BLACKROCK®

# What's Ahead in 2012

## An Investment Perspective: Year-End Summary and Market Outlook

- **A Review of 2011:** Last year featured some significant disappointments, but US stocks still managed to eke out small gains. *See pages 3 and 4.*
- **The Outlook for 2012:** While many of the same risks that dominated 2011 are likely to persist in 2012, conditions appear to be improving. *See page 5.*
- **The Scorecard for Our 2011 Predictions:** It was a close call on some, but the majority of our 2011 predictions did ultimately come to pass. *See pages 6 and 7.*
- **10 Predictions for 2012:** In the coming year, we offer 10 new predictions about the economy and financial markets. *See pages 8, 9 and 10.*
- **Investment Opportunities:** At this juncture, we recommend investors assume overweight positions in stocks, with a particular focus on companies with enough free cash flow to grow their dividends. *See page 11.*

**Bob Doll**
Chief Equity Strategist,
Fundamental Equities

# Executive Summary

2011 was a year of many disappointments for investors. When the year opened, there was a sense that the economic recovery that began in 2009 would persevere. While Europe's debt problems were certainly an issue, they appeared relatively well contained. It was only a few short months, however, when the world encountered a renewed recession scare sparked largely by deteriorating debt conditions in the eurozone as well as some weaker-than-expected US economic data. This Europe-induced fog of fear and uncertainty thickened over the summer, causing a severe pullback in risk assets.

Nevertheless, positive forces remained, and by the time the year drew to a close, the US economic growth picture had brightened and signs of progress regarding Europe's debt crisis began to emerge. These tailwinds were enough to allow stocks in most markets to recover from their lows and, in the United States, to end the year flat.

This sort of "middle ground" environment is one that we expect will persist in 2012. We are calling for another year of slow growth for the United States, but expect that Europe will slip into a (hopefully mild) recession while avoiding more dire financial contagion. The world will most likely avoid both the positive and the negative extremes, but a host of critical issues will likely remain unresolved. Nevertheless, this middle course should be good enough to get investors off of the sidelines, put their cash to work, and move into higher-risk assets. This, in our view, should bode well for the stock market in 2012.

# A Look Back at 2011

## 2011: A Year of Discontent

2011 was a frustrating year for most investors. Although ongoing debt and deleveraging concerns have been with us for some time, the degree to which they escalated in 2011 was a surprise to many (us included), with the European debt crisis becoming the most important driving force for global markets.

In addition to the debt crisis, the early part of 2011 was also negatively impacted by the social unrest in the Middle East/North Africa region that resulted in unexpected and damaging increases in oil prices. These events were quickly followed by a devastating earthquake, tsunami and nuclear power crisis in Japan. In our view, these events were more significant than many realized and caused a significant disruption to global economic growth in the first half of 2011.

Against this already damaged backdrop came the intensification of the debt and credit issues in Europe that led to the near collapse of the European Monetary Union. As the crisis unfolded, it became increasingly clear that the real problem was that Europe could no longer rely on its monetary union, but instead required additional fiscal union. Further fiscal union, however, required austerity policies that ultimately exacerbated default risks by acting as a drag on economic growth. As the debt issues were intensifying, the European Central Bank raised interest rates (foolishly, in our view) in an effort to stave off inflation when, in fact, deflation was the real threat in Europe.

In the United States, economic growth weakened early in the year, although the data improved in each successive quarter. On the political front, strident partisan bickering reached new heights as brinksmanship became the norm. The lack of leadership, cooperation and decisiveness ultimately served to damage corporate and consumer confidence.

In this environment, financial markets endured unprecedented volatility as correlations between and within asset classes rose. Almost all areas of the global financial markets experienced a broad “risk on/risk off” trading pattern, with the “risk off” assets winning for the year. Bond markets generally outperformed stocks while US equities, which finished the year flat to slightly up, were a noticeable outperformer. Emerging and European equities fell by double-digit percentages for the year.

Looking ahead, we expect that many of the themes that dominated 2011 will persist in 2012, but we do believe conditions should begin to improve, paving the way for a return to the “risk on” trade.

