

Capitalism takes a sabbatical

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Jumping on the TARP

Messrs. Bernanke, Paulson and Cox have advanced a plan before Congress to create a national superfund to acquire the bad mortgage and related debt that have continuously clogged up the US (and global) financial system. Such a government fund would relieve the Fed's balance sheet from having to serve as the *de facto* RTC of the present crisis (we explain the key differences below). This credit collapse has been with us for a year and clearly, policymakers have finally seen enough and are throwing in the towel on the case-by-case, ad-hoc solutions approach, which has backfired so far.

A chain of events that broke the camel's back

What appears to have broken the camel's back was a chain of events that followed the failure of Lehman and the need for the government to play the role of bankruptcy custodian for AIG. Nobody seemed prepared for the fact that a money market fund would "break the buck" for the first time since 1994 and for the second time ever. What happened the next day (Wednesday) was epic – investors pulled a net \$89.2 billion out of money market funds or 2.6% of total assets (over the week to Wednesday, the outflow totaled \$145 billion). Then Putnam announced that it was going to liquidate a money market fund that was funding intense redemption pressure (money market funds were rapidly building cash as they braced for large redemptions – resulting in massive cash hoarding).

We reached a point where T-bill yields briefly traded with a negative yield and Libor rates were surging. In an environment where nobody is too big to fail, no lender was willing to take on counterparty risks. That was enough, because the corporate sector needs buyers for its commercial paper to fund day-to-day working capital needs – and the commercial paper market imploded by \$52 billion in the week ending Wednesday (and the typical buyer of this paper are money market funds, which were actually in the process of liquidating).

Wall St. & Main St. intersect at commercial paper market

The commercial paper market is where Wall Street and Main Street intersect – hence the aggressive government intervention and the speed at which it has occurred. So we reached a tipping point, obviously, where the Fed, Treasury and SEC are moving much more forcefully in tackling the problem with this new "troubled asset relief program" (TARP), along with a slate of other aggressive measures in recent days to promote market stability.

The TARP will reportedly consist of periodic reverse auctions occurring over a period of two years. In total, the Treasury will be authorized to hold up to \$700 billion in bad mortgage debt at any one time (suggesting resales could open more room for purchases). Based on comments we heard from Treasury Secretary Paulson this morning on the Sunday talk shows, he did suggest that all banks, not just US financial institutions, will be eligible for the auction facility (and he did hint that other governments will defray part of the expense too)." The submitted plan calls for these auctions to be run by the private sector although we would stress that ongoing negotiations could lead to changes to any or all features versus the initially envisioned structure.

Much higher deficits over the next two years

The White House submitted to Congress a bill to fund the TARP up to \$700 billion. Starting from our initial estimate of a \$500 billion deficit for fiscal year 2009 and adding to it one half of the \$700 billion, it would not surprise us at all if next year's budget deficit approaches or breaches \$900 billion (the previous all-time high was \$413 billion back in 2004). So, as a share of GDP, the deficit will soar from 3.1% this year to 6.2% next year, surpassing the 1983 peak of 6.0%. If the original RTC of the late 80s/early 90s is any indication, initial estimates of the cost may end up being on the low side. This is akin to fighting another Iraq War in terms of the financial cost to the public purse and will severely limit the fiscal flexibility of the next Administration and Congress.

There is no doubt that Treasury issuance is going to surge to fund the TARP. We currently believe that the Treasury has ample room to raise the funds and will likely do so through the following:

1. Allow reopeners for the long bond auction each quarter (\$30 billion)
2. Add another 10-year reopener (\$40 billion)
3. Reinstate the 3-year note (\$100 billion)
4. Extra bill issuance (\$125 billion)
5. Increase the size of the auctions right across the curve (\$100 billion)

