Investment Strategy | Global
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# The Bond Era ends

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## 2013 could mark start of the Great Rotation

The era of bond outperformance has ended. Equities have staged a remarkable stealth rally, with US stocks not only outperforming Treasuries over the past one and three years, but also the past 10 years. And still, the consensus asset allocation is long bonds and short stocks. However, if the US successfully navigates the fiscal cliff, Europe continues to stabilize and Chinese growth reaccelerates, in our view 2013 could mark the start of the Great Rotation.


Click the image above to watch the video.

## The stealth rotation

Although the BofA Merrill Lynch macro base case remains high liquidity, low growth, the RIC's anticipation of a Spring 2013 Great Rotation from bonds to stocks continues to grow. The 3Bs – Bricks, Banks and Bonds – hint that a stealth rotation has begun, at least in the US financial markets. The turns in US housing activity indicators are very encouraging, such as the homebuilding stocks and US bank stocks in particular. Both signal markets are quietly beginning to discount the revival in 2013 of the two missing ingredients of a strong US recovery: credit and jobs. If bond yields begin to rise alongside homebuilder and bank stocks, a major asset allocation shift would be warranted, in our view.

## The RIC's asset allocation advice

**Stay overweight Bubble themes.** Stay overweight gold, corporate credit, EM debt, US stocks, Tech and large-cap, quality global stocks. The more liquidity central banks pump into the system, the greater the likelihood these popular investment themes evolve into full-scale bubbles. Asia's sovereign debt crisis in the 1990s and the subsequent Tech bubble is a good example of this.

**Add to Great Rotation themes.** Investors should be at least neutral in their equity allocations, in our opinion. A pick-up in the US housing market and policy support from the ECB have improved the outlook for Financials, which make up nearly 20% of the equity market. We recommend adding to US bank stocks and bonds and European bank bonds.

**Too early to play China themes.** We would stay overweight EM debt and consumer-led EM equity markets until acceleration in Chinese growth and earnings incites a recovery in China themes such as BRIC equities and global resource sectors.

## A word on the fiscal cliff and US election

We do not expect the US election outcome to impact equities or asset allocation meaningfully, but a very close election and an impasse on the fiscal cliff, or even greater partisan fighting in DC after the election, would likely have significant downside implications even for our economists' cautious growth forecasts. That said, we do not expect a recession. US companies have been slow to ramp up hiring, investment and M&A after the financial crisis, and thus have less fat to trim.

This report is an extract of a report of the same name published on 9 October 2012.


Refer to important disclosures on page 10 to 12. Link to Definitions on page 9.

## Third quarter review

Another round of extraordinary monetary policy easing by major central banks supported risk asset prices in September. Most major equity markets posted positive returns for the third quarter, with the greatest gains in Europe (+10.8%).

Emerging Markets were among the beneficiaries of the bullish policy announcements from the Fed and ECB. The strong 6.1% return from EM equities in September put EM in the lead over DM for the third quarter as a whole.

Across size and style segments, small caps outperformed large caps and Growth outperformed Value for the month. For the quarter, small cap Growth was the best performing segment.

Within US sectors, Energy (+10.1%), Telecom (+8.1%) and Discretionary (+7.5%) posted the strongest returns for the quarter. Utilities was the only sector to post a negative return (-0.5%) in 3Q.

Within fixed income, Emerging Market debt, and high yield and investment grade corporate bonds were the leaders in 3Q as investors continued to pour money into higher yielding assets.

The US dollar (-1.1%) declined in September as inflation expectations rose following the Fed's QE3 announcement. Meanwhile, inflation hedges such as gold (+4.7%) rallied.

Following a strong rally in July and August, oil prices pulled back slightly in September.

# Financial markets recap

Table 1: Total return (%)

