

Breaking the range

A New Year's quiz

Can you name the four best performing equity markets in 2011? Which country in the world is currently perceived by the CDS market to have the lowest probability of defaulting on its government debt? Did Irish equities outperform US Treasuries in 2011? In this month's RIC report, we kick off the New Year with a quick market quiz. We hope you enjoy it.

The key driver of 2011: deleveraging

From a macro perspective, the over-arching theme was once again deleveraging. The unwind of the great credit boom started in 2008 with the housing market bust and the demise of Bear Stearns, and continued in 2011, most visibly in Europe. Although deleveraging shifted continents, the outcome was more of the same for the world: low economic growth, low interest rates, and low asset price returns. The RIC has argued in recent years that the best strategy to outperform in an era of deleveraging is to overweight creditors and underweight debtors.

The RIC's 2012 asset allocation

The RIC's current asset allocation is 60% stocks, 35% bonds and 5% cash for a moderate investor. Within equities we favor the US over Europe, EM over Japan, large-caps over small-caps, and Growth over Value. Within fixed income, we are overweight corporate and EM bonds and underweight Treasuries. We also favor munis and MBS. Within commodities, we recommend exposure to gold.

Tactics for the New Year

In the short term, we expect the New Year rally in risk assets to continue. European government funding remains a huge issue, but the RIC would swim against the tide early in 2012 by betting on upside rather than downside, driven by bearish investor positioning and US growth upgrades. A grind higher in stock prices remains plausible but we recommend taking profits if equity markets move toward our year-end targets of 1350 for the S&P 500 and 330 for MSCI ACWI.

Breaking the range

The investment community by and large has a negative macro view and expects that major asset classes will be stuck in trading ranges in 2012. Looking further ahead, it is worth highlighting a few events that could surprise investors on the upside (and downside) this year. Potential reasons to be more optimistic on equities include: valuations, policy and a more self-sustaining period of US economic growth. On the other hand, the greatest upside risk to bonds and the largest downside risk to equity markets would be a major banking and debt crisis in Europe that spills over to the US and China.

Global
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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.

2011 review

2011 was a year marked by volatility and unprecedented levels of stock correlations, as waves of negative macro news put strains on financial markets and investor sentiment.

Most major equity markets finished the year in the red, with the greatest losses in Hong Kong (-17.4%). But US equities managed to end the year in positive territory in total return terms as better than expected US economic data in the back end of the year boosted markets.

EM equities underperformed DM in 2011 as doubts about the sustainability of EM growth weighed on equities, particularly in the second half of the year.

Within US markets, large caps beat small caps by 630bps for the year. Growth outperformed Value in both size segments.

Within US sectors, defensives beat cyclicals, with the greatest gains in Utilities (+19.9%) and Staples (+14.0%). Financials (-17.1%) and Materials (-9.8%) were the laggards for the year.

All major fixed income markets posted gains for 2011. Despite the US credit rating downgrade, the 10-year Treasury ended the year as one of the best performing assets (+17.1%) amid heightened risk-off sentiment. Munis posted a strong 11.2% return in spite of siren calls for widespread muni defaults.

In FX markets, the Yen was 2011's best performing currency (+5.9%) as it won a safe haven bid amid Europe's sovereign debt crisis. Meanwhile the Euro lost 3.2%.

Commodities rallied in the first half of the year as quantitative easing and geopolitical tensions in the Middle East boosted prices. But a stronger dollar in the second half of 2011 created headwinds for the asset class.

Financial markets recap

Table 1: Total return (%)

