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CIO Reports

THE MONTHLY LETTER

Lisa Shalett and the Chief Investment Officer Team • *OCTOBER 2011*

IN SUMMARY

- Fears persisted that the sovereign debt crisis would morph into a full-blown banking crisis as system liquidity, interbank lending and default insurance on bank debt all showed signs of stress, which would raise the odds of a global recession.
- Our framework for tactical adjustments to portfolios and for opportunities to deploy new money consists of four elements: valuation, volatility, correlation and catalysts.
- We think the combination of valuation, strong secular growth, stable sovereign debt and coming catalysts make Emerging Markets a strong opportunity in the coming months.
- While many are rightly concerned that tepid income growth and weak job creation will produce a double-dip recession, we just don't see the ingredients of economic excess to produce a true recession or sustained contraction of output.

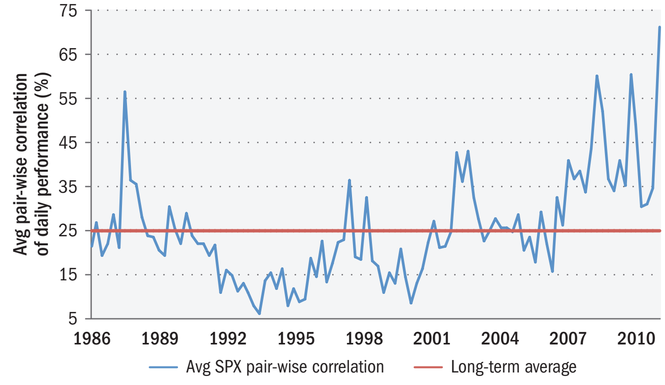
Recession Risks Revealed

Clients: In this edition of *CIO Reports: The Monthly Letter*, we reflect on the complex interplay of factors responsible for driving market volatility and a high degree of uncertainty in the near-term outlook. Our featured content focuses on the debate around the call for an imminent U.S. recession and what it may mean for capital markets. As always, we are here to serve you and welcome your questions and feedback. _ L Shalett

Portfolios This Month and in the Third Quarter

Although the seasons turned in September, the extreme patterns of volatility that first started in July, characterized by routine triple-digit daily moves in the Dow Jones Industrial Average, did not abate. As was the case in August, owners of risk-based assets, such as equities, suffered losses as investors were again forced to digest apparent policy maker paralysis against the backdrop of an intensifying crisis in the Eurozone and weakening global growth prospects that were exacerbated by negative feedback loops. Particularly vexing for investors was the possibility that the sovereign debt crisis would morph into a full-blown banking crisis as system liquidity, interbank lending and default insurance on bank debt all showed signs of stress. Fears persisted that this systemic contagion would raise the odds of a global recession. Unlike earlier in the summer, a complicating factor in September was the extreme rise in cross-asset-class correlation, signifying the increasing systematic nature of market moves. Cross-asset-class correlation undermines the advantages of diversification. Additionally, we saw the rise of intra-stock market correlation, which diminishes the effectiveness of stock-picking (see Exhibit 1). Cash, longer duration Treasuries, select high grade bonds and a handful of dividend paying stocks were the only assets spared in the month.

EXHIBIT 1: Intra-Stock Correlations Soar: Dampening the Efficacy of Stock-Picking



Source: BofA ML Research and GWM Investment Management & Guidance. Data as of Sept. 30, 2011.

For the month of September, global equities returned -9.5%, as measured by the MSCI All Country World (ACWI) Index, while domestic equities fared slightly better at -7%, as measured by the S&P 500. Europe, mired in the threat of a Greek default, declined 11%, while Emerging Markets were battered down 14.6%, as measured by the MSCI Europe and MSCI Emerging Markets Indexes, respectively. Year to date, U.S. equities have outperformed other regions, with the domestic equities down 9% versus the MSCI ACWI's decline of almost 12%. In sectors, Utilities, Telecom and Consumer Staples eked out relative outperformance in the month, benefiting as dividend-paying defensives, while Materials and Financials were most severely punished. Year to date, both those sectors are down approximately 25%. With investors abandoning securities with high exposure to the market and economy, small caps lagged large caps, while style diversification between growth and value was not effective in the month.

