CHIEF INVESTMENT OFFICE

Capital Market Outlook

March 1, 2021

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

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- Macro Strategy—Japanese equities have quietly outperformed most international equity markets for the last eight years. The V-shaped global expansion, driven by the U.S. and China, should be a strong tailwind for potential continued strength. Even as the major indices continue to make new highs, valuations remain relatively attractive. We think investors should consider strategic exposure.
- Global Market View— As we make progress in coronavirus vaccinations and the economy continues to reopen, this can help to drive future earnings growth and additional equity market rotations into cyclical sectors like Financials, Materials, Industrials and Energy. It may be a "sell the news" Q4 earnings season, but we are likely in the early stages of a new profit cycle and that supports our positive view on equities.
- Thought of the Week—Investors are beginning to evaluate whether higher and steeper yields, given the building narrative concerning inflation and rising growth expectations, might impede the attractiveness of stocks. Looking throughout recent history, we find that U.S. equities have rallied through rising rate cycles and believe that valuations don't depend exclusively on directional moves in rates.
- 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

Jonathan W. Kozy
Managing Director and
Senior Macro Strategy Analyst

GLOBAL MARKET VIEW

Brian Daley
Managing Director and
Head of Equity Strategy

THOUGHT OF THE WEEK

Nick Giorgi, CFA®
Director and Investment Strategist

Data as of 3/01/2021, and subject to change

MACRO STRATEGY

Japanese Equities: Unloved and Under-owned

Jonathan W. Kozy, Managing Director and Senior Macro Strategy Analyst

Unbeknownst to many investors, Japanese equities have solidly outperformed most markets except the U.S. since former prime minister Shinzo Abe's "Abenomics" was introduced in December 2012. The MSCI Japan Index has returned over 10% per year, versus around 7% annualized for MSCI Europe and MSCI Emerging Markets indexes over that same time period.[1] Broad Japanese equity indexes have broken out to the highest level in over 30 years. Importantly, the key forces driving Japanese equity outperformance versus international equities have survived the transition from Shinzo Abe's "Abenomics"

[1] Source: Bloomberg data December 2012 to February 19, 2021. U.S. Dollar Terms.

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to Yoshihide Suga's "Suganomics," and valuations are still reasonable. Investors who have missed the ride should consider strategic asset allocation exposure.

The V-shaped global expansion, driven by the U.S. and China, should be a strong tailwind for potential continued strength in Japanese equities. Profits growth in Japan is tightly tied to global growth with more than half of revenues of Japanese companies derived from outside Japan, according to Gavekal Research. While the level of real gross domestic product (GDP) in Japan remains below the pre-coronavirus high, both profits and real exports have already made new highs, reflecting the strength of the global expansion and the ability of Japanese companies to leverage it. Importantly, global leading indicators continue to point toward strong global growth. In the U.S., for example, the Leading Economic Index (LEI) registered an above-consensus 0.5% gain in January and points to strong growth through year-end. The yield curve is a key component and is currently steepening, a positive signal that foreign demand for Japanese goods has the potential to remain robust.

Like in the U.S., aggressive stimulus is a near-term tailwind and is more aggressive than in Europe. Money supply (M2) is up 9.4% year-over-year (YoY) and fiscal stimulus is helping to keep corporate bankruptcies near record lows.[2] The Bank of Japan remains active in purchasing equity exchange-traded funds (ETFs) in support of its reflation goal and has the 10-year yield pinned near zero, thus limiting concerns (seen in the U.S., for example) that rising long rates may stifle growth. Fiscal stimulus has been massive and comparable to the U.S., with outlays totaling around 20% of GDP.

Given the international exposure, currency plays an important role in the outlook for economic growth and equities in Japan, and the yen remains cheap relative to longer-term purchasing power parity metrics. The yen averaged ¥100 during last decade's expansion but risk-on sentiment has weakened it to an even more competitive ¥105 more recently. If the track of U.S. yields continues to move higher as we suspect, the yen could experience further downward pressure and continue to support the already competitive export-driven equity market. It is worth noting that Japanese equities performed relatively well during the "taper tantrum" of 2013.

Japanese companies are currently flush with cash and have very strong balance sheets. Businesses have nearly $3 trillion dollars in cash, according to third-quarter national accounts data (the latest available). Corporate cash is 60% of Japan's nominal GDP, leaving plenty of room for the potential to raise dividends, repurchase shares, invest, or engage in mergers and acquisitions.

Exhibit 1: Japanese Equities Relatively Attractive Versus U.S. Equities.

Sources: Bloomberg; Morgan Stanley Capital International. Data as of February 22, 2021. Past performance is no guarantee of future results.

