Investment Commentary

AUGUST 21, 2006

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Lower oil prices and reports showing that inflation was more subdued than expected in July helped set the stage for an excellent week for both stocks and bonds. The Dow Jones Industrial Average rose 2.7% last week to close at 11,381, the S&P 500® advanced 2.8% to 1,302 and the Nasdaq® Composite climbed 5.2% to 2,163. In the bond market, the yield on the 10-year Treasury fell from 4.97% to 4.83%, its lowest level in four months. (Bond prices, which move in the opposite direction of yields, rose.)

Despite the impressive gains in stocks last week, the bears would point out that some technical factors suggest the market is still experiencing weakness. Volume was relatively low during last week's rally and the advance/decline lines and new high/new low lists have not been strong lately, all of which are typical of a market trying to trace out a bottom rather than one attempting to move significantly higher.

Looking ahead, it appears to us that the economy has not yet weakened sufficiently for all inflation fears to recede, despite last week's good inflation news. However, the housing sector has been showing signs of increased softening and the index of Leading Economic Indicators has been trending downward, which suggests to us that additional economic weakness may be forthcoming. As a result, any lingering inflation concerns should ease before too long, which would be good news for investors. The current fed funds futures curve supports this contention, as there now appears to be only a small chance that the Federal Reserve will elect to raise interest rates again before the end of the year.

Despite our prediction of slowing economic growth, we continue to maintain that the economy is unlikely to enter into a recession. Outside of lower consumer spending levels, the economy remains in relatively decent shape. In particular, the corporate sector remains strong, with companies showing good cash flow levels and generally healthy balance sheets (although we do continue to expect corporate earnings growth to slow). Additionally, we do not expect the economic slowdown to be particularly long-lived, but we would acknowledge that there may be some rough patches over the next few months.

Ultimately, the slowdown in economic growth should ease inflation pressures enough to make it clearer that the Fed will be able to stay on hold for an extended period of time. In fact, within a few months, we believe the debate will shift to a discussion about how much easing the Fed will have to do to help stimulate growth. Assuming we are able to avoid the risk of a hard economic landing, we expect that the investment backdrop will improve and that bond and stock prices will both beat cash over the next 12 months. For equity investors, continued turbulence is likely as the economy slows and earnings expectations decline. Healthy valuation levels should eventually prevail, helping to drive stock prices noticeably higher. However, that is not likely to happen until the talk of Fed easing is more widespread.

On February 15, 2006, BlackRock, Inc. and Merrill Lynch & Co., Inc. entered into an agreement to combine Merrill Lynch Investment Managers and BlackRock to create a new independent company that will be one of the world' s largest asset management firms with over $1 trillion in assets under management (based on combined assets under management as of June 30, 2006). The transaction is expected to be completed around the end of the third quarter of 2006, subject to necessary shareholder and regulatory approvals and other customary closing conditions, with the full integration of both firms' operations shortly thereafter. The new company will operate under the BlackRock name.