Defying the skeptics

We expect the current sentiment- and profit-driven equity environment to maintain its current direction to close out the year. In our view, slightly higher interest rates or an expected slowdown in the growth of earnings early next year should not be major headwinds for equity markets. At current valuation levels, equities seem pricey on an absolute basis, but from such starting points their near- to medium-term annual returns have been in the single digits. On a relative basis, global equities remain attractive versus fixed income and therefore we maintain our overweight position, emphasizing non-U.S. equities.

We seem poised for a productivity lift-off

Economic data has been coming in stronger than expected as the synchronized global expansion seemingly defies the skeptics by having gained strength rather than peaking and rolling over as the bears have predicted. October proved to be another month of strong upside momentum for the global economy as the manufacturing purchasing managers’ index (PMI) rose to its highest level since April 2011. Over 90% of individual country PMIs remain in expansion territory.

The Institutional Resource Allocation Framework

<table>
<thead>
<tr>
<th>Asset Category</th>
<th>Protective</th>
<th>Market</th>
<th>Strategic</th>
</tr>
</thead>
<tbody>
<tr>
<td>Need addressed</td>
<td>To provide cash flows, as much and when needed, for an institution to function effectively in the near term.</td>
<td>Invest to maintain spending needs over the longer term.</td>
<td>Potential for significant growth in assets and impact, relative to its peer group.</td>
</tr>
<tr>
<td>Risk type</td>
<td>Operational risk that could jeopardize an institution’s basic operations</td>
<td>Market risk that comes from investment exposure to financial markets (the widely known dimension of risk)</td>
<td>Strategic risk that assets earmarked for future organizational growth fall short of their desired growth target</td>
</tr>
<tr>
<td>Examples</td>
<td>• Cash (emergency fund) • Certificates of Deposit (CD) • T-bills/notes</td>
<td>• Equities: Broadly diversified size/style/sector exposure • Fixed income: Credit quality and duration diversification • Cash (reserved for opportunistic investing) • Diversified Alternative Investments</td>
<td>• Concentrated stocks and bonds • Patents • Certain private equity funds • Ownership stakes in companies • Direct real estate</td>
</tr>
<tr>
<td>Risk-return characteristic</td>
<td>Often lower risk, but low return</td>
<td>Risk and return in line with market performance</td>
<td>High risk, but with the potential for above-market returns</td>
</tr>
<tr>
<td>Benchmark</td>
<td>Inflation: Protective assets are expected to help reduce downside risk and provide potential safety.</td>
<td>Risk-Adjusted Market Return: All traditional portfolio performance measures are applicable for market assets.</td>
<td>Absolute Return or Mission-Related: Strategic assets are intended to significantly outperform the market if and when they succeed, or to serve the organization’s strategic goals and advance its mission.</td>
</tr>
</tbody>
</table>

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The U.S. is no exception to this generally upbeat picture. After growing at a 3% pace in the second and third quarters, it has started off the final one of 2017 even stronger. According to the Atlanta Federal Reserve’s GDPNow tracker, the U.S. economy is potentially on course for growth of more than 3% in the fourth quarter. If it pans out, that would also put year-over-year growth close to the magic 3% level that some experts have dismissed as unattainable. This may help explain why U.S. corporations have been raising their guidance for earnings and revenues.

Key to the skeptics’ view that 3% growth is unattainable is a perception that productivity growth is stuck in a rut without a means of escape. We see no logical basis for that belief other than the fact that productivity growth has stalled for the last decade. As Exhibit 1 illustrates, at less than 1%, productivity growth has averaged its lowest five-year growth rate since the end of the stagflation era in the early 1980s.

As we have noted before, we believe the fundamental forces for a substantial rise in productivity growth are already in place. Combined with pro-growth, supply-side fiscal policies, the odds of this pickup are enhanced, in our view. The Reagan tax reform started the strongest secular bull market in U.S. history as persistently strengthening productivity growth rose over two decades from less than 0.5% per year to over 3.5% at the late 1990s peak. The reform seemingly brought a shift back to the pro-growth policies that have traditionally kept growth of U.S. gross domestic product on a 3%-plus trajectory.

