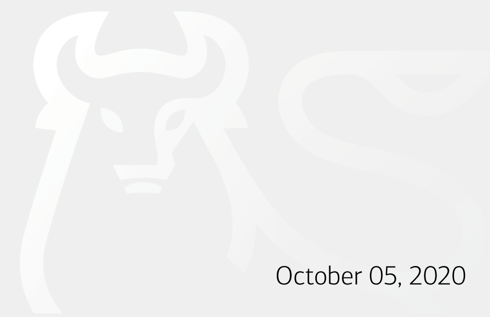
CHIEF INVESTMENT OFFICE

Capital Market Outlook



October 05, 2020

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

IN THIS ISSUE:

- **Macro Strategy**—Historically, September tends to be a weak month for equity market performance, and a confluence of factors has worked to validate this pattern once again. However, trepidations have been confined to certain assets such as equities and precious metals, suggesting that this is likely only a correction as investors reposition for the presidential election and for the next phase of growth as the new global expansion continues.
- **Global Market View**—Drought conditions and severe wildfires in California this year have been two extreme consequences of growing water shortages in the U.S. West. But water scarcity is still a growing challenge around the world and remains a major long-term investment theme.
- **Thought of the Week**—U.S. chip suppliers had long profited from one of the world's largest consumers of semiconductors (China), which created a web of U.S.-Sino tech dependence mutually beneficial to both parties. Not unexpectedly, U.S. trade restrictions on China seemed to squeeze U.S. semiconductor earnings in a key overseas market, while leaving China's digital economy deeply vulnerable to supply disruptions. Near-term weakness has the potential to offer a solid opportunity for longer-term investors to consider building portfolio positions in key tech names at reasonable valuations.
- **Portfolio Considerations**—For now, we do expect minor consolidation after earnings season as some enthusiasm wanes, cyclicals attempt to balance out the high-growth sectors, and investors remain grounded with the presidential election approaching. This is an opportune time, in our view, to re-examine portfolio strategy and have plans ready for the next "breaking away" period in the economy and equity markets.

MACRO STRATEGY

Chief Investment Office Macro Strategy Team

GLOBAL MARKET VIEW

Ehiwario Efeyini
Director and
Senior Market Strategy Analyst

THOUGHT OF THE WEEK

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

Data as of 10/05/2020, and subject to change.

MACRO STRATEGY

Stock Market Jitters Likely To Prove Just a Correction

Chief Investment Office Macro Strategy Team

Led by a relentless rally in a narrow set of large technology companies since the late-March shutdown trough in risk assets, the increasingly overextended U.S. equity market became highly vulnerable to a correction as the typically volatile presidential election season approached. Fears of a U.S. and European coronavirus case resurgence and renewed government-imposed restrictions to economic activity and personal mobility have offered another catalyst for profit taking, while Federal Reserve (Fed) officials' clamor for additional fiscal stimulus in the context of a political impasse around a new stimulus package only have exacerbated the adjustment lower.

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Indeed, Fed Chair Powell himself has been outspoken about his belief that more fiscal stimulus (including extended unemployment benefits, eviction protections, and state and local government support) is critical for achieving the Fed's forecast for further declines in the unemployment rate from 8.4% in August to 7.6% by the end of 2020 (the unemployment rate dropped to 7.9% in September). While this has raised concerns about the outlook and about the Fed's self-confidence in its ability to steer the economy in the right direction despite massive efforts to date and promises of extended policy support into 2023, we believe that the outlook is more robustly positive than the equity-market drop and dollar appreciation of the past few weeks seem to suggest:

