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2012 Investment Outlook

BlackRock Investment Institute

THE YEAR OF LIVING Divergently

What lies ahead in 2012 for financial markets? A time when emerging economies and asset prices finally come into their own? A descent into an investment nuclear winter? A re-run of 2011, with rudderless, 'risk-on/risk-off' market forces sidelining many investors? Or a sunny upland where policymakers pull the right levers and growth abounds?

We believe we are at an inflection point for economics, asset prices and risk appetite. Signs are everywhere: The euro debt crisis looks to come to a head, China and other emerging markets are easing monetary policy to regain growth momentum and the US economy is showing tentative signs of improvement.

We are likely to see a 2012 investing landscape that is very different from last year's environment of assets moving in lockstep. We have sketched out scenarios of how things could pan out this year, providing a framework for investors to take advantage of new opportunities and to guard against risks.

What Is Inside

How We See Clearly

More than three dozen leading BlackRock portfolio managers recently gathered at the BlackRock Investment Institute's Outlook 2012 Forum to exchange views. This publication summarises their ideas.

The **BlackRock Investment Institute** leverages the firm's expertise across asset classes, client groups and regions. The Institute's goal is to produce information that makes BlackRock's portfolio managers better investors and helps deliver positive investment results for clients.

Executive Director *Lee Kempler*
Chief Strategist *Ewen Cameron Watt*
Executive Editor *Jack Reerink*

Main Takeaways

Divergence and Nemesis

We see an increasing divergence between faster-growing emerging markets and the debt-ridden developed world. The 'real' economies and asset prices will likely decouple, helped by emerging markets having the room and cash to stimulate growth. In this 'Divergence' scenario, Europe is expected to have a recession followed by a snail-like recovery in 2013. The US economy and Japan muddle through.

The biggest risk is the European debt crisis spins out of control and plunges Europe into a deep recession that spreads to the rest of the world. This 'Nemesis' scenario – named after the Greek goddess who punishes the proud – would be bad because the developed world has little firepower left to fight another crisis.

Probabilities and Signposts

We see Divergence as our main, most probable scenario. The odds for Nemesis are much lower, but still uncomfortably high. Markets have not factored in either scenario, creating opportunities for smart investors. Other scenarios are: The current stagnation continues, inflation surges or global growth resumes.

There are big questions this year. Can policymakers pull back the eurozone from the brink? Will China be able to reaccelerate growth? Will smart monetary and fiscal policies offset the effect of global banks' shedding assets? Is the US economy's recent strength sustainable? The answers to these questions are signposts, and we want to see them clearly before we fully commit ourselves to taking a particular route.

Investment Strategy

In Divergence, we would like equities, investment-grade and high-yield bonds, and metals including gold. We would expect poor returns for safe-haven government bonds, the US dollar and the euro. Within equities, we would focus on emerging markets, and the energy and resources sectors. We would favour most alternative investments.

The usual suspects of cash and US, German and Japanese government bonds would dominate in Nemesis. Gold may also work. We would hold US dollars and prefer the yen to the euro. Alternative investments may offer protection – if they can stomach a short-term funding crunch. Within equities, we would like Asia and US defensive stocks while avoiding Europe.

Inflation and a New World

We believe inflation is unlikely in 2012. One caveat: Pretty much everybody backs this idea, and conventional wisdom is often upended. Global monetary easing or another run-up in commodities prices could conceivably spur inflation. Market prices reflect the consensus view, so there are risks.

Eventually, we expect a move to sustainable global economic growth at just above historical trends. The question is how we will get there and how fast. In the meantime, markets will be volatile, magnified by elections in key countries. Investors will hunt for safe income in a risky world with low interest rates. And cash will be an important tool to hedge against Nemesis and exploit short-term opportunities.

Ewen Cameron Watt
Chief Investment Strategist
BlackRock Investment Institute

We believe we are at an inflection point for economics, asset prices and risk appetite.

Signposts

We would only act on these signposts if they are crystal clear: We want to avoid 'hero trades.'

The second half of 2011 was dominated by the 'risk-on/risk-off' theme, whereby assets would move in lockstep on the latest headlines of the European debt crisis. Goethe summed up the prevailing investor psychology well when he coined the phrase "*Himmelhoch jauchzend, zum Tode betrübt*" more than 200 years ago. It roughly translates as "heavenly joy, deadly sorrow," aptly describing the swings in investor sentiment we saw on a daily basis in 2011.

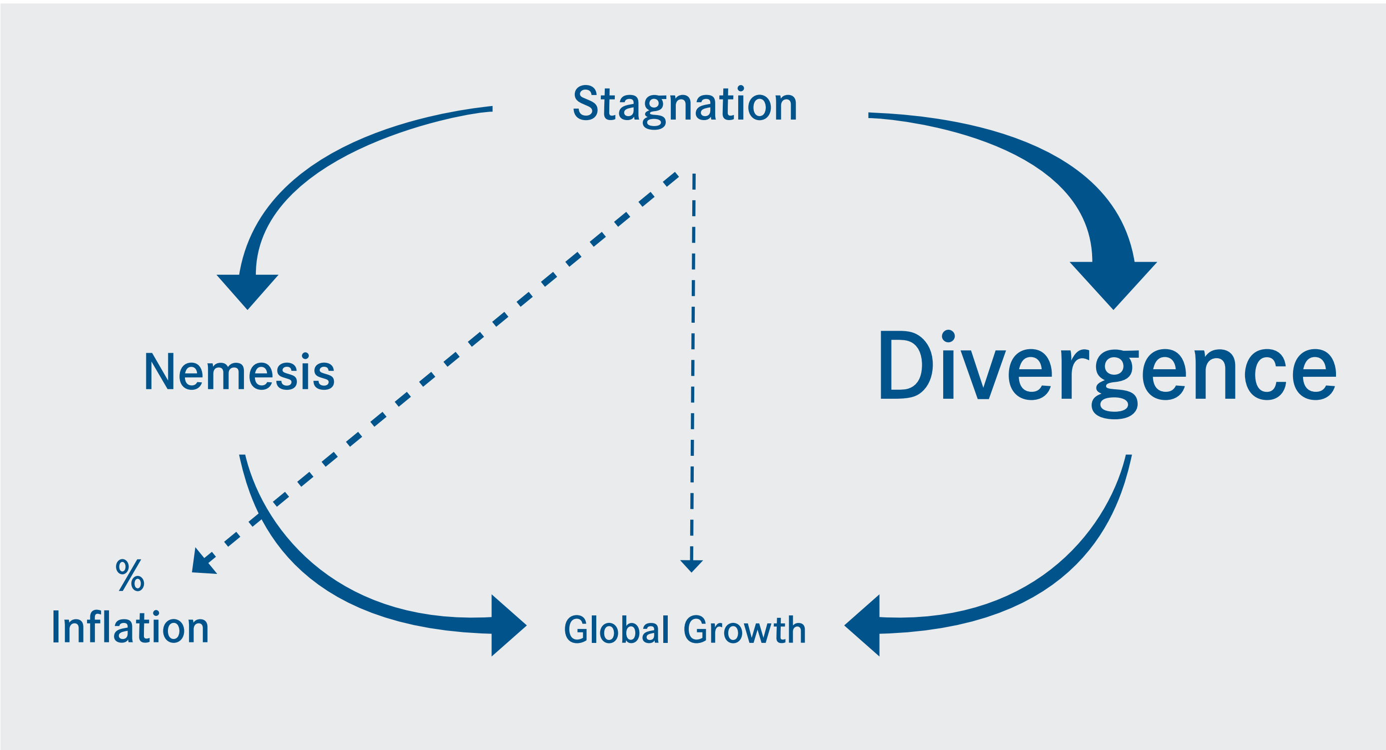
As this drama played out in markets, bank funding – the lifeblood of world commerce – dried up and key economies started to show cracks. Europe looked headed for a recession and emerging markets lost their growth momentum.

