

Uncertainty Shock

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A slow fragile recovery

- *Rehab recovery: 3%, at best*
- *2011 drivers: oil and Japan*
- *2012 drivers: fiscal policy*
- *Inflation fading; QE3 coming*

	2010	2011	2012	2013
Real GDP (SAAR)				
<i>BofAML</i>	3.0	1.8	2.1	1.5
<i>Consensus</i>	3.0	1.7	2.1	2.5
Core PCE				
<i>BofAML</i>	1.4	1.5	1.6	1.4
<i>Consensus</i>	1.3	1.5	1.7	1.8
Fed Funds Rate (eop)				
<i>BofAML</i>	0.125	0-0.25	0-0.25	0-0.25
<i>Consensus</i>	0.125	0.25	0.25	n.a.

Still in rehab



Rehab: Post-crisis GDP growth

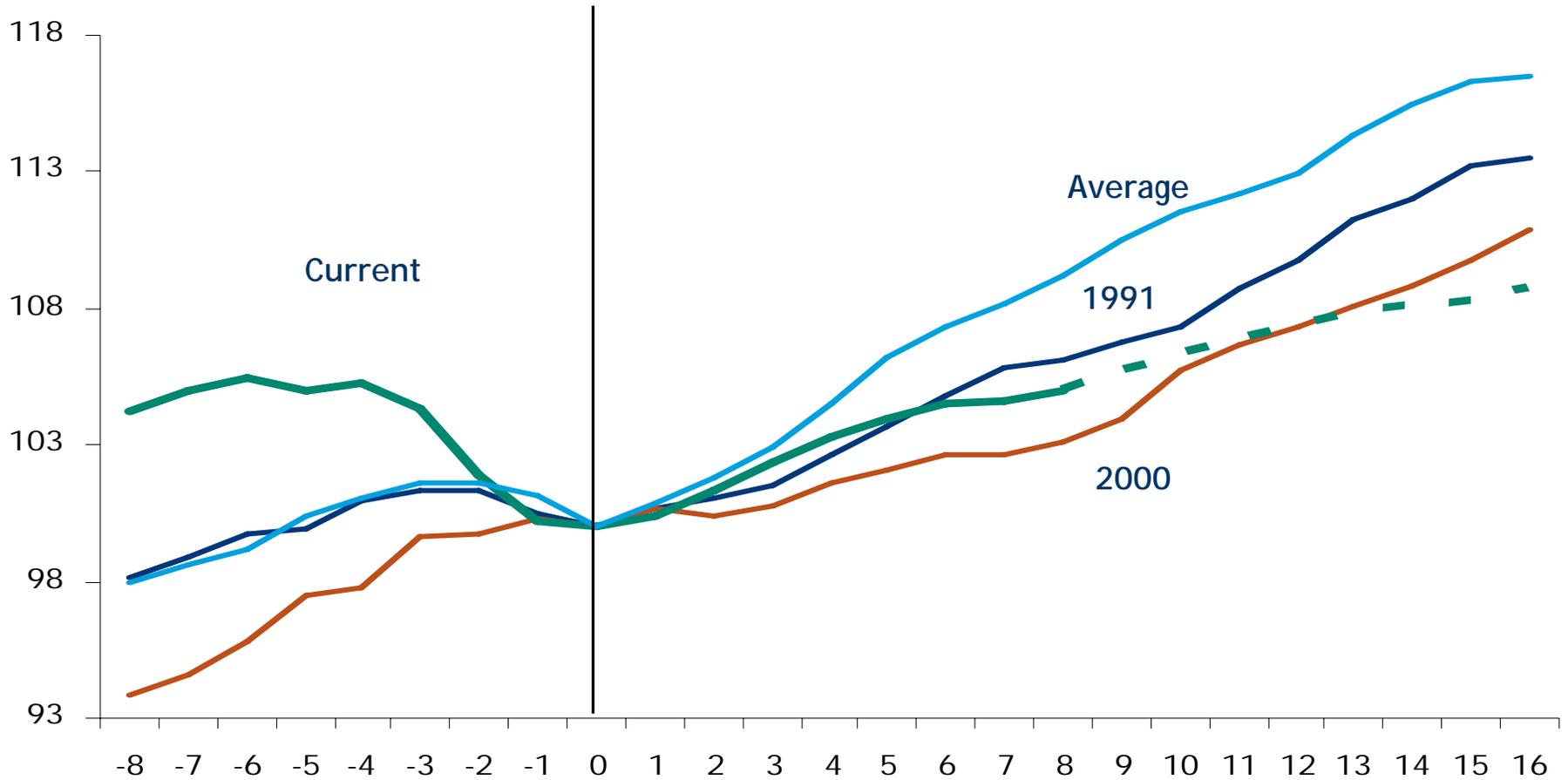
Real GDP
(YoY % change)

		First	Second	Third	Fourth
Spain	(1977)	1.4	0.0	0.6	1.8
Norway	(1987)	3.2	2.9	0.8	4.0
Finland	(1991)	4.4	3.7	3.5	5.8
Sweden	(1991)	2.5	5.3	2.7	1.1
Japan	(1992)	0.5	1.9	2.6	1.7
Average		2.4	2.8	2.1	2.9
US		3.3	1.5	2.0	n.a.
Eurozone		2.0	1.8	1.6	n.a.

"First" refers to the period T to T + 4, "Second" refers to T + 4 to T + 8, etc. where T is the trough quarter.
Source: Eurostat, OECD, Bureau of Economic Analysis, BofA Merrill Lynch Global Research

Rehab: Big fall; slow recovery

Real GDP
(index level)



Indexed to 100 at the recession trough. Average includes all recessions after 1950 excluding the 1980 and current recessions.

Dotted line represents BofA Merrill Lynch forecast.

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

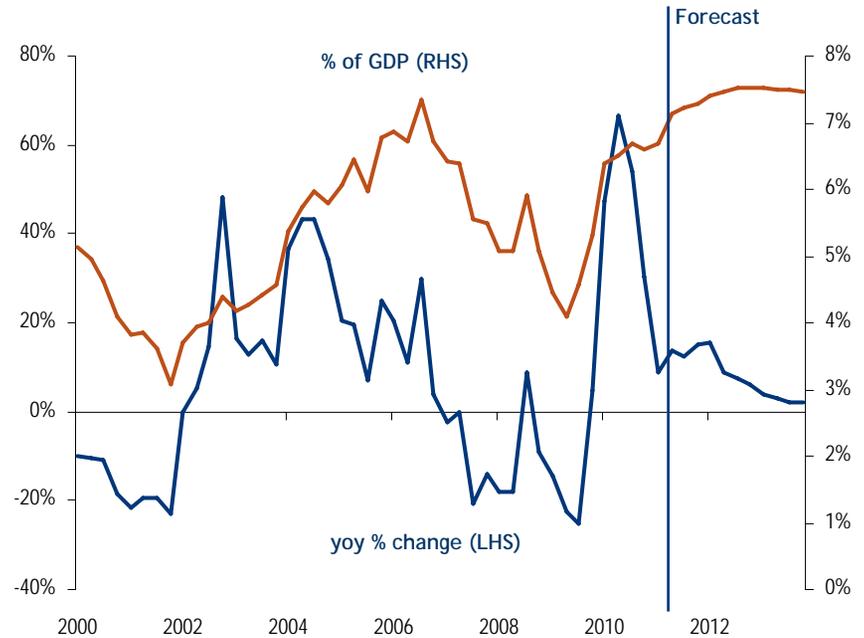
Rehab: Progress report

- *Good:*
 - *Corporations fully healed*
 - *Trading partners fully recovered*
- *Bad:*
 - *Banks still healing*
 - *Households still rebuilding wealth*
- *Ugly:*
 - *Housing recession continues*
 - *Two more years of state and local austerity*

Rehab: Corporate comeback

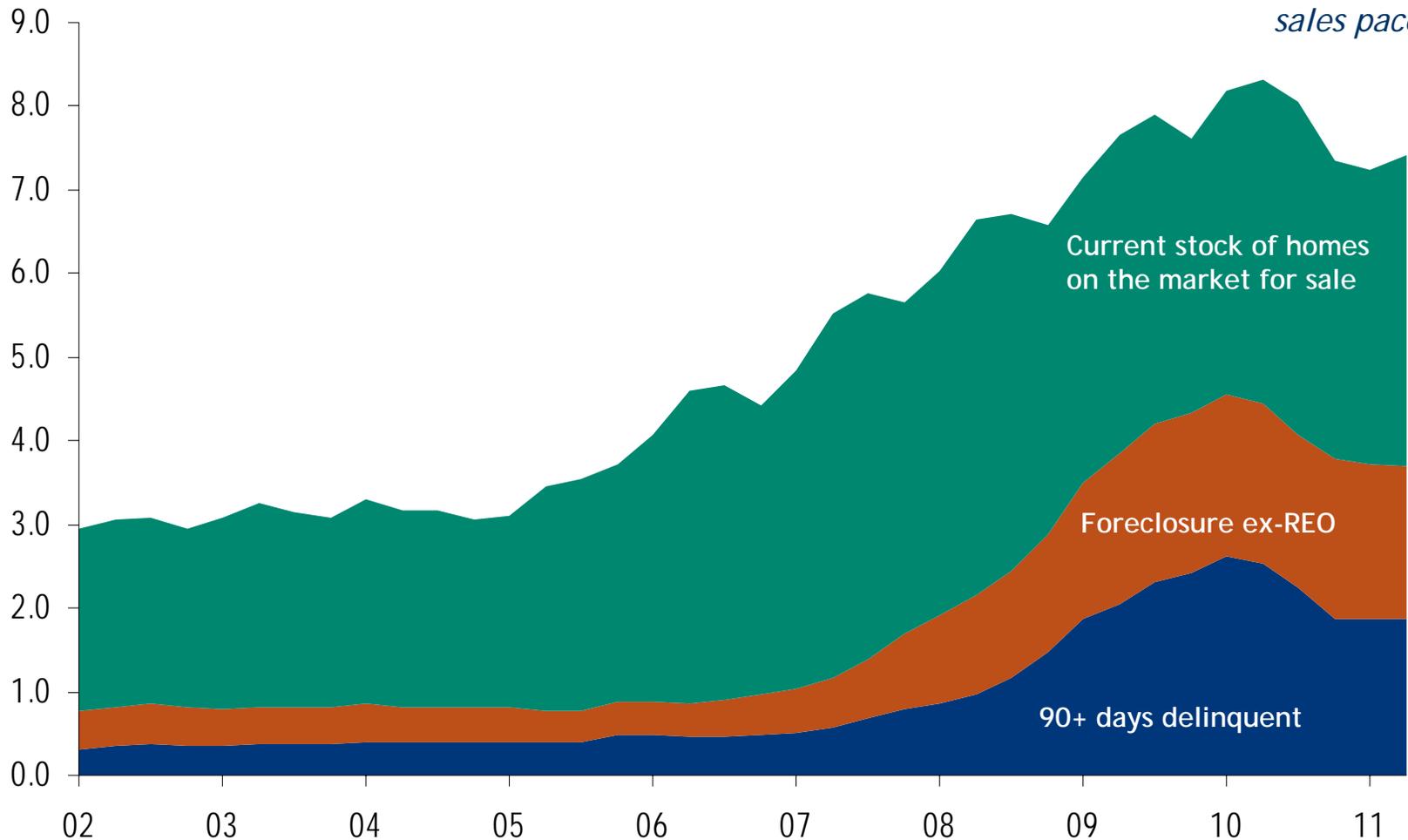
- Healthy balance sheets
- High sustainable profits
- Low valuations / high risk premia
- No (macro) news is good news

