Global Research Highlights
Down but not out

Investment Strategy

Recession remains unlikely this year
Continued weak data and confidence shocks from capital markets have led our US economics team to lower its 2016 GDP growth forecast from 2.3% to 2.1%. Our European economists also revised their growth forecasts to 1.5% in 2016 and 1.6% in 2017. Risk assets have been under pressure this year, and our Fund Manager's survey indicates cash levels have risen to 5.4%, the third highest level since 2009, but not yet at maximum bearish levels. Our US Equity Strategist Savita Subramanian notes still-deteriorating earnings revisions have kept her near-term cautious, but for those with a one-year time horizon, Subramanian sees healthy upside. Subramanian's year-end S&P 500 target remains 2200.

Insurance insights
In non-life insurance, the fundamentals remain challenging in most business lines, and ROEs are unlikely to improve over the next several years. However, the stocks have pulled back with the market, causing valuations to better reflect the realities of the environment, according to Analyst Jay Cohen. Should the economic backdrop remain uncertain and deflationary pressures persist, Cohen believes non-life stocks should prove to be defensive relative to other financial stocks. More M&A activity could act as a floor to multiples for the group.

YieldCos - prefer high quality to high yield
The simplicity of the YieldCo equity story proved elusive during a volatile 2015. Heading into 2016, Analyst Andrew Hughes believes that many of the core elements behind the creation of the business model remain in place. His long-term outlook for the sector remains positive, predicated on strong market fundamentals that remain in place and support the YieldCo value proposition. However, macro headwinds, and global oil prices in particular, could continue to drive significant volatility in the near term, as YieldCo valuations and oil prices remain highly correlated. Dividend growth execution among stronger names and clarity on a myriad of specific questions at weaker ones are necessary to break the sector of this technical correlation. Hughes prefers names with high quality cash flows, low risk to dividend levels and growth trajectories, and low leverage metrics.

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Investors not yet Max Bearish...
...just 12% believe a global recession will occur in the next 12-months, investors remain OW equities & UW bonds, and stubbornly long tech, Eurozone & Japanese stocks (assets now most vulnerable to a redemption/recession shakedown).

But cash levels surging higher...
...investors raise cash (to 5.4% = 3rd highest since 2009), cut growth & profit expectations (EPS expectations turn negative for 1st time since Oct’12), and rotate defensively (selling stocks, resources, industrials, banks & EM, and rotating to healthcare, staples, cash & bonds).

And long US dollar starts to unwind...
...US$ strength induces record UW in materials, 1st industrials UW in 40 months, and China recession/EM debt crisis remain biggest “tail risks”...but number of US dollar bulls drops to 3-year lows as Fed rate hike expectations start to fade (2 hikes forecast in 2016, down from 3).

Investors not in denial about recession/bear market risks...
...but have yet to accept macro/markets already well into a normal, cyclical recession/bear market. True capitulation would involve a bout of US$ weakness and outperformance of FMS ‘shorts’ (e.g. BRIC) as redemptions induce forced-selling of ‘longs’ (eg, FANG). Sell bounces until the 4Cs (China, Commodities, Consumer, Credit) improve.

Exhibit 1: The Longs & Shorts, relative to Global FMS history*

Source: BofA Merrill Lynch Global Fund Manager Survey

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Don’t get caught up in semantics
Correction or bear market? The S&P 500 is in correction territory, the Russell 2000 and almost 80% of regional stock indices are in bear markets. The average S&P 500 stock is in a bear market - down more than 25% from its 52-week high. Stocks are down a lot. Let’s move on. Same story for the economy: should we care whether or not the NBER will one day deem this slowdown an official recession, if PMIs suggest that manufacturing sectors have been in a recession in the three biggest economies (China, US, India) and Energy has been in a profit recession that has lasted twice as long as a typical economic recession.

What makes us feel better? Sentiment & valuation
The world hates risk. Wall Street houses have capitulated on targets, and our sell side indicator continues to flash a contrarian buy signal. The AAII survey results show 18% of mom-and-pop investors expect stocks to rise, the most bearish read since April ‘05 and vs. 19% during the 2008 crisis. The S&P 500 is now pricing in a 50% chance of a recession, but the rates term structure, historically more reliable, signals just an 18% chance. The S&P 500 P/E has round-tripped in the last year and is again below average.