We believe we have arrived at an inflection point. The period of stagnation accompanied by violent but highly correlated swings in asset prices simply cannot last.

Most likely, we will move to a period whereby emerging economies start diverging from the developed world. We give this 'Divergence' scenario a 40%-50% probability of happening, and will detail it on pages 10-13. At the same time, there is a risk that we will slide into another financial crisis. We put much lower odds of 20%-25% on this 'Nemesis' scenario, but are scared all the same. More on that on pages 14-16.

As you see in the chart below, we will eventually slide toward a period of sustainable global growth that is a tad above long-term trends. Do not count on it in 2012, though.

Left or Right?
Moving Into a New Scenario in 2012



Source: BlackRock

It is important to recognise turning points or signposts as we move into Divergence or – less likely – dive headfirst into Nemesis. We would only act on these signposts if they are crystal clear: We want to avoid 'hero trades.' We are willing to miss the first bite of a potential return because the risks of being wrong are too great and false signals abound.

Peter Fisher
Head of BlackRock's Fixed Income Portfolio Management Team

The European Debt Crisis: Make It Stop!

An obvious signpost is resolution of the European debt crisis. The eurozone tightened monetary policy too rapidly and imposed fiscal austerity too severely in a period when banks worldwide were shedding risky assets. We are now living with the consequences of that technocratic hubris.

We saw many attempts at a cleanup in 2011, culminating in the December 9 European summit. It wasn't the hoped for 'mother of all summits,' but it did provide a clearer framework for an eventual solution. And the accompanying actions by the European Central Bank (ECB) to alleviate a dangerous bank funding crunch just might prevent the crisis from spinning out of control, as we argued in *What's Next for the Eurozone*.

It is crucial to break the buyers' strike that at times has paralysed huge bond markets like Italy's, especially because eurozone governments must refinance more than 500 billion euros of debt in the first half alone. The crisis is mostly about the ability *to roll over* debt, not the ability *to pay* debt. If we could choose to read one December 2012 headline now, it would be the rate at which Italy rolls over its debt (and in which currency).

An Austerity Diet

The ECB has made clear it is the lender of last resort for banks – but not for government bonds. This disappointed some investors, but we believe banks can – and will – pick up some of the slack of buying sovereign debt nobody else wants. Measures such as cutting bank reserve ratios, accepting lower-rated collateral and extending funding have reduced the possibility of a doomsday credit crunch.

Eurozone leaders believe they have made progress toward a fiscal union, including automatic sanctions for countries that don't balance their budgets, but many questions remain: Will voters approve plans for centrally run budgets? How will the new fiscal rules be enforced? How exactly will the various rescue funds work? How will Europe cut budget deficits without killing growth and triggering social unrest?

It is crucial to break the buyers' strike that at times has paralysed huge bond markets like Italy's.

The last question goes beyond Europe: Do developed world policymakers have the wherewithal to implement smart policies to reduce long-term drags such as pensions and other benefits while boosting growth in the short term? Policymakers cannot cut near-term spending too deeply or risk plunging their economies into deep recession. Austerity alone starves the patient.

All these questions prevent us from calling an end to the European debt crisis – no matter how many of us would like to see that happen.

The bottom line: Do not expect China to bail out the world in 2012.

China Comes to the Rescue?

Another signpost is China's response to slowing growth. The country is moving away from its singular focus on pushing down inflation and crushing property speculation. It also has plenty of room for easing in 2012 with an arsenal of growth boosters. The impact of its social housing plans alone is huge. See the chart below.

The question is whether China will act on time and effectively to avoid wholesale capital outflows, a property crash and shattering of confidence. China's leadership change in late 2012 is a big risk. It will likely give even more prominence to domestic considerations of fighting inflation, keeping a lid on social unrest and furthering employment.

We are no panda bears, as we showed in our July 2011 paper *Can China's Savers Save the World?* We don't think a property bust is imminent but see it as an increasing possibility down the road given the current policy mix.

The bottom line: Do not expect China to bail out the world in 2012. The best we can hope for are policies that reaccelerate its economy. The good news? The policies could come sooner rather than later in response to an increasing probability for a growth shock. China is different: Economic growth of 6% is not good enough.

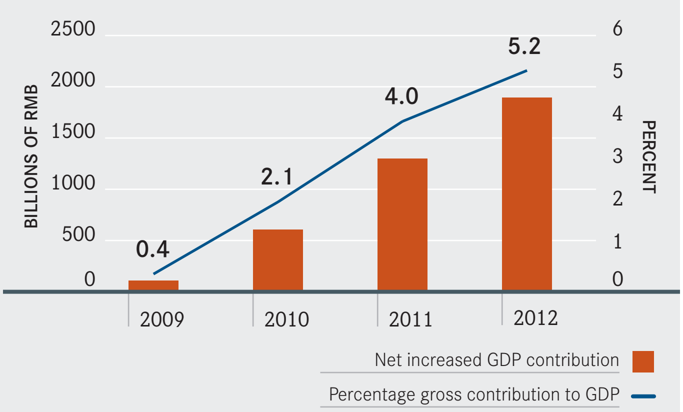
The Last Keynesian on Earth

China Has Ample Means to Stimulate Growth

China's Arsenal

Asset Type		Trillions of RMB
Foreign Reserves (Jun 11)	US $3.2 trillion	20.0
Gold Reserves (Jun 11)	33.8m ounces	0.4
China Investment Co. (Dec 10)	Cash and Investments	0.9
Social Security Fund (Dec 10)	Total Assets	0.9
Listed SoEs* (Oct 10)	Market Capitalisation	10.0
Total		**32.1**

Social Housing is Another Booster



Source: CLSA

Note: Amounts may not add up due to rounding. * State-Owned Enterprises.

Banks Deleveraging: An Under appreciated Force

A third signpost is how fast the global banking system will shrink – or how slowly it will grow. Bank deleveraging is an under appreciated but key force across asset classes. Pressured by new regulations, higher capital standards and more risk-averse investors, global banks have been shedding assets at every opportunity.

European banks in particular are under heavy pressure to rid themselves of assets that are either too risky, hard to price or outside the realm of traditional banking. They are much more reliant on money markets for funding than their US counterparts, and need to roll over a mountain of debt in the first half of the year.

