Chief Investment Office • MARCH 2016

Forget Jack, Focus on Charlie-in-the-Box

The year started out rocky, as growth disappointed and global uncertainty continued to rise despite optimistic expectations. Despite the negative revisions to 2016 growth forecasts, this is right in line with history, as the economy grew roughly 2% per year, on average, over the past five years—much less than in previous recoveries. In addition, inflation and wage growth have not risen as much as policymakers and economists had expected them to by this point in the recovery. The current market environment of higher volatility, lower expected returns and lower growth is different than what is perceived to be normal. The global growth backdrop is characterized by a number of global growth shifts, such as the shift in growth from Developed Markets to Emerging Markets and shifting demographics. Within the U.S., there is a reliance on the consumer sector to drive growth, while the manufacturing and business investment segments remain stagnant. The consumer sector's contribution to growth is one of the global growth shifts that are different from the perceived norm.

These global shifts represent the new and different. Now, all of these shifts, these breaks from the recent past, aren't negative, but they cause disruptions, concern, and potential unintended consequences. They are akin to Charlie-in-the-Box and the other residents of the Island of Misfit Toys, in the 1964 stop-motion-animated television classic "Rudolph the Red-Nosed Reindeer." Just like the "misfit toys" in the movie, which were misunderstood and unwanted, these global shifts are misunderstood and unwanted. But, also just like the "misfit toys" in the movie, which were not really misfits, but only different than the toy that was considered normal (Jack-in-the-Box), these global shifts aren't really misfits, but only different than conditions that are considered normal (see Table 1, on Page 2). Some successful areas of past cycles become obsolete as new areas emerge, grow successful, and lead to new opportunities.

Our base case is that the new, Charlie-in-the-Box, environment will likely result in a wider range of volatility, as markets dissect the economic data and central bank policy actions. In our view, this is a world that is changing structurally, with a market that is different but not a reason to abandon investing, and it therefore argues for a different approach to asset allocation—that is, traditional forms of asset allocation must be modified in a world of low rates and low returns. In order to reduce the concentration of risks in a portfolio, investors should consider a broader range of diversification and diversifying alternatives, as well as use market volatility to rebalance portfolios.

The Wealth Allocation Framework

LIFE PRIORITIES

The Wealth Allocation Framework helps you put your goals and aspirations at the center of decisions about allocating your financial resources. **Asset categories within the framework include:**

- **Personal:** Individual investors have a desire for safety and personal financial obligations they want to meet regardless of market conditions. To safeguard essential goals, investors can hold lower-risk assets—but they have to accept lower returns in exchange.
- **Market:** When we invest, we strive to capture market growth most efficiently. Today, access to a broadening array of asset classes and types makes diversifying beyond stocks and bonds easier than ever before.
- **Aspirational:** Investors seek significant wealth mobility. To pursue goals that require higher-than-market returns, investors often need to take higher and concentrated risks.

To learn more, read the whitepaper, *Investing in a Transforming World: The Wealth Allocation Framework*

Table 1

Jack-in-the-Box (Old Normal)	Charlie-in-the-Box (New Normal)
Higher oil prices, higher break-evens	Lower-for-longer oil prices, lower break-evens
Higher global growth	Structurally lower global growth
Traditional central bank policies	Non-traditional central bank polices (quantitative easing, negative interest rate policy—NIRP)
China's dollar-peg foreign exchange policy	China's currency-basket peg and new policy
China's export and trade-based economic plan	China's economic transition to consumer services and consumer spending economy
Normalized yield and inflation	Lower yields, lower inflation, for longer
Strong geopolitical leadership	Fractious, unstable geopolitical landscape
Emerging Markets as the engine of world growth	Developed Markets supporting world growth
Globalization (open trade, investment, movement of goods and people)	Rising anti-globalization forces, U.S. and globally
U.S. middle class spending trends	Millennials, Boomers, and Emerging Market middle class spending trends
Private sector pricing power	Commoditization, low barriers to entry, reduction in pricing power
Global goods, manufacturing, trade-based economy	Knowledge-based, consumer services-driven economic shift

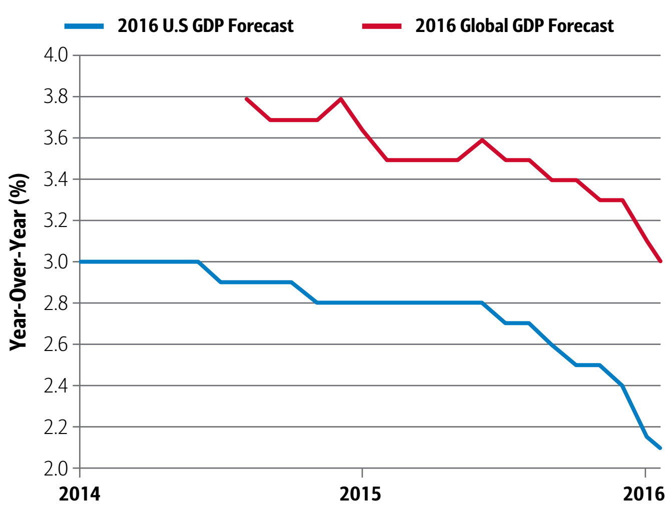
Source: Merrill Lynch Chief Investment Office.

