

US More Likely to Learn From (Than Repeat) Japan's Mistakes

Market Views From the Large Cap Series Team

In the midst, or aftermath, of a crisis, individuals are often compelled to draw parallels with the past to better inform handling of the present day's challenge. This inclination has certainly been manifest with the Great Recession of 2007-2009, and the analogy getting the most attention among investors is Japan's prolonged era of stagnation (now two "lost decades"). In effect, some commonalities do exist. The differences, however, are meaningful and, in our view, more significant determinants of the ultimate outcome for the United States.

In this report, Bob Doll, BlackRock's Chief Equity Strategist for Fundamental Equities and head of the US Large Cap Series equity team, homes in on some of the most striking points of comparison between the two countries' situations and experiences to support the contention that the United States will avoid Japan's fate.

Size of US Bubble – and "Pop" – Modest Relative to Japan

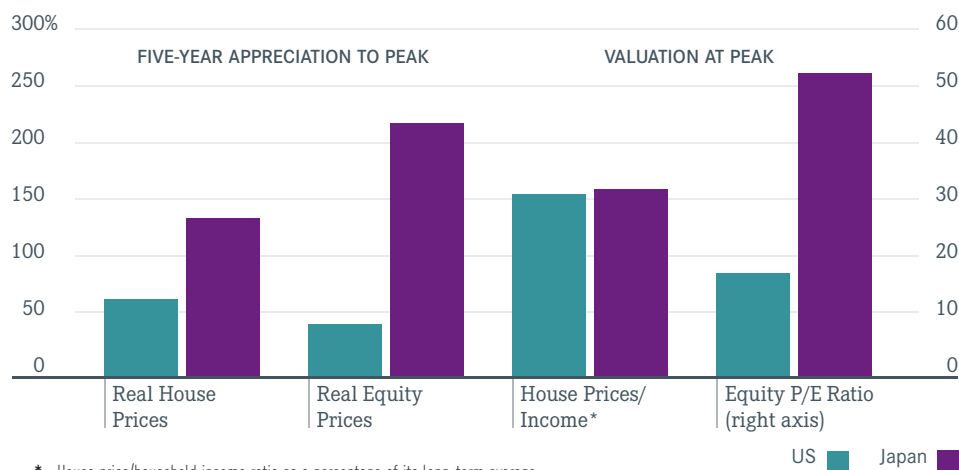
The first key difference between the US and Japanese crises relates directly to the overall size of their respective asset bubbles (see chart below). According to an influential *Foreign Affairs* piece (March/April 2009) by Richard Katz, commercial land prices in Japan's six largest cities increased by 500% between 1981 and 1991. This compares to the 200% housing price increase seen in the 20 largest US cities between 1996 and the peak of the US real estate bubble in 2006. The disparity is also visible in the aftereffects of the bubbles bursting. Whereas prices in Japan plummeted to a level well below that of 1981 (and, as of 2009, remained an average of 60% below the 1991 peak), US housing prices are currently down roughly 33% from peak to trough.



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Japanese Asset Bubble Much Bigger



* House price/household income ratio as a percentage of its long-term average.

Sources: Goldman Sachs. NAR. S&P 500. Dept. of Commerce. Min. of Int. Affairs and Comm. WSJ. Nikkei.

Japan's property bubble dwarfed that of the United States. One of the more popular anecdotes claimed that the grounds of Tokyo's Imperial Palace (the main residence of the Emperor of Japan) were worth more than the entire state of California.

