

The background of the slide features a geometric design with overlapping triangles in shades of blue and grey. The BlackRock logo is positioned in the upper left corner.

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**The Limits to Monetary Policy...
and More of My Favorite Themes for 2016**

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Chief Fixed Income Strategist

November 2016

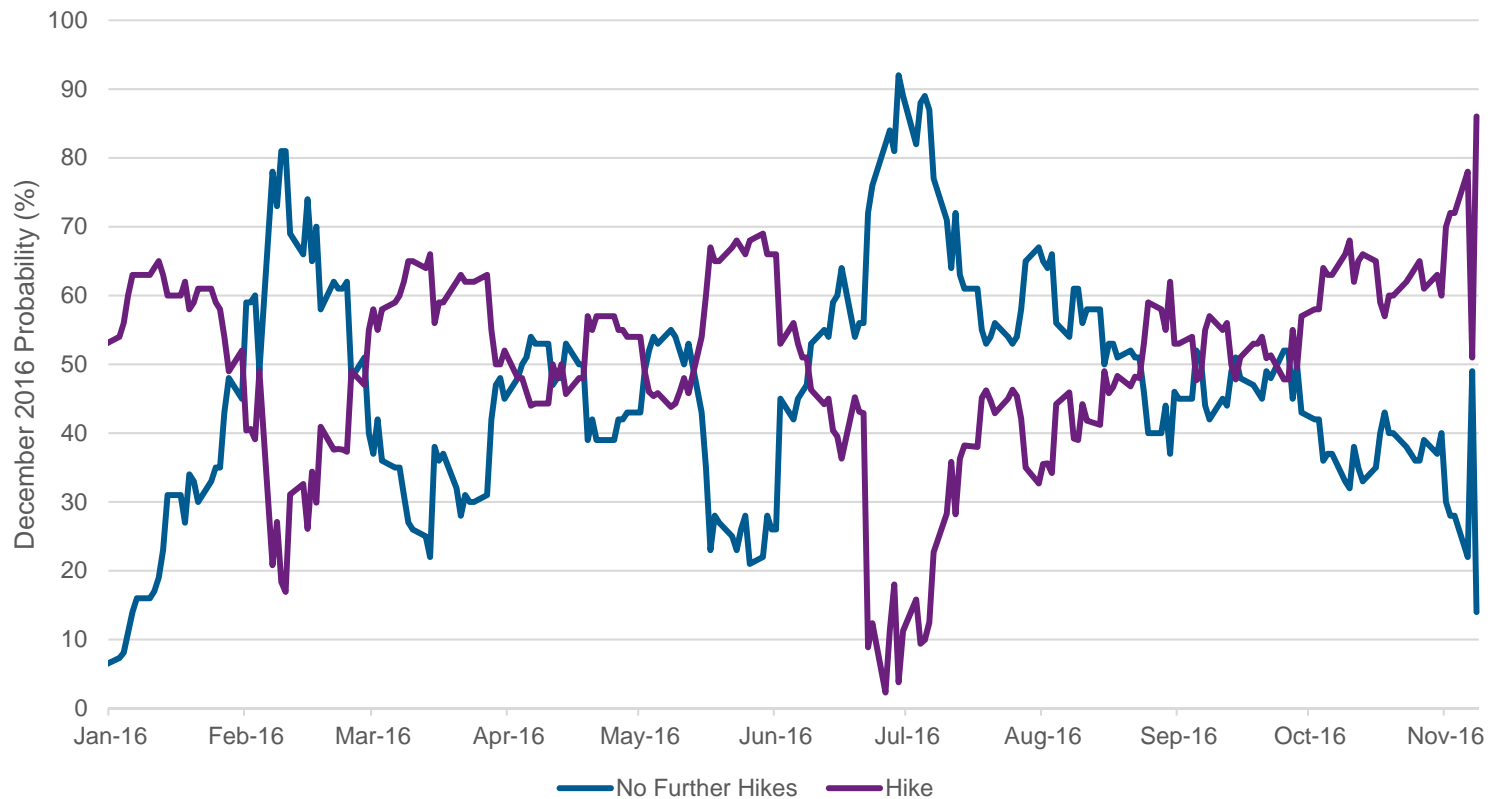
Investment Themes and Recommendations

Themes	Recommendations
<i>There Will Be Blood</i>	Corporates: We continue to have a positive view on credit, but political risks and high valuations continue to support our preference for higher-quality credits. Prefer going down in capital structure in higher quality sectors for yield (e.g. preferreds).
	High Yield and Loans: Round trip in commodity risk leaves valuation upside limited. Returns from carry likely only in 2 nd half but downside remains. Loans better relative value vs. high quality bonds.
	Emerging Markets: Revaluation in hard currency, FX and local rates alongside post-Brexit postponement of developed market rates normalization moves EMD to an overweight recommendation. Favor local currency, short end in countries with policy accommodation flexibility.
	Securitized Assets: US consumers and US real estate remain far from the commodity/EM/China epicenter of this cycle making this one of our preferred areas for taking credit risk in 2016. Liquidity concerns limits the size of allocations and are an important consideration for this sector.
<i>Promises, Promises</i>	Treasuries: Treasury remains a good long term hedge for portfolio risk; however 2 nd half US economic improvements, transitioning global monetary policy and rising hedging costs leading to steeper curves.
	Agency Mortgages: Valuations and prepay concerns keep mortgages at underweight. Greater liquidity and their high quality nature of yield enhancement argue for greater allocations while tight valuations argue for underweight.
<i>The Credit Cycle Leads the Business Cycle</i>	Bonds vs. Stocks: While for years we have favored stock returns over bonds, the combination of stretched equity valuations and significant repricing of bonds introduces a more balanced outlook.
<i>The "New" Divergences</i>	Non-USD: A more balanced outlook for FX returns (a significant detractor in 2015) improves the outlook for non-USD. However, significantly lower DM rates outside of the US keeps this sector at neutral.
<i>Commodities, Inflation and TIPs</i>	TIPs: A stable dollar and stable or even rising commodity prices all point to upside potential in inflation figures in the coming months. A broad range of indicators point to labor markets at full employment and emergence of wage inflation. Attractive valuations vs. nominal Treasuries alongside less downside risk from potentially falling commodity prices raises this sector to overweight.
	Commodities: Supply rebalancing in oil coupled with China stimulus stabilizes the near term outlook for prices. Gold however may benefit from "risk off" events and a slow pace of Fed normalization.

Tactical Themes and Views in Fixed Income

US Rate Normalization: On again, Off again, On ...again (as of November 9th)

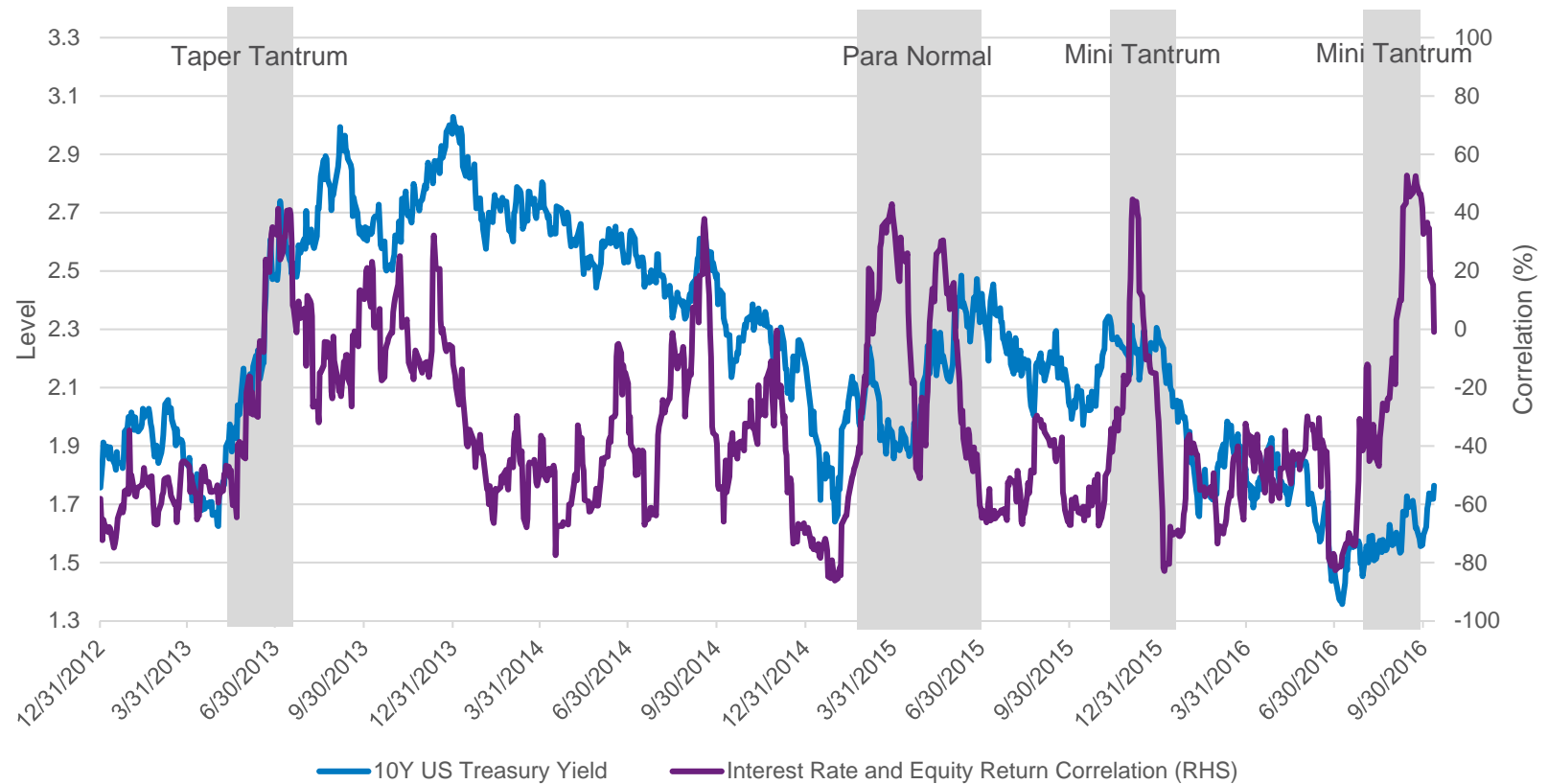
Fed Funds Futures' Implied Probabilities



Source: Bloomberg

A Mini Tantrum?

Correlation of Bonds and Equities vs. US 10 Year Treasury Yield

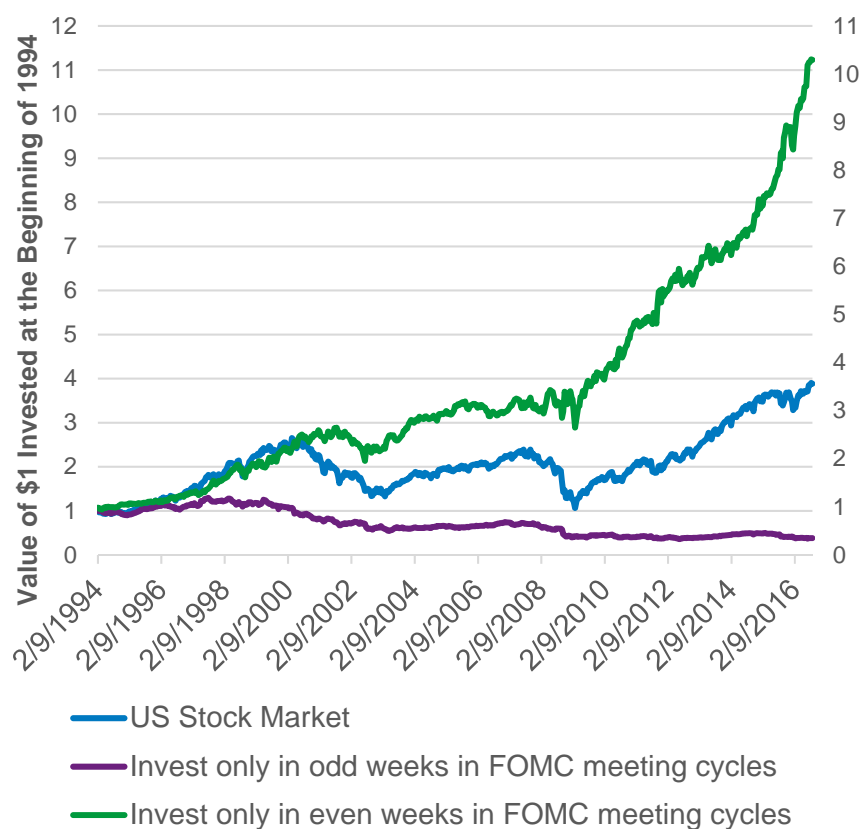


Sources: Bloomberg, BlackRock Calculation.

