

Election 2008: potential market implications

Varied policy impact on the markets

Based on candidate statements and proposals, Republican policy could benefit the stock and commodity markets, in our view, but may be less beneficial to the bond market and the US dollar. Conversely, Democratic proposals could benefit bonds and the dollar, and may be less beneficial to the stock and commodity markets.

Changing political winds?

The upcoming presidential election makes it hard to deny that the potential for significant economic and political change could be on the horizon. Investors need to consider these potential changes and the implications on asset classes, styles and sectors.

Investors receiving conflicting signals

The challenge at this point in the business cycle is that the economic and political cycles may be sending conflicting signals. From a strategic point of view, we recommend that investors look at sectors that are more defensive and produce good returns during periods of higher volatility, such as healthcare and consumer staples. However, if the Democratic Party wins the presidential election certain sectors, such as defense and healthcare, would probably come under increased scrutiny.

Investment performance relative to political party leadership

In this report, we review the history of investment performance under different political parties' leadership and investigate the potential risks and opportunities should the recent political rhetoric become reality.



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Table 1: Relative performance for asset classes in US Presidential cycles

(Performance relative to the S&P 500 - 1972 to present)

| Asset class | Republican | Democrat |
|------------------------|------------|----------|
| Stocks/Bonds | | |
| full cycle | | ✓ |
| final year | | ✓ |
| US Treasuries | | |
| full cycle | ✓ | |
| final year | ✓ | |
| Corporate Bonds | | |
| full cycle | ✓ | |
| final year | ✓ | |
| Gold | | |
| full cycle | ✓ | |
| final year | | |
| Cash | | |
| full cycle | | |
| final year | | |
| MSCI ex US | | |
| full cycle | ✓ | |
| final year | | |
| MSCI EAFE | | |
| full cycle | ✓ | |
| final year | | |
| MSCI Europe | | |
| full cycle | | ✓ |
| final year | | |
| MSCI Far East | | |
| full cycle | ✓ | |
| final year | | |
| Growth | | |
| full cycle | | ✓ |
| final year | | ✓ |
| Value | | |
| full cycle | ✓ | |
| final year | ✓ | |

Legend: a check implies relative outperformance for that asset class.

Source: ML ISG, Standard & Poors, MSCI

Implications of political change

The upcoming presidential election makes it hard to deny that the potential for significant economic and political change could be on the horizon. Investors need to consider these potential changes and implications on asset classes, styles and sectors. The challenge in this cycle is that the economic and political cycles may be sending investors conflicting signals.

Even though we are still at the relatively early stages of this presidential campaign, investors should begin to consider the possible asset class implications of the candidates' current policy prescriptions.

We emphasize that we are not judging one policy stance to be preferable over the other. As the election is still nine months away, proposed policies are likely to change between now and then. Upon such changes, we will update our view accordingly.

Periods of volatility? Get defensive

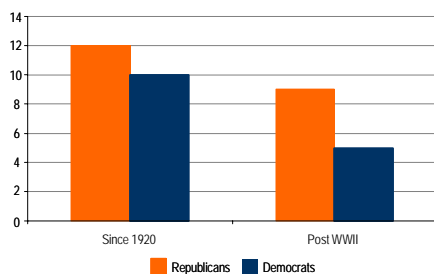
From a strategic point of view, we recommend investors look at sectors that are more defensive and produce good returns during periods of higher volatility, such as healthcare and consumer staples. However, if the Democratic Party wins the presidential election certain sectors, such as defense and healthcare, would probably come under increased scrutiny.

Political party policy impact on the markets

Given candidate statements and proposed policies, in our view Republican policy proposals could benefit the stock and commodity markets, but may be less beneficial to the bond market and the US dollar. On the other side, Democratic proposals could benefit bonds and the dollar, and be less beneficial to the stock and commodity markets.

In this report, we review the history of investment performance under different political parties' leadership and investigate the potential risks and opportunities should the recent political rhetoric become reality.

Chart 1: Presidential Victories



Source: ML ISG, US Census Bureau

Asset class generalizations are based on broader themes

Taxes and fiscal deficits

There seem to be considerable differences thus far in the parties' proposals regarding taxes and fiscal deficits. Republicans have advocated broader tax cuts more than the Democrats, and tended to deemphasize "paygo" policies (ie, linking tax cuts to spending cuts or spending increases to tax increases). If Republican policies were enacted according to current rhetoric, the fiscal deficit might expand, which could be detrimental to the dollar and longer-duration bonds. Those policies, however, might be positive for nominal economic growth, and therefore may benefit equities.

Democrats have been vocal about removing the current capital gains and dividend tax cuts enacted by the Bush Administration. If those cuts are allowed to expire in 2010, or are discontinued before then, such changes would lower investors' after-tax expected return on equities. Obviously, a number of factors would have to be taken into account, but investors would likely consider such policies to be equity unfriendly on the surface. It also makes sense to evaluate whether such tax increases could decrease the budget deficit and lower long-term interest rates.

The dollar and commodities

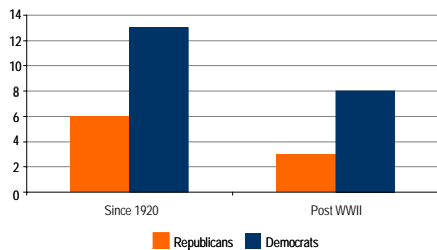
In the past, we have pointed out that there are three factors that influence commodity prices: 1) macroeconomic and microeconomic supply/demand factors; 2) the US dollar, because most commodities are denominated in US dollars; and 3) speculation. As it stands, Democratic policies seem more dollar friendly because they appear to be more focused on reducing budget deficits. A stronger dollar may not benefit commodities.

Political cycles

Historically, the US markets have responded to the business cycle, the profits cycle and the political cycle. A presidential election year is a part of the cycle during which financial markets historically have performed quite differently.

This election is a rare event because two cycles are in the midst of inflection points. Many anticipate that the US could experience both a presidential election and a recession in 2008. This has only happened twice since World War II in 1960 and 1980. In both instances there was a major political ideological change in the White House and major reforms were enacted into law. In 1960 the confluence of events led to complete control by the Democratic party of both the White House and Congress. In 1980, the Republicans controlled the White House and the Senate, but not the House.

Chart 2: Control of Congress



Source: ML ISG, US Census Bureau

Looking ahead to 2009, there have been six presidential cycles in which a president's first year in office coincided with a recession. The 2000 recession under George W. Bush was the only occurrence since 1972.

- This election is different because it is the first election since 1928 without an incumbent (either the president or a vice president) running in the primaries.
- We have had 14 presidential elections since the end of World War II, nine won by Republicans and five won by the Democrats.
- Democrats have controlled both houses of Congress in eight of those elections. The Republicans have controlled Congress only three times, while Congress has been split between the parties in three elections.
- Complete control of the reigns of power is not common. Of the 14 presidential elections, only half of them have resulted in either party controlling both the White House and the Congress: the Republicans twice (Eisenhower and George W. Bush) and the Democrats on four occasions (Kennedy, Johnson, Carter and Clinton).

Potential issues

Table 2: Candidates on the economy

| Fiscal policy - taxes and spending | | |
|------------------------------------|--|--|
| Candidate | Proposal | Impact |
| McCain | Extend Bush's personal income tax cuts Keep capital gains and dividend tax rates at 15% Lower corporate tax rate to 25% from 35% currently Repeal Alternative Minimum Tax (AMT) Favor line-item veto; veto all pork-laden spending; does not support PAYGO rules | Positive for consumer spending & GDP; negative for fiscal budget Equity-friendly Equity-friendly Unclear; he does not say how he would pay for the repeal Without PAYGO may see higher spending and wider budget deficits |
| Clinton | Raise top two personal marginal tax rates back to pre-2001 levels 35% rate rises to 39.6% and 33% to 36% Capital gains rate reverses back to 20% from 15% currently Dividend rate rises from 15% to ordinary income rate Repeal AMT; could require lifting top two income brackets to 43.5% & 41% PAYGO; offset new tax cuts or spending with higher taxes or less spending | Negative for high-end consumption and GDP; positive for fiscal budget Bond/dollar-friendly Bond/dollar-friendly Very negative for high-end consumption and GDP; positive for fiscal budget Positive for fiscal budget and negative for GDP |
| Obama | Raise top two personal marginal tax rates back to pre-2001 levels 35% rate rises to 39.6%, and 33% to 36% Increase capital gains rate to 24% from 15% currently Raise dividend rate to 24% from 15% Repeal AMT; could require lifting top two income brackets to 43.5% and 41% PAYGO; offset new tax cuts or spending with higher taxes or less spending | Negative for high-end consumption and GDP; positive for fiscal budget Bond/dollar-friendly Bond/dollar-friendly Very negative for high-end consumption and GDP; positive for fiscal budget Positive for fiscal budget and negative for GDP |
| Healthcare | | |
| Candidate | Proposal | Impact |
| McCain | Individual tax credits (\$2,500 per individual; \$5,000 per family) | Positive for long-term fiscal budget outlook, as it helps to reign in medical prices |
| Clinton | Mandated universal health care insurance; annual cost \$110bn | Negative for fiscal budget and not likely to reign in medical costs |
| Obama | Universal health care insurance; annual cost \$50-65bn | Negative for fiscal budget and not likely to reign in medical costs |
| Trade | | |
| Candidate | Proposal | Impact |
| McCain | Supports free trade, but also emphasizes fair trade | Supportive of export sector and GDP, but some chance increased protectionism |
| Clinton | Increase environmental and labor protections related to trade deals | Less friendly for exports and GDP |
| Obama | Increase environmental and labor protections related to trade deals | Less friendly for exports and GDP |

