CHIEF INVESTMENT OFFICE

Capital Market Outlook

March 15, 2021

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

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- Macro Strategy—The sharp rise in long-term interest rates over the past month has caused the S&P 500 Index rally to pause while portfolios position for a higher growth and inflation outlook. The yield curve tends to get much steeper early in the business cycle as monetary policy becomes increasingly accommodative for the improving growth and inflation environment until the Federal Reserve (Fed) tightens policy. We're not there yet, but investors have reasons to worry about potentially excessive policy accommodation.
- Global Market View—Interest rate-related volatility has been the primary driver of equity markets over recent weeks. But as we cross the 12-month mark since widespread shutdowns first brought large segments of the global economy to a virtual standstill last year, we look back at how equities have moved over the course of the pandemic so far.
- Thought of the Week—The 10-year Treasury at more than 1% below the Fed's inflation target was an excessively expensive valuation and one reason that the Chief Investment Office (CIO) was advocating short duration and underweight Treasurys. The correction from that level can lead to positive bond/equity correlations, but those episodes are generally short-lived, and the normal negative correlation generally asserts itself.
- Portfolio Considerations—This month we adjusted our sector views by raising Energy, which was balanced by a move lower in Technology and a downgrade to Consumer Staples. We reaffirm our positive view on Equities relative to Fixed Income and expect participation to broaden across sectors, regions and styles.

MACRO STRATEGY

Chief Investment Office Macro Strategy Team

GLOBAL MARKET VIEW

Ehiwario Efeyini
Director and Senior Market Strategy Analyst

THOUGHT OF THE WEEK

Matthew Diczok
Managing Director and Fixed Income Strategist

Data as of 3/15/2021, and subject to change

MACRO STRATEGY

Too Much Of A Good Thing?

Chief Investment Office, Macro Strategy Team

While a steepening yield-curve outlook is historically a positive sign of near-term economic and profits growth prospects, the impending flood of $1.9 trillion in new government stimulus in an economy already primed for the strongest growth in generations has caused financial-market turbulence in recent weeks. Uncertainty about the Fed's tolerance for inflation in excess of 2% and fears of excessive monetary-policy accommodation have exacerbated market volatility. Indeed, U.S. economic data have continued to surprise to the upside, with prospects for strong economic growth, a rapid drop in the unemployment rate, and a likely acceleration in inflation suggesting that the Fed may have to adjust its policy sooner and more significantly than currently planned.

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In recent Capital Market Outlook reports, we discussed why we believe the Fed may be underestimating upside inflation risks, all boiling down to massive government spending and related money-supply growth, both on a scale not seen since World War II. Here we discuss the outlook for the labor market, since the Fed has made it clear that it is not going to change its current policy until inflation and inflation expectations sustainably exceed 2% and the labor market reaches “full and inclusive employment.” In our view, the latter objective will also probably be achieved sooner than anticipated.

Basically, the labor market has broadly followed the pattern of coronavirus restrictions on service spending. The big initial rush of hiring following the pandemic trough stalled between November and January, when the reopening suffered a setback. Employment substantially exceeded consensus expectations once again in February, when states started to ease business restrictions again. Private-sector employment gained 465,000 jobs, of which 322,000 were added in lodging and food services. The employment report would have been stronger if not for a drop in government payrolls and poor weather, which reduced construction jobs, for example. Gains are also increasingly broad based, with almost 60% of industries expanding payrolls compared to just 48% in January 2021.

With mobility and credit card spending data indicating strong further service-sector recovery through early March, more states announcing normalizing business conditions, and large consumer cash balances as well as pent-up demand, the labor market is likely to quickly recover most of the pandemic job losses, in our view. The question is, are there enough people to hire in response to a period of strong domestic demand not seen in more than 30, if not 80, years?

