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BLACKROCK INVESTMENT INSTITUTE
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.

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SO WHAT DO I DO WITH MY MONEY?™

Cliff Insurance
Guard against a sell-off in risk assets in the run-up to the fiscal cliff. Volatility has been very low, so out-of-the-money options have been cheap. No hedge comes for free—but this one may pay off (and give peace of mind).

US Downgrade—Part 2
Another US debt downgrade is likely if Washington makes no progress on fixing the budget. This is unlikely to shock risk assets as much as it did in 2011: We have seen this movie before.

Tired Equities
US stocks have outperformed but have become relatively expensive and linked to monetary easing. If economic momentum weakens further, it may be time to head for the US departures lounge. Destination: emerging markets.

Dividend Shields
A dividend tax hike is unlikely to kill the sector’s renaissance. Investors are desperate for income and US companies historically have raised payouts to offset rising taxes. Details on page 16.

Magnificent Munis
Municipal bonds are likely to retain their sheen—despite prophecies of doom about their tax-exempt status. The market’s selling points hold up: income at relatively low risk, and the powerful mix of strong investor demand and shrinking supply. Details on pages 14 and 15.
First Words and Summary

Financial markets can only focus on one scary thing at a time. The European debt crisis has been the shark closest to the boat for years. Now the US fiscal cliff—a perfect storm of tax hikes and spending cuts that may go into effect Jan. 1—is moving to the fore.

Once the focus shifts across the Atlantic, markets will likely zero in on a familiar but depressing picture: A big budget hole and plenty of political dysfunction. The background? An economic recovery losing steam and an election showing an increasingly bitter divide. Our main conclusions are:

Dangerous Disconnect
Washington insiders are sure political dysfunction will push the nation off the fiscal cliff—if only briefly. The ensuing scare would provide political cover for compromise and a budget deal in the second half of 2013. By contrast, most financial experts believe in an 11th-hour rescue that will enable the country to avoid a recession.

Scenario Plotting
This disconnect between political and market pundits is scary. We have laid out three scenarios: a sky dive, a bungee jump and a hard stop. All involve lots of acrobatics.

Sky Dive
A second term for President Barack Obama could result in a sky dive off the cliff, with a risk of broken limbs on landing. A deal on income tax could be done, but another ugly fight over the debt ceiling would be brewing. The US Federal Reserve would be key in supporting the economy and markets.

Bungee Jump
A victory by contender Mitt Romney and a Republican sweep of Congress could entail a bungee jump with a well-broadcast plan to get back up. Tax hikes would be reversed retroactively and the debt ceiling would be raised ahead of a full budget deal. The Fed would be constrained.

Hard Stop
A third scenario would be a screeching halt just before the cliff. Lawmakers would agree to some spending cuts and then hammer out a budget deal in the summer of 2013. The impetus? A market plunge and/or public disgust with Washington. Fed action would take center stage.

Cliff Fears
Chances are risk assets will sputter well before the fiscal bomb is set to go off on Jan. 1. Businesses are curtailing investments and freezing hiring. Consumer confidence is wobbly. Uncertainty is a killer for business and markets.

Fed Rescue?
Fiscal cliff = market disaster. Or does it? A mix of tight fiscal budgets and loose monetary policy may boost risk assets. This view does have a lot riding on Fed action.

Limited Options
Doing nothing is not an option. Gaping deficits have created a pile of debt that will likely brake growth for decades. We need to see at least the outline of a comprehensive budget deal to turn things around. Closing the budget gap is a long, painful road of tax hikes and spending cuts.

The “T” Word
Simple math says the US government will have to increase revenues to make a dent in the deficit. The complicated tax code desperately needs an overhaul. We are, however, afraid this effort will end up in the “too difficult” box next year.

The “B” Word
The other part of the budget equation says spending must come down—even on benefits. Social Security and healthcare eat up a huge chunk of revenues, and are set to grow with a greying population. This is unsustainable.

Call to Action
The country is on the wrong fiscal path. Mathematically, it is pretty easy to change course through a combination of tax givebacks and spending cuts. Politically, this is very tough to do—unless Washington rediscovers the art of compromise. It is time to do just that.

BLACKROCK’S ELECTION FORUM
The US elections and “fiscal cliff” of tax increases and spending cuts are looming large. The first of a series of discussions organized by the BlackRock Investment Institute focused on the US budget.

It included presentations by leading BlackRock portfolio managers and speakers such as Peter Orszag, former Director of the US Office of Management and Budget, and budget reform advocate Maya MacGuineas. This publication captures the event’s highlights. All views are BlackRock’s.
Cliff Watching

**HARD STOP**

**Ingredients**
Lawmakers extend most programs in return for some spending cuts. They then work toward a comprehensive budget deal in mid-2013.

