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Global equities look attractive due solid earnings growth and dividend payouts exceeding bond yields in developed markets. Investors are desperate for yield and a wall of money is waiting to be deployed when confidence returns.

Stocks are reasonably priced at 10 to 12 times earnings in most markets. Earnings deterioration resulting from a shallow European recession would lift valuations to 15 times earnings — still fair value. A deep or lengthy European recession would change this view.

The eurozone crisis has presented the world with previously unthinkable scenarios. It has roiled markets. And it has BlackRock constantly review and question all our assumptions, and work on possible solutions. In this fast-moving and complicated environment, the need is greater than ever for policymakers to set and implement credible, decisive and thoughtful rules.

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Euro Crisis Fallout and a Call to Policymakers

Special Market Update

November 11, 2011

Governments are falling, bond yields are zig-zagging by whole percentage points and markets around the world are locking up: the eurozone turmoil risks turning into a global crisis.

Looking beyond the daily headlines and eye-popping price moves, this special market update reviews the impact on the real economy, what it means for financial markets and the tasks for European policymakers.

Highlights:

- ▶ The eurozone is already heading into a shallow recession and austerity measures will hurt even more. The biggest risk is that a crippled banking system could deepen and lengthen the region's recession. Bank recapitalisation and bond market stabilisation are therefore crucial in solving the crisis.
- ▶ A deep European recession would spur more quantitative easing in the United States and the UK, and interest rate cuts in the eurozone. Emerging markets have the most room to cut rates, but that could cause inflation to regain momentum. We still see positive global economic growth next year, albeit at temperate levels.
- ▶ Investors have fled equities and sought the safety of top-rated bonds. The two main catalysts for a reversal would be a decisive European crisis response and China's easing policy restrictions on growth.
- ▶ Global equities look attractive due to solid corporate earnings growth and dividend payouts exceeding bond yields in developed markets. For Italian and peripheral bonds, buying by the European Central Bank (ECB) is the most immediate way to restore confidence and bring markets back to normalised levels.
- ▶ European policymakers need to take four decisive actions to end the crisis: More bond buying by the ECB; more details on the rescue fund and less complexity; a real debt restructuring in Greece, Portugal and Ireland with private creditor write-downs of 75% to 80%; and fiscal discipline without choking off growth.

European Policymakers: A To-Do List

The current European bond market turmoil results from political twists and turns in Greece and Italy, and the fire sale of the sovereign debt portfolio of bankrupt brokerage MF Global. The market noise has obscured some realities. Italy, for example, is at no



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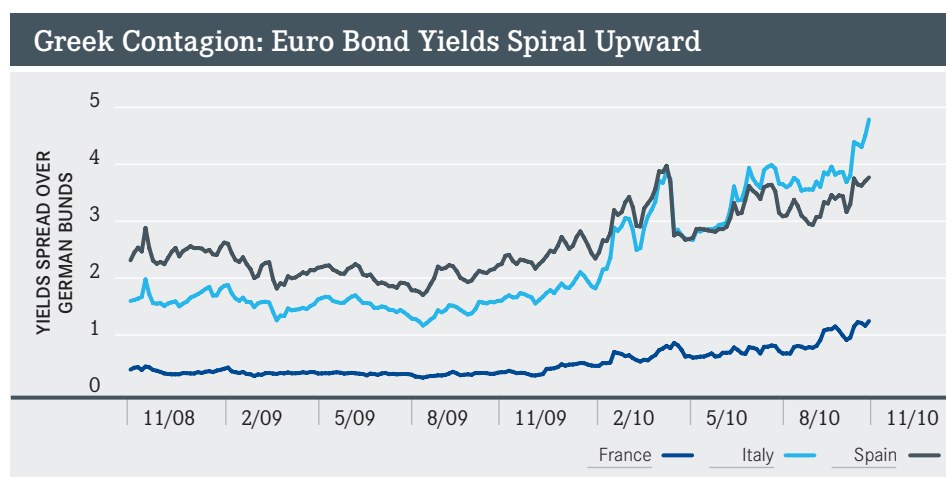
*European policymakers need
to take four decisive actions
to end the crisis.*

Fear has overtaken markets, exacerbated by global banks' shedding risk assets.

short-term risk of running out of cash – it has enough on hand to last until February. Its debt matures at an average of 7 years and its current debt servicing cost is just over 4 percent.

Italy essentially is a self-reinforcing crisis of supply. It needs to roll over more than 300 billion euros of debt next year. In addition, banks are selling Italian paper to reduce risk and because the spike in yield makes it tougher to use Italian bonds as collateral. Domestic players will soak up a lot, but the market needs the ECB to act as an active backstop.

