Europe on a Tightrope

BlackRock Investment Institute

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Europe's crisis is accelerating and the next month looks critical. Greece is running out of money fast and local politics are in disarray. Banks are reeling from ratings downgrades, asset write-downs and fragile funding. Global markets again are held hostage by the eurozone's turmoil.

This is a short- and long-term crisis. Today's is all about funding while tomorrow's is about structural reform, finding the right mix of spending cuts and growth, and – most difficult of all – giving up sovereignty. Politics will drive the outcome: If the US finds it tough to reach fiscal accord, consider the challenges of the 17 eurozone nations.

- The political and market turmoil is likely to intensify in the run-up to the Greek elections on June 17. The election of an anti-austerity government could trigger a Greek default. This does not necessarily mean Greece would leave the eurozone, but it could spark bank runs that could potentially spread to Portugal, Spain and Italy.
- Europe's defences against this and other "contagion" risks are inadequate with rescue funds still in gestation and no central decision making, we believe. The European Central Bank (ECB) has enough firepower to end any crisis immediately – but is loath to do so for fear of going beyond its inflation-fighting brief and giving a free ride to countries that do not even attempt to balance their books.
- European policymakers have shown they will act decisively only in times of crisis – but their pain threshold is much higher than that of their US, UK or Japanese counterparts. This is because the weak (voters in indebted nations) do not vote in elections of the strong. No pan-European guarantee or plan will see the light of day without severe duress – on creditors and debtors alike.
- We expect a call to action only at tipping points such as Spanish and Italian bond yields rising well above their November highs, massive deposit flight or severe bank funding problems. Paymaster Germany is likely to tweak its austerity prescription for the region: Countries' willingness to pay matters more than their ability to do so.
- The risks of a short-term cash crunch are currently low thanks to the ECB's bank funding, we believe. We worry most about Spanish banks buckling under bad property loans. Longer term, the challenge is to wean banks off the ECB's easy cash.

So What Do I Do With My Money?™

- Balance investing in risk assets for the long run with guarding against short-term price declines. Consider using out-of-the-money call options to capture a sudden risk rally. Investor positioning is bearish, especially for equities, upping the chances of a snap-back.
- We prefer top-quality multinational companies with strong overseas sales for now. This is a crowded trade, so we are looking to buy financials, dividend payers and domestically focused European companies when valuations hit bottom.
- Many investors are back to a "least-dirty shirt" investing strategy and have piled into government bonds that offer negative real yields. The risk of a "Nemesis" crisis has increased, but we still believe in emerging markets and US assets outperforming others.

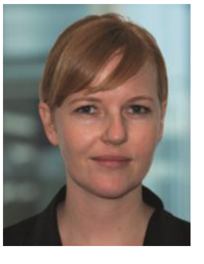
The opinions expressed are as of May 2012 and may change as subsequent conditions vary.

