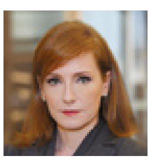
BLACKROCK INVESTMENT INSTITUTE

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 *blackrockinvestments@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

BLACKROCK®

Key points

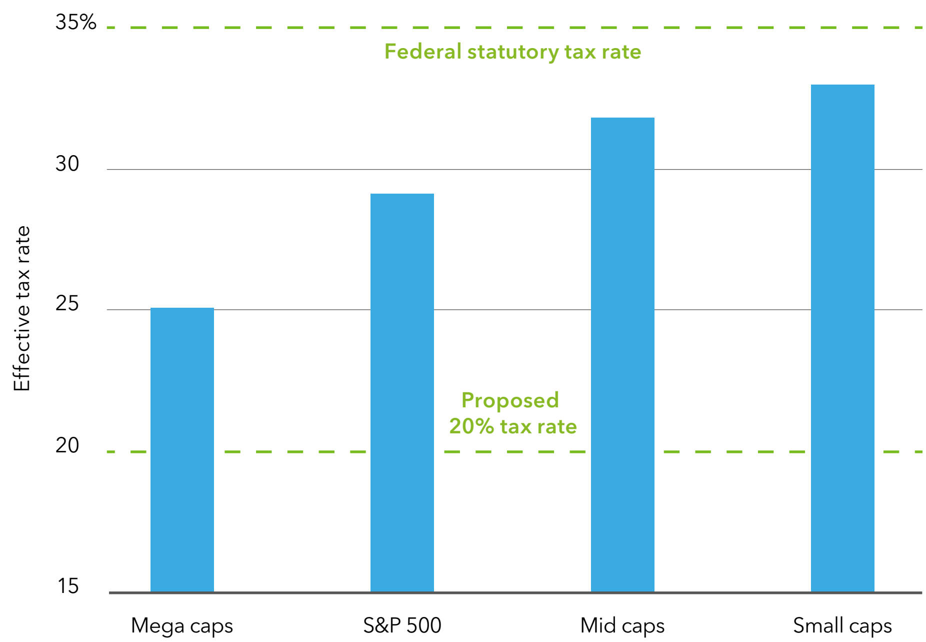
1. U.S. corporate tax reforms could reinforce a reflationary environment already in place before last November.
2. Some "Trump trades" partly unwound early last week, while political uncertainty sent French and Italian bond spreads wider.
3. Fed Chair Janet Yellen's testimony before Congress this week could raise market expectations of a March Fed rate increase.

1 Tax reform and the reflation trade

Our preference for reflation beneficiaries – or assets likely to benefit from rising growth and inflation – isn't contingent on U.S. corporate tax reform. Yet such reform does have the potential to amplify this market theme.

Chart of the week

Median effective U.S. corporate tax rates, 2016



Sources: BlackRock Investment Institute and Bloomberg, February 2017.
Notes: The bars show median effective corporate tax rates based on firms' latest fiscal-year earnings releases. Mega caps are the top-10 largest firms in the S&P 500 as measured by market cap. Mid caps are represented by the Russell Mid Cap Index and small caps by the Russell 2000 Index.

One example: We see reflation supporting more gains in U.S. small cap stocks. They typically outperform during periods of rising rates, as we note in our ***Global Equity Outlook***. Tax cuts would be an extra boost disproportionately benefiting small caps, given those corporations' higher effective tax rates.

Tax reform winners and losers

The reflation trade has waxed and waned since November along with expectations for U.S. tax reform. But any tax reforms this year should only reinforce a reflationary environment already in place before the U.S. presidential election. Significant uncertainty shrouds the final tax plan, and the need to find offsetting revenue means tax reform will create winners and losers.

The border tax adjustment would effectively subject imports to a 20% tax to help pay for any corporate tax cut. Proponents argue the U.S. dollar should rise in response, offsetting the impact on trade or consumer prices. We see only a partial currency adjustment, which could help exporters and hurt retailers and consumers. How the U.S. dollar behaves in such a scenario will be key for markets and the U.S. economy.

We also believe another proposed reform, scrapping the deductibility of interest expense, would ultimately hurt highly leveraged companies and have major implications for how companies finance themselves in capital markets. Without offsetting revenue, large corporate tax cuts would increase the deficit, creating a reflationary stimulus that could lead to higher interest rates. We see potential for volatility in the coming months as more reform details emerge.

2 Week in review

- Some "Trump trades" partly unwound amid policy uncertainty. Emerging market assets outperformed, U.S. Treasury yields fell sharply mid-week and U.S. value stocks underperformed a flat market.
- Political uncertainty sent French and Italian government bond yields to multi-year highs relative to their German peers. Half of the European firms that have reported earnings have beaten estimates.
- Oil fell to a near three-week low under the pressure of growing U.S. crude inventories, but pared some losses. China's PMI data showed expansion in both services and manufacturing sectors.

