CHIEF INVESTMENT OFFICE

Capital Market Outlook

November 2, 2020

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

IN THIS ISSUE

- **Macro Strategy**—Strong economic-growth momentum into the fourth quarter has been overshadowed by unsettling spikes in coronavirus cases both here and in Europe as well as by a closer-than-expected presidential election between two divergent economic and tax policies. Both events create downside risks to profits and stock market valuations, and their outcome is difficult to predict, causing a new round of rising equity-market volatility. Credit spreads, overall financial-stress indicators, and the dollar have remained relatively tame. This may be suggesting that the equity market is mainly consolidating its outsized gains since the pandemic trough while awaiting more clarity on the profits outlook.
- **Global Market View**—While the recent sell-off in global equities has focused on the negatives as it relates to event risks like the U.S. presidential elections this week and the rising number of coronavirus cases, higher bond yields and better performing cyclicals have pointed to rising economic activity. In the backdrop of likely further choppy trading in the weeks ahead, we attempt to explore the dualism that exists within key fundamentals that should ultimately dictate where asset prices are a year from now.
- **Thought of the Week**—The future contours of global growth and global earnings are inextricably tied to emerging market consumer demand, notably demand from China whose middle class is on track to likely spend an amount head and shoulders above the middle class spending in the U.S. this year. For this reason, we would consider allocating capital to Western multinationals leveraged to the Chinese consumer, one of the most powerful consuming cohorts in the world.
- **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

Niladri Mukherjee
Managing Director and
Head of CIO Portfolio Strategy

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Investment Analyst

THOUGHT OF THE WEEK

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

Data as of 11/02/2020, and subject to change.

MACRO STRATEGY

Housing Boom Leads The Recovery

Chief Investment Office Macro Strategy Team

With monetary stimulus still in the pipeline and likely to continue to support economic growth over the next year (given the lags involved between monetary policy changes and economic activity), the labor market recovering rapidly, and small business confidence elevated, the economy remains on a steeply rebounding path. This view is supported by large upside surprises to consensus expectations for housing and consumer-spending growth as well as big upward revisions to corporate profits. Manufacturing surveys and business capital-goods orders have also continued to surprise to the upside. Also positive, the Evercore ISI Research proprietary survey of trucking companies—which was conducted through late October and has the highest correlation with real gross domestic product (GDP) and industrial-production growth compared to their other proprietary surveys—increased more than expected to its highest level since December 2018, consistent with strong consumer demand and real economic growth conditions into the fourth quarter following a sharp Q3 recovery.

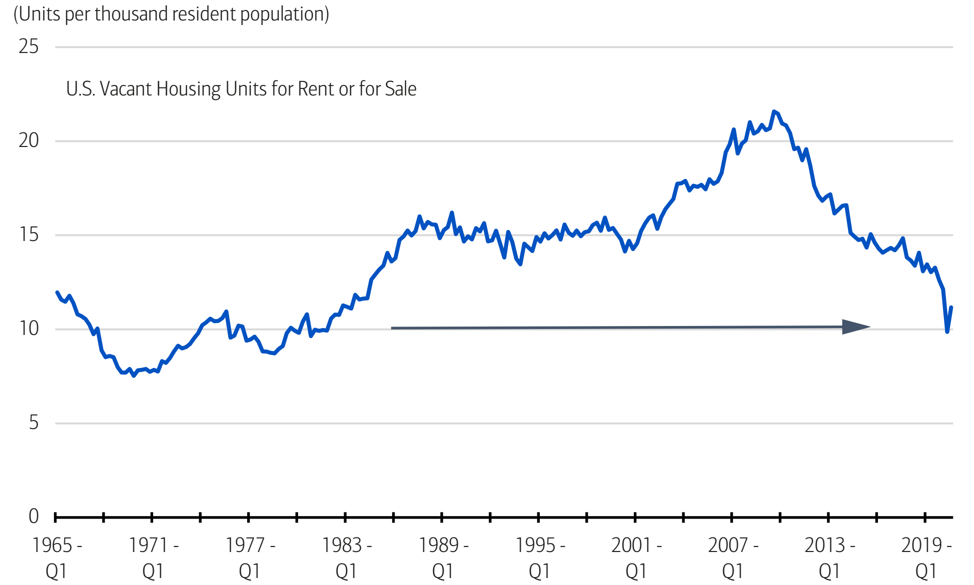
Indeed, just-released Q3 data show a 33% annualized quarterly gain in real GDP, led by a 41% annualized spike in real consumer spending. Business equipment investment has almost reached pre-recession levels following a large 70% Q3 annualized increase. As a result, real GDP is now about 3% below its 35-year trend compared to 9.5% below trend in Q2, and appears poised to return to trend by early 2021. This would compare favorably to the post-2008–2009 recession period, when GDP growth was too weak to bring economywide output level back to trend before 2017.

