The Credit Crisis, Government Action and the Economic and Investment Outlook

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Financial markets continue to trade in a volatile fashion as the Treasury Department, Federal Reserve and other policymakers remain extremely active in trying to restore some measure of normalcy to the banking system. In the following pages, we attempt to provide some perspective around the wave of recent government actions, discuss what signs investors can look to in determining when the economy might turn around and offer some suggestions as to where value can be found in the current market.

Bob Doll

BlackRock Vice Chairman; Global Chief Investment Officer, Equities

Peter Fisher

Co-Head of BlackRock's Fixed Income Portfolio Management Group

The Public-Private Investment Program

One of the government announcements that has garnered a number of headlines has been the plans recently announced by Treasury Secretary Tim Geithner for launching the Public-Private Investment Program (PPIP). The PPIP is designed to restore some measure of normalcy to the banking system by providing means by which banks can remove some of the toxic assets from their balance sheets.

There are essentially two key elements of the PPIP program. The first is a co-investment pledge of the Treasury to partner with investors on a one-to-one basis to invest in select legacy mortgage assets (a legacy securities program). The second element of PPIP is a non-recourse financing program that will provide leverage proceeds to investors (a legacy loan program). Both processes would be overseen by the government, which would also bear some of the downside risk, in the hope that government involvement will help stimulate demand.

We expect the legacy securities program to gain wide appeal among investors. There does remain some question, however, as to how many banks will want to participate in the legacy loan program, since such participation would likely require banks to sell their assets at a loss, requiring further markdowns.

In any case, we believe the PPIP is one of the most important initiatives recently launched by the government and one that should, over time, help stabilize the banking system. Two objectives are clear given the terms of the program. First, by virtue of Treasury's co-investment match and financing terms, the government is attempting to create larger pools of liquidity to be invested in legacy mortgage assets, in essence creating more efficient, liquid markets in these securities, which may establish a pricing floor. Second, by accomplishing the first objective, we believe Treasury is attempting to create meaningful incentive for the private sector to invest in these markets, taking risk with the potential for favorable returns. Over time, we fully expect that many private sector participants will take advantage of the non-recourse lending that has been made available. We believe that should create price stability and spread compression in these markets.

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Any plan designed to help the banking system needs to have, at its core, a method to deal with troubled balance sheets, and the PPIP is designed to do just that. By structuring the sale of assets through a public-private partnership, we will not need to wait for a bank to fail or for the government to take over a bank before that entity can start removing some of its bad assets. In other words, banks do not need to transfer their toxic assets to a government balance sheet before they can be worked off. The government will provide some financing and support to establish a price for the securities, which should help speed up the process of valuing and selling the assets.

Bank Stress Testing

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In addition to the PPIP, the Treasury and the FDIC will also be conducting "stress tests" for the nation's banks in which bank regulators will apply a consistent methodology for evaluating the stability of the major banks. It is no coincidence that these tests will be conducted in conjunction with the formation of the PPIP, since that program will provide an avenue through which banks that are under pressure can repair their balance sheets. In our opinion, such tests are necessary and are a chief factor in terms of restoring confidence in the banking system.

We do, however, have some reservations about the manner in which the stress tests are likely to be conducted. For starters, regulators tend to have a primary focus on the asset quality of the banks' balance sheets. While this is obviously important, banks' revenue streams also should be closely scrutinized and regulators should question whether a given bank has the revenue necessary to remain viable. On a related note, we expect the "pass rate" for the banks to be very high—perhaps too high. The government will be reluctant to declare a seemingly viable bank insolvent and will likely err on the side of caution by allowing troubled banks to remain in business. There is a risk that the stress tests could be too light, and if this does become the case, it would undermine confidence in the process.

The Nationalization Question

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As the state of the banking system continues to remain the focus of the financial headlines, the question that continues to arise is: To what extent will the government have to step in and assume partial or full control of the nation's banking system? Such a question, along with the concept of "nationalization," is politically loaded and can be frightening. In our view, it is important to remember that nationalization is not a black-and-white issue and it is not helpful to think about the process of supporting banks as being an all-or-nothing proposition.