U.S. Treasuries benefited again from safe haven status, up 10.8% in the month with 10-year yields ending at 1.92% (after hitting the historic low of 1.67% on September 23rd) and 30-year bonds breaking the historic 3% mark to end at 2.92%. Although modest inflation readings and weak economic readings combined with extreme risk aversion to sustain Treasury market momentum, the Federal Reserve's (Fed) "Operation Twist" policy provided additional support. This effort, aimed at extending the duration of central bank bond purchases through an exchange of shorter duration bonds for longer dated ones, drove longer-term rates down in an attempt by Fed Chairman Ben Bernanke to target rate relief on market segments that might help mortgages and longer term investments. In addition to this "flattening of the yield curve," Operation Twist had a secondary impact that was less discounted in markets—the implicit "sterilization" of purchases suggested a pause in U.S. dollar printing and thus created some support under the besieged currency. Specifically, the U.S. trade-weighted dollar was up 5% in the month. The U.S. dollar appreciated substantially against the euro (+6.6%) and against many Emerging Market currencies. Some currencies, such as the Korean won, Brazilian real and the South African rand, depreciated by 20% in the last two weeks of the quarter against the U.S. dollar. This reversal in the dollar, combined with developing worries about a potential global slowdown, drove a dramatic sell-off in commodities with the Merrill Lynch Commodities Total Return Index, which was down 10.5%. Oil, as measured by the current Brent crude oil contract, posted an 8.8% loss in the third quarter, while copper, a key industrial metal, fell more than 25% to below $7,000/ton on fears of a Chinese slowdown. And gold, increasingly seen as a currency, rose to a record high of $1,900/oz before reversing 11% in the month. Year to date, gold is still up 15%. Among alternative investments, the ML Investable Hedge Fund Index was down 2.3% in the month, roughly a third of the decline for the broader equity markets but capping off the worst quarter for hedge funds since 2008. For clients with a portfolio consisting of 60% stocks and 40% bonds, U.S. diversified returns were about the same—generally down 2% in the month.

→ Our Current View

We believe that the global capital markets are entering the final stages of a capitulation phase that requires extreme caution but are likely to present deep value opportunities by year-end. This is neither the time for panic selling nor to be heroic and attempt to "catch falling knives." Rather, prudence and caution are the order of the day, and investors—anchored to long-term asset allocations—should rebalance with a focus on income and "getting paid to wait." While equities are broadly cheap versus debt, they lack near-term catalysts, and in many cases credit markets are discounting extreme default scenarios. On the margin, we see the very short term outlook for these securities as better.

With a keen eye on capital preservation, we are focused on proactive risk management. Our approach has three prongs:

- First, we encourage investors to diversify risk through a more global and multi-segmented approach to asset allocation. For equities, this means eliminating excessive home-country bias and including exposure to Emerging Markets. In fixed income, while we have continued to favor high-quality Municipals, we think investors should consider exposure to a mix of corporate high-grade and high-yield bonds as well as non-U.S. sovereign and corporate debt. Broadening asset class exposure may also be appropriate for some investors who might consider including real assets, gold and low volatility/absolute return oriented alternatives in their portfolio.
- Second, we think overall portfolio risk can be reduced by exploiting today's scarcity themes of Growth, Quality and Yield. Where market volatility has caused portfolios to drift from long-term asset allocations, rebalancing opportunities exist to add to these themes. Large, multinational dividend growers, many of which gain market share in the secular growth story of the Emerging Market consumer, are opportunities.
- Finally, we see opportunities to be more tactical as we actively manage risk. Higher volatility creates more risk but also more opportunities. Utilizing a flexible multi-asset manager for a portion of your equity sleeve can help raise the odds that absolute return goals are met.