Fear has overtaken markets, exacerbated by global banks' shedding risk assets. See the chart "Greek Contagion" below. The result is paralysis. Only continued bond buying by the ECB can break the buyers' strike in the short term. This is a necessity: As the world's third-largest bond market, Italy is simply too big to fail.



Source: Thomson Reuters.

We already know some countries do not have the ability to pay. Calling into question their willingness to pay is even more dangerous territory.

The October 26 European Summit seems ages ago but is worth a quick review: Overall, we liked the outcome. Policymakers delivered the goods in laying the groundwork for debt write-offs, support for banks and the promise of more firepower for the European Financial Stability Fund (EFSF).

But they were short on the critical details of who, when and how (much). The events of the past few weeks confirm a need for more clarity and bolder steps. Policymakers need to take four decisive actions: Buy more bonds, provide details on the rescue fund, force debt write-downs in Greece, Portugal and Ireland, and impose credible long-term fiscal discipline.

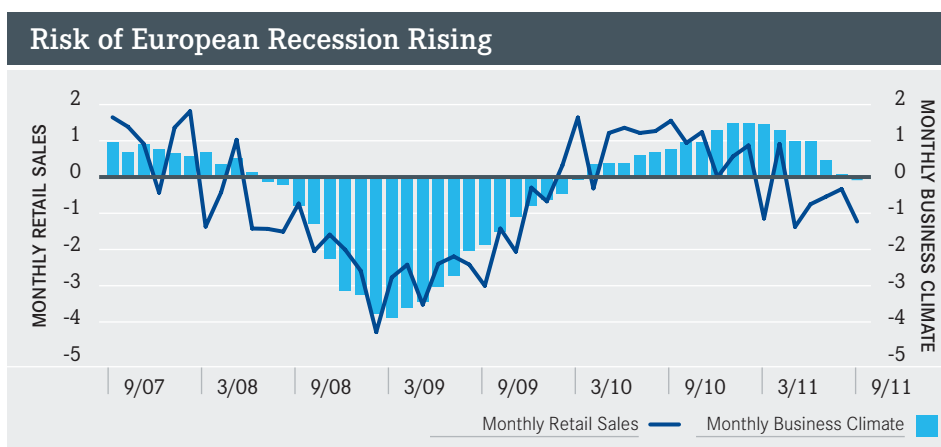
The bond buying is critical to tip the supply/demand balance in favour of demand. Without it, paralysis will set in and chaos is likely to follow. The market needs details on the EFSF's funding and how it will support markets. Its planned insurance scheme is too complex for many government bond buyers, and we are also concerned that the ECB would allow defaults on sovereign bonds partly guaranteed by the EFSF. We already know some countries do not have the ability to pay. Calling into question their willingness to pay is even more dangerous territory.

Our analysis suggests private creditors should write off 75% to 80% of Greek debt to allow for permanent stability. Arguably, holders of Portuguese and Irish debt are in for similar "haircuts". We believe banks need to be forced to take these charges rather than participate in a voluntary scheme that is unlikely to bear fruit.

Finally, European governments need to deliver credible fiscal policies that deliver long-term savings on pensions and other costs. Resorting to knee-jerk, short-term spending cuts is not the answer, and in fact would worsen the continent's economic troubles.

The Real Economy: A European Recession

The eurozone is in a shallow recession already and austerity measures will hurt even more. See chart below: "Risk of European Recession Rising." The biggest risk is that a crippled banking system could deepen and lengthen the recession. That is why bank recapitalisation is crucial in solving the crisis. In the United States, financial markets provide 70% of credit and banks 30%. In Europe, that ratio is reversed – making it even more important that the sector is restored to health.



Source: Thomson Reuters.

A deep European recession would likely spur more quantitative easing in the United States and the UK, and prompt the ECB to cut rates. Emerging markets have the most room for easing, but that would cause inflation to regain momentum. We still see positive global economic growth next year, albeit at temperate levels.

Financial Markets: Equities Look Attractive

A doomsday scenario of a eurozone split remains unlikely and we still believe in the euro – although that belief has seriously been tested in recent weeks. Talk about Germany and selected other member states forming their own block is just that: talk.

Investors have fled equities and sought the safety of top-rated bonds this year. The main drivers have been banks shedding risky assets, the fallout of likely fiscal tightening in the eurozone and a loss of investor confidence.

A decisive European crisis response (as outlined above), combined with China's easing policy restrictions on growth, would be catalysts for an equity market turnaround. Recent signs that inflation is abating should give Chinese authorities the room to stimulate the domestic economy. In many ways, China is the last man standing to prevent world economic growth from sliding downward.

The real question is how long and how deep the European recession will be.

We still believe in the euro – although that belief has seriously been tested in recent weeks.

Global equities look attractive.