NOVEMBER 2017

Investment directions
Rethinking risk, rethinking returns

Fly like an eagle
As markets continue to climb higher, investor sentiment seems to have turned from doubt to acceptance. Economic growth is above trend in most regions of the world, keeping us aloft, but we don’t appear to be soaring too dangerously and in peril of overheating. It is a good time to consider seeking out risk for the portfolio, but with many asset classes still pricey, where do we find opportunities? Given BlackRock’s recent fourth-quarter outlook, we see interesting potential opportunities in four areas.

The value of value
Momentum stocks have shined this year. But we also favor the value factor, and believe that it could benefit from an environment characterized by sustained global expansion and, more recently, higher energy prices, as well as the potential for rising rates.

Europe: Room to run
Despite recent headline noise around Spain and stubbornly low inflation, we believe the rally in Europe, which has outperformed other developed markets this year, still has legs. Ongoing expansion and strong earnings underscore this view.

Emerging markets: Still in the early chapters
The strong outperformance of EM stocks in 2017 has investors wondering if the rally’s days are numbered. We believe the strong performance can continue, as the underlying fundamentals of emerging markets are improving.

Playing defense with bonds
We have moved to a neutral view on U.S. investment grade debt from overweight, but the demand for income persists. Smart beta fixed income exposures that embed quality and value tilts relative to traditional market capitalization-weighted index exposures are one potential solution.

Don’t forget about geopolitical risk
The markets are calm, but geopolitics are anything but. Long-term government bonds can be useful diversifiers against volatility and equity market sell-offs sparked by geopolitical risks.

A note from the editor
We have updated the format for Investment Directions to be more streamlined to the key questions investors are asking us. Please let us know what you think and send feedback to GroupUS@blackrock.com.
Overview
We favor both the momentum and value factors and believe improved investor confidence in the sustained global expansion, backed by continued solid economic data, could help boost value stocks.

Consider
ETFs
• iShares Edge MSCI USA Value Factor ETF (VLUE)
• iShares Edge MSCI USA Momentum Factor ETF (MTUM)

U.S. equities
The value of value

Key points
• We like the momentum and value equity style factors. Stocks with strong price momentum, already up more than 30% this year, could continue to thrive amid a steady, sustained expansion. Historically, momentum has outperformed the broader market except in cases of recession or financial crisis, neither of which appear on the horizon.

• A shift in sentiment toward value? Some measure of caution has kept investors away from discounted segments of the market this year. But flows into exchange traded products suggest that could be changing.

• A solid macro backdrop—and improved sentiment—could benefit value. Improved confidence in the sustained global expansion, backed by continued solid economic data, could help boost value stocks.

Market pulse
U.S. equities have defied gravity this year, with the S&P 500 Index on track for its best yearly gain since 2013. Although elevated valuation metrics are a point of concern—and help underscore why we are neutral on U.S. stocks—we believe we will see further equity market strength given robust corporate earnings growth, a relatively low interest rate environment, sustained U.S. economic expansion, and low levels of volatility.

Against this backdrop, we like both the momentum and value style factors. Momentum has historically outperformed during periods of strong corporate earnings growth. This view has been reinforced by positive third-quarter earnings releases from momentum-driven mega-cap tech and semiconductor stocks.

However, we also like the value factor, home to the cheapest companies across U.S. sectors. The value factor seeks these underpriced securities and has historically delivered higher risk-adjusted returns than the broad market over the long run. Changing investor sentiment could support a value-driven rally. Moreover, increased benchmark interest rates as the Federal Reserve (Fed) continues its rate hikes could provide an additional tailwind. Indeed, it is important to note that in periods of rising interest rates and benchmark bond rates, value has tended to outperform.
A tale of flows

Overall within U.S. equities, we’ve seen a continuation of the trend of a structural shift in investment product preferences this year. In 2017, U.S.-focused mutual funds have experienced roughly $137 billion in outflows, while ETFs have gained $132 billion in inflows during the same timeframe. Within the ETF universe, most of these flows have been targeted into broad “core” exposures. That suggests virtually a one-to-one shift from one investment vehicle to another, but not necessarily a tilt toward a particular asset class, sector or style.

However, we are also seeing interesting trends within smart beta or factor positioning. Minimum volatility (+$1.9 billion YTD) and momentum (+$1.5 billion YTD) have led cumulative fund flows of YTD smart beta exposures, but October inflows into the value factor space after two months of relatively stable commodity prices and rising interest rates suggest leadership could be shifting.

