

US Fixed Income

Overview

US Economic Overview

The year 2009 ended with continued signs of an improving economy leading to higher intermediate and long-term interest rates. Positive news in housing, manufacturing, consumer sentiment, retail sales, and even within the labor market reinforced the widespread view that the US is experiencing a nascent economic recovery. This news, combined with record supply and concerns that an accelerating economy could fuel inflation, caused intermediate and longer-term interest rates to climb. The sharpest increases were in the “belly” of the curve and the gap between the 2-year US Treasury yield and the 10-year US Treasury yield reached a record high during the month. Further, investors continued to purchase riskier assets in their relentless quest for yield, and most non-US Treasury sectors outperformed the US Treasury sector.

The beleaguered housing sector continued to show signs of improvement. As of the end of November, existing and new homes sales were sharply higher than the lows reached in March. In November, existing home sales rose 7.40% to a 33-month high and both housing starts and building permits showed solid gains. Sales have been buoyed by the recently extended tax credit for first-time home buyers as well as attractive prices. Data through October 2009 showed that homes prices appear to have stopped falling, but remain lower than in October of 2008. The S&P/Case-Shiller Home Price Index of 20 cities was flat for the September/October period, but 7.30% lower than one year earlier. The manufacturing sector was also a source of positive news, with durable goods orders (ex-transportation) up 2% and industrial production posting a 0.80% gain.

This encouraging economic news translated into growing consumer confidence. The University of Michigan Consumer Sentiment Index climbed to 72.5 in December from 67.4 in November. Further, improved confidence inspired consumers to open their wallets over the holiday season. In spite of snowstorms hampering preholiday sales, indications are that post-Christmas sales were quite robust. Retail sales for the week ending December 26 jumped 8.80% from the same period last year, according to data from ShopperTrak. Encouraging signs also emerged in the weak labor market. The Labor Department reported that initial claims for unemployment insurance fell 22,000 to 432,000 for the week of December 26, the lowest level in nearly 18 months.

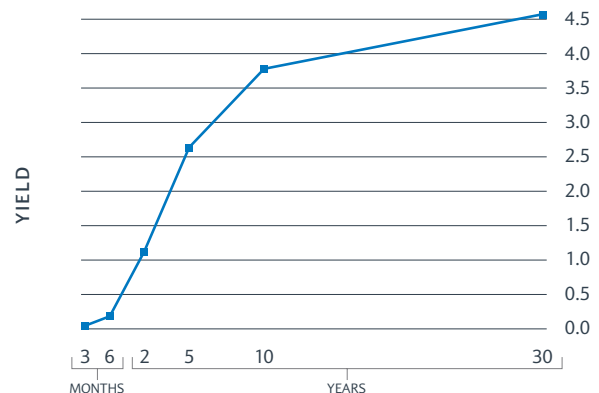
Fixed Income Index Returns by Sector

	DECEMBER RETURN (%)	YTD RETURN (%)
Barclays Capital US Aggregate	-1.56	5.93
Barclays Capital US Treasury	-2.61	-3.57
Barclays Capital US TIPS	-2.19	11.41
Barclays Capital US Corporate	-0.78	18.68
Barclays Capital US Corporate High-Yield	3.28	58.21
Barclays Capital US MBS	-1.41	5.89
S&P National Municipal Bond	0.52	12.20
JP Morgan Emerging Markets Bond	0.35	28.72

Index returns are for illustrative purposes only and do not represent actual iShares Fund performance. Index performance returns do not reflect any management fees, transaction costs or expenses. Indexes are unmanaged and one cannot invest directly in an index. Past performance does not guarantee future results.

Source: BlackRock. As of 12/31/09.

US Treasury Yield Curve



Source: Bloomberg Finance L.P. As of 12/31/09.

Sector Reviews

The Barclays Capital (BC) U.S. Aggregate Bond Index returned -1.6% in December, reducing its 2009 total return to 5.93%. Returns were negatively impacted by rising yields as positive economic data and an abundance of supply put pressure on intermediate and longer-term rates. Outside of US Treasuries, investors continued to exhibit a strong appetite for yield and thus most non-Treasury “spread sectors” fared better. High yield performed the best and along with investment grade and CMBS, were the only sectors to completely offset the impact of rising rates, producing a positive total return for the month. Mortgages delivered the worst performance of the spread sectors, suffering from duration extension as rates rose.

US Treasuries

This spate of relatively good economic news put pressure on interest rates. Though the Federal Reserve kept its benchmark fed funds rate “at or near 0%” at its mid-December meeting, the 10-year US Treasury yield climbed 64 basis points (bps) to close the month at 3.80%. On December 22, the yield differential between the 2-year US Treasury and the 10-year US Treasury reached a record 288 bps before closing the month at 270 bps. Since the beginning of the year, the 10-year Treasury yield has climbed 180 bps while the 3-month US Treasury bill has remained essentially unchanged at 0%. As a result, the US Treasury sector has delivered sharply negative returns this year in sharp contrast to robust gains in both the equity market and most non-Treasury fixed income sectors. For the month, US Treasuries were hampered by rising rates while non-Treasury sectors continued to attract demand from yield-hungry investors.

Investment Grade

The BC U.S. Credit Bond Index outperformed duration-matched US Treasuries by 192 bps in December, although rising rates hampered the total return. For 2009, excess returns versus Treasuries totaled 1,990 bps. Returns were strong across all sectors but were led by financials, particularly life insurers and non-captive finance companies. No sector produced a negative excess return in December, though the noncorporate sector was the laggard with only 61 bps of excess return. Lower quality continued to outperform; BBB's posted excess returns of 267 bps for the month versus 197 bps for the A sector. Spreads on the BC U.S. Credit Bond Index tightened 30 bps for the month and nearly 340 bps in 2009.

