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CHIEF INVESTMENT OFFICE

Capital Market Outlook

December 2, 2019

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IN THIS ISSUE

- **Macro Strategy**—While some transient increases in initial claims and a modest rise in unemployment are possible in a lagged response to past Federal Reserve (Fed) tightening, unusually high uncertainty during the past four years has restrained investment and consumer spending, keeping real gross domestic product (GDP) below potential. This current lack of overheating still evident in below-target inflation makes a recession unlikely in 2020, as more accommodative policy bolsters demand back in line with potential, keeping unemployment around 50-year lows.
- **Global Market View**—One key source of support for U.S. equities has been aggressive corporate share buyback programs, with companies repurchasing their own stock at record levels in 2018 and 2019. In this issue, we discuss the latest trends in share buyback activity and the outlook for 2020, which in our view will be a key determinant of market returns.
- **Thought of the Week**—China's growth has slowed, triggering fears among investors that global growth could disappoint in 2020. Real annual economic growth is estimated to be sub-6% for the first time in three decades. That said, incremental Chinese output in 2020 still equates to almost $800 billion, a figure larger than most economies. With the Chinese consumer expected to play a larger role in the economy in the coming years, China's growth story should remain intact.
- **Portfolio Considerations**—We maintain our preference for U.S. equities, but non-U.S. equities have been placed on our upgrade "watch list" as we head into next year. Within fixed income, we are overall neutral on credit and have a slight preference for short-dated investment-grade corporates.

MACRO STRATEGY

Chief Investment Office Macro Strategy Team

GLOBAL MARKET VIEW

Kathryn C. McDonald, CFA®
Vice President and
Market Strategy Analyst

THOUGHT OF THE WEEK

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

Data as of 12/2/2019 and subject to change.

MACRO STRATEGY

Unemployment Unlikely To Increase Much in 2020, Consistent with Continued Expansion

Chief Investment Office Macro Strategy Team

The damage from Fed tightening has been meaningful, but absent upside inflation pressures, the Fed had the ability to reverse course before triggering a recession. Our expectations for a new upturn in the U.S. and global manufacturing cycle in response to central-bank easing and fiscal stimulus in a growing number of countries are supported by the wide range of improving economic data thus far, from a housing-sector revival, rising consumer and business expectations, and a third consecutive monthly increase in the Markit manufacturing index in the U.S., to a stabilization in manufacturing conditions in the Eurozone and China.

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While this has relieved fears of recession and has boosted appetite for risk assets, monetary policy changes take time to work through the economy, and the aggressive Fed monetary restraint through mid-2019 is still being felt. Thus, even as U.S. housing has perked up and manufacturing is forming a bottom ahead of a likely rebound in 2020, the economic data have remained mixed. As a result, the Conference Board index of leading indicators, for example, posted another weak reading for October, creating confusion about the true direction of the economy. Notably, initial claims, one of the ten components of the index of leading indicators, have surprised to the upside in recent weeks, raising fears of fading consumer spending and employment growth, especially given slower-than-expected October retail sales and moderate fourth-quarter expectations for real consumer spending.

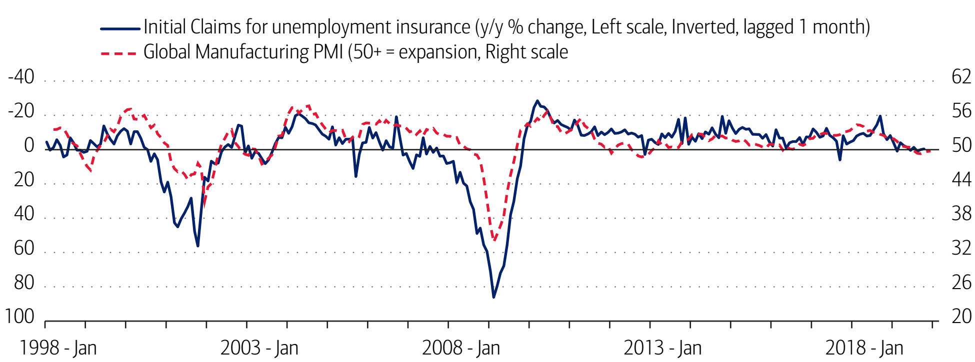
The direction of initial claims and the unemployment rate (UR) is important for the economic outlook. Initial claims lead the UR by about 7 months, so an increase usually precedes higher unemployment rates. Historical data show that when the 3-month average of the UR increases just 0.50 percentage points above its previous 12-month low point, the economy is in recession. Assuming that the September 2019 UR of 3.5% marks the lowest level of unemployment of the next 12 months, this suggests that a 4.0% 3-month average for the UR through September 2020 would mark the onset of recession.

