BLACKROCK INVESTMENT INSTITUTE – MAY 2018

BlackRock geopolitical risk dashboard

Tom Donilon

Chairman,
BlackRock Investment Institute

Isabelle Mateos y Lago

Chief Multi-Asset Strategist,
BlackRock Investment Institute

Theodore Bunzel

Member of BlackRock's
Corporate Strategy team

Eric Van Nostrand

Macroeconomic research,
BlackRock's Multi-Asset
Strategies group

Ron Ratcliffe

Member of BlackRock's Risk and
Quantitative Analysis group

Helen Zhu

Head of China Equities,
BlackRock Active Equities

The global economic expansion carries on, but geopolitical risks abound. They range from a potential conflict on the Korean peninsula to the risk of European fragmentation. Our global BlackRock Geopolitical Risk Indicator (BGRI) has ticked up from 11-month lows, indicating the market's attention to geopolitical risk has picked up. *Gulf tensions* is our focus risk this month as the U.S. steps back from the deal intended to curb Iran's nuclear ambitions.

Our geopolitical risk dashboard shows our global market barometer and our top-10 individual risks, assessing each risk's relative likelihood and potential market impact. We examine how closely markets are paying attention to each risk; explain the background, recent developments and catalysts; and gauge the possible impact on assets historically most sensitive to the risk. Highlights of our monthly update:

We surveyed the geopolitical landscape at the most recent meeting of our BlackRock Geopolitical Risk Steering Committee, and focused on increasing *tensions in the Gulf* and throughout the Middle East.

We see a risk the deal intended to curtail Iran's nuclear ambitions unravels further and could see one of the proxy conflicts between Saudi Arabia and Iran escalating. At the heart of our Gulf tensions risk: the U.S. withdrawal from the nuclear deal; an increasingly confident and hardline Saudi Arabia backed by a hawkish White House; Iran aggressively expanding its influence throughout the region; and direct Russian military involvement in Syria.

We reassessed our March focus risk: a potential trade war that upends the rosy growth outlook. An evolving U.S. probe into Chinese trade practices has shaken markets, while North American Free Trade Agreement (NAFTA) talks are limping along. Trade tensions are embedded in the dashboard's *U.S.-China relations* and *North American trade* risks. We expect the former to heat up as the U.S. clearly has China in its sights, and see reduced potential for a NAFTA deal in the near term.

The U.S. re-imposition of secondary sanctions on European and other companies doing business in Iran has pitted the U.S. against the European Union (EU) and exacerbated simmering tensions caused by proposed U.S. tariffs on steel and aluminum.

There has been a significant reduction in the risk of U.S. military action against North Korea in the wake of dialogue between North and South and a possible summit between U.S. President Donald Trump and North Korea's Kim Jong Un. Yet North Korean threats to pull out of the talks illustrate the risk of bumps in the road of any negotiation process. The prospect of an ultimate resolution remains uncertain. We upgraded the risk of a populist turn in *Latin American* politics as the leftist frontrunner in the Mexican presidential election has extended a healthy lead in the polls.

The effect of geopolitical shocks on global markets often is short-lived, according to our analysis of asset price reactions to 50 risk events since 1962. Yet the impact tends to be more acute and long-lasting when the economic backdrop is weak, we find. We are not there today, and see U.S. Treasuries and gold providing a buffer against risk asset selloffs trigged by geopolitical crises. These perceived safe havens also tend to rally ahead of "known unknowns" such as elections, then lag after the event as fading uncertainty boosts risk assets.

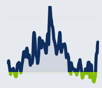
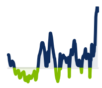
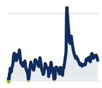
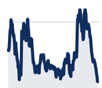
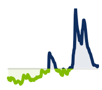
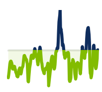
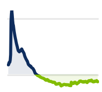
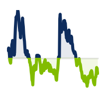
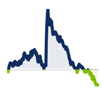
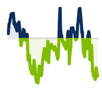
Tracking geopolitical risks and their market impact is as much an art as a science. We are continuously updating our risk scenarios and fine-tuning our methodologies. The scenarios are hypothetical, and our analyses related to market impact are not recommendations to invest in any particular investment strategy or product.

Contents

Global overview

We take a bird's eye look at our top-10 geopolitical risks, describing the hypothetical scenarios that power our market impact and likelihood analysis as well as summarizing our views. We show our focus risk first, then list the other nine risks by level of market attention as measured by the BGRIs. We next show the latest reading of our global geopolitical risk barometer, and plot the risks in a graphic that shows each risk's relative likelihood and potential market impact.

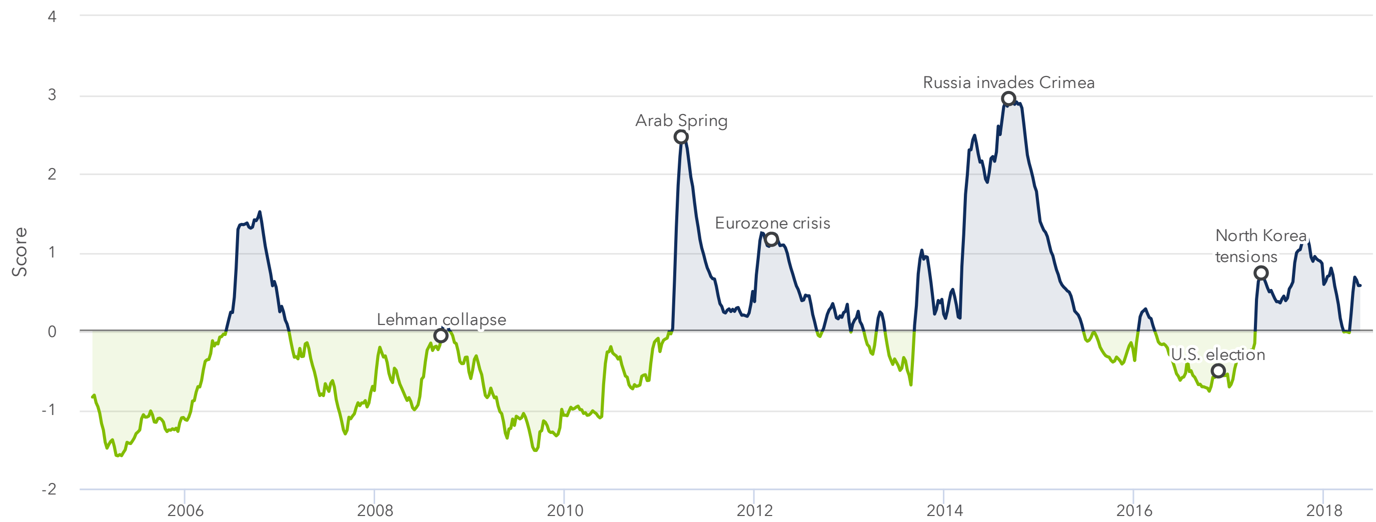
Snapshot of top-10 geopolitical risks, May 2018

Risk	Scenario description	Our view	Risk index since 2014	Page
Focus risk: Gulf tensions	Re-imposed U.S. sanctions hit European and Asian companies doing business in Iran, roiling the Iranian economy and threatening a full unraveling of the nuclear deal. The U.S., Saudi Arabia and Israel express increasing concerns about a potential nuclear restart, and Iran retaliates by emboldening its proxy forces.	The U.S. administration has taken an increasingly confrontational stance in the Middle East, reinforced by key personnel changes and evidenced by the withdrawal from the Iran nuclear deal. This has escalated tensions in an already tense, complex region.		5-6
U.S. - China relations	The U.S. sets tariffs on a wide range of Chinese goods, with the economic impact confined to specific sectors. China retaliates with its own tariffs and adds roadblocks for U.S. business.	We see a full-blown trade war averted but an extended period of tensions, including over restrictions on Chinese investments in the U.S., transfer of technology to China, and Chinese tech companies operating in the U.S. We expect tit-for-tat tariff actions to spook markets, with rivalry in the tech sector and disputes over reciprocal market access as more fundamental issues.		7
North American trade	The U.S. withdraws from the North American Free Trade Agreement (NAFTA) after talks with Canada and Mexico derail. The withdrawal does not call into question the U.S. commitment to other trade deals and only goes into effect six months later.	We see reduced chances for a preliminary NAFTA deal that can be ratified by the current U.S. Congress before year-end, as time is running out to accomplish this. We could see talks extending through the Mexican presidential and U.S. midterm elections – and even into 2019.		8
Major cyberattack(s)	Hackers take over the infrastructure of major cloud service providers and disrupt the operations of dependent industries. Cloud service providers suffer massive reputational damage and lose business.	Cyberattacks by state and non-state actors have increased in sophistication and quantity. We see a persistent risk of attacks on cloud technology, business-critical infrastructure and major elections – and would worry particularly about a nation state attacking the U.S.		9
North Korea conflict	A U.S. surgical strike neutralizes North Korea's missile capabilities after the country carries out a new nuclear test. North Korea retaliates with scattered firing across the demilitarized zone but ultimately backs down.	We see the risk of military conflict on the Korean peninsula reduced sharply ahead of possible U.S.-North Korea talks. If the summit takes place, we expect lengthy follow-on negotiations that may derail on implementation and verification. Tensions could increase quickly if talks come up short.		10
European fragmentation	Populist parties gain momentum beyond Italy, and governments in other EU countries adopt parts of the euroskeptic agenda to address voter discontent.	Momentum for deeper eurozone integration has slowed, and a populist coalition government in Italy could challenge the EU's fiscal pact. No major national elections are on the horizon. Anti-European sentiment is gaining in Eastern Europe, albeit from low levels.		11
Russia - NATO tensions	Simmering tensions between Russia and the West boil over due to an accidental clash between a Russian and NATO fighter jet. This leads to mutual recriminations, military preparations, and potential for direct conflict.	Russia and the West have reached an uncomfortable Cold Peace. Tensions could increase further, particularly if the West imposes additional sanctions in the face of any evidence of Russian interference in the U.S. midterm elections. An accidental military clash has been avoided for now.		12
South China Sea conflict	Vietnamese and Chinese naval forces exchange fire after the accidental sinking of a Vietnamese fishing boat near the disputed Spratly Islands. The countries withdraw their ambassadors, and the U.S. embarks on increased naval exercises in the area.	China has further militarized the region as the U.S. has focused on denuclearization of North Korea and trade talks with China. The potential for an accidental or deliberate clash between China and Vietnam remains.		13
Major terror attack(s)	Terror attacks in a major Western European city cause significant casualties. Investigations pinpoint a network originating in the Middle East and active in the U.S., prompting the U.S. and NATO allies to start planning for a military response against Middle East militants.	Most assaults now are carried out by autonomous cells or individuals. We see this risk as greatest if an attack triggers domestic strife or U.S. military retaliation against a suspected state actor.		14
LatAm populism	Voters in Mexico and Brazil favor populist candidates in upcoming elections. This reverses a trend toward pro-business, technocratic Latin American governments and scares off foreign investors.	We could see left-wing Mexican populist and front-runner Andrés Manuel López Obrador governing toward the center if elected, but his party's potential majority in Congress could herald more extreme policies. Brazil's election is wide open and a far-right populist victory is possible.		15

