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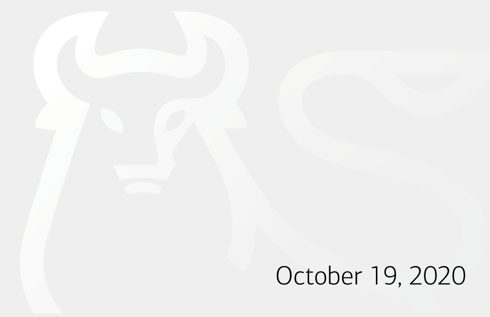
Capital Market Outlook



October 19, 2020

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

IN THIS ISSUE

- **Macro Strategy**—In September, the Federal Reserve (Fed) published its triennial Survey of Consumer Finances.[1] These surveys have been conducted since 1983. The latest survey shows bigger percentage increases in wealth and income for lower-income families than higher-income families. This evidence of declining income inequality over the 2016–2019 period corroborates wage and confidence data showing relative improvements for lower-income groups over the same period, in marked contrast to the 1980–2016 experience.
- **Global Market View**—America is on the cusp of a political Year 2000 (Y2K) moment, portending more near-term volatility. However, we believe the U.S. will pass the Y2K test. Investors shouldn't panic if there is no definitive winner on election night, in our opinion. Clear procedural guidelines and condensed deadlines should keep the post-election sausage-making moving, resulting in a clear winner sooner rather than later, as well as more upside for U.S. equities.
- **Thought of the Week**—Global cities have been on the frontlines of the coronavirus pandemic, with an estimated 90% of coronavirus cases noted by the United Nations (UN) having occurred in urban areas. Taking a closer look, we find that while coronavirus may lead to a slight deceleration of the rural-to-urban population shift, the data indicates that this is too large a global force to stop.
- **Portfolio Considerations**—Headline risk and presidential election uncertainty is likely to keep investor risk aversion and cash allocations high, and we expect this to lead to a "seesaw" investment environment well into November. We would use major weakness in equity markets as a buying opportunity for those who have at least a six-month-or-longer time horizon.

MACRO STRATEGY

Chief Investment Office Macro Strategy Team

GLOBAL MARKET VIEW

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

THOUGHT OF THE WEEK

Kathryn McDonald, CFA®
Vice President and Market Strategist

Data as of October 19, 2020, and subject to change.

MACRO STRATEGY

Fed Survey Shows Progress On Income Inequality

Chief Investment Office Macro Strategy Team

Since 1980, rising income inequality has been a major trend in the U.S., as globalization, technological change, and higher returns to education caused a widening gap between the top and bottom of the income distribution. The latest Fed Survey of Consumer Finances shows that the gap narrowed in the 2016–2019 period, a striking deviation from the 2010–2016 trend and earlier survey periods. In particular, the survey notes:

[1] "Changes in U.S. Family Finances from 2016 to 2019: Evidence from the Survey of Consumer Finances," Federal Reserve Bulletin, September 2020, Vol. 106, No. 5.

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- “Between 2016 and 2019, median family income rose 5%, and mean family income decreased 3%. These changes suggest that the income distribution narrowed slightly over the period, particularly as the decrease in mean income was mainly driven by families in the top 1% of the income distribution.
- Between 2016 and 2019, families that were high wealth, had a college education, or identified as white non-Hispanic experienced proportionately smaller income growth than other groups of families but continued to have the highest income.”[2]

These changes in relative income performance stand in stark contrast to the predominant trend from 1980 to 2016. For example, the survey report finds that the 2010–2016 period saw outsized gains in mean net worth and income relative to the median. Bigger gains in means than medians reflect more wealth and income going to higher-income groups, while bigger gains in median income and wealth relative to means reflects relatively more income going to the lower-income segments.

The pandemic recession has raised doubts that this tentative encouraging improvement in inequality trends can continue. Lower-income groups have been hit harder by the pandemic, possibly erasing much of the progress made during the last three years of the longest expansion in U.S. history. Nevertheless, a number of factors suggest that a return to the improving trend of the 2016–2019 period could be possible.

