CHIEF INVESTMENT OFFICE

Capital Market Outlook

November 1, 2021

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

IN THIS ISSUE

Macro Strategy—The surge in inflation this year has the potential to un-anchor inflation expectations and may create much greater economic and financial-market volatility in 2022. The well-anchored inflation expectations that developed through the 1980s and 1990s, as inflation was tamed, were a major factor behind the "Great Moderation" in macroeconomic volatility that resulted over the ensuing decades.

Global Market View—The 2021 United Nations (UN) Climate Change Conference (COP26) gets underway in Scotland this week. This comes at a time of severe stress in the global energy system, which potentially calls the green transition into question. But we nonetheless expect policymakers to maintain their commitment to decarbonization over the years ahead.

Thought of the Week—Questions about how high consumer prices might run and for how long remain central to the inflation debate. While investors have sided with the Federal Reserve's (Fed) assessment that near-term high-inflation reports will likely be transitory, recent moves higher in breakeven rates, an important measure of investors' inflation expectations, could be a signal that investors are starting to believe that increases in consumer prices may be higher and more persistent than previously expected.

Portfolio Considerations—The U.S. remains our preferred equity region relative to the rest of the world, with stronger balance sheets on aggregate, robust economic growth prospects, and strong earnings revisions. We prefer short duration relative to a stated Fixed Income benchmark that is aligned to investment goals.

MACRO STRATEGY

Inflation Expectations at Risk of Coming Loose

Chief Investment Office, Macro Strategy Team

The rise in inflation to the highest levels in about 40 years is starting to affect longer-term inflation expectations. Three major consumer surveys suggest inflation is expected to run between 4.8% and 7% in the year ahead. This is well above the consensus forecast of economists, though it too is moving higher. BofA Global Research, for example, recently boosted its outlook for 2022 "core" consumer price inflation from 2.5% to 3.2%.

While longer-term inflation expectations remain lower than current inflation, they have been rising and have recently moved to the top of the range that has prevailed over the past decade, with the 10-year Treasury breakeven inflation rate moving over 2.6% in

MACRO STRATEGY
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GLOBAL MARKET VIEW
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THOUGHT OF THE WEEK
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Data as of 11/1/2021, and subject to change

October. Since the Fed is ostensibly committed to averaging 2% inflation over the longer run, this raises concerns that it's starting to lose credibility over its inflation commitment. A lot will depend on how inflation evolves over the next year and how the monetary authority responds.

Current developments in financial markets and economic data suggest that inflation will continue to surprise to the upside in 2022. How that affects long-term inflation expectations will depend on how aggressively the Fed reduces the unprecedented accommodation of the past 18 months. In the past 120 years, there has been only one other instance of monetized fiscal stimulus comparable to the past 18 months. That was during World War II (WWII), and it also resulted in a rapid surge in inflation like that seen in 2021. The resultant massive excess demand has fueled the supply shortages that have pushed purchasing managers' measures of price increases and delivery wait times to levels rarely seen in history all across the globe. When demand grows faster than supply, bottlenecks develop, and when the gap between the two is the greatest in seven decades, the bottlenecks are the greatest in seven decades.

The solution to the bottleneck problems is straightforward: Economic stimulus has to be reduced to the point where demand growth is back in line with potential supply growth. This means bringing nominal gross domestic product (GDP) growth back to about 5% or 6%, assuming real GDP growth back in the 2%-to-3% range that is consistent with the Fed's inflation target and estimates of potential GDP growth. However, the current trajectory of monetary and fiscal policy is inconsistent with bringing demand growth in line with a lower inflation outcome in 2022. Money growth is still well over 10% after growing an unprecedented 36% over the past two years, and zero interest rates through mid-2022 are likely to keep the money spigot pouring liquidity into the economy even as the Fed tapers. If inflation and inflation expectations stay over 5% well into mid-2022, longer-term inflation expectations are likely to diverge even further from the Fed's 2% target.

There is no doubt the Fed can keep inflation from staying high. The real question is, will policy adjust enough to rein in excess demand that has created double-digit inflation and all the bottlenecks plaguing businesses and consumers? The answer from the Fed's current forward guidance is no. That's why, in our view, it's likely to evolve into a much more hawkish guidance during 2022. It will likely be a race between rising inflation expectations and Fed efforts to rein in those expectations (Exhibit1).