Nonfinancial corporate profits



Rehab: Shadow home inventory

(current and future inventory, millions of homes)



2011: Oil and Japan

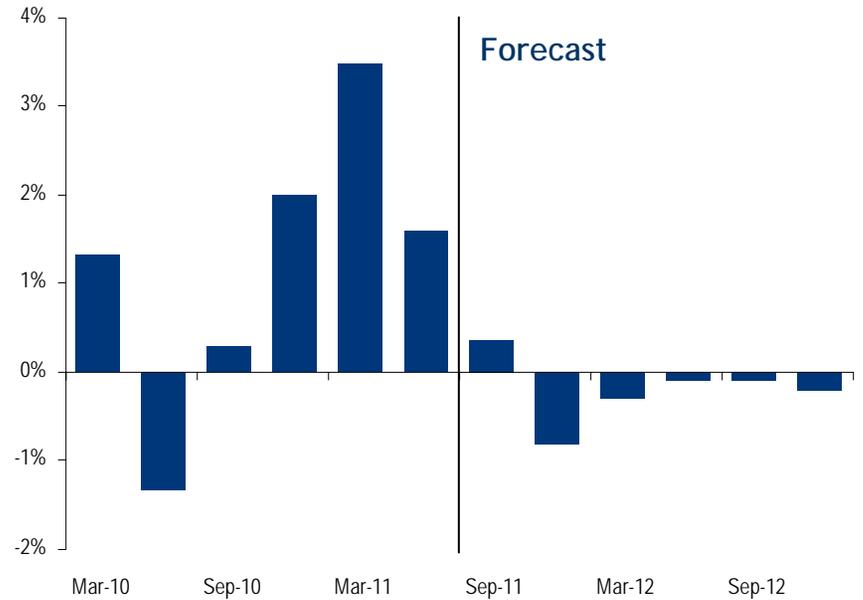


Oil: Fading energy tax

Crude oil
(\$/bbl)



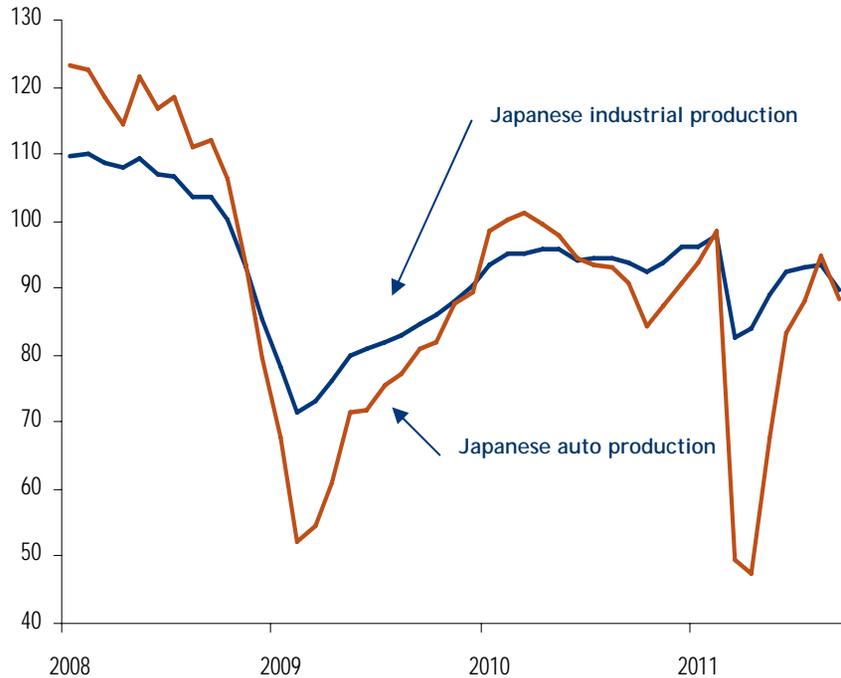
Headline inflation minus core inflation
(Annualized, percent)



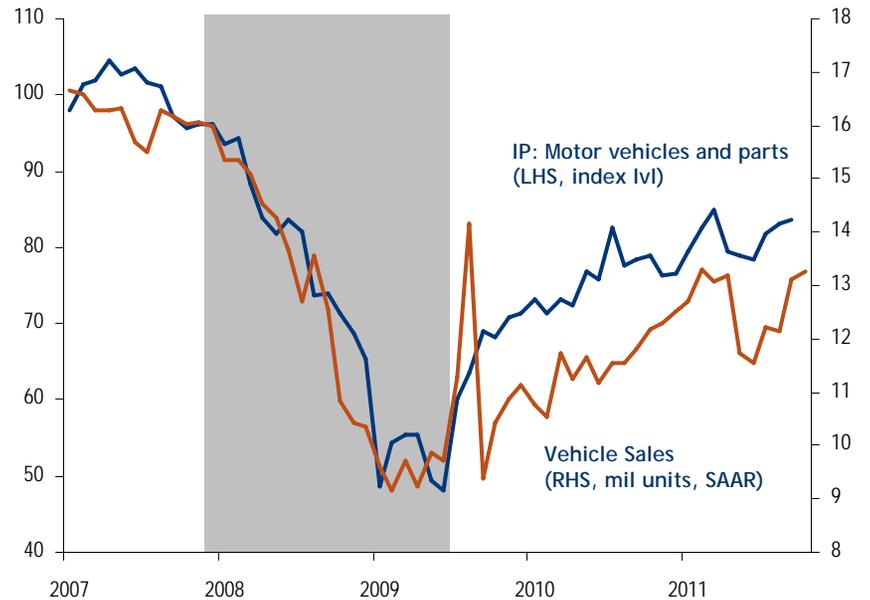
Note: WTI refers to West Texas Intermediate
Source: WSJ, BofA Merrill Lynch Global Research

Japan: Motoring ahead

**Japan comes backs
(index level)**



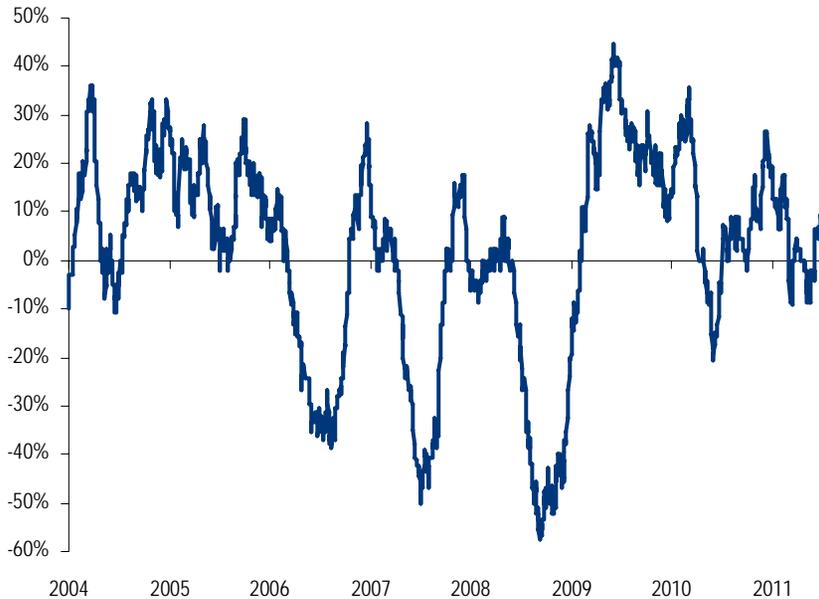
Auto rebound



Note: Japan IP forecasts are from the Survey of Production Forecast.
Source: Haver Analytics, Federal Reserve Board, Autodata, BofA Merrill Lynch Global Research

Result: Near term improvement

US economic data surprise index
(percent)



- Payrolls: 80k headline; 100k revisions
- Claims: 4wk avg 408k down from 422k
- Retail sales: 2 months of 0.5% core
- Core CapEx: 3-mo. 6% annual growth

Note: The US economic data surprise index is made up of 15 economic indicators. It is a diffusion index: number of positive surprises minus the number of negative surprises divided by the total number of economic releases over the past three months.

