SQUEEZING OUT MORE JUICE

2014 INVESTMENT OUTLOOK

DECEMBER 2013

BLACKROCK®

BLACKROCK INVESTMENT INSTITUTE

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The opinions expressed are as of December 2013 and may change as subsequent conditions vary.

SO WHAT DO I DO WITH MY MONEY?®

Big Picture

- **Helicopter View:** We generally prefer equities over bonds, particularly in our base case *Low for Longer* scenario.
- **Risk in Safety:** Equities and bonds are becoming more correlated. This is making "safe" portfolios a lot more risky.
- **Alternative Menu:** Infrastructure, real estate and other alternatives are real diversifiers—and offer attractive yields in a low-rate world.
- **Volatility on Sale:** It is better to buy an umbrella before the rain. Volatility is cheap and many assets are expensive.

Equities

- **Equity Value:** Equities are not cheap—but they are not (yet) in bubble territory. We generally favor Europe and Japan on valuation.
- **Yield Caution:** US yield plays will wrestle with tighter liquidity. Dividend growers still offer potential, as do non-US dividend payers.
- **Emerging Idea:** Our contrarian idea is to overweight emerging stocks vs. developed. Be selective and favor indirect exposures (multinationals).

Fixed Income

- **Carry On:** Many bonds still look expensive and risky (especially government debt). Go for carry (yield) in a barbell strategy.
- **Curve Plays:** Low rates support short maturities. Tapering fears have hammered many long-term bonds back to reasonable valuations.
- **Beware Traffic Jams:** Easy to get into, hard to get out of. Liquidity could dry up fast in some credit markets—when you need it most.

US Financial Advisors: More insights in *2014 Outlook: The List*.

Summary

- We are introducing three new investment scenarios for 2014 against a backdrop of low nominal growth and markets driven by monetary policy choices. *Low for Longer*, our base case with a 55% probability, features tepid economic growth and loose financial conditions. Our bull case (25%), *Growth Breakout*, has economic activity accelerating and liquidity gradually tightening. Our bear scenario (20%), *Imbalances Tip Over*, highlights the many things that could go (very) wrong.
- We are living in a low-growth world that is slowly returning to normalcy—if we are lucky. We expect US GDP growth to tiptoe to around 2.5% as the impact of tax hikes and spending cuts fades. We see the Eurozone eking out growth—but not enough to reduce debt loads. A slowing China is still set to be a major contributor to global growth (financial sector risks are its weak link). We are split on whether Japan's growth plan will work. The good news: Developed economies should accelerate in tandem for the first time since 2010.
- Our worry: Global central banks may be pushing on a string. Low nominal growth cannot be solved by monetary policy alone. "MQuantity" (monetary growth) does not address skills mismatches, aging populations, labor market red tape and protectionist policies. Central banks can ease some of the pain—but ultimately policymakers must deliver structural reforms to boost growth.
- Liquidity provision will grow more slowly in 2014—and markets invariably focus on rates of change as much as absolute levels. We expect the US Federal Reserve to scale back its bond purchases, but use *Low-for-Longer* forecasts, or "forward guidance," to keep a lid on interest rates. The European Central Bank's (ECB) balance sheet is shrinking. The Bank of England may raise policy rates on economic strength. The People's Bank of China is set to tighten slightly to reduce the risk of a credit bubble. The recycling of emerging market foreign exchange reserves is slowing.
- These liquidity-crimping measures will be partly offset by the Bank of Japan's Godzilla-sized asset purchases. And we could see some form of quantitative easing (QE) from an ECB worried about deflation. German opposition is a roadblock—unless the risk of deflation expands beyond Europe's southern tier.
- Should we worry about the Fed's (gentle) QE exit? It is not going to be a walk in the park, as some policymakers would like to think. We see it more as a triathlon in twilight. A healthy dose of humility is in order. The absence of a price-insensitive buyer will be felt. Policy words (forward guidance) replacing policy deeds (bond buying) equals a pick-up in rates and currency volatility.
- Currencies matter—and not just for asset returns in a particular country. A weaker yen (cheaper Japanese goods) is a deflationary force globally; the Eurozone needs a weaker euro to export its way out of trouble; and a stronger US dollar pressures emerging markets. Currencies will create winners *and* losers.
- As *Low for Longer* grinds on, imbalances grow. One is of particular interest to us as money managers: the potential for markets to overheat. Are we there yet? We do not think so. Irrational exuberance can last a long time. But much policy powder has already been spent, and we will be on bubble watch. 2014 is the year to squeeze out more juice from markets—and be ready to discard the fruit when it starts running dry.
- Bonds have long been expensive. The problem for stocks: The numerator of the P/E ratio (price) is driving returns, not the denominator (earnings). Investors have jumped on the momentum train—effectively betting yesterday's strategy will win again tomorrow. Rising correlations between bonds and stocks are making well-diversified, "safe" portfolios riskier than they appear.
- Diversification is like insurance: You do not need it—until you need it. Consider alternative investments for 2014. Some are real diversifiers (at least in theory). We like market neutral funds and strategies focused on "hard" assets such as infrastructure. The downside (illiquidity) appears a fair price for uncorrelated returns in a low-growth world.

3 KEY POINTS

1 GROWTH
Nominal growth is sluggish around the world—yet there is potential for upside surprises as fiscal austerity fades.

2 MARKETS
2014 is the year to squeeze more juice out of risk assets. Be ready to discard the fruit when it starts running dry.

3 RISKS
Obvious risks are few; hidden ones are plentiful. Beware of (well-meaning) central bankers, volatility spikes and rising correlations.

First Words

Tentative signs of economic growth; receding risks; plentiful, nearly free liquidity; and financial markets on fire: What was not to like about the investment landscape at the end of 2013?

It is tempting to believe what happened yesterday will happen again tomorrow (especially if momentum has been paying off, as it did in 2013). So we worked hard to look beyond current market conditions during our 2014 Outlook Forum in mid-November held in New York.

The semiannual event, the fifth of its kind, hosted 100 BlackRock portfolio managers and executives as well as a handful of external thought leaders. We intensely debated the impact of key policy, economic and market forces.

We did not always agree on everything (probably a good sign). In fact, disagreement happens every day. (We prefer to call this knowledge sharing.) One source of debate is a weekly poll of our portfolio managers on a question related to policy, economics or markets.

The graphic below visualizes our responses to these polls in 2013. Clearly, "growth" (or absence thereof) has been foremost on our minds, followed by "risk" and "rates." We did not keep score during our 2014 Outlook Forum, but chances are these terms would show up—as well as "policy," "value" and "jobs." (See our interactive *BlackRock Jobs Barometer*.)

One of our main objectives was to develop and debate new investment scenarios. We adopted a trio for 2014.

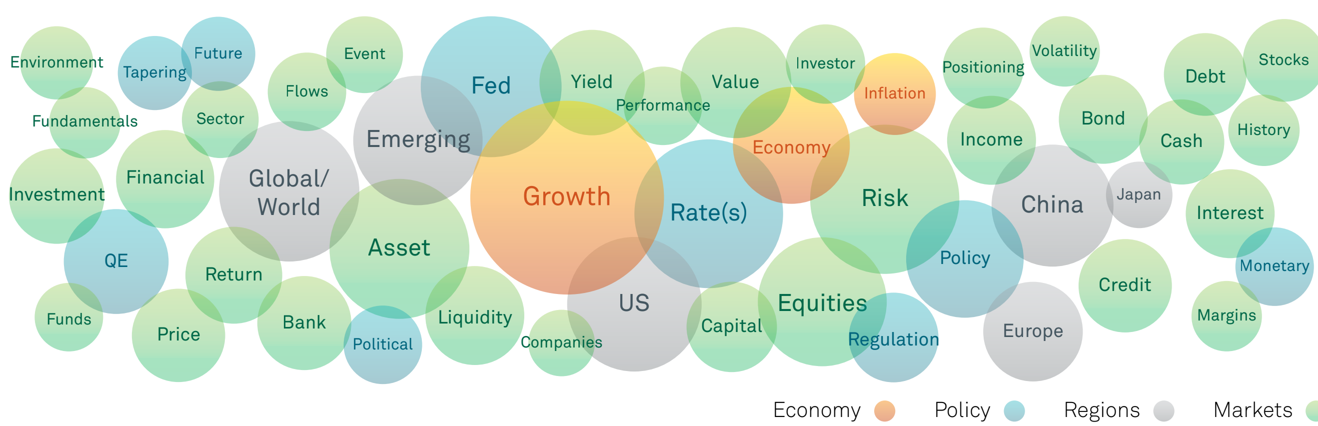
- Our base case (55% probability), *Low for Longer*, features subdued growth and very loose financial conditions. Most markets would do just fine—for a while. This flood of liquidity is helpful but scary.
- Our bull case (25%), *Growth Breakout*, essentially involves a return toward precrisis growth rates while financial conditions tighten gradually. This is largely bad for bonds and mixed for equities. (Caution: Markets have a way of getting ahead of themselves.)
- Our bear case (20%), *Imbalances Tip Over*, has assets re-price and volatility rise as imbalances snap. Think of markets addicted to monetary stimulus, countries relying on external funding, and deflation risk and its potential impact on fixed liabilities and corporate profitability.

The next page highlights how we see the economy, financial conditions, markets and companies behaving in each scenario. We also list various downside and upside investment risks that can be seen as signposts for evolving from one scenario to the next. Our scenarios play out differently across economies. We give the key characteristics of each as well as preferred assets for the United States (pages 12–13), Europe (14–15), Japan (16), China (17–18) and emerging markets (19).

Speaking of the latter, we believe the "developed" and "emerging" market labels are rapidly becoming irrelevant (see page 19). In fact, we offered a prize (dinner for two; transport at your own cost) to the person who could invent a substitute. One early entry was Resilient Economies and Markets (REMs) and Non-REMs (NREMs), which came with a lengthy sleep analogy. One with more potential: High Potential Markets (HPMs) and Limited Potential Markets (LPMs). Stay tuned.

