Investment Strategy | Global
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Our response to the skeptics

Bank of America Merrill Lynch

Martin Mauro +1 646 855 2998
Fixed Income Strategist
MLPF&S
martin.mauro@baml.com

Cheryl Rowan +1 646 855 3105
Portfolio Strategist
MLPF&S
cheryl.rowan@baml.com

Matthew Trapp, CFA +1 646 855 3084
Investment Strategist
MLPF&S
matthew.trapp@baml.com

Evan Richardson +1 646 855 3466
Fixed Income Strategist
MLPF&S
evan.richardson@baml.com

See Team Page for Full List of Contributors

Equity market fundamentals keep us optimistic

As Federal Reserve-injected liquidity begins to taper off, US stocks should be more dependent on fundamentals. Q2 earnings appear solid and, just as important, revenues are improving. Valuations remain attractive despite the equity market's strong return year-to-date. Corporate balance sheets are flush with cash, allowing for capital allocation strategies that often benefit shareholders.

Municipalities not likely to follow Detroit's lead

We do not believe that many other municipalities are likely to follow Detroit in filing for bankruptcy. For Detroit's general obligation bondholders, the outcome is likely to be decided by federal courts. The muni market remains attractive relative to other bond markets, but investors need to pay attention to credit ratings.

Fracking: the path to energy independence

Fracking, or pressure pumping a mixture into shale rock formations to release oil and gas deposits, is a technological innovation that has led to a surge in US oil and gas production. It is helping to reduce America's dependence on foreign oil – net imports are down by about 25% since 2005 – and there may be benefits to municipalities as well.

Guest column: Technicals - secular bull market road map

This month, technical analyst Steve Suttmeier asserts that, based on longer term technical analysis, the S&P 500 may be moving out of a secular trading range that it has been in from 2000-2013 and transitioning into a secular bull market. Though there may be significant pullbacks along the way, these are likely to bring in longer-term buyers and set the stage for a sustained secular bull market in stocks.

Click the image above to watch the video.

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This report is an extract of a report of the same name published on 13 August 2013.

Refer to important disclosures on page 22 to 24. Link to Definitions on page 21.

Financial markets recap

Table 1: Total returns (%)

Asset class	2011	2012	As of 31 July 2013 1mo	3mo	12mo	YTD	3yr²	5yr²	10yr²
Equity Indices (%, US dollar terms)									
S&P 500	2.1	16.0	5.1	6.1	25.0	19.6	17.7	8.3	7.6
NASDAQ Comp	-0.8	17.5	6.6	9.3	25.2	20.9	18.5	10.5	-
FTSE 100	-2.7	15.2	6.5	1.4	18.1	7.2	10.7	2.5	8.0
TOPIX	-11.9	8.1	0.8	-3.5	24.9	16.5	7.8	1.2	5.7
Hang Seng	-17.3	27.7	5.2	-1.6	14.5	-1.0	4.9	2.8	-
DJ Euro Stoxx 50	-16.7	20.2	8.7	4.5	32.3	8.3	4.4	-3.6	5.8
MSCI EAFE	-11.7	17.9	5.3	-0.8	24.0	10.0	9.1	1.5	8.5
MSCI Emerging Markets	-18.2	18.6	1.1	-7.7	2.3	-8.4	1.3	0.9	13.5
Size & Style (%, US dollar terms)									
Russell 2000	-4.2	16.3	7.0	10.7	34.8	24.0	18.7	9.5	9.6
S&P 500 Citigroup Growth	4.7	14.6	5.1	5.5	20.5	17.7	18.2	9.2	7.6
S&P 500 Citigroup Value	-0.5	17.7	5.1	6.7	30.3	21.6	17.4	7.3	7.7
S&P 600 Citigroup Growth	3.6	14.6	7.3	11.6	32.3	24.2	21.3	11.2	11.3
S&P 600 Citigroup Value	-1.4	18.2	6.4	11.1	37.4	24.1	19.8	10.6	10.6
S&P 500 Sectors (%, US dollar terms)									
Consumer Discretionary	6.1	23.9	5.2	9.1	38.7	26.0	25.9	17.9	9.5
Consumer Staples	14.0	10.8	4.1	1.5	18.9	19.9	18.8	11.9	10.4
Energy	4.7	4.6	5.1	5.6	18.6	15.3	17.1	3.8	14.5
Financials	-17.1	28.8	5.4	10.0	42.4	25.9	13.7	1.0	0.1
Health Care	12.7	17.9	7.3	8.3	35.6	29.0	24.0	12.2	7.9
Industrials	-0.6	15.3	5.7	9.5	28.7	20.3	16.9	7.6	8.6
Information Technology	2.4	14.8	4.2	5.0	11.1	10.8	14.4	9.0	7.4
Materials	-9.8	15.0	5.6	3.0	18.7	8.7	12.1	2.8	8.8
Telecom Services	6.3	18.3	0.2	-5.4	5.6	10.8	18.2	10.0	9.0
Utilities	19.9	1.3	4.3	-4.3	8.0	14.6	13.7	5.0	10.9
BofA Merrill Lynch Global Research Bond Indices (%, US dollar terms)									
10-Year Treasury	17.2	4.2	-0.8	-7.0	-6.5	-5.6	4.1	5.7	5.3
2-Year Treasury	1.5	0.3	0.1	0.0	0.2	0.1	0.7	2.0	2.7
TIPS	14.1	7.3	0.6	-7.7	-6.4	-7.3	4.9	4.7	5.8
Municipals*	11.2	7.3	-1.1	-5.4	-2.5	-3.9	3.8	5.2	5.1
US Corporate Bonds	7.5	10.4	0.7	-4.3	-0.3	-2.6	5.3	7.5	5.7
US High Yield Bonds	4.4	15.6	1.9	-1.3	9.5	3.4	9.9	11.4	9.1
Emerging Market Corporate Bonds	3.8	15.8	1.1	-4.5	2.9	-3.0	6.4	7.8	7.4
Emerging Market Sovereign Bonds	5.8	17.5	1.2	-6.3	1.1	-5.4	6.6	7.4	9.1
Preferreds	4.1	13.6	-1.4	-4.9	1.2	-1.0	6.9	4.6	2.5
Foreign exchange (%, in local currencies)**									
US dollar	0.5	1.5	-1.7	1.1	5.7	5.5	1.0	0.9	-2.0
British pound	1.9	2.9	-1.2	-1.8	-5.6	-5.0	-1.2	-3.2	-1.9
Euro	-3.2	0.9	1.3	1.9	11.4	5.2	0.8	-1.9	0.7
Yen	5.9	-11.0	0.2	-0.6	-22.1	-11.8	-4.4	3.3	1.3
Commodities (%, US dollar terms)**									
CRB Index	-8.3	-3.4	3.0	-1.5	-5.2	-3.8	1.2	-7.4	3.0
Gold	10.1	7.1	7.3	-10.3	-17.9	-20.9	3.9	7.7	14.1
WTI Crude Oil	8.2	-7.1	8.8	12.4	19.3	14.4	10.0	-3.3	13.1
Brent Crude Oil	13.8	3.8	7.0	6.9	2.6	-3.1	11.2	-2.5	14.3
Alternative Investments† (%, US dollar terms)									
Hedge Fund - CS Tremont¹	-2.5	7.7	-1.7	0.1	9.2	3.7	6.3	2.9	6.5
Hedge Fund - HFRI Fund of Funds¹	-5.7	4.8	-1.3	0.1	7.4	3.5	3.0	-0.6	3.5

Notes: *Not tax adjusted. **BoE calculated effective FX indices. ¹Data as of 6/30/2013; ²3yr, 5yr, and 10yr returns are annualized; CS AUM-weighted, HFRI equal-weighted; †AI data not comparable to other asset classes because of reporting delays, lack of standardized reporting, and survivorship and self selection biases. Crude oil prices are spot 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), BofA Merrill Lynch Global Research.

Cheryl Rowan
Portfolio Strategist
cheryl.rowan@baml.com
+1 646 855 3105

Martin Mauro
Fixed Income Strategist
Martin.mauro@baml.com
+1 646 855 3466

Equity market

Fundamentals keep us optimistic

In our recent meetings with investors, we observe a healthy degree of skepticism about whether US equities are attractively valued and therefore worthy of additional purchases. We use the term "healthy" because if investors are approaching the market with caution, it usually suggests that prices are not overheated.

Nonetheless, we agree with the skeptics who argue that the US stock market needs to prove that its fundamentals – good old fashioned earnings and revenues – are strong enough to carry prices higher, as we approach a period when the Federal Reserve begins its tapering of bond purchases and liquidity becomes less accommodative.

As Q2 earnings season comes to a close, the data give us reason to be optimistic about the stock market's fundamental health. Our US Equity Strategy team measures bottom-up consensus expectations for both earnings and sales growth each week during quarterly earnings reporting seasons. With 93% of S&P 500 companies reporting, expectations for year-over-year growth in earnings and sales are 2.7% and 2.4%, respectively (see Table 2). While earnings growth comes close to the 3.4% growth rate at the end of Q1, sales growth is markedly improved over last quarter's -0.4%. Currently, the only market sectors where we expect sales to contract are Energy and Materials – the two areas that are most exposed to global growth. We are encouraged by these data, since they could signal a higher quality source of future earnings that are generated from increased revenues – rather than just cost reductions or non-operating factors.

