

## What's Next for the Global Markets?

Special Market Update

September 27, 2011

It would be an understatement to suggest that the past several weeks have been eventful ones. Markets have remained in a highly volatile trading pattern since early August as investors have become increasingly concerned about the European debt crisis, the weakening US economy and potential actions by policymakers designed to address these problems.

Trying to assess what all of this means for the markets and what investors should do with their portfolios can be challenging. In the following pages, we provide some perspective on current events, discuss our economic and market outlooks and offer some specific investment ideas that investors can implement into their portfolios.

### Europe Remains the Key Risk

The European debt crisis has intensified in recent weeks as the possibility of a Greek default has grown and as contagion fears have been escalating. So far, policymakers in Europe have been taking incremental actions, such as increasing bond purchases through the European Central Bank (ECB), but clearly these actions have been insufficient to stem the crisis.

The divisive political backdrop in Europe has hindered aggressive action. Each country in the Eurozone has its own agenda and interests to consider and it's far from certain that individual countries would be able to come to agreements on their own (e.g., there is a strong resistance to anything perceived as a "bailout" among a large segment of German citizens). Additionally, conversations in Europe have been taking place against a backdrop of a pending change in ECB leadership, which is set for November 1 when current president Jean-Claude Trichet, who is from France, will step down in favor of Mario Draghi, who is from Italy. It is unclear what this leadership change will mean from a policy perspective, but this sort of uncertainty can be unnerving for markets.

In many ways, the best hope for Europe may lie with the potential expansion of the European Financial Stability Facility (EFSF). We believe there is a better-than-even chance that Europe will vote to enhance the EFSF, which could then employ leverage to expand the total pool of capital available to policymakers. Specifically, we expect the EFSF will act in the short-term to insulate some of the larger peripheral European countries (specifically Italy and Spain) from contagion while also attempting to secure some sort of orderly default of Greek debt in the medium-term. We also expect that the ECB will begin lowering interest rates, which could help promote economic growth and ease some of the region's debt pressures.



**Bob Doll**  
Chief Equity Strategist;  
Lead Portfolio Manager, Large Cap Series



**Peter Fisher**  
Global Head of Fixed Income



**Mike Trudel**  
Global Strategist,  
BlackRock Global Allocation Team

*The best hope for Europe may lie with the potential expansion of the European Financial Stability Facility.*

Ultimately, the hope is that the EFSF and ECB will be able to accomplish what European governments have not been able to due to political constraints. The extent to which Europe's policymakers are successful will be critically important in helping to determine the future direction of the world's economy and financial markets.

## US Economy Disappoints, but Recession Still Unlikely

The economic situation in the United States has clearly deteriorated over the past couple of months. The labor market has been stagnant, housing remains weak and the beleaguered US consumer is struggling. Additionally, the United States is facing its own fiscal issues.

Nevertheless, the United States remains in somewhat better shape than Europe. The data is pointing to weak growth, but growth nonetheless. On balance, we believe the economy will continue to "muddle through" at a weak, but still positive, rate. Over the coming quarters, we expect that US growth should be slightly better than the 1% rate it reached in the first half of this year, and while that growth rate could hardly be called robust, growth on the positive side of zero still places the US economy in expansion mode.

On balance, we would peg the odds of a recession occurring in the United States over the next two to three quarters at around one-in-three. Although that figure remains uncomfortably high, it still indicates a greater chance that a recession will not happen. Should the situation in Europe deteriorate further, however, that would certainly push the odds of a US recession higher. In any case, even if a recession were to occur, it would almost certainly be shallower than the recession sparked by the 2008-2009 credit crisis.

*We would peg the odds of a recession occurring in the United States over the next two to three quarters at around one-in-three.*

*The Fed's objective is to further push down long-term rates which, it hopes, will encourage additional lending and prompt investors to take on greater risk in their portfolios.*

## Additional Action From the Federal Reserve

At its regularly scheduled policy meeting last week, the Fed announced its new plan to engage in what is being called "Operation Twist," in which it will shift its balance sheet toward longer-dated assets. The Fed's objective is to further push down long-term rates which, it hopes, will encourage additional lending and prompt investors to take on greater risk in their portfolios.

In taking this action, the central bankers acknowledged that the US economy has weakened. The Fed appears to be particularly concerned with the decline in household balance sheets. The fragility of the situation is what drove the Fed, in August, to make its extraordinary commitment to keep rates low for the next two years. This earlier move helped ensure that short-term rates would remain low; the follow-up decision to purchase longer-dated assets is intended to hold down longer rates as well.

There has been some concern among investors that the Fed's actions will spark a rise in inflation, but we believe such fears are premature. With consumer spending at weak levels and with unemployment so high, the ingredients necessary for a higher inflation environment are simply not present. The Fed is (rightfully, we believe) much more concerned about the prospects for economic growth, and ultimately employment, than it is about inflationary pressures.

## Investment Opportunities: Fixed Income

The investing environment today is one that is dominated by uncertainty, with the Europe situation remaining dominant. These are clearly difficult times for investors, but we believe opportunities can still be found.

From a fixed income perspective, we would stress that this is not a time to be overly aggressive with interest rate risk. Given the economic uncertainty around the globe and the lingering questions over policy direction, it is not inconceivable that interest rates could fall further. If conditions deteriorate and if the European debt crisis becomes more chaotic, we could see yields on the 10-year Treasury fall to the 1.5% level or even lower. Conversely, it is also possible that we could see a steepening of the yield curve if economic data improves and if Europe is able to engineer a more stable outcome. Yields have and will likely continue to trade in a highly volatile fashion, and predicting short-term yield changes in this environment is extremely difficult.

