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CHIEF INVESTMENT OFFICE

Capital Market Outlook

February 24, 2020

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

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- **Macro Strategy**—The deflationary shock from the Wuhan Coronavirus scare has sent 30-year Treasury yields to the lowest levels on record. The yield spread between the Federal Reserve's (Fed's) policy rate and the 10-year Treasury note has turned negative again, a clear sign that inflation pressures are headed lower. Is "Japanification" headed for the U.S.?
- **Global Market View**—Owing to the Coronavirus, global policy makers have adopted a double-barreled response, leveraging both monetary and fiscal policies. The slowdown in China is expected to be steep but short and the recovery V-shaped. What is the next big worry?
- **Thought of the Week**—Given Europe's tepid risk-taking culture and underdeveloped venture capital markets, the European Union woefully continues to lag the U.S. and Asia.
- **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 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

Chief Investment Office Macro Strategy Team

GLOBAL MARKET VIEW

Joseph P. Quinlan
Managing Director and
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THOUGHT OF THE WEEK

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

Data as of 2/24/2020 and subject to change.

MACRO STRATEGY

Can the U.S. avoid "Japanification"?

Chief Investment Office Macro Strategy Team

Up until about 1990, Japan was the envy of the world. Books extolling the virtues of industrial policies compared to the limitations of U.S.-style capitalism were all the rage. At the peak of this "Japan will certainly take over the world" craze, eight of the world's top-ten companies by market capitalization were in Japan (Exhibit 1). Today, there are none.

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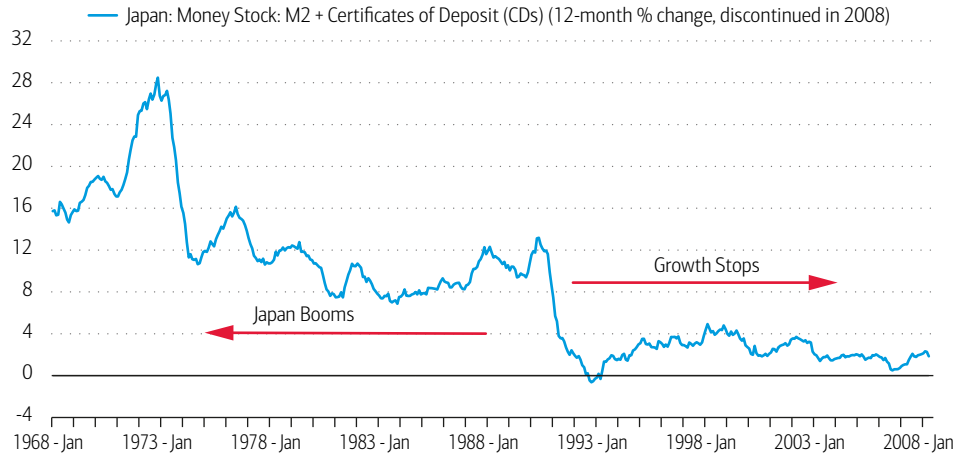
Exhibit 1: Comparing Top-ten Market Caps.

	1990		2020
Japan	NTT	U.S.	Microsoft
Japan	Bank of Tokyo Mitsubishi	U.S.	Apple
Japan	Industrial Bank of Japan	U.S.	Amazon
Japan	Sumitomo Mitsui Banking	U.S.	Google
Japan	Toyota Motors	U.S.	Facebook
Japan	Fuji Bank	China	Alibaba
Japan	Dai Ichi Kangyo Bank	China	Tencent Hldgs
U.S.	IBM	U.S.	Johnson & Johnson
Japan	UFJ Bank	U.S.	JP Morgan
U.S.	Exxon	U.S.	Exxon

Source: Gavekal Research as of February 2020.

Starting in 1990, Japanese money-supply growth collapsed from the roughly double-digit pace of the prior decades to barely positive levels for the next thirty years (Exhibit 2). For those familiar with Milton Friedman and Anna Schwartz's *Monetary History of the U.S.*, the results were predictable. Nominal gross domestic product (GDP) in Japan stopped growing. From 1993 to 2013, nominal GDP averaged a zero growth rate. The financial system adjusted to this environment. Interest rates fell to zero and eventually went negative. With the advent of Abenomics in 2013, more proactive monetary policy has lifted nominal growth into the one-to-two percent range. Unfortunately, an ill-timed value added tax (VAT) hike in October 2019 seems to have pushed the economy back into recession.

