CHIEF INVESTMENT OFFICE

Capital Market Outlook

December 9, 2019

The opinions are those of the author(s) and subject to change.

IN THIS ISSUE

- **Macro Strategy**—A fundamental change in the Federal Reserve's (Fed's) approach to achieving its inflation target means monetary policy is shifting from a headwind to a tailwind in 2020. The pattern of the U.S. business expansion over the past 10 years shares many similarities to the previous longest expansion in the 1990s. Like that episode, we believe the end-phase before the next recession could include a run-up in equity values way beyond historical norms.
- **Global Market View**—As we head into 2020, the world is undergoing profound macro and thematic changes. Especially during times of episodic volatility, we suggest gaining exposure to these ten global themes set to evolve as we head into the next decade.
- **Thought of the Week**—With the U.S. manufacturing sector still in contraction territory, the U.S. consumer has continued to drive economic growth. Strong retail sales data from the Thanksgiving weekend confirms the trend, with mobile commerce, millennials and multichannel strategies driving sales growth this holiday season. Holiday sales growth and 4Q S&P 500 performance have historically been highly correlated.
- **Portfolio Considerations**—We continue to favor global equities over fixed income; we maintain our constructive view on U.S. equities; and, 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

Lauren J. Sanfilippo
Vice President and
Market Strategy Analyst

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

THOUGHT OF THE WEEK

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

Data as of 12/9/2019 and subject to change.

MACRO STRATEGY

Policy Turns Stimulative

Chief Investment Office Macro Strategy Team

Ever since the great recession of 2008–2009, major global central banks have been fighting to head off deflation and get inflation back up to 2% targets. The Fed, the European Central Bank (ECB), and the Bank of Japan have all failed in this effort as inflation in each region has consistently fallen short of this objective despite unprecedented measures, including negative interest rates, quantitative easing, and explicit forward guidance of lower-for-longer interest rates.

One reason for this failure has been multiple premature reversals of the reflation effort. In 2011, the ECB raised rates and short-circuited the brief European recovery, causing a double-dip recession and fears of prolonged global stagnation. Starting in late 2015, the Federal Reserve began an overzealous campaign to "normalize" interest rates with a first

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tentative step off the zero lower bound. The markets rioted against the Fed's then-stated objective of raising rates throughout 2016, and then-Chair Yellen was forced to back away from that plan, helping to shape the synchronized global bull market that developed through 2016 into 2017, a pivot not unlike that of current Fed Chair Jay Powell's in January 2019. Once the markets and economy were running healthy again, the Fed began hiking rates continually from December 2016 through December 2018. In addition, quantitative tightening took about $1 trillion out of U.S. bank reserves, about a 25% reduction in the monetary base, an unprecedented tightening in such a short, or any, time frame in modern times.

These attempts to normalize policy turned out to be inconsistent with the goal of achieving a 2% inflation target. They imparted a huge deflationary shock that caused market-based inflation expectations to collapse, both in 2016 and in 2019. Tight policies and fears of recession and deflation also caused 10-year Treasury rates, for example, to retest the all-time low-points reached during the 2012 and 2016 recession-fear periods. Notably, the retest this past summer did not touch the low points of 2012 and 2016, suggesting a very slow, long-term bottoming process similar to that in the 1950s is developing as rates begin to normalize. For this to happen, however, the global central banks need to stick with reflationary policies and avoid the premature tightening that has caused these recurrent relapses in inflation expectations over the past decade. That, essentially, is what Fed Chairman Jay Powell committed to at his October 30 news conference.

Mr. Powell is not the only central banker to do a 180° shift this year. The ECB has also flipped from quantitative tightening to quantitative easing for 2020. Add in the Bank of Japan, and it looks like $1 trillion of new reserves will go into the major global banks after a similar size drain in 2017 and 2018. This new round of monetary ease, coupled with a pledge to not hike rates until inflation runs persistently above 2% for a while, has enhanced the Fed's inflation-targeting credibility and set off an upside breakout in equities after the global bear market that prevailed from January 2018 to August 2019 while the Fed was aggressively draining liquidity. The aggressive rotation from defensive to cyclical stocks confirms that investors anticipate better growth in 2020.

Also fueling this new bull market is a spate of fiscal easing around the world. U.S. government spending is currently slated to rise at a healthy pace through 2025 while taxes stay low. Various European governments, including France and Italy, have expansive fiscal policies in place. Germany is likely to adopt more spending on green energy and housing programs. According to the *Financial Times*, Japan Prime Minister Shinzo Abe "has given orders for Japan's first economic stimulus package since 2016...". Importantly, tighter fiscal policies have gradually fallen by the wayside, just like tighter monetary policies.

