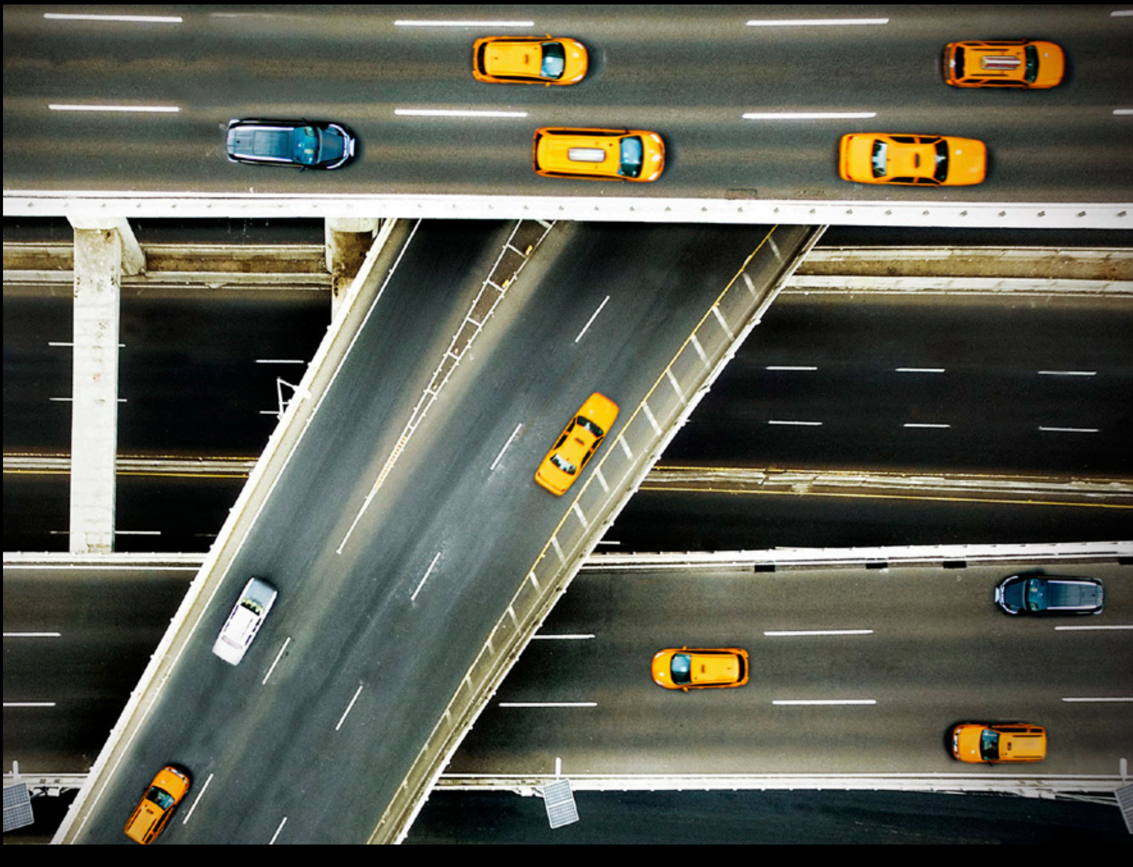
BlackRock

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 19% average allocation, based on total U.S. 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.

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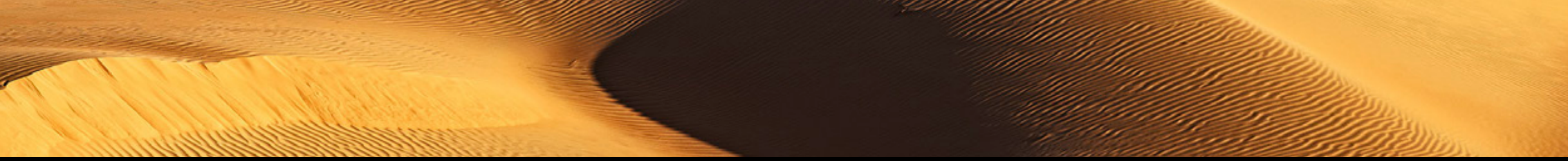

Introduction

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.

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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 Dec. 31, 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 Dec. 31, 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: U.S. Bureau of Labor Statistics, as of Dec. 31, 2023. U.S. annual CPI rose from 0.1% as of May 31, 2020 to a peak of 9.1% as of June 30, 2022. Current rate as of Dec. 31, 2023 is 3.4%. European Central Bank, based on HICP Overall Index, as of Dec. 31, 2023. Euro area inflation rose from -0.3% as of Dec. 31, 2020 to a peak of 10.6% as of Oct. 31, 2022. Current rate as of Dec. 31, 2023 is 2.9%. **5** Source: Bloomberg, Banco Central do Brasil, as of March 31, 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 March 31, 2024 vs. 13.75% in August 2023. **6** Source: Bloomberg, based on comparing the 5-year U.S. Treasury Index (GT5 Govt) with Fed funds rate (FDTR Index) from Jan. 1, 2000 to Feb. 29, 2024. **Past performance does not guarantee future results.**

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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.

