Outlook & Opportunities in 2009: Framework for Investing

BLACKROCK

Bob Doll

BlackRock Vice Chairman; Global Chief Investment Officer, Equities

Peter Fisher

Co-Head of BlackRock's Fixed Income Portfolio Management Group

The financial market turmoil that started in late 2007 has intensified as economic data continue to disappoint and the ongoing credit crisis shows few signs of abating anytime soon. In response, policymakers in the United States and around the world have employed aggressive policy reflation measures, providing liquidity to the markets and increasing government guarantees and capital injections into the financial system. At the same time, Congress, the Bush administration and President-elect Obama continue to debate and discuss potential fiscal stimulus packages aimed at getting the economy back on track. In the following pages, we attempt to provide some perspective on these events, discuss our outlook for the economy and financial markets, and offer some suggestions for where investors may find value in fixed income and equity markets in 2009.

The Political Backdrop and Fiscal Stimulus Plans

After Barack Obama's victory in the Presidential election, economists and market observers immediately turned their attention to his likely plans for dealing with the troubled economy. Mr. Obama wasted little time in formalizing who will be spearheading economic policy in his administration. The announced team includes Larry Summers, who will head the National Economic Council; Timothy Geithner, who will be nominated to serve as Treasury Secretary; and Peter Orszag, who will serve as director of the Office of Management and Budget. In our opinion, this is a strong and experienced team that has worked together in the past and shares similar economic philosophies. Importantly, this appears to us to be a broadly moderate group of professionals rather than a team of extreme and dissenting views. In particular, Mr. Obama's economic team is not made up of individuals who have a particularly protectionist view toward trade policies, which was a relief to the equity markets. Likewise, this does not appear to be a group that will focus on raising taxes quickly, and indeed, Mr. Obama's recent plans to enact a $300 billion tax cut bears that out.

"In our opinion, this is a strong and experienced team that has worked together in the past and shares similar economic philosophies. Importantly, this appears to us to be a broadly moderate group of professionals rather than a team of extreme and dissenting views."

Looking ahead, we believe investors are likely to focus on the scope and scale of a potential fiscal stimulus package. Mr. Obama has made it clear that one of his first priorities as President will be to enact a broad and far-reaching plan to stimulate the economy. The details are sketchy at present, but it seems likely that the overall fiscal stimulus program will be extremely large — likely totaling somewhere between 3% and 5% of US gross domestic product (GDP), and perhaps more.

"It seems likely that the overall fiscal stimulus program will be extremely large — likely totaling somewhere between 3% and 5% of US gross domestic product, and perhaps more."

Importantly, Mr. Obama has indicated that this will not be a front-loaded package targeting consumer spending, but that his approach will focus more on investment, with spending aimed at areas such as infrastructure and alternative energy — areas where the new administration believes there is a chronic shortfall. As referenced earlier, the stimulus package will also likely include a series of tax cuts and tax credits. Additionally, we believe it is probable that the package will include some sort of block grants to the states, which are suffering from budget shortfalls.

There are a number of important questions about the plan that have not yet been decided—chief among them is the extent to which the stimulus plan will deal with mortgage foreclosures. Congress has been emphasizing that keeping people in their homes should be a central goal of any fiscal stimulus program, but the manner in which this issue will be addressed remains unclear. Additionally, Mr. Obama has indicated that his fiscal stimulus program would be rolled out over a period of two years, so it remains unclear whether some of the elements would be "back loaded" or if all measures would take effect immediately.

Ongoing and Evolving Government Programs

While discussions about President-elect Obama's fiscal stimulus packages are ongoing, there continues to be a great deal of action taking place in terms of new and evolving government policies. At this point, the $700 billion Troubled Asset Relief Program (TARP) has largely shifted focus from its original intent of buying troubled mortgage assets in favor of providing direct equity injections into financial companies. At present, most of the first half of the $700 billion has been allocated, with the remainder likely to be spent by the Obama administration. It is unclear exactly what Mr. Obama intends to do with the remaining $350 billion, but we believe it is likely that the combination of equity infusions and capital purchases will continue. We expect that additional banks will require government infusions as the effects of the credit crisis continue to ripple through the financial system.