Against this backdrop, we see opportunity and would suggest a focus on municipal bonds. Due in large part to headline noise around municipal defaults and potential changes in tax policy, yields on municipal bonds are equal to, and in some cases above, those of their US Treasury counterparts. This suggests to us that municipal bond fundamentals are extremely attractive.

We also see some opportunities in the investment-grade credit markets, high yield and emerging markets debt. All of these areas of the market come with their own risks, however, and investments in these sectors require careful credit research.

## Investment Opportunities: Equities

Equity markets have been punished by the flight-to-quality trade that has dominated the markets in recent months. Yet, corporate earnings have remained resilient thus far, which suggests equity valuations have become more attractive. The question, of course, is whether markets have reached a bottom, or whether they have further to fall.

On a near-term basis, during times of extreme market volatility (such as what we have seen in recent weeks) technical indicators can be a helpful guidepost. Since the current market volatility began in early August, stocks have been trading between two important levels. The highpoint for the S&P 500 Index appears to be 1,250, which was an important floor for prices before the decline commenced a couple of months ago and now represents an important ceiling. The other level looks to be 1,100, which was the low reached during the height of the panic selling in August. Since that time, markets have tested those two levels, but have not broken through on either the positive or the negative side. Until more clarity emerges around the global economy and policy, we expect to see a fair amount of volatility between these two levels.

As with the direction of the economy and fixed income markets, the future direction of equity prices will be highly dependent on the outcomes for Europe and the US economy. As our view skews to the more optimistic side regarding these issues, we also are retaining our positive long-term outlook for stocks.

Within the United States, we see some significant opportunities in many areas of the market. Given our view that a US recession is unlikely, we find cyclical areas of the market (such as technology and energy) that have seen significant declines to be quite attractive

*From a fixed income perspective, we would stress that this is not a time to be overly aggressive with interest rate risk.*

*Yields on municipal bonds are equal to, and in some cases above, those of their US Treasury counterparts. This suggests to us that municipal bond fundamentals are extremely attractive.*

*We continue to focus on companies with the ability to generate strong levels of free cash flow. Companies that have the ability to raise dividends, buy back stock and make new investments are well positioned.*

— particularly those companies that have decent balance sheets. Additionally, we favor high-quality growth companies. Companies that have the ability to grow their earnings in a weak economy represent a particularly good opportunity; within this theme, we have a favorable view of the healthcare sector. Additionally, we continue to focus on companies with the ability to generate strong levels of free cash flow. Companies that have the ability to raise dividends, buy back stock and make new investments are well positioned.

Outside of the US, our investment themes are quite similar. There are many high-quality companies with attractive valuations and high earnings potential. In particular, we think it makes sense to focus on companies that have access to markets experiencing stronger economic growth (chiefly in emerging markets such as China). As with our preferences within the US, we are focused on companies that generate strong levels of free cash flow. Many companies around the world have robust balance sheets and the ability to return cash to shareholders through dividends, share buybacks, etc. and these companies offer some significant value, in our view.

Finally, we would point out that there are some opportunities available in European markets. Compared to US stocks, European equities have experienced much sharper declines, as these markets have already priced in an economic and financial meltdown. Certainly, this is an area of the market that must be approached cautiously, but we do see some value in select European stocks.

## Managing Through Uncertainty with a Long-Term View

We know that maintaining a long-term focus during times of intense market volatility can be difficult. At times like these, we would encourage investors to remain in close contact with their financial professionals, who can help identify tactical opportunities that may be appropriate for investors' long-term investment plans.

---

**Investment involves risks.** *Stock and bond values fluctuate in price so that the value of your investment may go down. International investing involves additional risks, including risks related to foreign currency, limited liquidity, less government regulation and the possibility of substantial volatility due to adverse political, economic or other developments. The two main risks related to fixed income investing are interest rate risk and credit risk. Typically, when interest rates rise, there is a corresponding decline in the market value of bonds. Credit risk refers to the possibility that the issuer of the bond will not be able to make principal and interest payments. The market for municipal bonds may be less liquid than for taxable bonds.*

*The opinions presented are those of the investment professionals profiled as of September 27, 2011, and may change as subsequent conditions vary. Individual portfolio managers for BlackRock may have opinions and/or make investment decisions that may, in certain respects, not be consistent with the information contained in this report. This is not intended to be relied upon as a forecast, research or investment advice, and is not a recommendation, offer or solicitation to buy or sell any securities or to adopt any investment strategy. Securities mentioned may not necessarily be held in any BlackRock client accounts. The information and opinions contained in this material are derived from proprietary and nonproprietary sources deemed by BlackRock to be reliable, are not necessarily all-inclusive and are not guaranteed as to accuracy. Past Performance is not a reliable indicator of future performance. There is no guarantee that any forecasts made will come to pass. Reliance upon information in this material is at the sole discretion of the reader.*

*This piece may contain forward-looking statements. Forward-looking statements are subject to numerous assumptions, risks and uncertainties, which change over time. Forward-looking statements speak only as of the date they are made, and BlackRock assumes no duty to and does not undertake to update forward-looking statements. BlackRock is not engaged in rendering any tax or legal advice. Please consult with a qualified professional on these matters.*

*Issued in Australia by BlackRock Investment Management (Australia) Limited ABN 13 006 165 975, AFS Licence 230523.*

*This document contains general information only and does not take into account an individual's circumstances and consideration should be given to talking to a financial or other professional adviser before making an investment decision.*

**FOR MORE INFORMATION: [www.blackrock.com](http://www.blackrock.com)**

BlackRock is a registered trademark of BlackRock, Inc. All other trademarks are the property of their respective owners.

Prepared by BlackRock Investments, LLC, member FINRA.

©2011 BlackRock, Inc. All Rights Reserved.

**Not FDIC Insured • May Lose Value • No Bank Guarantee**