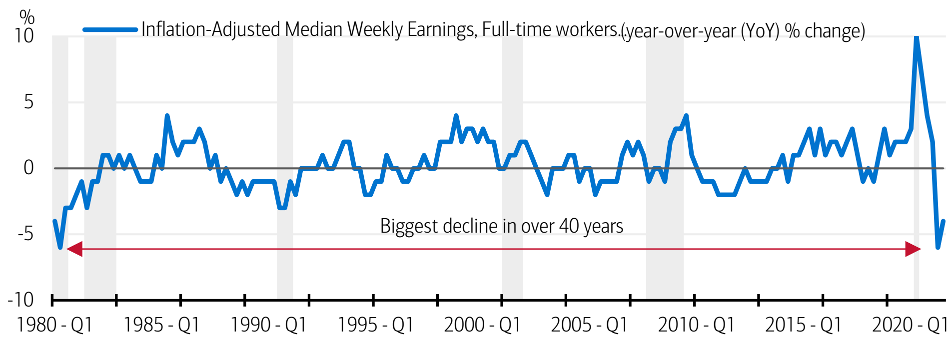
Exhibit 1: Inflation Measures Point To Inflation Well Above The Consensus Forecast.

Inflation Measures	%
Producer Prices (12-month % change through September 2021)	
Crude materials	46.2
Intermediate materials	23.9
Finished goods	11.7
Consumer Prices (latest 9-month annualized % changes through September 2021)	
Overall	7.1
"Core"	5.3
Consumer Expectations for Year-Ahead Inflation	
New York Fed Survey	5.3
Conference Board Survey	7.0
University. of Michigan Survey	4.8
Wage Inflation (12-month % change through September 2021)	
Average Hourly Earnings (private industries)	5.5
Housing Prices and Rent Inflation (% change latest 12 months)	
Zillow observed rent	13
CoreLogic rent	9.3
Consumer Price Index (CPI) Shelter measure	3.2
Case-Shiller home prices	19.9

Source: Haver Analytics; Chief Investment Office. Data as of October 27, 2021.

For example, producer prices still show building pressures in the pipeline consistent with sustained double-digit price increases for the foreseeable future. Overall, consumer prices are running over a 7% pace so far this year, with the "core" measure up over 5%, in line with consumer expectations for over 5% inflation in 2022. Even more worrisome is the outlook for wage and rent inflation. Average hourly earnings have grown at a 5.5% pace over the 12 months through September. Still, consumers have seen their real incomes drop at the fastest pace since the double-digit inflation days of the late 1970s (Exhibit 2), turning inflation into the main worry in consumer surveys. For example, the latest University of Michigan household survey noted the most inflation concerns since the 1978-1980 period.

Exhibit 2: Inflation Eroding Real Incomes.



Gray shaded areas represent recession periods. Source: Bureau of Labor Statistics/Haver Analytics. Data as of October 27, 2021.

It's no wonder workers are demanding higher wages to catch up with surging inflation. In fact, the wage-price spiral phase of inflation is likely to continue in 2022, given strong labor demand and widespread worker shortages. Excess demand is creating labor shortages just as it is creating goods shortages, with depressed labor force participation rates only amplifying the problem. The 5.9% rise in Social Security benefits and other government-linked pay increases for 2022 will also contribute to higher demand-pull inflation, as these cost-of-living adjustments apply to over 75 million consumers.

Besides wages, housing costs are another major factor driving inflation higher that is unlikely to slow down much in 2022. As Dallas Fed researchers found in a recent study, the record gains in home prices over the past year will filter into the shelter-cost components of the CPI and personal consumption expenditures (PCE) inflation measure over the next two years, boosting shelter costs for 2022 and 2023 well above the 3.2% pace of the past year. As shown in Exhibit 1, real-world measures of rent from Zillow and CoreLogic already show roughly double-digit rent increases over the past year, in sharp contrast to the much lower measure currently included in the CPI. Indeed, estimates of CPI inflation for 2021 already show double-digit increases when home prices are accounted for as they were in the 1970s. It is thus not surprising that consumers are feeling inflation pains to a degree not seen since the Carter presidency (Exhibit 2).

