

**STANDING STILL... BUT STILL STANDING**

UPDATE OF OUR 2012 OUTLOOK

JULY 2012

**BLACKROCK®**

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## BLACKROCK'S MID-YEAR OUTLOOK FORUM

About 50 BlackRock portfolio managers recently discussed the investment landscape for the second half of this year at an event organised by the BlackRock Investment Institute. Our mission was to assign new probabilities to our 2012 investment scenarios and identify signposts for adjusting portfolios. To prevent the eurozone crisis from overshadowing the forum, we offered a vintage €5 note issued by the Bank of Greece to the first participant who did not mention Europe. It took a while, but we did have a winner.

## 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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# First words

The second half of 2012 looks to be dominated by three factors: policy, policy and policy. European policymakers are working to end a three-year debt drama while trying to resuscitate growth. The US faces a weakening economy and a “fiscal cliff” of tax increases and spending cuts on 1 January. Japan is fighting a strong currency and ballooning trade deficits.

China is trying to move toward a consumption-driven economy while keeping up growth. Brazil is easing monetary policy to re-ignite growth while erecting trade barriers. India is caught in a downward spiral of political paralysis and big deficits. Global corporate earnings momentum appears to be weakening.

The big question is whether policymakers can tame Nemesis, the vengeful Greek goddess after whom we named our global recession scenario. If they are successful in addressing fiscal imbalances and spurring growth, we would put Nemesis back where she belongs: in the Greek mythology books. If not, scary myths could become reality.

On the plus side, we believe the world is about to get a major boost from lower energy and commodity prices. Against this backdrop, we revisited the five investment scenarios we detailed in “2012: The Year of Living Divergently” in January 2012.

## SO WHAT DO I DO WITH MY MONEY?™

- ▶ **Defend and counterattack:** Create a defensive portfolio with a focus on income. Use inexpensive options on emerging market currencies, commodities and equity indices to capitalise on risk-on/risk-off gyrations.
- ▶ **Super-short and ultra-long:** Focus both on near-term opportunities and themes that will play out over five years. Avoid a three- to six-month investment; policy uncertainty makes this dangerous ground.
- ▶ **Microscope in a macro-obsessed world:** Emphasise individual company opportunities and relative value trades. Examples are bonds of selected UK financials or buying Italian bonds and selling Spanish debt.
- ▶ **Inflate and deflate:** Use asset-based strategies in emerging markets where policy easing may result in inflation. Harvest scarce cash flows by focusing on income in deflation-prone developed markets.

### Equities

- ▶ We prefer direct emerging market exposure over buying multinationals based on relative valuations.
- ▶ Discounted European stocks could outperform US peers if the market’s focus shifts to Washington’s wobbly finances and political dysfunction.
- ▶ Companies with strong cash flows and a track record of increasing dividends are good bets. Deflation favours the strong and penalises the weak.

### Fixed income

- ▶ We prefer credit and emerging markets debt over sovereign bonds of the Western world and Japan.
- ▶ High-yield bonds and mortgage securities look attractive due to limited supply & their safety cushion.

### Natural resources

- ▶ Oil and copper are well supported in the long term because of looming supply gaps.
- ▶ We prefer natural resources equities over physical materials based on relative valuations.
- ▶ Grains and agricultural equipment are underpinned by emerging markets demand.

### Alternatives

- ▶ Foreclosed single family homes and prime development land offer upside in the US.
- ▶ Developers and operators of wind and solar farms look attractive, whereas the ultra-competitive businesses of manufacturing solar panels and wind turbines do not.
- ▶ Private equity funds with a focus on energy and hedge funds with relative value strategies offer opportunities.

### Contrarian ideas



- ▶ Sell Japanese government bonds in anticipation of monetary easing.
- ▶ Sell expensive put options that protect against Nemesis.

*For detailed investment opportunities, see pages 13–16.*

# Summary

- ▶ **Stagnation ahoy and divergence light:** Slowing growth across the world, the eurozone's ongoing debt struggle and market scepticism over policymakers' responses have led us to increase the odds of our Stagnation scenario. This is dominated by anaemic economic growth in the developed world and bouts of risk-on/risk-off market gyrations when assets move in lockstep. We have downgraded the probability of our main 2012 scenario, Divergence, to a likelihood of 35%-40% (from 40%-50%). However, we still believe the US economy will outperform Europe's, and that emerging markets will keep up growth by cutting interest rates and injecting fiscal boosters.
- ▶ **Dual citizenship for nemesis:** We see the likelihood of our Nemesis scenario at 15%-20% – still much higher than we would like. Policymakers so far have averted another global credit crunch, and the prospect of a disorderly eurozone breakup appears to be fading. That said, Nemesis may gain dual citizenship in the second half: Failure to resolve the US fiscal cliff could send her on a transatlantic journey. Our remaining scenarios are as far-fetched as ever. A resumption of self-sustained global growth is wishful thinking. Inflation is receding in most countries. In fact, investors should worry more about deflation.
- ▶ **Policy first:** Policymakers around the world face big challenges – and in many cases appear unable or unwilling to make the right calls. The developed world has largely exhausted monetary tools to jumpstart growth, given negative real interest rates and bulging central bank balance sheets. Fiscal policy and reform also appear far off as politicians have yet to put together sustainable budgets. We do not expect a sudden outbreak of statesmanship in Europe or the US. Emerging economies including China are in much better shape, with India a notable exception.
- ▶ **Getting out of debt:** A global trend of deleveraging has put downward pressure on markets. Banks are going to shed more assets, households are cutting debt and governments are reining in spending. Companies around the world are drowning in cash, but profit margins look to have peaked. When everybody saves and nobody spends, business activity and tax receipts dive, creating a vicious circle. Deleveraging has a profound deflationary effect. This means many asset-based strategies will only be rewarded from low (valuation) starting points.
- ▶ **Signposts for change:** The big signposts that would make us change tack are the eurozone's ability to fix its shaky banking system and outline a credible plan for closer fiscal union; the US showing renewed economic strength and an ability to resolve the fiscal cliff; and visible payoff of China's efforts to restart growth. A signpost for Nemesis is the risk that deposit withdrawals in Europe's southern tier turn into a fully fledged bank run. As before, we like to see clear signposts before wading in. This is no time for hero trades.
- ▶ **Eurozone's to-do list:** The most immediate challenges are, in our view, to recapitalise the eurozone's banks (or at the very least stem the erosion of capital created by shrinking deposits) and to set up credible eurozone-wide oversight. The good news is policymakers are finally realising the banking system is the region's Achilles' heel, and appear willing to fix it. Other items on policymakers' to-do list include: A credible plan for a tighter fiscal union, the resolve to bring down Italy's debt refinancing costs, and structural reforms to spur growth. Germany is key in this: A weakening economy and political noise ahead of the 2013 elections could force Chancellor Angela Merkel to jump on the growth bandwagon manned by France, Italy and others. Sadly, there are no instant fixes.
- ▶ **US cliffhanger:** The US economic expansion looks to be losing steam. A crucial issue is how Washington will handle the upcoming expiration of tax benefits and budget cuts that could shave 4% off GDP. Past performance (political dysfunction) is no guarantee of future results, but we worry a lot about this. Fear of the fiscal cliff and uncertainty over taxation already are causing CEOs to put investment and hiring plans on ice. On the plus side, the crucial US housing market is showing signs of recovery at long last and falling energy prices are a potential booster.
- ▶ **Chinese puzzle:** China is facing the momentous task of shifting to a consumption economy without losing growth momentum – in a year that will see a once-a-decade leadership change. There are signs Beijing's recent easing and stimulus measures could have an effect, and receding inflation gives policymakers room for a lot more. Major emerging markets (except India) appear to have enough arrows in their quivers to re-ignite domestic growth – although many remain dependent on exports to the developed world.

