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The Cliff, the economy and capital markets

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Fiscal cliff: a macro sized shock

The fiscal cliff impacts the economy both by creating uncertainty and by imposing austerity. The CBO estimates that if the full Cliff were to happen and not be reversed it would cut growth in the first half of next year by 6.6%. Here we look at the impact of the Cliff across two dimensions: the size of the austerity hit and the degree of dysfunction in the decision process. At one extreme, if the Cliff is resolved before year end and there are only modest cuts then the economy could sail through, with first half GDP growth of 2 1/2% or so. At the other extreme, if we go over the Cliff for an extended period of time a recession is likely.

Rates implications: not much is priced in

We believe that the fiscal cliff affects yields through 3 channels – lower growth, lower Treasury supply and more Fed buying under QE3. We estimate that only $40-80bn of the cliff is priced in. Under our base case cliff scenario of $325bn and a contentious process of negotiation, we see rates re-testing lows, a flatter curve and higher 30y volatility. A surprise resolution without any long term austerity plans is likely to take rates much higher (10y close to 2.2%) with the curve steepening significantly. On the other hand, a resolution with some long-term deficit reduction plans is likely to lead to a more moderate sell-off.

Equity market implications

Our cautious near-term outlook as we approach year-end (our S&P 500 target remains 1450) is partly based on the fact that we may be in the early innings of cliff risk affecting earnings expectations. Downward guidance and revisions have been focused on Europe/global growth risk, and only more recently on risks to US growth/government spending. Market implications under various scenarios of the cliff range from the S&P 500 climbing as high as 1500 under a surprise resolution, to falling to 1250 if we were to go over the cliff for a short period of time before it is fixed retroactively. However, if we go over the cliff for an extended period of time and a recession ensues, we think the market could correct to 1000.

This report is an extract of a report of the same name published on 17 October 2012.

Refer to important disclosures on page 17 to 18. Link to Definitions on page 16.

The Cliff and the economy

The fiscal Cliff creates two potential shocks to the economy. First, there is a pre-Cliff uncertainty shock. This has both a micro and a macro dimension. The micro shock is that the government is threatening to change many of the rules around taxes and government spending. This makes business and investment planning very difficult. Most important, companies that have contracts with the Federal government will worry about the impact of the “sequester”—even if across-the-board spending cuts will be avoided they will not be sure if they are among those who will be cut. The macro shock is a threatened recession. If the whole Cliff happens and is not reversed, the CBO estimates a huge 6.6% shock to annualized growth in the first half of 2013. We would expect the uncertainty shock to weaken the economy both in advance of the Cliff and as long as major issues about the Cliff remain unresolved.

The uncertainty shock impacts some parts of the economy more than others. We would expect it to mainly impact hard to reverse, durable business spending decisions. Companies will want to postpone big new commitments until there is clarity around the Cliff. The biggest impact will likely be on capital goods spending, but we also expect some slowing in hiring and other business spending. By contrast, we would expect consumers to be less forward-looking and react later to the risk of the fiscal Cliff. As with businesses, the biggest potential impact is on big ticket items such as auto and home sales.

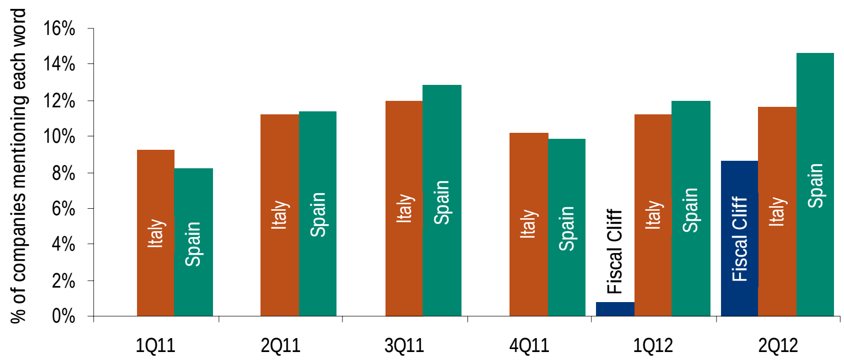
The second shock is the post-Cliff austerity shock. Again, the impact can be divided into micro and macro impacts. The direct micro effect depends on which parts of the budget are cut. As we will discuss in more detail, the two most likely first areas to be cut would be the payroll tax cut and extended unemployment benefits. Both of these cuts have the biggest impact on broad-based consumer spending. The other micro shocks depend on politics: high-end retailers will likely be very sensitive to what happens to upper-income tax rates and industries with government contracts will be impacted by how the “sequester” is modified.

The indirect macro impact is a general demand shock to the economy. When taxes are increased or spending is cut, it takes time for resources to shift in the economy. In the long-run, the resulting deficit reduction can spur growth by reducing the path for interest rates and shifting resources into more productive uses. However, in the short-run, the austerity hurts spending and growth. The International Monetary Fund has recently highlighted research that shows that the impact of fiscal austerity is more damaging when the economy is already weak. This is because the main constraint on growth is a lack of demand and fiscal austerity makes that worse. Moreover, when interest rates are already near zero, central banks have a hard time offsetting the negative impact of austerity.

When in doubt, wait

How big is the uncertainty shock? The Cliff has become a major focus of concern in the business community. Back in the second quarter, companies started to focus on the Cliff in their earnings reports, but concerns about the Cliff were a distant second to concerns about Europe (Chart 1). More recently, the Cliff has moved to the top of the list for many surveys:

Chart 1: Concerns about the Cliff are second to Europe, but rising fast



fSource: BofA Merrill Lynch US Equity & Quant Strategy, StreetEvents

- Our recent survey of Chief Financial Officers found that the “effectiveness of U.S. government leaders” is the number one concern of business leaders.
- The latest survey of business confidence from the Business Roundtable fell sharply on Cliff concerns.
- In July, a Chamber of Commerce survey of 1225 small business found that 65% of companies were “very concerned” about the Cliff, 25% were somewhat concerned, and only 10% were either “not very concerned” or “not concerned at all.”

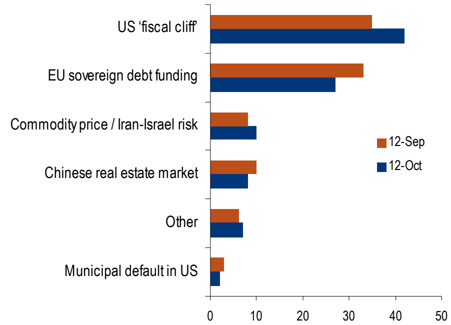
The Cliff has also risen to the top of concerns for investors:

- Our US fund managers survey for the month of October shows the Cliff surging to the top of investor concerns (Chart 2).
- The Cliff has also become the number one concern in our FX/Rates survey and even in our European fund manager survey.

