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CHIEF INVESTMENT OFFICE

Capital Market Outlook

May 17, 2021

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IN THIS ISSUE

- Macro Strategy—The track of the Institute for Supply Management (ISM) manufacturing index suggests cyclical momentum is as strong as we have seen in the post-war period. The headline index took a breather in April, but renewed strength is possible in our view and would tactically support Equities and higher interest rates.
- Global Market View—The recent equity market selloff has fallen unevenly across the emerging world, but emerging markets (EM) as a group have so far been relatively resilient. Rather than a broad-based flight from emerging market risk, the inflation concern has produced a similar rotation across emerging market sectors and regions as that seen in the rest of the world.
- Thought of the Week—Counterproductive to the ultimate clean energy goal, the push to boost capacity is extraordinarily metal-intensive, requiring more minerals than fossil fueled-based counterparts. We believe we are on the road to a more decarbonized future, albeit with some speed bumps, namely securing a stable and cost-effective mineral supply.
- Portfolio Considerations—When it comes to assessing the market environment we prefer to choose "half full." In terms of the broader economic environment, we believe we are closer to mid-cycle than late cycle and that growth is currently flashing bright green and surprising more than expected. We will remain vigilant for rebalancing opportunities in our asset allocation models as we expect rates and equities to drift higher.

MACRO STRATEGY

Jonathan Kozy
Managing Director and Senior Macro Strategy Analyst

GLOBAL MARKET VIEW

Ehiwario Efeyini
Director and Senior Market Strategy Analyst

THOUGHT OF THE WEEK

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

Data as of 5/17/2021, and subject to change

MACRO STRATEGY

What's Next for the Manufacturing Cycle?

Jonathan Kozy, Managing Director and Senior Macro Strategy Analyst

Relative to the last 10 manufacturing cycles, the path of the ISM manufacturing index during the post-pandemic recovery is tracking the strongest survey values (Exhibit 1). In April, all 18 industries reported growth for the month, indicating the expansion is as broad as it gets. The strength of the economic recovery reflects pandemic-driven goods demand as well as massive fiscal and monetary stimulus. For investors, the ISM manufacturing index is a reasonable proxy for cyclical momentum and can be a timely indicator of tactical turning points for Equities, interest rates, and risk appetite more broadly. Therefore, it is important to gauge whether or not we are at a peak and what historical analysis suggests

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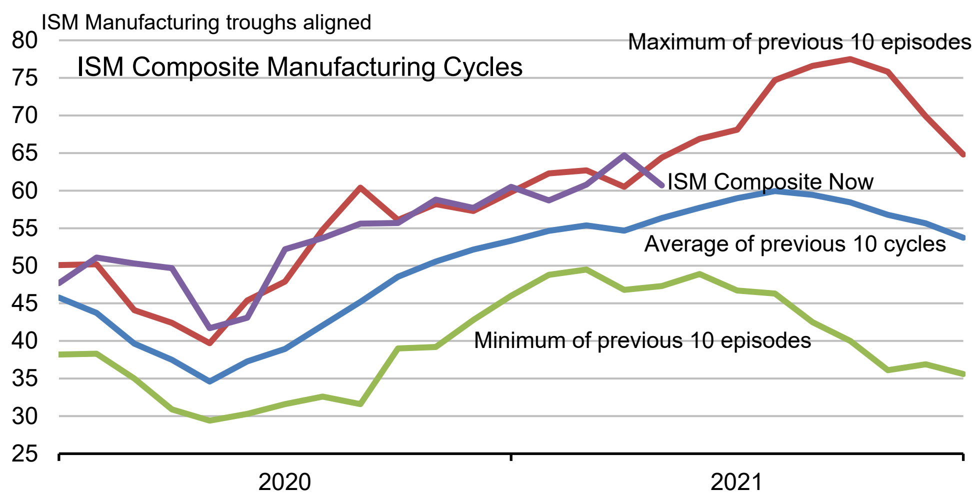
the path of the index could be over the balance of the year. The survey data also highlight key dynamics in the U.S. economy—resource scarcity, labor shortages and input price inflation.