WHAT'S BEEN ON OUR MINDS

Frequent Words in Internal Blog Posts by BlackRock Portfolio Managers, 2013



Source: BlackRock Investment Institute, November 2013.
Notes: The bubbles show the top-50 most frequently used investment terms in blog post responses by BlackRock portfolio managers to the firm's "question of the week." Bubbles are proportionally sized by word count to represent the frequency of usage.

2014 Scenarios

	IMBALANCES TIP OVER	LOW FOR LONGER	GROWTH BREAKOUT
ECONOMY	Squeezed real incomes, debt burdens or austerity cause recessions and/or China's economy slows markedly. Low inflation tips over into deflation.	Growth is low and fragile, running close to stall speed. Jobs and wage growth are muted in the developed world. Inflation is low but stable.	Global growth gains momentum, pent-up demand is unleashed and animal spirits return, creating a virtuous circle. Inflation rises gradually.
LIQUIDITY	Central banks either tighten policy too fast or too late. Capital flees emerging economies with external deficits.	Financial conditions stay very loose—but the growth of liquidity is slowing due to reduced Fed bond buying. The risk of QE-induced asset bubbles builds.	Liquidity provision is slowing—very gradually. Central bankers somehow engineer smooth policy transitions toward (eventual) monetary tightening.
MARKETS	A downturn delivers zero nominal interest rates—but rising real ones. Markets sell off on a QE exit or exogenous shock. Risk assets fall and volatility spikes. Safe-haven government bonds get a second life.	Real rates and overall volatility stay subdued. Momentum can easily propel equities higher. The hunt for yield intensifies. Low investor conviction in trades and lofty valuations leave little room for error.	Real rates go up, driven by rising inflation expectations. This is mostly bad for bonds and mixed for stocks (growth trumps income). Cyclical assets (including commodities) should do well before rate fears kick in. Volatility rises.
COMPANIES	Revenues and profit margins fall. Buybacks are suspended and some dividends cut. Layoffs and cost cuts increase as companies hunker down for another recession.	Corporate hiring and spending are lackluster. Revenues and margins struggle to expand. Buybacks, dividends, and corporate issuance galore. Growth companies demand a premium.	Revenues grow, and companies start hiring and investing again. Profit margins stay elevated—or go even higher. Mergers and acquisitions (M&A) boom.
PROBABILITY	20%	55%	25%

DOWNSIDE | **UPSIDE**

RISKS

Downside

- Markets cannot deal with tapering.
- Real rates rise and nominal rates are frozen.
- Deflation in the developed world.
- Rising correlations and volatility.
- Political dysfunction and populist anti-market measures.
- Middle East instability.

Upside

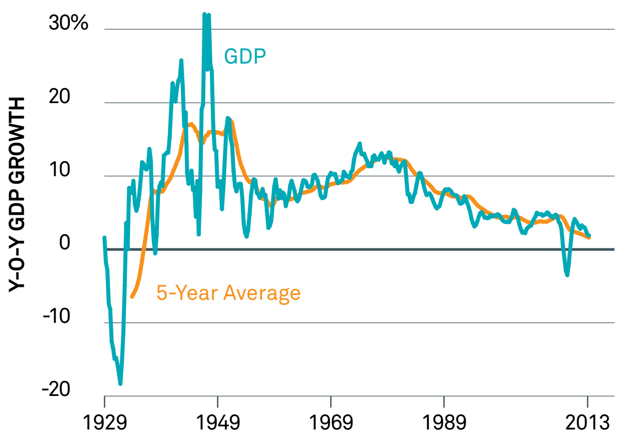
- Fading austerity delivers surprise growth boosts.
- Confidence builds and leads to a virtuous circle.
- Companies switch from buybacks to capex.
- The ECB eases further.
- Progress on China's reform plan.
- Abenomics actually works.

Growth

Growth trends are subdued. The five-year average of nominal GDP growth in developed markets has dipped to its lowest level since the 1930s, Deutsche Bank data show. See the chart below. Unless nominal growth moves above nominal rates (to 3%–5%), governments will find it tough to cut deficits. Even emerging markets are scraping the bottom of their 50-year range. The state of credit systems and deflationary forces determine how this plays out. Inflation is now well below most central banks' targets (especially in the Eurozone). Low nominal growth and disinflation could tip over into deflation (and a bear market).

DEPRESSION LOWS

Developed Market Nominal GDP Growth, 1929–2013

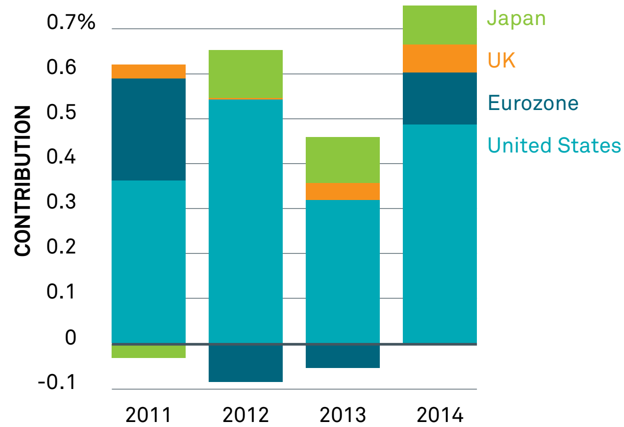


Source: Deutsche Bank and BlackRock Investment Institute, November 2013.
Notes: GDP growth is quarterly. The countries included are Australia, US, UK, Norway, Germany, Spain, Netherlands, Italy, Sweden, Canada, Japan, Taiwan, France, Denmark and Austria.

Can central banks come to the rescue again? With rates near zero and QE fully deployed, their tool boxes are pretty empty (except for forward guidance—which is likely to cause a lot more volatility once QE is gone). Plus, inflation is influenced by currency moves—which are not always within central bank control. Countries with rising currencies have seen the biggest fall in inflation (South Korea, UK and the Eurozone) and vice versa (Japan). The good news: 2014 will likely mark the first synchronized rise in global growth since 2010. See the top chart on the right. Better yet: Economic pessimists abound (leaving room for upside surprises). The key questions: Is the growth velocity strong enough for an exit from easy money? (answer: probably not) and is the rebound purely cyclical? (answer: perhaps).

START YOUR ENGINES!

Contributions to Global Real GDP Growth, 2011–2014

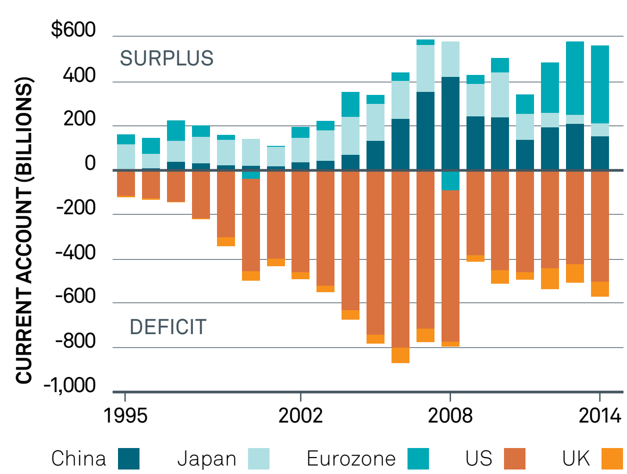


Sources: IMF and BlackRock Investment Institute, November 2013.
Notes: Contributions to global real GDP growth are in percentage points and based on purchasing power parity GDP weights. 2013 and 2014 are IMF forecasts.

The Eurozone, Japan and emerging markets are all trying to export their way out of trouble. Who is going to buy all this stuff? The US consumer? This is tough to imagine without a *Growth Breakout* (see pages 12–13). Global imbalances have shrunk but are still lopsided. See the chart below. Our conclusion: The math does not work. (Not everybody's currency can fall at once.) Rebalancing will be a big theme. Companies have been the main beneficiaries of government stimulus, squeezing the labor share and thereby consumption. Now public spending is in retreat. This will likely hurt the economy unless companies:
a) boost wages, helping consumers but eroding profits or
b) re-leverage. Either way, corporate health appears at risk.

BUYER OF LAST RESORT

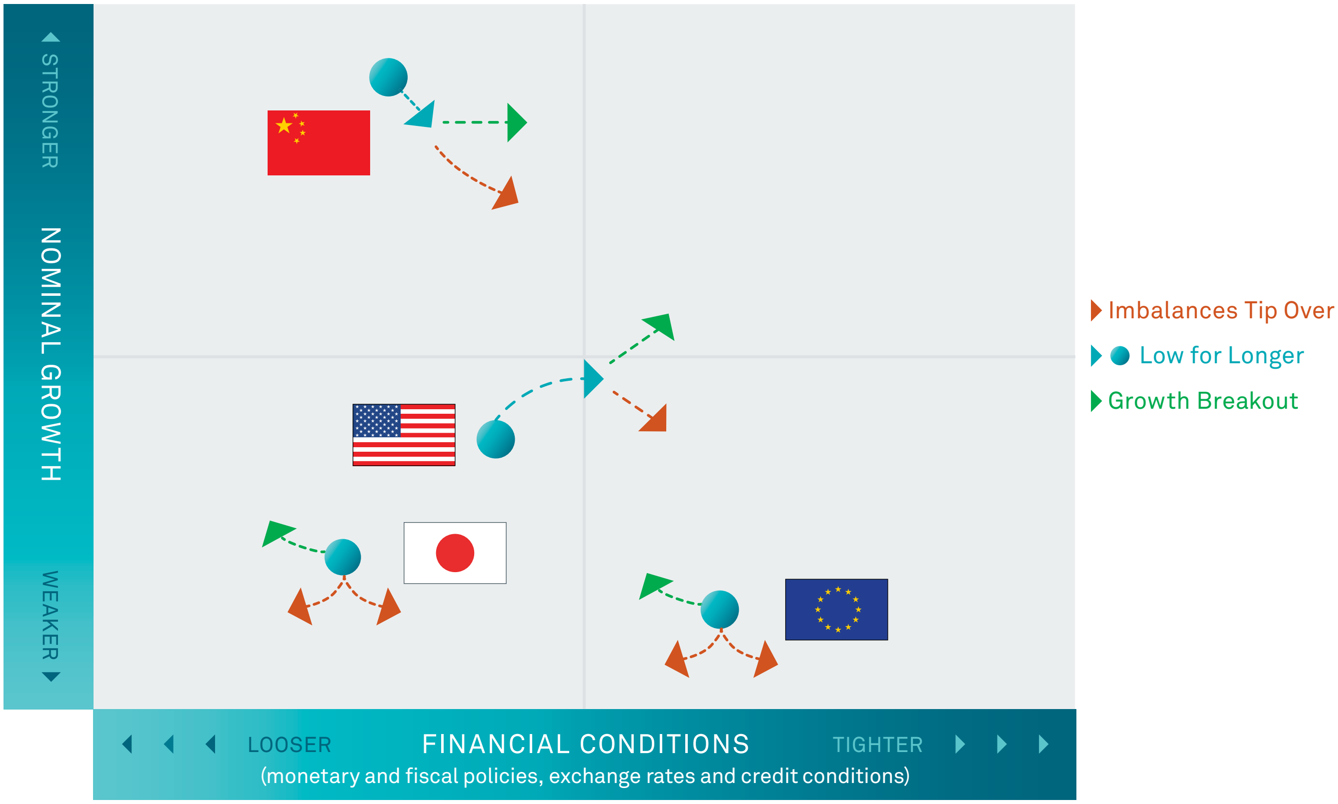
Global Current Account Balances, 1995–2014



