Year Ahead 2019: Powerful Waves of Change

There are Powerful Waves of Change occurring all around the world at the macroeconomic, geopolitical, corporate, demographic and investor psychology levels. The “waves” did not all arise at once, rather they have been building primarily since the Federal Reserve (Fed) began to normalize monetary policy and the U.S. economy broke free from the rest of the world with the help of tax reform and deregulation. This added a boost to rising business and consumer confidence, supported a corporate profits boom led by healthy capital equipment and consumer spending trends, spurred job growth to levels in which there are more job openings than available people to fill them at present, and eventually led to the largest economy in the world, the U.S., growing consistently above trend.

The result of this shift was a powerful wave of change from many years of economic stagnation to a more reflationary environment. This was a break from the most recent past in which deflation worries were an annual discussion. An environment that pivoted from low growth, low inflation, record low rates and low asset price volatility to an economic regime characterized by higher growth, higher secular inflation and rates, and a rise in volatility back to more “normal” levels. We view this as a secular change. One that can take years to ultimately play out, but also a shift that sparks volatility across asset classes.

The global equity market performance in 2017 discounted much of the positive nature of this secular change and drove the U.S. equity markets to record highs in 2018. The “market” led the economy in the U.S. as the rest of the world struggled throughout much of 2018, primarily as the strength of the U.S. dollar applied downward pressure to non-U.S. economic growth and global trade concerns spread throughout the summer months. Are the non-U.S. market corrections indicating a much slower growing U.S. economy is on its way?
This is the second major wave of change that drove the market activity we experienced in October and November.

In addition to the secular movement from stagnation to fiscal reflation, there is another more cyclical wave occurring that is currently gripping the markets—a shorter term re-pricing of risk and valuation led by a change in investor sentiment. Contrary to fears of an overheated economy—not too long ago—investors are now more concerned about a “growth scare or economic hard landing.” They point to the secondary effects of rising rates on the level of growth in the broader economy and on corporate profits, Europe’s fiscal inflexibility, Italy’s budget woes, the potential for higher costs from an extended trade and tariff war between the U.S. and China, the significant uncertainty over Brexit, the Fed raising rates too far and the uncertainty over a divided Congress. Most of these obvious concerns make sense to us and, yes, growth is set to slow next year globally and in the U.S. However, we do not expect a hard landing or the economy to grow significantly below trend. The market needs time to adjust to both the long- and short-term realities. This is why investors should expect a wave back to normalcy in many respects. More normal monetary policy and asset price volatility and lower equity returns versus what has been produced since the global financial crisis all require portfolio changes to be made. Coming into the fourth quarter of 2018, investors who were still overexposed to high valuation growth and momentum segments of the equity market as well as areas that were considered low-quality (companies with high debt loads, more volatile earnings, and/or firms in need of financing) were forced to re-balance portfolios to a more diversified mix. The same holds true, in our view, for fixed income investors who are coming to grips with a flatter yield curve and short-term yields that are more competitive with the dividend yield of the S&P 500. Regime shifts and re-pricing of valuation create week-to-week asset price volatility (at times very sharp) and also create opportunities for the patient investor who takes a long-term approach as markets overshoot. In terms of our portfolio positioning we aim for high levels of diversification across all risk profiles and look to use re-balancing opportunities where markets overshoot to the upside and downside. This leads us to our final wave of change—a changing political landscape around the globe centered around Germany’s post-Merkel era mixed with the ultimate exit of the United Kingdom (U.K.) from the European Union (EU), and despite a short-term truce, the trade uncertainty between the countries with the two largest economies, the U.S and China. The geopolitical “triangle” has the potential to upset the global supply chain of trade that has been well-entrenched for years. Without a transparent agreement multinational corporations will likely begin a wave of adjustments in order to protect margins and maintain global distribution systems. Initially this could lead to higher costs, and potentially lower business confidence, but eventually we expect new manufacturing centers to develop and mix with automation and other technological advancements such as robotics to kick-start a new supply chain cycle in the years ahead.

On the back of the much-welcomed “short-term trade truce” coming out of the G-20 it is still far too difficult to imagine a long-term trade agreement with China anytime soon. However, we do expect the two super powers to protect their own primary interests, which is “the advancement of growth,” and, at the same time, keep their home “base” from growing too frustrated. Therefore, over the next 90 days, we expect talks to center on the tariffs that China imposed, increased buying of agricultural and technology components, and potentially a stay on U.S. tariff increases. Growth-friendly initiatives are especially important in the U.S. given the fact that the 2020 presidential election is right around the corner. These negotiations are likely to keep us all guessing during the next three months, but for now this band-aid solution is needed.

As equity market volatility continues to jog its way back to higher, more “normal” levels, it is common to overshoot to the downside. We experienced this type of downdraft the past three months of this year. A slower-growth environment is also likely to confirm this trend and keep investor sentiment from turning positive as quickly as it turned negative. However, the two events that we have recently discussed that can help stabilize the markets (both equity and credit), in our view, are: (1) a pause by the Fed on the back of the more dovish comments from Chairman Powell in late November; and (2) some kind of trade agreement between the U.S. and China. If these events do not occur, we expect a longer period of consolidation with higher volatility in the markets and therefore caution would be warranted. We would then position portfolios in a more defensive posture.

**What is the yield curve telling us?**

As we close out 2018, the most important question to answer, in our view, is whether or not real growth is going to hold up in 2019? It seems like a simple question since the economic data, primarily led by strong consumer spending given the healthy jobs market, is still positive and the leading indicators are not suggesting that we are heading for an economic hard landing. However, the yield curve is perhaps telling us something different. Parts of the yield curve inverted recently
and many market participants are concerned that the probability of a recession is on the rise. Are the credit markets signaling something we are not expecting or are they simply saying that "real growth" is fine but the Fed needs to pause given the fact that cyclical inflation has already started to roll over? If this is the case then even if nominal growth comes down as the impact of higher interest rates filters through, the level of real growth can still be at or above trend, which could be positive for equities. This could be the surprise for 2019 - that economic growth actually is slightly above trend. In this case, earnings growth of around 5-6% for corporate America is achievable, which could translate into reasonable equity returns during next year given the most recent S&P 500 level of around 2700 in early December. The debate between the yield curve, the Fed and the level of real growth will likely come to a head early on in 2019. The Fed can help answer that question with a pause. The yield curve believes the Fed has already done their job with inflation. When has the yield curve been wrong?

What are the key trends for 2019?

- real economic growth stays at or above trend at 2.5% or higher; no economic hard landing
- cyclical inflation rolls over further and is contained below the Fed’s target rate of around 2%
- unemployment rate continues to head lower as job growth remains healthy
- a “heavy” equity market environment that contains multiple headwinds produces returns that track earnings growth around 5% or slightly higher
- long term interest rates slowly grind slightly higher; fixed income returns are muted
- market activity further drives portfolio re-positioning (investors overexposed to specific areas use market strength to diversify), which keeps the price-to-earnings multiple flat
- U.S. dollar weakens
- geopolitical and U.S. political landscapes remain volatile and uncertain; market volatility is episodic (driven by trade, debt ceiling, Fed meeting related headlines) and rises to more normalized levels
- non-U.S. growth remains a mixed bag with Europe the least attractive
- emerging markets (EMs) dependent on U.S.-China trade negotiations in the near term and on China’s growth and the yuan’s direction in the medium term
- WTI oil prices rise back toward $60 per barrel on average over the course of the year

What are the potential surprises for 2019?

- productivity picks up and U.S. gross domestic product (GDP) growth surprises to upside
- the Fed pauses early in the year as inflation rolls over further
- U.S. dollar weakens considerably
- a U.S.-China trade deal is signed
- a U.S. infrastructure bill is drafted
- emerging market equities outperform global markets as dollar weakens
- the debt ceiling debate gets contentious and a temporary government shutdown occurs
- China’s growth falls further due to additional tariff impacts or significant escalation in the trade war
- the credit backdrop deteriorates as a negative growth shock develops
- Italy’s budget battle creates a broader, long-term Euro bloc concern
- Brexit negotiations turn further negative and the U.K. is left in limbo

The bottom line: Headline and event risk is high in 2019 creating a “binary outcome” environment, which is likely to lead to muted returns in equities. But equities, including dividends, as well as cash are still expected to outperform fixed income over the course of the year.

What should investors consider in 2019 as the growth scare remains the primary concern?

Although we continue to believe the U.S. economy should grow at trend levels (approximately 2.5%) or higher in 2019 and expect earnings growth to stay positive at 5-6% over 2018, we recognize that investor sentiment continues to be affected by Fed policy in 2019, Italy’s budget battle with the European Commission, Brexit, oil price signals and the uncertain trade relationship with China. The “growth scare” has re-gathered steam as we close 2018, suggesting that an economic hard landing could be around the corner and price-to-earnings multiples are still too high. We don’t agree with that assessment at this point.

We recognize the strong headwinds but are not proponents of market timing, particularly as it relates to individuals and long-term institutional investors. Our view would change in this regard if we felt we were headed toward a recession in the near term. Market timing requires a decision at exactly the right
moment twice—the timing of the exit from the “market” and the eventual move back in. This is extremely difficult and also involves many decisions not to mention tax implications and potential additional costs and could significantly alter long-term investment returns.

