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CHIEF INVESTMENT OFFICE

Capital Market Outlook

October 4, 2021

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

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Macro Strategy—A key feature of this economic expansion has been unprecedented fiscal and monetary policy, and both will likely be downshifting in the months ahead. While fiscal policy has a great deal of near-term uncertainty, monetary policy is the more important piece to watch for tactical and strategic asset allocation decisions.

Global Market View—Large sums of money are relying on the robust U.S. economic and market recovery—and it's not just house money. By a real vote of confidence from the rest of the world, foreign investors have placed their faith in U.S. assets, with a trove of data suggesting all roads have led investors to the U.S., as measured by foreign holdings of U.S. dollar-denominated assets.

Thought of the Week—Clouded by the negative news about supply chain bottlenecks or an economic slowdown in China, U.S. foreign affiliate income (a proxy for U.S. global earnings) is currently clipping along at a record pace. According to recently released figures from the Bureau of Economic Analysis (BEA), U.S. foreign affiliate income totaled a record $123 billion in Q2—a figure not only well above the depressed numbers of a year ago but also a pre-pandemic high.

Portfolio Considerations—Given the impressive outperformance of Equities over bonds throughout the better part of 2020 and so far this year, Equity weights have drifted higher than our recommended tactical tilts, and Fixed Income weights have drifted lower. As such, the strategy to rebalance from Equities into bonds would bring them in line with our tactical weights, and we look to implement the same in our CIO Portfolios. Our tactical views are not changing as a result of this rebalance, and we still remain overweight Equities and underweight bonds as per our earlier recommended tactical asset allocation weights.

MACRO STRATEGY

Jonathan W. Kozy
Managing Director and Senior Macro Strategy Analyst

Chief Investment Office
National Wealth Strategy Team

GLOBAL MARKET VIEW

Lauren J. Sanfilippo
Vice President and Investment Strategist

THOUGHT OF THE WEEK

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

Data as of 10/4/2021, and subject to change

MACRO STRATEGY

Economic Policy Turbulence Ahead

Jonathan W. Kozy, Managing Director and Senior Macro Strategy Analyst

Chief Investment Office, National Wealth Strategy Team

After more than a year and a half of unprecedented economic policy stimulus, both fiscal and monetary policy will likely be downshifting. Faced with inflation that is running well above the Federal Reserve's (Fed) 2% target and an increasingly tight labor market, the Fed has signaled it will begin tapering asset purchases this year. On the fiscal side, policymakers are slowly paring back plans for trillions of dollars of additional stimulus

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coupled with tax increases, all while balancing concerns over a massive, growing budget deficit. While we think the business cycle has legs despite the downshift, investors should prepare for near-term fiscal volatility and a less bullish policy backdrop over the medium term.

Fiscal Game of Chicken

Game on.

Who will blink first, Republicans or Democrats? Or can we call it a draw?

Within hours of the end of the government's fiscal year (midnight of September 30, 2021), Democrats yielded on their demand to link continued government funding with a suspension of the debt ceiling. This appears to be a logical move, as most observers agree that Democrats have more to lose if the government shuts down since they control Congress and the White House. This resulted in the passage of a Continuing Resolution (CR) on September 30, 2021, which funds the federal government through December 3, 2021. Without such an agreement, the non-essential functions of government would have shut down on October 1. The last shutdown occurred on December 22, 2018, and lasted 35 days—the longest on record.

Funding the government, even temporarily, still leaves another looming deadline: the debt ceiling. The complications arise from the so-called "X date": the date on which the federal government could no longer legally borrow after exhausting extraordinary accounting measures. After a two-year suspension, the debt ceiling was reinstated on August 1, at a level covering all borrowing that occurred during the suspension. With Treasury's extraordinary measures in place that date, the X date could be as soon as October 18, according to Treasury Secretary Yellen. Others, such as the Bipartisan Policy Center, believe the X date would fall between October 15 and November 4. Republicans believe this can and should be resolved by the Democrats, who control Congress and the White House. Democrats believe this should be a bipartisan effort, since the extension of the debt ceiling is necessary to address prior spending.