While real residential investment increased at an amazing 60% annualized rate, its direct contribution to GDP growth has been small because of its low 3% share of GDP (2 percentage points of 33). What's more, though surging, existing home sales do not directly boost GDP growth since they just shift houses from one owner to another. Still, as noted in past reports, a booming housing sector strongly influences economic growth indirectly, by generating demand for housing-related goods and services. This is glaringly clear in Q3 data, which show real consumer spending on furnishings and durable household equipment up at the fastest pace since 1951.

The high economic multiplier effect of spiking home sales and construction is evident not only in the surge of consumer demand for durable goods, from cars and trucks to appliances and gardening equipment, but also in growing labor demand and a faster-than-expected rebound of service-sector surveys into robust growth territory. For example, the Institute for Supply Management (ISM) non-manufacturing index advanced to strong levels in September led by a big gain in new orders and an increase in its employment subcomponent into expansion territory for the first time since February. The IHS Markit service sector indicator rose further to quite elevated levels through October. Both are consistent with expanding service-sector activity in coming months. In fact, if past correlations between strong home sales and the non-manufacturing ISM index are any indication, the housing boom underway should create positive underpinnings for U.S. non-manufacturing conditions 12 months ahead, with favorable implications for employment and economic growth.

The pandemic-related strength in demand for homes has depleted inventories. With new home sales 32% above year-ago levels in September (to a 14-year high) and a surge in the homeownership rate to the highest level since 2009, the inventory of vacant housing for rent or for sale is down 23% from year-ago levels. This is the biggest decline ever, two to five times faster than the biggest declines in the past. As a result, vacant housing units adjusted for population growth have reached an almost 40-year low (Exhibit 1), galvanizing homebuilders' confidence to record highs and sparking a boom in home construction, with additional positive implications for labor demand and economic activity more broadly. As a result, both single-family housing starts and permits advanced in September to their highest levels in about 13 years.

Exhibit 1: Housing Units Available For Sale Or Rent Lowest In Almost 40 Years.



Sources: Census Bureau/Haver Analytics. Data as of October 29, 2020.

Strong demand and a tight housing inventory combined with rock-bottom mortgage rates suggest the boom in single-family home construction is likely to continue. In fact, interest rate cuts are still percolating through the economy, as it can take up to 18 months for mortgage rate declines to fully filter through. In addition, mortgage rates may decline further as credit spreads are likely to narrow more with an improving economy and easing lending conditions, supporting home-buying demand.

The combination of strong demand and declining supply has also resulted in rapid home-price appreciation, a significant factor behind rising household net worth and stronger-than-expected consumer spending in the face of large labor market slack and other pandemic woes. According to the National Association of Realtors, the median price of an existing home in September was up 15% from a year ago, the fastest appreciation in 15 years. On average, the S&P CoreLogic Case–Shiller U.S. National Home Price Index of single-family homes was up almost 6% in August from a year ago.

