21 February 2013

US Economics

Bank of America Merrill Lynch

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Public to private

Refer to important disclosures on page 29-34.

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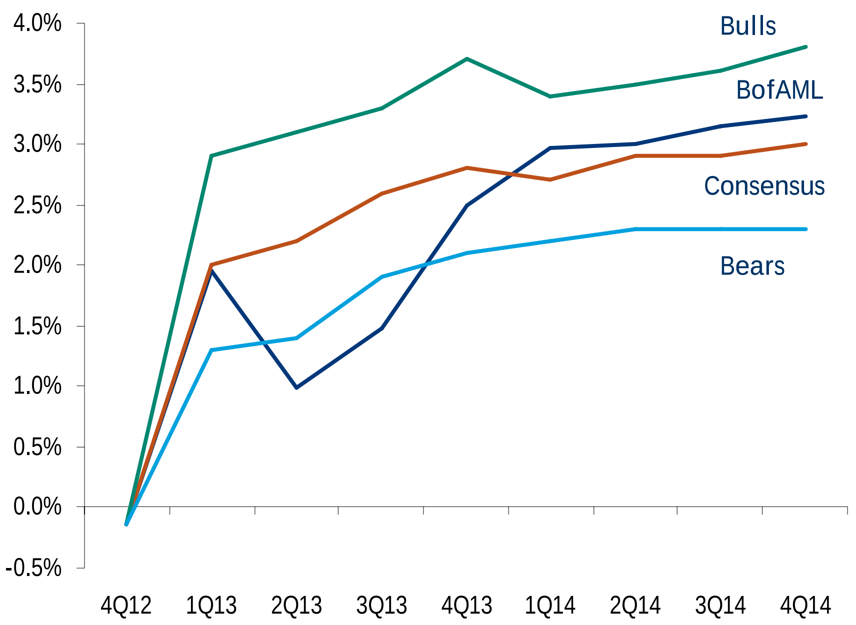
Slow growth now, recovery later

- Hand-off from the public to private sector begins this year, which will weigh on the recovery.
- Bad: government imbalances, underutilization in labor market, deleveraging.
- Good: housing recovery, shale revolution, state and local finances.
- Fed will continue with QE through this year and most of 2014. First hike in late-2015.

Summary of economic forecasts

	2011	2012	2013	2014
Real GDP (SAAR)				
BofAML	1.8	2.2	1.4	2.6
Consensus	1.8	2.2	1.9	2.8
Unemployment rate (4Q Avg)				
BofAML	8.9	8.1	7.8	7.3
Consensus	8.9	8.1	7.7	7.2
Core PCE inflation (%yoy)				
BofAML	1.4	1.7	1.4	1.8
Consensus	1.4	1.7	1.5	1.8
Fed Funds Rate (eop)				
BofAML	0-0.25	0-0.25	0-0.25	0-0.25
Consensus	0.25	0.25	0.25	0.25

Bulls, bears, BofAML and consensus
(Real GDP forecasts, qoq % annualized)



Source: BLS, BofA Merrill Lynch Global Research, Bloomberg, Blue Chip (Jan survey), BEA

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Cliff "compromise"

- *$200 bn in tax increases*
- *$85 bn in spending cuts*
- *Sequester to bring another $50-85bn in cuts this year*
- *Debt ceiling debate this summer*

Austerity has arrived

		$bn, 2013 CY
Current Fiscal Cliff Bill		
	Taxes	
	Payroll tax hike	120
	Bush tax cuts removed	60
	Obamacare taxes	20
	Under the radar	
	Budget caps (first debt ceiling deal)	40
	Expiring spending from ARRA	40
	Spending offsets	5
	Roth IRA conversion (over 10 years)	
	Discretionary caps for 2013 and 2014	
	Doc fix replacement	
Current cuts		285
Potential cuts to come		
	March 1 sequester	50-85
GRAND TOTAL		335-370
	(% of GDP)	2.1-2.3

*Includes marginal tax rates, capital gains/dividends, PEP/PEASE reinstatement, estate tax.
**Includes Roth IRA conversion (over 10 years), discretionary caps for 2013 and 2014, and Medicare doc fix replacement.
Source: JCT, CBO, H.R. 8, BofA Merrill Lynch Global Research

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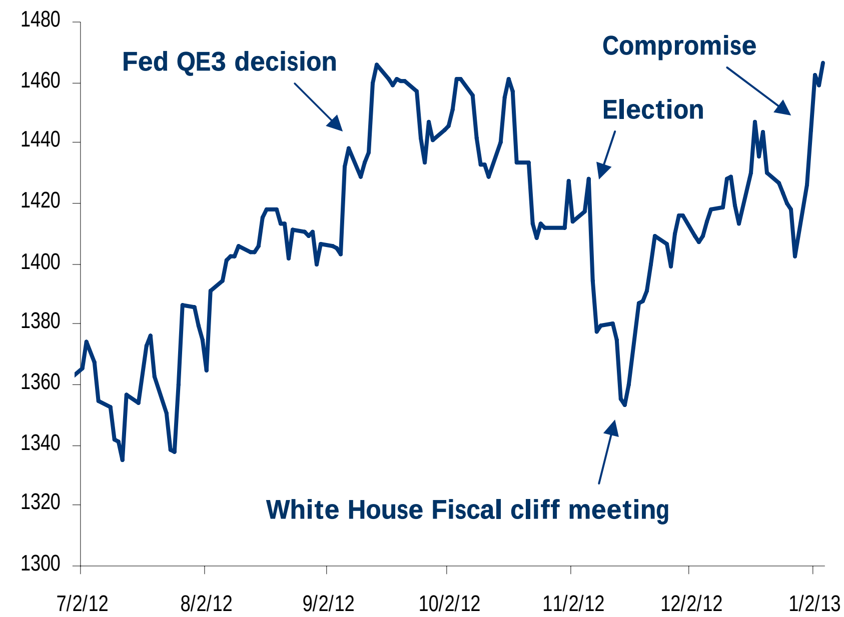
Resilient markets

- *Markets flat since Fed*
- *Cliff fears hit after election*
- *Compromise triggers recovery*
- *Higher pain threshold*

Stock swings
(S&P 500, index level)



Source: Wall Street Journal, BofA Merrill Lynch Global Research

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Consumer crunch

The payroll tax hits immediately.

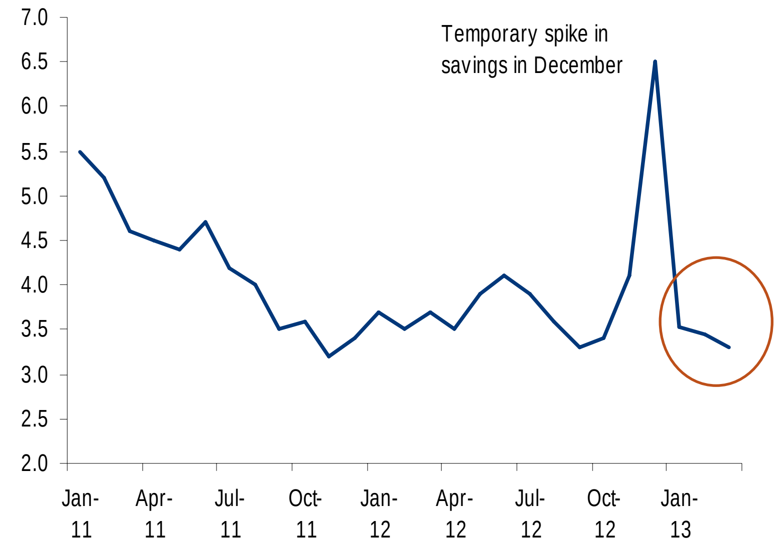
- Some smoothing with saving reduction
- but spending declines

Upper income taxes more complex

- Could cut in advance
- Could wait to withhold

Dismal arithmetic

- *Income and savings were boosted by accelerated dividend and bonus payments in December*
- *Should reverse in Q1*
- *In addition, taxes will spike in Q1*
  - → *Q1 real disposable income declines 4.4%*
  - → *Saving rate reverts back to 3.0%*



