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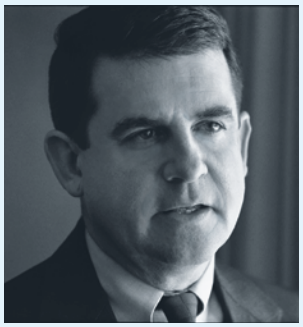
What's Ahead in 2012

An Investment Perspective: Summer Update

Executive Summary

- **Europe Remains Key:** European policymakers need to engage more forcefully to prevent the debt crisis from worsening. *See page 2.*
- **Pending Fed Action?** We are becoming more convinced that the Federal Reserve will again engage in quantitative easing—a positive for risk assets. *See pages 2 and 3.*
- **An Update on Our "10 Predictions for 2012:"** At the midway point of the year, most of our predictions are on track. *See pages 4 and 5.*
- **The Outlook:** The downside risks are dominating conversations, but if (when?) policy direction becomes more transparent, stocks should be poised for a rebound. *See page 6.*
- **So What Do I Do With My Money?™** We offer practical ideas to discuss with your financial professional. *See page 7 for more detail:*
  - *Stay overweight in stocks*
  - *Be on the lookout for free cash flow and dividend growth*
  - *Focus on US stocks*
  - *Consider sectors, styles and market caps*
  - *Expect the risk-on/risk-off pattern to continue—for now*



Bob Doll

Senior Advisor to BlackRock

The Economic and Market Backdrop

By at times appearing reluctant to act, the ECB runs the same risk that it did last summer when it actually increased the refinancing rate in the midst of the crisis. Unwittingly, the bank is sending out the message that it may not fully appreciate the magnitude of the crisis.

How Much Policy Help Can Europe Expect?

If the movements in financial markets so far this year have taught us anything, it's that the direction of the European debt crisis has been, and will almost certainly remain, the key to the outlook. At this point, all eyes are on European policymakers (the European Central Bank in particular) as the world awaits additional action.

Much of the attention is on Greece and whether that country will remain in the eurozone or instead opt for the so-called "Grexit." Although the recent Greek elections have (for now) assuaged those fears, the potential risks of such an exit were only highlighted and remain a frightening prospect for investors. Additionally, recent issues over bank recapitalization remind us that contagion risks for Europe remain very real.

Unfortunately, while the ECB has stepped up its efforts compared to where it was one year ago, the central bank still appears to be dragging its feet. The most recent development (or lack thereof) was the ECB's June decision to not cut the refinancing rate from its current level of 1%. While the central bank could argue that rates were already low, there is a clear perception issue. As the US Federal Reserve has learned, communication and articulating a clear message can be as important as actual policy. By at times appearing reluctant to act, the ECB runs the same risk that it did last summer when it actually increased the refinancing rate in the midst of the crisis. Unwittingly, the bank is sending out the message that it may not fully appreciate the magnitude of the crisis.

There are, however, still steps that the ECB and other policymakers can take in their efforts to stem the crisis. The creation of a new "Eurobond" is looking more and more like a distant possibility, but we still believe that pushing the European Monetary Union toward a closer political and fiscal union remains the right path. Should that occur, it would be good news for risk assets in general and for euro-related risk assets in particular. As has been the case since the debt crisis began, however, there are no quick fixes and perhaps the best we can expect are more agreements that buy policymakers more time.

Although the recent trend of weakening economic data (particularly employment data) has spooked investors and reinforced the notion that the United States has entered an economic soft patch, we do not believe US growth has materially changed trajectory.

US Remains (Relatively) Better Positioned

In contrast to Europe, the US economic backdrop appears fairly benign. Although the recent trend of weakening economic data (particularly employment data) has spooked investors and reinforced the notion that the United States has entered an economic soft patch, we do not believe US growth has materially changed trajectory.

As with Europe, attention in the United States is focused on policy and what it can do to help promote growth. The Fed's recent decision to extend its "Operation Twist" program may have been less than what many were hoping for, but it may pave the way for some additional quantitative easing later this year. Even without factoring in the impact of the problems in the eurozone, domestic growth risks are serious enough that the Fed may be inclined to take some additional action.

Looking ahead, it does seem clear that the United States is losing economic momentum, and this is without even considering the potential fallout of the looming "fiscal cliff." Our prediction is that Congress and the Obama administration will engineer some sort of delay or compromise (likely after the November elections), but regardless of what happens, the fiscal drag will likely be significant in 2013. On balance, we expect the US economy to "muddle through" in the coming quarters, with growth averaging somewhere around the 2% level.