First, trend economic growth picked up in the 2016–2019 period, helping to drive the economy closer to maximum employment. During the 2010–2016 period, real gross domestic product (GDP) grew just 2.1% on average, held back by historically low productivity growth averaging only 0.7% annually. During the 2016–2019 period, annual GDP growth averaged 2.5%, boosted by 1.4% average annual gains in productivity, double the rate of the first six years of expansion.

Factors behind stronger jobs and wage growth included, in our view, the tax and regulatory changes in the 2016–2019 period that encouraged businesses to expand and hire in the U.S. The new lower corporate tax rate was more in line with that in other countries, helping to slow the exodus of U.S. companies moving abroad to take advantage of lower taxes. The slower globalization trend and higher tariffs also helped keep lower-income jobs in the U.S. after decades of offshoring by multinational companies.

The economic growth acceleration during the last three years of the pre-pandemic expansion translated into a lower unemployment rate, which fell from 5% to less than 4%, greatly benefiting lower-income families, who are more sensitive to economic cycles. For example, as the pandemic experience shows, they disproportionately lose jobs and income during recessions. On the other hand, they benefit generally during the late stages of expansions when unemployment is low and the labor market tight, as during the 2016–2019 period. In short, they are first to get fired and last to get hired, which helps explain the relative income gains in the latest Fed survey.

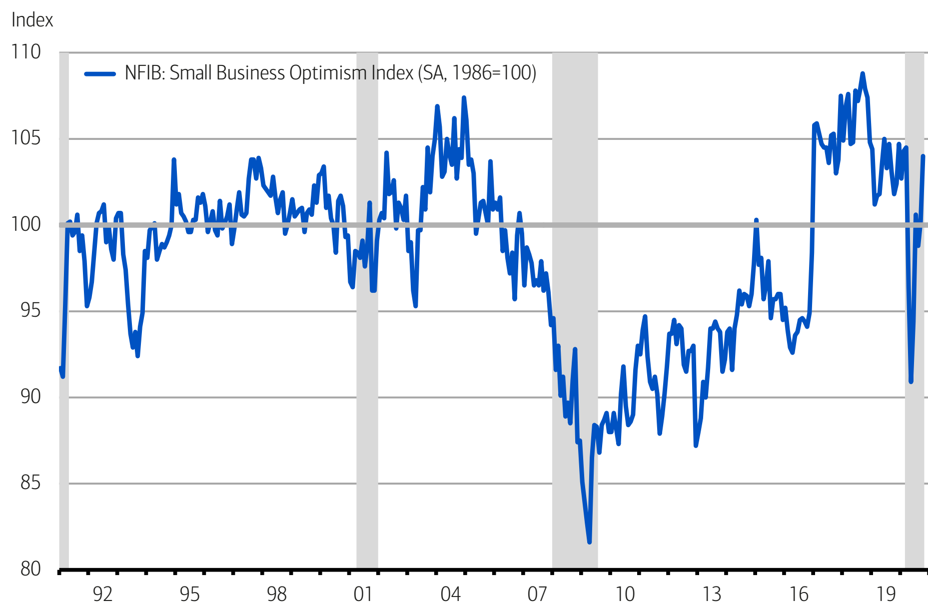
One positive structural shift currently underway in the economy favorable for reducing wage inequality is strong small-business confidence. One notable feature of the 2016–2019 years of expansion was the difference in small-business participation in the upswing compared to the period 2010 to 2016. Between 2010 and 2016, the National Federation of Independent Business (NFIB) Small Business Optimism Index remained stuck at recessionary levels. In contrast, after 2016, small-business confidence significantly increased and stayed at levels seen mainly during periods of strong expansion going back through the survey’s history to 1975.

