

SUMMER 2018

Investment directions

Summertime and the living is easy?



Chris Dhanraj
Head, U.S. ETF
Investment Strategy

Grant Dechert

Jasmine Fan

Thomas Logan

Dhruv Nagrath

Tushar Yadava

Contributors

Stephen Laipply
Head of U.S. Fixed Income iShares
Product Strategy

Patrick Nolan
Portfolio Strategist with the
BlackRock Portfolio Solutions Team

Del Stafford
Head of Multi-Asset Portfolio &
Investment Consulting

Editor
David Kurapka

Shifting tides

In the United States, the economic backdrop continues to shine, and earnings remain strong. But uncertainty surrounding trade tensions has sparked investor interest in more defensive factor exposures, like quality, while fervor has cooled for more cyclical factors such as value. At the same time, growth-oriented stocks have continued their momentum—although exhibiting bouts of volatility of late. Earnings have been the drivers of both performance and pullbacks.

Feeling the heat

Meanwhile, developed countries and regions outside the United States have not just suffered from historic heatwaves, but continue to face political and economic headwinds. As such, we have downgraded Europe to underweight and Japan to neutral. Political and economic uncertainty is casting a shadow over the former and lack of a catalyst in sight affects the latter.

Why we're sticking with emerging markets

Emerging market equities have performed miserably this year, a victim of tighter financial conditions (namely, the strong dollar) and trade tensions. However, we continue to favor the asset class and believe this year's poor performance has created an attractive entry point. Yet rising dispersion among emerging markets (EM) assets underscores the need for selectivity at the country level.

Focus on mortgage-backed securities

The fixed income market remains challenging, but market technicals have improved as demand from banks and others has absorbed the increased supply as the Federal Reserve (Fed) normalizes its balance sheet. The key is being selective: We think mortgage-backed security valuations remain attractive and prefer agency MBS over credit, TIPS over Treasuries and investment grade over high yield within credit.

The new yield environment

This year marks the most meaningful change in interest rates since the financial crisis. As the Federal Reserve increases interest rates and ends large-scale asset purchases in the United States, risk-free yields have increased. The current U.S. 2-year Treasury yield is greater than 95% of the curve just two years ago. The ability to earn attractive risk-free returns within short-maturity assets means that investors have a real alternative to earn yield without taking duration or equity risk. While long-duration bonds can offer diversification benefits, we continue to favor short-duration bonds.

Overview

Against a backdrop of strong earnings, along with concerns over trade tensions, investor interest has grown in defensive factor exposures, like quality, while growth-oriented stocks have exhibited continued momentum. We continue to prefer growth-gearred sectors, namely technology and financial companies, as well as the momentum and quality factors.

Consider

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

U.S. equities

Shifting tides

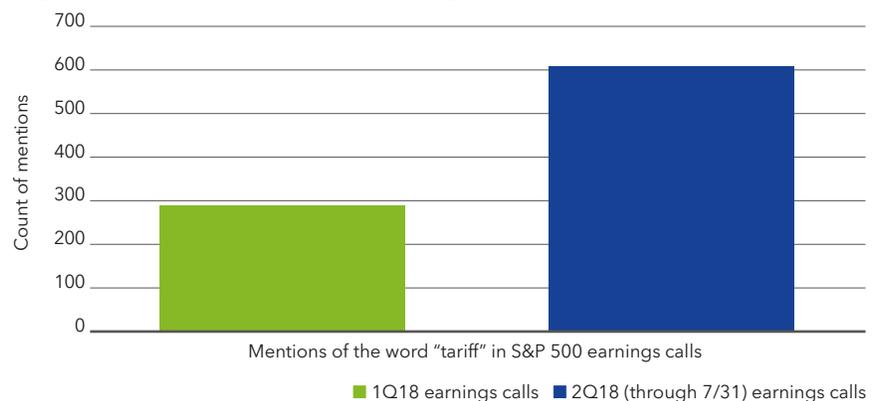
Key points

- **Moving from value to quality.** Uncertainty surrounding trade tensions has sparked investor interest in more defensive factor exposures, like quality, while cooling it in more cyclical factors such as value.
- **Growth-oriented stocks continue to perform despite exhibiting bouts of volatility of late, outperforming the market in spite of being prone to sell-offs.** High-profile earnings releases have been the drivers of pullbacks but have also led year-to-date performance.
- **Sector trends.** Upward revisions in sectors that have underperformed, like energy, seem to be priced in by markets. Meanwhile, sectors such as technology have continued to deliver strong top line earnings, despite some wobbles in guidance and revenues.

