Economic Analysis

Economics | United States
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Weekly guidebook for the global investor

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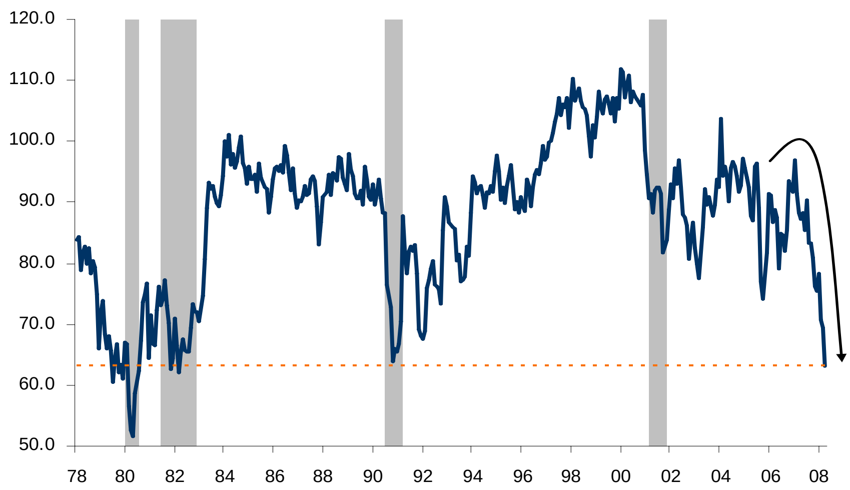
The Macro viewpoint: Over the peak, but long trek down

We may be past the worst of the financial market crisis, at the three-quarters point in the housing construction downturn and one-third to halfway through the real estate deflation, but we are likely only one-fourth of the way into the recession. Moreover, we have seen just 10% of the anticipated employment retrenchment, and the consumer pull back is just starting. That means we think we still have a long and hard downward trek ahead of us, fraught with unexpected obstacles.

The week ahead

Plenty of economic data lined up for next week with retail sales, consumer prices, and producer prices the highlights. On the Fed speaking front, it's busy as well, with a total of seven speakers on tap thus far. Last but not least, look out for the release of the Fed Beige book on Wednesday afternoon.

Consumer confidence has collapsed – lowest level since the 1981-82 recession
University of Michigan Index of Consumer Sentiment



Shaded region represents period of US recession
Source: University of Michigan, Merrill Lynch

This edition of the Market Economist represents our revised layout.

Table of contents

Macro viewpoint

Over the peak, but long trek down

The credit crisis has eased a bit, but is far from over

We may be past the peak of the financial market crisis, at the three-quarters point in the housing construction downturn and one-third to halfway through the real estate deflation, but likely only one-fourth of the way into the recession. Moreover, we have seen just 10% of the anticipated employment retrenchment, and the consumer pull back is just starting. That means we think we still have a long and hard downward trek ahead of us, fraught with unexpected obstacles, such as GE's surprise 12% drop in Q1 earnings and lowered guidance for 2008.

Recession = higher delinquency rates and bond downgrades

The financial Armageddon scenario has been removed by the Fed's move to open the discount window to non-banks, in our opinion. This has allowed many credit spreads to improve a bit, or at least stop widening. However, credit spreads remain elevated and signal continued financial market stress. Moreover, the tight historical link between recession and higher delinquency rates and corporate bond downgrades suggests that the credit crisis is just entering another stage. We call this the recession stage.

Higher corporate defaults and downgrades are ahead

Banks further tighten lending reins

Credit rating downgrades on corporate bonds will add further downward pressure on banks' risk-adjusted capital ratios. Banks' capital-to-asset ratios are risk-adjusted; therefore, downgrades to bonds held by banks lower their capital ratios. Shelia Bair, the chairman of the Federal Deposit Insurance Corporation (FDIC), says the downgrades to corporate bonds could compromise capital ratios enough that some of the largest financial institutions may no longer be considered well capitalized. That will require them to raise more capital and restrain the growth of assets, which further restricts lending to businesses and consumers.

Banks will tighten lending spigot further

Credit crunch to delay and dampen economic recovery

This is of grave concern to the Fed. Credit constriction is part of a nefarious "adverse feedback loop," whereby reduced credit availability retards economic activity, which in turn spurs additional credit tightening. In fact, several Fed members noted "strained financial market conditions could be quite persistent, restraining credit availability and thus economic activity for a time and having the potential subsequently to delay and damp economic recovery."

Credit crunch to intensify and ...

Total losses could hit $1 trillion

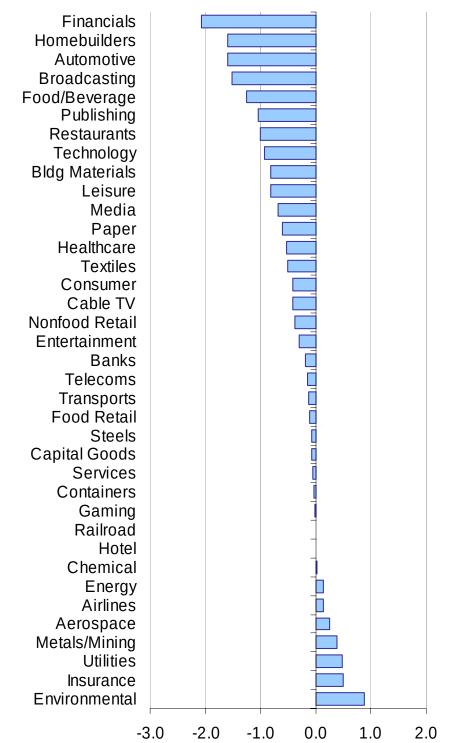
The International Monetary Fund said this week that total losses from the US mortgage crisis could hit $1 trillion world-wide. The report said that mortgage market losses from rising delinquencies and falling home prices could total $565 billion, while losses from securities tied to commercial real estate and consumer loans would make up the difference. According to Bloomberg, banks have only posted about $230 billion in asset write downs and credit losses thus far, suggesting that the worst of the credit crunch is in front of us. As such, it is not surprising to hear that the Fed is working on a contingency plan that would give them additional non-traditional monetary policy tools.

… Negatively feeds back to the economy

Fed staffers slash 2008 GDP forecast, again

Given the current state of the financial markets and economy, it was no surprise that the minutes from the 18 March FOMC meeting revealed that the Fed's economic staff substantially cut its 2008 real GDP growth estimate. Fed staffers say an outright contraction in growth is now expected in the first half of this year. The economy is expected to slowly improve in 2H 2008, boosted by the upcoming $170 billion fiscal stimulus. The fiscal stimulus will unwind in 2009, but "cumulative monetary policy easing, continued strength in net exports, a lessening drag from high oil prices, and a relaxation of financial market strains" should underpin growth close to potential in 2009. However, the Fed admitted there is a lot of uncertainty and downside risk associated with its 2009 outlook.