Source: Bloomberg, BofA Merrill Lynch Global Research

2012: Dueling debt debacles



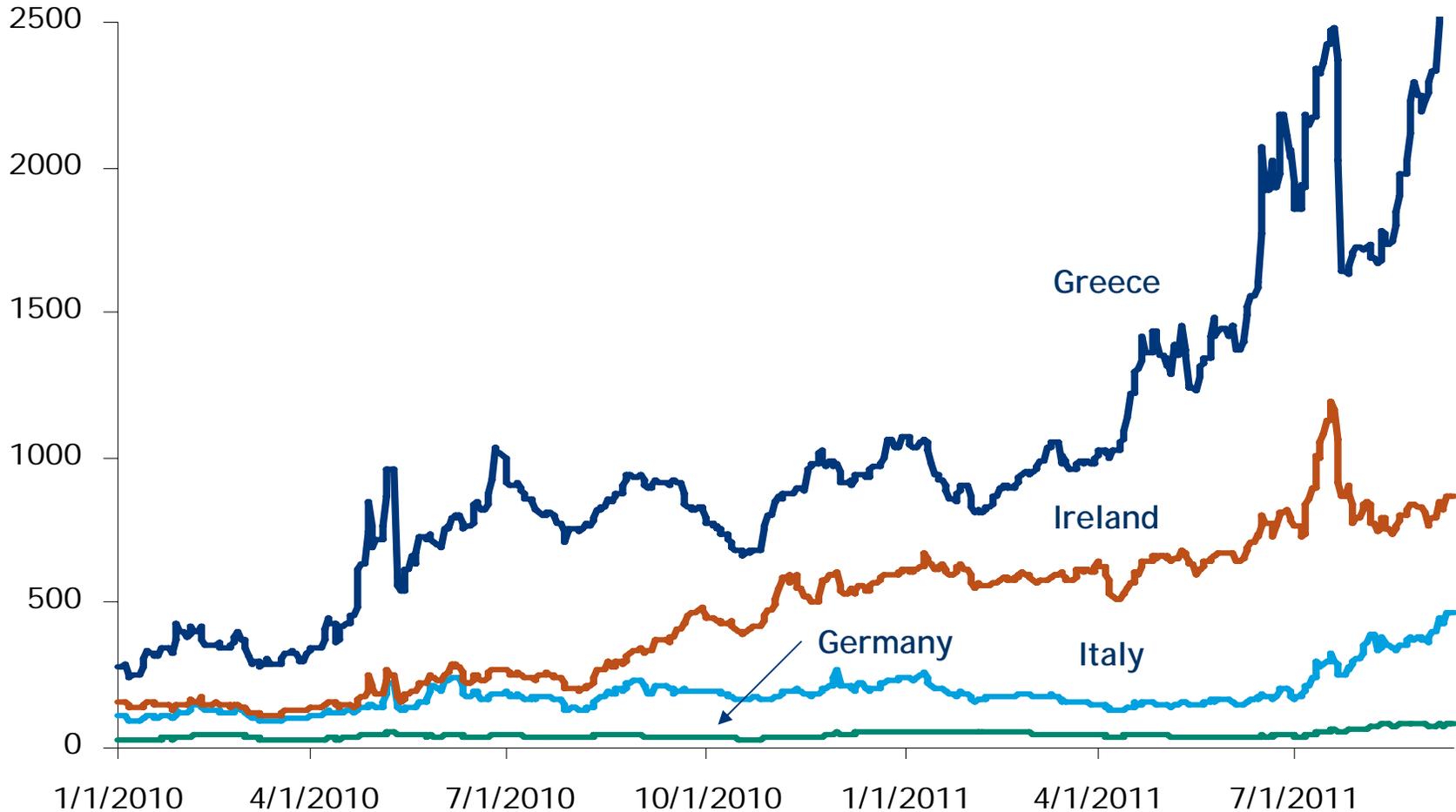


Europe: Dysfunctional decision process

- 17 countries + ECB + IMF = Dysfunction
- Games of chicken
 - Germany and Greece
 - ECB and Italy
- The result
 - Half solutions
 - Teaching markets to look for weakness
 - Real trouble when ammunition runs out

Europe: Never enough

Credit default swaps
(basis points)



Europe: A mild recession... or worse

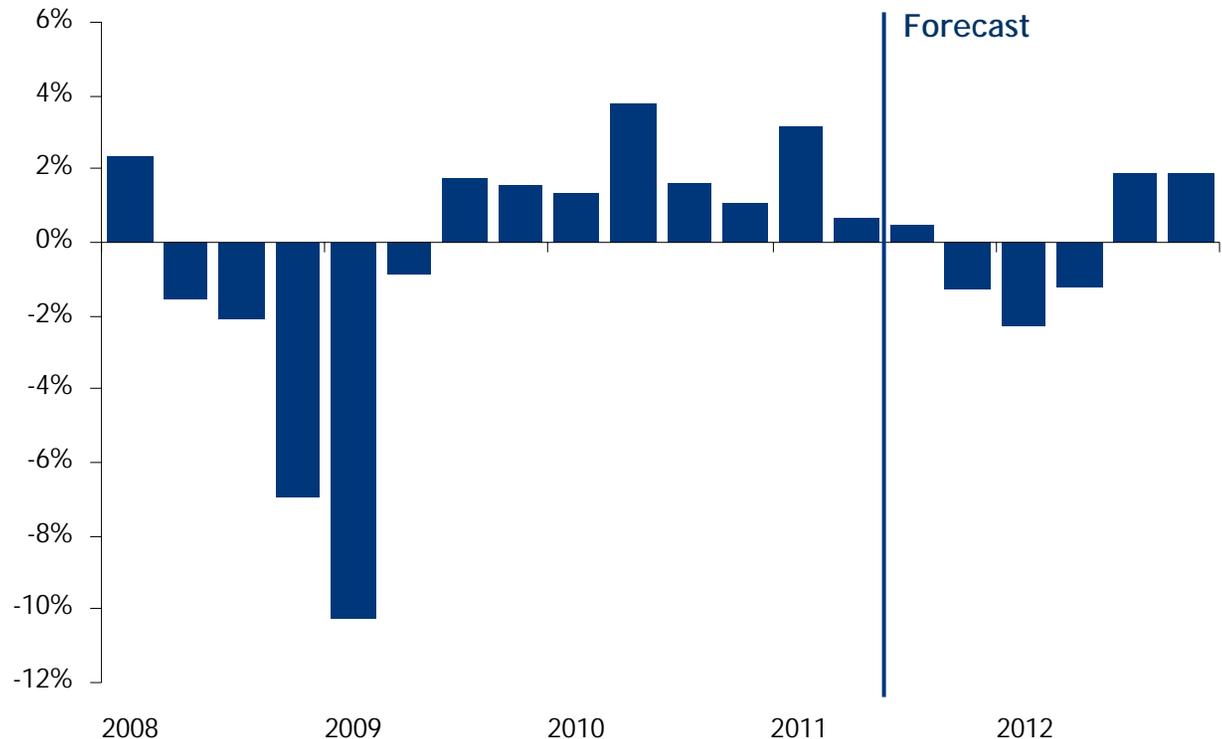
Three shocks

- Fiscal austerity
- Credit crunch
- Uncertainty shocks

...and a risk of

- Debt crisis in Italy
- Banking crisis

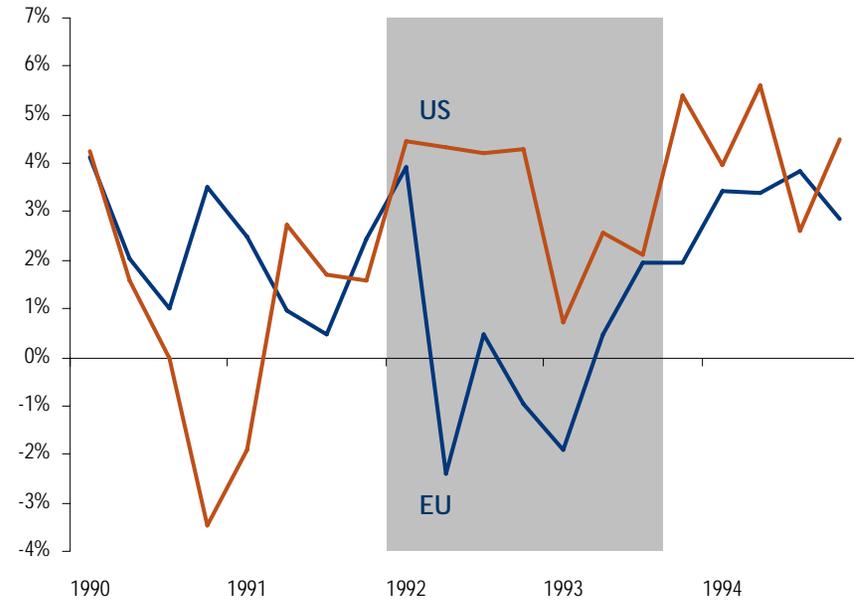
Eurozone GDP
(qoq % annualized)



Europe: Matters more

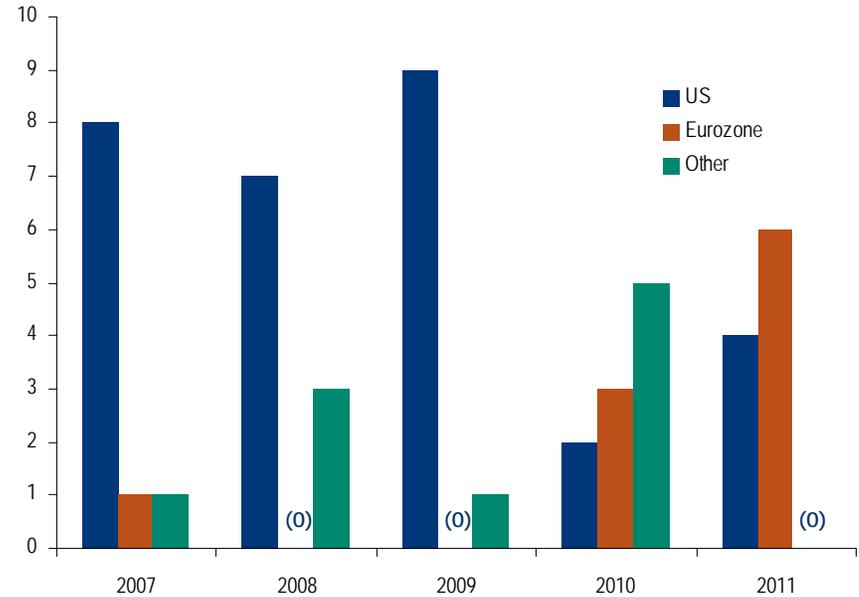
Shrugging off the 1992 crisis

Real GDP
(qoq % annualized)



The whole world is watching

Biggest market moves
(Source of news that caused 10 biggest moves in S&P 500)





Washington: Confidence killing

Four implicit messages this summer...