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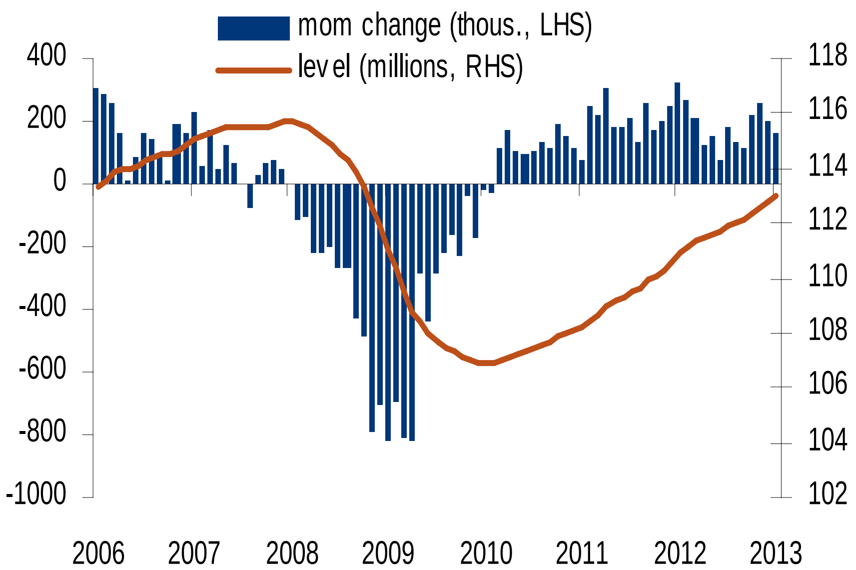
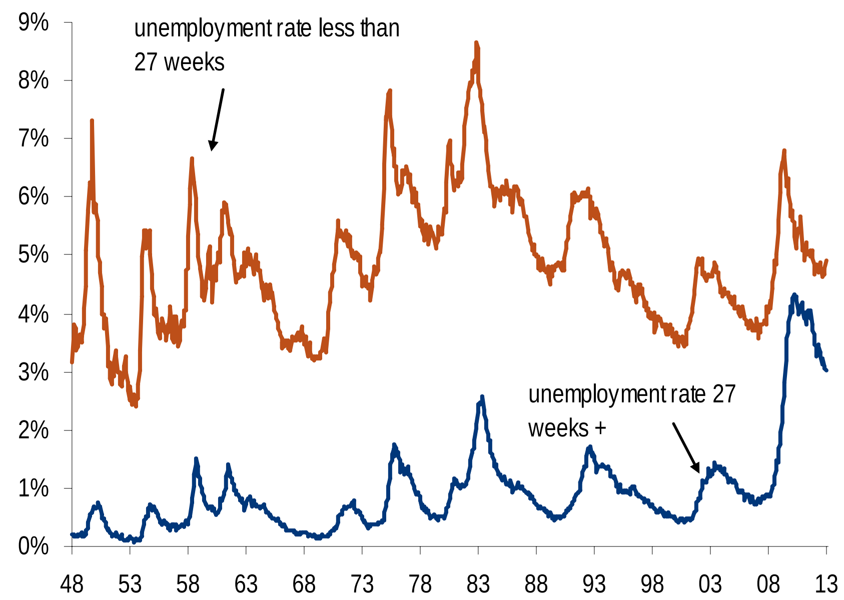
Labor market healing...

- Payroll growth averaging 177,000 a month for the past six months.
- Revisions: additional 600,000 jobs added from January 2011 through December 2012.
- Still considerable underutilization in the labor market with high long-term unemployment.

Job growth has accelerated, but remains below pre-crisis peak



High long-term unemployment
(%)



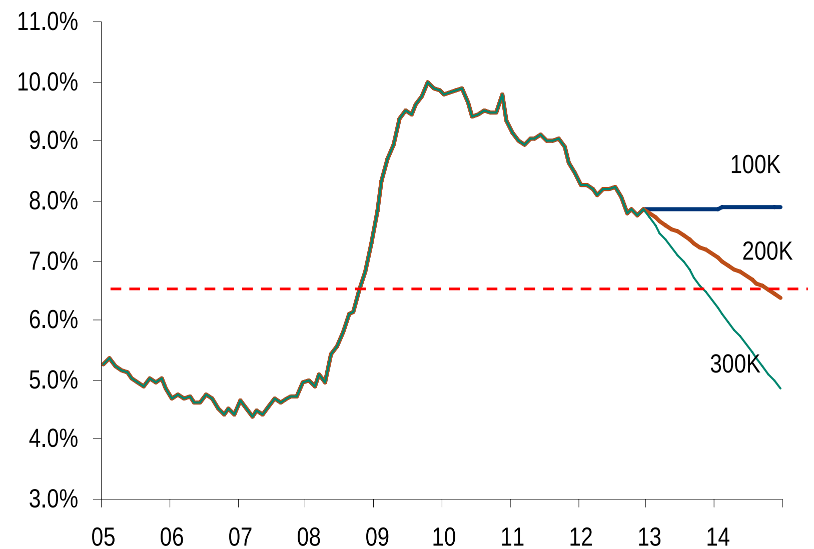
Source: BLS, BofA Merrill Lynch Global Research

...but still not strong enough

- A sharp drop in participation has helped to bring down the unemployment rate. As job growth accelerates, we expect some pickup in participation.
- Based on our forecast, the unemployment rate will not reach 6.5% until late-2015.

Part of the drop in labor force is structural, but a portion is cyclical
(%)

Simulations for unemployment rate based on NFP growth
(%, assumes unchanged LFPR)

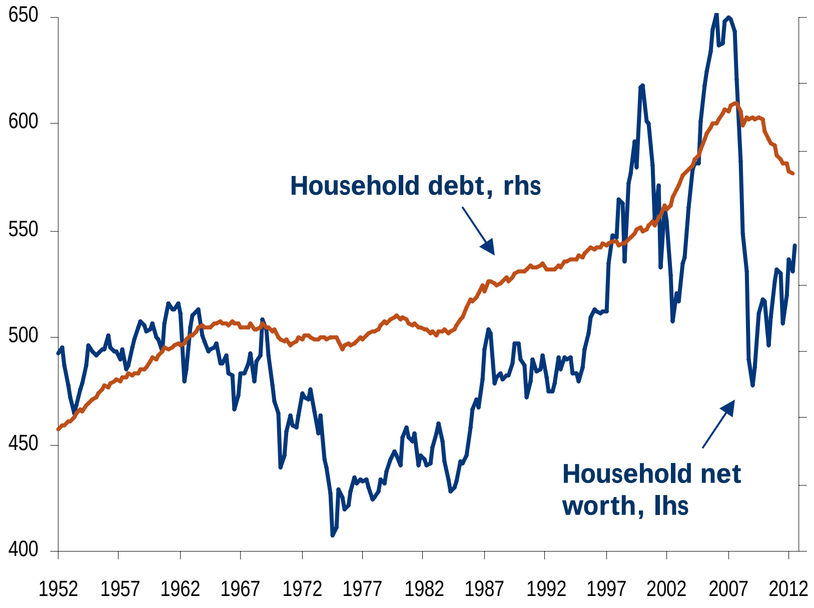


Source: BLS, BofA Merrill Lynch Global Research

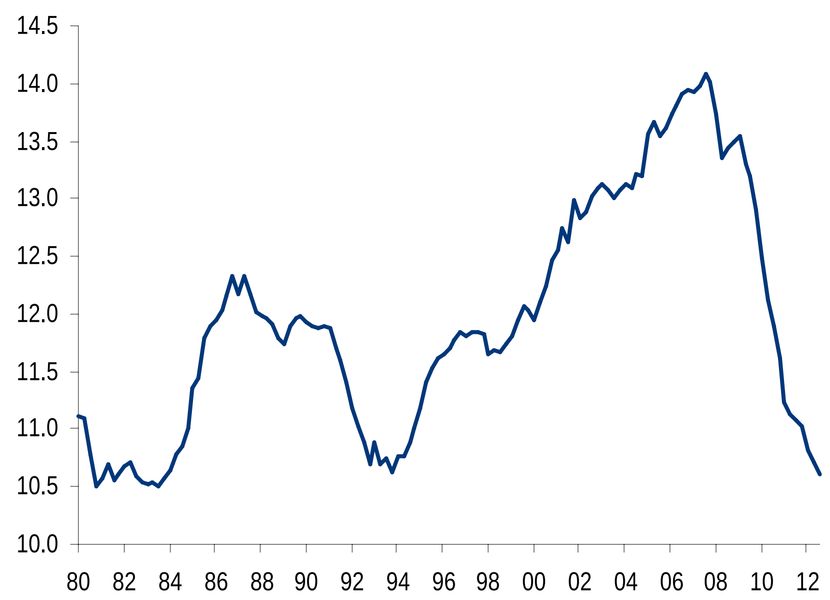
Households in rehab

- Slow deleveraging process and repair of household balance sheets.
- Financial wealth has recovered significantly and housing wealth slowly gaining.
- Debt service is helped by low rates, easing the adjustment.

Household balance sheets are impaired
(net worth and debt, % disposable income)



Debt service ratio has declined
(net worth and debt, % disposable income)

