

## Global Research Highlights



ML Investment Strategy  
MLPF&S

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**The next issue of Global Research Highlights will be published on 1 June 2007.**

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Refer to important disclosures on page 28 to 31. Analyst Certification on page 27.

## U.S. Strategy

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### For Full Report

[U.S. Strategy Update, 21 May 2007](#)

### Important Notes

See footnotes on page 28 to 31  
See footnote and opinion key on page 30

The market appears to be in a period of transition that favors large caps and growth.

## Large cap growth returns

Our tactical size and style recommendations are now heavily tilted in favor of large caps over small caps and growth over value. In this report, we explain why we think large cap growth is now particularly attractive.

### Four reasons we like large cap growth:

1. Continued slowing of profits growth, and narrowing leadership
2. Quality. SP/Citigroup Growth index has finally reversed its low quality bias from the bubble.
3. Large cap growth performs best when VIX rises.
4. Foreign exposure. Large Cap growth, on average, has nearly one-third more foreign exposure than large cap value.

History suggests that large caps have a tendency to outperform small caps when the market narrows. Over the past six years, when market breadth has been historically broad, small caps have outperformed large caps. As market leadership has narrowed over the past twelve months, the performance between small and large has started to change. For the 12-month period ending April 30th, the S&P 500 has DOUBLED the performance of the Russell 2000.

Investors need to increasingly monitor market breadth because the evidence continues to grow that the profits cycle might continue to slow. Equity markets have historically become increasingly "Darwinistic" when profits cycles decelerate and survival of the fittest determines stock market performance. Not only does this argue in favor of large caps, but it also argues in favor of growth.

Historically, growth indices consisted primarily of high quality, stable earnings growth companies. During the technology bubble this changed and most growth indices consisted of low quality, cyclical growth stocks. When the market peaked in 2000, approximately 50% of the S&P/Citigroup growth index and 58% of the S&P/Citigroup value index were considered high quality. Today the statistics are starkly different: 61% of the S&P/Citigroup growth index is now considered high quality, but only 50% of the S&P/Citigroup value index is considered high quality.

As the market has worked off the excesses of the technology bubble, growth indices have gradually returned to their original state. This most recent update shows that growth has become higher quality and more stable than in the recent past.

## Leadership has narrowed, but remains slightly broader than normal

Leadership is narrowing after six years of record market breadth. It is likely to narrow further if the profits cycle continues to decelerate and volatility increases further.

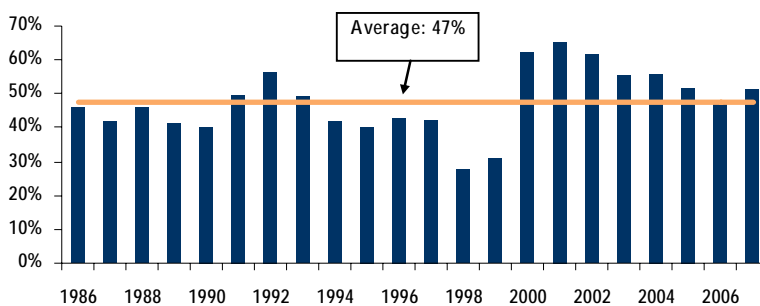
One of the most influential factors in determining the success or failure of an active portfolio manager is the relative breadth of the market. We use the percentage of stocks in the S&P 500 that outperforms the index as our measure of market breadth. For example, if 300 companies in the S&P 500 outperform the index in a given year, then the relative breadth would be 60%. During a normal year, approximately 47% of the stocks in the S&P 500 outperform the index (based on data from 1986 to December 2006).

The chart below shows that leadership during the tech bubble was historically narrow. For example 28% of the stocks in the S&P 500 outperformed the index in 1998.

One law of physics is that every action causes an equal and opposite reaction. Accordingly, the post-bubble period saw the broadest market in the history of our data. Breadth has been notable both in terms of magnitude and duration. Investors have witnessed the longest broad market in the last 20 years.

Following six years of record market breadth, leadership has now begun to narrow. Approximately 48% of the stocks in the S&P 500 outperformed the index in 2006 and roughly 51% are outperforming so far this year. That latter proportion is still slightly above the long-term average. However, if the profits cycle continues to decelerate in 2007, and volatility increases, leadership should narrow further as the year progresses.

Percent of Stocks in S&P 500 That Outperformed the Index (Based on Annual Performance 1986 Thru April 2007)



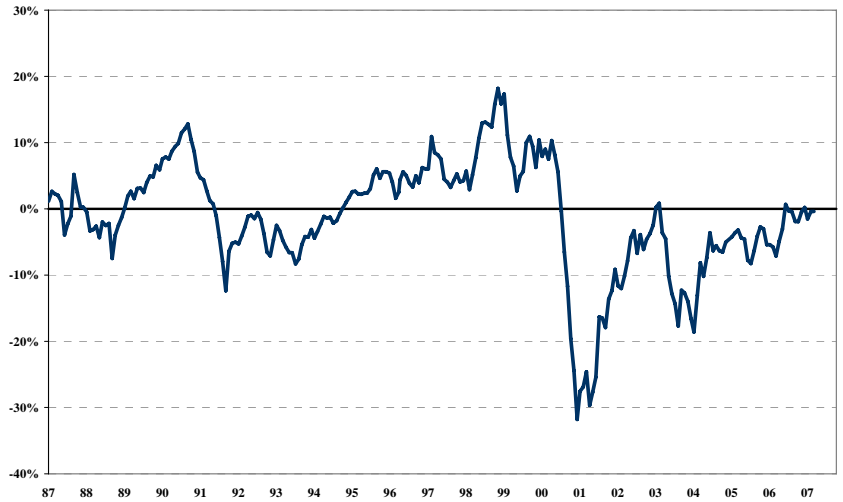
Source: Merrill Lynch Investment Strategy

The cap-weighted S&P 500 tends to do better than the equal-weighted index when the market narrows, and large caps tend to outperform small caps.

As we have pointed out in the past, the capitalization-weighted S&P 500 has a tendency to outperform the equal-weighted S&P 500 when the market narrows. When the market broadens, the opposite is true. Over the past six years, when market breadth has been historically broad, the equal-weighted S&P 500 has outperformed the capitalization-weighted S&P 500.

The following chart depicts the 12-month price performance spread between the S&P 500 and the equal-weighted S&P. Since late-2000, the line has remained predominantly in negative territory as the equal-weighted S&P has outperformed the cap-weighted S&P. However, during the past 12-months, as leadership has narrowed, the two indices have performed in line with one another.

**Rolling Twelve-Month Price Performance Spread Between the S&P 500 and the Equal-Weighted S&P 500**



Source: Merrill Lynch Investment Strategy

Similar to the Cap-weighted S&P 500 and the Equal-weighted S&P 500, large caps have a tendency to outperform small caps when the market narrows. Over the past six years, when market breadth has been historically broad, small caps have outperformed large caps.

As market leadership has narrowed during the past twelve months, the performance between small and large has started to change. In fact, we pointed out earlier this year that of the three S&P size indices, the S&P Small Cap Index had not achieved the best yearly performance since 2004. The S&P Mid Cap Index was the best performer in 2005, and the S&P 500 was the best performer in 2006.

A couple of weeks ago we uncovered a startling performance statistic that supports our contention that a transition from small cap to large cap leadership might be underway. For the 12-month period ending April 30th, the S&P 500 has DOUBLED the performance of the Russell 2000.

**Table 1: Index Returns from 4/30/06 to 4/30/07**

	Price Return	Total Return
S&P 500	13.1%	15.2%
Russell 2000	6.5%	7.9%

Source: Bloomberg, LP

**Investors need to increasingly monitor market breadth because the evidence is growing that the profits cycle might continue to slow. Equity markets have historically become increasingly “Darwinistic” when profits cycles decelerate and survival of the fittest determines stock market performance. Accordingly, we have recommended an overweight in larger capitalization stocks.**

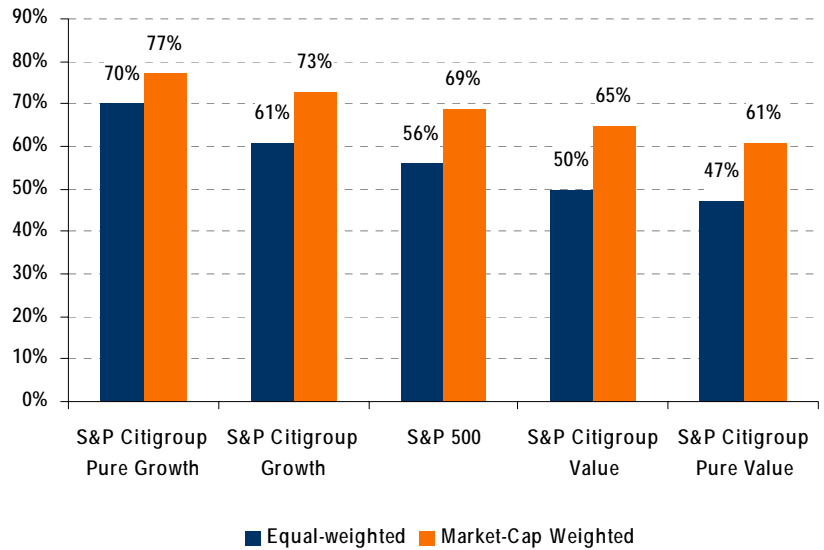
Welcome back: growth indices are returning to their roots.

## Growth & value

We have commented many times in the past that the Technology bubble significantly distorted style investing. Historically, growth indices consisted primarily of high quality, stable earnings growth companies. During the technology bubble this changed and most growth indices consisted of low quality, cyclical growth stocks. Seven years later, it appears as though most growth indices are returning to their roots.

