

# OUTLOOK 2009

## What's Next for the Markets & the Economy

**A panel discussion, moderated by Dan Sontag, head of  
Merrill Lynch Global Wealth Management**

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### TRANSCRIPT

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# OUTLOOK 2009

## What's Next for the Markets & the Economy

### CHAPTER 1: THE MARKETS & THE ECONOMY

**DAN SONTAG:** Well, good evening, everyone, and welcome. I'm Dan Sontag, head of the Merrill Lynch Global Wealth Management. I'd like to thank all of you for joining us tonight.

2009 will almost certainly turn out to be a pivotal year in the financial history books. Politically, the Obama administration has put solving the financial crisis at the top of its priority list, and around the world we continue to deal head-on with one of the toughest economic climates in memory. In this kind of market environment, it's easy to understand why so many investors are asking: What can I expect next, and what should I do now?

Tonight, our knowledgeable panel of experts will try to answer these questions, giving their perspectives on where the markets and the economy are headed. They will also recommend strategies you and your Financial Advisor can use to weather the current market and position your portfolio for better times to come. I encourage you to look at the many useful articles, research reports and related videos that we've gathered for you on the Outlook 2009 Web site. Similar to previous years, Outlook 2009 is part of Merrill Lynch's continuing commitment to provide you with the world-class research and strategies you need to help make your financial goals. To get the most from the information you'll hear tonight, please use this program to begin a conversation with your Financial Advisor. I'm confident that working together, you'll be able to prepare for whatever happens in 2009.

So, why don't we get started? Well, it gives me great pleasure to introduce our panelists. First, we have Rich Bernstein, Chief Investment Strategist for Banc of America Securities-Merrill Lynch Research, and David Rosenberg, Chief North American Economist for Merrill Lynch. We also welcome Michael Hartnett, Chief Global Emerging Markets Equity Strategist for Banc of America Securities-Merrill Lynch Research. And joining us from AllianceBernstein is Cathie Wood, Chief Investment Officer, Strategic Research and Global Thematic Growth.

So, Rich and Dave, why don't we get started with you. I guess the logical place to start is the big economic picture. So many of our clients want to know where are the markets--where does the economy stand right now--and what can they expect this year?

**DAVID ROSENBERG:** We actually have, Dan, an in-house barometer that we use, a compass, to determine how far into this recession, how deep it is that we're in right now, and it's showing that we're 40% into it. So, it started in December 2007; our work is showing that this recession doesn't end until probably the first quarter of 2010 at the earliest, and so, we're in a—obviously, the deepest recession in the post-World War II period.

It's a very tricky recession, because it's not really about manufacturing inventories. You know, the other nine recessions of the post-World War II period were about inventory cycles. It could be autos one cycle and heavy machinery and steel in another cycle, and it could be ... 2001 and 2002 was about

technology. It was about manufacturing inventories. This is—it's an asset deflation. So it's asset deflation and a credit contraction, so the things that you would normally look at to try and determine when we're going to get to the next sustainable bull market or the next sustainable economic expansion--the old metrics that we've used since 1945--aren't going to work this time around.

It's really going to be once we get housing inventories into much better shape-- when we can equilibrate the supply-and-demand for housing, put a floor under home prices--and my expectation is that that will happen in 2010, a little premature to talk about it happening in 2009. Once we stabilize home prices, the domino effect will head the other way, and we'll have a much more sustainable expansion, and I expect that's going to be more a 2010 story than a 2009 story.

**DAN SONTAG:** Rich, with what Dave said, what's our view in 2009 as it relates to the markets in general.

**RICH BERNSTEIN:** Well, you know Dan, I think it's pretty safe to make one forecast, and that is that 2009 is likely to be better than 2008 in the financial markets. I mean 2008 was such a miserable year across the board in so many markets, I think we can probably guess this is going to be a slightly better year. I think, whereas a year ago or two years ago, if you had asked me that question, I would have said the glass is definitively half empty. In fact, we probably would have said it was completely empty.

Now, I think you can look at the financial markets and kind of make an argument for half empty and half full. I think you can look at it a little both ways. The fundamentals that Dave talked about, I think, are still very poor. I still think that people are underestimating the effect of the credit bubble, but now you have to begin to say how much of that is in the marketplace, and should we start looking at various different asset classes other than cash, which is where a lot of people have been. I think the answer is slowly but surely becoming yes.