This is important because the Fed has pegged the monetary-policy path to the labor market reaching full and inclusive employment, which it doesn’t expect before 2023. Hence its plan to make no policy changes before that and the market’s increased discomfort with this assessment. Indeed, the Fed has been constantly surprised by the speed of the rebound out of the pandemic recession, and it is likely overestimating labor-market slack as well, in our opinion. Partly, this reflects a deliberate effort to now err on the side of excessive ease rather than premature tightening.

First, while there are still about 9 million fewer people getting a paycheck than before the pandemic, according to the Bureau of Labor Statistics, some of them have retired and some have stopped looking for work, which doesn’t qualify them for “unemployed” status. Overall, about 17 million people have gotten a job since April 2020, with “only” 4.2 million more people counted as unemployed than a year ago (when the economy was at full employment), which explains why the reported unemployment rate is already 6.2% (compared to 15% in April 2020 and 3.5% before the pandemic).

Second, leading indicators of employment suggest that 3 million to 5 million people could be reabsorbed this year as a result of a projected rush of activity as more states reopen their economies. Indeed, employment appears massively short of where the Chicago Fed survey of economic conditions would have it, suggesting it should spike up with the reopening. Manufacturing and nonmanufacturing surveys through February also point to strong employment growth in coming months, as does the surge in temporary employment, which leads employment growth by about three months. The economic rebound is global, with the IHS Markit manufacturing survey at a 34-year high through February, for example, pointing to strong further manufacturing production and trade gains ahead, also consistent with significantly higher labor demand.

This suggests that millions more must be drawn back into the labor force to meet labor demand and keep the unemployment rate from dropping much faster than the Fed expects. However, many people have retired early because of the pandemic, and few of those retired typically return to the labor market. Fear of contagion caused others to also drop out of the labor force, for a never-before-seen total of 6 million people out of the labor force over the past year. Compared to a year ago, only 2 million more people were interested in a job, although not seeking one over the past 12 months. According to the

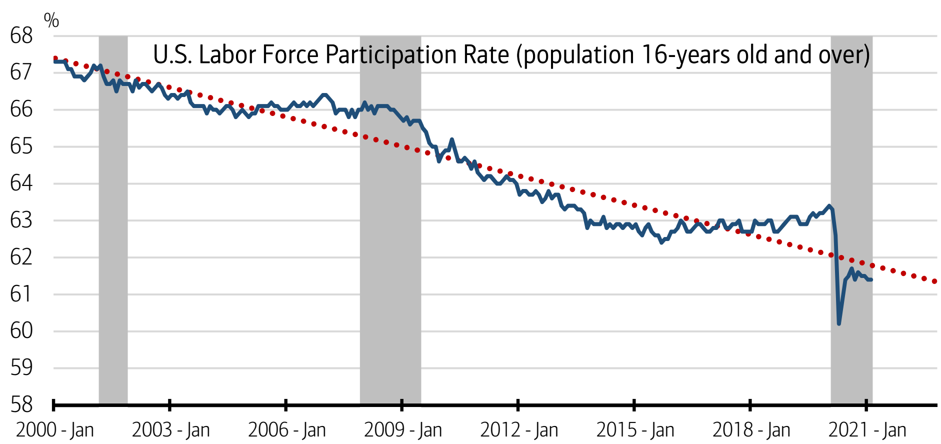
Bureau of Labor Statistics, just 530,000 people were not looking for a job in February because of discouragement over job prospects (compared to 277,000 before the pandemic). Not surprisingly, the National Federation of Independent Business (NFIB) small business survey for February already reports record difficulty filling job openings.

Thus, the fact that 18.5 million people receive some form of unemployment benefits (down from 31 million in April 2020, but still double the drop in payrolls over the past year) greatly exaggerates the labor-slack picture, in our view. In fact, disincentives to work related to massive government transfer payments are likely to cause businesses to continue to struggle to find labor without stronger wage gains or other costly incentives.

