Investment directions

The best of times?
The recent burst of volatility has been unnerving, but it is important to remember that the macro environment of synchronized economic growth and muted macro risks remains solid, although some are concerned about potential inflation and higher interest rates. Indeed, that backdrop supports our recent upgrade of U.S. equities to overweight.

Equities to yield curve: You talkin’ to me?
The shape of the yield curve can be a barometer for future growth, but its shape depends on a number of factors. Last year, it was relatively flat—often a sign of impending recession, but instead a result of higher short-term rates with expectations of Federal Reserve tightening. The curve began steepening later with expectations of stronger growth, underscoring our preference for cyclicals, namely financials and technology.

The specter of trade wars
What is the greatest risk to the markets right now? We would argue it is the potential for increased protectionism, which mostly just took the form of rhetoric in 2017. Investors may be discounting the risk that will change—and should evaluate whether their portfolios are exposed to risks from rising protectionism, particularly with respect to NAFTA and China.

Emerging markets: Commodity vs. non-commodity producers
During this recent market sell-off, EMs have held up relatively well—actually outperforming U.S. equities during this leg lower. Within EM, we are monitoring an interesting development. The rise in commodity prices in recent months historically would have resulted in a rally in EM commodity producers. This time, however, non-commodity producers have outperformed their commodity producing counterparts, as domestic growth and reform efforts are prevailing.

Taking a look at mortgages
It’s a tough environment for fixed income generally, but investors still need bonds in their portfolio for income and as a diversifier. One potential solution: consider agency mortgage-backed securities, which offer value relative to other high grade securities.

Reframing the volatility and correlations trends
Volatility and correlations have been relatively low, but that creates some challenges in finding the right blend of risk assets and stable diversification. Factor investing may be one solution, offering the potential for more consistent correlations.
Overview
We are overweight U.S. equities and specifically favor the financials and technology sectors. Higher interest rates and deregulation should benefit the former, while technology stocks appear most insulated from yield curve shifts.

Consider
• iShares U.S. Financial Services ETF (IYG)
• iShares North American Tech ETF (IGM)

U.S. equities
Equities to yield curve: “You talkin’ to me?”

Key points
• We believe the shape of the yield curve indicates continued economic expansion. The U.S. Treasury yield curve is steepening. We believe that this is a reflection of a stronger U.S. and global economy and a rise in the market’s inflation expectations.
• Don’t shy away from sector rotation. The dispersion of U.S. equity outcomes across yield curve regimes over the last 20 years highlights the importance of rotating sectors over the course of the business cycle.
• We are overweight U.S. stocks and like cyclicals, specifically financials and technology. We think yield curve steepening will feed bank profitability, and the sector stands to benefit from deregulation. Meanwhile, technology stocks appear most insulated from yield curve shifts, while also being supported by longer-term structural drivers.

Market pulse
The yield curve flattened for much of 2017, primarily due to a rise in short-term yields. While a flattening yield curve can signal slower growth, rising short-term yields in 2017 showed greater market confidence in the growth and inflation outlook, as well as the Federal Reserve (the Fed) continuing to raise interest rates. In recent weeks, however, the yield curve has steepened as bonds sold off and the market viewed the tax overhaul and prospects of increased government spending as harbingers of stronger growth and inflation, and a promising environment for a continuation of the bull market.

What’s notable about the rally in U.S. equities is what is powering it: While the gains of 2013-2017 were typified by multiple expansion, the past year has been all about corporate earnings.

Figure 1: S&P 500 sources of total return

Sources: Thomson Reuters Datastream, S&P Dow Jones Indices and BlackRock Investment Institute, February 1, 2018. The bars show the breakdown of the S&P 500’s 12-month return into dividends, earnings growth and multiple expansion. Earnings growth is based on the 12-month change in 12-month forward I/B/E/S earnings estimates. Returns are based on the S&P 500 Index. 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 underscores how, although the shape of the yield curve can be a barometer for future economic growth, it depends on a multitude of factors. Analysis of different yield curve regimes can then offer some insights into what equity sectors have historically outperformed in those different regimes.