Table 2: Bottom-up consensus expectations for 2Q13 earnings and sales growth

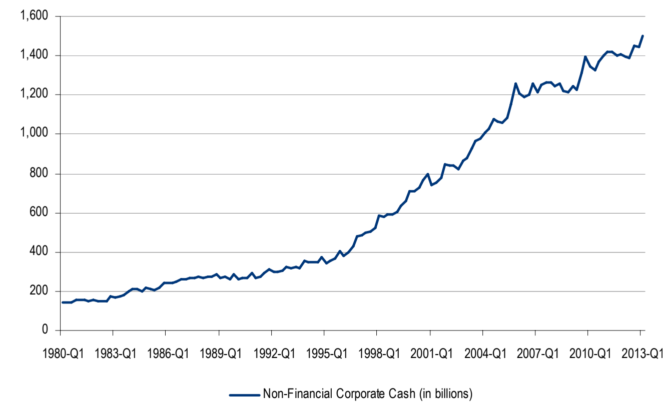
	Earnings		Sales	
	YoY%	QoQ%	YoY%	QoQ%
Consumer Discretionary	5.4%	15.7%	6.6%	4.0%
Consumer Staples	3.7%	10.7%	2.6%	1.1%
Energy	(10.3%)	(12.4%)	(5.3%)	2.0%
Financials	24.2%	1.2%	6.8%	(0.6%)
Health Care	2.0%	2.7%	4.2%	2.9%
Industrials	0.2%	11.9%	2.0%	5.2%
Information Technology	(5.5%)	(4.2%)	0.6%	(1.8%)
Materials	(8.0%)	(5.8%)	(1.1%)	2.7%
Telecommunication Services	(1.4%)	3.0%	2.5%	1.6%
Utilities	2.6%	(8.5%)	9.0%	(4.6%)
S&P 500	2.7%	1.3%	2.4%	1.6%
S&P 500 ex. Financials	(1.7%)	1.3%	1.7%	2.0%
ex. Fins & Energy	(0.3%)	3.8%	3.3%	2.0%

Note: Based on current constituents of the S&P 500
Source: FactSet/FirstCall, BofA Merrill Lynch US Equity & US Quant Strategy

Our US Equity Strategy team looks at market valuations a number of ways, and finds that the S&P 500 is trading below or in-line with historical norms on 14 of 15 valuation metrics. Valuation remains a driver
for their bullish view on stocks.

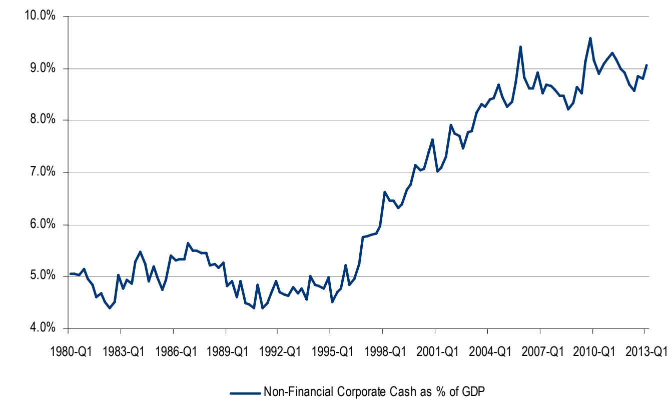
The corporate sector's balance sheet is likewise in pretty good shape. Since the peak of the financial crisis in late 2008, debt ratios have been steadily falling as companies have refinanced or retired much of their higher cost credit instruments. Debt/equity ratios are now back to pre-crisis levels. There has been much media attention given to the fact that US corporations have growing cash balances. According to the Federal Reserve's Flow of Funds data, as of Q1 2013, cash on nonfinancial corporate balance sheets stood at $1.5 trillion and has risen to a near-record 9% of GDP (see Charts 1 and 2).

Chart 1: Non-financial corporate cash is at a record high



Source: Federal Reserve Board, BofA Merrill Lynch Global Research

Chart 2: Non-financial cash as a percent of GDP near peak level



Source: Federal Reserve Board, BofA Merrill Lynch Global Research

Even though capital spending – longer-term investments to fuel future growth – has slowed, this growing pool of cash offers companies substantial flexibility in allocating their capital, in our view.

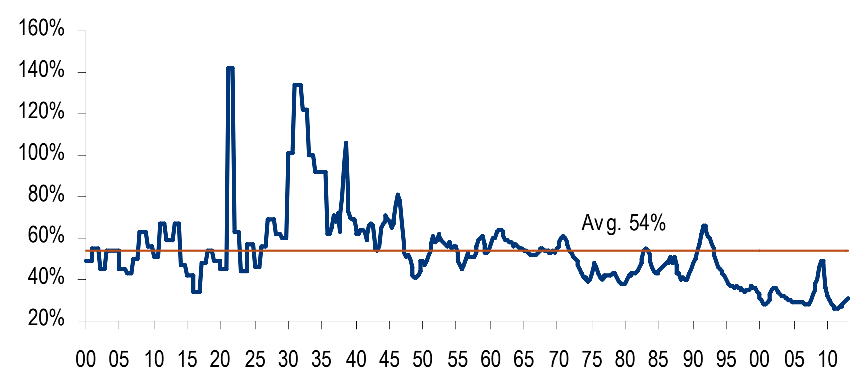
Many capital allocation strategies benefit shareholders

With anemic returns from cash investments, companies have been seeking higher return strategies from deployment of cash – typically by increasing dividends, buying back shares and/or engaging in merger activity. To varying degrees all three actions are positive for the stock market.

The ability of companies within the S&P 500 to increase dividends has never been better. Savita Subramanian, our US Equity Strategist, writes that the percent of S&P 500 earnings paid out as dividends, or payout ratio, has averaged 54% since the early 1900s, yet stands at just around 36% today (see Chart 3). This is despite the fact that 82% of securities in the index pay dividends – a level not seen since September 1999. According to S&P, dividend payments among the approximately 10,000 US traded stocks are up 13.9% year-to-date.

S&P 500 dividend payout ratio is near a historically low level, indicating the potential for dividend increases.

Chart 3: Low supply: S&P 500 dividend payout ratio, 1900-present

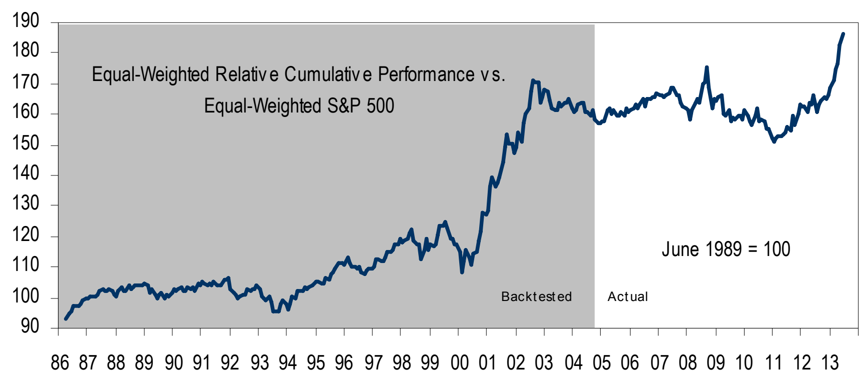


Source: S&P, BofA Merrill Lynch US Equity & US Quant Strategy

Another shareholder-friendly use of cash is to buy back outstanding shares, which has become quite a popular strategy. In each of the last two calendar years, $400 billion of shares were repurchased among S&P 500 companies – not quite the record near-$600 billion in 2007, but strong nonetheless. Our Equity Strategy team writes that over the last year, 56% of companies within the S&P 500 have reduced their share counts. They also note the strong outperformance so far this year of the top 50 stocks in the index that have reduced their shares the most (see Chart 4), but point out that shareholders may need to be more selective when looking for buyback candidates.

S&P 500 companies with the greatest percentage of share buybacks have significantly outperformed the index over the last two years.

Chart 4: Index of Relative Performance of Top Decile S&P 500 by share repurchase



Source: BofA Merrill Lynch US Equity & US Quant Strategy
The shaded area in performance chart shows back tested results during the period from month end March 1986 to month end December 2004. The unshaded portion represents actual performance since January 2005. Backtesting is hypothetical in nature and reflects application of the screen prior to its introduction. It is not intended to be indicative of future performance. Please see Appendix for performance data and performance calculation methodology

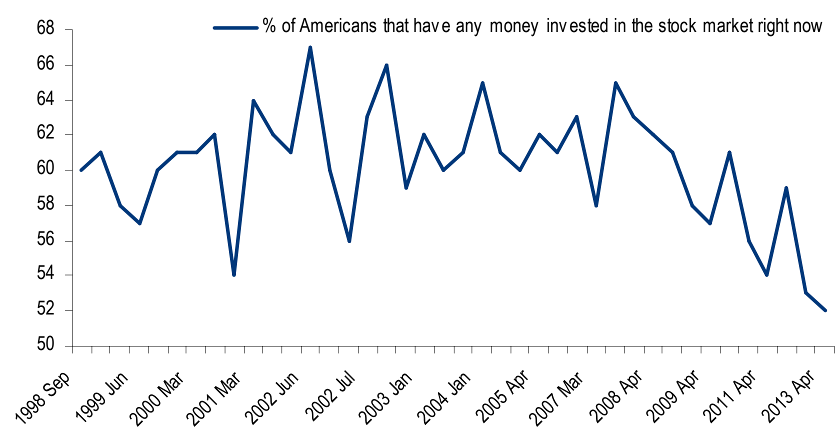
We would not be surprised to see merger and acquisition activity pick up as another outlet for low-return cash. Most recent deals have been financed with cash or cash plus stock, but overall M&A remains steady at levels below those of the mid 2000s. We believe that mid-cap stocks could be the biggest beneficiaries of any increase in mergers. Generally, they are cheaper than small-caps on a P/E basis, have strong balance sheets and can contribute more revenue to a large cap acquirer.

Stocks may still be climbing a wall of worry

According to Gallup, stock ownership among Americans is at a 15-year low.

Despite an equity market that has risen over 18% year-to-date, investors remain unconvinced that US stocks are the “real deal.” A recent Gallup poll reveals that a decades-low percentage of Americans are invested in the stock market (Chart 5).

