



333 Bush Street  
San Francisco, CA 94104  
(415) 263-5400  
www.statefundca.com

Date: February 6, 2015

**TO: MEMBERS, INVESTMENT COMMITTEE**

<b>I. AGENDA ITEM # AND TITLE :</b>	Open Agenda Item 4 - Economic and Investment Outlook
<b>II. NAME AND PROGRAM:</b>	Treasury and Investments
<b>III. ACTIVITY:</b>	<input checked="" type="checkbox"/> Informational <input type="checkbox"/> Request for Direction <input type="checkbox"/> Action Proposed <input type="checkbox"/> Exploratory
<b>IV. JUSTIFICATION:</b>	<input checked="" type="checkbox"/> Standard/Required Item <input type="checkbox"/> Board Request – New Item <input type="checkbox"/> New Topic from Staff

**V. EXECUTIVE SUMMARY:**

The attached slides highlight BlackRock’s Economic Outlook and provide a list of the “Five Things To Know and the Five Things To do in 2015”.

**BLACKROCK®**

# **2015 Outlook: What to Know, What to Do**

For professional clients / qualified investors only

State Compensation Insurance Fund  
Investment Committee – February 19, 2015  
Open Agenda Item #4 – Economic and Investment Outlook

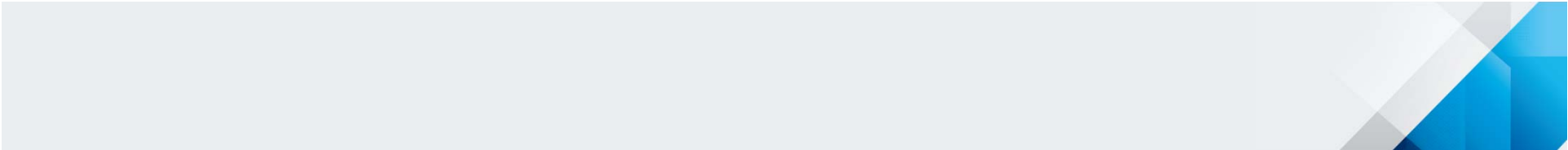
## The BlackRock List

### 5 Things to Know

- 1 Central Banks Diverge: Dollar Likely Higher
- 2 Long-Term Rates: Still Low for Long
- 3 U.S. Economy Leads the Pack
- 4 Inflation: Not on the Horizon—Yet
- 5 A Bumpier Road Ahead for Stocks

### 5 Things to Do

- 1 Prefer Stocks Over Bonds, But Be Choosy
- 2 'Stock Up' Outside the U.S., Too
- 3 Watch Your Step in Bonds
- 4 Resist the Urge to Exit
- 5 Seek Growth in a Low-Growth World



*Investing involves risk, including possible loss of principal. Bonds and bond funds will decrease in value as interest rates rise and are subject to credit risk, which refers to the possibility that the debt issuers may not be able to make principal and interest payments or may have their debt downgraded by ratings agencies. High yield securities may be more volatile, be subject to greater levels of credit or default risk, and may be less liquid and more difficult to sell at an advantageous time or price to value than higher-rated securities of similar maturity. In addition to the normal risks associated with investing, international investments may involve risk of capital loss from unfavorable fluctuation in currency values, from differences in generally accepted accounting principles or from economic or political instability in other nations. Emerging markets involve heightened risks related to the same factors as well as increased volatility and lower trading volume. Investing in alternative strategies such as a long/short strategy, presents the opportunity for losses which exceed the principal amount invested.*

The opinions expressed are as of January 2015 and may change as subsequent conditions vary. The information and opinions contained in this material are derived from proprietary and non-proprietary sources deemed by BlackRock to be reliable, are not necessarily all inclusive and are not guaranteed as to accuracy. There is no guarantee that any forecasts made will come to pass. Any investments named within this material may not necessarily be held in any accounts managed by BlackRock. Reliance upon information in this material is at the sole discretion of the reader. Past performance is no guarantee of future results.

©2015 BlackRock, Inc. All Rights Reserved. **BLACKROCK** is a registered trademark of BlackRock, Inc. or its subsidiaries in the United States and elsewhere. All other trademarks are those of their respective owners. USR-5163

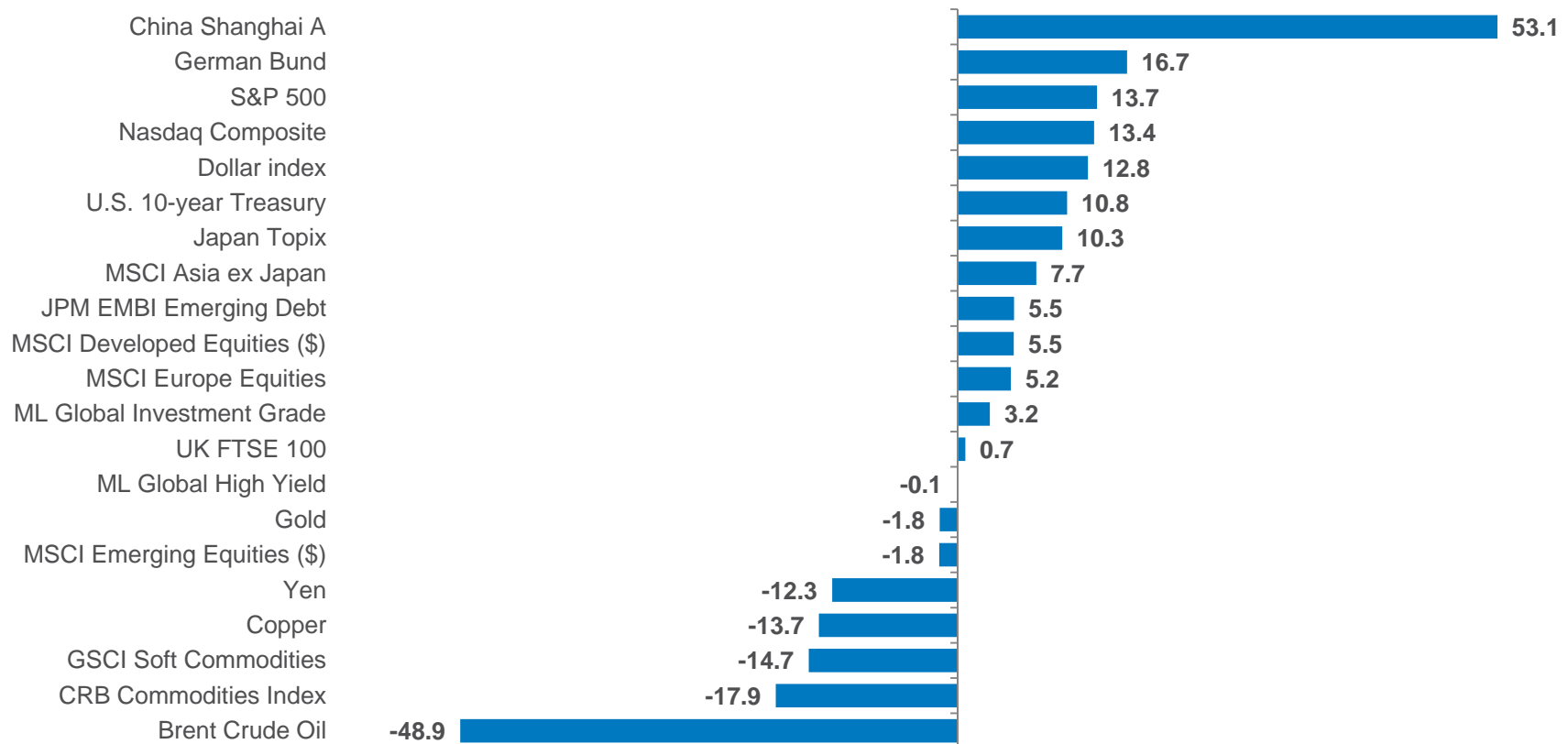


# APPENDIX

## Asset Class Performance: 2014

Easy monetary policy has suppressed volatility and pushed up asset prices across the board.  
Many assets look cheap only because everything else is so expensive.