All told, monetary and fiscal stimulus that has already begun and is likely to continue in 2020 has caused leading indicators of economic activity to turn higher, foreshadowing a growth pickup ahead. Forecasters are starting to incorporate this into their outlook. For example, the Blue Chip Consensus Forecast for U.S. GDP growth in 2020 ticked up in the November survey for the first time since March. For the global economy overall, the International Monetary Fund (IMF) is forecasting about a half-percentage point rise in world GDP growth next year. In our view, thanks to these major policy reversals, the risks have shifted to the upside for 2020.

Debt- vs. Equity-Driven Business Expansions

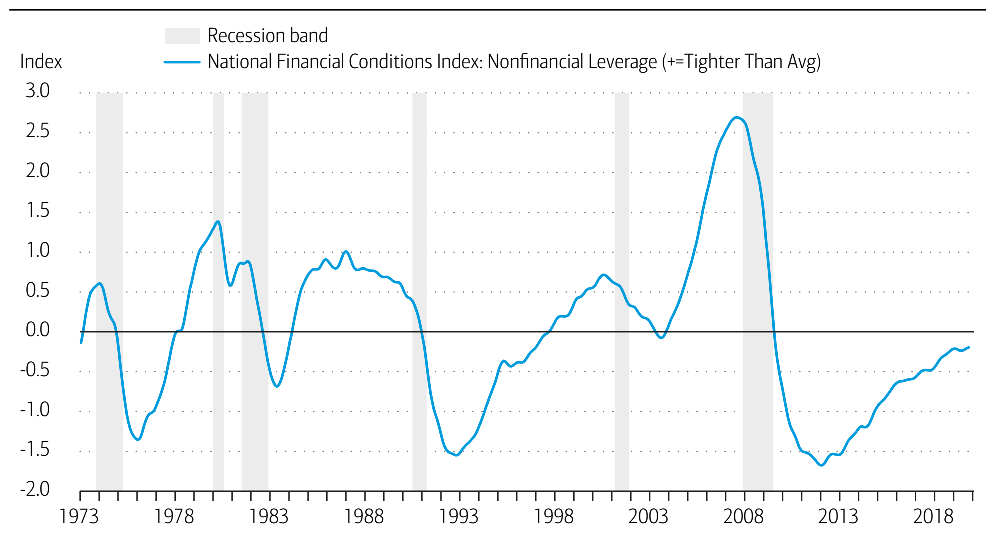
As this record-long U.S. business expansion moves well into its 11th year, speculation about its eventual inevitable decline into recession continues. However, as former Fed Chairman Ben Bernanke once said, "Expansions don't die of old age, they are murdered." The Fed's overly aggressive tightening in 2018 and early 2019 almost killed the current one, but the sharp policy reversal seems to have saved the day, and the odds of a recession have been receding since quantitative tightening switched to quantitative easing in September.

Aside from monetary or fiscal policy mistakes, a common feature of recessions are excesses that accumulate in the private sector and eventually need to correct, causing the severe economic pain of a downturn. In the old days, before real-time inventory management, this might have included working off excessive stocks of goods accumulated by overly-optimistic businesses. Other sources of excesses have been too much leveraging or debt-funded growth and asset price manias that eventually corrected. The underlining dynamics that drive expansions often include overly-concentrated funding sources directed at specific kinds of economic activity. For example, the run-up to the Great Financial Crisis was concentrated in the residential real-estate sector, where excessive mortgage borrowing set the stage for an eventual correction.

Some cycles rely less on debt funding for expansion and more on equity funding. This was the case in the 1990s. A strong bull market propelled by the first wave of internet and related technology stocks drove the up-until-then longest expansion in U.S. history. The new technology bolstered productivity, helping to keep inflation low and the Federal Reserve accommodative, especially in the lead-up to Y2K, when the Fed provided expansive liquidity to head off fears that some sort of systemic disruption would be triggered by the century-date change in outdated systems' software. This easy money helped fuel the bubble in technology stocks, which burst when the Fed reversed course after January 2000.