Chart 5: Stock ownership is at a 15 year low



Source: Gallup; BofA Merrill Lynch Global Research

BofAML internal surveys suggest that strategists and investors remain subdued in their enthusiasm for stocks.

Our internal surveys confirm this sentiment. Our Equity Strategy team's sell side indicator, a gauge of Wall Street strategists' average allocation to equities, stands at 52.3%. While this number is up significantly from last July, it remains well below the 15-year average of 60.4% – suggesting that strategists continue to recommend that investors underweight equities. Our Fund Managers' Survey (participants are willing bona fide institutional fund managers) showed a jump in average cash balances last month above the 4.5% trigger point. This triggered a contrarian buy signal for equities.

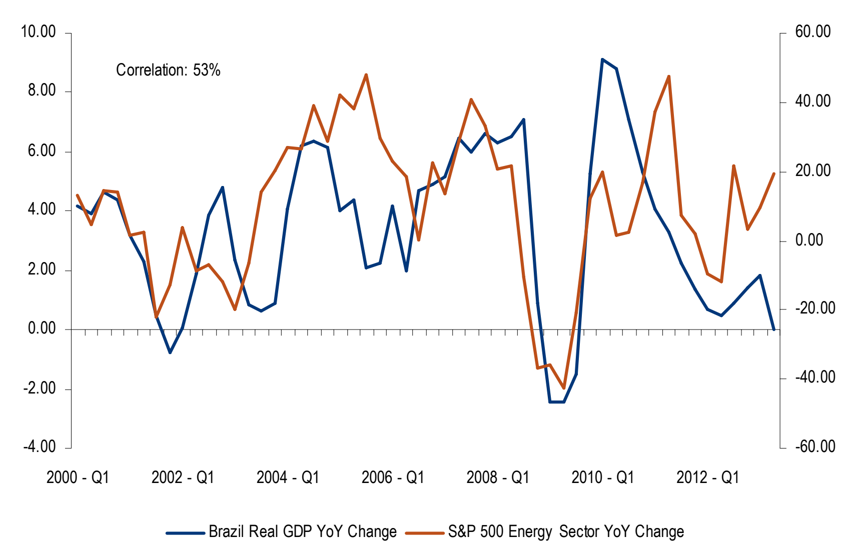
US economy, global growth remain significant risks

We find many reasons to favor US stocks over the next several months, but this rosy path is certainly not without its share of thorns. The most obvious concern is that, at some point, stocks are likely to correct. In the seven full months so far of 2013, the S&P 500 has had only one monthly negative return – and most of that came in the few days surrounding Federal Reserve Chairman Ben Bernanke's press conference following the June FOMC meeting.

The most recent US employment report and revisions to GDP revealed some of the economy's weakness. US economic growth was revised lower in each of the last four quarters. The jobs report also highlighted slowing wage growth and weakness in key areas of jobs such as construction, as well as a hiring preference for temporary over full-time workers. If the strength in housing and consumer spending were to wane and economic growth slowed from here, that could put corporate earnings at risk.

We also have to keep an eye on growth outside of the US. Corporate profits are leveraged to global growth; our US Equity Strategy team estimates that approximately 33% of S&P 500 sales come from outside the US. Although Europe seems to be slowly climbing back up the growth ladder, significant challenges remain in key markets such as China, Brazil and Russia. It appears that, at the very least, globally exposed sectors such as Energy, Industrials and Materials are unlikely to take over market leadership until there are clearer paths to growth in these emerging markets.

Chart 6: The S&P 500 Energy sector has a high correlation to Brazilian GDP growth



Source: Standard & Poor's; FactSet Research Systems; BofA Merrill Lynch Global Research

Detroit in bankruptcy

Detroit filed for bankruptcy on July 18. The action itself was not a big surprise to the market – Moody's has assigned a below investment grade to the city's debt since 2009 – but the timing was. Although the muni market sold off broadly in the days following the announcement, in our view it is unlikely that many other municipalities will decide to follow Detroit into bankruptcy.

Chapter 9

Detroit has filed under Chapter 9 of the Bankruptcy Code, the section that applies to municipalities.

States must authorize municipalities to file for bankruptcy, and two states prohibit municipalities from filing at all. Unlike with corporate bankruptcies, the creditors cannot force municipalities into bankruptcy.

Federal law will trump Michigan law.

Because Detroit has filed under the Federal Bankruptcy Code, federal law will generally dominate state law. That means, for example, that the clause in Michigan's constitution stating that pension obligations cannot be "diminished or impaired" may not necessarily prevail. In our view, pensioners are likely to suffer a substantial reduction in their payments. The city is attempting to have holders of its general obligation bonds (GOs) be treated as unsecured creditors. That matter will also likely be decided by the federal court.

Bankruptcy courts are courts of equity, so they are not bound to strictly follow the letter of the law, as with contract law. The judicial process in a court of equity is designed to achieve an equitable result, and does not have to follow the details of each contract.

Filing under Chapter 9 imposes an automatic stay on other legal actions, including the challenges to the city's eligibility to file. That may speed up the bankruptcy process, but there remains the potential for litigation challenging the decisions of the bankruptcy judge.

Detroit's debt

About 70% of Detroit debt is insured. All but one of the insurers presently appears adequately capitalized to make good on the payments.

Detroit has about $8.3 billion in debt outstanding. (See Table 3.) About $6 billion of that is insured. In the event of default, the insurer promises to replicate the coupons and payment at maturity of the bond. At present, most of the insurers of Detroit debt appear adequately capitalized to make good on these payments, but a series of other large scale defaults might threaten that. In contrast, FGLIC, which insures about $759 million of Detroit debt, appears unable to fully meet its insurance commitments. The market is pricing the insured bonds based upon the perceived quality of the individual insurer.

Table 3: Detroit bonds, $ Millions

	Unsecured GOs	Secured GOs	Pension Certificates	Water Revenue	Sewer Revenue	Total
Uninsured	68	479	-	516	1,206	2,269
Insured	464	-	1,452	2,032	2,146	6,094
Total	533	479	1,452	2,548	3,352	8,363

Source: BofA Merrill Lynch Global Research.

Table 3 shows that Detroit has $533 million in unsecured GOs outstanding, roughly 87% of which are insured. Water and sewer revenue bonds add up to about $5.9 billion of the $8.3 billion in Detroit debt. Although the bankruptcy proceedings inject an element of uncertainty, these bonds currently look to be well-funded, as the revenue sources are separate from the city's general funds, and the bulk of the bonds are insured.

Impact beyond Detroit

We don't think other municipalities will find bankruptcy appealing.

We do not expect other municipalities will find it desirable to follow in Detroit's footsteps. The recent experience in Detroit and elsewhere shows bankruptcy to be an expensive and time-consuming undertaking. Nor are unions likely to want to push for bankruptcy, in light of the likelihood that the Detroit pensioners will receive a small fraction of the promised payments.

Perhaps the most significant outcome from Detroit will be how the holders of the GOs are treated. The city wants to put the bondholders in the same category as the pensioners. Since most Detroit GOs are insured, that decision would not necessarily be damaging to its investors. But broadly treating GOs as unsecured obligations would likely reduce the valuations of GOs issued by other municipalities across the country. Still, it may be years before the court decides on the status of Detroit GO debt, and even then, the inferences for other debt might not be clear.

We have less of a concern with the credit risk associated with state GOs, since states are unable to file for bankruptcy (although a default is still possible). Credit risk varies among states, although all states but Illinois and California are rated AA or better.

The key outcome from Detroit might be a change in the status of GOs.

What to do

The muni market has been underperforming Treasuries all year, and the problems in Detroit have added to the shortfall. Our master index shows a broad-based 4.2% loss in total return so far this year, and a 5.7% loss since the end of April. And the ratio of the yield on 10-year AAA GOs to 10 year Treasuries has risen from 99% at the end of last year to 105%. Most of the selling appears to be coming from individual investors: funds have seen steady outflows, but "crossover" buyers, those who typically buy taxable securities, appear to be entering the market.

The muni market is attractive relative to other bond markets, in our opinion. The rise in the ratio of muni to Treasury yields suggests that the market is not factoring in the tax increases that took hold at the beginning of the year. But in light of our view that market yields will rise, we favor maturities under 10 years.

Use the credit rating as a guide to the quality of local GOs.

Credit risk will remain a factor in municipal investing for the coming years, but in our view the risk can be managed. Regardless of how Detroit GOs wind up being treated, the safety of GOs ultimately depends upon the fiscal health of the issuer. We recommend that investors pay heed to the credit rating of their bonds. We have less of a concern with the credit risk associated with *state* GOs, since states are unable to file for bankruptcy. Credit risk varies among states, although all states but Illinois and California are rated AA or better.

Historically, the credit rating has been a good indicator of the prospects of default. We recommend diversification, but investors who diversify through funds should not judge the funds by yield alone: be aware of the credit exposure of the fund. We favor state GOs, higher quality local GOs, and essential service revenue bonds.

American innovation

Fracking revolution

Matthew Trapp
Investment Strategist
matthew.trapp@baml.com
+1 646 855 3084

Claire Voorhees
Municipal Strategist
claire.voorhees@baml.com
+1 646 743 1475

A few months ago we introduced evidence, initially published by our US Equity Strategy team, that American companies across a wide variety of industries are opening paths toward higher levels of efficiency and solving problems with their skill in innovation.

This month, we continue our series focusing on industries that are particularly innovative – and highlighting stocks that play leading roles within those industries.

A decade ago, if someone said the word "fracking" in front of their mother, they might have gotten their mouth washed out with soap. Today, we know the term as a new way to drill for shale oil and gas that has the ability to change the global energy landscape.