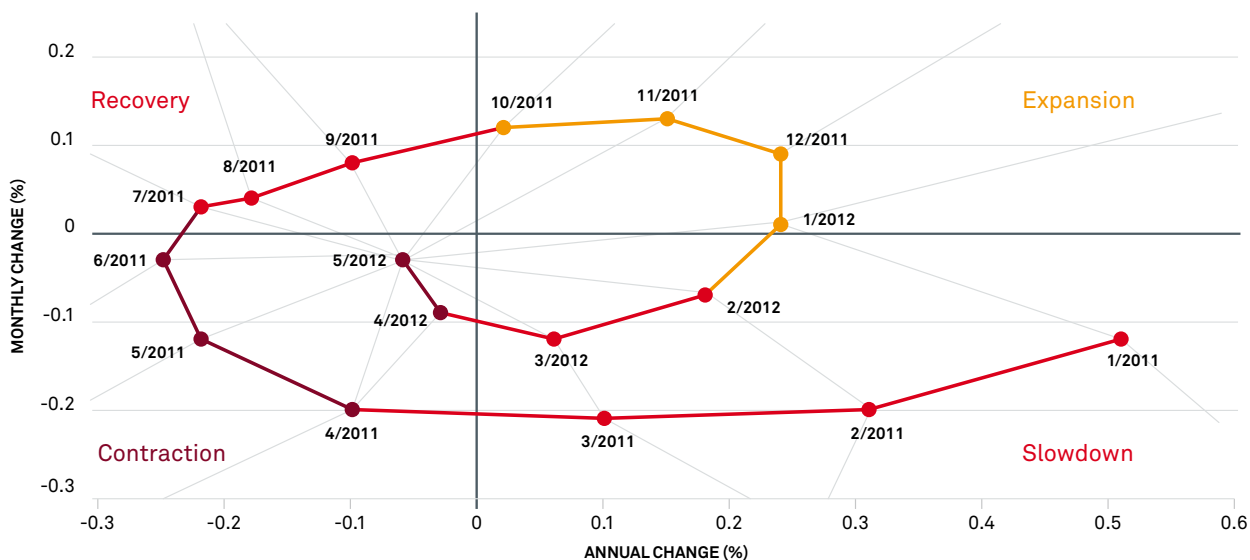
# Scenario scoring

Scenario	Description	Our view of the second half	Our year to date scorecard
<b>Stagnation</b> <b>40%–45%</b> (Previous 15%–25%) 	Sluggish global economic growth, with the US and emerging economies losing steam. A European recession and tight credit for those who need it. Risk-on/ risk-off market gyrations dominate trading.	Upgraded. Emerging markets have started to ease and have more room to go, but developed markets are running out of bullets. Global banks are shedding assets and governments in the developed world are tightening their belts. Business confidence and investment look to deteriorate and corporate profits appear to be peaking. These forces are delivering near-recessionary conditions.	Stagnation was shoved aside in the first quarter when the European Central Bank's (ECB) lifeline to banks ignited a risk rally and US economic momentum inspired confidence. It came roaring back in the second quarter, with assets once again moving in lockstep on worsening global economic data and ineffective policy moves to squash the European debt crisis.
<b>Divergence</b> <b>35%–40%</b> (Previous 40%–50%) 	Emerging economies outperform while the US and Japan muddle through. Europe recovers at snail's pace while China's economy regains momentum.	Downgraded. We worry about the weakening US economy and the looming fiscal cliff. Many emerging economies have slowed while China's efforts to re-accelerate growth have yet to pay off. We are hoping for much-needed recapitalisation of European banks, baby steps toward European bonds and credible growth plans. The ECB will likely remain a laggard in the global quantitative easing race because of its charter and angst over inflation.	Divergence worked like a charm in the first quarter, but economic clouds around the world pushed markets into Stagnation in the second quarter.
<b>Nemesis</b> <b>15%–20%</b> (Previous 20%–25%) 	Global recession, credit crunch, social upheaval and steep losses across asset classes. Named after the Greek goddess who punishes the proud.	Slightly downgraded – but still higher than we would like. A disorderly eurozone breakup appears less likely and China's economy looks to avert a “hard landing.” But the odds are rising Nemesis may appear across the Atlantic if political dysfunction in Washington plunges the nation off the fiscal cliff.	Nemesis briefly visited China, slapping down those who believed a command economy could morph into a consumption society without any hiccups. Europe avoided a looming credit crunch and eurozone breakup but remains vulnerable to a Nemesis event.
<b>Growth</b> <b>5%–10%</b> (Previous 0%–5%) 	The global economy weans itself off monetary stimulus and grows just above the long-term trend.	Slightly upgraded. Lower commodity prices and ebbing inflation in emerging economies are positives. Businesses and households have cash to invest.	“Dream on,” we said at the beginning of 2012. We are still dreaming.
<b>Inflation</b> <b>0%–5%</b> (Previous 5%–10%) 	High commodity prices and monetary easing drive up global inflation, effectively cutting the developed world's debt load.	Downgraded. Inflation is receding everywhere. If anything, the prospect of deflation is rising.	The market consensus was spot on. Sometimes the crowd is right.