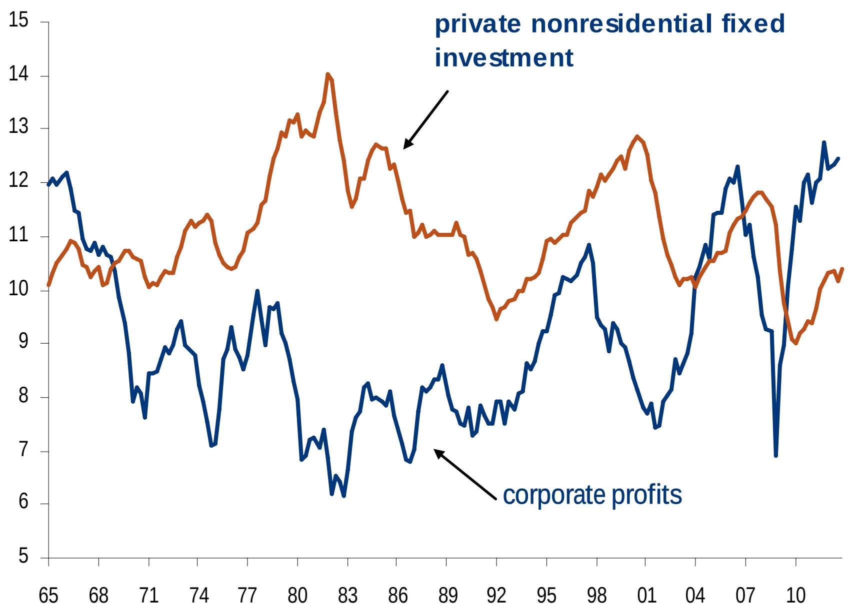


Source: BofA Merrill Lynch Global Research, Federal Reserve

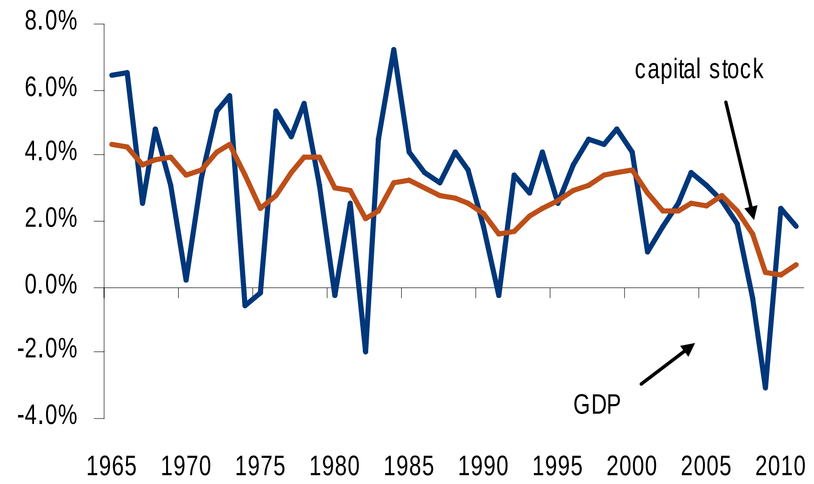
Corporations in good shape

- Corporations are primed for expansion as they have been extremely conservative heading into the cliff.
- But much depends on uncertainty and hence policy from Washington.

Investment remains weak despite strong corporate profits
(% of GDP)



Slow growth in capital stock relative to GDP
(%YoY)



Source: Bureau of Economic Analysis, Haver Analytics, BofA Merrill Lynch Global Research

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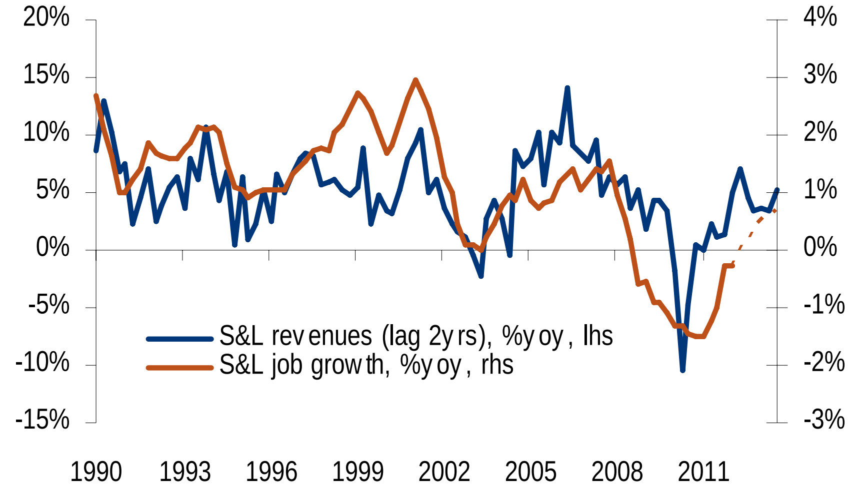
Boost from Sandy rebuilding and S&L

- Rebuilding after Hurricane Sandy
- State and local finances have improved

Sandy rebuilding will support growth

- Government: deficit-financed stimulus of about $60bn, but funds are distributed gradually
  - FY 2013: $8.9bn
  - FY 2014: $15.3bn
- Insurance companies (transfer from corporate balance sheets to consumers): $25bn
- Consumers: mostly a change in timing of composition of spend, rather than additional expenditure

State and local revenues have improved, which should support spending with a lag

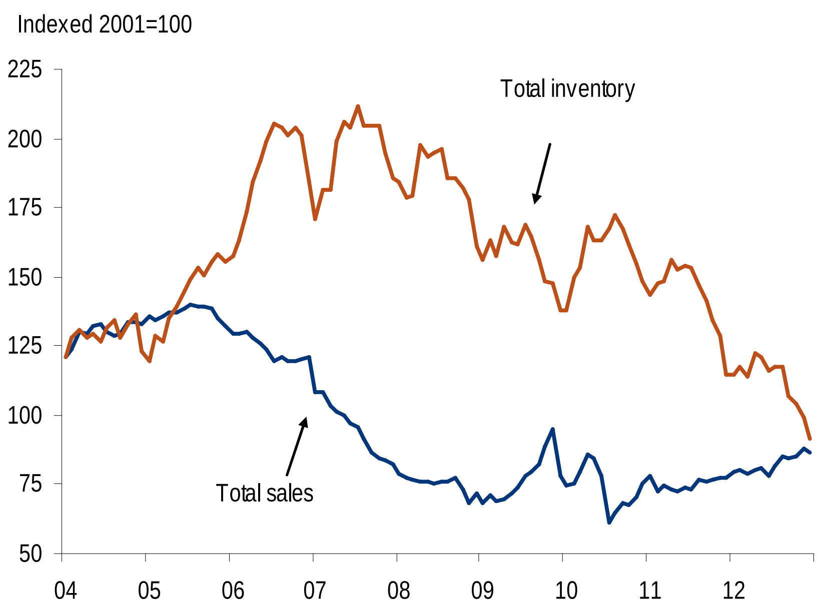


Source: BofA Merrill Lynch Global Research, Bloomberg News

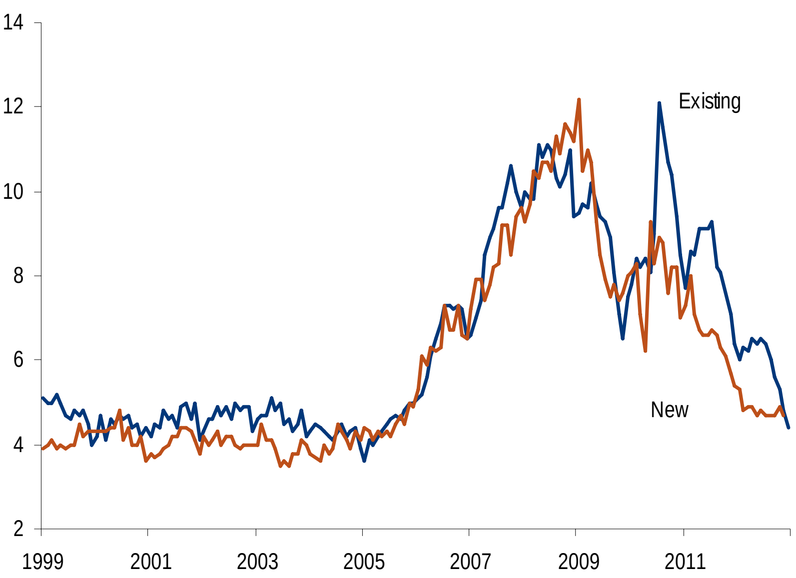
Housing: Low inventory

- The housing market has made significant progress toward reaching equilibrium.
- Inventory has declined, owing to the slower foreclosure process, low pace of new construction
- Months supply has returned to normal levels.

Housing supply and demand back in line



Months supply has plunged lower (# of months)

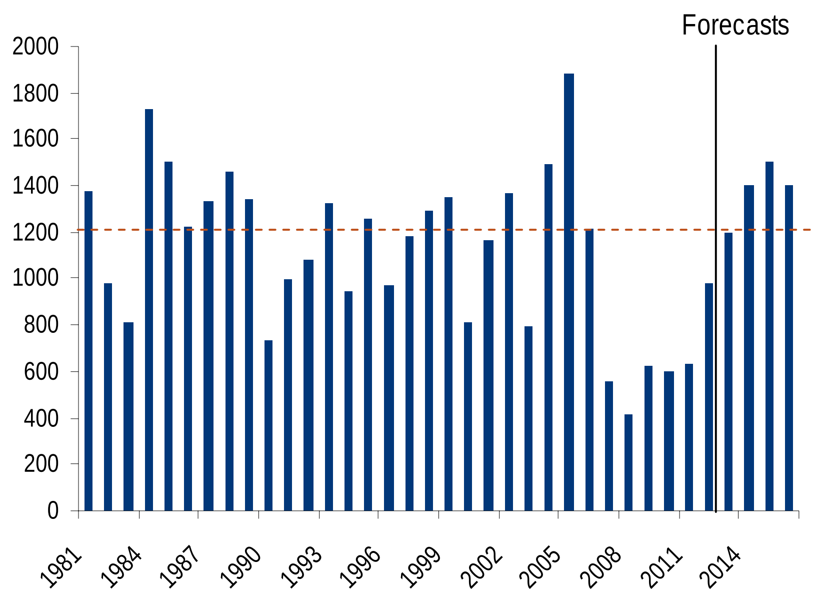


Source: BofA Merrill Lynch Global Research, NAR, Census Bureau

A need for building

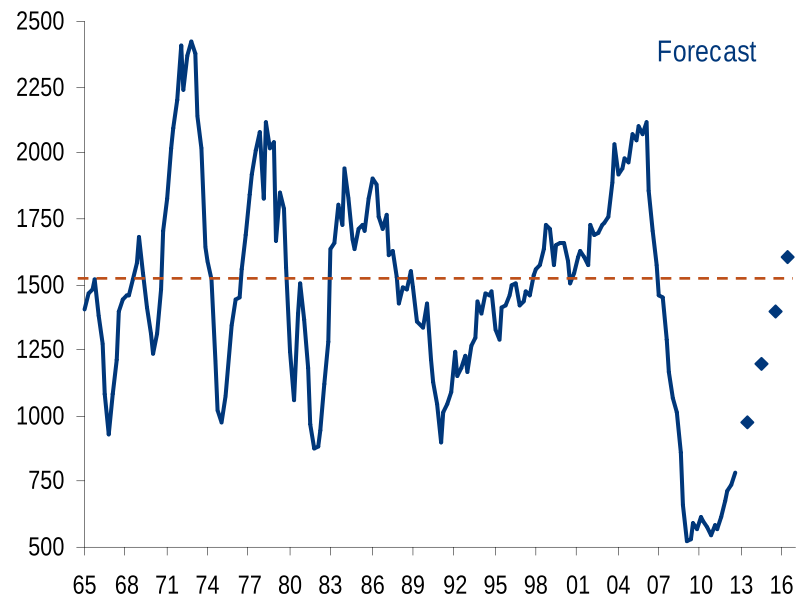
- Pent-up household formation will be realized over the next few years. We estimate a shortfall of about 2.5 million households from the past five years.
- We expect housing starts of 975,000 this year, up from 780,000 in 2012.

