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A repeat performance in 2014?

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US stocks poised for another good year

We expect further gains in the market in 2014, but equity market returns are unlikely to rival those of 2013. In the coming year, global cyclicals are likely to take over market leadership, with large cap stocks outpacing small caps, in our view. Europe is our favorite developed market.

Manage interest rate risk via barbells and ladders

Within bond market sectors, we favor municipals, fixed-to-floating preferreds, and, for investors who can accept credit risk, both high yield bonds and senior loan funds. We suggest managing interest rate risk through barbells and laddering.

Great Rotation likely continues in 2014

Michael Hartnett, chief investment strategist, gives an update on the Great Rotation from bonds to stocks. He believes the Great Rotation will continue in the US as housing/equity markets wealth has improved, bank lending is picking up and there is greater policy certainty. Europe's ability to join in depends on the ECB.

US on the road to energy independence

Technological advances in drilling for shale oil and gas, such as horizontal drilling and hydraulic fracturing, have led to a surge in the production of these commodities in the US. This is making the US significantly less reliant on expensive foreign oil and natural gas, reducing US cost of energy vs. the rest the world, and could eventually lead to the US being energy independent.

Click the image above to watch the video.

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2013 review

December's rally capped an exceptionally strong year for most major equity markets.

Within US markets, equities advanced 2.5% last month and 32.4% for the full year – the best annual performance since 1997.

Among size and style segments, small cap stocks outperformed large caps, while growth indices outperformed value. Small cap growth finished 2013 in the lead, posting a 42.7% gain for the year.

Among US sectors, Consumer Discretionary (+43.1%) was the best performing sector in 2013, followed by Health Care (+41.5%). The cyclical sectors of Industrials (+40.7%) and Financials (+35.6%) also outperformed the market. Telecom and Utilities – the bond proxies – were the worst performing sectors (+11.5% and +13.2%, respectively) despite their strong start to the year.

Within fixed income markets, rising yields pushed most sector returns into negative territory for the year. Among the few exceptions were high yield corporates (+7.4%) and two-year Treasuries (+0.3%).

In FX markets, the pound appreciated +1.7%, while the Yen came down by almost 19.0%. The dollar finished the year up 6.4%.

Within Commodities, the CRB Index declined by 5.0% in 2013. The price of gold continued to pull back in December, finishing the year down 28.0%.

Financial markets recap

Table 1: Total returns (%)

		As of 31 December 2013						
Asset class	2012	1mo	3mo	12mo	YTD	3yr[2]	5yr[2]	10yr[2]
Equity Indices (%, US dollar terms)								
S&P 500	16.0	2.5	10.5	32.4	32.4	16.2	17.9	7.4
NASDAQ Comp	17.5	2.9	11.1	40.1	40.1	17.7	22.9	8.6
FTSE 100	15.2	2.8	7.6	21.0	21.0	10.7	15.8	7.2
TOPIX	8.1	1.0	2.1	26.5	26.5	6.4	7.7	4.2
Hang Seng	27.7	-2.4	2.2	6.5	6.5	4.0	13.8	-
DJ Euro Stoxx 50	20.2	2.3	9.9	27.0	27.0	8.3	8.3	5.3
MSCI EAFE	17.9	1.5	5.7	23.3	23.3	8.7	13.0	7.4
MSCI Emerging Markets	18.6	-1.4	1.9	-2.3	-2.3	-1.7	15.1	11.5
Size & Style (%, US dollar terms)								
Russell 2000	16.3	2.0	8.7	38.8	38.8	15.7	20.1	9.1
S&P 500 Citigroup Growth	14.6	2.7	11.1	32.8	32.8	16.8	19.2	7.7
S&P 500 Citigroup Value	17.7	2.3	9.8	32.0	32.0	15.6	16.6	7.1
S&P 600 Citigroup Growth	14.6	1.3	10.1	42.7	42.7	19.2	22.7	11.2
S&P 600 Citigroup Value	18.2	1.6	9.6	40.0	40.0	17.7	20.1	10.0
S&P 500 Sectors (%, US dollar terms)								
Consumer Discretionary	23.9	2.3	10.8	43.1	43.1	23.5	27.7	9.4
Consumer Staples	10.8	0.6	8.7	26.1	26.1	16.8	15.9	10.0
Energy	4.6	3.1	8.4	25.1	25.1	11.1	13.4	13.4
Financials	28.8	2.2	10.3	35.6	35.6	13.2	13.8	-0.3
Health Care	17.9	0.8	10.1	41.5	41.5	23.4	18.3	8.3
Industrials	15.3	4.3	13.5	40.7	40.7	17.3	19.8	8.6
Information Technology	14.8	4.1	13.3	28.4	28.4	14.7	21.9	7.2
Materials	15.0	4.8	10.7	25.6	25.6	9.2	18.8	8.2
Telecom Services	18.3	-0.3	5.5	11.5	11.5	11.9	12.7	8.1
Utilities	1.3	0.9	2.8	13.2	13.2	11.2	10.2	9.2
BofA Merrill Lynch Global Research Bond Indices (%, US dollar terms)								
10-Year Treasury	4.2	-2.0	-2.5	-7.8	-7.8	4.0	1.8	4.6
2-Year Treasury	0.3	-0.1	0.1	0.3	0.3	0.7	1.1	2.6
TIPS	7.3	-1.5	-2.2	-9.4	-9.4	3.5	5.4	4.9
Municipals*	7.3	-0.4	0.4	-2.9	-2.9	5.0	6.3	4.5
US Corporate Bonds	10.4	-0.2	1.0	-1.5	-1.5	5.4	8.9	5.3
US High Yield Bonds	15.6	0.5	3.5	7.4	7.4	9.0	18.6	8.5
Emerging Market Corporate Bonds	15.8	0.3	1.8	-0.5	-0.5	6.2	13.2	7.0
Emerging Market Sovereign Bonds	17.5	0.6	1.7	-3.3	-3.3	6.3	10.5	8.0
Preferreds	13.6	-1.5	0.1	-1.5	-1.5	4.4	9.2	1.7
Foreign exchange (%, in local currencies)**								
US dollar	1.5	0.4	2.2	6.4	6.4	2.8	-0.3	-0.9
British pound	3.2	0.4	1.7	1.7	1.7	2.2	2.7	-1.5
Euro	0.9	1.1	2.2	6.8	6.8	1.4	-1.5	0.5
Yen	-11.0	-3.1	-7.1	-18.9	-18.9	-8.6	-3.4	-0.2
Commodities (%, US dollar terms)**								
CRB Index	-3.4	1.9	-1.9	-5.0	-5.0	-5.6	4.1	1.6
Gold	7.1	-3.8	-9.3	-28.0	-28.0	-5.3	6.4	11.2
WTI Crude Oil	-7.1	6.1	-3.8	7.2	7.2	2.5	17.2	11.7
Brent Crude Oil	3.5	1.0	2.2	-0.3	-0.3	5.4	19.4	13.9
Alternative Investments† (%, US dollar terms)								
Hedge Fund - CS Tremont[1]	7.7	1.3	4.2	10.0	8.4	5.4	8.4	6.4
Hedge Fund - HFRI Fund of Funds[1]	4.8	1.0	3.7	8.8	7.5	2.8	4.3	3.4

