Morning Market Tidbits

Cyprus rejects bailout, ECB to meet

Economics | United States
20 March 2013

Bank of America Merrill Lynch

US Economics
MLPF&S

Ethan S. Harris +1 646 855 3755
Global Economist
MLPF&S
ethan.harris@baml.com

Alexander Lin +1 646 855 6499
US Economist
MLPF&S
alexander.lin@baml.com

Joshua Dennerlein +1 646 855 8027
US Economist
MLPF&S
joshua.dennerlein@baml.com

Michael S. Hanson +1 646 855 6854
US Economist
MLPF&S
michael.s.hanson@baml.com

Michelle Meyer +1 646 855 6261
US Economist
MLPF&S
mmeyer2@baml.com

Market action

Asian equity markets were mixed after the Cypriot Parliament rejected a tax on bank deposits that would partially fund a bailout for the country. However, policy makers continue to consider other bailout packages that would keep Cyprus in the Euro Area. In an attempt to calm markets, the European Central Bank reaffirmed "its commitment to provide liquidity as needed within the existing rules."

Looking at individual markets, the Nikkei surged 2.0%, the Hang Seng jumped 1.0%, and the Shanghai Composite skyrocketed 2.7%. Meanwhile, the Korean Kospi fell 1.0%, and the Indian Sensex slid 0.7%.

In Europe, stocks are up 0.2% in the aggregate. The region's blue chips are outperforming the broader aggregate, trading 0.6% higher. Back at home, S&P futures are pointing to a strong open, up 0.3%.

In the bond market, Treasuries are selling off across the curve, as the 10-year and 30-year yields have increased 3bp, to 1.93%, and 2bp, to 3.15%, respectively. In Europe, UK gilts are up 6bp, to 1.88%, German bunds are up 3bp, to 1.37%, and Spanish 10-year yields are down 4bp, to 4.98%.

The dollar is weakening against a basket of other major currencies, with the DXY index down 0.2%. In the commodities market, WTI crude oil prices are up 72 cents, to $92.88 a barrel. Gold prices are down $1.75, to $1,611.00 an ounce.

Refer to important disclosures on page 5 to 7. Link to Definitions on page 4.

11258930

Overseas data wrap-up

United Kingdom: As expected, the ILO unemployment rate 3-month moving average was unchanged in January, at 7.8%. The number of employed increased by 131,000 in the 3-month period ending January, slightly below the consensus forecast of 140,000. In the same period, average weekly earnings slowed to 1.2% yoy from 1.3%, undercutting expectations of a pickup to 1.5%.

Today's events

Data deck for 20 March

Date	Time	Indicator	Period	BofAML Estimate	Consensus	Previous
3/20/13	14:00	FOMC Rate Decision	–	0.25%	0.25%	0.25%

Source: Bloomberg, BofA Merrill Lynch Global Research

FOMC preview

Two-handed Fed outlook

President Truman famously called for a one-handed economist, so he would not have to hear, "on the other hand…" So it may be at the March FOMC meeting with regard to the labor market — the key to both QE and forward guidance. On the one hand, the recent US employment data have been stronger. On the other, the sequester is likely to result in significant job loss. On the one hand, the FOMC's unemployment-rate projections are likely to be revised down. On the other, the labor market remains a long way from "substantially improved." The back-and-forth is likely to be broken by Chairman Bernanke's press conference, where we expect him to decisively come down on the side of an extended QE program. This should reduce concerns around the exit process. The Fed will also likely ratify market expectations of the first hike (priced for mid-2015).

The upside

The FOMC will release its statement at 2pm on Wednesday, along with an updated Summary of Economic Projections (SEP). In January, the Fed noted a temporary pause in 4Q12 growth; the more recent data suggest a rebound in activity for January and February. We expect that the statement will acknowledge the better momentum. With the unemployment rate down to 7.7% in February — which is at the upper-end of the current central tendency for the end of 2013 — we look for the unemployment-rate projections to be revised down for both this year and the next.

