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Chief Investment Office

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CIO Outlook
[The Forces Shaping Our World](#)

➔ **Taking Credit:** We highlight one of several reasons for the restrained pace of the economic recovery—tepid credit growth. We note, however, that we’re seeing signs of increased demand for borrowing by households thanks to reduced indebtedness, improved access to consumer credit and a healthy pick-up in asset prices. The moderate gains in the demand for and supply of credit that we see could be a sign that the economic expansion, while slow and shallow, could continue for another year or so.

➔ **Markets in Review:** Last week equities were mostly down. The S&P 500 Index rose 0.1%, less than its 0.6% gain the prior week. International equities, as represented by the MSCI EAFE Index, fell 0.6%. Bonds rose on the week, with the 10-year Treasury yield at 1.58% on Friday, down from 1.59% a week earlier. Commodities overall, as measured by the Bloomberg Commodity Index, gained 2.6% and WTI crude jumped 9.1% to \$48.50. Gold rose by 0.4%, to \$1,341.30 per ounce.

➔ **Looking Ahead:** In the U.S., economic releases are headlined by Markit’s U.S. Manufacturing Purchasing Manager’s Index (PMI) for August and the U.S. Census Bureau’s report on Core Capital Goods Orders for July. In the eurozone, Markit reports its Eurozone Composite PMI for August.

Taking Credit

Eight years into the expansion, the U.S. economy is still growing, but it hasn’t achieved the more rapid pace of prior recoveries. Coming out of a slow second quarter, we expect growth to accelerate to just 2.4% in the current one. There are many reasons for this sluggishness, including restrained investment, lower productivity, increased risks abroad, constrained fiscal policy, demographics and one other factor we highlight here—tepid credit growth.

Credit matters because it can fuel productive investments that support economic expansion, and because it can help households maintain smooth consumption even if their income drops. It also allows savers to generate returns when their savings are loaned out for productive investments.

We are, however, starting to see signs of increased demand for borrowing by households thanks to reduced indebtedness, improved access to consumer credit and a healthy pick-up in asset prices. A slight pick-up in credit is a positive sign for growth in the coming quarters.

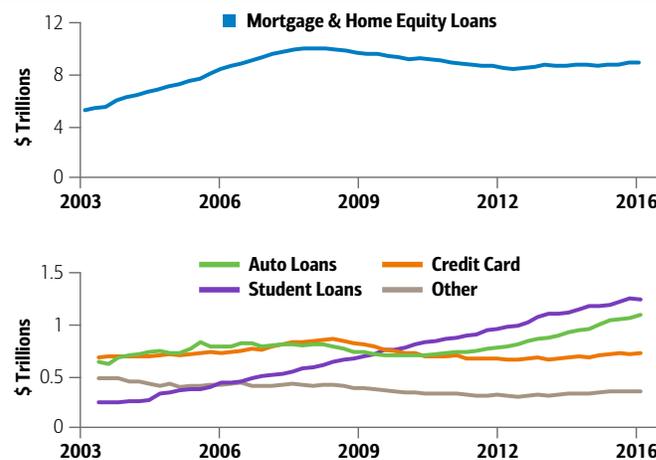
Demand for credit is rising

The most recent data from bank loan officers suggest rising household demand for most types of residential mortgages, credit card lending and general consumer borrowing. In fact,

the only segment where demand is not reported as rising is auto loans.

The post-crisis story of household deleveraging is now over. Households’ total stock of debt is rising very moderately, though the type of borrowing is changing. Student loans and auto loans have expanded at a faster clip, while mortgage and credit card debt have grown more slowly (see Exhibit 1). Recent research shows that borrowers with low credit scores have increased their debt faster than those with high credit scores.

