RIC-Monthly Investment Overview

Markets count down to Fed liftoff

10 November 2015

Don't be fooled by bond market's low quality rally

We are wary of the recent rally in low-quality bonds. Emerging markets remain vulnerable to currency weakness and further erosion of commodity prices. High yield issuers face high debt levels as well as deteriorating earnings.

Market now priced for a December rate hike

The market is now priced for a rate hike at the December 16 FOMC meeting. The key, in our view, is that the Fed will likely raise rates gradually in 2016, so most markets should be able to withstand the moves.

Quality the best hedge for volatility in equities

High-quality stocks have a track record of outperforming lower quality in periods of rising volatility. Our US Equity Strategy team identifies quality by low variability of earnings and high returns on equity. Low beta does not necessarily equate to higher quality. Big, old and ugly stocks are generally high-quality candidates.

Dividend growers offer "Fed-proof" income

Rather than looking for the highest yielding stocks in the market, Equity and Quant Strategist Savita Subramanian suggests that investors seek out stocks with dividend growth. In periods of rising rates, dividend growers have outperformed high dividend yielders. Currently, dividend growers have more attractive valuations than high dividend stocks as well. Screens of dividend growth stocks may be found on pages 13-15.

Lower but more balanced growth in China

Asian Economist Helen Qiao lowers her China GDP growth forecasts and offers rationale for her view that Chinese growth, although slower, should be more balanced. Weaker export and industrial sectors can be partially offset by growth in consumption and services. She also expects policymakers to weigh in with fiscal measures and interest rate cuts in 2016.

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This report is an abbreviated version of the full RIC report, provided for your benefit. It excludes our US and global client asset allocation tables, US and global market sector weightings and recommendations, our global stock lists, as well as global economic, interest rate, and FX forecast summaries.

Refer to important disclosures on page 19 to 20.
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Financial markets recap

October 2015 review

- Equity markets rebounded strongly in October. The TOPIX led the way, gaining 9.5%, and it has the best performance this year, at 11.5%. The S&P 500 was up 8.4%, and it moved back into the black for the year at 2.7%. EM stocks were the laggard in October, at 7.1%, and they are down 9.2% year to date..
- Small caps were down the most in the third quarter (-11.9%), but they were up the least in October's rebound (+5.6%). Large caps were on top last month, and they have a significant lead over both mid caps and small caps year to date. Growth beat value across all size segments last month and is ahead for the year.
- As for US sectors, Energy and Materials were up 13.5% and 11.4%, respectively, while Utilities only gained 1.1%. Consumer Discretionary continues to be the best performer this year, at up13.5%, while Energy is down 12.3%,
- Lower quality fixed income had the best performance in October with high yield and EM bonds up over 2%, while Treasuries across the maturity spectrum were down. For the year, preferreds have the best performance at 6.7%, while 30-year Treasuries are the laggard at -2.0%.
- Commodities were modestly higher in October. The yen and euro gained ground, while the dollar and the British pound were slightly lower.

Table 1: Equity indexes – total return (%)

	As of 31 October 2015						
Asset class	1mo	3mo	12mo	YTD	3yr[2]	5yr[2]	10yr[2]
Equity Indices (%, US dollar terms)							
S&P 500	8.4	-0.6	5.2	2.7	16.2	14.3	7.8
Dow Jones Industrial Avg.	8.6	0.5	4.1	1.0	13.2	12.5	8.2
NASDAQ Comp	9.4	-1.2	10.4	7.7	20.8	16.4	10.2
MSCI All Country World	7.9	-3.1	0.5	0.7	10.5	8.3	6.2
FTSE 100	7.4	-5.0	-2.6	-0.8	5.5	5.3	4.2
DJ Euro Stoxx 50	8.7	-4.7	-1.0	1.2	7.9	2.1	2.5
MSCI EAFE	7.8	-5.1	0.4	2.5	8.5	5.3	4.5
TOPIX	9.5	-2.8	10.6	11.5	13.7	7.3	2.3
Hang Seng	8.8	-7.1	-2.3	-0.8	5.3	3.2	8.3
MSCI Emerging Markets	7.1	-5.4	-14.2	-9.2	-2.5	-2.5	6.0
Size & Style (%, US dollar terms)							
Russell 1000	8.1	-1.2	4.9	2.4	16.3	14.3	8.0
Russell 1000 Growth	8.6	-0.5	9.2	6.9	17.9	15.3	9.1
Russell 1000 Value	7.5	-1.9	0.5	-2.1	14.5	13.3	6.8
Russell Midcap	6.2	-3.0	2.8	0.0	16.6	13.9	8.8
Russell Midcap Growth	6.3	-3.8	4.9	1.9	17.2	14.1	9.1
Russell Midcap Value	6.1	-2.3	0.5	-2.0	15.9	13.6	8.4
Russell 2000	5.6	-5.9	0.3	-2.5	13.9	12.1	7.5
Russell 2000 Growth	5.7	-8.5	3.5	-0.1	16.2	13.6	8.7
Russell 2000 Value	5.6	-3.1	-2.9	-5.0	11.7	10.5	6.2
S&P 500 Sectors (%, US dollar terms)							
Consumer Discretionary	9.1	1.4	20.9	13.5	22.7	20.2	11.6
Consumer Staples	5.8	0.1	9.4	4.8	15.1	14.8	10.9
Energy	11.4	-0.3	-19.3	-12.3	0.1	5.0	5.4
Financials	6.2	-3.9	2.8	-1.3	17.0	12.6	-0.2
Health Care	7.8	-6.4	7.6	5.5	23.4	20.3	11.0
Industrials	9.2	1.5	1.4	-1.5	16.7	13.7	8.0
Information Technology	10.8	3.6	11.2	7.5	18.8	15.1	9.9
Materials	13.5	-0.7	-4.5	-5.2	10.1	8.1	7.7
Telecom Services	7.1	-0.2	-2.3	2.9	5.1	9.6	7.6
Utilities	1.1	0.5	-0.3	-4.8	10.0	11.0	7.5

Notes: * Performance is gross of foreign dividend withholding taxes, [2] 3yr, 5yr, and 10yr returns are annualized

Source: BofA Merrill Lynch Global Research, S&P, MSCI, Bloomberg

Table 2: Bond/currency/commodity/hedge fund indexes–total return (%)

	As of 31 October 2015						
Asset class	1mo	3mo	12mo	YTD	3yr[2]	5yr[2]	10yr[2]
BofA Merrill Lynch Global Research Bond Indices (%, US dollar terms)							
2-Year Treasury	-0.1	0.2	0.7	0.8	0.6	0.6	2.6
5-Year Treasury	-0.6	0.7	2.5	2.3	1.0	2.1	4.6
10-Year Treasury	-0.6	0.9	3.6	1.7	1.3	3.8	5.3
30-Year Treasury	-0.9	0.4	4.6	-2.0	2.1	7.2	6.8
US Broad Market Index	0.0	0.6	2.1	1.2	1.7	3.1	4.7
TIPS	0.3	-1.2	-1.5	-0.8	-2.1	2.1	4.2
Municipals*	0.4	1.3	3.0	2.2	3.0	4.5	4.8
US Corporate Bonds	0.5	0.4	1.0	0.5	2.1	4.4	5.5
US High Yield Bonds	2.7	-1.7	-2.1	0.1	4.1	6.0	7.5
Emerging Mkt Corp Bonds	2.5	-0.6	-1.3	2.1	1.8	4.2	6.1
Emerging Mkt Sov Bonds	2.3	0.8	-1.5	0.7	1.6	4.1	6.8
Preferreds	2.1	2.2	8.3	6.7	6.9	7.0	3.3
Foreign exchange (%, in local currencies)**							
US dollar	-0.2	-0.4	11.4	7.0	8.9	5.5	0.7
British pound	2.2	-0.3	6.5	5.9	3.7	3.1	-0.8
Euro	-1.4	0.2	-7.5	-7.4	-1.3	-2.4	-0.5
Yen	-0.7	2.8	-2.1	2.8	-10.7	-6.1	0.0
Commodities (%, US dollar terms)**							
CRB Index	1.0	-3.4	-28.1	-14.9	-12.9	-8.2	-4.7
Gold	2.4	4.3	-2.6	-3.9	-12.8	-3.4	9.3
WTI Crude Oil	3.3	-1.1	-42.2	-12.5	-18.6	-10.6	-2.5
Brent Crude Oil	2.5	-5.1	-42.3	-13.6	-23.0	-9.8	-1.6
Alternative Investments† (%, US dollar terms)							
Hedge Fund - CS Tremont[1]	-1.4	-2.5	0.1	-0.6	5.0	4.5	5.2
Hedge Fund - HFRI Fund of Funds[1]	-1.8	-3.5	0.0	-0.9	4.2	2.7	2.4

Notes: *Not tax adjusted. **BoE calculated effective FX indices. [1]Data lagged by one month; [2] 3yr, 5yr, and 10yr returns are annualized; CS AUM-weighted, HFRI equal-weighted; †AI data not comparable to other asset classes because of reporting delays, lack of standardized reporting, and survivorship and self-selection biases. Crude oil prices are spot USD. Source: S&P, MSCI, Bloomberg, FactSet, BofAML Bond Indices (US Treasury Current 10yr, Current 2yr, Inflation-Linked; Muni Master, US Corp Master, US HY Master II, EM Corp Plus Index; EM External Debt Sovereign Index; US Preferred Stock Index).