Source: BlackRock Investment Institute, May 2018. Notes: The table shows the top-10 geopolitical risks identified by the BlackRock Geopolitical Risk Steering Group. The list is topped by our bi-monthly focus risk; other risks are organized by level of market attention as indicated by the BlackRock Geopolitical Risk Indicator for each. See the "How it works" section on page 4 for details.

Global overview

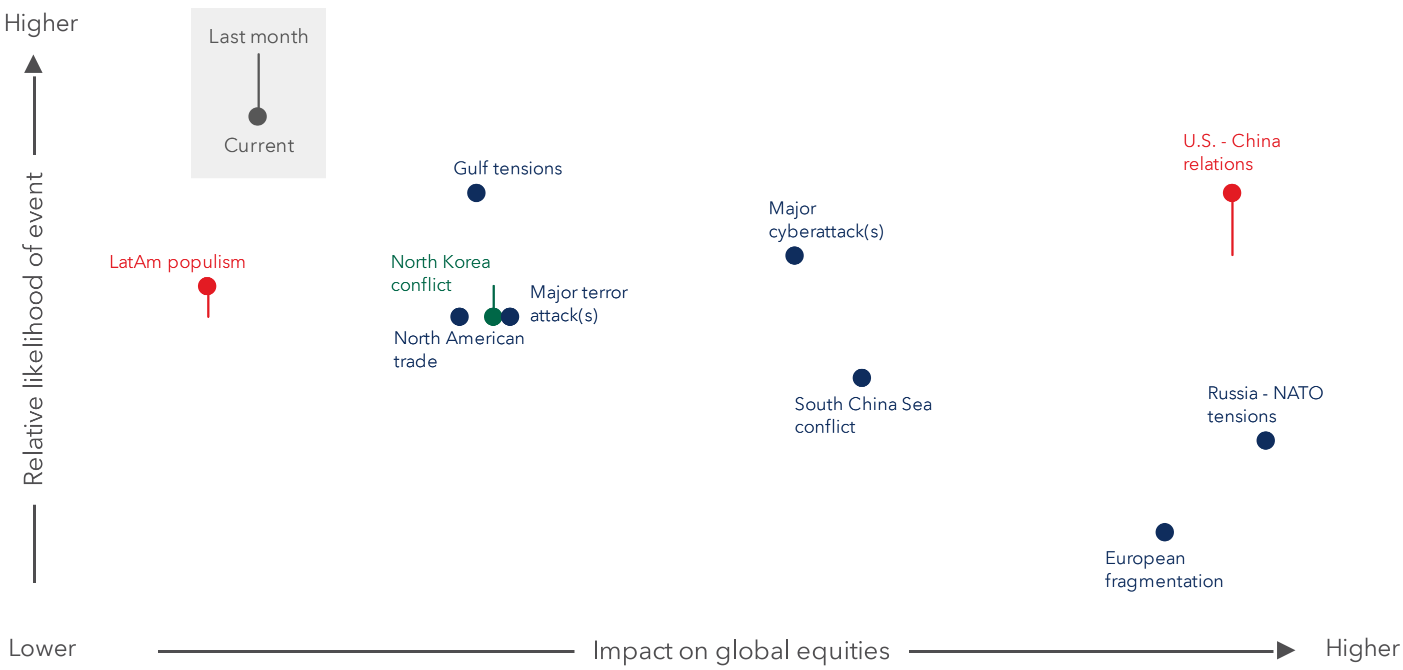
BlackRock Global Risk Indicator



Source: BlackRock Investment Institute, with data from Thomson Reuters. Data as of May 18, 2018. Notes: We identify specific words related to geopolitical risk and use text analysis to calculate the frequency of their appearance in the Thomson Reuters Broker Report and Dow Jones Global Newswire databases as well as on Twitter. We then adjust for whether the language reflects positive or negative sentiment, and assign a score. A zero score represents the average BGRI level over its history from 2003 up to that point in time. A score of one means the BGRI level is one standard deviation above the average. We weigh recent readings more heavily in calculating the average.

- Our global BlackRock Geopolitical Risk Indicator has been bouncing off 11-month lows, indicating many risks are back on the market's radar screen. Risks that have heated up: the North American trade risk, U.S.-China tensions, Gulf tensions and cyberattacks.
- We see rising U.S.-China trade tensions, causing us to raise the relative likelihood of the risk. We have also upgraded the risk of LatAm populism amid signs of a populist victory in the upcoming Mexican elections.
- We expect a temporary lull in the North Korea risk because of the dialogue between North and South and the possible summit between the U.S. and North Korea.

Relative likelihood and market impact of risks



Source: BlackRock Investment Institute. May 2018.
Notes: The graphic depicts BlackRock's estimates of the relative likelihood (vertical axis) of the risks over the next six months and their potential market impact on the MSCI ACWI Index (horizontal axis). The market impact estimates are based on analysis from BlackRock's Risk and Quantitative Analysis group. See the How it works section and the 2018 paper Market Driven Scenarios: An Approach for Plausible Scenario Construction for details. Some of the scenarios we envision do not have precedents – or only imperfect ones. The scenarios are for illustrative purposes only and do not reflect all possible outcomes as geopolitical risks are ever-evolving. Colored lines and dots show whether BlackRock's Geopolitical Risk Steering Committee has increased (green) or decreased (red) the relative likelihood of any of the risks from our previous update.

How it works

The **BlackRock Geopolitical Risk Indicator (BGRI)** continuously tracks the relative frequency of analyst reports, financial news stories and tweets associated with geopolitical risks. For sources, we use the Thomson Reuters Broker Report and the Dow Jones Global Newswire databases as well as the one million most popular tweets each week from Twitter-verified accounts. We calculate the frequency of words that relate to geopolitical risk, adjust for positive and negative sentiment in the text of articles or tweets, and then assign a score. We assign a much heavier weight to brokerage reports than to the other data sources because we want to measure the *market's* attention to any particular risk, not the *public's.*

The BGRI is primarily a market attention indicator, gauging to what extent market-related content is focused on geopolitical risk. The higher the index, the more financial analysts and media are referring to geopolitics.

We also take into account whether the market focus is couched in relative positive or negative sentiment. For example, market attention on geopolitical risks was extremely high during the Arab Spring of 2011. Much of the attention was focused on the potentially positive effects of the regime changes, however. The adjustment for this positive sentiment mitigated the Arab Spring's impact on the BGRI's level. Sentiment adjustment also helps us avoid overstating geopolitical risk when risks actually are being resolved.

Here's the step-by-step process:

1. **BGRI attention:** This is the market attention score. The global BGRI uses words selected to denote broad geopolitical risks. Local BGRIs identify an anchor phrase specific to the risk (e.g., North Korea) and related words (e.g., missile, test). A cross-functional group of portfolio managers, geopolitical experts and risk managers agrees on key words for each risk and validates the resulting historical moves in the relevant BGRI. The group reviews the key words regularly.

2. **BGRI sentiment:** This is the sentiment score. We use a proprietary dictionary of about 150 "positive sentiment" words and 150 "negative sentiment" words. We use a weighted moving average that puts more emphasis on recent documents.

3. **BGRI total score:** This is BGRI attention - (0.2 * BGRI sentiment). We want the indicator to fundamentally measure market attention, so we put a much greater weight on the attention score. A 20% weight of the sentiment score can mitigate spikes at times when risk may actually be receding.

4. **Meaning of the score:** A zero score represents the average BGRI level over its history from 2003 up to that point in time. A score of one means the BGRI level is one standard deviation above the average. We weigh recent readings more heavily in calculating the average.

Risk likelihood and impact chart

The risk likelihood and impact chart shows our assessment of the relative likelihood of our top-10 risks and the potential severity of their market impact. Our geopolitical experts identify potential escalation triggers for each risk and then assess the most likely manifestation of the risk over the next six months. The relative likelihood of each event (vertical axis) is then measured relative to the remaining risks. For example, we currently rate *U.S. - China relations* as having a relatively high likelihood, whereas we see *European fragmentation* at the lower end of the scale. The severity of market impact (horizontal axis) is based on Market-Driven Scenarios (MDS) analysis from our Risk and Quantitative Analysis group and estimates the one-month impact of each risk on global equities (as measured by the MSCI ACWI) if it were to come to pass. For example, we currently see *Russia - NATO tensions* having among the highest potential market impact, whereas we expect the market effects of *LatAm populism* to rank at the bottom. Colored lines and dots show whether BlackRock's Geopolitical Risk Steering Committee has increased (green) or decreased (red) the relative likelihood of any of the risks from our previous update. The chart is meant for illustrative purposes only.