To start, banks have long been highly regulated by the government. The FDIC guarantees deposits and now also guarantees bank bonds through insurance wraps. The government has always had the power to assume control over a bank that it deems to be insolvent, taking steps to restabilize, sell, reorganize or close the entity in question. This remains the case today. The concern at present is related to closures in the sense that the government takes over the bank and its equity value is wiped out. The scope and scale of the current problems in the banking system obviously raise the stakes surrounding this issue, but the fundamental backdrop of government oversight has not changed.

Fiscal Stimulus

Outside of the specific measures proposed by the Treasury, the White House and Congress also have been active in terms of combating the prevailing economic weakness. The $800 billion fiscal stimulus program that was recently enacted into law is, by our assessment, imperfect, but will nonetheless have a stimulative effect.

While there are a number of issues we could take with the plan, there are two things in particular that stand out in our minds. First, too much of the plan was aimed at longer-term "reforms" (such as healthcare, important as it is) and not enough was aimed at stimulating demand in the short run. Second, we believe the plan would have been much more effective had it increased the block grants to the states. This would have had the effect of offsetting some local tax increases, and the money would have flowed more quickly to construction projects and other state-sponsored initiatives.

On balance, we believe the peak impact of the stimulus package will probably be felt in early 2010 rather than later this year. In any case, this wide-scale increase in government spending remains ahead of us and should eventually act as an important factor in helping to at least reduce the pace of economic decline.

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The Fed, Monetary Policy and Inflation

Since the Federal Reserve cut the Fed Funds target rate to an all-time low range of 0% to 0.25% in December, it has kept that rate on hold and all indications are that it will continue to do so for the foreseeable future. At the same time, the central bank has remained committed to its program of quantitative easing, in which it injects money directly into the financial system. Most recently, the Fed announced that it would purchase upwards of $1 trillion worth of mortgage-backed and Treasury securities in an effort to boost economic growth.

The Fed's latest announcement had an immediate impact and prompted a rally in Treasury prices as interest rates plummeted. These programs should help the banking system by expanding the supply of credit and, once again, demonstrate the central bank's commitment to radically expanding its balance sheet and employing creative methods of monetary stimulus. From a consumer perspective, the Fed's plan to purchase massive amounts of mortgage debt is designed to lower mortgage rates to allow many homeowners to refinance, providing them with increased monthly cash flow. Ideally, the lower rates should also prompt some prospective buyers to move off the sidelines and enter the residential real estate market. We believe these actions should help to stabilize the banking system over the next quarter or two, but we would stress that the banking system remains extremely fragile and that success is by no means assured.

Coinciding with the Fed's announcements that it is, essentially, printing money, there have been some concerns that these actions could be inflationary. In normal times, it would be reasonable to expect that the expansion of the Fed's balance sheet by over $1 trillion would be inflationary. However, stacked against the destruction of some $11 trillion in US wealth since the credit crisis began, the Fed's actions are aimed at reducing the very real risk that a deflationary dynamic could set in if both consumers and businesses come to expect falling prices and

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falling incomes and further contract their plans for spending and investing. In our opinion, inflation is not a current danger, but eventually the Fed will have to manage an exit from the extraordinary balance sheet growth it is undertaking at some point in the future — perhaps as soon as late 2010 or 2011.

The Outlook for the Economy

As all of the above suggests, healing the banking system is an important precondition for stabilizing the economy. The growth and supply of credit need to improve for banks to begin lending normally again. There still may be limitations on demand since consumers and businesses may not want to borrow, but increasing the credit supply is critical. As we have indicated, we believe all of the steps taken by policymakers are important ones and should help the banking system to stabilize at some point later this year.

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Regarding the broader economy, some recent signals suggest we might be nearing an inflection point. Improvements in housing starts, the trade deficit and retail sales suggest that at least some parts of the economy may be bottoming and that the pace of decline may be slowing. This is not to say that the economy is about to recover, but it does point to a degree of stabilization and a potential end to the severe rates of decline. At present, we believe the fourth quarter of 2008 and the first quarter of 2009 will mark the low points for economic growth. While there remains a risk that households will want to reduce their debt burden and increase their savings, which could hold back consumption and the overall economy, there is a prospect that we will witness the start of an economic recovery by the end of the year, and that could lead into subpar, but positive, growth in 2010.

What Might Recovery Look Like?

It is difficult to predict with any accuracy exactly how and when the economy will begin to turn around, but past experience suggests that some segments of the economy should recover before others.

