

SPRING 2018

Investment directions

Spring planting



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Bloom off the rose?

The economic conditions that have supported markets over the last year are still flourishing, but this year has seen a variety of factors weighing on investor sentiment. Concerns around interest rate hikes, stock valuations (despite strong earnings), as well as potential trade disruptions and new tech regulations, all have led to higher volatility in 2018. Still, opportunities exist in this market for those with focus and discipline.

Ease on down the road

The Federal Reserve (Fed) is continuing on its path of interest rate hikes this year. Still, although financial conditions have moderately tightened, they remain relatively easy, at least by historical standards. In this environment, the financial sector is a particularly interesting one to monitor. The prospects could brighten if the yield curve, which has flattened since the start of the year, steepens.

The best offense is a good defense

Volatility has climbed higher, but in an era of rising rates what constitutes an effective portfolio hedge is changing. Rather than high-dividend “bond proxies,” which could do more harm than good in an era of higher rates and inflation in the U.S., we would advocate an allocation to quality companies.

Emerging markets: China A-shares inclusion update

This June, an important market event occurs: MSCI will begin including China’s Shanghai-traded A-shares in its key indexes, amplifying the importance of China in key benchmarks. Economic and reform prospects have us constructive on Chinese equities, but the MSCI event has important implications for investors and the way they think about emerging markets.

Opportunities within investment grade bonds

Although we are underweight fixed income, and neutral investment grade bonds within the asset class, spreads have widened and current levels present reasonable value from an overall portfolio diversification perspective. We would consider opportunities in floating rate notes, shorter-maturity fixed rate exposure or interest rate-hedged positions.

The commodity rally

Commodities are off to a strong start to the year, outperforming the S&P 500 Index by nearly 10%¹. At this point, energy equities may have more room to run than the commodities themselves in the short term, but investors looking to diversify risk or protect against inflation might consider exposure to commodities.

¹ Sources: Thomson Reuters, Goldman Sachs, year-to-date, as of 5/15/18.

Overview

Against a backdrop of moderately tighter financial conditions—but still relatively easy by historical standards—we continue to prefer growth-gearred sectors, namely technology and financial companies, as well as the momentum factor.

Consider

- iShares U.S. Financial Services ETF (IYG)
- iShares North American Tech ETF (IGM)
- iShares Edge MSCI USA Momentum Factor ETF (MTUM)

U.S. equities

Ease on down the road

Key points

- **Despite favorable economic conditions, a variety of factors have weighed on market sentiment this year.** These include: concerns over the pace of rate hikes, potential trade wars and new tech regulations.
- **We continue to prefer growth-gearred plays—technology and financial companies, and the momentum factor.** Financial conditions have moderately tightened, but remain relatively easy by historical standards.
- **The financial sector is a particularly interesting sector.** Broader financial conditions remain easy, a potential tailwind for economic activity and top-line growth, while interest rates are increasing, a potential tailwind for lenders' net interest margins.

Market pulse

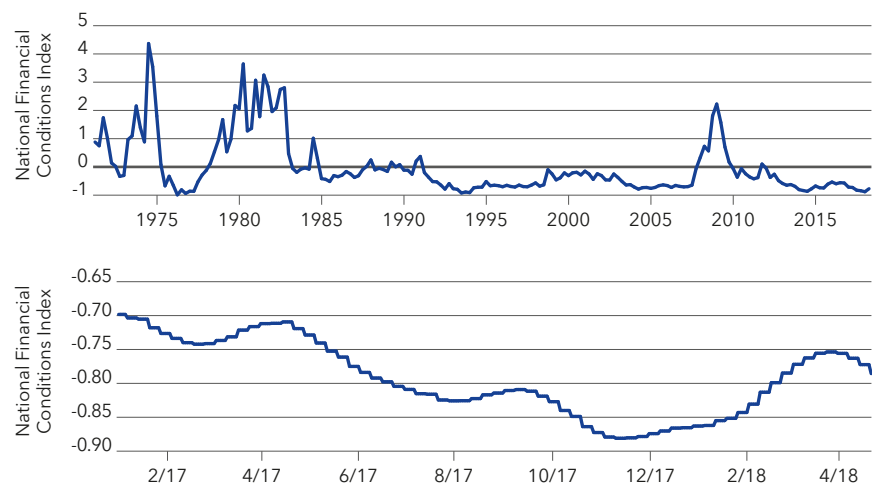
The “Goldilocks” economic conditions that many considered responsible for pushing equity volatility to all-time lows in 2017 have not disappeared this year. However, a variety of other factors have instead weighed on market sentiment: a combination of economic over-heating concerns, which have influenced the market's perception of the potential pace of rate moves, along with the specter of trade wars and increased tech regulation. The annualized realized volatility of the S&P 500 has been 18.4% so far this year, meaningfully higher than the 6.6% witnessed in 2017².