*Although ongoing debt and deleveraging concerns have been with us for some time, the degree to which they escalated in 2011 was a surprise to many (us included), with the European debt crisis becoming the most important driving force for global markets.*

*Looking ahead, we expect that many of the themes that dominated 2011 will persist in 2012, but we do believe conditions should begin to improve, paving the way for a return to the “risk on” trade.*

# A Look Back at 2011 (continued)

*By the time the year drew to a close, stocks had regained their footing, although most regions remained in negative territory for the year.*

*Outside of the United States, market conditions were far worse, with many regions experiencing double-digit losses for 2011.*

## 2011 by the Numbers

If there was any consistent theme we could ascribe to market action in 2011, it would be volatility. Stocks moved unevenly higher early in the year (buffeted by many of the factors we discussed previously), and at one point in April, US stocks were up almost 10% for the year. What followed was a sharp pullback and a dramatic collapse in the summer, with a primary catalyst being political acrimony and the inability to compromise, which led to the Standard & Poor's decision to downgrade the quality rating of US Treasuries. By the time the year drew to a close, stocks had regained their footing, although most regions remained in negative territory for the year.

In the United States, equity markets were mixed for the year overall. The Dow Jones Industrial Average was one of the few major equity indices to move higher for 2011, returning 8.4% to end at 12,217. The S&P 500 Index was unchanged from a point perspective, both entering and ending 2011 at 1,257. From a total return perspective (i.e., including dividends), the S&P 500 landed in positive territory, returning 2.1%. In contrast, the Nasdaq Composite declined for the year, losing 0.8% to end at 2,605. As part of the overall flight-to-safety trend that dominated much of 2011, small-cap stocks lagged, with the small-cap Russell 2000 Index losing 4.2% for the year.

Outside of the United States, market conditions were far worse, with many regions experiencing double-digit losses for 2011. Europe was especially hard hit, which is not surprising considering the region has been the focal point of massive financial unrest. German stocks lost 15.6% for the year, while the UK market was down 1.5%. Japan, hard hit by natural disasters early in the year, saw its stock market fall 15.6%. Emerging markets were not immune to the overall trend of weaker growth and have also been facing some inflationary pressures. Chinese stocks experienced a 24.1% loss, and emerging markets as a whole (represented by the MSCI Emerging Markets Index) were down 18.4%.

Not unlike stocks, bond markets were extremely volatile in 2011, as yields moved in a dramatic fashion, generally falling lower as investors continued to move into the relative safety of fixed income investments. As risk aversion grew in the middle of the year, the 10-year US Treasury yield fell to a historic low below 2% and remained roughly in that range for the subsequent months. In this environment, bonds handily outperformed stocks, with the Barclays Capital US Aggregate Bond Index posting a 7.8% return for the year. In an environment of near-zero interest rates, cash investments, as represented by the 3-month Treasury bill, continued to return barely a fraction over 0% and ended 2011 up 0.1%.

# Looking Ahead to 2012

## Avoiding Disaster Should Set the Stage for Equity Outperformance

Although we foresee an environment of ongoing debt problems and sluggish growth, such a scenario does not mean that stocks are doomed for another year of sub-par performance. In our view, stocks are priced for an environment significantly worse than what we expect, suggesting that muddling through and avoiding disaster should be enough for markets to post appreciable gains.

From an economic perspective, the world continues to operate in a post-credit-bust environment, meaning that significant deleveraging still needs to happen. As a result, economic growth will be slow. Slow growth should be partially offset by accommodative monetary policy in much of the world, but the combination of slow growth and debt repayment/deleveraging is a difficult one. We expect to see setbacks along the way and the environment will be one in which investors will have a low tolerance for policy errors.

On the "what can go right" front, we would include Europe moving toward a resolution of its debt crisis, the US heading toward fiscal responsibility, the emergence of a US manufacturing renaissance, a housing recovery and/or an increase in confidence. The "what can go wrong" list would include a systemic banking crisis in Europe, a true double-dip recession in the United States, a hard landing in China, a break-out of class warfare in the United States and/or a Middle East flare-up resulting in $150/barrel oil. Our base case is neither extreme, but one in which the world "muddles through," avoiding both ends of the spectrum, but leaving much unresolved.

In summary, the coming year should feature a slow-growth world that includes a recession in Europe. The United States is likely to face economic headwinds, but should manage to achieve growth of between 2% and 2.5%. China and India are likely to slow somewhat, but along with the United States will make up two-thirds of global gross domestic product (GDP) growth.

The main risk, in our view, continues to be that of a potential financial breakdown in Europe that could tip the developed world, if not the emerging world as well, into recession. Absent that scenario, however, we believe decent corporate earnings and some improvement in confidence levels should allow equity markets to move higher, with US stocks leading the way.

