INVESTLOGIC
Your Investment Connection

From BoAQML

C(onflict), R(ates), A(sia), S(peculation), H(ousing)

C for Conflict

Military conflict: watch for any escalation of Syria/geopolitical tensions that send Brent oil prices in excess of $125/barrel, the level in 2008, 2011 and 2012 that helped trigger a correction in equities. Historically during oil price spikes, equities have underperformed bonds, which have underperformed cash.

Table 2: Asset returns during oil price spikes

Oil spike episodes			Absolute Performance % (Total Return)			
	% increase Brent Crude	Duration of increase	T-bill	AAA Corp	10yr UST	US equities
Arab Oil Embargo (1973)	237%	12w	1.9%	-0.7%	-1.8%	-2.8%
Iranian Revolution (1978)	59%	22w	4.0%	1.2%	0.6%	9.8%
Iran-Iraq War (1980)	22%	8w	2.3%	-3.9%	-2.9%	12.9%
Iraqi- Kuwait (1990)	154%	14w	1.8%	0.2%	0.2%	-15.5%
Venezuela unrest (2002)	44%	16w	0.4%	6.1%	4.5%	-8.4%
Libya Crisis (2011)	40%	8w	0.0%	1.1%	1.4%	-1.5%
Median	**52%**	**13w**	**1.9%**	**0.7%**	**0.4%**	**-2.1%**

Source: BofA Merrill Lynch Global Investment Strategy, Bloomberg, Global Financial Data

Policy conflict. The dollar dispute between the US and Germany preceded the 1987 crash (Chart below). Today, EM policy makers are under pressure to stem capital outflows and currency loses, but may not receive outside help just yet. In previous meltdowns ('98 & '08), a global coordinated response only occurred after evidence of contagion and a dollar funding shortage for commercial banks induced forced selling of assets.

Chart 4: 1987 Crash – S&P 500, Gold, Treasuries

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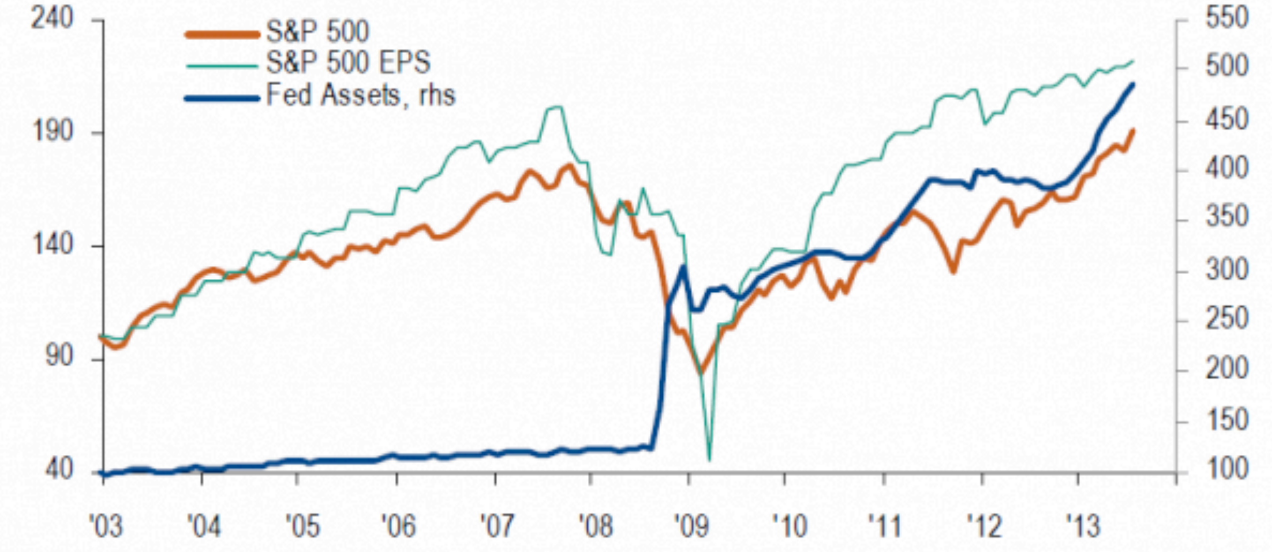
R for Rates

The opiate of investors has been central bank liquidity. The past 6 years have seen 520 rate cuts and an $11.5 trillion increase in global liquidity (asset purchases by the big 5 central banks + increase in FX reserves).

One of the worst things for markets right now would be another sell off in rates, confirming that the period of max liquidity is past, thus removing one of the two biggest drivers of the bull market (profits being the other one – Margin Chart). We would be worried should rising rates coincide with weaker bank stocks.