Exhibit 1: ISM Manufacturing Index: Just a Pause?



Source: The Institute for Supply Management. Data as of April 2021. Data would differ if a different time period was displayed. Short term shown to illustrate more recent trend. Past performance is no guarantee of future results.

As Exhibit 1 suggests, if the current cycle continues to track the stronger manufacturing cycles, it could have further upside. The simplest explanation for how this might happen would be an acceleration in production to rebuild inventories combined with easier pandemic restrictions and continued monetary and fiscal stimulus. If the current cycle instead follows the average of previous cycles, it will remain firmly in expansion territory but could flatten out. Bottom line: Historical context suggests that, given the decent correlation between six-month changes in the ISM manufacturing and six-month changes in the S&P 500, cyclical momentum should be supportive of equities, providing a neutral-to-possibly-risk-on backdrop.

The pandemic induced a very strong recovery in the goods sector, where manufacturing data are tightly linked. Within the goods sector, there are two driving factors—consumer retail sales on goods and business spending on equipment. The outlook for both also suggests a sustained downturn in manufacturing data is unlikely, supporting risk assets.

On the consumer side, spending may transition to services, but given the amount of liquid savings, the pace of income growth, and a booming housing market, goods spending should remain strong. According to BofA Global Research, aggregated credit and debit card data show spending on durable consumer goods like furniture and home improvement goods currently remains "extraordinarily robust." Overall, we expect real consumer spending growth to stay near a double-digit pace for the next few months at least. For the year, BofA Global Research has real consumer spending in the U.S. growing at 8.6%.

Business equipment spending plays an equally important role in demand for manufactured goods and the ISM manufacturing survey data. With profits booming, the global economy recovering, and financial conditions easy, business investment spending growth is also likely to remain robust. U.S. companies are well positioned and incentivized to invest in productivity-enhancing investments while liquidity and stimulus are in ample supply.

The capital expenditures (CAPEX) cycle and the ISM manufacturing index are sensitive to global growth, and the global backdrop is supportive. The larger companies in the index are increasingly globalized, as one would expect, so the survey responses also increasingly reflect the global backdrop. From this perspective, the survey data echo the International Monetary Fund (IMF) and other prognosticators in suggesting global growth will be very

strong this year. And the new export orders subcomponent index within the ISM survey data increased to 54.7 in April even as the headline index declined. Given the relatively slower pandemic reopenings in many economies, new export order could have upside as vaccinations spread globally. The weaker dollar trend seen the last few months will also play a key role in supporting cyclical momentum through the global trade channel. Overall, the global backdrop seems positive for manufacturing momentum.

Inventories also play a crucial role in the path of manufacturing survey data. Both the ISM inventory indexes are low and signaling a rising headline ISM manufacturing index. When inventory growth is low or negative, like it is now, production will likely need to move higher than incoming orders in order to rebuild inventories. The April ISM report, however, noted a number of pandemic-related factors preventing production growth: "Committee Members reported that their companies and suppliers continue to struggle to meet increasing rates of demand due to coronavirus (COVID-19) impacts limiting availability of parts and materials. Recent record-long lead times, wide-scale shortages of critical basic materials, rising commodities prices and difficulties in transporting products are continuing to affect all segments of the manufacturing economy. Worker absenteeism, short-term shutdowns due to part shortages, and difficulties in filling open positions continue to be issues that limit manufacturing-growth potential."[1]

In order for inventories to be rebuilt, production needs to pick up, and that is proving challenging, highlighting some key risks but also potential upside to cyclical momentum.

