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BlackRock: Inflation concerns and sustainability driving bond ETF flows in EMEA

Brett Olson, Head of iShares Fixed income EMEA, explores the top themes influencing how clients are thinking about their fixed income portfolios

1. **Inflation and rate volatility top of mind**
2. **Sustainability inflows contrast broader fixed income outflows**
3. **High yield and emerging markets in the spotlight amid search for yield**

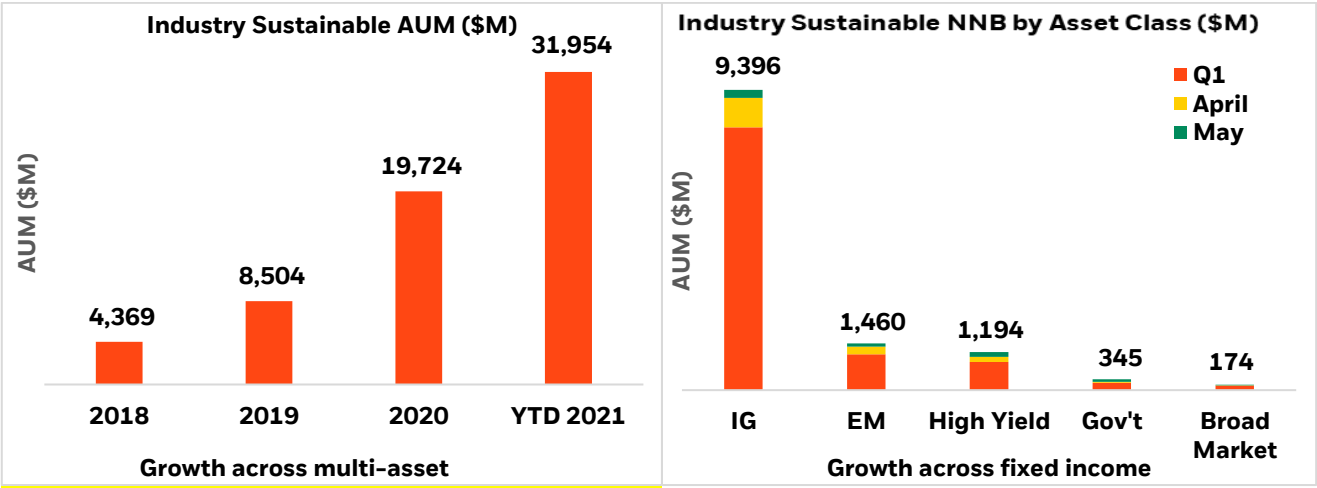
Are we in a rising rate environment?

- This is the key question on the lips of many investors looking to shore up their fixed income exposures against the potential for inflation and rate volatility.
- Looking beyond the transitory nature of the current inflation surge linked to the reopening dynamic, the BlackRock Investment Institute (BII) points to inflation building steadily over the medium-term as easy monetary policy allows the U.S. economy to run hot.
- Bond ETF flow data show investors are moving their allocations to use inflation-linked bonds with YTD inflows of $3.0bn at 31 May 2021, vs. $4.2bn for the entire of 2020*, as well as short duration corporate and government bonds to minimise rate volatility.
- The liquid, flexible nature of fixed income ETFs is enabling investors to remain nimble and stay adaptable to changing market conditions.

Investors are committed to their sustainability journey

- Sustainable flows across all major fixed income asset classes continued to be positive with total flows into fixed income ESG ETFs coming up to $12.6bn as at end of 31 May 2021, mainly driven by investment grade credit, which accounted for 73% of this total.
- Sustainable fixed income ETF flows are by far exceeding industry inflows into traditional, non-ESG exposures year-to-date – which stood up to only about $3.3bn as of end 31 May 2021*.
- Investors increasingly want to understand the impact of sustainability on their fixed income sleeve. Despite growing investor caution on fixed income as an asset class in recent months, the trend of switching out of traditional or non-ESG funds and actively transitioning into sustainable exposures is accelerating.