While markets have not had as euphoric a start to the year as 2017, we find confidence in strong U.S. macro signals and earnings growth. Financial conditions have moderately tightened, but remain relatively easy by historical standards (source: Thomson Reuters, as of 4/30/18). In this environment, we continue to prefer growth-gearred plays—technology and financial companies, and the momentum factor.

The financial sector is a particularly interesting sector to monitor if the favorable market environment can continue. Broader financial conditions remain easy, a tailwind for economic activity and top-line growth, while interest rates are increasing, a potential tailwind for lenders' net interest margins (the difference between interest income and the interest paid to lenders, or NIMs). We see regional banks and insurers as likely beneficiaries of this rising rate environment. Insurers may benefit from rising yields of perceived safe assets, helping them to match their liabilities and the discount rate used for funding needs, while regional banks could benefit from rising NIMs—potentially more so than industry giants whose business models are diversified across revenue streams other than core lending. It is also important to note that strength in NIMs is highly contingent upon the shape of the yield curve—which has flattened since the start of the year.

² Source: Thomson Reuters, as of 4/30/18. Volatility is the annualized standard deviation of daily returns.

Figure 1: Despite recent tightening, financial conditions remain relatively easy



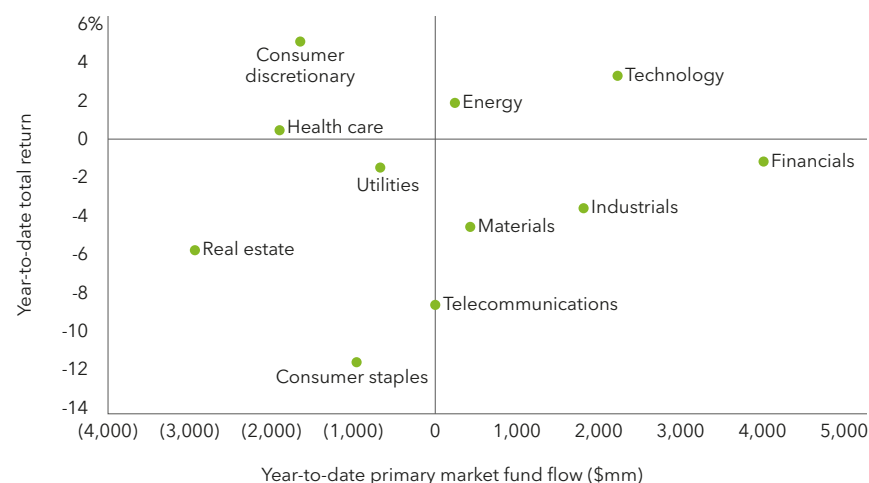
Sources: Thomson Reuters Datastream, BlackRock, as of April 30, 2018.
 Notes: The lines show the Chicago Fed's National Financial Conditions Index (NFCI). The NFCI is a weighted average of a large number of variables (105 measures of financial activity) each expressed relative to their sample averages and scaled by their sample standard deviations.

A tale of flows

Primary market flows into U.S. equity focused exchange traded products (ETPs) have continued to reflect bullish market sentiment. This year, flows into cyclicals have outpaced those of defensives and income proxies. Broad financials have led sector inflows as investors have positioned for rising rates and deregulation, but performance has not followed as the S&P 500 Financials sector is flat year-to-date³. Within financial services, broker/dealers and regional banks have seen outsized inflows.

Outside of financials, the start of first-quarter U.S. earnings season saw a rotation into aerospace and defense names. Inflows into energy focused products have been underwhelming since the start of earnings season, despite impressive earnings results and a supportive crude oil backdrop.