Sources: OECD and BlackRock Investment Institute, November 2013.
Note: 2013 and 2014 are OECD forecasts.

PLOT YOUR COURSE

BlackRock 2014 Investment Scenarios



How do our investment scenarios fit into this low-growth world? The four major economies will have different levels and trajectories of nominal growth and financial conditions. Our scenarios take this into account. The graphic above illustrates this by plotting the current position of each region in a growth and liquidity framework (the blue circles).

The economies at the top of the chart have the highest nominal GDP growth (China and the United States). Those on the left have the loosest financial conditions (Japan) and those on the right the tightest (the Eurozone). The length and direction of the blue arrows shows how we think growth and liquidity may develop in 2014.

The US economy looks set for a gentle acceleration to around 2.5% GDP growth as the impact of this year's tax hikes fades (the blue arrow). We also assume some tightening in overall financial conditions as the Fed scales back bond purchases (tapers). The big question is what happens next. A good outcome: A smooth QE exit. This would result in a *Growth Breakout* (the green arrow). A bad outcome results in our *Imbalances Tip Over* (the orange arrow): The Fed tightens too soon or too late.

China is likely to slow under any scenario. A *Growth Breakout* would see growth stabilize, due to economic rebalancing (good) or an old-fashioned mix of fiscal stimulus and credit growth (big problems later). China could also see a more rapid slowdown in *Imbalances Tip Over*. For Japan and Europe, *Low for Longer* means more of the same (low but positive growth). The key questions are: Can monetary policy engineer a sustainable increase in growth? And can it offset a tightening in other financial conditions?

Liquidity is set to tighten globally. What does this mean for markets? Our knowledge is limited by a lack of previous experience. Generally, we think of the graphic's top right corner as "risk on" (good for risk assets), and the bottom left corner as "risk off." An economy's *direction*, not position, is key. For example, risk assets would gain most if an economy were to move from the bottom left toward the top right.

1 GROWTH

Nominal growth is sluggish around the world—yet there is potential for upside surprises as fiscal austerity fades.

Markets

Global markets received a wakeup call this summer, when expectations of reduced bond buying by the Fed triggered a ramp-up in volatility and a stampede out of emerging markets. Could we see a replay when tapering actually starts in 2014? This is a tough call.

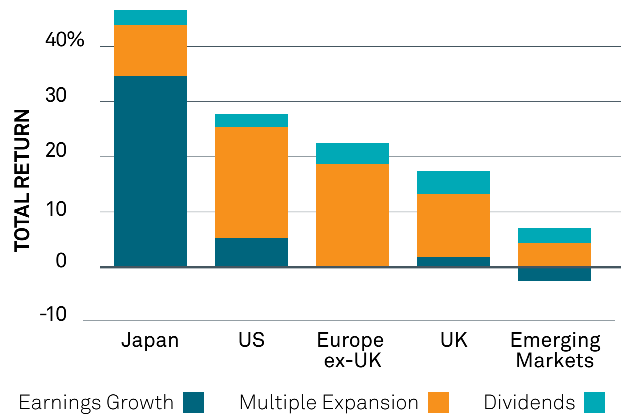
First, many interest-rate-sensitive assets have already moved. The yield on 10-year US Treasuries, for example, has risen by about 1% since Fed Chairman Bernanke's taper speech in May. Second, markets have seen this movie before. Third, the fear something bad is going to happen can do more damage than the actual event.

That said, many assets (developed market stocks and credit sectors) quickly shook off their taper hangover and some have scaled new highs. Another source of global liquidity—emerging markets recycling their current account surpluses—is slowing as foreign reserve growth shrinks. See page 19. And the absence of a price-insensitive buyer is bound to trigger more volatility.

Most important, we are not clairvoyants. We should be humble about what we know and do not know. This is especially true because many assets have been inflated by monetary policy. Bonds have long been expensive, especially "safe" sovereigns. Most equity markets are catching up quickly. See the chart below.

THE GREAT RERATING

2013 Equity Returns by Source

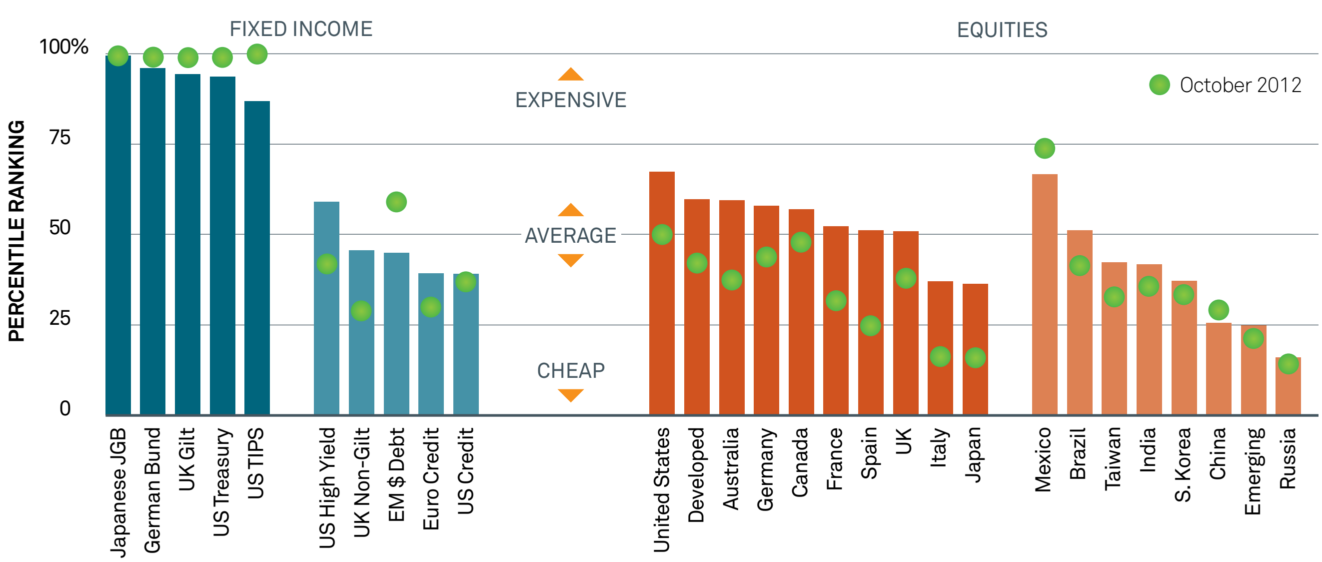


Sources: Thomson Reuters, MSCI and BlackRock Investment Institute, November 19, 2013.
Notes: All returns are in local currency terms. Multiple expansion is represented by the change in the price-to-earnings ratio. Earnings growth is based on aggregate 12-month forward earnings forecasts.

This year's equity gains, in particular, give us pause. The reason: They are largely disconnected from fundamentals (earnings growth). Multiple expansion (investors paying a higher price for the same level of earnings) drove gains in most markets except Japan. See the chart above. We worry about this. We know free cash flow and earnings growth usually account for the lion's share of equity returns in the medium term (five-year periods), as detailed in *Risk and Resilience* in September 2013. In other words: It would be nice to see more profit and revenue growth.

FEWER BARGAINS

Valuations by Percentile vs. Historic Norms, October 2013



Sources: Thomson Reuters and BlackRock Investment Institute, October 31, 2013. Notes: Valuation percentiles are based on an aggregation of a range of standard valuation measures versus their long-term history. Government bonds are 10-year benchmark issues.

BUBBLE WATCH

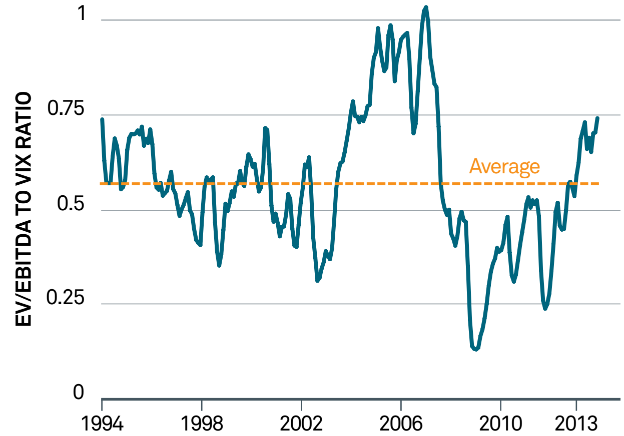
Bubble talk is bubbling up. Should we be worried? Not yet, according to a market gauge that measures US corporate valuations, leverage and investor complacency. This simple tool divides enterprise value (EV) by earnings before interest, taxes, depreciation and amortization (EBITDA). We then divide the total by the volatility index to gauge investor complacency.

