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Weekly Investment Commentary

Markets Continue to Look for Clarity

October 3, 2011

The Third Quarter Ends on a Mixed Note

The final week of the third quarter was again a highly volatile one, with markets generally moving higher early in the week before succumbing to weakness. The results were a mixed week, with the Dow Jones Industrial Average climbing 1.3% to 10,913, the S&P 500 Index falling 0.4% to 1,131 and the Nasdaq Composite declining 2.7% to 2,415. For the third quarter as a whole, US markets were down almost 14%, resulting in a close-to-10% decline for all of 2011 on a year-to-date basis.

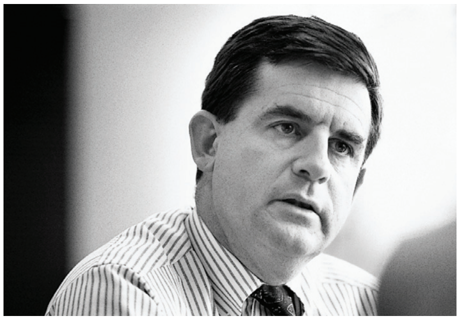
Further Policy Action Is Still Needed

The global financial stresses that have been contributing to market volatility have shown no signs of easing. Financial markets have been signaling that economic growth levels are too weak to support the current financial structure. Corporate bond spreads in most markets have been widening and euro-area bank bond spreads are close to their 2008 crisis levels. These signals suggest that economic growth needs to improve sharply (which is not likely to happen any time soon) or that further policy action is needed to ease the strain.

In Europe, last week's decision to increase the capacity of the European Financial Stability Fund (EFSF) was an encouraging one, but we believe that more still needs to be done. Specifically, just as the United States did in the latter stages of the 2008/2009 credit crisis, some sort of foundation needs to be erected under the European banking system. We believe the sooner a resolution is reached, the less costly it will be and the less damage will be inflicted on the global economy.

The United States remains in relatively better shape than Europe. The US corporate sector is far healthier today than it was during the credit crisis and has shown some willingness to invest. Even if hiring plans have not accelerated, they at least have not turned negative. Both consumer and business sentiment have weakened recently, but those trends have not translated into significant declines in consumption, hiring and capital spending.

Nevertheless, the risks to the US economy skew to the downside, particularly if the European debt crisis drags on and worsens. From a policy perspective, there is a lack of confidence in the country's political leaders and expectations are low that much help will be coming from that front. The Federal Reserve has been implementing some new easing measures and clearly indicated that it would keep interest rates low, but, as with Europe, we still believe more action is needed. Overall, our view remains that the United States will avoid a recession, but we acknowledge that the pressures are growing.



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.

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Markets Look to Earnings for Guidance

The third-quarter earnings season is set to begin and investors will be watching the results very closely to see how well companies have weathered the recent bout of economic and market volatility. Strong earnings results and positive statements about the future could result in some short covering and buying, while weak results would likely reinforce the negative sentiment.

From our vantage point, the data seems to suggest that third-quarter results should be decent. The economy is still growing (if only barely), unit labor costs have not been rising, capacity utilization has ticked up and most commodity prices have been falling. This backdrop suggests that we should see another quarter where positive earnings surprises outweigh negative ones.

Trading Range Likely to Continue

At present, the S&P 500 is closer to the lower end of the 1,100 to 1,250 trading range we have been talking about for some time and current price levels are discounting a mild recession. Since our view is that the United States will manage to avoid a recession, that would imply that equity prices have room to move higher. However, a further decline cannot be ruled out given the high degree of uncertainty.

For the time being, we continue to believe that markets will remain range bound. Since the panic selloff in early August, markets have tested the “floor” of 1,100 and we may see several more such tests in the week to come. Ultimately, we believe the outcome of the European situation will help determine whether or not, and in what direction, markets will be able to break out of their current trading range.

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