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

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The year 2013 was the best for US stocks since 1997, and was a pretty good year for developed market equities in general. Europe, Japan and the US all posted price returns of between 20% and 30% in 2013. In contrast, US bonds, as measured by our composite index, showed a 2.2% loss, the worst performance since 1994. Will the same strategies that worked well in 2013 repeat their gains in 2014? For some we say yes, and for some we say no.

Positive returns again from US stocks

In 2013, the S&P 500 posted a price return of 29.6%, the market's best year since the 31.0% return in 1997. Clearly, the monthly liquidity infusion from the Federal Reserve that totaled roughly $1 trillion was responsible for a lot of the good feeling surrounding US stocks. The market also was fueled by renewed growth in revenues, accelerating from the negative/flat year-over-year sales growth at the end of 2012 to +4% at the end of 3Q 2013. All 10 market sectors posted positive returns in 2013, and all are showing positive sales growth (y-y) for the first time in over a year.

Stock market returns should be positive in 2014, but less so than in 2013.

We are not looking for equities to match 2013 returns, but still expect a fairly robust performance from US stocks in the year ahead. Savita Subramanian, our US equity strategist, has a 2014 year-end price target for the S&P 500 of 2000, which implies a price return of about 9% from current levels. The US economy should continue to show improvement in 2014, as our US economics team expects GDP growth of 3.0% in 2014 vs 1.9% in 2013. We expect continued strength in revenues as the US economy improves, and that gives us confidence that earnings, now growing at around +5% y-y, will be favorable. Also, our currency strategists expect the dollar to strengthen in 2014. That suggests that capital will be drawn to US equities, although higher interest rates are likely to offer competition for the marginal investment dollar.

Leadership shift to global cyclicals

Within US equities, the best sectors were Consumer Discretionary, Health Care, and Industrials (see Table 2).

Industrials should perform well again.

Table 2: S&P 500 sector performance in 2013

S&P 500 Sectors	2013 Total Return
Consumer Discretionary	43.1%
Health Care	41.5%
Industrials	40.7%
Financials	35.6%
Information Technology	28.4%
Consumer Staples	26.1%
Materials	25.6%
Energy	25.1%
Utilities	13.2%
Telecommunication Services	11.5%

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

Within these three sectors, we have the most confidence that Industrials will repeat their stellar performance of 2013. Industrials should benefit from improvement in economic growth in the US and elsewhere. Housing and infrastructure development should be strong in 2014. US manufacturing is expected to be globally competitive, and the sector has a high level of exposure to an improving Europe.

We are not so confident that either Health Care or Consumer Discretionary will have such high returns in 2014. Health Care was a beneficiary of strong performance from Biotechnology, where there were a large number of important product announcements, along with robust merger activity – that is not likely to continue at its torrid pace. Consumer Discretionary benefited from Internet Retailers and Auto Parts, both having 60+% returns in 2013. The sector has had two consecutive years as one of the two best performing market sectors. In our view, while autos should stay strong, consumers are likely to save more, and spend more selectively. Also, many industries here are adversely impacted by rising interest rates.

Shift from small caps to mid caps

Small caps outperformed large caps in 2013, with the Russell 2000 up 37%, as ample liquidity and a pickup in merger activity boosted returns in this segment. As the Fed pumps less money into markets in 2014 and interest rates rise, merger activity will probably slow a bit. Global market returns are likely to rival those in the US as Europe and many emerging markets economies improve – setting the stage for outperformance by large cap global players rather than domestically oriented small caps.

Midcaps should outperform small caps.

Investors may want to move small cap exposure into mid caps that have more global exposure and less earnings volatility than small cap stocks. Mid caps also had an exceptional year in 2013 – up 32.7% – that is not likely to be repeated, but we believe they are likely to hold up better than small caps.

Europe and Japan are both favored regions

Regional equity performance in 2013 (price returns in US dollars) was as follows:

Table 3: Regional performance in 2013

Region	2013 Price Return
US	29.6%
Japan	24.9%
Europe	21.7%
Canada	3.3%
Asia Pacific ex. Japan	0.5%
Emerging Markets	-5.0%

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

We expect both the US and Japanese equity markets to have favorable performance again in 2014, although probably not rivaling 2013 returns. The Japanese equity market had solid returns each quarter throughout the year, particularly in 1Q as the country embarked on the quantitative and qualitative monetary easing and fiscal policy changes associated with the prime minister's goal to stimulate growth and investment, referred to as Abenomics. In 2014, we expect structural changes designed to augment the cyclical recovery in place in Japan, such as deregulation across a variety of industries and changes to investment policy among large pension funds. These should be favorable for equities, encouraging more comfort with stocks among the investing population. As the market gradually adjusts, we expect returns to be good, but they may lack the inflection point spark that characterized 2013.

We like both Europe and Japan.

European markets had very respectable returns in 2013 that may be repeated. Europe is poised to benefit from many of the structural changes implemented in 2013 that should help grow economies and heal the banking sector, in our view. Stabilizing credit trends, recovery in earnings and enhanced fund flows into European equities all should help extend the recovery through 2014, making Europe one of our favorite investment areas for the year.

After an abysmal 2013 for many emerging markets, we expect returns in EM to improve a bit along with better global growth, although they are likely to lag developed markets once again. Significant challenges remain for much of EM, particularly those countries with higher debt levels, as interest rates are likely to rise along with higher US rates – hindering earnings growth. A stronger US dollar and shrinking current account deficit in the US are likely to attract capital there, leaving a lower supply of more "expensive" dollars to support growth and repay debt within emerging markets economies. Many EM countries have experienced credit booms, with years of protracted borrowing by the consumer or corporate sectors. Associated narrowing current account surpluses, appreciating currencies and rising labor costs increase the financial vulnerability of these markets, particularly in an environment of rising rates.

