BLACKROCK INVESTMENT INSTITUTE

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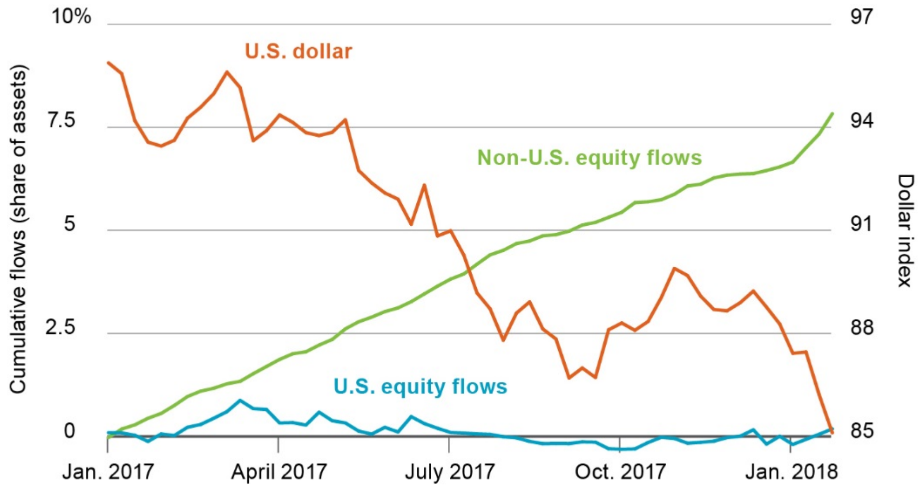
Key points

1. We believe stronger global risk appetite is a key driver behind a weakening U.S. dollar, with yield differentials taking a back seat for now.
2. Global equity markets pulled back last week after an exceptionally strong start of the year. Market volatility rose, and U.S. bond yields climbed.
3. The Bank of England will likely keep policy unchanged this week; focus will be on its 2018 tightening path as it seeks to lower UK inflation.

1 What's driving the U.S. dollar's slide

The U.S. dollar index's slide to three-year lows has caught many off guard, playing out despite interest rate differentials favoring the greenback. Different factors can dominate dollar swings – and higher U.S. yields are taking a back seat, for now, to rekindled risk appetite. We are neutral on the dollar's near-term outlook.

Chart of the week
Equity flows and the U.S. dollar, 2017-2018



Sources: BlackRock Investment Institute, with data from EPFR and the U.S. Federal Reserve, February 2018. Notes: The flows data show the cumulative flows into U.S. and non-U.S. equity mutual funds and exchange traded products as a percentage of starting assets. The U.S. dollar is represented by the Federal Reserve Major Currency Trade Weighted Index.

Foreign exchange (FX) movements can be tricky to predict due to their many drivers and the market's ever-shifting focus. Gauging the direction of the world's reserve currency is especially important given its influence on global trade activity and financial conditions. We thought the widening U.S. yield advantage – the spread between two-year U.S. and eurozone yields last month hit its widest since the euro's birth – would underpin the greenback in early 2018. Yet the dollar has kept sliding, and sizable positions have built up betting on a deeper drop. We find that stronger global risk appetite is playing a big role. Investors are ditching dollar safe havens to chase yield in emerging markets (EM) and returns in global equity markets. See the chart above. We see risk-on rebalancing eventually ending and yield spreads likely taking control again.

A bruised dollar for now

Broadening confidence that the synchronized global expansion – now juiced with U.S. fiscal stimulus – can persist has spurred an embrace of risk assets globally. Our analysis of rolling 12-month periods shows cumulative inflows into non-U.S. funds over the last 12 months were the highest as a percentage of assets under management since June 2014. This portfolio rebalancing fits with our asset preferences based on our outlook for global growth, even if the fast pace of returns has surprised. Another surprise: U.S. equities have outperformed non-U.S. ones year to date, reflecting the risk-on backdrop, tax-related earnings upgrades and a weaker dollar.

Interest rate differentials typically are a good predictor of currency moves, but not this time. Our work shows a breakdown in the U.S. dollar's historical performance relative to the role of U.S. yields against those of G10 economies. Yet if we look at the dollar's performance relative to a broad mix of risk proxies, a positive relationship holds. The dollar-risk appetite link did wobble last week, with the dollar and equity markets both retreating. This shows how quickly these relationships can change. Other recent key U.S. dollar drivers include momentum chasing and a flattening U.S. yield curve not replicated in the eurozone and Japan. One factor unlikely to play a role is the repatriation of U.S. company funds held overseas. Reason: They mostly already sit in U.S. dollar assets.

What could reverse the downtrend? The portfolio rebalancing trend will eventually lose steam. Yield spreads may also reassert control when markets reprice monetary policy expectations, which currently appear too dovish for the Federal Reserve (Fed) and too hawkish for other central banks, in our view. We can't predict the timing of a dollar reversal, but it may not be smooth given that short U.S. dollar positions are the most crowded since September 2017, according to Blackrock's Risk and Quantitative Analysis Team. We don't expect a sustained strong-dollar rally, as rates elsewhere will slowly approach those in the U.S. This is good news for the global economy.

