Year Ahead 2014

Back to fundamentals

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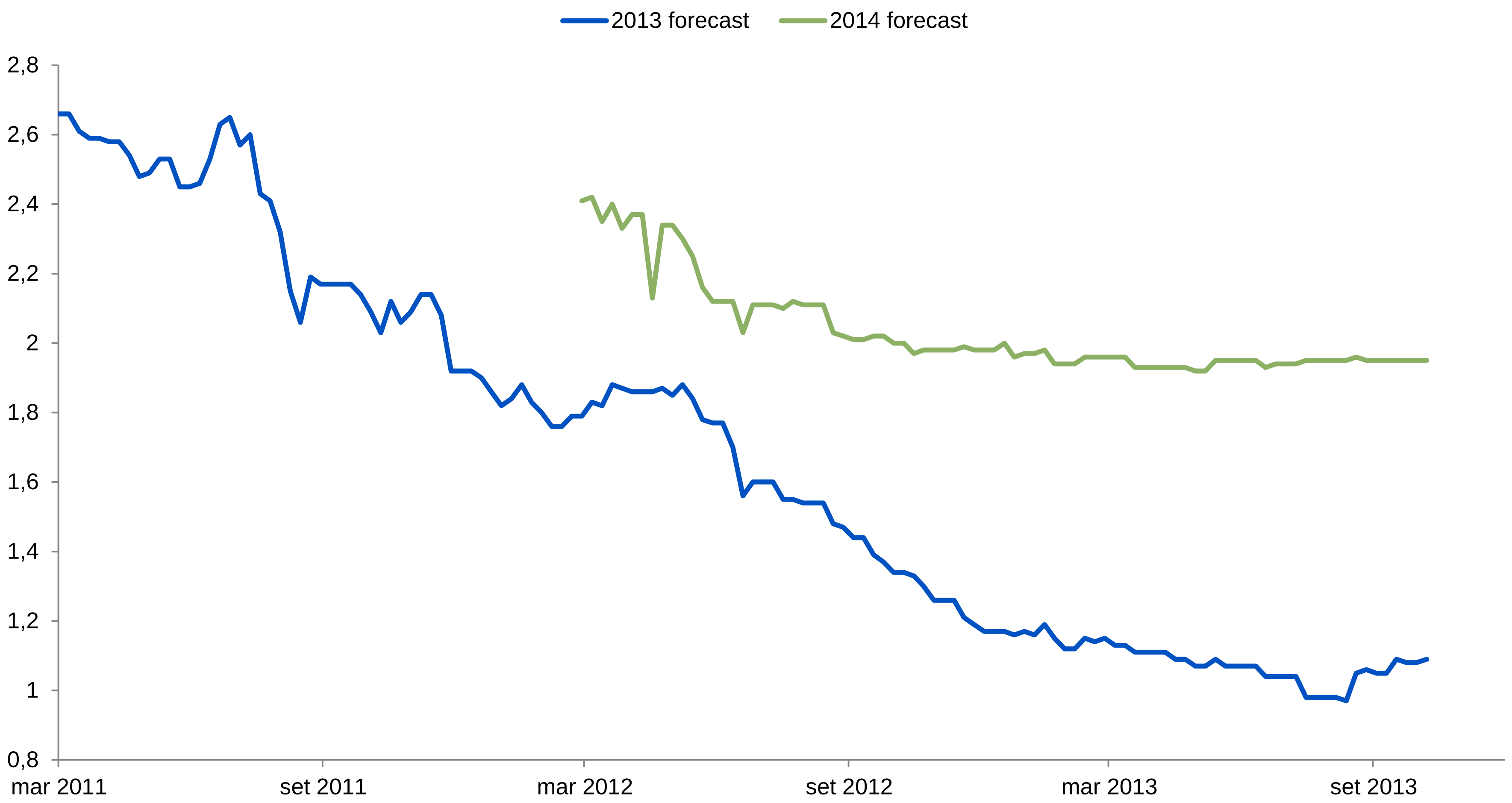
Developed market growth forecasts have started to stabilise...

