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Not everything can keep going up

Bank of America Merrill Lynch

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Most financial assets as well as gold are up for the year. As the Fed continues to taper its asset purchases, economic fundamentals will begin to matter more, in our view. If the economy behaves as we expect, stocks should show further gains, but bonds may lose ground. Emerging markets remain the major risk factor.

Asset Allocation changes

We are adjusting our allocations to large cap US equities to reflect more even weights between the style categories of growth and value. The two styles have become closely correlated and share many similarities, and we expect little difference in performance between them. We still favor growth over value within small caps. We also re-allocated our international equity weighting from emerging markets to developed markets.

Baby, it's cold outside

In this month's guest column, Rates Strategist David Woo examines the harsh winter weather of 2014 in the context of disruptions to the economy. He concludes that warmer weather, when it finally appears, is likely to be accompanied by rising US Treasury yields and a higher US dollar.

Click the image above to watch the video.

This report is an extract of a report of the same name published 11 March 2014

Refer to important disclosures on page 19 to 21. Link to Definitions on page 18.

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Financial markets recap

February review

Most financial markets saw gains in February, as investors became more comfortable taking risk.

Emerging Market equities, despite advancing 3.3% last month, remain in the red year-to-date.

Within US markets, equities more than recovered January's losses, with the S&P 500 index gaining 4.6% in February (+1.0% YTD).

Among size and style segments, the outperformance of large cap growth vs. value continued last month, while the reverse held true for small caps. Large cap growth remains in the lead year-to-date.

US sector performance last month was generally consistent with an uptick in risk appetite – cyclical sectors such as Materials (+6.9%), Discretionary (+6.2%) and Energy (+5.1%) outperformed the index while Health Care was the only defensive sector among the leaders with a 6.2 gain (+7.2% YTD, best of all sectors).

Within fixed income markets, sector performance reversed course last month, making for solid returns throughout most of the bond market. Fixed-rate preferreds returned 2.3% last month and continue to remain in the lead YTD.

In FX markets, the Euro appreciated 1.1%, while the Yen and US dollar both finished the month down 1.2%.

Gold (+6.6%) led all commodities last month, and has returned 10.0% YTD.

Table 1: Total returns (%)

		As of 28 February 2014						
Asset class	2013	1mo	3mo	12mo	YTD	3yr[2]	5yr[2]	10yr[2]
Equity Indices (%, US dollar terms)								
S&P 500	32.4	4.6	3.5	25.4	1.0	14.4	23.0	7.2
NASDAQ Comp	40.1	5.1	6.4	38.1	3.4	17.1	27.0	8.8
FTSE 100	21.0	6.8	5.3	22.3	2.4	9.3	20.0	6.9
TOPIX	26.5	-0.6	-3.2	14.6	-4.2	3.0	11.3	3.6
Hang Seng	6.5	3.8	-4.4	2.7	-2.0	2.9	16.0	-
DJ Euro Stoxx 50	27.0	6.9	4.0	29.9	1.7	5.0	15.4	5.0
MSCI EAFE	23.3	5.6	2.9	19.8	1.3	7.1	18.1	7.1
MSCI Emerging Markets	-2.3	3.3	-4.7	-5.7	-3.4	-1.7	17.2	10.3
Size & Style (%, US dollar terms)								
Russell 2000	38.8	4.7	3.8	31.6	1.8	14.4	26.6	8.7
S&P 500 Citigroup Growth	32.8	5.2	4.9	28.7	2.1	15.8	23.1	7.7
S&P 500 Citigroup Value	32.0	3.8	2.0	21.9	-0.3	12.9	23.0	6.6
S&P 600 Citigroup Growth	42.7	4.3	1.3	33.0	0.0	17.3	28.7	10.7
S&P 600 Citigroup Value	40.0	4.6	2.4	31.6	0.8	16.5	27.4	9.6
S&P 500 Sectors (%, US dollar terms)								
Consumer Discretionary	43.1	6.2	2.3	33.8	0.0	21.4	32.9	9.3
Consumer Staples	26.1	3.6	-1.2	13.5	-1.7	15.8	19.0	9.1
Energy	25.1	5.1	1.5	13.9	-1.5	5.5	16.8	12.6
Financials	35.6	3.1	1.6	25.6	-0.6	10.8	25.7	-0.9
Health Care	41.5	6.2	8.1	39.3	7.2	24.8	23.5	8.7
Industrials	40.7	3.9	3.5	28.9	-0.7	14.4	27.7	8.5
Information Technology	28.4	4.6	6.2	28.4	2.0	13.2	24.2	7.4
Materials	25.6	6.9	6.9	25.3	2.0	9.0	23.2	8.4
Telecom Services	11.5	-1.0	-4.4	0.9	-4.2	10.5	14.7	7.0
Utilities	13.2	3.4	7.5	12.5	6.5	12.6	14.7	9.5
BofA Merrill Lynch Global Research Bond Indices (%, US dollar terms)								
10-Year Treasury	-7.8	0.5	1.6	-3.6	3.7	5.4	3.8	4.7
2-Year Treasury	0.3	0.1	0.2	0.5	0.3	0.8	1.2	2.5
TIPS	-9.4	0.4	1.1	-6.2	2.6	4.1	6.3	4.8
Municipals*	-2.9	1.3	3.3	-0.5	3.6	6.0	6.1	4.6
US Corporate Bonds	-1.5	1.1	2.7	1.4	2.9	6.0	9.8	5.4
US High Yield Bonds	7.4	2.0	3.3	8.4	2.8	8.8	18.9	8.6
Emerging Market Corporate Bonds	-0.5	2.1	2.3	1.1	2.0	6.4	13.4	7.0
Emerging Market Sovereign Bonds	-3.3	3.6	2.9	0.3	2.2	7.1	11.5	8.2
Preferreds	-1.6	2.3	4.0	1.7	5.6	5.8	19.0	2.1
Foreign exchange** (%, in local currencies)								
US dollar	6.4	-1.2	0.3	2.4	-0.1	3.2	-1.5	-1.0
British pound	1.7	0.4	1.9	9.2	1.5	2.0	1.7	-1.8
Euro	6.8	1.1	0.2	3.3	-0.9	0.7	-0.7	0.6
Yen	-18.9	-1.2	-0.3	-11.4	2.9	-7.0	-2.0	0.2
Commodities** (%, US dollar terms)								
CRB Index	-5.0	6.7	10.0	3.2	7.9	-5.0	7.4	1.4
Gold	-28.0	6.6	5.8	-16.0	10.0	-2.1	7.1	12.8
WTI Crude Oil	7.2	5.2	10.6	11.5	4.2	1.9	18.0	11.0
Brent Crude Oil	-0.3	2.5	-0.6	-2.1	-1.6	-0.8	18.7	13.0
Alternative Investments† (%, US dollar terms)								
Hedge Fund - CS Tremont[1]	9.7	-0.3	2.2	7.2	-0.3	4.5	8.4	6.2
Hedge Fund - HFRI Fund of Funds[1]	8.7	-0.5	1.7	5.9	-0.5	2.2	4.6	3.1