The point is that the pool of available labor is probably shallower than perceived, with the unemployment rate likely to drop much faster than the Fed anticipates. In our view, it would take bigger incentives to work to bring some of the population currently out of the labor force back into the labor market, just as it took a significant tax policy change in 2017 to reverse the steep downtrend in the labor-force participation rate (LFPR) that began in 2000 when female LFPR peaked (Exhibit 1). Even then, LFPR only increased from an average of 62.7% in 2015 to 63.1% in 2019.

Taking all this into account along with the aging of the population and other structural downward pressures on the participation rate (such as longer schooling and increased wealth), we believe that the LFPR is unlikely to increase much from the current 61.4 %, which, although at decades lows, is very close to its trend (Exhibit 1). For example, after a deep pandemic decline, the 16 to 24 age cohort's LFPR quickly jumped back above its long-term downtrend, to levels similar to the 2010-2019 period. We assume it will remain above trend, as it typically does in expansions. The 24 to 54 prime age participation rate is the most important to watch. Its marked downtrend between 2000 and 2016 was interrupted by a sharper-than-expected late-cycle surge from 2016 to 2019 to a decade high of 83%. We assume it will go up from its current 81.1% (a five-year low, but right on trend) to about 82.5% in a year or two, which will bring it meaningfully above trend. It is unlikely that it will exceed its downtrend by more. In fact, risks are to the downside, with any shortfall limiting labor-force availability and lowering the unemployment rate much more than expected. This, along with the rising share of the 55+ cohort in total population (whose LFPR is unlikely to exceed 40% because of the aging of the population), other structural socioeconomic dynamics noted above, as well as pandemic scars, suggests that the overall LFPR is unlikely to increase much above 62% in the next three years (Exhibit 1). A possible increase to 62.3% as the economy heats up would still help boost the labor force by about 1.2% per year and allow employment to grow around 2.6% per year on average between 2020 and 2023, with the unemployment rate potentially averaging 4.5% in 2022 and 3.5% in 2023.

Exhibit 1: Demographics Keep Strong Downward Pressure On The U.S. Labor-force Participation Rate.



Sources: Bureau of Labor Statistics; BofA Global Research/Haver Analytics. Data as of March 11, 2021.

Thus, most of those interested in finding a job are likely to do so this year, which would quickly reduce labor-market slack and lower the unemployment rate much faster than in previous economic cycles, causing the economy to possibly overheat unusually early in the expansion and keeping pressure on the Fed to remove excess accommodation. If this view plays out, expect interest rate volatility to remain high as a secular shift to higher nominal gross domestic product (GDP) growth continues to fuel the rally in reflation beneficiaries and bear-market in bonds.

GLOBAL MARKET VIEW

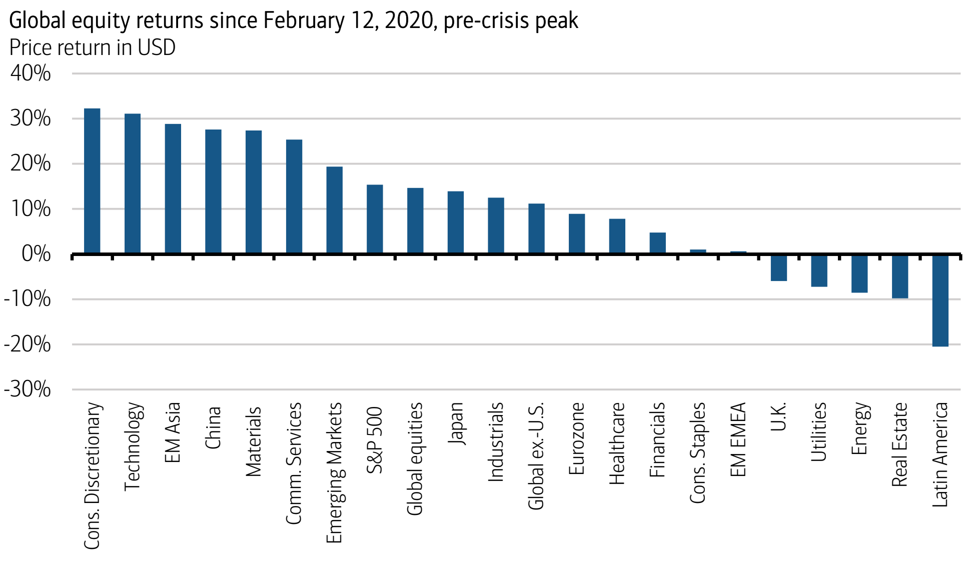
One Year Later: How Markets Have Moved Since the Start of the Coronavirus Outbreak

