CHIEF INVESTMENT OFFICE

Capital Market Outlook

January 11, 2021

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

MACRO STRATEGY
Chief Investment Office Macro Strategy Team

GLOBAL MARKET VIEW
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THOUGHT OF THE WEEK
Lauren Sanfilippo
Vice President and Investment Strategist

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IN THIS ISSUE:

- Macro Strategy—Policies aimed at raising inflation are likely favorable for commodity prices. Since the 2008-2009 Great Financial Crisis, equities have outperformed commodities by a wide margin. Stronger global growth, higher inflation, a weaker dollar, and negative real interest rates are factors that favor stronger commodity prices over the decade ahead. A new period of commodity outperformance may be just beginning.
- Global Market View—With a great deal of uncertainty hanging over the financial markets, we answer—in brief—some key questions that may affect this year's market outlook.
- Thought of the Week—While there's no shortage of remarks that can be made about 2020, the averages suggest 2020 was an abnormal year with above-average returns, with the S&P 500 ending 18.4% (total return) higher for 2020. As we turn the calendar page, we do see positive trends building for economic and earnings growth into the new year supportive of an equity uptrend in 2021.
- Portfolio Considerations—We expect a "grind-it-out" year in equity returns that could far outpace fixed income, and what matters most is our expectation for a broad market advance relative to the narrow advances we have recently experienced, in our view. The bull market for equities continues in 2021, in our opinion, and investors should consider reassessing their portfolio allocations early in Q1.

MACRO STRATEGY

Reflation Favors Commodities

Chief Investment Office, Macro Strategy Team

Commodity prices tend to go through long, multiyear cycles. Over a business cycle, demand for commodities fluctuates with economic growth, ebbing to a low point in recessions and peaking late in expansions, when overheating and higher inflation sow the seeds for restrictive monetary policy and slower growth. In addition, supply conditions also contribute to the longer cycles in commodity prices. It's often said that "the cure for high prices is high prices." That's because historically high commodity prices stimulate investment cycles that create new capacity to meet rising demand without much price pressure over several subsequent cycles. If supply capacity is ample, cyclical demand pressure on prices is generally muted.

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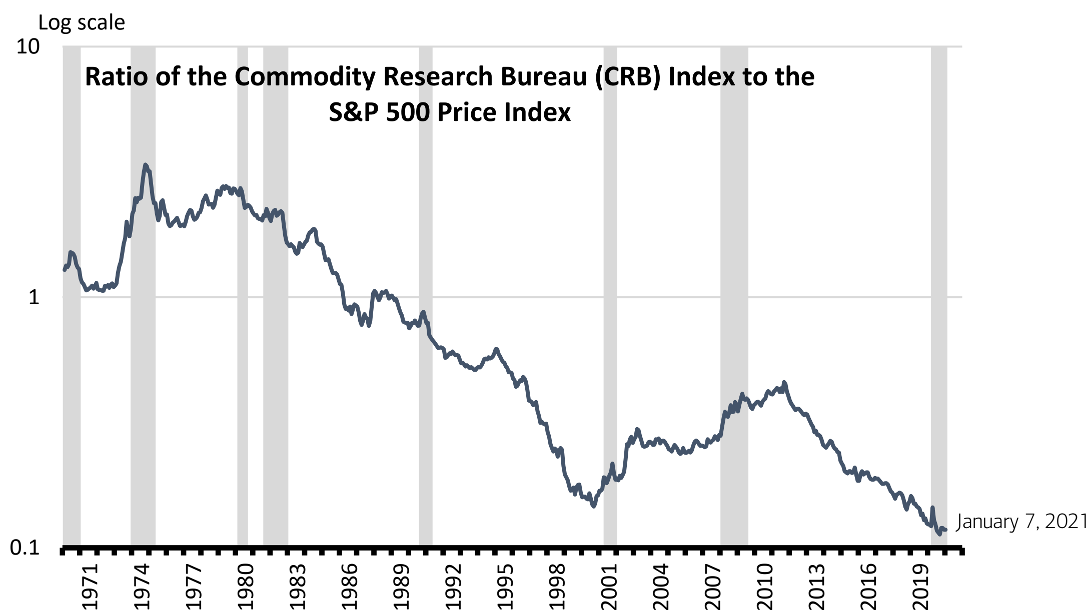
Exhibit 1 illustrates the historical relative performance of commodity prices compared to the S&P 500 price index. The low points in relative performance in 1972, 2000 and 2020 are all associated with the aftermaths of unusually strong equity market performance (the Nifty Fifty in the early 70s, the Y2K tech bubble in the late 90s, and the comparably strong stock prices of the current bull market). These rare junctures of unusually strong equity performance have also coincided with secular low points in commodity prices after prolonged bear markets. Low commodity prices help restrain inflation, making longer expansions possible as monetary policy remains accommodative. Accommodative monetary policy helps support strong stock prices, as we've seen over the past year.