Rising home prices and a surging aggregate personal saving rate along with years of restrained borrowing have resulted in the strongest household balance sheet in almost 40 years. Indeed, according to the Bureau of Economic Analysis, the household sector accumulated about $8 trillion in personal saving between 2011 and 2019 and is on track to add another eye-popping $3 trillion this year. Also important, according to the Federal Reserve (Fed), the homeowner share of home equity in the second quarter was the highest in 30 years (at 66%), while the household debt-to-asset ratio was the lowest since 1986.

High levels of personal saving and strong household balance sheets have not only helped spur consumer spending in the face of shocking pandemic-related unemployment but seem to have also encouraged a record surge in Q3 applications for new business formations.[1] That's not surprising since, according to the September 2017, Report to the Congress on the Availability of Credit to Small Businesses, "Small business owners often provide funding for their businesses from their personal savings, retirement accounts, or home equity loans or from funds they borrow personally. In 2014, about 55 percent of firms received funding from their owners, with 20 percent of those firms receiving $250,000 or more."[2]

[1] Census Bureau as of September 2020.

[2] Board of Governors of the Federal Reserve System as of September 2017.

The surge in new business formation and elevated small business sentiment help explain why labor demand has been surprising to the upside in spite of high, if declining, initial claims for unemployment compensation. Indeed, notwithstanding a four-week average of 788,000 new applications for unemployment compensation in October, continuing claims for unemployment compensation are running more than 3 million lower than in September, suggesting that jobs continue to be created at a much faster pace than layoffs, with a large potential surprise in employment growth as a result when the data are released on November 6.

Also encouraging, according to BofA Global Research October 25, 2020, Boom, not Gloom report, updated proprietary indicators in October show that the ongoing revival in global economic activity continues, "with 76% of 38 growth indicators aligning themselves along a bullish/neutral signal, just shy of the pre-pandemic highs of 77%... The pervasive and persistent recovery in growth has laid the groundwork for corporate earnings to blossom". In our view, the yield-curve steepening and relatively contained credit spreads confirm that the economy is currently mending, notwithstanding surging coronavirus cases, election uncertainty and heightened risk aversion.

GLOBAL MARKET VIEW:

The Dualism of Market Fundamentals

Niladri Mukherjee, Managing Director and Head of CIO Portfolio Strategy
Kirsten Cabacungan, Investment Analyst

Dualism, or the quality of having a dual nature especially of opposing principles, seems apropos to current market fundamentals. The sell-off in global equities recently has focused on the negatives as it relates to event risks like the U.S. elections this week and the rising number of coronavirus cases. On the other hand, higher bond yields and better performing cyclicals have pointed to rising economic activity. In the backdrop of likely further choppy trading in the weeks ahead, we attempt to explore the dualism that exists within key fundamentals that should ultimately dictate where asset prices are a year from now.

Dualism #1: Coronavirus cases are rising BUT the economy is making forward progress

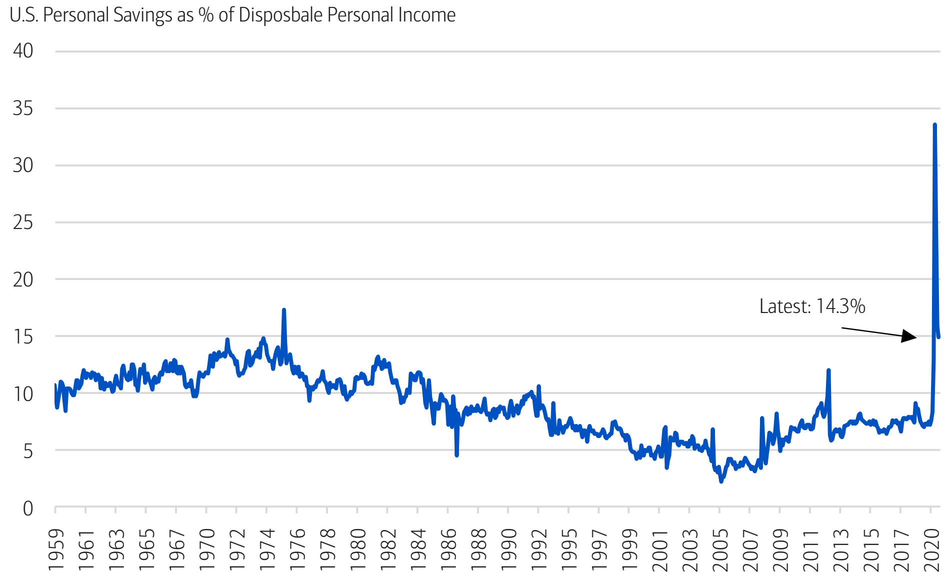
The coronavirus remains the top concern for investors, with cases spiking in parts of the U.S. and Europe. This has changed the reopening narrative to one replete with concern about another shutdown.