Market pulse

The second-quarter earnings season has been largely positive for U.S. stocks, particularly those in the S&P 500. With some companies still left to report at time of writing, the year-over-year rate of earnings growth looks to be healthy at more than 20%. This marks the second consecutive quarter of earnings growth above 20% and the third consecutive quarter of double-digit growth. Many companies may have reported concerns around trade uncertainties and an appreciating dollar, but sales growth is also humming along at a healthy 8%+, one of the highest levels this decade, with all 11 GICS sectors growing.

Figure 1: Trade concerns trending



Source: <https://www.bespokepremium.com/think-big-blog/tariffs-tariffs-tariffs>, accessed on July 31, 2018.

Much of the earnings growth can be attributed to the energy sector, which returned 13.5% in the second quarter, more than any other sector in the S&P 500. Of course, this suggests a lot of the good news is already in the price.

This far into an economic cycle, results this strong are impressive and, based on guidance, seem sustainable through 2018. Full-year earnings estimates remaining intact this late in the year are also a uniquely bullish phenomenon and the number of companies guiding lower is well below historical averages. As a result, the 2018 view from both strategists and analysts across Wall Street is summarily bullish.

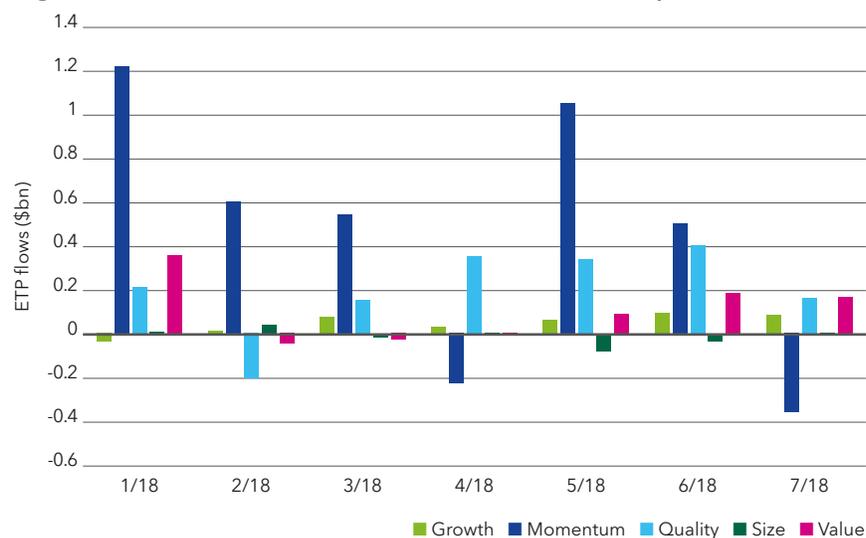
Can growth stocks continue to shine? Based on the incoming earnings data, they seem unlikely to dim anytime soon. However, going forward, we will also be watching the performance of value, which may begin to catch up to other factors or styles, should the economic momentum continue.

A tale of flows

Flows often follow performance, especially in the U.S. equity ETF space. As such, recent flows have largely reflected the underperformance of value as both a style and a factor. On the other hand, the quality factor category has seen continued inflows, as has the much larger and more recognized growth segment, which has a high degree of overlap to quality. Outflows have been most pronounced in large-cap value, where net outflows belie a shift of \$4 billion between the two largest funds in the space.

As small-cap stocks have outperformed their large-cap peers this year, demand remains strong for both small- and mid-cap value ETFs, with \$2 billion of inflows over the last two months. Growth funds have seen inflows across all cap ranges, to the tune of \$6 billion of inflows.

Figure 2: Slow mo: 2018 ETP flows into factor exposures



Sources: Thomson Reuters, BlackRock, as of July 30, 2018.

Overview

Given rising political risks and sluggish economic performance, we are now underweight European equities. We have a more favorable view on Japan but are neutral with no catalyst for growth in sight.

