CHIEF INVESTMENT OFFICE

The Weekly Letter

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Chief Investment Office

Niladri Mukherjee
Managing Director

Emmanuel D. Hatzakis
Director

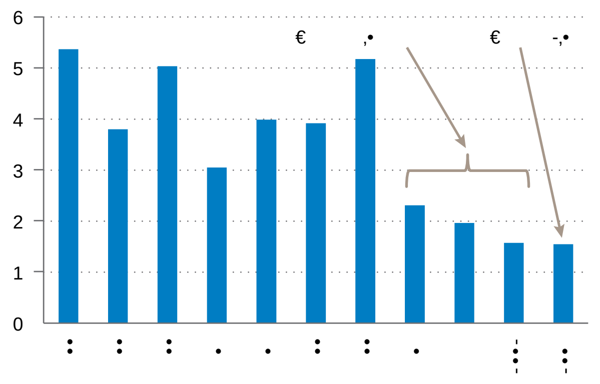
- Low volatility has become common across most markets. We look at why this is so and examine some of the catalysts for higher volatility that could arise—a geopolitical flare-up, a China slowdown, a policy mistake by the Federal Reserve or another central bank, Washington gridlock over issues like the debt ceiling or tax reform, and global political uncertainty.
- Equities were mixed last week, with the S&P 500 flat and international equities, as measured by the MSCI EAFE Index, down 0.2%. Bond prices edged slightly higher, with the 10-year Treasury yield down 1 basis point to 2.14% from 2.15% on Friday of the prior week. Commodities as measured by the Bloomberg Commodity Index fell 2.0%, with WTI crude oil falling 3.9% to $43.01 per barrel. Gold gained 0.2% to end at $1,256.71 per ounce.
- Attention concerning U.S. economic data this week will be focused in part on measures of inflation along with consumer demand and sentiment. Overseas, investors will be looking to see whether European confidence remains near recent highs.

Volatility and Market Risks

Asset price volatility remains extremely low. The VIX Index, a measure of stock-market volatility, closed at 9.75 on June 2, the lowest level since 1993 and less than half the long-term average of 20. It's not just a domestic stock market phenomenon though. Low volatility has become common across most markets, including international equities, bonds and currencies. This is puzzling, for while economic surprises have moderated recently, monetary policy is becoming less accommodative and political and policy uncertainty are high, chiefly due to the mixed outlook for fiscal reforms in the U.S., upcoming elections in Germany and Italy and the uncharted waters that Brexit negotiations are sailing into, especially given the U.K. government's election setback.

There are several reasons for such low volatility readings. We see volatility arbitraged away by automated quantitative investment programs that continue to search for any kind of volatility and yield. Many hedge funds seem over-hedged, given the latest positioning, and large liquidity pools globally (such as sovereign wealth funds) continue to rebalance across asset classes on weakness. We believe that as volatility rises, excessive liquidity around the world still earning close to zero percent will be used to fund increases in exposure. This situation is also keeping yields at the long end of the curve from popping higher.

Exhibit 1: U.S. economic growth has become more stable.



Source: BofAML Global Research. Years from National Bureau of Economic Research. Data as of June 18, 2017.
Past performance is no guarantee of future results.

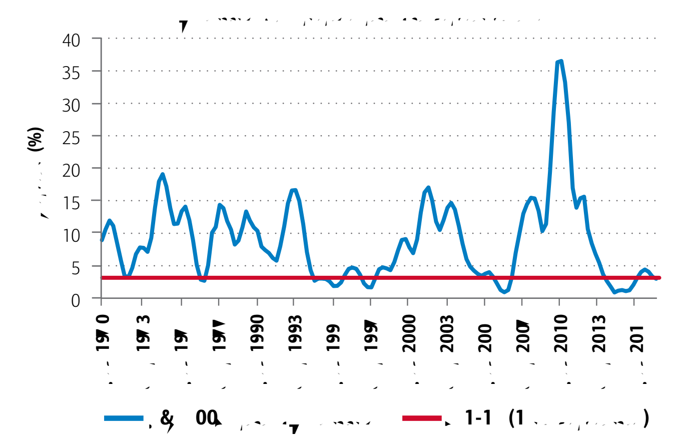
A few times in this cycle we've seen a sudden drop in stocks and a rapid rebound, demonstrating an unusual tendency for markets to quickly jump from calm to stress and back. Market shocks, it seems, have come to be viewed by investors as opportunities rather than the onset of a major decline. One possible explanation is that investors have retained a high degree of confidence in the ability and willingness of central banks to come to their rescue when economic data has deteriorated or financial stress has risen. Another, more fundamental reason for low market volatility could be that the volatility of U.S. economic growth (during times of expansion) has fallen to post-war lows, which has had a downstream dampening effect on the volatility of realized earnings (see Exhibit 1 on page 1 and Exhibit 2 below).