Notes: Correlation between interest rates and equity are calculated based on a 20 day rolling window of total return of S&P 500 index and Bloomberg Barclay US 7-10 Year Treasury index

A Novel Measurement of “Portfolio Balance” Impact on Stocks: The Bi-weekly Anomaly

Bi-weekly Anomaly in US Stock Excess Returns



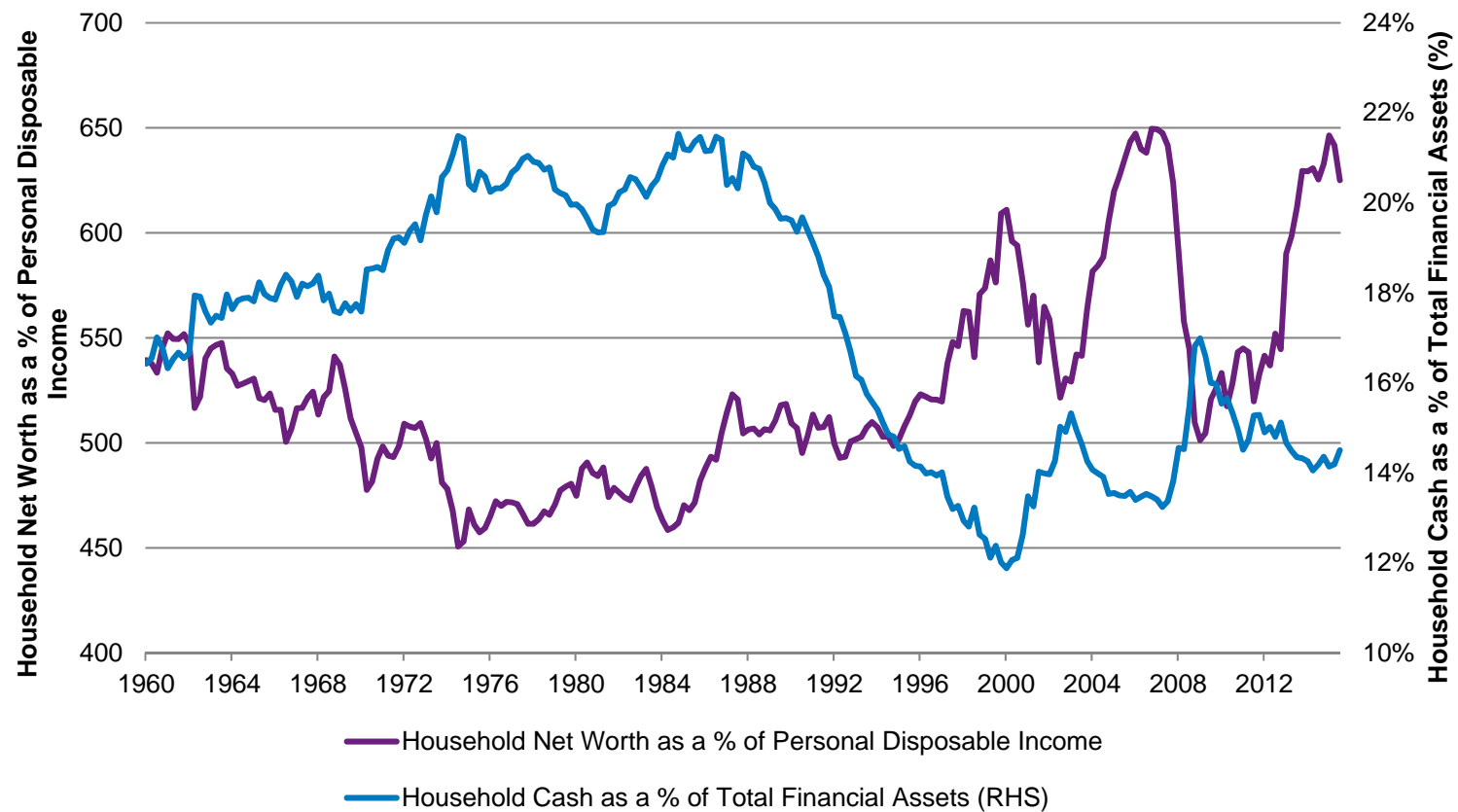
Sub Period Analysis	Average Weekly Return			Period Return	
	Total	Even	Rest	Even	Total
2/3/94 - 6/30/00	0.33%	0.54%	0.08%	145%	153%
6/30/00 - 3/31/03	-0.31%	0.12%	-0.81%	-4%	-45%
3/31/03 - 12/31/07	0.22%	0.21%	0.26%	27%	63%
12/31/07 - 2/27/09	-0.86%	0.01%	-1.81%	-2%	-50%
2/27/09 - 09/06/16	0.38%	0.72%	-0.02%	250%	246%
All	0.16%	0.45%	-0.17%	926%	296%

Sources: Source: Bloomberg; St Louis Fed; BlackRock Calculation; “Stock Returns over the FOMC Cycle,” Cieslak, Morse, Vissing-Jorgensen, 2016.

Note: The chart shows the cumulative excess return (defined by total return - return on 3m Treasury bill) among 3 strategies 1) Invest only in even weeks in FOMC meeting cycles 2) Invest in US S&P 500 Index all the weeks and 3) Invest only in odd weeks in FOMC meeting cycles.