Clearly people are worried, but is their bark stronger than their bite? Is actual behavior changing? Here the evidence is mixed. So far the strongest evidence comes from capital goods orders. As Chart 3 shows, the growth in capital goods orders has been slowing throughout the recovery, reflecting a general lack of faith in the economy. This summer, however, growth plunged into negative territory. Some of the initial drop probably reflected European concerns, but as Europe stabilized over the summer, the latest drop appears to be Cliff related. After all, given the long delivery lags, businesses have to decide early whether to postpone capital goods orders. We expect this weakness to be reflected in a mild capital good recession, with the growth in real spending on equipment and software falling from 5% in recent quarters to negative 2% in both Q4 and Q1.

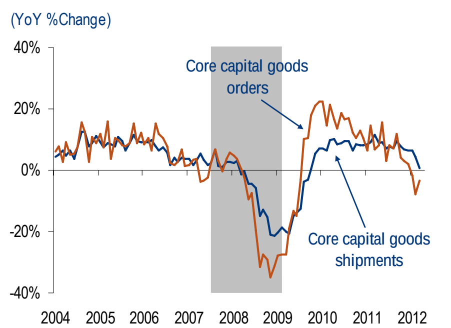
In our view, the second major shoe to drop should be employment growth. Seasonal distortions caused a big up-then-down pattern for private payrolls earlier this year, but the more recent movements have been inconclusive. Private payrolls have been growing at a trend-like 100,000 in each of the last two months. Our forecast is for payroll growth to drop close to zero by year end (Chart 4). If the uncertainty shock story is correct, the slowdown should come mainly due to delays in hiring. Keep in mind that in a typical month roughly 4 million people lose their jobs and roughly 4.1 million people are hired, for a net gain of 0.1 million jobs. Hence if hiring slows by just 2 ½%, payroll employment growth stops.

Chart 2: The top concern among US investors



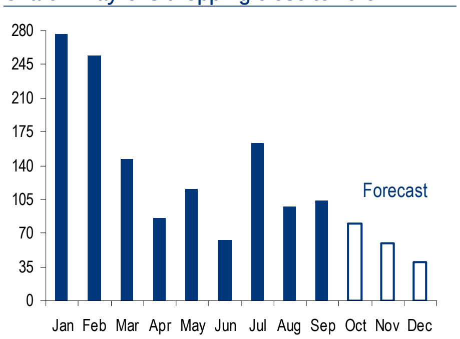
Source: BofA Merrill Lynch Global Research

Chart 3: Cooling capital



Source: BofA Merrill Lynch Global Research, Census Bureau

Chart 4: Payrolls dropping close to zero



Source: BofA Merrill Lynch Global Research, Bureau of Labor Statistics

Cliff scenarios: time and money

The market impact of the Cliff depends on how much of the Cliff is already priced in and how the Cliff is resolved. Before turning to what is priced in, let's consider the range of possible Cliff scenarios. In our view, much of the discussion of the Cliff is oversimplified, focusing just on the size of the austerity shock. In reality, the decision process will matter as well as the outcome.

A simple illustration underscores this point. Consider two scenarios. In the first, all of the Cliff is resolved before year end with a modest 1.5% of GDP tightening. In the second, due to infighting in Washington no agreement is reached, the entire Cliff austerity kicks in and it takes 2 months of painful negotiation to forge a compromise to do the same cuts as in the first scenario. Unless uncertainty is irrelevant to the economy and markets, clearly the second scenario is much more damaging to growth.

With this in mind, we look at cliff outcomes across two dimensions: time and money. Note that policy makers have left themselves with a huge list of items to resolve—payroll taxes, unemployment benefits, the "Bush" tax cuts, the "sequester", the annual mini-cliff of expiring programs, the debt ceiling, and so on. And they have given themselves a very short time frame to work through this list—the election ends on November 6th and then the Cliff needs to be resolved by the outgoing "lame duck" government before year-end.

With this in mind, we consider three scenarios for the timing of the Cliff resolution:

1. **Fix before year end**—In the best case scenario, there is a quick meeting of minds after the election. Politicians "turn their swords into plowshares" and work out a compromise around all the major elements of the Cliff. The only outstanding items are longer term Medicare and tax reform. Given the long list of items and the short time frame, we see only a 15% chance of a full resolution by year-end.

2. **Multi-stage fix**—In our view, the most likely outcome is a multi-stage fix. The key to resolving the Cliff is to get the most reluctant party to agree to compromise. Hence, in December we expect fiscal conservatives to agree to delay most of the Cliff for two or three months in exchange for modest initial austerity (letting the payroll tax cut and perhaps extended unemployment benefits expire) .We assume that fiscal conservatives will be unwilling to delay everything for a long period of time because it means giving up their bargaining chips from both last year's debt ceiling and the new debt ceiling. We assume that it takes three tries to work through all the elements of the cliff by April. We see a 60% chance that it takes several tries to resolve the Cliff.

3. **Retroactive fix**—A growing risk is that politicians decide to let the whole Cliff occur and then attempt to reverse much of it after the fact. Several factors could make this scenario likely: (1) a change in power in Washington so that the new government decides it can get a better deal when it is in power in late January, (2) a belief that going over the Cliff has a small negative impact on the economy and markets and is a reasonable price to pay for getting a good long-run deal, and (3) after using the debt ceiling as a negotiating tool, politicians decide the Cliff is also a good negotiating tool. For this scenario we assume it takes two months to resolve all the Cliff items and only after substantial pressure from the markets and the economy. We assign a 25% probability to this bad outcome.

Table 1: Three degrees of austerity

Austerity		Three scenarios		
	Full cliff	small	medium	large
Payroll tax cut expires	$120	$120	$120	$120
Extended unemployment expires	$40		$40	$40
Sequester	$110		$30	$70
Income tax increase	$180		$20	$60
Obama care taxes	$20	$20	$20	$20
Other:				
"Mini Cliff"	$160			
"Under radar screen"	$90	$90	$90	$90
Total austerity	$720	$230	$320	$400
(% of GDP)	4.6%	1.4%	2.0%	2.5%

Source: BofA Merrill Lynch Global Research

We also assume three different scenarios in terms of the ultimate amount of austerity imposed. Table 1 shows the breakdown of the Cliff and three scenarios. While politicians could decide to allow the whole Cliff to happen temporarily, ultimately we would expect some watering down. We consider three scenarios of roughly equal probability:

1. **Small**: At minimum we would expect three kinds of austerity. In our view, the payroll tax cut has the weakest political support. It is supposed to be temporary, it was hard to extend earlier this year and we believe fiscal conservatives will need to be placated with some kind of cut. Obamacare taxes are likely to kick in for at least some period of time because reversing that legislation could be quite time consuming. There is also about $90bn of programs that are likely to expire without debate.