With rapid money-supply growth, wages and rents set to boost inflation further in 2022, and given the actual momentum in real-world prices, it seems doubtful the consensus forecast for inflation to fall back to the Fed's 2% target in 2022 will materialize. That is also the message coming from the equity market, where relative performance is consistent with the idea that we are moving into a new, higher-inflation world. That helps explain why the risk-parity strategies that became widespread during the pre-pandemic, secular-stagnation era have not been working in the post-pandemic period. These strategies depended on the assumption that bonds would outperform stocks in risk-off episodes (when the risk of deflation was rising) and would provide some offsetting positive return. However, the correlations that made that strategy work before 2020 have broken down as inflation expectations have decoupled from the old 2% anchor. Prior to the pandemic, Growth and Value stocks tended to correlate similarly to 10-year Treasury yields. Since the pandemic, Growth stocks and Value stocks have diverged sharply in their responses to 10-year yields: Value has been benefiting from rising rates, while Growth has been hurt by rising rates. This new relationship suggests a secular shift is under way that will help Value stocks outperform as rates likely continue to rise as inflation expectations eventually reset at a new higher anchor, in our view. In the meantime, the uncertainty surrounding what that new anchor will be is likely to keep markets on edge next year.

Basically, high and volatile inflation changes the correlation between stocks and bonds that provided the basis for risk-parity strategies. In the 1960s and 1970s, when inflation was higher and much more volatile than during the past 30 years, correlations were also different. The Fed's higher tolerance of inflation also helps explain why strategists recommending bearish late-cycle positioning have missed the latest equity-market rally. Indeed, under the old, low-inflation regime, the Fed would have been slowing economic growth by now, causing a late-cycle bear market and defensive positioning. The continued outperformance of early-cycle beneficiaries of strong growth reflects the new philosophy at the Fed. The key question for 2022 is whether the Fed will remain loyal to its new lavish money-printing philosophy in an attempt to keep unemployment as low as possible or will take the punch bowl away from the party to bring inflation back in line with a 2% target.

GLOBAL MARKET VIEW

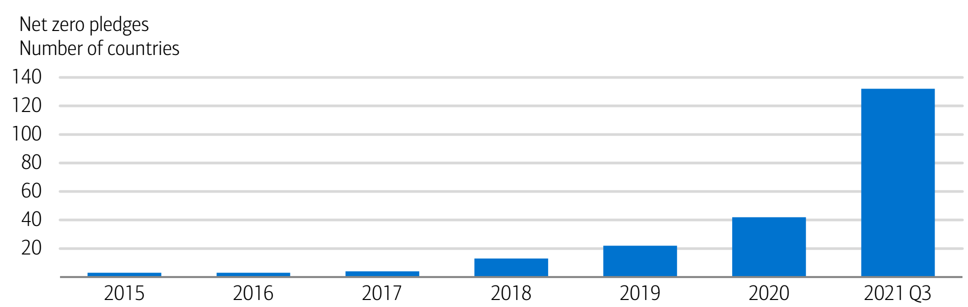
COP26, The Energy Crisis and the Green Transition

Ehiwario Efeyini, Director and Senior Market Strategy Analyst

The 2021 UN COP26 gets underway in Scotland this week, bringing together more than 100 world leaders and over 30,000 delegates from close to 200 countries. For the next two weeks, these representatives from governments and companies around the globe will conduct the first five-year review of national climate change mitigation commitments established at the Paris COP21 summit in 2015. The ultimate goal is to increase the pledges set out in Paris, with the aim of limiting global temperature increases to 1.5 degrees Celsius above pre-industrial levels and averting the most damaging effects of climate change. In the wake of the latest climate report from the UN Intergovernmental Panel on Climate Change[1] released this past August, COP26 is widely seen by policymakers as a final opportunity for concerted global action to meet key emissions reduction targets and should, therefore, be closely watched by investors.