Exhibit 2: The Collapse of Money-Supply Growth Ended Japan's Growth.



Sources: Bank of Japan; Haver Analytics. Data pulled as of February 15, 2020.

The massive deflation of Japan's financial structure over the past thirty years has been followed to some degree by interest rates in the Eurozone, where negative, or barely positive, rates are now the norm. While it's common to hear central banks being accused of reckless money printing, the fact is both the Bank of Japan (BOJ) and the European Central Bank (ECB) have restrained money growth to historically low rates that are insufficient to meet their inflation targets. This confusion of low interest rates with easy monetary policies is a classic example of how judging the stance of monetary policy by the level of interest rates can lead to policy mistakes, in this case, overly-tight policies that cause inflation to fall short of target levels.

The U.S. has avoided the zero and negative-rate trap by managing to keep inflation closer to the 2% target. Unfortunately, the deflationary shock from the Coronavirus has raised doubts about the Fed's claim that "*the current stance of monetary policy is appropriate to*

support…inflation returning to the Committee's symmetric 2% objective". Deflationary signals are coming from the decline in commodities prices, including oil, the drop in the 30-year Treasury yield to all-time lows, and the re-inversion of the yield-curve spread between the Fed funds rate and the 10-year Treasury note yield. The renewed strengthening of the dollar is also symptomatic of a deflationary shock. All these signals suggest that the Fed will need to cut its policy rate if it wants to "return" the inflation rate back to its target. Furthermore, a rate cut would be consistent with Mr. Powell's messaging that "*a material reassessment of the outlook*" would prompt a policy response. The Coronavirus is causing such a reassessment, as the spreading deflationary signals illustrate.

Critics of an easing move like to focus on the relative health of the U.S. economy, with a strong labor market, and high business and consumer confidence. What this misses, and the reason why global central banks have fallen short of their inflation targets, is a false theory of inflation based on real variables, like unemployment, instead of money-supply growth. The Fed's misconception about the impact of quantitative tightening in 2018 illustrates this error.

In the *Monetary History of the U.S.*, Friedman and Schwartz illustrate the concepts that business cycles are driven by accelerations and decelerations in money-supply growth. As Exhibit 2 illustrates, the mother of all monetary-growth decelerations accompanied the massive deflation of the Japanese financial structure after 1990. A more cyclical, less structural policy-tightening shift occurred in the U.S. between 2017 and 2018, putting the U.S. economy back into the deflationary danger zone that the Coronavirus has exacerbated. As the Fed raised interest rates 200 basis points and shrank the monetary base between 2017 and 2018, M2 money-supply growth decelerated from about 8% to about 3%. The lagged effects of this tightening are apparent in the sharp slowing of nominal GDP growth over the past year, from about 6% in early 2018 to about 3% by late 2019. This contradicts the Fed's view that inflation is moving back toward target. In fact, the latest University of Michigan survey of consumer inflation expectations finds the lowest 5-to-10-year forward inflation outlook in the survey's history. The trend of this inflation expectation metric has been declining since 1990.

To avoid falling in the deflationary zero-rate trap, the Fed will need to be more proactive. Hopefully, its mid-year release of policy recommendations to better achieve its inflation mandate will include credible measures to lift inflation and inflation expectations back up to its target rate. Current market signals and past performance have left major central banks without much credibility in this regard.

It is common for monetary policy discussions to focus on real growth rather than inflation because economists, and others, naturally assume a healthy real-growth rate will be associated with adequate pricing power. However, there are strong forces for deflation in the current economy. Information technology, which constitutes an increasing share of economic growth, is deflationary. An aging population also tends to be a deflationary force. Adding to the difficulty of creating target-level inflation is the unusually high debt burden accumulated in modern economies. To offset these strong deflationary forces, monetary policy has to work harder, that is, interest rates must stay lower than under prior conditions even when growth may otherwise appear robust. Experience shows that premature monetary-policy tightening in response to bursts of strengthening real growth has precluded inflation from reaching its target on a sustained basis.

Prior to World War II, frequent recessions, depressions and deflation served the purpose of forcing debt liquidation and preventing secular trends of increasing leverage such as that which has characterized the past 70 years. Debt and leverage have moved cumulatively higher since 1950, although banks and households have deleveraged during this expansion because leverage became unsustainable by 2006. When private-sector leverage becomes a barrier to money and credit growth, government spending or tax cuts need to fill the demand void. That is why the case for central-bank monetization of government debt is increasingly entering the political and economic policy debate, as we have seen with the increased attention being paid to Modern Monetary Theory proposals.