The global deleveraging trend has capped any gains in risk assets, at least in the short term. Again, policymakers must walk a fine line. Push too hard on bank deleveraging, and they will likely face a fire sale. The result? Bank failures or nationalisations that would plunge the world into deep recession as credit evaporates.

We are pretty sure Europe will have a recession in 2012 – hardly a help to anaemic world growth prospects. A key call between Nemesis and Divergence, therefore, is the degree to which policymakers prevent banks from shedding assets too fast or implement monetary and fiscal policies that offset the effects of deleveraging.

On the flipside, gradual bank dispositions open up opportunities to buy choice assets such as real estate securities and infrastructure projects. Nothing really juicy has materialised so far – a reminder that there is a big difference between a distressed *owner* and a distressed *asset*.

Reading US Tea Leaves

A final signpost is whether the surprising resilience of the US economy will hold up. On the one hand, the recent string of strong economic data shows the economy is still anchored by consumer spending and less susceptible to slowing global growth.

On the other hand, failure to agree on debt reductions has essentially rendered US Congress impotent until after the elections in November. This means the US economy will lack a stimulus boost in an election year for the first time in decades. And failure to extend employment tax holiday and unemployment benefits would severely handicap the economy. That is *not* what the doctor ordered.

The economy's resilience complicated the conundrum for the US Federal Reserve: to ease or not to ease? After its final 2011 meeting in December, the Fed was mum on even the possibility of more quantitative easing. This likely means there is a healthy debate raging within the central bank about whether the economy really needs another boost.

We still expect a third round of quantitative easing, likely after the first quarter when we see the US economy run out of steam. This would tilt the balance toward those advocating more easing. It may become easier to read the Fed tea leaves this year as the central bank is rolling out a new communications policy that will likely include setting an inflation target. This would also enable the Fed to update its commitment to keep interest rates low until at least 2013.

Ken Kroner
Head of Scientific Active Equity and Head of the Global Markets Strategies Group

Policymakers must walk a fine line. Push too hard on bank deleveraging, and they will likely face a fire sale.

Helping You See Clearly in 2012

Five Scenarios, Their Probabilities and Impact

Scenario Probability	Divergence 40%–50%	Nemesis 20%–25%
Ingredients	A true decoupling: Emerging economies keep outperforming, while the United States and Japan muddle through. Europe has a shallow recession and a recovery at snail's pace. China's economy reaccelerates. Elections in key countries are major risks.	Global recession, credit crunch, social upheaval and steep losses across asset classes around the world. China's economy screeches to a halt. The outcome could be worse than the 2008/2009 financial crisis.
Triggers	Policy moves halt – but don't solve – the euro debt crisis. These would likely include a backstop for besieged assets such as Italian bonds and a muddled road map for fiscal responsibility in the developed world. China and other emerging markets ease up on credit.	The most likely trigger is that the European debt crisis spins out of control, leading to a partial breakup of the eurozone and global banks' dumping all risk assets. Others include: An Israeli attack on Iran's nuclear facilities, a China growth shock or a buyers' strike in the US Treasury market.
Probability	Our most likely scenario. Markets are assigning a much lower probability to this scenario judged by the high correlations of most assets.	Bond prices may already reflect the chance of this outcome; risk assets such as equities do not.
Investment Strategy	Lots of opportunities to diversify. We prefer equities, investment-grade and high-yield bonds, and metals including gold. Expect poor returns for US, German and Japanese government bonds, the US dollar and the euro. Focus on emerging market equities and bonds, and the energy and resources sectors. Many European equities are priced for disaster and may outperform. We like alternatives, and would move toward shorter-duration bonds. Dividend stocks and US municipal and corporate bonds remain hot as investors hunt for yield.	Cash and US, German and Japanese government bonds are the places to be. Gold also may work. Pick the US dollar, yen and sterling over the euro and emerging currencies. Hedge funds, private equity and infrastructure could offer protection if they can stomach short-term funding crunches and regulatory measures such as short selling bans. Within equities, we would focus on US defensive and strong cash flow companies that have the ability to raise dividends. We would also like Asia and avoid Europe.
Caveat	The evil twin of divergence is fragmentation: A partial breakup of the eurozone could drive us straight into the arms of Nemesis and roll back trade liberalisation.	Difficult to hedge as downside protection is very expensive. One possibility is to reduce risk and simultaneously sell the pricey put options and other Nemesis hedges everybody else has put on.

Stagnation 15%–25%	Inflation 5%–10%	Growth 0%–5%
Sluggish global economic growth and high unemployment. A European recession hits emerging markets but doesn't choke them. Tighter credit conditions but no crunch. Emerging economies cut interest rates to maintain growth – or need to do so.	Inflation around the world effectively cuts the developed world's debt load but also raises the potential for social unrest and knee-jerk policy responses.	Sustainable global growth just above the long-term trend. Fears of a euro debt crisis dissipate and the continent's economy rebounds. Emerging markets accelerate without spurring much inflation. The US recovery is real.
The current state of play. A tug of war between seemingly ineffective policymakers and sceptical financial markets. Weekly summits and daily monster moves. Upcoming elections in the United States, France and Russia, and China's leadership change add more uncertainty.	The world's central bankers start running their printing presses day and night, a shortage of commodities leads to big price hikes even with moderate economic growth or a surprise global growth rebound spurs inflation.	Developed market policymakers don't just arrest the debt crisis but provide a credible road map for long-term solutions.
We believe the world is at an inflection point and see the current status quo as untenable.	Inflation is unlikely to pick up, especially in the developed world. But fixed income markets are likely to move lightening fast once they get a scent of it.	Dream on.
Assets move in lockstep with big price swings from one day to the next as investors buy into the latest policy moves to halt the debt crisis or poke holes in them. Banks' shedding risky assets keep a lid on permanent gains in risk assets. Buy long-duration US Treasuries, corporate bonds and emerging Asia debt. Avoid European and Japanese sovereigns. Pick emerging equities and local currency debt, and the yen over European assets.	US Treasuries and other safe-haven bonds fall off a cliff. Pick high-yield bonds over investment-grade. Income-focused investors switch to risk assets. Choose US, UK, LatAm and Japanese equities, and focus on the energy sector. Alternatives such as real estate/infra-structure (if indexed) and private equity should do okay.	Most markets rise, especially risk assets such as commodities, high-yield bonds, depressed European sovereigns and financials. US Treasuries, German bunds and other safe-haven investments fall. Pick the euro and emerging currencies over the yen and sterling. Emphasise European and emerging equities and focus on resources, financials and cyclicals.
Volatility and risk are here to stay under any scenario. What's needed is a new investor mindset, if only to get a good night's sleep.	The market consensus overwhelmingly dismisses the inflation scenario. If history is any guide, this means it actually may happen.	We will eventually end up here. The question is how: Through the doomsday Nemesis scenario or the benign Divergence outcome?

Divergence

The idea of decoupling is old – and often proved wrong.

