CHIEF INVESTMENT OFFICE

Capital Market Outlook

November 23, 2020

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

IN THIS ISSUE

- **Macro Strategy**—From manufacturing surveys to inflation and from productivity to corporate profits, our expectations for improved economic and financial-market conditions in line with typical business-cycle patterns have been confirmed, with few, if any, inconsistencies across incoming indicators. These positive dynamics engendered by massive, timely and targeted fiscal/monetary support have had concrete positive effects that in our view set the economy up for strong performance once the potential of vaccines help to get the coronavirus under control.
- **Global Market View**—Corporate earnings are fundamentally paramount for equity prices and profit margins are a key support driving that bottom line. While the pandemic recession pulled down S&P 500 margins, we find reason to believe the decline is slowing and catalysts for margin expansion await, which can likely help earnings grow into current valuations.
- **Thought of the Week**—The nature of the pandemic and attendant shutdowns has disproportionately affected services spending, which remains depressed compared to pre-crisis levels. With continued progress on the health front, our expectation is that the $1.3 trillion in excess savings as cash reserves for rising consumer expenditures into next year, especially in services once this part of the economy is unleashed.
- **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

Irene L. Peters, CFA®
Director and
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GLOBAL MARKET VIEW

Nick Giorgi, CFA®
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Neel Mukherjee
Managing Director and
Head of CIO Portfolio Strategy

THOUGHT OF THE WEEK

Lauren Sanfilippo
Vice President and
Investment Strategist

Data as of 11/23/2020, and subject to change.

MACRO STRATEGY

Financial Markets Shaped More By Profits Than Coronavirus News

Irene L. Peters, CFA®, Director and Senior Investment Analyst

Inherent daily market volatility, alarming coronavirus infection rates and unease/uncertainty about economic and tax policy have kept investors and consumers on edge. The election results and coronavirus contagion seem to have suppressed consumer sentiment, as reflected in the preliminary University of Michigan survey of consumer confidence, which hooked down in its preliminary mid-November reading, as well as

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mobility indicators, which have been flat to lower in recent weeks. An anticipated double-dip recession in Europe, where shutdowns are starting to materially affect economic activity, compound the near-term risks to U.S. and global growth from the pandemic.

However, financial markets have remained unphased, choosing to look beyond this hurdle. This is not surprising since, as we had expected, there's been unequivocal improvement on the economic conditions front to date, which has resulted in: 1) higher-than-expected third quarter S&P 500 profits, with 50% of sectors reporting rising pretax margins;[1] 2) declining credit spreads and equity-market Chicago Board Options Exchange (CBOE) Volatility Index (VIX); 3) a widening spread between the 10-year Treasury note yield and fed funds rate (i.e., a steeper yield curve); and 4) a relative market performance shift from Growth stocks to cyclical/Value stocks—all of which validate the strong signals for a likely brightening economic and profits outlook coming from the equity market since late March.

Moreover, recent incoming data continue to point up. National Federation of Independent Business (NFIB) global manufacturing and trade have turned sharply higher through September and October, small-business sentiment remained elevated in October, corporate earnings revisions have been overwhelmingly positive, and Q4 CEO business confidence sentiment (as measured by The Conference Board) has surged to the highest level since 2018-Q2. Also important, the unemployment rate has dropped way ahead of expectations to 6.9% in October, with almost 80% of the workers temporarily laid off in March/April rehired and rapid employment growth putting money in many consumers' pockets, likely helping to offset diminishing fiscal support. A big positive gap between small-business sentiment and consumer confidence measures is typical at the beginning of expansions, with consumer sentiment usually catching up as expansions mature, so we suspect the drop in the preliminary University of Michigan consumer confidence survey will prove short-lived.

In addition, a number of high-frequency proprietary surveys appear flat to higher through mid-November. For example, while the Evercore ISI Research surveys of homebuilders and auto dealers show slower sales, they also report strong demand, which suggests that it is supply constraints that have been hindering a faster expansion of business activity. Indeed, their transport and industrial activity surveys remain strong amid lean inventory, indicating increased business spending and revenues ahead.

