CHIEF INVESTMENT OFFICE

Capital Market Outlook

February 22, 2021

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

IN THIS ISSUE:

- Macro Strategy—Views about the inflation outlook have started to diverge widely. Rarely seen U.S. money-supply growth coupled with large government spending in the pipeline have spurred inflation concerns. Unusually dovish Federal Reserve (Fed) policy and rhetoric, massive consumer cash balances, and a strong global economic recovery underway amplify such concerns, while low current inflation readings and still-tame household inflation expectations are arguments used to refute them. Investors have taken the side of potential upside inflation surprises, validating our expectation for reflation-asset outperformance, which we maintain despite subdued inflation likely this year.
- Global Market View— Many U.S. companies have built up a rather large cash mountain despite the pandemic. Rather than widespread solvency issues resulting from economic shutdowns, corporations on aggregate entered the New Year well supported. Given the current improving economic backdrop, the time might be right for companies to normalize or increase the usages of their cash.
- Thought of the Week— The public-private partnership in coronavirus vaccine discovery helped to develop an effective vaccine in months, not the years or decades it typically takes. With vaccine development epitomizing the importance of innovation, from an investment standpoint we continue to be overweight both the Technology and Healthcare sectors, which include many leaders in research and development.
- 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
Chief Investment Office Macro Strategy Team

GLOBAL MARKET VIEW
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THOUGHT OF THE WEEK
Lauren J. Sanfilippo
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Data as of 2/22/2021, and subject to change

MACRO STRATEGY

Reflation Assets Benefit From Surge In Money Supply And Brewing Inflation Concerns

Chief Investment Office, Macro Strategy Team

We continue to believe that "core" inflation is likely to generally remain below 2% this year in a lagged response to big deflationary effects from the pandemic shutdowns. However, the clear U.S. monetary and fiscal policy regime change is conducive to much higher inflation ahead, in our view. For one, there have only been three other comparable U.S. money-supply surges in the past 120 years, and all have been accompanied by high inflation. The most recent episode in the 1970s saw an entrenched inflation environment

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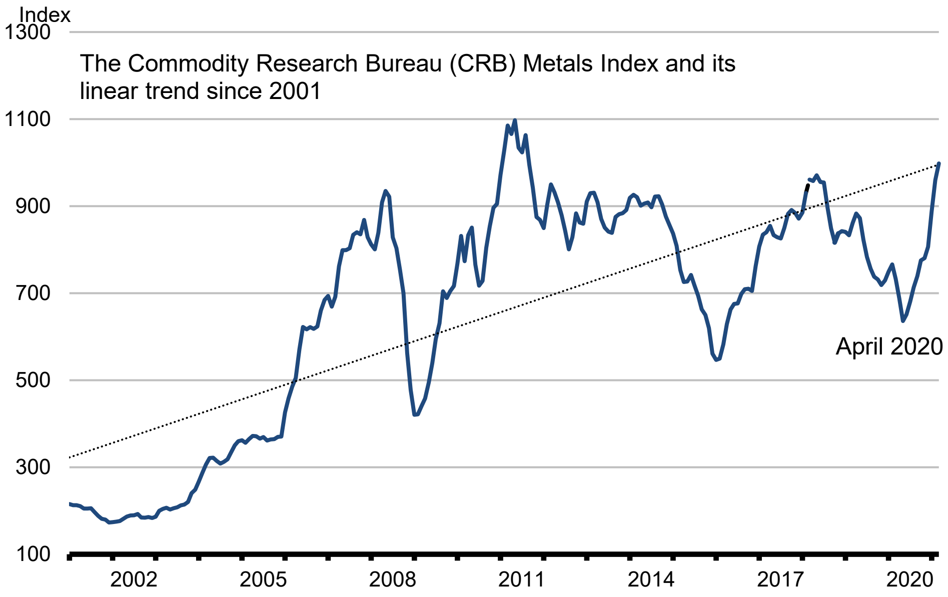
that couldn't be brought under control without major damage to the economy and labor market.

