

BANK OF AMERICA MERRILL LYNCH GLOBAL WEALTH & INVESTMENT MANAGEMENT

“How Could Federal Spending Cuts Affect Investors?”

**Christopher Wolfe
Chief Investment Officer
Private Banking and Investment Group**

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Hi, I'm Christopher Wolfe, the Chief Investment Officer for the Private Banking and Investment Group at Merrill Lynch. With all the focus on sequestration, we think there are really three issues: sequestration, the potential for a government shutdown, and then ultimately the renegotiation of the debt ceiling.

All of these events are likely to transpire in just the next several months. In fact, before the first half of the year is over. Now what's important about them is they're likely produce a reduction in overall GDP growth.

Our economists estimate Federal cuts could
reduce GDP growth by 2.0 - 2.5% in 2013

Our Bank of American Merrill Lynch Research global economists estimate that number at between two and two and a half percent. But what's important to remember about those cuts is that despite that reduction in growth, we're still seeing an economy that's likely to be growing somewhat this year.

Without budget cuts, the U.S. economy
might grow between 3.0 - 3.5% in 2013

Said another way, if we didn't have all these cuts coming, the U.S. economy might be growing at between three and three and a half percent in 2013.

The Strength in the Economy

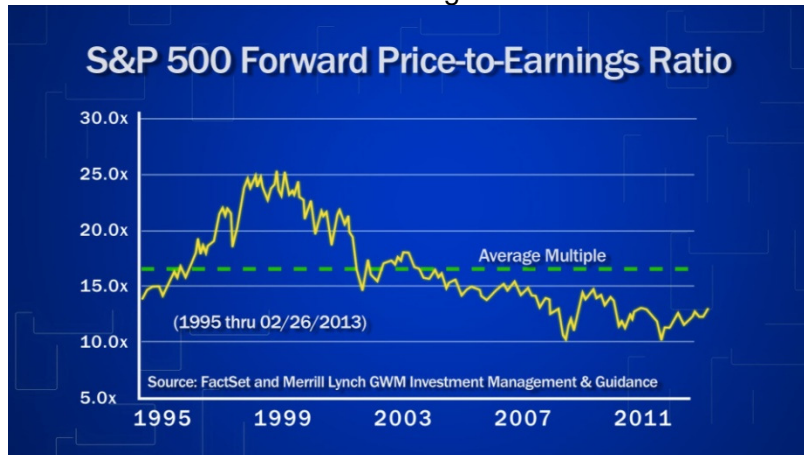
- Housing starts
- Auto sales
- Consumer spending
- Revival in business spending

And that argues for an understanding of the underlying fundamental strength and momentum in things like housing starts, in auto sales and in consumer spending and finally in the likelihood of a small revival in business spending in the second half of this year.

So one of the key questions we think investors should be asking is, is all of this already built into markets? We've seen analysts take down their forecasts; we've seen economists take down their forecasts for both growth in terms of GDP as well as growth in terms of revenues for companies. So to the extent that a lot of the political winds have been blowing in the face of corporate America, and they are likely to see a reduction in revenue growth, we think analysts have "A" picked up on this fact and "B" made adjustments to their forecasts.

What that really means for investors is that to a degree we believe that some of this news around the politics in Washington, some of this freight, is already built into prices at current market levels.

S&P 500 Forward Price-to-Earnings Ratio



For example, the S&P 500, the broad market index in the United States, trades at about 13 times earnings in the future. That's called forward earnings, and relative to history, that's a fairly low multiple. Historically the number has been closer to 15.

Now what that means is markets are starting to build in expectations that the first half of this year is likely to be slow and challenged by the headwinds coming not only from Washington but more broadly globally when we look at the developments going on in Europe. I think this news has largely translated into where we are in terms of current stock prices.

Now that doesn't mean that we won't see periods of volatility brought about by discussions going back and forth in Washington. In fact, we expect that and what we've highlighted for investors is that additional discussions coming from Washington that create volatility are really in our view an opportunity to rebalance and reallocate portfolios really towards that corporate balance sheet and ultimately towards equities.

We like the strong profit-margin story, we like the high returns on equities and ultimately we see that as an opportunity for long-term investors to take advantage of. So on pullbacks we want to be fairly confident and fairly assertive about rebalancing and reallocating portfolios towards the equity themes that we like that are anchored on that strong profit-margin story.

Investment Themes in 2013

- Dividend-paying securities
- Dividend-growth stocks
- Credit markets
(Investment grade and high yield)
- International bonds

Those themes look like high dividend-paying securities, dividend growth stocks, they look at the credit markets in a different light, not just investment grade but things like high yield. We also look at bonds outside the U.S., like international bonds as part of a theme of ultimately diversifying income in an environment that is likely to be challenged for some time.

So we really see the potential for a year of two halves: the clouds starting to part as we get into the third and fourth quarter. And I think we want to anticipate opportunities for clients to be rebalancing and reallocating portfolios in front of that.

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