

TECHNOLOGICAL INNOVATION DEMANDS THAT INVESTORS THROW AWAY PAST PLAYBOOK

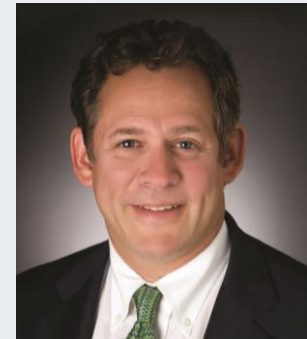
JANUARY 2015



Highlights

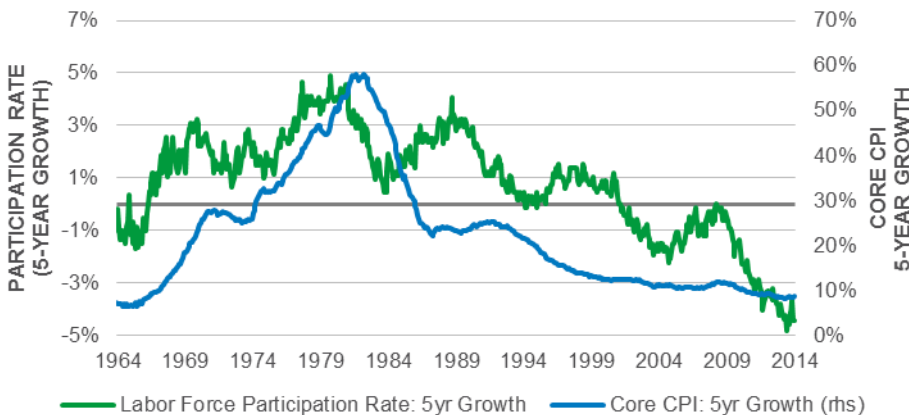
- ▶ While the media’s “hot topics” can distract investors (who tend to only focus on a few things) from more meaningful secular trends, it is the latter (e.g., technological innovation) that will drive economies and markets.
- ▶ Revolutionary technological advances are changing longstanding economic relationships regarding inflation and employment, which complicates the task of both policy maker and investor.
- ▶ Finally, there are indications that both policy risks and geopolitical risks are on the rise, and given our broad macro outlook, we suggest taking a barbelled approach to risk in portfolios today.

As we have argued in the past, financial markets tend to focus on (and market volatility is driven by) only a few factors at any given point in time. Indeed, short-term market gyrations are likely produced by both the human brain’s limited ability to process multiple functions at once and the tendency for market participants to coalesce around consensus viewpoints and positioning. The field of behavioral finance has done a great deal to expand our understanding of these matters, but it would be a mistake for any investor to consider themselves immune to these forces, even if they believe they understand them better today. Further, both traditional media and social media tend to reinforce these tendencies, focusing on one or two main themes that become dramatically overplayed and that may be of limited importance to broader economic, political, or social trends, which can then skew thinking as to what really matters to markets. Of course, this also creates investment opportunities in the process. Ultimately, true investment direction (over any reasonable time horizon) is driven more by the secular forces influencing investment fundamentals and valuations, and not by factors producing short-term volatility.



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Figure 1: U.S. DEMOGRAPHIC TRENDS WORK IN FAVOR OF LOWER INFLATION



Source: Bureau of Labor Statistics; Data through November 30, 2014

The opinions expressed are those of Rick Rieder as of January 15, 2015 and are subject to change at any time due to changes in market or economic conditions.

This is not to suggest that items covered in the media are unimportant, as the many stories today about the falling price of oil, the forthcoming policy changes from the European Central Bank (ECB), and the political and economic challenges in Russia all address genuinely important issues for markets. Nevertheless, it is not clear to us that the longer-term investment performance of many financial assets will turn vitally on these factors, or at least not in a simple way, particularly since markets do tend to be fairly effective at pricing in such information to asset valuations. Rather, we believe a set of critical secular themes is much more likely to tangibly influence the economy and markets in the long run. Those themes are: changing demographic trends, major innovations in technology (including in the energy sector), and the economic/monetary policy backdrop. Further, from a fundamental perspective, we think certain concepts form the cornerstone of stability for fixed income investments today, and they are: leverage, liquidity and cash flow. We will address each of these themes in turn, and in doing so we hope to illuminate why they are likely to be the forces driving asset prices in the years ahead.

