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CHIEF INVESTMENT OFFICE

Capital Market Outlook

May 26, 2020

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

IN THIS ISSUE

- **Macro Strategy**—Equity markets have currently rallied from their March lows despite painful economic data and the uncertain path of the virus. We argue that a new equity bull market is already underway but rather in a "Wait and Watch" stage as clarity emerges on the nature of this bear market (structural, cyclical or exogenous), which may ultimately lead to a "Path Forward" and establish new trends.
- **Global Market View**—China has so far this year been the best performer within the emerging market (EM) equity benchmark and one of the top-performing markets globally. But the potential for new tensions to interrupt China's growth rebound and market recovery could cause EMs to lag further over the period ahead. We remain tactically underweight in EM equities.
- **Thought of the Week**—While we do expect further market, volatility, the consistent read-across both energy equity and debt markets suggests we may not be at the beginning of the end, we are hopefully at least at the end of the beginning.
- **Portfolio Considerations**—We favor equities relative to fixed income; prefer U.S. large caps relative to the rest of the world and are underweight all non-U.S. assets; and, in fixed income, we favor investment-grade bonds. Overall on a portfolio rebalancing basis—for those with an 18-month or longer time frame—we are buyers of equities on large weakness and suggest investors consider having dollar cost averaging plans ready as we head fully into the spring and summer months.

MACRO STRATEGY

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GLOBAL MARKET VIEW

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THOUGHT OF THE WEEK

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Data as of 5/26/2020 and subject to change.

MACRO STRATEGY

Going from "Wait and Watch" Stage to a "Path Forward" Stage

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The S&P 500 has rallied an impressive 33% from its March 23 lows, getting further away from its 50% retracement level of 2,792 and its long-term secular support of 2,688. While some investors are justifiably concerned about the historically painful economic data and the uncertain path of the virus, we would argue that a new equity bull market looks to be underway.

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A bull market typically begins with a "Gasp for Air" stage, characterized by a strong rally off oversold levels, sparked by policy makers starting to panic, incrementally less damaging news flow and covering of excessive short positions. This then could lead to the "Wait and Watch" stage involving consolidation of recent gains and range-bound trading, as bulls and bears hash out their thesis for the future. Eventually, a "Path Forward" stage establishes new trends, as clarity emerges on the nature of the bear market, i.e., Structural (like 1929); Cyclical (like 1966); or Exogenous (like 1987).

U.S. equities appear to be in the "Wait and Watch" stage, which will potentially last into the third quarter, then followed by a "Path Forward" stage—dependent on the success of economic re-openings and ultimately vaccines and treatment. In this section, we address two investor questions during this current stage—seemingly higher valuations and what the market is pricing in, before taking a historical perspective of how a "Path Forward" happens.

Take the Price-per-Earnings (P/E) for what it is

Seeing that the S&P 500 index is currently trading at a 20x P/E, above the historical average of roughly 16x, some investors have been pointing to expensive equity valuations as reason for caution. In the near term, this is likely addressed by pullbacks within the "Wait and Watch" stage and stabilization of forward earnings estimates as economic activity stirs back to life, and ultimately earnings potentially growing into price gains.

However, we would argue that in the post-virus world, a higher valuation multiple for the S&P 500 may be the new normal. A gradual recovery in the consumer and services sectors, should keep inflation and interest rates at low levels, often considered a good position for multiples. Concurrently, the Federal Reserve's (Fed's) policy interest rates is seen to remain at or near zero-bound long after the recovery takes hold, translating into easier financial conditions and less uncertainty, helping to support higher multiples. In addition, the scarcity of assets that offer a combination of Quality, Yield and Growth should be able to enhance the attractiveness of U.S. large caps on a structural basis. Finally, the S&P 500 index of today seems to be more exposed to secular industries, which arguably seeks to help the market to see through near-term economic weakness. For example, the weight of secular growth sectors like Technology, Communication Services and Healthcare today is 50% of the index versus 30% back in 2005.

