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CHIEF INVESTMENT OFFICE

Capital Market Outlook

February 10, 2020

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- **Global Market View**—The end of last month saw the United Kingdom (UK) formally leave the European Union (EU), becoming the first country to do so since its inception. This historic event concluded three and a half years of deliberation and debate over the terms of withdrawal following the 2016 referendum and 47 years of UK membership in the Union.
- **Thought of the Week**—While investors and asset managers have been laser-focused on micro-level Environmental, Social and Governance (ESG) standards, there is room to expand ESG analysis to the macro level. For example, if you're an ESG-inspired investor, take note that eight countries in the MSCI Emerging Markets Index are authoritarian regimes representing over 40% of the index.
- **Portfolio Considerations**—We maintain our preference for equities relative to fixed income and still prefer the U.S. relative to the rest of the world. The Wuhan Coronavirus outbreak has imparted a deflationary shock to the global economy that may delay the full benefit of the underlying recovery that we believe is setting up a fourth mini-wave expansion.

MACRO STRATEGY

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GLOBAL MARKET VIEW

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THOUGHT OF THE WEEK

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Data as of 2/10/2020 and subject to change.

MACRO STRATEGY

Stocks Are Not Partying Like the Late 1990s

Niladri "Neel" Mukherjee, Managing Director and Head of CIO Portfolio Strategy

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Global equities ripped higher last year (up 27.3%),[1] powered by the S&P 500, which returned 31.5%, marking its strongest gain since 2013. This earnings-less increase in stock prices lifted valuation levels to the 88th percentile of their historical range. The forward price-to-earning ratio (P/E) rose from 14.5x at the beginning of 2019 to 18.3x by the end, as the Federal Reserve's (Feds) powerful pivot from a hawkish to dovish stance and three rate cuts proved to be a foundation for investors embracing risk.

[1] MSCI ACWI Index. As of date 2019.

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Given this experience, many have questioned whether this market is similar to that of the late 1990s. In 1998, the Fed cut rates three times from September to November. The S&P 500, which had been treading water before the cuts due to a number of risks such as the Asian financial crisis, Russian ruble devaluation and debt default, and the collapse of a giant hedge fund, put in a bottom and began its climb. From the time of the first rate cut to the peak of the dot.com bubble in March of 2000,[2] the S&P rose 36% and the NASDAQ 192%. Similar to the 2010s, the Fed had played a key role throughout the 1990s by adjusting monetary policy, thereby nursing the economy along and supporting the longest expansion at the time at 120 months. While the cycle eventually ended with the creation of the dot.com bubble and its subsequent crash, we are not convinced that today's market is in excessive territory. Despite the similarities with the late '90s, including the fact that the current expansion is the longest in history at 128 months, there are some key differences today, which we review below.

Valuations are more reasonable today

On both an absolute basis and relative to bonds, equities are more reasonably valued today. Closing out 1999, the S&P 500 was trading at a 25.2x P/E, whereas today this figure stands at 18.5x. The equity risk premium back then fell to the 1st percentile of its historical range, suggesting negligible benefit to picking equities over bonds, versus today at roughly the 75th percentile, making stocks much more attractive.

For many investors, the current near cyclical-high absolute valuation for equities may seem daunting; however, we would caution that valuations can be a poor indicator of near-term returns. Extreme levels of valuation can signal attractive long-term entry points or a sign of leaner returns going forward, but today's levels indicate that returns will be more guided by the business and profit cycle. We also believe that equity valuations can remain seemingly elevated due to major changes undergone by the U.S. economy. Over the past few decades, the volatility of gross domestic product (GDP) growth and inflation has declined due to more proactive fiscal and monetary policies, and a shift to less cyclical services from more cyclical manufacturing activity has made the modern economy less prone to recessions. Higher certainty on future cash flows and earnings is reflected in higher multiples on a structural basis.

