Chief Investment Office • JANUARY 19, 2016

A Market Under Stress — We Believe This, Too, Shall Pass

What is pressuring the markets?

- The underlying pressure is due to a significant growth scare and a subsequent recalibration of risk—a re-setting of risk is correcting the valuations of riskier assets and even pressuring higher-quality areas as key support levels are breached in market indices.
- The growth scare concerns are over the instability in China, its currency policy, its economic transition and market volatility.
- Concerns that a large scale recession is around the corner, given the hyper focus on the decline in manufacturing, trade, basic materials and commodities, transports, and other heavy industry areas.
- Elevated geopolitical risk since the summer of 2015.
- Concerns over the Federal Reserve (Fed) tightening into a protracted slowdown and removing inexpensive credit that fostered risk-taking.
- Energy and commodity asset deleveraging is leading to an increase in the need for liquidity.
- The sharp deterioration in riskier assets is emblematic of a change to monetary policy mix that is upsetting the over-reliance on cheap credit mixed with a large growth scare.
- Stricter financial regulation has caused banks to slash holdings of financial assets (dealer inventories currently total 2% of corporate bond fund assets, versus 20% 10 years ago), exacerbating the volatility that normally occurs when the Fed signals its intent to begin raising rates.
- The current correction is akin to the sharp fall of 20% in a matter of weeks in 1998, during the Asian currency crisis.

In our view, this, too, shall pass, given eventual stability based on more transparent economic data and improving earnings plus eventual significant benefits from the severe drop in energy and commodity prices finally coming through to consumers and business users; and, the recalibration of risk is bringing valuations back to longer-term attractive levels.

What is accelerating the recent weakness in the markets?

- Oil has fallen below a psychological threshold of $30 per barrel and is now at 12-year lows (a 6% fall on January 15).
- Quantitative-momentum selling has picked up at the index level to protect against losses in other areas.
- Further instability in China's capital markets. Many have begun to question China's ability to adjust its currency policy and communicate its plan accordingly.
- A technology bellwether's earnings suggested weakness in Asia.
- Further deleveraging as markets correct, creating a vicious circle.

What is our position on the big concerns?

What is China's growth path and currency policy, and what explains the trends?

- China is in a long and bumpy transition, which portends slower growth and market volatility in the near term. The economy is expected to expand by 5-6% in the years ahead and remain a key contributor to global growth.
- Services now account for a greater share of gross domestic product (GDP) than manufacturing, but state-owned manufacturing enterprises remain highly leveraged and a significant credit risk.
- While the consumer accounts for less than 40% of GDP, personal expenditures are expanding by double digits, boosting consumption in China: Millennials—in excess of

400 million—who are tech savvy, health conscious, and love to travel.

- China's diminished demand for basic commodities should continue to weigh on the world's primary commodity producers, which explains, in part, our underweight of Emerging Markets.
- China's stock market volatility reflects the mixed and misguided messages from government officials over the country's currency regime, stock market rules and regulations. Ad-hoc, stop-go policies have sowed a great deal of confusion in the minds of investors, but we expect the government to improve on its messaging this year.
- We expect more yuan-dollar depreciation in the months ahead but are not anticipating a very sharp, volatile and market-disrupting move in the currency this year.
- China has the financial firepower to manage the current credit stress, with more than $3 trillion in international reserves, a large trade surplus (in excess of $500 billion), and a current account surplus of 3% of GDP.
- U.S. commercial exposure to China is relatively minimal. China accounts for only 7.7% of U.S. total exports. The impact of China's slowdown on U.S. corporate earnings is more indirect than direct and transmitted via weaker global growth, swooning commodity prices, and rising credit stress in the oil patch and Emerging Markets.

Is a recession around the corner? Are the "recessions" in manufacturing and trade filtering into the consumer and broader economy?