Analysis of the ISM is incomplete without noting that the prices paid component is near a record high, highlighting another important risk. The prices component reflects record raw materials prices for copper, iron ore and timber—to name a few. At 89.6%, the prices paid index is about as high as it gets historically. The red-hot prices component combined with strong headline readings are a risk if they bring the Federal Reserve (Fed) off the bench. The above-consensus print on the consumer price index released last week elevates this risk. For now, the Fed has signaled its intention to run coincident measures of inflation above its 2% target for an extended period of time to reinforce inflation expectations. This also provides cyclical upside for the ISM and, therefore, risk assets.

Over the next few weeks, the regional survey data will start to provide color on manufacturing for the month of May. For April, the regional data were less weak than the ISM itself. The forward-looking expectations for new orders and shipments components of the Philadelphia Fed's Manufacturing outlook surged in April, for example. Other regional surveys showed similar jumps, perhaps suggesting May ISM data will remain at a strong level or pick back up.

The ISM typically only sustains such high levels coming out of a recession. If it is going to defy gravity, now is as good a time as any, as consumer pent-up demand is being amplified by extreme fiscal and monetary stimulus at the same time profits growth is reinforcing the cycle. And as mentioned, the easiest case to be made for a renewed upturn in the ISM, or sustained strength, is continued reopening both here and abroad. A resurgence or stabilization of the ISM manufacturing index would support risk assets and interest rates as has historically been the case over six-month time frames. Even if the U.S. is past the peak for the ISM, the backdrop described above suggests the level of the index will remain relatively high over the balance of the year.

[1]Timothy R. Fiore, "Manufacturing PMI at 60.7%: April 2021 Manufacturing ISM Report on Business," Institute for Supply Management, April, 2021.

A Two-Tiered Trend in Emerging Markets

Ehiwario Efeyini, Director and Senior Market Strategy Analyst

The recent equity market selloff has fallen unevenly across the emerging world, but EM as a group have so far been relatively resilient. Upward moves in U.S. bond yields of the type seen since late 2020 and the most recent leg higher that followed last week's consumer price index release for April have historically been a major hurdle for EM assets. A similar episode in the last cycle—the "taper tantrum" of May 2013—in which the U.S. 10-year Treasury rate soared by over 100 basis points within a few months, caused a drawdown of over 15% in EM equities. But a key difference in the current environment has been the much lower external funding needs of the overwhelming majority of the benchmark weighting, which has made EM less vulnerable overall to growing inflation concerns and rising U.S. rates. As a measure of reliance on external funding and vulnerability to higher yields, the current account positions for 13 of 20 major EM were in deficit at the time of the taper tantrum, representing 44% of EM market capitalization at the time. But today only five of the same 20 EM have negative current account balances, representing just 6% of total EM market cap (Exhibit 2).

Exhibit 2: Emerging Markets Less Vulnerable Than in the Past to Rising U.S. Rates.

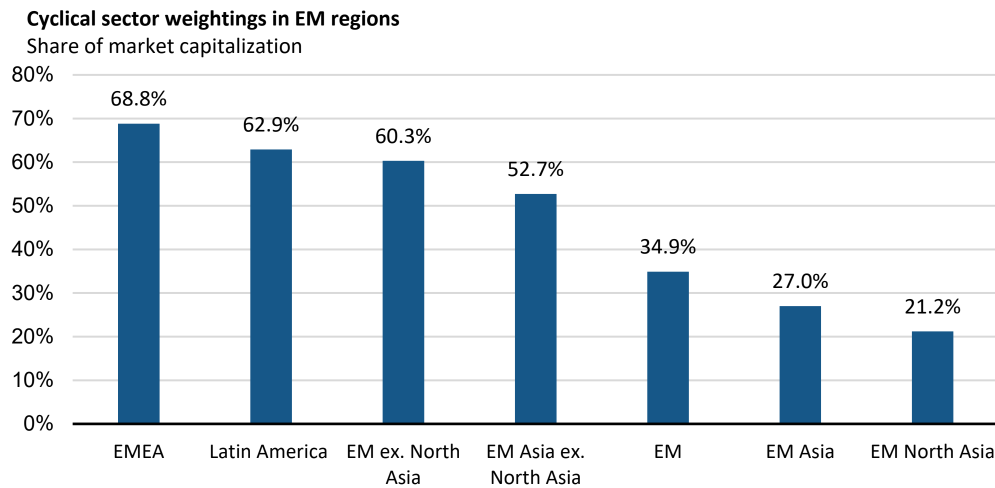
Major emerging economy current account balances and MSCI EM Equity Index weights