Figure 2: YTD sector returns and fund flows



Sources: Bloomberg, BlackRock, as of April 30, 2018. Year-to-date primary market fund flow is from BlackRock's internal categorization. Total return being tracked is for S&P 500 GICS 1 Sector Indexes. **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.**

³ Source: Bloomberg, as of 5/15/2018. The quoted performance is the YTD total return of the S&P 500 Financials Sector Index.

Overview

We continue to favor the momentum factor, given the current economic backdrop. However, investors may want to consider an allocation to quality as well.

Consider

- iShares Edge MSCI USA Momentum Factor ETF (MTUM)
- iShares Edge MSCI USA Quality Factor ETF (QUAL)

Developed market equities

The best offense is a good defense

Key points

- **We continue to like equities, and among developed markets prefer U.S. stocks.** We also favor the momentum factor, given the backdrop of synchronized global growth.
- **However, volatility has risen and in an era of rising rates, what constitutes an effective defense is changing.** Traditional high-dividend stocks could do more harm than good in an environment of higher rates and inflation.
- **Quality matters.** We would advocate an allocation to quality companies with the ability to increase dividend payouts and generate revenues that can outrun inflation.

Market pulse

Equity markets are at a crossroads. Nine years into the bull market, a synchronized global economic expansion amplified by U.S. fiscal stimulus is stoking higher earnings growth expectations—and interest rates. High-yielding “bond proxy” stocks earned their stripes as perceived equity safe havens for much of the period as bond yields were slow to revert to pre-crisis levels.

Yet these traditional high-dividend stocks could do more harm than good in an environment of higher rates and inflation. They have underperformed broad indexes year-to-date and are vulnerable to rate moves. Some minimum-volatility (min-vol) strategies have suffered a similar fate, suggesting a good defense is a multifaceted one.

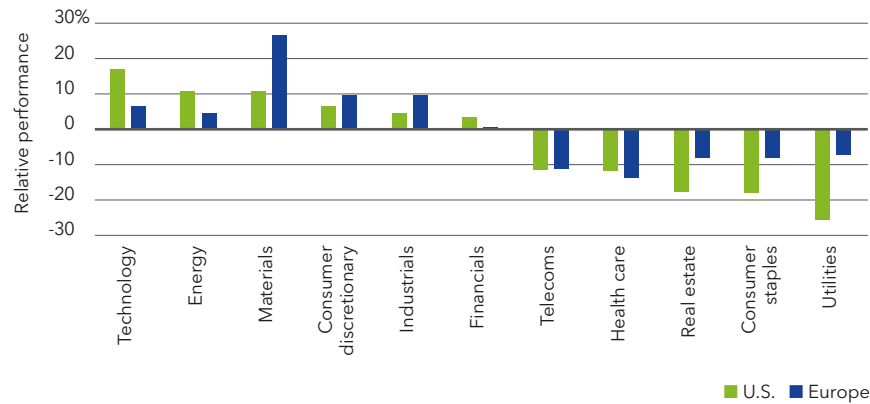
The “why” behind rate increases is important. Different sectors have tended to play better defense depending on the impetus for rising rates. When yields are increasing faster than inflation expectations, cyclical (rather than defensive) rate-sensitive sectors may lead.

Defense in stocks today is less about high yield and more about quality and the ability to outrun inflation, in our view. Companies with the free cash flow to boost dividends also have tended to sport attractive valuations versus the highly bid high yielders.

We continue to like equities, given the economic and earnings environment. Specifically, we favor the momentum factor among equities. However, quality characteristics and dividend growth potential may offer a better defensive hedge than high-yielding bond proxies.

Figure 3: Yields up, defensive stocks down

Sector performance when nominal yields rise, 2000-2018



Past performance is not a reliable indicator of current or future results. It is not possible to invest directly in an index.