Market impact – overall

Our MDS framework forms the basis for our scenarios and estimates of the one-month impact on global equities. The first step is precise definition of our scenarios – and well-defined catalysts (or escalation triggers) for their occurrence. We then use an econometric framework to translate the various scenario outcomes into plausible shocks to a global set of market indexes and risk factors.

The size of the shocks is calibrated by various techniques, including analysis of historical periods that resemble the risk scenario. Recent historical parallels are assigned greater weight. Yet historical data are not the only input to our analysis. Some of the scenarios we envision do not have precedents – and many have only imperfect ones. This is why we integrate the views of BlackRock's experts in geopolitical risk, portfolio management, and risk and quantitative analysis into our framework. See the 2018 paper Market Driven Scenarios: An Approach for Plausible Scenario Construction for further details. The BGRI's risk scenario is for illustrative purposes only and does not reflect all possible outcomes as geopolitical risks are ever-evolving.

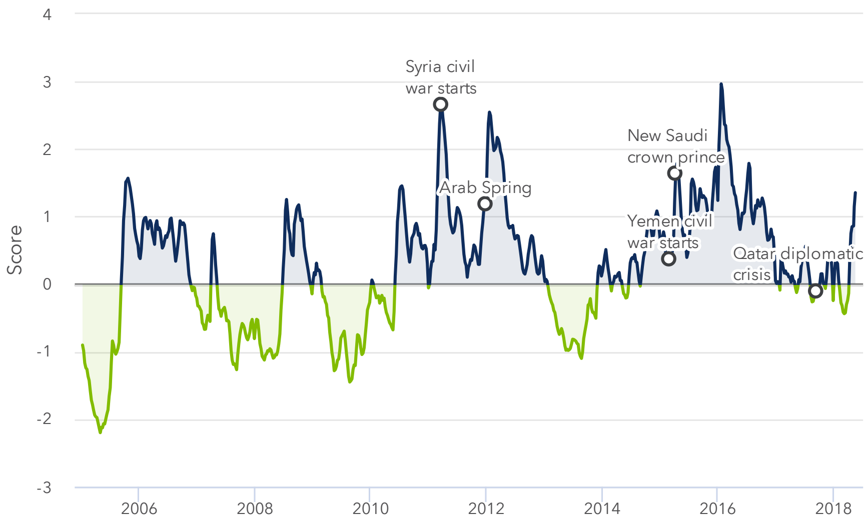
Market impact – sensitive assets

For each of our top-10 risks we identify assets that historically have been sensitive to upward movements in their respective BGRI, as measured by the correlation of returns to these assets and the BGRI when the BGRI rose more than 0.15 standard deviation in a week. We use data from 2005 to May 2018.

Focus risk

Gulf tensions

BlackRock Geopolitical Risk Indicator



Risk scenario description:

Re-imposed U.S. sanctions hit European and Asian companies doing business in Iran, roiling the Iranian economy and threatening a full unraveling of the nuclear deal. The U.S., Saudi Arabia and Israel express increasing concerns about a potential nuclear restart, and Iran retaliates by emboldening its proxy forces.

Our view:

The U.S. administration has taken an increasingly confrontational stance in the Middle East, reinforced by key personnel changes and evidenced by the withdrawal from the Iran nuclear deal. This has escalated tensions in an already tense, complex region.

Source: BlackRock Investment Institute, with data from Thomson Reuters. Data as of May 18, 2018. Notes: We identify specific words related to this geopolitical risk and use text analysis to calculate the frequency of their appearance in the Thomson Reuters Broker Report and Dow Jones Global Newswire databases as well as on Twitter. We then adjust for whether the language reflects positive or negative sentiment, and assign a score. A zero score represents the average BGRI level over its history from 2003 up to that point in time. A score of one means the BGRI level is one standard deviation above the average. We weigh recent readings more heavily in calculating the average. The BGRI's risk scenario is for illustrative purposes only and does not reflect all possible outcomes as geopolitical risks are ever-evolving.

Background

- Tensions between Iran (majority Shiite) and Saudi Arabia (majority Sunni) are fueling military and diplomatic conflicts in the region.
- Proxy wars rage in Yemen and Syria (where Russia intervened), a cold war has enveloped Qatar, and conflict looms in Lebanon.
- The U.S. has moved closer to Saudi Arabia, other Sunni states, and Israel, and become more confrontational toward Iran.
- The rise of Saudi Crown Prince Mohammad bin Salman (MBS), a reformer who is a hardliner on Iran, represents sweeping change.
- The U.S. withdrawal from the Iran nuclear deal has raised prospects for increased Iranian aggression and a potential nuclear restart.

Key recent developments

- MBS ordered the arrest of top Saudi business leaders and royals in an anticorruption sweep in late 2017, further consolidating power. Most detainees had been released by early 2018 after reaching financial settlements.
- The appointments of noted hawks Pompeo and Bolton suggest a further hardening of the U.S.'s anti-Iran posture and greater alignment with Iran's regional antagonists: Saudi Arabia and Israel.
- President Trump on May 8 announced his decision to withdraw from the Iran nuclear deal and to re-impose all U.S. sanctions lifted or waived in connection with the deal.
- Missiles fired from Houthi rebel-held territory in Yemen have targeted Riyadh and Saudi energy infrastructure, but so far have not done major damage.
- In the vacuum left by ISIS's defeat, Russian intervention, the assertiveness of Syria's Bashar al-Assad regime, and a rise in Turkish/Kurdish violence could have geopolitical knock-on effects in the Gulf region.
- Israeli actions against Iranian military facilities in Syria have increased in frequency.

Escalation triggers

- U.S. withdrawal from the Iran nuclear deal leads to a nuclear restart in Iran.
- A missile strike from Yemen sparks direct conflict between Saudi Arabia and Iran.
- Civil turmoil breaks out in Saudi Arabia in reaction to reform plans.
- Israel attacks Hezbollah or Iranian proxies in Lebanon or Syria, increasing the probability of wider conflict with Iran.

Potential market implications

- Oil prices rise on fears of supply disruptions.
- Gulf sovereign wealth funds potentially sell global risk assets to raise cash.
- Saudi stocks, gold and Brent crude oil have been among the assets sensitive to this risk.

Risk-sensitive assets
Saudi Arabia Tadawul All Share Index ↓
Gold ↑
Brent crude oil ↑

Source: BlackRock Investment Institute, with data from Thomson Reuters. Notes: The financial assets shown are those we have identified as being historically the most sensitive to swings in the **Gulf tensions** BGRI. We use data from 2005 to May 2018. We measure the sensitivity by calculating the correlations between returns on these assets and upward weekly moves of 0.15 standard deviation or more in the BGRI. The arrows show the historical direction of the sensitive asset response. The sensitive assets are shown for illustrative purposes only; other factors may have been at work in the past and markets may react differently in the future. The analysis is not intended to represent the performance of any specific product or security, nor is it a recommendation to invest in any particular investment strategy or product.

Focus risk

Gulf tensions

The BlackRock Geopolitical Risk Indicator (BGRI) for our *Gulf tensions* risk has ticked up. The current reading is around one standard deviation above the historical average, but well short of previous peaks. We expect limited impact on global markets. Gulf markets are vulnerable but have a small weighting in emerging equity and bond indexes.

Overall, we expect Saudi-Iran tensions to increase and regional proxy fights to escalate. At the heart of this dynamic: the U.S. withdrawal from the Iran nuclear deal; an increasingly confident and hardline Saudi Arabia backed by a hawkish White House; Iran expanding its influence throughout the region; the direct involvement of Russia in Syria; and elevated oil prices.

Highlights:

1. We expect the U.S. withdrawal from the Iran nuclear deal to be a significant blow to the Iranian economy and to the relationship between the U.S. and its European allies. It will further exacerbate geopolitical tensions in the Gulf. On May 8, President Trump announced his decision to cease U.S. participation in the Joint Comprehensive Plan of Action (JCPOA; Iran nuclear deal) and to re-impose, following a wind-down period, all U.S. sanctions lifted or waived in connection with the deal. This decision reflects the maximum steps the U.S. could have taken. The other parties to the deal (Iran, Europe, China, and Russia) have announced they remain committed to the agreement, but U.S. sanctions will likely curb economic activity and investment in Iran. This reduces incentives for Iran to continue meeting its deal obligations. We see the greatest impact of U.S. withdrawal on the Iranian economy, on oil supply and on European companies with economic interests in Iran.

2. We expect regional proxy conflicts between Saudi Arabia and Iran to intensify. We view direct conflict between Riyadh and Tehran as unlikely, but the potential for escalatory accidents abounds. These include a missile strike on Riyadh (or on Saudi energy infrastructure) originating from Yemen; an accidental clash between U.S. and Russian forces in Syria; direct conflict between Israel and Iran in Lebanon or Syria; or an eventual Israeli or U.S. pre-emptive strike on Iran's nuclear capabilities. We currently see a low chance of this fourth outcome but the market impact of any such action would be high, with potential for a global risk-off move and an oil-price spike on fears of supply disruptions.