| | | As of 28 September 2012 | | | |
|---|---|---|---|---|---|
| Asset class | 2011 | 1 mo | 3 mo | 12 mo | YTD |
| **Equity Indices (%, US dollar terms)** | | | | | |
| S&P 500 | 2.1 | 2.6 | 6.4 | 30.2 | 16.4 |
| NASDAQ Comp | -0.8 | 1.7 | 6.5 | 30.6 | 20.7 |
| FTSE 100 | -2.7 | 2.6 | 7.2 | 20.1 | 10.8 |
| TOPIX | -11.9 | 2.3 | -1.0 | -1.8 | 2.3 |
| Hang Seng | -17.3 | 7.5 | 8.1 | 23.4 | 17.1 |
| DJ Euro Stoxx 50 | -16.7 | 3.2 | 10.8 | 12.1 | 8.9 |
| MSCI EAFE | -11.7 | 3.0 | 7.0 | 14.3 | 10.6 |
| MSCI Emerging Markets | -18.2 | 6.1 | 7.9 | 17.3 | 12.3 |
| **Size & Style (%, US dollar terms)** | | | | | |
| Russell 2000 | -4.2 | 3.3 | 5.3 | 31.9 | 14.2 |
| S&P 500 Citigroup Growth | 4.7 | 2.1 | 6.4 | 29.6 | 17.0 |
| S&P 500 Citigroup Value | -0.5 | 3.1 | 6.3 | 30.8 | 15.8 |
| S&P 600 Citigroup Growth | 3.6 | 1.5 | 4.1 | 31.0 | 13.1 |
| S&P 600 Citigroup Value | -1.4 | 3.2 | 6.8 | 35.8 | 14.6 |
| **S&P 500 Sectors (%, US dollar terms)** | | | | | |
| Consumer Discretionary | 6.1 | 3.2 | 7.5 | 36.6 | 21.4 |
| Consumer Staples | 14.0 | 1.5 | 3.8 | 24.3 | 12.7 |
| Energy | 4.7 | 3.4 | 10.1 | 27.1 | 7.6 |
| Financials | -17.1 | 3.4 | 6.9 | 34.8 | 21.6 |
| Health Care | 12.7 | 4.0 | 6.2 | 29.5 | 17.8 |
| Industrials | -0.6 | 1.7 | 3.6 | 29.6 | 11.2 |
| Information Technology | 2.4 | 1.2 | 7.4 | 32.4 | 21.8 |
| Materials | -9.8 | 3.8 | 5.1 | 29.2 | 12.0 |
| Telecom Services | 6.3 | 4.0 | 8.1 | 35.8 | 25.9 |
| Utilities | 19.9 | 1.2 | -0.5 | 12.9 | 4.3 |
| **BofA Merrill Lynch Global Research Bond Indices (%, US dollar terms)** | | | | | |
| 10-Year Treasury | 17.1 | -0.5 | 0.9 | 5.6 | 4.4 |
| 2-Year Treasury | 1.5 | 0.0 | 0.2 | 0.3 | 0.2 |
| TIPS | 14.1 | 0.5 | 2.2 | 9.4 | 6.5 |
| Municipals* | 11.2 | 0.6 | 2.5 | 8.9 | 6.7 |
| US Corporate Bonds | 7.5 | 0.7 | 4.0 | 11.0 | 9.0 |
| US High Yield Bonds | 4.4 | 1.4 | 4.6 | 18.9 | 12.0 |
| Emerging Market Corporate Bonds | 3.8 | 1.4 | 5.2 | 16.3 | 12.2 |
| Emerging Market Sovereign Bonds | 5.8 | 1.7 | 6.3 | 16.7 | 13.6 |
| Preferreds | 4.1 | 0.6 | 3.3 | 15.0 | 12.8 |
| **Foreign Exchange** (%, in local currencies)** | | | | | |
| US Dollar | 0.5 | -1.1 | -2.5 | -0.4 | -1.1 |
| British Pound | 1.6 | 0.5 | 1.8 | 5.8 | 4.5 |
| Euro | -3.2 | 1.1 | -0.6 | -5.0 | -2.5 |
| Yen | 5.9 | -0.2 | 1.7 | -0.2 | -0.6 |
| **Commodities** (%, US dollar terms)** | | | | | |
| CRB Index | -8.3 | -0.1 | 8.8 | 3.7 | 1.3 |
| Gold | 10.1 | 4.7 | 10.9 | 9.1 | 13.3 |
| WTI Crude Oil | 8.2 | -4.4 | 8.5 | 16.4 | -6.7 |
| Brent Crude Oil | 13.8 | -2.2 | 16.1 | 6.6 | 4.3 |
| **Alternative Investments† (%, US dollar terms)** | | | | | |
| Hedge Fund - CS Tremont[1] | -2.5 | 0.8 | 1.9 | 1.9 | 4.5 |
| Hedge Fund - HFRI Fund of Funds[1] | -5.6 | 0.7 | 1.1 | -0.8 | 2.5 |
| Private Equity - Cambridge Assoc.[2] | 10.8 | NA | 5.4 | 10.8 | 5.4 |
| Private Real Estate - NCREIF TR[3] | 14.3 | NA | 2.7 | 12.0 | 5.3 |

Notes: *Not tax adjusted. **BoE calculated effective FX indices. [1]Data as of 8/31/12; CS AUM-weighted, HFRI equal-weighted [2]Quarterly data as of 3/31/2012 [3]Quarterly data as of 6/30/12†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 in 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 Index; EM Corporate Plus Index; EM External Debt Sovereign Index; US Preferred Stock, Fixed Rate).

