Fear Island is Too Crowded

We are maintaining our “get paid to wait” strategy as policy uncertainties remain, but the next cycle is already building.

For many investors, a decidedly shortsighted mentality continues to limit horizons and opportunities and is consigning them to an “island of fear.” While we recognize current concerns and uncertainties, we also see the positive near-term trends and solid longer-term investment outlook, and would position portfolios to take advantage of them.

There are certainly many reasons for current investor fear — the ongoing sovereign saga in Europe, the fiscal cliff worries in the U.S., worldwide political leadership changes, slower growth in emerging markets, geopolitical volatility, pension concerns, and an overindebted public sector, to name just a few.

We don’t need another research report, news headline, or think-tank study to reinforce what we have all experienced in the past five years and must be ready for in the future. The bottom line is that the public sector has a great deal of restructuring to do, the economic and employment growth curves are going to be slower than “normal,” central banks will have to remain easy, access to capital will be more restrictive than we have been used to, and the direction of global policy should remain erratic. Tough decisions will have to be made, and leadership will be needed to work through it all. We know this, and therefore the investment landscape remains fragile.

But these pervasive uncertainties and investor fears are overshadowing profits and solid long-term private-sector trends. In the U.S., with housing starting to recover, gasoline prices down, and mortgage rates at record lows, the stage is set for a possible better growth picture. At the same time,
Europe is making slow but more substantive moves toward addressing its problems, and China has reversed course and started to ease.

Still, widespread pessimism could very well dominate the markets through the rest of the year, and any further slippage in the global growth outlook would put additional pressure on the markets. At that time, we would look to take advantage of better prices in investments that should benefit from the ongoing global rebalancing and related themes.

For now, we remain neutral on equities overall. That said, we still favor solid cash flow investments and select growth ideas in equities; believe that deploying a crossover strategy in fixed income can increase after-tax yield; expect housing-related investments to go through a sustainable uptrend; and expect long-duration real assets such as timber and farmland to attract foreign investment flows.

In the coming months we will look for opportunities to increase our weights in equities, given our positive long-term expectations.

EXTREME PESSIMISM HAS TAKEN OVER (FOR NOW)

The global macro environment continues to be dominated by the dark cloud of policy. This is collateral damage from the financial crisis of 2008 – 2009 in the U.S. and the ongoing sovereign debt crisis in Europe, which is a direct result of decades of debt buildup. Through the balance of the year, we don’t expect the policy cloud to dissipate significantly. In fact, policy issues should continue to balance out positive trends — profits, payrolls, and the lift from “productivity” in the private sector. Extreme pessimism has taken over. This is the opposite of irrational exuberance. Since the beginning of 2007, according to the Investment Company Institute, investors have plowed approximately $1 trillion into bond funds while equity funds have endured outflows of close to $400 billion.

EXTREMES EXPAND LONG-TERM OPPORTUNITIES

Waiting for the “all clear” sign when looking to achieve above-average returns means you’ll be too late and trapped in catch-up mode.

If the current investment environment was generally decent and the economy was muddling along more reasonably, then prices for most asset classes would probably be flat with little volatility. In this type of environment, the opportunity set would be very narrow, and an investor would have to incur greater risks to achieve greater potential gains, or use leverage to expand thin spreads. The more appropriate decision would be to search for cash flow and receive yield while asset prices are static. This can be achieved across most asset classes, including equities, and is a strategy we call “get paid to wait.”

On the other hand, when you experience a massive bull market, asset prices can overshoot to the upside, valuations tend to go to extremes, and a fat-tail (outsized risk) environment builds. The risk to the downside grows, and eventually a catalyst or two (in many cases monetary policy tightening) pressure asset prices lower, and a bear market ensues.

Alternatively, when fear reigns supreme, valuation overshoots to the downside, risk aversion soars and flows shift from risk assets to riskless assets. This makes sense when the cyclical environment turns ugly (recession), the profit cycle declines substantially (for example, 2000 – 2002), inflation rises excessively (the late 1970s), an oil price shock sticks, a debt crisis craters the financial system (late 2007 – 2009) or central banks tighten far too much.