Exhibit 1: The Performance of Commodity Prices Relative to Equity Prices Goes Through Long Cycles.



Sources: Commodity Research Bureau/Haver Analytics. Data as of January 7, 2021. **Past performance is no guarantee of future results.**

In fact, a primary force behind the current strength in equity values is the unprecedented flood of fiscal and monetary stimulus to deal with deflation fears. After failing to attain their inflation mandates over the past expansion, central banks have ratcheted their efforts up by an order of magnitude, with the single-minded focus on finally getting inflation and inflation expectations up to levels that eliminate market fears of debt deflation like that of the 1930s. Based on past experience, this is a powerful tailwind for commodity prices, typical in the first year of a new economic expansion.

The 60% or so gain in the S&P 500 Index from its March 2020 to date is also similar to the record launches of new bull markets in 1983 and 2009, when expansions out of deep recessions were similarly just beginning. However, Exhibit 1 suggests that from a relative valuation standpoint, it's late in the game for equity valuations and very early for commodities. In general, over the past few months, the stock market has shown typical early-cycle rotation toward stocks that benefit from stronger growth and easy monetary policy. Among these are materials stocks, which include mining, metals and other commodity-producing companies.

During the past 10 years, these companies have had ample capacity for the 2009-2020 expansion because the commodity price boom of the early 2000s sparked a surge in investment in new production capacity. Over the past decade, this ample supply was more than sufficient to satisfy global demand, causing relatively weak commodity prices. However, this environment set the stage for a period of stronger prices ahead as the new synchronized global expansion raises demand for commodities in a world where producers have been holding back capacity expansion for about a decade. This suggests that there is a latent secular element to the recent relative outperformance of materials stocks along with their usual tendency to gain steam as an expansion progresses.

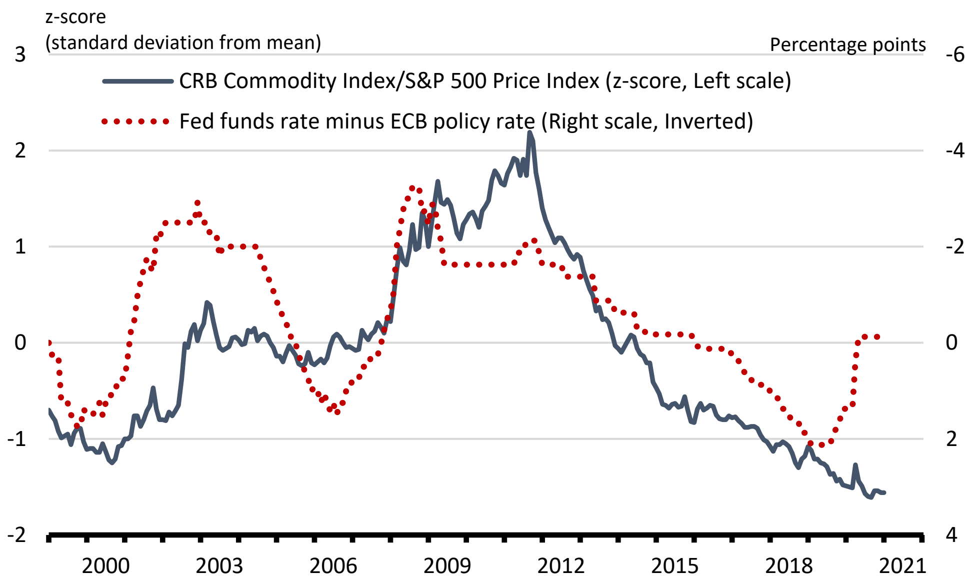
As the tech-stock mania peaked in 2000, a two-decade commodity bear market ended when China began its run of red-hot growth with its accession to the World Trade Organization in the early 2000s. As tech stocks valuations corrected, value stocks benefiting from strong global growth, surging Chinese fixed-asset investment, and the U.S. housing boom outperformed. Commodity prices were strong up until the summer of 2008. This commodity outperformance ended soon thereafter, and a long period of weak commodity prices and a new secular bull market in tech stocks began in a low inflation, strong dollar environment.

