

CHIEF INVESTMENT OFFICE

# Capital Market Outlook

January 10, 2022

All data, projections and opinions are as of the date of this report and subject to change.

## IN THIS ISSUE

**Macro Strategy—Expansion and Profits Growth to Continue in 2022:** Current Federal Reserve (Fed) projections and the leads and lags involved between changes in monetary policy and changes in economic conditions suggest policy will not become a meaningful restraint to growth in 2022, so real growth is likely to remain above trend and inflation high, in our view. The steepening yield curve suggests increasingly accommodative Fed policy. However, profit margins are elevated, and a moderation would not be surprising.

As pent-up demand for goods fades and the inventory/capital expenditures (capex) cycle catches up with demand, the Institute for Supply Management (ISM) index is likely to moderate further from its 40-year highs seen in 2021, consistent with some slowing in the U.S. manufacturing and trade cycle. Supply-chain problems should thus ease. Earnings revisions ratios tend to deteriorate when the ISM index declines, but with economic growth underpinnings strong, the index is unlikely to drop below the 50 mark, where risk aversion sharply increases because of growing recession/profits risks. We thus expect profits and equity markets to continue to advance in 2022, albeit at slower rates.

**Market View—Taking Stock of Potential 2022 Catalysts:** From a macroeconomic perspective, this year we anticipate a transition from a stimulus-induced pent-up demand phase of economic growth, inherently more intense and volatile, to one led by an improvement in the private-sector labor market and business spending. At 4.0%, our forecast for 2022 U.S. real growth of gross domestic product (GDP) would still nearly double the pre-pandemic average since the 2008 global financial crisis of 2.3%.

With sentiment relatively neutral, we believe equity markets are in search of a catalyst. Like in 2021, in our view, the pathogen's evolution and its effect on the economic outlook comprises our top category of potential catalysts, followed by policy responses and geopolitical developments, reviewed here.

**Thought of the Week—Memo to Investors: Don't Sweat America's Public Sector Debt:** For a variety of reasons, America's public finances remain constructive and, in our opinion, non-threatening to the capital markets and various asset classes. Pillars of support range from the low cost of capital to foreign demand for U.S. securities.

We are not anticipating a significant spike in interest costs near-term, and continue to believe that America's debt levels are non-threatening to current and future prices of U.S. securities. Don't sweat Uncle Sam's finances.

## MACRO STRATEGY ►

**Irene L. Peters, CFA®**  
Director and Senior Investment Strategist

## MARKET VIEW ►

**Rodrigo C. Serrano, CFA®**  
Director and Investment Strategist

## THOUGHT OF THE WEEK ►

**Joseph P. Quinlan**  
Managing Director and Head of CIO  
Market Strategy

## MARKETS IN REVIEW ►

Data as of 1/10/2022,  
and subject to change

### Portfolio Considerations

We expect a grind-it-out market environment in which valuations could remain flat or slightly decline but with profit growth to supersede this and Equity outperformance to continue, within Fixed Income, we favor credit overall, especially Investment-grade, and also prefer municipals relative to Treasuries. We continue to maintain a shorter duration stance. Qualified investors could also consider opportunities in Alternative Investments, which could add another layer of diversification to a portfolio.

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## Expansion and Profits Growth to Continue in 2022

*Irene L. Peters, CFA®*, Director and Senior Investment Strategist

As discussed in past reports, both the consensus of economists and the Fed seriously underestimated the effect of the biggest money-printing event since World War II (WWII). With inflation becoming a political problem, and concerned about its credibility, the Fed struck a more hawkish-than-expected tone at its December 14-15, 2021, Federal Open Market Committee (FOMC) meeting, as reflected in the reminder that the FOMC seeks to achieve inflation of 2% over the longer run, as well as in its immediate decision to double the pace of Fed monthly tapering of asset purchases from \$15 billion, announced just two months ago, to \$30 billion. This will help the Fed finish its quantitative easing (QE) program by mid-March, three months earlier than previously planned, opening the door for more, and sooner-than-previously signaled, rate hikes. According to the Fed, 10 of 18 FOMC participants anticipate three rate hikes in 2022 and another two expect four hikes. The minutes from the meeting also included a hawkish surprise with discussion of shrinking the balance sheet sooner than the market had anticipated (i.e., before rates are more normalized, as was the case when the Fed ended QE in 2014).