This is important because small and medium-sized businesses account for about half of all employment and are therefore critical to the outlook for a return to low

[2] “Changes in U.S. Family Finances from 2016 to 2019: Evidence from the Survey of Consumer Finances,” Federal Reserve Bulletin, September 2020, Vol. 106, No. 5.

unemployment. Fortunately, the small business optimism index has traced a V-shaped recovery, declining from about 104 in February to a low of about 91 in April before rebounding back to 104 in September. In a positive sign that small businesses will likely be growing rapidly ahead, plans to increase inventories touched the all-time high last reached in 2004, a very favorable sign that production and employment will likely be strong in the years ahead (Exhibit 1).

Exhibit 1: Small-business Optimism Back to Pre-pandemic Level.



Sources: NFIB/Haver Analytics. Data as of October 14, 2020.

In addition to the positive signs that small businesses are reverting to their strong 2016–2019 confidence levels, another reason to expect employment growth to help restore the positive income and wealth trends of the last three years of the pre-pandemic expansion is the change in the policy outlook. The most powerful fiscal stimulus since World War II is a major reason why the V-shaped recovery has surprised forecasters, who continue to raise their growth outlooks, as recently shown in the International Monetary Fund's (IMF) upward revision to its 2021 world growth forecast.

Also, monetary policy in the U.S. has undergone a fundamental change in the way it views the trade-off between inflation and unemployment. By constantly underestimating how high employment could go before triggering inflation, the Fed continually restrained economic growth and fell short of its inflation mandate. Over the course of 2019, it conducted a review of its operating procedures to see how it might do a better job of achieving its inflation mandate in the future. To reflect the conclusions from its *"review of the monetary policy, strategy, tools, and communications practices we use to pursue our congressionally mandated goals of maximum employment and price stability,"*[3] the Fed amended its *"Statement on Longer-Run Goals and Monetary Policy Strategy"* on August 27, 2020.

While most market attention was focused on the Fed's decision to *"aim to achieve inflation moderately above 2% for some time,"* a shift that was bullish for risk assets and reflation beneficiaries, arguably just as important is the new priority the central bank is placing on achieving maximum employment. The new statement of goals puts employment ahead of inflation in the statement ordering and adds more description of the employment mandate, stating for the first time that *"the maximum level of employment is a broad-based and inclusive goal that is not directly measurable and changes over time owing largely to non-monetary factors that affect the structure and dynamics of the labor market."*[4]

[3] Jerome Powell, Introductory note to "Fed Listens, COVID-19 update," May 21, 2020.

[4] Federal Reserve Statement on Longer-Run Goals and Monetary Policy Strategy, August 27, 2020.

The addition of the word "inclusive" to the maximum employment goal reflects the Fed's experience during the 2016–2019 period when it saw job gains for lower-income groups that took the unemployment rate down to unprecedented levels for many disadvantaged groups. This message was reinforced during the series of 20 Fed Listens: Perspectives from the Public events around the country in 2019. According to Fed Chair Powell, *"at the time of the Fed Listens events, our country was experiencing the strongest labor market in 50 years and generating employment opportunities for many Americans who had not found jobs readily available in the past. One clear takeaway from these events was the importance of sustaining a strong job market, particularly for people from low- and moderate-income communities. Everyone deserves the opportunity to participate fully in our society and in our economy."*[5]

This new commitment to inclusiveness of people from lower- and moderate-income communities is an important addition to the Fed's policy outlook. The improvements in the relative economic outcomes for lower-income families that are found in the latest Fed Survey of Consumer Finances can be furthered by the Fed allowing the economy to grow faster, as it did during the 2016–2019 period.

As the *Wall Street Journal* put it on September 29, 2020, in an article about the latest survey of consumer finances, *"families in the lowest two income groups recorded large percentage increases in median net worth, suggesting the decade-long expansion benefited a wide swath of society."* Indeed, net worth rose 37% and 40%, respectively, for the lowest and second-lowest income groups, while it declined 8% and 9%, respectively, for the highest and second-highest groups.

While the pandemic has abruptly interrupted this progress for many lower-income families, the strength of the economy before the pandemic, especially the strength in the small-business sector, as noted above, seems to be reemerging. One reason for the high level of small-business confidence in the face of an ongoing pandemic is the unprecedented fiscal and monetary policy support that has helped tide the economy through the crisis. Perhaps most important longer term, in our view, is the Fed's new priority of a more inclusive definition of maximum employment, which requires sustained stronger growth over time.