Other characteristics of secular bull markets in commodities include very low and even negative real interest rates as well as a weak dollar. For example, the big uptrend in Exhibit 1 during the 1970s coincided with the end of the Breton Woods agreement fixing the dollar's exchange value to gold. Inflation, which was already high in the early 70s, soared even higher over the decade. While the Federal Reserve (Fed) raised interest rates to double-digit levels by the end of the decade, they remained below inflation, causing real interest rates to stay very low and even negative, which exacerbated inflation and boosted commodity prices. In addition, by the late 70s, the dollar was under extreme downside pressure. This vicious cycle of accelerating inflation and a weak dollar eventually ended when then Fed Chairman Paul Volcker pushed interest rates well above inflation. The high real interest rates that followed in the 1980s and 1990s helped bring inflation down and kept commodity prices confined in a range from which they only broke out after 2000 when the next period of commodity outperformance started as noted above and as shown in Exhibit 1.

The coronavirus crisis has caused policymakers to engage in the biggest fiscal expansion since World War II. While the latest stimulus package was deemed too small by some, it is the second biggest since World War II, surpassed only by the first Coronavirus Aid, Relief, and Economic Security (CARES) Act of March 2020. Hence, the U.S. economy is experiencing its two biggest fiscal stimulus impulses within less than a year. Overall, the U.S. fiscal stimulus in 2020 and 2021 exceeds that of any other major economy in both absolute and per capita terms.

This is one reason why the U.S. has outperformed the economies of other major developed markets like those in the European Union (EU), where debates over mutualizing debt have delayed the implementation of fiscal stimulus. One consequence of the more aggressive U.S. fiscal and monetary policy is a weaker greenback, which declined about 7% on a trade-weighted basis in 2020.

Exhibit 2: Commodities Tend To Outperform Equities When The Gap Between The Fed Funds Rate And The European Central Bank (ECB) Policy Rate Declines.



Sources: Commodity Research Bureau; Federal Reserve Board; European Central Bank/Haver Analytics. Data as of January 7, 2021. **Past performance is no guarantee of future results.**

The appreciating dollar before 2020 was partly due to stronger U.S. growth and equity market performance during the 2009-2020 expansion. Also, despite low inflation, the Fed felt compelled to keep interest rates higher than those in Europe and Japan, which boosted the dollar's foreign exchange value (Exhibit 2). As a result, as shown in Exhibit 2, the Fed had more scope to cut rates when the pandemic hit. The relatively bigger decline in U.S. interest rates helps explain the dollar's weakness in 2020. Now that the Fed is committed to a more aggressive reflation policy, the likelihood that the dollar continues to depreciate and that inflation rises over 2% for a while has increased.

In summary, easier monetary and fiscal policy around the world makes reflation a global phenomenon. Resultant stronger global growth is also a force for higher commodity prices along with a weaker dollar, as a sustained global expansion could eventually start pressuring commodity supplies that have been constrained by a decade of weak prices and low investment. Tightening supply conditions would likely drive up prices, making new capacity expansion economically viable as in the 1970s and early 2000s. The search for new supply is bullish for smaller producing companies that would become more attractive to big producers looking for new supply. An active merger and acquisition phase is typically part of a commodity bull market. It is thus not hard to see why commodity-producing companies have been beneficiaries of the rotation-to-value, cyclical and Small-cap stocks over the past few months.

GLOBAL MARKET VIEW

10 Questions for 2021

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

Lauren J. Sanfilippo, Vice President and Investment Strategist

There is no shortage of uncertainty as the new year begins, so in an attempt to provide some clarity, we briefly answer some of the key macro questions of 2021.