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 has been very good so far for assets spanning from gold, to bonds, to US and developed country stocks (see Table 2). While the markets favored relative safety in January – Treasuries up, stocks down – risk assets rebounded in February, and Treasuries added to their gains. We sit in early March with stocks at record highs, and the yield on high yield bonds 40 basis points above all-time lows. Looking globally, the major YTD losses largely have been contained to emerging market stocks and local currency sovereign debt, although both rose in February. If the economy behaves as we expect, stocks should show further gains, but bonds may lose ground. The emerging markets remain the major risk factor.

Table 2: YTD returns (through March 7)

US Stocks	
S&P 500	2.0%
NASDAQ	4.1%
US Bonds	
Treasury	
10 Year	2.6%
30 Year	4.7%
High Yield	2.6%
Preferreds	5.7%
Emerging Markets	
MSCI Stocks	-3.3%
Corporate Bonds	1.6%
Sovereign Debt USD	2.2%
Sovereign Debt Local	-0.4%
$ and commodities	
US $	-0.4%
CRB Index	9.6%
Gold	11.1%
Oil	-1.6%

Source: BofA Merrill Lynch Global Research , Bloomberg

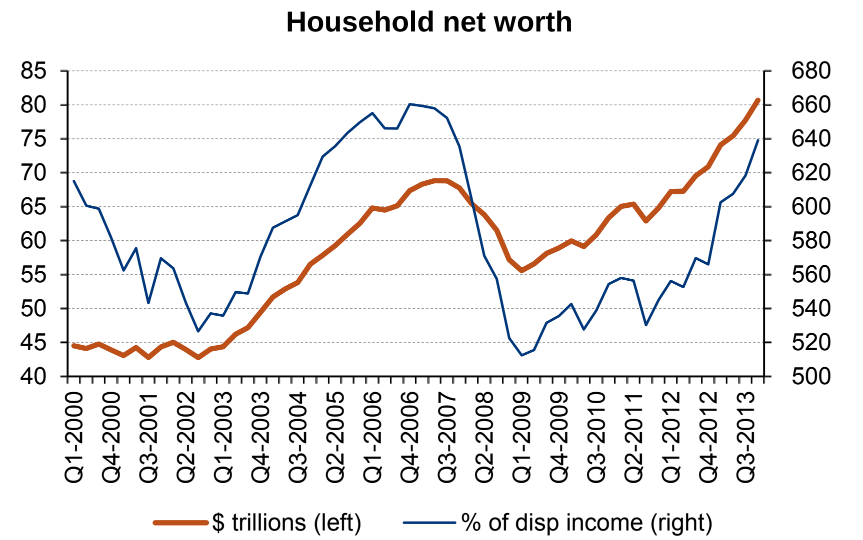
Will weather wither tapering?

The ongoing liquidity injection from the Federal Reserve through its Quantitative Easing (QE) is a big contributor to this broad based strength, in our view. Although the Fed has tapered its monthly asset purchases by $20 billion, the present pace of $65 billion translates to a still-hefty annual rate of $780 billion. But as the Fed pares back further, economic fundamentals will begin to matter more.

The US economic data for the past couple of months have been mixed. The first readings for February – the ISM index and the employment report – both checked in a bit above market expectations, but still short of the pace from last autumn. The key question in the markets now is whether the recent spate of mixed US economic data are a simply a result of the harsh weather over much of the country, or if they signal a true slowing in the economy that will derail the tapering in Fed asset purchases.

Our call for better US growth is based in part upon the balance sheet repair over much of the economy. Household balance sheets in particular have improved thanks to the climb in the stock market, the revival in real estate, and some paring of debt. Chart 1 shows that household net worth climbed to a record high at the end of last year.

Chart 1: Wealthier households



Source: Federal Reserve Flow of Funds

In our view, the weather accounts for much of the weakness in the economic data. We expect the Fed to maintain its present pace of tapering, ending QE by December. In our guest column this month, head of global rates and currencies David Woo spells out the extent of the abnormal weather in recent months and the potential impact on the economic data. (See page 9.)

The economic data are not weak enough for the Fed to suspend its tapering.

Based on comments from Fed officials and testimony from Fed Chair Janet Yellen, winding down QE is the clear preference at the Fed. The Fed will probably announce another installment of tapering at the March 18-19 FOMC meeting. The Fed prefers to shift its focus to its "forward guidance" regarding short term rates. The FOMC has stated that it expects to keep the federal funds rate near zero until "well past the time" that the unemployment rate declines below 6.5%. The unemployment rate stood at 6.7% in February. The advantage of providing such guidance instead of QE is that the Fed could still contain yields, but without adding further to its balance sheet.

A winding down in QE in the face of a better economy would probably damage Treasuries most. Not only would they suffer directly from the reduction in purchases, but an improved economy would take away some of the flight-to-quality bid. For stocks, the improved prospects for revenues and profits would probably outweigh the negative consequences of the reduction in new liquidity. But Treasuries will retain their allure in times of geopolitical stress or if problems in emerging markets deepen. We turn to that next.