Asset class	2010	As of 30 December 2011		
		1 month	3 months	2011
Equity Indices (% in local currencies)				
S&P 500	15.1	1.0	11.8	2.1
NASDAQ Comp	18.2	-0.5	8.2	-0.8
FTSE 100	12.6	1.3	9.4	-2.2
TOPIX	1.0	0.1	-4.2	-17.0
Hang Seng	8.6	2.6	5.1	-17.4
DJ Euro Stoxx 50	-2.8	-0.5	6.8	-14.1
MSCI EAFE	5.3	0.5	4.1	-11.7
MSCI Emerging Markets	14.4	0.0	4.9	-12.5
Size & Style (% US dollar terms)				
Russell 2000	26.9	0.7	15.5	-4.2
S&P 500 Citigroup Growth	15.1	0.3	10.8	4.7
S&P 500 Citigroup Value	15.1	1.8	13.0	-0.5
S&P 600 Citigroup Growth	28.0	0.5	15.9	3.6
S&P 600 Citigroup Value	24.7	2.0	18.6	-1.4
S&P 500 Sectors (% US dollar terms)				
Consumer Discretionary	27.7	1.3	12.6	6.1
Consumer Staples	14.1	2.8	10.3	14.0
Energy	20.5	-1.0	18.2	4.7
Financials	12.1	1.8	10.8	-17.1
Health Care	2.9	2.9	10.0	12.7
Industrials	26.7	1.2	16.5	-0.6
Information Technology	10.2	-0.9	8.7	2.4
Materials	22.2	-2.1	15.4	-9.8
Telecom Services	19.0	4.0	7.9	6.3
Utilities	5.5	3.4	8.3	19.9
BofA Merrill Lynch Global Research Bond Indices (% US dollar terms)				
10-Year Treasury	7.9	1.9	1.2	17.1
2-Year Treasury	2.3	0.0	0.1	1.5
TIPS	6.3	0.2	2.7	14.1
Municipals*	2.3	2.0	2.1	11.2
Corporate Bonds	9.5	1.9	1.8	7.5
High Yield Bonds	15.2	2.5	6.2	4.4
Emerging Markets	12.5	1.3	4.8	8.1
Preferreds	13.7	0.6	1.9	4.1
Foreign Exchange** (% in local currencies)				
US Dollar	-3.6	1.8	1.1	0.9
British Pound	-1.6	0.4	1.1	1.4
Euro	-9.0	-2.5	-2.6	-3.2
Yen	16.5	1.5	0.4	5.9
Commodities** (% US dollar terms)				
CRB Index	17.4	-2.7	2.4	-8.3
Gold	29.5	-10.5	-3.7	10.1
Oil	15.1	-1.5	24.8	8.2
Alternative Investments† (% US dollar terms)				
Hedge Fund - CS Tremont ¹	10.9	-0.8	-2.3	-2.3
Hedge Fund - HFRI Fund of Funds ¹	5.7	-0.6	-2.4	-4.9
Private Equity - Cambridge Assoc. ²	19.8	NA	4.5	10.1
Private Real Estate - NCREIF TR ³	13.1	NA	3.3	11.0

Notes: *Not tax adjusted. **BoE calculated effective FX indices. ¹Data as of 11/30/11; CS AUM-weighted, HFRI equal-weighted ²Quarterly data as of 6/30/2011 ³Quarterly data as of 9/30/11:AI data not comparable to other asset classes because of reporting delays, lack of standardized reporting, and survivorship and self selection biases.

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 Index; USD Emerging Market Sovereign Plus; US Preferred Stock, Fixed Rate).

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Breaking the range

Happy New Year from the RIC. In this month's report we review the key lessons from market performance in 2011, highlight our best asset allocation advice and investment themes for 2012, and examine what catalysts are necessary to cause more significant moves in asset prices than the widely expected trading ranges. But first, let's kick off 2012 with a quick market quiz (the answers to which are found on [page 8](#) at the end of the overview).

A New Year's quiz

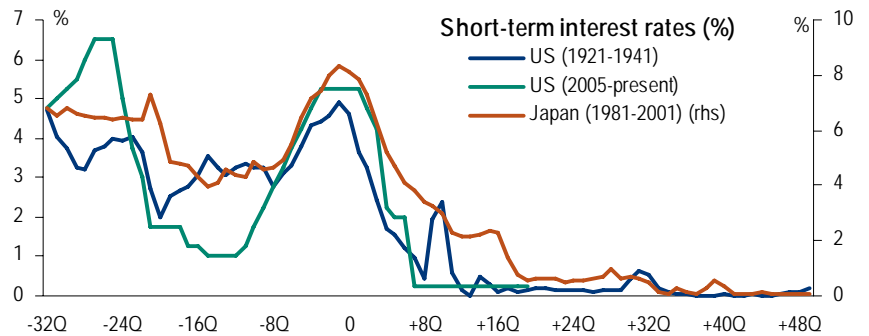
1. Greece was easily the worst performing market last year, falling 64% in value, but can you name the four best performing equity markets of 2011?
2. Which country had the best performing trade-weighted currency in 2011?
3. What has the direction of the US equity market in January accurately predicted in 14 out of the past 15 presidential election years?
4. Ten equity markets fell 30% or more in value in 2011. What is the historic probability that the same equity markets will rally in 2012, and what is the average historic gain?
5. Which country in the world is currently perceived by the CDS market to have the lowest probability of defaulting on its government debt?
6. Which is currently most at risk of default according to the CDS market: Iraq, Spain, AIG or General Motors?
7. Name the US sectors that currently have: 1) the highest investment grade corporate bond yield; 2) the highest high yield corporate bond yield; and 3) the highest dividend yield.
8. Were there more rate hikes or rate cuts in 2011?
9. How many countries will have elections in 2012?
10. US equities outperformed non-US markets by almost 15 percentage points in 2011. What was the last year the US equity market outperformed the rest of the world by such a large amount?
11. US AAA investment grade bond yields began 2012 below 4%. What year was the last time this occurred?
12. Irish equities outperformed US Treasuries in 2011 – true or false?
13. Is the current equity allocation of Merrill Lynch GWIM client base above or below 50%?