What does a Senate majority for the Democrats mean for the markets?

The Democratic sweep of Georgia gives the incoming administration some more legislative latitude, including around fiscal policies. However, with the narrowest of majorities in the Senate, the more progressive policies of the Democrats are likely off the table. Moderate, centrist Senators may have considerable sway in the new Congress. It seems likely the filibuster would remain in place for now. In terms of policy, we're not expecting moon shots—think, rather, along more traditional lines: another coronavirus-relief spending package, an infrastructure bill, more liberalization of trade and immigration, and some unwinding of the recent-era regulations on industry. For the broader economic/market environment and asset allocation, this means more upside to real gross domestic product (GDP) growth, inflation and interest rates and an increase in cyclical exposure across portfolios, in our view.

Do Deficits Matter?

No—at least not now. Rarely has deficit-spending been as warmly embraced by the financial markets as in the past 12 months given the massive need for government activism (aka spending) in the face of the growth-inhibiting pandemic and widening income inequality-cum-social instability. The bond vigilantes are hibernating—you would think a projected federal budget deficit of $3.3 trillion in fiscal year 2020 would result in "sticker shock" for investors, but that is currently not the case. Deficit spending will likely remain the norm over the medium term, supported by strong demand for U.S. Treasurys, low interest rates, the dollar's status as the world's reserve currency, and the ability of the U.S. government to manufacture as many dollars as needed. In terms of asset allocation and portfolio positioning, we are very mindful of the U.S. deficit and its potential long-term effects (i.e., higher interest costs, crowding-out effects, etc.) But that said, in lieu of the pandemic-cum-U.S. recession, the markets are very comfortable (demanding) of deficit spending.

Is Inflation Dead?

No—and inflation is expected to perk up this year as pent-up consumer demand runs high-long into truncated supplies. As the St. Louis Fed warned in December, Americans may have to "prepare themselves for a temporary burst of inflation." But the key word here is "temporary." A transitory rise in prices is expected this year, but a slack labor market, rising productivity, and demographic headwinds should keep a lid on a sustained and sizable move up in inflation. Think less "deflation" and more "reflation," which is bullish for equities, notably cyclicals. We would not abandon the growth side of the markets, however, as we continue to emphasize the need for both growth and value characteristics in a portfolio for a potentially more diversified advancement in the next couple of years.

U.S.-China relations: Sweet or Sour in 2021?

Less sour but certainly not sweet. Investors shouldn't expect a major U.S.-China reset given that America's adversarial posture toward China is bipartisan in nature. Anti-China sentiment runs strong on both sides of the political aisle. Accordingly, the new administration is not expected to roll back the tariffs the Trump administration imposed on two-thirds of imports from China. And we don't expect anything resembling détente over export controls, and competing tech standards. That said, however, the tone governing U.S.-China relations—while remaining stern—may become less confrontational, more orderly, and hopefully more constructive as the world's two largest economies seek paths of mutual interest. In the last few years, U.S.-Sino relations became a magnet for volatility, supply chain disruptions and earnings pressure; these negative forces are likely to ameliorate somewhat in the coming years.

Can the incoming administration restore a semblance of global order?

Yes, but the world isn't about to revert to the traditional days of U.S.-led globalization. The incoming administration is more multilaterally minded than the outgoing regime—watch for the U.S. to rejoin the Paris Agreement treaty on climate change, reaffirm its commitment to North Atlantic Treaty Organization (NATO), and add its weight to the continued viability of the World Trade Organization and other key institutions like the World Health Organization. All of the above is bullish for U.S. multinationals, the Industrial sector and heavy asset owners, in our opinion. However, after four years of uncertainty and pandemic-related global strains, the global economy is fragmenting along regional lines. Globalization isn't dead, but it is becoming less U.S.-centric and driven by a more integrated Asia and autonomy-seeking Europe. Importantly, as it pertains to global affairs, the new administration will likely be more amendable to trade liberalization (i.e., joining more trade partnerships) and immigration reform—both variables are likely bullish for the long-term growth of U.S. corporate earnings.

What is one key lesson of the pandemic?