Bonds will still lag but rate risk should be easier to manage

Bond returns should again trail stocks, but the risk/reward balance has improved.

In contrast to the stellar performance of stocks, bonds suffered losses in 2013, as Table 4 shows. Our broad US bond market index showed a 2.2% drop in total return. High yield stood as an exception with a +7.4% total return for the year. Emerging market sovereign market bonds, both local currency and dollar-denominated dropped nearly 6%.

Table 4:Bond market returns 2013

US Inv Grade Market	-2.2%
3-month Treasury bill	0.1%
Treasuries	-3.3%
2 Year	0.3%
10 Year	-7.8%
30 Year	-15.1%
TIPS	-9.4%
Mortgage Backed	-1.4%
IG Corps	-1.5%
HY Corps	7.4%
Senior Loans	2.4%
Preferreds	
Fixed Rate	-1.6%
Adjustable Rate	-7.9%
EM Sovereign	
$ denominated	-5.8%
Local currency	-5.7%
EM Corporate, $	-0.5%
IG Munis	-2.9%
HY Munis	-6.2%

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

We think that bonds will again fall short of stocks in 2014, and that some of the performance of 2013 will repeat. As in 2013, activities of the Fed should be a dominant influence on bonds.

- The reduction and eventual elimination of asset purchases should push yields higher, especially for Treasuries. We expect the yield on the 10-year Treasury to finish 2014 at 3.75%, up from 2.83% today.
- The Fed's plan to keep the funds rate near zero until "well past" when the unemployment rate falls below 6.5% indicates that the 3-month LIBOR rate and money market rates will remain near zero as well. Ethan Harris, chief North American economist, expects the federal funds rate to remain near zero until early 2016.

Because of the ongoing influence of the end of Fed purchases, we expect that long duration, especially long-term Treasuries will again show losses. High yield, the sector with the highest correlation to the stock market, will again be the best performing sector of the bond market, in our opinion, but even here the gains are likely to be small.

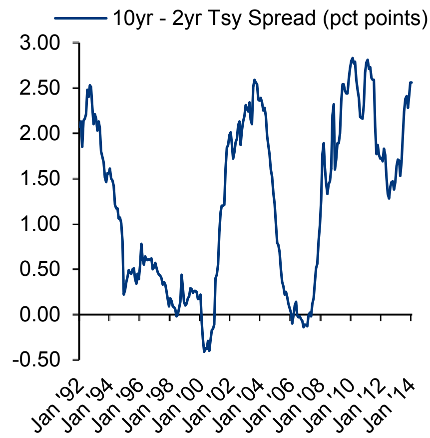
What has changed

The biggest difference between now and a year ago is where the market is: yields are higher, the yield curve is steeper, and we are further along in the interest rate cycle. Investors need to put the present and expected interest rate rise in some perspective.

Much of the damage has already been done

We may be about halfway through the rise in bond yields. The yield on the 10-year Treasury has climbed from its low of 1.4% in July 2012 to 2.83% now. Priya Misra, our US rates strategist, forecasts a yield of 3.75% for the end of this year and 4.25% for the end of next year. Beyond then, yields are not likely to rise substantially unless inflation heats up, which we do not expect.

Chart 1: Historically steep yield curve

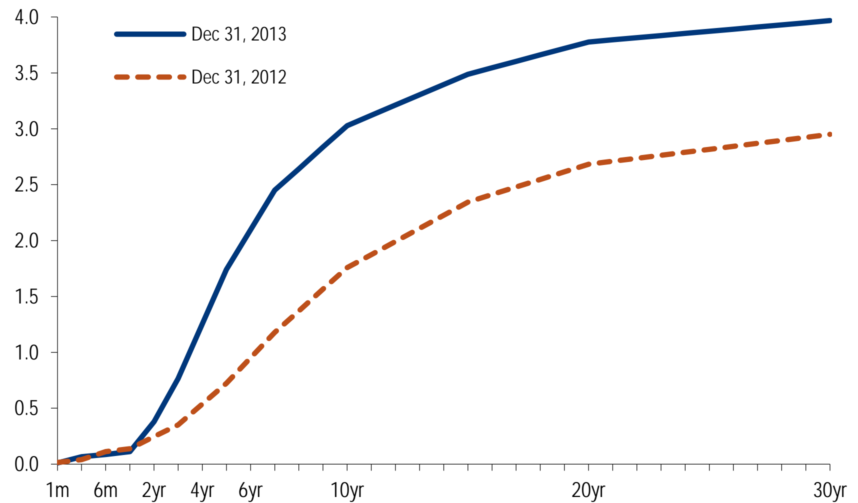


Source: Federal Reserve Board, BofA Merrill Lynch Global Research

Better reward for extending maturity

Yields on maturities of five years and longer rose by more than a full percentage point during 2013, while yields for maturities of one year and less declined slightly. Chart 2 compares the Treasury yield curve at the end of 2012 and the end of 2013. Reflecting the steepening in the yield curve, the spread between yields on 2- and 10-year Treasuries (Chart 1) is about as steep as it has ever been.

Chart 2: Rising Treasury yields



Source: BofA Merrill Lynch Global Research, Bloomberg

The rise in yields and steepening in the yield curve mean that investors get a better reward for the interest rate risk than before. The steepening in the curve also brings a greater potential to benefit from "rolling down the yield curve" – that is, taking advantage of the decline in yields that occurs with the shortening in maturity as time passes.

For example, a year from now, today's 10-year Treasury will have nine years remaining to maturity. The present yield on a 9-year Treasury is about 0.10 percentage points below the 10-year yield. That yield decline from the one year shortening in maturity could offset as much as a 0.48 percentage point rise in the 9-year yield a year from now.

Build ladders and barbells.

Manage interest rate risk with portfolio laddering and barbells

In our view, interest rate risk can be managed through portfolio laddering – combing different maturities, such as 1, 5 and 10 years, and as each leg of the ladder matures, re-investing in the longer leg. We would extend the ladder out to 10 years in the taxable market and 15 years in the municipal market. Another alternative is a barbell, which is combining a short- and long-term maturity. Both approaches enable reinvestment of maturing proceeds at what will be higher yields, based upon our interest rate forecast. Within bond market sectors, we favor municipals, fixed-to-floating preferreds, and, for investors who can accept credit risk, both high yield bonds and senior loan funds.

