The Global Interest Rate Limbo: How low can central banks go? The European Central Bank (ECB) on March 10th cut its policy rate even further into negative territory, bringing the rate to -0.40%, keeping the debate over negative interest rates at the forefront following the move by the Bank of Japan (BOJ) into negative rates in late January. As we highlighted in last month’s “Revenge of the NIRPs” (Negative Interest Rate Policy), the impact of negative rates depends on how they are transmitted between the credit, exchange and interest rate channels. Clearly, the ECB’s expansion of QE into corporate bonds accounts for the strong market reaction in credit. The exchange rate channels have been more mixed in reaction to negative rates, while longer-term yen and peripheral European bond yields have collapsed in reaction to and in anticipation of negative rates.

The U.S. in Limbo: Awaiting the Fed Decision. The “other” limbo definition highlights the debate over the course of U.S. interest rate policy. Bond market expectations have recovered from the mid-February pessimism that put odds of any increase in 2016 briefly at zero. While the market expects no action in March, June probabilities for a 25 basis-point increase stand around 60%. That still stands far below the “dots plot” indications from the Fed’s last Statement of Economic Projections (SEP) calling for four increases this year, leading the market to expect those dots to fall along with the updated SEP in March.

Pay no attention to that man behind the curtain! China’s National People’s Congress (NPC) communications prompted a massive rally in iron ore, but we see reasons to be skeptical. Why the focus on “overcapacity” distracts from the bigger problem: an inability or unwillingness to address the credit bubble.

Strategy and Outlook
Recent improving economic data in the U.S. appear to be easing the recessionary concerns. Coupled with stimulus news out of China, it bolsters hopes for stabilizing commodity demand. A huge rally in commodity prices and supply-side restrictions are leading to hope that the oil glut could soon be resolved, pushing oil prices higher and credit spreads tighter alongside. These short-term developments have improved the near-term outlook for risky assets. Yet the fundamental issues that our longer-term “There Will Be Blood” outlook highlighted from our year-ahead outlook remain intact: Massive overcapacity in commodities reflects a fundamental downshift in global demand. Decades of debt-fueled growth now look unsustainable, with a debt cycle the inevitable result. Tactically, we moved up some of our risky asset recommendations in emerging markets (EM), acknowledging both the prospects for a near-term easing of pressures alongside better relative value. We leave most of those recommendations in place and further reduce our defensive stance by downgrading the overweight to front-end Treasury exposure, taking all segments of the Treasury curve to neutral.

BOND MARKET SUMMARY

<table>
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<tr>
<th>Sector</th>
<th>Positioning</th>
<th>2/2016 Total Return (%)</th>
<th>YTD Total Return (%)</th>
<th>3/2016 Yield* (%)</th>
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<tr>
<td>High Yield</td>
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<td>0.57</td>
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As of 3/9/2016. * Yield to Maturity, † Yield to worst, ‡ Securitized Assets: ABS (MTD 0.21, YTD 1.24, YTM 1.56, Overweight), CMBS (MTD 0.73, YTD 2.16, YTM 2.75, Overweight), Non Agency RMBS § Emerging Market: Hard Currency (MTD 1.31, YTD 1.72, YTM 6.28, Neutral), Local Currency (MTD 1.44, YTD 1.80, YTM 6.65, Neutral), Corporate (MTD 1.03, YTD 0.67, YTM 6.27, Underweight), ** Treasuries: Short (1-3 years) (MTD 0.11, YTD 0.72, YTM 0.80, Neutral), Intermediate (4-10 years) (MTD 0.90, YTD 3.49, YTM 1.42, Neutral), Long (10+ years) (MTD 2.98, YTD 8.15, YTM 2.46, Neutral).
The Global Interest Rate Limbo

The ECB on March 10th cut its policy rate even further into negative territory, bringing the rate to -0.40% and keeping the debate over negative interest rates at the forefront following the move by the BOJ into negative rates in late January. As we highlighted in last month’s “Revenge of the NIRPs” (Negative Interest Rate Policy), the impact of negative rates depends on how they are transmitted between the credit, exchange and interest rate channels. Clearly, the ECB’s expansion of QE into corporate bonds accounts for the strong market reaction in credit. The exchange rate channels have been more mixed in reaction to negative rates, while longer-term yen and peripheral European bond yields have collapsed in reaction to and in anticipation of negative rates.

