What to Know, What to Do

2015 OUTLOOK

BLACKROCK®

Welcome to The BlackRock List

These last few post-crisis years could be called the Age of Recovery: The Federal Reserve and other central banks have kept interest rates extraordinarily low to try to revive their economies. In doing so, they've helped stocks, but the low rates have made it much more difficult for investors in need of income.

Now we are entering what we at BlackRock are calling the Age of Divergence: The U.S., U.K. and select emerging markets are getting stronger while other regions—including much of Europe—are still struggling. The result is that central banks are beginning to take different paths, with the Fed setting a course for higher interest rates and the European Central Bank and Bank of Japan doing the opposite.

What does this mean for you and your investment portfolio in the New Year?

Stocks may not march upward in a straight line, but they should continue to do relatively well in 2015—and better than bonds and cash. But you'll have to be even pickier about the stocks you select and also expand your investment horizons beyond the U.S. Tread lightly in the bond market, put excess cash to work and consider supplementing the traditional asset classes with high-potential alternative strategies.

This is the world as we see it. Of course, as is always the case in financial markets, uncertainty is one of the few certainties. For 2015, we expect most of the world's geopolitical conflicts to remain unresolved, a lingering source of risk for markets. Here at home, the Fed could increase interest rates too soon or by too much and rattle investors.

But uncertainty should not be a motive for inaction. Your financial future is worth your attention today, and we offer **The BlackRock List** to help you get your bearings and build your portfolios for 2015. The List suggests the essential things you need to know about the markets—along with our recommendations for navigating them—to help you cut through the clutter and focus on what's important to reaching your financial goals.

What to Know—and Do—in 2015

5 THINGS TO KNOW

1. CENTRAL BANKS DIVERGE: DOLLAR LIKELY HIGHER
2. LONG-TERM RATES: STILL LOW FOR LONG
3. U.S. ECONOMY LEADS THE PACK
4. INFLATION: NOT ON THE HORIZON—YET
5. A BUMPIER ROAD AHEAD FOR STOCKS

5 THINGS TO DO

1. PREFER STOCKS OVER BONDS, BUT BE CHOOSY
2. ‘STOCK UP’ OUTSIDE THE U.S., TOO
3. WATCH YOUR STEP IN BONDS
4. RESIST THE URGE TO EXIT
5. SEEK GROWTH IN A LOW-GROWTH WORLD

5 Things to Know in 2015

1 Central Banks Diverge: Dollar Likely Higher

As the Fed steps away from its economy-boosting, "easy money" policies in the U.S., the central banks in Europe and Japan have sights on more measures to stimulate their flagging economies. This has two important implications (at least): 1) Central bank action to lower rates in Europe and Japan will increase demand for long-term U.S. bonds offering more attractive yields. That supports prices for those bonds, keeping yields relatively low (even as the Fed raises rates). 2) Higher rates in the U.S. (vs. overseas) means a stronger dollar, and that has implications for markets. Among them: downward pressure on commodities and inflation.

KEY TAKEAWAY

The Fed is ready to raise interest rates in the U.S. Opposite action by other central banks, as a result of deflation concerns, will mute the move up, but even a small rate increase could impact the value of your bonds.

2 Long-Term Rates: Still **Low for Long**

Even with this rise in U.S. interest rates, our longer-term outlook is for rates to stay low for a while more. Short-term bonds will bear the brunt of a Fed rate hike; their prices will be affected more. Longer-term rates, on the other hand, should inch up at a gentler pace and are likely to remain low relative to their history for many years to come. And that means finding a steady income stream will continue to be a challenge.

KEY TAKEAWAY

Long-term interest rates may inch up this year, but expect them to be low for some time to come, meaning you'll need diversified sources of yield to meet your income needs.

3 U.S. Economy **Leads the Pack**

The U.S. is better positioned than other developed markets heading into 2015. Unemployment is coming down at a decent clip, retail sales are showing improvement and lower oil prices are helping to boost consumer purchasing power. The chinks in the armor? Slow wage growth and soft consumption. But perhaps the biggest challenge facing the U.S. economy is not what happens here at home, but what transpires overseas. Europe is shaky at best, China is a question mark and Japan has officially entered a recession.

KEY TAKEAWAY

Barring any shocks, we could see U.S. gross domestic product (GDP) growth in the area of 2.5% to 3% in the new year, which is better than the 2.2% achieved through the third quarter of 2014 and should lend support to stocks.