According to the fundamental forces that determine productivity, such as capital spending, the U.S. economy appears to be on the cusp of a similar pro-growth breakout in productivity (see Exhibit 1).

As in the Reagan years, we believe, on top of a good fundamental backdrop for enhanced productivity growth, supply-side policies such as reduced regulatory burdens and tax incentives for U.S. investment are setting up a stronger growth outlook.

An October 31 column in The Wall Street Journal by Gerald Seib, “Trump’s Deregulatory Juggernaut,” provides some numbers on the policy changes:

“A new set of figures from the U.S. Chamber of Commerce tells the tale of how far and fast the president, his administration and the Republican-controlled Congress have moved. The Business group has been keeping a tally of deregulatory actions this year, and its scorecard lists 29 executive actions—executive orders by Mr. Trump or directives from his White House—to reduce
regulatory requirements. In response, executive-branch agencies have issued 100 additional directives that either knock down regulations or begin a process to eliminate or shrink them.

The chamber’s count also lists almost 50 pieces of legislation that have been introduced or begun moving through Congress. And that count doesn’t include perhaps the most aggressive step the Republican Congress has taken: It has pioneered the use of a little-known 1996 law that allows lawmakers to repeal executive-branch regulations within 60 days after they are finalized. Using that law, Congress has passed and Mr. Trump has signed, legislation overturning 14 regulations promulgated by the Obama administration in its final days."

Despite what appears to be an improved environment for business investment, the consensus of economic forecasters has yet to accept the possibility that growth potential is rising. As a result, forecasters are being surprised by the better-than-expected economic data and relentless bull market in equities. They seem largely to have ignored the shifting regulatory backdrop and/or dismissed its potential for raising productivity growth. Likewise, they are dismissive of the potential impact from supply-side tax reforms, judging them as either ineffective or unlikely to be implemented. The collective wisdom of the stock market, on the other hand, says these economists are wrong, as does the “surprisingly strong” economic data. Similar disbelief and even disparagement was the norm during the first Reagan Administration, whose pro-business policies ushered in a long stretch of 4%-plus growth and the strongest bull market in U.S. history after they demolished the stagflation malaise of the late 1970s.

Financial conditions appear favorable
Better-than-expected incoming economic indicators, upside growth revisions and increased confidence in a related, but lagging, rebound in inflation have boosted the odds of another Federal Reserve (Fed) rate hike in December, and pushed the yield on the 10-year Treasury note up sharply in recent weeks. With inflation likely to continue to turn around as the effects of the mid-cycle slowdown fade and more pro-growth policies are implemented, the Fed should be able to gradually increase interest rates over the next year. That said, we do not believe that the conditions for tight monetary policy are on the horizon yet. Our projections of yield curve spreads based on labor market conditions indicate scant intrinsic cyclical pressures for a flat or inverted curve one year out (see Exhibit 2). In other words, economic conditions have not yet heated up enough, in our view, to require tight monetary policy. Therefore, we see no need for the Fed to flatten the yield curve more or to invert it. Given the typical long lead time from a flat or inverted yield curve to a recession, this suggests that the probability of recession should remain low into 2019.

All in all, we believe that financial market indicators remain consistent with each other and with the favorable “Goldilocks” environment of low inflation, low interest rates and accelerating growth. This backdrop appears poised to persist, according to positive signals from leading indicators.
Three perceived supports for equities, or “How I learned to stop worrying about the rally”

The cold War classic “Dr. Strangelove (or How I Learned to Stop Worrying and Love the Bomb)” satirizes the widespread paranoia that existed in the 1960s over the risk of all-out nuclear war with the Soviet Union. With the S&P 500 reaching another new high last week, some investors remain similarly uneasy over the length of the post-crisis economic expansion so far and the extent of the gains recorded by stocks over the same period. But even as the expansion approaches its 10th calendar year, we still expect both the economic cycle and the equity market advance to continue. Here, we make three observations in support of our positive view going into the final months of 2017.

