The opportunities and threats of 2012

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Bank of America Merrill Lynch

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For a year that has endured a Japanese earthquake, a US credit rating downgrade and a full blown European sovereign debt crisis, asset class returns in 2011 have been surprisingly resilient. Bond returns are up 5%, commodities are flat, and global equities have lost only 6%. After a sprightly first half, the reality of excess debt, deleveraging and deflation caused investors to de-rate risk assets aggressively during the second half of 2011.

The RIC's asset allocation for 2012

We enter 2012 with potential downside risks to financial markets in the form of a US recession, a potential breakup of the Euro and a hard landing in China. In addition, oil prices remain worryingly high, and markets are likely to be challenged by political and social tensions in the coming year. As a consequence, assets should be allocated conservatively. The RIC starts the year with a neutral view on equities, overweight gold, US corporate bonds, US equities and EM assets, and we continue to favor our long-held secular themes of Growth, Quality and Yield.

Opportunities and threats in 2012

The good news is investor sentiment is more defensive today than 12 months ago, and central banks are once again demonstrating they will do everything they can to prevent systemic financial market turmoil. The BofAML base case is that policymakers will once again succeed in avoiding the abyss in 2012. As a result, the RIC believes 2012 offers many investment opportunities, as well as threats.

The bull, bear and secular cases

The RIC believes a recovery in US real estate, a structural fix to Europe's debt problems and a supply-led drop in commodities would cause a more bullish new year outcome for risk assets. In contrast, a US recession is the major downside risk to equity and commodity prices. Despite our short-term caution, we believe that equities on a 2-3 year view look compelling, and believe that 2012 should represent the beginning of the end of the great bear market in equities.

10 key macro themes for 2012

Slower global economic growth; The US consumer will weaken again; A soft landing in China; QE in the US and Europe; Negative returns for holders of Treasuries; Modest upside for equities; Large-caps will outperform small; EM rate cuts support EM assets and commodities; Stock picking opportunities will emerge.

10 key trades for 2012

Buy: 1) gold; 2) US HG Financial bonds; 3) high quality/high yielding munis, and "kicker bonds"; 4) EM local currency debt; 5) high-yielding equities; 6) the Best and Distressed in Europe; 7) US Staples and Tobacco; 8) US Tech. We also recommend investors hedge risk and watch the technicals.

Click the image above to watch the video.

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 14 to 16. Analyst Certification on Page 13. Link to Definitions on page 13.
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November review

Negative macro news and risk aversion pushed equities lower in November. A rally at the end of the month driven by coordinated global central bank liquidity measures helped to pare losses, but all major equity markets still finished in the red for the month. Hong Kong, Japan and EM were the worst performing regions.

EM equities underperformed DM for the second month in a row. Year to date (YTD), EM equities are down 12.5%, while US equities have eked out a 1.1% gain.

Within US markets, large caps narrowly outperformed small caps in November, but have maintained a significant lead for the year (590bp). YTD, Growth is beating Value in both size segments.

Defensives fared better than cyclicals within US sectors for the month. Staples (+2.7%) was the best performing sector while Financials (-4.7%) lagged.

Within fixed income, riskier assets underperformed, with the greatest losses in HY (-2.2%) and IG corporate bonds (-1.9%). 10-year Treasuries (+1.3%) benefitted as investors sought out safer assets.

In FX markets, the US dollar (+2.1%) and Yen (+2.0%) were the best performing currencies as they won safe haven bids. Meanwhile the Euro lost 1.6% amid continued fears over the sovereign debt crisis.

Oil (+7.7%) and gold (+1.8%) prices moved higher in November. In the year to date, gold continues to be the winner (+22.9%).

Financial markets recap

Table 1: Total return (%)