Chart 1: Negative rating outlook scores prevail
April 2008



Source: Merrill Lynch High Yield Strategy

The Fed's Senior Loan Officer Survey is key, in our view

Moreover, some say "falling home prices and stresses in financial markets could lead to a more severe and protracted downturn in activity than currently anticipated." In this light, one of the most important economic reports released over the next month will be the Fed's Senior Loan Officer Survey. It likely will be released in early May, following the 29-30 April FOMC meeting. Additionally, the 1Q FDIC quarterly bank profile report due out in mid-May will also provide insightful information on the state of bank balance sheets.

Corporate defaults and downgrades likely will rise

Standard & Poor's rating agency forecasts the baseline corporate default rate for high-yield debt could rise to as high as 5.7% from a record low in 2007. The markets had been pricing in a default rate as high as 9-10%. The number of companies at risk of a credit-rating downgrade rose to a record 703 in March.

Merrill Lynch high yield strategists quantitatively show that rating agencies have turned decidedly more negative on the prospects of credit upgrades in the high yield bond market. They estimate that the average score of the agencies' credit watches and outlooks currently stand at -0.38, which is the lowest level for this indicator since its inception in mid-2004. They calculate this metric for each issuer in the Merrill Lynch High Yield Master index using a -3 to +3 range; an issuer on negative watch/outlook from all three agencies gets a score of -3, while three positive outlooks would result in a +3 score.

They then aggregate the metric for each sector in the market (see Chart 1), as well as for the full market (see Chart 2). Most negative outlooks are currently concentrated in financials, homebuilders, autos and broadcasting. Among the few sectors with positive net scores are environmental, insurance, utilities and metals/mining.

Chart 2: Average market outlook score at its lowest levels

Source: Merrill Lynch High Yield Strategy

Financial markets still unsettled

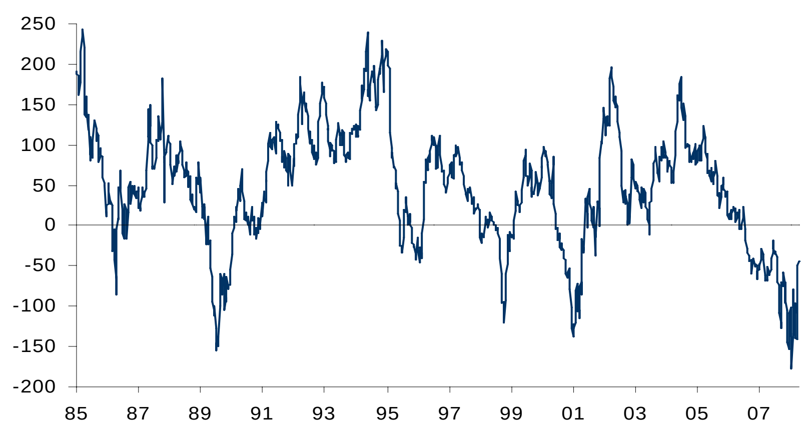
High stress remains in the financial market

The credit markets remain highly dysfunctional. In our research piece titled *Are we there yet*? published on 20 March, we listed a full gamut of credit spreads we are watching for signs of a turn around. All of the interest rate spreads remain elevated, signaling that credit markets remain highly fragile.

Two-year Treasury note minus Fed funds rate yield curve

This is probably the best indicator in predicting better times ahead. The two-year Treasure note yield to the Fed funds rate spread remains at a negative 51bp. This is an improvement from the -165bp spread we saw back on 17 March, but we think this spread needs to improve to around +20bp before we can say conditions are normal.

Chart 3: Two-year T-note/Fed funds yield spread suggest we are still not out of the woods
Two-year Treasury note minus Fed funds rate (bp)

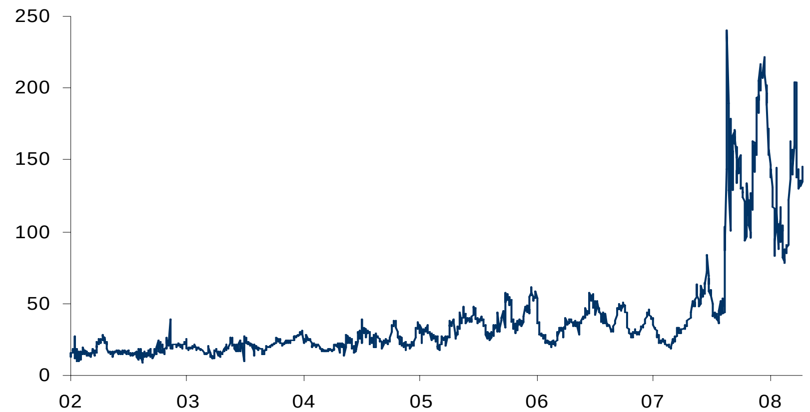


Source: Federal Reserve Board, Merrill Lynch

Three-month TED spread

Despite the cumulative 200bp rate cuts by the Fed so far this year, the three-month TED spread (LIBOR minus Treasury-bill rate) remains quite wide. In fact, it has increased further in the past week, up 9bp to 147bp. To see stable financial markets, we think this spread would need to contract to 35bp.

Chart 4: The TED spread has to narrow to around 40bp before we can say the coast is clear
Three-month Treasury bill minus three-month LIBOR rate (bp)

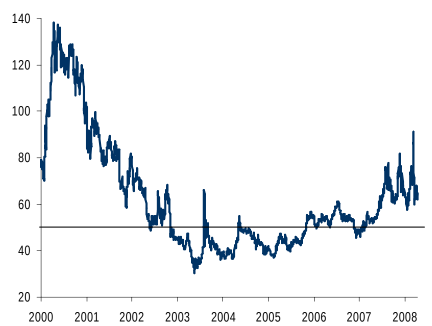


Source: Bloomberg, Merrill Lynch

10-year swap spreads

Spreads have narrowed to 65bp from a recent high of 91bp on 6 March, but we think it needs to get back to around 40bp to signal that the coast is clear.

Chart 5: Ten-year swap spreads still very high
10-year Swap spread (bp)



Source: Bloomberg, Merrill Lynch

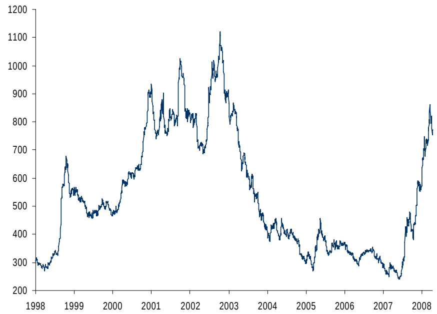
Baa corporate spreads

Corporate spreads are still well above normal at 338bp. Actually, Baa spreads have widened nearly 90bp since the beginning of the year and are up 130bp since the Fed started its easing campaign on 18 September2007. Before we can breathe a sigh of relief, we will have to see this spread to narrow to at least 240bp.

