BANK OF AMERICA

CHIEF INVESTMENT OFFICE

Capital Market Outlook

March 23, 2020

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

IN THIS ISSUE

- **Macro Strategy**—The oil market had a pre-existing condition when the demand shock from COVID-19 hit. The market was well-supplied, and oil producing countries were jockeying for market share by selling at low prices. At the same time, producers in the U.S. had ample access to capital and advanced technology to build supply and leverage. The demand shock and coinciding price wars are pushing a deleveraging cycle that is likely in its early stages. Oil companies and countries are rebalancing for the long term. Consolidation and persistent volatility in the energy space should be expected. Industry-focused fiscal aid is possible but may only add to the supply glut.
- **Global Market View**—U.S. equities entered bear market territory earlier this month, ending the decade-long bull run that began in 2009. Though the current downturn clearly comes amid a unique set of circumstances, a look at previous bear markets may give some indication as to what investors might expect this time around.
- **Thought of the Week**—Accounting for roughly 70% of U.S. gross domestic product (GDP), as the U.S. consumer goes, so not only goes the U.S. economy but also, to a large extent, the global economy. Not unexpectedly then, as the number of reported cases of COVID-19 has spiked in the U.S., the attitude of U.S. consumers has darkened considerably, shifting our GDP forecast and cutting S&P 500 earnings-per-share (EPS) estimates for 2020.
- **Portfolio Considerations**—We prefer equities over fixed income as valuations in bonds are at extreme levels. With Treasury yields still close to historically low levels, oil prices correcting aggressively, and investor sentiment in equities at previous crisis levels, we would have long-term plans ready to re-risk (rebalance) portfolios back to strategic and tactical targets as the bottoming process in equity markets unfolds over the coming weeks. There are five signs to watch to help determine the bottoming process, in our view:

  1. Capital needs to flow freely. This is being addressed by the various facilities put in place by the Federal Reserve and Treasury. We are watching credit improvement and liquidity in the daily funding markets.
  2. The relationship between stocks and bonds needs to shift back to somewhat normal inverse relationship.
  3. Volatility as measured by the Chicago Board Options Exchange (CBOE) Volatility Index (VIX) needs to recede when the markets are experiencing down days.
  4. Strength of the U.S. Dollar needs to slow down and crest.
  5. News flow regarding the virus and the overall economy/corporate profits begin to slow and be ignored by the broader market.

MACRO STRATEGY

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GLOBAL MARKET VIEW

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THOUGHT OF THE WEEK

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MACRO STRATEGY

Shock and Oil

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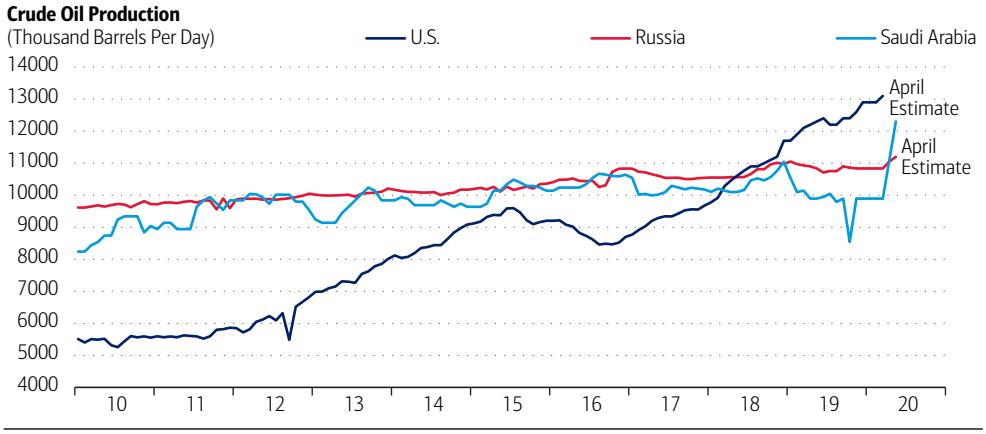
Warren Buffett famously observed that, "Only when the tide goes out do you discover who's been swimming naked." For the second time in the last six years, the tide went out on the oil industry. The spread of the COVID-19 virus sapped global energy demand at the same time an already well-supplied market merged with an oil price war that saw two of the largest producers (Saudi Arabia and Russia) plus the United Arab Emirates (UAE) raise production. The oil market also had a pre-existing condition (oversupply and ample capital) that made it vulnerable to a demand shock, similar to conditions in the U.S. housing market in the lead up to the Great Recession. The demand shock and price wars are pushing a deleveraging cycle that is likely in its early stages. Oil companies and countries are rebalancing for the next few decades. Consolidation and persistent volatility in the energy space should be expected. An industry-focused fiscal response is possible. Below we lay out some of the key features for the foreseeable future in the oil markets that are contributing to downside price shocks and deleveraging.

