CHIEF INVESTMENT OFFICE

Capital Market Outlook

November 9, 2020

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

IN THIS ISSUE

- **Macro Strategy**—Positive economic surprises continue to dominate negative ones by a wide margin. Leading indicators and rising global momentum point to stronger growth ahead even without additional fiscal stimulus in the U.S. This is also evident in the big positive corporate earnings surprises for the third quarter. This is a very favorable backdrop for the 2021 outlook for the global economy and stock markets, in our view.
- **Global Market View**—Owing to the pandemic and U.S.-Sino geopolitical tensions, the state now controls the "commanding heights" of the economy. Investors have welcomed this turn but should understand that the greater the role of the state, the greater the odds of market distortions over the long term.
- **Thought of the Week**—Recently, the fifth Plenum of the Chinese Communist Party's Central Committee approved broad policy recommendations for the country's 14th Five-Year Plan. Uniquely, though not unprecedentedly, a 15-year vision for China's development was also endorsed. In general, these communiqués stress higher-quality economic growth, and greater technological self-reliance while reinforcing the climate-change ambitions of the nation's leadership.
- **Portfolio Considerations**—We would use additional weakness in equity markets to rebalance portfolio positioning back to tactical targets, where appropriate, as we close out 2020. As valuations have corrected somewhat and our profit expectations have risen for the foreseeable future, we are bullish on equities relative to fixed income over both the short and long term.

MACRO STRATEGY

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GLOBAL MARKET VIEW

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THOUGHT OF THE WEEK

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Data as of 11/09/2020, and subject to change.

MACRO STRATEGY

Rapid Recovery Surprises Economists

Robert T. McGee, Managing Director and Head of CIO Macro Strategy
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Throughout the past six months, the speed of the recovery from the widespread spring shutdowns has consistently surprised economists on the upside. The "V-shaped" recovery was not the expected outcome. There is still a widespread view that without additional stimulus the strengthening U.S. economy will likely falter in the months ahead, given the surge in coronavirus cases threatening to further slow reopenings in certain parts of the economy.

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It's not unusual when an economy comes out of a recession for forecasters to remain overly pessimistic. For one thing, that's when conditions are at their worst, with economic activity at a multi-year low point at the end of a recession. Even as the economy begins to recover, it's easy to dismiss the improvements when you're still well below earlier levels of activity. Nevertheless, the speed of improvement this time around remains much faster than forecasters had anticipated. For example, the outlook for Q3 gross domestic product (GDP) growth at the end of July was around a 10% annualized rate and moved progressively higher over the next three months before coming in just over 33% when the Bureau of Economic Analysis reported its first official estimate. Economists have already dismissed this unprecedented record rise as water over the dam and focused their attention on a gloomy outlook for the months ahead as coronavirus cases continue to increase and further stimulus remains stalled in Congress.

In our view, this persistent underestimation of economic strength absent additional large fiscal stimulus may continue for several reasons. First, pundits have massively underestimated the effect of the initial stimulus, which was the biggest since World War II. The effects of that stimulus are likely to keep growth strong well into 2021 even without another dose of fiscal policy. Second, the signs of a new synchronized global expansion continue to proliferate as other countries have also resorted to strong fiscal and monetary expansion. Focus on coronavirus cases and the need for additional stimulus measures has kept attention on the negatives and caused insufficient attention to the growing evidence of a strengthening global economy.

Indeed, the continuing devastation in certain areas of the global economy makes it easy to find pockets of extreme weakness and to overlook the areas of impressive strength. Still, it's the overall size of the pie that best describes the net outcome of these unusually diverse positive and negative effects. A look at this mix in the entrails of Q3 U.S. GDP helps provide perspective on the outlook for 2021.

