The Market Economist

Weekly guidebook for the global investor

Economic Analysis

Economics | United States
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Merrill Lynch

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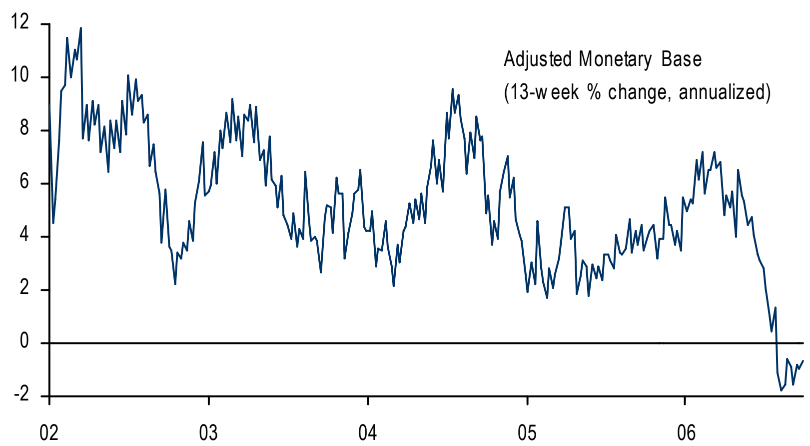
The emerging Bernanke-led Fed

Six-months ago, Fed Chairman Bernanke's "dovish" views about: (a) the outlook for a more moderately growing US economy; (b) a peaking in the inflation cycle; (c) the basis for a near-term "pause" in the Fed's tightening cycle; (d) the belief in the "restrictiveness" of a 5.25% target rate; and, (e) the basis of a lower "neutral" federal funds target rate over the remainder of the cycle, were controversial, and received with skepticism (and second guessing) by market participants and Fed officials alike.

The penny-pinchers

The looming prospect of a savings rebuild is one of the major downside economic risks often cited by the Fed, and we would agree. In fact, this was central to San Francisco Federal Reserve Board President Yellen's recent speech when she outlined her case as to why she thought it now made sense for the Fed to pause.

Fed policy is not tight?



Source: Federal Reserve Bank, Merrill Lynch

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View from the desk

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Nonetheless, with six additional months of economic performance under our belts, it appears to us that Mr. Bernanke's long-held views are working out; winning adherents amongst his colleagues and market participants.

Even though there is not unanimity among policymakers, it probably is not too much to say that a Bernanake-led Fed is starting to take shape.

Indeed, the tone of recent Fed-speak is decidedly more "balanced" than otherwise, and versus the official "tightening risk" stance in the 20 September FOMC Policy Statement (eg, the "balanced" 29 September comments of St. Louis Fed President Poole's – voter beginning 25 October).

The Chairman's outlook generally coincides with what we think is going on in the economy:

- The economic growth rate cycle likely "peaked" in the first quarter 2006;
- The inflation cycle seems to have peaked (the Chairman predicted a six-month lag between growth and inflation);
- The capacity utilization rate is likely to peak by the end of this year (or very early in 2007);
- Job growth probably will slow to about 100,000 a month (with the risk on the downside); and,
- The unemployment rate drifts up to about 5% from 4.7% over the coming quarters.

Data-dependent credibility building

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Moreover, Mr. Bernanke's belief in the "restrictiveness" of a 5.25% monetary policy stance (in both restraining growth, while containing inflation growth and pressures) appears to be winning out.

All of these factors suggest to us that the US yield curve will remain inverted for the foreseeable future and that the Fed is likely to ease by more rather than less in 2007 and into 2008. Against that backdrop, we think that the economy will keep growing below trend for the next six quarters.

Our views are congruent to Mr. Bernanke's views.

A "Bernanke Trade" seems to be emerging as the new Federal Reserve Board chairman puts his stamp on monetary policy.

The "Bernanke Trade"

Thus, a "Bernanke Trade" seems to be emerging as the new Federal Reserve Board chairman puts his stamp on monetary policy. What will the trade look like in the months ahead? An inverted Treasury yield curve and a neutral funds rate that is lower than what market participants expect – closer to 4% than the current 5.25% – as our Fed chief endeavors to ensure a soft landing in 2007-08.

Baseline Treasury & futures market views

Trading in the Fed funds and Euro dollar futures markets have been exceptionally "data dependent" of late, and especially responsive to Fed-speak. The upcoming three-week stretch of both a heavy economic data point release and Fed-speak calendar promises to heighten intraday trading volatility, especially as:

- the US data point flow will likely continue to be "uneven" and "noisy"; and,
- Fed-speak will likely demonstrate far less unanimity over the near-term outlook for growth versus inflation risks than the 10:1 voting margin at the 20 September FOMC meeting would suggest.

As for our position on economic data flow, Fed-Speak and market pricing, we think that:

- The US economy's growth rate will likely under-perform its trend rate by a significant margin for the next 6 quarters (possibly more), beginning in 3Q2006;
- Job growth will likely fall to a +1.0% year-over-year rate, going forward, prompting a rate cut by Chairman Bernanke (recall that Chairmen Volcker and Greenspan never permitted that y/y rate metric to fall below +1.3%, before cutting the federal funds target rate);
- The "tone" of Fed-speak likely will be "uneven," running the gamut from dove (Yellen) to hawk (Moskow);
- It should become evident that the Bernanke-led Fed is precisely that, now, a "Bernanke-led" Fed (see above);
- The US economy's "neutral" federal funds target rate is likely closer to 4.0% than it is to 5.25%;
- The December 2007 Euro dollar futures contract will richen to price in at least75 bps of cumulative tightening;
- The "red spread" (ie, the spread between the March '07 and March ''08 euro dollar futures contract) will further invert, to price in at least 75bps of monetary easing;
- The spread between the yield on the 10-year Treasury note and the federal funds target rate will likely remain inverted through June '07; and,
- The yield spread between the 2-year and 10-year Treasury notes will likely remain flat, in a range from -15bps to +10bps over the coming eight-months.

The economic basis for these interest rate projections is three-fold:

- That the sustainable year-on-year growth rate in nonfarm payrolls in the current decade is likely 115bps (or more) below its average year-on-year performance from 1996 through 2000, of +2.3%;
- The current decade's sustainable year-on-year growth pace of capex spending growth is likely 225bps below the average year-on-year performance from 1996 through 2000 of 11.85%; and,
- US housing markets are likely to undergo a multi-year revaluation of prices, sales and permits/starts, a process that likely began 12-months ago.

That said, going forward, economic activity will likely be sustained around the following features:

- greatly strengthened business balance sheets;
- strong levels of business cash reserves;
- diligent business cost controls;
- near record of household net worth;
- very low unemployment rate for "household heads";
- strengthening export growth;
- some business spending on structures; and,
- tax structures that favor proprietary risk taking.

John Herrmann, Economist, MLPF&S, +1 212 449 9527

Hot topic

The penny-pinchers

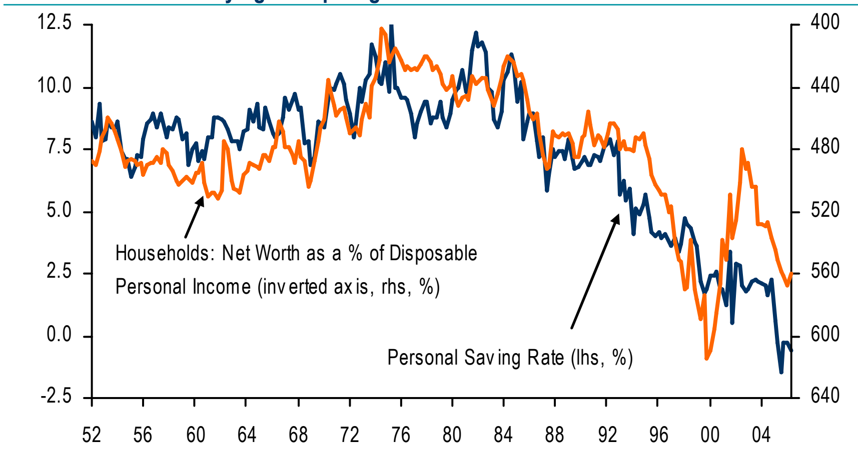
Highlights

- The increase in mortgage equity withdrawal (MEW) has played a very important role in the decline in the savings rate, in our view.
- A slump in asset values could prompt a sizable increase in the savings rate to as high as 3¼% by the end of '07.
- The savings rebuild could shave about 1.0-1.5 percentage points from consumers spending and 0.7-1.1 percentage points from GDP.

The looming prospect of a savings rebuild is one of the major downside economic risks often cited by the Fed, and we would agree. In fact, this was central to San Francisco Federal Reserve Board President Janet Yellen's recent speech when she outlined her case as to why she thought it now made sense for the Fed to pause. This is what she had to say in a speech she gave on 12 September 2006 in Boise, Idaho titled "Prospects for the US economy."

"Another risk has to do with household saving behavior. In the US, the personal saving rate has been declining for more than a decade. During the 1980s, it averaged 9 percent. This July, it was all the way down to minus 1 percent. Frankly, it's hard to see how it could go much lower. So the risk is that a sustained rise could occur, which would put a real crimp in consumer spending and therefore in overall economic activity. Though there's some uncertainty about why the saving rate has fallen into negative territory, I strongly suspect that part of it is related to the growth in consumer wealth over the last several years both through rising housing values and through rising stock values. Therefore, the more recent softening in both of those sources of wealth may provide a bit more impetus for a reversal in the saving trend; in other words, it is conceivable that people will shift gears and try to build up savings the old-fashioned way, by spending less. Whatever its source, the very low — in fact, negative — saving rate represents a downside risk for the economy, with the chance of sizeable drop-off in consumer spending likely to be bigger than a surge in spending."

