CIO REPORTS

The Weekly Letter

Office of the CIO • MAY 12, 2015

- **Europe - A deeper dive:** With the economic outlook for Europe increasingly positive, we see further upside in European equities with a 12-to-18-month horizon. However, the pace of gains is likely to moderate, suggesting selectivity and risk management are increasingly important. In addition, the dynamics of the European economy suggest the industries and equity sectors that outperform going forward may be different from those that stood out during the past few years.
- **Markets In Review:** Equities ended on a positive note, with the S&P 500 up 0.4% last week and the MSCI EAFE Index up 0.8%. Bonds continued to decline, bringing the 10-year Treasury yield to 2.15% from 2.11% the prior week. Commodities ended the week up 0.7%, as WTI Crude oil rose 0.4% to $59.39 per barrel and gold rose 0.8% to $1,188 per ounce.
- **Looking Ahead:** Retail sales growth in the U.S. is expected to have moderated in April, and industrial production should have rebounded from the dip in March. In Europe, first-quarter GDP growth is likely to have improved.

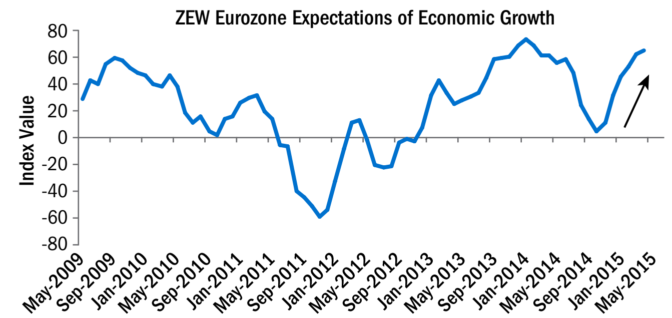
Europe - A deeper dive

European equities rallied more than 20% this year through mid-April, but have retraced some of their gains in the past month. We see this as a consolidation within a longer-term uptrend, and advise investors underexposed to the region's stocks to use the recent weakness as a buying opportunity.

Indeed, the economic outlook for Europe is increasingly positive, with industrial production and retail sales improving, and signs of credit growth finally starting to materialize. Additionally, while the impressive rally in European equities this year has closed some of the valuation gap with the U.S., fundamentals are still solid and earnings growth is showing promise. Lastly, after setting a torrid pace earlier in the year, investment fund inflows have moderated but continue to support positive momentum.

While we continue to see further upside in European equities with a 12-to-18-month horizon, the pace of gains is likely to moderate going forward, suggesting selectivity and risk management are increasingly important. The macro backdrop is certainly supportive for the region's stocks, but this has been incorporated into current valuations somewhat suggesting the market is vulnerable if stimulus from the European Central Bank (ECB) becomes less effective. Risks still linger around the periphery, particularly Greece, and while BofA Merrill Lynch (BofAML) Global Research economists foresee a positive resolution to the crisis, they expect further volatility until an agreement is finally reached.

Exhibit 1: Expectations for economic growth In Europe have been on an upswing



Source: Bloomberg, MLWM Investment Management & Guidance, data as of April 30, 2015.

Mind the euro

As with the Federal Reserve in the U.S., the ECB has embraced aggressive monetary policies to stimulate economic growth. The two main weapons in a central bank's arsenal are lower interest rates and an expanding monetary base. BofAML Global Research economists see evidence of the deployment of both over the past few quarters, as the number of government bond yields turning negative has ballooned, and money supply growth is now at its strongest since 2009. As a result, overall confidence in the Eurozone economy has improved. The ZEW Eurozone Expectations of Economic Growth Index has been on an uptrend since November and continued its rise this year with the announcement of the ECB Quantitative Easing program (see Exhibit 1).

The ECB's actions have sharply weakened the euro, which approached parity with the U.S. dollar last month before bouncing back to 1.12 on Friday. Although the swift decline since May of last year suggests a period of consolidation lies ahead, we reiterate our view of a stronger dollar in the medium term as the paths of the two central banks continue to diverge. **A weaker euro is paramount to the ECB's success in fending off deflation and stimulating growth of the export-led economy, and we would not expect to see further gains in the currency taken lightly.** For U.S.-based investors, the implications of this trend should be taken into consideration as a declining currency can have significant effects on performance.

Watch for a cyclical shift …

The improving dynamics of the European economy suggest the industries and equity sectors that outperform going forward may be different from those that stood out in the past several years. As the initial legs of the stock market rally appear to be fading, a broad brush approach to European equities may no longer be as effective. Our BofAML European Equity Strategist James Barty notes that **improving business confidence and growth suggest more cyclical sectors may begin to show leadership.**

So far, the rally in European equities has been dominated by valuation expansion as corporate earnings have remained flat. This is expected to change; **the BofAML European equity strategy team has doubled its forecast for earnings growth this year to more than 10%, increasing to nearly 12% in 2016.** This view supports a shift to more growth-oriented areas, which we expect to benefit the most.

