BlackRock®

Weekly Commentary

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Our market commentary is now authored by Richard Turnill, BlackRock's Global Chief Investment Strategist. Share your feedback at *blackrockinvestments@blackrock.com*.

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Key Points

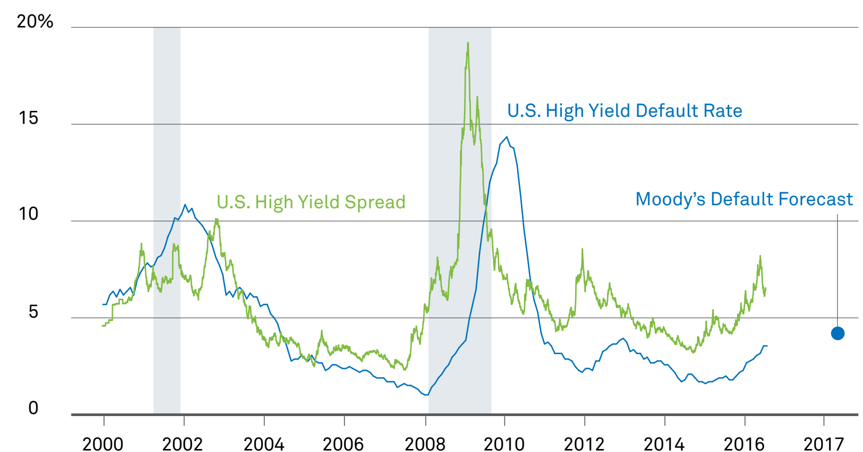
1. We have downgraded U.S. credit to neutral due to less attractive valuations after the recent high yield rally and rising default rates.
2. U.S. Federal Reserve Chair Janet Yellen's dovish remarks lowered expectations of rate increases and pushed down the dollar.
3. Global central bank minutes this week could show the degree of support for stimulus and the extent of future policy divergence.

1 AFTER THE HIGH YIELD RALLY

U.S. high yield bond spreads neared recession levels in February, as prices declined and yields increased. Credit markets have since rebounded sharply, despite rising default rates. See the chart below.

CHART OF THE WEEK

U.S. High Yield Spread and Default Rate, 2000-2017



Sources: BlackRock Investment Institute, Moody's and Barclays, March 2016.
Notes: The high yield spread is in percentage points over U.S. Treasuries and is based on the Barclays U.S. Corporate High Yield Index. The high yield default rate is represented by Moody's 12-month trailing default rate. The Moody's default rate forecast is for February 2017. The grey bars show the periods when the U.S. economy was in recession.

Spreads are back at November levels, before Fed lift-off and global recession fears hurt risk assets. Behind the rally: returning inflows amid firming oil prices, diminishing recession fears and a dovish Fed. High yield exchange traded products gathered $6.1 billion so far this year, bringing assets to $54 billion, our data show. The bulk of inflows have come since mid-February.

More Cautious on Credit

High yield isn't cheap anymore. With spreads approaching their 15-year average, the bonds no longer price in a high risk of a U.S. recession. Spreads remain above typical levels associated with an economic expansion, but they reflect today's low-growth world, highlighted by back-to-back quarters of around 1% annualized growth in U.S. gross domestic product (GDP).

We view the risk of a recession as low, yet acknowledge default rates are ticking up. Moody's sees the U.S. default rate rising to 4.7% in the next year, as the chart above shows, given deteriorating credit conditions in sectors sensitive to declining commodity prices. Our analysis of spread levels shows defaults could be even higher. We believe Moody's may underappreciate the potential for weakening credit availability among commodity issuers to spill over into other sectors.

We have downgraded our view of U.S. credit from overweight to neutral as a result. Note we generally prefer U.S. high yield over investment grade and sovereigns. Higher yields offer better compensation for risks such as rising corporate leverage. We like cable, building materials and gaming companies within the sector, and are avoiding utilities and resources. We generally prefer non-dollar credit to dollar credit, with quantitative easing (QE) from the European Central Bank (ECB) providing support for euro credit markets.

2 WEEK IN REVIEW

- Chair Janet Yellen said the Fed's path of rate increases was "now expected to be somewhat slower."
- The U.S. Dollar Index (DXY) hit a low for the year following Yellen's speech on Tuesday, but recovered partly after Friday's U.S. jobs report.
- Japanese foreign bond purchases accelerated after the Bank of Japan's negative interest rate policy sent domestic bond yields into negative territory.