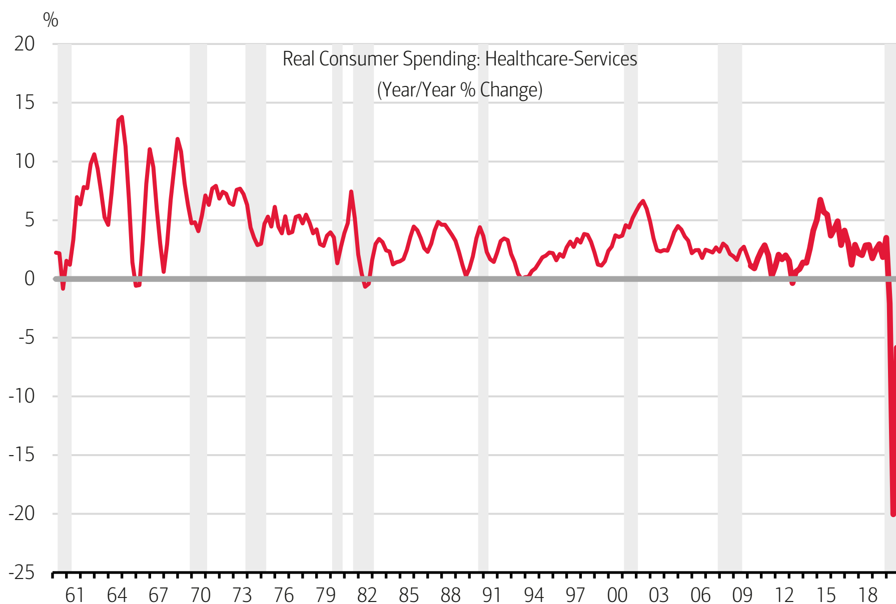
The most pronounced difference in GDP growth since the pandemic hit is clearly the unprecedented differential between goods and services. In past recessions, it was typical for goods sectors like Automobiles, Housing and other big-ticket Discretionary purchases to bear the brunt of the downturn, while service sectors held up much better, aided by their stronger relative growth trends as they accounted for an increasing share of GDP. This is the first recession with goods spending outperforming services. For example, at the end of the Q3, spending on motor vehicles and parts, as well as residential investment, surpassed their late 2019 peaks by about 8% and 5%, respectively. In other words, the economic recovery from the recession low point in these sectors took only three months.

Contrast that with the recovery in these sectors after the 2008–2009 recession. Motor-vehicle spending began to decline in the first quarter of 2008 and did not exceed pre-recession levels again until 2015. Similarly, residential investment spending, which began to decline when the housing bubble popped in 2006, declined continuously thereafter until 2012. In short, these key cyclical sectors took many years to recover from the Great Financial Crisis (GFC). This time around, they took just a few months.

This illustrates a critical difference between this pandemic recession and past recessions. As discussed in recent Capital Market Outlook reports, this was more like a natural disaster. The shutdowns hit and then they were gone, while unprecedented stimulus fueled the recovery of an otherwise healthy economy, setting the stage for the fastest, strongest recovery on record that economists are still having a hard time accepting. Importantly, work-from-home (WFH) and flight from congested urban areas have added a new structural-trend element to housing and auto demand that accelerated their recovery. It has also made information processing equipment a bigger priority. Q3 GDP statistics show business spending on information technology equipment has surged almost 15% above fourth quarter 2019 levels. As the economy transitions to this new WFH environment, investment spending is growing at a double-digit rate as reported by the latest GDP report and Atlanta Fed GDPNOW . This strength in goods purchases is driving the early stage of the current expansion and helping improve cyclical stocks' relative performance.

The bad news is the lagging performance of certain service-sector activity, as government restrictions and fear of coronavirus hamper reopenings. While consumption spending on goods set a fresh record almost 7% above pre-pandemic levels in the third quarter, spending on services was still about 8% below its year-end 2019 level. Although both sectors recovered sharply, the service sector remains on a much lower recovery path. The good news is that service-sector laggards are generally strong secular growers that have just been derailed by the pandemic. A good example is the unprecedented collapse in consumption of medical-care services. Aging demographics and technological advances and new medical treatments make this one of the strongest growth areas for the future. However, shutdowns and coronavirus precautions caused an unprecedented drop in medical-care spending by consumers in the second quarter (Exhibit 1).

Exhibit 1: Shutdown Caused Deepest Healthcare Spending Drop Ever.



Sources: Bureau of Economic Analysis/Haver Analytics. Data as of November 4, 2020.

In fact, this is a major reason why many scientists and healthcare professionals now believe the negative consequences of shutdowns outweigh the positives. Many consumers neglected normal basic health procedures to avoid contact with medical service providers. Fortunately, this consumption of medical services has recuperated about two-thirds of its unprecedented 21% second-quarter collapse. However, it remains about 7% below pre-pandemic levels, raising the risk that non-coronavirus health problems could become more of a long-term issue for households.

Still, as people adapt to the coronavirus and therapies continues to improve, demand for postponed and delayed medical care should continue to recover toward its strong long-term trend. For the same reasons, a similar unleashing of demand for travel, entertainment and other hard-hit services is also likely in 2021. Combined with the new, stronger underlying demand for goods led by the accelerated WFH trend, the preconditions for an overall economic boom in 2021 are thus falling into place, in our view.