In the meantime, with money-supply growth still running around 13% and the Fed projecting about a 1% fed funds rate by the end of the year, we believe the U.S. economy is likely to continue to overheat. Indeed, the Conference Board index of leading indicators points to solid real GDP growth through mid-2022. Extremely easy current financing conditions, strong wealth effects/housing demand, the surge in profits, and robust labor demand suggest economic growth is likely to remain much above potential at around 5% in 2022, with inflation likely to surprise to the upside again.

As a result, we believe nominal GDP is on track to increase around 10% on the heels of a similar gain in 2021, its biggest gains in 40 years. Such a strong nominal growth environment is positive for the business revenues and capital spending outlook. Also, while consumer spending growth is likely to moderate from its 2021 pace (its fastest since records started in 1959), we expect it to only slow from an estimated off-the-charts 8% average growth in 2021 to a very robust 4% to 5% pace as 2022 progresses. Spending is buoyed by rising employment and accelerating nominal wage and salary gains. Massive savings during the pandemic and the potential for a more complete reopening of the economy suggest that risks to demand are to the upside, in our view. This outlook is confirmed by credit markets, where, despite persistent nervousness about the outlook for growth and inflation, spreads remain relatively narrow, consistent with high margins, solid corporate revenue growth, and improved corporate balance sheets.

Continued double-digit money-supply growth has much to do with our outlook for 10% nominal GDP growth in 2022. As long as the Fed remains accommodative, as it currently plans, keeping real GDP growth much above potential, risks of continued overheating and higher-than-expected inflation remain high. Other developed markets have also overheated, though less than the U.S., with inflation running around 5% in Canada, the U.K. and the European Union (EU), for example. The U.K. and Norway have already started to raise interest rates, while Canada has prepared markets for rate hikes in response to inflation substantially exceeding its 1% to 3% target range. In contrast, already burnt by a premature rate hike that caused a double-dip recession in 2012, most analysts don't expect EU rate hikes before 2023. With fiscal transfers less generous than in the U.S. and less room to ease monetary policy during the pandemic, EU domestic demand remains below pre-pandemic levels and inflationary pressures appear mostly driven by regional energy shortages/global supply-chain problems, with wage growth soft. In contrast, with money supply still surging, consumer price inflation running at a 9% annualized rate by the end of 2021, durable goods inflation the highest since the 1950s, and booming household net worth and consumer demand, the U.S. has an inflation problem for the first time since the 1980s that is more serious than Europe's.

### Investment Implications

With interest rates rising and the yield-curve steepening, Financials are currently outperforming. The likely end of the low inflation/low interest rate environment of the past decade spurred an exodus from the Growth stock space (where most tech stocks belong) toward Value (where most reflation assets belong), with the most (speculative, unprofitable, and high-valuation) tech stocks dramatically underperforming.

We expect rising rates in 2022 to continue fueling this rotation from long-duration to short-duration assets that favors Value and cyclical stocks during the first half of 2022.

Pandemic-related monetary and fiscal policies have not only sent the developed world from recession to overheating in about a year, but also spurred an epic housing boom. According to Applied Global Macro Research, the developed world is experiencing a bigger housing cycle (bubble) than in the 2000s, with Organisation for Economic Co-operation and Development (OECD) house prices probably the highest ever relative to rents and incomes, and continuing to surge through late 2022 (as a result of low interest rates, significant demand, insufficient home construction, and rising building/land costs).

As we discussed in past reports, as a quintessential reflation asset, real-estate prices quickly reflect declines in interest rates and upside inflation pressures. 2021 was no different. The S&P CoreLogic Case-Shiller U.S. National Home Price Index was up 19% year over year in October, and real estate investment trusts (REITs) were the second-best performing S&P 500 sector (+42%) after Energy (+48%). The Technology (+33%) and Financials (+32%) sectors also outpaced the S&P 500 index (+27%), though by much less.