Nigel Bolton
Head European Equity team, Blackrock Fundamental Equity

Craig Phillips
Head Financial Markets Advisory Group, BlackRock Solutions

Nathalie Deliens
Credit Research Analyst, BlackRock Fundamental Fixed Income

Scott Thiel
Deputy Chief Investment Officer, BlackRock Fundamental Fixed Income



Alice Mew
Lead European Sovereign Analyst, BlackRock Fundamental Fixed Income

Ewen Cameron Watt
Chief Investment Strategist, BlackRock Investment Institute

Europe: A Tale of Many Nations

Key Data on Eurozone, the UK and Switzerland

Country	BlackRock Sovereign Risk Index Ranking	10-Year Bond Yield	YTD Yield Change (bps)	Budget Balance to GDP	Unemployment Rate	Number of Macro Imbalances	YTD Stock Market Change	Election Dates
Finland	5	1.84%	-45	-0.5%	8.5%	3	3.0%	2018 (parliamentary) *previous: Jan 22, 2012 and Feb 5, 2012*
Germany	8	1.43%	-39	-1.0%	6.8%	2	11.6%	Sep 2013 (parliamentary) *previous: Sep 27, 2009*
Netherlands	14	1.89%	-29	-4.7%	5.9%	4	-2.3%	Sep 12, 2012 (parliamentary- snap)
Austria	16	2.50%	-50	-2.6%	6.8%	3	7.9%	Sep 2012 (legislative) *previous: Sep 28, 2008 (snap)*
France	27	2.70%	-43	-5.2%	9.8%	2	-1.0%	June 10 and 17, 2012 (legislative)
Belgium	30	3.15%	-86	-3.7%	7.3%	4	4.8%	2014 (parliamentary) *previous: June 13, 2010*
Slovakia	34	3.37%	-207	-4.8%	13.7%	3	-9.3%	2014 (presidential) *previous parliamentary: March 10, 2012*
Slovenia	38	5.35%	-129	-6.4%	12.4%	2	-1.3%	Oct 8, 2012 (presidential) *previous parliamentary: Dec 4, 2011*
Spain	40	5.98%	64	-8.5%	24.4%	6	-18.3%	2015 (parliamentary) *previous: Nov 20, 2011*
Italy	43	5.50%	-153	-3.9%	8.8%	2	-6.9%	April 2013 (parliamentary) *previous: April 13-14, 2008 (snap)*
Ireland	44	6.80%	-146	-13.1%	14.3%	6	8.8%	May 31, 2012 (referendum) 2016 (parliamentary)
Portugal	47	10.69%	-208	-4.2%	14.0%	6	-5.7%	2015 (parliamentary) *previous: June 5, 2011*
Greece	48	24.75%	-1021	-9.1%	20.7%	4	-10.1%	June 17, 2012 (parliamentary)
Cyprus	NR			-6.3%	10.0%	6	-36.2%	March 2013 (presidential) *previous: Feb 17 and 24, 2008*
Estonia	NR			+1.0%	7.2%	3	18.0%	March 2015 (parliamentary) *previous: March 6, 2011*
Luxembourg	NR			-0.6%	6.2%	3	-5.4%	2014 (parliamentary) *previous: June13, 2009*
Malta	NR					3	-3.7%	March 2013 (parliamentary) *previous: March 8, 2008*
UK	24	1.96%	-7	-8.3%	8.3%		0.1%	May 7, 2015 (parliamentary) *previous: May 6, 2010*
Switzerland	4	0.63%	-11	+0.4%	3.1%		0.3%	Oct 2015 (parliamentary) *previous: Oct 23, 2011*

Sources: BlackRock, Bloomberg, Thomson Reuters Datastream, World Economy Watch, European Commission and International Foundation for Electoral Systems. Notes: NR = not ranked by the BlackRock Sovereign Risk Index. Bps= basis points. Bond yields and stock market returns as of May 11, 2012. Budget Balance figures as of Dec 2011 except the UK (March 2012). Unemployment rates vary from Dec 2011 to April 2012. Macro imbalances based on European Commission's Alert Mechanism Report methodology.

A Game of Chicken

Another act in the Greek drama, group huddles of European leaders and sliding markets: It is tempting to say we have seen this movie before. Yet we believe this time is a little different and Europe is barreling toward a crossroads without traffic control.

Europe's policymakers have started to talk openly about the possibility of Greece leaving the monetary union, the so-called "Grexit" scenario. The upcoming Greek elections on June 17 set up the country for a game of chicken with its European paymasters if populist anti-austerity parties win the day. Germany, the ECB and other key stakeholders are in no mood to renegotiate the terms of Greece's bailout, we believe, and are likely to cut off funding if Athens tears up the agreement.

This would herald a default by Greece, as we expect the country to run out of money by early July. In such a scenario, it is easy to imagine a further run on banks and financial mayhem. This in tum increases the risk of investor panic spreading to other eurozone members on life support such as Portugal and, more damaging, to Spain and Italy. Investors do well to closely monitor deposit withdrawals both in Greece and elsewhere.

