The Weekly Letter

NOVEMBER 22, 2016

- **Washington flips:** For now, investors seem focused on the pro-growth aspects of the president-elect's agenda. We identify infrastructure-related Industrials, Defense, Financials and Healthcare as areas benefitting both from Trump's proposals and long-term tailwinds. To be sure, we expect continued market volatility during Trump's transition and efforts to enact his proposals. In addition, an accelerating shift to a regime of rising interest rates argues for a greater embrace of active management of fixed income and increased scrutiny of companies with generous dividends.
- **Markets in Review:** Last week domestic equities rose, with the S&P 500 rising 0.9%, while international equities, as represented by the MSCI EAFE Index, fell 1.5%. Bonds declined on the week, with the 10-year Treasury yield at 2.35%, up from 2.15% on Thursday of the prior week. Commodities overall, as measured by the Bloomberg Commodity Index, rose 0.8%, led by WTI crude's 5.3% gain to $45.69 per barrel. Gold fell by 1.6%, to $1,207.93 per ounce.
- **Looking Ahead:** In the U.S. data reflecting the prospects of business investment and industry headline this week's releases. Core Durable Goods are expected to show growth, while the manufacturing sector is forecast to show signs of reacceleration. Meanwhile, Eurozone investors will focus on Markit's take on the state of economic growth throughout the bloc.

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Recent Publications

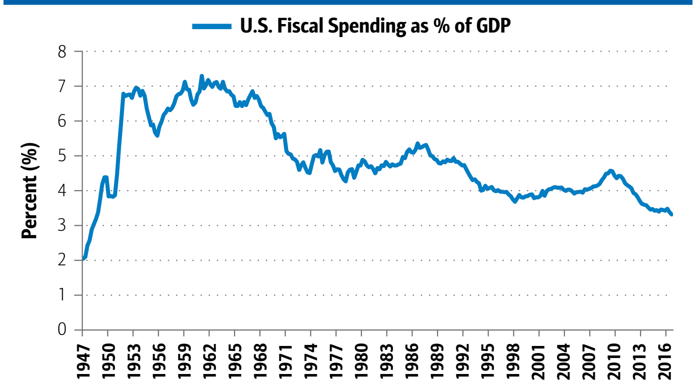
Washington flips

In the wake of the presidential election, risk assets staged a strong rally reminiscent of that following the U.K.'s Brexit vote in the summer. Global markets were poised for a historic crash well into the early morning on election night as the outcome was crystalizing. But on November 9, the S&P 500 closed at 2,163, a 6.4% swing from its overnight low of 2,031. The 10-year U.S. Treasury yield climbed from a midnight low of 1.71% to end the day at 2.06%.

As of November 18, the two measures were higher still, at 2,182 and 2.35%. Trump's win caused the U.S. Economic Policy Uncertainty Index to spike,[1] likely because success of his economic agenda as a whole cannot be predicted. Trump's proposals include growth-friendly initiatives: fiscal stimulus through tax reform and spending on infrastructure and defense, and rollbacks in regulation. Other elements are deemed adverse to growth: curbs to global trade and immigration, and hawkish Fed appointments. For now, investors seem focused on the pro-growth aspects of the president-elect's agenda, and on hopes of exodus from an era of secular stagnation, the threat of deflation and ultra-low interest rates.

We identify infrastructure-related Industrials, Defense, Financials and Healthcare as areas benefitting both from Trump's proposals and long-term tailwinds. To be sure, we expect continued market volatility during Trump's transition and efforts toward enacting his proposals. Furthermore, a budding shift to a regime of rising interest rates argues for a greater emphasis on active management of fixed income investments.

Exhibit 1: Enacting Trump's proposals could reverse a long decline in U.S. fiscal spending



Source: GWIM Chief Investment Office, BofAML Global Research, Bureau of Economic Analysis. **Past performance is no guarantee of future results.**

Focus on fiscal stimulus

U.S. fiscal spending as a percent of gross domestic product has been on a downward trend since the early 1960s and is now at levels last seen in the early 1950s (see Exhibit 1). The fiscal impetus from comprehensive tax reform and increased spending on infrastructure and defense can boost economic growth in the coming years. Tax cuts could increase disposable income for households to spend or invest, and buoy the earnings and

[1] PolicyUncertainty.com

competitiveness of U.S. corporations. A one-time tax holiday for cash repatriated by U.S. companies with significant overseas profits would bring home funds that could be used for additional domestic investment. Tax proceeds from this repatriation could fund a serious increase in infrastructure spending.