What's changed?

In macroeconomics:

We've been writing about the global growth shift from the developed world to the developing world for some time now. But, within that broad massive shift, there are many others. Demographics are shifting—some societies are aging, some, like the Emerging Markets, are growing a vibrant middle class with pent-up demand. Central bank policies are increasingly playing the role that fiscal policy filled in previous cycles. Innovative technologies are causing numerous disruptions, lowering barriers to entry, and creating commoditized pricing in areas that have been accustomed to pricing power. Consumer spending patterns are shifting as well, from goods to services and experiences. And then there's the shift in oil from higher to much lower prices, shifts in geopolitics, including the upcoming shift in leadership in the U.S., and many others. This all creates an environment in which greater volatility and large swings in prices may occur across asset classes.

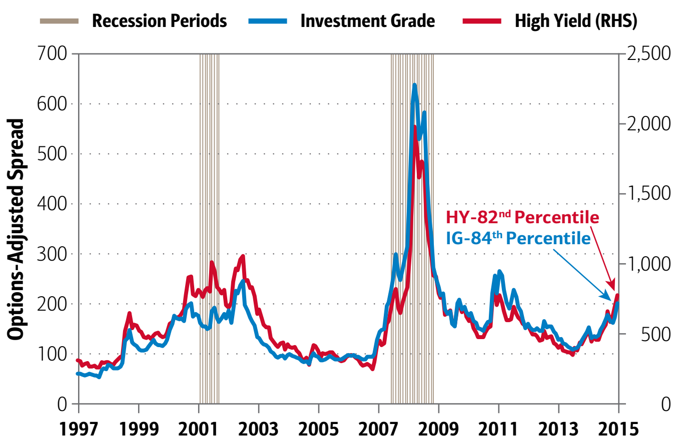
Exhibit 1: Growth expectations have been revised down



Source: Bloomberg and Merrill Lynch Chief Investment Office. Data as of March 18. Note: Bloomberg consensus estimates.

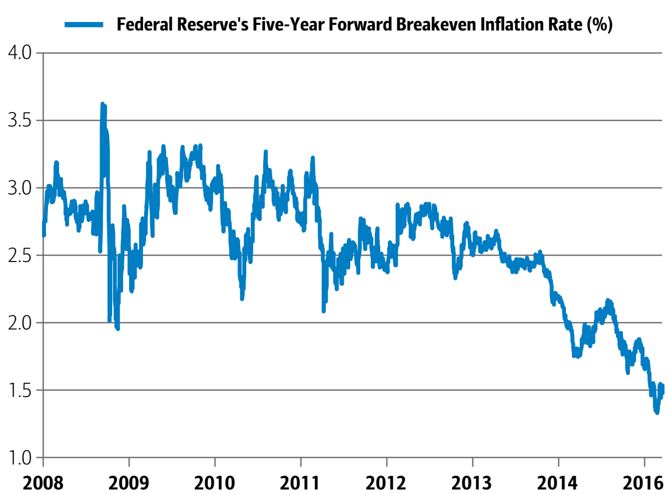
Markets have lowered growth views since mid-2014, alongside oil prices, China concerns and the global manufacturing slowdown (see Exhibit 1). Since the fourth quarter of 2015, the growth pessimism and deflation fears have intensified, resulting in another risk-off move until the recent rally starting on February 11. U.S. Investment Grade (IG) and High Yield (HY) credit trades below 2014 troughs, with spreads at recessionary levels; this is also true when excluding Energy and Metals & Mining (see Exhibit 2). Rates markets highlight the extent of growth pessimism, with U.S. 5-year/5-year forward rates below 2008 levels (see Exhibit 3) and U.S. 10-year breakeven inflation at only 1.6%. Of course, fixed income markets are at least in part distorted owing to monetary easing and thus the growth signal from bonds is not as reliable as it was.

Exhibit 2: IG spreads are trading at recession-like levels



Source: Bloomberg and Merrill Lynch Chief Investment Office. Data as of January 31, in basis points. IG index = BofA Merrill Lynch U.S. Corporate & Government A & Above Index. HY index = BofA Merrill Lynch High Yield Index. See Appendix for index and options-adjusted spread definitions. Past performance is no guarantee of future results.