[2] Tokyo Chamber of Commerce and Industry as of February 22, 2021

Valuations are currently attractive on a relative basis and not overly expensive on an absolute basis. The relative price-to-book of U.S. equities versus Japanese equities is near an all-time high using MSCI All Country World Index (ACWI) equity index data (Exhibit 1). On an absolute basis, normalized price-to-economy wide operating profits are slightly above zero (the historical average), suggesting valuations are not extreme.[3] A comparable measure in the U.S. is over 2 standard deviations above normal. And Japanese equities have a dividend yield around 2%, compared to near-zero on 10-year government bonds.

A greater focus on return on equity (ROE) and other governance reforms (like independent, diverse boards) were among the more important accomplishments of the Abe administration and are likely to continue under Prime Minister Suga. Reforms and deregulation are making Japanese equities currently more attractive to activist investors, while the focus on ROE could be a catalyst for multiple expansion in the years ahead.

Geopolitically, Japan has managed to reinforce its commitment to free trade and its position as a beneficiary of global growth, even as relations sour between the U.S. and China. As a well-developed example, Japan signed on to the November 2020 Regional Comprehensive Economic Partnership (RCEP), strengthening its trade relations with China, while simultaneously maintaining security ties with the U.S. in the region through regional defense agreements and alliances. Japan was one of the biggest beneficiaries of RCEP, as it will see tariffs reduced on a significant percentage of the products it exports to China. It has also signed bilateral trade agreements with the U.S. and Australia.

Foreign investors seem not impressed, as gauged by a number of sentiment metrics, leaving lots of room for flows to pick up. Net inflows to Japanese ETFs since December 2012 are near zero, and the latest BofA Global Research Fund Manager Survey shows only a net 8% of investors are overweight Japanese equities. Long-term pessimism surrounding Japanese equities remains well entrenched and is centered around weak demographics and lower potential growth, a story for Europe also. But this misses an important feature of Japan's economy by ignoring productivity, which is relatively better than Europe's. For example. Organisation for Economic Co-operation and Development (OECD) data from 2013 through 2018 (the most recent data available) show multifactor productivity outperforming France and Italy and matching that of Germany, and labor productivity per hour worked well above the major European countries over that time period.[4] Japanese companies are also well positioned to benefit from key themes like digitalization, consumer robotics and the Internet of Things.

One risk to our positive outlook for Japanese equities is unexpected economic weakness in the U.S. or China that derails the solid global demand backdrop. Second, the surge in the global business expenditure cycle (CAPEX) that was related to the pandemic (money typically spent on services was being spent on goods) was an important tailwind for Japanese equities that could also fade as the pandemic recedes. These could lead to near-term underperformance. If inflation picks up, there is headline risk from the Bank of Japan pulling up the anchor on the 10-year yield, but this seems unlikely in the next few years. Importantly, these do not derail the more fundamental reasons Japanese equities have outperformed Europe and emerging markets over the last eight years.

[3] Applied Global Macro Research January 2021.
[4] OECD, Haver Analytics February 2021.

Sell the News: Fourth-Quarter Earnings Review

Brian Daley, Managing Director and Head of Equity Strategy

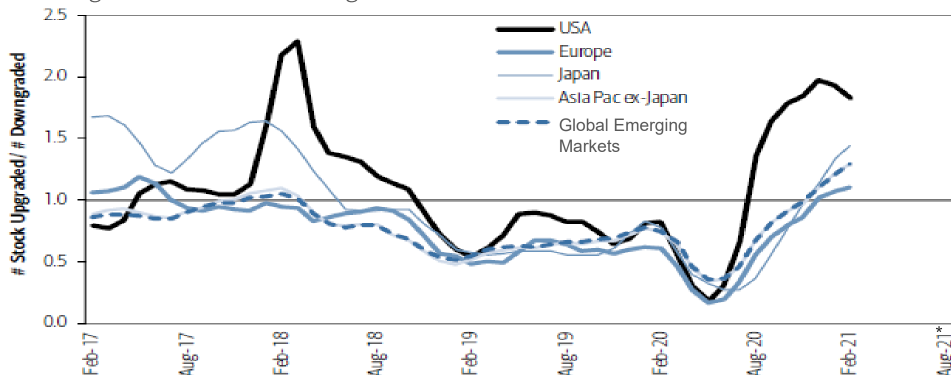
As the current earnings season winds down, the majority of S&P 500 companies reported better-than-expected fourth-quarter earnings results compared to consensus expectations, with 78% of companies beating expectations. Fourth-quarter 2020 earnings also turned positive, growing +5% for companies that reported Q4 results so far, compared to consensus estimates prior to earnings season of -9% earnings growth. However, the initial reaction for many stocks was to "sell the news" of improved earnings results, even for the companies that beat on both sales and earnings. Investors may ask why stocks underperformed after reporting better-than-expected earnings. It is important to remember the equity market is considered forward looking and discounts future earnings and cash flows ahead of actual results. The equity market as measured by the S&P 500 index discounted the improving economic and earnings environment with gains of over 20% and 11%, respectively, for the second half and fourth quarter of 2020. Arguably, the earnings improvements for Q4 were already discounted or baked into stock prices prior to this earnings season, and the market is currently consolidating the strong rally from last spring, in our opinion.

