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Chief Investment Office

Karin Kimbrough
Head of Investment Strategy, Merrill Lynch Wealth Management

→ **Policy Prognostications:** Navigating policy uncertainty is difficult. We've learned from experience that election outcomes and policy changes can be unpredictable. This week we look beyond the "howling and growling" surrounding global political and policy uncertainty to more moderate outcomes we anticipate with respect to Brexit, speculation about a Frexit and the ongoing development of U.S. fiscal and monetary policies. Our takeaway is to focus on fundamentals.

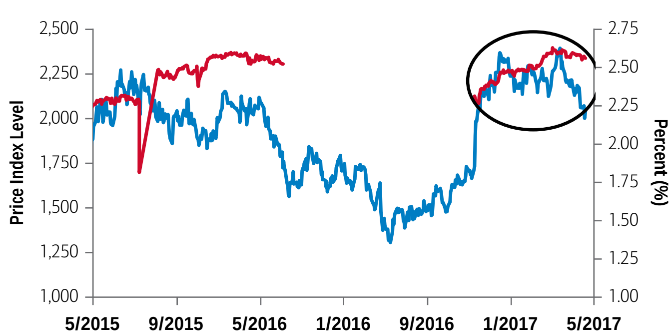
→ **Markets in Review:** Last week equities were higher, with the S&P 500 appreciating 0.9% and international equities, as represented by the MSCI EAFE Index, inching higher by 0.2%. Meanwhile, bonds marginally fell, with the 10-year Treasury yield up 1 basis point to 2.25% from 2.24% on Friday of the prior week. Commodities overall, as measured by the Bloomberg Commodity Index, fell 2.8%, with WTI crude leading the way with a 6.7% plunge to $49.62 per barrel. Gold moved slightly lower, falling 0.1% to $1,284.10 per ounce.

→ **Looking Ahead:** In the U.S., investors will digest gauges of consumer confidence and business investment. Notable regarding the latter would be hints that high optimism is spilling over into greater business spending. In the Eurozone, a busy economic week is highlighted by Eurostat's April inflation readings.

Policy Prognostications

We continue to witness the conundrum of relatively subdued market volatility in the face of a feverishly high level of global political and policy uncertainty. Key sources of it include a series of foreign elections, domestic tax and monetary policies and the geopolitical flashpoints of North Korea and Syria. Amidst it, two key U.S. markets have traded mainly sideways for months. The S&P500 and the 10-year Treasury appear mostly unmoved. Investors hit the pause button on their post-election exuberance, but they haven't turned to despair. (See Exhibit 1)

Exhibit 1: The S&P 500 and 10-year Treasury have traded sideways recently



round challengers, is heavily favored to win the run-off. No matter who does so, however, all eyes will quickly turn to the parliamentary elections in June. It is then that the coalitions will be decided and the majority party will establish its true power base for the to-be-named prime minister, and set out the governing agenda. A coalition is likely whatever the outcome of the May 7th vote since neither candidate is likely to win a big enough base in Parliament to govern alone. In France's recent past, when an election has led to an awkward coalition across parties, it has typically stymied the president's agenda. Macron, who is seen as close to Germany, has pushed for some tax cuts and labor market flexibility.

The tail risks of far left or far right victories are now vastly diminished, and the possibility of a Frexit, or French exit from the EU, is more remote. A more likely outcome after the second round is a tougher stance within the EU for more national expression and determination, rather than a full exit, in our view. The election may represent more of a victory for Europe as a union than for Macron specifically.

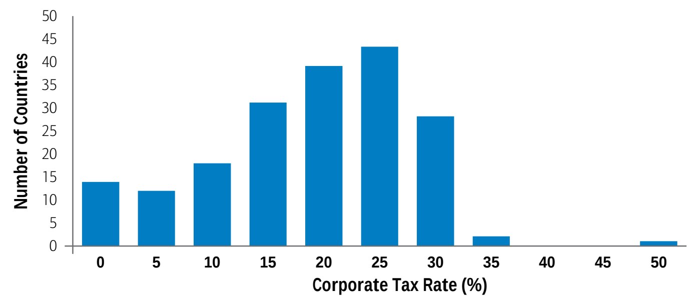
Markets reacted favorably to Sunday's outcome, with German and French bond yields higher, sovereign spreads narrower and the euro at least temporarily higher. The European Central Bank is likely to stay cool to any tightening until more political risk events pass, but the U.S. Federal Reserve (Fed) may feel more emboldened about it later in the year.