Chart 6: Corporate spreads remains lofty
Baa corporate bond minus 10-year Treasury note yield (bp)

Source: Federal Reserve Board, Merrill Lynch

Chart 7: High yield spreads still high
Merrill Lynch High Yield Master II Index minus 10-year T-note yield (option adjusted spread, bp)



Source: Merrill Lynch, Bloomberg

Junk bond yield spread

High yield spreads are starting to narrow (now down 92bp from its nearby high of 862bp set on 17 March), but they are still very lofty, hovering around the 770bp level. We need to see this spread pull back to around 500bp.

Jumbo rate minus conventional 30-year mortgage rate still very high

The extremely wide spread between jumbo mortgage rates and conventional 30-year rates has barely budged, improving just 34bp since its peak set in mid-March to currently stand at 173bp. Prior to the credit turmoil this spread was a thin 30bp.

Chart 8: Jumbo rate minus conventional 30-year mortgage rate still very high (bp)

Source: Bloomberg, Merrill Lynch

Chart 9: 30-year mortgage/10-year note spread (bp)

Source: Bloomberg, Merrill Lynch

Conventional 30-year mortgage rate minus 10-year note spread

One spread measure that has improved is the conventional mortgage rate to 10-year Treasury note spread. The spread between these two rates have come down to 176bp, which is a far cry from the 238bp spread we saw back on 6 March.

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Key market movers
The week ahead

Heavy flow of economic data with retail sales, CPI, and PPI the highlights

There is a plethora of economic data lined up for next week with retail sales, consumer prices, and producer prices the highlights. Headline retail sales are expected to decline 0.4% in March, with weak motor vehicle sales one of the main laggards. The latest chain store sales data also showed weakness in many components and thus we expect the declines to be very broad-based.

Consumer prices are expected to increase 0.3% in March with the energy component adding substantially to the headline. The increase in food prices will likely be elevated, similar to last month, as increases in agricultural prices over the past few months continue to trickle through. On the other hand, core CPI is expected to rise a modest 0.1% on the month as seasonal factors will play an important role in helping to keep the increases contained.

For producer prices we look for a 1.2% jump in March on a surge in (the usual suspect) the energy price component. Core PPI is expected to increase a firm 0.3% as other commodity prices were firm on the month as well and some pass-through from higher energy prices filters through.

Lots of Fed speak as well with a total of seven speakers on tap thus far

The Fed calendar is bustling next week with a total of seven speakers on tap thus far. The most noteworthy are the speeches by Fed Governor Warsh, San Francisco Fed President Yellen (non-voter, but alternate), and Philly Fed President Plosser (voter) who will be addressing monetary policy and/or the economic outlook. Fed Governor Kohn's speech on credit markets and banking should also be interesting as it is very apropos for the current environment.

Richmond Fed President Lacker (voter) and Boston Fed President Rosengren (non-voter) are also scheduled to speak on a panel about *Liquidity & Systemic Risk in the Financial System*. Last but not least, look out for the release of the Fed Beige book on Wednesday afternoon.

Monday, 14 April

Headline retail sales are expected to decline 0.4% MoM in March

Retail sales, March—8:30 am

	Exp	Cons	Range	History
Retail sales	-0.4%	0.1%	-0.4-0.6%	Feb = -0.6% vs Jan = 0.4%
Retail Sales ex Autos	-0.1%	0.2%	-0.1-0.8%	Feb = -0.2% vs Jan = 0.5%

Source: Merrill Lynch, Bloomberg

Headline retail sales are expected to decline 0.4% MoM in March, following a similarly weak 0.6% drop the previous month. Motor vehicle sales are one of the main laggards, as the annualized rate of sales slipped 1.7% to just 15.1 million units in March. Excluding motor vehicles, we look for a more modest 0.1% decline. The latest chain store sales data showed material weakness in apparel, department stores, luxury goods, and furniture sales – we expect this will show though in the retail sales report as well.

Three areas of strength are likely to be food, health care, and gasoline stations – though these are mainly a price story, not a volume one, and thus will fail to boost *real* personal consumption expenditures. Even adjusted for seasonality, gasoline pump prices were up more than 1% on the month while food and medical prices continue to grind higher month after month. As for the retail sales control measure, which excludes motor vehicle dealers, gasoline and building materials, it's expected to slip 0.2% after no change last month. This would take annualized momentum to -0.6% from 1.1% – a very weak handoff to the second quarter.

Business inventories are expected to rise 0.4% MoM in February

Business inventories, February—10:00 am

	Exp	Cons	Range	History
Business inventories	0.4%	0.5%	0.1-0.8%	Jan = 1.0% vs Dec =0.6%

Source: Merrill Lynch, Bloomberg

Business inventories are expected to rise 0.4% MoM in February, following a robust 1.0% jump in January. Manufacturing inventories were up 0.5% on the month while wholesale inventories surged by 1.1%. The remaining piece of the pie, retail inventories, is expected to be pared about 0.4%. We expect a sharp decline in motor vehicle inventories as light vehicle sales came in better than expected for the month and dealers continued to keep inventories lean in anticipation of a challenging sales environment near-term. Building materials should also see a pullback, as the weakness stemming from a depressed housing market discourages stockpiling in this space. Excluding these two components, retail inventories should see a substantial increase as evidenced by the very weak retail sales activity on the month.

Tuesday, 15 April

Headline producer prices are expected to jump 1.2% in March

Producer prices, March—8:30 am

	Exp	Cons	Range	History
PPI	1.2%	0.7%	0.1-1.2%	Feb = 0.3% vs Jan 1.0%
Core PPI	0.3%	0.2%	-0.1-0.4%	Feb = 0.5% vs Jan 0.4%

Source: Merrill Lynch, Bloomberg

Headline producer prices are expected to jump 1.2% in March after a modest 0.3% increase in the prior month. Driving this move is the surge in the energy price component, as natural gas and heating oil saw double digit monthly increases through the mid-month survey period, while wholesale gasoline rocketed by more than 8%. Food prices also look to rebound after a 0.5% decline last month. Indeed, CRB foodstuffs alone were up nearly 7%. Core PPI, which excludes the volatile food and energy components, is expected to increase a firm 0.3% as other commodity prices surged on the month and some pass-through from higher energy prices filters through. On our forecast, the YoY rate for headline PPI will rise to 7.1% from 6.8% while the core measure will tick up to 2.9% from 2.5%.

