iShares®

Investment Directions

Monthly Market Outlook

February 2012

Macroeconomic Outlook

Investors rediscovered their appetite for risk in January and early February amid new monetary stimulus from major central banks, signs of progress toward resolving the European sovereign debt crisis and better-than-expected economic numbers. Looking forward:

- Recent market developments confirmed our 2012 outlook for the global economy. Assuming that Europe manages to muddle through with a mild recession, we expect the global economy to experience slow, but positive growth and avoid a recession this year. The cyclical bull market rally we're experiencing could easily go on for the remainder of 2012.
- Still, a severe 2012 global recession remains a possibility. It would most likely stem from policy failure, and a banking crisis, in Europe. But it could also be the result of other developments including some unexpected event like an oil shock. As such, investors should continue to watch developments related to economic and debt restructuring in Greece and to the deleveraging of European banks.
- In terms of our investment view, we continue to hold a positive long-term view of global equities, which we believe still look cheap, particularly relative to bonds. We believe that equities can post additional gains in 2012, though those gains are likely to be harder to come by than in January and will likely be accompanied by more volatility. As such, we prefer to get equity exposure through global mega-cap stocks with high dividends, select developed and emerging markets, and lower-beta sectors.

Longer-Term Global Asset Allocation

	OVERWEIGHT	NEUTRAL	UNDERWEIGHT
Global Equities	■		
Treasury Bonds			■
Corporate Bonds	■		
Municipals	■		
Treasury Inflation-Protected Securities			■

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What's New:

Global Regions

- Initiation of Overweight Norway
- Initiation of Underweight South Africa
- Initiation of Neutral Mexico
- Initiation of Neutral Sweden
- Upgrade of China to Overweight
- Downgrade of India to Underweight
- Downgrade of South Korea to Underweight

Fixed-Income Sectors

- Downgrade of Non-US Developed Markets to Underweight

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BlackRock®

iShares Investment Strategy Group near-term outlooks

Global Region Developed Markets	Underweight	Neutral	Overweight	Related iShares ETF Tickers
Global Equities			X	ACWI
Developed Markets		X		EFA
Australia		X		EWA
Canada		X		EWC
European Equities (ex-Germany/Nordic Countries)		X		IEV
France		X		EWQ
Germany			X	EWG
Hong Kong			X	EWH
Italy	X			EWI
Japan			X	EWJ
Netherlands			X	EWN
Norway			X	ENOR
Singapore			X	EWS
Spain	X			EWP
Sweden		X		EWD
Switzerland		X		EWL
United Kingdom		X		EWU
United States		X		EUSA, IYY, IWV, ISI, IVV
Emerging Markets				
Emerging Markets		X		EEM
Brazil			X	EWZ
China			X	MCHI, ECNS
India	X			INDY
Indonesia		X		EIDO
Latin America			X	ILF
Mexico		X		EWW
Russia			X	ERUS
South Aftrica	X			EZA
South Korea	X			EWY
Taiwan			X	EWT
Global and US Sector	**Underweight**	**Neutral**	**Overweight**	**Related iShares ETF Tickers**
Consumer Discretionary	X			IYC, RXI, AXDI
Consumer Staples		X		IYK, KXI, AXSL
Energy			X	IYE, IXC, AXEN
European Banks		X		EUFN
Financials	X			IYF, IXG, AXFN, EMFN, EUFN, FEFN
Healthcare		X		IYH, IXJ, AXHE
Industrials		X		IYJ, EXI, AXID
Information Technology			X	IYW, IXN, AXIT
Materials		X		IYM, MXI, AXMT
REITs		X		ICF, IYR
Telecommunications			X	IYZ, IXP, AXTE
US Industrials			X	IYJ
US Regional Banks			X	IAT
US Retail	X			N/A
US Technology			X	IYW
US Utilities	X			IDU
Utilities		X		IDU, JXI, AXUT
Fixed-Income Sector	**Underweight**	**Neutral**	**Overweight**	**Related iShares ETF Tickers**
Emerging Markets		X		EMB
High-Yield Credit		X		HYG
Investment Grade Credit			X	LQD, FLOT
Mortgages			X	MBB
Municipals			X	SUB, MUB
Non-US Developed Markets	X			ISHG, IGOV
TIPS/Global Inflation-Linked		X		STIP, TIP, GTIP, ITIP
US Treasuries		X		SHY, IEI, IEF, TLH, TLT
Global Style	**Underweight**	**Neutral**	**Overweight**	**Related iShares ETF Tickers**
Global Mega Caps			X	OEF, IOO, HDV, DVY
Small Caps		X		IWM

Glossary:

Overweight = Potentially increase allocation

Underweight = Potentially decrease allocation

Neutral = Consider benchmark allocation

Long-Term = Longer than one year

Near-Term = 12 months or less

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Global Regions

Outlook

Global equities got off to a strong start in January, finishing the month up 5.8%, as investors focused on progress in Europe, new economic data showing the global economy may be in better shape than many thought and signs the European Central Bank and the Federal Reserve Board (Fed) appear ready to act to prop up the global economy. The global risk-on rally continued in early February amid strong global manufacturing numbers, better-than-expected US job data and more positive headlines out of Europe. In early February through February 8, global equities rose 3.4%. Looking forward, we continue to see certain opportunities within country and regional equities:

- In the developed world, we still expect certain smaller, developed countries — Canada, Australia, Singapore, Switzerland and Hong Kong (the CASSH countries) — to outperform other developed markets over the long term. In the near term, we especially like Hong Kong and Singapore, as well as Japan and certain countries in northern Europe.

- As many large, developed markets have yet to address their structural issues, emerging markets may arguably be a source of growth and stability in the long term. We expect emerging market equities will benefit from relatively faster local growth, particularly in the back half of the year. In addition, assuming Europe can avoid a full-blown crisis, continuing improvements in liquidity and sentiment would be supportive of emerging market stocks. As such, we continue to hold an overweight view of Latin America, which is our favorite region within the emerging markets, and we particularly like Brazil. We also like China and Taiwan, and favor Russia for more aggressive investors.

Global region near-term outlooks and the factors behind them*

Global Region Developed Markets	Valuations (P/B)	Growth	Profitability	Risk/ Sentiment	Our View: underweight	◀	neutral	▶	overweight	Related iShares ETF Tickers
Australia				+	○	○	●	○	○	EWA
Canada	—		—	+	○	●	○	○	○	EWC
France	+	—	—	—	○	●	○	○	○	EWQ
Germany	+	—		+	○	○	○	●	○	EWG
Hong Kong	+	—	+	+	○	○	○	○	●	EWH
Italy	+	—	—	—	●	○	○	○	○	EWI
Japan	+	+	—	—	○	○	○	●	○	EWJ
Netherlands					○	○	○	●	○	EWN
Singapore		—	—	+	○	○	○	●	○	EWS
Spain	+	—	—	—	●	○	○	○	○	EWP
Sweden	—	+		+	○	○	●	○	○	EWD
Switzerland	—	—	+	+	○	○	○	●	○	EWL
United Kingdom		—		+	○	○	●	○	○	EWU
United States	—	+	+	+	○	○	●	○	○	EUSA, IYY, IWV, ISI, IVV
Emerging Markets										
Brazil	+		+		○	○	○	○	●	EWZ
China	+				○	○	○	○	●	MCHI, ECNS
India		—	+	—	●	○	○	○	○	INDY
Indonesia	—	+	+	—	○	●	○	○	○	EIDO
Mexico	—	+			○	○	○	●	○	EWW
Russia	+	+	+	—	○	○	○	○	●	ERUS
South Africa	—	+	+	—	○	●	○	○	○	EZA
South Korea		—		—	●	○	○	○	○	EWY
Taiwan		—	+		○	○	○	○	●	EWT

* Please see appendix for an explanation of our factor methodology. **Norway is not included in this table due to its size.

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— unattractive + attractive ▭ neutral ● current month

Developed Markets

Europe: For the most part, European markets participated in the January and early February broad global rally as investors digested better-than-expected economic data and some progress in Europe, including a more aggressive stance by the European Central Bank toward stemming a banking sector crisis, developments in Greek debt restructuring talks, successful bond auctions and a new fiscal discipline treaty. Still, the risk of a European crisis remains uncomfortably high. Despite a second bailout agreement, longer-term risks associated with a Greek economic restructuring remain. In addition, Europe has yet to definitively address the fiscal and growth problems plaguing most of southern Europe. In terms of our outlooks:

- With the European crisis dragging on and Europe likely to experience at least a mild recession this year, stocks in the region have become very cheap. We still, however, continue to hold a neutral view of the region overall and to advocate avoiding large parts of Europe — particularly Spain and Italy. These markets are cheap for a reason.

- We do like some countries in the economically stable northern region of the continent. Much of northern Europe arguably represents a good value for long-term investors when you consider these countries' current valuations, relative growth prospects and perceived risk. As such, we continue to hold overweight views of Germany and the Netherlands, and we have initiated an overweight view of Norway and a neutral view of Sweden.