Due to the boom in fracking, production of natural gas in the US has increased 33% since 2005. Forecasts for natural gas production call for a continuation of strong growth and the US Energy Information Administration (EIA) now predicts that the US will be a net exporter of natural gas by 2020. Fracking has also led to significant increases in oil production in the US, growing more than 35% over the last three years after several decades of decline. This boom in energy production is reducing America's reliance on foreign crude oil and providing greater security of our energy supply.

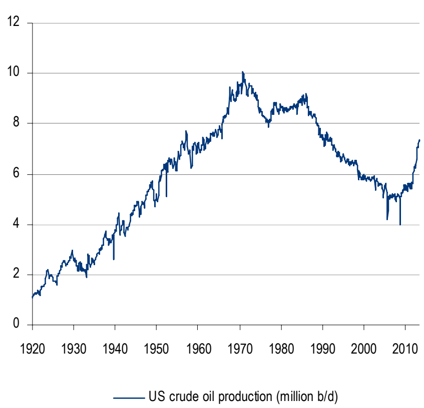
What is shale gas or shale oil?

Shale gas is a shale rock formation in which natural gas is trapped in tiny pockets within the rock. The gas trapped in the rock is similar to the way tiny air pockets are trapped in a cake as it bakes. Similarly, there is also shale oil, in which pockets of crude oil are trapped in the shale.

The oil industry has known that shale gas and oil exists deep beneath the ground for decades; however, traditional vertical drilling techniques were able to access only a small fraction of it within these formations. The ability to extract oil and gas in a profitable way had eluded the industry.

Mitchell Energy was an early pioneer in shale gas production, experimenting in the 1980s and 1990s in the Barnett Shale in Texas. After years of experimenting, they made a breakthrough in the mid 1990s with a process called hydraulic fracturing, or fracking. Fracking involves pumping a mixture of water, sand, and chemicals into a gas well under heavy pressure to help release gas and oil deposits by opening cracks in the rock. The second breakthrough was in horizontal drilling, which allowed the drill bit to bore a hole horizontally along the length of the shale formation. This allows for the well to be exposed to a significantly larger portion of the shale rock than if the well had just been drilled straight down. Improvements in drilling sensors and global positioning technology helped make vast improvements in directional drilling technology. The combination of hydraulic fracturing and horizontal drilling led to the breakthrough that allowed shale drilling to be economically viable.

Chart 7: Oil production is up 35% over the last 3 years



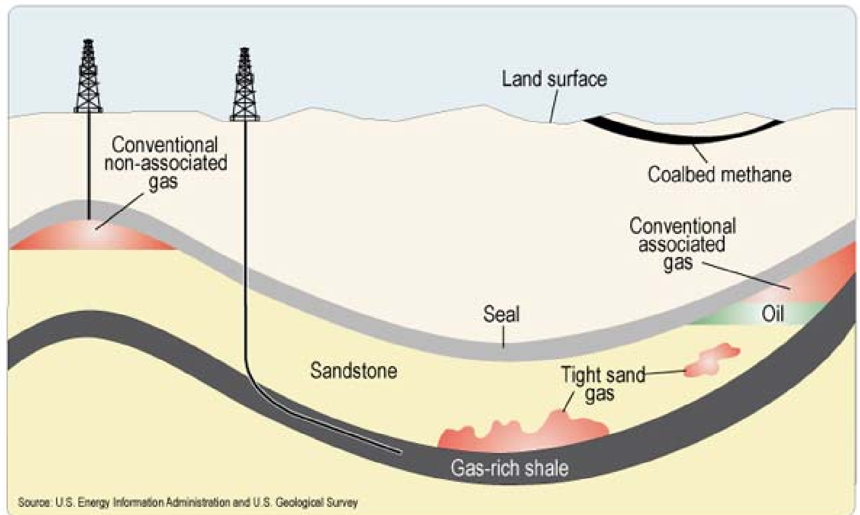
Source: U.S. Energy Information Administration , BofAML Global Research

The fracking process

In a typical shale gas well, a hole, or wellbore, is drilled to several hundred feet below a fresh water aquifer, which typically has a depth of around 300 feet. Steel casing is then inserted and cement is poured in to seal the wellbore from the fresh water and prevent contamination. The drill bit is then reinserted to continue the vertical drilling down to between 4,000 and 13,000 feet, depending on how deep the shale rock formation is located. The drill bit is removed when it is about 500 feet above the planned horizontal leg of the drilling.

A specialized drill bit is then used to drill the angled curve to the point where the horizontal drilling begins. This specialized drill bit has precision measurement capabilities that can fine tune the angle of the drilling. The horizontal drilling begins and can go to lengths of 10,000 feet. Production casing is now inserted into the full length of the hole. Cement is again pumped into the casing and forced through the end of the hole, which fills in the cement between the casing and the wall of the drill hole. This secures the wellbore and prevents oil or natural gas from seeping out into the rock formation.

Chart 8: Diagram of a horizontal shale gas well



Source: U.S. Energy Information Administration and US Geological Survey

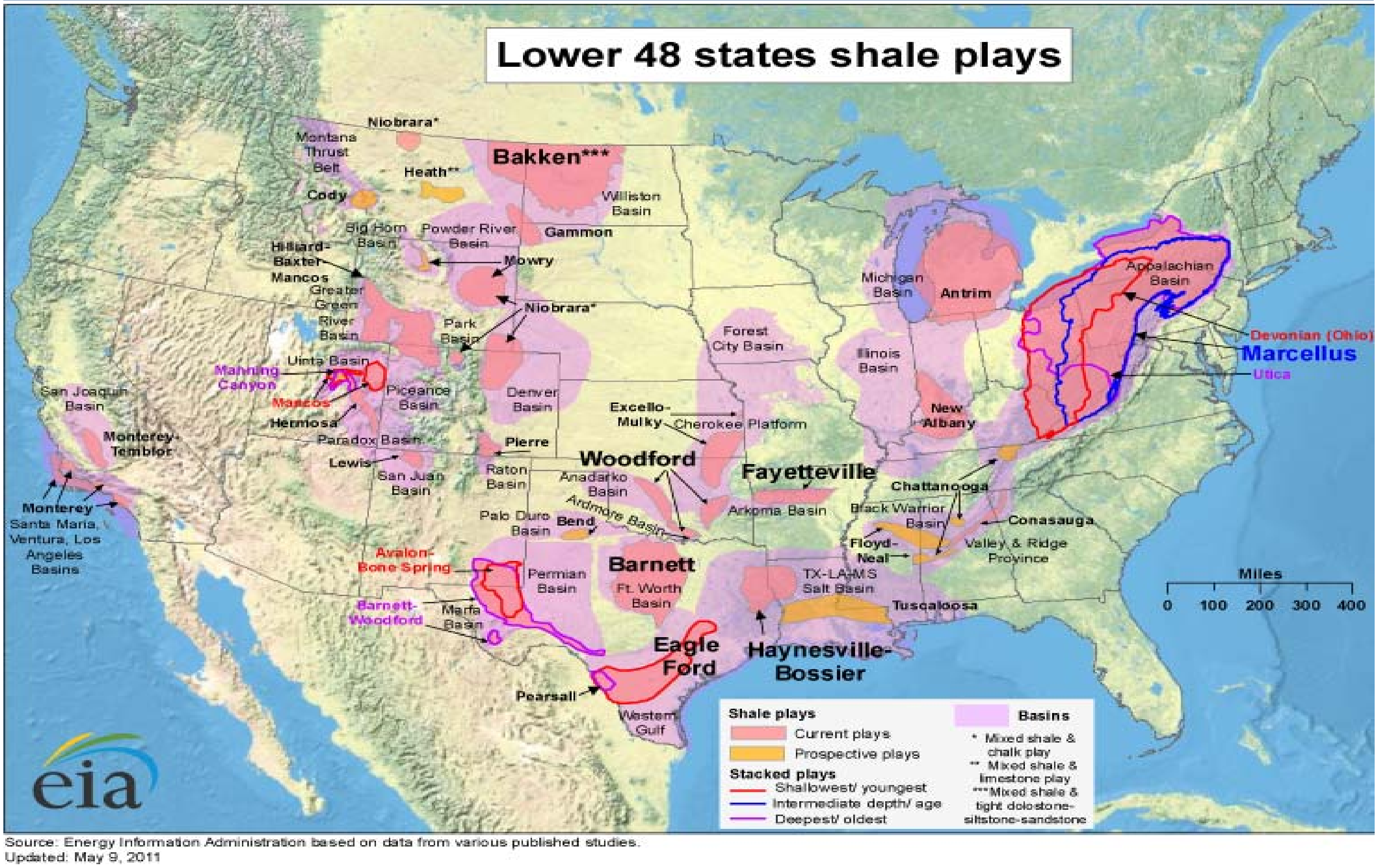
The next step is to perforate a section of the casing using a perforating gun, which shoots small holes through the casing and cement and into the shale rock formation. The hydraulic fracturing, or fracking, process then begins, which involves pumping a mixture of water, sand and chemicals (90% water, 9.5% sand, and 0.5% chemicals) into the wellbore at extremely high pressure. As the mixture is forced through the perforations and into the rock, the pressure fractures the shale. The sand helps keep the cracks open and the chemical additives help reduce friction and keep the sand suspended in the mixture. These fractures allow gas to flow into the wellbore. Without the fracturing process, the natural gas would not be able to be produced economically. The completed section is plugged and the process of perforating and fracking continues along the next section of the horizontal leg of the wellbore. When fracking is completed, the plugs are drilled out, allowing gas to flow up the wellbore. A permanent wellhead is then installed and connected to a pipeline allowing for transportation of the gas.

Shale opportunities are mainly in interior US

The Marcellus shale, which is located in the northeastern US, has natural gas reserves of 141 tcf, which would meet US natural gas demand for about six years.