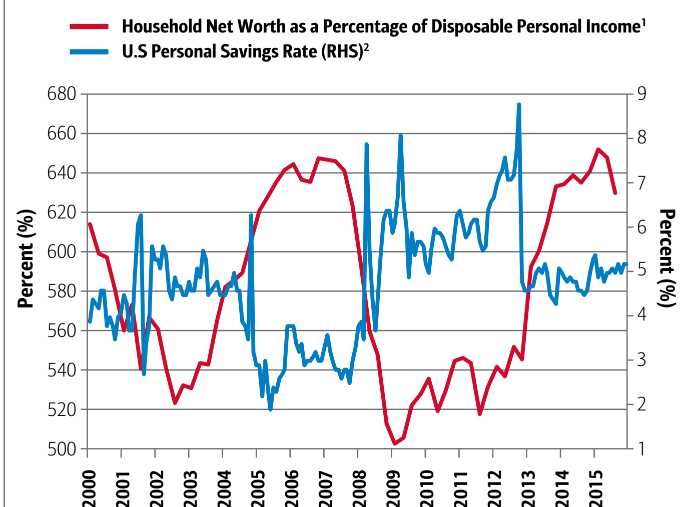
Exhibit 3: Inflation indicators do not show near-term inflationary pressures



Source: Bloomberg and Merrill Lynch Chief Investment Office. Data as of March 16.

Slow to moderate U.S. growth has led to a two-speed economy, with a strong consumer but a weak industrial sector. The consumer did well in 2015. Real Personal Consumption Expenditures (PCE) grew 1.4% in 2015. Investors are fearful that negative animal spirits have taken hold in the global economy and we are on the verge of a recession. However, quantitative and qualitative measures of consumer activity suggest spending will continue and the current economic expansion will persist. There are reasons to believe that consumption growth in 2016 will continue to be strong. One reason to remain upbeat is that the savings rate appears high compared to both recent history and its equilibrium level predicted by fundamentals such as the ratio of net worth to disposable income (see Exhibit 4).

Exhibit 4: Consumers remain in good shape, as household net worth is high relative to history and the personal savings rate is above average



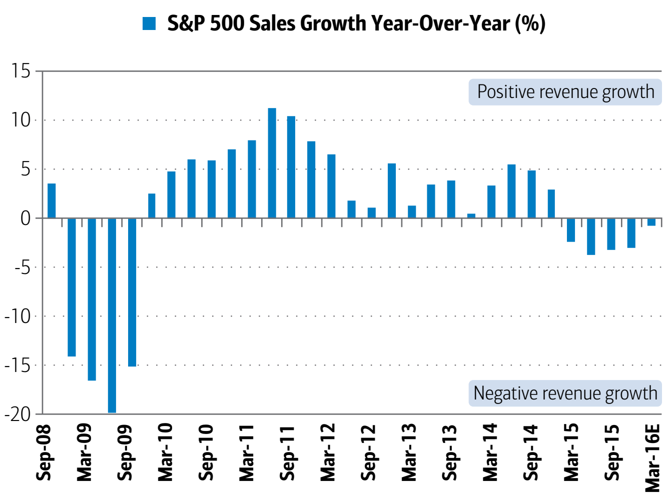
Source: Federal Reserve, Bloomberg and Merrill Lynch Chief Investment Office.
1. As of September 30, 2015. 2. As of January 31, 2016.

In markets:

Equities—The post-crisis environment of sub-trend growth, disinflationary pressures and uncertainty has increased the Equity Risk Premium (ERP) in countries/regions with negative rates, such as the eurozone and Japan, more than offsetting the positive effect falling risk-free rates would typically have on equity prices. Thus, very low risk-free rates—and even more so negative interest rates—likely have distortionary effects on valuation in equities (as well as other asset classes). That being said, the historical "normal" relationships have more recently begun to re-emerge, with lower bond yields again becoming "good" for equities.

However, we have dubbed this new environment in U.S. equities a “profits recession,” which is not the same as an economic recession. For the S&P 500 Index, the revenue projections for the first quarter of 2016 would signal the fifth consecutive quarter of year-over-year revenue declines. If those revenue projections are realized, it will be the first time the S&P 500 has seen five consecutive quarters of year-over-year declines in sales since FactSet began tracking the data, in the third quarter of 2008 (see Exhibit 5).

Exhibit 5: Revenue growth not expected to return until 2H 2016



Source: Haver Analytics, FactSet and Merrill Lynch Chief Investment Office. Data as of March 18. Past performance is no guarantee of future results.

Acknowledging recent market gyrations and near-term weakness in revenue and earnings, the BofA Merrill Lynch (BofAML) Global Research Equity Strategy team recently lowered its S&P 500 forecast for 2016 to 2,000, from 2,200. By the same token, the year-end S&P 500 earnings per share forecast has been lowered to $120, from $125, on lower commodity prices and slower global growth. Recent earnings data for larger companies have been slightly better than for smaller capitalization companies, as larger companies in the S&P 500 have seen higher earnings and sales growth.

Credit—The cyclical depression in oil markets has had a swift and significant effect on the credit quality and returns of primarily HY Energy issuers. Energy companies' credit quality has deteriorated significantly over the past 12 months, and we expect it to continue to decline, causing a wave of downgrades, defaults, and restructurings over the next 12-24 months. We expect further downgrades in the Energy sector if oil prices remain below $45 per barrel for an extended period. Despite the substantial rally in both oil prices (+40%) and HY spreads (-200 basis points) since mid-February (from February 11 to March 15), we believe pressure on spreads inflicted by weak oil markets is far from over, and we expect ongoing volatility through the rest of the year. Pressure on oil prices is likely to continue to exert pressure on the Energy sector, but we believe the risk of contagion to the broader taxable fixed income market is limited.