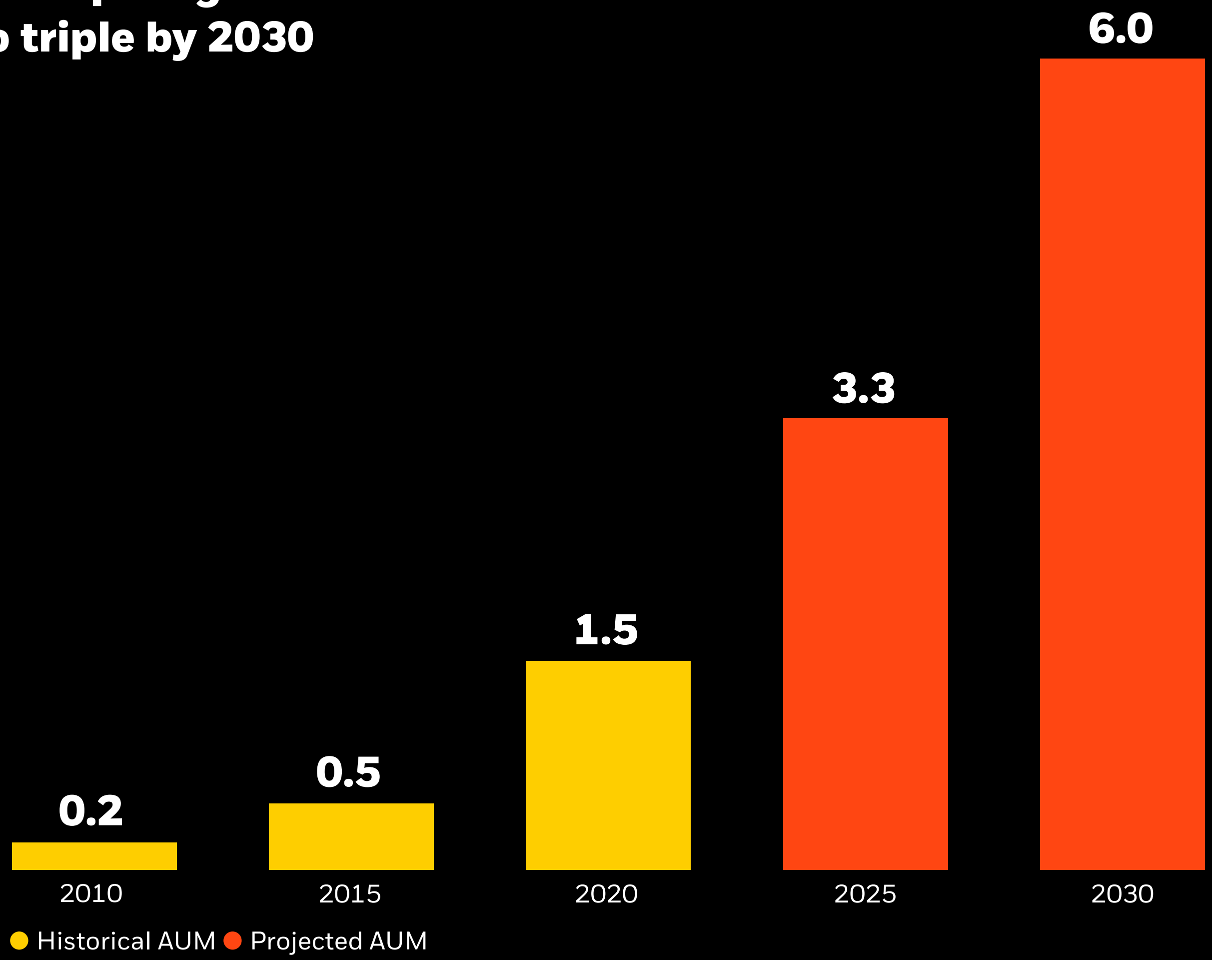
We expect bond ETFs to triple to

$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



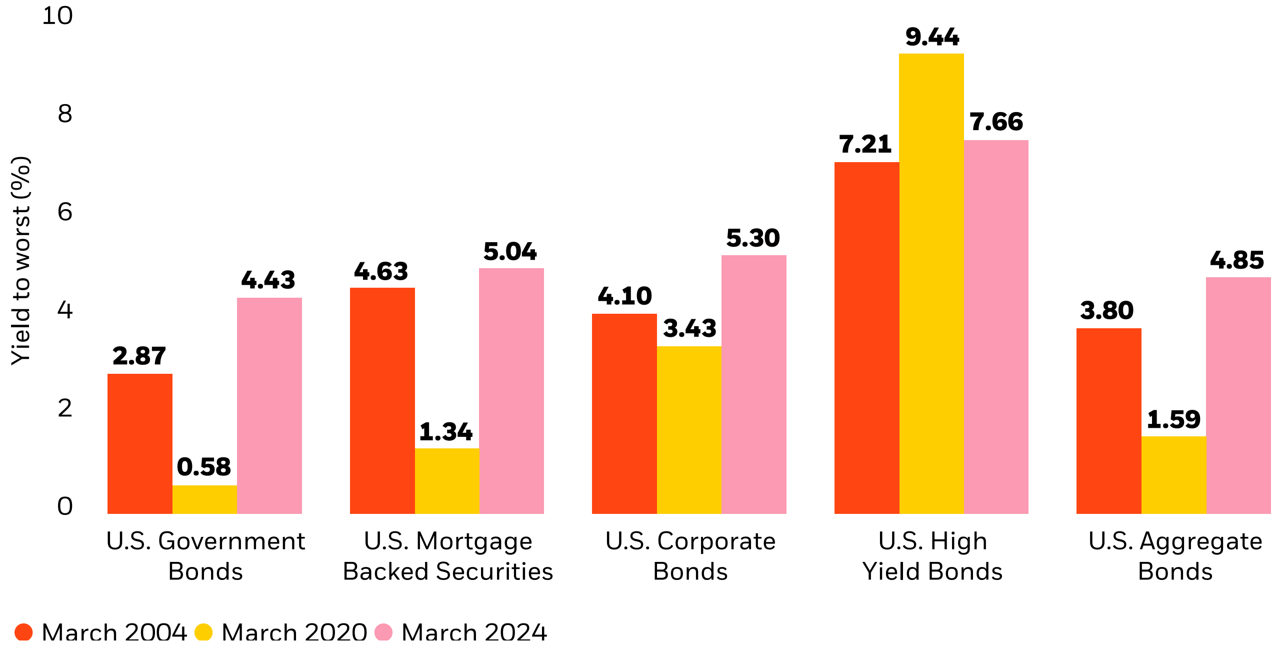
Source: From proprietary research. BlackRock projections as of March 31, 2024. Subject to change. The figures are for illustrative purposes only and there is no guarantee the projections will come to pass.