Since the Technology bubble we have been monitoring the quality composition of the S&P/Citigroup growth and value indices. The chart below depicts the quality composition of these indices. Interestingly, the S&P/Citigroup “pure” growth index (those stocks classified as growth only) has the largest concentration of high quality stocks, whereas the S&P/Citigroup “pure” value index (those stocks classified as value only) has the smallest concentration of high quality stocks.

Proportion High Quality (Data as of 4/30/2007)



Source: Merrill Lynch Investment Strategy

Some 70% of the stocks classified as “pure” growth are considered high quality (high quality is defined as those stocks with rankings of B+ or Better using the S&P Common Stock Rankings), 61% of the stocks in the S&P/Citigroup growth index (some stocks in this index are classified as value too) are considered high quality and 56% of the stocks in the S&P 500 are considered high quality.

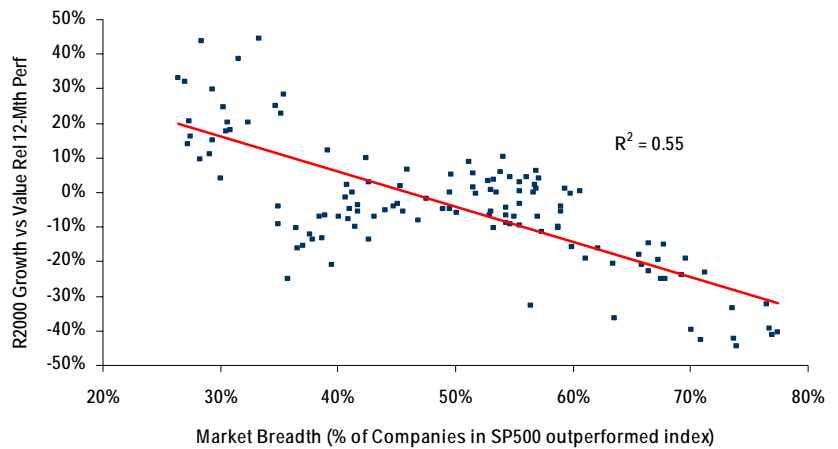
These proportions have changed noticeably in the past seven years. When the market peaked in 2000, approximately 50% of the S&P/Citigroup growth index and 58% of the S&P/Citigroup value index were considered high quality. **As the market has worked off the excesses of the technology bubble, growth indices have gradually returned to their original state. This most recent update shows that growth has become higher quality and more stable than in the recent past. Our preference of quality and stability has led us to recommend an overweight in growth.**

## Small cap growth & value

The chart below from Savita Subramanian, our Senior Quantitative Strategist, depicts the relative performance of the Russell 2000 growth and value indices and S&P 500 market breadth. The chart suggests the outperformance of growth may not be solely a large cap event.

Savita has found that there is a relatively strong correlation between market breadth and the relative performance of small cap growth and value. When market breadth narrows, the Russell 2000 growth index tends to outperform the value index, and when market leadership broadens the opposite is true. **If we are correct and market leadership continues to narrow, regardless of size, investors should overweight growth.**

### Small Caps: Russell 2000 Growth vs. Value & S&P 500 Breadth



Source: Merrill Lynch Quantitative Strategy

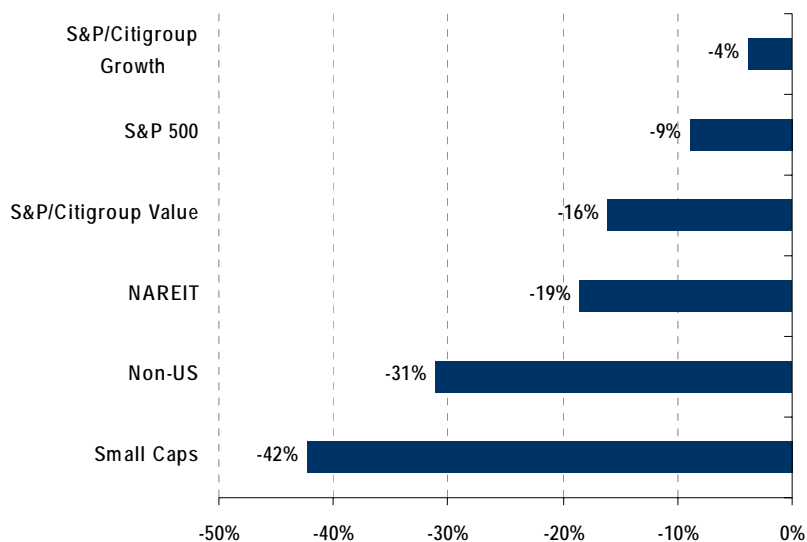
## Size, style & volatility

One of our main themes for 2007 has been that financial market volatility would trend upward during the year. So far, that seems to be happening. The VIX index, a standard measure of equity-market volatility, was 11.6 at the end of 2006. At the end of April, the VIX stood at 14.2, an increase of roughly 22%.

Accordingly, we have been recommending investors position themselves defensively. Our previous research shows that during periods of rising volatility, higher quality stocks tend to outperform lower quality stocks, defensive sectors tend to outperform cyclical ones and T-bills and Treasury Bonds tend to outperform stocks.

The following chart depicts the correlation of 12-month equity returns to the 12-month percent change in the VIX. During periods of rising volatility the S&P/Citigroup growth index and the S&P 500 are the most defensive equities of those selected. The most unattractive equities during periods of rising volatility are non-US and Small Caps, which tend to be lower quality and more cyclical.

**Correlation of 12-Month Total Returns of Select Equities to the 12-Month Percent Change in the VIX (1995-Present)**



Source: Merrill Lynch Investment Strategy

**Given that many of our recommendations have centered around our belief that stock market volatility would increase during 2007, the chart above further reinforces our preference for large over small and growth over value. Small caps and value have clearly been the winners so far this decade. Nonetheless, the evidence continues to mount that the market is in a period of transition in favor of large caps and growth.**

## Is liquidity starting to ebb?

Most investors seem to believe that nothing can alter the current liquidity trends that have been fueling rallies in many asset classes. However, we recently found two examples that suggest the financial markets' liquidity might actually be starting to ebb somewhat.

First, we heard from several knowledgeable sources that financing rates on LBOs were starting to rise. Certainly deals are still getting done, but apparently the cost of those deals is beginning to increase. Second, an article in *The New York Times* pointed out that some equity investors are beginning to demand higher premiums when their companies are taken private ("Just Saying No to Lowball Buyout Offers," 20 May 2007). The article makes it clear that at least some mutual fund companies are beginning to fight for their shareholders. If that becomes a trend, it would likely deter some marginal takeouts.

Those examples build on the first sign of the ebb in liquidity, which was coordinated tightening by central banks. We do not expect global liquidity to dry up quickly. Nonetheless, investors should keep a watchful eye on what's happening on the liquidity front.

## Housing data give the Fed food for thought

Is the Fed funds rate high enough at 5.25%?

Recent housing data may be an aberration to some extent, but they must be getting a lot of attention from central bankers. Economists expected April new home sales to increase by 0.2%; instead, they rose by a whopping 16.2%. Admittedly, the jump could be a fluke, but it is nonetheless hard to read the number as anything but a strong one. In fact, recent data in total (jobless claims, durable goods, housing) seem to point to an economy that is responding positively to the immense credit creation that has been the hallmark of this cycle.

We have previously suggested that the Fed might have continued to raise interest rates if housing had not seriously slumped. In that vein, if the stock market is something of a forecasting mechanism, the recent performance of the S&P 500 Homebuilders index seems to be more and more inconsistent with the notion that the Fed will remain on hold.

North American economist Dave Rosenberg has called for the Fed to ease during the second half of the year. Dave's economic forecast, however, is below the current consensus. If Dave's forecast is in the right ballpark, the Fed will of course be easing.

We continue to expect financial market volatility to increase as the markets begin to sense that the Fed may not ease anytime soon, and might even tighten. Even if April's housing figure is twice what it should be, it is still another data point that suggests a 5.25% Fed funds rate might not be high enough.

## European Strategy

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### For Full Report

[European Strategy Weekly, 21 May 2007](#)

### Important Notes

See footnotes on page 28 to 31  
See footnote and opinion key on page 30

### European sector recommendations

Overweight	Neutral	Underweight
Oil & Gas	Chemicals	Basic resources
Healthcare	Construction	Automobiles
Personal & hhold	Industrial goods	Media
Retail	Food & beverage	Travel & Leisure
Insurance	Telecoms	Utilities
IT hardware	Banks	Financial services
	Software	

Source: Merrill Lynch

## Oil & gas the cheapest defensive?

### Three reasons why we remain overweight oil & gas

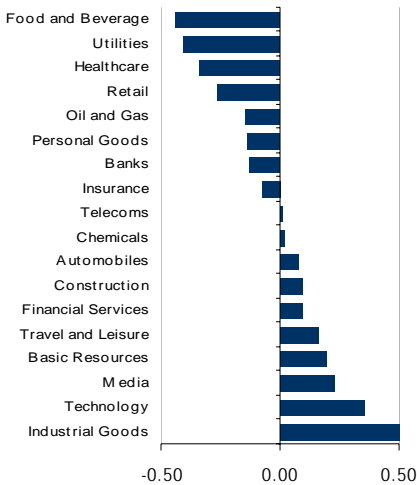
**The oil sector is cheap.** The chart below looks at the valuation of oil versus other sectors in Europe. Our ranking includes P/Es versus 16 year history, dividend and free cash flow yields, and long-term implied growth rates. **Oil is the second-cheapest sector in Europe** on this combined measure.

**The oil sector is defensive.** We look for cheap defensives, which are getting harder to find. The chart at the lower left measures the correlation between risk appetite and sector performance over the past 20 years. If history is any guide, the oil sector is negatively correlated to risk appetite and does well when investors get nervous. In each leg of this ongoing cycle the ability to maintain such robust profits growth is put to the test. As profit growth starts to slow, volatility usually goes up. Oil appears to be a safe place to hide during pockets of volatility.