The ratio of the two is the key. High valuations combined with low volatility can make for a lethal mix. This market gauge sounded the alarm well before the Great Financial Crisis (but underclubbed the dot-com bust). See the chart on the right.

Where are we today? Valuations are roughly in line with their two-decade average (and leverage is lower). Yet volatility is hovering just above two-decade lows. The result: The market gauge stands well above its long-term average, but is far short of its precrisis highs. A reduction has to be driven by a falling EV/EBITDA ratio if volatility stays low. The longer markets rerate without profits, the greater the risk of a bubble.

ARE WE THERE YET?

US Market Gauge, 1994–2013

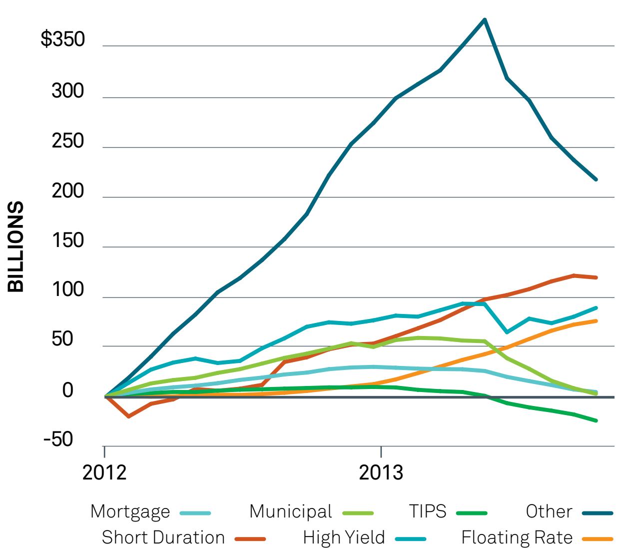


Sources: Bloomberg and BlackRock Investment Institute, December 2013.
Note: The market gauge measures US corporate valuations, leverage and investor complacency by first dividing EV by EBITDA and then expressing the total as a ratio of the VIX index of equity market implied volatility.

Tapering fears sparked a great rotation within fixed income. Short-dated bonds and floating rate funds boomed while assets sensitive to rising rates (think mortgages) bled money. See the chart below. This move may have been overdone; long-dated maturities look like better value again.

THE OTHER GREAT ROTATION

Cumulative Global Fixed Income Fund Flows, 2012–2013



Sources: EPFR, Bloomberg and BlackRock Investment Institute, October 2013.
Notes: Fund flows include mutual funds and exchange-traded products (ETPs). Mutual fund flows are sourced from EPFR monthly data. ETP flows are sourced from BlackRock and adjusted to conform with EPFR's classifications.

"Value" is relative, of course, especially in bonds. We experienced a "cathartic moment" during a recent high yield (BBB-) offering. Fair value seemed to be at a spread of 400 basis points (bps) over Treasuries. Instead, the deal priced at 195 bps and started trading at just 175 bps. Conclusion: Pockets of bond markets are overvalued. It is "sillydom." The return of risky "covenant lite" loans adds to a back-to-the-future feeling. The question (that risks alienating non-American readers by using a US sporting metaphor): Are we in the 6th, 7th or 8th inning?

There are signs of exuberance in stocks, too. A record 60% of top US fund managers had a greater risk exposure (beta) than the Russell 3000 benchmark at midyear, our analysis of regulatory filings shows.

So is "sillydom" another way of saying "bubble"? Yes—but we do not believe markets are there yet. See "Bubble Watch" above. Other things to consider include corporate buybacks (no signs of a bubble yet), takeovers (ditto) and initial public offerings (maybe).

2 MARKETS

2014 is the year to squeeze more juice out of risk assets. Be ready to discard the fruit when it starts running dry.

Risks

Which sharks are circling our boat? We do not see any up close. Indeed, a steady reduction in exogenous risks underpinned markets in 2013. (Sign of the times: We retired our doomsday *Nemesis* investment scenario, named after the vengeful Greek goddess who punishes the proud.) Yet monetary tightening in 2014 could easily magnify the market impact of any (re)surfacing risks, including those of the geopolitical variety. Other sharks in the distance:

Deflation: With aging populations putting the brakes on growth, we may not have seen the end of falling inflation. Why worry? When inflation and growth dip to very low levels, their volatility tends to increase. This raises the risk of flirting with Japan-style deflation. A squeeze in wages (in real terms) could hit consumer spending. Do central banks have enough ammunition left to forestall such an *Imbalances Tip Over* scenario? We are not sure.

US Political Paralysis: Rolling fiscal crises have become a fact of life in Washington. A Band-Aid deal to fund the US government ends on January 15, while a temporary debt ceiling extension expires in February. We expect the US Congress to be chastened after its flirtation with default this year led to record-low approval ratings—but politicians are not always rational. At the same time, the political noise is masking an improving US fiscal position.

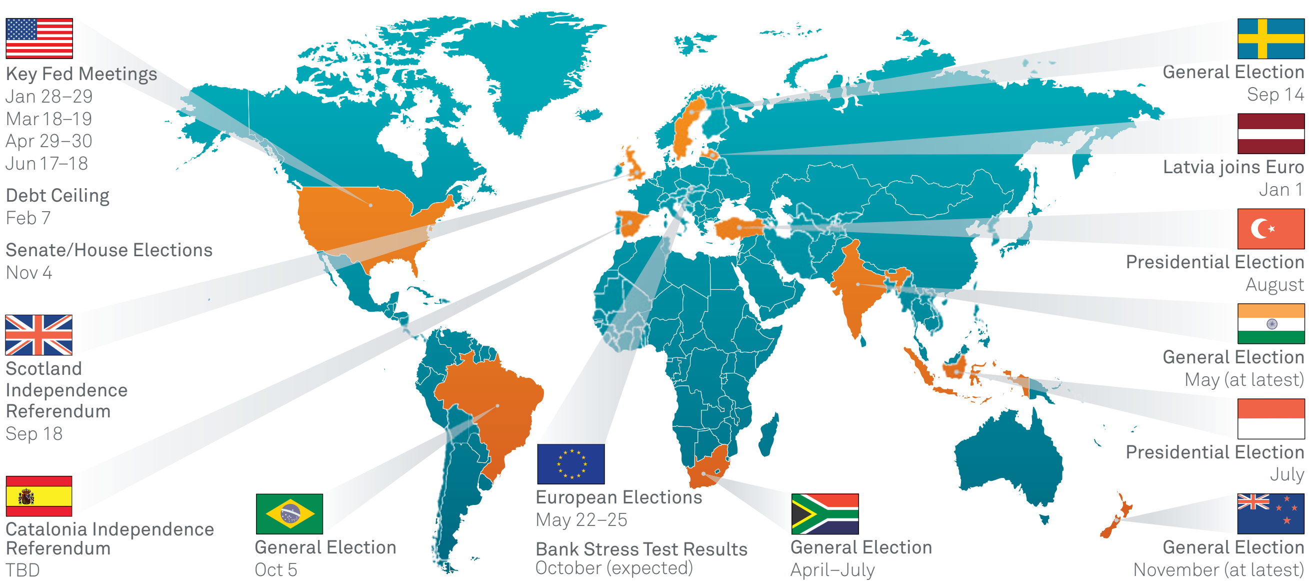
China Slowdown: The Chinese economy is slowing—but most observers expect the country to maintain a 7%-plus growth rate. What if they are wrong? The bears say rebalancing implies China will struggle to generate growth above 3%–4% over the coming decade. Bulls note the latest reform plan marks a sea change in China's growth dynamic. We think the outcome depends on reforming the opaque and somewhat extended financial system, so we cheer the focus on financial liberalization in China's Third Plenum plan. See pages 17–18.

Election Calendar: The key emerging markets of Brazil, India, Indonesia, South Africa and Turkey have elections in 2014. The prospect of anti-market policies or uncertain outcomes could further shake investor confidence in the "Fragile Five." Yet there is room for upside surprises, too. Victory by a pro-reform coalition in India's elections, for example, would put the world's largest democracy on track for a *Growth Breakout*—and would likely be cheered by markets. European Union elections are a barometer for anti- or pro-Europe sentiment. See the map below.

Populism: Angst about unemployment and inequality is rising around the world—and politicians are under pressure to respond. A symptom was Bill de Blasio's election to New York mayor on a populist platform that included higher taxes on the wealthy. Similarly, Switzerland held a referendum to dramatically curb CEO pay (it was rejected). Our worry: Knee-jerk policies to "right the ship" could end up capsizing it.

ON THE AGENDA

Select Events in 2014



Sources: BlackRock Investment Institute, November, 2013.

YEAR(S) OF THE DIVERSIFIER

Nobody cares about diversification when everything goes up; everyone cares on the way down. Alternative investments—those less impacted by yield curves, equity valuations or government policies— clearly should be on the investment menu in 2014.

Not all are effective diversifiers. Many are illiquid, others can be slow to reprice, and some are more correlated to traditional asset classes than commonly thought. Navigating alternatives requires patience, attention to the drivers of return and a focus on fund selection, as detailed in BlackRock's November 2013 issue of *Currents*.

Infrastructure debt can offer investors stable cash flows and long duration at fat fixed yields (characteristics once found in investment grade bonds). With rates likely to remain low and policy squeezing mainstream bond markets, infrastructure looks attractive. In theory, investors have a big sandbox in which to play: McKinsey forecasts infrastructure spending of $57 trillion to $67 trillion by 2030. Hurdles are uncertain government policies, the ability to take equity risk and few investable projects.

Private equity currently looks like a sellers' market. Funds are using buoyant markets to monetize investments and refinance. "Dry powder," or uninvested balances, is close to record levels at $789 billion, according to Preqin research. Fund raising is slow—a good sign for future returns. Debt, not equity markets, are the canary in the coal mine for future conditions.

