

Weekly Investment Commentary

Conditions Continue to Improve, but Risks Remain

November 21, 2011

Markets Weaken on Uncertainty

Last week was a tough one for equity markets. Investors grew uneasy in the face of renewed uncertainty about the state of the European debt crisis as well as growing indications that the US Congressional “super committee” charged with a massive deficit reduction task gave indications that they would be unsuccessful. For the week, the Dow Jones Industrial Average lost 2.9% to close at 11,796, the S&P 500 Index was down 3.8% to 1,215 and the Nasdaq Composite fell 4.0% to 2,572.

Concerns Over Europe Remain Key

In our view, the European debt situation remains the most important variable affecting the global financial markets. Concerns over Europe’s debt situation have been outweighing the positives coming from robust earnings reports and better-than-expected economic data as investors remain concerned over the possibility of a financial meltdown that could trigger a significant global economic slowdown or recession. Despite the ongoing fears, we do believe that some progress is being made.

The changes in government that have occurred in both Greece and Italy seem to be positive signs as new Prime Ministers Lucas Papademos and Mario Monti are well respected and are widely regarded as technocrats who appear committed to solving their nations’ debt problems. The question, of course, is whether or not any solutions implemented throughout Europe will take place fast enough to prevent widespread contagion.

US Super Committee Poised for Failure?

The Congressional super committee has been dominating headlines of late and current indications are that the committee may soon announce that it has failed to produce a framework for identifying the needed \$1.2 trillion in deficit reduction that it was charged with. We had long suspected that the committee would pass on the toughest issues, but we had thought it was possible that the group would be able to identify cuts and savings of around \$400 to \$600 billion, coming up with a sort of half-victory. At present, the odds of the committee announcing that it has reached absolutely no deal are rising, which would set the stage for an across-the-board automatic set of cuts that would commence in January 2013.

Although the uncertainty surrounding the super committee is a concern for investors, it is important to remember that, unlike the debt ceiling debate that occurred over the summer, there is no looming threat of a government shutdown or any sort of debt default associated with the committee’s plans. As a result, the market impact of the committee’s plan (or lack thereof) should remain relatively contained. To us, the more important issue is whether or not Congress will be able or willing to extend unemployment benefits and payroll tax reductions. If these extensions do not occur, it would act as an economic drag into 2012.



Bob Doll is Chief Equity Strategist for Fundamental Equities at BlackRock®, a premier provider of global investment management, risk management and advisory services. Mr. Doll is also Lead Portfolio Manager of BlackRock’s Large Cap Series Funds. Prior to joining the firm, Mr. Doll was President and Chief Investment Officer of Merrill Lynch Investment Managers.

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Economic Acceleration Continues (For Now)

Although the news has been overshadowed by events in Europe and the anticipation of the super committee's announcements, economic data has continued to be broadly encouraging. Retail sales for October were stronger than expected and initial unemployment claims recently fell to their lowest level since early 2011. A broader look back over the course of this year shows that economic growth has been accelerating. First-quarter gross domestic product grew by 0.4%, second quarter growth was 1.3%, third quarter growth was 2.5% and analysts are currently forecasting fourth-quarter growth of around 3.0%. While we do not expect this pace of economic acceleration to continue into 2012, we do think the data shows that the fears of a double-dip recession have largely passed.

Outlook Continues to Hinge on Europe

Notwithstanding last week's market setback, conditions have improved noticeably over the last couple of months. In late summer, many were predicting that there was a greater-than-50% chance that the United States would sink back into recession, Europe was on the verge of falling apart and there were widespread fears of a hard economic landing in China. Today, it is growing more clear that not only has the United States avoided a recession, but it is actually showing signs of growth acceleration, Europe is showing signs of progress (although much more needs to be done) and China appears poised for a soft landing. As a result, equity markets in most parts of the world have appreciated by double-digit percentages since the height of these problems.

The question for investors, of course, is whether these sorts of gains will continue. We lean toward the optimistic side of this question, but recognize that it takes no small amount of faith to do so. We are hopeful that the economic momentum from the United States and elsewhere will remain a tailwind, but, as has been the case for months now, much hinges on the outcome of Europe's debt problems.

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