CHIEF INVESTMENT OFFICE

Capital Market Outlook

February 16, 2021

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

IN THIS ISSUE:

- Macro Strategy—The unprecedented growth in the money supply and fiscal deficit since March 2020 has triggered a powerful reflation trade in financial markets. Anticipation of the new administration's additional $1.9 trillion fiscal stimulus plan has further bolstered the reflation trade. Here we discuss strategies investors have been employing to help preserve wealth from the likely resultant surge in inflation over the next few years.
- Global Market View—As it completes its first full month in office, the new U.S. administration has placed climate change mitigation among its top policy priorities. The combination of new policy commitments and market-based tailwinds may have pushed global climate change mitigation efforts toward a tipping point, and we would expect clean energy investments to be major beneficiaries over the coming years.
- Thought of the Week—The diverging paths of the service and industrial sectors of the euro area reflect restrictions to combat the coronavirus pandemic and may have regional implications for future economic performance within the bloc, in our view.
- Portfolio Considerations—Positive earnings estimate revisions and upside surprises expected into 2022 could potentially help equity valuations moderate; meanwhile, as yields back up, we expect this to be a pivotal year for portfolio rotation as years of fund flows favoring fixed income do not suggest equities are over-owned.

MACRO STRATEGY

Robert T. McGee
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GLOBAL MARKET VIEW

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THOUGHT OF THE WEEK

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Data as of 2/16/2021, and subject to change

MACRO STRATEGY

Deficits, the Money Supply and Inflation: Part 2

Robert T. McGee, Managing Director and Head of CIO Macro Strategy

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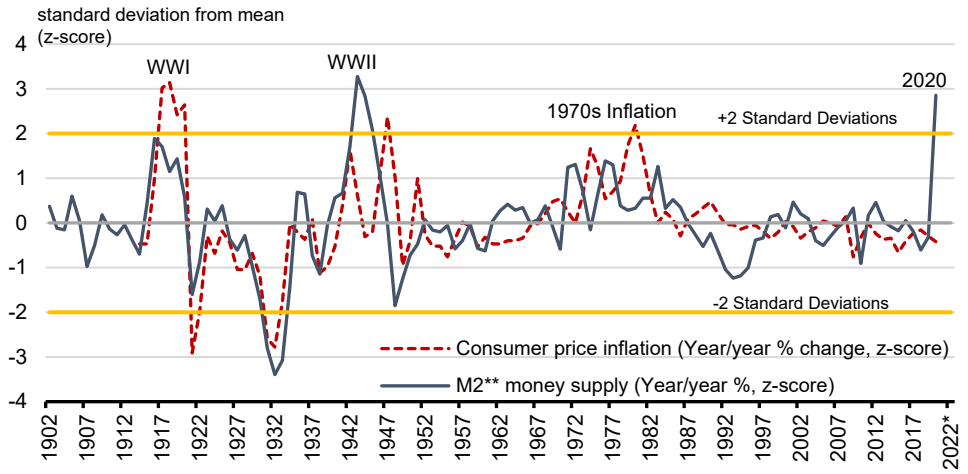
The monetary and fiscal stimulus already working its way through the U.S. economy is the greatest since World War II (WWII). Legislation currently moving through Congress would add another $1.9 trillion on top of what's been enacted as well as promised since March 2020. Many economists believe additional stimulus is not needed given the rapid recovery of gross domestic product (GDP) and employment since the first stimulus measure adopted last March. Forecasters were already looking for strong growth in 2021, with the latest dose of stimulus only adding more fuel to the fire.

Indeed, as we discussed last week in the Capital Market Outlook, *"While helpful for the time being, the current surge in government debt and money printing has raised concerns about the longer-term consequences of this massive government spending binge."* These concerns are evident in the massive rotation toward stocks that benefit from higher growth rates while also helping to guard against higher inflation. A look at Exhibit 1 shows why inflation

expectations are rising, as seen for example in the outperformance of Treasury Inflation Protected Securities (TIPS) and the surge in the Commodity Research Bureau (CRB) commodity price index to a 7-year high. Indeed, the TIPS break-even inflation rate has risen significantly in recent months to about a nine-year high and is on the cusp of moving into a new higher range well above the Federal Reserve's (Fed) 2% inflation target. Commodity prices are currently breaking out to new highs across the spectrum of food, energy and metals. Residential real estate prices are presently up by double digits over the past year, demand is as well, while the inventory of unsold homes is at an all-time low, keeping upside pressure on prices.

