The Weekly Letter

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R(E)nergized (M)arkets: Emerging Markets (EM) have been the top-performing equity asset class year-to-date, with the MSCI Emerging Markets Index up 8.0% through March 3. Given uncertainty over economic policy and the prospect of rising rates in the U.S., plus China's move toward new growth drivers, though, we suggest investors employ a barbell approach tailored to an appropriate risk profile. Holding EM allows for capture of improved cyclical momentum, alongside a position in higher-quality U.S. larger capitalization equities with healthy free cash flows and dividend growth.

Markets in Review: Last week, equities appreciated, with the S&P 500 Index up 0.7% and international equities, as represented by the MSCI EAFE Index, up 0.4%. Bond prices fell on the week, with the 10-year Treasury yield at 2.48% Friday, up from 2.31% the prior week. Commodities overall, as measured by the Bloomberg Commodity Index, fell 0.3% last week, while WTI crude fell 1.2% to $53.33 a barrel and gold fell 1.8% to $1,234.55 per ounce.

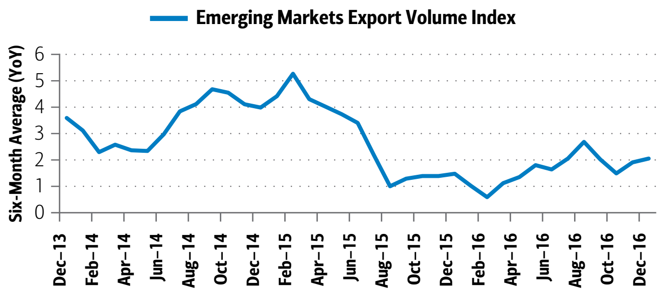
Looking Ahead: In the U.S., economic data this week will be focused on non-farm payrolls and average hourly earnings. A recent uptick in wages has helped bolster sentiment towards the U.S. consumer and the broader economy. In Europe, Eurostat will produce its final reading on Eurozone gross domestic product for the fourth quarter. (See Page 3.)

R(E)nergized (M)arkets

Emerging Market (EM) equities, as measured by the MSCI Emerging Markets Index, have been the best-performing equity asset class year-to-date (as of March 3), posting an 8.0% return. This compares to a year-to-date return of 6.4% for the S&P 500 and 5.6% for the MSCI Developed Markets Index. Currency markets are affirming the improving prospects. The J.P. Morgan Emerging Market Currency Index has returned 2.6% this year, closing in on a full recovery from post-U.S. presidential election losses. Emerging Markets have been on a tear. Meanwhile, key industrial metals—such as iron ore and copper, which have respectively returned 15.8% and 7.2%—further corroborate a synchronized global cyclical upswing taking hold.

Our October upgrade of EM to overweight was largely based on early signs of this now more evident development. Accelerating economic growth and rebounding inflation are poised to contribute to improving fundamentals and highlight the relative attractiveness of EM versus the U.S. equity market. We believe countries best positioned would be those such as India, which are less trade- and commodity-dependent and have more domestic support from monetary policy and internal reform. Over the longer term, we see the rise of the Emerging Market consumer, supported by rising income and, in turn, spending power, as a structural tailwind for the asset class.

Exhibit 1: A real—not just nominal—pickup is under way



Source: CPB World Trade Monitor, Bloomberg, GWIM CIO. Data as of December 31, 2016.
Past performance is no guarantee of future results.

Be that as it may, growing protectionist rhetoric has reduced some of our conviction. Other challenges for EM include still historically low commodity prices, gradual normalization of Federal Reserve (Fed) interest rate policy, and the structural downshift in China's growth rate. Given the current environment, we view EM as an attractive complement to more defensive assets to better capture the global synchronized cyclical pickup against a backdrop of continued uncertainty.

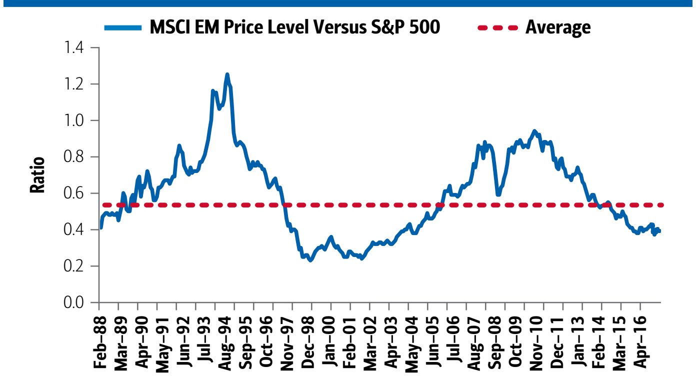
Cyclical upswing favors EM

Outperformance in EM equities, currencies and industrial metals can be traced to a broadening global cyclical pickup. Purchasing Manager Indices, surveys that track economic activity, began flagging an uptick in EM manufacturing in the first half of 2016, which was complemented by reaccelerating growth in Developed Markets later in the year. In addition, export growth has picked up across major EM economies such as China, Indonesia, Brazil, Taiwan and South Korea. While some of this growth is tied to a price rebound in commodities, a reacceleration in trade volumes throughout the latter part of 2016 suggests a pickup in real terms as well. (See Exhibit 1.)

