The Weekly Letter

OCTOBER 18, 2016

GWIM Chief Investment Office

Emmanuel D. Hatzakis
Director

- **Election clouds earnings impact:** We've seen some cautiousness in revisions of analysts' earnings estimates in the last month attributable to uncertainty over the upcoming election. Furthermore, the campaigning could distract investors from Q3 earnings reports and magnify the volatility typical of the reporting season. That said, we can point to several equity market sectors that look attractive based on management guidance and analyst revisions.
- **Markets in Review:** Last week equities were down, with the S&P 500 falling 1.0% from the previous Friday's close. International equities as represented by the MSCI EAFE Index declined 1.4%. Bonds fell on the week, with the 10-year Treasury yield finishing at 1.80%, up from 1.72% a week earlier. Commodities overall, as measured by the Bloomberg Commodity Index, rose 0.8%, with WTI crude up 1.1% to $50.35 per barrel. Gold fell by 0.4% to $1,251.43 per ounce.
- **Looking Ahead:** In the U.S., this week's economic data is headlined by the Bureau of Labor Statistics' Consumer Price Index for September and the U.S. Census Bureau's report on housing starts for September. In the Eurozone, releases are highlighted by Eurostat's regional Consumer Price Index for September.

Election clouds earnings impact

With the third-quarter U.S. earnings season getting underway, it's an opportune time to consider likely outcomes and what they could mean for portfolio positioning. U.S. firms will be reporting earnings for the next several weeks, and the process will be mostly completed by the first few days of November.

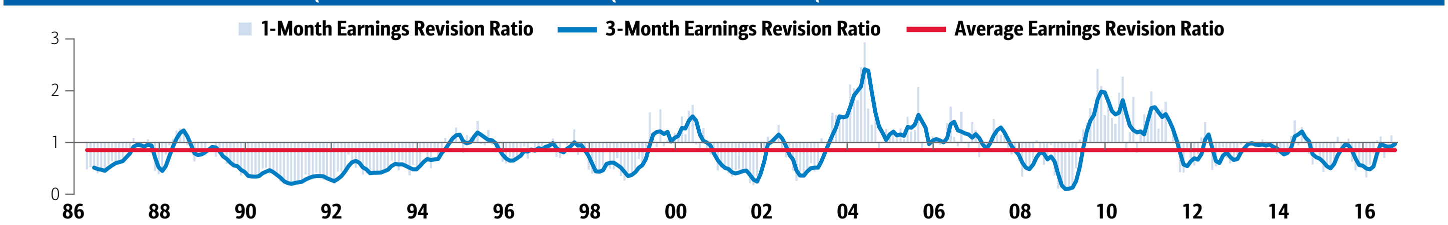
Large corporations in the U.S., as represented by the S&P 500 index, have been in an "earnings recession" for several quarters, meaning that their quarterly earnings as a group have declined on a year-over-year basis. The consensus among analysts is for this earnings recession to continue, but BofA Merrill Lynch (BofAML) Global Research differs in forecasting modest growth.[1] In an environment of elevated valuations, however, it doesn't see the magnitude of the growth as likely to lead to higher stock prices.

We have been seeing improving trends in revisions of analysts' earnings estimates in the last few months, with revision ratios indicating roughly the same number of positive and negative changes. However, there has been some caution in the last month, which BofAML Global Research attributes to election uncertainty. Furthermore, the upcoming election could distract investors from earnings, and the political uncertainty it entails could magnify the market volatility that is typical during the reporting season, as it has been doing recently.

Beyond earnings, sales growth is expected to remain weak, reflecting slow demand in the economy. It came in only slightly above expectations last quarter and downward revisions again outnumber positive ones this quarter. Decelerating business investment may contribute to this trend, as is usually the case in the politically uncertain environment around elections.

[1] BofAML Global Research. "Earnings Preview: 3Q16 Election uncertainty may overshadow 3Q earnings," October 3, 2016.

Exhibit 1: The Earnings Revision Ratio has Crept Above its Long-term Average



Source: BofA Merrill Lynch US Quantitative Strategy, I/B/E/S. Data as of September 30, 2016.