The Portfolio Balance Effect

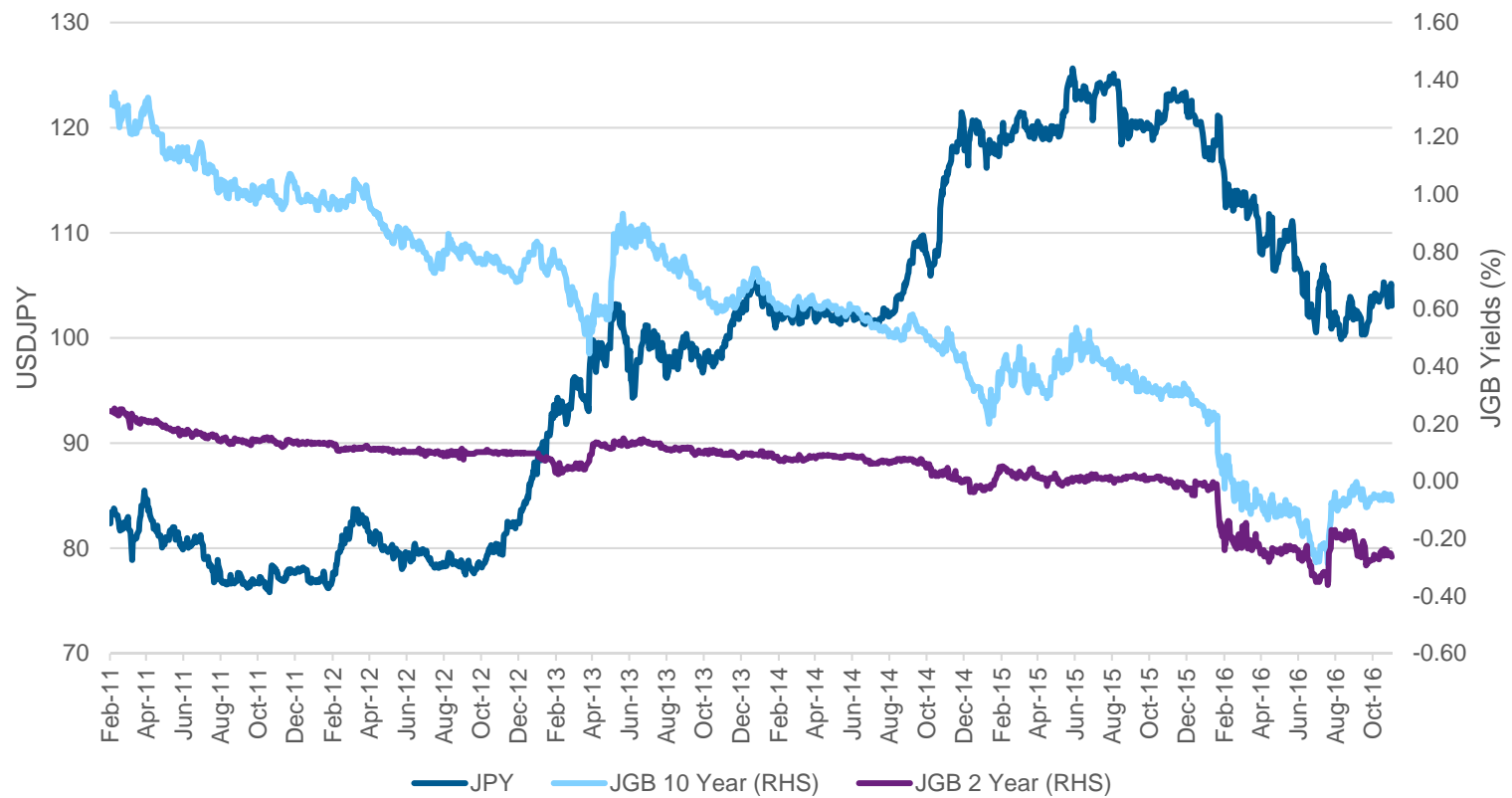
Wealth vs. Cash



Source: Federal Reserve

The Limits to Monetary Policy

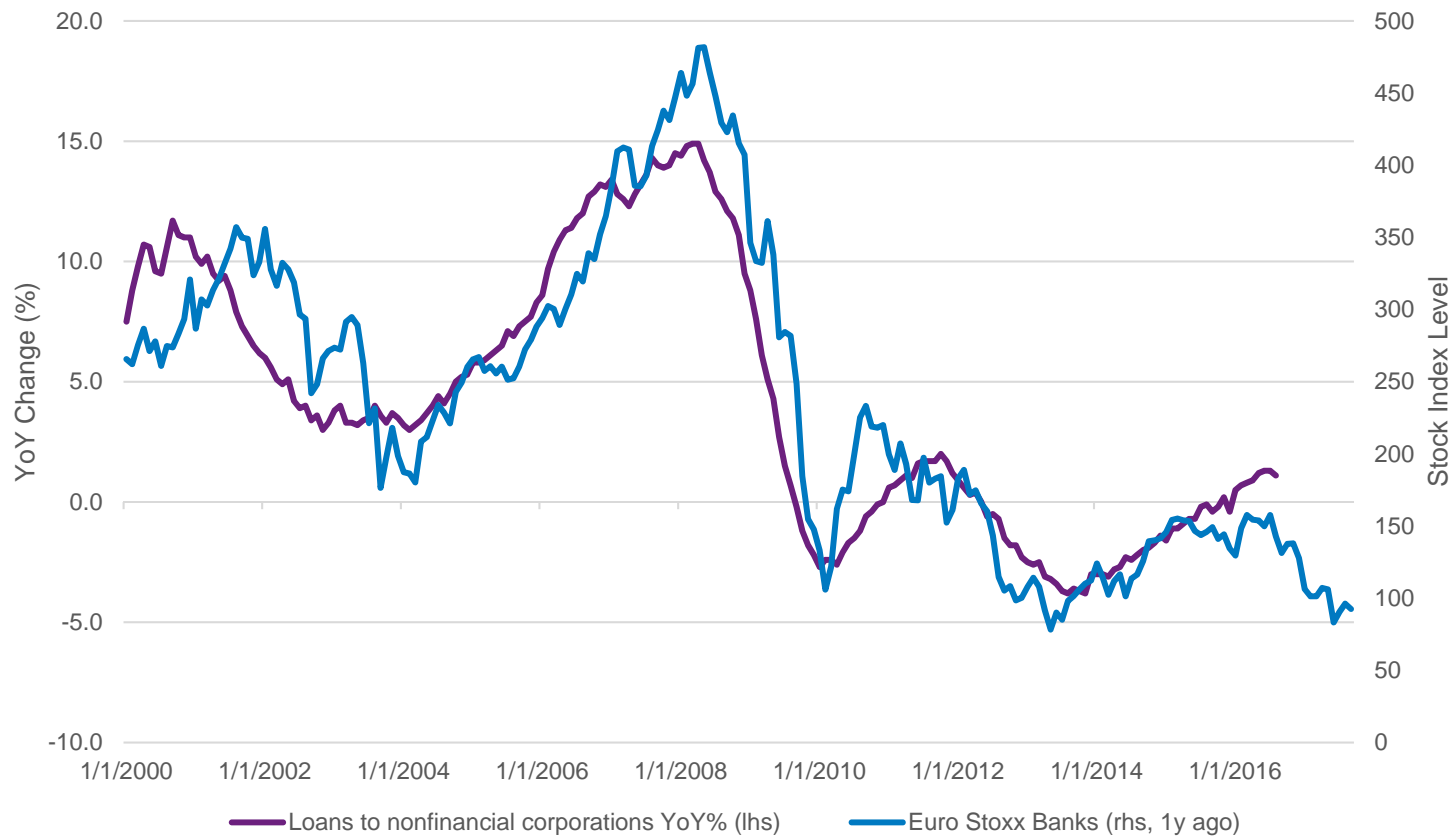
Declining Impact of Declining Interest Rates on JPY FX



Source: Bloomberg

The Unintended Impact of Regulatory Policy Enforcement

Credit Growth Rates Tracking Bank Stocks



Source: Bloomberg, ECB

Monetary Policy Transition and its Impact

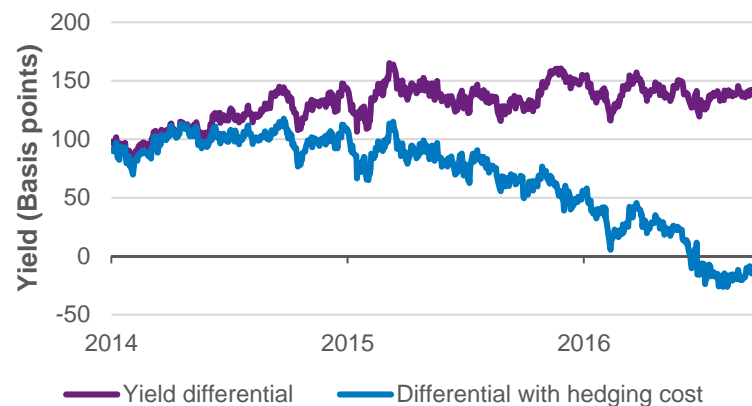
Curve Shape Changes, US vs other Developed Markets



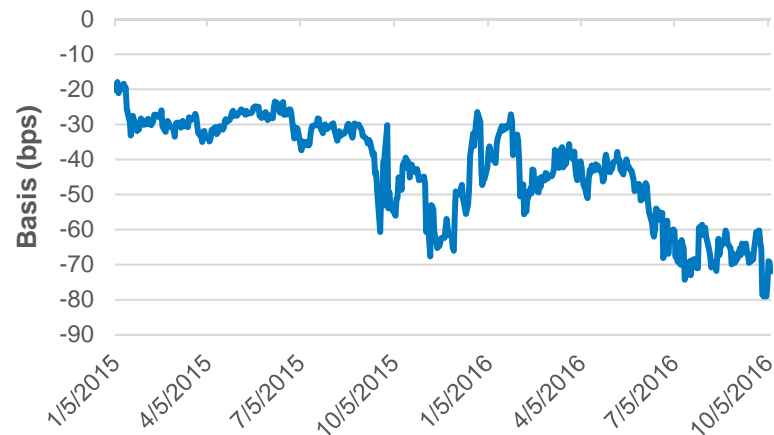
Source: Bloomberg, BlackRock calculation. Notes: The yield curves are the difference between 30 and 5 year benchmark government bond yields in the countries displayed. The lines show how yield curves have evolved in 2016 by rebasing them to 0 at the beginning of the year. Higher index levels suggest steeper curve.

Global Rates Influences on US Rates

US vs. the World



Cross Currency Basis Swap



US Yield Attractiveness Relationships, Japan Example

U.S. 10-year Treasury Yield (1.40%) –
JGB 10-year Yield (-.28%) = **1.68%**

U.S. 10-year Treasury – U.S. 3-month Libor

Japanese Hedging Costs = U.S. 3-month Libor
(0.66%) –
[JPY 3-month Libor (-.03%) + Cross Currency Basis
Swap
Spread (-.69%)] = **1.38%**

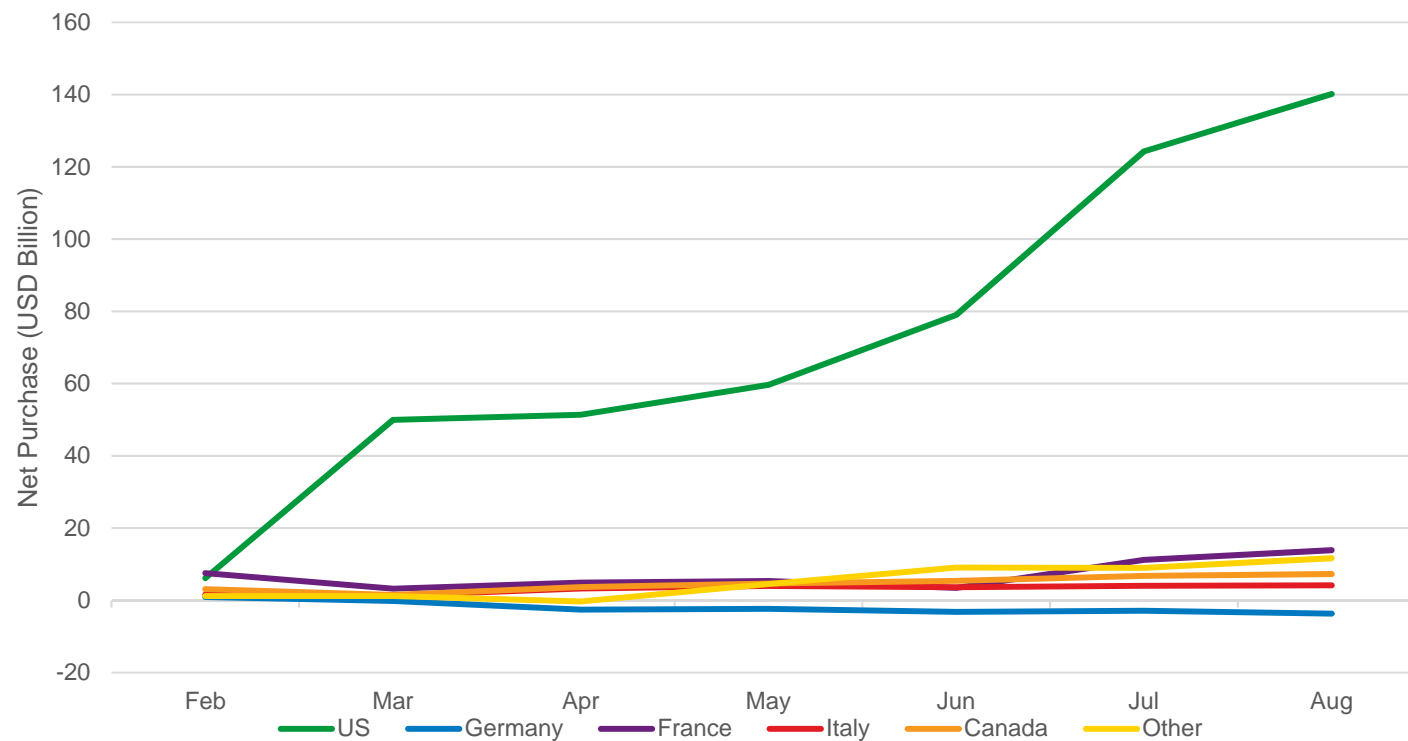
JGB 10-year – JPY 3-month Libor

Cross Currency Basis Swap Spread

Source: Bloomberg, Yield differential is the difference between US 10Y yield and weighted average of Japan, Switzerland, Germany, France, Italy & Spain 10Y yields (By nominal GDP). Hedging costs are estimated based on 3M FX forward points.

Foreign Flows US Impact: A Look at Japan Bond Buying

Japan's YTD investments in foreign sovereign bonds

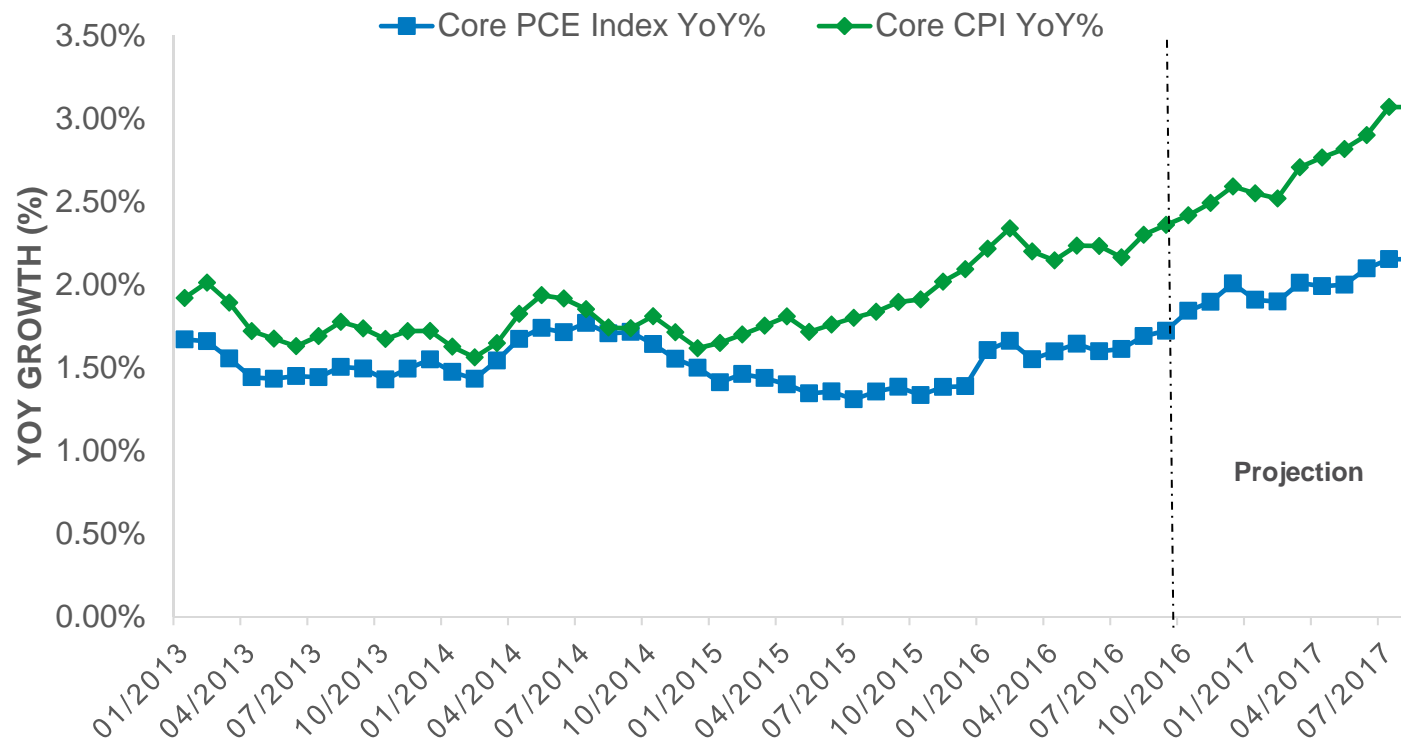


Source: Bloomberg, Japan Ministry of Finance.

