The Weekly Letter

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Chief Investment Office

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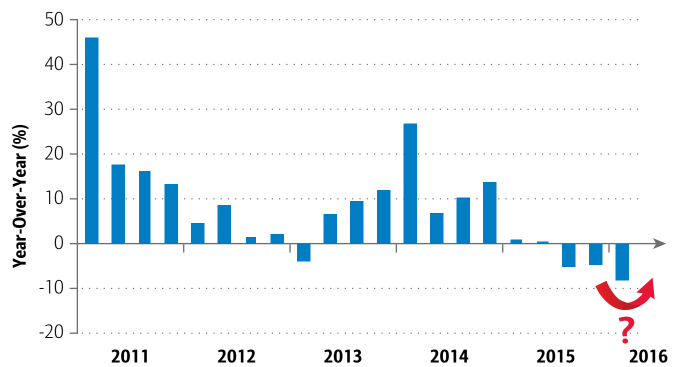
- **Will Earnings Blossom with Spring?:** Company earnings growth has been negative year-over-year for two consecutive quarters, raising concern that the S&P 500 may be overvalued and adding importance to the upcoming earnings season as investors try to determine whether we have reached a trough. The uncertain earnings environment and our expectation of episodic volatility over the shorter term highlight the need to focus on portfolio rebalancing and prudent risk management.
- **Markets in Review:** Last week equities were higher, with the S&P 500 Index up 1.6%, while international equities, as represented by the MSCI EAFE Index, rose 3.6%. Bonds fell on the week, with the 10-year Treasury yield at 1.75%, down from 1.72% the prior week. Commodities overall, as measured by the Bloomberg Commodity Index, rose 1.7% last week, paced by WTI crude, which rose during the week by 1.6% or $40.4, after rising 8.0% in the prior week. Gold fell 0.4%, to $1,234.2 per ounce.
- **Looking Ahead:** On Thursday the Federal Reserve Bank of Chicago will report its National Activity Index for March. On the same day, the Conference Board will report its leading indicator for March.

Will Earnings Blossom With Spring?

Company earnings are an essential factor for long-term equity market performance. According to FactSet, S&P 500 companies, on aggregate, have reported two consecutive quarters of declining year-over-year growth, with the first quarter of 2016 expected to extend the streak to three (see Exhibit 1). The deteriorating trend has been attributed to numerous factors, such as a lack of global and U.S. economic momentum, a stronger U.S. dollar, and falling commodity prices, and has raised concern that the equity market may be overvalued..

Given this backdrop, there is reason for caution. Yet, some contributors to the earnings weakness have begun to fade, raising hopes that this quarter will mark the trough for earnings growth. The U.S. dollar, down 4.1% year-to-date (through March 31), should give multinational companies a boost by way of currency translation of sales over the coming quarters, since non-US sales of S&P 500 firms make up about 40% of total sales. Meanwhile, commodity prices, up 0.4 %, led by oil, may improve the outlook for the Energy sector, which has been a major drag on earnings. A rebound in earnings should allay concerns about today's above-average price-to-earnings (P/E) ratio.

Exhibit 1: Have we troughed? S&P 500 quarterly earnings year-over-year growth rate

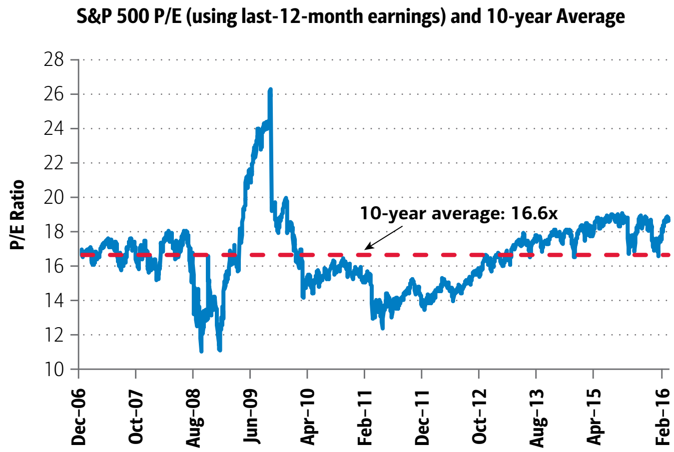


Source: Merill Lynch Chief Investment Office and Factset.
Past performance is no guarantee of future results.

