

BlackRock Investment Directions

Asset Allocation Overview

Over the past several months, markets have grappled with globally weak economic data, European and US political gridlock, downgrades of sovereign debt, and fears of escalating contagion in the European debt crisis. In this volatile environment, we recommend investors maintain a quality bias across allocations and keep a close eye on policy initiatives, as additional monetary stimulus could lift markets. However, in the near-term, investors should remain focused on risk management.

Investment Themes

- ▶ **Equity valuations are attractive, but risks have grown:** While equity valuations seem attractive and fundamentals remain solid, downside risks have grown from weakening US growth and crisis in Europe. Until there's more clarity in the US and Europe, stocks will remain range bound and volatile.
- ▶ **Anticipate additional Fed policy action:** With fixed income markets enduring volatility and illiquidity, policymakers will likely act aggressively to encourage stability. Investors should retain a high-quality bias, but prepare to move into higher risk assets should the Fed take additional easing action.
- ▶ **Munis continue to show resilience and value:** Amid limited supply and increasing attention from nontraditional investors, the sector is well positioned. Munis today out-yield some of their taxable counterparts (even on a pre-tax basis) and, given their comparatively low volatility, are an attractive investment option.



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Asset Allocation Views

Key ○ = previous quarter ● = current quarter

	Current Outlook	Strength of Preference						
		Strong	◀ Neutral ▶	Strong				
Asset Allocation	Volatility and decreased clarity compel a balanced approach	Bonds	○	○	●	○	○	Stocks
Equities								
Region	Favor US stocks over non-US	US	○	●	○	○	○	Int'l
	Too early to shift to emerging, but it will come	Developed	○	○	●	○	○	Emerging
Market Cap	Remain broadly neutral	Small	○	○	●	○	○	Large
Style	Favor growth given weak economic data	Value	○	○	○	●	○	Growth
Fixed Income								
Duration	Shift back to neutral	Short	○	○	●	○	○	Long
Quality	Favor high quality across sectors	High	○	○	●	○	○	Low
Region	Favor developed versus emerging	Developed	○	○	●	○	○	Emerging
Commodities & Currencies								
Commodities	Volatility and weak conditions will keep commodities in a range	Underweight	○	○	●	○	○	Overweight
Currencies	With anticipated ECB easing, lean toward USD	US	○	○	●	○	○	Foreign

In our view, markets have overly discounted the downside economic risks and have the potential for improved performance in the months ahead.

Over the longer-term, we believe that the current uncertainty creates investment opportunities — particularly for those who are able to bear the short-term risks.

Equity Market Outlook

Over the past three months, equity volatility levels has soared as a result of the elevated risks we discussed earlier and stocks have been trading in a “risk on/risk off” pattern (with the “risk off” trend dominating).

It looks to us as if stocks are now pricing in a greater-than-50% chance that the United States enters into a recession. Clearly, growth has slowed to a crawl, with a great deal of attention being paid to the softening of recent months’ payrolls figures. There are, however, some positive signs: trade levels, credit expansion, consumer spending trends, manufacturing and jobless claims are all at worst flat and in some cases improving.

In our view, markets have overly discounted the downside economic risks and have the potential for improved performance in the months ahead. We would peg the risk of a US recession at somewhere around 30% (lower than what stocks are pricing in) and would note that equities remain attractive due to a combination of strong corporate balance sheets, solid valuations and overly negative sentiment. The situation in Europe remains our key concern, and some sort of stabilization in that region would go a long way toward setting the stage for improved equity market performance.

In the near-term, we expect high levels of volatility will continue and that stocks will remain range bound unless and until additional clarity emerges. Over the longer-term, however, we believe that the current uncertainty creates investment opportunities — particularly for those who are able to bear the short-term risks.

Equity Views

- ▶ Our view remains that US stocks are better positioned than their developed market counterparts, due primarily to relatively better economic and earnings growth prospects. From a style perspective, we lean toward growth stocks given the uneven economy.
- ▶ One of our main investment themes remains a focus on investing in companies that have the ability to generate strong levels of free cash flow. From a sector perspective, healthcare remains our favorite defensive sector and we also like energy and technology from a cyclical perspective.