2. **Medium:** More likely there will be some further cuts out of whatever compromise emerges, including allowing extended unemployment benefits to expire, a small cut in discretionary spending (substituting for the sequester) and a token tax increase on upper incomes (perhaps through some loophole changes).

3. **Large:** If fiscal conservatives bargain aggressively, the spending cuts under the medium scenario could be bigger. At the same time liberals could demand significant tax increases from upper-income payers.

Table 2: The impact on H1 GDP growth

	Three degress of austerity		
	small	medium	large
Probability	30%	40%	30%
Fix before year end			
H1 GDP growth	2.5	2.0	1.5
(Probability)	5%	6%	5%
Multi stage fix			
H1 GDP growth	1.5	1.2	0.5
(Probability)	18%	24%	18%
Retroactive fix			
H1 GDP growth	0.0	-1.0	-1.5
(Probability)	8%	10%	8%

Source: BofA Merrill Lynch Global Research

The scenario matrix (Table 2) puts it all together and applies rough estimates of the GDP impact for the first half of 2013. Note that we believe the size of the cuts is less important than the process. Thus moving across the table, larger cuts cause somewhat weaker growth, while moving down the table, policy dysfunction has a very big impact on the economy. At one extreme, if the whole cliff is resolved before year-end and the cuts are modest, the economy survives largely unscathed, growing 2.5% in the first half (and then accelerating further). At the other extreme, going over the Cliff for two months and then imposing either medium or large cuts results in a mild recession. Our baseline forecast is in the middle of the table: medium sized cuts, after multiple tries means growth of just above 1%. Taking this all a step further, using the probabilities of each outcome, the “expected value” for GDP growth is 0.7%, reflecting the skewed downside risks to the forecast.

Table 3: Split government

Intrade	President	Senate	House	Sweep
Democrat	62	65	8	3
Republican	38	23	92	23
Neither	0	13	0	74

Iowa	President	Senate	House
Democrat	67	74	11
Republican	34	25	87

Source: BofA Merrill Lynch Global Research, Intrade, Iowa Electronic Markets

How does the election impact these scenarios? Under almost any election outcome the Cliff remains a major challenge. Table 3 shows the implied probabilities from the Intrade and Iowa electronic markets. While the Presidential divide has narrowed, as this goes to press Obama is still favored to win the electoral college. Both electronic markets and the Five-Thirty-Eight website (run by the New York Times) also show him leading. Democrats are also favored in the Senate, but trail badly in the House. If these markets are correct, the status quo will continue after the election.

Our tables assume split government continues, but we believe the probability of the various outcomes only changes modestly based on the election outcome. Consider the continuing challenges:

- Since the Cliff has been almost invisible in the election debate, there will be no clear mandate on how to fix it after the election.

- The old lame duck government will still have to make the first decision around the Cliff.

- Under almost any scenario, the minority party will have more than forty seats in the Senate and will be able to block or slow legislation.

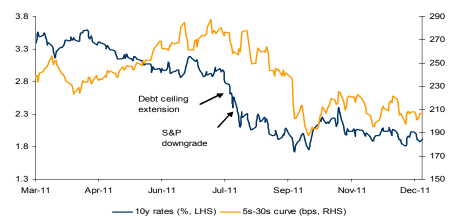
- While a sweep does increase the odds of a quicker resolution once the new government is in place, it actually increases the odds of going over the Cliff during the transition period. The new government might decide it can get a better deal once it is in power in late January.

Rates market implications

The fiscal Cliff affects Treasury yields through four channels:

- **Growth**: We don't believe that either a recession or solid growth are currently priced into the market.
- **Risk aversion**: If uncertainty is high around the resolution of the Cliff, investors will be inclined to seek the safety of government debt. As with the debt ceiling debate last summer, ironically the Treasury market will likely benefit from bad behavior (Chart 5).
- **Less Treasury supply**: The higher the Cliff, the lower the deficit and the lower is Treasury supply for 2013. Net issuance of Treasuries can vary between $600bn and 1200bn in 2013 (versus $1160bn in 2012), depending on the extent of the cliff.
- **More Fed buying**: A larger Cliff will translate into lower growth and likely greater Treasury buying (or a longer period of Treasury and MBS buying) by the Fed after the end of Operation Twist. Hence, net supply of Treasuries to the private market is likely to be substantially lower, both due to lower deficit and higher Fed buying.

Chart 5: Rates declined and the curve flattened last year primarily due to risk aversion



Source: BofA Merrill Lynch Global Research

Given the above, there is reason to believe that due to supply-demand dynamics, Treasury rates could decline further despite weaker growth being priced in already. We address the impact on rates using the two dimensions mentioned above: Cliff magnitude and process.

How much of the Cliff is priced in?

To estimate the amount of fiscal contraction priced in the rates, we use a model for the 10y rate based on the following variables: 1) Growth 2) Forward guidance 3) Risk aversion 4) Term premium 5) Share of riskless sovereign bonds.

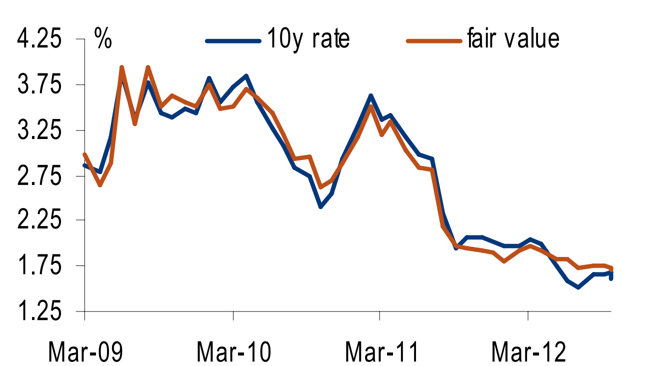
We fit the model to the current Fed-on-hold regime starting in 2009 (Chart 6).

Table 4: Model parameters

variable	beta	t-stat
constant	-0.43	-1.04
1y growth, %	0.20	8.82
2y rate, %	1.12	6.12
BTP/Bund spread, %	-0.03	-0.52
share of Aa2+ sovereign bonds, %	0.01	4.35
1y10y swaption vol, bp	0.01	4.47
R2=96%		

Source: BofA Merrill Lynch Global Research

Chart 6: The 10y rate is well explained by our variables



Source: BofA Merrill Lynch Global Research. Paramters for this model can be seen on Table 4

Although many of our variables were also important determinants of rates before 2009, the quantitative relationship between those variables and the 10y rate experienced a structural shift since early 2009 as we transitioned to the regime of a zero policy rate, most likely due to unconventional monetary policy and shortage of riskless assets. It is therefore necessary to constrain our analysis to a somewhat short time sample.