What happened to the Organization of the Petroleum Exporting Countries (OPEC) Alliance? Crude oil experienced its largest one-day price decline since 1991 after the existing production-cut agreement between Russia and OPEC (including Saudi Arabia) fell apart. Instead of agreeing to additional production cuts to offset declining global demand, the Russians walked away without agreeing to any production cuts, not even the existing agreement. This basically signaled the end of OPEC+ (OPEC + Russia) and the three years of production cuts by OPEC+ that was intended to manage global oil supply and support oil prices as U.S. production and exports accelerated. This first move by Russia was countered the very next day by Saudi Arabia when it reduced its official selling price (OSP) into Asia, the U.S. and Europe by the largest discounts on record. The largest Saudi OSP discounts were to Europe and were a clear and direct countermove to the Russians walking away from the OPEC meeting and production cuts. Besides an immediate sharp decline in oil prices, the secondary effect will be significant pressure on the U.S. energy industry. Until the game of chicken ends or a third party brokers a deal, the battle for market share will continue.

Looking Down a Double Barrel: Unfortunately for the energy industry, the newfound oil price war between Russia and OPEC is simply exacerbating existing trends. The market was already well supplied as the shale revolution enabled the U.S. to ramp up production. As seen in Exhibit 1, U.S. oil production exceeds Saudi and Russian production. The oil price war has Saudi Arabia verbally expressing a goal to raise production to 12.3 million barrels per day. United Arab Emirates is also raising production by 1 million barrels per day. All in all, BofA Global Research thinks the market could be looking at an additional 4 million barrels of oil per day at the same time demand has been decimated by COVID-19. Further, a number of major producers are offline or mostly offline. For example, Libya could ramp back up and add hundreds of thousands or nearly 1 million barrels per day to output. Iran and Venezuela are under intense pressure from economic sanctions and selling whatever they can at "clearance sale prices" to attract buyers and support the economy. As further evidence that the market has been well supplied, geopolitical shocks, such as the Iranian attack on Saudi oil infrastructure that would historically drive prices well above $100 per barrel, have been dampened by the supply glut.

Exhibit 1: Clearance Sale?



Sources: Bloomberg; U.S. Energy Information Administration (EIA). Data as of 3/16/2020.

The longer the market operates in a state of oversupply, the more inventory builds up on land and on ships at sea. Potential U.S. fiscal bailout options for targeted oil companies may only serve to add to the global surplus. Further, while the Saudi/Russia disagreement is cited as the source of the near-term oversupply, there are secular themes at work. Climate change, the shift to green energy and the prospect for peak oil demand in the years or decades ahead encourages countries with low production costs to monetize oil assets, and they may be willing to do so at low prices. For example, the two countries with the largest proven reserves, Venezuela and Saudi Arabia, have production costs that are well below even current prices. While energy bulls might cite fiscal budget breakevens that are at much higher oil prices as reasons for oil prices to move higher, there seems to be greater focus on market share at the expense of oil prices and revenues for social spending. While both Saudi Arabia and Russia have foreign reserves and can manage lower prices for longer to some extent, other oil producing countries such as Iraq, Nigeria, Libya and Venezuela will struggle at these prices.