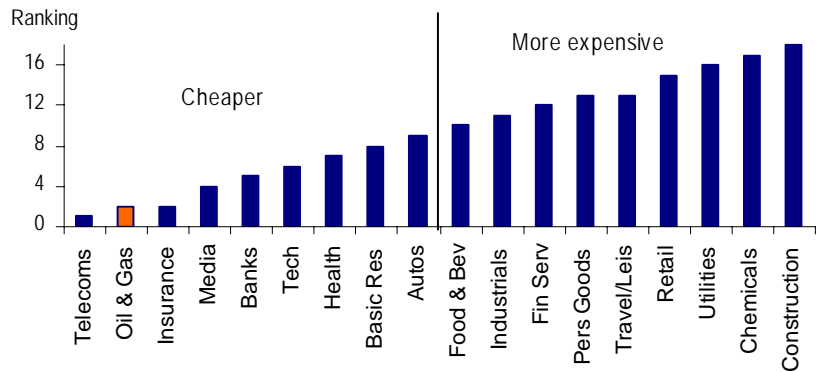
**The price of oil is rising.** Indeed, it is rising above analysts' consensus 2007 estimates (US\$60) on supply concerns and healthy demand. Our commodity team have increased their Brent oil price assumptions for 2007 and 2008 to US\$65 and US\$66 respectively. And, our oil sector team have increased EPS estimates by 6% (2007), 4% (2008) and 25% (2009). The oil sector is one of those odd sectors that can do well if global growth remains strong or offer protection if things take a turn for the worse.

### Oil is one of the cheapest sectors, and it has defensive qualities

### Correlation to risk appetite: oil & gas is negatively correlated to risk appetite



Source: Merrill Lynch estimates



Source: Datastream, IQ & Merrill Lynch calculations

## Spain: all geared up and nowhere to go?

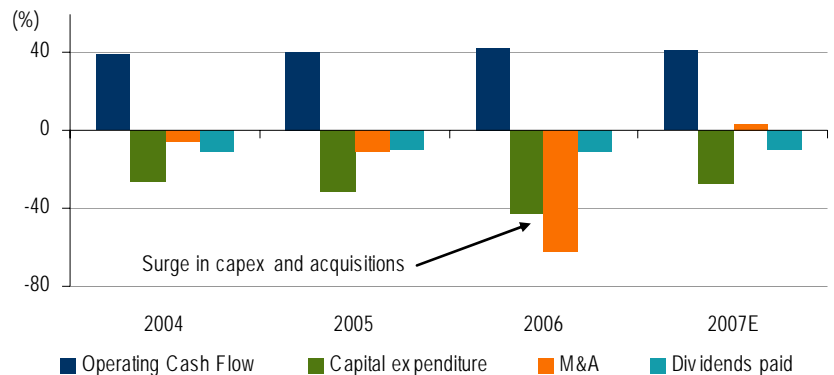
We have recently received a number of questions about the financial position of Spanish companies. When you take a look at these companies on a bottom-up basis, it is obvious why. **Net gearing over equity for Spanish companies (IBEX 35) sits at 200%.**

Having been through an economic, a construction and property boom, not to mention a back drop of negative real interest rates, Spanish companies have entered into a buying binge with both capex (including bolt-on deals) and acquisitions surging, as shown below. That at the same time that interest costs have gone up (not down) and the construction sector has collapsed to growth rates that are below even those for Germany.

Whether they felt the need to re-invent themselves by diversifying into different industries or regions, **we think the level of gearing is worrisome.** In our [European Strategy Weekly for 23 May 2007](#) we provide a list of Spanish companies covered by ML and flag those with the highest gearing levels and lowest interest cover. However, we do not pass judgment and leave that to the bottom up analysts.

Given that Spain has outperformed Europe by 30% since May 2002 and appears to be more expensive than Europe, we suggest there are better opportunities elsewhere.

### Aggregate cash flow statement expressed in terms of shareholders equity



Source: ML IQ database, Merrill Lynch Calculations

## Sector Strategy

Brian G. Belski  
US Sector Strategist  
MLPF&S

### For Full Report

[Sector Strategy Update, 24 May 2007](#)

### Important Notes

See footnotes on page 28 to 31  
See footnote and opinion key on page 30

### US Sector Research Weightings

#### **Overweight**

Consumer Staples, Health Care, Industrials, Telecom Services

#### **Market Weight**

Consumer Discretionary, Financials, Information Technology

#### **Underweight**

Energy, Materials, Utilities

Source: Merrill Lynch Sector Strategy

# From subtle to obvious; leadership is changing

## Sector leadership is changing

We believe changes in sector leadership are underway, ones that favor our preference for traditional growth investing strategies. In our view, the changes are related to increases in market volatility and the market's process of discounting a slower US economy and lower corporate earnings. Those trends ought to assign a "premium" to growth.

## Some changes are subtle

Areas such as Materials and Utilities have been doing better than the market so far this year, but their performances have slowed recently, especially since the sharp broader market pullback and subsequent recovery in February/March.

## Some changes are not so subtle

Technology and Health Care have risen to the top of the leader board after languishing for several months, while Energy continues to gain momentum despite less-than-stellar earnings.

## What's wrong with Consumer Discretionary?

Traditionally, Consumer Discretionary stocks at least perform in-line with the market when the major indices are hitting news highs. However, that's not the case for the sector this time around.

## Playing the rotation; not just market cap

Common sense would argue that a rotation to large-cap and growth strategies clearly favors Consumer Staples, Financials, Health Care, Technology, Industrials, and Telecom Services – sectors that account for majority of the market's capitalization. However, the sectors we currently favor combine positive market-cap characteristics (e.g., large-cap) and attractive fundamental attributes. That said, we continue to be constructive toward Technology. Meanwhile, the Financial sector's fundamental volatility has not likely run its course.

## Sector leadership is changing

We have written recently about the rotation we see in the market away from the “old” leadership that was more value-driven and focused on dividend yield, toward new sector leadership that represents more traditional growth-oriented components. If we carve up year-to-date performance into two segments—one that looks at just Q1, and the second that examines Q2 so far—we see a marked difference in market character.

Granted, Q1 performance all around was not very spectacular, with the S&P 500 posting only a 0.18% return. However, some areas of the market did quite well even in this environment. Utilities, Materials and Telecom Services were each up more than 6% in the quarter. Since the end of March, though, the picture looks completely different. The best performing sectors lately have been Energy, Information Technology, Health Care and Industrials. This may be the start of the rotation we have been looking for (we have been recommending a return to growth investing for 2007).

When we dissect Q1 earnings, we find a similar pattern. Earnings for the market look to be up around 8.6% year-year, with the greatest contribution to earnings growth coming from Financials. As the largest market sector by far, it is no surprise that Financials contributes the most to quarterly earnings growth. However, next in line we find Health Care, Information Technology and Industrials—clearly growth-oriented sectors—with Utilities, Materials and Energy near the bottom. Even though the latter three are small sectors in relative size, these areas have contributed more to earnings than their size would dictate over the past couple of years, as they have also been principal drivers of performance. We believe that tide is changing.

### Why is the market focusing on growth now?

We believe that the market is beginning to discount a real economic slowdown in the US, one in which the consumer will need to re-trench and repair household balance sheets. As the forward earnings numbers indicate, it will likely become increasingly difficult for companies to post double digit earnings expansion, with growth prospects likely to be scarce. In this environment, growth stocks should command a premium multiple. Further, chief investment strategist Rich Bernstein has written about the higher quality component of current growth indices, and mentions that large cap growth stocks tend to outperform when volatility rises. (Please see Rich’s note [“Large Cap Growth Returns”](#) for more details.)

### Growth investing duration - here to stay

Our primary investment theme for 2007 was and remains a return to growth investing. With former commodity-sensitive sector leadership (Energy, Materials) and Utilities showing signs of fundamental deceleration, we believe traditional growth areas will benefit due to a renewed emphasis on stable/improving earnings growth and multiple expansion – trends that typically define growth investing. As a result, we believe a broader shift to growth investing is just beginning to take shape, one that will likely proceed for the next several months and well into 2008. Therefore, we continue to favor Health Care, Industrials, Telecom and even more defensive areas like Consumer Staples (which is displaying strong revenue growth and recovering earnings). In addition, with Technology valuations hovering below long-term averages and earnings growth projections providing an increased leadership contribution to overall market growth, we believe the sector’s recovery is well underway – but would prefer to become more aggressive upon periods of broader market price weakness.

#### Sector Performance

Sector	H2 2006	Q1 2007	Q2 To-date
Consumer Discretionary	15.00%	-0.99%	4.61%
Consumer Staples	8.18%	1.59%	4.00%
Energy	8.37%	1.72%	11.97%
Financials	14.09%	-3.44%	6.11%
Health Care	10.85%	0.62%	8.45%
Industrials	4.72%	0.58%	7.31%
Information Technology	14.78%	-1.10%	8.46%
Materials	9.49%	8.38%	6.09%
Telecom Services	18.21%	6.38%	7.12%
Utilities	13.92%	8.43%	6.99%
<b>S&amp;P 500</b>	<b>11.66%</b>	<b>0.18%</b>	<b>7.17%</b>

Source: Datastream

Our primary theme: a return to growth investing.

## Sector relevance - historical and current contexts

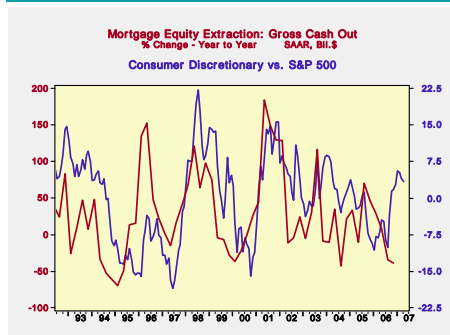
The table below provides both an historical and current context to the traditional fundamental growth attributes from our perspective for each of the ten primary sectors of the market.

