

## BlackRock Investment Directions

### Asset Allocation Overview

With the soft patch of weaker US economic growth, increased risks in Europe, negative aftermath of the Japan earthquake and conclusion of the Federal Reserve's QE2 bond buying program, volatility in equity and fixed income markets will be elevated in the near term. At present, markets are currently demonstrating uncertainty and risk-averse sentiment, and we would urge continued caution. However, as the third quarter progresses, we believe market risks should recede and buying opportunities should accelerate, allowing investors to consider a shift back toward risk assets.



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### Investment Themes

- ▶ **Equity market weakness presents buying opportunities:** Equities continue to be fundamentally strong, with profits and cash flow driving growth. We continue to believe the cyclical recovery continues and that price weakness presents a buying opportunity.
- ▶ **Remain cautious in fixed income:** With softening economic data and the conclusion of QE2, we believe volatility and illiquidity will remain high but rates will remain low or drift marginally higher. Investors should increase quality within each sector allocation, and reduce interest rate risk.
- ▶ **Municipal bonds market seeing positive supply/demand dynamics:** While the fundamental credit backdrop for states and cities is showing some improvement, the best value remains in certain revenue sectors like healthcare, transportation and education.

### Asset Allocation Views

Key ○ = previous quarter ● = current quarter

|                                     | Current Outlook   | Strength of Preference |   |         |   |        |   |   |            |
|-------------------------------------|---|------------------------|---|---------|---|--------|---|---|------------|
|                                     |   | Strong                 | ◀ | Neutral | ▶ | Strong |   |   |            |
| <b>Asset Allocation</b>             | Strong fundamentals and greater clarity warrant overweight stocks | Bonds                  | ○ | ○       | ○ | ●      | ○ | ○ | Stocks     |
| <b>Equities</b>                     |   |                        |   |         |   |        |   |   |            |
| <b>Region</b>                       | Bias remains toward US stocks                                     | US                     | ○ | ○       | ○ | ○      | ○ | ○ | Int'l      |
|                                     | Potential shift toward emerging over time                         | Developed              | ○ | ○       | ○ | ○      | ○ | ○ | Emerging   |
| <b>Market Cap</b>                   | Retain broadly neutral outlook                                    | Small                  | ○ | ○       | ○ | ○      | ○ | ○ | Large      |
| <b>Style</b>                        | Modest preference for growth given economic weakness              | Value                  | ○ | ○       | ○ | ○      | ○ | ○ | Growth     |
| <b>Fixed Income</b>                 |   |                        |   |         |   |        |   |   |            |
| <b>Duration</b>                     | Reduce duration given increased volatility and risks              | Short                  | ○ | ○       | ○ | ○      | ○ | ○ | Long       |
| <b>Quality</b>                      | Remain high quality within each sector                            | High                   | ○ | ○       | ○ | ○      | ○ | ○ | Low        |
| <b>Regional</b>                     | US and global markets each face risks                             | US                     | ○ | ○       | ○ | ○      | ○ | ○ | Int'l      |
| <b>Commodities &amp; Currencies</b> |   |                        |   |         |   |        |   |   |            |
| <b>Commodities</b>                  | Remain cautious given challenging global environment              | Underweight            | ○ | ○       | ○ | ○      | ○ | ○ | Overweight |
| <b>Currencies</b>                   | No clear advantage with global crosscurrents                      | US                     | ○ | ○       | ○ | ○      | ○ | ○ | Foreign    |

*“After the worst financial crisis of a generation and a tepid economic recovery, it should not be surprising that investor sentiment levels are depressed and that investors remain quite risk averse.”*

*“The combination of still-strong corporate earnings and a downturn in equity prices has made stocks more attractive. To us, this scenario represents a potential buying opportunity.”*

## Equity Market Outlook

As the second quarter draws to a close, markets are in a period of uncertainty. Stocks have been drifting sideways or lower for the last couple of months in the face of weaker economic data and ongoing concerns over the European sovereign debt crisis, policy tightening in China and the ending of the QE2 program in the United States.