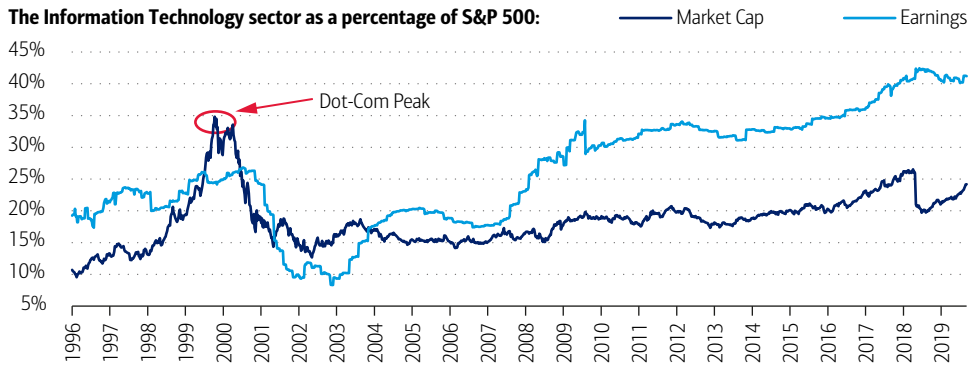
In the second half of 1999, then Fed Chair Alan Greenspan started to hike policy rates. This seems unlikely today given that inflation is quiescent and the Fed is becoming more tolerant of it moving higher. In fact, the probability of the Fed lowering rates this year has risen recently in part due to the economic uncertainty from the coronavirus outbreak. Therefore, given the significant role of lower interest rates today in keeping equities relatively attractive, it seems that rates are poised to remain lower for longer.

The technology sector today is producing real earnings and cash flows

At the height of the tech bubble in 2000, the technology sector traded at a near 2.5x premium to the overall market on a price-to-earnings basis. Today, this premium is only 1.2x. Back then, the sector's weight in the broader S&P 500 nearly doubled its earnings contribution—today, that story has reversed (Exhibit 1). The sector is not punching above its weight and has rightfully earned its outperformance and dominance in the current cycle. Also unlike 1999, the average technology company of today tends to be more mature, often delaying Initial Public Offerings (IPOs) in efforts of boosting profitability.

[2] 9/28/1998 – 3/10/2000

Exhibit 1: The Tech Sector Simply Didn't Earn its Weight.



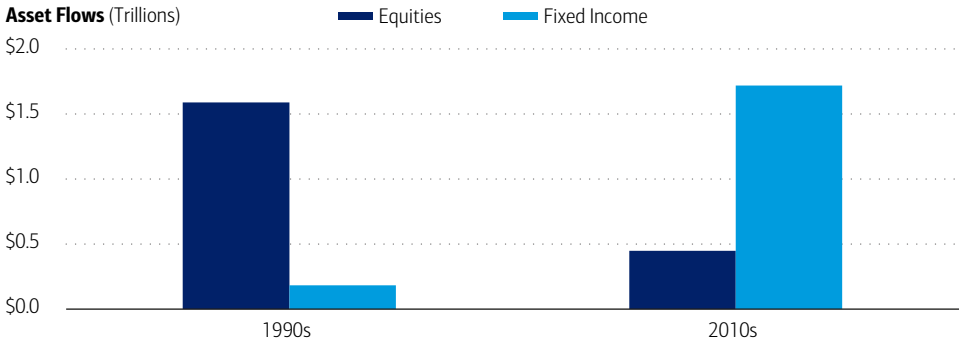
Sources: Bloomberg; Chief Investment Office. Data as of January 31, 2020. **Past performance is no guarantee of future results.**

Another difference is that in 2000, the technology sector generated subzero free-cash-flow margins when accounting for employee stock options, according to Empirical Research Partners. That figure is currently 18%. Empirical also notes that expectations were much higher back in the late 1990s. Research analysts then estimated that the earnings of technology stocks would grow four times as fast as that of the broad market's. Current expectations call for a 1.6x differential. Lower expectations and cheaper valuations compared to the late '90s keep us bullish on the sector in the long term, which is being driven by the accelerating digital transformation of enterprises and customer experiences on a global basis. As labor markets tighten further and more companies choose to re-shore production and supply chains, it will incentivize further technology spending to drive productivity and security.