Note: US sovereign bonds include both Treasury securities and agency mortgage back securities.

Inflation is in the Eye of the Bondholder

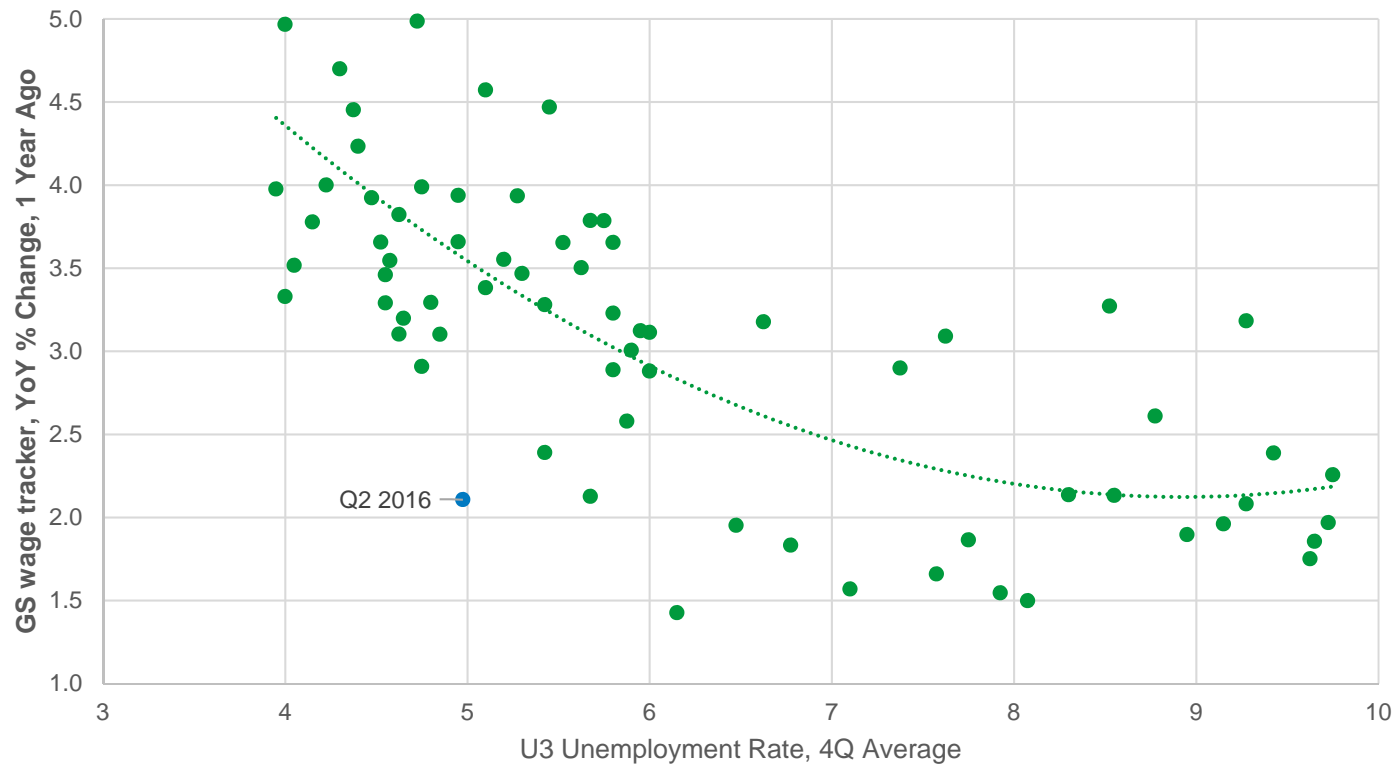
Core CPI and PCE should Grind Higher as Oil and USD Stabilize



Source: Bureau of Labor Statistics, BlackRock Calculation; Note: Forecasted levels assume the indices grow at most recent MoM % rates, which is then used to calculate YoY % change together with historical index levels.

Wage Growth Puzzle

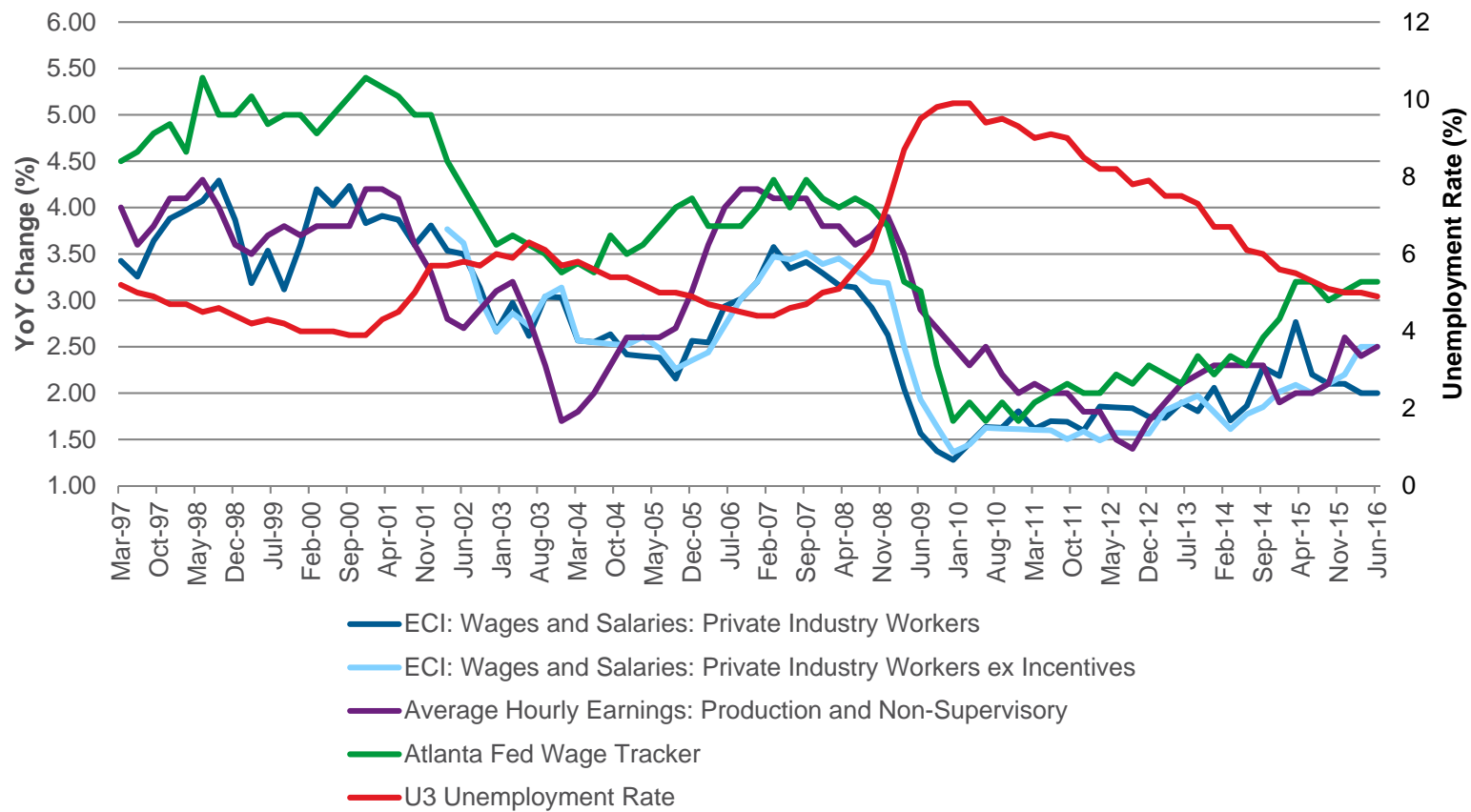
Wage Phillips Curve – Wages vs. Unemployment Rate



Source: Goldman Sachs

Wage Growth Puzzle ... Solved

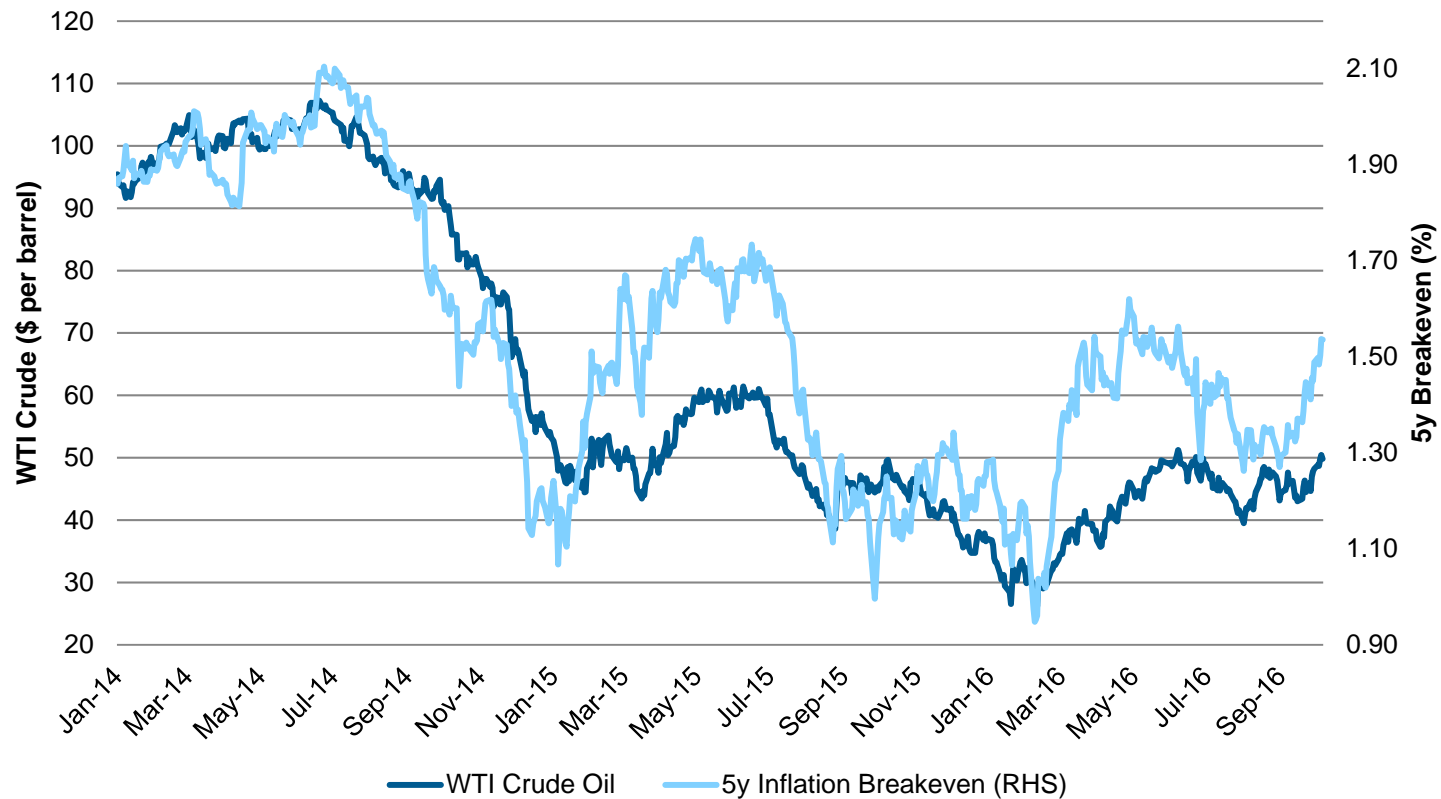
Most Recent Trends Show Mixed Picture on Wage Growth