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 U.S. fixed income exposures (%), 2004-2024

Yields today are at decades-highs



Source: Bloomberg, as of March 29, 2024. Yield to worst as of March 31, 2004, March 31, 2020, and March 31, 2024. Indices used: U.S. Treasuries: ICE U.S. Treasury Core Bond Index; U.S. Mortgages: Bloomberg U.S. MBS Index; U.S. Corporates: Markit iBoxx USD Liquid Investment Grade Index; U.S. High Yield: Markit iBoxx USD Liquid High Yield Index; U.S. Aggregate: Bloomberg U.S. Aggregate Bond Index. **Index performance is for illustrative purposes only. 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) around the world, 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.

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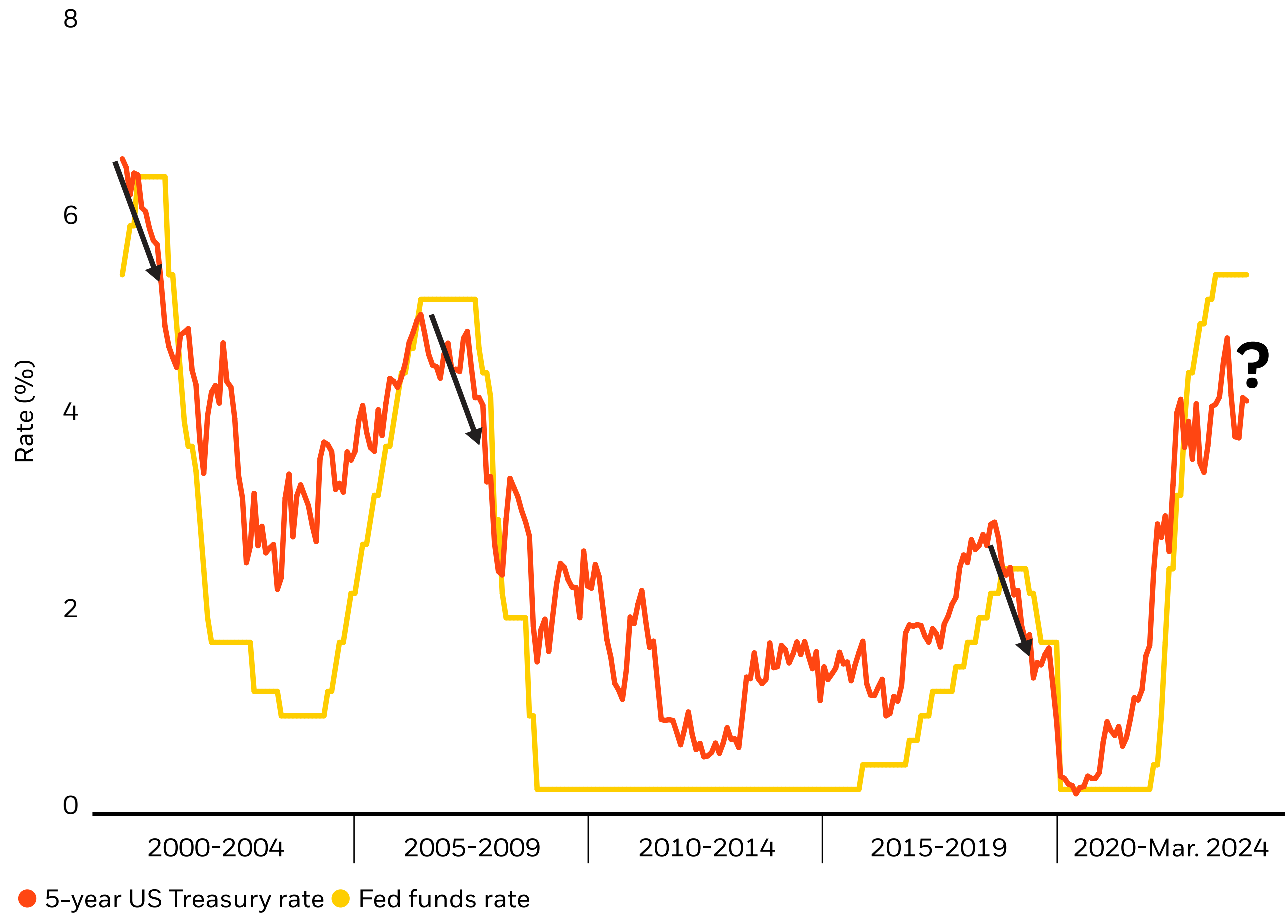
Historically, longer term yields have moved ahead of policy shifts (Figure 3). Investors who wait for a definitive answer may miss the opportunity to capture yields at these levels. And while history may not repeat, volatile data in inflation and economic activity have kept yields elevated even as central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