Consider

- iShares MSCI Eurozone ETF (EZU)
- iShares Core MSCI Europe ETF (IEUR)
- iShares Currency Hedged MSCI Eurozone ETF (HEZU)
- iShares MSCI Japan ETF (EWJ)
- iShares Currency Hedged MSCI Japan ETF (HEWJ)

Developed market equities

Feeling the heat

Key points

- **Developed market downgrades.** We have downgraded our views on Europe and Japan: We favor an underweight position on Europe and are neutral on Japan.
- **Political uncertainty.** An anti-establishment Italian government, Brexit uncertainty and renewed immigration tensions create new challenges for Europe.
- **ECB challenges.** Lingering risks and sluggish core inflation are likely to keep the European Central Bank (ECB) on its slow path to normalization.
- **Neutral on Japan.** Improving governance and profitability are encouraging in Japan, but there is a lack of near-term catalysts to propel relative equity outperformance.

Market pulse

Italy's March 2018 election of an anti-establishment, euro-skeptic government and renewed tensions over immigration have raised long-term risks for the European Union. The resurfacing of political risk in the eurozone's third largest economy sent shockwaves as fears of a euro exit by Italy shook regional bond markets, widening the spreads between Italian and German government bonds. Although it is too early to assess the impact of the new Italian government's policy agenda, investors were provided a taste of how contagion could quickly spread throughout the euro area in the event of a crisis.

Meanwhile, the United Kingdom has been struggling with the conditions for its departure from the European Union. The debate between a soft Brexit and a hard one has upped political uncertainty without much progress made. While the falling U.K. currency has helped aid a short-term boost to U.K. equity prices, the ongoing Brexit-related risks could threaten the economy in the long run as the March 2019 deadline approaches.

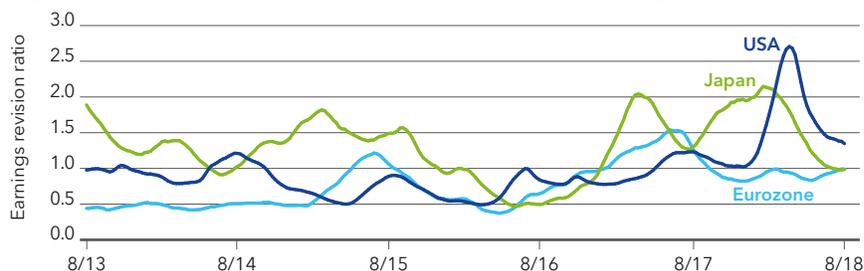
The eurozone and Japanese inflation outlooks remain subdued (Figure 3). Weakness in core inflation has reduced speculation that the Bank of Japan or the European Central Bank may tighten their monetary policies soon. Earnings revisions ratios across different developed markets (Figure 4) also point to weaker earnings momentum in Europe and Japan compared to that in the United States. Although friendly corporate behavior, solid company earnings and supportive monetary policy remain encouraging for Japanese equities, a clear growth catalyst is missing in the near term, while yen appreciation could become a potential risk to the market.

Figure 3: Sluggish core inflation in Europe and Japan



Source: Thomson Reuters Datastream, ETF Investment Strategy, July 23, 2018.

Figure 4: Japan and Europe fall behind in earnings momentum



Source: Thomson Reuters, as of July 30, 2018.

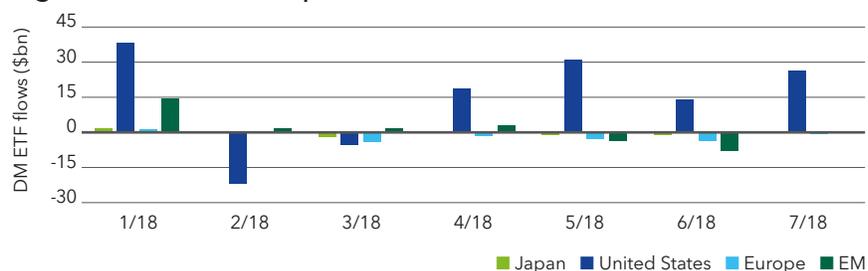
Note: Earnings revisions ratio is the number of equities with EPS estimates up on month divided by down.

