U.S. iSHARES INVESTMENT STRATEGY

iShares by BlackRock

SPRING 2019

Investment directions

Spring forward

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Once again, spring is near, a time of growth, renewal and restoration. But with concerns over slowing growth, uncertainty around economic and earnings outlooks, and ever-present U.S.-China and European political risks, investors should be prepared for potential spring storms and begin to consider defensive exposures. Our take on the major themes for this quarter:

U.S. equities: The healthy healthcare sector

In an environment of slowing growth and less certain earnings outlooks, the traditional defensive qualities and resilient earnings growth of healthcare stocks are appealing. Plus, valuations broadly look reasonable compared to historical levels. Tactical investors may consider getting more granular with the medical devices industry.

Developed markets: What next for Brexit?

With Theresa May's Brexit plan resoundingly defeated, she must now renegotiate a deal. We believe the United Kingdom is likely to avoid a hard exit with an extension of the March 29 deadline to exit and gain time to draft a passable proposal. But lingering uncertainty is likely to keep U.K. assets under pressure while a deeper slowdown in European and global growth only accentuates the challenges. We remain underweight U.K. and European equities.

Emerging markets: After a bad year, China looking ahead

Although Chinese equities tumbled in 2018, we continue to favor China as well as emerging markets overall. Although trade tensions are likely to persist, we believe frictions will subside in the short run. And we find trade tensions are reasonably priced into Chinese equities. Meanwhile, accommodative policy measures and sustained earnings growth in China could lift investor sentiment.

Fixed income: Ballast matters

In 2018, investors were rightly concerned about duration risk as interest rates rose due to Fed tightening, inflation fears and rising deficits. But during December's equity sell-off, yields fell—long-duration U.S. Treasuries (as measured by the ICE U.S. Treasury 20+ Year Index) returned +5.6%—a stark reminder of the key role bonds can play as a diversifier in a portfolio. We favor holding long-duration Treasuries and highly rated investment grade bonds for this purpose.

Factors: Momentum on defense, divergence in quality

Our outlook for momentum has declined to a moderate overweight; it remains attractive, but its relative strength has markedly weakened from the strong levels seen since fourth quarter 2016. Our outlook for minimum volatility has improved from moderately underweight to moderately overweight this quarter and we have downgraded quality from moderately overweight back to neutral. We remain neutral on value, and underweight size.

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Overview

We continue to prefer the healthcare sector within U.S. equities. Within the sector, the medical devices industry bears watching.

Consider

- iShares U.S. Healthcare ETF (IYH)
- iShares U.S. Medical Devices ETF (IHI)

U.S. equities

The healthy healthcare sector

Key points

- **The healthcare sector has had a healthy start to 2019.** The sector outperformed the rest of the market during December's volatility.
- **We favor healthcare stocks.** In an environment of slowing growth and less certain earnings outlooks, their traditional defensive qualities and resilient earnings growth are appealing. Broadly, valuations look reasonable compared to historical levels.
- **Medical devices is a key industry to watch.** Its considerable momentum, exposure to innovation and significant ETF investor flows are noteworthy. Tactical investors may consider getting more granular with their exposures.

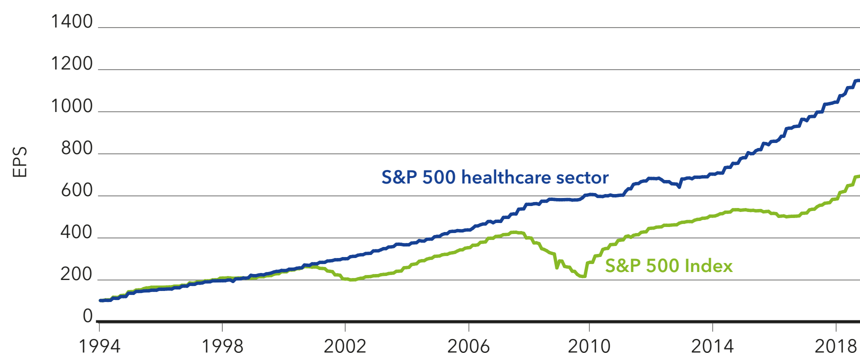
Market pulse

The prospect of a U.S. Federal Reserve on hold from increasing interest rates, along with potential easing of trade tensions, has led U.S. equities to one of their brightest starts in 20 years. Even so, we consider that a focus on late-cycle portfolio resilience—without giving up on seeking gains completely—is warranted. Healthcare stocks appear to fit the bill.

