BLACKROCK INVESTMENT INSTITUTE

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Key points

1 We see a modestly higher U.S. dollar ahead. This supports the case for non-U.S. stocks, and we see resilience in emerging market (EM) equities.

2 The Bank of England (BoE) increased rates for the first time in 10 years, and European stocks hit a ten-year high on upbeat eurozone growth data.

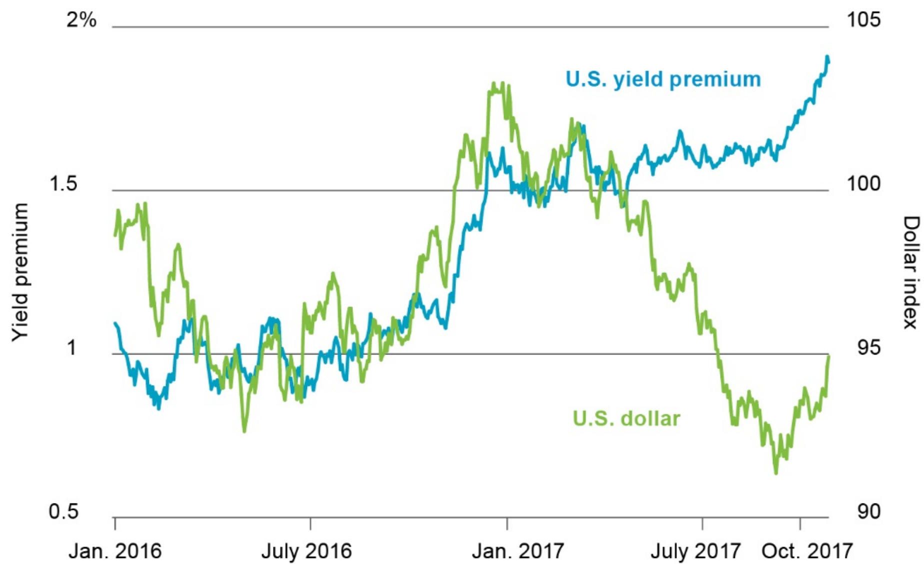
3 U.S. President Trump plans to visit China this week, as part of a multi-country trip in Asia. We expect trade and North Korea will be in focus.

1 Where the U.S. dollar is headed

We see a mildly stronger U.S. dollar (USD) ahead. But we believe many of the asset classes that generally suffer when the USD appreciates – including commodities and most EM assets – will be more resilient this time around.

Chart of the week

U.S. two-year yield premium and U.S. dollar, 2016-2017



Sources: BlackRock Investment Institute, with data from Thomson Reuters, IMF, Bloomberg, November 2017. Notes: The U.S. dollar is based on the U.S. Dollar Index (DXY). The U.S. yield premium is calculated as the U.S. two-year government bond yield minus a composite of two-year eurozone, Japanese and UK yields that are gross domestic product (GDP)-weighted. The premium is shown in percentage points. The eurozone yield is based on an average of German, French and Italian two-year government bond yields.

A key U.S. dollar index has depreciated roughly 7% this year. Some are betting on further declines; speculative short positioning is at three-and-a-half year highs in the futures market. We believe this positioning buildup led to an April break in the usual positive correlation between the USD and the U.S. yield premium over other developed markets. Yet we see the USD's broad uptrend since mid-2014 slowly resuming as monetary policy divergence re-emerges. The Fed is normalizing rates while the European Central Bank and Bank of Japan maintain easier policies, and the positive correlation between the USD and yield premium has returned.

Weathering a stronger dollar

We see a stronger U.S. dollar as the Fed normalizes ahead of its developed market peers and U.S. economic growth shows upside potential. However, we expect the gains to be moderate over the short term, as Fed rate rises will likely be slower than in past cycles given relatively tame U.S. inflation. Our BlackRock Inflation GPS points to U.S. core inflation returning to 2% in six months' time.

Commodities and EM assets have had an inverse correlation to the USD in many historical periods, falling when the USD is stronger and vice versa. But we don't believe a mildly stronger dollar necessarily spells bad news this time around. This is because we see other factors driving these assets' performance. Commodities have rallied and EM equities have outperformed their developed market counterparts over the past month despite a stronger USD. Local EM debt was an exception, with returns dragged down by local currency weakness. Supply-demand fundamentals can also trump the usual negative relationship between commodity prices and the dollar. Oil prices, for instance, neared a 27-month high last week on improving demand and expected supply cuts. Similarly, we see EM equities able to withstand a modestly higher USD amid improving economic conditions, earnings growth and investor sentiment. We see a stronger USD versus the euro and yen supporting equities in the eurozone and Japan, given these stock markets' export-oriented nature. The major risk to our view is a sharper dollar appreciation. U.S. tax reform is a wildcard here: Deficit-financed tax cuts could boost U.S. Treasury issuance and growth, leading to higher interest rates and a more rapid dollar rise.

Bottom line: We believe a modestly higher USD ahead supports the case for favoring eurozone and Japanese equities, and it does not change our preference for EM stocks. Within currencies, we favor the USD to the euro and yen amid monetary policy divergence.

2 Week in review

- The U.S. House of Representatives released its tax reform bill. Homebuilder shares fell, as the plan cuts the mortgage interest deduction to the first $500,000 in mortgage debt. October U.S. jobs growth was weaker than expected.
- The BoE increased rates for the first time in 10 years but indicated the tightening path from here would be very gradual. Markets interpreted this as dovish, sending the pound lower versus the USD. The Fed maintained rates as expected. U.S. President Trump nominated Jerome Powell to succeed Janet Yellen as Fed chair.
- European stocks hit a ten-year high after eurozone third-quarter gross domestic product (GDP) growth surprised to the upside. Eurozone headline and core inflation missed expectations. Japanese stocks extended their strong performance.