Asset Class Performance in 2014 (% Return)



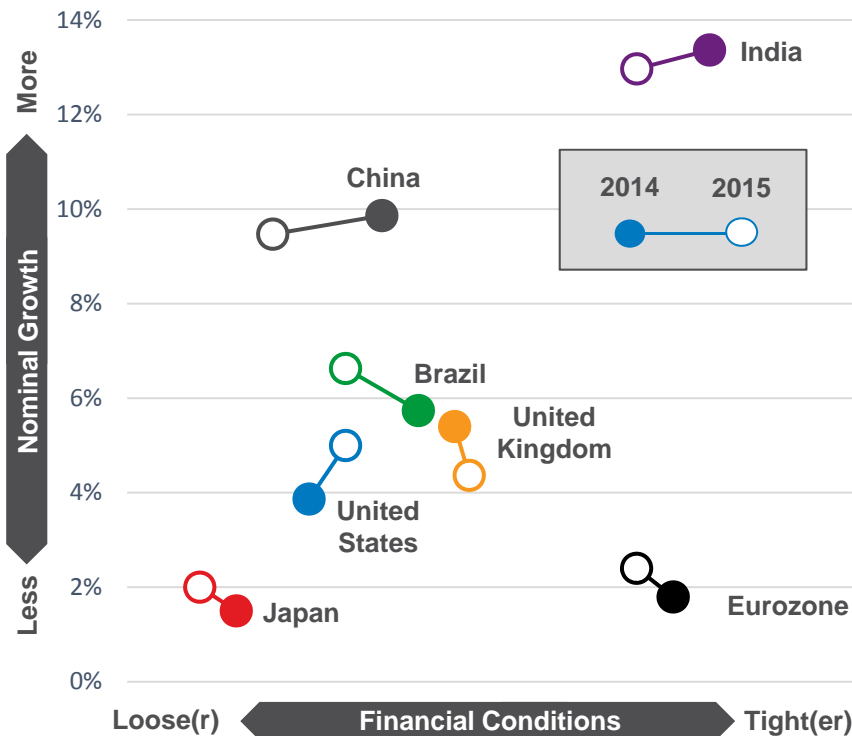
Sources: Thomson Reuters Datastream, BlackRock Investment Institute, December 31, 2014. Notes: Total return in local currency except currencies, gold and copper, which are spot returns. Government bonds are 10-year benchmark issues,

# 1

## Central Banks Diverge: Dollar Likely Higher

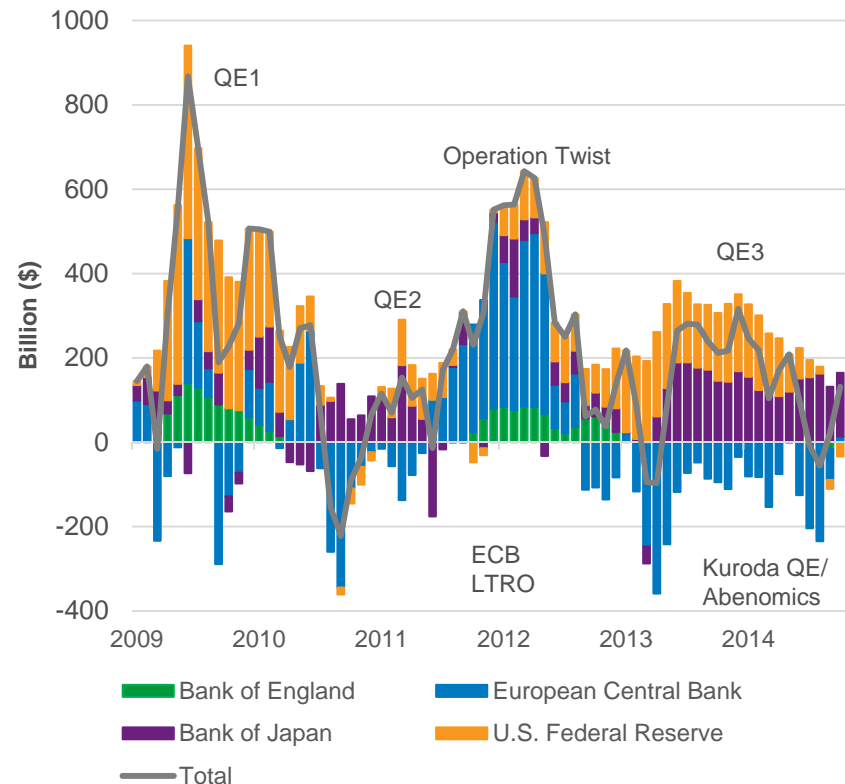
**We expect tightening financial conditions in the U.S. and U.K.  
Lackluster growth and low inflation expectations support looser monetary policy elsewhere.**

**GDP Growth & Financial Conditions in Selected Economies**



Sources: BlackRock Investment Institute and IMF, October 2014. Notes: Nominal growth forecasts are from the IMF World Economic Outlook. Global GDP weights of economies are based on purchasing power parity, rather than on current exchange rates. Financial conditions are BlackRock's estimates of monetary policy, fiscal policy, exchange rates and credit conditions.

**Central Bank Liquidity Injections**



Sources: BlackRock Investment Institute and Citi Research, November 2014. Notes: Liquidity injections are net securities purchases plus long-term repos. Data are rolling three-month averages. LTRO is long-term repurchase operation, the ECB program to provide financing to eurozone banks.

For professional clients / qualified investors only

1

# Central Banks Diverge: Dollar Likely Higher

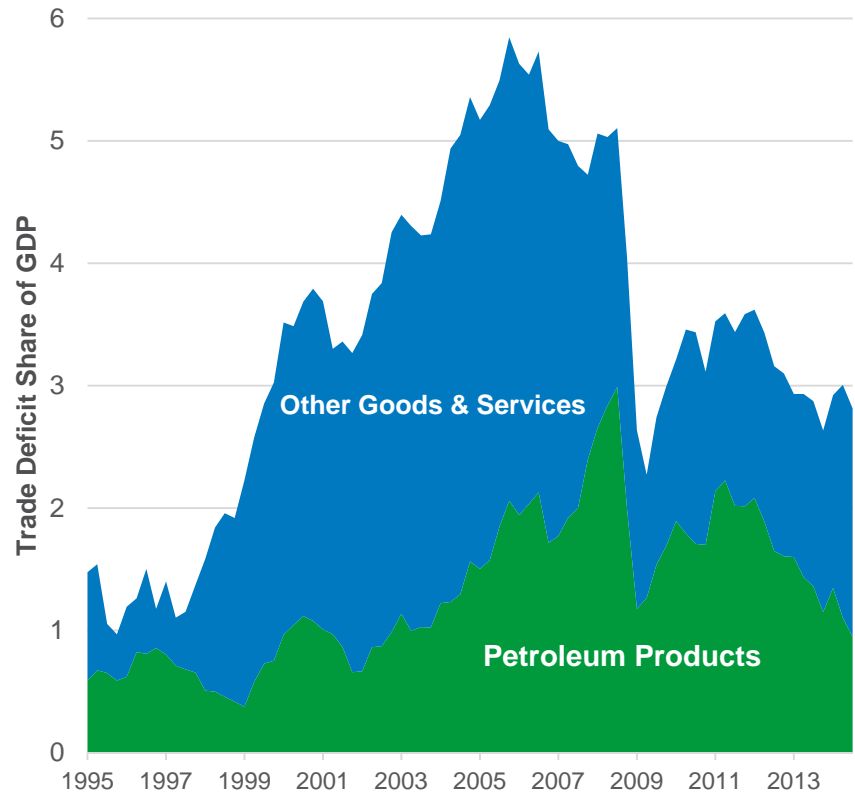
The prospect of U.S. rate hikes and a shrinking trade deficit support a stronger dollar, which puts downward pressure on commodities and inflation.

Trade-Weighted Major Currency U.S. Dollar Index



Source: Bloomberg, 12/31/14. Note: The shaded areas show the periods of a rising U.S. dollar.

U.S. Trade Deficit



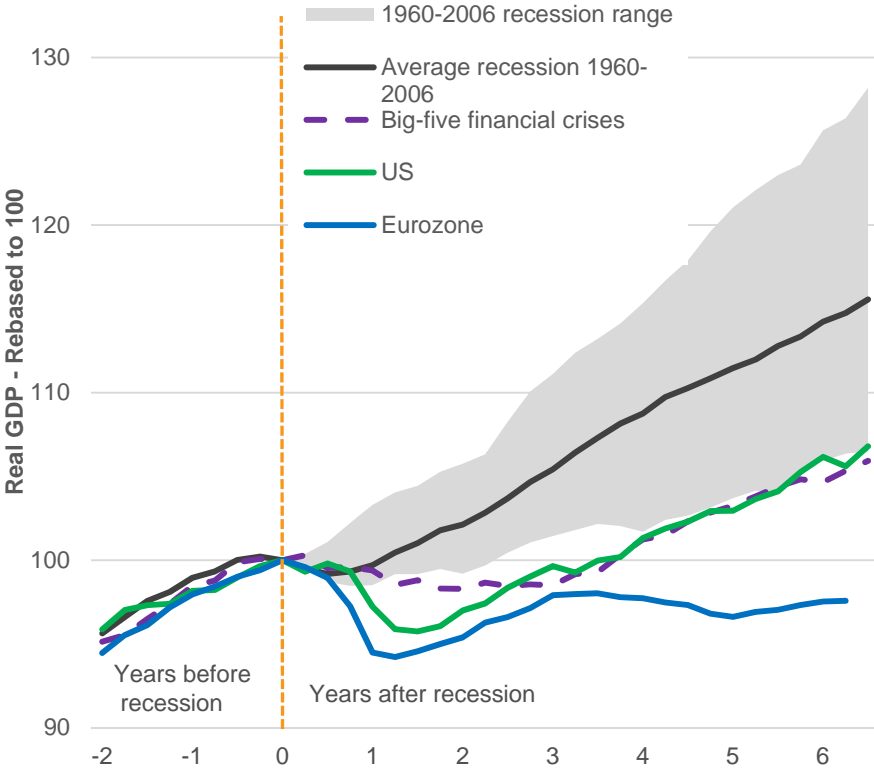
Sources: BlackRock Investment Institute, U.S. Census Bureau and U.S. Bureau of Economic Analysis. November 2014.



