



## **Bob Doll: Why the US is Positioned Strongly**

Sponsored Content by BlackRock

October 18, 2011

### **Europe in the Balance**

Investor unease has risen dramatically over the past quarter in the face of growing concerns about the world's economic and financial health. The focal point has been the intensifying debt crisis in Europe. The issues facing Europe are highly complex, but essentially are underscored by a single question: Is Europe facing a solvency crisis or a liquidity crisis? If it is the former, there is little policymakers can do other than continue to enact austerity measures as banks fail and as the region plunges into a severe recession. If, however, the crisis is primarily one of liquidity issues, then there is hope. Fortunately, it seems to us that this is the case.

In our view, policymakers have options for helping to ease Europe's liquidity constraints. The recent decision to increase the capacity of the European Financial Stability Fund (EFSF) was one such step, and an encouraging one at that, but we believe more needs to be done. The European Central Bank (ECB) could be purchasing more sovereign debt and providing more long-term funding for banks. Just as the United States did in the latter stages of the 2008-2009 credit crisis, some sort of foundation needs to be erected under the European banking system. The sooner a resolution is reached, in our view, the less costly it will be and the less damage will be inflicted on the global economy.

Ultimately, European policymakers will have to choose whether to allow the single-currency Eurozone to collapse or to take the actions needed to transform the region into one with a more unified fiscal policy (including the creation of some sort of Eurobond). We believe the latter is the more likely outcome since, over the long-term, the costs of keeping the Eurozone intact would be less than letting it dissolve. Regarding the specific issue of Greece's debt, we believe the markets have already priced in a high likelihood of default. As such, if any sort of default is conducted in an organized manner, it might not have an oversized impact on financial markets.

### **US: Recession or Recovery?**

As with Europe, the United States faces some formidable economic and fiscal headwinds, but the US remains relatively better positioned. There are pressures to enact fiscal restraint measures in the United States, but those pressures pale in comparison to what is happening in Europe. Real gross domestic product (GDP) growth in the United States appears to be stuck at around the 1% to 2% level and, at this point, we would expect growth to remain somewhere around 2% through next year.

Growth in the area of 2% is hardly robust, but it could be considered acceptable in normal times. Unfortunately, the current environment is hardly normal. Real GDP is still below the



peak it reached in late 2007, meaning the economy technically remains in recovery mode, and 2% is quite anemic compared to what we would normally expect in an economic recovery. Additionally, since that late 2007 peak, the working-age population has expanded by around 7 million people, yet there are 6.8 million fewer people employed today than at that time. All of this suggests the economy is operating far below its potential.

As in Europe, the outlook for the United States is highly dependent on the potential for future policy action. The Federal Reserve recently announced its “Operation Twist” program in which it will shift its balance sheet toward longer-dated assets. The Fed’s objective is to further push down long-term rates in hopes of encouraging additional lending and prompting investors to take on greater risk. The central bank’s August announcement that it would keep rates exceptionally low for the foreseeable future also serves as a form of stimulus. Nevertheless, market reactions to the Fed’s moves were hardly supportive, implying that the Fed may have limited ability to restore confidence. Ultimately, what the economy really seems to need is a jolt in the form of fiscal stimulus accompanied by a massive overhaul of entitlement programs. Unfortunately, that seems unlikely to happen since Washington appears far more focused on immediate spending cuts and has shown little appetite to address entitlement reforms.

Looking ahead, we expect the economy will continue to “muddle through” in the coming quarters. We expect the United States will be able to avoid a recession, although we acknowledge that the pressures are growing. In the near-term, we would place decent odds that economic growth will improve from the 1% level it experienced in the first half of 2011 and, as we stated earlier, that growth will average around 2% next year.