In addition, given our view that we are still in a very long multi-decade bull market that involves many cycles and a few re-sets (corrections and recessions) we prefer to maintain a strategically diversified core allocation across equities, fixed income, alternatives and cash, where appropriate. This is imperative in order to meet your long-term objectives through various business cycles, economic transitions and emotionally driven volatile market periods.

We will continue to weigh all the short-term concerns with the more favorable long-term global demographics and structural growth trends when making near-term adjustments to our overall view and portfolio positioning. At this point we believe we are in a sharp consolidation period that is close to ending (an almost 20% valuation correction in equities since the September 2018 highs). Although caution is warranted and keeping risk balanced is important during more volatile times, we maintain our slight equity overweight. Further downside risks are certainly possible, particularly given the Fed’s view on still nudging rates higher, but we would expect the Fed to capitulate and pause its hiking cycle if growth slows too aggressively or if it begins to focus on the latest inflation readings. This, in our view, would stabilize investor sentiment and wipe away a major concern.

**Portfolio Considerations**

- Keep portfolios appropriately diversified across multiple asset classes. Higher volatility will require greater discipline. Consider re-balancing equity positions back to original plans if markets overshoot and a hard landing does not materialize.
- Don’t completely abandon exposure to international investments (particularly if the U.S. dollar weakens) as they possess attractive attributes for long-term patient investors—cheaper valuations, disliked, weak fund flows. However, we are not favorable on Europe.
- Move up higher in quality across portfolios
  - Favor large-cap stocks over small caps
  - Companies with healthy balance sheets and wider economic moats (i.e., pricing power)
  - Dividend growth should be rewarded – stability of cash flows is important

---

**Revisiting our Outlook for 2018: What Came to Pass and What Didn’t**

**What Came to Pass**

- **U.S. Economy Strengthened**—On top of strong fundamentals in the U.S. economy heading into 2018, stimulus in the form of tax reform and deregulation provided an additional boost to corporate profits and consumer spending. These forces, coupled with higher government spending and an uptick in productivity, have helped the U.S. economy break out from secular stagnation into a regime of stronger growth and higher interest rates, as we had expected heading into 2018.

- **Profit Cycle Accelerated**—Consensus expectations heading into 2018 were for S&P 500 operating profits in the $146-$149 range and we expected profits to accelerate due to accelerating GDP growth, fiscal policy catalysts and regulatory policy easing. We forecasted stronger than consensus earnings per share (EPS) growth with $153 our base case and a high probability we exceed $153 and end closer to $158. Full year profits for 2018 are tracking even higher to the mid $160 range. A combination of revenue growth, tax cuts, capital investments and stock buybacks are driving earnings growth above expectations.

- **Robust Capital Expenditures**—A number of conditions have led to the strength in capital spending that we expected for 2018. Record-high jobs openings compelled companies to augment their labor force with capital equipment and automation in order to enhance productivity and protect margins, while incentives from tax reform have been an additional boost to spending as well. Capital expenditures for S&P 500 companies have been robust this year, logging double-digit growth for each of the first two quarters this year, but guidance has weakened slightly, perhaps impacted by lower oil prices and uncertainty surrounding trade.

- **Uptick in Productivity**—A central component of the breakout from secular stagnation in 2018 has been a gradual pickup in productivity. Aided by rising capital spending, the year-over-year labor productivity growth rate has gradually accelerated from -0.3% in 2016 to 1.3% this year. In addition to leading to higher potential growth over the long term, higher productivity is one of the key reasons why, despite a tightening labor market and rising wages, inflation has not accelerated to the upside, helping to improve the longevity of the expansion.
• **Higher Volatility**—Heading into 2018, with the Fed gradually raising interest rates and shrinking its balance sheet, we had expected equity market volatility to trend higher towards more “normal” levels. The flattening of the yield curve (measured by the spread between the yield of 10-year Treasury notes and the fed funds rate) to around 70 basis points suggests that the Fed is still accommodative, but less so. A flatter yield curve typically signals that the economy is entering its later stages, contributing to higher market risk and, consequently, the higher volatility that we’ve seen this year. While a number of risks, ranging from trade wars to geopolitics, have grabbed headlines and contributed to episodic sell-offs, we feel monetary policy is the underlying driver of higher equity market volatility in 2018.

**What Didn’t Come to Pass**

• **Global Equities Didn’t Strongly Outperform Fixed Income**—For most of the year, global equities outperformed fixed income, driven by solid economic growth and rising corporate profits. Heading into October, concerns about a slowdown in growth in 2019, along with numerous risks from the U.S.-China trade war, the potential for a global economic slowdown and fear of over-tightening by the Fed weighed on valuations and resulted in a number of major sell-offs. These forces culminated in a near convergence of returns for global fixed income and equities in 2018 (as of December 4, 2018). However, U.S. equities were continuing to outpace U.S. fixed income on a total return basis in 2018 as this publication went to print.

**Exhibit 1:** Late year sell-off causes a convergence in returns for global fixed income and equities

Bloomberg. Data as of December 4, 2018. Global Bonds is Bloomberg Barclays Global Aggregate Total Return Index (Investment Grade). Global Equities is MSCI ACWI Total Return USD Index. *Past performance is no guarantee of future results. Performance would differ if a different time period was displayed. Short term performance shown to illustrate more recent trend.*

• **Synchronized Global Growth Didn’t Continue**—Global growth has become less balanced in 2018, with the U.S. economy strengthening while the rest of the world has moderated. Outside the U.S., growth across Europe has slowed down, led by key economies like Germany and Italy, while manufacturing activity has decelerated and business sentiment has waned. Populist pressures continued to build in countries such as Italy while businesses and investors weighed the potential outcomes of Brexit. Emerging markets have come under pressure as a result of a stronger dollar from rising interest rates in the U.S., as well as higher oil prices earlier in the year that hurt energy importers such as India. Trade wars were also detrimental to emerging markets, which depend heavily on external demand for growth, as China’s structural slowdown has been a drag on global demand.

• **U.S. Corporate Credit Spreads**—There were two main causes of the widening in credit spreads over U.S. Treasuries that occurred during 2018, with the latter being more fundamental in nature than the former. The first driver was cash flows from repatriation in the first part of the year as companies brought money from overseas back to the U.S. by selling corporate bonds that were held abroad and were subsequently not reinvested in corporate bonds but rather used for capital spending, buybacks etc. The second was risk-off sentiment that began in early October as fears over trade, global growth and a policy mistake by the Fed led to a selloff in corporate credit, as well as concern over the absolute growth of corporate credit since the financial crisis, in particular BBB-rated issuers.

• **Emerging Market Stocks Didn’t Outperform**—A number of factors have contributed to the underperformance of emerging markets this year, not the least of which has been trade tensions contributing to deteriorating economic growth across a number of key economies such those of China, Brazil, Argentina and Korea, along with uncertainty that has reduced risk appetite and investor sentiment. A stronger dollar has led to tighter financial conditions, which have hurt financial stability and contributed to episodic sell-offs. The structural slowdown in China (which makes up around a third of the MSCI Emerging Markets Index), concerns over a hard landing there, its leverage and the nation’s future relationship with the U.S. were all key drivers in emerging market underperformance in 2018.
- Favor U.S. equities over international for more stability and for top-line growth fundamentals, improving cash flows augmented by repatriation
- Lower exposure to leverage as a factor
- Use more diversified investment managers

- The growth versus value decision is not clear cut given the later stage of the cycle. Value is gaining momentum. Maintain a more balanced view.
- One of the better environments for income generation—cash and short-term fixed income yields, dividend growth—in a while.
- Raise exposure to strategic allocation levels in non-correlated strategies as appropriate.
- Continue to favor the shorter-term portion of the Treasury yield curve.

What's on the tactical watch list heading into 2019?

Given the expected slowdown in growth, the geopolitical headwinds and risks of the dollar not reversing its strengthening course early in 2019, we have the following observations:

- Cash is on the potential upgrade list for purposes of hedging downside in risk assets and the attractive levels of shorter-term yields.
- The commodity asset class should benefit if our dollar weakness expectations pull through. However, any potential benefit could be muted given the slower-growth environment. If we are correct and real growth remains above trend while the dollar weakens there is potential for positive adjustments.
- U.S. small caps (higher beta risk), non-U.S. developed markets (slower growth, fiscal inflexibility, Italy’s budget woes) and emerging markets (need a weaker dollar, less Fed tightening) stay on the watch list.
- In fixed income, we do not foresee any change to our preference for higher-quality, lower-to-neutral-duration bond (short-term fixed income) positioning and the attractiveness of yields in this section of the yield curve relative to longer-duration areas. Corporate credit spreads have recently widened out as growth concerns have risen. This is an area to watch closely. We are analyzing balance sheet trends closely for any signs of a significant deterioration in corporate fundamentals.

MACRO OUTLOOK

Describe the macro economic landscape for 2019. What are the major changes from 2018? What are the key areas to watch to assess where we are in the cycle?

Going into 2019, the U.S. economy and equity market valuations are transitioning to a more historically normal interest rate structure as economic growth normalizes after the long period of secular stagnation that followed the financial crisis. The U.S. breakout contrasts sharply with the lack of economic progress made in Europe.

The three main risks to our generally constructive outlook are: (1) the Fed over tightens and brings back heightened deflation risks; (2) Europe continues to dither with anti-growth policies that undermine the viability of the single currency; and (3) the broader geopolitical confrontation with China disrupts global economic growth. Of these we are least confident that the European situation will be resolved favorably.