Importantly, flush with cash (real personal disposable income up 12% year over year in Q2 and 6% in Q3 according to Bureau of Economic Analysis (BEA), many consumers quickly adjusted their spending patterns in response to the pandemic, with a surge in consumer-goods spending, while services spending collapsed. Given their greater exposure to the more capital-intensive and more volatile (cyclical) goods side of the economy, financial markets greatly benefited from this shift. Also, housing has been a more significant source of stability and growth than had been expected. Massive global stimulus helped engender strong demand for housing in European countries as well, but particularly in the U.S., where policy support has been most aggressive and the housing shortage most pronounced. Thus, while goods and housing demand surged, production and supply disruptions caused a big drop in inventories, spurring a global manufacturing and trade inventory cycle, with significant growth tailwinds into 2021 that in our view should help overcome the effects of new, localized shutdowns on service spending until the potential of vaccines help normalize conditions. This firming backdrop helps explain the impressive stability of financial markets and low levels of financial stress in the face of unresolved contagion, massive labor-market slack, and doubts about a quick economic recovery out of the pandemic.

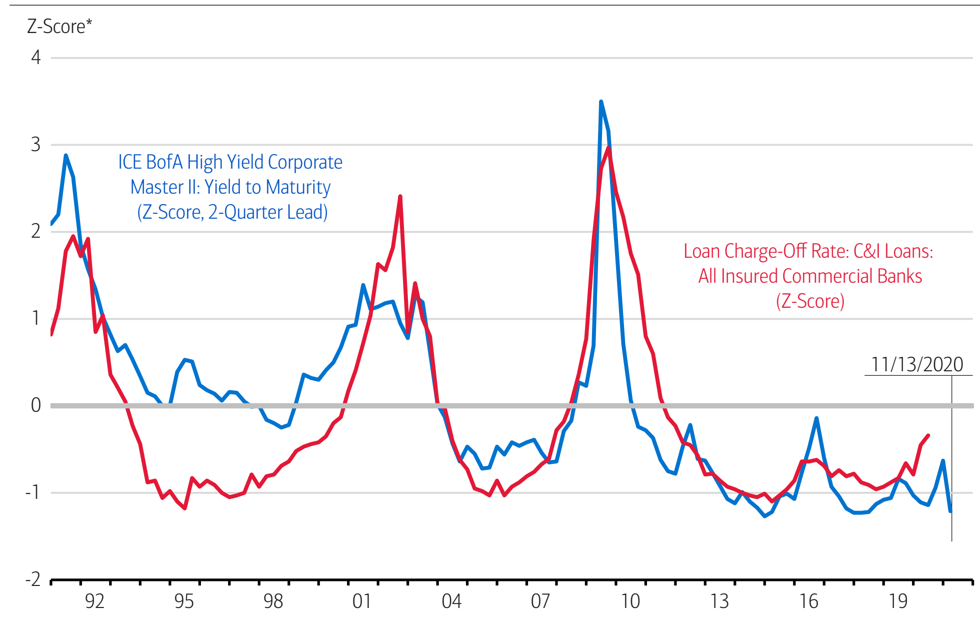
Basically, despite much skepticism, rising profits and profit margins are positive for risk-on sentiment across financial markets. On the credit-market front, for example, well-targeted support from the Federal Reserve (Fed) and the faster-than-expected rebound in economic

[1] Empirical Research Partners, November 11, 2020.

growth and profits have helped credit conditions to heal much quicker than expected, a necessary condition for financial-market stability and a growing economy. Yields on speculative bonds have dropped to record lows, and credit spreads have narrowed to below-average levels. According to Moody's November 12, 2020, Capital Market Research, the coronavirus-driven upturn in net investment-grade downgrades has been tame compared to prior recessions, and "*credit rating upgrades have outnumbered downgrades thus far during 2020's final quarter. Debt refinancings, infusions of equity capital, mergers and acquisitions, as well as improved outlooks for operating earnings have abetted the stabilization of corporate credit quality…The Fed's unprecedented support of investment-grade corporate bonds has helped to rein in the net downgrades of U.S. investment-grade corporations…A partial recovery by business sales, ample systemic liquidity, and an equity market rally quickly pared the number of downgrades to Caa3 or lower…*"

