BLACKROCK INVESTMENT INSTITUTE

Richard Turnill
Global Chief Investment Strategist

Richard Turnill is BlackRock's Global Chief Investment Strategist. He was previously Chief Investment Strategist for BlackRock's fixed income and active equity businesses, and has also led the Global Equity investment team. Richard started his career at the Bank of England.

Share your feedback at
BlackRockInvestmentInstitute@blackrock.com

Isabelle Mateos y Lago
Chief Multi-Asset Strategist
BlackRock Investment Institute

Kate Moore
Chief Equity Strategist
BlackRock Investment Institute

Jeff Rosenberg
Chief Fixed Income Strategist
BlackRock Investment Institute

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Key points

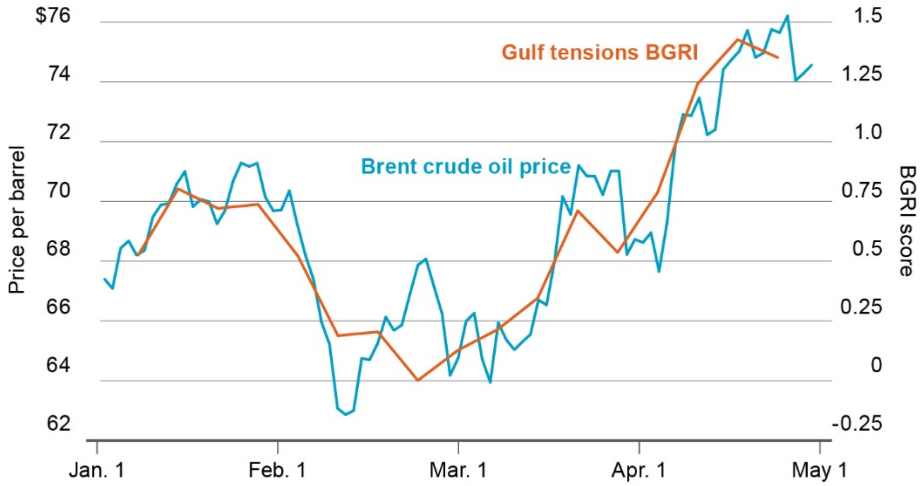
1. The price of oil has surged in 2018, setting crude apart from other assets. For investors seeking exposure, we prefer energy equities to crude itself.
2. The Fed last week reiterated its confidence in the U.S. inflation outlook. The U.S. dollar rose, and Latin American stocks and currencies fell.
3. The U.S. appears unlikely to extend Iranian oil sanction waivers on May 12, which would mean effectively pulling back from the Iran nuclear deal.

1 How to play the oil rally

A rise in Persian Gulf-related geopolitical risks has helped fuel double-digit gains in oil this year. A favorable supply-demand picture has provided additional juice, making oil a top-performing asset class in 2018. For investors seeking exposure to oil now, we see more appeal in energy equities than in the commodity.

Chart of the week

Brent crude oil prices and Gulf tensions BGRI, 2018



Sources: BlackRock Investment Institute, with data from Thomson Reuters, May 2018. Notes: The Gulf tensions BlackRock Geopolitical Risk Indicator (BGRI) is based on continuous text analysis of the Dow Jones Global Newswire and Thomson Reuters Broker Report databases. We calculate the frequency of words that relate to Gulf tensions risk, adjust for sentiment (whether the market focus is couched in relatively more positive or negative sentiment), and then assign a score. A zero score represents the average BGRI level over its history from 2003 up to that point in time. A score of one means the BGRI level is one standard deviation above the average. We weigh recent readings more heavily in calculating the average. BGRI data as of April 27, 2018 and price data as of May 3, 2018.

This year's spike in the oil price coincides with rising concerns about Persian Gulf tensions. This is reflected in a proprietary BlackRock indicator that scrapes the text of broker reports and financial news articles to assess the market's attention to the risk. See the orange line above. Investors today appear to be pricing in potential for supply disruptions if the U.S. does not extend its waivers on Iran oil sanctions – and worries over proxy wars in the Gulf region. This geopolitical risk premium comes amid OPEC production cuts and firming global demand for oil thanks to the global expansion. It also may explain why recent higher oil prices have not been associated with strong performance in other risk assets, a break from the past two years.

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A stronger case for energy equities

We see today's backdrop of heightened Gulf tensions, supply constraints and steady global economic growth persisting. Geopolitical tensions in the Middle East could flare further in the near term, particularly between the U.S. and Iran (see the Week ahead). Oil supply could also tighten if OPEC extends production cuts in June, or Venezuelan production falls further. Yet the rise in oil prices we have seen so far is unlikely to pose a significant drag on the global economy and its impact on core inflation should be minimal, we believe.

