

MAPPING SOVEREIGN RISK
BSRI QUARTERLY UPDATE
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Mapping Sovereign Risk



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Our latest quarterly update of the BlackRock Sovereign Risk Index (BSRI) highlights Japan, the United States and selected movers among the 48 countries we track. A newly created *interactive BSRI* allows for viewing individual country scores, comparing two countries and sorting overall rankings by index components.

Highlights for the quarter ended December 31:

- ▶ **Japan** fell two spots in the rankings as a result of its sharply deteriorating fiscal balance—a space worth monitoring in 2013 as a new government and central bank governor settle in.
- ▶ The **United States** remained at 15th place even as it teetered on the edge of the “fiscal cliff” of automatic tax hikes and spending cuts.
- ▶ **China, Australia** and **New Zealand** moved up in the rankings, with Australia jumping three spots thanks to an improved primary budget balance.
- ▶ **India’s** profile improved on most fronts, but the country remained stuck at 39th place. **South Africa** dropped two notches to 36th place.

Drawing on a pool of financial data, surveys and political insights, the BSRI provides investors with a framework for tracking sovereign credit risk. The index uses more than 30 quantitative measures, complemented by qualitative insights from third-party sources.

The index breaks down the data into four main categories that each count toward a country’s final BSRI score and ranking: Fiscal Space (40%), Willingness to Pay (30%), External Finance Position (20%) and Financial Sector Health (10%).

- Fiscal Space includes metrics such as debt to GDP, the debt’s term structure, tax revenues and dependency ratios.
- Willingness to Pay measures a government’s perceived effectiveness and stability, and factors such as perceived corruption.
- External Finance Position includes exposure to foreign currency debt and the state of the current account balance.
- Financial Sector Health gauges the banking system’s strength.

For full descriptions, see *Introducing the BlackRock Sovereign Risk Index* of June 2011. The BSRI’s inputs are updated at irregular intervals, meaning some ratings changes may only reflect the timing of data releases. Small changes in ratings can spur big changes in rankings, as many issuers are bunched together in the index. The BSRI is not meant to forecast the creditworthiness of countries.

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

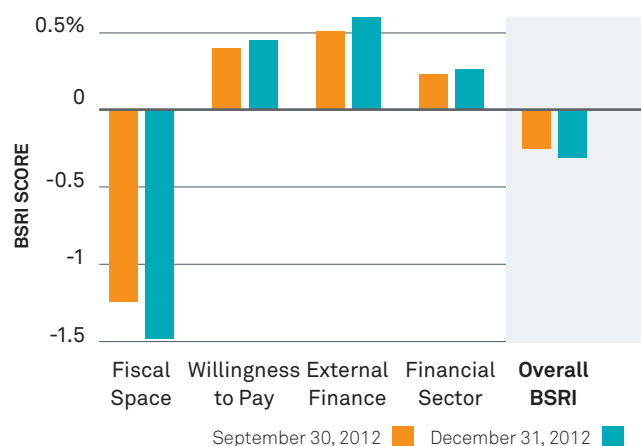
JAPAN: FROM BAD TO WORSE

The fiscal profile of Japan worsened enough to cause it to slip two spots to 35th place, even as its other BSRI components improved. Japan now ranks just ahead of South Africa but below the likes of Turkey, Indonesia and Slovakia. See the chart on the right.

Japan slipped into recession in the fourth calendar quarter, according to the most recent BlackRock Economic Cycle Survey. See the chart at the top of the next page. This happened as the country's overall debt rose and its primary balance to Gross Domestic Product (GDP) went downhill.

Japan's public debt burden—the highest in the developed world in relation to GDP—keeps growing. The market is expecting more fiscal stimulus from the incoming government and looser monetary policy from a new central bank chief to be appointed in April.