We studied a range of regimes and concluded that the current one—“bear steepening” led by longer-term rates rising more than short-term rates—suggests stronger conviction around the growth and inflation outlook. However, the dispersion of subsector outcomes in the ‘worst’ performing yield curve regime—bull steepening—highlights the importance of sector rotation over the course of the business cycle.

**Figure 2: Sector returns and yield curve regimes**

<table>
<thead>
<tr>
<th>Yield curve regime</th>
<th>Average 6-month return</th>
<th>Risk on</th>
<th>Risk off</th>
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<tr>
<td></td>
<td>Bear steepener</td>
<td>Bear flattener</td>
<td>Bull flattener</td>
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<tr>
<td>S&amp;P 500</td>
<td>10.9</td>
<td>5.8</td>
<td>5.6</td>
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<td>9.0</td>
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<tr>
<td>Energy</td>
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<td>8.8</td>
<td>1.4</td>
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<tr>
<td>Real estate</td>
<td>7.6</td>
<td>6.5</td>
<td>7.1</td>
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<td>5.2</td>
<td>4.6</td>
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<tr>
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<td>16.2</td>
<td>5.0</td>
<td>6.2</td>
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<tr>
<td>Materials</td>
<td>15.7</td>
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<td>13.3</td>
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<td>2.9</td>
<td>5.8</td>
</tr>
<tr>
<td>Utilities</td>
<td>3.6</td>
<td>2.8</td>
<td>7.3</td>
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<tr>
<td>Telecommunication</td>
<td>6.0</td>
<td>1.0</td>
<td>6.7</td>
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<th>Equity sector breadth</th>
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<tr>
<td>% of positive returning sectors</td>
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<td>% of negative returning sectors</td>
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</table>

Source: Thomson Reuters, as of November 29, 2017. Data covers 150 S&P 500 subsectors since 1995. Average returns are measured over 6 months for consistency with the lookback window to classify yield curve regimes. It is not possible to invest directly in an index. Past performance is no indication of future results.

Cyclical sectors have historically performed well in a risk-on environment. We like financials as yield curve steepening should boost bank lending margins, while the prospect of far-reaching financial sector reforms is encouraging. We also favor the technology sector as it appears less impacted by yield curve shifts. We further consider that investors tend to underestimate its long-term potential: Disruption and transformation across the tech universe are creating attractive long-term investment opportunities for both growth and income seekers.

**A tale of flows**

2017 saw U.S. equity ETPs hit a new annual record of $196.1 billion, including $97.2 billion into large caps. Cyclical sector funds added $22.4 billion, led by financials with $9.3 billion and technology with $6.9 billion. U.S. equity ETFs have gathered approximately $46 billion year-to-date; an explosive start driven by broad risk-on flows continuing last year’s trend. Investors making more specific sector calls have also favored cyclical this month: Industrials have taken in $3 billion, followed by information technology and energy with approximately $1.4 billion apiece.
Overview
The market impact of geopolitical shocks is typically short-lived when the economic outlook is strong. That changes when the risk calls into question this very outlook. Protectionist actions could do just that.

Consider
- iShares MSCI China ETF (MCHI)
- iShares MSCI Mexico ETF (EWW)

International developed market equities
The specter of trade wars

Key points
- The BlackRock Investment Institute has identified potential increased protectionism as one of the major risks to the market. Investors may be discounting the impact.
- Two areas to watch: NAFTA negotiations and ongoing trade tensions with China. The administration’s rhetoric on trade and immigration catalyzed a sell-off of the peso. A full-blown trade war with China is not our base case, but events warrant monitoring since the impact could be significant.
- Low inflation is still a concern. We view the European Central Bank’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.
- We encourage investors to evaluate whether their portfolios are exposed to risks from protectionism.