Pent-up household formation
(thousands of households)



Source: Census Bureau, BofA Merrill Lynch Global Research

Housing starts bouncing
(thousands of homes, saar)

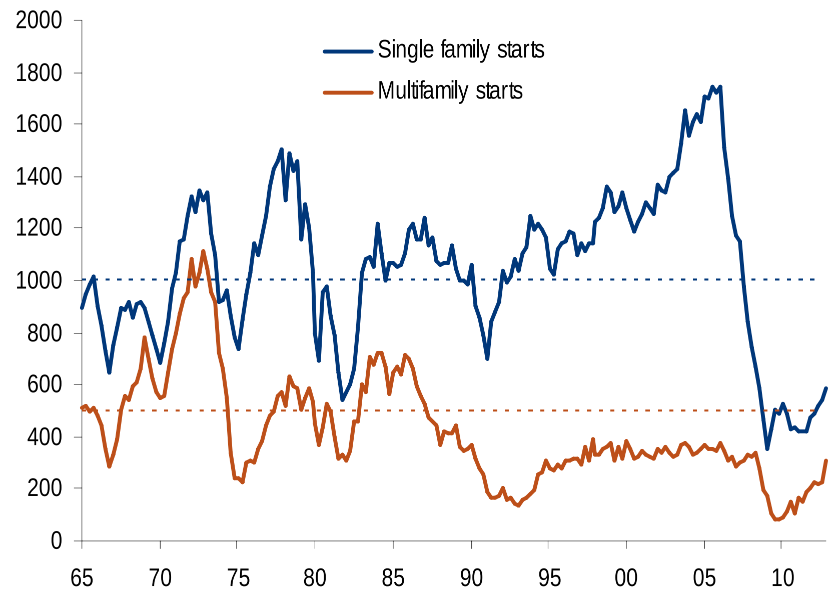


Source: Census Bureau, BofA Merrill Lynch Global Research

Construction transformation

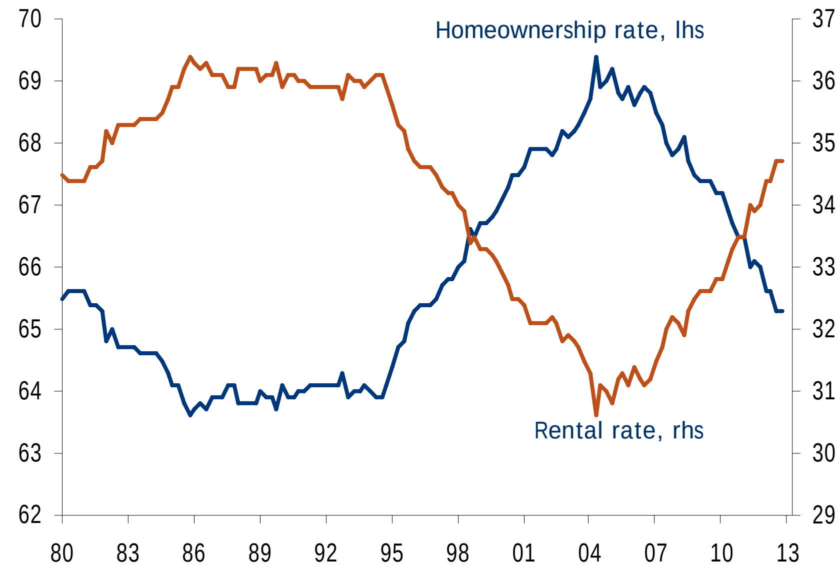
- The gain in housing construction was initially driven by multi-family building. We are now starting to see a turn in single family. We expect both to continue to increase.
- We expect the homeownership rate to stabilize around 63%, but could temporarily undershoot.

Gain initiated by multi-family, but single-family has started to turn
(thousands of homes, saar)



Source: Census Bureau, BofA Merrill Lynch Global Research

Shift from owning to renting
(% occupied housing stock)

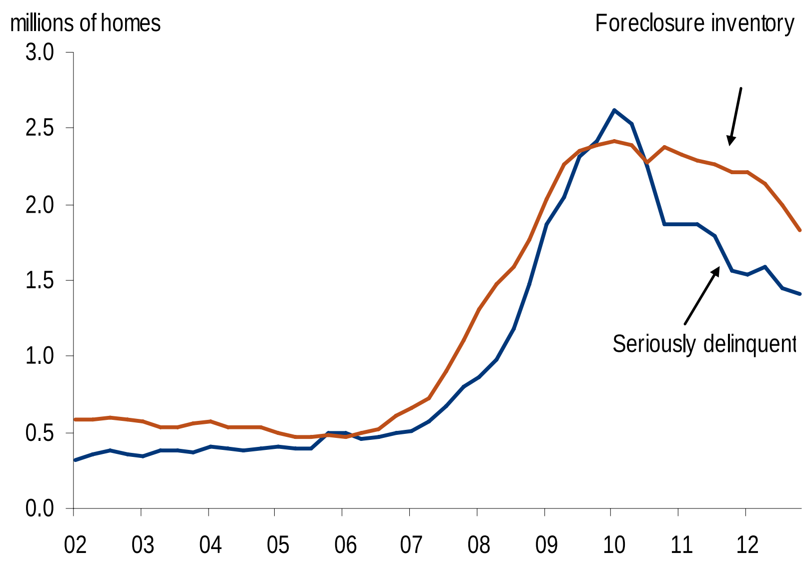


Source: Census Bureau, BofA Merrill Lynch Global Research

Stuck foreclosure pipeline

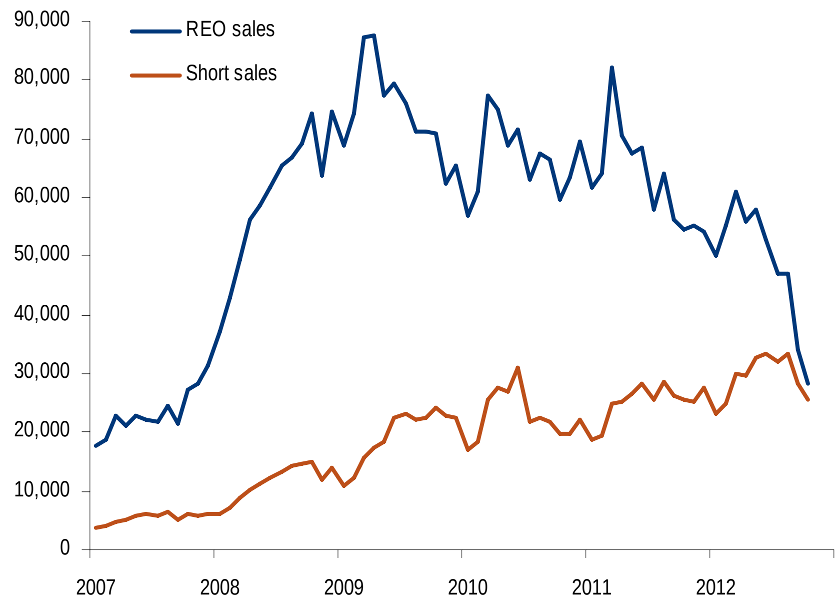
- Pipeline of foreclosures remains elevated, but will be cleared only slowly.
- REO sales fell sharply in the second half of 2012. This reflects delays in the process and a shift toward short sales.