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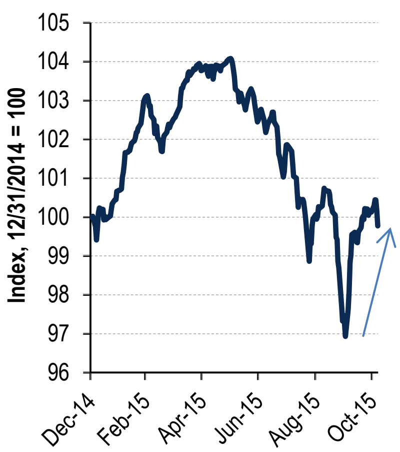
Market to Fed: We're OK with that!

We have been recommending high quality for the past few months, but low quality has ruled in the bond market recently. Since the end of September, our high yield corporate bond index has enjoyed a 2.4% return (Chart 1, below left), while our Emerging Market dollar-denominated sovereign index had a 2.6% return. This happened as the market was raising its expectations for a Fed rate hike at the December 16 FOMC meeting. The stock market has largely ignored the prospect a rate hike, with total return of the S&P 500 up 9.5% since the end of September.

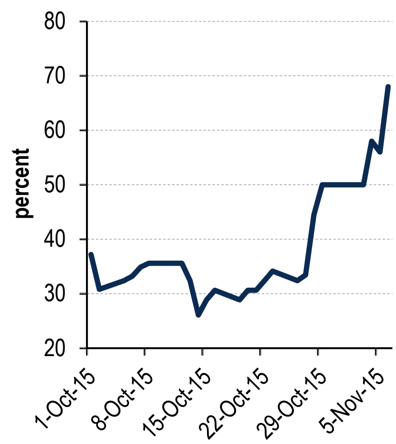
We remain wary about the rally in both HY and EM. We favor quality both in stocks and bonds.

Chart 1: BAML High Yield Total Return Index
High yield rebounds in October



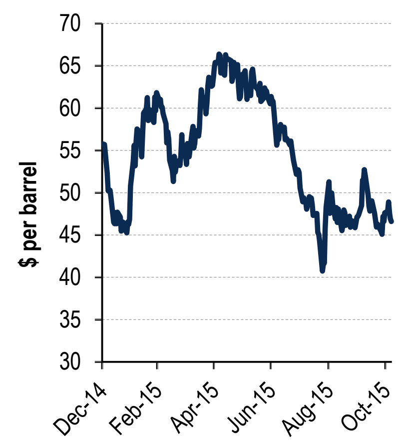
Source: BofA Merrill Lynch Global Bond Indexes

Chart 2: Fed Fund Futures
Market pricing in December rate hike



Source: BofA Merrill Lynch Global Research, Bloomberg

Chart 3: Brent crude oil
Have oil prices bottomed?



Source: BofA Merrill Lynch Global Research, Bloomberg

What's changed

Low quality bonds have performed well since the end of September. Especially noteworthy is that the strength continued even after the statement from the Fed's October 28 meeting signaled that the Fed may hike its benchmark rate at the December 16 meeting. After the release of the strong October jobs report, the market is now pricing in a 68% chance of a hike. (Chart 2 above middle).

In our view, the rebound in lower quality reflects two interrelated factors: reduced likelihood of a hard landing in China, and the flattening in the price of oil after its four month slide.

China's growth is clearly slowing, but not severely, in our view. China and Asia Economist, Helen Qiao recently lowered her China GDP growth forecast for 2016 to 6.6% from 6.8%. The manufacturing and exports sectors are pulling back, but consumer spending appears to be picking up. The result, in Qiao's view, should be slower, but more balanced growth. Qiao expects policymakers to adopt more targeted fiscal stimulus measures and implement two more interest rate cuts in 2016. (For more on China's economy, see our Guest column on page 8).

Oil prices have flattened (Chart 3 page 2, right) and we expect them to rise in 2016. Commodities Strategist Francisco Blanch expects the price of Brent crude oil, now $47/bbl, to average $55/bbl in 2016 and $61/bbl in 2017, as demand growth eventually catches up with the present oversupply.

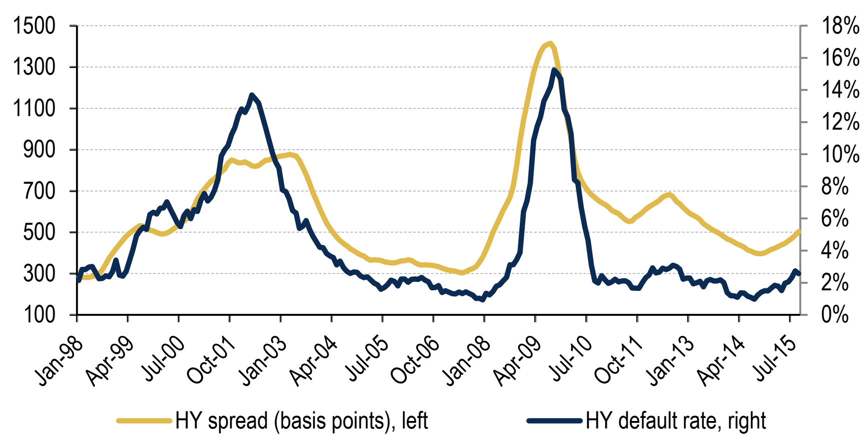
Key drivers: profits, commodity prices, and currencies

A leveling in oil prices and just a modest slowing in China would remove some of the risks that we see in emerging markets. But EM nations remain vulnerable to continued weakness in prices for industrial commodities as well as the risk that oil prices head back down. Alberto Ades, EM strategist, argues that heavy borrowing in EM nations, mostly in Latin America, combined with falling commodity prices, is pushing external debt ratios higher and may force central banks to tighten despite slowing economic growth.

Another risk for EM countries is the weakening in their currencies that might ensue if the Fed raised rates, or if China allows its currency to weaken further. A weakening in EM currencies would cut returns on local-currency-denominated assets for dollar-based investors, and might make it more difficult for EM entities to service dollar-denominated obligations.

As for US high yield corporates, strategist Michael Contopoulos doubts the staying power of the recent rebound. His concerns extend beyond the course of energy prices. High yield companies have been taking on more debt and re-leveraging, even outside of energy. And both earnings and revenues for non-energy high yield issues have been weak or declining for most of the past year. Contopoulos expects default rates to rise in the coming years, which would bring bigger losses to investors, and probably a widening in credit spreads, as spreads tend to widen as defaults rise (Chart 4).

Chart 4: High yield spreads widen as defaults rise



Source: BofA Merrill Lynch Global Research, Standard & Poor's

Bonds and the Fed

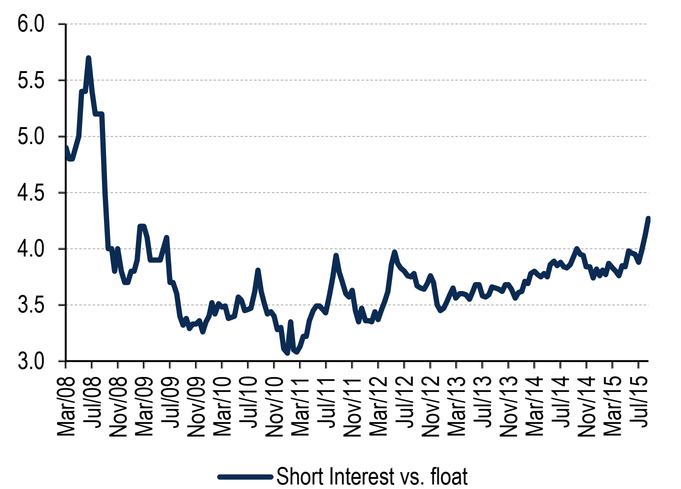
A December rate hike would apparently not unsettle the markets. The important point to us is that even the more hawkish Fed officials do not expect a long series of additional rate hikes following the first move. Chief North American Economist Ethan Harris believes that the Fed will raise rates four times between now and the end of 2016, which would put the federal funds rate at a bit above 1%.

Since we do not expect rates to rise substantially, we are comfortable in extending out to intermediate maturities – 5 to 10 years in the taxable market, and 10 to 15 years in munis. In the taxable market, our top choice remains investment grade corporates, which presently yield about 161 basis points above Treasuries. In our view, munis are a better choice than corporates for those facing high federal marginal tax rates. These securities have underperformed amid the swing toward low quality, so we believe their relative value has improved. We also like fixed-to-floating rate preferreds and Treasury Inflation Protection Securities (TIPS).