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# The Bond Era ends

The age of bond outperformance has ended. Equities have staged a remarkable stealth rally in recent years, with US stocks not only outperforming Treasuries over the past one and three years, but also over the past 10 years (Chart 1). And still, the consensus asset allocation is long bonds and short stocks. However, if the US successfully navigates the fiscal cliff, Europe continues to stabilize and Chinese growth reaccelerates, in our view 2013 could mark the start of the Great Rotation from bonds into stocks.

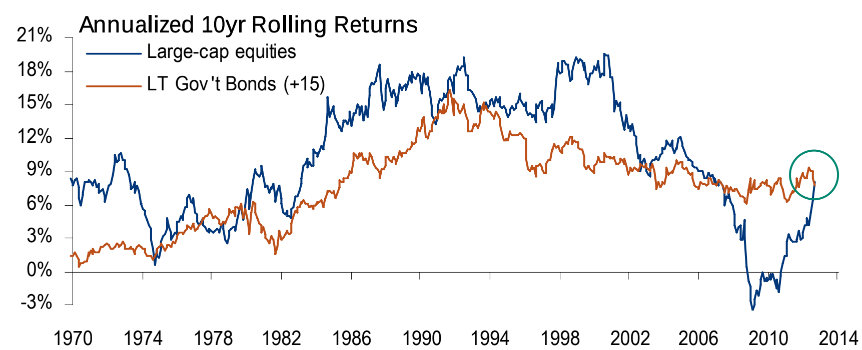
Substantial liquidity and policy support from European Central Bank President Mario Draghi and Federal Reserve Chairman Ben Bernanke in 3Q resulted in more equity outperformance. Stocks are up 15% in 2012, led by the US and Pacific Rim. Bonds are up 5%, boosted by chunky gains in the riskier areas of US high yield and EM debt. And commodities have lagged – up just 3% this year – despite big QE3-inspired September gains (Table 2).

Table 2: Stocks beat bonds and commodities

| | Sept | YTD |
|---|---|---|
| Global Equities | 3% | 15% |
| US | 3% | 18% |
| Europe | 3% | 16% |
| UK | 2% | 13% |
| Japan | 2% | 1% |
| Pacific Rim ex-Japan | 4% | 19% |
| Emerging Markets | 6% | 13% |
| Global Fixed Income | 1% | 5% |
| Government | 1% | 3% |
| US Treasuries | 0% | 2% |
| Quasi-government | 1% | 6% |
| Investment Grade Corporate | 1% | 10% |
| High Yield Corporate | 2% | 15% |
| EM Corporate Debt | 1% | 13% |
| Collateralized Debt | 1% | 4% |
| Commodities | -1% | 3% |
| Energy | -2% | -1% |
| Industrial Metals | 10% | 5% |
| Precious Metals | 6% | 14% |
| Agriculture | -3% | 10% |
| Cash | 0% | 0% |
| US Dollar | -1% | -1% |

Notes: Total returns in USD; Equity returns are MSCI indices; BofA Merrill Lynch Global Bond Indices are: Fixed Income Markets; Government Bond II; US Treasury Master; Large Cap Quasi-Govt; Large Cap Corporate; High Yield; Emerging Markets Corporate Plus; Large Cap Collateralized; Commodity returns are Merrill Lynch Commodity eXtra TR Indices.
Source: BofA Merrill Lynch Global Equity Strategy; Bloomberg