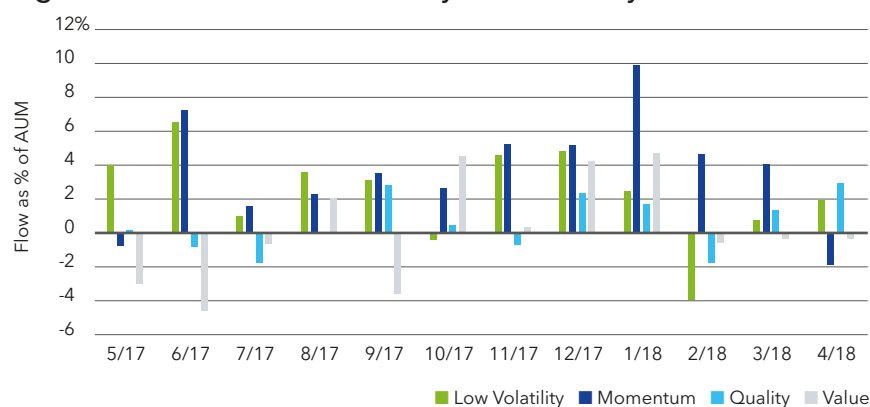
Sources: BlackRock Investment Institute, with data from Thomson Reuters, S&P, MSCI and the European Central Bank, March 2018. Notes: The bars show the average annualized monthly performance of U.S. and European equity sectors during months when 10-year yields rose. Sector performance is relative to the broad market; indexes used are the S&P 500 and the MSCI Europe. We define a rise in the 10-year as a change greater than 15 basis points. We use the 10-year Treasury for the U.S. and a GDP-weighted 10-year rate for the euro area.

A tale of flows

The 2017 U.S. tax overhaul and increase in fiscal spending fueled global growth, and earnings estimates drove outperformance of the momentum style factor in January. But a sudden reversal in the volatility environment has posed significant challenges to financial markets as well as the style factors since February. Low-volatility ETFs saw \$311 million in net outflows in February, during sharp sell-offs in U.S. stocks.

As global trade war fears escalated and concerns over data privacy issues pushed tech shares lower, confidence in momentum deteriorated with more than \$2 billion of net outflows in April. Flows into exchange traded products also signaled a risk-off sentiment that drove assets into defensive factors such as quality and low-vol. Value saw a modest amount of net outflows in recent months due to its underperformance relative to other style factors.

Figure 4: U.S. factor ETF flows by % of industry AUM



Source: BlackRock, as of April 30, 2018 using Markit smart-beta definitions.

Overview

The inclusion of China A-shares occurs at a time when we are constructive on Chinese equities. We see U.S. protectionist threats as largely negotiating tactics, while Chinese reforms, a stable growth environment and a solid earnings outlook may support equities.

Consider

- iShares MSCI China ETF (MCHI)
- iShares MSCI China A ETF (CNYA)
- iShares MSCI China Large-Cap ETF (FXI)
- iShares MSCI China Small-Cap ETF (ECNS)

Emerging markets

China: A-shares inclusion update

Key points

- **This June, MSCI will begin including A-shares in key indexes**, kicking off a landmark event as the world's second largest equity market is opened to foreigners.
- **As China's concentration in broad emerging market (EM) indexes grows**, investors should start taking a view on China and EM ex-China separately, just as investors do with U.S. and non-U.S. developed markets.
- **Global ETP flows show investors are increasingly taking a single-country view** on China instead of accessing it through broad EM index exposure.

Market pulse

This June begins a significant development in the way investors can access Chinese equities. MSCI will begin including a portion of the China A-shares market in the MSCI Emerging Markets Index, a key index tracking EM equities, as well as other key China and EM indexes.

A-shares, representing "onshore" stocks, have been available only to foreign institutions under strict quotas set by the Chinese government. On their own, they represent the world's second largest equity market by market capitalization. The inclusion will be slow and gradual, but eventually A-shares could account for 9% of the broad EM index after 50% of the A-shares are included, and then 17% after full inclusion. At that point, China's weight in the MSCI EM Index could be more than 40%.

The opening of China's A-shares market and accompanying index inclusion is a landmark event for the global investor community. As China's concentration in broad EM indexes eventually grows, albeit slowly, investors should consider taking a view on China and EM ex-China separately, just as investors do with U.S. and non-U.S. developed markets. Global ETP flows suggest investors are beginning to do just that.