North America: In January and early February, US stocks generally performed in line with the broader global market. During the period, stocks rose after the Fed extended low interest rates and signaled its willingness to provide liquidity. Also supporting the rally, strong US economic data confirmed that the world's largest economy has so far withstood the effects of the European debt crisis. In terms of our outlooks:

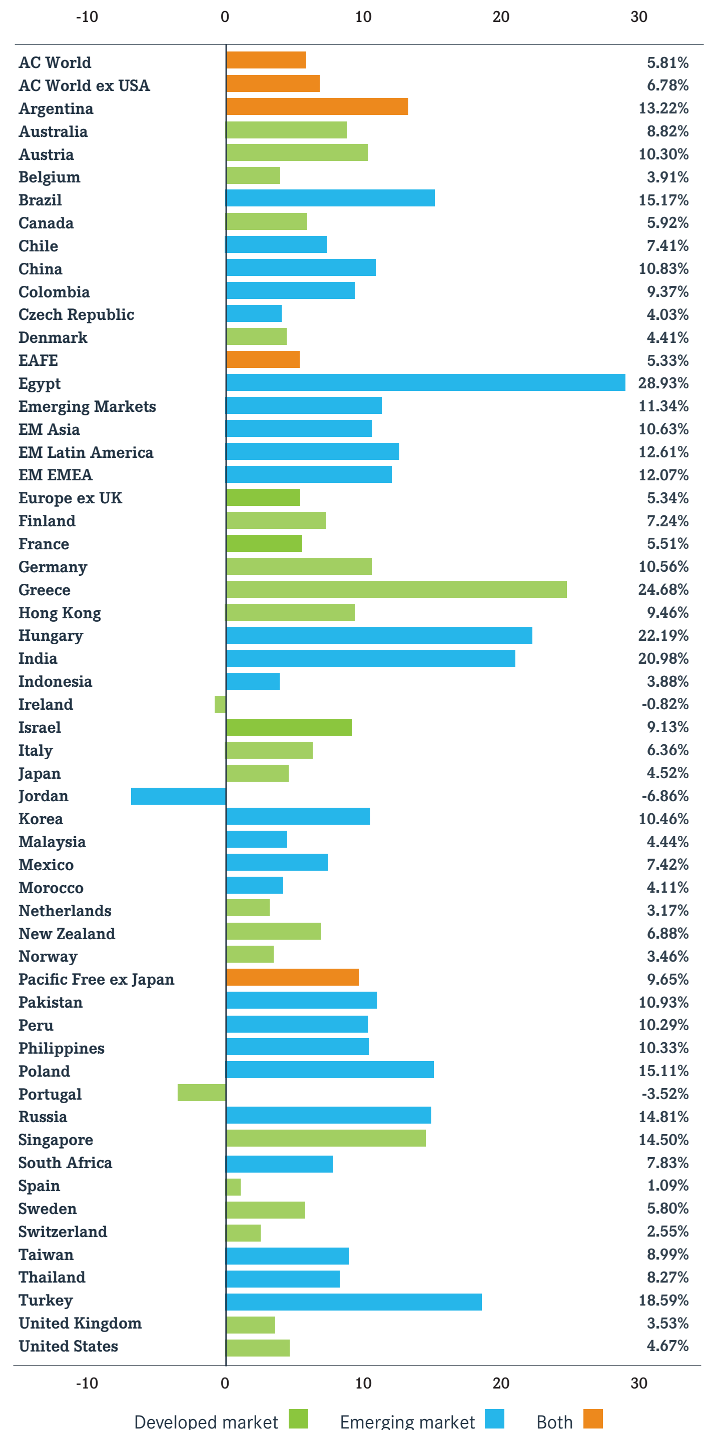
- We continue to hold a neutral view of US equities. While most measures continue to suggest that the United States will avoid another severe recession and that first quarter US GDP growth may surprise to the upside, US equities no longer look cheap on a relative valuation basis, having outperformed markets globally over the past 12 months.

- Congress' deal to extend the payroll tax holiday and unemployment benefits through the end of 2012 removes a near-term risk for the US economy. Failure to extend the benefits when they expire at the end of February would have raised the risk of another slowdown in the United States by undermining the already fragile US consumer.

Asia: Developed markets in Asia participated in the global equity rally in January and early February, performing generally in line with or outperforming the broader global market. In terms of our outlooks:

- Given rising concerns about the fragility of the recovery and how exposed the Australian economy is to global growth, we are maintaining our neutral near-term view of Australia. Still, Australia is not suffering from the same type of sovereign debt problems plaguing Europe, the United States and Japan and it's expected to continue to benefit from the secular increase in commodity demand from China.

MSCI Country and Region Index January 2012 Returns



Source: MSCI. As of 1/31/12. Index returns are for illustrative purposes only and do not represent actual iShares Fund performance. Index performance returns do not reflect any management fees, transaction costs or expenses. Indexes are unmanaged and one cannot invest directly in an index. Past performance does not guarantee future results.

- We continue to hold an overweight view of Japan. Japanese equities are trading at a good value relative to their own history. In addition, Japan is likely to be the fastest growing of the major economies thanks to reconstruction from last year's earthquake and the relative stability of the Japanese banking system. Finally, despite Japan's high government indebtedness, a lot of the debt is held domestically and credit default swap spread levels suggest that the market doesn't perceive Japan as a highly risky sovereign.