- The Fed has already flooded the system with liquidity, but there's still massive stimulus in the pipeline that will take time to filter through the economy. Typically, Fed policy changes affect the economy with a lag of about one year. Also, the Fed could expand its asset purchase or lending programs if need be.
- Decisive Fed action to stimulate the economy, improve credit market conditions, and reduce financial market stress was a critical factor shaping our expectations for a quick rebound out of the shutdown recession. There was also a swift and large global policy response that further helped contain the credit fallout from the pandemic. Abundant Fed liquidity has no doubt helped contain risk aversion to the dollar, equity space and precious metals in recent weeks. Indeed, the credit market has remained quite calm, with spreads not widening much and other financial stress indicators remaining close to normal, consistent with limited expectations for a systemic deterioration of economic and financial conditions. Unfazed base metals prices corroborate this view, as they tend to be early indicators of changes in economic prospects. So does the relatively well-contained equity market volatility index—as measured by the Chicago Board Options Exchange (CBOE) Volatility Index (VIX).
- The economy's dependence on further massive fiscal support is likely overstated because of the quicker-than-expected drop in the current unemployment from almost 15% in April to 7.9% in September. No fewer than 14 million new jobs have been created since April, while hours worked surged to a 20-year high, further enhancing wages and salaries. This combination is generating steady labor income streams that offset much of the expired unemployment benefits.
- Low interest rates and the pandemic-induced surge in demand for housing and related big-ticket items have been a major reason why we have expected the economy to snap back quickly out of the shutdown recession. Because of high multiplier effects on the economy and high sensitivity to interest-rate declines, housing tends to lead the economy out of recessions and is an important engine of growth during expansions. This was not the case following the 2008-2009 recession, as housing and credit excesses took a long time to unwind. While this kept economic growth subpar, it also created room for a strong housing boom during the current cycle.
- We believe that housing, manufacturing and technology are likely to remain a strong source of growth ahead due to cyclical and pandemic-related structural changes in demand. The sectors leading the next expansion employ many more people than retail, travel and leisure-related businesses, and have much higher multiplier effects, suggesting that tailwinds are likely to overcome headwinds despite current anxiety about the outlook.
- Leading indicators continue to suggest a positive growth dynamic ahead. The U.S. Institute for Supply Management (ISM) manufacturing index new-orders component remained strong in September despite some moderation from a 16-year high in August, and the global IHS Markit survey manufacturing index reached a two-year high, strongly suggesting continued manufacturing sector growth ahead. Given the close link between global manufacturing and trade cycles in today's globally integrated economy, it is not surprising that international trade has already recovered much of its precipitous 18% year-over-year May drop, with a swing to positive growth of +3% to +4% likely by early 2021, in our view, which would be the strongest in three years.

- Despite great volatility, the Economic Policy Uncertainty Index has been on a declining trend, which tends to be positive for investment and hiring.
- U.S. consumer expectations have increased in September, and high frequency and proprietary indicators through late September point to continued robust economic recovery. For example, trucking and rail shipment data, which correlate strongly with gross domestic product (GDP) growth, have been surging, consistent with strong U.S. growth momentum into the fourth quarter. Evercore ISI retailers' sales surveys of restaurants, auto dealers and industrial orders are also rising. The BofA Global Industrial Momentum Indicator is up to its highest levels since January 2018 and its U.S. truckload diffusion index is back at its April 2014 record level. Also according to BofA Global Research, China is undergoing a particularly impressive recovery, and there are growing signs of a sustained recovery in global economic activity through September.
- Global short rates are at fresh lows and should continue to boost growth as their effect takes time to fully filter through.
- Energy prices should remain favorable for global growth given the excess supply accumulated in the oil market.
- BofA Global Research investor risk and positioning indicators appear anchored at neutral, far from euphoric levels.
- According to the BofA Global Research library of indicators update on September 28, 2020, "since the end of the Bretton Woods system in the 1970s, only 6 out of 25 corrections (declines of 10% or more) in the S&P 500 Index have intensified into bear markets (declines of 20% or more), with all of them barring the 1987 crash being associated with a business cycle contraction (as defined by the National Bureau of Economic Research (NBER)—which does not align with our house view for the near future."
- With high operational leverage and productivity growth likely to fluctuate around a stronger trend, in our view, we expect margins to start expanding again from already elevated levels. Stronger productivity growth and rising margins are important reasons behind our view that the U.S. economy will continue to surprise to the upside, with pre-tax GDP profits likely up by mid-double digits next year. Overseas profits will likely contribute to profits reaching new highs in coming quarters if our outlook for sustained global economic normalization and a softer dollar prove correct.