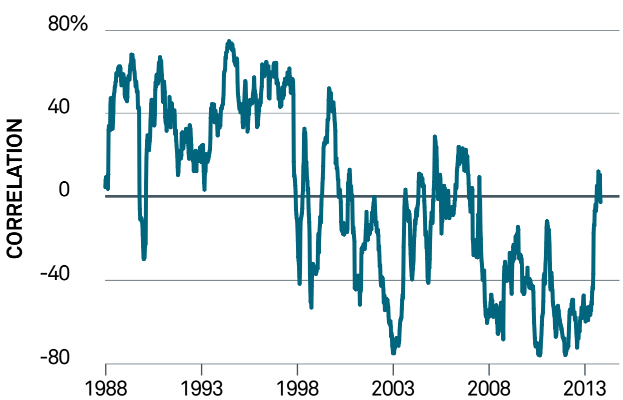
Hedge funds are such a blanket term as to be almost unusable. We prefer market neutral strategies. More takeovers, restructuring and dispersion should create opportunities in 2014 (as well as areas unexplored by banks, such as peer-to-peer lending).

Real estate is driven by urbanization and demographics. We see value in exploiting the funding gap left by bank shrinkage. We favor Asia as it is set to rise from 27% to almost half of the global real estate market over the next 15–20 years. What about property bubbles? We see few for now. Yet strong demand has driven capitalization rates down for prime properties, leaving investors to seek riskier opportunities.

Correlation Spike: Bonds have been a great shock absorber for equity portfolios for much of the new millennium. See the chart below. Those with long (and non-selective) memories recall correlations were positive for much of the long downswing in rates that started in 1982, and worry a long, slow upswing could produce a similar outcome. This would challenge diversification models, and make "safe" portfolios a lot more risky. The alternative? See "Year(s) of the Diversifier" above.

DIVERSIFICATION FRUSTRATION

Correlation: US Equities and Treasuries, 1988–2013



Sources: Thomson Reuters and BlackRock Investment Institute, November 2013.
Note: The chart shows 90-day rolling correlations calculated on the daily returns of the S&P 500 Index and 10-year US Treasuries.

We are not born pessimists (at least, not all of us). **Upside risks** for 2014 include:

- The ECB could finally start easing in earnest, starting with cutting bank deposit rates (below zero) to spur lending and consumption. See pages 14–15.
- Japan's recipe for growth, Abenomics, might actually work. See page 16.
- China gets serious about reforms, particularly in granting property rights to farmers and liberalizing the financial system. The world's greatest-ever privatization could boost urbanization and consumption. See pages 17–18.
- Fiscal austerity fades in both the US and Europe in 2014. A mix of consumer and business confidence frees up "animal spirits" and leads to a virtuous growth cycle (the UK appears to be drifting in this direction).
- Against all odds, Washington makes progress on a sustainable US budget and corporate tax reform.

3 RISKS

Obvious risks are few; hidden ones are plentiful. Beware of (well-meaning) central bankers, volatility spikes and rising correlations.

United States

Incoming Fed chief Janet Yellen faces a tough challenge: How to end an era of ever-easy monetary policies gracefully. This is the eventual goal—but Yellen may not start there. We see her giving even greater weight to the second part of the Fed's dual mandate: full employment (over inflation), as detailed in *Next Exit* of October 2013. This means any QE exit will likely be offset by reassurances that rate hikes are still far away (forward guidance) and other measures.

Can Yellen get her committee to go along on this path (including perhaps lowering the Fed's target jobless rate) as a quid pro quo for scaling back QE? Maybe. In any case, 2014 is set to be the second-most accommodative year in US monetary history (after 2013). *Low for Longer* interest rates, a shortage of quality fixed income and ample liquidity are here to stay—for now.

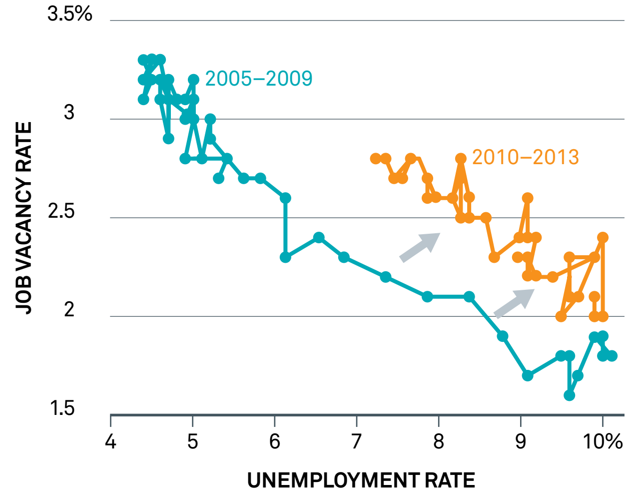
A critical question for Yellen (and policymakers elsewhere): How much of an economy's woes (weak jobs and income growth) can be cured by monetary policy alone? Or are these problems largely structural and beyond the Fed's reach? Consider these stats from the US Department of Labor:

- US private sector employment is still 1.5 million below its precrisis peak—and 10 million short of where it needs to be just to have kept up with population growth.
- There are more job vacancies than you would expect given high unemployment, the so-called "Beveridge Curve" shows. See the chart on the right. This suggests skills shortages are holding back jobs growth.
- The unemployment rate is falling—but not always for the right reasons: Baby boomers are retiring, the share of women in the workforce has stabilized after a multi-decade rise, and young people are spending more time in school (racking up student debts in the process).

IN SEARCH OF SKILLS

US Beveridge Curve, 2005–2013

Click for interactive data



Sources: Bureau of Labor Statistics and BlackRock Investment Institute, October 2013.

The US unemployment rate could reach the Fed's threshold of 6.5% by early 2015, yet we expect the central bank to wait longer before raising rates. Instead, we see the Fed using "forward guidance." This means a lot of soothing promises not to raise rates until the economy is strong enough to warrant it. The Fed might even try to convince investors a little burst of inflation lies around the corner, encouraging people to spend.

The problem: Structural reasons behind the slow jobs recovery may mean the Fed is powerless. It is like pushing a car's accelerator when the transmission is broken. Some Fed officials have warned prolonged low rates could have unintended consequences for financial stability (central banker speak for asset price bubbles). Yellen seems wholly focused on jobs growth. Yet she is not a perma-dove—and appears ready to change tack if incoming data do not match her models. Our concern: The Fed appears to have a code to crack the labor market, yet no formula (we know of) to measure financial stability. *Plus ça change...*

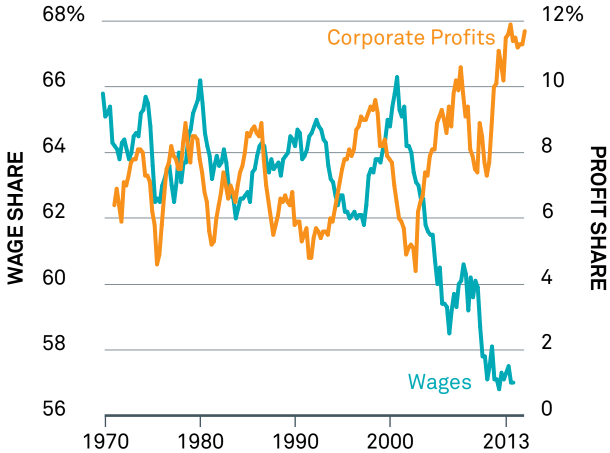
IMBALANCES TIP OVER	LOW FOR LONGER	GROWTH BREAKOUT
Rising rates kill the housing recovery. Falling nominal GDP hits profits. Federal and state budget woes worsen.	US growth inches toward 2.5%—and is stuck there. The Fed tapers lightly but keeps rates low. No fiscal stimulus or structural reforms.	Corporate capex and hiring recover. Wages actually increase. The housing recovery picks up steam.

PREFERRED ASSETS

Scenario	Asset	Preference
Imbalances Tip Over	Equity	Overweight vs. world. Volatility and quality stocks.
Imbalances Tip Over	Bond	Duration and Treasuries are your friends. Sell high yield.
Low for Longer	Equity	Momentum and quality stocks. Go global.
Low for Longer	Bond	Carry on with yield plays. Relative value.
Low for Longer	Alternative	Mezzanine property debt, and long-short.
Growth Breakout	Equity	Underweight vs. world. Industrials.
Growth Breakout	Bond	Underweight vs. world. Sell 2- to 5-year bonds.

HAPPY SHAREHOLDERS, UNHAPPY WORKERS

Share of US Corporate Value Added, 1970–2013



Sources: Bureau of Economic Analysis and BlackRock Investment Institute, October 2013.
Notes: Based on national accounts data. Non-financial companies are excluded in all calculations. The corporate profit share is after tax.

A big risk of the Fed's QE exit is the impact on the key but fickle housing market. The hike in mortgage rates caused by taper fears slowed down home sales and price gains—even though housing affordability remains near its highest level in decades. Housing starts are still 44% below their 1970–2008 average, data from the St. Louis Fed show. The recovery has relied on investors chasing yield (first-time buyers are largely absent). And Fed purchases of mortgages in 2013 amounted to more than three times net issuance, according to Credit Suisse. What happens when the Fed exits QE in earnest? Imbalances just might tip over.

The other market at risk: US equities. Many investors are reluctant longs, and US equities look rich by most valuation metrics. Corporate profits are at a record share of output, with the wage share at a low. See the chart above. This speaks to troubling trends of growing inequality and weak wage growth—and brings into question the sustainability of these margins. If they were to fall to historical averages, earnings would take a hit—and equities could head south. A red-hot new issue market and the return of venture capital are putting high valuations on (expected) growth. This rhymes with increased investor exuberance—rational or otherwise.