All our variables have intuitive directional impacts and are statistical significant, with the exception of risk aversion (Table 4). The reason risk aversion is insignificant is that it is highly correlated with the share of riskless bonds in our sample. Nevertheless, jointly these two variables are highly significant. Although inflation and inflation expectations should, theoretically, also determine the level of the 10y, we have found that inflation-related variables are insignificant in our regression framework, probably because inflation is mostly determined by growth expectations, already incorporated in our model.

According to our model, the market is pricing in about 1.55% growth for Q1-Q3 2013 which is lesser than the recent trend of 2.2% (growth rate achieved in 4Q 2011-2Q2012). This translates to about 0.5% cumulative drag on growth in 1H 2012, which we attribute primarily to pricing in of the fiscal Cliff. *Therefore, we estimate that about $40- 80bn of fiscal tightening is priced in to 10y rates at current levels.*

The process could be more important in the near term

This would argue for a decline in rates even if a medium portion of the Cliff (>100bn) were to pass through and vice versa a rise in rates if the Cliff is completely extended. Ultimately fundamentals matter and we believe that any fiscal drag of >1% is likely to impact growth and will translate into lower rates and a flatter curve.

However, the near-term rate reaction is more likely to be determined by the following two factors:

- **The process** through which a deal has been achieved. A relatively smooth and credible bipartisan process is likely to boost confidence and may lead to relief rise in rates.
- **The reaction of risk assets** to the resolution. If the risky asset market takes a smooth process and the fact that the worst case scenario has been averted as a significant positive, rates are likely to back up in the near term.

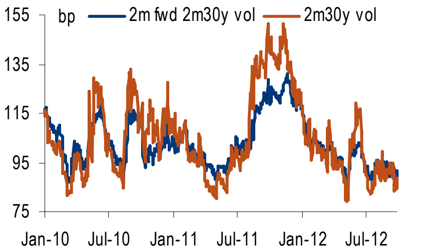
Rates implications of the cliff scenarios

1. Multi-stage fix: Lower rates, flatter curve, higher vol

Our economists' base case scenario of total fiscal tightening of $325bn and a multi-stage fix would argue for lower rates, a flatter curve and higher volatility. 10y rates can re-test lows (1.4%) in this scenario. But the reaction could be partially offset by increase in inflation expectations if the Fed steps up its response with large scale Treasury buying during QE3. In this scenario, we can also see the 5s-30s curve flatten by 25bp (under a scenario in which breakevens decline 25bp and the S&P 500 retests 1300 based on the model described here).

A multi-stage fix also argues for a volatile period after the election. The debt ceiling complicates the process much more, and adds uncertainties to the US rating outlook as well. Currently, we project the debt ceiling to be hit by mid January. Using some extraordinary measures, the Treasury is likely to be able to extend this date to late Feb/early March 2013. The significant coupon and

Chart 7: 30y vol richened by August 2011



Source: BofA Merrill Lynch Global Research

Chart 8: The surprise fiscal easing agreement by Congress in 2010 was met with a relief sell off in rates and increased growth projections

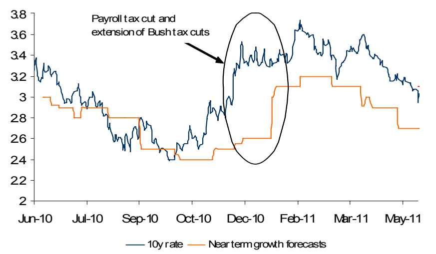


Chart shows 10y rate vs. Bloomberg economic forecasts. Post June, forecasts for the following year are used. Source: BofA Merrill Lynch Global Research, Bloomberg

Table 5: Current rating agency outlook on US sovereign debt

	Current rating	Outlook	Effective
S&P	Aa+	Neg	8/5/2011
Moody's	Aaa	Neg	8/2/2011
Fitch	AAA	Neg	11/28/2011

Source: Bloomberg

maturing debt payments during the February refunding (2/15/2013) may shorten the "extraordinary measures" period relative to 2011. Thus we would expect a period of significant volatility and uncertainty around the turn of the year, but believe the market is likely to stay in a range until the election. In this scenario we expect 3m30y volatility to richen to 1m30y volatility.

2. Retroactive fix: Significant flattening of the curve

In this less likely worst case scenario, in which the whole cliff is allowed to hit the economy, at least temporarily, we expect 10y rates to make new lows around 1.25%. A reduction in supply, risky-asset sell-off and increased Fed buying are likely to take rates much lower from current levels. Worries about a recession are also likely to mean a much flatter curve. We expect the 5s-30s curve to flatten by 50-70bp in this scenario.

3. Fix before year end: much higher rates if no austerity

There is also a chance that Congress resolves the cliff before year end – either by a plain "kick of the can" with no accompanying austerity plans, or by a postponement of the Cliff along with a Simpson-Bowles-like long-term deficit reduction plan. Note that in 2010, rates rose significantly after Congress effectively kicked the can by extending the Bush tax cuts and cutting payroll taxes. However, there are some critical differences with 2010, which make us more pessimistic about such a deal. The need to extend the debt ceiling at the same time along with rating agency fears complicates the decision much more. Further, the cliff is much larger than what we faced in 2010. And finally, the presidential election has never been this negative or this focused on fiscal issues in the past, which makes it difficult for both parties to compromise right after the election.

If Congress somehow agrees to fix the issue before year end by kicking the entire cliff by a year (with no austerity plans), we expect 10y rates to back up to 2.25%. The rate increase would not only be driven by a boost to growth expectations and risky asset cheer but also highlight that politicians are not ready to deal with the longer deficit issue anytime soon. This is likely to mean a significant steepening of the 10s-30s curve. If the kick of the cliff accompanies a longer term deficit reduction plan, the steepening and the sell off is likely to be less pronounced.

Rating agency implications

We expect some rating agency actions in 2013. Table 5 illustrates the current ratings on US sovereign credit. The rating agencies are watching the process to determine how it might impact the medium term ability to reduce the deficit. We believe the agencies will continue to keep the US on a negative watch in the near term. Potential triggers for a downgrade in 2013 could be

- **A messy process** in which Congress and the White house have great difficulty in addressing the Cliff and the debt ceiling. A situation similar to 2011 where Congress fails to act on the debt ceiling until the "drop dead date" could lead to a negative credit watch (rather than a negative outlook) or even a downgrade if cooperation fully breaks down.