**Market Reception**
Bliss—if there are enough signs and specifics to indicate a real budget deal is in the making. Fed actions dominate trading.

**Wild Card**
Risk assets could sell off if the deal is seen as another Band-Aid.

**BUNGEE JUMP**

**Ingredients**
A Republican sweep of the presidency, House and Senate. No deal in the lame-duck session. A well-telegraphed plan to reverse tax increases in January.

**Market Reception**
Initial euphoria. Possibility of later disappointment if no real progress is made to address structural budget issues.

**Wild Card**
Can one party really make the tough calls (including cutting benefits) without the political cover of compromise?

**SKY DIVE**

**Ingredients**
Obama wins the election. No deal in the lame-duck session. Possible income tax deal in early January. Expect wrangling on the debt ceiling—again.

**Market Reception**
High anxiety in December that is likely to spill over into 2013 if Washington cannot compromise. Fed policy takes center stage.

**Wild Card**
Expectations for sound fiscal policy are sub-zero. This makes it easy for Washington to surprise on the upside—and ignite a risk rally.
A Dangerous Disconnect

You can always count on Americans to do the right thing—after they’ve tried everything else.

This quote, attributed to Winston Churchill, sums up the market consensus on the fiscal cliff: Washington will do the right thing—at the 11th hour.

Pretty much everybody agrees the country needs to start narrowing its fiscal deficits and slowing the growth of its colossal debt load—just not so fast and all at once. The reason? The fiscal cliff—a term coined by Fed Chairman Ben Bernanke earlier this year—is high and the fall is deep.

If nothing is done, the tax hikes and spending cuts could reduce gross domestic product (GDP) by an estimated $807 billion in 2013, or about 5%. In the unlikely event Congress does not raise the debt ceiling (the statutory US debt limit), the impact could be even worse. See the table below.

Even a realistic scenario—the extension of most income tax benefits but a hike in payroll taxes and a few spending cuts—would hurt GDP growth by about 2% in 2013, we believe. This could negate (at least economically) the effect of the Fed’s open-ended quantitative easing, or “QE Infinity” in market speak.

These are big, scary numbers—especially considering the US economic recovery is the feeblest in post-WWII history by almost any measure. Yet markets are giving very low odds to the possibility that the country will actually go off the cliff. Consider:

- 79 economists polled by Bloomberg in September all predicted positive GDP growth for the first quarter and full year of 2013, with the consensus calling for 2.1% annual growth.
- Equity analysts expect S&P 500 companies to increase earnings by 12% next year, according to Thomson Reuters.
- The S&P 500 Index has been close to record highs and volatility has been eerily low.

Conclusion: Markets have not priced in the fiscal cliff and assume QE Infinity will drown out other factors.

### WATCH YOUR STEP!
#### Fiscal Cliff Components and Estimated 2013 Impact

<table>
<thead>
<tr>
<th>Cliff Event</th>
<th>Cliff Details</th>
<th>2013 Fiscal Impact</th>
<th>2013 GDP Impact</th>
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<tbody>
<tr>
<td><strong>Tax Policy</strong></td>
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</table>
| 2001-2003 tax cuts expire and Alternative Minimum Tax (AMT) expands | - Marginal tax rates increase; top rate rises to 39.6%, from 35%  
  - Estate taxes return to a 55% top rate with a $1 million exemption  
  - Long-term capital gains taxes increase to 20%, from 15%  
  - Dividends taxed as ordinary income, from 15%  
  - Millions of taxpayers no longer exempt from AMT | $294 billion | 1.9% |
| 2011 payroll tax cut expires | - Employee payroll taxes return to 6.2%, from 4.2% | $126 billion | 0.8% |
| Expiration of other tax benefits | - Research and experimentation tax credits disappear | $86 billion | 0.5% |
| Affordable Care Act taxes | - New taxes on high incomes for healthcare legislation | $24 billion | 0.2% |
| **Spending Cuts** | | | |
| Mandatory budget cuts (sequestration) | (The Budget Control Act of 2011 calls for automatic spending cuts after US Congress failed to identify means to cut the deficit)  
  - Defense spending cut by 10%; other spending by 8%  
  - $1.2 trillion in spending cuts over 10 years | $86 billion | 0.5% |
| Extended unemployment benefits end | - Reduces period people can collect unemployment insurance | $35 billion | 0.2% |
| Medicare payments to physicians cut | - Medicare rates for doctors cut by nearly 30% | $15 billion | 0.1% |
| Other revenue and spending cuts | - Congressional Budget Office estimates not linked to policies | $140 billion | 0.9% |
| **Total** | | $807 billion | 5.1% |