## 2 Long-Term Rates: Still Low for Long

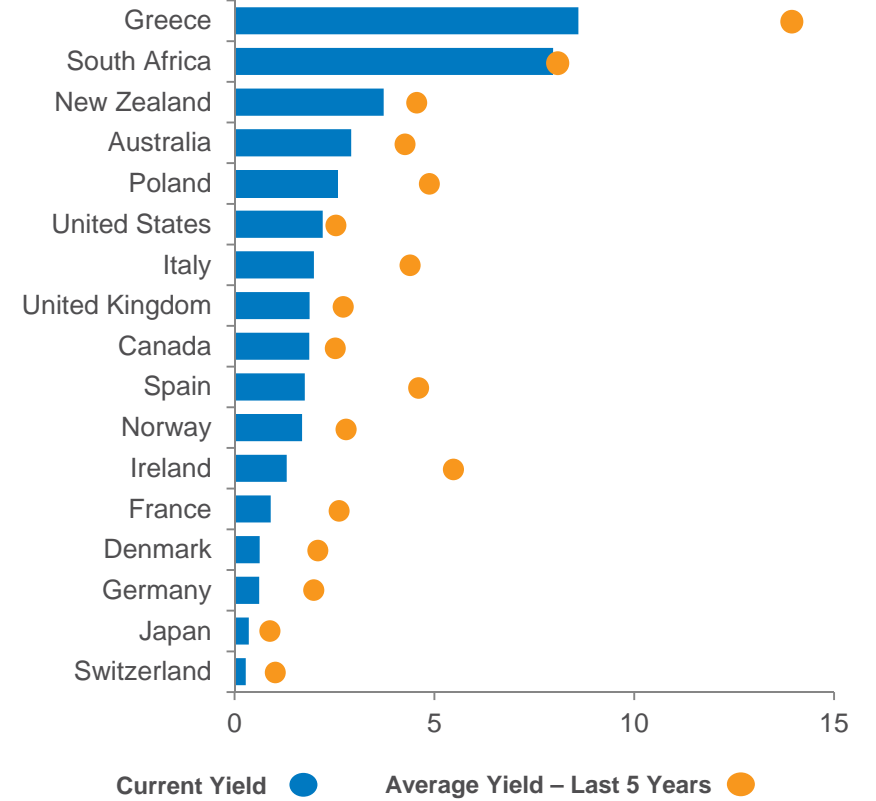
Long-term interest rates may inch up this year, but expect them to be low for some time to come.

Current vs. Past Recoveries from Recession



Sources: BlackRock Investment Institute. Thomson Reuters Datastream and IMF November 2014. Notes: Real GDP is rebased to 100. The big five financial crises are Spain (1977, Norway (1987), Finland (1991), Sweden (1991) and Japan (1992). The average recession (two straight quarters of contraction) is based on G20 countries since 1960. The recession range is based on an average of the three best and worst recessions.

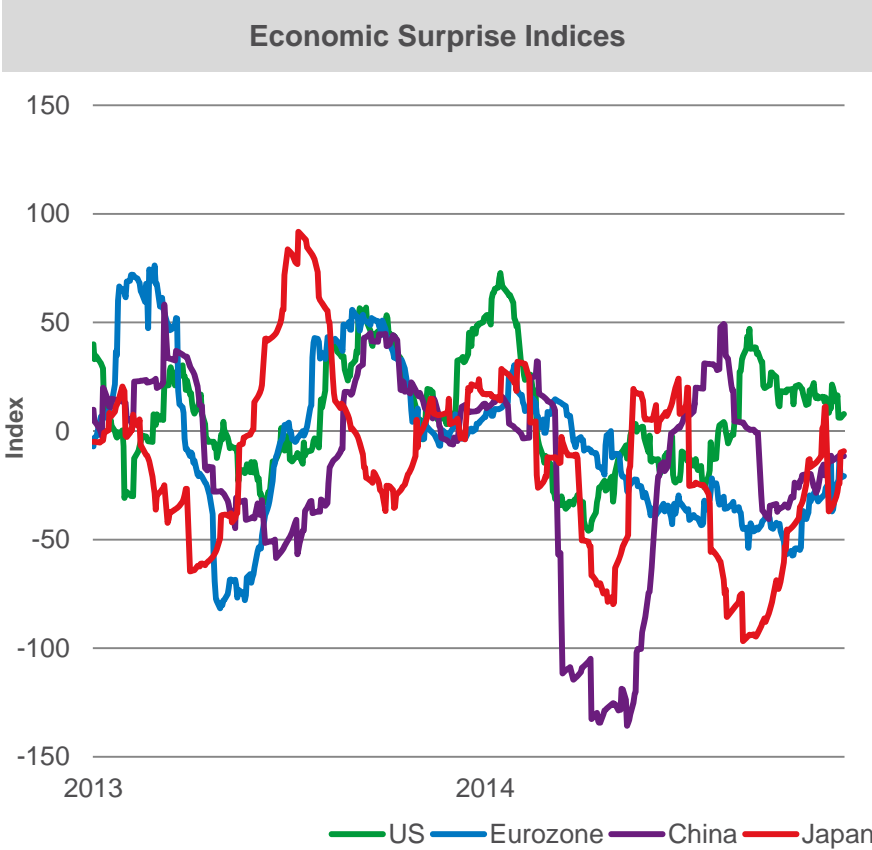
Global 10-Year Government Bond Yields (%)



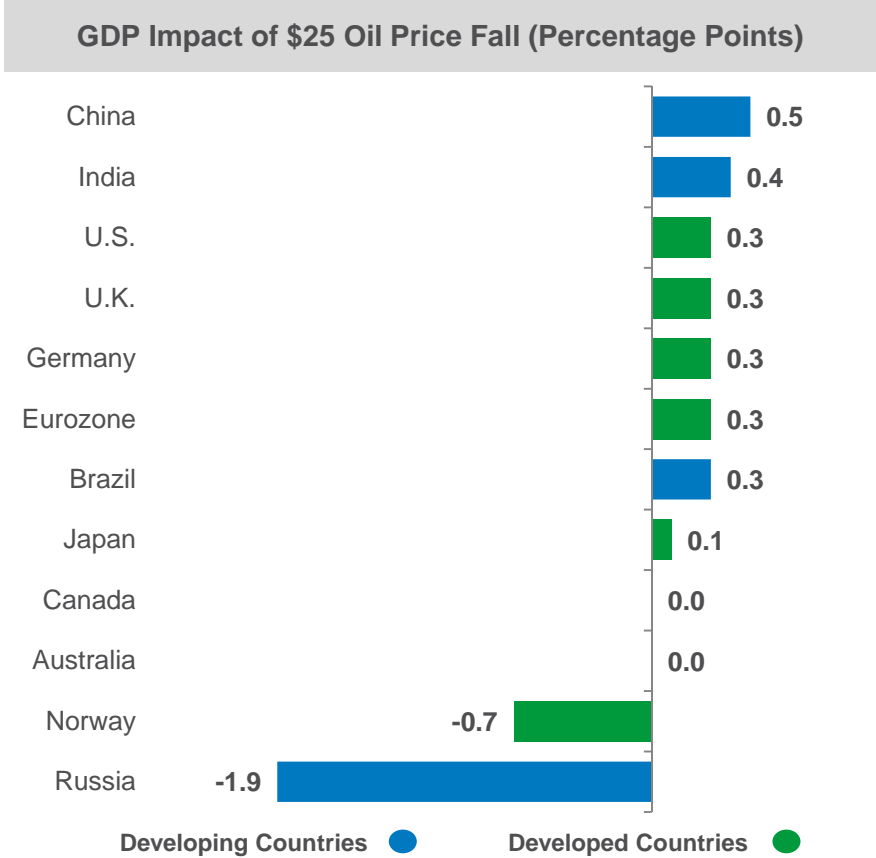
Sources: Thomson Reuters Datastream, BlackRock Investment Institute, December 2014.

