

Fixed Income Corporate Credit Market Outlook

June 2010

Volatility Remains High Amid Headline Risk and Expected Stimulus Contraction

As we argued last month, the roots of the recent volatility seen within virtually all risk asset markets has more to do with fear surrounding actual (and expected) contractions in governmental stimulus efforts globally (QE, asset purchases, and monetary policy accommodation, for instance), and with declines in the monetary base, than merely with investor concern over the organic strength of the economic recovery. As the month of June progressed, these factors continued to be key sources of market volatility, along with a steady stream of negative or mixed headlines the month produced. The Eurozone sovereign debt crisis continued to be the most significant headline driver of recent market stress and volatility, and we think the fiscal adjustments that many European nations face in the years to come will be a drag on markets through economic influence and negative sentiment. Moreover, the fact that China is proactively slowing its growth rate should also continue to weigh on markets near-term, although unlike some observers, we still think that China will continue to deliver solid economic growth (albeit at a modestly slower pace).

In a very real sense, we believe the credit markets are being driven, like virtually every market, by changes to these broad-based macro market factors, and as a result we have seen a spike in the volatility of volatility. This is a very difficult environment for active market traders (such as the broker-dealer community) to be profitable in, as the markets have tended to be characterized by seemingly random, and often violent, shifts that do not display discernable trends. As we describe later, however, we think the environment we find ourselves in can provide opportunity for more patient money.

As we have argued for some time, we believe the strength of the economic rebound (which has recently moderated, as we suspected it would) owes a great deal to the unprecedented governmental fiscal and monetary stimulus introduced during the financial crisis. Thus, to the extent that the risk rally that began in March 2009, and the associated economic revival, were driven by massive levels of policy-induced liquidity, perhaps the volatility we are seeing today is simply a reflection of the abatement of those capital flows.

When looking to discern the degree of impact of government support of the economy, one can look at several metrics, such as the short-term funding markets, for guidance. It is not entirely surprising that as the Fed officially ended its quantitative easing programs at the end of March 2010; it took only 26 trading days before three-month (USD) LIBOR rates more than doubled. At that time, headlines coming out on the European debt crisis seemed dire, but it has essentially taken further government intervention in the economy (this time from Europe) to stabilize short-term funding markets, albeit at a higher level. Additionally, another dramatic depiction of the impact of government aid to the economy comes in the support the US residential housing sector has received

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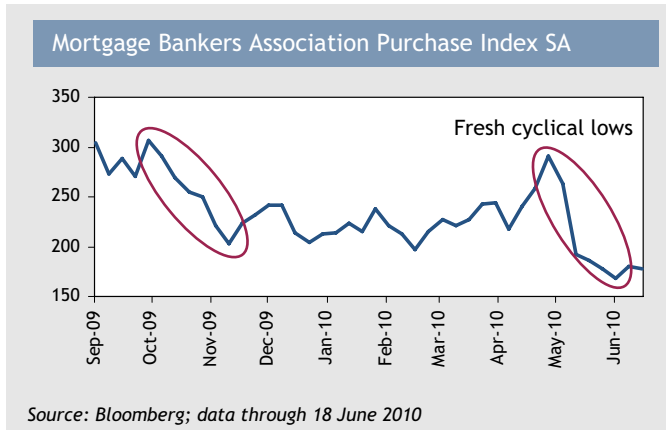
Highlights

- Contracting governmental stimulus, and a steady stream of negative headlines (primarily surrounding the Eurozone sovereign debt crisis), continued to drive market stress and volatility.
- Despite some stabilization in the employment picture, meaningful progress in job creation remains illusive, as some segments of society (such as younger workers) suffer extraordinary burdens.
- Moreover, while there is evidence that recessionary periods have been able to stimulate entrepreneurial innovation, and eventually new job creation, we think that start-ups will be more difficult to launch in this tougher credit environment.
- We seek investment opportunities in credits where the companies have already gone through a restructuring/business rationalization process and therefore seem better prepared for the slow growth we see ahead.

The views expressed are those of BlackRock's Fundamental Corporate Credit Fixed Income team as of June 2010 and may change as subsequent conditions vary.