Macroeconomics

2013 and 2014 growth forecasts for G10* economies

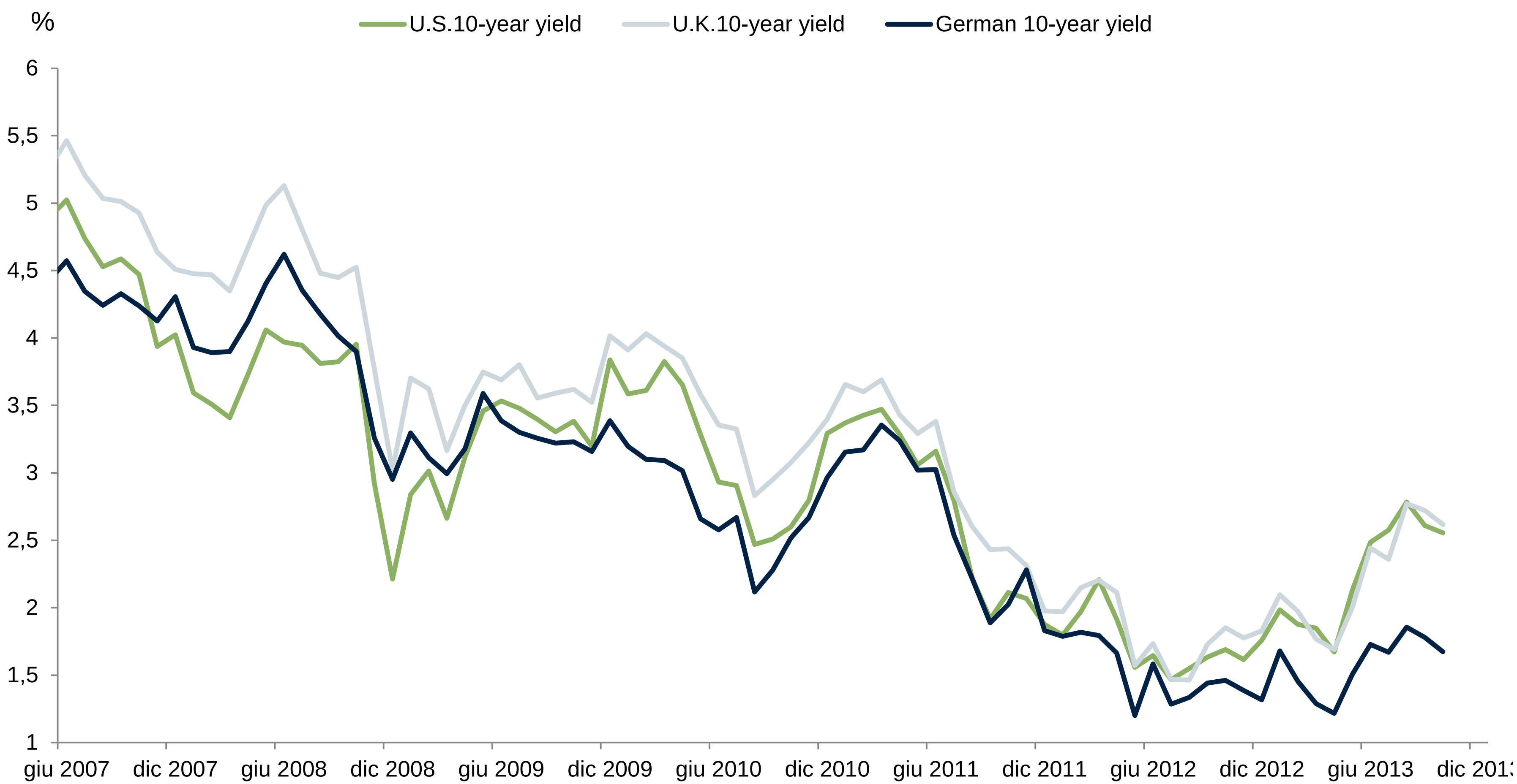


*Sources: Bloomberg, Merrill Lynch EMEA CIO. Data as of November 2013. *G10 = Group of 10 major developed economies (Belgium, Canada, France, Italy, Japan, Netherlands, United Kingdom and United States)*

...and easy developed monetary policy no longer means rock-bottom bond yields

Macroeconomics

10-year government bond yields for the U.S., Germany and the U.K.



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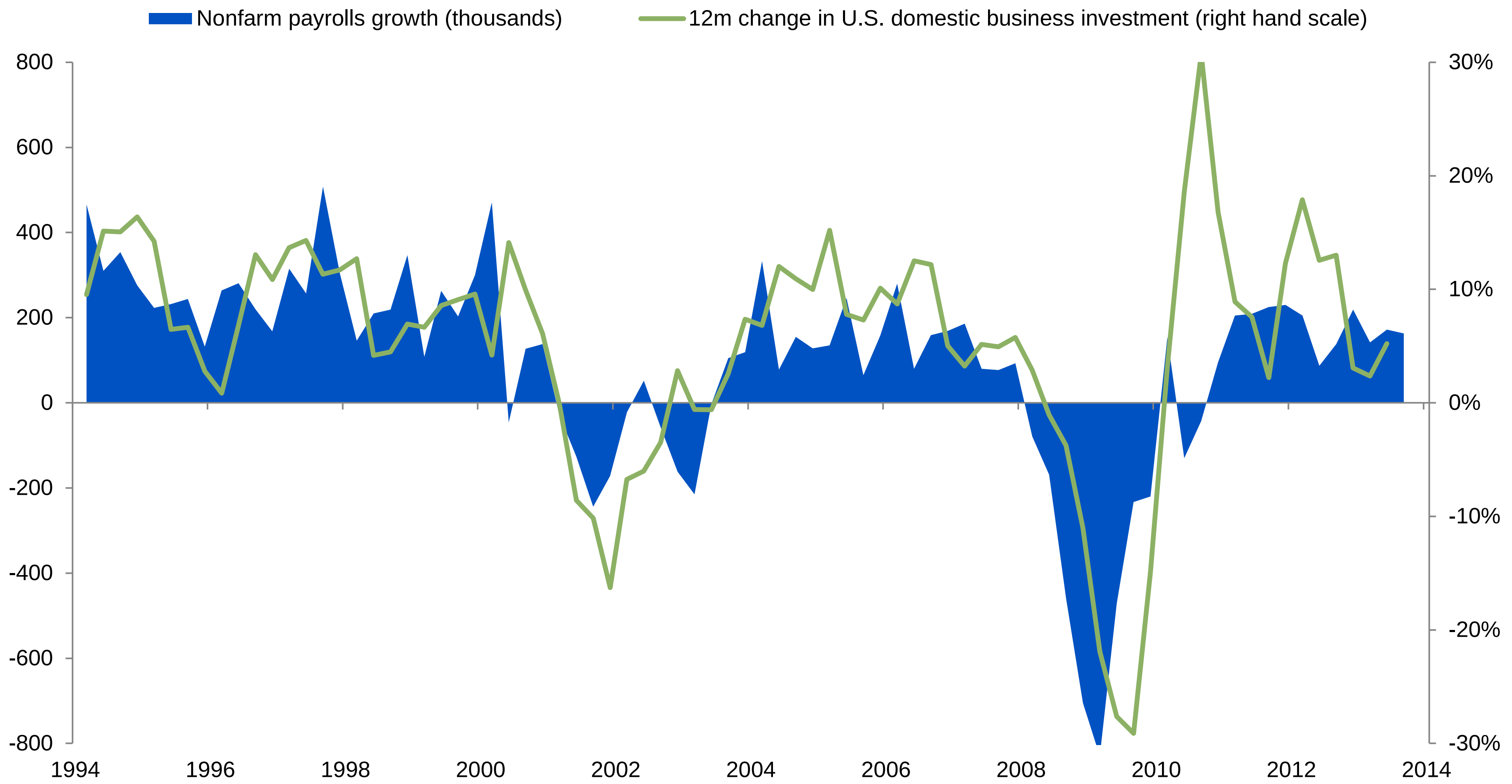
Sources: Bloomberg, Merrill Lynch EMEA CIO. Data as of October 2013.

The U.S. private sector should accelerate in 2014, with businesses to hire and to spend