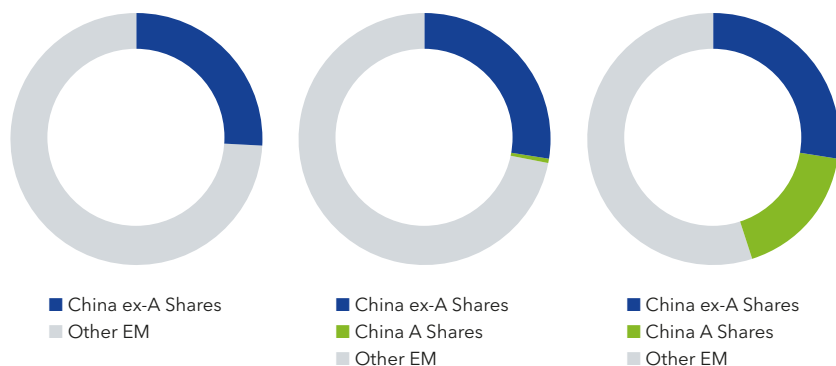
In other words, for investors, having a view on China is moving from "nice to have" to "have to have"—it's simply too big to ignore.

Figure 5: MSCI Emerging Markets Index inclusion roadmap

May 31, 2017
 Total China exposure
 30%

Announced 5% inclusion
 Total China exposure
 31%

Potential 100% inclusion*
 Total China exposure
 45%



Current state

- Inclusion of overseas-listed Chinese companies such as Baidu and Alibaba in November 2015

Current proposal

- To be implemented in summer 2018

Needed steps

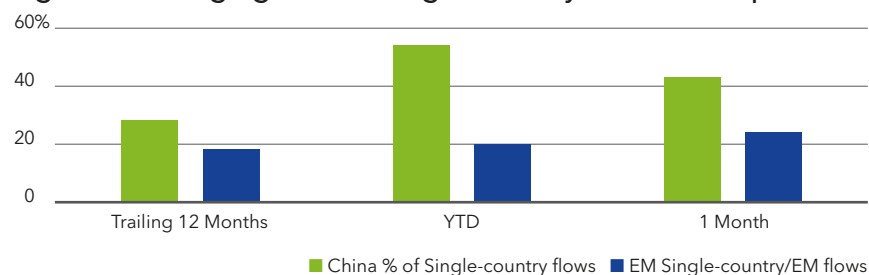
- Abolishment of the quota system
- Full liberalization of capital mobility restrictions
- Alignment of international accessibility standards

Sources: BlackRock, MSCI, as of April 16, 2018. Notes: Index constituents subject to change. * The percentage number refers to the inclusion factor applied to the free float-adjusted market capitalization of China A-share constituents in the pro forma MSCI China Index. References to specific securities should not be construed as a recommendation to buy or sell any such security.

A tale of flows

Global ETP flows suggest investors are already adopting a single-country focus on China and rethinking EM as EM ex-China instead. EM equity flows have been increasingly single-country focused over the past year—a notable contrast to developed market flows, which have favored broad exposure. Moreover, there is a meaningful acceleration in EM single-country flows led by China. EM single-country flows as a percent of total EM flows have risen from 18% over the trailing one year to 20% YTD and to 24% over the last month. Over the same time, China has seen its share of single-country flows rise from 28% over the trailing one year to more than 50% YTD, before pulling back to 43% as trade worries hit market sentiment in March. However, annualizing the trailing one-month and YTD China flows suggests a more than double and triple increase, respectively, over the trailing one-year flows.

Figure 6: Emerging trends: Single-country vs. broad exposure



Source: BlackRock with Markit flow data, as of April 12, 2018.

Overview

It's a difficult environment for bonds, but we believe investment grade credit may now offer reasonable value in the overall context of portfolio diversification.

Consider

- iShares iBoxx \$ Investment Grade Corporate Bond ETF (LQD)
- iShares 1-3 Year Credit Bond ETF (CSJ)
- iShares Floating Rate Bond ETF (FLOT)
- iShares 0-5 Year Investment Grade Corporate Bond ETF (SLQD)
- iShares Interest Rate Hedged Corporate Bond ETF (LQDH) (Active)

Fixed income

Opportunities within investment grade bonds

Key points

- **Investment grade corporate spreads have widened significantly** since early February.
- **We remain neutral on an absolute basis**, but believe that current levels represent reasonable value from a portfolio diversification perspective.
- **Investors may want to consider implementing exposure** via investment grade floating rate notes, shorter-maturity fixed rate exposure or interest rate hedged exposure.