1. We have a serious debt problem
2. We are too dysfunctional to fix it
3. Threatening to default is an acceptable negotiating tactic
4. There is no fiscal-easing safety net

Washington: Eye of the hurricane

Near term improvement...

- *No default or major shutdown until after election...*
- *...and only brief brinkmanship over continuing resolution*

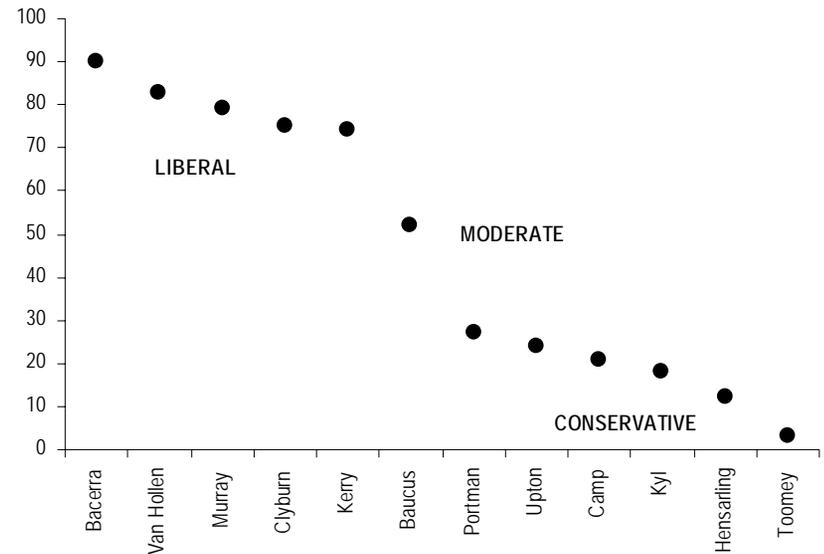
...but three shocks ahead:

1. *“Super Commission” is unlikely to agree on credible plan*
2. *Fiscal austerity in early 2012*
3. *Uncertainty shock on late 2012*

Shock #1: Twelve angry men

- Fallback: \$1.2 tr in discretionary cuts
- Credible plan: \$4 tr across the board
- No taxes, no entitlements, no deal
- Eventual credit downgrade

The deficit commission
(100 = most liberal; 0 = most conservative)



Shock #2: Automatic austerity

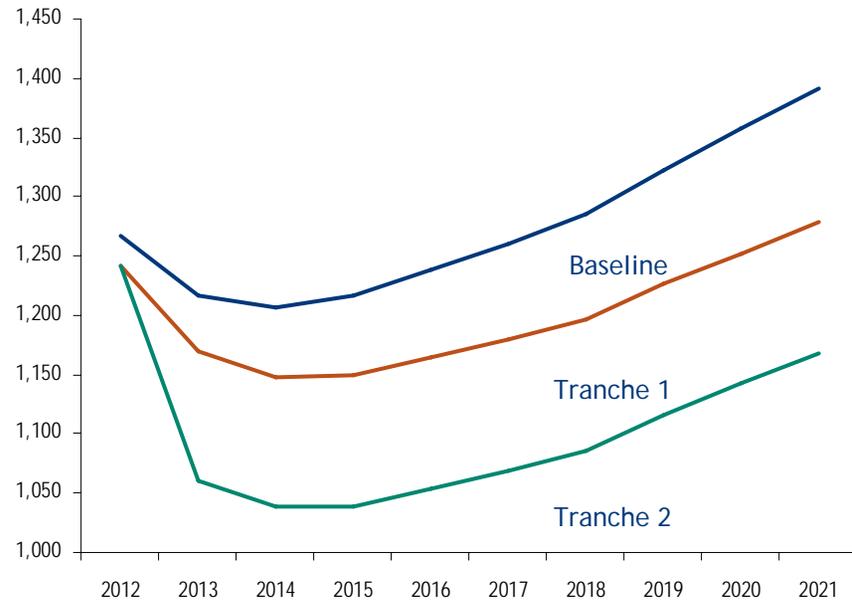
- Some chance of payroll extension...
- ...but low multiplier
- Expiration of CapEx incentives hurts

Programs expiring in 2012

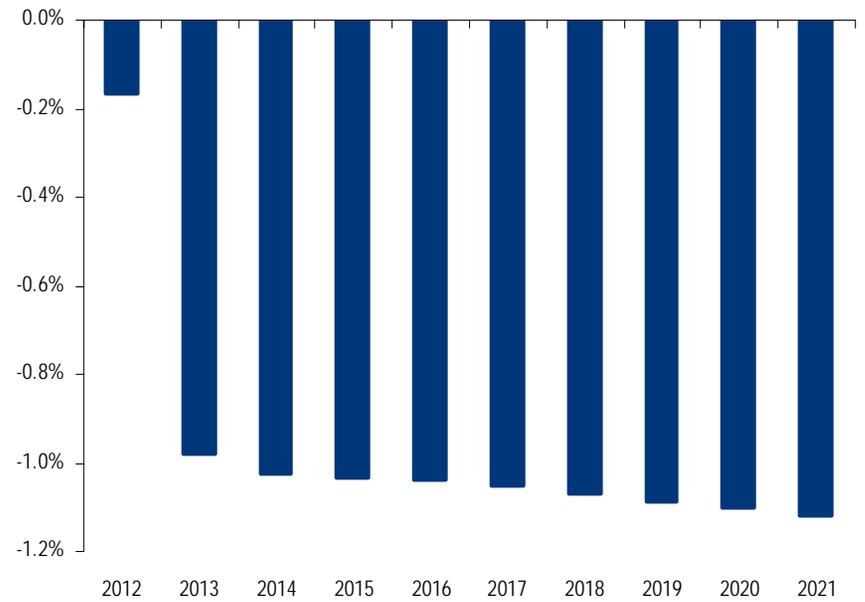
Payroll tax	\$90 bn
Extended unemployment	\$40 bn
Infrastructure spending	\$40 bn
Spring cuts kick in	\$15 bn
Tranche 1	\$20 bn
Total	\$205 bn
(% of GDP)	1.3%

Shock #3: Discretionary cuts

Discretionary spending
(\$ billion)



Spending cuts
(% of GDP)



Shock #3: Post election pothole

- Three major sources of uncertainty
- Left to a lame duck Congress
- Partial repeal likely

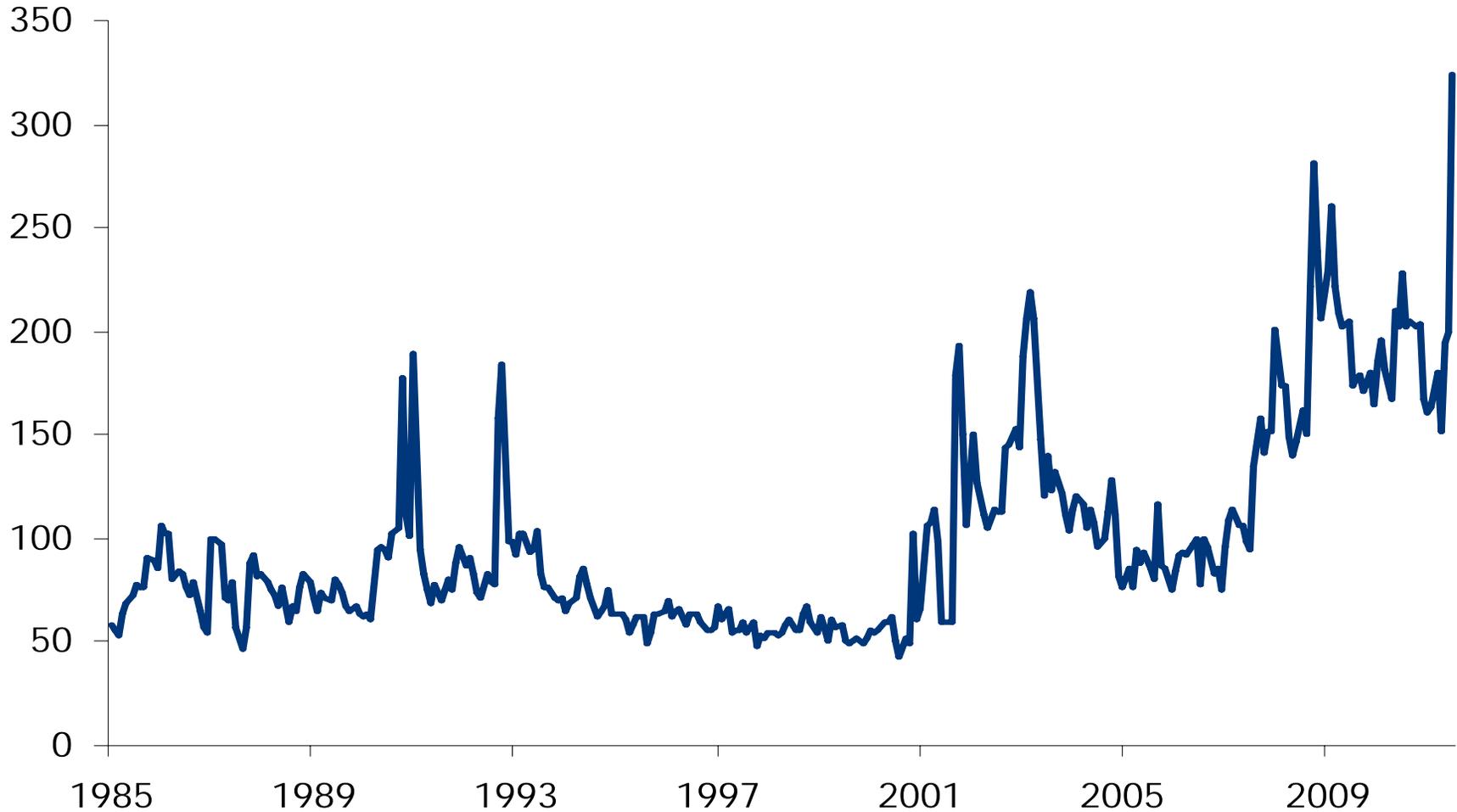
Post-election fiscal shocks

Tranche 1	\$40 bn
Tranche 2	\$110 bn
Bush tax cuts expire	\$240 bn
Other	\$40 bn
Total	\$430 bn
(% of GDP)	2.9%

