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Investment Commentary

February 28, 2011

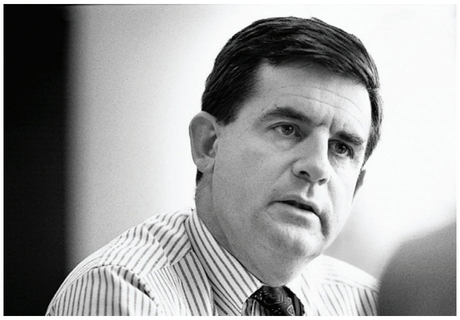
Escalating turmoil in the Middle East and North Africa (specifically in Libya) caused oil prices to spike higher last week and stock prices to fall. Oil prices briefly went over the $100 a barrel mark and despite a late-week rally, stocks ended the week noticeably lower, with the Dow Jones Industrial Average falling 2.1% to 12,130, the S&P 500 Index declining 1.7% to 1,320 and the Nasdaq Composite dropping 1.9% to 2,781.

In many ways, it could be argued that a stock market correction was overdue—before last week, the US stock market had gone 107 days before experiencing a peak-to-trough decline of 3.5%, which represents a new record. Our long-term view is that while short-term volatility is likely to persist, the growing geopolitical risks are unlikely to derail the global economic recovery or the bull market in equities.

With growing civil unrest in the Middle East and North Africa, it appears that the political framework that has dominated the region for the last several decades is in the process of unraveling. We first saw this occur in Tunisia, followed by Egypt, and uprisings and protests have since spread throughout the region, most notably in Libya. As a member of OPEC, Libya produces more than 1.5 million barrels of oil a day. While this is certainly a significant number, it represents less than 5% of OPEC's average daily production. From our perspective, the spike in oil prices is more of a reflection of the fear of the unknown than a result of real changes in the supply/demand dynamic. Libya's future political direction is an unknown at this point, but with Col. Moammar Gadhafi taking a hard stance against the protesters, it seems unlikely that tensions will ease any time soon.

Higher oil prices and political unrest are causing a downturn in equity prices since markets loathe uncertainty and higher oil prices have the potential to trigger inflation and slow global economic growth. While the specter of past oil-related recessions is present in some investors' minds, we do not believe that the global economic recovery will become derailed. There are still a number of important economic factors acting as a counterweight (including still-accommodative central bank policies) and the balance of economic data continues to suggest that growth is accelerating.

At the same time, we do not believe that higher oil prices will trigger serious inflation concerns, at least in the developed world. In addition to higher energy prices, food prices have been rising (which has been one of the catalysts for protests in the Middle East). In contrast to the emerging world, consumers in the United States and other developed markets spend only a small percentage of their income on food and energy. While higher food and energy prices are causing problems in several emerging economies, we do not expect to see a spillover effect into the United States or most other developed markets. Although the trend of falling prices in globally traded goods seems to have faded on at least a temporary basis, unless we see a significant decline in the value of the US dollar we do not expect noticeable increases in US inflation.



Bob Doll is Chief Equity Strategist for Fundamental Equities at BlackRock®, a premier provider of global investment management, risk management and advisory services. Mr. Doll is also Lead Portfolio Manager of BlackRock's Large Cap Series Funds. Prior to joining the firm, Mr. Doll was President and Chief Investment Officer of Merrill Lynch Investment Managers.

Outside of geopolitical risks and higher energy prices, other items that have been making headlines include housing prices and US fiscal policy debates. On the housing front, home prices are again approaching new lows. The Case-Shiller Home Price Index hit a low in May 2009 and after hovering above that level, the low has recently been tested again, a reminder that housing remains quite weak and has not yet begun to recover. On the political and fiscal front, the key date of March 4 is fast approaching when the continuing resolution that has been keeping the federal government funded is set to expire. Congress and the Obama Administration have three choices: to pass a budget for the current fiscal year, to pass another continuing resolution or to shut down the federal government. In our view, the second option remains the most likely, although since House Republicans, Senate Democrats and the Administration remain far apart on some key issues, the risks of a shutdown are certainly real.

Taking a broad look at equity markets, it appears to us that while stocks certainly are not as cheap as they were when they hit their lows in March 2009 (the S&P 500 Index has doubled since that point) and while stocks may appear overextended given their sharp rally since August 2010, we still think the bull market has further to run. As of now, stocks are only about 3% below their recent highs, suggesting that some further corrective action may follow and that more turbulence is likely. Absent an additional major spike in oil prices, we expect the global economic recovery will continue. This backdrop, combined with low inflation in most markets, should be conducive to continued strong equity market performance, and we continue to expect stocks to outperform Treasuries and cash over the next several years. While heightened geopolitical risks may prompt some investors to remove money from the table, our advice would be to remain invested and look at short-term dips as buying opportunities.

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