The winners, losers and drivers of 2011

It was a tough year for investors. The strong rally in US Treasuries caught many by surprise, including ourselves; correlations within the stock market were extremely high, causing four out of five large-cap managers to underperform; and hedge funds found equity and currency trading ranges difficult to navigate. In addition, the reality that cash returns would remain at zero for perhaps many years to come (compare the US 1921-41 and Japan 1981-2001 with today – Chart 1) continues to make private clients more rather than less cautious.

Despite sensational news and dramatic headlines, broad asset returns were surprisingly muted. Global equities declined 7%, US equities were flat, commodities lost 3%, and global fixed income markets gained 6%.

Chart 1: Short Rates in US (1921-41), Japan (1981-2001), US (2005-present)



Source: BofA Merrill Lynch Global Equity Strategy, Bloomberg

Table 2: Creditors vs. Debtors

Country	Current account surplus/ deficit as % of GDP
Saudi Arabia	20.6%
Singapore	19.0%
Switzerland	13.5%
Hong Kong	6.0%
Russia	5.6%
Germany	5.5%
China	2.5%
Japan	2.2%
Korea	1.9%
Ireland	1.4%
Indonesia	0.1%
Australia	-1.5%
Brazil	-2.0%
France	-2.2%
Italy	-2.8%
Canada	-2.8%
US	-2.9%
Spain	-3.5%
India	-4.0%
UK	-4.0%
Turkey	-9.4%
Greece	-9.4%

Data as of 3Q11 or latest available

Source: BofA Merrill Lynch Global Equity Strategy, Haver, Bloomberg

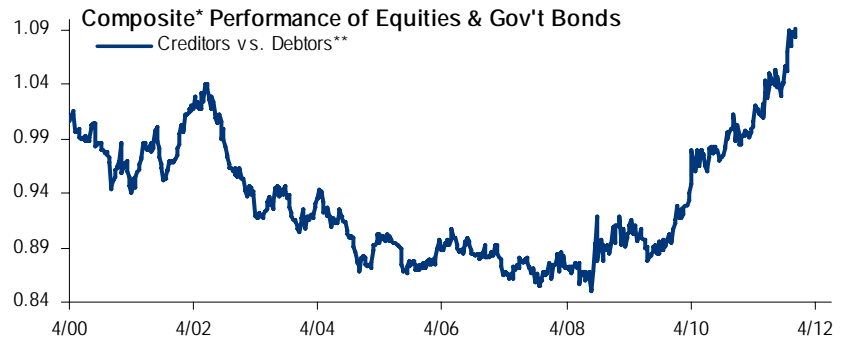
The key driver of 2011

From a macro perspective, the over-arching theme was once again deleveraging. The unwind of the great credit boom started in 2008 with the housing market bust and the demise of Bear Stearns, and continued in 2011, most visibly in Europe. Although deleveraging shifted continents, the outcome was more of the same for the world: low economic growth, low interest rates, and low asset price returns.

The RIC has argued in recent years that the best strategy to outperform in an era of deleveraging is to overweight creditors (markets and companies with good balance sheets) and underweight debtors (markets and companies with bad balance sheets). This strategy continued to win in 2011 (creditors outperformed debtors by over 8ppt for the year— see Chart 2) as did an emphasis on high quality assets such as best of breed companies (please see [Global Best of Breed for 4Q11](#) for our Best of Breed screen).

Deleveraging did not end last year. Until the global economy is strong enough for central banks in the US, Europe and Japan to normalize monetary policy and end zero interest rates, asset allocation should continue to be biased over the medium term toward financial assets that provide high growth, high quality, and high yields.