Chart 1: Households relying on capital gains



Source: Federal Reserve Bureau, Bureau of Economic Analysis, Merrill Lynch

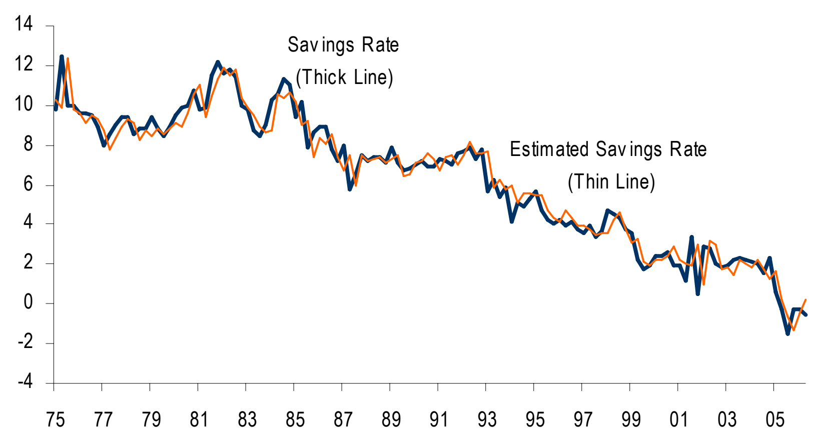
Rising asset values have played a significant role in the drop in the savings rate from the 8-10% average over up until the mid-1980s to the negative savings rate that exists today.

MEW, a big driver of the savings rate decline

What we have found is that rising asset values have played a significant role in the drop in the savings rate from the 8-10% average over up until the mid-1980s to the negative savings rate that exists today. To cut into just what type of risk households are running by choosing to depend so heavily on capital gains, we constructed a simple model of the savings rate based on household asset values. We started with a basic model, inspired by a recent San Francisco Federal Reserve note, that was based on 10-year Treasury yields, equity values and real estate wealth[1]. To get an idea of how important the increased ability of homeowners' to extract wealth from their homes has been in driving the savings rate lower, we took the model one step further by dividing real estate wealth into realized and non-realized capital gains (using our estimate of mortgage equity withdrawal (MEW) as a proxy for realized capital gains).

The model fits the savings rate very well. Higher interest rates push the savings rate higher while increases in asset values push the savings rate lower. What we found most interesting is that MEW has a much larger impact on the savings rate than non-realized capital gains – packing four times the punch, in fact (see Chart 2).

Chart 2: Rising asset values explain the savings rate decline



Savings rate = 20.19 + 0.26*(10-Year Treasury) – 0.33*(S&P500/PDI) – 0.10*(Non-realized Real Estate Capital Gains/PDI) – 0.41 (MEW/PDI).
(2.07) (3.00) (2.61) (2.70) R^2 = 94.6%

Note: Equation is adjusted for autocorrelation; ( ) = t-statistic.

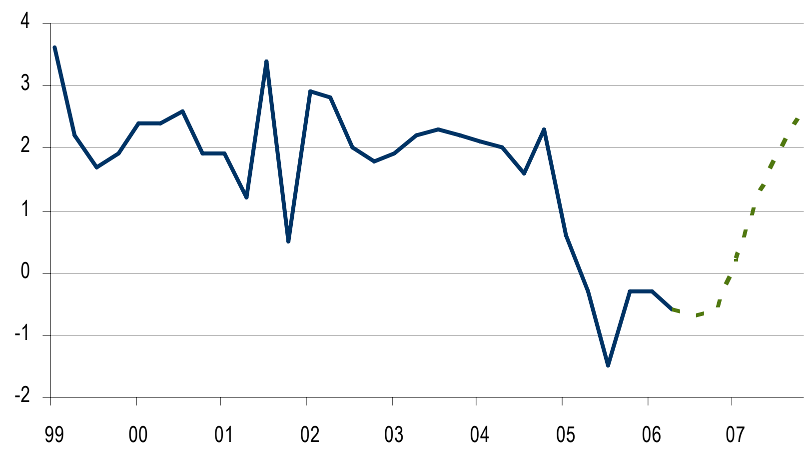
Source: Bureau of Economic Analysis, Merrill Lynch

A downturn in real estate wealth could push the savings rate up to 2.5% by the end of 2007.

The estimation has some interesting implications for our economic forecast, which sees the savings rate rising by about a percentage point by the end of 2007. Using our forecast of real estate net worth (which we estimated in the 24 August *Market Economist* could be about a $1 trillion decline over the next six quarters), interest rate forecast and assuming a relatively flat performance for equities, would push the savings rate up to about 2.5% – a full three-percentage point rise from where we stand currently. Even if we had a 20% increase in equity values, the model still predicts a two-percentage point rise in the savings rate. And of course, a decline in the equity market would put even more upward pressure on the savings rate. Clearly, unless the equity market continues a massive rally or some other asset class emerges that households can take a shine to, there is a significant risk that the consumer could enter a savings rebuilding phase.

[1] Kevin J. Lansing (2005), *Spendthrift Nation*, FRBSF Economic Letter, San Francisco Federal Reserve Bank, Number 2005-30, November 10, 2005.

Chart 3: An asset price slump could spark a massive savings rebuild



Source: Bureau of Economic Analysis, Federal Reserve, Merrill Lynch.

Shift to savings could topple consumer spending

An abrupt rebuild in savings next year could restrain consumer spending growth by 1.0 to 1.5 percentage points and shave 0.7 to 1.1 percentage points from GDP.

The knock-on effects on consumer spending and the broader economy could be considerable. An abrupt rebuild in savings next year could restrain consumer spending growth by 1.0 to 1.5 percentage points and shave 0.7 to 1.1 percentage points from GDP.

Going back over the past 30 years, there have been five different periods in which we saw a multi-quarter rise in the savings rate from relatively depleted levels, and on three occasions they coincided with hard landings in the overall economy and only twice did they line up with soft landings. On average, the savings rate rose around 2½ percentage points and the balance sheet repair process typically lasts two years.

What typically happens during this period is we see a discernible slowing in consumer spending and housing-related expenditures are virtually flat. So cyclically-sensitive consumer spending is something you want to trade but not own during these savings rate rebuild phases, and keep in mind that this process is only starting now with the savings rate near a historic low of -0.6%.

If GDP were the stock market, the areas to be positioned in are in companies with foreign sales exposure because export volumes tend to rise at a 7.5% annual rate, and capex and commercial construction, while they also slow down along with the consumer, still doubling the pace of consumers. In terms of asset mix, bonds have generated an average return of 7%, stocks 4% and cash 7.5% during these phases, so again, combined with other research on the cycle we have done recently, augurs for a rate-sensitive posture in the equity market. And believe it or not, the dollar rallies slightly during these periods. Consistently our strategy team's recent sector work found, that if you are going to go cyclical, media and industrials screened very well during these savings rate rebuilding periods as did telecom and insurers on the rate-sensitive front.

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Fed Monitor

Key economic data releases (month/month % change, unless noted otherwise)

	September				October				November		
Indicator	Day	Period	Actual	Prior	Day	Period	ML	Cons	Day	Period	ML
Core PCE Price Index (y/y)	29	August	2.5%	2.4%	30	September	—	—	30	October	—
Productivity (SAAR)	—	—	—	1.1%	—	—	—	—	2	3Q(P)	—
ULC (SAAR)	—	—	—	4.2%	—	—	—	—	2	3Q(P)	—
Nonfarm Payrolls (000s)	1	August	128k	113k	6	September	—	—	3	October	—
Unemployment Rate	1	August	4.7%	4.8%	6	September	—	—	3	October	—
Avg Hourly Wages	1	August	0.1%	0.4%	6	September	—	—	3	October	—
Retail Sales ex Autos	14	August	0.2%	1.0%	13	September	—	—	14	October	—
Cap. Utilization Rate	15	August	82.4%	82.4%	17	September	—	—	16	October	—
Core PPI (y/y)	19	August	0.9%	1.3%	17	September	—	—	14	October	—
Housing Starts	19	August	1.67mn	1.80mn	18	September	—	—	17	October	—
Core CPI (y/y)	15	August	2.8%	2.7%	18	September	—	—	16	October	—
Durables Ex Trans	27	August	-2.0%	0.5%	26	September	—	—	28	October	—
Existing Home Sales	25	August	6.30mn	6.33mn	25	September	—	—	28	October	—
New Home Sales	27	August	1.05mn	1.07mn	26	September	—	—	29	October	—
GDP (SAAR)	28	2Q (F)	2.6%	3.3%	27	3Q(A)	—	—	29	3Q(P)	—
Employment Cost Index	—	—	—	—	31	3Q	—	—	—	—	—
FOMC Rate Decision	20	—	5.25%	5.25%	24-25	—	5.25%	5.25%	—	—	—

(A) Denotes actual figure. Source: Bloomberg, Merrill Lynch

Long term quarterly forecasts

	3Q06			4Q06			1Q07			2Q07		
Indicator	ML	Cons	Cons Δ*	ML	Cons	Cons Δ*	ML	Cons	Cons Δ*	ML	Cons	Cons Δ*
Real GDP (ann %)	1.7	2.7	—	1.8	2.4	-0.3	1.7	2.6	-0.1	1.5	2.6	-0.1
CPI (ann %)	2.9	3.4	+0.3	0.4	2.3	-0.2	1.7	2.6	—	1.3	2.6	+0.1
U-Rate (avg, %)	4.8	4.7	—	5.0	4.8	+0.1	5.2	4.9	+0.1	5.5	4.9	—
3-Month T Bill (avg,%)	4.95	5.10	—	4.80	5.10	-0.1	4.65	5.10	—	4.20	5.00	-0.1
10-Year T Note (avg,%)	4.85	5.00	-0.2	4.70	5.00	-0.2	4.45	5.10	-0.1	4.45	5.10	-0.1

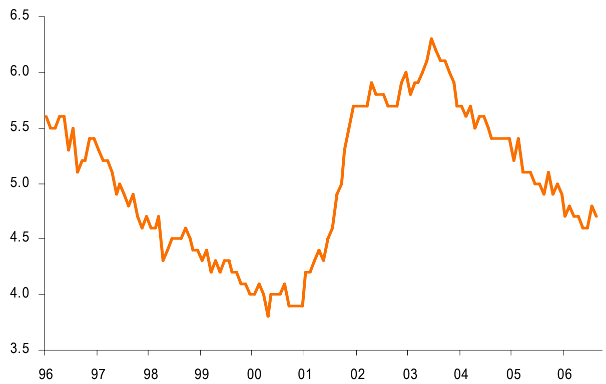
*Cons Δ are month-to-month changes in consensus. Source: Blue Chip, Merrill Lynch