Figure 2: Resurgence of value? Monthly primary market inflows into U.S.-listed factor ETFs

Source: BlackRock, as of 10/31/17.
Overview
European equities have outperformed the United States and other developed markets this year, but we continue to favor them against a backdrop of sustained, above-trend economic expansion and a steady earnings outlook.

Consider ETFs
• iShares MSCI Eurozone ETF (EZU)
• iShares Core MSCI Europe ETF (IEUR)

International developed market equities
The case for Europe: Still room to run

Key points
• We remain positive on European equities against a backdrop of sustained, above-trend economic expansion and a steady earnings outlook.
• Recent political developments—such as the current dispute between Spain and Catalonia—have not deterred us from our positive view on the region. While headline grabbing, the situation in Spain does not have implications for European integration, we believe. (If anything, the Catalans may hope to be allowed to be part of the EU alone, a parallel between Catalonia and the Scottish independence referendum in the United Kingdom on this point.)
• Low inflation is still a concern. We view the European Central Bank’s (ECB’s) decision to extend its asset purchases, while halving the monthly net amount starting in January, as another potential positive catalyst for the markets. To be sure, the reason for that move—still-low inflation—troubles us.
• Still room to run. Flows into European ETPs and mutual funds have been strong this year, but still well short of the 2016 outflows. This suggests the trade is not yet “crowded” and, with above-trend economic expansion and a steady earnings outlook, could still experience further gains.

Market pulse
Despite the cheering of U.S. equity indexes reaching new highs this year, it is not fake news to note that European equities have outperformed the United States and other developed market equities in 2017 in dollar terms. Broadly, the eurozone area is reaching levels of economic growth not seen since before the 2011 European debt crisis. The sustained economic expansion has in turn been supportive for earnings growth.

Figure 3: European forward earnings growth

Inflation has remained subdued, allowing the ECB to keep interest rates low and provide additional monetary policy support. Indeed, at its October meeting, the ECB extended its asset purchase program for an additional nine months and indicated a willingness to keep it open ended beyond the September 2018 end date should inflation fail to pick up. This extension of stimulus should be favorable for economic growth.
With political risks in France, the Netherlands, and Germany behind us, investors’ attention has more recently turned to the Spanish region of Catalonia. After the Catalan parliament declared independence, the Spanish Senate granted Madrid the power to implement direct rule over the region, which ousted Catalan leadership. Spanish assets initially sold off on the news, but contagion into other markets was muted, although the euro did fall. We do not see the situation as having broader economic or political implications for European integration. Still, further escalation of these tensions may weigh on the broader periphery of Europe.

Figure 4: Spanish equities and government bond spreads

Source: Thomson Reuters as of 11/1/17.

A tale of flows

Flows into European investment products have amassed an impressive comeback from 2016, when the region saw more than $100 billion in outflows. In 2017, European-focused ETFs have gathered $38 billion since the start of the year, while European mutual funds have gained $1 billion. In other words, investors have yet to replace the money withdrawn in 2016, suggesting the trade has not become crowded.

Within the single-country European exposures, United Kingdom- and French-focused ETFs have experienced the most inflows. Spain led this category prior to October, but as geopolitical risk intensified through the month, investors withdrew $500 million from Spanish-focused products.

Figure 5: Still playing catch-up

Cumulative flows into European ETFs

Source: BlackRock, as of 10/31/17.
Overview
The broad outlook appears positive for emerging markets; our favored markets include India, Indonesia, Brazil and Argentina.

Consider
Emerging Market Equity ETFs
- iShares Core MSCI Emerging Markets ETF (IEMG)
- iShares Edge MSCI Min Vol Emerging Markets ETF (EEMV)

Country Equity ETFs
- iShares MSCI India ETF (INDA)
- iShares MSCI Indonesia ETF (EIDO)
- iShares MSCI Brazil Capped ETF (EWZ)
- iShares MSCI Argentina and Global Exposure ETF (AGT)

Emerging Market Equity Small-Cap ETFs
- iShares MSCI India Small-Cap ETF (SMIN)
- iShares MSCI Brazil Small-Cap ETF (EWZS)

Emerging markets
EM: Still in the early chapters

Key points
- We are overweight emerging market (EM) equities. As BlackRock’s Chief Equity Strategist Kate Moore notes in this month’s equity outlook, the underlying fundamentals for EM equities are improving after five years of declining profitability and weak earnings growth. We believe the recent outperformance is the start of a longer trend.
- A trio of forces offer support for EM equities today: structural reforms that are leading to higher profitability, synchronized global growth that is fueling improved demand, and stimulative fiscal and monetary policies.
- All three major EM regions are contributing to robust earnings growth for the asset class, although the spotlight has focused on EM Asia, led by China. Our favored markets include India, Indonesia, Brazil and Argentina.
- Flows into EM investment products suggest room for further growth. Flows have been strong this year, but still well below previous post-crisis periods.