With the UR at a 50-year low, a record-long expansion, high uncertainty levels and soft global growth, worries about such an increase are understandable. However, we believe that the unemployment rate is unlikely to deteriorate enough to cause a recession next year:

1. In our view, monetary policy was eased just in time to avoid a recession. The housing sector promptly responded to an easier policy, with home sales reaccelerating, and building permits increasing in recent months. This is important given the sector's high multiplier effect through consumer spending on goods and services as well as employment. This rebound explains why the new-orders component of the ISM non-manufacturing index avoided a big drop below average through October and suggests additional gains through mid-2020. The upturn in housing momentum combined with signs of manufacturing stabilization suggests that most of the employment weakness is likely behind us.

2. Manufacturing and nonmanufacturing new orders have not dropped enough to cause a big increase in initial claims; only enough for them to stop declining. Moreover, evidence of improving global manufacturing conditions argue for little change in initial claims over the next year. For example, the U.S. Markit index has increased substantially over the past three months, and the global index appears poised to increase above 50 based on favorable flash estimates for November. Chinese manufacturing Purchasing Managers' Index (PMI) export orders are also indicating positive momentum, supporting expectations for an upturn in the global manufacturing cycle in 2020. As shown in Exhibit 1, this argues against further gains in initial claims in coming months.

Exhibit 1: Manufacturing Slump Not Deep Enough for a Meaningful Increase in Initial Claims.



Sources: JPM; Department of Labor; Haver Analytics. Data as of November 26, 2019.

3. A historically low unemployment rate in itself is not a reason to anticipate a recession. The unemployment rate has historically risen at the end of expansions because of accumulated excesses in the economy or due to energy supply constraints, aggressive Fed tightening to fight inflation, or some other shock. Despite the record length of this expansion, its stop-go pattern and the unusually high level of uncertainty characterizing it have prevented the buildup of excesses typical of late expansion periods. As a result, we believe that initial claims are unlikely to rise much more, as would be consistent with rising recession risk. For example, changes in initial claims tend to correlate with changes in the share of non-financial sector interest in business revenues, as a proxy for business-sector excesses, with a 4-to-6-quarter lag. The drop in this share in 2019 suggests little upside pressure on initial claims from current levels over the next year, despite some near-term labor market weakness from the lagged response to past Fed tightening.

4. Based on past performance, the fact that the yield curve was inverted only briefly and the money supply has reaccelerated is inconsistent with a recession next year, strongly arguing against much bigger gains in initial claims for unemployment compensation any time soon.

5. Given various crosscurrents affecting employment growth (e.g., high uncertainty, lagged effects of ISM surveys' deterioration, moderate economic growth with healthy consumer income growth and a housing rebound), we expect employment growth of around 1.2% in 2020, with an UR of 3.6% to 3.9%, depending on the labor force participation rate (LFPR). Given the correlation between economic dynamism and changes in the participation rates, our moderate 2020 growth outlook implies that the LFPR is likely to average about 63.2%, which would correspond to the low end of our estimated unemployment range.