Chart 2: Creditors have significantly outperformed Debtors since 2008



* simple avg of equities and bonds

**Creditors = equal-weighted basket of Saudi, Austria, Denmark, Hungary, Indonesia, Korea, Japan, China, Thailand, Philippines, Russia, Germany, HK, Sweden, Netherlands, Taiwan, Malaysia, Switzerland, Singapore, Norway. Debtors = equal-weighted basket of Portugal, Turkey, Greece, Poland, New Zealand, Italy, S Africa, Czech, Spain, India, Mexico, France, Israel, Ireland, UK, Brazil, Canada, US, Australia

Note: total returns (\$ terms)

Source: BofA Merrill Lynch Global Equity Strategy, Haver, MSCI

Table 3: Winners & losers in 2011

	\$100 invested in 2011
Municipals	\$111
Gold	\$110
Treasuries	\$110
US IG corporate bonds	\$108
Global fixed income	\$106
Growth stocks	\$105
US high yield bonds	\$104
Energy	\$104
US equities	\$102
Cash	\$100
Value stocks	\$100
Nasdaq	\$99
Commodities	\$97
Small cap equities	\$96
Global equities	\$93
European equities	\$89
Japanese equities	\$86
US Financials stocks	\$83
EM equities	\$82

Note: Total returns, USD. Indices used: S&P 500, Russell 2000, S&P 500 Growth, S&P 500 Value, S&P 500 Financials, Nasdaq, MSCI ACWI, MSCI Europe, MSCI Japan, MSCI EM, Gold, ML US Treasury Bill Index, ML Muni Master Index, ML Treasury Master Index, ML US Corporate Master Index, ML US High Yield Index, ML Commodity Index, ML Energy Index
Source: BofA Merrill Lynch Global Equity Strategy, Bloomberg

Asset class winners and losers in 2011

All major fixed income sectors had positive returns in 2011 (Table 3). The key themes for the market were a desire for safe havens, as evidenced by the outperformance of Treasuries, as well as the need for portfolio income. Both high yield and EM debt funds were once again recipients of large inflows as low cash rates caused investors to increase risk in search of yield. Munis were among the top performing fixed income assets in 2011 despite siren calls for widespread municipal defaults.

In contrast, equities were essentially de-rated in the second half of 2011 despite the strength of corporate earnings and exceptionally low interest rates. Volatility, correlation and macro event risks caused investors to lower the multiple they were willing to pay. The US equity market significantly outperformed the rest of the world as debt problems in Europe and monetary tightening in EM put the global theme on ice. Elsewhere, defensives outperformed cyclicals, large-caps beat small-caps, Growth stocks beat Value stocks, high quality beat low quality, and dividend paying stocks outperformed.

Within commodity markets, 2011 was a story of two halves. Quantitative easing and geopolitical tensions in the Middle East drove commodities higher in the first half of the year. But the strength of the dollar in the second half made it difficult for commodity outperformance to continue.

Allocation, trades and tactics for 2012

In the [December RIC Report](#), we detailed our base case for 2012, our initial asset allocation, and identified 10 key trades. All are outlined below.

Table 4: Equity allocations

	Moderate Investor	
	Strategic	Tactical
Large cap growth	38%	47%
Large cap value	38%	33%
Small growth	4%	4%
Small value	4%	1%
International: Developed	13%	10%
International: Emerging	3%	5%

Source: BofA Merrill Lynch Global Research

On asset allocation: The RIC maintains its current asset allocation of 60% stocks, 35% bonds and 5% cash for a moderate investor. Assets tied to growth, quality and yield should continue to outperform in the medium term.

On equities: Regionally, we favor the US over Europe, and EM over Japan. We continue to be bullish on large caps over small caps, as earnings growth and valuations are better up the market cap spectrum. Scarce economic growth and regulatory risks in the Financials sector are likely to continue to fuel the outperformance of Growth over Value stocks. See Table 4 for specific allocations.

On fixed income: We are overweight corporate and EM bonds and underweight Treasuries. We expect total returns of 4.8% for US IG bonds, 13.9% for US HY bonds, and 10.4% for EM local currency debt. We also favor munis and MBS. See Table 5 for specific allocations.

Table 5: Fixed income allocations

	Moderate Investor	
	Strategic	Tactical
Tsys, CDs & GSEs	40%	32%
Mortgage Backeds	25%	25%
IG Corp & Preferred	25%	28%
High yield	5%	7%
International	5%	8%

Source: BofA Merrill Lynch Global Research

On commodities: We recommend investors position for growth and large-scale monetary easing. Gold and oil are likely to benefit from low real interest rates and abundant liquidity. Our 12-month gold target is \$2000/oz, and we expect Brent crude oil to average \$108/bbl this year. In the near term, we see downside risks to industrial metals as the growth outlook deteriorates.

10 key trades for 2012

1. Buy gold
2. Buy US high grade Financial bonds
3. Buy high quality/high yielding munis & "kicker bonds"
4. Buy EM local currency debt
5. Buy high-yielding equities
6. Buy the Best & Distressed in Europe
7. Buy US Staples and Tobacco
8. Buy US Tech
9. Hedge risk
10. Watch the technicals

Tactics for the New Year

In the short term, we expect the New Year rally in risk assets to continue. A grind higher in stock prices remains plausible but the RIC recommends taking profits if equity markets move toward our year-end targets of 1350 for the S&P 500 and 330 for MSCI ACWI.