Risks in a Charlie-in-the-Box world

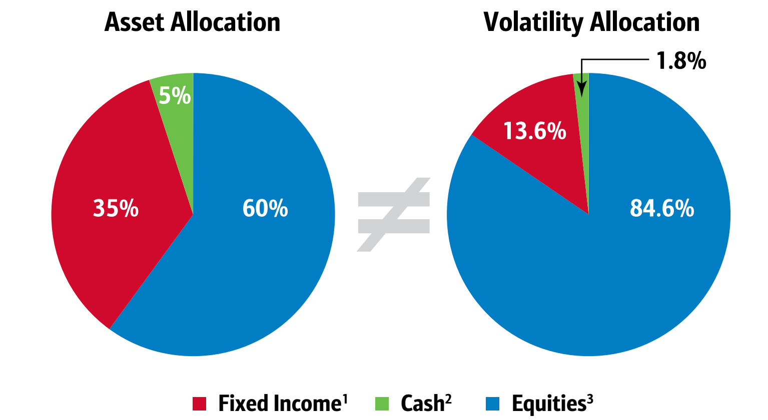
There is no shortage of risks as we enter the second quarter of 2016. There is Brexit (Great Britain's exit from the European Union), though its odds remain low, and U.S. elections are likely to bring some near-term volatility and policy uncertainty. However, we are most focused on oil, a China policy mistake, and rate shocks from an inflation pickup. The oil price recovery since February 11 has come with a broad relief rally across risk assets (see the February 23 Weekly Letter, **Relief Rally**). However, that rally might lose momentum from here, as we expect oil prices to remain volatile near-term. The Chinese government recently released an updated gross domestic product forecast of 6.5–7.0%, lower than expected but more in line with market expectations. The risk of a Chinese policy mistake is likely to persist near-term, adding to uncertainty and therefore to episodic volatility. Inflation expectations globally, particularly in the U.S., remain anchored by low rates. As we discussed in the December Monthly Letter, **2016 Outlook: You Can Go Your Own Way**, the increase in wages and tightness in the labor market leave the risk that inflation could surprise on the upside.

Portfolio Positioning in a “wide and flat” world full of “misfit toys”

In the February Monthly Letter, **Asset Allocation in a Flatter World**, we discussed the current environment as one where the assumed relationship between risk and return (in which higher returns are commensurate with higher risk) has flattened and investors typically require higher returns because market volatility has increased. However, this is not the case, as the potential return profile for many asset classes has not increased commensurately while in many cases the same or lower returns have come with greater risk. **Within the equity markets, we describe the path forward as “wide and flat”—a wide trading range with relatively low aggregate returns.** On such a path, higher and episodic volatility makes it harder to recover from market drawdowns, and therefore we emphasize diversifying strategies to ultimately reduce the concentration of risk within a portfolio.

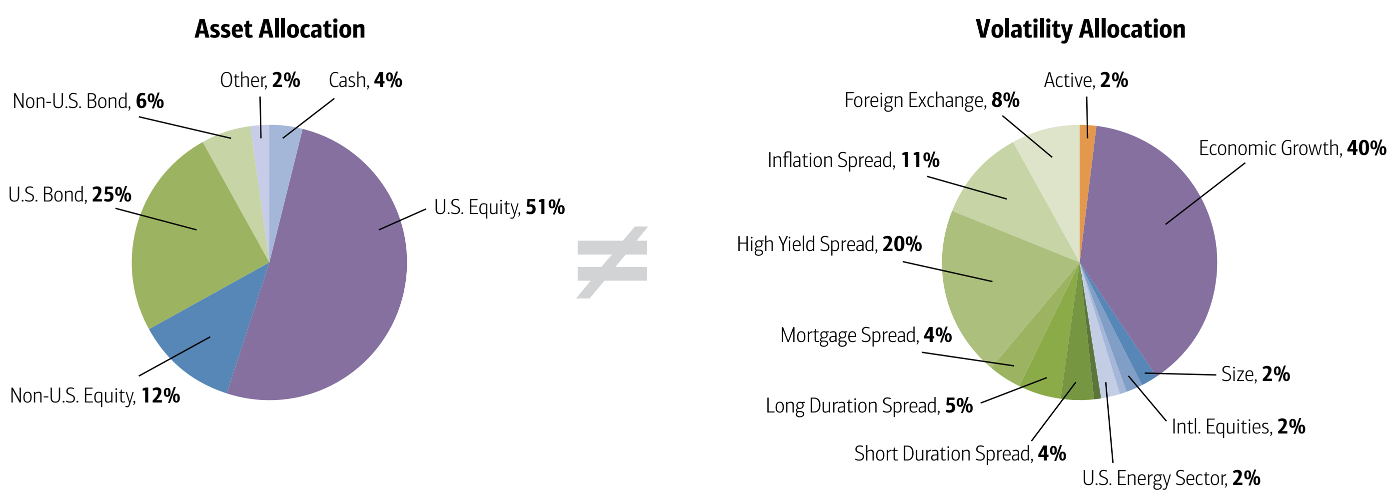
We prefer to be "paid to wait" and continue to manage portfolios across all assets with income as a central goal. This is not the time in the cycle to reach for higher beta investments, excessive yield, or "growth" at all costs. We would use market volatility to rebalance back to strategic allocations. One way to help reduce the concentration of risk within a portfolio is to look to a broader approach to diversification, including diversifying alternative strategies (see Exhibits 6 and 7). We recommend being active around opportunities when they correct too far and adding to non-financial assets and alternative investments, if suitable—particularly diversifying strategies that have lower correlations with the broader market.

