BANK OF AMERICA MERRILL LYNCH
GLOBAL WEALTH & INVESTMENT MANAGEMENT

Merrill Lynch Outlook 2013

The "Great Rotation" to Equities

December 10, 2012

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Hello. I'm Lisa Shalett, chief investment officer at Merrill Lynch Global Wealth Management. Many of our clients have been asking us when we think we'll see a real and sustained turn for equities. We think this moment has in fact already arrived and that 2013 will be a watershed year for stock markets around the world.

I recently spoke with my colleagues from BofA Merrill Lynch, Global Research and U.S. Trust about this transition and how our clients can best prepare for what we believe will be a great rotation to equities.

CHAPTER #1
Why Equities? Why Now?

MS. SHALETT: 2012 was full of surprises and probably, you know, the biggest one was how well risk assets did.

MR. HARTNETT: [interposing] Yeah.

MS. SHALETT: Michael, I know -you've written a little bit about how this might be the beginning of that great rotation, you know, people, in fact re-embracing equities and maybe, you know, start sourcing that from bonds, which has just done so well--

MR. HARTNETT: [interposing] Yeah, yeah.

MS. SHALETT: --over the last four to five years.

MR. HARTNETT: Yeah, I do think it's the beginning of something. I mean, obviously 2012 was the year when policy makers, you know, helped out enormously. Where you had the liquidity injections out of Europe, the US, which were, you know, real inflection points for the market. And the economy, you know, it didn't do very well at all. And so, you know, I think that the key to, you know, the sustainability of the trend toward, you know, these assets that people have really shunned in the last couple of years, the equities, you know, the banks, the value stocks, you know, the small cap, Is that, you know, 2013 shows that that policy is beginning to work, that we shift a little bit out of this environment where there's tons of liquidity and not a lot of growth to, there's still tons of liquidity but there's a little more, bit more growth.

MS. SHALETT: So, is it that growth that kind of defeats the fear and allows people to maybe take a little bit of risk and wade in a little bit?

MR. HARTNETT: I think a lot of the pieces of the jigsaw puzzle are there to tell you that, you know, this era of deleveraging that we've been in, this sort of painful adjustment, you know, post the global financial crisis is coming to an end, at least in the US.

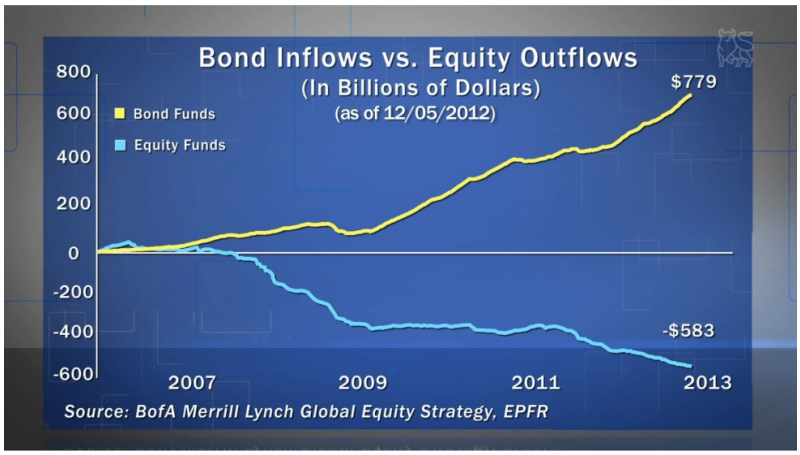
MR. CHRIS HYZY: Yeah, I think when you look at it on its face, since the credit crisis broke back in late '07, '08, you had this natural inclination to look to the Fed and to fill the gap of fiscal policy.

MR. HARTNETT: Mm-hmm.

MR. HYZY: So, there was this grand or great experiment where monetary policy was the insulation on the runway and now you're shifting towards this movement to the great rotation which could be driven from monetary policy. Now it's shifting to fiscal policy being that catalyst. And then, of course, knee jerk reaction is going to be, well, fiscal policy, we need to fix everything now. And that's really not the case. It's more about this year, in 2013 being the beginning of transparency in fiscal policy.

MR. HARTNETT: That's right. And I think that the, you know, what we also, sort of, see and I think is, you know, that helps the rotation story is that

[INSERT CHART]
["Bond Inflows v. Equity Outflows"]



There have been very, very few people that are in equities. We've seen something, like, $800 billion of money going into bond funds--

MS. SHALETT: [interposing] Yeah.

MR. HARTNETT: --over the past, you know--

MS. SHALETT: [interposing] Four years, yeah.

MR. HARTNETT: --five or six years. We've seen about $600 billion kind of come out of long-only equities. So, you know, it's not just policy, you know, there's a profit story , I mean, just all goes well if you get the right subseries of events occurring for equity.

MS. SAVITA SUBRAMANIAN: I think it's interesting that at the end of this year, Wall Street strategists are recommending the lowest allocation to equities that we've seen in, since we began tracking this data. And, you know, I think that what happened in 2012 that caused the, a little bit of a resurgence in the equity market is that investors did dip their toe back in the equity water but they went for yield -

[INSERT LOWER 3RD]
Equities could continue to offer competitive yields to bonds

MR. HARTNETT: [interposing] Mm-hmm.