1. Investor cash balances are still relatively high

On top of positive earnings growth and attractive relative valuations, the level of investor cash balances also points to continuing support for equity markets. According to the BofA Merrill Lynch Global Fund Manager Survey (FMS), the average investor cash balance was 4.4% in November—well below the 5.0% level of 12 months ago, and well above the 3.5% threshold at which the FMS would generate a sell signal (see Exhibit 3). We believe cash levels would therefore have to come down much further and managers would have to become more fully invested before this measure of positioning would begin to suggest reducing market exposure.

2. Global growth has become more synchronized

The global economy is also experiencing an improvement in growth, which should support both international markets and the roughly one-third of U.S. domestic earnings sourced from abroad. A total of 73% of the 192 countries tracked by the International Monetary Fund (IMF) are expected to grow at more than 2% this year, up from just 61% in 2016. This would be the highest share for any year since the peak of the last cycle in 2007. Similarly, the share of countries with a contracting economy is expected to fall to just 6% in 2017 from 12% last year, with large economies such as Brazil and Russia expected to emerge from recession (see Exhibit 4). This would be the lowest number of countries since 2007. Alongside the recent improvement in global trade, the strength of foreign exchange rates relative to the U.S. dollar and the outperformance of non-U.S. equity markets, we believe this is an additional reflection of the broadening global expansion that we have discussed in the past. And with international economies and equity markets having lagged the U.S. for most of the current cycle, we anticipate that this improvement should have further room to run as we move toward year-end and into 2018.

3. There is no such thing as an average cycle

October marks the 100th month of the current expansion, which has become the third longest in the post-war period, but the aforementioned developments temper concerns we might have that the cycle may have run too far. The average length of the 11 previous post-war expansions has been 58 months. But they have varied considerably, from just 12 months to the longest at 120 months in the 1990s (see Exhibit 5). Indeed, the notion of an average expansion has little meaning, in our view. Just one matches the average duration of five years, no others have fallen within 12 months of it and most have been much shorter or longer. The current cycle already falls into the latter group, but notwithstanding the risk of any major unforeseen shocks, we believe there is room for further output gains. This will matter for investors because expansions typically go hand-in-hand with bull markets, and bull markets tend to run until recession is around the corner.
That said, there are risks that could derail this bull market. Among them are geopolitical flare-ups, most notably one involving the Korean peninsula; at the least, they have caused volatility recently and may do so again if they resurface. A potential failure to achieve tax reform is another factor that could trigger a sell-off, since expectations that it will likely succeed are currently baked into prices and valuations, and are responsible to a large degree for the positive sentiment in the markets. However, as we are not expecting a recession in the next year, we believe any near-term market decline should be short-lived, since historically there have not been severe bear markets in the absence of a realized or expected recession.

Reform doesn’t look taxing for bonds
Politics—in the form of U.S. fiscal policy and the thrust of Federal Reserve policy—has come to the fore as a key market-moving concern. The current tax reform proposals are generally perceived as positive for investors, although they have yet to be reconciled and there are offsetting factors. While there are changes for the municipal bond sector, the tax exemption remains and still appears extremely beneficial to investors with high tax rates. For taxable debt, the partial elimination of the deductibility of corporate interest expenses may be a negative for the high yield sector.

In terms of the Federal Reserve, the administration has chosen an existing Governor, Jerome Powell, to succeed Janet Yellen as Chair. Powell is generally viewed as a wise political choice, providing continuity, and his selection has been favorably received by the market. While the question of the Chair has finally been resolved, there are still four open governor spots and the Vice Chair of the Federal Open Market Committee has announced his retirement. There is a still a “changing of the guard” occurring at the Federal Reserve that needs to be watched closely.