Important Fed events and speeches

	October	November	December
FOMC Meeting	24-25	—	12
FOMC Minutes	11	15	—
Beige Book Release	12	29	—
Speakers			
Ben S. Bernanke, Board of Governors, Chairman	4, 16	1, 10	1
Timothy F. Geithner, New York, Vice Chairman	4	29	—
Susan Schmidt-Bies, Board of Governors	11, 17	30	—
Donald L. Kohn, Board of Governors	4	—	1
Randall S. Kroszner, Board of Governors	—	16	—
Kevin M. Warsh, Board of Governors	—	—	—
Jack Guynn, Atlanta Fed President	—	—	—
Jeffrey M. Lacker, Richmond Fed President	11	—	1
Sandra Pianalto, Cleveland Fed President	—	—	—
Janet L. Yellen, San Francisco Fed President	16	—	—
Thomas M. Hoenig, Kansas City Fed President	3	—	—
Cathy E. Minehan, Boston Fed President	—	14	—
Michael H. Moskow, Chicago Fed President	5, 12, 30	—	—
William Poole, St. Louis Fed President	16	14, 16	—
Charles I. Plosser, Philadelphia Fed President	5	28	1
Gary H. Stern, Minneapolis Fed President	—	—	—
Richard W. Fisher, Dallas Fed President	6	2	—

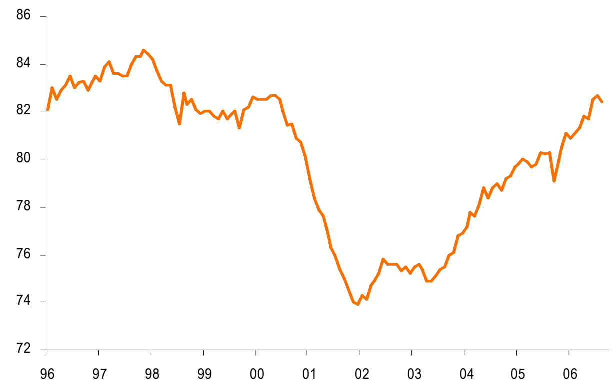
Bolded names denote current FOMC voters. Source: Bloomberg, Merrill Lynch

Civilian unemployment rate—labor resource utilization
(percent)



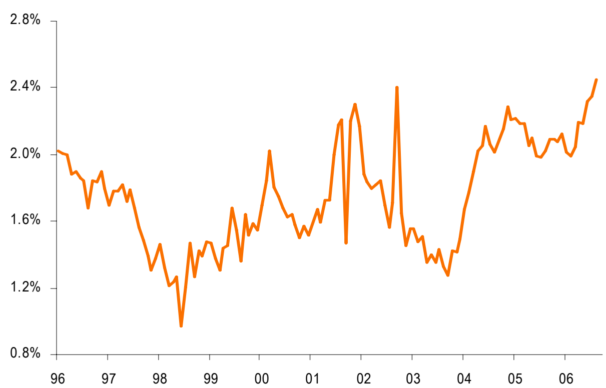
Source: Bureau of Labor Statistics, Merrill Lynch

Capacity utilization rate—product resource utilization
(percent)



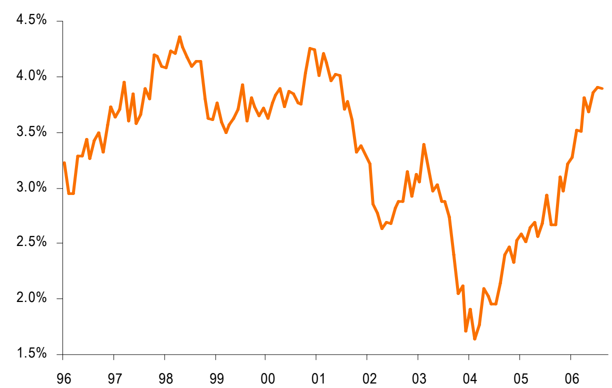
Source: Federal Reserve Board, Merrill Lynch

PCE price index less food & energy
(year/year percent change)



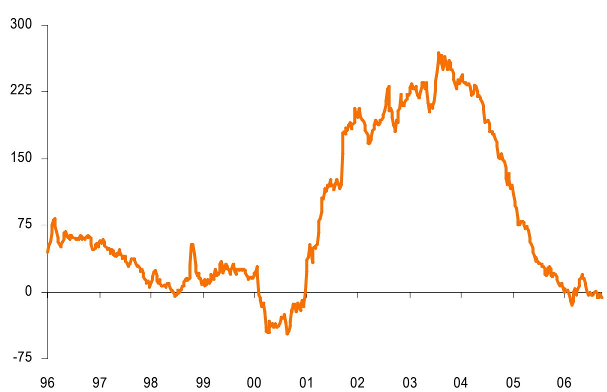
Source: Bureau of Economic Analysis, Merrill Lynch

Average hourly earnings
(year/year percent change)



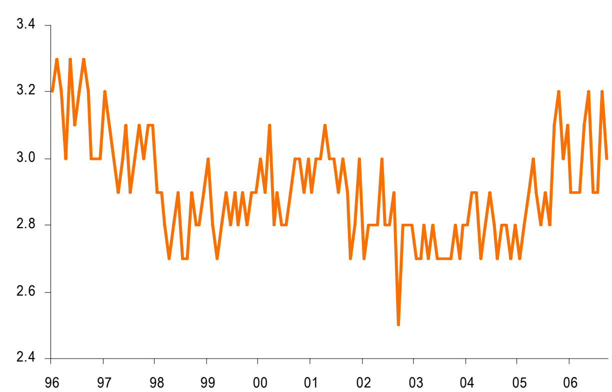
Source: Bureau of Labor Statistics, Merrill Lynch

The yield curve
10-year minus 2-year Treasury yields (basis points)



Source: Federal Reserve Board, Merrill Lynch

University of Michigan 5-10 year inflation expectations
median increase (percent)



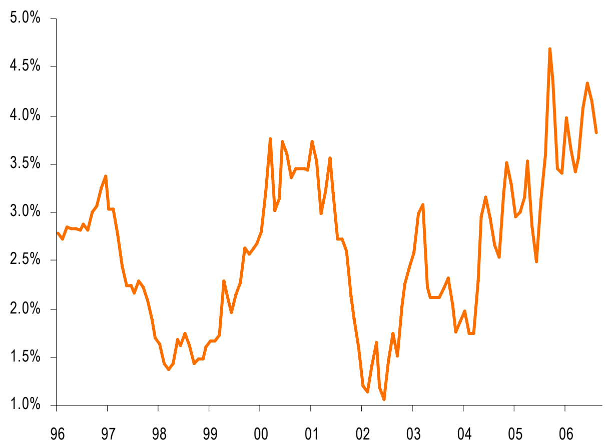
Source: University of Michigan, Merrill Lynch

Monthly CPI forecast update

	Total CPI					Core CPI			
	NSA			SA		NSA		SA	
	Level	m/m	y/y	m/m	y/y	m/m	y/y	m/m	y/y
2006: Apr	201.5	0.85	3.5	0.60	3.6	0.29	2.3	0.29	2.3
2006: May	202.5	0.50	4.2	0.45	4.1	0.10	2.4	0.29	2.4
2006: Jun	202.9	0.20	4.3	0.20	4.3	0.10	2.6	0.29	2.7
2006:Jul	203.5	0.30	4.1	0.44	4.2	0.15	2.7	0.19	2.7
2006: Aug	203.9	0.20	3.8	0.25	3.8	0.24	2.8	0.24	2.8
2006: Sep	203.1	-0.38	2.2	-0.38	2.2	0.21	2.9	0.21	2.9
2006:Oct	203.2	0.04	2.0	0.09	2.0	0.45	2.8	0.21	2.8
2006: Nov	203.3	0.03	2.9	0.18	2.9	-0.08	2.8	0.17	2.8
2006: Dec	202.9	-0.18	3.1	0.17	3.1	-0.07	2.8	0.17	2.8
2007: Jan	203.4	0.24	2.6	0.13	2.6	0.19	2.7	0.14	2.7
2007: Feb	203.9	0.28	2.6	0.13	2.6	0.48	2.7	0.13	2.7
2007: Mar	204.6	0.32	2.4	0.12	2.4	0.42	2.5	0.12	2.5

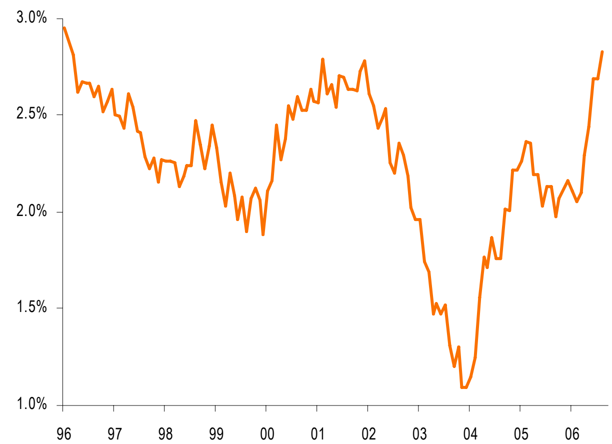
NSA: Not seasonally adjusted, SA: seasonally adjusted. M/M is monthly percent change; Y/Y is year-over-year percent change.
Source: Merrill Lynch

Consumer price index
(year/year % change)



Source: Bureau of Labor Statistics, Merrill Lynch

Consumer price index less food & energy
(year/year % change)

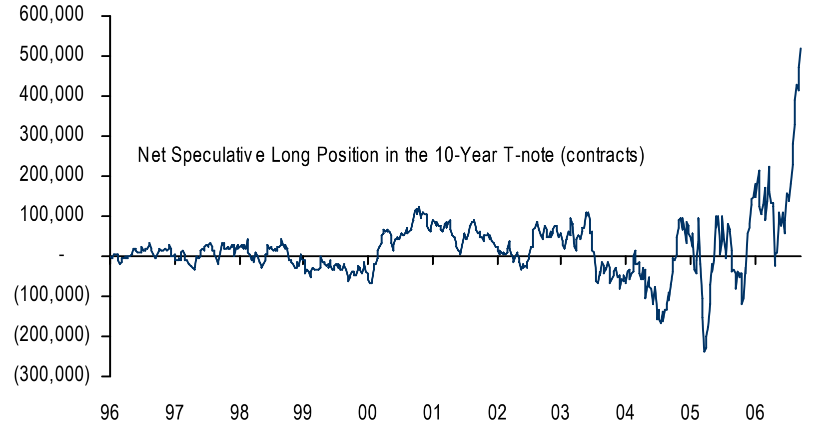


Source: Bureau of Labor Statistics, Merrill Lynch

Charts of the week

Net long speculative position on the 10-year T-note again broke to a fresh record high of 518,157 contracts (both futures and options) for the week ending September 19. The 10-year yield, meanwhile, has rallied more than 60bp from its 2006 high.

