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CHIEF INVESTMENT OFFICE

Capital Market Outlook

January 21, 2020

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

IN THIS ISSUE

- **Macro Strategy**—A confluence of structural changes in the U.S. economy over the past 70 years has dramatically reduced the incidence of recessions and raised the value of each dollar of corporate earnings. This helps explain why traditional valuation metrics have trended higher in the recent decades, confounding those looking at old guideposts for clues about equity returns.
- **Global Market View**—At nearly 60% of gross domestic product, the global economy rests on the shoulders of the consumer. Looking beyond day-to-day worries over trade policy and geopolitics, we believe portfolios should maintain long-term exposure to key industries within wealthy consumer markets in the U.S., Europe and Japan, in addition to select emerging markets (EMs) such as China.
- **Thought of the Week**—Negative corporate bond returns are not a base case, but a potential risk when yields are this low. Implications: maintain diversification across bond sectors, resist the urge to reach for yield, and manage returns expectations accordingly.
- **Portfolio Considerations**—We still remain underweight international developed equities overall but cut the large underweight approximately in half. We also raised EM equities slightly to neutral from a slight underweight. On the back of these adjustments, we still remain overweight the U.S. and maintain our overall overweight in equities.

MACRO STRATEGY

Chief Investment Office Macro Strategy Team

GLOBAL MARKET VIEW

Brian T. Wilczynski
Assistant Vice President and Investment Analyst

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

THOUGHT OF THE WEEK

Matthew Diczok
Managing Director and CIO Fixed Income Strategist

Data as of 1/21/2020 and subject to change.

MACRO STRATEGY

Structural Shift in Equity Valuations

Chief Investment Office Macro Strategy Team

Valuation is an important guide for prudent investment management. At the macro level, investors have relied on certain "rules of thumb" over the years to decide when the stock market is above or below "fair value," counting on the fact that eventually "fair value" will be reflected in equity prices. Many approaches to determining "fair value" depend on historical relationships and the ultimate reversion to the mean of historical valuation metrics. Nevertheless, veteran investors recognize the limitations of past performance as a timing tool because "*the market can stay over or undervalued longer than you can stay solvent.*" Also, history shows that these "rules of thumb" can stop working when the fundamental economic forces underpinning them change.

A good example of a pervasive belief or "rule of thumb" that stopped working after more than a century was the orthodoxy about the relationship between the dividend yield in the equity market and the interest rate on Treasury bonds. Since equities were known to be more volatile than Treasury bonds and did particularly poorly in periods of deflation, they were expected to yield more. Therefore, when the dividend yield fell below the yield on Treasury bonds in the 1950s, historically-based prudence suggested that stocks were overvalued. This rule caused old-timers operating on its dictate to remain underinvested starting in the 1950s as dividend yields never reverted to the old relationship while they missed one of the greatest bull markets in U.S. history.

The reason was straightforward, but underappreciated for a long time. After more than a century of inflation averaging zero and investors' expectations anchored around that reality, inflation became persistently positive and trended higher for the next 25 years. In addition, fear of deflation disappeared, as persistently positive inflation became the rule. Equities are a better hedge against inflation than fixed-coupon Treasury bonds, which caused a new "fair-value" environment with dividend yields well-below Treasury yields.