4 Inflation: **Not on the Horizon**—Yet

Despite predictions to the contrary, inflation remains low in the U.S. But key indicators, including wage growth, warrant watching. Elsewhere in the world, particularly in Europe, deflation is the greater concern. This could lead the European Central Bank to enact additional easing measures to combat the problem.

KEY TAKEAWAY

We believe inflation will stay low for now, and that means companies' costs should remain contained—a plus for American businesses, and thus, for stocks.

5 **A Bumpier Road Ahead** for Stocks

The last three years have been characterized by unusual calm for stocks. 2015 is likely to be marked by a return to more typical levels of volatility, particularly as U.S. monetary policy starts to normalize. The good news is that conditions are broadly supportive of stocks and, therefore, any corrections that volatility brings aren't likely to be severe.

KEY TAKEAWAY

Stock market volatility will likely revert to normal in 2015. The silver lining: Volatility means down ... and up. Stock market pullbacks could create buying opportunities for long-term investors.

With this as context for the year ahead, what follows are **WHAT TO DO** actions that investors should consider in 2015.

THINGS TO DO

Prefer Stocks Over Bonds, But Be Choosy

Stocks still look attractive versus bonds and cash.

An uptick in stock market volatility can be unnerving for investors. Corrections are always painful. The irony is that market gyrations are a natural leveling mechanism in that they can restore value when prices get too lofty, and this creates opportunity for buyers of stock. Our best advice is to stick with stocks, but to be choosy in your selection.

Overall, the economic and monetary environment remains supportive of equities, but not every country or market segment is the same. Corrections may be more severe and enduring in some areas than others. We recommend investors do their comparison shopping across markets and sectors.

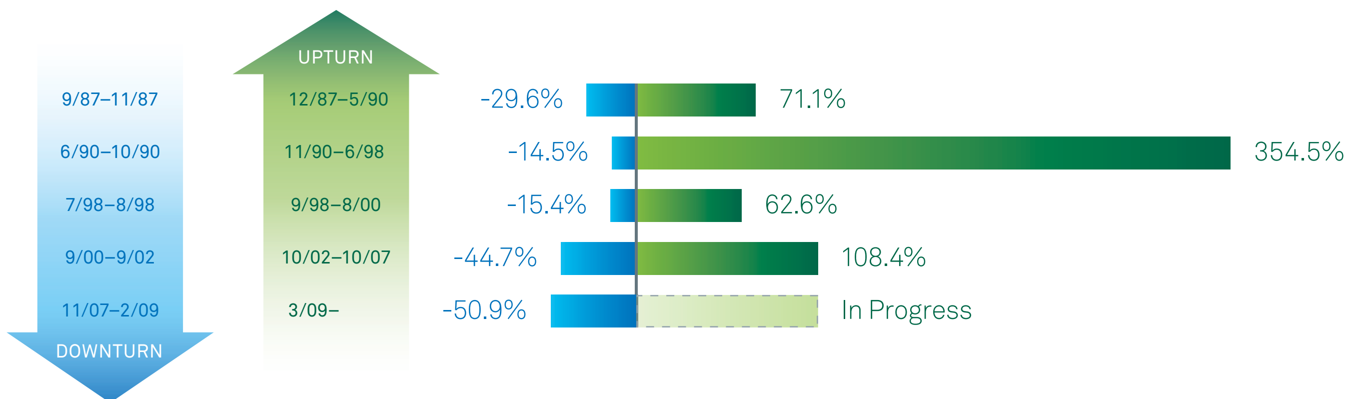
In the U.S., we are cautious on segments of the stock market that are most affected when interest rates go up. This includes certain defensive sectors, such as utilities, which have performed well recently but historically have been vulnerable to losses as rates rise. Greater value can be found in sectors positioned to benefit from economic growth, such as technology and large, integrated oil companies, which have cheapened after a difficult few months.

KEY TAKEAWAY

Stick with stocks for long-term growth.

Downturns have always returned to upturns.

Market Downturns Have Been **Followed by Market Rallies**



Sources: BlackRock; Informa Investment Solutions; SBBI 2006 Yearbook. Downturns are defined by a time period when the stock market value declined by 10% or more from its peak, while upturns are the time period from the trough of downturn to the market's subsequent peak. Performance is represented by the SBBI's Large Company Stocks (1929 to 1956) and the S&P 500 Index (1957 to present), an unmanaged index that consists of the common stocks of 500 large-capitalization companies, within various industrial sectors, most of which are listed on the New York Stock Exchange. **Past performance is no guarantee of future results.** It is not possible to directly invest in an index. The data assumes reinvestment of all income and does not account for taxes or transaction costs.

