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WEEKLY INVESTMENT COMMENTARY

BLACKROCK®

Where to Turn as Volatility Climbs?

Stocks Tumble on Weaker Data

After getting close to some new records the week before, stocks experienced a downturn last week as investors reacted to negative economic news and to some disappointing earnings reports. For the week, the Dow Jones Industrial Average fell 2.1% to 14,547, the S&P 500 Index also fell 2.1% to 1,555 and the Nasdaq Composite declined 2.7% to 3,206. Fixed income markets were relatively static, with the yield on the benchmark 10-year Treasury falling slightly from 1.72% to 1.70%.

Last week's economic data continued to disappoint, with some regional manufacturing reports showing signs of weakness. Additionally, on Thursday, the Conference Board's index of leading economic indicators fell for the first time since last August, suggesting that the slowdown is likely to continue. While we remain confident that the US economy will continue to grow in 2013, the road ahead will be a tougher one, especially since we will continue to see the effects of the sequester-related spending cuts. We are also starting to see the effects of slower growth reflected in corporate earnings—last week, both Bank of America and IBM reported some disappointing results, which negatively impacted the markets. Even for those companies that are showing improvements in earnings, in most cases earnings growth is coming from cost containment rather than from improved revenues and profits.

Nervous Investors are Becoming Defensive

For much of the past few months, stock market volatility has been relatively muted, but we are finally starting to see that change. The horrific events in Boston contributed to this trend, but even before the bombings occurred investors were reacting to a weak first quarter gross domestic product report from China and signs of slower growth in the United States.

In response to signs of slower growth, investors are starting to become more defensively positioned and are growing more nervous about the state of the markets. One way this can be measured is by looking at the VIX Index, a gauge of stock market volatility that is also known as the "fear index." Until recently, the VIX had been trading close to a multi-year low of 11, signaling widespread complacency. Last week, however, the VIX spiked to 18, which is closer to its historical average.

In the present environment, we would continue to suggest that investors overweight equities, but we also think it makes sense to consider a more defensive portfolio positioning. That said, we would be careful about rotating into classic defensive

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areas of the market such as the utilities and consumer staples sectors, both of which look extremely expensive. We would also be cautious about small cap stocks, which look more vulnerable in times of slower growth and higher volatility. Instead, we would stick with our recommendation to focus on mega-cap stocks (which have recently been outperforming). In fixed income markets, we would also re-emphasize our favorable view toward municipal bonds.

Investors who are holding gold for its diversification benefits and/or as an inflation hedge should continue to do so.

Don't Give up on Gold

Stocks are not the only area of the market that has been more volatile lately. Investors have witnessed a violent selloff in gold prices over the past couple of weeks. From April 9 through April 15, gold fell by more than 17%, although prices have since recovered a bit (the precious metal is now trading around $1,400 per ounce).

In the near-term, we do not have a strong view about the short-term direction of gold prices and cannot say whether gold has hit a bottom. Determining valuation levels for gold is notoriously difficult since gold does not have a cash flow that can be discounted. Additionally, it is hard to assess supply and demand dynamics since there is very little industrial or practical demand for gold.

We do believe, however, that there is some benefit to holding small amounts of gold in a portfolio on a long-term basis. As a physical asset and as a historic store of value, gold remains an important source of diversification since it tends to behave differently than paper assets. Further, gold has historically performed well when interest rates are low, as they are today. To the extent that central banks will be maintaining a stance of accommodative monetary policy, this should be supportive of gold prices. Given this backdrop, our view is that investors who are holding gold for its diversification benefits and/or as an inflation hedge should continue to do so.

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