Investors are less optimistic today

Despite strong equity returns in this cycle, investor sentiment can hardly be characterized as euphoric or even optimistic today. Compared to the 1990s, investor flows throughout this cycle have largely preferred the perceived safety of bonds at the expense of equities (Exhibit 2). Ageing demographics, a scarcity of high-quality yield outside the U.S. and a general aversion to risk coming from the shock of a deep financial crisis in 2008 have all contributed to this behavior. In addition, equity ownership is lower today than in the late '90s. According to the Fed, households and nonprofit organizations had 27% of their total financial assets in equities in 2000, which cratered to 12% in 2009, before recovering to 23% as of Q3 2019. As noted earlier, unlike the late 1990s, attractive equity earnings yields today versus those of competing assets like cash and bonds may nudge households to further increase their equity allocations.

Exhibit 2: Aggregate Fund Flows by Decade.



Sources: Investment Company Institute; Strategas Research Partners; Chief Investment Office.
Data as of December 31, 2019. Note: Includes Exchange-Traded Funds (ETFs) and Mutual Fund Flows.

Other measures of investor euphoria such as put/call ratios, sentiment surveys and credit spreads are also not flashing red at the moment. BofA Global Research's sell side indicator (Wall Street's recommended equity allocation) is currently under 56%, a neutral level and well below the euphoric 70% level seen during the dot.com era.

Conclusion

There is no doubt that last year's equity returns are eye-popping, but we believe there could be further upside. Lower global rates, a "Phase I" U.S.-China trade deal, a strong U.S. consumer, central bank accommodation, a potential improvement in the manufacturing sector and corporate earnings should mitigate higher absolute valuations, and the near-term economic impact from the Coronavirus outbreak. As such, it may be too early to leave this party!

GLOBAL MARKET VIEW

AdiEU: The UK Formally Leaves the European Union

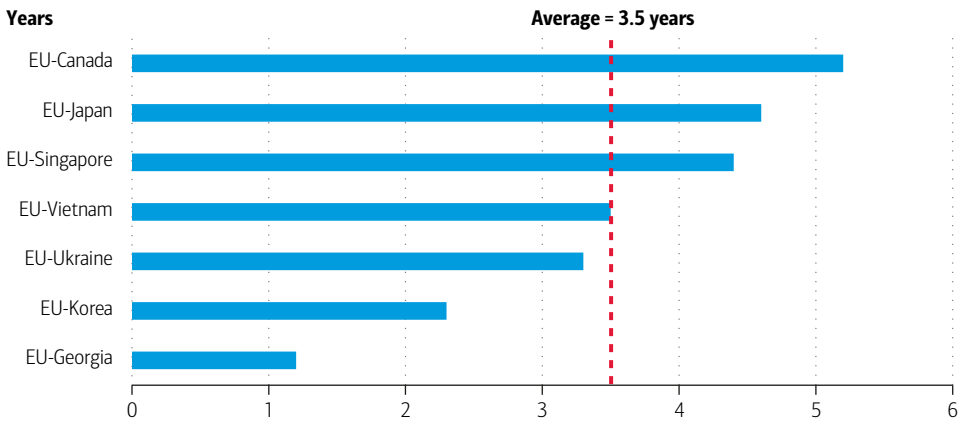
Ehiwario Efeyini, Senior Vice President and Senior Market Strategy Analyst

The end of last month saw the UK formally leave the EU, becoming the first country to do so since its inception. This historic event concluded three and a half years of deliberation and debate over the terms of withdrawal following the 2016 referendum and 47 years of UK membership of the Union.

While the formal exit of January 31 ends UK participation in the EU decision-making process, it does not have any immediate direct impact on the economic relationship between the two markets. Now will begin the process of negotiation for the UK and the EU-27 on their new trade relationship, and the two sides have set a target of year-end 2020 to complete the talks with the aim of reaching a free trade agreement by the end of this transition period. There is of course no guarantee that a deal will be reached over this relatively short time frame, and for this reason, it remains to be seen whether the optimism expressed by investors ahead of the UK's departure will remain intact as we move through 2020. If a free trade agreement is not reached by the end of the year, the result will be a hard "no-deal" outcome with higher tariff and regulatory barriers between the UK and its largest trading partner. And even if both sides agree to extend the talks beyond 2020 (which would have to be decided by June 30), uncertainty around the final outcome could resurface.