While the inflation outcome this time around remains to be seen, as we have expected since the $2.2 trillion Coronavirus Aid, Relief, and Economic Security Act ("CARES Act") of March 2020 and aggressive Fed stimulus opened the floodgates of liquidity, assets that benefit from faster growth and inflation have outperformed. From crude oil to Treasury Inflation-Protected Securities (TIPS) and small-caps, and from real estate to base metals and commodity currencies, demand for reflation beneficiaries has surged. What's more, in our view, conditions remain favorable for reflation trades for a number of reasons, all tracing back to the unusually lax liquidity environment:

- Inflation is a lagging indicator and is likely to move up as the deflationary coronavirus effects dissipate and the money-supply surge percolates the economy.
- The surge in money supply implies easy credit, low interest costs, high savings and rising asset prices, which reduces pressure on financially strained entities, containing credit defaults. Indeed, despite the still-raging pandemic, the biggest increase in money supply since World War II (WWII) has been accompanied by unusually strong demand for high-yield debt, fresh lows in high-yield interest rates, and very narrow credit spreads.
- Large-caps initially outperformed in the pandemic because of expectations for outsized credit defaults, which never materialized. As these expectations unwound with the surge in liquidity, small caps started to outperform large-caps, as they typically do in these circumstances. The new administration's promise for massive extra government spending further enhanced their relative appeal. Looked at through this lens, there is nothing unusual about the small-cap outperformance of recent months. In fact, money and credit conditions suggest their outperformance may not be over, notwithstanding temporary corrections. Given the lags involved, the money-supply infusion and narrowing high-yield spreads to date suggest new lows in loan charge-off rates and additional easing of lending conditions. For example, while the Fed's survey of senior bank lending officers showed a big credit tightening campaign early in the pandemic, it quickly reversed course by the end of 2020 and appears poised to ease considerably more in coming quarters. Based on past correlations, this environment is consistent with above-average gains in equity prices, especially small-caps.
- As we discussed in past reports, a lack of real-time demand-and-supply data and uncertainty about the direction of the dollar make commodity prices difficult to predict. However, commodities tend to outperform early in economic expansions, so their sharp upturn over the past year has been an indication that ultra-aggressive monetary and fiscal stimulus worked to shorten the pandemic recession and to reflate the economy.
- Impending massive new U.S. fiscal injections and Fed Chair Powell's avowed determination to provide unlimited liquidity (until inflation averages above the 2% Fed target for an unspecified period of time and job-market slack is fully absorbed) imply continued economic growth, rising demand for commodities, a dollar downtrend and higher inflation, all favorable for commodities and other reflation beneficiaries.
- This view is supported by the strong outperformance of base metals into 2021, for example. As shown in Exhibit 1, metal prices have quickly returned to trend following a moderate drop early in the pandemic and are likely to soon match their 2011 peak.

Exhibit 1: Rally In Base Metals Reflects Reflation Success And Is Unlikely To Stop Before New Highs.



Source: CRB. Data as of February 15, 2021. Past performance is no guarantee of future results.

- In our view, a sustained commodity price uptrend is likely not only because of the newfound government tolerance for ultra-liquidity, but also because energy represents a major input in the supply of most commodities. A return to higher oil prices solidifies the commodity reflation trend. Crude oil and related stocks are highly sensitive to global growth, liquidity conditions and changes in the dollar, so it is not surprising that these assets have significantly outperformed in the current reflationary environment after three years of underperformance. Also, with U.S. government policy now frowning upon fossil-fuels production despite vast available domestic resources, the oil market has started to price in the risk of renewed global supply constraints, higher production costs and larger risk premia related to security of supply concerns. In turn, the high sensitivity of energy stocks to oil-price changes has created big pressure to increase energy-sector portfolio allocations from rock-bottom levels, spurring their swing from the worst performing over the last three years to the top performing S&P 500 sector year to date. The sharp reversal in oil-price sentiment has also created an opportunity for a squeeze on short sellers of energy shares, reinforcing the sector's outperformance, as has frigid weather in the U.S. and Europe.