Chart 5: Fed Assets vs. S&P 500 & EPS



Source: BofA Merrill Lynch Global Investment Strategy, Bloomberg

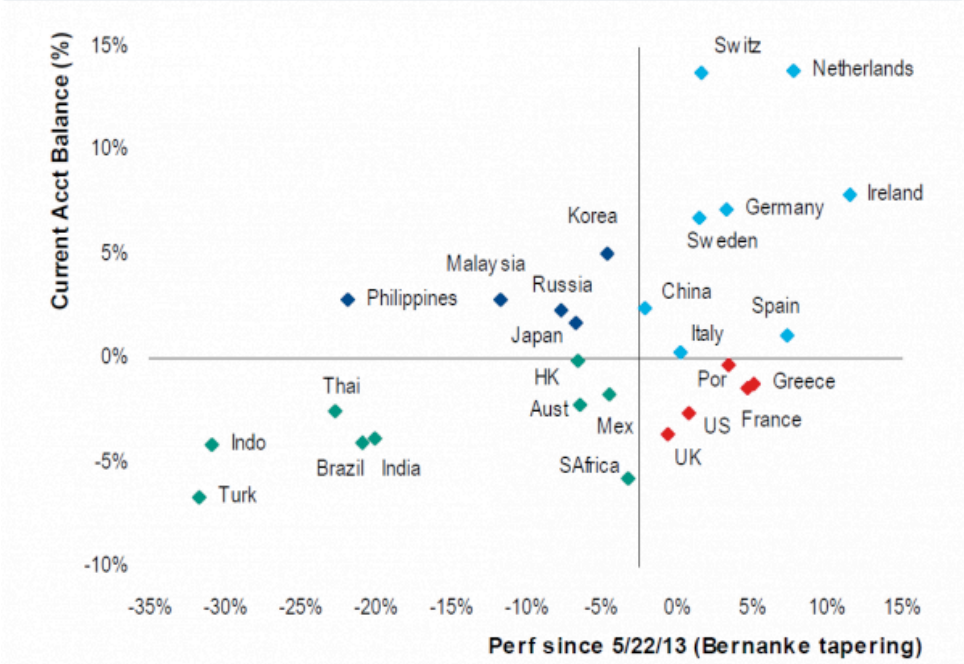
Another risk that could see volatility move higher is a potential bungling of Fed “tapering”, i.e. a "token taper" that would smack of way too much "fine-tuning". In addition, a new Fed Chairman is expected to be announced in September.

A for Asia

As in the Asia crisis of the 1990s, current account deficits are proving the Achilles Heel for Asia & Emerging Markets. The improvement in Peripheral European external balances was the catalyst for strong Mediterranean asset price performance in the past 12 months. That’s now the model for EM to follow after this collapse in FX, stocks and bonds across the Southern Hemisphere (Chart below).

India’s current account crisis continues to grow as rupee weakness accelerates. Higher oil/commodity prices, domestic fiscal concerns, and the absence of direct policy action are all to blame. Claudio Piron offers three policy risk scenarios, but mentions the status quo is for the INR to continue to depreciate to 70 by the year-end.

Chart 6: Current Account Balance versus Performance since Tapering talk began



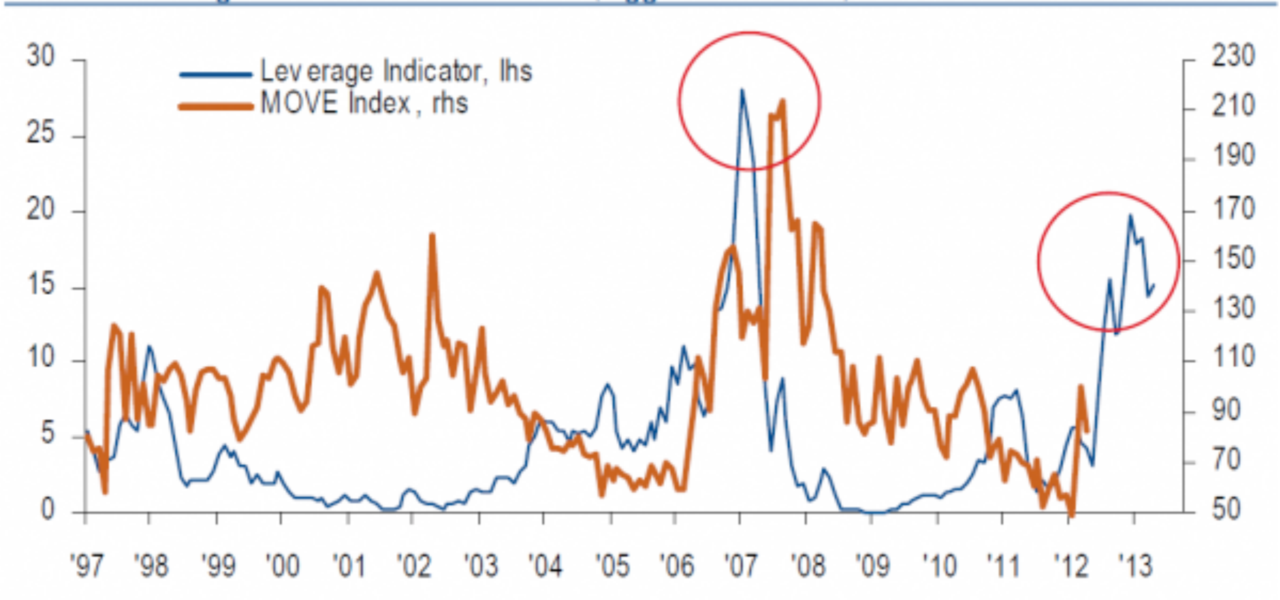
Source: BofA Merrill Lynch Global Investment Strategy, Haver, Bloomberg