The sector has had the lowest maximum drawdown in the post-crisis expansion of all sectors, and the lowest rate sensitivity among defensives.[1] Meanwhile, healthcare's earnings growth since the early 1990s has outpaced the broad market and been remarkably resilient; demographics and breakthroughs have helped power it through economic downturns (See Figure 1).

Figure 1: Relative value: Trailing 12-month earnings per share (EPS)

Rebased to 100, January 31, 1994 to January 18, 2019



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1 Source: BlackRock Investment Institute with data from Thomson Reuters, as of October 2018, based on analysis of the max drawdown of the S&P 500 Level 1 GICS sectors between 2008-2018, and their correlation to monthly changes in the 10-year U.S. Treasury yield.

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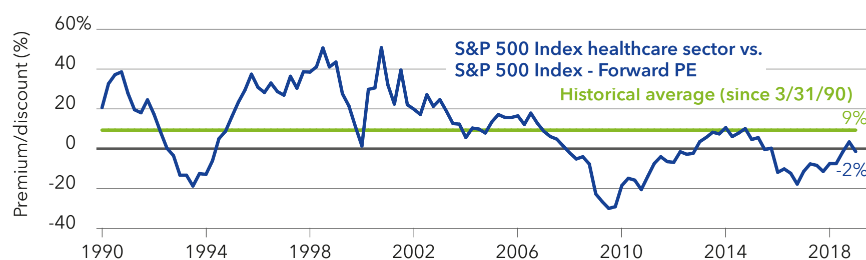
Valuations appear reasonable: The S&P 500 Index healthcare sector currently trades at a slight discount to the S&P 500 Index, lower than the historical average 9% premium for the sector (See Figure 2).

Figure 2: Forward P/E Ratio – S&P 500 healthcare sector vs. S&P 500 Index

March 31, 1990 to January 18, 2019



Source: Bloomberg, as of January 18, 2019. Based on the forward price-to-earnings ratios of the S&P 500 Index healthcare sector relative to the S&P 500 Index. The ratio is calculated by dividing the current price by forward earnings. Forward earnings calculated based on Bloomberg estimates. **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. Index performance does not represent actual iShares fund performance. For actual fund performance, please visit www.iShares.com or www.blackrock.com.**

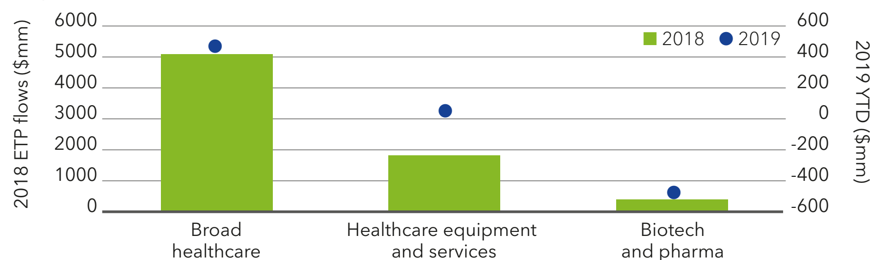
Tactical investors may consider a more targeted approach: Medical devices outperformed the broad sector by 10% over the past year, aided by tax savings, R&D spending driving innovation and international demand—more than 40% of the revenues of companies in the Dow Jones U.S. Select Medical Equipment Index come from overseas.[2]

A tale of flows

Risk-off sentiment toward the end of 2018 catalyzed a divergence in performance between cyclical and defensive sectors. This divergence was also apparent in ETP flows, where defensive sectors saw $12.7 billion of net inflows compared to $17.8 billion of outflows from cyclical U.S. sector ETPs (Source: Markit, BlackRock, as of January 22, 2019).