Stock buybacks, a factor that has played a significant role in supporting the market and providing healthy returns in the last few years, are mostly absent during the earnings reporting season, as firms are in a buyback blackout for a time leading up to their earnings reporting date.

Earnings drivers

We can examine factors that drive or influence corporate earnings.

Economic growth: After a few quarters of weakness, real growth in U.S. gross domestic product (GDP) is expected to come in at a healthy 3% seasonally adjusted annual rate in the third quarter, which should be a tailwind for earnings.

Oil prices: The decline of oil prices since the middle of 2014 was a drag on earnings of energy firms, which pulled down the aggregate level for the S&P 500. They boosted the sectors of the economy not directly linked to energy, but not as much as similar declines did in the past. This is because the U.S. has again become a major oil producer and the Energy and related sectors have become a significant part of the economy and of the corporate earnings pool. As oil markets rebalance to a better supply and demand equilibrium, oil prices should rise, which can improve Energy sector earnings in the future.

Interest rates: While long-term rates have declined to historic lows, with the 10-year Treasury yield below 1.40% in early July, they have edged higher in recent weeks at the prospect of stronger economic growth and higher inflation. Higher rates should positively impact earnings in the future through improvement in bank profitability. Investors have been anticipating this, as several financial sector stocks have risen recently. For the third quarter, however, BofAML Global Research expects modestly lower earnings for U.S. banks, in line with consensus expectations.

Foreign exchange: The U.S. dollar should have ceased to be a profit headwind, especially for large U.S. multinationals, and turned into a mildly supportive factor.

Viewing the broader economic landscape, we do see improvement globally. Consumer confidence and global indicators tracked by BofAML Global Research, such as the Global Wave and GLOBALcycle, are robust. However, economic surprises have been negative recently. The Institute for Supply Management's Purchasing Managers' Index turned lower starting in June, dropping below 50 in August before rebounding above it in September. This again could reflect uncertainty around the election, and so may the deteriorating trend of forward guidance by company management. In the June-to-October period of election years, guidance has been more conservative compared to non-election years, even when the historically weak 2008 period is not included.

This tendency may be especially pronounced this election year with so many issues at stake and diverging views between the major party candidates on issues that could impact economic activity and business profitability. They include trade agreements, fiscal policy, infrastructure investment, tax legislation and regulation, especially as it may impact the financial sector. The bright side is that once the election outcome is known, it could provide a tailwind in the release of pent-up demand in subsequent quarters.

Potential winners and losers

BofAML Global Research tracks the attractiveness of sectors to own heading into earnings reporting season based on earnings and sales revisions and guidance in the prior quarters, which it has found to carry forward to subsequent quarters.

Based on its models, the organization currently ranks Technology and Health Care as the most attractive sectors. Technology has been among the sectors with the largest percentage of companies beating earnings and sales forecasts for the last 10 quarters, and Health Care has been among that group for the last eight quarters. Technology should benefit from even modestly improving GDP growth, which should be positive for IT spending. A split Congress should minimize uncertainty around healthcare legislation. We also like Technology and Health Care as beneficiaries of our long-term investment themes of innovation and longevity.

Energy is ranked the third-most attractive sector, even though its performance is linked to oil prices and is therefore more volatile. It should be minimally impacted by the outcome of the election, however, since energy policy is not one of the major issues at stake.

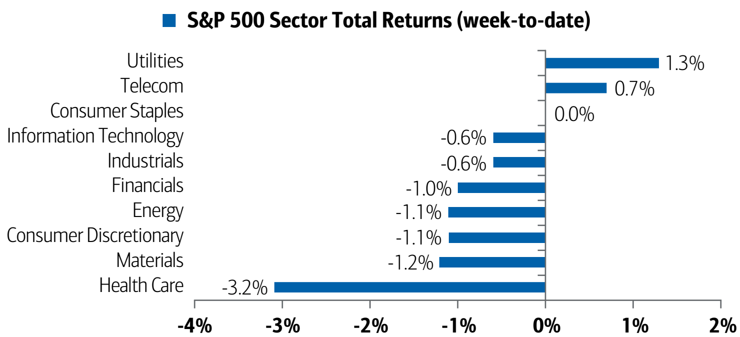
Portfolio Considerations: With stock valuations at historically elevated levels, though not extreme ones, we welcome recent forecasts of increased corporate earnings for the third quarter, and more so predictions that profits will rebound in 2017. We believe that sticking to strategic allocations can help shield investor portfolios from the volatility typical of the earnings reporting season, which may be more elevated this time due to political uncertainty around the upcoming election. We continue to favor equities over fixed income, and within equities high-quality large caps with healthy dividend growth.