The downside

On the other hand, the long list of downside risks that Fed officials have mentioned in the minutes — Europe and China, fiscal austerity, uncertainty — has only worsened since the last FOMC meeting. The Italian elections and Cyprus bailout have brought European woes back to the front page. Chinese data have softened recently. And the sequester, which many Fed officials hoped would be averted, instead looks likely to hit with full force. We expect that will be a strong headwind to job creation in 2Q13, perhaps resulting in as many as 500,000 jobs being lost over the course of the year.

Bernanke breaks the tie

As a result of this mixed picture, we expect the dispersion of FOMC growth forecasts, which has already started to widen again, to expand further in March. On net, however, we still expect the Fed's growth forecasts to remain above consensus. So, are the changes to the SEP on net hawkish?

We do not think so, and expect Bernanke to sound rather dovish in his post-FOMC press conference at 2:30pm on Wednesday. He is likely to reiterate his view that the benefits of QE outweigh the costs, and that the cost of ending QE too quickly would also be significant. He is also likely to argue that the Fed needs to keep policy accommodative for quite some time, in order to see a "substantial" improvement in labor-market conditions. For example, despite the fairly steady improvement in the unemployment rate since the recession ended, the employment-to-population ratio has barely budged. In other words, the reduction in the unemployment rate has been driven largely by people exiting the labor force — giving up looking for work — which is not a desirable outcome in the mind of Bernanke and many of his FOMC colleagues.

Thus, we expect Bernanke to push back against questions that suggest a relatively early end to QE3. Despite the December and January minutes highlighting that "some" to "several" FOMC participants expected to end asset purchases this year, we expect Bernanke's comments at the press conference to suggest that QE3 is likely to extend through the year-end, at least. One way to clarify just where the Committee sits in terms of the outlook for QE: to include member's views on the likely path of the balance sheet over time, just as they do now for the likely path for the federal funds rate. That would help anchor market expectations of when QE3 might be cut back or concluded. While that addition to the SEP is not a guarantee for this meeting, we see a significant chance that it will happen sometime this year.

Rate-market implications

The rate-market implications will depend on its perception of the Fed's commitment to its two-pronged easing approach – forward guidance and QE3. With the recent flight to quality decline in rates, the market is now pricing the first Fed hike in mid-2015, which is reasonable, in our opinion. As for QE3, our model (using the spread between inflation breakevens and real rates) estimates five more months of buying at the same pace, or a longer period with some tapering of purchases at the end. We expect the market to extend this timing, primarily if economic data weakens. However, the steepness of the curve and richness of the payer skew in the options market indicate that the market is concerned about a substantial rise in rates as we approach the end of QE3 and the exit. If the Chairman reduces some of this risk during the press conference, Treasuries should do well at the margin, especially in the belly of the curve, in our view.

To read the full report: Liquid Insight, 19 March 2013.

In the news

Home healing

According to the Wall Street Journal Online article, "More Homeowners Dig Out," rising home prices are translating into fewer households underwater, a positive sign for the economy. As reported by CoreLogic, the percent of households with a mortgage that was underwater fell to 21.5% in 2012 from 25.2% in 2011. The article mentions that increasing household wealth should also lead to greater consumer spending and improving sentiment. However, we believe that this wealth effect may be muted, particularly for lower-income households.

As we mentioned in our most recent weekly, upper-income households are the main driver of spending today. Meanwhile, lower-income households are the main driver of spending volatility and face many challenges. Specifically, they struggle with low wage growth and little access to wealth appreciation – they own a very small share of financial wealth, and tight lending standards make it difficult to realize increased home equity. Furthermore, the payroll tax hike will continue to weigh heavily on these households, leading to decreased spending and declining sentiment. Thus, while increasing home prices are certainly a piece of the puzzle, we are still far from a healthy and sustainable broad-based consumer recovery.