Emerging markets

The potential Fed tapering is one of at least three developments in the emerging markets sphere that raises market risks. The other two are the crisis in Ukraine, and the recent default of a solar power company in China, neither of which appear to be a large risk for now, but they bear watching.

A winding down in Fed purchases would probably curtail capital inflows into emerging markets

Tapering risks for EM

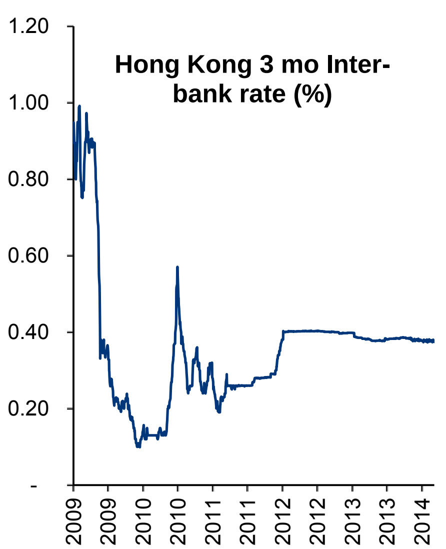
Emerging markets, particularly equities, would suffer the most from an end to QE, in our view. GEM Equity Strategist Ajay Kapur believes that the Fed's QE explains a large part of the enormous capital flows into EM countries in recent years. The decline in US yields drove investors to seek better returns in EM. As the Fed pulls back on its liquidity injections, EM countries face a potential outflow of liquidity.

Alberto Ades, co-head of global economics and head of GEMs fixed income strategy and economics, notes that other factors contributed to the capital inflows in EM countries, but also sees the risk of higher rates as the Fed pulls back on QE. Yields in emerging markets are at levels that are hard to rationalize without help from low policy rates in developed countries. Higher rates that would come with stronger developed economies would probably push up EM rates and cause currencies to stabilize or weaken, although the market has already priced some of that in.

First default in China corporate bond market

The default on the bond interest payment by Chaori Solar may lead the market to re-assess Chinese subprime debt risk, in the view of China Strategist David Cui and his team. Credit Strategist Michele Barlow believes that defaults in other industries will follow. But the macro impact should be contained. Our economists note that the bonds are a modest part of China's capital markets, and that the Chinese government has both the resources and the will to intervene forcefully if contagion kicks in.

Chart 2: Calm China market



Source: Bloomberg

The default in China comes amid worries of slowing economic growth in the country. Chief Investment Strategist Michael Hartnett believes that the Hong Kong interbank rate (HIBOR) would be one of the first indicators to signal possible financial problems in China. It is not flashing a warning sign now. (Chart 2 on the left.)

Ukraine tensions

The military tensions in the Ukraine have been defused for now, but risks remain. One important consequence of the conflict might be higher energy costs in Europe. Francisco Blanch, head of global commodities and derivatives research, notes that Russia supplies one-third of Europe's natural gas, with 55% of that flowing through the Ukraine. Yet, the Ukraine holds large shale gas reserves. With NATO military protection, European capital and American technology, the Ukraine could become a competitive supplier to European markets. Francisco does not see the risk of a spike in oil prices, unless a Black Sea disruption occurs. Not much Russian crude flows through the Ukraine, and Russia has little incentive to unilaterally cut oil exports.

The Crimean parliament has voted to join Russia, and on March 16, residents will vote on accepting this decision. Vladimir Osakovskiy, our Russia and CIS economist, believes that if the referendum to join Russia passes, the key for the markets would be whether Russia formally annexes the region or just takes effective control. The latter seems more likely and would probably have limited market impact. But formal inclusion of Crimea into Russia would raise the risk of economic sanctions from the US and Europe, and a harsh response in return from Russia.

Bottom line

Our base case remains that US real GDP grows at 2.8% this year, and that stocks and low quality bonds outperform Treasuries.

We think stocks will move higher. Corporate earnings and sales are both growing at attractive rates and the stock market does not look overvalued to us, while sentiment remains muted.

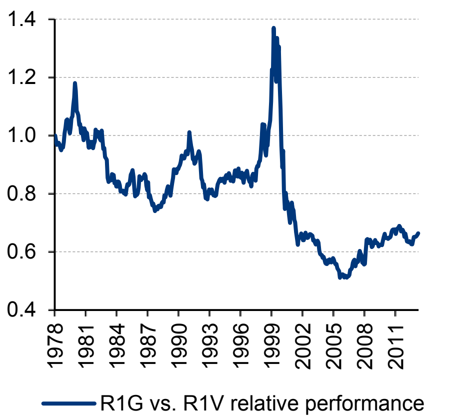
Within large cap stocks, we have no strong preference for either growth or value (see following page), but we prefer large caps over small caps and equities in developed markets over emerging. In the US, we favor global cyclicals and stocks with dividend growth potential.

Among bonds, a clear improvement in the economy and ongoing tapering in QE would probably do the most damage to Treasuries. High yield bonds, whose prices are less sensitive to rises in interest rates than most of the bond market, would probably suffer less than Treasuries, although yields there might still rise.

What's your style?

In this month's RIC, we are changing our asset allocation recommendations for large cap style to reflect more even distribution between the two main style categories of "growth" and "value" (please see Table 4 for details). Investors often expend great energy in allocating equity portfolios between the two, and an entire mutual fund sub-industry is built on this style platform. In addition, we reduced our allocation to Emerging Markets given our concerns about the impact that Fed tapering could have on those countries.

Chart 3: Relative performance of R1G vs R1V



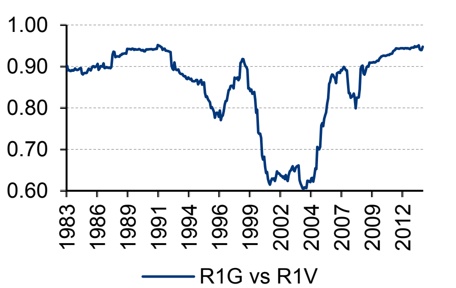
Source: BofA Merrill Lynch Global Research , Russell Investment Group

The classic adage is to "buy growth" when earnings growth is scarce and "buy value" when growth is plentiful. This is based on the assumption that value will usually be cheaper than growth, so there is no need to pay up for growth when profits are accelerating. The RIC had been favoring growth over value for precisely this reason. As the economy and profits struggled from the middle of the last decade until recently, growth outperformed value (Chart 3). Now, however, our US equity strategy team expects a modest recovery in profits, as flat nominal growth is boosted by a stronger economy and improving pensions. We therefore do not expect much of a performance differential between the two styles.