Figure 3: Five-year U.S. 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 Jan. 1, 2000 to March 31, 2024. Price returns based on monthly data comparing the 5-year U.S. Treasury Index (GT5 Govt) with Fed funds rate (FDTR Index). **Past performance does not guarantee future results.**

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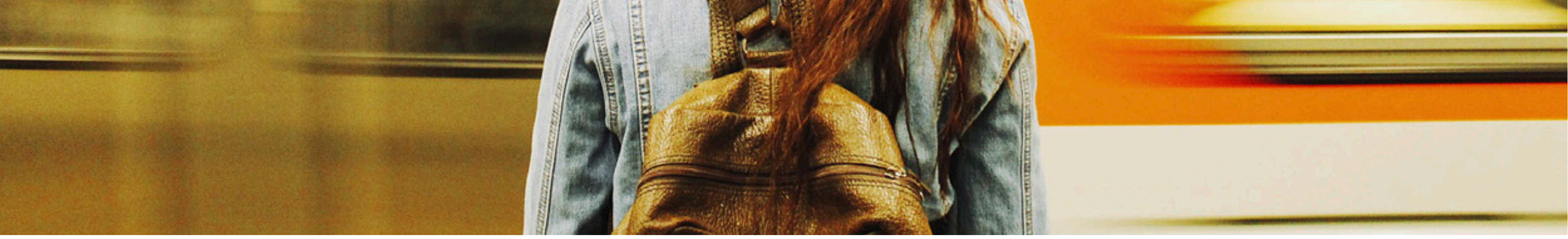
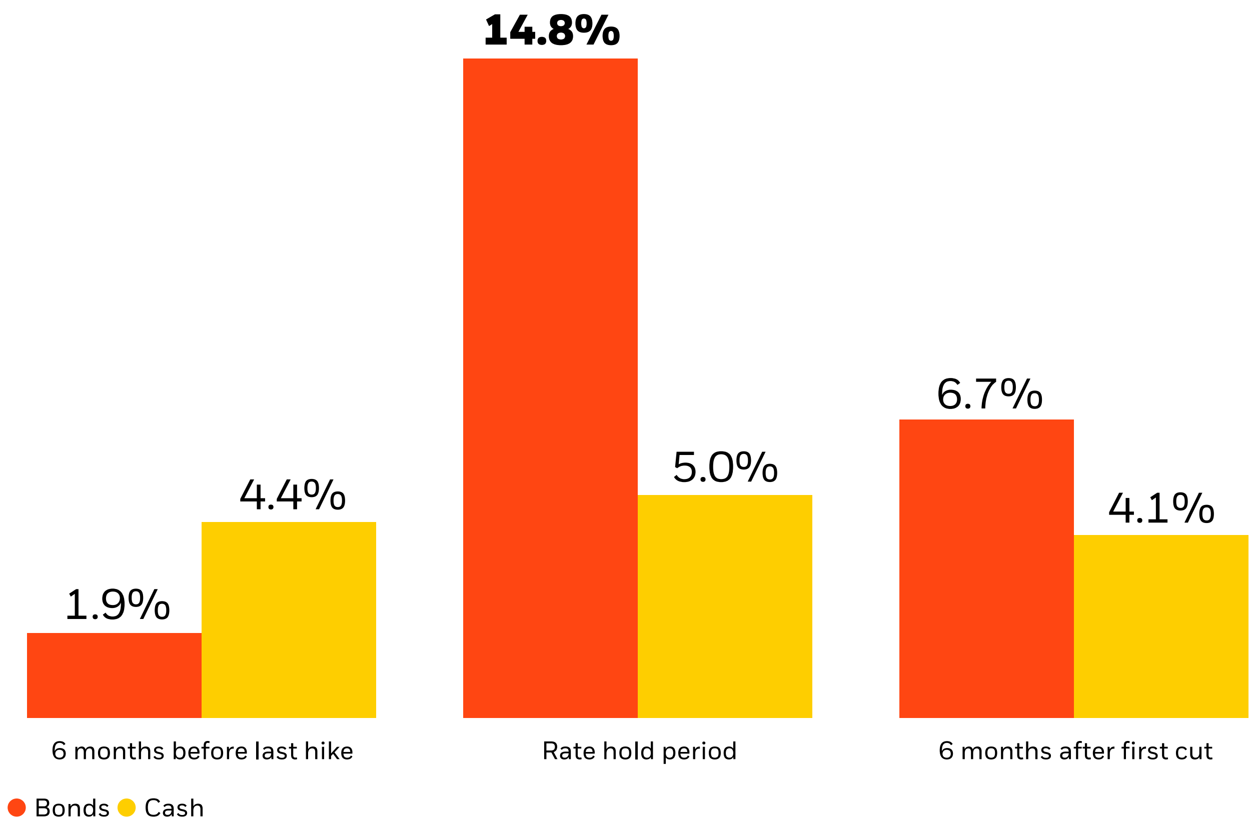


From history, we also know that when central banks implement pauses, bond markets have tended to do well as Figure 4 below illustrates. We believe investors could benefit from getting ahead of potential interest rate cuts.