### Sector Relevance to the growth investing theme - historical and current contexts

Sector	Historical	Current	Comment
Consumer Discretionary	YES	NO	Bifurcation proceeds - the have and have not stock fundamentals are a microcosm of the US economy Not being rewarded for current growth prospects and large-cap bias within sector
Consumer Staples	YES	YES	Price momentum intact despite deteriorating earnings and margins - are analysts and companies being too conservative?
Energy	NO	YES	Earnings in totality continue to pace contribution of market growth, but could really surge if Fed provides clarity
Financials	YES	NO	Earnings are rebounding and valuations remain near multi-year lows - multiple expansion theme works here
Health Care	YES	YES	Exporter theme is helping drive fundamental momentum; only sector expected to display sequential earnings growth in 2Q07
Industrials	YES	YES	Akin to Health Care, but lacks defensive attributes; valuations are at/near historic lows - multiple expansion works longer-term
Information Technology	YES	YES	Momentum beginning to wane as earnings and margins roll over; still cyclical after all
Materials	NO	NO	Earnings and dividend growth are helping support long-term
Telecommunication Services	YES	YES	tough valuations; infrastructure theme is still early.
Utilities	NO	NO	Valuations are at all time highs and earnings are being overly discounted in some cases - very speculative

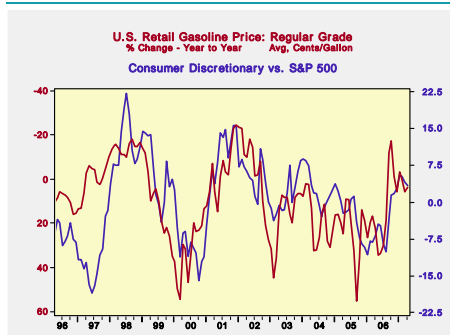
Source: Merrill Lynch Sector Strategy

### Mortgage Equity Withdrawals and Consumer Discretionary Performance



Source: Federal Reserve Board, Standard and Poor's.

### Retail Gas Prices and Consumer Discretionary Performance



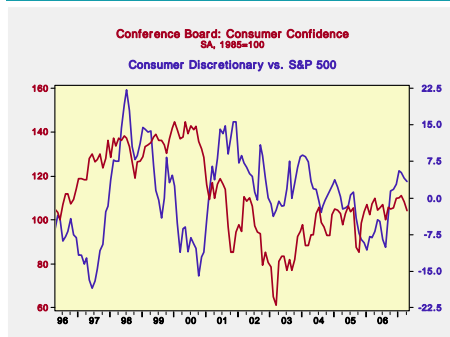
Source: Department of Energy, Standard and Poor's.

## Why is Consumer Discretionary *not* working?

Although we have seen some improvement in fundamentals and the macro environment recently, Consumer Discretionary has continued its slump. In fact, Discretionary stocks have been one of the worst performers for all of 2007. What is preventing this sector from participating in a return-to-growth theme? We think that three factors are the main culprits: a slumping housing market, soaring gas prices, and struggling retail sales.

- Housing** – After several years of torrid growth, the housing market has finally showed signs of vulnerability. Not surprisingly, home prices have declined to their lowest levels in almost three years. Declining home prices have led to a reduction in home equity and most likely a decrease in disposable income as fewer consumers are able to withdraw equity from their homes. In fact, we found a pretty strong relationship between relative Consumer Discretionary performance and mortgage-equity-withdrawals. As the top chart (left) shows, Discretionary stocks tend to underperform in periods where mortgage-equity-withdrawals decline, (as currently is the case), and outperform when the opposite is true. Although we do not anticipate a severe downturn in the housing market longer-term, volatility is likely to persist in coming months.
- Gas prices** – The price of oil continues to make headlines. True, oil prices are lower now than they were a year ago. However, retail gasoline prices have increased by more than 40% during that time. That increase has been acting as a tax on consumers and helps to explain a slowdown in consumer spending and a decline in consumer confidence. With the summer driving months approaching, retail gas prices are likely to remain elevated and continue to weigh on Discretionary stocks (bottom chart, left).

**Consumer Confidence and Consumer Discretionary Performance**

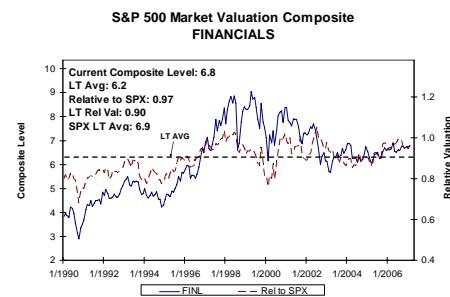


Source: Conference Board, Standard and Poor's.

- **Retail sales** – Retail sales have slid to their lowest level since the beginning of 2006 on a year-over-year basis. Although they remain above their October 2002 low, retail sales are likely to continue to face pressure in the months ahead, especially as disposable income likely erodes in light of the housing and oil situation. We think that until consumers can start to feel more confident about their personal finances, retail sales should continue to struggle. As the top chart (left) suggests, the recent drop in consumer confidence would suggest otherwise.

Although we do not anticipate any reason to hit the panic button, pressure from these three factors on Discretionary stocks are likely to persist in the near-term. This, along with the sector's seasonal performance (Consumer Discretionary typically underperforms in summer and fall), is reason enough for us to become increasingly cautious on the sector.

**Financial Sector Valuation Model**



Source: Merrill Lynch Sector Strategy

Our models continue to indicate that Financial sector valuation is neither cheap, nor expensive. However, investors should be aware that valuation is now well above historical averages.

**Move to growth does not include Financials - for now**

Financials is another sector that traditionally outperforms when the market returns to a growth investing mode, let alone when broader indices are hitting new price highs. However, the sector continues to lag the market year-to-date. As we have been saying for several months, we believe Financials remain a classic neutral in terms of our sector and portfolio weightings. While we continue to overweight the capital markets (growth), trust banks (growth at a reasonable price), and insurance (value) components of the sector, banks (the largest group in terms of market capitalization) will likely endure continued fundamental volatility thanks to the sub prime over hang, deteriorating credit quality and an indecisive Fed policy. It is precisely that Fed clarity that we believe will likely help normalize the yield curve and provide increased stability for banks and financials in general. As a result, we believe it is too early to overweight Financials at current levels, and instead, are playing the waiting game – just like everyone else. Furthermore, the temptation to be early on banks is more than compensated by the more clearly discernible fundamental outlooks in other traditional growth sectors – especially Health Care.

**Not just growth; large-cap is playing, too**

The table below lists stock performance during several different time periods of within the S&P 500 Index, ranked by market cap and separated by quintile. Performance is then listed by quintile. While the S&P 500 Index is primarily a large-cap index, it too is displaying discernible performance shifts within capitalization ranges. Namely, the smallest 100 stocks within the index (ranked by market capitalization) clearly outperformed in 2006, Q107 and year to-date. However, a decided upward bias in capitalization is taking place so far in Q207 – a move which has coincided with traditional growth sector out performance.

**S&P 500 Average Performance within Market Cap Quintile**

	Performance				% Mkt Cap 12/31/06
	Q1	Q2	YTD	2006	
Quintile 1	0.9%	8.1%	8.9%	12.6%	65%
Quintile 2	2.2%	6.1%	8.6%	12.4%	16%
Quintile 3	2.2%	7.1%	9.7%	12.3%	10%
Quintile 4	3.1%	7.0%	10.6%	13.5%	6%
Quintile 5	4.7%	6.0%	10.9%	17.1%	3%

Source: Merrill Lynch Sector Strategy

Note: Market capitalizations are free-float adjusted as of 5/21/07

## GEM Strategy

Michael Hartnett  
Global EM Equity Strategist  
MLPF&S

### For Full Report

[GEM in Pictures, 24 May 2007](#)

### Important Notes

See footnotes on page 28 to 31  
See footnote and opinion key on page 30

### Country & regions price return (%)

	MTD	YTD
Peru	8.0	52.7
Malaysia	4.6	30.9
Turkey	5.5	26.5
Philippines	11.8	24.6
Brazil	10.9	23.6
Israel	4.7	22.6
LatAm	9.0	20.8
Mexico	9.6	18.0
Czech Rep	1.8	17.2
South Africa	1.2	15.7
Chile	-2.6	15.5
Indonesia	8.1	14.6
India	5.8	14.2
South Korea	6.1	13.8
Poland	-1.7	13.8
Thailand	5.3	12.8
MSCI EM	4.7	11.3
Asia	6.1	10.7
China	7.9	9.1
Hungary	0.1	7.6
EMEA	-0.8	5.9
Argentina	3.6	4.0
Colombia	6.0	3.6
Taiwan	4.6	1.0
Russia	-6.0	-10.4

Data as of 23 May 2007. Source: Merrill Lynch GEM Equity Strategy

Short-term, we remain directionally positive on markets. We expect summer gains and look for an autumn sell-off. We remain happy with our existing country recommendations. The best looking trades to us are:

Macro: Korea, Brazil, Indonesia, Malaysia, Poland

Contrarian: Russian energy, India tech

Liquidity: Chinese H-shares

## The second half of the bull

### Second half of bull market well under way...

...led by Asia, growth stocks, mid- and small-cap and consumer/infrastructure sectors within the global emerging markets. This is the new core leadership within EM. Robust EM economic growth and liquidity and the bear market in the US dollar argue that the secular trend remains up.

### The second half of the EM bull market

Second Half (June 2006 to ...)	First Half (Oct 2002 to May 2006)
Micro	Macro
Earnings	Liquidity
Growth	Value
Mid- & small-cap	Mega-cap
Domestic demand stocks	Global cyclical stocks
EM consumers	EM producers
Spending	Savings
Financial leverage	Financial de-leveraging
FX differentiation	FX appreciation
FX volatility	Spread volatility
Domestic investor buying	Foreign investor buying

Source: Merrill Lynch GEM Equity Strategy

### A bubble before a bear market

EM equities are up by 10% so far this year. We expect that 2007 returns will pale in comparison with those of recent years and that another bout of volatility will occur before the year is finished. But a bull market it remains, and a bubble in 2007-08 is more likely than a bear market, in our opinion.