Higher U.S. Rates and Trade Tensions

The global economy entered 2018 with a full head of steam in a synchronized global expansion that almost immediately began to succumb to the forces of rising inflation and oil prices along with the impact of persistent U.S. monetary policy tightening. Countries and sectors that had taken advantage of zero interest rates on dollar loans to leverage balance sheets began to feel the impact of higher rates. By the spring, it became apparent that a strong U.S. economy buoyed by tax reform, deregulation and fiscal stimulus was accelerating, while the European economy and some emerging markets started to slow down. The U.S. policy shift to trade issues early in the year caught the markets by surprise, however, injecting an additional source of uncertainty alongside concerns about tightening dollar liquidity as the Fed was on course to drain about $500 billion from the U.S. monetary base. The big difference between stronger U.S. growth and weakening momentum elsewhere caused a major divergence in equity market performance over the summer until the U.S. market eventually corrected on fears that the Fed was on course to snuff out the expansion, if the trade war did not do it first.

At year-end, the markets are expecting U.S. real GDP growth to moderate by about a half-point in 2019 from a roughly 3% pace in 2018. The 200-basis-point jump in interest rates since 2016 has clearly taken a toll on the residential real estate market, which is also suffering from the loss of property tax deductions in high-tax states, as well as softening demand at the high end of the market, where reduced foreign-buyer interest and overbuilding are now weighing on prices. While inflation and
commodity prices were rising earlier in the year, the situation has changed as the growing economic divergence and a stingier Fed strengthened the dollar and tightened financial conditions.

Going into 2019, there is a growing worry that policymakers in Europe and the U.S. are erring on the side of restrictive policy. Global economic momentum peaked in the spring at the highest level in over a decade and has been slowly subsiding over the past seven months. Significantly, while the momentum has declined, it remains high by historical standards suggesting that global growth is still solid. While the initial slowdown occurred outside the U.S., recent developments have also raised questions about the longevity of the U.S. expansion as higher rates have begun to restrain interest-sensitive sectors, with housing and automobile sales the most prominent examples.

Europe has been the most disappointing region, with the biggest surprise decline in growth of the major economic areas. Europe’s growth rate dropped sharply in the winter and has never recovered. The conflict between the new populist Italian government and the EU bureaucrats illustrates the main problem that has plagued the Eurozone for the past decade. Refusal to allow stimulative fiscal policy and the tendency to force austerity on members help explain the severe underperformance of Europe since the financial crisis a decade ago. The punitive approach that the EU is taking toward the U.K.’s Brexit effort is another example of the anti-growth bias that is stymying the continent’s progress. The failure of the anti-populist leadership in France and Germany, together with the rise in populism elsewhere, including Italy, is a sign that the single currency is living on borrowed time. An eventual day of reckoning remains one of the biggest risks to our outlook given the inability of European leaders to formulate a pro-growth strategy and fix the flawed financial architecture of the single-currency system. Because of Europe’s setbacks this year, it is hard to believe that the European Central Bank (ECB) will begin normalizing interest rates in 2019.

Japan, on the other hand, appears to be on a more solid growth track. Third-quarter growth was hit by natural disasters, but a recovery seems to be underway. A fourth-quarter 2018 and first-half 2019 turnaround should be supported by slowing inflation, an expected China rebound, and ongoing construction for the 2020 summer Olympics. Unlike Europe, the world’s third-largest economy enjoys pro-growth fiscal and monetary policies that are lifting it out of the deflationary funk of the past 25 years. A scheduled value-added tax (VAT) increase for October 2019 is likely to cause a front-running burst of consumer spending that will stimulate growth further ahead of year-end, and measures to offset that tax hike are expected to mitigate its subsequent negative impact.

China and other emerging markets are expected to benefit from the less robust dollar when the Fed finally signals a pause in rate hikes. High dollar oil prices were a major restraint on oil importers that saw big depreciation in their currencies against the greenback. That drag should reverse a bit now that oil prices have cooled off and the dollar has stabilized some. A key factor for 2019 will be China’s currency policy. Will it continue to engage in competitive depreciations that drag down other emerging market currencies similar to this year’s response to trade pressures?

All told, global growth is likely to cool some in 2019 unless other countries follow the U.S. and Japanese leads with more pro-growth fiscal and monetary policies. This is what happened in the 1980s when competitive pressures forced the rest of the world to follow Reagan’s lower tax policies. Already we are seeing this happen in China, Canada and other places since the U.S. tax reform in 2017. A bigger positive policy response would be a catalyst for stronger growth in 2019.

What is your view regarding Fed policy in 2019? What should we watch closely as the year progresses?

Spreading signs that the Fed’s rate hikes to date are causing a global slowdown have focused attention on how far monetary tightening can go. It’s important to realize that rate hikes take a year or two to work their way through the economy, so there is a lot of restraint still to come from what the Fed has already done. Recently, senior Fed officials, like Chairman Jerome Powell and Vice Chairman Richard Clarida, have said that moving rates to neutral, rather than a restrictive setting, makes sense given the lack of an inflation problem. In fact, this year’s global slowdown has turned inflation back below the Fed’s target.

The problem is that the Fed is unsure of where the neutral rate is, with Federal Open Market Committee (FOMC) members’ estimates ranging between 2.50% and 3.50%. These “guesstimates” have come down substantially over the past few years, indicating that the Fed was seriously overestimating the neutral rate. Similarly, the Fed has been uncertain about the so-called natural rate of unemployment, another example of a key policy guidepost that is “fuzzy” and was revised substantially lower over the past few years. These overestimates have caused the Fed to be overly tight and fall short of its inflation target during the past decade, contributing to the “secular-stagnation” malaise.

As a result, risk management considerations suggest that the Fed should err on the side of ease until it has a better handle on where the neutral rate resides. Market indicators suggest that the Fed is already near neutral. Vice Chair Clarida has admitted as much. First, the yield-curve spread between
the overnight and 10-year Treasury rate is arguably the best gauge of the stance of monetary policy. Currently, this spread is well below its long-run average of about 100 basis points, suggesting that policy is already around neutral. Second, this view is also suggested by stock market volatility, as measured by the Chicago Board Options Exchange Volatility Index (VIX). The relationship between volatility and the yield curve indicates that policy is already neutral, as the VIX has increased from about 10 in 2017 to about 20 in 2018, which happens to be about its long-run average as well (see Exhibit 2). Basically, over the course of a monetary policy tightening cycle the yield curve flattens and volatility rises. Currently, both measures are near their long-term averages, which suggests that policy is already around neutral.

**Exhibit 2: Volatility trends above average once the Fed exceeds the neutral rate**

![Volatility trends graph](image)


Forecasts for Fed policy in 2019 range up to a maximum of four rate hikes. As inflation has rolled over and growth fears have risen, the market has built in just one rate hike for next year. The actual result will be data-dependent. Importantly, the Fed does not want to be unnecessarily restrictive given the absence of sufficient inflation pressures to justify causing a recession. This means that the Fed would need to see continued strong data and evidence of rising inflation to justify more rate hikes. This is what the consensus expects. The risk that the Fed will overshoot as it tries to normalize rates and cause a recession is rising. That is why volatility increases with the flattening yield curve. The biggest U.S. risk we see for 2019 is a Fed overshoot given the lagged effects of Fed hikes to date and the big gap that has opened between market indicators and Fed guesses about where the neutral rate lies. An inverted yield curve would be a sign that the Fed has overreacted and created a high risk of recession.

There has been recent concern about inversion in the belly of the Treasury curve, but even a dramatically flattening yield curve doesn’t need to lead to a significant inversion. In 1994, for example, the Fed doubled the fed funds rate from 3% to 6%. Shorter-term Treasurys sold-off, causing the spread between two-year and 10-year notes (the 2s/10s spread) to collapse; it fell from more than 100 basis points to flat in less than two months. Anyone looking simply at the pace and trajectory of the flattening at that time would have taken inversion as a given. However, the Fed correctly read the tea leaves and paused in February 1995. The 2s/10s curve stopped flattening, and stayed essentially flat — mostly between 0 and 50 basis points — for the rest of the decade. As long as the Fed pays attention and responds, inversion — and an eventual recession thereafter — is not a done deal. The Fed still has both the time and the tools necessary to extend the current expansion, and recent disinflation provides a good excuse to pause.

**Exhibit 3: Mid-course policy correction prevented inversion in 1995**

![Mid-course policy correction graph](image)

*Source: Bloomberg. Data as of December 4, 2018. Past performance is no guarantee of future results.*

Discuss your view on the direction of the U.S. dollar and short- and long-term interest rates. What are the key catalysts that will determine their trend?

When the Fed pauses, it will likely take upward pressure off the dollar, helping to stop the currency depreciation in emerging markets and to close some of the performance gap between the U.S. and other markets. When the Fed pauses will depend primarily on the course of inflation, which has rolled over since most global equity markets turned bearish. An extended downturn in inflation would likely cause long-term interest rates to fall and the yield curve to invert as the deflation fears of the post-financial crisis period reignite in the U.S. This would be a grave monetary policy mistake, which the Fed should avoid at all costs. As a result, we expect
a more pro-reflationary effort from the Fed to prevail, with stronger growth and a slower, more stretched-out pick-up in interest rates rather than the abrupt, overly restrictive path the markets fear. Delaying restrictive policy until inflation calls for it allows reflation to work longer and short and long rates to drift higher over time.