# Moving at different speeds

## CAUGHT IN THE SPIDER WEB

Global leading indicators, 2011-2012



Source: Goldman Sachs.

Note: Based on Goldman Sachs Global Leading Indicators.

The global picture was not pretty at mid-year. The eurozone's economy was flatlining with even the continent's engine, Germany, showing signs of sputtering. US and Japanese economic momentum was weakening. China's stimulus and easing had yet to pay off. Brazil and India were on a downhill trajectory. The impact of lower energy and commodities prices had yet to be felt. See the chart above.

Against this gloomier economic backdrop, one trend keeps pushing down risk assets: deleveraging. Banks are shedding assets to beef up their balance sheets. Households are paying down debt. Governments are reining in spending to close gaping budget holes. This process is taking place at different speeds. For example, the US and Japanese governments have yet to start. See the table below.

## GET OUT OF DEBT

Pace of deleveraging globally

Pace of deleveraging				
	Not yet started	Early stages	Getting there	No pressure
Governments	US, Japan	Europe	UK	Emerging (exception: India)
Companies				All
Banks		Europe	UK	US, Emerging
Households		UK, Europe		US, Japan

Source: BlackRock.

On the other hand, policymakers in emerging markets have the manoeuvring room to actually increase spending and cut interest rates. The ability – and willingness – to use fiscal and monetary tools to restart growth varies greatly around the world. So does the likely effectiveness of these policy actions, with the developed world fast running out of ammunition. See the table to the right.

Another factor is how much of a country's debt is held by foreigners. Countries with a high level of foreign-held debt are more likely to be at the mercy of outside investors and susceptible to sudden capital outflows. See the chart below. In extreme cases, they are more likely to default as non-payment would not directly affect their core constituency, as we showed in "Introducing the BlackRock Sovereign Risk Index" in June 2011.

Policy will likely dominate investor sentiment in the second half of the year. Combined with weakening economic activity, this increases the odds of our Stagnation scenario taking root.

If this is right, expect volatile, short-lived rallies and declines on headlines about policy moves (or the absence thereof) and macro-economic data.

## A GLOBAL POLICY MIX

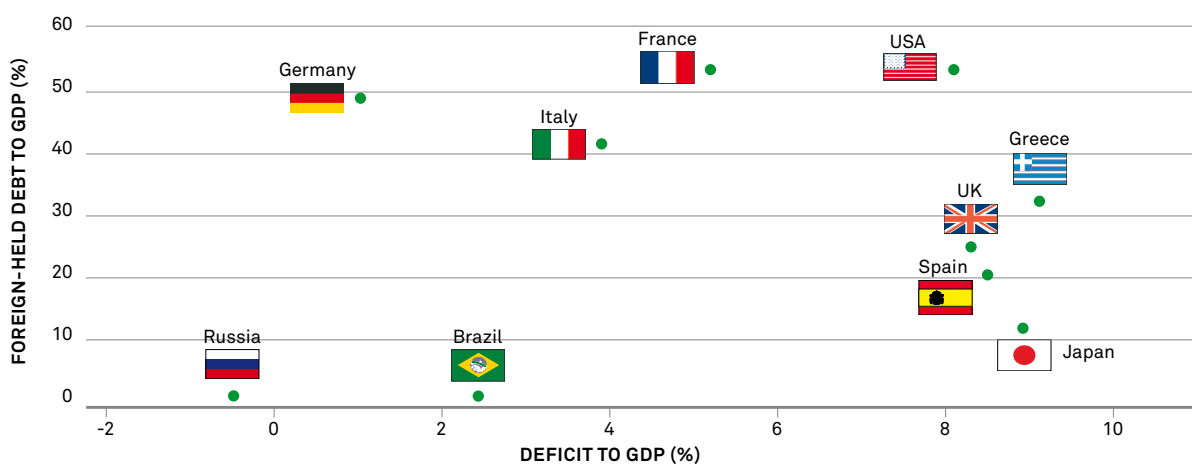
Ability and willingness to set effective economic policy

		Policy impact		
		Low	Medium	High
Willingness/Ability	High	UK monetary policy US monetary policy		China monetary policy Brazil monetary policy
	Medium	Japan monetary policy	Eurozone monetary policy China fiscal policy	Eurozone fiscal policy
	Low		India fiscal policy India monetary policy	Eurozone fiscal reform Japan fiscal policy US fiscal policy

Source: BlackRock.

## AT YOUR MERCY

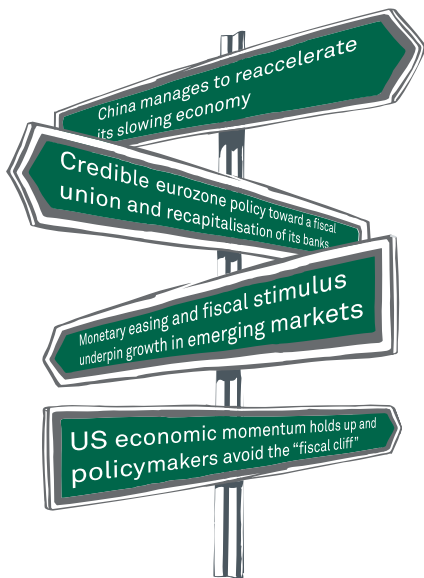
Deficits and foreign-held debt of major economies, May 2012



Source: Bloomberg, Morgan Stanley and Haver Analytics.

## SHOW ME THE WAY

Signposts for an improved investment landscape



We are always on the lookout for signposts that point to major shifts in the investment landscape, including events in the world's three major economies. See the illustration to the left.