On the demand side, this will also be the first year where oil demand falls since 2008. While the demand collapse is directly related to the spread of COVID-19 and the slowdown in manufacturing, shipping, air freight, commercial air travel and general transportation, as mentioned, the longer-term demand dynamics are also shifting. The end result is in a double-barrel problem for the U.S. energy industry, which has higher production costs than other major producers—a simultaneous oil price war and slowing global oil demand.

Sliding Down a Giant Oil Slick: The U.S. energy industry experienced an amazing resurgence over the last decade, becoming the world's largest oil producer, due to innovation and technology, capital markets and investors open to funding the industry regardless of cost of capital or returns on capital, and old fashioned U.S. ingenuity. However, the "dry hole" for the U.S. energy industry is that the economics do not work for U.S. exploration and production (E&P) companies at $25 to $35 oil prices. This means that a lengthy price war or a prolonged virus impact on demand will increase the financial pressure on smaller and weaker energy producers and U.S.-centric oil service companies.

Similar to expectations for higher housing prices in the early 2000s, the assumption for decades in the oil markets has been that demand would be consistently higher and prices were well supported. Like the housing market in the lead-up to the financial crisis, the oil market was well supplied, and, in the U.S., there was ample access to capital. When the music stops the deleveraging starts, and high-yield energy credit spreads reflect the second coming of a deleveraging cycle in the energy sector. The first time around, in the 2014–2016 period time frame, falling oil prices led to a business investment and profits recession in the U.S. but not a complete washout of weaker operators in the energy industry. The double-barrel threat this time around is much more severe on both the demand and supply sides. Oil had a pre-existing condition when COVID-19 hit demand and the new supply shock may put a more permanent stamp on the oil markets in terms of expectations for supply, demand and prices.

Strategy Perspectives: The double barrel dynamic is driving the oil futures curve and spot prices lower over the rest of 2020 and 2021. BofA Global Research sees downside risks for oil prices in the near term, with the potential for prices to fall below $20 per barrel. For the calendar year, they expect Brent crude oil prices to average $45 per barrel. Brent prices averaged around $50 per barrel through February.

GLOBAL MARKET VIEW

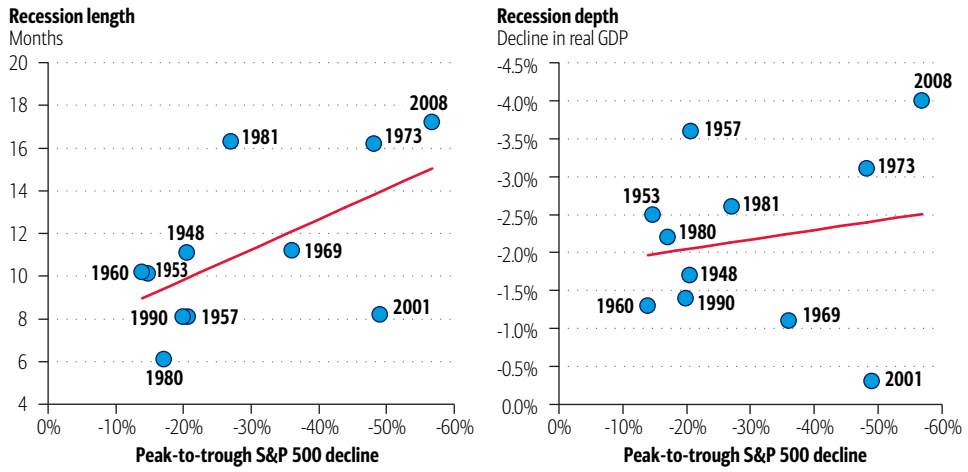
Bear Statistics: Lessons from Past Downturns for the COVID-19 Bear Market