Source: ML Economics

Turning the economy around

The US economy appears to be leading the global economy into a period of slower growth. Simultaneously, a global credit cycle is being unwound. This combination of events will likely cause severe economic dislocation. The candidates have views on how to use fiscal policy to turn the economy around, which should have different effects on financial market sectors.

Concerns:

- How deep and protracted will the economic slowdown be?
- Will credit-sensitive sectors recover along with the economy?
- Expansive Stimulus plans may cause longer-term deficits to rise.

Strategies:

- As outlined in Table 1, market strategy will depend on the nature of the proposals.
- The Democratic Party seems more likely to raise corporate taxes and personal income taxes for the wealthy, which may be bad for financials, suggesting a rotation towards consumer staples.

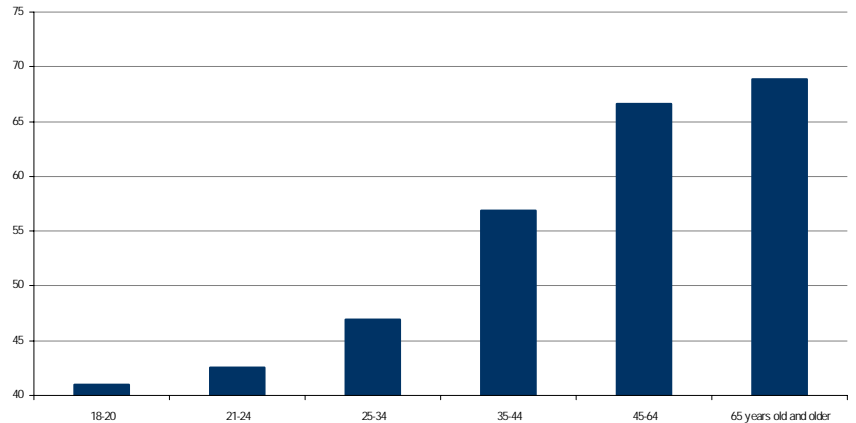
Healthcare a critical campaign issue

Healthcare is a critical issue in this election, and is divisive in many ways. Demographics and income disparities have been, and will probably continue to be, important determinants of this issue. Some of the major healthcare-related issues are insurance affordability and coverage, long-term care, and LTC insurance.

Concerns:

- New regulations could hurt the insurance industry, as government intervention could lower client payments, cutting into profitability.
- Will we see a shift toward more government healthcare plans?
- The aging population tends to vote more often (see Chart 3), so there could be legislation to put price controls on drugs, despite the anticipated rise of generics in the next few years.
- Long-term care issues are increasing in importance as aging baby boomers will live longer, but need more care and health-related services.
- How will medical device safety issues affect regulators in new product approvals?

Chart 3: Percent voting by age, 2006 (%)



Source: ML ISG, US Census Bureau

Strategies:

- Historically, healthcare is one of the top-performing sectors during periods of increased volatility, and a solid defensive investment. It remains one of our favored sectors.
- However, the uncertainty about possible legislative action in healthcare could dampen returns due to the political cycle.
- Lack of action on healthcare could be seen as troubling for the future of the US fiscal deficit, and could be negative for inflation and for bonds.
- Digitization of patient records should be a positive for IT-related companies.
- Democrats might be less likely to attempt to reduce potential lawsuits through tort reform.
- Insurance companies could suffer if major healthcare insurance initiatives are enacted into law.

Bush tax cuts in or out? Taxes up or down?

The Bush Administration pushed for major tax reform and was able to cut the top marginal rate and the capital gains tax rate. Many of the Bush tax cuts begin to expire in FY2010. Only John McCain maintains a “pro-growth” tax policy, with the idea of keeping taxes low and making the Bush tax cuts permanent.

All three major candidates have endorsed the idea of lowering middle class taxes either by extending the middle class tax cuts or repealing the Alternative Minimum Tax (AMT).

Concerns:

- Individual tax cuts are set to expire in 2010. Could we see a hike in the top marginal tax rate toward 40%?
- Estate taxes promise to become a major political issue as the Baby Boomer Generation begins estate planning.

- Will capital gains taxes be raised and, if so, by how much?
- Could Democratic control lead to more green taxes?
- If the dividend tax rate rises relative to the capital gains tax rate, yield-oriented investments like utilities could be negatively affected.

Strategies:

- Making the Bush tax cuts permanent could be seen as positive for stocks, but a negative for the deficit, inflation and bonds. An extension of the tax cuts could be seen as expanding the fiscal deficit.
- If taxes are raised, especially for the wealthy, it could be a negative for certain financials because savings flows could diminish.

Political control key is for defense sector

If the Republicans retain control, it can be viewed as a net positive for the defense theme. If the Democrats establish control, it could be seen as a negative for defense stocks in the short term, as the party seems to be focused on ending the war in Iraq.

Recall that many defense project contracts are in place for the next few years. As Merrill Lynch defense analyst Ron Epstein points out, Democratic control “could lead to a decline in defense spending authorization in the FY11 timeframe which could in turn impact outlays in the FY12/FY13 timeframe.” In addition, the leading Democratic candidates seem to have greater focus on domestic Homeland Security issues, such as cyberterrorism and border control.

Concerns:

- How much could ending the war in Iraq affect defense stocks?
- Would spending on domestic security issues lead to a mix-shift, draining money away from other more traditional defense initiatives?

Strategies:

- Investing in defense companies, a traditionally defensive strategy, has provided solid returns and remains one of our favored tactical and strategic long-term themes.
- If the Democratic agenda gains momentum, it would probably mean a shift in defense spending away from the war in Iraq toward a greater focus on Homeland Security and issues of domestic security. A shift in focus to more non-traditional defense companies like IT and telecommunications could be advisable.
- A large part of Democratic defense plans seems focused on multilateralism and diplomacy. Perhaps IT could benefit, as part of the solution could be increased use of technology for security and information gathering.

Climate change proposals abound

All of the major candidates have proposals to deal with the climate change issues. In general, they appear to be in favor of limiting carbon emissions and reducing US dependence on foreign sources of energy.

The Democratic agenda on climate change issues is more aggressive and seen as being less pro big business. Increased auto efficiency standards, reduced greenhouse gas emissions levels, developing renewable sources of energy and creating systems for trading carbon emissions are a few of the examples.

Concerns:

- Democratic control would probably block domestic projects using environmentally-protected land in search of new sources of energy.
- Much of the climate change legislation is likely to raise costs for manufacturers.
- Focus on biofuels development could continue to be inflationary, as food prices will be pressured upward (Agflation).
- The Merrill Lynch pollution control analyst, Jonathan Ellis, has observed that under Democratic control, Congress could push for a closer look at recycling standards, putting pressure on the waste industry.

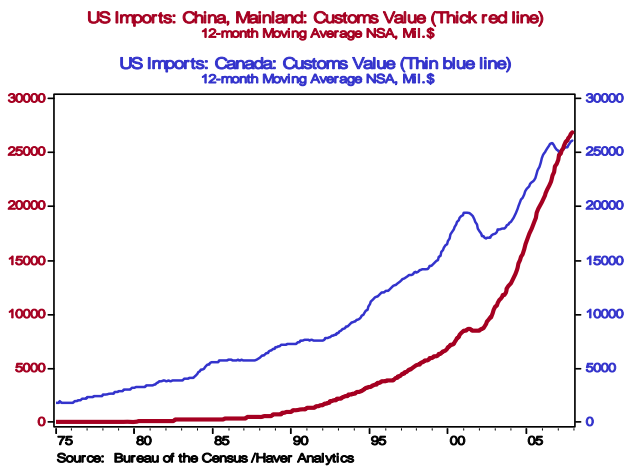
Strategies:

- Investing in green technologies and companies that are already providing those capabilities to the marketplace.

