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CHIEF INVESTMENT OFFICE

Capital Market Outlook

June 10, 2019

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- **Macro Strategy**—Accelerating productivity growth raises the potential growth rate of the economy. The big rise in productivity growth has caught Federal Reserve (Fed) policymakers by surprise, causing them to overtighten in 2018. To get inflation up to target, the Fed will need to ease.

- **Global Market View**—Amid rising protectionism and greater trade frictions, multinational companies' supply chains are under review and are likely to be gradually unwound in the years ahead. One of the main beneficiaries around the rethink and reconfiguration of global supply chains will be automation, in our opinion—or advanced robotics, artificial intelligence, additive manufacturing (3-D printing), digital platforms and related activities geared towards the ability to suppress costs, boost margins and nimbly reach more-demanding consumers.

- **Thought of the Week**—The rapid market decline seen in May amidst trade friction and curve inversions seems overextended, in our view, as fundamentals remain solid and valuations have turned more attractive relative to bonds.

- **Portfolio Considerations**—We still believe equities are more attractive relative to bonds at current valuations and prospects. We maintain our constructive view on U.S. equities versus non-U.S. equities in the medium term on the basis of a strong potential for real economic growth and corporate profits.

MACRO STRATEGY

Chief Investment Office Macro Strategy Team

GLOBAL MARKET VIEW

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THOUGHT OF THE WEEK

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Assistant Vice President and
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Data as of 6/10/2019 and subject to change.

MACRO STRATEGY

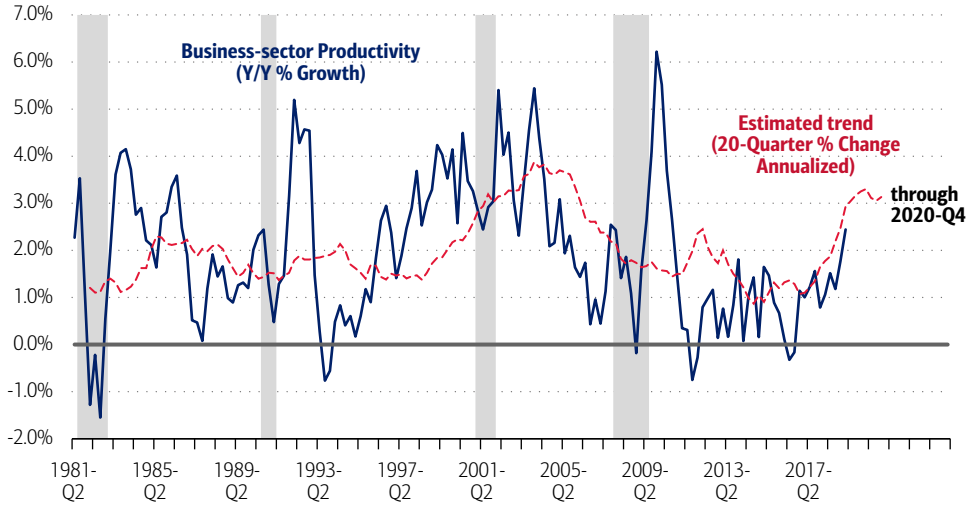
Productivity Liftoff: The Story of the Decade

Chief Investment Office Macro Strategy Team

More economists are starting to acknowledge the rising trend in U.S. productivity growth. We agree with Cornerstone Macro research, who has been among the first to sniff out the end of secular stagnation and call the new stronger productivity trend "the story of the decade."

As shown in Exhibit 1, the year-over-year growth rate in productivity has risen to about 2.5% (blue solid line). Aside from the rebound out of the last recession, that's the best showing in about 15 years. Typically, there are surges in productivity at the end of recessions (gray-shaded areas). That's because the resumption of growth allows for fuller utilization of existing capacity and already employed labor.

Exhibit 1: Surging Productivity Causes Accelerating Potential GDP Growth.



Sources: Bureau of Economic Analysis/Haver Analytics; Chief Investment Office. Data as of May 21, 2019.

Despite the typical surge in productivity after the last recession, the longer-term trend (red-dotted line) continued to plunge and hit a bottom that rivaled the post-World-War II low of the early 1980s at about 1%.