Within defensive sectors, healthcare was able to gather the most attention. Healthcare sector-focused ETPs attracted $6.2 billion of inflows in 2018 (Source: Markit, BlackRock). Looking under the hood, there was a clear investor preference for broad healthcare and equipment and services healthcare products over the historically more volatile biotech- and pharmaceutical-focused funds. This trend has continued in 2019.

Figure 3: 2018 ETP flows into healthcare sectors



Source: Markit, BlackRock, as of January 22, 2019.

2 Source: BlackRock Aladdin, as of December 31, 2018.

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Overview

With regards to Brexit, the only certainty is uncertainty at this point. We remain underweight both U.K. and European equities.

Consider

- iShares MSCI United Kingdom ETF (EWU)
- iShares MSCI United Kingdom Small-Cap ETF (EWUS)
- iShares MSCI Eurozone ETF (EZU)

Developed market equities

Brexit: What next?

Key points

- **In January, Theresa May's Brexit plan was resoundingly defeated.** May then survived a no confidence vote but must now contend with the opposition and renegotiate a deal.
- **Market reaction has been muted to positive.** U.K. equities have moved in tandem with EU equities while the British pound strengthened, likely reflecting the lower probability that a worst-case, no-deal exit will materialize.
- **We remain underweight both U.K. and European equities.** The market is now looking for the March 29 Brexit deadline to be extended, an option that has received EU and U.K. support. It seems even the non-worst case scenarios call for continued uncertainty.

Market pulse

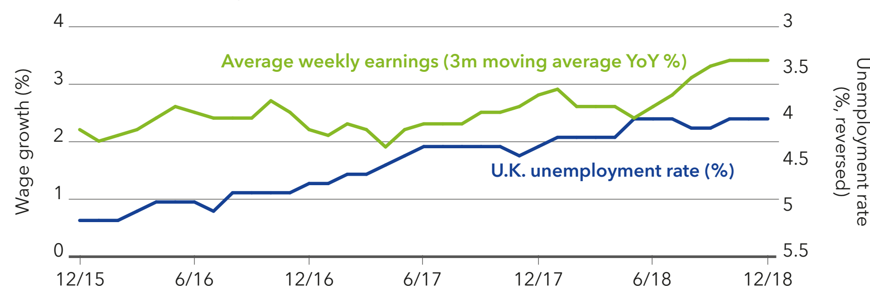
Conservative party members joined the opposition to reject Theresa May's EU withdrawal agreement resoundingly by 432 to 202 on January 15. May's government then survived a no confidence vote by 325 to 306. The only issue where a sufficient majority in Parliament exists is being against a no-deal Brexit (i.e., hard Brexit). That has led many, including Germany, France and even some pro-Brexit U.K. parliament members, to call for an extension of the March 29 exit deadline to avoid a worst-case, no-deal outcome.

U.K. assets have not sold off despite the uncertainty, suggesting a meaningful risk premium is already in place. U.K. equities have moved in tandem with European equities while the British pound has strengthened. In our view, this reflects lower expectations for left-tail risk outcomes—diminishing risks—rather than an outright improvement in the economic outlook.

Political developments ahead of March 29 are critical. February 26 is the proposed deadline for the United Kingdom to extend Article 50. An EU withdrawal bill would then need to be formalized by U.K. and EU parties, followed by trade talks. No matter the outcome, Brexit uncertainty will loom large for some time.