Describe the geopolitical climate in 2019. What are the key risks and potential hotspots?

There will be no shortage of geopolitical hotspots next year, although we do not expect any major global event to fundamentally alter our global economic or earnings expectations. Ongoing tensions in the Middle East between the Sunni and Shiites, China’s expansionary thrust in the South China Sea and North Korea’s nuclear intentions—while all of these dynamics are important, we believe they will remain secondary threats to the financial markets next year. Of more consequence to the market—rising political populism across Europe, the known unknowns related to “Brexit” and political tension points between the Republicans and Democrats in the United States. Meanwhile, despite a temporary U.S.-EU trade “truce” declared over the summer, renewed talk of auto tariffs may upset markets in the coming months, when the U.S. Commerce Department is anticipated to release the results of its national security investigation into auto imports. U.S.-China tensions will ebb and flow throughout the year, although we don’t expect a full-blown crisis to emerge. Globalization will continue, but at a more halting pace; populism-cum-nationalism is gaining strength in certain parts of the world (Europe, the United States) but has yet to upend the decades-long run in globalization.

How will the U.S.-China trade battle play out? What types of outcomes do we expect in 2019, and how will this affect the markets?

Sweet and sour is the best way to characterize U.S.-China relations over the near term. We expect there will be periods of calm and episodes of tension again in 2019. Our base case is that the U.S. and China avoid a full-blown trade war, although periodic skirmishes over forced technology transfers and intellectual property rights will bubble up at certain points in 2019. Positive developments at the G-20 summit did little to address these fundamental issues, and uncertainty surrounding upcoming trade talks between the two nations has kept global markets on edge. That said, we believe tough talk from both sides will not be matched by extreme measures that inhibit trade, investment and cross-border commercial linkages. U.S.-Sino relations go well beyond trade; the two largest economies in the world are co-dependent in terms of trade, finance, investment, energy and a host of other areas. A trade “truce” is expected to remain in place next year, with trade tensions between the two parties less of a headwind in 2019 versus 2018.

Is Europe slowly moving towards a more destabilizing bloc in the post-Merkel era? What does this mean for European growth and assets? What is the latest on Brexit?

2019 will be a challenging year for Europe—Italy, Brexit and the EU parliamentary elections remain tension points; compounding matters is the cyclical downswing in real growth. Additionally, Europe’s export-dependent economy leaves the region highly exposed to a global slowdown in demand and a pullback in trade flows. Thus, a protracted U.S.-China trade war could have significant consequences for exporters in the region. Concerning Brexit, the United Kingdom is scheduled to depart the EU on March 29, 2019. Although a draft of the withdrawal agreement was approved by the EU at the end of November, many challenges remain. The U.K. House of Commons still has to approve the deal, and even if passed by the U.K. and EU parliaments, detailed trade negotiations and transition plans remain points of uncertainty.

Notably at risk from Europe’s slowdown and political uncertainty are U.S. multinationals with large investment stakes in the region that rely on Europe as a key source of foreign profits. Decelerating growth in Europe threatens to undermine U.S. global earnings heading into next year.

That said, we believe the European Central Bank will become less hawkish in 2019 (and back off from raising rates), while populist pressures across Europe result in more fiscal spending, not less. Both components are supportive of growth and earnings and should dampen the negative impact of a structurally and cyclically weaker Europe.

EQUITIES

What’s your view on equities in each corner of the world in 2019? What should we expect for returns, volatility, earnings growth, valuation and market internals in the U.S.? What sectors, size (large, mid, small), styles (value and growth) and factors (high quality, low quality, momentum, dividend growth, etc.) are expected to be the leaders?

Global equities appear to be bruised but not broken. The selloff in international equities this year came to the U.S. in October as investors began to reconcile the moderating pace of economic and profit growth, tighter financial conditions and a boil-up in the trade war with China. At the present time, we retain our preference
for U.S. equities in light of their higher quality, and monitor a slight overweight to emerging markets reflecting a better risk/return skew and our base case outlook for a weaker dollar.

The flattening of the Treasury yield curve and specifically the recent inversion of the 2-year-to-5-year part of the curve has spooked investors. We are monitoring this important development and watching the 3-month/10-year as well as the 2-year/10-year spread but note that the yield curve has provided mixed signals for equities. While there is some lead time between inversion and the onset of subsequent economic recessions (18 months on average), the range has been wide (from nine to 29 months). Importantly, the S&P 500 index has risen by 20% on average from the inversion date to its peak with a range of 5% to 38%. Therefore, history would dictate equity investors should pay attention to the shape of the curve but also include economic activity, profits, valuations and sentiment to decide on shifts in equity allocations.

U.S. equities still have room to run: The current bull market rally, traced back to March 9, 2009, is the longest on record since World War II and has generated a total return of 389% (as of December 4, 2018). However, the climb has been daunting at times, with numerous threats including the European crisis, U.S. debt ceiling and Chinese slowdown fears building up a wall of worry that the market has overcome via corporate profit growth, historically low interest rates and accommodative monetary policy. Two of those pillars are now removed as interest rates have risen, albeit not to a level causing fundamental stress for equities, while the Fed moves further from accommodation and closer to neutral or beyond. Corporate profits remain the keystone for stock returns and we expect earnings per share growth to slow from the torrid pace of late (+20%) and settle toward 5%-6% in 2019, guided by nominal economic growth and buybacks. Going forward, the bull market should continue its run, with returns more aligned to this trajectory of profit growth with less multiple expansion.

While we expect the level of earnings to rise in 2019, earnings estimates have deteriorated over recent months, with declining oil prices, fears of a slowdown in global growth, trade wars and potential Fed over-tightening weighing on analyst expectations (see Exhibit 4). Including these recent revision trends, earnings growth should still be reasonable in 2019. This should be supportive of global equities but we are watching for further weakness to guide our outlook.

Exhibit 4: Earnings estimates have deteriorated, but growth should still be reasonable

<table>
<thead>
<tr>
<th></th>
<th>U.S.</th>
<th>Europe</th>
<th>Japan</th>
<th>Asia Pac ex-Japan</th>
<th>Emerging Markets</th>
</tr>
</thead>
<tbody>
<tr>
<td>Nov-14</td>
<td>0.2</td>
<td>0.7</td>
<td>1.2</td>
<td>2.2</td>
<td>2.7</td>
</tr>
<tr>
<td>May-15</td>
<td>1.7</td>
<td>2.2</td>
<td>2.7</td>
<td>3.2</td>
<td>3.7</td>
</tr>
<tr>
<td>Nov-15</td>
<td>2.2</td>
<td>2.7</td>
<td>3.2</td>
<td>3.7</td>
<td>4.2</td>
</tr>
<tr>
<td>May-16</td>
<td>2.7</td>
<td>3.2</td>
<td>3.7</td>
<td>4.2</td>
<td>4.7</td>
</tr>
<tr>
<td>Nov-16</td>
<td>3.2</td>
<td>3.7</td>
<td>4.2</td>
<td>4.7</td>
<td>5.2</td>
</tr>
<tr>
<td>May-17</td>
<td>3.7</td>
<td>4.2</td>
<td>4.7</td>
<td>5.2</td>
<td>5.7</td>
</tr>
<tr>
<td>Nov-17</td>
<td>4.2</td>
<td>4.7</td>
<td>5.2</td>
<td>5.7</td>
<td>6.2</td>
</tr>
<tr>
<td>May-18</td>
<td>4.7</td>
<td>5.2</td>
<td>5.7</td>
<td>6.2</td>
<td>6.7</td>
</tr>
<tr>
<td>Nov-18</td>
<td>5.7</td>
<td>6.2</td>
<td>6.7</td>
<td>6.7</td>
<td>7.2</td>
</tr>
</tbody>
</table>

Source: BofA Merrill Lynch Global Research, MSCI, IBES. Data as of November 26, 2018. Past performance is no guarantee of future results. Performance would differ if a different time period was displayed. Short-term performance shown to illustrate more recent trend.

The U.S. continues to lead other regions in quality metrics such as return on equity and top-line fundamentals, while the earnings outlook remains solid. Overseas, earnings growth tumbled in Europe (4% in 2018 versus 27% in 2017), while consensus estimates for 2019 have fallen as economic growth has slowed, led by key economies such as Germany and Italy. Valuations have compressed as uncertainty over Brexit and Italy’s budget have dampened risk appetite, with no immediate end in sight. The combination of weakening growth fundamentals and political fragmentation makes us incrementally cautious on Europe. Japan offers a better risk/reward in our view, with improving fundamentals such as return on equity, supportive monetary policy and more attractive valuations. Japan is also less reliant on trade (exports of goods and services are 18% of GDP versus 28% for the euro area) so corporate earnings should be relatively insulated from flare-ups in trade tensions.

Emerging markets have faced a confluence of headwinds, including a slowdown in China that contributed to slower earnings growth, fears of a global growth slowdown, trade uncertainty and a stronger U.S. dollar. As a condition of our confidence in EMs, we expect to see reduction in trade uncertainty and more dovish language from the Fed. Over the intermediate term, economic data and profits will be the drivers, with monetary and fiscal stimulus in China standing out as a potential source of relief for EM growth. And for more patient, long-term investors, valuations and secular trends (such as the rising middle class consumer) remain compelling opportunities.