A tale of flows

The change in views for Europe and Japan reflects ongoing preference across the ETF landscape. U.S.-listed ETFs with broad exposure to Europe have seen \$5 billion exit over the last two months, across funds that hedged currencies as well as those that offered unhedged exposures. Adding in EMU single-country ETFs and one finds another \$500 million has flowed out of European funds.

Another shift in preference has been seen in Japan, where ETFs offering lower cost exposure and small caps have seen some inflows to offset the outflows occurring in the larger funds focused on the broader market. So far in 2018, this has amounted to just under \$2.5 billion of outflows. However, an acceleration in outflows is a more recent phenomenon. The year began with slow inflows into unhedged currency Japan ETFs, only for \$3 billion to flow out overall over the last two months, across both hedged and unhedged currency exposures.

Figure 5: 2018 developed market ETF flows



Source: BlackRock, as of July 30, 2018.

Overview

The sell-off in emerging markets this year has created attractive valuations. We remain overweight EM equities, with a preference for EM Asia.

Consider

- iShares MSCI China ETF (MCHI)
- iShares MSCI Emerging Markets Asia ETF (EEMA)
- iShares Core MSCI Emerging Markets ETF (IEMG)

Emerging markets

Why we're sticking with emerging markets

Key points

- **We continue to favor emerging markets.** However, macro uncertainty has tightened financial conditions. Rising dispersion underscores the need for selectivity.
- **Escalating trade tensions remain top of mind,** but we continue to favor EM Asia on the back of strong growth, supportive fundamentals and cheap valuations.
- **A potential bargain?** Cheaper valuations combined with investor underpositioning suggest an attractive entry point.

Market pulse

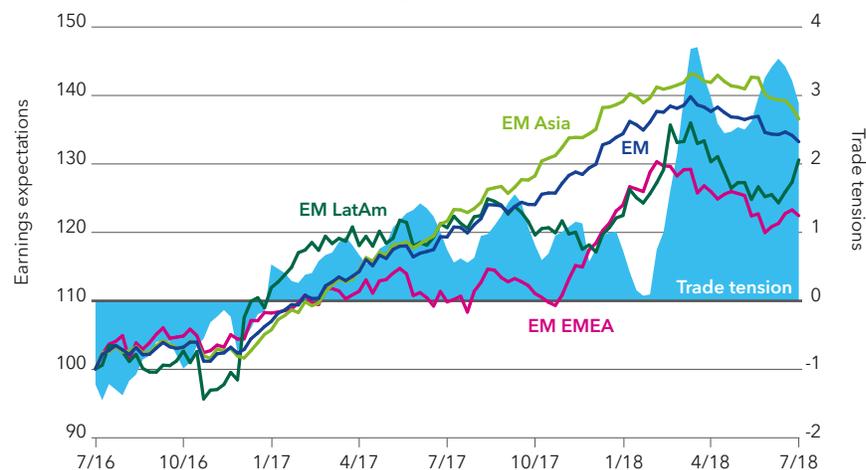
Emerging markets have stumbled this year, buffeted by growing macro uncertainty and escalating trade frictions that have tightened global financial conditions. However, we continue to favor the asset class and believe this year's poor performance has created an attractive entry point. Yet rising dispersion among EM assets suggests the pain is not being evenly felt and underscores the need for selectivity.

The U.S. dollar's rally, underpinned by widening U.S. growth and rate differentials versus other economies, has tightened global financial conditions. EM assets with external financing needs, such as Argentina, Brazil and Turkey, have come under pressure. Higher oil prices have amplified the inflationary effects of a weaker exchange rate; however, oil exporters with stable currencies have reaped the benefits. Saudi Arabian equities, for example, are up more than 19% year-to-date.

Still, equity valuations have cheapened in every country in the MSCI Emerging Markets Index. EM rates markets have turned hawkish, pricing in rate hiking cycles to support their currencies and limit further U.S. rate differential widening. Brazil, in particular, is currently priced to hike policy rates by more than 260 basis points (bps), or 2.6%, over the next year.

Within EM, our preference is for EM Asia. Trade tensions have ratcheted higher, yet fundamentals, earnings outlooks and valuations remain compelling. EM Asia has the strongest balance of payments, earnings growth remains strong and the MSCI EM Asia Index trades at just 11.5 times next twelve months earnings. Despite trade risks, we see cheap valuations and the ongoing tech-led U.S. capex cycle supporting EM Asia growth.