Equity markets are not cheap

The price-to-earnings ratio, a traditional valuation measure for the equity market, is the price level of the S&P 500 divided by its constituents' aggregated earnings per share (EPS). It fluctuates according to investor sentiment regarding the level and certainty of profits of the index's members. The worry is that the equity market, at nearly 19 times earnings due to the deteriorating earnings picture over the past two quarters, has become expensive. The index's price has diverged from its earnings. The historical long-term average for the market's P/E ratio is 16.6 times (see Exhibit 2).

Exhibit 2: Many worry the equity market has become overvalued



Source: Merrill Lynch Chief Investment Office and Bloomberg.
Past performance is no guarantee of future results.

A reprieve of the four Cs

Earlier this year, we noted that stability in key risk areas we call "the four Cs"—China, commodities, credit, and consumers—helped ignite a risk rally that continued throughout the rest of the first quarter (see the March 15 Weekly Letter, **Stability in the Four Cs**). From the market bottom on February 11 through March 31, the MSCI All Country World Index rose 13.0% and oil prices rose 46.3%, while Investment Grade and High Yield bond spreads tightened 51 and 182 basis points, respectively. During this period, markets priced in a diminishing likelihood of a recession in China or the U.S., the prospect of improving in supply/demand imbalances in oil markets, and a continued dovish stance among global central banks. These factors imply increased confidence that earnings growth will rebound later in the year. Consequently, the S&P 500 rose 13% in the same period, increasing its P/E ratio from 16.5 times (below its 10-year average) to 18.8 times.

Low expectations set up for a beat, but will it matter?

Near-term, according to BofA Merrill Lynch (BofAML) Global Research, analysts have slashed first-quarter earnings estimates by 9% since the start of 2016, more than double the typical 4% pre-EPS season cut and the most extreme three-month cut since the first quarter of 2009. The largest cuts have been in the Energy and Financials sectors. Meanwhile, the best projected earnings are expected to be in Telecom (13% year-over-year growth), Consumer Discretionary (9%), and Health Care (6%). The worst performers are forecast to be Energy (-104 %), Materials (-20%), and Financials (-12 %). On aggregate, first-quarter S&P 500 earnings are expected to fall 9.1 %, but only 4.5% when excluding Energy. Should earnings contract in the first quarter, it would be the third consecutive quarter of year-over-year contraction. Sales growth may also be a main focus this quarter. According to FactSet, Wall Street analysts expect a slight drop of 0.3% from the same quarter a year ago and for growth to increase by 2.4% excluding energy.

However, these estimates seem too low, given that early-reporting companies have beaten their earnings and sales estimates 63% and 60% of the time, respectively. While the likelihood of a better-than-expected earnings season is significant, markets may have largely priced in the result, according to BofAML Global Research.

What does this mean?

Key to this earnings season should be the tone of companies' earnings outlooks and whether there is more evidence that improved and sustained economic and financial conditions will translate into a rebound in sales and earnings trends in the quarters ahead. A reversion to earnings growth would alleviate concerns of the market's high P/E ratio, while improved economic and financial conditions would provide a clearer earnings outlook, allowing for the ratio to increase. The consensus expects these events to occur, but we see formidable risks in the outlook and, as a result, anticipate episodic market volatility.

Economic weakness persists both domestically and globally. BofAML Global Research U.S. Economics team recently downgraded their forecast for U.S. economic growth from 2.0% to 1.7%. The International Monetary Fund (IMF) reduced its 2016 global growth forecast from 3.4% to 3.2%, though the IMF raised its forecast for Chinese growth (from 6.3% to 6.5%). Finally, the World Trade Organization recently stated that global trade volumes would grow at the same feeble rate of 2.8% as last year, below the rate of global growth. These announcements cloud the economic outlook and raise the risk that year-over-year earnings contractions may continue, leading to a correction of risk asset prices.

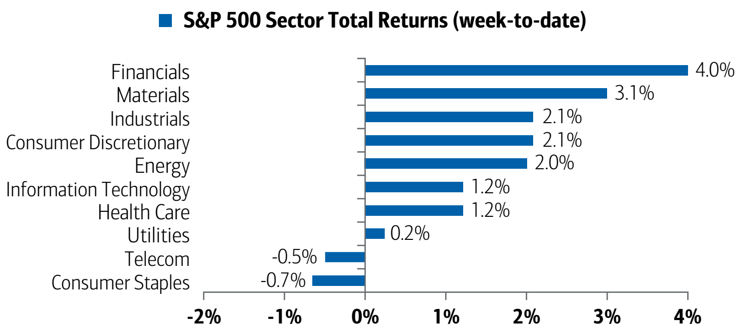
Portfolio Strategy: We would avoid making investment decisions purely on the basis of the outcome of an earnings season, preferring to focus on investors' long-term goals and strategic allocations. We encourage investors to think of this earnings season in the broader context of equity performance and how it fits in the risk management and asset allocation process. To this end, we expect episodic volatility over the shorter-term, highlighting the need for portfolio rebalancing. We believe the uncertain earnings environment favors growth-oriented companies that have retained earnings power and strong balance sheets. Over the longer-term, we favor sectors with income and growth potential, such as health care, consumer staples, and select companies in technology and industrials.