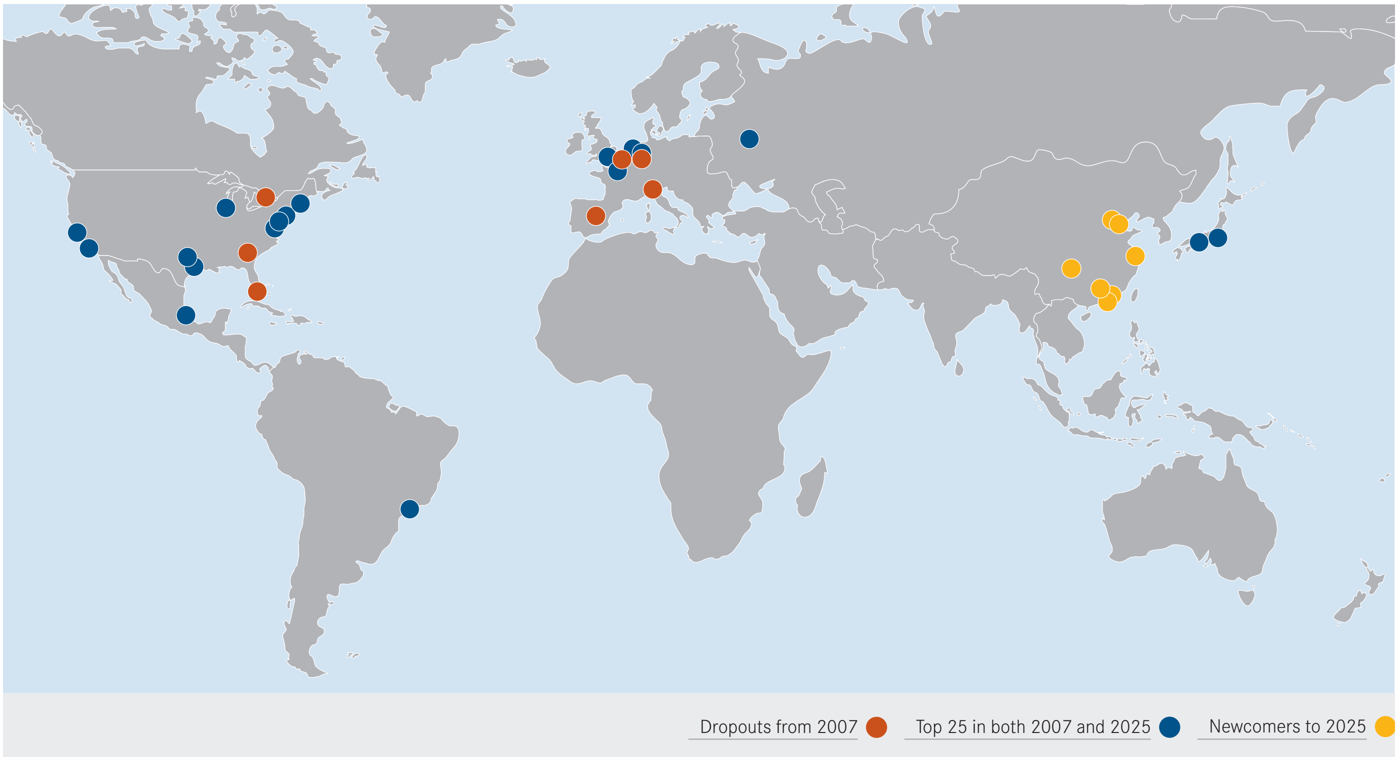
When we look into our 2012 crystal balls, what jumps out is a decoupling of faster-growing emerging markets and the debt-ridden developed world. We believe this is likely to take place this year, both for the 'real' economies and asset prices.

Emerging markets account for almost half of the global economy, and their economies are growing at a much faster clip than the developed world. Research and development spending is keeping pace, with the global shares of US, European and Japanese expected to decline in 2012 due to faster growth in emerging markets led by China, according to a Battelle and *R&D Magazine* study. Young populations underpin the long-term trend, while urbanisation is creating new metropolis powerhouses. See the chart below.

We would expect the US economy to muddle through and avoid falling back into recession in Divergence. Europe should have a shallow and short-lived recession, followed by a snail-like recovery in 2013. Japan is a toss-up: It is embarking on a huge stimulus program, but the soaring yen is making life tough for exporters.

New Centres of Power

Top 25 Cities by GDP, 2007 and 2025



Source: McKinsey Global Institute

This Time *Is* Different

The idea of decoupling is old – and often proved wrong. This is especially true when it comes to asset prices: There is a big difference between great economic performance and great returns.

Just look at China. Its economy has notched double-digit growth in most years of the past decade. It has surpassed Japan as the No. 2 economy and has become the world's top market for new cars. Cities, harbours and roads are being built at breakneck speed.

Yet when you look the performance of Chinese equities, as we did in our August 2011 paper *Are Emerging Markets the next Developed Markets?*, the picture is very different. The Shanghai stock market has barely outperformed Hungary – which has grown at a much slower pace.

This phenomenon again played out in 2011. Emerging market economies held up pretty well, but asset prices fell off a cliff as investors pulled back on all (perceived) risk in the face of a worsening European debt crisis.

Why would 2012 be any different? We see two main reasons: First, emerging market policymakers have plenty of room for both monetary easing and fiscal stimulus. Second, emerging market assets are no longer overvalued compared with developed world securities by historical standards. See chart on page 13.

We also believe there is an important long-term trend that makes the case for investing in emerging markets: They are becoming less risky. Their economies are becoming less volatile and dependent on exports. Their fiscal budgets have room for expansion and carry less debt.

Look Inside the Package

If you believe the developing world will decouple, emerging equities and local currency debt look attractive. Some pointers on each:

It is important to zero in on companies benefiting from growing consumption in emerging markets. Global companies, even if they're domiciled in developed markets, can get a piece of that growth. Many of them are priced reasonably and offer dividend yields at or above yields on government bonds.

In other words, have a good look inside the package before you buy it. For example, you could make the case South Korea's Samsung Electronics is a developed market stock in disguise. By contrast, the UK's Burberry or Freeport-McMoRan of the United States are emerging market plays.

The chart on the following page shows how companies with big exposure to emerging markets have outperformed ones that have little. The trend has been most pronounced in UK stocks, closely followed by European equities.

Dennis Stattman
Head of BlackRock's Global Allocation Team

Emerging market policymakers have plenty of room for both monetary easing and fiscal stimulus.