One key lesson: health=wealth. If we have learned anything from the coronavirus pandemic, it's that health is a fundamental determinant to economic growth. The healthier the population, the stronger, more dynamic the nation's human capital and the more competitive the economy. Less healthy nations, in contrast, are handicapped in terms of production, consumption and aggregate growth.

That said, it took a pandemic to expose the fragility of the global healthcare infrastructure. Global healthcare expenditures have climbed steadily over the past two decades, reaching nearly $8 trillion in 2017 (the last year of available data). However, spending on global healthcare as a percentage of world GDP has barely budged, flatlining at around 9% to 10% over the past two decades. So even before the coronavirus hit, the world's healthcare infrastructure was straining at the seams. In the post-pandemic world, global healthcare expenditures are set to accelerate, a bullish prospect for world leaders in pharmaceuticals, diagnostic equipment, medical software/hardware, telemedicine and related medical goods and services.

Could the U.S. dollar continue to weaken this year?

Yes, but moderately over the next twelve months. In March 2020 as the pandemic swept the world, the U.S. dollar initially strengthened but has subsequently declined by roughly 12% on a trade-weighted basis, with the downside fueled in large part by uber-loose monetary policies of the Fed. The latter has compressed U.S. interest rates on both ends of the yield curve relative to global interest rates, undercutting the attractiveness of the buck. The soft dollar trend is set to likely continue, and is supportive of non-U.S. economies, notably the emerging markets, and reflation assets like cyclicals, commodities, and emerging market stocks and bonds. A weaker dollar is also a historical tailwind for the earnings of U.S. multinationals.

Should investors stick with market-leading technology equities?

Yes, we maintain our overweight to Information Technology and view the recent pullback in various tech leaders as an attractive entry point for long-term investors or those lacking tech exposure. As outlined in the January Viewpoint, we have increased our cyclical exposure to Industrials, Financials and Materials, yet remain long-term investors in Technology for a number of reasons, ranging from the pandemic-induced boost to the digital global economy, rising capital expenditures (capex) spending in productivity-enhancing technology, and the fact that over two billion people have yet to log on to the internet. Increased U.S. spending on infrastructure—think 5G, electrical vehicles and renewable energy—is also supportive for Technology for the long term.

What are the key risks to the economy/market outlook this year?

The risks run the gamut and include overly optimistic market sentiment in the U.S.—setting up for a market correction later this year—to an unexpected geopolitical event, with U.S.-Sino tensions front and center. Other risks to watch carefully this year: a slower-than-expected rollout of the vaccine, mounting inflationary pressures and the response of the Fed, and excessive government activism. Lastly, any potential changes regarding tax policy and/regulations under the new administration that are growth inhibiting would likely dent market sentiment and induce negative market volatility, in our opinion.

What are your favorite themes entering 2021?

Our top themes for this year pivot around the C.H.I.Ps—or cybersecurity, HealthTech, infrastructure, and the platform economy. Summarizing: Cybersecurity spending is set to accelerate as more of the global economy goes digital and the number of cases of cybercrime/-hacks soars. The premium on public health has fused two of the economy's largest sectors: Healthcare and Technology. Constructing the infrastructure of the 21st century entails billions of dollars in capital investment in 5-G, renewable energies and electrical vehicles. And the future of the U.S. economy (and global economy) increasingly rests on the platform economy, with more and more platform companies disrupting and controlling an increasing share of aggregate output.

THOUGHT OF THE WEEK

With 2020 Hindsight, Markets Look Toward 2021

Lauren J. Sanfilippo, Vice President and Investment Strategist

Who could have imagined the events of 2020? A global pandemic, the sharpest market downturn on record, extraordinary stimulus measures from the Fed and a dizzying market comeback amid a contentious presidential election. While the economy remains off its pre-pandemic levels by a number of measures, the equity market charted a different story by year-end.