The main pushback against this optimistic view is based on the notion that consumers and businesses need more help from the government to continue spending at the strong pace of recent months. However, the Q3 data suggest this may not be the case. Consumers' after-tax incomes adjusted for inflation have grown about 6% since the end of 2019, which is unprecedented for a recession, when incomes always fell in the past. Furthermore, the savings rate remains double than usual as reported in the latest GDP statistics as the inability to spend on vacations, restaurants, and other services has caused a lot of forced savings and pent-up demand. As this pent-up demand is unleashed

in 2021, we believe economists will continue to be surprised on the upside. In addition, the rise in employment is replacing the loss of emergency government benefits, leaving many consumers in their strongest financial position in 40 years.

Also encouraging is the surprisingly strong position of small businesses despite the widespread damage evident in boarded-up store fronts. In the aggregate, despite a 10% second quarter decline, proprietors' incomes recovered completely in the third quarter and stood about 6.6% above year-end 2019 levels. Strong balance sheets buoyed by record levels of equity and real-estate wealth, together with the accelerated WFH trend, have spurred a surge in new business formations which reflects a high level of confidence in the much changed economic environment. Thus, in addition to strong consumer demand, it seems reasonable to expect continued strength in business spending on equipment in the year ahead.

The unexpectedly strong and rapid recovery from the widespread spring shutdowns has caused corporate earnings to rise much faster than had been expected as well, helping to explain the strength in the U.S. equity market that baffled economists in the second quarter. As usual, however, in the midst of the worst economic data in the spring, the equity market was looking forward and saw the positive economic surprises that typically accompany the first year of a strong expansion out of a deep recession. Positive third quarter earnings surprises have been much higher than normal, confirming the equity market expectations for a strong recovery. The global synchronized nature of this new expansion also bodes well for equities in 2021, in our view.

GLOBAL MARKET VIEW:

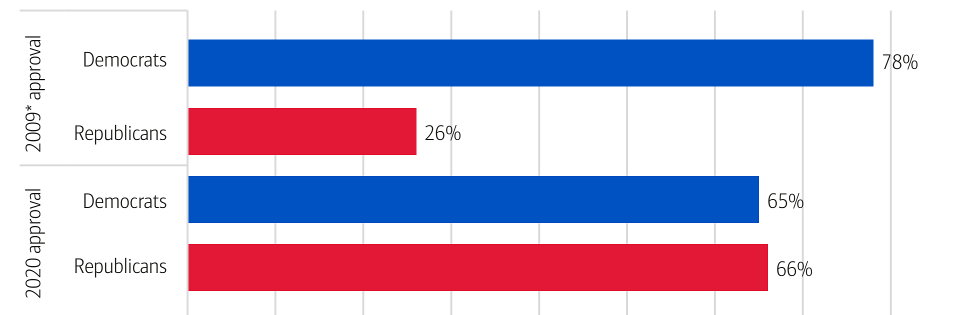
The Coming Shift in the "Commanding Heights" and the Investment Implications

Joseph P. Quinlan, Managing Director and Head of CIO Market Strategy
Lauren J. Sanfilippo, Vice President and Investment Strategist

It's back—and we're not talking about coronavirus or vinyl records. We are talking about "Big Government" and a spike in public-sector activism in the U.S. and abroad not seen in decades. In a seismic U-turn, the pendulum for control of the "commanding heights"—or the most important elements of the economy—is swinging back to the state, away from the markets. And this historic shift is bipartisan in the U.S., meaning that regardless of the composition of Washington come January 2021, the role of government in the U.S. is set to expand over the medium term (Exhibit 2).

Exhibit 2: New Agreement.

There is a bipartisan support for the government's expanded role during the coronavirus crisis, unlike during the 2009 recovery from financial crisis.



*March 2009 Gallup Poll.
Sources: Wall Street Journal; NBC News telephone poll of 900 registered voters conducted from April 13–15, 2020; margin of error +/- 3.27 pct. pts. Data as of October 2020. **Past performance is no guarantee of future results.**

Channeling Lenin

The "commanding heights" were dubbed the most important elements of the economy by Vladimir Ilyich Lenin—political theorist— in 1922, and, ever since then, the pendulum for control of the "heights" has ebbed and flowed between the state and marketplace. The Roaring Twenties favored "Big Business" until the economy and stock market cratered in 1929; the pendulum swung toward "Big Government" over the 1930s and 1940s, and became more firmly entrenched in the decades following the end of World War II.