Many reasons to like stocks in the US

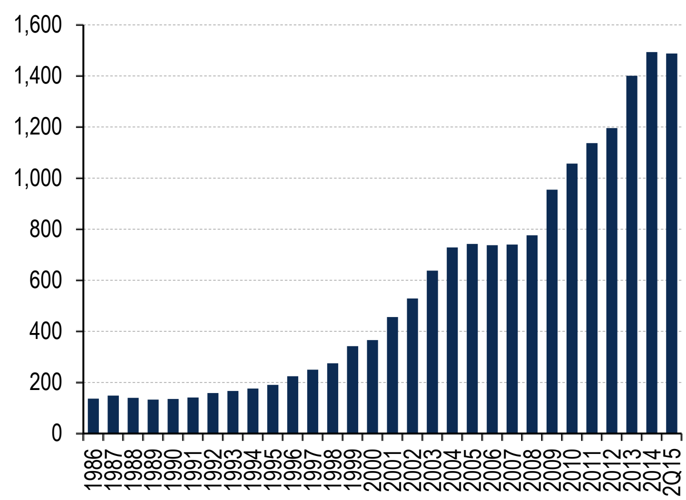
We think US equities are likely to outperform bonds in the US over the next several months. A slow growing economy with a gradual, measured rise in short-term interest rates should be a favorable environment for most stocks. US Equity Strategist Savita Subramanian forecasts an 8% return for US stocks over the next 12 months – in line with the 10-year average of around 7.6%. She also notes that the market appears reasonably valued relative to history on most measures. Investor bullishness remains well tamed, in our view, as evidenced by a rise in the short interest ratio to the highest level since 2008 (Chart 5). And corporate cash balances are close to all-time highs (Chart 6), affording companies the flexibility to increase dividends, buy back shares or engage in M&A. Stability in oil prices and greater confidence in a soft landing in China give us greater confidence that stocks can do well.

Chart 5: Short interest at highest levels since 2008



Source: Bloomberg, BofA Merrill Lynch US Equity & US Quant Strategy

Chart 6: S&P 500 ex. Financials Total Cash ($mn), 1986-present



Note: Excludes Financials and Managed Health Care companies
Source: FactSet, BofA Merrill Lynch Us Equity & US Quant Strategy

Adjusting to market volatility – buy quality

Expect increased volatility around earnings

Stocks are notoriously more volatile during quarterly earnings announcements, and the recent third quarter reporting period was no exception. We advise investors to be cautious in making significant portfolio adjustments during earnings releases because often it is difficult to determine whether a stock is undergoing a one-time or temporary event vs. a break in its business pattern. Stocks usually react more an earnings beat or miss rather than pure growth rate in quarterly results and those reactions can be measurable. In the most recent quarter, stock prices of Netflix and Walgreens lost 8.3% and 10.7%, respectively, on the day they announced results. Even conservative IBM and American Express were each down more than 5% in a single day, while McDonalds and Nike were each up more than 8%. Single day returns from Microsoft (+10%) and eBay (+14%) further point to the volatile nature of stock prices when earnings are released.

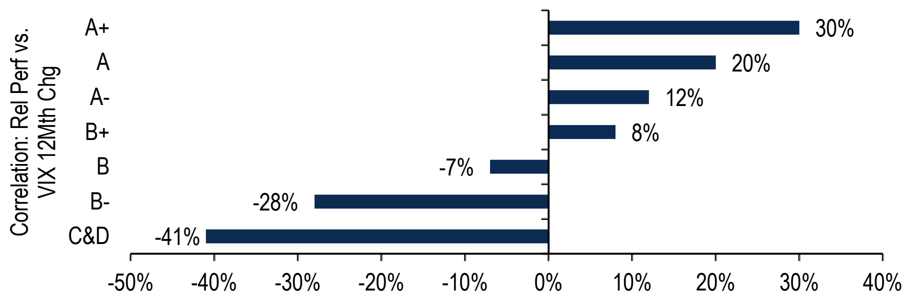
Another factor influencing earnings-induced price movements is the guidance offered by company management for future quarters. Often stocks will react negatively to a good earnings report because of negative guidance, or vice versa. Our US Equity Strategy team writes that management guidance has become more positive over the last few quarters. This has historically been a leading indicator of earnings estimate revisions, but that correlation is not as strong in recent years, as corporate management guidance has been persistently negative. Nonetheless, comments issued by management can heighten the natural volatility that surrounds earnings announcements.

Third quarter earnings generally were better than expected, although overall growth remains weak with the S&P 500 tracking -2.5% growth year over year (+4.2% ex-Energy). Based on companies that have reported so far, earnings are exceeding expectations in all sectors except Materials, with the largest percentage of earnings beats in the Health Care and Energy sectors.

Higher quality may be the answer – but where to find it?

Our US Equity Strategy team writes that the slope of the yield curve, which has been a reliable indicator of predicting volatility, suggests elevated volatility over the next year or two. The best hedge against rising volatility is quality. Even though low quality stocks beat high quality during the market's recent rally, high quality stocks have a track record of outperforming in periods of rising volatility (Chart 7). But how is quality defined and where do we find those stocks?

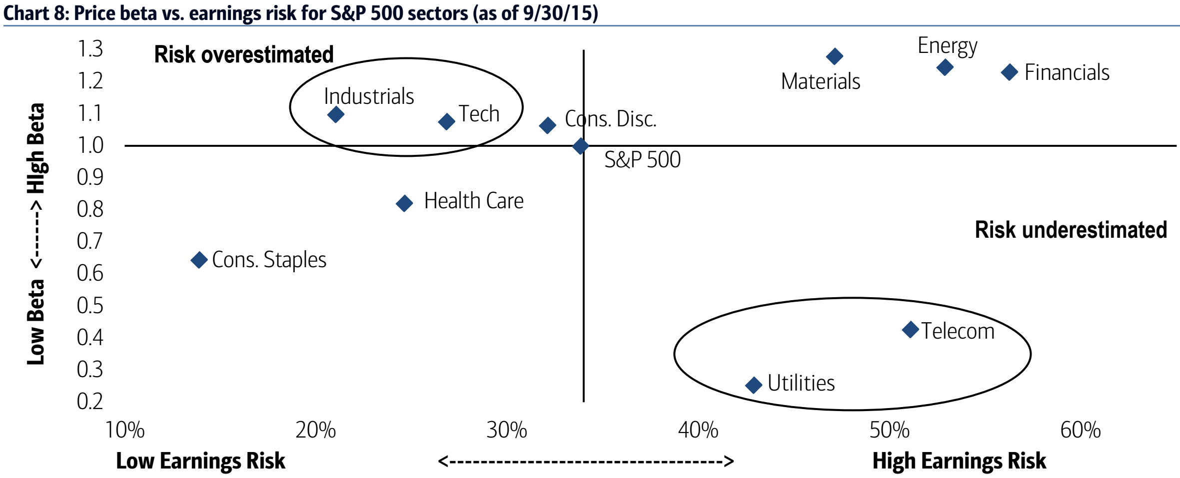
Chart 7: Correlation of BofAML Quality Indices 12-month returns to 12-month changes in VIX



Source: BofA Merrill Lynch US Equity & US Quant Strategy, CBOE, S&P

Subramanian believes that stocks with lower earnings estimate dispersion (lower earnings risk) and those with high returns on equity tend to offer better risk-adjusted returns than lower quality securities. She prefers those metrics as a gauge of quality instead of the more widely used beta (a measure of the volatility of a security relative to the overall market). Low beta stocks do not necessarily have higher quality attributes, in her view. When assessing the earnings volatility, rather than price volatility, of various market sectors, Subramanian and team find Consumer Staples and Health Care to be low beta sectors that also have low risk of earnings, while Industrials and Technology also have low earnings risk despite their higher betas (Chart 8).

Chart 8: Price beta vs. earnings risk for S&P 500 sectors (as of 9/30/15)



Source: BofA Merrill Lynch US Equity & US Quant Strategy

One of our themes for finding attractive stocks is "big, old and ugly" – well capitalized companies that have been around for a while and may be in the mature phase of growth. Many of these stocks generate relatively high cash flow that is used partially to fund dividends. They tend to have a low degree of earnings volatility and would therefore be considered higher quality. We also like strong dividend growers. Companies that pay dividends usually are more mature than those that do not, and those that generate large amounts of free cash flow can grow those dividends, making them attractive total return candidates. Currently, dividend payout ratios (dividends as a percent of earnings) are low and have room to grow. For more on dividend growth, see our Idea section beginning on page 11.

China - Lower but more balanced growth

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Lowering our China growth forecasts for 2015 and 2016

We lower our China real GDP growth forecast for 2015 to 6.9% yoy from 7.0% yoy and for 2016 to 6.6% yoy from 6.8% yoy. This reflects the potential drag from weak investment and manufacturing sector growth, plus lower property and financial sector contributions to overall growth, especially in the next two quarters. On the positive side, we believe terms-of-trade gains will likely remain positive for the rest of 2015 and 2016, while further fiscal expansion and monetary easing buffer significant downside risks.

Trimming CPI inflation forecasts on weak aggregate demand

We cut our CPI inflation forecast for 2015 to 1.6% yoy from 1.7% yoy and for 2016 to 1.8% yoy from 2.4% yoy. Relative to our expectation, CPI inflation did not hold up well following better-than-expected GDP growth in 3Q. As non-food price inflation seemed anchored given stabilizing trends in fuel and rental equivalence, food price inflation remained muted due to weak aggregate demand. As a result, we trimmed our inflation forecast levels while maintaining the expectation of a growth-led rebound in 2H16.

A more balanced economy with resilient consumption and growing services

China has undergone a tough period of growth deceleration in actual and potential terms in the last four years (Chart 9). Coincidentally, the economy has become more balanced with the help of resilient consumption and growing service sectors. In our view, there are a few signs of growth stabilization from auto sales, property sales and land purchases in recent months (Chart 12 and Chart 13). However, the stabilizing force from consumption and the service sector is not strong enough to offset the drag from industrial sector deceleration in the near term. Continued import contraction, persistent PPI deflation and industrial sector profit deterioration still suggest growth has yet to return to a firm footing (Chart 10 and Chart 11). We outline two major short-term growth catalysts as follows.