	Current account/GDP (%)		Index weight (%)	
	Apr-21	May-13	Apr-21	May-13
China	2.4	2.6	37.9	18.5
India	1.3	-4.8	9.7	6.8
Indonesia	-0.5	-3	1.2	3
Korea	4.4	4.6	13.3	14.9
Malaysia	4.4	5.2	1.4	3.9
Philippines	3.5	4.1	0.6	1.1
Taiwan	13.9	8.9	13.8	11.5
Thailand	3.3	-2.2	1.9	2.7
Brazil	-1.5	-3.6	4.5	12.2
Chile	1.3	-4.7	0.6	1.8
Colombia	-3.4	-3.5	0.2	1.1
Mexico	2.3	-1.8	1.7	5.2
Peru	0.7	-4.2	0.2	0.5
Czech Republic	3.6	-1.8	0.1	0.2
Hungary	0.1	2.5	0.2	0.2
Poland	3.3	-2.8	0.6	1.6
Russia	2.4	2.5	3.1	5.6
Turkey	-5.2	-5.1	0.3	2.1
Egypt	-5.7	-2.7	0.1	0.3
South Africa	2	-5.6	3.8	6.8

Sources: MSCI, Bloomberg. Data as of April 2021.

Rather than a broad-based flight from EM risk, the inflation scare has produced a similar rotation across EM sectors and regions as that seen in the rest of the world. Weakness in high-growth areas with higher-duration cashflows, such as information technology, internet retail and communications services, has contributed to the significant underperformance in the tech-driven north Asian markets of China, Korea and Taiwan. By contrast, outperformance in cyclical sectors tied more closely to the near-term economic recovery and steepening yield curve has been a tailwind for the other major regions of Latin America and EMEA (Europe, Middle East and Africa), both of which have climbed this month in absolute terms despite the pickup in volatility. This divergence highlights the two-tiered style composition of the aggregate EM equity market, in which a few heavyweight countries in north Asia have limited exposure (21%) to the cyclically oriented sectors of Energy, Materials, Industrials and Financials, while the remainder of the index in the EMEA and Latin America regions has a much higher concentration in these four sectors of 60% to 70% (Exhibit 3).

Exhibit 3: Emerging Market Equity Exposure to Key Cyclical Sectors.



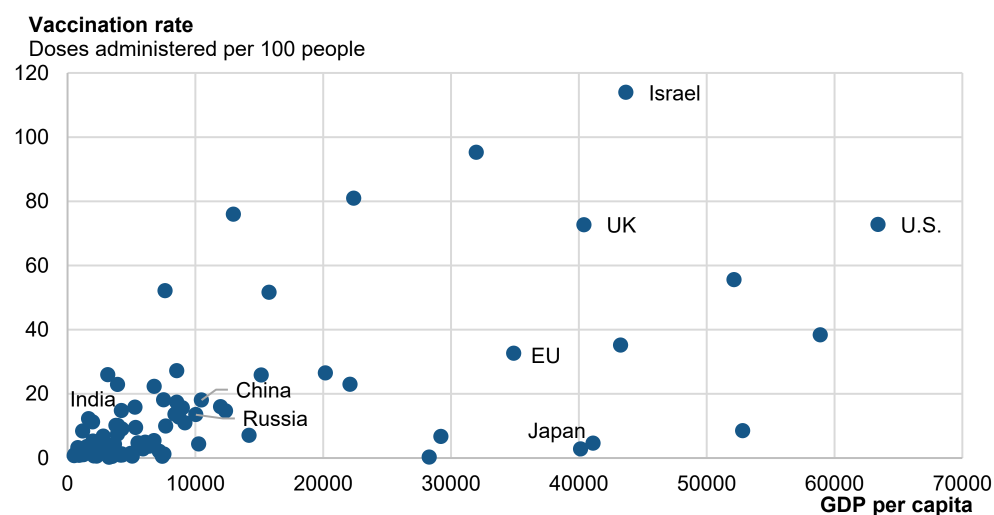
Sector exposures based on MSCI country indices. Cyclical sectors are Industrials, Financials, Energy and Materials. EMEA is Europe, Middle East and Africa. North Asia is China, Korea, Taiwan. Source: MSCI. Data as of 2020.