Figure 6: Trade tensions rising, EM Asia still resilient



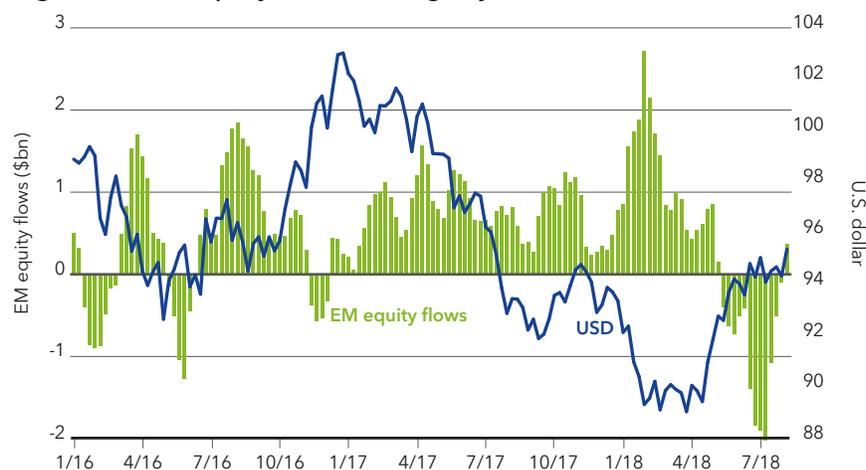
Source: Thomson Reuters, I/B/E/S. Indices shown are the MSCI Emerging Markets Index, MSCI Emerging Markets Asia Index, MSCI Emerging Markets Latin America Index and MSCI Emerging Markets EMEA Index. Trade tensions are measured by the BlackRock Investment Institute of the frequency of mentions of trade-related words, adjusted for whether the language is positive or negative, and then assigned a score.

A tale of flows

In contrast to last year, EMs have fallen sharply in 2018 and investor positioning has followed suit. U.S.-listed EM equity ETP flows experienced their worst quarter in the second quarter since the 2013 taper tantrum. EM equity flows exhibit a tight relationship with the U.S. dollar and suggest investors are currently more concerned with a stronger U.S. dollar tightening financial conditions than escalating trade frictions.

EM equity outflows accelerated in June but have since slowed. In fact, EM equity flows have since stabilized alongside EM exchange rates and higher equity prices. By mid-July, the 11 week stretch of outflows was broken. EM equity positioning is now lighter; however, with valuations even cheaper, fundamentals still intact and limited scope for future U.S. dollar appreciation, we're overweight EM equities with a preference for EM Asia.

Figure 7: EM equity flows are tightly linked to the U.S. dollar



Sources: BlackRock, Bloomberg. Flows measure U.S.-listed EM equity ETP flows. Flows are shown on a four-week moving average. U.S. dollar is measured with the DXY index.

Overview

It's a difficult environment for bonds, but technicals have improved. We think mortgage valuations remain attractive and prefer agency MBS over credit, TIPS over Treasuries and investment grade over high yield within credit.

Consider

- iShares MBS ETF (MBB)
- iShares TIPS Bond ETF (TIP)
- iShares Floating Rate Bond ETF (FLOT)
- iShares iBoxx \$ Investment Grade Corporate Bond ETF (LQD)