Figure 4: Average annualized returns (%), 1990-2024

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



Source: Bloomberg as of March 31, 2024. Historical analysis calculates average performance of the Bloomberg U.S. Aggregate Bond Index (bonds) and the Bloomberg U.S. Treasury Bills: 1-3 Months TR Index (cash) over different time periods. The dates used for the last rate hike of a cycle are: Feb. 1, 1995, March 25, 1997, May 16, 2000, June 29, 2006, Dec. 19, 2018. Dates used for the first-rate cut are: July 7, 1995, Sept. 29, 1998, Jan. 3, 2001, Sept. 18, 2007, Aug. 1, 2019. **Index performance is for illustrative purposes only. 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.**

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 U.S. 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]

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

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 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. Cash has not provided the same level of potential ballast and portfolio diversification against riskier assets such as equities. Figure 5 shows that during the 2001-2002 rate cut cycle, money market fund returns fell from a high of 5.8% in March 2001 to below 2% in July 2002.

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

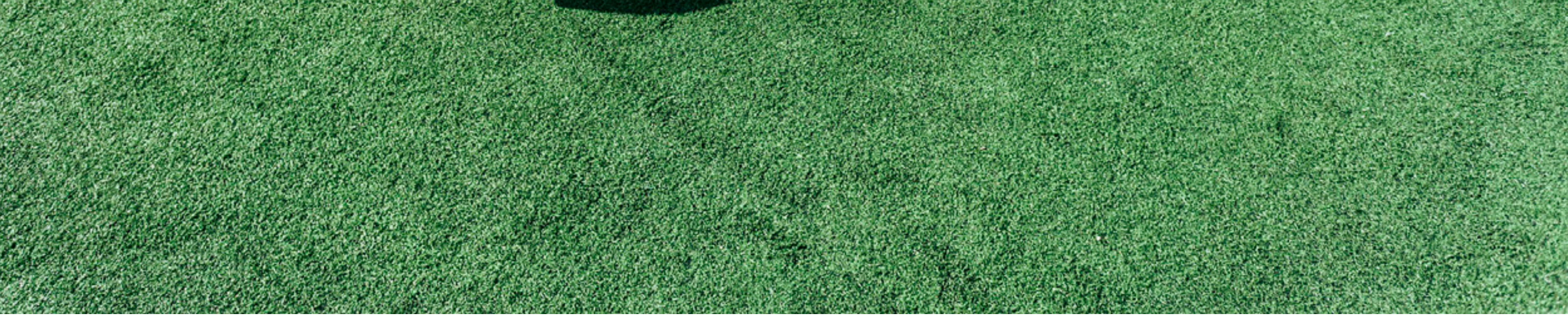
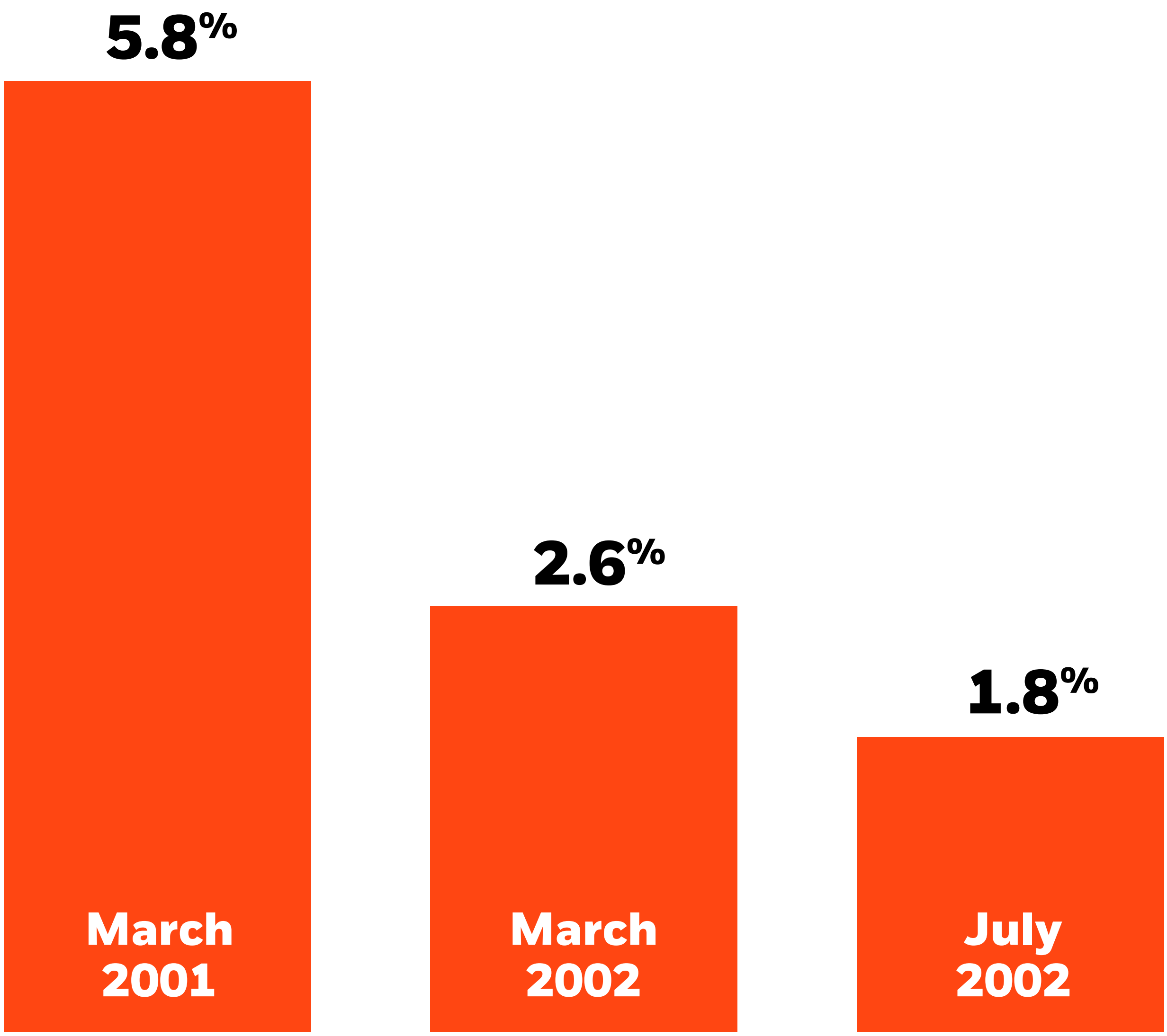


