CIO REPORTS
The Weekly Letter

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GWIM Chief Investment Office

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Director

→ **Oil's Balancing Act:** With West Texas Intermediate crude tumbling over 10% so far this year, we take a closer look at the supply and demand for oil and our outlook for energy prices this year. We see modest upside when it comes to oil, with a forecast of $50 to $70 per barrel at year-end. Separately, we consider last week's hike in the federal funds rate, highlighting our view that short-term rates could rise above 2.0% by the end of 2018.

→ **Markets in Review:** Last week equities rose, with the S&P 500 adding 0.3% and international equities, as represented by the MSCI EAFE Index, appreciating by 2.1%. Bond prices also rose, with the 10-year Treasury yield at 2.50%, down from 2.57% on Friday of the prior week. Commodities overall, as measured by the Bloomberg Commodity Index, rose 1.1%. WTI crude stabilized last week, rising 0.6% to $48.78 per barrel, while gold appreciated by 2.0% to $1,229.30 per ounce.

→ **Looking Ahead:** In the U.S., this week investors will digest gauges of home sales and business investment. The latter is notable in signaling whether higher confidence among consumers and executives is translating to rising investment. In the Eurozone, Markit is set to release a general indicator gauging the pace of economic growth.

Recent Publications

Weekly Letter
Housing rises
R(E)nergized (M)arkets
Europe's New Challenges
CEO Talk

Monthly Letter
Volatility and Sentiment: What Gives?

ISC Viewpoint
The Madness of March

Oil's Balancing Act

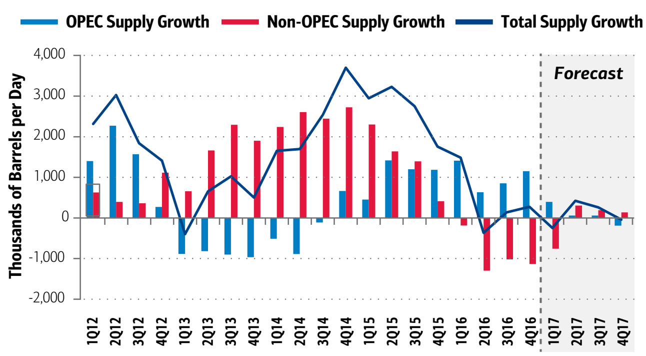
So far it's been a rocky start to the year for energy prices, with West Texas Intermediate (WTI) crude oil tumbling over 10%, in part due to reports of record U.S. inventories. Such developments have prompted us to take a closer look at the supply and demand picture, and our own outlook for energy prices this year.

As the role of the United States as a producer increases, the Energy sector is becoming more important to the overall economy, building on the critical role it's played in capital expenditures, durable goods orders, housing and employment.

A serious supply-demand imbalance that caused inventories to swell started developing in mid-2014, when a surge in production met anemic demand amid a global economic slowdown. Since then, a rebalancing in the oil market, helped by several supply disruptions and strengthening demand, has been helping reduce inventories, a trend that is expected to continue.

We see a credible scenario for inventory drawdowns to continue and higher oil prices this year given the strengthening demand combined with the November 30 agreement by the Organization of Petroleum Exporting Countries (OPEC) to reduce production, the first since 2001, enhanced by non-OPEC Russia contributing additional cuts.

Exhibit 1: OPEC is the main contributor to oil supply growth



Source: GWIM Chief Investment Office. BofAML Global Research. Bloomberg. Data updated on December 22, 2016. The economic and market forecasts presented are for informational purposes as of the date of this report. There can be no assurance that the forecasts will be achieved. **Past performance is no guarantee of future results.**

Demand has been strong…

The collapse in petroleum prices from mid-2014 to early 2016 helped demand for gasoline grow to a record high last year, and it was strong even in the vulnerable economy of the European Union (EU).

BofA Merrill Lynch (BofAML) Global Research sees global oil demand as resilient; even after two years of strong growth, momentum remains positive. Evidence has been mounting for a synchronized global expansion, including strong global manufacturing Purchasing Managers Indexes.

Hikes on the Horizon

Karin Kimbrough
Head of Investment Strategy, Merrill Lynch Wealth Management

Last week the Federal Reserve raised its overnight federal funds rate by 0.25% to 0.87%, in a widely anticipated move. It signals a slightly faster pace of the tightening cycle that began several years back. With the Fed expected to hike two more times this year, in September and December, and possibly three times next year, short-term rates could rise above 2.0% by the end of 2018.