The RIC sees two main drivers behind the rally in the New Year

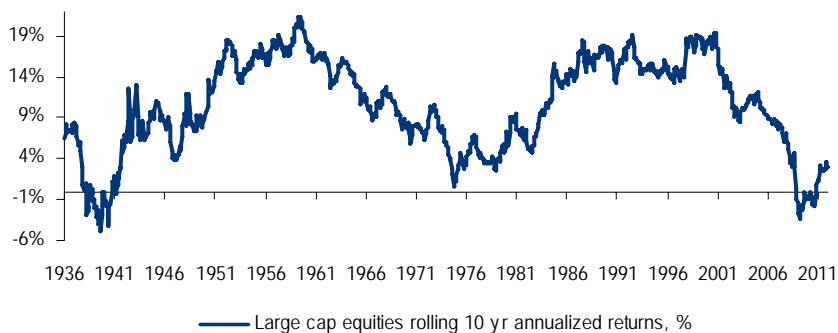
- **Bearish investor positioning:** High cash levels and low levels of equity optimism triggered buy signals on several of our tactical trading rules in 4Q11, including our Global Flows Trading Rule in December (see [Rules and Tools](#) for an in-depth explanation of our trading rules). On a recent marketing trip, we found that sentiment even in Asia was quite bearish.
- **US growth upgrades:** US economic data has surprised to the upside – from payrolls to manufacturing, and our economics team has just revised up its 2012 US GDP forecast from 1.9% to 2.1%.

European government funding remains a huge issue, but the RIC would swim against the tide early in 2012 by betting on upside rather than downside driven by factors above.

Breaking the range

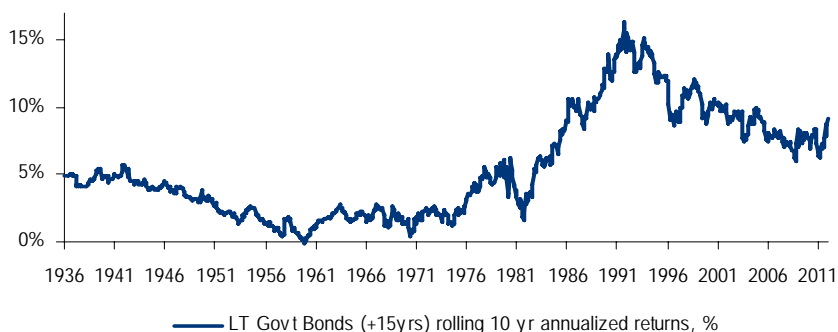
Looking further ahead, it is worth highlighting a few events that could surprise investors on the upside (and downside) this year. The investment community by and large has a negative macro view and expects that major asset classes will be stuck in trading ranges in 2012. In addition, long-term asset allocation remains skewed toward fixed income and away from equity, despite the strong performance of bonds relative to stocks over the past decade (Charts 3-4).

Chart 3: Rolling 10yr annualized equity returns



Source: BofA Merrill Lynch Global Equity Strategy, Ibbotson, Bloomberg

Chart 4: Rolling 10yr long-term government bond returns



Source: BofA Merrill Lynch Global Equity Strategy, Ibbotson, Datastream

Reasons to be more optimistic on equities

Three factors are potentially supportive for the equity market: valuations, policy and a more self-sustaining period of US economic growth.

Valuations

Global equity valuations are attractive, and our Global Quantitative Strategist Nigel Tupper notes that historically, when the forecast P/E has been close to the current level (10.6x), global equities have averaged over 28% over the following 12 months. Similarly, when the P/B was close to the current level of 1.6x, equities averaged 15% in the subsequent 12 months. In addition, investors and pension funds are facing lackluster returns on their bond investments with all-in yields near their all-time lows.

Policy

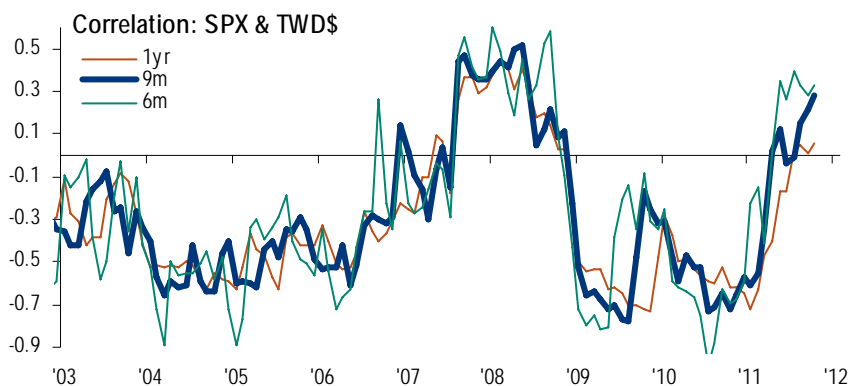
Markets could be surprised by policy developments in both the US housing market and Chinese monetary policy. Risk assets would do much better-than-expected if 1) the US government announced a big, credible plan to clean up foreclosed properties to boost home prices and construction activity, and 2) the Chinese government were sufficiently satisfied with lower inflation to cut interest rates and stimulate the Chinese economy more aggressively.