…and sector rotation

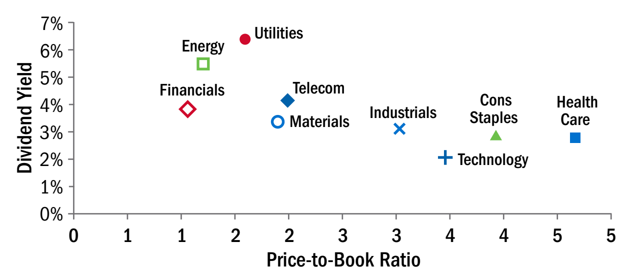
Barty favors the Energy, Industrials and Banks sectors. Last year, Utilities was the best performing sector in Europe, while Energy was the only one to post a loss. This year has seen the tables turn, with Utilities eking out a small gain but Energy companies outperforming the broader index. We expect the commodities markets to remain volatile as global demand struggles to catch up to a rapidly increasing supply base, but there is an increasing likelihood that oil prices are stabilizing and will continue to move higher over the next 12 to 18 months, lending support to the Energy sector.

An improving manufacturing sector suggests industrial stocks, which have fallen out of favor, may see a rebound. As in the U.S., they have underperformed other cyclical sectors as falling energy prices have led many resource-related companies to slash their capital spending budgets. However, our BofAML Global Research analysts believe this has been largely factored into stock prices, and the improving growth outlook could see the sector outperform.

A major focus of the ECB's monetary policy has been resuscitating the banking system. This effort has begun to bear fruit in the form of improvement in bank lending, with loan growth moving into positive territory in the past six months. Low interest rates have been a huge benefit to the industry, keeping interest costs down while many banks were forced to raise capital and debt. The outlook for Financials is improving as a result, and last month the ratio of earnings forecast upgrades to downgrades for the sector rose to the highest level in nearly a year.

Within cyclicals, the European Consumer Discretionary sector has been the best-performing one by far since the market bottom in March 2009; Barty believes valuations have become stretched and recommends investors now underweight it. In fact, automobile manufacturers have led all European sectors this year, and are trading near 30-year highs relative to the broad index. Health Care has also had an exceptional run in the past several years, and as many pharmaceutical stocks now look somewhat expensive we would advise any overweight positions be trimmed.

Exhibit 2: In Europe, higher-yielding sectors of the market also happen to be some of the cheapest



Source: Bloomberg, MLWM Investment Management & Guidance, data as of April 30, 2015. Sectors represented by MSCI Europe Index.

Portfolio Strategy: We expect European equities to be volatile in the near term, but an improving outlook for economic activity supports our positive view with a 12-to-18-month horizon. However, given the magnitude of the rally since late last year, we suggest a more selective approach going forward. We favor risk-managed strategies, as well as investment vehicles that hedge currency exposure where appropriate for U.S. dollar-based investors.

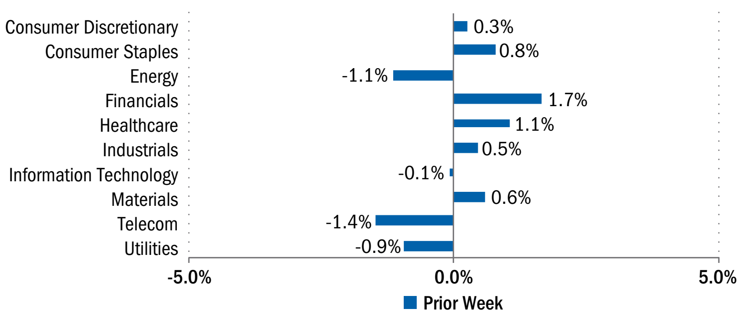
Taking a deeper dive into the market, we favor Industrials, Banks and Energy. While these are more cyclically-oriented sectors, they are also attractive for investors seeking income given relatively cheap valuations and high dividend yields (see Exhibit 2). Select integrated oil producers offer attractive yields, and BofAML Global Research analysts forecast bank dividends to more than double over the next two years.