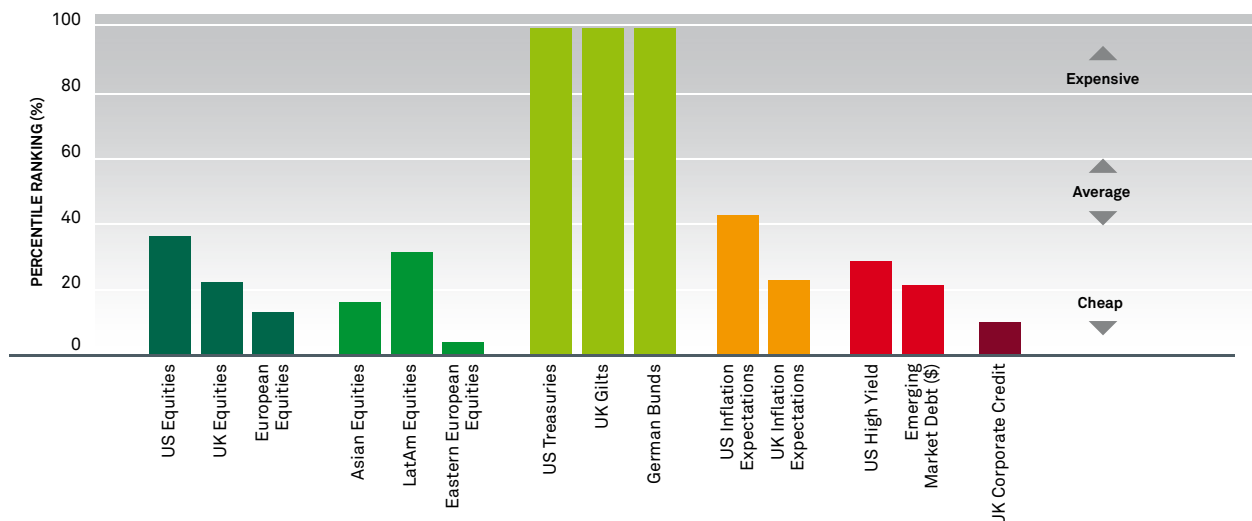
Depending on the outcome of these events, we could move into a new investment scenario. If things work out, Divergence again would take hold – emerging economies and assets would outperform those of the developed world and US assets would trade at a premium.

If events take a turn for the worse, Nemesis becomes a possibility. Risk assets would sell off and safe-haven bonds would become dearer yet. We would suggest investors act only when the signposts are crystal clear.

Temptations abound: Valuations of many asset classes look compelling (or overpriced) compared with their historic levels. Markets appear to price in prolonged Stagnation – but not a return to growth or a full-blown global recession. See the chart below. This brings both opportunities and risks for investors.

## VALUE IS IN THE EYE OF THE BEHOLDER

Valuations of asset classes by percentile vs. historic norm, June 2012



Sources: BlackRock, Thomson Reuters and Bloomberg.

Notes: Time periods vary by asset class and range from 7 to 30 years. US Treasuries, UK Gilts and German Bunds represent the real yield. Equity valuations are the average of dividend yields, book values and price earnings ratios. Inflation expectations are 10-year inflation break-even rates or the difference between the yield on Treasuries/Gilts and TIPS/Linkers.



# Eurozone: crisis management

Europe's leaders have just concluded their 19<sup>th</sup> summit since the eurozone's debt crisis started in early 2010. The cast of characters has changed – pretty much every election produces a new leader as voters reject the incumbent's austerity diet of rising unemployment, tax hikes and pension givebacks. The problems have not changed, however, and permanent solutions still appear far off.

The latest summit achieved one important goal: allowing the European bailout funds to directly recapitalise weak banks in Spain – a move long opposed by Germany. This shows policymakers realise the banks are the eurozone's Achilles heel. The move to promote the ECB to become a pan-European bank regulator (and, by deduction, an active lender of last resort) faces political challenges, but also has the potential to stabilise fragile sentiment. The devil will be in the details – which are still sketchy. European policymakers are good at making pronouncements, but so far have proved less adept at implementation.

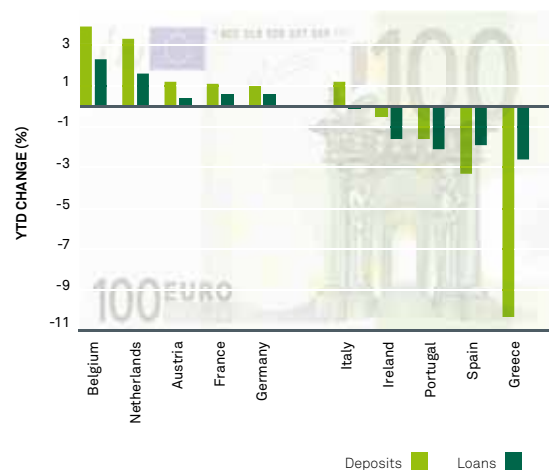
The eurozone is hobbled by the lack of central decision making: It is much tougher having 17 people agree on a decisive course of action than having one leader set a course. Recent history shows European policymakers act only when they are with their backs against the wall, as we discussed in "Europe on a Tightrope" in May 2012. This is unlikely to change.

We are carefully watching deposit outflows from Europe's southern-tier countries. Some of these outflows accelerated this year, and run the risk of turning into a full-fledged bank run. See the chart on the right. Policymakers are keeping a close eye on this, but it is tough to stop a panic once it has started.

In the meantime, the eurozone's economy looks troubled, with momentum slowing even in core countries such as France and Germany. Austerity alone will not solve this crisis and runs the risk of deepening it. The European pro-growth crowd is getting more boisterous, helped by the election of French President François Hollande. Merkel, the eurozone's pay- and taskmaster, is increasingly isolated. We are carefully watching for any signs of German economic weakness. This could cause Merkel to change course ahead of Germany's elections next year.

## SIGNS OF DOOM?

Private deposit and loan flows in the eurozone, 2012



Sources: Morgan Stanley and ECB.

Notes: Deposit and loan flows of households and non-financial entities. Year-to-date data to May 2012. Loans data adjusted for sales and securitisations. Spanish deposit outflows include outflows into local retail bonds. Data adjusted for foreign currency fluctuations.

The other factor is the ECB. Unlike its US and UK peers, it has been wary of outright asset purchases and is reluctant to overstep its mandate of containing inflation. It is quick to relieve stresses on the banking system, but otherwise prefers sitting on the sidelines to force indebted nations to balance their books and liberalise their economies. When a credit crunch was looming in late 2011, the ECB blanketed the region's banks with easy cash through two long-term refinancing operations (LTRO). This elixir helped fuel a global risk rally in the first quarter of 2012 but now has pretty much run its course.