Portfolio Considerations: Despite our positive bias, we would not be surprised by a short-term sell-off in risk assets, such as equities, given this years’ strong outperformance thus far and the record low volatility. However, since financial conditions continue to be attractive globally, we believe investors should “stay the course,” diversifying and rebalancing during this kind of market volatility. As usual, we also believe in maintaining a disciplined asset allocation and a goals-based approach.
Maintaining our overweight to global equities versus fixed income based on expectations for higher growth and 

improving corporate profits.

Positive based on higher growth, improving sales and earnings growth for S&P 500 companies, despite extended 

valuations. Favor cyclical sectors such as consumer discretionary, financials, select industrials and factors like 

dividend growth, high quality. Slight preference for Value over Growth based on improving earnings.

Slight overweight due to rising fiscal policy uncertainty, especially concerning tax reform and investor complacency.

We are overweight as Europe continues to improve within the global cycle, rising domestic demand and 

bank lending. Also, Japan is benefiting from rising real GDP growth and earning revision ratios among the 

strongest globally.

Valuations are attractive for long-term investors. Beneficiaries of the pickup in global cyclical momentum. 

Favor reform-oriented countries and consumer spending.

Bonds provide portfolio diversification, income and stability, but low rates skew down-side risk. Neutral to slightly 

short duration is warranted, balancing expectations of higher short-term rates in the U.S. with overwhelming 

demand for fixed income and extremely low rates globally.

Offers good relative value for high-tax investors. Muni interest tax-exemption likely to survive tax reform, although 

certain sectors may be eliminated prospectively, which could cause an uptick in volume before year end. Credit 

generally stable, notwithstanding certain headline risks (e.g. Puerto Rico).

Despite near cycle-low spreads, we continue to have a favorable view on investment grade credit predicated on 

strong demand—particularly from institutional and foreign investors, a steadily improving macro backdrop, and our 

expectation for a gradual reduction in corporate leverage. Our overweight positioning remains biased towards U.S. 

Financials which continue to boast strong underlying fundamentals and attractive relative valuations.

Valuations are rich. Expect a high degree of volatility. Prefer actively managed solutions that are higher in credit 

quality. Fundamentals remain soft. Allocation to floating rate, secured bank loan strategies is advised.

Mortgage-backed security (MBS) spreads expected to widen further, as the market anticipates the Fed balance 

sheet unwind. Carry continues to be the main theme in Commercial MBS and asset-backed securities (ABS) space 

as spreads remain on the tighter side of the range. We are cautious on certain retail and offices segments. Select 

opportunities exist in properly structured CMBS and ABS.

Yields continue to be low. Despite valuations, we see spreads grinding tighter for the next few months thanks to 

favorable tailwinds.

Compressed yields and risk premiums around the globe compared to the U.S., combined with potentially higher 

volatility in non-U.S. markets, present unfavorable risk/reward conditions for non-U.S. fixed income, justifying an 

underweight position.

Bonds provide portfolio diversification, income and stability, but low rates skew down-side risk. Neutral to slightly 

short duration is warranted, balancing expectations of higher short-term rates in the U.S. with overwhelming 

demand for fixed income and extremely low rates globally.

We see the environment for active management, and hence hedge funds, improving through 2017 into 2018 and 

we continue to recommend a diversified approach when investing in this heterogeneous asset class. We maintain 

our moderately positive view on equity long/short.

We view private equity strategies as potential portfolio return enhancers with unique access to specialized 

deals unavailable to most investors. When committing capital to private equity, we favor a disciplined multi-

year commitment strategy that builds portfolio diversity among different managers, styles, geographies and, 

importantly, vintage. Currently, we see opportunities in special situations and private credit.

The U.S. real estate markets are mostly healthy with supply and demand in balance for most property sectors. 

Notwithstanding what we consider to be full valuations and a mature real estate cycle, both supply-side and 

demand-side fundamentals for rentable space across the major property sectors and in most U.S. markets are 

generally in good shape and will likely remain that way through 2017, in our view.