The muted reaction to Q4 earnings is not a signal that the earnings recovery is over. To the contrary, a new profit cycle recently started and can continue over the course of 2021, in our view. The Street may still be underestimating the tailwinds from the record stimulus, improving coronavirus vaccination numbers, rebound in economic data, and recovering sentiment from both consumers and corporations on the gradual reopening of the economy. Surprising many market participants, the S&P 500 experienced sequential earnings growth in Q4 for the first time since Q4 2019. In the coming quarters, earnings expectations and YoY comparisons could provide an attractive setup for additional positive earnings revisions and for earnings to potentially beat expectations given that earnings estimates were cut too drastically last year.

Furthermore, initial S&P 500 consensus earnings estimates were not only negative for Q4, but also below the weak and negative Q3'20 results. This was too bearish, and consensus earnings estimates were revised higher over the course of the fourth quarter and into 2021 as the Street and analysts realized estimates and expectations were too low (Exhibit 2). Despite earnings revision ratios (ERR) moving higher over the course of Q4, earnings are still coming in above expectations, with 79% of companies reporting upside surprises to earnings compared to a five-year average of 74% above expectations. We could see earnings revisions moderate in the short term with some market consolidation and as analysts finish updating estimates as earnings season ends. We would not view this as negative, as earnings estimates catch up to the rally in stock prices last year.

Exhibit 2: Trends In Earnings Expectations By Region.

Global Regions—3-month Earnings Revision Ratio



*=Estimate. Source: BofA Global Research, MSCI, IBES. Data as of February 24, 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.

In addition, as earnings improve off the 2020 low base, we could see elevated valuation multiples contract as the denominator in the price-to-earnings (P/E) ratio increases. In 2020, equity market gains were driven by P/E multiple expansion, but now we are in the part of the profit cycle where earnings growth would be the key driver of future equity market gains.

Cyclical and Defensive Stocks

Earnings growth surprises have come from the Financials, Technology, Healthcare, Materials and parts of the Consumer sectors. Importantly, and part of the thesis for potential upside to aggregate earnings from current levels, some cyclical industries are still experiencing negative earnings growth. As the economy reopens and reflation continues, we expect to see potentially strong improvements in revenues for commodity-related industries (Materials and Energy sectors), transportation, travel and leisure, and restaurants. We saw the consumer adapting to the pandemic in 2020 and omnichannel (in-store and online) retailers likely benefited from the acceleration in e-commerce sales. Across both Consumer Staples and Discretionary, a lack of price discounting or promotions could be additive to operating leverage and profit margins. Data on consumer disposable income, savings levels and stimulus checks remain supportive to the consumer outlook, even before considering the potential for pent-up demand in consumer activities and services. Healthcare results were better-than-expected overall, but guidance was underwhelming and probably overly cautious amid uncertainties for coronavirus vaccination timing and new policy. Potential policy changes from the Biden administration could be a near-term overhang, especially for the managed care industry. Investor focus continues to be on life sciences, tools, medical tech devices and healthcare technology (digitalization).

In general, Technology continued to benefit in Q4 from the digitalization of the economy and accelerating trends from the pandemic. Although supply chains and inventory issues in the semiconductor industry could result in some inconsistent results near term, demand for technology products remains solid. Technology was an equity market leader over recent years, but some recent profit taking on better-than-expected results could be signaling a rotation to the more cyclical areas of the market, and more cyclical areas of Technology like semiconductors and semiconductor capital equipment. Digital payment fundamentals remain strong, and the longer-term outlook for this thematic trend remains positive. Financials reported some of the largest Q4 earnings beats amid higher credit card volumes, increased capital market activity, and banks releasing some excess capital reserves, which is a trend that should continue over 2021 and be a tailwind to bank earnings.