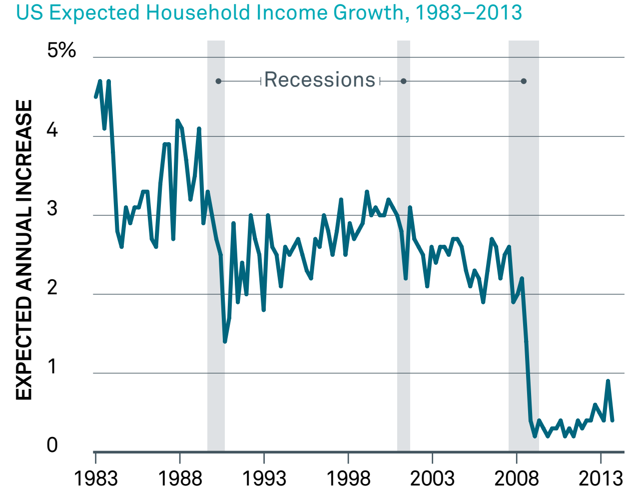
Others argue these indicators are less relevant than in the past. Bond markets are effectively subsidizing equities by allowing companies to reduce debt service costs and push out maturities. This means happy times for shareholders, who gain a greater (and more stable) share of cash flows. This plays into the "bondification" of equities and rising correlations between stocks and bonds.

Other key trends that are affecting the US outlook:

- Cheap US energy is a game changer. It is bolstering the US competitive position in energy-heavy industries, narrowing the current account deficit and underpinning long-term dollar strength. Energy price drops tend to increase GDP, push down inflation and boost consumption.
- The country is the nicest house on a bad street. Its fiscal health is reasonable, at least in the medium term. (The country ranks 15th in our 48-country *BlackRock Sovereign Risk Index*.) The effect of this year's tax hikes and spending cuts is fading, likely boosting GDP growth in 2014 to around 2.5%. Not bad in a low-growth world—and a potential springboard for a *Growth Breakout*.
- Consumer deleveraging may be nearing an end. A key measure of households' ability to pay mortgage and other debt service costs has fallen to its lowest level in three decades, Fed data show. And rising home prices are making consumers feel wealthier. The key to a revival of animal spirits? Turn around expectations for future wage growth. These plummeted to a record low in 2008—and have been stuck there ever since. See the chart below.
- The US corporate sector is a conundrum. Balance sheets are strong—but we see few companies investing. Instead, many are buying back shares and increasing dividends. This is good for shareholders but not for the economy. Certainties over consumer demand, corporate tax rates and regulation are crucial to boost capital spending.

LOW EXPECTATIONS

US Expected Household Income Growth, 1983–2013



Sources: Thomson Reuters, the University of Michigan and BlackRock Investment Institute, November 2013.
Note: The line shows the median expected increase in household income for the next year.

Europe

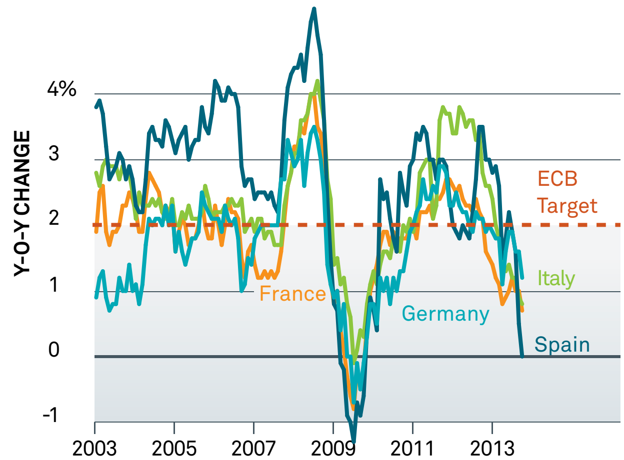
The Eurozone is out of intensive care ... and is now stuck in the recovery ward.

- The banking system in Europe's periphery is under water, with a non-performing loan pile of 1.5 trillion to 2 trillion euros, Deutsche Bank estimates. Germany and other core countries are unlikely to pick up the tab. The upcoming bank asset quality review and the ECB's taking on bank regulation duties are helpful but limited steps.
- The Eurozone's debt burden is huge and increasing due to tepid growth and budget deficits. Europe needs annual GDP growth of 2.5% to grow its way out of it, a far cry from current levels. Low inflation does not help.
- Imbalances remain: Interest rates and the euro are too high in the periphery and too low in the core. Credit growth in the non-financial sector is very weak—and is still shrinking in Italy and Spain (in stark contrast with the US and UK). See the chart at the top of the next page.
- The competitive position of Europe's southern tier versus the likes of Germany has improved ... but the gap still exists. Few structural reforms have been implemented.
- The risk of a funding crunch and bank run has faded. Yet billing depositors for Cyprus' bailout set a troubling precedent. A future crisis in a larger southern-tier nation could spark a deposit flight that is impossible to stem.

Europe is stuck in a monetary corset: It needs a weaker currency to export its way out of debt and import some inflation. Yet the euro is rising due to a trade surplus and reduced financial risk. This is deflationary. Inflation is running far below the ECB's 2% target. See the chart on the right. (Eurozone inflation crept up to 0.9% in November, but is near four-year lows.) The likely result? More monetary easing. A dip below 1% in German inflation may persuade inflation hawks more ECB action is needed.

OFF TARGET

Eurozone Consumer Price Inflation, 2003–2013



Sources: Eurostat and BlackRock Investment Institute, October 2013.

We do not expect UK and Japan-style fiscal backing to shore up banking systems. The reasons: The dynamics of 17 different governments and an aversion to unrestrained monetary expansion. So what *can* the ECB do?

- The conventional option: Cut interest rates to zero (with diminishing returns). Or slightly unorthodox: Bring deposit rates into negative territory to spur lending.
- The radical route (at least for the ECB): Buy long-dated government bonds and perhaps other assets. Do not expect this overnight: For one, the ECB would first have to scrap the (still unused) outright monetary transactions (OMT) program, which prohibits buying bonds with maturities longer than three years.

If the ECB changes course, we could see a passing of the QE batons that would largely preserve global liquidity. The ECB's balance sheet has been shrinking as banks return funds borrowed under long-term refinancing operations (LTROs). QE would reverse this process—just as the Fed would be cutting its monthly bond purchases.

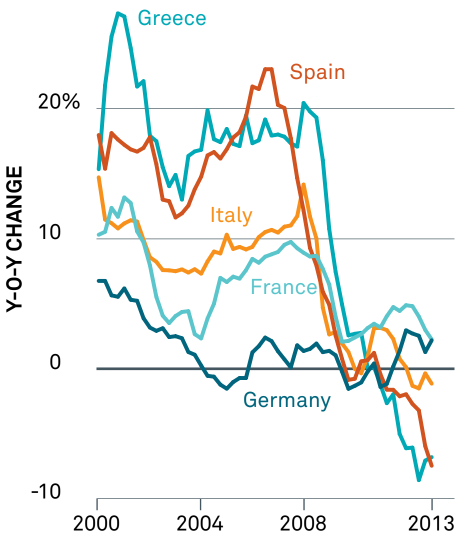
IMBALANCES TIP OVER	LOW FOR LONGER	GROWTH BREAKOUT
Fiscal austerity and private sector debt burdens strangle the periphery, reviving breakup fears. Bad loans spike.	Fiscal austerity and aging populations keep growth sluggish. Southern Europe groans under a heavy debt load, struggling to regain competitiveness.	Fiscal stimulus and low rates boost spending and investment, especially in the periphery. Banks recapitalize.

PREFERRED ASSETS

Scenario	Asset	Preference
Imbalances Tip Over	Equity	Underweight financials and the periphery.
Imbalances Tip Over	Bond	Seek shelter in Bunds and underweight peripherals.
Low for Longer	Equity	Overweight vs. world. Quality cyclicals, growth.
Low for Longer	Bond	North-South rates convergence.
Low for Longer	Alternative	German real estate and infrastructure.
Growth Breakout	Equity	Overweight vs. world. Cyclicals and peripheral banks.
Growth Breakout	Bond	Italian and Spanish bonds. Underweight quality bank debt.

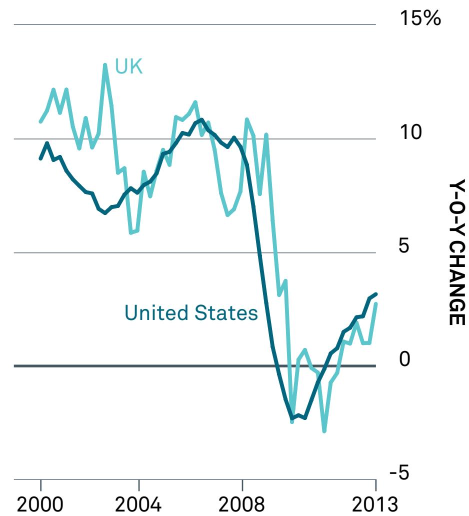
EZ LENDING IS NOT EASY

Private Sector Non-Financial Credit Growth, 2000–2013



CORPORATE LENDING RATES

Country	2005	2013
Greece	4.96%	6.63%
Portugal	5.75%	6.24%
Spain	3.72%	4.98%
Italy	3.95%	4.31%
Ireland	4.33%	4.2%
Netherlands	3.42%	3.28%
Germany	4.38%	2.97%
France	3.51%	2.15%
Range	2.33%	4.48%



Sources: Bank for International Settlements, European Central Bank and BlackRock Investment Institute, November 2013.
Notes: Lending rates are for new loans up to 1 million euros to non-financial companies. The range is the difference between the highest and lowest rates. Data as of September 2013.

We are cautiously bullish on European equities. Valuations are relatively low, especially compared with US peers (less so when financials are excluded). Companies could notch 8%–10% earnings growth in 2014 based on new order trends (although a stronger euro could erode these figures). After 2013's rerating (multiple expansion), this growth is now of greater importance. One caution: European blue chips are highly geared toward emerging market demand.

A small improvement in GDP growth makes a big difference in the Eurozone, in numeric and psychological terms. There is a lot of pent-up demand. New car registrations, for example, have slumped to the lowest level on record—and are roughly one-third below their early 2000s peak. Germany is taking steps to boost consumption, including introducing a minimum wage.