Opportunities to Put Money to Work Now

As we noted last month, while our primary approach to money management is anchored on long run goals and thus strategic asset allocation, high volatility demands attention to tactical opportunities. Our framework for tactical adjustments to portfolios and for opportunities to deploy new money consists of four elements: valuation, volatility, correlation and catalysts. On the margin, we are always looking to raise exposure to attractive valuations and catalysts, while reducing portfolio volatility and cross-asset-class correlations. This month we focus on Emerging Markets. Although these investments are typically viewed as having high exposure to the economy and market sentiment, we believe the combination of valuation, strong secular growth, stable sovereign debt and coming catalysts make it a strong opportunity in the coming months.

EXHIBIT 2: Emerging Markets Valuation Comparison

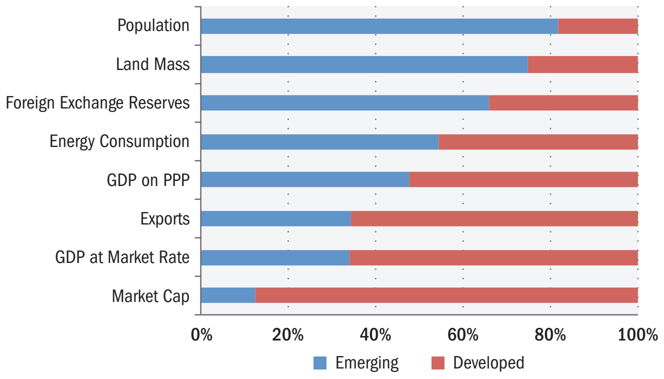
	P/BV	Div Yield	12M fwd P/E	2012E EPS Growth	2012E GDP Growth	Current Debt/ GDP	YTD Total Return*
MSCI Emerging Markets	1.5x	3.2	8.1x	12.8	6.2	39.3	-21.7
US	1.9x	2.3	10.5x	13.4	1.8	62.0	-8.7
Japan	0.9x	2.5	10.8x	20.7	2.7	197.5	-10.8
Australia	1.6x	5.3	9.5x	10.2	4.3	26.6	-17.0
United Kingdom	1.5x	4.0	8.3x	10.5	1.6	76.1	-10.7

*Total Return, in USD. Country returns were proxied by the corresponding MSCI Country Index. Source: FactSet, IBES, Bloomberg, BofA ML Research and GWM Investment Management & Guidance. Data as of Sept. 30, 2011. Note: MSCI Emerging Markets 2012E GDP Growth from BofA ML Research and Current Debt to GDP from International Monetary Fund.

Year to date, Emerging Markets have been the laggards of the global equity market, despite boasting superior growth rates, solid balance sheets and the absence of sovereign debt distractions (see Exhibit 2). In the third quarter, Emerging Markets extended its relative underperformance, falling 23% versus Developed Markets, down only 17%. This underperformance is attributable to tight monetary policies tied to stubbornly persistent levels of inflation. Unlike the developed countries that have been mired in debt and deleveraging pressures that risk deflation, Emerging Markets have been fighting a classic brand of inflation fueled by wage/price spirals and food price increases as the burgeoning middle class transforms living standards.