By the end of the 1970s, however, and against the back drop of stagnation, rising inflation and spreading economic malaise, control of the "commanding heights" pivoted decisively to the free market, jumpstarted by the Margaret Thatcher-former U.K. Prime Minster—and Ronald Reagan—former U.S. President—anti-government, pro-market revolution. In the ensuing decades, governments around the world—in both the developed and developing nations—relinquished or reduced their grip of the commanding heights in favor of the markets. Politics followed economics. Market-friendly polices became the norm—think greater levels of deregulation and privatization, trade and investment liberalization, reduced capital controls and financial reform, and greater global integration of heretofore closed economies like India, China and the former communist states of Eastern Europe.

All of the above helped create a golden era of globalization—the world became "flat" owing to unfettered crossborder flows of trade, capital, investment and people. It was a propitious time for U.S. multinationals, which planted investment roots all over the world in order to gain access to new foreign markets and to leverage the resources (workers, technology and raw materials resources) of other states. The upshot: A long-term boost to corporate earnings. The markets controlled the "commanding heights"—until they didn't.

Big shocks = Big government

The pendulum began to swing back to the state in the aftermath of the Great Financial Crisis (GFC) of 2008/09. The crisis was blamed on excess financial leverage and little regulatory oversight, and compounded by widening income inequality and rising unemployment rates among unskilled workers.

Even before the pandemic of 2020, in other words, the tide was turning against the markets—and turned even harder toward more government once coronavirus struck. How couldn't it? Nothing demands more of government than a once-in-a-century-public-healthcare-crisis-cum-deep recession. As Exhibit 3 highlights, the government policy response—both fiscal and monetary—has been unprecedented, totaling 44% of GDP in the U.S., 52% of GDP in the eurozone and a staggering 60% in Japan. Rarely has the footprint of government been so large; and rarely in the past few decades has the government exerted so much control of the "commanding heights."

Exhibit 3: Global Monetary and Fiscal Stimulus to Fight Coronavirus Effect.

	Potential Central Bank Liquidity Injection		Potential Fiscal Stimulus		Central Bank Liquidity Injection and Fiscal Stimulus	
	$ Trillion	% GDP	$ Trillion	% GDP	$ Trillion	% GDP
U.S.	$6.21	29.0%	$3.29	15.4%	$9.50	44.3%
Eurozone	$2.65	19.9%	$4.27	32.0%	$6.92	52.0%
Japan	$1.03	20.0%	$2.08	40.3%	$3.11	60.3%
UK	$0.57	20.7%	$0.59	21.6%	$1.16	42.3%
China	$1.43	10.0%	$1.22	8.4%	$2.64	18.4%
Others	$0.92		$2.85		$3.77	
Total	**$12.80**	**14.8%**	**$14.30**	**16.5%**	**$27.11**	**31.3%**

Source: Cornerstone Macro Research. Data as of November 5, 2020.

But all crises spur government activism. As a recent Wall Street Journal article noted,

"The Great Depression produced both a bigger social safety net and a host of new government programs, World War II led to the creation of a unified Defense Department, and the Cold War spawned an interstate highway system. In just the past two decades, the 9/11 terrorist attacks produced new consolidated agencies to handle homeland security and national intelligence, and the 2008 financial meltdown led to a broad range of new actions by the Federal Reserve that are being replicated and expanded now."[1]

And then there is China and the rising U.S.-Sino tensions that have triggered U.S. trade sanctions against Chinese goods; a geostrategic attack on Huawei, a Chinese multinational technology company; and U.S. government demands that U.S. firms decamp from China and produce more goods at home, among other initiatives. None of these actions, to say the least, are pro-market. And neither is the U.S. response to China's rising global competitiveness, which the current administration sees both as an economic and national security threat. This has sparked rising bipartisan support for a U.S. industrial policy in such key sectors as Aerospace, Electronics, rare earth minerals, Telecom, Agriculture and other sectors deemed vital to national security.

Similar strategies are being considered overseas; meanwhile, the idea and acceptance of "Big Government" is gaining traction in virtually every part of the world. Whether in France, Japan or India, governments are becoming more involved in imposing conditions on which goods, services and technologies can be bought or sold, and which foreign partners are deemed trustworthy. The fostering of "national champions" demands that supply chains be redesigned and brought home; greater scrutiny of foreign investment deals; the creation of indigenous data firewalls; financial support/subsidies to encourage in-country mergers—these policies, and many more like them, are anathema to the private sector and could lead over the long term to a number of unfavorable, unintended consequences.