This low productivity growth in the first five years of this economic expansion, together with the slower labor-force growth implicit in an aging U.S. population, was the basis for the conventional wisdom that the U.S. "potential" growth rate had fallen below 2% (the sum of about 1% for productivity growth and less than 1% for labor force growth). This secular stagnation view is still the conventional wisdom. For example, as recently as the past few weeks, Fed officials have referred to 1.8% as the U.S. economy's potential growth rate.

In this view, the potential for continued growth of the U.S. economy around 3% is not possible without eventually causing inflation to overshoot the Fed's target. This was the basis for the aggressive rate-hiking campaign in 2018 that ultimately inverted the yield curve as inflation dropped below the 2% target starting last summer. This has created cognitive dissonance for the secular stagnation crowd and caused the Fed to reevaluate its weak estimate for potential growth. As Fed Vice Chair Clarida put it in a recent speech to the New York Economics Club:

> *"Over the past few years, we have also seen evidence of a pickup in U.S. productivity growth, albeit from the very depressed average pace that prevailed throughout most of the expansion. Indeed, as of the first quarter of this year, productivity in the nonfarm business sector rose 2.4 percent over the previous four quarters, its fastest pace since 2010 when the U.S. economy was coming out of the Great Recession. By contrast, in both the 2001–07 and 1982–90 economic expansions, productivity growth was actually slowing relative to its average pace during those expansions. That said, while identifying inflection points in trend productivity growth in real time is notoriously difficult, a pickup in trend productivity growth relative to the pace that prevailed earlier in the expansion is a possibility that we should not, I believe, dismiss."*

The Fed's low expectations for non-inflationary economic growth are also behind its big misses in estimating the neutral interest rate and neutral unemployment rate. Over the past five years, the Fed's guess of the neutral interest rate has dropped from over 4% to just over 2%, while its guess about the neutral unemployment rate has also dropped by over a percentage point. These low expectations for the economy cause premature tightening and help explain why the U.S. economy persistently falls short of the 2% inflation target.

Forces Behind the Productivity Liftoff

The red-dotted line in Exhibit 1 shows our estimates for productivity growth (the 20-quarter moving average) based on the macroeconomic factors we believe are the important determinants of the intermediate trend in productivity. Watching these factors has allowed us to catch the turn in productivity that the Fed is still only tentatively acknowledging. As can be seen, these factors point to a further rise in the productivity growth rate to just over 3% during the next 18 months. If this pans out and the recent Fed pivot persists then U.S. economic growth is likely to surprise to the upside even as the expansion passes its 10th anniversary milestone in July.

There are four macroeconomic factors that tend to track the productivity trend illustrated in Exhibit 1. They are: (1) the growth rate of the labor force; (2) the trend in the trade-weighted dollar; (3) the trend in gross domestic product (GDP) growth; and (4) the trend in consumer confidence. Slower labor force growth makes labor scarcer relative to capital and incentivizes businesses to find ways to boost labor efficiency or productivity. We saw this in the 1950s, which was the last time labor force growth was as comparably weak as today's level. Similarly, a strong dollar creates tough competition for U.S. companies on the trade front incentivizing ways to produce more with less. Japanese firms mastered this during the recent decades of a strong yen. This along with weak labor growth helps explain how Japan has managed to grow its per capita GDP faster than the other G-7 countries in recent years.

Stronger GDP growth and consumer confidence that persists at a high level also helps incentivize businesses to invest for the longer term which is another critical dimension for strong productivity growth. Currently, all four factors remain in position to keep boosting productivity growth and sustain it at higher than historically average levels. Fed Vice Chair Clarida is watching this process, and we believe he will be pleased with what he sees based on the factors that have helped determine the intermediate term trend in productivity over the past 50 years.

Aside from the factors in the estimated productivity trend in Exhibit 1, there are other factors that can help boost productivity, factors that are more difficult to quantify in a consistent way. Nevertheless, these factors are associated with past periods of strong productivity growth and currently are tilted in the right direction to help sustain the productivity breakout that appears to be under way.