Chart 1: The era of bond outperformance ends

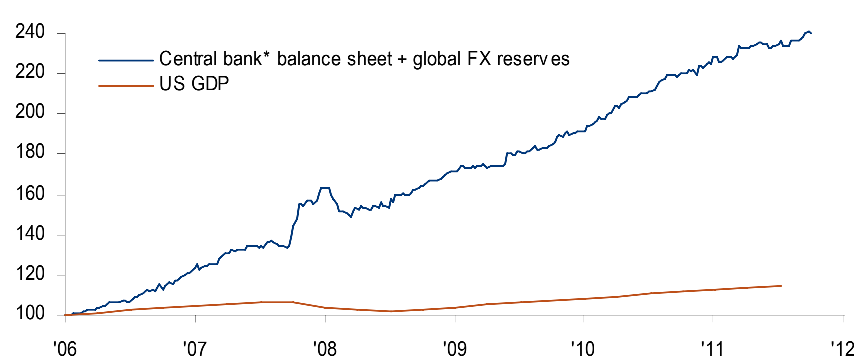



Monthly total returns, USD.
Source:BofA Merrill Lunch Global Equity Strategy, Ibbotson, Bloomberg, DataStream

## The investment backdrop: high liquidity, low growth

The abundance of central bank liquidity in recent years has been fantastic for asset prices. As central bank liquidity has more than doubled in the past five years, the market cap of global bond markets has increased over 80%, and stocks have doubled from their 2009 lows. But global GDP has grown just 25% and the US economy by a feeble 12% (Chart 2).

Chart 2: Central bank liquidity versus US GDP




* ECB + Fed + BoJ + BoE. Both series are re-indexed to 100
Source: BofA Merrill Lynch Global Equity Strategy, Bloomberg

The BofA Merrill Lynch macro base case remains high liquidity, low growth. As a result, we remain convinced that the vigorous bull markets in deleveraging winners such as gold, credit and Growth stocks will continue (Table 3), and likely form investment bubbles (see commentary on page 5).

Table 3: The Great Divergence of 2007-2012

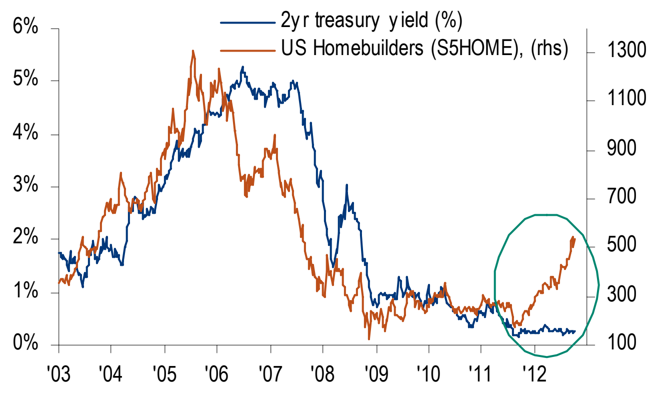
| Winners | Losers |
|---|---|
| Mayfair | Madrid |
| Creditors | Debtors |
| Income | Beta |
| Credit | Equity |
| Gold | Cash |
| US | Europe |
| EM | Japan |
| MIST | BRIC |
| Growth | Value |
| Tech | Banks |
| Correlation | Dispersion |
| Companies | Countries |
| Quality | Junk |
| Large | Small |

Source:BofA Merrill Lynch Global Equity Strategy

## A stealth Great Rotation begins

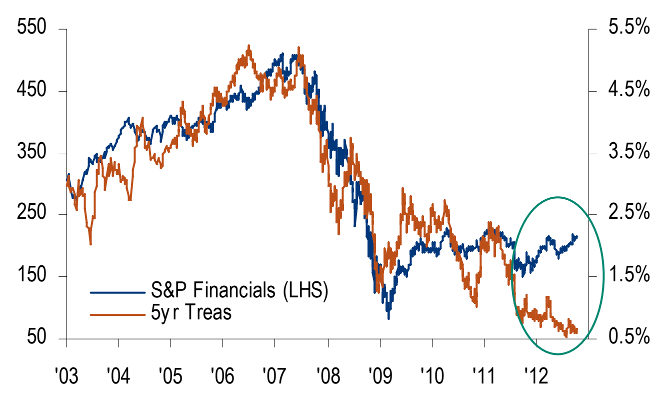
The RIC's anticipation of a Spring 2013 Great Rotation from bonds to stocks continues to grow. The 3Bs – the Bricks, Banks and Bonds – are hinting that a stealth rotation has begun, at least in the US financial markets. A meaningful recovery in the labor market has yet to occur, but the turns in US housing activity indicators are very encouraging, such as the homebuilding stocks (Chart 3) and US bank stocks in particular (Chart 4). Both signal that markets are quietly beginning to discount the revival in 2013 of the two missing ingredients of a strong US recovery: credit and jobs. If bond yields begin to rise alongside homebuilder and bank stocks, a major asset allocation shift would be warranted, in our view.