Demographics Revisited: The Implications for Growth and Inflation

In last month's market outlook, we touched upon some elements of demographic change, such as how generational transition in many developed market (DM) countries was resulting in rising old age dependency ratios, how that would lead to increased demand for stable income-producing securities, and how even global economic growth itself would likely moderate as a result of the trend. This month, we expand this examination to include our thoughts about aging and inflation. To reiterate, as more and more people in DM countries begin to draw from the economy, rather than contribute to it (in other words, as old age dependency ratios rise), aggregate global economic growth should remain slower than it has historically been. That fact in turn may result in historically accommodative monetary policy being maintained for a long time (more on this later), even despite the fact that this policy isn't likely to meaningfully influence growth in the face of such structural headwinds. So while it can be exceedingly difficult to determine how demographic change will ultimately influence markets, it's also important to not ignore the relationship altogether.

In fact, there is a remarkable symmetry between population growth dynamics and potential economic growth, which holds clear implications for the regions one might look to when seeking to own different segments of the capital structure. Indeed, owning risk assets in higher growth regions may make good sense, unless valuations or other fundamental factors would suggest otherwise. In our view, economic growth and high levels of recurring cash flows are key tenets of stable system-wide equilibrium. In contrast, as we will explore later, regions where monetary policy is used

excessively to support growth, but where organic growth is absent, are likely to experience disequilibrium and market volatility. With these factors in mind, countries that hold relatively favorable secular demographic dynamics include the United States, India, and Mexico, while some that appear more challenged from a demographic standpoint are China, Italy, and perhaps most notably, Japan.

When we compare the population dynamics in the U.S. with those of the Eurozone, we quickly come to see how the latter region is likely to struggle to produce solid growth in the decades to come. Today, the total population of the Eurozone resides at 334 million people, a bit higher than that of the U.S., which comes in at 316 million people, but the population growth trajectories of the two regions could not be more different. The modest population growth experienced in the Eurozone is set to peak sometime around the year 2020, after which it is expected to decline slowly. In contrast, U.S. population growth is expected to rise, such that by around the year 2050 the country may have a population near 440 million people, while the Eurozone may be closer to 310 million people, a remarkable reversal.

Obviously, birth rates, longevity, and immigration levels are all difficult factors to handicap over a three decade long period, but since nominal GDP growth can be seen as a function of labor force growth, productivity increases and inflation, paying attention to longer-term population dynamics is important. Furthermore, demographic change in the U.S. also appears to be working to structurally lower the rate of inflation. Specifically, as the Baby Boom generation heads into retirement (in the wake of the financial crisis and subsequent recession), we have seen a marked decline in the labor force participation rate, which in turn may also be holding core Consumer Price Index (CPI) levels down (see Figure 1 on preceding page). Also, as rent/housing is a major contributing factor to CPI growth, continued home price normalization (with modest levels of new construction), may well contribute to structurally lower inflation rates than in the pre-crisis period. Lower (yet stable) levels of inflation can serve as a tailwind to growth in the U.S., and will hold significant implications for assets of all kinds.

Technology and Inflation: A Changing Dynamic

As we have argued for many months now, the rapid pace of technological innovation today has profoundly influenced virtually every aspect of the economy and society, and when combined with previously discussed demographic trends, this dynamic holds major implications for inflation rates and investment decision making. There are too many facets to our current technological revolution to address them all here, but last month we extensively looked at the rise of online retailing and the tremendous degree of price transparency it affords for U.S. consumers. Of course, the natural economic consequence of that innovation is a reduction of retailer

pricing power, a moderation in inflation levels, and a shift in employment away from brick-and-mortar stores. We also considered how technology is reducing the total cost of labor through robotics, and of course, it can increase rates of labor productivity.

Other aspects in which technological innovation influences the economy include: the consolidation of devices into more compact/efficient forms, the development of “asset-light” businesses, enhanced logistics, distribution, and inventory management, and broad-based improvements to the standard of living that do not require wage gains. Additionally, it must be understood that these technological advances are almost all disinflationary in nature, and not solely as a matter of hedonic quality adjustment.¹ Indeed, the very nature of modern computational progress appears to hold a deflationary/efficiency impulse, as per Moore’s Law.² This is perhaps best exhibited by the smartphone revolution, whereby the multiple capabilities that a typical smartphone can bring to bear are dramatically less expensive than purchasing the individual items required separately. A popular example might be the iPhone 6, which can replace the following devices (and more): alarm clock, calculator, camera, compass, flashlight, GPS, iPod, radio, voice recorder, and Wi-Fi, along with serving as an actual phone.