Republicans, on the other hand, are nearly united about not providing votes for the debt ceiling, at least at this time. When one political party controls Congress and the White House, that party usually supplies the votes to address the debt ceiling. When Congress is divided, it becomes a bipartisan effort.

Intertwining politics and the extension of the debt ceiling appear to make a toxic political cocktail.

There are no simple answers. Increasing the debt ceiling could be accomplished by a reconciliation bill, but it would need another budget resolution to kick-start the process. Could there be a bipartisan deal? Perhaps. But what would entice Republicans to join in? Republicans are not currently asking for any concessions and Democrats are not yet prepared to yield any ground. Here are some possibilities in this political game of chess:

Infrastructure Leads the Way—Although there is disagreement within the Democratic Party on the process for passing both the bipartisan infrastructure bill and the reconciliation bill (Build Back Better Act), adding the infrastructure bill to a bill that addresses the debt ceiling may attract Republican votes and become more palatable to progressive democrats.

Democrats Go it Alone 1.0—The Democrats could address the debt ceiling without Republicans providing any votes, but Republicans, nonetheless, must help in the process. If Republicans agreed not to filibuster such a bill in the Senate, then it could proceed to a floor vote, which could be successful with only Democratic support. Essentially, the Republicans remove the roadblocks to raising the debt ceiling but the Democrats provide the votes to get it done. Possible, but not likely at this point. This was attempted on September 28, when Majority Leader Schumer sought unanimous consent to move

directly to a vote on the debt ceiling, which would need only a simple majority. Such an effort was blocked by Minority Leader McConnell.

Democrats Go it Alone 2.0—Addressing the debt ceiling is permitted under budget reconciliation rules, so long as it is authorized by a budget resolution. Therefore, Democrats could authorize another budget resolution (and a separate reconciliation bill) or address it in the current reconciliation bill without Republican support. But first, another budget resolution would be necessary, which itself is time consuming and raises a host of ancillary issues. Doing so more closely ties Democratic spending packages with the growing federal debt and makes for unfavorable headlines. Another problem: the debt ceiling cannot be suspended to a future specific date, but rather must be tied to a specified dollar amount. This further highlights the magnitude of the government's spending addiction. Not politically pleasing.

Article 14 of the U.S. Constitution—Once viewed as unlikely, there is an argument that the President could invoke Section 4 of the 14th Amendment of the U.S. Constitution and unilaterally raise the debt ceiling. The 14th Amendment states, in part, that "the validity of the public debt of the U.S., authorized by law … shall not be questioned." Does this give the President authority to authorize the Treasury to continue to issue new debt? President Clinton appeared comfortable relying on such an amendment, but never needed to do so. The Obama administration seemed unwilling to rely on this authority and test the constitutional issues. In a recent letter to her Democratic colleagues, Speaker Pelosi made direct reference to the 14th Amendment, while at the same time insisting that Democrats would not pursue another reconciliation bill.

Default—A possibility, but the risk is low since Democrats can avoid this on a party-line vote. However, the thought or possibility of default has consequences. In 2011, S&P downgraded the credit rating of the federal government for the first time in history. And the mere delay in raising the debt ceiling was estimated to have increased borrowing costs by $1.3 billion in 2011 according to the Government Accountability Office. Already the Treasury Bill yield curve is showing volatility, but rate markets are digesting rising uncertainty in both monetary policy and fiscal policy.