All in all, we believe that the September equity market swoon is a typical seasonal correction in a secular bull market driven by the new synchronized global expansion.

GLOBAL MARKET VIEW:

California's Challenges and the Growing Risk of Global Water Scarcity

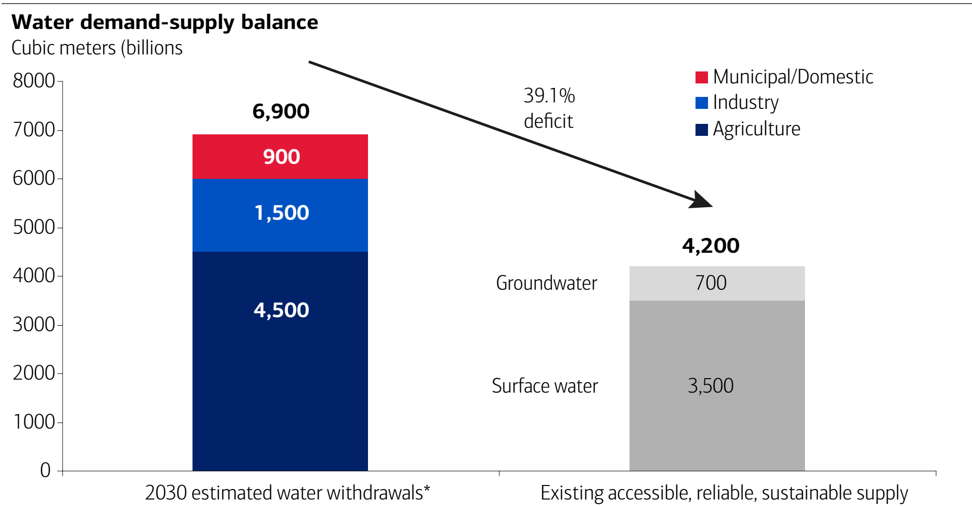
Ehiwario Efeyini, Director and Senior Investment Strategy Analyst

Drought conditions and severe wildfires in California this year have been two extreme consequences of growing water scarcity in the U.S. West. As we now enter the fourth quarter of 2020, yet another indication of this emerging challenge will be the launch of the world's first water futures market toward the end of the year. The CME Group last month announced its plans for the new futures contract, which will be based on weekly prices for California water rights per acre-foot (the volume required to cover one acre of land in one foot of water) and will allow farmers, businesses and municipalities in the state to protect against significant price swings. But while California's troubles have been among the most visible, water scarcity is still a growing challenge worldwide and remains a major long-term investment theme.

Only around 1% of the earth's water occurs in the liquid freshwater form found in rivers, lakes, streams and aquifers. And as the global population grows and becomes more prosperous, this limited freshwater supply is coming under increasing pressure. The global population is expected to grow by roughly 750 million people between 2020 and 2030, meaning more individuals consuming more discretionary items such as cars, household appliances, electronics and higher-protein diets. And this translates into more demand for natural resources—including water. According to the International Fund for Agricultural Development for example, up to 15,000 liters of water are required to produce a single kilo of grain-fed beef, with up to 3,000 liters needed to grow a kilo of rice. Electricity generation for lighting homes and offices, running industrial machinery and charging electronic devices is another major source of demand. It takes for example an estimated one liter of water to light a single 60 watt light bulb for 12 hours. Add to that the supply-side effects of global climate change, and the scope of the looming water scarcity challenge becomes clear.