However it is achieved, there is always a level of money-supply growth that can create a target rate of inflation. After all, inflation is "*too much money chasing too few goods.*" The failure of major central banks to hit their inflation targets for so long that inflation expectations have sunk well below target levels is prima facie evidence that not enough money is chasing the goods that the world economy has the capacity to produce. The latest Coronavirus-related deflationary market signals are clear signs that central banks, including the Fed, need to step up their game if they want to restore their inflation managing credibility. The Fed is the last major central bank to avoid the zero-rate trap that comes with "Japanification." A lot is riding on its long effort to find ways to better and "resoundingly" achieve a symmetric 2% inflation target. If it moves money-supply growth more explicitly into its operating framework, that could likely be a step in the right direction. Unfortunately, academic resistance to that approach has become a formidable barrier to central banks' success. Avoiding Japanification in the U.S. hinges on breaking down the intellectual barriers to what really causes inflation.

GLOBAL MARKET VIEW

It's the Virus vs. the Policy Makers

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

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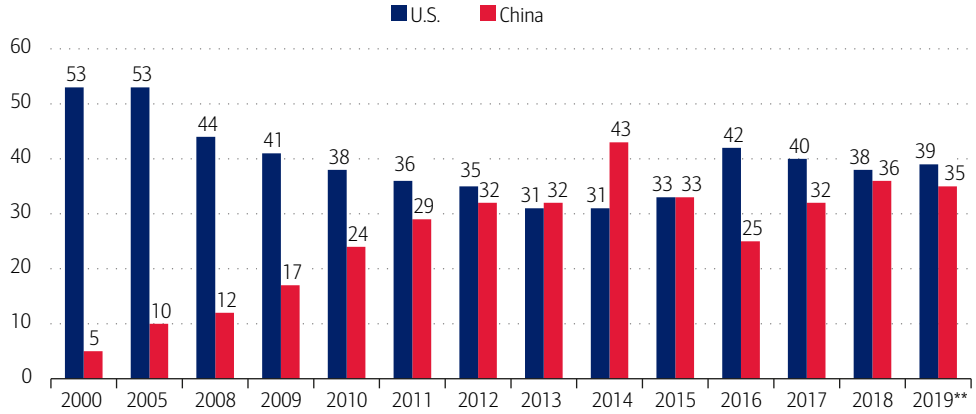
The U.S. government debt downgrade in 2011, the European debt crisis in 2012, the China currency scare in mid-2015, Brexit in June 2016, Donald Trump's election in November 2016, excessive Fed tightening in 2018, the U.S.-Sino trade war in 2019 and now the outbreak of the Coronavirus in China in 2020—pick your fear, as one of the longest bull markets in history rumbles on, there's always been something to worry about, which helps explain why investors have generally preferred bonds to equities over the past decade.

However, the strategy of "better to be safe than sorry" has cost many investors dearly. To wit, the MSCI All Country World equity benchmark in the 2010s yielded annualized total returns of 9.4% versus 2.5% returns of the Barclays Global Aggregate Fixed Income Index—even better are total returns from the S&P 500 over 2010-2019 of 13.5%.

The most recent worry for investors is the Coronavirus in China and the collateral damage to not only the world's second largest economy but also the global economy. As Exhibit 3 highlights, what happens in China doesn't stay in China. Some 35 nations now count China as their number one export market versus just five at the start of the century. Whereas the United States used to be the engine of global trade, today it's the U.S. and China that pull along the rest of the world. They are the co-managers of global trade.

Exhibit 3: Trading Places? Countries with U.S. & China as Top Export Partner.*



*Excludes Taiwan. **Data through October 2019. Source: International Monetary Fund.

Under current Chinese circumstances, global supply chains have been disrupted, a key source of global demand (the Chinese consumer) has been throttled, and multiple global sectors (tourism, transportation, automobiles, electronics, to name a few) have felt the ill effects of the Coronavirus. China is in the midst of one of the most pronounced slowdowns in decades. As evidence, auto sales in the world's largest car market plunged 92% in the first half of February.[1] And per trade, the first signs of damage are filtering in, with South Korea's exports to China down nearly 14% in the first 20 days of February; Korean imports from China imploded over the same period, plunging by 46% from the same period a year ago.