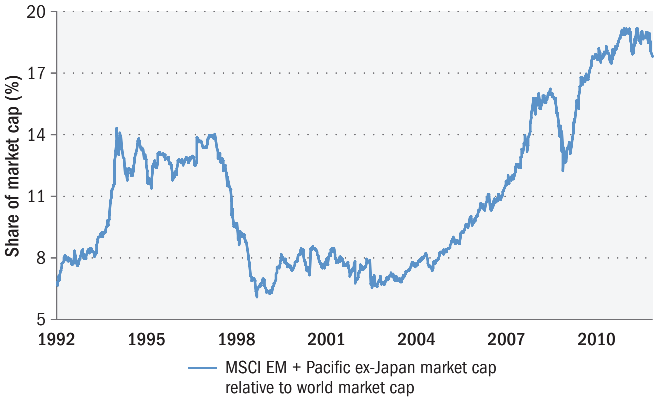
Although these challenges are real, valuations are now increasingly compelling—even in a slowing global growth scenario. Today, the MSCI Emerging Markets Index is selling at 8.8x on one-year forward earnings—20% below the average since 2002. On a price-to-book basis, at 1.6x, the index is 28% below its 10-year average. Compared to other regions, Emerging Markets are increasingly attractive as analyst earnings revisions have already been harshly negative, and earnings are on track to grow at 16.5% in 2011 and projected to grow at 12.3% in 2012 versus low single-digit estimates for developed regions. Perhaps even more important, many of these multinational corporations are expected to pay dividends, with forecast payouts to grow by 10% each year for the next several years. The multiyear secular growth in Emerging Markets is well documented, but as we illustrate in Exhibits 3 and 4, valuations have not caught up with global representation and potential. With more labor, more savings and more debt capacity, the likelihood of fundamentally derailing growth in Emerging Markets is low.

EXHIBIT 3: Emerging Markets as Share of World



Source: International Monetary Fund, BofA ML Research and GWM Investment Management & Guidance. Data as of Sept. 20, 2011.

EXHIBIT 4: Emerging Markets as Share of Market Cap



Source: BofA ML Research, MSCI and GWM Investment Management & Guidance. Data as of Oct. 5, 2011.

Most important, however, this is not simply about valuation. With commodity prices, especially oil, falling by more than 20% in the quarter, we now see inflation peaking. Energy and food comprise roughly two-thirds of the Consumer Price Index (CPI) in Emerging Markets as compared to about 15% in Developed Markets. We believe as global growth concerns rise and inflation ebbs, Emerging Market central banks will move toward an easing cycle in monetary policy, providing the necessary catalyst to reengage investors. Already Brazil, Israel, Indonesia and Turkey have cut rates and we expect more cuts over the next 12 months. Similarly, as European debt woes slowly resolve through the end of the year, we expect currency markets to stabilize and the U.S. dollar, which many Emerging Market currencies are pegged to, will resume the trend of relative weakness.

This Month's Feature: Recession Risks Revealed

2011 has certainly been an interesting journey for investors. During the first three to four months of the year, momentum from 2010 continued to carry capital markets forward on the hopes that a recovery cycle, first kicked off by QE2 last fall, would be self-sustaining. The miracle of the "Arab Spring" was the first obstacle, introducing meaningful geopolitical uncertainty and disruption to Middle East oil supply, that sent commodities prices soaring. This was quickly followed by a devastating earthquake and tsunami in Japan that transformed into a tragic nuclear disaster and upset global supply chains. Through all of this, markets remained somewhat resilient, with the S&P 500 up 6% in the first half of the year. As we entered July, the extent of global supply chain disruptions and commodity inflation were the key investment controversies.

But, the political dysfunction of the U.S. debt ceiling negotiations and intensification of the Eurozone Debt Crisis were still ahead and only seemed to come into full view and focus when the U.S. announced a disappointing first half gross domestic product (GDP) rate of 1.0%. That, combined with a mid-year stall in employment gains, suddenly suggested that the U.S. might be headed for a double-dip recession. Over the third quarter, global markets fell 18%–23% from the peak. Many segments entered a full blown bear correction and volatility soared. And today, risk aversion still reigns. *As we enter the final quarter of the year, the most pressing investment controversies remain:*

- *Are Europe and the U.S. already in or heading into recession and what does that mean for company earnings and markets?*
- *To what extent do required austerity measures drag on growth and is there no more room for policy stimulation?*