Market pulse

Interest rates have been steadily rising, with the yield on the 10-year Treasury now hovering around 3%. A strong move in the dollar has spooked investors in emerging markets and has highlighted some of the vulnerabilities with the weaker EM sovereigns, namely Turkey and Argentina, where monetary and fiscal policy is running loose relative to market expectations. Current and historical questions about willingness to pay obligations could explain some of the sharp moves in their currencies of late. EM debt is off to one of its worst starts on record, down 5.47% for the year, but it has cheapened relative to both local currency EM and U.S. credit markets⁴.

Meanwhile, investment grade corporate spreads have widened significantly since their tights in early February on declining demand due to previously rich valuations, a sustained increase in longer-term rates and rising currency hedging costs, which have crimped foreign demand.

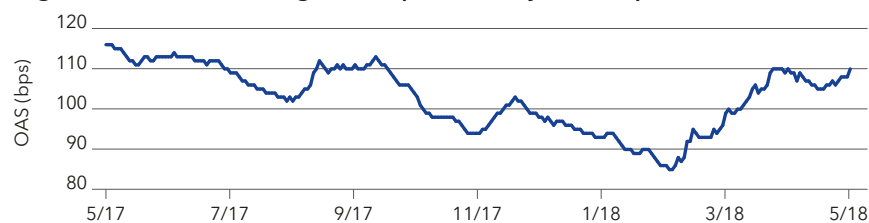
While spreads have been much wider post-crisis⁵, we believe that current levels represent reasonable value when viewed in the context of overall portfolio diversification. On an absolute basis, however, we remain neutral.

Positives for investment grade credit include an estimated 13% reduction in net supply year-over-year, according to JP Morgan, improving corporate earnings, declining leverage and rising interest coverage. Risks include an unexpected surge in longer-term rates, increasing volatility and ongoing competition for investable assets amid more attractive yields in Treasuries and more compelling relative value in general across shorter-dated fixed income assets. As such, investors may want to consider implementing exposure via investment grade floating rate notes, shorter-maturity fixed rate exposure or interest rate-hedged exposure.

⁴ Source: Bloomberg, as of 5/17/18, based on the J.P. Morgan EMBI Global Core Index, J.P. Morgan GBI-EM Global Diversified 15% Cap 4.5% Floor Index, and Markit iBoxx USD Liquid High Yield Index.

⁵ Source: Bloomberg Barclay, as of 5/15/18.

Figure 7: Investment grade options-adjusted spreads



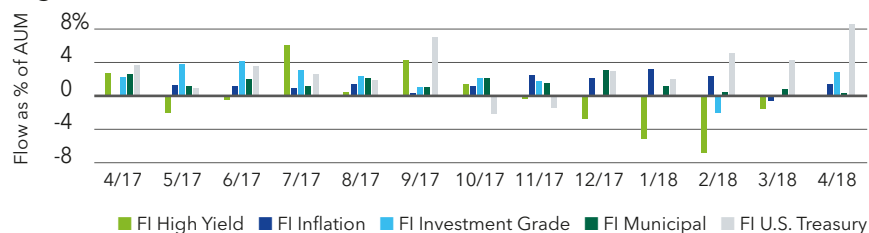
Source: Bloomberg, as of May 1, 2018. Based on Bloomberg Barclays U.S. Corporate Bond Index. Option Adjust Spread is the weighted average incremental yield earned over similar duration US Treasuries, measured in basis points. This metric considers the likelihood that bonds will be called or prepaid before the scheduled maturity date. **Past performance does not guarantee future results.**

A tale of flows

With the rise in short-term yields and return of equity market volatility, demand for perceived “safe income” assets surged. Investors came to realize that they could earn decent income without taking indecent risk by investing in government bonds. U.S.-listed ETPs saw \$7.4 billion of net inflows in the first quarter into U.S. Treasury products. The lion’s share went to short-dated government bonds, as they can provide cushion against interest rate risk and potential for an improved risk-adjusted return profile.

In addition, the latest flows data suggest investors have been paying more attention to the opportunities in U.S. investment grade corporates after spreads widened materially while high yield spreads tightened since mid-February. High yield products suffered \$6.2 billion of net outflows in the first quarter due to their negative convexity and minimal ability to provide equity diversification in portfolios.