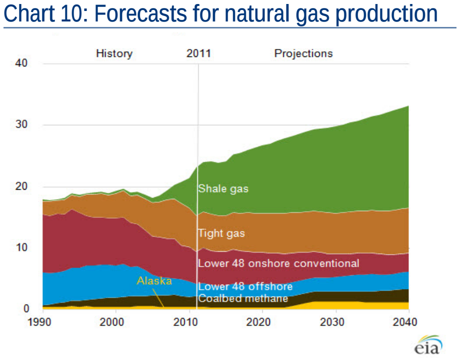
Shale oil and gas opportunities are primarily located in the interior of the US. One of the largest shale gas regions is called the Marcellus, which is primarily located in Pennsylvania, New York, Ohio, and West Virginia. The Marcellus is estimated to contain reserves of 141 trillion cubic feet (tcf), which would meet US natural gas demand for about six years. The Haynesville shale, which is located in Louisiana, Texas, and Mississippi, is another large gas play with about 66 tcf in reserves. The Eagle Ford shale, located in Texas, is both a shale gas and oil play, with gas reserves of 50 tcf and oil reserves of 2.5 billion barrels. The Bakken is a shale oil play located in North Dakota and Montana, with oil reserves of 5.4 billion barrels.

Chart 9: Shale oil and gas plays in the US



Source: U.S. Energy Information Administration

Chart 10: Forecasts for natural gas production



Source: U.S. Energy Information Administration , BofAML Global Research

The road to energy independence

The technological advances in drilling for shale oil and gas have led to a surge in the production of these commodities in the US. Natural gas production in the US increased by 33% from 2005 to 2012, according to BP, largely due to higher shale gas production. Total US natural gas production is projected to increase by 44% between 2011 and 2040, according to the US Energy Information Agency. Shale gas is the greatest contributor to this growth, as its production is expected to grow over 110% during that time horizon. The percent of total natural gas production that is shale should rise from 34% in 2011 to 50% in 2040.

In the US, crude oil production increased 14% last year to 8.9 million barrels/day (MMBpd) with most of the new production coming from shale oil, according to BP. Shale oil production growth has averaged 64% a year over the last three years. This increase in domestic shale oil production has helped reduce net imports by around 25% since 2005. BofAML expects shale oil production to reach 2.3 MMBpd in 2014 up from 1.4 MMBpd currently.

Benefits extend to the environment, jobs

The boom in oil and gas production is not just affecting the energy sector. Other benefits include:

- Greenhouse gas emissions in the US have been declining over the last several years, due in part to lower natural gas prices that caused electric utilities to switch from burning coal to cleaner burning natural gas. Natural gas has the lowest carbon content of the fossil fuels and gas-fired electricity generation has about one-half the carbon content of coal-fired electricity, according to the EPA.

- Manufacturers are finding lower energy prices in the US attractive. Price Waterhouse estimates that lower energy prices could boost US factory employment by over 1 million people over the next 10 years.

- Oil extraction is also creating jobs in the US, leading to a 67% increase in oil and gas extraction employment from 2003 through 2012. The job creation is not just benefitting the energy sector. According to a study by global information company IHS, for each energy sector job created, three indirect jobs are also created.

Prices, regulation, environmental concerns are all risks

One of the risks to shale oil drilling comes from lower oil prices. Currently, US regulations prevent crude oil exports. There is a risk that landlocked crude oil becomes trapped in the US due to the lack of exports and limited refining capacity, temporarily dropping WTI oil prices. This could lead to a decline in drilling activity. Douglas Becker, our oil services analyst, estimates that at WTI oil prices of $85-$90/bbl some areas of the Bakken will be uneconomic and below $80/bbl some small producers could become cash constrained. Currently, WTI oil prices are $106/bbl. Similarly, lower natural gas prices could cause producers to cut back on drilling activity.

Risks to the shale boom include lower oil and gas prices, additional state and federal government regulation, and concerns about the environmental impact.

There is also the risk of additional regulation from state and federal governments. Other states could issue a moratorium on shale drilling as New York did in 2008. Government agencies could also issue regulations that raise cost of drilling.

Environmentalists have raised concerns over shale drilling. Chemicals used in fracking could be released into the water supply if the well is not properly constructed. In addition, the fracking process requires large amounts of water, which could affect the availability of water for other uses.

Positive credit implications for municipalities

The vast majority of US oil and gas production occurs on private lands, so in our view, states and local governments stand to benefit significantly from fracking. The production of oil and gas is taxed and regulated almost entirely by state and local governments, and the revenues derived from fracking can have a meaningful impact on states and their municipalities' financial position. Various states have already begun to reap the financial and economic benefits. However, some states have a ban on fracking, and others are still unlocking the revenue producing potential. The additional tax revenue derived from fracking not only has the potential to improve the current economic position of a number of states and municipalities, but also enables states to set aside future funds via the establishment of permanent trusts. The benefits of a stronger local economy, improved infrastructure, higher levels of tax revenues, and additional jobs could drive positive rating actions for municipal credit.

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The 16 largest oil and gas states include: AR, CA, CO, KS, LA, MS, MT, NM, ND, OH, OK, PA, TX, UT, WV, and WY. However, states vary widely in their taxation of oil and gas, particularly in severance taxes. Severance taxes differ in rate as well as in how they are calculated. Some states' severance tax rates are based on the taxpayer's gross oil and gas income, and others calculate the tax based on the amount of oil and gas extracted.

IHS-Global/Cambridge Energy Research released studies in December of 2011 and 2012 on the economic and employment contributions of shale gas in the US. They projected the unconventional oil and unconventional gas activity contribution to government revenue and private lease payments from 2012 through 2035 (see Table 5). Given the potential for California, this estimate could be quite low. According to a report released by the University of Southern California, developing California's Monterey Shale formation could increase state and local tax collections to $24.6bn by 2020.

State trusts from oil and gas revenues

Alaska is the primary and frequently cited example of a state that has used energy taxes and royalties to create a permanent trust fund. The Alaska Permanent Fund, which was created in 1975, has reached $42bn. The fund pays annual cash disbursements to residents, as well as aids the state in subsidizing non-fossil fuel power sources. Texas, Wyoming, and New Mexico, are three of several examples of states that have large trust funds in place. Earnings from the Texas State Land Board investments and oil and gas royalties and bonuses are the second largest source for the state's Permanent School Fund. Wyoming's Wealth Fund, which receives disbursements from fuel taxes, totals approximately $5.4bn, and the fund's distribution formula allocates 5% of the five-year average of its assets to the state legislature. New Mexico has an $11bn land grant fund and $4bn in its severance tax fund, which together distributed $700mn to schools and other uses in 2012.

Due to fracking of the Bakken formation, North Dakota is now the second largest producer of oil in the US. In 2012, fracking contributed $3.9bn in state and local taxes, enabling the state to enjoy continued record-setting budget surpluses. In 2010, the state created a Legacy Fund, which receives 30% of North Dakota's oil tax collections. The fund reached $580mn within 12 months, now topping $1bn.

In 2012, Utah approved a constitutional amendment requiring that up to half of its new energy revenues be placed into a permanent trust fund. Other states including Pennsylvania, Ohio, and West Virginia have considered similar proposals. Despite Pennsylvania's substantial oil and gas reserves, the state does not have a severance tax and only assesses an impact fee that assists localities with drilling damage.

The December IHS study indicated that in 2012 drilling added $4.1bn to Ohio's GDP and contributed $911mn to the state's tax revenues. The report indicated those amounts could increase to $18bn and $4.6bn, respectively, by 2020. Ohio's severance tax is among the lowest in the nation, but legislation has been put forth proposing a 7.5% severance tax on oil, gas, and condensate extracted from fracking. Preliminary estimates show that under this rate, the state would collect nearly $400mn in 2014, increasing to almost $1bn in five years. The bulk of the revenue would be reinvested in the state's local governments which have faced cuts over the past several budget cycles. Additionally, 1% would be invested in a Severance Tax Trust Fund.

New York banned fracking in 2008 until its impacts could be analyzed further. We agree with Kroll BondRatings™ that, if done carefully, New York and many of its western municipalities could see significant economic benefits from fracking.

Table 5: Contribution to US lower 48 govt. revenue, total* unconventional activity ($mn)

	2012	2015	2020	2035	2012-2035
Federal Taxes	$28,936	$42,183	$50,229	$57,846	$1,137,602
Personal Taxes	$22,110	$32,003	$38,082	$44,214	$865,197
Corporate Taxes	$6,827	$10,180	$12,147	$13,631	$272,405
State and Local Taxes	$30,931	$46,582	$57,731	$64,967	$1,317,506
Personal Taxes	$3,536	$5,136	$6,112	$7,067	$138,650
Corporate Taxes	$19,150	$28,539	$34,024	$38,186	$763,165
Severance Taxes	$5,450	$8,657	$11,769	$13,442	$279,882
Ad Valorem Taxes	$2,795	$4,251	$5,825	$6,272	$135,809
Federal Royalty Payments	$1,964	$2,639	$3,204	$1,593	$62,141
Total Government Revenue	$61,832	$91,404	$111,164	$124,406	$2,517,248
Lease Payments to Private Landowners	$504	$711	$913	$1,232	$23,599

*Total unconventional activity represents total unconventional gas activity (which represents the production of gas and liquids recovered from shale gas and tight gas plays) and total unconventional oil activity (which represents the production of oil and condensate and associated gas recovered from tight oil plays).
Source: IHS Global Insight