1 Source: Bloomberg.
Volatility

There are a number of potential sources of episodic equity volatility in 2019 such as debt ceiling discussions, Fed meetings, the slope of the yield curve, U.S.-China trade dialogue and developments regarding Brexit and Italy. However, we identify monetary policy as the primary driver of higher levels of volatility going forward. The spread between the 10-year Treasury yield and the Fed funds rate is a powerful measure of the monetary accommodation in the economy, with higher inflation typically prompting the Fed to gradually raise rates, tightening financial conditions and leading to higher market risk as the end of the cycle approaches. Ultimately, this typically leads to higher volatility as the yield curve flattens. The spread has tightened to around 70 basis points, suggesting that volatility should normalize to levels approaching 20 for the VIX volatility index. What should give investors some comfort, however, is that bouts of volatility that are not associated with recessions tend to be relatively short-lived. Looking at data going back to 1945, recessions have generally been associated with market declines of 29.5% on average tending to last around 13 months. In contrast, 10%+ declines during non-recessions have been more short-lived (three months on average) and leave equities well-positioned to continue their uptrend (see Exhibit 6).


Exhibit 5: Highlighted Sectors and Industries

<table>
<thead>
<tr>
<th>Sector</th>
<th>Rationale</th>
<th>Subsectors in Focus</th>
</tr>
</thead>
</table>
| Health Care    | • Strong fundamental, positive earnings revision ratios, and attractive absolute and relative valuations  
• Focus on innovation within Med Tech, Life Sciences & Tools with U.S. and global demographics indicating larger aging populations  
• Recommend high quality Health Care exposure with strong fundamentals and reduce lower quality and higher beta companies  
• Selective on Pharma and Biotech giving drug pricing headwinds for the foreseeable future | Med Tech, Life Sciences & Tools, select Pharma and Biotech |
| Financials     | • Banks are attractive on absolute and relative valuation metrics with stronger balance sheets, higher capital reserves and lower asset/equity ratios  
• An inversion between longer and shorter points on the yield curve represents a risk to banks, however we do not anticipate an inversion  
• Potential catalysts include higher interest rates, U.S. economic growth, increasing capital return and a more bank friendly regulatory regime | Banks, Credit Card Networks, Mobile Payments |
| Information Technology | • High foreign sales exposure for the sector is counterbalanced by the software sub-sector that is relatively immune to tariff concerns  
• Strong free cash flow, increased capital return to shareholders, large stock buyback plans and recurring revenue businesses offer stability  
• Semiconductors pricing in bad news on global growth and trade and offer long-term investors good relative value | Software and Cloud |
| Industrials    | • Cyclical momentum across the U.S. economy and improvements in capital spending trends but potential offsets depending on trade tariff outcome  
• Focus on high quality industrials with strong ROE, balance sheets and returns of capital  
• Potential catalysts include infrastructure programs, global aerospace spend, HVAC replacement trends, waste and defense fundamentals | Commercial Aerospace & Defense, HVAC, Waste, Infrastructure |

Market Internals

Market flows, sentiment and structure do not appear to be signaling a consensus or conclusive directional opportunity.
There appears to have been multiple bouts of deleveraging from programmatic trading systems, due in part to elevated equity, bond and foreign exchange volatility, but no clear capitulation indicating a path forward. Risk assets including credit-sensitive fixed income have been battered and suffered recent outflows, while some defensive sectors and money market funds have enjoyed inflows.

Investor sentiment is trending closer towards positive contrarian territory but is not yet offering a resounding signal. Private client, sell-side and institutional measures are indicating more trepidation towards the equity market. The BofA Merrill Lynch (BofAML) Global Research Global FMS Average Cash Balance indicator stands at 4.7%, a contrarian “buy” signal, based upon the intuition that fund managers have cash to deploy. Finally, the organization’s Sell-Side Indicator currently tracks the average strategists allocation well below the threshold representing a more frothy market. While the backdrop of sentiment appears more favorable now than at earlier points, market internals are not presently conclusive.

**Size, Styles, Factors and Sectors**

After historic outperformance by the Growth style over Value (by roughly 34% from December 2016 to September 2018), Value has held up better through the recent market decline. While our strategic asset allocations continue to favor Value for long-term portfolios, the tactical decision is not clear-cut and we suggest a balanced approach between the two going forward. A rising rate environment supported by a strong economy in the U.S., coupled with depressed relative valuations, typically favors Value over Growth. However, an earnings slowdown benefits the Growth style, which has outperformed Value 38% versus 29% during periods of profit deceleration, according to BofAML Global Research. Given the mixed forces at play, we suggest investors identify attractive themes, sectors, and industries rather than place great emphasis on Growth versus Value.

High-quality and dividend-growth stocks should be better positioned to insulate against the risks of rising interest rates as the business cycle further matures. Higher quality has outperformed lower quality recently and we expect this trend to continue, especially as volatility moves higher and accessing capital become more expensive for lower-quality companies. Dividend-growth offers investors a medium duration entry point into both profit growth and yield exposure, providing cyclical exposure and higher payouts as rates rise.

The preference for higher quality also leads us to favor large cap over small cap equities. Small caps are more at the mercy of rising rates and widening credit spreads. They have higher exposure to floating rates, with more than 50% of small caps’ debentures floating-rate, compared to just 27% for large cap. In addition, leverage is at historically high levels and the weighted average maturity of Russell 2000 debt is just five years, compared to the S&P 500 at nine years. Small caps have also seen a deterioration in fundamentals, with weaker forward guidance and more earnings estimate cuts than large caps. Any moderation in economic activity, which we expect in 2019, should be felt hardest by small caps.

At the sector level, we recommend being selective, with a preference for technology (quality growth), financials (domestic value), healthcare (defensive but attractively priced) and industrials (beaten down global cyclicals with bounce-back potential). Within these sectors, higher-quality companies—those with strong balance sheets, business models that provide an economic “moat” or pricing power—are better-equipped to outperform in the higher-volatility environment that we expect in the coming year (see Exhibit 5).

**Have we hit peak valuations in U.S. equities?**

The S&P 500 forward price-to-earnings multiple has receded since the beginning of this year, peaking near 19x and currently residing just above 15x, leading some to question if “peak valuation” has been set and what implications that may bring. U.S. valuations presently trade near historic averages, and given the macroeconomic backdrop of heightened geopolitical risk, higher rates and moderating growth, we find the probability of valuation expansion rather slim. However, the risk in the near term is to the upside if the Fed pauses on its intended hiking path or U.S.-China trade negotiations turn constructive.

The relative attractiveness of equities to bonds peaked back in 2011. But equities remain more attractive. The spread between the S&P 500’s earnings yield and the 10-year Treasury yield is currently 250 basis points, well above the 56-year average of 39, but far from the 2011 peak of 644 (see Exhibit 7). In addition, short-dated Treasurys have emerged as a viable challenger to equities as rates have risen; the 3-month Treasury bill, for example, currently yields 2.4%, exceeding the S&P 500 index’s 2.0% dividend yield. Going forward, we believe equities will have to work harder for investor dollars and therefore corporate earnings will be the foundation for equities to grind higher. One additional point worth noting is that according to empirical data, starting valuation is the primary driver of future long-term returns. In fact, according to BofAML Global Research,

1 Returns measured by Russell 1000 Growth and Russell 1000 Value indices.
the predictive power of the normalized price-to-earnings ratio versus subsequent 10-year S&P 500 returns is 80%, with the current figure suggesting annualized returns approximating 6% over the next decade.

While valuation expansion is unlikely in the U.S., the narrative differs overseas. Current international equity valuations remain attractive on both an absolute and relative basis, incorporating a higher risk premium for patient investors. From a price-to-book (P/B) standpoint, Europe currently trades at 1.7x (the 28th percentile of its historical range) and Japan at 1.3x (the 29th percentile), and both are below their respective historic averages. Meanwhile, emerging markets have seen their P/B ratio (at 1.5x) contract more than any other region in 2018, down 15% from the start of this year. Therefore for most long-term investors, international equities should remain a part of their strategic asset allocations. International equities will need a near term catalyst to kickstart a re-valuation upward, however.

**Exhibit 7: Equities vs. fixed income: which is more attractive?**

[Graph showing spread between S&P 500’s earnings yield and 10-year Treasury yield (basis points)]

Source: Chief Investment Office, Bloomberg. As of December 5, 2018. Past performance is no guarantee of future results.

Describe your view on emerging markets? What catalysts are out there that can turn them around in 2019? What would prompt a downgrade for EM as an asset class?

Emerging markets were major laggards relative to global equities for most of 2018, giving back their outperformance from the previous year and leaving relative valuations at multi-year lows. Three main drivers in our view explain the recent weakness. Balance sheet reduction and interest rate increases by the Fed have tightened EM financial conditions, particularly for countries with large current account deficits. A strengthening U.S. dollar has raised the external debt burden for EM foreign currency borrowers. And U.S./China trade frictions have undermined the outlook for exports and inward investment, particularly in the Asia-Pacific region.