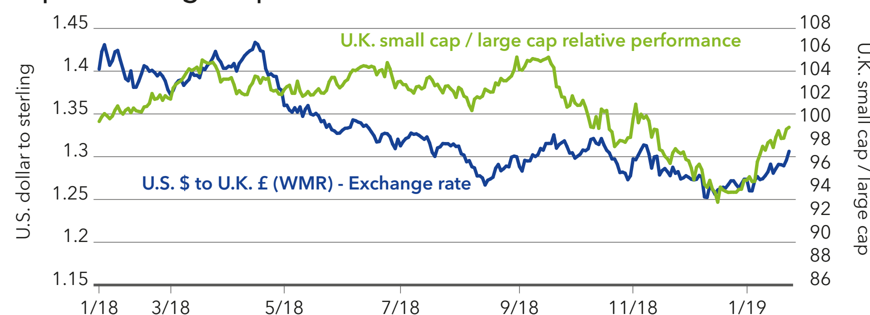
Our base case sees the United Kingdom avoiding a no-deal Brexit, with an extension of the March 29 deadline giving much-needed time to draft a passable exit proposal. But we expect lingering uncertainty to keep U.K. assets under pressure, while a deeper slowdown in European and global growth only accentuates the issues. We remain underweight U.K. and European equities.

Figure 4: Underlying labor data has held up well amid Brexit uncertainty



Source: Thomson Reuters, as of January 24, 2019.

Figure 5: Sterling appreciation may bode well for U.K. small caps over large caps



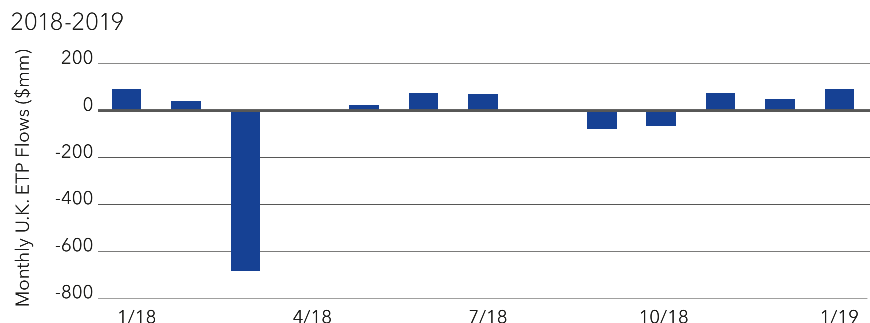
Source: Thomson Reuters, as of January 24, 2019. Based on the MSCI UK Small Cap and MSCI UK Large Cap Indexes.
Index performance is for illustrative purposes only. Index performance does not reflect any management fees, transaction costs or expenses. Indexes are unmanaged and one cannot invest directly in an index. Past performance does not guarantee future results.

A tale of flows

Global ETP flows into U.K. equities have been supportive over the past three months, particularly against the backdrop of large equity outflows from U.S. equities over the same time. Still, these recent inflows fail to account for the sizeable de-risking and shift away from U.K. equities witnessed in March 2018. We expect continued uncertainty to weigh on risk appetite and asset valuations, and keep inflows muted; however, the tepid inflows since March do suggest that market positioning reflects these risks, making any favorable upside surprises—unlikely as they may be—a catalyst that could lead investors to re-establish positions in U.K. equities.

Figure 6: Impact of uncertainty: Monthly U.K. ETP flows

2018-2019



Source: Markit, BlackRock, as of January 22, 2019.

Overview

The sell-off in emerging markets this year has rattled investors. In China, the economic backdrop is encouraging, with near-term resilience and solid corporate earnings. Overall, we remain overweight EM equities, with a preference for EM Asia.

Consider

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

Emerging markets

China: Looking ahead after a rough 2018

Key points

- **We continue to favor China and emerging markets overall.** Although Chinese equities tumbled in 2018, we view the current risk/return profile as quite attractive.
- **Easing trade frictions.** Tensions are likely to persist, but we see frictions subsiding in the short run. And we find trade tensions are reasonably priced into Chinese equities.
- **Looking at policy and earnings.** Accommodative policy measures and sustained earnings growth in China could lift investor sentiment.

