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BlackRock.

The great yield reset

Bond ETFs and the generational opportunity in fixed income

MKTGM0723E/S-3026116-1/18

Executive summary

A watershed moment in bond investing is occurring and the opportunity is profound. After last year — the most challenging bond market in decades — yields are back across most fixed income sectors. As a result, there are strong flows into fixed income assets, much of which are migrating into bond ETFs as investors adjust risk and recalibrate portfolios to higher yield levels. This new fixed income paradigm is accelerating bond ETF adoption — a trend that paradoxically gathered speed in 2022 despite the challenging bond market and was most recently evident in March 2023, when volatility was triggered by concerns about the banking sector. Once again, investors turned to bond ETFs to adjust their portfolios and navigate market uncertainty, reinforcing the more traditional 'flight to safety' role of bonds.

Not only has it been true that 'yields are back' but the notion of 'bonds as ballast' has begun to reappear after going missing in action, particularly during 2022.[1] The role of bonds as a potential diversifier to riskier assets is returning as a fundamental element of portfolio construction. While fixed income investors have a range of vehicle choices, the desire for transparency, access, liquidity and efficiency is driving ever greater numbers to turn to bond ETFs to retool and refocus portfolios as they navigate this rapidly changing bond market. Global bond ETF assets are approaching $2T; all of this reinforces our belief that global bond ETF assets will reach $5T by 2030, and likely even sooner.

Diversification and asset allocation may not fully protect you from market risk.

1 Source: Bloomberg, May 2023. Based on weekly returns, the correlation between the S&P 500 & the Bloomberg US Treasury Index was −0.37 from 31/12/2002-31/12/2021. The same correlation was +0.24 from 31/12/2021-31/12/2022.

Investors are turning to bond ETFs to retool portfolios, driven by higher yields and a desire for transparency, access, liquidity and efficiency.

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Key themes we discuss in this piece:

1

A generational opportunity

- The new regime of greater macro and market volatility is here to stay, in our view, and demands a new investment playbook, with more frequent asset allocation changes.
- We saw this volatility play out in Q1, and investors once again turned to bond ETFs to navigate the market turmoil.
- For investors who have had to look elsewhere for income over the past decade, the great yield reset has transformed the strategic opportunity in fixed income.

2

Time for a portfolio rethink

- We believe the average multi-asset portfolio is under-allocated to fixed income, calling for a rethink of strategic asset allocation.
- Now is the time to increase fixed income allocations, in our view — a 'wait and see' approach poses further challenges and potential missed opportunities.
- A blend of index and alpha-seeking exposures can offer investors transparency and the opportunity to be nimble in their fixed income allocation.

3

Getting active with index

- Bond ETFs are made for these times, enabling investors to make rapid tactical asset allocation changes, improve operational efficiency and enhance the liquidity of fixed income portfolios.
- As a result, bond ETFs have become the tool of choice for active managers, who are required to move nimbly in rapidly changing market conditions.

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A generational opportunity

Out with the old, in with the new regime

Gone are the days of the Great Moderation, the four-decade period of largely stable activity and inflation. The new regime of greater macro and market volatility is playing out. The trade-off central banks face — suppress economic activity or live with higher inflation in a world shaped by supply — is front and centre. Their projections for higher inflation and slowing growth suggest they are waking up to this trade-off now. Persistent inflation means we expect rates to stay higher for longer. Although some production constraints could ease as spending normalises, we see long-term trends keeping production capacity constrained and cementing the new regime of higher macro and market volatility. For example, ageing populations mean continued worker shortages in many major economies, while persistent geopolitical tensions are rewiring globalisation and supply chains.

Volatility in rate markets reached post-Global Financial Crisis highs in March 2023, as bonds — particularly US Treasuries (USTs) — experienced significant moves amid stress in the global banking sector. At the height of the volatility, between 13 March and 17 March, we witnessed:[2]

1. The 2-year US Treasury yield experienced its largest one-day decline since 1982.
2. The difference between two- and 10-year yields steepened the most since the 1980s.
3. Interest rate volatility reached its highest level since the Global Financial Crisis.
4. US Treasury bond market liquidity was challenged the most since March 2020.