Guest column

Technicals: Secular bull market road map

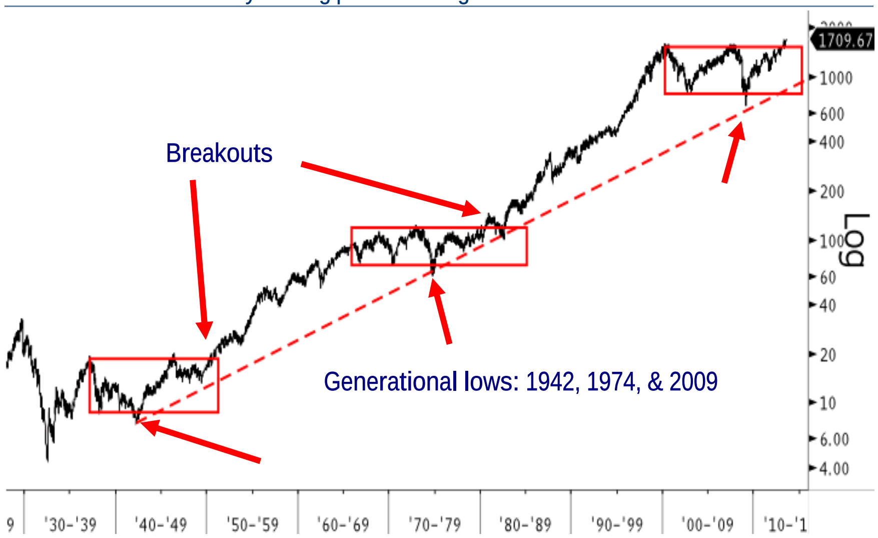
Stephen Suttmeier, CFA, CMT
Chief Equity Technical Strategist
stephen.suttmeier@baml.com
+1 646 855 1888

Based on longer-term technical analysis, we view the S&P 500 as moving out of the secular trading range that has gripped the US equity market from 2000 to 2013 and transitioning into a secular bull market. Using history as a guide, upside breakouts from big trading ranges are bullish long-term, but the bears often have a parting shot or pullback that retests the upper portion of the trading range. This pullback deeply tests the resolve of investors given fresh memories of the sharp stock market declines that occurred during the secular trading range. The key message is that patience with an emerging secular bull market may be required.

The secular trading ranges for the S&P 500 from 1937-1950 and 1966-1980 lasted 13 to 14 years.

After the range breakouts, the secular bull markets from 1950-1966 and 1980-2000 lasted 16 and 20 years, respectively.

Chart 11: S&P 500 monthly closing price semi-log chart

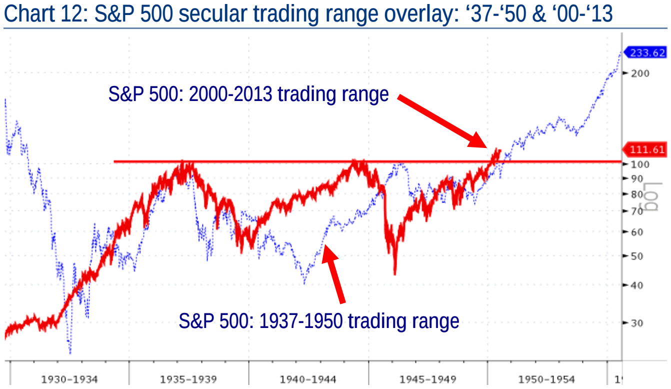


Source: BofA Merrill Lynch Global Research, Bloomberg

History as a guide: lessons from the 1950s and 1980s

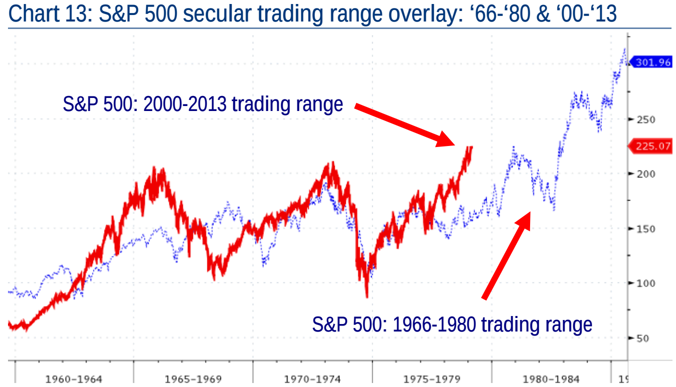
Below we illustrate the prior S&P 500 secular trading ranges from 1937-1950 and 1966-1980 overlaid with the 2000-2013 pattern. Based on the 1937-1950 trading range, the S&P 500 is breaking out from its 2000-2013 secular trading range on schedule. However, the breakout is early when compared to the 1966-1980 trading range. The move out of the 2000-2013 range looks a lot like the 1950s, but there is the risk of a 1982-style pullback.

Chart 12: S&P 500 secular trading range overlay: '37-'50 & '00-'13



Source: BofA Merrill Lynch Global Research, Bloomberg

Chart 13: S&P 500 secular trading range overlay: '66-'80 & '00-'13



Source: BofA Merrill Lynch Global Research, Bloomberg

Using the prior rallies off the generational lows from 1974 and 1942 as a guide suggests the risk of a parting shot by the bears.

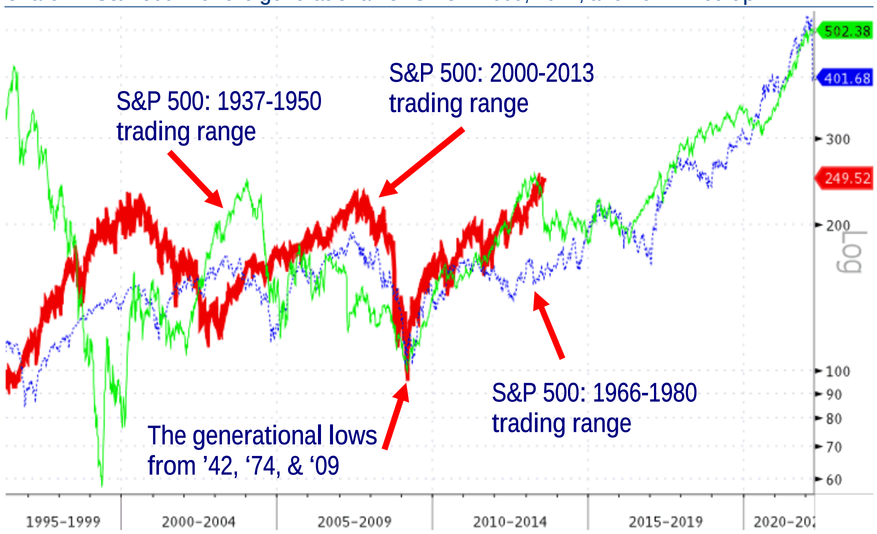
With a gain of 153%, the rally for the S&P 500 from the March 2009 low is the fifth best bull market in excess of 20% going back to 1928. This is difficult to chase, but a pullback in excess of 20% - similar the pullbacks from the late 1940s and early 1980s - could bring in longer-term buyers and set the stage for a sustained secular bull market.

Lining up the generational lows reveals where we stand

Using the overlay of the S&P 500 off the 1942, 1974, and 2009 generational lows suggests that the US equity market is in a risky position as the S&P 500 moves out its trading range. The risk is for a parting shot from the bears and a 1982-style buying point for the US equity market. In mid 2013, this risk coincides with the US equity market moving into the weakest part of the Presidential Cycle.

If the US equity market follows the Presidential Cycle, which it has so far this year, the risk is for lackluster returns in the last four months of 2013 and well into 2014 or the mid-term election year. Based on the cycle, a strong bottom and rally occur after the mid-term year low. This low tends to form in September of the midterm year. See the next page for more details on the Presidential Cycle.

Chart 14: S&P 500 with the generational lows from 2009, 1974, and 1942 lined up

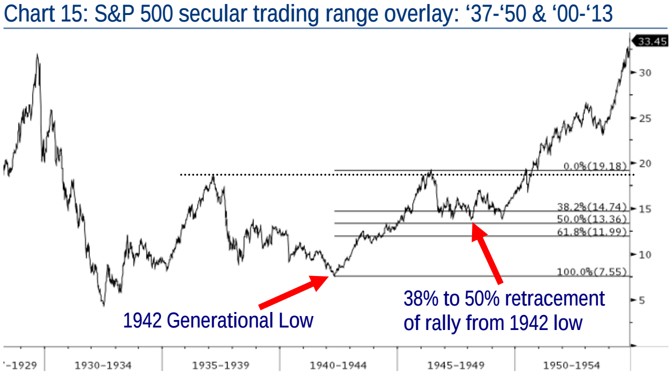


Source: BofA Merrill Lynch Global Research, Bloomberg

A parting shot from the bears could be in excess of 20%

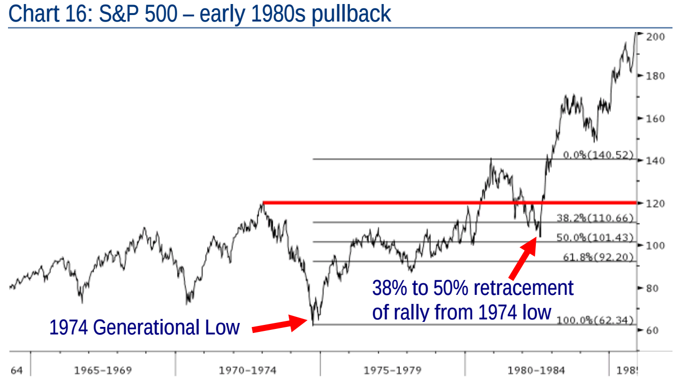
Based on prior pullbacks within the transition from a secular trading range to a secular bull, a parting shot from the bears could be in excess of 20% and retrace 38-50% of the rally off the generational low. Once again, patience with an emerging secular bull market may be required, but a pullback in excess of 20% – similar to the pullbacks from the late 1940s and early 1980s – could bring in longer-term buyers and set the stage for a sustained secular bull market.