These exogenous factors include: (1) technological change, (2) the age composition of the labor force and (3) the regulatory environment. More and more evidence is accumulating to suggest that automation, artificial intelligence, robotics and rising big data capabilities are causing more and more pockets of productivity explosion. This factor is creating big differences across and within sectors in the pace of productivity growth. A recent research study by Cornerstone Macro—How To Invest In Productivity, April 16, 2019—notes that:

1. S&P 1500 productivity growth continued to accelerate in 2018. But, the gap between the most- and least-productive firms widened to a new high.
2. The dispersion in productivity trends is not a sector issue; we show that it also exists within sectors, underscoring the need to be very selective.
3. Investors have rewarded the fastest productivity growers, which have outperformed the slowest growers by over seven percentage points per year since 2010.

In short, faster productivity translates into faster profit growth potential. First adapters who are successful are pulling ahead as the accelerating pace of technological change reinforces a "winner-take-all" environment.

The aging of the millennial generation into its peak earnings years is also a likely catalyst for faster productivity growth potential. When baby boomers transitioned from their low-

productivity 20s into their high-productivity 30s and early 40s, productivity growth moved from unusually low to unusually high. The millennial generation is moving through that inflection point today, helping to support currently strong productivity and higher wages.

Finally, a more efficient, less burdensome regulatory environment promotes productivity by reducing deadweight losses from excessive and poorly constructed regulation. This together with all of the other factors suggests that a perfect storm is brewing for stronger growth without inflation. Recent Fed commentary suggests that policy makers are slowly embracing "the story of the decade."

GLOBAL MARKET VIEW

The Golden Era for Multinationals is Over—Now What?

Joseph P. Quinlan, Head of CIO Market Strategy

Kathryn A. Cassavell, CFA®, Vice President and Market Strategy Analyst

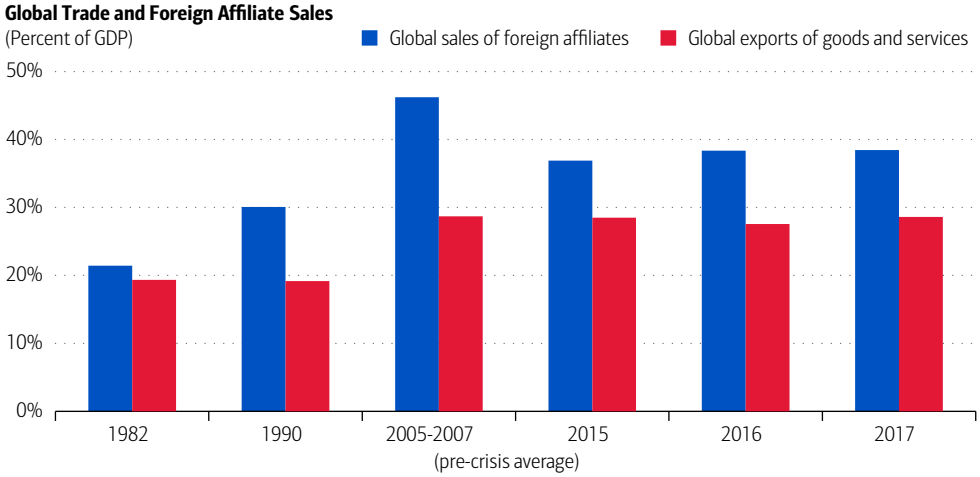
For decades, the world was their oyster. China's "opening" to the West in 1979; the collapse of Communism in 1989; sweeping economic reforms in India in 1991; the creation of the European Single Market in 1992; the passage of the North America Free Trade Agreement in 1994; the European Union "enlargement" to 28 member states earlier this century—all of these seminal events helped forge a golden era for U.S. multinationals.

So did the spread of globalization—or unfettered cross-border flows of capital, goods, ideas, people and data—which knitted more and more nations into the fabric of the global economy, giving multinationals access to more resources, more workers and more consumers. One key upshot: rising earnings from abroad, with Rest of World profits of American firms rising by over 250% since the start of the century, or 6.9% annualized.

Falling transportation and communication costs also helped to grease the wheels of global commerce, allowing U.S. firms to operate virtually any place in the world. With American firms in the forefront, global foreign direct investment outflows have soared over the past few decades, rising from an annual average of just $47 billion over 1980–85 to an estimated $1.2 trillion last year. The more the investment, the more the trade, with global trade regularly outpacing the rate of global growth for decades. In turn, the combination of rising trade and investment has meant thicker and more complicated global supply chains and the rise of foreign affiliates as the main conduit for global commerce. Think of the latter as foot soldiers of globalization. They are at the core of any global supply chain—and key cogs in the financial success of any multinational. They are also the bedrock of the global economy.