Market pulse
EM earnings have come a long way: After disappointing annual earnings growth since 2011, the past 18 months have brought a broad-based recovery. Performance has largely followed. MSCI EM valuations are at their highest since 2010, but 24% below developed markets—not expensive, on a relative basis. Overinvestment and capacity expansion weighed on profitability from 2011 to 2015. Yet, the recent slowdown seen in investment and capex has resulted in an increased return on equity within EM.

Figure 6: A turn in profitability
Emerging markets return on equity and prices, 2001-2017

Three themes could support EM equities: structural reforms that are leading to higher profitability, global growth that is fueling demand, and stimulative fiscal and monetary policies. These trends are broad based, though we also favor specific markets such as India, Indonesia, Brazil and Argentina.
India. India has seen some of the most substantial reform progress among EMs, kicked off by Prime Minister Narendra Modi’s election in 2014. Company margins have been challenged as the government has undertaken these reforms, but are slowly showing signs of improvement amid lower expenses and inflation.

Indonesia. Reform progress is supporting Indonesia’s equity market as well. Broader fundamentals are also strong. The fact that Indonesian equities have lagged both EM broadly and EM Asia may mean room for catch-up, we believe.

Brazil. We see a favorable economic, political and fundamental environment for Latin America’s anchor market. The largest companies by market cap were historically commodity producers, but today market leadership comes from consumers and banks. The country is less dependent on global trade than conventional wisdom suggests, a positive as trade pacts come into question.

Argentina. We see Argentina as a small market with potentially big opportunity. The MSCI Argentina Index, at just $41 billion in size as of October, has soared 75% year-to-date in U.S. dollar terms. The run-up comes as the country’s inclusion in the MSCI EM Index looms next year, and is further supported by favorable political and economic conditions. The risks: Large fiscal and external imbalances make Argentina dependent on foreign capital and vulnerable to currency swings.

Small-cap effect? In Brazil and India rising real wages have helped smaller, more locally focused consumer discretionary names, which outperformed the broader equity markets this year. Investors looking for targeted exposure to the emerging middle class could consider the more domestically oriented small caps in Brazil and India.

A tale of flows
Flows into EM exchange traded products (ETPs) and mutual funds have been consistently strong since 2016 compared to other asset classes, but in percentage of total AUM terms are still well below previous post-crisis periods. Notably, EM ETPs—both equity and debt—continued to gather assets throughout the third quarter, shrugging off tensions in the Korean peninsula and a more hawkish Fed.

Figure 7: Periods of flows into EM equity mutual funds and ETPs as a % total AUM

Source: BlackRock Investment Institute with data from EFPR, September 2017. Notes: The lines represent the U.S. dollar flow into emerging market equity mutual funds as a % of total fund AUM according to EFPR. The periods represented are March 2009 - January 2011, December 2011 - February 2013 and June 2016 - September 2017.
Overview
With investment grade spreads tight at levels not seen in years, fixed income investors continue to face challenges in their bond portfolios in seeking income.

Consider ETFs
• iShares Edge Investment Grade Enhanced Bond ETF (IGEB)
• iShares Edge High Yield Defensive Bond ETF (HYDB)

Fixed income
Playing defense with bonds

Key points
• We have downgraded U.S. credit from overweight to neutral. Both investment grade and high yield credit spreads are the tightest in several years, a sign of how expensive they’ve become, and we prefer to take risk with equities.
• Potential risk outweighs potential income. Our neutral view implies that both investment grade and high yield allocations should be held at benchmark weight due to the increased potential for spread widening, which could potentially offset the income benefits.
• Seek defensive exposures. Investors should consider accessing these asset classes through more defensive exposures.

Market pulse
The sustained global economic expansion and an outlook for gradual monetary policy normalization could make for a positive backdrop for risk assets. Yet we believe equities offer a better risk-reward profile than credit given their potential for greater upside in returns and more balanced downside risks.

Tight yield spreads on U.S. high yield bonds today reflect the current benign environment for defaults. This leaves little safety cushion against risks, either from rising interest rates or any increase in default risk.