- **A postponement of the cliff** by a year or more without any long term deficit reduction plan. This could lead to a downgrade in 2013 by all the major rating agencies.

Moody's: Moody's has been quite explicit in their reaction function to the fiscal cliff, in our view. Although they expect to resolve their negative outlook in 2013, they may extend their observation period (holding the Aaa rating with negative outlook) into 2014 if a large fiscal cliff hits the economy. In this case they would wait to see the resulting impact on growth. If a medium term plan to stabilize the debt emerges, the rating would probably be affirmed and the outlook returned to stable. In the event that Congress fails to produce such a plan, they could lower the rating, probably to Aa1.

S&P: S&P emphasizes that their rating stance is most dependant now on the political and fiscal risk factors (2 of their 5 sovereign risk factors which include monetary, external, and economic factors). Political and fiscal risks would only ease in the event that strong bipartisan support creates a credible medium term fiscal consolidation plan. While they recognize that a postponement of the cliff may be warranted (and is part of their base case outlook), they generally view the fiscal and political factors to be slowly worsening over time. To prevent an eventual downgrade, S&P would need to see a reversal in both of these trends.

Equity market implications

While we are reasonably optimistic on equities for the long-term, as reflected by our 2013 year-end S&P 500 target of 1600, one reason we remain cautious on equities for the next few months is the likelihood for heightened volatility and the potential for a near-term correction amid the risks posed by the US presidential election and the fiscal cliff. We have retained 1450 as our 2012 year-end target but suspect that the risk-reward is currently skewed to the downside.

We see macro and micro risk for the remainder of the year.

Downside risk is evident for both macro and micro reasons. We expect more downward revisions to earnings amid a potentially choppy earnings season, an environment that is normally accompanied by flat to negative market returns. From a macro perspective, economic growth could disappoint in the second half and early next year, as uncertainty weighs on business and consumer spending in anticipation of the fiscal cliff. This could add to the drag on growth from both the recession in Europe as well as decelerating growth trends in emerging markets.

In a recent sentiment survey conducted by our Rates and FX team, 50% of respondents believe the total cliff will be $300bn or under, out of a possible $700bn. But the greatest pain is forecast for equities, where 55% of respondents see this as the market with the least priced risks, while holding the largest downside. And the majority of respondents believe the impact occurs in the next two quarters.

Given the risk the cliff poses to the equity market, we explore some scenarios around the fiscal cliff and its impact on US equities in the near term on pg 14.

Equity investors are worried about the cliff…

As we approach the US presidential election, the media has increasingly been highlighting the risks pertaining to the fiscal cliff, and the topic has also increasingly begun to dominate our meetings with institutional investors. Our Global Equity Strategy team's October Fund Manager Survey results suggest that the fiscal cliff has become firmly established as the #1 risk for investors (42% of respondents vs. 27% for the EU debt crisis), after modestly eclipsing the EU crisis in last month's survey.

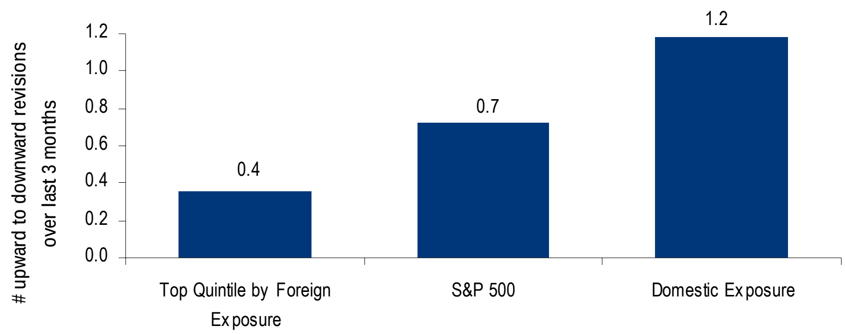
…but earnings may only be starting to reflect this

Up until the last quarter, corporations had been keeping surprisingly mum on the topic. We counted the number of companies in the S&P 500 mentioning various key words during their earnings conference calls, going back to 2010. Companies appear to be more focused on problems in Europe than they are with the policy issues at home. In fact, it was not until 1Q earnings that a single company mentioned the fiscal cliff, and even in the latest completed earnings season, the fiscal cliff was cited by fewer than 10% of companies (Chart 9). To put this into perspective, more companies talked about Spain and Italy, which we estimate make up less than 3% of S&P 500 revenues, than talked about the cliff. And earnings downgrades have been focused more on stocks with global exposure than on stocks with pure domestic exposure (Chart 10).

Chart 9: Companies have been more focused on the problems in Europe than the fiscal cliff

Source: BofA Merrill Lynch US Equity & Quant Strategy, StreetEvents

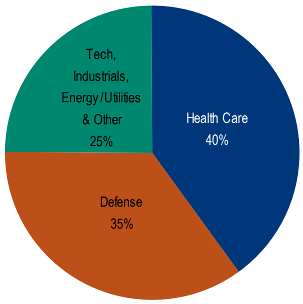
Chart 10: Three-month ERR for foreign-exposed vs. pure domestic stocks in the S&P 500



Source: BofA Merrill Lynch US Equity & US Quant Strategy, I/B/E/S

But we appear to be in the early days of corporations scaling back on fiscal cliff concerns. Based on the US Machinery team's most recent dealer survey, Senior Machinery analyst Ross Gilardi notes that the outlook in North America deteriorated. 50% of dealers are expecting decreased purchasing of new equipment in the next six months and many dealers cited a combination of political gridlock/elections/fiscal cliff/uncertainty regarding infrastructure spending projects.

Chart 11: S&P 500 Govt. Exposure by Sector



Source: BofA Merrill Lynch US Equity & US Quant Strategy

Is the cliff priced in?

Sectors with direct exposure may be discounting the cliff…

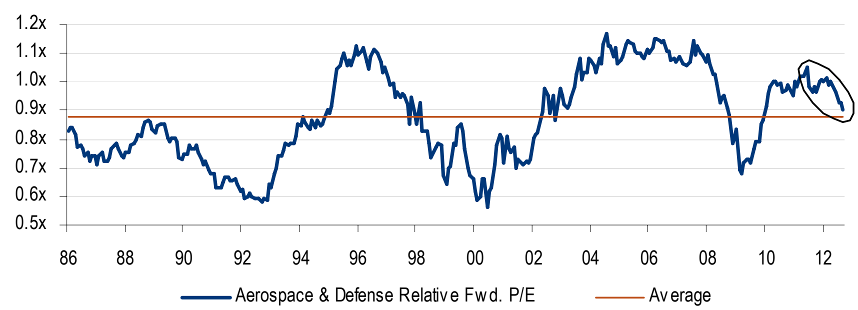
Sectors and industries with direct government exposure may be pricing in some cliff risk. As Chart 11 shows, three quarters of the S&P 500's US government spending exposure (which amounts to 8-10% of S&P 500 revenues) is from Health Care and Defense. Table 6 below summarizes the projected automatic cuts that would begin in 2013 from sequestration, one of the biggest components of the fiscal cliff (Table 7). Defense would be the hardest hit, with $55bn/year in spending cuts (6-8%/year, with the biggest hit in 2013). As Chart 12 shows, Aerospace and Defense's relative forward P/E has been contracting since last year.