What do we think the market is pricing in?

This is a common query by investors during the "Wait and Watch" stage and is not precisely answered amid the wide dispersion in data, with both bulls and bears in the analyst community and media having enough ammunition. Just looking at how much equities have curently rallied off the lows also may not provide an accurate picture and has to be combined with past and present headlines, investor sentiment and positioning, and market internals like volatility, technicals, market breath, etc. In other words—it's art and science with a healthy dose of history. In our view, the S&P 500 has absorbed the rescue dose of Fed liquidity and fiscal stimulus and has transitioned its focus from economic shutdowns to the beginning of economic re-openings, but the post-virus corporate earnings and consumer pent-up demand acceleration slated potentially for 2021 may yet to be priced in. Meanwhile, the possibility of a second wave of infections, negative headlines and rising U.S./China tensions may be the risks equities still have to contend with and therefore will keep the market in a wide trading range during this stage.

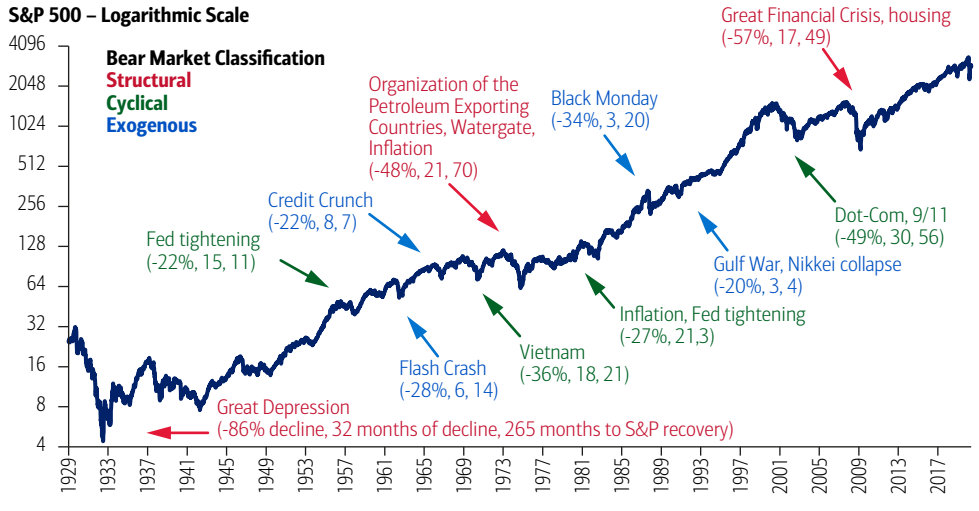
In our view the likelihood of a retest of the March market lows has declined, given the unprecedented monetary and fiscal stimulus measures and investor sentiment remaining bearish, even as this "don't fight the Fed" rally has kept going. Bearish sentiment appears to have hit a high so far for the year, according to the well-followed survey by American Association of Individual Investors, suggesting that investors are more bearish now near 3000 levels for the S&P 500 than they were near 2200 levels in March. Meanwhile, cash

held in money market funds has reached $4.8 trillion, according to BofA Global Research as of May 2, 2020, surpassing the 2008 financial crisis highs of $3.9 trillion, which shows a lack of enthusiasm for this rally.

Getting to A Path Forward

History suggests that some bear markets are due to structural economic pressures, and some are cyclical downturns, while others are caused by unforeseen exogenous shocks. The depth and speed of the decline and subsequent time to recovery vary, with the root cause ultimately determining the potential path forward.

Exhibit 1: There Are Different Causes For Bear Markets, With Varying Declines and Recoveries.



Source: Chief Investment Office. Data as of May 19, 2020.

Structural bear markets are the product of systemic imbalances often built up across multiple cycles. These fester and grow in significance, until a catalyst produces a cascading fallout and ultimately reorganization. For example, the Global Financial Crisis of 2007–2009 was considered to be primarily caused by a downturn in the U.S. housing market, brought about by excessive risk-taking, bloated debt levels, and poor regulation built up over the years.