Looking ahead, the drop in speculative-bond yields to fresh lows following encouraging coronavirus vaccine news bodes well for commercial-and-industrial (C&I) loan charge-off rates. As shown in Exhibit 1, they appear poised to peak soon and at levels way below the 2008–2009 recession. Similarly, following a pandemic-related spike to levels of tightness last seen in 2008–2009, bank lending standards[2] have eased sharply in the fourth quarter and appear likely to continue to reverse their shock surge and return to more favorable levels, consistent with inflation, profit margins, credit-spread and the VIX conditions.

Exhibit 1: Financial Stress Much Lower Than In Past Recessions.



*Standard deviation from mean.
Sources: Federal Reserve Board; ICE BofA High Yield Corporate Master II/Haver Analytics. Data as of November 13, 2020.
Past performance is no guarantee of future results.

Indeed, the VIX has currently declined sharply, though a still relatively flat yield curve is keeping it slightly above average, consistent with somewhat elevated risks of recession. Based on historical patterns, the yield curve must steepen to more normal levels for the VIX to decline further, which we expect as a result of favorable incoming economic data and unambiguously positive news on the vaccine front.

All this depends on the manufacturing cycle and specifically on the strength of the Institute for Supply Management (ISM) index as a proxy for the strength of the manufacturing cycle. It remains to be seen how long the ISM index can remain as elevated as it currently is given the drop in German manufacturing sentiment indicators

[2] Board of Governors of the Federal Reserve System, Senior Loan Officer Opinion Survey On Bank Lending Practices, as of August 2020.

such as the ZEW Financial Market Survey, undoubtedly related to the renewed European shutdowns. While we expect some eventual ISM moderation in 2021 as the index is currently overshooting our expectations, a continued housing boom (possibly the biggest in 40 years) should provide support for manufacturing and trade, with broad macroeconomic and market implications. Housing activity and home price growth tend to lead U.S. consumer spending, so the housing boom now underway will likely continue to buoy U.S. consumer spending into late 2021, helping offset negative effects from resurgent coronavirus cases.

All in all, the combination of the fastest economic rebound ever, surge in goods and housing-sector demand, record-low corporate interest rates, and slowing wage growth has set the stage for more margin expansion and a big profit growth spurt through 2021, which should continue to shape financial-market trends ahead more than coronavirus contagion news, in our view.

GLOBAL MARKET VIEW:

Margins Should Help Earnings Grow into Valuations

Nick Giorgi, CFA®, Vice President and Investment Strategist
Neel Mukherjee, Managing Director and Head of CIO Portfolio Strategy

Corporate earnings are the ultimate harbinger for equity prices, and profit margins are key support driving that bottom line. Historically, U.S. companies have consistently demonstrated the ability to preserve and grow their margins through the business cycle, and particularly out of recessions. The pandemic-induced downturn dragged down S&P 500 net margins to 9% in the third quarter from 11% at the same point last year, representing the slimmest level since 2010. However, the decline appears to be slowing with green shoots for improvement.

Currently, consensus projects S&P earnings per share (EPS) to rise to $168 in 2021, from expectations of $138 in 2020, as economic expansion makes forward progress. We believe there may be upside to these estimations based upon companies being able to derive better revenues from higher nominal gross domestic product (GDP) growth, but also lower interest costs and rising productivity. The makeup of the stock market, which is skewed toward asset-light business models (such as Technology, Healthcare, Communications) also favors higher profitability and margins.

