CIO REPORTS

The Weekly Letter

Office of the CIO • FEBRUARY 24, 2015

- **The Silver Lining in Gold:** Given concerns over rising market volatility, geopolitical risks and stretched valuations for both equities and bonds, it makes sense to consider the role of gold as a portfolio diversifier. We believe investors should consider some allocation to commodities such as gold, consistent with their investment objectives and risk tolerance. Steadily growing demand should support the metal's long-term outlook.
- **Markets In Review:** Equities climbed higher for the third straight week, as an agreement was reached to extend financial aid to Greece. The S&P 500 rose 0.7%, and the MSCI EAFE Index of foreign stocks was up 1.6%. Treasury yields continued their rise, with the 10-year yielding 2.11% from 2.05% the prior week. WTI crude oil fell 4.6% but managed to stay above $50 per barrel, and gold fell 2.2% to $1,203 per ounce.
- **Looking Ahead:** Federal Reserve Chairwoman Janet Yellen is set to deliver the Semiannual Monetary Policy Report to Congress, and consumer prices in both the U.S. and Europe are expected to remain weak.

The Silver Lining in Gold

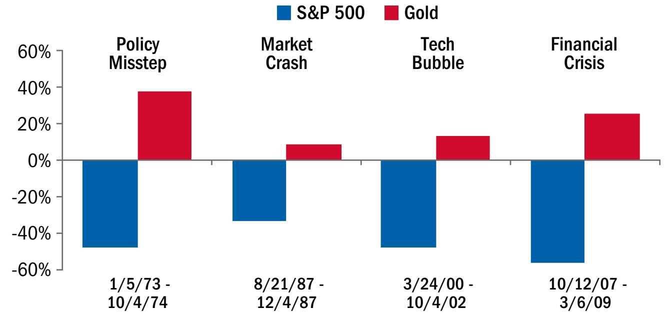
Gold has lost some of its luster recently, and investors have shunned the metal given its underperformance over the past few years. **We believe that gold has beneficial characteristics that justify its role in well-diversified portfolios, as valuations for equities and bonds have gotten richer, market volatility has picked up and geopolitical risks have escalated.** These developments all serve to increase the relative attractiveness of gold as a diversifier, in our view.

However, gold remains a difficult asset to value, principally due to its lack of cash flows. Its performance is unpredictable as it has many drivers: It can move in reaction to the U.S. dollar, trade in line with other commodities, or act as a store of value during times of financial market stress. For example, last month when the S&P 500 fell by 3% and the VIX Volatility Index rose sharply, gold rallied by over 8%.

Gold is an effective portfolio diversifier

We believe investors should consider some allocation to commodities such as gold, consistent with their long-term investment objectives and risk tolerance. Historically, gold has shown little to no correlation with equities, supporting its diversifying properties. Despite disappointing returns in the past several years, it has proven to be effective in offsetting sharp losses in equities, particularly during large event-driven corrections (see Exhibit 1).

Exhibit 1: Gold has historically performed well during stock market crashes



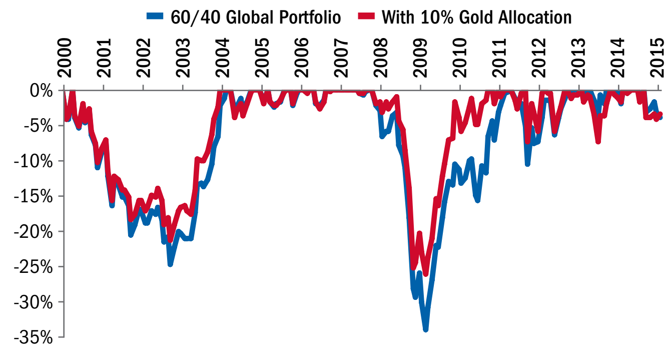
Source: Bloomberg, MLWM Investment Management & Guidance. Data as of February 23, 2015. Graph shows S&P 500 price index peak-to-trough performance on a weekly basis, and the performance for gold for the corresponding dates.

As stocks reach all-time highs, we have seen a pickup in market turbulence. As we wrote in our January 20 Weekly Letter "*An Uneasy Transition*," we expect volatility to remain elevated this year. To adjust to this shift, investors should reassess their portfolios, considering the use of diversifiers such as gold to protect against tail risk events (see Exhibit 2).

Monetary policy divergence is creating uncertainty

We expect the divergence in global monetary policies to be a major source of this market volatility, with all eyes on the Federal Reserve (Fed) as it prepares to raise interest rates later this year. Meanwhile, the

Exhibit 2: Adding a small gold allocation to a balanced portfolio has helped reduce drawdowns



Source: Bloomberg, MLWM Investment Management & Guidance. Data as of February 19, 2015. 60/40 Global Portfolio consists of 60% MSCI ACWI, 40% BofAML Global Broad Market Index.