- With corporate revenues, import prices, crude oil and other commodity prices inversely correlated with the dollar, the greenback's depreciation since its April 2020 peak has been an important channel through which the money-supply surge has benefited reflation assets. In fact, the debate about inflation and relative asset performance in large part boils down to the view about the direction of the dollar, which is typically most difficult to predict and thus accounts for most of the surprises in consensus forecasts. However, for a number of reasons, we anticipate additional dollar softening ahead, which would act as a continued direct tailwind for commodity prices and other reflation assets, such as TIPS. These include: (1) the dollar tends to inversely correlate with changes in relative money supply and inflation across countries. This makes sense, since the value of a currency boils down to relative money supply, which has rarely been as large in the U.S. as over the past year, both compared to historical experience and compared to other developed countries, suggesting continued dollar depreciation ahead; (2) the dollar tends to depreciate when risk aversion drops, as has been the case since the beginning of the global rebound out of the pandemic trough nine months ago; (3) in our view, lagged dollar-depreciation effects from the widening trade deficits of the past eight years are likely to weigh on the greenback. The surge in U.S. consumer spending since March 2020 has widened the trade deficit massively, and this is likely to persist given outsized consumer outlays anticipated as the pandemic gets under control. A rising oil-price trend and restrained U.S. oil production and exports would also contribute to growing trade deficits and downward pressure on the dollar; and (4) the dollar has been retracing its coronavirus appreciation and appears close to neutral when measured by the real trade-weighted U.S. dollar index (which adjusts for relative inflation). However, this index tends to move over long cycles from overvalued to neutral and then into undervalued territory, so its slightly-above-average current level leaves room for continued depreciation.

- Inflation is also likely to be boosted by disincentives to work due to unusually large government transfers, which are likely to depress labor-force participation precisely when consumption has the potential to surge the most since WWII once the pandemic gets under control by expanding vaccinations.
- Gold underperformance does not invalidate our expectations for a rising inflation trend and additional reflation asset outperformance. Gold has remained on an uptrend for two decades, with periods of big over- and undershooting depending on global economic conditions, interest rates, the dollar and risk appetite. For example, its peak of $2,067/oz on August 6, 2020, was about 20% above its extended 2001-2018 trend line. Extrapolating this trend to 2023 indicates prices around $1,900/oz two years out. While worries over rapid money-supply growth and further likely dollar depreciation could continue to keep gold prices close to trend for the foreseeable future, receding concern of eurozone disintegration (given pan-European policies in support of the currency bloc) and less demand to hedge given declining economic policy uncertainty and coronavirus-related risks are likely to restrain its relative performance against other reflation assets, in our view. Still, while gold may disappoint for a while, it will most likely make up for lost ground, as it always does.

GLOBAL MARKET VIEW

Cash Buildup And Deployment For U.S. Corporations

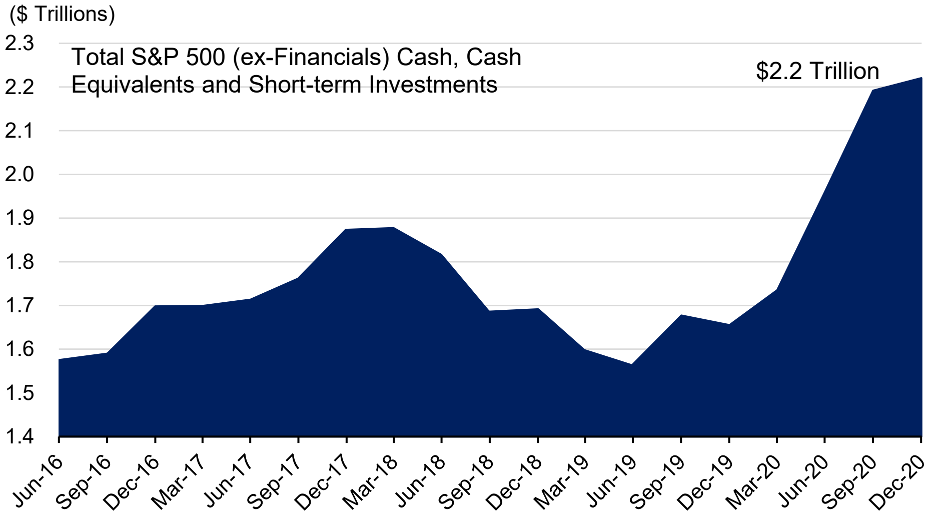
Nick Giorgi, CFA®, Director and Investment Strategist

Kirsten Cabacungan, Assistant Vice President and Investment Strategist

Remarkably, many U.S. companies have built up a rather large cash mountain despite the pandemic. Rather than widespread solvency issues resulting from economic shutdowns, corporations on aggregate entered the New Year well supported. Total cash holdings and short-term investments sitting on corporate balance sheets for many S&P 500 companies, excluding Financials, grew to as high as $2.2 trillion recently (Exhibit 2), with the Technology and Industrial sectors holding the largest share of the cash pile.