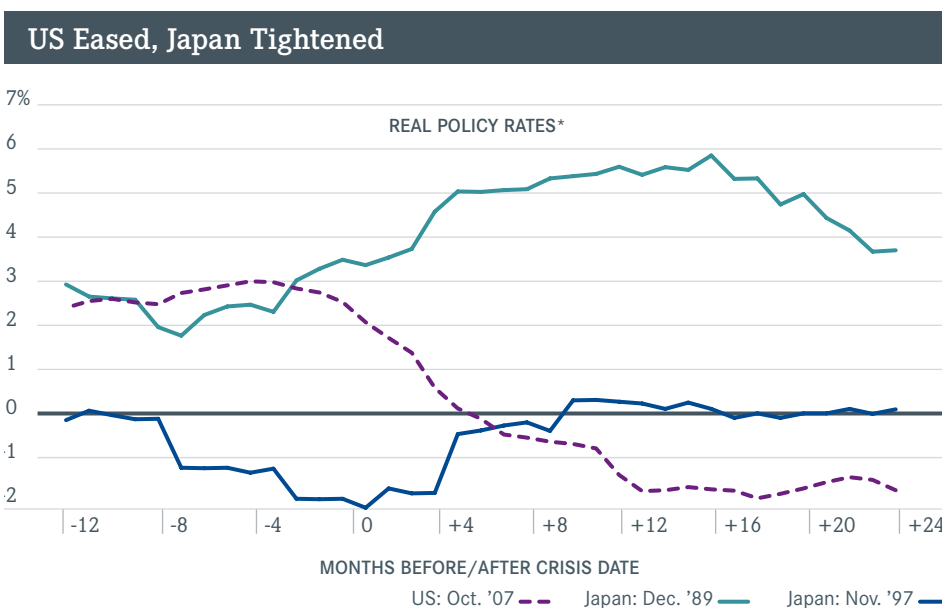
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The reflationary measures carried out by US and Japanese authorities (e.g., zero interest rate policy, multiple stimulus packages and quantitative easing) were quite similar in character and sequence. However, the US response has been significantly swifter, bolder and more adroit, which should expedite the recovery.

Exacerbating conditions in Japan were an equally overheated stock market and overleveraged corporate sector. At its asset bubble peak, the price-to-earnings (P/E) ratio for Japanese equities was quite lofty at more than 50 times (versus less than 20 times for US equities pre-crisis), while nonfinancial corporate debt comprised 125% of gross domestic product (GDP) in 1991 (versus just 50% of US GDP at the end of 2008). The US equity market already endured 10 years of valuation compression following the 2000-2002 dot-com bust. The upshot: Corporate America – having spent the better part of the last decade wringing out capacity excesses – entered the most recent credit downturn in fit shape, boasting underlying profit and productivity growth, strong balance sheets and diversified global business footprints. The US financial sector did take a significant hit, but the magnitude of the correction in asset values was dramatically less than that experienced in Japan post-peak. As confirmed by Goldman Sachs, losses to US banks are in the neighborhood of \$1 trillion, corresponding to approximately 7% of GDP; in Japan, collective write-offs totaled nearly 20% of GDP over the 1992-2005 period.

US Policy & Regulatory Response Comparatively Swift and Thorough

The timing and scope of government intervention is another key distinction between the two crises. The chart below illustrates the stark difference in monetary policy reactions of the United States and Japan. The Federal Reserve (Fed) responded quickly and forcefully to mend US credit markets and kick-start the economy. Among its most notable actions: slashing the target rate more than 500 basis points and broadening its policy toolkit to include unconventional measures, such as the creation of liquidity facilities and expansion of its own balance sheet (i.e., quantitative easing) – all this within the first 18 months of the crisis. Japan responded much more slowly. It took almost nine years for the Bank of Japan (BoJ) to bring its target interest rate to zero, from a peak of 8% in 1991. Moreover, the BoJ actually tightened monetary policy in the early stages of its crisis, as the roots of deflation were taking hold. Though Japanese policymakers also employed quantitative easing, they did not begin this until the early 2000s.



* Deflated using core consumer price index.

Sources: Goldman Sachs. Bank of Japan. Labor Department. Federal Reserve Board.

Beyond monetary policy, fiscal support packages have been larger and further reaching in the United States. In addition to the massive \$787 billion stimulus bill passed in early 2009, US authorities passed a series of narrower programs aimed at invigorating consumption (e.g., Cash for Clunkers, tax incentives for prospective home and auto buyers). Japanese policymakers also provided stimulus measures, but they were incremental and a large portion was allocated to public works, where the overall benefit is small and slow to be realized. US regulatory efforts (namely, bank stress tests and recapitalization programs) were also hugely successful in maintaining the flow of credit and, more critically, reestablishing confidence in the banking sector. Here, again, Japanese policymakers were extremely slow to react and their eventual responses were too timid and inconsistent to have a meaningful and sustained impact.