### 3 U.S. Economy Leads the Pack

**We believe the U.S. economy will show gross domestic product (GDP) growth in the area of 2.5% to 3% in 2015. The biggest challenge facing the U.S. economy is what transpires overseas.**



Sources: Thomson Reuters Datastream, Citigroup, BlackRock Investment Institute, December 2014. Notes: Surprise tracks actual economic data relative to consensus estimates of market economists. A number above zero shows data on average beating expectations.



Source: BlackRock Investment Institute and UBS, November 2014. Note: The chart shows the simulated impact on GDP after one year from a permanent \$25 decline in the price of oil, as estimated by UBS in an econometric model that takes into account linkages between existing economies, GDP and inflation.

# 4

## Inflation: Not on the Horizon—Yet

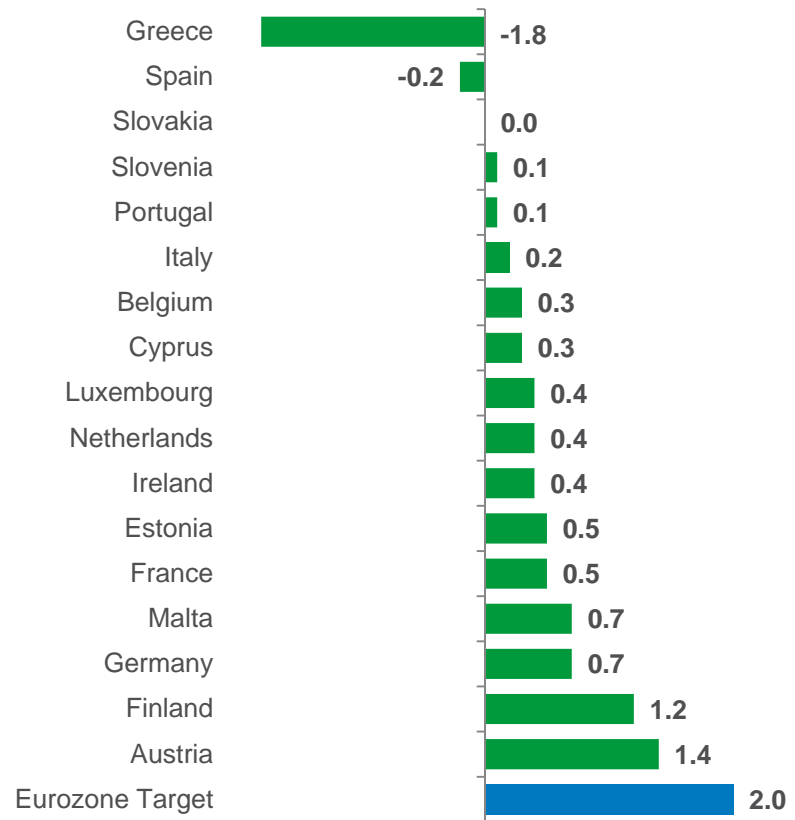
**Inflation remains low in the U.S., but wage growth warrants watching. Elsewhere in the world, particularly in Europe, deflation is the greater concern.**

**U.S. Wage Growth and Unemployment**



Sources: BlackRock Investment Institute and U.S. Bureau of Labor Statistics, November 2014. Note: The short-term unemployment rate is defined as those unemployed less than six months as a share of the total labor force. Wages are represented by the Employment Cost Index, which tracks the total cost of U.S. labor including wages, benefits and bonuses.

**Eurozone Inflation Rates vs. Target**



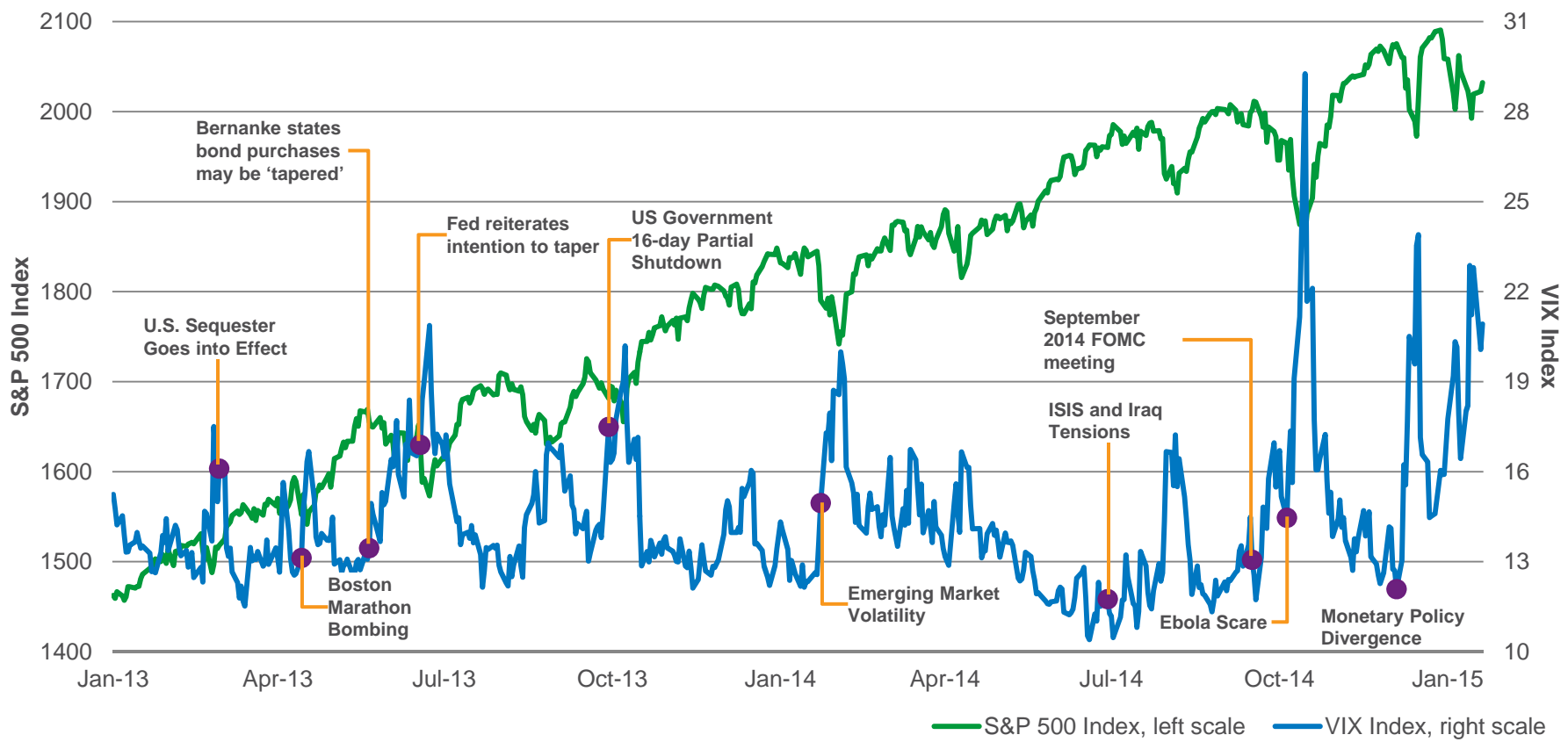
Sources: BlackRock Investment Institute and Eurostat, November 2014.

5

# A Bumpier Road Ahead for Stocks

With the Fed ready to change tack, the economy struggling in Europe and geopolitical tensions in places like Ukraine, we expect higher volatility in 2015.

Implied Volatility in the Equity Markets



Source: Bloomberg, BlackRock, January 2015. Note: The Chicago Board Options Exchange Volatility (VIX) Index shows the market's expectation of 30-day volatility in the S&P 500.