We expect a slight upward track as the global expansion gains more traction.

In our view, the dollar is mildly overvalued on a trade-weighted basis, but interest rate differentials are favorable 

and we think the dollar will remain broadly stable with slight upside risks against the yen.

We have a small cash position awaiting deployment when opportunities arise.
Appendix

Index Definitions

The Bloomberg Barclays U.S. Aggregate Bond Index is a broad-based flagship benchmark that measures the investment grade, U.S. dollar-denominated, fixed-rate taxable bond market. The index includes Treasuries, government-related and corporate securities, MBS (agency fixed-rate and hybrid ARM pass-throughs), ABS and CMBS (agency and non-agency).

The Bloomberg Barclays U.S. Municipal Index covers the U.S. dollar-denominated long-term tax exempt bond market. The index has four main sectors: state and local general obligation bonds, revenue bonds, insured bonds and prerefunded bonds.

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The EUR STOXX 50 Index, Europe’s leading blue-chip index for the eurozone, provides a blue-chip representation of supersector leaders in the eurozone. The index covers 50 stocks from 12 eurozone countries.

The Euro TWI is represented by the Goldman Sachs Euro Trade Weighted Index.

The MSCI Europe Index captures large and mid cap representation across 15 Developed Market (DM) countries in Europe. With 441 constituents, the index covers approximately 85% of the free float-adjusted market capitalization across the European DM equity universe.

The MSCI Japan Index is designed to measure the performance of the large and mid cap segments of the Japanese market. With 318 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in Japan.

The MSCI USA Index is designed to measure the performance of the large and mid cap segments of the U.S. market. With 636 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in the U.S.

The Nikkei 225 is comprised of 225 stocks selected from domestic common stocks in the first section of the Tokyo Stock Exchange, excluding ETFs, REITs, preferred equity contribution securities, tracking stocks (on subsidiary dividend), etc., other than common stocks.

The S&P 500 Index is widely regarded as the best single gauge of the U.S. equities market. This world-renowned index includes a representative sample of 500 leading companies in leading industries of the U.S. economy. Although the S&P 500 focuses on the large cap segment of the market, with approximately 75% coverage of U.S. equities, it is also an ideal proxy for the total market. An investor cannot invest directly in an index.

The Yen TWI is represented by the Goldman Sachs Yen Trade Weighted Index.
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Asset allocation and diversification do not ensure a profit or protect against loss in declining markets.

Alternative Investments such as derivatives, hedge funds, private equity funds, and funds of funds can result in higher return potential but also higher loss potential. Changes in economic conditions or other circumstances may adversely affect your investments. Before you invest in Alternative Investments, you should consider your overall financial situation, how much money you have to invest, your need for liquidity, and your tolerance for risk.

Investments have varying degrees of risk. Some of the risks involved with equities include the possibility that the value of the stocks may fluctuate in response to events specific to the companies or markets, as well as economic, political or social events in the U.S. or abroad. Bonds are subject to interest rate, inflation and credit risks. Investments in high-yield bonds may be subject to greater market fluctuations and risk of loss of income and principal than securities in higher rated categories. Income from investing in municipal bonds is generally exempt from federal and state taxes for residents of the issuing state. While the interest income is tax exempt, any capital gains distributed are taxable to the investor. Income for some investors may be subject to the federal alternative minimum tax (AMT). Investments in foreign securities involve special risks, including foreign currency risk and the possibility of substantial volatility due to adverse political, economic or other developments. These risks are magnified for investments made in emerging markets. Investments in a certain industry or sector may pose additional risk due to lack of diversification and sector concentration. Investments in real estate securities can be subject to fluctuations in the value of the underlying properties, the effect of economic conditions on real estate values, changes in interest rates, and risk related to renting properties, such as rental defaults. There are special risks associated with an investment in commodities, including market price fluctuations, regulatory changes, interest rate changes, credit risk, economic changes and the impact of adverse political or financial factors.

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