		As of 30 November 2011			
Asset class	2010	1 month	3 months	12 months	YTD
Equity Indices (%, in local currencies)					
S&P 500	15.1	-0.2	2.9	7.8	1.1
NASDAQ Comp	18.2	-2.2	1.9	6.0	-0.3
FTSE 100	12.6	-0.2	2.9	3.2	-3.4
TOPIX	1.0	-4.7	-4.5	-13.4	-17.1
Hang Seng	8.6	-9.2	-11.7	-19.3	-19.4
DJ Euro Stoxx 50	-2.8	-2.0	1.9	-9.0	-13.7
MSCI EAFE	5.3	-2.5	-0.9	-8.0	-12.2
MSCI Emerging Markets	14.4	-3.8	-2.9	-8.5	-12.5
Size & Style (%, US dollar terms)					
Russell 2000	26.9	-0.4	1.9	2.8	-4.8
S&P 500 Citigroup Growth	15.1	-0.1	3.1	9.8	4.3
S&P 500 Citigroup Value	15.1	-0.3	2.6	5.8	-2.3
S&P 600 Citigroup Growth	28.0	0.6	3.9	9.7	3.1
S&P 600 Citigroup Value	24.7	0.7	3.7	5.3	-3.3
S&P 500 Sectors (%, US dollar terms)					
Consumer Discretionary	27.7	-0.7	3.6	9.2	4.8
Consumer Staples	14.1	2.7	3.7	15.6	10.9
Energy	20.5	2.0	4.4	15.3	5.8
Financials	12.1	-4.7	-3.6	-9.7	-18.5
Health Care	2.9	1.0	2.1	14.4	9.5
Industrials	26.7	1.0	4.6	5.9	-1.7
Information Technology	10.2	-1.7	6.0	8.8	3.3
Materials	22.2	0.1	-1.4	1.7	-7.8
Telecom Services	19.0	0.8	2.6	10.2	2.2
Utilities	5.5	1.1	4.9	19.6	16.0
BofA Merrill Lynch Global Research Bond Indices (%, US dollar terms)					
10-Year Treasury	7.9	1.3	1.7	10.3	15.0
2-Year Treasury	2.3	0.0	0.0	1.2	1.4
TIPS	6.3	0.6	2.0	12.0	13.9
Municipals*	2.3	0.5	1.4	6.8	9.0
Corporate Bonds	9.5	-1.9	-0.3	4.5	5.5
High Yield Bonds	15.2	-2.2	0.5	3.7	1.9
Emerging Markets	12.5	-0.8	-0.2	6.0	6.7
Preferreds	13.7	-1.8	-1.2	3.5	3.5
Foreign Exchange (%, in local currencies)**					
US Dollar	-3.6	2.1	4.2	-3.9	-0.9
British Pound	-1.6	0.0	1.9	-1.1	1.0
Euro	-9.0	-1.6	-3.4	0.1	-0.7
Yen	16.5	2.0	1.8	6.3	4.4
Commodities (%, US dollar terms)**					
CRB Index	17.4	-1.9	-8.0	4.1	-5.7
Gold	29.5	1.8	-4.9	26.0	22.9
Oil	15.1	7.7	12.9	19.3	9.8
Alternative Investments† (%, US dollar terms)					
Hedge Fund - CS Tremont[1]	10.9	1.7	-3.8	1.1	-1.5
Hedge Fund - HFRI Fund of Funds[1]	5.7	1.1	-4.3	-2.2	-4.2
Private Equity - Cambridge Assoc.[2]	19.8	NA	4.5	24.7	10.1
Private Real Estate - NCREIF TR[3]	13.1	NA	3.3	16.1	11.0

Notes: *Not tax adjusted. **BoE calculated effective FX indices. [1]Data as of 10/31/11; CS AUM-weighted, HFRI equal-weighted [2]Quarterly data as of 6/30/2011 [3]Quarterly 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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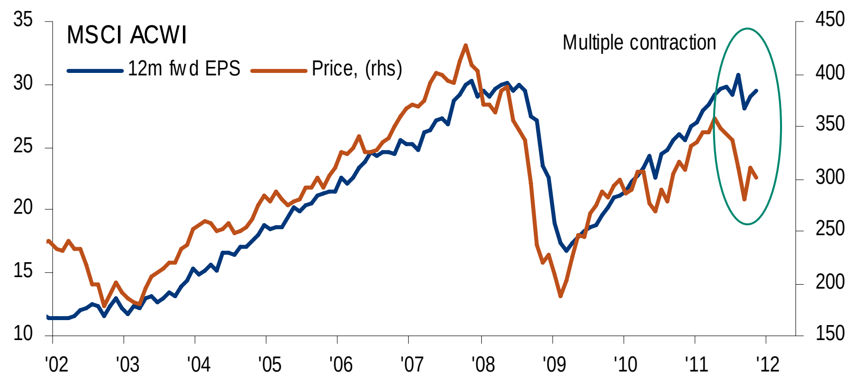
The best performing assets of 2011 were gold and government bonds, particularly in those countries that took fiscal austerity seriously, eg, Ireland and the UK. The worst performing assets were European peripheral bonds, industrial metals and equities in Emerging Markets and Japan (Table 2). After a sprightly first half, the reality of excess debt, deleveraging and deflation caused investors to de-rate risk assets aggressively during the second half of 2011 (Chart 1).

