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What's Ahead in 2008

An Investment Perspective

Second Quarter Update

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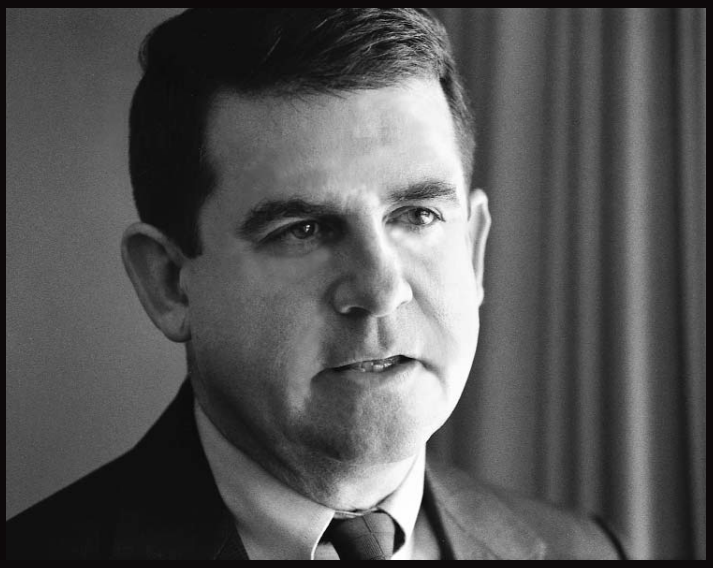

Bob Doll is a Vice Chairman and Director of BlackRock, a premier provider of global investment management, risk management and advisory services. Bob also is the Global Chief Investment Officer of Equities, a member of the BlackRock Executive Committee and holds a seat on the BlackRock Board of Directors. Additionally, he is lead portfolio manager of BlackRock's Large Cap Series Funds. Prior to joining BlackRock, Bob was President and Chief Investment Officer of Merrill Lynch Investment Managers. BlackRock has $1.36 trillion in assets under management as of March 31, 2008.

The Economic and Market Backdrop and Outlook

- The economy is doing better than might have been expected given the proliferation of negative shocks, but the growth outlook is at best mediocre, and the risks remain tilted to the downside.
- Looking ahead, we believe that the U.S. economy will remain mired in a growth range between 0% and 2%.

A Still Weak (But Growing) Economy

The U.S. economic and financial environment remains troubled, but it is important to emphasize that the economy is still growing. The economy is doing better than might have been expected given the proliferation of negative shocks, but the growth outlook is at best mediocre, and the risks remain tilted to the downside. Meanwhile, the credit system remains badly impaired, highlighted by the ongoing freefall in financial stocks. It is virtually impossible to judge when oil prices will suffer a meaningful decline, and there is no sign of an end to the bad news emanating from the housing and banking sectors. Strong corporate profits and still-robust levels of exports remain among the few bright spots in the economic picture, however, and have helped keep the economy from sinking into recession. Looking ahead, we believe that the U.S. economy will remain mired in a growth range between 0% and 2%.

- Faced with the crosscurrents of inflation on the one hand and financial strains on the other, we believe the Fed will opt to stay on the sidelines for at least several more months.

A Holding Pattern for the Fed

On the inflation front, the rhetoric from the Federal Reserve and other central banks around the world indicates growing discomfort with inflation trends. After cutting rates 0.25% on April 30, the Fed fulfilled market expectations by holding its target rate at 2% at its June policy meeting, although there was likely intense debate about the appropriate timing of tightening. The fed funds rate is at its current low level because of financial strains, not because of economic trends. As policymakers grew increasingly concerned about inflation trends, the discussion in the marketplace shifted to timing the eventuality of rate hikes. In our opinion, however, it is not reasonable to expect the Fed to raise rates when the financial sector is still under pressure and the economy faces significant downside risks. Thus, current market expectations of 50- and 100-basis-point rate hikes in the next 6 and 12 months, respectively, appear misguided. At the same time, it would take a serious worsening in economic and/or financial conditions to cause the Fed to ease further. Faced with the crosscurrents of inflation on the one hand and financial strains on the other, we believe the Fed will opt to stay on the sidelines for at least several more months.

The Oil Outlook

There are some encouraging signs that the spike in oil prices may be on borrowed time. An easing of demand pressures is clearly under way in many developed economies, subsidies are being reduced in the developing world, and Saudi Arabia is promising to boost output. A drop in oil prices would be bullish for both stocks and bonds. The markets would likely revise down interest rate expectations as inflation fears recede, and stocks would rally. Although prices seem to have reached a choke point for the global economy, the

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supply/demand balance is still tight, and it would not take much in the way of supply disruptions to cause prices to move even higher. At present, it is clear that the current level of prices represents a major headwind for the global economy and markets, and reinforces the case for a cautious investment stance. While we continue to believe that oil prices are due for a correction (and the sooner prices fall, the better), we do acknowledge that it is notoriously difficult to accurately predict where oil prices are headed.