**Debt Ceiling**

- Debt ceiling authorization (yes, that one again)  
  - The US debt limit was lifted to $16.6 trillion in a last-minute drama that triggered the US debt downgrade in 2011  
  - The new ceiling may be hit before year’s end. US Congress needs to raise it again, or face a US default or total spending freeze

Sources: Credit Suisse, Congressional Budget Office, Office of Management and Budget and BlackRock.
Notes: Estimated impact in calendar year 2013. Totals may not add up due to rounding.
Yet political insiders are pretty sure—if not convinced—Washington will push the nation over the cliff and allow it to go into free fall at least for a while. They believe this is likely to happen no matter who wins the Nov. 6 elections.

This experience would likely hurt financial markets and trigger another US debt downgrade—but also would give decision makers political cover to compromise and eventually strike a budget deal in the fall of 2013, these insiders believe. Their view represents a big disconnect with the market consensus.

Are the political junkies too close to the issue or are the financial wizzes too complacent? Time will tell. For now, all we can say is markets appear to underestimate:

- The potential for panic in the run-up to the cliff
- The possibility of the nation falling off the edge
- The cliff’s impact on economic growth

STOP BICKERIING!

A crisis is a terrible thing to waste.  
— US economist Paul Romer

The budget trends are troubling. The problems will only grow bigger and solutions more painful. Unbridled spending and ballooning debt could raise borrowing costs. This would further pressure budgets, requiring even deeper cuts just to service the debt. Look no further than Europe to get a taste of the (bitter) austerity medicine.

The United States is not short on ideas and workable plans to fix its debt problems. Examples are:

- The bipartisan Simpson-Bowles plan of 2010 to put the budget on a sustainable track
- Reforms proposed by the President’s Commission to Strengthen Social Security in 2001

Both of these plans can be dusted off and put in place—if politicians are willing to compromise. Maybe the fear of the fiscal cliff and its impact on the nation’s economy will bring about the lost art of working together for the greater good. We certainly hope so.

It is time to take action and start down a sustainable budget path. Deficits eventually crowd out private investment and choke economic growth. Failing to act now not only exacerbates the problem; it unfairly pushes the burden to future generations.

PRE-CLIFF FEAR (AND LOATHING)

Always make the audience suffer as much as possible.  
— Alfred Hitchcock

Cinema’s master of fear and suspense understood showing a ticking time bomb creates a lot more anxiety in an audience than the actual explosion.

Similarly, risk assets could dive well before the fiscal bomb is set to go off on Jan. 1. Businesses are already putting investments on ice and freezing hiring. Consumer confidence is shaky and spending is weak.

A temporary budget deal with vague promises to conclude a full agreement later may be the worst-case scenario for risk assets. This proverbial “kicking the can down the road” has become a tough sell. The can has become too big, and the road has devolved into a treacherous dirt track.

ANOTHER SUMMER OF DISCONTENT?

Markets would fear a repeat of 2011’s summer of discontent—which put Washington’s bickering, posturing and eventual inability to negotiate the budget on full display. Fear of a replay would not inspire the business and consumer confidence needed to turn around weakening economic momentum.

Deficit warriors are calling for a deal to cut the mounting debt pile by $5 trillion–$6 trillion over 10 years. This would put the nation’s finances back on a sustainable track. Few people believe this will happen, and we do not hold our breath either.

What could happen is an agreement of $2.5 trillion–$3 trillion in deficit reduction, similar to the “grand bargain” Obama and House Republican Speaker John Boehner almost struck in 2011. The deal would entail both spending cuts (including entitlements) and revenue increases (tax hikes).

This would fall short of the bipartisan Simpson-Bowles plan to achieve $4 trillion in deficit reduction and cut annual budget shortfalls to 1.2% of GDP over a decade, but it would buy time. The prospects for such a deal by the autumn of 2013 are good, according to political experts.

The problem is the turmoil that precedes this.

Regardless of the election result, both parties have little to gain by striking a comprehensive budget deal in the so-called lame-duck session, the time between the elections and the newly elected officials taking office in January 2013.

It would be smart to at least temporarily stop the full implementation of the automatic spending cuts, which would cause a lot of angst. Unfortunately, politicians have failed to do so at every opportunity.
(Limited) Options

The US debt load has exploded, almost tripling since 2000 to $16 trillion today. At this rate, Congress will need to raise the debt ceiling soon—a potentially confrontational process that led to the historic US debt downgrade to AA+ by ratings agency Standard & Poor’s in 2011.