A prolonged pandemic would likely be the result of slower progress on the science front. But as individuals and businesses are learning to adapt, it could be less of a major headwind to growth as safety precautions are learned and implemented. Over the course of the eight months since the World Health Organization declared the coronavirus outbreak a pandemic, society has for the most part tried to limit the spread of the coronavirus including through social distancing, wearing masks and basic hygiene. Meanwhile, testing capability has increased, and the healthcare community has become more skilled at treating patients. Taken together, these have helped to keep hospitalizations and death rates relatively contained allowing specific regions within states to continue to steadily reopen.

Even without a firm handle on the coronavirus, a rebound in economic activity has been possible. Many businesses have been able to hire back workers. The number of continuing unemployment claims has moved consistently lower, declining by 17 million from its high of 24.9 million in early May.

Small business optimism has improved to levels not seen since the beginning of the year. Retail sales have surprised to the upside. Higher levels of household savings from earlier in the pandemic have been used to support spending. At 14%, the savings rate is still higher than the pre-pandemic level of roughly 8%, meaning there is still some cushion for consumers (Exhibit 2).

Exhibit 2: Higher Consumption Levels Have Not Forced Most Consumers To Draw Down All Of Their Savings.



Source: Bloomberg. Data as of November 2, 2020.

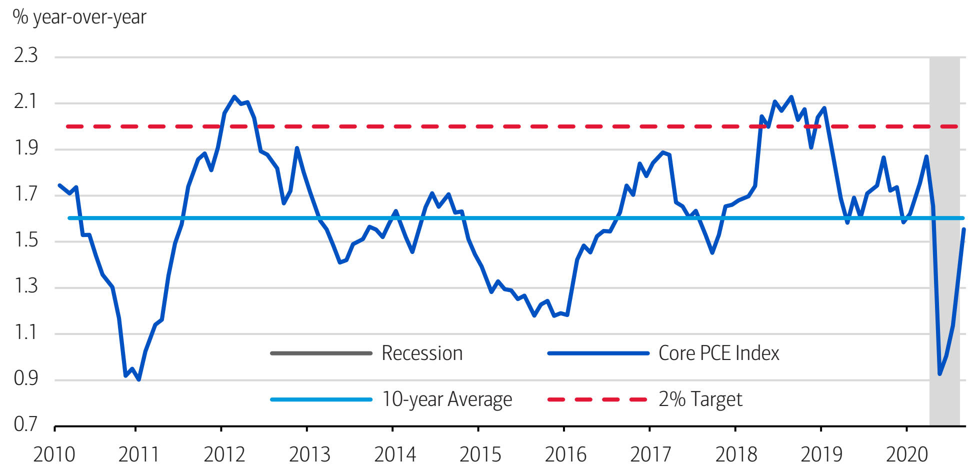
We cannot ignore the possibility of regional shutdowns and further targeted reversals in reopenings. We do not envision, however, prolonged nationwide shutdowns similar to those enacted in March and April. As such, our base case remains that growth and consumption continue to improve with the expectation of real GDP to be up 3% for Q4 and 4.5% for 2021.