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Guest column

The case for more Great Rotation in 2014 is strong; But Europe's ability to join the shift to equities before next year remains highly dependent on the ECB.

In the aftermath of the financial crisis, equities were shunned. But 2013 was the year policymakers were winning the war against deflation, bonds declined in popularity and the Dow Jones Industrial Average passed 16,000.

Underpinning this growing movement out of fixed income into equities – which we first dubbed The Great Rotation in October 2012 – have been recoveries in real estate, in bank lending and renewed confidence in mid caps and small businesses. Fed tapering is a vote of confidence in the US economy. It will incite further the Great Rotation. This asset shift is part of a five-year story that kicked into gear in the autumn of 2011.

In the wake of the financial crash of 2008, we saw the culmination of the greatest bear market since the Wall Street crash. Equities had fallen 54% from the peaks of August 2000 to the nadir of February 2009. In contrast, bonds were on a long-term bull run. Between 2009 and 2011, bonds were the only game in town. The game changer arrived in late 2011 with the first evidence of a recovery in US real estate.

This first recovery in US real estate was an important symbol because it meant the unprecedented stimulus of zero rates and quantitative easing was working. It was the start of a shift from the new normal back to the old normal. But when the market finally woke up in 2013 to find a stealth bull market in equities had started, few believed it had the legs to go the distance.

Now, the Great Rotation is far from invisible. Last year was the year that the 30-year bull market in bonds ended and a secular recovery in stocks began. By December, global stocks were up 19.5% on an annualized basis while bonds were down 1.7%, and commodities were down 3.7%.

According to our December *Fund Manager Survey*, everyone is bullish about equities over bonds. The spread between investors overweight in equities and those overweight bonds stood at 118 percentage points in December, compared with 76 points one year ago and just 19 points in July 2012. That said, cash levels are still very high, and years of bond allocation cannot be undone in just a few months.

But clearly, investors are happy to embrace risk. And in other markets, this too has become evident: developed markets have outperformed emerging markets; small caps have prevailed over large caps; real estate has outperformed commodities; the dollar has triumphed over gold; and banks have prevailed over both defensive stocks and technology.

We are convinced this process is incomplete and will continue to play out in 2014 and beyond. In the US, we are forecasting growth of 3% or more, which is generally in line with consensus. This is for three reasons: First, the housing market and the equity market are boosting wealth and consumer confidence. Second, there is dramatically less fiscal austerity as well as greater policy certainty. And third, there is less banking austerity, meaning lending is picking up. Bank of America Merrill Lynch's own lending to large corporations appears to be accelerating well into double-digit growth, while lending to small businesses is now positive, year-on-year, for the first time since May 2008.

Further afield

Beyond the US, we believe that Japan is best placed to be the next beneficiary. There is currently $20 billion of capital sitting in cash and liquid assets in Japan that could be reallocated to risk assets. This process of reallocation is now official Japanese government policy. The $2 trillion Government Pension Investment Fund recently announced that it would shift its asset allocation, from 60% allocation to bonds towards riskier assets.

We see this as a key moment for Japan – the start of a new period of Japanese capital outflow. Over several years, this will be negative for the yen but bullish for Japanese stocks.

The ability of Europe to join the rotation before 2015 remains highly dependent on the European Central Bank. We know the actions of the Federal Reserve and the Bank of Japan have been very supportive of asset prices, but the strength of the euro shows that right now investors believe the ECB is not supporting asset prices in the same way.

What could throw the Great Rotation off course? For at least a time, the market will worry that we could see a short-circuit as in 1994 when the Fed dramatically tightened policy.

A second big question is bubble risk. It would be surprising if a world awash with liquidity did not produce localized areas of exuberance. But our indicators do not yet show that an intermediate high is just around the corner. Bank of America Merrill Lynch's Bull & Bear Index is currently reading 6.2, well below its sell threshold of 8.0.

Our Fund Manager Survey says that average portfolio cash balances are 4.5%, well above the overbought threshold of close to 3.5%.

Looking at our forecasts for 2014, we see the S&P 500 hitting 2000, while benchmark 10-year US Treasuries will rise to 3.75%. In 12 months from now, we expect returns of 12% on the S&P 500 but down 7% on 10-year Treasuries.

Put simply, 2014 looks set to be another year of greater rotation where equities – in the absence of higher than expected inflation or lower than expected corporate earnings – can outperform bonds. Albeit less dramatically.

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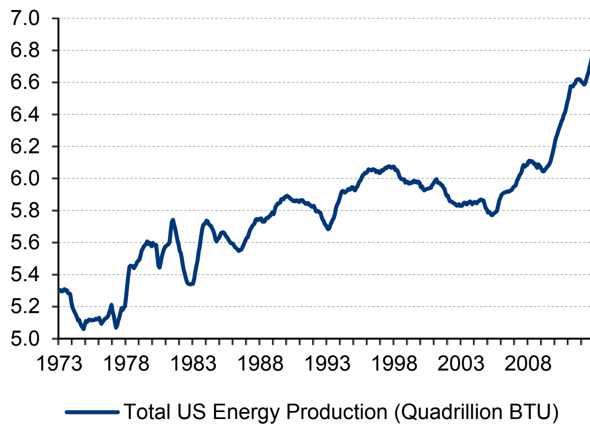
The road to energy independence

Technological advances in drilling for shale oil and gas, such as horizontal drilling and hydraulic fracturing, have led to a surge in the production of these commodities in the US. This is making the US significantly less reliant on expensive foreign oil and natural gas, reducing US cost of energy vs the rest the world, and could eventually lead to the US being energy independent.

US energy production sharply higher

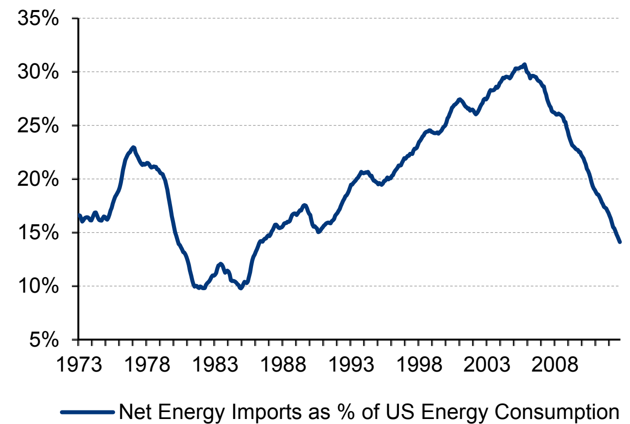
Total US energy production, which had virtually no growth from 1990 through 2007, grew 13% from 2008 to September 2013 (Chart 3). This domestic production growth has resulted in a significant decline in net energy imports, which fell 54% over the same period. Net energy imports as a percent of total energy consumption also dropped significantly, currently at 14.1%, down from 25% at the end of 2007 (Chart 4).