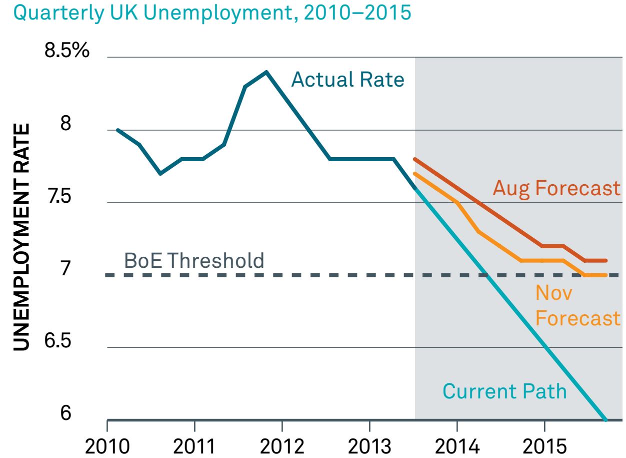
The UK has sprinted ahead, with GDP growth (finally) picking up. House prices are rising (albeit not uniformly). Business surveys are at 15-year highs. Lower inflation could finally ignite household spending power after a vicious three-year squeeze. The Bank of England (BoE) has said it will not consider raising interest rates until the jobless rate falls to 7% or lower. But the central bank may be falling behind the curve. The jobs market has kept surprising on the upside. See the chart on the right.

This has prompted markets to bring forward expected monetary tightening to early 2015—despite the best efforts of the BoE to keep rate expectations low for long. How well founded is the (surprising) strength in demand?

The bear case: It simply reflects a classic British housing bubble—and a burst of pent-up demand that will inevitably wither due to fiscal tightening, weak real wages and a shrinking financial sector. The optimists argue the UK rebound has a firmer base: A pause in austerity leads to a virtuous circle of stronger demand, growing confidence and companies that finally start to spend again. Financial market activity also helps an economy where financial services represent a fifth of final demand. Perhaps the UK is leading where others will follow—and is the first to experience a true *Growth Breakout.*

JOLLY GOOD

Quarterly UK Unemployment, 2010–2015



Sources: Bank of England and BlackRock Investment Institute, November 2013.
Notes: The current path assumes the rate improves at the pace seen in the latest quarter. The Bank of England's forecasts do not reflect third-quarter actual data.

Japan

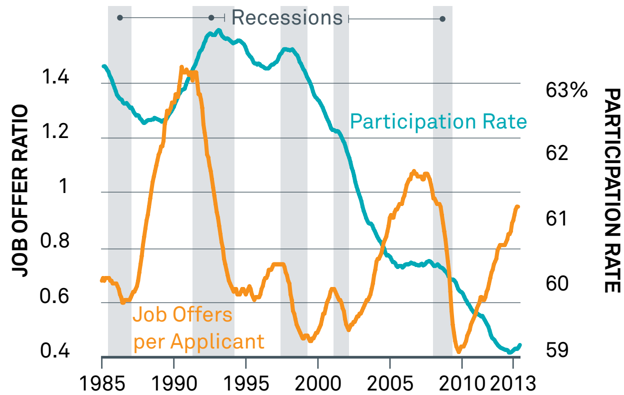
We are split on Japan's future, raising the possibility of either very good outcomes—or very bad ones. The case for a *Growth Breakout*? Prime Minister Shinzo Abe's "three arrows" plan (see *Exit, Entry and Overshoot* of June 2013) to reinvigorate the world's third-largest economy will work:

- Incrementalism is out. Bank of Japan (BoJ) Governor Haruhiko Kuroda is about shock and awe: huge asset purchases and a drive to weaken the currency. The flood of yen will be slow to leak into world markets due to a home bias of domestic investors. Eventually, however, some of Kuroda's largesse will pass through Narita airport.
- The country fears becoming an insignificant island and/or a vassal state of China, the bulls argue. The solution? Obtain a nuclear deterrent (unlikely) or modernize the economy—fast. In this view, Abe's plan is a necessity. Territorial squabbles and Sino-Japanese business tensions offer a compelling case.
- Japan's jobs market is slowly on the mend. Job offers per applicant have risen to a five-year high. And the participation rate shows signs of bottoming out after a long decline. See the chart on the top right. More working women would give Japan's economy a welcome boost.
- Wage growth is key to the success of Abenomics. Wages fell for the 16th straight month in September, labor ministry data show. Yet there are signs of change. Large companies will boost winter bonuses by 5.8% this year, the most since 1990, a Keidanren business survey shows.
- The BoJ's liquidity hose should weaken the yen and support stocks (earnings growth, not multiple expansion, has driven the rally). A depreciating yen is good for Japanese equities in the short term, our research shows. Caution: Cheaper Japanese exports driven by a weak yen are deflationary for the rest of the world.

JAPAN AT WORK

Japan Employment Indicators, 1985–2013

Click for interactive data



Sources: Japan Statistics Bureau, Institute for Labour Policy and Training, and BlackRock Investment Institute, September 2013.
Note: The participation rate is a 12-month moving average.

The bears are skeptical: Abenomics will turn out to be another false dawn at best—or a prelude to the *Imbalances Tip Over* scenario at worst.

- Abe's second arrow—achieving long-term fiscal health—is mathematically challenged. Any attempts to chip away at Japan's debt load could tip the economy back into recession. And if the economy takes off and rates rise, spiraling debt servicing costs would brake any expansion and could even trigger a debt crisis. Note: This is a concern for 2015 and beyond. For now, a weaker yen should help boost the economy—and tax receipts.
- Structural reform (the third arrow) may not show up in the near term. Change comes slowly in Japan, or not at all. Similarly, changing consumer and corporate behaviors is tough. Try changing the mind of an 80-year old (Japan already has five million of them); chances are it is difficult, one of our (emerging market) investors noted.

Our bottom line: There is juice left in the long Japanese equities/short yen trade—but the ride could be bumpy.

IMBALANCES TIP OVER		LOW FOR LONGER			GROWTH BREAKOUT	
Rising rates threaten to trigger a debt crisis *or* the three arrows fail to reboot growth *or* the yen collapses.		Slow or no progress on structural reforms. Demographic headwinds and weak global demand keep growth tepid. Liquidity is ample.			The BoJ keeps flooding the market with liquidity. Fiscal stimulus offsets tax hikes. Structural reforms kick off.	
PREFERRED ASSETS						
Equity	Bond	Equity	Bond	Alternative	Equity	Bond
Stay out. Underweight banks.	Sell bank credit.	Domestics.	Don't bet against JGBs.	Tokyo offices with a little TLC.	Overweight vs. world. Domestics.	Domestics. Dump JGBs (finally).

China

China's reform plan could set the stage for a multi-year bull market in Asian equities. The key is whether policymakers actually follow through on their promises. Key points of the bull case:

- Financial sector reforms (interest rate liberalization, current account opening and broader funding options for local governments) are game changers.
- China needs market pricing and stronger institutions to avoid falling into the middle income trap. The new reforms (if enacted) give it a good chance of achieving this.
- Markets like reforms—a lot. Positioning in emerging markets and Chinese equities is low. Valuations are cheap—and performance could change on a dime if investment tourists spot a catalyst for change.
- President Xi Jinping has pinned his authority to this mast. He has consolidated power and now controls the three arms of the state: the party, government and military.

The skeptics (read: bond investors) argue:

- The reforms mean short-term pain for long-term gain—and could slow growth in the near term. Liquidity is already tight in pockets of the economy: Banks are still licking wounds sustained in June's crunch.
- Many reforms are rehashes of previous policy goals stymied by vested interests. China is taking a risk by raising expectations so high.
- Interest rate deregulation is a slow burn—and would hurt banks as margins compress, bad loans shoot up and funding costs rise.
- The hefty cost of resolving bad loans and industry overcapacity will fall on the government and taxpayers—but also partly on (capital-constrained) banks.

WATCHING THE INK DRY

China's reform blueprint appears encouraging. Just remember any changes will come slowly and gradually at best. The plan calls for:

- Freeing up interest rates (no longer punishing savers) and liberalizing the RMB currency.
- Allowing land ownership in rural areas. This would be the biggest wealth transfer in history. It makes capital portable and has optimists predict mass migration to the cities.
- Dismantling of the *hukou* system of residency permits that prevents rural migrants from using social services in cities, starting with smaller towns.
- Relaxing the one-child policy to offset a greying population, starting by allowing couples to have two children if one parent is an only child.

- Land reforms are positive—but likely will exacerbate local governments' financing woes (they rely on land sales). Reform of the *hukou* residency permit system would likely be opposed by urbanites footing higher bills for social services.

China is promoting broader RMB use in settling trade. This would give it greater insight into pricing trends of tradable goods, reduce its dependency on US dollar financing, and help lock in supplies. China has set up 24 bilateral swap agreements with other central banks, and Standard Chartered expects global trade settlements in RMB to double to 28% of the total by 2020 (to $3 trillion).

A true opening up of the capital account and genuine currency convertibility are still to come. These moves are not without risk. China has been largely shielded from time bombs buried in the world's financial system—and vice versa. Private capital is already seeping out of the country. A trickle could turn into a flood.

IMBALANCES TIP OVER		LOW FOR LONGER			GROWTH BREAKOUT	
China rebalances too fast, strangling growth *or* a credit and property bubble pop.		Weak global demand and a repressed household sector dampen growth. Reforms proceed—but only slowly.			Rebalancing revs up domestic demand or fiscal stimulus juices growth. Strong global demand buoys exports.	
PREFERRED ASSETS						
Equity	Bond	Equity	Bond	Alternative	Equity	Bond
Overweight vs. EM. Dump everything commodity related.	Desert the Aussie.	Healthcare, consumer and Internet stocks.	Hedged Australian rates.	Real estate (2nd-3rd-tier cities).	Autos, infrastructure, consumer and retail.	Copper, iron ore and steel debt.

