

Special Market Update

Despite Recent Darkness, Long-Term Picture Brighter for Equities

August 9, 2011

Equity markets have experienced extreme volatility recently, particularly on Monday, August 8, following the Standard & Poor's downgrade of US sovereign debt on the evening of Friday, August 5. To provide some perspective on what has happened and how investors should view current market conditions, Bob Doll, BlackRock Chief Equity Strategist for Fundamental Equities, offers the following thoughts. Note: This was written prior to the 4% to 5% rally in stocks on Tuesday, August 9.

US Stocks Are Oversold

A review of some of the data provides valuable perspective on the recent extreme market volatility. The recent weeks' correction has taken US equities down about 18% from their April high. About 11% of that decline has come in the past three days. In comparison, when equity markets began to price in a double-dip recession last summer, US stocks fell 17%, a decline of virtually identical magnitude. Following sharp reversals of this sort, we have in the past seen the market quickly recover 33% to 50% or more of its losses.

We Don't Foresee Another Recession

Overall, we continue to hold the view that the US economy is not headed toward a double-dip recession, though the risk of that happening, given how slow economic growth has been, is higher than normal. In a normal environment, the probability of a recession is about 15%, while we currently believe there is about a 30% probability of recession.

Since the Great Depression, there have been 30 market declines of 15% or more — but only two of those predicted a recession. Some of those declines happened during a recession, but more than half were unrelated to a recession and the market came back, which is what we believe in this case this time around. Indeed, it would be rare for a recession to begin at a time when initial unemployment claims have not gone up in recent weeks. It would also be unusual to have a recession when the Treasury yield curve is positive, as it is today. Likewise, it would be unusual to have a recession with bond spreads fairly stable as they are today.

We don't anticipate a vigorous economic cycle, but we are not arguing for recession either. We believe the US economy will be in a subpar economic cycle for some time. When cyclical areas like housing and autos are experiencing growth rates lower than the rate of population growth, it is a good sign that the business cycle can only improve. As such, we do not believe that second half economic growth will be as weak as either bonds or equities currently imply. At the same time, we do not believe that the imposition of fiscal austerity or lack of pent-up demand will give us a robust business cycle.



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Markets Hate Uncertainty: Political Leaders Have Only Provided More

Much of this recent market decline marks a lack of confidence in our political leaders and, unfortunately, we are not seeing signs that the political leaders have received the message. The genesis of this selloff was the debt ceiling wrangling and brinksmanship. While no one expected a default, our politicians only kicked the can down the road again. Markets hate uncertainty, and Washington gave us more. Add on top of that the weak second quarter GDP report, the sharp downgrade of the first quarter number, the poor purchasing managers survey, and a disappointing consumer spending report, and that provided a negative framework.

Should the market decline continue, the likelihood of additional stimulus from some part of the world rises, which is what the rising price of gold is telling us. Compared to the situation in 2008, we would note a significant difference: gold was falling, suggesting a deflationary debt problem. Conversely, gold is rising this time, we believe signaling expectations for additional stimulus in some shape or form.

US Debt Downgrade Was July's News

The S&P debt downgrade was significant for political and historic reasons, but the actual impact of the rating change on the Treasury market should not be that significant. The biggest news should have been in July when S&P announced it was putting the United States on credit watch-negative signaling a downgrade was imminent. When S&P's ambitious \$4 trillion deficit reduction target was not passed by Congress, it should have been pretty obvious that it was only a matter of time before the agency lowered the US rating.

From our point of view, the country's credit is not simply a function of the fiscal metrics that S&P uses. We see two other important variables at play: First, political will; and second, the fact that the US dollar is the reserve currency of the world. On the first point, the appearance of dysfunction in Washington means we can't give high marks for political will. But on the second point, the fact that the dollar is the reserve currency of the world gives the United States a big advantage, meaning debt funding costs are not simply a reflection of the country's balance sheet.

Paradoxically, we believe the downgrade of US debt may have more relevance for Europe, where there are a number of countries with more vulnerable public finances and limited track record on debt consolidation. Ultimately, the damage is not the downgrade itself but the timing. The market risks have been unprecedented: the significant deleveraging cycle, the housing downturn, drags from government fiscal contraction, the European sovereign debt crisis, quantitative easing, zero interest rates, to mention a few issues. Coming at a time when risk aversion has been rising rapidly, the increased uncertainty of the downgrade weighed heavily on equity market risk premiums.