Though it could yet change its position, the UK government has pledged to end the transition period at the end of 2020 with or without an agreement. The first round of talks is due to start on March 3 after a negotiating mandate is agreed, and a full month will be required at the end of the transition period for the ratification of any deal. This effectively leaves only a nine-month period for an agreement to be struck. The UK starting point of full alignment as an EU member could in theory make for a speedier process, but past EU free trade deals have taken much longer—three and a half years on average across seven examples counted by the UK Institute for Government (Exhibit 3).

Exhibit 3: EU Free Trade Agreements by Duration of Negotiations.
Time to negotiate free trade agreements



Source: UK Institute for Government. Data as of 2019.

In any case, the trade negotiations due to start next month will determine the ultimate economic consequences of Brexit, and markets should begin to price the expected outcome as talks proceed and key dates in the process are reached over the course of 2020 (Exhibit 4).

Exhibit 4: Key 2020 Dates in Brexit Transition Period.
Key Brexit transition period dates

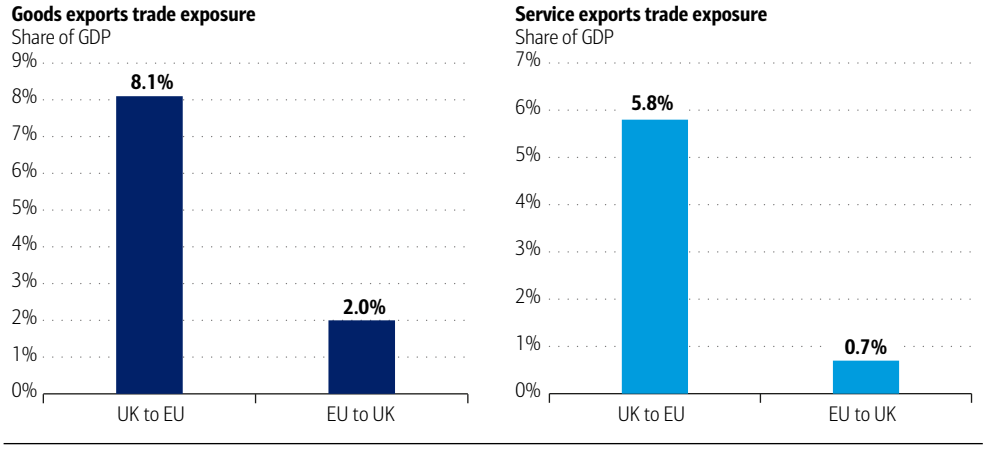
Date	Event
January 31	UK formally leaves EU
March 3	UK-EU talks start after agreement of negotiating mandate
June	High level UK-EU meeting to assess progress
June 30	Final date to extend transition period
November 30	Final date to conclude agreement to allow time for ratification
December 31	Transition period ends and new trade relationship begins

Source: Chief Investment Office. Data as of February 10, 2020.

We would emphasize that any set of post-transition arrangements is expected to lead to weaker economic growth for the UK economy through trade, investment, immigration and regulatory compliance. The midpoint of official government estimates for the cumulative loss of output for the UK over the next 15 years ranges from -9.3% under a worst case "no-deal" scenario to -1.4% under the softest possible Norway-style exit. These potential market headwinds would, however, need to be balanced against competitiveness and currency translation benefits from any accompanying exchange rate weakness, as well as the more pro-market domestic policy direction that should be offered by the new Conservative government.