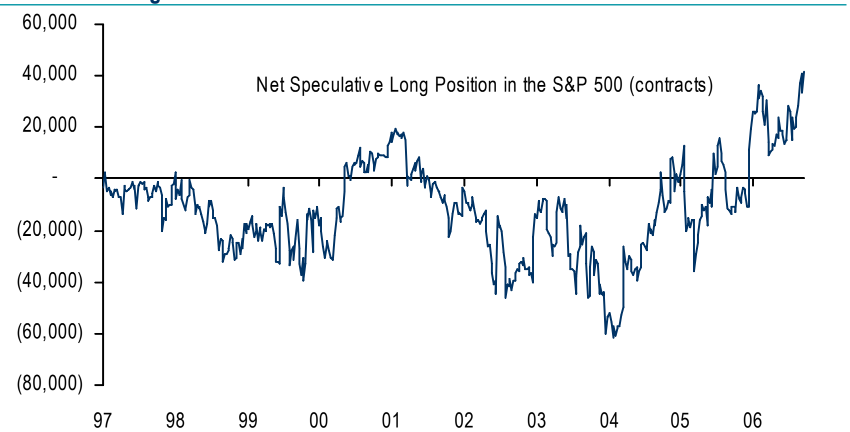
Net spec long positions in the 10-year note surge



Source: Federal Reserve Board, Merrill Lynch

The net speculative long positions on the S&P 500 rose 7,655 contracts to a new high of 41,230. Not surprisingly this has reflected in the index's performance of late. It is now up more than 9% since hitting its 2006 low point of 1223.69 in June. However, the index still needs to grow another 14% before it reaches its record high set in 2000.

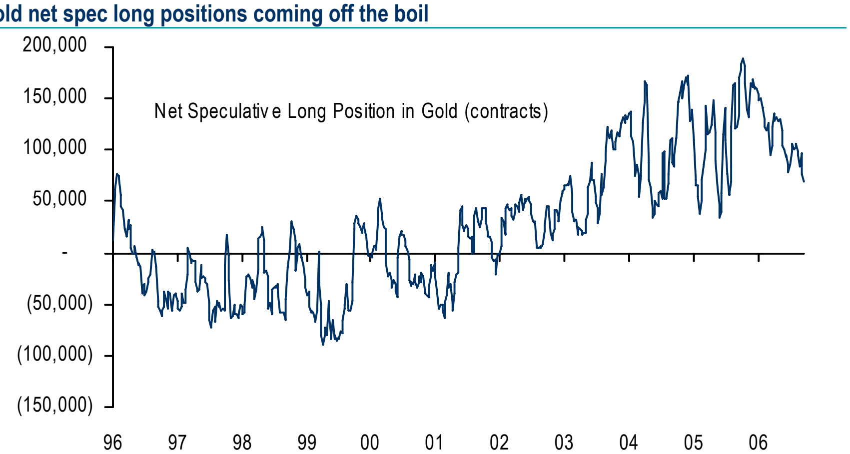
Investors still "long" the S&P 500



Source: Federal Reserve Board, Merrill Lynch

Net speculative long positions on gold are being pared, now down to 69,393 contracts this latest week — compared to 76,142 the prior week and down from 106,963 just six weeks ago. This could explain some of the decline in gold prices that we have seen of late. Although it has recovered slightly this week, gold is still off more than 15% from its 2006 peak set back in May.

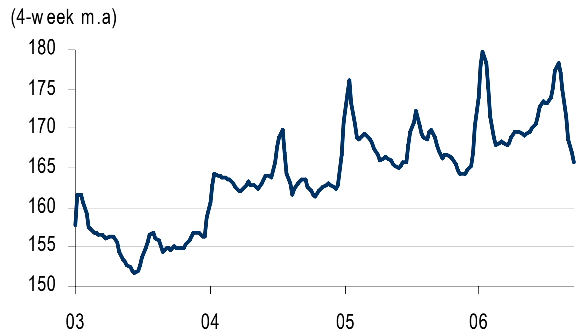
Gold net spec long positions coming off the boil



Source: Federal Reserve Board, Merrill Lynch

Merrill Lynch proprietary weekly indicators

The Merrill Lynch production index

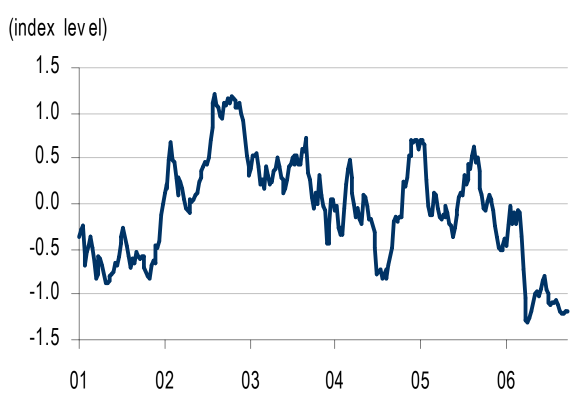


Our production index fell 0.6% for the week — the seventh weekly drop in a row. This was enough to push the four-week moving average to its lowest level since December. For the week, six out of the eight components that make up our metric were down. The largest drop was seen in auto production, which was expected given the production cuts announced by the Big Three automakers. Electricity output has now fallen seven weeks in a row, a streak last seen in May/June 2003. Other notable declines were seen in coal and lumber production and railcar loadings. Providing an offset was a 1.2% gain in crude oil production.

The Merrill Lynch consumer index

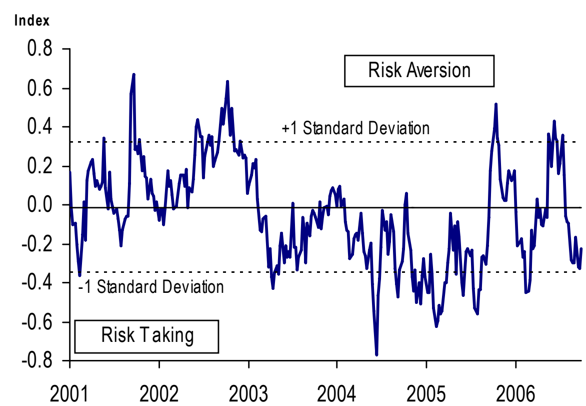
For the week ending September 23, our consumer index improved once again, to now stand at its best reading in 11 weeks, and it looks like it has broken above the upper range of its downward channel. A better tone to the stock market, solid chain-store sales, lower mortgage rates, falling energy prices and a still-supportive employment backdrop, are all positives for our index. However, acting as offsets are the slowing pace in consumer credit, real estate and home-equity loans and refi activity, which is now down over 40% from its high. Nonetheless, this upward trend bears watching as we head into the fourth quarter.

The Merrill Lynch housing index



Our housing indicator inched higher again this week making this the third increase in a row. The main driver of the increase came from the improvement in continuing claims, which is at its lowest level in eight weeks. Moreover, because of the lags in some of the components (one month on real estate loans and new mortgage purchases, and two-month lag in mortgage rates) our index is hitting some favorable data points. Nevertheless, the index is mired deep in negative territory and the four-week moving average is still falling, which confirms that the US housing market is in a recession.

The Merrill Lynch financial stress index



Our financial stress index remains in risk-taking terrain as investors are encouraged by the developments they see in the equity markets, the narrowing of SWAP spreads, the widening of TED spreads and the bid in high-beta currencies in relation to safe-haven denominations. However, keep in mind, the overall equity market does not perform well during Fed pauses and despite the fact that the Dow is close to breaking to a new high the broader S&P 500 is still 188 points away from its record level. Moreover, global liquidity growth is set to slow as the ECB and BoJ raise their respective interest rates.

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S&P 500 earnings update

- 3Q earnings expected to come in at 14.2% by industry analysts.
- 3Q consumer discretionary EPS continued to be marked down.
- Materials poised to be 3Q winner.
- Less profit guidance issued by companies.

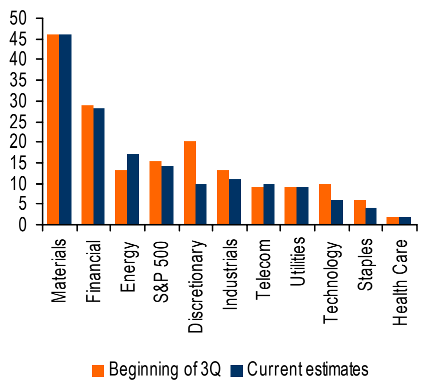
No major movements in EPS estimates ahead of 3Q season

There was not much movement in analysts' third-quarter estimates this week as we await the start of the earnings season (which begins around 9 October). Industry-analysts are looking for 14.2% year-over-year growth in S&P profits (same as last week), which would mark the 13th consecutive quarter of double-digit earnings growth (according to Thomson Financial) but would be slightly slower than the 16% result in 2Q.

Consumer discretionary extends downward streak

However, there were a few interesting changes within the sectors. Consumer discretionary estimates were taken down a few notches to 10%, which is quite the hair cut from the 20%+ estimates forecast back in June. From our macro view point, we have a negative stance on the consumer spending, given the numerous headwinds facing consumers – the real estate sector being the number one risk here. Materials saw a downgrade to 46%, but still remains the leader by far of the 3Q earnings season. On the positive side, early results from a few brokerages helped boost financials' blended estimate by one percentage point to 28%.