Russ Koesterich
Chief Investment Strategist,
BlackRock's iShares Business

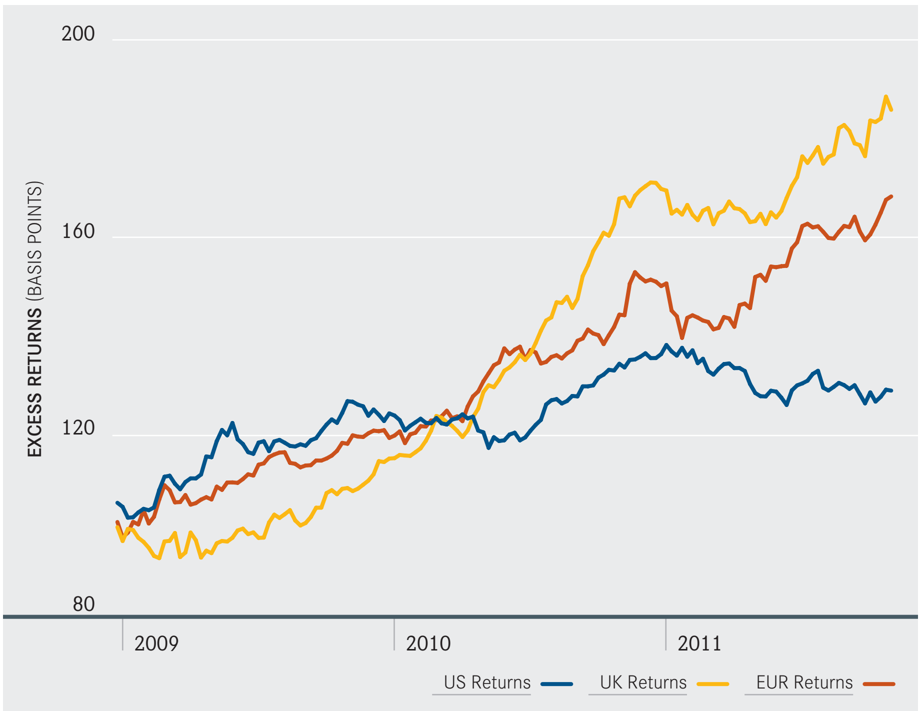
Emerging Safety?

Pure emerging equities did poorly in 2011. Knowing why – it came down to tight monetary policy and slowing capital inflows – helps answer the question of whether investors should look for direct or indirect emerging markets exposure. We believe looser policies, low valuations and poor sentiment are setting up emerging markets for a rebound in 2012.

You could argue emerging market debt is not just higher yielding, but also safer than developed world sovereign bonds. South Korea and Chile, for example, are ranked above the United States and Germany in the BlackRock Sovereign Risk Index. A bevy of countries, including Thailand, Malaysia and Peru, rank higher than the UK. See chart on page 16.

A word of caution on emerging market debt: Market stress will often trigger capital flight accompanied by steep drops in local currencies. This can hurt returns much more than declines in actual bond prices, as we showed in our October 2011 paper *The Rising Prominence of Asia's Debt Markets*. In addition, liquidity can dry up fast in emerging markets – magnified by government intervention. And an asset you cannot price or trade is worth very little.

Emerging Markets Make All The Difference
Stocks With High Emerging Markets Exposure Outperform



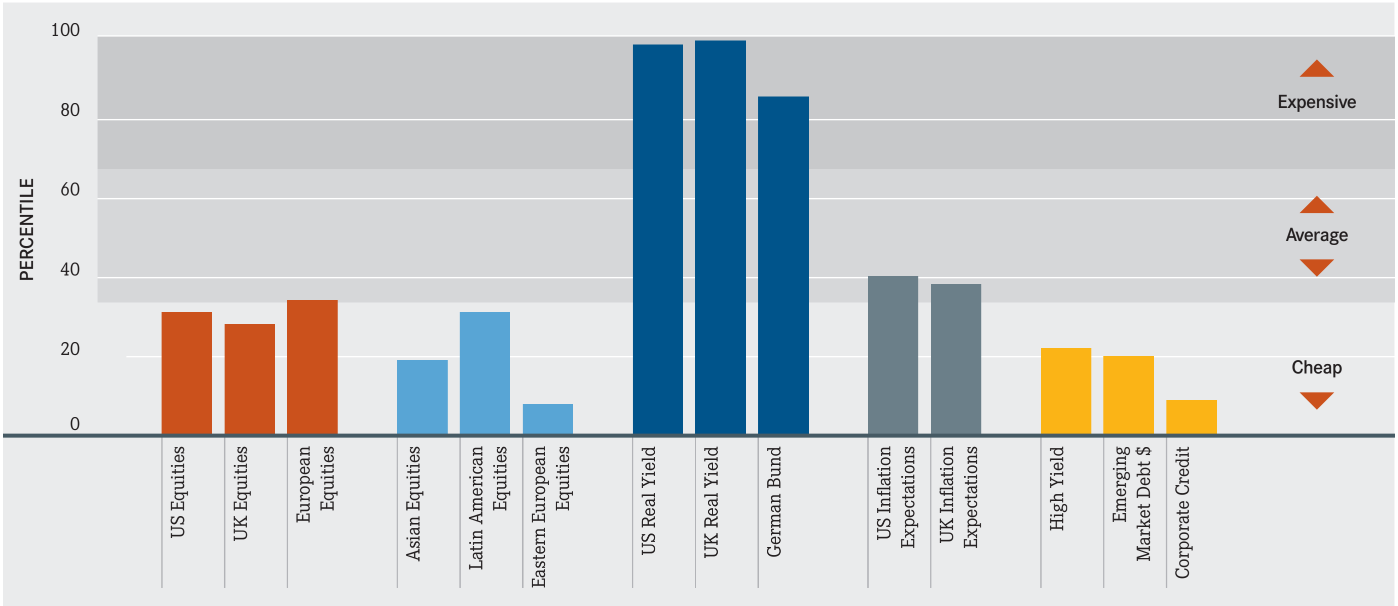
Source: BlackRock

Note: Emerging market (EM) exposure is based on proprietary BlackRock sell-side survey data. Returns represent the difference between share price returns of the top and bottom deciles of EM exposure in each market. Returns are beta adjusted, based on regional Barra risk models. Returns prior to 2010 are based on static December 31, 2010 EM exposure.

We believe looser policies, low valuations and poor sentiment are setting up emerging markets for a rebound in 2012.

Opportunities Abound – If You Believe in Divergence

Valuations of Various Asset Classes by Percentile vs. Historical Norm



Source: Thomson Reuters, Bloomberg and BlackRock

Note: Valuations as of October 31, 2011. Time periods vary for each asset class, depending on when the appropriate indexes were created. Equity valuations are the average of dividend yield, book value and price/earnings ratio. Inflation expectations are 10-year inflation breakeven rates or the difference between the yield on Treasuries/gilts and TIPS/linkers.

Self-Help Stories

Markets are not putting much stock in the possibility of Divergence, as evidenced by assets moving in concert on the latest news from Europe. Indeed, 2011 was a tough year. Many equities lost money – without much regional variation. Ostensibly overpriced high-quality bonds once again defied naysayers and racked up great returns. It all came down to macro-economic and confidence factors.

The market is being driven by short-term risk aversion for now. This creates anomalies and opportunities for fundamental investors to buy attractive assets at exceptional valuations. If you are a believer in Divergence, opportunities abound. The chart above outlines which assets are mispriced by historical standards.

Beyond the investment choices discussed in the scenarios box on pages 8 and 9, some of us are starting to warm to European equities. There is no question they are cheap: Pan-European stocks (including UK equities) traded at around nine times expected earnings at the end of 2011. This is at the bottom end of the 35-year range.