Despite the recent weak market performance, however, the reality is that the world remains in a global cyclical recovery mode (albeit a subpar one). The fact that markets have not been focusing on the positives of the recovery is, in many ways, due to investor psychology. After the worst financial crisis of a generation and a tepid economic recovery, it should not be surprising that investor sentiment levels are depressed and that investors remain quite risk averse. In the current environment, investors have been reacting quickly and negatively to any bad news and have been shrugging off positive news.

We believe that stock valuations will soon settle at a point at which investors will decide that the risks inherent in equities are worth taking. The combination of still-strong corporate earnings and a downturn in equity prices has made stocks more attractive. To us, this scenario represents a potential buying opportunity, particularly for those who share our view that the economy should see a reacceleration in the months ahead. We would caution that volatility levels will likely remain elevated and that additional corrective or sideways action could persist, but we also believe this could be an appropriate time for investors to take on more risk in their portfolios.

## Equity Views

- ▶ As has been the case for some time, we continue to believe that US stocks are more attractive than their developed market counterparts. Regarding styles, we are beginning to favor growth over value given the ongoing relative weakness of economic growth.
- ▶ From a sector perspective, healthcare remains our favorite area of the market. We are also upgrading our forecast on technology given better growth prospects in the coming months. We remain cautious on utilities and still list the financials sector as our least favorite.

## Equity Sector Outlook

Key ○ = previous quarter ● = current quarter

|                        | Current Outlook   | Strength of Preference |   |         |   |            |
|------------------------|---|------------------------|---|---------|---|------------|
|                        |   | Underweight            | ◀ | Neutral | ▶ | Overweight |
| Healthcare             | Strong cash flow growth; best defensive sector                      | ○                      | ○ | ○       | ● | ●          |
| Telecom Services       | Good cash flows and high dividends; restructuring potential         | ○                      | ○ | ○       | ● | ○          |
| Information Technology | Should perform better in the second half of 2011                    | ○                      | ○ | ●       | ● | ○          |
| Industrials            | Near-term growth risks warrants neutral position                    | ○                      | ○ | ●       | ○ | ○          |
| Energy                 | Slow growth and volatile oil prices cause a shift to neutral        | ○                      | ○ | ●       | ● | ○          |
| Consumer Discretionary | Mixed trends; mixed valuations                                      | ○                      | ○ | ●       | ○ | ○          |
| Materials              | Outlook mixed as global growth expectations moderate                | ○                      | ○ | ●       | ○ | ○          |
| Consumer Staples       | Neutral fundamentals with mixed valuations                          | ○                      | ○ | ●       | ○ | ○          |
| Utilities              | Mixed fundamental outlook; not cheap                                | ○                      | ● | ○       | ○ | ○          |
| Financials             | Slowly improving balance sheets; regulatory overhang; not expensive | ○                      | ● | ○       | ○ | ○          |

## Taxable Fixed Income Market Outlook

In the current economic environment of moderate economic growth and less liquidity after the conclusion of QE2, volatility will be elevated. But with the structural headwinds of unemployment, depressed housing and a dynamic of increased demand/moderate supply of fixed income keeping a cap on rates, we expect that yields could drift slowly higher by year-end. In this environment, Treasuries may, in fact, become a safe haven for investors in a flight-to-quality trade.

In the near term, the market environment after the end of QE2 remains an unknown given the multiple significant global monetary crosscurrents, including the removal of massive Fed liquidity, the flood of liquidity from Japan, austerity measures in Europe and tightening policy in emerging markets. This environment calls for a cautious approach and an increase in quality within each sector allocation. At the same time, these dynamics are causing some market aberrations across sectors, which may provide opportunity for carefully researched and selected investments.

Beyond this expected period of short-term volatility, however, we believe investors will need to focus on income and yield in the medium to long term. We believe there are attractive opportunities in high yield corporates, commercial mortgage-backed securities (CMBS) and parts of the asset-backed market. The investment-grade credit sector, in contrast, has seen considerable appreciation and we believe holds less opportunity for returns. We continue to recommend a focus on risk management and careful selection of securities.