Dualism #2: Inflation is rising BUT the Fed should remain accommodative

Investors have remained divided over the course of inflation. The unprecedented fiscal stimulus and accommodative monetary policy have led people to argue that the lagged effects of these policies could lead to an unexpected upward spiral of prices once the pandemic comes to an end and consumers fully tap into pent-up demand. To that point, inflation has picked up, but there are no signs yet of runaway inflation. Core personal consumption expenditures (PCE) index has moved higher since its steep fall in April, but the inflation measure still sits well below the Fed's 2% target at 1.5% as of September. For now, higher levels of inflation appear to be a sign that the actions taken at the start of the pandemic by the Fed are currently working to prevent a deflationary spiral.

But the probability that higher inflation could make the Fed reverse course on its current accommodative stance appears low. The Fed failed to reach its 2% inflation target over the last decade (Exhibit 3), and recently announced a new meaningful change to its strategy with its average inflation targeting framework that focuses on re-anchoring inflation expectations. Unlike the last recovery, the Fed will look to tolerate higher inflation that overshoots its target as a way to compensate for any periods that inflation undershoots. Fed officials have made clear their intentions to hold this course for years to come. Given that inflation still remains at modest levels, it could be some time before the Fed even thinks about becoming less accommodative.

Exhibit 3: The Fed Seeks To Move Inflation Back To 2%, Which It Failed To Do In The Last Recovery.



Source: Bloomberg. Data as of November 2, 2020. **Past performance is no guarantee of future results.**

Dualism #3: U.S. government finances have deteriorated BUT bond yields and the dollar are apathetic

U.S. debt is currently at 105% of GDP, close to its highs during World War II, and the budget deficit for 2020 came in at $3.1 trillion, a 218% increase from the 2019 fiscal year, according to the U.S. Department of the Treasury. The transition from a V-shaped to a moderate pace of the recovery next year likely ensures further deficits and rising debt levels. However, until now the financial markets have not pushed back on rising treasury issuances, with the dollar only slightly lower this year and bond yields remaining near historically low levels.

In our view, in the medium term, the dollar should gradually weaken and interest rates on the long end move modestly higher as the global economy improves. Debt raised to plug the deep economic hole should not be inflationary but rather help to stave off deflationary headwinds. The U.S. dollar remains the reserve currency of the world, with no other currency as a viable alternative as far as the eye can see. Global capital should continue to be attracted to the U.S. for its economic dynamism, innovation prowess and access to skilled labor, a world class healthcare system, and deep capital markets. Plus, most other developed markets like Europe and Japan have similarly ramped up their spending and ripped up their playbook on balancing budgets—so the U.S. balance sheet does not stand out.

However, once the pandemic is behind us, how the government spends will matter for the financial markets. The bond market and the dollar are likely to act as vigilantes more so than in previous decades, given the starting point of higher debt and deficits. Smart spending that raises the productive capacity of the economy such as in areas like technology and innovation, manufacturing and reshoring, education and skills development, and infrastructure will be seen as additive to potential growth and a path to lower debt/GDP ratio.

Dualism #4: Political dysfunction is rampant BUT fiscal stimulus may still come

Recent tightening in poll numbers in certain battleground states has raised the prospect of higher political uncertainty in the weeks ahead. Policy paralysis weighs on investor sentiment during normal times, but the risk is especially heightened today due to the pandemic. There are still roughly 12.6 million[3] people out of work, and the recent rise in infections could lead to some stalling of the reopening process. Over the course of the next 12 months, coordination and prompt decision making by policy makers will be needed to deliver more fiscal stimulus to individuals and small businesses and implement a nationwide policy for vaccine distribution and administration.

[3] Bureau of Labor Statistics as of October 2020.

A split government scenario will likely result in some delays and less stimulus. However, in our view, it is a question of 'when and not if' as it relates to fresh stimulus. A unique point in today's raucous political climate is that both political parties are espousing higher spending and bigger deficits, which makes this a uniquely bullish bipartisan backdrop for fiscal stimulus, one that is born out of the pandemic.