The problem is that they are cheap for a reason. Analysts have ratcheted down 2012 profit forecasts for European companies, but are still too optimistic in our view. As a result, we remain cautious and look for 'self-help stories' – companies that can withstand a recession or worse. And we still like companies that derive a large proportion of sales and earnings from emerging markets.

The market is being driven by short-term risk aversion for now. This creates anomalies and opportunities.

Richard Urwin
Head of Investments, Fiduciary Mandates

Nemesis

If the European debt crisis were to spin out of control, it would likely plunge Europe into a deep recession that would spread to the rest of the world, including China. The result would not be a simple *addition* of problems, but a *multiplication*. It could be bad because the developed world has used up much of its firepower to fight another credit crunch and deep recession.

We call this scenario Nemesis, after the Greek goddess who wreaks havoc and vengeance on the prideful. Some would argue creating a European monetary union without a fiscal union was an act of hubris with punishment long overdue.

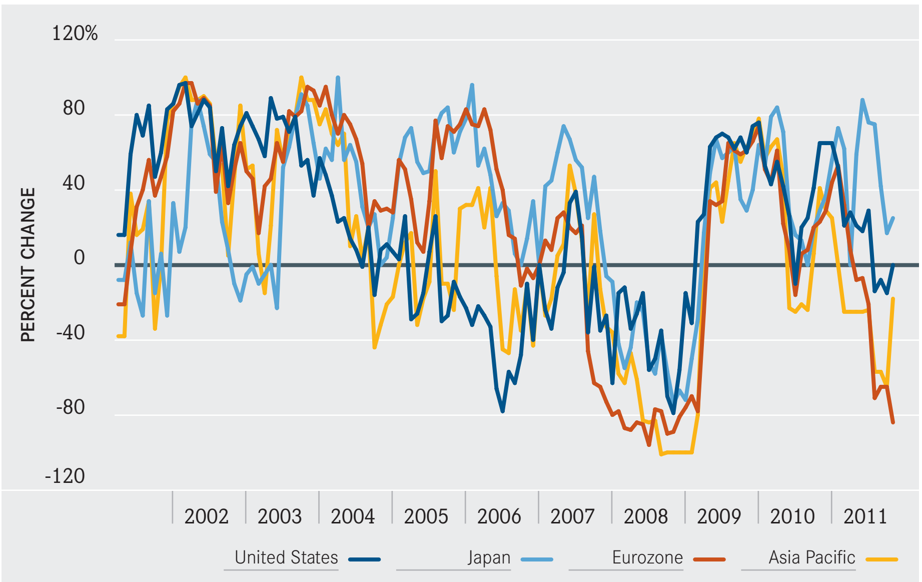
The European debt crisis already has dented business confidence and capital spending, not just in Europe but around the world. Expectations for growth in key economies have already taken a hit. See the chart below.

Against this gloomy backdrop, it would not take much to set off Nemesis: Policymakers could fail to stabilise government bond and credit markets. Banks could dump risky assets *en masse*. Developed world governments could impose austerity measures that trigger recessions and social unrest. And there is a possibility of a partial breakup of the eurozone – the evil twin of our Divergence scenario.

There is also a chance we are focusing too much on the European crisis. Other potential Nemesis triggers include an Israeli strike on Iran's nuclear facilities that causes oil prices to hit $150 a barrel, a growth shock in China due to bad policy choices or a buyers' strike in the US Treasury market on renewed fears of a fiscal train wreck.

And then there is the stuff we have not thought about yet: The shell you hear is not the one that hits you.

Getting Gloomier
Fund Manager Expectations of Economic Performance



Source: BofA Merrill Lynch Fund Manager Survey

Note: Based on the question: "How do you think the region's economy will develop over the next 12 months?" Data as of November 10, 2011.

Some would argue creating a European monetary union without a fiscal union was an act of hubris with punishment long overdue.

Hedging or Dodging Nemesis

It is tough – and expensive – to hedge against Nemesis. Beyond the investment choices discussed in the scenarios box on pages 8 and 9, alternative investments can offer protection for long-term investors if:

1. The underlying investment can withstand a deep recession, short-term funding crunch or regulatory crackdown. Examples are companies that have the ability to keep paying dividends and interest payments in a depression. Or hedge funds that can stomach short-selling bans, a sudden cut-off in credit and mass redemptions.
2. The investor can afford to take a long-term view. This means not being forced to sell when the investment's value tumbles or its credit rating drops off a cliff.

There is a third prerequisite: The investment should yield an attractive return. This is much easier said than done these days, which we will discuss on pages 17 and 18.

Alternative investments work well in pretty much any scenario if they live up to their promise of delivering superior, uncorrelated returns. For hedge funds as a group, this did not happen in 2011. This once again brings home the message of how important it is to pick the right manager in alternative investing.

It is crucial to hold cash, both to guard against Nemesis and to take advantage of opportunities. Nemesis, however horrible it would be for most people, would represent a fantastic buying opportunity – much like equities, high-yield bonds and resources were great buys in early 2009.

While we believe Nemesis would really hurt, three factors could mitigate its impact: Corporate cash coffers are filled to the brim. Banks are in much better shape than in 2008, especially in the United States. And emerging markets have plenty of room for boosting growth, both through monetary easing and stimulus spending.

Bob Doll
Chief Equity Strategist

A Big Election Year

How do you really feel about the economy and the widening gap between the haves and have-nots? It depends who you are and where you are. Country, region, age group, ethnicity and residency make all the difference. And the gap between rich and poor has reached its highest level in more than 30 years in the industrialised world, according to a recent study of the Organisation for Economic Co-operation and Development. These differences have caused political stress and soul searching on both sides of the Atlantic as well as in emerging markets.

You could argue policymaking is almost antiseptic: It is about making a few good, rational choices and avoiding a lot of bad choices. Politics, by contrast, can have unexpected twists and turns. Politics can be emotional. Politics can be ugly.