Since the 2015 summit, a growing number of countries has announced ambitions to reach net-zero emissions by the middle of the century. As of Q3, a total of 132 nations (with major exceptions including India, Russia and Indonesia) had proposed or adopted such a target, up from just 42 at the end of last year (Exhibit 3).

Exhibit 3: Growing Number Of Countries Committing To Net-Zero Carbon Emissions.



Source: International Energy Agency. Data as of October 28, 2021.

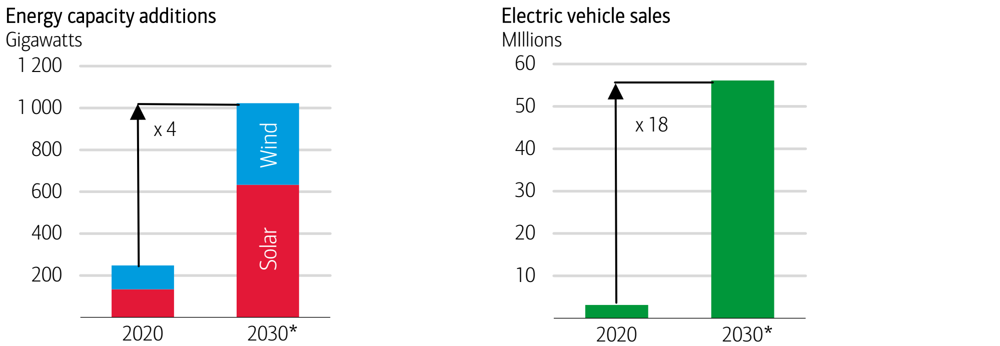
At the same time, subnational authorities and companies have also made significant efforts to reduce emissions. A total of 19 U.S. states now have plans to become carbon neutral over the coming decades, with Illinois becoming the latest this past September. And the U.S. Environmental Protection Agency (EAP) Green Power Users list of organizations that get 100% of their electricity from renewable sources reached 352 at

[1] "Climate Change 2021: The Physical Science Basis" (United Nations Intergovernmental Panel on Climate Change, August 2021).

the end of last month for a combined amount of nearly 41 billion kilowatt-hours, equivalent to the annual electricity usage of more than 3.8 million homes.

On a global basis, the International Energy Agency (IEA) anticipates a steep increase in annual energy investment in the global transition to net zero, from just over $2 trillion on average over the past five years to almost $5 trillion by 2030 and moderating slightly to $4.5 trillion by 2050. This projection spans clean electricity generation, network infrastructure and end-use sectors such as buildings and transportation. For most countries, the nearer-term focus will be on emissions reduction by 2030. And the IEA expects massive additions to solar, wind and electric vehicle deployment to account for the bulk of this transition over the next 10 years (Exhibit 4).

Exhibit 4: Clean Technology Deployment Expected To Multiply Over The Next Decade.

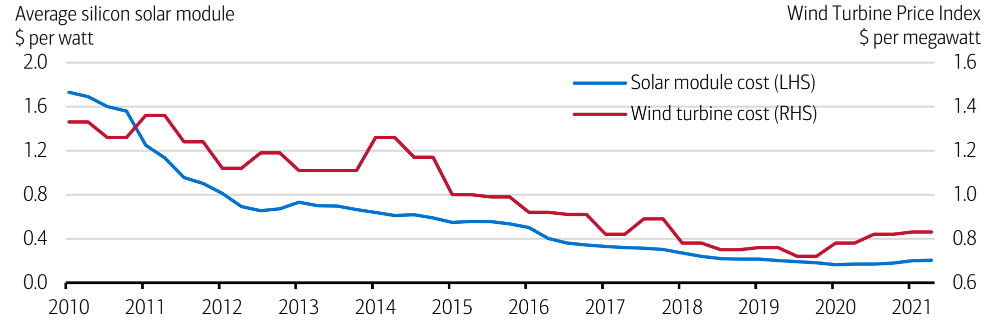


*=Estimate. Source: International Energy Agency. Data as of October 28, 2021.

The remaining contribution is expected to come from decarbonization of industrial processes such as cement and steelmaking, building retrofits, energy-efficient appliances, shifts in transportation habits to substitute away from car trips and long-haul flights and, ultimately, air carbon extraction techniques to reach carbon neutrality.