U.S. nonfarm payrolls growth and business investment



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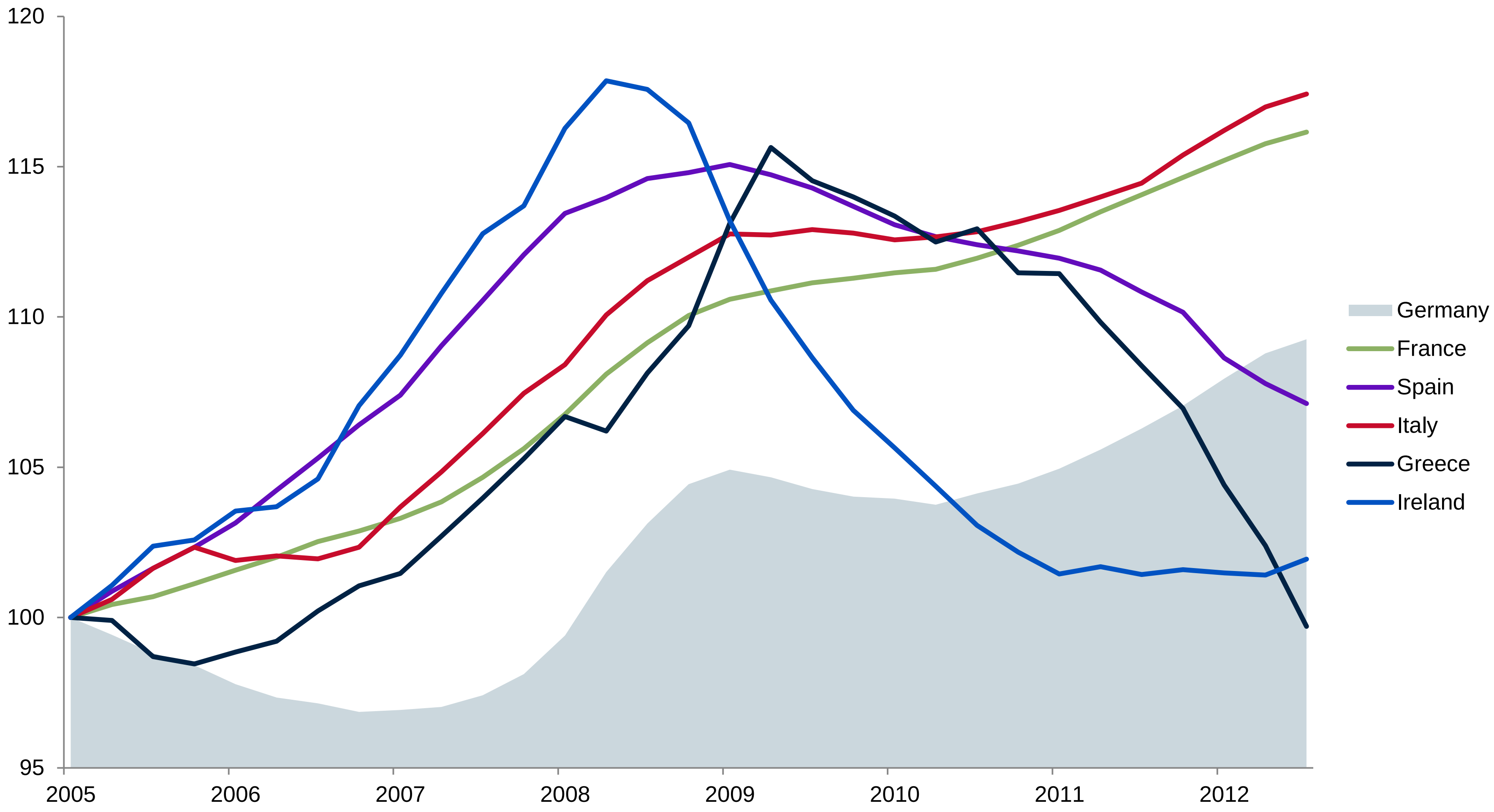
Sources: Bloomberg, Federal Reserve, Merrill Lynch EMEA CIO. Data as of September 2013.

European labour force competitiveness should continue to support a fragile recovery and rebalancing

Unit labour costs (indexed to 100 as of 2005) for selected eurozone nations

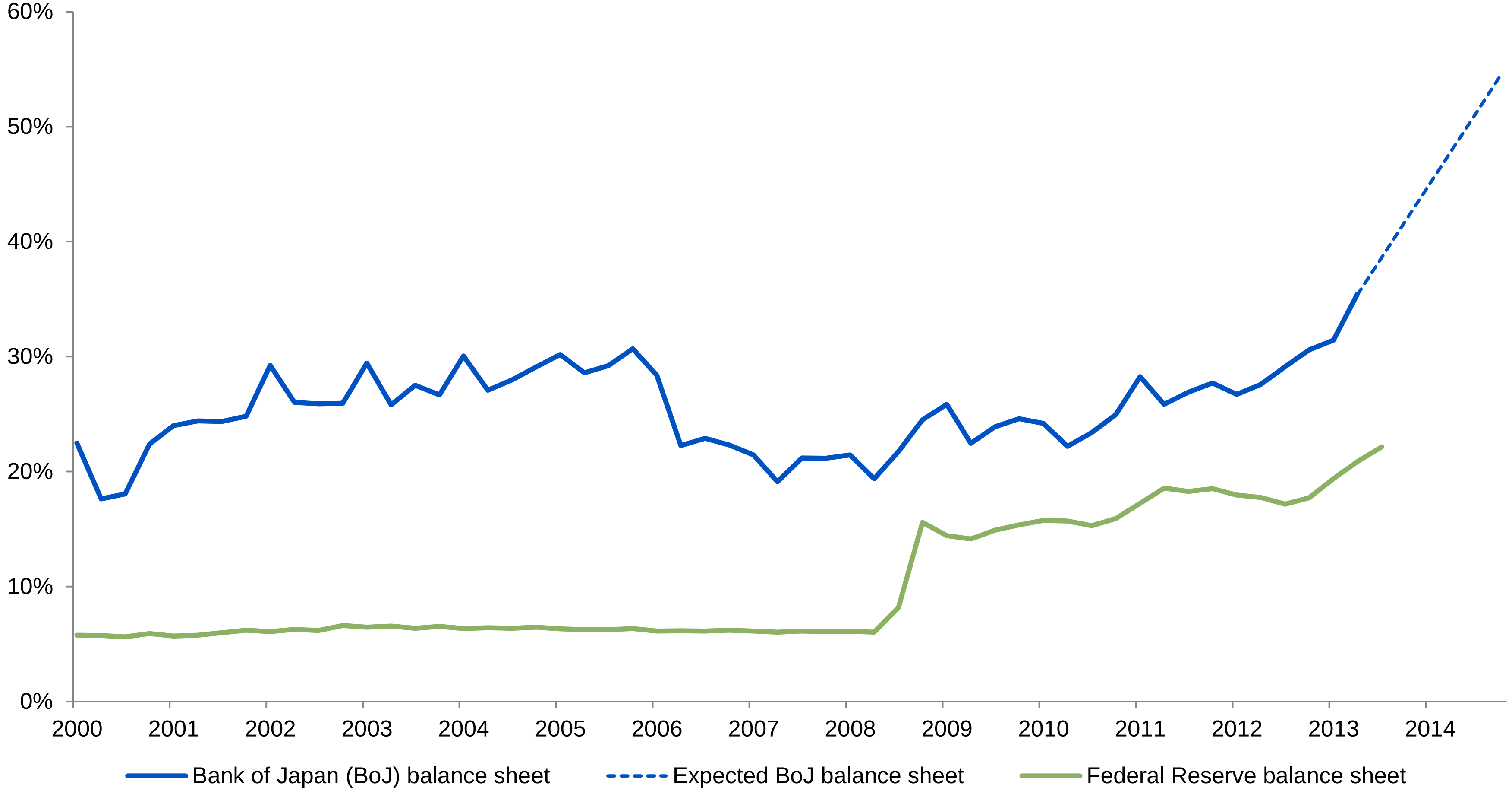


Sources: European Central Bank, Factset, Merrill Lynch EMEA CIO. Data as of June 2013.