Free trade/protectionism dichotomy

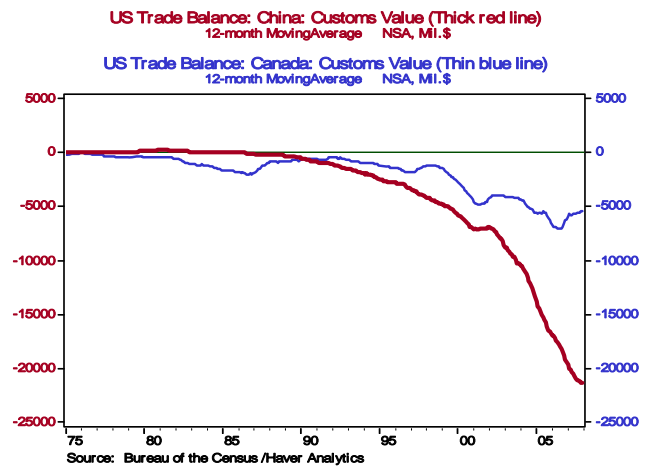
Free trade is becoming more of an issue. The US economy is no longer just dealing with the issues of outsourcing and/or off-shoring. China's surging imports into the US have created a bilateral trade deficit that must be addressed. Protectionism may also rise in importance, as hourly wages continue to feel the downward pull of cheap foreign labor.

Chart 4: China is largest importer into US ...



Source: ML ISG

Chart 5: ... with a trade deficit that must be addressed



Source: ML ISG

Concerns:

- The rising surge of protectionist sentiment in an election year is not new. It is of concern this time because China is now the largest importer into the US.
- Protectionism could affect US exports in the long run as other countries could retaliate with trade barriers of their own.
- Protectionism could also lead to higher inflation because curbs on goods from China, or curbs on certain types of goods (e.g., food), could result in less supply.
- The weak US dollar is aiding export growth. Increased protectionism could hinder US exports.
- Increased protectionism could reduce imports, especially from countries with low labor costs (i.e., China), lifting inflation.

Strategies:

- If protectionism does not rise, a weak currency should favor large-cap exporting companies.
- Increase exposure to companies within regional trading blocs (NAFTA, ASEAN) where protectionism should be less pervasive.
- Reduce exposure to emerging markets, especially those with rising labor costs.

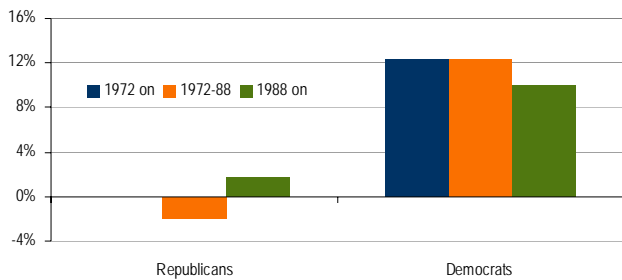
Election adds to market uncertainty

As mentioned, many of the Republican policy proposals are more directed toward improving business conditions, and in our view would seem to benefit the stock and commodity markets. They may be less beneficial to the bond market and the US dollar as policies — like making the tax cuts permanent — and would be seen by the markets as expanding the budget deficit and potentially inflationary. On the other side, Democratic proposals may benefit bonds and the dollar, and be less beneficial to the stock and commodity markets.

Stocks and bonds

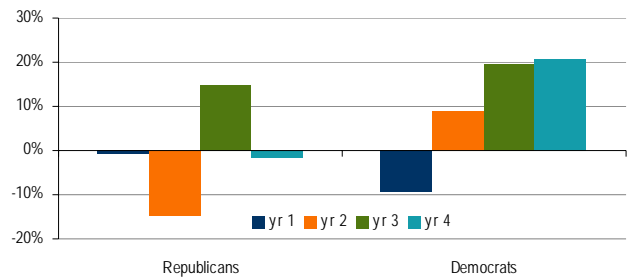
Even though their current proposals particularly for taxes and healthcare would not necessarily be stock market-friendly, we note that Democratic administrations historically have produced significant outperformance for stocks versus bonds. However, in the fourth year of a Republican presidential cycle, bonds historically have outperformed stocks. In the first year of a new presidential cycle, bonds have historically outperformed stocks under either political party.

Chart 6: Median relative performance of stocks vs long-term Treasuries during Republican and Democratic presidencies, varying time periods from 1972 (4 yr annualized total returns based on monthly data from 10/31 week before election, includes the 3 yrs 3 mos avail for current incumbent)



Source: ML Investment Strategy

Chart 7: Median relative performance of stocks vs long-term Treasuries: 12 months performance for years 1-4 (4 yr annualized total returns based on monthly data from 10/31 week before election, includes the 3 yrs 3 mos avail for current incumbent)

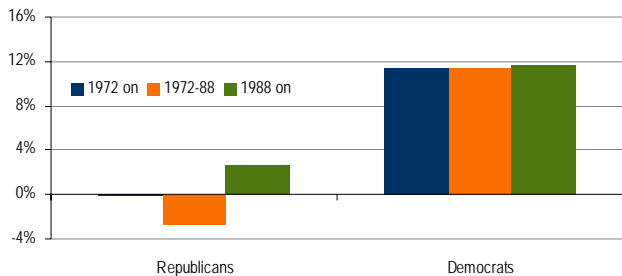


Source: ML Investment Strategy

Corporate bonds

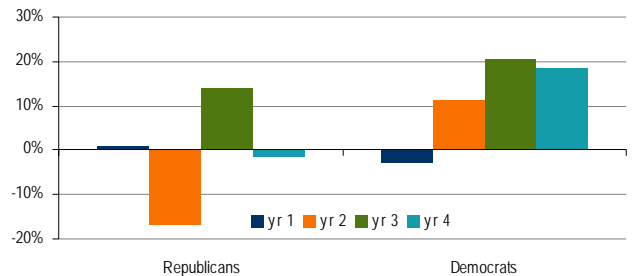
As with Treasuries, stocks have historically outperformed corporate bonds during Democratic administrations. Also, corporate bonds have outperformed stocks in the fourth year of a Republican administration over the last 36 years. In the first year of a presidential cycle, stocks have modestly outperformed Corporates in Republican administrations, while Corporates have outperformed in the first year of Democratic cycles.

Chart 8: Median relative performance of stocks vs high grade corporates during Republican and Democratic presidencies varying time periods from 1972 (4 yr annualized total returns based on monthly data from 10/31 week before election, includes the 3 yrs 3 mos avail for current incumbent)



Source: Merrill Lynch Investment Strategy

Chart 9: Median relative performance of stocks vs high grade corporate bonds: 12 months performance for yrs 1-4, (monthly data beginning 10/31 of election year 1972 through 1/31/08, includes the 3 mos of year 4 avail. for current incumbent)

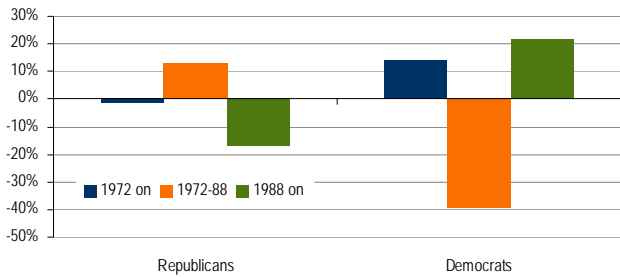


Source: Merrill Lynch Investment Strategy

Gold

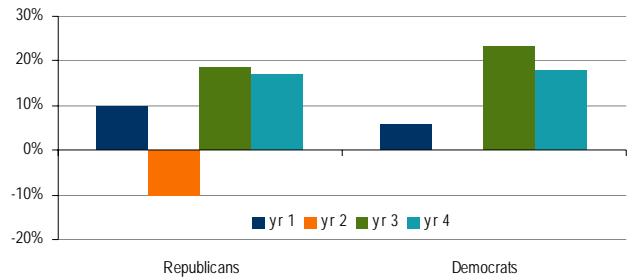
Gold, the ultimate inflation hedge, historically has outperformed modestly during Republican administrations, but underperformed during Democratic administrations. For those investing in the commodity super-cycle, the political cycle offers little help, as gold has underperformed during the final and first years of presidential cycles.

