Global Credit Crisis
Special Market Report

4 November 2008

BLACKROCK

The turmoil in financial markets has accelerated over the last couple of months, and in response, governments and policymakers worldwide have taken aggressive and creative action in order to provide relief. This report offers a perspective on current events, discusses signs that investors should look for to determine when the turmoil will ease, and makes suggestions on where value can be found in the current market.

Recent Government Action

Additional government action has been taken since our last update on credit markets, which discussed in detail the passage of the TARP legislation and the many new central bank actions. Perhaps the most notable steps were those first taken in the U.K., and subsequently followed by several other countries, to directly nationalize parts of the banking system through government purchases of equity stakes in certain banks. In the U.S., similar action was taken as part of the TARP legislation, in which the Treasury Department elected to shift its focus from the purchase of bad loans to the purchase of preferred equity shares in many of the nation's banks. In our opinion, the government's willingness to use public sector funds to support the financial system by increasing lending, backstopping credit markets, providing guarantees, and acquiring equity stakes in banks is a major step towards restoring confidence in credit markets.

In addition, the Federal Reserve and other central banks have sought to keep liquidity flowing through the markets by expanding the Fed's swap facilities and creating a short-term debt purchase program designed to shore up the money market industry. Most recently, the Fed again cut the fed funds target interest rate by 0.50%, or 50 bps, on 29 October to 1.0%, which equals the rate during the bottom of the last interest rate reduction cycle in 2003. In the statement that accompanied the latest cut, the Fed indicated that "downside risks to growth remain" and suggested the possibility of additional cuts. Outside of central bank action, there has been increased discussion in Congress about enacting another broad-based fiscal stimulus plan. The outlines of such a plan are still being formed and the timing and scope of such a plan remains uncertain.

The Current Economic Landscape

Before September, the world economy retained some lingering strength despite the credit market turmoil. Whatever vigor remained after September, however, has since evaporated. At this time, we are convinced that the US economy has entered a recession, with the first estimate of third-quarter GDP growth showing that the US economy contracted by 0.3%. Investment and hiring plans have been cut, labor market weakness has accelerated, and the unemployment rate has been climbing. Consumer spending continues to weaken, and exports, which had previously been a bright spot, have been dimming given the deteriorating prospects for the global economy.

We believe the global economy is sliding into a recession, marking the first time since the 1970s that economies around the world would be in recession concurrently. Looking ahead, we expect most developed economies will contract for two or three consecutive quarters. Some emerging markets are likely to maintain positive growth rates while others experience zero growth, but overall, emerging market growth will likely slow sharply.

About BlackRock

BlackRock is a premier provider of global investment management, risk management, and advisory services. As of 30 September 2008, the firm manages US$1.26 trillion across equity, fixed income, real estate, liquidity, and alternative strategies. Clients include corporate, public, and union pension plans, insurance companies, mutual funds, endowments, foundations, charities, corporations, official institutions, and individuals worldwide.

Through BlackRock Solutions®, the firm offers risk management and advisory services that combine capital markets expertise with proprietarily-developed systems and technology. BlackRock Solutions provides risk management and enterprise investment services for US$7 trillion in assets.

BlackRock serves clients in North and South America, Europe, Asia, Australia, Africa, and the Middle East. Headquartered in New York, the firm maintains offices in 22 countries around the world.

Bob Doll is a Vice Chairman and a member of the BlackRock Board of Directors. He is also the Global Chief Investment Officer of Equities and head of the US Large Cap Series equity team. Prior to joining BlackRock, Mr. Doll was President and Chief Investment Officer of Merrill Lynch Investment Managers.

Peter Fisher is a Managing Director and co-head of BlackRock's Fixed Income Portfolio Management Group. He co-chairs the Fixed Income Investment Strategy Group. Prior to joining BlackRock, Mr. Fisher served as the Under Secretary of the U.S. Treasury for Domestic Finance.

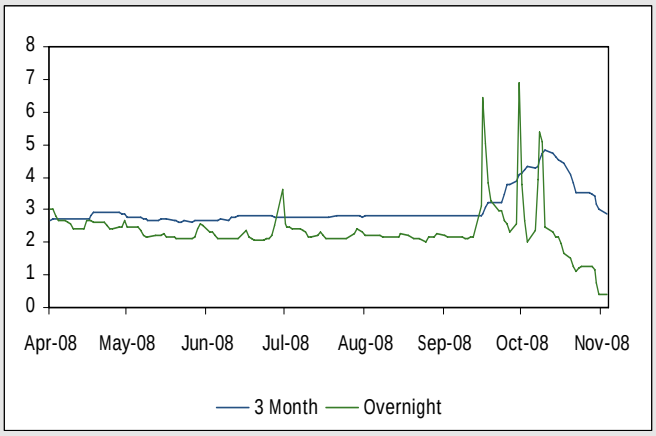
When Will All of This End?

Coordinated interest rate cuts, recapitalization of the banking system, nationalization of financial institutions, massive liquidity injections, increased deposit insurance, explicit and implicit guarantees of interbank loans, mark-to-market accounting changes, fiscal stimulus, and government purchases of assets are actions that should help financial markets function more normally. In our opinion, while it may be some time before the effects of the new programs and interest rate cuts work their way through the system, we are optimistic that all of these actions will help stabilize the banking system and cause credit to flow again.