Mortgages

The mortgage sector suffered its first month of underperformance in more than a year in December, underperforming duration-matched Treasuries by 29 bps. The BC U.S. MBS Index delivered a total return of 1.41% as the rise in 10-year US Treasury yields and an increase in

volatility resulted in a significant extension of mortgage duration and spurred forced selling, particularly from mortgage servicers. Fed purchases were the most important drivers of relative performance among mortgage securities again in December. Purchases were focused on lower coupon securities, helping this segment of the market outperform middle coupons. Higher coupon mortgages also fared well relative to the middle coupons, benefiting from slower prepayment speeds in November.

High Yield

The high-yield sector posted another positive month to end the year with a record-breaking 58.21% total return, beating 1991's record return by more than 12%. Inflows continued into the sector, and the market digested another \$14.4 billion in new issues. This was the biggest new issue year in the history of the high-yield market, topping the previous record of \$142 billion in 2006. The best-performing sectors on the month were life insurance, finance and banking, while the worst performers were supermarkets, REITs and home construction. Strong returns were broad-based, with all segments of the quality spectrum performing well. However, the lowest quality continued to post the best returns with the Caa sector up 4.5% for the month. For the year, Caa bonds were up 90.60% versus 46.10% for Ba's.

Emerging Markets

Emerging markets performance was modestly positive in December as economic data was generally supportive. Higher risk countries (Argentina, Venezuela, Ukraine) rebounded from underperformance in November. Argentina was up 5.90%, driven by increased commitments by the government to service the public debt and to deal with the long-standing issue of holdouts through a debt exchange. Venezuela returned 3.50% despite threats to nationalize the banking sector, which were later retracted. Higher quality credits such as Brazil, Chile, Mexico, Peru, China and Malaysia underperformed as they reacted more negatively to US rate increases. In ratings news, Peru was upgraded to investment grade by Moody's and Turkey was upgraded to BB+ by Fitch.

TIPS

The BC U.S. TIPS Index fell 2.19% in December, modestly outperforming the BC U.S. Treasury Index as economic news continued to surprise on the upside. Real yields rose in December roughly 30 bps while a modest uptick in inflation contributed slightly to the monthly return. The 10-year breakeven rate closed the month at 2.40%.

Municipals

Municipal bonds outperformed most taxable sectors of the fixed income market. Performance for 2009 also handily beat other high-grade sectors. As in the corporate sector, lower quality outperformed.

iShares Fixed Income Funds

FIXED INCOME PRODUCT	TICKER	MANAGEMENT FEES (%)*	EFFECTIVE DURATION***
iShares Barclays Aggregate	AGG	0.24**	4.29
iShares Barclays Short Treasury	SHV	0.15	0.34
iShares Barclays 1-3 Year Treasury	SHY	0.15	1.87
iShares Barclays 3-7 Year Treasury	IEI	0.15	4.47
iShares Barclays 7-10 Year Treasury	IEF	0.15	7.22
iShares Barclays 10-20 Year Treasury	TLH	0.15	9.33
iShares Barclays 20+ Year Treasury	TLT	0.15	14.76
iShares Barclays Agency	AGZ	0.20	3.09
iShares Barclays Credit	CFT	0.20	5.88
iShares Barclays 1-3 Year Credit	CSJ	0.20	1.81
iShares Barclays Intermediate Credit	CIU	0.20	4.16
iShares iBoxx \$ Investment Grade Corporate	LQD	0.15	7.23
iShares Barclays Government/Credit	GBF	0.20	5.05
iShares Barclays Intermediate Government/Credit	GVI	0.20	3.70
iShares Barclays MBS MBB	MBB	0.34**	3.00
iShares Barclays TIPS	TIP	0.20	4.45
iShares iBoxx \$ High Yield Corporate	HYG	0.50	4.27
iShares S&P Short Term National AMT-Free Municipal	SUB	0.25	2.14
iShares S&P National AMT-Free Municipal	MUB	0.25	7.27
iShares S&P California National AMT-Free Municipal	CMF	0.25	7.73
iShares S&P New York National AMT-Free Municipal	NYF	0.25	7.23
iShares S&P/Citigroup 1-3 Year International Treasury	ISHG	0.35	1.79
iShares S&P/Citigroup International Treasury	IGOV	0.35	6.30
iShares JPMorgan USD Emerging Markets Bond	EMB	0.60	6.87

Sources: BlackRock, Bloomberg Finance, LP. As of 12/31/09.

* "Management Fees" are fees paid to BlackRock Fund Advisors, the Fund's investment advisor. A Fund may also incur indirect expenses on its investments, if any, in other investment companies. Please see the Fund's prospectus for more information on such expenses.

** The total annual operating expenses are shown for the iShares Barclays Aggregate Bond Fund and iShares Barclays MBS Bond Fund. In addition to the management fees, the total expenses include "acquired fund fees and expenses" of 0.04% and 0.09%, respectively, which are related to the funds' investments in the BlackRock Cash Funds: Prime (the "money market fund"). "Acquired fund fees and expenses" represent the funds' pro rata share of the fees and expenses charged by the money market fund and may vary based on the funds' allocation of assets to the annualized net expenses of the money market fund. Annual operating expenses do not include the effect of interest earned by investments in the money market fund, which is expected to offset the money market fund's fees and expenses.

*** Effective duration is a measure of the responsiveness of a bond or portfolio's price to changes in interest rates. Effective duration takes into account the possible changes in expected bond cash flows due to interest rate changes.

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