Exhibit 1: Fastest Money-Supply Growth In 80 Years Likely To Spur Inflation.



*=Estimate. **M2=a calculation of the money supply that includes all elements of M1 (a narrow measure of the money supply that includes physical currency, demand deposits, traveler's checks and other checkable deposits) as well as "near money." Sources: Bureau of Labor Statistics; Federal Reserve Board. Data as of February 2, 2021. Past performance is no guarantee of future results.

In addition, all across the manufacturing sector, shortages of key components such as semiconductor chips—the basic building blocks of the modern economy—are currently constraining output, lengthening delivery times and creating the early stages of a massive demand-pull inflation. This is evident for example in the cautioning from the biggest U.S. car maker by sales on February 9, 2020, that the global chips shortage could cut its 2021 earnings by up to $2 billion. It is also evident in the fact that the Institute for Supply Management (ISM) January survey found that over 80% of purchasing managers in the manufacturing sector reported paying higher prices for inputs. Going back to 1948, whenever the price component of the survey averaged over 80% for a sustained period, consumer price inflation tended to average in the high-single-digit to double-digit range. Of course, an optimistic view would hope these price pressures are short-lived, since a few months of 80%-plus readings can be associated with transitory inflation as opposed to the more severe outbreaks seen in the past when this measure stayed above 80% for protracted periods.

Worries that an inflation outbreak may be brewing are also based on the expected surge in consumer demand as the U.S. reaches herd immunity later this year and pent-up consumer demand for services comes back, particularly since government stimulus already in place has left many consumers across all income quartiles with a-third-to-a-half more cash balances than before the pandemic. Real disposable income is also well above pre-pandemic levels, having grown a red-hot 6% in 2020 (the most in 35 years) despite the recession and high unemployment. In addition, record home and equity prices have created record net worth on household balance sheets while record-low interest rates have reduced consumer interest expense, further boosting spending power. Given the unprecedented financial health of many consumers, not least because of the exceptional largess already provided to them by the government, it is not surprising that car makers and home builders are struggling to meet demand.

Given all this, after two decades of falling short in meeting its main long-term policy objective, it looks like the Fed will finally get its wish for sustained inflation above its 2% target while inflation expectations become entrenched in a new higher range. The main questions are: 1) how much will inflation overshoot the target, and 2) how long will higher inflation persist? The latest flood of proposed policy stimulus suggests that: 1) the overshoot will likely be bigger than implied by the stimulus to date, and 2) it may persist longer and be harder to contain without negative consequences. That's why prominent economists such as Larry Summers and Olivier Blanchard have cautioned about the destabilizing consequences of another $1.9 trillion in deficit spending.

Assuming more stimulus is coming, and looking at the history of the U.S. over the past 120 years in Exhibit 1, we can see how past comparable surges in the money supply and fiscal deficits affected subsequent inflation. The almost-three-standard-deviation surge in money growth over the past year is comparable to those in three other episodes of American economic history since 1900. In all three instances, consumer price inflation subsequently rose to double-digit rates. This suggests inflation could reach or even surpass 10% over the next few years, as it did in all the previous episodes of massive money-supply growth. It is thus not surprising that investors may have started to guard against this possibility.

A more difficult question is how long this new high-inflation period will persist. The world war examples and the 1970s offer alternative scenarios. After the wars, money-supply growth (blue line) was reined in fairly quickly, and inflation (red line) came back to, and even below, trend (Exhibit 1). In contrast, during the 1970s inflation episode, money-supply growth remained above trend for a decade before Paul Volcker became Fed Chair and reined it in. As a result of the protracted nature of excess money growth throughout the 1970s, inflation expectations became unanchored, and the hangover effects of bringing them down were much more severe and persistent, as economists learned during the stagflation era.

From these examples, we can surmise that by 2023, it will be crucial for the Fed to decide how it will handle the likely inflation outbreak of the next few years. A "cold-turkey" policy would cause a shorter, sharper recession and bring inflation back to trend sooner than a gradualist approach that could go on for years, as the 1970s stagflation experience proved. Most concerning would be political interference with the Fed that precluded it from bringing inflation back under control in order to keep household benefits funded by money printing.