Furthermore, if the investment objective is not necessarily to achieve above-average returns but simply to maintain purchasing power and/or principal, then investing in cash flow investments that compound over time is the only “hammock” on any island. In other words, portfolio construction is dominated by fixed income assets, hard assets with yield, and may include an allocation to dividend-paying companies that are growing their dividends and some nondirectional investments. The macro environment could
dramatically affect the level of rates, thereby making it more difficult to achieve an attractive level of overall absolute yield. For longer-term investors, maintaining purchasing power is achievable since inflation is generally not an issue. However, for those who need to meet specific liability hurdles based on historical returns, the objective becomes much more difficult.

BUT WHERE ARE WE TODAY?
The world is undergoing a massive transition, a powerful demographic shift and full-scale global rebalancing. It can be summarized as a balance sheet exercise between the developed world (led by the U.S.) and the emerging world (led by China). The balance sheets of each country or region (government or public sector) and their consumers and corporations (private sector) are the keys to the strength or weakness of the cycle and its duration. This linkage eventually determines the trends in asset prices and the size of the global opportunity set.

THE U.S.: IN THE EARLY STAGES OF REVITALIZATION
The revitalization stage in the U.S. should be led by manufacturing, advanced technology and robotics across all sectors; new industries and growth pockets in energy; cloud computing, data security, data management, mobile transactions and digital entertainment; the spending patterns of the boomers as they enter their second act; better bank balance sheets; and a housing liftoff.

The revitalization stage, in our view, provides a larger risk-adjusted investment opportunity set, and it is why we favor a higher exposure to the U.S. than the industry benchmark in global equity portfolios. Over the next three years, we should see this revitalization stage unfold in a more transparent manner.

EUROPE: IN THE VERY EARLY STAGES OF REPAIR AND REFORM
Europe is still on the backside of the credit cycle as the sovereign debt crisis continues to unfold. Although recent policy responses have lowered the possibility of a Lehman-like event, and the probability of a short-term financial crisis has declined, a long-term recession is developing as severe austerity programs are creating a negative cash flow backdrop.

A more effective mix of growth and austerity plus further reflationary efforts by the European Central Bank (ECB) and continued movement toward a banking union are needed to advance further into the Repair and Reform stage. Ultimately, we believe that a banking union will develop, the euro will likely weaken further, and the large European exporters should benefit.

At this point, valuation appears attractive but profits are suspect given the poor growth outlook for the rest of this year and next. European equities in aggregate are still a value trap, in our view.

JAPAN: STILL RECYCLING THROUGH DEFLATIONARY FORCES
Japan continues to grapple with the consequences of long-term deflation and a poor demographic picture that leads to a declining trend in consumer spending, a relatively strong currency, and the ongoing flight of some of its leading manufacturers to the U.S. We do not see this dynamic changing anytime soon, and so it will likely continue investing into the areas of the world — such as the emerging Asian countries — that are growing and need its sophisticated automation techniques.

EMERGING MARKETS: GROWTH AREAS, GOING THROUGH A REBIRTH
The emerging markets are often lumped together for simplicity purposes, but this does a disservice to the opportunities in the “pockets of growth” societies versus the “aging” societies in many regions.

Regionally, we continue to favor Latin America and the gateway countries to China (the growth pockets) versus Eastern Europe (the aging societies). Latin America and many countries in Asia are
benefiting from favorable demographics that are leading to increased spending power by their consumers and corporations. We believe the emerging market consumer is one of the more powerful long-term themes and that it will actually work to accelerate the global rebalancing trend.

In the short term, these economies and markets tend to go through mini boom/bust cycles due to their hypercyclical tendencies and still-nascent capital markets. However, over the next three years, the trend should be upward as the developed world moves through the stages of revitalization, reform and repair, and realignment, and as the rebirth of consumerism in some emerging markets takes over.

**THE RELATIVE IMPROVEMENT FACTOR SHOULD EVENTUALLY HELP ASSET PRICES**

The fiscal crisis in the U.S., the sovereign debt crisis in Europe, the volatility of the emerging economies, China’s great transformation from export-only to the advancement of a domestic consumer base, the revolutions in Middle Eastern countries, and Japan’s deflationary struggles are all components and aftereffects of global rebalancing. Given the break from the past and the new catalysts, this is complex and confusing and creates a difficult macro environment that wreaks havoc in the capital markets from time to time. However, it is inevitable — and needed to establish the foundation for future growth, in our view. This is where we are today. It will become more transparent in the next three years as the trends mentioned above unfold. As transparency improves, market participants should applaud the relative improvement by allocating capital to less risk-averse assets. We do not expect an imminent and sharp flow from more conservative assets to equity investments, but we do expect the extreme pessimism to recede as the worst-case scenarios do not materialize.