Market pulse
While investors continue to enjoy relatively low volatility and muted macro risks, they might be discounting the potential impact of greater American protectionism on global markets. Since his campaign in 2016, President Donald Trump has pledged to modify U.S. trade agreements. The world first got a taste of the transition from rhetoric to action as the Trump administration withdrew the United States from the Trans-Pacific Partnership in 2017. More recently, the administration imposed tariffs on imported solar panels and washing machines that were particularly felt by Chinese and South Korean producers. The material impact of these developments has not moved the dial on global trade, but it is crucial to determine how these precedents and upcoming resolutions of current trade disputes will impact world trade.

We encourage investors to evaluate whether their portfolios are exposed to trade protectionism risks, specifically with respect to NAFTA negotiations and ongoing investigations into China’s intellectual property practices and steel/aluminum industries.

On Mexico, Trump’s rhetoric on both trade and immigration catalyzed a 2016 sell-off of the peso as the country exports 81% of its goods to the United States. The peso declined 17% to an all-time low against the dollar—roughly 22 pesos to one dollar. This weakness later subsided in 2017 as synchronized global growth and U.S. political uncertainty helped push the peso up 11% against the dollar. However, with the peso up against the dollar on a 12-month basis, the broad trade-weighted dollar at multi-year lows, and the seventh round of NAFTA negotiations expected to be completed sometime in February ahead of the March 31 resolution deadline, further FX risks are skewed to the downside for Mexican assets.
China has also faced fierce criticism from the Trump administration. But a tarnished trade relationship between the two nations could have global ramifications as the world’s two largest economies share a goods and services trade estimated at $700 billion. The Office of the United States Trade Representative is investigating Chinese intellectual property acts and the country’s policies and practices in regard to theft and technological innovation. Additionally, the Commerce Department is to provide an analysis on whether U.S. import volumes of steel and aluminum harm national security. We see little risk of a Chinese equity market sell-off in response to limited intellectual property action against China, plans for which have been well telegraphed. But any unexpectedly harsh conclusions from these investigations could have multi-asset implications on a Chinese equity market that increased more than 50% in 2017, as well as global commodity prices.

**Figure 3: The peso feels the heat**

MSCI Mexico and peso performance

![MSCI Mexico and peso performance graph](source: Thomson Reuters, as of January 31, 2018)

**A tale of flows**

Within ETP flows, investors have not been discouraged from allocating to China and the broad Asia Pacific ex Japan region as both areas have benefited from robust growth, with flows up 4% and 2%, respectively. Flows into Canada and Mexico have been less constructive, as the threat to NAFTA, which underpins $1 trillion of annual trade between the United States, Mexico, and Canada, could have severe economic consequences for the two countries.

**Figure 4: What, me worry?**

January ETF flows by % of industry AUM in U.S. trade policy sensitive countries

![January ETF flows by % of industry AUM in U.S. trade policy sensitive countries](source: Thomson Reuters, as of January 31, 2018)
Overview
The broad outlook appears positive for emerging markets, and we believe the recent outperformance is the start of a longer trend. Our favored markets include China, India, Indonesia and Brazil.

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 Brazil Capped ETF (EWZ)
- iShares MSCI China ETF (MCHI)
- iShares MSCI India ETF (INDA)
- iShares MSCI Indonesia ETF (EIDO)

Emerging markets
EM: Commodity vs. non-commodity producers

Key points
- Emerging market (EM) equities have enjoyed a strong rally over the last year, and we believe they still have room to run on the back of synchronized global growth. Unlike past rallies, however, today’s growth drivers are different.
- Growth and tighter oil inventories have also led to higher commodity prices. However, commodity producing EMs have underperformed non-commodity producers. One reason: investors suspect price increases are a temporary phenomenon.
- Equity prices in EM non-commodity countries are largely driven by structural advances in technology, and by domestic growth stories. We continue to favor EM equities, with a preference for China, India, Indonesia and Brazil. Only the latter is a commodity producer.