Growth and value have many similarities today

It is often recommended that investors own securities from both style categories to help diversify the overall portfolio and manage risk. Over time, many classic investment categories have become more closely correlated – US and non-US equities, large cap and small cap stocks, and also growth and value equities. In 2008, the rolling five-year correlation between large cap growth and large cap value stocks was around 0.80; today, it is around 0.95 (Chart 4) – meaning that growth and value are very closely correlated and including both in a portfolio does not meaningfully enhance diversification.

Chart 4: Rolling 5-Year correlations



Source: BofA Merrill Lynch Global Research , Russell Investment Group

Our US Equity Strategy team recently compared several metrics across large cap style categories, and across the Russell 1000 index, and found a number of similar qualities (Table 3). For example, both have similar market capitalizations, sensitivity to the US economy, percentage of high quality stocks and dividend growth rates. One would expect higher dividend yield for value stocks and higher non-US sales for growth stocks, but on most parameters measured, the two style indices are not that far apart.

Table 3: Russell 1000 Growth vs Russell 1000 Value

Weighted Average:	Russell 1000 Growth	Russell 1000 Value	Russell 1000
Market Cap ($mn)	83,748	95,289	97,172
Dividend Yield	1.70%	2.40%	2.00%
Dividend Payout Ratio	35%	46%	41%
Dividend Growth (LTM YoY %)	16%	19%	17%
% Foreign Sales	25%	13%	19%
US GDP Beta	0.68	0.59	0.63
% High Quality (B+ or Better) stocks	46%	37%	41%

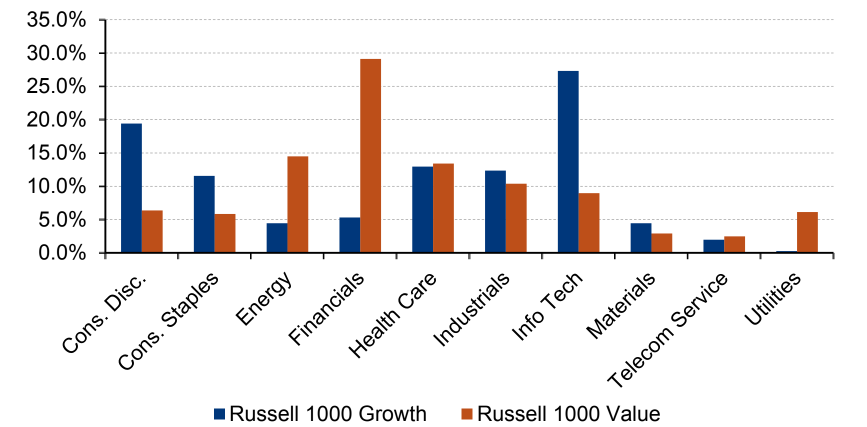
Note: All based on weighted average except for % of high quality stocks which is absolute %.
Source: BofA Merrill Lynch US Equity & US Quant Strategy, Russell, Compustat, WorldScope, S&P, BEA

Sector allocations important for investment goals

Shifting portfolio emphasis to either growth or value may depend more on the investor's goals than on any other consideration. While some market sectors such as Health Care, Industrials and Telecom Services have similar weights in both style indices, there remains a sector bias that has withstood the test of time (Chart 5). Growth indices are skewed toward Technology and Consumer

Discretionary, where historical earnings growth rates have been robust, while Value indices show a striking preference for Financials and Energy – where price-to-book values are attractive.

Chart 5: Russell 1000 Growth and Russell 1000 Value sector weights



Source: BofAML Global Research, Russell Investment Group

Growth still favored among small caps

We maintain our growth style bias among small cap stocks, as Small Cap Strategist Steven DeSanctis continues to favor growth over value. Small cap growth continues to outperform small cap value and it remains cheaper, but relative valuations have become less attractive along with this outperformance. Steven currently overweights Technology and Industrials, which are much larger constituent sectors of small cap growth indices. Further, improved performance from global cyclicals favors growth over value among small cap stocks.

Asset allocation change details

The RIC has removed our growth bias in the large cap style equity allocation. For US investors with Tier 0 liquidity and a moderate risk profile, we reduced the Large Cap Growth weight by 4% to 26% and increased the Large Cap Value weight by 4% to 26%.

The RIC also reduced the equity weight for International: Emerging by 1%, which now puts EM in line with the strategic weight at 2%, for a moderate risk profile and Tier 0 liquidity. Emerging markets would suffer the most from an end to QE, in our view. In a corresponding move, we increased International: Developed by 1%, taking its weight up to 11%.

Table 4: RIC asset allocation changes for US clients with a Tier 0 liquidity profile

	Conservative			Moderately Conservative			Moderate			Moderately Aggressive			Aggressive		
	Previous	New	Diff.	Previous	New	Diff.	Previous	New	Diff.	Previous	New	Diff.	Previous	New	Diff.
Stocks	24%	24%	0%	45%	45%	0%	68%	68%	0%	80%	80%	0%	88%	88%	0%
Large Cap Growth	10%	9%	-1%	20%	18%	-2%	29%	26%	-3%	32%	29%	-3%	32%	28%	-4%
Large Cap Value	12%	13%	1%	16%	18%	2%	23%	26%	3%	25%	28%	3%	21%	25%	4%
Small Growth	0%	0%	0%	2%	2%	0%	2%	2%	0%	3%	3%	0%	6%	6%	0%
Small Value	0%	0%	0%	1%	1%	0%	1%	1%	0%	2%	2%	0%	5%	5%	0%
International: Developed	1%	1%	0%	4%	5%	1%	10%	11%	1%	13%	14%	1%	19%	20%	1%
International: Emerging	1%	1%	0%	2%	1%	-1%	3%	2%	-1%	5%	4%	-1%	5%	4%	-1%

Source: BofA Merrill Lynch Global Research

The weather consensus

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The vigorous rally of S&P 500 in the face of steadily mixed US data since early February (Chart 6) can only mean one thing, in our view – the weather hypothesis has now taken hold in the market. An informal survey we conducted suggests that most market participants believe that poor weather has been behind three-quarters of the weak data since the second week of January.