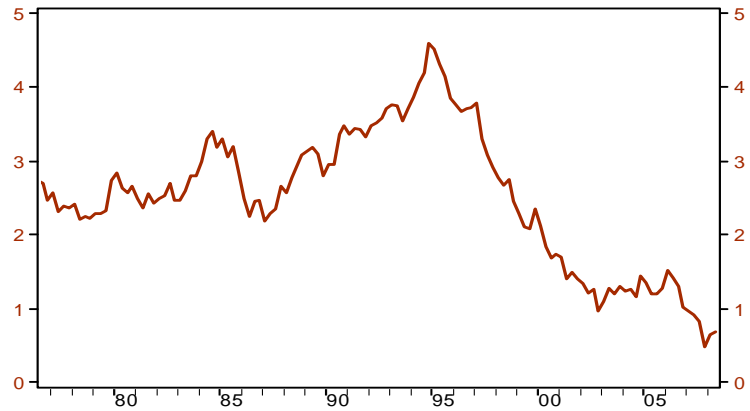
Embrace, do not fear, the looming bond crop

We know, we know. Why do we remain bullish on bonds with the crop about to yield a major harvest (see more below on our reasoning)? Because, to come up with the price of anything, you cannot simply look at supply. You also have to look at demand, and we believe that retail and institutional investors alike will be seeking safe income-generating securities in a fragile financial and deflationary macroeconomic environment. If you only focused on pending bond supply in the aftermath of RTC back in 1989, you would have missed one of the great rallies in Treasuries in the subsequent three years.

Yes, the budget deficit in that period of RTC jumped 2 percentage points to 4.7% and yes, the fiscal pressures boosted the federal government debt by \$1.6 trillion or more than 50% over that time frame. But in an environment where excess capacity was building in the real economy and banks were recapitalizing with a steep coupon curve in the financial economy, the demand for fixed-income securities overwhelmed the new supply issuance. Demand came from all fronts – the commercial banks about doubled their government bond portfolio to \$700 billion; mutual funds raised their exposure by more than \$50 billion; and the household sector directly added \$220 billion of Treasuries to its balance sheet (expanding its exposure to govies by 70%).

One additional note: In the last credit crunch in the late 1980s, early 1990s, the household sector owned well more than \$600 billion of Treasury securities. They now own half of that and the share of these bonds in the financial assets of the household sector is less than 0.7% – a historic low. We think this must have to do with concerns over the low level of the yield, but when investors more fully realize the return potential of the bond market – after all, a 4.8% yield on a 30-year Treasury bond twelve months ago managed to generate a total positive return for investors of 16% (compared, by the way, to a -20% total return in the S&P 500).

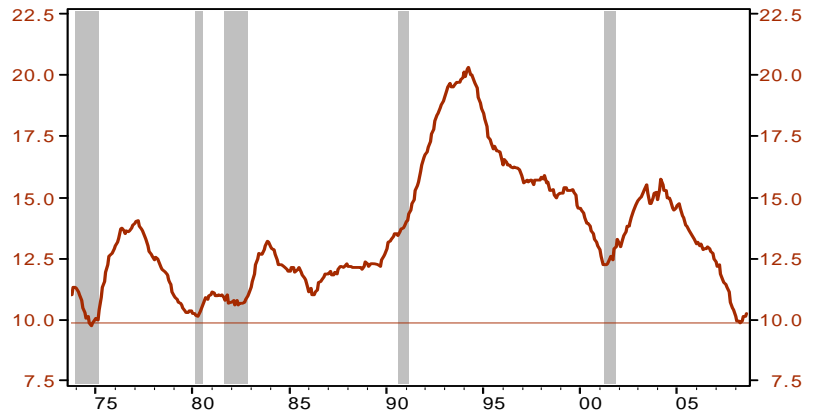
Chart 1: Lots of room for households to add to bond holdings
Bond share of assets (percent)



Source: Federal Reserve Board, Merrill Lynch

And take the commercial banks. When they were able to re-liquify during the credit crunch of the early 1990s, courtesy of the steep yield curve induced by aggressive Fed rate cuts, the share of government securities in their balance sheet expanded from a 12% share to a 20% share, over a four-year period (1989-93). The current government bond share in the banking sector balance sheet is closer to 10% today – the lowest in three decades. So it stands to reason based on all this available data that despite the impressive bond rally of the past year, government bonds are still grossly underweighted in most private sector portfolios (including pension funds).