### Bond markets end bull markets

This EM equity bull market began at a time of deflation and is likely to end at a time of inflation. Higher inflation and yields are necessary to curb global growth, liquidity and risk appetite, and this is a normal late-decade phenomenon. Productivity gains in EM argue that this moment may be many moons away, but we are nonetheless vigilant to anything that might violate the steady state of the US Treasury market. Anything that causes 10-year Treasury yields to break out of their low and stable 4-to-5% trading yield (effectively in place for almost four years now) would be problematic for emerging market equities.

### The US and China remain the key trip wires for future global inflation

The US has been a very positive force for EM in recent years. In particular, the orderly depreciation of the dollar, which Merrill Lynch forecasts to continue, has been bullish for EM FX rates, bonds and equities. Should the dollar's decline at some point in the future turn disorderly, this could raise US inflation expectations and bond yields and in turn hurt EM over the medium-term. Alternatively, a strong contrarian rally in the US dollar could potentially raise FX volatility and inflation risks across EM. Rising risk aversion would damage high yielding currencies such as the South African rand and the Turkish lira. (This is probably the most obvious risk for EM in the next two quarters given global investors' underweight position across US assets. If it were to occur, expect a counter-rally in the mega-cap global cyclical stocks in EM.)

## Recommendations

**Table 2: Country Recommendations**

Country	MSCI Weight	Stance	Rationale	What would change our view?
Korea	15.6	Overweight	Cheap, investors UW, domestic demand to recover	US recession; politics
Brazil	11.6	Overweight	Cheap, rate cuts, growth recovery. Buy the banks	A slump in Chinese growth
Russia	9.3	Overweight	Russian energy arguably the most contrarian trade in GEM	Oil prices collapse
Malaysia	3.0	Overweight	Domestic demand expansion, FX appreciation	Restructuring gains disappoint
Poland	1.8	Overweight	Domestic demand strong; earnings expectations too modest	Sharp rise in inflation
Indonesia	1.6	Overweight	Consumer expansion, cheap, lower rates	Risk aversion increases sharply
China	11.7	Neutral	Still looks overbought, policy is being tightened	Big policy easing
Taiwan	11.5	Neutral	Investors pessimistic, high dividend yields, but tech cycle dull	NASDAQ slumps
South Africa	8.3	Neutral	Strong infrastructure/consumer secular themes, cheap, but large FX vulnerability	Rand strength
Mexico	6.3	Neutral	Not cheap but fine domestic demand story	U.S. equity outperformance
Rest of MSCI**	4.7	Neutral	Overweight: Pakistan, Vietnam, Morocco	Global risk aversion returns
Israel	2.5	Neutral	Good momentum, clients underweight but not cheap	Politics
Turkey	1.6	Neutral	Investors still overweight, but market is cheap and rate cuts would make it a buy	Sharply lower domestic rates
India	6.6	Underweight	Expensive GEM market, inflation, CB tightening	Cheaper market
Chile	1.5	Underweight	Expensive, vulnerable to copper price decline	Cheaper market
Thailand	1.4	Underweight	Investors overweight, shame as its cheap, capital control uncertainties	Falling oil prices bullish
Hungary	1.0	Underweight	Cheap market but FX vulnerability/poor EPS momentum	M&A activity boosts region
<b>Total EM</b>	<b>100.0</b>	<b>Overweight</b>		

Data as of 22 May 2007. \*\*Includes: Argentina, Colombia, Egypt, Jordan, Morocco, Pakistan, Peru and Philippines. Source: Merrill Lynch, Factset, MSCI

### Emerging market investors are differentiating the story

The most popular emerging equity markets are presently in countries with strong domestic demand credit cycles such as Russia, China, Malaysia, Mexico, Poland. These markets are selling at a forward price/earnings ratio of more than 18. These are market that investors want to *own*, and over time they are likely to get more expensive so long as credit cycles are not short-circuited by rising inflation and rising yields. Meanwhile, low-growth, more mature market such as Korea and Taiwan or those with macroeconomic problems such as current account deficits in Turkey and South Africa are selling at 14 times forward earnings or less. These are markets investors only *rent*. Tactically our preference is for Brazil and Korea, markets where we believe investors are underestimating domestic demand, but the secular story in EM remains one of ownership of emerging markets with strong domestic credit stories.

## Quantitative Strategy

Savita Subramanian  
 Quantitative Strategist  
 MLPF&S

Kevin Lui  
 Quantitative Strategist  
 MLPF&S

### For Full Report

[US Quantitative Strategy Update, 23 May 2007](#)

### Important Notes

See footnotes on page 28 to 31  
 See footnote and opinion key on page 30

## US stocks for global growth

### Quant work confirms that stocks with foreign exposure could benefit from global/US decoupling

Our work has found that the relative performance of US stocks with the highest percentage of foreign to total sales has had a positive relationship to Global Ex-US GDP growth, and no relationship to domestic GDP growth (for further details, please see our full report). **If global growth remains strong and domestic growth slows, history suggests that a strategy of stocks with the highest foreign exposure should outperform the S&P 500.**

### Unlike many other markets, global growth does not appear to be discounted

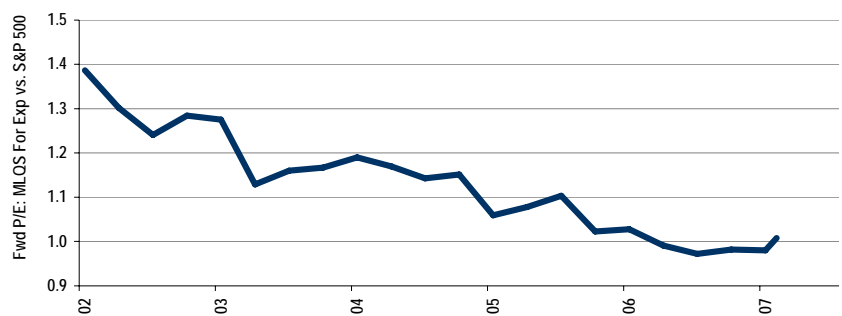
The relative P/E of the Foreign Exposure strategy has trended down during the past five years and appears to be bottoming, but it is almost 30% lower than it was in Q1 2002. In stark contrast, MSCI Emerging Markets has enjoyed consistent multiple expansion relative to the US during the same period, and is now 55% higher.

### 22 stocks passed “global decoupling” screen

We screened our latest foreign exposure list for stocks with buy ratings from ML Equity Research (see table on next page). These stocks could benefit from global decoupling, and have attractive fundamentals according to ML research. The resulting screen has on average 72% exposure to foreign sales (70% sales-weighted) and is most overweight in Technology, Energy, and Staples stocks.

### US stocks with foreign exposure have hardly participated in global growth expectations -- multiples have *contracted*, not expanded.

Relative Fwd P/E of ML USQS Foreign Exposure strategy vs. S&P 500 (Q1 2002 to April 2007)



Source: ML US Quantitative Strategy

## “Global decoupling” stock screen

The screen is overweight Staples, Energy and Technology, is equal weight Health Care, and is underweight Industrials, Discretionary and Financials. No constituents from Materials, Telecom Services or Utilities passed the screen.

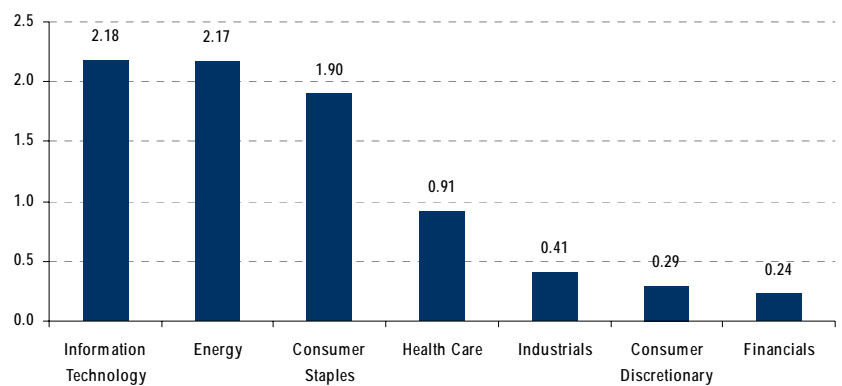
### Screen for Global Decoupling

(ML Buy-rated companies in the top decile of S&P 500 by % Foreign to Total Sales)

Name	Ticker	% of Foreign to Total Sales	Price as of 5/22/07	ML Invest Opinion
NVIDIA CORP	NVDA	89%	35.32	C-1-9
QUALCOMM INC	QCOM	87%	46.38	C-1-7
TEXAS INSTRUMENTS INC	TXN	87%	35.49	B-1-7
INTEL CORP	INTC	83%	22.99	C-1-7
NATIONAL SEMICONDUCTOR	NSM	80%	26.53	C-1-7
KLA-TENCOR CORP	KLAC	80%	54.05	C-1-7
TRANSOCEAN INC	RIG	79%	95.31	B-1-9
COLGATE-PALMOLIVE CO	CL	79%	66.95	A-1-7
NOBLE CORP	NE	73%	89.86	B-1-7
AFLAC INC	AFL	72%	52.16	B-1-7
COCA-COLA CO	KO	71%	51.48	A-1-7
AVON PRODUCTS	AVP	71%	37.62	B-1-7
EXXON MOBIL CORP	XOM	69%	82.77	A-1-7
WATERS CORP	WAT	68%	60.70	B-1-9
AUTODESK INC	ADSK	66%	45.53	C-1-7
MCDONALD'S CORP	MCD	65%	52.50	A-1-7
HEWLETT-PACKARD CO	HPQ	65%	45.58	B-1-7
APACHE CORP	APA	63%	78.40	B-1-7
BAKER HUGHES INC	BHI	62%	82.21	B-1-7
3M CO	MMM	61%	87.78	A-1-7
MILLIPORE CORP	MIL	61%	75.54	B-1-9
XILINX INC	XLNX	61%	29.24	C-1-7

Source: Merrill Lynch Quantitative Strategy

### Sector Weighted: Global Decoupling Screen vs. S&P 500 stocks with Buy-ratings



Merrill Lynch Quantitative Strategy

## A look at REITs

**Mary Ann Bartels**

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### For Full Report

[Weekly Stock Charts, 23 May 2007](#)

### Important Notes

See footnotes on page 28 to 31  
See footnote and opinion key on page 30

We remain comfortable with our longer term targets, but believe there are some short-term risks. We welcome a short-term term correction that will most likely launch the market into a summer rally to new highs.