We continue to expect longer-term rates to rise this year and next. We forecast the 10-year Treasury reaching 3.0% in second quarter but then settling into a range through the end of the year.

The other question for the Fed is when it should start to reduce the size of its balance sheet. In our estimation, it won't start until three conditions are met: 1) the fed funds rate is over 1%, 2) it has more clarity around the domestic tax and trade policies currently under debate, and 3) the global financial markets look calm. In our view the earliest this could happen would be very late in 2017, or early in 2018. When the process does begin, though, expect it to coincide with a slowing or stopping altogether of asset purchases by the European Central Bank. This confluence of central bank action suggests gradually higher rates for the world's sovereign bonds is on the horizon.

Demand remains resilient despite structural forces that should slow its growth, including increased fuel efficiency, the rise in alternative fuel vehicles, aging populations in the U.S., Europe, Japan and China, urbanization trends and China's transition to a more service-based economy.

The Organization for Economic Cooperation and Development and others have revised global oil demand upward.

...but supply has been stronger (so far)

Despite recent cuts by OPEC, we've seen supply from other sources increase so far this year. U.S. domestic output has been growing since last summer, and BofAML Global Research sees shale production bottoming in the current quarter.

In fact, BofAML Global Research calculates that 84% of non-OPEC supply gains are coming from U.S. shale, as production in many parts of the world either stagnates or declines outright. A key factor is lower breakeven costs, which now stand at around $55 per barrel for major U.S. players. As a result, Saudi Arabia is no longer the swing producer, it's North America.

However, uncertainty still clouds the global oil supply picture. The Middle East, a region where geopolitical tensions pose risks of supply disruption, accounts for about 40% of the projected growth. Production outlooks in countries like Iraq and Libya come with a high degree of uncertainty as concerns with stability and security cast doubt on their ability to boost production. If ambitious forecasts are met, however, there could be more downside pressure on oil prices for longer.

What's next?

BofAML Global Research believes the oil price war—in which OPEC members aggressively increased their market share over the past few years—is now over. Instead, it says, "OPEC will revert to what it does best: verbal and physical manipulation of the oil market to push oil curves into backwardation ." That condition, in which futures prices are below the spot price, is favorable for those with long positions since they want the futures price to rise to the level of the current spot price. As a result, the expectation is for limited growth in OPEC oil output over the next five years.

OPEC's next meeting is May 25th, when it will discuss extending the production cuts agreed upon in November.

BofAML Global Research forecasts WTI to finish 2017 at $59 a barrel and North Sea (Brent) crude to reach $60 a barrel; but its longer-term forecasts have them at $66 and $68 respectively in 2019, indicating an outlook of lower for longer. Our Chief Investment Office (CIO) also sees modest upside to oil prices from here, with a forecast of $50 to $70 per barrel at year-end and movement slightly higher in 2018.

Risks to our view

While global supply and demand forces continue to rebalance, other factors pose risks to our view of higher (though still moderate) oil prices. Fed tightening and a strong dollar do not bode well for oil, as rising U.S. rates and flatter yield curves hurt demand from emerging markets. Other downside risks include the impact on supply, and in turn prices, from new shale technology, and another price war led by OPEC. Typically, geopolitical tensions and higher inflation could tilt price forecasts upwards.

Portfolio Considerations: The Energy sector has been the worst-performing one in the S&P 500 so far this year. In our CIO Year Ahead report, we identified the sector as one that may benefit from reduced regulation under the new administration and highlighted more cyclical sectors, including Energy, as beneficiaries of a broader rotation within the equity market. This week, BofAML Global Research upgraded the Energy sector to overweight based on the commodity team's outlook for higher oil prices, attractive valuations and a broad underweight by active fund managers.

