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To: jeffrey E.; Richard Kahn
Subject: Cheap hedge

While we are still constructive equities and see further upside potential, given the large recent moves and our binary view of the markets for 2017 (+20% bull case / -30% bear case - see below), buying cheap tail protection to hedge a long equity portfolio is prudent.

You can achieve significant savings on a tail hedge by monetizing the low correlations between sectors that we have seen in the multi-year bull market. In a tail event, correlations generally move towards 1 as you know very well.

Buy a best-of-put on 3 sectors: tech, consumer discretionary and utilities

- * Underlying ETFs: XLK (Tech Selector Sector SPDR), XLY (Consumer Discretionary Select Sector SPDR), XLU (Utilities Select Sector SPDR)
- * Your payoff is on the best performing of the 3 sectors
- * 95% strike
 - o 6 months: 1.0% premium
 - o 1 year: 1.85% premium

This is ~64% savings compared to a 6 month SPX 95% put (2.75%) and a 1 year SPX 95% put (5.1%)

We like the best-of-put because all three sectors are near cycle or all-time highs and should all be vulnerable in a large market pullback, especially in a tail event. Even utilities, a defensive sector, are less safe in our view given elevated valuations and crowding. Our utilities analyst sees 10% downside to the sector with the 10y at these levels (2.62% today) and 16.7% downside at 3.0%.

There is a high amount of potential leverage on this trade – for example, on the 1 year best-of-put, if the sectors were all down > 20%, you would have 8.1x payoff on your premium (15%/1.85%).

<<http://rsch.baml.com/r?q=Xs2Bc6MU6pTCNQsJR2M5Jw&e=amanda.ens%40baml.com&h=1PXt6Q>> US Equity
Strategy Year Ahead: 2017 – the year ahead: Euphoria or fiscal fizzle?

<<http://rsch.baml.com/r?q=Xs2Bc6MU6pTCNQsJR2M5Jw&e=amanda.ens%40baml.com&h=1PXt6Q>>

Savita Subramanian thinks 2017 could be anything but normal – Subramanian notes that if the market moves from skepticism to euphoria then the S&P 500 could trade as high as 2700 in a bull case scenario. Meanwhile, applying typical (not extreme) recessionary returns to current S&P 500 levels yields a bear case scenario of 1600. Her base case is a year-end 2017 S&P500 target of 2300.

10 Year Graph: XLY, XLK, XLU

Source: Bloomberg

Regards,

Amanda

Amanda Ens

Director

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