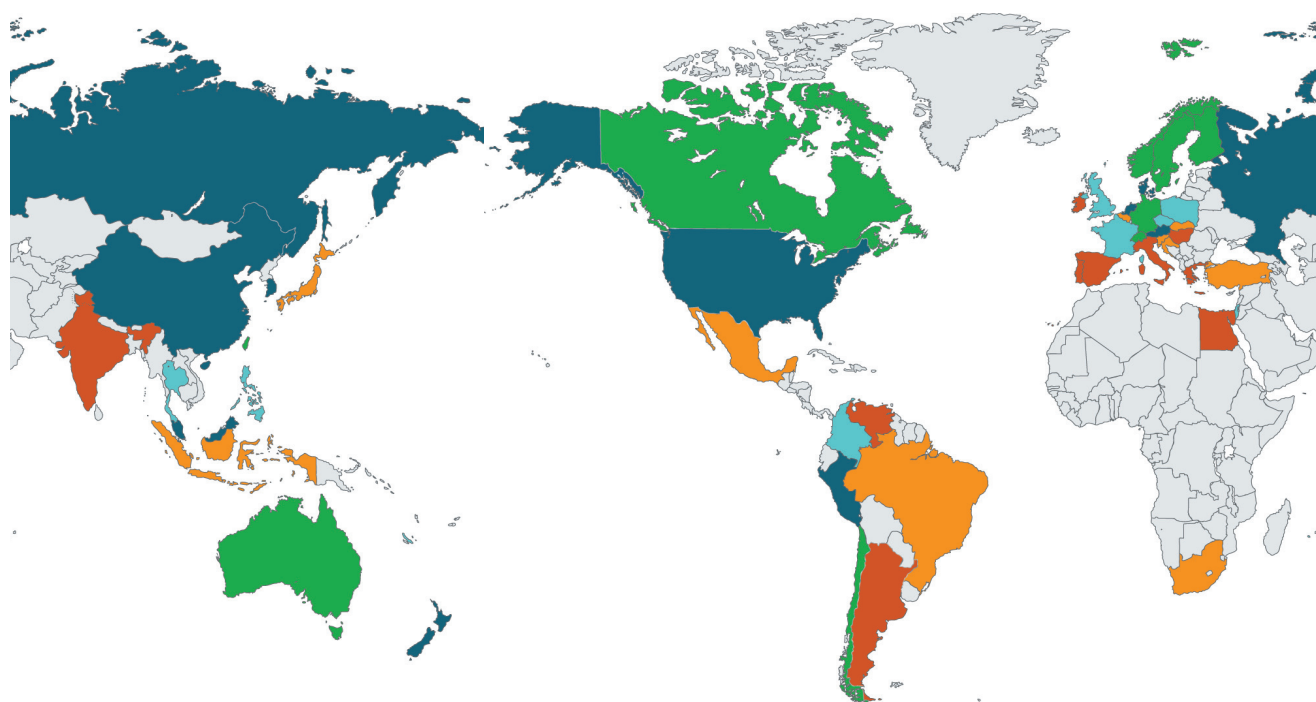
JAPAN: LAND OF THE RISING DEBT



Source: BlackRock.

A WORLD OF SOVEREIGN RISK

BSRI Country Rankings by Quintile, December 2012



1 Norway	11 New Zealand	21 Israel	29 Brazil	39 India
2 Singapore	12 South Korea	22 Czech Republic	30 Belgium	40 Spain
3 Switzerland	13 Denmark	23 United Kingdom	31 Mexico	41 Hungary
4 Sweden	14 Netherlands	24 Thailand	32 Slovakia	42 Argentina
5 Finland	15 USA	25 Philippines	33 Indonesia	43 Ireland
6 Canada	16 China	26 Poland	34 Turkey	44 Italy
7 Australia	17 Austria	27 France	35 Japan	45 Venezuela
8 Taiwan	18 Malaysia	28 Colombia	36 South Africa	46 Egypt
9 Germany	19 Peru		37 Croatia	47 Portugal
10 Chile	20 Russia		38 Slovenia	48 Greece
Top ten	11-20	21-28	29-38	Bottom ten