Source: BLS, Atlanta Fed

TIPs Inflation Expectations Hostage to Oil Prices

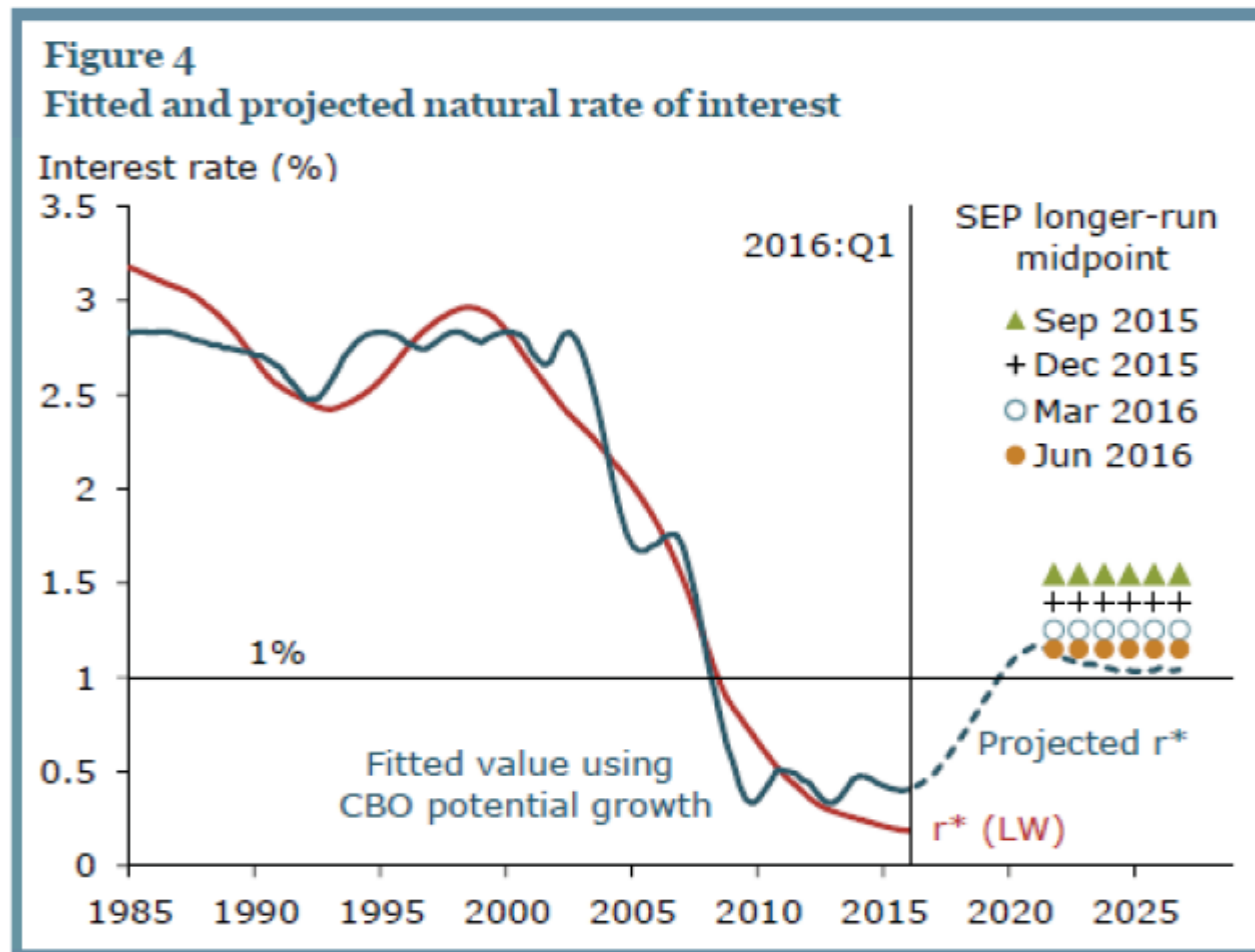
5yr US TIPs Breakeven Inflation vs. Oil



Source: Bloomberg

Demographics + Technology + Productivity + Global Savings Glut = low R^*

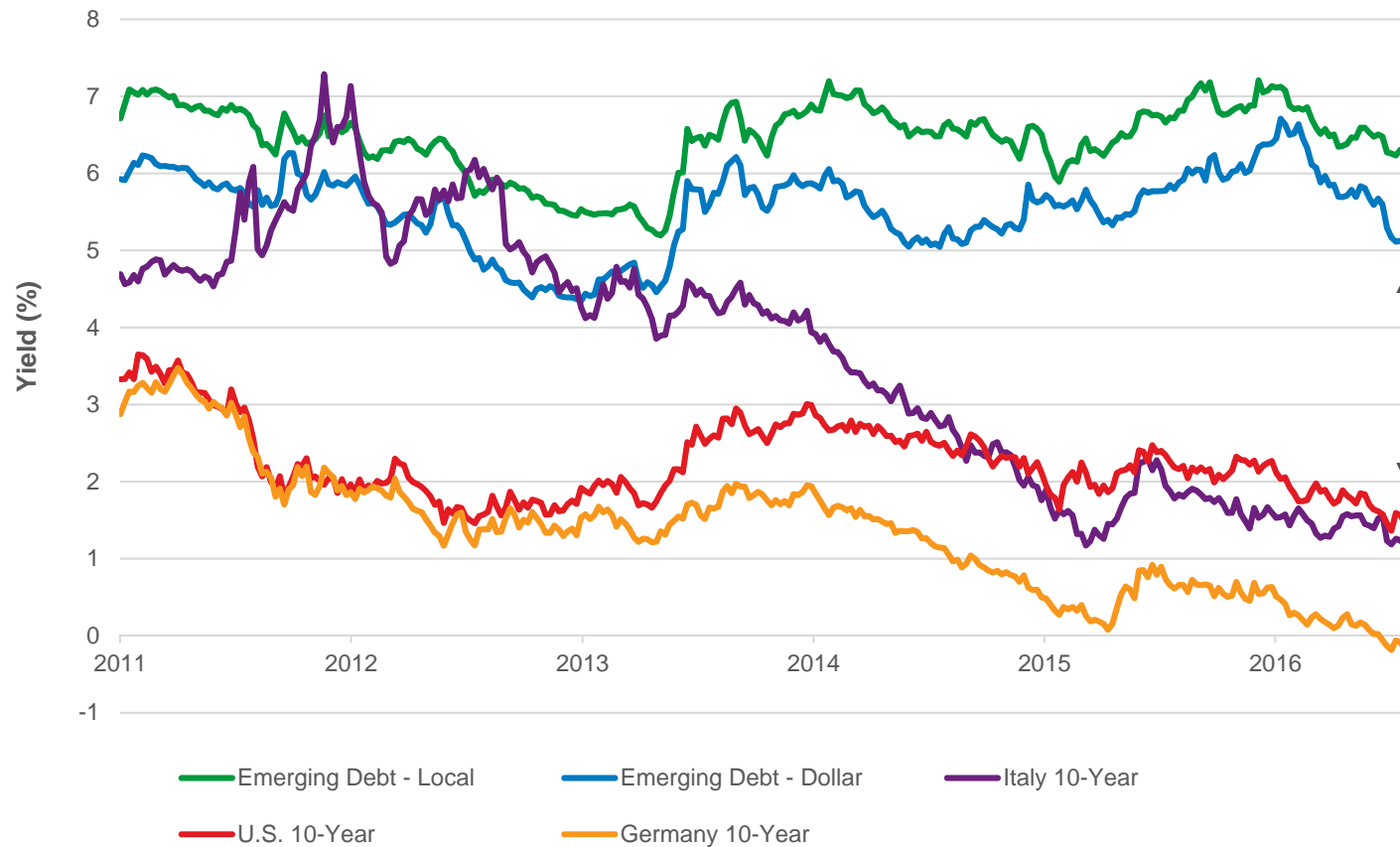
The Fundamental Case for Lower for Longer



Sources: Projecting the Long-Run Natural Rate of Interest (2016) by Kevin Lansing, Federal Reserve Bank of San Francisco,

Low for Longer Raises the Attractiveness of Emerging Markets

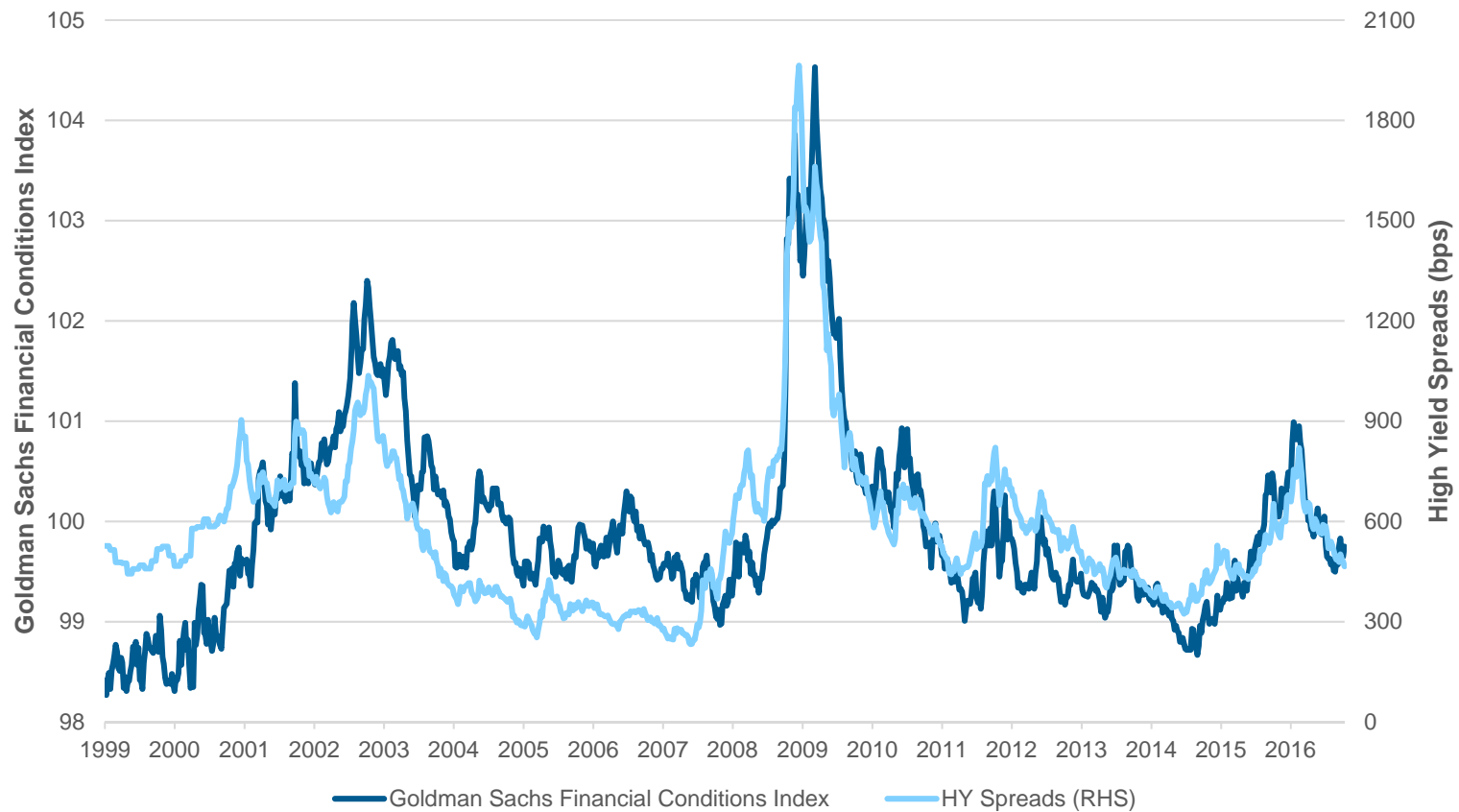
Emerging Markets vs. Developed Market Bond Yields