Infrastructure spending would translate to greater economic activity and provide more jobs for Americans. Trump signals a shift from a globalization agenda to a U.S.-centric program of supporting investments in transportation, clean water, security and a reliable, modern electricity grid. These policies would favor industrial companies focusing on water infrastructure, engineering, construction and machinery. Some commodities would also benefit from an increase in demand for raw materials along with increasing inflation expectations.

Defense, Financials and Healthcare could also gain

Trump has indicated plans to increase military spending to reinforce the U.S. military in an increasingly uncertain global geopolitical landscape. Meanwhile, growth in the frequency, sophistication and severity of cyber-attacks, currently estimated at about 90 million worldwide per year on governments, corporations and households,[2] should bode well for continued investment in cybersecurity. Increased spending on national defense and cybersecurity would support certain companies in areas such as Defense, Aerospace and Information Technology.

As of the close on November 18, the S&P 500 Financials have rallied nearly 11% since Election Day. Driving this performance have been prospects for greater economic activity increasing opportunities to lend along with rising interest rates and lighter regulation. Life Insurance companies and pension managers have benefitted from the promise of greater investment opportunities, which would allow them to meet return targets for future entitlements. From a longer-term perspective, history's most remarkable demographic shift, the rise of aging populations, should position the financial sector, including banks and wealth management services, as a pivotal player in addressing the saving and investment needs of a population with increased life expectancy.

Healthcare has emerged as another potential beneficiary of the electoral outcome and aging demographics. The uncertainty around potential drug price controls has diminished, allowing investors to anticipate better earnings growth for biotech and pharmaceutical companies. Also viewed as tailwinds are proposals to overhaul the Affordable Care Act, provide block grants to states for Medicaid and allow insurance to be sold across state lines.

Setbacks for cleantech, renewables, fixed income

Trump's campaign rhetoric was less supportive than Clinton's of cleantech and renewable energy. He has proposed reductions of federal spending targeting climate change and challenged America's participation in the Paris Climate Agreement. Such positions do not favor providers of clean technologies and renewables such as solar power, and mark a notable shift from prior investor expectations for a Clinton victory.

The rise of interest rates has accelerated in response to Trump's victory and its potential legislative implications. Amidst this backdrop of rising yields across the debt spectrum and the emergence of exchange-traded funds intended to passively track fixed income indexes, it may be prudent to explore the benefits of the experience and flexibility of active managers in navigating these market dynamics. Over recent years there's been a secular rise in index duration and a decrease in effective yield, along with a more recent increase in corporate credit rating downgrades. These developments have been reflected in the passive vehicles designed to track them (see Exhibit 2).

Exhibit 2: Less yield, more interest-rate risk

Index	Attribute	January 2008	November 2016	Change
BofAML U.S. Treasury Market	Duration	5.16	6.22	1.06
	Effective Yield	3.59	1.72	-1.87
BofAML U.S. Corporate Investment Grade	Duration	6.22	6.92	0.70
	Effective Yield	5.78	3.26	-2.52
BofAML High Yield	Duration	4.62	4.37	-0.25
	Effective Yield	9.52	6.72	-2.80

Source: GWIM Chief Investment Office. Data as of November 15. 2016

Increasing yields in fixed income markets mean declines in the value of bonds and most vehicles investing in them. Active managers, by way of their more flexible mandates and ability to assume active risk, could help mitigate such price declines through tactical measures including the management of duration, curve positioning, sector allocation and credit research. Active management should benefit more specialized sectors such as high yield and international debt.

Portfolio Considerations: Donald Trump's electoral victory could signal a major regime change in markets in shifting the backdrop from secular stagnation and ultra-low interest rates to fiscally-driven reflation. This carries important investment implications. We are moving from a "get paid to wait" core portfolio theme to a more cyclical- and value-oriented one. Industries supported by the potential of fiscal stimulus such as infrastructure-related Industrials, Defense and Financials look to become investment destinations for a repositioning of portfolios through year-end 2017. However, we still believe exposure to dividend-growth investments as opposed to the "bond proxies" in equities makes sense even as bond yields rise. Dividend-growth mixed with more cyclical value factors is an effective combination in the environment that we are heading into, characterized by reflation but still elevated uncertainty, in our view.