Higher nominal growth potential in 2021

Margins have tended to be cyclical by nature and typically follow the business cycle. As the economy expands, demand and pricing power pick up, and a shift from consumer's saving to spending ultimately drives corporate revenues higher. Companies that can efficiently manage their costs relative to the increase in sales, namely via operating leverage, can subsequently boost their profit margins to capitalize on the expansion. According to Cornerstone Macro Research, profit margins for the S&P 500 have historically tended to follow manufacturing activity, which itself is a leading economic indicator of the business cycle (Exhibit 2) and has been in expansion since this summer.

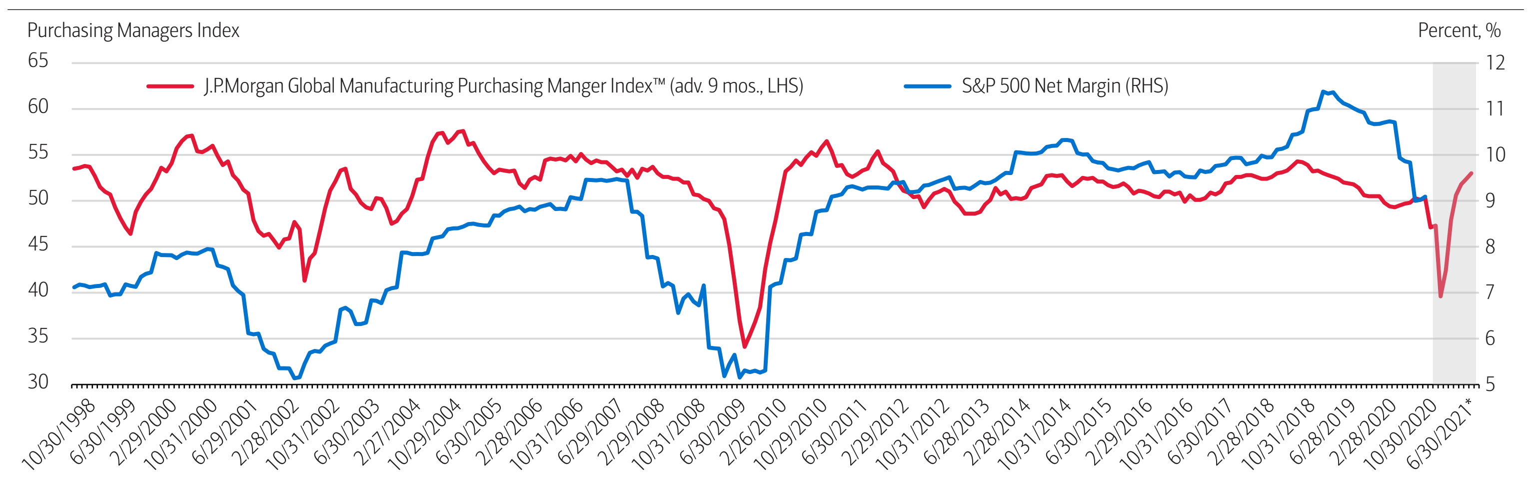
As the economic recovery continues and may exceed expectations, the conditions for higher levels of nominal growth are ripe, especially given the unprecedented backdrop of synchronized global fiscal and monetary accommodation. In addition, the U.S. personal savings rate remains elevated after spiking to 33.6% in April as demand cratered, and a normalization back to pre-pandemic levels could represent new consumption of approximately $1.3 trillion.[3] BofA Global Research projects nominal growth to exceed 6% in the U.S. next year and 8%, globally.[4] Given expectations for higher nominal growth, we would expect margins to follow suit in expansion, which should help equities to "grow

[3] Bureau of Economic Analysis.

[4] Nominal total reflects estimates of real GDP (4.5% in the U.S., 5.6% globally) plus CPI (1.8%, 2.6%).

into” their valuations. (Exhibit 2)

Exhibit 2: After Suffering Contraction, Conditions May Be Ripe For Margins To Improve.



*Estimate and subject to change.