Table 2: Asset returns

	2010	2011*
Global Equities	13%	-6%
North America	16%	0%
Europe	4%	-9%
UK	9%	-2%
Japan	16%	-13%
Pacific Rim ex-Japan	17%	-9%
Emerging Markets	19%	-14%
Global Fixed Income	6%	5%
Government	6%	6%
Quasi-government	5%	5%
Investment Grade Corporate	5%	4%
High Yield Corporate	14%	1%
Emerging markets Debt	16%	3%
Collateralized Debt	5%	5%
Commodities	13%	-1%
Energy	4%	7%
Industrial Metals	18%	-19%
Precious Metals	35%	20%
Agriculture	30%	-15%
Cash	0%	0%
US Dollar	-4%	-1%

*Year to date as of 12/2/2011
Notes: Total returns in USD; Equity returns are MSCI indices; BofA Merrill Lynch Global Bond Indices are: Fixed Income Markets; Government Bond II; Large Cap Quasi-Govt; Large Cap Corporate; High Yield; Emerging Markets Sovereign & Credit; Large Cap Collateralized; Commodity returns are Merrill Lynch Commodity eXtra TR Indices.
Source: BofA Merrill Lynch Global Equity Strategy; Bloomberg

Chart 1: The big equity story of 2011 was multiple contraction



Source:BofA Merrill Lynch Global Equity Strategy, Bloomberg

The RIC's asset allocation in 2011

One year ago we argued for cyclical upside for risk assets and negative returns from government bonds, and that proved wrong. In particular, US Treasuries were stronger than expected and EM equities underperformed our expectations. But we remained steadfast bulls of gold, corporate bonds, US large cap stocks and Best of Breed global growth stocks throughout the year, and all have been outperforming strategies.

The RIC turned risk-defensive in early 2011, called for a 10% equity correction in May (albeit not a 20% bear market), and argued throughout autumn that 280 on the MSCI ACWI and 1100 on the S&P500 would prove tactical floors. Earnings have been equity supportive throughout recent quarters, but are likely to be less so in 2012, one reason why we reduced our equity allocation in early November.

Opportunities and threats in 2012

We enter 2012 with potential downside risks to financial markets in the form of a US recession, a potential breakup of the Euro and a hard-landing in China. In addition, oil prices remain worryingly high, and markets are likely to be challenged by political and social tensions in the coming year. As a consequence, assets should be allocated conservatively. The RIC starts the year with a neutral view on equities, overweight gold, US corporate bonds, US equities and EM assets, and we continue to favor our long-held secular themes of Growth, Quality and Yield.

The good news is investor sentiment is more defensive today than 12 months ago and central banks are once again demonstrating they will do everything they can to prevent systemic financial market turmoil. The BofA Merrill Lynch base case is that policy makers will once again succeed in avoiding the abyss in 2012. Consequently, the RIC believes 2012 offers many investment opportunities, as well as threats, and below we detail those in our favored themes and trades for next year.

10 key macro themes for 2012

Heading into 2012 the RIC believes investors should position for the following 10 macro themes:

Chart 2: The secular bull market in Growth over Value continues

Source:BofA Merrill Lynch Global Equity Strategy, Bloomberg

1. Slower global economic growth

Co-heads of Global Economics Ethan Harris and Alberto Ades forecast that global GDP growth will slow modestly to 3.5% in 2012. The US economy will expand by 1.9% in 2012 but will weaken in the second half. In Europe, our base case is for a mild recession, and we expect EM growth to slow to 5-6%.

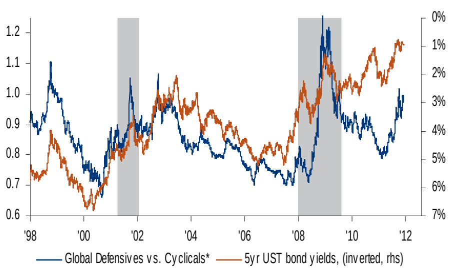
How to play it: Neutral equities until lead indicators trough; overweight Growth versus Value and large versus small cap stocks; reduce Treasury allocations in the spring as our fixed income strategists expect a trough in Treasury yields by early 2Q12.

2. The US consumer will weaken again

Our economics group expects the recent momentum from US consumer spending to subside in coming quarters, in the absence of much stronger jobs creation or wage growth.

How to play it: Weaker US consumption growth means portfolios should be tilted toward defensives in the US in early 2012 (Chart 3). Within defensives, US Equity and Quantitative Strategist Savita Subramanian's favored sector is Consumer Staples.

Chart 3: Defensives will outperform cyclicals for a little longer



Grey columns = recession shading
* Cyclicals = materials, industrials, financials, tech & cons disc
Defensives = healthcare, staples, utilities & telcos
Source:BofA Merrill Lynch Global Equity Strategy, Datastream, Bloomberg

3. A soft landing in China

China is vulnerable to a US and European recession, but a healthy balance sheet, a huge current account surplus and massive foreign reserves mean China can ease aggressively if necessary. Economist Ting Lu expects China to avert a hard-landing, and forecasts GDP growth of 8-9% in 2012.