Ehiwario Efeyini, Senior Vice President and Senior Market Strategy Analyst

The steep market losses of recent trading sessions continued over the course of last week, extending beyond a full month since the highs of mid-February. With the peak-to-trough decline for the S&P 500 moving past 20% on March 12, U.S. equities entered bear market territory earlier this month, ending the decade-long bull run that began in 2009. Equity market declines associated with the 11 recessions since World War II have registered an average of 29.5%—comparable with the drawdown seen to date in the current episode. The time taken for this latest market selloff to reach -20% has been the most rapid in post-war history at just 16 trading days, but its total magnitude so far has therefore been more typical for bear markets of the past 75 years. A key question now for investors is how much further the market may have to fall. Though the current downturn clearly comes amid a unique set of circumstances, a look at previous bear markets may give some indication as to what investors might expect.

First to note is that the depth of past market drawdowns around recessions has varied considerably. The smallest (-13.9%) was associated with the 1960–1961 recession, while the largest (-56.8%) accompanied the 2008–2009 financial crisis. Broadly we have seen two distinct types of recession-driven market downtrend that have produced the 29.5% post-war average. Six of the 11 episodes have been more benign at around 20% or less, with an average magnitude of 17.8%. But the remaining five have been much deeper at 27% or more, with an average magnitude of 43.5%. In general, the more severe the recession in terms of both its duration and the amount of lost real output, the deeper has been the market decline (Exhibit 2).

Exhibit 2: Severe Recessions Have Tended To Produce Deeper Market Drawdowns.



Sources: Bureau of Economic Analysis; National Bureau of Economic Research; Bloomberg. Data as of March 2020. **Past performance is no guarantee of future results.**

The main outlier has been the bear market associated with the dot-com bust and 2001 recession. The recession itself was the mildest of the 11 post-war cases in terms of

lost output (0.3%) and among the shortest in duration at eight months, but the peak-to-trough equity market decline (49.1%) was the second most severe as valuations continued to adjust downward for a full year after the recession ended.

Large bear market rallies (major price recoveries within the ongoing downtrend that are not sustained) have also been a key feature among the latter group of deeper recession-driven equity declines. Each of the five episodes in which the S&P 500 fell by more than 27% included two major relief rallies in which the market rose by around 10% or more but failed to regain its previous high before going on to set new lows. And across the 11 post-war episodes, the market took an average of 2.7 months from its final price low to achieve a sustained price increase of 10% (Exhibit 3). This reinforces our view that bottoming after such a severe market drawdown should be a process that occurs over time, and there are likely to be a number of short-lived attempts at recovery before a more durable market uptrend is resumed.

Exhibit 3: Bear Market Rallies and a Prolonged Bottoming Process Have Been Key Features of Past Market Downtrends.
Post-war market drawdowns associated with recessions

Smaller Market Drawdowns

Recession	S&P 500 peak-to-trough	Time to sustained 10% rise (months)
Nov 48 – Oct 49	-20.6%	1.2
Jul 53 – May 54	-14.8%	3.7
Aug 57 – Apr 58	-20.7%	6.0
Apr 60 – Feb 61	-13.9%	2.1
Jan 80 – Jul 80	-17.1%	1.9
Jul 90 – Mar 91	-19.9%	3.3