Chart 3: Total US Energy Production (Quadrillion BTU)



Source: BofA Merrill Lynch Global Research

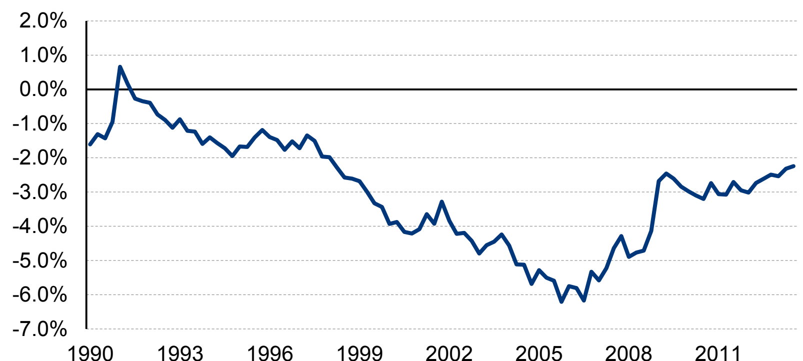
Chart 4: Net Energy Imports as % of US Energy Consumption



Source: BofA Merrill Lynch Global Research

The reduction in energy imports is helping reduce the US current account deficit to levels not seen since the 1990s. The current account deficit is -2.2% of GDP, which is a significant improvement from trough levels of -6.6% (Chart 5). A lower current account deficit should be bullish for the US dollar, according to David Woo, our FX and Rates Strategist.

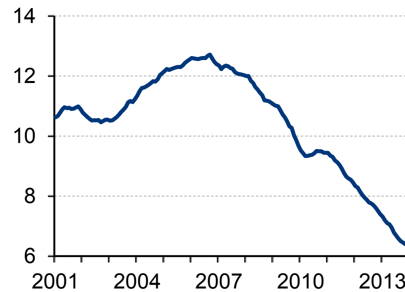
Chart 5: US current account balance as % of GDP



Source: BofA Merrill Lynch Global Research

The US Energy Information Agency (EIA) forecasts US total energy production to expand from 79.1 quadrillion BTUs at the end of 2012 to 102.1 quadrillion BTUs by 2040. In addition, net imports as a percent of total production should continue to decline, falling to only 4% of consumption by 2040, according to the EIA.

Chart 6: US petroleum net imports (million b/d)

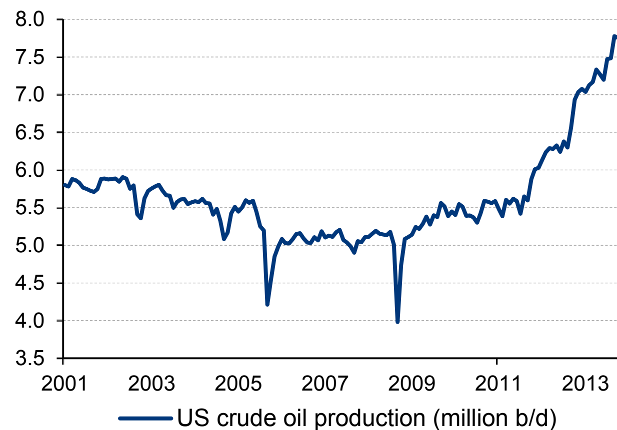


Source: EIA; BofA Merrill Lynch Global Research

Much of the forecasted growth in total energy production is due to continued growth in both shale gas and oil production. Efficiency gains in shale oil drilling have helped increase US crude oil production by almost 1 million barrels/day in 2013, and should add another 750-800 thousand b/d in 2014, according to our global commodity team. Oil production in the US has increased 51% since the end of 2007 (Chart 7). This is causing a significant reduction in net petroleum imports in the US, falling from its 12-month moving average peak of 12.7 million b/d in 2006 to 6.4 million b/d in November 2013, a 50% reduction (Chart 6).

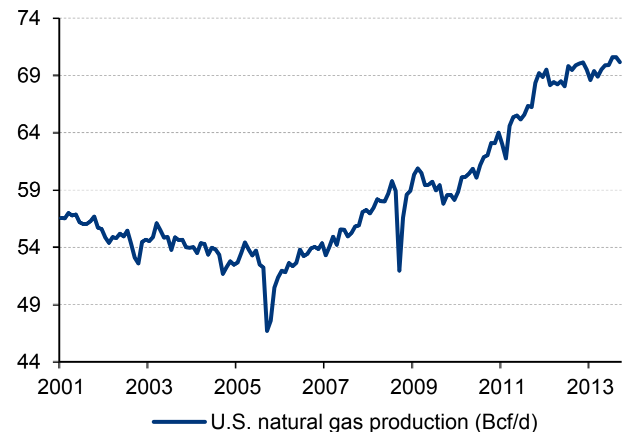
Natural gas production in the US increased by 36% from 2005 to September 2013, largely due to higher shale gas production (Chart 8). Total US dry natural gas production is projected to increase by 56% between 2012 and 2040, according to the EIA. With the continued increase in production, the US will be a net exporter of natural gas as soon as 2018, according to the EIA.

Chart 7: US crude oil production (million b/d)



Source: EIA; BofA Merrill Lynch Global Research

Chart 8: US natural gas production (Bcf/d)



Source: EIA; BofA Merrill Lynch Global Research

Increased energy production has broad economic benefits

David Woo has identified three ways the increase in energy production has boosted US GDP. First, the direct contribution to GDP growth from oil & gas extraction was 0.2% to 0.3% in 2012, according to his rough estimate.

In addition, David estimates the indirect effect from increased job growth in the energy sector could have added another 0.2% to GDP growth in 2012. There has been 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 formed.

Finally, the impact of lower natural gas prices for US consumers could be the most important part of the energy boom. The increased supply of natural gas has resulted in significantly cheaper prices in the US than in other countries, and our commodities team believes this pricing gap is unlikely to shrink. We see a similar structural discount with oil prices, as WTI crude oil at $92 trades at a significant markdown to Brent crude, at $107.