We believe policymakers would quickly try to stop bank runs outside Greece, and would come up with the beginnings of a eurozone retail deposit insurance programme.

But it is hard to stop a panic once it has started. And a retail insurance programme would likely leave open many questions, including around bank and corporate obligations.

To be sure, a Grexit is not a given. Polls show Greeks overwhelmingly want to remain in the monetary union, so no political party will have the direct mandate to take Greece out. There is no mechanism for countries to leave the monetary union, and keeping membership intact is a key political objective. Lastly, nobody really wants to test the fallout of Greece's leaving. Governments and banks seem better prepared than a year ago – but these are still very much unchartered waters.

One possible outcome could be a cash-strapped Greek government issuing California-style IOUs used for payment of civil servants, services and taxes. This parallel currency would likely lead to hoarding of euros and trigger a greater economic collapse than the disaster already in motion.

The outcome of the Greek elections is far from certain. European leaders have positioned them as a referendum on the euro, so parties committed to the bailout could win. Populist parties could fall victim to their own success in the polls if Greeks massively withdraw savings in the run-up to the elections. Another deadlock is a possibility, likely leading to a third election that would keep markets on tenterhooks.

A High Threshold for Pain

European policymakers time and again have shown they only match up to market expectations under extreme duress. Investors have noticed they have a much higher pain threshold than their US, UK or Japanese counterparts. Markets have to fall off a cliff before policymakers jump in to clean up the mess. This summer is unlikely to be any different.

Eurozone countries still have sovereignty, so only a crisis will bring them to the table. This is one reason why the ECB and other policymakers have refrained from setting up a permanent "firewall" to fight the crisis: They fear this would give a *carte blanche* to politicians in debt-ridden nations to continue their ruinous ways. Right or wrong, one thing is crystal clear: Investors cannot count on certainty.

Does this mean our "Year of Living Divergently" has met a premature end? We do not believe so. Yes, the risks of a "Nemesis" crisis scenario – named after the Greek goddess who punishes the proud – are rising. This is reflected in risk assets selling off across the globe. Yet the major themes – an outperforming US economy, strong emerging markets and a recession-struck Europe – are very much alive.

Even Europe is showing signs of strength and change, with the German economy seeing strong domestic demand and supposedly uncompetitive Spain racking up export growth. The eurozone appears in relatively good fiscal shape with an overall deficit of 4%, compared with double that amount for the US and the UK. Spain and Italy arguably have done enough already to meet International Monetary Fund conditions for aid – if needed.

That said, crisis trumps value for now. Investors do well to balance a search for long-term value in risk assets with a buffer of safe-haven bonds and cash against short-term price declines. The latter is no investment strategy for the long run because it offers negative real yields. But it will help weather the storm and can be reversed if markets snap back.

Forcing Draghi's Hand

Europe's defences to prevent an investor panic from spreading are weak: Decision making is often ineffective when leaders of 17 independent countries work to find consensus. Rescue funds such as the European Stability Mechanism and the European Financial Stability Facility are either still not approved by member state parliaments or properly funded.

This leaves the ECB. It has the firepower to stop any crisis in its tracks. Unlike the US Federal Reserve and the Bank of England, it has been loath to embark on purchases of government bonds and other assets. If it had spent the same amount as the others did as a percentage of GDP, the ECB would have bought an additional €1.4 *trillion* in assets, according to Berenberg Bank.

Why hasn't it acted? It is reluctant to overstep its brief of fighting inflation (asset purchases actually would raise the risk of inflation). The ECB also holds back so countries make a real effort to balance their books and liberalise their economies. This is not a central bank that wants to restore confidence and calm markets. It wants balanced budgets and structural reform.