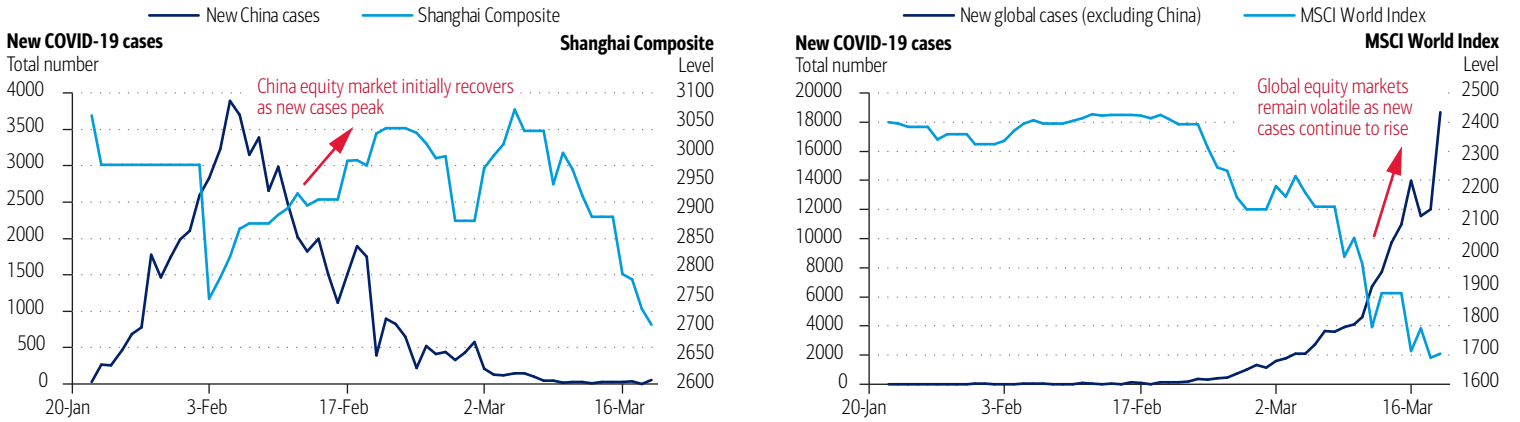
Larger Market Drawdowns

Recession	S&P 500 peak-to-trough	Time to sustained 10% rise (months)	Decline 1	Rally 1	Decline 2	Rally 2	Decline 3
Dec 69 – Nov 70	-36.1%	2.8	-9.6%	8.4%	-15.7%	9.9%	-25.9%
Nov 73 – Mar 75	-48.2%	3.0	-28.5%	10.9%	-18.6%	10.0%	-37.6%
Jul 81 – Nov 82	-27.1%	0.3	-19.7%	12.0%	-15.0%	11.3%	-14.3%
Mar 01 – Nov 01	-49.2%	5.3	-27.8%	19.0%	-26.4%	21.2%	-33.6%
Jan 08 – Jun 09	-56.8%	0.1	-18.6%	12.0%	-47.2%	24.2%	-27.1%

Sources: Chief Investment Office; Bloomberg. Data as of March 2020. **Past performance is no guarantee of future results.**

In the current environment, the main source of uncertainty remains the extent of the demand shock from the virus containment measures being taken by governments, companies and households. And the expected impact on economic growth and corporate earnings has already placed the current bear market into the more severe category of post-war drawdowns. There remains, however, a lack of visibility on the extent of the underlying public health crisis. For investors to anticipate a reduction in the pace of economic contraction and look ahead to a bottoming in earnings, we should therefore need to see some indication that the epidemic itself is being brought under control in the major economies of Western Europe and the U.S. After a near-10% decline between mid-January and early February, equity markets in China were only able to make an initial bottom when the rate of newly confirmed cases began to decelerate (local markets have since rolled over again with the surge in global cases). But as yet, there are no signs that the outbreak is abating in the rest of the world (Exhibit 4).

Exhibit 4: New COVID-19 Virus Cases Continue To Trend Higher Outside China.



Sources: Bloomberg; World Health Organization. Data as of March 19, 2020. **Past performance is no guarantee of future results.**

The monetary, fiscal and legislative support measures unveiled by policymakers over recent weeks have been necessary to prevent a larger deterioration in investor sentiment, but they may therefore not yet be sufficient to halt the market downtrend until more progress is made on dealing with the underlying health crisis. Many of the emergency support measures introduced for example during the 2008–2009 financial crisis preceded the eventual market bottom by several months and did not gain traction until U.S. home prices (which were driving the losses on troubled mortgage-linked assets) began to show signs of stabilization.