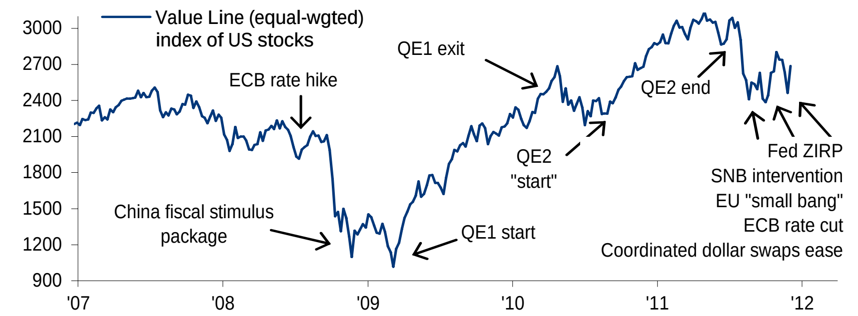
How to play it: As inflation risks fade in 2012, look for Chinese policies to turn increasingly pro-growth. Maintain exposure to commodities and begin to look for opportunities in other EM assets as more EMs join the easing cycle.

4. Quantitative easing in the US and Europe

Tighter fiscal policies in the US, Europe and Japan are likely to be offset by accommodative monetary policies around the world, aided by lower inflation. Importantly, our economists expect fresh rounds of quantitative easing by mid 2012 in both the US and Europe. This will prove to be an important inflection point for risk assets (Chart 4).

How to play it: Buy gold and gold stocks. Commodity Strategist Francisco Blanch has a 12-month gold price target of $2000/oz.

Chart 4: Markets stop panicking when policy makers start panicking



Source:BofA Merrill Lynch Global Equity Strategy, Bloomberg

5. Negative returns for holders of US Treasuries

Treasury returns were one of the biggest surprises in 2011. Next year, US Rates Strategist Priya Misra expects 10-year Treasury yields will fall to 1.6% by early 2Q (before the Fed launches QE3), before rising to 2.4% by year-end. This would imply a total return of -0.7% for the year. While Treasuries are likely to remain a safe-haven asset, the downside and upside on yields will be limited.

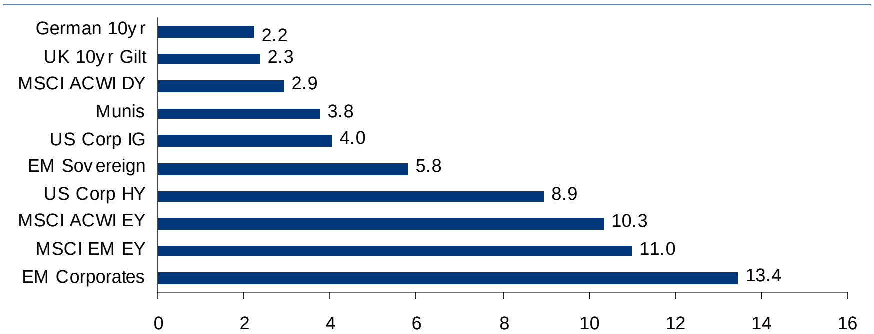
How to play it: Underweight Treasuries and overweight corporate and Emerging Market bonds, which offer a more attractive risk-reward profile.

6. Yield and income will remain paramount

This will be another year of low rates and scarce yield, and investors will continue to seek assets that provide quality income. Credit Strategists Hans Mikkelson and Oleg Melentyev are bullish on corporate credit. They expect credit spreads to significantly tighten by the end of 2012 and forecast total returns of 4.8% and 13.9% from US IG and HY bonds, respectively.

How to play it: Within corporate bonds, favor the US over Europe, and overweight IG Financials. Within equities, favor high quality and high dividend yielding companies, US Staples and Tobacco stocks, REITs and MLPs. Also see the Research Portfolio team's Income Portfolio.

Chart 5: Yields across asset classes



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

7. Modest upside for equities

Equities should offer roughly 10% upside in 2012. Our year-end targets for equities are 330 for the MSCI ACWI and 1350 for the S&P 500. Deleveraging and slower earnings growth will limit upside, but quantitative easing, valuation and positioning will limit downside. We remain convinced that the true equity bull market is in stocks and sectors that provide high growth, high quality and high yields.

How to play it: 2012 portfolios should continue to be tilted toward Creditors over Debtors, Growth over Value, large over small, quality over junk, US over Europe and EM over Japan. Select US sectors (Consumer Staples, Tech) and themes that offer a combination of high quality and strong secular growth.

8. Large-caps should outperform small-caps

The RIC expects large-caps to continue to outperform small-caps in 2012, as earnings growth and valuations are better up the market cap spectrum. The heightened volatility and macro uncertainty offsets the clean balance sheets and potential for more M&A within small-caps.

How to play it: Avoid small-cap ETFs. Within small-caps, look for size and quality to outperform along with secular growth stocks. Small-cap Strategist Steven DeSanctis' favored sectors are Energy, Health Care and Tech, and his least-favored are Financials and Materials.

9. EM rate cuts support EM assets and commodities

Our economists expect Emerging Markets to continue to be the engine of global growth in 2012. EM government debt-to-GDP ratios are well below those in DMs, leaving room for increased public spending. And as recent policy easing in Brazil, Russia, Turkey and Indonesia suggest, EM central banks will be pre-emptive in supporting growth.