Going into 2019, it will therefore be important to assess the sensitivity of individual EM countries and regions to any improvement or deterioration in these external factors. With the weakest current account balances and largest share of U.S. dollar debt to GDP, Latin America and EMEA (Europe, Middle East and Africa) remain the most exposed to U.S. rate hikes and dollar appreciation and would stand to gain the most from a Fed pause or a U.S. dollar reversal. By contrast, the fundamental picture in emerging Asia, which accounts for over 70% of EM market capitalization, is much stronger. Of the nine Asian markets in the MSCI index, eight have current account surpluses or only moderate (less than 3%) deficits as a share of GDP, while dollar borrowing as a share of the regional economy is much lower than in the rest of the EMs. And growth rates in EM Asia remain strong, with five of the nine countries growing at 5% or more.

But how the U.S.-China trade relationship develops will likely be the biggest directional catalyst for Asian markets over the near term, not only for China itself but also for Korea and Taiwan, which are closely tied to U.S.-China supply chains in information technology and consumer electronics. The direct impact from tariffs introduced so far remains relatively low—the $250 billion of Chinese exports subject to U.S. tariffs only account for around 2% of China’s GDP. But the indirect effects from higher uncertainty leading to weaker business confidence and lower investment, as well as the risk of further protectionist measures in the future, have been additional headwinds for local markets.

At the same time, it is important to keep in mind that China’s economy is becoming increasingly driven by domestic demand. Even though China’s overall growth rate is gradually slowing down, service activity now represents 52% of Chinese GDP—up 10 percentage points from a decade ago (see Exhibit 8).

China is therefore becoming less dependent on the traditional growth drivers of trade and investment. And we continue to view the broader Asia region as well-positioned to benefit from the structural rise of the emerging market consumer class, especially from current valuations. According to the Brookings Institution, 2.4 billion new middle class consumers will be created in the emerging world between 2015 and 2030, with just under 90% of the increase coming from the Asia-Pacific. On a sector basis, this implies greater demand for discretionary items such as autos, electronics, health services, international travel and media. Asia’s relatively large weighting in consumer-linked sectors (over 50% in consumer discretionary, consumer staples, technology and healthcare) leaves it more exposed to growth in these areas over the longer-term.
**INVESTMENT STRATEGY OVERVIEW**

Expansion to continue—our outlook is cautiously optimistic. With this backdrop—including a Fed intent on allowing the cycle should have already occurred, as the bulk of price drops that the majority of the move lower in Treasury prices for this cycle. This means neither accommodative nor restrictive—and so longer-term rates believers the Fed is approaching the neutral fed funds rate—yield curve has continued to flatten, highlighting that the market lowered the expected path for long-term rates in 2019. The yields sooner. Finally, the significant move this year has likely higher rates means that investors can reinvest at more attractive interest rate or credit risk. Second, the quicker adjustment to streams that keep pace with inflation without taking significant financial repression is over. Investors can now create income toward a higher rate regime sooner or later.

There are three silver linings for investors in 2019. First, the era of financial repression is over. Investors can now create income streams that keep pace with inflation without taking significant interest rate or credit risk. Second, the quicker adjustment to higher rates means that investors can reinvest at more attractive yields sooner. Finally, the significant move this year has likely lowered the expected path for long-term rates in 2019. The yield curve has continued to flatten, highlighting that the market believes the Fed is approaching the neutral fed funds rate—neither accommodative nor restrictive—and so longer-term rates should be closer to their terminal value for this cycle. This means that the majority of the move lower in Treasury prices for this cycle should have already occurred, as the bulk of price drops should be behind us.

With this backdrop—including a Fed intent on allowing the expansion to continue—our outlook is cautiously optimistic. Municipals ("Munis") should perform reasonably well, as credit risks are broadly low while technicals remain supportive. Munis are a relatively safe asset class with regards to credit risk—their 10-year cumulative default rate is just 0.17%, according to Moody’s, which tends to make them a decent relative investment later in the economic cycle. Even with several high-profile defaults in recent years, we expect municipal defaults to remain infrequent events over the near-to-intermediate term. Furthermore, technicals are positive, as we only expect a modest increase in supply in 2019.

Investment grade had a more challenging year. Spreads are almost 50 basis points above their recent tights at 137 basis points currently, a more than 50% jump. This sell-off has been significant, echoing other signs in the market that the Fed is closer to neutral and should consider a pause. A central bank policy mistake—not our base case—could force spreads even wider. With this backdrop, short-end high-quality corporates appear to be one of the better risk-adjusted return potentials in fixed income markets, with yields of around 3.80% for less than three years of duration risk, beating inflation handily as well as 10-year Treasury yields, and reducing corporate spread risk. Given the risks cited, we advocate for neutral positioning on corporate credit.

As recent volatility highlights, U.S. Treasurys will continue to provide a diversification benefit for equity portfolios, and have higher running yields now than in 2017. Treasurys should still be a core component of fixed income portfolios. Rates gradually moving higher will continue to erode coupon returns, however—a "coupon-lite" environment.

For high yield, the story is less clear. The significant correction in valuations has moved yields to around 7.30%—the highest in two-and-a-half years, inching closer to an equity-like return. If economic strength continues and volatility recedes, high yield could perform well near-term. However, yields and spreads still do not compensate for an unforeseen economic shock, or central bank policy error. On a five-year time horizon, assuming a recession occurs before 2024 returns through the cycle will be very meager. Given our equity overweight, therefore, we continue to slightly underweight high yield, as price risk in a downturn is not adequately compensated by good near-term return potential, and equity-like risk is still more rewarded outside of fixed income. To the extent that high yield does do well near-term, it is likely to coincide with better equity returns; diversified investors will hopefully have that to console them.
**Special topic: Discuss the size and potential market implications of the BBB marketplace in fixed income.**

Low rates and favorable markets have encouraged corporations to issue debt to finance capital returns to shareholders and merger and acquisition (M&A) activity. This has increased leverage across corporate America. Nowhere has this been more evident than in BBB-rated corporate debt, which has grown to become 48% of the market, up from 35% ten years ago. Furthermore, a significant portion of this BBB debt would have been rated high yield before the financial crisis, as rating agencies have become more lenient on leverage metrics—giving companies more credit for size and diversification. Not surprisingly, investors are becoming increasingly wary.

On the positive side, the Fed wants this economic recovery to continue, and expansion of corporate balance sheets is a natural part of that economic cycle. Corporate profit margins and interest coverage ratios are near cycle peaks, both positives. The sectors that have driven increased leverage include more defensive and consumer-related areas, whose earnings and debt service capacity should prove more resilient in a downturn.

On the negative side, the amount of BBB-rated bonds has grown disproportionately relative to the high yield market, and is at the highest relative amount on record (see Exhibit 9). This inhibits the high yield market’s future ability to absorb large volumes of “fallen angels”—bonds from investment grade companies that have ‘fallen’ into the high yield rating category. This could lead to significant price, spread and yield dislocations for any large issuers downgraded to below BBB. In particular, the high yield market generally only invests out to 10 years, so longer-dated bonds that fall into high yield could be particularly affected. Price declines could trigger further selling, causing a negative feedback loop.

Sentiment and technicals do matter; the large price declines that could accompany a wave of fallen angels is a risk. Still, we believe this needs to be taken in context. First, a portion of investment grade companies moving to high yield is also a natural part of the economic cycle. Fallen angel volume always peaks during an economic downturn, or periods of idiosyncratic stress. This movie has played out before, and digesting fallen angel volumes is not a new issue for fixed income markets. Secondly, credit losses exhibited by BBB companies are just not that large, in either absolute or relative terms. BBB bonds average 0.87% credit losses over 5 years—that is only 18 basis points per annum—relatively minor compared to the overall high yield market (11.9% over five years) or the BB market (5.0%). Even if overleveraged companies lead future BBB losses to be three times the average, those credit losses would still be approximately half of BB bonds’ credit losses, and therefore unlikely to be significant enough to derail large parts of the economy. Third, this is largely an issue for industrial and corporate America—not banks or financials. An issue with the latter is always more concerning for the economy as a whole.

For these reasons, while we acknowledge that fallen angel volumes and BBB credit losses will likely be larger than average when the cycle turns, we view this as more of an issue of significant price declines for selected issuers, not a systemic concern for fixed income markets overall. Prices and yields will adjust, bonds will transition from ratings-sensitive investors, and new pools of capital will form to absorb the higher risk at commensurately higher yields. In this vein, a strong credit team, security selection and diversification are of

---

1 Source: Bloomberg, as of November 2018.

paramount importance for investors, and focusing on up-in-quality corporates is advised.

**COMMODITIES AND ALTERNATIVE INVESTMENTS**

What’s your view on commodities? Is a mini-cycle brewing given your thoughts on the dollar and inflation in 2019? Or does the asset class have too many cross currents in it?

We are maintaining a neutral tactical weight on commodities as an asset class given a number of cross currents and uncertainties. Demand for most commodities should remain firm with global growth expected to stabilize near trend in 2019. Stronger-than-expected growth in emerging markets like China and Brazil could offer some upside to demand forecasts even as fiscal stimulus fades in the U.S. The downside risks parallel our risks to global growth—an escalation of trade wars, a growth shock from Europe or China or a hard Brexit. Commodity prices will also remain vulnerable to dollar strength, but our base case is that the dollar weakens slightly in 2019, acting as additional support for commodity prices. As always, there is a lot of uncertainty around the direction of the dollar. Lastly, global financial conditions could be a swing factor. A Fed “pause,” for example, could reignite risk appetites and the late-cycle reflation trade that has historically been positive for commodities as an asset class. We think this is a compelling case to maintain strategic exposure.