The objective of COP26 will be to formalize these investment targets, but the summit comes at a time of severe stress in the global energy system, which potentially calls this green transition into question. The energy supply crisis and surge in fossil fuel prices in Europe and China over recent months have demonstrated the inadequacy of intermittent renewable sources for baseload power, especially during periods of excess global demand. And as world leaders meeting in Glasgow express the urgent need to decarbonize, this serves as a reminder that the transition will take time and that electrical grids will still need backup from traditional sources such as natural gas, nuclear and even, temporarily, coal and oil to cushion supply-demand imbalances. In the longer run however, the energy crisis also underscores the importance of scaling up the supply of renewable sources that are domestically generated rather than imported, available at zero marginal cost and not subject to global price shocks and supply chain disruptions. And with oil and gas prices at multiyear highs, adoption should be supported by ongoing cost declines for wind and solar power (Exhibit 5).

Exhibit 5: Cost Declines Continue To Support Adoption Of Solar And Wind Power.



Sources: PVinsights; Bloomberg. Data as of October 28, 2021.

As the energy crisis has also shown, a growing share of renewables in the system will require additional support from battery storage in order to separate the timing of electricity production and consumption, and to allow supply to match demand independent of fluctuations in generation. Hydrogen could have a growing role to play here as a means of energy storage, as well as for use in industry and transportation. And the buildout of ultra-high voltage power transmission infrastructure would further increase the flexibility of a renewable-based grid by essentially enabling the "export" of electricity generation capacity to balance demand where it is needed. In the current environment, this would be of particular importance in Europe, which has been most adversely affected by the spike in natural gas prices, has a large installed base of renewable power, and is looking to integrate national grids across individual markets across the European Union. On top of these grid enhancements a continuing residual presence of fossil fuels in the energy mix will also require negative emissions technologies such as carbon capture systems in order to reach net zero by midcentury.

Over the next two weeks, delegates to COP26 are likely to make the argument that, while the energy crisis may require an increased reliance on coal, oil and natural gas in the immediate term, the only long-term solution to these energy supply shocks is to build out renewable capacity at sufficient scale to limit future dependence on fossil fuels. Amid its ongoing challenges from spiking wholesale gas prices, the U.K., for example, last month announced plans to fully decarbonize its electricity sector by 2035—a full 15 years earlier than previously projected. And despite continuing power disruptions from local coal shortages, China last week published a detailed plan to reach peak emissions by 2030, including specific targets such as a 25% share of renewables in its overall energy mix. Policymakers should therefore look to maintain their commitment to the green transition over the years ahead.

For investors, we would expect clean energy and related materials, equipment and infrastructure to be the principal beneficiaries of this trend over the course of the 2020s and beyond. Key growth areas, in our view, should include suppliers of solar modules and wind turbines, as well as providers of the balance of system components such as batteries, power optimizers and inverters. Developers of electrolyzers and fuel cells should benefit from growth in green hydrogen for energy storage and use in industrial applications such as steelmaking and fertilizer production, in addition to commercial transportation segments such as heavy-duty trucks and forklifts. Electric vehicle manufacturers should also see tailwinds from growing consumer demand as battery costs decline, driving ranges increase, and charging infrastructure is built out. And the commodities, such as copper, nickel, lithium, graphite and cobalt, used to build renewable energy hardware, electric vehicles and batteries are also likely to perform well over the longer term. At the same time, renewable energy utilities and providers of smart grid features such as demand-response and vehicle-to-grid systems should benefit as greater volumes of alternative energy are connected to the power grid. And makers of industrial cables for long-distance power transmission and grid connections from renewable sources should be well positioned, including market leaders in France, Italy and Denmark. As we look further out into the green transition, providers of negative emissions technologies such as carbon capture, utilization and storage are also likely to become more mainstream as countries look to reach their net-zero targets.

THOUGHT OF THE WEEK

Team Transitory Wavering?