When you combine China's challenges with the the fact that Japan is on the brink of recession, and the Eurozone, per usual, is flat-lining, and one can understand the more "risk-off" mentality of some investors versus "risk-on". Investors fear the global economic recovery may be fading. It's not. It has lost momentum, for sure. But while the Coronavirus represents a stiff headwind to global growth, the global reflationary efforts of central banks and governments will ultimately prevail. The question is when.

China's unexpected slowdown has only added to the vigilance of world's central banks to stand ready to ease monetary policies yet again. In turn, ultra-low interest rates have embolden governments around the world to load up on more debt and to borrow more credit at rock bottom rates.

Missing from the debate over the threat of the Coronavirus is the fact that global policy makers are firing from both barrels of the gun by leveraging monetary and fiscal policies to promote growth. Japan, for example, recently announced a $120 billion fiscal stimulus package, while the European Union (EU) has embraced more fiscal leniency among member states in support of greater growth. Even Germany has come around to the fact that the nation—with one of the largest pools of savings in the world—needs to spend more and save less. China, meanwhile, is in the mode of "whatever it takes" when it comes to stimulating the economy. And watch for Chinese consumers to step up consumption with a vengeance later this year, adding even more vigor to the China growth rebound. The prevailing market view is that the slowdown in China will be steep but short and the recovery V-shaped.

Against this backdrop, our portfolio strategy remains unchanged: We expect equities to outperform fixed income, with a preference for U.S. large-cap equities relative to the developed markets and emerging markets (EM). Backed by an accommodating Fed, an uptick in year-over-year earnings growth, and an improving global growth backdrop as the year progresses, signals U.S. equities are poised for mid-single-digit returns in 2020, or a reversion to the mean after the outsized gains of 2019. That said, we are monitoring the recent strength of the U.S. dollar, with the greenback becoming the safe haven currency of choice; the U.S. dollar has risen by more than 3% against the euro and yen, respectively, since the start of the year, and has pushed higher against a number of emerging market currencies. We maintain a slight underweight allocation to international developed and are neutral EM equities.

Supportive of our view on U.S. equities is the fact that the U.S. economy is the most dynamic, competitive and resilient on planet Earth, bar none—including China. No nation produces as much output in a year ($22 trillion), with a fraction of the world's population (4.5%), than the United States. No nation consumes as much, with the U.S. consumer an economy unto itself, as U.S. personal consumption expenditures of $14 trillion in 2019 were in excess of China's total output, according to the United Nations. And no economy is as diversified: The United States is a hydra-headed superpower, a global leader in agriculture and aerospace, education and energy, banking and brands, computing and cybersecurity, and defense and the dollar.

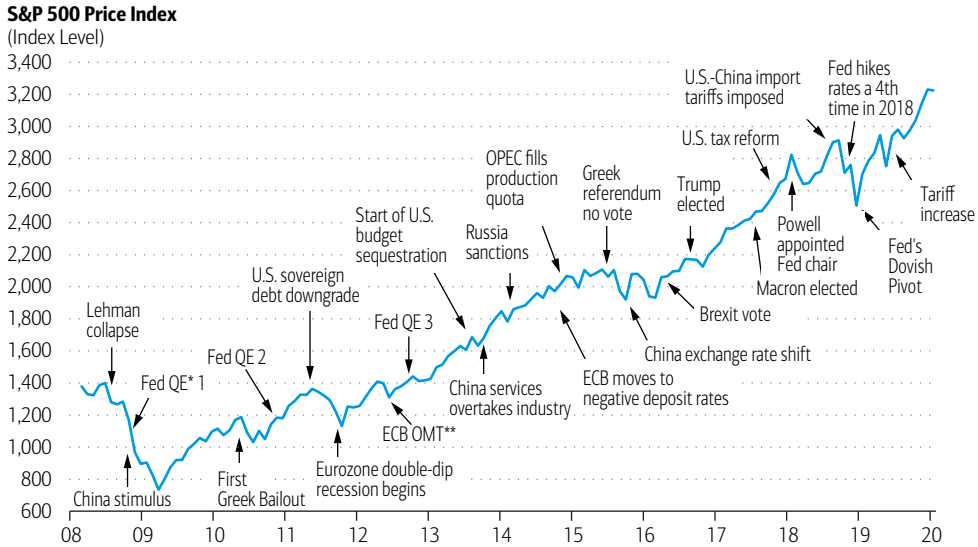
[1] See "*Coronavirus: Car sales in China fall 92% in February*," February 21, 2020, The BBC News.