In March and April of last year, economic shutdowns initially propelled companies to focus on building up cash as a precaution on economic uncertainty at that time. Liquidity dried up as capital market turmoil increased, and credit spreads widened out to levels not seen since the Great Financial Crisis (GFC). The Fed quickly moved to backstop funding markets by cutting interest rates to near zero last year and announcing large-scale bond buying programs that helped to shore up confidence in the markets. Credit spreads thereafter quickly recovered much of their widening, and investor confidence was restored before the Fed even made any asset purchases. Debt issuance briskly picked up as companies looked to take advantage of low borrowing costs and renewed investor demand to help replace lost earnings as a result of the shutdowns and to bolster their balance sheets.

Exhibit 2: Many U.S. Companies Quickly Increased Their Cash Holdings.



Source: Bloomberg. Data as of February 18, 2021. Past performance is no guarantee of future results.

Companies have remained conservative with their cash deployment, keeping their balance sheets flush as they continue to monitor the economic recovery, but there are some signs of the purse strings loosening. With the distribution of coronavirus vaccines, additional fiscal stimulus, and accommodative monetary policy and pent-up consumer demand supporting profit margins and cash flows, and the time might be right for companies to normalize or increase the usages of their cash.

Capital expenditures (CapEx) should be a beneficiary

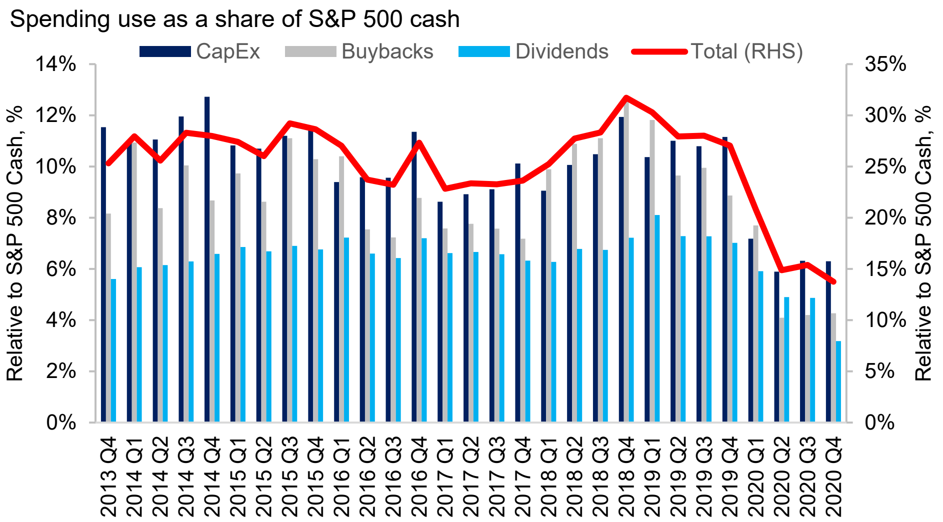
From an investor perspective, higher CapEx would signal better growth prospects at the company level and higher productivity at the macro level. Business investment for the S&P 500 wasn't spared from last year's pandemic fallout, and data from Bloomberg suggests an approximate 12% year-over-year decrease from 2019 expenditures of $765 billion. CapEx had been enjoying much stronger growth since 2018 as a result of favorable expensing policy within the Tax Cuts and Jobs Act (TCJA) so there's reason to believe that a continuation of those stronger trend levels could re-emerge as corporations gain solid footing. We find the endogenous factors that drive business spending to be mostly supportive going forward, with secular tailwinds from the continued transition to the new and more digitized economy. Financials, Energy and Real Estate sectors saw especially deep cuts last year but could be significant movers in a "CapEx catch-up phase," while the Technology and Communication Services sectors grew their investment last year. As suppliers of the investment, Technology and Industrial capital goods companies could benefit from corporate cash being put to work through capital expenditures.