Market pulse

The year 2018 was a rough one for China's financial markets. Rattled by an aggressive campaign against high leverage and rising trade frictions with the United States, Chinese equities plunged 18.8%, based on the MSCI China Index as of December 31, 2018, recording one of their worst performances in years. Recent negative surprises in China's macro data highlighted the impact of tariffs on both exports and imports, adding to broader anxiety about a global growth slowdown.

The United States has imposed 10% to 25% tariffs on a total of $250 billion of imports from China and has implemented new rules to restrict China's overseas investments in sensitive U.S. industries such as semiconductors and aircraft (Source: Bloomberg). Last December, however, the United States and China agreed to put further tariff hikes on hold for 90 days while resuming negotiations, offering some respite from a year marked by escalating trade tensions.

While tensions are likely to persist, we see room for frictions to subside in the short run. Both sides have incentives not to escalate the conflict and December's market volatility in the United States has led to wider recognition that trade tensions could hurt domestic business confidence and employment. And Chinese leaders have promised to take targeted measures, such as increasing U.S. soybean imports, in order to mitigate potential trade conflicts.

Progress made on trade—both reducing trade barriers and increasing intellectual property protection—could lead to potential upside surprises in 2019 and may boost Chinese equities. Moreover, with leverage and overcapacity reduced, we see potentially more accommodative measures from Chinese policymakers that could stabilize the economy and support investor sentiment.

Figure 7: Recent Chinese trade slowdown shows negative impact of tariffs

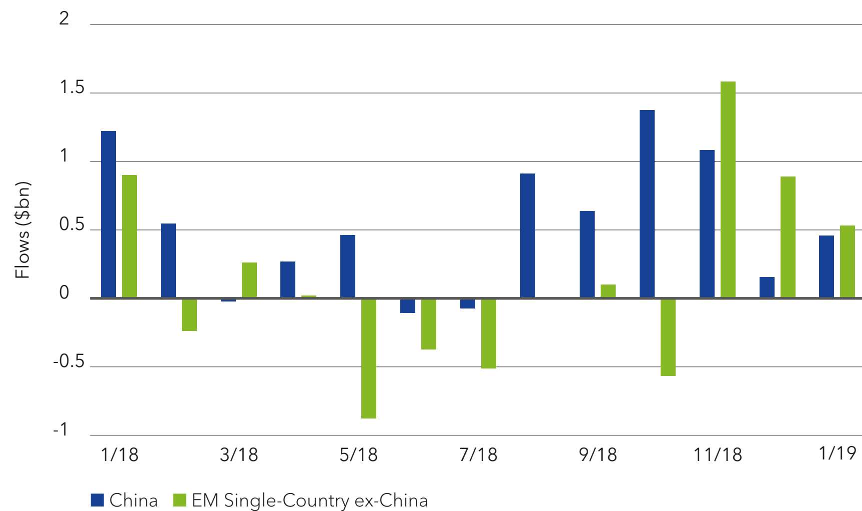
Source: Bloomberg, BlackRock, as of January 15, 2019.

A tale of flows

Despite weakness in Chinese equities throughout 2018, China-focused exchange traded fund products registered record inflows in 2018, gathering more than $6 billion in 2018. That's in stark contrast to the $1.2 billion in inflows across all dedicated-country funds in the EM ex-China universe in 2018 (Source: Markit, BlackRock).

Figure 8 shows dedicated China ETP flows tend to be "stickier" than the aggregate emerging markets (EM) single-country universe. Chinese ETPs experienced inflows in all but three months of last year, compared with six months of outflows for other single-country EM exposures.

Figure 8: Over the last 12 months, China-focused ETPs gathered more inflows than all other single-country exposures combined



Source: Markit, BlackRock, as of January 22, 2019.