3. Saudi Crown Prince Mohammad bin Salman (MBS) looks set to further consolidate his power and gradually implement his ambitious reform agenda. There are risks: We expect uncertainty around the Saudi succession process, and we see reforms being rolled out in a piecemeal fashion. MBS's broad-based popularity and support among Saudi youth buy him time, but he has many irons in the fire: managing Iran, Qatar, Yemen, Trump, and his own family. High oil prices may reduce incentives to move ahead on structural reforms to liberalize the economy. If the reforms backfire and lead to domestic instability, we expect oil prices to rally and Gulf markets to sell off.

Oil's slippery slope

The recent rise in oil prices to four-year highs is a reminder of oil's sensitivity to regional geopolitics. Highlights:

> The oil market is particularly tight right now. Inventories are below their five-year average and OPEC production cuts have corrected the supply glut that depressed prices in 2016 and 2017. Prices are hovering near multi-year highs – in part driven by increasing geopolitical tensions.

> Why do oil prices matter so much? Rising oil prices currently exert only a tiny drag on global growth, in our view. We see U.S. fiscal stimulus supporting above-trend global growth – and lingering economic output gaps in other parts of the world pointing to room to run in the current cycle. A persistent rise in crude to $100/barrel or more – driven by supply cuts or geopolitical shocks – would hit consumption and sentiment harder. The economic blow could be partially offset by energy-sector spending.

> For emerging markets, oil is currently trading at the high end of what we call a "sweet-spot range" of $50 to $80 a barrel. This range gives the majority of oil exporters fiscal maneuvering room while keeping intact their willingness to implement structural reforms. Any further rise in the oil price, and the appetite for reforms generally starts waning.

> Increased revenues from oil exports should help narrow budget deficits in the region. This could deliver a reprieve from domestic economic concerns, but may also embolden the foreign policies of regional actors in the near term, leading to increased defense purchases. A recent currency collapse in Iran and U.S. withdrawal from the nuclear deal make elevated oil prices much more important to domestic stability.

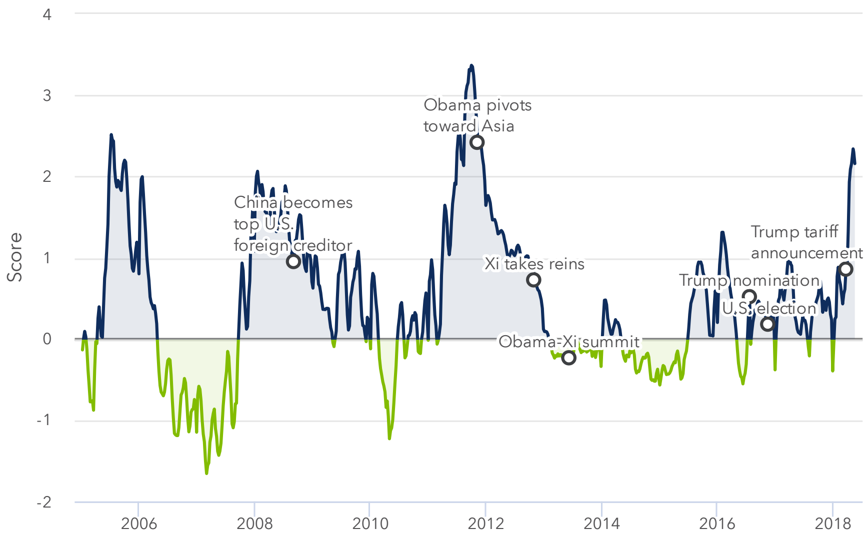
> A slump in oil prices in the second half of the year could direct Iran and Saudi Arabia's attention to domestic economic issues. Consistently low oil prices in 2017 influenced budget decisions in Saudi Arabia to boost government spending and slow the country's austerity drive, in an effort to lift the economy out of recession. This year's protests in Iran were prompted in part by a stagnating economy and rising cost of living. Similar forms of unrest are not out of the question in Saudi Arabia.

> MBS needs an initial public offering (IPO) of Saudi Aramco to fund the country's economic transformation – and a successful IPO requires high oil prices. The international listing will likely be delayed to 2019, when higher crude prices are expected to drive a more favorable valuation.

> Gulf countries will have to grapple with oil prices that are lower relative to history due to U.S. shale production (the U.S. Energy Information Administration forecasts U.S. production will top 11 million barrels per day in 2018) and the long-term trend of reduced dependency on fossil fuels.

U.S. - China relations

BlackRock Geopolitical Risk Indicator



Risk scenario description:

The U.S. sets tariffs on a wide range of Chinese goods, with the economic impact confined to specific sectors. China retaliates with its own tariffs and adds roadblocks for U.S. business.

Our view:

We see a full-blown trade war averted but an extended period of tensions, including over restrictions on Chinese investments in the U.S., transfer of technology to China, and Chinese tech companies operating in the U.S. We expect tit-for-tat tariff actions to spook markets, with rivalry in the tech sector and disputes over reciprocal market access as more fundamental issues.

Source: BlackRock Investment Institute, with data from Thomson Reuters. Data as of May 18, 2018. Notes: We identify specific words related to this geopolitical risk and use text analysis to calculate the frequency of their appearance in the Thomson Reuters Broker Report and Dow Jones Global Newswire databases as well as on Twitter. We then adjust for whether the language reflects positive or negative sentiment, and assign a score. A zero score represents the average BGRI level over its history from 2003 up to that point in time. A score of one means the BGRI level is one standard deviation above the average. We weigh recent readings more heavily in calculating the average. The BGRI's risk scenario is for illustrative purposes only and does not reflect all possible outcomes as geopolitical risks are ever-evolving.

Background

- We see the U.S.-China relationship as the world's top geopolitical and economic nexus. Political (an emerging power challenging an existing one) and economic forces (trade and technology transfers) portend greater hostility.
- U.S. President Donald Trump campaigned on labeling China "a currency manipulator," yet has struck a more conciliatory tone since.
- Xi announced a more assertive approach for China on the global stage at the National Party Congress (NPC) in October. Legislation to eliminate term limits further consolidates Xi's control and extends his authority at home and abroad.
- China's 2025 plan seeks to seize the commanding heights of key technologies and industries.

Key recent developments

- We view announced U.S. tariffs on Chinese goods as the start of ongoing negotiations about the bilateral trade deficit, market access and technology transfers.
- The U.S. and China reached an agreement not to impose new tariffs while talks proceed, but structural issues such as market access and high-tech competition loom large. A key issue for markets: potential U.S. restrictions on Chinese investments.
- A high-level U.S. trade delegation to China delivered a broad set of demands with no immediate progress, pointing to a lengthy period of negotiating. And China has increased inspections of American products at its ports, causing slowdowns.
- We see significant risk of supply chain disruption for Chinese industrials and tech companies, as well as a renewed focus by China on indigenous tech development.
- China has tried to mollify U.S. concerns about market access by cutting import taxes and opening sectors such as financial services to foreign competition. Xi re-iterated his willingness to open up the Chinese market at the Boao Forum for Asia.

Escalation triggers

- The U.S. ultimately enacts an extreme version of recently announced tariffs on Chinese imports, prompting retaliation.
- The U.S. places investment restrictions on U.S. companies investing in Chinese joint ventures that involve sophisticated technology.
- China retaliates meaningfully, either with trade measures or an adjustment to U.S. Treasury purchases.
- Professionals at the U.S. Trade Representative and Treasury lose control of negotiations.

Potential market implications

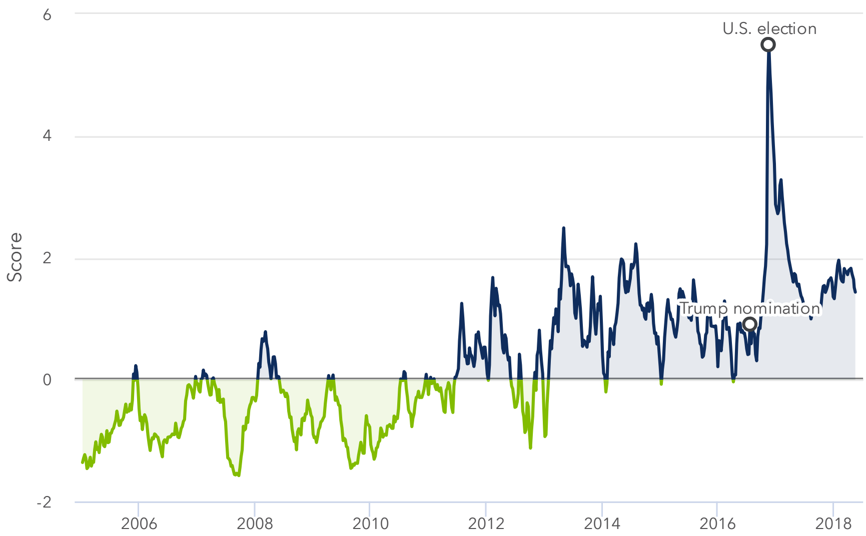
- Chinese equities sell off and the currency weakens. Sectors with high levels of U.S. dollar-denominated debt suffer.
- An actual trade war could lead to a broad downturn in risk assets and flight to quality.
- Gold, the Japanese yen and Asia ex-Japan consumer electronics stocks have been among the assets sensitive to this risk.

Risk-sensitive assets
Gold ↑
Japanese yen vs. U.S. dollar ↑
MSCI Asia ex Japan Consumer Electronics Index ↓

Source: BlackRock Investment Institute, with data from Thomson Reuters. Notes: The financial assets shown are those we have identified as being historically the most sensitive to swings in the **U.S. - China relations** BGRI. We use data from 2005 to May 2018. We measure the sensitivity by calculating the correlations between returns on these assets and upward weekly moves of 0.15 standard deviation or more in the BGRI. The arrows show the historical direction of the sensitive asset response. The sensitive assets are shown for illustrative purposes only; other factors may have been at work in the past and markets may react differently in the future. The analysis is not intended to represent the performance of any specific product or security, nor is it a recommendation to invest in any particular investment strategy or product.