### Support Levels

	1st support (3%)	2nd support (5%)
S&P 500	1465-1475	1420-1440
DJIA	13000-13100	12600-12800
NASDAQ Comp	2490-2510	2425-2455

Source: Merrill Lynch Market Analysis

### 10-12 Month Targets

	10-12 month Targets
S&P 500	1670-1700
DJIA	14500-14800
NASDAQ Comp	2800-3000
S&P 500 2-3 yr target	2000-2100

Source: Merrill Lynch Market Analysis

## REITs correcting short-term, but uptrends mostly intact

### REITs correcting short-term, but multi-year uptrends intact

The predominant pattern for REITs is that short-term trends are weakening, but that is happening within intermediate-term uptrends that extend back to at least 2004.

In our [Weekly Stock Charts, 12 April 2007](#), we discussed REITs and noted that Regional Mall and Hotel REITs appeared more attractive in relation to Apartment and Residential REITs. Many REITs, regardless of sub-group, have completed (or are near completing) short-term top patterns, but as long as multi-year uptrend lines hold, short-term weakness should be viewed as corrective. However, we note that some of those top patterns have objectives below major uptrend lines.

Our overbought/oversold model ranks REITs as the most oversold industry group in the S&P 500. Should an OB/OS upgrade occur while REITs are above intermediate-term uptrend lines, it would likely confirm short-term weakness as corrective. For a detailed look at the REIT group, please see our full report.

## The stock market as a whole: short term pullback to set the stage for a summer rally

Since the first week in May, there have been signs that the stock market is entering a consolidation/corrective phase. We view this as a healthy and normal short-term pattern, which should be the prelude to a summer rally. The Dow Transportation Index, which has led this market since November 2004, has not exceeded the highs of April 25, 2007. In addition, lately we have had days where the Dow Industrials has closed up, while other major indexes closed down. Moreover, last week's NYSE advance/decline line was positive, but the NASDAQ A/D was negative.

S&P 500 Index (SPX) – 3-year daily price chart



Source: Merrill Lynch Market Analysis, Bloomberg

## Munis & Derivatives Commentary

Philip J. Fischer  
 Municipal Strategist  
 MLPF&S

### For Full Report

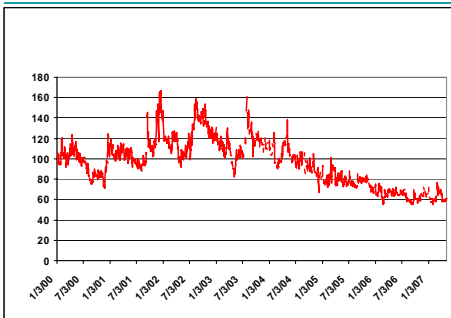
[Munis & Derivatives Commentary, 21 May 2007](#)

### Important Notes

See footnotes on page 28 to 31

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### MOVE Index



Source: ML

# Steamrolling into rollover season

## Steamrolling into rollover season

The propensity for state and local governments to have June fiscal year ends works its way into the structure of the Muni bond market. A disproportionately large amount of bonds mature or have coupon payments during the May/June period. That cash flow is primarily responsible for the improved technical picture for municipals.

## Munis outperform treasuries

For the month to date, the Muni master index has outperformed the Treasury master index by about 29 basis points in total rate of return, without adjusting for taxes. Performance has been mixed along the curve, but the BBB sector continues to outperform other rating groups. This is largely due to the outperformance of tobacco. In the money market sector, ratios of tax-exempt notes to one-month LIBOR have fallen to about 71% and we would expect them to trend down to the middle 60% range over the course of the next couple of weeks as tax-exempt money market fund flows turn strongly positive.

## Issuance returned to trend

Total issuance this month is on track to be in the mid-30 billion-dollar range, which is in line with prior years. Demand from all sectors remains robust including international.

## Volatility collapses

The chart at the left shows the MOVE Index, which is currently near an all-time low. This is a forward-looking index in that it is an average of the implied (future) volatilities of one-month treasury options from two to 30 years. The index surged to 76.7% in March as problems in subprime mortgage lending swept the market. It has subsequently worked its way down to its current level of 52.7%.

## Cash Muni market follows MOVE down

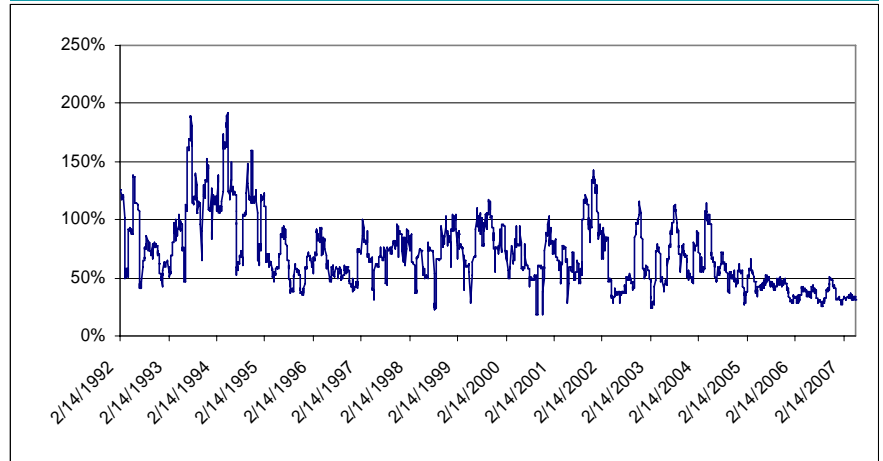
The rolling 30 day volatility of the Muni market has trended down with the MOVE Index. The first chart on the next page shows this behavior for the 10 year AAA yield; the second presents the rolling 30 day standard deviation for the 10 year Muni Treasury ratio. As we can see, inter market volatility as well as Muni volatility has fallen.

## Has risk gone away?

Periods of low volatility in interest rates are not a signal for investors to forget about risk. Even in fairly priced markets, volatility is typically not exactly random. With financial instruments we often find that large changes in price tend to be followed by large changes, and small ones by small ones. In fact this behavior is so ubiquitous in finance that it has a name -- volatility clustering. As a result, low

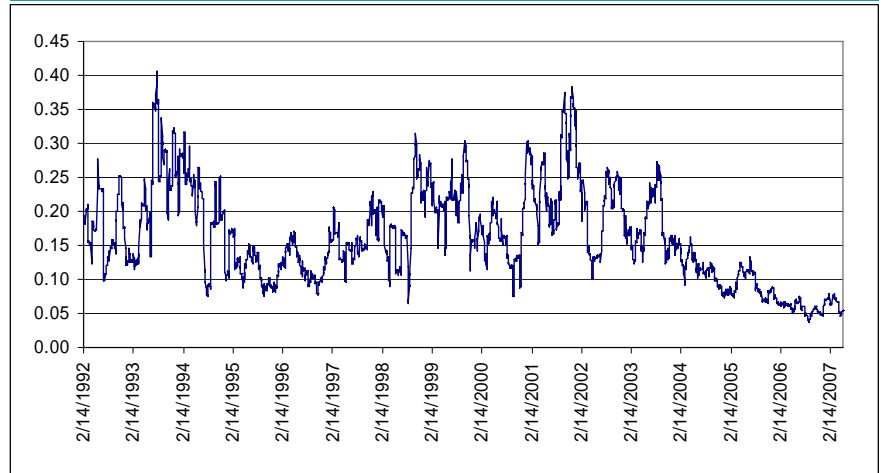
volatility doesn't ensure that periods of high volatility won't unpredictably and suddenly emerge. Low volatility doesn't mean that risk has gone away. (See [Explaining Municipal Bond Volatility: Implications for Practice](#) [Municipal Finance Journal](#), Lakshmiarahan, S.; Stock, Duane R. April 2006 for an explanation of GARCH modeling.)

**Muni 10 Yr Vol**



Source: ML

**Annualized Ratio Volatility**



Source: ML

**Reasons for clustering**

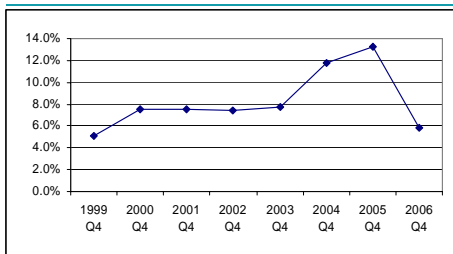
The academic literature provides a host of reasons why volatility tends to cluster at high or low levels. At the top of the list is the idea that information arrives in clusters. But there are other reasons as well, including both herding by investors and investor inertia.