Economy on Stronger Footing This Year Than 2010

In these kinds of unprecedented times, we need to look at vital signs, particularly versus last year:

	Summer 2010	Summer 2011
Money growth	Flat	positive
Velocity of money	Flat	modestly positive
Job growth	Barely positive	somewhat positive
Loan growth	Negative	positive

As you can see, overall we have a better scenario than last summer's downturn. In addition to the above improvements this year we have less pain at the pump, with further price declines to come given the recent decline in crude prices. This should add dollars for consumer discretionary spending. In addition, the supply chain disruptions from Japan have abated and the US consumer's pace of deleveraging has been slowing, which leaves more money to either save or spend.

What Are the Catalysts for Upside and Downside?

What is the catalyst from here for a further decline or a rise? A continued market decline is likely if fear continues without anything stepping in the way. An upside move comes:

1) if at the same yield, investors like stocks better than bonds, so they buy some stocks, or **2)** if we return to a couple of weeks ago when economic statistics were mixed, a sort of muddle through environment, which is our main line scenario. We think the trend of the last 10 days, which was more uniformly negative, is not likely to continue. **3)** Another catalyst could be the European Central Bank changing direction from its tightening process and announcing that it is willing to expand its balance sheet. While perhaps not a high probability, with more negative days, its stance could change. **4)** In addition, China could end tightening and begin to go to neutral or ease monetary policy, which would get a lot of attention. **5)** Here in the US, we could see more quantitative easing — a mild sort where the Fed extends accommodation and/or talks about maintaining a full balance sheet wherein they reinvest. A larger action would mean something like QE1 or QE2, though we believe that is unlikely. **6)** Most positive, but unfortunately the lowest probability, would be a bipartisan pro-growth policy to promote capital formation and, by extension, employment. **7)** Some smaller items with higher probabilities include extension of the payroll tax cut, extending unemployment benefits or a repatriation holiday.

Will the Market Follow History?

In the past 25 years, the market has endured 11 sovereign debt downgrades. In eight of those cases, the equity markets have risen, with an average rise of 17% within the 12 months following those downgrades. We are hopeful that history repeats itself.

If the fundamental case makes sense, the market will rebound off the oversold low. If history is any guide, a bottom will be found, but investors will continue to ask if it represents a true bottom. Given the amount of selloff we've seen, an equity recovery bounce of 6% to 9% (1/3 to 1/2 of the 18% decline) typically occurs at this point in an oversold environment. At that point, economic data would take over.

Stock Valuations Are at an Extreme Low ...

Currently, the S&P 500 is selling at an extremely low price-to-earnings multiple of under 12x trailing earnings. (Valuation is never an indicator of timing, just an indicator of risk-reward.) The last time this occurred was decades ago when the 10-year US Treasury yield was at 8%. As such, the equity risk premium for stocks is at its highest in 30 years, and equity yield for the S&P 500 is just a few basis points under the 10-year US Treasury yield, a historically low spread.

If you believe there is any growth potential in the dividend yield—we believe high single digits—that would mean that stocks should outperform bonds and present a more interesting opportunity. Since the March 2009 bottom, earnings are up 125%, while the S&P 500 is up “only” 75% in the same timeframe, implying P/E ratios have shrunk noticeably, and pricing in a recession that, in our view, is unlikely to occur.

... While Fundamentals Continue to Be Strong

However, on a fundamental basis, stocks continue to perform strongly. Thus far, with second quarter earnings nearly complete, earnings are up 18%, with 75% of companies exceeding expectations by an average of 5%. From a revenue standpoint, 72% of companies have reported beating revenue expectations, by an average of 2%. At the same time, cash flow has exceeded both earnings and revenue growth, and excess free cash flow is very high, which has led to outsized increases in dividends, buybacks and merger and acquisition (M&A) activity, though this activity may slow in the near term.

Stay Focused on Cash Flow Generation

With fundamentals intact, we find some cyclical stocks to be very attractive. We find some defensive names with good free cash flow to be similarly compelling. We expect that a market bounce will feature cyclicals, which were hurt the most on the way down. We would also include some conservative stocks that are generating increasing amounts of free cash flow. Overall, we believe the equity market to be more attractive than the bond market.

Should the catalysts we discussed take place in Europe, China or the US, that could provide a boost to confidence. The economy is better than it was last year at this time, in our view, an important consideration for investors. Given our belief that the economy is unlikely to fall into a recession, we believe it makes sense to put cash to work in the current market environment and that dollar cost averaging into stocks is a prudent approach.

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