**Discuss your view across alternative investments. What areas are most/least attractive? What is needed to provide more competitive returns or more effective diversification opportunities?**

Challenging markets such as these have long been associated with strong relative showings from alternative investments (AI). Whereas volatility tends to grate on traditional investors’ nerves, common wisdom is that AI investors typically welcome these environments because asset price swings and dislocations provide opportunity for managers who seek to profit during upswings and drawdowns alike. But, while opportunity is certainly a necessary ingredient for outperformance in the AI space, it is hardly sufficient in and of itself. Individual manager skill plays an equally important role in AI performance (as evidenced by mixed strategy and manager performance this year), perhaps even more so during late-cycle periods like this when returns are in scarce supply.

Looking ahead, we believe certain market developments could go a long way toward laying the groundwork for alternative investments to generate competitive returns next year. Continued normalization of correlations and widening dispersion should support stock-picking strategies in 2019. We favor incremental allocations to equity-oriented strategies such as equity long/short and equity market neutral within multi-asset portfolios as a means of capturing differentiated equity exposure (alpha and beta). If the knock-on effects of tightening and tariff concerns result in sustained volatility across stocks, bonds, currencies and commodities, we think it could signal better times ahead for diversifying AI strategies with flexible mandates. Accordingly, we are monitoring global macro for signs that this strategy has once again found its way after years of underwhelming returns.

We see similar return drivers shaping areas of private equity (PE) in 2019. Though we view implementation of PE through a strategic lens and strongly advise against timing PE investments, we do believe that near-term dynamics such as the normalization of interest rates, default rates and volatility, not to mention secular shifts due to technological disruption, could help counter-cyclical strategies such as special situations next year and beyond. Last, we remain optimistic, albeit cautiously so, on opportunistic real estate, underpinned by our sanguine outlook for the U.S. economy, low vacancy rates and good supply/demand balance across various property types. That said, at this point in the cycle, allocations are advisable only in select markets and with top-tier experienced managers.

If this year’s trends are any indication of what to expect in 2019, we think returns in the AI space could be more reflective of individual manager-level positioning rather than strategy exposure (as described by industry benchmarks). Returns from market sources could also be scarcer than in previous years. To us, this underscores the increased importance of careful manager selection and sizing when investing in alternative investments.

**ADDITIONAL THOUGHTS ON THE YEAR AHEAD**

What can we expect from Washington given the midterm election and split Congress?

With the midterms behind us, and Washington facing a likely gridlock scenario with a split Congress, political rhetoric will likely be elevated, and the likelihood of a significant policy change between now and 2020 is low, in our view. However, this may not be a negative environment for stocks. First, political noise seems to have been a factor contributing to the higher volatility we have seen so far in 2018, which is par for the course in midterm election years, during which stocks have experienced an average correction of 19%. However, equities historically tend to bounce back from that correction on average by 31% over the next year. A possible explanation for this dynamic could be that during midterm election

---

1 Source: Strategas. Data as of November 6, 2018.
Special topic: What are mutual fund managers doing regarding the recent volatility in order to prepare portfolios for 2019?

Mutual fund managers we partner with tell us they are taking the following steps.

Regarding equities, the general consensus among the managers is:

- Reduce cyclical, interest rate and economically sensitive exposures and reallocate to more secular growth and defensive positioning in the portfolios.
  - Strongly preferred sectors: Healthcare, Financials; preferred sectors: Information Technology, Consumer Staples, Communication Services, Consumer Discretionary.
  - Regional: Prefer U.S. over international, increasing interest in Asian companies.
- Focus on high-quality businesses; look for balance sheet strength (prefer companies with fixed debt vs. floating), wide moats.

A contrarian view expressed is to stick with cyclical value sectors in the belief that the cycle still has legs, while recommending investors consider rotating into some sectors that offer a more balanced return between income and capital appreciation and out of sectors that offer high capital appreciation.

When it comes to fixed income, the managers tell us:

- They are stressing diversification, not only among risk assets but for interest rate risk and credit risk and across countries and sectors while maintaining liquidity to take advantage of buying opportunities presented by the volatility.
- Managers are emphasizing short duration and floating-rate securities to manage the interest rate risk.
- Multi-sector funds have shifted to a more defensive profile, holding higher levels of cash and short-term Treasurys while maintaining exposure to investment grade and high yield corporates.
- Within credit sectors, they are favoring areas of securitized credit over corporate bonds, such as commercial mortgage-backed securities, collateralized loan obligations, asset-backed securities and other areas of infrastructure debt.
- Emerging markets are highlighted as they are expected to be volatile and therefore offer opportunities, but investments need to be very selective and closely managed.

So what can we expect in terms of policy? With a divided government, additional tax cuts are unlikely and fiscal spending is expected to be constrained. A modest infrastructure bill is likely, as both Democrats and Republicans support greater infrastructure spending; however, a major legislative initiative could face hurdles, especially from political disagreements on funding and spending priorities. On the regulatory front, we expect the current regulatory framework to change little. Most regulatory changes from the administration have not required congressional approval. We expect a great deal of political bluster for tighter regulation in energy, financials and healthcare, but don't expect any significant policy changes. Lower drug prices, however, is a bi-partisan goal, and could have an impact on certain healthcare stocks.

In our opinion, the debt ceiling needs to be raised in 2019, which undoubtedly will bring to the fore much political grandstanding and threats of a government shutdown. Debt-limit debates are also usually the most divisive and bitter with a divided Congress. We hardly expect 2019 to be different, although we believe the debt limit will be raised in the end. One key trend to watch will be capital expenditures; while conditions are still favorable for them to rise given tax incentives and a tight labor market, we are watching for signs of headwinds to business optimism from a rise in policy and trade uncertainty from Washington.

On trade, the U.S.-Mexico-Canada Agreement will be up for a vote in early 2019, and is expected to garner Democratic support given that the updated version includes provisions that raise wages in Mexico and boost manufacturing in the U.S., and has broad support among labor groups, generally aligning with Democratic interests.

In our view, the “core” areas that are likely to set the tone for investors in the next year include the debt ceiling decision, a trade agreement with China, the Fed’s pace of hikes, immigration, infrastructure and healthcare. All of these except the Fed’s monetary policy are likely to be used in a variety of negotiations as both parties try to solidify their base heading into the 2020 election. At the end of the day, headline risk is high in the coming year but we do not expect material changes to policy that would undermine economic fundamentals.
Opportunity Zones: Describe the main components and what do we expect in 2019?*

Included in the Tax Cuts and Jobs Act passed in late 2017, which cut corporate and individual income taxes, was a plan to incentivize capital to find its way into Opportunity Zones. Opportunity Zones were originally proposed in 2015 as a method of dealing with the uneven economic growth between different communities seen in the U.S. in the last 20 years. While the provision had strong bi-partisan support, it was ultimately included in the very partisan tax reform legislation. The idea behind Opportunity Zones is to identify economic areas that are economically weaker than other areas, and attract capital to provide a lift to jobs and housing in that currently under-resourced area.

While the broad framework was laid out in the tax act, many important details around the program were left to the U.S. Treasury and the IRS to define. Some, but not all, of those details were provided by the Treasury department in October 2018. More details are expected in an additional round of Treasury guidance. The broader idea is that in order to attract private capital into Opportunity Zones, tax-deferment, tax-reduction and tax forgiveness were offered to taxpayers. This means that investors with capital gains embedded in current holdings are able to defer their liabilities by rolling that gain into new or improved assets (or businesses) within an Opportunity Zone, eventually reduce some of the deferred tax liability and completely avoid taxes on subsequent gains from the Zone asset, as long as certain rules and timelines are met. Zone Assets may be new private businesses or tangible assets, such as substantially improved real estate. In some instances, a significant portion of the business’ cash flow must emanate from within the Zone itself. For this reason, real estate has largely been identified as the more suitable investment for outside capital of material scale. Ultimately, tax savings for investors may be 10%-15% of their rolled over capital gain, along with 100% of the new asset gain, as long as the program milestones are met.

Next year is an important one for Opportunity Zone investing, as the federal tax savings can be maximized on assets that are identified and initially funded before the end of 2019. With additional guidance still anticipated from Treasury, it means the window for raising capital and funding investments is narrowing. There are over 8,700 Opportunity Zones identified in the U.S., so that leaves the possibility of a lot of real estate assets to be supported by the plan, but our expectation is that real estate in Zones in and around Gateway cities are already likely more fairly valued, reflecting the historic period of low interest rates and strong recovery of values in Gateway areas during the last 10 years. It’s hard to say whether the narrowing window for the program might push some of those assets higher, or drive capital into secondary or rural markets in the U.S. Suffice it to say, in our search for partners to manage Opportunity Zone investments, we will pay close attention to those partners’ history of discipline in their capital allocation decisions. Additionally, while execution during 2019 is important, these investments must be held for at least 10 years to maximize the tax benefit, so near-term market conditions are less relevant than the longer-term management of the asset for investors.

What changes are you making to long-term capital market assumptions (CMAs) given the financial market activity in 2018?

We review our long-term CMAs annually to account for changes in key market conditions, such as those in equity valuations or in interest rates, which serve as foundational inputs to our disciplined investment process. It’s important to note that our CMAs are long-term in nature and are used to set strategic asset allocations (SAAs) for investors with planning horizons of 15 to 25 years. Our CMAs, which include return expectations, asset price volatility and correlations for various asset classes, help drive our strategic asset allocation models across a variety of risk profiles.