North American trade

BlackRock Geopolitical Risk Indicator



Risk scenario description:

The U.S. withdraws from the North American Free Trade Agreement (NAFTA) after talks with Canada and Mexico derail. The withdrawal does not call into question the U.S. commitment to other trade deals and only goes into effect six months later.

Our view:

We see reduced chances for a preliminary NAFTA deal that can be ratified by the current U.S. Congress before year-end, as time is running out to accomplish this. We could see talks extending through the Mexican presidential and U.S. midterm elections – and even into 2019.

Source: BlackRock Investment Institute, with data from Thomson Reuters. Data as of May 18, 2018. Notes: We identify specific words related to this geopolitical risk and use text analysis to calculate the frequency of their appearance in the Thomson Reuters Broker Report and Dow Jones Global Newswire databases as well as on Twitter. We then adjust for whether the language reflects positive or negative sentiment, and assign a score. A zero score represents the average BGRI level over its history from 2003 up to that point in time. A score of one means the BGRI level is one standard deviation above the average. We weigh recent readings more heavily in calculating the average. The BGRI's risk scenario is for illustrative purposes only and does not reflect all possible outcomes as geopolitical risks are ever-evolving.

Background

- U.S. President Donald Trump campaigned on scrapping NAFTA and replacing it with a more U.S.-friendly trade deal.
- All parties agree on the need to modernize the pact to include e-commerce, digital content, intellectual property and other services.
- Many U.S. proposals, however, are contentious, including a "sunset clause," higher U.S. content requirements, monitoring currency manipulation, procurement rules, and setting up new dispute-resolution mechanisms.

Key recent developments

- U.S. Trade Representative Robert Lighthizer has signaled progress on NAFTA but emphasized there is work to be done. The front-runner in Mexico's July presidential election, Andrés Manuel López Obrador, has expressed willingness to implement a new agreement if talks conclude prior to his election. An increase in his populist economic policy rhetoric could threaten this positive outlook.
- We are increasingly skeptical the three countries can reach a preliminary deal this spring. Officials have a narrow window, since any further delay may not leave enough time for the current U.S. Congress to approve a deal by year-end. There is a possibility the U.S. administration could threaten NAFTA withdrawal to force Congress's hand if time is short.
- We expect Mexico and Canada to maintain their hardline stance in talks, and make contingency plans for NAFTA dissolving. These plans could involve bilateral trade agreements and a broader pivot to Asia.
- The U.S. has shifted its trade focus toward China.

Escalation triggers

- The U.S. announces its intent to withdraw from NAFTA.
- The U.S. imposes duties targeting Canadian or Mexican goods.
- A populist outcome in Mexico's election halts talks, and escalating rhetoric leads to potential border closings.

Potential market implications

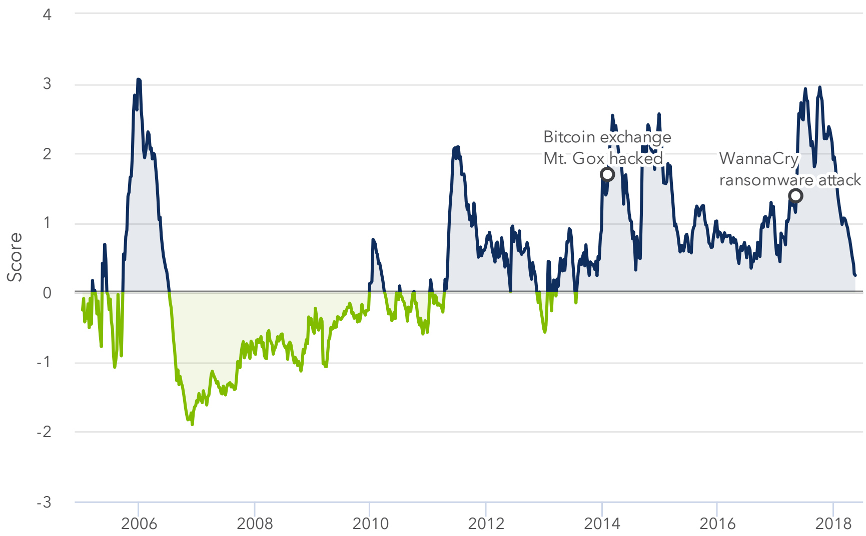
- Mexican and (to a lesser extent) Canadian currencies and equities suffer.
- Global risk assets could sell off if any U.S. withdrawal brings into question other trade deals and is seen as a shift away from globalization.
- Mexican stocks, bonds and currency have been among the assets sensitive to this risk.

Risk-sensitive assets
Mexican 10-year government bond price ↓
Mexican peso vs. U.S. dollar ↓
Mexic IPC Equity Index ↓

Source: BlackRock Investment Institute, with data from Thomson Reuters. Notes: The financial assets shown are those we have identified as being historically the most sensitive to swings in the **North American trade** BGRI. We use data from 2005 to May 2018. We measure the sensitivity by calculating the correlations between returns on these assets and upward weekly moves of 0.15 standard deviation or more in the BGRI. The arrows show the historical direction of the sensitive asset response. The sensitive assets are shown for illustrative purposes only; other factors may have been at work in the past and markets may react differently in the future. The analysis is not intended to represent the performance of any specific product or security, nor is it a recommendation to invest in any particular investment strategy or product.

Major cyberattack(s)

BlackRock Geopolitical Risk Indicator



Risk scenario description:

Hackers take over the infrastructure of major cloud service providers and disrupt the operations of dependent industries. Cloud service providers suffer massive reputational damage and lose business.

Our view:

Cyberattacks by state and non-state actors have increased in sophistication and quantity. We see a persistent risk of attacks on cloud technology, business-critical infrastructure and major elections – and would worry particularly about a nation state attacking the U.S.

Source: BlackRock Investment Institute, with data from Thomson Reuters. Data as of May 18, 2018. Notes: We identify specific words related to this geopolitical risk and use text analysis to calculate the frequency of their appearance in the Thomson Reuters Broker Report and Dow Jones Global Newswire databases as well as on Twitter. We then adjust for whether the language reflects positive or negative sentiment, and assign a score. A zero score represents the average BGRI level over its history from 2003 up to that point in time. A score of one means the BGRI level is one standard deviation above the average. We weigh recent readings more heavily in calculating the average. The BGRI's risk scenario is for illustrative purposes only and does not reflect all possible outcomes as geopolitical risks are ever-evolving.

Background

- The volume and sophistication of cyberattacks on government entities, businesses and individuals have been increasing.
- Attacks originate from both state and non-state (i.e., criminal) actors.
- Attacks have targeted elections, most notably the 2016 U.S. presidential election (the U.S. intelligence community has agreed Russia was behind the attacks).

Key recent developments

- 2017 was a record year for cyber breaches. We see relatively low barriers-to-entry to cybercrimes contributing to increased attacks.
- North Korea's cyber capabilities are growing in scale and sophistication. McAfee has identified hackers linked to Pyongyang as responsible for the global data theft campaign, "Operation GhostSecret."
- The U.S. and UK governments have issued a joint alert accusing the Kremlin of mounting a "malicious" Internet offensive aimed at espionage, intellectual property theft, and potential attacks on infrastructure. We don't see these accusations as preventing the proliferation of Russian cyberattacks and capabilities.
- There is rising concern of Russian interference in the upcoming Mexican presidential and U.S. midterm elections, after U.S. Special Counsel Robert Mueller indicted more than a dozen Russian nationals for 2016 U.S. election meddling.
- We expect commercial attacks (ransomware and data breaches) to grow in size and number, with the potential to hurt both individual companies and the economy.

Escalation triggers

- A major cyberattack on a top cloud services company.
- More adverse versions of this scenario would be: a major cyberattack by a nation state on key U.S. infrastructure, such as financial and election systems; a cyberattack disrupts critical global financial infrastructure (e.g., SWIFT); cyberattacks on major elections in the West.

Potential market implications

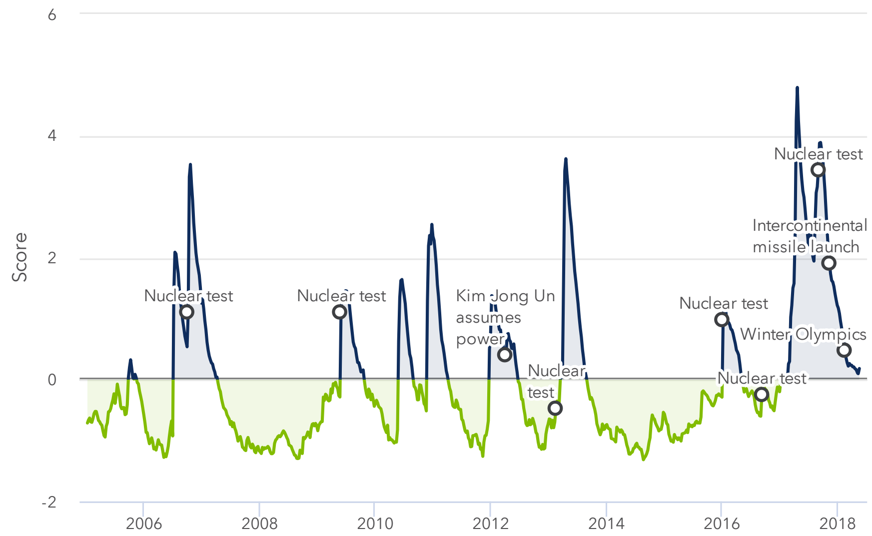
- Global risk assets sell off and investors flee to perceived safe-haven assets. Market moves reverse within a few days.
- Industries most at risk are information security, communications, financials and energy.
- We have found no assets that have consistently been sensitive to this risk.