Chart 10: Median relative performance of stocks vs gold during Republican and Democratic presidencies varying time periods from 1972 (4 yr annualized total returns based on monthly data from 10/31 week before election, includes the 3 yrs 3 mos avail for current incumbent)



Source: ML ISG, MSCI

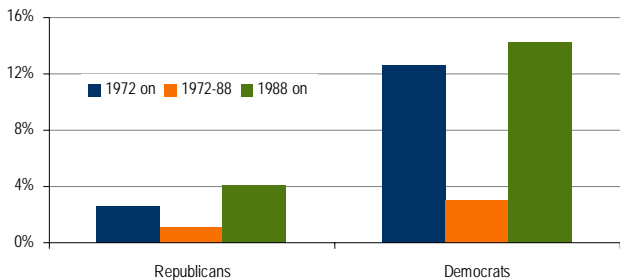
Chart 11: median relative performance of stocks vs gold: 12 months performance for yrs 1-4, (monthly data beginning 10/31 of election year 1972 through 1/31/08, includes the 3 mos of year 4 avail. for current incumbent)



Source: ML ISG, MSCI

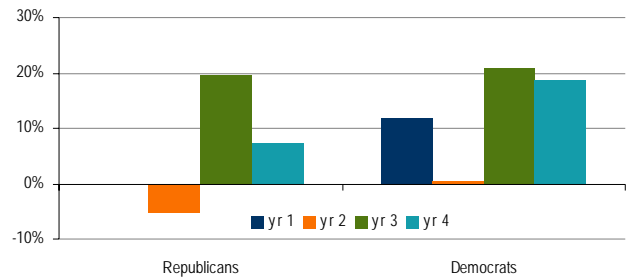
Cash

Chart 12: Median relative performance of stocks vs cash during Republican and Democratic presidencies varying time periods from 1972 (4 yr annualized total returns based on monthly data from 10/31 week before election, includes the 3 yrs 3 mos avail for current incumbent)



Source: Merrill Lynch Investment Strategy

Chart 13: Median relative performance of stocks vs cash: 12 months performance for yrs 1-4, (monthly data beginning 10/31 of election year 1972 through 1/31/08, includes the 3 mos of year 4 avail. for current incumbent)

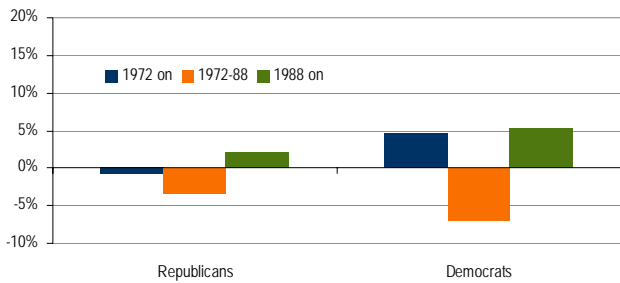


Source: Merrill Lynch Investment Strategy

International World versus the US

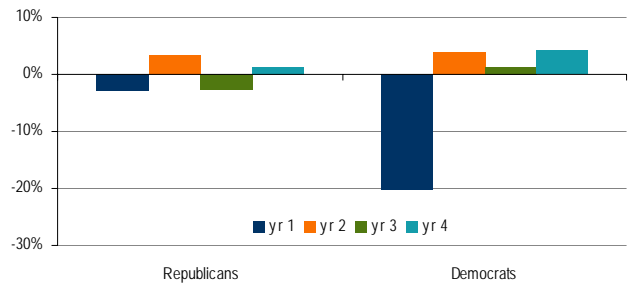
In looking at global markets, it is interesting to note that the S&P 500 has outperformed global markets during Democratic administrations, but underperformed during Republican terms. In the fourth year of any presidential administration, US markets have historically outperformed with either party in power. However, the US has usually underperformed in the first year of a new administration, regardless of which party is in power.

Chart 14: Median relative performance of S&P 500 vs MSCI World ex US during Republican and Democratic presidencies varying time periods from 1972 (4 yr annualized total returns based on monthly data from 10/31 week before election , includes the 3 yrs 3 mos avail for current incumbent)



Source: Merrill Lynch Investment Strategy, MSCI

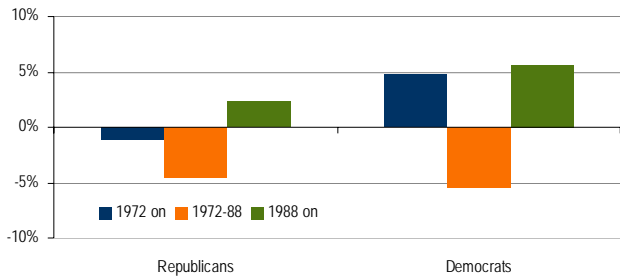
Chart 15: Median relative performance of S&P 500 vs MSCI World ex US: 12 months performance for yrs 1-4, (monthly data beginning 10/31 of election year 1972 through 1/31/08 , includes the 3 mos of year 4 avail. for current incumbent)



Source: Merrill Lynch Investment Strategy, MSCI

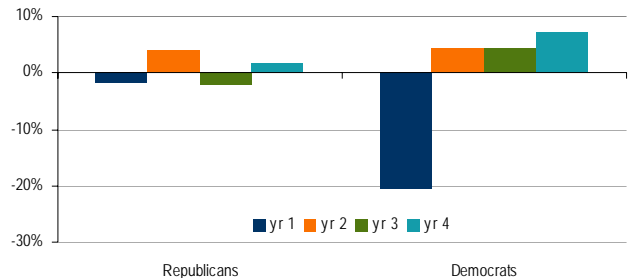
MSCI EAFE®: Europe, Australasia, Far East

Chart 16: Median relative performance of S&P 500 vs MSCI EAFE® during Republican and Democratic presidencies varying time periods from 1972 (4 yr annualized total returns based on monthly data from 10/31 week before election , includes the 3 yrs 3 mos avail for current incumbent)



Source: Merrill Lynch Investment Strategy, MSCI

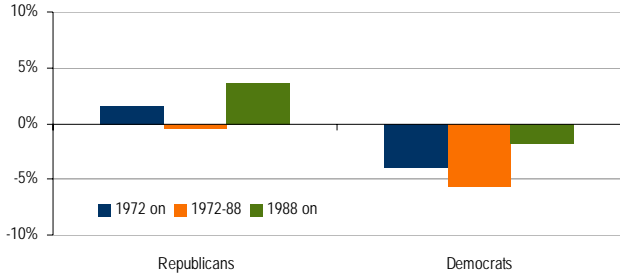
Chart 17: Median relative performance of S&P 500 vs MSCI EAFE®: 12 months performance for yrs 1-4, (monthly data beginning 10/31 of election year 1972 through 1/31/08 , includes the 3 mos of year 4 avail. for current incumbent)



Source: Merrill Lynch Investment Strategy, MSCI

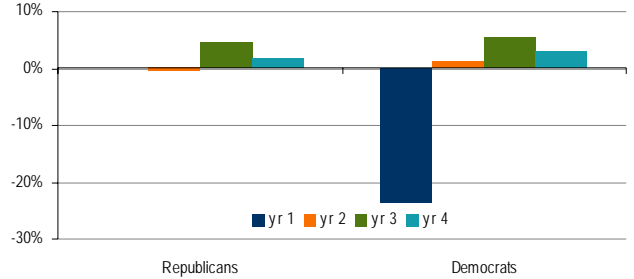
Europe

Chart 18: Median relative performance of S&P 500 vs MSCI Europe during Republican and Democratic presidencies varying time periods from 1972 (4 yr annualized total returns based on monthly data from 10/31 week before election , includes the 3 yrs 3 mos avail for current incumbent)



Source: Merrill Lynch Investment Strategy, MSCI

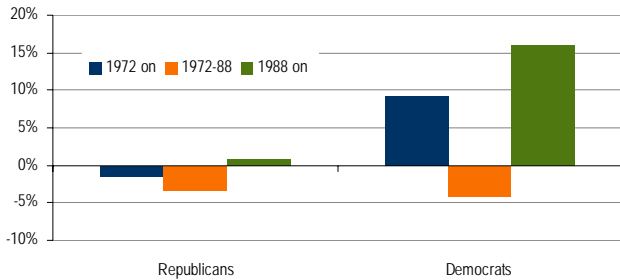
Chart 19: Median relative performance of S&P 500 vs MSCI Europe: 12 months performance for yrs 1-4, (monthly data beginning 10/31 of election year 1972 through 1/31/08 , includes the 3 mos of year 4 avail. for current incumbent)



