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WEEKLY COMMENTARY • JULY 31, 2017

Key points

1. We see many factors supporting industrial metals prices from here but favor a selective approach to metals and mining equities and bonds.
2. The U.S. dollar fell and equity market volatility plumbed lows last week. Many U.S. and Japanese earnings results exceeded expectations.
3. Friday's U.S. wage growth data will be in focus after weak inflation readings and a cautious Federal Reserve outlook.

1 Digging into the metals and mining rally

Industrial metals have rallied on healthy demand and lower supply, and bellwether firms in related sectors have reported upbeat earnings and outlooks. We see stability in commodities prices but are selective in related stocks and bonds.

Chart of the week

Performance of industrial metals and related equities, 2011–2017

Sources: BlackRock Investment Institute, with data from MSCI and Bloomberg, July 2017.
Notes: Metals and mining equities are represented by the MSCI World Metals and Mining Total Return Index. Industrial metals are represented by the Bloomberg Industrial Metals Total Return Index. The lines show the percentage change in these indexes since the start of 2011.

Industrial metals have generally outperformed their commodity peers this year, with copper prices hitting a two-year high last week. A big reason for the rally: Production has been falling from last year's levels. This is a result of firms cutting capital expenditures after multi-year price slides. Related stocks have closely tracked metals prices, as the chart above shows.

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A stable price backdrop

We see signs that reduced supply and increased demand may be more than temporary and are likely to help keep industrial metals prices stable from here. Metals and mining firms have been improving their balance sheets by reducing debt and decreasing investment in additional production capacity. Ongoing supply-side reforms in China, meanwhile, are curtailing overproduction of certain metals.

On the demand side, we see sustained global economic expansion and relatively healthy demand from China providing support. Our base case: Chinese demand growth should slow only gradually as the country rebalances its economy toward consumption. Risks to this supportive backdrop are any re-emergence of value-destructive mergers that have long dogged the sector, as well as escalating trade tensions between the U.S. and China.

The steady price backdrop in metals and mining appears to be reflected in the prices of many related assets. We advocate a neutral stance to metals and mining stocks overall. We do see opportunities in emerging market companies as well as in global firms with robust cash flows and dividend-growth potential. We favor a selective approach to metals and mining companies' debt, with a preference for higher-quality high yield bonds.

2 Week in review

- The VIX index hit a record low amid persistently subdued S&P 500 historical volatility, and the U.S. dollar fell to a 13-month low against a basket of currencies.
- Many U.S. and Japanese firms surprised to the upside on earnings per share, while earnings misses globally triggered sharp individual share price declines. A strengthening euro began to weigh on European earnings estimates.
- The Fed hinted at a September balance-sheet-reduction announcement. The U.S. Employment Cost Index and U.S. gross domestic product (GDP) grew slightly less than expected. Germany's core inflation hit its highest rate since 2008.

Global snapshot

Weekly and 12-month performance of selected assets

Equities	Week	YTD	12 Months	Div. Yield
U.S. Large Caps	0.0%	10.4%	13.9%	2.0%
U.S. Small Caps	-0.4%	6.1%	19.0%	1.2%
Non-U.S. World	0.3%	18.0%	20.3%	3.0%
Non-U.S. Developed	0.2%	16.8%	19.6%	3.2%
Japan	-0.3%	11.8%	17.8%	2.1%
Emerging	0.3%	25.1%	24.2%	2.5%
Asia ex-Japan	0.4%	28.7%	25.6%	2.4%

Bonds	Week	YTD	12 Months	Yield
U.S. Treasuries	-0.3%	2.0%	-2.2%	2.3%
U.S. TIPS	0.1%	1.4%	-0.6%	2.2%
U.S. Investment Grade	-0.3%	4.6%	1.9%	3.1%
U.S. High Yield	0.2%	6.1%	10.8%	5.4%
U.S. Municipals	-0.1%	4.4%	0.3%	2.2%
Non-U.S. Developed	0.4%	8.6%	-1.0%	0.8%
EM $ Bonds	-0.2%	7.0%	5.0%	5.3%

Commodities	Week	YTD	12 Months	Level
Brent Crude Oil	9.3%	-7.6%	23.0%	$52.52
Gold	1.2%	10.6%	-4.9%	$1,270
Copper	5.3%	14.3%	29.2%	$6,325

Currencies	Week	YTD	12 Months	Level
Euro/USD	0.8%	11.7%	6.1%	1.18
USD/Yen	-0.4%	-5.4%	5.1%	110.68
Pound/USD	1.1%	6.5%	-0.2%	1.31

Source: Bloomberg. As of July 28, 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.

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3 Week ahead

July 31	China NBS Manufacturing Purchasing Managers' Index (PMI); eurozone inflation, unemployment rate
Aug. 1	U.S. PCE Price Index, ISM Manufacturing Index, PMI Manufacturing Index; China Caixin Manufacturing PMI; eurozone GDP
Aug. 4	U.S. jobs report

Friday's U.S. payroll report is likely to show the labor market recovery is firmly on track, based on economists' expectations and trends in high-frequency economic data. Wage growth data will be in focus given concerns about recent weaker-than-expected headline inflation. We expect ongoing labor market strength will allow the unemployment rate to march lower by year-end.

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. Fading prospects for tax reform have been largely discounted, leaving room for positive surprises. We like value, momentum, financials, technology and dividend growers.
	Europe	▲	We see sustained above-trend economic expansion and an improving earnings outlook supporting cyclicals and exporters, particularly industrials and multinationals with EM exposures.
	Japan	▲	Positives are improving global growth, more shareholder-friendly corporate behavior and earnings upgrades 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. Sustained above-trend expansion in the developed world are other positives. Risks include sharp changes in currency, trade or other policies.
	Asia ex-Japan	▲	The region's economic backdrop is encouraging. China's economic growth and corporate earnings outlook look 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 falling oil prices and 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	—	Demand for income and diversification are likely to drive further demand for munis despite tightening valuations. We see seasonally weak supply supporting the sector in coming months and favor intermediate to 20+ year maturities.
	U.S. credit	▲	Stronger growth favors credit over Treasuries. We generally prefer up-in-quality exposures and investment grade bonds due to elevated credit market valuations. 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. Waning political risks should cause core eurozone yields to rise and spreads of semi-core and selected peripheral government bonds to narrow.
	European credit	▼	Risks are tilted to the downside amid heady valuations and the possibility of shifting market expectations for central bank support. We are defensive and prefer selected subordinated financial debt.
	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 are focused on income, especially in markets with positive fundamentals such as Indonesia and India. We see a stable near-term cyclical outlook for China but have a selective stance overall amid tightening valuations.
Other	Commodities and currencies		We see oil prices supported as supply-and-demand rebalancing gets underway. We are neutral on the dollar in the near term due to market uncertainty over the pace of central bank normalization.

▲ Overweight — Neutral ▼ Underweight

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