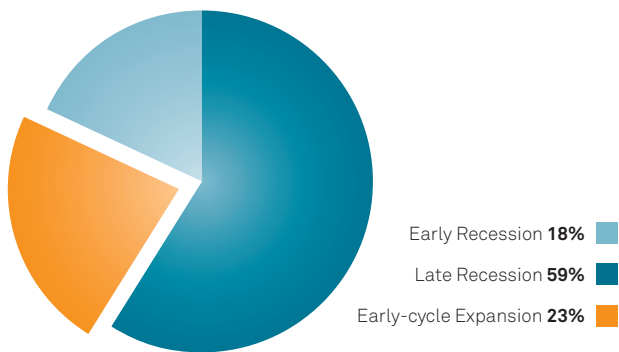
Click for
interactive charts



Source: BlackRock.

DOOM AND GLOOM

Economists' Assessment of Japan's Economy, December 2012



Source: BlackRock.

On the surface, all this would appear to increase Japan's debt load. The country's 12-month forward budget deficit shows little signs of improving, despite being slightly off lows seen from May 2011 until the middle of 2012. See the chart below.

On the other hand, Prime Minister Shinzo Abe may succeed in weakening the country's currency and inflating away the debt in the long run.

A weaker yen should benefit Japanese equities—which still appear cheap compared with other markets and their own history. A contrarian pick for 2013 is buying Japanese exporters while selling the yen currency, as detailed in our *Slow Turn Ahead? 2013 Investment Outlook* of December 2012.

DIGGING A DEEP HOLE

Japan's Expected Budget Deficits, 2008-2013



Sources: Consensus Economics and Bloomberg.
Note: Budget deficits are 12-month forecasts by economists.

UNITED STATES: STEADY SHE GOES

Political dysfunction was on display in Washington during the feverish negotiations to avoid the fiscal cliff over the New Year holiday.

The last-minute deal was better than nothing, we think, but its limited scope means more tortured budget talks—and market volatility—ahead. For details, see BlackRock's *US Fiscal Cliff Deal: A Stopgap, not a Solution* of January 2013 and our post-US election analysis *Now for the Hard Part* of November 2012.

The effectiveness—or impotence—of government lies at the heart of our Willingness to Pay score. It is important to realize, however, this metric and others do not turn on a dime.

LOTS OF DRAMA ... WITH LITTLE IMPACT

US Willingness to Pay Score, 2011-2012



Debt Ceiling Crisis US Election Campaign Fiscal Cliff Talks
Source: BlackRock.

Willingness to Pay also measures perception of government's stability, the rule of law and other factors that foster a favorable investment climate.

For all the political drama during the debt ceiling crisis in 2011, the 2012 presidential election campaign and the recent fiscal cliff negotiations, the US score in this area has held steady since the summer of 2011.

To be sure, the periods of political uncertainty have had a (temporary) impact. See the chart above. The issue at the heart of the budget arguments—US Fiscal Space—has not budged by our measures, however.

The United States still ranks 11th in Willingness to Pay, ahead of Australia and the UK. Overall, the country remains in 15th place, between the Netherlands and China.

MOVING UP: CHINA, AUSTRALIA AND NEW ZEALAND

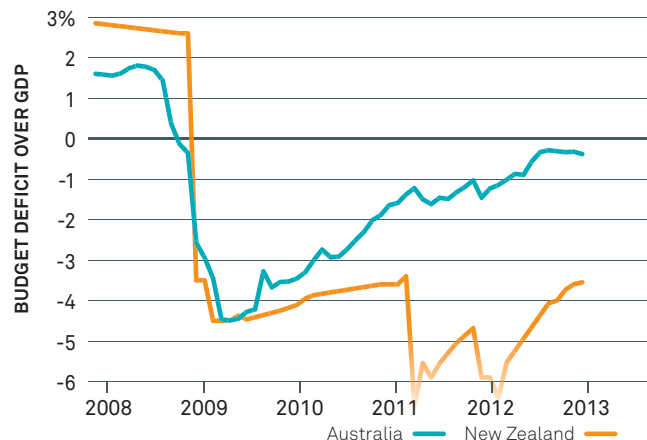
China rose two spots to 16th place on the back of higher government revenues as a percentage of GDP. China's Willingness to Pay score improved due to the relatively smooth once-a-decade leadership change, as detailed in *The Next Generation: What to Expect from China's New Leadership* by BlackRock's Asia team in November 2012.

