

BlackRock Investment Directions

Asset Allocation Overview

Over the past three months, the macroeconomic backdrop has improved slightly with economic data moving from “bad” to “less bad” (but not yet “good.”) Both equity and fixed income markets, however, are pricing in a gloomier outlook than we expect. While we would continue to advise investors to proceed with caution, we believe this disconnect presents investment opportunities.

Investment Themes

- ▶ **Equity valuations are attractive:** We believe equities are underpriced at current levels. The tricky economic backdrop suggests a continued focus on high-quality equities, but also some allocation to cyclical areas of the market.
- ▶ **Search for income favors credit sectors:** With Treasury issues offering little value, investors should seek out higher-quality regions of credit-sensitive spread sectors, which offer a more compelling yield and total return profile.
- ▶ **Take a fresh look at munis:** Municipal bonds are offering attractive after-tax yields that would become even more appealing should tax rates rise.



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Asset Allocation Views

Key ○ = last quarter ● = current quarter

	Current Outlook	Strength of Preference							
		Strong	◀	Neutral	▶	Strong			
Asset Allocation	Slowly improving economy warrants tilt toward equities	Bonds	○	○	○	●	○	○	Stocks
Equities									
Regional Allocation	US stocks remain more attractive	US	○	●	○	○	○	○	Int'l
	Emerging economies recovering more quickly	Developed	○	○	○	●	○	○	Emerging
Market Cap	Broadly neutral	Small	○	○	●	○	○	○	Large
Style Allocation	Broadly neutral (extremely slight preference for growth)	Value	○	○	●	○	○	○	Growth
Fixed Income									
Duration	Effectively neutral, as rates remain low and range bound	Short	○	○	●	○	○	○	Long
Quality	Higher-quality segments of spread sectors continue to offer value	High	○	○	○	●	○	○	Low
Regional	US dollar decline and solid performance from international markets warrants rebalancing	US	○	○	●	○	○	○	Int'l
Commodities & Currencies									
Commodities	Strong long-term outlook, but price momentum may be fading	Underweight	○	○	●	○	○	○	Overweight
Currencies	Expect weakness in developed market currencies (including US dollar) vs. emerging	US	○	○	○	○	●	○	Foreign

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Equity Market Outlook

Equities have remained trapped in a broad trading range for the past several months, caught between deflation threats and a mixed economic outlook on the one hand, and strong corporate earnings and attractive valuations on the other. In recent weeks, however, the positive forces have been winning out. The question investors are asking is whether this move represents a mere move toward the upper end of the trading range or a longer-term, more positive shift in tone. While we acknowledge that a number of risks remain, we are leaning more toward the positive outlook.

In hindsight, the midsummer equity market upheaval appeared to be a reaction to a series of negative economic reports. At present, it appears that phase has at least paused, and possibly has reversed. Financial conditions have continued to ease and central banks have reiterated their intentions to combat deflation. Our forecast calls for modest and uneven levels of growth throughout most of the developed world, including the United States.

We believe that, absent any significant economic disappointments, stocks are likely to continue to make modest gains in the months ahead. Nevertheless, it will take more than an absence of bad news for the rally to proceed further. Our impression is that although investors have begun to re-enter the markets, most still have lower-than-normal levels of equity exposure in their portfolios. In our view, equity valuations are attractive and, looking ahead, stocks appear likely to outperform Treasuries and cash over a two- to three-year time horizon.

Equity Views

- ▶ A slow, uneven recovery means that many companies may struggle, suggesting to us that a focus on higher-quality equities still makes sense. Over the past several months, however, many investors have already made the move to higher-quality stocks and may be underweight some of the cyclical areas of the market that could benefit from continued “less bad” economic data.
- ▶ From a sector perspective, we continue to like the telecommunications sector, and have grown more positive about the healthcare, consumer staples and materials sectors. We have adopted a more cautious view toward information technology and still believe that financials are facing a difficult environment.