Markets in Review

Trailing Economic Releases

- The U.S. trade report was much weaker than expected, as the deficit expanded dramatically in March to $51.4 billion from $35.9 billion. Imports rebounded with the opening of the West Coast ports following an extended shutdown. Exports only nudged higher, resulting in a drag on first-quarter growth.
- Retail sales for the euro-area disappointed, growing by only 1.6% year-over-year (YoY) in March following a downward-revised 2.8% rise the previous month. The Eurozone Retail Purchasing Managers Index improved slightly in April however, pointing to further upside as internal demand for the region continues to improve.
- The U.S. employment report was a mixed bag, as nonfarm payrolls grew 223,000 in April but the prior two months were revised lower by a total of 39,000 jobs. This brought the unemployment rate down slightly to 5.4%. Wage growth continues to be a pain point; hourly earnings only rose 0.1% from March. However, 2.2% annual wage growth remains higher than the broad inflation rate.

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



View the Q1 2015 Market Quarterly

Equities

	Level	Total Return in USD (%) WTD	MTD	YTD
DJIA	18,191.1	1.1	2.1	2.9
Nasdaq	5,003.5	0.0	1.3	6.1
S&P 500	2,116.1	0.4	1.5	3.5
S&P 400 Mid Cap	1,518.8	0.4	1.3	5.1
Russell 2000	1,234.9	0.6	1.2	2.9
MSCI World	1,794.7	0.5	1.0	5.8
MSCI EAFE	1,925.4	0.8	0.5	9.7
MSCI Emerging Mkts	1,034.9	-1.0	-1.2	8.8

Fixed Income

	Yield (%)	Total Return in USD (%) WTD	MTD	YTD
ML U.S. Broad Market	2.09	-0.1	-0.4	0.8
U.S. 10-Year Treasury	2.15	-0.3	-0.9	0.9
ML Muni Master	2.46	-0.1	-0.3	0.3
ML U.S. Corp Master	3.07	-0.2	-0.7	1.0
ML High Yield	6.12	0.1	0.1	3.9

Commodities & Currencies

	Level	Total Return in USD (%) WTD	MTD	YTD
Bloomberg Commodity	209.7	0.7	0.3	-0.2
Gold Spot[1]	1,188.4	0.8	0.3	0.3
WTI Crude $/Barrel[1]	59.4	0.4	-0.4	11.5
Level	**Current**	**Prior Week End**	**Prior Month End**	**2014 Year End**
EUR/USD	1.12	1.12	1.12	1.21
USD/JPY	119.8	120.2	119.4	119.8

Source: Bloomberg. [1]Spot Price Returns. **All data as of last Friday's close. Past performance is no guarantee of future results.**

Looking Ahead

Retail sales growth in the U.S. is expected to have moderated in April, and industrial production should have rebounded from the dip in March. In Europe, first-quarter GDP growth is likely to have improved.

Upcoming Economic Releases

- On Wednesday, retail sales in the U.S. are expected to be flat for April after rising a strong 0.9% in March. A weak month for auto sales likely weighed on the overall number. Core control retail sales, which exclude gasoline, autos and building materials, likely rose albeit at a slightly more moderate pace than in March. The consumer remains the bulwark of the economy, and overall the picture looks positive.
- Also on Wednesday, first-quarter GDP growth for the euro area is expected to be 0.5% annualized from the prior quarter. BofAML Global Research economists see strong internal demand driving growth, while external demand remains buoyed by a weakening currency. Structural issues for the region remain, but the tailwinds of low energy prices, a declining euro and strong monetary stimulus are providing positive momentum for change. Greece remains in focus, as progress continues to be slow at best and there are risks that negative sentiment will expand to other periphery countries.
- On Friday, we are looking for U.S. industrial production to rise 0.3% for April, bouncing back from the sharp 0.6% drop in March. The ISM index of manufacturing production rose last week, suggesting some acceleration in output for the month; however growth in the sector faces headwinds from weak commodity prices, as demand remains tepid. BofAML Global Research economists see a rebound in GDP growth in the second quarter, but the balance of risks is to the downside.

BofA Merrill Lynch Global Research Key Year-End Forecasts

S&P Outlook	**2015 E**
S&P 500 Target	2,200
EPS	$117.50
Real Gross Domestic Product	**2015 E**
Global	3.2%
U.S.	2.4%
Euro Area	1.6%
Emerging Markets	4.1%
U.S. Interest Rates	**2015 E**
Fed Funds	0.50-0.75%
10-Year T-Note	2.35%
Commodities	**2015 E**
Gold	1,238
WTI Crude Oil	$57

All data as of last Friday's close.

OFFICE OF THE CIO

Ashvin B. Chhabra
Chief Investment Officer, Merrill Lynch Wealth Management
Head of Investment Management & Guidance

Mary Ann Bartels
CIO, Portfolio Solutions,
U.S. Wealth Management

Karin Kimbrough
Head of Macro
and Economic Policy

Christopher J. Wolfe
CIO, Portfolio Solutions,
PBIG & Institutional

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