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Once the banking system has stabilized, we will be focused on identifying a floor for consumption spending. When personal spending has stopped dropping, it should be a sign that the broader economy is set to recover. Within the business sector, a sustained increase in durable goods orders could signal a turnaround and would be an important leading indicator. A decline in inventory levels also will be an important sign that the business sector has started to improve.

One area of the economy that we expect will lag significantly is employment. It is important to remember that the available labor force continues to grow even as the economy shrinks and as jobs disappear. As a result, unemployment will continue to rise even as the economy starts to recover. It may very well take a year or more from the time the economy bottoms for unemployment to peak.

Financial Markets as an Indicator

As always, financial markets are in the business of futures forecasting, and investors in general tend to act in anticipation of events. This means that equity, fixed income and other markets will begin to price in a recovery before concrete evidence of one exists. As such, higher-risk assets (such as equities) are likely to recover before the economy as a whole.

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Outlook and Opportunities in Fixed Income

With the abrupt rally in Treasuries that occurred after the announcement of the Fed's asset purchase plan, the yield on the 10-year Treasury moved from over 3% to around 2.5%, but it subsequently retraced about half that gain. Should economic news worsen and the Fed continue its aggressive policies, yields might move down to the low 2% range, but that would likely mark the bottom point. Likewise, it is hard to imagine yields breaking through 3% until clearer evidence of an economic recovery emerges.

Our investment themes in fixed income have remained largely unchanged for some time. While we are in the midst of a recession, a focus on higher-quality investments is appropriate. Within that context, however, selective risk-taking may be rewarded. There will be winners and losers in every category of fixed income, meaning disciplined credit research will be critical.

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Within this high-quality theme, select corporate bonds look attractive to us. There are companies out there that have the ability to weather the current recession and whose bonds are offering attractive yields. Another area of the market that interests us is the government-guaranteed sector. Agency mortgages (Ginnie Mae in particular) are offering attractive yields and represent a good investment opportunity, particularly when compared to Treasuries.

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Finally, we continue to have a favorable view toward municipal bonds. Municipal yields are attractively valued when compared to taxable equivalents, and munis are supported by a long history as a high-quality asset class with low relative volatility, consistency in performance and low default rates. As such, we believe munis continue to represent a good long-term investment. As with our views regarding the corporate sector, we would stress that there will be winners and losers among municipal bonds, again suggesting that individual credit research is critical. In general, we favor higher-quality municipal issuers who will not have to struggle as much in terms of generating revenues.

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Outlook and Opportunities in Equities

As with our stance in fixed income markets, our investment themes have remained consistent in the equity space as well. On balance, a bias toward higher quality continues to make sense, and we retain our conviction that the most compelling values can be found in higher-quality companies that have relatively strong balance sheets, healthy levels of free cash flow and adequate financing. At the same time, however, it would be appropriate to gradually take on some lower-quality and more cyclical investments in anticipation of economic recovery.

Regarding geographic opportunities, among developed markets we continue to favor overweight positions in US stocks. Policy responses to the credit crisis have been stronger and more rapid in the United States than in other markets, and US stocks tend to have higher earnings predictability and lower volatility compared to most other markets. Additionally, we continue to believe that the long-term case for investments in emerging markets remains intact. In particular, we favor investments in Asia ex-Japan and in Latin America, where signs of economic revitalization are stronger.

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Our views toward different market sectors follow our views on quality. We continue to prefer a more defensive stance, and believe that healthcare, with relatively good earnings prospects and strong cash flows, remains the most attractive defensive

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sector. Our preferred cyclical sector is energy, an area that we believe is attractively valued. Finally, from a growth perspective, we are focused on technology, which appears to have relatively solid earnings prospects.

Looking ahead, a clear outlook for equities remains difficult to ascertain. The positive move in the stock market that has occurred since early March (when stocks sank to a new low of 667 for the S&P) appeared overdue, but it remains to be seen whether this represents the beginning of a turnaround or merely a bounce from oversold levels. Some evidence suggests that market conditions are improving. The March rally has been broad-based and volume has been heavy, which are strong technical factors. Additionally, lower-quality stocks have been outperforming, which usually happens when markets rebound. Nevertheless, it is important to remember that equities are still in the midst of a bottoming process and that stocks could experience another setback. At some point, one of the bottoms we have hit in recent months will mark the final bottom for the current cycle, and our conviction is growing that the March 6 low may have been it.

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