US housing economist Michelle Meyer believes that while there will likely be a housing plan, it is unlikely to be big enough to prevent a further decline in house prices in 2012. China economist Ting Lu believes policy makers will be reluctant to cut rates as the government seeks to cool borrowing (especially housing-related borrowing).

Macro

Few expect the current bout of US economic strength to persist. Should it do so, the US economy would surprise to the upside in 2012 and risk assets would respond favorably. This is not the RIC's base case, but we must highlight that for the first time in several years, a stronger dollar is now going hand-in-hand with a stronger equity market (Chart 5). This offers a glimmer of hope that the US economy is in a more self-sustaining recovery, and if so, Treasury yields at less than 2.0% would become less attractive to long-term investors.

Chart 5: Correlation between S&P 500 and US trade-weighted dollar



Using monthly price change over 6, 9 and 12 months
Source: BofA Merrill Lynch Global Equity Strategy, Bloomberg

Reasons to be more optimistic on bonds

Put simply, the greatest upside risk to bonds and the largest downside risk to markets would be a major banking and debt crisis in Europe that spills over to the US and China. If this were to happen, we would expect to see double-digit declines in earnings growth, and further weakness in the stock prices of banks. Bonds would outperform stocks, and within equities, this would be very negative for US cyclicals, EM consumer stocks, and global Energy stocks.

The answers to the quiz

1. The four best performing equity markets in 2011 were Venezuela (79%), Mongolia (33%), Iraq (32%), and Iran (29%). It was *that* tough a year.
2. China. The trade-weighted renminbi appreciated almost 6% last year, and if this pace slackens or even reverses in 2012, it would be a signal that monetary policy is being eased.
3. The direction of the market for the full year.
4. The probability of any equity market down 30% or more in a year rebounding the following year is roughly 2/3. The average return of such markets is remarkably slightly over 50%.
5. Norway (followed by the US and then Switzerland).
6. General Motors.
7. 1) Financials have the highest IG corporate bond yield (4.6%); 2) Tech has the highest HY corporate bond yield (9.8%); and 3) Telecoms have the highest dividend yield (5.9%).
8. There were almost twice as many rate hikes in 2011 (108) as rate cuts (55).
9. 70 countries will have elections in 2012 (either presidential, parliamentary, legislative, or referendums).
10. 1998.
11. 1958. Investment grade corporate bonds yields started 1958 around 3.8%.
12. True – Irish equities returned 14.3% in 2011 while our BofAML Treasury Master Index returned 9.8% (total returns, USD).
13. Slightly below.

