CIO REPORTS
The Weekly Letter

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Recent Publications

→ **REITs Enter Adolescence:** Where are yield- and growth-seeking investors to go these days? Real Estate Investment Trusts may be one place. REITs, soon to become a distinct Global Industry Classification Standard (GICS) sector, must distribute most of their earnings and should benefit from the growth in technology, the changing U.S. housing landscape, and the secular shift in self storage.

→ **Markets in Review:** Last week equities rose, with the S&P 500 Index up 1.8%, while international equities, as represented by the MSCI EAFE Index, fell 0.2%. Bonds rose on the week, with the 10-year Treasury yield at 1.77%, down from 1.90% in the prior week. Commodities overall, as measured by the Bloomberg Commodity Index, fell 1.6% last week, as WTI crude fell 6.8%, to $36.8 per barrel, while gold rose 0.5%, to $1,222.5 per ounce.

→ **Looking Ahead:** In the U.S, the February consumer credit and wholesale inventories reports are scheduled for release on Thursday and Friday, respectively. Consensus expectations are for credit to have expanded by $15 billion and for wholesale inventories to have contracted by 0.2%. In the eurozone, Markit's Retail Purchasing Manager Index (PMI) is on tap for Wednesday.

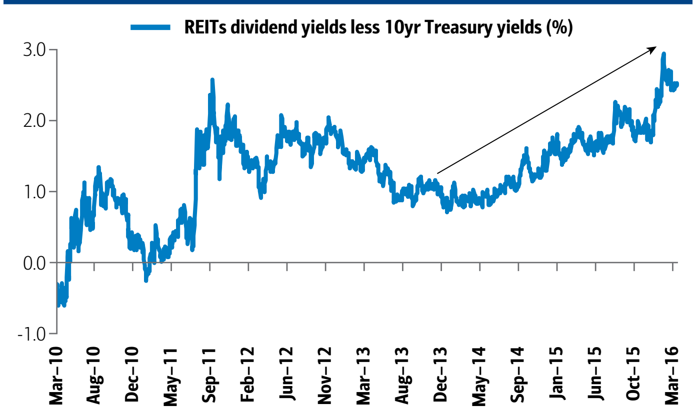
REITs Enter Adolescence

Last week, we shopped for yield and growth in the U.S. Consumer Staples sector (see the March 29 Weekly Letter, **Shopping for Yield and Growth**). This week, we look at Real Estate Investment Trusts (REITs), another U.S. sector we think may provide yield-starved investors with both appealing dividend yields (see Exhibit 1) and capital appreciation potential. REITs are required by law to maintain dividend payout ratios of at least 90%, making them attractive in a yield-scarce world. Furthermore, we believe they are poised to benefit this year from the growth in technology, the changing U.S. housing landscape, and the secular shift in self storage. REITs, now part of the Financials sector within the Global Industry Classification Standard (GICS) system, will soon break out on their own. REITs becoming a distinct GICS sector represents their entry into adolescence and, therefore, we would expect increasing sector awareness, recognition and inflows.

REITs to become their own sector

On August 31, REITs will be removed from the Financials sector within the GICS system and obtain their very own GICS sector. This move will be followed by the sector's implementation within the S&P 500 Index on September 16.

Exhibit 1: REITs offer significantly higher yields than Treasuries



Source: Merrill Lynch Chief Investment Office and Bloomberg. REITs as measured by the FTSE NAREIT All Equity REITs Total Return Index. Data as of March 30. Past performance is no guarantee of future results. **Note: Unlike REITs, U.S. Treasuries are government guaranteed for the timely payment of principal and interest.**

REIT Milestones

1960	1965	1969	1985	1986	1991	2001	2016
President Eisenhower signs the REIT Act into law.	The first REIT is listed on the New York Stock Exchange.	REITs go global. (Thirty-one countries have enacted REIT legislation, with another 10 under way.)	Martin Cohen and Robert Steers launch the first open-ended mutual fund focused on U.S. REITs.	The Tax Reform Act makes the U.S. REIT structure more compelling for both companies and investors.	The modern REIT era begins with the IPO of Kimco Realty.	The first REIT is added to the S&P 500 Index.	REITs to become the 11th GICS sector.

Source: Merrill Lynch Chief Investment Office, National Association of Real Estate Investment Trusts and Cohen & Steers.