Chart 15: S&P 500 secular trading range overlay: '37-'50 & '00-'13



Source: BofA Merrill Lynch Global Research, Bloomberg

Chart 16: S&P 500 – early 1980s pullback



Source: BofA Merrill Lynch Global Research, Bloomberg

Presidential Cycle sets up a midterm pullback, but…

The Presidential Cycle calls for a July/August peak in year 1 (in this case 2013) ahead of a pullback into September of year 2 (2014), or the midterm year. The average *decline* over this 13-month period is 4% vs an average 13-month period *gain* for the S&P 500 of 8% going back to 1928. The S&P 500 is down 62% of the time during this weak period for the Presidential Cycle and is down only 33% of the time for all 13-month periods going back to 1928.

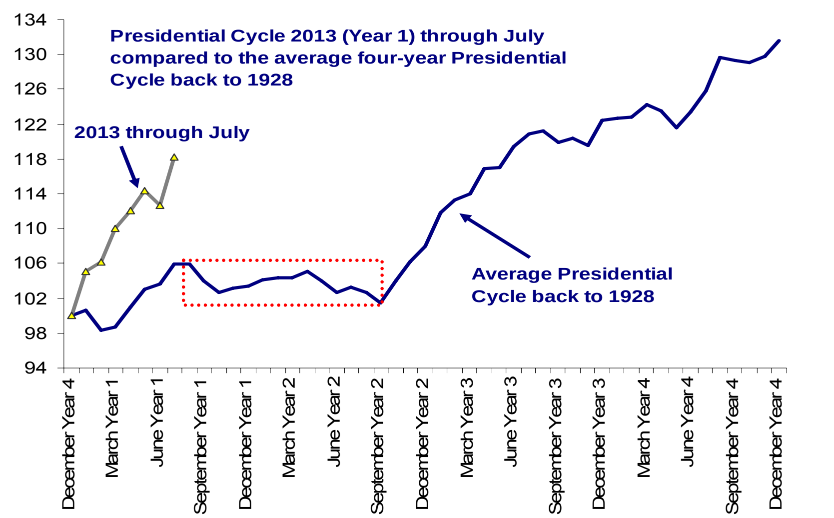
…the midterm pullback is a potential buying opportunity

The good news is that a midterm year pullback is typically followed by the strongest part of the Presidential Cycle from the September year 2 low through August of year 3. The average return for this 11-month period of the cycle is 19%, and the S&P 500 is up 86% of the time. This compares to the average S&P 500 return of 6.8% for all 11-month periods going back to 1928, with the S&P up 67% of the time.

The September year 1 through September year 2 (mid-term) period is the weakest part of the Presidential Cycle.

September year 2 to August year 3 is the strongest part of the Presidential Cycle.

Chart 17: Presidential Cycle 2013 (Year 1) through July & the average Presidential Cycle back to 1928



Source: BofA Merrill Lynch Global Research, Bloomberg

Five sectors that make up 64% of the S&P in secular bulls

Sectors that have broken out to new all-time highs are Discretionary, Staples, Health Care, and Industrials. These are secular bull market patterns. Staples was the first sector to move to new all-time highs in April 2011. Discretionary was next in early 2012 followed by Health Care in mid 2012. Industrials broke to new all-time highs in July. Although Technology is not at new all-time highs, the sector broke out from a decade-long trading range and entered a new secular bull market in early 2012. These five sectors make up 64% of the S&P 500.

Financials are in a strong cyclical bull market with leadership from the Banks and Insurance – a market positive. Commodity sensitive Energy and Materials and defensive Telecom, and Utilities are lagging on the S&P 500 breakout to new all-time highs given generally weaker commodity prices and the move up in US Treasury yields, respectively.

RIC asset class views

Table 6: Research Investment Committee asset class views

Asset class	RIC view (+ / = / –)	Comments
Equity Markets		
US Equities	+	Q2 earnings growth solid, revenues improving; cash levels are high; expect growth cyclicals to take over leadership
Consumer Discretionary	=	Favor housing or auto-related stocks; increasingly selective among retailers as sector has gotten more expensive
Consumer Staples	=	Defensive with good div. yields and global reach but many valuations are stretched; look for unexploited stocks
Energy	+	Underweighted and unloved; earnings are mixed, so be selective as forecast is for lower oil prices
Financials	=	Benefits from US housing/cyclicals recovery; favor higher quality banks and insurers
Healthcare	=	Obamacare, looming govt. cutbacks keep us neutral; pharmaceuticals good income source, biotechs have M&A appeal
Industrials	+	Benefits from cyclical recovery with many high quality stocks. US manufacturing well positioned
Info Technology	+	Sector has lagged yet operating margins and balance sheets are strong; expect more cash return to shareholders
Materials	=	Weak commodity prices, low US inflation, China slowdown weigh on earnings & stocks—stick to chemicals & fertilizers
Telecom	–	Good div. yields but not much room for div. growth any more; expensive sector according to US Strategy
Utilities	–	Div. yields still well above Treasuries, but rising rates narrows that gap; stocks lag in economic recovery
Growth	+	Slow earnings growth recovery, low inflation favor growth stocks; has lower valuation and better div growth than value
Value	=	Look for value stocks with secular growth characteristics in Technology, Industrials and Energy
Small cap	+	Have outperformed large, but stocks are now expensive and close to peak valuations; stocks dependent on earnings
Large cap	+	Beneficiaries of fund flows into US equities/ETFs; look for cyclical growth and div. growers to outperform
Europe (ex. UK)	=	Macro data show signs of stabilization, expansion of mfgr sector. Valuations cheap; favor financials & selected cyclicals
United Kingdom	=	Data suggest economy broadly improving; BoE may keep rates on hold watching employment; favor financials
Japan	+	BoJ committed to QQE framework with focus on stimulating growth and ending deflation; like domestic stocks
Asia Pac (ex. Japan)	=	Valuations attractive, preference is for cyclical yield vs. defensives; prefer autos, banks, hardware; cautious on Australia
Emerging Markets	=	Current accounts worsening, rising US bond yields, weak commodity prices are negs; too early to buy aggressively
Fixed income markets		
Treasuries	–	Income is low, and yields are likely to rise.
Agencies / MBS	–	Vulnerable to a tapering in Fed purchases, benefiting from improved GSE profitability, but yields are too low.
TIPS	=	Inflation protection desirable, even though yields are low.
US IG Corporates	+	Preferable to Treasuries for conservative investors. We favor lower quality, and intermediate maturities.
US HY Corporates	+	Yield spreads have widened, duration is lower than in other sectors.
Preferred securities	–	Duration risk too high for sector as a whole.
Non-US DM sovereigns	–	Yields are low and currency translation should work against $ based investors.
EM $ Sovereigns	=	Risks from rising US Treasury yields and slowing growth in EM nations.
EM Local crncy Sovereigns	–	Same risks as for $ denominated, plus near-term risk of weaker currencies.
Gold	=	Near-term range of $1,000/oz and $1,500/oz.
Oil	–	Year end price target of $103/bbl for Brent crude. But downward pressures longer term due to increased supply.
US dollar	+	Greenback should strengthen against most developed and EM countries.

Source: BofA Merrill Lynch Research Investment Committee

Notes to RIC views

Ratings designations are as follows: (+) favorable view; (=) neutral view; (-) unfavorable view. Ratings reflect the Research Investment Committee's view for an investment time horizon of 12-18 months. Typically, the RIC view will agree with regional/product strategists, but at times there may a difference of opinion based on investor suitability or time frame.

