

AUGUST 26, 2013

WEEKLY INVESTMENT COMMENTARY

BLACKROCK®

Watch Housing: It's Critical (to the Recovery and Markets)

Stock and Bond Markets Remain Volatile

With uncertainty around economic growth and Federal Reserve policy, markets have lurched from one data release to another. The past week was no different, with mixed reports leading to continued volatility in both stock and bond markets. The Dow Jones Industrial Average declined for a third consecutive week, down 0.5% to 15,010. Meanwhile, the S&P 500 Index inched up 0.5% to 1,663 and the Nasdaq Composite advanced 1.5% to end the week at 3,657. Medium-term interest rates hit another multi-year high last week before pulling back on Friday. The yield on the 10-year US Treasury note climbed above 2.90%, its highest level since July of 2011, but ended the week roughly where it started at 2.82%.

Rising Rates Threaten Housing... and the Economy

As interest rates have climbed, mortgage rates have followed suit. The cost of a 30-year conventional mortgage is now at about 4.7%, up from 3.6% in early May, and the monthly mortgage payment on a median US house has increased roughly \$200 during the same period. As rates (and mortgage costs) have risen, mortgage and home sales activity has started to falter. A recent Mortgage Banker Association survey shows loan activity down by more than 50% from a May peak, and on Friday, the market learned that new-home sales plunged 13.4% in July, the biggest drop in three years.

The bond market quickly took notice of the drop in new-home sales. Bond prices rallied and yields fell following the news, a tacit acknowledgement of how critical the housing market is to the broader recovery. Indeed, if steeply rising rates cause the housing market to roll over, the economy is likely to go with it.

Housing is important in that it drives jobs and new construction, but perhaps more significantly because higher home prices have been a big factor supporting consumer confidence and consumption. As the US economy is roughly 70% consumption-driven, that confidence is crucial. So even in the absence of higher disposable income, consumers have been more inclined to spend as their "paper wealth" has increased (underpinned by a higher home value), a phenomenon known as the "wealth effect."



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.

If steeply rising rates cause the housing market to roll over, the economy is likely to go with it.

SO WHAT DO I DO
WITH MY MONEY?

It's the question on everyone's mind. And fortunately, there are answers. Visit blackrock.com for more information.

The Faster Rates Rise, the Larger the Threat

Our baseline view is that investors have mostly factored in an autumn reduction in Fed bond buying (so-called “tapering”), and that the majority of the near-term adjustment in interest rates has already taken place. The Fed knows the recovery is still tepid, and higher rates will slow it further. If higher yields start to impede the recovery, it would put pressure on the Fed to maintain or even increase accommodation.

But there is the risk of rates rising faster than expected. Retail investors are becoming increasingly frustrated with bonds. Last week marked the fourth straight week of fixed income outflows, with investors selling over \$7 billion in bond funds. If investors grow even more aggressive in selling their bond funds, long-term rates could breach 3% for a prolonged period, endangering the housing market and the economic recovery.

Expect More Volatility, Stick With Stocks

In the near-term, uncertainty around the timing of the Fed’s tapering and the direction of economic data is likely to lead to broad-based financial market volatility. But assuming inflation stays muted and the rise in interest rates gradual, stocks appear better positioned to weather this backdrop. Of course, selectivity is key. There are segments of the equity market that are vulnerable. In the past we’ve spoken about utilities. Another example is consumer discretionary companies, particularly those tied to the housing market. It’s worth highlighting that an index of home builders is down roughly 30% from its May highs.

Scheduling note: *The weekly commentary will not be published next week (September 2) due to the Labor Day holiday in the US. The next commentary will appear on Monday, September 9.*

If investors grow even more aggressive in selling their bond funds, long-term rates could breach 3% for a prolonged period, endangering the housing market and the economic recovery.

Visit www.blackrock.com

For additional information, or to subscribe to weekly updates to this piece.

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 opinions expressed are as of August 26, 2013, and may change as subsequent conditions vary. 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 is no guarantee of 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. Investment involves risks. International investing involves additional risks, including risks related to foreign currency, limited liquidity, less government regulation and the possibility of substantial volatility due to adverse political, economic or other developments. The two main risks related to fixed income investing are interest rate risk and credit risk. Typically, when interest rates rise, there is a corresponding decline in the market value of bonds. Credit risk refers to the possibility that the issuer of the bond will not be able to make principal and interest payments. Index performance is shown for illustrative purposes only. You cannot invest directly in an index.

FOR MORE INFORMATION: www.blackrock.com

©2013 BlackRock, Inc. All Rights Reserved. BLACKROCK, BLACKROCK SOLUTIONS, iSHARES and SO WHAT DO I DO WITH MY MONEY are registered and unregistered trademarks of BlackRock, Inc. or its subsidiaries in the United States and elsewhere. All other trademarks are those of their respective owners.

Prepared by BlackRock Investments, LLC, member FINRA.

Not FDIC Insured • May Lose Value • No Bank Guarantee

AC6646-0813 / USR-2690