The UK nonetheless remains much more dependent on goods and services trade with the EU than vice-versa. On goods, UK exports to the EU were 8.3% as a share of UK GDP in 2018, roughly four times more than EU exports to the UK as a share of EU GDP. While on services, UK exports to the EU were 5.8% of UK GDP in the same year, over eight times more than EU service exports to the UK as a share of EU GDP (Exhibit 5). One potential outcome suggested to avoid a hard exit at the end of 2020 has been an initial deal covering goods trade to be agreed by the end of the year, with the tougher negotiations around services trade to be concluded at a later stage.

Exhibit 5: UK More Dependent on Trade with EU than Vice-Versa.



Sources: Office for National Statistics; International Monetary Fund; Bloomberg. Data as of 2018.

In the meantime however, the UK economy also faces risks from its investment exposure to the EU. Inward foreign direct investment into the UK totaled $64 billion in 2018, and by number of investment projects it remains the top market for the establishment of European headquarters by international firms, particularly in service sectors such as information technology, business services and financial services. Moreover, data from the *Financial Times* fDi Markets database on the factors cited by companies when announcing a new investment project suggest that proximity to customers has been the most common reason for choosing the UK market. This matches with anecdotal evidence of companies, whether financial services firms, automakers or aircraft manufacturers announcing plans to move their European operations onto the mainland in order to retain unrestricted access to the single market. And it further hints at the downside risk to UK economic activity from any reduction in the freedom of movement for goods, services, labor and capital after the transition period.

Outside the UK, the rest of the EU would be the most exposed of the major economies under any post-transition scenario (particularly Ireland as the UK's closest trading partner). But the aggregate impact would be much smaller given the lower trade and investment dependencies. And some individual markets in continental Europe could be potential beneficiaries under a hard "no deal" outcome if more firms decide to shift project activities to an EU member state. Meanwhile, for other large economies around the world such as the U.S., China and Japan, aggregate exposure to the UK market is lower still. It should also be emphasized that no post-transition scenario (even a "no-deal" outcome at the end of 2020) would represent a systemic risk for the financial system as we saw with peripheral eurozone countries during the euro crisis. And if necessary, the Bank of England and the UK government would be able to use monetary and fiscal policy to counteract any negative effect on real activity in trade, investment or employment. While we therefore acknowledge the local downside risks stemming from a more distant UK-EU economic relationship from the end of this year, the fallout is likely to remain contained, and the global implications should be limited.

THOUGHT OF THE WEEK

Macro ESG: A Look At Governance In the MSCI Emerging Markets Index

Jonathan W. Kozy, Senior Vice President and Senior Macro Strategy Analyst

While investors and asset managers have been laser-focused on micro-level ESG standards, there is room to expand ESG analysis to the macro level. On the governance side, for example, investors should consider the trend toward authoritarianism globally

and particularly in emerging markets (EM). According to the Economist Intelligence Unit's (EIU) 2019 Democracy Index, "the average global score for democracy fell from 5.48 in 2018 to 5.44 (on a scale of 0-10). This is the worst average global score since the index was first produced in 2006." As background, the EIU scores 167 countries globally and buckets the scores into the following categories: Full Democracy, Flawed Democracy (the U.S. is in this category), Hybrid Regime or Authoritarian.

Consider a macro level ESG analysis of the MSCI Emerging Markets Index seen in Exhibit 6. Eight of the 26 countries in the index are Hybrid or Authoritarian Regimes. Using the current EM index weights, the Authoritarian regime countries make up over 40% of the index (China is over 30% of the MSCI EM index). The weighted average score for the index is 5.15, placing the index as a whole firmly in the Hybrid Regime category.

Exhibit 6: MSCI Emerging Markets Index Countries.

Full Democracies	Flawed Democracies	Hybrid Regimes	Authoritarian Regimes
Chile	India	Turkey	China
	Argentina	Pakistan	Russia
	Brazil		Qatar
	Colombia		Egypt
	Mexico		Saudi Arabia
	Peru		United Arab Emirates
	Czech Republic		
	Greece		
	Hungary		
	Poland		
	South Africa		
	Taiwan		
	Indonesia		
	South Korea		
	Malaysia		
	Philippines		
	Thailand		

Source: Economist Intelligence Unit Democracy Index 2019.