   In our view, a steady-to-slightly-lower LFPR compared to the current 63.3% rate is more likely than an increase for two reasons. First, the LFPR has surged across age groups over the past year but overall did not advance much because of the rising share of the 65+ cohort in the population, which has the lowest participation rate and acts as a drag on the average. Second, the LFPR tends to increase when economic growth accelerates and vice versa. The softening in consumer spending this year, and likely continued moderate pace over the next several months, is likely to restrain the LFPR in 2020. In this context, we believe that our expectations for 120,000 to 150,000 monthly employment growth would probably be sufficient to keep the unemployment rate from rising above 3.9% in 2020, which would fall short of reaching the recession rule mentioned above.

6. Economic conditions need to deteriorate much more, in our opinion, to cause initial claims to rise significantly. However, average hourly earnings are likely to move into a 3.5% to 4% range in 2020 as a result of current labor-market tightness. This, combined with elevated personal saving rates, double-digit household net-worth growth, and benign leading indicators of initial claims, suggests robust wherewithal for continued spending and an ongoing expansion.

   In sum, with low interest rates, no significant apparent investment excess, and potential for sustained consumer spending and improving business revenue growth, we believe that companies are unlikely to shed labor as at the early onset stage of past recessions. Instead, we see continued job growth sufficient to maintain the UR around current levels. As a result, although initial claims are extremely depressed, and the unemployment rate is already at a 50-year low, the expansion is likely to continue at a moderate pace, in our view. It would take lower uncertainty, a meaningful pickup in leading indicators, and much stronger business and consumer spending than we anticipate for the economy to overheat enough to create the imbalances that typically precede recessions. Eventually that could happen, but, for now, continued low unemployment with rising real wage growth seems likely in 2020.

The Corporate Buyback Bid in 2020

Kathryn C. McDonald, CFA® Vice President and Market Strategy Analyst

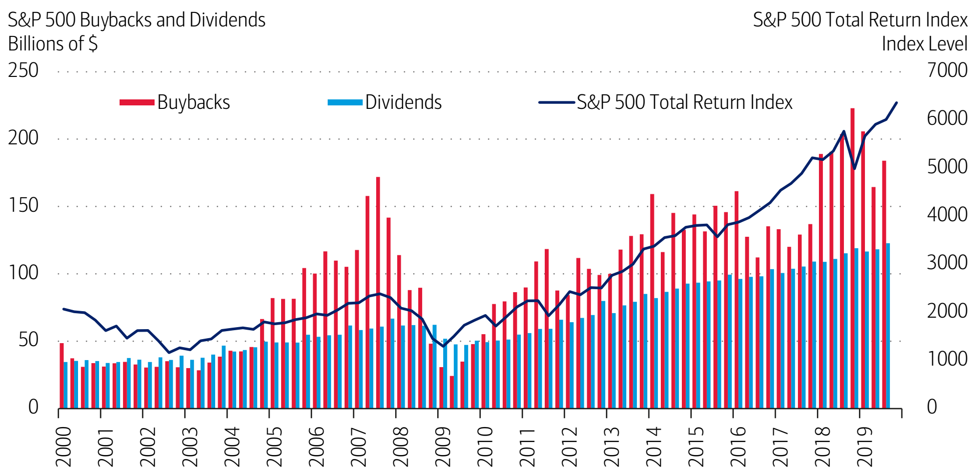
It seems paradoxical that market volatility, as measured by the VIX Index and daily S&P trading ranges, has remained muted, while economic policy uncertainty is near record highs. Despite volatile trade talks, 2020 election risks and lackluster corporate earnings, the S&P 500 reached new highs last week. Looking beneath the surface, we find many factors behind the rally, including central banks' return to easing, continued strength in the U.S. consumer and renewed investor optimism.

Another key source of support for U.S. equities has been aggressive corporate share buyback programs, with companies repurchasing their own stock at record levels in 2018 and 2019. Below, we discuss the latest trends in share buyback activity and the outlook for 2020, which in our view will be a key determinant of market returns.