As demand increases for agricultural, industrial and consumer use, the 2030 Water Resources Group – a partnership between the World Bank, the World Economic Forum and a series of multinational organizations – has projected a near 40% global shortfall in available freshwater by 2030 based on historical water productivity (Exhibit 1). And the United Nations (UN) predicts that around 50% of the world's population will be living in areas of high water stress by the same year. The key question for investors is how this gap will be closed and who will benefit as it does so.

Exhibit 1: Global Water Scarcity—A Near 40% Deficit By 2030.

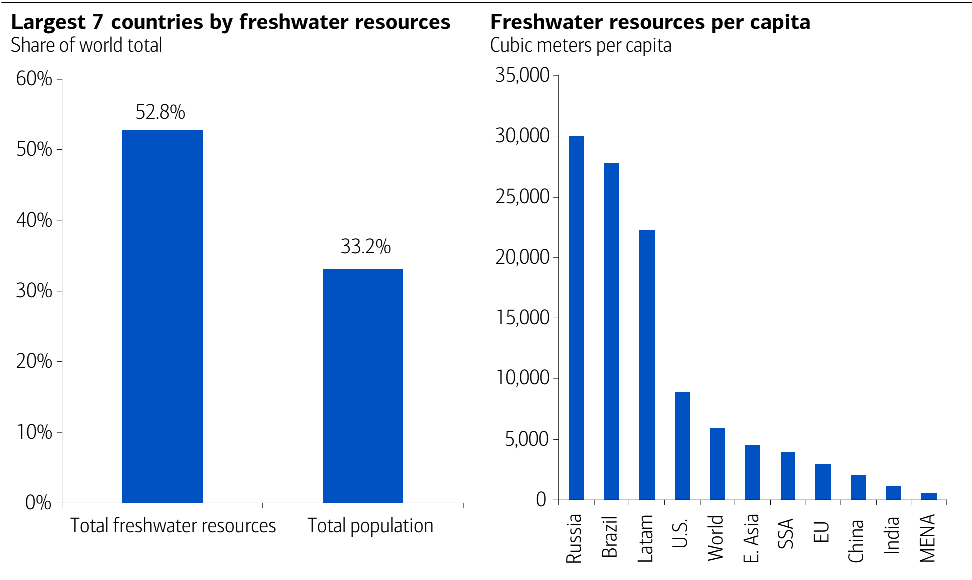


*Water withdrawals refers to the amount of water removed from the source, a portion of which can potentially be reused. In contrast, water consumption refers to the amount that is expended and not available for reuse. Data shows existing supply, which can be provided at 90% reliability, based on historical hydrology and infrastructure investments scheduled through 2010; net of environmental requirements.
Source: 2030 Water Resources Group. Data as of 2010. Data shown is latest available but illustrative of long-term trend of supply deficit relative to projected global demand.

On both the demand side and the supply side, the global water scarcity challenge varies considerably across geographic regions. And beyond the recent shortages in parts of the U.S. West, many of the poorest and fastest-growing economies of the world will be those worst affected. According to the 2030 Water Resources Group, a whopping 70% of the global increase in freshwater demand out to 2030 is projected to come from just Asia and Africa. And with more than 55% of the increase on a sector basis expected to come from agriculture, the bulk of global demand growth is likely to be relatively inelastic in the face of income headwinds from the pandemic. Demand-side solutions should therefore play a part in addressing future shortages. These include rationing measures as a means of curbing overuse, higher rates from local utilities and gains in efficiency. Indian agriculture for example is projected to account for over 10% of the global increase in water demand out to 2030, and the use of more efficient methods such as drip irrigation (over traditional and far more wasteful spray irrigation) is likely to increase as a result.