In addition to uncertainty over the severity of the expected recession and the extent of the earnings decline, the strength and sustainability of the subsequent economic recovery may also play a role in determining the ultimate depth of the current bear market. Investors could assign a lower valuation multiple to the major indices if the likelihood of a second wave of new infections increases as containment measures are eventually scaled back. This would mean that any economic recovery may prove unsustainable even after an initial slowdown in the case count. And despite record low interest rates, equity markets could also be de-rated if investors price a slower pace of future nominal GDP growth due to any persistence in social distancing behavioral changes after the epidemic finally subsides; or on expectations for downward pressure on prices (exacerbated by the oil price collapse) that pushes inflation back toward its cycle lows. The trailing earnings multiple for the S&P 500 has already fallen from a recent peak of 22.0x on February 19 (one standard deviation above its long-term average of 18.2x since 1990) to 15.6x on March 18 (0.7 standard deviations below this long-term average). But it remains well above its low for the post-financial crisis economic expansion of 11.7x in late 2011. The wide range of price levels implied by these potential outcomes for growth, earnings and valuation (Exhibit 5) is therefore likely to keep volatility high until investors gain more visibility in these areas.

Exhibit 5: S&P 500 Price Levels Implied by Earnings and Valuation Assumptions.
Implied S&P 500 price levels.

Assumed 2020 earnings growth							
Assumed trailing P/E ratio	**0%**	**-5%**	**-10%**	**-15%**	**-20%**	**-25%**	**-30%**
10x	1,630	1,549	1,467	1,386	1,304	1,223	1,141
12x	1,956	1,858	1,760	1,663	1,565	1,467	1,369
14x	2,282	2,168	2,054	1,940	1,826	1,712	1,597
16x	2,608	2,478	2,347	2,217	2,086	1,956	1,826
18x	2,934	2,787	2,641	2,494	2,347	2,201	2,054
20x	3,260	3,097	2,934	2,771	2,608	2,445	2,282
22x	3,586	3,407	3,227	3,048	2,869	2,690	2,510
24x	3,912	3,716	3,521	3,325	3,130	2,934	2,738

Sources: Bloomberg; Chief Investment Office. Data as of March 2020. Earnings growth assumptions starting from 2019 EPS level of $163.

THOUGHT OF THE WEEK

The Bane Toward the Basics: The Shifting Mood of the U.S. Consumer

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

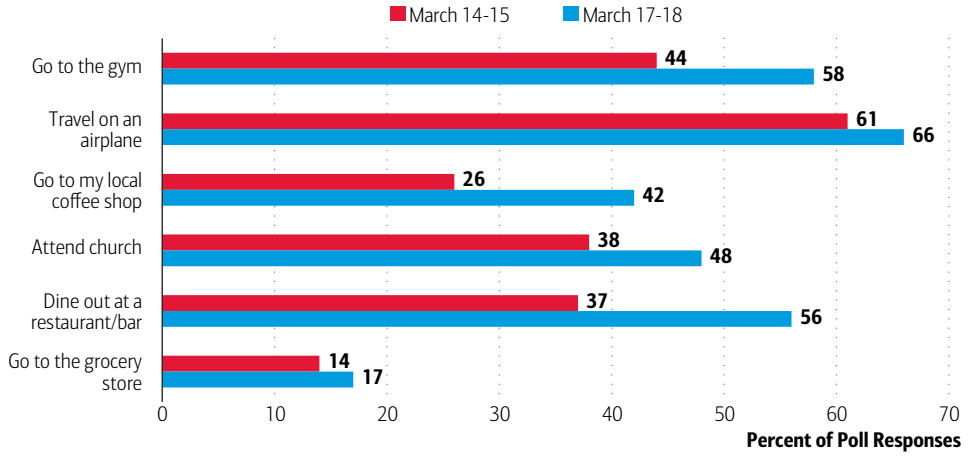
Lauren J. Sanfilippo, Vice President and Market Strategy Analyst

The U.S. consumer is one of the most powerful economic forces in the world, so when the mood and temperament of the consumers changes, so do the contours of the U.S. economy. Accounting for roughly 70% of U.S. GDP, as the U.S. consumer goes, so goes not only the U.S. economy but also, to a large extent, the global economy, since U.S. personal consumption accounts for 28.9% of aggregate global consumption.