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The Second Quarter by the Numbers

Following a strong (and relatively quiet) first quarter for the financial markets, the second quarter saw a return of volatility as investors again began reacting to the latest developments in Europe and weakening economic data at home. Early in the quarter, a growing sense that stocks had risen too far, too fast was weighing on the markets and, in retrospect, it does appear that stocks had become overdue for a correction. By early June, the selloff in US stocks met the technical definition of a correction when they declined 10% from their April highs. Stocks did manage to stage a bit of a recovery in the last few trading weeks of the quarter, thanks primarily to a growing sense that policymakers in both Europe and the United States were set to engage in additional easing measures.

For the quarter as a whole, stocks suffered a modest loss, but not enough of one to erase the gains made in the first three months of the year. In the United States, the Dow Jones Industrial Average lost 1.9% for the quarter, but is still up 6.8% on a year-to-date basis. Likewise, the S&P 500 Index and Nasdaq Composite fell 2.8% and 4.8% on a quarterly basis, but still held onto gains of 9.5% and 13.2%, respectively, at the mid-year point. Small cap stocks, represented by the Russell 2000 Index, fared slightly worse during the quarter, falling 3.5% (although they, too, are in positive territory for the year, showing gains of 8.5%).

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Outside the United States, results were generally worse. The MSCI World ex-US Indewx declined 7.2% in the second quarter, with losses of 7.6% in Germany, 2.1% in the UK, 10.6% in Japan. Chinese stocks bucked the trend and rose 1.6% in the second quarter (returns expressed in local currencies). Emerging markets as a whole tended to trail, with the MSCI Emerging Markets Index down 8.9% in the quarter.

As uncertainty levels rose, investors moved back into safe-haven government bonds, once again driving yields lower. The yield on the benchmark 10-year US Treasury fell noticeably during the quarter to trade at 1.66% at the end of the June. In this environment, the Barclays Capital US Aggregate Bond Index posted a gain of 2.1%. As has been the case for quite some time, cash investments (as represented by the 3-month Treasury bill) returned a minor fraction over 0% for the quarter, as short-term rates have been and remain exceptionally low.

10 Predictions for 2012:

Although economic and financial conditions worsened during the second quarter compared to the first, our overall macro outlook has not changed and our predictions generally appear to be on track.

1

The European debt crisis begins to ease even as Europe experiences a recession.

The second half of this prediction has already come true, as Europe is mired in a recession. The critical question is whether or not the debt crisis will begin to ease and, obviously, the jury is still out on that one. As we discussed earlier, if progress can be made in terms of promoting a stronger fiscal union, we should see some easing in overall conditions.

2

The US economy continues to muddle through yet again.

We have been calling for a 2% real growth rate in the United States, and that appears to be about where we are. Growth for the first half of the year looks to be slightly below that trend line. We would categorize the current rate of growth as acceptable but not exceptional.

3

Despite slowing growth, China and India contribute more than half of the world's economic growth.

One of the main downside risks we faced coming into this year was the possibility of a hard landing in China. That risk has faded a bit as Chinese policymakers have pushed forward with stimulus measures that have helped orchestrate an orderly economic slowdown. India, in contrast, has weakened more than most expected. That said, given that there is little robust growth anywhere in the world, China and India do appear to be set to generate more than half of the world's growth this year.

4

US earnings grow moderately, but fail to exceed estimates for the first time since the Great Recession.

This is another prediction that appears on track. Earnings have been growing at a solid pace this year, but it does seem that expectations were too lofty at the beginning of 2012. While we expect corporate earnings to remain decent, they are unlikely to surpass expectations this year.

5

Treasury rates rise and quality spreads fall.

At this point, we would score this one as half correct. Notwithstanding a noticeable spike in yields early in the year, Treasury rates are lower now than they were at the beginning of 2012. Spreads over Treasuries for other fixed income assets, however, have fallen as credit sectors of the fixed income market have performed reasonably well.

Our Scorecard So Far

6

US equities experience a double-digit percentage return as multiples rise modestly for the first time since the Great Recession

Price-to-earnings ratios have advanced since the beginning of the year, and should that trend continue, we'll get the second half of this one right. For the first half to be correct, the S&P 500 Index would need to close the year at 1,350 or higher. After a strong last trading day of the second quarter, that's about where we are already, and we think stocks have a good chance of advancing further in the second half of the year.

7

US stocks outperform non-US markets for the third year in a row.

Thanks in large part to solid earnings and strong cash flow yields, US stocks have been outperforming their international counterparts so far in 2012. On a year-to-date basis, US stocks are up close to 10%, while non-US markets have advanced a relatively modest 2.4%. Assuming risk-averse investors continue to view domestic stocks as a defensive play, the United States should continue to benefit.

