

# BlackRock Investment Directions

THIRD QUARTER 2010



## Asset Allocation Overview

The debt crisis in Europe and ensuing sell-off in risk assets in the second quarter have raised fears that the global economy could slip back into recession. We view these events as a speed bump for the recovery, and maintain a bias toward higher-quality assets in light of their attractive valuations and tendency to perform well during periods of weak economic growth.

## Investment Themes

- **Stay with risk assets:** We have not changed our broad view that risk assets (including stocks, credit-related fixed income and commodities) should outperform in an environment of slow, but positive, economic growth.
- **In equities, continue with quality:** Our focus on higher-quality equities remains unchanged, and we believe good quality companies can be found across styles, capitalizations and sectors.
- **Spread sectors remain compelling:** We think investor demand for higher-yielding assets and favorable technical factors should support spread assets.



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Asset Allocation Views		Strength of Preference						
	Current Outlook		Strong	◀ Neutral ▶	Strong			
Asset Allocation	Prefer equities to bonds; focus on higher-quality in both	Bonds	○	○	○	●	○	Equities
Equities		Strength of Preference						
	Current Outlook		Strong	◀ Neutral ▶	Strong			
Regional Allocation	The US recovery is stronger and valuations are attractive	US	○	●	○	○	○	Int'l
	Despite underperformance, emerging markets remain attractive	Developed	○	○	○	●	○	Emerging
Market Cap	Broadly neutral (extremely slight preference for large cap)	Small	○	○	●	○	○	Large
Style Allocation	Broadly neutral (extremely slight preference for growth)	Value	○	○	●	○	○	Growth
Fixed Income		Strength of Preference						
	Current Outlook		Strong	◀ Neutral ▶	Strong			
Duration	Rates should remain range bound	Short	○	○	●	○	○	Long
Quality	Prefer moderately higher-yielding non-cyclical sectors	High	○	○	○	●	○	Low
Regional	US outperformance warrants rebalancing	US	○	○	○	●	○	Int'l
Commodities & Currencies		Strength of Preference						
	Current Outlook		Strong	◀ Neutral ▶	Strong			
Commodities	Global economic recovery should slowly increase demand	Underweight	○	○	○	●	○	Overweight
Currencies	Flight to US dollar continues on euro weakness	US	○	○	●	○	○	Foreign

Invest Key ○ = last quarter ● = current quarter

► It is a cliché (but nonetheless true) that markets loath uncertainty, and it is precisely the current high levels of uncertainty that have been dominating market action.

► As long as a renewed economic contraction is avoided, we believe equity prices should grind higher over the course of the year, albeit with continued high levels of volatility.

► We would expect those areas of the market that have been hit the hardest in recent months (i.e., cyclical stocks) to outperform, so a slight rotation to those areas would make sense.

## Equity Market Outlook

At the beginning of this year, we described the macroeconomic backdrop as being a sort of tug of war between a cyclical recovery and ongoing structural concerns. For the first part of this year, the former dominated, but over the past couple of months, structural problems have won out, which has resulted in a significant downturn in global equity prices.

Investors have grown increasingly nervous about the potential contagion from the European sovereign debt crisis, and less positive economic data has called into question the strength of the ongoing recovery. It is a cliché (but nonetheless true) that markets loath uncertainty, and it is precisely the current high levels of uncertainty that have been dominating market action.

The bearish view is that renewed credit concerns will overwhelm a still-fragile global financial system, that the long-term threats of high inflation, large deficits and rising tax levels will become stronger headwinds and that equity markets are entering a bear market. From our perspective, these issues are real concerns, but are unlikely to come to fruition. When it becomes clearer that the economic recovery remains intact and when the ultimate resolution of European credit issues is better crystallized, we expect investors will return to a focus on market fundamentals, which should allow risk assets to embark on a renewed rally. As long as a renewed economic contraction is avoided, we believe equity prices should grind higher over the course of the year, albeit with continued high levels of volatility.