Sources: BlackRock Investment Institute, JP Morgan Index Data and Thomson Reuters, July 2016

From “Normalization” to “Accommodation”

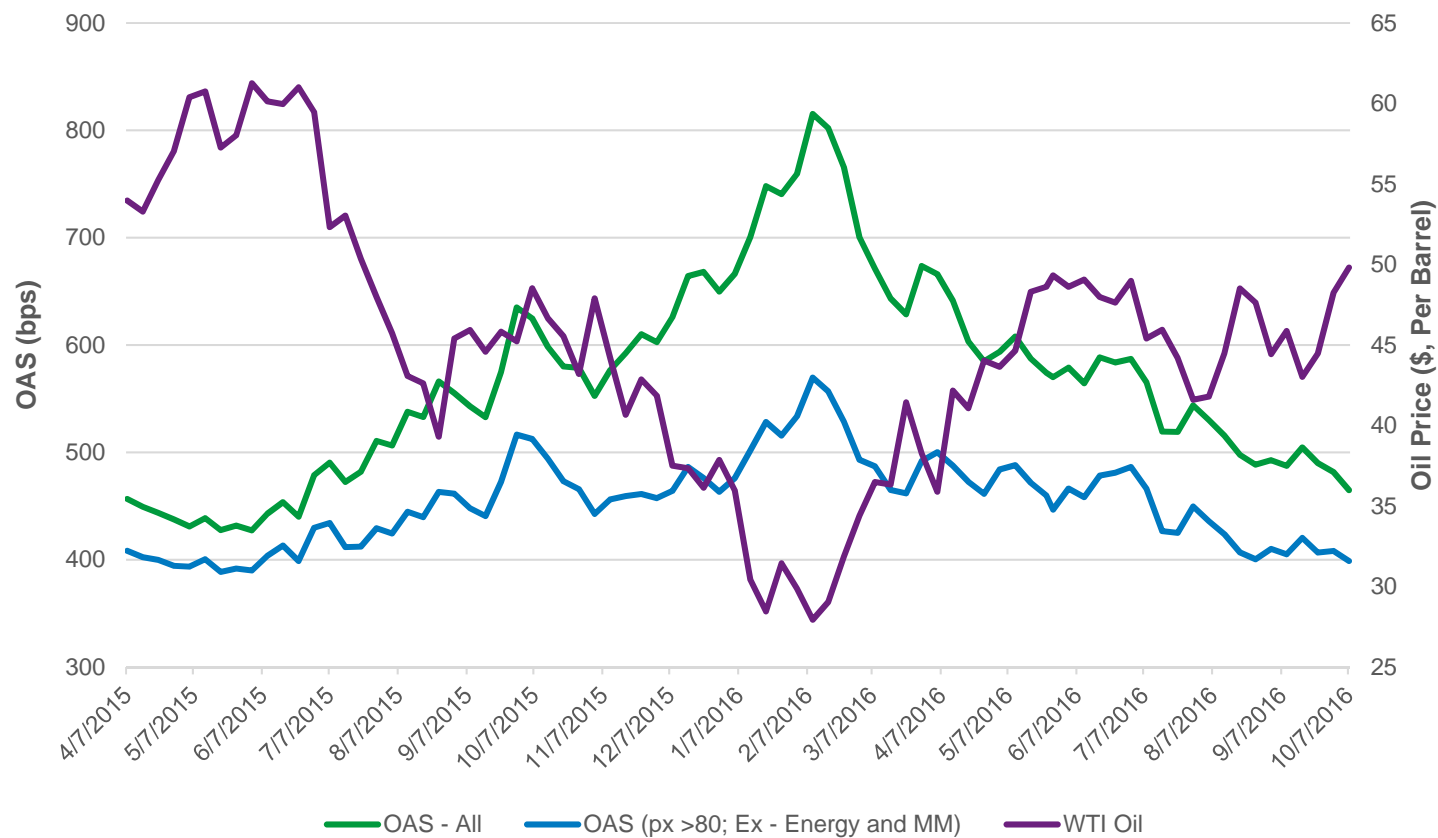
Financial Conditions Have Eased



Source: Goldman Sachs, Bloomberg Barclays US HY Index

Credit Comeback on the Back of Oil

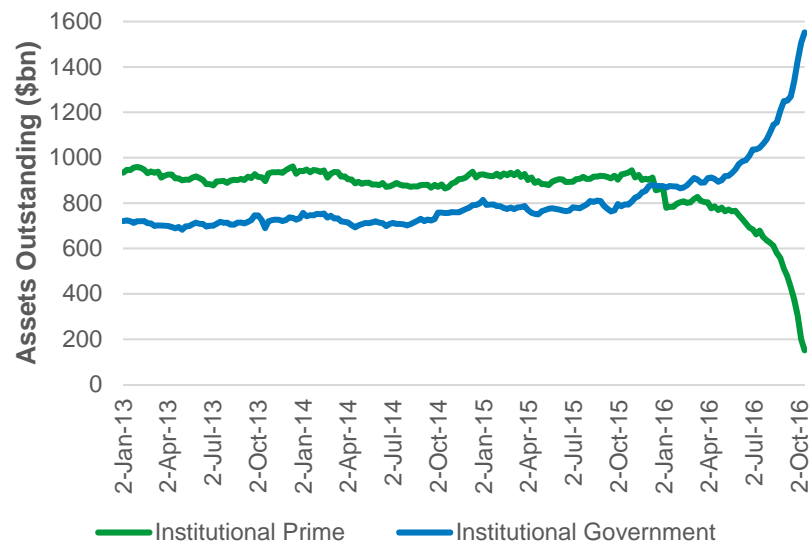
High Yield Spreads vs. Oil Prices



Source: Bloomberg, BlackRock

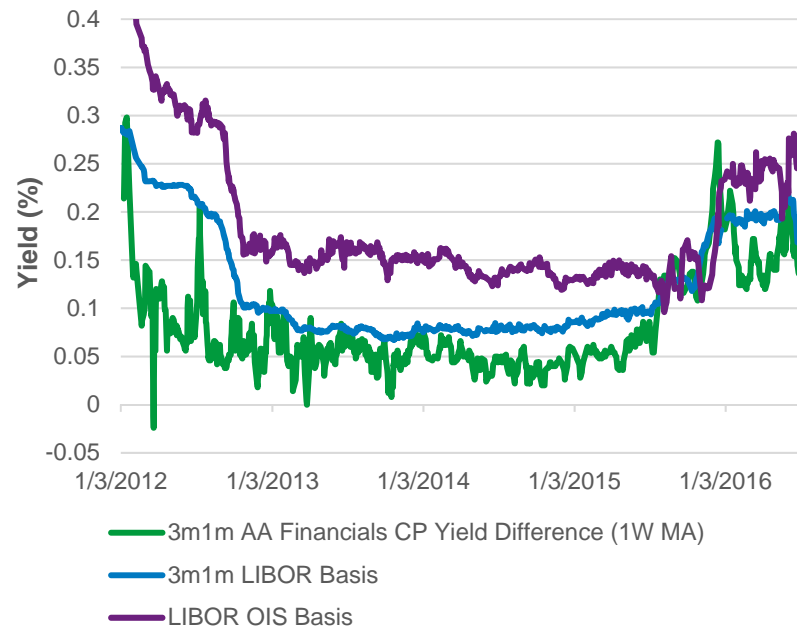
The Impact of Uncertainty from Regulatory Change: Borrowing Costs Rise

Pending Changes Prompt Assets Shifting



Investor Type	Money Market Fund Type	NAV	Redemption Fee	Redemption Suspension
Institutional	Prime, Municipal/Tax Exempt	Floating	Up to 2%	Up to 10 Business Days
Institutional	Government	Stable (\$1.00)	None*	None*
Retail	Prime, Municipal/Tax Exempt	Stable (\$1.00)	Up to 2%	Up to 10 Business Days
Retail	Government	Stable (\$1.00)	None*	None*

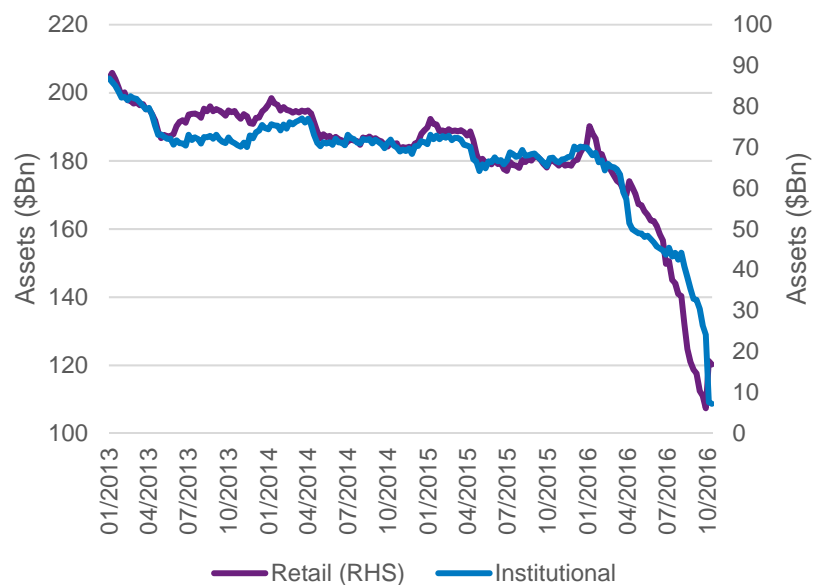
Impacts on Other Short Term Borrowing Costs



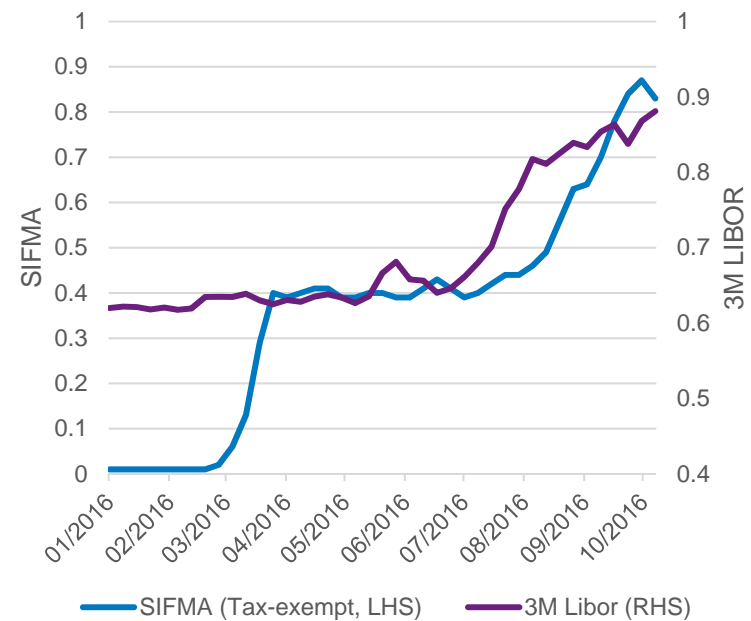
Source: ICI, Haver Analytics, Federal Reserve Board, ICE, Bloomberg and SEC.

