond ETFs are slicing the fixed income marketplace into ever more granular exposures that can be blended into highly customisable portfolios. Many strategies featured in newer bond ETFs were previously available only to larger investors at high cost and great difficulty, if at all. The breadth of the fixed income ETF toolkit provides the flexibility to suit almost any investor income/return objective and risk profile.

- Investors may now build portfolios either broadly through aggregate bond ETFs, or in a more tailored manner across sectors, maturities, and credit ratings.
- Investors may choose from traditional perpetual funds or defined maturity funds (the global iShares® iBonds® suite). iBonds ETFs are designed to trade like a stock, diversify like a fund, and mature like a bond.
- The development of exposures such as interest rate and inflation-hedged, defined outcome products (e.g., option-overlay products such as fixed income buy-writes) and actively managed funds allow for even more robust portfolio construction by introducing potential excess return, income, and hedging opportunities than with traditional index exposures alone.

Investors will decide for themselves how to best allocate their fixed income exposure based on investment objectives and risk profiles. We believe the ever-evolving bond ETF universe provides ample tools to create the right portfolio solution.

10 Source: BlackRock Global Business Intelligence, total number of bond ETFs globally is 2,392, as of 31 March 2024.

iBonds ETFs
are designed
to trade like a
stock, diversify
like a fund,
and mature
like a bond

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 sidelines and back into fixed income 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 a tremendous opportunity to retool, rebalance, and reduce risk in portfolios for the future.

The granularity, efficiency, and versatility of fixed income ETFs make them an effective tool for fortifying portfolios with fixed income exposure.

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