For investors seeking exposure to oil today, we see a stronger case for investing in energy equities over crude itself or energy-related debt. Oil prices have run well ahead of energy stocks this year but this trend has started to turn. One factor supporting energy firms: their focus on capital discipline, evident in first-quarter earnings results. Unlike in some past oil market rallies, companies are not making huge investments in future production. Instead, they are using free cash flow to return capital to shareholders via increased buybacks and dividends.

Risks to our view: a hefty drop in oil prices, possibly sparked by a large U.S. shale production boost or falling demand. Oil futures have lagged the rise in spot prices, indicating the supply/demand balance may be more challenged in 2019. Further U.S. dollar gains could also weigh on oil – with a knock-on to related assets – if the historical negative correlation between the dollar and oil prices reasserts itself after a recent breakdown. The good news: Current oil prices offer potential upside for energy companies' earnings and stock prices. Most energy companies have budgeted for mid-$50s oil prices in 2018, with this conservative outlook reflected in share prices today. This points to valuation upside should current levels of oil prices be sustained. In energy equities, we like exploration and production firms and midstream companies. We also see some opportunities in emerging market (EM) energy stocks.

2 Week in review

- Global equities fell modestly before bouncing back. Tech stocks outperformed on strong earnings. The U.S. Dollar Index returned to positive territory year-to-date. UK data disappointed, and the British pound fell vs. the dollar. Eurozone growth came in as expected but inflation data disappointed. European stocks outperformed. The euro slid.
- The Fed kept rates on hold but reiterated confidence in the U.S. inflation outlook. Its preferred inflation measure – the core U.S. PCE index – came in at 1.9% in March. The U.S. jobless rate fell below 4% for the first time since 2000.
- Latin American stocks fell, and a local currency selloff steepened. Argentina's peso slid to an all-time low versus the U.S. dollar, and Argentina's central bank announced a third surprise rate increase in less than a week. Brazil said the U.S. cut off steel tariff talks. China manufacturing PMIs came in marginally better than expected.

Global snapshot

Weekly and 12-month performance of selected assets

Equities	Week	YTD	12 Months	Div. Yield
U.S. Large Caps	-0.2%	-0.4%	11.5%	2.0%
U.S. Small Caps	0.6%	2.3%	14.2%	1.2%
Non-U.S. World	-0.7%	-0.5%	13.9%	3.2%
Non-U.S. Developed	-0.5%	0.2%	12.6%	3.3%
Japan	-0.4%	1.5%	19.0%	2.2%
Emerging	-1.7%	-1.4%	18.5%	2.8%
Asia ex-Japan	-0.8%	-0.7%	20.6%	2.7%

Bonds	Week	YTD	12 Months	Yield
U.S. Treasuries	0.1%	-2.0%	-0.8%	2.9%
U.S. TIPS	0.1%	-1.0%	1.2%	3.0%
U.S. Investment Grade	-0.2%	-3.5%	0.7%	4.0%
U.S. High Yield	-0.1%	-0.3%	3.2%	6.3%
U.S. Municipals	0.6%	-1.0%	2.0%	2.8%
Non-U.S. Developed	-0.9%	0.5%	7.2%	0.9%
EM $ Bonds	-1.3%	-4.3%	0.1%	6.2%

Commodities	Week	YTD	12 Months	Level
Brent Crude Oil	0.3%	12.0%	54.8%	$74.87
Gold	-0.7%	0.9%	7.0%	$1,315
Copper	0.4%	-5.8%	23.1%	$6,826

Currencies	Week	YTD	12 Months	Level
Euro/USD	-1.4%	-0.4%	8.9%	1.20
USD/Yen	0.1%	-3.2%	-3.0%	109.12
Pound/USD	-1.8%	0.1%	4.7%	1.35

Source: Bloomberg. As of May 4, 2018. Notes: Weekly data through Friday. Equity and bond performance are measured in total index returns in U.S. dollars. U.S. large caps are represented by the S&P 500 Index; U.S. small caps are represented by the Russell 2000 Index; non-U.S. world equity by the MSCI ACWI ex U.S.; non-U.S. developed equity by the MSCI EAFE Index; Japan, Emerging and Asia ex-Japan by their respective MSCI indexes; U.S. Treasuries by the Bloomberg Barclays U.S. Treasury Index; U.S. TIPS by the U.S. Treasury Inflation Notes Total Return Index; U.S. investment grade by the Bloomberg Barclays U.S. Corporate Index; U.S. high yield by the Bloomberg Barclays U.S. Corporate High Yield 2% Issuer Capped Index; U.S. municipals by the Bloomberg Barclays Municipal Bond Index; non-U.S. developed bonds by the Bloomberg Barclays Global Aggregate ex USD; and emerging market $ bonds by the JP Morgan EMBI Global Diversified Index. Brent crude oil prices are in U.S. dollars per barrel, gold prices are in U.S. dollar per troy ounce and copper prices are in U.S. dollar per metric ton. The Euro/USD level is represented by U.S. dollar per euro, USD/JPY by yen per U.S. dollar and Pound/USD by U.S. dollar per pound. Index performance is shown for illustrative purposes only. It is not possible to invest directly in an index. Past performance is not indicative of future results.