Chart 3: Homebuilders leading short rates




Source: BofA Merrill Lynch Global Equity Strategy, Bloomberg

Chart 4: But banks must now lead bond yields higher




Source: BofA Merrill Lynch Global Equity Strategy, Bloomberg

# The RIC's asset allocation

The RIC's current asset allocation advice is as follows:

- **Stay overweight bubble themes.** The RIC recommends investors stay overweight gold, corporate credit, EM debt, US stocks, Tech and large-cap, quality global stocks. The more liquidity central banks pump into the system, the greater the likelihood that these popular investment themes evolve into full-scale bubbles.

- **Add to Great Rotation themes.** Investors should be at least neutral in their equity allocations, in our opinion. A pick-up in the US housing market and policy support from the ECB have improved the outlook for Financials, which make up nearly 20% of the equity market. The RIC recommends adding to US bank stocks and bonds, and adding to European bank bonds.
- **Too early to play China themes.** We would stay overweight EM debt and consumer-led EM equity markets until acceleration in Chinese economic growth and earnings incites a recovery in China themes such as BRIC equities and global resource sectors.

## Stay overweight bubble themes

The divergence between the winners and losers over the past five years has been marked. Financial assets that provide high growth, high yield and high quality have been enormously popular. High liquidity has boosted the prices of relative safe haven trophy assets such as gold, corporate credit, EM debt, US equities, Tech, high quality mega-cap multinational stocks, and scarce urban real estate (see margin comment). Meanwhile, investors have shunned low growth assets like debtors, Value stocks, banks, and regions such as Europe and Japan.

Scarce urban real estate in Hong Kong, Singapore, Dubai, central London and Manhattan has also been boosted by geopolitical capital flight.

So why should investors remain overweight the Three Wise Themes of Yield, Growth and Quality, even though they are consensus favorites? Our macro base case is still one of high liquidity and low growth. As central banks pump even more liquidity into the system, the greater the likelihood that these popular investment themes evolve into investment bubbles.

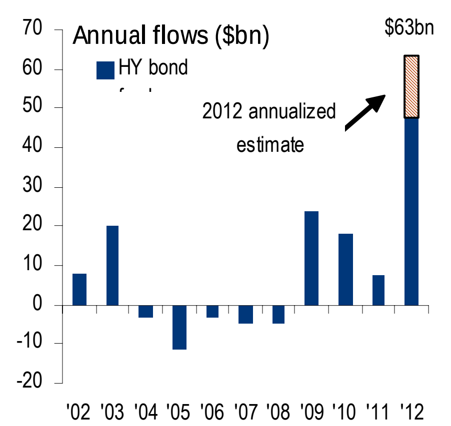
### Bubbles beget bubbles

As central banks are forced to take aggressive action to combat deflation, the bursting of one asset bubble can eventually contribute to the creation of a new bubble. Such was the case in the late 1990s when the Fed cut rates to mitigate the threat to growth from the Asian financial crisis and the Long-Term Capital Management (LTCM) bust. Tech stocks were already a popular consensus trade, and supportive monetary policy contributed to the tripling in the Nasdaq from the 1998 low.

Today, new investment bubbles appear to be forming in assets such as corporate bonds and US Tech stocks as central banks use liquidity injections in the war against deflation. Bellwether investments have already rallied hard, but history tells us that they could have further to go (Chart 6).

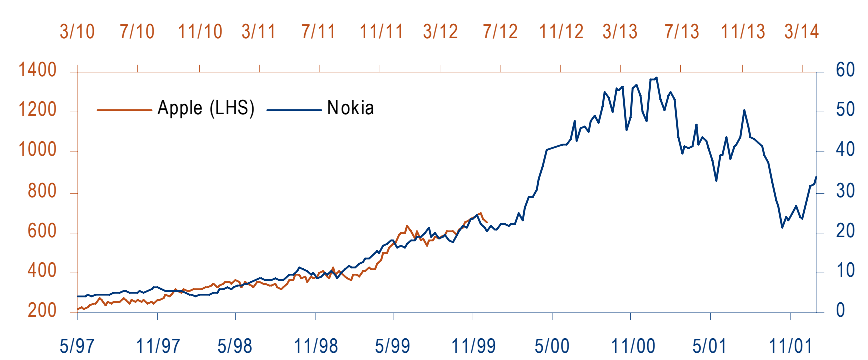
Note that inflows into high yield bond funds are running at an annualized pace of $63 billion, nearly three times the record inflow of $24 billion in 2009 (Chart 5). In our view these bubbles are just beginning to form, and have further to grow – a key reason why we remain overweight these assets.