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through the home buyer tax credit program. As illustrated clearly by the October 2009 and May 2010 declines in the Mortgage Bankers Association Purchase Index, which are both moments at which the credit was scheduled to expire, mortgage applications for purchases (and actual home purchases) plunged. Government support has clearly aided economic recovery globally, but we believe historical evidence illustrates that once the aid is pulled, true demand declines precipitously.

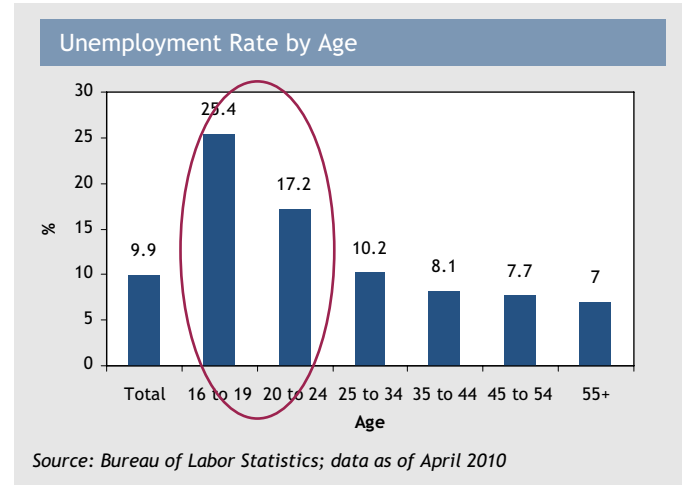


Labor Market Woes: The Enduring Implications of “Right-Sizing” the Economy

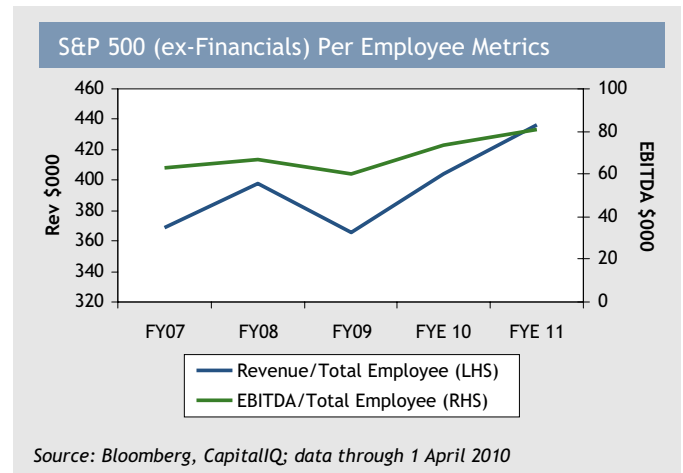
The economy has been suffering through a major structural adjustment in the wake of the financial crisis and credit contraction, and nowhere is this more evident than in the pain seen in the employment numbers. Despite the fact that the labor market has clearly bounced from generational lows, genuine progress here remains illusive. Private sector job losses have abated, but meaningful job creation (particularly relative to the levels required to replace lost jobs) has yet to take place, and both initial and continuing jobless claims benefits remain stubbornly high. Moreover, the Bureau of Labor Statistics (BLS) May data releases were disappointing, with deterioration in private sector job growth. Indeed, the BLS’s household survey showed declines in both the number of people employed as well as in the size of the labor force, an occurrence that is atypical for the recovery phase of an economic cycle.

Additionally, this downturn has hit certain segments of society particularly hard, a fact that will hold important implications for thinking about investments, economic growth, and corporate activities for years to come. The unemployment rate has been staggeringly high among the younger generations, which research has shown will have large implications for their ability to generate wealth throughout their working lives. At the same time, older workers have remained in the workforce for longer, a trend