The result is that US consumers are paying less for energy and can use the savings to spend elsewhere. For energy-intensive manufacturers, the lower cost of energy is a game-changer for US competitiveness with Europe, Japan, and China. Price Waterhouse estimates that lower energy prices could boost US factory employment by over 1 million people over the next 10 years.

Industries that benefit from the continued increase in US energy production include: domestic refiners and leading oil & gas producers, Consumer Discretionary and Staples, oil services firms with a domestic focus, US ethylene & nitrogen fertilizer producers

Beneficiaries expand beyond energy stocks

US Equity Strategist Savita Subramanian has identified several industries that benefit from the continued increase in US energy production.

- **Domestic refiners and leading domestic oil & gas producers** – even though rising supply is set to keep US domestic energy prices contained, the volume pick-up as domestic production replaces higher-cost foreign energy is likely to benefit leading producers of non-conventional domestic energy. Large domestic refiners that are able to capture the benefit of lower feedstock prices should also benefit.
- **Consumer Discretionary and Consumer Staples** – US consumers have more disposable income as a result of lower energy prices; even if global energy prices rise as the world economy improves, the relative purchasing power of US consumers should benefit from lower domestic prices.
- **Oil services firms with a domestic focus** – as production volumes increase, US rig and well counts should rise, and oil services firms with a large domestic footprint may have scope to boost earnings.
- **US ethylene and nitrogen fertilizer producers** – the US basic chemicals industry generally is a direct beneficiary of lower gas prices as it uses natural gas and natural gas liquids as feedstocks to a much greater extent than its Asian and European peers who rely on crude oil based feedstocks; ethylene producers as well as some nitrogen fertilizer producers are the most direct beneficiaries of this falling input cost in the chemicals sector.

RIC themes for 2014

Here are the themes for 2014 that the RIC introduced in the Year Ahead RIC report in December.

Table 5: RIC themes for 2014

Theme	Rationale	Idea
1. Be an owner, not a lender	Fed tapering with accompanying higher interest rates, an improving US economy, and healthy earnings and sales growth all favor stocks over bonds.	Buy US equities, particularly large caps with reasonable earnings and dividends growth. Consider closed-end equity funds that trade at a discount.
2. Cash is trash, but high yield is not junk	High yield bonds and senior loans will be among the best performing sectors of the bond market in 2014, in our view, while returns on money market funds and other short-term assets should remain near zero until early 2016.	Reinvest cash not needed for liquidity purposes. Invest in high yield bonds and senior loans funds (not recommended for conservative investors).
3. Pick stocks, not markets	Falling correlations among individual equities suggest divergent returns and an environment that favors stock selection over indexing.	Add actively managed funds; employ specific stock selection methodologies.
4. Bigger is better	Small caps have outperformed large caps in 2013, but are now expensive and not expected to outperform large when global growth accelerates.	Evaluate allocation to small caps in relation to portfolio. Within the small cap space, we prefer larger market caps, higher quality, and Industrials over Consumer.
5. Look after tax, not before tax	For most investors, even those not in the top tax brackets, yields on municipal bonds are higher than the after-tax yield on other bonds.	Ladder municipals in maturities out to 15 years in a diversified portfolio. Avoid long-duration funds or leveraged muni closed end funds.
6. Warehouses over townhouses	We may be in the early stages of an equity market leadership shift away from consumer-related sectors and toward industrials and global cyclicals.	Look for stocks or ETFs in areas of the market such as Industrials, Energy, Technology, and Materials.
7. Ride the curve	We recommend some exposure to intermediate-term maturities, primarily through portfolio laddering, even though we expect yields to rise.	Ladder maturities from one to 10 years in the taxable market and one to 15 years in munis.
8. Find the next Google	In our view, some of the best equity themes can be found among innovative companies that benefit from their investments in technology.	Add innovation theme-based stocks to equity portfolios. Look for theme-based managed products.
9. Look across the pond	European recovery is only just beginning, in our view, and the region is poised for a longer and more sustainable rally in the equity market in 2014.	Add European stocks, ETFs to portfolios. Add exposure to US Industrials, which have the highest correlation to the Euro Stoxx index.
10. Don't get real	We expect a modest decline in a broad array of commodity prices in 2014, caused by Fed tapering, higher US rates, a stronger dollar, slowing economic growth in China, and oversupply.	Underweight commodities and commodity funds. Emphasize metals like palladium, platinum, if possible.

Source: BofA Merrill Lynch Global Research

RIC asset class views

Table 6: Research Investment Committee asset class views

Asset Class	RIC view (+ / = / –)	Comments
Equity markets		
US equities	+	Revenue growth better - should support earnings. Low but rising rates, low inflation & improving economy sweet spot for stocks.
Consumer Discretionary	–	Rising rates favor saving over spending and may slow down housing recovery; expensive by all measures.
Consumer Staples	=	Best defensive sector with high quality, good yield and div growth plus higher non-US exposure; look for unexploited stocks.
Energy	+	Beneficiary of global growth and US energy independence; very under-owned by investors; risk is lower oil prices.
Financials	=	Easy returns are likely over, but should benefit from US economic and housing recoveries; balance sheets improved.
Healthcare	=	HC reform favors hospitals, managed care, PBMs; pharma best yield play; biotechs are merger beneficiaries.
Industrials	+	Benefits from cyclical recovery, especially Europe. Capex trends getting better. US manufacturing well positioned.
Info Technology	+	Beneficiary of improving cyclical and secular growth trends; cash return strategies, non-US exposure are positives.
Materials	=	Benefits from improving global growth; risk of lower commodity prices as inflation remains low and US dollar strengthens.
Telecom	–	Best dividend yield sector, but not much room for dividend growth as payout ratios high; worst risk/reward trade-off.
Utilities	–	High payout ratios and low EPS growth keep us UW; dividend yields still above Treasuries, but rising rates narrow that gap.
Growth	+	Slow earnings growth recovery, low inflation favor growth stocks; has lower valuation and better dividend growth than value.
Value	=	Indices exposed to Financials and other interest sensitive sectors; focus on opportunities in Energy, Industrials and Tech.
Small cap	–	Absolute and relative valuations at extreme levels, earnings estimates likely to fall; suggest investors move up in market cap.
Large cap	+	Beneficiaries of fund flows into US equities/ETFs; expect further P/E expansion; like cyclical growth and dividend growers.
Europe (ex. UK)	+	Expect 10-15% total return and strong 2H14 as earnings recover, credit stabilizes and asset allocators seek relative value.
United Kingdom	=	Manufacturing sector, fiscal outlooks improving. Defensive market that should outperform if 1H 2014 pullback materializes.
Japan	+	Opening of savings accounts shifts funds into equities; more BoJ easing probable; corporates focused on high ROE, capex.
Asia Pac (ex. Japan)	–	Stronger US dollar and shrinking US current acct deficit creates challenges; emphasis on Asian SOEs, Korean semis/autos.
Emerging markets	=	Flat to neg. returns possible, but tactical opportunities. Avoid expensive high-growth names; favor China, Korea, Russia, Brazil.
Fixed income markets		
Treasuries	–	Yields are likely to rise in 2014, mostly in the five year and longer range.
Agencies / MBS	–	Fed tapering and policy risks argue for a defensive positioning for now.
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	+	Duration is lower than in other sectors, spreads are likely to narrow.
Preferred securities	–	Yields are attractive, but be mindful of duration risk.
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	–	Higher interest rates, a stronger $ and weaker commodity prices could push price to $1,100/oz in 2014.
Oil	–	Increases in production should keep prices soft.
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 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 Strategist views & associated risks