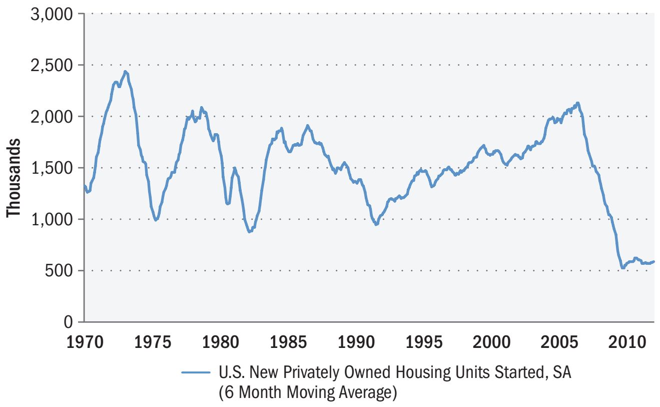
U.S. Cycle: "This Time Is *Definitely* Different"

It is undeniable that recent economic data on job creation, income growth, manufacturing output, new orders and trade continues to flash warning signs for slowing growth. The mixed set of fundamental data combined with fragile confidence measures indicate that the economy is likely skating on the edge. In fact, the Economic Cycle Research Institute (ECRI), a well-known economic consultancy that specializes in business cycle research, recently issued an explicit call for recession in the U.S. Although we acknowledge the negative trend data—including the recent revision to GDP forecast by Bank of America Merrill Lynch Co-Head of Global Economics, Ethan Harris, down to 1.6% for 2011 and 2012—we believe growth will stop short of recession for three key reasons:

1. Fundamental excesses that lead to economic contraction are not in place;
2. Temporal factors that impacted growth in the first half are being removed; and
3. Policymakers around the world still have many options to help support and create stimulus for growth.

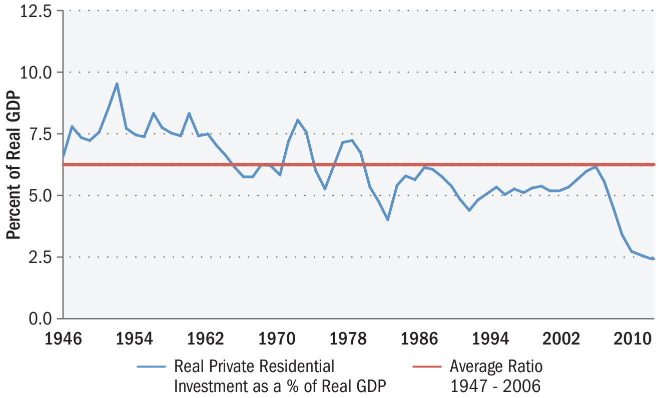
Recessions typically occur as a natural response to correct imbalances—most specifically excesses—of investment, inventory, credit, labor and/or an oversaturation of demand, which can be induced by central banks to control inflation. An examination of the current backdrop suggests few of these traditional elements are in fact in place. *In a recession, things need to contract—so the question becomes where does the contraction come from?*

EXHIBIT 5: U.S. New Privately Owned Housing Units Started



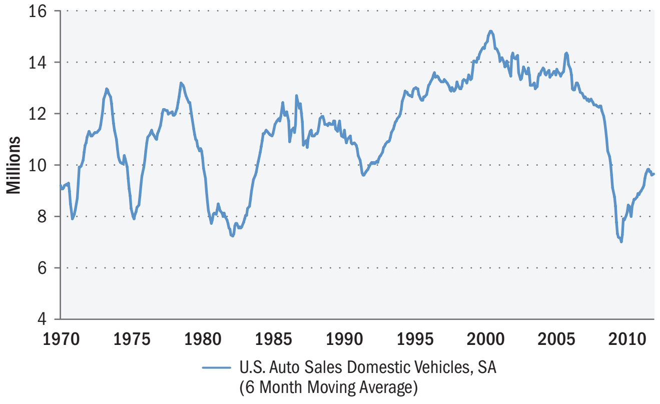
Source: Bloomberg and GWM Investment Management & Guidance. Data as of Aug. 31, 2011.