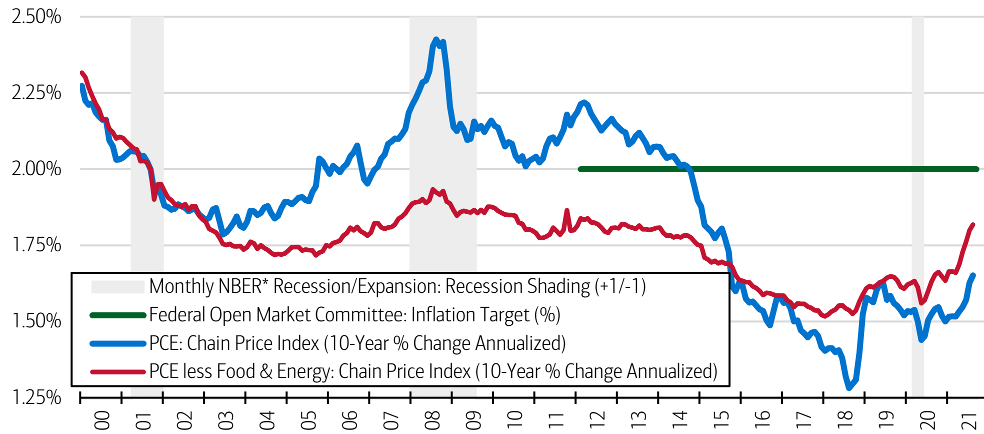
How this game of political chess ends is yet to be determined. One thing we do know: time is of the essence. Given the options and the time frame, pursuing another reconciliation bill seems to be the most appealing and likely option.

Fed Yet To Ruffle the Market's Feathers

Monetary policy may be more relevant for long-term asset allocators and is likely playing an outsized role in interest rate and Equity market volatility even if fiscal policy steals the near-term headlines. The current stance of monetary policy, consisting of a historically low real Fed funds rate coupled with a large and expanding balance sheet, is increasingly out of tune with its policy mandate of full employment and stable prices, with inflation around 2%. Year-over-year inflation growth, as measured by the personal consumption expenditures (PCE) price index, has been overshooting the Fed's target since March and the labor market is tight by many metrics. Fed Chair Powell seems to be waiting on a pickup in the participation rate to become even more hawkish on labor market dynamics.

The Fed's goal of making up for past periods of undershooting the inflation target may also be achieved sooner rather than later. The Fed started formally targeting 2% inflation in 2012, and the 10-year annualized rate is heading in that direction (Exhibit 1). It is worth noting that the 10-year annualized rate of change in the core consumer price index (CPI) is already running over 2%. Mission almost accomplished.

Exhibit 1: Fed's Formal 2.0% Inflation Target Started in 2012. 10-Year Average Inflation Closing In On Target.



*NBER=National Bureau of Economic Research. Source: Bureau of Economic Analysis. Data as of August 27, 2021

Through the most recent Federal Open Market Committee (FOMC) statement, its forecasts and Chair Powell's post-meeting press conference, the Fed quietly acknowledged higher than expected inflation and labor market progress without spooking the markets. The tapering of asset purchases, akin to easing off the accelerator, is likely to begin in November and conclude by the middle of next year. Some FOMC participants believe rate hikes will be necessary by the end of next year. For now though, BofA Global Research believes the Fed will not raise rates until 2023, leaving investors a long runway ahead. But given the conditions described above, a key risk to the business cycle and risk assets is if the pace of inflation growth and continued progress in the labor market push the Fed to pull forward its median path of rate hikes even more, in our view.

Just as important for investors, even as the Fed downshifts, policy is likely to remain accommodative for the next few years. The Fed's forecast for the neutral policy rate is 2.5%, a real policy rate of around 50 basis points (bps). If the Fed is raising rates bps at every meeting starting at the end of next year until the end of 2023, the Fed funds rate will still be below the neutral rate. And monetary policy operates with a lag. This also suggests that, in the context of monetary policy, risk assets probably have some room to run heading into 2022.

All in all, there is a lot of potential for economic-policy-based volatility to pick up, but given the lags involved in monetary policy and the likelihood that policymakers push through additional fiscal stimulus at some level and avoid an unthinkable default, economic policy will likely remain accommodative for some time, or at least as long as the inflation beast can be tamed.