The Second Quarter by the Numbers

Starting in mid-March, at the time of the Bear Stearns collapse, equity markets bounced around but generally moved upward throughout most of April and May. As the second quarter drew to a close, however, stocks began plummeting in the face of climbing oil prices, concerns about inflation and lingering credit and financial market issues. For the quarter as a whole, U.S. equity markets experienced sharp losses. The Dow Jones Industrial Average, which suffered as a result of some high-profile losses from such key components as General Motors and Bank of America, fell 6.9%, or almost 1,000 points, to end the quarter at 11,350. The Dow is down 13.4% for the year. The broader market averages fared somewhat better, with the S&P 500® Index losing 2.7% to end the quarter at 1,280 (leaving it with an 11.9% loss year-to-date) and the Nasdaq® Composite eking out a small quarterly gain of 0.6% to close at 2,292 (notching a 13.6% loss for the year). The Russell 2000®, an index of small-cap stocks, also managed to post a small gain of 0.6% for the quarter.

Most international equity markets registered losses for the quarter as well. Japan, where inflation has remained muted, was one of the few standouts, with its market posting a 7.6% gain. European markets, which are combating financial problems and inflationary pressures, suffered losses, with German stocks off 1.8%, French stocks down by 5.8% and U.K. stocks losing 1.3%. Emerging markets experienced mixed performance. Chinese stocks continued to lose ground, falling 21%, and most other Asian markets also notched significant losses. In contrast, Latin American markets continued to perform well, led by Brazilian stocks, which gained 6.6%.

In fixed income markets, the flight to quality that was so evident early in the year reversed course somewhat throughout the second quarter as investors sold off Treasuries. The yield on the 10-year Treasury, which began the quarter at 3.41%, climbed up to the 4.20% range in mid-June before declining to 3.97% at the end of the quarter amid the sharp stock market sell-off. In this environment, the Lehman Brothers Aggregate Bond Index lost 1.0%. Finally, cash investments, as represented by the three-month Treasury bill, returned 0.3% for the quarter.

The Outlook

We are not among those predicting a disaster scenario for the markets (i.e., surging inflation and/or a deep recession), but it remains to be seen whether economic and financial conditions will improve enough to warrant a more aggressive investment stance later this year. Key developments that would support a more positive environment include a sustained drop in oil prices, a moderation in the rate of decline in house prices, fiscal measures to ease the plight of homeowners and a further easing in credit market strains. In the absence of these developments, we prefer a more cautious approach.

On the whole, our assessment of overall equity market prospects has not changed. We believe equities should outperform both bonds and cash over the coming year, but it will come via a grinding upturn in prices, not a powerful bull run. However, there is a good chance that economic disappointment will keep the market under pressure in the near term. Within the market, we would still emphasize globally oriented sectors rather than those more dependent on domestic activity.

These remain challenging times for both investors and policymakers. The unfortunate reality is that the U.S. economy faces a protracted period of subpar growth, which hardly sounds much more appealing than a sharp and short recession. In some ways, it may be even worse, as a long period of disappointing performance could have a lasting and corrosive effect on confidence. If businesses start to believe that a recovery is a long way off, they may decide to adopt tougher measures to control costs, including bigger cuts in employment and capital spending.

We want to again emphasize that we are not among those who expect a dire outcome for the economy and markets, but we also realize that there is not much of a case for taking the opposite extreme. It will take time to work through the aftermath of a major credit bubble bursting and we cannot count on further significant help from the monetary authorities given the inflation situation. Certainly, things would look a lot better if oil prices were to suffer a large drop, but that is far from assured. Crises always create opportunities, and the prices of some equities have fallen by enough to create excellent value by historical standards. Caution remains the order of the day, however, until some of the economic and financial headwinds diminish.

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The Scorecard So Far

At the halfway point for the year, most of our predictions remain on track. Global growth has clearly slowed, earnings have declined sharply and the Fed has cut rates drastically. Nevertheless, some of our predictions are looking a little dicier, most notably our call that oil prices will end the year lower than where they started and our prediction that stocks will reach a new all-time high in 2008.

1. World growth dips below trend for the first time since 2002.	The global economy clearly has weakened in the first half of the year. The U.S. economy has been leading the way on the downside, but other developed markets also have been slowing. Importantly, however, the emerging market experience has been very different, as these markets continue to expand at a healthy pace.
2. The United States narrowly escapes an economic recession, but experiences a profits recession.	As detailed earlier, we acknowledge that the data continue to point to a fragile U.S. economy that is clearly facing some downside risks. Nonetheless, it is an economy that is still growing, and appears to be set to avoid entering into a recession. From a corporate earnings standpoint, the United States appears to be at the tail-end of a profits recession. We believe the second quarter will mark the fourth and last of negative year-over-year comparisons.
3. The fed funds rate falls to 3.5% or lower as Treasury bond yields rise.	All told, the Fed cut the fed funds rate by 225 basis points in the first half of this year, leaving the rate at 2% by the end of the second quarter. Treasury yields fell sharply during the height of the credit crisis, but have moved noticeably higher over the past couple of months as the inflation outlook has become more worrisome. As the second quarter ended, the yield on the 10-year Treasury was slightly below where it was at the start of the year.
4. The dollar rises against the euro, but falls against developing market currencies.	The dollar weakened sharply early in the year as the U.S. economy slowed and as the Fed cut interest rates aggressively. The dollar has been showing signs of stabilizing recently, however, and global policymakers have made it clear that they do not wish to see the dollar fall much further. While that does not guarantee an end to the dollar's slide, the currency is cheap versus its major counterparts, and the underlying U.S. trade picture is improving. During the second quarter, the dollar strengthened very slightly against the euro and was mixed when compared to developing market currencies.
5. Stocks achieve a new all-time high in 2008 as price/earnings ratios improve.	Based on market performance over the first half of the year, we appear to be on the wrong side of this prediction. Stock prices would have to climb by around 20% over the next six months to reach new records from this point, and we acknowledge the difficulty of that task given the prevailing environment. As indicated earlier, however, our long-term view of the market is for rocky, but generally positive, performance.