Asia/EM contagion into the Chinese economy, which has recently shown signs of stabilization, would clearly be a worry. While it is not yet a liquidity crisis that warrants global policy coordination, watch anything that causes another lurch lower in Chinese growth expectations.

S for Speculation

Indicators of leverage such as non-coupon notes, Covenant-Lite Loans,LBO/Dividend Recaps and 2nd Lien Loans have picked up sharply in recent quarters. This speculative activity was also elevated ahead of the 2008 GFC and leads fixed income volatility by 9-12 months (Chart below).

Chart 7: Leverage Indicator* versus MOVE (lagged 12 months)



Source: BofA Merrill Lynch Global Investment Strategy, LCD, Bloomberg

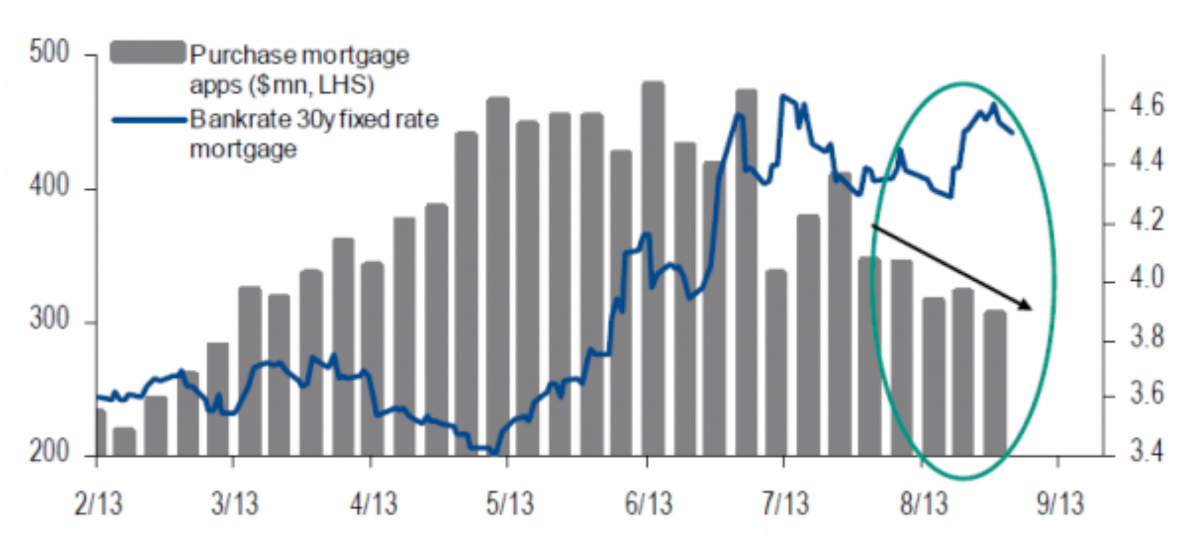
*simple average of Non-Coupon Notes, Covenant-Lite Loans, LBO/Dividend Recaps, and 2nd Lien Loans as a percentage of total

Peaks in NYSE margin debt preceded peaks in the S&P 500 in 2007 and 2000. Margin debt reached a record high of $384.4m in April, but the S&P 500 continued to rally into July and August. Stephen Suttmeier, our Technical Strategist, notes that this is a similar setup to previous peaks.

H for Housing

The rapid rise in rates has arrested the recent improvement in the housing market. Purchase mortgage applications have been falling for several weeks now as rates have been rising. Investors have been worried about tapering and liquidity, do they now have to worry about the economy? Weak July core capital goods orders puts our 3Q GDP tracking estimate at 1.7%, below the our official 2.0% forecast.

Chart 8: Mortgage rates & purchase applications



Source: BAC internal data, Bloomberg

To be really confident that we are shifting toward sustained higher growth we need to see a combination of higher rates and higher growth. In the last couple of weeks we have seen the opposite from the housing market.