The NY Empire manufacturing index likely ticked up to a still weak -12 in April

NY Empire manufacturing, April—8:30 am

	Exp	Cons	Range	History
NY Empire	-12	-18	-25 to -4	Mar = -22 vs Feb = -12

Source: Merrill Lynch, Bloomberg

The NY Empire manufacturing index likely ticked up to a still weak -12 in April, after plunging to -22 in March – the weakest print in the brief history of the series. This tech heavy region suffered sharp declines due to a substantial pullback in orders of computers and electronics products. We believe this trend will reverse somewhat in April. Indeed, market sentiment for the tech sector in general has improved with the S&P 500 information technology index up more than 6% since mid-March – when the previous NY Empire survey was released. The new orders, shipments, and inventories components will likely improve but still post small negatives. Employment will likely be soft, after a 4.5 print last month, as the job market continues to feel the effects of a weak economy. Prices paid are expected to slip as commodity prices pulled back thus far in April.

Net foreign purchases of US long-term securities probably slipped to $45 billion in February

Net foreign purchases of US long-term securities, February—9:00 am

	Exp	Cons	Range	History
TIC flows	$45bn	$52.5bn	$45-70bn	Jan = $62.0bn vs Dec $56.5bn

Source: Merrill Lynch, Bloomberg

Net foreign purchases of US long-term securities probably slipped to $45 billion in February from $62 billion the previous month. Marketable securities held in custody at the Fed for foreign official and international accounts rose by roughly $29 billion in February, after a more robust $56 billion increase in January, suggesting a pullback in the TIC flows is in order. This would leave net foreign purchases below the 12-month moving average for the trade balance and thus suggests somewhat stronger flows in March.

NAHB housing index, April—1:00 pm

The NAHB index probably slipped to 19 in April

	Exp	Cons	Range	History
NAHB	19	20	19-21	Mar = 20 vs Feb = 20

Source: Merrill Lynch, Bloomberg

The National Association of Home Builders (NAHB) index probably slipped to 19 in April from 20 in March. We expect the decline in sentiment to stem from a deteriorating outlook for the spring home selling season. New single family home sales have slipped for four months in a row through February and the mortgage applications data suggests the weakness persisted into March. The sharp declines in home prices have thus far failed to elicit any sort of correction on the inventory side, with latest new home sales data showing supply at a cycle high 9.8 months. This is likely to keep builder sentiment depressed as well, as it becomes clear that further price capitulation will be necessary to move product. We do not expect builder sentiment to return to constructive levels until the inventory overhang is corrected – and this will only come via lower home prices.

Wednesday, 16 April

Consumer prices, March—8:30 am

Headline consumer prices are expected to increase 0.3% MoM in March while core prices were likely up a more modest 0.1%

	Exp	Cons	Range	History
CPI	0.3%	0.3%	0.1-0.7%	Feb = 0.0% vs Jan 0.4%
Core CPI	0.1%	0.2%	0.1-0.3%	Feb = 0.0% vs Jan 0.3%

Source: Merrill Lynch, Bloomberg

Headline consumer prices are expected to increase 0.3% MoM in March after no change in February. This will leave the YoY rate unchanged at 4.0%. The energy component, which we estimate will increase 1.7%, will add substantially to the headline. Gasoline pump prices were up about 7% on the month which is well above the increase expected by the seasonal factors. The increase in food prices will likely be similar to last month at roughly 0.4% as the increases in agricultural prices over the past few months continue to trickle through. Indeed, farmers' prices received are running at a whopping 13% YoY.

The core CPI measure, which excludes food and energy, is expected to rise a modest 0.1% on the month. Owners' equivalent rent looks to be up a trend-like 0.2% as the substantial increases in natural gas prices over the past three months continue to keep OER down (this is due to the fact that higher utility prices tamp down OER). Medical care prices will likely see a 0.4% increase – in line with recent trends – as employers continue to boost medical co-pay rates to lessen their cost burden.

Seasonal factors will play an important role in helping to keep the increases in some of the other components contained. One example is apparel prices, where the seasonals are expecting a 3.7% increase on the month. Although, historically, apparel prices do rise about 3.5% in March, we find an increase of this magnitude unlikely in the currently depressed retail environment and thus expect this to translate into a sharp seasonally-adjusted decline. Airfares also look to be higher on the month, as airlines continue to pass through higher jet fuel prices to consumers – with many of these sticking quite well. On our forecast, the YoY rate for core CPI will tick up to 2.4% from 2.3%. We continue to look for this measure to pull back to 1.6% by the end of the year.

Housing starts are expected to slip about 8% MoM to an annualized rate of just 980k in March

Housing starts and building permits, March—8:30 am

	Exp	Cons	Range	History
Housing starts	0.98mn	1.02mn	0.95-1.10mn	Feb = 1.065mn vs Jan = 1.071mn
Building permits	0.96mn	0.97mn	0.93-1.02mn	Feb = 0.984mn vs Jan = 1.061mn

Source: Merrill Lynch, Bloomberg

Housing starts are expected to slip about 8% MoM to an annualized rate of just 980k in March. The continued weakness in new home sales coupled with an already massive inventory overhang is likely more than enough reason for builders to cut back substantially on production. Indeed, months' supply of new homes was running 64% above normal levels in February and the recent mortgage application activity suggests this is not likely to change much. Prospective home buyers are also limited given the current weakness in the economy and the fact that lending standards remain extremely tight – thus crimping demand for home buying. Builders will likely need to pare back building for some time until inventory levels go back to normal. We expect building permits will decline about 2.5%, extending the string of monthly declines to ten months. We look for completions to decline by 64k to 1144k units, the lowest since May 1993, but month's supply will tick up to 9.9 months from 9.8 on a larger decline in sales.

Industrial production will likely decline by a sharp 0.6% MoM in March

Industrial production, March—9:15 am

	Exp	Cons	Range	History
Industrial production	-0.6%	-0.1%	-0.6-0.4%	Feb = -0.5% vs Jan = 0.1%
Capacity utilization	79.9%	80.3%	79.9-81.1%	Feb = 80.4% vs Jan = 81.0%

Source: Merrill Lynch, Bloomberg

Industrial production will likely decline 0.6% MoM in March, after a 0.5% downturn in February. The pullback should be driven by a substantial decrease in motor vehicle production as more than 30% of GM's production was halted due to an ongoing strike at a major parts supplier. This sharp pullback will be slightly offset by firm production in the high-tech space, while the upturn in aggregate manufacturing hours will help boost the ex tech and motor vehicle components. Mining will likely see an increase as demand for metals continues to look robust while utility production is expected to rebound after a sharp 3.8% pullback in February – as March was relatively cold. On our forecast, the capacity utilization rate will decline to just 79.9% from 80.4% – the lowest since the Hurricane Katrina disruptions.