Given still-positive cyclical dynamics, investors should stay laser focused on the Fed and inflation and should consider using bouts of fiscal-policy-related volatility to rebalance. In terms of interest rates, the fiscal uncertainty adds to the potential for a rates "tantrum," and investors should maintain exposure to asset classes like financials that are more resilient or beneficiaries of higher rates. Lastly, while the fiscal follies give ammunition to the narrative that the dollar's reserve currency status is in jeopardy, the fundamental anchors of the exorbitant privilege suggest otherwise (economic size, inertia, alliances/partnerships, governance, financial institutions and military strength).

GLOBAL MARKET VIEW

Faith and Funds: The U.S. as the Final Destination

Lauren J. Sanfilippo, Vice President and Investment Strategist

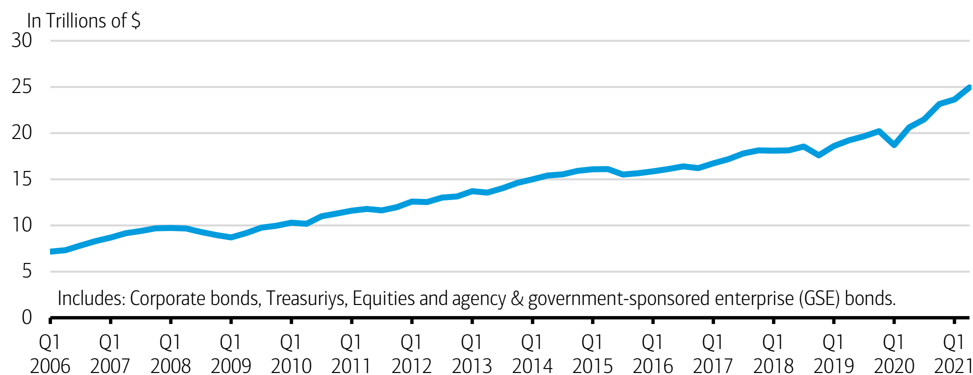
Outperforming most major markets, U.S. equities have returned some 15% on a year-to-date (YTD) basis. Performance shows venturing abroad hasn't paid, with non-U.S. Developed Markets returning a less impressive 8.4% and Emerging Markets essentially flat-to-down on the year.[1] Over the recent quarter and closing out a seasonally mixed period, the U.S. finished in positive territory for Q3 2021, trouncing the -3% performance of all other global equities-excluding the U.S. Adding insult to injury, and without naming names, certain regions of the world have lost their luster and have even been dubbed "uninvestable" by some. The U.S. seems to be the final destination for many investors in spite of U.S.-based concerns about budget deficits, elevated equity valuations, or Fed direction/tapering, by way of the TINA ("there is no alternative") principle or relative attractiveness.

Large sums of money are currently relying on the robust U.S. economic and market recovery—and it's not just house money. By a real vote of confidence from the rest of the world, foreign investors have placed their faith in U.S. assets, with a trove of data suggesting all roads have led investors to the U.S., as measured by foreign holdings of U.S. dollar-denominated assets. For better or for worse, foreign investors have a significant stake in U.S. assets, leveraging the mature, open, competitive and sophisticated U.S. capital markets. Below we illustrate this point.

Resilience for All Things American

Foreign demand for U.S. securities by most measures and across asset classes remains healthy and, in some cases, elevated. According to the latest Flow of Funds data courtesy of the Fed, foreign ownership of U.S. securities hit a record high of $24.95 trillion in Q2 of this year (Exhibit 2), although it's been surging over the past two-and-a-half decades. Foreign ownership of U.S. securities (specifically Equities, government agency bonds, corporate bonds and Treasurys) has doubled since the start of the 2008 Great Financial Crisis and increased more than six-fold since the beginning of the century. This includes current foreign holdings making up 40% of the corporate bond market, 30% of marketable U.S. Treasurys, and $12 trillion worth of equities—or 19% of the market (Exhibit 3)—all, for sure, market-moving levels of ownership.