Table 6: Automatic cuts by category ($bn and %) in the event of sequestration

Billions $	2013	2014	2015	2016	2017	2018	2019	2020	2021	Total 2013-21
Defense	-55	-55	-55	-55	-55	-55	-55	-55	-55	-492
Nondefense Discretionary	-39	-38	-37	-36	-36	-36	-34	-33	-33	-322
Medicare	-11	-11	-12	-13	-13	-14	-15	-16	-17	-123
Other Mandatory	-5	-5	-6	-6	-5	-5	-5	-5	-5	-47
										$984
% Cut	**2013**	**2014**	**2015**	**2016**	**2017**	**2018**	**2019**	**2020**	**2021**	
Defense ex. Overseas Contingency (Wars)	10.0	9.8	9.7	9.5	9.3	9.1	8.9	8.7	8.5	
Defense Total	7.5	7.3	7.2	7.0	6.8	6.7	6.5	6.4	6.2	
Nondefense Discretionary	7.8	7.4	7.1	6.8	6.6	6.4	6.1	5.8	5.5	
Medicare	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	
Other Mandatory	7.8	7.4	7.1	6.8	6.6	6.4	6.1	5.8	5.5	

Source: CBO, BofA Merrill Lynch US Equity & US Quant Strategy

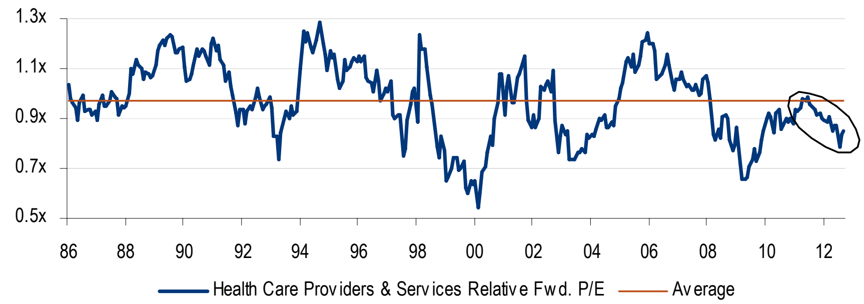
Chart 12: Aerospace & Defense Relative Forward P/E (1986-9/2012)



Source: I./B/E/S, BofA Merrill Lynch US Equity & US Quant Strategy

According to our Health Care analysts, cuts to Medicare and Medicaid could be $200-300bn over 10 years (vs. $123bn in cuts to Medicare from sequestration). This would have direct and indirect impacts on many industries including lab services, hospitals and managed care companies. Reductions in discretionary spending could also impact research funding from organizations such as the National Institutes of Health (NIH), impacting industries such as medical devices and life science tools and services. While Health Care Reform may offset some of these cuts given increased insurance coverage and therefore greater demand for pharmaceuticals and services, overhang on the sector is still apparent. Health Care Providers and Services, which has the greatest direct US government exposure, has seen its relative P/E contract since late last year, trading at a discount to its historical average multiple (Chart 13).

Chart 13: Health Care Providers & Services Relative Forward P/E (1986-9/2012)



Source: I./B/E/S, BofA Merrill Lynch US Equity & US Quant Strategy

...but some impacted industries may not reflect true risk

There is some evidence that, even for the most impacted industries, investors are not fully pricing in the cliff. Recently, Aerospace & Defense company Rockwell Collins lowered its guidance well below consensus to incorporate the full impact of sequestration, stating that it is "more than reasonable" to assume sequestration will occur. Despite the lowered guidance, the stock traded up on the day, as the guidance was generally in-line with consensus, excluding the impact of sequestration. As we move closer to the end of the year with no resolution on the sequestration issue, this could become a bigger overhang for these stocks.

Note: Please see Appendix for S&P 500 stocks with the highest direct sales exposure to US government spending.

Table 7: Sizing up the shock: US fiscal cliff

Pending tax increases	
Bush tax cuts	$180 bn
AMT	120 bn
Payroll tax	120 bn
Tax extenders	20 bn
Obamacare	20 bn
Business expensing	10 bn
Pending expiring programs	
Extended UI	$40 bn
Medicare doc fix	20 bn
Other programs	40 bn
Pending spending cuts	
Sequester	$110 bn
Initial debt plan	40 bn
Total	$720 bn
Percent of GDP	4.6%

Source: BofA Merrill Lynch Global Research, Congressional Budget Office

Sectors with indirect exposure also at risk

Other sectors and industries that may be affected less directly by the fiscal cliff may not be discounting the impact. If all or most of the fiscal cliff were to occur, this could result in as much as a 4.5% hit to US GDP growth, which could force the US into a recession and would likely be detrimental to US consumer spending.

Additionally, as companies spend less on capex and reduce hiring until they get more clarity on the policy outlook, this could weight on industrial production and big-ticket spending. Admittedly, the current rate of spending is below normal, and suggests that the impact to the economy could be less dramatic than it would be in a more normal economic cycle.

As companies spend on capex and reduce hiring until they get more clarity on the policy outlook, this could weight on industrial production and big-ticket spending.

Less dramatic but maybe more likely, if the Bush Tax Cuts were left to expire, at least for the higher income brackets, this could negatively impact the luxury goods retailers.

The indirect impact of the cliff does not appear to be discounted at all in the Consumer sector: Nearly every industry within Consumer Discretionary is trading at a premium to its historical average relative P/E multiple (Table 8). Only Autos, which may be more tied to Europe/global growth expectations, and Media, which is driven more by business spending and tends to be less cyclical, are historically inexpensive.