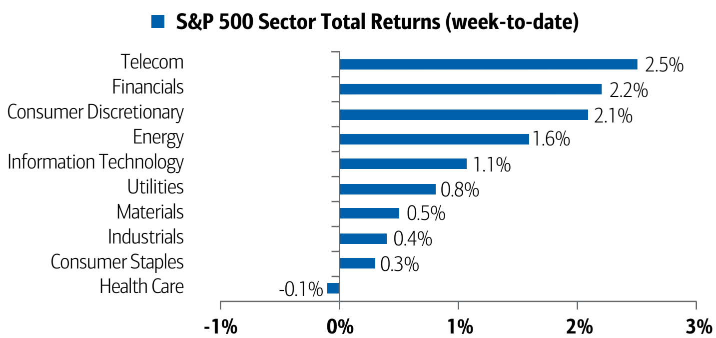
[2] BofA ML Global Research. "Thematic Investing: You've Been Hacked!—Global Cybersecurity Primer," September 3, 2015.

Markets in Review

Trailing Economic Releases

- The U.S. Census Bureau released its Retail Sales report, a key indicator of consumption, for October. Headline and core month-over-month (MoM) increases of 0.8% were higher than BofA Merrill Lynch (BofAML) Global Research estimates.
- The U.S. Bureau of Labor Statistics published its Consumer Price Index (CPI) for October. MoM headline and core increases of 0.4% and 0.1%, respectively, were weaker than expected by BofAML Global Research. Inflation has taken on added importance given its close proximity to Federal Reserve targets and resulting potential to drive monetary policy moving forward.
- Eurostat disseminated the Eurozone's final CPI report for October. Increases of 0.2% MoM and 0.5% year-over-year were mostly in line with estimates from BofAML Global Research. Inflation remains below the European Central Bank's target.

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



Equities

	Level	Total Return in USD (%) WTD	MTD	YTD
DJIA	18,867.9	0.3	4.3	11.0
NASDAQ	5,321.5	1.7	2.7	7.5
S&P 500	2,181.9	0.9	2.8	8.9
S&P 400 Mid Cap	1,605.9	2.8	6.5	16.5
Russell 2000	1,315.6	2.6	10.5	17.3
MSCI World	1,697.4	0.1	0.5	4.0
MSCI EAFE	1,614.2	-1.5	-3.0	-3.3
MSCI Emerging Mkts	844.5	-0.5	-6.6	8.6

Fixed Income

	Yield (%)	Total Return in USD (%) WTD	MTD	YTD
ML US Broad Market	2.46	-1.0	-2.3	2.6
ML 10-Year US Treasury	2.35	-1.7	-3.8	1.4
ML US Muni Master	2.45	-1.6	-2.5	0.6
ML US IG Corp Master	3.35	-1.2	-2.7	5.2
ML US HY Corp Master	6.70	-0.3	-1.2	14.3

Commodities & Currencies

	Level	Total Return in USD (%) WTD	MTD	YTD
Bloomberg Commodity	167.8	0.8	-2.2	6.0
WTI Crude $/Barrel[1]	45.7	5.3	-2.5	23.4
Gold Spot $/Ounce[1]	1,207.9	-1.6	-5.4	13.8

Level	Current	Prior Week End	Prior Month End	2015 Year End
EUR/USD	1.06	1.09	1.10	1.09
USD/JPY	110.91	106.65	104.82	120.22

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 Wednesday the U.S. Census Bureau releases its October report on Core Durable Goods Orders, an important proxy for business investment. BofAML Global Research expects MoM growth of 2.5%. Uncertainty regarding the outcome of the U.S. presidential election could have affected business spending.
- On Wednesday, Markit reports its U.S. Manufacturing Purchasing Managers Index (PMI) for November. The consensus expectation is for a reading of 53.4, indicating continued expansion in the sector. After its slowdown throughout 2015, industry has shown signs of reacceleration, according to this indicator.
- Also on Wednesday, Markit reports its Eurozone Composite PMI for November. BofAML Global Research expects a reading of 53.6, suggesting continued, steady growth throughout the bloc.

BofA Merrill Lynch Global Research Key Year-End Forecasts

S&P 500 Outlook	2016 E
Target	2,000
EPS	$117.00
Real Gross Domestic Product	**2016 E**
Global	3.1%
U.S.	1.6%
Euro Area	1.5%
Emerging Markets	4.1%
U.S. Interest Rates	**2016 E**
Fed Funds (eop)	0.62%
10-Year T-Note (eop)	2.35%
Commodities	**2016 E**
Gold ($/oz-period average)	$1,301
WTI Crude Oil ($/bbl-eop)	$51.00

All data as of last Friday's close.

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Past performance is no guarantee of future results.

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