Energy earnings are still negative YoY with realized energy prices for Q4 2020 still lower compared to Q4 2019 oil price levels, but oil and natural gas prices are currently moving higher and with significant operating leverage built into energy companies over recent years, there is considerable room for energy earnings to move higher in 2021. Similarly, Industrial stocks could see earnings improvements on the back of the global economy reopening and some Industrials with commodity exposure reported strong Q4 results. Materials experienced strong growth in Q4 earnings as volumes started to improve, consumer product demand remains firm, and rebounds in the automotive, durable goods and construction markets. Inventories are at low levels and are helping to drive improving pricing trends and margin improvement. There are some early signs of cost inflation, including logistic, energy and raw material cost inflation, but these cost increases are not large enough right now and not a large enough weight of aggregate S&P 500 earnings to derail the earnings improvement story.

The cyclical areas of the equity market could deliver operating leverage as the economy continues to open as a result of lower cost structures and more efficient operational improvements made over the last few years. Large portions of these improvements are likely driven by technology and automation. Pricing power will be watched closely to see how it offsets any future cost inflation and its effect to earnings. In addition, the reflation pressures position cyclical earnings for recovery, while defensive and bond proxy stocks may see stable to low growth in earnings. With operating leverage at some of the highest levels in the last decade, future top line sales growth will likely be a catalyst to help drive

higher earnings in coming quarters. We are not in the part of the cycle where defensive equities outperform, and equity portfolios could have a good balance of secular growth and high quality cyclical equities. As we make progress in coronavirus vaccinations and the economy continues to reopen, this can help to drive future earnings growth and additional equity market rotations into cyclical sectors like Financials, Materials, Industrials and Energy. It may be a "sell the news" Q4 earnings season, but we are in the early stages of a new profit cycle and that supports our positive view on equities.

THOUGHT OF THE WEEK

All Rise? Equities Have Gained Through Recent Episodes Of Rising Rates

Nick Giorgi, CFA®, Director and Investment Strategist

The S&P 500 hesitated last week, while Treasury yields have crept higher. The building narrative concerning inflation and rising growth expectations has contributed to a steepening of the curve, and investors are evaluating whether this might impede the relative attractiveness of stocks. In recent history, we find that U.S. equities have consistently rallied through rising rate cycles, with small-cap equities potentially benefiting, in particular. Moreover, research suggests that valuation does not always depend exclusively on directional moves in rates.

Over the past 25 years, there have been nine cycles where 10-year U.S. Treasury yields increased by 100 basis points (bps) or more. In each and every instance the move higher in yields coincided with positive total returns for both the S&P 500 and Russell 2000, with averages of 17.6% and 26%, respectively (Exhibit 3). These figures are even more impressive considering that they took place during relatively short periods—an average of just 195 trading days per episode. There has been one instance of a +2% move in the 10-year Treasury since 1996, during which the S&P 500 produced a total return of 48.7%. In fact, the last time that a rising rate cycle coincided with negative equity returns was in 1984-1985, when yields rose by 383 bps. Expanding our analysis even further into history does introduce more dramatic instances of yield spikes and a couple instances of negative equity returns, but the main tenets remain.

Exhibit 3: Equities Have Generally Done Well Through Recent Rising Rate Cycles.

	1/18/96-6/12/96	10/5/98 1/20/00	11/7/01 4/1/02	6/13/03 6/14/04	6/1/05 6/28/06	12/18/08 6/10/09	10/7/10 2/8/11	7/24/12 12/31/13	7/6/16 12/15/16	8/4/20 Present
10 Year Treasury Yield Increase (bps)	154	263	125	176	136	187	135	164	123	86
Bloomberg Barclays U.S. Aggregate Bond Total Return Index	-3.5%	-2.4%	-2.4%	-2.4%	-1.3%	-0.1%	-3.0%	-1.7%	-4.1%	-2.4%
S&P 500 Total Return Index	11.1%	48.7%	3.3%	15.8%	5.7%	7.6%	15.1%	42.6%	8.8%	18.3%
Russell 2000 Total Return Index	18.9%	59.0%	15.1%	25.4%	11.7%	10.2%	19.3%	54.7%	19.8%	49.3%
Trading days	105	328	98	252	272	119	99	364	115	139

Sources: Chief Investment Office, Bloomberg. Data as of February 23, 2021. Past performance is no guarantee of future results.