5

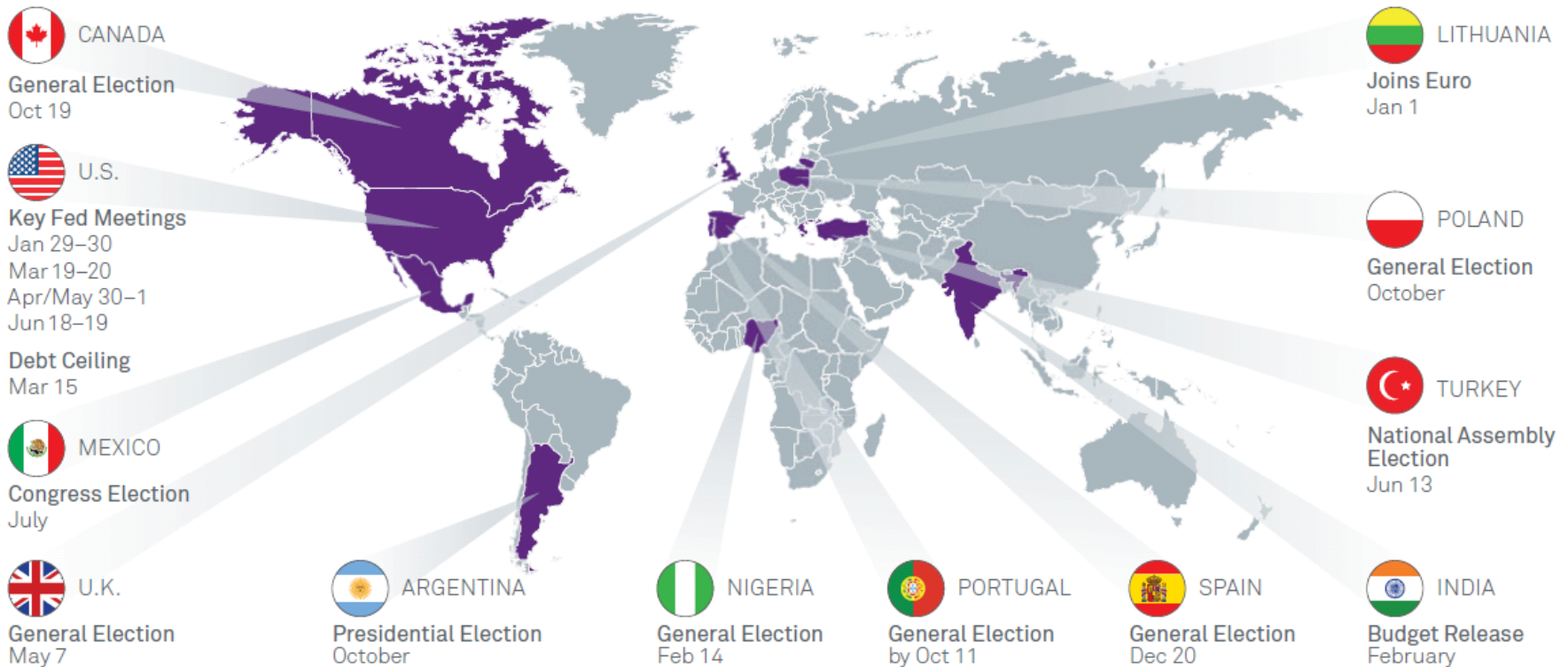
# A Bumpier Road Ahead for Stocks

With the Fed ready to change tack, the economy struggling in Europe and geopolitical tensions in places like Ukraine, we expect higher volatility in 2015.

## Events to Watch in 2015

### MARK YOUR CALENDAR

Events to Watch in 2015



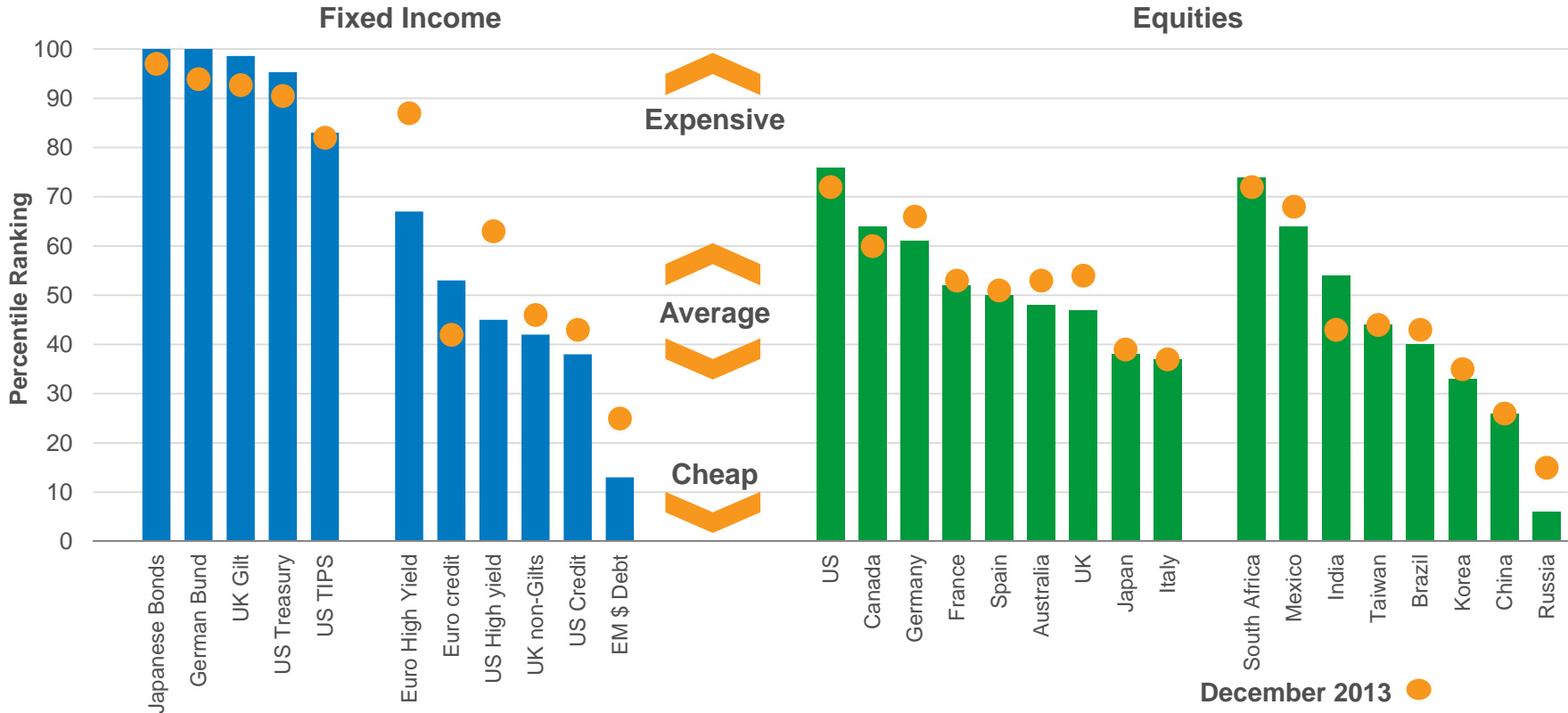
Source: BlackRock Investment Institute, November 2014

# 1

## Prefer Stocks Over Bonds, But Be Choosy

Valuations range from sky-high (government bonds) to average (most credit and developed equities). We continue to prefer stocks over bonds and cash, even with volatility expected to rise.

Valuations by Percentile vs. Historical Norms



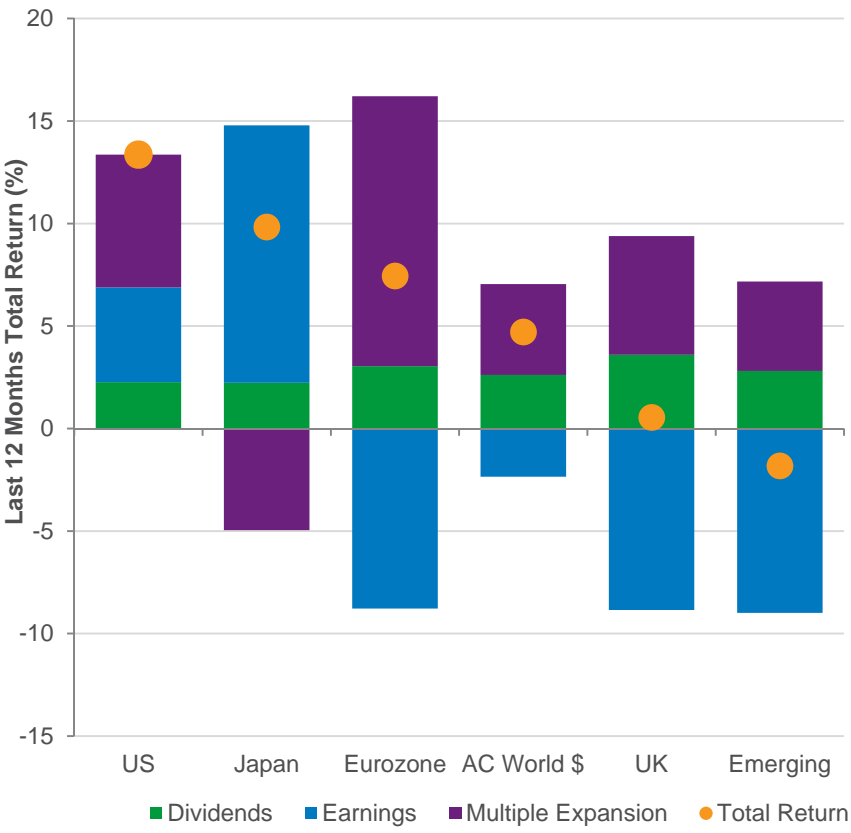
Source: BlackRock Investment Institute (BII) and Thomson Reuters as of 12/31/14. Valuation percentiles are based on an aggregation of standard valuation measures versus their long-term history. Government Bonds are 10-year benchmark issues. Equity valuations are average percentile ranks versus available history of earnings yield, cyclically adjusted earnings yield, trend real earnings, dividend yield, price to book, price to cash flow and forward 12-month earnings yield