2019 Buybacks: Slower but Solid Pace

During the past year, over 75% of S&P 500 companies bought back their stock, up from 35% at the end of the financial crisis. Aggregate S&P 500 share buybacks totaled an estimated $184 billion in 3Q 2019, an uptick from the prior quarter but down roughly 10% from a year ago (Exhibit 2).

Exhibit 2: Share Buybacks Rebounded in Third Quarter.



Q3 2019 buybacks are estimates from S&P Dow Jones Indices. Source: S&P Dow Jones Indices. Data through Q3 2019.
Past performance does not guarantee future results.

The slower pace of buybacks comes as business confidence in the U.S. economy has dropped. The latest survey data indicates that more than two-thirds of U.S. CFOs believe the U.S. will be in recession by the end of 2020.[1] Also, the effects of U.S. corporate tax reform have been fading. U.S. companies repatriated foreign earnings at a slower rate this year compared with 2018, leaving firms with less overseas cash to distribute to shareholders via dividends and buybacks (See Capital Market Outlook 9/30/2019).

Yet while share buybacks have slowed, the 2019 figures are still strong, helping to underpin market returns at a time when businesses and investors have been increasingly anxious about the economic backdrop. In fact, S&P Global estimates for Q3 put aggregate buybacks on track to total $748 billion for the full year in 2019.[2]

[1] Duke University/CFO Global Business Outlook Q3 2019.

[2] *Financial Times*, "U.S. Companies Stay Cautious on Spending Under Strain of Trade War," November 12, 2019.

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Bank of America client trading flows also show strong buyback activity this year. According to the latest data, year-to-date buybacks by corporate clients are up 27% compared to the prior year.[3] Meanwhile, companies continue to increase dividends at a steady pace. Combined, the shareholder yield (dividend + buybacks) of the S&P 500 easily outstrips that of a 10-year Treasury bond (5.4% vs. 1.8%, respectively).[4] This should drive investor preference for stocks over bonds in the year ahead.

By sector, U.S. share buybacks have been dominated by tech and financial companies. Since the end of the financial crisis, 27% of total S&P 500 shares repurchased were tech stocks, while 16% were from the financial sector. While full Q3 buyback data is not yet available, our bottom-up analysis using Bloomberg data for S&P 500 companies shows that tech and financial firms—driven by a concentrated few mega-cap companies—continue to drive the bulk of buyback activity.

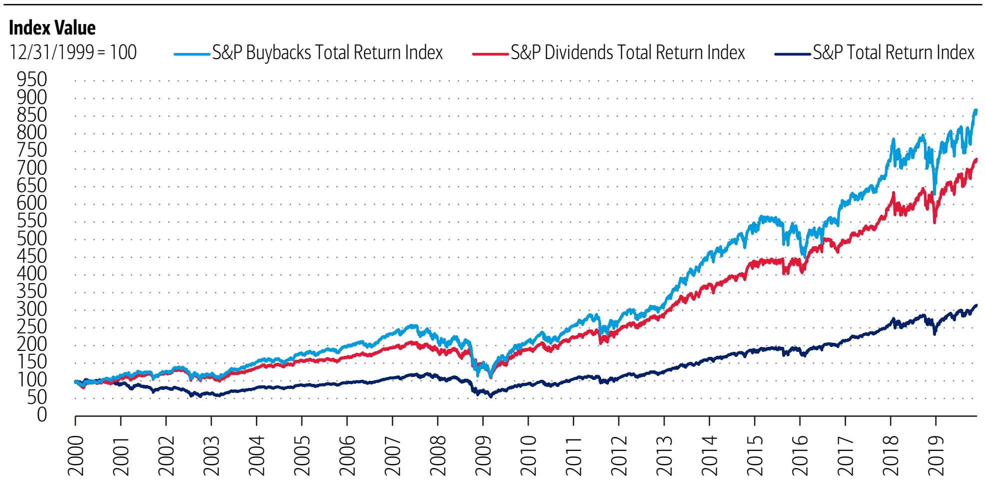
Equity Demand, Earnings and Market Returns This Cycle: Three Reasons to Care about Share Buybacks

Demand: Corporations have been a major source of U.S. equity demand this cycle. In the 10 years since the end of the financial crisis, cumulative share buybacks from corporations were $5.1 trillion, according to data from S&P Global. This compares with less than $150 billion in net purchases from foreigners and about $450 billion in net sales from households and nonprofits, according to the latest Fed flow of funds data (also covering the 10 years through Q2 2019).