Thursday, 17 April

We expect initial jobless claims will tick up to 370k in the week ending April 12

Initial jobless claims, week ending 04/12/08—8:30 am

	Exp	Cons	Range	History
Initial claims	370k	365k	345-395k	April 5 = 357k

Source: Merrill Lynch, Bloomberg

We expect initial jobless claims will tick up to 370k in the week ending April 12, after a temporary pullback to 357k the previous week. Most of the seasonal quirkiness witnessed over the past several weeks should now have dissipated, leaving the claims numbers at a level that is reflective of the economic backdrop. That said, the strike at American Axle continued through this week and we could see some further upside from temporary layoffs at auto manufacturing plants. Also, the recent grounding of more than 3,000 American Airline flights could have added to the employment insurance ranks – though this is not easily quantified and we are merely suggesting it as a source of upside risk. These factors are significant given that this is the survey week for employment and could impact nonfarm payrolls negatively. We expect the grind higher in continuing claims to persist as well, indicating upward pressure on the unemployment rate.

The Philadelphia Fed manufacturing index likely remained deep in negative terrain at -14 in April

Philly Fed manufacturing, April—10:00 am

	Exp	Cons	Range	History
Philly Fed	-14	-15	-22 to -5	Mar = -17 vs Feb = -24

Source: Merrill Lynch, Bloomberg

The Philadelphia Fed manufacturing index likely remained deep in negative terrain at -14 in April, a small improvement from the -17 print in March. This region continues to be plagued by the depressed housing market, and given that we have not seen any improvement in this space we believe sentiment is unlikely to turn positive any time soon. That said, we could get a *less negative* headline number due to the significant rally in the HGX homebuilder index – which could have suggested to some survey participants that we have put in a bottom for housing (something we do not believe has happened yet). In terms of the components, new orders and shipments should remain in negative territory though could see some modest improvement. Inventories probably remained around March levels at -13, as the housing market outlook discourages stockpiling in this region. Prices paid index is expected to pull back somewhat, after a 54.4 print last month, as commodity spot prices are about 2% down from last month's average.

The LEI will probably rebound 0.1% MoM in March

Index of leading economic indicators, March—10:00 am

	Exp	Cons	Range	History
LEI index	0.1%	0.1%	-0.3-0.4%	Feb = -0.3% vs Jan = -0.4%

Source: Merrill Lynch, Bloomberg

The index of leading economic indicators (LEI) will probably rebound 0.1% MoM in March, on the heels of five consecutive monthly declines. Despite the monthly increase, however, the key YoY rate will descend deeper into negative terrain – to -2.0% from -1.5%. Eight of the ten indicators that make up the index are already known; therefore market reaction will likely be negligible. Firm manufacturing hours, stronger vendor deliveries, robust money supply increases, and wider 10-year/Fed funds spread will contribute positively to the headline. Providing some offset to this will be lower consumer expectations, declining stock prices, weak building permits, and higher initial jobless claims. In sum, the current trend in the LEI suggests more weakness ahead.

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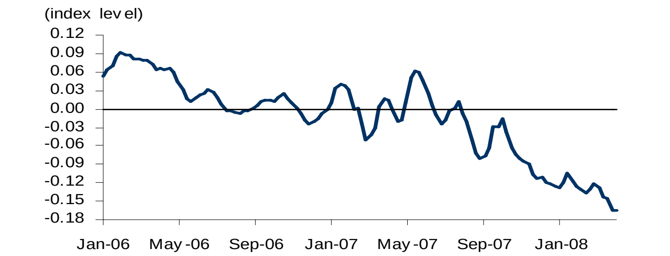
Merrill Lynch proprietary indicators

The Merrill Lynch production index

Our production index fell for the fourth consecutive week to the lowest level since June 2007. This suggests that the sluggishness we've seen in industrial production is likely to continue. The components of our index, however, were better than the headline let on. Lumber production rose 1.5% – that's the seventh consecutive weekly increase. Railcar loadings rose 2.4%, up for the second week in a row. Electrical production rose 0.3% on top of a 0.1% increase last week, while coal production was up for the second consecutive week, rising 1.8%. Crude oil production was up as well, rising 0.7% after last week's 0.3% decline. The components that put downward pressure on the index were truck production, which sank 0.3% – marking the fifth decline in a row and raw steel production, which fell 0.2% after last week's 0.7% decline.

The Merrill Lynch consumer index

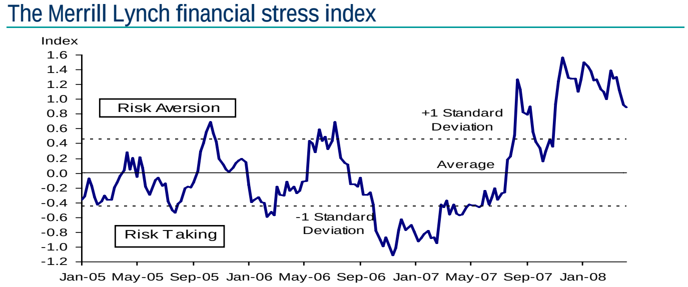


Our consumer index ticked up, albeit fractionally, for the first time in five weeks. The index level has been in negative territory for nine months and reflects the fact that the US consumer is experiencing its first recession in over 15 years. Of vital importance is the health of the labor market. Here we see that the four-week moving average on initial jobless claims has risen for five weeks in a row. Continuing claims rose to their highest level since July 2004 and point to rising unemployment. Energy prices continue to bite as well. Crude oil prices remain near $110 a barrel and that will only pinch consumers at the retail pump going forward. This combo of rising energy prices and a deteriorating labor market is further eroding consumer confidence, which has dropped for the last two weeks. And, not surprisingly, we have seen a visible slow-down in chain-store sales, which are running 0.8% on a year-over-year basis – the slowest pace since 2003.

The Merrill Lynch housing index

Our housing index fell fractionally, but it marked the fifth consecutive weekly decline reflecting a US housing market in a state of recession. The MBA's purchase index continues to run below its one-year average, suggesting that the demand for housing remains weak. The lending environment remains tight. Commercial bank real estate loans are running below their one-year average. And finally, the labor market has cracked. The four-week moving average on initial jobless claims, at 378,000 is at level not seen since mid 2005. Continuing claims, which just hit 2.94 million, have risen for three of the past four weeks indicating that it is only getting tougher to find new employment once out of work.

The Merrill Lynch financial stress index



Our financial stress index fell for the third consecutive week to its lowest level since November 2007. Financial conditions are improving, to be sure, but our index, which is almost two standard deviations above average, reflects a market that remains under considerable stress. Gold prices, for example, rose in the latest week and remain well above their one-year average. The TED spread widened to 170 bps; that is roughly 8x above *normal*. Baa spreads, though falling in the latest week, remain well above their three-year average. Ditto for two-year swap spreads, which are 14 bps above their one-year average. And, while volatility has been coming down, the VIX index, which measures equity market volatility, remains above its one-year average.