Sources: Cornerstone Macro Research; Chief Investment Office. Data as of October 30, 2020. **Past performance is no guarantee of future results.**

Higher productivity potential growth

An often overlooked catalyst to sticky margins and profitability is productivity growth, or getting more with the same or even less. Productivity growth had been elusive following the Global Financial Crisis, held back by weaker capital expenditures (capex), but began to pick up in recent years with business spending appearing to strengthen. The pandemic, however, put an abrupt stop to that outlook for capital spending as nonfinancial business fixed investment dropped 20% year-over-year (YoY) in June. However, the data has begun to turn upwards with the National Federation of Independent Business (NFIB) small business capex plans bouncing from the bottom and capital goods new orders surging 6.1% YoY in September, while posting five consecutive months of growth.

Remarkably, U.S. businesses have also quickly adapted to become leaner and more efficient with cost-cutting measures enhancing the productivity of their operations. The Bureau of Labor Statistics reports that quarterly productivity growth during the peak of the pandemic (Q2) was 10.6%, the highest level since the early 70s, and remains elevated. While businesses continue to optimize themselves to manage through the pandemic, we believe that the longer-term implications include a secular shift higher in capex toward productivity-enhancing initiatives—including 5G, robotics, artificial intelligence, etc.—as the economy transitions to the “New Frontier.”

The changing nature of the stock market

A shift in the composition of equity indexes has had a major effect on margins. The share of the S&P 500 composed by the Healthcare, Technology and Communication Services sectors has increased over 20 percentage points over the past 10 years and now totals 53%. These businesses tend to enjoy higher and more stable margins, in part due to achieving high operational leverage. For example, the net margin of the Technology sector has averaged 15.4% from 2004 through 2019, which is nearly 70% greater than the overall index during that period according to FactSet. Sectors such as Financials and Energy typically have lower or more volatile margins, are fixed-asset intensive, and have seen their collective market share shrink over time. Within this context of elevated profitability, growth and quality, a higher valuation multiple for the S&P 500 is likely justified.

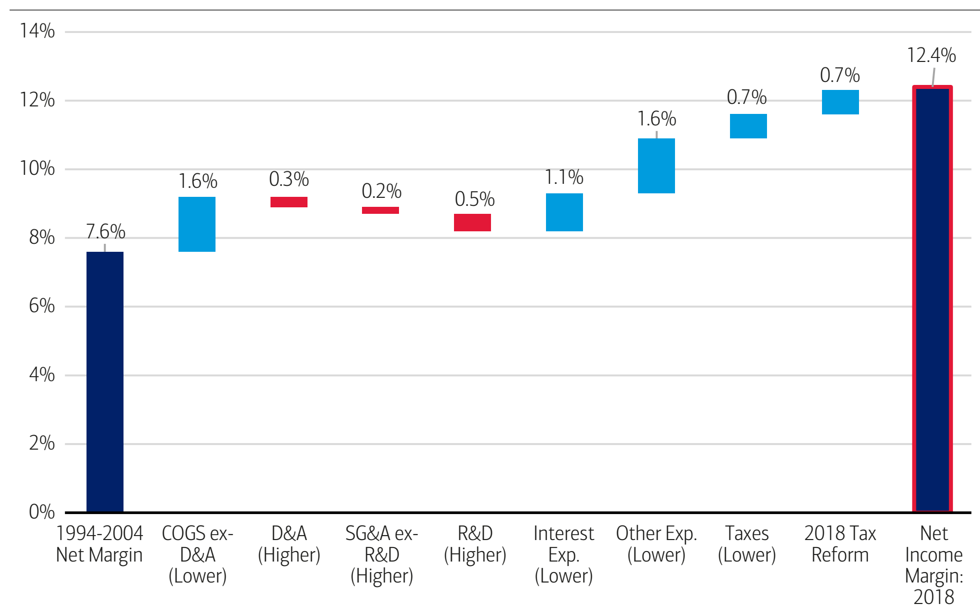
Going forward, we expect the primacy of technology-related sectors to increase within the overall market as they become a larger part of the accelerating digital economy. The digital economy now contributes almost $2 trillion to the U.S. economy, surpassing the combined size of the construction, educational services, and accommodation and food services industries. It's also growing much faster! Since 2005, the digital economy's average growth rate was more than triple that of the overall economy—6.8% vs. 1.7%. And it is doing so with a less labor-heavy but higher-compensated footprint as the digital economy only accounts for 5.7% of U.S. jobs but contributes a 9% share of total economic output, while workers in the digital economy average annual compensation benefits 49% greater than the average American worker.[5]