Budget surpluses of the late 1990s have turned into monster deficits, with the shortfall this fiscal year once again expected to top $1 trillion. This increases the debt load by about $2 million a minute. Gross debt, which includes intra-governmental debt, already exceeds GDP and deficits are only slowly coming off the post-WWII high of 10.1% in 2009. See the chart on the right.

How did America dig a hole this deep? Key drivers include:

- One depression-like downturn (the housing collapse and global financial crisis)
- One recession (the dot.com crash and Sept. 11 attacks)
- Two wars (Afghanistan and Iraq)
- Many tax cuts and credits
- Lots of spending (health, pensions and other entitlements)

Politicians started playing the blame game long ago but have made no progress in slowing the trend toward bigger deficits—let alone reversing it.

This partly explains the lowly 14th place of the United States in our BlackRock Sovereign Risk Index, behind developing nations such as Chile and Taiwan. By more conventional measures such as debt to GDP and interest to revenues, the country is between France and Belgium. The next stop is Portugal! See the chart below.
GOLDEN OLDIE: A BUDGET SURPLUS

The National Debt Clock in Manhattan, an electronic billboard that displays the estimated US debt in real time, was mothballed in 2000 for a couple of years. It would have had trouble running backwards to account for the declining debt load caused by budget surpluses. People worried what life would be like without a Treasury market.

These days, the worries from a decade ago seem quaint and the clock is ticking away faster than ever.

This is why merrily extending current tax policies and preventing spending cuts are wishful thinking. The math just does not work. Avoiding the fiscal cliff would pile an additional $1 trillion on top of the US debt load in the next two years and around $8 trillion over the next decade, according to the public policy organization Committee for a Responsible Federal Budget.

Similarly, the Congressional Budget Office (CBO) predicts annual deficits would average an unsustainably high 5% of GDP in the next decade under an “alternative” fiscal scenario. This would keep in place most tax cuts (except the 2011 payroll tax reduction) and nix most mandatory spending cuts. See the chart below.

The bottom line: Politicians do not have the option to stick their heads in the sand.

DOING NOTHING HAS A PRICE


<table>
<thead>
<tr>
<th>Year</th>
<th>Baseline</th>
<th>Extend Tax Policies</th>
<th>Prevent Spending Cuts</th>
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<tr>
<td>2012</td>
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Source: Congressional Budget Office, August 2012.
Notes: Baseline: Assumes most fiscal cliff measures take effect. Extend Tax Policies: Assumes all tax cuts are kept as they are except the payroll tax hike. No Spending Cuts: Assumes none of the Budget Control Act of 2011 cuts are implemented. Additional Debt Service: Interest on additional debt in case the fiscal cliff is avoided.

ON THE BALLOT

With about a month to go before the Nov. 6 elections, most polls predicted Obama would gain another term. The Republicans looked to keep control of the House of Representatives. A simple majority in the Senate was a toss-up, while neither party appeared even close to getting to the magic 60 seats.

Most pundits expected the elections to produce an even more polarized Washington. Moderates are leaving Congress and being replaced by a new generation that puts little value on compromise. Few Washington insiders expected major policy shifts during the campaign and the immediate aftermath—or a sweeping budget debt deal, for that matter.

This is our base case—but it could change over the next month. (We are not in the business of forecasting political elections; predicting financial markets is tough enough.) Swing voters are still sizing up the candidates. Many polls show most people feel the country is headed in the wrong direction—a key factor in the re-election of an incumbent president. Bottom line: Obama appears close—but has not closed the deal yet.

Key events that could affect the election’s outcome:
- Monthly jobs numbers on Oct. 5 and Nov. 2. These are now covered intensively by mainstream media and can swing the country’s mood. Obama needs good new jobs numbers—not a further slide from August’s disappointing rate.
- The remaining presidential debates on Oct. 16 and Oct. 22. These are largely scripted, but there are always a few moments where candidates show their true colors. The debates are especially important for lesser-known quantity Romney.
- Polls in swing states such as Virginia, Ohio and Michigan will increasingly become important. Many state polls do not take into account voters’ party affiliations, so they should be read with care.
- A wild card is a foreign policy blow-up just before the elections. Speculation about an Israeli attack on Iran’s nuclear facilities has been mounting, for example. If this were to lead to a wider Middle East conflict, all bets are off (except for buying oil futures).
Sky Dive, Bungee Jump or Hard Stop?

What will happen as we near the cliff? There are at least three scenarios. All involve acrobatics and adrenaline.