The pipeline of seriously delinquent mortgages remains elevated
(# of mortgages)



Source: BofA Merrill Lynch Global Research, MBA

REO sales have declined, but short sales have increased
(# of mortgages**)**

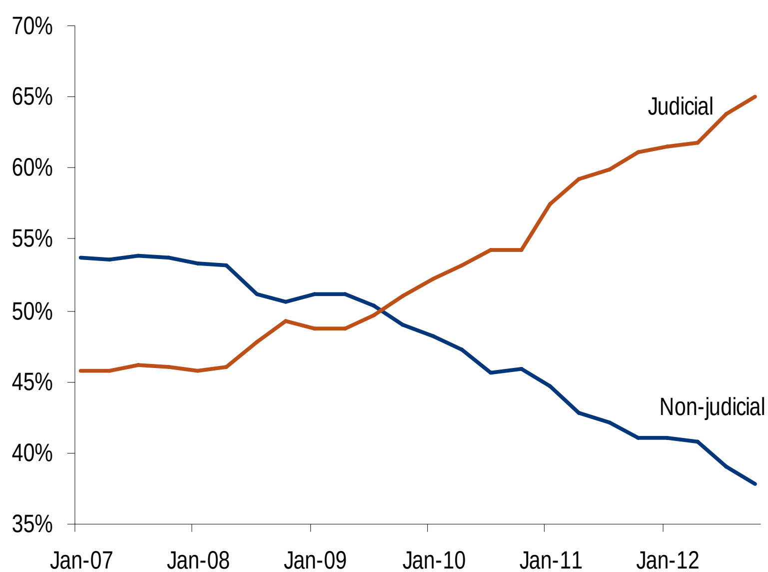


Source: CoreLogic, BofA Merrill Lynch Global Research

Judicial vs. non-judicial

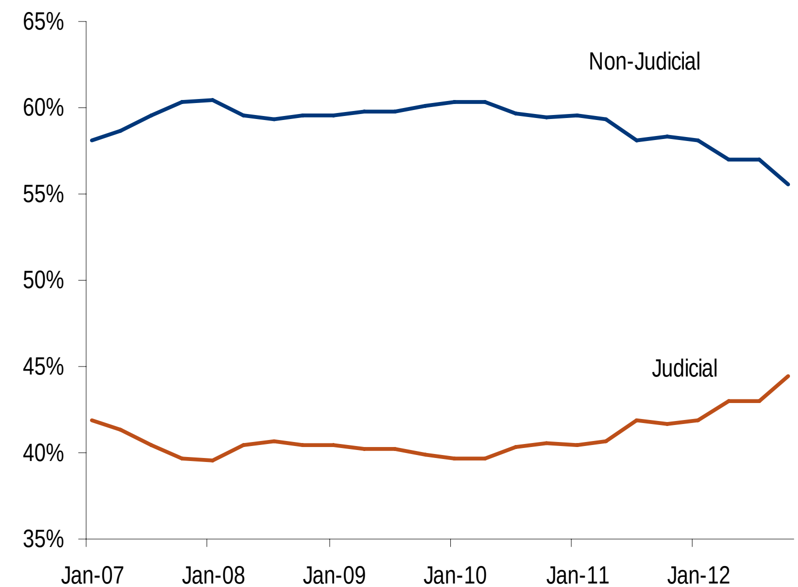
- Foreclosures are concentrated in those states with a judicial process, which has been a reason for the delays in clearing distressed properties.
- The delay appears to be during foreclosure rather than at the early stages of the delinquency process.

Foreclosure inventory is concentrated in states with a judicial process



Source: MBA, BofA Merrill Lynch Global Research

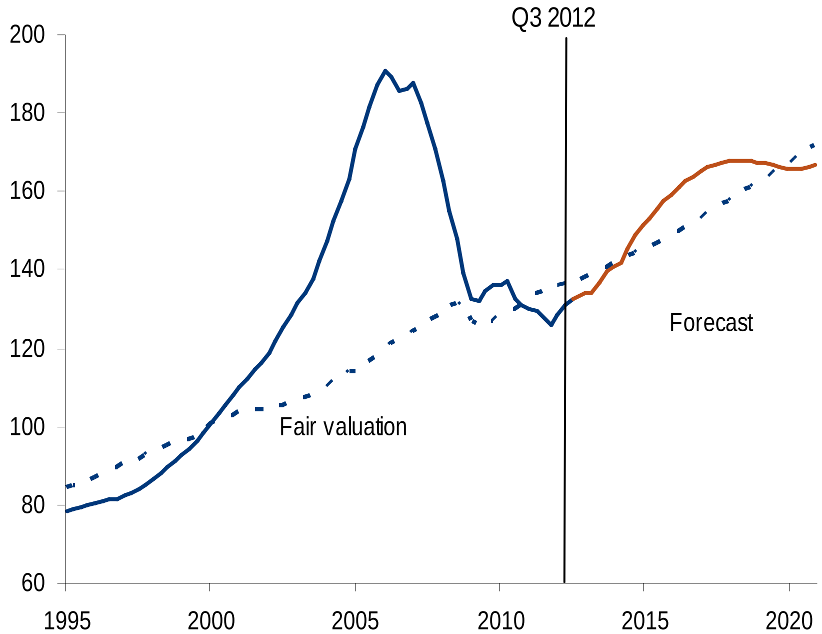
There is no such bias in the pipeline of 90+ days delinquent loans



Source: BofA Merrill Lynch Global Research, MNA

Home prices on the rise

Case-Shiller Home price forecast (indexed level)



Home price forecasts and history
(S&P Case Shiller national composite, q4/q4 %)

	Forecast
2005	14.6
2006	-0.3
2007	-8.4
2008	-18.3
2009	-2.4
2010	-3.7
2011	-3.7
2012E	6.4
2013E	4.7
2014E	7.7
2015E	5.2
2016E	3.7
2017E	1.6
2018E	-0.1
2019E	-1.0
2020E	0.6

Source: BofA Merrill Lynch Global Research, Case Shiller

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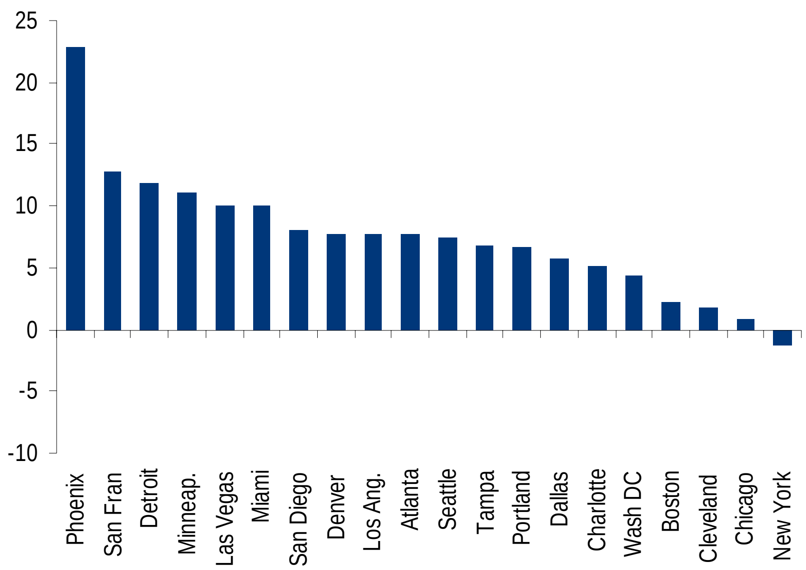
Location, location, location

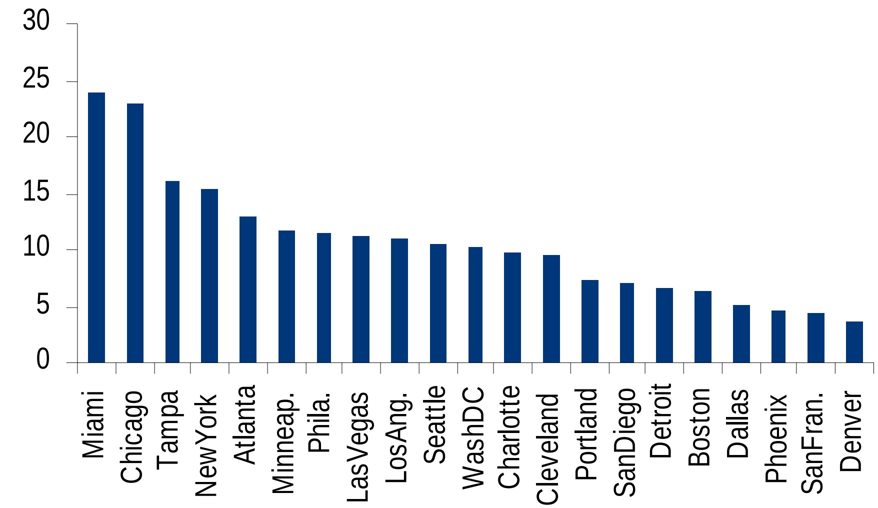
- The markets that have cleared foreclosures are seeing price appreciation. Phoenix and Detroit, for example.
- Those that are slow to clear foreclosures will continue to face price depreciation.
- The Florida metro areas are exceptions as the non-distressed market has strengthened and much of the distressed inventory is held in the pipeline.

Home prices by major metro area (%yoy)



Source: S&P Case Shiller, through November 2012.

Months to clear delinquent supply at current sales pace



Source: CoreLogic, BofA Meril Lynch Global Research; data through 3Q12

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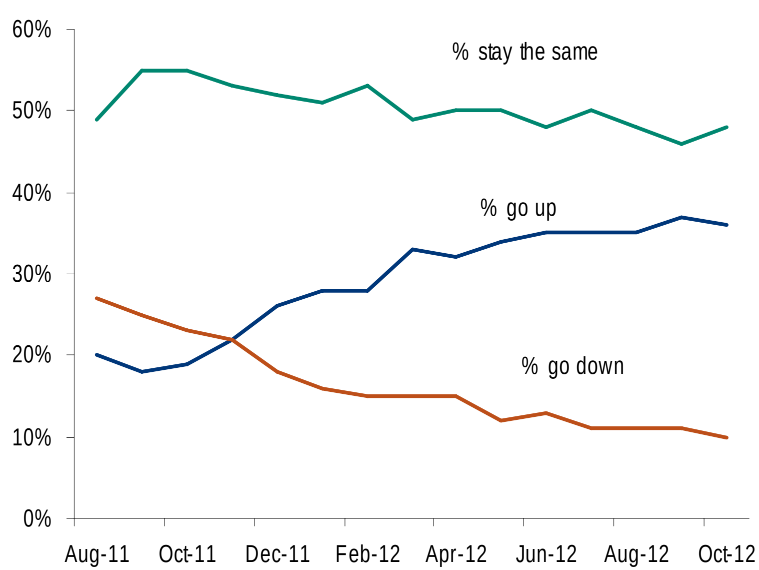
Is it sustainable?