Ehiwario Efeyini, Director and Senior Market Strategy Analyst

Interest rate-related volatility has been the primary driver of equity markets over recent weeks. But as we cross the 12-month mark since widespread shutdowns first brought large segments of the global economy to a virtual standstill in mid-March of last year, it is worth looking back at how equities have moved over the course of the pandemic so far.

The past year has been a historic period for investors, who have faced not only a once-in-a-century public health crisis, but also the deepest (-10.0% [1]) peak-to-trough contraction in world GDP and the fastest (21 trading days to reach a 20% decline[2]) global equity bear market in post-war history. But one year later, following aggressive monetary intervention by central banks, trillions of dollars in global fiscal support, and a major reconfiguration in the behavioral patterns of households and businesses, markets have made significant aggregate gains. As of March 10, 2021, the MSCI All-Country World Index stood 14.7% above its pre-pandemic peak, though returns have been widely dispersed across individual sectors, regions and countries (Exhibit 2).

Exhibit 2: One Year On: Equity Market Returns Have Diverged From The Pre-pandemic Peak.



Sources: MSCI; Bloomberg. Data as of March 10, 2021. Sectors, regions and countries based on MSCI All-Country World Indexes. 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.

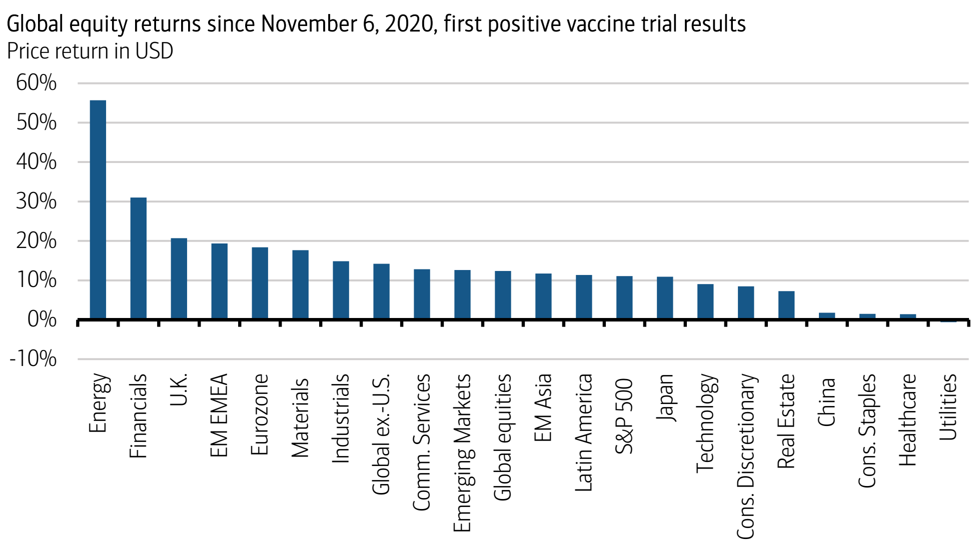
1 Purchasing power parity weighted at 2011 prices for 85% of global real GDP.