**Home Sales (Q1 % Change, 2006-07)**

US	-6.6%	NV	-27.4%
Northeast	1.2%	HI	-25.5%
Midwest	-6.1%	FL	-25.1%
South	-7.3%	LA	-19.5%
West	-11.9%	NM	-16.3%

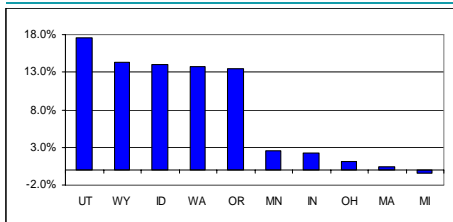
Source: National Association of Realtors

**House Price Appreciation from same Quarter One Year Earlier**



Source: OFHEO

**States with Most and Least Home Appreciation 2005-06**



**Portfolio design in a low volatility environment**

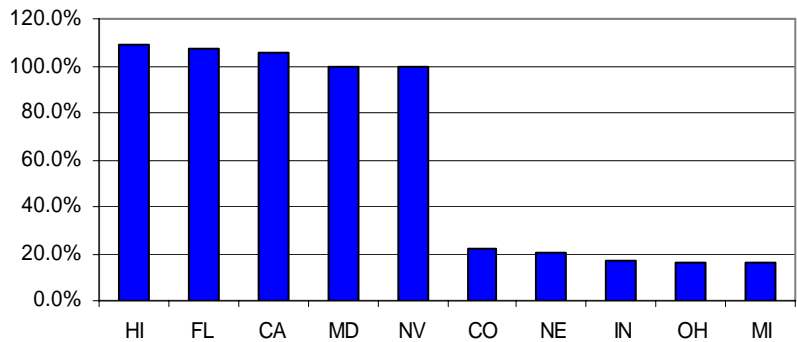
Investors should avoid the temptation of overweighting their portfolios with higher-yielding (higher risk) securities just because volatility is low. Investors have two clear choices. They can either keep the portfolio within their long term risk tolerances or buy higher risk securities and relatively cheap option hedges, depending upon the returns available.

**States respond to housing and mortgage concerns**

**Housing market continues to decelerate with regional disparities**

Total state existing-home sales declined 6.6% in the first quarter of 2007 from the first quarter of 2006, according to the National Association of Realtors. The table at the left illustrates the five states which experienced the largest declines over that period, with Nevada leading the way (-27.4%), followed by Hawaii (-25.5%) and Florida (-25.1%). Home prices in the fourth quarter of 2006 continued a trend of deceleration, growing 5.9% over the same quarter the prior year, reflecting a substantial slowdown from the 11.8% and 13.3% growth rates in 2004 and 2005, respectively. In addition, there are noteworthy regional disparities. The bottom table at the left shows the five states with the largest increases in home prices over the last five calendar years, and the five with the least. Hawaii experienced the largest appreciation with a 108.5% increase, followed by Florida, California, Maryland and Nevada. Of the states with the least appreciation, all experienced more moderate increases, ranging from 22.2% in Colorado to 16.5% in Michigan. While home prices decelerated over the past year, Michigan was the only state in the nation where prices declined, at -0.44 %.

**States with Most and Least Home Appreciation 2001-06**



Source: OFHEO

**Mortgage market downturn to exacerbate the effect on state economies**

With the housing market slowing nationally, Fitch released a report warning against the compounding effect of delinquency and increased foreclosure levels on certain state economies. In particular, the report noted the vulnerability of the manufacturing-based economies in the Midwest - including Michigan, Ohio and Indiana - and those still recovering from Hurricane Katrina, such as Louisiana and Mississippi. Underlying economic factors including income and employment levels have accounted for high mortgage foreclosures. The report also notes that while delinquencies and foreclosures are still relatively low in some of the states that experienced the most rapid appreciation, such as California, Florida, Nevada and Arizona, the levels are increasing relatively rapidly. These same states are also four of the five states with the highest percentage of mortgages that are subprime ARMs (Nevada at 13.3% and California at 8.6%). As a whole, the

concentration of ARMs, the rising number of delinquencies and foreclosures coupled with the slowdown of the national economy and the housing market present an ongoing risk to state revenues and will continue to be a major concern among state and local governments.

#### **State legislation emerging across the nation**

Responding to this growing concern, a number of state legislators have recently introduced bills to assist homeowners and thereby also mitigate the impact on local economies. Ohio has directed its Mortgage Finance Agency to issue approximately \$100M taxable bonds to help homeowner refinance mortgages they can't afford. Similarly, a bill was introduced in New Jersey to authorize the issuance of \$500M bonds, while a bond package and the creation of a fund to bail out homeowners were proposed in Pennsylvania. A number of other states have also proposed consumer protection laws, such as a foreclosure prevention hotline in Colorado, counseling and education programs in Indiana, and mortgage counseling before taking out certain mortgages in Texas.

## US 1 List

ML-US 1 Committee  
MLPF&S

### For Full Report

[US 1, 22 May 2007](#)

### Important Notes

See footnotes on page 28 to 31

See footnote and opinion key on page 30

## Red Hat removed from the list

The US 1 list is intended to represent a collection of our best investment ideas that are drawn from the universe of “BUY” rated US listed stocks (including ADRs), covered by Merrill Lynch fundamental equity research analysts. The list will be managed with a goal of providing superior investment performance over the long term.

### Red Hat well-positioned as a 2H07 story

Red Hat has been removed from the US 1 list. We continue to rate Red Hat a Buy and it remains a high-conviction idea. We remain strong supporters that Red Hat has long-term potential from the platform shift from Unix to Linux, better than expected uptake of its new RHEL 5.0 platform, and its JBoss acquisition (leveraged to the Service Oriented Architecture theme). The positive change in ownership of Red Hat stock has been driven by value investors in recent quarters. Still we think that the rotation back to growth investors driven by good news from RHEL 5.0 is more likely a 2H07 event. Consequently, we are removing Red Hat from the US 1 list.

### US 1 list

Ticker	Company	Analyst	Rating	Date added to US 1 list	Time added to US 1 list	* Current price	Addition price
AER	AerCap Holdings	Linenberg, Michael	C-1-9	03/12/07	7:00:35	30.01	27.13
AFL	Aflac Inc	Spehar, Ed	B-1-7	03/12/07	7:00:35	51.79	46.90
AIG	Amer Intl Group	Cohen, Jay A.	B-1-7	03/12/07	7:00:35	71.99	68.78
ATR	AptarGroup Inc.	Gilardi, Ross	B-1-7	05/15/07	12:15:46	36.84	36.65
BAC	Bank of America	Najarian, Edward	A-1-7	03/12/07	7:00:35	51.23	51.09
BRCM	Broadcom Corp	Pajjuri, Srin	C-1-9	03/12/07	7:00:35	30.85	33.83
KO	Coca-Cola	Farkas, Christine	A-1-7	03/12/07	7:00:35	51.91	47.95
CNX	CONSOL Energy	Lipschitz, David A.	C-1-7	03/12/07	7:00:35	46.56	35.63
GLW	Corning Inc	Fox, Steven	C-1-9	03/12/07	7:00:35	24.52	21.77
RIOPR	CVRD	Hirai, Felipe	C-1-7	03/12/07	7:00:35	37.67	30.28
CVS	CVS/Caremark	Baker, Patricia A.	B-1-7	03/12/07	7:00:35	37.80	31.98
ERJ	Embraer	Epstein, Ronald J.	C-1-7	03/12/07	7:00:35	47.09	45.76
FE	FirstEnergy Corp	Arnold, Jonathan	B-1-7	05/07/07	11:26:47	72.23	71.52
GPI	Group 1 Auto	Murphy, John	C-1-7	04/03/07	11:48:53	40.51	41.31
JPM	JP Morgan Chase	Moszkowski, Guy	B-1-7	03/12/07	7:00:35	52.56	48.84
MAN	Manpower	Morin, Michel	B-1-7	03/12/07	7:00:35	87.40	73.86
WFR	MEMC Electronic	Hodess, Brett	C-1-9	03/12/07	7:00:35	56.59	56.46
MRK	Merck & Co	Risinger, David	B-1-7	04/23/07	10:56:43	53.79	51.67
MTD	Mettler-Toledo	Groberg, Jonathan	B-1-9	03/12/07	7:00:35	98.74	88.26
MTG	MGIC	Ryan, Robert	B-1-7	04/23/07	10:01:19	66.30	61.96
MIL	Millipore	Groberg, Jonathan	B-1-9	03/12/07	7:00:35	75.17	72.01
MON	Monsanto	Carson, Don	B-1-7	03/12/07	7:00:35	61.83	54.66
NBR	Nabors Inds Ltd	Laws, Alan D.	C-1-9	05/04/07	14:21:28	35.94	33.39
NWS	News Corp	Reif Cohen, Jessica	B-1-7	03/12/07	7:00:35	23.90	23.98
NRG	NRG Energy, Inc.	Parrella, Elizabeth	C-1-9	03/12/07	7:00:35	87.12	69.65
SPR	Spirit AeroSys-A	Epstein, Ronald J.	RSTR**	RSTR**	RSTR**	RSTR**	RSTR**
VRSN	VeriSign Inc.	Maguire, Ed	C-1-9	03/12/07	7:00:35	27.39	24.24
WYE	Wyeth	Risinger, David	B-1-7	03/12/07	7:00:35	58.41	50.07

Source: Merrill Lynch Research

\* Current Price as at 21st May 2007

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## Server & Enterprise Software

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### For Full Report

[Server & Enterprise Software, 25 May 2007](#)

### Important Notes

See footnotes on page 28 to 31

See footnote and opinion key on page 30

# Unlocking value through optimal capital structure II

## Leverage is becoming fashionable in the software industry

We discussed the merits of “Unlocking value through optimal capital structure” in June 2006. Steps taken by companies including Microsoft, Oracle, Symantec and Cadence to improve their capital structures appear to have been well-received by investors. Most visible is Microsoft’s efforts to execute a reverse auction. While that was a step in the right direction, we think Microsoft should go further and introduce leverage in its capital structure like Oracle and Symantec. Microsoft’s AAA balance sheet is a gold mine sealed with resistance.

## Our model for identifying potential leverage is detailed

Most repurchases have historically gone towards neutralizing options overhang. We are talking about bolder steps to lever up and contract the share base. Our analysis considers 1) coverage ratios such as Debt/FCF, Debt/EBITDA and EBIT/Interest to quantify potential debt; 2) straight and convertible debt scenarios using both Oracle and S&P500 as benchmarks (see page 18); 3) median credit ratings at various levels of debt; 4) share buy backs phased throughout 07 and 08, which factors in overhang from options.