More inflows and less volatility

As a result of REITs being buried inside the Financials GICS sector, U.S. equity funds have been significantly underweight Real Estate and would need to buy more than $100 billion in REITs to achieve a market-neutral position in the new REIT sector, according to Cohen & Steers. REITs' volatility may also decline due to increased liquidity and the separation of Real Estate from Financials, historically among the most volatile sectors in the S&P 500. Furthermore, the recently passed Foreign Investment in Real Property Tax Act (FIRPTA) allows overseas investors to own up to 10% of a publicly traded U.S. REIT (up from 5%), and foreign pension funds are allowed to own U.S. real property interests without triggering FIRPTA withholding tax. These changes could bring billions of dollars of foreign investment into the U.S. commercial real estate market.

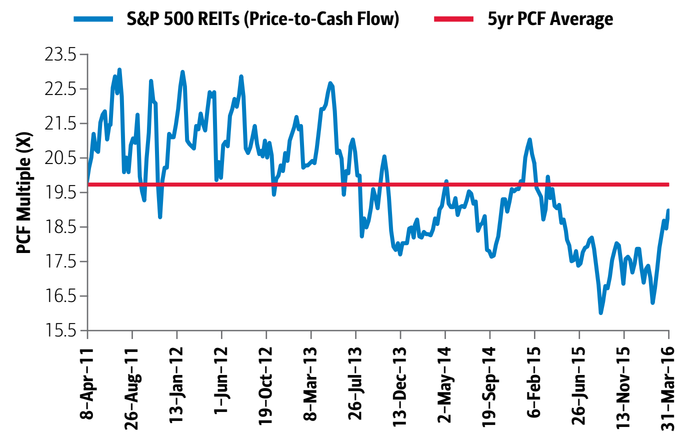
Potential for attractive dividends

REITs are required by law to maintain dividend payout ratios of at least 90%, making them attractive in a yield-scarce world. As of the end of March, U.S. REITs[1] offered a dividend yield of 4.2%, versus 2.2% for the S&P 500. The yield differential between REITs and 10-year U.S. Treasuries has been trending upward since 2011 and, as of the end of March, stood at 2.0%, underscoring the relative attractiveness of REITs as a source of income. Additionally, U.S. REITs enjoy attractive dividend growth potential due to their ability to grow distribution both through internal sources, such as healthy fundamentals and redevelopments, and external sources, including acquisitions and developments.

Attractive valuations

REITs outperformed the U.S. stock market year-to-date (through March 31), with a total return of 5.8%, versus 1.4% for the S&P 500. In addition, REIT prices have bounced 18.6% since their February 11 low, in part supported by subdued interest rates. However, despite the recent rally in REITs, the sector is still trading below its five-year price-to-cash flow average of 19.7x (see Exhibit 2). Furthermore, BofAML Global Research finds that REITs are trading at 99% of net asset value, versus their long-term average of 101%.

Exhibit 2: REITs trading below their 5yr PCF average



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

REITs and interest rate risk

We have argued that REITs can be an attractive source of income due to their generous dividend payouts and one therefore could reasonably infer that REITs behave as bond proxies. In case interest rates accelerate, not our base case, one may thus be concerned about bond sell-offs bleeding into REITs. However, according to BofAML Global Research, the impact of rising rates on REITs should be modest, and evidence is inconclusive on relative performance during previous Federal Reserve tightening cycles. In the last three tightening cycles, REITs underperformed in two and outperformed in one. Thus, history does not offer clear-cut guidance as to how REITs behave in rising interest rate environments.

Portfolio Strategy: With Real Estate increasingly viewed as a distinct asset class and being incorporated separately into strategic asset allocations, exposure to it through REITs could grow in investor portfolios. Thus, REITs may serve as portfolio diversifiers, since Real Estate enjoys relatively low correlations with the broader stock and bond markets, while offering the potential for attractive dividend yields. In our view, the outlook for Apartments and Self Storage is favorable, given Millennial housing preferences, while Health Care also should do well in the long term, given the aging of Baby Boomers. Finally, robust consumer spending could make us cautiously optimistic on Retail, chiefly because online is gaining on bricks and mortar.

The BofAML Global Research Equity REITs team is overweight Apartments, Self Storage and Specialty; equal-weight Industrials, Office and Retail; and underweight Health Care and Triple Net Leases.