Given the void caused by the unwillingness of banks to lend to one another, the Fed and other central banks have stepped in as lender of last resort. Direct lending by central banks is an important backstop, but in our opinion, the difficult lending environment will persist until interbank lending returns to more normal conditions.

But how will investors know when interbank lending has returned to normal? One indication is the London Interbank Offered Rate (LIBOR). As credit conditions seized up earlier in the year, and as banks became increasingly unwilling to lend to one another, the overnight LIBOR rate spiked repeatedly and jumped as high as 6.88%. More recently, as central banks worldwide have been actively injecting additional liquidity into the system and cutting interest rates, the overnight LIBOR rate has dropped sharply to less than 1.00%. Similarly, the more closely watched three-month LIBOR rate climbed from under 3.00% to near 5.00%, then retreated to levels around 3.00%, a sign that bank lending has begun to normalize, but has not completely returned to normal.

Figure 1. Daily Overnight and Three-Month LIBOR



Source: Bloomberg. Data from 1 April to 3 November 2008

Another way to gauge lending conditions is through swap spreads. Banks and other financial institutions routinely use swaps as a means to manage their exposures to interest rate changes and, in normal times, the spread between fixed and floating rates tends to be quite narrow. During times of financial crisis, however, the spread increases (as it did during the savings and loan crisis of the late 1980s and the collapse of Long-Term Capital Management in 1998) as banks become reluctant to lend to one another and begin charging one another higher interest rates. In recent months, swap spreads have spiked as credit conditions tightened. We have recently seen a modest improvement in this market as lending conditions have begun to improve, but current spreads still point to a distressed market, and we believe further spread narrowing must occur as evidence that trust among banks has been restored.

Figure 2. U.S. Dollar 2-Year Swap Spread

Source: Bloomberg. Weekly data from January 2003 to October 2008

Outlook and Opportunities in Fixed Income

In an environment of wider credit spreads, we believe there is value in some higher-yielding securities, provided that investors focus on higher quality assets. For example, some areas of the corporate bond market, including financial institutions, represent attractive value, but a focus on quality is critical.

We have a similar view regarding municipal bonds with respect to yield and quality. After rising sharply in September, municipal yields have begun to normalize, but remain at close to all-time highs relative to Treasury yields in all maturity ranges, suggesting that high-yielding, high-quality municipal bonds represent good value.

We also draw investors' attention to what will be a new class of US government-guaranteed bonds—the financial sector bonds that will be issued as part of the government's partial takeover of some of the nation's banks. These bonds are a potentially attractive opportunity given that they will have higher yields than Treasuries while still being backed by the "full faith and credit" of the US government. Investors should note, however, that these bonds will be significantly less liquid than Treasuries.

Finally, we encourage investors to look for opportunities in non-US markets, where many bonds are attractively valued. In general, government bond yields in most developed non-US markets are higher than those in the U.S. in part because non-US central banks have been slower in lowering interest rates, and there is room for further easing.

Outlook and Opportunities in Equities

We continue to believe that the best value in this uncertain period can be found in higher-quality companies that have relatively strong balance sheets, strong levels of free cash flow, and adequate financing. In general, a focus on such companies would lead to an overweighting in large cap and growth stocks. From a geographic perspective, non-US stocks have been hit harder than US stocks, largely due to the same focus on quality. Going forward, we expect US stocks will continue to outperform stocks in other developed markets. Emerging markets have experienced some of the worst performance lately, but we believe the long-term fundamental case for this area of the market remains intact.

With respect to market sectors, we do not believe that the worst is over for financials, and continue to recommend underweight positions. We are, however, seeing value in some financial companies, including some of the larger global banks that are likely to be net beneficiaries in the current environment. One area of the market we continue to find attractive is US multinationals, which has maintained evidence of good growth, despite the rise in the US dollar and global economic weakness. A final sector theme we believe is important can be found in resources. We believe energy companies remain well positioned and are attractively valued despite the pullback in oil prices, but we do not find most of the materials area of the resources market attractive.

A few weeks ago, equity markets appeared to have imploded, and although volatility has continued, markets seem to have regained some footing. The key question is whether we have seen the market bottom. At this point, the S&P 500® and the DJIA have come close to, but have not yet penetrated, their 10 October intraday lows of 840 and 7,900, respectively, although other indices have since reached new lows. From a historical perspective, the current equity bear market has brought stocks down 47% from their peak in October 2007 to their trough in October 2008, roughly in line with the 2002 bear market (50%) and the 1974 decline (48%). Bear markets of this magnitude rarely have a "V-bottom," however, and we expect equities will continue to test the levels of October 10. Over the longer term, we remain cautiously optimistic that equity markets will regain their footing. At current prices, we believe that equities are very attractively valued, and in hindsight, we expect investors will come to this view as well.

FOR MORE INFORMATION
www.blackrock.com

Prepared by BlackRock, Inc.

AC2481-11/2008
SPEC-TARP-RPT-1008

BLACKROCK