Markets in Review

Trailing Economic Releases

- On Wednesday, the U.S. Census Bureau reported that retail sales for March fell 0.3%, worse than the consensus estimate of an increase of 0.1%. This comes after a flat February reading and 0.4% contraction in January.
- On Thursday, the Bureau of Labor Statistics reported the consumer price index for March increased 0.9% year-over-year, slightly less than the consensus expectation of 1.0% and the lowest since December.
- In the eurozone, on Thursday Eurostat reported the consumer price index for March, which was flat year-over-year and slightly better than the consensus expectation of -0.1%. The core measure was inline at 1.0% year-over-year.

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



Equities

		Total Return in USD (%)		
	Level	WTD	MTD	YTD
DJIA	17,897.5	1.8	1.3	3.5
NASDAQ	4,938.2	1.8	1.4	-1.0
S&P 500	2,080.7	1.6	1.1	2.5
S&P 400 Mid Cap	1,464.8	2.7	1.4	5.2
Russell 2000	1,130.9	3.1	1.6	0.0
MSCI World	1,670.5	2.4	1.5	1.1
MSCI EAFE	1,682.1	3.6	2.0	-1.0
MSCI Emerging Mkts	846.7	3.7	1.3	7.0

Fixed Income

		Total Return in USD (%)		
	Yield (%)	WTD	MTD	YTD
ML US Broad Market	2.04	0.1	0.4	3.5
ML 10-Year US Treasury	1.75	-0.2	0.3	5.0
ML US Muni Master	1.94	0.1	0.7	2.4
ML US IG Corp Master	3.11	0.3	0.9	4.8
ML US HY Corp Master	7.91	1.6	2.0	5.4

Commodities & Currencies

		Total Return in USD (%)		
	Level	WTD	MTD	YTD
Bloomberg Commodity	162.1	1.7	2.0	2.4
WTI Crude $/Barrel[1]	40.4	1.6	5.3	9.0
Gold Spot $/Ounce[1]	1,234.2	-0.4	0.1	16.3

Level	Current	Prior Week End	Prior Month End	2015 Year End
EUR/USD	1.13	1.14	1.14	1.09
USD/JPY	108.76	108.07	112.57	120.22

Source: Bloomberg.[1] Spot price returns. All data as of last Friday's close.
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Looking Ahead

On Thursday the Federal Reserve Bank of Chicago will report its National Activity Index for March. On the same day, the Conference Board will report its leading indicator for March.

Upcoming Economic Releases

- On Wednesday, the Federal Reserve Bank of Chicago will report its National Activity Index for March. The consensus estimate is for a decrease of 0.13, following a decrease of 0.29 in February. This is an aggregate indicator of U.S. economic activity.
- On Thursday, the Conference Board will report its leading indicator for March. The consensus estimate is for an increase of 0.4% from February, following an increase of 0.1% in February and a decrease of 0.2% in January.
- In the eurozone, on Friday Markit is set to report April's preliminary reading of its Composite Purchasing Managers Index. The consensus expects a reading of 53.3, rising from 53.1 in March. A reading below 50 marks contraction, while one above 50 represents expansion.

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	3.2%
U.S.	1.7%
Euro Area	1.5%
Emerging Markets	4.2%
U.S. Interest Rates	**2016 E**
Fed Funds	0.88%
10-Year T-Note	2.00%
Commodities	**2016 E**
WTI Crude Oil $/Barrel	$45.00
Gold $/Ounce	$1,232

All data as of last Friday's close.

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Asset allocation and diversification do not assure a profit or protect against a loss during declining markets.

Alternative Investments are speculative and involve a high degree of risk. An investor could lose all or a substantial amount of his or her investment. Interests in funds may be illiquid and subject to restrictions on transferring fund investments. Funds may be leveraged and performance may be volatile. Funds are subject to substantial fees and expenses, which may offset any trading profits.

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Past performance is no guarantee of future results.

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