Differing views about the effect of bad weather on the economic data have been a big driver of market movements.

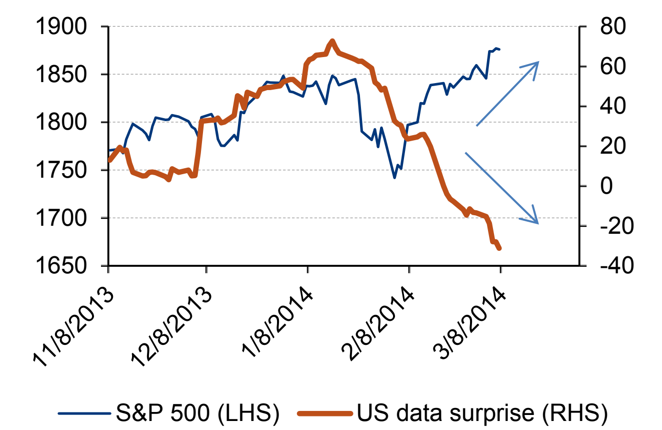
At the same time, many investors think that if it turns out that there is more to the soft data than the weather, the Fed can always be counted on to slow down the pace of tapering. This latter line of thinking is probably why, in the weeks prior to the release of the jobs report for February, the S&P 500 and 10-year Treasury yields parted ways, with the former making a new record high while 10-year Treasury yields trading in a tight range some 20bp below its own year-high (Chart 7). The jobs report pushed Treasury yields higher as investors became more confident that tapering will continue at the March 18-19 FOMC meeting.

This divergence suggests to us that US rates (and the USD by extension) have much at stake in how the weather story will play out. If the weather hypothesis turns out to be correct and data begin to improve with the weather, Treasury yields and the USD have to go up a lot just to play catch-up with stocks. This is why we continue to believe there is nothing more important than US weather for the outlook for the rates and FX markets over the next four to six weeks. To us, understanding the weather deeply has never been more important than right now.

This report seeks to answer three key weather-related questions right now:

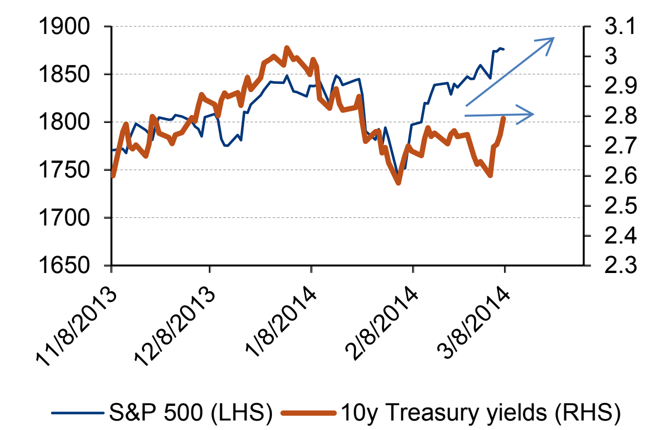
- How bad is this winter in historical context? The answer to this question may help us assess how much of the weak data can be attributed to the weather.
- In the case of similarly severe winters in the past, how did the data behave during the weather disruptions and afterward? The answer to this question may help investors position for any turning points in the data.
- How much longer is the severe weather likely to drag on? This is the most difficult, even though obviously the most crucial, question.

Chart 6: S&P 500 and US data surprise



Source: BofA Merrill Lynch Global Research

Chart 7: S&P 500 and 10y Treasury yields (%)



Source: BofA Merrill Lynch Global Research

“On average” weather data do not look severe, but certain areas have seen extreme cold and extreme precipitation.

2014 in historical context

So how bad has this winter been in the US? Ironically, the data at first glance do not suggest that it has been especially severe. Notwithstanding reports of extreme cold in many regions, average temperature across the country was 30.34 degrees (F) in January – lower than the last two Januaries, but in line with the average since 2007. If winter weather disruptions are about the quantity of snow, average precipitation across the country was only 1.32 inches in January – the lowest since 2003. In other words, on average, this winter has neither been especially cold nor had particularly a lot of snow.

However, this has not been an average year by any stretch of the imagination. What the average numbers do not show are the extremities across different regions. To quantify these extremities and to place the severity of this winter in a historical context, we have developed an Extreme Winter Weather (EWW) index using state level data going back to 1960.

The EWW index has three sub-components:

- **Extreme cold**: We define this as the difference between the number of US states whose temperature over the month was at least one standard deviation below its historical average and the number of cold states[1] whose temperature was at least one standard deviation above its historical average.
- **Extreme precipitation:** We define this as the difference between the number of states with freezing temperature whose precipitation over the month was at least one standard deviation above its historical average and the number of states with freezing temperature whose precipitation was at least one standard deviation below its historical average.
- **Extreme snow storms**: We define this as the number of snow storms that fall in the top 50 of the most severe storms since 1953, weighted by its NESIS score.[2]

Each sub-component of the EWW is calculated as a z-score. Given we do not have full-month temperature and precipitation data for February yet, the first two sub-components use only the December and January data while the extreme snow storm component includes all the storms from December to February. Below are the key results:

- December and January were extremely cold, with the number of unusually cold states far outstripping the number of unusually warm states. According to this measure, *the 2013 winter is the 10th coldest winter since 1960 and the second coldest since 1984.* This is even before we take into account an extremely cold February.
- Our measure of extreme precipitation shows this winter to be in line with the

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[1] Cold states are defined as the 40 states with lower temperatures than the remaining 10 (which we call warm states). We are assuming that if Minnesota has a particularly warm winter it will have a better impact on economic activities than if Florida has a particularly a warm winter.

