JULY 1, 2013

# WEEKLY INVESTMENT COMMENTARY

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## A Look Back: Reviewing Our 2013 Calls

### Some Stock and Bond Surprises

Despite the recent rise in market volatility, stocks finished the first half of 2013 up firmly in double digits, a surprising outcome given the various risks investors faced at the beginning of the year. Since the beginning of the year the Dow Jones Industrial Average has gained 13.8% to reach 14,909, its best performance for the first half of a year since 1999. For the six months, the S&P 500 Index advanced 12.6% to 1,606 and the Nasdaq Composite has risen 12.7% to 3,415. On the other hand, bond yields have risen much more sharply than we expected (prices move in the opposite direction of yields) over that time period, with the benchmark 10-year Treasury rising from 1.76% to close on Friday at 2.49%.

### The Economy Has Performed as Expected (Positive but Sluggish)

Coming into the year, our view was that the US economy would not break out of its doldrums, but would continue its slow growth path as it was held back by higher taxes and lower government spending. We expected growth to be positive but sluggish, at around 2%, and inflation to remain low. The first half pretty much played out that way, with growth coming in for the first quarter at 1.8%, and we expect the second quarter to be similar. Looking forward, we expect a modest acceleration in economic growth toward year's end, but growth will likely continue to be below trend.

Given this backdrop, we were surprised by the recent abrupt spike in interest rates. While we expected interest rates to rise, we were not expecting such a sharp move this early in the year, particularly in light of virtually non-existent inflation. Our view is that in the near term, interest rates may continue to shoot higher, but we believe that there are a number of factors conspiring to keep long-term yields from running too far up. Factors include: short-term rates anchored at zero via the federal funds rate; a dearth of new supply of bond issuance from the private sector; smaller deficits (hence less need for the government to issue bonds); and a persistent demand from institutions and other central banks for quality bonds of any sort. For all these reasons, our assumption is that interest rates end 2013 close to their current levels.

### Stick with Stocks over Bonds but Trim Emerging Markets

In January, we emphasized that stocks were a better investment than bonds given the low rate environment, and suggested that investors lean toward large and mega-cap stocks. Stocks clearly won the first half, trouncing bonds. We believe stocks have more room to run in the second half with valuations still attractive.

Russ Koesterich, Managing Director, is BlackRock's Global Chief Investment Strategist, as well as Global Chief Investment Strategist for BlackRock's iShares business. Mr. Koesterich was previously Global Head of Investment Strategy for active equities and a senior portfolio manager in the US Market Neutral Group. Prior to joining the firm in 2005, he was Chief North American Strategist for State Street Bank.

*For the remainder of the year we continue to emphasize large and mega-cap US stocks.*

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But we believe gains going forward will likely be at a slower pace and with increased volatility. In terms of styles, our calls at the beginning of the year have been a bit of a wash as US large cap names are up roughly 13% year-to-date, but small caps have narrowly outperformed them. For the remainder of the year we continue to emphasize large and mega-cap US stocks and we would suggest a focus on select cyclical sectors, namely energy and technology.

We also called for taking a currency-hedged position in Japanese equities and an overweight to emerging markets. While the Japanese equities positioning was a good call, emerging markets performance this year so far has been a disaster. Emerging markets suffered amid investor concerns about the implications of a possible Fed tapering later this year. So while we like emerging markets stocks as a long-term value investment, for the second half of 2013, we would selectively trim some of our exposure to this area of the market, particularly to Russia and South Africa.

*Going forward, we would continue to emphasize credit over interest rate sensitivity.*

### Within Fixed Income, Emphasize Credit; Underweight Treasuries & TIPS

With regard to our fixed income calls, we were more successful. We emphasized credit over interest-rate sensitivity (duration), focusing on municipals, bank loans, floating rate notes and (for more aggressive investors) high yield. While no segment particularly distinguished itself, high yield, floating rate notes and to a lesser extent municipals have all outperformed Treasuries and TIPS. Going forward, we would continue to emphasize credit over interest rate sensitivity.

### Gold is Looking Risky

Finally, while we came into the year with a view that investors should maintain a benchmark weight to gold, we would now suggest trimming that position. As we've seen in recent weeks, with real (inflation adjusted) interest rates rising, gold is particularly vulnerable.

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