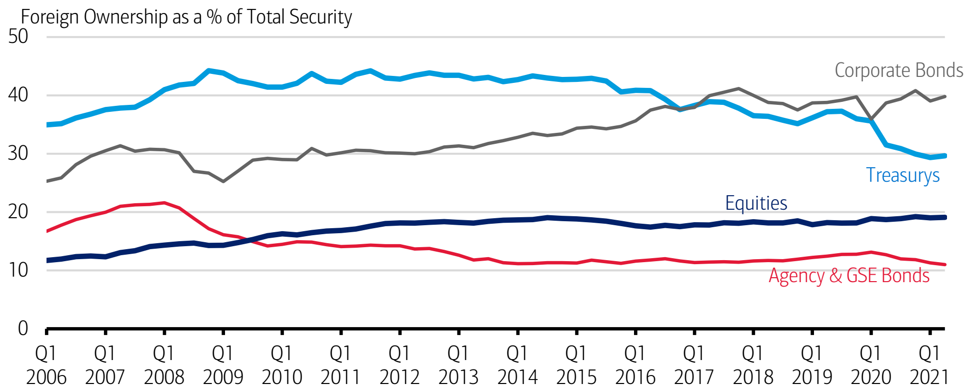
Exhibit 2: Don't Call it a Comeback: Foreigner's Ownership of U.S. Securities.



Source: Federal Reserve. Data through Q2 2021, as of September 2021.

[1] Total return unless otherwise stated. MSCI U.S. as U.S.; MSCI EAFE as non-U.S. Developed Markets; MSCI EM as Emerging Markets. Data as of September 30, 2021.

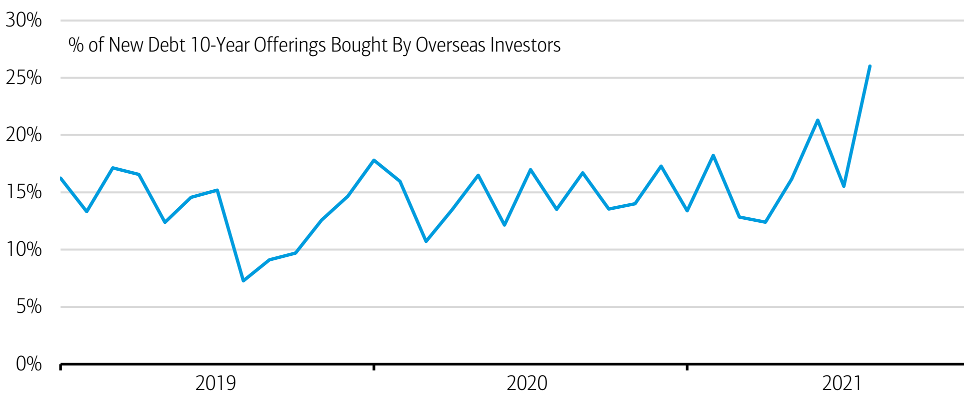
Exhibit 3: Foreigner's Slice of U.S. Assets.



Source: Federal Reserve. Data as of September 2021. Note: Only as a percentage of an elevated total, foreigner's ownership of Treasurys appears to be trending down.

The buck doesn't stop there. The perception and comparative allure of U.S. Treasury debt matters hugely with foreign central banks and other foreign investors who help finance America's perennial budget deficit. To this point, foreign investors continue to exhibit plenty of faith in U.S. government debt. Feeling encouraged by an as-advertised accommodative/dovish Fed, as Exhibit 4 shows, of the $41 billion of 10-year notes on auction in August, overseas buyers accounted for almost 30%, the highest percentage in three years. Similar trends were seen at previous auctions, like the two-year in August where investors bought 22%, the highest since December 2019.[2] Corroborating this point are foreign holdings of U.S. government bonds in July, which rose to a record $7.5 trillion according to recent Treasury Department data. For the sake of comparison, foreign holdings of Treasurys totaled $6.8 trillion at the end of December 2019, pre-pandemic. This uptick, a bullish prospect, is supportive to markets, especially as Fed Chair Powell recently signaled the curtailing of the $120 billion monthly debt purchases likely approaching.