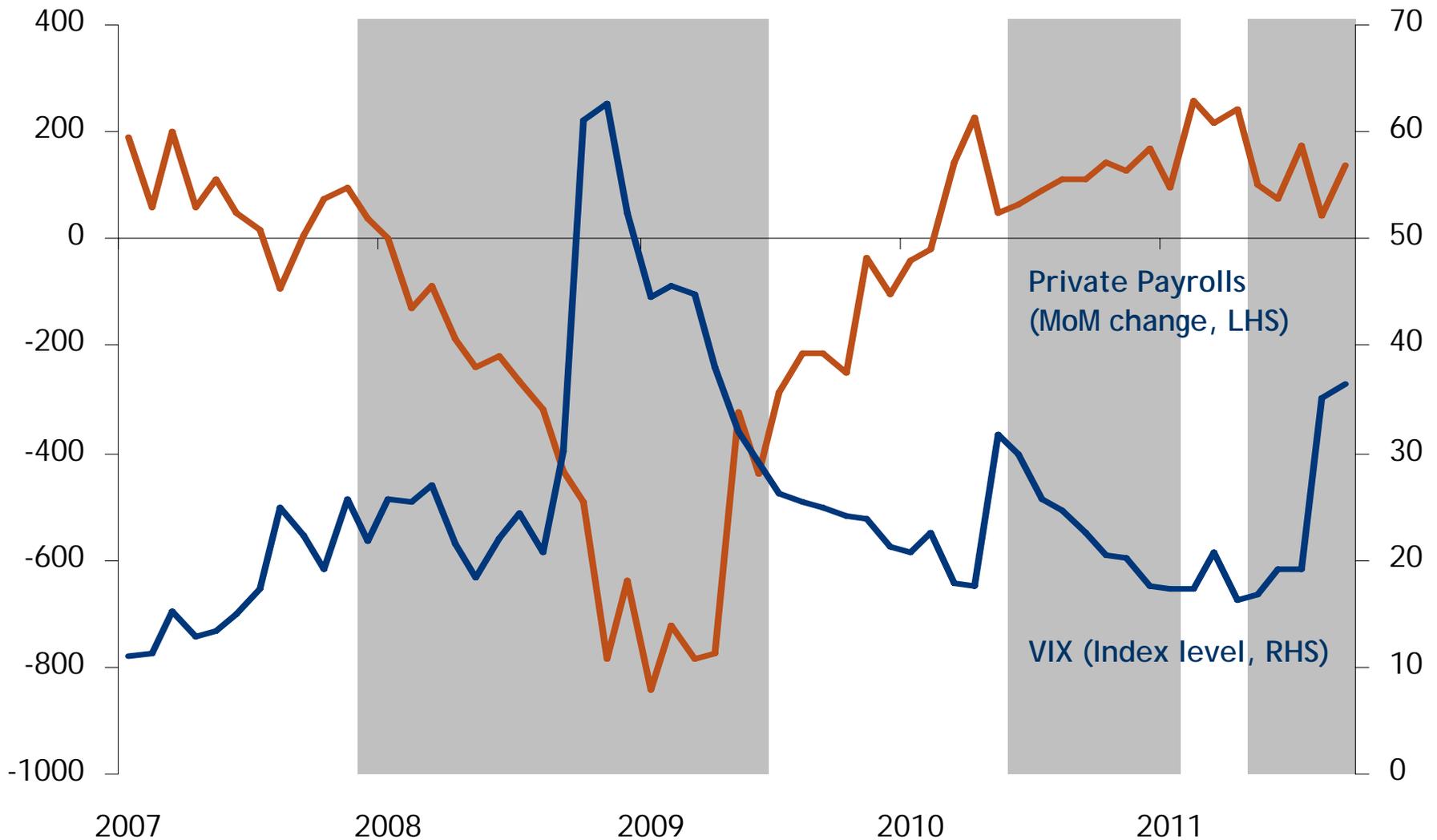
...and could hit debt ceiling

A policy of uncertainty

Policy uncertainty index
(index level)

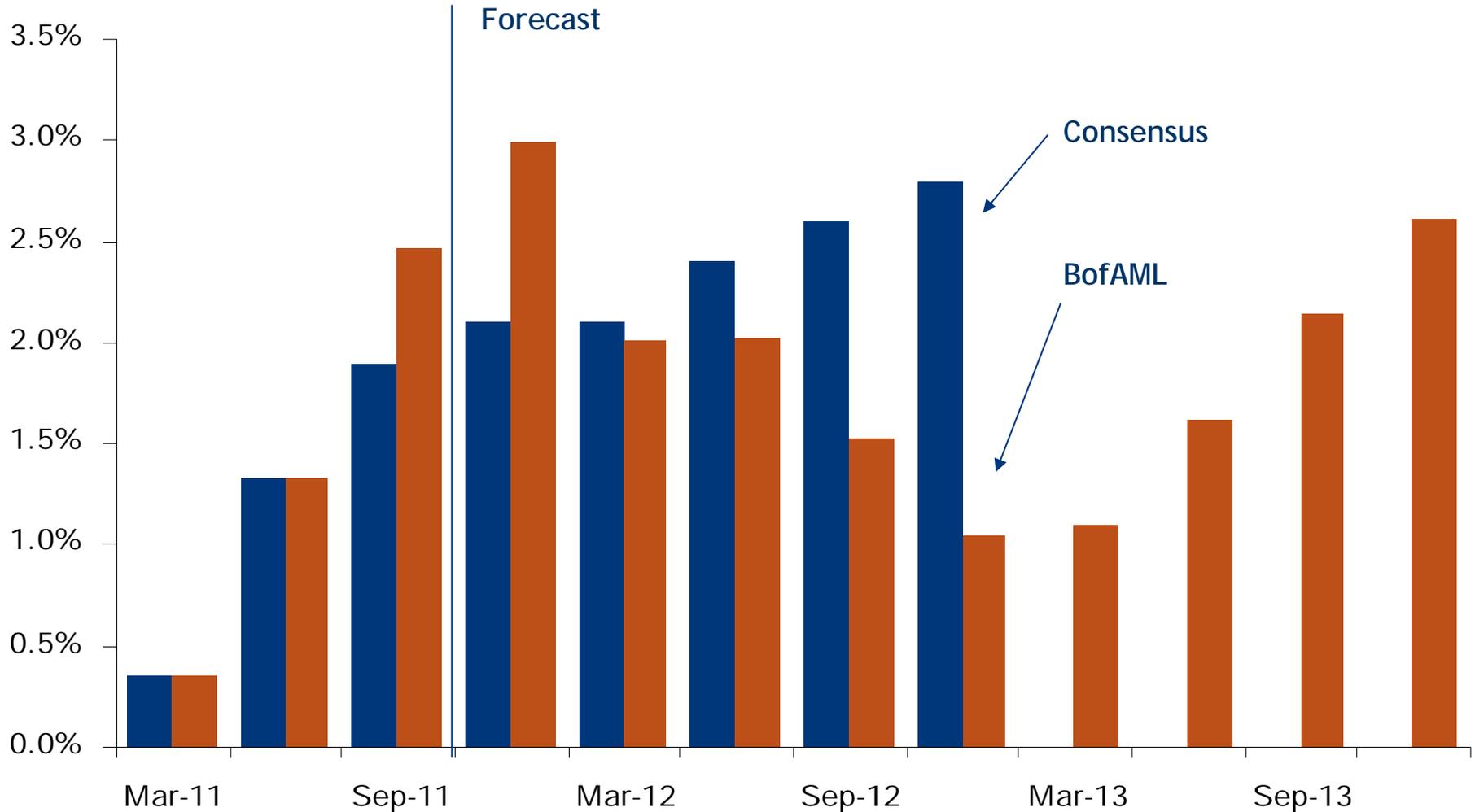


Uncertainty and job growth



Result: Triple dip

Real GDP
(QoQ SAAR)



Note: Consensus are from Blue Chip Economic Indicators survey released on September 10, 2011