Exhibit 1: Student and auto loans are growing more rapidly

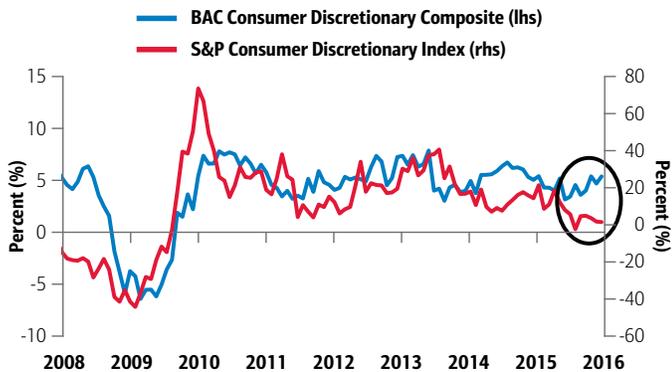


Source: New York Federal Reserve Bank Consumer Credit Panel/Equifax. Data as of August 9, 2016.

Are Not FDIC Insured	Are Not Bank Guaranteed	May Lose Value
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The upside to lower leverage among households and a mild growth in credit is that there is more scope for consumer spending. Indeed, that has been one of the main engines of U.S. economic growth in recent years. The latest Bank of America credit and debit card data, for July, show more strength in discretionary spending than is reflected in the S&P index of Consumer Discretionary stocks (see Exhibit 2).

Exhibit 2: Credit card spending on discretionary items has outpaced the performance of Consumer Discretionary stocks



Source: BofAML Global Research, BAC internal data, Bloomberg, data as of August 9, 2016.

Although households are taking on more debt, we do not believe we are in for a repeat of the financial crisis. Total household indebtedness is 3% below its 2008 peak and households appear mindful of becoming overextended. They are saving more—the personal savings rate is running about 5.3%, down from the post-crisis peak of over 10% but still above the 20-year average of 5%. Another sign that households have not overextended themselves yet is loan delinquency rates, reflecting those 90 or more days past due, which continue to come down on most types of debt other than student loans.

Firms are seeking credit too

Surveys of senior loan officers show that, for the first time since last year, more banks than not report that firms are increasing their demand for commercial and industrial loans, though only slightly. For the last eight years, corporate demand for credit from banks has been tempered by firms’ restrained investment plans and low interest rates that encouraged them to borrow through the capital markets rather than from banks. Given that investment follows credit, the survey is a sign that capital expenditures could return next year.

Growth in commercial lending by banks has taken longer to bounce back in this expansion than in prior ones. Typically, growth in lending returns to pre-recession levels 14 to 15 quarters later; in this case, it has yet to reach the 50% level after 28 quarters. Credit to small and large businesses has been restrained in part by regulation that discourages banks from taking risks and expanding their balance sheets. In the past quarter, banks have further tightened their standards for commercial and industrial lending.

The cost of policy uncertainty

Still, despite a moderate pick-up in demand for credit, we think the current economic policy uncertainty is keeping a lid on the demand for and supply of credit and investment. Last week, in “The U.S. election: Can two negatives make a positive,” we highlighted how political negativity and economic uncertainty could weigh on consumer and business sentiment.

It has been shown that businesses and households defer investments and banks restrict lending when they face greater uncertainty. This is likely the case in the U.S. today, where high economic uncertainty around regulation, and future tax policy, may have contributed to the slower-than-normal pace of economic expansion. The same is true of the U.K., where the process of exiting the European Union has left companies in a state of uncertainty and caused economists to forecast several quarters of markedly lower growth due to restrained investment.