Global snapshot

Weekly and 12-month performance of selected assets

Equities	Week	YTD	12 Months	Div. Yield
U.S. Large Caps	0.9%	3.5%	25.1%	2.1%
U.S. Small Caps	0.8%	2.4%	46.3%	1.5%
Non-U.S. World	0.3%	4.6%	22.5%	3.1%
Non-U.S. Developed	0.0%	3.5%	18.5%	3.3%
Japan	1.0%	4.4%	24.8%	2.0%
Emerging	1.2%	7.9%	30.3%	2.7%
Asia ex-Japan	1.5%	8.4%	25.3%	2.6%

Bonds	Week	YTD	12 Months	Yield
U.S. Treasuries	0.4%	0.5%	-1.8%	2.4%
U.S. TIPS	0.5%	1.0%	4.0%	2.1%
U.S. Investment Grade	0.5%	0.6%	5.9%	3.3%
U.S. High Yield	0.1%	2.0%	24.5%	5.8%
U.S. Municipals	0.2%	0.9%	-0.5%	2.5%
Non-U.S. Developed	-0.9%	0.9%	-1.9%	0.8%
EM $ Bonds	0.6%	2.7%	14.0%	5.5%

Commodities	Week	YTD	12 Months	Level
Brent Crude Oil	-0.2%	-0.2%	83.9%	$56.70
Gold	1.1%	7.5%	3.0%	$1,234
Copper	5.5%	10.0%	37.0%	$6,090

Currencies	Week	YTD	12 Months	Level
Euro/USD	-1.3%	1.2%	-5.7%	1.06
USD/Yen	0.5%	-3.2%	-0.1%	113.22
Pound/USD	0.1%	1.2%	-14.0%	1.25

Source: Bloomberg. As of Feb. 10, 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

Feb. 13-17 European firms, mainly defensives and financials, report earnings

Feb. 14 U.S. NFIB Small Business Optimism Index; China Consumer Price Index (CPI)

Feb. 14-15 Fed Chair Janet Yellen gives her semiannual monetary policy testimony before Congress

Feb. 15 U.S. retail sales, U.S. CPI

Markets are likely to react to any signals from Yellen regarding a March Federal Reserve rate rise, the odds of which we believe markets may be underpricing. NFIB's report will show if small business owners' economic confidence remains at a 12-year high.

Asset class views

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

Asset class		View	Comments
Equities	U.S.	–	A shift toward fiscal expansion and deregulation are supportive, but uncertainties about the timing and implementation abound. Valuations are elevated. We like value, financials, health care and dividend growers.
	Europe	▲	Signs of global reflation, an improving earnings outlook and a weak euro support cyclicals and exporters. We see near-term political risk as overstated, and an unlikely global slump as the key risk.
	Japan	▲	Positives are a weaker yen, improving global growth and more shareholder-friendly corporate behavior. We see the BoJ anchoring 10-year yields near zero as supportive. Risks are renewed yen strength and rising wages eating into margins.
	EM	▲	Economic reforms, improving corporate fundamentals and reasonable valuations support EM stocks, we believe. Reflation and growth in the developed world are another positive. Risks include shifts in currency policies and trade conflicts.
	Asia ex-Japan	▲	Financial sector reform and rising current account surpluses are encouraging. China's economic transition is ongoing, but we believe lower growth rates are priced in. We like India and selected Southeast Asian markets.
Fixed income	U.S. government bonds	▼	A reflationary outlook challenges longer-term bonds. We favor TIPS over nominal debt. Widening in agency mortgage spreads improves valuations, yet changes to the Fed's reinvestments are a longer-term concern.
	U.S. municipals	–	Higher rates have restored value to the asset class, renewing inflows since the start of the year. We favor the short to intermediate part of the curve ahead of a seasonal period of higher issuance and uncertainty around tax reform.
	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	–	The recent improvement in economic data and underperformance of the sector keep us neutral. Political risks in Italy and France make us cautious on semi-core and peripheral government bonds.
	European credit	–	Elevated valuations keep us neutral. Steepening yield curves and rising bank share prices should bolster the outlook for selected financials, including subordinated debt, but Italian banking sector woes pose a risk.
	EM debt	–	Economic reflation should benefit EMs. Risks include a rising U.S. dollar and global rates, and threats to free trade. Strong post-U.S. election performance versus other risk assets makes us cautious. We still see selected opportunities, mostly in hard-currency debt.
	Asia fixed income	–	Valuations have become less compelling as spreads have compressed along with the recent rise in yields. We are positive on the cyclical outlook for China, but see rising U.S. trade protectionism as a risk.
Other	Commodities and currencies	–	Supply rationalization and reflation are underpinning oil and industrial metals in the near term. We see the U.S. dollar strengthening, especially against the yen and EM currencies, on stronger growth expectations and interest rate differentials.

▲ Overweight – Neutral ▼ Underweight

BlackRock Investment Institute

The ***BlackRock Investment Institute*** (BII) provides connectivity between BlackRock's portfolio managers, originates market research and publishes insights. Our goals are to help our fund managers become better investors and to produce thought-provoking content for clients and policy makers.

BLACKROCK VICE CHAIRMAN
Philipp Hildebrand

GLOBAL CHIEF INVESTMENT STRATEGIST
Richard Turnill

HEAD OF ECONOMIC AND MARKETS RESEARCH
Jean Boivin

EXECUTIVE EDITOR
Jack Reerink

008237A-US1-0217 / BRB-0074

BLACKROCK®