This wide range of possibilities means the uncertainty around the inflation outlook is likely to grow over the next few years. Given the increased likelihood of higher inflation ahead, investors may have already started to guard themselves, however. The purchasing power of cash balances and fixed-coupon bonds declines fast in a high-inflation environment. Allocating funds to TIPS exposure may be a way to help maintain that purchasing power while maintaining some of the liquidity cash and bonds provide. A diversified portfolio of stocks that benefit from increased pricing power has the potential to help against inflation as well. When output prices rise relative to input prices, companies may benefit from inflation. Companies that have been outperforming this year include materials, energy, small-caps, and various Value sectors such as Financials, all of which historically benefit from stronger growth, a steeper yield curve, and rising inflation. Small-caps are particularly sensitive to money-supply growth, which suggests that they have further room to outperform large-caps in response to the spike in money-supply growth to date.

All told, it's clear by the dominance of reflation trades so far in 2021 that investors have been increasingly repositioning for a higher likely inflation environment in the wake of the rarely seen money-supply surge and promises for continued large deficit spending.

GLOBAL MARKET VIEW

A Tipping Point for Climate Policy?

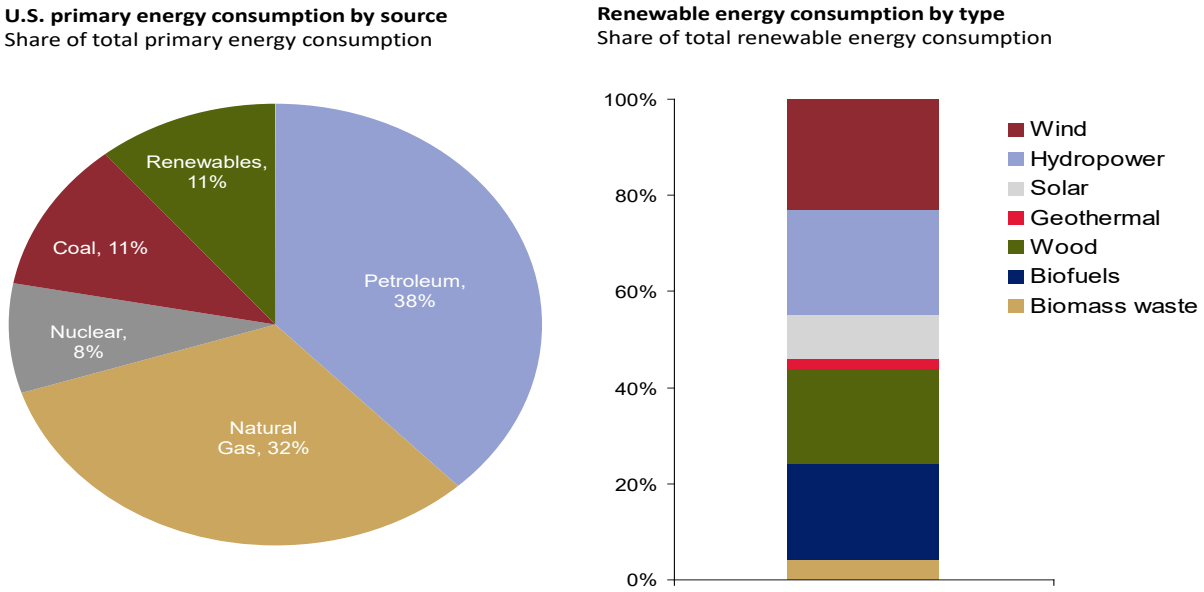
Ehiwario Efeyini, Director and Senior Market Strategy Analyst

As it completes its first full month in office, the new administration in Washington has placed climate change mitigation among its top policy priorities. Later this week, the U.S. will officially rejoin the Paris Climate Agreement, with President Biden set to host a Leaders' Climate Summit in April aimed at raising global emissions reduction targets ahead of the next United Nations Climate Change Conference (COP26) in November. Domestically, President Biden has already established a "whole-of-government" approach for the administration's climate agenda, including a National Climate Task Force represented by 21 federal agencies to review government actions taken over the past four years that have weakened regulations on greenhouse gas emissions, fuel economy and appliance energy efficiency standards. Along with the Democratic majority in Congress, the Biden White House is also expected to propose a clean energy-led infrastructure investment plan of up to $2 trillion later in 2021, which would target low-carbon transportation, renewable energy in the power sector and green building retrofits. And a list of sector-specific green incentives is also expected to be introduced over the coming years, including the extension of tax credits for solar, wind and hydrogen fuel cell installation; the potential raising of the 200,000 unit manufacturer cap for electric vehicle tax credits; the expiry of Section 201 tariffs on solar module imports; the possible introduction of a new battery storage credit; and potentially even a price on emissions through either a carbon tax or a cap and trade system, both of which have been variously supported by leading companies in the energy, utilities, auto and consumer product industries.

