

## BlackRock Investment Directions

### Asset Allocation Overview

Conditions have improved compared to last quarter, with the US economy showing signs of acceleration and European policymakers moving further along the path of progress. With the bearish tone receding, investors should consider moving into “risk” assets and out of “safe” assets, especially on pullbacks.

### Investment Themes

- ▶ **The recent equities rally could continue:** With risks of a US recession diminished and the European debt crisis tempering a bit, major investor concerns are receding somewhat. Risks remain, but continued global policy stimulus should support investor confidence.
- ▶ **Artificially low rates should rise:** Some easing of concerns out of Europe and surprisingly resilient US economy is negative for long duration. Consider shedding long duration Treasury assets for high yield, mortgages and inflation protected Treasuries.
- ▶ **Munis continue to perform:** Fiscal optimism, investor demand and lower volatility versus comparable US Treasuries make the sector attractive on both an absolute and relative value basis.



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### Asset Allocation Views

		Key ○ = previous quarter ● = current quarter						
		Strength of Preference						
		Strong	◀	Neutral	▶	Strong		
<b>Asset Allocation</b>	With bearish tone receding, anticipate shift to risk-on sentiment	Bonds	○	○	●	○	○	Stocks
<b>Equities</b>								
<b>Region</b>	Continue to favor US stocks over non-US	US	○	●	○	○	○	Int'l
	Supply/demand dynamics favor developed markets, at least for now	Developed	○	●	○	○	○	Emerging
<b>Market Cap</b>	Too soon for a shift to small cap	Small	○	○	●	○	○	Large
<b>Style</b>	Uncertain economic data continues to favor growth	Value	○	○	○	●	○	Growth
<b>Fixed Income</b>								
<b>Duration</b>	Potential risk-on sentiment warrants shortening	Short	○	●	○	○	○	Long
<b>Quality</b>	Lower quality is attractive given positive data and wider spreads	High	○	○	●	○	○	Low
<b>Region</b>	Rising rate risks in developed vs policy cuts in emerging move us to neutral	Developed	○	○	●	○	○	Emerging
<b>Commodities &amp; Currencies</b>								
<b>Commodities</b>	Slowing growth in emerging markets balanced against global policy inflationary pressures keep us neutral	Underweight	○	○	●	○	○	Overweight
<b>Currencies</b>	Easing the euro crisis requires a lower euro; US economic strength favors USD	US	○	○	●	○	○	Foreign

*Our base case outlook is that these improving trends will continue along an uneven path, suggesting that stocks are poised for additional outperformance in the months ahead.*

*Our main investing theme as we enter 2012 is a focus on free cash flow generation, particularly those companies that have the cash flow needed to increase their dividends.*

## Equity Market Outlook

Three months ago, stocks were pricing in about a 50% chance of a US recession and it looked increasingly likely that the European debt crisis would escalate into an Armageddon scenario. Today, while we would hardly say that the United States is poised to enter boom conditions or that the eurozone crisis has been solved, these risks have clearly receded, which has helped stocks to regain some footing. Our base case outlook is that these improving trends will continue along an uneven path, suggesting that stocks are poised for additional outperformance in the months ahead.

As was the case for the latter half of 2011, the key wildcard for global stocks remains the extent to which progress can be made in terms of resolving the European debt crisis. Over the closing months of last year, there did appear to be a change in tone among Europe's policymakers and elected officials as they moved from a sort of complacency into taking more forceful action. The difficult decisions that need to be made combined with a contentious political backdrop in Europe do mean that progress will be slow and uneven, but we do expect it will continue.

Over the near term, we expect volatility levels will remain high given that we will likely see a "two steps forward, one step back" theme in both the eurozone debt crisis and in US economic growth. Nevertheless, we also expect that conditions should improve enough that investors will be willing to move back into risk assets. That trend, combined with attractive valuations and still-decent earnings growth, should set the stage for equity market outperformance.

## Equity Views

- ▶ Our main investing theme as we enter 2012 is a focus on free cash flow generation, particularly those companies that have the cash flow needed to increase their dividends. These types of companies can be found across capitalizations, styles and sectors.
- ▶ From a geographic perspective, we continue to believe that the United States is better positioned than other developed markets. Regarding emerging markets, we may see a turnaround at some point in 2012, but we believe it is too early to make that call.