That's not to say all is perfect in the state of the union—it's not. Nearly 40 million Americans live in poverty. The number of Americans without health insurance rose to 27.5 million in 2018, according to the federal government. There are around 553,000 people on any given night in the U.S. homeless.[2] Roughly 7 million school-age children in the U.S. live in households without the internet. And the high school graduation rate, while trending higher, is just 85%.[3] Across Asia, the comparable rate is closer to 99%. The physical and human infrastructure of the United States, in other words, needs some fixing.

In addition, all of the above runs counter to the current market narrative that the U.S. economy is strong and most policies are viewed favorably. But the fact that a significant swath of America doesn't own a house, doesn't have health insurance, doesn't have access to the internet, and lacks a retirement account and the means to attend college challenges the incumbent side of the political equation.

The Coronavirus remains a clear and present danger to the financial markets, although the markets will increasingly start to focus on the presidential election, adding volatility and uncertainty to future growth and earnings expectations. In the end, despite several growth scares and financial shocks over the past decade, U.S. equities have proved resilient (Exhibit 4), sending a signal to investors: It rarely pays to bet against the U.S. economy.

Exhibit 4: The Long Road Back from 2008.



*Quantitative Easing. **Outright Monetary Transactions. Source: Bloomberg. Data as of February 2019.

That said, investors should not lose sight of either the cyclical tailwinds at play or a number of secular, long-term global themes that may potentially offer solid returns. To highlight a few: Global health care expenditures are rising as the world's population ages and demands more medical goods and services. As an aside, the outbreak of the Coronavirus will refocus attention among Asian states on greater expenditures on healthcare. Investment in automation and advance robotics/artificial intelligence is just ramping up and promises potential investment opportunities for investors. Ditto for cybersecurity expenditures, waste management and renewable energy sources. Finally, the EM consumers, notably women, are poised to drive growth in a number of sectors over the next decade, boosting the earnings of many U.S. and leading global firms.

[2] According to the National Alliance to End Homelessness.

[3] The U.S. Department of Education, National Center for Education Statistics.

The bottom line: For more than a decade, there has always been something brewing/threatening to derail the longest U.S. economic expansion in history and the bull market in U.S. equities. While recessions and bear markets have not been banished for good, we believe the risk of either in 2020 is significantly low.

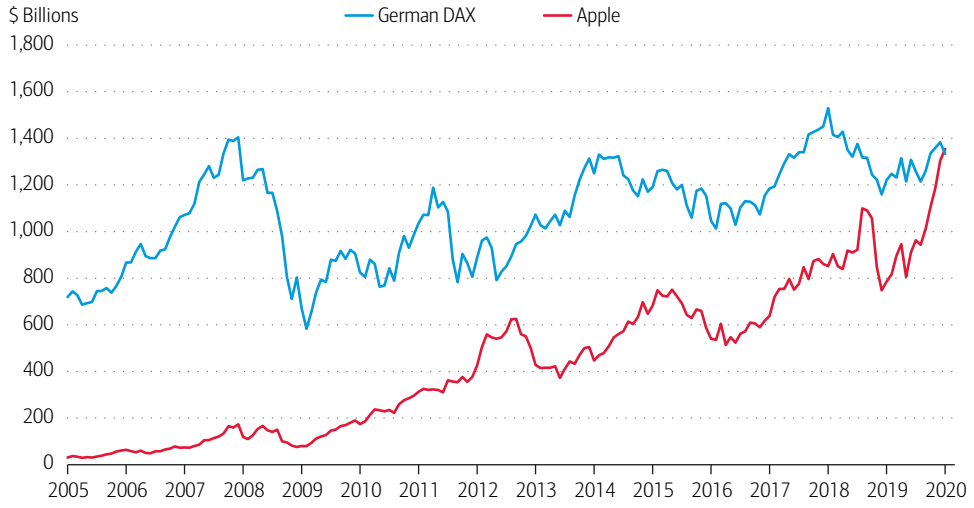
THOUGHT OF THE WEEK

The Transatlantic Digital Divide

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

It's an open secret that the European Union currently woefully lags the United States and Asia in terms of technological capabilities, but Exhibit 5 brings the point brutally home. The market capitalization of Apple is now greater than the 30 largest publicly traded, blue chip companies in Germany. Relative to the FAANGs[4] (market cap = $3.9 trillion), Germany, along with the rest of Europe for that matter, is a digital pygmy.

Exhibit 5: Comparing Market Caps: DAX vs. Apple.