Money Market Reform Municipal Market Impact

Continuing Outflows from Tax Exempt Money Market Funds



Increase in Short Maturity Rates

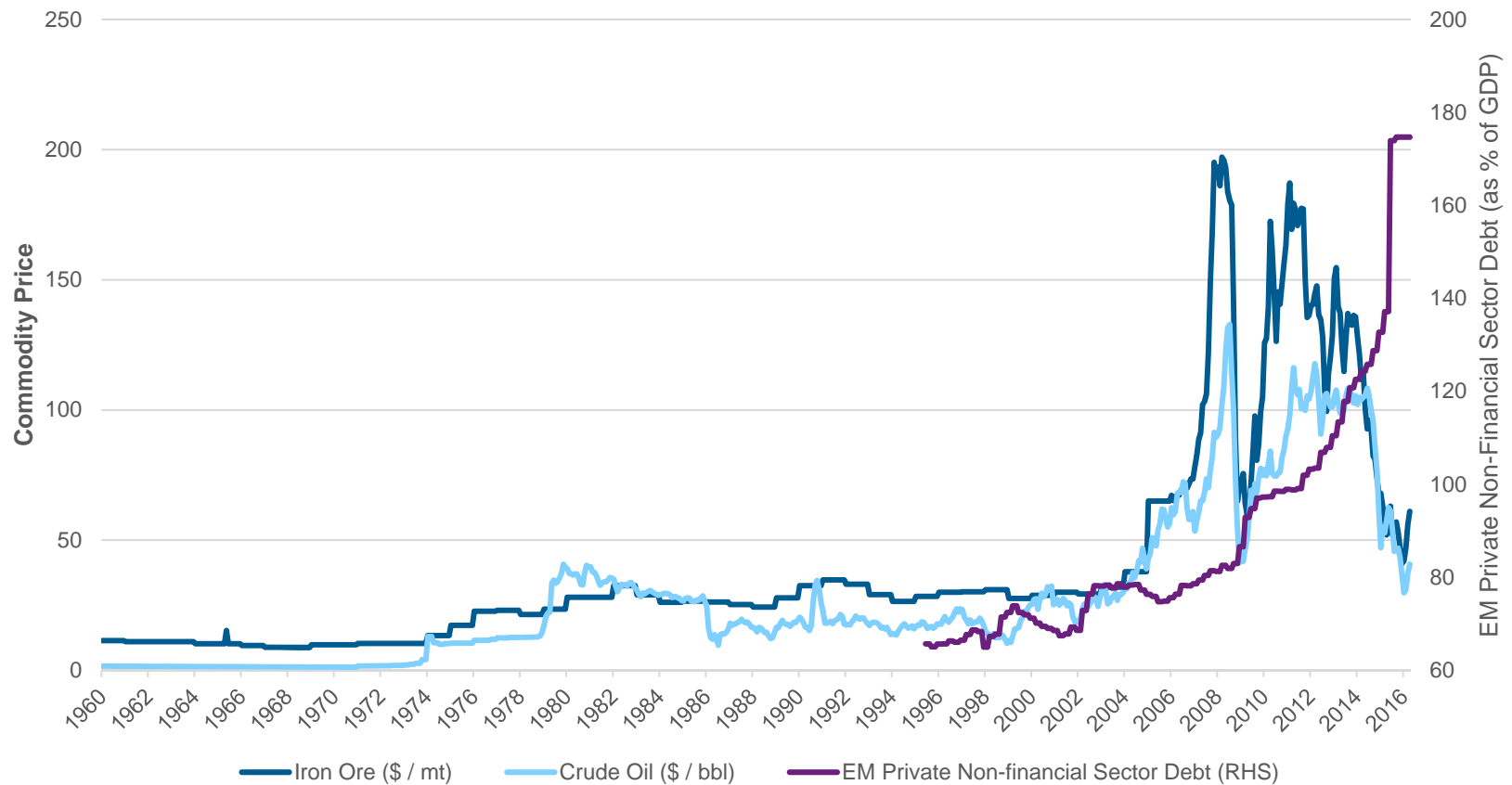


Source: ICI, Haver Analytics

Strategic Themes and Views in Fixed Income

There Will Be Blood

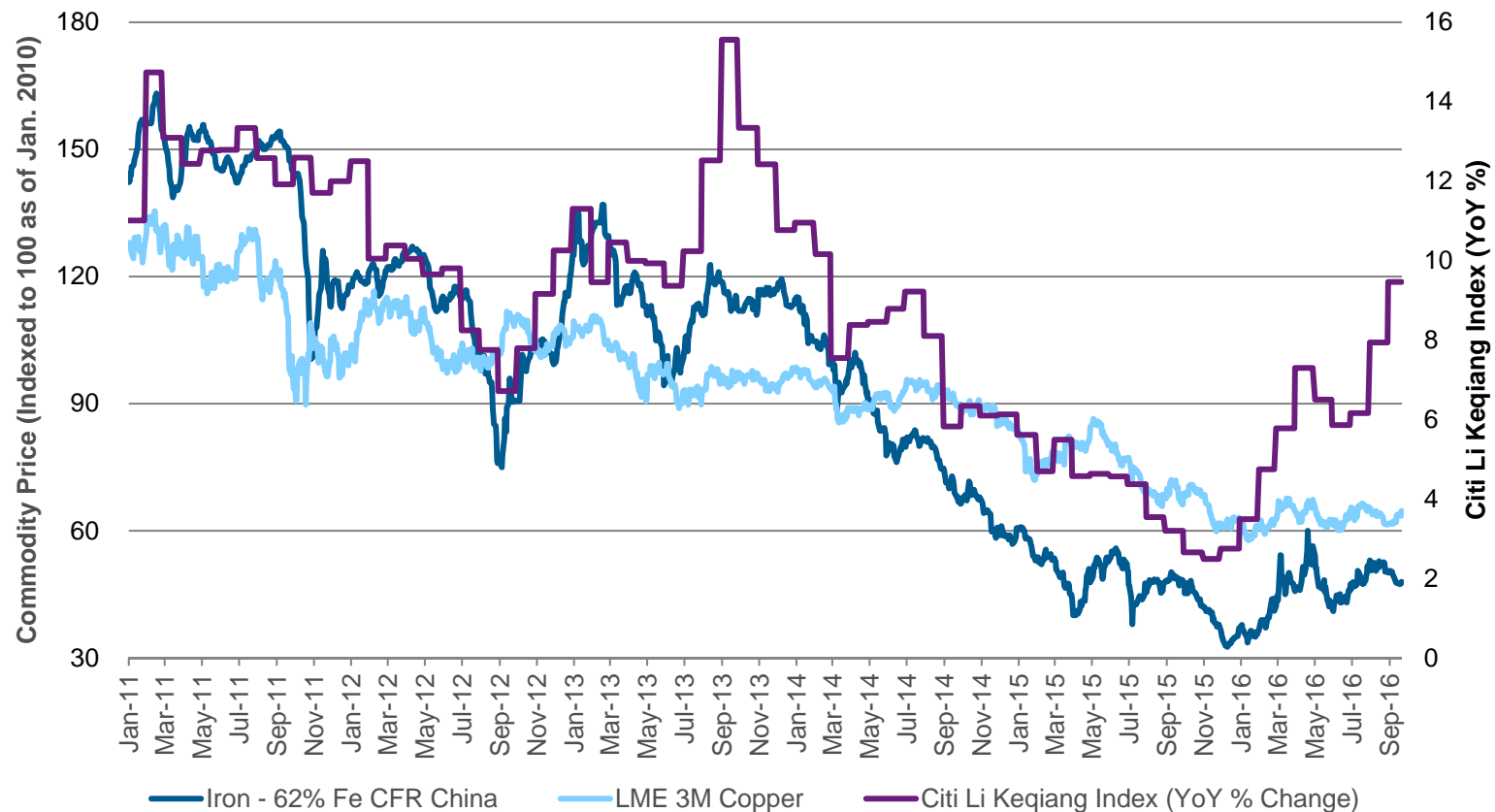
The Longer Term Perspective on the Commodity Bubble



Source: Haver, World Bank, BlackRock, IMF

China Reflects a Demand Side Commodity Story

Commodity Prices Track China Growth Outlook

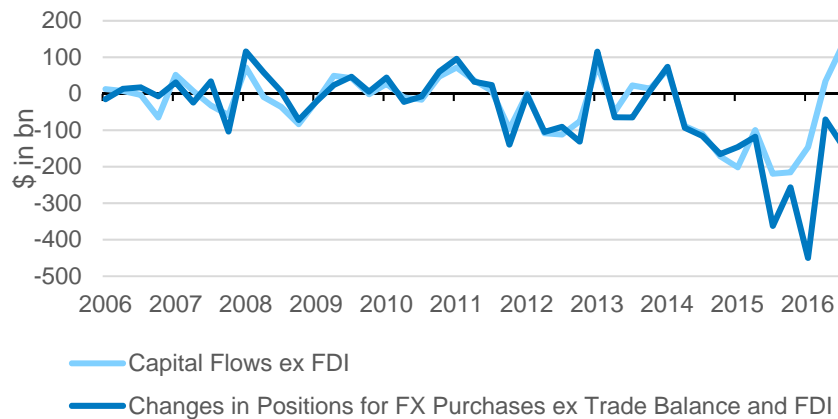


Source: Bloomberg, Citi Li Keqiang Index, BlackRock

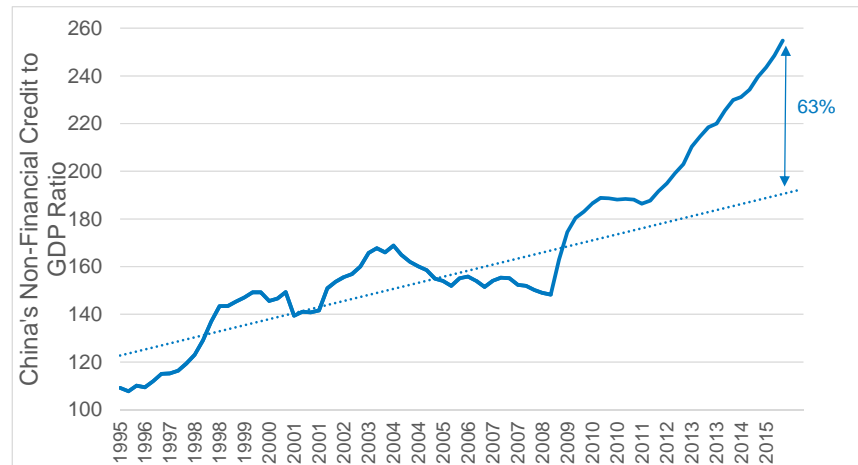
Note: The Chinese premier, Li Keqiang, has reportedly preferred to use three indicators – railroad cargo volume, electricity consumption and bank lending, as both timelier and more accurate indicators of Chinese growth than GDP