Short-term catalyst #1: further easing measures

We believe there is still room for policymakers to adopt countercyclical measures, including increasing fiscal expenditure, cutting property related fees and taxes, as well as monetary easing to help narrow the negative gap, in the next few quarters. The faster pace of public spending year-to-date implies a potentially higher fiscal deficit than in previous years, along with tax reduction initiatives introduced for housing and auto purchases.

In our view, the central bank will likely cut benchmark interest rates twice (each by 25bp) in the coming 12 months, to reduce funding costs further in real terms. Our FX strategists also expect further CNY depreciation against the dollar to 6.5 by the end of 2015 and 6.9 by the end of 2016.

Short-term catalyst #2: terms of trade gains

Material gains from terms-of-trade improvement have realized, given the average 11.3% import price declines year to date. Until any meaningful pickup in commodity prices, China will likely continue to benefit from terms-of-trade gains. According to the International Monetary Fund, China' terms-of-trade gains from lower commodity prices will reach 1.0% of GDP this year.

Risks to our forecasts

In the near term, risks on the upside of our growth and inflation forecasts will likely increase if the rebound in property sales expands into lower tier cities and triggers more property development activities. In addition, policy easing with more fiscal expansion toward year-end on the expenditure side could reverse the deceleration in infrastructure investment growth, especially with additional effort to ensure funding availability for public-sector projects. On the other hand, weaker external demand, potential disorderly capital outflow triggered by narrower interest rate differential and/or exchange rate movements could escalate the risks on the downside.

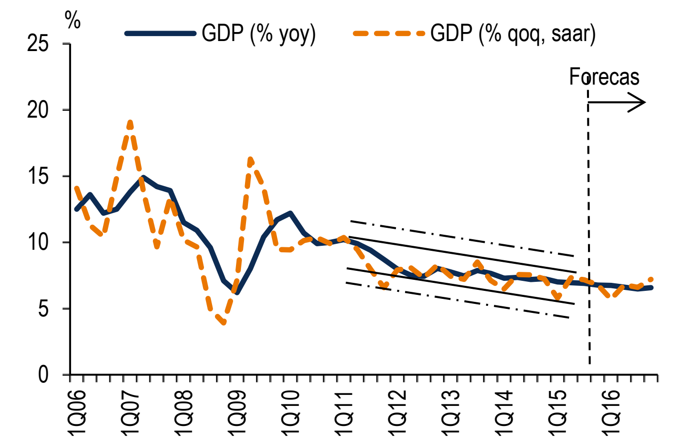
Slowdown due to structural and cyclical causes

The gradual slowdown over the last four years has been due to the potential growth rate grinding lower and cyclical pressure on the economy, in our view. That implies there is room to support potential growth with structural reforms and room to make counter-cyclical policy measures more effective. If proper initiatives were implemented, there could be further upside to the current growth level in the short term and long term. On the other hand, a further slide in potential growth and mismanagement of business cycles could result in downside risks to growth.

Reforms remain key to maintain potential growth

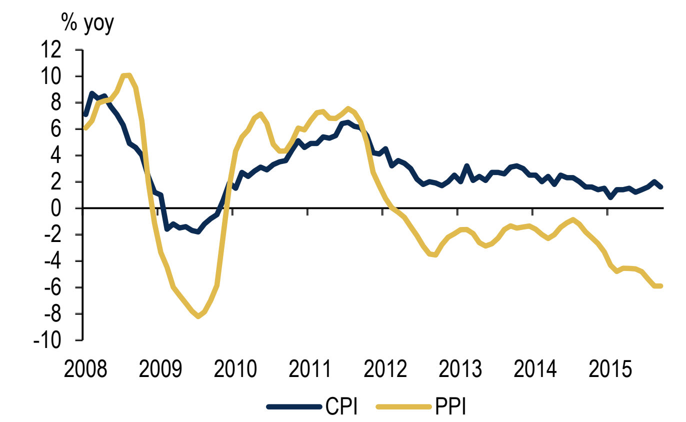
We believe structural reforms and services sector deregulation hold the key to increasing the potential growth rate to close to 7%. We remain hopeful that policymakers will implement key structural reforms, including for fiscal, financial, state-owned enterprises, demographic, service, and other areas to increase efficiency and remove excess capacity gradually.

Chart 9: GDP growth trapped in a downward channel



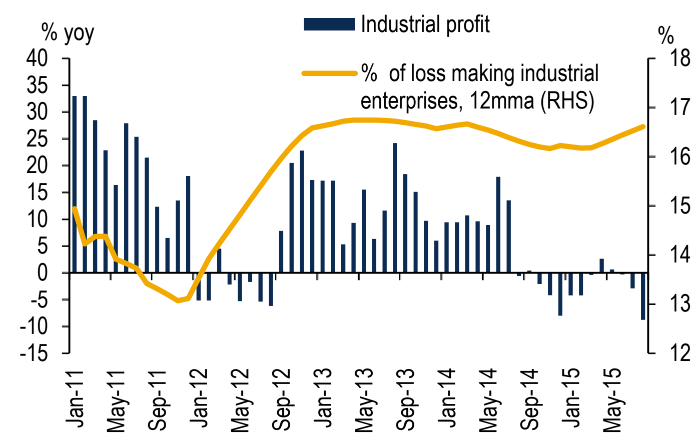
Source: BofA Merrill Lynch Global Research, CEIC

Chart 10: Deflationary pressure persists



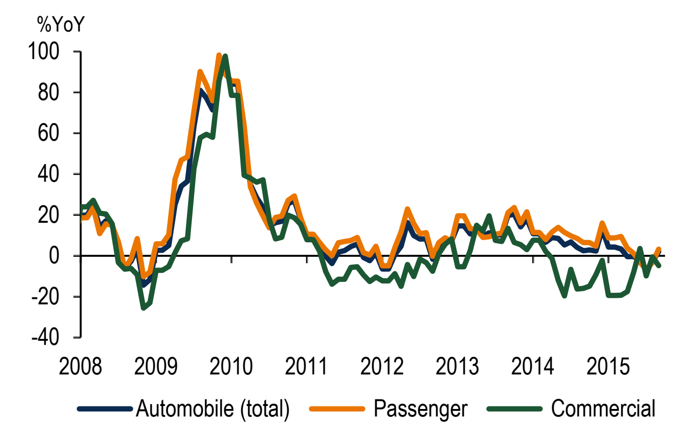
Source: BofA Merrill Lynch Global Research, CEIC

Chart 11: Profit deteriorated across industrial sectors



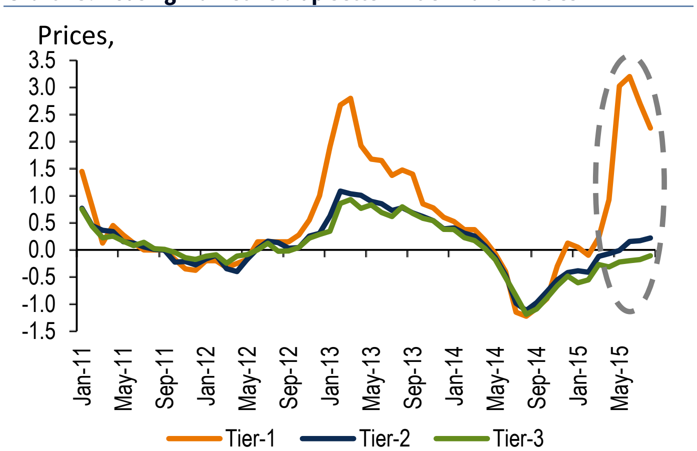
Source: BofA Merrill Lynch Global Research, CEIC, NBS

Chart 12: Early signs of a pickup in auto sales



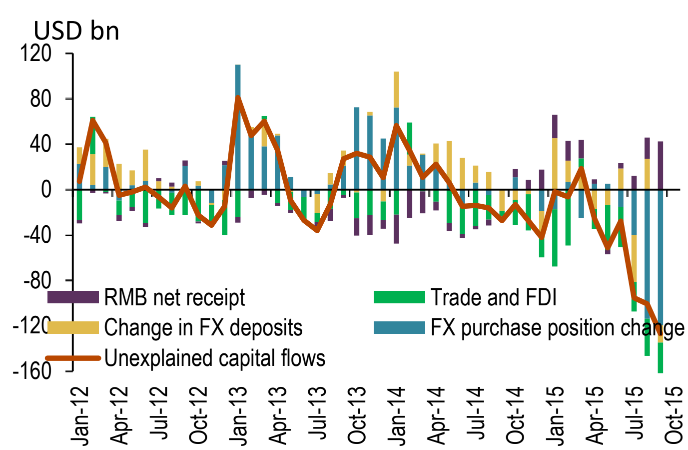
Source: BofA Merrill Lynch Global Research, CEIC