Bottom line: Credit has little further price upside in the case of ongoing economic growth and strong equity markets, but plenty of downside risk in a growth slowdown and equity market sell-off.

Figure 8: Investment grade & high yield option adjusted spreads

Source: Bloomberg, as of 10/31/17.
For investors who need income, accessing these asset classes through more defensive exposures is another possible answer. Smart beta exposures that embed quality and value tilts relative to traditional market capitalization-weighted index exposures are one potential solution. The result of this process is that investors potentially have more defensive exposure to these asset classes but with similar yield, duration, etc. as the traditional market capitalization-weighted credit indexes.

A tale of flows
Flows into global fixed income-focused mutual funds and ETFs have surged to $320 billion this year, more than double last year’s number. U.S. investment grade and broad market exposures have gathered the bulk of primary market inflows while notable inflows into emerging market debt and European investment grade have also occurred. Conversely, investors have withdrawn from products exposed to high yield (both in the United States and Europe).

This strong demand for bonds at a time when bonds are expensive by most measures is indicative of several factors unrelated to market sentiment: an ongoing need for income and the diversification of bonds, a structural shift from ownership of single issuance to funds, and demographic-based increased demand for bonds. All of these suggest that the demand for bonds will remain strong for the foreseeable future. This may keep a lid on higher interest rates, even as the Fed hikes. The Fed may then be less worried about a “melt-up” in rates given these structural factors.

Figure 9: A strong year: Top five bond ETF asset class 2017 flows

Source: BlackRock, as of 10/31/17.
Multi-asset insights
Geopolitical risks we’re watching

Key points
• If markets are a sea of calm, geopolitics are anything but. We have our eyes on 10 geopolitical risks and are tracking their likelihood and potential market impact.
• Three key risks that we are monitoring include: North American trade negotiations, North Korea and U.S.-China relations.
• Long-term government bonds can be useful diversifiers against volatility and equity market sell-offs sparked by geopolitical risks.

Market pulse
We have our eyes on 10 geopolitical risks and are tracking their likelihood and potential market impact, highlighted in the figure below.

Figure 11: A world of risk
BlackRock’s top-10 geopolitical risks, September 2017

Source: BlackRock Investment Institute, September 2017. Notes: the graphic shows the top-10 geopolitical risks BlackRock tracks. Flags denote key nations exposed to these risks; major cyber attack and major terror attack are global in nature. This is for illustrative purposes only.
Our top-three geopolitical risks right now:

**North American trade negotiations.** Although the latest round of talks ended with Mexico and Canada rejecting what they view as harsh U.S. proposals, news reports did suggest apparent progress on less contentious parts of the agreement. Our base case is that successful negotiations will be completed in early 2018. However, our hopes for this outcome have recently diminished given tough positions and rhetoric from the United States. Market risks are biased to the downside given that a good outcome is priced in, in both Canadian and Mexican markets.

**North Korea.** The possibility of armed conflict has risen, raising the chance of a misstep or miscalculation. Yet we currently see a low probability of all-out war. Instead, we expect the United States to intensify its “peaceful pressure” campaign, evident in it imposing unilateral sanctions and leaning hard on China to participate. We see the crisis straining U.S.-China relations just as economic tensions are rising.

**U.S.-China relations.** We see frictions between the Unites States and China heating up over time. We see trade and market access disputes straining an increasingly competitive U.S.-China relationship in the long run, and believe markets have yet to factor in this gradual deterioration.

**Market impact.** Most geopolitical shocks have short-lived market impacts, except in regions directly affected. Long-term government bonds can be useful diversifiers against volatility and equity market sell-offs sparked by such shocks.

**How geopolitics can affect flows**

Market reactions to geopolitical developments can be incredibly diverse. For example, the news implicating Brazilian President Michel Temer in a corruption scandal on May 18 sent the MSCI Brazil U.S. Dollar Index down 18% in a single day. Investors feared the accusation would halt his market-friendly reform agenda. However, market makers actually increased their positions in a Brazilian ETF to take advantage of heightened volumes by investing more than $500 million into the product. The Brazilian market ended up rallying off these lows as Temer stayed in office and his reform agenda remained robust. Elsewhere, shocks have not been so forgiving. The Qatar-Gulf Cooperation Council (GCC) rift that occurred in June has kept investors net bearish on the region. Qatar is down 10% since the event and has the worst performing equity market in both EM and DM.

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