Now, I'm not saying one should go out and be tremendously bullish yet. I don't think our work supports that at all. But again, the markets are down so substantially, you're really beginning to see some signs of life, if you will. I still think caution and quality are still very important words, but it's not where we were a year, a year and a half ago.

**DAN SONTAG:** Now Dave talked about one of the—I would describe it as a signpost for recovery--is the housing market has to stabilize. Are there other signposts that we look for for economic recovery?

**RICH BERNSTEIN:** I'll just say one thing very quickly. You know, in what Dave mentioned about housing, I think one of the critical aspects here is employment. If we don't—if we as a country don't stabilize household cash flow--it really doesn't make any difference what we're going to do for the financial sector, because you know the U.S. consumer is such a large part of the global economy.

**DAVID ROSENBERG:** We're talking about employment, but you know, there are secular trends right now. What is happening on the household balance sheet, this credit contraction and the asset deflation is going to have a lag—I think a multi-year impact--that will transcend the recession and have an impact on what the shape of the recovery is going to be like, because people's attitudes towards credit, towards home ownership and towards discretionary spending have been altered, and I actually think this is an intergenerational change. This isn't something that's just cyclical, and it's something that we have to be braced for.

**CATHIE WOOD:** We agree with you in terms of the structural problems this economy faces, absolutely, and you've been right-on in terms of the focus you've placed on it. We believe, however, that in the past year, with the credit market shutting down around the world, that there has been such a severe reaction--corporations collapsing inventories, supply chains collapsing around the world, and everybody waiting around to see when the banks might lend again--that everybody's watching for the bottom.

Now housing is the most severe example, but we're seeing inventories collapsing in all kinds of industries. If we got even housing starts moving up from 550,000 to 600,000 that would be a big surprise. Everyone's expecting continuation of the deterioration, and we think we're seeing signs where, again--market clearing--that perhaps the inventory draw-down has gone too far.

**DAN SONTAG:** Michael, I'm interested, stocks and bonds overseas, that's your expertise. What do you think for 2009?

**MICHAEL HARTNETT:** Well, I think the, you know, what we learned--or re-learned-- in 2008 was that overseas equity markets will move very much in line with U.S. equity markets. The U.S. equity market was an outperforming equity market last year, having been an underperforming equity market for many years before that. So looking into 2009, I think Rich has made the point that the U.S. market has a fairly defensive market.

It should hold up well vis a vis its international peers. I think if, as Cathie points out, you get some sort of recovery through the year, at some point you are going to get a return of interest towards emerging markets and, maybe, Europe. If that's not the case, and we have to wait until next year for signs of recovery, then the only market that will likely perform in line with U.S. is going to be Japan.

**RICH BERNSTEIN:** I don't think people realize that the credit bubble contributed so much to global performance of markets, and if you think about—we go back to 2005 and 2006--it was something like 90% of the world's markets outperformed the United States. Last year it was only 20%. So, you know, are we going back to 90%? I think we'd all probably agree we're not going back to 90%. You're not going to get that kind of credit creation around the world. But could we go back to the norm, which is roughly 40 or 50%? Yeah, we probably could.

**CATHIE WOOD:** As we've studied how different administrations around the world have responded to the crisis, we're looking at China, and China's really doing all the right things in terms of cutting taxes, cutting regulations. They're sort of doing something similar to Japan in the '70s, when Japan was the only country that didn't allow inflation to get out of control. China might be using this moment, this moment of crisis, as a way of doing the right things to really emerge in a much bigger way.

**MICHAEL HARTNETT:** The other thing—I mean we all say we like the Chinese market. I mean it's one of our favorite emerging markets, sort of non-U.S. market. The other thing I'd tell you is I think there are lots of opportunities in fixed income overseas.

I think—I was talking to my Financial Advisor the other day, and I learned that it now takes me 97 years to double my money in my money market fund, because interest rates are so low, but that's not the case in many markets outside of the U.S. You can pick up an 8% yield in Brazilian dollar-denominated bond, and a 12% yield in a local currency bond in Brazil. So I think there are good fixed income opportunities overseas, and there are now, of course, ETF instruments by which you can play those in the U.S.

## CHAPTER 2: WILL FISCAL STIMULUS WORK?

**DAN SONTAG:** Why don't we turn to a different topic, which is the new administration, what's going on in the United States and Washington, D.C. and the stimulus package, and what's it all going to mean? And David, I'm going to turn to you first. There's a lot going on in Washington. A lot has been past, and a lot has been proposed. What's your view?