2 Source: Bloomberg, as of 3 April 2023. Interest rate volatility measured using the ICE BofA MOVE Index while US Treasury liquidity is measured using the Bloomberg US Government Securities Index.

Throughout this period, investors once again turned to bond ETFs to manage interest rate risk and access the bond market. Flows into rates ETPs reached a record level in March, with $33.2B added globally, driven by inflows into US Treasury ETPs ($28.6B).[3] We also saw a spike in trading volumes for iShares US Treasury exposures as investors turned to Treasury ETFs to navigate volatile market conditions: across the iShares UCITS Treasury suite, average daily trading volumes in the week of 13-17 March were more than 300% higher than their averages over the prior three years, highlighting the extent to which EMEA investors have adopted bond ETFs for rapid asset allocation changes amid market turbulence.[4]

This wasn't the first time investors had turned to ETFs to help manage volatility. The efficiency and liquidity of bond ETFs supercharged investor adoption in 2022 amid a historically fraught and complex market environment, and we saw a similar phenomenon in 2020, when Covid-induced market turmoil spurred investors to use bond ETFs for rapid asset allocation changes.

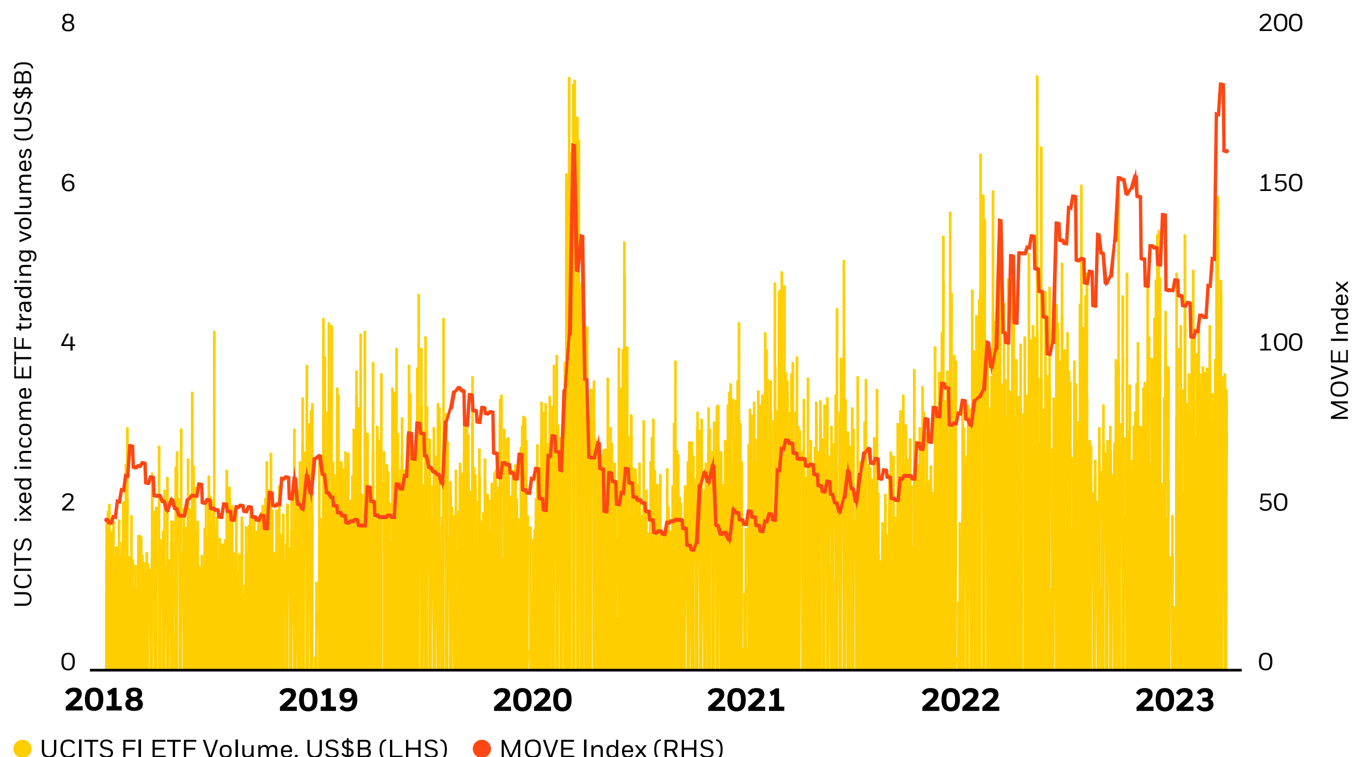
Mapping trading volumes and the MOVE Index of US Treasury volatility as a proxy for the broader bond market (Figure 1), we can see clear spikes in bond ETF trading at times of heightened bond market volatility, such as March 2020 and March 2023. In fact, bond ETF liquidity has been trending higher for years, alongside a similar climb in bond market volatility. The two trends are not a coincidence, in our view, and we see reason to believe both will continue — potentially offering a more persistent catalyst for bond ETF adoption.