Source: Merrill Lynch Investment Strategy, MSCI

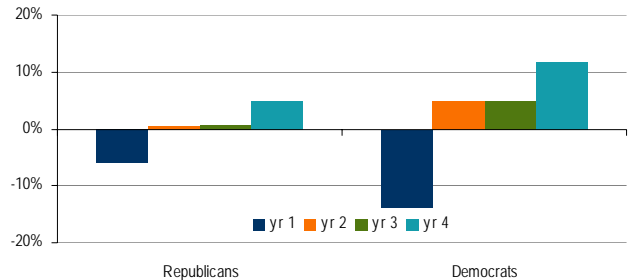
Far East

Chart 20: Median relative performance of S&P 500 vs MSCI Far East during Republican and Democratic presidencies varying time periods from 1972 (4 yr annualized total returns based on monthly data from 10/31 week before election , includes the 3 yrs 3 mos avail for current incumbent)



Source: Merrill Lynch Investment Strategy, MSCI

Chart 21: Median relative performance of S&P 500 vs MSCI Far East: 12 months performance for yrs 1-4, (monthly data beginning 10/31 of election year 1972 through 1/31/08 , includes the 3 mos of year 4 avail. for current incumbent)

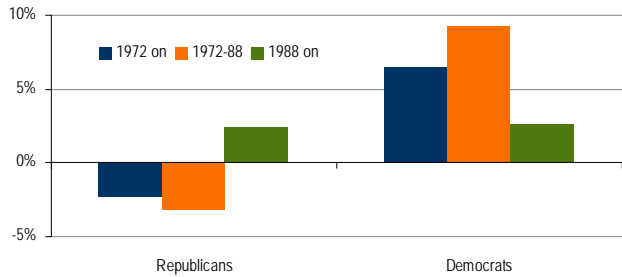


Source: Merrill Lynch Investment Strategy, MSCI

Investment styles

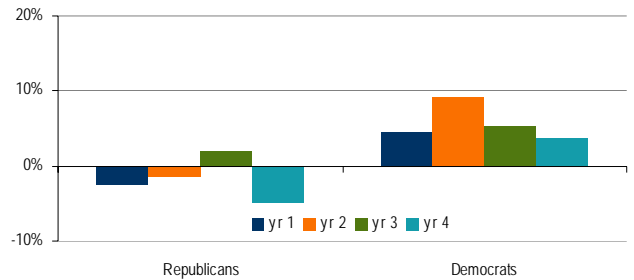
In looking at different investment styles, such as growth versus value, growth has outperformed significantly during Democratic years, but underperformed during Republican years. Historical precedent suggests that value has historically outperformed during the final year of a Republican president. In the first year of a presidential cycle, value has typically outperformed with Republican presidents, while growth managers usually outperform with Democratic presidents.

Chart 22: Median relative performance of ML Growth Fund Index vs ML Value Fund Index during Republican and Democratic presidencies varying time periods from 1972 (4 yr annualized total returns based on monthly data from 10/31 week before election , includes the 3 yrs 3 mos avail for current incumbent)



Source: Merrill Lynch Investment Strategy

Chart 23: Median relative performance of ML Growth Fund Index vs ML Value Fund Index: 12 months performance for yrs 1-4, (monthly data beginning 10/31 of election year 1972 through 1/31/08 , includes the 3 mos of year 4 avail. for current incumbent)



Source: Merrill Lynch Investment Strategy

US sectors - stay defensive

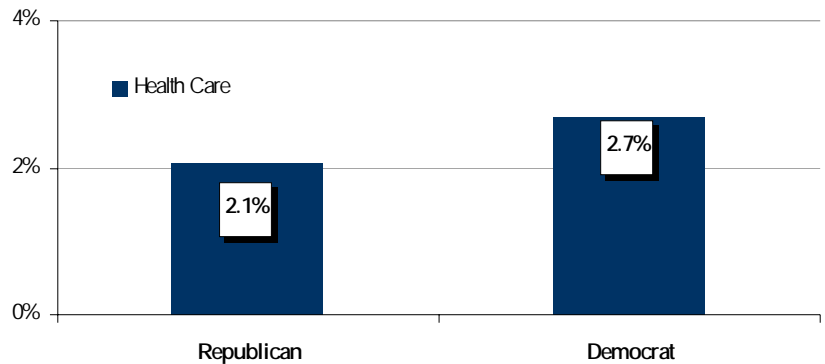
As mentioned, we recommend that investors look at more defensive sectors, such as healthcare and consumer staples. Longer term, we remain bullish on several themes, including in defense, several healthcare issues and on food companies.

Most of the comments in this section come from Merrill Lynch senior analysts who felt that the presidential election may be particularly meaningful to the performance of stocks within their sectors.

Healthcare a defensive strategy

We recommend healthcare from a cyclical perspective because it has outperformed during presidential cycles. However, investors must be wary of particular subsectors that could face increased scrutiny during this election year.

Chart 24: Sector average performance relative to the S&P 500 under Republican and Democratic presidents (4 yrs subs performance from Oct 30 of election year, 1988 on)



Source: Merrill Lynch Investment Strategy, Standard & Poors

Healthcare spending is an issue that will carry increasing importance over the next few years. Below are some of the major issues in the sector.

- Historically, Democrats have favored a larger governmental role in healthcare. Both leading candidates seem to favor more government intervention in issues like universal coverage.
- The FDA is expected to continue to be tough on pharmaceuticals and medical device safety.
- We expect additional investigations/hearings to scrutinize for-profit healthcare.
- Managed care will face more criticism as politicians debate healthcare affordability.
- Rising levels of the uninsured is a pressing issue, affecting insurance companies and the industry as a whole.
- Healthcare reform is vital as the single payer system and the inability to differentiate based on risk are debated. Democrats are perceived as negative on this issue.

- In the healthcare insurance industry, exposure could be a perceived issue for companies like Aflac, Assurant, Principal and Torchmark.
- Our analysts do not see many negatives for Aflac. Under Hillary Clinton's 1994 healthcare proposals, there were exclusions for Aflac-type products. Moreover, Aflac is still very successful in Japan, which has a national healthcare system.
- For Torchmark, a Democrat could be a positive because cuts in reimbursement rates for Medicare Advantage (managed care) plans could push more seniors into a traditional Medicare supplement market (Torchmark business).
- Democrats are generally considered less likely to eliminate estate taxes (which would hurt demand for life insurance), but the issue seems off the table, regardless of which party rules the White House.
- The Merrill Lynch Healthcare Research team sees three key themes in 2008 — earnings resilience, Washington headwinds, and ongoing generics expansion. We recommend investing in companies that have fundamental drivers that should warrant outperformance.

Financials will depend on the credit market situation

Financials have historically underperformed during Republican administrations. There are many issues that, given the current situation in the credit markets, may result in regulatory or legislative action.

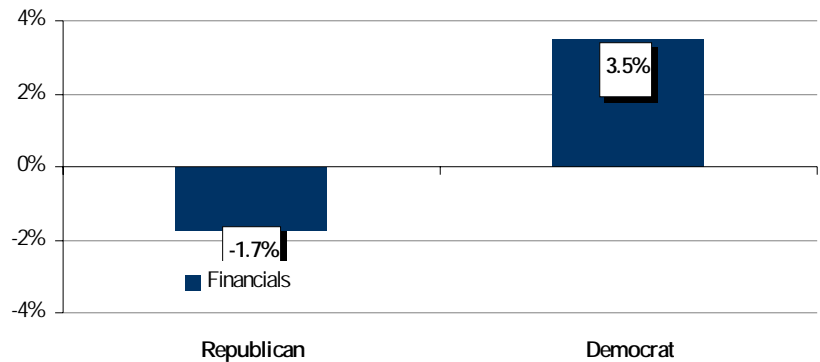
- The Democrats seem more likely to raise taxes to try to balance the budget, with favorable dividend and capital gains treatment vulnerable and estate tax reductions likely to sunset. Democrats may be slightly more likely to press mortgage reform, which could hurt the industry, and curtail mortgage availability.
- Possible regulatory/legislative action in the CDO business.
- Regulatory action as a response to the housing and credit expansion probable.
- The Bush tax cuts could be reversed, affecting savings and investment flows.
- Taxation of partnerships engaged in asset management: Congress could revive plans to tax partnerships if Democrats win. This would hurt Och-Ziff (OZM), possibly doubling its tax rate. It might also temporarily hurt AllianceBernstein (AB); however, in our view, their grandfathered status could ultimately help them because they could keep their low tax rate.
- Higher taxes if Democrats are elected might help Eaton Vance (EV) because they specialize in tax-managed products, including tax-managed mutual funds, separately managed accounts (SMAs), muni bonds, dividend-themed equity funds and tax-efficient overlay products. They might also help REIT manager Cohen & Steers (CNS) by putting REIT fund income on a more equal footing with dividends.
- Conversely, if the Republicans win, it would probably hurt Eaton Vance by making some of their tax-efficient products less necessary; the rest of the group might benefit from lower capital gains.