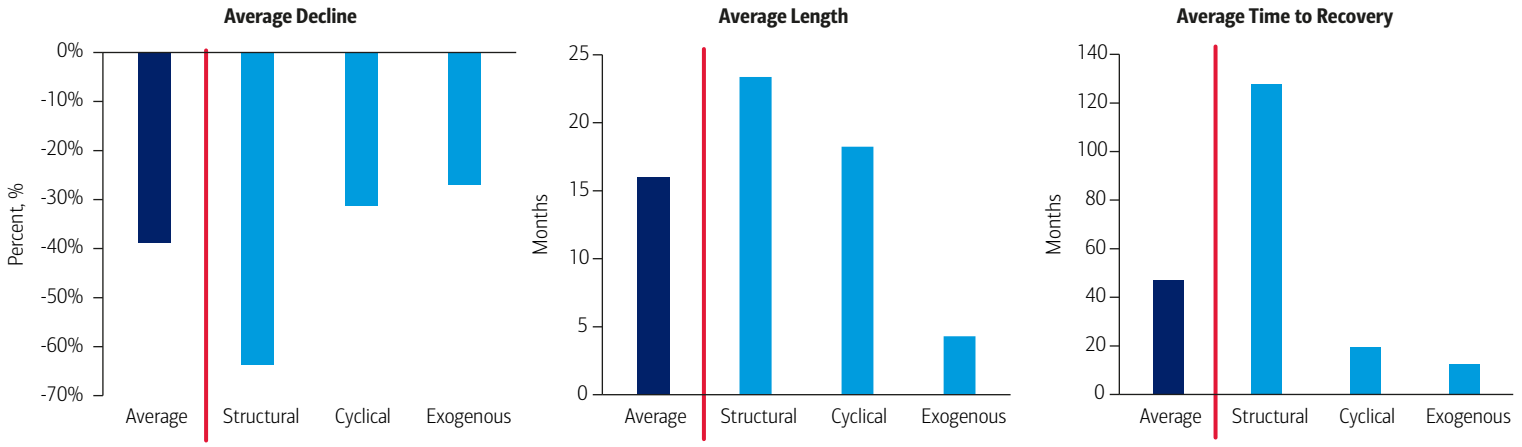
The Great Depression of 1929 was a cyclical bear market that turned structural due to the lack of policymakers to provide timely stimulus, a decrease in money supply and ill-timed trade wars. In 2002, Ben Bernanke, past Chair of the Federal Reserve, in retrospect, acknowledged that the Fed's mistakes contributed to the "worst economic disaster in American history." As a result, U.S. equities lost 86% of its value across 32 months and took over 22 years to recover. Structural bear markets tend to produce greater declines with longer recovery time, given the substantial reorganization needed to correct imbalances within financial markets and institutions.

Cyclical bear markets correspond with the natural lifecycle of economic activity, corporate profits and credit. These bear markets seem to be more frequent as cycles refresh regularly, using the downturn to correct cyclical excesses. As such, cyclical bear markets are typically less severe, and the recovery seems quicker. For example, in 1966, the U.S. economy endured a credit crunch after a series of rate hikes by the Fed and solvency fears pertaining to financial institutions. The S&P 500 fell 22% over eight months and would subsequently take seven months to likely recover.

Exogenous bears come unannounced, when economic and financial conditions appear stable, until some sort of event (war, pandemic etc.) supersedes all other context. These

would include the proverbial "black swans" or "unknown unknowns" that lurk in the background and have a minimal probability of materializing. By their nature, exogenous shocks have usually been an abrupt interruption of otherwise normal conditions, so their outcome may not require the same effort of reorganization or time as structural and even cyclical bears. As a result, the initial market reaction is typically sharp, accounting for the surprise, but the length is relatively short, and the time to recovery may be swifter. The market crash of 1987, punctuated by a 20.5% decline in the S&P 500 on Black Monday is one such unique example. It didn't correspond with a recession, was caused primarily by financial innovation (i.e., program trading) that went too far, with the recovery supported by timely policy response and a strong underlying economy.