The eurozone still has a tool box – or rather, a tool shed – of measures to stabilise jittery markets. The ECB has enough firepower to stop any credit crunch in its tracks and its printing presses could monetise the eurozone's debt load; the European Stability Mechanism (ESM) and European Financial Stability Facility (EFSF) are slowly moving from rescue funds on paper to reality; and the European Commission may finally get teeth. See the table on next page.

The recent Greek elections have reduced the prospects of an imminent and messy “Grexit,” a departure of the country from the eurozone. This has closed “Papandreou’s Box – a crisis scenario we named after former Greek Prime Minister George Papandreou, who hijacked a G-20 meeting in November 2011 by unexpectedly floating the idea of a Greek referendum on the euro. This infuriated eurozone leaders and raised the likelihood of a disorderly eurozone breakup.

Like Pandora’s Box, however, the resident evil is still lurking about.

Eurozone policymakers again and again have kicked the can down the road – but at least they have managed to keep it on the road. An optimist would also say investors will become desensitised to a daily menu of gloom-and-doom headlines and a monthly rhythm of disappointing eurozone summits.

## A EUROPEAN CRISIS TOOL SHED

### Possible European policy actions

Institution	Action	Pros and cons	Likelihood
European Central Bank	Inject more LTRO	Relieves temporary funding stresses but is not a solution. Strengthens the damaging links between weak banks and their weak governments, and delays a return to market funding.	<b>Likely.</b> Requires only an ECB governing council decision and could be done quickly.
	Relax rules for collateral	Reduces the likelihood of bank failures, but reinforces the bank-sovereign debt linkage.	
	Cut interest rates	Lowers cost of funding for banks, but the credit channel is ineffective in southern-tier countries such as Italy and Spain.	<b>Somewhat likely.</b> Not much room left after the 5 July cuts.
	Reactivate Securities Markets Programme	Unlocks peripheral debt markets and may bring down yields. May have a temporary effect only and increases subordination of private sector creditors.	Somewhat likely. Previous purchases have proved ineffective.
	Embark on quantitative easing	Triggers risk rally and could be done in ECB capital contribution proportions to reduce the effect of debt monetisation. Only a severe crisis would cause this ECB change of heart.	<b>Unlikely.</b> Probably would require a Treaty change and trigger a German constitutional court challenge. Needs steps toward a fiscal union to assuage fears of subsidising spendthrifts.
Rescue Funds EFSF and ESM	Recapitalise banks directly	Breaks negative feedback loop between banks and sovereign debt, and takes away a major risk that is dampening market sentiment.	<b>Likely.</b> Agreed in principle at the June 28-29 European Summit. The devil will be in the details. Fiscal transfers are unpopular in creditor countries and member states are leery to cede control of their banks.
	Banking license for ESM and/or ESM buys government bonds	Brings down peripheral rates and increases “firewall” against yield spikes. Leads to debt monetisation and may only give temporary relief.	<b>Somewhat likely.</b> It is an ECB decision. But the central bank is not keen on the idea and probably would prefer to monetise the debt itself.
European Union	European deposit insurance and/or European bank rescue programme	Prevents or stems capital flight from peripheral banks. Takes time to implement, would need federal banking supervision and is unlikely to stop a run on Greek banks.	<b>Somewhat likely.</b> It needs an EU directive, put together by the European Commission and approved by the European Council.
Eurozone	Eurobonds	A permanent solution that would ensure affordable borrowing costs for weaker eurozone states. Takes time to implement, as German approval is dependent on agreement on closer fiscal union.	<b>Unlikely.</b> Germany is vocally against and views differ on whether eurobonds would require a Treaty change.

# Keeping up US momentum

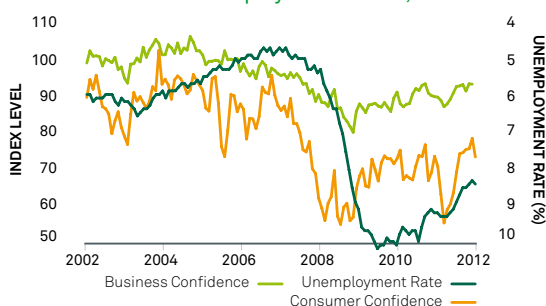
Is the US still the best house in a bad neighbourhood? Investors started to doubt this in the second quarter, and acted accordingly. Like a vicious squad of property surveyors, global markets swiftly wrote down the valuation of US risk assets and downgraded the entire neighbourhood in the process.

We worry about the US losing its economic momentum. Scary signs have emerged that US growth fell off a cliff toward the end of the second quarter. Job growth stalled. One of our pet indicators, the Chicago Fed National Activity Index, was showing recession-like conditions in May. Another piece of bad news was the 13% quarterly drop in the national savings rate in the first quarter. Such declines have precipitated a fall in personal consumption in the subsequent quarter 75% of the time since 1960.

There is mounting anecdotal evidence of US companies freezing hiring due to the deteriorating economy and fiscal cliff jitters. Decelerating job growth already has dented consumer confidence while business sentiment has stopped its steady rise. See the chart below.

## CONFIDENCE IS EASILY SHATTERED

US sentiment and unemployment trends, 2002-2012



Source: Bloomberg. Notes: Consumer confidence is the University of Michigan Consumer Sentiment Index. Business confidence is the NFIB Small Business Optimism Index. Consumer confidence data to June 2012. Unemployment and business confidence data to May 2012.

On the upside, the US housing market is showing signs of a long-awaited recovery, as we detailed in "In the Home Stretch? The US Housing Market Recovery" in June 2012. This is a key development because housing dominates consumer sentiment and spending. Another point of light is the shale oil and gas boom, as we discussed in "US Shale Boom: A Case of (Temporary) Indigestion" in June 2012.

## A FRAGILE RECOVERY

Key US indicators in post-recession periods

US economic data	Current	Average post-recession
Unemployment	8.2%	6%
Private payrolls	82,000	215,000
Jobless claims	376,000	343,000
ISM manufacturing	53.5	56.4
Business confidence	94.4	101.5
Consumer confidence	64.9	96.7
Housing starts	708,000	1.7 m
New home sales	328,000	782,000
Quarterly GDP growth	1.9%	2.6%

Sources: Bloomberg, Strategas and Société Générale.