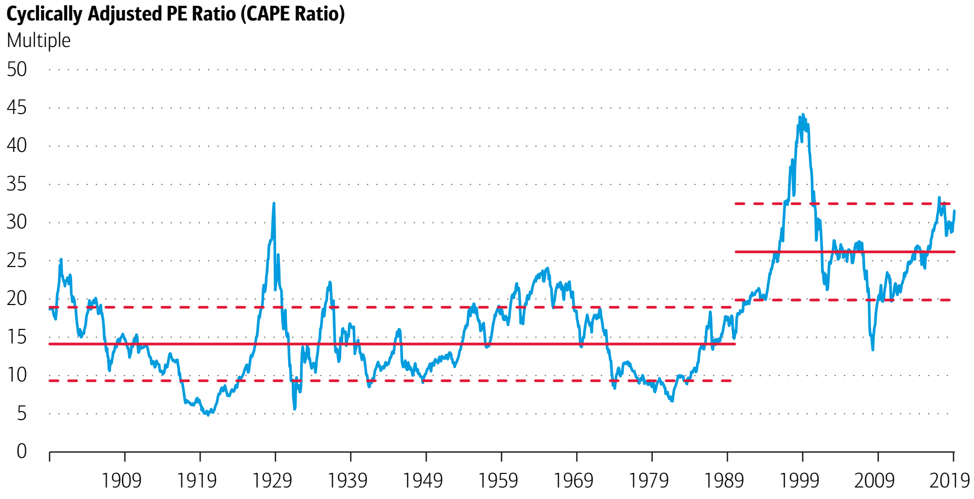
Another "rule of thumb" often attributed to Warren Buffett, based on a 2001 *Fortune* magazine interview, is the ratio of the equity-market's total value to gross domestic product (GDP). When the market's capitalization exceeded GDP, this ratio was judged to be too high and the market overvalued. The more the market's capitalization fell below GDP, the better the value according to this framework. Unfortunately, this measure stopped fluctuating around a fixed "fair value" mean as in the past. It has been persistently well above the old mean and has been trending higher over the past 30 years.

One reason for its rising trend is the globalization of U.S. corporate profits. The share of S&P 500 earnings generated abroad has risen to over 40%, suggesting the size of the domestic economy is less of a constraint on earnings power. Also, a disproportionate share of new market value is being created in the tech sector, where the U.S. dominates globally, adding to the reduced relevance of the domestic economy for U.S. stock-market valuation.

The major structural shift to a low and stable inflation environment has been particularly important in increasing the value of each dollar of U.S. corporate earnings and in breaking down old valuation "rules of thumb." The CAPE ratio (cyclically-adjusted price earnings ratio) clearly reflects this influence. Most closely associated with Yale Professor Robert Shiller, the CAPE ratio smoothes short-term volatility in price-earnings (PE) ratios by averaging earnings over a decade so that weak recession years and strong expansion years don't create distortions of the sustainable earnings power of companies.

The ratio has tended to foreshadow long-term equity-market returns. When the CAPE ratio has been low by historical standards, forward returns have been higher, and when the CAPE ratio has been high, forward returns have been lower. However, this ratio shifted up about 30 years ago. As shown in Exhibit 1, prior to 1990, the CAPE ratio averaged about 14, that is, stock prices averaged about 14 times the 10-year average of the earnings generated over the preceding decade. Since 1990, the CAPE ratio has averaged about 26, fluctuating in the top decile of the old range "*more than 75 percent of the time!*" according to research by Jim Paulsen at the Leuthold Group.

Exhibit 1: “Fair value” or Mean CAPE Ratio Has Almost Doubled Since 1990.



Source: Robert Shiller. Data as of January 14, 2020.

Basically, these traditional valuation metrics, like the dividend yield-Treasury yield relationship, the ratio of market capitalization to GDP, and the Shiller CAPE ratio show that based on previous valuation “rules of thumb,” the stock market has been and continues to be persistently overvalued. However, as noted, there are strong reasons for these valuation metrics to have shifted given the confluence of structural changes in the economy since World War II. As a result, the old “fair value” is not the new “fair value.” A dollar of earnings power today gets a higher valuation than it did in grandpa’s economy.

The change in the inflation environment has been particularly important in breaking down old “fair-value” guideposts. This is not only evident in the breakdown of the past relationship between the dividend yield and Treasury yields. Research by Leuthold shows that since 1900, the CAPE ratio closely tracks an index composed by averaging the trend in inflation and the volatility of inflation over the past 100 years. Taking account of these inflation dynamics allows much better forecasts of the “fair-value” CAPE. Lower, more stable inflation raises the “fair-value” level of CAPE.