In many cases, idiosyncratic market drivers in the current environment have only acted to reinforce this two-tiered trend across EM equities. Natural resource producers in Latin America and EMEA, such as Brazil, Colombia, Peru and Russia, have benefited from the rise in commodity prices, while the advance in raw materials prices has been an additional headwind for Asia as a net importing region. The ongoing supply shortages in semiconductors and consequent risks from weaker global electronics and auto production remain a near-term challenge for chip manufacturers, which constitute close to 60% of market capitalization in Taiwan. In China, policy risks have weighed on the local market for much of the year as the authorities attempt to cool housing prices through bank lending caps and more restrictive financing policy. And for China's fast-growing technology platforms, a widening antitrust crackdown has been a further return constraint. Though we would expect any regulatory tightening in this domain to avoid undermining longer-term growth in the technology sector, this policy shift will also bear close watching. Following the suspension of a high-profile initial public offering in late 2020, the Chinese State Administration of Market Regulation has investigated more than 30 technology firms across segments such as internet retail, food delivery and fintech with a view to promoting industry competition and limiting the expansion of individual business activities such as non-bank lending, which are viewed as potential sources of economic instability.

Elsewhere in Asia, markets with a high dependence on tourism and remittances, such as Thailand and the Philippines are also likely to remain under pressure as the movement of people across borders for either leisure or migration lags behind the reopening of activity within borders. And though the Indian market has remained stable over recent weeks in the face of a severe coronavirus wave that has put more than 80% of the population under varying degrees of state-directed restriction, its high valuation multiples (roughly two standard deviations above the 10-year average across price-earnings and price-book) could yet be vulnerable. There has already been evidence of eroding political support for prime minister Narendra Modi's ruling Bharatiya Janata Party (BJP) during the recent series of state elections, and this could potentially reduce expectations for India's longer-term emergence as a global manufacturing power. The BJP has been a major driver of foreign direct investment inflows into India and structural reforms that have boosted its domestic manufacturing capacity. And as we look ahead to early 2022 elections in populous northern and western India, where the recent outbreaks have been particularly severe, it will therefore be important to monitor the extent to which the political fallout from the current crisis undermines the BJP reform agenda and potentially makes India less attractive as an investment destination.

But looking ahead to the rest of 2021 and into next year, we still expect EM to remain relatively resilient with a narrower divergence between these two tiers of a growth-oriented Asia and other more cyclically driven regions. Goods exporters in Asia should ultimately benefit from stronger growth in most developed economies on the back of the boost from government stimulus, economic reopening and strong household finances. High asset prices, rising employment levels and double-digit growth in household bank deposits across the U.S., Europe and Japan should provide fuel for developed market consumption in the coming quarters, with the IMF projecting stronger real gross domestic product (GDP) growth in 2021 for developed economies in aggregate (5.1%) than for all EM regions outside Asia (8.6%), including Latin America (4.6%), emerging Europe (4.4%), the Middle East (3.7%) and Africa (3.4%). As we move toward the second half of the year, the relative pace of growth in these lower-income markets is likely to trail the rest of the world due to their lower levels of fiscal support, operating constraints from lower rates of digital penetration, slower vaccination rollouts (Exhibit 4) and ultimately a slower pace of economic reopening.