Chart 2: Banking sector exposure to government bonds at 3-decade low
Government securities as a share of commercial bank assets (percent)



Source: Haver Analytics, Merrill Lynch

Consider that if individual investors were to go back to the near-4% share of their asset base comprised of Treasury bonds that prevailed in the early 1990s, they would have to add more than \$1 trillion of these securities to their balance sheet. And, for the banks to get back to their 20% exposure, it would mean more than \$1 trillion of incremental buying of Treasuries as well. This pent-up demand for Treasury securities, just from these two sources alone, represents a very powerful antidote to the looming supply of government bonds.

Other measures introduced to bolster confidence

Other measures were unveiled last week that sought to bolster confidence and liquidity. These include the announcement from the Fed to open the discount window a bit further and for the Fed to purchase agency debt for its portfolio (the first round of buying occurred Friday). Both measures were designed to bring order to the markets and relieve pressures caused by money market fund outflows which began Thursday and which appear to be the impetus for the TARP.

Likewise, the Treasury's announcement insuring money market funds for a fee fulfills the same purpose (it will make \$50 billion available from its Exchange Stabilization Fund to guaranty the safety of money market funds, essentially guarantying the \$1.00 value of most money market funds. Earlier, the SEC precluded short selling against 799 financial companies for ten days; though it could be extended). Call it an all-out assault on the shorts.

A word on inflation and interest rates

Those who believe that we have managed, in one day, to switch from a deflationary to an inflationary backdrop because of additional government debt creation are not taking into account the offsetting credit contraction in the private sector, which occurs from asset liquidation, debt repayment and increased savings. The Fed and Treasury are merely cushioning the massive deflationary forces in the financial system. We hearken back to that 1989-93 experience with RTC-1, and can tell you with certainty that the 10-year Treasury note yield during that prolonged debt deflation period plunged 400 basis points as the inflation rate fell from over 5% to 2-3/4%.

Or we can look at the Japanese experience. Our policymakers had been underestimating the severity of the credit collapse for a year, in contrast to the five years it took in Japan. But by November 1997, the Japanese government moved forcefully to recapitalize the beleaguered banking sector through outright injections of taxpayer money into bank equity. Although in Japan the equity market soared when the bailout plan was unveiled, surging more than 10% the week of the announcement, it was 10% lower exactly one year later. No government in the post-WWII tried to reflate its way out of its credit crisis as much as Japan did, and after an early selloff (as we saw with Treasury yields Friday), JGBs rallied 70 basis points in the ensuing year.

Yes, M2 growth nearly doubled to over 5% in that period as the BoJ attempted to reflate, but a contraction in money velocity got in the way of the inflation process. This can be seen by the weakening in nominal GDP growth from +1.2% YoY when the rescue plan was initiated to -1.6% one year out. The headline CPI inflation rate was cut in half, falling from 2% to below 1%. Those believing that the government can wave a magic wand and instantaneously create inflation when the private sector is deleveraging may be in for a surprise. By the fourth quarter of 1998, a year after the Japanese government embarked on its bank recapitalization plan, the pace of deflation in consumer credit, as an example, had doubled to -11%. This contraction swamped the tripling in the government deficit/GDP ratio (to 10%) that occurred during that period.

This is a secular decline in credit

We have been in this credit collapse for over a year and, because it is beyond most of our experience, there is still a tendency for many investors not to believe that this is a secular trend. While the government's current scramble to keep the system together is a reflection of how deflationary the situation is, we must face the fact that this is not a correction in an ongoing credit expansion, but a secular decline in credit. Act accordingly. We see today's sharp backup in long-term high-quality bond yields as a great buying opportunity.