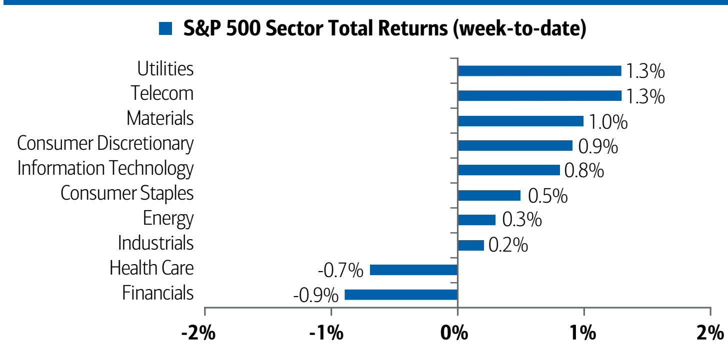
Low oil prices devastated capital spending in recent years, since there tends to be a concentration of it in the Energy sector. A rebound in oil prices could be a key factor in improving overall risk sentiment and corporate earnings if it brought an increase in capital expenditures.

Markets in Review

Trailing Economic Releases

- On Wednesday, the Federal Open Market Committee concluded its March meeting, electing to raise its federal funds rate by 0.25%, which was widely expected. Commentary from the committee, along with the Summary of Economic Projections, suggest two more hikes are in store this year, an outcome that undercut rising expectations for a quicker pace of normalization.
- Also on Wednesday, the U.S. Bureau of Labor Statistics released February's core Consumer Price Index (CPI), which excludes food and energy. A month-over-month (MoM) gain of 0.2% was in-line with BofAML Global Research and consensus estimates. Consumer inflation has maintained its uptrend in 2017. An average target of 2% allows the Federal Reserve to tolerate a slight overshoot currently seen.
- On Thursday, the Bank of England's Monetary Policy Committee kept its benchmark interest rate at 0.3%. By a vote of 8-1, members agreed the current rate is appropriate given the uncertainty created as the U.K. proceeds to trigger Article 50 on March 29th on the way to its Brexit.

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



Equities

		Total Return in USD (%)		
	Level	WTD	MTD	YTD
DJIA	20,914.6	0.1	0.6	6.5
NASDAQ	5,901.0	0.7	1.4	9.9
S&P 500	2,378.3	0.3	0.7	6.7
S&P 400 Mid Cap	1,731.1	1.2	0.2	4.6
Russell 2000	1,391.5	2.0	0.4	2.8
MSCI World	1,863.1	1.0	1.4	6.8
MSCI EAFE	1,799.0	2.1	2.8	7.3
MSCI Emerging Mkts	965.6	4.3	3.2	12.2

Fixed Income

		Total Return in USD (%)		
	Yield (%)	WTD	MTD	YTD
ML US Broad Market	2.64	0.5	-0.7	0.2
ML 10-Year US Treasury	2.50	0.7	-0.8	0.1
ML US Muni Master	2.60	0.3	-0.5	0.7
ML US IG Corp Master	3.41	0.5	-0.9	0.6
ML US HY Corp Master	5.96	0.2	-0.9	2.0

Commodities & Currencies

		Total Return in USD (%)		
	Level	WTD	MTD	YTD
Bloomberg Commodity	172.4	1.1	-2.9	-2.6
WTI Crude $/Barrel[1]	48.8	0.6	-9.7	-9.2
Gold Spot $/Ounce[1]	1,229.3	2.0	-1.5	6.7
Level	Current	Prior Week End	Prior Month End	2016 Year End
EUR/USD	1.07	1.07	1.06	1.05
USD/JPY	112.70	114.79	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, the U.S. Census Bureau reports new home sales for February. BofAML Global Research expects an increase to 570,000 new homes sold from 555,000 in January. Sales have slowed since the third quarter of last year.
- On Friday, the U.S. Census Bureau reports preliminary February core capital goods orders, an important proxy of business investment. BofAML Global Research expects a rebound to 0.5% MoM growth from a 0.1% decline in January. Investors are searching for signals that increasing confidence is translating to greater business investment.
- In the Eurozone, on Friday investors will be awaiting Markit's preliminary March release of its Composite Purchasing Managers' Index. BofAML Global Research expects a reading of 55.8, mostly steady versus the prior reading of 56.0. Since mid-2016, the bloc's service sector has reaccelerated, providing an important tailwind for stronger-than-expected growth of the region's corporate profit cycle.

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)	$1,286
WTI Crude Oil ($/bbl-eop)	$59.00

All data as of last Friday's close.

CHIEF INVESTMENT OFFICE

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