Table 8: Consumer Discretionary Relative Forward P/E vs. S&P 500 (1986-9/2012)

	Forward P/E (Relative)		
Consumer Discretionary *(# of co's)*	Current	Average	Implied upside
Auto Components (3)	0.70	0.82	17%
Automobiles (2)	0.59	0.73	25%
Hotels Restaurants & Leisure (11)	1.35	1.17	-14%
Household Durables (7)	1.17	0.88	-25%
Internet & Catalog Retail (5)	3.69	2.88	-22%
Leisure Equipment & Products (2)	1.02	0.88	-13%
Media (16)	1.09	1.63	50%
Multiline Retail (8)	1.02	1.07	6%
Specialty Retail (17)	1.17	1.15	-2%
Textiles Apparel & Luxury Goods (5)	1.25	0.93	-26%

Source: I./B/E/S, BofA Merrill Lynch US Equity & US Quant Strategy

Consumer Discretionary stocks valuations do not appear to be discounting cliff risk.

Our outlook assumes about half of the cuts go through

Our US Economics team does not believe this entire can can be kicked down the road given the unprecedented size of the cliff, and assumes that approximately half of the $720bn cliff will occur. This would result in a 2% hit to economic activity over four quarters, and forms the basis for their US GDP growth forecast of just 1.4% for 2013. The election results are not likely to have a big impact on how much of the $720bn cliff is allowed to happen, but would likely impact the internals of the deal (Table 9). For example, if President Obama is re-elected, we would be more likely to see the Bush tax cuts expire for the highest income earners. But if the Republicans were to sweep, we would be more likely to see a larger portion of discretionary spending cuts implemented and a higher likelihood of a repeal of Health Care Reform. Either way, we expect to see roughly $300bn of cliff-related drag in 2013.

Table 9: Our economics team's fiscal cliff forecasts under three scenarios

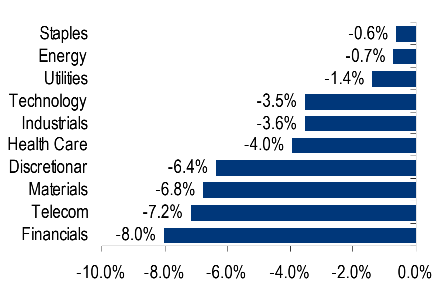
	Split govt.	Republican sweep	Democratic sweep
Payroll tax cut	120	120	$0 - 120
Extended Unemployment	40	40	0
Debt ceiling II	50	75	50
Bush tax cuts	10	0	40
Obamacare	20	0	20
Annual extenders	0	0	0
Stealth tightening	90	90	90
	$330	$325	$200-320

Source: BofA Merrill Lynch Global Research

EPS bull/bear scenarios

Our earnings forecasts incorporate the direct impact on growth from the partial fiscal cliff as well as the indirect impact as consumers and businesses delay hiring/spending in anticipation of the fiscal cliff. As a result, our forecasts remain below consensus across every sector, with a particularly cautious outlook for government-exposed, cyclical and big-ticket/luxury consumption related industries. If the most of the $720bn fiscal cliff were to impact growth in 2013, we could see EPS fall to a level in line with the $80 we laid out in our recessionary scenario back in July. This represents about 25% downside to our current $109 forecast for 2013. In contrast, in the unlikely scenario that we saw little or no impact from the fiscal cliff, EPS could rise as high as $122 (12% above our current forecast) depending on how the European crisis plays out.

Chart 14: BofAML 2013 EPS vs. consensus



Source: BofAML US Equity & Quant Strategy, S&P

Table 10: 2013 Base/Bull/Bear Scenario Analysis for Earnings

	Base Case	Bull Case	Diff from Base Case (%)	Bear Case	Diff from Base Case (%)
Consumer Discretionary	90.8	97.0	6.9%	70.0	-22.9%
Consumer Staples	89.9	92.0	2.4%	84.0	-6.5%
Energy	128.0	150.0	17.2%	70.0	-45.3%
Financials	165.1	190.0	15.1%	90.0	-45.5%
Health Care	118.1	127.0	7.5%	100.0	-15.3%
Industrials	99.8	115.0	15.2%	75.0	-24.8%
Information Technology	209.6	234.0	11.6%	170.0	-18.9%
Materials	34.9	38.0	9.0%	20.0	-42.6%
Telecom	21.3	23.0	8.2%	17.5	-17.6%
Utilities	30.3	32.0	5.7%	27.0	-10.8%
S&P 500 EPS	109.0	122.0	11.9%	80.0	-26.6%

Source: BofAML US Equity & Quant Strategy, S&P

Near-term cliff scenarios for the S&P 500

Given the near-term uncertainty caused by the fiscal cliff, we provide some scenarios around the fiscal cliff for our S&P 500 year-end target.

1. Multi-stage fix (base case)

In this most likely scenario, we see modest multiple expansion based on improving visibility. Earnings in this environment would likely come in below consensus' estimates and closer to our published earnings expectations to reflect anemic GDP growth. But a significant sell-off in equities on a larger cliff amount than what is currently anticipated would be mitigated by negative sentiment, conservative positioning of investors and attractive valuations for US equities, factors which we expect to drive the market higher in the next twelve months. Continued uncertainty could keep corporate cash spend at current low levels. Our expected range for the S&P 500 in this scenario would be 1350 to 1500, encompassing our year end S&P 500 target of 1450.

2. Fix before year end

A significant amount of uncertainty overhang would be lifted by year end, which could translate into multiple expansion as well as a confidence boost to corporations that could drive accretive cash use. Stronger growth prospects for the first half if the cliff amount is in-line with or smaller than market expectations would also translate into a lift to 1Q13 and 2Q13 earnings. Our expected range for the S&P 500 in this scenario would be 1400 to 1600, where in the best case scenario, this would effectively pull forward our projected equity gains for the full year of 2013, and would mirror returns seen during the relief rallies of 1Q12 and 3Q12. That said, if we see a larger austerity program than what market participants are currently expecting, this would likely cap any rally based on improving visibility. Additionally, the closer we get to year-end with no resolution, the more downward pressure we would expect to see on the market.

3. Retroactive fix

In this less likely scenario, in which the whole cliff occurs and then is partially reversed after the fact, we would expect to see a significant sell off in equities. The feedback loop that a market sell-off would create is important to consider, as a dramatic sell off would likely spur quicker resolution. For context, the market sell-off ahead of TARP was 12% (from 9/19/08 to 10/3/08) with a one day drop of 9% occurring after the House initially failed to pass TARP. A similar sell-off today would put the S&P 500 near 1300 on a one day drop, with a full correction approaching 1250. In the event that this scenario caused a full-blown US recession, we would expect to see support near 1000, accompanied by a 20% decline in S&P 500 earnings (typical in a recession). We would expect a PE multiple comparable to that of the most recent recession, in line with a peak equity risk premium of about 850bp.