Exhibit 4: Pass the Buck: Foreign Buyer Presence At The 10-Year Auction.



Source: U.S. Treasury Department. Data as of September 2021. Short-term time period shown to illustrate more recent trends.

All of the above reflects a strong conviction in U.S. financial assets and is a sign of confidence that the world's largest economy will remain just that, with capital inflows pointing to bullish underlying economic and market conditions for U.S. securities—a narrative happily adopted by U.S. and foreign investors alike. Heightened foreign demand for U.S. assets translates into higher/elevated levels of financial liquidity, which in turn helps fuel U.S. economic output, job growth and rising incomes for U.S. workers; it also greases underlying demand for U.S. securities and supports our base case that, despite particular headwinds, U.S. Equities are poised to grind higher over the medium term. And

[2] *Financial Times*, September 21, 2021.

speaking of support, strong foreign demand for U.S. assets is one key reason the U.S. dollar continues to defy the doomsayers, with the greenback[3] up 4.9% on a trade-weighted basis YTD, remaining the world's reserve currency.

The bottom line is this: While we are not oblivious to the multiple economic challenges in front of the U.S.—including burdensome entitlement expenditures, the rising cost of servicing America's debt, anti-trade and anti-immigration sentiment—foreign demand for U.S. securities remains robust and supportive across multiple asset classes, adding to the conviction we have for U.S. assets as a geographic preference. Widening the lens, strong earnings, robust corporate and consumer balance sheets, and unprecedented support from the Fed should continue to support a favorable U.S. Equity environment in the near term. Within this outlook, we continue to emphasize Equities relative to Fixed Income and U.S. Equities relative to the rest of the world.

THOUGHT OF THE WEEK

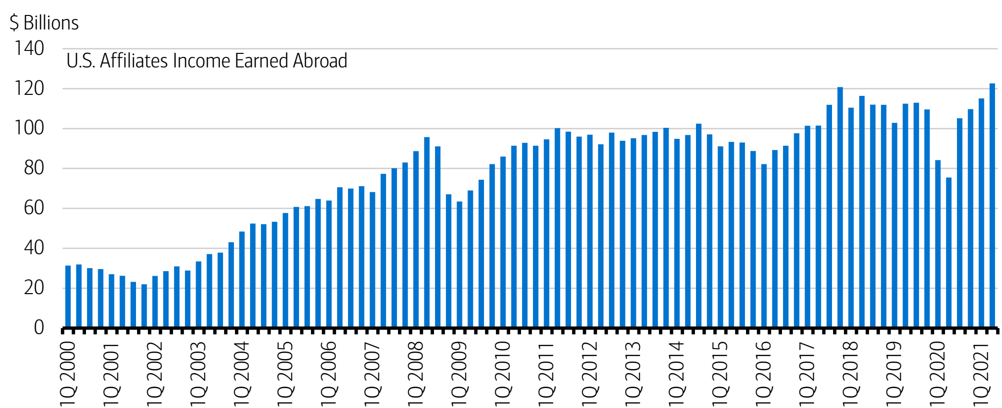
It's Not All Gloom and Doom on the U.S. Global Earnings Front

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

Supply chain bottlenecks, China's economic slowdown, a strengthening greenback—there are numerous headwinds to the earnings of U.S. multinationals, all of which were highlighted at length in the popular media over the past few weeks. The negative drumbeat, not surprisingly, has dampened Q3 earning expectations for many U.S. Large-cap companies, although we are more sanguine.

Missing from the consensus is the simple fact that U.S. foreign affiliate income (a proxy for U.S. global earnings) is currently clipping along at a record pace. According to recently released figures from the BEA, U.S. foreign affiliate income totaled a record $123 billion in Q2—a figure not only well above the depressed numbers of a year ago but also a pre-pandemic high (Exhibit 5). For the first half of 2021, affiliate income was nearly 50% higher than the comparable period a year ago, reflecting a much faster-than-expected snapback in U.S. global earnings.