Bulls and bears agree Chinese GDP growth is slowing (in a *Low for Longer* world). The debate has shifted to how much further it will fall. A little slowdown is good, especially if it involves a rebalancing toward a consumption-led economy. The share of consumption in China's economy is just 36%—well below that of India (59%) and Brazil (60%), World Bank data show. (Consumption's share of GDP *growth* was a little higher at 55% in 2012.) See the bottom chart on the right.

We do not see the dragon crash landing (à la *Imbalances Tip Over*), but do worry about credit growth. History shows rapid credit expansion usually ends in tears. The upper chart on the right shows China created a record amount of credit in 2012, much of it hidden in off-balance-sheet constructions such as wealth management products. The risk is duration mismatch: Many products offer short-term financing for long-term assets. This makes them very vulnerable to any squeezes in liquidity.

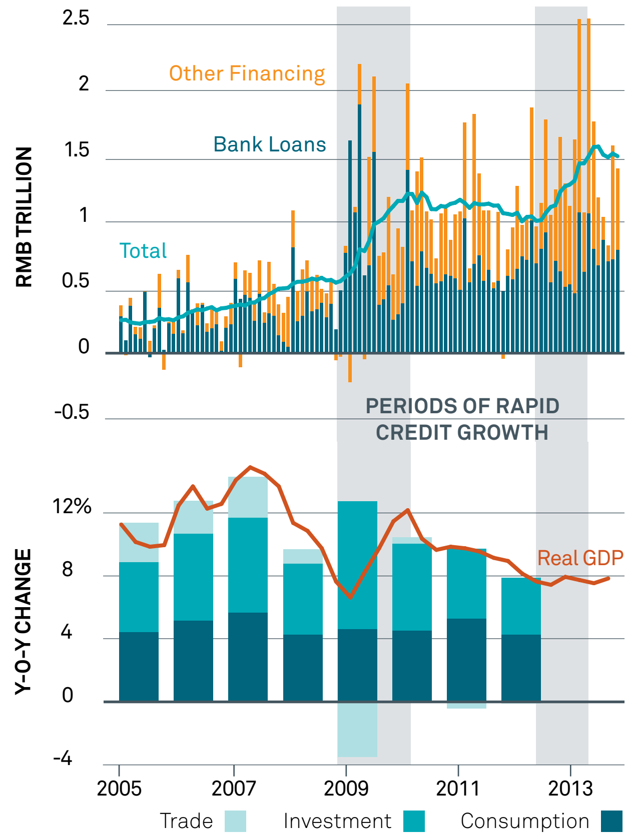
This is troubling. The good news is twofold:

1. Regulators appear aware of the risks, and are taking action to curtail growth and avoid a bust.
2. China's financial system is not (yet) integrated with the rest of the world, so any credit implosion appears to pose limited global systemic risk.

The bad news: Fixing this (letting zombie borrowers go bust rather than rolling over their loans and recapitalizing banks) will be painful.

LESS BANG FOR THE RMB

China Total Social Financing and GDP Growth, 2005–2013



Sources: Thomson Reuters, People's Bank of China, National Bureau of Statistics and BlackRock Investment Institute, November 2013.
Note: The total line on the upper chart is a trailing 12-month average.

STOPPED AT THE TRAFFIC LIGHT?

BlackRock Sovereign Risk Index (BSRI) Score Cards, September 2013

Click for interactive data

		TW	SK	CN	RU	PL	BR	MX	TR	ID	ZA	IN	AR
100%	**BSRI Ranking**	7	13	19	22	25	27	31	34	35	36	39	43
40%	Fiscal Space	Green	Green	Green	Green	Yellow	Yellow	Orange	Yellow	Yellow	Orange	Orange	Orange
	Proximity to Distress	Green	Green	Green	Green	Orange	Yellow	Orange	Orange	Yellow	Orange	Orange	Orange
	Distance From Stability	Green	Green	Green	Green	Yellow	Yellow	Yellow	Yellow	Yellow	Orange	Orange	Yellow
30%	Willingness to Pay	Green	Green	Orange	Orange	Yellow	Orange	Orange	Orange	Orange	Orange	Orange	Orange
20%	External Finance Position	Green	Green	Green	Green	Yellow	Yellow	Yellow	Orange	Yellow	Yellow	Yellow	Yellow
	External Debt Position	Green	Green	Green	Green	Yellow	Green	Yellow	Yellow	Yellow	Yellow	Green	Orange
	External Debt Term Structure	Green	Green	Green	Green	Green	Green	Green	Green	Green	Green	Green	Yellow
	Current Account Position	Green	Green	Yellow	Yellow	Orange	Orange	Orange	Orange	Orange	Orange	Orange	Orange
10%	Financial Sector Health	Orange	Green	Orange	Yellow	Yellow	Yellow	Green	Yellow	Yellow	Green	Yellow	Yellow
	Bank Stability	Yellow	Green	Orange	Orange	Orange	Yellow	Green	Yellow	Orange	Yellow	Orange	Orange
	Capital Adequacy	Yellow	Yellow	Yellow	Yellow	Yellow	Green	Green	Green	Green	Yellow	Yellow	Green
	Credit Bubble Risk	Yellow	Green	Orange	Yellow	Green	Yellow	Green	Orange	Orange	Green	Green	Orange
	Banking System vs. Economy	Orange	Green	Yellow	Green	Green	Green	Green	Green	Green	Green	Green	Green

Source: BlackRock Investment Institute, November 2013. Notes: The chart shows the top-12 emerging markets by GDP, ranked by their overall score in the 48-country BSRI. Orange dots signify a BSRI score of less than -0.25, green dots signify a score of more than 0.25. Scores in between are colored in yellow. Major BSRI components Fiscal Space, External Finance Position and Financial Sector Health are broken down by their subcomponents.

Emerging Markets

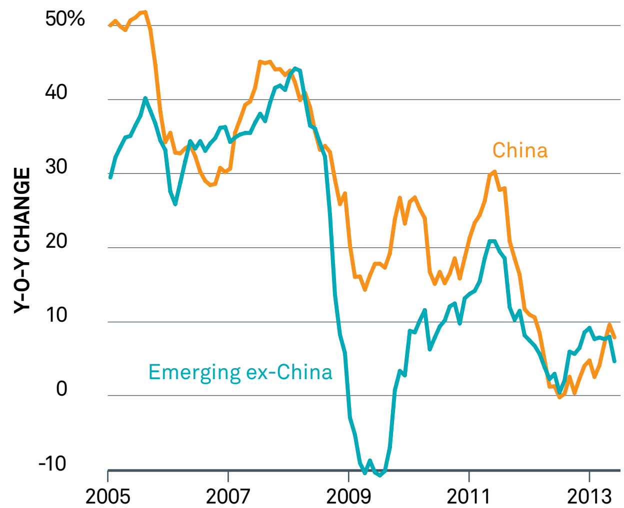
The locomotive of the global economic recovery is running out of steam. Growth in emerging markets has slowed to 4.5% this year, the lowest since 2009, the IMF estimates. The recycling of current account surpluses through foreign exchange reserves is slowing, too. See the chart on the right. This is bad news for struggling advanced economies and financial markets addicted to monetary stimulus. What about the emerging world itself? EM has become a dirty word among investors of late:

- Currencies are key. A strong US dollar hurts countries dependent on foreign funding. And propping up local currencies by selling dollars effectively tightens domestic liquidity. Eastern Europe may become the epicenter for funding risk in 2014 due to big refinancings. A longer-term worry: Rising unit labor costs are hurting competitiveness, and could forebode more depreciations. Not good, considering foreign exchange movements explained 88% of monthly returns in EM local sovereign debt over the past five years, according to HSBC.
- Emerging equities look cheap on almost every measure—except the stuff that really counts in a liquidity crunch: free cash flow. EM companies generally are not great stewards of capital. And the few quality EM stocks have rocketed upward—leaving little room for error. Countries are in a beauty contest, trying to attract money flows by raising rates and implementing investor-friendly measures. Yet this pageant could turn ugly if *Imbalances Tip Over* and currencies go into freefall. Think capital controls and expropriations.

Even the bears acknowledge emerging markets increasingly are diverging. See *What's Developing* in April 2013. Indeed, the 12 largest show a broad spectrum of strengths and vulnerabilities, our *BlackRock Sovereign Risk Index* shows. See the table on the previous page.

LESS FX RECYCLING

Growth in Emerging Market Foreign Reserves, 2005–2013



Sources: IMF and BlackRock Investment Institute, June 2013.
Note: Foreign currency reserves are measured in US dollars.

So what is the bull case? We do not really expect a sudden *Growth Breakout*. Yet valuations are cheap, positioning is light (investors are bearish) and growth is likely to pick up a bit in 2014. Overweighting emerging stocks versus developed markets was the top contrarian idea for 2014 among our portfolio managers in a recent poll.

The long-term arguments for emerging markets are compelling, too:

- Rising real wages have boosted emerging market consumption (along with trends such as urbanization and better access to financial services). This is a boon for EM companies and multinationals alike.
- Countries such as China could boost productivity through automation and improved management.
- Many EM economies have better credit reports than developed markets. (Taiwan, Chile and South Korea all rank higher than the United States in our BSRI.)

IMBALANCES TIP OVER		LOW FOR LONGER			GROWTH BREAKOUT	
Currencies collapse, triggering balance of payment crises. Structural reforms stall and economies get tied up in red tape.		Dependence on foreign capital hurts deficit countries. Weak global demand and lack of reforms slow growth.			Strong global demand boosts exports. Governments ram through structural reforms and currencies stabilize.	
PREFERRED ASSETS						
Equity	Bond	Equity	Bond	Alternative	Equity	Bond
Seek safety in multinationals. Forget the rest.	Underweight high yield and resources in deficit countries.	Underweight deficit countries. African safari.	Select US dollar debt and South African rates.	Commodity hedge funds.	Miners, exporters and beaten-up Brazil stocks.	Commodity rates and currencies.

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