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Debt issuance

Treasury financing (billions of $)

Announcement date	Auction date	Settlement date	Issue	Size	New cash
Apr-7	Apr-10	Apr-15	10-year TIPS (R)	6.0	6.0
Apr-10	Apr-14	Apr-17	3- & 6-month	42.0	7.0
Apr-14	Apr-15	Apr-17	4-week	10.0*	(21.0)*
Apr-14	Apr-15	Apr-17	CMB 4/22	15.0*	15.0*
Apr-17	Apr-21	Apr-24	3- & 6-month	37.0*	0*
Apr-17	Apr-22	Apr-30	5-year TIPS	8.0*	8.0*

* Estimate. ( ) = Paydown. (R) = Reopening. CMB = Cash Management Bill.
Source: Bloomberg, U.S. Treasury, Merrill Lynch

Agency financing (billions of $)

Announcement date	Auction date	Settlement date	Issue	Size
Apr-11	Apr-14	Apr-15	FRE 3-month	3.0
Apr-11	Apr-14	Apr-15	FRE 6-month	2.0
Apr-14	Apr-16	Apr-17	FNM 3-month	
Apr-14	Apr-16	Apr-17	FNM 6-month	
Apr-18	Apr-21	Apr-22	FRE 3-month	
Apr-18	Apr-21	Apr-22	FRE 6-month	

FRE = Freddie Mac, FNM = Fannie Mae, (R) = Reopening
Source: Bloomberg, Freddie Mac, Fannie Mae.

Policy speakers

Key speaking engagements and news events*

Monday, April 14	2:30pm	Federal Reserve Governor Kevin Warsh Speaks at Economic Policy Forum in New York
Tuesday, April 15		(nothing scheduled at this point)
Wednesday, April 16	11:45am	Federal Reserve Bank of San Francisco President Yellen (non-voter) Speaks in Alameda, California on U.S. Outlook
	12:30pm	Philadelphia Federal Reserve Bank President Plosser (voter) Speaks on Goals, Monetary Policy in Pennsylvania
	2:00pm	Fed Releases Beige Book Economic Report
Thursday, April 17	9:45 am	Federal Reserve Board Vice Chairman Kohn Speaks at Conference on Credit Markets, Banking
	1:45pm	Federal Reserve Bank of Dallas President Richard Fisher (voter) speaks on Global Affairs
	3:00pm	Federal Reserve Bank of Richmond President Lacker (voter) to Speak to Media at Charlotte Credit Conference
Friday, April 18	8:30 am	Federal Reserve Bank of Richmond President Lacker (voter) and Boston Fed President Rosengren (non-voter) Speak on Liquidity, Systemic Risk
	10:45 am	Greenspan, Marchionne, Barroso Speak at Conference in Turin

*Time and date subject to change
Source: Bloomberg, Market News, Merrill Lynch

Economic forecast summary

Real Economic Activity, % SAAR	4Q2007	1Q2008	2Q2008	3Q2008	4Q2008	1Q2009	2Q2009	3Q2009	4Q2009	2007	2008F	2009F
Real GDP	0.6	0.4	-0.9	0.2	-0.5	-0.2	1.5	2.7	2.8	2.2	0.9	0.6
% Change, Year Ago	2.5	2.4	1.2	0.1	-0.2	-0.4	0.2	0.9	1.7			
Final Sales	2.4	0.2	-0.5	0.1	-0.6	0.0	1.9	1.7	2.0	2.5	1.1	0.5
Domestic Demand	1.3	-0.3	-1.2	-0.6	-1.6	-1.3	1.0	1.5	2.0	1.8	0.2	-0.3
Consumer Spending	2.3	0.6	-0.7	0.3	-1.6	-0.7	1.5	2.0	2.3	2.9	0.8	0.2
Durables	2.0	-5.7	-4.0	-12.3	-10.0	-1.4	1.0	3.1	3.2	4.7	-3.4	-3.4
Nondurables	1.2	-2.1	-3.6	0.3	-4.3	-4.7	1.0	2.0	2.5	2.4	-1.0	-1.6
Services	2.8	3.1	1.3	2.5	1.2	1.3	1.7	1.8	2.1	2.8	2.4	1.6
Residential Investment	-25.2	-24.6	-26.6	-22.9	-23.5	-9.3	1.0	2.5	2.8	-17.0	-23.5	-11.6
Nonresidential Investment	6.0	1.2	0.7	-1.5	0.7	-7.3	-3.0	-1.2	1.4	4.7	3.2	-2.5
Structures	12.4	0.8	1.8	-0.3	-2.8	-4.5	-4.3	-3.5	1.2	12.9	5.9	-2.8
Equipment and Software	3.1	1.4	0.1	-2.1	2.3	-8.6	-2.3	-0.1	1.5	1.3	1.9	-2.4
Government	1.9	0.8	1.3	1.4	1.6	1.4	1.3	1.0	0.7	2.0	1.8	1.3
Exports	6.5	9.0	5.2	4.7	4.5	4.7	4.5	4.1	3.4	8.1	8.0	4.5
Imports	-1.4	3.5	-0.5	-1.2	-3.0	-4.5	-1.7	2.4	2.5	1.9	0.5	-1.8
Net Exports (Bil 00$)	-503.2	-488.3	-466.7	-443.5	-411.5	-371.1	-345.3	-340.6	-339.2	-555.6	-452.5	-349.0
Inventory Accumulation (Bil $)	-18.3	-11.9	-22.8	-22.4	-19.7	-24.9	-35.8	-5.4	16.9	4.6	-19.2	-12.3
Nominal GDP (Bil $)	14074	14169	14212	14301	14359	14419	14531	14675	14817	13841	14260	14610
% SAAR	3.0	2.7	1.2	2.5	1.6	1.7	3.1	4.0	3.9	4.9	3.0	2.5
% Change, Year Ago	5.1	4.5	3.2	2.4	2.0	1.8	2.2	2.6	3.2			
Key Indicators												
Industrial Production (% SAAR)	0.2	-1.1	-0.7	-0.1	-1.0	0.6	1.5	1.7	1.8	1.7	0.2	0.5
Capacity Utilization (%)	81.0	80.4	80.0	79.6	79.1	78.8	78.8	78.8	78.8	81.0	79.8	79.4
Civilian Unemployment Rate (%)	4.8	4.9	5.4	5.6	5.7	6.0	6.0	5.9	5.8	4.6	5.4	6.0
Productivity (% SAAR)	1.9	1.2	-0.9	1.9	1.2	1.7	2.7	2.6	3.0	1.8	1.7	1.8
% Change, Year Ago	2.9	3.0	2.1	1.0	0.8	1.0	1.9	2.0	2.5			
Real Disp. Personal Inc. (% SAAR)	0.1	1.4	7.7	0.5	0.1	0.0	2.9	2.1	2.7	3.1	2.3	1.5
% Change, Year Ago	2.2	1.2	3.3	2.4	2.4	2.0	0.9	1.3	1.9			
Personal Savings Rate (%)	0.0	0.0	1.8	2.9	2.2	2.5	2.8	2.8	2.7	0.4	1.7	2.7
Light Vehicle Sales (Millions SAAR)	16.2	15.3	15.2	14.4	14.0	13.8	14.4	14.8	15.1	16.4	14.7	14.5
Housing Starts (Thous. SAAR)	1151	1039	947	800	700	750	800	820	850	1344	871	805
Current Account (Bil $)	-172.9	-179.9	-169.2	-160.3	-150.2	-137.0	-129.4	-128.4	-130.0	-738.6	-659.6	-524.7
U.S. Budget Balance (Bil $)										-163	-525	-375
Corporate Profits and Earnings												
Operating Corp. Profits After Tax (Bil $)	1114.6	1078.1	1012.2	975.9	901.4	973.7	985.9	1014.6	1079.3	1128.6	991.9	1013.4
% Change, Year Ago	3.3	-1.6	-12.1	-15.3	-19.1	-9.7	-2.6	4.0	19.7	2.6	-12.1	2.2
S&P 500 Reported EPS ($)	7.8	17.0	18.0	13.0	13.5	17.5	19.0	13.5	14.0	66.2	61.5	64.0
% Change, Year Ago	-61.4	-20.4	-17.7	-14.2	72.9	2.9	5.7	3.8	3.7	-18.8	-7.1	4.1
S&P 500 Operating EPS ($)	15.2	19.0	21.0	18.5	17.0	19.5	21.5	19.0	18.0	82.5	75.5	78.0
% Change, Year Ago	-30.8	-15.1	-12.7	-11.4	11.7	2.6	2.4	2.7	5.9	-5.9	-8.5	3.3
Inflation												
GDP Price Index (% SAAR)	2.4	3.0	2.1	2.0	1.6	1.9	1.0	0.8	0.8	2.7	2.2	1.5
% Change, Year Ago	2.6	2.3	2.1	2.4	2.2	1.9	1.6	1.3	1.1			
CPI, Consumer Prices (% SAAR)	5.0	4.3	1.7	2.4	1.4	1.0	0.6	0.3	1.1	2.9	3.3	1.2
% Change, Year Ago	4.0	4.2	3.4	3.3	2.4	1.6	1.4	0.8	0.8			
CPI ex Food & Energy (% SAAR)	2.5	2.5	1.5	1.8	1.2	1.3	1.3	1.3	1.6	2.3	2.1	1.4
% Change, Year Ago	2.3	2.4	2.2	2.1	1.7	1.4	1.4	1.3	1.4			