Earnings: It is estimated that 30% of total earnings-per-share (EPS) growth over the last five years has been attributed to share buybacks alone. Buybacks in 2019 are estimated to contribute about two percentage points to EPS growth.[5]

Returns: Since the bull market began in March 2009, S&P 500 companies with the highest buyback ratios have outperformed the broader index by about 330 basis points each year on average (total return). Taking the longer view, since the start of the century, the S&P 500 buyback index and dividend payers have outpaced the broader market by a wide margin (Exhibit 3).

Exhibit 3: Market Returns of Top Buyback and Dividend Stocks.



The S&P 500® Buyback Index is designed to measure the performance of the top 100 stocks with the highest buyback ratios in the S&P 500. The S&P 500® Dividend Aristocrats® Index measures the performance of S&P 500 companies that have increased dividends every year for the last 25 consecutive years. Sources: Bloomberg; S&P Dow Jones Indices. Data as of November 26, 2019. **Past performance does not guarantee future results.**

[3] BofAML Global Research, "Bank of America Merrill Lynch Equity Client Flow Trends: Clients No Longer Buying the Market Wholesale," November 26, 2019. Data is as of 11/22/2019, and measures aggregate Bank of America Merrill Lynch client trading flows into U.S. stocks executed by the cash equities business of the firm. It does not measure the entire S&P 500 Index and can thus differ from the official buyback figures posted by S&P Dow Jones Indices.

[4] Shareholder yield for S&P 500 is as of Q2 2019. Source: S&P Dow Jones Indices.

[5] BofAML Global Research, "The Age of Balance Sheet Repair," November 12, 2019.

The debate on share repurchases is likely to ramp up as the 2020 election nears. Some critics assert that outsized buybacks diminish long-term economic growth, as companies forego investments in more productive uses of cash such as capital investment or research & development. The other side of the argument claims that buybacks don't detract from capital investments, but rather they efficiently redistribute capital in the economy—away from mature companies to newer companies with better investment opportunities. Over the past year, while investment in traditional capital equipment has slowed, tech capital expenditures (capex) has soared—software capex are now growing around 10% annual rates.

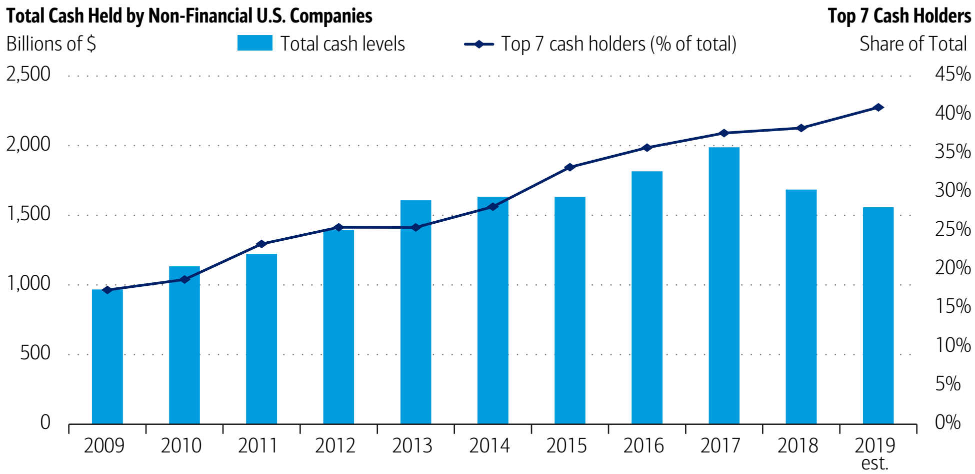
Cautious outlook for 2020

The number of buybacks conducted each quarter tends to be more volatile than dividend payments, as companies can more easily adjust buyback plans than dividend payout guidance. Share buybacks are also volatile because they tend to be highly concentrated/ increasingly driven by just a handful of companies. Indeed, in Q2 2019, just 20 companies in the S&P 500 made up over half of the total share repurchase volume.