More dramatic historical examples of the extent of this technology revolution are easy to find, for instance: the chip inside singing birthday cards has more computing power than the Allied forces did in World War II; and the A7 chip inside the (now outdated) iPhone 5S is 1,300 times faster and has 16 million times more memory than the guidance computer used in the early Apollo spacecraft of the mid-1960s. We can draw a more mundane, but nevertheless striking, example of how smartphone technology has transformed our culture from *Barron’s* magazine, which recently reported on the woes of the pay phone business. It appears that near 150,000 pay phones remain in the U.S. today, down from a peak of more than two million in 1999, but New York City will soon be replacing all its remaining pay phones with “digital kiosks that can make calls, charge devices, and emit wireless signals,” according to the story, an inventive repurposing of outdated technology (*Barron’s*, November 21, 2014).

The transformative character of this progress is extraordinary, but why does all this matter for the economy and markets? As we have discussed, modern technological progress holds deflationary potential, which in turn has an influence on economic growth, interest rates, and thus, ultimately, asset prices. And while there are limits on the relationship, for example, the shelter/rent component to CPI is a significant driver of generalized price change, but is an area in which Moore’s Law is less pertinent, the concept is vital to understand. In contrast with shelter, CPI segments such as

fuel/utilities, transportation/autos, education, and medical care are more impacted by technological change, and we have witnessed their contributions to CPI collapse. In short, many traditional economic principles, such as the Phillips Curve of employment vs. inflation, supply and demand curves of all kinds, and the relationships between savings and money supply appear to not hold today the way they have in the past.

Figure 2: U.S. WAGE GROWTH MUST BE REAL TO BE MEANINGFUL



Source: Bloomberg; Data through November 1, 2014

For instance, in the U.S., we are witnessing demand that leads to growth without attendant inflation, merely a higher standard of living. And while anemic wage growth is a well-documented problem in the U.S. today, real (which is to say, inflation-adjusted) wage growth was better in the 1990s and 2000s than it was in 1970s and 1980s, when higher nominal gains masked the earnings erosion suffered by many households (see Figure 2). Without question, the technology revolution is partly responsible for holding wages down, but even in such an environment (as long as inflation remains low) net disposable income can rise, standards of living can improve, and eventually higher wages should follow. In fact, there is already some evidence to suggest that wages have started to recover, as a recent research note from Evercore ISI cited ADP survey data showing 5% annualized wage growth for those earning between \$20,000 and \$50,000 per year (for the period ended Q3 2014), which is welcome news for many middle-income households.

Technology and Employment: A Changing Dynamic

Not only is technology impacting inflation, and a variety of other well-established economic principles, but it is also changing the dynamic of employment in the U.S. in ways that are not immediately obvious from the aggregate data. For example, the strong growth of the economy (and the tailwinds from commodity price declines) is leading to a significant

¹ The Bureau of Labor Statistics defines hedonic quality adjustment as a: “method [that] removes any price differential attributed to change in quality by adding or subtracting the estimated value of that change from the price of the old item.”

² This observation, named after Gordon E. Moore, the co-founder of the Intel Corporation, suggests that over the history of computing hardware, the number of transistors in a dense integrated circuit doubles roughly every two years.

upturn in many consumption-related industries, and at the same time technology is facilitating the use of more “just-in-time” hiring practices. Indeed, the January 3 cover story in *The Economist* magazine, entitled “Workers on tap,” provides a nice overview of what they call the “on-demand economy” and the challenges and opportunities it presents. Interestingly, expanding upon the wage growth data discussed above, some of the strongest wage growth in recent months has come in sectors that represent the lowest paying jobs, such as leisure/hospitality and retail.