Views	Risks
Global Economics *(Ethan Harris, Alberto Ades)*	
■ US growth is likely to strengthen in 2014 while the Fed tapers slowly. ■ The largest developed economies are likely to expand at above-trend pace. ■ EM is likely to benefit from stronger global growth and accommodative DM policy.	■ Downside risks: US political gridlock and housing slowdown, weak Chinese growth and political instability in the European periphery. ■ Upside risks: stronger US labor market recovery, faster EM growth.
Global Rates *(Priya Misra, Ralf Preusser, John Wraith)*	
■ US: We maintain our bearish bias on rates given better growth and lower downside risks to the economy in 2014. Demand from the traditional sources for the belly of the UST curve is also fading. The market has already priced in a strengthening of forward guidance, in our view, and any further room for appreciation in the 5y part of the curve is limited. We recommend 5s-30s flatteners.	■ US: An unexpected growth shock in 2014 either due to tighter financial conditions or other factors is a risk to much lower rates as the market is biased short. Our latest client survey indicates that very few investors expect 10y rates below 2.4%.
■ Europe: Into 2014, Fed tapering should warrant a slow rise in yields, while an accommodative ECB will keep curves steep. The periphery will perform well as a carry trades as long as deflation does not become entrenched.	■ Europe: Following the ECB refi rate cut, upside risks to the front-end have become more limited. Should inflation continue to surprise to the downside, there could be a deposit rate cut, which would trigger an aggressive rally in EUR rates and spreads.
■ UK: The Bank of England's decision to end Funding for Lending support for mortgage lending shows a determination to keep the UK economic recovery steady and stable, and to keep short rates very low. We still expect the yield curve to bear steepen into the New Year as a result.	■ UK: economic data is still printing with surprising strength. This will keep the ability of the MPC to enforce guidance effectively under close scrutiny.
Global Commodities *(Francisco Blanch)*	
■ We hold a moderately negative stance on commodity prices in 2014 as a strong trade-weighted USD and sluggish nominal GDP growth will likely cap the upside to dollar-denominated commodity prices. ■ Many commodity markets are moving from a relatively balanced to a slightly oversupplied market this year, particularly oil, US natural gas and copper, in our view. ■ Gold prices continue to be challenged by rising interest rates and a stronger USD. We see gold averaging $1,150/oz in 2014, but expect prices to bottom later this year as concerns of unexpected inflation attract some buyers.	■ The potential return of Libyan and Iranian oil could significantly exacerbate surpluses, triggering additional downside in oil prices. ■ Extreme weather has depleted US nat gas inventories. We see US Henry Hub prices trading between $4-4.40/MMBtu this winter, but expect prices to ease off again in 2Q. ■ A reacceleration of global growth is not bearish industrial metals, but upside may be limited on persistent EM headwinds. Supply-constrained commodities like zinc and platinum could outperform.
Global Credit *(Michael Contopoulos, Hans Mikkelsen)*	
■ Longer-term outlook for corporate credit spreads remains positive. We remain overweight high grade and high yield corporate spreads relative to governments, and favor US HY and European IG over US IG.	■ The biggest risk to US IG is the possibility of wider credit spreads following fund outflows and institutional repositioning, should interest rates rise rapidly again.
■ Short term macro risks, such as China and the US fiscal situation, have faded. Rising interest rates, and the circumstances leading to that, are typically positive for credit spreads. However, we believe interest rates will increase too rapidly at times and lead to periods of wider credit spreads.	■ In HY, we caution investors away from high duration risk heading into January and the possibility of rate volatility associated with tapering, but view any weakness as a buying opportunity given improving fundamentals.
■ High beta sectors (ie, Financials and Cyclicals) should outperform, as they have more spread cushion to offset higher interest rates. We prefer lower quality positioning in HY and over the next three months would look to add risk in the 3-6y part of the curve.	■ HY has capacity to offset some further interest rate increases, but that would change if rates rise by more than a nominal amount and very quickly. ■ We look for companies to add leverage to the detriment of bondholders, especially in the higher quality industrial segment.
Municipals *(Municipal Strategy Group)*	
■ While the headlines have gone to troubled credits like Detroit and Chicago, the credit quality of the muni sector remains very high. Moody's has removed its negative outlook for states and local governments and is now neutral. State tax revenues are now increasing rapidly as the economy grows faster. ■ The decision in the Detroit bankruptcy case to the effect that state law cannot protect labor contracts in bankruptcy should lead to fewer bankruptcy filings as debtors are incented to negotiate outside of court. ■Issuance in the muni market should remain at about $330bn/yr as both new money and refundings remain low. The net new issuance should be around -30 bn.	■ Rising interest rates pose a challenge for investment strategies. Higher yields offer the opportunity to lock in tax exempt yields of 100% of treasuries or more. ■ We view the risk of tax reform as remote, but expect a continuing discussion about it in Washington. ■ Muni defaults in 2014 should continue to decline as tax income increases at both the state and local level.
Global FX *(David Woo, Alberto Ades)*	
■ Look for the USD to strengthen against G10 on eventual Fed tapering, US energy discoveries, and chronic European weakness, with further downside to risky and commodity currencies.	■ A downside surprise to US inflation, which has already been persistently low, would push off Fed tapering, lowering USD in the process.
■ We continue to expect EUR-USD lower medium term, with an end 2014 target of 1.25. We maintain our USD-JPY target to 108 for year-end 2014.	■ USD-JPY has upside risk from domestic investors selling yen in Japan or positive macro shocks in the US that would increase growth and yields.
■ Tapering expectations could continue to dominate EM in the near term. However, we think MXN and KRW could outperform.	■ Although we do not expect the selloff to be as violent as in May, if US data comes in stronger than expected, that is the main risk.