Exhibit 5: The U.S. Earned A Record $123 Billion Abroad In Q2.



Source: BEA. Data as of September 22, 2021. Excluding other Western Hemisphere.

The earnings comeback has been clouded by all the negative news emanating from China and mounting concerns that the world's second-largest economy is on the cusp of a major slowdown. We are not as pessimistic about China's macro prospects; what's more, at the micro level, it's worth noting that according to the latest "China Business Report" from the American Chamber of Commerce in Shanghai, U.S. firms remain bullish on China, with 82.2% of U.S. companies surveyed expecting higher revenues in 2021 than in 2020.

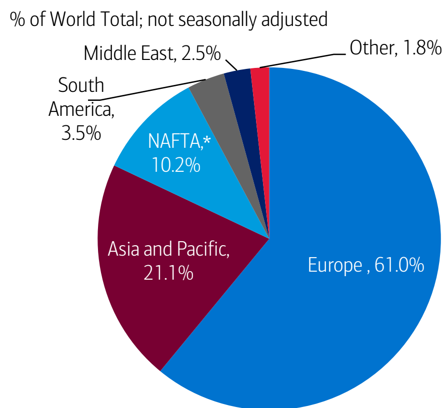
[3] The U.S. Dollar Index (DXY), as of September 30, 2021.

Supporting this optimism, U.S. foreign affiliate income from China in the first half of 2021 was up 73% from the prior year.

China aside, it's Europe that really matters to U.S. global earnings, with the region accounting for over 60% of total U.S. affiliate income over this century (Exhibit 6). Europe's economic rebound-cum-earnings boost to U.S. multinationals has been underreported and underappreciated on Wall Street. We believe upside U.S. earning surprises in Q3 will reflect, in part, the better-than-expected global backdrop for U.S. multinationals, with Europe providing the main earnings ballast.

Exhibit 6: Earnings Lift, By Region: U.S. Affiliate Income Earned Abroad Since 2000.

% of World Total; not seasonally adjusted

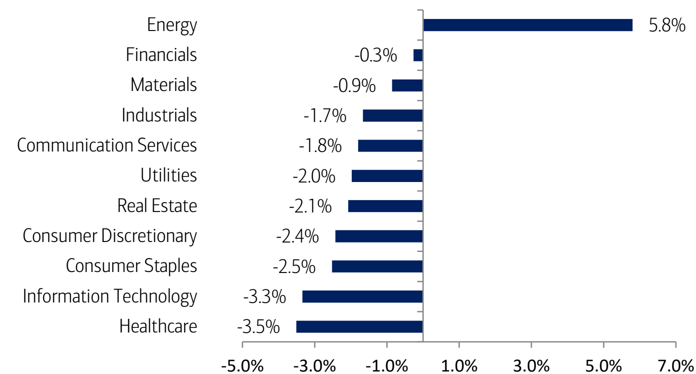


*NAFTA= North American Free Trade Agreement. Source: BEA. Data as of 2Q 2021.

Equities

	Total Return in USD (%)			
	Current	WTD	MTD	YTD
DJIA	34,326.46	-1.4	-2.8	13.7
NASDAQ	14,566.70	-3.2	-4.5	13.6
S&P 500	4,357.04	-2.2	-3.6	17.3
S&P 400 Mid Cap	2,683.64	-0.5	-2.4	17.4
Russell 2000	2,241.63	-0.2	-1.3	14.3
MSCI World	3,022.83	-2.5	-3.6	13.7
MSCI EAFE	2,263.90	-3.1	-3.6	7.5
MSCI Emerging Markets	1,246.60	-1.4	-4.5	-1.8

S&P 500 Sector Returns



Fixed Income†

	Total Return in USD (%)			
	Current	WTD	MTD	YTD
Corporate & Government	1.43	-0.23	-0.75	-1.62
Agencies	0.81	0.05	-0.39	-0.58
Municipals	1.12	-0.51	-0.73	0.78
U.S. Investment Grade Credit	1.53	-0.12	-0.59	-1.28
International	2.09	-0.41	-0.66	-0.88
High Yield	4.03	-0.31	-0.01	4.54
90 Day Yield	0.03	0.03	0.04	0.06
2 Year Yield	0.26	0.27	0.21	0.12
10 Year Yield	1.46	1.45	1.31	0.91
30 Year Yield	2.03	1.98	1.93	1.64