Looking ahead, we expect share buybacks in 2020 to remain strong but are more cautious about companies' ability to pay out at the same levels of 2018/19. Buybacks should provide a 0.6 percentage point benefit to EPS in 2020, versus the ~1 to 2 percentage point annual contribution over the past five years.[6]

One reason for caution is that cash balances have declined and have become increasingly concentrated among top holders (Exhibit 4), suggesting less support for incremental share buybacks. Meanwhile, corporate debt has risen to a record high of 47% of GDP, calling into question the strategy of some companies to issue debt to repurchase shares. Rising wages due to a tight labor market could also take away some of the momentum for buybacks.

Exhibit 4: Concentration of U.S. Corporate Cash.



Source: Moody's Investors Service. Data as of November 2019.

Earnings repatriations from abroad should continue to wane but should still be higher than historical averages, given the shift to a territorial tax regime and the changing incentives for U.S. multinational companies. Also, an uptick in corporate confidence with a potential easing of U.S.-China tensions and reflationary economic conditions around the world could offset some of these negative factors. Rising net income and still-high levels of free cash flow should support strong levels of buybacks in 2020.

In the end, cash payouts through dividends and share buybacks have been a key pillar of the equity bull market, but their impact has at times gone unnoticed amid all the fears

[6] BofAML Global Research, "U.S. Equity Strategy Year Ahead," November 19, 2019.

in Washington and Wall Street about trade wars, elections and global recession. With the bull market still standing after 10+ years, it's time to pay attention.

THOUGHT OF THE WEEK

Don't Sweat the China Slowdown

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

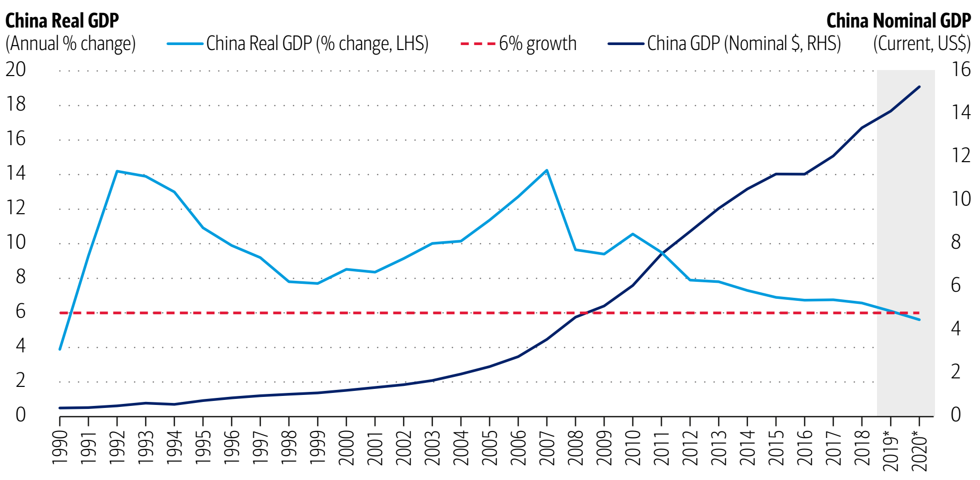
China's economy has expanded by at least 6% per annum in real terms since 1990, a run unparalleled in modern economic history. Economic output topped $13 trillion in 2018, a staggering increase from just $400 billion in 1990. Then, China's economy was smaller than Spain's or Canada's; today, only the U.S. economy is larger based on nominal U.S. dollars, with total U.S. output of $20.6 trillion in 2018 versus $13.4 trillion in China. Based on figures from the International Monetary Fund (IMF), the mainland's output will exceed $14 trillion in 2019.