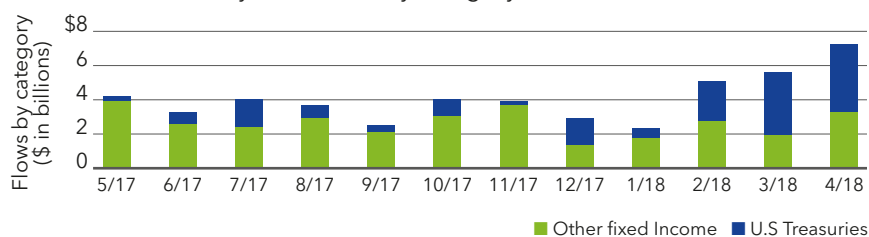
Figure 8: Flows into U.S. bond ETFs as % of AUM



Source: BlackRock, as of April 30, 2018. U.S.-listed ETF flows using Markit flow data definition.

Figure 9: Getting short

Global short-maturity ETFs, flows by category (\$ in billions)



Source: BlackRock, as of April 30, 2018.

Overview

Historically, commodities have offered some protection against inflation and provided diversification benefits.

Consider

- iShares Commodities Select Strategy ETF (COMT) (Active)
- iShares Bloomberg Roll Select Commodity Strategy ETF (CMDY) (Active)
- iShares U.S. Energy ETF (IYE)

Multi-asset insights

The commodity rally

Key points

- **Commodities are off to a strong start**, outperforming the S&P 500 Index by nearly 10% year-to-date⁵.
- **Strong global growth**, tighter U.S. oil inventories and OPEC production cuts have pushed energy prices higher.
- **We believe** commodities can serve as attractive diversifiers to traditional stock/bond portfolios.

Market pulse

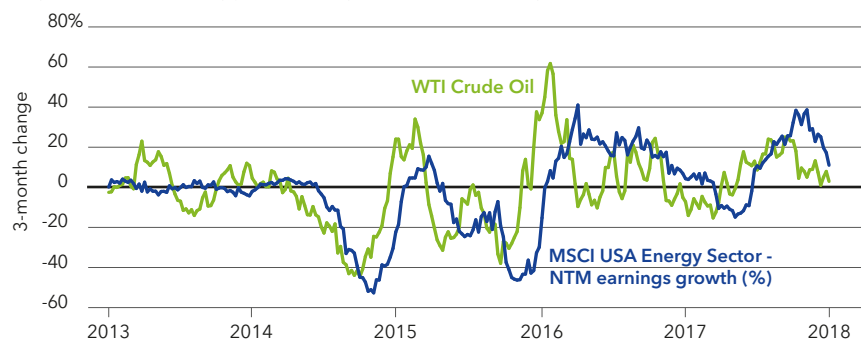
Commodities have outperformed the S&P 500 Index by nearly 10% so far this year, while commodity prices have reached levels not seen since 2014⁶.

In some respects, the surge is typical for the late stages of an economic cycle when dynamics are often supportive of commodities with strong growth, tighter capacity constraints and firmer inflationary pressures. This cycle is no exception—strong global growth, tighter U.S. oil inventories and OPEC production cuts have pushed energy prices higher, while concerns over U.S. inflation and a weaker dollar renewed interest in the asset class.

We believe commodities can serve as attractive diversifiers within traditional stock/bond portfolios, but in the short term, we see a stronger case for considering energy equities versus crude itself. One factor supporting energy firms: their focus on capital discipline, which is evident in first-quarter earnings results. Unlike in some past oil market rallies, companies are not making huge investments in future production.

Direct exposure to commodities still offers portfolio benefits, we believe. Investors looking to diversify risk or protect against inflation should consider exposure to commodities.

Figure 10: Energy earnings revisions lag crude moves



Sources: Thomson Reuters, IBES, as of April 30, 2018. The green line tracks the three-month change in the MSCI USA Energy Sector's forward earnings growth, an amalgamation of sell-side earnings reports tracked by IBES. **Indexes are unmanaged and one cannot invest directly in an index. Past performance does not guarantee future results.**

⁶ Source: Thomson Reuters, Goldman Sachs, BlackRock as of 5/15/18. Based on Goldman Sachs Commodity Index.

Portfolio trends: Notes from the field

Here's a roundup of the trends we're seeing among a range of investors.