Emerging Markets

Latin America: Latin American markets generally outperformed the broader global market in January and early February as investors embraced risky assets amid improving sentiment. In terms of our outlooks:

- We continue to hold an overweight view of Latin America, which is our favorite region within emerging markets. The region should post good relative growth this year and has decent corporate sector profitability. Latin American countries are also perceived by CDS investors as less likely to default than emerging market countries on average, especially those in emerging Europe, the Middle East and Africa. These factors, however, do not seem to be fully reflected in the region's current valuations.

- Within the region, we continue to hold an overweight view of Brazil, our favorite location within Latin America. From a valuation standpoint, Brazil looks like a good value relative to other emerging market countries. In addition, we expect the Brazilian market to benefit disproportionately from decreasing inflation, as investors tend to be particularly sensitive to price volatility in countries with a history of hyperinflation. We also are initiating a neutral view of Mexico. While the country has decent growth prospects, and corporate sector profitability and CDS spreads are in line with emerging market and Latin American averages, it currently looks somewhat overvalued.

Asia: Emerging markets in Asia mostly outperformed or performed in line with the broader global economy in January and early February amid strong manufacturing data out of China, as well as efforts by central banks to support growth. In terms of our outlooks:

- We have upgraded our view of China to overweight from neutral. Chinese equities currently look undervalued compared to other emerging markets, especially given increasing evidence, including the recent PMI data, that growth in China seems to be holding up relatively well and China may be able to master a soft landing. In addition, inflation in China has been stabilizing in recent months.

- We have downgraded our view of South Korea to underweight from neutral. South Korea looks cheap relative to other emerging markets, but this is typical for the country, presumably thanks to the political uncertainty surrounding North Korea. While China's growth seems be holding up relatively well, South Korea has recently suffered a sharp drop in its future growth expectations.

- We have downgraded our view of India to underweight from neutral. After this month's rally, Indian equities currently look overvalued compared to other emerging markets. In addition, the country has below-average expectations of growth relative to long-term trends, downward trending profitability and still suffers from uncomfortably high inflation.

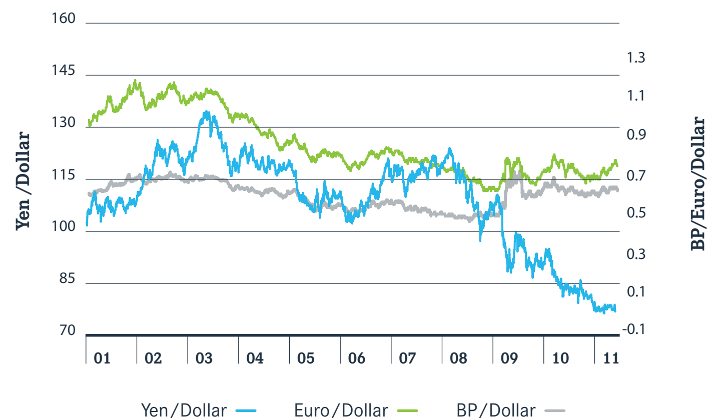
Europe, Middle East & Africa: Emerging markets in this region, known as EMEA, generally outperformed or performed in line with the broader market in January and early February. In general, we believe that investors should consider minimizing their exposure to emerging markets in this region as they generally have close economic ties to the euro zone. Among our outlooks:

US Dollar Performance versus Other Currencies

	JANUARY PERFORMANCE
Australian Dollar	–3.53%
Brazilian Real	–6.16%
Canadian Dollar	–1.51%
Swiss Franc	–1.66%
Euro	–0.83%
Pound Sterling	–1.52%
Indian Rupee	–6.89%
Japanese Yen	–0.90%
South Korean Won	–2.49%
Taiwan Dollar	–2.28%
Russian Ruble	–5.78%

Source: WM/Reuters Closing Spot Rates taken at 4:00PM London Time as of 1/31/2012.

Performance of US Dollar by Year



Source: MSCI, FactSet, BlackRock. As of 1/31/12.

Other Closed Calls	Underweight	Neutral	Overweight	Related iShares ETF Tickers
Chile		X		ECH
Turkey		X		TUR

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- We have an initiated an underweight view of South Africa, the largest country in the MSCI Emerging Markets EMEA Index. While South Africa's growth prospects seem relatively robust and it has above-average corporate sector profitability, the country appears expensive compared to other emerging market countries and, according to CDS spreads, it seems to be a riskier trade than many Asian and Latin American emerging markets. South Africa is also suffering from somewhat high inflation, a persistent current account deficit and a high unemployment rate.

Global Sectors

Outlook

Cyclical sectors greatly outperformed defensive sectors in January amid the broad global risk-on rally. Not only did defensive sectors look more expensive, but evidence that the global economy may be rebounding was supportive of cyclicals. In fact, the more cyclical the sector, the better it generally performed last month, while the more defensive the sector, the worse it performed.