Government has been behind the curve

This credit collapse is epic but what amazes us is how the government has been so far behind the curve every step of the way. In the process they may have contributed, albeit inadvertently (despite their best intentions), to the instability. The fact that the government is now moving so aggressively is a testament to the view that the policy responses thus far have been wholly inadequate as both the Fed and the Treasury have consistently underestimated the severity of the credit collapse from the get go. First, the orchestrated Bear Stearns bailout in March left investors believing that the preferred stock and bond holders would be made whole. Next came the GSEs. As they came under government ownership the policy changed. This time around, the bondholders were money good, but the preferreds were left out along with the common shareholder. Then we get to the Lehman story and find out that nobody is too big to fail and no investor is safe, causing a fallout in money market funds and commercial real estate. Finally, the AIG fiasco came upon us, and this was dubbed a bailout though it was really a managed bankruptcy. Four similar events, four different policy responses. In this sense, the patchwork policy response may have actually contributed to the instability that brought us to where we are today.

We doubt the Fed and Treasury thought the sharp negative market reaction last Wednesday was what we were going to see, especially after the bout of euphoria on Tuesday afternoon. But the real kicker is that in this new era of "none too big to fail," no bank wanted to lend to another (haven't we seen this play before?). As a result, we had the 3-month T-bill yield trading at 2 bps on Wednesday and at just a handful Thursday.

The elusive bottom

Keep in mind, for all the bottom pickers out there, that after the RTC was established in 1989 it took a year for the stock market to bottom, two years for the economy to bottom, and three years for the housing market to bottom. And recall that after the FSA in Japan was unveiled in 1997 the stock market didn't bottom for another five years and it's an open question as whether the economy ever did manage to stage a sustainable recovery. In the Swedish case of the early 1990s, even with an effective government solution, the process of extinguishing the bad debts via government intervention was painful – the equity market incurred a 28-month long bear market that saw Sweden's major index decline 45% from peak to trough and the economy undergo a 20-month recession that saw domestic demand contract by 2-1/2%.

Consumer recession followed by a negative credit cycle

Let's assess the current US situation. The entire credit collapse to date has reflected the unwind of the largest bubble of all time – residential real estate. It is not clear to us that we have seen anything in these proposals that will prevent still-overvalued home prices from reaching their equilibrium level, which we estimate is still 15-20% lower from where they are today (they are already down 20% from the 2006 peaks). Meanwhile, a consumer-led recession is taking hold this very quarter, for the first time in 17 years. Every consumer recession in the past was followed by a negative credit cycle of its own. The TARP brings us to a new chapter but it's very tough to say at this point that the book is finished. Suffice it to say that all the changes being proposed are taking the 'fear factor' out of the market, but that only takes you so far if you want to turn fundamentally bullish on risk assets. This is especially true as we continue to believe that S&P 500 operating earnings will decline a further 7% next year, as the consumer recession that just began intensifies, versus the 20% increase the consensus has penned in.

Protecting the Taxpayer

What caught our eye the most in Mr. Paulson's speech on Friday was that the plan was "including features that protect the taxpayer to the maximum extent". So once again, the taxpayer comes first, as should be the case (though the cost to the public purse will still be hefty). Clearly, anyone who believed that it was going to be Uncle Sam that was going to recapitalize the banks is going to be disappointed – there is no Japanese FSA-style government buying of preferred stock or US government buying of Chrysler warrants back in 1979. The banks are not going to be recapitalized by the government directly. What the government is going to establish is a repository for the banks to sell their bad assets into.