Source: BofA Merrill Lynch Research Investment Committee

Global equity markets: views & risks

Table 8: Regional Strategist views & associated risks

Views	Risks
Global Equities *(Michael Hartnett)*	
■ The MSCI All-Country World Index year-end 2014 target is 444. We are bullish growth, bullish stocks, bullish the US dollar, and bearish rates. ■ The investment regime will change from High Liquidity & Low Growth to Higher Growth & Lower Liquidity. ■ The Macro Trade is US GDP surprising to the upside. This supports long US banks/short US treasuries; and long US tech/short EM energy. ■ The Liquidity Trade is Japan's "Great Rotation" policy & the Fed's taper. This supports Japanese equities (particularly banks & small cap) and short the front end of the US curve. ■ The Contrarian Trade will likely be EM, but wait for "humiliation" via credit rating downgrades & bond distress before going long.	■ Risk of a correction in the first half is growing. Markets enter '14 with more greed than fear, and the end of QE should lead to volatility. ■ The Bull Case for risk assets is that policy uncertainty continues to fade, bank lending causes sales growth to beat expectations, and investor & corporate cash is put to use. ■ The Bear Case for risk assets is that policy makers fall behind-the-curve as inflation accelerates, EPS growth falls as cheap financing costs vanish, and investors come to the realization that we are coming close to the third longest bull market in the last 90 years.
United States *(Savita Subramanian)*	
■ 2014 year-end S&P 500 target is 2000, which is 17x our 2014 EPS of $118. ■ In the short-term, as global growth improves and interest rates rise, we prefer half-growth/half-yield stocks, self-help stories, multinationals, and GDP-sensitive stocks. For the longer term, we recommend investors "do the opposite" of what worked for the last 30 years and buy large, high quality cash-rich US stocks. ■ Sector preferences: OW Tech, Industrials & Energy. UW Utilities, Telecom Services & Cons. Disc.	■ Corporations continue to hoard their cash, no bottom in China growth, reemergence of tail risks from Europe, US economic growth does not reaccelerate, global recession.
Europe *(John Bilton)*	
■ We see 10-15% total returns from European indices in 2014 with a FY14 target on SX5E of 3400; we anticipate a period of consolidation in 1H14 before re-acceleration in 2H14. ■ Our target is driven entirely from EPS growth, and we see little scope for further rerating in 2014. EPS growth of 12% is driven largely from operating leverage as EU margins recover. ■ We believe three themes dominate in 2014 – cash return/dividend growth, operating leverage, and macro stabilization. ■ European Strategic sector preferences: OW Pharma, Energy, Telcos, Banks, Aerospace, Food Retail; UW Staples, Chems, PHH, Tech.	Downside risks ■ Further euro area disinflation (especially HICP <1%). ■ Failure of ECB to address balance sheet shrinkage. ■ Turbulence in funding/repo mkts as further debate LTRO intensifies. ■ AQR prompting an acceleration in bank deleverage. Upside risks ■ Faster than anticipated rebound in capex. ■ Rights issues from key banks clean balance sheets quickly and kick-start euro area credit formation.
Japan *(Naoki Kamiyama)*	
■ Target level of TOPIX is 1,420 (next 12 months), which is16x our FY03/15 EPS of ¥87. Our target and EPS estimate are based on currency forecast of 105. ■ Potential additional easing by BoJ in January-March and regular wage increase in April are likely the next catalyst. Corporate tax cut may be added in 2014. ■ Positive for Autos, Trading houses, Technology, Energy, and Retail; negative for defensives such as Utility, Pharma, and Transportation.	■ US employment trend and Fed's communication to the market. ■ PM Abe's leadership depends on his popularity, which can be unstable with his potential foreign affairs actions.
Asia-Pac ex-Japan *(Ajay Kapur)*	
■ After being tactically bullish on Asian equities since mid-August, we have changed our minds last month. We now believe that Asia ex-Japan equities may deliver flat to negative returns in 2014. ■ A stronger $ and shrinking US current account deficit is a challenging environment for Asian equities. ■ Equity Risk-Love (sentiment) is elevated globally, normally leading to flat/negative equity returns for Asia. ■ Our rates strategist sees US bond yields rising to 4% by Q2 2015. As Asia's debt levels have surged since 2007, a sympathetic rise in Asia's bond yields can hurt EPS growth. Also, high duration stocks in Asia (Internet, Gaming, Staples, and Healthcare) are likely to be de-rated if yields rise. ■ Overweight Australia, Japan, China/HK; Underweight: Indonesia, Malaysia, Philippines, Thailand. Overweight: Telecom, Semis, Banks, and Food Beverage/Staples/ Retailing. Underweight: Utilities, Software, Tech Hardware, Diversified Financials, Materials, and Energy. ■ We recommend buying selected Asian state-owned enterprises (SOEs), Korea's semis and autos, and India's beaten-down "Policy Ignition" themes.	Upside risks ■ A weak $, and low bond yields reflecting another round of global QE. ■ Any drop in US/Europe policy uncertainty would be a boost to multiples for Asia's high-flying growth stocks. ■ China and India's focus on reforms/growth could also be an upside catalyst.
Emerging Markets *(Ajay Kapur)*	
■ We believe Emerging Market (EM) equities may deliver flat-to-negative returns in 2014. Still, tactical opportunities are likely just as in this gone summer. ■ Equity Risk-Love (sentiment) in developed markets is euphoric which may lead to flat/negative returns for emerging markets. ■ A stronger $ and shrinking US current account deficit is a challenging environment for EM equities. ■ US/European policy uncertainty has collapsed this year, increasing equity market multiples in these markets. While policy certainty can go up further, not much room left from here. ■ Overweight: Russia, China, Korea, Turkey, Brazil and South Africa. Underweight: Mexico, Malaysia, Chile, Taiwan, Thailand and Indonesia.	Upside risks ■ A weak $, and low bond yields reflecting another round of global QE and drop in US/Europe policy uncertainty.

Source: BofA Merrill Lynch Research Investment Committee

Link to Definitions

Macro

Click here for definitions of commonly used terms.

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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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