**DAVID ROSENBERG:** Look, the fiscal stimulus package is big. Eight hundred and twenty-five billion dollars over two years, and when you look at the overall multiplier impacts on the taxes, which are small, and you look at the infrastructure spending, you know, I think that we have to get a grip on reality that infrastructure spending ... you don't use it to end recessions.

There's never been an infrastructure package that had a discernible impact on the contours of the business cycle. It probably hopefully will increase productivity growth. The education spending is worthwhile, digitizing medical records, I think we're the last country to start doing that. I think that's all welcome.

I think people that are using the fiscal stimulus package as a reason to think that this recession is going to end early, I think, are extremely optimistic. The fiscal package is enough to stop the unemployment rate from going above 10% this year. It's not enough to stop the unemployment rate from going to 9%, so it's going to cushion the blow. It's going to cushion the blow. It is not going to end the recession in GDP or profits, and ultimately, that's what investors pay for--profits.

**DAN SONTAG:** Let's talk about what we think that the sector benefits are--from what Dave just talked about--from the standpoint of how do investors employ assets into the proper sectors, against the backdrop of what he talked about.

**RICH BERNSTEIN:** I think there's two. One, people have sort of thought of--but they may not have thought of the details of it--and the other, I don't think people have thought of at all. The first one is infrastructure. But I don't think what people have thought of in investing in infrastructure themes is that a lot of the major engineering and construction-type companies are also very exposed to the commodity sector, and commodity prices are down dramatically. Commodity capital expenditures are down dramatically, and so for those companies, the infrastructure projects may only be a balance to what they're losing in some of these other sectors.

However, our Infrastructure Analyst, Andrew Obin, has tried to point out that there are smaller, mid-cap—small and mid-cap infrastructure companies--that are more dedicated to highway and water and are not exposed to the energy and commodities sectors, and his argument is *those* are the companies you really want to look at, are those small and mid-cap infrastructure-related companies, not the big ones that we could all name because they're going to have problems.

The second theme I'll give you is one that I don't think many people would attach to the Democrats, and that's defense. Now this may not be the most socially responsible theme I can give you. I understand that, but that's something for each individual to decide if it's appropriate for them or not. But I will say that defense stocks, historically, have performed better under Democrats than under Republicans. Nobody believes this, but it's absolutely true. And defense spending, despite the war, defense spending as a percentage of GDP has been remarkably low in this cycle. Dave's done some work on that. So, the odds are I think, if you think about the politics that are involved here, you think

about the historical precedent, you think about where we are in this relationship, the multiplier effects through the economy--meaning that if you spend on defense it actually ripples through the economy--I think defense stocks are actually going to perform better than people think under a Democratic administration.

**DAN SONTAG:** Cathie, your view?

**CATHIE WOOD:** We would agree with Rich on the engineering and construction names. We've been very focused on the utility space. Obviously, nuclear is going to be very, very big, and there are a lot of very interesting mid-cap EMC names. We have thematically—we run thematic portfolios--we have focused for some time on many of the measures that the Obama administration is proposing. A lot of them climate-change related, which is cross sector, so there are industrial names, there are energy names, utility names, technology names. And then health care, health care IT and R&D, very focused on that, and education as well, so we're participating in each of those.

**DAN SONTAG:** Michael, around—the view from around the world on the U.S. government stimulus?

**MICHAEL HARTNETT:** Number one is infrastructure overseas, because it really gives the green light for a lot of other governments, such as in China and elsewhere, to stimulate their economy via infrastructure, and that's what they're doing. I think, secondly, is what else is the U.S. government doing. I mean it's creating a lot of sort of—trying to create a lot of monetary stimulus with very low interest rates. And again, I come back to some fixed income opportunities overseas, because, you think about it, you know the U.S. is going to end up with very low rates, so is the U.K., so is Japan. So, I think in some of these emerging markets, the high level of interest rates can be quite attractive at this particular moment.

## **CHAPTER 3: WHAT'S AN INVESTOR TO DO?**

**DAN SONTAG:** A lot of clients that I talk to ask me: Is it safe to be in the stock market, and should I be more risk-averse here?

**RICH BERNSTEIN:** I think one thing we have to remember is that one of the keys to long-term outperformance and long-term building wealth is what we all call diversification. And my argument has been, and continues to be, that about the worst way to—or the best way to ruin a sound financial plan is to allow that financial plan to deviate by recent events.