Fed-exit, yes, but tax policy is the focus

Back in the U.S., economic policy is increasingly—and rightfully—shaped by fiscal measures rather than the monetary authorities. Investors have realized that Republican control of the House, Senate and White House does not mean they are monolithic in their objectives, highlighting the challenges of forging tax policy. Our best guess, based on work by BofAML Global Research Economist Ethan Harris, is that comprehensive tax reform encompassing permanent cuts for both corporations and individuals may be an ambitious goal. A more likely outcome that the range of Republicans can probably agree upon is temporary corporate tax cuts and repatriation of foreign earnings, given that the current U.S. policy, with its 35% federal corporate tax rate, is so clearly not competitive with the rest of the world. (see Exhibit 2)

As we head toward the Fed's next rate decision on May 3, we do not expect a change then and look for no more than two more hikes in 2017. Despite some recently softer economic data pointing to a weak first quarter, we still think the next hike could come in June. The big picture, in our view, is that short-term rates will rise slowly for a few more years to come. It would take dramatically faster inflation to provoke an acceleration in the rate-hike cycle, but as long as slack remains in the economy and it continues to grow more slowly than potential GDP estimates, inflation should not accelerate too abruptly.

Exhibit 2: Distribution of countries by their corporate tax rates (2016)



Source:Chief Investment Office. Bloomberg, April 20, 2017

Beyond rates, the real parlor game among Fed watchers is when, and how, the Fed will reduce its $4.5 trillion balance sheet. In our view, the Fed will launch an adjusted plan late in 2017 to slowly taper its reinvestment of proceeds from its maturing bond holdings. We estimate that its balance sheet will settle at around $2.5 trillion in the long-term.

Portfolio Considerations: Navigating the policy uncertainty is difficult. We've learned from experience that election outcomes and policy changes can be unpredictable. As a result, we look through the "howling and growling" surrounding global political and policy uncertainty and focus on fundamentals. We expect a good first-quarter earnings season. We see a synchronized global recovery still intact, with non-U.S. economies providing solid momentum. We think the recent spate of "soft" sentiment data will eventually lead to positive "hard" activity data.

With another political hurdle cleared and earnings anticipated to exceed expectations, we continue to advise investors to consider buying on weakness as we still expect markets to move toward new highs. The main catalyst is global earnings, and our predictive Global Wave indicator is flashing green.

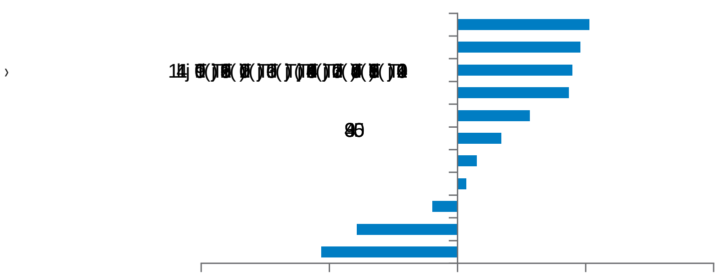
As we reiterated in our most recent **ISC Viewpoint**, we remain overweight equities, and while we prefer those from outside the U.S., we still like U.S. equities too. We maintain our focus on healthcare, energy and financials, as well as longer-term exposure in technology. We do not subscribe to the notion that the U.S. bond market is in a bubble, given our expectation that yields should gradually grind higher rather than shoot up abruptly.