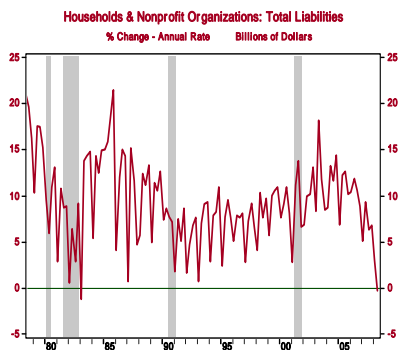
Banks will post significant losses

This in turn means that we are going to see the banks post some significant losses in the next few weeks, with the hope that this will be the final loss. It would appear reasonable to assume that one of the government's primary goals in terms of promoting stability is to finally terminate this endless quarter-after-quarter stream of unprecedented writedowns in the financial sector. So, the assets in the banking system are about to receive a big haircut, but the benefit is going to be (hopefully) greater transparency. This begets increased confidence in bank balance sheets, which then improves liquidity and allows credit spreads to narrow providing financial institutions with the capacity to raise capital and have other banks lend to them saving an interbank market which essentially failed this past week.

Banks still face the enormous task of recapitalizing

For the here and now, look for steeper losses to be reported. Look for equity to become highly dilutive. The temptation, of course, is to turn bullish on the financials, and that is not our call to make. But our understanding is that most banks are carrying these illiquid assets at 85-90% of par, either because they don't have the capital, or the accounting necessity, to mark them to appraised value. Most likely the offers submitted to the Treasury in these TARP auctions will be considerably lower than that. Additionally, there was no talk of credit cards, leveraged loans or C&I loans and all of these are deteriorating rapidly in terms of delinquency and default rates. And the \$700 billion of public funds being put to work to solve the problem must be assessed in the broader context of whether even this will be enough seeing as total residential mortgage debt outstanding is nearly \$11 trillion and over \$2 trillion in the commercial sector. Furthermore, banks still face the enormous task of recapitalizing in coming months and quarters as their assets shrink further so we would expect credit to remain quite constricted for both households and businesses over the intermediate-term.

Chart 3: First household debt deflation in 25 years



Source: Federal Reserve Board, Merrill Lynch

Consumer and financial sector both deleveraging

As we saw in the second quarter flow-of-funds data, households cut their overall level of indebtedness for the first time in 25 years. Not only is the financial sector in a secular deleveraging process, but so is the consumer sector, which represents 70% of GDP. While more money is likely to be printed, the negative implications for the velocity of money from the shrinkage in credit ensures that deflation, not inflation, is the primary risk for the next 12-24 months. The consensus today is that financials are the big winner from all this, and the bond market the big loser. We are not so sure. As we invoke Bob Farrell's Market Rule #9: "When all the experts and forecasts agree, something else is going to happen". We still expect the Fed to ease policy, and for long Treasury yields to retest and likely breach their historic lows.

Economic Implications: removes the worst case scenario

As to the implications for our economic outlook, we do not think it seriously changes the end game – the US economy is in recession and likely to remain so. At best, the TARP merely removes what was looking like the worst case scenario: the entire collapse of the global financial system and a deep global depression. The ball is already rolling on the first US consumer recession since the early 1990s and the forces exerting the drag have not materially changed. The unemployment rate is already just two tenths away from the recession peak of the 2001 downturn.

Banking system is still limping along

More importantly, despite this new initiative, the banking system is still limping along and this is likely to continue until it can adequately recapitalize. That will require a steep yield curve that keeps the cost of funds low relative to lending interest rates. Nor will the constriction in credit be limited to the consumer; business access to bank funding is likely to remain extremely restricted as well. Once we get through this upcoming period of consolidation and insolvency of the weak banks, the industry is going to come under greater regulatory oversight which will constrain leverage, off-balance sheet activities and future earnings growth. And, of course, we have history to tell us that what led the market down in the bear phase – in this case, financials and consumer cyclicals – never go on to lead in the next bull market.

There will be bank failures and consolidation

Will some banks fail? Most likely. However, part of this Kindleberger process involves weeding out weak banks while ensuring that the strong banks remain solvent. Will there be consolidation? Absolutely. The process of taking excess capacity out of the banking system, as we did in the tech sector in the last cycle, is essential for future profitability. This is perhaps the reason why the decision was made to (temporarily, in our view) ban short sales on financials – to ensure that this merger wave goes smoothly.

Signs of success?