Against this backdrop, when China's economic engine slows, investors take notice. And China's growth has slowed, triggering fears among investors that global growth will disappoint in 2020.

2020 will be a watershed year for the Middle Kingdom: Real annual economic growth will be sub-6% for the first time in three decades based on estimates from BofAML Global Research. They expect U.S.-Sino trade uncertainty, weaker domestic demand and belated policy measures to reduce growth to 5.6% in 2020, the softest reading since 1990 (3.9%).

That said, don't sweat it. Do the math: 5.6% real growth on a $14 trillion base equates to roughly $790 billion in incremental Chinese output in 2020, a figure larger than most economies (Turkey, Poland and Saudi Arabia, among others). What's more, the growth mix is shifting away from exports and investment toward services and consumption. Consumerism has been bolstered by rising per capita incomes (in excess of $10,000), greater urbanization and 350 million millennials that are better educated and digitally connected. The Chinese consumer accounts for only 40% of GDP, but that share is set to rise over the next decade, keeping China's growth story intact. Large-tech China remains among the best investment plays for U.S. investors.

Exhibit 5: China's Growth Slowdown.



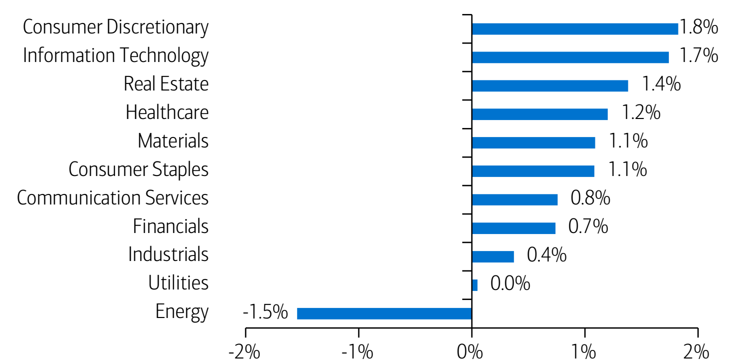
*Forecast for real GDP growth is from BofAML Asia Economics Research. Forecast for nominal GDP is from IMF.
Sources: International Monetary Fund; BofAML Global Research. Data as of November 2019.

MARKETS IN REVIEW

Equities

		Total Return in USD (%)		
	Current	WTD	MTD	YTD
DJIA	28,051.41	0.7	4.1	23.0
NASDAQ	8,665.47	1.7	4.6	31.9
S&P 500	3,140.98	1.0	3.6	27.6
S&P 400 Mid Cap	2,010.15	1.3	3.0	22.8
Russell 2000	1,624.50	2.3	4.1	22.0
MSCI World	2,292.26	0.8	2.8	24.0
MSCI EAFE	1,974.47	0.5	1.1	18.2
MSCI Emerging Markets	1,040.05	-0.8	-0.1	10.2

S&P 500 Sector Returns



Fixed Income[1]

		Total Return in USD (%)		
	Current	WTD	MTD	YTD
Corporate & Government	2.21	0.2	-0.1	9.9
Agencies	1.85	0.1	-0.1	6.1
Municipals	1.81	0.2	0.3	7.2
U.S. Investment Grade Credit	2.30	0.2	-0.1	8.8
International	2.87	0.4	0.3	14.2
High Yield	5.59	0.4	0.3	12.1

	Current	Prior Week End	Prior Month End	2018 Year End
90 Day Yield	1.53	1.53	1.47	2.36
2 Year Yield	1.61	1.63	1.52	2.49
10 Year Yield	1.78	1.77	1.69	2.68
30 Year Yield	2.21	2.22	2.18	3.01

