The Weekly Letter

JUNE 13, 2017

Author
Marci A. McGregor
Director

- **Japan: A Summer Rally?**–Japan has arguably the most stable policy backdrop in the world as it navigates a cyclical upswing while addressing medium- and longer-term issues. We see hints of a summer rally for Japanese equities based on fund manager positioning, currency levels and fundamentals. Japan is not without risks, however, including the pressure a tight labor market may put on corporate profits.
- **Markets in Review:** Last week equities traded lower, with the S&P 500 losing 0.3% and international equities, as measured by the MSCI EAFE Index, shedding 1.2%. Bond prices also declined, with the 10-year Treasury yield up 4 basis points to 2.20% from 2.16% a week earlier. Commodities, as measured by the Bloomberg Commodity Index, added 0.1%, yet WTI crude fell 3.8% to settle at $45.83 per barrel. Gold lost 1.0%, ending the week at $1,266.63 per ounce.
- **Looking Ahead:** Investors get a heavy week of data releases in the U.S. Inflation readings, industrial production, and manufacturing levels accompany what is expected to be a "live" FOMC meeting. Overseas, pricing data is set to confirm concerns echoed by the European Central Bank.

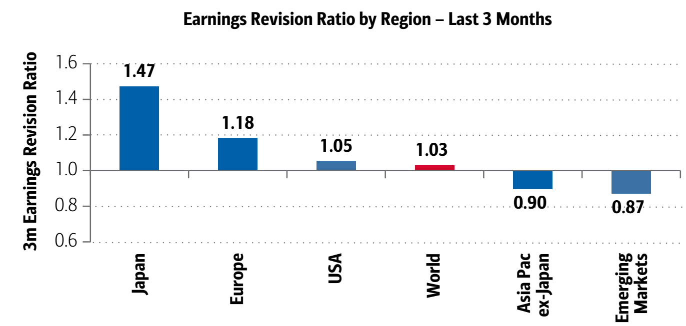
Japan: A Summer Rally?

Earlier this year Japanese equities underperformed many of their global peers in local currency terms under the weight of external macro issues, such as prospects for U.S. tax reform, the recent election in France and geopolitical concerns around North Korea. As many of these risks have receded, however, we've seen the Nikkei index resume its move higher.

Historically, investors have been hesitant to put money to work in Japanese equities over longer-term concerns around Japan's aging population and corporate management's lack of focus on shareholder returns. However, Japan currently has arguably the most stable policy backdrop in the world as it navigates a cyclical upswing while addressing these medium- and longer-term issues. The Japanese equity strategy team at BofA Merrill Lynch (BofAML) Global Research sees hints of a summer rally for Japanese equities based on fund manager positioning, currency levels and fundamentals, but says a catalyst may be needed.

The BofAML Global Research economics team is forecasting growth of Japan's gross domestic product (GDP) to pick up this year to a 1.6% annualized rate, from 1.0% last year. Near-term indicators of cyclical momentum are also positive. In Japan, both economic and equity performance have strong correlations to global manufacturing, and data shows that global manufacturing continues its recovery.

Exhibit 1: Analysts have revised their earnings estimates upward



Source: Source: Source: BofA Merrill Lynch Global Quantitative Strategy, MSCI, IBES. Data as of May 29, 2017.
Past performance is no guarantee of future results.

Earnings revisions are strong

Corporate profit growth has kept valuations reasonable in Japanese equity markets and the outlook is for profits to continue to grow. Take the earnings revision ratio (ERR), which tracks analysts' upgrades and downgrades of earnings estimates, with a ratio above 1.0 indicating more upward revisions than downward ones. Japan's three-month ERR is currently the highest among major global equity markets (see Exhibit 1).

The ERR remains strong in Japan despite moderating in May to 1.47 from 1.61 the previous month. The global ratio breached 1.0 in March, and continues to strengthen as earnings expectations rise. On average, global equity markets tend to rally when the ratio is above 1.0. Our view is that the corporate profit cycle is reinforcing domestic growth.

A contrarian buy on fund flows

Investor positioning is another important factor when considering an allocation, and one measure to look at is BofA ML Global Research's proprietary Fund Manager Survey, which tracks allocations of fund managers on a monthly basis. In the past two months, they have lowered their allocations to Japanese equities from an overweight to a marginal underweight as record allocations flowed into Europe following the Macron victory in France. With investor focus shifting toward Europe, the chief investment strategist at BofAML Global Research, Michael Hartnett, now sees Japan as a contrarian "buy."