*In our view, stocks are priced for an environment significantly worse than what we expect, suggesting that muddling through and avoiding disaster should be enough for markets to post appreciable gains.*

*We believe decent corporate earnings and some improvement in confidence levels should allow equity markets to move higher, with US stocks leading the way.*

# The 2011 Scorecard

## Overall Scoring

| | |
|---|---|
| ✓ Correct | 5 |
| — Half Correct | 4 |
| ✗ Wrong | 1 |
| Total | 7/10 |

*Although 2011 was a difficult year for the markets, much of what we projected would happen did come to pass. Notably, we were wrong on our call that stocks would outperform bonds in 2011, but the overall economic backdrop matched our expectations and we were correct that US stocks would surpass international stocks for a second consecutive year.*

1 ✓

*US growth accelerates as US real GDP reaches a new all-time high.*

Several months ago, it would have been nearly impossible to imagine this prediction could come to pass, but as the year drew to a close, it did. Growth was at a near-zero stall point in the first quarter of the year and accelerated noticeably each subsequent quarter. At this point, it looks as if the fourth quarter of the year will see GDP growth come in at around 3%. Additionally, on a real basis, GDP did reach a new high in the middle of the year.

2 —

*The US economy creates 2 million to 3 million jobs in 2011 as unemployment falls to 9%.*

Although jobs growth accelerated significantly in 2011 compared to 2010, this prediction is one we'll have to mark as half-correct for the year given that the overall pace of growth was less than we expected. Final numbers will be available in early January, but at this point, it looks as if net jobs growth for the year was around 1.5 million. Unemployment did fall below 9% during the course of the year, but remains stubbornly high.

3 —

*US stocks experience a third year of double-digit percentage returns for the first time in over a decade as corporate earnings reach a new all-time high.*

This is another prediction for which we'll take half credit. As discussed earlier, earnings surpassed expectations yet again in 2011 and reached a new high. However, equities obviously did not experience double-digit gains, although we are forecasting that they do so in 2012.

4 —

*Stocks outperform bonds and cash.*

This prediction came down to the final day of the year since, rather amazingly, the S&P 500 finished the year exactly where it began in point terms, and delivered modestly positive results on a total return basis. Although persistently low interest rates helped bonds outperform stocks in 2011, equities did manage to outperform the 0% return that cash has been delivering.

5 ✓

*The US stock market outperforms the MSCI World Index.*

This prediction came true by a wide margin. US stocks were up marginally, which was a significantly better result than was seen in non-US markets, many of which were down in double-digit territory.

6 ✓

*The US, Germany and Brazil outperform Japan, Spain and China.*

Thanks mostly to the relative strength of US stocks, this prediction lands in the "correct" category. A basket of US, German and Brazilian stocks outpaced a basket of equities from Japan, Spain and China. Overall, Brazil was the worst-performing market of the group, while Germany, Japan, Spain and China also delivered disappointing results.

7 —

*Commodities and emerging market currencies outperform the dollar, euro and yen.*

Commodities were somewhat mixed in 2011, with some sectors, such as agriculture-related commodities, producing negative results. The most visible sectors of the commodities market, oil and gold, were both up for the year, helping the first half of this prediction to come true. Emerging markets currencies, however, underperformed for the year.

8 ✓

*Strong balance sheets and free cash flow lead to significant increases in dividends, share buybacks, mergers and acquisitions (M&A) and business reinvestment.*

Despite the relatively weak economy, corporations continued to perform well in 2011, which helped promote high levels of dividend growth, share buybacks, business reinvestment and M&A activity. As we indicated earlier, these are trends we believe will carry over to 2012.

9 ✗

*Investor flows move from bond funds to equity funds.*

This is one we were very wrong on. Given the flight-to-quality trade that dominated 2011, bond funds saw greater inflows than did equity funds.

10 ✓

*The 2012 presidential campaign sees a plethora of Republican candidates while President Obama continues to move to the center.*

This past year saw a number of GOP candidates announce their intention to run, making for a relatively crowded field. On the other side, President Obama has been taking a more partisan approach in recent months, but for most of 2011 he adopted a relatively centrist stance.

# Our Predictions for 2012

*Although 2012 is likely to feature many of the same risks that dominated 2011, we expect economic and market conditions will see some notable improvements. Against that backdrop, we venture forward with 10 predictions for the new year.*

1

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

The European debt crisis loomed large and drove high levels of volatility in 2011, causing most risk assets to experience significant downturns. Unfortunately, we expect the debt crisis will dominate discussions in 2012 as well. Thankfully, the authorities – political and monetary – moved from a position of complacence and inaction to one of irregular, but somewhat constructive, action. The ultimate path to a solution is unclear, particularly given the varied interests of multiple countries and constituencies. Formulating incremental fiscal union, creating the enforcement mechanisms for austerity measures and attempting to generate economic grow are each difficult, and seemingly impossible when combined. Nevertheless, we believe all parties recognize the seriousness of the crisis and will continue to take sufficient action to avoid an outright catastrophe. In any case, however, it seems clear to us that Europe's problems are significant enough to drive the region into a (hopefully mild) recession in 2012.