Notes: Average post-recession period reflects data 35 months after the recession ended. Data since 1960. Data does not include the short recession ending in July 1981.

This helps push down energy costs and raises prospects of lower trade deficits, a competitive manufacturing base and increased government revenues.

It is important to remember the current US recovery is one of the feeblest in history. In fact, it is not a recovery at all for many Americans facing falling real wages and housing prices. Growth is lagging historic trends by almost any measure. See the table above. We also worry about the fiscal cliff. How likely is an unexpected outbreak of statesmanship in (dysfunctional) Washington? Not very, we think. The bipartisan Simpson-Bowles plan is likely to make a comeback after the 6 November elections. The plan entails a set of proposed spending cuts (including sacred cows such as Social Security) and tax increases.

One scenario is lawmakers adopting an incremental deal that would generate \$200-\$400 billion in savings in the lame duck session following the elections.

The parties would agree to extend the tax benefits for one year and pledge to reach a full-fledged deal by mid-2013. Another possibility is a second failed presidential attempt at a "grand bargain," followed by a mad scramble and a deal in early January. By that time, Republicans could vote for a tax cut (from the newly elevated levels that would go into effect on 1 January).

Whatever happens, it is likely to be a cliffhanger. This is bad news for markets. It is one of those events that everybody knows is coming – but has the capacity to surprise nevertheless.

# Chinese jigsaw puzzle

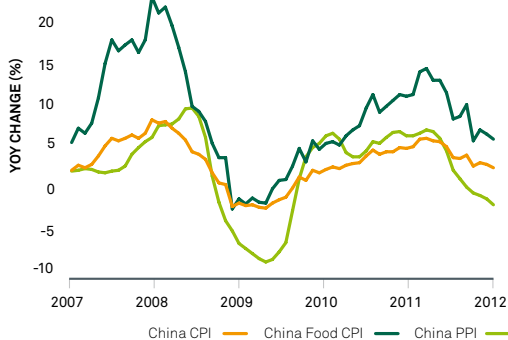
It is now clear China's economy slowed dramatically in the spring. Key indicators such as power generation and small business investment pointed down. Trade growth flatlined. Political intrigue – and the risk of resulting paralysis – reached a fever pitch with the ousting of “princeling” Bo Xilai, the former populist leader of Chongqing, ahead of the once-a-decade leadership change later this year.

Lame duck is not on the menu in Beijing, however. The current leadership has launched a series of monetary and fiscal stimulus measures to engineer a turnaround. First, it recently allowed banks to pay 10% more on deposits and cut their lending rate by up to 20%. This is a critical move toward interest rate liberalisation – and will be difficult to undo for the new leadership. Sure, bank margins will compress – but the industry has been making money hand over fist (on paper, at least).

Second, the stimulus machine appears to be cranking up. Officials have flagged they are ready to loosen curbs on consumer property buying, with banks poised to offer 20%–25% discounts on mortgages for first-time home buyers. A raft of (environmentally friendly) projects has been approved and the government is hanging out smallish incentives for purchases of cars and household goods. Third, a decline in the Consumer Price Index (also known as the Consumer Pork Index), including a fall in all-important food prices, is giving Beijing manoeuvring room to focus on re-igniting growth rather than fighting inflation. See the chart below.

## CONSUMER PORK INDEX IN RETREAT

Chinese inflation, 2007–2012

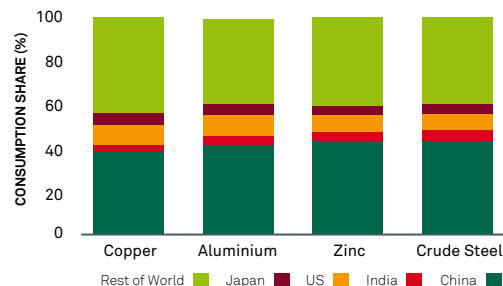


Source: Bloomberg.

Notes: Year-over-year changes. Data to May 2012.

## A CHINESE METALS BANQUET

Breakdown of global metals consumption, 2010



Source: Macquarie.

There are tentative signs the pro-growth policies are having some effect: New loans totaled a higher-than-expected 793 billion RMB (\$125 billion) in the month of May. Key activity indicators such as the sales of excavators appear to be bottoming out after sharp declines. To be sure, challenges are big as China attempts a transition to a consumption society from a command economy where investment still makes up a mind-boggling half of GDP, as we detailed in “Braking China ... Without Breaking the World” in April 2012.

Nobody expects a repeat of 2009, when Beijing engineered a huge monetary stimulus that doubled credit to 14 trillion RMB a year. Policymakers are still cleaning up the mess left by this Great Credit Leap Forward (white elephant projects and housing prices out of reach for most ordinary Chinese). Beijing also has no aspirations of becoming the white knight of the global economy. The basic view of one policymaker we spoke with: If we manage to help about a fifth of the world's population (China), we are doing a pretty good job. Any stimulus is likely to be smaller than in 2009 – and more risky given the underlying icebergs of poor-quality credit and dodgy property assets.

We care about China – a lot. The country will account for two-fifths of global GDP growth this year, according to Deutsche Bank estimates. China has become a profit centre for multinationals catering to its upcoming middle class. Global machinery makers are helping to upgrade the workshop of the world as real wages rise. The country is the main swing factor for many commodities prices and accounts for two-fifths of the global consumption of key metals such as copper. See the chart above.

# Investment opportunities

## EQUITIES: IN SEARCH OF INCOME AND EMERGING OPPORTUNITIES

Global equities are priced for extended Stagnation, and valuations look reasonable by historic standards in our view. See the table below. This means stock investors face downside risk if Nemesis rears her ugly head or could see upside if our Divergence theme regains momentum.

One caution: Earnings estimates are in a downward trend that is gathering momentum. In addition, profit margins look unsustainably high in some markets. For example, US corporate profits now make up a near-record high of 13% of GDP, according to the US Bureau of Economic Analysis.

US stocks look expensive relative to other developed markets because they have enjoyed a safe-haven status. This could change in the second half of 2012. Fiscal cliff jitters could take centre stage, triggering declines in business, consumer and investor sentiment. If this happens, beaten-down European equities may actually outperform their US peers – even without a solution for the eurozone's debt crisis. For now, investor sentiment overwhelmingly favours US stocks, according to the Bank of America Merrill Lynch Global Fund Manager Survey. This trade has paid off in recent years, but may be long in the tooth. See the chart on the next page.