[2] The Northeast Snowfall Impact Scale (NESIS) developed by Paul Kocin and Louis Uccellini of the National Weather Service (Kocin and Uccellini, 2004) characterizes and ranks high-impact Northeast snowstorms. These storms have large areas of 10 inch snowfall accumulations and greater. NESIS has five categories: Extreme, Crippling, Major, Significant, and Notable. The index differs from other meteorological indices in that it uses population information in addition to meteorological measurements. Thus, NESIS gives an indication of a storm's societal impacts. This scale was developed because of the impact Northeast snowstorms can have on the rest of the country in terms of transportation and economic impact.

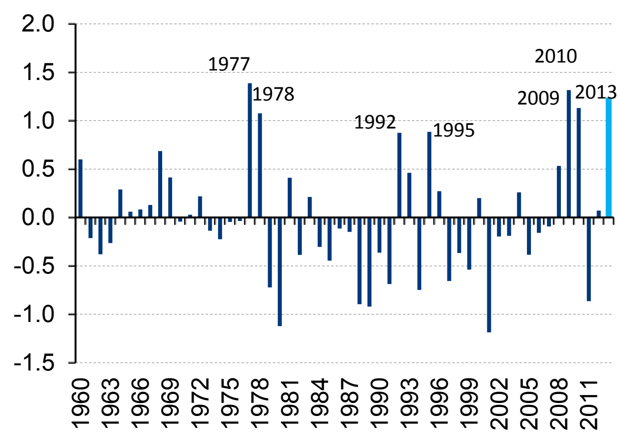
historical norm but more moderate than seven of the last 10 winters. We certainly cannot blame the negative data on precipitation.

- This winter has been notable for the severity and frequency of the snowstorms in the Northeast. Indeed, since December, the Northeast has been pummeled by five of the 50 biggest snow storms to hit the country since 1956. This is why the 2013 winter so far is ranked third since 1960 in our definition of extreme snowstorms, just behind 2009 and 2010.

What happens when we combine these three sub-components into a single index? For simplicity, we give equal weights to the three sub-components so that the total index is just an average of their respective z-scores. *According to this index, this winter is the third most severe winter since 1960, just behind 1977 and 2009* (Chart 8).

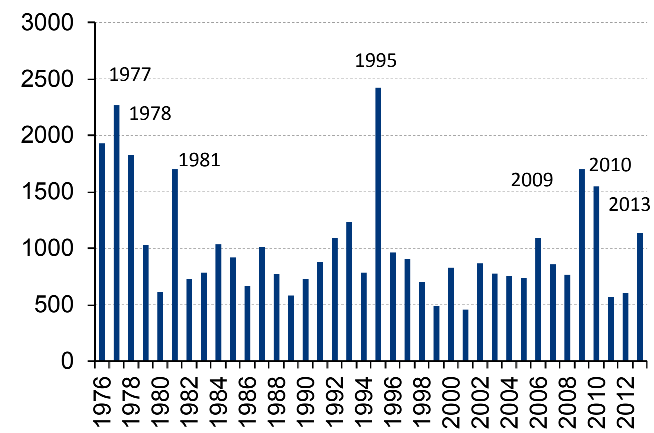
To make sure that our EWW index is useful not only in identifying extreme weather conditions, but also extreme economic disruptions, we compare it with the number of people who said they were not at work due to the weather between December and February every year (Chart 9). This comparison shows that most of the years that are ranked highly in the EWW index also happened to be the years with greatest number of people whose ability to go to work was affected by the weather (1977, 1978, 1995, 2009 and 2010). This important finding and the fact that the EWW index suggests this winter is the third most severe winter in 50 years strengthen our view that weather has been behind most of the deterioration of the US data of late.

Chart 8: BAML extreme winter weather (EWW) index



Source: BofA Merrill Lynch Global Research

Chart 9: Number of people who said they were not at work due to weather in December-February (thousands)



Source: BofA Merrill Lynch Global Research

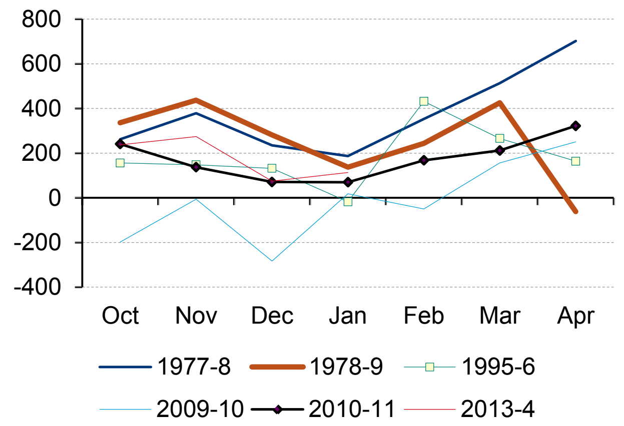
Common themes among cold winters

Our view is that the recent slowdown in the US economy was weather driven and therefore likely to be temporary. For investors who share our view and want to position for higher US rates and higher USD, the million-dollar question right now is when the data will turn. We believe that the data will only turn once the weather begins to improve. While in the next section we will discuss the weather outlook in March, we will focus in this section on the key lessons from previous winters with severe weather conditions and significant economic disruptions.