Figure 5: Money market fund average annualized returns (%), 2001-2002

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



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

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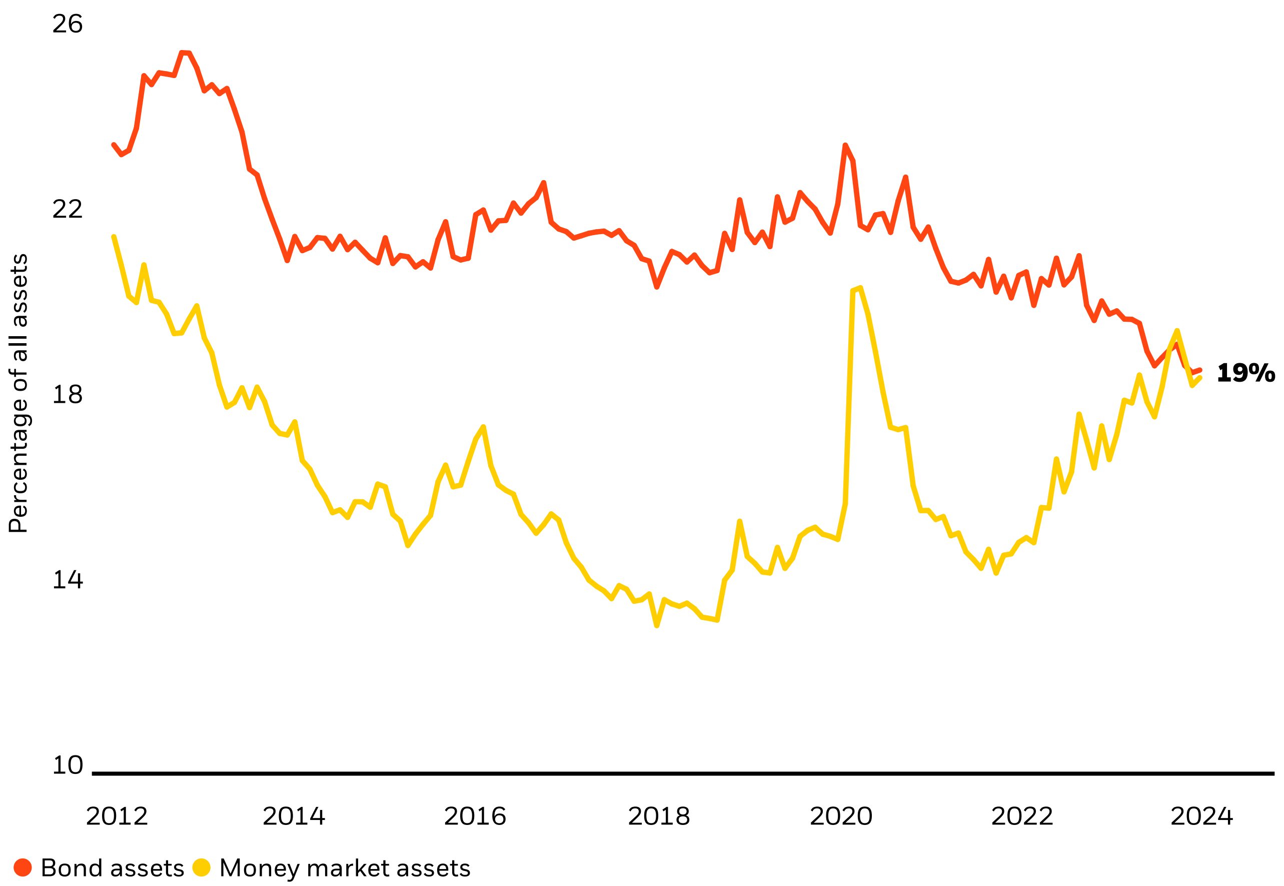
Portfolios have room for bonds. Many investors are still significantly underweight to fixed income, with a 19% average fixed income allocation, based on total U.S. industry assets under management (Figure 6). The allocation has fallen from 24% at the start of March 2020, as the COVID-19 pandemic began, 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.