While the Fed remains behind the curve on inflation, economic growth is self-calibrating to some extent. According to December Markit and ISM manufacturing surveys, materials shortages and supplier delays dragged on through the end of the year, slowing U.S. and global manufacturing output growth. At the same time, according to the ISM survey, “the Employment Index expanded for a fourth straight month, with some indications that ability to hire is improving,” and there are clear signs of improved delivery performance, with supplier pricing power continuing to rise, but to a lesser degree. Also important, “panel sentiment remains strongly optimistic, with six positive growth comments for every cautious comment” and the ISM’s Semiannual Economic Forecast, released in December, indicates a strong 2022 in terms of revenue growth and profitability.

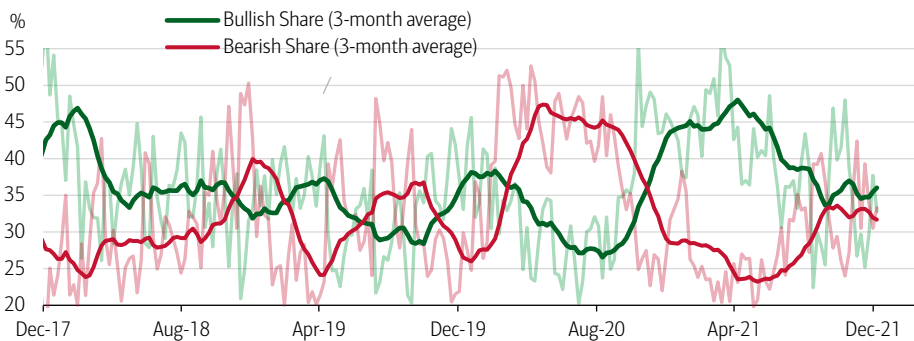
In our view, the supply shortages disrupting business equipment, housing and auto-sector production/sales have extended the cycle by creating a huge backlog of unfilled orders and record low inventories that need to be rebuilt in the year ahead. Surging profits along with low interest rates, the biggest post WWII inventory cycle, and the need for capital investment to meet demand and shorten supply chains suggest solid underpinnings for business investment, hiring, and growth. While a moderation from unsustainably high U.S. manufacturing surveys levels is to be expected, our research suggests that the ISM index will remain elevated through most of 2022, consistent with continued, though slower, profits growth, and relatively benign credit-market conditions. Reflation assets and Value stocks should continue to outperform in this environment.

## Taking Stock of Potential 2022 Catalysts

Rodrigo C. Serrano, CFA®, Director and Investment Strategist

Numerous measures of equity market sentiment suggest a less extreme, more neutral investor stance. In the U.S., the American Association of Independent Investors reports greater week-to-week volatility in retail bias, with neither oversized optimism nor pessimism (Exhibit 1). The Bull & Bear Indicator also reveals undecidedness by professional market participants.<sup>1</sup> However, also catalogued, the Global Fund Manager Survey (FMS) has registered rising portfolio cash levels, recently triggering a contrarian “buy” signal. This panorama suggests to us an equity market awaiting a catalyst. Helping it grind out new all-time highs, a “wall of worry” seems ready to be scaled, an evolution contemplated in our team’s base case for 2022.

### Exhibit 1: Individual Investors Are Roughly Split On the Equity Market Outlook



Light green and red lines are three-month moving averages of faded weekly readings. Source: American Association of Individual Investors. Data as of January 6, 2022.

### Controlled or Disruptive?

Undoubtedly, the evolution of the pandemic will likely continue to be the most important driver of macroeconomic outcomes. With every subsequent wave of the coronavirus, the harm to the economy and markets has diminished. Markets seem to be signaling that Omicron, the latest variant of the pathogen, should not bring a major disruption to global economic growth, at least over the medium term. Since mid-December, even as cases have been spiking globally, U.S. Treasury yields and Equities have been in an uptrend, led by cyclical segments.