We focus on 1977, 1978, 1995, 2009 and 2010, winters that rank highly in our EWW index as well as having the greatest number of people out of work due to weather. Charts 10-13 show the evolution of nonfarm payrolls, car sales, existing home sales, and the new order component of the ISM survey from October to April associated with each of these winters. The key lessons are:

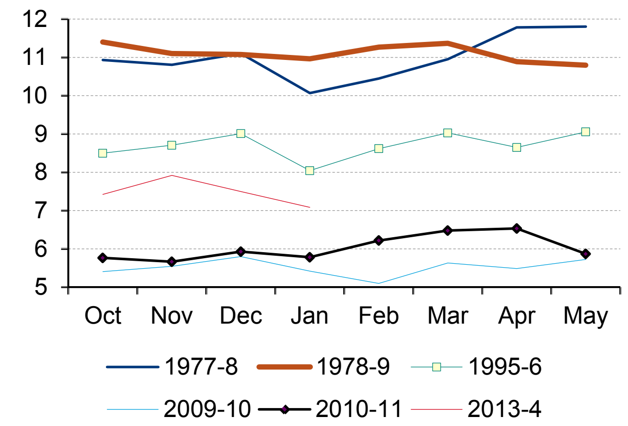
- For all these benchmark winters, nonfarm payrolls and car sales *showed improvement in the subsequent March*, and with the exception of the winter of 2009-10, they *already showed improvement in February.* We cannot rule out that this year may resemble more 2009-10 as both years saw a high number of severe snowstorms in the first half of February.
- There is *much less consistency in the evolution of existing home sales or ISM manufacturing* survey for these benchmark winters. For the former, it would appear that the recovery usually began only in March. For the latter, the lack of consistency across all the winter months leads us to conclude that weather is not a key driver. By the way, none of the benchmark years exhibits the same precipitous drop as in January this year.

Chart 10: Changes in nonfarm payroll (thousands)



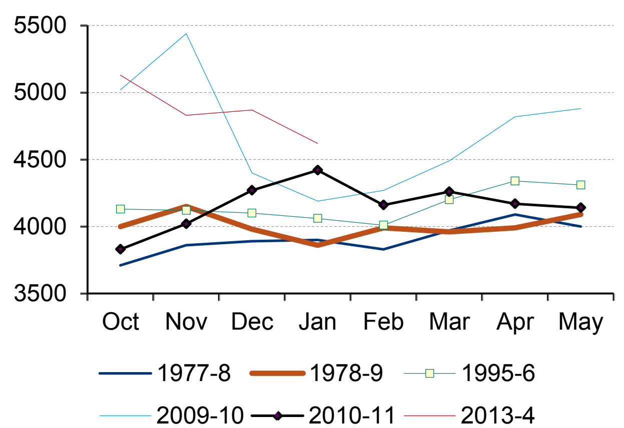
Source: BofA Merrill Lynch Global Research

Chart 11: Car sales (SA)



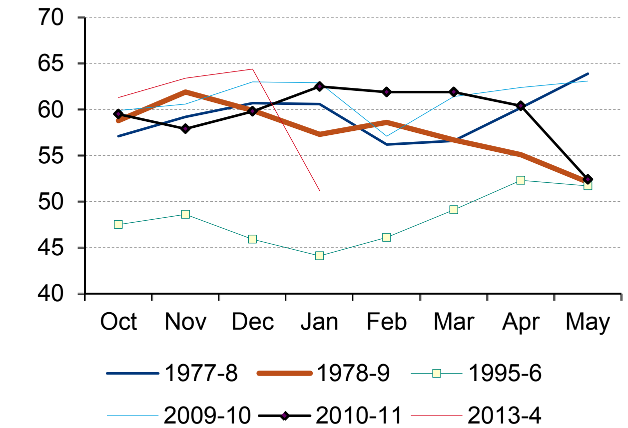
Source: BofA Merrill Lynch Global Research

Chart 12: Existing home sales



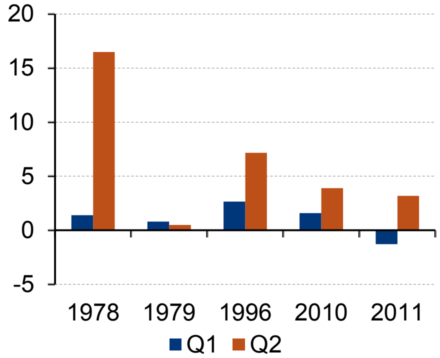
Source: BofA Merrill Lynch Global Research

Chart 13: ISM manufacturing, new orders



Source: BofA Merrill Lynch Global Research

Chart 14: GDP growth (Q/Q, SA, AR)



Source: BofA Merrill Lynch Global Research

- In four of our five benchmark years, GDP growth accelerated in the spring (Chart 14), with the average difference between 1Q and 2Q GDP growth of 5pp. Although this was distorted by the 1978 winter, 2*Q GDP growth was more than 2pp higher than 1Q growth* following both the winters of 2009 and 2010.

- Treasury yields tend to follow US data. Therefore, it is unsurprising that in all five of our benchmark winters, *10-year Treasury yields rose in February and, with only the exception of 2009-10, rose again in March*. Of those years, Treasury yields rose the most in the spring of 2006, when the pick-up in the leading indicator was the most pronounced, and the least in the spring of 2011 (Treasuries had sold off aggressively late 2010 due to a combination of QE2 and fiscal easing). However, by April, yields went up again in only three out of the five years.

- USD/JPY tracked Treasury yields higher in March in both 1996 and 2010. If we are correct in our assessment that this year most resembles the winter of 2009-10, *then USD/JPY could have a 5 big figure upside in March* if history were to repeat itself.

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 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 and EPS at risk.
Consumer Staples	=	Best defensive sector with high quality, good yield and div growth plus higher non-US exposure and less govt. risk .
Energy	+	Beneficiary of global growth and US energy independence; under-owned, but large cap oils struggling with EPS growth.
Financials	=	Easy returns are likely over, but should benefit from US economic and housing recoveries; balance sheets improved.
Healthcare	=	Best performing sector YTD; HC reform favors hospitals, managed care, PBMs; pharma best yield play.
Industrials	+	Benefits from cyclical recovery, especially Europe. Capex trends getting better. US manufacturing well positioned.
Info Technology	+	Benefits from improving cyclical and secular growth; cash return strategies, non-US exposure, good EPS growth are positives.
Materials	=	Benefits from improving global growth; risk of lower China growth and commodity prices as inflation remains low.
Telecom	–	Best dividend yield sector, but not much room for dividend growth as payout ratios high; poor 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	=	As earnings growth becomes more broad-based, PMs less likely to pay up for growth; indices favor Tech/Industrials.
Value	=	Should do better as profits accelerate; good dividend growth here; favor Energy within value indices.
Small cap	–	Absolute and relative valuations at extreme levels, earnings expected to decline; favor higher quality, growth over value.
Large cap	+	Beneficiaries of fund flows into US equities/ETFs; attractively valued, better EPS growth among midcaps.
Europe (ex. UK)	+	PMIs suggest recovery continues, but EPS guidance is lower, valuation stretched; flows may slow; favor defensives/lower beta.
United Kingdom	=	Strong growth continues, esp. business investment, QE and rates "on hold" at BOE.
Japan	+	More BOJ asset purchases, easing, wage hikes offset consumption tax increase; P/Es expanding; like defensives, tech, autos.
Asia Pac (ex. Japan)	–	Challenges are higher US yields, dollar; weaker op margins, falling commod. prices, China trust/debt rollover cycle.
Emerging markets	=	QE debt-driven carry trade unwind weighs on EM; indicators not at "buy" yet for Asia or Russia; Latam earnings ests falling.
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, but yields could rise.
Preferred securities	=	Favor high coupons, and fixed-to-floating structures.
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 result in an average price of $1,150/oz in 2014.
Oil	–	Increases in production should keep prices soft.
US dollar	+	Greenback should strengthen against most developed and EM currencies.