Fixed income

Focus on mortgage-backed securities

Key points

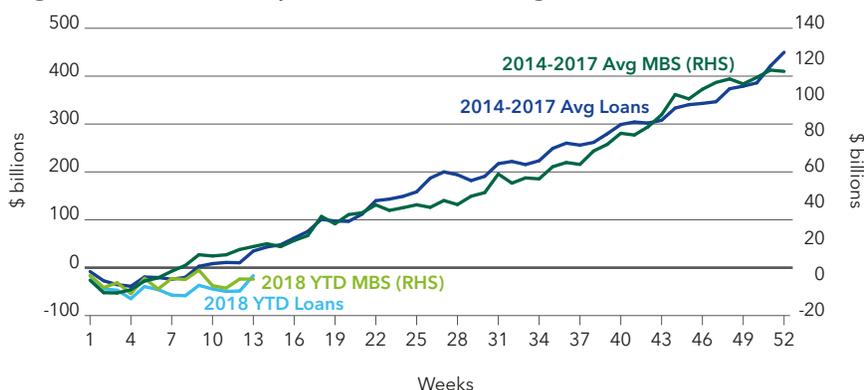
- **While fixed income markets overall remain challenging given the rising rate environment**, market dynamics for agency mortgage-backed securities (MBS) have improved. Higher demand from banks, REITs and overseas purchasers has absorbed increased supply as the Federal Reserve normalizes its balance sheet.
- **Relative valuations continue to support agency MBS over investment grade (IG) credit.** Although heavy new issuance this year has pushed IG credit spreads off of their historical tight, the asset class remains fairly rich from a valuation standpoint. In contrast, MBS spreads remain near their historical midpoint.
- **Overall, we continue to favor a shorter-duration and an up-quality bias in fixed income allocations.** We prefer agency MBS over credit, TIPS over Treasuries and investment grade over high yield within credit.

Market pulse

The yield on the 10-year U.S. Treasury remains range bound between 2.8% and 3.0% while steadily rising short-term rates continue to flatten the 2s/10s Treasury curve. Markets have fully priced in a third rate hike in 2018 and currently put the odds of a fourth rate hike in 2018 at roughly 75%. We expect the Fed to continue to normalize rates.

Elsewhere, market supply/demand dynamics are playing an important role in credit and securitized markets. While IG credit spreads have widened under heavy new issuance this year, they have begun to retrace to tighter levels. In contrast, agency MBS supply/demand dynamics continue to improve. The Fed's well-telegraphed balance sheet runoff has been offset by stronger demand from banks, REITs and foreign buyers. Banks, in particular, have purchased 85% of the \$20 billion in net purchases in the first half of 2018, totaling \$17 billion. General market expectations are for this favorable demand dynamic to continue, in line with 2014-2017 averages, as shown below.

Figure 8: Bank MBS purchases vs. loan growth, 2014-2018 YTD



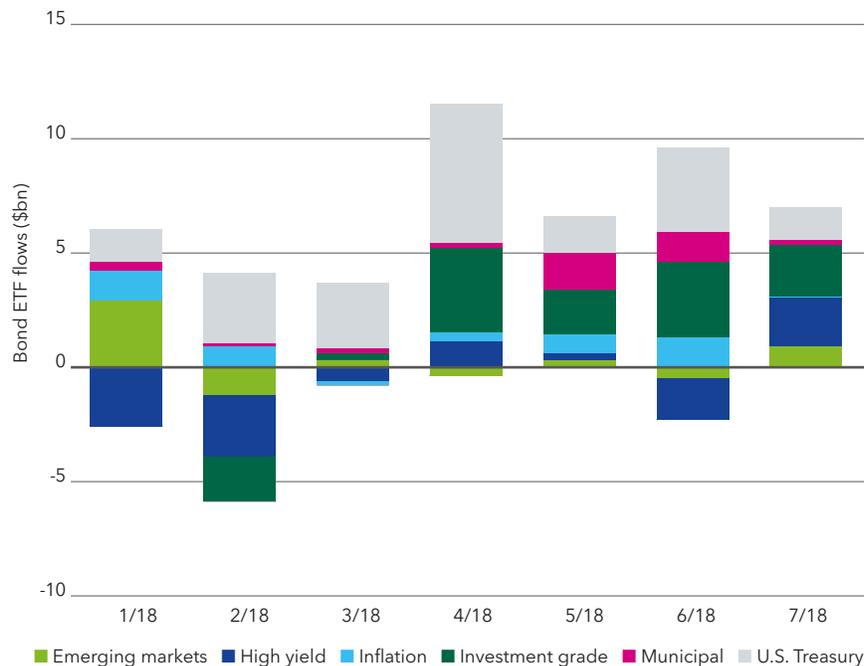
Source: Federal Reserve H8 data, as of March 28, 2018.

MBS valuations remain attractive. While MBS spreads have been tightening against a backdrop of declining rate volatility in recent years, they continue to look quite favorable versus comparable high-quality corporate credit. Agency MBS spreads are currently trading near the midpoint of their historical range versus investment grade credit, which remains closer to historical tights.