- For the trust banks and online brokers, given that these companies are impacted by continued good flows into investment products, the biggest issues from any administration changes would be: 1) the ability for the administration to influence economic growth and 2) taxation on capital gains, as well as income.

Regarding economic growth, greater fiscal stimulus would help and be naturally supportive for employment and wages, and thus likely a positive for discretionary income growth and equity markets in general. Higher taxes on capital gains would be a negative for stocks, and would at least modestly reduce demand for equity mutual funds and retail equities trading (each of which devise a component of trust banks and online broker revenue streams). Higher income taxes could also reduce discretionary income available for investment.

- If a Republican administration means continued favorable tax treatment, this would be a modest positive for both sectors, provided the economy resumed at least a modest growth trajectory. We argue that the online brokers would be more levered to that outcome (versus the trust banks) because a much larger portion of their earnings (95% plus) are sourced from the US (versus only about 60-65% of trust bank earnings sourced from the US).

Chart 25: Sector average performance relative to the S&P 500 under Republican and Democratic presidents (4 yrs subs performance from Oct 30 of election year, 1984 on)



Source: Merrill Lynch Investment Strategy, Standard & Poors

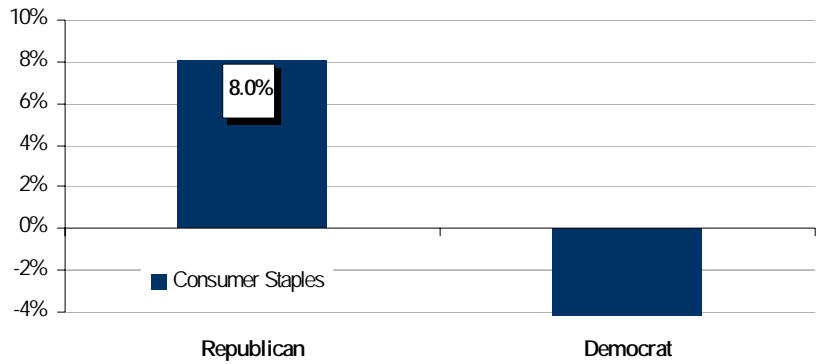
Consumer staples the new leadership?

We remain concerned about the state of the US economy in 2008. Our strategy is a defensive one, with consumer staples an emerging leadership sector. Some issues from the election that could affect the consumer sector are:

- Increasingly, the government will have to intervene on consumer products and food safety issues.
- Greater concern from Democrats on wage disparities and tax rates.
- Democrats could push for higher individual income tax rates.
- Democrats are known to favor higher capital gains tax rates.

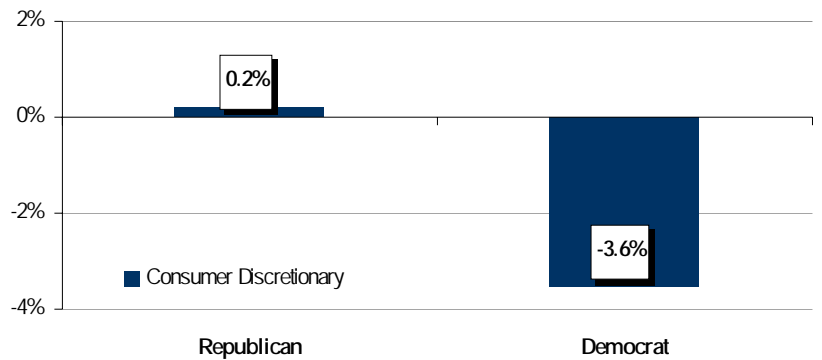
- Raising the minimum wage may become an issue.
- Ease of financing in the for-profit education spend.
- A new Farm Bill is also an issue. The bottom line is that agriculture should do well, regardless of which party gets in.
- Taxes and the impact on consumer spending of higher rates.
- There are several political risks for tobacco companies: 1) tobacco stocks have historically performed better under Republican administrations (risk of further litigation lower); 2) the odds of anti-tobacco legislation probably increase under a Democratic presidency; 3) Democratic control of Congress could lead to another attempt to enact a federal excise tax on tobacco (vetoed by Bush); and 4) Congress could ask for FDA oversight of the tobacco industry.

Chart 26: Sector average performance relative to the S&P 500 under Republican and Democratic presidents (4 yrs subs performance from Oct 30 of election year, 1984 on)



Source: Merrill Lynch Investment Strategy, Standard & Poors

Chart 27: Sector average performance relative to the S&P 500 under Republican and Democratic presidents (4 yrs subs performance from Oct 30 of election year, 1984 on)



Source: Merrill Lynch Investment Strategy, Standard & Poors

Industrials and autos

Several potential issues stand out for the sector: economic stimulus, monetary or fiscal policy; the impact of the election on the fuel economy; and how healthcare has become a back-burner issue for US automakers. Due to the point we are at in the economic cycle, industrials and autos remain tied to the consumer. As a result we do not favor the sector.

- Will economic stimulus come in the form of monetary or fiscal policy? The two variations of stimulus will likely provide some buffer to the obvious pressures on demand. However, given that the majority of auto purchases are financed, we believe monetary policy is more effective; therefore, a president that supports the Fed's recent and expected rate cuts would be best for the auto industry.

At this time, there appears little pushback on rate cuts from any candidates, Democratic or Republican, so this will unlikely be any change based on the outcome of the election. (Please see our note *Can the Fed fuel autos?* published 25 January 2008 for further detail).

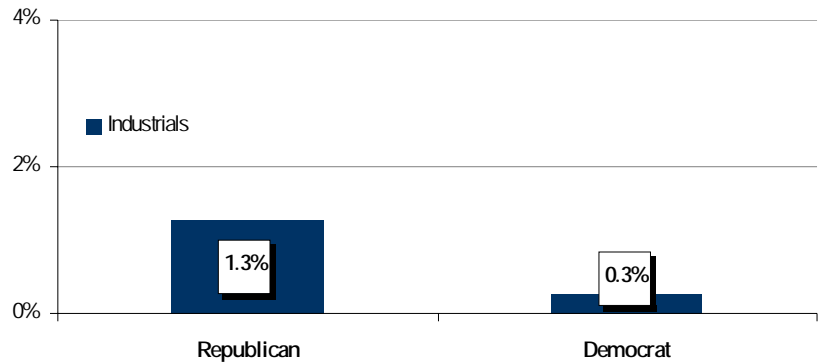
- Given the new fuel standards put in place in late 2007, the outcome of the election will have little to no impact on the fuel economy, in our estimation. The heavily contested automotive fuel standards bill passed on 19 December 2007 creates an additional hurdle for the domestic OEMs as they fight to regain competitive footing.

The revised CAFE standards sharply boost the average required new vehicle fuel economy to 35 mpg by 2020, from 2008's 27.5 mpg level. As a result, the cost of developing and sourcing new fuel-efficient technologies will be an added pressure for all automakers, but more so for the Detroit Three that are in restructuring mode. Partially offsetting Detroit's pain, however, will likely be a series of concessions designed to make the transition not only more palatable, but ultimately attainable.

The most probable breaks that OEMs will qualify for include an extension of the flex fuel credit, separate and less stringent standards for trucks and SUVs, and subsidies for redesigning factory footprints. Meeting the revised fuel standards will likely prove challenging for all automakers, particularly those that have primarily focused on larger, gas-guzzling models.

- Healthcare has become more of a back burner issue for US automakers due to the labor deal reached between the UAW and the Detroit Three in 2007. However, this was at considerable cost to the Detroit Three, but the ongoing expense and liability have now been capped and will be eliminated in early 2010, at the latest. There are still large healthcare expenses associated with salaried workers, so any relief would be a positive.