Majority of 3Q estimates taken lower
(bottom-up EPS estimates: y/y% change)



Source: Merrill Lynch, Thomson Financial

Less guidance so far

There have been less profit outlooks provided by companies leading up to the 3Q earnings season. This time last year, about 180 companies had issued profit outlooks whereas only 124 have given guidance so far. Overall, there has been fewer negative profit warnings than this time in 2005 – 58% of companies have guided lower compared to 64% for 3Q05.

Analysts optimistic on 2007 profit outlook

Bottom-up analysts remain quite optimistic on the 2007 profit landscape, expecting 10.1% profit growth. Six of the ten sectors are projected to register double-digit growth, with the technology sector coming in on top (18%). Indeed, the tech sector – with its high percentage of foreign sales – may benefit from steady global growth (our global economics team expects global growth outside of the US to hold up, slowing slightly from around 6% GDP growth in 2006 to 5% in 2007.) Following strong leadership over the past few years, the energy sector is slated to underperform, with just 3% growth expected – a considerable loss in momentum from the 22% expected EPS growth rate in 2006. According to industry analysts, consumer discretionary is poised to come in at a healthy 14% rate in 2007. Our below-consensus 2007 GDP forecast (we are looking for just 1.8% in 2007, compared to Street estimates of 2.7%), is underpinned by our negative view on the consumer. We have already started to see consumer cyclical areas of the economy start to weaken – both cyclically-sensitive consumer spending and employment have rolled over considerably, suggesting downside risk to this group's profits.

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3Q06 earnings expectations
S&P 500 bottom-up EPS estimates (year-over-year % change)

	May 06	Jun 06	Jul 06	Aug 06	1 Sep 06	8 Sep 06	15 Sep 06	Current
Consumer Discretionary	23%	22%	20%	15%	13%	13%	12%	10%
Consumer Staples	5%	5%	6%	5%	4%	4%	4%	4%
Energy	9%	10%	13%	17%	18%	18%	17%	17%
Financials	29%	28%	29%	28%	27%	27%	27%	28%
Health Care	3%	2%	2%	3%	2%	2%	2%	2%
Industrials	13%	13%	13%	13%	12%	12%	11%	11%
Materials	34%	38%	46%	45%	47%	47%	47%	46%
Technology	11%	11%	10%	5%	5%	5%	6%	6%
Telecom	11%	10%	9%	10%	10%	10%	10%	10%
Utilities	11%	10%	9%	10%	10%	10%	9%	9%
S&P 500	**15.0%**	**14.9%**	**15.4%**	**15.0%**	**14.6%**	**14.4%**	**14.2%**	**14.2%**

Source: Merrill Lynch, Thomson Financial

4Q06 earnings expectations
S&P 500 bottom-up EPS estimates (year-over-year % change)

	May 06	Jun 06	Jul 06	Aug 06	1 Sep 06	8 Sep 06	15 Sep 06	Current
Consumer Discretionary	21%	20%	19%	17%	14%	14%	12%	10%
Consumer Staples	9%	10%	10%	10%	9%	9%	9%	9%
Energy	-2%	0%	2%	4%	4%	4%	2%	2%
Financials	28%	28%	30%	30%	30%	29%	29%	30%
Health Care	5%	4%	5%	5%	5%	4%	4%	4%
Industrials	16%	16%	16%	18%	17%	17%	17%	17%
Materials	27%	31%	40%	41%	42%	41%	41%	40%
Technology	12%	12%	12%	9%	9%	9%	9%	9%
Telecom	9%	9%	9%	9%	8%	8%	8%	8%
Utilities	4%	5%	6%	5%	5%	5%	5%	5%
S&P 500	**14.7%**	**14.8%**	**14.8%**	**14.8%**	**14.3%**	**14.2%**	**13.7%**	**13.7%**

Source: Merrill Lynch, Thomson Financial

2006 earnings expectations

S&P 500 bottom-up EPS estimates (year-over-year % change)

	Jan 06	Apr 06	Jul 06	Aug 06	1 Sep 06	8 Sep 06	15 Sep 06	Current
Consumer Discretionary	20%	14%	15%	14%	13%	13%	13%	12%
Consumer Staples	8%	5%	5%	6%	6%	6%	6%	6%
Energy	13%	13%	18%	21%	22%	23%	22%	22%
Financials	14%	17%	19%	20%	20%	20%	20%	20%
Health Care	9%	6%	5%	7%	7%	6%	6%	6%
Industrials	14%	14%	16%	16%	16%	16%	16%	15%
Materials	8%	10%	25%	27%	28%	27%	27%	27%
Technology	16%	13%	11%	9%	10%	10%	10%	10%
Telecom	9%	13%	14%	15%	14%	14%	14%	15%
Utilities	14%	9%	9%	9%	8%	8%	8%	8%
S&P 500	**13.1%**	**12.5%**	**14.0%**	**14.8%**	**14.9%**	**14.9%**	**14.7%**	**14.7%**

2007 earnings expectations

S&P 500 bottom-up EPS estimates (year-over-year % change)

	May 06	Jun 06	Jul 06	Aug 06	1 Sep 06	8 Sep 06	15 Sep 06	Current
Consumer Discretionary	15%	15%	15%	9%	13%	13%	14%	9%
Consumer Staples	12%	12%	12%	13%	12%	12%	11%	12%
Energy	4%	4%	4%	21%	4%	4%	4%	20%
Financials	9%	10%	9%	8%	9%	8%	8%	8%
Health Care	11%	11%	11%	4%	10%	11%	11%	4%
Industrials	12%	12%	12%	11%	13%	13%	13%	10%
Materials	2%	4%	4%	11%	4%	4%	4%	12%
Technology	18%	18%	18%	10%	18%	18%	18%	13%
Telecom	9%	9%	9%	9%	7%	7%	7%	7%
Utilities	12%	12%	12%	15%	13%	13%	13%	8%
S&P 500	**10.8%**	**10.7%**	**10.8%**	**10.7%**	**10.2%**	**10.1%**	**10.1%**	**10.4%**

Source: Merrill Lynch, Thomson Financial

Key market movers

The week in review

Fed's favorite inflation measure bumped up slightly year-on-year but with economic growth slowing we are very likely at the peak.

The core PCE price index was the highlight this week. It rose 0.2% month-on-month in August, which lifted the year-on-year rate to 2.5% from 2.3% in July. This was an above consensus outcome but we are also likely at the peak. Over the next several quarters we expect inflation will grind lower as economic activity decelerates. The real spending increase of 0.13% was in line with our expectations and so we continue to expect real consumer spending growth of 3.5% in the third quarter. Also this week: new and existing sales showed that housing will continue to be a drag on growth in coming quarters and the durable goods report suggested our current estimate for 3Q capex looks good, but that caused us to reduce our 4Q capex forecast slightly. We continue to forecast 1.7% growth in real GDP in 3Q2006, but have taken our 4Q number up to 2% from 1.8%. The 4Q upgrade reflects a stronger consumer spending outlook, (now 3% versus 2% previously) based on the significant drop in energy prices in the past month, but a lower residential investment outlook (-15% down from -12%).

The week ahead

Employment is the highlight in the coming week. We expect a below consensus 110k job gain. Several Fed Speakers are on tap including Chairman Bernanke.

The coming week is highlighted by the employment report on Friday. We expect a below consensus 110k jobs were created in September after having averaged 128k over the three previous months. We believe the tend in payrolls has shifted lower along with economic growth to a range of between 100k and 125k, after having averaged gains of 165k during 2005. We expect the unemployment rate held steady at 4.7% and look for average hourly earnings to rise 0.3% and average weekly hours to hold at 33.8. Also key next week is ISM. A pullback is expected to 52.9 in September from 54.5 in August. This would mark the second lowest reading since July 2003. We also expect weakness in new orders, which we expect will continue to slow, placing downward pressure on overall ISM in the months to come. Look for an easing in the price index in September given the decline in energy prices.

There are a number of Fed officials scheduled to speak, including Chairman Bernanke on Wednesday speaking about savings to the Economic Club of Washington. Three other officials, including KC Fed President Hoenig, Vice Chairman Kohn and new Philly Fed President Plosser, speak on the economic outlook.

Monday, 2 October

Residential sector expected to weigh on overall construction.

Construction Spending, August—10:00 am

	Exp	Cons	Range	History
Construction Spending	-0.1%	-0.4%	-1.5-1.0%	Jul = -1.2% vs. Jun = 0.4%

Source: Merrill Lynch, Bloomberg

Construction spending is expected to fall 0.1% in August following a 1.2% decline in July. Dragging down the headline is another decline in private construction, where weakness is centered in the residential sector. All three components of residential spending are weakening (single and multi-family, and home improvements). We believe the value of residential construction fell for the fifth consecutive month, declining by 1.4% in August. Offsetting the decline in the residential sector, continued low vacancy rates are keeping spending on nonresidential structures buoyant – we expect a 1.5% increase in August.

ISM expected to fall to lowest reading since August 2005.

ISM Manufacturing, September—10:00 am

	Exp	Cons	Range	History
ISM Manufacturing	52.9	53.5	51.9-56.5	Aug = 54.5 vs. Jul = 54.7

Source: Merrill Lynch, Bloomberg

We expect ISM fell 1.6 points in September to 52.9 from 54.5 in August. This is the second lowest reading since July 2003 and well below the 55.4 average of the first half of this year. Such a decline would comport with our view that the economy's capacity utilization rate will likely peak in either 3Q or 4Q2006. When we re-weight the regional Fed manufacturing reports, from Philadelphia, New York, Richmond, Dallas and Kansas City, with ISM seasonal factors, on balance, they point to a decline of over 1.0-point in September. We look for a bifurcation in the report: new order growth slowing, but current production run-rate levels firm, supported by an aggressive work-off rate of backlogs. High run-rate levels have supported the employment component this summer, as well, but we look for that to change over the near-term. As the likely pullback in new orders should show, the pace of future activity is likely to slow, which will put downward pressures on overall ISM in the months to come – our baseline scenario. The price index likely also fell back in September, following a 5.5 point decline in August to 73.0, on declining energy prices. This is down from the 2006 high of 78.5 hit back in July.

Tuesday, 3 October

Increased incentives likely gave a boost to auto sales in September.