Chart 13: Housing market held up better in tier 1 and 2 cities



Source: BofA Merrill Lynch Global Research, CEIC

Chart 14: Capital outflows widened notably in the past months



Source: BofA Merrill Lynch Global Research estimates, CEIC

Tomorrow's scarcity: Fed-proof income

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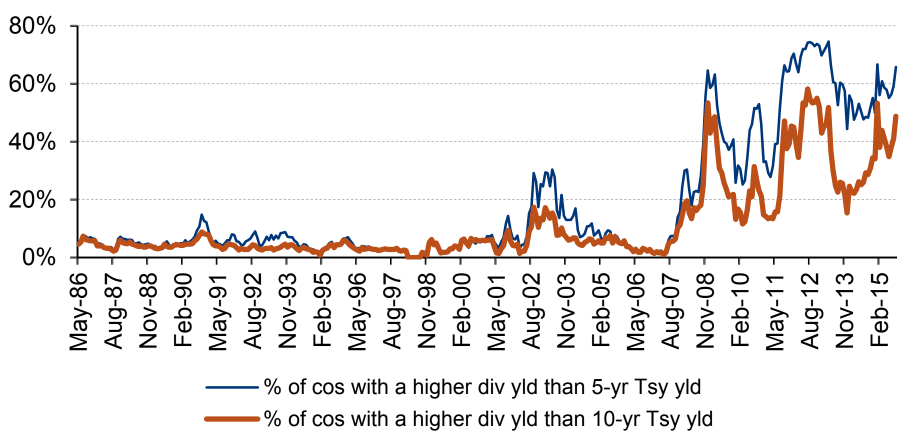
A new sheriff in town

A growing population of investors seeking high quality investment income has had to cope with shrinking supply due to the steady downward march in interest rates as well as still historically low payouts. As we approach the start of a potential Fed rate hiking cycle — which our economists expect could start as soon as December — the beginnings of the first secular period of rising rates in over 30 years could introduce new challenges for income investors. Since the great recession, the scarcity of growth and yield has driven up the valuations of the fastest growing and highest yielding stocks. But in our view, a new regime of rising interest rates, albeit at a modest pace, could bring about a new scarcity in tomorrow's markets that could benefit dividend growth stocks: that of income strategies not hurt by rising rates.

Kill two birds with one stone: buy stocks

Investing in stocks and receiving income are not mutually exclusive goals. With discipline and patience, our work suggests investors can capitalize on better fundamentals of stocks relative to bonds and also meet their future income needs. Over 60% of the companies in the S&P 500 pay a higher dividend yield than the 5-yr Treasury yield (Chart 15). But we caution investors against blindly seeking out the highest dividend yielding stocks, or even worse, equating high dividend yield with perceived safety. Just as with distressed bonds, some higher dividend yields could be viewed as a function of unsustainable dividends. Despite their defensive perception, High Dividend Yield stocks are seeing EPS declines across seven of the ten sectors, with overall median EPS growth of -9% vs. 14% for Dividend Growth. Given that the typical high yielding stock's profile is that of slower growth and higher payout ratios, these stocks are more likely to live up to their nickname of "bond proxies": like bonds, they are vulnerable to the negative impact of rising interest rates.

Chart 15: Percentage of companies with higher dividend yield than the current Treasury yield



Source: BofAML US Equity & Quant Strategy, FactSet, Federal Reserve Board, Compustat

Less is more

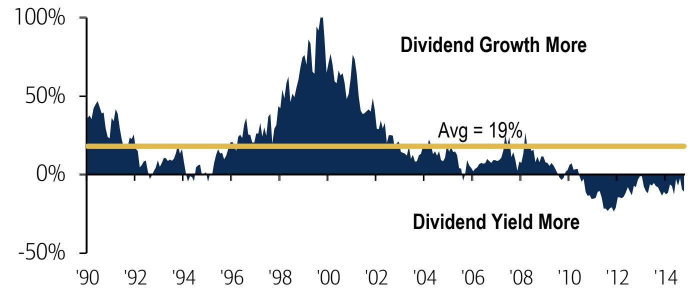
Our scenario analysis suggests that in exchange for a little less current yield, investors generally are presented with companies that are cheaper, more globally diversified, have stronger balance sheets, solid earnings growth potential and plenty of room to increase payout ratios over time (Table 3). Most importantly, the potential to grow dividends is likely to shield investors from much of the negative impact of rising rates to which other income-oriented strategies are subject. Unlike High Dividend Yield, which has historically underperformed when rates are rising as performance is inversely correlated with interest rates, Dividend Growth has outperformed and is actually slightly positively correlated with rates. Dividend Growth has historically traded at a 19% premium to High Dividend Yield, but the scarcity of yield has resulted in Dividend Growth trading at a discount (Chart 16). And while Dividend Growth has recently lost momentum, we believe these stocks will once again outperform as we enter the upcoming rate hiking cycle.

Table 3: Comparing high dividend yielders vs. high dividend growers

Median	Top 50 by Dividend Yield	Top 50 by Dividend Growth
Dividend Yield	4.8%	1.4%
Dividend Growth	3.5%	46.7%
Forward PE	18.2x	14.5x
Net Debt/EBITDA	3.1x	2.1x
Cash % Mkt Cap	4.0%	6.9%
Dividend Payout Ratio	71.7%	24.6%
Trailing EPS Growth	-8.8%	13.6%
Consensus LT Growth	2.7%	11.0%
Foreign Sales	4.6%	20.9%

Source: BofAML US Equity & Quant Strategy, Compustat, FactSet, First Call

Chart 16: Relative valuation: High DPS Growth vs. High Dividend Yield (based on median forward P/E of top decile), 1990-9/2015



Source: Compustat, BofA Merrill Lynch US Equity & US Quant Strategy

The power of dividend growth

Income-oriented investors often focus on current yield, as it allows for a comparison across equity and fixed income securities. While this matters when comparing fixed rate investments or stocks with limited dividend growth, it is less useful when including companies with potential to grow dividends. Our scenario analysis suggests that a stock with a 3% dividend yield growing its dividend by 15% per year could double its yield on the original investment in just five years, and nearly one in three S&P 500 companies has a dividend yield of more than 5% on its ten-year ago price.

Table 4: Scenario analysis: Dividend yield of a stock with starting dividend yield of 3%

			Dividend Growth		
Years	0%	5%	10%	15%	20%
1	3.0%	3.2%	3.3%	3.5%	3.6%
2	3.0%	3.3%	3.6%	4.0%	4.3%
3	3.0%	3.5%	4.0%	4.6%	5.2%
4	3.0%	3.6%	4.4%	5.2%	6.2%
5	3.0%	3.8%	4.8%	6.0%	7.5%

Source: BofA Merrill Lynch US Equity & Quant Strategy

Dividend Growth Screens
Top Decile S&P 500 stocks by dividend growth

Table 5: Top Decile S&P 500 stocks by dividend growth (as of 10/26/2015)

