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Weekly Investment Commentary

Policymakers and Investors Are on a Razor's Edge

September 4, 2012

Stocks Sink Slightly

Last week featured relatively light trading volume in advance of the unofficial end of summer. The highlights last week included Federal Reserve Chairman Ben Bernanke's much-anticipated Jackson Hole speech (in which he confirmed that the Fed still has some easing options) as well as an upward revision to second-quarter gross domestic product growth (from 1.5% to 1.7%). Despite a rally on Friday, stocks closed the week slightly in the red, with the Dow Jones Industrial Average dropping 0.5% to 13,090, the S&P 500 Index falling 0.3% to 1,406 and the Nasdaq Composite losing a fractional amount to 3,066.

More Action From the Fed?

As last week's GDP revision confirmed, the US economy is still growing, but not at a quick enough pace to bring down the unemployment rate. We have been seeing signs of improved business investment levels, increases in consumer spending and a recovery in the housing market, but the labor market remains troubled and the recent rise in energy prices will weigh on sentiment and spending levels. Additionally, uncertainty over fiscal policy is acting as a drag on the economy. In our view, economic growth is likely to remain modest over the course of 2012 and into 2013 and we continue to expect GDP to grow at around the 2% level.

It was with this backdrop that Ben Bernanke delivered his address at the annual policy symposium at Jackson Hole last week. In his speech, Mr. Bernanke defended the effectiveness of unconventional monetary policies and provided a hint that more easing from the Fed may be forthcoming. The implication of his speech was that there may be a QE3 program in the offing, possibly one that consists of additional purchases of Treasuries and mortgage-backed securities. It is also possible that the Fed could extend its zero-interest-rate forecast beyond 2014. Should the Fed follow through with possible new easing measures, we believe they would provide a boost to the economy but would not materially alter our 2% growth forecast.

Fiscal Problems Remain on the Horizon

In addition to debates over monetary policy, fiscal issues remain in the headlines. At present, the consensus expectation is that politicians in the United States will attempt to hammer out some sort of fiscal policy agreement after the November elections. Although the sides remain far apart and statesmanship is sorely lacking in

Bob Doll is a Senior Advisor to BlackRock®, a premier provider of global investment management, risk management and advisory services. Mr. Doll also formerly served as Chief Equity Strategist for Fundamental Equities and Lead Portfolio Manager of BlackRock's Large Cap Series Funds. Prior to joining the firm, Mr. Doll was President and Chief Investment Officer of Merrill Lynch Investment Managers.

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Washington, DC, we still think there is a better-than-50% chance that we'll see an eleventh- or twelfth-hour agreement to enact a temporary extension of the Bush-era tax cuts and a delay in scheduled spending cuts with real and hopefully long-term action being taken in early 2013.

Outside of the United States, the policy focus over the next several weeks will be in Europe. This Thursday, the European Central Bank (ECB) will meet and expectations are high that ECB President Mario Draghi will clarify plans to purchase distressed bonds and help repair Europe's financial markets. The outlook for Europe remains murky, but we expect that policymakers' pro-growth policies should help the region's economy to recover (although peripheral European countries will likely remain in recession into next year).

The "Muddle Through/Grind Higher" Environment is Likely to Persist

Although there are multiple threats to the world's economy and financial system, global policy has clearly shifted to a trend of reflationary support and we expect that policy actions should help stimulate additional growth in the coming months. On balance, we believe that the cyclical outlook is improving and that the near-term dangers may be receding instead of intensifying. If our outlook is correct, global financial markets may currently be discounting an overly pessimistic economic outlook, suggesting that risk assets may have more room to run.

Much, of course, still depends on policymakers (including politicians) and their ability and willingness to act. Uncertainty levels remain high and we will likely see some setbacks in risk assets should policymakers appear tentative in their actions. Nevertheless, we expect to see the global economy continue to muddle through in its slow growth course. For the markets, we still think risk assets look attractive and believe that stocks should continue to grind unevenly higher. Given better relative economic and earnings growth levels as well as highly accommodative monetary policies, we continue to favor US stocks versus global benchmarks.

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