Shareholder returns should rise

While companies were quick to lever up during the pandemic in response to record low rates and the desire to bolster liquidity, they were also quick to taper their pace of buybacks (Exhibit 3). As opposed to dividends, which tend to be treated in a more programmatic manner, and CapEx, which generally is longer term in focus, buybacks are amongst the quickest programs for management to suspend, which they did in earnest. Buybacks for many S&P 500 companies hit their high-water mark in 2018 at $751 billion following the TCJA. However, net share repurchases plunged 41% from that level in 2020, to an estimated $444 billion, according to Evercore ISI Research. There are green shoots for renewed activity as the economy begins its journey toward normalization, and the pace of buybacks has recovered a bit from its bottom (2Q 2020). In fact, the number of announced buybacks over the past three months is more than double the average from last April through October, according to Strategas Research Partners. But this level is still below prepandemic levels. For context, third-quarter buybacks were about 50% less than average quarterly activity before the pandemic and even 10% less than levels prior to the

TCJA. However, the same agility to cut buybacks can be used to ramp them back up. For example, many Financials voluntarily suspended buyback programs and may decide to restart them. As the sector with the second-largest repurchase footprint, that would be a significant kick-start back to a normal repurchase level which would be a support for equities.

Exhibit 3: Total "spend share" On Dividends, Buybacks, And CapEx Cratered And Could Indicate Capacity For A Bounce.



Sources: Chief Investment Office; Bloomberg. Data as of February 17, 2021. Past performance is no guarantee of future results.

Dividends, like buybacks, are welcomed by shareholders as a return of capital and could be a use for excess cash on corporate balance sheets. However, unlike buybacks and other forms of capital deployment, dividends are typically more stable. From 2010 through 2019, S&P 500 dividends grew at a stable 10% annualized rate, until the pandemic-induced dip last year. As such, an economic recovery with strengthening corporate fundamentals doesn't necessarily mean that much higher levels of dividend growth are on the way. Rather, the actual proportion of shareholder yield that is attributable to dividends has been in decline relative to buybacks. Due to the sharp reduction in net buybacks, 2020 is expected to mark only the fourth year since 2005 in which dividends paid surpassed share repurchases. That being said, for dividends paid to recover back to the average annual growth trend of 10% from prepandemic levels, it would imply an additional $136 billion paid this year on top of expected 2020 dividends of $487 billion, according to Evercore ISI Research calculations. There is the potential for companies in the Financial, Real Estate, Energy, Materials, and Industrial sectors to boost dividends as cyclically-oriented pockets of the economy improve; however, the increased market share of sectors that traditionally offer lower payouts may limit aggregate dividends paid.

Mergers & Acquisitions (M&A) should ramp higher

Some of the large corporate cash pile may be attributable to a dearth of M&A deals in 2020, as acquisition cash outlays were the second-lowest in 15 years for the S&P 500. Data from Evercore ISI Research illustrates that cash spend on acquisitions had averaged approximately $342 billion each year since 2015 and was accelerating, but last year's expenditures cratered to $151 billion. The intense freeze in M&A activity is further illustrated when viewed within the context of the broader equity market, as monthly deal value as a percentage of S&P 500 market cap was only 0.2% across the summer months. This was the lowest proportion on record dating back to 1995, according to Strategas Research Partners. However, a recent pickup in activity has also been noted. Since September, the average number of deals and transaction values has rebounded to prepandemic levels and could even reflect nascent pent-up demand for deal making. A renewed focus on growth, the need for accelerated innovation, and more stable capital markets are likely to fuel M&A outlays going forward.

Paying down debt

As interest rates have ground lower, the amount of corporate debt has risen, actually outpacing the cash buildup to a degree. Companies within the S&P 500 have borrowed at a historically brisk pace, with corporates issuing net debt of $549 billion in the four quarters through 2Q 2020, the most in 12 years, according to Ned Davis Research. Some investors have questioned whether the buildup in debt reflects overleveraging, but we don't view it as an acute risk. Coverage ratios have improved off from pandemic lows and are well within the post-GFC range. In addition, while the amount of nonfinancial corporate debt in the U.S. has grown by almost $1.7 trillion since 2015, the percentage relative to market cap has declined from 36.4% to 29.2%, according to the Federal Reserve Bank of St. Louis. For many companies, the impulse to add leverage was less about the immediate need for capital and more about the flexibility and extremely low servicing costs of it, and large aggregate cash balances support this view. We suspect that as interest rates rise and costs become a greater burden on coverage ratios, boardrooms will find the impetus to use cash buildup to pay down debt.