Over the longer term however, supply-side measures are likely to play a larger role in addressing the scarcity challenge. As on the demand side, global supply constraints are uneven. Seven countries accounting for just one-third of the world population control more than half of the world's freshwater resources. Four of the seven—Brazil, Canada, the U.S. and Colombia, which together account for over 30% of freshwater supply—are in the Americas, and along with Russia have per capita freshwater availability in excess of the global average (Exhibit 2). By contrast, Asia and Africa (the regions with the fastest-growing demand) as well as Europe and the Middle East have the world's lowest per capita water levels.

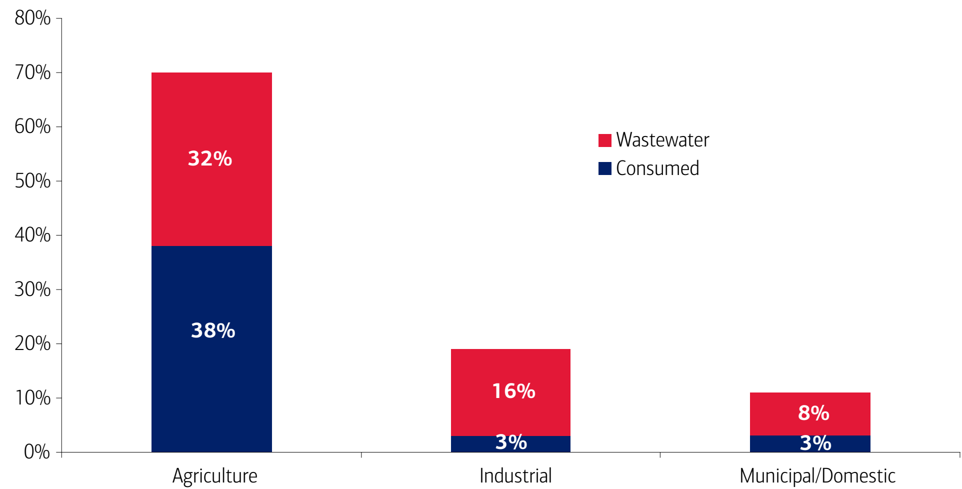
Exhibit 2: Freshwater Supply Varies Considerably By Geographic Region.



Source: World Bank. Data as of 2018. Data for renewable internal freshwater resources. Largest 7 countries are Brazil, Russia, Canada, U.S., China, Colombia, Indonesia. SSA is Sub-Saharan Africa. MENA is Middle East and North Africa. Data shown is latest available but illustrative of long-term trend of supply deficit relative to projected global demand.

Two supply-side solutions in particular—wastewater treatment and desalination—should play a major role in addressing these imbalances. According to the UN Food and Agriculture Organization, of the roughly 4000 cubic kilometers of freshwater withdrawn globally every year, only 44% is consumed, with more than half turned into wastewater in the form of industrial and municipal effluent and agricultural drainage (Exhibit 3). The overwhelming majority of this wastewater ultimately remains untreated—more than 80% worldwide according to UN estimates, with the share rising to over 90% in lower-income countries. This leaves considerable scope for treatment and reuse, including in high-income countries where as much as 30% of wastewater still goes untreated. California for example has adopted potable water reuse as part of its solution to local drought conditions, with the San Diego County Water Authority expecting the technique to provide around 15% of its water supply by 2035. And beyond the use of recycled water for human consumption, higher rates of wastewater treatment would also bring a wide range of other economic benefits such as reuse in crop irrigation, apparel cleaning, heating for buildings and cooling for data centers.

Exhibit 3: Wastewater Accounts for More Than Half Of Global Freshwater Withdrawals.



Source: "Wastewater: The Untapped Resource," United Nations Water, 2017. Data shown is latest available but illustrative of long-term trend in wastewater output.