During 2022's historically complex market environment, investors traded a record

$856B

of UCITS bond ETFs.[5]

Figure 1: UCITS bond ETF trading volumes and the MOVE Index, 2018-2022



UCITS FI ETF Volume, US$B (LHS) MOVE Index (RHS)

Source: Bloomberg and BlackRock, as of 31 March 2023. The yellow bars show the total daily volume traded in UCITS fixed income ETFs (USD billions). The orange line shows the Merrill Lynch Option Volatility Estimate (MOVE) Index of implied US Treasury market volatility.

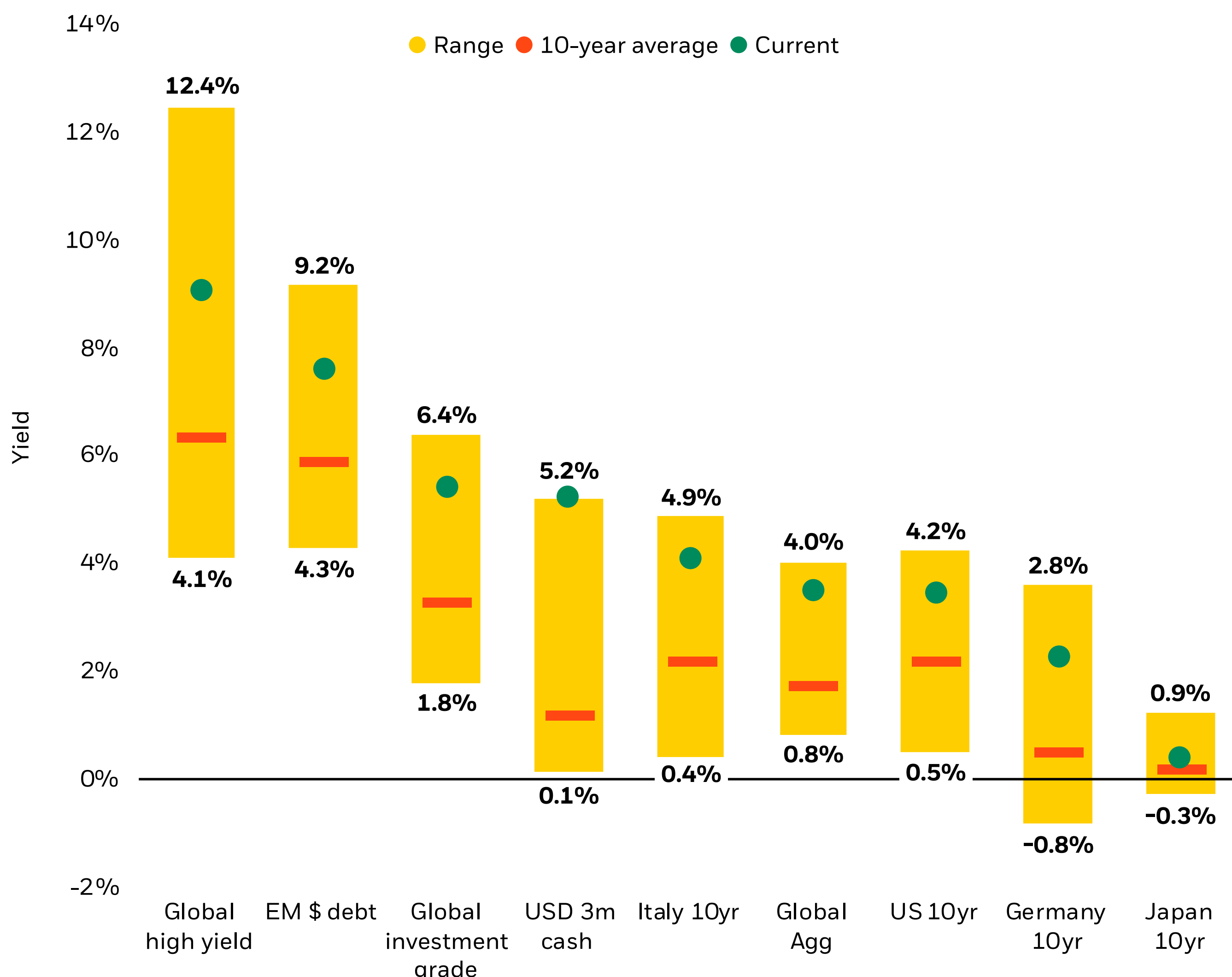
3 Source: BlackRock and Markit, as of 12 April 2023. **Past flows into global ETPs are not a guide to current or future flows and should not be the sole factor of consideration when selecting a product.** **4** Source: BlackRock and big xyt, as of 31 March 2023. **5** Source: BlackRock and big xyt, as of 5 May 2023, covering the period 01/01/2022-31/12/2022.

The great yield reset

The fixed income market rout of 2022 — which led to bond yields not seen in years — is a tale well told at this point. Suffice to say that investors who for years sought yields and returns by overweighting equities and going down in credit and liquidity, were suddenly gifted 2-year US Treasuries yielding more than 4.75%.[6] Figure 2 illustrates the seismic shift that has occurred, with yields from many fixed income exposures now significantly above their 10-year average.

The risk-free rate available in Europe today (3.15%) is higher than yields on European high yield bonds in 2021 (2.65%).[7]

Figure 2: Fixed income yields — April 2023 vs. last 10 years



Source: Refinitiv Datastream, Bloomberg and BlackRock Investment Institute, as of 4 April 2023. The bars show the range over yields from highest to lowest over the past 10 years (highs and lows are labelled). The line shows the average over that period. The dot is the current yield.

6 Source: Bloomberg, as of 31 December 2022. **7** Source: Bloomberg, as of 12 May 2023. Risk-free rate based on Euro short-term rate (ESTR). European high yield bond yields based on Markit iBoxx Euro Liquid High Yield Index, which averaged 2.65% yield-to-maturity in 2021.