Asset markets: base case, ideas, risks

Table 6: RIC base case for global asset markets

Region/sector	Convictions	Ideas & risks
Global Economics: Ethan Harris Alberto Ades	<ul style="list-style-type: none"> Global growth slows down. Developed economies remain vulnerable, with crippled sectors and regions. 	<ul style="list-style-type: none"> Policy uncertainty freezing activity. Additional central bank support in year ahead. Biggest risks: escalating crisis in Europe, policy paralysis in US, oil supplier off-line in Mideast.
Global Equities: Michael Hartnett	<ul style="list-style-type: none"> 2012 MSCI All-Country World Index target is 330. Developed markets in wide trading ranges until central banks can raise interest rates and cause a "good" bear market in bonds. Secular Emerging Market bulls. Secular bull markets in equities that offer growth, quality and yield. 	<ul style="list-style-type: none"> Overweight US, Australia, EM (Russia, Brazil); Underweight China, Turkey. Own growth, yield and high quality Best of Breed stocks. Mega-cap multinationals; EM/Asia consumer remain core structural theme. Risks: European recession spreads to the US or Asia; policy errors including premature tightening; excess of deficits driving up interest rates; weaker EM growth.
Global Rates: Priya Misra Bin Gao John Wraith Ralf Preusser	<ul style="list-style-type: none"> 10-year US Treasury yield to stay range bound through the year, ending at 2.4%. We like owning 5s as the Fed is likely to communicate a longer on-hold period. We also recommend 10s-30s curve flatteners as Operation Twist creates a demand-supply mismatch in the long end. European rates are likely to remain well supported in the face of a looming further deceleration in economic activity, irrespective of the continued volatility in peripheral politics. UK: Growth is expected to be very weak at best, with ongoing fiscal tightening offset by prolonged monetary stimulus through additional Central Bank Gilt purchases. 	<ul style="list-style-type: none"> US: We forecast 10y yields to reach their lows in Q1 2012 as: 1) the European situation is likely to worsen before policy makers intervene and 2) policy uncertainty in the US creates downside risks to growth. We see yields modestly rising in 2H due to rising inflation expectations as a result of QE3. However, given an increased perception of ineffective monetary policy, impending fiscal tightening in the US and continuing concerns in Europe, we don't see 10y yields rising above 2.4%. Europe: We like receiving front-end forwards in Euribor-based products (e.g. 1y->2y) after the larger-than-expected demand in the December 3y LTRO and look for further ECB rate cuts. UK: Gilts are expected to richen persistently over the coming months, with long end bonds outperforming. The main risk to the UK appears to be either a full resolution of the Eurozone crisis which reverses the flight from risk flows, or an even more rapid rise in borrowing/decline in growth than forecast, which could put the UK's AAA rating in some danger in due course. Australia: 3y bonds appear expensive while 10y bonds look more fairly valued.
Global Commodities: Francisco Blanch	<ul style="list-style-type: none"> Given the weak global economic growth backdrop, we retain a negative bias on the commodity complex in the short-run. However, commodity prices should be supported by aggressive monetary easing across both developed and emerging economies, particularly in 2H2012. We see limited upside to oil prices in 2012 as global balances improve with weak demand and supply recovery. In the second half of the year, a combination of low stocks and further monetary policy loosening will likely support prices. We forecast an average 2012 Brent crude oil price of \$108/bbl in 2012, \$101/bbl for WTI. We maintain our 12-month gold target of \$2,000/oz given loose monetary policy and scope for further balance sheet use in the US and Europe. Negative real rates are also positive for gold and should persist through 2012. 	<ul style="list-style-type: none"> Key risks to our outlook include a deeper-than-expected Eurozone recession, increased Middle East tensions, faster-than-expected US fiscal tightening, and a China hard-landing scenario. US natural gas will continue to be characterized by extremely loose fundamentals in the foreseeable future given record inventories, buoyant production and weak demand. With continued structural (eg, high debt in developed markets) and cyclical (low confidence) headwinds, we maintain our cautious stance on base metals.
Global Credit: Hans Mikkelsen Oleg Melentyev	<ul style="list-style-type: none"> With a slowly expanding US economy we expect that favorable excess demand conditions in the credit market will resume. Our 2012 year-end spread targets of 180bp in HG and 550bp in HY imply significant tightening next year. Increasing interest rates partially offset the effect of tighter spreads, and we expect total returns for HG and HY in 2012 of 4.8% and 13.9%, respectively. HG: modest OW higher beta, lower quality and financial bonds. HY: Up-in-quality positioning to start. Then as Europe is resolved we plan to become less defensive. OW US credit relative to EU credit. 	<ul style="list-style-type: none"> Bullish on US corporate credit because: 1) Risks more than fully priced in credit markets, thus credit has attractive return profile with limited downside; 2) Globally negative real yields and low expected growth is just right for corporates – provided that uncertainty declines. Growth is not expected to be strong enough to prompt a big rotation into equities, thus we expect a favorable technical liquidity environment for credit in 2012; 3) We expect US financial markets to decouple from the European debt crisis. Risks: situation in Europe causes a US recession.
Global FX: David Woo Alberto Ades	<ul style="list-style-type: none"> ECB rate cuts, further intensification of the Euro debt crisis and tighter US fiscal policy worries will help boost the USD in H1 2012. The worsening of the European crisis will put further downward pressure on EMFX in 1H12. However, we expect policymakers to be forced into a response and see upside in 2H12. 	<ul style="list-style-type: none"> Despite relatively high inflation expectations and mounting political pressure presenting a high hurdle for the Fed to implement QE3, should recession concerns rise dramatically or deflation concerns gain, the Fed may move down that road again. This would be USD negative. A lasting solution to the Eurozone crisis would also be USD negative, although we believe this is unlikely to happen in the next few months. As European banks deleverage and investors become more concerned over growth, capital flight from EM could put significant pressure on currencies.