As control of the "commanding heights" shifts toward the state, the macro risks to the private sector could manifest themselves in slower/stagnate economic growth, lower return on invested capital, higher taxes, less offshoring and greater margin pressure as a result, and higher inflation and therefore interest rates. Nothing just mentioned—in most cases—is favorable for corporate profits or valuations.

In the end, and looking forward, investors would increasingly have to weigh the effects of a more visible hand (state) in the economy versus the invisible hand (the markets) and the underlying effects on future corporate earnings and profit growth. That said, let's be clear: State intervention during the pandemic has been largely effective in helping to provide support for the capital markets and strengthening the global economy. But history shows that the bigger the government presence in the economy, the greater the odds of misallocated resources and market distortions over the long term. Future market returns will increasingly be influenced by the delicate balance in who controls the "commanding heights."

THOUGHT OF THE WEEK:

China's Fifth Plenum: Quality, Self-Reliance, Leadership

Rodrigo C. Serrano, Director and Senior Investment Strategist

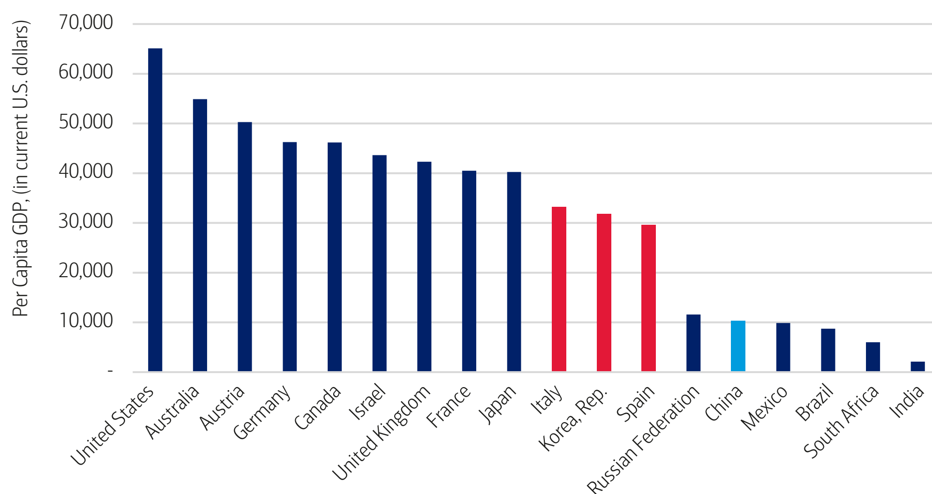
In late-October, the Fifth Plenum of the Chinese Communist Party's Central Committee approved broad policy recommendations for the country's 14th Five-Year Plan, set to be released and approved by the National People's Congress in March. Uniquely, though not unprecedentedly, a 15-year vision for China's development was also endorsed. In general, these communiqués stress higher-quality economic growth and greater technological self-reliance while reinforcing the climate-change ambitions of the nation's leadership.

[1] See, the Wall Street Journal, "Coronavirus Means the Era of Big Government Is...Back," April 26, 2020.

According to the communications, by 2035 China's per capita GDP is expected to "reach the level of moderately developed countries." Some analysts believe this means reaching a level comparable to that of Italy, Spain or South Korea (Exhibit 4).[2,3] Gavekal Research believes that the establishment of this long-term growth objective marks a step toward a more holistic view of economic development, marrying it with social and political objectives. This will probably allow for greater flexibility in setting nearer-term growth targets. Also receiving mention was the country's "dual circulation strategy," a novel economic framework, unveiled in May, which stresses "internal circulation," or the development of the domestic market, alongside "external circulation," its export markets. Aimed at diversifying China's growth engines and improving the quality of economic growth, officials stressed that the new strategy would run alongside China's continued efforts to open up its economy.

Exhibit 4: China's Fifth Plenum Produced a Longer-term Economic Growth Goal.

(Per Capita GDP for 2019—shaded red are countries analysts believe classify as moderately developed)



Sources: World Bank; Chief Investment Office. Data as of 2019.

According to Trivium Research, science and technological self-reliance forms core pillars of China's national development strategy for the first time in the history of its Five-Year Plans. In our view, this reflects a move to shore up vulnerabilities within its technological supply chain, exposed by U.S. sanctions and export controls. By 2035, the country aims to achieve major breakthroughs in key technologies. The plan also calls for a modernization of the industrial supply chain, alongside supply-side structural reform.