Bank of Japan will likely be the only major central bank easing further in 2014

Macroeconomics

Balance sheets (as a percentage of GDP) for the Federal Reserve and Bank of Japan (including projections)



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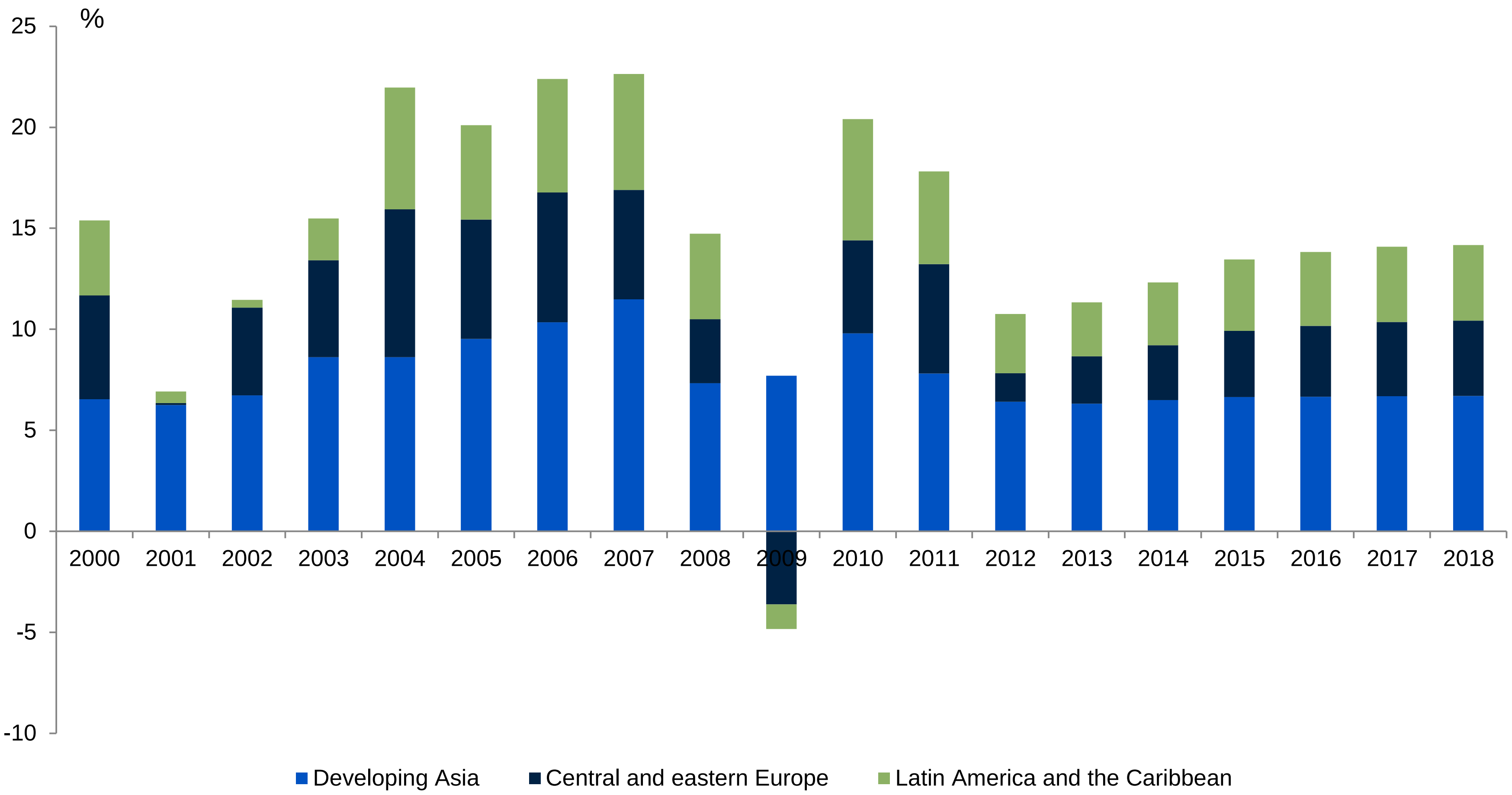
Sources: Bloomberg, Merrill Lynch EMEA CIO. Data as of September 2013.

Emerging economies growth is expected to moderate in 2014 but Asia should lead the pack...

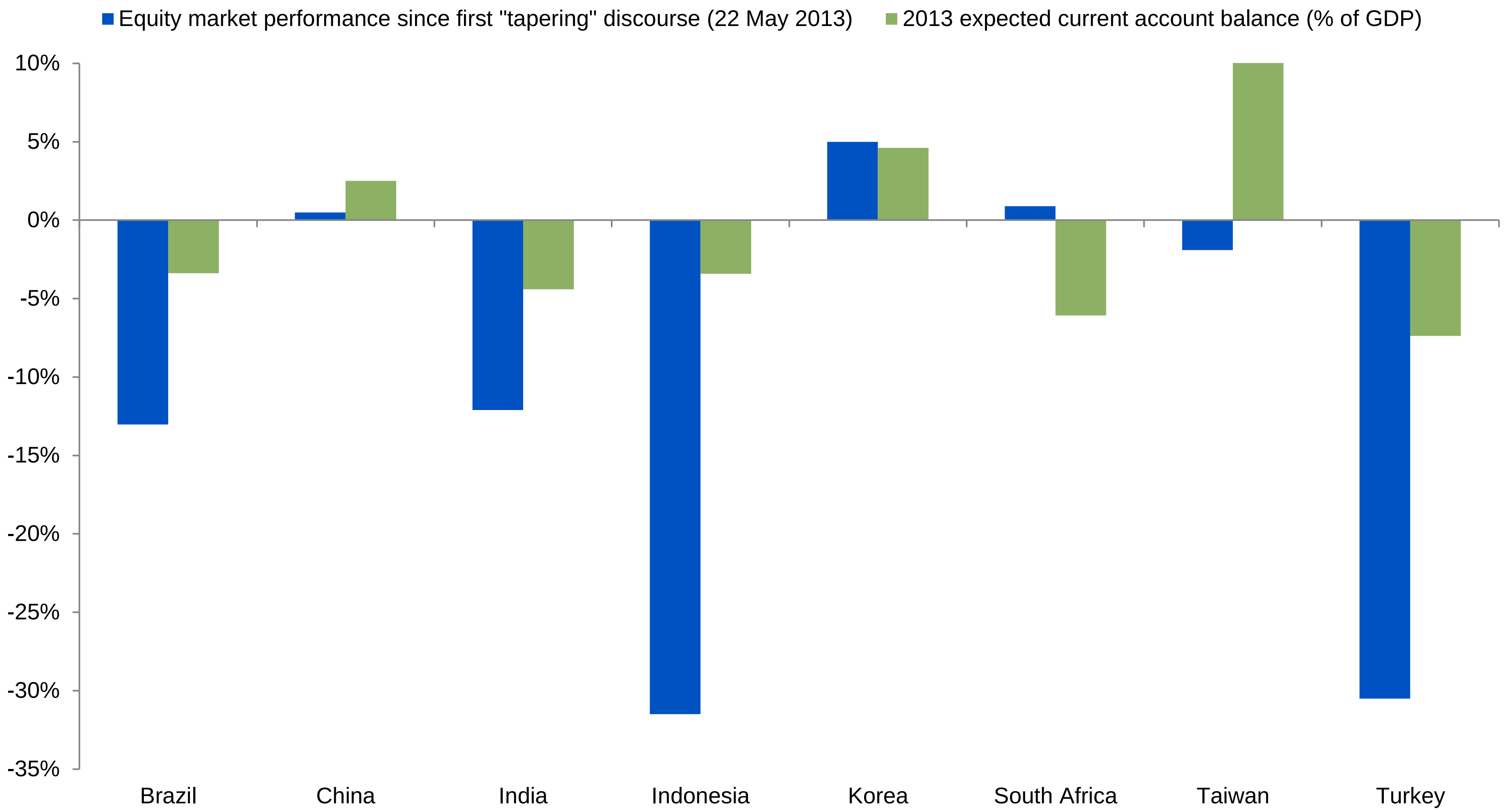
Real GDP growth rates (including forecasts beyond 2012) for major emerging regions