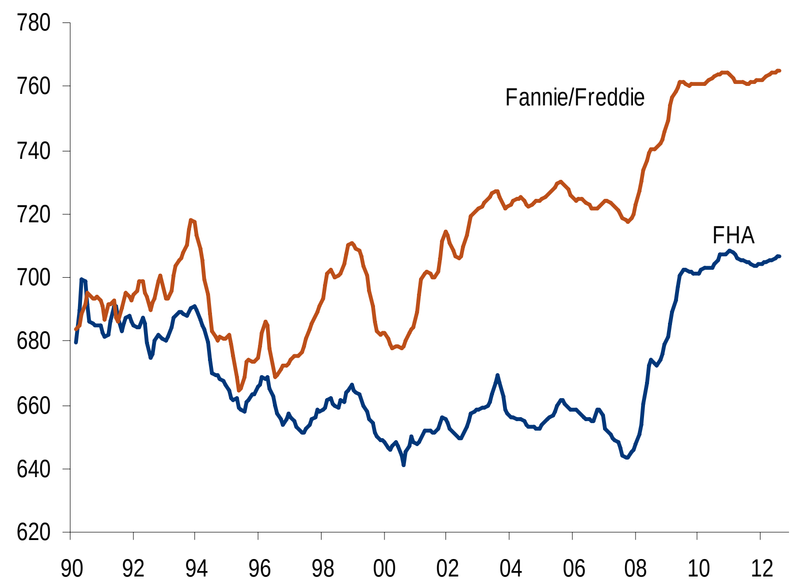
- The key to a sustainable housing recovery is for confidence to return.
- Missing ingredient: credit creation.
- We expect a modest easing of mortgage credit this year.

Perceptions of home prices over the medium term
(% of households)



Source: Fannie Mae monthly housing survey, BofA Merrill Lynch Global Research

Elevated credit scores for new mortgages
(average FICO score for purchase loans, 3m avg)



Source: CoreLogic, BofA Merrill Lynch Global Research

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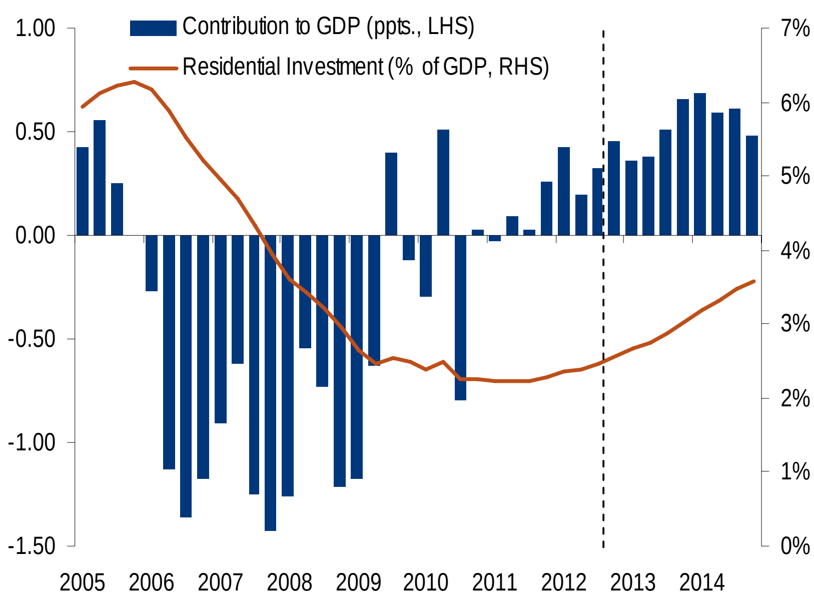
Spillover to economy: construction

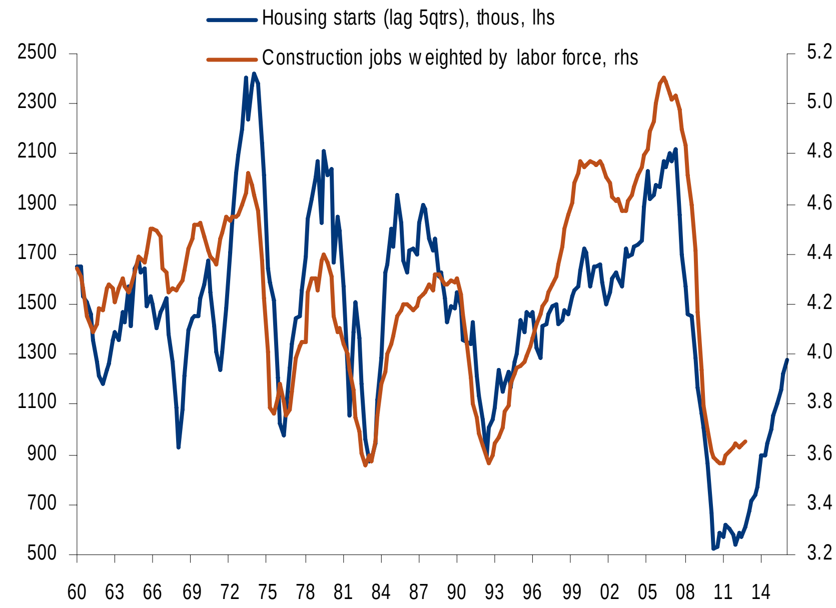
- We expect residential investment to add 0.4pp to growth this year.
- Adding to the gain will be multipliers to housing-related industries.
- Construction hiring should recover. We forecast 200,000 – 250,000 jobs this year.

Residential investment to add to GDP growth



Source: BofA Merrill Lynch Global Research, Commerce Dept

Construction jobs to turn higher
(construction payrolls vs. starts (with forecasts through 2014)

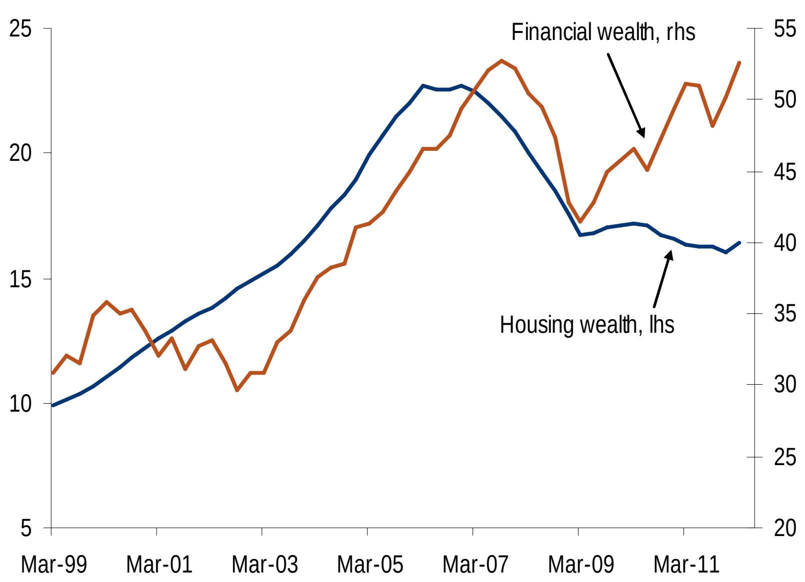


Source: BofA Merrill Lynch Global Research, BLS

Spillover to economy: wealth

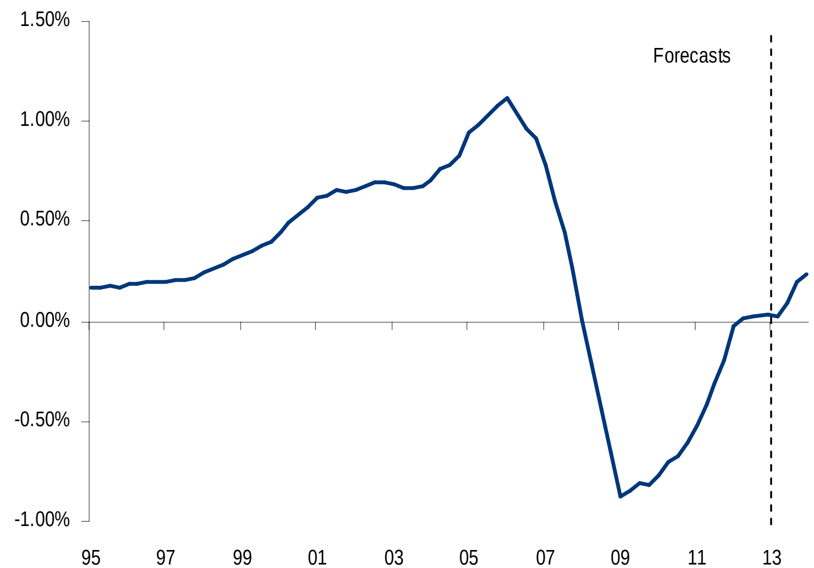
- We estimate spending increases by 4 cents for every dollar gained of housing wealth over three years.
- The impaired credit markets will reduce the strength of the wealth effect.