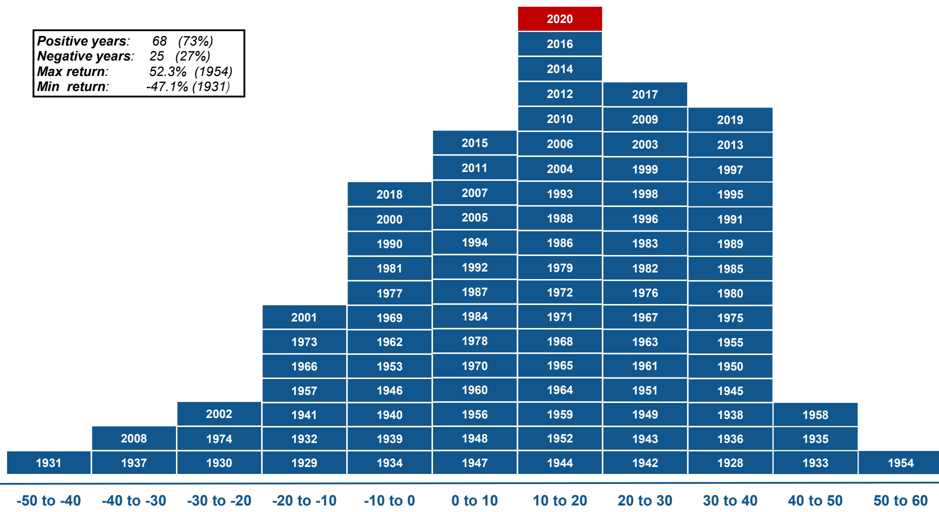
Capping the year, the S&P 500 ended 16.26% (18.4% Total Return (TF) higher for 2020 and has gained almost 50%[1] over the past two years—its largest two-year gain since 1999. The Dow Jones Industrial Average (DJIA) added over 2,000 points, or 7.25% (9.7% TR) in 2020, while far behind the tech-heavy Nasdaq Composite gain of 43.6% (45.1% TR).

[1] Absolute price return = 49.83%.

An incredible year indeed for U.S. equities after a drastic selloff in February and March, set against a backdrop of human and economic devastation.

Historically speaking, returns on the S&P 500 have run the gamut (Exhibit 3). As for the best year (1954), the S&P 500 gained 52%, while the worst year (1931), the S&P 500 lost 47%. Since inception, the S&P 500 has impressively ended in positive territory 73% of the time. Globally, the picture finished mixed with the MSCI Emerging Markets Index (+18.3%) in line with the S&P's advance. Both gauges outpaced the MSCI Europe Index (+5.25%). The U.S. outperformed the rest of the world as measured by the MSCI All World ex-U.S. Index by at least 7%.

Exhibit 3: S&P 500 Total Return.



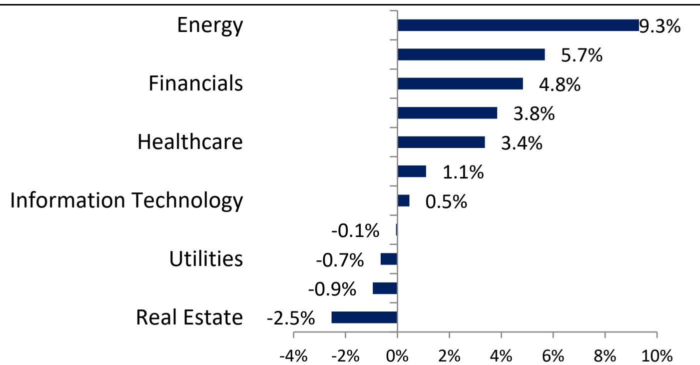
Source: Bloomberg. Data as of December 31 2020. **Past performance is no guarantee of future results.**

While there's no shortage of remarks that can be made about last year, the averages suggest 2020 was an abnormal year with above-average returns. As we turn the calendar page, we do see positive trends building for economic and earnings growth into the new year supportive of an equity uptrend in 2021.