Lower interest and tax costs potential

We anticipate that interest rates will remain low for the foreseeable future given monetary policy and market forces. Lower interest rates, all else equal, auger for lower interest costs, which also should bolster net margins especially considering the swell in nonfinancial corporate leverage, which now totals nearly $11 trillion.[6] This year alone Securities Industry and Financial Markets Association (SIFMA) tracks almost $2.1 trillion of U.S. corporate bonds having been issued with many companies citing the desire to refinance or lock in lower rates for longer as their driving force. Some S&P 500 constituents issued 40-year paper with coupons at or below 2.5%.

In addition, tax policy also takes on particular relevancy. Corporate taxes have trended lower over the past couple of decades, with the Tax Cuts and Jobs Act of 2017 being the most recent stimulant, which helps to increase after-tax profit relative to prior periods. According to BofA Global Research, lower interest expenses have added approximately 1.1% to net income margins since 2004, to which tax reduction has contributed an additional 1.4% through 2018 (Exhibit 3).

Exhibit 3: S&P 500 Margins Had Picked Up Tailwinds Over Time.



Source: BofA Global Research. Data as of June 8, 2020. **Past performance is no guarantee of future results.**

Portfolio strategy

The story of 2021 for equities is going to be dependent on whether profit margins continue to rise towards pre-pandemic levels and even surpass them, as we move toward the "New Frontier." There is no doubt that much work needs to be done on the road to normalization, and, for some

[5] Bureau of Economic Analysis, Nicholson. "New Digital Economy Estimates." August 2020.

[6] Board of Governors of the Federal Reserve System.

industries, maintaining margins and generating profits will be permanently challenged. However, the relative stability of margins at larger companies in particular has been an important support for the markets and could lead to upside earnings surprises in 2021 and 2022 as rising GDP, productivity, lower interest costs and mix shift toward more profitable business models provide tailwinds. Based upon financial figures provided by Bloomberg, a 1% change in the net margin of the S&P 500 index in a given year could represent a $10 to $15 swing for earnings, so these catalysts could prove powerful.

The positive margin story in the post-pandemic world is not without its risks. The narrative of big businesses gaining at the expense of small companies as the pandemic rages on has the potential to trigger populist redistribution policies that could pressure profit margins. This could be especially true for the high-flying technology and communications companies, which currently find themselves under political and regulatory scrutiny. Finally, higher corporate taxes would be considered a culprit as would a further escalation of the trade war, which could create uncertainty for corporates leading to weaker capex while threatening the profitability of global manufacturers.

THOUGHT OF THE WEEK:

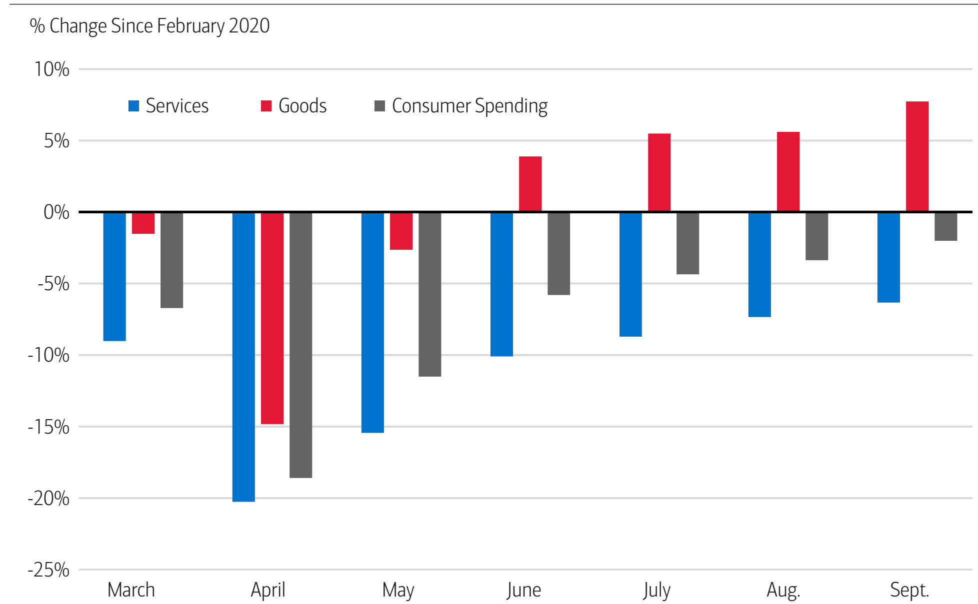
Squirreling Away Savings for Future Spending on Services