Data recap

Housing starts in line with expectations

Housing starts rose to 917,000 saar in February, in line with expectations of 915,000. January data were revised upward to 910,000 from 890,000 and December data were revised up to 982,000 from 973,000. Due to the strong revisions, the data pushed up our 1Q GDP tracking estimate by 0.1pp to 3.1% qoq saar. Also, our 1Q residential investment tracking estimate is now 17.5%.

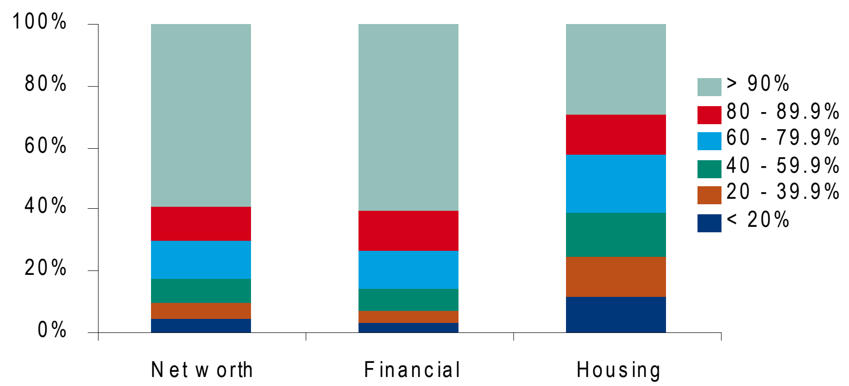
Looking at the details, single-family starts increased 0.5% mom, to 618,000 saar, and multi-family starts jumped 1.4%, to 299,000. Building permits surged 4.6% mom, up to 946,000, beating expectations of 925,000. Meanwhile, the number of homes under construction climbed 2.3% mom, to 575,000.

We continue to expect strong housing starts throughout this year as pent-up demand and low inventory in the real estate market facilitates greater investment and construction activity. Specifically, we forecast starts increasing to 990,000 in 2013 from 781,000 in 2012.

Charts of the day

Distribution of wealth by income cohort: The individuals who earn the most income are the ones with the greatest net worth. The top 10% of earners holds 59.0% of net worth. This is concentrated in financial assets, since 68% of total wealth is comprised of financials. Outside of retirement accounts, such as 401K plans or pension funds, lower-income households have little exposure to the stock market. In contrast, housing wealth is more evenly distributed with the top 10% of the income cohort holding 29% of housing wealth.

Chart 1: Distribution of wealth by income cohort (% share of asset)



Source: BofA Merrill Lynch Global Research, FRB Survey of Consumer Finances 2010

Link to Definitions

Macro

Click here for definitions of commonly used terms.

Important Disclosures

BofA Merrill Lynch Research personnel (including the analyst(s) responsible for this report) receive compensation based upon, among other factors, the overall profitability of Bank of America Corporation, including profits derived from investment banking revenues.

Other Important Disclosures

Individuals identified as economists do not function as research analysts under U.S. law and reports prepared by them are not research reports under applicable U.S. rules and regulations. Macroeconomic analysis is considered investment research for purposes of distribution in the U.K. under the rules of the Financial Services Authority.

BofA Merrill Lynch Global Research policies relating to conflicts of interest are described at http://www.ml.com/media/43347.pdf.

"BofA Merrill Lynch" includes Merrill Lynch, Pierce, Fenner & Smith Incorporated ("MLPF&S") and its affiliates. Investors should contact their BofA Merrill Lynch representative or Merrill Lynch Global Wealth Management financial advisor if they have questions concerning this report.
"BofA Merrill Lynch" and "Merrill Lynch" are each global brands for BofA Merrill Lynch Global Research.