Ticker	Company	Sector	Div Growth (%)	Div Yld (%)	Forward PE	Net Debt/EBITDA	Cash % Mkt Cap	Payout Ratio (%)	Trailing EPS Growth (%)	Expected LT Growth (%)	Foreign Sales (%)
SWKS	Skyworks Solutions, Inc.	Information Technology	355	0.6	13.2	1.0	7.0	10.3	76.4	19.8	96.8
JNPR	Juniper Networks, Inc.	Information Technology	300	1.3	14.8	4.0	16.4	21.9	23.6	13.5	47.9
CCI	Crown Castle International Corp	Financials	212	3.8	47.6	6.1	1.1	76.5	41.1	7.9	4.2
C	Citigroup Inc.	Financials	200	0.2	9.4	N.A.	99.9	2.8	3.6	30.8	53.0
LRCX	Lam Research Corporation	Information Technology	167	1.3	12.0	5.0	36.6	16.2	29.3	11.3	86.5
VMC	Vulcan Materials Company	Materials	167	0.3	29.1	3.1	0.6	31.7	106.1	9.0	0.4
ALLE	Allegion PLC	Industrials	124	0.6	19.2	3.3	3.3	13.5	N.A.	15.5	37.1
DIS	Walt Disney Company	Consumer Discretionary	110	1.6	20.1	1.3	2.3	37.4	15.2	14.2	24.7
UHS	Universal Health Services, Inc. Class B	Health Care	100	0.3	15.6	1.9	0.4	6.2	29.0	12.1	0.0
IRM	Iron Mountain, Inc.	Financials	100	6.9	22.9	5.4	1.8	179.6	11.1	15.0	35.9
CF	CF Industries Holdings, Inc.	Materials	76	2.2	11.3	2.7	6.8	29.7	3.4	9.5	15.8
AES	AES Corporation	Utilities	67	2.7	8.5	5.7	23.4	23.4	6.7	N.A.	77.7
DHI	D.R. Horton, Inc.	Consumer Discretionary	67	0.8	13.1	4.3	7.2	13.6	26.0	18.5	0.0
MS	Morgan Stanley	Financials	67	1.5	10.5	N.A.	295.4	21.1	-2.5	16.4	28.2
PHM	PulteGroup, Inc.	Consumer Discretionary	60	1.7	12.0	4.1	11.9	26.9	-13.8	8.8	0.0
GT	Goodyear Tire & Rubber Company	Consumer Discretionary	60	0.7	9.3	3.3	18.4	8.5	2.2	N.A.	58.3
DHR	Danaher Corporation	Industrials	55	0.5	19.0	3.5	2.9	12.3	13.9	8.5	57.2
EOG	EOG Resources, Inc.	Energy	53	0.8	N.A.	1.1	2.9	27.8	-51.9	-33.3	7.1
MA	MasterCard Incorporated Class A	Information Technology	51	0.6	25.8	N.A.	5.1	17.8	17.3	16.3	61.0
DAL	Delta Air Lines, Inc.	Industrials	50	0.8	9.2	1.8	9.5	9.6	31.7	21.0	33.4
NOV	National Oilwell Varco, Inc.	Energy	48	4.7	18.9	1.7	17.1	35.2	-9.5	-17.1	71.6
GMCR	Keurig Green Mountain, Inc.	Consumer Staples	48	2.0	15.6	0.4	1.0	30.8	-7.9	14.0	0.0
HST	Host Hotels & Resorts, Inc.	Financials	48	4.8	22.5	N.A.	2.1	51.6	15.7	3.3	5.2
GM	General Motors Company	Consumer Discretionary	47	3.7	6.8	5.1	44.7	27.3	92.8	21.5	38.4
STI	SunTrust Banks, Inc.	Financials	47	2.1	11.8	N.A.	22.9	26.5	-1.5	5.6	0.0
WMB	Williams Companies, Inc.	Energy	46	5.9	32.9	8.2	0.7	371.0	-32.6	-1.2	5.3
TSO	Tesoro Corporation	Energy	45	1.4	11.2	1.7	7.7	14.3	250.2	10.2	0.0
NDAQ	Nasdaq, Inc.	Financials	43	1.4	16.1	N.A.	27.0	24.5	15.2	8.8	27.9
VLO	Valero Energy Corporation	Energy	42	2.2	8.8	1.5	18.8	16.1	63.6	9.5	30.1
ICE	Intercontinental Exchange, Inc.	Financials	38	1.1	18.5	N.A.	3.9	24.8	25.6	17.3	39.9
OKE	ONEOK, Inc.	Energy	38	6.6	21.7	6.5	3.0	168.4	-14.0	14.5	0.0
RF	Regions Financial Corporation	Financials	38	2.3	11.4	N.A.	40.6	31.4	-18.6	6.6	0.0
AVGO	Avago Technologies Limited	Information Technology	37	1.2	13.6	2.0	3.8	18.3	120.1	26.2	94.3
HBI	Hanesbrands Inc.	Consumer Discretionary	36	1.4	14.8	3.2	2.9	24.7	29.7	13.6	15.0
WDC	Western Digital Corporation	Information Technology	36	2.7	9.8	2.7	33.0	24.5	-4.4	7.5	80.1
AON	Aon plc	Financials	35	1.1	14.2	N.A.	3.3	17.9	12.7	9.7	52.7
LUV	Southwest Airlines Co.	Industrials	35	0.6	11.7	1.2	10.4	8.4	83.0	28.7	1.2
UNH	UnitedHealth Group Incorporated	Health Care	34	1.5	16.3	N.A.	9.0	27.8	13.3	11.3	5.0
APC	Anadarko Petroleum Corporation	Energy	33	1.5	N.A.	6.0	5.9	131.7	-81.6	-25.8	20.1
AME	AMETEK, Inc.	Industrials	33	0.6	20.1	1.9	2.4	14.3	12.0	12.3	54.6
PH	Parker-Hannifin Corporation	Industrials	33	2.4	15.7	2.6	12.8	36.8	2.7	7.7	40.6
TSN	Tyson Foods, Inc. Class A	Consumer Staples	33	0.8	13.3	2.8	3.3	12.5	15.2	6.5	3.0
INTU	Intuit Inc.	Information Technology	32	1.0	26.9	2.0	6.2	37.9	-24.1	18.4	0.0
LB	L Brands, Inc.	Consumer Discretionary	31	1.8	23.0	2.3	3.0	46.2	16.7	11.0	10.1
FDX	FedEx Corporation	Industrials	31	0.5	14.1	2.1	7.9	9.2	24.3	12.9	27.8
ANTM	Anthem, Inc.	Health Care	31	1.5	12.8	N.A.	58.5	20.6	34.0	10.9	0.0
AMT	American Tower Corporation	Financials	30	1.6	42.8	6.2	1.1	95.8	-6.7	14.1	33.3

Source: BofAML US Equity & Quant Strategy, Compustat, FactSet, First Call

Note: Dividend growth is calculated based on last 12-month's DPS vs. prior 12-month's DPS. This differs from the Dividend Growth screen from our Quantitative Profiles report, which is based on last 12-month's dividends paid vs. prior 12-month's dividends paid.

Note: This screen is not a recommended list either individually or as a group of stocks. Investors should consider the fundamentals of the companies and their own individual circumstances/objectives before making any investment decisions

S&P 500 Consistent Dividend Growers

S&P 500 companies that have grown their dividends every year since 1980.

Table 6: S&P 500 Consistent Dividend Growers

Ticker	Company	Sector	Dividend Growth - CAGR over period (1980-2014)
WMT	Wal-Mart Stores	Consumer Staples	24%
SHW	Sherwin-Williams Co	Materials	19%
MCD	McDonald's Corp	Consumer Discretionary	18%
MDT	Medtronic Inc	Health Care	17%
WBA	Walgreens Boots Alliance Inc	Consumer Staples	15%
ADP	Automatic Data Processing	Information Technology	14%
SIAL	Sigma-Aldrich Corp	Materials	14%
LEG	Leggett & Platt	Consumer Discretionary	13%
JNJ	Johnson & Johnson	Health Care	13%
ADM	Archer-Daniels-Midland Co	Consumer Staples	13%
HP	Helmerich & Payne Inc	Energy	12%
TGT	Target Corp	Consumer Discretionary	12%
VFC	VF Corp	Consumer Discretionary	11%
BDX	Becton Dickinson & Co	Health Care	11%
PEP	PepsiCo Inc	Consumer Staples	11%
GWW	Grainger W.W. Inc	Industrials	11%
HRL	Hormel Foods Corp	Consumer Staples	11%
DOV	Dover Corp	Industrials	10%
BCR	Bard C.R. Inc	Health Care	10%
KO	Coca-Cola Co	Consumer Staples	10%
PNR	Pentair PLC	Industrials	9%
KMB	Kimberly-Clark	Consumer Staples	9%
CB	Chubb Corp	Financials	8%
EMR	Emerson Electric Co	Industrials	8%
PH	Parker-Hannifin Corp	Industrials	8%
PPG	PPG Industries Inc	Materials	7%
SWK	Stanley Black & Decker	Industrials	7%
XOM	Exxon Mobil Corp	Energy	7%
MMM	3M Co	Industrials	6%
ED	Consolidated Edison Inc	Utilities	4%

Source: Compustat, First Call, S&P, BofA Merrill Lynch US Equity & US Quant Strategy

Note: This screen is not a recommended list either individually or as a group of stocks. Investors should consider the fundamentals of the companies and their own individual circumstances/objectives before making any investment decisions

Potential Dividend Growers Screen

We screened the S&P 500 ex Financials for companies that have room to increase their dividends based on the following:

- Low leverage vs. its industry: Net Debt/NOPAT less than the median Net Debt/NOPAT for their respective industry
- Low dividend payout ratio vs. its industry: (Indicated DPS rate / Consensus fwd. EPS) < industry median
- Dividend Coverage: the ratio of the last 12mos free cash flow to dividends must be greater than 1.0
- Stable earnings: FY0 and consensus FY1 EPS growth must be positive

Table 7: Potential Dividend Growers Screen (as of 10/23/2015)

Ticker	Company	Industry	Net Debt/ NOPAT	Industry Net Debt / NOPAT	Indicated Payout	Industry Payout	FCF / Div	FY0 EPS Growth	FY1 EPS Growth
AAPL	Apple Inc.	Technology Hardware Storage & Peripherals	0.39	0.62	21.0	28.3	4.2	13.6	41.6
BF.B	Brown-Forman Corporation Class B	Beverages	1.41	3.46	34.5	41.1	4.0	4.9	8.6
CI	Cigna Corporation	Health Care Providers & Services	0.87	3.36	0.4	8.1	217.5	51.2	16.0
COST	Costco Wholesale Corporation	Food & Staples Retailing	0.01	2.49	27.9	29.3	1.6	15.5	7.1
CTAS	Cintas Corporation	Commercial Services & Supplies	2.47	4.18	25.6	36.9	3.1	12.8	16.5
CVS	CVS Health Corporation	Food & Staples Retailing	2.29	2.49	23.8	29.3	2.9	5.6	14.4
DG	Dollar General Corporation	Multiline Retail	2.27	3.59	20.0	33.7	4.0	10.1	12.3
DIS	Walt Disney Company	Media	1.28	4.40	23.4	26.1	2.9	26.0	17.7
EFX	Equifax Inc.	Professional Services	2.67	6.22	23.9	24.6	3.6	10.4	14.4
EXPD	Expeditors International of Washington, Inc.	Air Freight & Logistics	-2.42	1.83	28.9	34.9	3.2	14.3	22.7
FLIR	FLIR Systems, Inc.	Electronic Equipment Instruments & Components	-0.83	0.53	24.2	28.3	3.4	13.9	17.5
FOXA	Twenty-First Century Fox, Inc. Class A	Media	1.13	4.40	15.4	26.1	24.4	135.3	4.4
GD	General Dynamics Corporation	Aerospace & Defense	-0.21	2.10	29.5	31.8	3.2	11.4	13.0
HAR	Harman International Industries, Incorporated	Household Durables	1.17	3.81	20.4	21.0	3.2	44.0	13.6
HAS	Hasbro, Inc.	Leisure Products	2.16	3.77	47.2	78.9	2.1	47.5	7.7
HRL	Hormel Foods Corporation	Food Products	0.37	4.11	35.5	43.8	2.5	14.4	16.8
LRCX	Lam Research Corporation	Semiconductors & Semiconductor Equipment	-2.44	-1.58	19.3	36.4	4.6	2.2	19.7
LYB	LyondellBasell Industries NV	Chemicals	1.11	2.57	30.3	32.6	2.9	18.3	15.1
MA	MasterCard Incorporated Class A	IT Services	-1.08	2.09	16.6	18.2	5.5	21.1	8.5
MKC	McCormick & Company, Incorporated	Food Products	3.14	4.11	42.9	43.8	2.0	14.8	3.2
NEE	NextEra Energy, Inc.	Electric Utilities	7.76	8.48	50.7	60.3	1.5	39.0	6.7
ROK	Rockwell Automation, Inc.	Electrical Equipment	-0.72	1.81	38.2	43.1	2.6	10.3	7.1
ROST	Ross Stores, Inc.	Specialty Retail	-0.26	1.29	17.7	22.9	3.4	13.9	11.3
SBUX	Starbucks Corporation	Hotels Restaurants & Leisure	0.26	2.33	33.6	36.9	2.4	27,000.0	19.2
SHW	Sherwin-Williams Company	Chemicals	2.26	2.57	21.5	32.6	3.7	20.9	23.6
SNA	Snap-on Incorporated	Machinery	1.64	3.19	23.8	38.0	3.8	20.4	12.9
SNI	Scripps Networks Interactive, Inc. Class A	Media	2.66	4.40	19.2	26.1	7.5	12.6	13.8
TYC	Tyco International PLC	Commercial Services & Supplies	2.56	4.18	36.5	36.9	1.6	52.7	12.5
VLO	Valero Energy Corporation	Oil Gas & Consumable Fuels	0.33	1.32	22.8	23.9	5.3	40.2	26.6