Exhibit 1 helps illustrate the role of leverage in business cycles. It charts how many standard deviations above or below historical norms leverage use is at any point in time. For example, at the peak of the housing mania in 2006 and 2007, an incremental unit of economic growth was associated with over 2.5 standard deviations of excess borrowing compared to normal. This was by far the biggest overdependence of economic growth on borrowing in the past 50 years. In sharp contrast, the 1990s cycle was much less dependent on debt-finance, similar to the current cycle, which hasn't even seen debt and leverage dependence get back to average levels. In fact, both the 1990s and the current economic expansion included long periods of deleveraging and unusually sluggish debt use compared to the 1980's and 2000's expansions, which were both heavily debt-fueled. It's normal after a debt bubble pops for a long healing process to dampen debt use in the next cycle.

Exhibit 1: Current Cycle Less Dependent on Borrowing Than Prior Cycles.



Sources: Federal Reserve Bank of Chicago/Haver Analytics. Data through Dec 1, 2019.

Without excessive leverage and with low inflation and an accommodative Fed, the risk of excesses that cause recessions shifts to abnormally high equity values. In 1999, the result of this mix was the highest stock-market valuation of the past century. When the market bubble eventually burst, only a mild recession ensued despite a vicious bear market in stocks. In modern times, debt bubbles have been associated with more severe recessions than equity bubbles because of the drawn-out nature of debt workouts

compared to equity collapses, as, for example, we saw in the housing market and financial sector after the Great Financial Crisis.

When we combine these insights with the likely course of Federal Reserve policy in 2020, the comparisons with the late 1990s situation are striking. Rather than Y2K, we now have a situation where a gusher of liquidity is being provided to move inflation higher for a sustained period. This liquidity has already begun to bolster global equity markets. As in 1999, it could well cause already full valuations to become excessive and eventually cause the kind of overheating and inflation that has so far failed to materialize during the first 10 years of this expansion (similar to the first eight years of the 1990s expansion). In our view, this makes the likelihood of a stock market melt-up in 2020 much greater than the consensus believes.

GLOBAL MARKET VIEW

20/20 Vision: 10 Themes for 2020

Lauren J. Sanfilippo, Vice President and Market Strategy Analyst

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

The world is undergoing profound macro changes as we head into 2020—advancements in technology are creating the contours for "smart everything"; demographics are being shaped by unprecedented waves of migration, record levels of global aging and longevity; planet Earth is heating up, while the new space age takes radical shape as the next frontier. Against this backdrop, and amid times of market volatility, it is beneficial for investors to reset and think longer-term. Below are key 2020 investment themes developed by BofA Global Research.

Peak Globalization: the world is not flat

Globalization—or unfettered cross-border flows of capital, goods, ideas and people—is no longer a given. The powerful force that gave multinationals access to more resources, more workers and more consumers is in retreat owing to the global spike in nationalism and populism. Multinationals, as a result, have had to rethink how they do business.

One of the main beneficiaries around the reconfiguration of global supply chains will be automation—or advanced robotics, artificial intelligence, additive manufacturing (3-D printing), digital platforms and related activities geared towards the ability to suppress costs, boost margins and nimbly reach more-demanding consumers. All of these forces will likely help multinationals shorten and simplify their global supply chains, and "build where they sell."

Beneficiaries: Local markets, real assets. ***At-Risk:*** Global supply chains, multinationals.

Recession: late cycle, bond bubble, inflation

Concerns around yield curve inversions, a no-deal Brexit, rising recession risks and the U.S.-China trade dispute have variably waned in recent months. While recessionary threats are receding, the current expansion remains one of the weakest in history, and prone to risks in the year ahead. Looking ahead, monetary policy largess over the past decade increases the risks of a disorderly rise in bond yields, and could also amplify a policy mistake and/or increase the risks of monetary policy impotence. Higher debt levels have failed to deliver stronger growth and fueled wealth inequality.

We think the policy responses to the next recession will include higher taxes, more fiscal spending (aka, more government debt), and more regulation—all of which means limited upside to asset prices, a cap on earnings and higher inflation.

Beneficiaries: Value, real assets, commodities. ***At-Risk:*** Growth, credit, deflation.

Quantitative Failure: post QE decade

Quantitative failure, or diminishing returns from ultra-active monetary policies, refers to the monetary impotence of the past decade. Despite unprecedented action from the world's central banks, global growth and inflation remain subdued more than 10 years after the Great Recession. Meaningful reflation and inflation remains elusive, creating fears among investors that central banks are "pushing on a string." The evidence comes in the way of negative yielding debt, currently around $12 trillion.