**OBAMA’S PARACHUTE**
The most likely scenario—an Obama victory coupled with a Republican-held House of Representatives—could result in a sky dive off the cliff. This would include that moment of panic before the chute opens and the very real possibility of breaking a leg on landing.

A deal would be unlikely in the lame-duck session, mainly because of disagreement over extending tax cuts for the wealthy. Lots of drama would ensue, with December a period of maximum uncertainty. Media would broadcast the end of the world. Fiscal cliff countdowns would replace most clockwork.

The silver lining could be a deal on income tax. Think about it this way: Once tax hikes take effect on Jan. 1, things start to look up. Washington can now cut taxes for everybody! Obama could even agree to a tax holiday on corporate cash held abroad in return for promises of jobs.

Structural tax reform, however, would not come easily. Obama’s plans to reduce mortgage interest tax deductions or limit tax exemptions for municipal bonds are unlikely to gain traction because the housing market is fragile at best and state budgets are in horrible shape.

Another tough nut is raising the debt ceiling. Republicans would likely not agree to anything permanent without a give-back. A horror scenario would be rolling two-month extensions, creating a permanent game of chicken that would spook financial markets and ratings agencies.

**ROMNEY’S BUNGEE CORD**
A Romney victory would likely mean a Republican sweep of the House and Senate (shy of 60 seats, however). Democrats would have no incentive to compromise on spending cuts or extending tax benefits in the lame-duck session. A bungee jump would follow: A plunge with a well-broadcast plan to bounce back immediately. Tax increases would be reversed retroactively by mid-January.

The debt ceiling would be raised for a six-month period with the intent to have a full fiscal package in place by the summer of 2013. The biggest focus would likely be on cutting Medicaid health programs for low-income groups. Tax reform sounds easy, but is tough because every tax exemption has fervent supporters. Medicare, which makes up the lion’s share of health expenditures, is difficult to touch because of resistance from senior citizens.

This scenario assumes it is easier to make big decisions with a political trifecta—single-party control of the White House, Senate and House. The idea is that divided government can no longer make sweeping policy changes because it relied on centrists in Congress—who are long gone.

This dynamic also creates uncertainty, flip-flopping policies and periods of inaction. Why? First, a trifecta seldom happens. And when it does, it typically triggers a backlash that brings the other party to power.

**WASHINGTON’S HARD STOP**
Miracles do happen—even in Washington. This is the assumption underlying our third scenario.

Lawmakers could delay most fiscal cliff measures in return for a couple hundred billion dollars in spending cuts. Sure, it would be chump change in US budget land. But it could represent a step toward a comprehensive budget deal in the second half of 2013. The nation would barrel toward the cliff, and screech to a halt just in time to avoid disaster. The reasoning:

- Everybody knows jumping off the cliff is bad for the economy, and many people understand temporary measures will not do the trick. Politicians will realize they are more polarized than their voters.
- Going off the cliff does not necessarily make a budget deal easier. There is no secret “Plan B.” Plus, will the artificial new baseline that sets the stage for universal tax cuts really fool anyone?
- A truly comprehensive budget deal is likely to be bipartisan. Any one party is unlikely to cut entitlements on its own. Everybody needs the political cover that comes with compromising.
- As markets start showing signs of distress, it will become easier to take steps to avoid the cliff. There is a point when political rhetoric becomes obstructionism—and a liability. Or at least we hope so.

The downside of this scenario? Washington makes no real progress on putting the budget back on track. Markets would not take kindly to vague promises.
Debt Hangovers

Debt is not necessarily a bad thing—until it starts to get too big. Then it can dampen economic growth, restrict policy choices, drive up costs for all borrowers and leave a nation at the mercy of (foreign) creditors.

The impact on long-term growth can be massive, according to academics Carmen Reinhart, Vincent Reinhart and Kenneth Rogoff in Debt Overhangs: Past and Present.

Their April 2012 paper identified 26 separate periods in which debt exceeded 90% of GDP for at least five years in 14 advanced economies. These “debt overhangs” on average lasted 23 years. Most investors are braced for slow growth—but not for quite so long.

Countries achieved 2.3% annual GDP growth in these debt overhangs, compared with 3.5% the rest of the time. GDP was, on average, 24% smaller after each debt overhang than it would have been otherwise. It is a simple case of asset allocation: More debt needs more foreign inflows and/or more domestic purchases. The latter implies other investments get crowded out, hurting growth.

The other eye opener: Real interest rates in 42% of the debt overhangs were lower or similar to the ones in periods when debt made up less than 90% of GDP.