Overview

Despite the potential for inflation, stronger growth, Fed tightening and other trends that could impact long-term bonds, they still play a key role as potential ballast in times of equity volatility. We favor holding long-duration Treasuries and highly rated investment grade bonds for this purpose.

Consider

- iShares 20+ Year Treasury Bond ETF (TLT)
- iShares iBoxx $ Investment Grade Corporate Bond ETF (LQD)
- iShares Long-Term Corporate Bond ETF (IGLB)

Fixed income

Bonds as ballast in portfolios

Key points

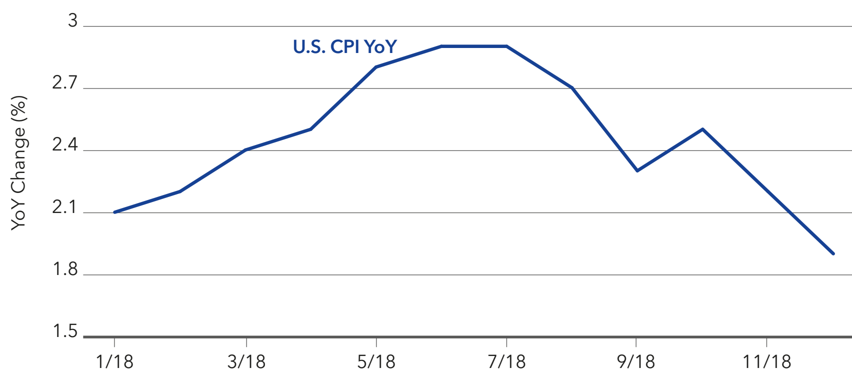
- **Concerns over duration risk.** Investors have been concerned about duration risk as interest rates rose in 2018 due to Fed tightening, inflation fears and rising deficits.
- **Yields fell during December's risk-off environment.** Long-duration U.S. Treasuries (as measured by the ICE U.S. Treasury 20+ Year Index) returned +5.6% in December.
- **Reminder of bonds' role as ballast.** December was a stark reminder of the key role bonds play as a diversifier in a portfolio. We favor holding long-duration Treasuries and highly rated investment grade bonds for this purpose.

Market pulse

For much of 2018, investors reduced duration risk in their fixed income portfolios in response to the potential for rising interest rates driven by a number of factors: the threat of rising inflation, a backdrop of tightening Federal Reserve (Fed) policy, a shrinking Fed balance sheet, and increasing U.S. Treasury supply due to growing deficits.

Indeed, the 10-year U.S. Treasury yield rose from 2.41% on December 29, 2017 to a peak of 3.24% on November 8, 2018 before retracing in December during a strong risk-off environment. However, inflation never materialized. The realized Consumer Price Index over 2018 actually finished at 1.9% in December, down from 2.1% in January.

Figure 9: Headline U.S. CPI in 2018



Source: Bloomberg, as of January 25, 2019.

The events of December 2018, in which U.S. equities (as measured by the S&P 500 Index) sold off by more than 9% and high yield credit spreads widened by more than one percent, reminded investors of the importance of holding high-quality fixed income exposures as ballast against risk assets despite the duration risk. In fact, long-duration U.S. Treasuries (as measured by the ICE U.S. Treasury 20+ Year Index) returned +5.6% in December.