Nevertheless, stricter government measures are clearly possible if more severe strains emerge or healthcare systems become overwhelmed. We have recently seen several instances of economic disruption, including a rise in school closures, companies returning to remote working, and airline flight cancellations due to a large-scale infection of the workforce.

The uncertainty surrounding the pandemic implies that the risks around our base case will continue to be large. While the demand side of the economy remains strong, potentially excluding travel, restaurant dining and other service-oriented areas, the supply side of the economy may face increasing pressure from a lack of workers, disrupting activity and/or boosting higher wages, which may exacerbate inflationary pressures.

### Managing the Supply Side

An adverse market catalyst may stem from this continued imbalance more decisively shifting sentiment away from the view that inflation will end up being transitory. This is

<sup>1</sup> The BofA Global Research Bull & Bear Indicator tracks capital flows and institutional positioning, among other elements of market behavior.

### Investment Implications

We expect a climate defined by more persistent inflation and higher levels of economic growth. This argues for progressively favoring cyclical Value-oriented over secular Growth-focused investments within an Equity barbell strategy. Anticipating outperformance by sectors such as Energy, Materials and Financials, this stance also implies the prospect for a preponderance of upside catalysts, which should also boost U.S. Small-cap Equities, which are attractively valued relative to their large-caps counterparts.

That said, we emphasize sound risk management, maintaining a well-diversified portfolio across and within asset classes. This translates to our preference for high-quality firms with strong balance sheets and with the ability to command pricing power, grow free cash flows and grow dividends over time.

still a prevalent judgment among institutional investors, according to the latest FMS. Such a development may intensify a relatively novel challenge for policymakers. Raising uncertainty, it may limit the ability of central banks to aid economic growth, or worse, lead to an unexpected acceleration in the tightening of monetary policy in the U.S. President Biden's Build Back Better (BBB) platform may also be undermined by greater political opposition, particularly as contentious mid-term electoral contests approach.

Still, a more optimistic scenario would see a continued easing of supply-chain bottlenecks, soothing inflation worries and relieving the global economy and markets over time. Following pandemic-related restrictions, industrial production in some major Asian economies has rebounded, while IHS Markit has recently reported that many European firms had experienced a tentative clearing of congestion. In the U.S., manufacturing-order backlogs, supplier deliveries and prices paid by firms have signaled cooling pressures since peaking around mid-2021, according to the ISM. Therapeutic advancements, bolstering confidence, may buoy the labor force participation rate, raising the supply of labor.

While these events would help raise policymaking flexibility, another positive equity market catalyst may well be a gradual tightening of monetary policy by the Fed, if investors perceive it done in response to building economic momentum. An ultimately shallower path of interest rate hikes would imply a largely sustained stimulative policy overall, fostering an environment of strong nominal economic growth, which would serve as a backbone for better-than-expected corporate profits.

Cooling inflation expectations may widen the path for a scaled-down version of BBB, appeasing investors worried about too restrictive fiscal policy over the medium-to-longer term. Tailored more to address supply-side impediments, a U.S. package would join the EU's fiscal recovery fund, termed NextGenerationEU. This initiative, already being infused into the region's economy to modernize it, is expected provide a supportive fiscal backdrop this year, according to the European Fiscal Board.

## **Global Focus Points**

For China, the global spread of a more infectious variant of the coronavirus may raise the costs of sustaining a zero-coronavirus or elimination strategy, which could stress global supply chains. Also raising greater economic uncertainty, lacking clarity on a path forward for the nation's beleaguered property market may similarly catalyze a renewed swoon for emerging market assets.

On the other hand, President Xi Jinping is poised to begin an unprecedented third term as China's head of state in October. Investors may gauge more cautious management of the economy approaching this event as an upside catalyst for attractively valued emerging market assets. Indeed, in last month's Central Economic Work Conference, Chinese authorities signaled for "keeping economic development as the central task," suggesting a more supportive policy backdrop.