# 1

## Prefer Stocks Over Bonds, But Be Choosy

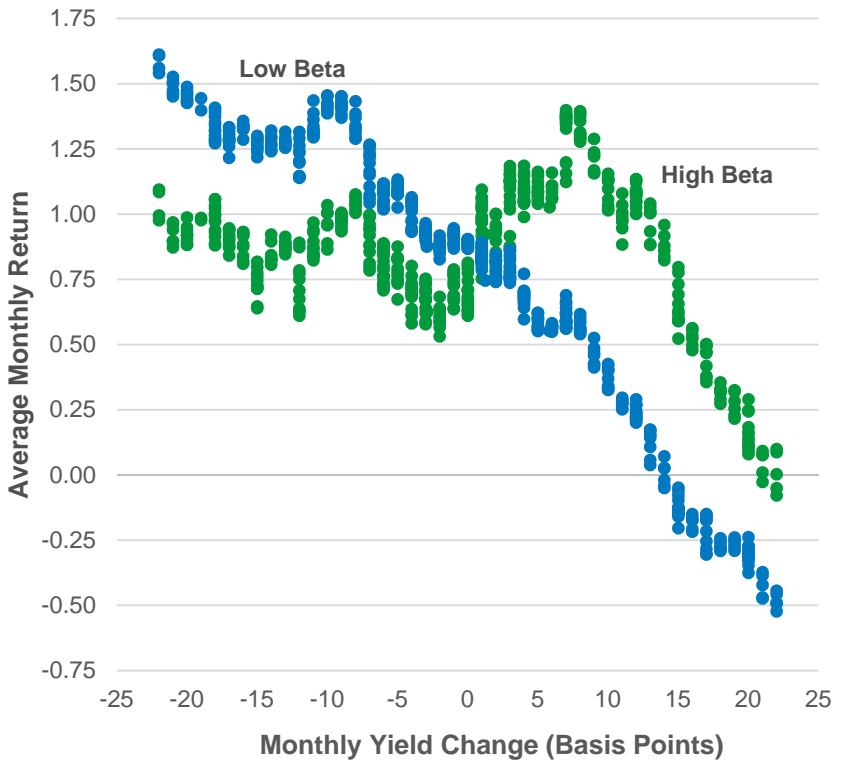
Greater value can be found in sectors positioned to benefit from economic growth, such as technology and large, integrated oil companies.

Equity Market Total Return by Source of Return



Sources: BlackRock Investment Institute, December 2014.

U.S. High- and Low-Beta Stocks vs. Yield Changes



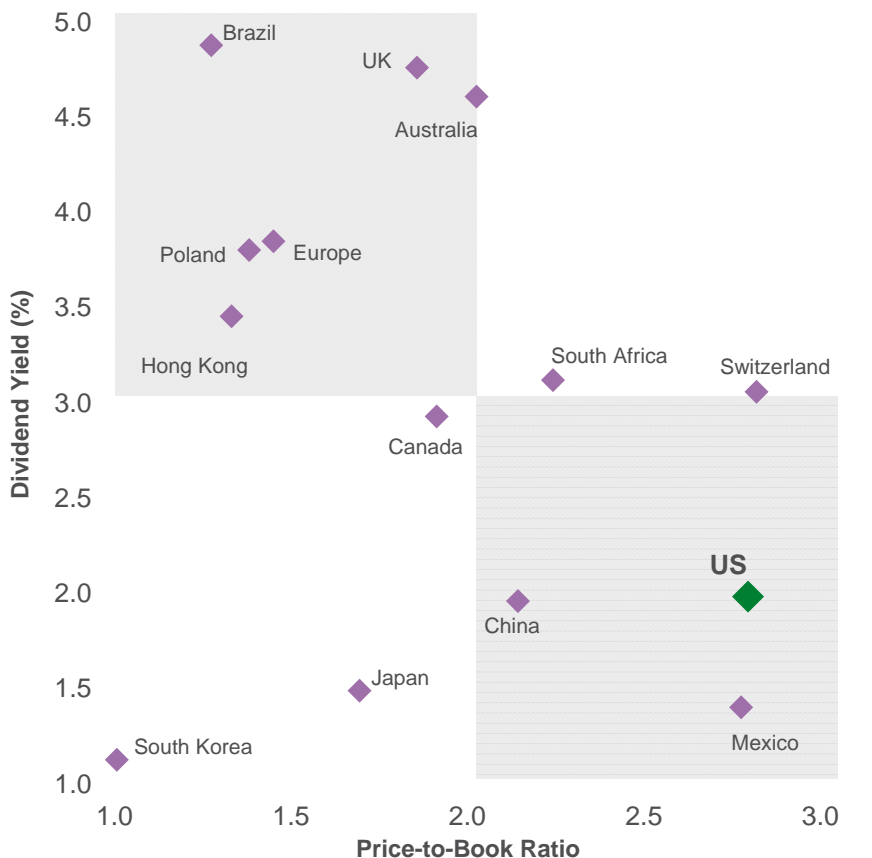
Sources: BlackRock Investment Institute, November 2014. Note: The analysis plots the monthly performance of two portfolios of U.S. stocks (one high-beta and one low-beta) against monthly yield changes in 10-year treasuries. The average monthly returns are excess returns above the risk-free rate and are based on a rolling window of 30% of the available history. Historical returns are not indicative of future performance.

# 2

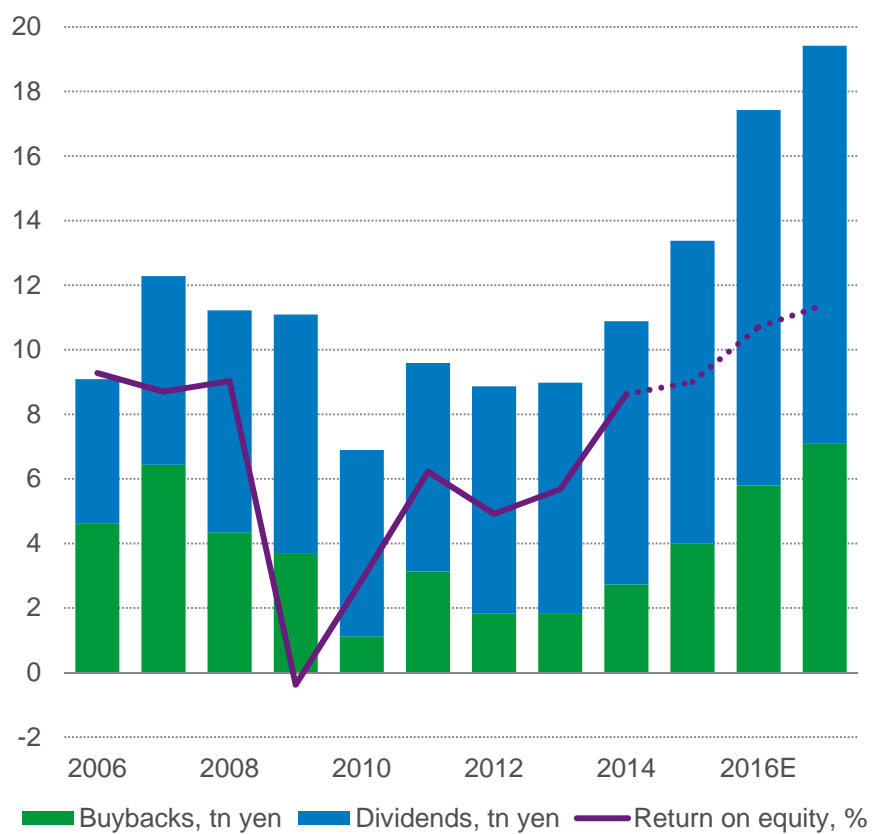
## 'Stock Up' Outside the U.S., Too

We would focus on opportunities in certain international markets. Japan remains the most attractively priced developed market, with catalysts for further stock gains on the horizon.

P/B and Dividend Yield by Country



Japanese Buybacks and Dividend Payouts



Source: Bloomberg, January 2014. Past performance is no guarantee of future results.