Companies have drawn in their horns and many are sitting on record piles of cash. Some cash is making its way to shareholders in the form of dividends and share buybacks (we like the former better – companies typically buy at the high). Other corporate cash is “earning” negative interest in short-term money accounts as companies shy away from investments and takeovers. The global value of announced deals fell 22% to \$1.1 trillion in the first half, according to Thomson Reuters. This is a mixed blessing: Takeovers can light a fire under equity markets but statistically do not deliver value for shareholders of acquiring companies.

We would advocate a modestly defensive equities strategy for the second half. Our main themes:

- **Income is key:** We like companies with strong cash flows and a track record of raising dividends. Payout ratios are low and corporate cash piles are at record levels. This bodes well for dividend growth, a key component of successful dividend investing, as we detailed in “Means, Ends and Dividends” in March 2012. Traditional US dividend stocks look a little crowded, but opportunities abound in Singapore, Australia, Norway and other selected European markets.

## COMPELLING NUMBERS?

### Global equity valuations

Market	Price earnings ratios			Earnings per share YOY growth			Price to book	Return on equity	Dividend yield	Enterprise value to sales	Enterprise value to EBITDA	Local market performance
	2011	2012	2013	2011	2012	2013						
Global	12.9	11.9	10.5	6.9%	9%	13.4%	1.6	13.1	3.0	1.5	7.2	4.8%
Developed markets	13.3	12.2	10.8	6.5%	8.9%	13.6%	1.6	12.9	3.0	1.5	7.4	5%
Emerging markets	10.9	10.1	9.0	9.3%	9.3%	12.4%	1.4	14.2	3.1	1.4	6.2	3.2%
US	14.2	13.2	11.7	14.7%	8.1%	12.8%	2.0	15.4	2.2	1.7	7.9	8.3%
UK	10.3	10.1	9.2	12.9%	2.4%	9.8%	1.5	15.0	4.3	1.3	6.7	0.1%
Europe ex-UK	11.5	10.7	9.4	-9.1%	7.6%	13.6%	1.3	11.6	4.4	1.3	6.8	1.1%
Japan	17.4	13.1	10.6	-16.2%	43.5%	26.8%	0.9	7.0	2.6	1.0	7.3	5.7%
Asia Pacific ex-Japan	12.1	11.2	9.9	3.8%	10.2%	13.3%	1.5	13.2	3.5	1.4	7.0	3.6%
Latin America	12.2	11.7	10.5	8.4%	4.4%	11.3%	1.6	13.4	3.4	1.9	6.8	1.4%
CEEMEA	7.8	7.8	7.3	31.2%	0.3%	6.8%	1.2	14.9	4.1	1.2	4.3	3.9%

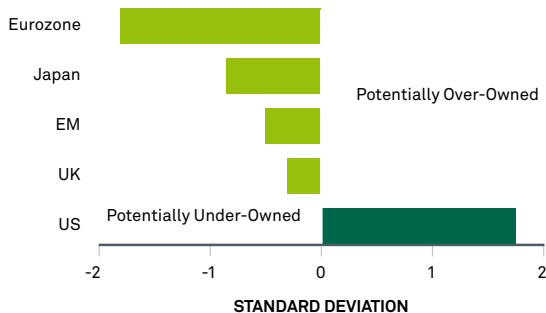
Sources: Citigroup, MSCI, Worldscope and FactSet.

Notes: 2012 and 2013 are estimated. CEEMEA is Central and Eastern Europe, Middle East and Africa. Data as of 29 June, 2012.

- ▶ **Emerging opportunities:** Emerging markets are coming into their own, and we believe valuations should equal those of developed markets over time. Low inflation (except in India) and likely policy actions to re-accelerate growth bode well for the second half of 2012. Many emerging markets now trade at a 20% discount to developed markets – a level that historically has been the launching pad for outperformance. We like direct exposure better than multinationals with extensive revenues in emerging markets. The latter group has become relatively expensive.
- ▶ **Opt for options:** Consider option strategies for downside protection and income. Whenever option market volatility falls below 15%, consider buying put options. Conversely, if option volatility reaches 25% or higher, consider writing covered calls. This does especially well in rudderless markets with bouts of risk-on/risk-off trading – a characteristic of our Stagnation scenario.

## EXTREME HERD MENTALITY

Investor positioning by region, June 2012



Source: Bank of America Merrill Lynch Global Fund Manager Survey. Notes: Survey period 31 May to 7 June, 2012. Standard deviations from historic norms.

## FIXED INCOME: DANGER IN SAFETY AND HUNGER FOR YIELD

Global investor fear has driven up demand for, and prices of, safe-haven bonds to record highs. At the same time, supply has been falling. Buckets of eurozone bonds and US mortgage-backed securities are no longer considered “safe.” In addition, the US Federal Reserve and the Bank of England have drained supply by buying piles of their countries’ long-dated government bonds.

We believe interest rates are going to be low for a long time, but the influx has made the US Treasury, German Bund and UK Gilt markets treacherous grounds. This “danger in safety” is caused by record-low yields and big price swings.

## COMFORTABLE CUSHIONS

Yields, duration and safety cushions, June 2012

Fixed income instrument	Yield (basis points)	Duration (years)	Safety cushion (basis points)
US Industrials (High Yield)	856	4.1	207
US CMBS 2006/2007 (AJs)	912	4.7	194
US High Yield	747	4.2	177
US Loans	611	3.5	175
US Financials (High Yield)	734	4.2	174
US Utilities (High Yield)	757	4.4	172
India	476	3.8	126
Kazakhstan	558	4.9	115
China	480	4.5	107
EM Americas Corporates	561	6.3	89
Hong Kong	433	4.9	88
Brazil Corporates	549	6.3	88
Mexico Corporates	571	6.9	82
Euro Transport Aggregate	386	4.7	82
Euro Corporates Aggregate	324	4.0	80
Euro Technology Aggregate	270	3.4	80
US Securitised Assets	240	3.1	78
US MBS	238	3.1	78
US CMBS (AAA)	219	2.9	76
South Korea	280	3.9	72
Euro Utilities Aggregate	337	4.8	70
Euro Communications Aggregate	323	4.6	70
Euro Consumer Cyclical Aggregate	212	3.2	67
Australia	304	4.6	66
Singapore	299	4.5	66
Euro Capital Goods Aggregate	258	4.0	65
US Financials (Investment Grade)	361	5.6	64
Euro Energy Aggregate	268	4.2	63
Malaysia	298	4.7	63
Euro Basic Industry Aggregate	226	3.6	62
Indonesia	434	7.5	58
Euro Consumer Non-Cyclicals Agg.	201	4.1	49
US Investment Grade	306	6.9	44
Philippines	373	8.5	44
US Industrials (Investment Grade)	312	7.5	42
US Utilities (Investment Grade)	336	8.9	38
US ABS	116	3.3	35
US 10-Year Treasury	161	9.1	18
German 10-Year Bund	152	9.1	17

Sources: Bloomberg and Barclays.