Chart 5: Record setting flows into HY bonds



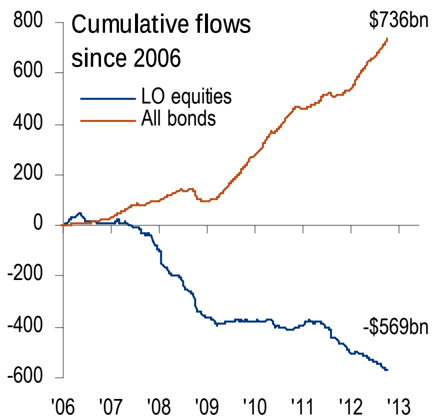

Source:BofA Merrill Lynch Global Equity Strategy, EPFR Global

Chart 6: Nokia in the late 1990s vs Apple today




Source:BofA Merrill Lynch Global Equity Strategy, Bloomberg

Chart 7: The Great Divergence




Source:BofA Merrill Lynch Global Equity Strategy, EPFR Global

## Add to Great Rotation themes

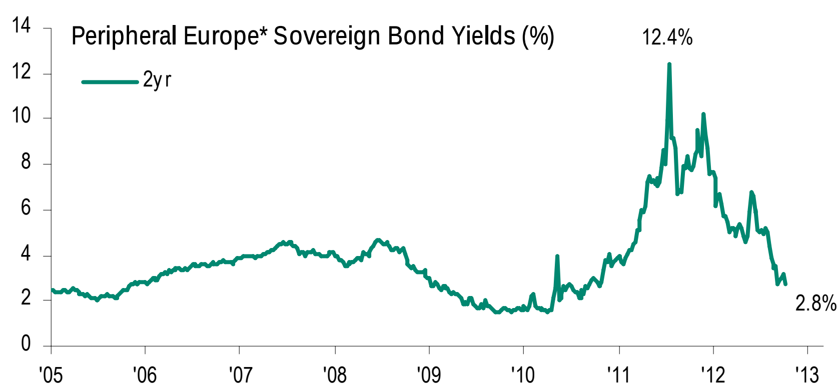
The upside risk to current conservative asset allocations over the next 12 months would be better than expected growth. The September Fund Manager Survey showed that just 7% of investors forecast above-trend growth in 2013. And our fund flow and FMS data show that investors are not positioned for the Great Rotation.

In the September RIC report we outlined three potential catalysts for a shift in allocation toward stocks and away from bonds: a resolution to the fiscal cliff uncertainty, an improvement in the outlook for Chinese growth, and a sustained recovery in the housing market that improves consumer and bank balance sheets.

The US real estate recovery is already under way, and the ECB has largely stabilized the situation in Europe (Chart 8 of peripheral bond yields). If the US successfully navigates the fiscal cliff, Europe subsides from the headlines and Chinese growth reaccelerates, we believe the Great Rotation could begin in earnest in 2013. As a result, we recommend adding to the Great Rotation themes of US real estate and distressed Europe. Note that last month we raised our allocation to international Developed Market equities to a neutral position, removing our longstanding underweight.

Beneficiaries of the US housing recovery include US banks, mortgage REITs, apartment REITs and MBS. Beneficiaries of the stabilization of the European sovereign debt crisis include European bank bonds and best of breed companies.

Chart 8: Peripheral European bond yields have declined dramatically




*Simple average of Portugal, Italy, Ireland and Spain
Source:BofA Merrill Lynch Global Equity Strategy, Bloomberg

## Too early to play China themes

Market leadership over the past decade has largely come from China, Emerging Markets, resources and commodities. But in more recent years the transition from a producer-led to a consumer-led economy in China has caused its leadership to fade. EM valuations now appear more attractive, at just 10x forward earnings and a 17% discount to DM, than they have been since early 2009. Consensus has dropped their growth forecasts for China from 8.4% to 7.7% for 2012 (right in line with BofA Merrill Lynch) and lowered earnings expectations from 10.6% to 2.7% since the start of the year. At nearly 18% of the index, China matters as much to EM as Tech matters for the US equity outlook.