Equity Sector Outlook

Key ○ = previous quarter ● = current quarter

	Current Outlook	Strength of Preference				
		Underweight	◀	Neutral	▶	Overweight
Healthcare	Strong cash flow growth; best defensive sector	○	○	○	○	●
Energy	Attractive valuations and good cash flow	○	○	○	●	○
Information Technology	Gaining market share; strong financials	○	○	○	●	○
Materials	Outlook mixed as global growth expectations moderate	○	○	●	○	○
Consumer Staples	Neutral fundamentals with mixed valuations	○	○	●	○	○
Consumer Discretionary	Mixed trends; mixed valuations	○	○	●	○	○
Telecom Services	Competition is significant; move to neutral	○	○	●	○	○
Industrials	Downside earnings risk; retain neutral	○	○	●	○	○
Utilities	Mixed fundamental outlook; not cheap	○	●	○	○	○
Financials	Earnings estimates continue to fall	●	○	○	○	○

Taxable Fixed Income Market Outlook

The fixed income investing environment today is one that is dominated by uncertainty, with the European debt crisis at the center. Some recent signs have suggested that policymakers may take appropriately significant steps to contain contagion, but many political, economic and cultural hurdles remain before the outlook becomes clear. In the interim, even with the “operation twist” program from the Federal Reserve, we believe additional coordinated developed-market monetary stimulus could be employed to dampen volatility and bolster confidence.

With questions surrounding the timing, size, nature and potential of new policy, we expect high levels of volatility will impact markets for some time. In this environment, the timing and calibration of investment decisions around risk and rates will continue to be difficult. If the European situation devolves into chaos, we could see 10 year Treasury rates fall to the 1.5% level.

Anticipation of policy and timing of entry are the critical components in successful positioning. We favor high yield especially if additional policy easing is announced, as well as asset-backed securities. Investment grade credit can provide quality attractive yield in longer duration issues, and will benefit from demand in the low rate environment. In anticipation of (or coincident with) the potential additional policy easing, we believe beaten-down financial institution securities in the US and Europe could be great yield-enhancing opportunities, though not without risk. In this volatile environment, credit research remains critical.

We believe additional coordinated developed-market monetary stimulus could be employed to dampen volatility and bolster confidence. As such, anticipation of policy is the critical component in successful positioning.

Taxable Fixed Income Views

- ▶ Illiquidity and volatility based on uncertainty over US data and the European crisis will drive markets, but we believe policy could be implemented to bolster confidence and mute volatility.
- ▶ With uncertainty, investors should retain high quality in each sector, while gaining yield in sectors such as high yield, asset backed securities and longer maturity investment grade credit.

Taxable Fixed Income Sector Outlook

		Key ○ = previous quarter ● = current quarter				
	Current Outlook	Strength of Preference				
		Underweight	◀	Neutral	▶	Overweight
High Yield	High yield fundamentals and supportive supply/demand dynamics are favorable	○	○	○	●	○
Securitized Assets	Yield and supply/demand remain compelling	○	○	○	●	○
Agency Mortgages	Favorable supply/demand dynamics warrant overweight	○	○	○	●	○
Corporates	Long end investment grade offers yield opportunities	○	○	●	○	○
Inflation Protected	Overweight is not warranted in the current rate environment	○	○	●	○	○
Non-US Dollar	Global policy risks make non-US dollar less attractive	○	○	●	○	○
Emerging Markets	Slowing growth and policy crosscurrents make sector less favorable	○	●	○	○	○
Treasury/Agency	Spread sectors offer better relative value	○	●	○	○	○

Municipal Market Outlook

The municipal market has demonstrated resilience amid some notable events in recent months and offers attractive fundamentals. Munis directly linked to US government debt assumed the new AA+ rating following the S&P downgrade, although this represented a very small fraction of the market. In other headlines, Jefferson County, Alabama, averted what would have been the largest-ever

municipal bankruptcy, and the president's new jobs plan included a provision to cap tax exemption. While we don't believe it will be passed, the proposed cap could portend a change in tax policy going forward.

A key driver in the market has been the steady reduction in new-issue supply. With 2011 on pace for record-low issuance, municipal bonds could benefit from a scarcity value. We maintain a favorable outlook and a neutral posture, with a bias to add credit risk in more liquid areas of the market.

Municipal Market Views

- ▶ We continue to favor a barbell approach to yield curve positioning, with exposure to short and long maturities. In terms of particular investments, we favor dedicated-tax bonds, as well as certain revenue sectors such as hospitals, transportation, housing and education.
- ▶ We remain less enthusiastic about land-secured bonds, senior living bonds, bond insurers, student loans and local tax-backed issues.

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Municipal Market Positioning

Key ○ = previous quarter ● = current quarter

		Strength of Preference				
Current Outlook		Strong	◀	Neutral	▶	Strong
Duration	Stay neutral duration	Short ○	○	●	○	Long ○
Yield Curve	Favor a barbell approach (i.e., long and short maturities)	Short ○	●	○	●	Long ○

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