Pensions: We see many institutional investors using ETF portfolios that proxy the economic exposures of alternative investments benchmark or policy portfolio. We are also seeing a strong focus on factor investing, particularly interest in matching factor exposures with credit ETFs.

Family offices: We are noting an uptick in building ETF-only portfolios, and a tendency toward disaggregating international exposures into regions with active country and sector tilts.

Insurance: Insurance companies, because of their concentrated usage of fixed income, are increasingly looking for ways to mitigate the negative impact of rising rates.

Advisors: We see more advisors embracing factor investing, particularly with an emphasis on dividends and minimum-volatility strategies. In addition, international equity weightings are finally trending higher in the models many advisors use, following a lengthy period of stagnation.

Let us know...



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You also can find the latest market commentary from the ETF Investment Strategies & Insights group at **iShares.com**.

Our View and Outlook

Global Region	underweight	◀	neutral	▶	overweight
Developed markets	○	○	●	○	○
North America					
United States	○	○	○	●	○
Canada	○	○	●	○	○
Europe					
Eurozone	○	○	●	○	○
United Kingdom	○	●	○	○	○
Asia Pacific					
Japan	○	○	○	●	○
Emerging Markets	○	○	○	●	○
Asia Pacific					
China	○	○	○	●	○
India	○	○	○	●	○
Latin America					
Brazil	○	○	○	●	○
Mexico	○	●	○	○	○
Fixed Income Sector	underweight	◀	neutral	▶	overweight
U.S. Treasuries	○	●	○	○	○
U.S. TIPS	○	○	○	●	○
U.S. Investment Grade Credit	○	○	●	○	○
U.S. High Yield Credit	○	○	●	○	○
U.S. Municipals	○	○	●	○	○
U.S. Mortgage-Backed Securities	○	○	●	○	○
Non-U.S. Developed Markets	○	●	○	○	○
Emerging Markets	○	○	●	○	○

● underweight outlook ● slightly underweight outlook ● current neutral outlook
 ● slightly overweight outlook ● overweight outlook

Underweight: Potentially decrease allocation

Neutral: Consider benchmark allocation

Overweight: Potentially increase allocation

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Investing involves risk, including possible loss of 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, in concentrations of single countries or smaller capital markets. Frontier markets involve heightened risks related to the same factors and may be subject to a greater risk of loss than investments in more developed and emerging markets. There is no guarantee that any fund will pay dividends.

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. There may be less information on the financial condition of municipal issuers than for public corporations. The market for municipal bonds may be less liquid than for taxable bonds. Some investors may be subject to federal or state income taxes or the Alternative Minimum Tax (AMT). Capital gains distributions, if any, are taxable. Noninvestment-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.

A fund's use of derivatives may reduce a fund's returns and/or increase volatility and subject the fund to counterparty risk, which is the risk that the other party in the transaction will not fulfill its contractual obligation. A fund could suffer losses related to its derivative positions because of a possible lack of liquidity in the secondary market and as a result of unanticipated market movements, which losses are potentially unlimited. There can be no assurance that any fund's hedging transactions will be effective.

An investment in the Fund(s) is not insured or guaranteed by the Federal Deposit Insurance Corporation or any other government agency and its return and yield will fluctuate with market conditions.

There can be no assurance that performance will be enhanced or risk reduced for funds that seek to provide exposure to certain quantitative investment characteristics ("factors"). Exposure to such investment factors may detract from performance in some market environments, perhaps for extended periods. In such circumstances, a fund may seek to maintain exposure to the targeted investment factors and not adjust to target different factors, which could result in losses. The iShares Minimum Volatility ETFs may experience more than minimum volatility as there is no guarantee that the underlying index's strategy of seeking to lower volatility will be successful.

Funds that concentrate investments in specific industries, sectors, markets or asset classes may underperform or be more volatile than other industries, sectors, markets or asset classes and than the general securities market. Technology companies may be subject to severe competition and product obsolescence. Small-capitalization companies may be less stable and more susceptible to adverse developments, and their securities may be more volatile and less liquid than larger capitalization companies.

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

Securities with floating or variable interest rates may decline in value if their coupon rates do not keep pace with comparable market interest rates. The Fund's income may decline when interest rates fall because most of the debt instruments held by the Fund will have floating or variable rates.

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