CMAs are driven by changes in fundamental and macroeconomic inputs; given the uptick in cash yields as the Fed has hiked multiple times in the past 12 months, the rise in inflation expectations and the shift in the yield curve, our CMAs have been adjusted slightly for 2019. The CMA changes with the most widespread impact therefore include a somewhat higher expected rate of inflation, which is positively contributing to the nominal capital market return assumptions across all asset classes. The biggest beneficiary of this is our expected return assumption for cash. In other asset classes such as equities and fixed income, the effects of additional marginal changes in valuations (for equities) and the yield curve (for fixed income) largely offset the increase in expected inflation on their respective expected returns. Therefore, the only material change to our 2019 CMAs is the expected return assumptions for cash.

What is the overall portfolio strategy and positioning for 2019? What are the main risk budgets we should consider as the year unfolds?

Since the CMA adjustments are relatively minor, the changes to SAAs are modest for 2019. In summary, the SAA adjustments included a rise in cash at the expense of longer-dated fixed...
income in the conservative profiles, and, generally, an increase in quality via a minor increase in U.S. large caps. Our tactical tilts relative to the strategic allocations are expected to remain unchanged at this point, but are subject to adjustments based on the increase in event risk as we head into 2019. These SAA changes will be reflected in the Chief Investment Office portfolios starting in January 2019.

In addition, changes in our tax assumptions this year are driven by the Tax Cuts and Jobs Act of 2017, which reduced the marginal tax rates for individuals starting in the 2018 tax year. Therefore, we have adjusted our assumptions for the income tax rate and short-term capital gains tax rate applicable to the top federal income tax bracket for 2018, the former of which was lowered from 39.6% to 37.0%. We believe this change in the tax bracket has a very small impact overall, and is limited to only those SAAs with high tax-sensitivity.

INDEX DEFINITIONS

The Bloomberg Barclays Global Aggregate Index is a measure of global investment grade debt from twenty-four local currency markets. This multi-currency benchmark includes treasury, government-related, corporate and securitized fixed-rate bonds from both developed and emerging markets issuers.

CBOE Volatility Index (VIX) is a popular measure of the stock market’s expectation of volatility implied by S&P 500 index options, calculated and published by the Chicago Board Options Exchange. It is colloquially referred to as the fear index or the fear gauge.

The MSCI ACWI Net Total Return USD Index is a market capitalization weighted index designed to provide a broad measure of equity market performance throughout developed and emerging markets across the globe. A total return index tracks both the capital gains of a group of stocks over time, and assumes that any cash distributions, such as dividends, are reinvested back into the index.

The MSCI EAFE Index is a stock market index that is designed to measure the equity market performance of developed markets outside of the U.S. & Canada.

MSCI Emerging Market Index captures large and mid cap representation across 23 Emerging Markets (EM) countries. With 832 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country. EM countries include: Brazil, Chile, China, Colombia, Czech Republic, Egypt, Greece, Hungary, India, Indonesia, Korea, Malaysia, Mexico, Peru, Philippines, Poland, Russia, Qatar, South Africa, Taiwan, Thailand, Turkey and United Arab Emirates.

Russell 1000 Growth Total Return measures the performance of the large-cap growth segment of the U.S. equity universe. It includes those Russell 1000 companies with higher price-to-book ratios and higher forecasted growth values.

Russell 1000 Value Total Return measures the performance of the large-cap value segment of the U.S. equity universe. It includes those Russell 1000 companies with lower price-to-book ratios and lower expected growth values.

The Russell 2000 Index measures the performance of approximately 2,000 small-cap companies in the Russell 3000 Index, which is made up of 3,000 of the largest U.S. stocks in terms of market capitalization. The Russell 2000 serves as a benchmark for small-cap stocks in the United States.

S&P 500 Index includes a representative sample of 500 leading companies in leading industries of the U.S. economy. Although the index 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.
IMPORTANT DISCLOSURES

This material was prepared by the Chief Investment Office (CIO) and is not a publication of BofA Merrill Lynch Global Research. The views expressed are those of the CIO only and are subject to change. This information should not be construed as investment advice. It is presented for information purposes only and is not intended to be either a specific offer by any Merrill Lynch or U.S. Trust entity to sell or provide, or a specific invitation for a consumer to apply for, any particular retail financial product or service that may be available.

Global Wealth & Investment Management (GWM) is a division of Bank of America Corporation. Merrill Lynch Wealth Management, Merrill Edge®, U.S. Trust, and Bank of America Merrill Lynch are affiliated sub-divisions within GWM. The Chief Investment Office, which provides investment strategies, due diligence, portfolio construction guidance and wealth management solutions for GWM clients, is part of the Investment Solutions Group (ISG) of GWM.

This publication is designed to provide general information about economics, asset classes and strategies. It is for discussion purposes only, since the availability and effectiveness of any strategy are dependent upon each individual’s facts and circumstances. Always consult with your independent attorney, tax advisor and investment manager for final recommendations and before changing or implementing any financial strategy.

Neither Merrill Lynch, U.S. Trust nor any of their affiliates or advisors provide legal, tax or accounting advice. You should consult your legal and/or tax advisors before making any financial decisions.

OTHER IMPORTANT DISCLOSURES

Past performance is no guarantee of future results.

Investing involves risk, including the possible loss of principal. No investment program is risk-free, and a systematic investing plan does not ensure a profit or protect against a loss in declining markets. Any investment plan should be subject to periodic review for changes in your individual circumstances, including changes in market conditions and your financial ability to continue purchases.

Economic or financial forecasts are inherently limited and should not be relied on as indicators of future investment performance. All sector and asset allocation recommendations must be considered in the context of an individual investor’s goals, time horizon, liquidity needs and risk tolerance. Not all recommendations will be suitable for all investors.

Equity securities are subject to stock market fluctuations that occur in response to economic and business developments. Asset allocation, diversification, dollar cost averaging and rebalancing do not ensure a profit or protect against loss in declining markets. Dollar cost averaging involves continual investment in securities regardless of fluctuating price levels; you should consider your willingness to continue purchasing during periods of high or low price levels.

Investing in fixed-income securities may involve certain risks, including the credit quality of individual issuers, possible prepayments, market or economic developments and yields and share price fluctuations due to changes in interest rates. When interest rates go up, bond prices typically drop, and vice versa. 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).

Tax-exempt investing offers current tax-exempt income, but it also involves special risks. Single-state municipal bonds pose additional risks due to limited geographical diversification. Interest income from certain tax-exempt bonds may be subject to certain state and local taxes, and if applicable, the alternative minimum tax. Any capital gains distributed are taxable to the investor.

Investments in high-yield bonds (sometimes referred to as “junk bonds”) offer the potential for high current income and attractive total return, but involve certain risks. Changes in economic conditions or other circumstances may adversely affect a junk bond issuer’s ability to make principal and interest payments. International investing involves special risks, including foreign taxation, currency risks, risks associated with possible differences in financial standards and other risks associated with future political and economic developments.

Global investing poses special risks, including foreign taxation, currency fluctuation, risk associated with possible differences in financial standards and other monetary and political risks. Investments focused in a certain industry may pose additional risks due to lack of diversification, industry volatility, economic turmoil, susceptibility to economic, political or regulatory risks and other sector concentration risks.

Investing in emerging markets may involve greater risks than investing in more developed countries. In addition, concentration of investments in a single region may result in greater volatility. Stocks of small and mid cap companies pose special risks, including possible illiquidity and greater price volatility than stocks of larger, more established companies.

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. Tangible assets can fluctuate with supply and demand, such as commodities, which are liquid investments unlike most other tangible investments. Nonfinancial assets, such as loosely-held businesses, real estate, oil, gas and mineral properties, and timber, farm and ranch land, are complex in nature and involve risks including total loss of value. Special risk considerations include natural events (for example, earthquakes or fires), complex tax considerations, and lack of liquidity. Nonfinancial assets are not suitable for all investors.

Always consult with your independent attorney, tax advisor, investment manager, and insurance agent for final recommendations and before changing or implementing any financial, tax, or estate planning strategy.

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 risks related to renting properties, such as rental defaults.

Alternative investments are intended for qualified and suitable investors only. 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.

Alternative investments are speculative and involve a high degree of risk.

An investment in a hedge fund involves a substantially more complicated set of risk factors than traditional investments in stocks or bonds, including the risks of using derivatives, leverage and short sales, which can magnify potential losses or gains. Restrictions exist on the ability to redeem units in a hedge fund. Hedge funds are speculative and involve a high degree of risk.

Treasury bills are less volatile than longer-term fixed income securities and are guaranteed as to timely payment of principal and interest by the U.S. government. Dividend payments are not guaranteed. The amount of a dividend payment, if any, can vary over time.

Diversification does not ensure a profit or protect against loss in declining markets. The investments discussed 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 in income and principal than securities in higher rated categories.

Investments in foreign securities involve special risks, including foreign currency risk and the possibility of substantially volatile 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. 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).

MLPF&S is a registered broker-dealer, Member SIPC and wholly owned subsidiary of BofA Corp.

This report may not be reproduced or distributed without prior written consent.

© 2018 Bank of America Corporation. All rights reserved.

Merrill Lynch
Bank of America Corporation