Lauren J. Sanfilippo, Vice President and Investment Strategist

Dollars held in savings deposit accounts (including money-market and high-yield savings) totaled $11.9 trillion for the week ending November 2[7]—an amount that suggests many Americans aren't sitting on a savings cushion, but a couch. Separate data shows the U.S. savings rate hovering at 14.3%, well above the 20-year average annual rate of 6.6% although down from an all-time high of 33% when stimulus checks hit bank accounts back in April. So with household savings as an indicator for future consumer spending, think of the $1.3 trillion in excess savings as cash reserves for rising consumer expenditures into next year, especially in services once this part of the economy is unleashed with continued progress on the health front.

While we've seen consistent month-to-month improvement in personal consumption broadly recovering in line with GDP, the latest data show the drop in spending is attributable to services remaining depressed at 6.3% lower compared to pre-crisis levels. As highlighted in Exhibit 4, in the months since February, goods have helped balance the spending equation, up 7.7%.

Exhibit 4: Waiting For The Snap Back In Services.



Source: Bureau of Economic Analysis. Data through September 30, 2020. **Past performance is no guarantee of future results.**

[7] Federal Reserve data as of November 18, 2020.

The far larger services sector has borne the brunt of the pandemic, as people avoided spending on services such as going to a movie theater, traveling or dining out, and instead directed spending on goods like home furnishings, bikes, or at-home computer equipment. Indeed, the nature of the pandemic and attendant shutdowns has disproportionately affected services spending. While the consumer typically drives about two-thirds of the economy, two-thirds of all spending is specifically on services, making it the biggest component of consumer spending.

Looking forward, we expect recent vaccine developments, the potential passage of a fiscal stimulus bill, and already strong household balance sheets to spur consumer spending in the first quarter of '21 and beyond. This will underpin a new "Pent-Up Demand Cycle" or the next stage of the workout process focused on service activities. Think recreational activities, transportation, healthcare and those industries aligned to travel and entertainment. In the end, we believe the U.S. economic expansion is poised to broaden out next year, supporting our base case that assumes 3% annualized growth in the fourth quarter and 4.5% for full year 2021.[8]

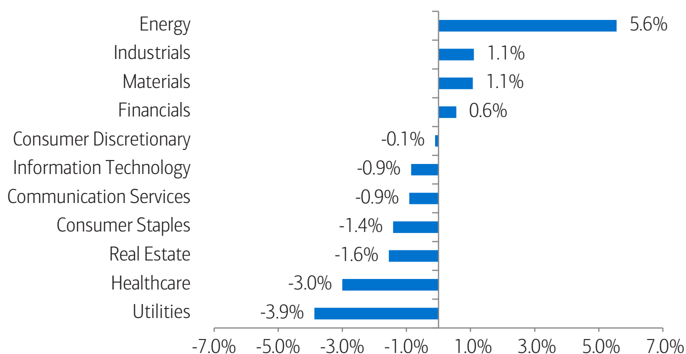
[8] BofA Global Research as of October 2020.