Appendix

Table 11: S&P 500 companies with direct government sales exposure

Ticker	Company	Sector	Industry	% Sales Exposure	Notes
SAI	SAIC Inc.	Information Technology	IT Services	97%	Defense
NOC	Northrop Grumman Corp.	Industrials	Aerospace & Defense	90%	Defense
LMT	Lockheed Martin Corp.	Industrials	Aerospace & Defense	82%	Defense - 99% of total sales (82% US, 17% foreign)
LLL	L-3 Communications Holdings Inc.	Industrials	Aerospace & Defense	82%	Mostly defense
HUM	Humana Inc.	Health Care	Health Care Providers & Services	77%	Health Care
RTN	Raytheon Co.	Industrials	Aerospace & Defense	74%	Defense - 86% of total sales (74% US, 12% foreign)
HRS	Harris Corp.	Information Technology	Communications Equipment	73%	Mostly defense
GD	General Dynamics Corp.	Industrials	Aerospace & Defense	69%	Defense
DVA	DaVita Inc.	Health Care	Health Care Providers & Services	66%	Health Care
LIFE	Life Technologies Corp.	Health Care	Life Sciences Tools & Services	55%	Academic & government; 15-20% NIH exposure
FLIR	FLIR Systems Inc	Information Technology	Electronic Equipment Instruments & Components	50%	Defense
VMC	Vulcan Materials Co.	Materials	Construction Materials	50%	Public works
THC	Tenet Healthcare Corp.	Health Care	Health Care Providers & Services	50%	Health Care
BA	Boeing Co.	Industrials	Aerospace & Defense	47%	Defense
COL	Rockwell Collins Inc.	Industrials	Aerospace & Defense	43%	Defense
UNH	UnitedHealth Group Inc.	Health Care	Health Care Providers & Services	40%	Health Care
TXT	Textron Inc.	Industrials	Aerospace & Defense	37%	Defense
CSC	Computer Sciences Corp.	Information Technology	IT Services	36%	11% Public Sector and 24% Defense
WM	Waste Management Inc.	Industrials	Commercial Services & Supplies	35%	Municipalities
BMY	Bristol-Myers Squibb Co.	Health Care	Pharmaceuticals	33%	Health Care
JEC	Jacobs Engineering Group Inc.	Industrials	Construction & Engineering	32%	Public Sector (inc. overseas)
WPO	Washington Post Co. (Cl B)	Consumer Discretionary	Media	26%	Education (Kaplan)
TMO	Thermo Fisher Scientific Inc.	Health Care	Life Sciences Tools & Services	26%	Academic & government; 5% NIH exposure
SIAL	Sigma-Aldrich Corp.	Materials	Chemicals	26%	Academic & government; <5% NIH exposure
AET	Aetna Inc.	Health Care	Health Care Providers & Services	20%	Health Care
ESRX	Express Scripts Inc.	Health Care	Health Care Providers & Services	20%	Health Care
LH	Laboratory Corp. of America	Health Care	Health Care Providers & Services	19%	Health Care
DGX	Quest Diagnostics Inc.	Health Care	Health Care Providers & Services	18%	Health Care
UTX	United Technologies Corp.	Industrials	Aerospace & Defense	17%	Defense
A	Agilent Technologies Inc.	Health Care	Life Sciences Tools & Services	17%	Academic & govt; 8% life sciences, 9% aerospace/defense
PH	Parker Hannifin Corp.	Industrials	Machinery	16%	Defense
CVS	CVS Caremark Corp.	Consumer Staples	Food & Staples Retailing	15-20%	Health Care
WAG	Walgreen Co.	Consumer Staples	Food & Staples Retailing	15-20%	Health Care
WAT	Waters Corp.	Health Care	Life Sciences Tools & Services	15%	Academic & govt; <5% NIH exposure
AGN	Allergan Inc.	Health Care	Pharmaceuticals	15%	Health Care
LLY	Eli Lilly & Co.	Health Care	Pharmaceuticals	15%	Health Care
FLR	Fluor Corp.	Industrials	Construction & Engineering	15%	Services to Federal Government
EMC	EMC Corp.	Information Technology	Computers & Peripherals	15%	
NTAP	NetApp Inc.	Information Technology	Computers & Peripherals	15%	
APH	Amphenol Corp. Cl A	Information Technology	Electronic Equipment Instruments & Components	15%	Commercial Aerospace & Military
XRX	Xerox Corp.	Information Technology	Office Electronics	15%	
PFE	Pfizer Inc.	Health Care	Pharmaceuticals	14%	Health Care
HON	Honeywell International Inc.	Industrials	Aerospace & Defense	12%	Defense
WLP	WellPoint Inc.	Health Care	Health Care Providers & Services	12%	Health Care
ALTR	Altera Corp.	Information Technology	Semiconductors & Semiconductor Equipment	11%	
ADI	Analog Devices Inc.	Information Technology	Semiconductors & Semiconductor Equipment	11%	
XLNX	Xilinx Inc.	Information Technology	Semiconductors & Semiconductor Equipment	11%	
DELL	Dell Inc.	Information Technology	Computers & Peripherals	10-15%	
HPQ	Hewlett-Packard Co.	Information Technology	Computers & Peripherals	10-15%	
IBM	International Business Machines Corp.	Information Technology	IT Services	10-15%	
LLTC	Linear Technology Corp.	Information Technology	Semiconductors & Semiconductor Equipment	10%	
NUE	Nucor Corp.	Materials	Metals & Mining	10%	Public works
INTC	Intel Corp.	Information Technology	Semiconductors & Semiconductor Equipment	9%	
AMD	Advanced Micro Devices Inc.	Information Technology	Semiconductors & Semiconductor Equipment	9%	
TXN	Texas Instruments Incorporated	Information Technology	Semiconductors & Semiconductor Equipment	9%	
AIV	Apartment Investment & Mngmt. Co.	Financials	Real Estate Investment Trusts (REITs)	8%	Affordable housing
FFIV	F5 Networks Inc.	Information Technology	Communications Equipment	7%	12% global govt. exposure
NVDA	NVIDIA Corp.	Information Technology	Semiconductors & Semiconductor Equipment	6%	
RHT	Red Hat Inc.	Information Technology	Software	5-10%	
CSCO	Cisco Systems Inc.	Information Technology	Communications Equipment	5%	18-20% global govt. exposure
BRCM	Broadcom Corp.	Information Technology	Semiconductors & Semiconductor Equipment	4%	
GE	General Electric Co.	Industrials	Industrial Conglomerates	3%	Defense

Source: Company report, BofA Merrill Lynch Global Research estimates, BofA Merrill Lynch US Equity & US Quant Strategy
Note: Table may not be all inclusive. Some companies do not breakout government sales exposure.

Link to Definitions

Macro

Click here for definitions of commonly used terms.

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