DECEMBER 31, 2012

# WEEKLY INVESTMENT COMMENTARY

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## Outlook 2013: Fiscal Cliff Remains Unresolved, but Opportunities Still Exist

### Fiscal Cliff (Still) Hanging in the Balance

As we look ahead to 2013, it is impossible to make any sort of forecast without first turning our attention to the still-unresolved fiscal cliff debate. We have long said that unless we were to see significant movement on the issues of tax rates and entitlement spending, the most likely outcome would be some sort of bare-bones deal. At the time of this writing, Congress and the President were still negotiating, but our analysis suggests that such a bare-bones resolution remains the most probable result, even if it does not come before the January 1 deadline.

While even a small, stop-gap agreement would be better than nothing, a limited compromise is likely to have a modest short-term negative impact on the economy and financial markets for several reasons. First, a limited deal will almost certainly include some significant tax increases and spending cuts, which implies at least some drag on the economy. Second, any delay in reaching an agreement would probably mean that tax refunds (which totaled $2 billion in the first quarter of 2012) are likely to be delayed until the second quarter of 2013, which could act as a near-term drag on consumption. Third, at this point, a broader budget deal is looking less likely, meaning the debt ceiling may come into play again, which could trigger uncertainty and market volatility. Finally, should politicians be unable to pull together even a limited deal, that scenario could create some downside risk for US stocks since most investors are expecting at least some sort of progress from Washington.

### Opportunities Amid Uncertainty

Although the fiscal cliff issues represent a near-term modest negative part of our outlook, there are some positives to consider. Long term, we would point to reasonable valuations for risk assets, acceleration in emerging market economies and a likely continuation of the low-inflation/low-interest-rate environment as reasons to be optimistic. As such, we would suggest that near-term volatility could represent good buying opportunities for investors with longer time horizons.

Regarding our outlook for economic growth, we still believe the US economy will grow modestly in 2013. While fiscal policy and political gridlock are negatives, there are other factors that remain supportive of growth, including a modest recovery in housing and further improvements in household balance sheets. Additionally, we expect both interest rates and inflation in the United States to remain well contained, at least for the first half of the year. In sum, we expect US

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.

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economic growth to remain around the 2% level—a slow rate, to be sure—but absent a complete failure from Washington, growth should remain positive.

Outside of the United States, we expect European growth to continue to struggle, possibly recovering in the second half of 2013. However, we expect to see stronger growth levels in China and other emerging markets, as well as stronger growth levels in smaller developed markets such as Australia, Singapore and Hong Kong.

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**Investment Ideas for 2013: Mega Caps, Emerging Markets, Fixed Income Credit and Municipals**

Taking a look at financial markets, we would expect stocks to outperform bonds again in 2013. On a relative basis, we prefer US mega caps, global technology companies and emerging markets, including China. We have a less favorable view on US small caps and areas of the market dependent on household spending, such as retailers.

Within fixed income, we remain cautious on Treasuries. While we are not forecasting a significant rise in yields, even a modest backup would be a significant negative for Treasuries. As such, we suggest investors focus on credit risk as opposed to duration risk in 2013, and emphasize such sectors as high yield, bank loans and secured credit. Additionally, we believe that with tax rates likely to rise on at least some Americans, municipal bonds continue to look attractive.

*In this environment, we believe investors would be well advised to overweight their allocations to equities and to focus on credit sectors and municipals within fixed income.*

In conclusion, while we agree that the failure to reach a comprehensive fiscal agreement would be a negative, the United States is still likely to expand in 2013 thanks to low rates, somewhat cleaner consumer balance sheets and an improving housing market. In this environment, we believe investors would be well advised to overweight their allocations to equities and to focus on credit sectors and municipals within fixed income. The year ahead will certainly bring with it its share of challenges, but we believe that opportunities remain as well.

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