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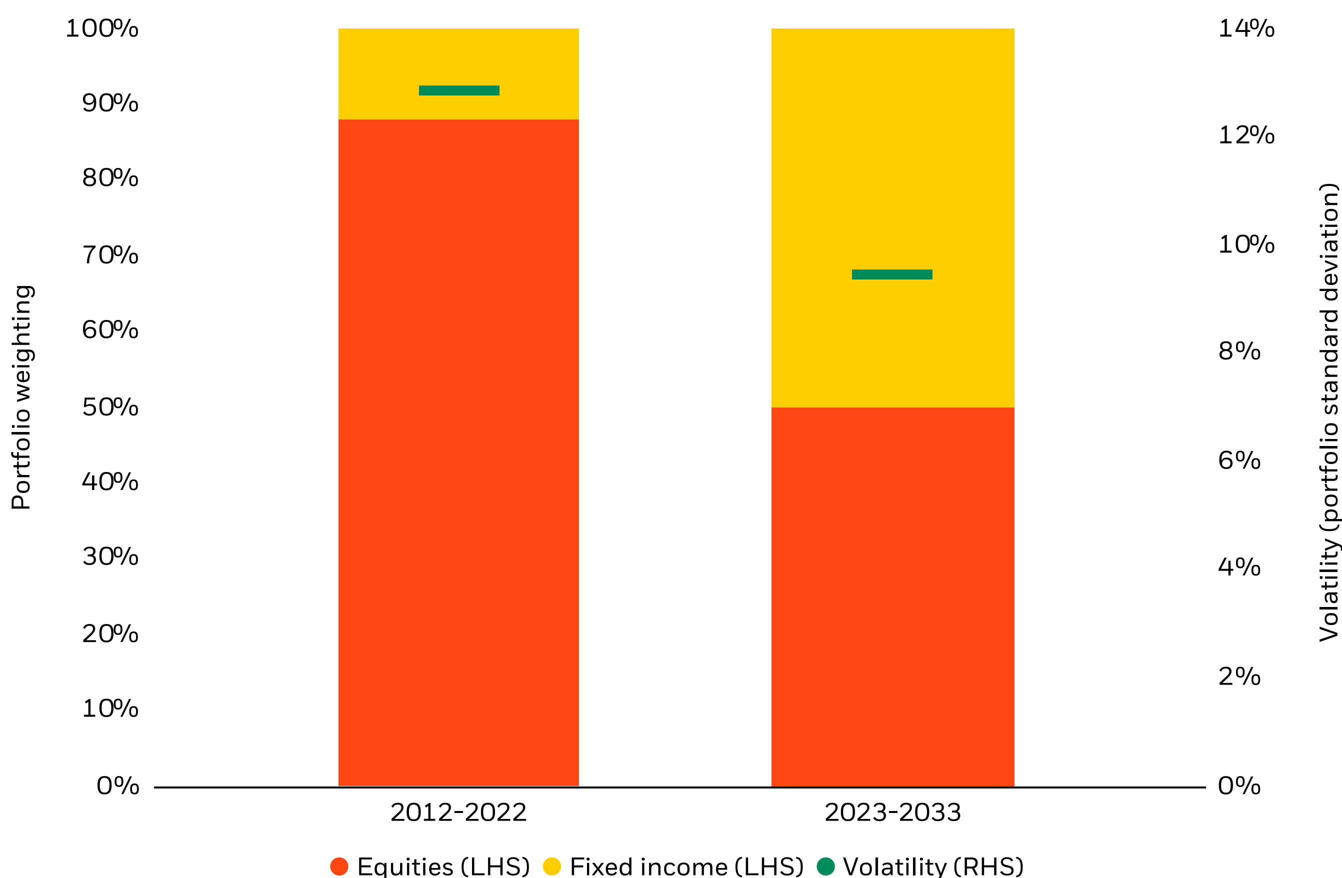
The 'great yield reset' is resulting in far greater portfolio flexibility and could lead to better risk-adjusted outcomes, in our view. To illustrate, consider a hypothetical portfolio allocated to global equities and global fixed income (based on the MSCI ACWI and Bloomberg Barclays Global Aggregate indices). Between 2012 and 2022, an investor seeking a 7% return target would have had to hold 88% equity and 12% bonds. For the same 7% return target on a 10-year forward looking basis today, we find that this asset mix is now 50:50. This composition also reduces portfolio risk by more than 25%, with portfolio standard deviation falling from 12.9% to 9.5%.[8]