Over the near-term, it is going to be critical to assess the effectiveness of this new TARP by (i) the degree of participation (ii) the degree of consolidation that follows, (iii) and the capacity of the banking system to recapitalize itself on its own. The key sign of success will be if the TARP rekindles the desire of banks to lend and limits the dramatic reduction in bank balance sheets that is underway. As a first sign that the TARP is working, we will be watching for signs that financial institutions are willing to lend amongst themselves in the interbank market. With this in mind, the one market metric that will provide confirmation will be the TED spread (gap between 3-month Treasury/Eurodollar rates). This credit crisis only ends when this spread gets back its more normal level of around 30 basis points. When you think about it, the narrowest it ever got during this credit crunch was 75 basis points so despite all the hopes that we were reaching some sort of bottom in anything, and there were times when it looked like we were, they were never ratified by the TED spread. It closed above 230 basis points and its still signaling that a very high degree of significant counterparty risk exists despite all the hoopla on Friday.

Original RTC was an evolutionary process

This is not the first time the government has had to step in and buy nonperforming assets from troubled financial institutions. The savings and loan crisis of the late 1980s ended when the federal government stepped in and bought the assets of failed thrift banks after a similar patchwork of solutions such as we have seen in the past year.

In 1989, the US government enacted the Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA), which abolished existing thrift oversight boards and established the Office of Thrift Supervision, within the Treasury and set up the Resolution Trust Corporation (RTC) to purchase the assets of the failed thrifts. The assets included mortgage backed securities, high yield bonds but, overwhelmingly, it was mortgages the RTC purchased. The RTC disposed of the \$394 billion worth of assets of 747 failed thrifts from the time of inception until 1995. Initial estimates of the final cost to the tax payer proved extremely optimistic: the initial estimate was that the tab would be no more than \$50bn but the final tally ended up being \$125bn. In other words: a 32% realized loss rather than a 12% haircut. If the TARP sees similar losses it suggests the final taxpayer bill would be in excess of \$250bn.

It must be noted that what the government is doing today with (TARP) is much bigger and more complex than RTC was back in 1989. What Mr. Paulson wants to establish is a “good bank, bad bank” much like RTC, but RTC sold off assets from banks that had folded, not assets from the living zombies. The assets sold in the open market were not opaque CDO’s but “real” stuff like buildings, cars, planes and art. This time around, banks are going to be forced to mark down their assets to market values – and the government is about to set up a process to discover what those prices are. Estimating the total losses was far less complicated back then. And it was a regional problem, not a national or even global dilemma. What Paulson is really doing is digging into the 1930s playbook – the Federal Reconstruction Finance Corporation; as well at the Home Owner Loan Corporation (since the Democrats are very likely going to want to modify the mortgages they end up taking into the government’s books to avoid a further uptrend in foreclosures).

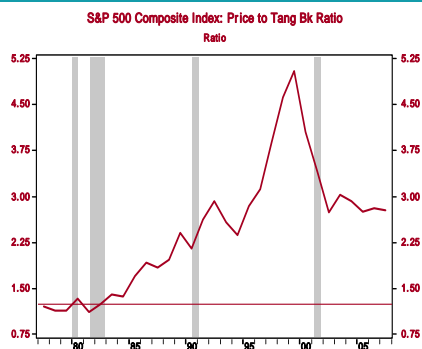
The bottom line: P/E purgatory

We are witnessing the greatest government intervention in the financial sector since the 1930s. Hopefully, this will not be a lasting development, and we are optimistic that it will not be once the system is fixed. And, this intervention, sadly enough, is necessary since the alternative (we don’t have to say it), is far worse. But as government involvement in the economy grows inexorably – spending, deficits, and debt – then one would expect the stock market to be trading at far lower multiples in coming years. Much closer to price-to-book, for example, than the current 3x ratio. If we are correct on what the future intervention and regulation is going to do investor sentiment and the price investors will be willing to pay for earnings, then the current P/E of over 25x could well end up back at 10x (we realize that sounds draconian, but the level of government involvement in the economy and markets for the next few years is also going to be rather draconian).