We don't believe negative interest rate policies are coming to the United States, although Europe and Japan, and therefore the global economy, have yet to break from the side effects of Quantitative Failure.

Beneficiaries: Real assets, gold. ***At-Risk:*** Financial assets, Monetarism.

Demographics: the new consumer

In 2018, for the first time in history, persons aged 65 years or over worldwide outnumbered children under age five, according to the U.N. In addition, not only is the planet's population aging, it's also declining, or set to decline, in a number of key nations over the next few decades. Global aging suggests continued earnings upside for the global health care industry, notably drugs and medical equipment/devices. For equities, the forces of demographic deflation favor companies that can grow their dividends, and grow earnings at a rate above average for the economy and peer group. In a world rapidly growing short of workers, portfolios should be tilted toward health care and technology/innovation leaders in robotics, automation and artificial intelligence.

Beneficiaries: eCommerce, new consumer. ***At-Risk:*** Bricks and mortar, legacy consumer.

Climate Change: make earth green again

Climate change and extreme weather have taken a toll on the planet and are acknowledged as the world's number one global risk. The past five years (2014–2018) have been the hottest ever recorded, according to the National Oceanic and Atmospheric Administration (NOAA), as global temperatures in 2018 were 1.5 degrees Fahrenheit warmer than the 1951 to 1980 mean.[1] A warming climate can seriously disrupt and intensify weather patterns—like the frequency and severity of heat waves, hurricanes, floods and droughts. The price tag was $91 billion for full-year 2018 data, the fourth highest total number of events behind only 2017 (16 events). So far in 2019 (as of October 8), there have been ten $1 billion weather and climate events across the U.S. among the western wildfires in California, Hurricane Florence across the Carolinas, and Hurricane Michael making landfall in Florida.[2]

Beneficiaries: Clean energy, electric vehicles. ***At-Risk:*** Fossil fuels, diesel cars, single-use plastics.

Splinternet: the race for technological supremacy and sovereign internets

The U.S.-China trade dispute is not just about trade deficits; it's about the strategic rivalry over tech dominance in the 21st century. China is rapidly emerging as an innovation superpower, moving quickly up the tech value chain while busy setting the global standards for the industries of the future. At current growth rates, China is on track to overtake the U.S. in research and development spending by as early as next year. In terms of 5G infrastructure, Deloitte estimates that China has outspent the U.S. by $24 billion since 2015.

Beneficiaries: Emerging markets/the East. ***At-Risk:*** Developed markets/the West.

[1] NASA Global Climate Change, "2018 fourth warmest year in continued warming trend", February 6, 2019.

[2] National Centers for Environmental Information, National Oceanic and Atmospheric Administration, October 8, 2019.

Moral Capitalism: stakeholders take over from shareholders

We believe the trend toward investing in socially responsible and 'impact first' solutions is set to intensify over the next decade. This is especially true among the Gen X and Gen Y (Millennials) who are increasingly interested in Environmental, Social and Governance (ESG) solutions. The UN Sustainable Development Goals (SDGs) serve as a roadmap for reducing inequality, opening up a $12 trillion opportunity over the next decade across four economic areas: food and agriculture, cities, energy and materials, and health and wellbeing, while creating 380 million new jobs by 2030.[3]

Beneficiaries: ESG impact investing, stakeholders. ***At-Risk:*** Business-as-usual investing, solely profit-maximizing firms.

Robots and Automation: rise of the AI machines

The global pool of labor is poised to tighten and shrink in the coming decades, with the U.S. labor market already at or near full employment. And given the global shift toward de-globalization, nationalism, and anti-immigration policies gaining traction, it's important for investors to realize the march of machines and artificial intelligence (AI)-led activities can't come fast enough in the United States and other nations. The upshot: the industrial revolution in robotics is just starting, portending more long-term upside for global robotics manufacturers.

We believe demand for robotics and AI/data-driven production processes among multinationals is a secular trend that should help boost investments in capital equipment and intellectual property products (i.e., software, R&D spending) over the long run.

Beneficiaries: Automation, local production, big data AI. ***At-Risk:*** Global supply chains.

Smart Everything: ubiquitous connectivity and the death of privacy

Presently, with almost 20 billion connected devices (to grow to 34 billion by 2025), 4.5 billion internet users, and 3.5 billion social media accounts, the world has never been so connected. This global connectedness poses material cyber and privacy risks/opportunities across all sectors. The U.S. is the largest market for security solutions, followed by the United Kingdom at $6.5 billion, China ($6.0 billion) and Japan ($5.1 billion).