Another key supply-side solution is desalination—the process of removing salt and other minerals from saline water. This method has been used under varying guises for centuries, but today is usually performed through one of two broad approaches. Membrane-based techniques essentially squeeze freshwater out of saltwater by pumping it at high pressure through a semi-permeable barrier, while thermal desalination techniques distill saline water using steam tubes to heat and condense it in successive stages. Both approaches are still generally viewed as too costly for large-scale water provision. But technological improvements such as the use of thinner, more durable membranes have seen aggregate costs follow a gradual downtrend, allowing output to increase significantly over recent years. According to the UN-affiliated International Desalination Association, global desalination capacity nonetheless still accounts for only a negligible share (roughly 0.002%) of global water consumption and so has scope to increase further as costs continue to decline.

We therefore expect demand for water services to increase over the coming years, both in emerging and developed economies. This should benefit companies involved in a range of related industries such as water monitoring, wastewater treatment and liquid purification services, in addition to those that provide industrial equipment for fluid handling such as pumps, valves, filters, seals and water analysis instruments. Desalination plant developers and operators should benefit from growing adoption, alongside materials producers involved in the development of new membrane technologies. Providers of other products and services that target efficient water use should also be well-positioned. These include techniques such as drip irrigation and rainwater harvesting, piping infrastructure maintenance to reduce leaks, water-efficient appliances and water utilities that can raise rates as a means of better aligning demand with available supply.

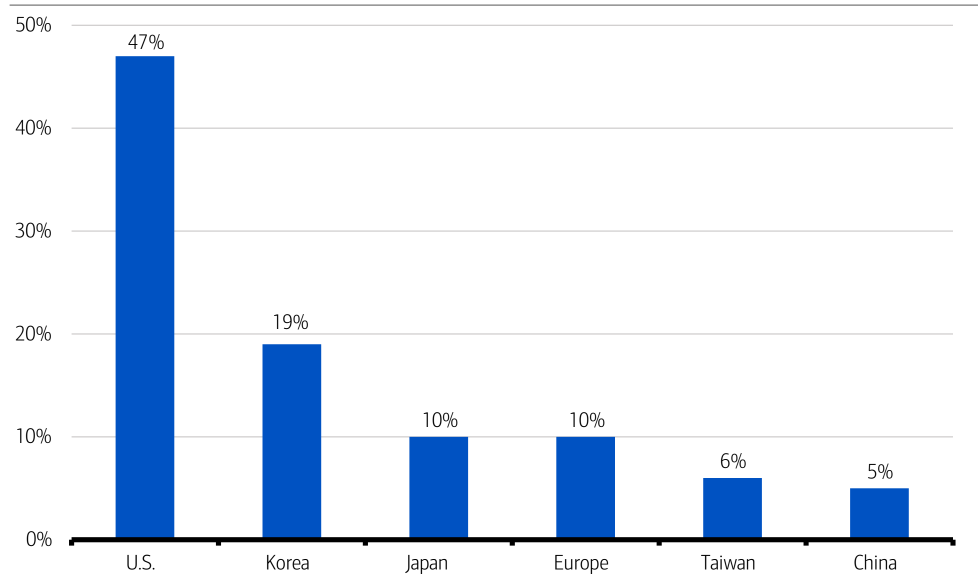
THOUGHT OF THE WEEK:

Are There any Winners to the U.S.-Sino Tech War?

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

When one of the world's largest consumers of semiconductors (China) has a falling out with the world's largest supplier of chips (U.S.), something has to give. Here are the salient numbers: As the world's semiconductor leader, the U.S. accounts for roughly 45% to 50% of the global share of semiconductor production. That is considered a commanding lead (Exhibit 4).

Exhibit 4: 2019 Global Semiconductor Sales, (Market share as a %).



Note: Column totals may not sum to 100 because of rounding.
Source: Semiconductor Industry Association. Data as of June 2020.

On the demand side, outside the U.S., no one consumes chips like China. According to the Semiconductor Industry Association, the mainland accounts for roughly 25% of global chip demand, reflecting China's solid growth in such industries as quantum computing, artificial intelligence, electric vehicles, 5G and the like. But here's the rub: Indigenous China semiconductor production covers only 14% of its domestic demand. U.S. suppliers had long been known to fill the gap which created a web of U.S.-Sino tech dependence mutually beneficial to both parties.