Not unexpectedly then, as the number of reported cases of COVID-19 have spiked in the U.S., the attitude of U.S. consumers has darkened considerably. This notable shift is captured in the accompanying chart (Exhibit 6), which comes courtesy of The Harris Poll and Axios. The chart benchmarks the rapid shift in consumer attitudes toward everyday basic activities. According to the poll, going to a grocery store seems to be the safest bet but that's out of necessity—families need to eat. In contrast, there is less of an appetite for discretionary activities like dining out, stopping into a coffee shop, going to the gym, and traveling on an airplane. The latter, of course, has caused U.S. airline stocks to crater, while the rising bane toward basic activities/services has crushed many small businesses across the U.S. Even attending church has lost its luster.

All of the above is being repeated around the world and helps explain why our research partners at BofA Global Research now expect global GDP to be effectively zero in 2020, an outlook akin to the major recessions of 1982 and 2009. For the U.S. economy, the forecast is for a record 12% quarter-on-quarter Seasonally Adjusted Annual Rate (SAAR) drop in GDP in the second quarter, followed by a second-half recovery. Against this backdrop, S&P 500 EPS estimates have been cut to $138 (from $169) for 2020. All of these numbers, of course, will depend on the speed and magnitude of the global policy response and, of course, the U.S. consumer. The latter, as the exhibit highlights, is hunkering down and will remain in bunker mode until clarity and certainty around COVID-19 surfaces.

Exhibit 6: Which of the Following Are You Not Willing To Do Given the Current Outbreak of COVID-19?

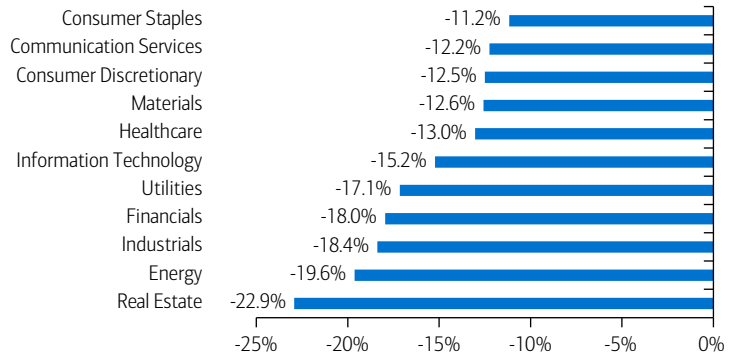


Sources: Axios; Harris Poll of 4,069 adults. Data as of March 2020.

Equities

		Total Return in USD (%)		
	Current	WTD	MTD	YTD
DJIA	19,173.98	-17.3	-24.4	-32.4
NASDAQ	6,879.52	-12.6	-19.6	-23.1
S&P 500	2,304.92	-15.0	-21.9	-28.3
S&P 400 Mid Cap	1,258.73	-18.6	-30.5	-38.7
Russell 2000	1,013.89	-16.2	-31.2	-39.0
MSCI World	1,650.94	-12.2	-22.8	-29.7
MSCI EAFE	1,393.92	-5.8	-22.8	-31.3
MSCI Emerging Markets	803.23	-9.8	-20.0	-27.8

S&P 500 Sector Returns



Fixed Income[1]

		Total Return in USD (%)		
	Current	WTD	MTD	YTD
Corporate & Government	2.12	-3.1	-4.6	-0.3
Agencies	1.14	-0.4	-0.2	2.9
Municipals	3.51	-6.6	-10.3	-7.5
U.S. Investment Grade Credit	2.18	-2.3	-3.6	0.0
International	4.58	-8.9	-13.8	-10.6
High Yield	10.93	-10.2	-17.0	-18.1

	Current	Prior Week End	Prior Month End	2019 Year End
90 Day Yield	0.08	0.24	1.24	1.49
2 Year Yield	0.31	0.49	0.91	1.57
10 Year Yield	0.85	0.96	1.15	1.92
30 Year Yield	1.42	1.53	1.68	2.39