In other words, you're reacting to what's happened. I don't think that's ever a very good strategy. I don't think history shows that's ever been a good strategy. So I think what we want to do is sit down, look at that financial plan first of all and see where we sit now, given the performance of the various markets--where do we sit relative to that financial plan--and decide, "You know, two years ago, we thought it was a pretty sound plan."

Now, do we only think it's not a sound plan because of the performance of the markets? And I think there may be some reasons that, if we're looking at five years, 10 years, 15 years, 20 years, that we may want to rebalance back to what we thought was the proper asset allocation. That might actually mean increasing your equity weight a little bit ... surprise surprise. And I think, regardless of whether you're looking at stocks or bonds or countries, however you want to structure this portfolio, I think quality should be a very key theme.

**DAN SONTAG:** I want to have a conversation with all of you, but I also want to have a conversation with our clients that are watching, and somebody just pulled a question in, Rich, against what you said, and I think it's a good question, so I want to read it and ask that you react to it. "You advise investing in quality. How can I determine quality when almost all the stable blue chips have fallen dramatically in value in the last year?"

**RICH BERNSTEIN:** What you really need to look for is the stability of cash flow and the stability of earnings. That is the key here. If you do not think that we are going to see a significant upturn in the economy--we will not see the so-called V-shaped recovery in the economy--the stability of earnings is going to be very, very important. And so what does that mean, from my point of view?

I think it is a function of the necessity of the product. Discretionary items are not really going to be high-quality companies anymore, because, as we know, the household sector, as Dave described, is under pressure, and so companies that might have done very well, as the household sector was expanding, are probably not going to do very well now. So we have to say: what are the companies that are going to have stable cash flows in this new environment that we are actually, I would argue, still entering?

**MICHAEL HARTNETT:** It goes back to my sort of Japanese experience. I think that in Japan, once the market had found a level from which it created a floor for the market for a sustained period of time, and once the correlation dropped, you really started to get the market differentiating between the men and the boys, so to speak. And some stocks did extraordinarily well: Toyota being a perfect example, a stock that quadrupled between 1992 and the end of the decade. And other stocks, like Nissan, halved over that period.

Why? Toyota was a great stock, a great management, a great brand, as Rich says, a wonderful balance sheet, and Nissan didn't have any of those qualities. So, we have this theme, which is sort of best of breed. We think that whether it's in the U.S. or other equity markets, if you can find the right management product balance sheet, you will do very well over the next couple of years, but it really will kick in and your client will reap the benefits on it only once the market finds a floor and that correlation drops, I think.

**DAN SONTAG:** When I talk to clients, many of them are retired. They had balances in 401(k) and retirement accounts. They were deriving income from those accounts that they thought was relatively stable, secure income ... 2008 happens. Both the balances and the retirement accounts, as well as the income, has been coming to—what do you say to somebody about how do they get income here in a market where there's as much uncertainty as there is?

**RICH BERNSTEIN:** One thing I will say is people always think about diversification. We talk about diversification a lot in terms of capital appreciation within the portfolio, and rarely do we actually talk about diversifying streams of income in the portfolio. So I mean, already tonight you've heard several different ways. You know, we've talked about quality stocks that provide income. We've talked about non-U.S. bonds that provide income. You know, there's lots of different ways for investors to try and get a diversified portfolio of streams of income. Anybody who is upset with what's happened to their income stream in the last couple years should realize that you have to diversify for income as well as you do for capital appreciation.

**CATHIE WOOD:** And if you want to go out the risk spectrum a little bit, you could diversify with corporate bonds as well, high-quality corporate bonds, where the yields have gone up significantly relative to treasuries—

**RICH BERNSTEIN:** —especially if you're going to hold to maturity.

**CATHIE WOOD:** Yes.

**RICH BERNSTEIN:** You're not going to trade the bonds, absolutely.

**MICHAEL HARTNETT:** There are lots of various income streams out there, whether it's corporate bonds or government-guaranteed bonds, and I think, you know, that, I think is one of the big takeaways from tonight, is I mean you have to talk to your FA and find a way to sort of diversify the income stream...

**DAN SONTAG:** Now, we've always thought about the mix between equities and fixed income. Where do we feel like we are as far as where we should be there, and the traditional value-growth mid-cap, small-cap kind of getting into a portfolio construction, how do we feel about where we should be as it relates to building portfolios or adjusting portfolios and reallocating portfolios, given what we're talking about tonight?