THINGS TO DO

'Stock Up' Outside the U.S., Too

Broadly speaking, U.S. investors tend to prefer the comfort of home and are biased toward U.S. stocks over the international alternatives. Even those investors who hold overseas investments are keeping their exposure at fairly modest levels. BlackRock's Investor Pulse Survey found only 13% of Americans hold international stocks, and they make up a mere 13% of their portfolios. Our take: You are missing out. Yes, international investing involves increased risk, including the risk of heightened volatility. Still, we believe increasing international exposure makes sense in general, but even more so these days when most of the stock market bargains are found overseas.

Of course, the world is a big place, so where should you look? Among the developed markets, Japan represents one of the few stock market bargains in the world today. Not only is the pricing good, but earnings in Japanese companies have been better than expected. Opportunities are also becoming more evident in emerging markets, particularly in China and other parts of Asia. In Europe, although economic growth is troublesome, further market-friendly actions by the European Central Bank should support stocks in 2015.

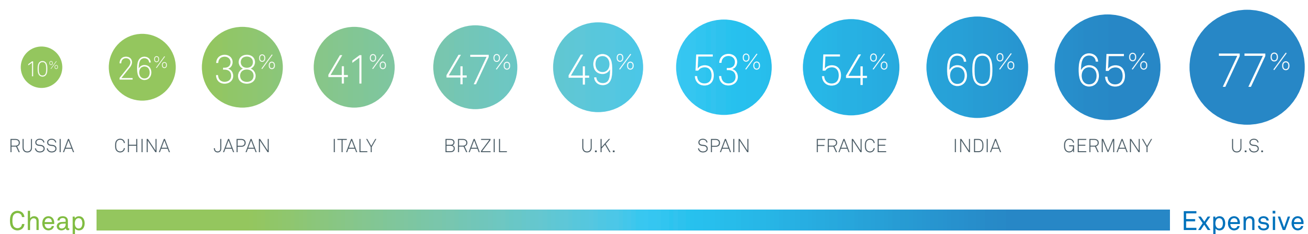
Are you tapping into all the world markets have to offer?

Most stock market bargains live outside the U.S. Ensure you're taking advantage.

KEY TAKEAWAY

Look for **Bargains Beyond U.S. Borders**

Valuation Percentile Relative to Historic Norms



Sources: BlackRock Investment Institute and Thomson Reuters, 11/28/14. Valuation percentiles are based on an aggregation of standard valuation measures versus their long-term history. Equity valuations are based on MSCI indexes and are an average of percentile ranks versus available history of earnings yield, cyclically adjusted earnings yield, trend real earnings, dividend yield, price to book, price to cash flow and forward 12-month earnings yield. Historical ranges vary from 1969 (developed equities) to 2004 (EM$ Debt).

THINGS TO DO

Watch Your Step in Bonds

Not all bonds are created equal. Know what you own, and be flexible.

With yields low (and prices, therefore, high), we still see few bargains for buyers of bonds. And the likelihood of a Fed rate hike in the first half of 2015 has already caused typically stable bonds to experience bouts of instability.

While navigating the fixed income market remains challenging, bonds are an important source of income and serve as a critical ballast to your equity investments. Our advice: Tread carefully and know what you own. Some types of bonds (e.g., those with shorter maturities) are more vulnerable to rising rates than others.