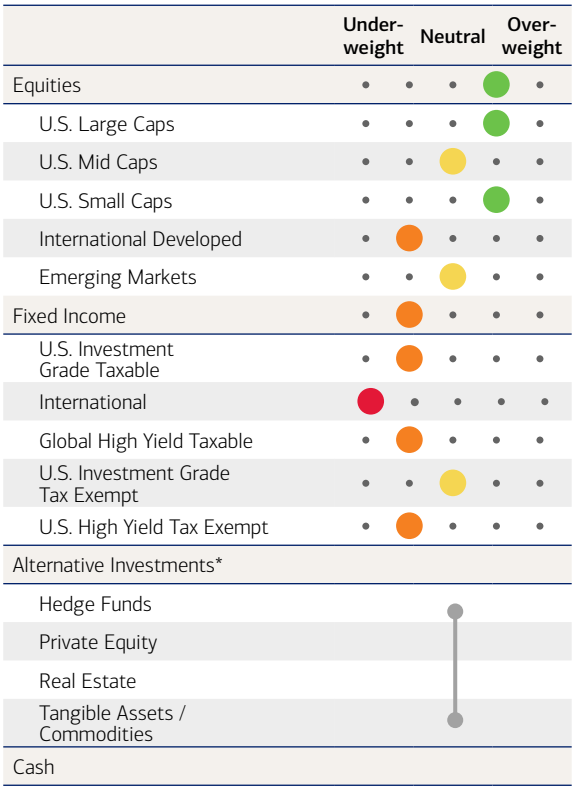
Commodities & Currencies

		Total Return in USD (%)		
Commodities	Current	WTD	MTD	YTD
Bloomberg Commodity	130.32	-6.4	-13.9	-24.2
WTI Crude $/Barrel[2]	22.43	-29.3	-49.9	-63.3
Gold Spot $/Ounce[2]	1,498.65	-2.0	-5.5	-1.2

Currencies	Current	Prior Week End	Prior Month End	2019 Year End
EUR/USD	1.07	1.11	1.10	1.12
USD/JPY	110.93	107.62	107.89	108.61
USD/CNH	7.12	7.02	6.98	6.96

Source: Bloomberg, Factset.Total Returns from the period of 03/16/20 to 03/20/20. Bloomberg Barclays Indices.[1] Spot price returns.[2] All data as of the 03/20/20 close.
Past performance is no guarantee of future results.

Asset Class Weightings (as of 1/9/2020)



* 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 03/20/20)

	Q3 2019A	Q4 2019A	2019A	Q1 2020E	Q2 2020E	2020E
Real global GDP (% y/y annualized)	–	–	2.9	–	–	0.3
Real U.S. GDP (% q/q annualized)	2.1	2.1	2.3	0.5	-12.0	-0.8
CPI inflation (% y/y)	1.8	2.0	1.8	2.2	0.8	1.2
Core CPI inflation (% y/y)	2.3	2.3	2.2	2.3	2.2	2.1
Unemployment rate (%)	3.6	3.5	3.7	3.7	6.0	5.5
Fed funds rate, end period (%)	1.90	1.55	1.55	0.13	0.13	0.13
10-year Treasury, end period (%)	1.66	1.92	1.92	0.75	0.85	1.25
S&P 500 end period	2977	3231	3231	–	–	3100
S&P earnings ($/share)	42	42*	163*	35.0	26.0	138
Euro/U.S. dollar, end period	1.09	1.12	1.12	1.08	1.10	1.15
U.S. dollar/Japanese yen, end period	108	109	109	110	107	103
Oil ($/barrel, avg. of period, WTI**)	56	57	57	49	31	41

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 March 20, 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.

Chicago Board Options Exchange's CBOE Volatility Index (VIX) is a popular measure of the stock market's expectation of volatility based on S&P 500 index options.

MSCI World is a market cap weighted stock market index of 1,655 stocks from companies 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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