The Chinese Capital Outflow and Other Concerns

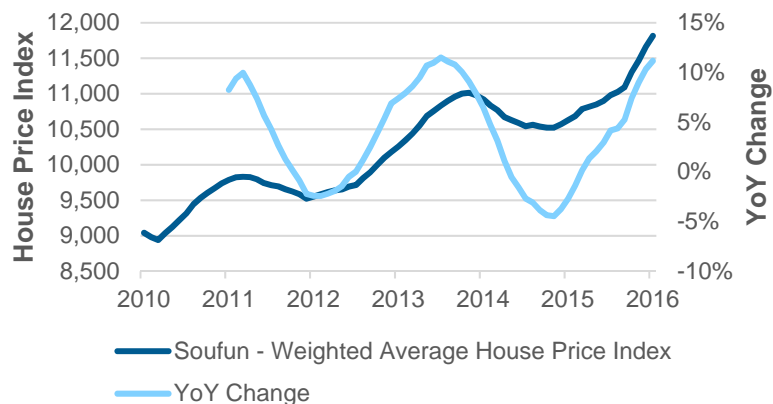
Chinese Capital Outflows



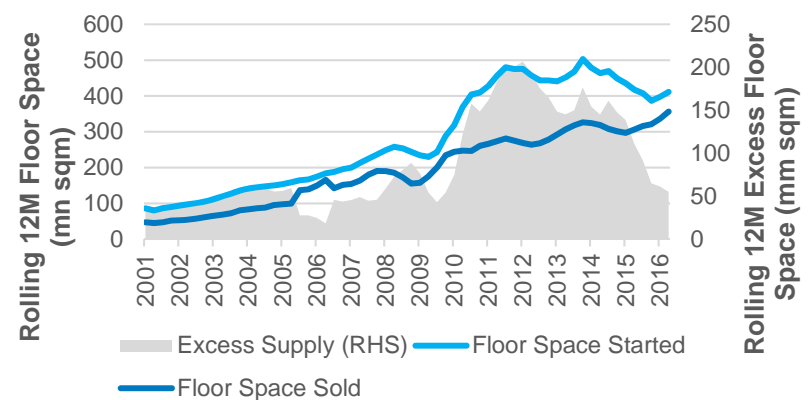
Credit to GDP Gap and Debt Sustainability



100 City Weighted Average House Price Index



Chinese Excess Property Supply



Source: SAFE, IMF, Haver, BIS, BlackRock, CEIC, Soufun.

The Policy Pivot . . .

PBOC Governor Zhou Xiaochuan, February 15, 2016

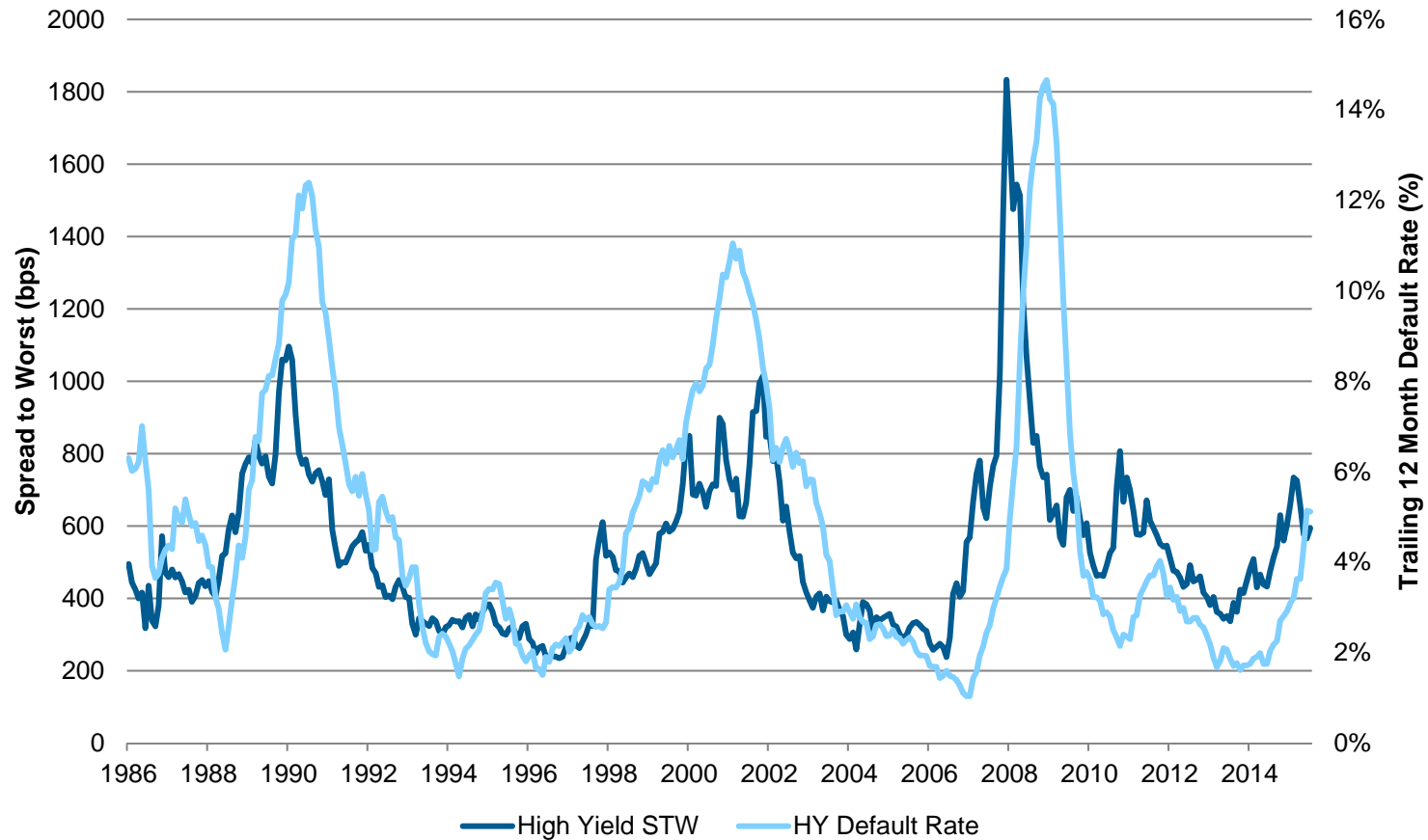
For a country as big as China, to achieve the reform goal may require a considerable period of time. To press ahead with reform, one should **take decisive actions when windows of opportunities open up, but refrain from reckless moves in the absence of such windows. We can wait a bit and create more favorable conditions for reform.**

We emphasize balancing reform, development and stability for the Chinese economy. The international economy is recovering from the crisis. This emphasis is still relevant. We are pragmatic, patient and determined with our goals, but do not target to move in a straight line toward reform goals. We will continue with reform efforts, and will also continue to be a responsible big economy.

Source: PBOC

“Like a Rolling Loan”

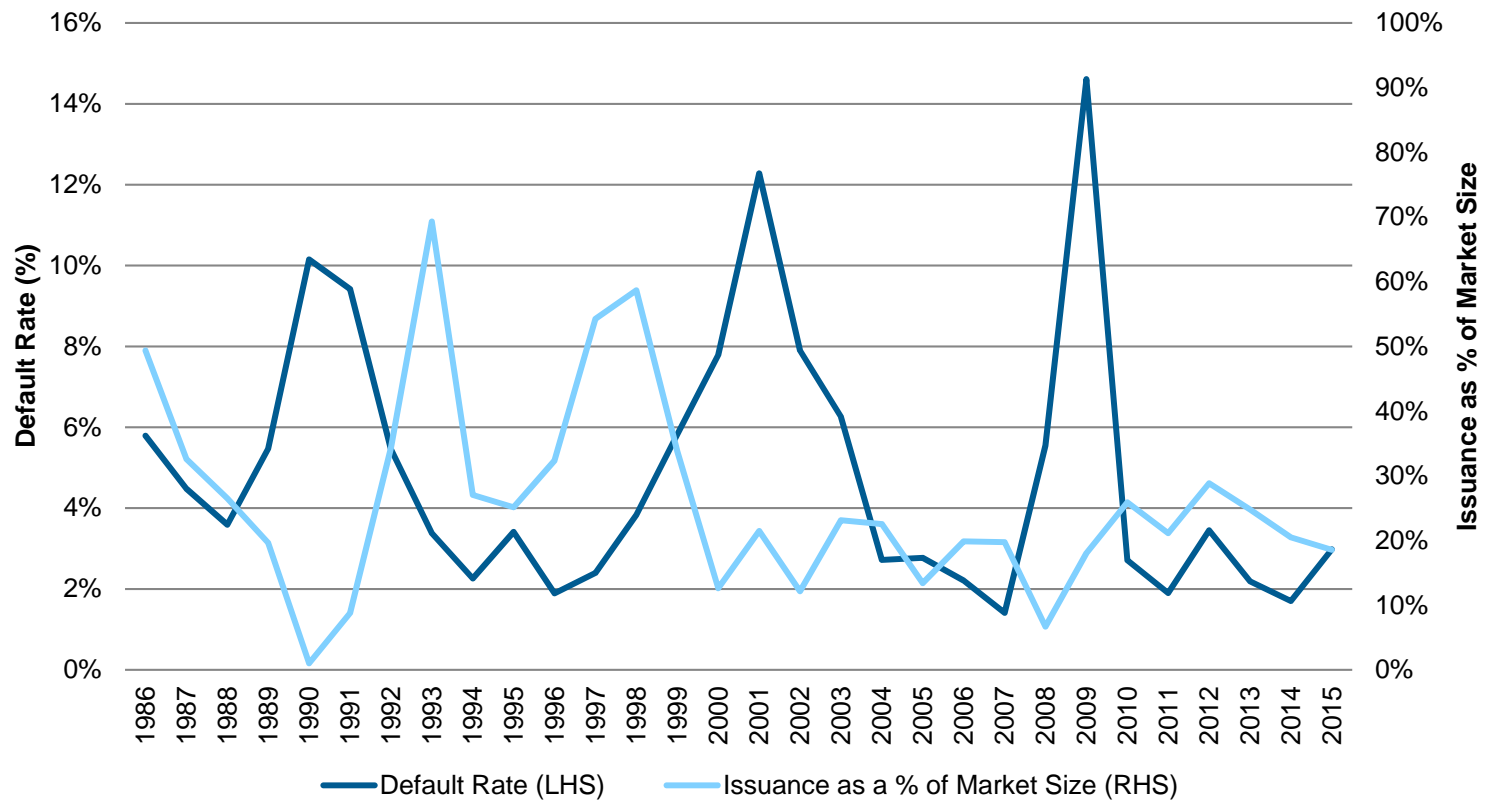
High Yield Spreads vs. High Yield Default Rates



Source: Barclays, Moody's. HY spreads represented by the Barclays US corporate High Yield Index.

A Rolling Loan Gathers No Loss

High Yield Default Rates vs. Issuance



Source: BAML, Moody's.

3 Key Action Items

1. Manage rate risk in fixed income: duration, curve, global

- Utilize flexible strategies for curve, duration and global rates and FX risk management
- Tactically overweight Inflation Breakevens (TIPs vs Nominals) (upgraded from neutral)

2. Rebalance credit and interest rate risks

- Overweight EM, Investment Grade Credit and CMBS
- Favor municipal bonds for income for taxable accounts
- Tactically neutral High Yield and Bank Loans;

3. Yield curve strategies

- Reduce exposure to long end on fading foreign support and global policy shifts leading to steeper global curves
- Implement bond ladders for hold to maturity investors

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