MS. SUBRAMANIAN: --rather than capital appreciation.

MR. HARTNET: Yeah.

MS. SUBRAMANIAN: And I think that that could be a continued theme that equities actually offer competitive yield to bonds in such a low interest rate environment.

CHAPTER #2
Surprising sources for yield

MS. SHALETT: So, a lot of our clients do need to be in fixed income.

MR. HARTNETT: Mm-hmm.

MS. SHALETT: For those who are really need to remain anchored in fixed income. How, Michael, how are you thinking about that?

MR. HARTNETT: Just stick with the higher quality--

MS. SHALETT: [interposing] Yeah.

MR. HARTNETT: --areas, you know, I think high quality muni's and I think just high quality across the board—-

MS. SHALETT: [interposing] Right.

MR. HARTNETT: --in fixed income is the way I would go.

MS. SHALETT: Now, Chris, I know a lot of your clients are in this boat where, you know, they have anchored into fixed income. Let's talk a little bit about some of the advice and guidance you may be giving them and in terms of how they might get comfortable repositioning the portfolio just a little bit.

MR. HYZY: Right.

MS. SHALETT: To take advantage of what we might see as some opportunities in the equity side of the equation.

MR. HYZY: Yeah, that's, it's a difficult task. It's, you mentioned an anchor. One of the ways to look at that on its face is, you know, this is about portfolio construction. and in this year, in 2013, it'll be more about dividend growth even though that's what we were all counseling, last, in 2012 dividend growth, earnings growth, mixture of emerging market growth,

[INSERT LOWER 3RD]
As bonds mature, consider adding
the proceeds to your equity allocation
... and then as bonds mature in your portfolio, allow them to mature and then use those proceeds to reallocate back into equities. So, it's almost a natural movement of rotation rather than a forced rotation. So, that's really what we're looking at in 2013.

MS. SHALETT: Yeah, I think our strategy is very similar to yours, Chris. You know, we're kind of encouraging folks after we get through a period of kind of managing tax liability, let's, you know, think about putting new money to work with a little bit more risk associated with it into those equities. Potentially equities that have dividends and potentially equities that have the dividend growth component. You know, one of the things we've been thinking a lot about is the role that balance sheets may play for corporations in driving the earnings story. You know, a lot of folks have talked about profitability peaking or profit margins peaking. And I know, Savita's done some work on, you know, this idea that, you know, maybe, in fact, share repurchase is adding to the earnings per share growth as folks, you know, start to relever those balance sheets after, kind of, years of cleaning them up.

MR. HYZY: Right.

MS. SHALETT: Right.

MS. SUBRAMANIAN: Yeah, and share buy-back activity came back with a vengeance in 2012. I think, again, that continues because if you look at cash on balance sheets of US corporations. We're still at sky high levels and that story could go on for another year.

CHAPTER #3
New areas of growth

MS. SHALETT**:** Yeah. So, where do we think we're going to find this growth, you know Michael's talked about it being the scarcity theme--

MR. HARTNETT: [interposing] Yeah.

MS. SHALETT: --of, kind of the decade. And where does the growth come from? Is, are there pockets, either by geographies or by sectors is, that you guys are saying you might find it?

MR. HARTNETT: I think real estate, you know, in 2012 was another one of those great, you know, stories that came back. We had a 25 year, sort of real estate boom and it all came crashing down for one reason or another. But, ever since then, 2006-2007, you know, put it very simply, interest rates haven't worked.

[INSERT LOWER 3RD]
Low interest rates are finally
helping the real estate recovery
But, I think that 2012 was so important because it was the first time you actually started to see rates, low interest rates work because if you - - real estate most rate sensitive part of the economy

MS. SHALETT: Yeah.

MR. HARTNETT: So, you know, people are seeing low rates and what they did to mortgage rates is just really sort of pushed them lower. If that means now as it seems that we're starting to see activity and animal spirits grow in the real estate market, bingo, I mean—you're off and running.

MS. SHALETT: You know, I, the, one of the things that we've been intrigued by is the linkages that housing can have--

MS. SHALETT: Kind of to, up to driving this jobs equation we know that two thirds of the jobs engine, right, in the country is small businesses. In fact, a huge host, more than 50 percent of small businesses actually have a disproportionate amount of their net worth tied to some type or real estate, either the real estate of their company or their real estate linked companies or their financial companies that are linked to real estate.

[INSERT LOWER 3RD]
US small businesses could play a
key role in job creation in 2013
And so, if you can really get that going small jobs, we think that there's a chance that small job creation is one of those surprise on the upside in 2013--

MR. HARTNETT: [interposing] Mm-hmm.

MS. SHALETT: --as well.

MR. HYZY: Yeah, no question about it. Lisa, you're onto something that is hard to forecast. But I would point to in the small and midsize business segment, one thing that you do know, they have an incredible ability to create new industries themselves.