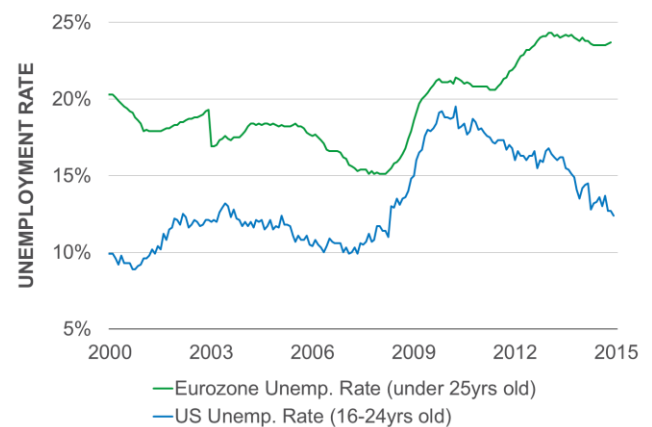
Further evidence of the strength of this cyclical recovery (dovetailing with the trend toward on-demand labor) is the rise in seasonal retail hiring to levels not seen in more than a dozen years, alongside a plummeting rate of youth unemployment (those 16 to 19 years of age saw their unemployment rate plunge 4% in 2014, to 16.8%), which tends to be the age cohort occupying many of these positions. The fact that younger, and less educated, workers have finally started participating in the employment recovery and wage gains is very heartening, and suggests to us that the monetary policies of the past several years have accomplished what they can and it is now time to move on from emergency-level policy. That is particularly the case since at least some of the wage stagnation seen in the aggregate data, which Federal Reserve officials have expressed some concern about, is the result of changes to the industry employment mix and of greater hiring.

Still, as we have long contended, there are structural headwinds at play in employment too, as has been ably shown in research by Massachusetts Institute of Technology economist David Autor (see nextbigfuture.com, June 13, 2013). Specifically, it is particularly concerning to see what we have referred to as the “earnings smile” phenomena (of course, for how the distribution of the graph appears, not for how it makes anyone feel), which is to say that over the past three decades or so, real hourly wage gains have mostly gone to those workers at the top and the bottom segments of skill levels, with a large proportion of middle-skilled workers seeing only anemic gains. The “smile” phenomena is also present when looking at the changes to employment by skill level, again with the highly skilled doing well, along with the lower-skilled whose jobs happen to be difficult to automate. In the middle, however, we have seen what Autor calls a “hollowing out” of the middle class, as many routine jobs have been susceptible to replacement by technological alternatives. Examples Autor provides of highly skilled positions include technical jobs, such as software engineers, while routinized jobs that are increasingly vulnerable to replacement include bank tellers and cashiers.

In the U.S., we have seen corporations increase the flexibility they have in hiring, and in recent decades the overall cost of labor in the cost of goods sold has dropped markedly. With flexible on-demand hiring and the automation of many routine

jobs coinciding with the financial crisis/recession, is it any surprise that LinkedIn has a market cap of \$28 billion today, whereas it was virtually unknown a few years ago? We have created an economy in which many individuals are in a near-continual state of having to “sell themselves” for new temporary or contract positions as prior work ends. And while this does provide flexibility to workers as well as employers, it has squeezed the middle class, despite also providing standard of living benefits. In the end, however, these profound structural changes are taking place not only in our economy, but also in the global economy generally, and it is an aspect to labor markets that cannot be easily aided by monetary policy.

Figure 3: LABOR MARKET FLEXIBILITY AND YOUTH UNEMPLOYMENT



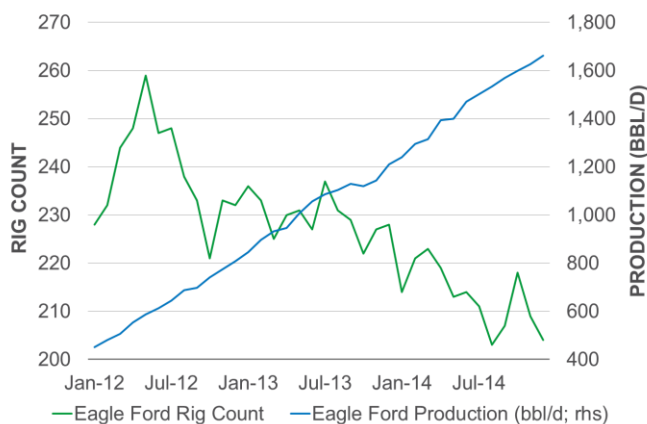
Source: Eurostat and the Bureau of Labor Statistics; Data through November 30, 2014

The Cornerstone for Investments Today: Cash Flow, Liquidity, and Leverage

In between demographic trends and technological change, disinflationary influences are occurring everywhere in the world today, yet cyclical progress is very different by region, and consequently economic growth and monetary policy by region are in the process of diverging. That fact is remarkably on display in the separate paths of youth unemployment in the U.S. and in the Eurozone since 2010 (see Figure 3). Extraordinary policy by the Fed combined with organic economic healing to improve youth joblessness in the U.S. (admittedly, still elevated), while the unemployment of young people in Europe has remained disastrously high. The Eurozone’s lack of flexible labor markets, its absence of fiscal policy, and until recently, a less forceful monetary policy than required, all contribute to this state of affairs. Still, since in many respects central banks are only passengers on the way to system-wide structural change, it is not yet clear that further policy accommodation in Europe may not present greater financial market risks than economic benefits.