We believe most volatility indicators should remain abnormally low and episodic in nature until a policy error occurs or there's a major profit miss by a big-cap technology name that is over-owned. Other event risks include geopolitical flare-ups, China's credit problems, Washington gridlock over issues like raising the debt ceiling and tax reform, and global political uncertainty.

Let's take a closer look at these risks.

Markets tend to underprice geopolitical risks. Most of them are known but some, the most disruptive ones, are unknown. Among the known ones are the situations in Syria, Iraq and other places in the Middle East, and the escalation of tensions around the Korean peninsula, Ukraine and the South China Sea. The market seems to be rather insensitive to them. For example, the tough rhetoric from both North Korea and the U.S. hardly seems to register in global markets, even those of South Korea and its neighbors. It is hard to predict what might happen should words change to actions, and even more difficult if an as-yet-unknown geopolitical situation materializes.

Exhibit 2: Volatility of U.S. earnings is also low.



Source: BofAML Global Research. Data as of June 18, 2017.
Past performance is no guarantee of future results.

The resurgence of economic growth in China to rates above 6% was aided by sizable fiscal stimulus. This led to rising debt levels and prompted policymakers to start tightening to prevent instability from developing. Since so much of China's growth depends on credit, any restriction of it could slow the economy down. Early indications that this may be happening are drops in demand manifested in lower prices for some commodities, such as iron ore, that are fundamental to Chinese economic growth and therefore sensitive to its swings. The risks go both ways: A large slowdown from over-tightening could disrupt capital flows and the global commodity markets, as we are currently witnessing. Insufficient tightening would allow imbalances to continue growing, possibly turning the already high debt levels into a much bigger problem.

With the U.S. economic expansion entering its ninth year, the Fed just hiked its benchmark interest rate for the fourth time off the zero bound that started in December 2015. The puzzling element of this slow expansion and tightening cycle is that while the unemployment rate has dropped to some if its lowest peace-time levels, inflation remains unusually subdued, and has been below the Fed's target and market expectations for the last several months. With the economy at conditions of full employment, it is reasonable to expect a build-up in wage pressures, which would be passed on to consumers through higher prices. The outlook for that development remains uncertain. Should the Fed continue tightening, it might put this economic expansion at risk. If it takes a pause, the economy may overheat, which could cause a severe inflation overshoot that would need to be dealt with through more aggressive tightening down the road, potentially killing this expansion.

The optimism with which the market greeted Trump's election in November was based on his pro-growth agenda, and lasted for a few months as his administration was being staffed by business leaders who could be trusted to implement it. As delays in passing key items of that ambitious agenda, such as healthcare reform, started to materialize, it became obvious that it was not going to be easy. Five months on, healthcare reform is still being debated, and the longer it drags on, the less likely Congress will have a meaningful tax reform package in place this year or early in 2018. With other contentious issues coming up, such as the debt ceiling, the risk of further delays or adverse outcomes could spook the market. Elsewhere, election outcomes in Germany and later Italy are potential volatility triggers, and so are Brexit negotiations, which are becoming trickier with the U.K. government's weakened mandate following the recent election.

Undoubtedly, volatility at today's low levels has the effect of making investors more complacent. We see it in higher valuations for U.S. stocks and also tighter credit spreads in the bond market. The longer such conditions persist, the more fragile asset prices could become. Volatility levels should rise somewhat and move closer to normal levels over the next couple of years as the expansion matures. Our recommendation remains to stay invested in long-term, goals-based, balanced portfolios and to emphasize the themes of higher quality, secular growth and yield at a reasonable price.