Figure 3: Risk levels for a hypothetical multi-asset portfolio targeting 7% return, 2012-2022 vs. 2023-2033

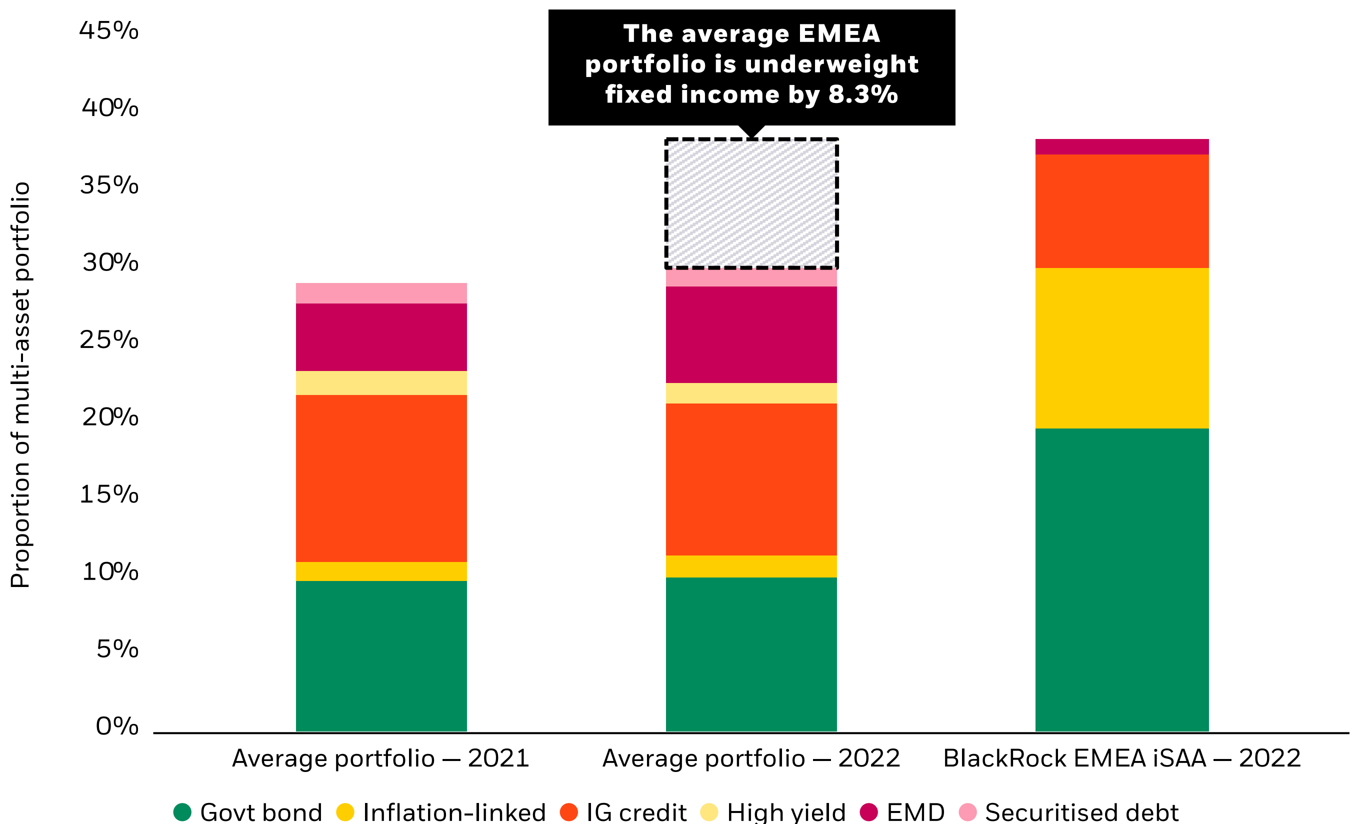


Source (Figure 3 & Footnote 8): BlackRock, as of 11 April 2023. **Ex-post:** BlackRock, Morningstar, from 31/12/2012 to 31/12/2022. Currency = USD. Data frequency = monthly. Rebalance frequency = annual. **The figures shown relate to past performance. Past performance is not a reliable indicator of current or future results and should not be the sole factor of consideration when selecting a product or strategy.** Index performance returns do not reflect any management fees, transaction costs or expenses. Indices are unmanaged and one cannot invest directly in an index. **Ex-ante:** 10-year forward looking views based on BII Capital Market Assumptions as at February 2023, in USD. **This information is not intended as a recommendation to invest in any particular asset class or strategy or as a promise — or even estimate — of future performance.** Return assumptions are total nominal returns. Asset return expectations are gross of fees. Indices are unmanaged and used for illustrative purposes only. They are not intended to be indicative of any fund or strategy's performance. It is not possible to invest directly in an index.

Time for a portfolio rethink

Even after the surge in yields, we believe that multi-asset portfolios have been slow to adjust and are significantly under-allocated to fixed income (Figure 4). The upshot is an opportunity to revamp portfolio construction through a reallocation to fixed income: reducing equity overweights and moving up in credit quality and liquidity — all while diversifying and reducing aggregate portfolio risk. We estimate that over 8% of the average EMEA multi-asset portfolio needs to shift to fixed income based on a strategic 10-year investment horizon.

Figure 4: The shift needed in fixed income average allocations at the same portfolio risk level



This information is not intended as a recommendation to invest in any particular asset class or strategy or as a promise — or even estimate — of future performance. Source: BlackRock Investment Institute (BII), February 2023, EUR. The BlackRock EMEA iSAA is produced by BII Portfolio Research Group-built scenario-based optimiser run with target risk of 9.2% leveraging capital market assumptions as of 31/12/22 with a 10-year investment horizon. Return assumptions are gross of fees. Average portfolios produced by BlackRock Portfolio Consulting EMEA, BlackRock Aladdin on estimated 663 portfolios collected in 2021 and 641 in 2022. Currency: EUR. For Illustrative purposes only.