It is this prudence that may underpin continued stability in geopolitical affairs. For the U.S., improving its economic relationship with China may help the Biden administration's fight against inflation and serve as an upside catalyst for markets. Conversely, rising tensions—whether related to Taiwan, the South China Sea, and/or long-armed jurisdiction covering capital and technological regulations—may hamper the longer-term outlook for commercial interests.

Also for Europe, we believe investors will scrutinize notable electoral contests in France and Hungary, both set to occur in April. They may also be apprehensive in the case of a nearer-term military escalation between Ukraine and Russia. The secondary effects of this crisis could spill over into an already volatile energy market. Finally, the state of ongoing U.S.-Iran nuclear negotiations is also on our watch list.

## Memo to Investors: Don't Sweat America's Public Sector Debt

Joseph P Quinlan, Managing Director and Head of CIO Market Strategy

Taking on debt is nothing new in Washington but the gusher in federal spending and attendant rise in public sector debt since the pandemic has been nothing short of extraordinary. Some key numbers to consider: federal debt held by the public was equal to 99.7% of GDP in fiscal year 2021, down slightly from 100.3% the year before. Roughly a decade ago (2010), the comparable figure was 60.8%; in 2000, the percentage was just 33.7%.<sup>2</sup> Since the start of this century, then, America's gross public sector debt as a percentage of GDP has tripled—a rise associated with excess federal spending due to multiple wars in the post 9/11 world; soaring entitlement liabilities as the U.S. population ages; the carnage of the Great Financial Crisis; and the economic and financial havoc wreaked by the pandemic.

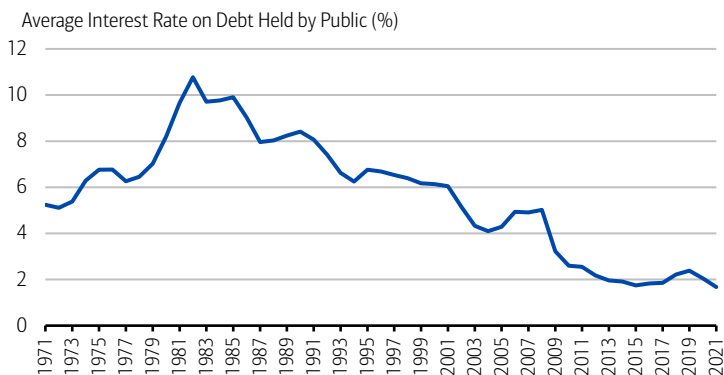
All of the above has generated a tsunami of red ink and raised concerns among investors over the sustainability of U.S. finances. That said, while mindful of America's public sector debt, we don't believe current debt levels are a risk to the capital markets for a number of reasons. One, America's debt is being financed at very low interest rates, as depicted in Exhibit 2. Two, while net interest payments rose moderately in FY 2021 (to \$352 billion from \$344.7 billion the year before), interest payments were actually 9.1% below the peak of 2019 (\$375.2 billion). Why the decline: think maturing debt being rolled over at ultra-low interest rates over the balance of last year. Three, net interest payments as a percent of GDP declined in full year 2021, to a very doable 1.6% of total output. Finally, never forget that Uncle Sam's finances are backstopped by the world's reserve currency (the U.S. dollar) and underpinned by the most dynamic and resilient private sector in the world. The latter has been key in expanding the U.S. economic pie and attracting foreign capital flows, making U.S. debt and servicing levels quite manageable.

### Investment Implications

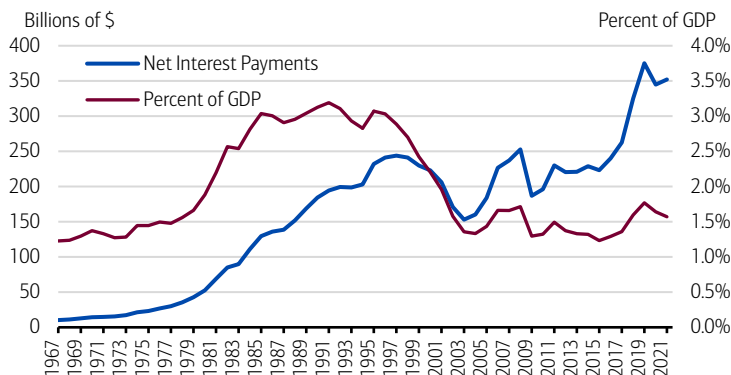
Soaring pandemic-related spending has sharply raised the U.S. federal budget deficit and the attendant need to borrow capital. Gross public sector debt now stands at multidecade highs. For a variety of reasons, however, America's financing liabilities are very manageable and, as of now, secondary to our market outlook. Nominal real GDP and earnings will remain the key drivers of asset prices in 2022.