Sources: International Monetary Fund (IMF), Merrill Lynch EMEA CIO. Data as of October 2013.

...but current account vulnerabilities in EM may still weigh on selected markets, warranting caution

Current account balance forecasts and equity market performance for selected EM nations



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Sources: Bloomberg, IMF, Merrill Lynch EMEA CIO. Data as of 14 November 2013.

Winners in 2013

Which of our calls worked well in 2013?

"Equities to outperform fixed income, including credit"

- Global equities, as measured by MSCI AC World (USD total return) +18.8% versus BofA Merrill Lynch Global Broad Market Index (USD total return) -2.4%

"In the U.S. …high yield still offers value"

- High yield as measured by BofA Merrill Lynch U.S. High Yield Master II Index returned +5.9%, whereas the return of investment grade bonds (BofA Merrill Lynch U.S. Corporate Master Index) was -2% and US Treasuries (BofA Merrill Lynch Unsubordinated U.S. Treasury/ Agency Master) -2.5% on a year to date basis.

U.S. financials equities as a way to play U.S. housing recovery

- From opening to closing the U.S. financial equity position, our play on a U.S. housing recovery outperformed the broader U.S. equity index (3% outperformance over 2013).

Sources: Bloomberg, Merrill Lynch EMEA CIO. Data as of November 2013.

Losers in 2013

What missed our expectations in 2013?

"Europe and emerging markets equities to lead a higher beta, value-driven regional performance"

- Whereas European, Japanese and US equities have all returned in excess of 20% total returns (USD, MSCI indices), emerging markets rallied only 0.6% (as of end October), given weaker local economic and profits dynamics, in addition to selected higher funding costs

"U.S. dollar to move higher as selected 'risk-on/risk-off' correlations begin to break down"

- The U.S. Dollar (DXY) index has risen a modest 1.9% in 2013, as market expectations of Federal Reserve tapering have been pushed into late 2013/early 2014, euro and sterling strengthening on more stable growth expectations

"Emerging market sovereign debt to be rewarded for better fundamentals"

- After initial fears of Fed tapering caught the market unawares, worsening external dynamics in selected Ems hurt our local currency debt position (now sold, -8.5% in U.S. dollar total return terms according to JPM GBI-EM Global Index)

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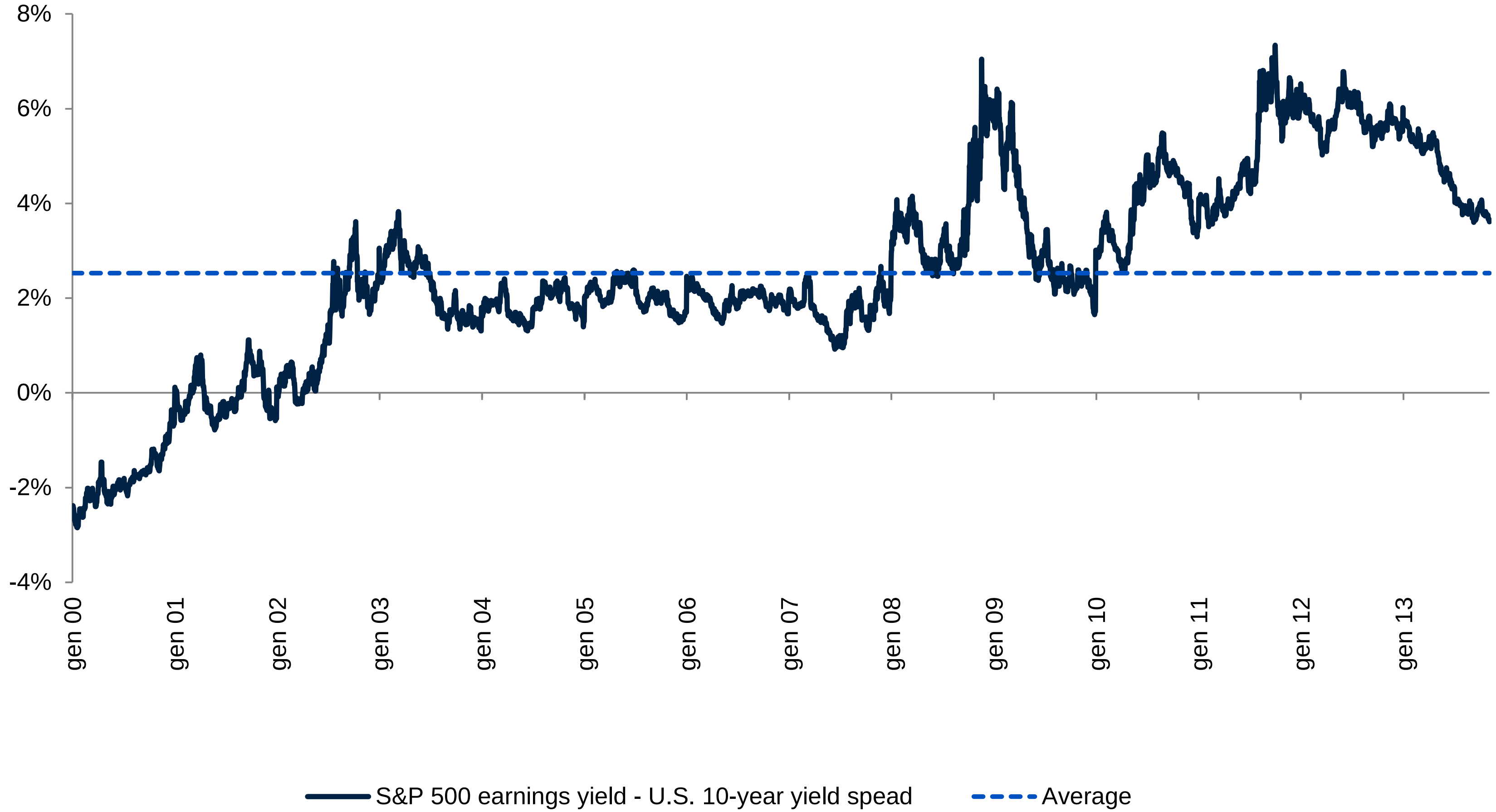
Sources: Bloomberg, Merrill Lynch EMEA CIO. Data as of November 2013.