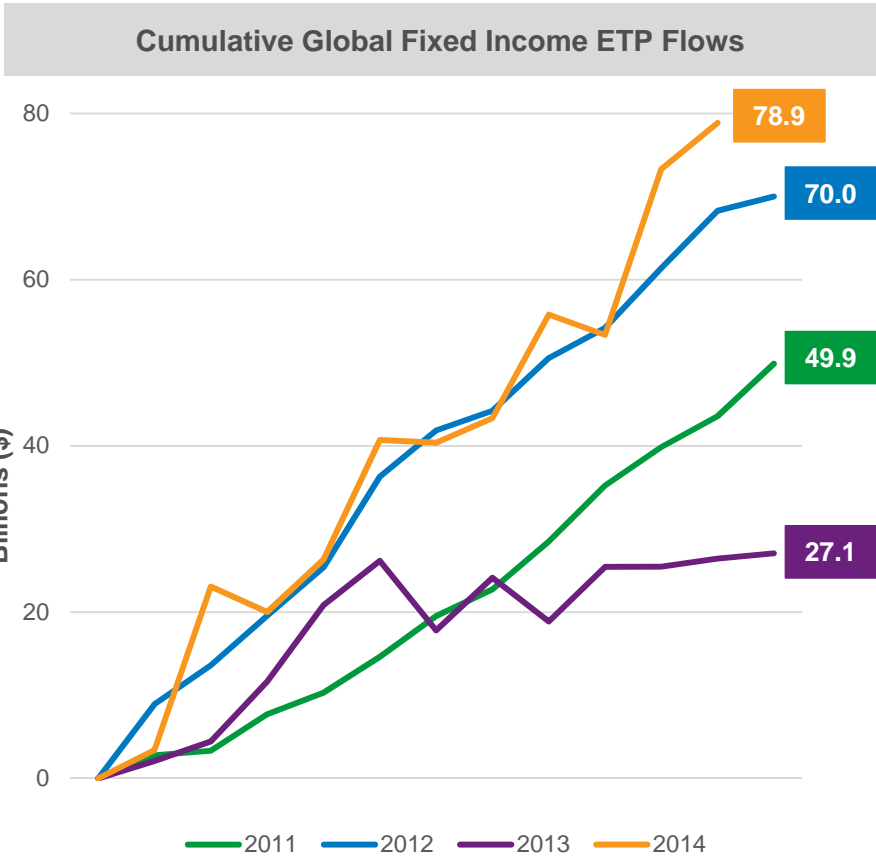
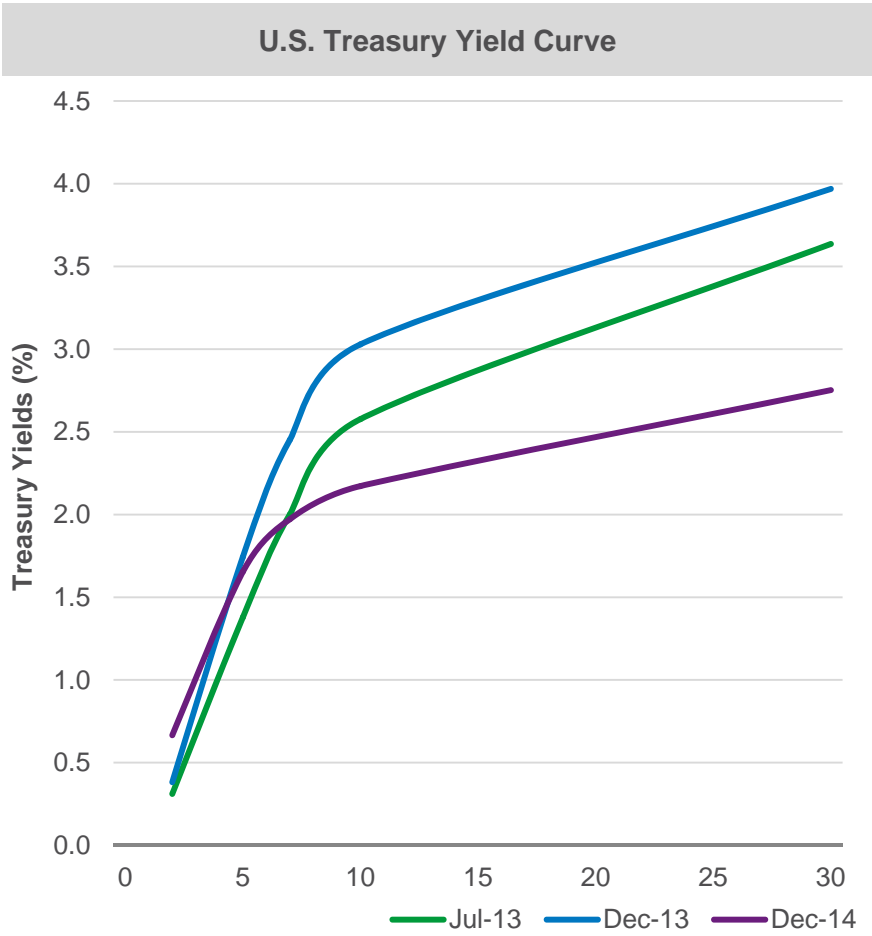
Sources: Goldman Sachs, January 2015. Note: The analysis is based on 1,689 Tokyo Stock Exchange-listed companies. 2015-17 are Goldman Sachs estimates.



# 3

## Watch Your Step in Bonds

**With rising interest rates, bond principal is at risk.  
Be wary of shorter maturities in particular, which would be most affected by a Fed rate hike.**



Sources: BlackRock Investment Institute, December 2014. Notes: ETP is an exchange-traded product. Industry flow data collected by BlackRock

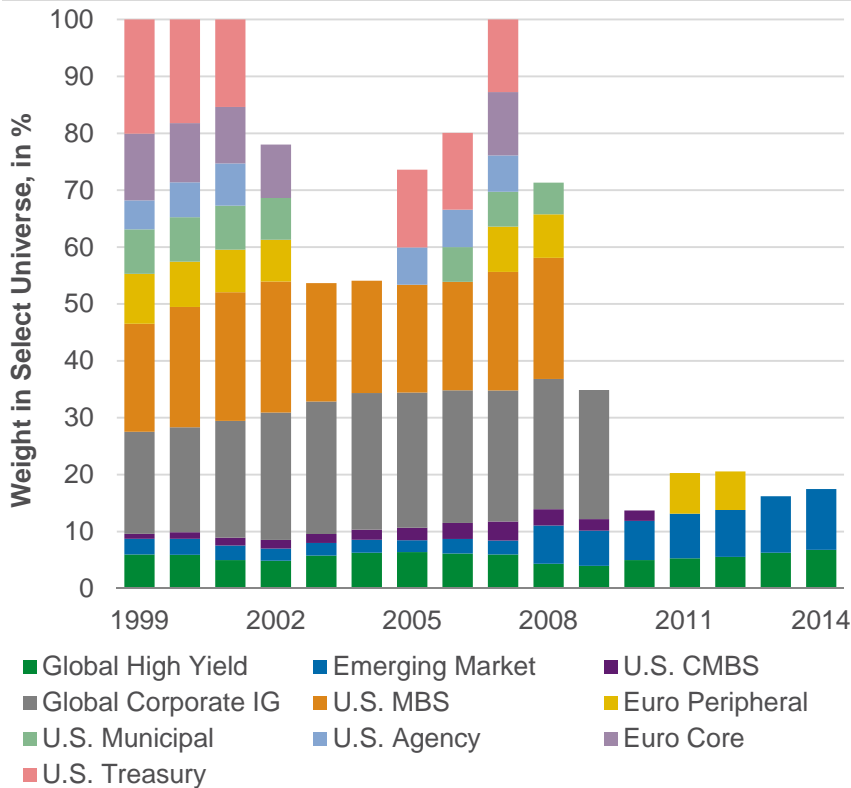
Source: Bloomberg, BlackRock, December 2014