On a global basis, climate change mitigation ambitions also appear to be reaching a critical mass. According to National Aeronautics and Space Administration (NASA), 2020 was tied with 2016 as the hottest year on record. Several extreme weather events occurred over the past year, including wildfires in California, Australia and South America, severe flooding in Europe and Asia, and the most active ever recorded Atlantic hurricane season. Alongside the U.S. targets of zero-carbon electricity generation by 2035 and net-zero total emissions by 2050, the European Union (EU) has also made a net-zero pledge for 2050, with China set to release details of its 2060 net-zero plan at the next annual session of the National People's Congress in March. In total, more than 100 countries representing over 60% of world emissions have now adopted net-zero targets as part of the global effort to keep earth temperature increases to less than two degrees Celsius above pre-industrial levels. And as world leaders now look ahead to the first progress review on national emissions goals under the Paris framework at COP26, decarbonization is likely to become a major investment theme for the current decade.

As the two largest sources accounting for more than half of U.S. greenhouse gas emissions in 2019, transportation (28%) and electricity (27%) are likely to be the main focus for policymakers. Crude oil and natural gas were correspondingly the largest pre-pandemic sources of primary energy consumption, but renewable energy demand grew to a record 11.4 quadrillion Btu in 2019, surpassing coal consumption (which fell to its lowest level since 1964) for the first time. Over recent years, the rise in renewable energy demand has been almost exclusively driven by growth in solar and wind power in the electricity sector, with wind also surpassing hydro power in 2019 to become the single largest source of alternative energy in electricity generation. Renewables overall, however, still account for a relatively small 11% share of primary energy consumption, with solar and wind together making up just 3.6% (Exhibit 2).

Exhibit 2: Renewables Have Surpassed Coal But Still A Small Share Of Total Energy Consumption.

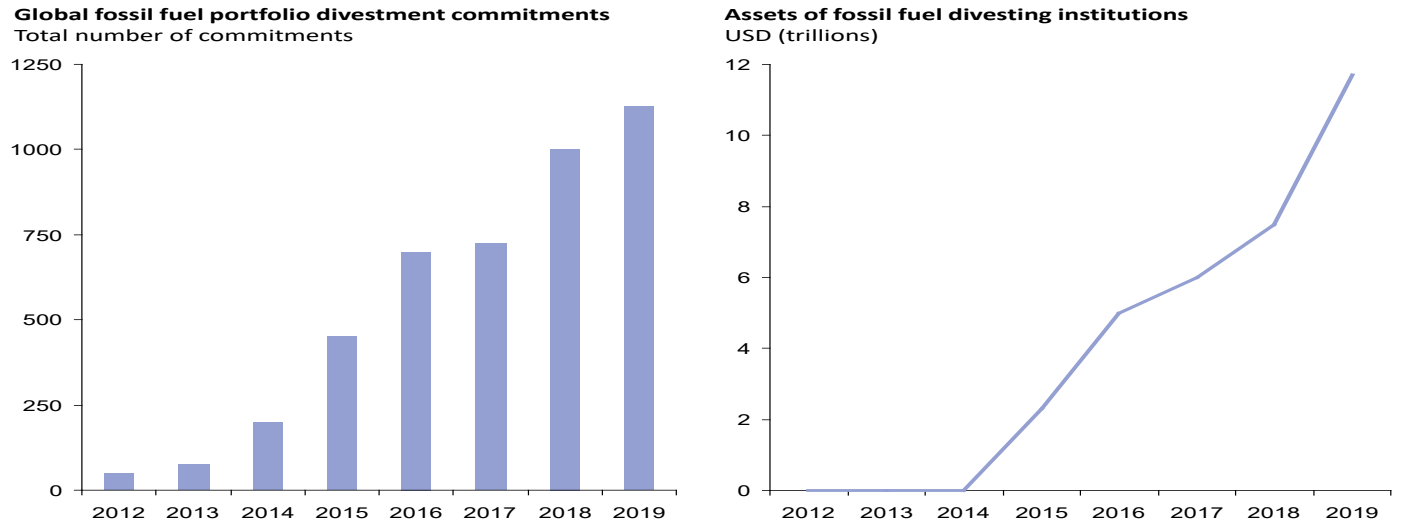


Source: U.S. Energy Information Administration. Data as of 2019. Past performance is no guarantee of future results.