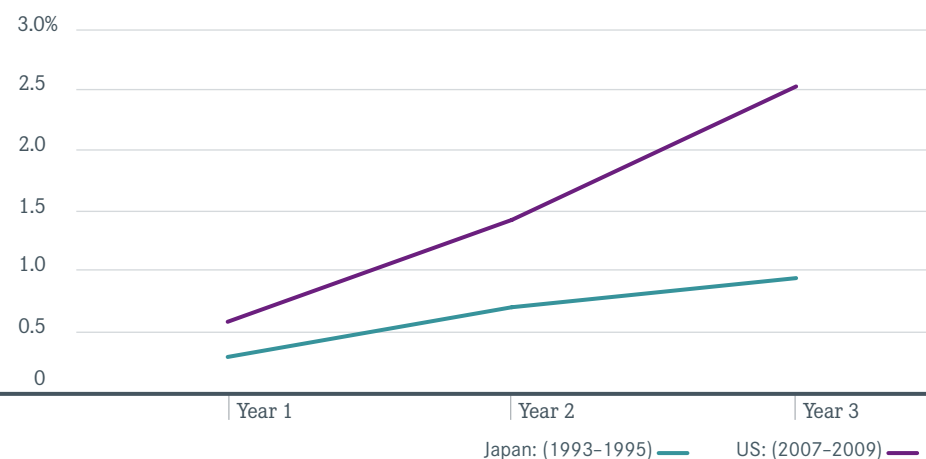
Open US Economy Dynamic and Proactive

The last critical distinction can be ascribed to culture. The United States is innately flexible, dynamic and industrious. It boasts an open economy, with policies that promote efficiency and enterprise – international and domestic competition is embraced and ailing and/or unproductive businesses are allowed (and, in some instances, encouraged) to fail or merge into stronger entities. This latter characteristic speaks to capitalism’s “creative destruction” and was apparent throughout the Great Recession, as a host of institutions folded (e.g., IndyMac, Lehman Brothers), were bailed out/seized by the government (e.g., AIG, Fannie Mae and Freddie Mac) or sold off to a more able counterpart (e.g., Bear Stearns, Wachovia, Washington Mutual). Of the solvent banks, US authorities demanded the rapid write-down of bad debt (see chart below), allowing for faster recapitalization of the banking system and, thus, a swifter resumption of lending. It was a painful process in the short term, but one that was necessary to guide the US economy onto a true path of long-term financial stability and recovery.

The United States is inherently flexible, dynamic and proactive. Importantly, its belief in creative destruction allowed for a much faster adjustment as losses were recognized quickly and only few “zombie” firms were given lifelines. This is in sharp contrast to a more rigid and passive Japan, which prolonged its malaise by delaying recognition of bad assets and providing cover for countless insolvent “zombie” firms.

Faster Loss Recognition by US Banks

Charge-offs (% of loans), Japan 1993–1995 and US 2007–2009



Source: BofA Merrill Lynch.

Unlike Japan, the United States has the benefit of a historical precedent. For certain, much of the response by US policymakers in the last few years has been driven by a determination to learn from, rather than repeat, Japan's mistakes.

Contrast this with Japan, whose closed economy promotes a more rigid structure that is less tolerant of the concept of creative destruction. Japanese regulators dallied in their response, initially denying the existence and gravity of the crisis, which subsequently led to delays in the realization of their losses, vital bank recapitalizations/restructurings and more expansive structural reforms. Case in point: Eight years elapsed before Japan acknowledged the severity of its crisis and began to use public funds to recapitalize its banks; in the United States, this process began in less than one year. Worse yet, insolvent companies in Japan were kept on life support (dubbed “zombie” firms), poisoning the financial system and stifling the economy, as they distorted the market and consumed capital that otherwise would have gone to more productive firms.

Learning From History

There is something to be said for studying past experiences—they can certainly be instructive. Regrettably, Japan did not have the benefit of a historical precedent, but that misfortune is the United States’ opportunity. Indeed, Fed Chairman Ben S. Bernanke is a student of asset bubbles and was particularly watchful of (and outspoken on) Japan’s policy mistakes. There is a clear understanding of what not to do. This, of course, does not mean the United States won’t make different mistakes.

That being said, no two crises are exactly alike. As observed by Mark Twain: “History does not repeat itself, but it does rhyme.” In our view, the US and Japanese crises “rhyme.” Their fundamental dissimilarities, however, should forestall a “repeat.”

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