The Weekly Letter

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→ **Europe Corporate Easing:** The European Central Bank program to buy corporate bonds is a game changer. It is potentially bullish for global credit markets and, we believe, making U.S. Investment Grade corporate bonds the main game. It could also benefit equities. Of concern is the possibility ultra-low or negative interest rates will cause misallocation of capital and spur poor lending decisions. We also comment on benefits of the Greek parliament's approval of a reform package.

→ **Markets in Review:** Last week, equities rose, with the S&P 500 Index up 0.4%, while international equities, as represented by the MSCI EAFE Index, increased 0.3%. Bonds sold off on the week, with the 10-year Treasury yield at 1.84%, up from 1.70% in the prior week. Commodities overall, as measured by the Bloomberg Commodity Index, increased 0.5% last week, as WTI crude rose 3.3%, to $47.75, and gold fell 1.6%, to $1,252.15 per ounce.

→ **Looking Ahead:** In the U.S., first-quarter gross domestic product (GDP) growth is expected to be revised higher, while the University of Michigan Sentiment Index is expected to pull back slightly. In the U.K., the final report for first-quarter GDP growth is expected to be unchanged from the preliminary estimate.

Recent Publications

Weekly Letter
The Long and Short of Japan
Stay the Course and Rebalance
Pick Your Spots
Reading the Chinese Tea Leaves

Monthly Letter
Where's the Beef? Finding Value in Fixed Income

CIO Outlook
The Forces Shaping Our World

Europe Corporate Easing

More than a year after the European Central Bank (ECB) announced its Quantitative Easing (QE) program in January 2015 it is broadening its scope to include purchases of corporate bonds. The move is intended to provide further monetary policy accommodation to support economic growth, improve the financing conditions of the real European economy, and help lift inflation rates in the medium term. Overall, QE is potentially bullish for credit markets globally and, since it could spur a refinancing wave, equity markets may also benefit.

The ECB's new corporate sector purchase program (CSPP) is scheduled to launch in June. Through the CSPP, the ECB will buy Investment Grade (IG) non-bank corporate bonds from eurozone issuers, even if their parent companies are headquartered outside the union[1]. The CSPP complements the ECB's existing asset purchase plans under QE, through which it has bought more than EUR 900 billion in government and covered bonds and asset-backed securities as of the end of April 2016.

A boost to refinancing and new issuance?

Under the CSPP, the ECB is permitting bond purchases with negative yields. This is a meaningful game changer for both the credit markets and issuers' funding costs, and strongly signals the ECB's commitment to drive down corporate financing costs. Companies with high-coupon bonds outstanding could use refinancing opportunities to save on interest expense and thus lower the cost of debt in their capital structures, which would ultimately boost earnings per share.

BofA Merrill Lynch (BofAML) Global Research contends that companies have already reacted to the CSPP with significant debt issuance, even before its launch. We saw record-high IG supply in Europe, to the tune of EUR 69 billion in March, while April was also very strong, at EUR 50 billion. Furthermore, lower coupons are already appearing. A recent example is Unilever's unprecedented issuance of zero-coupon four-year corporate bonds. We expect such favorable financing conditions to keep encouraging new-issue supply by U.S. issuers in the euro-denominated IG corporate bond market, which would reduce the U.S. dollar-denominated IG corporate bond supply and help support tighter credit spreads in the U.S. IG corporate bond market.

U.S. IG benefits from global QE

BofAML Global Research estimates that negative-yielding assets total USD 9 trillion, and about a quarter of bonds globally have negative yields. Easy monetary policy from the ECB and the Bank of Japan (BoJ) is forcing fixed income investors to reach for yield

[1] For example, euro-denominated bonds issued by a European subsidiary of a U.S. parent qualify.

beyond the eurozone and Japan. Recent Treasury data show that foreign investors bought (net) USD 22.6 billion[2] of long-term U.S. corporate bonds in March, the highest level since at least March 2009. In a world with more and more negative-yielding assets, U.S. IG corporate bonds are becoming the main game in town. They offer a 3.16% yield and have favorable technicals in terms of inflows, improving fundamentals, and attractive valuations. Spreads stand at 156 basis points (bps), as of May 20, and BofAML Global Research's year-end target is 135bps.

