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WEEKLY INVESTMENT COMMENTARY

BLACKROCK®

Expect Higher Volatility to Persist

Stocks Sink and Bonds Rise as Investor Anxiety Increases

After a rocky first few weeks of the year, equity markets succumbed to rising negative sentiment last week and experienced sharp declines. Most of the media coverage attributed the selloff to market turmoil in emerging markets (EMs), but there were multiple culprits, as we describe below. For the week, the Dow Jones Industrial Average lost 3.5% to close at 15,879, the S&P 500 Index declined 2.6% to 1,790 and the Nasdaq Composite fell 1.6% to 4,128. As stock prices fell, bond prices rose as investors appeared to be seeking out some safe havens. The yield on the 10-year Treasury fell from 2.82% to 2.72% last week (prices move in the opposite direction of yields).

Behind the Selloff: EM Issues, Stretched Valuations and Mediocre Earnings

Some issues coming from emerging markets helped contribute to the broader decline in stocks last week. China reported some surprisingly weak economic data, and financial turmoil in Argentina and Turkey led to a selloff in EM currencies.

While that volatility was a factor, we believe the decline in U.S. stocks also can be attributed to issues closer to home. We have discussed previously that last year's gains were powered primarily by multiple expansion, meaning prices were rising faster than underlying corporate earnings. In fact, 2013 saw the largest single-year increase in market valuations since 1998. As stocks grew more expensive over the last year, bonds became less so. As a result, we have been seeing some investors (notably large institutional investors) shifting more assets into bonds over the past few weeks. This helps explain why bond yields have been declining since the start of the year.

On a related point, corporate earnings so far have been less than stellar for the current reporting cycle. Last year's rally was, to a large extent, based on an act of faith that the economy and corporate earnings would improve, which would, in turn, justify higher stock prices. While the economy does appear to be mending, improvements are modest and so far are not evident in corporate earnings reports.

It is still relatively early in the fourth-quarter reporting season, and to date, the results have been respectable, but hardly inspiring. The percentage of companies that are reporting better-than-expected results is actually below the four-year average, which appears to be frustrating investors. We're seeing this frustration in the form of fund flows: U.S. equity funds have been seeing outflows, while European and global equity funds have been attracting assets.

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 U.S. Market Neutral Group. Prior to joining the firm in 2005, he was Chief North American Strategist for State Street Bank.

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Expect Higher Levels of Volatility; Diversify Internationally

Market volatility in 2013 was unusually low, thanks in large part to the Federal Reserve's extraordinary monetary policies. As the central bank begins its tapering process and is starting to move away from its ultra-easy approach to policy, we expect market volatility to climb to levels that are closer to long-term averages. While we still think stocks will post gains this year, those gains will be accompanied by more ups and downs.

In this environment, we'll echo an investment recommendation we have been making for some time: Diversify into international stocks. We'll point out that during a week where most of the news was negative, Europe surprised to the upside with a surge in manufacturing data. For those investors who have been overly focused on U.S. stocks, we would suggest increasing exposures to international equities—specifically to the other large developed markets of Europe and Japan. In fact, we would recommend overweight positions to both of those regions.

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