- Looking forward, despite the recent rally, we expect markets to remain volatile in coming months. In addition, today's slow, but positive growth environment continues to be more supportive of lower-beta sectors and we believe that the largest stocks in most defensive sectors still appear to be a bargain. As such, we maintain a bias toward sectors that are more defensive, or have more mega-cap exposure. We especially like telecom, a defensive sector that we expect to hold up better than other sectors.

Global sector near-term outlooks and the factors behind them*

Global Sector	Valuations (P/B)	Profitability	Risk/ Sentiment	Our View: underweight ◀	neutral	▶ overweight	Related iShares ETF Tickers
Consumer Discretionary				●	○	○	IYC, RXI, AXDI
Consumer Staples	—	+		○	●	○	IYK, KXI, AXSL
Energy			—	○	○	●	IYE, IXC, AXEN
Financials	+	—	—	●	○	○	IYF, IXG, AXFN, EMFN, EUFN, FEFN
Healthcare	—	+	+	○	●	○	IYH, IXJ, AXHE
Industrials		—		○	●	○	IYJ, EXI, AXID
Information Technology	—	+	+	○	○	●	IYW, IXN, AXIT
Materials	+	+	—	○	●	○	IYM, MXI, AXMT
Telecommunications			+	○	○	●	IYZ, IXP, AXTE
Utilities	+	—		○	●	○	IDU, JXI, AXUT

* Please see appendix for an explanation of our factor methodology.

This chart focuses on global sector views only. For US sector views, please see the chart on pg. 2.

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— unattractive + attractive ▭ neutral ● current month

Defensive Sectors: Telecommunications was the worst performing defensive sector last month, followed by utilities and consumer staples.

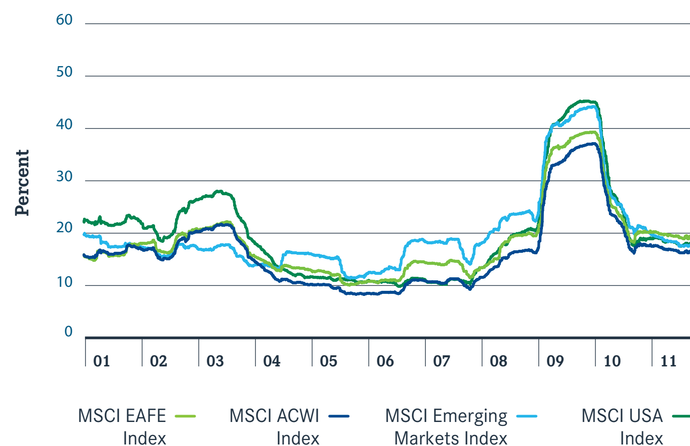
- We continue to hold an overweight view of telecom, which we believe currently looks cheap from a historical perspective, offers some income potential and is likely to hold up better than other sectors.
- While we continue to a hold a neutral view of the global utilities sector, we would advocate that most of the benchmark sector exposure come from outside of the United States as we hold an underweight near-term view of US utilities. The US stocks look overvalued and could be impacted by potential upcoming changes in US tax law.
- We continue to hold a neutral view of the healthcare sector as it stopped looking cheap to us in October.

Cyclical Sectors: Among cyclical sectors, the riskiest sectors — materials and financials — posted the strongest performance last month. Materials was the top performing cyclical sector, followed by financials and consumer discretionary.

- We continue to like the global energy sector because it looks inexpensive, offers an attractive yield and oil prices are likely to remain elevated.
- We still hold a positive view of the information technology sector, which we believe has become more defensive recently than it used to be. We also continue to believe that valuations in the sector remain compelling in the longer term and, if anything, the technology sector is recovering faster than the broader economy, a fact not yet reflected in its valuation.

- We continue to hold a negative view of the consumer discretionary sector. It looks expensive and, compared to most other sectors, has more companies with high debt and low quality ratings. In addition, the sector is dependent on consumer spending in an environment of high unemployment, and faces the risk of a fiscal drag in the future. We believe the sector, and the US retail sector in particular, is vulnerable to the economic slowdown. Unless real wage growth picks up in the near term, which is unlikely, consumption will have to fall. The investment implication of this is to stay underweight US retailers, which will likely suffer the most if consumption drops.
- We still hold a negative view of the financials sector in general. We believe it's likely to remain under pressure and its earnings expectations are too high given the risk posed by Europe and headwinds from increasing regulation. But we continue to hold a neutral view of European financials as the subsector has dramatically underperformed developed markets. We also continue to have a more positive view of US regional banks, which should benefit from a particularly wide yield curve.
- We continue to hold a neutral view of REITs. First, a broad index of US REITs is currently trading in line with its historical value compared to both the broader market and the US financial sector. Second, and probably more important for yield-hungry investors, the current spread between the yield on a broad REIT portfolio and the yield on the US 10-year Treasury suggests that while REITS are reasonably priced, they aren't particularly cheap.