EXHIBIT 6: Real Private Residential Investment



Source: Bureau of Economic Analysis, Haver Analytics and GWM Investment Management & Guidance. Data as of 2Q 2011.

EXHIBIT 7: U.S. Auto Sales Domestic Vehicles

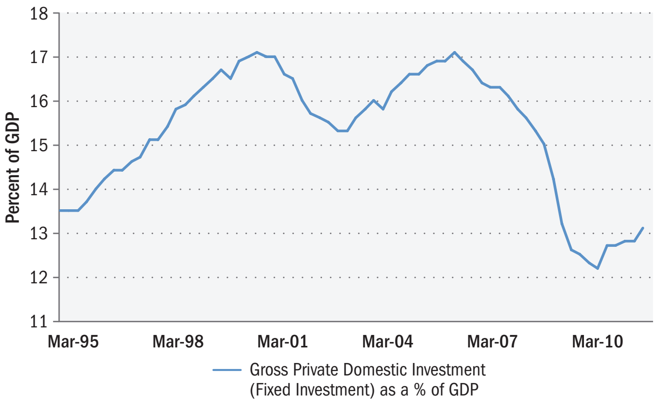


Source: Bloomberg and GWM Investment Management & Guidance. Data as of Sept. 30, 2011.

Housing remains deeply depressed, with new housing units skating along at an annual rate of 450-500K, roughly a third of the 40-year average and down 75% from the peak (see Exhibit 5). In terms of the total housing related impact to GDP, as measured by real private residential investment (which includes home improvements), the share is only 2.3% of first half 2011 GDP compared to the long-run average of 6.25% (see Exhibit 6). A similar story can be told for autos, where demand lingers roughly 15% below the 15 million average annual units sold in recent decades (see Exhibit 7). Extending this analysis to all capital investment by private sources, including corporations and small businesses, further extends the argument (see Exhibit 8 on the next page). Reluctance to invest has shaved an average of 2% off recent GDP levels, and current investment is 4% below prior peaks. Excesses do not appear to exist in inventory pipelines either, as stock levels are stable relative to selling rates and continue to follow the pattern of long-run secularly leaner supply chains (see Exhibit 9 on the next page).

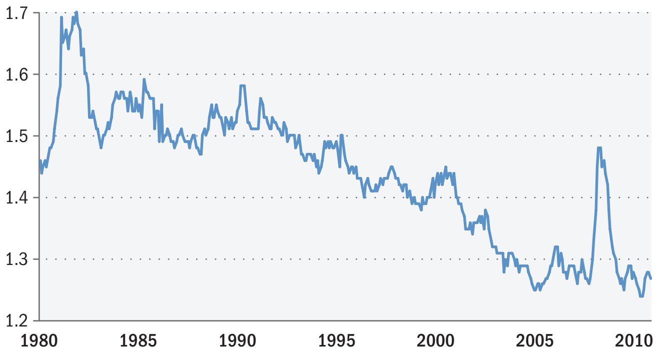
In addition to the lack of excesses, and thus the likely building up of pent-up demand as a counterweight to contraction, deleveraging has permitted the accumulation of “dry powder” in the form of cash balances. Corporations are sitting on $1.1 trillion of cash—6.5% of GDP—almost a third of their current assets (See Exhibit 10 on the next page). Not only are housing affordability and mortgage rates at all-time lows, but aggregate debt service as a share of personal disposable income is back to normal at roughly 11%, while household cash balances of roughly $8 trillion are about two-thirds higher than the last 30 years.