Why does this matter? If you're an ESG-inspired investor passively* invested in the MSCI Emerging Markets Index, over 40% of your investment in equities is in countries that likely do not have free and fair elections, repress criticism of government, and/or have "disregard for abuses and infringements of civil liberties," according to the EIU definition of Authoritarian regimes. Represssion of free speech was specifically cited as a driver of the Authoritarian shift in developing countries. For this reason, investing in democratic countries is desirable in itself, but it has another advantage. "By requiring constant consultation of the population, democracy provides a powerful corrective to economic and social trends that may be detrimental to the common good."[3] Put simply, democracies offer a macro governance level of due diligence for equity investors and, in particular, ESG investors.

* Passive investment seeks to outperform benchmarks by making tactical allocation decisions. Will mirror the returns of asset classes within the portfolio.

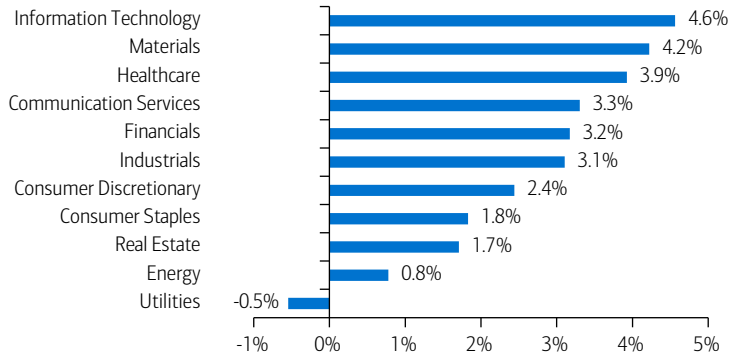
[3] Milanovic, Branko. "The Clash of Capitalisms." Foreign Affairs, January/February 2020, p. 18.

MARKETS IN REVIEW

Equities

		Total Return in USD (%)		
	Current	WTD	MTD	YTD
DJIA	29,102.51	3.1	3.1	2.1
NASDAQ	9,520.51	4.1	4.1	6.2
S&P 500	3,327.71	3.2	3.2	3.2
S&P 400 Mid Cap	2,049.30	2.1	2.1	-0.6
Russell 2000	1,656.78	2.7	2.7	-0.6
MSCI World	2,404.75	2.7	2.7	2.1
MSCI EAFE	2,030.29	1.9	1.9	-0.3
MSCI Emerging Markets	1,091.64	2.8	2.8	-2.0

S&P 500 Sector Returns



Fixed Income[1]

		Total Return in USD (%)		
	Current	WTD	MTD	YTD
Corporate & Government	1.97	-0.1	-0.1	2.2
Agencies	1.67	-0.2	-0.2	1.4
Municipals	1.51	-0.1	-0.1	1.7
U.S. Investment Grade Credit	2.05	-0.1	-0.1	1.9
International	2.59	0.1	0.1	2.4
High Yield	5.27	0.6	0.6	0.6

	Current	Prior Week End	Prior Month End	2019 Year End
90 Day Yield	1.51	1.50	1.50	1.49
2 Year Yield	1.40	1.31	1.31	1.57
10 Year Yield	1.58	1.51	1.51	1.92
30 Year Yield	2.05	2.00	2.00	2.39

Commodities & Currencies

		Total Return in USD (%)		
Commodities	Current	WTD	MTD	YTD
Bloomberg Commodity	159.22	-0.1	-0.1	-7.4
WTI Crude $/Barrel[2]	50.32	-2.4	-2.4	-17.6
Gold Spot $/Ounce[2]	1,570.44	-1.2	-1.2	3.5

Currencies	Current	Prior Week End	Prior Month End	2019 Year End
EUR/USD	1.09	1.11	1.11	1.12
USD/JPY	109.75	108.35	108.35	108.61
USD/CNH	7.01	7.00	7.00	6.96

Source: Bloomberg, Factset.Total Returns from the period of 02/03/20 to 02/07/20. Bloomberg Barclays Indices.[1] Spot price returns.[2] All data as of the 02/07/20 close.
Past performance is no guarantee of future results.