European Central Bank and Bank of Japan have expanded their Quantitative Easing programs, and policymakers in many other developed and Emerging Markets have slashed key policy rates. Financial assets such as equities and credit have been major beneficiaries of these accommodative actions. **Therefore a policy mistake could hurt levered positions that excess liquidity has been supporting.**

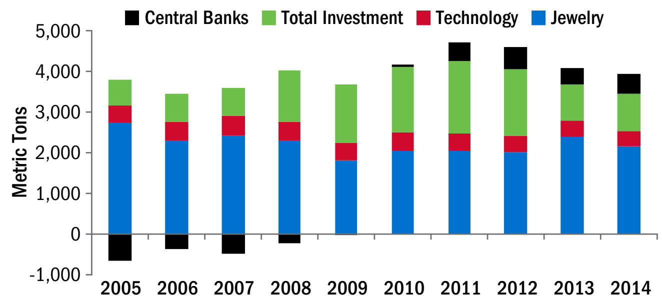
What could policy mistakes look like? For one, central banks could find that they are behind the curve as inflation unexpectedly accelerates, forcing them to raise interest rates quickly. Alternatively, the massive stimulus already in place could prove insufficient to drive sustainable growth and inflation, leading markets to lose faith in the ability of central banks to fend off deflation. **In both of these extreme events—unexpected inflation and deflation—gold prices can help protect against equity market sell-offs.**

Central banks are buying gold again

Taking a closer look at the internal dynamics of the gold market, jewelry production accounts for the largest source of demand, and has remained largely stable over time. Central banks however have emerged as buyers since 2010, even as private investor demand for gold bars, coins and investment vehicles has declined (see Exhibit 3).

The competitive devaluation of currencies around the world may be prompting reconsideration of gold as a store of value. Last year, central banks were net purchasers of 477 tons, a 17% increase over 2013, with Russia being the largest buyer, according to the World Gold Council. According to the BofA Merrill Lynch (BofAML) Global Research commodity team, rising volatility in Emerging Market currencies suggests growing demand for gold as a diversifier for banks and individuals.

Exhibit 3: Central Banks have become net buyers of gold in recent years, helping to offset declining demand from individual investors



Source: The World Gold Council, GFMW Thomson Reuters. Data as of February 2015. Total investment demand includes gold bars and coins, ETFs and similar investment vehicles.

Roughly 70% of the demand for gold comes from the Emerging Markets, with China and India alone accounting for more than half of all purchases. **With our expectation of improving economic growth and rising incomes, particularly in the world's two largest gold markets, the long-term outlook for the precious metal is improving.**

Portfolio Strategy: Our commodities team at BofAML Global Research has a neutral view on gold, with its year-end price target of $1,238 per ounce only slightly above current levels. Some investors buy gold for tactical purposes, but predicting the near-term direction of its price can be difficult. We prefer to focus on its diversification properties. Our expectation that market volatility will pick up this year enhances the case for gold as part of a well-balanced portfolio. With equity valuations appearing full on most measures, and the prospect for rising rates in the U.S. challenging the bond market's multi-decade rally, the case for considering alternative assets such as gold has strengthened further.

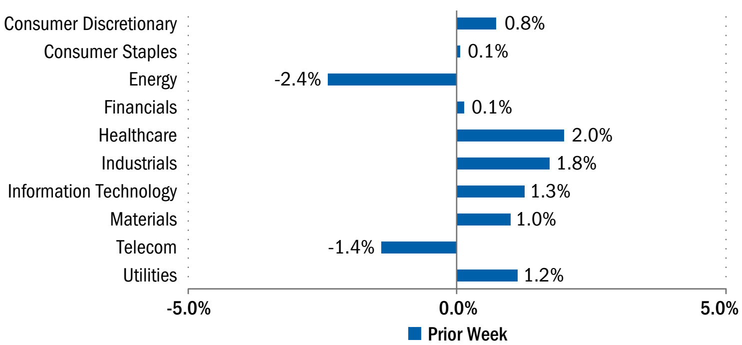
Greece in focus: *On Friday, Eurozone finance ministers (the Eurogroup) accepted Greece's request to grant a four-month extension to the existing bailout program, subject to approval of Greece's proposed reforms and budgetary measures. The decision should avert a potential liquidity crunch and a run on Greek banks as it signals a commitment from both sides to keep the Eurozone intact, with Greece in it. However, some political and financial risks remain, as the Greek government may be seen as breaking certain pre-election promises for austerity.*