Partly due to such concerns, we have seen the introduction of negative policy rates alongside “tiered systems” of application. This simply means that rather than applying the negative rate to the entirety of a bank’s reserves held at the central bank, only a portion, and in many cases a very small portion, of reserves actually face the negative deposit rate. These tiered systems are explicitly intended to limit the negative effects on bank profitability (as stated in the BOJ communication on January 29th).

Clearly, if negative rates are not intended to work on the credit transmission mechanism (as the imposition of tiered application would imply), then the intended effect of negative interest rates is in lowering longer-term interest rates and reducing the exchange value of the currency. While negative rates have successfully lowered longer-term interest rates in both Europe and Japan, the impact on the currency has been less successful.

Both a recent Bank for International Settlements (BIS) paper¹ and a recent speech by Bank of England Governor Mark Carney² highlight the pitfalls of negative interest rates when the currency appears the main target. From the BIS paper: If negative policy rates do not feed into lending rates for households and firms they largely lose their rationale. The BIS goes on to conclude that if the objective of negative rates is, however, to influence the exchange rate then “other thorny issues arise, not least the issue of cross-border spillovers.” In other words, beggar thy neighbor policies pushing one country’s problems onto another’s simply won’t work. Governor Carney was even more explicit in castigating the exchange rate transmission mechanism:

“When negative rates are implemented in ways that insulate retail customers … while allowing wholesale rates to adjust, their main effect is through the exchange rate channel. From an individual country’s perspective, this might be an attractive route to boost activity. But for the world as a whole, this export of excess savings and transfer of demand weakness elsewhere is ultimately a zero sum game … For monetary easing to work on a global level it cannot rely simply on moving scarce demand from one country to another. Instead, policy needs to increase primarily domestic demand, with the exchange rate channel more of a side effect.”

Financial markets have tended to cheer any expansion of monetary policy. Yet the negative reaction to the BOJ expansion of negative rates in risky assets, while strengthening the currency, and the initial lukewarm reaction to the smaller imposition of negative rates in Europe, highlights the limits to efficacy of such a policy as described by Carney above. The market appears to see through these “beggar thy neighbor”

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¹ See link for BIS paper: How have central banks implemented negative rates? https://www.bis.org/publ/othpdf/l_tg1603e.pdf
policies with the risk being their obtuse pursuit further undermines that other transmission mechanism of even greater import: The confidence channel.

The Fed’s Interest Rate Limbo
Which brings us to our other “limbo” definition: the uncertain course of Fed policy. In February, market concerns over global spillovers leading to a U.S. recession highlighted the negative interest rate debate in the context of what more the Fed could do with monetary policy. But recent improvements in economic data, alongside an easing of commodity and credit market pressures, has led to increasing probability of some recommencement of normalization this year.

FIGURE 2: U.S. ECONOMIC SURPRISES AND ODDS OF FED ACTION

Figure 2 nearby highlights the trajectory of market expectations for Fed normalization and economic data “surprises.” Clearly, the better trend of recent data—payrolls, housing, PMI surveys and durable goods—has coincided with easing fears of recession and rising expectations for the Fed to continue with normalization, albeit at a slower pace.