With historically high levels of portfolio assets allocated to cash and reduced allocations to fixed income, we believe there is an opportunity to rebalance portfolios and adjust fixed income allocations. Figure 6 shows that since 2021, the allocation of cash and bonds as assets have moved toward parity, becoming equal by late 2023. We would expect them to potentially diverge again as investors move back into bonds.

Figure 6: U.S. domiciled bond funds and money market assets as a percentage of total U.S. industry assets (%), 2012-2024

Money market and bond fund assets are at parity



Source: Morningstar as of Jan. 31, 2024. Represents U.S. bond and money market ETF and mutual fund assets as a % of all U.S. ETF, mutual fund, and money market assets. Based on managed assets only. Single bond allocations are 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 **Utilize 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.

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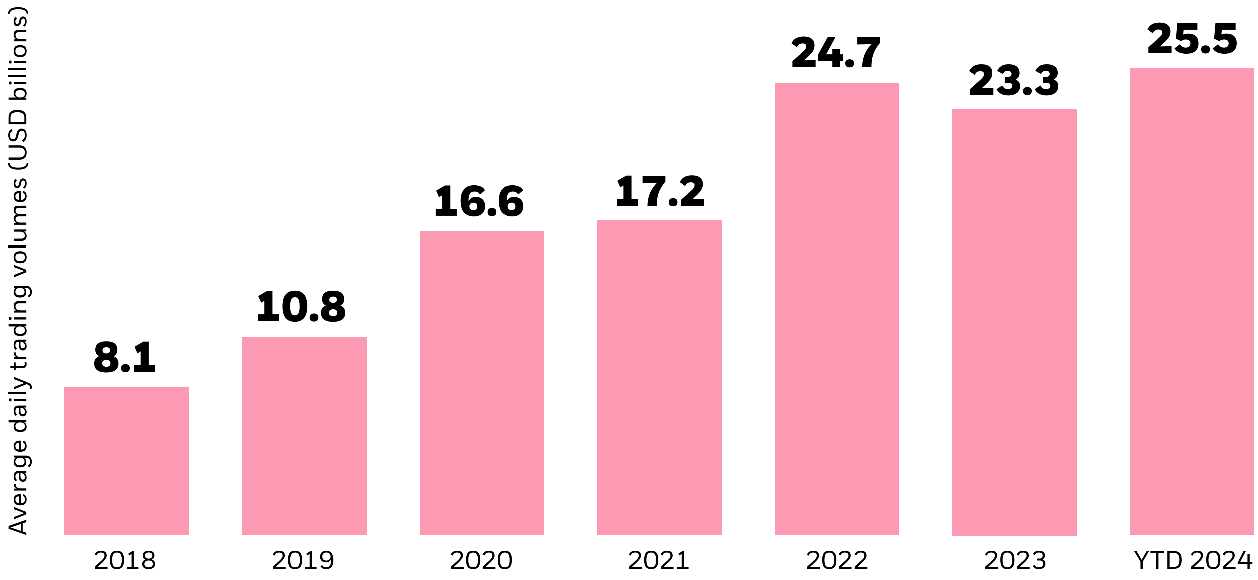
Why bond ETFs can be a good fit for the new market regime

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 catalyze 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 revolutionized 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: U.S. bond ETF average daily trading volumes (USD billions), 2018-2024

U.S. bond ETF trading has grown at a rate of 21% since 2018



Source: Bloomberg, as of March 29, 2024. Average daily trading volumes of all U.S. bond ETFs. The compound annual growth rate from 2018-March 2024 was 21%.

9 Source: Bloomberg. Average bid/ask spreads over the past 30 days (as of from Feb. 29, 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 customizable 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.

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

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

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.

The Appendix shows ways that bond ETFs can be used by investors to deploy cash and address several scenarios. No matter what specific prescription investors choose, we believe the opportunity to fortify portfolios is here and it is compelling.

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Appendix

Investors who are recalibrating their bond portfolios may be confronted with a range of macro environments going forward. Will central banks keep policy restrictive for too long and tip the economy into a hard landing and recession? Or will they actually "land the plane" in the idealistic soft-landing scenario?

No matter how investors expect near- and long-term markets to unfold, bonds have returned as a key ingredient in portfolios, and low-cost bond ETFs could be an effective transition vehicle from cash.

In this section, we explore three scenarios: (i) whether the global economy will pull off a "soft landing"; (ii) whether restrictive monetary policy results in the economy tipping into recession; or (iii) whether the economy slows while inflation persists resulting in further future rate hikes.

We believe that in each of these scenarios, at least some movement out of cash and into longer maturities is warranted. Depending on the scenario, investors may also increase or decrease credit risk.