According to the latest figures from the United Nations, the total assets of all foreign affiliates in the world topped a staggering $100 trillion in 2017, with total affiliate output (value added) in excess of $7.3 trillion, a figure well in excess of the aggregate output of the world's largest economies, save China and the U.S. Affiliates employed over 73 million workers worldwide in 2017, while sales of affiliates were nearly $31 trillion. Affiliate sales were some 34% larger than global exports of goods and services in 2017, and accounted for roughly 38% of world GDP versus 29% for global exports (Exhibit 2).

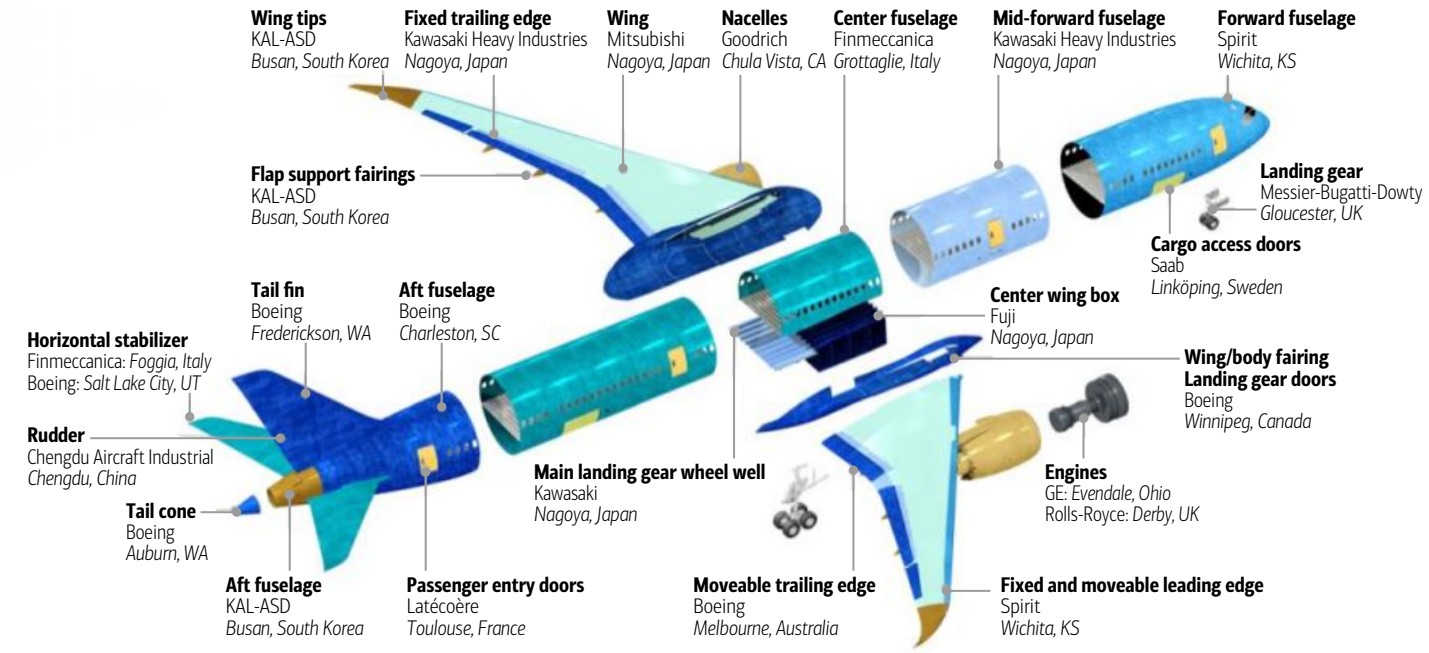
Exhibit 2: How Global Companies Reach Consumers.



Sources: UNCTAD World Investment Report (global sales); World Bank (exports); International Monetary Fund (GDP). Data as of 2019.