What makes us feel worse? Two fundamental “gaps”
Still deteriorating earnings revisions have kept us near-term cautious, and two worrisome trends are also on watch: 1) a divergence between earnings and sales – EPS beats vs. sales misses is now the most extreme since 1Q09; and 2) the gap between reported (GAAP) and adjusted (pro forma) earnings is at its widest since the ‘08 crisis, with energy write-downs a key culprit. Downside to 4Q15 EPS of $30.25 is likely with recent macro data and oil still in decline, but EPS growth should recover to 5% in ’16.

Buy or sell? Depends on your time horizon
For investors with a one-month time horizon, we would wait for revision ratios to stop decelerating before finding an entry point. But for a one-year time horizon, we see healthy upside – our year-end S&P 500 target remains 2200. And for the very long-term investor, valuation is almost all that matters, historically explaining 60-90% of subsequent returns over a 10-year time horizon. Our 10-year target for the S&P 500 is based on this historically predictive framework, and suggests 3500 by 2025.

What to own? Not your typical recession screen
This sell-off differs from a typical growth scare in that parts of the recession playbook are failing miserably. For instance, secular growth stocks are underperforming, whereas they typically lead ahead of recessions as investors hide in idiosyncratic, non-economically sensitive areas. Instead, our themes on positioning and “anti-credit” are in full force; we screen for stocks at the intersection of these drivers on page 7. A caveat: once stocks find a bottom, a short-term rally in distressed, low quality names might ensue, but is not sustainable in our view. Credit headwinds are likely to remain with more tightening (Fed, SLO, HY spreads,) further dividend cuts and bankruptcies ahead.

Get used to volatility
We are today operating under one of the tightest financial regulatory backdrops in history. One important consequence is that banks are no longer substantial providers of liquidity. Flash crashes may be the new normal. Less liquid areas of the investment landscape (small caps, high yield, EM) are likely to fare less well, and multiples here appear to be de-rating to reflect this risk. This dynamic represents another reason to stick with large caps in our view.

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We have revised our 2016 US GDP growth forecast to 2.1% from 2.3%, and our 2016 Euro area GDP growth forecast to 1.5% from 1.7%. Details of these and other forecast changes are in the corresponding country sections below.

**Global: China and deflation channels**
We find limited direct impact on consumer prices in developed countries for a 10% depreciation in the CNY-USD. Half the impact of the lower currency is lost to margin behavior. China fuels global deflation through lower demand, which dampens commodity prices and widens the global output gap.

**United States: double discount**
With continued weak data and confidence shocks from capital markets, we are lowering 2016 GDP growth forecast from 2.3% to 2.1%.

**Euro Area: ECB ahead of the curve, outlook still behind**
We bring our ECB call to March. We do not expect ‘more of the same,’ even if more than a 10bp cut on the repo rate is unlikely. Mere extension would not be on par with ‘new circumstances.’ We expect some acceleration in the buying pace. We cut our growth forecasts to 1.5% in 2016 and 1.6% in 2017. Inflation would average 0.2% and 1.4%.

**Japan: main focus on assessment of downside risk**
Given the magnitude of the volatility in financial markets and the time-lag before monetary policy works its effects, our main scenario is for additional BoJ easing in March or April, though we cannot rule out the possibility of additional easing at the upcoming meeting.

**Emerging Asia: what’s driving Korea’s big current account surplus?**
The current account surplus is expected to hit a record high of 8% of GDP for 2015 amid collapsing oil prices and sluggish growth. In our view, cyclical factors (weak oil price and domestic demand) may explain as much as half the forecast surplus for 2015. Going forward, we reckon that current account surplus would stay in the range of 3-4% of GDP over the medium term.

**Emerging EMEA: Poland in focus: doubts bring jitters**
As the market is re-pricing political risks, investors are in great doubt about PiS policy moves. We raise EUR/PLN forecasts. Not much challenge to our constructive MT view on macro for now, but this is probably of second order of importance. Weak PLN offset by oil decline. But NBP’s caution suggests risks to our call of a 25bp rate cut in April.

**Latin America: searching for the bottom**
The Central Bank of Brazil surprised the market and left the Selic unchanged. Watch for the release of the minutes next week. We are increasingly concerned about downside risks to our growth forecasts in Brazil, Mexico and Colombia. In Venezuela, we expect market-positive announcements on FX and gasoline prices in the coming days.

**UK: a trickier year for house prices**
Low interest rates and inadequate housebuilding point to strong house price gains. But tax changes for private landlords pose a potentially large headwind, as could uncertainty around the Brexit referendum. UK house price gains will probably slow in 2016.

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