"It is unclear exactly what Mr. Obama intends to do with the remaining $350 billion, but we believe it is likely that the combination of equity infusions and capital purchases will continue. We expect that additional banks will require government infusions as the effects of the credit crisis continue to ripple through the financial system."

In other policy news, a significant development in late November involved a new program in which the Federal Reserve will directly buy obligations of the government-sponsored enterprises (GSEs) and GSE-originated mortgage-backed securities. All told, the Fed could purchase nearly $700 billion worth of debt, an amount that equals the size of the TARP. With these purchases, the Fed is now operating directly in the mortgage market and will work to stabilize housing prices and inject additional cash into the financial system, which is key in terms of stabilizing the overall economy. Ultimately, the Fed's actions should reduce the cost and increase the availability of credit for the purchase of homes, which, in turn, should support housing markets and foster improved conditions in financial markets more generally.

"All told, the Fed could purchase nearly $700 billion worth of debt, an amount that equals the size of the TARP. With these purchases, the Fed is now operating directly in the mortgage market and will work to stabilize housing prices and inject additional cash into the financial system, which is key in terms of stabilizing the overall economy."

We have already seen some impact from this new program, as the Fed's debt purchases were a key factor in driving down Treasury yields in recent months. In mid-November, the yield on the 10-year Treasury stood at 3.75% and it quickly dropped to the 2.5% range after the program was announced. Likewise, we have seen mortgage rates drop noticeably in anticipation of the new demand.

Deflation and Federal Reserve Policy

On December 16, the Fed announced a cut in the fed funds target rate from 1% to what the central bank described as a "target range" of between 0% and 0.25%, its lowest level in history. By essentially slashing the rate to zero, the Fed acknowledged that "weak economic conditions are likely to warrant exceptionally low levels of the federal funds rate for some time."

"The Fed's decision is an acknowledgement that attention has shifted from inflationary concerns to the prospects for outright deflation in the United States—a risk that has not been present in almost 50 years. However, we do not expect to see a significant, long-term deflation problem emerge, although deflation expectations will certainly keep investors on edge."

The Fed's decision is an acknowledgement that attention has shifted from inflationary concerns to the prospects for outright deflation in the United States—a risk that has not been present in almost 50 years. In our opinion, the odds are good that inflation will be at or near 0% over the next year or so given the weakness in the economy and the downturn in commodity prices. However, we do not expect to see a significant, long-term deflation problem emerge, although deflation expectations will certainly keep investors on edge.

While the Fed has now run out of traditional ammunition, we believe that quantitative easing measures (in which the Fed injects cash into the financial system by purchasing assets) are more powerful—as can be seen by the immediate impact of the Fed's mortgage-purchase program. Looking ahead, we believe the Fed and other central banks around the world will continue to keep interest rates low and enact quantitative easing measures as they work toward policy reflation. Over the longer term, as the economy begins to recover, low interest rates could begin to trigger inflation pressures, although such concerns seem a long way off in the current environment.

The Economic Outlook

On December 1, the National Bureau of Economic Research (NBER) officially announced what nearly everyone had already come to believe: that the United States had entered into a recession. The start date of the recession was pegged at December 2007, the time at which the NBER believes economic activity had peaked. Recent economic data have been uniformly poor, with the latest reports showing declines in jobs, climbing unemployment, weakening retail sales, a troubled housing market and declining consumer confidence. Business spending and production levels also have been suffering, and we expect businesses to continue paring back expenditures as the cost of credit increases and the prospects for earnings darken. Outside of the United States, the global economy also appears to be in a recession, which has been hurting the once-strong US export sector.