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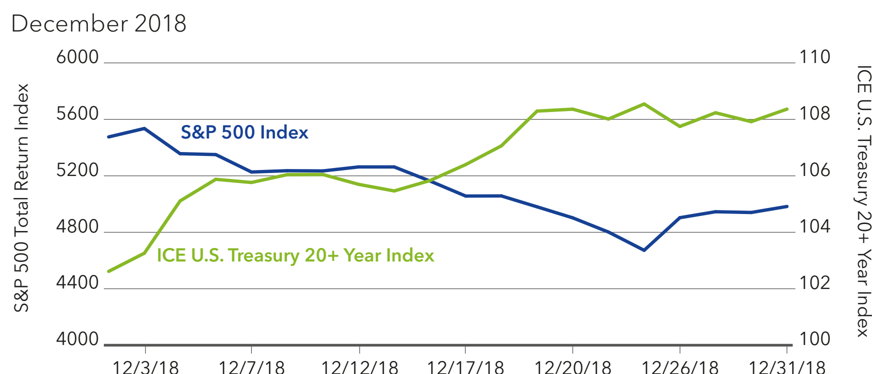
Accordingly, despite a retracement of 10-year Treasury yields back below the 3% level, we believe that portfolio diversification with intermediate- to longer-duration Treasuries or highly rated investment grade corporate bonds would be beneficial in most investors' portfolios.

Figure 10: S&P 500 Total Return Index vs. ICE U.S. Treasury 20+ Year Index

December 2018



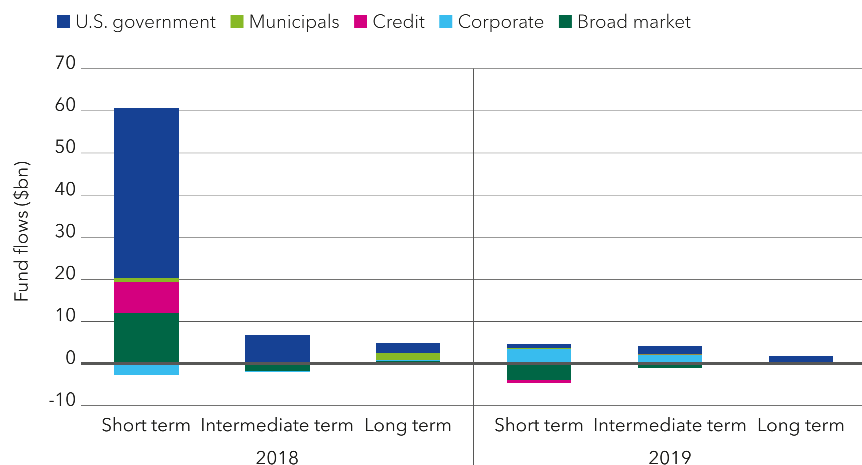
Source: Bloomberg, as of January 25, 2019. **Index performance is for illustrative purposes only. Index performance does not reflect any management fees, transaction costs or expenses. Indexes are unmanaged and one cannot invest directly in an index. Past performance does not guarantee future results.**

A tale of flows

U.S.-listed fixed income ETPs experienced $98 billion of net inflows in 2018 (Source: Markit, BlackRock). Inflows were particularly concentrated in short-duration exposures, not surprising given the rising interest rate environment experienced through most of the year.

However, the direction of benchmark rates reversed course toward the end of 2018 amid a slowdown in growth expectations. Against this backdrop, recent ETP inflows echoed this trend and suggest that investors have grown more comfortable with duration. The start of 2019 witnessed a slight rotation out of shorter-duration broad market exposures while long- and intermediate-term inflows held at relatively high levels on a proportional basis to their 2018 numbers.

Figure 11: Fixed income ETP flows by maturity and asset class in 2018 and 2019



Source: BlackRock, as of January 22, 2019.

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Overview

Tighter financial conditions and elevated concerns about trade frictions between the United States and China spooked investors in the fourth quarter of 2018, and have led to a heightened focus on portfolio resilience across our factor outlook for the first quarter. We favor momentum and minimum volatility in this environment.

Consider

- iShares Edge MSCI USA Quality Factor ETF (QUAL)
- iShares Edge MSCI USA Size Factor ETF (SIZE)
- iShares Edge MSCI USA Momentum Factor ETF (MTUM)
- iShares Edge MSCI USA Value Factor ETF (VLUE)
- iShares Edge MSCI Min Vol USA ETF (USMV)

Q1 factor outlook

Outlook views

- After seven consecutive quarters at a firm overweight, our outlook for momentum has now declined to a moderate overweight.
- Our outlook for minimum volatility has decidedly improved from moderately underweight to moderately overweight this quarter.
- Our outlook for quality has moved back to neutral from moderately overweight last quarter. We remain neutral on value, and underweight size.