Total Vehicle Sales, September—All day

	Exp	Cons	Range	History
Vehicle Sales	16.7mn	16.5mn	15.9-16.8mn	Aug = 16.1mn vs. Jul 17.2mn

Source: Merrill Lynch, Bloomberg

Auto sales are expected to rise to a 16.7 million unit annual rate in September, from 16.1 million units in August. This reasonable pace of sales (inline with recent full year selling rates) is driven by slightly more aggressive incentives and a pullback in gasoline prices. In the breakdown, we expect domestic sales of 12.8 million units (up from 12.3 million in August) and imported sales of 3.9 million units (from 3.8 million in August).

Wednesday, 4 October

Sharp decline in durable orders is expected to drag down factory orders.

Factory Orders, August—10:00 am

	Exp	Cons	Range	History
Factory Orders	-0.1%	-0.1%	-0.5-0.8%	Jul = -0.6% vs. Jun = 1.5%

Source: Merrill Lynch, Bloomberg

We expect factory orders fell 0.1% in August following a 0.6% decline in July. The recently released durable goods report showed that orders unexpectedly fell 0.5% and that weakness was generally widespread. We expect nondurables will rise 0.5% in August following a 1.6% increase in July. There were likely some pricing cross-currents at play given the surge in natural gas and the decline in gasoline prices. This report warrants close attention for two reasons: it will likely support our view of 3Q2006 real capex spending growth of near 8.0% (SAAR), and, secondly, it should show a turning point in the growth rate for order backlogs – which have surged over the past 12 consecutive months. If our view is right, that new orders growth remains soft, and that backlogs have turned, then manufacturing will slow, reinforcing our view of a housing-led slowdown for the next six quarters.

ISM non-manufacturing index expected to slip 2 points in September, capping off weak quarter.

ISM Non-manufacturing, September—10:00 am

	Exp	Cons	Range	History
ISM Non-manufacturing	55.0	56.0	53.0-58.5	Aug = 57.0 vs. Jul = 54.8

Source: Merrill Lynch, Bloomberg

The ISM non-manufacturing index is expected to slip two points to 55 in September from 57 in August, capping off the weakest quarter since 2Q2003, as the residential construction sector decelerates further. The quarterly average of 55.6 compares with full year 2005 average of 60.1 and first half 2006 average of 59.6. Gauges of future activity from the August report suggest additional slowing in the pace of expansion for September: the new orders index fell to its lowest point since April 2003 and backlogs plunged to the lowest since January 2005. One likely bright spot may be the price index. With energy prices moving lower in September some further easing is expected following the 2.4 point decline in August to 72.4.

Thursday, 5 October

A rise in claims in the coming week will boost the 4-week moving average to the highest since late August.

Initial Jobless Claims, Week ending 09/30/06—8:30 am

	Exp	Cons	Range	History
Initial Claims	322k	315k	310-322k	23 September = 316k

Source: Merrill Lynch, Bloomberg

Initial jobless claims are expected to rise 6k to 322k for the week ending September 30. This would boost the four-week moving average to 317.75k from 315.5k, the highest since the last week of August. Overall, recent claims data continue to suggest that the economy is creating jobs near the trend range of about 100k to 125k. Because the economy's overall utilization rate is at a cycle high, we think that worker retention rates are high, but that new job growth is moderating towards the low end of the trend range.

Friday, 6 October

We expect a below consensus 110k payroll gain for September, reflecting general economic weakness and job losses in manufacturing, construction and retail trade.

Employment Report, September—8:30 am

	Exp	Cons	Range	History
Nonfarm Payrolls	110k	120k	100-150k	Aug = 128k vs. Jul = 121k
Unemployment Rate	4.7%	4.7%	4.6-4.9%	Aug = 4.7% vs. Jul = 4.8%
Avg Hourly Earnings	0.3%	0.3%	0.2-0.4%	Aug = 0.1% vs. Jul = 0.5%
Avg Weekly Hours	33.8	33.8	33.8-33.9	Aug = 33.8 vs. Jul = 33.9

Source: Merrill Lynch, Bloomberg

Nonfarm payrolls are expected to increase 110k in September after having averaged 128k jobs over the previous three months. This would mark the weakest gain since the +100k posted in May of this year. While our payroll forecast is 110k, we recognize downside risks emerging from the construction, manufacturing, retail and transportation/warehousing sectors. The trend in payroll gains has shifted lower along with economic activity and now likely stands in a range of +100k to +125k, following average gains of 165k jobs during 2005. Consensus is looking for an increase of 120k for September and the range is between 100k and 150k. As in Chairman Bernanke's opinion, our view of trend monthly payroll growth is 100k, with downside risks.

The median estimate of our 31 models is about 150k. However, many of these models have not quite caught up with the slowdown in the general economy, and to we see the risks shifting. For this reason, we are inclined to go with our fundamental model, which is forecasting an increase of 140k. We then subtracted about 30k jobs to reflect expected secular and structural losses in autos, construction and retail trade, which the model does not capture.

Recent data on continuing claims and the insured unemployment rate suggest that the unemployment rate held steady at 4.7% in September. The economy's run rate is currently high, supporting worker retention. That said, we are identifying a turning point in both new order and backlogs growth, which points to an erosion in the unemployment rate after year-end 2006. Average hourly earnings likely rose 0.3% and average weekly hours are expected to hold at 33.8. That said, downside risks to the workweek originate in the construction and manufacturing sectors.

We expect a rise of $8.2 billion in consumer credit outstanding.

Consumer Credit, August—3:00 pm

	Exp	Cons	Range	History
Consumer Credit	$8.2bn	$4.8bn	$2.0-10.0bn	Jul = $5.5bn vs. Jun = $14.1bn

Source: Merrill Lynch, Bloomberg

Consumer credit outstanding likely rose $8.2 billion in August following a $5.6 billion advance in July. We expect non-revolving credit rose $7.4 billion on an increase in bank consumer loans and short-term interest rates that were little changed. Revolving credit rose about $0.8 billion, the weakest since March, as suggested by the modest 0.2% increase in retail sales.

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Debt issuance

Treasury financing (billions of $)

Announcement date	Auction date	Settlement date	Issue	Size	New cash
25-Sep	27-Sep	2-Oct	2-year	20.0	(3.7)
25-Sep	28-Sep	2-Oct	5-year	14.0	14.0
28-Sep	2-Oct	5-Oct	3 & 6 month	31.0	2.0
2-Oct	3-Oct	5-Oct	1-month	8.0*	(4.0)*
5-Oct	10-Oct	12-Oct	3 & 6 month	31.0*	3.0*

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

Agency financing (billions of $)

Announcement date	Auction date	Settlement date	Issue	Size
29-Sep	2-Oct	3-Oct	FRE 1-month	1.5
29-Sep	2-Oct	3-Oct	FRE 3-month	1.5
29-Sep	3-Oct	4-Oct	FRE 6-month	1.0
2-Oct	4-Oct	5-Oct	FNM 3-month	
2-Oct	4-Oct	5-Oct	FNM 6-month	
6-Oct	10-Oct	11-Oct	FRE 1-month	
6-Oct	10-Oct	11-Oct	FRE 3-month	
6-Oct	10-Oct	11-Oct	FRE 6-month	

FRE = Freddie Mac, FNM = Fannie Mae.
Source: Bloomberg, Freddie Mac, Fannie Mae.

Policy speakers

Key speaking engagements and news events*

Monday, 2 Oct		Nothing scheduled at this point.
Tuesday, 3 Oct	9:45 pm	KC Fed President Hoenig (non-voter) speaks about the economic outlook. Q&A possible.
Wednesday, 4 Oct	3:25 am	ECB President Trichet testifies at EU Parliament hearing on “The interception of bank transfer data from the Swift system by US Secret Service”.
	12:00 pm	Fed Chairman Bernanke speaks to the economic club of Washington DC.
	12:00 pm	NY Fed President Geithner speaks about financial crises in emerging markets.
	7:30 pm	Fed Vice Chairman Kohn addresses the Money Marketeers of NYU. Q&A possible.
	NA	BoJ’s Muto speaks.
Thursday, 5 Oct	7:00 am	Bank of England announces rate decision.
	7:45 am	ECB announces rate decision.
	10:40 am	Chicago Fed President Moskow (non-voter) makes welcoming remarks at conference.
	12:00 pm	Philly Fed President Plosser (non-voter) speaks about the economy and policy. Q&A expected.
	NA	BoJ’s Muto speaks.
Friday, 6 Oct	9:30 am	Dallas Fed President Fisher (non-voter) makes welcoming remarks at conference.
	2:00 pm	Bond Market Association recommends early close ahead of Columbus Day.