When China sneezes, its raw materials supplier Australia catches a cold, investors say these days. In BSRI terms, however, the lucky country appears to be taking its flu shots. It has remained largely immune to China's slowdown in economic growth last year. Its steady march up accelerated this quarter when it jumped three notches to seventh place, mainly thanks to an improved primary balance.

Increases in government receipts have more than offset an uptick in spending, and the country is expecting a surplus this fiscal year, according to the *Australian Government Budget 2012-2013*. Both Australia and New Zealand are showing improving primary balances. See the chart on the right.

DOWN UNDER BUDGETING

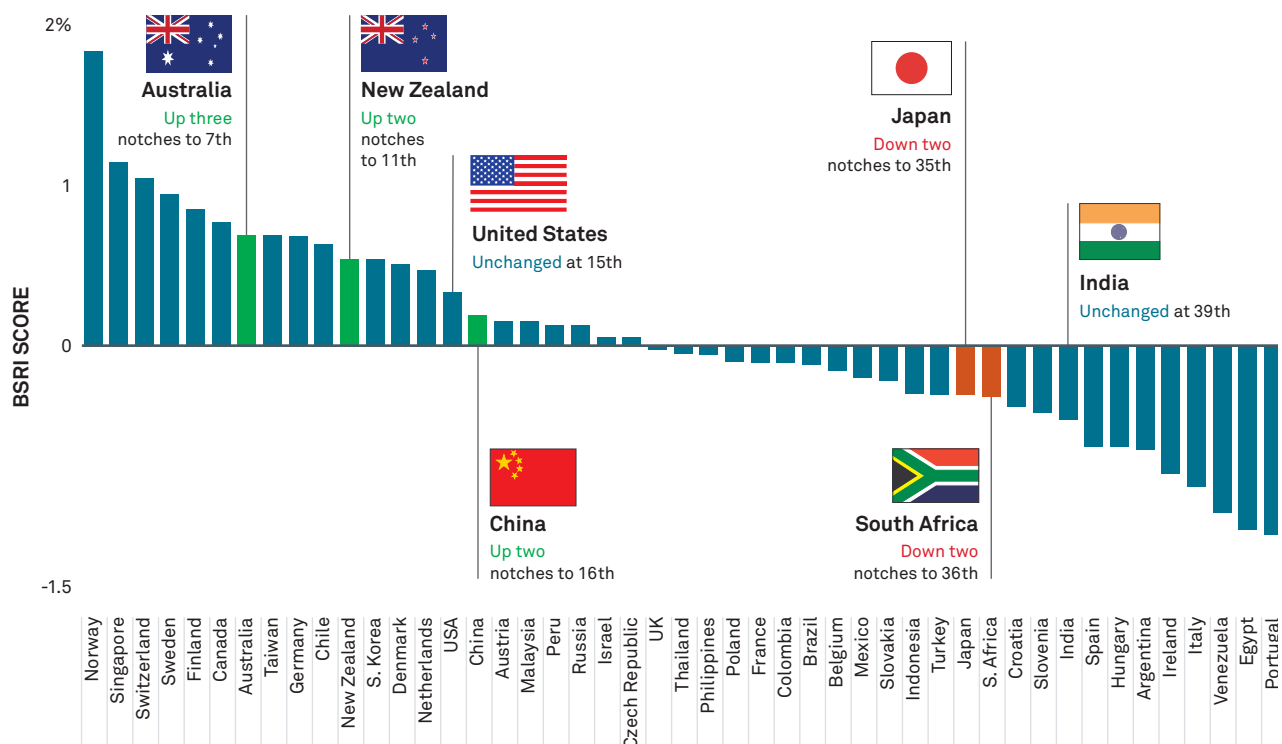
Expected Budget Deficits, 2008-2013



New Zealand also moved up in the BSRI rankings and now occupies the 11th spot. The country's Willingness to Pay score is the highest in the BSRI and its fiscal position is improving. New Zealand's financial sector health improved due to bank downgrades in other countries.