Source: BofA Merrill Lynch Research Investment Committee

Global equity market convictions: ideas & risks

Table 7: Global equity weightings by region

Region/sector	Analyst(s)	Recommendation*	Convictions	Ideas & risks
US:	Savita Subramanian	Overweight	<ul style="list-style-type: none"> 2012 year-end S&P 500 target is 1350, which is 13x our 2012E EPS of \$104.50. OW Staples and Tech; UW Materials and Financials. Macro market continues into 2012 with 1) the European crisis, 2) US policy, 3) risks of material slowdown in China/Emerging Markets, and 4) financial regulatory reform. 	<ul style="list-style-type: none"> Expect a structurally higher equity risk premium over next several years given increased macro risk, but expect healthy 2012 EPS growth. Favor yield, quality & growth over beta. Europe, government & consumer exposure are key risks. Focus on sectors/industries with more stock picking opportunity.
UK:	Gary Baker	Underweight	<ul style="list-style-type: none"> Economic data at the margin show signs of stabilization albeit at weak levels. BoE stands poised for more assistance and government enjoying strong momentum post EU spat. Gilt market remains strongly supported. Defensive make-up of FTSE index continues to offer relative attractions to the slow motion crisis in Europe. 	<ul style="list-style-type: none"> Overweight Healthcare and Telecom stocks offering high quality, strong cash flow, secure dividends, big cap exposure: all themes that we like. Despite global growth concerns we are also overweight Energy and Basic Resources to add some beta exposure.
Europe ex-UK:	Gary Baker	Underweight	<ul style="list-style-type: none"> GDP downgrades of late 2011 have temporarily abated on marginally stronger (less worse?) data but unconvincing. 0% EPS forecast leaves market trading on 10.4x PER. Our 250 Y/E target for Stoxx600 implies flat performance but forecast 4.2% div yield. Resilient global growth centered on the US is a lifeline for Europe while it addresses deep-seated political problems. The pace of change remains frustratingly slow. 	<ul style="list-style-type: none"> OW Pharma, Telecom, Basic Resources. UW Industrials, Chemicals. Y/E index target for SXXP is 250. Investors are watching for signs of a greater risk on rotation after flaccid attempts to rally over holiday period. More summits over next 3 weeks are a cause for concern as much as opportunity. Government debt refinancing mountain looms large.
Japan:	Masatoshi Kikuchi	Neutral	<ul style="list-style-type: none"> The Nikkei will bottom at around 8,000 in February and should rebound beyond 10,000 between the end of March and July-August. We recommend looking at opportunities for buying the dip in January-March. The expectation of global economic recovery with monetary easing of emerging countries and the positive impact of large supplementary budgets for reconstruction should be positive for the market. The strong yen and unstable politics should remain negative for the market. 	<ul style="list-style-type: none"> We continue to OW construction/real estate, trading houses, machinery, industrial electronics, precisions/electronic components, and foods, and UW non-bank financial, electric power/gas, and materials. We lower consumer electronics from neutral to UW as Japanese producers will struggle to compete with Apple, Samsung, and the Chinese. We upgrade our stance on transportation stocks from neutral to OW since railways are likely to benefit from the opening of the Tokyo Sky Tree in May. Marine transport also has good potential for the container vessel market to bottom out in 1H 2012.
Asia-Pac ex-Japan:	Nigel Tupper	Neutral	<ul style="list-style-type: none"> Earnings growth forecasts remain high in Asia but have moderated in recent months. More earnings downgrades are expected as the cycle deteriorates. Inflation should fall in Asia in the next 12 months as the cycle slows, which should provide more room for central banks to cut rates. With the US slowing and Europe moving into recession, domestic demand is becoming an increasingly important driver of the Asia growth story. 	<ul style="list-style-type: none"> Prefer defensives, structural growth stories and the more resilient Energy sectors across the region.
Emerging Markets:	Michael Hartnett	Overweight	<ul style="list-style-type: none"> EM in a secular bull market. High growth, infant credit cycles and abundant global liquidity are secular positives for EM. Shorter-term investors should wait for an abatement of DM macro risks before adding to positions. 	<ul style="list-style-type: none"> Long EM resources; Best of Breed; mega-cap production stocks; Russian equities. Risks: Major banking and debt crisis in Europe that triggers a recession in the US and a hard-landing in China.

*Recommendations are relative to regional weightings in the MSCI All Country World Index.

Source: BofA Merrill Lynch Research Investment Committee

Link to Definitions

Macro

Click [here](#) for definitions of commonly used terms.

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Investment rating	Total return expectation (within 12-month period of date of initial rating)	Ratings dispersion guidelines for coverage cluster*
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Neutral	≥ 0%	≤ 30%
Underperform	N/A	≥ 20%

* Ratings dispersions may vary from time to time where BofA Merrill Lynch Research believes it better reflects the investment prospects of stocks in a Coverage Cluster.

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