Markets in Review

Trailing Economic Releases

- The Conference Board published its U.S. Leading Index for March. A greater than expected result of 0.4% month-over-month growth versus the consensus expectation for 0.2% bodes well for economic acceleration from what is expected to be weak growth of first-quarter real gross domestic product (GDP).
- Markit published its preliminary April Purchasing Managers Index for the U.S. service sector. The result of 52.5 was lower than the consensus estimate of 53.2 and marginally less than March's reading of 52.8. Yet the index continues to signal expansion for nearly 68% of the total economy.
- In the Eurozone, investors cheered a higher than expected Composite Purchasing Manager's Index from Markit. The result of 56.7 surpassed the BofAML Global Research and consensus estimate of 56.4.

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



Equities

	Level	Total Return in USD (%) WTD	MTD	YTD
DJIA	20,547.8	0.5	-0.5	4.7
NASDAQ	5,910.5	1.8	0.0	10.1
S&P 500	2,348.7	0.9	-0.5	5.5
S&P 400 Mid Cap	1,717.7	2.2	-0.1	3.9
Russell 2000	1,379.9	2.6	-0.4	2.1
MSCI World	1,842.1	0.6	-0.5	5.8
MSCI EAFE	1,780.8	0.2	-0.5	6.7
MSCI Emerging Mkts	961.8	0.2	0.5	11.9

Fixed Income

	Yield (%)	Total Return in USD (%) WTD	MTD	YTD
ML US Broad Market	2.44	0.0	0.9	1.8
ML 10-Year US Treasury	2.25	0.0	1.4	2.3
ML US Muni Master	2.32	0.2	1.0	2.4
ML US IG Corp Master	3.22	0.0	1.1	2.5
ML US HY Corp Master	5.79	0.2	0.5	3.2

Commodities & Currencies

	Level	Total Return in USD (%) WTD	MTD	YTD
Bloomberg Commodity	170.0	-2.8	-1.6	-3.9
WTI Crude $/Barrel‡	49.6	-6.7	-1.9	-7.6
Gold Spot $/Ounce‡	1,284.1	-0.1	2.8	11.4

Level	Current	Prior Week End	Prior Month End	2016 Year End
EUR/USD	1.07	1.06	1.07	1.05
USD/JPY	109.09	108.64	111.39	116.96

Source: Bloomberg. ‡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 Tuesday, the Conference Board publishes its U.S. Consumer Confidence index for April. BofAML Global Research expects a downtick to 120.0 from 125.6 in March. At this level, confidence would remain at healthy pre-2008 levels. Confidence has shifted higher since the 4th quarter of 2016 and suggests steady consumption growth.
- On Thursday, the U.S. Census Bureau releases its March preliminary report on Core Capital Goods Orders, an important measure of business investment. BofAML Global Research expects a month-over-month increase of 0.5%. Investors may be focusing on orders to determine whether rising optimism is spilling over into companies' investment plans.
- In the Eurozone, on Friday investors will be awaiting Eurostat's Consumer Price Index estimate for April. BofAML Global Research expects headline inflation to have increased 1.7% on a year-over-year basis, and core prices, which exclude food and energy, to have appreciated 1.1%.

BofA Merrill Lynch Global Research Key Year-End Forecasts

S&P 500 Outlook	2017 E
Target	2,450
EPS	$129.00
Real Gross Domestic Product	**2017 E**
Global	3.5%
U.S.	2.1%
Euro Area	1.5%
Emerging Markets	4.6%
U.S. Interest Rates	**2017 E**
Fed Funds (eop)	1.38%
10-Year T-Note (eop)	2.85%
Commodities	**2017 E**
Gold ($/oz-period average)	$1,286
WTI Crude Oil ($/bbl-eop)	$59.00

All data as of last Friday's close.

CHIEF INVESTMENT OFFICE

Christopher Hyzy
Chief Investment Officer
Bank of America Global Wealth & Investment Management

Mary Ann Bartels
Head of Merrill Lynch Wealth Management Portfolio Strategy

Karin Kimbrough
Head of Investment Strategy
Merrill Lynch Wealth Management

Niladri Mukherjee
Director of Portfolio Strategy,
Private Banking & Investment Group (PBIG) and International

Nicholas Giorgi
Vice President

Tony Golden
Director

Emmanuel D. Hatzakis
Director

Marci McGregor
Director

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Vice President

John Veit
Director

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