2 Week in review

- Global equity markets pulled back following exceptionally strong start-of-the-year performance, with all global sectors in the red and equity market volatility higher. U.S. 10-year government bond yields climbed to the highest point since 2014 after the U.S. Treasury announced larger auctions, especially for shorter-term Treasury notes.
- U.S. January jobs and wage growth were strong. The Fed maintained policy but suggested further rate increases are ahead. Market expectations for a March Fed move rose. The U.S. saving rate dropped to its lowest level since September 2005. U.S. earnings were on track to post the highest percentage of quarterly positive surprises in years.
- China manufacturing PMIs held at high levels but showed signs of weakness ahead. Japan's industrial production and consumption data came in very strong. The eurozone economy grew the fastest in 2017 since a decade earlier.

Global snapshot

Weekly and 12-month performance of selected assets

Equities	Week	YTD	12 Months	Div. Yield
U.S. Large Caps	-3.8%	3.3%	21.1%	1.9%
U.S. Small Caps	-3.8%	0.8%	15.5%	1.2%
Non-U.S. World	-3.0%	3.9%	27.2%	3.0%
Non-U.S. Developed	-2.7%	3.6%	25.6%	3.2%
Japan	-2.6%	4.9%	26.2%	1.9%
Emerging	-3.3%	6.3%	37.5%	2.6%
Asia ex-Japan	-2.9%	5.7%	40.5%	2.4%

Bonds	Week	YTD	12 Months	Yield
U.S. Treasuries	-0.9%	-2.0%	0.1%	2.8%
U.S. TIPS	-0.9%	-1.6%	0.7%	2.6%
U.S. Investment Grade	-1.0%	-1.8%	4.3%	3.5%
U.S. High Yield	-0.7%	0.2%	6.0%	5.9%
U.S. Municipals	-1.0%	-1.6%	3.1%	2.7%
Non-U.S. Developed	-1.0%	2.2%	10.8%	0.9%
EM $ Bonds	-0.8%	-0.6%	7.6%	5.4%

Commodities	Week	YTD	12 Months	Level
Brent Crude Oil	-2.8%	2.6%	21.3%	$68.58
Gold	-1.2%	2.3%	9.7%	$1,333
Copper	-0.6%	-2.8%	19.7%	$7,045

Currencies	Week	YTD	12 Months	Level
Euro/USD	0.3%	3.8%	15.8%	1.25
USD/Yen	1.5%	-2.2%	-2.3%	110.17
Pound/USD	-0.3%	4.5%	12.7%	1.41

Source: Bloomberg. As of Feb. 5, 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.

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3 Week ahead

Feb. 5	Global services PMI	**Feb. 8**	Bank of England (BoE) policy meeting; U.S. federal funding expires
Feb. 7	Germany industrial production	**Feb. 9**	China inflation data

The BoE is widely expected to keep policy unchanged at its meeting this week and focus will be on the central bank's 2018 tightening path as it seeks to lower UK inflation to a 2% target. BoE Governor Mark Carney last week said slack in the UK economy has been reduced and tackling inflation is the central bank's focus. UK inflation fell to 3% in December and has likely peaked, as the impact of a weaker British pound washes out. The pound recently surged to its highest level versus the U.S. dollar since the mid-2016 Brexit referendum. We see market expectations of 1.5 rate increases from the BoE this year as reasonable given the improving UK economy and broader synchronized global expansion. Markets are 50-50 on the next increase coming in May.

Asset class views

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

Asset class		View	Comments
Equities	U.S.	—	Earnings momentum is strong heading into 2018. U.S. corporate tax cuts should boost earnings. We like the momentum and value style factors, financials, technology and dividend growers.
	Europe	▲	We see sustained above-trend economic expansion and a steady earnings outlook supporting cyclicals. Euro strength is still playing out in company results and could cause more pain.
	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 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, and like Brazil and India. We are cautious on Mexico.
	Asia ex-Japan	▲	The economic backdrop is encouraging. China's growth and corporate earnings appear 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 expect rates to move moderately higher amid a sustained economic expansion and a tightening Fed. Rising inflation and lower valuations give TIPS an edge over nominal Treasuries. We are neutral on agency mortgages, given full valuations and the uncertain effect of the Fed's unwinding its balance sheet.
	U.S. municipals	—	Increased issuance driven by tax reform expectations should reverse in 2018, creating a more supportive supply/demand balance. This, plus solid appetite for tax-exempt income, underpins the asset class. We favor maturities of 0-2 and 20+ years.
	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 appear increasingly well positioned for rising rates.
	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, and spreads of semi-core and selected peripheral government bonds to narrow.
	European credit	▼	Ongoing ECB purchases have compressed spreads across sectors and credit-quality buckets. Negative rates have crimped absolute yields – and rising rate differentials make currency hedged positions increasingly attractive for U.S. dollar investors. Subordinated financial debt is less alluring versus equities after a strong 2017.
	EM debt	—	Gradual Fed rate increases favor local-currency exposures – especially their higher yields relative to major bond markets. A shift by EM central banks towards tighter policy reduces our return expectations. Solid fundamentals and inflows should limit EM currency volatility.
	Asia fixed income	—	Regional growth and inflation dynamics are supportive of credit. China's rising representation in the region's bond landscape 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	*	Oil prices are underpinned by supply-and-demand rebalancing. We are neutral on the U.S. dollar. The factors driving its recent slide are likely temporary, but it's unclear when the U.S. yield differential with other economies will reassert itself as the main driver.

▲ Overweight — Neutral ▼ Underweight

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

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