2

*The US economy continues to muddle through yet again.*

The US economy ended 2011 stronger than it started, although growth continues to be lackluster. Our view is that the deleveraging process will continue to limit growth to a sub-par rate, but that recession will again be avoided. A strong corporate sector, improving consumer sector and financially strapped government sector will combine to set the stage for variable but positive growth for all four quarters of 2012. Overall, we predict GDP growth of somewhere in the 2% to 2.5% range. Modest employment gains are key to reversing the steady decline in corporate and consumer confidence. Low interest rates, a bottoming process in housing and low inflation could aid the economy in its "muddle through." We also expect that European recession and fiscal policy drags will become important headwinds.

3

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

Emerging market economies continue to be critical components of global growth in both the short and long term. China and India are especially important given both their size and growth rates. And while growth in both countries is likely to be slower in 2012 than it was in 2011, we expect that together these two countries will account for more than half of 2012 global growth. We anticipate China will account for more than 40% of global growth, with India and the US accounting for about 15% each. Until recently, increasing inflation in the emerging markets had caused policymakers to raise interest rates and/or reserve requirements in an attempt to slow inflation, with the effect of dampening growth. We expect this process will begin to reverse itself sometime in 2012.

4

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

One of the standouts of 2011 was the performance of corporate earnings. S&P 500 per-share profits consistently beat expectations, increasing approximately 14% despite a relatively weak macroeconomic backdrop. This trend of surpassing expectations has been in place since the start of the economic recovery in 2009, but we believe is nearing an end. Our view is that the pace of earnings growth will slow in 2012 and fail to exceed expectations (currently $108) for the first time in the current business cycle. Comparisons are getting tougher, the dollar has strengthened somewhat, profit margins are unlikely to climb further and non-US growth is slowing. All of this points to acceptable, but not stellar, earnings reports.

5

*Treasury rates rise and quality spreads fall.*

Arguing for interest rate increases has been fruitless for some time as investors have been in a persistent "risk off" trading mode. Having said that, at some point, the world will have to either move into an environment where deflationary pressures justify a very low interest rate structure, or one in which deflationary risks dissipate somewhat. We believe the latter scenario is more likely. If the "crisis premium" that has kept risk assets cheap and Treasury rates low lessens in 2012, then Treasury rates are likely to move somewhat higher. That is indeed our hypothesis, with the European sovereign debt problem being the chief candidate for some improvement. Should the Europe risks dissipate, risk assets should perform better, which would include a reduction in credit spreads of all types. On a related note, we are not yet convinced that a sizeable quantitative easing program (i.e., QE3) from the Fed is a given unless European credit markets freeze further and/or the US economy shows a noticeable stumble.

6

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

We are forecasting that earnings rise around 6% in 2012. Should that happen, and should stocks continue yielding somewhere around 2%, it would take only modest valuation improvements to reach double-digit return territory in 2012. We believe valuations are compressed for a host of reasons, most notably concerns over the risks for potential European financial contagion. After contracting by roughly 15% in 2011, we think valuations will expand modestly in 2012 as confidence improves on the back of acceptable, non-recessionary economic growth, continued low inflation and interest rates, and modest net new jobs growth. Strong financial health in the corporate sector should provide some support as well. Importantly, as with many of our predictions, we do not believe it will take a return to boom conditions for this one to come true – simply avoiding the most dire "what can go wrong" scenario should be enough to allow for decent gains for US stocks.

# Our Predictions for 2012 (continued)

7

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

The US stock market has been a standout performer over the past two years compared with other equity markets. In 2011, US stocks were flat to modestly positive and significantly outperformed non-US markets, many of which were down double-digit percentages. With reasonable earnings growth and attractive valuations, we think the US can outperform again in 2012. We believe such an outcome will require only modest economic and earnings growth versus calls for recession in Europe and malaise in Japan. Emerging markets underperformance has been significant of late, largely due to monetary tightening enacted to combat inflation concerns and which ultimately has resulted in economic slowdown. At some point, perhaps sometime during 2012, emerging market equities will resume outperformance, but we think it is too soon to make that call.

8

*Company dividends and share buybacks hit a record high.*

Cash spent by US corporations to raise dividends and buy back stock increased approximately 35% in 2011. Despite that, cash as a percentage of profits used for these purposes is still below long-term averages. As a result, it is possible that the amount of cash used for these purposes could grow by another 20% or more in 2012, which would surpass the record dividend increase and share buybacks set in 2007. On a related note, corporations used cash in 2011 for a significant number of acquisitions, an activity that is likely to continue in 2012 given low valuation levels and low cash returns.