- Concerns that a decline in manufacturing could tip the economy into a recession are overblown, in our opinion.
- The U.S. industrial sector has experienced a downturn across mining, utilities and manufacturing in the past year, thanks to slumping energy prices and unseasonably warm weather and weaker foreign demand. However, the contribution of manufacturing to growth (about 12% of GDP and 8% of jobs) is small and dwarfed by consumers, who continue to do fine, with a strong labor market, a rise in real income and not experiencing a recession.
- The market is right to question how much an additional drop in global demand can chip away at U.S. growth. At present, however, U.S. growth is running on the consumer and domestic oriented industries, like services. This should keep the U.S. a bit more immune to the ills abroad. U.S. households direct two-thirds of their spending to services—most job growth has been in services, not goods.
- There have been 15 bear markets in the U.S. since 1928. Ten occurred in tandem with recessions with a median length of just over twenty months and a median market drop of 44 percent. Five bear markets occurred without a recession (1987, 1998 and 2011 are examples). Historically, they had a median life of just five months and a drop of 26 percent on average.
- The current technical evidence suggests that additional market pressure is likely in the very short term. But, importantly, the all-in fundamental economic evidence is stronger now that this latest market drop is occurring without a recession, in our view.
- There are major similarities to the 1990s expansion, which ended up being 120 months long, while the current expansion is just shy of 80 months long. Back then, a series of Emerging Market currency crises unfolded, including a Russian default (1998) and an oil price collapse from $25 per barrel in 1996 to $10 per barrel in 1998.

Is the impact of the severe fall in oil and commodity prices in general a net positive or negative?

The latest downdraft in oil prices has accelerated. A global growth scare and macro cross-currents, led by weakness in Chinese financial markets, corresponding weakness in Emerging Markets, and continued currency volatility—specifically, fears of China aggressively devaluing its currency—are driving investor concerns regarding energy demand. We believe the significant fall in oil and gas prices is ultimately a net positive.

- We continue to see the decline in oil as a moderate boost for consumers. Bank of America Merrill Lynch Global Research Economics estimates that consumers spent about 60% of the energy windfall in the past year-and–a-half.
- Various measures of consumer health, such as the Michigan Consumer Sentiment Index and the Conference Board Consumer Confidence Index, provide optimism on consumer spending. The recent jobs data support the expectations of a slight pick-up in incomes and continued spending growth.

What is the latest elevated geopolitical risk?

- Outside the western hemisphere, geopolitical risks have escalated sharply over the past few years. Until recently, the impact has been relatively minor on the capital markets.
- The Middle East is littered with failed states, while the Islamic State of Iraq and Levant (ISIL) has run rampant in Syria and Iraq, threatening to redraw the map of the Middle East.
- The growing virulent feud between Sunni Saudi Arabia and Shiite-led Iran threatens to undermine the fragile stability of the region—the reach of ISIS could be global, with the number of ISIS-inspired attacks multiplying last year hitting targets in Europe, the United States and now Asia, with the current attack in Indonesia.
- In Europe, Russia's annexation of Crimea and military presence in Syria has chilled relations with Russia and the West.
- China's military build-out in the South China Sea threatens the region's military and economic stability, as does the unpredictable regime in North Korea.
- Given the multiple global hotspots of today, we continue to favor large-cap U.S. defense companies as military spending in the U.S. and around the world is on secular upswing, which favors the world's top arms manufacturers—U.S. defense firms.

What are the market internals?

- Equity valuations are at discounts now:
  - Market valuations have dropped to two-year lows.
  - All three major indices (S&P 500, NASDAQ, Dow) are down well over 10% from their recent highs in 2015 (market multiple was above historical levels then).
  - The S&P 500 forward-price–to-earnings ratio has round-tripped since January 2014 and now trades slightly below its historical average of 15 times for the first time in two years. The index also trades just below its historical average on trailing earnings and more than 10% below its historical average on normalized earnings, book value and free cash flow.
- Stock market declines are par for the course:
  - 5% plus pullbacks for the S&P 500 have occurred three times on average per year and 10% plus corrections have occurred once on average per year since 1928. Pull-backs that have not included a recession have historically created attractive opportunities at better valuations for long-term investors.
- The S&P 500 is roughly 8% lower this month. Since 1928, after a 10% correction, the average return of the S&P 500 in three months that followed has been roughly 14%.
- About 55% of S&P 500 stocks have a dividend yield above the 10-year Treasury yield (as of January 15). High-quality companies with good yields and dividend growth characteristics should attract capital by long-term total return investors as the market stabilizes.
- While commodity-based sectors such as energy and industrials suffered, corporate profits rose for technology, health care and consumer sectors of the S&P 500, in 2015. We believe this should be the case in 2016 as well, which should help keep the overall economic expansion chugging along.
- Credit spreads and financial conditions:
  - The recent volatility and stock market correction have tightened financial conditions. The Fed will closely monitor this as a key barometer of how markets impact the real economy.
  - The longer and deeper the equity correction, the more likely it is that the Fed will be more inclined to pause in March. Current markets are pricing in a total of two hikes instead of four for the full year.
  - Recent Fed commentary supports the view that the real economy is still on solid footing.
- Although the yield curve has flattened in recent weeks, this does not signal an imminent recession, in our view. In the past, 2-10 year yield curve flattened at the start of a tightening cycle and inverts only when the Fed becomes too tight.
- Investment Grade (IG) and High Yield (HY) spreads have widened 18 basis points and 75 basis points, respectively, year-to-date. The energy and metals and mining sectors have led the weakness, but most other sectors have followed wider.
- The HY market continues to significantly underperform IG as stress in the energy market accelerates. HY energy spreads are 220 basis points wider this year and yields have risen from 15.8% to 18%. Over half of the energy sector is now trading at distressed levels (above 1,000 basis points). Two HY defaults were announced last week, and we expect a sharp up-tick in default rates as we progress through 2016.