6. Large cap and growth outperform small cap and value.	Since the beginning of the year, we have been advocating that investors focus on higher-quality investments, given slow levels of economic growth and weakening earnings. This approach would translate into a focus on large-cap and growth styles. Growth styles have weathered the downturn in equity markets better than value has, and growth has outperformed on a year-to-date basis. Although large caps outperformed in the first quarter, smaller-cap stocks have slightly outperformed their large-cap counterparts year-to-date. That said, we remain convinced that large caps are a more attractive option in the prevailing environment.
7. Developing economies and equity markets outperform developed ones yet again.	Emerging markets have been doing reasonably well in terms of economic growth, and we believe the emerging economies should continue to outpace those in the developed world. From a markets perspective, emerging markets have posted some mixed performance. China has experienced a noticeable downturn, but many Latin American markets (notably Brazil) have continued to post strong performance.
8. Despite rising above $100 per barrel, oil prices end the year lower than where they started.	High oil prices have become one of the dominant market stories over the past couple of months as prices have hit records in excess of $140 per barrel. While there is some degree of speculative buying being built into current prices, supply/demand dynamics remain the key determinant of long-term pricing. We continue to believe that oil is due for a short-term correction, but energy prices will likely remain at elevated levels over the long term.
9. Information technology, healthcare and energy outperform utilities, financials and consumer discretionary.	Although there are some outliers, this prediction is on track, primarily because energy has been the strongest-performing sector of the market while financials have lagged significantly. Altogether, a basket of the IT, healthcare and energy sectors have outperformed a basket of the utilities, financials and consumer discretionary sectors.
10. Democrats capture the White House and increase their lead in the Senate, House and governors' mansions for the first time since 1992.	The outlook for Republicans this fall continues to look grim. In what many are interpreting as a sign of things to come, Democrats have increased their majority in the House in a series of three special elections, and even some leaders in the Republican Party are talking about the likelihood of additional losses in GOP seats in Congress this election cycle. The race between Senators Barack Obama and John McCain is just beginning to take shape, but the backdrop of an unpopular war and a struggling economy, combined with Obama's impressive fundraising and organizational abilities, seems to give him the edge as well.

What's an Investor to Do?

Weathering a significant market downturn and high levels of market volatility has been difficult for many investors, but opportunities remain. We encourage investors to work with their financial professionals to find tactical investment strategies that work within the context of their long-term investment plans. At present, our advice to investors matches what we have been saying for the last several quarters:

Increase weightings to U.S. large-cap stocks: The environment of uncertainty and subpar economic growth is likely to persist, supporting an overweighting in large-cap and high-quality stocks, with an orientation toward growth. A specific area of the market we like is U.S. multinationals, as these companies currently offer strong growth, high quality and are selling at reasonable prices.

Complement U.S. holdings with faster-growing international markets: Not only does international investing offer diversification benefits, but we believe some non-U.S. markets look especially attractive given stronger levels of domestic economic growth. We also continue to have a positive long-term view toward selected emerging markets, most notably key markets in Latin America.

Consider commodities as a long-term investment: We believe that a cautious approach toward commodities is warranted in the near term, as oil and other hard commodities may be overdue for some sort of cyclical downturn given their current lofty prices. However, long term, the fundamental secular case for commodities remains sound.

Keep your focus: In the face of ongoing market volatility, we would encourage investors to remain focused on the long term, ride out any potential storms, look for buying opportunities and, above all, rely on the basic tenets of staying fully invested and well diversified.

No investment is risk free. International investing involves additional risks, including risks related to foreign currency, limited liquidity, less government regulation and the possibility of substantial volatility due to adverse political, economic or other developments. The two main risks related to fixed income investing are interest rate risk and credit risk. Typically, when interest rates rise, there is a corresponding decline in the market value of bonds. Credit risk refers to the possibility that the issuer of the bond will not be able to make principal and interest payments. Investments in commodities may entail significant risks and can be significantly affected by events such as variations in the commodities markets, weather, disease, embargoes, international, political and economic developments, the success of exploration projects, tax and other government regulations, as well as other factors. Index performance is shown for illustrative purposes only. You cannot invest directly in an index.

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