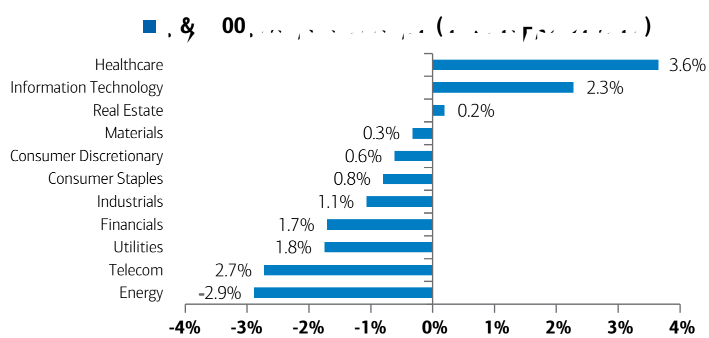
Vice President

Markets in Review

Trailing Economic Releases

- The Conference Board reported its U.S. leading indicator rose 0.3% month-over-month for May, surpassing April's rise of 0.2%. After sluggish growth in recent economic data, the new reading lends support to the narrative that weakness is transitory.
- Markit released its preliminary manufacturing and services Purchasing Managers Indices (PMI) for June at 52.1 and 53.0, respectively. The pace of growth has been trending downward since May, and while pricing pressures are emerging within services, they remain weak within manufacturing.
- In the Eurozone, Markit reported a flash reading for its manufacturing PMI of 57.3 and a services reading of 54.7. On aggregate, preliminary second-quarter European PMI data reflect the strongest quarter of economic growth in more than six years.

S&P 500 Sector Returns (as of last Friday's market close)



Equities

				(%)
			M	
DJIA	21,394.8	0.0	2.0	9.6
NASDAQ	6,265.3	1.9	1.1	17.0
S&P 500	2,438.3	0.2	1.2	10.0
S&P 400 Mid Cap	1,744.0	-0.5	1.4	5.8
Russell 2000	1,414.8	0.6	3.3	4.9
MSCI World	1,925.0	0.1	0.8	11.1
MSCI EAFE	1,889.2	-0.2	0.1	14.1
MSCI Emerging Mkts	1,011.7	1.0	0.9	18.3

Fixed Income

				(%)
	(%)		M	
ML US Broad Market	2.41	0.2	0.5	2.9
ML 10-Year US Treasury	2.14	0.1	0.6	3.5
ML US Muni Master	2.23	0.1	0.2	3.9
ML US IG Corp Master	3.13	0.3	0.8	4.5
ML US HY Corp Master	5.66	-0.3	-0.2	4.6

Commodities & Currencies

				(%)
			M	
Bloomberg Commodity	161.6	-2.0	-3.8	-8.7
WTI Crude $/Barrel[1]	43.0	-3.9	-11.0	-19.9
Gold Spot $/Ounce[1]	1,256.8	0.2	-1.0	9.1
			M	201
EUR/USD	1.12	1.12	1.12	1.05
USD/JPY	111.28	110.88	110.78	116.96

Source: Bloomberg.[1] Spot price returns. All data as of last Friday's close.
Past performance is no guarantee of future results.

Looking Ahead

Upcoming Economic Releases

- On Friday, the Bureau of Economic Analysis will report its Personal Consumption Expenditure (PCE) Core Prices Index, the Federal Reserve's preferred measure of inflation. BofAML Global Research expects no change for May, after a month-over-month gain of 0.2% in April. The flat reading would put year-over-year inflation at 1.4%, trailing the Fed's 2.0% target.
- Also on Friday, the University of Michigan's Consumer Sentiment Index will be released. BofAML Global Research estimates a reading of 94.5. While still at high levels, sentiment has come down a bit from its multi-year peak in January due in part to gridlock in Washington.
- On Thursday, the European Commission will issue its June report on economic confidence for the region. BofAML Global Research expects a reading of 108.8, a slight decline from May's 109.2 and a multi-year peak of 109.7 reached in April. Confidence within the Eurozone has been buoyed since late last year.

BofA Merrill Lynch Global Research Key Year-End Forecasts

[illegible]	201
Target	2,450
EPS	$129.00
[illegible]	201
Global	3.5%
U.S.	2.1%
Euro Area	1.7%
Emerging Markets	4.6%
[illegible]	201
Fed Funds (eop)	1.38%
10-Year T-Note (eop)	2.85%
[illegible]	201
Gold ($/oz-period average)	$1,286
WTI Crude Oil ($/bbl-eop)	$51.00

All data as of last Friday's close.

Merrill Lynch
Bank of America Corporation