*“As long as the yield curve remains steep, we believe holding shorter duration higher-yielding assets is the best way to generate long-term returns in an environment of only modest inflation and high levels of rate volatility.”*

## Taxable Fixed Income Views

- ▶ The more volatile environment following the conclusion of QE2 calls for a tactical near-term increase in quality as a defensive step.
- ▶ As long as the yield curve remains steep, we believe holding shorter duration higher-yielding assets is the best way to generate long-term returns in an environment of only modest inflation and high levels of rate volatility.

## Taxable Fixed Income Sector Outlook

|                     |  | Key ○ = previous quarter ● = current quarter |   |         |   |            |
|---------------------|--|--|---|---------|---|------------|
|                     | Current Outlook  | Strength of Preference                       |   |         |   |            |
|                     |  | Underweight                                  | ◀ | Neutral | ▶ | Overweight |
| High Yield          | We continue to favor high yield for supportive supply/demand dynamics and fundamentals           | ○  | ○ | ○       | ● | ○          |
| Securitized Assets  | Supply/demand and yield are compelling   | ○  | ○ | ○       | ● | ○          |
| Agency Mortgages    | Selected opportunities exist based on supply/demand dynamics                                     | ○  | ○ | ○       | ● | ○          |
| Corporates          | Spreads have widened, improving the attractiveness of the sector                                 | ○  | ○ | ○       | ● | ○          |
| Inflation Protected | Macro environment not yet favorable for an overweight position                                   | ○  | ○ | ○       | ● | ○          |
| Non-US Dollar       | Remain broadly neutral given global policy and inflationary tensions and sovereign headline risk | ○  | ○ | ○       | ● | ○          |
| Emerging Markets    | Emerging market policy crosscurrents are temporarily slowing the sector's performance            | ○  | ○ | ○       | ● | ○          |
| Treasury/Agency     | Better relative value can be found in spread sectors   | ○  | ○ | ○       | ● | ○          |

## Municipal Market Outlook

As the year progresses, the dire default predictions made late in 2010 appear increasingly less likely to come to fruition. In fact, favorable news has prevailed recently, with states reporting positive

revenue growth for five consecutive quarters, and the second quarter seemingly on pace to continue the trend. After a difficult first quarter, the tax-exempt market performed well through the second quarter as new issuance remained low and total supply appears likely to remain scarce for the remainder of the year. The market should also benefit from the wave of cash expected from maturing bonds during the summer rollover season. In June and July alone, that amounts to \$78 billion in cash that will need to be reinvested during a period of limited supply.

*“As the year progresses, the dire default predictions made late in 2010 appear increasingly less likely to come to fruition. In fact, favorable news has prevailed recently, with states reporting positive revenue growth for five consecutive quarters, and the second quarter seemingly on pace to continue the trend.”*

## Municipal Market Views

- ▶ We favor a barbell approach to yield curve positioning, with exposure to short and long maturities and continue to favor state tax-backed and essential service bonds, particularly the Southwest, Plains and Southeast regions. We like dedicated-tax bonds and housing bonds backed by state agencies as well as certain revenue sectors like healthcare, transportation and education.
- ▶ Our least favorite sectors include land-secured bonds, senior living bonds, tobacco bonds, student loans and local tax-backed issues.

## Municipal Market Positioning

|                    |   | Key ○ = previous quarter ● = current quarter |   |         |   |        |   |      |
|--------------------|---|--|---|---------|---|--------|---|------|
| Current Outlook    |   | Strength of Preference                       |   |         |   |        |   |      |
|                    |   | Strong                                       | ◀ | Neutral | ▶ | Strong |   |      |
| <b>Duration</b>    | Stay neutral duration                                       | Short  | ○ | ○       | ● | ○      | ○ | Long |
| <b>Yield Curve</b> | Barbell approach with exposure to short and long maturities | Short  | ○ | ●       | ○ | ●      | ○ | Long |

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