While the widening of spreads reflects increased risk across the credit spectrum, importantly, the funding market is not showing stress. We examine the funding market closely to look

for signs of systemic financial risk. Thus far, valuations and activity in key spread indicators, like the difference between Treasury bill yields and the London Interbank Offered Rate (Libor), have been consistent with the volatility observed in risk assets and not deeper funding stress.

What is needed, in our view, to turn the markets around?

- Oil prices need to stabilize and bottom.
- China growth needs to stabilize and its currency devaluation needs to be orderly.
- Fear and volatility gauges need to indicate an end to forced selling.
- China market stability is needed overall.
- U.S. corporate earnings need to show resiliency and exhibit positive growth quarter-over-quarter.
- The need to see more positive economic developments and ultimately avoid off a recession.
- The Fed needs to remain patient.
- The European Central Bank and the Bank of Japan need to stay accommodative.
- The trade-weighted dollar needs to avoid further sharp acceleration.

What should we expect for the rest of the year?

- Volatility subsides as earnings show positive developments driven by the consumer sector.
- No economic recession as the healthier parts of the economy balance out those in contraction.
- China's economy stabilizes at an acceptable growth level and currency policy is better managed versus a trade-basket.
- Oil prices stabilize around mid-year, after major capital expenditure (CAPEX) cuts filter through to supply.
- Consumer spending holds up enough to keep the economy moving forward.
- Market valuations become attractive given the broader backdrop and long term investors begin to allocate risk capital back into equity markets.
- Market turn around begins as investors realize a major contraction or systemic financial event is not around the corner.
- Stock buybacks gather momentum again.
- Fed shows further patience while the ECB and BOJ continue with reflationary policies
- Focus shifts to earnings and Fed policy.

What is our portfolio strategy through the market weakness and as asset prices stabilize?

- Given our view that volatility and fragility are going to remain elevated until certain events (see above) are resolved, we would wait for signs of stability before fully re-balancing.
- With so much of the global growth story hinging on China, within equity portfolios we think Developed Markets will continue to outperform Emerging Markets. However, as China stabilizes in the next 12 months, it will be time to revisit Emerging Market investments. We remain underweight at present.
- During the global market sell-off, Europe and Japan have retreated to multiples last seen in 2012 and 2013—13 times forward earnings—making them attractive again and a place to consider rebalancing equity portfolios as markets stabilize. A diversified allocation across the U.S., Europe and Japan makes sense, given valuation and quality.
- Once volatility subsides, we would consider allocating cash to high-quality large-caps that have solid balance sheets, low leverage, attractive dividend growth prospects, and good transparency on earnings.
- We continue to favor longer-term, high-quality municipal bonds for taxable investors. In addition, we see value in shorter-term corporate bonds in the Investment Grade space. Overall, we maintain a barbell strategy for diversified fixed income portfolios.

Conclusion

Although there is large-scale weakness in manufacturing, energy, commodities and heavy industry, the 80-month-long U.S. economic expansion (led by the consumer) is still alive, in our view. We do not expect a recession to develop. Rather, we view the latest negative volatility and equity downdraft as a major cyclical correction in which risk is being re-priced, with volatility shifting higher, as the Fed has removed its zero percent interest rate policy. A stronger dollar from last year, a tightening in financial conditions, China's confusing currency policy, elevated geopolitical concerns, and fears of a full-scale recession have created a large risk-off environment. We believe this backdrop has many similarities to the late 1990s'

Asian currency crisis. Back then, a 20% fall in U.S. equities was over in about two-and-half months, from mid-June to early September in 1998, and market indices recovered to new highs by the end of that year, after oil prices had stabilized and a recession had not occurred.