Chart 28: Sector average performance relative to the S&P 500 under Republican and Democratic presidents (4 yrs subs performance from Oct 30 of election year, 1984 on)

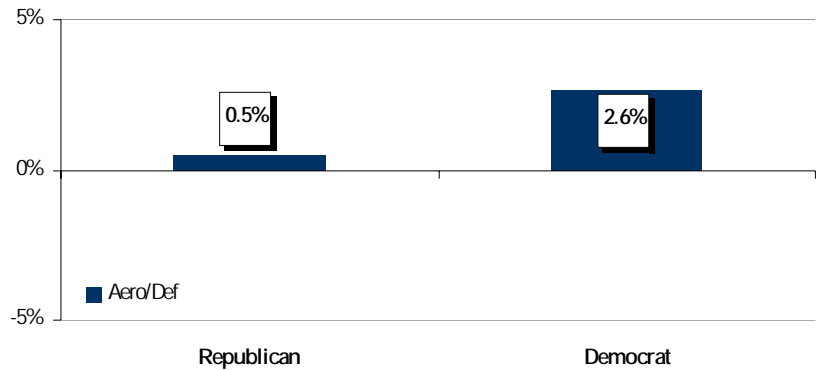


Source: Merrill Lynch Investment Strategy, Standard & Poors

Aerospace/defense remains a favorite

- In both the short and long term, the defense sector remains one of our favorite defensive sectors. Despite the traditional view that Republicans favor defense companies, paradoxically, the sector has outperformed more during Democratic administrations.
- Our aerospace/defense team has pointed out that defense has outperformed the market during the last two recessions by 17.4% on average.
- The Merrill Lynch aerospace/defense team maintains that “it is hard to imagine any other industry more insulated from the broader economy including the credit tightening environment than large cap defense.”
- If a Democrat is elected, the Merrill Lynch Political Control Model suggests that the total defense budget could decrease by \$30bn in FY 2010. The Merrill Lynch defense team expects the “overall baseline budget to continue to grow, if not remain fairly constant, but supplemental spending should significantly decrease.”

Chart 29: Sector average performance relative to the S&P 500 under Republican and Democratic presidents (4 yrs subs performance from Oct 30 of election year, 1984 on)



Source: Merrill Lynch Investment Strategy, Standard & Poors

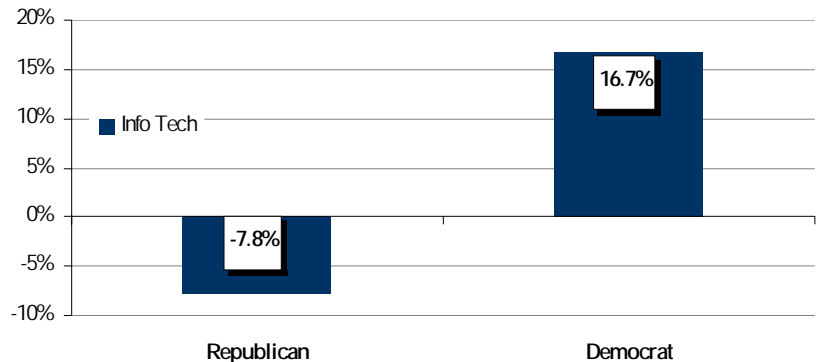
Technology

We like large-cap “old” technology tech companies or high quality companies with good export opportunities..

Some of the major issues facing IT during this election include the following:

- Renewal of R&D tax credits are an important concern of all tech companies. The perception in Silicon Valley is that the Democrats are much more likely to renew or even increase R&D tax credits, as the current administration has not been very helpful on this subject.
- Funding basic research both academic and through public/private institutes is also a political issue. Such funding declined significantly under the current administration, and the Democratic candidates, particularly Hillary Clinton, have been most vocal about increasing such funding — at least that is the perception again in Silicon Valley.
- Immigration is an issue, as tech companies are very concerned with the availability of advanced technical degree employees in the US. These companies rely heavily on foreign students that are educated in the US to fill vital jobs. Democrats are viewed as more open to lenient immigration reform, but it is tough to say which party would actually be friendlier.
- The view (and fundraising) from Silicon Valley has been tilted heavily toward Democrats so far. However, as an offset, many tech executives are very concerned about the potential for Democratic tax increases that would offset positives in the above-mentioned bullets and by slowing consumer demand.

Chart 30: Sector average performance relative to the S&P 500 under Republican and Democratic presidents (4 yrs subs performance from Oct 30 of election year, 1984 on)



Source: Merrill Lynch Investment Strategy, Standard & Poors

Media/telecom

Potential major election issues related to telecom include the following:

- A Democrat win could affect treatment of dividends, which would be important for big cap telcos (AT&T, Verizon et al).
- Our Media team believes that ad spending rises during election years. In the last two presidential election years, TV station advertising revenue grew 12% in 2004 and 11% in 2000, and declined 16% and 9% in 2001 and 2005, respectively.

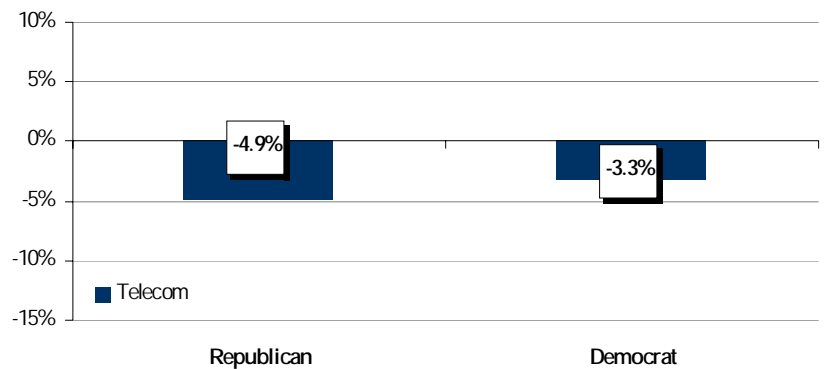
Telecom services

- Some general impacts include the overall level of economic activity and investor confidence and potential changes in the current favorable tax treatment of dividends (due to expire in 2010). While Republican administrations have been historically positive for investor sentiment, the differences between the Democratic front-runners could be just as important on this issue. Within the sector, high-beta, advertising-driven stocks are more sensitive to investor sentiment and economic activity than the telecom, cable and satellite operators.
- Regulation is less critical to the telecom/cable sector than in the past, but it still matters and is politically sensitive. In general, telecom carriers have benefited from a swing in the pendulum toward deregulation and easier M&A approvals under the Republicans. A regime change in the White House would likely move the pendulum back.
- In the media sector, a political regime change would likely stop or reverse the trend toward looser cross-ownership rules.
- In the cable and telecom sectors, the most critical regulatory issue is network neutrality. Proponents (consumers, Internet portals and content owners) want broadband networks to be neutral as to the type and source of Internet content carried on broadband networks, and the type of equipment attached to them. Carriers want to preserve their position as default providers of voice and video services, which are threatened by net neutrality. This issue is

growing in importance with the explosion of web-based video, the key source of broadband capacity pressure (and demand for related network equipment). There have been several draft net neutrality bills, none of which have passed yet. The most recent of these, the Internet Freedom Preservation Act (the Snowe-Dorgan bill) was signed by Barack Obama and Hillary Clinton, among others, and would have banned the blocking or degradation of content, tying Internet access to the purchase of other services or prioritizing third-party services. It would not prohibit packet prioritization for carrier-provided services.

- There is a parallel "open access" concept in the wireless sector, by which customers are entitled to use any device or application on a wireless network. This concept has been implemented with respect to a portion (the C-block) of the 700MHz spectrum to be released shortly.
- On both of these issues, we believe the risks to carriers are greater in theory than they would be in practice. As long as retail and broadband pricing remain unregulated, we think it would be difficult to legislate terms of service. As long as bandwidth demand is growing and further infrastructure investment is required, we do not see legislators interfering with the core economics of the triple play model.
- In the cable sector, a la carte pricing has also been a high-profile issue. We see implementation of a la carte pricing as unlikely, but if implemented, it would undermine the current "sell-through" cable-TV model, which packages channels in order to lower the per-channel price, boosting cable TV revenues.