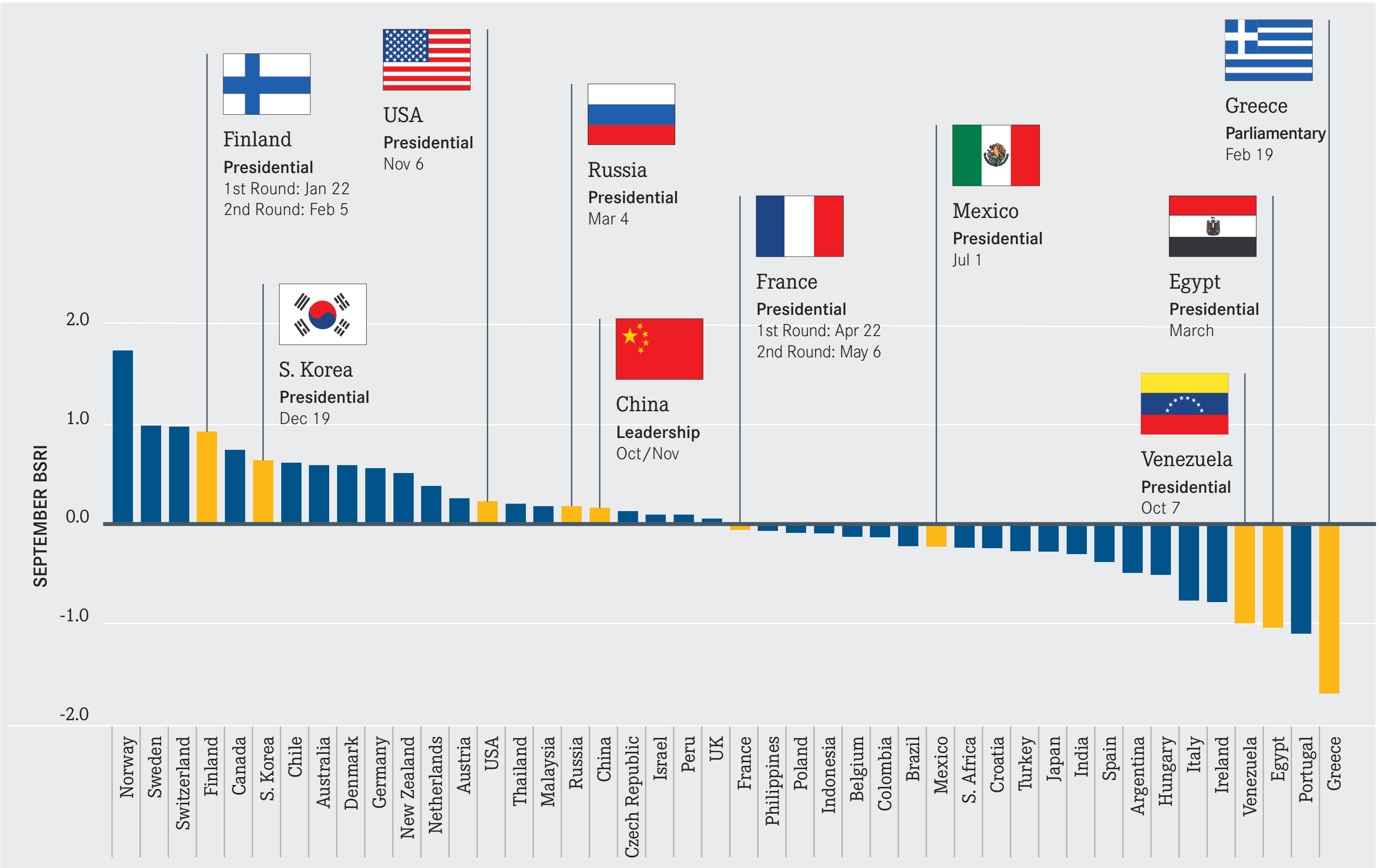
To financial experts, some political decisions may make no sense whatsoever. Politicians are not stupid, though. And their decisions – or lack thereof – may make all the sense in the world in a political context.

The fact is that policymaking and politics are intertwined. This is why it is important to track and understand domestic politics. This has long been the case in emerging markets investing, but it is a newish concept in the developed world.

Policymaking is almost antiseptic: It is about making a few good, rational choices and avoiding a lot of bad choices. Politics can be emotional. Politics can be ugly.

Politics Matter More Than Ever

Scheduled 2012 Elections in Countries Tracked by the BlackRock Sovereign Risk Index



Source: BlackRock

Note: The BlackRock Sovereign Risk Index ranks selected countries' sovereign debt using a set of fiscal, financial and institutional metrics.

A flurry of elections next year could magnify risks or usher in scenarios we have not yet contemplated.

The possibility of social unrest is high in many nations at a time of power shifts or vacuums in key countries. A flurry of elections could magnify risks or usher in scenarios we have not yet contemplated. Governments could change in about a quarter of the countries tracked by the BlackRock Sovereign Risk Index. See the graphic above.

Taiwan kicks off the elections calendar in January with a close race that will determine its economic linkage with China and the likelihood of a blow-up between the two. Finland, which has played the Scrooge in the European debt drama, is next.

The outcome of Russia's March election is a given, even if selected billionaire oligarchs jump into the fray. The scale of Vladimir Putin's victory, however, will determine the probability of needed economic reforms and the likelihood of stability. Russia may appear less relevant today than in the cold war era, but a Russia that is not doing well is dangerous.

Onto Paris in the spring, where the weaker half of the Merkozy duo is trying to crawl out of a deep unpopularity hole. Nicolas Sarkozy faces a struggle to get through the first round, let alone kick sand in the face of socialist opponent François Hollande in the final. China's formal leadership handover in the autumn is likely to turn the country's focus even more inward in the run-up. The grand finale is US President Barack Obama's bid for an Act 2. And we have not even talked about Greece, Mexico, South Korea and others.

Hunt for Yield

The big opportunity in 2012 and beyond is: Where do I clip yield?

Erstwhile safe havens are no longer there. Many top-rated bond yields are either at record lows or negative. Others are too good to be true or too scary to touch. At the same time, retirees live longer and are growing in numbers. Many of these people – and their pension funds – are looking for income.

Two long-term demographic trends are driving investor appetite for income: an explosion in the number of pensioners and higher life expectancies around the world. The global retirement population will almost triple to 2 billion by 2050, the United Nations estimates. See the chart below.

Pensioners are also far more active in retirement than in previous decades and have higher expectations for living standards. Inflation has a devastating impact on the real value of savings over longer periods of time. And people are living longer in retirement: For every US couple aged 65, for example, there is a 50% chance one of them will live to be 92.

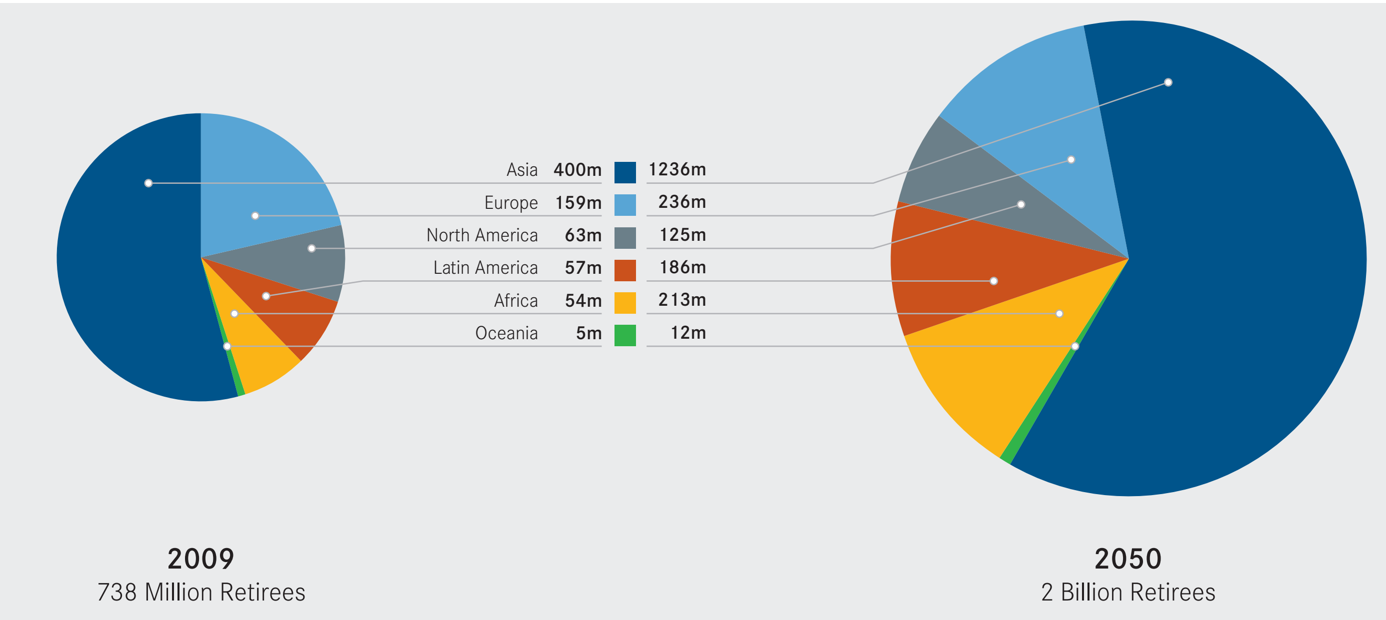
This is great for the couple – if they get along, that is – but it is a strain on society. The numbers translate into increased demand for pension payments and medical benefits. This will put stress on government finances – at a time budgets are already in horrible shape and pension investment returns have lagged projections. This is old news – but it gets more important each year.