Exhibit 4: Global Vaccination Rollout Has Been Slowest in Lower-Income Countries.



Sources: International Monetary Fund; Johns Hopkins; Bloomberg. Doses administered across 87 economies. Data as of May 13, 2021.

The ongoing crisis in India has been an extreme example of the type of capacity constraints faced by lower-income countries. And its role in global vaccine manufacturing and distribution could yet have wider implications for other low-income EM over the remainder of the year. Contract manufacturers in India were expected to provide around half of the two billion vaccine doses targeted by the World Health Organization for the lower-income emerging world by the end of 2021. But the greater need under current circumstances to use more of this local production domestically poses a new risk for other low-income countries by further prolonging their vaccination programs. Redirected doses may be at least partially offset by supplementary vaccine output from China and Russia, as well as excess supply from the U.S. and Europe. But as the developed world and many of the key Asian economies continue to normalize over the months ahead, these challenges mean that large parts of the emerging world are likely to remain under pressure.

THOUGHT OF THE WEEK

Reality Check: Some Inconvenient Truths about the Green Revolution

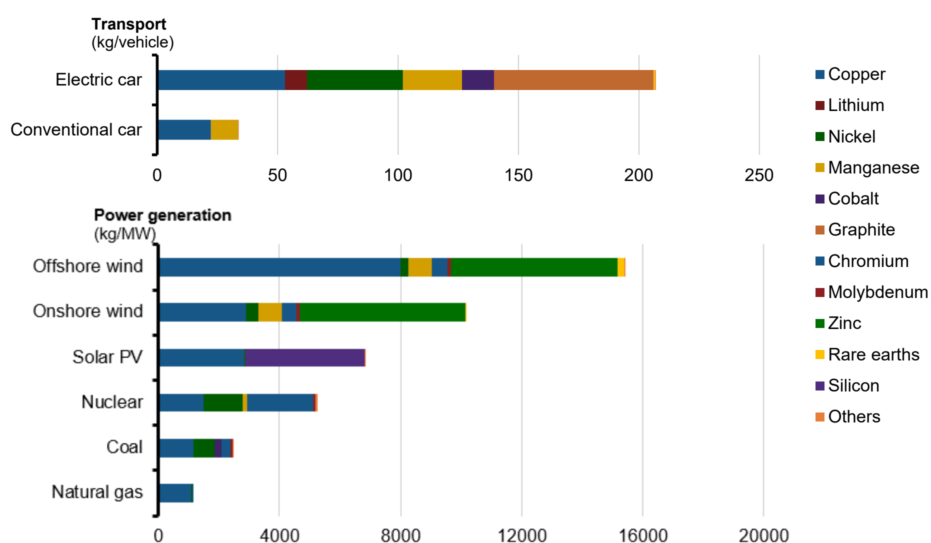
Joseph P. Quinlan, Managing Director and Head of CIO Market Strategy

The transition toward a clean energy future won't be easy. Indeed, going green, in the end, could be counterproductive to the ultimate goal: a cleaner, decarbonized environment.

Here's the problem—the push to boost renewable power capacity (think solar, wind and batteries) is extraordinarily metal-intensive, requiring more minerals than fossil fueled-based counterparts. Not surprisingly, then, the 45% surge in renewable electricity capacity last year has triggered a commodities boom in mining and production. However, the metals extraction and processing businesses are significant contributors to carbon emissions, as well as an acute source of stress on the world's air quality, water reserves and soil composition. Perversely, then, the transition to clean energy could be less "clean" and "green" than commonly thought.