GLOBAL MARKET VIEW

America's Political Y2K Moment Will Come and Go

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

It feels a little like December 1999. Back then, recall, the world held its collective breath as January 1, 2000, approached, fearing that computers around the world would not interpret 00 as 2000 but as 1900, triggering catastrophic consequences for banks, utilities, airlines and many other sectors of the economy. The Y2K bug—as it became known—caused people to hoard food and stockpile cash; it compelled some airlines to ground planes on New Year's Eve. Such were the concerns of possible glitches associated with Y2K.

Fast forward to today, and a similar wave of anxiety is mounting over the U.S. presidential election—notably the prospect of a delayed result or contested election due to a range of possible glitches, including an overwhelmed Postal Service, late counts of mail-in votes and the verification of absentee ballots. As for mail-in votes, a 50-state survey by *The Washington Post* found that a staggering 198 million eligible voters have the option to vote by mail; that's not a bad idea during a pandemic but a logistical nightmare in tallying and certifying votes.[6] Throw in the possibility of a record voter turnout and the potential for foreign interference, and America's electoral machinery—

[5] Jerome Powell, Introductory note to "Fed Listens, COVID-19 update," May 21, 2020.

[6] See "The Election That Could Break America," The Atlantic, November 2020.

like computers back in December 1999—will be put to a severe test in early November. America is on the cusp of a political Y2K moment, portending more investor angst and market volatility over the near term.

However, our base case is that the U.S. passes the political Y2K test, just as the computers did 20 years ago. If there is no clear winner on election night, don't panic. In most years, it takes officials days or weeks to fully canvass and then certify the results. Most legal challenges emerge during the canvassing process, but clear procedural guidelines and condensed deadlines keep the electoral sausage-making moving. Here are the key post-election dates to keep in mind:

- December 8—this day is designated as the "safe harbor" deadline for states to appoint 538 men and women who make up the Electoral College; critically, it is the date by which states must finish all procedures for the popular vote count, including any recounts or judicial reviews, or risk having Congress getting involved, which is anathema to most governors. Electors are typically chosen by popular vote, but, according to the Supreme Court, a state "can take back the power to appoint electors," raising fears that either party in a state with a legislative majority could choose their own loyal electors.[7] And if states submit competing slates of electors—which happened in 1876—Congress will have to determine which one to count.
- December 14—the date when electors are required to meet in their states and formally cast ballots for president and vice president.
- December 23—the day states are supposed to transmit their votes to Congress.
- January 3—the new Congress is sworn in.
- January 6—Congress counts the electoral votes and certifies a winner. Note: If no candidate wins a majority of electors, the House votes to determine who becomes president. The Senate votes for the vice president.
- January 20—according to the Constitution, a new presidential term begins by noon of this day. If Congress has not yet certified a presidential winner, the Speaker of the House becomes president. If there is no speaker in office, the President Pro Tempore of the Senate becomes president.

Don't underestimate the electoral machinery/infrastructure of America's democracy

All of the above is another way of saying that elections can be messy. Petitions for recounts, lawsuits, voter irregularities, and misplaced ballots—none of these dynamics are uncommon in most post-elections and are dealt with within a constitutional framework as old and sturdy as the Republic itself.