CSPP impact on equities

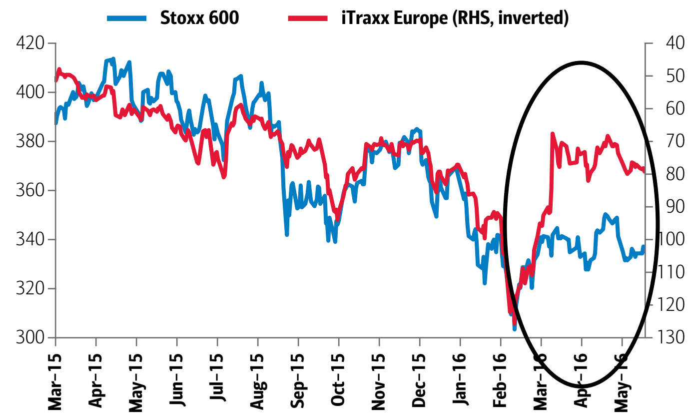
In our view, the CSPP has the potential to benefit equities in various ways. Lower debt service costs from refinancing could boost corporate earnings. Low interest rates imply lower weighted average cost of capital, which is supportive of equity valuations. And subdued fixed income yields may encourage investors in need of yield (and capital appreciation) to buy high-dividend stocks instead of bonds.

The announcement of the CSPP is potentially bullish for credit, since the program is intended to ease access to financing for corporate issuers. However, European equity price performance has lagged recently (Exhibit 1), reflecting investors' concerns over earnings growth trends. A significant correlation exists between European stocks and credit spreads—that is, when spreads tighten, stocks tend to rise. Credit spreads will likely tighten further after the CSPP's launch. BofAML Global Research assessed that a spread tightening of 20-30 bps in the Markit iTraxx Europe index, an important bond benchmark, could spell a return to recent peak valuations for the Stoxx 600 index of European equities.

Long-term concerns of CSPP

One may need to look no further than the U.S. credit markets when thinking about the end game for the CSPP. U.S. credit markets saw unprecedented growth during the Federal Reserve (Fed) QE era, though it focused on Treasuries and mortgage-backed securities, instead of corporate bonds. BofAML Global Research argues that the CSPP could lead to a doubling of the European IG credit market over the next five years. In our view, this is potentially concerning, as ultra-low or negative debt costs could cause misallocation of capital and spur some poor lending decisions and ultimately keep fundamentally unsound companies alive. The U.S. High Yield market is in the midst of a rising default cycle chiefly due to easy lending during the Fed QE era. When the ECB eventually withdraws from QE, we see risks of a deteriorating credit cycle in Europe accompanied by higher yields and wider spreads. This would be similar to the taper tantrum in 2013, when the Fed threatened to curb its bond buying program in September, but was forced to delay until December.

Exhibit 1: European equity price performance has lagged credit market performance



Source: Bloomberg and Merrill Lynch Chief Investment Office. The Markit iTraxx Europe index comprises 125 equally weighted credit default swaps on IG European corporate entities. Data as of May 19. Past performance is no guarantee of future results.

A Greek relief vote

On Sunday, the Greek Parliament voted in favor of a reform package to raise taxes, facilitate sales of non-performing loans by banks, set up a new privatization fund, and implement a correction mechanism to help the country remain on track with fiscal targets. The vote was critical to completing the review of the Greek adjustment program and help unlock additional bailout funds, as agreed with the country's creditors. It was scheduled just ahead of a Eurogroup meeting convening on Tuesday. Greece depends on this tranche of financial aid to meet its needs and make debt service payments totaling EUR 3.5 billion to the International Monetary Fund and the ECB. Furthermore, passing this measure was an important prerequisite for talks on meaningful sovereign debt relief, which should help jumpstart the Greek economy after several years of contraction and make the risk of the country leaving the Eurozone (Grexit) a more remote possibility.

Portfolio Considerations: Negative interest rate policies from the ECB and BoJ are forcing investors to reach for yield beyond the European Union and Japan. In our view, U.S. IG corporate bonds are the main game in town, offering a combination of high quality, favorable technicals, improving fundamentals, and appealing valuations. We also believe that high-quality stocks and dividend-paying stocks, especially those that are growing dividends in a sustainable fashion, stand to benefit in a yield-scarce world.