2 Based on MSCI All-Country World Indexes in USD price terms as of March 10, 2021.

Consumer Discretionary and Information Technology have been the leading sectors of the past year as dependence on internet services has increased with the need for physical distancing. Emerging Asia—led by China and other north Asian markets that limited the spread of their local outbreaks by responding quickly in the initial stages of the pandemic—has been the top-performing region. And the digital economy-oriented U.S. market has outperformed International Developed, particularly developed Europe, which has much lower exposure to related sectors such as Information Technology and Communication Services. At the tail end of the return distribution meanwhile have been the Energy sector, Real Estate and Latin America as markets geared to travel, hospitality and natural resources.

This 12-month snapshot of course masks the more recent rotation that began in early November of last year. The November 9 release of the first successful trial results on the coronavirus vaccine efficacy began a shift into many of the pandemic laggards, which was reinforced by similar announcements from other leading pharmaceutical companies over the following weeks. Since this period, cyclical sectors such as Energy and Financials have continued to benefit from regulatory approvals and now the first disbursements of the new vaccines as investors look ahead to economic reopening in more economies around the world later in 2021. And most recently, rising inflation expectations and the current runup in global bond yields have only provided an additional relative tailwind for the markets most beaten down by the pandemic. Over the past four months, Energy and Financials have led all other global sectors, Latin America has outperformed China, and non-U.S. markets have outperformed the S&P 500, particularly Western Europe and emerging EMEA (Europe, Middle East and Africa), which have some of the highest regional concentrations within the cyclical sectors (Exhibit 3).

Exhibit 3: Equity Market Returns Since Start Of Vaccine-driven Recovery In Cyclicals.



Sources: MSCI; Bloomberg. Data as of March 10, 2021. Sectors, regions and countries based on MSCI All-Country World Index. 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.

We expect this relative shift in sector returns to likely persist as global growth recovers and global interest rates move higher. But technology-related segments and emerging Asia have nonetheless been able to keep pace with the broader market advance of recent months, even as investors anticipate normalization in the most depressed segments of the global economy from the second half of 2021. And as we look further ahead into the current decade, these growth leaders of the past 12 months across sectors, regions and countries could also be able to perform well alongside better returns across more cyclical segments.

A post-coronavirus world should bring forward the expansion of the digital economy as a greater portion of healthcare, education, retail, entertainment and other services are delivered remotely. This in turn will likely boost demand for cloud-based software services, and increase the need for upgrades to supporting infrastructure and hardware such as high-speed telecommunications networks and advanced semiconductors for data processing and storage. As online activity commands a larger share of global output over the years ahead, these improvements in network reliability, speed and capacity will be critical in supporting a larger number of wireless connections consuming ever larger amounts of data.

Manufacturers are likely to favor more localized, automated and capital-intensive supply chains, both to reduce costs and to lower dependence on overseas suppliers of components and finished goods (including medical supplies and pharmaceuticals) in case of future disruptions. This too should increase demand for electronic equipment, components and enterprise software, as well as for new production techniques such as additive manufacturing.

Headwinds may persist for key segments of the real estate market such as retail, office and hotel as more activity is conducted online and virtually. And though base metals and other commodities used in the production of low-carbon energy and battery storage may see increased demand, fossil fuels are also likely to remain under pressure as remote activity caps mass transportation demand, and as economies around the world look to reduce their greenhouse gas emissions and ultimately transition to net-zero. Lower-income, natural resource-dependent economies in Latin America, the Middle East and Africa are therefore likely to account for a relatively small share of global growth, with the largest increase in the global consumer class expected to come from the Asia-Pacific region. Per capita incomes across these regions are likely to grow most quickly in markets that can increase their share of value-added in the expanding digital economy, though supply chain localization among leading global manufacturers could limit the potential gains. Many of these trends predate the outbreak. But moving beyond the past 12 months and looking through the recent volatility, one of the main legacies of the pandemic is likely to be an acceleration of these changes as we move deeper into the 2020s.