This means two things:

- The combination of high debt, record-low interest rates and minimal growth seen in much of the developed world today is not unique (and, unfortunately, it can last for an extended period of time).
- The idea that markets will pressure proliferate governments to shape up by demanding punitive rates is overrated. The “bond market vigilantes” are nowhere in sight these days. They were trampled by the stampede of yield-hungry and risk-averse investors bidding up safe-haven bonds.

Indebted governments typically make structural reforms only when three elements are in place:
1) Financial market pressure
2) A change of government
3) A clear mandate for policy change

At least two are missing in the United States: The government’s borrowing costs are at record lows and the electorate is split on the nation’s future course.

Most of the developed world is drowning in debt and is facing similar choices. Emerging markets, by contrast, are in much better shape after a grueling adjustment following the 1980s debt crisis. See the chart below. This is one reason we believe emerging markets assets will outperform those of the developed world.

Change of the (Debt) Guard
Debt-to-GDP in Developed and Emerging Markets, 1900–2011

[Chart showing debt-to-GDP ratio for Developed and Emerging Markets from 1900 to 2011, highlighting key events such as WWI, WWII, Great Depression, 1980s Debt Crisis, and 2008-2009 Financial Crisis.]

Source: Reinhart and Rogoff.
Notes: Debt-to-GDP ratios are based on gross debt loads.
Don’t Raise My Taxes

Many voters still believe closing the budget gap is a matter of cutting waste—and not a long, painful road of tax hikes and cuts in entitlements such as Social Security, Medicare and Medicaid. As a result, most politicians have steered clear of an adult conversation about debt. We can only hope they move beyond demagoguery as the fiscal cliff nears—if only to maintain credibility.

A budget deficit typically is expressed as a percentage of GDP. As a result, it does not appear scary to the uninitiated. It starts to look different when you liken it to a family trying to make ends meet. The federal household budget in 2011 looked like this:

In other words, the US government spent about 56% more than it took in last year. This is akin to a household earning $100,000 a year but spending $156,000. Few families would get away with such a lifestyle.

Even a government that can borrow as much as it wants at negative real rates will eventually run into a brick wall. The US government is at risk of doing just that, we believe. Some things will have to give, both on the revenue and spending sides of the equation.

Let us start with taxes. The US tax take totaled 24.8% of GDP in 2010, the third-lowest rate among the 34 countries of the Organization for Economic Co-operation and Development (OECD). Only Mexico and Chile had lower rates, according to a 2011 OECD analysis.

Raising revenues is easier said than done. Nobody wants to pay more taxes. The most contentious issue between the parties is about taxing the rich (and defining this group)—a bone of contention that will likely prevent a budget deal in the lame-duck session.

This is not just an ideological fight—it is also a practical one. About 46% of US households did not pay any federal income taxes in 2011, according to the watchdog group Tax Policy Center. (Many of these households did, however, pay federal payroll and excise taxes as well as state and local taxes.) By contrast, the top fifth of US households by income paid more than two-thirds of all taxes in 2009, according to a 2012 CBO analysis. See the chart below.
The top 1% of households earned 18.7% of the nation’s income in 2007, a post-WWII high. Their average pre-tax income peaked at $1.9 million that year—80 times the average of the bottom quintile of households. This growing inequality has struck a nerve, even in a country where many people aspire to become wealthy.

Add in billionaire Warren Buffett’s observation that he should not pay less in taxes than his secretary (as a percentage of his income), and you have powerful momentum for increased taxation of the rich. (After Buffett’s comments, the “Buffett Rule” was born and quickly made its way into proposed legislation called the “Paying a Fair Share Act of 2012.”)

Then there is the tax code itself. First, it is complicated. The code had 72,536 pages in 2011, according to tax information service CCH. That was up 150-fold from 504 pages in 1939 and almost triple the number in 1984.

Second, there are 173 different tax credits and deductions in the code. These “cost” the government around $1 trillion in lost revenue each year, according to the US Treasury. Over the next five years, tax credits and deductions will have a value of $6.6 trillion, according to the Office of Management and Budget. See the table below.

Last, the tax code changes all the time. At the end of 2011, the code had more than 100 temporary provisions set to expire within two years, according to the Congressional Joint Committee on Taxation. This causes uncertainty and political horse trading, and results in businesses delaying or shelving investments.

Most people want to cut taxes, simplify the tax code and close loopholes ... for other people. Every tax exemption or credit has a group of passionate supporters. This makes much-needed tax reform unlikely in the near future, we believe.