Markets in Review

Trailing Economic Releases

- On Friday, the U.S. Census Bureau reported headline growth in retail sales of 0.6% for September, in line with consensus estimates. Growth in core control sales came in at 0.1%, below the consensus estimate of 0.4%.
- Also on Friday, the University of Michigan released a preliminary October reading of consumer sentiment of 91.8, above the BofAML Global Research estimate of 90.5.
- In the Eurozone on Wednesday, Eurostat reported growth in regional industrial production for August of 1.6%, below BofAML Global Research estimates.

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



Equities

		Total Return in USD (%)		
	Level	WTD	MTD	YTD
DJIA	18,138.4	-0.6	0.0	6.3
NASDAQ	5,214.2	-1.5	-1.0	5.2
S&P 500	2,133.0	-1.0	-0.8	6.2
S&P 400 Mid Cap	1,519.8	-0.9	-1.2	10.1
Russell 2000	1,212.4	-1.9	-2.0	8.0
MSCI World	1,693.7	-1.1	-1.5	3.6
MSCI EAFE	1,664.7	-1.4	-2.4	-0.5
MSCI Emerging Mkts	897.0	-1.9	-1.8	15.2

Fixed Income

		Total Return in USD (%)		
	Yield (%)	WTD	MTD	YTD
ML US Broad Market	2.03	-0.2	-1.0	5.1
ML 10-Year US Treasury	1.80	-0.3	-1.6	5.5
ML US Muni Master	2.01	-0.4	-1.0	3.1
ML US IG Corp Master	2.93	-0.2	-1.0	8.4
ML US HY Corp Master	6.13	0.1	0.7	15.9

Commodities & Currencies

		Total Return in USD (%)		
	Level	WTD	MTD	YTD
Bloomberg Commodity	174.4	0.8	1.3	10.2
WTI Crude $/Barrel[1]	50.4	1.1	5.3	35.9
Gold Spot $/Ounce[1]	1,251.4	-0.4	-5.2	17.9
Level	Current	Prior Week End	Prior Month End	2015 Year End
EUR/USD	1.10	1.12	1.12	1.09
USD/JPY	104.18	102.98	101.03	120.22

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

Looking Ahead

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Upcoming Economic Releases

- On Tuesday, the Bureau of Labor Statistics is set to release its Consumer Price Index for September. BofAML Global Research estimates 0.3% month-over-month growth, in line with consensus estimates.
- On Wednesday, the U.S. Census Bureau is set to report housing starts for September. BofAML Global Research estimates that there were 1,170,000, below the consensus estimate of 1,173,000.
- On Thursday, the U.K.'s Office for National Statistics announces retail sales ex-auto for September. BofAML Global Research estimates growth of 0.2% month-over-month.

BofA Merrill Lynch Global Research Key Year-End Forecasts

S&P 500 Outlook	2016 E
Target	2,000
EPS	$117.00
Real Gross Domestic Product	**2016 E**
Global	3.0%
U.S.	1.6%
Euro Area	1.5%
Emerging Markets	4.0%
U.S. Interest Rates	**2016 E**
Fed Funds (eop)	0.63%
10-Year T-Note (eop)	1.50%
Commodities	**2016 E**
Gold ($/oz-period average)	$1,301
WTI Crude Oil ($/bbl-eop)	$54.00

All data as of last Friday's close.

CHIEF INVESTMENT OFFICE

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

Mary Ann Bartels
Head of Merrill Lynch Wealth Management Portfolio Strategy

Karin Kimbrough
Head of Macro and Economic Policy
Merrill Lynch Wealth Management

Niladri Mukherjee
Managing Director
Chief Investment Office

Emmanuel D. Hatzakis
Director

Rodrigo C. Serrano
Vice President

John Veit
Vice President

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Past performance is no guarantee of future results.