Risk-sensitive assets
Not available

Source: BlackRock Investment Institute, with data from Thomson Reuters. Notes: The financial assets shown are those we have identified as being historically the most sensitive to swings in the **Major cyberattack(s)** BGRI. We use data from 2005 to May 2018. We measure the sensitivity by calculating the correlations between returns on these assets and upward weekly moves of 0.15 standard deviation or more in the BGRI. The arrows show the historical direction of the sensitive asset response. The sensitive assets are shown for illustrative purposes only; other factors may have been at work in the past and markets may react differently in the future. The analysis is not intended to represent the performance of any specific product or security, nor is it a recommendation to invest in any particular investment strategy or product.

North Korea conflict

BlackRock Geopolitical Risk Indicator



Risk scenario description:

A U.S. surgical strike neutralizes North Korea's missile capabilities after the country carries out a new nuclear test. North Korea retaliates with scattered firing across the demilitarized zone but ultimately backs down.

Our view:

We see the risk of military conflict on the Korean peninsula reduced sharply ahead of possible U.S.-North Korea talks. If the summit takes place, we expect lengthy follow-on negotiations that may derail on implementation and verification. Tensions could increase quickly if talks come up short.

Source: BlackRock Investment Institute, with data from Thomson Reuters. Data as of May 18, 2018. Notes: We identify specific words related to this geopolitical risk and use text analysis to calculate the frequency of their appearance in the Thomson Reuters Broker Report and Dow Jones Global Newswire databases as well as on Twitter. We then adjust for whether the language reflects positive or negative sentiment, and assign a score. A zero score represents the average BGRI level over its history from 2003 up to that point in time. A score of one means the BGRI level is one standard deviation above the average. We weigh recent readings more heavily in calculating the average. The BGRI's risk scenario is for illustrative purposes only and does not reflect all possible outcomes as geopolitical risks are ever-evolving.

Background

- North Korea has made faster-than-expected progress on its nuclear and missile programs, and now poses a multi-dimensional threat to U.S. interests: the U.S. mainland, allies South Korea and Japan, and global nuclear proliferation. The country has ramped up missile tests under Kim Jong Un.
- Kim declared in November 2017 North Korea had achieved its aim of creating a nuclear deterrent.
- North Korea is under the toughest ever U.N.-, China- and U.S.-imposed sanctions.

Key recent developments

- A historic summit in April culminated in North and South Korea resolving to end their 65-year war by year-end and to work toward full denuclearization of the peninsula.
- North Korea has said it will halt nuclear and missile tests and shut down its nuclear test site, while also removing U.S. troop withdrawal as a precondition for denuclearization. The rapprochement shows sanctions on North Korea are biting, and that North Korea is confident in its nuclear abilities. North Korea can now turn to seeking sanctions relief and economic assistance.
- A North Korean threat to pull out of possible talks between U.S. President Donald Trump and Kim illustrates the potential for negotiations to break down. If the meeting occurs, we could see parties agree to a set of principles followed by extended negotiations. These may derail on implementation and verification. The skepticism of Trump's advisors may further complicate the process. Peace overtures by North Korea will make it hard for the U.S. to stick to a tough line.
- A much less likely outcome is an immediate, good-faith denuclearization that lifts sanctions. A third possibility: It becomes clear the summit is merely a North Korean negotiating ploy, and tensions flare up again.

Escalation triggers

- Talks between the U.S. and North Korea don't materialize or break down without success, leading to a resumption of hostility.
- North Korea conducts larger nuclear tests or launches longer-range ICBMs.
- Tougher U.S. and U.N. sanctions send the North Korean economy into a tailspin.
- The U.S. takes some pre-emptive military action, from shooting down a missile to striking a launch pad.

Potential market implications

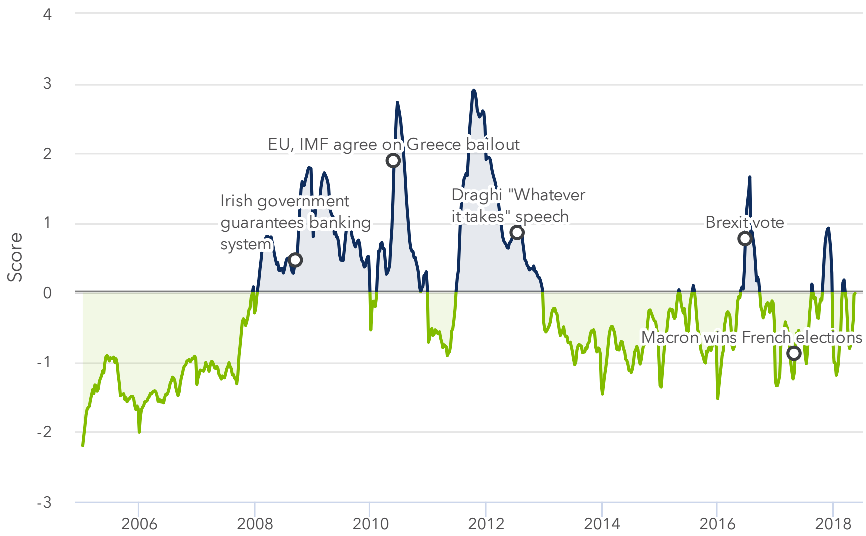
- Gold, South Korean stocks and government bonds, and the Japanese yen have been among the assets most sensitive to this risk.
- A major confrontation may cause risk assets to sell off globally.

Risk-sensitive assets
Gold ↑
Korea Composite Stock Price Index ↓
South Korean 10-year government bond price ↓
Japanese yen vs. U.S. dollar ↓

Source: BlackRock Investment Institute, with data from Thomson Reuters. Notes: The financial assets shown are those we have identified as being historically the most sensitive to swings in the **North Korea conflict** BGRI. We use data from 2005 to May 2018. We measure the sensitivity by calculating the correlations between returns on these assets and upward weekly moves of 0.15 standard deviation or more in the BGRI. The arrows show the historical direction of the sensitive asset response. The sensitive assets are shown for illustrative purposes only; other factors may have been at work in the past and markets may react differently in the future. The analysis is not intended to represent the performance of any specific product or security, nor is it a recommendation to invest in any particular investment strategy or product.

European fragmentation

BlackRock Geopolitical Risk Indicator



Risk scenario description:

Populist parties gain momentum beyond Italy, and governments in other EU countries adopt parts of the euroskeptic agenda to address voter discontent.

Our view:

Momentum for deeper eurozone integration has slowed, and a populist coalition government in Italy could challenge the EU's fiscal pact. No major national elections are on the horizon. Anti-European sentiment is gaining in Eastern Europe, albeit from low levels.

Source: BlackRock Investment Institute, with data from Thomson Reuters. Data as of May 18, 2018. Notes: We identify specific words related to this geopolitical risk and use text analysis to calculate the frequency of their appearance in the Thomson Reuters Broker Report and Dow Jones Global Newswire databases as well as on Twitter. We then adjust for whether the language reflects positive or negative sentiment, and assign a score. A zero score represents the average BGRI level over its history from 2003 up to that point in time. A score of one means the BGRI level is one standard deviation above the average. We weigh recent readings more heavily in calculating the average. The BGRI's risk scenario is for illustrative purposes only and does not reflect all possible outcomes as geopolitical risks are ever-evolving.

Background

- Populists in Europe have been gaining ground but failed to gain enough electoral support to come to power – until the Italian election.
- Populist candidates typically have rejected the EU's economic and political integration. Anti-European sentiment is also gaining influence in Eastern Europe, especially in Poland and Hungary.
- Migration has been a leading cause of growing populist sentiment.

Key recent developments

- Italy's March 4 elections dealt a blow to established political parties. A coalition between populist parties could challenge EU agreements on fiscal spending and other matters.
- Momentum for eurozone reform has slowed, reflecting a combination of political delays in Germany and Italy, a realization that there are deeply disparate views on critical issues, and leaders prioritizing matters such as border control and defense. We could see some progress on a banking union, but political ambitions are limited.
- A Brexit "no deal" seems unlikely after parties in March reached an agreement in principle on a transition period. The UK's land border with EU member Ireland is at the heart of current talks.
- Tensions between the EU and the U.S. have increased over trade and the U.S. re-imposing secondary sanctions on European companies doing business in Iran.

Escalation triggers

- An acrimonious turn in EU-Brexit negotiations.
- Further deterioration of the EU relationship with Hungary and Poland.
- An unravelling EU-Turkey refugee deal re-ignites the migrant crisis and spurs border closings.
- A confrontation between Italy's populist government and the EU over fiscal spending.