Market pulse
Emerging market assets have rallied over the past year, outperforming developed markets (DM), on the back of strong earnings growth and synchronized, above-trend global growth. However, unlike the 2003-2007 bull market, when the global economy was similarly in sync and EM assets were outperforming DM assets, today’s growth drivers are dramatically different. China’s insatiable commodity demand from the mid-2000s has rapidly declined as China’s growth continues to slow while the economy has pivoted away from commodity intensive industries and toward tech and consumer-focused areas. Meanwhile, supply-side technological advances, most notably horizontal shale drilling, have weighed on commodities.

Despite these secular challenges, robust global growth and tighter oil inventories have provided a lift to commodity prices, although there has been a pullback recently. However, EM commodity countries have failed to rally in concert with higher commodity prices. Although EM overall has performed well, the non-commodity producing countries have outperformed the commodity producers (see “The new EM”).

The commodity term structure is helpful in understanding the emerging disconnect. Oil, for example, has seen a 50% rally in spot prices since June 2017. However, longer-dated futures prices are unchanged and remain well below historical levels. This shows that commodity markets believe price increases are only a temporary phenomenon and ultimately will move lower. In other words, the markets expect cyclical pricing dynamics to fade over the next several years.

In contrast, equity prices in EM non-commodity countries are largely driven by structural advances in technology, such as in Korea, Taiwan, and China itself, and by domestic growth stories, such as in India and Indonesia. We continue to favor EM equities, with a preference for China, India, Indonesia and Brazil. Only the latter is a commodity producer.
A tale of flows

Flows into exchange traded products appear to show a degree of mistrust in the commodity market’s rally. In the United States, dedicated energy flows were essentially flat in the third quarter of 2017, while fourth quarter 2017—already three months into the oil rally—took in $1.0 billion in ETP flows. In EM, Brazil, China and India continue to dominate single-country inflows, and even here there is a distinct preference for dedicated Chinese tech-focused products. Although Brazil is considered a commodity country here, the inflows are driven by the improving macro backdrop and reform agenda and not as an “EM commodity play.”

Source: Thomson Reuters, as of January 30, 2018. Commodity countries include Brazil, Chile, Colombia, Malaysia, Mexico, Peru, Russia, South Africa. Non-commodity countries include China, India, Indonesia, South Korea, Philippines, Poland, Taiwan, Thailand, Turkey. “EM Commodity Alpha” denotes the relative return between EM commodity countries and EM non-commodity countries. All returns measured in U.S. dollars using respective MSCI country indices. 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.
Overview
It’s a difficult environment for bonds, but we believe that agency mortgage-backed securities offer value relative to other high grade securities such as Treasuries and investment grade credit.

Consider
• iShares MBS ETF (MBB)

Fixed income
Taking a look at mortgages

Key points
• Yields have been steadily rising in recent weeks, but we believe that rates will grind, not spike, higher.
• It’s a difficult environment for bonds, but we believe that agency mortgage-backed securities offer value relative to other high grade securities such as Treasuries and investment grade credit.
• We prefer physical agency MBS pools, which tend to have less prepayment and duration extension risk relative to the more liquid TBA contracts (agency MBS forward contracts).

Market pulse
Interest rates have been steadily rising, with the yield on the 10-year Treasury now above 2.80%. However, the increase has been fairly gradual and we believe that rates will grind higher, not gallop. Accordingly, we believe that agency mortgage-backed securities offer value relative to other high grade securities such as Treasuries and investment grade credit.

Despite the risk of rising interest rates, investors still need diversification and ballast in their portfolios. Agency MBS have been highly correlated with Treasuries and negatively correlated with equities. While investment grade credit spreads are approaching pre-crisis levels, agency MBS are currently trading at yield levels in excess of 70 basis points relative to comparable duration U.S. Treasuries.