Exhibit 6: Risks may be more concentrated than asset allocation suggests



For illustrative purposes only. Asset allocation cannot eliminate the risk of fluctuating prices and uncertain returns. Volatility allocation is the contribution to total portfolio volatility, by asset class. It implies that risk may come not only from asset classes, but also from factors within each asset class. Based on pro-forma monthly data from January 1994 to December 2015. 1. Fixed Income Composite (60% US Long Term Govt TR, 40% US Long Term Corp TR). 2. US 30-Day T Bill TR. Risk allocation based on Merrill Lynch Capital Market Assumptions. 3. Standard & Poor's 500 Total Return. See Appendix for index definitions. Source: Merrill Lynch Investment Analytics and Merrill Lynch Chief Investment Office.

Exhibit 7: Risk comes in many forms in a Charlie-in-the-Box world



For illustrative purposes only. Asset allocation cannot eliminate the risk of fluctuating prices and uncertain returns. Volatility allocation is the contribution to total portfolio volatility, by asset class. It implies that risk may come not only from asset classes, but also from factors within each asset class. Source: Morningstar and Merrill Lynch Investment Analytics.

Finally, we would take today's many Charlie-in-the-Boxes—the new normal—in stride. They're different, and they may lead to further near-term market volatility. However, we believe this slower-growth, lower-inflation, central bank policy-driven world lengthens the business cycle rather than producing a boom-bust type of cycle. In a Charlie-in-the-Box world, asset allocation needs to adapt, and we believe certain investments will best weather this new world (see Table 2, on Page 6).

When assessing your portfolio in light of our current guidance, consider the tactical positioning around asset allocation in reference to your own individual risk tolerance, time horizon, objectives and liquidity needs. Certain investments may not be appropriate, given your specific circumstances and investment plan. Certain security types, like hedged strategies and private equity investments, are subject to eligibility and suitability criteria. Your financial advisor can help you customize your portfolio in light of your specific circumstances.

Table 2: Preferred Asset Classes in a Charlie-in-the-Box World

Asset Class	What to do Now
Equities	
International Developed	Positive view based on extension of European Central Bank quantitative easing till March 2017, and evidence of green-shoots in European economy should drive European equities higher. Japan should continue to benefit from reflationary "Abenomics."
U.S. Equities	High-quality equities with growing dividends, strong balance sheets and growing free cash flow.
Fixed Income	
Investment Grade	Risk of rates rising subsiding. Stable to improving fundamentals expected to attract high-quality foreign investors as yield differentials are supported by divergent monetary policy.
U.S. Municipals	Valuations relative to U.S. Treasuries remain attractive, and tax-exempt status is not likely to be threatened in the near term; advise a nationally diversified approach.
U.S. Treasury Inflation-Protected Securities (TIPS)	An alternative to U.S. Treasuries. Given expectations for real rates to remain contained but higher pressure on inflation, we prefer TIPS over U.S. Treasuries. TIPS are one of the few fixed-income asset classes that tend to be uncorrelated to equities.
Alternative Investments	
Diversifying Alternative Hedge Funds	Global Macro and Managed Futures a timely diversifier, given higher expected volatility across equity, fixed income and foreign exchange markets.
Real Estate	Strong fundamentals and more-lenient debt terms have boosted investment volumes. Capitalization rates continue to compress and are now below prior peak levels. Opportunities exist for skilled managers. We favor global opportunistic strategies.

Source: Merrill Lynch Chief Investment Office.
Note: Please see last page for a discussion of the risks involved with these investments.

CIO Insights A Conversation with Henry H. McVey*

Insights and the best thinking from distinguished investors around the world.

Henry H. McVey joined KKR in 2011 and is Head of the Global Macro and Asset Allocation team. Mr. McVey also serves as Chief Investment Officer for the Firm's Balance Sheet. Prior to joining KKR, Mr. McVey was a managing director, lead portfolio manager and head of global macro and asset allocation at Morgan Stanley Investment Management (MSIM). Prior to that he was a portfolio manager at Fortress Investment Group and chief U.S. investment strategist for Morgan Stanley. While at Morgan Stanley, Mr. McVey was also a member of the asset allocation committee, and the top ranked asset management and brokerage analyst by *Institutional Investor* for four consecutive years before becoming the firm's strategist. He earned his B.A. from the University of Virginia and an M.B.A. from the Wharton School of the University of Pennsylvania. Mr. McVey serves as co-chair of the TEAK Fellowship board of trustees and is a member of the Pritzker Foundation and Lincoln Center Investment Committees. He is also a member of the national advisory board for the Jefferson Scholarship at the University of Virginia.