Notes: Duration is adjusted for different coupon frequency and callability. The safety cushion represents how many basis points in yield rise would trigger a price decline that would wipe out one year's worth of yield. Data as of 29 June, 2012.



- ▶ Exhibit 1: 30-year US Treasuries have moved an average of 1% a day so far this year, compared with daily volatility of 0.67% for the S&P 500.
- ▶ Exhibit 2: Duration, or a bond's price sensitivity to interest rate moves, is near record highs. An uptick of 13 basis points in the yield of a 30-year Treasury bond currently would trigger a price decline that would wipe out an entire year of yield. It would take 5.8 years to recoup price losses from a 1% yield rise.

This makes "risky" fixed income securities such as corporate bonds and emerging markets debt look much safer. Duration is shorter and higher yields provide a nice safety cushion against price declines. See the table on the previous page.

Playing into this is insatiable investor hunger for yield in a world of ultra-low interest rates, longer lives and lots of uncertainty. What is less obvious is the shrinking supply of fixed income securities across the board. When all the chatter is about heavy debt loads, this is a counter-intuitive notion.

The US fixed income market is instructive. Net supply in 2012 will be lower for a second year in a row, we estimate. Why? The US Federal Reserve is mopping up long-dated Treasuries and mortgage securities in an effort to bring down consumer lending rates and tempt investors into buying risk assets. Financial institutions are deleveraging, shrinking the financial corporate debt market. The end result is a market with high demand and shrinking supply. Not a bad place to be.

In general, we favour a fixed income portfolio that emphasises credit (or spread products) and underweights sovereign debt. We like core holdings in high yield, mortgage securities and some emerging markets debt. We suggest a barbell strategy that uses low-volatility options to capture short-term moves. Put options on currencies and call options on US Treasuries, for example, currently appear good downside protection.

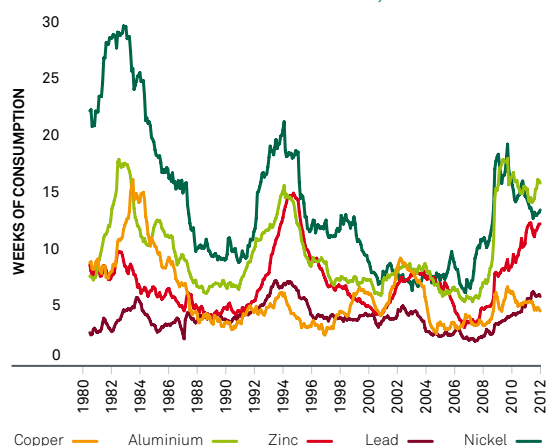
## NATURAL RESOURCES AND ALTERNATIVES: TAKING THE LONG VIEW

We are bullish on most metals and energy-related commodities, particularly copper and oil. Both should be good long-term bets because of looming supply gaps. These gaps are widening as resource companies are cutting investment into new mines and projects because of spiraling costs, falling commodities prices and investor pressure to pay out more dividends.

The world is facing a supply gap of almost 20 million barrels of oil a day by 2030 if global growth ticks along at a 3% clip, according to research firm Wood Mackenzie.

## STOCKING UP

Warehouse stocks of selected metals, 1980–2012



Source: Macquarie.  
Note: Data to April 2012.

Deepwater and shale exploration is taking off, but not fast enough to offset depleting conventional fields.

Oil also is subject to supply disruptions due to conflicts. This could cause price spikes – especially at a time when the industry is near full capacity. The spare capacity of the Organization of Petroleum Exporting Countries is around 3% currently, far below the normal comfort level of 5%.

Copper faces a similar squeeze. Global copper supply needs to grow by 6.2 million metric tonnes in the period 2010–2020 to keep up with demand, according to research firm Macquarie, 50% more than in both of the preceding two decades. New mines will have to close this gap – at a time when many miners are cutting back capital expenditures. In addition, copper stocks are currently low compared with both their historic average and other base metals. See the chart above. We prefer miners over the physical materials for now. The valuation gap between mining stocks and copper prices widened this year, making the former group more attractive. See the chart on the next page. This is also playing out in gold and other metals.

Agricultural commodities, especially grains, appear attractive due to demand from middle class consumers in the emerging world. We like companies that benefit from production growth and increases in farmland prices such as agricultural equipment makers and land banks. It also pays to watch long-term weather trends. New patterns are game changers for agricultural and energy production – and prices. Alternative investments can help provide a non-correlated buffer against markets swept by macroeconomic and policy events – at least in theory. Selecting the right manager is key.

## A WIDENING GAP

Performance of copper prices vs. copper miners, 2011–12



Source: Macquarie.

Note: Index levels are set at 100 on 31 March, 2011. Data to 25 June, 2012.

Hedge funds are still seeing investor inflows, with assets surpassing a record \$2.1 trillion, according to Hedge Fund Research (HFR). Returns have disappointed in 2012, with HFR's weighted composite index up just 1.7% through June. Private equity funds are busy raising money, but deal activity has all but dried up except for funds swapping portfolio companies.

Investor hedge fund flows have favoured relative value strategies – a good bet as Stagnation creates short-term opportunities and temporary mispricing of related securities. The field is wide open as banks are downsizing proprietary trading desks. We like private equity funds focused on undervalued energy assets.

Alternative energy is another long-term investment theme. We would steer away from manufacturers of solar panels and wind turbines because the business is mercilessly competitive. We focus on developers and operators of wind and solar parks instead. Bank deleveraging has hit financing for new alternative energy projects, but new players are emerging.

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