Sector Outlook

Key ○ = last quarter ● = current quarter

Sector	Current Outlook	Strength of Preference				
		Underweight	◀	Neutral	▶	Overweight
Telecom Services	Good cash flows and high dividends	○	○	○	○	●
Healthcare	The healthcare reform cloud has lifted; stocks reasonably priced	○	○	●	●	○
Consumer Staples	Moderately attractive with mixed valuations	○	○	●	●	○
Consumer Discretionary	Consumers slowly increasing spending; stocks reasonably priced	○	○	○	●	○
Information Technology	Mixed outlook due to some inventory overhang	○	○	●	●	○
Industrials	Global cyclical slowdown offset by improved valuations	○	○	●	○	○
Materials	Should benefit from “less bad” macro outlook	○	●	●	○	○
Energy	Excess inventories; oil prices under pressure	○	●	○	○	○
Utilities	Regulatory risks and cost issues; not cheap	○	●	○	○	○
Financials	Troubled balance sheets and regulatory uncertainty, but now cheaper	○	●	○	○	○

Taxable Fixed Income Market Outlook

We continue to forecast a slow-growth environment, with low (and range-bound) interest rates and only moderate inflation levels, for the time being. Moreover, the “mixed messages” we are seeing from economic indicators may well lead to increased market volatility. We also run the risk of weaker growth rates over the longer term and the added likelihood that recessions may become more frequent. Since an anemic recovery does not make for a sustainable long-term recovery, we think additional government action will be required to “break out” onto a more favorable trajectory. This is likely to come in the form of further quantitative easing by the Fed and might include fiscal stimulus as well, a pairing that will need to be well coordinated to be effective. Should a significant expansion of the Federal Reserve’s balance sheet take place with quantitative easing, this would likely produce a very supportive context within which to own higher-quality spread sector assets.

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Other positive technicals include considerable capital flows toward fixed income and limited supply in certain high-quality spread sectors. As such, we continue to find value selectively in high yield bonds and securitized assets. With yield in short supply, we think these parts of the market should outperform higher-quality regions, such as Treasuries and agency MBS, although investors expecting to see a collapse in the prices of these high-quality assets (due to a purported “bubble” in fixed income assets) are likely to be disappointed.

Taxable Fixed Income Views

- ▶ Economic growth prospects will likely remain subdued unless significant monetary and fiscal stimulus is introduced to allow this recovery to “break out” onto a more favorable trajectory.
- ▶ The economic and policy backdrop are supportive of spread assets, as are favorable supply/demand technicals within higher-quality spread sectors.

Sector Outlook

Key ○ = last quarter ● = current quarter

Sector	Current Outlook	Strength of Preference				
		Underweight	◀	Neutral	▶	Overweight
High Yield	Supportive technicals and decent valuations continue to make selected issues look attractive	○	○	○	●	○
Securitized Assets	Despite strong performance, we are still positive on the sector	○	○	○	●	○
Emerging Markets	Selectivity required, as strong capital flows result in some overvaluations	○	○	○	●	○
Corporates	Strong balance sheets and investor demand	○	○	○	●	○
Non-US Dollar	Modest reduction due to euro/yen rally and decent performance	○	○	○	●	○
Treasury/Agency	Neutral, as better relative value can be found in spread sectors	○	○	○	●	○
Inflation Protected	Useful as a long-term inflation hedge	○	○	○	●	○
Agency Mortgages	Improved valuations, yet we remain underweight	○	○	○	●	○

Municipal Markets Outlook

Within the tax-exempt sector, we expect the negative headlines that have persisted for some time to continue in the near term, as the slowly improving economic environment has not translated into meaningfully increased revenues for states and municipalities.

Nevertheless, with tax-exempt yields at all-time lows, we see income as the greatest opportunity in new investments, as price appreciation potential from current levels will be difficult to achieve. Additionally, the possibility of higher tax rates makes traditional tax-exempt municipal bonds particularly attractive. Overall, the municipal asset class remains in excellent technical shape, as demand continues to be strong while new-issue supply remains relatively low. The yield curve is also at historically steep levels, thereby rewarding investors for moving further out.

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Municipal Markets Views

- ▶ At present, we favor state tax-backed and essential service bonds, particularly the Southwest, Plains and Southeast regions. We also like dedicated-tax bonds and housing issues.
- ▶ We have a less favorable view toward land-secured bonds, senior living bonds, bond insurers, student loans, pre-refunded bonds and local tax-backed issues.

Municipal Market Positioning

Key ○ = last quarter ● = current quarter

	Current Outlook	Strength of Preference						
		Strong	◀	Neutral	▶	Strong		
Duration	Neutral to modest long bias	Short	○	○	○	●	○	Long
Yield Curve	Favor longer maturities	Short	○	○	○	●	○	Long

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