Underscoring the importance of foreign affiliates to U.S. multinationals, sales of affiliates totaled an estimated $6.9 trillion in 2018, almost three times larger than U.S. exports.[1] With more than 37,000 foreign affiliates scattered around the world—from Albania to Zimbabwe—U.S. multinationals have been at the forefront of the golden era of globalization, building out some of the most extensive and thickest supply chains in the world to their competitive advantage. As a real world example of a global supply chain—in this case Boeing—take a look at Exhibit 3, which underscores the complexity and global scale of building/assembling an aircraft.

Exhibit 3: Global Supply Chains Explained: Aircraft Example.



For illustrative purposes only. Sources: Boeing; U.S. Chamber of Commerce. Data as of 2015.

However, given all of the above, times are changing. The days of U.S. multinationals being largely unbound are over. The tide of globalization is in retreat. To the

[1] Source: Bureau of Economic Analysis, total sales of all foreign affiliates.

disadvantage of many firms operating outside their own borders, nationalism and populism are on the rise around the world. Rather than being seamless, the world is becoming balkanized or fragmented, which is another way of saying that the golden era for multinationals is history.

The past won't be the prologue, so what now?

It's a new world for multinationals. Forty years of declining tariffs and non-tariff barriers, and relatively open borders that allowed companies to disaggregate production around the world, is reversing. The pendulum is swinging back toward protectionism, populism and nationalism, all of which are inimical to globalization and existing global supply chains of multinationals. Escalating trade tensions between the U.S. and China—in addition to friction with Mexico, India and Europe—not only portend weaker global growth and added market volatility near term but also a long-term rethink among multinationals on how to do business on a global scale.

Complex, multinational supply chains are under review and are likely to be gradually unwound in the years ahead. Where for the past four decades global manufacturing operations of firms were geographically diffuse, with plants spread across borders and reliant on a network of international suppliers, future operations will be more local and regional in scope. Think less 'offshoring' of production and a movement to 're-shore' or 'near-shore' – that is, for U.S. firms to perform more of their manufacturing closer to home—a la Tijuana, Mexico or Toledo, Ohio. Given the ongoing spat with Mexico, the latter looks more attractive.

The U.S. is hardly the cheapest place in the world to manufacture, but higher relative U.S. labor costs will be offset by increased automation, greater supply chain mobility, lower shipping costs and very competitive energy costs thanks to the American energy renaissance. Add in tax reform and other government incentives like job training credits and favorable treatment of capex spending, in addition to a large and wealthy consumer market, and the U.S. emerges as one of the most attractive places in the world for investment. (As a footnote, and as we recently highlighted, the U.S. ranked first in terms of new greenfield investment among foreign investors in 2018).[2]

Who wins?

One of the main beneficiaries around the rethink and reconfiguration of global supply chains will be automation, in our opinion—or advanced robotics, artificial intelligence, additive manufacturing (3-D printing), digital platforms and related activities geared towards the ability to suppress costs, boost margins and nimbly reach more-demanding consumers. Yes, lower-cost locales like Vietnam, Cambodia and perhaps Mexico will see a rise in foreign direct investment. But the attractiveness of these nations will be offset by the rapid adoption of robotics and related activities, the next advancements in 3-D printing, and the growing penchant among multinationals to shorten and simplify their global supply chains, and "build where they sell."

U.S. firms bringing their supply chain closer to home will allow them to better serve the end consumer in two main ways. The first is simply by granting them more flexibility to respond to new orders and to reduce delivery times. But second, and perhaps more important, is by improving their product offering via better-integrated research & development (R&D). Housing manufacturing alongside core activities such as design, marketing and product development, the argument goes, should help to spur innovation, increasing responsiveness to shifts in consumer preferences and boosting competitiveness and profitability in the process.