Current market technicals suggest more negative volatility (perhaps down to 1,820 on the S&P 500) is needed to correct the last leg of overvaluation, given the re-pricing of risk.

Investors should consider a plan to rebalance back into investments that exhibit characteristics of low leverage, attractive yields, solid balance sheets, and dividend growth. These areas should represent the core of a re-balancing strategy, in our view, as the U.S. economy staves off recession and continues on its long-term expansion.

Our opinion: This, too, shall pass.

CHIEF INVESTMENT OFFICE

Christopher Hyzy
Chief Investment Officer
Bank of America Global Wealth & Investment Management

Christopher J. Wolfe
Head of the Merrill Lynch Chief Investment Office

Mary Ann Bartels
Head of Merrill Lynch Wealth Management Portfolio Strategy

Karin Kimbrough
Head of Macro and Economic Policy

Maxwell Gold
Vice President

Emmanuel D. "Manos" Hatzakis
Director

Jon Lieberkind
Vice President

Niladri "Neel" Mukherjee
Managing Director

John Veit
Vice President

GWM Investment Management & Guidance (IMG) provides industry-leading investment solutions, portfolio construction advice and wealth management guidance.

Investing involves risk, including the possible loss of principal. The views and opinions expressed are subject to change without notice at any time, and may differ from views expressed by Merrill Lynch or any of its affiliates. These views are provided for informational purposes only and should not be used or construed as a recommendation of any service, security or sector.

This material was prepared by the Investment Management & Guidance Group (IMG) and the Chief Investment Office of the Private Banking & Investment Group , and is not a publication of BofA Merrill Lynch Global Research. The views expressed are those of IMG only and are subject to change. This information should not be construed as investment advice. It is presented for information purposes only and is not intended to be either a specific offer by any Merrill Lynch entity to sell or provide, or a specific invitation for a consumer to apply for, any particular retail financial product or service that may be available.

This report provides general information only. Neither the information nor any views expressed constitutes an offer or an invitation to make an offer, to buy or sell any securities or other investment or any options, futures or derivatives related to such securities or investments. It is not intended to provide personal investment advice and it does not take into account the specific investment objectives, financial situation and the particular needs of any specific person who may receive this report. Investors should seek financial advice regarding the appropriateness of investing in any securities, other investment or investment strategies discussed in this report and should understand that statements regarding future prospects may not be realized. Investors should note that income from securities or other investments, if any, may fluctuate and that price or value of such securities and investments may rise or fall. Accordingly, investors may receive back less than originally invested. Past performance is not necessarily a guide to future performance. Neither Merrill Lynch nor any of its affiliates or financial advisors provide legal, tax or accounting advice. You should consult your legal and/or tax advisors before making any financial decisions.

The investments discussed have varying degrees of risk. Some of the risks involved with equities include the possibility that the value of the stocks may fluctuate in response to events specific to the companies or markets, as well as economic, political or social events in the U.S. or abroad. Bonds are subject to interest rate, inflation and credit risks. Investments in high-yield bonds may be subject to greater market fluctuations and risk of loss of income and principal than securities in higher rated categories.

Income from investing in municipal bonds is generally exempt from federal and state taxes for residents of the issuing state. While the interest income is tax exempt, any capital gains distributed are taxable to the investor. Income for some investors may be subject to the federal alternative minimum tax (AMT).

Investments in foreign securities involve special risks, including foreign currency risk and the possibility of substantial volatility due to adverse political, economic or other developments. These risks are magnified for investments made in emerging markets. Investments in a certain industry or sector may pose additional risk due to lack of diversification and sector concentration.

Trading in commodities is speculative and can be extremely volatile. Market prices of the commodities may fluctuate rapidly based on numerous factors, including changes in supply and demand relationships; weather; agriculture; precious metals; trade; fiscal, monetary and exchange control programs; domestic and foreign political and economic events and policies; disease; technological developments; and changes in interest rates.

Alternative investments are intended for qualified and suitable investors only. Alternative investments involve limited access to the investment and may include, among other factors, the risks on investing in derivatives, using leverage, and engaging in short sales, practice which can magnify potential losses or gains. Alternative investments are speculative and involve a high degree of risk.

Investing directly in Master Limited Partnerships (MLP's), foreign equities, commodities or other investment strategies discussed here, may not be available *to*, or appropriate *for*, Merrill Edge clients. However, these investments may exist as part of an underlying investment strategy within exchange-traded funds (ETF's) and mutual funds, which are available to Merrill Edge clients.

ARDXG7SF

Merrill Lynch
Bank of America Corporation