# 3

## Watch Your Step in Bonds

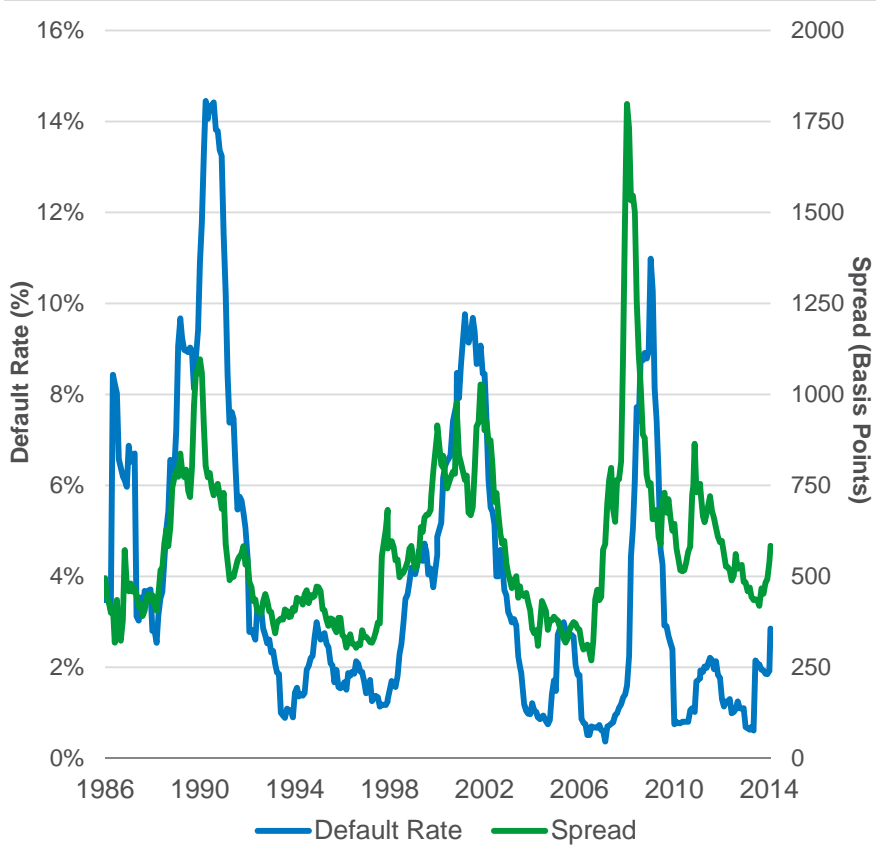
**While the Fed may hike, a lack of bonds likely to keep long-term yields low.  
Low defaults still lend support to high yield.**

**Fixed Income Assets Yielding Over 4%**



Sources: BlackRock Investment Institute, Barclays and Thomson Reuters, June 2014  
 Note: The bars show market capitalization weights of assets with an average annual yield over 4% in a select universe that represents about 70% of the Barclays Multiverse Bond Index. Euro core is based on French and German government debt indexes. Euro peripheral is an average of government debt indexes for Italy, Spain and Ireland. Emerging markets combine external and local currency debt.

**U.S. High Yield Default Rate vs High Yield Spread**



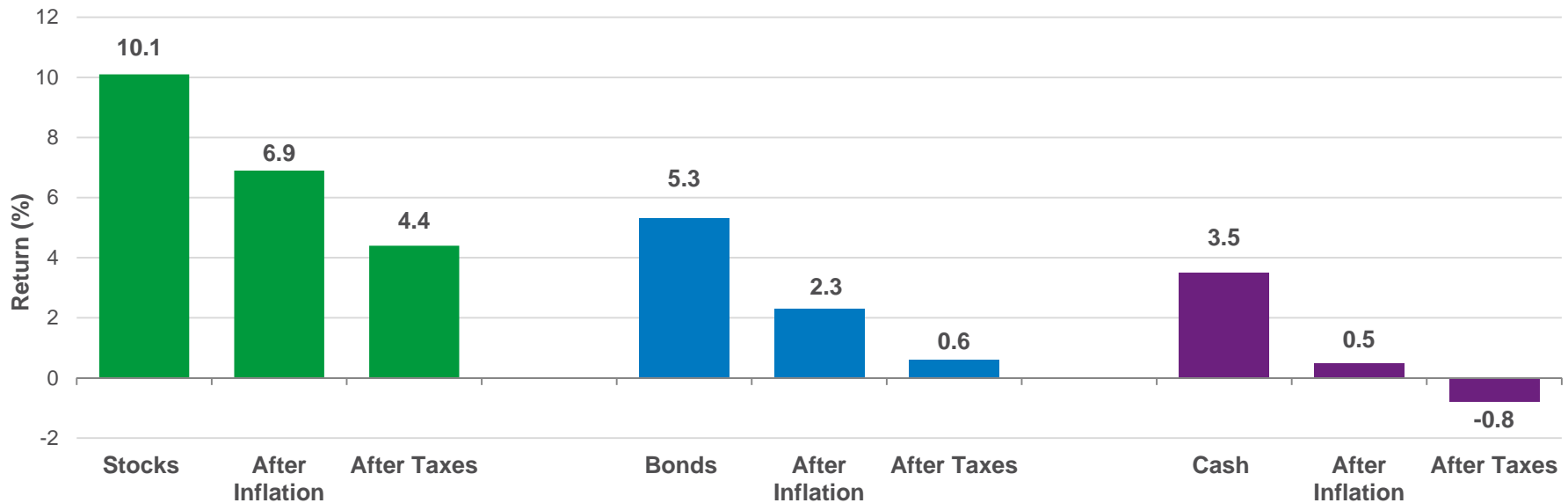
Source: Barclays, J.P. Morgan, BlackRock, December 2014

4

# Resist the Urge to Exit

**It's important to hold some cash, but too much can set you back.  
Cash comes with a cost after inflation and taxes.**

**Compound Returns of Cash After Inflation and Taxes (1926-2013)**

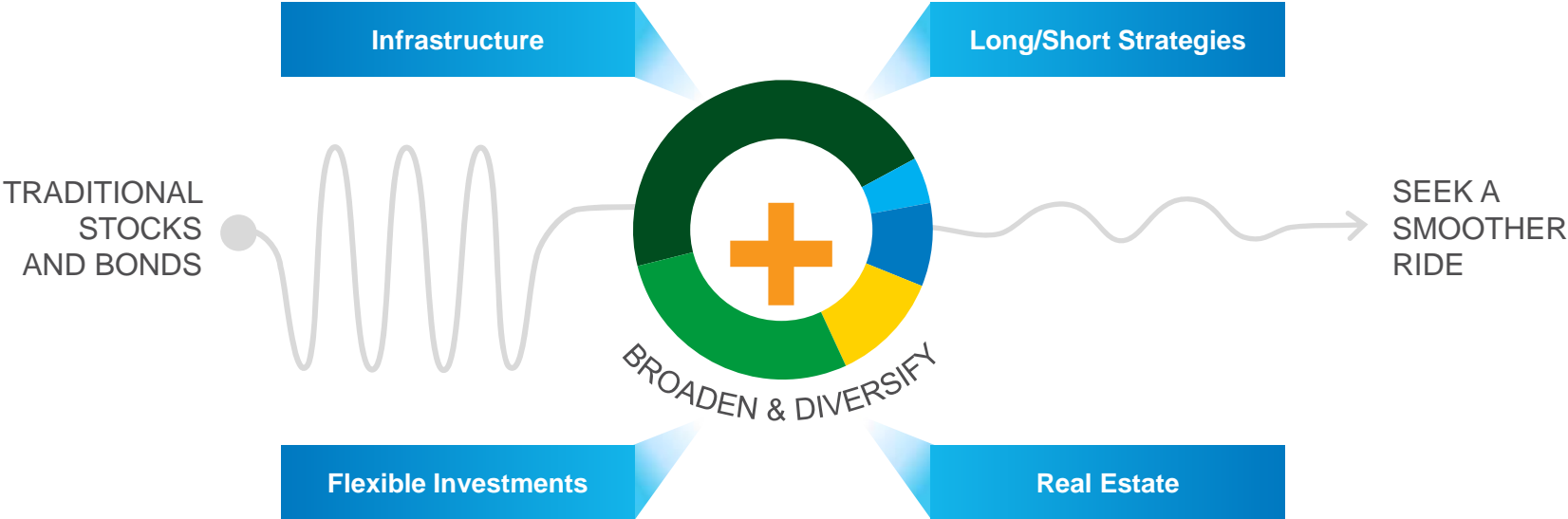


Sources: BlackRock; Morningstar; Tax Foundation. Past performance is no guarantee of future results. Assumes reinvestment of income and no transaction costs. This is for illustrative purposes only and not indicative of any investment. Federal income tax is calculated using the historical marginal and capital gains tax rates for a single taxpayer earning \$110,000 in 2012 dollars every year. This annual income is adjusted using the Consumer Price Index in order to obtain the corresponding income level for each year. Income is taxed at the appropriate federal income tax rate as it occurs. For the period covered (1926-2013), the high capital gains tax rate was 28% and the low was 3%. The high ordinary income tax rate was 55% and the low was 3%. No state income taxes are included. Stocks are represented by the S&P 500 Index. Bonds are represented by the Morningstar/Ibbotson Intermediate-Term Government Bond Index. Cash is represented by the Morningstar/Ibbotson 30-Day U.S. Treasury Bill Index. Inflation is represented by the Consumer Price Index. It is not possible to invest directly in an index.

## 5 Seek Growth in a Low-Growth World

Expand beyond traditional assets in an effort to optimize your portfolio's results.

Use **non-traditional tools** to diversify and seek a smoother ride



Consider **long/short strategies, infrastructure, real estate, and flexible investments**