EXHIBIT 8: Gross Private Domestic Investment (Fixed Investment)



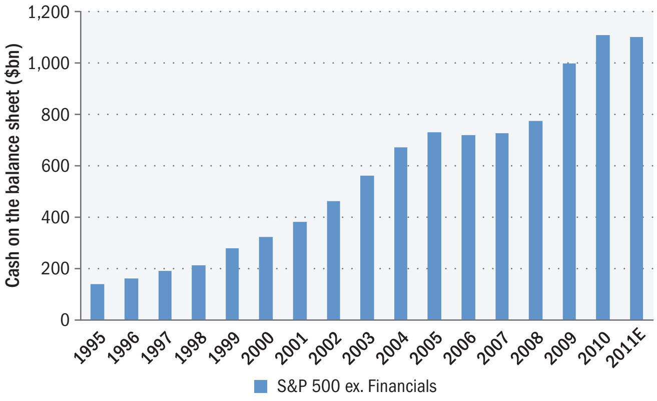
Source: FactSet and GWM Investment Management & Guidance. Data as of Sept. 30, 2011.

EXHIBIT 9: Inventory to Sales Ratio: Total Business



Source: U.S. Department of Commerce: Census Bureau and GWM Investment Management & Guidance. Data as of July 31, 2011.

EXHIBIT 10: Cash on Corporate Balance Sheets is Swelling



Source: BofA ML Global Research and ML GWM Investment Management & Guidance. Data as of Sept. 30, 2011.

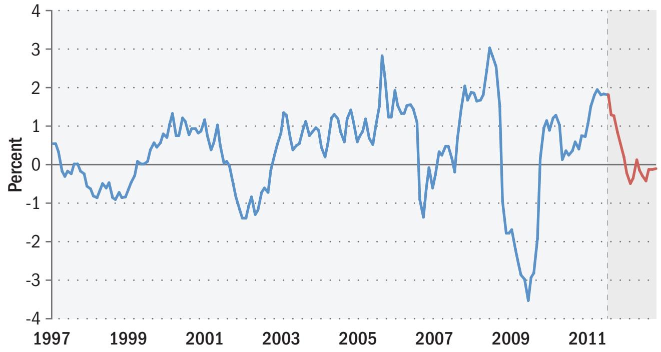
Austerity Will Be a Drag, but Offsets Exist

Acknowledging the lack of excesses, many of the bears suggest it will be the austerity and negative feedback loops between fiscal contraction and growth that will drive the next dip in economic activity. We strongly believe this argument has strong footing when it comes to Europe, and that the odds of a recession are greater there than in the U.S. In the U.S., however, we see offsets to the fiscal contraction that is forecast to shave 1.5%-1.7% off GDP over the next 2-3 years. Not only do we expect some of Obama's jobs plan to be implemented—albeit in discrete pieces—but we see consumer windfalls from easing energy prices. Specifically, we cite Ethan Harris' recent analysis that suggests 1% of consumer expenditures, or roughly seven-tenths of a percent of GDP growth, was absorbed by rising energy and food prices that were likely funded through an equal combination of reduced savings and reduced spending. As shown in Exhibit 11 (on the next page), food and energy inflation peaked in May and are now declining. Gasoline prices at the pump have now fallen by more than 15%, while oil prices are down more than 20% from their peak.

Recession Risk with a Global Perspective

A final point worth noting is that the recession call is no longer one that can be regionally made in isolation. That is the issue we have with the ECRI model at this juncture. Borrowing a phrase recently coined by U.S. Trust Chief Marketing Strategist Joe Quinlan, "we don't subscribe to the notion of global decoupling, but rather to the idea of global rebalancing." Although the intertwining of the global economy certainly suggests directional synchronicity—especially given the importance of global trade—connectivity exists alongside fundamental structural change, which in the Emerging Markets is about developing the consumption side of the economy. That is a secular trend resulting from the force of 20 years of globalization. Despite much rhetoric to the contrary about the slow speed of this transition, in China exports as a share of GDP have fallen from 35% in 2007 to 25% today. (For more on this topic, see our soon to be published paper, "*New World Order, New Rules*", co-authored with Ian Bremmer of Eurasia.)

EXHIBIT 11: Fading Food and Energy "Tax": Headline Inflation Minus Core Inflation



Source: BofA ML Research, FactSet and GWM Investment Management & Guidance. Data as of 3Q 2011.