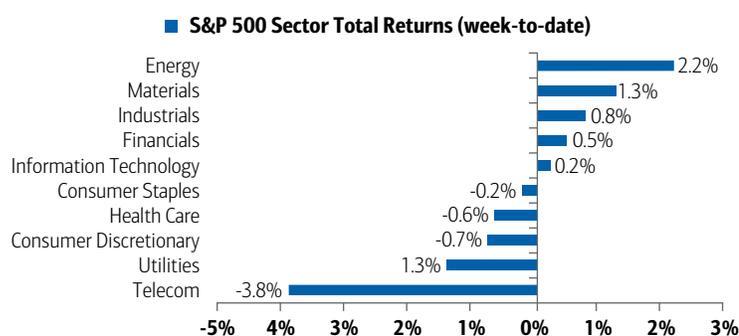
Portfolio Considerations: The moderate gains in the demand for and supply of credit that we see could be a sign that the economic expansion, while slow and shallow, could continue for another year or so. The extension of credit can support the next phase of the expansion. In the meantime, portfolios should continue to face the challenge of low rates and moderate growth. We expect monetary policy eventually to be supported by fiscal policy and, with this transition, more volatility and thus a need for more frequent rebalancing to adjust to more rapid valuation changes. As always, we believe it is essential to maintain an investment policy that is aligned with well-established goals and centered on a strategy of accumulating cash flows across assets.

Markets in Review

Trailing Economic Releases

- On Tuesday, the U.S. Bureau of Labor Statistics reported no change in its Consumer Price Index (CPI) for July. The result came in below BofAML Global Research's estimate of an increase of 0.1% from June.
- On Thursday, the Conference Board released its Leading Economic Index for July. The result was month-over-month growth of 0.4%, above last month's increase of 0.3%.
- On Thursday, Eurostat reported the eurozone's region-wide CPI for July. On a month-over-month basis the index fell 0.6%, below the consensus estimate that it would decline by 0.5%.

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



Equities

	Level	Total Return in USD (%)		
		WTD	MTD	YTD
DJIA	18,552.6	0.0	1.0	8.5
NASDAQ	5,238.4	0.2	1.6	5.5
S&P 500	2,183.9	0.1	0.7	8.4
S&P 400 Mid Cap	1,562.8	0.4	0.3	12.9
Russell 2000	1,236.8	0.6	1.5	9.9
MSCI World	1,731.9	-0.2	0.8	5.7
MSCI EAFE	1,699.8	-0.6	0.9	1.3
MSCI Emerging Mkts	910.3	0.1	4.3	16.6

Fixed Income

	Yield (%)	Total Return in USD (%)		
		WTD	MTD	YTD
ML US Broad Market	1.88	-0.2	-0.3	5.8
ML 10-Year US Treasury	1.58	-0.5	-0.9	6.8
ML US Muni Master	1.68	0.1	0.2	4.6
ML US IG Corp Master	2.79	0.0	0.0	9.1
ML US HY Corp Master	6.40	0.5	1.9	14.2

Commodities & Currencies

	Level	Total Return in USD (%)		
		WTD	MTD	YTD
Bloomberg Commodity	174.1	2.6	2.3	10.0
WTI Crude \$/Barrel ¹	48.5	9.1	16.6	31.0
Gold Spot \$/Ounce ¹	1,341.3	0.4	-0.7	26.4

Level	Current	Prior Week End	Prior Month End	2015 Year End
EUR/USD	1.13	1.12	1.12	1.09
USD/JPY	100.22	101.30	102.06	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

In the U.S., economic releases are headlined by the Markit U.S. Manufacturing PMI for August and the U.S. Census Bureau's report on Core Capital Good Orders for July. In the eurozone, Markit reports its Eurozone Composite PMI for August.

Upcoming Economic Releases

- On Tuesday, Markit is set to report its U.S. Manufacturing Purchasing Managers Index (PMI), which tracks business conditions. The consensus estimates a 52.6 reading for August, down from 52.9 in July.
- On Thursday, the U.S. Census Bureau is set to report its measure of Core Capital Goods Orders for July. BofAML Global Research estimates no change from June.
- On Tuesday, Markit reports its August Eurozone Composite PMI, an index measuring economic activity in the region. BofAML Global Research estimates a reading of 52.9, down from the previous month's 53.2 but still suggesting economic expansion.

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.	1.5%
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 (period average)	\$1,323
WTI Crude Oil (eop)	\$54.00

All data as of last Friday's close.

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