Global snapshot

Weekly and 12-month performance of selected assets

Equities	Week	YTD	12 Months	Div. Yield
U.S. Large Caps	0.3%	15.6%	23.9%	1.9%
U.S. Small Caps	-0.9%	11.3%	31.0%	1.2%
Non-U.S. World	1.1%	23.9%	25.6%	2.9%
Non-U.S. Developed	0.9%	22.2%	24.8%	3.1%
Japan	1.0%	21.0%	19.2%	2.0%
Emerging	1.5%	33.1%	30.1%	2.4%
Asia ex-Japan	2.1%	38.6%	33.8%	2.3%

Bonds	Week	YTD	12 Months	Yield
U.S. Treasuries	0.5%	2.3%	-0.6%	2.3%
U.S. TIPS	0.6%	2.1%	0.3%	2.5%
U.S. Investment Grade	0.5%	5.8%	3.7%	3.2%
U.S. High Yield	0.0%	7.4%	9.7%	5.4%
U.S. Municipals	0.2%	5.0%	2.2%	2.3%
Non-U.S. Developed	0.4%	7.6%	-0.4%	0.8%
EM $ Bonds	0.1%	9.2%	6.3%	5.3%

Commodities	Week	YTD	12 Months	Level
Brent Crude Oil	2.7%	9.2%	33.9%	$62.07
Gold	-0.3%	10.7%	-2.5%	$1,270
Copper	1.0%	24.6%	39.0%	$6,895

Currencies	Week	YTD	12 Months	Level
Euro/USD	-1.5%	10.4%	6.5%	1.16
USD/Yen	0.1%	-2.8%	8.0%	113.67
Pound/USD	-0.5%	6.4%	7.9%	1.31

Source: Bloomberg. As of Nov. 3, 2017. 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

Nov. 7-9	Germany industrial production; China foreign exchange reserves, trade data, inflation data
Nov. 8-10	U.S. President Donald Trump in China
Nov. 10	UK industrial production; U.S. consumer sentiment

President Trump will visit China this week as part of a multi-country visit to Asia. We expect the Chinese will seek to have the trip seen as a success, with some short-term steps taken toward managing frictions over trade and North Korea's nuclear program. Longer term, we see the U.S.-China relationship drifting toward greater tensions due to increased economic competition and the inevitable friction of a rising power challenging an established one. Overall, we believe the impact of these tensions on markets will be mostly bilateral.

Asset class views

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

Asset class		View	Comments
Equities	U.S.	—	2017 earnings momentum is strong. Proposed U.S. corporate tax cuts could provide an extra leg up for earnings. We like value, momentum, financials, technology and dividend growers.
	Europe	▲	We see sustained above-trend economic expansion and a steady earnings outlook supporting cyclicals. This year's euro strength is still playing out in company results, but it should become less of a drag, we believe.
	Japan	▲	Positives are improving global growth, more shareholder-friendly corporate behavior and solid earnings amid a stable yen outlook. We see BoJ policy and domestic investor buying as supportive. Yen strength is a risk.
	EM	▲	Economic reforms, improving corporate fundamentals and reasonable valuations support EM stocks. Above-trend global expansion in the developed world is another positive. Risks include a sharp rise in the U.S. dollar, trade tensions and elections. We favor Brazil and India, and are cautious on Mexico.
	Asia ex-Japan	▲	The region's economic backdrop is encouraging. China's economic growth and corporate earnings outlook appear solid in the near term. We like India, China and selected Southeast Asian markets.
Fixed income	U.S. government bonds	▼	Sustained economic expansion challenges nominal bonds. We favor TIPS for the long run after valuations cheapened amid weaker inflation readings. We are neutral on agency mortgages due to current valuations and potential future impacts of the Fed's balance sheet run-off.
	U.S. municipals	—	Income and diversification needs are likely to drive further demand for munis despite an outlook for increased supply in the coming months. We favor maturities of 20+ years for their incremental income benefit.
	U.S. credit	—	Sustained growth is supportive of credit but we are neutral due to tight valuations that skew risks to the downside. We generally prefer up-in-quality exposures within credit. Floating rate bank loans appear to offer insulation from rising rates, but we find them pricey.
	European sovereigns	▼	High valuations and the market's focus on improving economic data make us cautious. The growth outlook should cause core eurozone yields to rise and spreads of semi-core and selected peripheral government bonds to narrow.
	European credit	▼	Ongoing ECB purchases provide key support. The sector's overall tight spreads and relatively unattractive yields are a concern. We see selected subordinated financial debt as a bright spot.
	EM debt	—	We see sustained global growth benefiting EM debt. The asset class tends to perform well in such an environment — even if the Fed is raising rates. We focus on income as high valuations make further capital gains less likely.
	Asia fixed income	—	We like Asian credit given a benign economic backdrop and supportive corporate fundamentals. We favor investment grade credits in China and India due to improving credit trends, and have a selective stance overall on high yield.
Other	Commodities and currencies		Oil prices are underpinned by supply-and-demand rebalancing. The U.S. dollar has scope to strengthen, with the Fed normalizing ahead of its DM peers and potential for U.S. economic upside.

▲ Overweight — Neutral ▼ Underweight

BlackRock Investment Institute

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