The current economic expansion is the longest in U.S. history. The four longest expansions have all occurred since 1960. Prior to World War II, recessions were five times more likely than afterward. In addition, the amplitude of economic fluctuations measured by standard deviations was about three times greater before 1940 for both real and nominal GDP. Between pro-active fiscal and monetary policy and the structural shift to less cyclical services from more cyclical manufacturing activity, the modern economy is much less prone to recessions.

In addition, the conduct of monetary policy has gone through several phases since World War II as central banks learned how to best control fiat money not backed by gold or any tangible asset. By 1990, the Federal Reserve (Fed) and other major central banks were well under way to taming inflation around the 2% target. Since then, inflation has been extremely stable around that target. In fact, according to Leuthold Research, “*Since the late 1990’s, the trailing 15-year volatility of inflation has hovered near 1%, lower than any other time since at least 1900. Inflation has not only been low, it has been predictably low.*” In short, the reduced economic volatility of recent decades makes both inflation and growth much more predictable and stable than during the previous historical record, which is still the basis for many existing valuation “rules of thumb.” This increased stability warrants higher valuations, and that’s what we observed across most valuation metrics over the past 30 years as this more predictable economic structure filters into asset values.

In conclusion, the high valuations of equities by historical standards can be misleading since, as the economy has evolved, various forces have substantially reduced the risks from macroeconomic volatility related to inflation. Central-bank efforts to keep inflation expectations anchored around 2% seem to have caused a positive re-evaluation of future corporate cash flows and earnings. Contrary to critics' claims, this upward valuation seems justified by a change in economic fundamentals rather than a sign of irresponsible bubble blowing. Stable, predictable inflation around low levels has also been associated with longer expansions than in the past. All in all, central bank efforts to achieve this modern version of price stability seems to be working, and the results seem to support this primary focus of monetary policy.

GLOBAL MARKET VIEW

Leveraging the Power of the Global Consumer

Brian T. Wilczynski, Assistant Vice President and Investment Analyst
Joseph P. Quinlan, Managing Director and Head of CIO Market Strategy

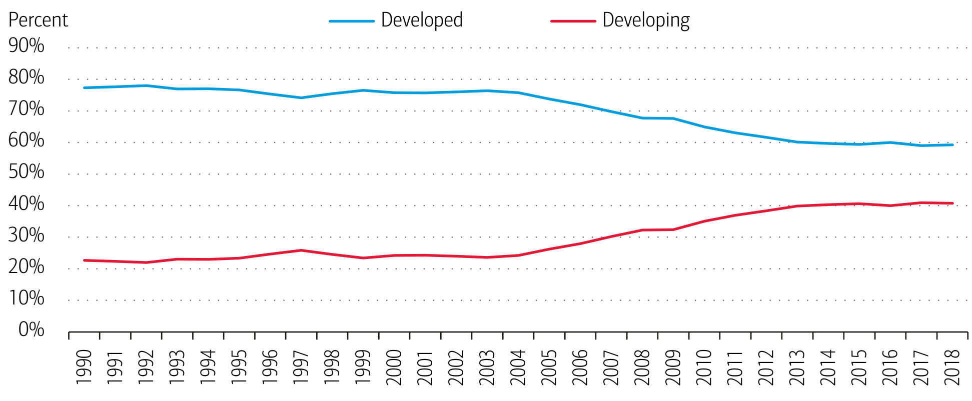
Over the course of any business cycle there are a host of factors that can impact the value of a portfolio, ranging from corporate earnings reports to interest rates, global trade, geopolitical risks and more. But over the long term, we believe that every portfolio should have exposure to one of the most powerful economic forces of the 21st century: the steady rise of global consumer spending, both in the developed and developing economies. While it may get lost in the headlines on trade wars, impeachment and the Middle East, consumer spending is the key driver of economic growth in the U.S. and abroad, accounting for nearly 60% of the world's GDP, according to the United Nations (UN).

According to the latest data, global consumer spending reached a record $48.4T in 2018, thanks to steady job gains and rising wages in many parts of the world, to go along with structural tailwinds such as higher education rates and greater labor force participation among women.