WHO'S UP AND WHO'S DOWN

BlackRock Sovereign Risk Index Rankings, December 2012



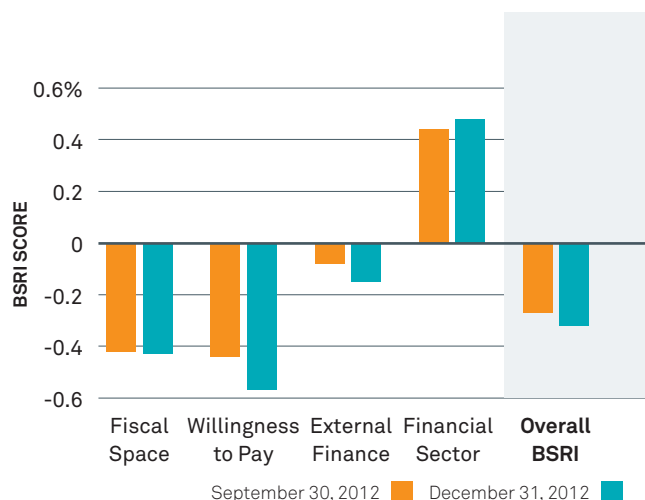
Sources: BlackRock, Bloomberg, IMF, World Bank, central banks, Eurostat, BIS, Consensus Economics, UN, Moody's, Standard and Poor's, Fitch, PRS Group and www.euromoneycountryrisk.com.

Note: Ranking changes based on movement from October 8 to December 31, 2012.

IN AND (NEARLY) OUT OF SICK BAY: SOUTH AFRICA AND INDIA

South Africa slid two spots to 36th place mainly due to a rapidly worsening current account deficit. Anecdotal evidence has money fleeing the country at a rapid pace, and the BSRI appears to reflect this. South Africa's external debt position declined while political unrest and widespread strikes helped pull down its Willingness to Pay score. See the chart below.

SOUTH AFRICA: SLIP SLIDIN' AWAY

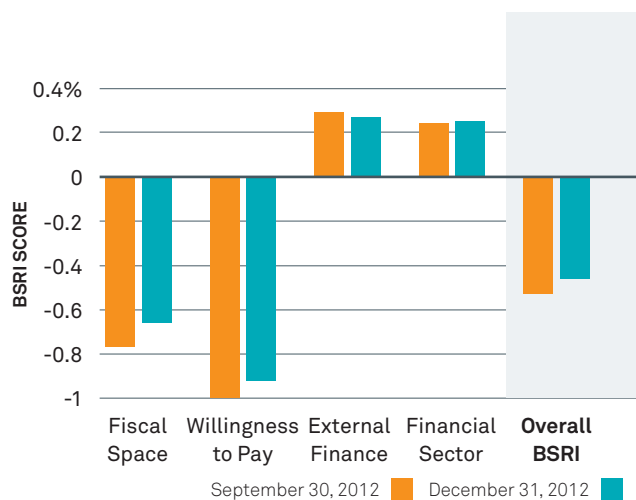


Source: BlackRock.

India, on the other hand, looks to be on the mend. We highlighted its deteriorating fiscal profile six months ago—a dynamic that had been in place since the fourth quarter of 2011. The trend reversed over the past quarter, although it (again) did not result in a ranking change.

India's Fiscal Space improved on a lower debt-to-GDP level and an improving primary balance. The country's Willingness to Pay score improved as well, thanks to recent reforms on foreign investment. See the chart below.

INDIA: THE ELEPHANT GETS BETTER



Source: BlackRock.

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