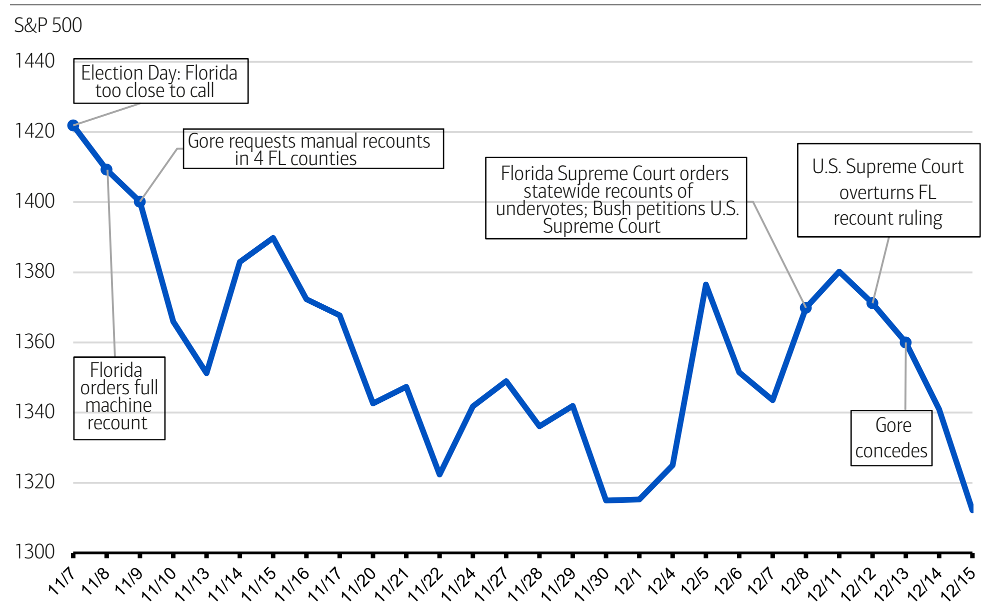
So yes, investors should prepare for post-election volatility but not underestimate the electoral infrastructure of the United States. Investors should also bone up on history. The most recent example of a post-election dispute was in 2000, when missing chads in Florida threw the presidential election results into disarray. The markets were not happy—while waiting on Florida, market volatility and uncertainty were the norm. The S&P 500 index fell 8.4% between Election Day November 7 and December 15, the day after Al Gore conceded in the wake of the Supreme Court ruling that ended the Florida recount (Exhibit 2).

That said, the election-induced downdraft proved to be a favorable entry point for equities, considering that since the beginning of this century and through October 14, 2020, the S&P 500, according to Bloomberg, has returned some 302% to investors (total returns).

[7] Ibid.

Near term, we expect more of a “seesaw” investment environment, shaped by daily headlines speaking to political uncertainty, narrowing margins of victory, incessant polling updates, etc. Against this backdrop, however, we continue to expect equities to outperform fixed income, with a preference for U.S. equities relative to the rest of the world. As presented in the latest CIO “Viewpoint” publication—“Five Elements of Growth,” October 2020—the emphasis remains on Quality, Yield and Growth in regards to equity allocation and portfolio construction. Long-term, we favor such sectors as healthcare, technology and communication services. Our preferred themes: health-tech, cybersecurity, robotics and the platform economy.

Exhibit 2: Recounting the Count: How the S&P 500 Handled the Bush-Gore Election, 11/07/2000–12/15/2000).



Sources: uselectionatlas.org; Bloomberg; MarketWatch. Data for S&P 500 as of 11/07/2000 to 12/15/2000. Short-term performance shown to illustrate similar election scenarios. **Past performance is no guarantee of future results.**

In the end, elections matter to the capital markets. But what matters more are current market-driving fundamentals like better-than-expected earnings growth; ultra-loose monetary policies, combined with mega fiscal spending; a V-shaped global economic recovery; and an eventual vaccination for coronavirus.

On the political front, while it might feel like December 1999, we expect the same results (non-event) of 20 years ago. In other words, America’s political Y2K moment is set to come and go.

THOUGHT OF THE WEEK

Can Coronavirus Halt the Urbanization Megatrend?