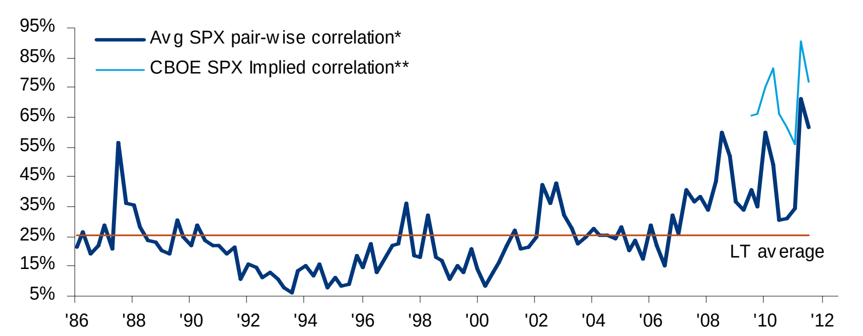
How to play it: Aggressive EM easing is positive for EM bonds and equities, although the upside to EM currencies will be constrained. Asian easing should be positive for commodity prices.

10. Stock picking opportunities likely to emerge

A decline in correlation and volatility is very likely from the current unprecedented levels and should engender higher returns from active fund management in 2012. The growth of high frequency program trading and widening use of ETFs has simultaneously increased correlations and inefficient pricing of individual stocks. Correlations are likely to drop once a macro solution is forced upon Europe.

How to play it: This can be exploited with a buy-and-hold strategy for the best companies and aggressive stock pair trades, as well as favoring active fund management.

Chart 6: Stock correlations are unlikely to remain obscenely high in 2012



*average pair-wise correlation of daily price performance per quarter for all S&P 500 stocks.
** expected average correlation implied by Jan'12 option prices for the 50 largest S&P 500 stocks.
Source: BofA Merrill Lynch US Quantitative Strategy, Bloomberg

The bull, bear and secular cases

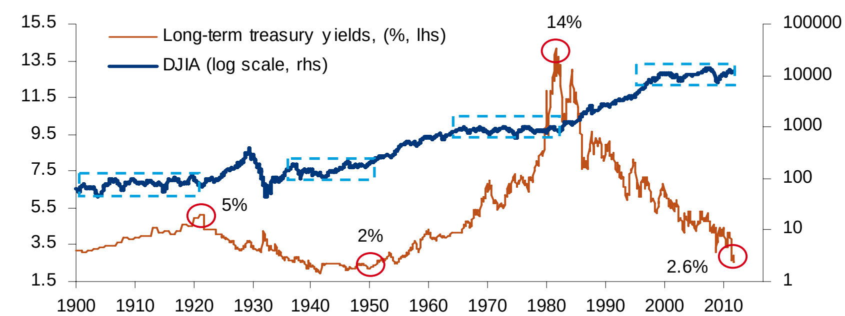
With many forecasts for existing trading ranges across asset classes to hold in 2012, we highlight the tail risks that could cause major bull or bear markets, and catalysts to watch for.

The bull case for 2012

The upside risk to markets comes via a credible, coordinated policy response (ECB QE + EU fiscal contraction + Fed QE3 + China ease), and/or a recovery in the real estate, banking and labor markets. The latter would allow the Fed to raise interest rates, resulting in a "good" bear market in bonds (Chart 7). This in turn would unlock a secular bull market in equities, and allow the MSCI ACWI to break above 375 next year. Equity leadership would likely come from Developed Market (EU + US) bank stocks, Asian industrials, Japanese autos, and EM resources.

Catalysts to watch: US initial weekly unemployment claims dropping below 375k, boosting the domestic demand story; meaningful declines in EU sovereign debt spreads driven by a pro-active ECB; a supply-driven slump in oil prices.

Chart 7: No secular bull market in equities without a bear market in bonds



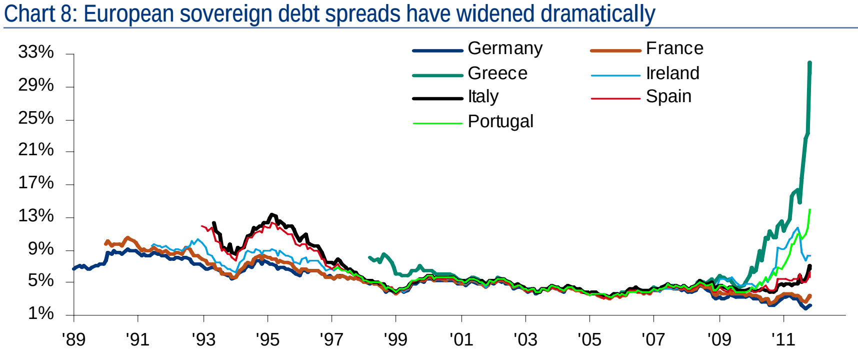
Source:BofA Merrill Lynch Global Equity Strategy, Bloomberg, Haver

The bear case

The key downside risk to markets would be a major banking and debt crisis in Europe that triggers a recession in the US and a hard landing in China. In this scenario earnings growth would likely have double-digit declines, and Financials would take another leg down. Bonds would outperform stocks and we would expect the MSCI ACWI to fall to 225. Within equities, this would be very negative for US cyclicals such as Tech and Resources, EM consumer stocks, and global energy stocks.