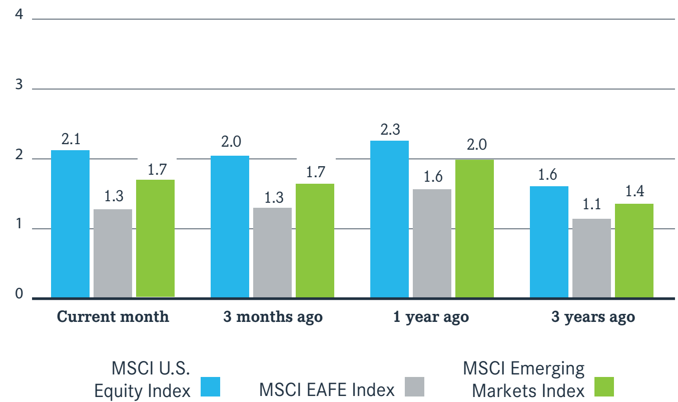
Volatility by Year



Source: MSCI. As of 1/31/12.

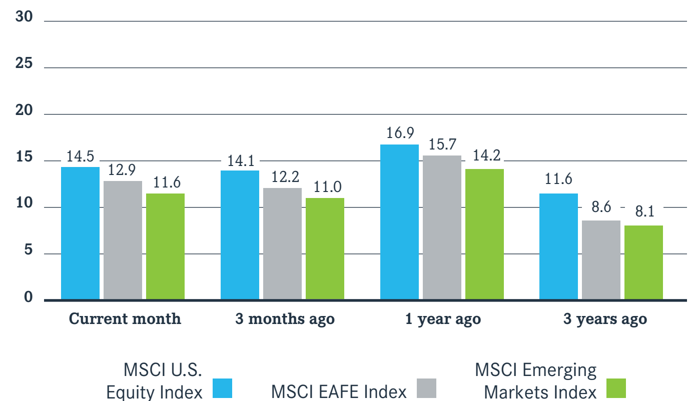
Valuations and Market Returns

Price/Book



Sources: MSCI, FactSet. As of 1/31/12.

Price/Earnings



Sources: MSCI, FactSet. As of 1/31/12.

Returns by MSCI Global Sectors*

	JANUARY RETURN (%)	YTD RETURN (%)
Energy	2.34%	2.34%
Materials	11.08%	11.08%
Industrials	7.31%	7.31%
Consumer Discretionary	7.40%	7.40%
Consumer Staples	-0.96%	-0.96%
Healthcare	2.28%	2.28%
Financials	8.69%	8.69%
Information Technology	7.00%	7.00%
Telecommunications Services	-2.13%	-2.13%
Utilities	-1.42%	-1.42%

Sources: MSCI, FactSet. As of 1/31/12.
*MSCI World

Fixed-Income Sectors

Outlook

During January's "risk-on" atmosphere, more traditionally risky fixed-income sectors rallied. The Barclays Capital US Credit Index posted a total return of about 2.1% for the month and outperformed similarly-dated US Treasuries by about 1.7%. The Barclays Capital US High Yield Index, meanwhile, returned around 3% and experienced excess returns of 2.6% versus duration-matched US Treasuries.

- Looking forward, yield levels should continue to be driven by continued Fed purchases and the risk-on/risk-off sentiment as dictated by the European sovereign debt crisis. This month we have downgraded non-US developed market bonds to underweight and maintained our other fixed-income outlooks.

Fixed-income sector near-term outlooks

Fixed-Income Sector	Underweight	Neutral	Overweight	Related iShares ETF Tickers
Emerging Markets		X		EMB
High-Yield Credit		X		HYG
Investment Grade Credit			X	LQD, FLOT
Mortgages			X	MBB
Municipals			X	SUB, MUB
Non-US Developed Markets	X			ISHG, IGOV
TIPS/Global Inflation-Linked		X		STIP, TIP, GTIP, ITIP
US Treasuries		X		SHY, IEI, IEF, TLH, TLT

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US Government: The Federal Open Market Committee meeting on January 25 was the main event last month in the Treasury sector. The Fed adopted a very dovish stance, extending its zero interest rate policy until late 2014. The immediate reaction came from 5-year notes, which closed the month at an all-time low yield of 70.5 basis points. The 5-year/30-year part of the curve steepened about 25 basis points for the month. TIPS, meanwhile, now have negative real yields out to 2025 and 5-year, 10-year, and 30-year real yields ended the month at -131, -30, and 59 basis points, respectively.