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Blending index and active

We believe the 'active versus passive' dichotomy is a long-outdated construct. Many investors now adopt a blended approach across asset classes to help improve portfolio outcomes over time.

In our view, focusing purely on combining several active managers in a fund-of-fund portfolio can lead to unintended consequences such as asset allocation drifts, cancellation of active bets and unintended risk exposures potentially revealing themselves in the least favourable moments. For example, many unconstrained fixed income fund managers have tilted to sectors such as high yield or lower quality securitised assets to generate greater portfolio income. Over the most recent three- and five-year periods ending December 2022, the average fund in the Morningstar EUR Diversified Bond category was 63% and 56% correlated with the MSCI Europe Index, respectively.[9] Over the same periods, the Bloomberg Euro Aggregate Bond Index was 51% and 41% correlated with the MSCI Europe Index.[10] This demonstrates the importance of transparency and looking beyond past performance to determine an appropriate fixed income composition.

In times of higher macro volatility, we believe it is important for investors to take charge of their fixed income allocation and truly understand what they are owning. In our view, a more robust approach combines elements of index and alpha-seeking exposures: using low-cost index components to create a more diverse and predictable exposure for greater transparency, freeing up time and resource to identify complementary active strategies in the pursuit of excess returns.

9 Source: Morningstar, as of 31 December 2022. Based on 458 alpha-seeking funds within Morningstar Category: EUR Diversified Bond with at least five-year track record as of 31 December 2022. **10** Source: Bloomberg, as of 31 December 2022.

"We are in a very interesting market that could shift at any moment. It is more important than ever to stay flexible and nimble and I have found that bond ETFs are a highly efficient way to reposition and take advantage of evolving market conditions."