Portfolio Strategy

Our base case remains that the economy, corporate profits and investor sentiment will be potentially higher a year from now. The drivers of this new business cycle are housing, innovation, manufacturing and reshoring, and accommodative monetary policy. Also, more fiscal stimulus will be needed and is likely to be delivered. Bond yields should drift higher as inflation firms from low levels, which should help the cyclical sectors over defensive ones while creating headwinds for fixed income.

THOUGHT OF THE WEEK:

The Power of the Chinese Consumer

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

Taking the long view, we believe the future contours of global growth and global earnings are inextricably tied to emerging market consumer demand, notably demand from China. The accompanying exhibit underpins our conviction and is obtained from the Brookings Institution.[4]

Exhibit 4 highlights the attractiveness of the Chinese consumer to leading U.S. multinationals; simply put, when it comes to middle class consumption, there's China and the rest of the world. According to Brookings Institution, Chinese middle class consumers are on track to spend $7.3 trillion in 2020, head and shoulders above the U.S. ($4.7 trillion). Total household spending in the U.S., of course, is higher than in China because U.S. households are richer (higher per capita incomes) although the sheer number of Chinese consumers makes its market size larger—much larger. To this point, in 2006, China's middle class was estimated to number 90 million people. But after adding an average of 60 million people to its middle class every year since then, China's middle class now numbers roughly 750 million people. By 2027, according to Brookings, an estimated 1.2 billion Chinese will be considered middle class—a staggering consuming cohort.

Exhibit 4: Top 10 Countries By Total Middle Class Expenditures in 2020.

Country	Middle-Class Consumption (Trillions, USD)
China	$7.3
United States	$4.7
India	$2.9
Japan	$2.0
Russia	$1.6
Germany	$1.5
Indonesia	$1.2
United Kingdom	$1.1
Brazil	$1.1
France	$1.0

Table shows consumption by the middle class only. Total household consumption in the United States is higher than in China because of consumption by rich U.S. consumers.
Source: Brookings Institution; Homi Kharas and Meagan Dooley-authors-calculations, based on methodology in 2010 and using International Monetary Fund June 2020 GDP estimates. USD 2011 Purchasing Power Parity. Data as of October 2020.

[4] See Brookings Institution, "China's Influence on the Global Middle Class," by Homi Kharas and Meagan Dooley, October 2020.

Emblematic of this spending power, China now accounts for one-third to one-half of all global car sales and 40% of the global smartphones market.5 In 2019, Chinese citizens took a staggering 300 million vacation and business trips, with more than half (116 million) of those trips abroad. Over 90% of Chinese own their own home, with homeownership among Chinese millennials (roughly 70%) much higher than the comparable figure in the U.S. (35%). Meanwhile, Gen Z accounts for 15% of all household spending in China, compared with 4% in the U.S. China e-commerce accounts for 40% of global e-commerce, while the country remains out front in terms of mobile money—90% of Chinese consumers rely on mobile money as their primary form of payment.[5]

All of the above is neatly summarized in a recent essay from Bridgewater's Ray Dalio in the entitled, "Don't be blind to China's Rise in a Changing World"[6] and, when it comes to investing in either the U.S. or China, "allocate money to both countries." Also consider allocating capital to Western multinationals leveraged to the Chinese consumer, one of the most powerful consuming cohorts in the world.

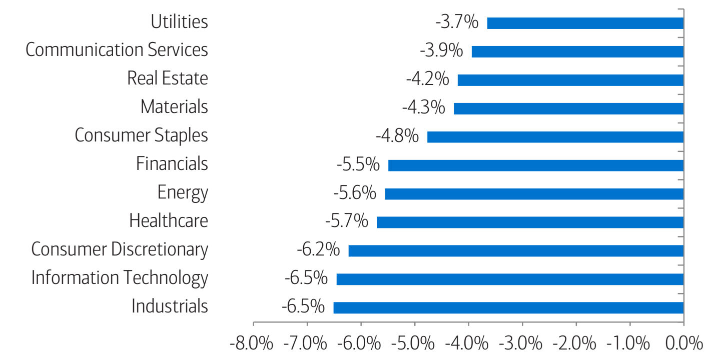
[5] Ibid.