From a historical perspective, over the past 25 years, recessions occurred, on average, once every nine years and were generally quite mild. In the 25 years before then, recessions occurred about once every three years and were deeper. Unfortunately, we expect that the future environment is more likely to mirror the latter scenario. The current recession is highly atypical, which makes forecasting its eventual end more difficult. Most recessions occur due to an unwanted build-up in inventory and/or because of inflation expectations. In these environments, the Fed steps in and raises interest rates, the economy enters into a recession, unwanted inventory is worked off and the economy starts to recover. The current recession, however, was brought about by a credit bust, and it seems we will be living in an environment of restricted credit for some time. In recent recessions or other times of economic slowdown, credit remained available, which helped elevate consumer and business spending. This is not occurring this time around, meaning spending levels are, and will continue to be, more volatile.

Looking ahead, our view is that the fourth quarter of 2008 should be the worst of the current recession, with a decline in real US GDP somewhere in the neighborhood of 5% to 7%. The first half of 2009 is also likely to exhibit negative GDP growth, although probably to a lesser extent. Depending on how well reflation policy takes hold, there is a good chance that we could start to see positive levels of GDP growth in the second half of next year, but we would stress that we are unlikely to see a strong recovery since the effects of deleveraging will be ongoing even after the technical recession is over.

There are some signals investors can look for to determine when the economy is starting to recover. Chief among them are credit spreads. Spreads widened dramatically as credit issues caused a contraction in the lending environment. A sustained narrowing of spreads would indicate that credit issues are receding.

"We believe the Fed and other central banks around the world will continue to keep interest rates low and enact quantitative easing measures as they work toward policy reflation."

"The current recession is highly atypical, which makes forecasting its eventual end more difficult. The current recession was brought about by a credit bust, and it seems we will be living in an environment of restricted credit for some time."

"Looking ahead, our view is that the fourth quarter of 2008 should be the worst of the current recession, with a decline in real US GDP somewhere in the neighborhood of 5% to 7%. The first half of 2009 is also likely to exhibit negative GDP growth, although probably to a lesser extent."

"There are some signals investors can look for to determine when the economy is starting to recover. Chief among them are credit spreads. Similarly, the extent to which the banking system grows will be a good indicator. Finally, from a broader perspective, we await an upturn in durable goods orders."

Similarly, the extent to which the banking system grows will be a good indicator. Currently, bank balance sheets are still shrinking. When bank lending improves, that would be a positive sign. Finally, from a broader perspective, we await an upturn in durable goods orders. Typically, durable goods orders begin rising when the economy starts to improve. We believe this measure will be a better barometer of when the worst has passed than income and employment will be. Employment, in particular, is a lagging indicator, and we would expect to see several months of poor employment reports even after the economy has begun to improve.

Outlook and Opportunities in Fixed Income

From a fixed income perspective, the current environment is, in many ways, the best of times and the worst of times. The reasoning behind the "worst of times" is fairly obvious: The banking system remains deeply troubled, there is a pervasive lack of lending and the economic recession presents a number of risks for nearly all asset classes. The "best of times" scenario plays out in the sense that investors can be well rewarded for taking on risk in the current market.

As noted earlier, the months-long flight to quality that has pushed Treasury yields down to historic lows has resulted in extremely wide credit spreads in nearly every sector of the market, including municipals, investment-grade corporate bonds, mortgage-backed securities and high yield investments. There is, of course, a reason for the wider spreads and higher yields since investors would be taking on risk by investing in spread sectors of the market. Nevertheless, with judicious security selection, we believe value can be found.

We believe the prevailing environment will cause the dispersion within sectors to be greater than the overall dispersion between sectors. There will be winners and losers in every category of fixed income, meaning disciplined credit research will be critical. Overall, we continue to advocate a focus on higher-quality investments. In the midst of a recession, lower-quality investments have been hit the hardest, and we do not believe we have seen the end of that trend.