MARKETS IN REVIEW

Equities

	Total Return in USD (%)			
	Current	WTD	MTD	YTD
DJIA	29,263.48	-0.7	10.6	4.7
NASDAQ	11,854.97	0.2	8.7	33.2
S&P 500	3,557.54	-0.7	8.9	12.0
S&P 400 Mid Cap	2,147.61	1.6	13.1	5.6
Russell 2000	1,785.34	2.4	16.1	8.3
MSCI World	2,540.02	0.4	10.9	9.3
MSCI EAFE	2,035.27	1.9	14.4	2.1
MSCI Emerging Markets	1,209.26	1.8	9.6	10.6

S&P 500 Sector Returns



Fixed Income†

	Total Return in USD (%)			
	Current	WTD	MTD	YTD
Corporate & Government	1.11	0.77	1.26	8.75
Agencies	0.52	0.21	0.21	5.34
Municipals	1.19	0.64	1.36	4.42
U.S. Investment Grade Credit	1.16	0.59	0.94	7.32
International	1.85	1.22	2.44	9.04
High Yield	4.84	0.61	3.23	4.40

	Current	Prior Week End	Prior Month End	2019 Year End
90 Day Yield	0.06	0.08	0.09	1.54
2 Year Yield	0.16	0.18	0.15	1.57
10 Year Yield	0.82	0.90	0.87	1.92
30 Year Yield	1.52	1.65	1.66	2.39

Commodities & Currencies

	Total Return in USD (%)			
Commodities	Current	WTD	MTD	YTD
Bloomberg Commodity	158.25	0.6	3.2	-8.0
WTI Crude $/Barrel††	42.15	5.0	17.8	-31.0
Gold Spot $/Ounce††	1870.99	-1.0	-0.4	23.3

Currencies	Current	Prior Week End	Prior Month End	2019 Year End
EUR/USD	1.19	1.18	1.16	1.12
USD/JPY	103.86	104.63	104.66	108.61
USD/CNH	6.55	6.60	6.70	6.96

Sources: Bloomberg, Factset. Total Returns from the period of 11/16/2020 to 11/20/2020. †Bloomberg Barclays Indices. ††Spot price returns. All data as of the 11/20/2020 close.
Past performance is no guarantee of future results.

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

	Under-weight		Neutral	Over-weight	
Equities	•	•	•	● (green)	•
U.S. Large Caps	•	•	•	● (green)	•
U.S. Mid Caps	•	•	● (yellow)	•	•
U.S. Small Caps	•	•	•	● (green)	•
International Developed	•	•	● (yellow)	•	•
Emerging Markets	● (red)	•	•	•	•
Fixed Income	•	● (orange)	•	•	•
U.S. Investment Grade Taxable	•	● (orange)	•	•	•
International	● (red)	•	•	•	•
Global High Yield Taxable	•	● (orange)	•	•	•
U.S. Investment Grade Tax Exempt	•	•	● (yellow)	•	•
U.S. High Yield Tax Exempt	•	● (orange)	•	•	•
Alternative Investments*					
Hedge Funds			●		
Private Equity			|		
Real Estate			|		
Tangible Assets/ Commodities			●		
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 11/20/2020)

	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	1.1	1.2
Core CPI inflation (% y/y)	2.3	2.1	1.2	1.7	1.6	1.7
Unemployment rate (%)	3.5	3.8	13.0	8.8	6.6	8.1
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	0.90	0.90
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 November 20, 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.

Chicago Board Options Exchange (CBOE) Volatility Index (VIX) is a real-time market index that represents the market's expectation of 30-day forward-looking volatility.

Purchasing Managers' Index (PMI) is a measure of the prevailing direction of economic trends in manufacturing.

J.P.Morgan Global Manufacturing Purchasing Managers' Index™ are compiled by IHS Markit from responses to monthly questionnaires sent to purchasing managers in survey panels in over 40 countries.

ICE BofA High Yield Corporate Master II uses an index of bonds that are below investment grade (those rated BB or below). Index constituents are capitalization-weighted based on their current amount outstanding.

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