Kirsten Cabacungan, Assistant Vice President and Investment Strategist

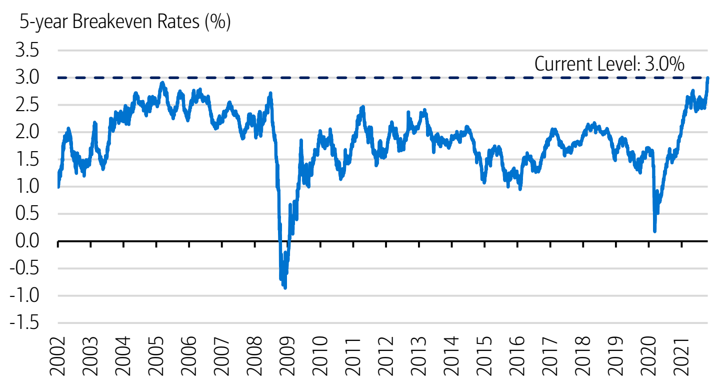
Questions about how high consumer prices might run and for how long remain central to the inflation debate. While investors have so far sided with the Fed's assessment that near-term high-inflation reports will likely be transitory, recent moves higher in breakeven rates, an important measure of investors' inflation expectations, could be a signal that investors are starting to believe that increases in consumer prices may be higher and more persistent than previously expected.

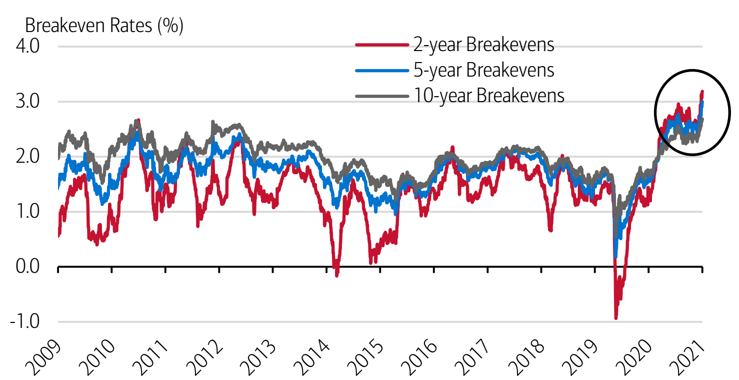
The two-year breakeven rate, an implied average inflation rate over a two-year period measured by the spread between the yields on the two-year U.S. Treasury and Treasury-Inflation Protected Securities (TIPS) of the same maturity, recently moved up to 3.2% for the first time in over 15 years. Despite the fact that the inflation expectations curve remains inverted, with the front end on a sharp move higher driven by concerns over surging commodity prices and supply chain disruptions, longer-term expectations for inflation have also notably risen. The five-year breakeven rate is at all-time high and the 10-year breakeven rate has moved up from 2.2% in August to now 2.7% (Exhibit 6), well above the Fed's 2% target. A few factors help to explain these recent moves on the longer end, namely stickier prices, including rents ticking higher and greater upward pressure on wages as the unemployment rate continues on a strong downward trend.

As a result of the broadening out of inflationary pressures, economists have revised their forecasts for inflation higher and pulled forward their timelines for the Fed's hiking cycle. BofA Global Research now expects core PCE to end next year at 2.6% YoY versus a previous forecast of 2.1%, and expects the Fed to start raising rates in Q4 2022 followed by quarterly hikes of 25 basis points thereafter. Their expectations for Treasury yields have also moved up with the 10-year Treasury yield now expected to end the year at 1.65% and end 2022 at 2.0%.

All eyes will be on the Fed at the next Federal Open Market Committee meeting this week, especially as it gives more details surrounding its program to taper asset purchases before the end of the year. Investors will likely be keenly focused on any messaging surrounding the Fed's inflation outlook and potential changes to its rates policy. Still, it is important to remember that the central bank's response to the Great Financial Crisis was inadequate in getting inflation up and, therefore, could keep the Fed more patient this time around. For now, the Fed's accommodative stance and rising inflationary environment continue to provide tailwinds for equities, especially cyclical and Value-oriented areas of the market.

Exhibit 6: Inflation Expectations on the Rise.