Source: BEA, BofA Merrill Lynch Global Research

Imported inflation; domestic disinflation



Inflation: Starting to turn

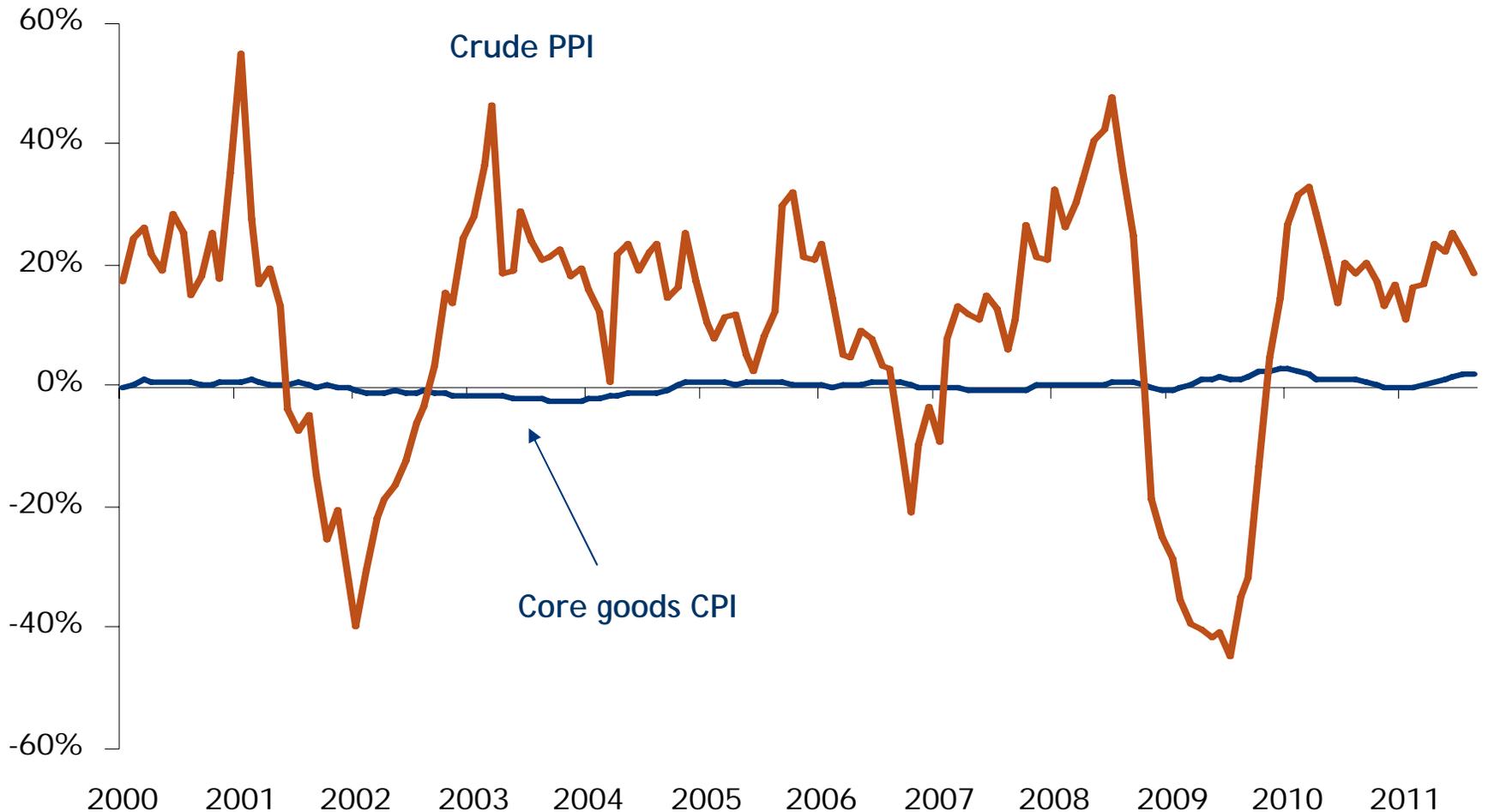
Core CPI
(year-over-year percent change)



Shaded regions represent periods of US recession
Source: Bureau of Labor Statistics, BofA Merrill Lynch Global Research

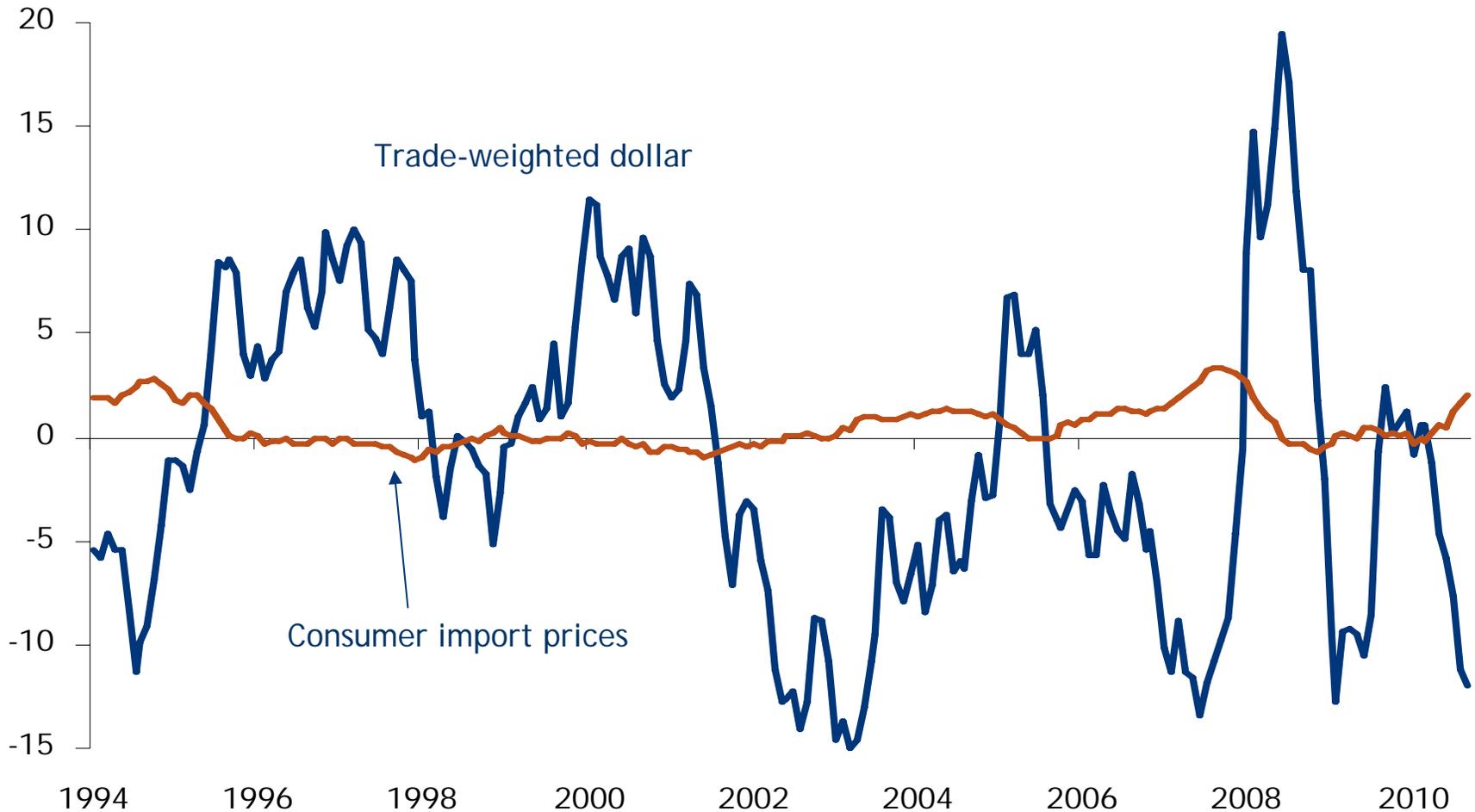
Inflation: Some commodity pass through

(YoY % change)

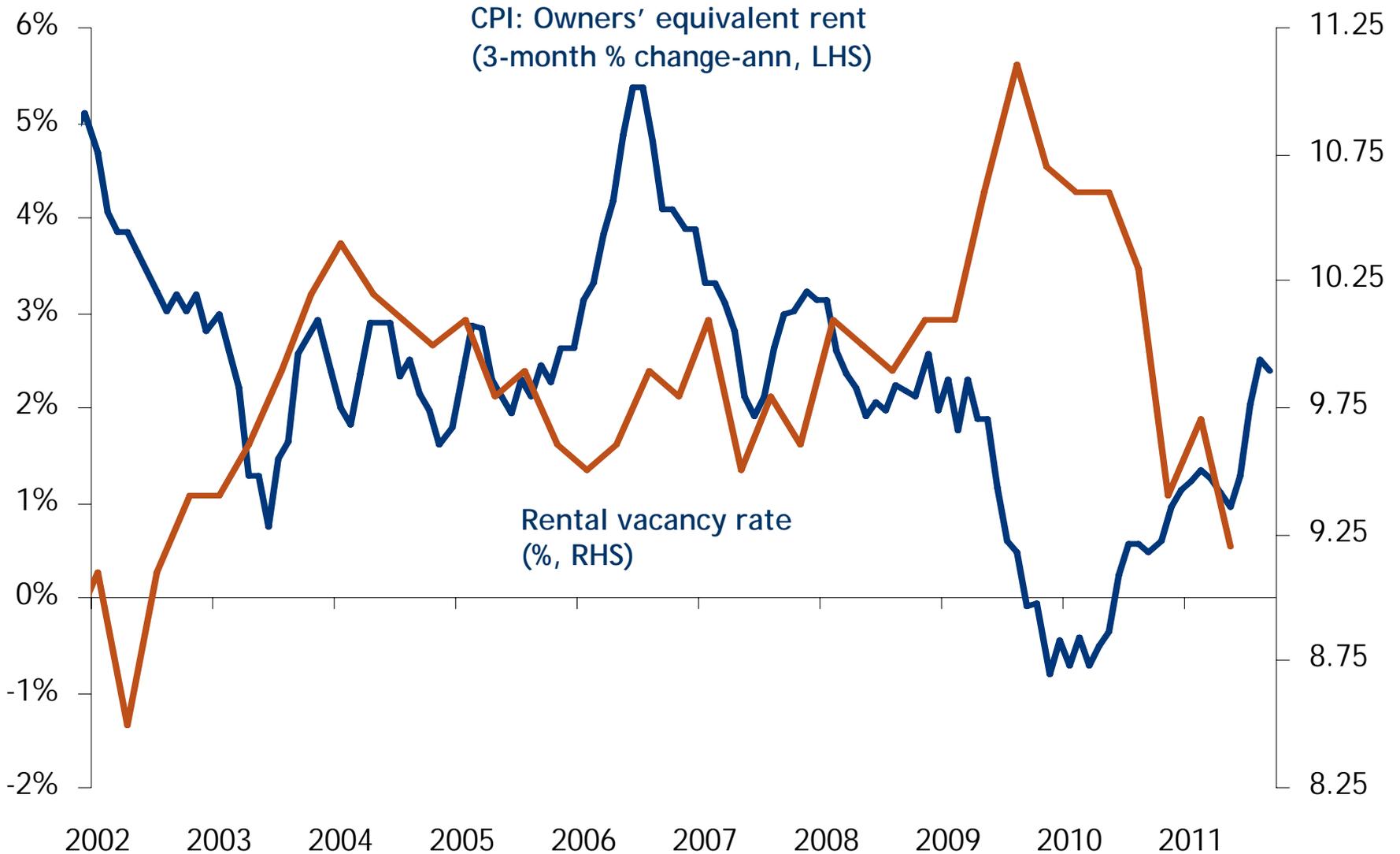


Inflation: Some dollar pass through

(year-over-year percent change)