Renewable adoption is largely concentrated in the power sector, with 56% used in electricity generation. But with the remainder used widely across industrial (22%), transportation (12%) and residential (7%) applications, there remains considerable scope for greater penetration over the coming years, particularly given official policy support, as well as market-based tailwinds from falling installation prices, lower storage costs and improvements in artificial intelligence (a major investment theme of the past decade) for better load forecasting to manage supply intermittency.

Global equity markets currently appear to have begun pricing a faster pace of renewable adoption, with the MSCI Global Alternative Energy Index outpacing all 11 global sectors from the pandemic lows of March 2020 and also outperforming since the Biden election victory last November. This has been mirrored by a longer-term trend toward portfolio divestment from fossil fuels by a range of global organizations from pension and sovereign wealth funds to universities and philanthropic foundations (Exhibit 3).

Exhibit 3: More Global Institutions Divesting Their Portfolios From Fossil Fuels.



Source: Fossil Free. Data as of 2019 and released in 2020. Latest available data. Past performance is no guarantee of future results.

This trend is only likely to accelerate over the years ahead as global climate commitments are ratcheted up under the Paris review framework and as more companies potentially move to disclose climate risks and greenhouse gas emissions in their operations and supply chains. Indeed this is a process that is already underway in the EU. And similarly, the U.K. and New Zealand recently announced plans to introduce mandatory climate-related disclosures for specified financial sector firms under the Financial Stability Board Task Force on Climate-related Financial Disclosures (TCFD). In the U.S., the Fed also late last year included climate risks faced by financial institutions for the first time in its biannual financial stability report.

The combination of ongoing cost declines, low penetration rates and improving artificial intelligence capability for renewable energy adoption, alongside increasingly volatile weather patterns, greater financial incentives for companies and investors, growing renewable energy commitments by countries around the world and now the post-election return of the U.S. to the Paris Agreement may have pushed global climate change mitigation efforts toward a tipping point. We would expect clean energy and related investments to be the principal beneficiaries of this trend over the course of the 2020s and beyond. The key growth areas in our view should include material suppliers for solar modules and wind turbines, as well as providers of balance of system components such as power optimizers and inverters. Developers of fuel cells and electrolyzers should benefit from growth in green hydrogen for use in industrial applications such as oil refining and steelmaking, in addition to commercial transportation segments such as heavy-duty trucks and forklifts. And electric vehicle manufacturers should also see tailwinds from growing consumer demand as battery costs decline, driving ranges increase with higher energy densities and charging infrastructure is built out by power utilities, automakers and dedicated charging network providers. Renewable power utilities should be well positioned as greater volumes of alternative energy are connected to the power grid, while providers of negative emissions technologies such as Carbon Capture and Storage are likely to become more mainstream as a growing number of countries commit to net-zero emissions targets.