**RICH BERNSTEIN:** In terms of our benchmark asset allocation, we are still underweight equities and overweight bonds and underweight cash. As I said, we are beginning to look at the world as a little bit more glass half full, as opposed to glass half empty, but we still think it's a little bit premature to start becoming very bullish on equities yet, so we're still underweight in equities.

Within that though, we're still overweight defensive sectors. We like things like consumer staples and health care, traditional utilities and telecom, the very defensive sectors. In the growth and value derby, we are much bigger fans of growth than we are of value. When you're in a disinflationary or deflationary environment, value does not tend to perform very well. Growth tends to perform much better in that environment. In terms of large-cap small-cap, I think this is one of the great dilemmas of—or the great puzzles ... enigmas ... of 2008 was that small-cap stocks are extremely credit sensitive, and somehow small-cap stocks outperformed large-cap stocks last year. This goes against complete history. There's really very little to support what went on there, but still, small-caps outperform.

We're still fans of large-caps, based on the historical relationships and what should happen; although I have to tell you, mid-cap growth is now selling at some of the cheapest valuations it ever has in history, so ... but the basic theme would be growth over value.

## **CHAPTER 4: WHERE TO GO FROM HERE**

**DAN SONTAG:** Before we wrap up, I want to go around, and I'm going to put you a little bit on the spot. I hope that's OK. Just as you sit out there, and you know we're talking to a lot of our clients, what's your best advice here, just on a general basis, as they think about the year forward? Rich, I'll start with you as the Chief Investment Strategist. It's probably putting you less on the spot in the moment.

**RICH BERNSTEIN:** I'll tell you, Dan. I think the best advice I can give people right now is very simple, and that is that financial market volatility is always scary, and we all know that. However, we should also always realize that financial market volatility is a signal that the global economy is

changing and that there will be new growth stories coming out the other side. I think the best advice I can give is for investors not to look longingly back at the stories they were talking about three or four years ago and saying, “Are they going to come back?” Rather, I think what they should do is be looking forward and try to figure out what are the new growth stories that are going to come out.

**DAN SONTAG:** OK. Rosey?

**DAVID ROSENBERG:** I think people have to perhaps adjust their expectations. We’re in a secular bear market in equities, and we’re in a secular bull market in fixed income. There is tremendous uncertainty. There is no visibility right now as far as the economy is concerned. There is no visibility, and we’re getting trade barriers, protectionism, geopolitical tensions are starting to build. It is a period of still—of political and economic and financial uncertainty. So I think that, you know, you want to be, shall we say, prudent?

I still like treasuries, but I don’t love them like I did. I still like them, but there’s other ways you can get relatively safe income, whether it’s a Single-A corporate bond that you’re confident is still going to—it’s going to survive this cycle, munis, what about the stuff that’s FDIC guaranteed? I still say focus on income, and there are alternatives, as Richard pointed out, beyond just the Treasury market.

**DAN SONTAG:** Michael?

**MICHAEL HARTNETT:** I think diversification is always the key watchword for individual investors, and I still think there are many opportunities around the world, whether it’s income or growth, to actually sort of grow your portfolio. But I think another keyword is just differentiation. I mean you are going to see, I think, markets differentiate between the strong and the weak. Going forward, I think market share is going to be a big, you know, game going forward, and just own stuff that you trust. You know, that’s very much our best-of-breed idea. The best qualities will win.

**DAN SONTAG:** Cathie?

**CATHIE WOOD:** I would say to your clients, if you feel as though we’ve said anything here in terms of whether it’s innovation or, you know, maybe a little bit of a cyclical experiment, if you feel at all, I would start averaging in, nothing—you know you don’t have to go whole hog, but there is so much cash out there, and if people do see prices starting to move up, there will be an averaging in, and it would just be good to get there maybe a little bit ahead of the game.

**DAN SONTAG:** Great advice by all. I appreciate that Cathie, Michael, Rosey and Rich. Thanks for joining us tonight. I also want to thank everyone for tuning in this evening for this, what I hope, was a very important conversation for you.

This is clearly a difficult environment. We heard a lot of that tonight, for all of us, and even with the best asset allocations and portfolio strategies, they’ve been tested in these markets, but as we’ve heard tonight, there are opportunities out there.

I encourage you to speak to your Financial Advisor about the ideas and insights the panel shared with us, and how you can put them to work in your own financial strategy. With that, thank you, thanks for tuning in, and good night to everyone.