Commodities & Currencies

	Total Return in USD (%)			
Commodities	Current	WTD	MTD	YTD
Bloomberg Commodity	215.53	2.0	5.2	29.3
WTI Crude $/Barrel††	75.88	2.6	10.8	56.4
Gold Spot $/Ounce††	1760.98	0.6	-2.9	-7.2

	Total Return in USD (%)			
Currencies	Current	Prior Week End	Prior Month End	2020 Year End
EUR/USD	1.16	1.17	1.18	1.22
USD/JPY	111.05	110.73	110.02	103.25
USD/CNH	6.44	6.46	6.45	6.50

Sources: Bloomberg, Factset. Total Returns from the period of 9/27/2021 to 10/1/2021. †Bloomberg Barclays Indices. ††Spot price returns. All data as of the 10/1/2021 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.**

Asset Class Weightings (as of 9/7/2021)

Asset Class	CIO View: Underweight		Neutral	Overweight	
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 qualified investors.
CIO asset class views are relative to the CIO Strategic Asset Allocation (SAA) of a multi-asset portfolio.

Economic Forecasts (as of 10/1/2021)

	2020A	Q1 2021A	Q2 2021A	Q3 2021A	Q4 2021E	2021E
Real global GDP (% y/y annualized)	-3.1	-	-	-	-	5.8
Real U.S. GDP (% q/q annualized)	-3.4	6.3	6.6	4.5*	6.0	5.9
CPI inflation (% y/y)	1.2	1.9	4.8	5.2*	5.3	4.3
Core CPI inflation (% y/y)	1.7	1.4	3.7	4.1*	4.1	3.4
Unemployment rate (%)	8.1	6.2	5.9	5.2*	4.5	5.5
Fed funds rate, end period (%)	0.09	0.06	0.08	0.06	0.13	0.13

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 October 1, 2021.
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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.

Personal Consumption Price Expenditures (PCE) Index are imputed household expenditures for a defined period of time used as the basis for the PCE Price Index.

Consumer Price Index (CPI) is a price index, the price of a weighted average market basket of consumer goods and services purchased by households.

MSCI USA Index is designed to measure the performance of the large and mid cap segments of the US market.

MSCI EAFE Index is a stock market index that is designed to measure the equity market performance of developed markets outside of the U.S. & Canada.

MSCI Emerging Markets Index is a selection of stocks that is designed to track the financial performance of key companies in fast-growing nations.

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All 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.

Asset allocation, diversification and rebalancing do not ensure a profit or protect against loss in declining markets.

Investments have varying degrees of risk. Some of the risks involved with equity securities include the possibility that the value of the stocks may fluctuate in response to events specific to the companies or markets, as well as economic, political or social events in the U.S. or abroad. Investing in fixed-income securities may involve certain risks, including the credit quality of individual issuers, possible prepayments, market or economic developments and yields and share price fluctuations due to changes in interest rates. Bonds are subject to interest rate, inflation and credit risks. Treasury bills are less volatile than longer-term fixed income securities and are guaranteed as to timely payment of principal and interest by the U.S. government. Investments in foreign securities involve special risks, including foreign currency risk and the possibility of substantial volatility due to adverse political, economic or other developments. These risks are magnified for investments made in emerging markets. Investments in a certain industry or sector may pose additional risk due to lack of diversification and sector concentration. There are special risks associated with an investment in commodities, including market price fluctuations, regulatory changes, interest rate changes, credit risk, economic changes and the impact of adverse political or financial factors. There are special risks associated with an investment in commodities, including market price fluctuations, regulatory changes, interest rate changes, credit risk, economic changes and the impact of adverse political or financial factors.

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