Conclusion

U.S. corporates should begin to deploy their cash hoards as economic growth accelerates in 2021 and 2022. In varying degrees, cash outlays could be deployed in shareholder friendly actions such as higher dividends and buybacks, paying down debt and investing for higher growth and productivity. These actions should be ultimately supportive of higher valuation levels and investor sentiment.

THOUGHT OF THE WEEK

Big Spenders: A Look At Research And Development

Lauren J. Sanfilippo, Vice President and Investment Strategist

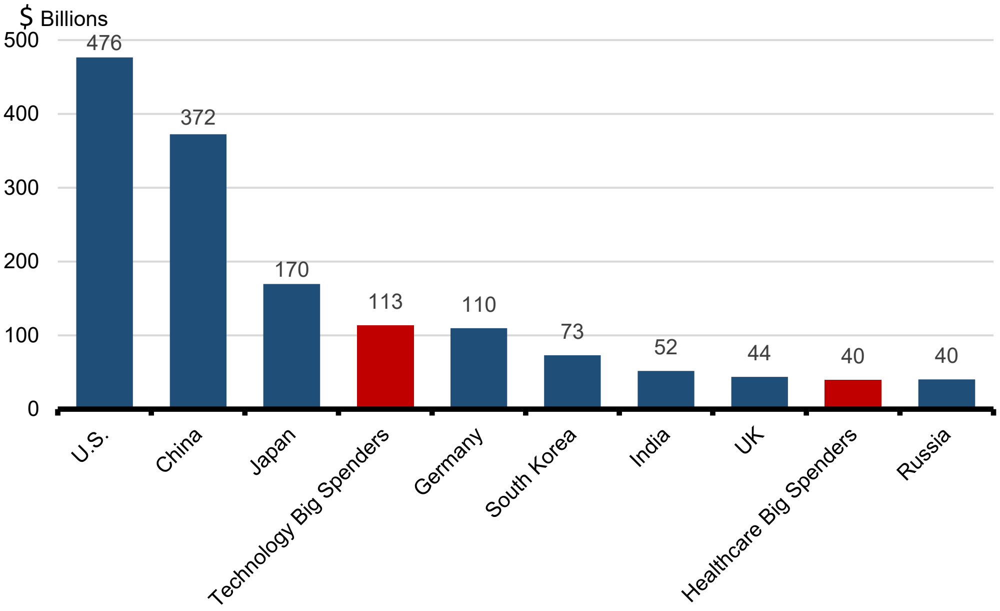
It was all downhill one year ago as the S&P 500 closed at its prepandemic high of 3,386 on February 19, 2020. What ensued was a devastating healthcare crisis, the fastest bear market in history and an epic decline in global output. One year on, the mood of the market is much different thanks to private sector innovation in coronavirus vaccine development and distribution, and generous government spending on finding a vaccine at "warp speed." With all hands on deck, pharmaceutical and biotechnology companies developed a number of vaccines to combat the coronavirus in as little as 11 months—a stunningly fast timeline. End to end, it can take years—if not decades—to develop effective vaccines, with the public-private partnership accelerating the cycle this time.

Case in point: The first two vaccines to be authorized by the Federal Drug Administration (FDA) for emergency use rely on discoveries that resulted from research funded by the U.S. government: The Messenger Ribonucleic acid (mRNA) viral protein design was developed by colleagues at the National Institutes of Health, and the RNA modification concept was first developed by researchers at the University of Pennsylvania. And to accelerate vaccine delivery, the government poured an additional $10.5 billion into vaccine companies since the onset of the pandemic.[1] Evidently, the public-private sector partnership has been a key ingredient to vaccine development and afforded the U.S. a brighter outlook.

[1] See Scientific American, "For Billion-Dollar COVID Vaccines, Basic Government-funded Science Laid the Groundwork", November 2020.

When it comes to research and development (R&D) spending, the U.S. business sector helps to drive investments in innovation, contributing almost three-fourths of total R&D. Some of the most innovative companies in the world, with the deepest pockets, are technology companies with R&D budgets that rival small countries. FAAMG[2] as a technology aggregate ranks just above Germany in R&D spending, while healthcare companies spend an amount on par with Russia. With vaccine development epitomizing the importance of innovation, from an investment standpoint we continue to be overweight both the Technology and Healthcare sectors, which include many leaders in R&D.

Exhibit 4: R&D's Country And Company Big Spenders.