Source: Merrill Lynch

Interest rate forecast summary

(% EOP)	4Q 07	1Q 08	2Q 08	3Q 08	4Q 08	1Q 09	2Q 09	3Q 09	4Q 09	2007	2008	2009
Fed Funds	4.25	2.25	1.50	1.25	1.00	1.00	1.00	1.00	1.00	4.25	1.00	1.00
3-Month T-Bill	3.36	1.38	1.00	0.90	0.90	1.00	1.05	1.05	1.10	3.36	0.90	1.10
3-Month LIBOR	4.85	2.95	1.65	1.40	1.35	1.35	1.30	1.30	1.35	4.85	1.35	1.35
2-Year T-Note	3.04	1.62	1.00	1.00	0.85	1.00	1.00	1.10	1.20	3.04	0.85	1.20
5-Year T-Note	3.45	2.46	1.80	1.45	1.25	1.55	1.60	1.65	1.70	3.45	1.25	1.70
10-Year T-Note	4.05	3.45	3.25	3.10	2.95	2.85	2.80	2.75	2.70	4.05	2.95	2.70
30-Year T-Bond	4.45	4.30	4.05	3.90	3.75	3.55	3.40	3.35	3.30	4.45	3.75	3.30

Shaded regions represent Merrill Lynch forecast.
Source: Merrill Lynch

Monthly CPI forecast update

	Total CPI					Core CPI			
	(nsa)			(sa)		(nsa)		(sa)	
	level	MoM	YoY	MoM	YoY	MoM	YoY	MoM	YoY
2007: Sep	208.490	0.28	2.8	0.37	2.8	0.24	2.1	0.22	2.1
2007: Oct	208.936	0.21	3.5	0.26	3.5	0.33	2.2	0.18	2.2
2007: Nov	210.177	0.59	4.3	0.90	4.4	0.06	2.3	0.24	2.4
2007: Dec	210.036	-0.07	4.1	0.36	4.1	-0.04	2.4	0.22	2.4
2008: Jan	211.080	0.50	4.3	0.39	4.4	0.37	2.5	0.31	2.5
2008: Feb	211.693	0.29	4.0	0.03	4.1	0.34	2.3	0.04	2.3
2008: Mar	213.495	0.85	4.0	0.31	4.0	0.47	2.4	0.15	2.4
2008: Apr	214.321	0.39	3.7	0.06	3.7	0.09	2.3	0.10	2.3
2008: May	214.857	0.25	3.3	0.10	3.3	0.00	2.3	0.15	2.3
2008: Jun	215.253	0.18	3.3	0.26	3.3	0.03	2.2	0.17	2.2
2008: Jul	215.297	0.02	3.4	0.27	3.4	0.05	2.1	0.15	2.1
2008: Aug	215.202	-0.04	3.5	0.16	3.5	0.14	2.1	0.13	2.1
2008: Sep	215.259	0.03	3.2	0.12	3.2	0.13	2.0	0.11	2.0
2008: Oct	215.378	0.06	3.1	0.10	3.1	0.23	1.9	0.08	1.9
2008: Nov	214.984	-0.18	2.3	0.12	2.3	-0.09	1.7	0.10	1.7
2008: Dec	214.330	-0.30	2.0	0.12	2.0	-0.16	1.6	0.10	1.6

nsa: not seasonally adjusted, sa: seasonally adjusted
Source: Merrill Lynch

FX rate forecast summary

(end of period)		Spot	Jun 08	Sep 08	Dec 08	Mar 09	Jun 09	Sep 09	Dec 09
Euroland Euro	US$/Euro	1.58	1.55	1.51	1.48	1.40	1.33	1.30	1.28
Japanese Yen	¥/US$	101	102	102	102	100	98	98	98
	¥/Euro	160	158	154	151	140	130	127	125
British Pound	US$/£	1.97	1.99	1.91	1.87	1.79	1.73	1.71	1.68
	£/Euro	0.80	0.78	0.79	0.79	0.78	0.77	0.76	0.76
Swiss Franc	SF/US$	1.00	1.03	1.05	1.07	1.11	1.16	1.18	1.20
	SF/Euro	1.58	1.59	1.58	1.58	1.55	1.54	1.54	1.54
Canadian $	C$/US$	1.02	1.02	1.04	1.06	1.08	1.11	1.12	1.12
Australian $	US$/A$	0.93	0.94	0.91	0.84	0.80	0.74	0.72	0.70
Chinese Renminbi	RMB/US$	7.00	6.85	6.70	6.60	6.55	6.60	6.50	6.50
Hong Kong $	HK$/US$	7.79	7.75	7.75	7.75	7.75	7.75	7.75	7.75
Korean Won	KRW/US$	976	900	885	870	855	835	835	830
Singapore $	SGD/US$	1.36	1.36	1.37	1.36	1.37	1.38	1.39	1.40
Taiwan $	TWD/US$	30.30	31.00	30.75	31.00	31.25	31.75	32.00	32.25
Brazilian Real	BRL/US$	1.68	1.70	1.80	1.80	1.85	1.85	1.90	1.90
Mexican Peso	MXN/US$	10.53	10.90	11.20	11.00	11.15	11.20	11.40	11.20