Kathryn McDonald, CFA®, Vice President and Investment Strategist

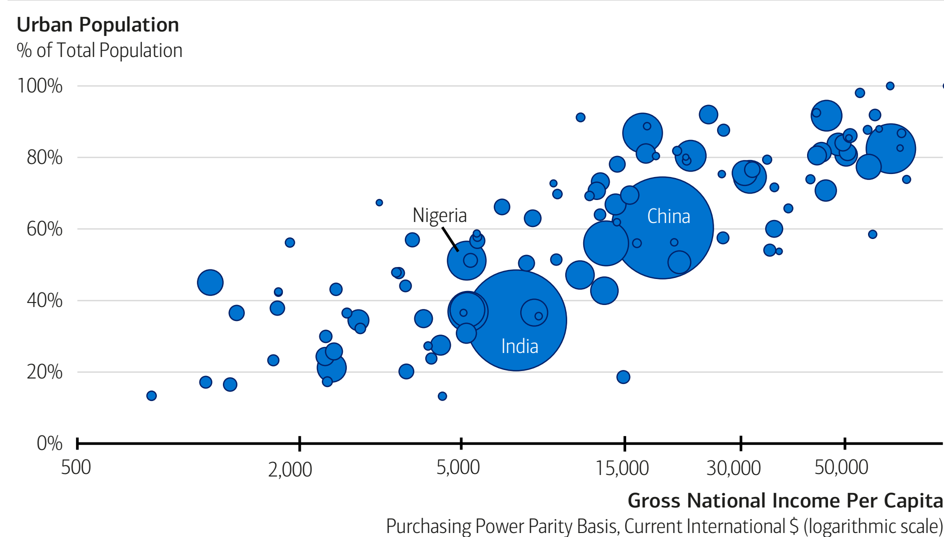
Global cities have been on the frontlines of the coronavirus pandemic, with an estimated 90% of coronavirus cases having occurred in urban areas. As a result, the future of cities has been in question. Signs of de-urbanization in developed countries have caused many to question whether the force of urbanization has finally reached its peak.

Taking a closer look, we find that while coronavirus may lead to a slight deceleration of the rural-to-urban population shift, the data indicates that this is too large a global force to stop. Consider the following:

- Discussion of “de-urbanization” primarily revolves around the developed countries and Western cities. Yet, the reality is that 90% of the growth of the urban population by 2050 is projected to occur in Asia and Africa, according to UN estimates. Just three countries—China, India and Nigeria—are expected to account for 35% of the world’s urban population growth by 2050.
- Part of projected urbanization in developing countries is caused by a natural increase of the population within the borders of urban areas, not solely by migration patterns. For example, in Sub-Saharan Africa, where the urban population is expected to triple by mid-century, this natural population increase is the primary determinant of urban growth.[8]
- Employment opportunities are a main reason why people migrate from rural to urban areas, and this is expected to continue after the coronavirus. In history, evidence has shown that people have moved to cities after pandemics for better job opportunities and higher wages.[9]

The Economics of Cities. As shown in Exhibit 3, incomes per capita and urbanization rates are highly correlated. Agglomeration effects, technological innovation, entrepreneurship and strong labor markets are some of the many factors causing cities to be the engines of growth for economies around the world. Organisation for Economic Co-operation and Development (OECD) studies have shown that for each doubling of population size, the productivity of a city increases by 2% to 5%.

Exhibit 3: Higher Urbanization Associated with Greater Income Per Capita.



Bubble size indicates country population in 2019. Data shown is latest available but illustrative of long-term trend and may be impaired due to the pandemic.
Sources: World Bank; United Nations. Data as of 2019.

Challenges and Opportunities. While cities tend to provide enormous opportunities for residents, they also come with a host of challenges including congestion, urban health, housing, environmental degradation and mobility concerns. Innovative solutions to these problems will need to be carefully constructed in the aftermath of the global pandemic. Addressing these challenges leaves large opportunities for investments in infrastructure, smart buildings and technologies, telecommunications networks, urban e-commerce logistics and other related subthemes.