At the top of the list is the United States, amassing $14T in consumer spending for the year, more than the next five countries combined. The strong consumer was one of the key reasons that economic growth in the U.S. accelerated in 2018 even as global economic growth slowed, and a key reason that even in the face of a U.S. manufacturing slowdown last year, the U.S. economy chugged on. At nearly 70% of GDP, the U.S. economy follows the consumer, which was supported by a robust jobs market, healthy household balance sheets and strong consumer confidence, which we expect to continue in 2020 and keep the record economic expansion going.

Looking abroad, the next largest consuming cohort is the European Union (EU), which by itself makes up 21% of global spending. Remarkably, while the EU has less than half the population of China, the EU consumer still spends nearly twice as much, totaling $10.4T in 2018 compared to $5.3T for China. This disparity is explained partly by the large wealth gap that exists between the two, as per capita income in the European Union currently stands at $36,570, about four times that of China, according to the World Bank. In fact, despite the rise of emerging markets like China and India, it may come as a surprise to many investors that the U.S. and EU still command the largest share of global consumption, 50% together in 2018 versus only 14% from China and India combined. The latter have gained significant share over the past few decades, but the gap remains wide and has actually been very steady over the past few years. Throw in other nations such as Japan, Germany and the UK, and the share of global consumption by developed nations totals $28.7T, nearly 60% of global spending (Exhibit 2).

Exhibit 2: Share of Global PCE.

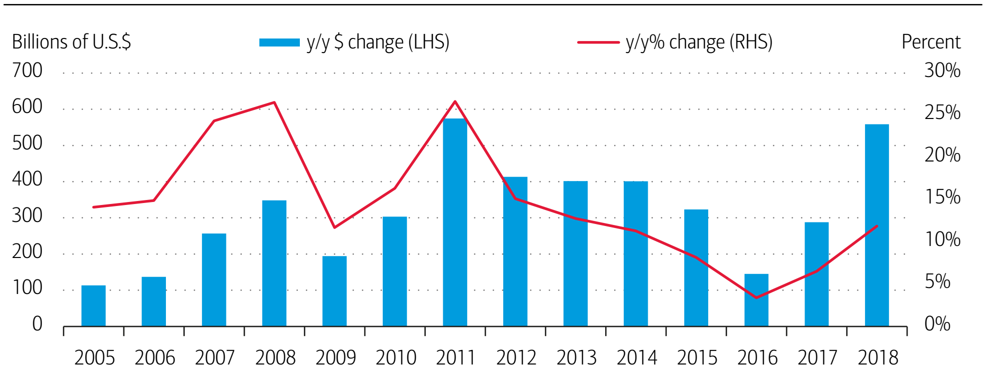


Source: United Nations. Data through 2018 (latest available) as of January 2020.

The large and wealthy consumer base in the EU is one of the key reasons that the bloc is an extremely important driver of earnings for U.S. multinationals, accounting for 46% of U.S. foreign affiliate income in the first nine months of 2019, according to the Bureau of Economic Analysis. Europe would be one of the main beneficiaries of a pickup in global economic growth in 2020 and as such consumer spending in key European economies could have some upside, especially if fiscal stimulus in Germany or the UK pulls through. The labor market for the EU is solid in aggregate, with unemployment reaching its lowest level on record in 2019, but mixed across key economies with unemployment in the UK and Germany near all-time lows while Spain and Italy remain elevated compared to pre-Financial Crisis levels.

While its economy has continued to slow over the past decade, the spending power of the Chinese consumer remains unmatched in the developing world, reaching a total of $5.3T for 2018. While the percentage growth of consumer spending pales in comparison to the 25%+ growth rates of the late-2000s, spending rose by $559B in absolute dollar terms, which is close to the fastest on record (Exhibit 3). The consumer has in turn become a bigger driver of Chinese equity performance, with consumer-oriented sectors like Consumer Discretionary/Staples, Technology, Healthcare and Communication Services accounting for 58% of market capitalization in late 2019, versus just 28% in 2010. With the broader economy slowing down and shifting away from investment and trade, this supports a sector-specific approach to investing in EMs like China, in our opinion. For instance, while the auto sector in China remains under pressure, the rise of e-commerce could present opportunities for the major internet retailers/e-commerce giants. With over 560 million online shoppers, China is the largest ecommerce market in the world, totaling an estimated $1.3T in 2018 and making up more than 50% of global online spending.

