



BlackRock's Rieder: The US Faces a Structural Dilemma

By Robert Huebscher

October 29, 2010

The U.S. economy faces a structural dilemma with high unemployment that cannot be addressed with conventional policy measures, according to Rick Rieder. Rieder, the CIO of Fixed Income for BlackRock, spoke on Wednesday at the Schwab IMPACT conference. The "bond bubble" will not burst, he said, and the high-yield market now offers attractive yields.

The structural dilemma

"What is happening in policy and in structural dynamics is generational," Rieder said. Those structural issues are high unemployment which, he said, shows no signs of improvement. The break-even level for unemployment is approximately 150,000 weekly new unemployment claims, but claims have been consistently in excess of 400,000.

Companies are increasing their part-time hiring due to rising health care and other costs, Rieder said. Unemployment is particularly bad among 16-19 year olds. In addition, those aged 55 and older are staying in the workforce longer, because they are healthier and cannot afford to retire.

Companies are becoming more efficient, he said, as they are increasing their spending on information technology as a substitute for human capital. Data show that revenues per employee have been increasing for U.S. corporations.

The result, Rieder said, is that there is no significant turnover in employment. The specific structural problem is a lack of job opportunities for those with "lesser skills."

Those problems cannot be fixed with monetary policy, Rieder said. The Fed's announcement of QE II has moved money into both the equity and fixed income markets, he said, pushing those markets higher but not creating the economic growth necessary to reduce unemployment. Most of the growth recently, according to Rieder, has been from stimulus measures and inventory building, both of which will "fade away."

The US can pull out of this

The US consumer is in better shape than at any time in the last several years, due to deleveraging of household balance sheets. Non-discretionary spending is down too, Rieder said, as consumers have chosen to save instead of spend.

Rieder noted that the velocity of money has slowly picked up recently, which would presage a rise in inflation that would be healthy for the economy. What would really



increase the velocity, he said, would be when companies begin to deploy the \$2 trillion of cash they have on their balance sheets. That cash store is increasing as companies, in general, have been profitable and generating positive cash flow.

The challenge facing policy makers is how to create economic growth without increasing leverage (i.e., deficits). Rieder said the economy is now roughly twice as levered as it should be. While the resulting debt servicing costs may be acceptable in the current low interest rate environment, the economy "could not survive" a spike in interest rates, he said.

Policy makers need to move the economy from its current state of low growth and low inflation to one of high growth and low inflation. Historically, the S&P has returned 23% annually in periods of high growth and low inflation. Rieder expects to see policies geared to stimulate small business lending and to provide tax incentives for hiring and capital expenditures in order to achieve this goal.

Investment Implications

Rieder discussed several investment implications of his economic forecast. The "bond bubble" will not burst, he said, because of continued high demand for Treasury securities from banks and households. U.S. Treasury bonds are one of few remaining AAA-rated assets in the market. Approximately 80% of the fixed income supply in the next couple of years will be from the Treasury, he said.

Yields on Treasury bonds will be lower, he said, and high-yield bonds, which now yield approximately 7.5% are attractive. Those yields will come down as that asset class draws very strong cash flows.

www.advisorperspectives.com

For a free subscription to the Advisor Perspectives newsletter, visit:
<http://www.advisorperspectives.com/subscribers/subscribe.php>