But then came the tech cold war. Not unexpectedly, U.S. trade restrictions on China squeezed U.S. semiconductor earnings in a key overseas market while leaving China's digital economy deeply vulnerable to supply disruptions. Both parties have felt the pain near term. But there are long-term considerations as well.

Denied access to U.S. product, China's state-led economy is focused on building out its own indigenous supply of chips. The goal of semiconductor self-sufficiency could not only undermine the future sales of U.S. chip producers, it also runs the risk of creating new Chinese competitors that could erode the dominant market share of U.S. firms over the long-term. China hopes to have domestic suppliers meet 70% of the nation's semiconductor needs by 2025.[1] That's an ambitious target, but the trend seems clear: China is scaling up its chip production. And if history is any guide, China's domestic production could spill over into foreign markets and further challenge the U.S. semiconductor industry.

[1] See "How Restrictions to Trade with China could End US Leadership in Semiconductors," Boston Consulting Group, March 2020.

Given the above and the growing U.S. "entity list"—a list of entities that are ineligible to receive any item subject to the Export Administration without a license—what is the potential effect to U.S.-based Semiconductor Capital Equipment (SCE) earnings? With the SCE group now down 20% in the last four weeks, a great deal of bad news may have been priced in. The current "entity list" may result in around an 8% to 10% impact to earnings power for SCE companies. Investors' concern may be that the administration does not stop and that other domestic China semiconductor manufacturers may be at risk. If this proves true, this will likely result in a new normal worldwide Wafer Fab Equipment (WFE) Street estimate of $55 billion for 2020 based on data from FactSet. This suggests only modest downside risk to the calendar year 2021 Street estimates ($58 billion) as China currently represents about $10 billion WFE demand.

Near-term weakness has the potential to offer a solid opportunity for longer-term investors to consider building portfolio positions in key tech names at reasonable valuations. The U.S. has the technological wherewithal to compete with China in chips, and, with the digitalization of the global economy in the post-pandemic world, global demand for semiconductors is expected to remain robust. The CHIPS for America Act[2], which would provide about $30 billion to domestic production, and the growing U.S. tech alliance with Japan and the European Union and could add favorably to the long-term outlook.

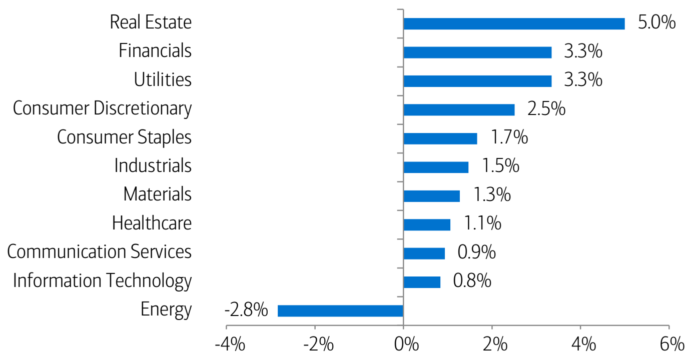
Consider staying long chips.

[2] Creating Helpful Incentives to Produce Semiconductors (CHIPS) for America Act, June 2020.