Henry H. McVey

Member and Head of Global Macro and Asset Allocation, KKR

Question: Expectations for global growth in 2016 seem to have moved lower recently on the back of slowing global trade, as you've pointed out. What is your outlook for domestic economies in the U.S. and internationally?

McVey: The biggest headwind for global growth is simply that there is too much supply relative to demand, which is leading to low inflation in many parts of the world. Against this backdrop, global GDP in *nominal* terms has collapsed. For investors, this environment is a big deal because companies' revenues are measured in nominal terms, not real terms. A lot of the drop in global inflation is linked to China's excess capacity as well as a slowdown in its pace of fixed investment, which has affected commodity prices. In our view, this shift in China's growth profile is secular, not cyclical. If there is good news in terms of global growth trends, we think it now centers on the health of the consumer. In the U.S., for example, the savings rate is back to 2003 levels and double the level of 2007. We see similar positive trends in Europe, albeit from a lower base. Within the consumer story, however, our belief at KKR is that spending patterns are likely to be much more nuanced than in past cycles. Specifically, we think that investors should largely focus their attention towards companies that provide value-added experiences and/or can deliver differentiated value to the end-user consumer. Otherwise, we think the risk of either disintermediation or disenfranchisement from low-cost competitors is significant.

In your 2016 outlook, you highlighted that in the current macro environment investors are not being rewarded to extend their portfolios further along the risk curve (resulting in flatter efficient frontier curves). Which assets classes remain attractive in this type of environment and can still add benefit to portfolio positioning?

In our target asset allocation portfolio, credit looks more attractive than equities. As an asset class, liquid credit notably underperformed equities in 2015. We see this divergence as unsustainable, which is why we currently favor credit over equities (i.e., either credit snaps back or equities sell off meaningfully). We continue to see strong relative value across credit, particularly in high quality Levered Loans.

In the less liquid parts of the fixed income market, we continue to see significant opportunity in the direct corporate lending arena as Wall Street is shrinking both its headcount and its footprint. In many instances a lender can get high up in the capital structure and enjoy some call on the collateral. Second, we see a growing opportunity in the asset-based lending market, including airplanes, real estate, renewables, rail cars, and housing. In our view, most deals with any real complexity are now being offloaded from traditional financial intermediaries to the private lending markets, a trend we expect to accelerate under new and increasingly onerous regulatory-driven retention rules. These deals are now coming with better terms, including lower leverage, improved call protection, and more rigorous documentation. Third, given recent market volatility in an environment of tighter leveraged lending guidelines, there is definitely the opportunity for investors to again embrace mezzanine-like lending structures. In particular, the opportunity for private lenders to opportunistically provide mezzanine-like capital in complex corporate take-overs at attractive rates of return has definitely gained momentum in recent months, a trend we expect to accelerate in 2016. Finally, there are a growing number of corporate deleveraging and restructuring opportunities, particularly in the small-to mid-size market, that many banks no longer consider core to their lending franchises.

You've stated that your current target asset allocation portfolio positioning for 2016 is defensive with an overweight to cash and underweight to public equities. What would you need to see in markets to begin to rotate back into risk assets?

We have had eight straight up years in the U.S. equity market from a total return perspective, and we are now 81 months into an economic expansion. Meanwhile, operating margins in the corporate sector are now closer to a peak than a trough. Given these factors, we have turned more defensive. For us to move back to an overweight position in public equities, we would like to first see the multiple on stocks de-rate and future earnings expectations being much more conservative. In particular, earnings estimates for financial services companies look too high for the low rate, low liquidity environment that we are experiencing.

Among equities, where do you see opportunities? What fundamentals are important to you as you navigate equity markets currently?

Within equities, our strong preference remains for developed market equities. Specifically, parts of the U.S. equity market (e.g., risk arbitrage stories and rising ROE stories) and parts of the European equity markets (e.g., dividend yielders with growth) will likely outperform again in 2016, we believe. By comparison, we remain underweight emerging markets. However, we do think that the bear market in EM public equities is in its later stages after 65 months of underperformance relative to developed markets. At the moment, we favor consumer-oriented markets like Mexico when these markets trade down to more reasonable valuation levels, or we would look to buy beaten-up stocks in Asia as the China Growth Miracle that defined the 2000-2010 period unwinds further.

You've highlighted the impact to traditional fixed income markets due to a secular change across Wall Street. How do you see this evolving short- and long-term?

After a rash of disappointing earnings, leadership changes across the sector, and increased regulatory oversight (e.g., Basel III, TLAC), it is clear that most global wholesale banks will continue to move more aggressively to shrink their lending/trading footprints and capital bases in 2016. Against this backdrop, traditional credit availability is under siege. We also note that total dealer inventories across Wall Street have collapsed 80% since 2007, which has adversely impacted liquidity in the fixed income markets. Against this backdrop, corporate credits that have any level of complexity are now moving off market and being negotiated between private lenders and companies. We see this reshaped competitive landscape as an opportunity for investors to earn a substantial incremental yield in today's low rate environment.