Regardless, it is quite clear that the U.S. economic growth trajectory is diverging from that of Europe, Japan, and some segments of the emerging markets (EM), and we believe this will likely persist for some time. The U.S. economy will continue to display relative strength for the next couple years, and achieving sustained growth will be much harder in Europe and Japan, where both demographic trends and labor market dynamics are considerably less favorable. This economic dispersion, and the differing inflationary characteristics it engenders, cannot be brought to greater relief than when considering the dynamics around oil. Driven by what we consider to be one of the most important new technologies of our era, horizontal fracking, the energy industry illustrates an extraordinary example of how the application of technology can be a deflationary force. In our view, the primary driving force behind the dramatic drop in oil prices is the unleashing of new reserves of oil supply in recent years, rather than pervasively slowing global demand, which has not meaningfully deviated from its long-term trend line.

Figure 4: EAGLE FORD, A MICROCOSM OF THE SHALE REVOLUTION



Source: Baker Hughes; Data through December 31, 2014

After years of technological progress in unconventional drilling, and rising production levels in the U.S., we finally (and quite suddenly) saw oil prices plunge in the back half of 2014. The decline was exacerbated by the Thanksgiving Day announcement by the Organization of the Petroleum Exporting Countries that it would not cut production levels in response to the weakening oil price. And while the lower oil price clearly hurts higher-cost producers in the U.S. and Canada, as well as some EM countries, such as Russia and Venezuela, it just as clearly presents a massive economic boon to consumption globally, particularly for U.S. consumers. The deflationary pressure of lower oil prices acts as an effective tax cut, or as a much-needed “synthetic fiscal

stimulus,” on employment and consumption, and it creates a relentless bid for the U.S. dollar. Yet, we believe any eventual oil price recovery is likely to appear more “L-shaped,” rather than “V-shaped,” as production has continued to grow in the U.S. despite declining rig counts and the prospective drop in capital expenditures. In fact, activity in the Eagle Ford shale formation in Texas provides a case in point: the Eagle Ford rig count is down 25% since peaking roughly two years ago, but production from the region has grown by nearly three times over the period (see Figure 4). Productivity gains at U.S. oil fields have been improving for three years now, and remarkably it accelerated by 10% in the fourth quarter of last year, driven by necessity.

In the context of the macro backdrop we have laid out, we think economic leverage, liquidity and cash flows will continue to be hugely influential in determining the course of growth, alongside the evolution of monetary policy. Indeed, in our view markets grossly underestimate the importance of an economy’s “balance sheet,” which is to say its aggregate level of leverage relative to its cash flows (and liquidity position), by over-emphasizing growth per se. As we recently argued in an article in *Institutional Investor*, these three factors are also likely to provide the basis for the fundamental stability of debt investments in what are likely to be increasingly volatile markets.³ As a result, we think a careful consideration of these factors in areas such as EM debt markets can allow for differentiated alpha opportunities in the year ahead. For example, hard currency EM bond yield spreads have recently widened to more attractive levels, amid oil-price-inspired market volatility, while at the same time inflation in many of these countries has moderated. This presents an opportunity for investing in some of the stronger EM countries, such as Mexico, Indonesia, and India, where healthy sovereign balance sheets combine with better liquidity than might be expected to deliver a compelling holding, but as we mention differentiation will be the watchword for the sector.