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

	Under-weight		Neutral		Over-weight
Global Equities	•	•	•	●	•
U.S. Large Cap Growth	•	•	•	●	•
U.S. Large Cap Value	•	•	•	●	•
U.S. Small Cap Growth	•	•	•	●	•
U.S. Small Cap Value	•	•	●	•	•
International Developed	•	●	•	•	•
Emerging Markets	•	•	●	•	•
Global Fixed Income	•	●	•	•	•
U.S. Governments	•	●	•	•	•
U.S. Mortgages	•	•	●	•	•
U.S. Corporates	•	•	●	•	•
High Yield	•	●	•	•	•
U.S. Investment Grade Tax Exempt	•	•	●	•	•
U.S. High Yield Tax Exempt	•	●	•	•	•
International Fixed Income	●	•	•	•	•
Alternative Investments*	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 02/07/20)

	Q2 2019A	Q3 2019A	Q4 2019A	2019A	Q1 2020E	2020E
Real global GDP (% y/y annualized)	–	–	–	2.9	–	3.1
Real U.S. GDP (% q/q annualized)	2.0	2.1	2.1	2.3	1.0	1.7
CPI inflation (% y/y)	1.8	1.8	2.0	1.8	2.2	2.1
Core CPI inflation (% y/y)	2.1	2.3	2.3	2.2	2.3	2.4
Unemployment rate (%)	3.6	3.6	3.5	3.7	3.5	3.5
Fed funds rate, end period (%)	2.40	1.90	1.55	1.55	1.63	1.63
10-year Treasury, end period (%)	2.01	1.66	1.92	1.92	1.80	1.80
S&P 500 end period	2942	2977	3231	3231	–	3300
S&P earnings ($/share)	41	42	41.5*	164.1*	40.5	177
Euro/U.S. dollar, end period	1.14	1.09	1.12	1.12	1.10	1.15
U.S. dollar/Japanese yen, end period	108	108	109	109	110	103
Oil ($/barrel, avg. of period, WTI**)	60	56	57	57	59	57

The forecasts in the table above are the base line view from BofA 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 2020. **West Texas Intermediate

Sources: BofA Global Research; GWIM ISC as of February 07, 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 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.

MSCI Emerging Markets Index is used to measure equity market performance in global emerging markets. The index captures mid and large caps in 26 countries including China, India, Korea, Mexico, Taiwan, and the United Arab Emirates. Investors can invest in the index directly.

MSCI ACWI is a market capitalization weighted index designed to provide a broad measure of equity-market performance throughout the world.

EIU Democracy Index provides a snapshot of the state of world democracy for 165 independent states and two territories. The Democracy Index is based on five categories: electoral process and pluralism; civil liberties; the functioning of government; political participation; and political culture.

Important Disclosures

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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.

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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Investments have varying degrees of risk. Some of the risks involved with equity securities include the possibility that the value of the stocks may fluctuate in response to events specific to the companies or markets, as well as economic, political or social events in the U.S. or abroad. Investments in foreign securities involve special risks, including foreign currency risk and the possibility of substantial volatility due to adverse political, economic or other developments. These risks are magnified for investments made in emerging markets. Investments in a certain industry or sector may pose additional risk due to lack of diversification and sector concentration. There are special risks associated with an investment in commodities, including market price fluctuations, regulatory changes, interest rate changes, credit risk, economic changes and the impact of adverse political or financial factors.

Impact investing and/or Environmental, Social and Governance (ESG) managers may take into consideration factors beyond traditional financial information to select securities, which could result in relative investment performance deviating from other strategies or broad market benchmarks, depending on whether such sectors or investments are in or out of favor in the market. Further, ESG strategies may rely on certain values based criteria to eliminate exposures found in similar strategies or broad market benchmarks, which could also result in relative investment performance deviating.

Impact investing and/or ESG investing has certain risks based on the fact that ESG criteria excludes securities of certain issuers for nonfinancial reasons and therefore, investors may forgo some market opportunities and the universe of investments available will be smaller.

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