Catalysts to watch: A collapse in the Euro that kills US Tech earnings; EU bank deleveraging causing a slump in China/Asia export growth and currencies; a quick end to the current "deflationary recovery" in US consumption.

Chart 8: European sovereign debt spreads have widened dramatically



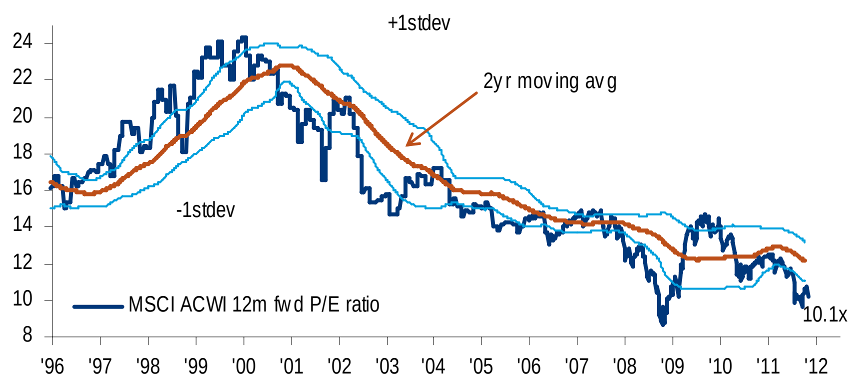
Source:BofA Merrill Lynch Global Equity Strategy, Bloomberg

Please see our scenario table on page 10 for cross asset implications of the bull and bear cases.

The secular case: buy humiliation, sell hubris

While the focus of this RIC report is on 2012, we offer a quick word on the longer-term outlook for equities. Despite our short-term caution, in our view equities on a 2-3 year view appear compelling. Investors enter 2012 in a fearful state, but *in our opinion any sharp declines in equities in 2012 should be bought.* The ingredients for equity outperformance over the medium term are being put in place, and 2012 could represent *the beginning of the end of the great bear market in equities*. Companies are in immaculate shape, US consumer deleveraging is already under way, public sector deleveraging will accelerate dramatically in Europe, and political change is likely in 2012 in many countries. Further, fixed income valuations may soon become bubble-like versus equities (Chart 9), and extreme volatility and correlations are destroying any public interest in equities. The secular hubris is in fixed income, not equities.

Chart 9: Equity valuations are cheap relative to history



Source:BofA Merrill Lynch Global Equity Strategy, DataStream

10 key trades for 2012

1. Buy gold

Our 12-month gold price target of $2000/oz implies a 16% price gain from current levels. In 2012 we expect QE3 from the Fed, an aggressive QE program by the ECB and significant monetary easing elsewhere. Gold remains one of the best ways to play this attempt by global policy makers to mitigate the negative impact of debt deleveraging.

2. Buy US high grade Financial bonds

Improving credit fundamentals, wide spreads and systemic support will benefit the sector. Our credit strategists forecast a total return of 8.9% in 2012, and prefer the six large US banks over Yankee and regional banks.

3. Buy high quality/high yielding munis, & "kicker bonds"

Tighter US fiscal policies on the federal, state and local government levels will be positive for bonds of high quality municipal issuers. Within high yield, Municipal Research Strategist John Hallacy favors AA rated hospital system bonds, Airport General Aviation revenue bonds, and Dedicated Sales Tax or other special tax Transportation bonds. Hallacy also recommends "kicker bonds" (high coupon munis with short calls).

4. Buy EM local currency debt

Our strategists forecast a 2012 target return of 10.4% for EM local currency debt. This can be played via bond funds, but for investors looking for more specific holdings, our strategists favor long-duration Mexican bonds. These bonds (MBONO 2038) have a 7.8% yield, and the added benefits are that positioning is very light and the MXN is about 11% undervalued relative to the USD.

5. Buy high-yielding equities

International dividend-paying stocks offer exceptionally attractive income streams. Some examples: Aussie banks (7%) and Eurozone Telecoms (10%). See our International High Quality and Dividend Yield screen on page 21 of the full RIC report for specific ideas. MLP analyst Gabe Moreen recommends liquefied natural gas (LNG) and crude oil infrastructure plays. REITs in the self-storage, datacenter, and high quality/ infill retail sectors offer the best combination of quality and yield, according to analyst Jeff Spector.