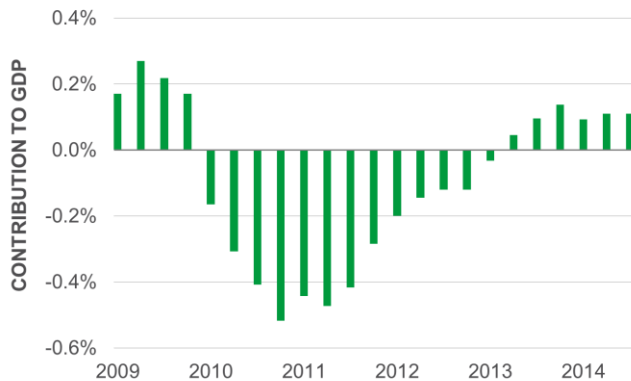
Monetary Policy Points to Investment Ideas, but Risks of Market Recalibration Rise

We think the three fundamental factors highlighted above are vital for capital allocation in the coming years, but of course market technical factors can also afford shorter-term opportunities. As a case in point, similar to the emerging world, DM countries can provide significant dispersion in economic performance and policy action, which create trading opportunities, and Japan in particular presents an unusual case. As we argue in our article referenced above, “Japan may be living on borrowed time,” since the country’s leverage is far too high relative to its cash flow (GDP), its demographic

³ Rick Rieder. “10 Key Investment Themes for 2015,” on *Institutional Investor’s* Global Market Thought Leaders platform, January 15, 2015: <http://www.institutionalinvestor.com/gmtl/3417391/10-Key-Investment-Themes-for-2015.html>.

profile is among the most worrying in the world, economic growth has been stagnant, and while inflation showed signs of life recently, it has also turned over and is expected to move lower. Still, with the most aggressive and coordinated set of monetary/fiscal policies in the world, this is a place where taking risk down the capital stack (currency hedged equities) still makes some sense. Of course, Japan's longer-term challenges are truly historic in nature, so that must be kept top-of-mind. In stark contrast, U.S. municipal markets have seen significant fundamental improvement in cash flows relative to leverage and in fact state and local government no longer represents a drag on U.S. GDP (see Figure 5). We have seen quarterly state revenue improvement, which has long overtaken its pre-crisis peak, property tax revenues are also back on solid footing, and according to National League of Cities data, U.S. cities' ability to balance budgets recently hit a 20-year high.

Figure 5: STATE & LOCAL GOVERNMENT, NO LONGER A DRAG ON U.S. GDP



Source: Strategas Research; Data through 3Q 2014

At this stage, however, we want to sound a note of caution, since while monetary policy can certainly aid leveraged entities in refinancing, and it clearly dulls market volatility, we have also long argued that it introduces distortions into markets and into capital allocation decisions. And in fact those distortions can result in the temporary interruption of what are fairly regular market cycles. For example, since 1990, we have seen a spike in market volatility and a decline in asset prices almost precisely every four years, except in 2006, when arguably excessively easy monetary policy delayed the recalibration until 2008. Of course, by 2008,

policy-distorted markets had allowed a tremendous leverage build-up, which then resulted in the financial crisis and recession, a much more severe re-pricing of risk than might have been the case had markets been allowed to function more normally. Can the Fed (and other central banks) avoid this eventuality in this cycle? No one can be sure, but as the Fed presses into the seventh year of extraordinary monetary policy accommodation, we certainly believe playing significant defense makes sense.

Fascinatingly, if we look over the past 30 years, the average level of the Fed Funds rate that corresponds to current levels of six-month payroll growth is a remarkable 6.84%, a far distance from our 0.25% rate today. Thus, it is abundantly clear to us that the Fed can move off the zero bound for its policy rate in the first half of the year, and can safely take us to 1% in fairly short order. This would still be extraordinarily accommodative, but at least no longer at "emergency levels." Furthermore, even as the Fed normalizes rates, ramped up QE from the ECB and from the Bank of Japan will keep some market distortions present. In this kind of environment, and given the macro backdrop we have outlined, we think it makes a great deal of sense to: barbell portfolio risk exposures with long maturity U.S. Treasuries and municipals at one end, and equity-like risk (much of which still appears better valued than debt) such as high yield bonds and selective emerging market debt, on the other. In between the extremes, we like securitized debt such as commercial mortgage-backed securities and non-Agency mortgages more than we like high-grade corporates.

Also, U.S. dollar holdings are preferable to those denominated in Euro or Yen, and modest positions in Euro- or Yen-denominated gold can make sense as a portfolio hedge against currency devaluations and potential financial contagion. That is because even as the U.S. begins the process of departing from its extraordinary monetary accommodation, Europe and Japan are pressing ahead with this experiment in dramatically expanding the monetary base. Historically, gold has performed well in periods of monetary expansion, and with a limited set of options to extricate systemic leverage, the currency is likely to become the ultimate relief valve in the Eurozone and Japan. In the end, 2015 may well present a volatile and challenging year to navigate, so a balanced approach to risk with some hedged exposures is most advisable.

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