Spot prices are as of Friday morning
Source: Merrill Lynch FX Strategy Team., Bloomberg

Rolling Calendar of Business Indicators

Monday	Tuesday	Wednesday	Thursday	Friday
14 April 8:30 am: Retail Sales Jan .... 0.4% Feb .... -0.6% Mar .... -0.4%* 8:30 am: Retail Sales ex Autos Jan .... 0.5% Feb .... -0.2% Mar .... -0.1%* 10:00 am: Business Inventories Dec .... 0.6% Jan .... 1.0% Feb 0.4%*	15 April ABC/Washington Post Consumer Comfort Survey —(week ending 4/13/08) LJR Redbook —(week ending 4/12/08) 8:30 am: PPI Jan .... 1.0% Feb .... 0.3% Mar .... 1.2%* 8:30 am: Core PPI Jan .... 0.4% Feb .... 0.5% Mar .... 0.3%* 8:30 am: Empire Manufacturing Index Feb .... -11.7 Mar .... -22.2 Apr .... -12.0* 9:00 am: Net Long-Term Treasury Flows Dec .... $56.5bn Jan .... $62.0bn Feb .... $45.0bn* 1:00 pm: NAHB Housing Market Index Feb .... 20 Mar .... 20 Apr 19*	16 April MBA Mortgage Applications —(week ending 4/11/08) 8:30 am: CPI Jan .... 0.4% Feb .... 0.0% Mar .... 0.3%* 8:30 am: Core CPI Jan .... 0.3% Feb .... 0.0% Mar .... 0.1%* 8:30 am: Housing Starts Jan .... 1.071mn Feb .... 1.065mn Mar .... 0.980mn* 8:30 am: Building Permits Jan .... 1.061mn Feb .... 0.984mn Mar .... 0.960mn* 9:15 am: Industrial Production Jan .... 0.1% Feb .... -0.5% Mar .... -0.6%* 9:15 am: Capacity Utilization Jan .... 81.0% Feb .... 80.4% Mar .... 79.9%* 2:00 pm: *Fed's Beige Book released*	17 April 8:30 am: Initial Jobless Claims —(week ending 4/12/08) – 370K* 10:00 am: Philly Fed Index Feb .... -24.0 Mar .... -17.4 Apr .... -14.0* 10:00 am: Leading Indicators Jan .... -0.4% Feb .... -0.3% Mar .... 0.1%* 5-year TIPS announcement—$8.0bn*	18 April
21 April 2-year note announcement —$30.0bn* 5-year note announcement —$19.0bn*	22 April ABC/Washington Post Consumer Comfort Survey —(week ending 4/20/08) LJR Redbook —(week ending 4/19/08) 5-year TIPS auction—$8.0bn*	23 April MBA Mortgage Applications —(week ending 4/18/08) 10:00 am: Existing Home Sales Jan .... 4.89mn Feb .... 5.03mn Mar .... 5.00mn* 2-year note auction—$30.0bn*	24 April 8:30 am: Initial Jobless Claims —(week ending 4/19/08) 8:30 am: Durable Goods Orders Jan .... -4.4% Feb .... -1.1% Mar .... 2.7%* 8:30 am: Durable Goods Orders ex Transportation Jan .... -0.8% Feb .... -2.4% Mar .... 2.4%* 10:00 am: New Home Sales Jan .... 601k Feb .... 590k Mar .... 578k* 10:00 am: Help Wanted Index Jan .... 22 Feb .... 21 Mar .... 20* 5-year note auction—$19.0bn*	25 April 10:00 am: University of Michigan Consumer Sentiment Mar .... 69.5 Apr (P) .... 63.2 Apr (F) 62.0*
28 April	29 April ABC/Washington Post Consumer Comfort Survey —(week ending 4/27/08) LJR Redbook —(week ending 4/26/08) 9:00 am: Case-Shiller 20-City – Feb Dec .... -2.1% Jan .... -2.4% 10:00 am: Consumer Confidence – Apr Feb .... 76.4 Mar 64.5	30 April MBA Mortgage Applications —(week ending 4/25/08) 8:15 am: ADP Employment – Apr Feb .... -18k Mar .... 8k 8:30 am: Real GDP – 1Q (A) 3Q .... 4.9% 4Q .... 0.6% 8:30 am: GDP Price Index – 1Q (A) 3Q .... 1.0% 4Q .... 2.4% 8:30 am: Employment Cost Index – 1Q 3Q .... 0.8% 4Q .... 0.8% 9:45 am: Chicago PMI – Apr Feb .... 44.5 Mar .... 48.2 2:15 pm: *FOMC Rate Decision Expected*	1 May 8:30 am: Initial Jobless Claims —(week ending 4/26/08) 8:30 am: Personal Income – Mar Jan .... 0.3% Feb .... 0.5% 8:30 am: Personal Spending – Mar Jan .... 0.4% Feb .... 0.1% 8:30 am: Core PCE (YoY) – Mar Jan .... 2.0% Feb .... 2.0% 10:00 am: ISM Manufacturing – Apr Feb .... 48.3 Mar .... 48.6 10:00 am: Construction Spending – Mar Jan .... -1.0% Feb .... -0.3% All day: Vehicle Sales – Apr Feb .... 15.4mn Mar 15.1mn	2 May 8:30 am: Nonfarm Payrolls – Apr Feb .... -76k Mar .... -80k 8:30 am: Unemployment Rate – Apr Feb .... 4.8% Mar .... 5.1% 8:30 am: Avg Hourly Earnings – Apr Feb .... 0.3% Mar .... 0.3% 8:30 am: Avg Weekly Hours – Apr Feb .... 33.7 Mar .... 33.8 10:00 am: Factory Orders – Mar Jan .... -2.3% Feb .... -1.3%

*Projections—subject to revision as additional data become available during the month. (R) denotes reopening.

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