Rising real and nominal economic growth provide a positive fundamental backdrop for EM and augurs well amid attractive relative valuations. Our Global Emerging Markets Strategist, Ajay Kapur, expects an upside surprise to the consensus expectation of 12-14% annual growth in earnings per share (EPS) of Asian and EM companies. Proprietary Bank of America Merrill Lynch Global Research leading indicators suggest roughly 20% EPS growth this year for Asia excluding Japan.

The case for these gains materializing and remaining sustainable is gaining favor. EM sold off in the immediate aftermath of the election of President Donald Trump on fear that his protectionist rhetoric would translate into action. Since then, he has moderated his stance, raising expectations that he will instead negotiate with trading partners to avoid a destructive trade war that would harm the global economic pickup. Should this scenario gain momentum and EPS growth materialize, it would bolster the case for EM equities to catch up with their Developed Market counterparts and make other cyclical assets within the space, such as EM debt, more appealing. A comparison of the MSCI Emerging Markets Index versus the S&P 500 shows the former is attractively priced versus the latter (see Exhibit 2). What's more, the MSCI EM index trades at a discount to its 10-year average valuation versus the S&P 500. For trailing price-to-earnings (P/E), forward P/E, and price-to-book, EM trade at a 9%, 14% and 30% discount, respectively.

Exhibit 2: EM equities are attractively priced vs. U.S. equities



Source: FactSet, Bloomberg, GWIM CIO. Data as of March 3, 2017.
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Emerging *Headaches*?

While we highlight the positive aspects of investing in EM, there remains notable uncertainty in the outlook. Despite President Trump's moderation in protectionist rhetoric, his appointment of Wilbur Ross as Secretary of Commerce, Robert Lighthizer as U.S. Trade Representative (pending Senate confirmation), and Peter Navarro as the head of a newly created National Trade Council make clear his intention to reshape U.S. trade relations with the rest of the world. In addition, the controversial Border Adjustment Tax—a key component of comprehensive tax reform espoused by Republican leadership and designed to encourage exports and dissuade imports—may reduce demand for EM goods, raising incertitude as to the response of major U.S. trading partners.

Another risk for EM is the normalization of the Fed's interest rate policy, which would increase the relative attractiveness of U.S. assets and raise the risk of dollar appreciation. Last week, a plethora of Federal Open Market Committee voting members and Chair Janet Yellen hinted at an approaching rate hike, sending the market-implied probability of a rate increase in March over 90%. While stronger growth in the U.S. should be positive for EM, trade policy uncertainty may buffer the positive spillover from this improvement.

An additional hazard lies in the outlook for China's economy. While it has enjoyed a pickup on the back of fiscal stimulus and reaccelerating credit growth, debt levels have increased. Furthermore, home price growth may have recently peaked, as policies enacted to temper sales activity have started to bite. How Chinese officials manage the ongoing handoff from the old economic drivers of exports and fixed asset investment to consumption and services is paramount to the outlook for EM and the global economy.

Portfolio Considerations: The evolving synchronized cyclical pickup has positioned EM equities as the top-performing equity asset class year-to-date (through March 3). Firming growth of trade volumes implies the pickup has not been solely due to a rebound in inflation. Improving real and nominal economic growth create a propitious backdrop for an upside surprise in earnings growth, which may precipitate a catchup phase for EM equities to their Developed Market counterparts.