Technology big spenders = Facebook, Apple, Amazon, Microsoft, Alphabet (Google); Healthcare big spenders = Eli Lilly, Merck, Pfizer, Abbvie, Bristol Myers. Sources: UNESCO; Bloomberg; company reports. Data as of December 2020.

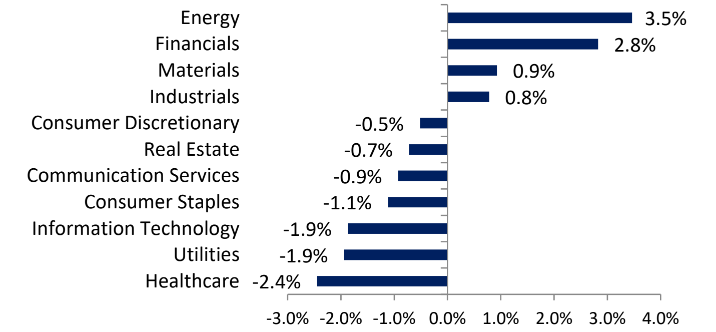
[2] FAAMG: Facebook, Apple, Amazon, Microsoft, Alphabet (Google) aggregate.

MARKETS IN REVIEW

Equities

		Total Return in USD (%)		
	Current	WTD	MTD	YTD
DJIA	31,494.32	0.2	5.2	3.2
NASDAQ	13,874.46	-1.5	6.2	7.8
S&P 500	3,906.71	-0.7	5.3	4.2
S&P 400 Mid Cap	2,535.39	-0.3	8.4	10.1
Russell 2000	2,266.69	-1.0	9.4	14.9
MSCI World	2,806.47	-0.4	5.5	4.5
MSCI EAFE	2,232.56	0.3	5.2	4.1
MSCI Emerging Markets	1,430.03	0.1	7.6	10.9

S&P 500 Sector Returns



Fixed Income[†]

	Total Return in USD (%)			
	Current	WTD	MTD	YTD
Corporate & Government	1.27	-0.72	-1.37	-2.40
Agencies	0.61	-0.28	-0.51	-0.68
Municipals	1.05	-0.77	-0.40	0.24
U.S. Investment Grade Credit	1.33	-0.57	-1.09	-1.80
International	1.97	-0.70	-1.27	-2.53
High Yield	3.99	-0.05	0.96	1.29

	Current	Prior Week End	Prior Month End	2020 Year End
90 Day Yield	0.03	0.04	0.05	0.06
2 Year Yield	0.10	0.11	0.11	0.12
10 Year Yield	1.34	1.21	1.07	0.91
30 Year Yield	2.13	2.01	1.83	1.64

Commodities & Currencies

	Total Return in USD (%)			
Commodities	Current	WTD	MTD	YTD
Bloomberg Commodity	182.12	1.5	6.5	9.3
WTI Crude $/Barrel[††]	59.24	-0.4	13.5	22.1
Gold Spot $/Ounce[††]	1784.25	-2.2	-3.4	-6.0

Currencies	Current	Prior Week End	Prior Month End	2020 Year En
EUR/USD	1.21	1.21	1.21	1.22
USD/JPY	105.45	104.94	104.68	103.25
USD/CNH	6.45	6.42	6.45	6.50

Sources: Bloomberg, Factset. Total Returns from the period of 2/16/2021 to 2/19/2021. [†]Bloomberg Barclays Indices. [††]Spot price returns. All data as of the 2/19/2021 close.

Past performance is no guarantee of future results.

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

	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*					
Hedge Funds			●		
Private Equity			●		
Real Assets					
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 2/19/2021)

	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	33.4	4.0	-3.5	5.5	6.5
CPI inflation (% y/y)	1.5	0.4	1.3	1.2	1.2	1.8	2.6
Core CPI inflation (% y/y)	2.1	1.3	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.

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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 19, 2021.

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Index Definitions

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

S&P 500 Index includes a representative sample of 500 leading companies in leading industries of the U.S. economy. Although the index focuses on the large-cap segment of the market, with approximately 75% coverage of U.S. equities, it is also an ideal proxy for the total market.

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

Real Trade-weighted US **Dollar Index** is a measure of the value of the United States **dollar** relative to other world currencies.

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Asset allocation, diversification and rebalancing do not ensure a profit or protect against loss in declining markets.

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