THOUGHT OF THE WEEK

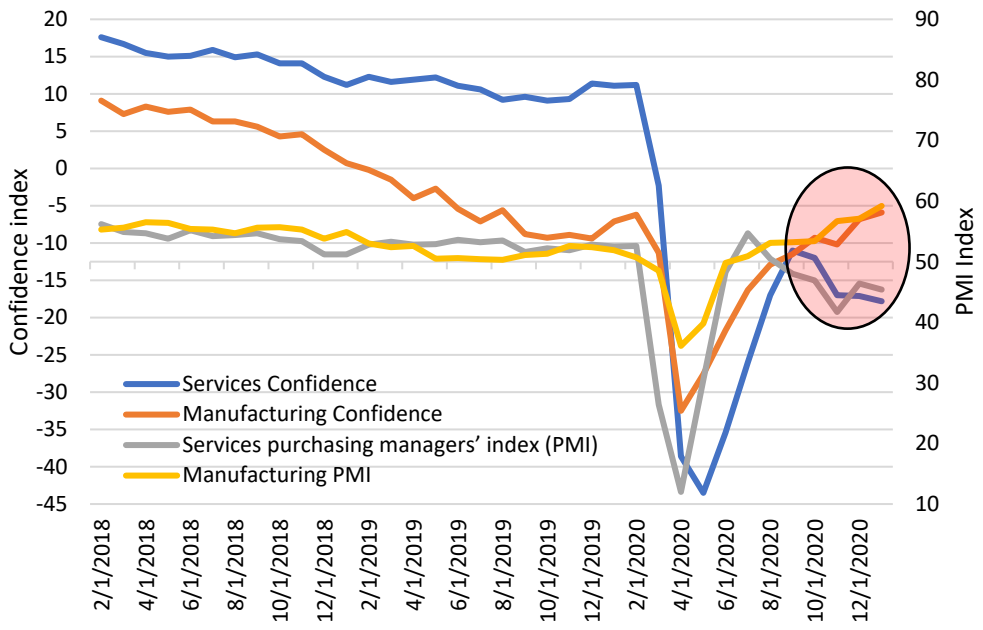
Diverging Paths in Europe

Rodrigo C. Serrano, CFA®, Director and Senior Investment Strategist

In the final quarter of 2020, the real gross GDP of the euro area contracted by -0.6% from the prior quarter. In our view, renewed restrictions to limit the spread of the coronavirus have played an outsized role on the service sector, which comprised 66.2% of the region's economy in 2019, according to the World Bank.

From its nadir of -43.5 in May last year, the European Commission's service sector confidence indicator peaked at -11.0 in September but has since fallen to -17.8 in January. In contrast, with a reading of -5.9 to likely begin this year, its manufacturing counterpart hit its highest result since August 2019, well before the pandemic hit the bloc. This indicator bottomed in April at -32.5. These trends correlate well with those from Markit's Purchasing Manager Indexes, which aim to capture business conditions in the private economy (Exhibit 4). With 88.2% of the bloc's economy exposed to trade in 2019, according to the World Bank, manufacturing in the euro area has benefitted off a rebound in the growth of global trade volumes, which rose 1.5% in November on a year-over-year (YoY) basis, the quickest pace since March 2019.

Exhibit 4: Eurozone Sentiment Indicators Display Diverging Paths In Pivotal Economic Sectors, In Our View.



Source: Confidence indicators are published by the European Commission, PMIs by IHS Markit. Data as of January 2021. Performance would differ if a different time period was displayed. Short term performance shown to illustrate more recent trend. Past performance is no guarantee of future results.

The diverging paths of the service and manufacturing segments of the economy may have regional implications. On a YoY basis, Germany's real GDP has currently outperformed other major euro area economies throughout most of the pandemic, such as those of France and Spain, according to Bloomberg. It may not be a coincidence, due to the service sector of the two latter countries having comprised 70.2% and 67.6% of their economies respectively in 2019, compared to 62.6% for Deutschland.

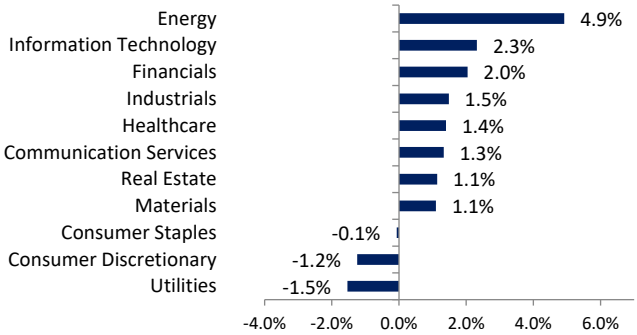
Whether this development becomes prolonged may depend on whether Europe can accelerate its coronavirus vaccination drive, which would raise expectations for quicker reopening plans. This could allow for the service sector segments of these economies to rebound. Once the coronavirus pandemic is under control, governments could take greater advantage of the EU's fiscal recovery fund and the stimulative monetary policy of the European Central Bank to focus on structural reforms, in our view.

MARKETS IN REVIEW

Equities

	Total Return in USD (%)			
	Current	WTD	MTD	YTD
DJIA	31,458.40	1.1	5.0	3.0
NASDAQ	14,095.47	1.7	7.9	9.4
S&P 500	3,934.83	1.3	6.0	4.9
S&P 400 Mid Cap	2,544.55	2.8	8.8	10.4
Russell 2000	2,289.36	2.5	10.5	16.0
MSCI World	2,818.85	1.7	5.9	4.9
MSCI EAFE	2,227.70	2.1	4.9	3.8
MSCI Emerging Markets	1,428.87	2.4	7.5	10.8