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

Historical economic data

	Sep.2006	Aug.2006	Jul.2006	Jun.2006	May.2006	Apr.2006	Mar.2006	Feb.2006	Jan.2006	Dec.2005	Nov.2005	Oct.2005	Sep.2005
Payroll Employment (000)		128	121	134	100	112	175	200	154	145	354	37	48
% Change, Year Ago		1.3	1.3	1.4	1.4	1.4	1.5	1.5	1.6	1.5	1.5	1.3	1.6
Unemployment Rate (%)		4.7	4.8	4.6	4.6	4.7	4.7	4.8	4.7	4.9	5.0	4.9	5.1
Avg. Hourly Earnings (% Chg.)		0.1	0.5	0.4	0.1	0.6	0.2	0.4	0.3	0.4	0.0	0.6	0.2
% Change, Year Ago		3.9	3.9	3.9	3.7	3.8	3.5	3.5	3.3	3.2	3.0	3.1	2.7
PPI (% Chg.)		0.1	0.1	0.5	0.1	0.9	0.4	-1.2	0.3	0.7	-0.5	0.8	1.4
% Change, Year Ago		3.6	4.1	4.8	4.3	4.0	3.6	3.9	5.7	5.5	4.3	5.8	6.6
CPI (% Chg.)		0.2	0.4	0.2	0.4	0.6	0.4	0.1	0.7	-0.1	-0.7	0.3	1.2
% Change, Year Ago		3.8	4.1	4.3	4.2	3.5	3.4	3.6	4.0	3.4	3.5	4.3	4.7
ISM Diffusion Index (%)		54.5	54.7	53.8	54.4	57.3	55.2	56.7	54.8	55.6	57.3	58.1	58.0
Industrial Production (% Chg.)		-0.2	0.4	1.1	0.1	0.8	0.5	0.4	-0.1	0.9	0.9	1.1	-1.3
% Change, Year Ago		4.7	5.2	4.7	4.5	4.6	3.6	3.1	3.2	3.5	3.2	2.5	2.0
Capacity Utilization, %		82.4	82.7	82.5	81.7	81.8	81.3	81.1	80.9	81.1	80.5	79.9	79.1
Durable Goods Orders (% Chg.)		-0.5	-2.7	3.3	0.3	-4.7	6.0	3.6	-7.6	0.9	4.4	3.2	-1.6
% Change, Year Ago		3.6	10.3	6.4	5.9	6.8	19.2	8.7	6.9	14.2	13.8	12.2	7.8
Factory Orders, (% Chg.)			-0.6	1.5	1.0	-2.0	4.0	0.1	-2.7	0.6	2.5	1.6	-1.1
% Change, Year Ago			8.9	6.4	7.3	5.4	12.2	6.9	7.6	10.3	9.6	8.6	8.0
Retail Sales (% Chg.)		0.2	1.4	-0.5	0.2	0.7	0.7	-0.8	3.0	0.4	0.6	0.3	0.4
% Change, Year Ago		6.8	4.0	5.6	9.4	5.8	7.8	7.4	9.6	5.5	6.8	6.1	7.2
Personal Consumption (% Chg.)		0.1	0.8	0.4	0.7	0.6	0.5	0.5	0.8	0.4	0.1	0.3	0.6
% Change, Year Ago		6.1	5.8	6.3	6.9	6.1	6.5	6.6	6.6	5.9	6.1	6.6	7.0
Personal Income (% Chg.)		0.3	0.5	0.6	0.4	0.7	0.5	0.5	1.3	0.5	0.2	0.5	2.9
% Change, Year Ago		9.4	7.0	7.3	7.3	7.2	7.0	6.7	6.4	2.6	5.6	5.7	6.2
New Home Sales (SAAR, mn.)		1.05	1.01	1.09	1.10	1.12	1.12	1.04	1.17	1.26	1.24	1.35	1.25
% Change, Year Ago		-17.4	-26.2	-14.2	-16.0	-11.7	-15.3	-17.1	-1.7	1.4	4.8	3.1	3.2
Existing home Sales (SAAR, mn)		6.30	6.33	6.60	6.71	6.75	6.90	6.90	6.57	6.75	7.03	7.05	7.20
% Change, Year Ago		-12.6	-11.2	-9.2	-6.0	-5.9	-1.0	-0.4	-5.1	-1.5	0.7	3.4	7.8
Housing Starts (SAAR, mn)		1.67	1.77	1.83	1.95	1.83	1.97	2.13	2.27	2.00	2.13	2.05	2.16
% Change, Year Ago		-19.8	-14.4	-11.8	-4.0	-11.9	6.3	-3.7	6.0	-2.0	19.6	-1.3	13.3
International Trade (Bils $)			-68.0	-64.8	-65.4	-63.6	-62.1	-62.7	-66.3	-64.2	-64.0	-66.6	-65.0
Consumer Conf. Board	104.5	100.2	107.0	105.4	104.7	109.8	107.5	102.7	106.8	103.8	98.3	85.2	87.5
Consumer Conf.-U. of Mich.	85.4	82.0	84.7	84.9	79.1	87.4	88.9	86.7	91.2	91.5	81.6	74.2	76.9

	Q2.2006	Q1.2006	Q4.2005	Q3.2005	Q2.2005	Q1.2005	Q4.2004	Q3.2004	Q2.2004	Q1.2004	Q4.2003	Q3.2003	Q2.2003
Real GDP, Chain Weighted, SAAR	2.6	5.6	1.8	4.2	3.3	3.4	2.6	3.1	4.0	3.8	2.7	7.5	3.5
% Change, Year Ago	3.5	3.7	3.1	3.4	3.1	3.3	3.4	3.4	4.5	4.3	3.7	3.1	1.8
Chain-Weighted Price Index, SAAR	3.3	3.3	3.3	3.3	2.5	3.4	3.2	2.1	3.7	3.8	2.2	2.1	1.3
% Change, Year Ago	3.3	3.1	3.1	3.1	2.8	3.1	3.2	2.9	2.9	2.3	2.2	2.2	2.0
Nominal GDP, SAAR	5.9	9.0	5.1	7.6	5.8	7.0	5.9	5.3	7.9	7.8	4.9	9.7	4.8
% Change, Year Ago	6.9	6.9	6.4	6.6	6.0	6.5	6.7	6.4	7.5	6.8	5.9	5.3	3.9
Employment Cost Index, %	0.9	0.6	0.8	0.8	0.7	0.9	0.7	0.9	1.0	1.1	0.7	1.0	0.9
% Change, Year Ago	3.0	2.8	3.1	3.0	3.2	3.6	3.7	3.8	3.8	3.7	3.9	3.9	3.7
Productivity Nonfarm, SAAR	1.6	4.3	-0.1	4.4	2.3	3.6	0.4	0.2	5.1	1.9	-0.6	10.3	6.0
% Change, Year Ago	2.5	2.7	2.5	2.7	1.6	2.3	1.9	1.6	4.1	4.3	4.6	4.8	3.3
Unit Labor Costs, Nonfarm, SAAR	4.9	9.0	3.0	3.3	-0.7	0.7	5.1	4.3	-1.4	-0.5	3.8	-4.4	0.8
% Change, Year Ago	5.0	3.6	1.6	2.1	2.3	2.2	1.8	1.5	-0.7	-0.1	0.5	-0.4	0.2

Source: Haver Analytics

Economic forecast summary

(as of 22 September 2006)

Real Economic Activity, % SAAR	4Q05	1Q06	2Q06	3Q06	4Q06	1Q07	2Q07	3Q07	4Q07	2005	2006	2007
Real GDP	1.8	5.6	2.6	1.7	2.0	1.7	1.5	2.0	2.5	3.2	3.3	1.8
% Change, Year Ago	3.1	3.7	3.5	2.9	2.9	2.0	1.7	1.8	1.9			
Final Sales	-0.3	5.6	2.1	1.9	2.6	1.8	1.2	2.2	2.7	3.5	3.0	2.0
Domestic Demand	0.7	5.4	1.6	2.4	2.1	1.1	0.4	1.4	2.0	3.6	3.0	1.4
Consumer Spending	0.8	4.8	2.6	3.5	3.0	1.2	0.5	1.7	2.0	3.5	3.2	1.9
Durables	-12.3	19.8	-0.1	6.0	1.0	-0.5	-2.5	-1.1	0.1	5.5	4.8	0.2
Nondurables	3.9	5.9	1.4	3.8	5.2	1.0	1.0	2.3	2.5	4.5	3.7	1.7
Services	2.0	1.6	3.7	2.8	2.3	1.5	0.7	1.9	2.0	2.6	2.5	1.9
Residential Investment	-1.0	-0.3	-11.1	-19.0	-15.0	-10.3	-13.0	-12.3	-7.5	8.6	-4.0	-13.0
Nonresidential Investment	5.2	13.7	4.4	8.8	5.6	5.2	4.8	5.7	6.3	6.8	7.7	5.7
Structures	12.0	8.8	20.3	12.5	5.8	5.5	5.0	5.5	6.0	1.1	8.9	7.2
Equipment and Software	2.8	15.6	-1.4	8.0	6.0	5.3	5.0	6.0	6.7	8.9	7.2	5.5
Government	-1.1	4.9	0.8	1.7	2.0	2.2	2.0	2.2	2.5	0.9	2.0	2.0
Exports	9.6	14.0	6.2	5.0	8.3	6.8	6.3	6.0	5.7	6.8	8.5	6.6
Imports	13.2	9.1	1.4	7.0	3.2	1.0	-0.5	-0.4	0.3	6.1	6.4	1.6
Net Exports (billions of $)	-636.6	-636.6	-624.2	-641.1	-630.4	-612.9	-589.2	-566.7	-548.4	-619.2	-633.1	-579.3
Inventory Accumulation (billions of $)	43.5	41.2	53.7	46.8	32.2	29.0	35.3	27.3	21.4	19.7	43.5	28.3
Nominal GDP (billions of $)	12731	13008	13197	13355	13520	13665	13793	13927	14071	12456	13270	13864
% SAAR	5.1	9.0	5.9	4.9	5.0	4.4	3.8	3.9	4.2	6.3	6.5	4.5
% Change, Year Ago	6.4	6.9	6.9	6.2	5.9	4.5	3.7	3.0	2.5			
Key Indicators												
Industrial Production, FRB, % SAAR	5.2	5.0	6.8	4.3	1.0	0.1	-0.1	2.6	2.6	3.2	4.4	1.6
Capacity Utilization (percent)	80.5	81.1	82.0	82.5	82.3	81.9	81.5	81.6	81.7	80.1	82.0	81.7
Civilian Unemployment Rate (%)	4.9	4.7	4.6	4.8	5.0	5.2	5.5	5.7	6.0	5.06	4.8	5.6
Productivity, % SAAR	-0.1	4.3	1.2	0.9	1.7	2.3	2.4	2.7	3.6	2.3	2.2	2.1
% Change, Year Ago	2.5	2.7	2.4	1.6	2.0	1.5	1.8	2.3	2.7			
Real Disp. Personal Inc. % SAAR	5.5	4.6	1.7	2.5	2.8	2.7	1.6	1.8	1.3	1.2	2.9	2.2
% Change, Year Ago	0.3	2.5	2.8	3.6	2.9	2.4	2.4	2.2	1.8			
Personal Savings Rate (%)	-0.3	-0.3	-0.6	-0.7	-0.5	-0.1	0.2	0.2	0.0	-0.4	-0.5	0.0
Light Vehicle Sales (Millions SAAR)	16.0	16.9	16.3	16.6	15.7	15.0	14.8	15.5	16.0	17.0	16.4	15.3
Housing Starts (Thousands SAAR)	2060	2123	1873	1747	1680	1610	1500	1450	1420	2073	1856	1495
Current Account (billions of $)	-223.1	-213.2	-218.4	-208.8	-208.5	-205.6	-200.7	-195.3	-190.2	-791.5	-848.9	-791.8
U.S. Budget Balance (billions of $ FY)										-319	-275	-335
Corporate Profits and Earnings												
Operating Corp. Profits After Tax (Bil $)	968.9	1112.1	1115.7	1106.5	1094.7	1089.9	1092.3	1117.1	1156.2	931.4	1107.2	1113.9
% Change, Year Ago	5.7	21.0	17.4	24.7	13.0	-2.0	-2.1	1.0	5.6	5.5	18.9	0.6
S&P 500 Earnings Per Share ($)*	17.3	19.7	20.1	19.2	18.4	20.4	20.5	20.1	19.0	69.93	77.5	80.0
% Change, Year Ago	24.1	16.2	10.1	10.6	6.6	3.6	1.8	4.5	3.0	19.4	10.8	3.2
S&P 500 Operating EPS ($)	20.2	20.8	21.9	20.5	21.1	21.0	22.0	21.0	22.0	76.45	84.3	86.0
% Change, Year Ago	12.5	15.3	13.0	9.1	4.5	1.2	0.3	2.2	4.3	13.0	10.3	2.0
Inflation												
GDP Price Index, % SAAR	3.3	3.3	3.3	3.0	2.4	2.2	1.8	1.6	1.4	3.0	3.1	2.2
% Change, Year Ago	3.1	3.1	3.3	3.2	3.0	2.7	2.3	2.0	1.7			
CPI, Consumer Prices, % SAAR	3.2	2.2	5.0	2.9	0.4	1.7	1.3	1.5	1.9	3.4	3.4	1.7
% Change, Year Ago	3.7	3.7	4.0	3.3	2.6	2.5	1.6	1.2	1.6			
CPI Ex Food & Energy, % SAAR	2.4	2.4	3.5	2.9	2.3	1.8	1.7	1.7	1.6	2.1	2.5	2.1
% Change, Year Ago	2.1	2.1	2.5	2.8	2.8	2.6	2.2	1.9	1.7			