Chart 31: Sector average performance relative to the S&P 500 under Republican and Democratic presidents (4 yrs subs performance from Oct 30 of election year, 1996 on)

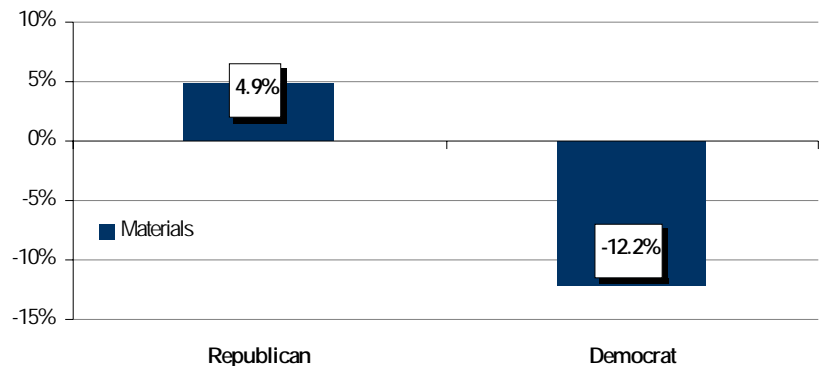


Source: Merrill Lynch Investment Strategy, Standard & Poors

Materials

Energy policy is a key issue. Demand for alternative energy, carbon credits, etc are generally considered positive for timber. Some people wonder if wood could be the next corn?

Chart 32: Sector average performance relative to the S&P 500 under Republican and Democratic presidents (4 yrs subs performance from Oct 30 of election year, 1984 on)

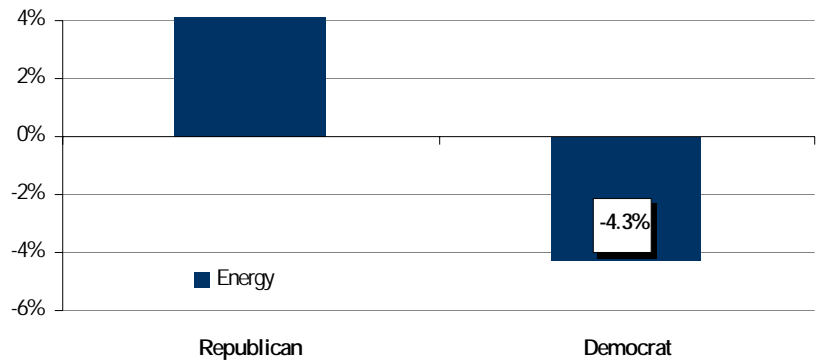


Source: Merrill Lynch Investment Strategy, Standard & Poors

Energy

- Probably the main policy issue for the oil sector is security of supply or energy independence. This affects foreign policy, especially with respect to the Middle East.
- The election may determine the attitude toward allowing access to new regions for exploration/exploitation (notably Alaska and the Arctic).
- Either party will encourage domestic ethanol production through regulation/subsidy.
- Energy conservation (eg, CAFE standards) remains important.
- A key issue from our point of view (domestic E&Ps) is CO₂ legislation and how it will impact demand for natural gas. Clearly, any legislation that deters construction of coal-fired generation is a positive for our natural gas-weighted E&Ps in general. Long reserve life, heavily gas-weighted producers, like Cabot Oil and Gas (COG), with 95% of its production natural gas, should benefit most (as the future value of captured inventory increases) if legislation leads to structurally-higher natural gas prices (through an outward shift in the demand curve). It should also directly benefit E&Ps that have a tertiary oil recovery model, if they receive some form of carbon credits for the CO₂ they inject to increase reserve recovery. In our coverage universe, Denbury Resources (DNR) and Whiting Petroleum (WLL) have significant tertiary operations.
- In summary, given their green reputation, a Democrat in the White House could actually benefit the majority of US independents by increasing demand for natural gas through CO₂ legislation. Conversely, Democratic control could be negative for the large oil-integrated companies and majors that have significant free cash flow, as the subject of a windfall profits tax (or a reduction in certain subsidies that incentivize activities like deepwater oil production) as a way to fund renewables could arise.

Chart 33: Sector average performance relative to the S&P 500 under Republican and Democratic presidents (4 yrs subs performance from Oct 30 of election year, 1984 on)



Source: Merrill Lynch Investment Strategy, Standard & Poors

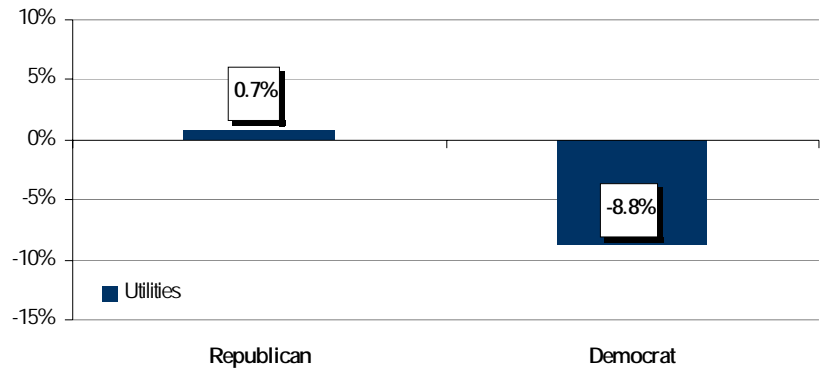
Utilities

- In terms of the dividend tax rate, Republicans might make Bush tax breaks permanent, rather than allowing them to expire in 2010. Presumably, Democrats favor limits or non-extension. This is perceived as a big issue for utilities, although they have not been trading as yield stocks lately. Yield relative on S&P Electrics is pushing back toward more normal levels versus recent historical lows (i.e., high valuations). This is less of an issue for generators/independent power companies that do not pay dividends.
- Clinton and Obama are talking about 80% carbon reductions and talking tough on allocations (i.e., would make the emitters purchase allowances). The general sense is that Democrats would want to do something faster and more draconian, although it appears either side is going to want to push a greener agenda, including acting on carbon. Much of the industry is pushing for something to get passed this year (unlikely to happen, in our view) on the basis that it would be more palatable and less sudden, with more concerns paid to limiting the economic fallout.

This is also the position of Exelon, the largest owner of nuclear generation. On paper, Exelon is the largest obvious beneficiary if you drive up the costs of coal generation overnight. In our view, they realize that too much of a good thing could be a problem politically, perhaps. In terms of beneficiaries, you have the non-regulated nuclear generators (EXC, D, ETR, FPL and CEG). Those more challenged would be the non-regulated coal generators.

- Energy efficiency, renewable energy and the green agenda in general are key issues and more likely to be pushed further under a Democratic administration. However, both sides seem eager to embrace these themes. That said they are very costly. This is positive for wind, solar and other forms of renewable energy. Utilities are also able to make a business out of incentives for efficiency.

Chart 34: Sector average performance relative to the S&P 500 under Republican and Democratic presidents (4 yrs subs performance from Oct 30 of election year, 1984 on)



Source: Merrill Lynch Investment Strategy, Standard & Poors

Dates to remember

April 2008

- April 22 - Pennsylvania primary

May 2008

- May 6 - North Carolina, Indiana primary
- May 13 - West Virginia primary, Nebraska caucus
- May 20 - Oregon, Kentucky primary
- May 23 to May 26 - The 2008 Libertarian National Convention will be held at Adam's Mark Hotel in Denver, Colorado (the same city as the party's first convention in 1972). The party's 2008 presidential candidate will be chosen.
- May 27 - Idaho (R) primary

June 2008

- June 3 - Montana (D), South Dakota, and New Mexico (R) primaries

July 2008

- July 10 to July 13 - The Green Party will hold its 2008 national nominating convention in Chicago, Illinois.

August 2008

- August 25 to August 28 - 2008 Democratic National Convention convenes in Denver, Colorado

September 2008

- September 1 to September 4 - 2008 Republican National Convention convenes in Minneapolis-St. Paul, Minnesota
- September 26 - First Presidential Debate at the University of Mississippi on domestic policy.

October 2008

- Early October - Early voting commences in selected states. Absentee balloting begins.
- October 2 - Vice Presidential Debate at Washington University will be on domestic and foreign policy.
- October 7 - Second Presidential Debate at Belmont University will be in a town meeting format and include any issues raised by members of that audience.
- October 15 - Third Presidential Debate at Hofstra University on foreign policy.
- Late October - Absentee ballot application deadlines.

November 2008

- November 4 - Election Day

December 2008

- December 15 - Electoral College casts official votes for President and Vice-President; each state's electors meet in their respective state capitals

2009

- January 5 - The Vice President counts the electoral votes, formally ending the election process.
- January 20 - The inauguration of the 44th President of the United States and 47th Vice President.

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