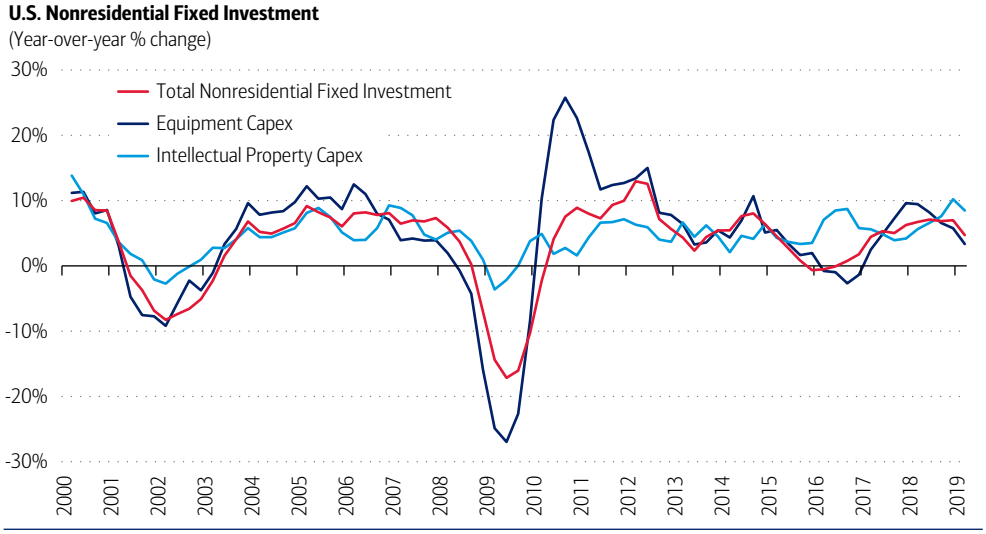
Among sectors, robotic manufacturers should stand to gain as global robotic penetration accelerates not only in the U.S. and the developed nations but also in the emerging

[2] See Capital Market Outlook May 20, 2019, "Global Greenfield Investment: America is First."

world, notably China. The mainland is already one of the largest users in the world of robots and will maintain this position as it adopts to the new world order in trade and rising wage costs at home.

Although the U.S. capex cycle has recently lost momentum (Exhibit 4), we believe that demand for robotics and AI/data-driven production processes among multinationals is a secular trend that should help boost investments in capital equipment and intellectual property products (i.e., software, R&D spending) over the long run. This shift toward more automated manufacturing provides an important buying opportunity for long-term investors considering building exposure in leading global robotics companies.

Exhibit 4: U.S. Capital Expenditures (capex) Cycle.



Source: Bureau of Economic Analysis. Data as of June 2019.

THOUGHT OF THE WEEK

Three Tidbits to Support Our Relative Preference for U.S. Equities

Kishan Chhatwal, Assistant Vice President and Investment Analyst

U.S. equities fell over 6% last month amid unresolved trade uncertainty, marking the first market decline in May in seven years. Elevated volatility is not abnormal, in our view, and uncertainty often presents opportunity for prudent investors. Oversold conditions, attractive valuations, risk-off asset flows and improving earnings revision trends could support the market in the near term, bolstered by our expectations for the Fed to turn more accommodative.

I. Valuations

The S&P 500's forward price-to-earnings multiple appreciated nearly 20% in the first four months of the year to peak at 17.0x but has fallen over 7% in the past month. The rapid decline seen in May amidst trade friction and curve inversions seems overextended, in our view, as fundamentals remain solid and valuations have turned more attractive relative to bonds. In just the past month, the U.S. Equity Risk Premium picked up to 4.1%, well above its historic average (Exhibit 5).

II. Asset Flows

While the S&P 500 has outperformed both bonds and international equities thus far in 2019, global asset flows remain bearish. Bonds have enjoyed over $180B of inflows year-to-date, while equities have seen outflows of nearly $160B, according to Emerging Portfolio Fund Research (EPFR) Global. Within equities, the U.S. region has accounted

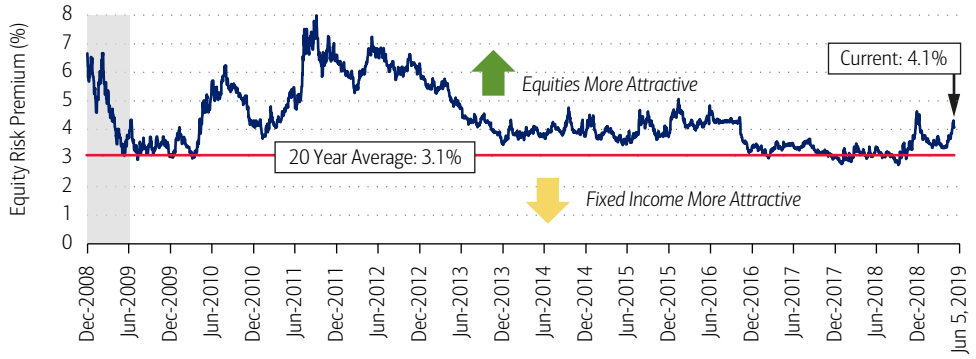
for more than 40% of outflows, and in the past three months equities have had just one week of inflows, suggesting buying power remains on the sidelines.

