

Special Market Update

Markets Enter Correction Territory as Economic Concerns Set In

August 5, 2011

Stocks have endured sustained volatility recently, falling 10% over the last two weeks and dropping close to 5% on Thursday, August 4, the largest one-day decline since 2008. 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.

What is behind the sharp downturn in stocks?

While markets have been in an uncertain environment for much of 2011 based on weaker economic data, the current volatility seems to have escalated considerably with the debate and resolution over the debt ceiling issue.

Based on the amount of time spent on this debate and the intense focus that market participants had concerning debt and deficit issues, there was an expectation that the deal that was reached would provide some sort of relief rally, but that did not really happen. When investors took a step back and looked at the deal, it became clear that the long-term debt issues have yet to be resolved and that some hard decisions still need to be made. Investors do not like uncertainty, and being faced with the continued uncertainty surrounding additional rounds of contentious debates over debt issues does not bode well for investor sentiment.

At the same time that these debates were going on, investors witnessed a rash of disappointing economic data. Last week's second-quarter gross domestic product report was much worse than expected and showed that the United States economy has only expanded at around a paltry 1% rate in the first half of the year. That data was followed this week by a weak manufacturing report and disappointing consumer spending numbers, all of which prompted renewed fears of a recession.

All of this also occurred against the backdrop of escalating concerns over European debt problems. Europe is struggling over mounting debt pressures and continues to face significant structural problems in the form of being a region that essentially has a single monetary policy but many fiscal policies. The degree of uncertainty over potential resolution of the sovereign debt problems has been weighing on the markets as well.

On Thursday, August 4, markets began declining sharply, and broke through some important technical trading floors (such as the 1,250 mark for the S&P 500 Index). This prompted a further acceleration in selling, the result of which became the worst day of trading in several years.



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What is likely to happen next?

In many ways, markets are in uncharted territory and are facing so many unknowns, which makes it difficult to forecast what will happen next. In our view, however, the key question is what will happen with the global and US economies.

At present, we do not believe that the economy is really facing significant fundamental weakness that would lead to a new recession; rather, the economy is being held back by ongoing credit issues and renewed deflation fears. This may sound like a technical point, but it is an important one, given that, in many ways, the economy is stronger than it was a year ago.

Unlike the market downturn that occurred last year around this time, there are some important differences in the macro backdrop that investors should be aware of. Unlike last year, the growth in the supply of money is positive as is the velocity of money growth. Jobs growth is still weak, but is significantly better than it was 12 months ago (as can be seen by the better-than-expected labor market report issued on August 5). Additionally, bank lending is expanding, a particularly important point for small businesses that conduct a great deal of the hiring in the United States. To this list we would also add the fact that gasoline prices have been falling, which should help provide a boost to consumer confidence and consumer spending. Finally, we would also point out that the supply chain disruptions that occurred due to the earthquake in Japan earlier this year have mostly eased, which should provide a boost to such sectors of the US economy as auto manufacturing.

For all of these reasons, we do not believe that the United States will be entering a recession any time soon. US growth in the second half of 2011 is unlikely to be strong, but we do not believe it will be as weak as the markets are currently predicting.

What are some potential catalysts for improvement?

The risks to the economy and the market are well known, but it is equally important to recognize that there is also a list of things that could “go right.”

First, we would expect to see the trend of economic data moving from negative to mixed. We’ve been saying for some time that we expect the economy to “muddle through” and we do expect to see some positive surprises in the economic data. The July employment report was stronger than expected, so perhaps that represents the start of this trend.

Outside the US, we are hopeful that we will see some clarity around the European sovereign debt issues. Europe will likely remain a troubled region and growth will be weak, but we believe that the eurozone will hold together. Additionally, we think there is a good chance that Chinese policymakers will be successful in lowering inflation and engineering a soft landing, which would also take some risks out of the market.

Federal Reserve action could also represent a potential positive. While we are not expecting to see a new “QE3” type of program (unless the economy performs significantly worse than we expect), should the Fed merely choose to announce it will maintain its balance sheet for an extended period that would represent a de facto form of quantitative easing.

It is also possible that we could see some progress on the US political front. There is a very low likelihood that Congress and the President would be able to agree on some sort of package that would result in significant structural changes designed to create capital formation and hiring, but there is an outside chance that the weakness in the economy

could prompt the parties to come together to enact some new policy initiatives on that front. More likely would be some sort of agreement to extend the current payroll tax cuts or to extend unemployment benefits, both of which would help promote economic growth.

Finally, we would point to corporate earnings. Corporate earnings have long been a source of strength, and despite the weakness in the economy, companies have been able to show impressive growth. The most recent data from the second quarter shows that over 75% of companies have beaten expectations and the average beat has been by 5%. This is not a new phenomenon. Earnings are up 128% since the market lows in March 2009. In contrast, the S&P 500 is up 80% over that same time. As a result, stock valuations are more attractive now than they were when markets were at their worst during the credit crisis, and particularly so as compared with bonds.

What should investors do?

There is a great deal of fear and risk present in the markets, and we are hardly suggesting that everything will be smooth sailing from here, but nothing that has happened over the last couple of weeks fundamentally alters our cautiously optimistic outlook for stocks.

Our summary view is that if investors believe (as we do) that the US will avoid recession, then continued overweights in risk assets makes sense. Cash is still yielding essentially zero percent, and Treasury yields have fallen sharply as well, so compared to alternatives, stocks continue to represent an attractive option.

We expect to see continued high levels of volatility in the weeks ahead given the lack of clarity around all of the issues we outlined earlier, but we do believe that conditions should improve. We are closely monitoring economic and sentiment signals, as well as the labor market, as new trends could be starting. This is not a time that investors should panic and overreact to short-term market swings. Maintaining a focus on long-term objectives is always critical during times of market stress.

Two weeks ago, we did not think that stocks were expensive. Now, with markets lower by 10%, stocks are pricing in a more negative scenario than we expect. To us, this suggests that the present market could represent an opportunity to accelerate moves out of cash and Treasuries and into risk assets.

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