Exhibit 3: The Chinese Consumer Remains a Powerful Force.



Source: United Nations. Data through 2018 (latest available) as of January 2020.

Fueled by the rise of China, emerging market consumers experienced remarkable growth this century, seeing their share of total consumption rise from 24% in 2000 to 41% in 2018. But over the past five years, growth among EMs has slowed markedly, and its share of global spending has started to show signs of stalling. Weakness in 2018 was primarily driven by Latin America, where consumption contracted by 5.8%, driven by a collapse in spending by Argentina (-21%), while spending in Brazil fell by 9%. The engine of growth for EMs continues to be Developing Asia, with growth accelerating to 8.9% in 2018 and now making up 21.7% of global personal consumption expenditures (PCE), but remove China and the figures are somewhat less impressive, as spending growth slowed from 9.5% in 2017 to 6.1% in 2018.

Aside from cyclical headwinds like slower global trade and a stronger dollar that weigh disproportionately on EM economies, per capita incomes in many emerging economies remain very low compared to the U.S., which may be capping their contributions to global consumption. According to the World Bank, U.S. nominal GDP per capita in 2018 was $62,795, which towers over prominent EMs like China ($9,771), Brazil ($8,921), South Africa ($6,374) and India ($2,010). This underscores the need for policymakers to develop their nations' human capital capabilities (education and training), export structure (high value-add production and exports) and enhance productivity to close the income gap with developed countries. As Exhibit 4 highlights, global spending is skewed toward just a few countries, as the top 10 largest consuming nations in the world account for more than two-thirds of global consumption.

Exhibit 4: Top-Ranked Countries in the World by PCE.

Rank	Country	Billions of $	Percent of World Total
1	United States	$13,999	28.9%
2	China	$5,263	10.9%
3	Japan	$2,763	5.7%
4	Germany	$2,059	4.3%
5	United Kingdom	$1,871	3.9%
6	India	$1,651	3.4%
7	France	$1,498	3.1%
8	Italy	$1,258	2.6%
9	Brazil	$1,202	2.5%
10	Canada	$997	2.1%
Top 10 Total		**$32,560**	**67.2%**

Source: United Nations. Data through 2018 (latest available) as of January 2020.

Portfolio Strategy

All of the above serves as a reminder that the outlook for the global economy in large part rests on the consumer. We believe investors should maintain exposure to wealthy consumer markets in the U.S., Europe and Japan, in addition to select emerging markets such as China. Examples include best-in-breed U.S. companies in sectors like consumer discretionary and technology, as well as consumer-product leaders in Europe and Japan. In EMs, investors can take advantage of the rise of e-commerce through exposure to select internet retailers in China, while the surge in global obesity and rising incomes could represent a major tailwind for healthcare. Other beneficiaries at the industry level could be consumer electronics and department stores; household products and packaged foods; and higher-end segments like tourism and luxury goods.