6. Buy the Best & the Distressed in Europe

European stocks are the most oversold they have been relative to US equities in 20 years. Go shopping for high quality European equities with strong earnings, healthy balance sheets and solid margins. European companies have as much cash on their balance sheet as US companies. In addition, bank deleveraging should create distressed asset bargains for savvy private equity funds.

7. Buy US Staples and Tobacco

US Consumer Staples has above 3% dividend yields, accelerating earnings growth in 2012 and is a sector that traditionally outperforms during periods of decelerating profits. Tobacco is the preferred industry on valuation grounds.

8. Buy US Tech

US Tech companies have the highest cash levels of any sector and are more likely to grow dividends, buy back stock and increase capex. Additionally, companies in this sector have high earnings stability and attractive valuations – over 80% of stocks in Tech are trading below their five-year average P/E. Within Tech, Internet Software & Services and Computers have the strongest secular growth prospects.

9. Hedge risk

As we remain in a risk-on/risk-off world, many asset prices move together when a tail risk strikes. The cost of hedging these risks can be reduced by looking across markets and assets for the cheapest options relative to the asset's beta in a stress event. According to Equity-Linked Analyst Ben Bowler, tail risk hedging remains better value in Emerging Markets where options are priced more optimistically. Value can also be found in sector and country indices away from the mainstream hedging markets, which can become crowded.

10. Watch the technicals

As long as asset prices remain in trading ranges, technical analysis will be relevant. Technical Research Analyst Mary Ann Bartels believes that the best entry point into US equities is at the 1074-1100 level on the S&P500 index. In contrast, Mary Ann would take profits on the S&P500 in the 1300-1350 range.

Three scenarios and market implications

		Market impact								
	2012 GDP*	US Rates	Agency MBS	Credit	Munis	EM Mkts	S&P 500	MSCI world	FX	Gold/Oil
Present market level		*US 10y 2.1%*	*108bp*	*267HG/795HY*	*10y/30y 2.22%/3.84%*	*EM Sov spd +416bp*	*1246*	*300*	*EUR = 1.34*	*1746/110*
Base case BAD (50%)										
US: Slow growth w/some QE3. Fiscal drag means growth eases to 1-1.5% in 2H12. Europe: Recession w/strong policy response: ECB cuts target to 0.50%, ramps up QE and might implicitly target rates. As a result, 2H12 is an improvement. China: Modest growth downtick based on lower export growth.	US: 2.0% EZ: -0.6% EM: 5.5%	10y =2.25%. Small rise in rates as the tail risk of Euro break-up fades but Fed on hold for much longer as growth headwinds remain due to fiscal drag.	Spreads in 90-115bp range in environment of stable rates, limited supply, and manageable prepayment risk	180HG/550HY This is “Goldilocks” for corporate bonds. Not a recession so investors are reaching for yield, and growth is not fast enough to prompt a big shift into equities.	State budget gaps widen. Pension returns sound. Avg10y@2.81%/ 30y@4.37%. Supply sensitive. USA downgrade sensitive. Some downgrades.	Stable FX with a mild appreciation of around 2% vs USD, mostly in 2H12. Lower short term rates, concentrated in Latam due to lower growth. Credit spreads 15bp wider.	1350. Europe recession is a growth headwind for foreign exposed cyclical sectors, but B2B spending and oil prices remain solid.	330. Modest upside for equities. Deleveraging & slower earnings growth limits upside. QE policies, valuation & positioning limit downside	1.35. This is a scenario currently priced into markets so implications for EUR/USD will be limited	1850/108 avg. Gold continues to trend higher as Fed and ECB engage in some QE. Growth is sluggish but supply is tight so Brent stays supported.
Bearish UGLY (40%)										
US: Europe contagion affecting US financial sector Europe: Policy too slow. A major banking and debt crisis triggers a deeper recession China: Liquidity issues = harder landing.	US: -0.5% EZ: -2.5% EM: 3.8%	10y = 1.50% Bull flattener. Significant flight to quality event with risk of spillover to US banks. Higher US recession risk limits fiscal easing/bailout options.	Spreads widen to 125-150bp range on flight to quality trade, increased funding costs, and higher credit risk for GSEs. QE3 is a backstop.	300HG/900HY HY spreads typically peak at 1100bp in recession but balance sheets in better shape. Low interest rates and flat curve detrimental to HG, esp. financials.	State budget gaps even wider. Revenues behind estimates. 10y@1.75%/30y @ a ratio of 125%. More downgrades.	Further FX depreciation in excess of 10% vs USD w/EMEA underperforming. Bull steepening reflecting higher risk premium. Credit spreads 150bp wider.	1000. Global recession and falling oil prices result in a significant market correction consistent with the average recessionary peak to trough decline of about 30%.	225. Bear market driven by policy mistakes and recession. US tech, EM consumer & global energy stocks underperform as investors forced to sell risk.	1.20: the USD will be the best performing currency in the world in this scenario of flight to safety.	1600/80 avg. Gold heads lower as deflation takes hold in Europe, US. Global oil demand drops off sharply, taking Brent prices much lower.
Bullish GOOD (10%)										
US: Pro-activity by Washington and less contagion from Europe Europe: Quick budget actions by countries under stress triggers aggressive ECB action China: Exports surprise to upside keeping growth closer to 9%	US: 2.5% EZ: 1.0% EM: 6.3%	10y = 2.75% Bear steepener, but Fed stays on hold until 2014 which will limit how high 10y rates can go.	Spreads tighten to 75-85bp range as refinancing potential and volatility drop.	180HG/500HY There is little difference between a growth rate of 2.5% and 2% as credit will be driven more by favorable liquidity technicals than fundamentals.	Supply sensitive. Upgrades possible. 10y@2.50%/30y @100% ratio. Fewer ST Note Sales. Greater demand overall.	Strong currency appreciation of 7% or more vs USD. Bear flattening. Credit spreads about 70bp tighter.	1500. S&P 500 EPS comes in better than expected for cyclical sectors, Financials enjoy a relief rally, and the avoidance of a recession results in a lower equity risk premium.	375. Bull market driven by above trend recovery and “good” bear market in bonds. EU/US banks, Asian industrials, Japan autos, EM resources outperform.	1.45: USD remains a countercyclical currency that is vulnerable to good news.	2000/118 avg. Gold heads higher as Europe, US engage in aggressive QE. Global oil demand reaccelerates, pushing oil higher.