With China having well controlled the coronavirus, spurring a relatively robust economic recovery, President Xi Jinping in September vowed to the United Nations General Assembly that China would achieve "carbon neutrality by 2060." The plenum communiqué adds further that China's carbon emissions would peak by 2035 and decline gradually thereafter.[4] Reinforcing its position as a signatory of the Paris Climate Agreement, China sees its battle against climate change as an opportunity to showcase its leadership on the global stage.

[2] China aims to reach "new level" of prosperity by 2035—Nikkei Asia as of October 29, 2020.

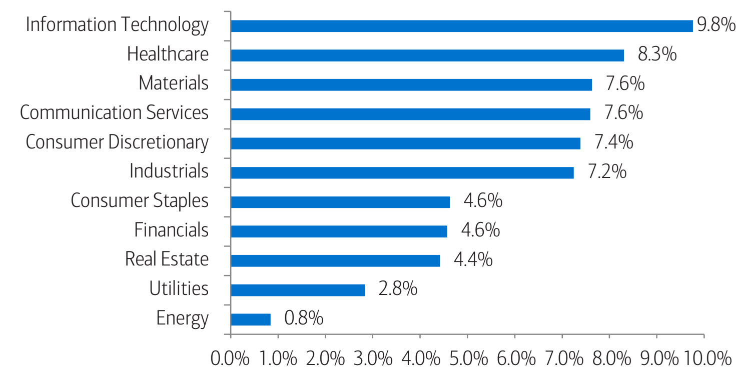
[3] Here's What Economists Are Saying About China's New 5-Year Plan—Bloomberg as of October 29, 2020.

[4] China sets "pragmatic" targets through 2035—Global Times as of October 29, 2020.

Equities

	Current	WTD	MTD	YTD
		Total Return in USD (%)		
DJIA	28,323.40	6.9	6.9	1.1
NASDAQ	11,895.23	9.0	9.0	33.6
S&P 500	3,509.44	7.4	7.4	10.3
S&P 400 Mid Cap	2,026.95	6.7	6.7	-0.4
Russell 2000	1,644.16	6.9	6.9	-0.3
MSCI World	2,470.05	7.7	7.7	6.2
MSCI EAFE	1,924.19	8.1	8.1	-3.6
MSCI Emerging Markets	1,176.36	6.6	6.6	7.6

S&P 500 Sector Returns



Fixed Income[†]

	Current	WTD	MTD	YTD
		Total Return in USD (%)		
Corporate & Government	1.15	0.68	0.68	8.12
Agencies	0.51	0.14	0.14	5.26
Municipals	1.31	0.63	0.63	3.67
U.S. Investment Grade Credit	1.19	0.49	0.49	6.83
International	1.93	1.32	1.32	7.86
High Yield	5.01	2.11	2.11	3.27

	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	0.15	0.15	1.57
10 Year Yield	0.82	0.87	0.87	1.92
30 Year Yield	1.60	1.66	1.66	2.39

Commodities & Currencies

Commodities	Current	WTD	MTD	YTD
		Total Return in USD (%)		
Bloomberg Commodity	155.44	1.4	1.4	-9.6
WTI Crude $/Barrel[††]	37.14	3.8	3.8	-39.2
Gold Spot $/Ounce[††]	1951.35	3.9	3.9	28.6

Currencies	Current	Prior Week End	Prior Month End	2019 Year End
EUR/USD	1.19	1.16	1.16	1.12
USD/JPY	103.35	104.66	104.66	108.61
USD/CNH	6.59	6.70	6.70	6.96

Sources: Bloomberg, Factset. Total Returns from the period of 11/02/2020 to 11/06/2020. [†]Bloomberg Barclays Indices. [††]Spot price returns. All data as of the 11/06/2020 close.
Past performance is no guarantee of future results.

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

	Under-weight		Neutral		Over-weight
Equities				●	
U.S. Large Caps				●	
U.S. Mid Caps			●		
U.S. Small Caps				●	
International Developed			●		
Emerging Markets	●				
Fixed Income		●			
U.S. Investment Grade Taxable		●			
International	●				
Global High Yield Taxable		●			
U.S. Investment Grade Tax Exempt			●		
U.S. High Yield Tax Exempt		●			
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 11/06/2020)

	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	1.7	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 6, 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.

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