EXHIBIT 12: Global GDP Forecasts

	GDP growth, %			
	2009	2010	2011E	2012E
Global	**-0.9**	**5.1**	**3.8**	**4.2**
Global ex US	**-0.2**	**5.6**	**4.4**	**4.9**
Developed Markets	-3.9	2.8	1.5	1.8
G5	-4.1	2.6	1.4	1.6
Emerging Markets	2.6	7.6	6.3	6.2
Europe, Middle East and Africa (EMEA)	-4.2	2.9	2.3	1.8
European Union	-4.1	1.8	1.7	1.2
Emerging EMEA	-3.5	4.5	4.0	3.6
PacRim	3.8	8.1	6.1	6.8
PacRim ex Japan	6.1	9.0	7.4	7.6
Emerging Asia	6.6	9.2	7.8	7.8
Americas	-3.1	3.9	2.5	2.5
Latin America	-2.0	6.3	4.6	4.1

Source: BofA ML Research and GWM Investment Management & Guidance. Data as of Oct. 07, 2011.

Although much has been made of the risks in China specifically, and the potential for them to suffer a hard economic landing at the hands of slowing growth in Europe and the U.S., it is our view that the policy options available to Chinese leaders are just too vast and the incentives so high given that 2012 is a transition year for government leaders, to bet against a soft landing there. These factors imply a global economy that can grow at 3.5-4.5% in 2012 (see Exhibit 12) with Emerging Markets growing at more than 6%, roughly 3 times the rate of the U.S. At this rate, not only are Emerging Markets driving annual growth rates, **but they are quickly becoming half the total global output.** That means that actions by their central banks to cut rates, especially as inflation eases, confers global benefits that will further buffer the U.S. economy and our export machine.

→ Conclusion: Rogoff and Reinhart, not the Bears, are Right

In what is likely to become **the** seminal work of economic analysis of our era, ***This Time is Different***, professors Ken Rogoff and Carmen Reinhart have argued that recovery from financial crises are different than the bursting of other asset bubbles that typically characterize economic cycles. When financial crises damage the banking system and credit transmission, and when these factors combine with deleveraging and fragile confidence, recoveries are very long and the resumption of normal economic growth is slow. ***We believe we are in such a low growth world now, but that recession will be averted.*** While many are rightly concerned that tepid income growth and weak job creation will produce a double-dip recession, we just don't see the ingredients of economic excess to produce a true recession or sustained contraction of output. Pent-up demand for durables and capital equipment continues to build against a backdrop of swelling cash hordes. U.S. housing continues to bottom. Although the global economy is more intertwined than ever and systemic risks remain, we see globalization and global diversification as an important strengthening feature to our cycle where the secular growth trends of Emerging Markets can effectively cushion some of the slowing in the developed world. Finally, while policy makers in the U.S. may have limited maneuverability to stimulate in the intermediate term because of debt/deficit and political constraints, the rest of the world is not as constrained. With global inflation readings potentially peaking, we see potential catalysts for monetary action on the horizon. Finally, we remain hopeful that policy makers in Europe will find the will to act and push toward a visible resolution to the crisis.

→ Whether Recession Comes or Not, Markets are Prepared

One of the common jokes on Wall Street is that the market has discounted 12 of the last six recessions. With risk-based assets from equities to high yield bonds all at valuation extremes that seem to be discounting a decline in corporate profitability of 15-20% in 2012 and a pickup in default rates from ≈2% to 7.5%, we think the recession scenario is already "baked in." With global growth ultimately likely to end up in the 3.5%-4.5% range in 2012, we think it is still possible that corporate profits can grow at low single digits. Although that may mean that analyst estimates must still be cut, and downside risk of 5-10% clearly exists, we believe that by year-end that process will be well under way and that market capitulation phase will be complete, setting up a more constructive backdrop for risk-taking.

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There are special risks associated with an investment in commodities, including market price fluctuations, regulatory changes, interest rate changes, credit risk, economic changes, and the impact of adverse political or financial factors. ,

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