3 Week ahead

May 7	Germany factory orders
May 8	China trade balance; Germany industrial production
May 9	U.S. Producer Price Index (PPI)
May 10	U.S. Consumer Price Index (CPI); China CPI, PPI; Bank of England monetary policy summary
May 12	Deadline for U.S. to extend Iranian oil sanction waivers

We expect the U.S. to effectively pull back from the international deal that was designed to curb Iran's nuclear ambitions by declining to extend Iranian oil sanction waivers on May 12. Oil sanctions could snap back six months later. Even if other participants (the European Union, Russia and China) stay in the Iran deal, we see the agreement unraveling and contributing to increasing Gulf tensions. The U.S. could re-impose secondary sanctions immediately or not extend current waivers when they expire in July. This could cause European and Asian companies to pull back from doing business with Iran, limiting incentives for Iran to remain in the deal.

Asset class views

Views from a U.S. dollar perspective over a three-month horizon

Asset class		View	Comments
Equities	U.S.	▲	Extraordinarily strong earnings momentum, corporate tax cuts and fiscal stimulus underpin our positive view. We like the momentum and value style factors, as well as financials and technology.
	Europe	—	We see economic expansion and a steady earnings outlook supporting cyclicals. Our neutral stance acknowledges that earnings momentum lags other regions. Euro strength also is a source of pain.
	Japan	▲	Positives are improving global growth, more shareholder-friendly corporate behavior and solid earnings. We see Bank of Japan policy and domestic investor buying as supportive. Further yen strengthening would be a risk.
	EM	▲	Economic reforms, improving corporate fundamentals and reasonable valuations support EM stocks. Above-trend expansion in the developed world is another positive. Risks include a sharp rise in the U.S. dollar, trade tensions and elections. We see the greatest opportunities in EM Asia. We like Brazil and India, and are cautious on Mexico.
	Asia ex-Japan	▲	The economic backdrop is encouraging. China's growth and corporate earnings appear likely to remain solid in the near term. We like selected Southeast Asian markets but recognize a faster-than-expected Chinese slowdown would pose risks to the entire region.
Fixed income	U.S. government bonds	▼	We see rates rising moderately amid economic expansion and Fed normalization. Shorter maturities offer a more compelling risk/reward tradeoff. They and inflation-linked securities can be buffers against rising rates and inflation. We like 15-year mortgages relative to their 30-year counterparts and to short-term corporates.
	U.S. municipals	—	Solid retail investor demand and muted supply are supportive of munis, but rising rates weigh on absolute performance. A more defensive stance is warranted near term, we believe, though any material weakness due to supply may represent a buying opportunity. We favor a barbell approach focused on two- and 20-year maturities.
	U.S. credit	—	Sustained growth supports credit, but high valuations limit upside. We prefer up-in-quality exposures as ballast to equity risk. Higher-quality floating rate instruments and shorter maturities are well positioned for rising rates, in our view.
	European sovereigns	▼	The ECB's negative interest rate policy has made yields unattractive and vulnerable to the improving growth outlook. We expect core eurozone yields to rise. We are cautious on peripherals given tight valuations and the prospect of the ECB reducing its asset purchases.
	European credit	▼	Recent spread widening driven by increased issuance has created some value, while ongoing ECB purchases should support the asset class. Negative rates have crimped absolute yields — but rising rate differentials make currency-hedged positions increasingly attractive for U.S.-dollar investors. Subordinated financial debt looks less compelling versus equities.
	EM debt	—	Gradual Fed rate rises favor local-currency exposures — particularly given their higher yields relative to major bond markets. A shift by EM central banks toward tighter policy reduces our return expectations. We see solid fundamentals and investor inflows limiting EM currency volatility.
	Asia fixed income	—	Regional growth and inflation dynamics are supportive of credit. China's rising representation in the region's bond universe reflects its growing credit market. Higher-quality growth and a focus on financial sector reform are long-term positives, but any China growth slowdown would be a near-term challenge.
Other	Commodities and currencies	*	Declining global crude inventories underpin oil prices, with geopolitical tensions providing further support. We are neutral on the U.S. dollar. Factors driving its recent strengthening are likely temporary, but higher global uncertainty and a widening U.S. yield differential with other economies may provide support.

▲ Overweight — Neutral ▼ Underweight

*Given the breadth of this category, we do not offer a consolidated view.

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