Equities

	Total Return in USD (%)			
	Current	WTD	MTD	YTD
DJIA	31,097.97	1.7	1.7	1.7
NASDAQ	13,201.98	2.5	2.5	2.5
S&P 500	3,824.68	1.9	1.9	1.9
S&P 400 Mid Cap	2,416.37	4.8	4.8	4.8
Russell 2000	2,091.66	5.9	5.9	5.9
MSCI World	2,753.31	2.4	2.4	2.4
MSCI EAFE	2,215.12	3.2	3.2	3.2
MSCI Emerging Markets	1,353.53	4.8	4.8	4.8

S&P 500 Sector Returns



Fixed Income

	Total Return in USD (%)			
	Current	WTD	MTD	YTD
Corporate & Government	1.19	-1.3	-1.3	-1.3
Agencies	0.55	-0.4	-0.4	-0.4
Municipals	1.09	-0.1	-0.1	-0.1
U.S. Investment Grade Credit	1.21	-0.9	-0.9	-0.9
International	1.88	-1.5	-1.5	-1.5
High Yield	4.16	0.2	0.2	0.2

	Current	Prior Week End	Prior Month End	2019 Year End
90 Day Yield	0.07	0.06	0.06	0.06
2 Year Yield	0.13	0.12	0.12	0.12
10 Year Yield	1.12	0.91	0.91	0.91
30 Year Yield	1.87	1.64	1.64	1.64

Commodities & Currencies

	Total Return in USD (%)			
Commodities	Current	WTD	MTD	YTD
Bloomberg Commodity	170.06	2.1	2.1	2.1
WTI Crude $/Barrel††	52.24	7.7	7.7	7.7
Gold Spot $/Ounce††	1,849.01	-2.6	-2.6	-2.6

Currencies	Current	Prior Week End	Prior Month End	2019 Year End
EUR/USD	1.22	1.22	1.22	1.22
USD/JPY	103.94	103.25	103.25	103.25
USD/CNH	6.46	6.50	6.50	6.50

Sources: Bloomberg, Factset. Total Returns from the period of 1/4/2021 to 1/8/2021. †Bloomberg Barclays Indices. ††Spot price returns. All data as of the 1/8/2021 close.
Past performance is no guarantee of future results.

Asset Class Weightings (as of 1/5/2021)

	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*					
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.
CIO asset class views are relative to the CIO Strategic Asset Allocation (SAA) of a multi-asset portfolio.

Economic & Market Forecasts (as of 1/8/2021)

	Q1 2020A	Q2 2020A	Q3 2020A	Q4 2020A	2020A	Q1 2021E	2021E
Real global GDP (% y/y annualized)	-	-	-	-	-3.5*	-	5.3
Real U.S. GDP (% q/q annualized)	-5.0	-31.4	33.1	5*	-3.5*	1.0	4.6
CPI inflation (% y/y)	1.5	0.6	1.4	1.2*	1.2*	1.6	2.2
Core CPI inflation (% y/y)	2.1	1.2	1.7	1.6*	1.7*	1.5	1.8
Unemployment rate (%)	3.8	13.0	8.8	6.8*	8.1*	6.8	5.9
Fed funds rate, end period (%)	0.08	0.08	0.09	0.09	0.09	0.13	0.13
10-year Treasury, end period (%)	0.67	0.66	0.68	0.91	0.91	1.00	1.50
S&P 500 end period	2585	3100	3363	3756	3756	-	3800
S&P earnings ($/share)	33	28	39	38*	138*	36	165
Euro/U.S. dollar, end period	1.10	1.12	1.17	1.22	1.22	1.20	1.25
U.S. dollar/Japanese yen, end period	108	108	105	103	103	103	100
Oil ($/barrel, avg. of period, WTI**)	46	29	40	44	40	46	47

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.

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A = Actual. E/* = Estimate. S&P 500 represents the year-end target for 2021. **West Texas Intermediate.
Sources: BofA Global Research; GWIM ISC as of January 8, 2021.

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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 Commodity Research Bureau (CRB) Index measures the aggregated price direction of various commodity sectors, and is designed to isolate and reveal the directional movement of prices in overall commodity trades.

Nasdaq Composite Index is the market capitalization-weighted index of over 2,500 common equities listed on the Nasdaq stock exchange.

Dow Jones Industrial Average (DJIA) Index is a widely-watched benchmark index in the U.S. for blue-chip stocks that tracks 30 large, publicly-owned companies trading on the New York Stock Exchange and the NASDAQ.

MSCI Emerging Markets Index is an index used to measure equity market performance in global emerging markets.

MSCI Europe Index captures large and mid-cap representation across 15 Developed Markets (DM) countries in Europe.

MSCI World ex USA Index captures large and mid-cap representation across 22 of 23 Developed Markets (DM) countries-- excluding the United States.

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