Rick Rieder – The Fixed Income Outlook for 2017

October 26, 2016

by Robert Huebscher

This article is part of our Schwab IMPACT 2016 Special Coverage this week. More articles are listed below.

The Fed will raise rates in December, as long as the election goes as expected and there are no surprises in the economic data, according to Rick Rieder. But, Rieder said there are secular influences in the economy that are much more important than monetary policy.

Rieder is a managing director and the global chief investment officer of fixed income at BlackRock. He spoke yesterday at the Schwab IMPACT conference in San Diego. It is the industry's largest conference, with approximately 2,000 advisor attendees.

Rieder also expects the Fed to execute two rate hikes in 2017 and another three in 2018. That will be "really powerful" for the yield curve, he said, which he predicted will steepen. Indeed, he said the value is in the "belly" of the yield curve – where investors can capitalize on rising short-term rates.

He said his forecast is based on a prediction that the Fed will allow inflation to run "hotter" than its current level of approximately 2%.

Looking back at 2016, Rieder said the year can be parsed into four segments, punctuated by three key dates. The year started with a risk-off framework driven by concern over China and a fear of capital flight from that country. The second segment began on February 15, when a governor from the People's Bank of China said that the country was going to grow instead of pursuing structural reforms. With 50% of global growth coming from China, that statement triggered a positive investment sentiment. The third was the Brexit vote on June 23, and Rieder said the data on the U.K. looked "okay" so far. The fourth was on September 21, when the Bank of Japan made the decision to move off of zero interest rates, letting its yield curve steepen and inflation run hotter. It recognized that a zero-interest rate policy was hurting pensions, insurance companies and banks.

Looking forward, Rieder said we live in a world of big data, but we focus on "small data" like CPI, GDP and employment. "The influences on the economy are much more complex and much of the data we get is wrong," he said.

Unique secular influence

Two forces – demographics and technology – are shaping the economic landscape and make the current environment unique, according to Rieder.

Globally, we are facing an unprecedented demographic cycle as the population ages, he said, most evident in Japan, which is shrinking. "That is the most important force we face," he said, "economies grow when the working-age population grows." Output consumption is tied to that age cohort.

Given our aging population, Rieder said that 2% growth is "pretty good," especially when you consider that Europe is at 1% and Japan at 0% because of demographics. Interest rates will stay low because the demand for income among retirees is extraordinary and will be long-lived, according to Rieder. He said that demand for U.S. securities is driven in part by foreign investors, who want our higher interest rates.

A byproduct of that dynamic, he said is that where you hold fixed income is important, and that interest rates in the emerging markets won't follow the developed world.

On the technology front, Rieder said we are in the fifth big technology revolution. Steam power was the first, followed by electricity, telecom and vehicles; now data transmission is changing how companies run their business. He said that the cost of storage capacity has dropped precipitously. Revenues among the S&P 500 constituents have contracted, because technology has changed the framework of consumption, with services such as Uber and Airbnb. Technology has forced vertical integration, and is motivating companies to own supply chains, as in the case of AT&T's proposed merger with Time Warner.

Technology advances are deflationary, according to Rieder, and should give the Fed the confidence to allow inflation to increase, since it will face a natural, market-driven limit.

Rieder said that the credit cycle is unique. "We've created more jobs in the past three years than in the prior 10," he said. "But all the hiring has been in education, professional business services, and leisure and hospitality." As a result, productivity is not really declining, contrary to much of the published data. Manufacturing is highly productive, he said. But in the service sector, there has been a huge increase in hiring. He expects wages to go up along with inflation. Margins have grown as a result of productivity enhancements, he said, and wage increases will follow.

Portfolio positioning

Diversify globally, especially into emerging markets, Rieder said.

"The leverage in the world is in the developed markets," he said, "not the emerging markets." Japan, Europe and the U.S. face high debt-to-GDP ratios, he said, whereas the emerging markets went through their crisis 20 years ago and have built reserves to stay liquid.

Moreover, the emerging markets don't have to keep rates at zero, he said. They can have positive real rates and can ease monetary policy, particularly in places like Brazil.

That hinges on an assumption that the dollar will be relatively stable, he said. The dollar is highly correlated to trade flows in oil, so an energy crisis is a risk to dollar stability. Rieder said that the Fed understands that it cannot let the dollar get too strong, which would have adverse effects for the emerging markets.

The U.S. economy is in "pretty decent shape," he said. The leverage-driven risk is in China, he said, which could face problems even if it grows at 6-7%. But Rieder said he believes China has a "series of tools" to let its economy grow without incurring a debt-driven crisis.

The demand is high for new-issue debt, Rieder said. That will keep interest rates low. He said it is better to go down the credit spectrum than to take duration risk. He likes TIPS, in part because of his prediction of higher inflation.

"You can generate a lot of yield owning the front end of the curve," he said, "including asset-backed securities." The long end of the yield curve will not be of much of a help, he said, particularly if the Fed hikes rates.

The credit cycle is "funky," Rieder said, because leverage is growing but interest coverage is safe 8-to-1. Rieder said that leverage, cash flow and liquidity are all that matters in the bond market. As long as interest coverage is okay and companies can roll their debt, he said, investors will be insulated from default risk.

Rieder said he likes high-yield and long-term investment-grade bonds. He doesn't like foreign sovereign debt. He said the CLO market is "really cheap" relative to the collateral, and investors can get AAA risk exposure with short duration. The muni market will benefit from more fiscal spending and possibility of higher taxes, he said. He also likes non-agency mortgages.

Liquid alternatives may make sense, Rieder said. But liquidity is tight in the bond markets, and investors need to understand the asset and its liquidity, he said. Long-short funds are worth looking at, he said, since volatility will get higher. Quantitative easing has forced volatility down and it is priced incorrectly. Some long-short funds have attractive yields and downside protection. "Look for things that get decent yield, take advantage of low volatility and have downside protection."

Overall, Rieder said investors should take exposure globally, while understanding the embedded risks.

This article is part of our Schwab IMPACT 2016 Special Coverage this week. Check out our other articles:

- Liz Ann Sonders: Don't Fear a Recession or Market Overvaluation Oct 25, 2016 9:16a
- Greg Valliere - Two Possible Election Outcomes Oct 25, 2016 12:02p
- Ian Bremmer – We Face a Profound Geopolitical Recession Oct 26, 2016 10:29a