The RIC believes the robust bull markets in EM debt and consumer-led equity markets should continue in the near future, namely in the so-called MIST markets of Mexico, Indonesia, South Korea and Turkey. But investors likely need to see stabilization in Chinese growth and earnings expectations before rotating back into pro-growth cyclical trades. We are watching for positive policy moves following the Chinese political transition and signs that export demand from the US and Europe has stabilized.

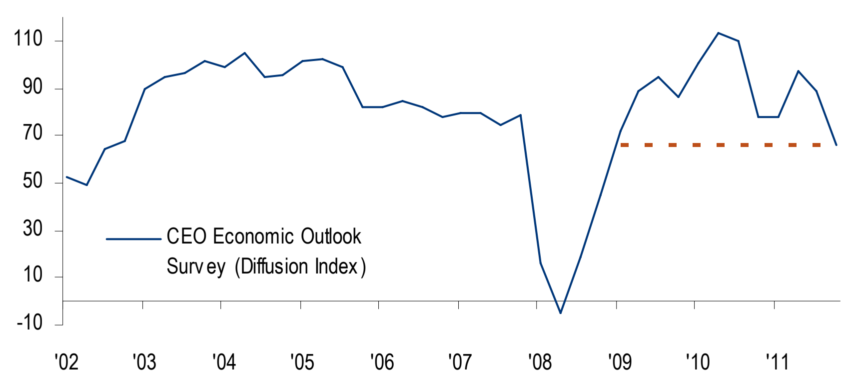
## A word on the fiscal cliff and US Election

In the past few weeks US macro data have picked up with PMI and payroll data for September strong, but our optimism on the US economy remains tempered by the fiscal cliff. Uncertainty around fiscal policy has already caused businesses to postpone capital goods orders, and our economics team expects job growth to fade in 4Q.

Recent data have shown that there is a growing disconnect between what consumers and CEOs are expecting over the next six months. While consumer confidence ticked up in September, companies have turned more cautious as the US election and fiscal cliff approach. Historically the corporate sector has been more forward-looking than the consumer sector, and the latest Business Roundtable CEO Outlook survey fell to the lowest level since 3Q09.

While we do not expect the outcome of the US election to impact equities or asset allocation meaningfully, a very close election (such as in 2000) and an impasse on the fiscal cliff, or even greater partisan fighting in DC after the election, would have significant downside implications even for our economists' cautious growth forecasts. That said, we do not expect the US to fall into a recession. US companies have been slow to ramp up their businesses after the financial crisis in terms of hiring, investment and M&A, and thus have less fat to trim.