### Exhibit 2: A Look at U.S. Government Financing.

The Cost of Capital



Net Interest Payments



Sources: Congressional Budget Office; U.S. Department of the Treasury/Haver Analytics. Data as of November 2021.

Looking forward, we are very mindful of the fact that as interest rates rise this year, interest costs will eventually rise as well. And past isn't prologue—more structurally embedded inflation expectations could structurally shift upwards the future cost of capital. But that said, we are not anticipating a significant spike in interest costs near-term, and continue to believe that America's debt levels are non-threatening to current and future prices of U.S. securities.

<sup>2</sup> As a footnote, this figure excludes debt owed to another arm of the government (social security) and is therefore lower than the widely-reported debt/GDP figure of 120-125%.

Equities

	Total Return in USD (%)			
	Current	WTD	MTD	YTD
DJIA	36,231.66	-0.2	-0.2	-0.2
NASDAQ	14,935.90	-4.5	-4.5	-4.5
S&P 500	4,677.03	-1.8	-1.8	-1.8
S&P 400 Mid Cap	2,793.14	-1.7	-1.7	-1.7
Russell 2000	2,179.81	-2.9	-2.9	-2.9
MSCI World	3,177.54	-1.7	-1.7	-1.7
MSCI EAFE	2,328.99	-0.3	-0.3	-0.3
MSCI Emerging Markets	1,226.10	-0.5	-0.5	-0.5

Fixed Income<sup>†</sup>

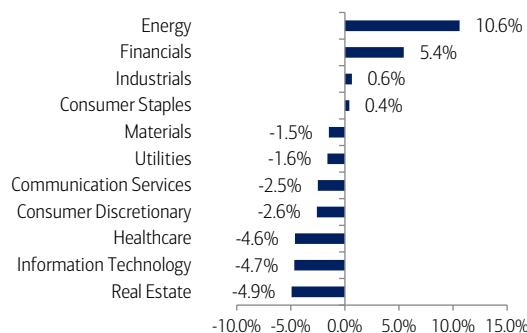
	Total Return in USD (%)			
	Current	WTD	MTD	YTD
Corporate & Government	1.88	-1.71	-1.71	-1.71
Agencies	1.33	-0.83	-0.83	-0.83
Municipals	1.26	-0.70	-0.70	-0.70
U.S. Investment Grade Credit	1.98	-1.53	-1.53	-1.53
International	2.55	-1.93	-1.93	-1.93
High Yield	4.60	-0.94	-0.94	-0.94
90 Day Yield	0.09	0.03	0.03	0.03
2 Year Yield	0.86	0.73	0.73	0.73
10 Year Yield	1.76	1.51	1.51	1.51
30 Year Yield	2.12	1.90	1.90	1.90

Commodities & Currencies

	Total Return in USD (%)			
	Current	WTD	MTD	YTD
Commodities				
Bloomberg Commodity	216.33	2.1	2.1	2.1
WTI Crude \$/Barrel <sup>††</sup>	78.90	4.9	4.9	4.9
Gold Spot \$/Ounce <sup>††</sup>	1796.55	-1.8	-1.8	-1.8

	Total Return in USD (%)			
	Current	Prior Week End	Prior Month End	2020 Year End
Currencies				
EUR/USD	1.14	1.14	1.14	1.14
USD/JPY	115.56	115.08	115.08	115.08
USD/CNH	6.38	6.36	6.36	6.36