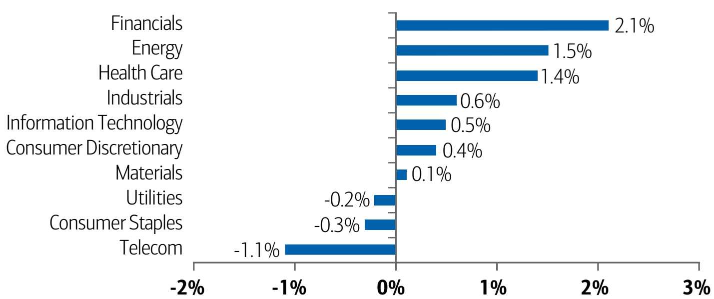
However, the outlook remains notably clouded. While President Trump has toned down his protectionist rhetoric, his economic team includes officials focused on remaking America's economic relationship with the rest of the world, aiming to improve the terms of trade in favor of the American worker. Given still high unpredictability in economic policy and the prospect of rising interest rates in the U.S., and China proceeding in its precarious economic transition to new growth drivers, we recommend that investors in Emerging Markets use a barbell approach tailored to an appropriate risk profile. This way, they can take advantage of the unfolding cyclical recovery, while maintaining a position in higher-quality U.S. larger capitalization equities with healthy free cash flows and dividend growth.

Markets in Review

Trailing Economic Releases

- On Wednesday, the U.S. Bureau of Economic Analysis reported personal spending for January of 0.2% month-over-month, slightly below the BofAML Global Research target of 0.3%.
- On Friday, Fed Chair Yellen suggested an increased likelihood of a policy interest rate hike in March during a speech in Chicago, with the markets pricing in greater than a 90% chance of a hike. BofAML Global Research now projects three rate hikes for 2017.
- On Tuesday, Eurostat released its February Consumer Price Index (CPI) for the Eurozone. The Eurozone finally hit 2% year-over-year inflation, slightly surprising on the upside. BofAML Global Research expected 1.9%. Inflation was bolstered by food price inflation. BofAML Global Research expects food and energy prices to continue to add to inflation until April.

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



Equities

		Total Return in USD (%)		
	Level	WTD	MTD	YTD
DJIA	21,005.7	0.9	0.9	6.8
NASDAQ	5,870.8	0.5	0.8	9.3
S&P 500	2,383.1	0.7	0.9	6.8
S&P 400 Mid Cap	1,739.5	0.2	0.6	5.0
Russell 2000	1,394.1	0.0	0.6	2.9
MSCI World	1,849.0	0.5	0.6	5.9
MSCI EAFE	1,757.3	0.4	0.3	4.7
MSCI Emerging Mkts	931.1	-1.3	-0.5	8.1

Fixed Income

		Total Return in USD (%)		
	Yield (%)	WTD	MTD	YTD
ML US Broad Market	2.62	-0.8	-0.6	0.3
ML 10-Year US Treasury	2.48	-1.4	-1.0	-0.1
ML US Muni Master	2.56	-0.5	-0.6	0.6
ML US IG Corp Master	3.37	-0.7	-0.6	0.9
ML US HY Corp Master	5.66	0.3	0.1	3.0

Commodities & Currencies

		Total Return in USD (%)		
	Level	WTD	MTD	YTD
Bloomberg Commodity	176.4	-0.3	-0.6	-0.3
WTI Crude $/Barrel[1]	53.3	-1.2	-1.3	-0.7
Gold Spot $/Ounce[1]	1,234.6	-1.8	-1.1	7.1
Level	Current	Prior Week End	Prior Month End	2016 Year End
EUR/USD	1.06	1.06	1.06	1.05
USD/JPY	114.04	112.12	112.77	116.96

Source: Bloomberg.[1] Spot price returns. All data as of last Friday's close.
Past performance is no guarantee of future results.

Looking Ahead

Upcoming Economic Releases

- On Thursday, in the U.S., the Bureau of Labor Statistics is set to release its change in non-farm payrolls for February. BofAML Global Research expects 185,000, less than its 227,000 reading from January.
- On Friday, the U.S. Bureau of Labor Statistics will release its month-over-month average hourly earnings for February. BofAML Global Research estimates 0.3%, an increase from earnings growth of 0.1% in January. Wages have been increasing in the U.S., helping bolster the U.S. consumer and economy more broadly.
- On Thursday, Eurostat is set to report its final growth reading of the Eurozone's seasonally adjusted gross domestic product. BofAML Global Research expects 0.4% quarter-over-quarter growth for the fourth quarter, consistent with third-quarter growth.

BofA Merrill Lynch Global Research Key Year-End Forecasts

S&P 500 Outlook	2017 E
Target	2,450
EPS	$129.00
Real Gross Domestic Product	**2017 E**
Global	3.5%
U.S.	2.1%
Euro Area	1.5%
Emerging Markets	4.6%
U.S. Interest Rates	**2017 E**
Fed Funds (eop)	1.38%
10-Year T-Note (eop)	2.85%
Commodities	**2017 E**
Gold ($/oz-period average)	$1,275
WTI Crude Oil ($/bbl-eop)	$59.00

All data as of last Friday's close.

CHIEF INVESTMENT OFFICE

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