U.S. equities still look attractive compared to bonds – a continued 2014 trend

S&P 500 equity index earnings yield minus U.S. 10-year Treasury yield



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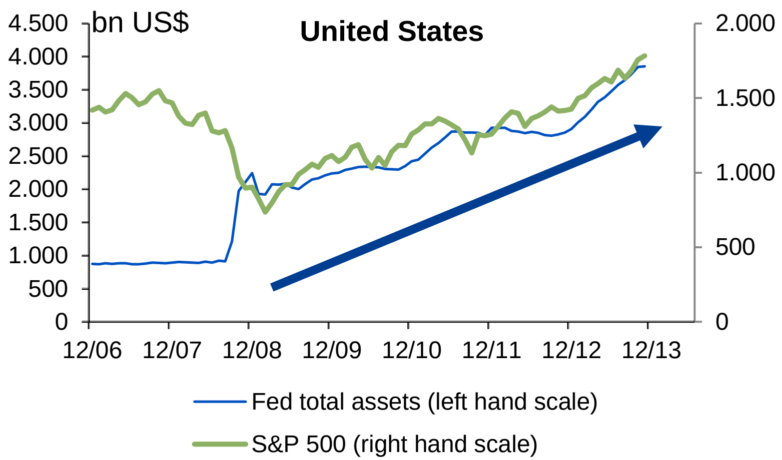
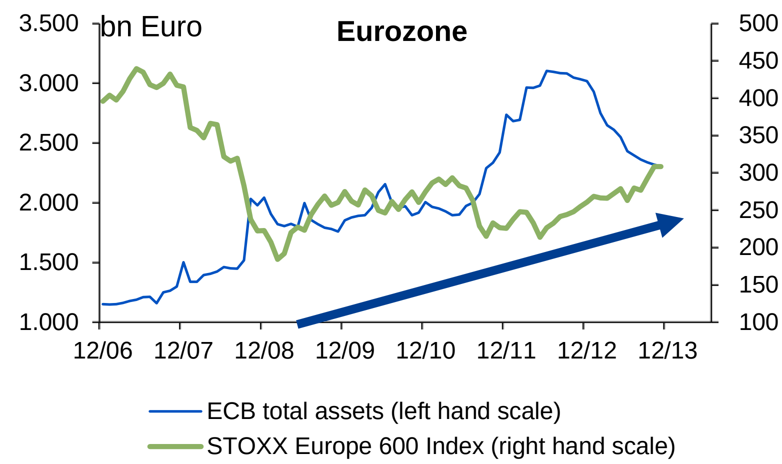
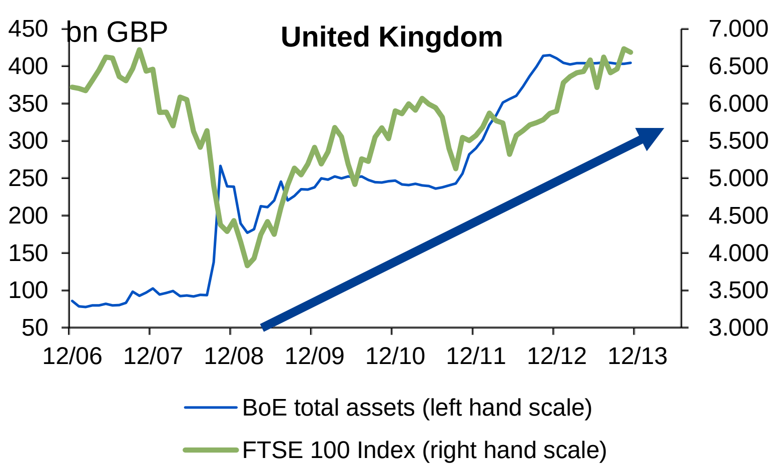
Sources: Bloomberg, Merrill Lynch EMEA CIO. Data as of November 2013.

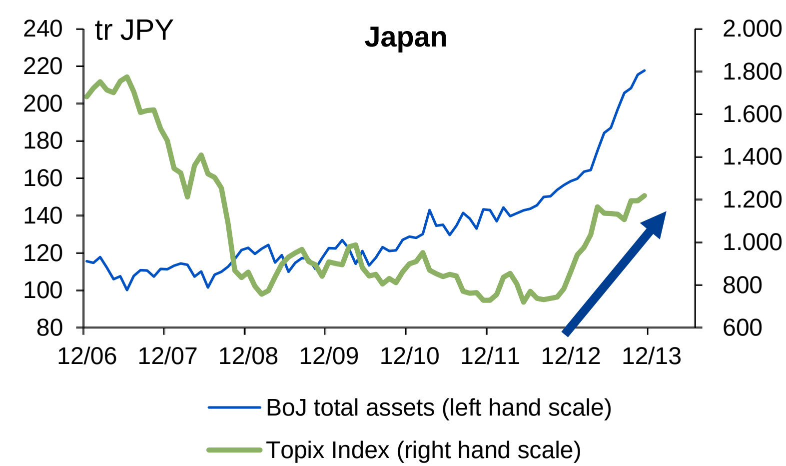
Central bank liquidity will continue to underpin equity markets...

Selected developed equity markets and corresponding central bank balance sheets









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Sources: Bloomberg, Merrill Lynch EMEA CIO. Data as of November 2013.

...but fundamentals should play a greater role in 2014

Stock performance in most developed equity markets (excluding Japan) was driven by multiple expansion in 2013