Information relating to Non-US affiliates of BofA Merrill Lynch and Distribution of Affiliate Research Reports:

MLPF&S distributes, or may in the future distribute, research reports of the following non-US affiliates in the US (short name: legal name): Merrill Lynch (France): Merrill Lynch Capital Markets (France) SAS; Merrill Lynch (Frankfurt): Merrill Lynch International Bank Ltd., Frankfurt Branch; Merrill Lynch (South Africa): Merrill Lynch South Africa (Pty) Ltd.; Merrill Lynch (Milan): Merrill Lynch International Bank Limited; MLI (UK): Merrill Lynch International; Merrill Lynch (Australia): Merrill Lynch Equities (Australia) Limited; Merrill Lynch (Hong Kong): Merrill Lynch (Asia Pacific) Limited; Merrill Lynch (Singapore): Merrill Lynch (Singapore) Pte Ltd.; Merrill Lynch (Canada): Merrill Lynch Canada Inc; Merrill Lynch (Mexico): Merrill Lynch Mexico, SA de CV, Casa de Bolsa; Merrill Lynch (Argentina): Merrill Lynch Argentina SA; Merrill Lynch (Japan): Merrill Lynch Japan Securities Co., Ltd.; Merrill Lynch (Seoul): Merrill Lynch International Incorporated (Seoul Branch); Merrill Lynch (Taiwan): Merrill Lynch Securities (Taiwan) Ltd.; DSP Merrill Lynch (India): DSP Merrill Lynch Limited; PT Merrill Lynch (Indonesia): PT Merrill Lynch Indonesia; Merrill Lynch (Israel): Merrill Lynch Israel Limited; Merrill Lynch (Russia): OOO Merrill Lynch Securities, Moscow; Merrill Lynch (Turkey I.B.): Merrill Lynch Yatirim Bank A.S.; Merrill Lynch (Turkey Broker): Merrill Lynch Menkul Değerler A.Ş.; Merrill Lynch (Dubai): Merrill Lynch International, Dubai Branch; MLPF&S (Zurich rep. office): MLPF&S Incorporated Zurich representative office; Merrill Lynch (Spain): Merrill Lynch Capital Markets Espana, S.A.S.V.; Merrill Lynch (Brazil): Bank of America Merrill Lynch Banco Multiplo S.A.; Merrill Lynch KSA Company, Merrill Lynch Kingdom of Saudi Arabia Company.

This research report has been approved for publication and is distributed in the United Kingdom to professional clients and eligible counterparties (as each is defined in the rules of the Financial Services Authority) by Merrill Lynch International and Banc of America Securities Limited (BASL), which are authorized and regulated by the Financial Services Authority and has been approved for publication and is distributed in the United Kingdom to retail clients (as defined in the rules of the Financial Services Authority) by Merrill Lynch International Bank Limited, London Branch, which is authorized by the Central Bank of Ireland and is subject to limited regulation by the Financial Services Authority – details about the extent of its regulation by the Financial Services Authority are available from it on request; has been considered and distributed in Japan by Merrill Lynch Japan Securities Co., Ltd., a registered securities dealer under the Financial Instruments and Exchange Act in Japan; is distributed in Hong Kong by Merrill Lynch (Asia Pacific) Limited, which is regulated by the Hong Kong SFC and the Hong Kong Monetary Authority; is issued and distributed in Taiwan by Merrill Lynch Securities (Taiwan) Ltd.; is issued and distributed in India by DSP Merrill Lynch Limited; and is issued and distributed in Singapore by Merrill Lynch International Bank Limited (Merchant Bank) and Merrill Lynch (Singapore) Pte Ltd. (Company Registration No.'s F 06872E and 198602883D respectively) and Bank of America Singapore Limited (Merchant Bank). Merrill Lynch International Bank Limited (Merchant Bank) and Merrill Lynch (Singapore) Pte Ltd. are regulated by the Monetary Authority of Singapore. Bank of America N.A., Australian Branch (ARBN 064 874 531), AFS License 412901 (BANA Australia) and Merrill Lynch Equities (Australia) Limited (ABN 65 006 276 795), AFS License 235132 (MLEA) distributes this report in Australia only to 'Wholesale' clients as defined by s.761G of the Corporations Act 2001. With the exception of BANA Australia, neither MLEA nor any of its affiliates involved in preparing this research report is an Authorised Deposit-Taking Institution under the Banking Act 1959 nor regulated by the Australian Prudential Regulation Authority. No approval is required for publication or distribution of this report in Brazil and its local distribution is made by Bank of America Merrill Lynch Banco Múltiplo S.A. in accordance with applicable regulations. Merrill Lynch (Dubai) is authorized and regulated by the Dubai Financial Services Authority (DFSA). Research reports prepared and issued by Merrill Lynch (Dubai) are prepared and issued in accordance with the requirements of the DFSA conduct of business rules.