S&P 500 Sector Returns



Fixed Income†

	Total Return in USD (%)			
	Current	WTD	MTD	YTD
Corporate & Government	1.22	-0.11	-0.65	-1.69
Agencies	0.56	-0.03	-0.23	-0.40
Municipals	0.90	0.28	0.37	1.01
U.S. Investment Grade Credit	1.24	-0.13	-0.52	-1.23
International	1.90	-0.09	-0.57	-1.84
High Yield	3.96	0.30	1.01	1.34

	Current	Prior Week End	Prior Month End	2020 Year End
90 Day Yield	0.04	0.02	0.05	0.06
2 Year Yield	0.11	0.10	0.11	0.12
10 Year Yield	1.21	1.16	1.07	0.91
30 Year Yield	2.01	1.97	1.83	1.64

Commodities & Currencies

	Total Return in USD (%)			
Commodities	Current	WTD	MTD	YTD
Bloomberg Commodity	179.47	1.9	5.0	7.7
WTI Crude $/Barrel††	59.47	4.6	13.9	22.6
Gold Spot $/Ounce††	1824.23	0.6	-1.3	-3.9

Currencies	Current	Prior Week End	Prior Month End	2020 Year End
EUR/USD	1.21	1.20	1.21	1.22
USD/JPY	104.94	105.39	104.68	103.25
USD/CNH	6.42	6.46	6.45	6.50

Sources: Bloomberg, Factset. Total Returns from the period of 2/8/2021 to 2/12/2021. †Bloomberg Barclays Indices. ††Spot price returns. All data as of the 2/12/2021 close.
Past performance is no guarantee of future results.

Asset Class Weightings (as of 1/5/2021)

	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 Investment					
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 qualified investors.
CIO asset class views are relative to the CIO Strategic Asset Allocation (SAA) of a multi-asset portfolio.

Economic & Market Forecasts (as of 2/12/2021)

	Q1 2020A	Q2 2020A	Q3 2020A	Q4 2020A	2020A	Q1 2021E	2021E
Real global GDP (% y/y annualized)	-	-	-	-	-3.3	-	5.5
Real U.S. GDP (% q/q annualized)	-5.0	-31.4	33.1	4.0	-3.5	4.0	6.0
CPI inflation (% y/y)	1.5	0.6	1.4	1.2	1.2	1.8	2.6
Core CPI inflation (% y/y)	2.1	1.2	1.7	1.6	1.7	1.4	1.7
Unemployment rate (%)	3.8	13.0	8.8	6.7	8.1	6.3	5.6
Fed funds rate, end period (%)	0.08	0.08	0.09	0.09	0.09	0.13	0.13
10-year Treasury, end period (%)	0.67	0.66	0.68	0.91	0.91	1.10	1.75
S&P 500 end period	2585	3100	3363	3756	3756	-	3800
S&P earnings ($/share)	33	28	39	38*	138*	36	165
Euro/U.S. dollar, end period	1.10	1.12	1.17	1.22	1.22	1.20	1.15
U.S. dollar/Japanese yen, end period	108	108	105	103	103	103	100
Oil ($/barrel, avg. of period, WTI**)	46	29	40	44	40	46	47

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 2021. **West Texas Intermediate.
Sources: BofA Global Research; GWIM ISC as of February 12, 2021.

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.

Commodity Research Bureau (**CRB**) **commodity price Index** acts as a representative **indicator** of today's global **commodity** markets. The **CRB** measures the aggregated **price** direction of various **commodity** sectors, and is designed to isolate and reveal the directional movement of **prices in** overall **commodity** trades

MSCI Global Alternative Energy Index includes developed and emerging market large, mid and small cap companies that derive 50% or more of their revenues from products and services in Alternative energy.

IHS Markit Purchasing Managers' Index (PMI) are compiled for more than 40 economies worldwide. The monthly data are derived from surveys of senior executives at private sector companies.

Confidence Index is a measurement of attitudes about current and future economic conditions. It tells you how optimistic people are about the economy and their ability to find jobs.

Services and Manufacturing Purchasing Managers' Index (**PMI**) is an index of the prevailing direction of economic trends in the manufacturing and service sectors. It consists of a diffusion index that summarizes whether market conditions, as viewed by purchasing managers, are expanding, staying the same, or contracting.

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Investing involves risk, including the possible loss of principal. Past performance is no guarantee of future results.

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All recommendations must be considered in the context of an individual investor's goals, time horizon, liquidity needs and risk tolerance. Not all recommendations will be in the best interest of all investors.

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