According to the International Data Corporation (IDC), the amount of data exchanged over the internet increased by a compound annual growth rate (CAGR) of 29% over the 2018–2025 forecast period.[4] The more data available, the greater the opportunities for hackers and data thieves. The cost of cybercrime is set to grow to $6 trillion by 2021[5] as more people come online, per-user data consumption increases, and attack threats become more mainstream and sophisticated.

Beneficiaries: IoT, connectivity, smart cities, "big brother tech." ***At-Risk:*** Privacy, offline.

Space: final frontier of exploration

Not only a new decade but a new space age, the next decade will enable the final frontier of exploration. Private companies' support has boosted space innovation and discovery while encouraging innovation and functionality for other technological advances, e.g., the nanosatellites' applicability of 5G network discovery and services, while delivering worldwide broadband to more than 40% of humanity.

Beneficiaries: Aerospace and defense. ***At-Risk:*** Legacy satellites.

The bottom line: As the 10 global themes evolve in 2020, we believe equity investors should gain exposures to various industries at the forefront of these powerful forces.

[3] Business & Sustainable Development Commission, 2017.

[4] International Data Corporation, "*The Growth in Connected IoT Devices*", data as of June 18, 2019.

[5] Cybercrime Magazine 2019.

THOUGHT OF THE WEEK

Multichannel, Millennials and Mobile: Retail Trends for the Holiday Season

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

The results are in: Total online sales this Thanksgiving weekend hit a record $28 billion this year, a 17% increase from 2018.[6] Almost 60% of the U.S. population, or 189.6 million consumers, shopped from Thanksgiving Day through Cyber Monday, according to the National Retail Federation. That's up an astonishing 14% from last year, with the average spend up 16% to $362.

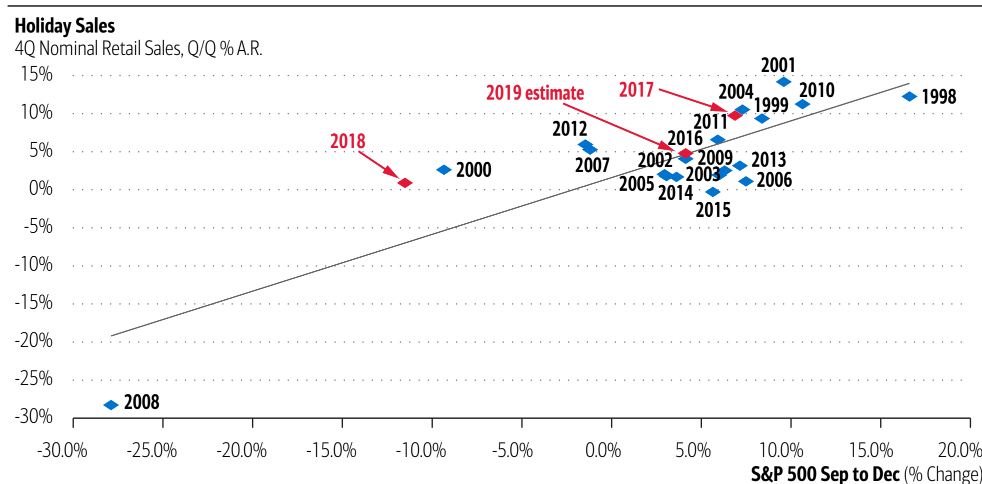
Multichannel strategies continue to pay off. On average, consumers who shopped both in stores and online spent 25% more than those who shopped in only one or the other. Retailers who can successfully drive this multichannel strategy will be best positioned to compete in the shopping digital age.

Millennials drove the holiday spending surge. Shoppers aged 25 to 34 years old spent the most on average over the Thanksgiving weekend ($440.46), closely followed by the 35-to-44-year-old cohort. We remain bullish on brands, services and sectors leveraged to millennials, such as technology, travel and leisure, and ecommerce.

Mobile sales were also strong. About $3 billion of the total $7.4 billion of online Black Friday sales were done via smart phone. Mobile sales surged almost 50% YoY on Cyber Monday.[7] Yet we believe the U.S. ecommerce trend is still in early innings. As of Q3 2019, U.S. ecommerce sales made up just 11.2% of total retail sales, significantly lagging China (36.6%) and the world average (14%).[8]

Solid spending growth should also bring some holiday cheer for investors. According to an analysis by Evercore ISI, there has been an 82% correlation between S&P performance in the 4th quarter and holiday sales over the last 20 years (Exhibit 2).