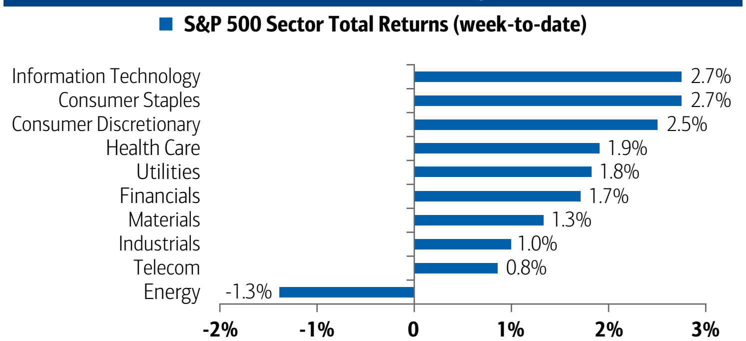
[1] As measured by the FTSE NAREIT All Equity REITs Total Return Index, a free float adjusted market capitalization weighted index that includes all tax qualified REITs listed on the New York Stock Exchange, American Stock Exchange, and NASDAQ National Market.

Markets in Review

Trailing Economic Releases

- On Friday, the Bureau of Labor Statistics reported 215,000 non-farm jobs created in March, better than the consensus estimate of 205,000. A rise in the unemployment rate to 5.0%, versus consensus expectations of 4.9%, was attributed to more people entering the workforce. Year-over-year wage growth ticked higher, to 2.3%.
- Also on Friday, the Institute of Supply Management reported that its manufacturing gauge rose to 51.8 from 49.5 in March, signaling a reversion to growth after five months of contraction. The result was better than consensus expectations of 51.0.
- On Thursday, eurozone preliminary headline and core inflation for March were reported at -0.1% and 0.9%, respectively. This marks two consecutive negative readings for the headline measure.

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



Equities

		Total Return in USD (%)		
	Level	WTD	MTD	YTD
DJIA	17,792.8	1.6	0.6	2.8
NASDAQ	4,914.5	3.0	0.9	-1.5
S&P 500	2,072.8	1.8	0.6	2.0
S&P 400 Mid Cap	1,451.6	2.7	0.4	4.2
Russell 2000	1,117.7	3.6	0.3	-1.2
MSCI World	1,640.1	1.1	-0.5	-0.8
MSCI EAFE	1,616.2	-0.2	-2.1	-5.1
MSCI Emerging Mkts	826.2	1.7	-1.3	4.4

Fixed Income

		Total Return in USD (%)		
	Yield (%)	WTD	MTD	YTD
ML US Broad Market	2.21	0.6	0.0	3.0
ML 10-Year US Treasury	1.77	0.9	-0.1	4.5
ML US Muni Master	2.09	0.5	0.1	1.7
ML US IG Corp Master	3.34	0.7	0.0	3.9
ML US HY Corp Master	8.39	0.3	0.0	3.2

Commodities & Currencies

		Total Return in USD (%)		
	Level	WTD	MTD	YTD
Bloomberg Commodity	157.2	-1.6	-1.1	-0.7
WTI Crude $/Barrel[1]	36.8	-6.8	-4.0	-0.7
Gold Spot $/Ounce[1]	1,222.5	0.5	-0.8	15.2
Level	Current	Prior Week End	Prior Month End	2015 Year End
EUR/USD	1.1	2.0	0.1	4.9
USD/JPY	111.7	-1.2	-0.8	-7.1

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

In the U.S, the February consumer credit and wholesale inventories reports are scheduled for release on Thursday and Friday, respectively. Consensus expectations are for credit to have expanded by $15 billion and for wholesale inventories to have contracted by 0.2%. In the eurozone, Markit's Retail Purchasing Manager Index (PMI) is on tap for Wednesday.

Upcoming Economic Releases

- On Thursday, consumer credit for February is set to be reported. The consensus estimate is for a $15 billion increase, accelerating from an expansion of $10.5 billion in January.
- On Friday, consensus expectations are for wholesale inventories to have contracted by 0.2% in February, following an accumulation of 0.2% in January.
- In the eurozone, Markit's Retail PMI for March is scheduled for release on Wednesday. In February, the reading was 50.1.

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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