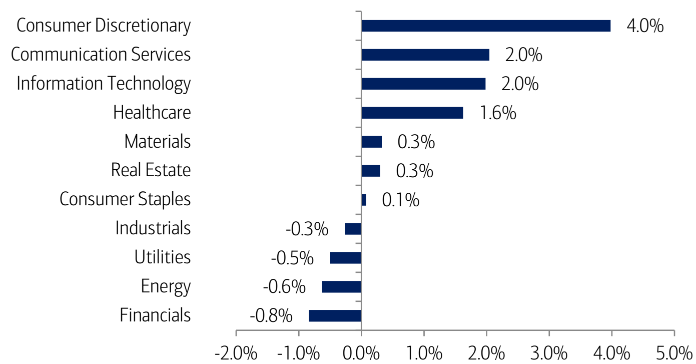
Note: The blue dotted line is meant to call out the latest level of the 5-year breakeven rate. Source: Bloomberg. Data as of October 27, 2021.

MARKETS IN REVIEW

Equities

	Total Return in USD (%)			
	Current	WTD	MTD	YTD
DJIA	35,819.56	0.4	5.9	18.8
NASDAQ	15,498.39	2.7	7.3	20.9
S&P 500	4,605.38	1.3	7.0	24.0
S&P 400 Mid Cap	2,794.11	-0.1	5.9	22.3
Russell 2000	2,297.19	0.3	4.3	17.2
MSCI World	3,174.73	0.8	5.7	19.4
MSCI EAFE	2,335.53	-0.1	2.5	11.0
MSCI Emerging Markets	1,264.75	-2.2	1.0	-0.3

S&P 500 Sector Returns



Fixed Income†

	Total Return in USD (%)			
	Current	WTD	MTD	YTD
Corporate & Government	1.57	0.62	0.05	-1.88
Agencies	1.01	0.18	-0.42	-1.15
Municipals	1.21	0.10	-0.29	0.50
U.S. Investment Grade Credit	1.66	0.52	-0.03	-1.58
International	2.22	0.80	0.25	-1.02
High Yield	4.23	0.09	-0.17	4.35
90 Day Yield	0.05	0.05	0.03	0.06
2 Year Yield	0.50	0.45	0.28	0.12
10 Year Yield	1.55	1.63	1.49	0.91
30 Year Yield	1.93	2.07	2.04	1.64

Commodities & Currencies

	Total Return in USD (%)			
Commodities	Current	WTD	MTD	YTD
Bloomberg Commodity	220.73	-0.4	2.6	32.5
WTI Crude $/Barrel††	83.57	-0.2	11.4	72.2
Gold Spot $/Ounce††	1783.38	-0.5	1.5	-6.1

	Total Return in USD (%)			
Currencies	Current	Prior Week End	Prior Month End	2020 Year End
EUR/USD	1.16	1.16	1.16	1.22
USD/JPY	113.95	113.50	111.29	103.25
USD/CNH	6.40	6.38	6.45	6.50

Sources: Bloomberg, Factset. Total Returns from the period of 10/25/2021 to 10/29/2021. †Bloomberg Barclays Indices. ††Spot price returns. All data as of the 10/29/2021 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 10/5/2021)

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 10/29/2021)

	2020A	Q1 2021A	Q2 2021A	Q3 2021A	Q4 2021E	2021E
Real global GDP (% y/y annualized)	-3.1	-	-	-	-	5.7
Real U.S. GDP (% q/q annualized)	-3.4	6.3	6.7	2.0	6.0	5.6
CPI inflation (% y/y)	1.2	1.9	4.8	5.3	6.0	4.5
Core CPI inflation (% y/y)	1.7	1.4	3.7	4.1	4.4	3.4
Unemployment rate (%)	8.1	6.2	5.9	5.1	4.5	5.4
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 29, 2021.
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Index Definitions

Securities indexes assume reinvestment of all distributions and interest payments. Indexes are unmanaged and do not take into account fees or expenses. It is not possible to invest directly in an index. Indexes are all based in U.S. dollars.

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.

Consumer Price Index (CPI) is a measure that examines the weighted average of prices of a basket of consumer goods and services.

Wind Turbine Price Index tracks turbine supply agreements for turbines to be delivered within the next 18 months.

Important Disclosures

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

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