A new report from the International Energy Agency ("The Role of Critical Minerals in Clean Energy Transitions") puts all of this into perspective: "A typical electric vehicle (EV) requires six times the mineral inputs of a conventional car, and an onshore wind plant requires nine times more mineral resources needed than a gas-fired plant. Since 2010, the average amount of new minerals needed for a new unit of power generation capacity has increased by 50% as the share of renewables has risen." Exhibit 5 underscores the fact that the Energy sector is emerging as a major force in the minerals markets.

Exhibit 5: Minerals Used In Selected Clean Energy Technologies.



Source: International Energy Agency. Data as of May 10, 2021. Notes: kg = kilogram; MW = megawatt. Steel and aluminum not included.

Paraphrasing from the report:

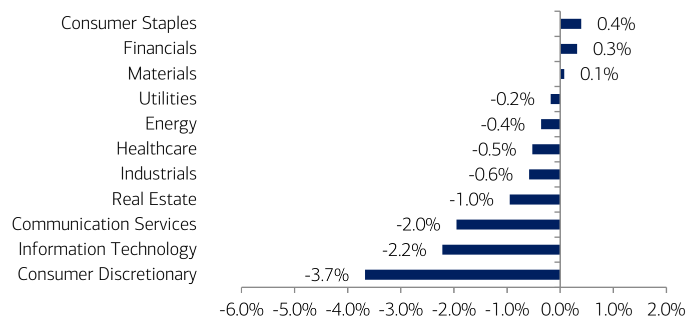
- To reach the goals of the Paris Agreement would mean a quadrupling of mineral requirements for clean energy technologies by 2040.
- It has taken on average over 16 years to move mining projects from discovery to first production. These long lead times raise questions about the ability of suppliers to ramp up output if demand were to pick up rapidly.
- Copper and lithium are particularly vulnerable to water stress given their high water requirements. Over 50% of today's lithium and copper production is concentrated in areas with high water-stress levels.
- Production of many energy transition minerals is more concentrated than that of oil or natural gas. The Democratic Republic of Congo is responsible for over 70% of cobalt output; China controls 60% of rare earth minerals and graphite; South Africa supplies roughly 70% of platinum production; and Australia accounts for over half of global lithium output. The upshot: Concentrated production and processing represent a serious supply chain risk to end users.

Bottom line: One of our key long-term themes is Climate Change, with renewable energy front and center. We believe we are on the road to a more decarbonized future, albeit with some speed bumps, namely securing a stable and cost-effective mineral supply.

Equities

	Current	WTD	MTD	YTD
	Total Return in USD (%)			
DJIA	34,382.13	-1.1	1.6	13.1
NASDAQ	13,429.98	-2.3	-3.8	4.5
S&P 500	4,173.85	-1.3	-0.1	11.7
S&P 400 Mid Cap	2,721.89	-1.7	-0.1	18.5
Russell 2000	2,224.63	-2.0	-1.8	13.0
MSCI World	2,938.63	-1.3	0.1	9.9
MSCI EAFE	2,292.17	-1.3	1.3	7.9
MSCI Emerging Markets	1,307.53	-3.0	-2.9	1.8

S&P 500 Sector Returns



Fixed Income†

	Current	WTD	MTD	YTD
	Total Return in USD (%)			
Corporate & Government	1.46	-0.41	-0.03	-3.47
Agencies	0.74	-0.16	0.06	-1.12
Municipals	1.06	-0.17	0.02	0.51
U.S. Investment Grade Credit	1.54	-0.37	-0.09	-2.70
International	2.17	-0.47	0.04	-3.55
High Yield	4.12	-0.27	0.03	1.97

	Current	WTD	MTD	YTD
90 Day Yield	0.00	0.01	0.00	0.06
2 Year Yield	0.15	0.14	0.16	0.12
10 Year Yield	1.63	1.58	1.63	0.91
30 Year Yield	2.34	2.28	2.30	1.64