Commodities & Currencies

		Total Return in USD (%)		
Commodities	Current	WTD	MTD	YTD
Bloomberg Commodity	163.75	-2.0	-2.6	2.5
WTI Crude $/Barrel[2]	55.17	-4.5	1.8	21.5
Gold Spot $/Ounce[2]	1,463.94	0.2	-3.2	14.2

Currencies	Current	Prior Week End	Prior Month End	2018 Year End
EUR/USD	1.10	1.10	1.12	1.15
USD/JPY	109.49	108.66	108.03	109.69
USD/CNH	7.03	7.04	7.05	6.87

Source: Bloomberg, Factset.Total Returns from the period of 11/25/19 to 11/29/19. Bloomberg Barclays Indices.[1] Spot price returns.[2] All data as of the 11/29/19 close.
Past performance is no guarantee of future results.

Asset Class Weightings (as of 10/1/2019)

	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*	see CIO Asset Class Views				
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.

Economic and Market Forecasts (as of 11/29/19)

	Q2 2019A	Q3 2019A	Q4 2019E	2019E	Q1 2020E	2020E
Real global GDP (% y/y annualized)	–	–	–	3.1	–	3.2
Real U.S. GDP (% q/q annualized)	2.0	2.1	1.5	2.3	1.7	1.7
CPI inflation (% y/y)	1.8	1.8	2.1	1.8	2.4	2.2
Core CPI inflation (% y/y)	2.1	2.3	2.3	2.2	2.4	2.5
Unemployment rate (%)	3.6	3.6	3.6	3.7	3.7	3.7
Fed funds rate, end period (%)	2.40	1.90	1.63	1.63	1.63	1.63
10-year Treasury, end period (%)	2.01	1.66	2.00	2.00	1.80	1.80
S&P 500 end period	2942	2977	2950	2950	–	3300
S&P earnings ($/share)	41	42*	42	164.5	40.5	177
Euro/U.S. dollar, end period	1.14	1.09	1.10	1.10	1.10	1.15
U.S. dollar/Japanese yen, end period	108	108	108	108	110	103
Oil ($/barrel, avg. of period, WTI**)	60	56	55	56	52	54

The forecasts in the table above are the base line view from BofAML Global Research team. The Global Wealth & Investment Management (GWIM) Investment Strategy Committee (ISC) may make adjustments to this view over the course of the year and can express upside/downside to these forecasts.

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 a fair value estimate for 2019. **West Texas Intermediate

Sources: BofA Merrill Lynch Global Research; GWIM ISC as of November 29, 2019.

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Index Definitions

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

Indexes are all based in dollars.

S&P 500 is a stock market index that tracks the stocks of 500 large-cap U.S. companies. It represents the stock market's performance by reporting the risks and returns of the biggest companies.

The Markit survey covers economic indicators for private sector companies, but not the public sector.

Conference Board Leading Economic Index is an American economic leading indicator intended to forecast future economic activity.

ISM Manufacturing Index is a widely-watched indicator of recent U.S. economic activity.

CBOE Volatility Index, known by its ticker symbol VIX, is a popular measure of the stock market's expectation of volatility implied by S&P 500 index options.

S&P total return index is a type of equity index that tracks both the capital gains of a group of stocks over time, and assumes that any cash distributions, such as dividends, are reinvested back into the index.

S&P 500 Buyback Index is an index designed to track the performance of the 100 S&P 500 stocks with the highest buyback ratios over the past 12 months.

S&P Dividend Total Return index is a benchmark index of large-cap stocks in the united states.

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Economic or financial forecasts are inherently limited and should not be relied on as indicators of future investment performance.

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Asset allocation, diversification, dollar cost averaging and rebalancing do not ensure a profit or protect against loss in declining markets. Dollar cost averaging involves continual investment in securities regardless of fluctuating price levels; you should consider your willingness to continue purchasing during periods of high or low price levels.

Past performance is no guarantee of future results.

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