

## 2012: A Look Ahead

December 30, 2011

### The Frustrations of 2011

2011 was a volatile and disappointing year for most investors. Expectations entering 2011 featured a continuation of economic recovery around the world from the Great Recession, despite ongoing deleveraging and residual debt and credit concerns. Debt and credit issues, however, obviously exploded over the past year, particularly in Europe. The investment landscape was one driven by fear and anxiety and while corporate earnings were up in most places, stock multiples were down, causing equity markets to struggle.

### 10 Predictions for 2012

Making predictions for a new year is always a difficult task, but this year the uncertainty associated with emerging markets growth, upcoming elections, and the European debt situation in particular make the forecasting exercise especially precarious. Nevertheless, it is with this backdrop that we move forward with our predictions for 2012:

1. **The European debt crisis begins to ease, even as Europe experiences a recession.**
2. **The US economy continues to muddle through yet again.**
3. **Despite slowing growth, China and India contribute more than half of the world's economic growth.**
4. **US earnings grow modestly, but fail to exceed estimates for the first time since the Great Recession.**
5. **Treasury rates rise and quality spreads fall.**
6. **US equities experience a double-digit percentage return as multiples rise modestly for the first time since the Great Recession.**
7. **US stocks outperform non-US stocks for the third year in a row.**
8. **Dividends and buybacks hit a record high.**
9. **Healthcare and energy outperform utilities and financials.**
10. **Republicans capture the Senate, retain the House and defeat President Obama.**

### A "Muddle-Through" World Should Allow Stocks to Outperform

We continue to operate in a post-credit-bust world, a chief consequence of which is ongoing deleveraging. As a result, economic growth will likely be slow in 2012. Slow growth should be partially offset by the forces of accommodative monetary policy in much of the world, designed to provide the liquidity necessary for solvency and debt repayment. This combination of slow growth and debt repayment/deleveraging is likely to be a difficult one, fraught with occasional accidents and subject to low tolerance for policy errors.



Bob Doll is Chief Equity Strategist for Fundamental Equities at BlackRock®, a premier provider of global investment management, risk management and advisory services. Mr. Doll is also Lead Portfolio Manager of BlackRock's Large Cap Series Funds. Prior to joining the firm, Mr. Doll was President and Chief Investment Officer of Merrill Lynch Investment Managers.

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A scenario of slow, but positive, economic growth should allow for acceptable, but lackluster, earnings growth. Both “risk” and “safe” assets seem priced for such an environment, but not for a “left-tail” event whereby financial contagion could do significant damage. Our mainline scenario assumes a continued “muddle-through” global environment, especially regarding the European debt problem. Whenever deflation is a risk factor for the global economy, equity valuations remain under pressure. Importantly, the US household sector has been steadily restructuring its balance sheet and lowering its debt service ratio. This positive step, combined with some increase in the pace of job creation, provides hope for a better year for equities.

On the “what can go right” front, we would list Europe moving toward resolution of its debt crisis, the United States heading toward fiscal responsibility, the emergence of a US manufacturing renaissance, a housing recovery and/or an increase in confidence. The “what can go wrong” list would include a systemic banking crisis in Europe, a true double-dip recession in the United States a hard landing in China, a breakout of class warfare in the United States, and a Middle East flare-up that drives the price of oil to \$150. Our “muddle-through” scenario avoids both extremes, but leaves much unresolved.

In summary, 2012 is likely to feature a slow-growth world that includes a recession in Europe. The United States faces headwinds, but manages to achieve growth of between 2% and 2.5%. China and India slow somewhat, but, along with the United States, make up two-thirds of global GDP growth. The big risk remains that of a financial breakdown in Europe, which would tip the developed world, if not the emerging world, into recession. Inflation should also continue to move lower. Should the muddle-through environment come to pass, we believe decent earnings and some improvement in confidence would allow equity markets to move higher, with US stocks leading the way.

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