Source: Compustat, First Call, S&P, BofA Merrill Lynch US Equity & US Quant Strategy

Note: This screen is not a recommended list either individually or as a group of stocks. Investors should consider the fundamentals of the companies and their own individual circumstances/objectives before making any investment decisions

RIC asset class views

Table 8: Research Investment Committee asset class views

Asset Class	RIC view (+ / = / –)	Comments
Equity markets		
US equities	+	Low but rising rates, tame inflation and a strong dollar are good for stocks, but volatility and slower global growth work against stock prices. Focus is on larger cap, high quality stocks that are dividend growers.
Consumer Discretionary	–	Best sector YTD because of domestic focus, but usually underperforms when rates rise. It is expensive and overowned by active funds.
Consumer Staples	=	Defensive sector with high quality, good yield and good dividend growth. Benefits from low oil prices.
Energy	+	Cheap on most metrics and unloved by fund managers. Needs improved global growth for stocks to outperform. Investors will likely need patience.
Financials	=	Benefits from US economic/housing recovery; outperforms with rising dollar and higher short-term rates; good dividend growth potential.
Healthcare	=	Our preferred defensive sector that has been pressured by biotech selloff. Pharma a good yield play. Lags in cyclical recoveries.
Industrials	+	Good value and high quality stocks, but be selective given the slowdown in global growth. Most exposed sector to Europe.
Info Technology	+	Our favorite sector. It has the highest foreign exposure and is the only sector with more cash than debt. EPS volatility is low. We like "old tech" and newer, thematic companies.
Materials	=	Poor risk/reward trade-off. Benefits from cyclical recovery in US. Highly correlated with China.
Telecom	–	The best dividend yield sector, but payout ratios are high. The sector typically underperforms when rates rise. Worst risk/reward of any sector.
Utilities	–	Typically lags in cyclical recoveries. It is hurt by rising rates. Stocks have little room to raise dividends as payout ratios are high.
Growth	=	Not much value in the "growth vs value" trade, but growth is cheaper on most metrics.
Value	=	Scarcity of yield gives credence to value stocks; an acceleration in profits growth should begin to favor value.
Small cap	=	Volatility works against small caps, but valuations have come down a lot. Stronger dollar a negative. Stick with larger cap/higher quality.
Large cap	+	Large look attractively valued vs small or mid caps. Prefer high quality stocks with good dividend growth potential.
Europe (ex. UK)	+	ECB tone suggests continuation of QE beyond September 2016. Growth recovery is on track although inflation remains low. Valuations attractive; favor domestic cyclicals including financials, technology, media.
United Kingdom	=	Expectations for growth and inflation have come down; BOE on hold for now and risks skewed toward waiting longer to hike rates.
Japan	+	End of deflation, new management focus on corporate profits now at record highs, valuation recovery and public flows into equities keep us positive. Labor shortage should lead to wage increases, helping inflation story. Favor financials and utilities.
Asia Pac (ex. Japan)	–	The region depends on PBOC easing to fight looming deflation or a strong global recovery. EPS growth slowing, EBIT margins contracting, valuations not attractive. Expect further interest rate cuts. Stay defensive and look for div yield.
Emerging markets	–	Need monetary policy response in China and lower valuations. Concern about broader currency weakness, especially in light of probable rate increases by the US Fed. Not yet investors in Brazil; India and Taiwan favored major EM markets.
Fixed income markets		
Treasuries	=	Intermediate and long-term yields should end the year close to today's levels.
Agencies / MBS	=	A shortage of new supply should contain yields.
TIPS	+	Inflation will likely remain low, but yields and breakevens on TIPS look attractive.
US IG Corporates	+	We favor average quality and intermediate maturities. Liquidity poses a risk.
US HY Corporates	-	**High debt levels and weak earnings pose a risk.**
Preferred securities	=	Favor QDI payers and fixed-to-floating structures.
Non-US DM Sovereigns	–	Yields are low, and currency translation should work against dollar-based investors.
EM $ Sovereigns	-	**Weak commodity prices, possible central bank rate hikes, and falling currencies are risks.**
EM local crncy Sovereigns	-	**Strengthening dollar should hold back performance.**
Commodities/FX		
Gold	=	We expect gold prices to bottom in 2016. Our 2016 price forecast is $1,088/oz.
Oil	=	Gradual price increases for next couple of years. We forecast WTI prices will average $55/bbl in 2016 and $61/bbl in 2017.
US dollar	+	The US dollar should strengthen vs the euro, hold about steady vs yen, and rise against most EM currencies.

Source: BofA Merrill Lynch Global Research

Notes to RIC views

Ratings designations are as follows: (+) favorable view; (=) neutral view; (-) unfavorable view. Ratings reflect the Research Investment Committee's view for an investment time horizon of 12 months. Typically, the RIC view will agree with regional/product strategists, but at times there may a difference of opinion based on investor suitability or time frame.