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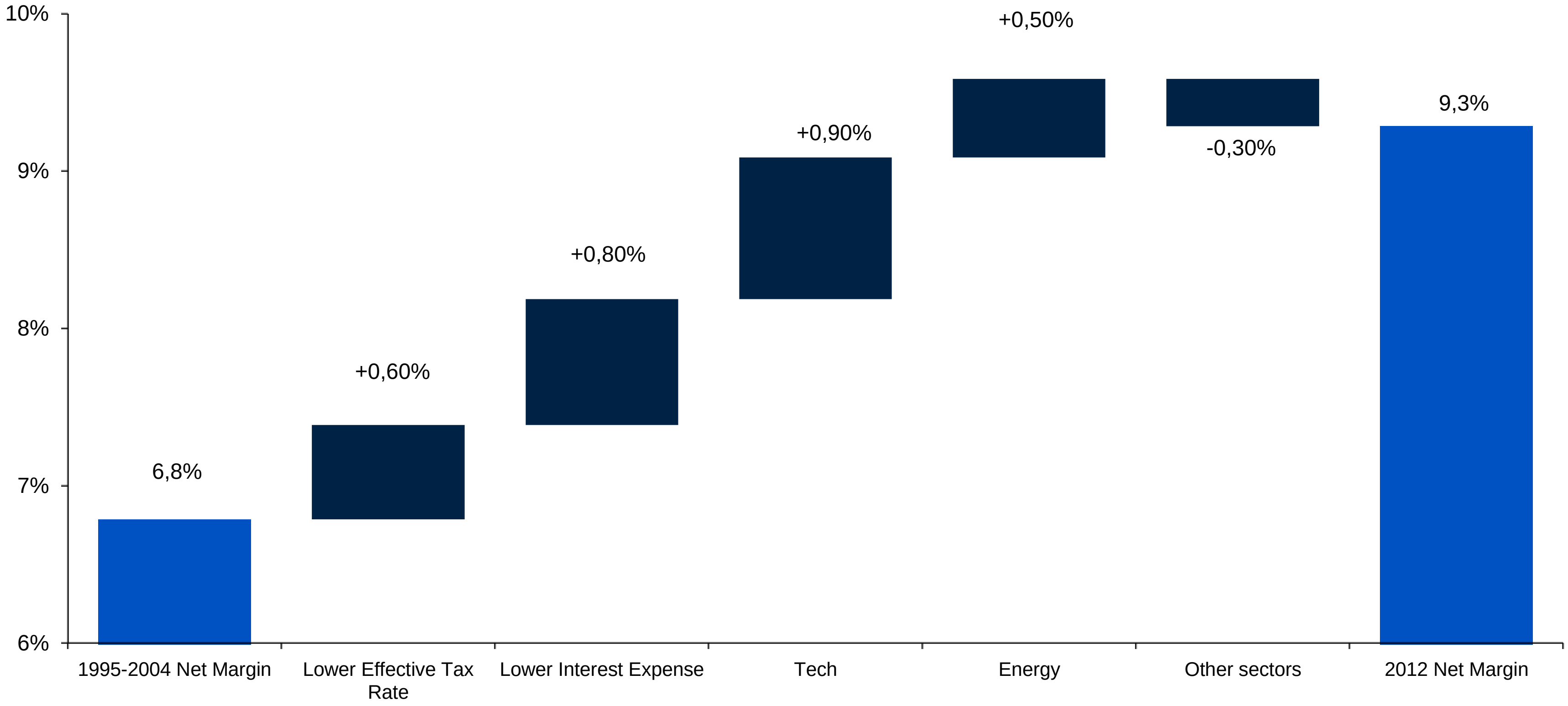
Sources: Datastream, Merrill Lynch EMEA CIO. Data as of 11 November 2013.

U.S. equity earnings quality continues to be questionable as interest expenses, taxes drive margins

Net margin breakdown for U.S. equities



Sources: BofA Merrill Lynch U.S. Equity Strategy Research, Merrill Lynch EMEA CIO. Data as of end 2012.

Manufacturing indices lead earnings growth by 3-8 months – yet earnings quantity not there yet

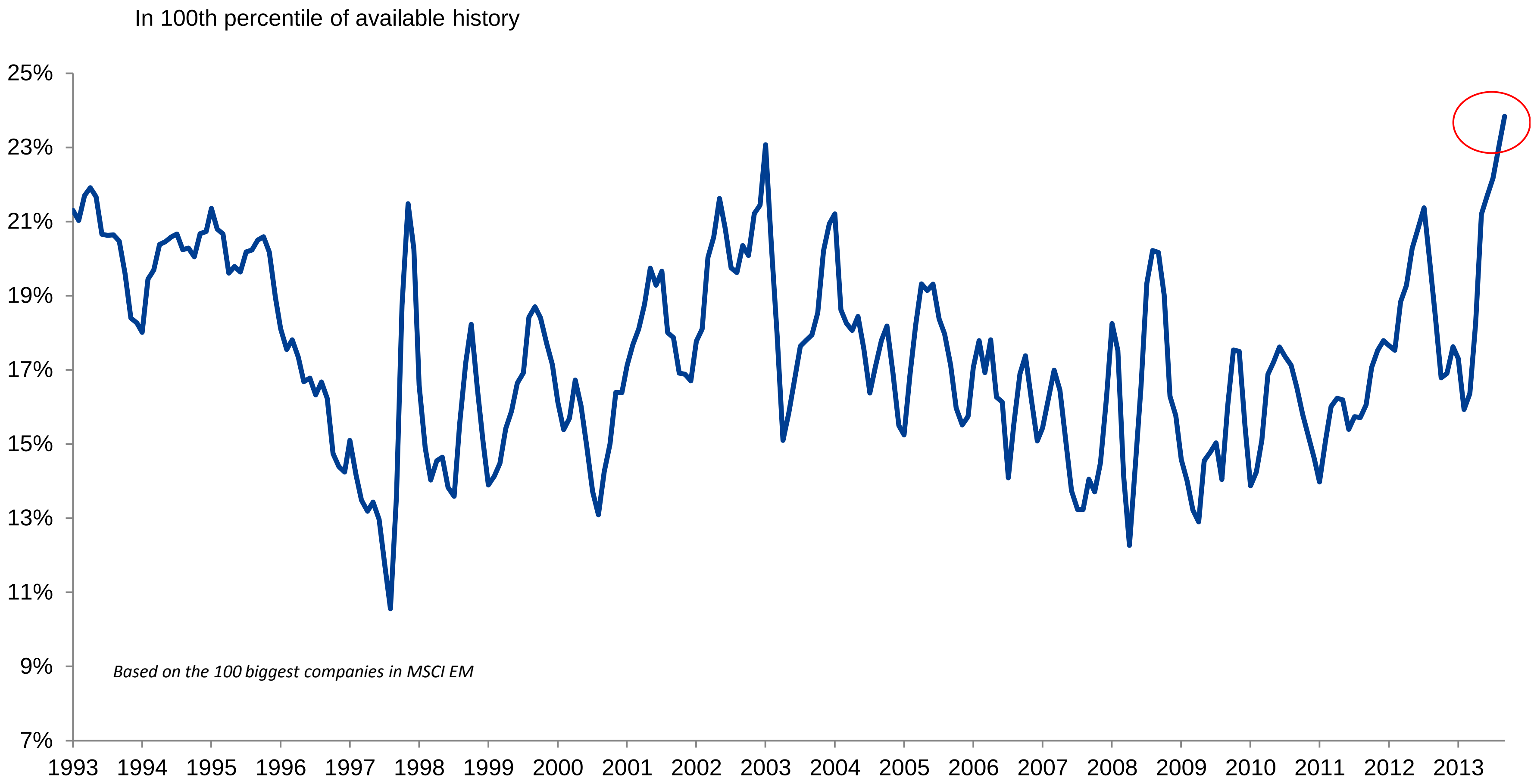
Uptick in manufacturing purchasing managers' indices (PMIs) yet to be seen in results