Fixed Income, Econ, Commodities, Currencies: views & risks

Table 7: Regional Equity Strategist views & associated risks

Views	Risks
Global Economics *(Ethan Harris, Alberto Ades)*	
■ Europe is exiting recession but risks remain skewed to the downside. ■ The ECB stands ready to back Euro area countries with its OMT program if any countries request help and sign an MoU. ■ US growth will likely strengthen in the fourth quarter. We expect the Federal Reserve to announce QE tapering in December.	■ Downside risks: US fiscal tightening, slow progress on structural and fiscal reforms in Europe, and a soft recovery in China. ■ Upside risks: US housing market rebound, stronger US labor market recovery.
Global Rates *(Priya Misra, Ralf Preusser, John Wraith)*	
■ US: We maintain our sell on rallies bias. Improving data, a changing Fed reaction function and concerns about a slowdown in demand for USTs from the traditional investor base is likely to keep rates at the higher end of the range. ■ Europe: Now that the ECB has adopted its own form of forward guidance we expect to see EUR rates de-correlate further from the US, with the front-end more anchored going forward. This will also lend support to carry trades in semi-core sovereigns. ■ UK: We anticipate that the MPC under new Governor Mark Carney will introduce some form of rate guidance over the next couple of months, and expect short yields to fall back towards the level they were at prior to the sell off that began in mid-May. We do not expect QE to return for the foreseeable future, absent a major negative shock in the UK or Eurozone.	■ US: US: Continued selling by emerging market central banks and a further widening in mortgages could add to the technical factors pushing rates higher. On other hand, an unexpected debt ceiling debacle in the fall could be a risk off catalyst, moving Tsy yields lower. ■ Europe: The EUR curve will trade directionally with the US, suggesting steepeners as a hedge against a further US-led sell-off. ■ UK: There has been a clear improvement in various data releases over the past month or two. If these intensify, the Bank may be happy to proceed without guidance, and short rates could drift higher in that event.
Global Commodities *(Francisco Blanch)*	
■ Commodity demand should be modestly supported by global economic growth of about 3% this year, but we remain concerned by the lack of growth momentum in EMs. ■ Weaker EM oil demand growth should push Brent crude oil prices lower to an average of $103/bbl in 2H13. Prices will likely fail to push much higher in 2014. ■ Gold prices remain challenged by a lack of technical and fundamental support.	■ A deeper-than-expected Euro area recession, increased Middle East and African tensions, faster-than-expected US fiscal tightening, and a China hard-landing scenario. ■ A deteriorating geopolitical outlook in the Middle East could lead to further crude oil supply disruptions and be a major swing factor for Brent.
Global Credit *(Hans Mikkelsen)*	
■ The macro backdrop for corporate credit in 2013 remains positive. We remain overweight high grade and high yield corporate bond spreads and favor US HY and European IG over US IG. ■ Some short term macro risks - including the US fiscal tightening and Europe - have faded, while others - such as China—have increased. Rising interest rates, and the circumstances leading to that, are typically positive for credit spreads. Thus, unless interest rates increase too rapidly, credit spreads should tighten. ■ High beta sectors (i.e., Financials and Cyclicals) should outperform as they have more spread cushion to offset higher interest rates. We prefer lower quality positioning in HY.	■ The biggest risk to US IG is the possibility of wider credit spreads following massive fund outflows, should interest rates again rise rapidly. ■ HY has capacity to offset most initial interest rate increases now, but that would change if rates were to rise by more than a nominal amount. ■ We look for companies to add leverage to the detriment of bondholders – especially in the higher quality industrial segment.
Municipals *(Municipal Strategy Group)*	
■ Tax revs are improving. Housing recovery will be meaningful to local govts that have been stressed ■ Outflows from muni mutual funds continue to persist which has resulted in a dramatic steepening on the long end of the muni curve and kept muni ratios to Treasuries elevated. ■ Defaults and bankruptcies trended lower in 1Q2013. We expect this to continue.	■ Puerto Rico has a $2bn budget gap expected for FY2013, which ended 30 June. Gov. Padilla just signed a FY2014 budget that includes several tax measures. Recovery in the Commonwealth's economy remains a focus. ■ The City of Detroit, with $8.4bn total muni debt outstanding, filed for bankruptcy protection under Chapter 9 which has added stress to the muni market but is largely contained and viewed as idiosyncratic. ■ Possible changes to the tax exempt status of muni bonds.
Global FX *(David Woo, Alberto Ades)*	
■ Look for the USD to strengthen against G10 on worries around China, Europe and Fed tapering, with further downside to risky & commodity currencies. ■ Continue to expect EUR-USD lower, with an end-13 1.25 target; and we maintain our USD-JPY target to 105 for 2013 YE. ■ EMFX appreciation will only be gradual in near term as the markets continue to digest the Fed's tapering intentions. Recommend buying MXN and BRL and look to sell INR, TRY, SGD and MYR.	■ A surprise resolution to the European crisis provides further upside risk to our view, while a country exit would cause the euro to fall further. ■ USD-JPY has upside risk from the participation in yen selling from domestic investors in Japan or positive macro shocks in the US that would push up growth and yields. ■ Better US data could increase expectations of Fed tapering, sending EMFX lower.

Source: BofA Merrill Lynch Research Investment Committee

Global equity markets: views & risks

Table 8: Regional Equity Strategist views & associated risks

Views	Risks
Global Equities *(Michael Hartnett)*	
■ The MSCI All-Country World Index year-end target for 2013 is 400. ■ The breakout of equities from their long-run trading range, the rise in Treasury yields and the significant decline in gold prices suggest investors are discounting the beginning of a stronger economic recovery. ■ Bank stocks, Europe and Japan remain our favored picks to play the ongoing Great Rotation.	■ Downside risks: crash in bonds, relapse in US real estate, or an FX war spurred by recession fears. ■ Upside risks: policy stimulus works to create much stronger than expected growth in 2013.
United States *(Savita Subramanian)*	
■ 2013 year-end S&P 500 target is 1750, which is 16x our 2013 EPS of $109 and 15x our 2014 EPS of $115 ■ We recommend taking advantage of attractive valuations via four flavors of growth: 1) Dividend Growth; 2) Cyclical Growth; 3) Global Growth; and 4) Stable Growth (Quality). ■ Pro-cyclical sector preferences: OW Tech, Industrials & Energy, UW Utilities & Telecom.	■ No bottom in China growth, re-emergence of tail risks from Europe, global recession.
Europe *(John Bilton)*	
■ Europe is transitioning from being a passenger in the global recovery, to early signs of a self-sustaining bull market. Healing consumer and improving manufacturing sentiment in Europe combined with improving credit sentiment provides confirms a recovery in the economic growth in 2H13. ■ A modest earnings growth and a nominal re-rating will allow Eurostoxx 50 to reach 3100 on 12m view, DAX to 9200 and FTSE 100 to 7100. Offering 10-16% upside. ■ Themes: 1) Stocks exposed to domestic EU economies as they offer value and improving earnings trends 2) Avoid expensive GEM exposed stocks primarily consumer oriented.	■ EU austerity measures begin to dominate ECB's reflationary bias. ■ ECB's Asset Quality Review is a headwind for Eurozone Banks and holding investors to form a positive outlook for EU equities.
Japan *(Naoki Kamiyama)*	
■ Target level of TOPIX is 1,350 (next 12 months), which is 15.5x our FY03/15 EPS of ¥87. Our target and EPS estimate are based on currency forecast of 105. ■ The tax reform including consumption tax rate hike and other related changes is likely to be the next catalyst. ■ Positive for autos, trading house, telecom, and financials (ex. Banks); negative for bank, materials, and real estate under the current slow momentum.	■ US employment trend and Fed's communication to the market. ■ Further slow down in China.
Asia-Pac ex-Japan *(Nigel Tupper)*	
■ The Asia Pacific ex-Japan region rebounded 1.8% in July, but still underperformed MSCI AC World by 2.9%. This was the fifth consecutive month that the Asia Pacific ex-Japan region has underperformed. ■ With a PE of 10.8x and a PB of 1.6x, valuations in the Asia Pacific ex-Japan region remain attractive. Asia Pacific ex-Japan equities have historically returned 20% on average in the subsequent 12 months when the PE ratio has been at this level. ■ As the cycle improves, we recommend investors rotate away from expensive High Quality into inexpensive Risk, and from Defensive Yield to Cyclical Yield.	■ Asia Pacific ex-Japan equities have rallied 4.5% over the last 12 months. However, this rally has not been earnings-based, but rather has been a re-rating. We need to see an earnings recovery for us to be more comfortable with equities rallying further. ■ Seasonality studies have shown that equities struggle to provide positive absolute returns from May to October. This suggests that there may be more attractive entry points.
Emerging Markets *(Michael Hartnett)*	
■ We continue to view cheap and unloved Emerging Market equities as one of the best near-term contrarian trading opportunities. ■ EM continues to trade at a steep discount to DM. The relative 12 month forward P/E is 2.5 standard deviations below its 5 year average. ■ Our longer-term outlook on EM remains skewed to the bear case. The combination of weaker China growth and a stronger dollar are not the best combination for EM strength.	■ EM debt crash, social unrest, signs of rising inflation. ■ A further unwind in EM debt positions could force EM equity investors to sell their beloved consumer stocks, which have been big winners in recent years.

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%

* 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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Team Page

Research Investment Committee (RIC)

Alberto Ades +1 646 855 4044
GEM FI/FX Strategy, Economist
MLPF&S
alberto.ades@baml.com

John Bilton, CFA >> +44 20 7995 2392
European Investment Strategist
MLI (UK)
john.bilton@baml.com

Francisco Blanch +1 646 855 6212
Global Investment Strategist
MLPF&S
francisco.blanch@baml.com

Jill Carey +1 646 855 3327
Equity Strategist
MLPF&S
jill.carey@baml.com

Steven G. DeSanctis, CFA +1 646 855 5262
Small-Cap Strategist
MLPF&S
steven.desanctis@baml.com

Philip Fischer +1 646 743 1446
Municipal Research Strategist
MLPF&S
philip.j.fischer@baml.com

Christina Giannini, CFA +1 646 855 1444
Small-Cap Strategist
MLPF&S
christina.giannini@baml.com

Ethan S. Harris +1 646 855 3755
Global Economist
MLPF&S
ethan.harris@baml.com

Michael Hartnett +1 646 855 1508
Chief Investment Strategist
MLPF&S
michael.hartnett@baml.com

Naoki Kamiyama, CFA >> +81 3 6225 7643
Equity Strategist
Merrill Lynch (Japan)
naoki.kamiyama@baml.com

Martin Mauro +1 646 855 2998
Fixed Income Strategist
MLPF&S
martin.mauro@baml.com

Hans Mikkelsen +1 646 855 6468
Credit Strategist
MLPF&S
hans.mikkelsen@baml.com

Priya Misra +1 646 855 6467
Rates Strategist
MLPF&S
p.misra@baml.com

Ralf Preusser, CFA +44 20 7995 7331
Rates Strategist
MLI (UK)
ralf.preusser@baml.com

Evan Richardson +1 646 855 3466
Fixed Income Strategist
MLPF&S
evan.richardson@baml.com

Cheryl Rowan +1 646 855 3105
Portfolio Strategist
MLPF&S
cheryl.rowan@baml.com

Savita Subramanian +1 646 855 3878
Equity & Quant Strategist
MLPF&S
savita.subramanian@baml.com

Stephen Suttmeier, CFA, CMT +1 646 855 1888
Technical Research Analyst
MLPF&S
stephen.suttmeier@baml.com

Dan Suzuki, CFA +1 646 855 2827
Equity Strategist
MLPF&S
dan.suzuki@baml.com

Matthew Trapp, CFA +1 646 855 3084
Investment Strategist
MLPF&S
matthew.trapp@baml.com

Nigel Tupper >> + 852 2161 7887
Strategist
Merrill Lynch (Hong Kong)
nigel.tupper@baml.com

Mark Ulrich +1 646 855 5206
Portfolio Strategist
MLPF&S
mark.ulrich@baml.com

David Woo +1 646 855 5442
FX and Rates Strategist
MLPF&S
david.woo@baml.com

John Wraith +44 20 7996 0405
Rates Strategist
MLI (UK)
john.wraith@baml.com

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