Within this high quality theme, select corporate bonds look attractive to us. There are companies out there that have the ability to weather the current recession and whose bonds are offering attractive yields. Higher-yield corporate bonds as a whole also are trading at extremely wide spreads, but it may be too early to call a bottom for this sector.

Another area of the market that interests us is the government-guaranteed sector. Agency mortgages (Ginnie Mae in particular) are offering attractive yields and represent a good investment opportunity. We have a similar view toward the financial sector bonds that are now guaranteed by the US government as part of the capital injection programs that have taken place. In both cases, these bonds trade at a premium over Treasuries, but investors should remember that these bonds are significantly less liquid.

Finally, we continue to have a favorable view toward municipal bonds. Municipal yields are attractively high, and despite recent volatility, municipals are supported by a long history as a high quality asset class with low relative volatility, consistency in performance and low default rates. As such, we believe munis continue to represent a good long-term investment. As with our views toward corporate bonds, we would stress that there will be winners and losers among municipal bonds, again suggesting that credit research is critical in this regard. In general, we favor higher quality municipal issuers who will not have to struggle as much in terms of generating revenues.

"Investors can be well rewarded for taking on risk in the current market. The months-long flight to quality that has pushed Treasury yields down to historic lows has resulted in extremely wide credit spreads in nearly every sector of the market, including municipals, investment-grade corporate bonds, mortgage-backed securities and high yield investments."

"Overall, we continue to advocate a focus on higher quality investments."

"Agency mortgages (Ginnie Mae in particular) are offering attractive yields and represent a good investment opportunity."

"Municipal yields are attractively high, and despite recent volatility, municipals are supported by a long history as a high-quality asset class with low relative volatility, consistency in performance and low default rates."

Outlook and Opportunities in Equities

On the whole, quality is key among equities as well. We have been saying for some time that, in the current environment, the most compelling values can be found in higher quality companies that have relatively strong balance sheets, healthy levels of free cash flow and adequate financing. We would point out, however, that over the past few months, we have seen several market rallies, and in each case, lower-quality investments outperformed. To us, this suggests that while our overall bias toward higher quality makes sense at present, investors should be prepared for lower-quality investments to perform well—particularly in times when they become oversold.

From a geographic perspective, we continue to favor overweight positions in US stocks. Policy responses to the credit crisis have been stronger and more rapid in the United States than in other markets, and US stocks tend to have higher earnings predictability and lower volatility compared to most other markets. In particular, we are wary about European markets, where we see less value and where central banks have been slower to respond to the crisis. Conversely, we believe the long-term case for investments in emerging markets remains sound. The recent strong sell-off in these markets has created what we view as attractive relative value.

From a sector positioning standpoint, we prefer a more defensive stance and see healthcare companies as particularly attractive. This sector has relatively good earnings prospects, strong cash flows and is more attractively valued than the traditionally defensive consumer staples and utilities sectors. From a higher-risk perspective, we are finding selective value in some areas of the technology sector, which is relatively cheap when compared to other traditional growth areas of the market. Likewise, energy stocks have experienced a downturn amid declining oil prices, but we believe energy companies remain attractively valued. Finally, we do not believe the worst is over yet for financials, and continue to recommend an underweight position in this sector, although additional sporadic rallies in financials are likely to occur.

Positioning for Recovery

Looking at the big picture, we believe a bottoming and base-building process began on October 10 and continues today. Although stocks sank below their October 10 low in late November, volatility measures were lower then, which supports our view that prices are finding a floor. Based on patterns observed during past recessions, bottoming processes typically last several months. This suggests to us that we are still likely to see some significant back-and-forth movement for stocks and continued sharp volatility.

How, then, should investors position themselves in the current environment? While the downturn to date has been sharp, rapid and difficult to endure, we would encourage investors to remember that history suggests that markets will eventually recover. Throughout history, we have seen a number of significant market declines, but as the accompanying graphic points out, the recoveries that follow these declines tend to last longer and are of a greater scale. While it would be premature to suggest that we are at the beginning of the next broad recovery, those who await clearer signs to get back into the markets run the risk of missing the eventual upswing. With that in mind, then, we would encourage investors who have cash to put to work to employ dollar cost averaging strategies to get back into the markets.

