

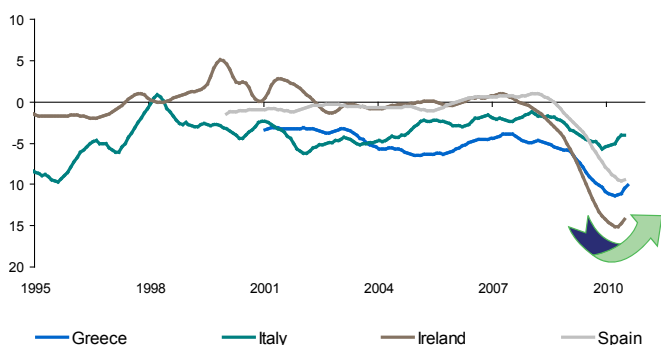


Review of the third quarter 2010

The third quarter of 2010 was a strong one for financial markets as one of the major headwinds of the second quarter, European financial system instability, abated. There was a noticeable shift in concern away from the peripheral eurozone sovereign crisis towards nervousness over a slowdown in the global economy, led by fears of a double dip back into recession in the U.S. The positive bank stress test results published by the European Central Bank at the end of July provided evidence of the health of European banks and the financial system in general. This mitigated the immediate concern of imminent financial crisis in Europe. However, pressure on the Irish banking system highlighted the longer term financial and sovereign headwinds that remain.

Across the Atlantic, economic data from the U.S. indicated a slowing in the recovery's momentum, igniting speculation over a second round of quantitative easing by the Federal Reserve. Fears spread over a return to recession and a drift into deflation in the U.S., but we feel these are significantly overblown. Elsewhere, China appears more certain to be heading for a soft landing. The recent data supports the view that the majority of the economy's slowdown is behind us and that growth is likely to remain in the healthy 8-9% range. All in all, the third quarter drew attention to the vast divergence between the stronger recovery in the emerging economies and the volatile and difficult recovery amongst the developed economies. Despite concerns over the economic recovery, risk markets rallied, reversing many of the falls from the second quarter. This was largely attributed to the impact of potential aggressive stimulus from the U.S. Federal Reserve.

Peripheral eurozone government deficit as a percentage of GDP



Source: International Monetary Fund. Data as at September 2010..

Outlook

- After a burst of growth in the first half of 2010, the global economy is slowing down; the main disappointment is consumer demand in developed economies
- As the risk of a hard landing in China diminishes, it is clear that the larger emerging economies will continue to outperform
- The U.S. economy is shifting painfully from policy to private sector led recovery
- A big positive surprise from Europe would be evidence that domestic demand is revving up. That, plus eurozone members making progress in curtailing government borrowing further, would sustain the European Central Banks' gradual withdrawal of support
- The U.K. outlook is finely balanced. Public sector cutbacks kick-off in earnest next year. It is still unclear whether the private sector can take up the slack. A second round of U.K. quantitative easing is still highly plausible in the medium term
- Japan remains in policy gridlock. To really achieve a weaker yen (thus avoiding a new recession) it needs tighter fiscal policy as well as aggressive easing by the Bank of Japan

Macro overview

- Market behaviour at mid year has generated a huge number of anomalies across asset markets. Clarity on 2011 recovery will help these unwind before year end
- There is a very large amount of investor cash sitting on the sidelines. Reassurance about an economic revival would see that drawn into risk markets as interest rates remain close to zero. Equities are likely to be the main beneficiary
- Within the developed world, we maintain our current preference for Europe over the U.S. and Japan. The earnings outlook for Europe is more favourable than for the U.S., Europe also offers higher yield and greater exposure to emerging markets

Equities:

Equity markets experienced a robust third quarter, reversing almost all of the declines from the second quarter of the year. Between the start of July and the end of September, global equities, represented by the MSCI All Country World Index (ACWI), rose by 13.8%. The majority of the quarter's gains were experienced in September, a month in which equities rose 9.4% - the fifth best month for the MSCI ACWI since its inception in 1988. The third quarter marked a stark reversal from the second quarter in which global equities fell by almost 15%. Year to date equities are now up a modest 1.9%.

Fixed Income:

The third quarter was dominated by a decline in government bond yields in core sovereign markets reflecting weaker G7 growth momentum and the risk of a second round of quantitative easing (QE). The quarter also saw the return to favour of risky fixed income assets. In general, high yield bonds delivered better performance than high grade, and high grade performed better than government bonds. Emerging market bonds also put in a solid performance. In the U.S., the Merrill Lynch High Yield Master Index was up 6.7%, the Merrill Lynch Corporate Master Index up 4.9% and the Merrill Lynch U.S. Treasury Master Index up 2.7%. A similar pattern played out in other regions (Europe and the U.K.). Driving the renewed strength in risky assets was a very strong bid: there is ample liquidity entering the market both at the fund level and in the primary market for new issuance. This is a trend that is supportive of credit assets globally.

Commodities:

The third quarter of 2010 saw a continued but unsteady appreciation of commodity investments with all sectors ending the quarter in positive territory. The Merrill Lynch Total Return Commodities Index (MLCX TR) returned 10.2% for the quarter. Agriculture saw exceptional returns for grains and soft commodities, particularly for wheat where supply disruptions caused the strongest two-month rally in over twenty years, and sugar, which appreciated throughout the quarter. Energy was more unsteady and traded range-bound. In precious metals, gold ended the quarter at a new record level just above \$1300/troy ounce, with silver also gaining sharply especially in September.

Currency:

The U.S. dollar rolled back and forth through the quarter as the market focused on U.S. economic data for signs of further recession or recovery. It initially reacted counter-intuitively as poor U.S. economic numbers led to risk aversion and therefore a strengthening of the dollar, while

stronger numbers encouraged risk and saw the currency weaken. The market shook this off towards the end of the quarter as expectations increased of further Federal Reserve quantitative easing measures being applied, viewed as dollar negative. U.S. dollar/Japanese yen saw the market testing the resolve of the Japanese government to follow up on its interventionist rhetoric by taking action. The yen appreciated to 83 (to the U.S. dollar) - a fifteen-year record - and subsequently moved even higher as the markets buzzed in anticipation of Bank of Japan's intervention to buy dollars. Sterling generally tracked the euro, the two currencies currently closely linked in the markets, with sterling initially tending to strengthen against the euro. The euro has since reversed this move, strengthening against sterling largely on comparative economic performance, but, more recently, due to expectations that the U.K. government might also introduce quantitative easing earlier than expected.

Other Alternatives:

The annual estimate for the Investment Property Databank index (IPD) total return came in at 0.7% in August, with capital growth slowing to 0.1%. The capital values are now up 19.2% from their trough in July 2009, however remain 31.7% below the high water mark of mid 2007.

The HFRI Fund Weighted Composite Index was up 0.4% for August, with strong performance in macro and relative value strategies only partially offset by weakness in equity hedge and event driven funds. Direct investment in hedge funds reached \$1,084 billion at the end of June, marking a recovery to heights last seen in 2007. The HFRI Macro Index gained 2.2% as strong gains in systematic trend following strategies were complemented by more moderate gains in discretionary macro strategies.

Private equity-backed buyouts reached \$69.1 billion in the third quarter of 2010, the highest quarter since the second quarter of 2008. Activity for the first nine months of the year had a total value of \$150.6 billion, 93% more than the same time period in 2009.

Equity Indices referenced (for regions and sectors) are all MSCI indices. Data from Factset.

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