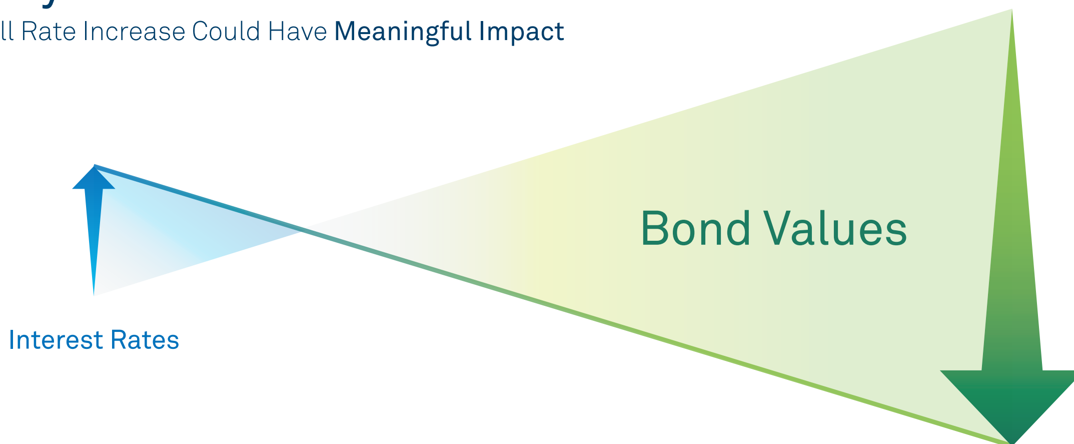
What do we like? Tax-exempt municipal bonds look attractive versus Treasuries and corporate bonds—both before and after tax. Some value also has been restored in high yield bonds, which tend to be less sensitive to movements in interest rates. Finally, we suggest investors look to funds that can deftly navigate rate-sensitive parts of the bond market, such as a flexible, go-anywhere bond portfolio or segment-specific exchange traded funds (ETFs) that may do well in a rising-rate environment.

KEY TAKEAWAY

With rising interest rates, bond principal is at risk. Be wary of shorter maturities in particular, which would be most affected by a Fed rate hike.

Bond **Buyers Beware**

Even a Small Rate Increase Could Have **Meaningful Impact**



THINGS TO DO

Resist the Urge to Exit

Higher volatility in 2015 might tempt some investors to head for the exits. But avoiding the markets can cost you over time. In addition, our research shows investors are already overallocated to cash (and they know it). For the most part, they hold cash out of an abundance of caution.

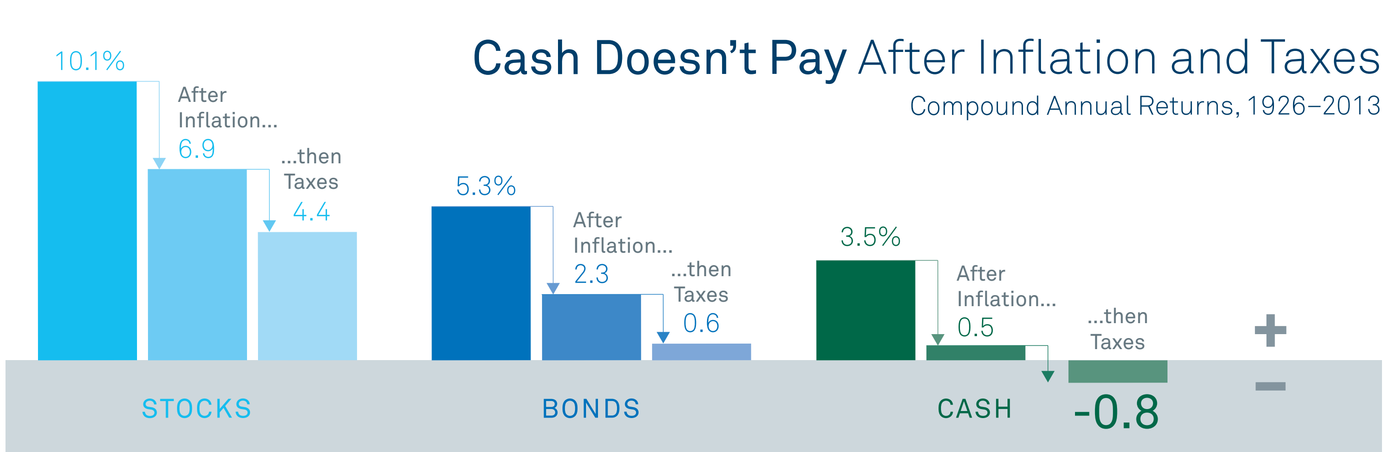
Truth be told, all investing requires trade-offs. Even cash comes with a few: It won't fluctuate in value like stocks and bonds, but it will undoubtedly provide negative returns when you factor in inflation and taxes. With that in mind, following are strategies to help you get off the sidelines and put your cash to work:

- Multi-asset funds, which invest across all asset classes, are designed to provide some cushion against declines while still participating in market upside.
- Dividend-paying strategies tend to provide a smoother ride, as dividends can help offset market losses.
- A core stock ETF can provide broad market exposure at low cost, which can help you keep more of what you earn.

Sitting in cash can get you nowhere fast.