Potential market implications

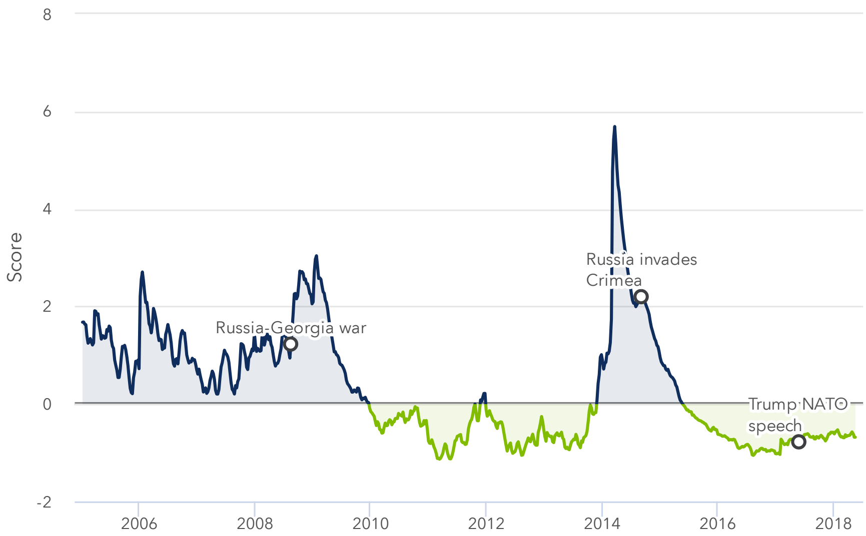
- European equities fall, peripheral sovereign bond yields jump and corporate spreads widen.
- A weaker pound and lower gilt yields if fears of a disruptive Brexit rise.
- Investors flee to perceived safe havens such as German bunds.
- European high yield and Italian government bonds have been among the assets sensitive to this risk.

Risk-sensitive assets
European high yield price ↓
Italian - German 10-year government bond yield spread ↑
Italian 10-year government bond price ↓

Source: BlackRock Investment Institute, with data from Thomson Reuters. Notes: The financial assets shown are those we have identified as being historically the most sensitive to swings in the **European fragmentation** BGRI. We use data from 2005 to May 2018. We measure the sensitivity by calculating the correlations between returns on these assets and upward weekly moves of 0.15 standard deviation or more in the BGRI. The arrows show the historical direction of the sensitive asset response. The sensitive assets are shown for illustrative purposes only; other factors may have been at work in the past and markets may react differently in the future. The analysis is not intended to represent the performance of any specific product or security, nor is it a recommendation to invest in any particular investment strategy or product.

Russia - NATO tensions

BlackRock Geopolitical Risk Indicator



Risk scenario description:

Simmering tensions between Russia and the West boil over due to an accidental clash between a Russian and NATO fighter jet. This leads to mutual recriminations, military preparations, and potential for direct conflict.

Our view:

Russia and the West have reached an uncomfortable Cold Peace. Tensions could increase further, particularly if the West imposes additional sanctions in the face of any evidence of Russian interference in the U.S. midterm elections. An accidental military clash has been avoided for now.

Source: BlackRock Investment Institute, with data from Thomson Reuters. Data as of May 18, 2018. Notes: We identify specific words related to this geopolitical risk and use text analysis to calculate the frequency of their appearance in the Thomson Reuters Broker Report and Dow Jones Global Newswire databases as well as on Twitter. We then adjust for whether the language reflects positive or negative sentiment, and assign a score. A zero score represents the average BGRI level over its history from 2003 up to that point in time. A score of one means the BGRI level is one standard deviation above the average. We weigh recent readings more heavily in calculating the average. The BGRI's risk scenario is for illustrative purposes only and does not reflect all possible outcomes as geopolitical risks are ever-evolving.

Background

- Border tensions in the Baltics and Nordics are rising, including military buildup, fly-bys and cyberattacks.
- Friction between the West and Russia is increasing over the latter's election interferences and intervention in the Syrian civil war.
- We see Russian President Vladimir Putin testing U.S. President Donald Trump and the West in Ukraine or elsewhere this year after a cautious approach in 2017.

Key recent developments

- U.S. sanctions in early 2018 against Russia's financial sector for alleged meddling in the U.S. elections were softer than expected. But more recent sanctions against Russian oligarchs with ties to Putin, along with a dozen other Russian companies, were stronger than expected – perhaps reflecting a more hawkish White House.
- The UK and other nations expelled Russian diplomats and froze assets after a nerve-gas attack on a former Russian spy and his daughter on British soil. Russia responded by expelling British, American and other diplomats.
- U.S. intelligence chiefs reported to Congress that Russia is seeking to undermine the 2018 midterm elections through cyberattacks and other digital disruption.
- Putin took an aggressive anti-Western stance in the run-up to his re-election to a fourth term, as displayed in his state-of-the-nation address.
- Russia and NATO have conducted exercises across their respective borders in Europe, as Russia completed tests of an upgraded air defense missile system. Arms spending is up: An early 2018 NATO summit ended with eight countries (versus three in 2014) committing to spend 2% of GDP on defense.

Escalation triggers

- A Baltics border incident sparks an accidental clash between Russia and NATO forces.
- The Ukrainian conflict escalates.
- Regular Russian and U.S. troops clash in Syria.
- U.S.-Russia recriminating sanctions escalate.
- Evidence of Russian interference in the 2018 U.S. midterm elections.

Potential market implications

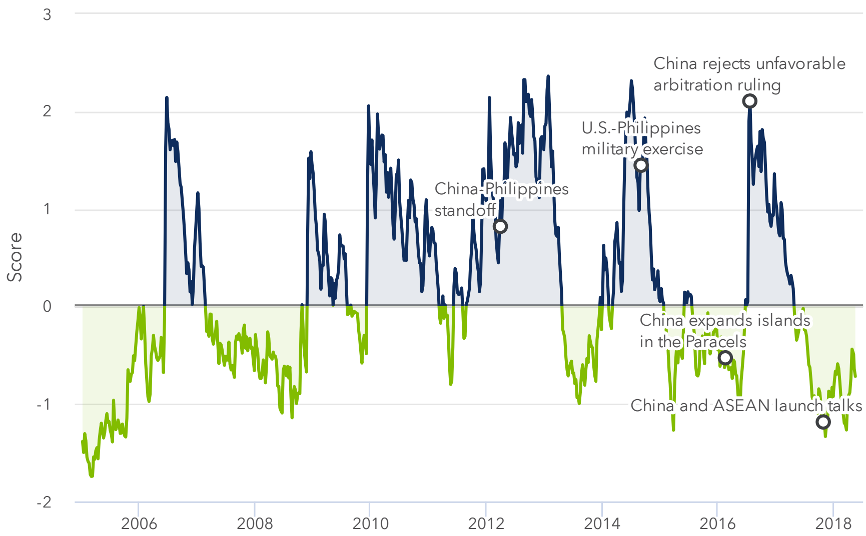
- Russian and other CEEMEA risk assets suffer; oil prices rise (Russia is a big supplier).
- A broad global selloff of risk assets (particularly in other EMs) and flight to perceived safe havens if the conflict escalates.
- Russian corporate bonds and stocks have been among the assets sensitive to this risk.

Risk-sensitive assets
Bloomberg Barclays EM Russia Corporate Bond Index ↓
Russia Trading System Index ↓

Source: BlackRock Investment Institute, with data from Thomson Reuters. Notes: The financial assets shown are those we have identified as being historically the most sensitive to swings in the **Russia - NATO tensions** BGRI. We use data from 2005 to May 2018. We measure the sensitivity by calculating the correlations between returns on these assets and upward weekly moves of 0.15 standard deviation or more in the BGRI. The arrows show the historical direction of the sensitive asset response. The sensitive assets are shown for illustrative purposes only; other factors may have been at work in the past and markets may react differently in the future. The analysis is not intended to represent the performance of any specific product or security, nor is it a recommendation to invest in any particular investment strategy or product.

South China Sea conflict

BlackRock Geopolitical Risk Indicator



Risk scenario description:

Vietnamese and Chinese naval forces exchange fire after the accidental sinking of a Vietnamese fishing boat near the disputed Spratly Islands. The countries withdraw their ambassadors, and the U.S. embarks on increased naval exercises in the area.

Our view:

China has further militarized the region as the U.S. has focused on denuclearization of North Korea and trade talks with China. The potential for an accidental or deliberate clash between China and Vietnam remains.

Source: BlackRock Investment Institute, with data from Thomson Reuters. Data as of May 18, 2018. Notes: We identify specific words related to this geopolitical risk and use text analysis to calculate the frequency of their appearance in the Thomson Reuters Broker Report and Dow Jones Global Newswire databases as well as on Twitter. We then adjust for whether the language reflects positive or negative sentiment, and assign a score. A zero score represents the average BGRI level over its history from 2003 up to that point in time. A score of one means the BGRI level is one standard deviation above the average. We weigh recent readings more heavily in calculating the average. The BGRI's risk scenario is for illustrative purposes only and does not reflect all possible outcomes as geopolitical risks are ever-evolving.

Background

- China has been building military and other infrastructure on seven reefs it controls in the Spratly Islands in the South China Sea, a crucial international shipping route.
- The islands or parts thereof are claimed by China, Taiwan, Vietnam, the Philippines, Malaysia and Brunei.

Key recent developments

- The U.S. has announced it would conduct regular naval patrols in the South China Sea, which is likely to increase tensions with China. China voiced discontent after a U.S. warship sailed near an artificial island in August.
- China and the Philippines released a statement in February re-affirming their intentions to resolve the South China Sea dispute peacefully, following an agreement in November to avoid using force.
- Other South-East Asian foreign ministers have recently voiced concerns around China's activities in the area.
- Chinese state media confirmed the deployment of fighter jets to Woody Island.
- Chinese President Xi Jinping counted island construction as a top accomplishment, in addition to his "successful prosecution of maritime rights," in his October NPC speech.
- Recent intelligence reports have indicated Chinese missile deployments to man-made island outposts in the South China Sea. If confirmed, this would mark the first reported Chinese missile deployment in the Spratly Islands.

Escalation triggers

- An accidental or deliberate military clash between China and the U.S. during Freedom of Navigation Exercises.
- A military clash between China and Vietnam or the Philippines over the islands or maritime rights.

Potential market implications

- Most impact is limited to Asia-Pacific risk assets.
- Broader risk-off moves could arise if the U.S. is involved in an escalating local conflict.
- The Japanese yen and the CBOE SKEW index have been among the assets sensitive to this risk.