A tale of flows

Fixed income ETP flows remain strong for shorter-duration products. Treasury ETPs have gathered \$21 billion in inflows year-to-date, led by more than \$13 billion into short-term Treasury ETPs. However, high yield and emerging market outflows have continued amid the risk-off sentiment in the second quarter of 2018. Higher-quality credit and securitized markets continue to attract inflows. In addition to strong demand from real money investors, MBS-focused ETPs continue to attract steady inflows. Year-to-date, MBS-focused ETPs have gathered just over \$1 billion.

Figure 9: Flows into bond ETFs



Source: BlackRock, as of July 30, 2018.

Overview

Amid a changing yield environment, we favor short-duration bond exposure, which we believe will continue to offer investors favorable risk-adjusted carry versus longer-duration instruments.

Consider

- iShares Treasury Floating Rate Bond ETF (TFLO)
- iShares Short Maturity Bond ETF (NEAR)
- iShares Short Treasury Bond ETF (SHV)
- iShares Floating Rate Bond ETF (FLOT)
- iShares 1-3 Year Treasury Bond ETF (SHY)

Multi-asset insights

The new yield environment

Key points

- **The cross-asset yield environment is shifting.** Short-term U.S. debt instruments currently offer investors the highest yields of the post-crisis period.
- **We prefer short-duration bonds versus longer duration.** However, we also find that there are some multi-asset exposures that still offer attractive risk-adjusted yields.
- **ETP flows indicate a departure from the broader post-crisis period.** Investor flows have followed suit, shifting to the short end of the curve. Flows into higher yield equity ETPs have also decelerated.

Market pulse

This year, we have seen the most meaningful change in interest rates since the financial crisis, a move that has changed the yield picture across asset classes. As the Federal Reserve increases interest rates and ends large-scale asset purchases in the United States, risk-free yields have increased, especially at the front end. Today, investors can capture 80% of the current 30-year yield in the 2-year while taking just one-tenth of the duration risk—meaning it is no longer necessary to reach for yield by extending duration.

Figure 10: Cross-asset yields across fixed income exposures



Source: Bloomberg, as of 7/10/2018. Notes: Indexes listed are Bloomberg Barclays. For the precise indexes used, please see footnote 1 on page 12. **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.**

This environment has sparked investor demand in shorter-duration ETPs. Flows have shifted from the clear preference for yield, regardless of the risk, toward a more discerning environment of quality assets and shorter duration at that. There has also been a reduced pace of inflows into yield proxies.

We think that the balance of risks is near fully priced in and that short-duration products will continue to offer investors favorable risk-adjusted carry versus other longer-duration instruments.

Portfolio trends: Notes from the field

The iShares Portfolio Solutions team recently analyzed more than 6,710 advisor models. Three main takeaways emerged:

- As the financial markets exhibit lower returns and higher volatility, multi-asset funds continue to offer attractive opportunities; however, advisors remain largely underweight to this area.
- The terrific returns of the S&P 500 have buoyed clients' investment portfolios over the past nine years. Achieving return goals from here may involve overcoming discomfort with non-U.S. investments.
- Advisor models appear well positioned for further economic growth and not as well prepared for a recession. Advisors may want to consider a tilt toward quality.

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

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

Underweight: Potentially decrease allocation

Neutral: Consider benchmark allocation

Overweight: Potentially increase allocation

1 Indexes used are as follows: Bloomberg Barclays Pan-European Agg Index, Bloomberg Barclays GA Treasuries Index, Bloomberg Barclays Global Aggregate (GA) Index, Bloomberg Barclays U.S. Short Duration Treasury Index, Bloomberg Barclays U.S. Floating Rate Notes Index, Bloomberg Barclays U.S. Agency Index, Bloomberg Barclays U.S. Long Treasury Index, Bloomberg Barclays TIPS Index, Bloomberg Barclays GA Credit Index, Bloomberg Barclays Agg Index, Bloomberg Barclays U.S. MBS Index, Bloomberg Barclays U.S. Corp Index, Bloomberg Barclays U.S. IG Index, Bloomberg Barclays EM USD Aggregate Index, Bloomberg Barclays Global High Yield Index, Bloomberg Barclays U.S. High Yield Index.

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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.

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