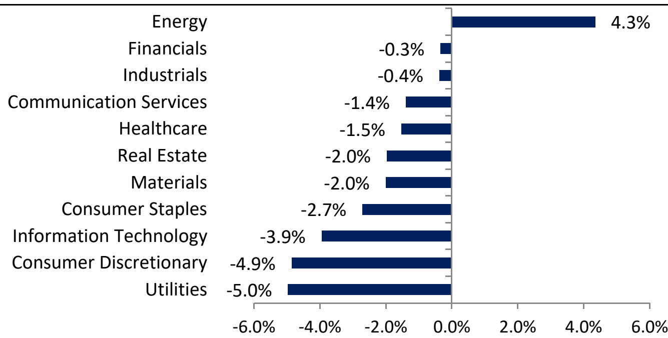
Our analysis suggests that focusing on the simple direction of yields may be fruitless, especially given the subjective nature on what levels are most relevant in signaling attractive alternatives to equities. Rather, we find a more holistic approach that accounts for the context of ultra-low rates, tight credit spreads, and positive driving forces for higher yields such as economic activity to be ideal. With this backdrop in mind, we remain supportive of equities.

MARKETS IN REVIEW

Equities

	Total Return in USD (%)			
	Current	WTD	MTD	YTD
DJIA	30,932.37	-1.7	3.4	1.4
NASDAQ	13,192.35	-4.9	1.0	2.5
S&P 500	3,811.15	-2.4	2.8	1.7
S&P 400 Mid Cap	2,496.26	-1.5	6.8	8.4
Russell 2000	2,201.05	-2.9	6.2	11.6
MSCI World	2,726.91	-2.8	2.6	1.5
MSCI EAFE	2,168.87	-2.8	2.2	1.2
MSCI Emerging Markets	1,339.26	-6.3	0.8	3.9

S&P 500 Sector Returns



Fixed Income[†]

	Total Return in USD (%)			
	Current	WTD	MTD	YTD
Corporate & Government	1.35	-0.39	-1.76	-2.78
Agencies	0.68	-0.24	-0.75	-0.91
Municipals	1.27	-1.20	-1.59	-0.96
U.S. Investment Grade Credit	1.42	-0.36	-1.44	-2.15
International	2.05	-0.46	-1.72	-2.98
High Yield	4.25	-0.59	0.37	0.70

	Current	Prior Week End	Prior Month End	2020 Year End
90 Day Yield	0.03	0.03	0.05	0.06
2 Year Yield	0.13	0.10	0.11	0.12
10 Year Yield	1.40	1.34	1.07	0.91
30 Year Yield	2.15	2.13	1.83	1.64

Commodities & Currencies

	Total Return in USD (%)			
Commodities	Current	WTD	MTD	YTD
Bloomberg Commodity	182.07	0.0	6.5	9.3
WTI Crude $/Barrel[††]	61.50	3.8	17.8	26.8
Gold Spot $/Ounce[††]	1734.04	-2.8	-6.1	-8.7

Currencies	Current	Prior Week End	Prior Month End	2020 Year End
EUR/USD	1.21	1.21	1.21	1.22
USD/JPY	106.57	105.45	104.68	103.25
USD/CNH	6.48	6.45	6.45	6.50

Sources: Bloomberg, Factset. Total Returns from the period of 2/22/2021 to 2/26/2021. [†]Bloomberg Barclays Indices. [††]Spot price returns. All data as of the 2/26/2021 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 Investments*					
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 2/26/2021)

	Q1 2020A	Q2 2020A	Q3 2020A	Q4 2020A	2020A	Q1 2021E	2021E
Real global GDP (% y/y annualized)	-	-	-	-	-3.3	-	5.6
Real U.S. GDP (% q/q annualized)	-5.0	-31.4	33.4	4.1	-3.5	5.5	6.5
CPI inflation (% y/y)	1.5	0.4	1.3	1.2	1.2	1.8	2.7
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 ($/share)	33	28	39	38*	138*	36	165
Euro/U.S. dollar, end period	1.10	1.12	1.17	1.22	1.22	1.20	1.15
U.S. dollar/Japanese yen, end period	108	108	105	103	103	105	106
Oil ($/barrel, avg. of period, WTI)**	46	29	40	44	40	57	57

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 26, 2021.

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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 Total Return 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.

MSCI Japan Index is designed to measure the performance of the large and mid cap segments of the Japanese market.

MSCI Europe Index captures large and mid cap representation across 15 Developed Markets (DM) countries in Europe.

MSCI All Country World Index (ACWI) is a stock index designed to track broad global equity-market performance.

MSCI Emerging Markets Index is used to measure equity market performance in global emerging markets.

Leading Economic Index (LEI) is an index published monthly by The Conference Board. It is used to predict the direction of global economic movements in future months.

Russell 2000 Total Return Index is an index measuring the performance of approximately 2,000 smallest-cap American companies in the Russell 3000 Index, which is made up of 3,000 of the largest U.S. stocks.

Bloomberg Barclays US Aggregate Bond Total Return Index is a broad base, market capitalization-weighted bond market index representing intermediate term investment grade bonds traded in the United States.

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