## The industry is still under-leveraged, so who is next?

Despite early steps, most software companies have under-levered balance sheets. Software Debt/Equity of 10% is a fraction of the S&P 500 average of +250%. Debt could help companies unlock value by lowering the cost of capital and deploying cash for share buybacks. Our model for identifying EPS leverage through buybacks **continues to validate companies identified in our earlier report such as Microsoft, Oracle, Symantec, Checkpoint and Cadence and turns up new ones, including Sybase, Citrix and Parametric.**

## Our model suggests sizeable potential EPS accretion

Our analysis suggests significant potential CY08 EPS accretion for **Sybase-49%, CheckPoint-24%, Oracle-24%, Citrix-21%, Symantec-20%, Microsoft-20%, Cadence-17%, Parametric-15%, and TIBCO-13%** using S&P 500 level leverage. It is interesting to note the potential for such healthy accretion despite meaningful stock price appreciation over the past year.

## Software LBOs are feasible today even after the runup

Software companies have three ways to add value: 1) execute on superior growth opportunities or 2) leverage up or 3) let someone else like a PE firm offer a premium to investors, leverage up beyond the scope of public markets and drive IRR. Our LBO scenarios **continue to validate TIBCO identified in our earlier report and uncover new companies such as Symantec, BEA, Sybase and Fair Isaac.** These LBOs can be supported by attractive equity premiums of 20% and internal rates of return (13%-22%) even assuming conservative exit multiples in 2012.

For a detailed discussion, which includes sections dealing with LBO scenarios and unlocking EPS leverage, please see our full report

## Transport Thoughts

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### For Full Report

[Transport Thoughts, 18 May 2007](#)

### Important Notes

See footnotes on page 28 to 31  
See footnote and opinion key on page 30

**The view from China: the slowdown of the U.S. economy doesn't seem to be a major concern. Growth in Europe, Latin America, and Africa has nearly decoupled from the U.S., which represents less than one-third of total volumes.**

# China trip confirms growth continues unabated

## China visit confirms growth

Long-term growth will continue unabated, particularly in core infrastructure, such as ports, railways, and roadways, under China's 11<sup>th</sup> 5-year plan. We recently visited with 16 companies in Shanghai, Beijing, and Hong Kong, as well as the Ministry of Transportation, toured airfreight and warehouse facilities, and the Port of Yangshan, the newest and largest Port terminal in Shanghai, with a target capacity of 25 million TEUs (twenty-foot-equivalent units) per year.

## U.S. slowdown not a major factor for China

Being U.S. centric, our questions sometimes focused on what impact the ongoing slowdown in the U.S. was having on China's growth. Most companies noted that because they are planning for the next five years (they are in the midst of their 11<sup>th</sup> 5-year plan), near term blips were not important. But more impressively, the companies noted that the U.S. is not their sole end market, but only 30% of a world market, with other markets (Latin America, Europe and intra-Asia) growing much faster, and thus able to chew up capacity from the slowdown in the U.S.

## Intermodal service still immature, limiting development

As cargo rail has typically been behind military, passenger, energy, and food stuffs, the country historically has not focused on intermodal transportation. However, the Governments current 5-year plan calls for building 18 intermodal facilities to begin increasing the service and help penetrate the hinterlands, although the infrastructure is still in the early stages.

## Environment actually mentioned

Impacts to the environment are now becoming major discussion points in each infrastructure expansion as China engages in its rapid development, indicating a maturing on a global scale.

## Infrastructure opportunities abound

The country is still focused on building infrastructure along its dense coastal markets, including ports, railways, logistics/distribution parks, etc. However, it is also looking westward, as it moves to tap the natural resources and nearly 50% of the population who live in its hinterlands.

## Companies accessing China opportunities

We believe the various infrastructure plays (China Construction, Shanghai Ports), airfreight/forwarders (FedEx, DHL, Sinotrans, and Kuehne + Nagel), rail/intermodal carriers (BNSF, J.B. Hunt, and Canadian National), and shipping carriers (OOCL and China Shipping) are directly benefiting from construction and port development, as well as utilizing the improved infrastructure supply chain.

For further details, please see our full report.

## Analyst Certification

We, Kash Rangan and Brian G. Belski, hereby certify that the views each of us has expressed in this research report accurately reflect each of our respective personal views about the subject securities and issuers. We also certify that no part of our respective compensation was, is, or will be, directly or indirectly, related to the specific recommendations or view expressed in this research report.

25 May 2007

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Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	18	54.55%	Buy	7	43.75%
Neutral	15	45.45%	Neutral	2	13.33%
Sell	0	0.00%	Sell	0	0.00%

### Investment Rating Distribution: Banks Group (as of 31 Mar 2007)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	119	44.57%	Buy	49	52.13%
Neutral	122	45.69%	Neutral	57	54.81%
Sell	26	9.74%	Sell	14	58.33%

### Investment Rating Distribution: Beverages - Soft Drinks Group (as of 31 Mar 2007)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	4	26.67%	Buy	1	25.00%
Neutral	10	66.67%	Neutral	0	0.00%
Sell	1	6.67%	Sell	0	0.00%

### Investment Rating Distribution: Business Services Group (as of 31 Mar 2007)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	9	47.37%	Buy	1	11.11%
Neutral	8	42.11%	Neutral	0	0.00%
Sell	2	10.53%	Sell	1	50.00%

### Investment Rating Distribution: Chemicals Group (as of 31 Mar 2007)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	42	58.33%	Buy	8	21.05%
Neutral	26	36.11%	Neutral	6	27.27%
Sell	4	5.56%	Sell	2	66.67%

### Investment Rating Distribution: Consumer Products Group (as of 31 Mar 2007)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	33	50.77%	Buy	8	26.67%
Neutral	29	44.62%	Neutral	10	38.46%
Sell	3	4.62%	Sell	0	0.00%

### Investment Rating Distribution: Distributors Group (as of 31 Mar 2007)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	4	44.44%	Buy	1	25.00%
Neutral	4	44.44%	Neutral	1	25.00%
Sell	1	11.11%	Sell	0	0.00%

### Investment Rating Distribution: Electrical Equipment Group (as of 31 Mar 2007)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	28	54.90%	Buy	8	34.78%
Neutral	16	31.37%	Neutral	4	26.67%
Sell	7	13.73%	Sell	1	16.67%

### Investment Rating Distribution: Electronics Group (as of 31 Mar 2007)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	47	41.23%	Buy	7	17.07%
Neutral	49	42.98%	Neutral	6	14.29%
Sell	18	15.79%	Sell	3	18.75%

### Investment Rating Distribution: Energy Group (as of 31 Mar 2007)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	137	57.81%	Buy	48	41.03%
Neutral	92	38.82%	Neutral	24	30.38%
Sell	8	3.38%	Sell	0	0.00%

### Investment Rating Distribution: Financial Services Group (as of 31 Mar 2007)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	92	38.02%	Buy	45	52.33%
Neutral	141	58.26%	Neutral	63	47.01%
Sell	9	3.72%	Sell	2	22.22%

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**Investment Rating Distribution: Health Care Group (as of 31 Mar 2007)**

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	97	46.86%	Buy	25	27.78%
Neutral	100	48.31%	Neutral	32	34.41%
Sell	10	4.83%	Sell	3	33.33%

**Investment Rating Distribution: Industrials/Multi-Industry Group (as of 31 Mar 2007)**

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	46	58.97%	Buy	7	17.95%
Neutral	28	35.90%	Neutral	7	31.82%
Sell	4	5.13%	Sell	1	33.33%

**Investment Rating Distribution: Media & Entertainment Group (as of 31 Mar 2007)**

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	60	37.04%	Buy	16	29.63%
Neutral	94	58.02%	Neutral	20	23.53%
Sell	8	4.94%	Sell	2	25.00%

**Investment Rating Distribution: Non-Ferrous Metals/Mining & Minerals Group (as of 31 Mar 2007)**

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	51	47.22%	Buy	15	36.59%
Neutral	44	40.74%	Neutral	9	25.71%
Sell	13	12.04%	Sell	1	9.09%

**Investment Rating Distribution: Packaging Group (as of 31 Mar 2007)**

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	2	28.57%	Buy	0	0.00%
Neutral	2	28.57%	Neutral	1	50.00%
Sell	3	42.86%	Sell	0	0.00%

**Investment Rating Distribution: Restaurants Group (as of 31 Mar 2007)**

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	9	42.86%	Buy	4	44.44%
Neutral	12	57.14%	Neutral	4	33.33%
Sell	0	0.00%	Sell	0	0.00%

**Investment Rating Distribution: Retailing Group (as of 31 Mar 2007)**

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	67	39.18%	Buy	13	20.97%
Neutral	92	53.80%	Neutral	14	16.47%
Sell	12	7.02%	Sell	2	18.18%

**Investment Rating Distribution: Technology Group (as of 31 Mar 2007)**

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	114	41.76%	Buy	21	20.39%
Neutral	146	53.48%	Neutral	31	22.79%
Sell	13	4.76%	Sell	1	9.09%

**Investment Rating Distribution: Telecommunications Group (as of 31 Mar 2007)**

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	89	44.50%	Buy	18	24.32%
Neutral	85	42.50%	Neutral	16	22.22%
Sell	26	13.00%	Sell	8	40.00%

**Investment Rating Distribution: Utilities Group (as of 31 Mar 2007)**

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	62	37.35%	Buy	19	37.25%
Neutral	89	53.61%	Neutral	39	51.32%
Sell	15	9.04%	Sell	2	14.29%

**Investment Rating Distribution: Global Group (as of 31 Mar 2007)**

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	1562	45.16%	Buy	415	30.09%
Neutral	1615	46.69%	Neutral	446	30.65%
Sell	282	8.15%	Sell	49	19.76%

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25 May 2007

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