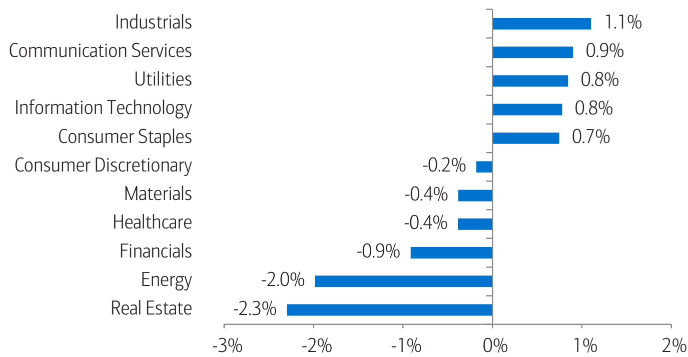
[8] Sources: World Happiness Report, Urban-Rural Happiness Differentials Across the World, March 20, 2020. United Nations, World Urbanization Prospects 2018 Highlights.

[9] Richard Florida, “Cities Will Survive the Coronavirus.” Foreign Policy, May 2020.

Equities

	Total Return in USD (%)			
	Current	WTD	MTD	YTD
DJIA	28,606.31	0.1	3.0	2.1
NASDAQ	11,671.56	0.8	4.5	31.0
S&P 500	3,483.81	0.2	3.7	9.4
S&P 400 Mid Cap	1,997.34	0.1	7.4	-1.9
Russell 2000	1,633.81	-0.2	8.4	-1.0
MSCI World	2,440.14	-0.3	3.1	4.9
MSCI EAFE	1,882.36	-1.5	1.5	-5.7
MSCI Emerging Markets	1,124.08	0.1	3.9	2.7

S&P 500 Sector Returns



Fixed Income†

	Total Return in USD (%)			
	Current	WTD	MTD	YTD
Corporate & Government	1.14	0.3	0.0	8.1
Agencies	0.50	0.1	-0.1	5.3
Municipals	1.39	0.1	-0.3	3.0
U.S. Investment Grade Credit	1.18	0.2	0.0	6.8
International	1.96	0.5	0.6	7.3
High Yield	5.33	0.1	1.4	2.0

	Current	Prior Week End	Prior Month End	2019 Year End
90 Day Yield	0.09	0.09	0.09	1.54
2 Year Yield	0.14	0.15	0.13	1.57
10 Year Yield	0.75	0.77	0.68	1.92
30 Year Yield	1.53	1.57	1.46	2.39

Commodities & Currencies

	Total Return in USD (%)			
Commodities	Current	WTD	MTD	YTD
Bloomberg Commodity	156.63	0.2	3.6	-8.9
WTI Crude $/Barrel††	40.88	0.7	1.6	-33.0
Gold Spot $/Ounce††	1,899.29	-1.6	0.7	25.2

Currencies	Current	Prior Week End	Prior Month End	2019 Year End
EUR/USD	1.17	1.18	1.17	1.12
USD/JPY	105.40	105.62	105.48	108.61
USD/CNH	6.69	6.69	6.78	6.96

Sources: Bloomberg, Factset. Total Returns from the period of 10/12/2020 to 10/16/2020. †Bloomberg Barclays Indices. ††Spot price returns. All data as of the 10/16/2020 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*					
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 10/16/2020)

	2019A	Q1 2020A	Q2 2020A	Q3 2020A	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*	3.0	-3.6
CPI inflation (% y/y)	2.3	1.5	0.6	1.3	1.2	1.3
Core CPI inflation (% y/y)	2.3	2.1	1.2	1.7	1.8	1.7
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 ($/share)	163	33	28	35*	33	125
Euro/U.S. dollar, end period	1.12	1.10	1.12	1.17	1.14	1.14
U.S. dollar/Japanese yen, end period	109	108	108	105	103	103
Oil ($/barrel, avg. of period, WTI**)	57	46	29	40	44	40

The forecasts in the table above are the base line view from 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. 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 2020. **West Texas Intermediate.
Sources: BofA Global Research; GWIM ISC as of October 16, 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 r epresents the stock market's performance by reporting the risks and returns of the biggest companies. 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.

National Federation of Independent Business (NFIB) Small Business Optimism Index is a composite of ten seasonally adjusted components. It provides an indication of the health of small businesses in the U.S., which account of roughly 50% of the nation's private workforce.

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