Source: Bloomberg. Monthly data as of January 31, 2020. **Past performance is no guarantee of future results.**

The digital divide reflects many variables, namely Europe's tepid risk-taking culture and underdeveloped venture capital markets, which stunts the growth of startups and minimizes the chances of game-changing, technological moonshots. America's risk perceptions and preferences are more aligned with Asia than Europe. China, Japan and South Korea are formidable (and investable) technology players; the same cannot be said of Europe's largest economies like Germany, France and the United Kingdom.

Owing to Europe's underwhelming tech ecosystem, the region now finds itself technologically stuck in the middle of the great U.S.-Sino rivalry over the next generation of wireless networks. The United Kingdom has already agreed to use the equipment of Chinese telecom giant Huawei, while other countries are leaning in the same direction, against the wishes of the U.S. The end result: an even greater digital divide between the U.S. and EU, and the rising risks of transatlantic trade tensions over technology. As Exhibit 5 illustrates, the digital gap between the two parties is already extraordinarily large—and threatening to future transatlantic commerce and the earnings of both U.S. and European firms.

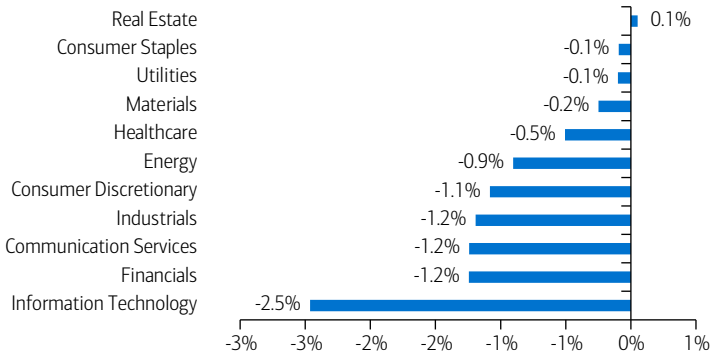
[4] Facebook, Apple, Amazon, Netflix and Google.

MARKETS IN REVIEW

Equities

		Total Return in USD (%)		
	Current	WTD	MTD	YTD
DJIA	28,992.41	-1.4	2.9	1.9
NASDAQ	9,576.59	-1.6	4.8	6.9
S&P 500	3,337.75	-1.2	3.6	3.6
S&P 400 Mid Cap	2,084.33	-0.6	3.9	1.2
Russell 2000	1,678.61	-0.5	4.1	0.7
MSCI World	2,402.80	-1.1	2.7	2.1
MSCI EAFE	2,002.86	-1.2	0.6	-1.5
MSCI Emerging Markets	1,084.22	-2.0	2.1	-2.6

S&P 500 Sector Returns



Fixed Income[1]

		Total Return in USD (%)		
	Current	WTD	MTD	YTD
Corporate & Government	1.89	0.7	0.6	3.0
Agencies	1.61	0.4	0.3	1.8
Municipals	1.40	0.6	0.5	2.3
U.S. Investment Grade Credit	1.97	0.6	0.5	2.5
International	2.52	0.6	0.8	3.2
High Yield	5.16	0.1	1.2	1.2

	Current	Prior Week End	Prior Month End	2019 Year End
90 Day Yield	1.52	1.53	1.50	1.49
2 Year Yield	1.35	1.43	1.31	1.57
10 Year Yield	1.47	1.58	1.51	1.92
30 Year Yield	1.91	2.04	2.00	2.39

Commodities & Currencies

		Total Return in USD (%)		
Commodities	Current	WTD	MTD	YTD
Bloomberg Commodity	162.51	1.2	2.0	-5.5
WTI Crude $/Barrel[2]	53.38	2.6	3.5	-12.6
Gold Spot $/Ounce[2]	1,643.41	3.7	3.4	8.3

Currencies	Current	Prior Week End	Prior Month End	2019 Year End
EUR/USD	1.08	1.08	1.11	1.12
USD/JPY	111.61	109.78	108.35	108.61
USD/CNH	7.04	6.99	7.00	6.96

Source: Bloomberg, Factset.Total Returns from the period of 02/17/20 to 02/21/20. Bloomberg Barclays Indices.[1] Spot price returns.[2] All data as of the 02/21/20 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 02/21/20)

	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	2.0
Core CPI inflation (% y/y)	2.1	2.3	2.3	2.2	2.3	2.3
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 21, 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.

Barclays Capital Global Aggregate Bond Index is a market-weighted index of global government, government-related agencies, corporate and securitized fixed-income investments.

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

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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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