KEY TAKEAWAY

It's important to hold some cash, but too much can set you back. Cash comes with a cost after inflation and taxes.



Sources: BlackRock; Morningstar; Tax Foundation. Past performance is no guarantee of future results. Assumes reinvestment of income and no transaction costs. This is for illustrative purposes only and not indicative of any investment. Federal income tax is calculated using the historical marginal and capital gains tax rates for a single taxpayer earning $110,000 in 2012 dollars every year. This annual income is adjusted using the Consumer Price Index in order to obtain the corresponding income level for each year. Income is taxed at the appropriate federal income tax rate as it occurs. Capital gains for stocks are assessed every five years when there is a cumulative gain from the last high and assume a five-year holding period to determine the long-term capital gains rate. Bonds are assumed to be held to maturity. No state income taxes are included. Stocks are represented by the S&P 500 Index. Bonds are represented by the Morningstar/Ibbotson Intermediate-Term Government Bond Index. Cash is represented by the Morningstar/Ibbotson 30-Day U.S. Treasury Bill Index. Inflation is represented by the Consumer Price Index. It is not possible to invest directly in an index.

THINGS TO DO

Seek Growth in a Low-Growth World

Granted, growth is picking up in the U.S. But as we noted earlier, that's not the case everywhere. What's an investor to do in a slow-growth world where many traditional assets are looking pricey? Cast a wider net in pursuit of your financial goals. International stocks, emerging markets bonds or frontier markets can add growth to a portfolio. You might even consider alternative investments. These additions can help to diversify a portfolio while providing greater growth opportunities.

Equip your portfolio with differentiated sources of risk and return.

Diversification doesn't guarantee profits or prevent loss (nothing does), but it does allow you to spread your risk across a broader set of instruments that may respond differently to a given set of market conditions. And in a world that still offers little in the way of screaming opportunities, mixing it up may be one of the best things you can do.

Also consider your ability to take on more risk—especially when you're younger and there is ample opportunity to recover losses. Many investors grew extremely cautious following the 2008 financial crisis. It's understandable. But without taking sufficient risk, you may be short-changing yourself in the long run.

KEY TAKEAWAY

Expand beyond traditional assets in an effort to optimize your portfolio's results.

More Growth **Doesn't Have to Mean More Risk** 1999–2013

* Reallocated 5% Equity and Fixed Income to Alternative Strategies. Sources: BlackRock, Informa Investment Solutions. Equity is represented by the S&P 500 Index. Fixed Income is represented by the Barclays U.S. Aggregate Bond Index. Enhanced portfolios include a 15% allocation to alternative assets, a 5% allocation to alternative equity strategies within the equity allocation and a 5% allocation to alternative fixed income strategies within the fixed income allocation. To fund these additional allocations, the equity allocation is reduced by 15% and the fixed income allocation is reduced by 10%. The 15% allocation to alternative assets is represented by a 5% allocation to the Goldman Sachs Commodity Index, a 5% allocation to the Barclay Currency Traders Index and a 5% allocation to the NAREIT Equity Index. The 5% allocation to alternative equity strategies is represented by the Dow Jones/Credit Suisse Long Short Equity Index. The 5% allocation to alternative fixed income strategies is represented by the Dow Jones/Credit Suisse Fixed Income Arbitrage Index.

Past performance is no guarantee of future results. Index performance is shown for illustrative purposes only. It is not possible to invest directly in an index.

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Russ Koesterich, CFA, Managing Director, is BlackRock's Global Chief Investment Strategist. He is a founding member of the BlackRock Investment Institute, delivering BlackRock's insights on global investment issues. During his more than 20-year career as an investment researcher and strategist, Russ has served as the Global Head of Investment Strategy for scientific active equities and as senior portfolio manager in the U.S. Market Neutral Group at BlackRock.

Russ is a prolific commentator on the markets, can regularly be seen on CNBC, Fox Business News and Bloomberg TV, and is often quoted in the print media, including *The Wall Street Journal*, *USA Today* and *Barron's*.

RELATED RESOURCES

2015 Outlook: Dealing With Divergence

The latest publication from the BlackRock Investment Institute provides a more in-depth discussion of the global trends that may drive financial markets in the coming year.

BlackRock Investment Directions

BlackRock's monthly asset allocation recommendations, with a focus on ways to position your portfolio in 2015.

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* AUM as of 9/30/14. † Source: Pensions & Investments as of 12/31/13.

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