## Equity Sector Outlook

Key ○ = previous quarter ● = current quarter

	Current Outlook	Strength of Preference				
		Underweight	◀	Neutral	▶	Overweight
Healthcare	Strong cash flow growth; still the best defensive sector	○	○	○	○	●
Energy	Attractive valuations and good cash flow warrant increased overweights	○	○	○	●	●
Telecom Services	Attractive yields, positive cash flows and competitive fundamentals	○	○	●	●	○
Consumer Staples	Neutral fundamentals with mixed valuations	○	○	●	○	○
Industrials	Downside earnings risk; retain neutral	○	○	●	○	○
Information Technology	Fundamentals mixed; valuations are fair	○	○	●	●	○
Consumer Discretionary	Mixed trends & mixed valuations	○	○	●	○	○
Materials	Uncertain outlook in a modest growth environment	○	○	●	○	○
Utilities	Mixed fundamental outlook; somewhat expensive	○	●	○	○	○
Financials	Earnings estimates continue to fall, but valuations improving	●	●	○	○	○

## Taxable Fixed Income Market Outlook

Fears regarding European debt crisis contagion and, ultimately, the viability of the financial system and the euro have driven fixed income market volatility and flight-to-quality sentiment. However, we believe positive winds of change are afoot stemming from policymakers' extension of banking system funding and support. These moves should mitigate near-term risks of a banking system failure that is a root cause of risk aversion. That said, considerable risks remain, particularly the speed of European bank deleveraging and its impact on the depth of the eurozone recession in 2012. If the deleveraging is measured or even postponed, the recession should be short and mild. However, accelerating deleveraging would create a negative feedback loop of credit contraction and credit losses, contributing to a more severe recession.

The United States, in contrast, continues to demonstrate surprising growth despite the negative impacts from the eurozone crisis and slowing growth in emerging markets. While we anticipate slowing from the current pace, easing of macro concerns in this context should induce higher interest rates in the intermediate to long duration part of the yield curve. However, expanded Fed QE potential in the face of any slowing in growth should limit the scope of potential increases.

With minimal US fiscal policy improvements available to ameliorate moribund housing and employment, we expect additional monetary stimulus in 2012 if the current pace of growth slows. This would dull volatility and take out some shock risk, leading to an upward move in abnormally-low interest rates, a negative for US Treasuries and long duration. As such, credit sectors such as high yield, securitized assets and agency mortgage backed securities will provide income while policymakers seek structural change.

*Investors should anticipate a shift back to risk by reducing exposure to Treasuries and increasing exposure to risk assets, particularly credit sectors.*

## Taxable Fixed Income Views

- ▶ We continue to believe additional policy stimulus could come to mute volatility and support moribund employment and housing markets, taking out shock risk and encouraging risk-on trades.
- ▶ Investors should anticipate a shift back to risk by reducing exposure to Treasuries and increasing exposure to risk assets, particularly credit sectors.

## Taxable Fixed Income Sector Outlook

		Key ○ = previous quarter ● = current quarter				
	Current Outlook	Strength of Preference				
		Underweight	◀	Neutral	▶	Overweight
<b>High Yield</b>	Yield and fundamentals compel a core overweight strategic position	○	○	○	●	○
<b>Securitized Assets</b>	Yields are attractive but markets remain illiquid	○	○	○	●	○
<b>Agency Mortgages</b>	Yield advantage over Treasuries but sector is volatile	○	○	○	●	○
<b>Corporates</b>	Recent widening increases attractiveness of sector vs. financial sector risks	○	○	○	●	○
<b>Non-US Dollar</b>	Higher US rates vs. potential near-term euro crisis easing and EM rate cuts favors non-USD	○	○	○	●	○
<b>Emerging Markets</b>	Slowing growth raises corporate risks but policy favors local currency debt	○	○	○	●	○
<b>Inflation Protected</b>	Expensive in absolute terms though prefer them to nominal bonds	○	○	○	●	○
<b>Treasury/Agency</b>	Yields may rise with investor sentiment improving	○	○	○	●	○

## Municipal Market Outlook

Tax-exempt supply picked up in in the final quarter of the year, but continued to be met with strong demand, particularly from individual investors. Issuers' return to the market seems to suggest greater

fiscal optimism among political leaders and reduced anxiety around the idea of incurring debt. Notably, a year since the doomsday prediction of mass municipal bond defaults, Standard & Poor's data reveals that muni bond defaults in 2011 were well below 2010 levels. In fact, munis were the best-performing fixed income asset class for all of 2011. With munis attractive on both an absolute and relative value basis (as well as being less volatile than comparable US Treasuries) we believe the asset class remains compelling. Given low absolute rates currently, we believe performance will be driven by yield curve positioning, accrual of principal and capital preservation.

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## Municipal Market Views

- ▶ We continue to favor a barbell approach to yield curve positioning, with exposure to both long and short maturities. We recommend overweighting state tax-backed and essential service bonds, as well as revenue sectors such as hospitals, transportation, housing and education.
- ▶ We are less inclined toward land-secured bonds, senior living bonds, bond insurers, student loans and local tax-backed issues.

Municipal Market Positioning		
		Key ○ = previous quarter ● = current quarter
Current Outlook		Strength of Preference Strong ◀ Neutral ▶ Strong
Duration	Recently shifted from neutral to long duration bias for munis	Short ○ ○ ● ○ ● Long
Yield Curve	Favor a barbell approach (i.e., long and short maturities)	Short ○ ● ○ ● ○ Long

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