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**LAND OF DEDUCTIONS**

Projected Value of Tax Deductions and Credits, 2013–2017

<table>
<thead>
<tr>
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</thead>
<tbody>
<tr>
<td>For the year Jan. 1-Dec. 2013 or other tax year beginning</td>
<td>2013, ending</td>
</tr>
<tr>
<td>Your first name and initial</td>
<td>Last name</td>
</tr>
<tr>
<td>If a joint return, spouse’s first name and initial</td>
<td>Last name</td>
</tr>
<tr>
<td>Home address (number and street). If you have a P.O. box, see instructions.</td>
<td></td>
</tr>
</tbody>
</table>

**Deductions**

1. Employer contributions for medical insurance and care
2. Mortgage interest on owner-occupied homes
3. Contributions to 401(k)-type pension plans
4. Accelerated depreciation of machinery and equipment
5. Net imputed rental income
6. Capital gains (except agriculture, timber, iron ore and coal)
7. Interest on municipal bonds
8. Pension contributions and earnings for employer plans
9. State and local taxes other than on owner-occupied homes
10. Charitable contributions other than education and health
11. Deferral of income from controlled foreign corporations
12. Capital gains at death
13. Capital gains on home sales
14. Social Security benefits for retired workers
15. Interest on life insurance savings
16. Other
17. Combine the amounts for lines 1 to 16. This is the total of your deductions and credits.

Sources: Morgan Stanley (Sept. 4, 2012) and Office of Management and Budget estimates of February 2012. Note: Interest on municipal bonds includes state and local bonds as well as hospital and other tax-exempt bonds.
Don’t Cut My Benefits

So-called mandatory spending programs—spending mandated by federal law—accounted for 88% of the government’s revenues in 2011. These programs—which can only be changed by an act of Congress—include Social Security, Medicare and Medicaid. Spending on healthcare in particular has ballooned.

This leaves so-called discretionary spending—which is negotiated each year between the executive branch and Congress. The biggest posts are defense (30% of revenues in 2011) and other discretionary spending (28%). Interest on the debt ate up 10%—thank record-low interest rates for this relatively low share. See the chart below.

There are many tough choices to be made. Chief among them: reform of the two largest entitlement programs, Social Security and Medicare. Together, they accounted for 36% of federal spending in 2011. This is a huge chunk—and one that is only set to grow.

The burden of financing these programs mounts as the population grows older. This increases both the number of recipients and the years of benefit collection. Plus, the number of workers funding the system is decreasing. Spending on both programs is expected to hit 12% of GDP by 2040, according to the 2012 annual reports of the Social Security and Medicare Boards of Trustees. See the chart above.

Medicare and Social Security’s dedicated revenues (payroll taxes) already fall short to pay for benefits. The government picks up the shortfall, increasing pressure on the budget. Financing could more than double to 4.8% of GDP by 2040, according to the Trustees’ reports. See the chart below.
Magnificent Munis

Cassandras are once again prophesizing about municipal bond markets. Their dire pronouncements in 2010 centered on a tidal wave of municipal bankruptcies that would kill the market. Investors took fright and pulled money from muni funds in 2011—and missed out on bumper gains.

The big prophecy this year? An election tragedy. An Obama re-election would damage the market because of his plans to limit the tax exemption of municipal bond interest. A Romney victory could be even worse because Republicans would hurt all tax-exempt instruments by cutting dividend and capital gains taxes. Couple this with a steady drumbeat of high-profile municipal bankruptcies, and the scene is set for a tragic muni play.

The pundits have it wrong once again, we believe.

First, the likelihood of real tax reform is low. It would be tough for Obama to follow through on his plan to limit the muni tax exemption at a time when state financing needs all the help it can get. Republicans are more likely to focus on restructuring Medicaid, rather than tackling the tougher issues of tax reform.

Second, the muni market has grown up. Investors increasingly understand not all munis are created equal. The market was an endless, low-maintenance forest of AAA bonds five years ago—sustained by bond insurance companies that guaranteed more than half of the market.

These days, just a trickle of new issuance comes to market with insurance. The muni forest has been re-appraised with AAA-rated bonds becoming as rare as California redwoods.

This new realism has reduced systemic risk, or the snowball effect of any single bankruptcy. At the same time, muni credit ratings still compare favorably with those in the investment-grade corporate bond market.

Given all this, muni bonds will likely retain their sheen for the same reasons they became popular in the first place:

- A shrinking market and strong investor demand
- Tax-exempt income at relatively low risk

MUNIS SHRINK

The first point is a technical—but very powerful—factor. We expect the municipal market to shrink by about $25 billion a year through 2015.