THOUGHT OF THE WEEK

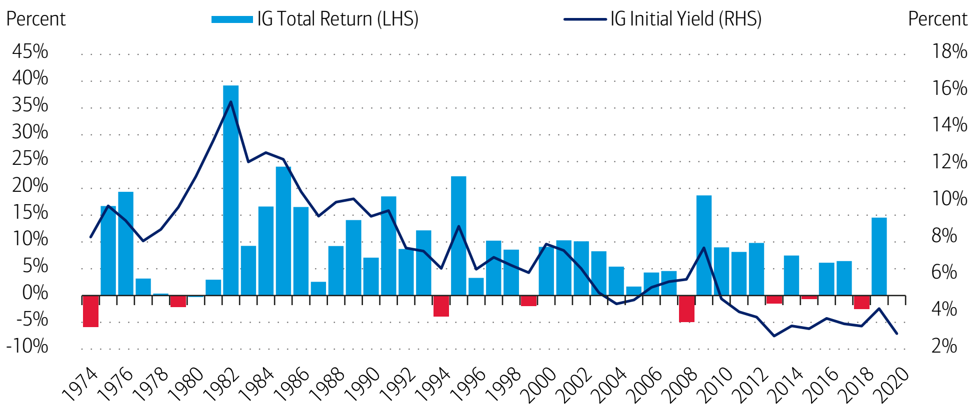
Low Corporate Yields an Achilles' Heel? Potential Concerns Over Negative Returns

Matthew Diczok, Managing Director and CIO Fixed Income Strategist

Our 2020 fixed income outlook is positive, but modest. We expect coupon-like returns across most sectors. This contrasts last year's double-digit returns across many sectors—including corporates, preferreds, and high yield. We do want to highlight, however, one risk to our outlook: the potential for negative total returns in low-yielding bond sectors like investment-grade corporates.

There have only been nine instances since 1974 when corporate bond total returns have been negative. While this has happened in both low and high yield environments, the risk is greater—from a probability perspective—when rates are low. Three of those instances of negative returns happened in just the last seven years. In each year, yields were close to where they are now: 2.7% (2013), 3.1% (2015) and 3.3% (2018). Currently, corporate yields are 2.77%, the lower end of that range.

Exhibit 5: Negative Corporate Bond Returns: Three of Nine Episodes Have Happened in Last Seven Years.



Source: Bloomberg Barclays Indices, January 14, 2020. **Past performance does not guarantee future results.**

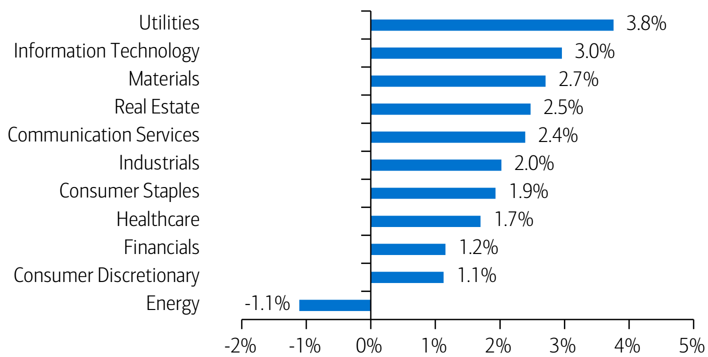
The greater possibility of negative returns is just a function of bond math. Higher durations and lower coupons mean that it takes less spread or yield widening to lower bond prices enough to offset any positive contribution from coupon income. At a duration of approximately eight and yields just below 3%, only +36 basis points (0.36%) of widening in spreads or yields would completely erase coupon income from a total return perspective. This is the lowest reading we have ever seen.

This is yet another good reminder to remain diversified across fixed income assets. Compressed spreads and yields mean there are relatively few opportunities for relative value between sectors. Some allocation to Treasurys is important; an environment leading to worse corporate bond returns—a risk-off event causing spreads to widen, for example—may be offset by lower Treasury yields and positive returns in that sector. This is a good time to re-emphasize what role bonds should perform in a portfolio: a source of income and a diversifier for risk assets primarily, not a source of capital appreciation or insulation from short-term price dislocations. When held to duration, the initial yield of a portfolio is the best predictor of the central tendency of its future returns. Manage your expectations accordingly, and be cognizant of potential price volatility—negative and positive—along the path.