Markets in Review

Trailing Economic Releases

- The minutes of the Federal Open Market Committee's January meeting allayed concerns that the Federal Reserve would begin to raise interest rates as early as June. Many members saw downside risk to the outlook for the U.S. based on international disinflationary pressures. However, the Committee still sees these as transitory, although several members worried about declines in core inflation measures.
- U.S. industrial production for January rose 0.2% month-over-month (MoM) as expected, following a downward-revised 0.3% decline in December. This was consistent with the ISM manufacturing survey out earlier this month. However, mining production fell 1.0% due to cutbacks in oil and gas drilling. Capacity utilization was unchanged at 79.4%.
- Looking abroad, the euro-area composite Purchasing Managers Index (PMI) rose to 53.5 for February from 52.6 in January, above expectations of a rise to 53.0. This follows a stronger-than-expected reading for fourth-quarter GDP, and lends further evidence to the view that growth in the region is picking up. Germany led broad-based improvement across the Eurozone, with its composite PMI rising to 54.3, above expectations. Numbers above 50 signal an expansion in economic activity, while numbers below 50 signal a contraction.

S&P 500 Sector Returns (as of last Friday's market close)



Equities

		Total Return in USD (%)		
	Level	WTD	MTD	YTD
DJIA	18,140.4	0.7	6.0	2.2
Nasdaq	4,956.0	1.3	7.1	4.8
S&P 500	2,110.3	0.7	6.0	2.8
S&P 400 Mid Cap	1,516.8	1.0	5.8	4.6
Russell 2000	1,231.8	0.7	5.8	2.4
MSCI World	1,768.1	1.0	5.5	3.6
MSCI EAFE	1,866.7	1.6	4.8	5.3
MSCI Emerging Mkts	984.4	-0.2	2.5	3.1

Fixed Income

		Total Return in USD (%)		
	Yield (%)	WTD	MTD	YTD
ML U.S. Broad Market	2.14	-0.4	-1.7	0.5
U.S. 10-Year Treasury	2.11	-1.0	-3.9	0.6
ML Muni Master	2.29	0.0	-1.2	0.6
ML U.S. Corp Master	3.12	-0.3	-1.8	0.9
ML High Yield	6.16	0.4	1.6	2.3

Commodities & Currencies

		Total Return in USD (%)		
	Level	WTD	MTD	YTD
Bloomberg Commodity	206.9	-1.7	1.9	-1.5
Gold Spot[1]	1,202.0	-2.2	-6.4	1.4
WTI Crude $/Barrel[1]	50.3	-4.6	4.4	-5.5
Level	Current	Prior Week End	Prior Month End	2014 Year End
EUR/USD	1.14	1.14	1.13	1.21
USD/JPY	119.0	118.8	117.5	119.8

Source: Bloomberg. [1]Spot Price Returns. All data as of last Friday's close.

Past performance is no guarantee of future results.

Looking Ahead

Federal Reserve Chairwoman Janet Yellen is set to deliver the Semiannual Monetary Policy Report to Congress, and consumer prices in both the U.S. and Europe are expected to remain weak.

Upcoming Economic Releases

- On Tuesday, the euro-area Consumer Price Index (CPI) for January is expected to be unchanged from the flash estimates, with the headline number falling 0.6% year-over-year and Core CPI, which excludes food and gasoline, up 0.6%. Economic indicators for the region have begun to stabilize after several months of deterioration, as indicated by last week's PMI readings for January.
- On Tuesday and Wednesday, Federal Reserve (Fed) Chairwoman Janet Yellen will testify on the Fed's Semiannual Monetary Policy Report to Congress. The focus will be on whether her tone will tilt hawkish, in line with recent speeches by other Fed members, particularly on how she characterizes the trade-off between better-than-expected job growth and continued softness in inflation.
- On Thursday, the U.S. CPI for January is expected to be down 0.8% MoM following a 0.4% decline in December. This would be the third consecutive negative reading, as energy prices and gasoline in particular weigh on the overall index. It would bring the year-over-year number to -0.3%, the first of what are expected to be several months of negative inflation on that basis. Core CPI is expected to rise 0.1% following an unchanged reading in December. Even with annual core inflation remaining steady, it should be difficult for the Fed to raise rates with headline inflation in negative territory.

BofA Merrill Lynch Global Research Key Year-End Forecasts

S&P Outlook	2015 E
S&P 500 Target	2,200
EPS	$119.50
Real Gross Domestic Product	**2015 E**
Global	3.5%
U.S.	3.3%
Euro Area	1.4%
Emerging Markets	4.2%
U.S. Interest Rates	**2015 E**
Fed Funds	0.50-0.75%
10-Year T-Note	2.35%
Commodities	**2015 E**
Gold	1,238
WTI Crude Oil	$57

All data as of last Friday's close.

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