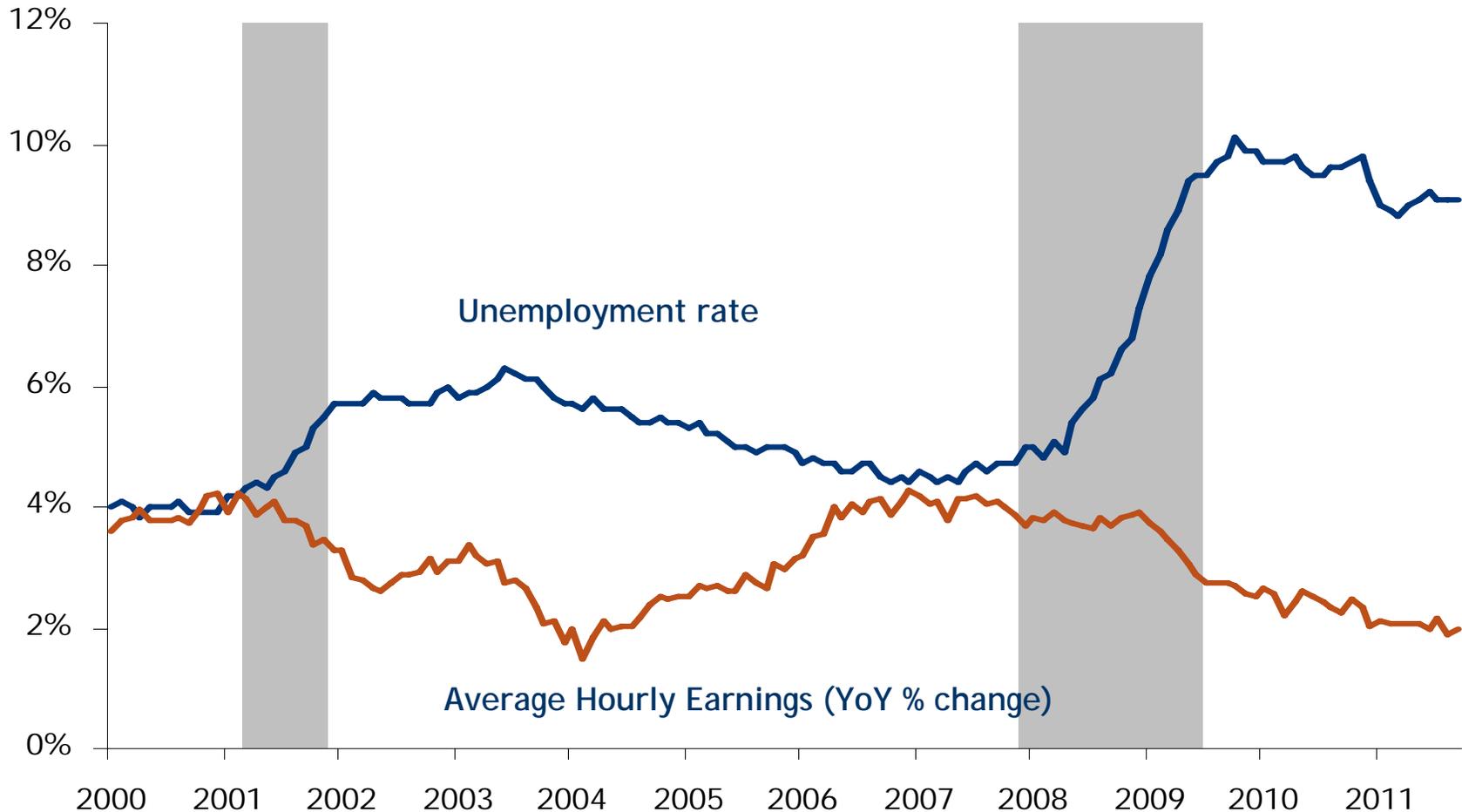


Inflation: Vacancy down, rent up

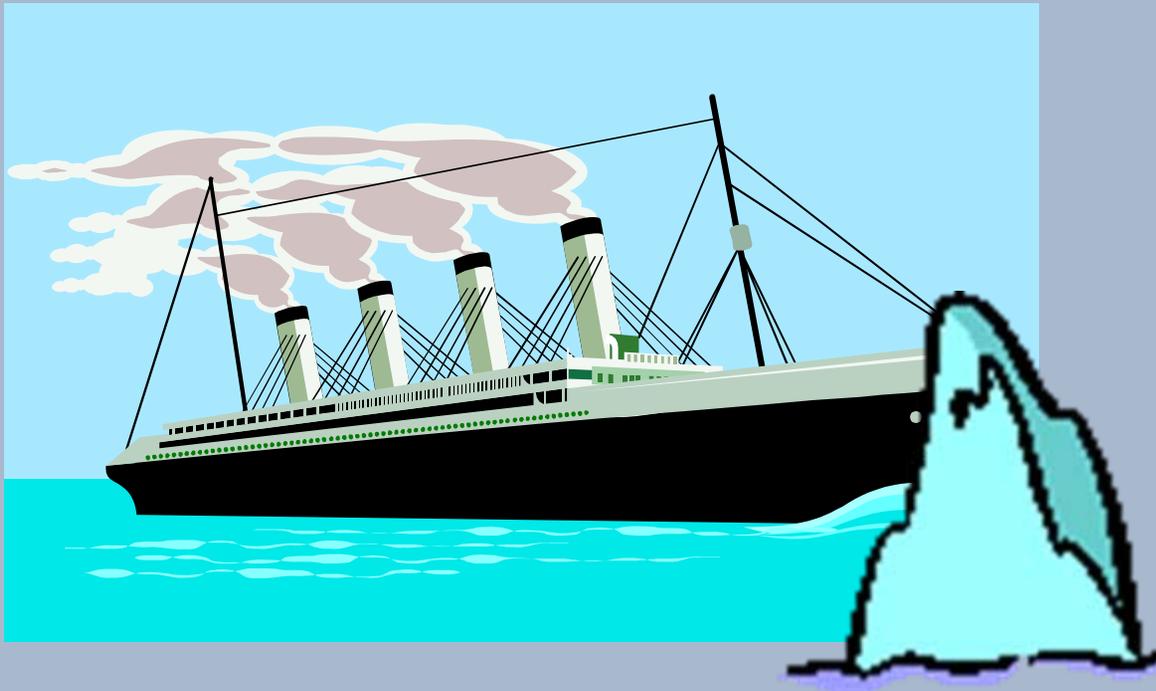


Inflation: Slacking off

(percent)

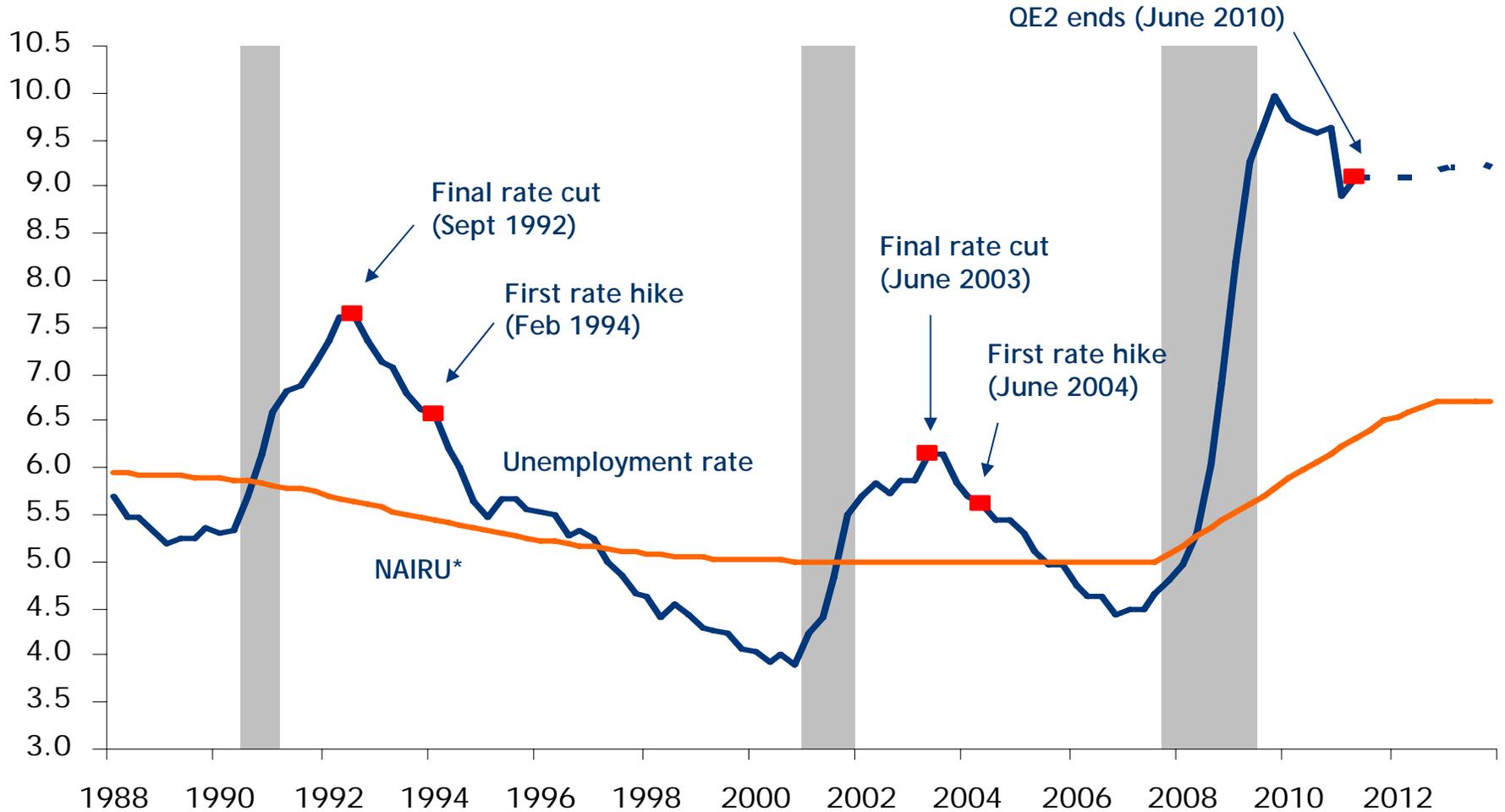


QE: Love Boat or Titanic?