[6] See, "Don't be blind to China's Rise in a Changing World", The Financial Times, October 24, 2020.

Equities

	Total Return in USD (%)			
	Current	WTD	MTD	YTD
DJIA	26,501.60	-6.5	-4.5	-5.4
NASDAQ	10,911.59	-5.5	-2.3	22.5
S&P 500	3,269.96	-5.6	-2.7	2.8
S&P 400 Mid Cap	1,900.18	-5.7	2.2	-6.6
Russell 2000	1,538.48	-6.2	2.1	-6.8
MSCI World	2,292.93	-5.6	-3.1	-1.4
MSCI EAFE	1,780.08	-5.5	-4.0	-10.8
MSCI Emerging Markets	1,103.46	-2.9	2.1	0.9

S&P 500 Sector Returns



Fixed Income†

	Total Return in USD (%)			
	Current	WTD	MTD	YTD
Corporate & Government	1.19	-0.08	-0.60	7.39
Agencies	0.54	0.02	-0.30	5.12
Municipals	1.41	0.08	-0.30	3.02
U.S. Investment Grade Credit	1.24	-0.04	-0.45	6.32
International	2.03	-0.23	-0.18	6.45
High Yield	5.78	-1.05	0.51	1.13

	Current	Prior Week End	Prior Month End	2019 Year End
90 Day Yield	0.09	0.09	0.09	1.54
2 Year Yield	0.15	0.16	0.13	1.57
10 Year Yield	0.87	0.84	0.68	1.92
30 Year Yield	1.66	1.64	1.46	2.39

Commodities & Currencies

	Total Return in USD (%)			
Commodities	Current	WTD	MTD	YTD
Bloomberg Commodity	153.35	-2.3	1.4	-10.8
WTI Crude $/Barrel††	35.79	-10.2	-11.0	-41.4
Gold Spot $/Ounce††	1878.81	-1.2	-0.4	23.8

Currencies	Current	Prior Week End	Prior Month End	2019 Year End
EUR/USD	1.16	1.19	1.17	1.12
USD/JPY	104.66	104.71	105.48	108.61
USD/CNH	6.70	6.67	6.78	6.96

Sources: Bloomberg, Factset. Total Returns from the period of 10/26/2020 to 10/30/2020. †Bloomberg Barclays Indices. ††Spot price returns. All data as of the 10/30/2020 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 10/30/2020)

	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	33.1	3.0	-3.6
CPI inflation (% y/y)	2.3	1.5	0.6	1.3	1.2	1.2
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 ($/share)	163	33	28	34.5*	35	131
Euro/U.S. dollar, end period	1.12	1.10	1.12	1.17	1.14	1.14
U.S. dollar/Japanese yen, end period	109	108	108	105	103	103
Oil ($/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. 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 Global Research; GWIM ISC as of October 30, 2020, 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 Index includes a representative sample of 500 leading companies in leading industries of the U.S. economy. Although the index focuses on the large-cap segment of the market, with approximately 75% coverage of U.S. equities, it is also an ideal proxy for the total market.

S&P CoreLogic Case-Shiller U.S. National Home Price Index is a composite of single-family home price indices for the nine U.S. Census divisions and is calculated monthly.

Institute for Supply Management (ISM) Non-manufacturing Index is an economic index based on surveys of more than 400 non-manufacturing (or services) firms' purchasing and supply executives.

Personal Consumption Expenditure (PCE) Index measure is the component statistic for consumption in gross domestic product collected by the United States Bureau of Economic Analysis. It consists of the actual and imputed expenditures of households and includes data pertaining to durable and non-durable goods and services

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