– Rick Rieder, CIO of Global Fixed Income, BlackRock

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Getting active with index

Bond ETFs: made for these times

The new regime calls for a new playbook, in our view, with more dynamic, granular and precise asset allocation adjustments, making liquidity and flexibility in implementation choices paramount to a successful strategy. Many investors have turned to bond ETFs as important tools to help them navigate the rapidly changing market conditions and efficiently access the fixed income market.

While most bond ETFs seek to track indices, many traditional active fixed income managers have come to realise that bond ETFs can also be used to help generate alpha or for efficiency gains in the following ways:

The new playbook calls for more dynamic, granular and precise asset allocation adjustments, making liquidity and flexibility in implementation choices paramount to a successful strategy.

Tactical asset allocation

Investors can use bond ETFs to rapidly scale into or out of exposures, in order to take advantage of or hedge against rapidly changing market conditions — far more quickly and efficiently than trading individual bonds.

Liquidity sleeve

By using bond ETFs for a portfolio liquidity sleeve, investors can avoid having to sell individual bonds in conditions that can be far more costly — especially in stressed markets.

Operational efficiency

By aggregating hundreds or thousands of line items into a single vehicle, bond ETFs can provide a high level of investment efficiency. Investors are relieved of the operational complexity of reinvesting cash flows from individual bonds or rebalancing the exposure to maintain duration targets. Bond ETFs can often be far more cost efficient to trade than individual bonds.

These benefits have not been lost on large and sophisticated institutional investors: 10 out of 10 of the largest global asset managers and 8 of the 10 largest US insurance companies all use bond ETFs.[11]

11 Source: Asset Manager figures based on BlackRock analysis of SEC 13-F filings for US; BlackRock analysis of self-reported holdings by asset managers in Europe and Asia, April 2023. Top 10 global asset managers determined by Pensions & Investments in 2021.

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The modernisation of the bond market powers ahead

We think bond ETFs will continue to drive — and benefit from — the modernisation of the fixed income market. Over the past several years, bond ETFs and their infrastructure have been catalysts for change, helping to improve transparency and efficiency in the notoriously opaque and fragmented global bond market. Because of the evolution of the bond ETF creation/redemption mechanism (through which authorised participants are able to exchange portfolios of bonds for shares), investors are now able to trade large baskets of bonds — known as portfolio trades — instantaneously and at one price.

Sourcing and pricing large numbers of bonds in the over-the-counter (OTC) market would be quite challenging without bond ETFs and their infrastructure. In Europe, portfolio trading volumes grew by an estimated 61% year-on-year to €145B in 2022 (versus €90B in 2021), and were almost 15x higher than in 2019 (€10B).[12] Growth in bond ETFs and portfolio trades has resulted in advances in algorithmic pricing and electronic trading. Last year, on average 40% of investment grade bonds and 30% of high yield bonds traded electronically.[13] These innovations have benefited not only bond ETFs, but the bond market itself through enhanced transparency and fungibility between the OTC market and exchange.

12 Source: Goldman Sachs, as of 31 December 2022. **13** Source: J.P. Morgan US Credit Market Liquidity: YE 2022 update, TRACE.

Conclusion

Bond ETFs' liquidity, efficiency and breadth of exposures have helped them gain widespread adoption as instruments for fixed income investment exposure and portfolio risk management. The market dynamics of the past three years — starting with the onset of the pandemic, followed by the great reflation and culminating in the great reset in yields — has resulted in significant amounts of assets shifting into bond ETFs. More than ever, investors are turning to bond ETFs to seek desired investment outcomes and to navigate rapidly and ever-changing market dynamics. The long-term, structural drivers of bond ETF adoption have only been accelerated by these events. This reinforces our belief that bond ETFs will continue to grow, reaching $5T in assets globally by 2030, while further cementing their role as a central and important part of the bond market itself.

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