The other big issue is that we may have reached an inflection point where central bank tools have gone too far with their unconventional policies. In particular, we think we may look back at the decision by Governor Kuroda of the Bank of Japan on January 29, 2016, to implement negative deposit rates as a major inflection point in investor confidence towards unconventional monetary policy. Beyond impact of negative rates on deposit income for banks, more traditional Quantitative Easing is significantly affecting the long end of the fixed income market. All told, we estimate that total negative-yielding sovereign debt outstanding is now above $7 trillion globally (about a third of all global sovereign debt).

Against this backdrop, traditional "savers," including pension funds and individuals, must now find higher yielding products that allow them to earn a better return. Given that central bank policy is not likely to reverse course anytime soon in places like Europe and Japan, we view the current low rate environment for global bonds as potentially more permanent in nature than some investors may think. If we are right, then non-traditional credit is likely to play a more significant role in both an individual's and an institution's overall asset allocation.

It seems clear that China needs to continue to devalue its currency, yet this is a careful balancing act for Chinese officials, given issues in other segments of its economy and financial system. What implications does continued uncertainty around the yuan have for other currencies and markets?

We think that China's currency will continue to devalue versus the USD, but this story is more complicated than it seems. For starters—and contrary to popular opinion—China is actually not losing market share in exports. In fact, compliments of a successful high-end export strategy, China's overall market share of total global exports has increased to 13.7% in 2015 from 10.7% in 2011. At the same time, however, the country's debt load has ballooned to $23.9 trillion in 2015 from $14.4 trillion in 2011 (a 66% increase); meanwhile, its producer price index has been running negative for 47 consecutive months. As a result, its *real* 10-year rate has soared to 1.1% from -3.0% in 2011, which suggests to us that the country needs to significantly lower rates to offset this more restrictive monetary condition. If it does not, then we are confident that growth will likely continue to disappoint. However, if it does lower rates to ease the deflationary headwinds it now faces, its currency too must depreciate, we believe. Importantly, this conundrum is being exacerbated by the fact that the country's capital account outflows are now larger than its current account inflows.

Importantly, we are not talking about a massive devaluation. In fact, we believe that current fair value for the yuan is around 7.00, and over the next 12 months the currency could trade towards or beyond fair value on divergent monetary policy and interest rate differentials. However, implementation in capital markets has proven volatile, and with volatility at 10%, an overshoot of fair value could easily imply 7.50 or more. Against today's level of 6.52, the differential between our forecast and the spot rate is around 6.8%. By comparison, the 12-month forward is already priced at 6.77, which implies appreciation of 3.7%, or about half of what we envision over the next year.

* The views and opinions expressed are those of the speaker as of March 31, are subject to change without notice at any time, and may differ from views expressed by Bank of America Corporation, Merrill Lynch, Pierce, Fenner & Smith Incorporated, or any affiliates. This conversation is presented for informational purposes only and should not be used or construed as a recommendation of any service, security or sector. Before acting on the information provided, you should consider suitability for your circumstances and, if necessary, seek professional advice.

When assessing your portfolio in light of our current guidance, consider the tactical positioning around asset allocation in reference to your own individual risk tolerance, time horizon, objectives and liquidity needs. Certain investments may not be appropriate, given your specific circumstances and investment plan. Certain security types, like hedged strategies and private equity investments, are subject to eligibility and suitability criteria. Your financial advisor can help you customize your portfolio in light of your specific circumstances.*