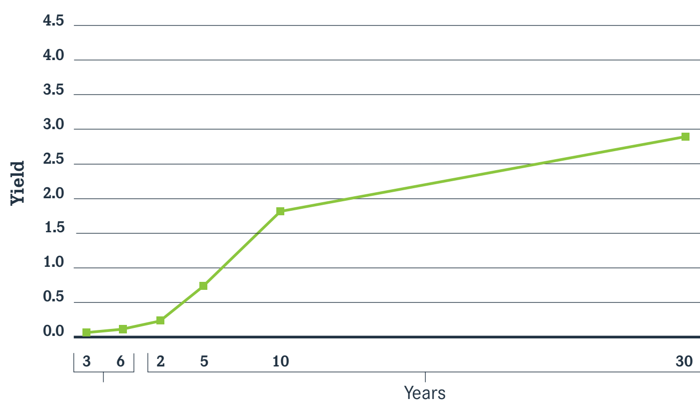
- Our near-term view of Treasuries is neutral, but we hold a negative longer-term view. With 10-year Treasury yields hovering around 2%, investors in 10-year notes are accepting a flat to negative real return. In addition to a loss of purchasing power, they are also implicitly accepting more risk. Still, we expect Treasuries to continue to be supported in the near term due to concerns about euro zone stability and questions about the strength of the US economic recovery. Looking forward, we continue to like both municipals and corporate bonds better than US Treasuries. They look cheap and provide a rich yield relative to US Treasuries.

- We maintain a neutral view of Treasury Inflation Protected Securities (TIPS) in the near term. While there is some risk of inflation down the road, inflation is unlikely to be a problem for at least a couple of years. TIPS implied breakeven inflation rates are hovering around 2%. Although this has been an attractive entry point at times in the past, we are cautious given the anemic recovery and the low level of real yields. In the longer term, however, we hold a negative view of TIPS as the real yield is near zero.

US Credit: In January, investment grade credit posted its strongest month since October. The Barclays Capital US Corporate Index tightened by 28 basis points to an option-adjusted spread of 206 basis points, which is just 5 basis points shy of recent tights. High yield, meanwhile, started off the year with a solid month of performance as investors looked to put cash to work. The Barclays Capital US High Yield Index gained around 3% in January. Excess returns for the month were 2.6%.

- Although we are wary of increased credit concerns, we continue to hold an overweight view of investment-grade credit. Corporate America's balance sheet looks exceptionally strong, corporate bonds currently offer a rich yield relative to US Treasuries and a reasonably steep spread curve makes longer-duration investment grade attractive.

US Treasury Yield Curve



Sources: Bloomberg, BlackRock. As of 1/31/12.

- We remain neutral on high yield as we believe these bonds are currently close to fair value and the extra yield they offer comes with extra risk. As we expect more market volatility, we advocate a modest reallocation out of high-yield fixed income toward investment-grade bonds, an asset class that currently appears to be a better relative value.

Municipals: The strong technicals that largely drove municipal performance in 2011 have carried into 2012. January tax-exempt performance was the best in more than a decade, returning 2.3% on the month. The Barclays Capital US Taxable Municipals Index experienced similar performance, returning 4%, and outperformed duration-weighted Treasuries by 371 basis points. January performance can be attributed to a continued imbalance between limited supply and renewed demand from retail and institutional investors, as well as a broad rally in rates.

- We are maintaining our overweight view of municipals, which we believe can continue to outperform the broader fixed-income segment this year. Despite municipals' 2011 rally, the spread between municipal bonds and Treasuries is now the widest since 2009 and current spreads offer investors an opportunity for a significant after-tax pickup in income. Municipal finances also continue to improve and it doesn't look likely that municipals will lose their tax-exempt status anytime soon. Still, we would advocate avoiding lower-quality issues.

International: Emerging market assets – including in fixed income – saw a widespread rally in January as macro headwinds seemingly eased. Local emerging market fixed income indices outperformed last month, with the J.P. Morgan GBI-EM index gaining 7.4%. External debt extended December gains, with the J.P. Morgan EMBIG index of external debt up 1.6%. The European sovereign market, meanwhile, continued to trade with fairly positive sentiment following the better-than-expected economic data in the United States and very well received local auctions. The large supply of covered and supranational issues also found ample demand. Elsewhere, as markets globally continued to react positively to the developments emanating from Europe, Japanese yields continued to grind tighter.

Fixed Income Index Returns by Sector

	JANUARY RETURN (%)	YTD RETURN (%)
Barclays Capital US Aggregate	0.88%	0.88%
Barclays Capital US Treasury	0.42%	0.42%
Barclays Capital US TIPS	2.29%	2.29%
Barclays Capital US Corporate	2.21%	2.21%
Barclays Capital US Corporate High-Yield	3.04%	3.04%
Barclays Capital Mortgages	0.41%	0.41%
S&P Municipal Bond	2.55%	2.55%
JP Morgan Emerging Markets Bond	1.64%	1.64%

Sources: BlackRock, Barclays Capital, S&P and JP Morgan. As of 1/31/12.