THOUGHT OF THE WEEK

"This Too Shall Pass": Bond/Stock Correlation Unlikely to Remain Positive on a Long-term Basis

Matthew Diczok, Managing Director and Fixed Income Strategist

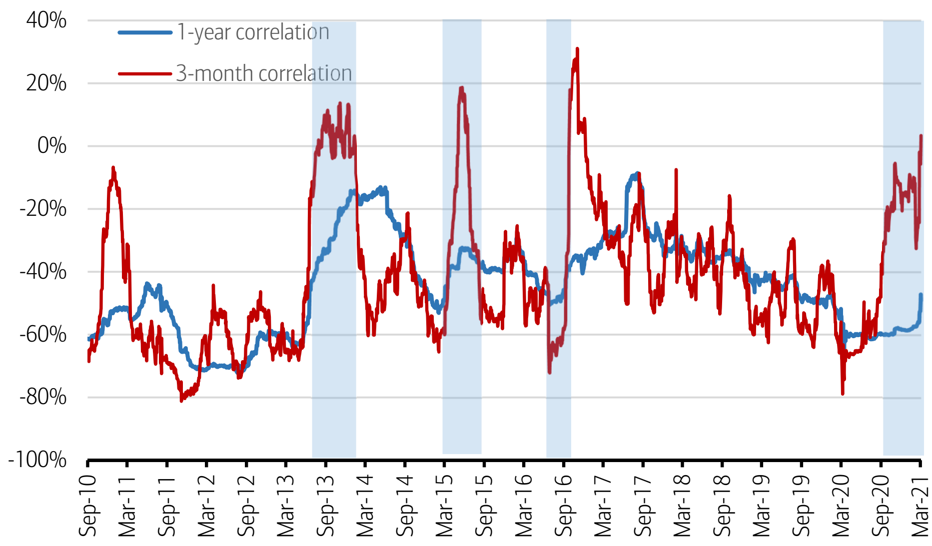
The current 10-year Treasury yield has been well below the Fed's 2% inflation target three times in the last decade. For the Chief Investment Office, these extremely negative "real" rates represent an excessive misvaluation based predominantly on "risk-off" sentiment, rather than a historically informed view of rates and inflation. This valuation is one reason that the CIO is advocating an underweight Treasury and short-duration positioning currently.

Now for the third time in 10 years, this misvaluation seems to be correcting. The 10-year Treasury has tripled from ~0.5% (August 2020) to ~1.5% currently. This is a massive move higher, but 1.5% is still actually the lower end of where rates bottomed the last two times. (Rates doubled from 1.5% to 3%+ in both 2013 and the period 2016-2018.)

In each correction from deeply subinflation interest rates, the negative correlation between rates and equities—bond prices rising when equities fall, and vice versa—flipped to a positive correlation. This typically triggers concerns as to whether Fixed Income would still be considered a good diversifier going forward.

If recent history is any guide, bonds will likely remain a reasonable diversifier and "this too shall pass." A rate spike of this magnitude generally does rattle markets somewhat, and it may take weeks or months to digest. If the parallels hold, however, these episodes of positive correlation generally do not last. Similar to the rate spikes themselves, the correlation flips may be quick and relatively severe, but they generally find an equilibrium and return to their recent normal state (negative correlation).

Exhibit 4: The Fixed Income/Equity Correlation Flipping To Positive Has Coincided With Rate Spikes, And Generally Been Very Short-lived.



Note: Shaded area represents when the fixed income/equity correlation flips to positive. Sources: Bloomberg; CIO calculations. Data as of March 5, 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.