Exhibit 2: S&P 500 4Q Returns and Holiday Sales Highly Correlated.



Sources: Evercore ISI. S&P 500 change compares September average index value to December. Data as of November 2019.

With the U.S. manufacturing sector still in contraction territory, the U.S. consumer has continued to drive economic growth. Employment figures released on Friday showing solid wage growth and low unemployment should continue to support consumer spending into 2020.

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[6] Adobe Analytics, Statista. Data as of December 2019. Time period from Thanksgiving through Cyber Monday.

[7] Source: Adobe Analytics. Data as of December 2019.

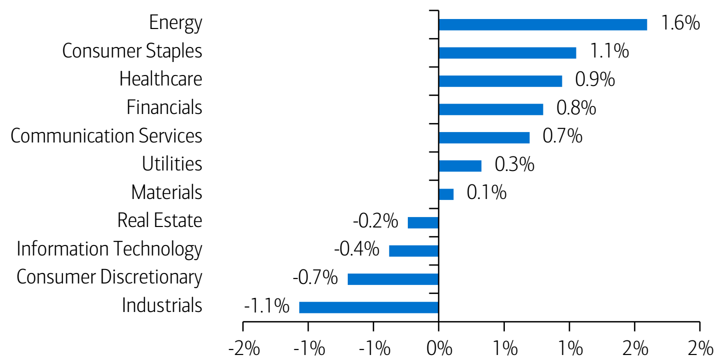
[8] Source: eMarketer. Data as of 2019.

MARKETS IN REVIEW

Equities

		Total Return in USD (%)		
	Current	WTD	MTD	YTD
DJIA	28,015.06	-0.1	-0.1	23.0
NASDAQ	8,656.53	-0.1	-0.1	31.8
S&P 500	3,145.91	0.2	0.2	27.9
S&P 400 Mid Cap	2,021.98	0.6	0.6	23.5
Russell 2000	1,633.84	0.6	0.6	22.7
MSCI World	2,296.39	0.2	0.2	24.2
MSCI EAFE	1,981.63	0.4	0.4	18.6
MSCI Emerging Markets	1,048.96	0.9	0.9	11.2

S&P 500 Sector Returns



Fixed Income[1]

	Total Return in USD (%)			
	Current	WTD	MTD	YTD
Corporate & Government	2.25	-0.3	-0.3	9.6
Agencies	1.89	-0.2	-0.2	5.9
Municipals	1.82	0.0	0.0	7.2
U.S. Investment Grade Credit	2.34	-0.2	-0.2	8.6
International	2.90	-0.2	-0.2	14.0
High Yield	5.48	0.4	0.4	12.5

	Current	Prior Week End	Prior Month End	2018 Year End
90 Day Yield	1.47	1.54	1.54	2.36
2 Year Yield	1.61	1.61	1.61	2.49
10 Year Yield	1.84	1.78	1.78	2.68
30 Year Yield	2.28	2.21	2.21	3.01

Commodities & Currencies

	Total Return in USD (%)			
Commodities	Current	WTD	MTD	YTD
Bloomberg Commodity	166.20	1.5	1.5	4.1
WTI Crude $/Barrel[2]	59.20	7.3	7.3	30.4
Gold Spot $/Ounce[2]	1,460.16	-0.3	-0.3	13.9

Currencies	Current	Prior Week End	Prior Month End	2018 Year End
EUR/USD	1.11	1.10	1.10	1.15
USD/JPY	108.58	109.49	109.49	109.69
USD/CNH	7.02	7.03	7.03	6.87

Source: Bloomberg, Factset.Total Returns from the period of 12/2/19 to 12/6/19. Bloomberg Barclays Indices.[1] Spot price returns.[2] All data as of the 12/6/19 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 12/6/19)

	Q2 2019A	Q3 2019A	Q4 2019E	2019E	Q1 2020E	2020E
Real global GDP (% y/y annualized)	–	–	–	3.1	–	3.1
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	2.0	1.8	2.3	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	3.6	3.6
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.

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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 December 6, 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.

National Financial Conditions Index (NFCI) provides a comprehensive weekly update on U.S. financial conditions in money markets, debt and equity markets and the traditional and "shadow" banking systems.

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

It is not possible to invest directly in an index.

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