Merrill Lynch (Frankfurt) distributes this report in Germany. Merrill Lynch (Frankfurt) is regulated by BaFin.

This research report has been prepared and issued by MLPF&S and/or one or more of its non-US affiliates. MLPF&S is the distributor of this research report in the US and accepts full responsibility for research reports of its non-US affiliates distributed to MLPF&S clients in the US. Any US person receiving this research report and wishing to effect any transaction in any security discussed in the report should do so through MLPF&S and not such foreign affiliates.

General Investment Related Disclosures:

This research report provides general information only. Neither the information nor any opinion expressed constitutes an offer or an invitation to make an offer, to buy or sell any securities or other financial instrument or any derivative related to such securities or instruments (e.g., options, futures, warrants, and contracts for differences). This report is not intended to provide personal investment advice and it does not take into account the specific investment objectives, financial situation and the particular needs of any specific person. Investors should seek financial advice regarding the appropriateness of investing in financial instruments and implementing investment strategies discussed or recommended in this report and should understand that statements regarding future prospects may not be realized. Any decision to purchase or subscribe for securities in any offering must be based solely on existing public information on such security or the information in the prospectus or other offering document issued in connection with such offering, and not on this report.

Securities and other financial instruments discussed in this report, or recommended, offered or sold by Merrill Lynch, are not insured by the Federal Deposit Insurance Corporation and are not deposits or other obligations of any insured depository institution (including, Bank of America, N.A.). Investments in general and, derivatives, in particular, involve numerous risks, including, among others, market risk, counterparty default risk and liquidity risk. No security, financial instrument or derivative is suitable for all investors. In some cases, securities and other financial instruments may be difficult to value or sell and reliable information about the value or risks related to the security or financial instrument may be difficult to obtain. Investors should note that income from such securities and other financial instruments, if any, may fluctuate and that price or value of such securities and instruments may rise or fall and, in some cases, investors may lose their entire principal investment. Past performance is not necessarily a guide to future performance. Levels and basis for taxation may change.

BofA Merrill Lynch is aware that the implementation of the ideas expressed in this report may depend upon an investor's ability to "short" securities or other financial instruments and that such action may be limited by regulations prohibiting or restricting "shortselling" in many jurisdictions. Investors are urged to seek advice regarding the applicability of such regulations prior to executing any short idea contained in this report.

Foreign currency rates of exchange may adversely affect the value, price or income of any security or financial instrument mentioned in this report. Investors in such securities and instruments effectively assume currency risk.

UK Readers: The protections provided by the U.K. regulatory regime, including the Financial Services Scheme, do not apply in general to business coordinated by BofA Merrill Lynch entities located outside of the United Kingdom. BofA Merrill Lynch Global Research policies relating to conflicts of interest are described at http://www.ml.com/media/43347.pdf.

Officers of MLPF&S or one or more of its affiliates (other than research analysts) may have a financial interest in securities of the issuer(s) or in related investments.

MLPF&S or one of its affiliates is a regular issuer of traded financial instruments linked to securities that may have been recommended in this report. MLPF&S or one of its affiliates may, at any time, hold a trading position (long or short) in the securities and financial instruments discussed in this report.