"While our overall bias toward higher quality makes sense at present, investors should be prepared for lower-quality investments to perform well—particularly in times when they become oversold."

"From a geographic perspective, we continue to favor overweight positions in US stocks."

"From a sector positioning standpoint, we prefer a more defensive stance and see healthcare companies as particularly attractive. Likewise, energy stocks have experienced a downturn amid declining oil prices, but we believe energy companies remain attractively valued."

"Looking at the big picture, we believe a bottoming and base-building process began on October 10 and continues today."

"While the downturn to date has been sharp, rapid and difficult to endure, we would encourage investors to remember that history suggests that markets will eventually recover."

"While it would be premature to suggest that we are at the beginning of the next broad recovery, those who await clearer signs to get back into the markets run the risk of missing the eventual upswing. With that in mind, then, we would encourage investors who have cash to put to work to employ dollar cost averaging strategies to get back into the markets."

Market Downturns and Recoveries: 1950 – Present

Dates of Downturn	Duration of Downturn (Months)	Dates of Recovery	Duration of Recovery (Months)	Loss During Downturn (Cumulative % Return)	Gain During Recovery (Cumulative % Return)
8/56 – 2/57	7	3/57 – 7/57	5	-10.4	12.5
8/57 – 12/57	5	1/58 – 7/58	7	-15.0	20.8
1/62 – 6/62	6	7/62 – 4/63	10	-22.3	31.2
2/66 – 9/66	8	10/66 – 3/67	6	-15.7	19.9
12/68 – 6/70	19	7/70 – 3/71	9	-29.2	41.7
1/73 – 9/74	21	10/74 – 6/76	21	-42.7	76.6
1/77 – 2/78	14	3/78 – 7/78	5	-14.4	18.2
12/80 – 7/82	20	8/82 – 10/82	3	-16.5	26.6
9/87 – 11/87	3	12/87 – 5/89	18	-29.6	46.8
6/90 – 10/90	5	11/90 – 2/91	4	-14.5	22.2
7/98 – 8/98	2	9/98 – 11/98	3	-15.4	22.0
9/00 – 9/02	25	10/02 – 10/06	49	-44.7	81.9
Average	11	Average	12	-22.5	34.5

Sources: Morningstar; PSN Enterprise; BlackRock®. Downturns are defined by a time period when the stock market value declined by 10% or more from its peak, while the recovery period indicates the number of months from the trough of downturn to the market's subsequent peak. Performance is represented by the S&P 500 Index, an unmanaged index that consists of the common stocks of 500 large capitalization companies, within various industrial sectors, most of which are listed on the New York Stock Exchange. Past performance is not a guarantee of future performance. It is not possible to directly invest in an index. The data assumes reinvestment of all income and does not account for taxes or transaction costs.

Overall, the economic environment remains a challenging one and deflationary pressures present an ongoing risk to equities. Having said that, however, we would also point out that the approximately 50% drop in stock prices does represent a significant discount to that risk. Our view is that, at this point, we do not actually need to see outright signs of economic improvement. A belief among investors that things are no longer getting worse should be enough to spark a cyclical rally. Our sense is that we are getting close to such an environment, and could see such a rally develop in 2009 on the back of continued aggressive policy reflation.

"A belief among investors that things are no longer getting worse should be enough to spark a cyclical rally. Our sense is that we are getting close to such an environment, and could see such a rally develop in 2009 on the back of continued aggressive policy reflation."

FOR MORE INFORMATION
www.blackrock.com/au

Prepared by BlackRock Investments, Inc., member FINRA.

AC2538-1/2009
SPEC-GCC-RPT-0109

BLACKROCK