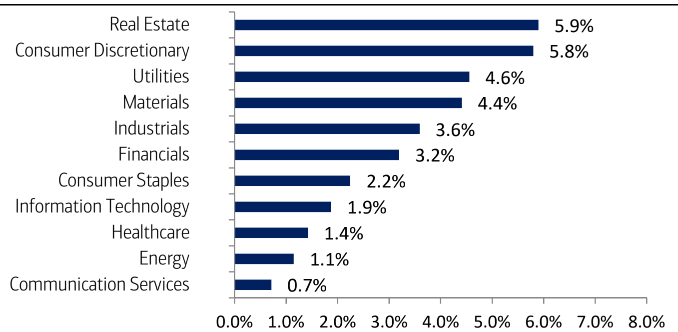
This is not to say that the bond-to-equity correlation is always negative. In fact, for four decades before 2000, it was a positive correlation the vast majority of the time. A significant increase in inflation, for example, could change this dynamic. Nevertheless, while we do not take anything for granted, continuously monitor the correlations and are open to changing our view if the environment changes dramatically, this negative correlation has been persistent for two decades—even at similarly low rate levels. We do not expect the recent move to be a regime change, but rather a likely and expected consequence of a small rate shock.

MARKETS IN REVIEW

Equities

	Total Return in USD (%)			
	Current	WTD	MTD	YTD
DJIA	32,778.64	4.2	6.1	7.6
NASDAQ	13,319.86	3.1	1.0	3.5
S&P 500	3,943.34	2.7	3.5	5.3
S&P 400 Mid Cap	2,646.34	5.4	6.1	15.0
Russell 2000	2,352.79	7.4	7.0	19.3
MSCI World	2,807.21	2.9	3.0	4.6
MSCI EAFE	2,219.30	3.0	2.5	3.7
MSCI Emerging Markets	1,348.20	0.7	0.8	4.6

S&P 500 Sector Returns



Fixed Income†

	Total Return in USD (%)			
	Current	WTD	MTD	YTD
Corporate & Government	1.51	-0.53	-1.62	-4.35
Agencies	0.77	-0.19	-0.54	-1.45
Municipals	1.14	0.42	0.72	-0.24
U.S. Investment Grade Credit	1.57	-0.43	-1.22	-3.35
International	2.29	-0.64	-2.18	-5.10
High Yield	4.39	-0.06	-0.22	0.48

	Current	Prior Week End	Prior Month End	2020 Year End
90 Day Yield	0.02	0.03	0.03	0.06
2 Year Yield	0.15	0.14	0.13	0.12
10 Year Yield	1.62	1.57	1.40	0.91
30 Year Yield	2.38	2.30	2.15	1.64

Commodities & Currencies

	Total Return in USD (%)			
Commodities	Current	WTD	MTD	YTD
Bloomberg Commodity	183.53	0.1	0.8	10.1
WTI Crude $/Barrel††	65.61	-0.7	6.7	35.2
Gold Spot $/Ounce††	1727.11	1.6	-0.4	-9.0

Currencies	Current	Prior Week End	Prior Month End	2020 Year End
EUR/USD	1.20	1.19	1.21	1.22
USD/JPY	109.03	108.31	106.57	103.25
USD/CNH	6.50	6.52	6.48	6.50

Sources: Bloomberg, Factset. Total Returns from the period of 3/8/2021 to 3/12/2021. †Bloomberg Barclays Indices. ††Spot price returns. All data as of the 3/12/2021 close.
Past performance is no guarantee of future results.

Asset Class Weightings (as of 3/2/2021)

	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 3/12/2021)

	Q1 2020A	Q2 2020A	Q3 2020A	Q4 2020A	2020A	Q1 2021E	2021E
Real global GDP (% y/y annualized)	-	-	-	-	-3.2	-	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	1.8
Unemployment rate (%)	3.8	13.0	8.8	6.7	8.1	6.2	5.5
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 ($/share)	33	28	39	42*	140*	36	165
Euro/U.S. dollar, end period	1.10	1.12	1.17	1.22	1.22	1.20	1.15
U.S. dollar/Japanese yen, end period	108	108	105	103	103	105	106
Oil ($/barrel, avg. of period, WTI)**	46	29	40	44	40	58	60

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 March 12, 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 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 All Country World Index (ACWI) is a stock index designed to track broad global equity-market performance. The index is comprised of the stocks of about 3,000 companies from 23 developed countries and 26 emerging markets.

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