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 capex softness, Chinese financial crisis and weak corporate investment in Japan. ■ Upside risks: stronger US labor market recovery, faster EM growth.
Global Rates (Priya Misra, Ralf Preusser)	
■ US: We maintain our medium term shorts while turning cautious in the near term. Improving growth as the fiscal drag fades, diminished downside risks, declining demand and deteriorating credibility of forward guidance argue for higher rates in 2014. In the near term weakness in equity markets, short positioning in rates and a softening of data given the cold weather are risks. ■ 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.	■ US: An unexpected growth shock in 2014 either due to tighter financial conditions or weaker EM growth or a stock market correction 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 2.6%. ■ Europe: The ECB has signaled that they are willing to look through near term volatility in inflation, which coupled with the German constitutional court ruling on the ECB's OMT could raise volatility in the periphery and expose the curve to flattening risks.
Global Commodities *(Francisco Blanch)*	
■ We hold a moderately negative stance on commodity prices this year 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 believe gold could fall back below $1,200/oz as immediate concerns over the US and EM subside through 2Q14, and 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. ■ Oil may briefly jump by $10/bbl or more if the 1 about 1 million b/d of Russian oil flowing through the Black Sea is temporarily disrupted. ■ 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 IG and HY corporate spreads relative to governments, and favor US HY and European IG over US IG. ■ 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.	■ 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. ■ 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)*	
■ Puerto Rico has announced that it will sell $3bn GO bonds on 11 March. In the GDB's Special Liquidity Update, the GDB estimates that it should have sufficient liquidity to sustain a positive cash balance through FY2015. ■ 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.	■ 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 revenues rise 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. ■ 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. ■ Growth concerns are the likely culprit behind the turmoil in EM. We await further signals from China and largely avoid USD exposure. MXN and KRW could outperform, though on a relative basis.	■ A downside surprise to US inflation, which has already been persistently low, would push off Fed tapering, lowering USD in the process. ■ 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. ■ Tighter liquidity or credit concerns in China remain the main risk for EM currencies.

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 keys for US "escape velocity" continue to strengthen. Real Estate prices remain robust, bank lending is accelerating, and small business confidence continues to strengthen. ■ Bull markets do not end with high investor and corporate cash and policy makers in "whatever it takes" mode.	■ An era of unprecedented intervention in financial markets may threaten a parabolic overshoot in some asset prices. ■ EM pessimism driven by bond/FX carnage, a China slowdown/trust default, and EPS recession concerns could hurt developed market sentiment and risk assets.
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. ■ The path to 2000 may not be a straight line; 5% pullbacks happen on average 3x per year. ■ Continued downside in EM could put pressure on the more crowded US stocks with EM exposure. Fortunately, most have been shed by active managers over the last few years, so downside may be limited.
Europe *(John Bilton)*	
■ We see 10-15% total returns from European indices in 2014 with a FY14 target on SX5E of 3400 and 7400 on FTSE 100; 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, Banks, Aerospace, Food Retail; UW Cap goods, Chems, Autos, PHH. Within Banks – we prefer Pan-EU banks over Euro-area banks.	Downside risks ■ Further euro area disinflation (especially HICP <1% beyond 1Q14). ■ Failure of ECB to address balance sheet shrinkage. ■ 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. ■ A prolonged weakness in inflation in core countries would lead to a strong policy response from the ECB.
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 2Q and regular wage increase in April are likely the next catalyst. Corporate tax cut for 2015 may be added to Third Arrow in June. ■ Positive for Autos and Technology to the year end, but also positive for defensives such as Utility and Pharma in the short run due to negative sentiment from geopolitical instability	■ 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. ■ Geopolitical issues in Europe and Asia, with potentially high energy/natural resources cost.
Asia-Pac ex-Japan *(Ajay Kapur)*	
■ Flat-to-negative returns expected this year. Tactical trading opportunities are likely just like last summer. ■ Challenges for Asia – tapering concerns, higher interest rates, stronger US$, shrinking US current account deficit, slowing growth, China trust debt problems, weakening EBIT margins. ■ China cyclical indicators continue to be a worry, with most China cyclical indicators weak/rolling over. ■ We recommend buying selected Asian state-owned enterprises (SOEs), Korea's semis and autos, and India's beaten-down "Policy Ignition" themes. ■ We need to see sentiment indicators reach panic levels, price technical indicators get to oversold, and capitulation in flows to make any tactical buy calls; until then we remain negative.	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 remain unenthusiastic about EM equities. ■ Since 3Q2008, the US Fed QE has unleashed a massive USD2tn debt-driven carry trade into EMs. If QE is coming to an end, ideas that worked since end-2008 should be questioned. ■ LatAm 12m forward EPS growth estimates have begun falling and we expect this to continue due to the slowdown in China, although recent strength in commodities may provide some support. ■ Michael Harris, our EMEA strategist, thinks that cheap Russian equity needs more than just no escalation in Ukraine. Russian stocks need negotiations to lead to a Russian standing back from Crimea.	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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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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