

Weekly Investment Commentary

Positive Forces Should Win Out, But It Will Take Some Time

May 31, 2011

Economic data has continued to come in on the weak side, which caused stock prices to slide yet again last week. For the week, the Dow Jones Industrial Average dropped 0.6% to 12,442, the S&P 500 Index fell 0.2% to 1,331 and the Nasdaq Composite declined 0.2% to 2,797. In our opinion, some of the recent weakness in economic data can be attributed to temporary factors such as the spike in oil prices, the natural disasters in Japan and flooding in the Southern United States. In any case, however, the soft patch in the economy has dented the pace of economic acceleration and we expect to see some continued signs of weakness in the weeks ahead, including perhaps in this Friday's labor market report for May.

In some ways, the current period of economic weakness is similar to what occurred in the second quarter of 2010, when the global economy experienced a slowdown in the face of rising sovereign debt issues in Europe, concerns over policy tightening in China and slower levels of consumption in the United States. One key difference, however, is that in the current slowdown the reductions in the forecasts for growth levels are centered around the United States, the United Kingdom and Japan. Weakness in Japan can be largely attributed to the earthquake and resulting nuclear issues and the US and UK slowdowns can be explained in part by greater-than-expected levels of consumer deleveraging. Forecasts for the rest of the world are holding up reasonably well.

One potential downside risk for the economy and the markets that has many concerned is the coming end of the Federal Reserve's QE2 program. It is not surprising that investors are focusing on the end-of-June timeframe with concern. When Fed Chairman Bernanke first indicated that the QE2 program would be launched last August, it defined the start of a sharp uptrend in risk asset prices, so some are concerned that the end of the program will reverse this trend. We do not expect this to be the case. QE2 has been a tailwind for stocks, but only one of many, and the end of the program should not have an oversized impact on the markets. It is possible that we will see a modest rise in bond yields when the program ends, but yields have moved lower in recent weeks anyway in the face of some weaker economic data. In any case, the end of QE2 has been well telegraphed and has already been priced into the financial markets.

An additional issue that has some investors concerned is the ongoing debate over potentially raising the debt ceiling and what it will mean for spending levels. At this point, a consensus of sorts seems to be emerging that Congress will cut spending by approximately \$1 trillion over the next 10 years as part of a package to raise the debt ceiling. There is also a growing consensus that spending cuts in the neighborhood of over \$4 trillion are needed to stabilize the country's debt-to-GDP ratio, but changes of that magnitude are unlikely to occur before next year's election.



Bob Doll is Chief Equity Strategist for Fundamental Equities at BlackRock®, a premier provider of global investment management, risk management and advisory services. Mr. Doll is also 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.

Despite the recent tone in the markets, not all of the news has been bad. Corporate earnings in particular have remained an important source of strength. Nearly all companies have reported first-quarter earnings and, on average, results beat expectations by over 6%. Compared to last year, earnings grew by more than 20%, with particular strength emanating from the healthcare, technology and materials sectors. From this vantage point, it looks like second-quarter earnings should also be healthy. In addition to the corporate earnings backdrop, industrial production levels should be rising as inventories fall, which should help economic growth. We are also expecting to see some clarity around support mechanisms for the ongoing European debt issues.

Taking a broader view of the markets, we can see that the current market rough patch has emerged in part because of a softening in economic data. However, it is also due to the increasing number of downside risks, including geopolitical tensions, a lack of clarity over how to deal with the debt problems in Europe, the earlier spike in oil and other commodities and pending changes in monetary and fiscal policies.

It is important to note, however, that stocks have only dropped by a few percentage points over the last month. We would attribute this result to the fact that several factors remain as important tailwinds, including still-easy monetary and fiscal policies, high levels of liquidity, strong profit growth and reasonable valuations. The recent easing of oil prices is also a positive factor. On balance, we expect these positive forces to win out, but that may take some time, meaning that continued patience is warranted.

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