Commodities & Currencies

Commodities	Current	WTD	MTD	YTD
	Total Return in USD (%)			
Bloomberg Commodity	196.40	-1.9	1.8	17.9
WTI Crude $/Barrel††	65.37	0.7	2.8	34.7
Gold Spot $/Ounce††	1843.43	0.7	4.2	-2.9

Currencies	Current	Prior Week End	Prior Month End	2020 Year End
EUR/USD	1.21	1.22	1.20	1.22
USD/JPY	109.35	108.60	109.31	103.25
USD/CNH	6.44	6.42	6.47	6.50

Sources: Bloomberg, Factset. Total Returns from the period of 5/10/2021 to 5/14/2021. †Bloomberg Barclays Indices. ††Spot price returns. All data as of the 5/14/2021 close. **Past performance is no guarantee of future results.**

Asset Class Weightings (as of 5/4/2021)

	Underweight		Neutral	Overweight	
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 5/14/2021)

	Q4 2020A	2020A	Q1 2021A	Q2 2021E	Q3 2021E	Q4 2021E	2021E
Real global GDP (% y/y annualized)	-	-3.2	-	-	-	-	5.9
Real U.S. GDP (% q/q annualized)	4.3	-3.5	6.4	10.0	9.0	5.0	7.0
CPI inflation (% y/y)	1.2	1.2	1.9	4.5	4.2	4.0	3.6
Core CPI inflation (% y/y)	1.6	1.7	1.4	3.4	3.4	3.4	2.9
Unemployment rate (%)	6.7	8.1	6.2	5.6	4.6	4.2	5.1
Fed funds rate, end period (%)	0.09	0.09	0.06	0.13	0.13	0.13	0.13
10-year Treasury, end period (%)	0.91	0.91	1.74	1.85	2.00	2.15	2.15
S&P 500 end period	3756	3756	3973	-	-	-	3800
S&P earnings ($/share)	42	140	42*	46	48	49	185
Euro/U.S. dollar, end period	1.22	1.22	1.17	1.18	1.16	1.15	1.15
U.S. dollar/Japanese yen, end period	103	103	111	107	110	113	113
Oil ($/barrel, avg. of period, WTI**)	44	40	58	64	60	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.

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 May 14, 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 U.S. dollars.

S&P 500 Index is a stock market index that measures the stock performance of 500 large companies listed on stock exchanges in the United States. It is one of the most commonly followed equity indices.

Institute for Supply Management (ISM) manufacturing index is a composite index that gives equal weighting to new orders, production, employment, supplier deliveries, and inventories.

New export orders subcomponent index within the ISM has five components of the composite index: new orders, production, employment, supplier deliveries, and inventories (their own, not customer inventories).

Consumer Price Index measures the average change in prices over time that consumers pay for a basket of goods and services.

Prices paid index is an index that measures changes in the prices paid for goods and services used in crop and livestock production and family living.

MSCI Emerging Markets Index is a selection of stocks that is designed to track the financial performance of key companies in fast-growing nations.

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All recommendations must be considered in the context of an individual investor's goals, time horizon, liquidity needs and risk tolerance. Not all recommendations will be in the best interest of all investors.

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

Investments have varying degrees of risk. Some of the risks involved with equity securities include the possibility that the value of the stocks may fluctuate in response to events specific to the companies or markets, as well as economic, political or social events in the U.S. or abroad. Investments in foreign securities involve special risks, including foreign currency risk and the possibility of substantial volatility due to adverse political, economic or other developments. These risks are magnified for investments made in emerging markets. Investments in a certain industry or sector may pose additional risk due to lack of diversification and sector concentration. There are special risks associated with an investment in commodities, including market price fluctuations, regulatory changes, interest rate changes, credit risk, economic changes and the impact of adverse political or financial factors. Investing in fixed-income securities may involve certain risks, including the credit quality of individual issuers, possible prepayments, market or economic developments and yields and share price fluctuations due to changes in interest rates.

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