- Issuers are taking advantage of record-low rates and strong investor demand to refinance, effectively downsizing the market.
- Cash-strapped states and cities are not initiating grand new infrastructure works—if only because of the likely backlash from tax-paying voters and skeptical investors.

At the same time, the average maturity has shrunk to about 15 years, from 21 years in 2007. This also reflects the refinancing wave, which favors 10-year general obligation bonds over longer-term project finance. See the chart at the top of the next page.

The trend toward shorter maturities runs counter to strong investor appetite for long-term and high yield municipal funds. These funds have attracted almost 80% of investor money so far this year, according to fund tracker Lipper. This marks a sharp reversal from previous years when short and intermediate funds received the lion’s share of muni inflows.
TAXING CALCULATIONS

Munis’ tax exemption is the other big draw—and it may get bigger yet under most fiscal cliff scenarios.

At the current top 35% income tax rate, a 4% municipal bond yields the taxable equivalent of a 6.15% coupon. Two new taxes could hit high-income earners in 2013: a 4.6% increase in the top marginal rate and a new 3.8% tax for the Affordable Care Act. Muni income is exempted from both. This leads to the simple equation:

Investors would have to find a comparable corporate bond yielding 7.1% to get the after-tax yield of a 4% muni. Sure, it can be done—in (riskier) high yield land.

Yields on AAA-rated 10-year munis have imploded in the past five years, from 4.5% in 2007 to less than 2% now. Their safety cushion has shrunk, meaning it would take just a slight yield rise to trigger a bond price decline that would wipe out an entire year’s worth of interest.

Munis, however, tend to outperform other bonds when yields rise. They also are currently yielding slightly more than Treasuries above their five-year average.

The magnificent muni story comes with two caveats:

- **Seasonal Whammy**
  The fall usually brings an uptick in new issuance, pressuring long bonds. Coupled with strong market performance so far this year, it may be prudent to reduce risk by rebalancing toward shorter-term bonds. We preferred long-term bonds for much of the year, but recently moved to a neutral stance. We like to buy new issues because of their discounts to bonds traded in the secondary market.

- **Recession Blues**
  If the cliff actually happens, the resulting recession would hit the market hard. Overall credit risks would increase. Defaults would make scary headlines. Even selected spending cuts could hurt, with defense cutbacks hitting states such as Hawaii and Virginia particularly hard. Reduced federal Medicaid spending would increase pressure on state health budgets.

Any market weakness late in the year would present a buying opportunity, we believe. And if the nation looks to go off the cliff, munis would likely be hot commodities as safe havens.
Dividend Shields

Uncertain times mean defensive ... dividend stocks. Yes, the very stocks that are supposed to get hammered because of the fiscal cliff. The dire dividend story goes like this: The dividend tax hike would upend a sector that has thrived as an income play in a zero-rate world. Investors would sell dividend stocks to pocket capital gains at the current low rates. The stocks would fall hard because they have risen fast.

We do not think this story holds up. Even if we go off the cliff, the resulting recession, ultra-low bond yields and plunge in risk assets would keep the sector attractive as a source of income:

- The tax hike—if it happens—is likely to jack up rates to a maximum of 20% to 25%, we expect. This would bring dividend taxes in line with capital gains taxes. As a result, the tax treatment of dividends would still be attractive to those in the highest income tax brackets.
- Companies typically make shareholders whole by raising payout ratios in response to higher taxes, according to Goldman Sachs. Payout ratios are at lows, leaving room for increases. See the chart on the right.
- Executive compensation is starting to tilt toward restricted stock rather than options. This is helping dividend payers as top corporate executives start to appreciate the income stream in their own portfolios.

Investors are desperate for income. They are pressuring companies to increase payouts, and CEOs are responding.

The exception would be utilities stocks: This is the sector that gained the most in the wake of the tax cut—and now has the most to lose.

The key is to focus on companies with strong balance sheets, exposure to fast-growing emerging markets and a track record of dividend growth. Also consider international and “new” dividend plays such as cash-rich technology stocks.

MAKING YOU WHOLE

Dividend Payout Ratios, 1960-2011

<table>
<thead>
<tr>
<th>Year</th>
<th>Tax-Adjusted Payout Ratio</th>
</tr>
</thead>
<tbody>
<tr>
<td>1960</td>
<td>27%</td>
</tr>
<tr>
<td>2011</td>
<td>23%</td>
</tr>
</tbody>
</table>

Source: Goldman Sachs.
Notes: The tax-adjusted payout ratio is calculated by subtracting tax on dividend income for households in the top tax bracket. Year-end data through 2011.

FOR MORE INFORMATION: www.blackrock.com

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