Fixed-Income Option-Adjusted Spreads

SECTOR	OAS
High Yield	6.43
Investment Grade	2.06
Mortgages	0.73

OAS = Option-Adjusted Spread, the amount a bond yields more than a similar duration Treasury when accounting for the optionality embedded in the bond.
Source: Bloomberg. As of 1/31/2012

- While we maintain a neutral view on emerging markets debt, our view leans toward the positive as spreads remain near the widest levels we have seen in the past year. Recently, we have seen increased spread and currency volatility due to elevated geopolitical risk, though the prospect of heightened inflationary pressures has lessened as emerging markets growth has slowed. In addition, emerging markets debt is supported by the fact that the world's sovereign debt problems are centered in developed markets. Still, these are generally new debt markets with corporate debt and corporate governance issues. In addition, widespread risk aversion would hurt emerging markets debt. In light of these risks, investors – particularly risk-averse ones – should be cautious, and keep their allocation to this asset class modest.

- We have downgraded non-US developed markets to underweight from neutral. The sector has performed very well so far this year, but the situation in Europe is highly tenuous and volatile and could deteriorate further on short notice. At current market levels, we do not feel that investors are being adequately compensated for the risk that they are taking on.

Securitized: With the risk-on theme prevailing across global capital markets, agency mortgages outperformed Treasury hedges by 13 basis points in January. While the overall sector outperformed, performance diverged across the coupon stack and between various tenors and agency programs. Concerns surrounding further potential government refinancing initiatives once again weighed on the top of the coupon stack, whereas current coupon mortgages tightened sharply on the back of positive demand and supply dynamics.

- We continue to hold an overweight view of mortgages. Government-sponsored programs have largely been priced into the market and thus far have had a smaller impact than anticipated.

Contributors

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Appendix:

The analysis behind our views:
Our country and sector views are based on a systematic analysis of the extent to which macroeconomic factors have been priced in at the country and sector level.

In coming up with our country views, we use price-to-book (P/B) ratio as a measure of a country's value. This ratio captures how the market prices a given country relative to the assets it has available for production. The higher the ratio, the more favorably the market views the country relative to its own history and to other countries.

The price the market is willing to pay for the assets of a country is positively related to its expected future growth and corporate sector profitability, and negatively related to the riskiness of its assets. We use factors such as leading economic indicators and retail sales growth as proxies for expected future growth. We use return on assets (ROA) as a proxy for future profitability and we use credit default swap spreads as a measure of risk and sentiment. In addition, we consider factors such as commodity prices that affect importer and exporter countries in opposite ways.

In determining the sensitivity of a country's valuations to these macroeconomic factors, we look at trends both over time and across countries. We are overweight (underweight) countries where market valuations are low (high) relative to what we would expect, with the expectation that the economic factors will be fully incorporated into prices in the future. We use a similar process for coming up with our sector views.

Factor table methodology:
Here's an explanation of the methodology of our country factor table: Valuations: In determining whether a country looks cheap or expensive, we focus on price-to-book ratio (P/B), both over time and across countries. If a country has a low P/B relative to both its own trading history and to other countries, we assign it a "+"; if it has a high P/B, we assign it a "–." We mainly compare developed market countries to other developed market countries and emerging market countries to other emerging market countries. We compare countries that benefit or suffer from their own specific issues, e.g., corporate governance problems in Russia, to their own trading histories.

Growth prospects: We focus on leading economic indicators that are constructed to predict a country's future economic growth relative to the country's own trend level growth. We assign a "+" to countries that are growing faster than their past trends and a "–" to countries that are growing more slowly.

Corporate sector profitability: We focus on return on assets (ROA) and on cross-country comparisons, although we also take into account developments in a country's ROA over time. A country with a highly profitable corporate sector is assigned a "+"; one with low profitability is assigned a "–."

Risk / sentiment: We focus on sovereign credit default swap (CDS) spreads, which measure investor perception of the likelihood that a given country will default on its obligations. We mainly compare CDS spreads across countries, although we also take into account trends in a country's CDS spreads over time. A country that is perceived as relatively safe is assigned a "+"; a risky country is assigned a "–."

While the valuation, growth, profitability and risk / sentiment factor readings are discrete, we use continuous measures in our investment process. In addition, the factors are not equally important in driving returns at a given point in time. As a result, when it comes to formulating our final views, the various factor readings are not additive. For example, a "+" value factor, indicating that a country looks cheap, may overshadow negative readings in other factors, leading us to still like the country.

We use a similar methodology in coming up with the readings in our sector factor table. We focus on a mix of cross-sectional and time-series comparisons of valuations (P/B), profitability (ROA) and risk / sentiment (sector spreads). In addition, we consider the global growth outlook for cyclical and defensive sectors.

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