Chart 9: Business Roundtable CEO Outlook lowest since 3Q09




Source:BofA Merrill Lynch Global Equity Strategy, Business Roundtable, Haver

# Asset markets: base case, ideas, risks

Table 4: RIC base case for global asset markets

| Region/sector Analyst(s) | Convictions | Ideas & risks |
|---|---|---|
| Global Economics:<br>Ethan Harris<br>Alberto Ades | ▪ Europe remains mired in a prolonged recession, contracting -0.7% annually in both 2012 and 2013. Risks remain skewed to the downside.<br>▪ The ECB stands ready to back Euro area countries with its OMT program if any countries request help and sign a MoU.<br>▪ The US faces a fiscal drag of as much as 4.6% of GDP at the end of 2012. We believe growth will slow before year-end as the fiscal cliff creates macro and micro uncertainty – fears of recession coupled with uncertainty around tax policy.<br>▪ The Fed continues its opened ended MBS purchases and finishes Op-twist. After op-twist finishes we expect they will announce additional Treasury purchases on top of the $40 bn a month in MBS purchases. | ▪ Risks: US fiscal tightening; Chinese hard landing; Europe fails to ratify fiscal integration; Greece leaves Euro area. |
| Global Equities:<br>Michael Hartnett | ▪ 2012 MSCI All-Country World Index target remains 330.<br>▪ Positives: bearish investors, low bond returns, healthy corporate balance sheet, US real estate, easy money policies.<br>▪ Negatives: US & EU fiscal policy, bank deleveraging, slowing China.<br>▪ OW US vs. Europe, EM vs. Japan, creditors vs. debtors, large vs. small, and the "Three Wise Themes" of yield, growth and quality. | ▪ Cautious in the near-term, but barring a credit crash or recession, we remain constructive on equities in the medium-term. Buy the dips.<br>▪ Add exposure to assets tied to US Real Estate (US banks), distressed Europe (European bank debt), and EM Wealth (MIST and EM debt).<br>▪ Upside risks: policy stimulus works to create stronger than expected growth in 2013.<br>▪ Downside risks: crash in credit, relapse in US real estate, or financial event in China. |
| Global Rates:<br>Priya Misra<br>Ralf Preusser<br>John Wraith | ▪ US: QE, the end of Operation twist sales and the expiration of unlimited FDIC insurance on noninterest bearing accounts should help lower yields in the front end of the Treasury curve. We also recommend staying long 7s as the market has not fully priced in risks from the impending fiscal cliff, in our view. We would wait to see weakening data before initiating long end flatteners.<br>▪ Europe: ECB OMT helped removed some tail risks and resulted in a normalization of peripheral curves, but plenty of event risks in Europe still await and along with the weakening global growth outlook should limit the sell-off in Bunds.<br>▪ UK: We expect outright yields in Gilts to stay close to current levels, with further downside progress increasingly difficult, but safe haven demand preventing a material sell-off. | ▪ US: A surprise resolution of the cliff is likely to lead to a back up in rates.<br>▪ UK: The UK's weak economic outlook risks putting mounting pressure on the fiscal policy stance and the AAA credit rating. This could undermine Gilts, and we recommend underweight positions against Treasuries. |
| Global Commodities:<br>Francisco Blanch | ▪ We believe the global economic backdrop has improved on the back on monetary policy easing. Given improving momentum in global activity and a tight supply side for oil, we now see Brent crude oil prices reaching $120/bbl before year-end and averaging $114/bbl in 4Q.<br>▪ In our view, further interest rate cuts, particularly in EM countries, and looser fiscal policies will also boost confidence into year-end despite event risk around the fiscal cliff.<br>▪ Still, as long as the danger of a Euro area debt deflation collapse and currency break up persists, the risk of $60/bbl Brent crude oil prices will likely remain for years.<br>▪ We see gold moving to $2,500/oz range over the next 24 months on the back of additional quantitative easing in the US and Europe. | ▪ Risks: Deeper-than-expected Euro area recession; Increased Middle East tensions; Faster-than-expected US fiscal tightening; A China hard-landing scenario. |
| Global Credit:<br>Hans Mikkelsen<br>Oleg Melentyev | ▪ We remain bullish on US corporate credit. The recent ECB debt buying program significantly reduces the risk of European contagion to US financial markets, although key uncertainties remain. The search for yield should sustain the current favorable technical environment of excess demand for corporate bonds. But from a fundamental point of view, although credit spreads are relatively wide in some sectors, record low yields mean that credit risk as a proportion of yield is relatively high.<br>▪ Corporate bonds are particularly attractive relative to Treasuries because they offer some protection against rising interest rates.<br>▪ While we expect high yield to produce the highest absolute returns, we prefer high grade bonds on a risk adjusted basis. | ▪ We recommend that high grade investors buy financials over industrials. In HY, we see relative value in the single-B segment, which combines attractiveness of protection against rising rates vs BBs, and lower sensitivity to macro risks vs CCCs. And, we prefer to add exposure to sectors and names that benefit from the ongoing turnaround in the housing market.<br>▪ Risks: US fiscal uncertainties - including the cliff- are the main risks for the remainder of the year. Despite the progress in Europe there are important residual risks. We are concerned about a hard lading in China and, with QE3 on the table and geopolitical risks, the potential for further increases in oil prices |
| Global FX:<br>David Woo<br>Alberto Ades | ▪ We expect the euro to drop over the rest of the year, with a target of 1.23 for end-2012. Despite ECB promises, we still have core concerns around sovereign debt.<br>▪ USD should still strengthen over Q4, given European worries, risk-negative impacts of the US fiscal cliff, and concerns about a hard landing in China.<br>▪ Increased inflows to EM following QE3 should propel EM currencies higher. We like high beta currencies with low intervention risk and therefore favor MXN, KRW and INR. | ▪ A surprise resolution to the European crisis provides further upside risk to our view, while a country exit would likely cause the euro to fall further.<br>▪ Should G3 easing not sufficiently lift global activity, we think EMFX could sell off as investors expectations go unfulfilled. |

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* |
|---|---|---|
| Buy | ≥ 10% | ≤ 70% |
| Neutral | ≥ 0% | ≤ 30% |
| Underperform | N/A | ≥ 20% |

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