We consider different ETFs that investors may wish to explore depending on their view on the markets and which portfolio outcome they are seeking.

Potential ETFs for consideration

Scenario 1: Central banks engineer a soft landing

In this 'goldilocks' scenario, we see falling inflation and central banks starting to gradually cut rates and re-steepen/normalize the yield curve to become upward-sloping once again.

In this scenario, investors could consider balancing the belly of the curve with high-quality, longer-duration bonds and higher income asset classes. We look to duration exposures in a range of 3-7 years, which may offer a good trade-off between current yield and potential upside valuation gains as rates fall. Additionally, for investors seeking higher income, high yield credit and risk assets in general could become much more attractive with lower refinancing risk and positive economic growth helping to contain default risk.

AGG	**iShares Core US Aggregate Bond ETF**
IUSB	**iShares Core Total USD Bond Market ETF**
USHY	**iShares Broad USD High Yield Corporate Bond ETF**
BEMB	**iShares J.P. Morgan Broad USD Emerging Markets Bond ETF**
BINC	**BlackRock Flexible Income ETF**

Scenario 2: Central banks cut rates given fears of recession

In a hard landing/recessionary scenario, both growth and inflation may recede rapidly, which may lead to a sudden decrease in policy rates. Such a scenario could harm risk assets and historically has triggered a flight to quality in which the longest maturity instruments should benefit from falling yields.

Investors may not want to abandon ballast just because short-term rates are higher. Cash likely will not provide the same potential ballast as bonds, so investors believing that such a scenario is more likely could consider at a minimum "barbelling" their current cash allocation with long duration instruments to help cushion risk assets and provide equity diversification. Investors may consider holding high quality assets like U.S. treasuries and higher quality credit exposures.

IEF	**iShares 7-10 Year Treasury Bond ETF**
TLH	**iShares 10-20 Year Treasury Bond ETF**
TLT	**iShares 20+ Year Treasury Bond ETF**
QLTA	**iShares Aaa-A Rated Corporate Bond**
IGLB	**iShares 10+ Year Investment Grade Corp Bond ETF**

Scenario 3: Central banks hike again

For those investors who believe that inflation will persist and that central banks will maintain or even enhance restrictive monetary policy — even at the cost of deteriorating economic growth, it may make sense to continue owning shorter maturity instruments (both nominal and inflation protected) which may help insulate investors from further increases in policy rates and stickier inflation.

With current inverted yield curves, where short-term interest rates are higher than long-term interest rates, we believe shorter-duration maturities could offer attractive yields versus cash and could support those seeking capital preservation. Like the prior scenario, investors may want to consider holding high quality assets like U.S. treasuries and higher quality credit exposures.

SGOV	**iShares 0-3 Month Treasury Bond ETF**
NEAR	**BlackRock Short Duration Bond ETF**
STIP	**iShares 0-5 Year TIPS Bond ETF**
IGSB	**iShares 1-5 Year Investment Grade Corporate Bond ETF**
IBDQ	**iShares® iBonds® Dec 2025 Term Corporate ETF**

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Important information

Carefully consider the Funds' investment objectives, risk factors, and charges and expenses before investing. This and other information can be found in the Funds' prospectuses or, if available, the summary prospectuses which may be obtained by visiting www.iShares.com or www.blackrock.com. Read the prospectus carefully before investing.

Investing involves risk, including possible loss of principal.

It's important to note that there are material differences between Money Market Funds and ETFs, including investment objectives, risks, fees, and expenses. Money Market funds typically seek to maintain a net asset value of $1.00 per share, but there is no guarantee they will do so and are not FDIC insured. Most ETFs seek to track an index, before fees and expenses. ETFs trade on exchanges intraday at market price, which may be greater or less than net asset value. Transactions in shares of ETFs may result in brokerage commissions and may generate tax consequences. There can be no assurance that an active trading market for shares of an ETF will develop or be maintained. Short duration bond ETFs typically carry a higher degree of risk than the other cash alternatives and should not always be used as a substitute. **An investment in fixed income funds is not equivalent to and involves risks not associated with an investment in cash.**

Fixed income risks include interest-rate and credit risk. Typically, when interest rates rise, there is a corresponding decline in bond values. Credit risk refers to the possibility that the bond issuer will not be able to make principal and interest payments. Non-investment-grade debt securities (high-yield/junk bonds) may be subject to greater market fluctuations, risk of default or loss of income and principal than higher-rated securities. An investment in the Funds is not insured or guaranteed by the Federal Deposit Insurance Corporation or any other government agency and their return and yield will fluctuate with market conditions.

If the index measuring inflation falls, the principal value of inflation-indexed bonds will go down and the interest payable will be reduced. Any increase in the principal amount will be considered taxable as ordinary income. Repayment of the original bond principal upon maturity (adjusted for inflation) is guaranteed for US Treasury inflation-indexed bonds. For bonds that do not provide a guarantee, the adjusted principal value repaid at maturity may be less than the original principal.

International investing involves risks, including risks related to foreign currency, limited liquidity, less government regulation and the possibility of substantial volatility due to adverse political, economic or other developments. These risks often are heightened for investments in emerging/developing markets and in concentrations of single countries.

NEAR and BINC are actively managed funds and do not seek to replicate the performance of a specified index. Actively managed funds may have higher portfolio turnover than index funds.

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