Furthermore, the U.S.-China trade war has the potential to evolve into a longer-term "technology cold war," creating extended uncertainty for the global economy. While not our base case, as we believe the economics for both countries ultimately favor cooperation, extended friction could benefit U.S. assets including equities as the higher-quality destination for safe-haven flows relative to international markets.

III. Improving Earnings Revision Trends

After a series of earnings downgrades, a possible green shoot has emerged in that revision ratios have picked up globally, with the biggest improvement seen in the U.S. The S&P 500's three-month earnings estimate revision ratio (ERR) recently breached 1.0 for the first time in seven months, indicating more raises to earnings estimates than cuts. The ratio is now above its long-term average, supportive of near-term returns.

Exhibit 5: U.S. Equities Reasonably Attractive Compared to Bonds.

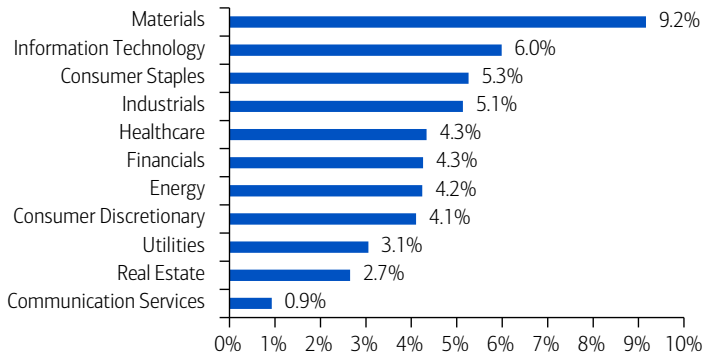


Sources: Bloomberg, Chief Investment Office. Data as of June 5, 2019. Equity risk premium defined as the spread between the S&P 500's Earnings Yield and the 10-Year Treasury Yield. Shaded region indicates prior recession.

Equities

		Total Return in USD (%)		
	Current	WTD	MTD	YTD
DJIA	25,983.94	4.8	4.8	12.7
NASDAQ	7,742.10	3.9	3.9	17.3
S&P 500	2,873.34	4.5	4.5	15.7
S&P 400 Mid Cap	1,892.00	4.5	4.5	14.6
Russell 2000	1,514.39	3.4	3.4	12.9
MSCI World	2,126.88	4.0	4.0	14.1
MSCI EAFE	1,875.62	3.2	3.2	11.1
MSCI Emerging Markets	1,007.39	1.0	1.0	5.2

S&P 500 Sector Returns



Fixed Income[1]

		Total Return in USD (%)		
	Current	WTD	MTD	YTD
Corporate & Government	2.55	0.4	0.4	5.8
Agencies	2.16	0.3	0.3	3.7
Municipals	2.04	0.2	0.2	4.9
U.S. Investment Grade Credit	2.62	0.4	0.4	5.2
International	3.37	0.5	0.5	7.8
High Yield	6.24	0.9	0.9	8.5

	Current	Prior Week End	Prior Month End	2018 Year End
90 Day Yield	2.21	2.29	2.29	2.36
2 Year Yield	1.85	1.92	1.92	2.49
10 Year Yield	2.08	2.12	2.12	2.68
30 Year Yield	2.57	2.57	2.57	3.01

Commodities & Currencies

		Total Return in USD (%)		
Commodities	Current	WTD	MTD	YTD
Bloomberg Commodity	162.32	-0.7	-0.7	1.6
WTI Crude $/Barrel[2]	53.99	0.9	0.9	18.9
Gold Spot $/Ounce[2]	1,340.81	2.7	2.7	4.6

Currencies	Current	Prior Week End	Prior Month End	2018 Year End
EUR/USD	1.13	1.12	1.12	1.15
USD/JPY	108.19	108.29	108.29	109.69
USD/CNH	6.94	6.94	6.94	6.87

Source: Bloomberg, Factset.Total Returns from the period of 6/3/19 to 6/7/19. Bloomberg Barclays Indices.[1] Spot price returns.[2] All data as of the 6/7/19 close.
Past performance is no guarantee of future results. Please see the Index Definitions at the back of the document.