## Equity Views

- We have had a long-held view that investors should focus on high-quality equities in the current environment. The wrinkle we would add at present is as we expect markets to recover later this year, we would also expect those areas of the market that have been hit the hardest in recent months (i.e., cyclical stocks) to outperform, so a slight rotation to those areas would make sense.
- From a sector perspective, we have a particularly favorable view of telecommunication services and have upgraded our outlook on the consumer discretionary and utilities sectors. We still recommend a broad underweight to financials, but that sector is slowly improving. Energy stocks are looking less appealing in the short-term.

Sector Outlook		Strength of Preference				
Sector	Current Outlook	Underweight	◀ Neutral ▶	Overweight		
Telecom Services	Good cash flows and high dividends	○	○	○	○	●
Consumer Discretionary	Consumers slowly increasing spending, stocks now cheaper	○	○	◐	●	○
Information Technology	New products, further market penetration, good financials	○	○	○	●	○
Healthcare	The healthcare reform cloud has lifted, but fundamentals mixed	○	○	●	◐	○
Industrials	Global cyclical slowdown offset by improved valuations	○	○	●	◐	○
Utilities	Regulatory risks and cost issues, but a good defensive play	○	◐	●	○	○
Consumer Staples	Moderately attractive with mixed valuations	○	○	●	○	○
Financials	Troubled balance sheets and regulatory uncertainty, but now cheaper	○	●	○	○	○
Materials	Global slowdown hurting prices and volumes	○	●	◐	○	○
Energy	Excess inventories; oil prices under pressure	○	●	◐	○	○

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## Fixed Income Market Outlook

Investor fears over rising rates quickly dissipated as a combination of moderating economic performance and concerns over credit quality deterioration in European sovereign debt markets left many investors scrambling to adjust interest rate positioning. We continue to believe that a variety of structural headwinds will place limits on economic growth prospects, although we view a “double dip” recession scenario as a lower probability outcome. We also believe it will be important to see how regulatory regimes, such as the forthcoming Basel capital rules, are structured in the coming months; and we are closely watching political developments surrounding the November US elections.

Continuing investor demand for yield and favorable technical dynamics, such as moderate supplies of higher-yielding assets, provide a favorable context for strong performance by spread assets. As such, we continue to like the non-Agency mortgage-backed securities sector, despite modestly rotating capital from this sector to select high-yield names we find attractive. Moreover, various other spread sectors, such as higher-quality corporate debt issues that saw spreads widen over the quarter, look more compelling than the Treasury/Agency sectors or Agency MBS, where we have lightened exposures on solid gains amid risk averse market dynamics.

Turning to municipals, the negative headlines that have persisted for the last several quarters are expected to continue as the slowly improving economic environment has not translated into increased revenues for states and municipalities. While spending cuts are beginning to play a larger role in balancing budgets, stimulus monies from the federal government are running out, increasing the likelihood of further budget deficits.

## Fixed Income Views

- Investor thirst for yield amid a moderate supply of high-quality higher-yielding assets should support spread assets going forward.
- Although the supply of municipal debt continues to be manageable, a neutral stance is warranted as absolute yields are low while headline risk remains.

▶ We continue to believe that a variety of structural headwinds will place limits on economic growth prospects, although we view a “double dip” recession scenario as a lower probability outcome.

▶ Continuing investor demand for yield and favorable technical dynamics, such as moderate supplies of higher-yielding assets, provide a favorable context for strong performance by spread assets.

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Sector Outlook		Strength of Preference				
Sector	Current Outlook	Underweight	◀ Neutral ▶	Overweight		
High Yield	Added to the sector with rotation from securitized assets	○	○	○	●	○
Securitized Assets	Modest reduction in non-Agency RMBS, but still positive on the sector	○	○	○	●	○
Non-US Dollar	Prefer UK and Canada given recent strong US performance	○	○	◐	●	○
Inflation Protected	Breakevens fairly priced, still useful primarily as inflation hedge	○	○	●	○	○
Municipals	Absolute yields low while fiscal headwinds remain	○	○	●	○	○
Emerging Markets	Underperformed most other spread sectors despite improved fiscal positions	○	○	●	○	○
Corporates	Wider high-quality credit spreads look attractive in a low-yielding environment	○	◐	●	○	○
Treasury/Agency	Still duration neutral, but better relative value can be found elsewhere	○	●	◐	○	○
Agency Mortgages	Better values can be found in other high-quality spread sectors	○	●	○	○	○

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