Shareholder focus is improving

Japanese corporate management's focus on rewarding shareholders still lags that of other developed markets. Corporate behavior is improving, however, and in the most recent earnings season, companies that demonstrated a focus on shareholder returns, including increasing dividends, were highly rewarded by the market. Corporations' ability to remain committed to shareholder returns will be an important factor going forward.

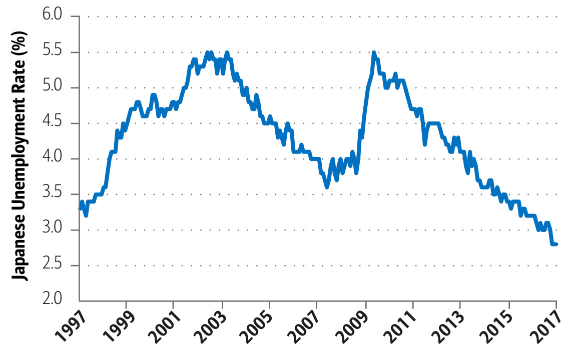
Politics and policy look stable

Based on approval ratings, it appears Prime Minister Shinzo Abe is likely to be in power until 2021, as the limit on holding office was recently extended to three consecutive three-year terms to allow this to be possible. At the same time, Bank of Japan (BoJ) monetary policy is stable and supportive of equities, as we expect real interest rates to remain low for the foreseeable future. This political and monetary stability is an important factor when considering whether Japan can balance near-term pro-growth policies and longer-term fiscal austerity.

Not without risks

One risk for Japanese equities is the pressure a tight labor market may put on corporate profits. With an unemployment rate below 3%—the lowest since 1994—and a dynamic labor market, wage growth could potentially put downward pressure on margins, but in our view the profit cycle will stay on track (see Exhibit 2). Aggregate sales for the fourth quarter of 2016 increased 4% year-over-year (YoY) and net income rose 138% from a weak prior period. Most notably, for the full 2016 fiscal year, net profits rose 14% YoY despite a 2% drop in sales, resulting in record net profit margins and high free cash flow levels (see Exhibit 3).

Exhibit 2: Japanese unemployment has been at 20-year lows

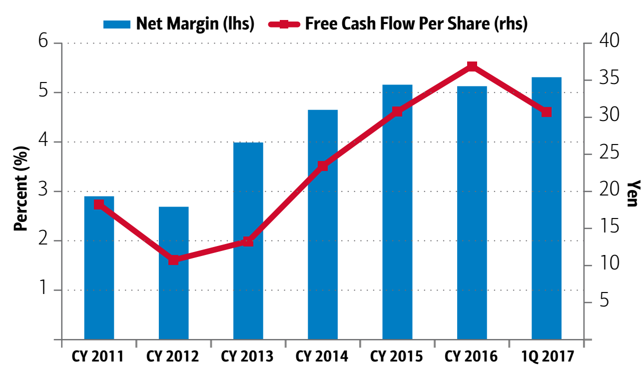


Source: Bloomberg and GWIM Chief Investment Office. Data as of May 2017.

Investor focus will be on how companies adjust to labor pressures, with one potential solution being increased investment in labor-saving technology, including robotics and other forms of automation.

Other risks continue to loom outside of Japan, including North Korean geopolitics and concerns around China's slowing growth. While BofAML Global Research views the slowdown in Chinese growth as contained currently, if it becomes more pronounced it may pose additional downside risks to our outlook.

Exhibit 3: Last year brought record cash flow per share and continued strong profit margins



Source: FactSet and GWIM Chief Investment Office. MSCI Japan Index is used in this analysis. Data as of 1Q 2017. **Past performance is no guarantee of future results.**

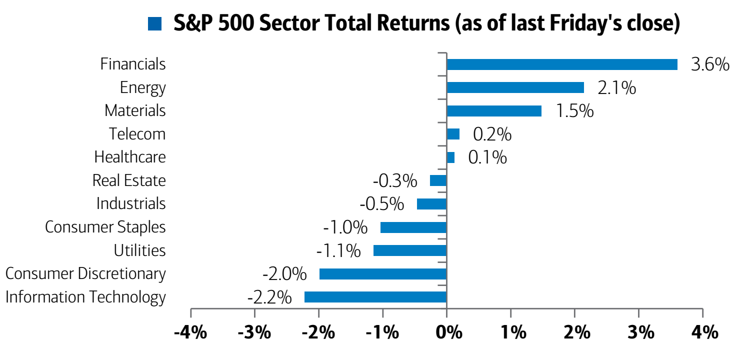
Portfolio Considerations: We recommend an overweight in international developed equities. We have become more favorable on European equities given their attractive valuation and improving earnings potential versus U.S. equities. We acknowledge that Japan's economy has structural impediments to growth such as high debt levels and demographics. However, cyclically, growth there should accelerate on rising global activity, improving domestic demand and a weaker currency. Along with monetary policy, fiscal policy should be supportive of growth.