Equities

	Total Return in USD (%)			
	Current	WTD	MTD	YTD
DJIA	27,682.81	1.9	-0.3	-1.3
NASDAQ	11,075.02	1.5	-0.8	24.3
S&P 500	3,348.44	1.5	-0.4	5.1
S&P 400 Mid Cap	1,902.79	4.8	2.2	-6.6
Russell 2000	1,539.30	4.4	2.1	-6.8
MSCI World	2,362.41	1.6	-0.2	1.5
MSCI EAFE	1,855.10	1.5	0.0	-7.1
MSCI Emerging Markets	1,081.71	2.2	0.0	-1.2

S&P 500 Sector Returns



Fixed Income†

	Total Return in USD (%)			
	Current	WTD	MTD	YTD
Corporate & Government	1.14	-0.1	-0.1	8.0
Agencies	0.50	-0.1	0.0	5.4
Municipals	1.34	-0.1	-0.1	3.2
U.S. Investment Grade Credit	1.18	-0.1	0.0	6.7
International	2.01	0.1	0.0	6.7
High Yield	5.69	0.9	0.2	0.8

	Current	Prior Week End	Prior Month End	2019 Year End
90 Day Yield	0.09	0.09	0.09	1.54
2 Year Yield	0.13	0.13	0.13	1.57
10 Year Yield	0.70	0.65	0.68	1.92
30 Year Yield	1.49	1.40	1.46	2.39

Commodities & Currencies

	Total Return in USD (%)			
Commodities	Current	WTD	MTD	YTD
Bloomberg Commodity	148.98	-1.2	-1.5	-13.4
WTI Crude $/Barrel††	37.05	-8.0	-7.9	-39.3
Gold Spot $/Ounce††	1,899.84	2.1	0.7	25.2

Currencies	Current	Prior Week End	Prior Month End	2019 Year End
EUR/USD	1.17	1.16	1.17	1.12
USD/JPY	105.29	105.58	105.48	108.61
USD/CNH	6.75	6.83	6.78	6.96

Sources: Bloomberg, Factset. Total Returns from the period of 09/28/2020 to 10/02/2020. †Bloomberg Barclays Indices. ††Spot price returns. All data as of the 10/02/2020 close.
Past performance is no guarantee of future results.

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

	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.

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

Economic and Market Forecasts (as of 10/02/2020)

	2019A	Q1 2020A	Q2 2020A	Q3 2020E	Q4 2020E	2020E
Real global GDP (% y/y annualized)	2.9	-	-	-	-	-3.8
Real U.S. GDP (% q/q annualized)	2.2	-5.0	-31.4	33.0	3.0	-3.6
CPI inflation (% y/y)	2.3	1.5	0.6	1.2	1.2	1.3
Core CPI inflation (% y/y)	2.3	2.1	1.2	1.7	1.8	1.8
Unemployment rate (%)	3.5	3.8	13.0	8.8	7.7	8.3
Fed funds rate, end period (%)	1.55	0.08	0.08	0.09	0.13	0.13
10-year Treasury, end period (%)	1.92	0.67	0.66	0.68	1.00	1.00
S&P 500 end period	3231	2585	3100	3363	3250*	3250*
S&P earnings ($/share)	163	33	28	31	33	125
Euro/U.S. dollar, end period	1.12	1.10	1.12	1.17	1.14	1.14
U.S. dollar/Japanese yen, end period	109	108	108	105	103	103
Oil ($/barrel, avg. of period, WTI**)	57	46	29	40	44	40

The forecasts in the table above are the base line view from BofAML Global Research team. The Global Wealth & Investment Management (GWIM) Investment Strategy Committee (ISC) may make adjustments to this view over the course of the year and can express upside/downside to these forecasts. 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. S&P 500 represents the year-end target for 2020. **West Texas Intermediate.
Sources: BofA Merrill Lynch Global Research; GWIM ISC as of October 02, 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.

Chicago Board Options Exchange's (CBOE) Volatility Index (VIX) is the ticker symbol and the popular name for the a popular measure of the stock market's expectation of volatility based on S&P 500 index options.

Institute for Supply Management (ISM) Purchasing Manager's Index **(PMI)** measures manufacturing activity based on a monthly survey of purchasing managers at more than 300 manufacturing firms with data compiled by **IHS Markit**.

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Investing involves risk, including the possible loss of principal. Past performance is no guarantee of future results.

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. 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. 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.

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