Fixed Income, Economics, Commodities, Currencies: views and risks

Table 9: Regional strategist views and associated risks

Views	Risks
Global Economics (Ethan Harris, Alberto Ades)	
• US growth should remain stable allowing the Fed to begin its tightening cycle starting at the December meeting. However, concerns on low inflation persist among the FOMC members. • Growth in other developed markets has remained stable recently and should improve in 4Q15 and next year, aided by additional ECB easing. • EM growth slowdown will continue. We expect activity to bottom out in 1Q16, buoyed by greater China stimulus. Inflation remains subdued in most of EM.	• Downside risks: Weakness in China triggers a major slowdown in Asia and in commodity economies. Increased volatility from the Fed hiking rates earlier than market expectations. • Upside risks: Chinese policy stimulus is effective, stabilizing the economy and markets. US growth momentum builds.
Global Rates (Shyam Rajan, Ralf Preusser)	
• US: Our tactical bearish duration stance has been validated by the recent price action. We believe the move in the front end of the curve is done and that the next leg of the sell-off has to be led by forwards further out the curve. At current levels, we are close to our year-end target of 2.35% for 10s and recommend turning neutral. • Europe: With Bunds in our 50-75bp trading range, we are neutral duration outright, but like receiving EUR rates vs the US and receiving 5y EUR real rates. We continue to like carry and roll-down trades in the periphery, but reckon that vol there could remain elevated on political risks.	• US: A return to the policy mistake theme and/or a return to weakness in commodity prices and EM are downside risks to our rates forecasts. • Europe: Risks are symmetric. A convincing tweak to the QE program, coupled with renewed confidence in a Fed rate hike could see a repeat of the sell-off in Q2. At the same time, aggressive rate cuts could see Bund yields materially lower.
Global Commodities (Francisco Blanch)	
• With oil balances next year looking softer and costs coming down, we recently reduced our 2016 and 2017 forecasts for Brent to \$55 and \$61/bbl. Yet we still see an oil price rebound to year-end especially in WTI as US oil production falls sequentially and US refiners ramp up demand as they return from maintenance. We see WTI ending the year at \$50 and Brent at \$55/bbl. • Copper prices have not bottomed yet, and we see copper prices falling to \$4,400/t (\$2/lb) in 2016. Incorporating Glencore's recent 400kt production cut into our supply and demand model and maintaining a 6%/ 1.3mt disruption allowance, we still expect a 280kt refined surplus in 2016. Hence, we believe at least500kt of additional strategic cuts (ie, not output losses due to strikes or bad weather)are necessary to rebalance the market.	• If cyclical conditions worsen or China experiences a hard landing, oil could head much lower than our \$61/bbl forecast for average Brent prices in 2016. • Since crude oil is a very cyclical commodity, and demand and supply are inelastic in the short run, OPEC's formalized policy shift will mean much more volatile oil prices going forward. • Looking to the next five years, technical and political challenges in large oil producers such as Kazakhstan, Russia, Iran and Iraq, combined with capex cuts in response to recently low oil price, put investments in oil production growth here at risk. This should continue to put upward pressure on long-dated crude oil prices.
Global Credit (Michael Contopoulos, Hans Mikkelsen)	
• We expect US high grade and high yield credit spreads to widen in 2015 and produce zero and low-single-digit returns, respectively. Globally, we recommend quality positioning. • We are overweight high grade credit as the asset class benefits from credit spreads having re-priced materially wider. Spreads now provide an attractive cushion against further spread widening. We also expect favorable market technicals in 2016. • In high yield, we expect low-single-digit returns for this year. Globally, we recommend high quality positioning. The case for loan outperformance over bonds keeps getting stronger. Loan issuance year to date is running 35% lower than the same time last year, while CLO supply has not fallen nearly as much.	• The biggest risk to US investment grade is the possibility of wider credit spreads following fund outflows and institutional repositioning should interest rates rise meaningfully in the front end of the curve. • The most underappreciated HY risk over a 12-18 month horizon is that global growth improves, the dollar weakens, and the Fed raises rates more aggressively than the market expects, in our view.
Municipals (Philip Fischer)	
• Puerto Rico's financial crisis was the focus of a recent Senate hearing. At the hearing, the US Treasury proposed a new, US-territory specific chapter of the bankruptcy code, which would give PR the ability to restructure central government debt, including its general obligations, a power not afforded to the states. We view the likelihood of any near-term Congressional action as remote. • On 19 October, Fitch downgraded Illinois' general obligation rating to BBB+ from A-, citing "the deterioration of the state's financial flexibility as its budget stalemate continues deep into the current fiscal year." Fitch also pointed to the state's outsized, \$112bn unfunded pension liabilities. On 22 October, Moody's followed suit, downgrading Illinois' GOs to Baa1. • The Chicago City Council approved the mayor's budget proposal, which included a \$543mn property tax hike, phased in over four years, to fund the city's police and fire pension systems. Also, the constitutionality of Chicago's pension reforms addressing its municipal and laborers plans will be heard by the Illinois Supreme Court on 17 Nov. We take the position that the court will strike down the reforms as unconstitutional under the state's Pension Clause.	• We expect 2015 issuance to hit \$440-450bn. • The tax risk to munis lies at the margin this year. In order to finance some other governmental objectives, constraints to the municipal bond tax exemption may be attempted. • Away from Puerto Rico, muni defaults and bankruptcies in 2015 should remain low as tax revenues rise at the state and local levels.
Global FX (David Woo, Alberto Ades)	
• We continue to look for a stronger USD, targeting EUR-USD at 1.05 for the end of the year and parity in 2016, and generally expect a higher dollar across the board. • Look for the USD to strengthen against G10 on stronger US growth, concomitantly higher US yields, and chronic European weakness. • We are cautious on EMFX given the upcoming Fed liftoff and room for easing in Asia and Europe. In LatAm, Turkey, and Malaysia, heavy borrowing followed by plunging commodity prices has pushed external debt ratios higher. Exchange rates will remain under pressure given hedging demand from indebted firms.	• An upside surprise to persistently low US inflation could induce expectations of faster Fed normalization, higher yields, and thereby a higher USD. • Downside risk for EUR-USD comes from the possibility of more aggressive QE moves from the ECB and falling oil prices. • Downside risks in China pose a significant risk for EM. Improving economic activity in the US and a pick-up in inflation that lead the Fed to hike earlier rather than later, could be negative for EMFX.

Source: BofA Merrill Lynch Global Research

Global equity markets: views and risks

Table 10: Regional strategist views and associated risks

Views	Risks
Global Equities (Michael Hartnett)	
• The MSCI All-Country World Index is down 1% YTD; our year-end 2015 target is 470. We are bullish stocks, bullish US dollar and bearish rates. We are opportunistic in EM and Commodities. • The investment regime will change from High Liquidity & Low Growth to Higher Growth & Lower Liquidity. • We believe the modest normalization of monetary policy will not lead to lower growth. It will likely raise volatility; gold is suitable hedge against this risk.	• A rate shock in either the US or Europe, and/or a worsening US EPS trends in 4Q15, could be catalysts for asset prices to surprise on downside. • On the upside, an uber-dovish Fed could fuel speculative activity in risk asset prices.
United States (Savita Subramanian)	
• Our year-end 2015 S&P 500 target is 2000, which is 17.0x our 2015 EPS forecast of $117.50 and 15.9x our 2016 EPS of $126. Our 12-month price return target is +8%. • Valuations are not as cheap as they were several years ago, but most metrics are far from stretched, and stocks still look attractive relative to bonds. • The bull market is not over, but it is time to be selective. Positioning should continue to matter in 2015, and we see the biggest opportunities in two areas of the market: 1) High Quality stocks and 2) "Big, Old & Ugly" stocks. Quality is the best hedge against volatility. • Sector preferences: O/W tech, industrials and energy, U/W utilities, telecom and consumer discretionary.	• Risks: global growth continues to disappoint, economic shock tied to credit, global recession, US growth does not reaccelerate, oil prices continue to fall, corporates continue to hoard their cash. • We see another round of QE as one of the biggest risks to equities, suggesting $4.5tn was not enough to prop up the economy. • If the Fed remains on hold, high-growth and high-yield stocks could continue to work. • 5% pullbacks happen on average 3x per year; 10% corrections happen on average 1x per year.
Europe (James Barty)	
• A succession of solid data points have helped the European equity markets grind higher following the ECB-related surge a few weeks back. We are constructive on the outlook and think of the path of least resistance is higher from here reflecting the combination of attractive valuations, cautious investor sentiment, a resilient cyclical outlook and the prospect of on-going policy support. We retain our 425 price objective for the Stoxx 600 on a 12-month view. • Q3 earnings season has underwhelmed with investors punishing earnings misses more than rewarding beats. Commodities weakness is dragging down overall EPS growth, which is now tracking 1% (13% EMU) 2015, 8% (13% EMU) 2016. Valuations offer room for further upside at 14.8 times PE and a dividend yield of around 3.6% for 2016. • Sector wise, we retain our preference for domestically exposed sectors over EM/China exposed and commodity ones. We are overweight Banks on European macro and fundamentals; Technology offers attractive upside and ex-commodities global GDP exposure; Media should see strong growth after a poor earnings season; and recently added some quality via Healthcare. • We are underweight Miners, which have been weighed down by continued commodity weakness; Autos, which have been hurt by VW related fall out and Chinese over-capacity; and Staples, which we believe valuations are stretched and look too high to withstand any negative news.	• Downside risks are signs of deterioration in European/ China economic data and/or another devaluation of the CNY, a delay in central bank actions despite recent ECB statements and heightening Fed hike expectations and a possible left-field credit event.
Japan (Kenji Abe)	
• We remain bullish as we believe the end of deflation, new management mindset, record-high corporate profits, valuation recovery, and public money flows into Japanese equities. • Labor shortage would cause wages to rise. This should help achieve the government's commitment of and the BoJ to end deflation. • We recommend domestic oriented sectors such as utilities and construction given strong earnings momentum. We like financials as the sector benefits the most from the end of deflation.	Downside risks • Strong consensus USD bullishness is a contrary negative for yen and Japan equities. A sharp slowdown of the Chinese economy could hurt Japanese company earnings. • The inflation target not being met in the given timeframe due to lower oil and slow pace of wage hikes can weaken inflation expectations.
Asia-Pac ex-Japan (Ajay Kapur)	
• We are structurally bearish on Asia/EMs vs DMs, but we think the current tactically bull rally may continue as the Risk-Love (investor sentiment) though not at washed out levels is still weak, a positive contrarian sign. Chinese monetary policy is easing (see CHBGMCI Index on Bloomberg) – next few month data may surprise positively. Seasonality is positive. • We are structurally bearish as the world (mainly the US, Europe, Japan and China) is old, indebted and unequal, i.e. slower growth for longer. The ongoing capex cuts in commodities are deflationary along with China property capex. Valuations are not that attractive for Asia/EMs (ex-energy). Also, the Fed's cheap money has created massive booms in debt and property markets in Asia/EM, and the reversal of this carry trade and the associated period of deleveraging could lead to lower nominal growth for the coming years. • OW: India, Taiwan UW: The Philippines, Malaysia and Hong Kong	Downside risks • Sharp slowdown in China • Depreciating Asian currencies that will put downward pressure on Thailand, Malaysia and Indonesia as they have seen huge debt inflows in past 7 years • Political risks in Malaysia
Emerging Markets (Ajay Kapur)	
• While tactically bullish, our long-held and long-term pessimism on EM equities remains in place. • For us to become structurally bullish, we will need to see: 1) Domestic (not currency devaluation) monetary reflation in China that is much stronger than the mild consensus 2) A longer delay in US Fed hikes 3) A valuation adjustment, about 20% 4) A rise in US inflation expectations. • Stay with defensives (though may underperform in this ongoing tactical rally), underweight cyclicals until a reversal in Chinese monetary policy. Buy high dividend yield names. • LatAm Strategist Felipe Hirai believes Brazil would remain volatile and still prefers Mexico (best macro story) and Chile (best valuation story), while being underweight Colombia. • OW: India, Taiwan, South Africa, Brazil; UW: The Philippines, Mexico, Malaysia, Chile and Turkey	Downside risks • The data flow from China deteriorates further and authorities don't respond. • US growth is weaker than what consensus expects and the Fed still moves with a rate hike this year. • Any unexpected rise in US bond yields and stronger USD, which will reverse the carry flow and hurt dollar-short EM countries.

Source: BofA Merrill Lynch Global Research

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