Shaded regions represent Merrill Lynch forecasts.
Source: Merrill Lynch

Interest rate forecast summary

(% EOP, as of 25 August 2006)	1Q06	2Q06	3Q06	4Q06	1Q07	2Q07	3Q07	4Q07	2005	2006	2007
Fed Funds	4.75	5.25	5.25	5.25	4.75	4.50	4.25	4.00	4.25	5.25	4.00
3-Month T-Bill	4.63	5.01	4.95	4.80	4.65	4.20	3.95	3.70	4.10	4.80	3.70
3-Month LIBOR	4.99	5.48	5.30	5.30	5.15	4.35	4.05	3.80	4.54	5.30	3.80
2-Year T-Note	4.82	5.16	4.90	4.70	4.45	4.00	3.80	3.60	4.40	4.70	3.60
5-Year T-Note	4.81	5.10	4.80	4.60	4.35	4.30	4.15	4.00	4.35	4.60	4.00
10-Year T-Note	4.85	5.15	4.85	4.70	4.45	4.45	4.35	4.25	4.39	4.70	4.25
30-Year T-Bond	4.90	5.19	4.95	4.85	4.60	4.60	4.55	4.50	4.54	4.85	4.50

Shaded regions represent Merrill Lynch forecast.
Source: Merrill Lynch

FX rate forecast summary

(EOP, as of 6 September 2006)		Spot	Dec 06	Mar 07	Jun 07	Sep 07	Dec 07
Euroland Euro	US$/Euro	1.26	1.34	1.26	1.26	1.27	1.30
Japanese Yen	¥/US$	118	107	110	103	100	96
	¥/Euro	149	143	139	130	127	125
British Pound	US$/£	1.86	1.94	1.77	1.75	1.74	1.75
	£/Euro	0.54	0.69	0.71	0.72	0.73	0.74
Swiss Franc	SF/US$	1.26	1.16	1.21	1.19	1.19	1.19
	SF/Euro	1.59	1.55	1.52	1.50	1.51	1.53
Canadian $	C$/US$	1.12	1.09	1.16	1.15	1.13	1.11
Australian $	US$/A$	0.74	0.76	0.71	0.67	0.68	0.70
Chinese Renminbi	RMB/US$	7.90	7.88	7.87	7.62	7.52	7.34
Hong Kong $	HK$/US$	7.79	7.75	7.75	7.75	7.75	7.75
Korean Won	KRW/US$	946	915	960	970	950	915
Singapore $	SGD/US$	1.58	1.56	1.57	1.53	1.51	1.47
Taiwan $	TWD/US$	33.09	32.00	33.00	32.80	32.10	31.20
Brazilian Real	BRL/US$	2.18	2.30	2.45	2.55	2.50	2.45
Mexican Peso	MXN/US$	10.99	10.40	10.50	10.60	10.80	10.90

Spot prices are as of Thursday evening
Source: Merrill Lynch FX Strategy Team., Bloomberg

Rolling calendar of business indicators

Monday	Tuesday	Wednesday	Thursday	Friday
2 October **10:00 am: Construction Spending** Jun .... 0.4% Jul .... -1.2% Aug .... -0.1%* **10:00 am: ISM Manufacturing** Jul .... 54.7 Aug .... 54.5 Sep .... 52.9* **10:00 am: Pending Home Sales** —Aug Jun .... 0.0% Jul .... -7.0%	**3 October** **ABC/Washington Post Consumer Comfort Survey** —(week ending 10/02/06) **LJR Redbook** —(week ending 10/01/06) **All Day: Vehicle Sales (SAAR)** Jul .... 17.2mn Aug .... 16.1mn Sep 16.7mn*	**4 October** **MBA Mortgage Applications** —(week ending 09/29/06) **8:15 am: ADP Employment Change** —Sep Jul .... 99k Aug .... 107k **10:00 am: Factory Orders** Jun .... 1.5% Jul .... -0.6% Aug .... 0.1%* **10:00 am: ISM Non-manufacturing** Jul .... 54.8 Aug .... 57.0 Sep 55.0*	**5 October** **8:30 am: Initial Jobless Claims** —(week ending 09/30/06)—322k*	**6 October** **8:30 am: Nonfarm Payrolls** Jul .... 121k Aug .... 128k Sep .... 110k* **8:30 am: Unemployment Rate** Jul .... 4.8% Aug .... 4.7% Sep .... 4.7%* **8:30 am: Avg Hourly Earnings** Jul .... 0.5% Aug .... 0.1% Sep .... 0.3%* **8:30 am: Avg Weekly Hours** Jul .... 33.9 Aug .... 33.8 Sep .... 33.8* **3:00 pm: Consumer Credit** Jun .... $14.1bn Jul .... $5.5bn Aug $8.2bn*
9 October **Columbus Day Holiday**	**10 October** **ABC/Washington Post Consumer Comfort Survey** —(week ending 10/09/06) **LJR Redbook** —(week ending 10/08/06) **10:00 am: Wholesale Inventories** Jun .... 0.8% Jul .... 0.8% Aug .... 0.7%* **2:00 pm: Monthly Budget Statement** Sep 2005 .... $35.7bn Sep 2006 .... $40.0bn* **10-year TIPS (R) note announcement**—$8bn*	**11 October** **MBA Mortgage Applications** —(week ending 10/06/06) **2:00 pm: Minutes from the 20 September FOMC Meeting**	**12 October** **8:30 am: Initial Jobless Claims** —(week ending 10/07/06) **8:30 am: Trade Balance** Jun .... -$64.8bn Jul .... -$68.0bn Aug .... -$68.4bn* **2:00 pm: Fed Beige Book** **10-year TIPS (R) note auction** —$8bn*	**13 October** **8:30 am: Import Price Index** Jul .... 1.0% Aug .... 0.8% Sep .... -1.0%* **8:30 am: Retail Sales** Jul .... 1.4% Aug .... 0.2% Sep .... -0.1%* **8:30 am: Retail Sales Ex Autos** Jul .... 0.6% Aug .... 0.2% Sep .... -0.6%* **9:45 am: University of Michigan Consumer Sentiment** Aug .... 82.0 Sep .... 85.4 Oct(P) .... 87.0* **10:00 am: Business Inventories** Jun .... 0.9% Jul .... 0.6% Aug 0.5%*
16 October **8:30 am: NY Empire Mfg Index** —Oct Aug .... 11.0 Sep 13.8	**17 October** **ABC/Washington Post Consumer Comfort Survey** —(week ending 10/15/06) **LJR Redbook** —(week ending 10/14/06) **8:30 am: PPI**—Sep Jul .... 0.1% Aug .... 0.1% **8:30 am: Core PPI**—Sep Jul .... -0.3% Aug .... -0.4% **9:00 am: Net Foreign Purchases of US Securities**—Aug Jun .... $75.1bn Jul .... $32.9bn **9:15 am: Industrial Production** —Sep Jul .... 0.4% Aug .... -0.1% **9:15 am: Capacity Utilization**—Sep Jul .... 82.7% Aug .... 82.4% **1:00 pm: NAHB Housing Market Index**—Oct Aug .... 33 Sep 30	**18 October** **MBA Mortgage Applications** —(week ending 10/13/06) **8:30 am: CPI**—Sep Jul .... 0.4% Aug .... 0.2% **8:30 am: Core CPI**—Sep Jul .... 0.2% Aug .... 0.2% **8:30 am: CPI Level NSA**—Sep Jul .... 203.5 Aug .... 203.9 **8:30 am: Housing Starts**—Sep Jul .... 1.77mn Aug .... 1.67mn **8:30 am: Building Permits**—Sep Jul .... 1.76mn Aug 1.73mn	**19 October** **8:30 am: Initial Jobless Claims** —(week ending 10/14/06) **10:00 am: Leading Indicators**—Sep Jul .... -0.2% Aug .... -0.2% **12:00 pm: Philly Fed Index**—Oct Aug .... 18.5 Sep .... -0.4 **5-year TIPS (R) note announcement**—$8bn* **2-year note announcement** —$20bn* **5-year note announcement** —$14bn*	**20 October**

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

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