8

Company dividends and share buybacks hit a record high.

We haven't gotten there yet, but this prediction still has a good shot. Companies are still hoarding extremely high levels of cash and we expect they will continue to deploy that cash in a variety of shareholder-friendly ways.

9

Healthcare and energy outperform utilities and financials.

We are on the wrong side of this prediction at the midway point of the year. The energy sector has been struggling so far this year, while healthcare stocks have been performing slightly better than average. The utilities sector has produced meager returns, but financial stocks have been a bright spot.

10

Republicans capture the Senate, retain the House and defeat President Obama.

This prediction remains a huge wildcard, with questions over the economy, the budget and the looming fiscal cliff likely to decide this year's election results. Regarding Congress, we think there is a better than 50% chance that the Republicans capture the Senate and a much better than 50% chance that they retain the House. At this point, the presidential election looks as if it could go either way.

The Outlook

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It has become clear in recent weeks that the economic, market and policy risks have become skewed toward the downside, but we believe it would be a mistake to overlook the positive forces also present.

In the United States, policy is still easy and may yet become even easier. Additionally, while the US economy does appear to be in the midst of a soft patch, it is still growing and should continue to churn along at a modestly positive pace. Importantly, several leading indicators are pointing in the right direction. Housing permits, which are one of the strongest indicators of future economic activity, appear to be in a period of improvement. The commercial banking system also continues to heal, which is supporting domestic nonfinancial profits, another economic bellwether. Finally, we would point out that the concerns over higher oil and energy prices evident earlier this spring have faded, which has been helping to suppress inflation readings.

Importantly for stocks, most corporations remain in strong shape. Balance sheets are very healthy and cash levels remain high. Companies have been reluctant to spend their cash, but we do expect to see increased spending in the months ahead.

In any case, investors are faced with a high degree of uncertainty and continue to approach the markets with caution. Markets have been seesawing amid the crosscurrents of macro risks and hopes for new (or at least clearer) policy direction. The war between the two will be long and hard fought, but our guess is that the positive forces will eventually win out.

In our view, the downside risks are well established and well known, giving us confidence in our view that valuations for equities are quite compelling.

The macro environment is fraught with risk: The situation in Europe obviously remains troubling, and the pending fiscal cliff in the United States could cause some serious issues. The real question for investors is how much of this risk is already reflected in asset prices. In our view, the downside risks are well established and well known, giving us confidence in our view that valuations for equities are quite compelling. We recognize, however, that policymakers continue to hold the cards and would suggest that policy direction needs to become more transparent before risk assets can resume a stronger uptrend.

So What Do I Do With My Money?

Although risk assets have outperformed on a year-to-date basis, the ride has been anything but smooth, leaving investors highly uncertain about how to position their portfolios. As always, we encourage investors to work with their financial professionals to focus on their long-term objectives and to find tactical investment strategies that work within the context of their long-term plans. Our current preferences follow:

- **Stay overweight in stocks.** The downside risks are clear, but we continue to believe stocks are the best game in town. As long as the world manages to slog along at a positive pace, stocks should outperform in the coming quarters, given the combination of decent earnings, low interest rates and attractive valuations. As such, we would recommend maintaining overweight positions in equities relative to cash and bonds.
- **Be on the lookout for free cash flow and dividend growth.** Our primary equity investment theme for 2012 has not changed. We advocate a focus on ample free cash flow that could allow companies to engage in shareholder-friendly practices. Some argue that the dividend theme is played out, so we would add an important nuance: It is not dividend payments themselves that are attractive, but the quality of those dividends and a company's ability to grow them that investors should seek out.
- **Focus on US stocks.** The first half of the year saw US stocks outperform international markets and we do not see this trend changing at any point soon. At the same time, the long-term case for investments in emerging markets remains intact.
- **Consider sectors, styles and market caps.** We continue to like healthcare and energy and have a less positive view toward financials and utilities. From a style perspective, we have a preference for growth over value, given that economic activity is likely to remain modest. We believe good opportunities can be found across all capitalizations.
- **Expect the risk-on/risk-off pattern to continue—for now.** Macro news and events are likely to continue driving trading patterns for a while, but investors should be prepared for sentiment to eventually improve. When that happens, we would expect to see heightened dispersion between winners and losers, meaning security selection will become more critical.

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Source: BlackRock, Bank Credit Analyst. The opinions presented are those of the author on July 10, 2012, and may change as subsequent conditions vary. Individual portfolio managers for BlackRock may have opinions and/or make investment decisions that, in certain respects, may not be consistent with the information contained in this report. This material 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. 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 does not guarantee future results. 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.

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