ASSET CLASS	CHIEF INVESTMENT OFFICE VIEW					COMMENTS
	Negative		Neutral		Positive	
Global Equities				●		Further upside expected based on improving economic and earnings growth and valuations, which remain close to fair value. However, return expectations should be lower than in recent history.
U.S. Large Cap			●			Full valuations and headwinds of stronger dollar, lower energy prices and weak economic activity may lead to higher volatility. Higher quality is preferred in a rising volatility environment.
U.S. Mid & Small Cap			●			Valuation multiples remain extended, although the valuation gap with large caps has narrowed. Investors with a higher risk tolerance may consider select opportunities within higher-quality small caps.
International Developed				●		Extension of European Central Bank quantitative easing till March 2017 and evidence of green-shoots in European economy should drive European equities higher. Japan should continue to benefit from reflationary "Abenomics."
Emerging Markets		●				Stronger dollar, weaker growth in China and downward pressure on commodity prices will challenge Emerging Markets (EM).
Global Fixed Income		●				Bonds continue to provide diversification, income and stability within total portfolios. Interest rates remaining lower for longer limit total return opportunities in bonds.
U.S. Treasuries		●				Current valuations are stretched, especially on longer maturities. Consider TIPS as a high-quality alternative.
U.S. Municipals				●		Valuations relative to U.S. Treasuries remain attractive, and tax-exempt status is not likely to be threatened in the near term; advise a nationally diversified approach.
U.S. Investment Grade				●		Risk of rates rising subsiding. Stable to improving fundamentals expected to attract high-quality foreign investors as yield differentials are supported by divergent monetary policy.
U.S. High Yield			●			We remain cautious, as defaults expected to increase; spreads to remain range-bound until further economic growth.
U.S. Collateralized			●			Higher rates and Federal Reserve tapering are likely to increase spread volatility. A shortage of new issues should counter the effects of tapering.
Non-U.S. Corporates			●			Select opportunities in European credit, including financials; however, any yield pickup likely to be hampered by a stronger dollar.
Non-U.S. Sovereigns		●				Yields are unattractive after the current run-up in performance; prefer active management.
Emerging Market Debt			●			Vulnerable to less accommodative Fed policy and lower global liquidity; prefer U.S. dollar-denominated EM debt. Local EM debt likely to remain volatile due to foreign exchange component; prefer active management.
Alternatives**				●		Select Alternative investments help broaden the investment toolkit to diversify traditional stock and bond portfolios.
Commodities			●			Medium-/long-term potential upside on stabilizing oil prices; near-term opportunities in energy equities/credits.
Hedged Strategies			●			Equity Event-Driven & Distressed gain from recent event selloff and increasing default potential. Global Macro a timely diversifier, given higher expected volatility across equity, fixed income and foreign exchange markets.
Real Estate				●		Strong fundamentals driving increased investment; cap rates continue to compress; favor global opportunistic.
Private Equity			●			Strong fund raising and high valuations; special situations, energy, and private credit favored.
U.S. Dollar				●		Stronger domestic growth and a less dovish Federal Reserve policy (relative to the monetary policies of other Developed Market central banks) support a stronger dollar going forward.
Cash		●				Monetary policy by Developed Market central banks reduces the attractiveness of cash, especially on an after-inflation basis.

* Boxed sections, updated since last month.

** Many products that pursue Alternative Investment strategies, specifically Private Equity and Hedge Funds, are available only to pre-qualified clients.

Appendix

Index Definitions

The **BofA Merrill Lynch U.S. Corporate & Government A & Above Index** is a subset of the BofA Merrill Lynch U.S. Corporate & Government Index, which tracks the performance of U.S. dollar-denominated Investment Grade debt publicly issued in the U.S. domestic market, including U.S. Treasury, U.S. agency, foreign government, supranational and corporate securities, including all securities rated AAA through A3, inclusive.

The **Fixed Income Composite:** 60% Ibbotson U.S. Long-Term Government Index and 40% Ibbotson U.S. Long-Term Corporate Index.

IA SBBI U.S. 30-Day T-Bill TR (Source: Ibbotson): For the U.S. Treasury Bill index, data from *The Wall Street Journal* are used for 1977 to the present; the CRSP U.S. Government Bond File is the source from 1926 to 1976. Each month, a one-bill portfolio containing the shortest-term bill having not less than one month to maturity is constructed. (The bill's original term to maturity is not relevant.) To measure holding period returns for the one-bill portfolio, the bill is priced as of the last trading day of the previous month-end and as of the last trading day of the current month.

The **ML High Yield Master Index** tracks the performance of below Investment Grade U.S. dollar-denominated corporate bonds publicly issued in the U.S. domestic market. "Yankee" bonds (debt of foreign issuers issued in the U.S. domestic market) are included in the index provided the issuer is domiciled in a country having an Investment Grade foreign currency long-term debt rating (based on a composite of Moody's and S&P).

The **S&P 500 Index** is a market-capitalization weighted index that measures the market value of 500 large U.S. companies having common stock listed on the NYSE or NASDAQ. The index components and weightings are determined by S&P Dow Jones Indices.

Other Definitions

Options-adjusted spread: The yield spread that has to be added to a benchmark yield curve to discount a security's payments to match its market price, using a dynamic pricing model that accounts for embedded options.

CHIEF INVESTMENT OFFICE

Christopher Hyzy
Chief Investment Officer
Bank of America Global Wealth and Investment Management

Christopher J. Wolfe
Head of the Merrill Lynch Chief Investment Office

Mary Ann Bartels
Head of Merrill Lynch Wealth Management Portfolio Strategy

Karin Kimbrough
Head of Macro and Economic Policy
Merrill Lynch Wealth Management

Niladri Mukherjee
Managing Director
Chief Investment Office

Maxwell Gold
Vice President

Emmanuel D. "Manos" Hatzakis
Director

Jon Lieberkind
Vice President

John Veit
Vice President

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Alternative investments, such as hedge funds and private equity funds, are speculative and involve a high degree of risk. There generally are no readily available secondary markets, none are expected to develop and there may be restrictions on transferring fund investments. Alternative investments may engage in leverage that can increase risk of loss, performance may be volatile and funds may have high fees and expenses that reduce returns. Alternative investments are not suitable for all investors. Investors may lose all or a portion of the capital invested.

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No investment program is risk-free, and a systematic investing plan does not ensure a profit or protect against a loss in declining markets. Any investment plan should be subject to periodic review for changes in your individual circumstances, including changes in market conditions and your financial ability to continue purchases.

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