### **The Third Quarter by the Numbers**

Markets began the third quarter on a relatively calm note, but that tranquility was quickly broken. By late July, the outlook for the US economy had dampened and fears were mounting that Europe’s debt problems would lead to a broader contagion of the global banking system and economy. Conditions worsened as the political debate over the expansion of the debt ceiling intensified, culminating with the August 5 announcement by Standard & Poor’s that it would downgrade its rating of US sovereign debt. This event set off a frenzied selling of risk assets around the world as investors embarked on yet another flight to quality. Since that time, global financial markets have been subject to intense volatility, with daily swings of more than 1% becoming commonplace in the world’s equity markets.

In the United States, stocks suffered their worst quarterly decline since the first quarter of 2009, sending the major averages into negative territory for the year. The Dow Jones Industrial Average fell 11.5% and is now down 3.9% for the year. The S&P 500 Index fared even worse, losing 13.9% for the quarter and bringing its year-to-date decline to 8.7%. The Nasdaq Composite also fell sharply, losing 12.7% for the quarter and posting a year-to-date return of –8.3%. Small cap stocks (as represented by the Russell 2000 Index) fared worse during the downturn, losing 21.9% for the quarter and 17.0% for all of 2011.



As bad as conditions were for US markets, international stocks fared even worse. European markets in particular were hit hard, with sharp declines in the banking sector driving markets down significantly. German stocks lost more than 25% for the quarter, with the United Kingdom faring better with a loss of 12.8%. Markets in Asia were also caught up in the selling, with Japan's stock market falling 10.7%. Emerging markets continued to underperform in the third quarter. Chinese stocks dropped 15.0% and the emerging markets as a whole (as represented by the MSCI Emerging Markets Index) declined 22.6%.

Fixed income markets also traded in a highly volatile pattern, with Treasury yields falling (and prices rising) sharply as investors flocked to the perceived safe-haven asset class. The yield on the 10-year Treasury, which began the quarter above the 3% level, dropped to below 2% for the first time since the 1940s and ended the quarter at around 1.9%. In this environment, the Barclays Capital US Aggregate Bond Index posted a quarterly gain of 3.8% and is up 6.7% for the year. Finally, cash investments, as represented by the 3-month Treasury bill, returned a minor fraction over 0% for the quarter, as short-term rates have been and remain very low.

### **Opportunities for Investors**

These are difficult times for investors, and we know that maintaining a long-term focus during periods of intense market volatility can be challenging. In this sort of environment, we would encourage investors to remain in close contact with their financial professionals, who can help identify tactical opportunities that may be appropriate for investors' long-term investment plans.

**Remain cautious, but stick with equities:** While short-term risks for stocks are ample and an environment of volatility is likely to persist, we continue to believe stocks should outperform over time.

**Consider buying on weakness:** Market conditions are set to remain volatile and we expect to see continued back-and-forth in asset prices. For those investors with longer time horizons who can bear short-term market swings, it may make sense to view market setbacks as potential buying opportunities.

**Look at geographies and sectors:** Geographically, we continue to prefer US stocks over other developed markets, given better economic and earnings growth prospects. Over time, we also expect emerging market performance to improve, but would caution that this theme could take time to develop. From a sector perspective, healthcare remains our favorite defensive play, while we like energy and technology for their cyclical characteristics.

**Rotate toward growth:** Although positive, economic growth remains relatively weak. At the same time, corporate earnings growth should continue, albeit at a slower pace than



seen in recent quarters. In this sort of environment, we believe growth styles are likely to outperform.

**Stay selective:** We have said this before, but it bears repeating. The environment should continue to be marked by relatively high volatility and increased dispersion among winning and losing investments. Given this backdrop, selectivity among sectors and individual stocks will be critical, implying that actively managed portfolios capable of tapping diverse opportunities could be an attractive strategy.

To read more, or for more information from BlackRock or Bob Doll, please call us at 877-ASK-1BLK (977-275-1255) or visit: <http://www2.blackrock.com/US/individual-investors/market-insight/special-reports/whats-ahead-in-2011>.

[www.advisorperspectives.com](http://www.advisorperspectives.com)

For a free subscription to the Advisor Perspectives newsletter, visit:  
<http://www.advisorperspectives.com/subscribers/subscribe.php>