Fed: Heal then hike

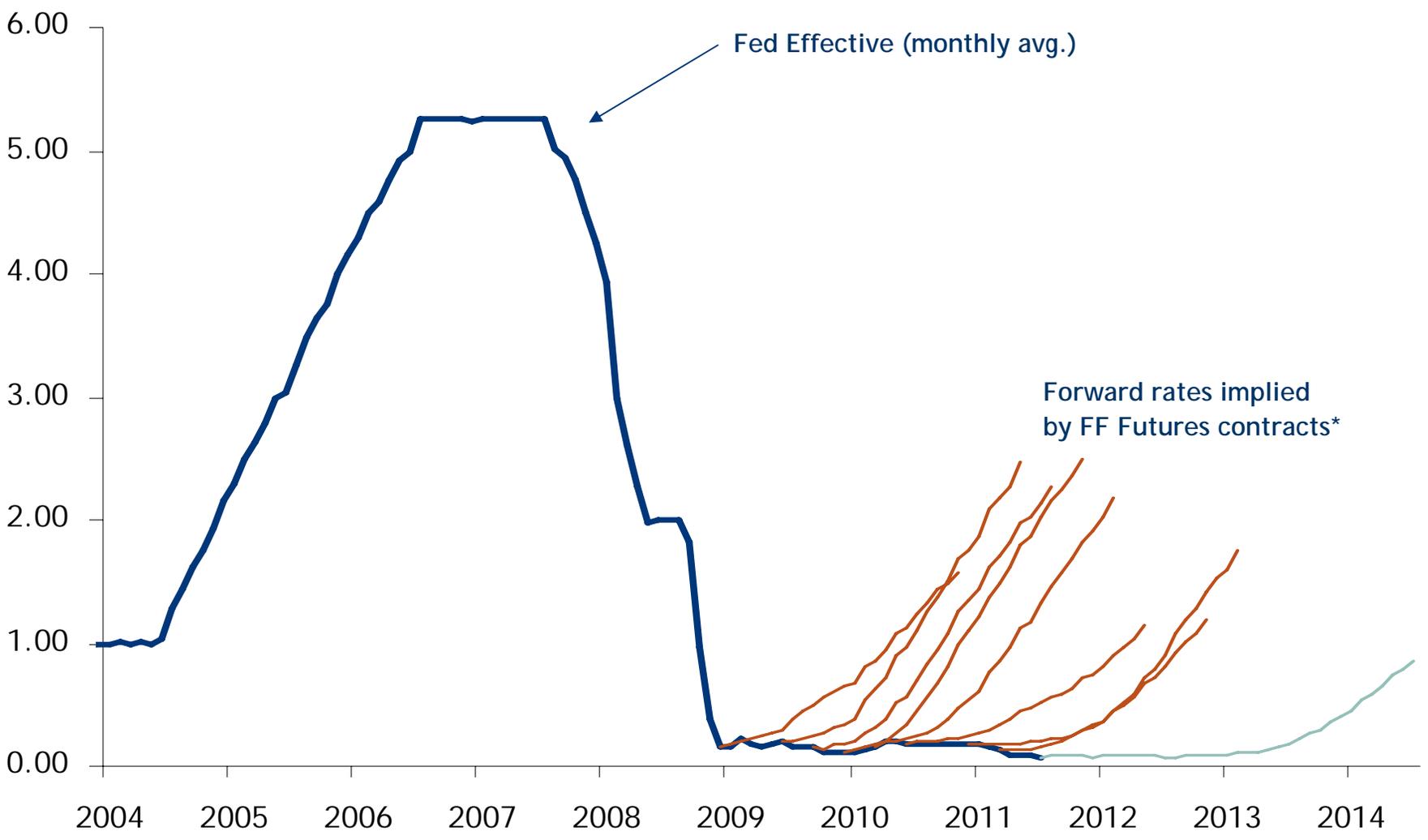
Unemployment rate
(percent)



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

Fed: Tone deaf debt markets

(percent)



Note: * End of quarter projections of Fed Funds rate. Green colored line is the most recent quarter
Source: Federal Reserve Board, Bloomberg, BofA Merrill Lynch Global Research

Fed: To QE or not to QE?

QE2:

- *Only after very weak jobs...*
- *...and near zero core inflation*

Operation twist:

- *Only after weak jobs...*
- *Supplemented by language change*

QE3:

- *Only after very weak jobs...*
- *...and lower core inflation*

US outlook table

Real Economic Activity, % SAAR	3Q 11	4Q 11	1Q 12	2Q 12	3Q 12	4Q 12	2011	2012	2013
Real GDP	2.5	3.0	2.0	2.0	1.5	1.0	1.8	2.1	1.5
% Change, Year Ago	1.6	1.8	2.2	2.4	2.1	1.7			
Consumer Spending	2.4	2.6	2.0	2.0	1.5	1.3	2.3	2.0	1.6
Residential Investment	2.4	-2.0	-2.0	0.0	0.0	0.0	-2.0	-0.3	2.5
Nonresidential Investment	16.3	4.1	5.7	5.7	4.9	4.3	8.8	6.7	5.3
Structures	13.3	-6.0	2.0	2.0	2.0	2.5	4.1	2.9	3.6
Equipment and Software	17.4	8.0	7.0	7.0	6.0	5.0	10.6	8.1	5.9
Government	0.0	-1.9	-1.7	-1.3	-0.9	-0.9	-2.0	-1.3	-0.9
Exports	4.0	5.0	8.0	8.0	7.5	5.5	6.7	6.4	6.3
Imports	1.9	3.0	5.0	5.0	5.5	5.5	5.0	4.1	5.5
Net Exports (Bil 05\$)	-409	-404	-396	-388	-384	-389	-413	-389	-395
Inventory Accumulation (Bil 05\$)	5	35	40	41	42	42	32	41	44
Key Indicators									
Industrial Production (% SAAR)	5.1	2.5	2.0	1.5	1.0	0.5	3.9	2.1	1.0
Private Payrolls (Avg MoM change, 000s)	145.3	108.0	100.0	90.0	75.0	65.0	145.8	82.5	95.0
Civilian Unemployment Rate (%)	9.1	9.0	9.0	9.0	9.1	9.1	9.0	9.1	9.1
Personal Savings Rate (%)	4.1	3.9	4.0	4.1	4.3	4.3	4.5	4.2	4.4
Inflation									
CPI, Consumer Prices (% SAAR)	3.1	1.4	1.5	1.4	1.4	1.4	3.2	1.8	1.6
% Change, Year Ago	3.8	3.4	2.5	1.8	1.4	1.4			
CPI ex Food & Energy (% SAAR)	2.7	1.6	1.6	1.6	1.6	1.6	1.7	1.8	1.6
% Change, Year Ago	1.9	2.1	2.1	1.9	1.6	1.6			
Rates									
<i>Fed Funds</i>	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
<i>3-Month LIBOR</i>	0.37	0.45	0.45	0.45	0.50	0.50	0.45	0.50	n.a.
<i>2-Year T-Note</i>	0.24	0.20	0.25	0.40	0.60	0.80	0.20	0.80	n.a.
<i>10-Year T-Note</i>	1.92	2.30	2.50	2.75	3.00	3.25	2.30	3.25	n.a.

Recession risk: Japanese lessons

Stage one:

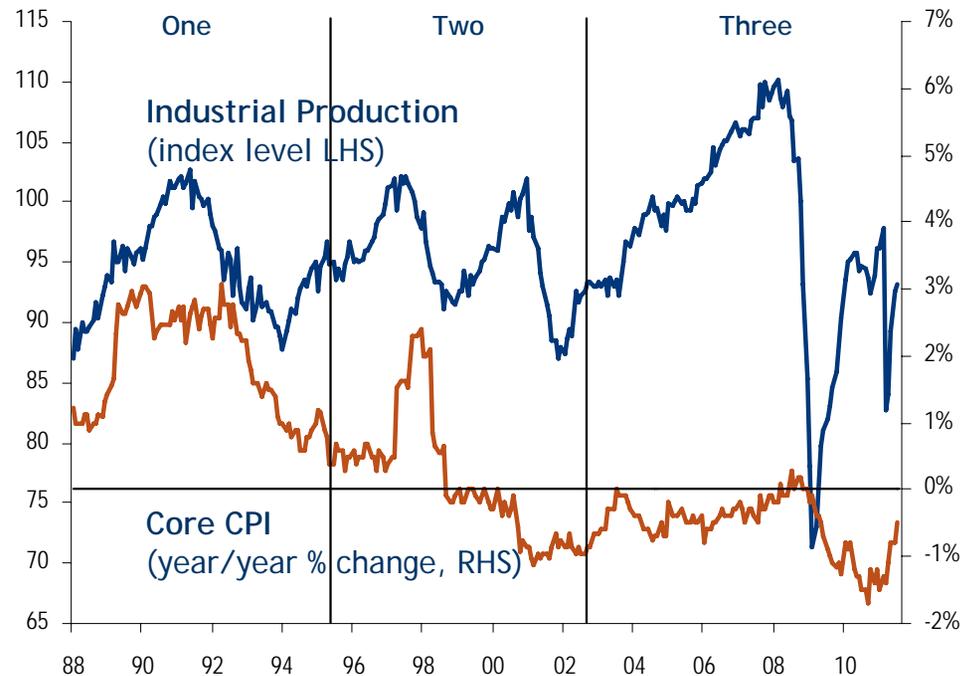
- *Massive asset bubble pops*
- *Impaired banking system*
- *Near zero inflation*

• Stage two:

- *Zombie banking system*
- *Large external shock*
- *Premature fiscal tightening*

• Stage three:

- *Deflation*
- *Policy paralysis*



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