Asset Class Weightings (as of 6/4/19)

	Under-weight		Neutral		Over-weight
Global Equities	•	•	•	●	•
U.S. Large Cap Growth	•	•	•	●	•
U.S. Large Cap Value	•	•	•	●	•
U.S. Small Cap Growth	•	•	•	●	•
U.S. Small Cap Value	•	•	●	•	•
International Developed	●	◀	•	•	•
Emerging Markets	•	●	•	◀	•
Global Fixed Income	•	●	•	•	•
U.S. Governments	•	●	•	•	•
U.S. Mortgages	•	●	•	•	•
U.S. Corporates	•	•	●	•	•
High Yield	•	●	•	•	•
U.S. Investment Grade Tax Exempt	•	•	●	•	•
U.S. High Yield Tax Exempt	•	●	•	•	•
International Fixed Income	●	•	•	•	•
Alternative Investments*	see CIO Asset Class Views				
Hedge Funds					
Private Equity					
Real Assets					
Cash					

* Many products that pursue Alternative Investment strategies, specifically Private Equity and Hedge Funds, are available only to pre-qualified clients.

Economic and Market Forecasts (as of 6/7/19)

	Q3 2018A	Q4 2018A	Q1 2019A	Q2 2019E	2018A	2019E
Real global GDP (% y/y annualized)	–	–	–	–	3.6	3.3
Real U.S. GDP (% q/q annualized)	3.4	2.2	3.1	1.9	2.9	2.4
CPI inflation (% y/y)	2.6	2.2	1.6	1.9	2.4	1.7
Core CPI inflation (% y/y)	2.2	2.2	2.1	2.1	2.1	2.2
Unemployment rate (%)	3.8	3.8	3.9	3.6	3.9	3.7
Fed funds rate, end period (%)	2.18	2.40	2.43	2.38	2.40	1.88
10-year Treasury, end period (%)	3.06	2.68	2.41	2.05	2.68	2.00
S&P 500 end period	2914	2507	2834	–	2507	2900
S&P earnings ($/share)	43	41	39*	42	161.5	166
Euro/U.S. dollar, end period	1.16	1.15	1.12	1.10	1.15	1.17
U.S. dollar/Japanese yen, end period	114	110	111	109	110	101
Oil ($/barrel, avg. of period, WTI**)	69	59	55	62	65	59

The forecasts in the table above are the base line view from BofAML Global Research team. The Global Wealth & Investment Management (GWIM) Investment Strategy Committee (ISC) may make adjustments to this view over the course of the year and can express upside/downside to these forecasts.

Past performance is no guarantee of future results. There can be no assurance that the forecasts will be achieved. Economic or financial forecasts are inherently limited and should not be relied on as indicators of future investment performance.

A = Actual. E/* = Estimate. S&P 500 represents a fair value estimate for 2019. **West Texas Intermediate

Sources: BofA Merrill Lynch Global Research; GWIM ISC as of June 7, 2019.

Index Definitions

Securities indexes assume reinvestment of all distributions and interest payments. Indexes are unmanaged and do not take into account fees or expenses. It is not possible to invest directly in an index.

Indexes are all based in dollars.

S&P 500 Index includes a representative sample of 500 leading companies in leading industries of the U.S. economy. Although the index focuses on the large-cap segment of the market, with approximately 75% coverage of U.S. equities, it is also an ideal proxy for the total market.

S&P 1500, or S&P Composite 1500 Index, is a stock market index of US stocks made by Standard & Poor's. It includes all stocks in the S&P 500, S&P 400, and S&P 600. This index covers 90% of the market capitalization of U.S. stocks.

Important Disclosures

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Economic or financial forecasts are inherently limited and should not be relied on as indicators of future investment performance.

It is not possible to invest directly in an index.

Asset allocation, diversification, dollar cost averaging and rebalancing do not ensure a profit or protect against loss in declining markets. Dollar cost averaging involves continual investment in securities regardless of fluctuating price levels; you should consider your willingness to continue purchasing during periods of high or low price levels.

Past performance is no guarantee of future results.

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