Markets in Review

Trailing Economic Releases

- The Federal Reserve reported an expansion of Total Net Consumer Credit of $8.2 billion for April, the smallest increase since August 2011. With a consensus forecast of $15.0 billion, the result may bolster fears that spending hasn't kept pace with high confidence.
- The Department of Labor reported Initial Jobless Claims for the week ending June 3rd at 245,000, higher than the BofAML Global Research forecast of 240,000 but down 10,000 from the prior week's revised figure. Continued labor market tightness may lead to gains in wage growth.
- In the Eurozone, the European Central Bank maintained key policy rates and the outlook for continued asset purchases but tweaked its statement, ruling out further interest rate cuts. While the growth prospects for the Eurozone are balanced, inflation remains subdued.

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



Equities

		Total Return in USD (%)		
	Level	WTD	MTD	YTD
DJIA	21,272.0	0.3	1.3	8.9
NASDAQ	6,207.9	-1.5	0.2	15.9
S&P 500	2,431.8	-0.3	0.9	9.6
S&P 400 Mid Cap	1,757.5	0.4	2.1	6.5
Russell 2000	1,421.7	1.2	3.8	5.3
MSCI World	1,922.8	-0.6	0.6	10.9
MSCI EAFE	1,893.0	-1.2	0.2	14.3
MSCI Emerging Mkts	1,018.2	0.4	1.4	18.9

Fixed Income

		Total Return in USD (%)		
	Yield (%)	WTD	MTD	YTD
ML US Broad Market	2.44	-0.2	0.0	2.5
ML 10-Year US Treasury	2.20	-0.2	0.1	3.0
ML US Muni Master	2.24	-0.1	0.1	3.8
ML US IG Corp Master	3.19	-0.2	0.1	3.7
ML US HY Corp Master	5.57	-0.1	0.1	4.9

Commodities & Currencies

		Total Return in USD (%)		
	Level	WTD	MTD	YTD
Bloomberg Commodity	167.2	0.1	-0.5	-5.5
WTI Crude $/Barrel[1]	45.8	-3.8	-5.2	-14.7
Gold Spot $/Ounce[1]	1,266.6	-1.0	-0.2	9.9
Level	Current	Prior Week End	Prior Month End	2016 Year End
EUR/USD	1.12	1.13	1.12	1.05
USD/JPY	110.32	110.40	110.78	116.96

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

Looking Ahead

Upcoming Economic Releases

- On Wednesday the Federal Open Market Committee will meet with the market pricing in a greater than 90% probability of a Fed Funds rate hike of 25 basis points. Much attention will be placed on its statement and any further guidance on plans for balance sheet normalization.
- Also on Wednesday, the Bureau of Labor Statistics will release its Core Consumer Price Index (CPI) for May. BofAML Global Research expects a month-over-month increase of 0.2%, a healthy increase over the 0.1% in April. Overall inflation has been benign, but the Fed is likely to attribute the weakness to transitory factors.
- On Friday Eurostat will report month-over-month change in the consumer price index across the Eurozone for May. BofAML Global Research projects a decrease of 0.1%, which would be a disappointing follow-up to 0.4% growth in April. Inflation has been stubbornly low within the Eurozone, with the ECB recently downgrading predictions.

BofA Merrill Lynch Global Research Key Year-End Forecasts

S&P 500 Outlook	**2017 E**
Target	2,450
EPS	$129.00
Real Gross Domestic Product	**2017 E**
Global	3.5%
U.S.	2.1%
Euro Area	1.7%
Emerging Markets	4.6%
U.S. Interest Rates	**2017 E**
Fed Funds (eop)	1.38%
10-Year T-Note (eop)	2.85%
Commodities	**2017 E**
Gold ($/oz-period average)	$1,286
WTI Crude Oil ($/bbl-eop)	$51.70

All data as of last Friday's close.

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

Mary Ann Bartels
Head of Merrill Lynch Wealth Management Portfolio Strategy

Karin Kimbrough
Head of Investment Strategy
Merrill Lynch Wealth Management

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