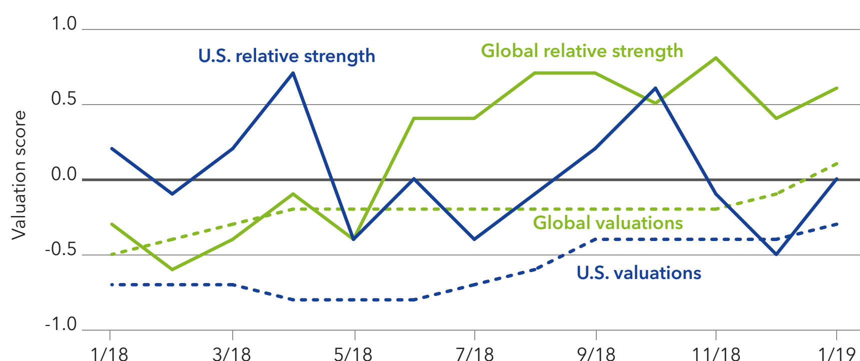
Market pulse: Momentum on defense, divergence in quality

While we advocate for a strategic allocation to all five factors for long-term outperformance and diversification, we have downgraded our short-term outlook for momentum from a firm to moderate overweight. We still hold a positive outlook in this supportive slowdown regime, but have moderated our view due to declining relative strength and rich valuations.

We have upgraded our outlook for minimum volatility to a moderate overweight this quarter for its downside protection in an environment of rising geopolitical and macro uncertainties. (For example, in 2018, the MSCI USA Minimum Volatility Index was up 1.55%, while the S&P 500 Index declined 4.38%.[3]) However, we are neutral on quality in the United States. Quality also exhibits defensive characteristics and has shown resilience in down markets, but is considered a return-seeking factor due to its historical outperformance versus the market. Our view on quality, however, improves when we look outside the United States and expand the scope to global equities, where valuations and relative strength are more supportive.

Figure 12: Regional differences

Relative strength & valuations for US and global quality



Source: MSCI, BlackRock, as of December 31, 2018. U.S. Quality is represented by the MSCI USA Sector Neutral Quality Index. Global Quality is represented by the MSCI World Sector Neutral Quality Index. Valuation scores are based upon one-year forward earnings yield and cash flow-to-price metrics. A score greater than 0 indicates "cheap" while a score less than 0 indicates "expensive". Relative Strength scores are based upon price momentum metrics.

3 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. Index performance does not represent actual iShares Fund performance. For actual fund performance, please visit www.iShares.com or www.blackrock.com.

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Portfolio trends: Notes from the field

The BlackRock Portfolio Solutions team recently analyzed 9,940 models provided by advisors from throughout the industry over the past 12 months. Three main takeaways:

- **Observations from 2018:** Corrections still happen and advisor portfolios were not well positioned for them coming into 2018. Second, cash actually produces yield—even after accounting for inflation.
- **Concerns we are monitoring:** We've seen a consistent overweight of U.S. equities (and the U.S. dollar), underweight of U.S. Treasuries and shorter-duration in fixed income for many years, and higher yields that some feel may justify a cash buildup.
- **Areas to focus on in 2019:** First, to prepare for more potential turbulence in 2019, it is important to build resilient portfolios that are properly diversified. Second, distinguish between "bearish" and "uncertain." For bearish views, consider adding more conservative exposures such as areas in fixed income or minimum volatility. When managing uncertainty, it is important to avoid making large directional bets for both bullish and bearish views.

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/ insights.**

Underweight: Potentially decrease allocation
Neutral: Consider benchmark allocation
Overweight: Potentially increase allocation

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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. 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.

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