Loss of wealth from housing and stocks
(Housing and financial wealth, $trillions)



Source: Federal Reserve Flow of Funds, BofA Merrill Lynch Global Research

Housing wealth effect to turn positive
(contrib. to real consumption from housing wealth effect, %q/q saar)



Source: Federal Reserve Flow of Funds, BofA Merrill Lynch Global Research

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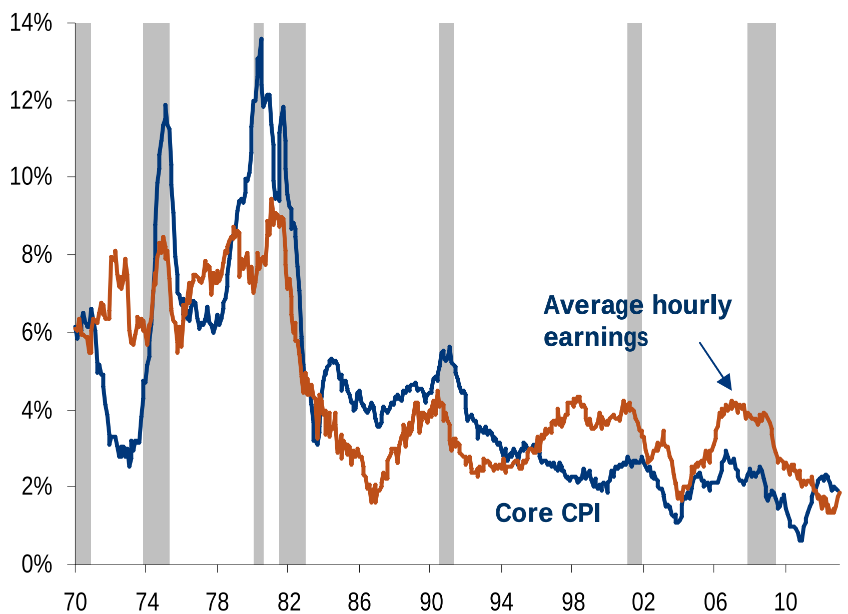
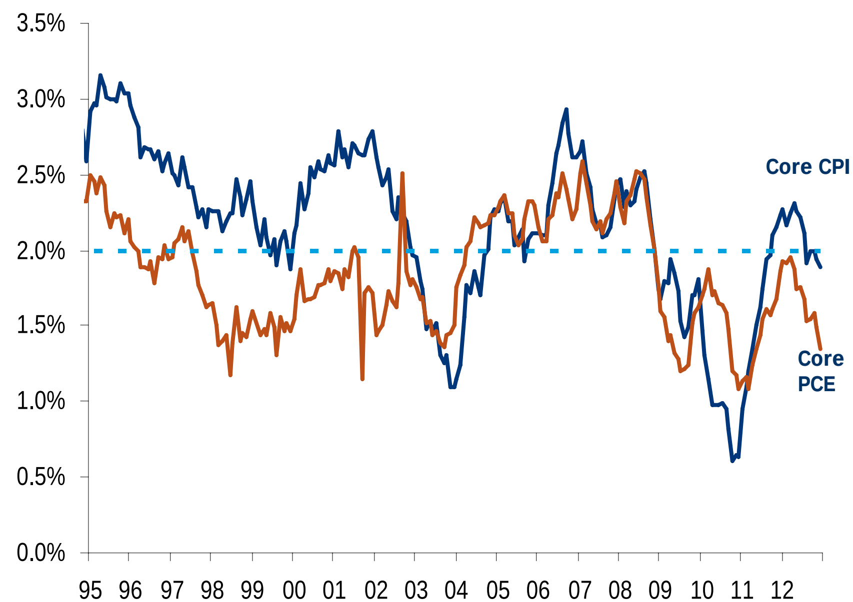
Inflation: contained

- Purchasing power pushback given household budget constraints.
- Core inflation to remain close to target of 2.0%.
- Inflation expectations to remain contained.

The wage-price squeeze
(%y/y)

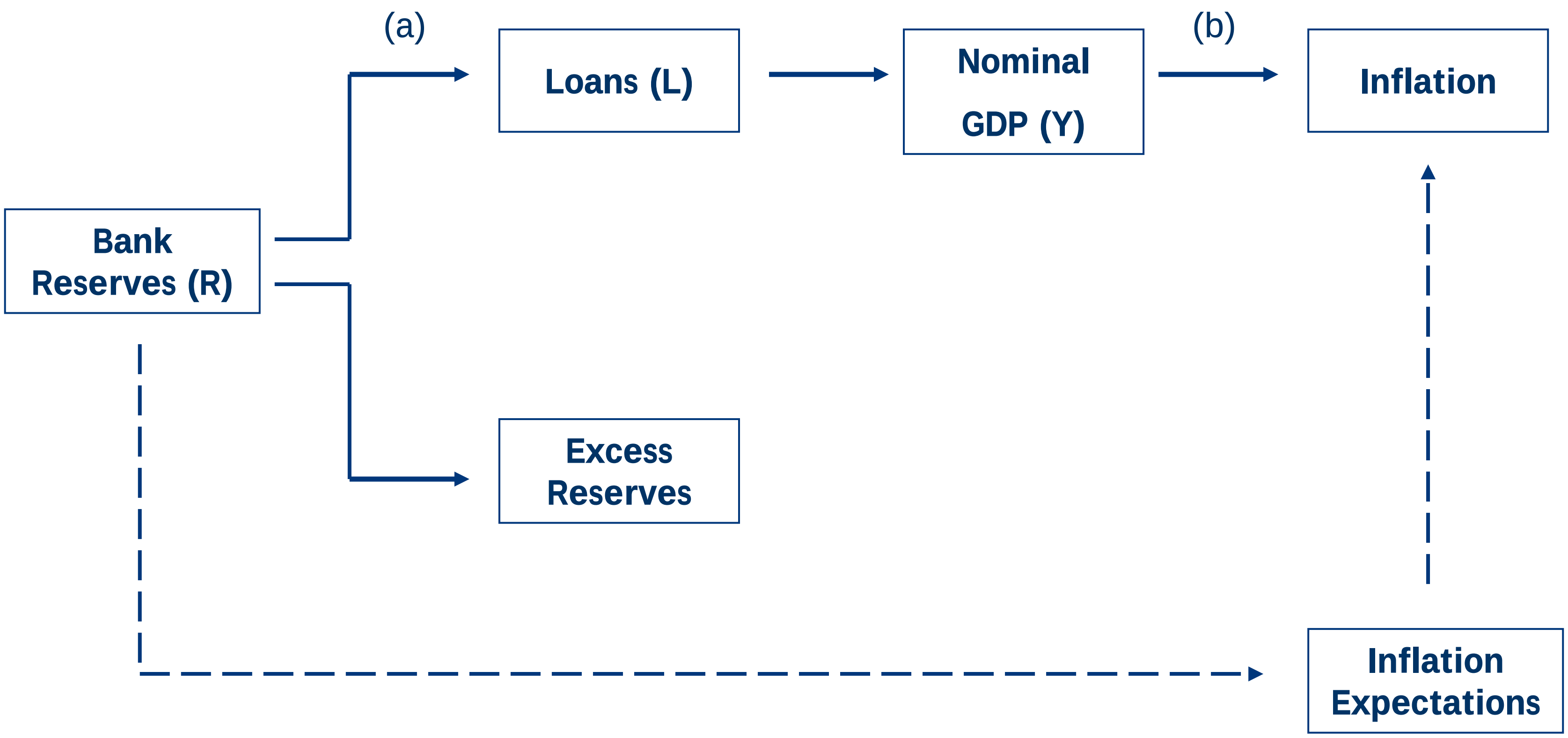


Core inflation: at target, starting to decelerate
(%y/y)



Source: BofA Merrill Lynch Global Research, Census Bureau, BLS

Inflation: No ReLaY



(a) money multiplier **(b) quantity equation**

Source: BofA Merrill Lynch Global Research

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Inflation: Reserved spending

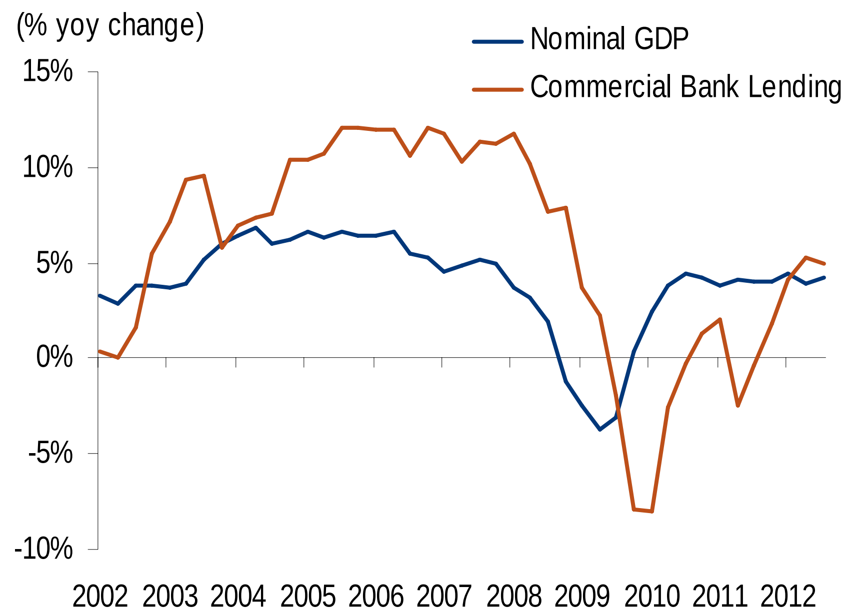
Monetary transmission:

- *Booming reserves (R)*
- *…but weak lending (L)*
- *…and weak nominal GDP(Y)*

…but the exit will be tricky

- *Must offset pick-up in bank lending*
- *…with higher market interest rates*

Slow lending and GDP growth



Source: Federal Reserve Board, Bureau of Economic Analysis, BofA Merrill Lynch Global Research

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Fed: QE3+4

Highly accommodative policy…

- *Continues until "the outlook for the labor market… improve(s) substantially"…*
- *…and "for a considerable time after the economic recovery strengthens"*
- *Translation: easy policy until full employment is in sight*

Total buying:

- *$40 bn in mortgages and $45 bn in tresuries*
- *($40bn + $45bn) x 12 months = $1,020 bn / year*

Source: BofA Merrill Lynch Global Research

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Fed: Labor link

Zero remains “appropriate”:

- *“at least as long as the unemployment rate is above 6 ½ percent*
- *“inflation between one and two years ahead is projected to be no more than a half point above” 2%*
- *“and longer-term inflation expectations continue to be well anchored.”*

We expect:

- *Continued $85 bn per month in buying until unemployment hits 7%*
- *Exit only triggered if is a “good” drop in the unemployment rate*
- *Exit only if <u>sustained</u> 200,000-plus job gains*

Source: BofA Merrill Lynch Global Research

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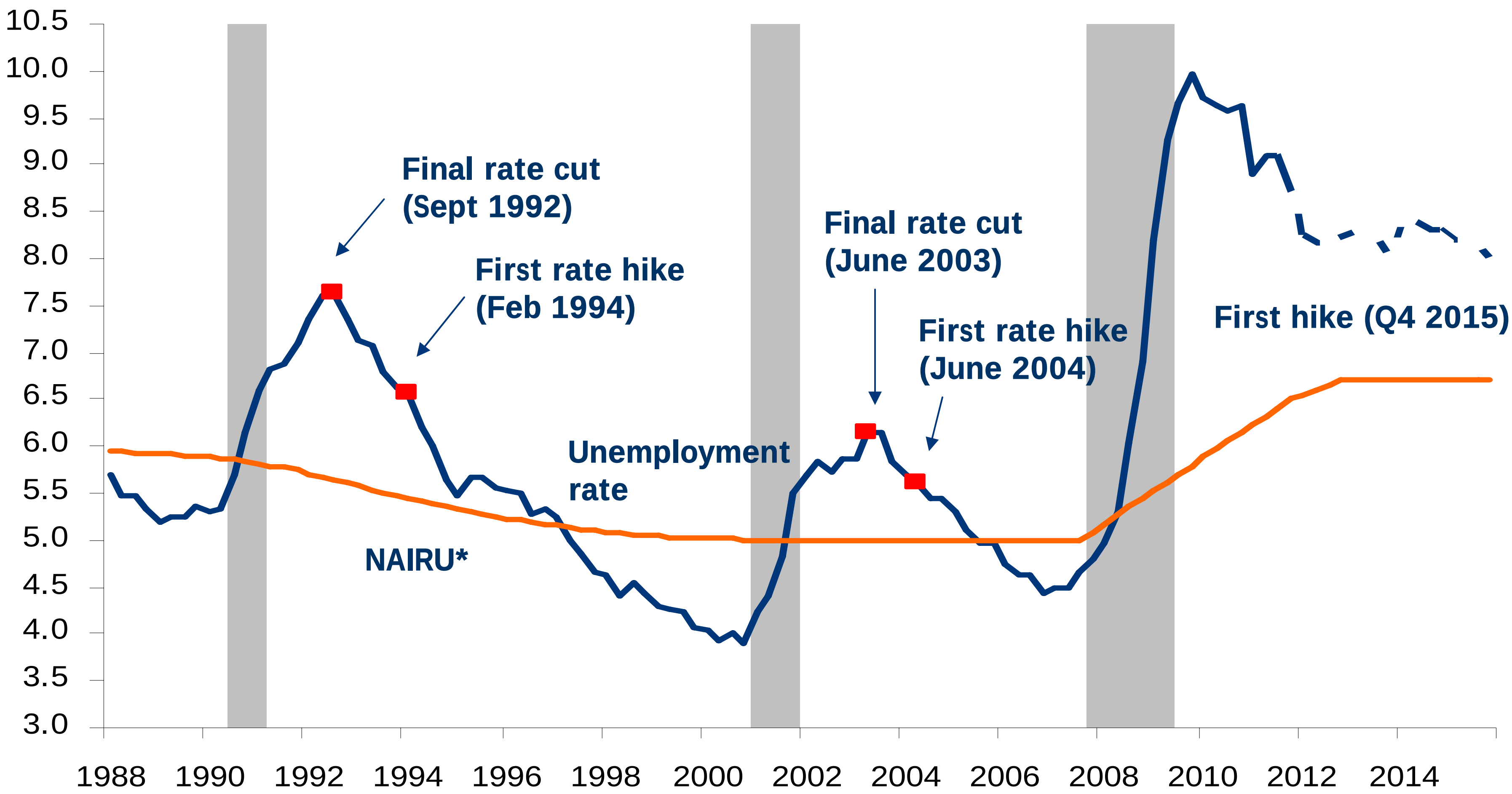
Fed: Heal then hike

Unemployment rate (%)



*NAIRU is the CBO estimate of the inflation-neutral unemployment rate; post-2008 are our estimates. Shaded regions represent periods of US recession
Source: Bureau of Labor Statistics, Federal Reserve Board, Haver Analytics, BofA Merrill Lynch Global Research

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US outlook table

Real Economic Activity, % SAAR	3Q 12	4Q 12	1Q 13	2Q 13	3Q 13	4Q 13	2012	2013	2014
Real GDP	3.1	-0.1	2.0	1.0	1.5	2.5	2.2	1.4	2.6
% Change, Year Ago	2.6	1.5	1.5	1.5	1.1	1.7			
Consumer Spending	1.6	2.2	0.5	1.2	1.5	2.0	1.9	1.4	2.3
Residential Investment	13.6	15.3	20.0	15.0	20.0	25.0	11.9	17.0	21.5
Nonresidential Investment	-1.8	8.4	4.9	3.4	3.7	8.0	7.7	4.4	7.3
Structures	0.0	-1.1	2.0	2.0	3.0	8.0	9.6	1.6	7.4
Equipment and Software	-2.6	12.5	6.0	4.0	4.0	8.0	6.9	5.5	7.3
Government	3.9	-6.6	-0.5	-3.0	-2.0	-1.0	-1.7	-1.8	-0.9
Exports	1.9	-5.7	3.5	5.0	5.0	5.0	3.2	2.2	5.3
Imports	-0.6	-3.2	1.0	5.0	5.5	6.0	2.5	1.7	5.9
Net Exports (Bil 05$)	-395	-404	-394	-399	-406	-417	-406	-404	-438
Inventory Accumulation (Bil 05$)	60	20	32	37	42	46	45	39	50
Key Indicators									
Industrial Production (% SAAR)	0.3	0.8	3.0	2.4	3.0	3.0	3.7	2.1	3.4
Nonfarm Payrolls (Avg MoM change, 000s)	152	201	130	90	125	145	181	123	215
Civilian Unemployment Rate (%)	8.0	7.8	7.9	7.8	7.7	7.7	8.1	7.8	7.3
Personal Savings Rate (%)	3.6	4.7	3.6	3.9	4.1	4.4	3.9	4.0	3.5
Inflation									
CPI, Consumer Prices (% SAAR)	2.3	2.1	1.1	2.4	2.0	1.9	2.1	1.6	1.8
% Change, Year Ago	1.7	1.9	1.5	2.0	1.9	1.8			
CPI ex Food & Energy (% SAAR)	1.5	1.6	1.6	1.9	2.1	2.1	2.1	1.8	2.0
% Change, Year Ago	2.0	1.9	1.8	1.7	1.8	1.9			
Rates									
Fed Funds	0-0.25	0-0.25	0-0.25	0-0.25	0-0.25	0-0.25	0-0.25	0-0.25	0-0.25
3-Month LIBOR	0.36	0.30	0.28	0.25	0.28	0.30	0.30	0.30	0.40
2-Year T-Note	0.23	0.25	0.18	0.15	0.15	0.15	0.25	0.15	0.60
10-Year T-Note	1.63	1.75	1.60	1.75	1.75	2.00	1.75	2.00	3.00

Source: Bureau of Economic Analysis, BofA Merrill Lynch Global Research estimates; Note: rates are EOP

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Global growth: Below trend

- *US: Cliff now, return to rehab later*
- *Europe: Bottoms, but no boom*
- *China: Slow landing*

Not really strong
(real GDP growth, % change)

	2012	2013	2014
US	2.2	1.4	2.6
Euro area	-0.4	-0.4	0.8
Japan	1.7	1.5	1.1
China	7.7	8.1	7.7
EM	4.9	5.2	5.7
Global	3.1	3.2	3.9

Source: BofA Merrill Lynch Global Research estimates

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