[INSERT LOWER 3RD]
Energy and natural gas could be at
the center of new industry growth
And if there's anything that needs to be created new nowadays outside the tech world, it's the energy space and natural gas is clearly going to be at the center of all of that. You add to that the fact that autos have already gotten very close to their

peak on a yearly basis from where they were back in ’07 and ’06. And the next step is housing which we’re already seeing. So, the linkage factor that you mentioned--

MS. SHALETT: [interposing] Yes.

MR. HYZY: --in terms of job growth plus the new industry growth and then perhaps a real energy policy would be very interesting to see, you know, how we move forward in the next few years.

MS. SUBRAMANIAN: When I look at the US, and when you think about equities what are you buying but the health of the corporate sector? I think that’s the strongest story to be made for the US equity market.

[INSERT LOWER 3RD]
US companies with global exposure
offer attractive values in 2013
And within US equities the area of growth at this point, I think, is the more globally exposed stocks. Because those stocks have sold off for most of 2012 based on fears around a global slowdown. At this point they’re cheap ‘cause they’re probably poised for a stronger recovery than within the US. So, I think that’s a great buying opportunity for that segment of the market.

CHAPTER #4
A Global Recovery?
MS. SHALETT: Yeah, Michael, I know you’re adding some new regions to your portfolios. Let’s talk a little bit more about that.

MR. HARTNETT: Sure. One of the great risks of 2012 was the idea that the Euro would, you know, collapse and the banking system would cause a great depression in Europe and, you know, policy makers just prevented that from occurring. This year, now, you know, we need to at the very least in Europe see some stabilization. But, you know, I’d be amazed if that collapse in interests rates that you’ve seen in Europe doesn’t show up one way or another. China, we think, has already begun to grow a little bit more strongly and it’s still growing at a fairly healthy, you know, rate - if not.

I think Japan’s going to be much more of a wild card, and much more interesting this year. I think that the Japanese equity market has a share of all the equity market’s in the world, you know, recently fell to an all time low of about seven percent and finally it looks like, you know, the heads coming out of the sand and you’re actually going to start to see a much more aggressive, sort of, reflationary approach in Japan.

So, I think there are going to be opportunities, you know, I think in large cap multinational’s and some of the banks in Europe, you know, and Japan. Whereas in the US, I still think in the US, the financials will do well--

MS. SHALETT: [interposing] Yes.

MR. HARTNETT: --but I think there's a slightly more sort of cyclical bias is warranted there.

MS. SHALETT: So what sectors fit that kind of profile?

[INSERT LOWER 3RD]
Technology, Energy & Industrials are great opportunities to buy global growth

MS. SUBRAMANIAN: So from a growth perspective I think tech, energy and the industrials are great opportunities to buy global growth at very attractive prices. I mean, those three sectors are trading at relative discounts to their averages. They're the most tethered to an economic recovery. They're much more tethered to a global recovery then just the US recovery. So, I think from a country diversification standpoint these are the three best sectors in the market.

CHAPTER #5
Risks and Opportunities

MR. HARTNETT: But I think a lot of what we're saying in terms of equity markets, I mean, it's kind of played itself out in the credit markets.

MS. SHALETT: Yeah.

MR. HARTNETT: I mean, that's the kind of, the thing that sort of gives us confidence is that, again, we're talking about corporate sectors, the corporate bond market, things are just fine, you know? And so, you know, really I think we, the missing ingredient is just the belief in growth. That's what's missing.

MS. SHALETT: Yes.

MR. HYZY: That's right.

MR. HARTNETT: If you start to see unemployment come down in the US, bonds are going to have a tough time. And, you know, when that begins then, you know, people, I think, are going to gravitate towards the equity market. You know, this time last year everyone was talking about downsides, you know, risks, the China hard landing and fiscal cliff and Europe is something different. I mean, I just think one of the risks, you know, next year is actually macro surprising the upside. If the economy picks up to quickly, you know, that liquidity story may be withdrawn.

MS. SHALETT: Yes. So, that's an interesting risk. So, inflation and, you know, do we somehow, you know, get to a place where we start worrying that not that the policy makers don't have all the keys to the car.

MR. HARTNETT: Right.

MS. SHALETT: And maybe they're getting behind it would be, do you guys have a sense of that?

MS. SUBRAMANIAN: Well, if you're an inflationist than you want to be in equities.

‘Cause equities are nominal and bonds are not.

MS. SHALETT: Yeah [laughter].

MS. SUBRAMANIAN: So, I think that’s all the more reason--

MS. SHALETT: [interposing] Yeah.

MS. SUBRAMANIAN: --to rotate back into the equities market. You know, I think one thing that worries me is if we do see inflation reemerge in any sort of meaningful way, fixed coupons are not going to get you that.

MS. SHALETT: Yeah.

MS. SUBRAMANIAN: So, I think that that’s another argument for equities.

MS. SHALETT: Well, this has been a wonderful conversation. I want to thank you all for participating. I think, you know, we’ve given everybody a lot of food for thought here as we enter a new year which too, will be full of surprises, as they all are. Thank you very much.

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