True, rising rates are a concern for most fixed income asset classes. However, the Bloomberg Barclays U.S. MBS Index has outperformed the similar duration Bloomberg Barclays U.S. Treasury 3-7 Year Index by 130 basis points since rates began rising last September (though both indexes did experience losses over this period).

That said, the form of MBS exposure matters. Given the current Fed tightening cycle and balance sheet normalization, the highly liquid MBS TBA market (the forward market for MBS) is coming under pressure, with implied financing levels exceeding the return on cash (see accompanying figure) and contract deliverables becoming more adverse given the Fed’s reduced buying activity of these more “cuspy” securities—current coupon MBS that have worse prepayment characteristics. Accordingly, we prefer physical agency MBS pools, which tend to have less prepayment and duration extension risk.
A tale of flows
While fixed income investors are increasingly cautious in the rising rate environment, fund flow data indicated a good start to the year, with $11.5 billion of net inflows into all fixed income exchange traded products in the first four weeks of January.

As inflation expectations rose to the highest level since September 2014, suggested by the premium between regular 10-year Treasury securities over 10-year Treasury Inflation-Protected Securities (TIPS), TIPS ETFs also enjoyed the largest net inflows out of all the fixed income exchange traded products as investors are hedging against inflation risk in their portfolios. Providing liquidity and tax advantages, MBS and municipal ETFs also attracted positive flows.

On the other hand, taxable bonds have suffered the most from rising rate concerns. Both high yield (-$1.6 billion) and investment grade (-$1.5 billion) bond ETPs saw large net outflows in January.
Overview
The low volatility and correlation environment has created challenges for portfolio construction. Historically, factors have offered lower, more consistent correlations and may provide more stable diversification benefits.

Multi-asset insights
Reframing the volatility and correlations trends

Key points
- **The recent burst of volatility is worth examining against a longer-term trend of volatility drifting lower across most asset classes.** While we do not expect the ultra-low volatility of 2017 to be the norm going forward, neither do we expect a regime shift.
- **The market backdrop remains favorable to risk assets, but even after the sell-off valuations are at the higher ends of the range.** Thanks to the growth environment, investors can still consider risky assets like emerging markets, but should similarly consider exposures that have longer-term stable correlations that are less prone to snap-backs.
- **Factor investing strategies may offer more stable diversification benefits since they have historically had relatively low correlations with one another and lower than between sectors or single stocks.** This stability could be useful in forecasting risk budgets in 2018.

Market pulse
Last year, volatility and correlations drifted lower across most asset classes against a backdrop of a synchronized acceleration of global growth. The sustainability of this “drift lower” came into question when global equity markets suffered sharp reversals recently. Still, periodic outbreaks of higher volatility can happen even within low-volatility market regimes. These regimes can be incredibly persistent, and occasional spikes do not suggest the sustainability of such a low volatility regime has ended, given the current growth backdrop. However, as the cycle advances and central bank normalization continues, it also does not necessarily imply markets will return to the unusually low volatility levels seen in 2017. A market regime change would typically require a deterioration in the economy and be accompanied by rising macro volatility. We don’t see that shift at this point.

Although we find the market backdrop to be favorable for risk assets in 2018, the low volatility/correlation environment has pushed valuations toward all-time highs. Even following a brief correction,* they remain closer to fully valued than “cheap” in some areas, including the United States. Investors concerned with elevated valuation levels seen in the current environment should consider diversifying by considering factor strategies, which historically have had relatively low correlations between the different factors, and lower than between sectors and single stocks. This stability could be useful in forecasting risk budgets in 2018.

*To learn more about the recent volatility and ETFs we encourage readers to read Martin Small’s contributions to the BlackRock blog: https://www.blackrockblog.com/2018/02/07/leveraged-etps-vs-etfs/
Figure 9: A spike, not a change in regime
Volatility Feb 2016 - Feb 2018

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.

Source: Thomson Reuters, as of February 6, 2018.

Our View and Outlook

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<th>Global Region</th>
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<th>neutral</th>
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<td>Gold</td>
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- 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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