Fig.1: UCITS Fixed Income Sustainable ETF flows



Source: BlackRock GBI as at 31 May 2021. For illustrative purposes only. All amounts reported in USD.

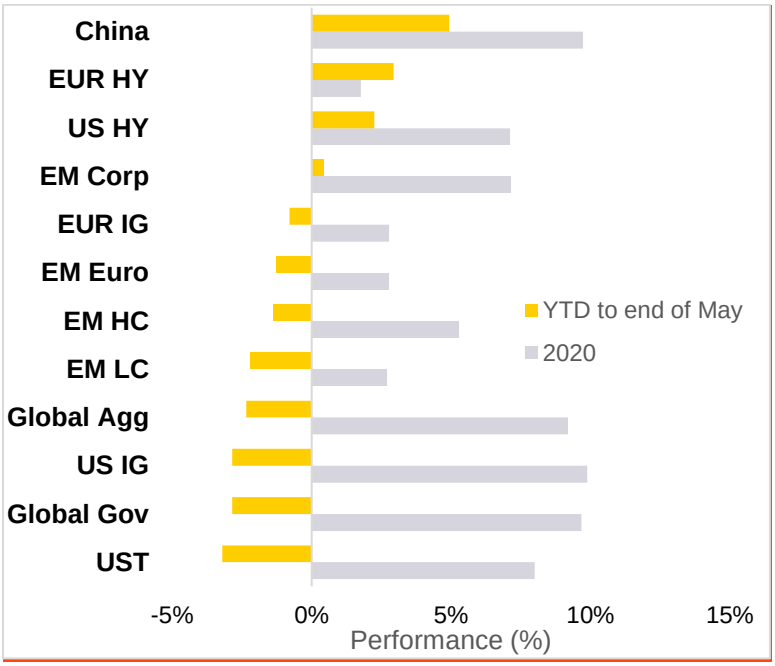
*Source for all data points BlackRock.

The search for yield continues

- Today's fixed income markets are mainly driven by central bank policies, which in turn have caused negatively yielding debt to grow at a record pace. The extraordinary level of central bank stimulus has pushed interest rates lower, and as a result, the search for yield has never been stronger.

- High Yield ["HY"] continues to be in favour by investors in 2021, as it is also a lower duration asset class, relative to Investment Grade, in addition to its strong fundamentals. HY ETFs saw $2bn of inflows as at 31 May 2021, with a strong preference for USD HY exposures supported by lower EUR/USD hedging costs, along with the higher exposure to energy names.
- HY has traditionally been viewed through a lens of requiring specialist knowledge and expertise in order to 'pick and choose' between the best names in the sector. However, as the ongoing hunt for yield continues, HY debt may benefit from inflationary pressures as investors may prefer the shorter duration exposures that HY offers versus investment grade debt. In this space, more and more clients are using ETFs to bring diversification and flexibility to their portfolio alongside alpha and index exposures.
- Looking at the portion of the fixed income market which yields over 2.5%, more than half is made up of China bonds and investors are increasingly taking note: the 5-year China government bond yield is at 3.0% compared to the equivalent 5-year US Treasury which is yielding just 0.9%, offering a 2.1% yield pick-up. The inclusion of onshore bonds into global indices provides a structural tailwind and low correlation with other major markets is attracting investors looking to build resilience against market volatility.
- Against this backdrop China on shore bond ETFs gathered more than $4bn inflows as at 31 May 2021, mainly used for strategic asset allocation purposes from a diverse set of investors across asset owners, asset managers and wealth as well as from multiple regions.

Fig 2: Comparing returns across asset classes



Source: BlackRock, Bloomberg as at 31/05/21. For illustrative purposes only.

For more information on these trends, or to speak with one of our fixed income specialists, please contact us.

*Source for all data points BlackRock.

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*Source for all data points BlackRock.