The focus for the March Federal Open Market Committee meeting, then, likely will be more about what the Fed communicates as to its future behavior than any actual policy move. We expect that to occur only possibly by June, and even then much can change to again—as was the case last year—lead the Fed to continue to defer its normalization path. Signs for that will lie in the statement changes that may, for example, recognize a greater role of financial market conditions or global factors weighing on the Fed’s balance of risks. Additionally, the market expects some decline in the SEP indications of individual participants’ views on appropriate stance of monetary policy. While back in December the FOMC indicated likely four increases in 2016, financial market conditions in the rest of the world, though recently improved, have likely resulted in a downgrading of those expectations. That should serve to help narrow the gap between Fed and market expectations for the pace of normalization highlighted in Figure 3.

China and the Wizard of Oz
Additionally contributing to the recovery in risk assets since mid-February are the increasingly positive signals coming out of China. On top of a relatively stable currency policy, outflows appear to have moderated, and though trade flows disappointed, enough ambiguity around Chinese New Year’s distortions lends uncertainty to the data coming out of China during this period. Into that vacuum, the reassurance of pursuing headline growth of 6.5% to 7% coming out of this month’s NPC meeting, along with fiscal spending and tough talk around structural reforms to address excess capacity issues resulted in by one measure—the roughly 20% rise in iron ore prices immediately following the NPC comments over the weekend and the nearly 50% rise since the beginning of the year—suggested China demand was back on track, helping to stabilize global financial markets.

The skeptical response, however, counters that by holding to unrealistic goals for growth, China will force itself down unsustainable policies over the intermediate to longer term. Those policies rely to a great extent on continuing the now much-questioned reliance on continued credit growth.

Jonathan Anderson of Emerging Market Advisors makes a convincing case that the focus on excess capacity distracts from the larger policy issues: addressing the unsustainable rise in credit. He summarizes: “Industrial overcapacity is not a serious problem in China today. The massive leverage bubble in the non-industrial economy is. But once again, this year’s work report focuses on the former and pretends the latter doesn’t exist.” To bolster his claims, he highlights that, unlike in the last period when then-premier Zhu Rongji went about attacking the overcapacity in the industrial sector, today the industrial sector is on net more profitable.

FIGURE 3: FED’S MEDIAN DOT VS MARKET PRICING

Source: Fed, JPMorgan

Source: Citi, Bloomberg
than it has been during 2000–2010. The overcapacity segments—indicated by no or low profitability—are there but they are not that large and by international comparison not any larger as a concentration of sectors suffering from excess capacity in other large economies.

All of this serves to distract from the more important issue: addressing the credit bubble. But instead of addressing it, China now appears to be pursuing policies that ensure further expansion. The target for total social financing (TSF) at 13%, Anderson points out, “might have been reasonable five years ago when nominal GDP was also expanding at a mid-teens pace, but in today’s environment when nominal growth has fallen to 6% and the outstanding credit base has already exploded (Figure 4), keeping the same target is now hugely expansionary.” This is not “moderate” and “prudent” monetary policy as described.

In the short run, the ability of China to yet again ramp up its traditional avenues of credit-fueled growth appears credible in the minds of commodity markets. Whether such policies can address the long-run structural growth issues facing China—the limits to debt-fueled growth and the ability to transition away from such a model towards domestic consumption-fueled growth—will remain a focus for longer-term investors. We doubt such concerns have permanently been addressed, and expect the potential for a resurgence of concerns around the implications of such policy will yet again reemerge. That tempers our allocations to riskier portions of the credit markets most impacted by such an outcome, in high yield and EM debt markets, for example.

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*The sector performance and yields listed are represented by, respectively: Barclays U.S. High Yield Index, S&P Leveraged Loan Index, Barclays U.S. Securitized ex-MBS Index, Barclays U.S. Mortgage Backed Securities Index, Barclays U.S. Corporate Investment Grade Index, Barclays Global Aggregate ex-USD Index, JP Morgan EMBI Global Diversified Index, Barclays U.S. Inflation Protected Securities Index and Barclays U.S. Treasury Index. The reference indexes are represented by the Barclays U.S. Aggregate and the Barclays Municipal Bond Index.*

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