Risk-sensitive assets
Japanese yen vs. U.S. dollar ↓
CBOE SKEW index ↑

Source: BlackRock Investment Institute, with data from Thomson Reuters. Notes: The financial assets shown are those we have identified as being historically the most sensitive to swings in the **South China Sea conflict** BGRI. We use data from 2005 to May 2018. We measure the sensitivity by calculating the correlations between returns on these assets and upward weekly moves of 0.15 standard deviation or more in the BGRI. The arrows show the historical direction of the sensitive asset response. The sensitive assets are shown for illustrative purposes only; other factors may have been at work in the past and markets may react differently in the future. The analysis is not intended to represent the performance of any specific product or security, nor is it a recommendation to invest in any particular investment strategy or product.

Major terror attack(s)

BlackRock Geopolitical Risk Indicator

Risk scenario description:

Terror attacks in a major Western European city cause significant casualties. Investigations pinpoint a network originating in the Middle East and active in the U.S., prompting the U.S. and NATO allies to start planning for a military response against Middle East militants.

Our view:

Most assaults now are carried out by autonomous cells or individuals. We see this risk as greatest if an attack triggers domestic strife or U.S. military retaliation against a suspected state actor.

Source: BlackRock Investment Institute, with data from Thomson Reuters. Data as of May 18, 2018. Notes: We identify specific words related to this geopolitical risk and use text analysis to calculate the frequency of their appearance in the Thomson Reuters Broker Report and Dow Jones Global Newswire databases as well as on Twitter. We then adjust for whether the language reflects positive or negative sentiment, and assign a score. A zero score represents the average BGRI level over its history from 2003 up to that point in time. A score of one means the BGRI level is one standard deviation above the average. We weigh recent readings more heavily in calculating the average. The BGRI's risk scenario is for illustrative purposes only and does not reflect all possible outcomes as geopolitical risks are ever-evolving.

Background

- Sophisticated attacks in the West by groups with defined chains of command (e.g., Al Qaeda) have become rare. The threat from ISIS remains significant, however, even as it has lost almost all its territory. The group seeks continuing relevance, and its fighters and their families are returning to their native countries.
- Most attacks are now carried out by autonomous cells or individuals.
- Terrorists have attacked civilians in cities including Barcelona, Berlin, Brussels, London, Manchester, New York, Nice and Paris.

Key recent developments

- In the UK, security and intelligence officials have cited terrorism as the most prominent threat faced by the country.
- In the U.S., a man who pledged loyalty to ISIS killed eight in New York City on Oct. 31, marking the most deadly terrorist attack in Manhattan since 9/11.
- A man detonated a pipe bomb in the subway underpass near New York's Times Square on Dec. 11, injuring several but killing no one. He also claimed inspiration from ISIS.

Escalation triggers

- A terrorist attack leads to material U.S.-led military action against a suspected state actor or enabler.
- A terror attack leads to the imposition of martial law and internal strife in major Western nations.

Potential market implications

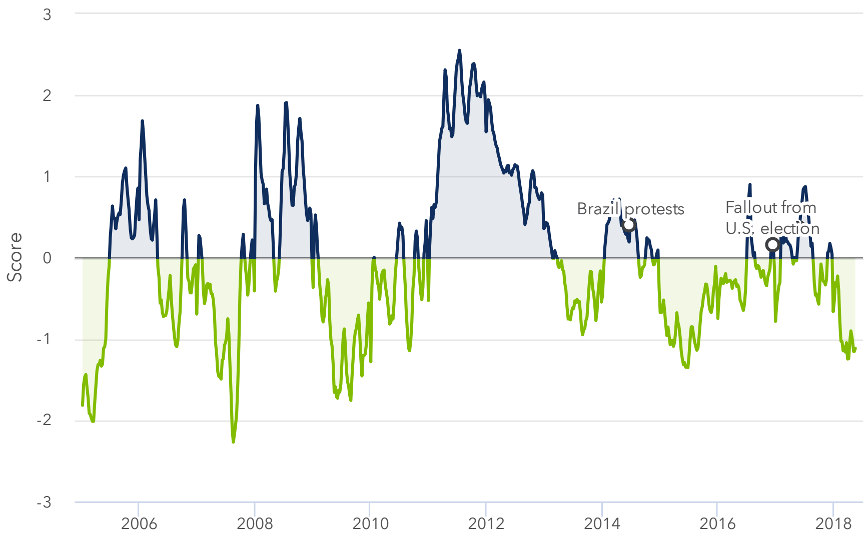
- Risk assets of the attacked country sell off.
- Global risk asset prices fall, and investors flock to perceived safe havens if U.S.-led military action is declared.
- We have found no assets that have consistently been sensitive to this risk.

Risk-sensitive assets
Not available

Source: BlackRock Investment Institute, with data from Thomson Reuters. Notes: The financial assets shown are those we have identified as being historically the most sensitive to swings in the **Major terror attack(s)** BGRI. We use data from 2005 to May 2018. We measure the sensitivity by calculating the correlations between returns on these assets and upward weekly moves of 0.15 standard deviation or more in the BGRI. The arrows show the historical direction of the sensitive asset response. The sensitive assets are shown for illustrative purposes only; other factors may have been at work in the past and markets may react differently in the future. The analysis is not intended to represent the performance of any specific product or security, nor is it a recommendation to invest in any particular investment strategy or product.

LatAm populism

BlackRock Geopolitical Risk Indicator



Risk scenario description:

Voters in Mexico and Brazil favor populist candidates in upcoming elections. This reverses a trend toward pro-business, technocratic Latin American governments and scares off foreign investors.

Our view:

We could see left-wing Mexican populist and front-runner Andrés Manuel López Obrador governing toward the center if elected, but his party's potential majority in Congress could herald more extreme policies. Brazil's election is wide open and a far-right populist victory is possible.

Source: BlackRock Investment Institute, with data from Thomson Reuters. Data as of May 18, 2018. Notes: We identify specific words related to this geopolitical risk and use text analysis to calculate the frequency of their appearance in the Thomson Reuters Broker Report and Dow Jones Global Newswire databases as well as on Twitter. We then adjust for whether the language reflects positive or negative sentiment, and assign a score. A zero score represents the average BGRI level over its history from 2003 up to that point in time. A score of one means the BGRI level is one standard deviation above the average. We weigh recent readings more heavily in calculating the average. The BGRI's risk scenario is for illustrative purposes only and does not reflect all possible outcomes as geopolitical risks are ever-evolving.

Background

- The political ascensions of Mauricio Macri in Argentina, Michel Temer in Brazil and Sebastián Piñera in Chile appeared to solidify a trend toward pro-business, technocratic governments in Latin America. Colombia looks set to follow on a business-friendly path.
- Key elections in Mexico and Brazil – against a backdrop of low growth and declining support for democracy in the region – might upend this pattern.

Key recent developments

- In Mexico, left-wing populist Andrés Manuel López Obrador (AMLO) is ahead in polls for the July 1 election. As his lead has been widening, his populist rhetoric on economic policy has increased. AMLO's unpredictable style could surprise markets, and even complicate any NAFTA 2.0 approval process.
- In Brazil, former President Luiz Inácio Lula da Silva's corruption conviction was upheld, barring the moderate from seeking election. The October election is too far off to call, but we see prospects for a victory by right-wing populist Jair Bolsonaro.
- In Colombia, right-wing presidential candidate Ivan Duque has consolidated his polling lead above left-wing populist Gustavo Petro.
- Argentina's prospects have recently soured as rising interest rates and a stronger U.S. dollar led markets to focus on the country's gaping twin deficits. Macri has requested help from the IMF, an unpopular step that could undermine his chances of re-election in 2019.
- Large numbers of Venezuelan migrants are putting stress on neighboring Colombia, Brazil and Peru.

Escalation triggers

- Left-wing populist AMLO wins the Mexican presidential election and a parliamentary majority.
- Extreme-right populist Bolsonaro wins the Brazilian presidency.
- Left-wing populist Gustavo Petro wins Colombia's presidential election in June.
- The humanitarian crisis in Venezuela spills into Colombia or Brazil.

Potential market implications

- Mexican, Brazilian and Colombian risk assets fall on populist wins. Such an outcome would hit Brazil hardest given a dire need for structural reforms and stability.
- We see an AMLO presidency leading to deterioration in Mexican economic policy over time. There is potential for Mexican assets to sell off ahead of the vote, but we could see them staging a post-election relief rally as uncertainty lifts.
- Colombian, Peruvian and Mexican credit default swaps (CDS) have been among the assets sensitive to this risk.

Risk-sensitive assets
Colombia five-year CDS spread ↑
Peru five-year CDS spread ↑
Mexico five-year CDS spread ↑

Source: BlackRock Investment Institute, with data from Thomson Reuters. Notes: The financial assets shown are those we have identified as being historically the most sensitive to swings in the **LatAm populism** BGRI. We use data from 2005 to May 2018. We measure the sensitivity by calculating the correlations between returns on these assets and upward weekly moves of 0.15 standard deviation or more in the BGRI. The arrows show the historical direction of the sensitive asset response. The sensitive assets are shown for illustrative purposes only; other factors may have been at work in the past and markets may react differently in the future. The analysis is not intended to represent the performance of any specific product or security, nor is it a recommendation to invest in any particular investment strategy or product.

BLACKROCK INVESTMENT INSTITUTE

The BlackRock Investment Institute (BII) provides connectivity between BlackRock's portfolio managers, originates economic and markets research, develops investment views for clients, and publishes insights. Our goals are to help our portfolio managers become even better investors and to produce thought-provoking investment content for clients and policymakers.

BII0518U/E-503725-1582432