Few Choices

Top-rated sovereign bonds, long investors' prime choice for safe income, return very little or actually lose money after factoring in inflation. That leaves investment choices such as high-yield corporate bonds, dividend stocks, Asian debt, alternative investments such as private equity, infrastructure and real estate, and options strategies from covered call writing to volatility spreads.

World Retirement Boom

The Number of 60+ers Is Expected to Triple to 2 Billion by 2050



Source: United Nations Population Ageing and Development 2009

Rick Rieder
Chief Investment Officer, Fixed Income, Fundamental Portfolios

Many real estate securities look pricey after a big run-up in 2011. High-yield bonds have appreciated but still offer value as a potential hedge against a recession. Historically, high-yield bonds have performed well in periods of negative economic growth.

Dividend stocks are another avenue, but some are starting to look relatively expensive. The valuation gap between high- and low-payout US stocks is currently at a record low, suggesting companies with strong free cash flows are better buys at this time. These companies can raise dividends, and the key with equities is dividend *growth*, not *yield*.

Other Hunting Grounds

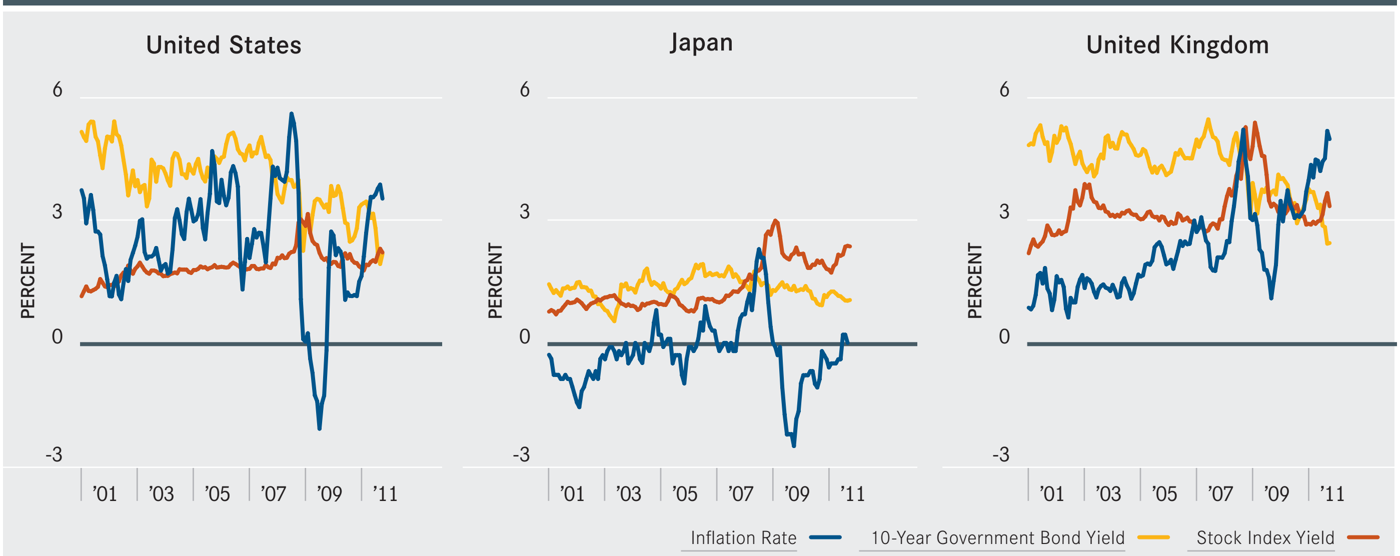
The US municipal bond market has been prime territory for yield hunters. It has held up well, despite Cassandra-like warnings of defaults and some high-profile bankruptcies. We see regulatory risk as a bigger potential scourge. The Fed's admission it underclubbed the size of the market by some $800 billion is more than an 'oops.' It may bring regulation, scrutiny and attacks on the tax-exempt market as a shelter for the wealthy.

Alternative investments such as private equity are other options for long-term investors. Private equity should do well in most scenarios as long as it is not dependent on funding. The big challenge these days is eking out synergies in target companies: There is not a lot of corporate fat left after the recession.

Infrastructure is good for stable, long-term income as long as returns are indexed against inflation and investors have enforceable claims on the hard assets. This includes renewable energy projects, which now make up roughly half of new power generation. The main challenge here is a dearth of investable projects.

With so much demand for income, our longtime investment theme of the 'structural bid for yield' holds true more than ever. We expect it to play out this year in particular because it has become so tough to find safe and stable income. The big opportunity in 2012 and beyond is: Where do I clip yield?

Got Income?
Real Bond Yields Have Turned Negative in Many Developed Markets



Source: Thomson Reuters

Note: Stock index dividend yields based on S&P 500, TOPIX and FTSE All Shares.

We hope this publication has given you a framework to navigate the investing landscape and recognise signposts along the road. To see clearly in 2012, five points are worth remembering:

- Expect a decoupling of fast-growing emerging economies and the developed world. Emerging market assets would outperform in this 'Divergence' scenario.
- The odds of a 'Nemesis' crisis are much lower, but still uncomfortably high. The biggest potential trigger is an escalating European debt crisis.
- Investors will scrounge for income in a risky world with ultra-low interest rates. A global retirement boom and longer life expectancies underpin this trend.
- Market volatility is here to stay, magnified by elections and power handovers in key countries. Politics matter more than ever in investing.
- Inflation is unlikely to pick up. This market consensus view could be upended by a global monetary easing or a run-up in commodities prices.

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