S&P Sector Returns



Sources: Bloomberg, Factset. Total Returns from the period of 1/3/2022 to 1/7/2022. <sup>†</sup>Bloomberg Barclays Indices. <sup>††</sup>Spot price returns. All data as of the 1/7/2022 close. Data would differ if a different time period was displayed. Short term performance shown to illustrate more recent trend. **Past performance is no guarantee of future results.**

Economic Forecasts (as of 1/7/2021)

	2021E	Q1 2022E	Q2 2022E	Q3 2022E	Q4 2022E	2022E
Real global GDP (% y/y annualized)	5.8*	-	-	-	-	4.3
Real U.S. GDP (% q/q annualized)	5.6*	4.0	4.0	3.0	2.0	4.0
CPI inflation (% y/y)	4.7*	7.1	5.8	4.7	3.1	5.2
Core CPI inflation (% y/y)	3.6*	6.2	5.1	4.4	3.5	4.8
Unemployment rate (%)	5.4*	3.8	3.6	3.5	3.4	3.6
Fed funds rate, end period (%)	0.07	0.38	0.63	0.88	1.13	1.13

The forecasts in the table above are the base line view from BofA Global Research. 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. Historical data is sourced from Bloomberg, FactSet, and Haver Analytics. **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.

Sources: BofA Global Research; GWIM ISC as of January 7, 2022. BofA Global Research is research produced by BofA Securities, Inc. ("BofAS") and/or one or more of its affiliates. BofAS is a registered broker-dealer, Member SIPC, and wholly owned subsidiary of Bank of America Corporation.

Asset Class Weightings (as of 12/7/2021)

Asset Class	CIO View		
	Underweight	Neutral	Overweight
Equities	●	●	●
U.S. Large Cap	●	●	●
U.S. Mid Cap	●	●	●
U.S. Small Cap	●	●	●
International Developed	●	●	●
Emerging Markets	●	●	●
Fixed Income	●	●	●
U.S. Investment Grade Taxable	●	●	●
International	●	●	●
Global High Yield Taxable	●	●	●
U.S. Investment Grade Tax Exempt	●	●	●
U.S. High Yield Tax Exempt	●	●	●
Alternative Investments*	●	●	●
Hedge Funds	●	●	●
Private Equity	●	●	●
Real Estate	●	●	●
Tangible Assets / Commodities	●	●	●
Cash	●	●	●

CIO Equity Sector Views

Sector	CIO View		
	Underweight	Neutral	Overweight
Energy	●	●	●
Financials	●	●	●
Industrials	●	●	●
Materials	●	●	●
Information Technology	●	●	●
Consumer Discretionary	●	●	●
Real Estate	●	●	●
Healthcare	●	●	●
Communication Services	●	●	●
Consumer Staples	●	●	●
Utilities	●	●	●

\*Many products that pursue Alternative Investment strategies, specifically Private Equity and Hedge Funds, are available only to qualified investors. CIO asset class views are relative to the CIO Strategic Asset Allocation (SAA) of a multi-asset portfolio. Source: Chief Investment Office as of November 9, 2021. All sector and asset allocation recommendations must be considered in the context of an individual investor's goals, time horizon, liquidity needs and risk tolerance. Not all recommendations will be in the best interest of all investors.

## 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 U.S. dollars.**

**S&P 500 Index** is a stock market index that measures the stock performance of 500 large companies listed on stock exchanges in the United States. It is one of the most commonly followed equity indices.

**Institute for Supply Management (ISM) index** is a composite index that gives equal weighting to new orders, production, employment, supplier deliveries, and inventories. Each factor is seasonally adjusted.

**Conference Board index of leading indicators Index** is an American economic leading indicator intended to forecast future economic activity.

**S&P CoreLogic Case-Shiller U.S. National Home Price Index** measures the value of single-family housing within the United States.

**Employment Index** is defined as the total number of persons working in an observation unit (inclusive of working proprietors, partners working regularly in the unit and unpaid family workers), as well as persons who work outside the unit who belong to it and are paid by it (e.g. sales representatives, delivery personnel, repair and maintenance teams).

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