GLOBAL SNAPSHOT

Weekly and 12-Month Performance of Selected Assets

EQUITIES	WEEK	12 MONTHS	DIV. YIELD
U.S. Large Caps	1.8%	2.8%	2.2%
U.S. Small Caps	3.6%	-9.4%	1.7%
Non-U.S. World	0.3%	-11.2%	3.4%
Non-U.S. Developed	-0.2%	-10.4%	3.6%
Japan	-3.9%	-9.7%	2.5%
Emerging	1.7%	-13.9%	2.8%
Asia Ex Japan	1.0%	-13.3%	2.9%

BONDS	WEEK	12 MONTHS	YIELD
U.S. Treasuries	0.6%	2.0%	1.8%
U.S. TIPS	1.3%	0.6%	1.8%
U.S. Investment Grade	0.7%	0.4%	3.2%
U.S. High Yield	0.3%	-3.7%	8.2%
U.S. Municipals	0.5%	4.0%	1.9%
Non-U.S. Developed	1.4%	6.1%	0.7%
Emerging Market $ Bonds	0.8%	3.7%	5.8%

COMMODITIES	WEEK	12 MONTHS
Brent Crude Oil	-4.4%	-32.3%
Gold	0.5%	1.5%
Copper	-2.2%	-20.0%

CURRENCIES	WEEK	12 MONTHS
Euro/USD	2.0%	5.8%
USD/Yen	-1.2%	-6.7%
Pound/USD	0.7%	-4.0%

Source: Bloomberg. As of April 1,2016. Notes: Weekly data through Friday. Equity and bond performance are measured in total index returns in U.S. dollars. U.S large caps are represented by the S&P 500 Index; U.S. small caps are represented by the Russell 2000 Index; Non-U.S. world equity by the MSCI ACWI ex U.S.; non-U.S. developed equity by the MSCI EAFE Index; Japan, Emerging and Asia ex-Japan by their respective MSCI Indexes; U.S. Treasury by the Barclays U.S. Treasury Index; U.S. TIPS by the US Treasury Inflation Notes Total Return Index; U.S. investment grade by the Barclays U.S. Corporate Index; U.S. high yield by the Barclays U.S. Corporate High Yield 2% Issuer Capped Index, U.S. municipal by the Barclays Municipal Bond Index; non-U.S. developed bonds by the Barclays Global Aggregate ex USD; and Emerging Market $ bonds by the JP Morgan EMBI Global Diversified Index. Index performance is shown for illustrative purposes only. It is not possible to invest directly in an index. Past performance is not indicative of future results.

3 WEEK AHEAD

April 5	U.S. ISM Non-Manufacturing Index
April 6, 7	Federal Open Market Committee (FOMC) Minutes (4/6); Janet Yellen Speaks (4/7)
April 7	European Central Bank (ECB) March Meeting Minutes

Central bank minutes and comments this week may illuminate the future path of monetary policy divergence and reveal the degree of support within the ECB for stimulus measures. Major central banks have turned more accommodative in recent months, with the ECB and Bank of Japan implementing or expanding negative interest rate policies and QE. A more dovish Fed has remained on hold. This collective stimulus has helped risk assets regain ground they lost earlier this year.

We believe the Fed's wait-and-see approach is warranted, given global growth risks posed by China's economic slowdown and the ECB and BoJ's easy monetary policies. We expect the Fed to raise rates twice in 2016 at most, with the potential for no movement at all. We could even could see QE again from the Fed if conditions were to warrant it.

ASSET CLASS VIEWS

Views on selected asset classes over a three-month horizon.

ASSET CLASS		VIEW	COMMENTS
EQUITIES Overweight	U.S.	▲	The U.S. consumer and housing sectors are strong, and growth appears to be stabilizing. We see peak margins and payout ratios limiting returns, however.
	Europe	▲	Reasonable valuations and ECB policy are supportive, but weak growth and a challenged banking system are risks. Domestic U.K. equities look vulnerable to Brexit fears.
	Japan	—	Attractive relative value and improving corporate governance are positives. Yet much is priced in, and the BoJ may have reached its limits in weakening the yen.
	EM	—	Structural challenges such as excess debt persist. Yet we see value for long-term investors. An expected slower pace of Fed rate increases is a positive.
	Asia ex Japan	—	Long-term headwinds persist as imbalances are unwound. While we view Chinese devaluation as unlikely, the tail risk remains. Prefer India.
FIXED INCOME Underweight	U.S. Treasuries	▼	Improving data are a short-term risk. Long bonds have a structural bid amid low rates and are portfolio diversifiers, but vulnerable to upticks in inflation in the short run.
	U.S. Municipals	▲	We like relatively attractive (tax-exempt) yields and low volatility. We see potential for inflows after recent strong performance.
	U.S. Credit	—	We generally prefer U.S. high yield over investment grade. Higher yields offer better compensation for risks such as rising corporate leverage.
	DM ex-U.S. Fixed Income	▲	Both sovereigns and credit outside the U.S. are underpinned by very easy monetary policies. Slowing Fed normalization is checking the dollar's rise, supporting returns on non-USD bonds.
	EM Debt	—	We lean toward local-currency EM debt. Currencies have adjusted, yields have risen to attractive levels, and the U.S. dollar has slowed its appreciation trend.
COMMODITIES Neutral	Commodities	—	Commodity markets are oversupplied and sensitive to downward global growth revisions. A strategic allocation to gold makes sense for diversification.

▲ Overweight — Neutral ▼ Underweight

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