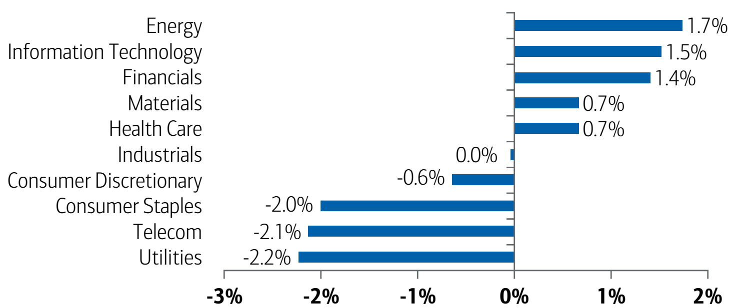
[2] BofAML Global Research believes that the real number is probably at least twice as high because of problems with the way the U.S. Treasury Department records these transactions.

Markets in Review

Trailing Economic Releases

- U.S. consumer prices rose 0.4% month-over-month (MoM) in April, versus 0.1% in March and consensus expectations of 0.3%. The core Consumer Price Index (CPI) rose 0.2% MoM, driven chiefly by Owners' Equivalent Rent (OER), which rose 0.30% MoM (the fastest OER pace since June 2015).
- U.S. existing home sales rose 1.7% MoM, to 5.45 million, in April, beating expectations of a 1.3% MoM gain, to 5.40 million. We also saw a drop in the share of distressed sales, to 7%, from 8% last month and 10% a year ago.
- Eurozone CPI year-over-year (YoY) growth in April was -0.4%, versus expectations and a prior reading of -0.5%. MoM CPI growth was 0.4%, versus 0.0% in the prior reading and consensus expectations of 0.3%.

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



Equities

		Total Return in USD (%)		
	Level	WTD	MTD	YTD
DJIA	17,500.9	0.0	-1.2	1.6
NASDAQ	4,769.6	1.2	0.0	-4.2
S&P 500	2,052.3	0.4	-0.4	1.3
S&P 400 Mid Cap	1,450.1	0.7	-0.7	4.3
Russell 2000	1,112.3	0.9	-1.6	-1.5
MSCI World	1,639.9	0.3	-1.6	-0.4
MSCI EAFE	1,634.3	0.3	-3.0	-3.2
MSCI Emerging Mkts	785.3	-1.3	-6.4	-0.6

Fixed Income

		Total Return in USD (%)		
	Yield (%)	WTD	MTD	YTD
ML US Broad Market	2.13	-0.6	-0.1	3.3
ML 10-Year US Treasury	1.84	-1.1	-0.3	4.2
ML US Muni Master	1.90	-0.2	0.4	2.9
ML US IG Corp Master	3.16	-0.8	-0.4	4.9
ML US HY Corp Master	7.65	0.2	-0.2	7.2

Commodities & Currencies

		Total Return in USD (%)		
	Level	WTD	MTD	YTD
Bloomberg Commodity	171.2	0.5	-0.8	8.1
WTI Crude $/Barrel[1]	47.8	3.3	4.0	28.9
Gold Spot $/Ounce[1]	1,252.2	-1.6	-3.2	18.0
Level	Current	Prior Week End	Prior Month End	2015 Year End
EUR/USD	1.12	1.13	1.15	1.09
USD/JPY	110.15	108.63	106.50	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

In the U.S., first-quarter gross domestic product (GDP) growth is expected to be revised higher, while the University of Michigan Sentiment Index is expected to pull back slightly. In the U.K., the final report for first-quarter GDP growth is expected to be unchanged from the preliminary estimate.

Upcoming Economic Releases

- On Friday, first-quarter U.S. GDP growth is expected to be revised higher, to 1.0%, in the second release, from seasonally adjusted quarter-over-quarter (QoQ) growth of 0.5% in the initial reading.
- Also on Friday, the University of Michigan Sentiment Index is expected to pull back slightly, to 95.0, in the final release for May, after jumping to 95.8 in the preliminary release.
- On Thursday, the final release for U.K. first-quarter GDP growth is expected to be unchanged from the preliminary estimate, at 0.4% QoQ and 2.1% YoY.

BofA Merrill Lynch Global Research Key Year-End Forecasts

S&P 500 Outlook	2016 E
Target	2,000
EPS	$120.00
Real Gross Domestic Product	**2016 E**
Global	3.1%
U.S.	1.7%
Euro Area	1.5%
Emerging Markets	4.1%
U.S. Interest Rates	**2016 E**
Fed Funds	0.63%
10-Year T-Note	2.00%
Commodities	**2016 E**
Gold $/Ounce	$1,232
WTI Crude Oil $/Barrel	$54.00

All data as of last Friday's close.

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