An Action-Packed Calendar

Key Events in the Month Ahead

Event	Date	Likely Outcome or Subject
Irish Referendum on Stability Treaty	May 31	Yes vote
French Legislative Elections	June 10-17	Socialist majority
Greek Elections	June 17	Anybody's guess
G-20 Summit	June 18-19	Themes: stability and growth
Eurogroup/Ecofin Meeting	June 21-22	Subject: Greek election
European Summit	June 28-29	Theme: growth
ESM Comes into Force	July 1	May approve lending to banks
ECB Meeting	July 5	Possible rate cut

What would force ECB chief Mario Draghi's hand? Yields on 10-year Italian and Spanish bonds would have to spike to 7%-8% and short-term yields would have to revisit their 2011 highs. There would have to be signs of an impending credit crunch or an acceleration of deposit flight in Spain. Only then would we expect the ECB to launch a new round of long-term refinancing operations (LTRO) or make outright sovereign debt purchases. The fat lady of the Italian opera has not sung yet.

German Chancellor Angela Merkel wants eurozone members to sign up to her fiscal pact. Germany cut its deficit and implemented labour market reforms starting in 2004. Germany's leadership believes combining austerity with labour reform offers a valuable lesson for the rest of Europe: You will hit a rough patch, but you will be rewarded in the long run.

Merkel is willing to water down agreed-upon austerity measures as long as countries abide by the spirit of fiscal discipline, we believe. This is helped by the recent election of French President François Hollande on a platform to spur growth. We agree austerity alone is not good enough. Plans to spur growth and attract investment are crucial for a recovery.

Banks: The Eurozone's Achilles Heel

Banks remain at the heart of the turmoil. They are shedding assets outside their home markets, pressuring global risk assets. They are replacing private sector loans with sovereign bonds – good for regulatory and funding needs, but bad for domestic economic growth.

Many banks these days are alive only by the grace of the ECB's LTRO. Spanish banks have borrowed a gross €317 billion from the ECB, equaling 19% of their deposits. By contrast, German banks' total ECB tab is €60 billion. This equals 2% of deposits and is offset by €190 billion in cash reserves at the ECB.

It is tough to see how banks will wean themselves off the ECB's LTRO. It has been a wonder drug for those who took it – but is only effective for a limited time. Plus, it has side effects on banks not taking the medicine because funding costs of the LTRO crowd are close to zero. A signpost for picking long-term winners is how fast a bank can wean itself off the ECB elixir.

In the short term, we worry about parts of Spain's banking system buckling under bad property loans, deposit flight and the rating agency downgrades of European banks.

A Spanish Awakening

Spain's finances, fiscal deficit and huge unemployment are very problematic – but not unsolvable. The health of the financial sector is of bigger, immediate concern, we believe.

There are no quick fixes for Spain's soured property and construction loans. The market is in the doldrums with a huge overhang of empty properties. We estimate some 2 million houses are vacant, while land banks hold an additional 3.7 million homes – almost a quarter of Spain's total housing stock. By contrast, we estimate the US figure at about 5%,

We believe it is prudent to separate the bad loans and house them in a separate entity. Having well-capitalised banks buying weak ones would be less desirable. This would make it tougher to understand how exactly much bad debt is rotting in the system and increase the risk of "infecting" strong banks. This is when investors run scared.

Overhanging Spain's financial sector is the impact of the recent Moody's downgrade and likely ratings cuts of its sovereign debt this year. Moody's is likely to cut Spain by up to two notches to Baa2 and S&P by one notch to BBB, we believe. Other eurozone sovereign ratings are likely to remain as they are, barring a disorderly Greek default or some countries abandoning austerity.

Moody's recent downgrade of Spanish banks heralds further cuts, with French and UK banks likely next this summer, we expect. This may drive up their short-term funding costs and have a ripple effect on subordinated debt and securitisation.

We have not detected any serious pressures on bank funding yet, but are watching. One thing to remember is few banks have opened the ECB's second gift from December 2011: relaxing the rules for collateral to obtain funding. Spain, for example, has posted just 0.25% of total assets under the new rules, which leaves room for a lot more.

About Us

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.

Lee Kempler Executive Director
Ewen Cameron Watt Chief Investment Strategist
Jack Reerink Executive Editor

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