Tax rates have nowhere to go but up

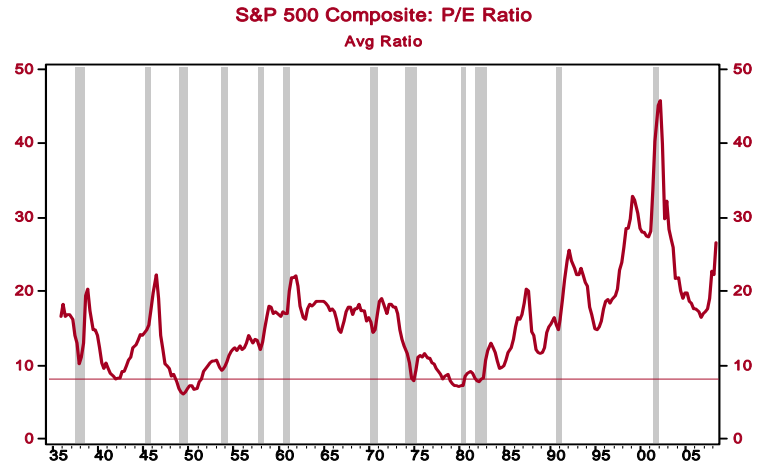
Don’t forget, not only is the government going to be intervening and regulating to a much greater extent, but the additional hundreds of billions, if not more, of extra debt is going to have to be funded in the future at a time when the demographic profile sharply increases the nation’s ‘dependency ratio.’ This means that tax rates have nowhere to go but up, and materially so. This is going to act as a heavy weight on any estimate of fair-value multiples in the equity market. And as the historical P/E chart below clearly illustrates, every post-bubble period unleashes a new regulatory regime, whether it was the New Deal in the 1930s, ERISA in the 1970s, Sarbanes-Oxley in 2002, and with it, a secular decline in the market multiple.

Chart 4: No reason for the market to be trading near 3x book



Source: Haver Analytics, Merrill Lynch

Chart 5: No reason for the market to be trading at a 25x P/E, either

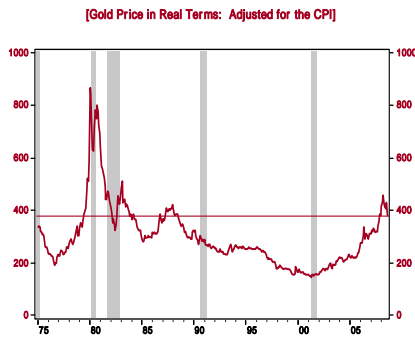


Source: Haver Analytics, Merrill Lynch

We still expect Treasury yields to set new cycle lows

Equity sectors and companies should be screened intensively for balance sheet quality in a deleveraging cycle and for a high variable-cost/low fixed-cost mix in a deflationary environment. Since deflationary pressures will still trump inflationary pressures over the next 12-24 months, in our view, the allure of high-quality bonds with callable protection should remain intact and we still expect Treasury yields to set new cycle lows.

Chart 6: Gold may still be a good place to be



Source: Haver Analytics, Merrill Lynch

More upside than downside risk to bullion

Gold will not only serve as a refuge in its role as a store of value, but is a useful hedge against both inflation as well as deflation since deflation is inherently destabilizing for financial assets (in that deflationary period from 2001 to mid-2003, gold managed to rally more than 30%), not to mention the prospect of a return to a dollar bear market. Moreover, the price of gold is still just half of its prior peak in 'real' terms, even after the rally of the past eight years. So, we see much more upside than downside risk to bullion.

Because what the future holds is a regulatory environment that will allow for far less volume of lending available per unit of GDP, the level of interest rates (i.e. the 'neutral' funds rate) will be much lower than they have been in the past twenty years of cowboy credit creation. It really was the Wild West. And now, Hank Paulson is playing the role of Wyatt Earp. Hopefully his successor can go back to a pistol (in this new regulatory regime it may have to be a shotgun) instead of a bazooka.

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