9

*Healthcare and energy outperform utilities and financials.*

Our sector preferences include one defensive and one cyclical sector. We believe healthcare should benefit from continued good and predictable earnings growth coupled with reasonable valuations. Energy is our cyclical choice and is inexpensive relative to its history, the overall market and oil prices. Financials have been a significant underperformer for several years now and, at some point, should enjoy a rally, but probably not quite yet. Our underweight position stems from continued concerns regarding revenue growth potential, regulatory risks and deteriorating and residual credit concerns. Finally, we believe utilities are overvalued, especially given weak earnings prospects.

10

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

Predicting elections is always treacherous, and assessing the impacts is even more precarious. At this early stage, we see a strong chance the Republicans retain the House of Representatives while losing a few seats, and a reasonable chance they capture the Senate and, while a very diffcult call, win the Presidency. The last part of this prediction is especially tough given the historic advantage of incumbency and the President's campaign war chest, not to mention the uncertainty as to the eventual Republican nominee. Critical to the President's re-election chances, however, are his approval ratings and the unemployment rate, neither of which are currently in his favor. From a markets perspective, we would point out that, historically, equity returns have been strongest under Republican control of Congress regardless of the President's party.

# Opportunities for Investors

The start of a new year is always a good time to review your investment goals and asset allocation with your financial professional, and to make portfolio changes where necessary. With that in mind, following are some ideas investors may wish to consider as the calendar turns from 2011 to 2012:

- **Assume an overweight in equities:** We have said it several times before, but it bears repeating: As long as the world manages to slog along in a slow-growth environment, stocks should outperform in 2012, given the combination of decent earnings, low interest rates and attractive valuations. As such, we would recommend moving to overweight positions in equities relative to cash and bonds.
- **Eyes peeled for free cash flow and dividend growth:** Our main investment theme for 2012 is a focus on ample free cash flow that would allow companies to engage in shareholder-friendly practices. While many are talking about the attractiveness of dividend payers, we would add an important nuance: It is not dividend payments themselves that are attractive, but the quality of those dividends and the ability to grow them that investors should seek out.
- **Focus on US stocks:** As was the case in 2011, we expect 2012 to be a year in which US stocks outperform international markets. Economic growth should continue to be better in the United States compared with other developed markets, and while our long-term view of emerging markets remains a positive one, we are not convinced that the near-term underperformance trend of those markets is at an end.
- **Consider every angle – sector, style, market cap:** From a sector perspective, we favor healthcare and energy and have a less positive view toward financials and utilities. From a style perspective, we have a slight preference for growth over value and are neutral regarding capitalization size.
- **Expect further divergence of returns:** For some time, markets have been trading in a "risk on/ risk off" fashion – a pattern we expect will diminish as investor sentiment improves. This suggests we might expect to see heightened dispersion between winners and losers in 2012, meaning security selection will become more critical.

*For additional information, or to subscribe to quarterly updates to this piece, please visit www.blackrock.com.*

## The BlackRock Advantage

**Delivering Scale That Benefits You**

When you invest with us, you benefit from the size, stability and experience we offer. We have been entrusted with more than $3 trillion in assets, making us the largest investment manager in the world, and giving us the opportunity to help millions of investors build a better financial future.

**Transforming Local Presence Into Global Perspective**

Every day, our portfolio managers and analysts become better investors by sharing with each other insights from around the world. We provide you with up-to-date developments on major markets and asset classes at www.blackrock.com.

**Managing Risk With a Disciplined Approach**

The cornerstone of our investment philosophy is to understand the sources of investment risk and make certain the risk we take is appropriate for every investment portfolio. Our goal? To provide you and your clients consistent investment results with fewer surprises.

---

*Source: BlackRock, Bank Credit Analyst. The opinions presented are those of the author on January 1, 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.*

*No investment is risk-free. 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. Investments in commodities may entail significant risks and can be significantly affected by events such as variations in the commodities markets, weather, disease, embargoes, international, political and economic developments, the success of exploration projects, tax and other government regulations, as well as other factors. Index performance is shown for illustrative purposes only. You cannot invest directly in an index.*

FOR MORE INFORMATION: www.blackrock.com



Prepared by BlackRock Investments, LLC, member FINRA.



**Lit. No. DOLL-OUTLOOK-1211** AC5645-0112 / 12-0006

BLACKROCK®