**PORTFOLIO CONSIDERATIONS**

Worries over the fiscal cliff, concerns over rising Spanish and/or Italian bond yields, and slower-than-expected growth in China could be the reasons behind another bout of weakness in the global equity markets through year end. At that time, we would look to take advantage of lower prices in investments that should benefit from global rebalancing and related themes.

For now, we remain neutral on equities overall and maintain our full-year 2012 S&P 500 target at 1350. We still favor solid cash flow investments and select growth ideas. In the coming months we will look for opportunities to increase our weights in equities, given our positive long-term (three-year) expectations and the potential for U.S. equities to hit new highs during that time frame.

We remain underweight fixed income. Within this space, we would emphasize higher-yielding investment-grade corporate bonds, mortgage-backed securities, municipal debt, high-yield bonds and certain nondollar sovereign bonds, as opposed to Treasuries.

While we are neutral on hedge funds, we continue to recommend allocations to this area as an alternative source of alpha. We would emphasize long/short equity and equity market neutral strategies and remain constructive on managers with a macro focus.

For investors who are eligible to invest in private equity, we recommend a neutral allocation. We prefer managers with a strong track record in the full private equity cycle over multiple market periods. We see opportunities for long-term growth across the overall asset class, but we are currently most optimistic on managers dealing in healthcare, energy and infrastructure.

Regarding tangible assets, we remain neutral. The fundamental forces behind tangible assets remain intact, but in the near term, they are vulnerable to the recession “winds” blowing from Europe.

Housing, on the other hand is ready for liftoff. A liftoff on housing coupled with opportunistic commercial opportunities provides a solid enough backdrop to upgrade our tactical view on real estate to neutral from underweight.
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OTHER IMPORTANT INFORMATION

Past performance is no guarantee of future results.

All sector and asset allocation recommendations must be considered in the context of an individual investor’s goals, time horizon and risk tolerance. Not all recommendations will be suitable for all investors.

Equity securities are subject to stock market fluctuations that occur in response to economic and business developments.

Investing in fixed income securities may involve certain risks, including the credit quality of individual issuers, possible prepayments, market or economic developments and yields and share price fluctuations due to changes in interest rates. When interest rates go up, bond prices typically drop, and vice versa.

Tax-exempt investing offers current tax-exempt income, but it also involves special risks. Single-state municipal bonds pose additional risks due to limited geographical diversification. Interest income from certain tax-exempt bonds may be subject to certain state and local taxes and, if applicable, the alternative minimum tax. Any capital gains distributed are taxable to the investor.

Mortgage-backed securities are subject to credit risk and the risk that the mortgages will be prepaid, so that portfolio management may be faced with replenishing the portfolio in a possibly disadvantageous interest rate environment. Any capital gains distributed are taxable to the investor. A portion of the income may be taxable.

International investing involves special risks, including foreign taxation, currency risks, risks associated with possible differences in financial standards and other risks associated with future political and economic developments.

Global investing poses special risks, including foreign taxation, currency fluctuation, risk associated with possible differences in financial standards and other monetary and political risks.

Investing in emerging markets may involve greater risks than investing in more developed countries. In addition, concentration of investments in a single region may result in greater volatility.

Stocks of small and mid cap companies pose special risks, including possible illiquidity and greater price volatility than stocks of larger, more established companies.

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.

Tangible assets can fluctuate with supply and demand, such as commodities, which are liquid investments unlike most other tangible investments.

Investments in real estate securities can be subject to fluctuations in the value of the underlying properties, the effect of economic conditions on real estate values, changes in interest rates, and risks related to renting properties, such as rental defaults.

An investment in a hedge fund involves a substantially more complicated set of risk factors than traditional investments in stocks or bonds, including the risks of using derivatives, leverage, and short sales which can magnify potential losses or gains. Restrictions exist on the ability to redeem units in a hedge fund. Hedge funds are speculative and involve a high degree of risk.

Treasury bills are less volatile than longer-term fixed-income securities and are guaranteed as to timely payment of principal and interest by the U.S. Government.

Diversification does not ensure a profit or guarantee against loss.

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