* As of 30 November 2011. Source:BofA Merrill Lynch Global Research

Asset markets: base case, ideas, risks

Table 3: RIC base case for global asset markets

Region/sector Analyst(s)	Convictions	Ideas & risks
Global Economics: Ethan Harris, Alberto Ades	■ Global growth slows down. ■ Developed economies remain vulnerable, with crippled sectors and regions.	■ 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	■ 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.	■ 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	■ 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.	■ US: We forecast 10y yields to reach their lows in Q1 2012 as the European situation is likely to worsen before policy makers intervene and given the many downside risks to growth in the US due to policy uncertainty. 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 the belly of the curve in EUR, as money market curves are likely to continue flattening aggressively. ■ 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	■ 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.	■ 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	■ 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 180bps in HG and 550bps 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.	■ 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) Both EU and US policy risks likely to abate in 2012 as Europe plays out in the shorter term, and US risks are unlikely to get worse. ■ Risks: situation in Europe causes a US recession.
Global FX: David Woo, Alberto Ades	■ ECB rate cuts, further intensification of the Euro debt crisis and tighter US fiscal policy worries will help boost the USD in Q4 and Q1 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.	■ 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 4: Global equity weightings by region

Region/sector Analyst(s)	Recommendation*	Convictions	Ideas & risks
US: Savita Subramanian	Overweight	■ 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.	■ 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	■ Economic data continue to disappoint with BoE now flagging further QE. But a robust policy restatement is maintaining confidence in gilts. ■ Defensive make-up of FTSE index continues to offer relative attractions to the sovereign crisis in Europe.	■ 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 to the risk of policy bazookas.
Europe ex-UK: Gary Baker	Underweight	■ A sharp downgrade to 2012 GDP forecasts means we are now expecting a recession in Europe next year. ■ 0% EPS forecast leaves market trading on 10.3x PER. Our 250 Y/E target for Stoxx600 implies just 5% upside plus 4.3% div yield. ■ The global growth backdrop provides a lifeline for Europe while it sorts out political and institutional problems. The pace of change is set by German willingness.	■ OW Pharma, Telecom, Basic Resources. UW Industrials, Chemicals. Y/E index target for SXXP is 250. ■ A more convincing policy response would likely need to add risk to portfolios- Basic Resources, Autos and Financials are candidates.
Japan: Masatoshi Kikuchi	Neutral	■ The Nikkei should continue to trend in the box range of 8,000 to 9,000 until the European financial crisis eases. ■ The Nikkei will trend toward 10,750 at the middle of 2012 due to the expectation for global economic recovery and Japanese corporate earnings recovery. ■ The Nikkei will finish the year at around 10,000 at the end of 2012 as investors anticipate tax hikes and a resulting economic slowdown in 2013.	■ Machinery and trading sector will benefit from the expectations of economic recovery in emerging markets. ■ Construction companies should benefit from public works projects since the government will implement the ¥12tn supplemental budget from early 2012. ■ Food should benefit from the strong yen, improved margins, and (over the long term) the lifting of import tariffs on farm products should Japan join the TPP.
Asia-Pac ex-Japan: Nigel Tupper	Neutral	■ 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.	■ Prefer defensives, structural growth stories and the more resilient Energy sectors across the region.
Emerging Markets: Michael Hartnett	Overweight	■ 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.	■ 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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