		Surprises versus consensus (latest quarter)			2013E Revisions*	2014E Revisions*
	% reported	Beats	In line	Miss	Since Oct 2013	Since Oct 2013
S&P 500	**91%**					
Sales		54%	0%	46%	0%	0%
EPS		74%	1%	24%	1%	0%
Eurostoxx 600	**86%**					
Sales		35%	1%	64%	0%	-1%
EPS		53%	1%	46%	-2%	-2%
TOPIX	**91%**					
Sales		60%	0%	40%	0%	0%
EPS		61%	0%	39%	0%	0%
FTSE 100	**83%**					
Sales		54%	0%	46%	0%	0%
EPS		61%	0%	39%	-2%	-1%

*Sources: Bloomberg, Merrill Lynch EMEA CIO. Data as of 12 November 2013. * Revisions since October 2013, the beginning of the last earnings season.*

Search for earnings quality in emerging markets key in 2014...but at a record cost

Spread of return on equity between the most expensive and cheapest big EM stocks is at record highs

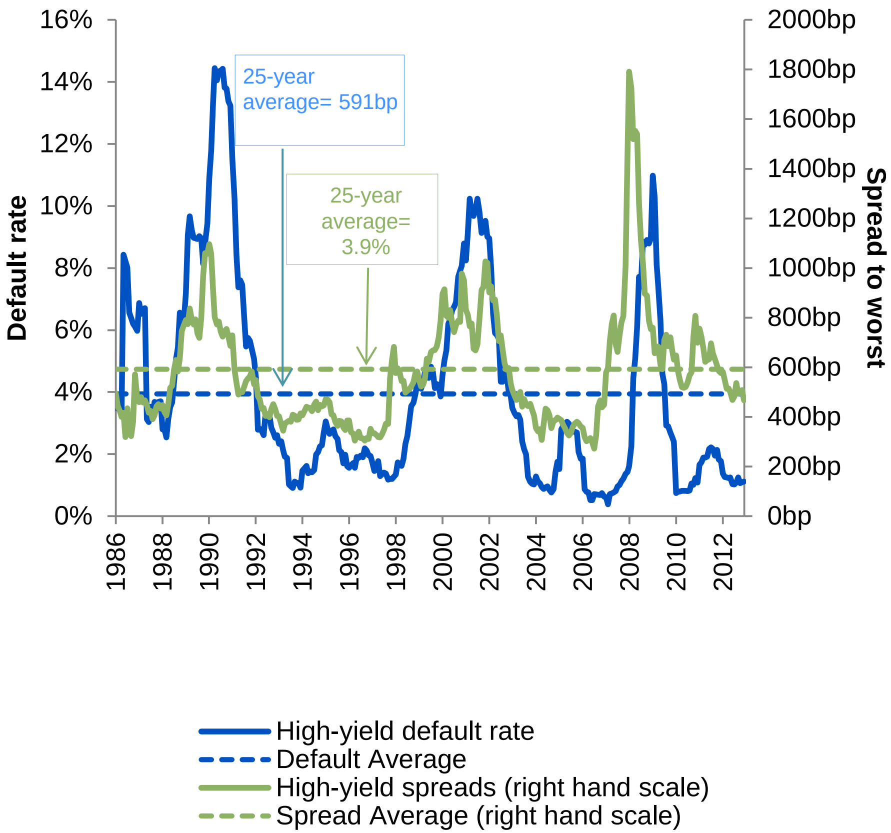


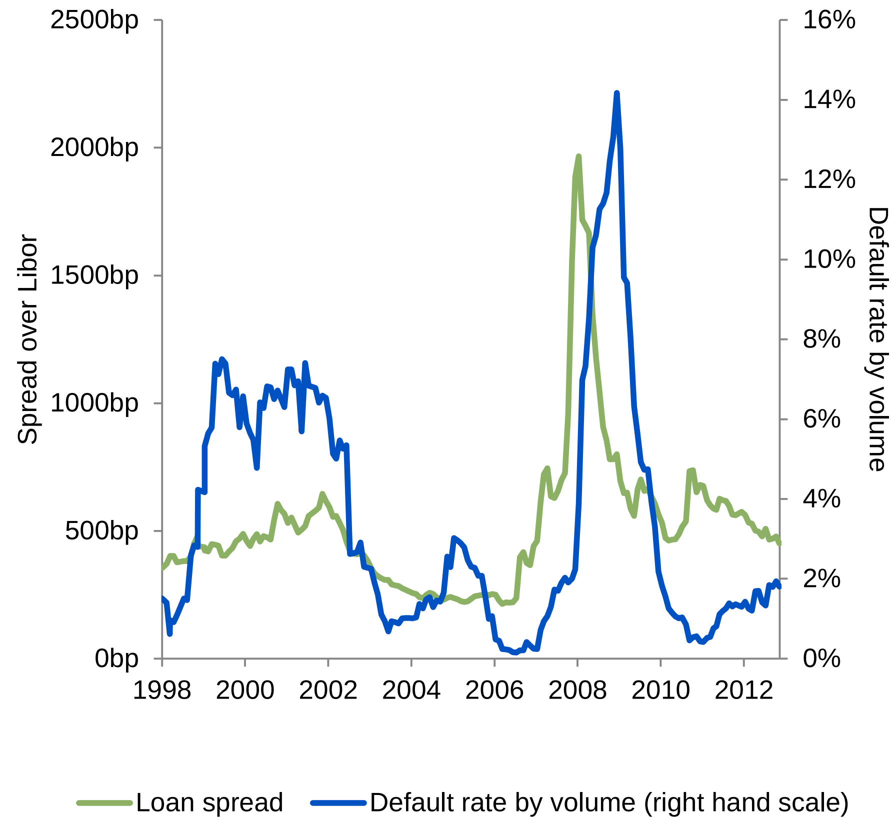
Sources: BofA Merrill Lynch Asia-Pacific Equity Strategy Research, Factset, Merrill Lynch EMEA CIO. Data as of October 2013.

U.S. high yield debt, levered loans attractive for 2014, as spreads still offer value versus default risk

Strategy

U.S. high yield (left-hand side) and levered loans (right-hand side) spreads versus default rates





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Sources: JP Morgan, Merrill Lynch EMEA CIO. Data as of October 2013.

Key views for 2014

- Global economic improvement will continue, albeit at a gradual pace
- Central bank liquidity will underpin growth improvements, yet private sector fundamentals will likely play a more important role
- Emerging market growth dynamics will remain less favourable than developed market analogues...
- ...but emerging Asia will be a likely bright spot

- Relative valuations and improving cyclical activity favour equities over fixed income...
- ...but quantity and quality of earnings will be more driven by sales than margin expansion in many developed markets
- Within fixed income, favour credit over duration risk, as the beginning of Federal Reserve policy normalisation sees a growth-discounted move higher in core government yields
- Within currencies, expect relative growth and interest rate differentials to play a more important role...but a downward Japanese yen bias will likely persist, albeit at a smaller rate

Source: Merrill Lynch EMEA CIO. Data as of November 2013.

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