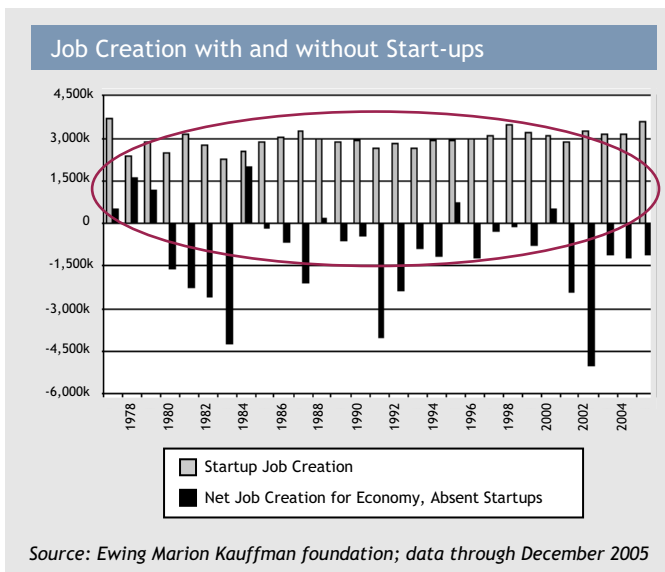
that is expected to persist, as many mid-to-late-stage Baby Boomers saved too little for retirement and were overly dependent on (now much depleted) housing equity as a source of savings. In fact, the labor force participation rate among individuals aged 55 and above has drifted to 40%, significantly higher from where it stood twenty years ago when the rate sat at 30%.



Another critical point to consider is that many firms that have cut employees during the recession now seem to be operating much more efficiently than in the pre-crisis period, and thus are not expected to hire back as many employees during the recovery. Moreover, the industries where the hiring does eventually occur will likely be different from those that saw the deepest job losses. Over the past 60 years, the composition of the workforce has changed markedly from decade to decade, as different sectors in the economy have carried the mantle of job growth in different periods. Thus, while we believe many of the recent job losses have come from the real estate, construction, and finance sectors, new job creation will likely come from areas such as healthcare, technology, and energy.



So while we are encouraged by the spirit of economist Joseph Schumpeter's concept of "creative destruction," which would suggest that a good deal of future economic growth will be generated by entrepreneurial innovation and the development of new start-up firms, we have concerns about the efficacy of that process for this recovery. Recessions have historically been fertile periods for new business formation, and in fact over the last 30 years all net new job creation has come from firms that were five years old or younger. Moreover, according to Kauffman Foundation research, 57% of Fortune 500 companies were founded during a recession. That said, the reduced availability of credit to small businesses at this time may hamper this avenue of job creation and serve as a headwind to growth more generally.



Opportunities Exist in Right-Sized Industries and Companies

While the right-sizing of the economy is clearly a painful and difficult process, as it is with individual firms as well, the result for companies can often be positive longer-term, as they achieve greater efficiencies and production capacities fall better in line with actual demand. Given the economic outlook we have expounded in recent months, where solid shorter-term growth prospects recede in the back half of 2010 as government stimulus wears off and structural headwinds to growth take hold, we are seeking investment opportunities in firms that have already gone through this process and are structured to operate effectively in a slower growth environment.

A great example of an industry that was forced to restructure prior to and during the financial crisis, but is now seemingly much better positioned for the current environment, are the auto manufacturers and suppliers. The severity of the current recession has resulted in extraordinarily negative trends in most auto-related data series; for instance, US light vehicle sales remain 23% below their 20-year average, and for the first time in decades vehicles per household numbers have begun trending lower.¹ Still, the "Big Three" auto manufacturers and many of the suppliers can survive this structurally lower demand dynamic (and can be good investments), given the re-tooling they have gone through. Now, we believe many of these firms should be able to operate reasonably effectively in what we expect to be a structurally slower growth paradigm over the coming years.

For the balance of this year, and potentially longer, we like owning the debt of companies that have already dealt with their capacity issues, and other such areas include selected homebuilders and airlines. We believe some homebuilders are seeing their gross margins begin to normalize, and some firms' large cash balances should allow them to take advantage of lower priced properties. Many airlines had already taken capacity out during the beginning of the last decade and they now find themselves better off in a longer-term low growth dynamic. It is important to understand that investments of this kind can take a while to pay off, and some research we have examined suggests that while companies/industries can perform very well after a restructuring/business rationalization, the process can take years.

In terms of where we see valuations in the credit space more generally, we would argue that decent value can still be found, particularly in the high yield sectors that boast near double-digit yields for companies that have already gone through their "near death" experiences and have rationalized their capacity issues. We believe high yield generates almost as much pick-up in spread (in percentage terms) today as it did during the crisis, although with some improved fundamental characteristics relative to the crisis period. Finally, as we argued last month, we think that it is still difficult to make a "beta bet" on investment grade or high yield credit sectors, and investors are better off looking at idiosyncratic investment opportunities (as we have identified above) in this economic context.

¹ Bloomberg, BlackRock

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