Equities

		Total Return in USD (%)		
	Current	WTD	MTD	YTD
DJIA	29,348.10	1.8	2.9	2.9
NASDAQ	9,388.94	2.3	4.7	4.7
S&P 500	3,329.62	2.0	3.1	3.1
S&P 400 Mid Cap	2,095.55	2.2	1.6	1.6
Russell 2000	1,699.64	2.5	1.9	1.9
MSCI World	2,415.03	1.6	2.5	2.5
MSCI EAFE	2,056.00	0.9	1.0	1.0
MSCI Emerging Markets	1,145.68	1.2	2.9	2.9

S&P 500 Sector Returns



Fixed Income[1]

		Total Return in USD (%)		
	Current	WTD	MTD	YTD
Corporate & Government	2.18	0.1	0.6	0.6
Agencies	1.85	0.0	0.3	0.3
Municipals	1.60	0.3	1.0	1.0
U.S. Investment Grade Credit	2.25	0.1	0.5	0.5
International	2.78	0.2	0.7	0.7
High Yield	5.12	0.3	0.7	0.7

	Current	Prior Week End	Prior Month End	2019 Year End
90 Day Yield	1.49	1.49	1.49	1.49
2 Year Yield	1.56	1.57	1.57	1.57
10 Year Yield	1.82	1.82	1.92	1.92
30 Year Yield	2.28	2.28	2.39	2.39

Commodities & Currencies

		Total Return in USD (%)		
Commodities	Current	WTD	MTD	YTD
Bloomberg Commodity	169.85	-1.1	-1.3	-1.3
WTI Crude $/Barrel[2]	58.54	-0.8	-4.1	-4.1
Gold Spot $/Ounce[2]	1,557.24	-0.3	2.6	2.6

Currencies	Current	Prior Week End	Prior Month End	2019 Year End
EUR/USD	1.11	1.11	1.12	1.12
USD/JPY	110.14	109.45	108.61	108.61
USD/CNH	6.87	6.92	6.96	6.96

Source: Bloomberg, Factset.Total Returns from the period of 1/13/20 to 1/17/20. Bloomberg Barclays Indices.[1] Spot price returns.[2] All data as of the 1/17/20 close.
Past performance is no guarantee of future results.

Asset Class Weightings (as of 1/9/2020)

	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 1/20/20)

	Q2 2019A	Q3 2019A	Q4 2019A	2019A	Q1 2020E	2020E
Real global GDP (% y/y annualized)	–	–	–	2.9	–	3.2
Real U.S. GDP (% q/q annualized)	2.0	2.1	2.2*	2.3*	1.0	1.7
CPI inflation (% y/y)	1.8	1.8	2.0	1.8	2.4	2.4
Core CPI inflation (% y/y)	2.1	2.3	2.3	2.2	2.3	2.4
Unemployment rate (%)	3.6	3.6	3.5	3.7	3.5	3.6
Fed funds rate, end period (%)	2.40	1.90	1.55	1.55	1.63	1.63
10-year Treasury, end period (%)	2.01	1.66	1.92	1.92	1.80	1.80
S&P 500 end period	2942	2977	3231	3231	–	3300
S&P earnings ($/share)	41	42	41.5*	164.1*	40.5	177
Euro/U.S. dollar, end period	1.14	1.09	1.12	1.12	1.10	1.15
U.S. dollar/Japanese yen, end period	108	108	109	109	110	103
Oil ($/barrel, avg. of period, WTI**)	60	56	57	57	59	57

The forecasts in the table above are the base line view from BofA 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 2020. **West Texas Intermediate

Sources: BofA Global Research; GWIM ISC as of January 20, 2020.

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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 is a stock market index that tracks the stocks of 500 large-cap U.S. companies. It represents the stock market's performance by reporting the risks and returns of the biggest companies.

The cyclically adjusted price-to-earnings ratio, commonly known as **CAPE**, is a valuation measure usually applied to the US S&P 500 equity market. It is defined as price divided by the average of ten years of earnings (moving average), adjusted for inflation.

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Investing involves risk, including the possible loss of principal. No investment program is risk-free, and a systematic investing plan does not ensure a profit or protect against a loss in declining markets. Any investment plan should be subject to periodic review for changes in your individual circumstances, including changes in market conditions and your financial ability to continue purchases.

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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