Exhibit 2: Bear Markets Characterized by Exogenous Shocks Typically Are Considered Sharp but Shorter.



Source: Chief Investment Office. Data as of May 19, 2020.

CONCLUSION

In our view, the current episode is similar to past instances of exogenous bears, causing a pause within a long-term secular bull market. BofA Global Research notes that secular bull markets are multi-business cycle uptrends that include cyclical bulls and bears as well as economic expansions and recessions. Importantly, they note that bear markets within secular bull markets tend to find support above or near a rising 200-week moving average (MA). The S&P 500 did break below its 200-week MA recently but reversed quickly and has had weekly closes above this key support of 2,688 since April 10, keeping the secular uptrend intact.

We are keeping an eye on key investment risks especially as re-openings gather pace. Those risks would include a re-escalation of U.S./China tensions and the second-order effects of this recession, including corporate bankruptcies, the timeline for small businesses to recover, and behavioral changes regarding consumer spending post-virus. If these risks remain reasonably contained against the backdrop of improving economic activity and stimulus measures, then markets should continue to climb the wall of worry from a 12- to 18-month perspective in our view.

GLOBAL MARKET VIEW

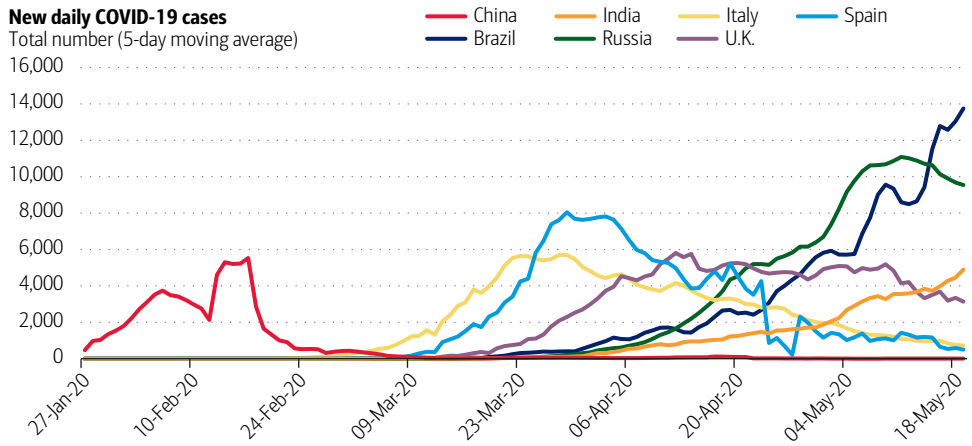
China's Recovering Economy and Rising Market Risks

Ehiwario Efeyini, Director and Senior Market Strategy Analyst

China was ground zero for the coronavirus pandemic at the start of 2020, but so far this year has been the best performer within the MSCI EM equity benchmark and one of the top-performing markets globally. The relative strength of Chinese equities owes much to

the country's handling of the outbreak. From its peak in mid-February, the trend rate of new daily cases had fallen to below 100 by mid-March and had collapsed into the single digits by late April. And though factories, department stores, restaurants and internal borders nationwide have now been reopened for several weeks, new cases have been isolated and localized. This quashing of the epidemic curve in China over recent months stands in stark contrast with other large EM countries. New case curves have steepened for example in Brazil and India, which, along with Russia, have now surpassed the worst affected countries in Europe such as Italy, the U.K. and Spain (Exhibit 3).

Exhibit 3: Large Emerging Economies Outside China Have Surpassed Worst Affected European Countries in New COVID-19 Cases.

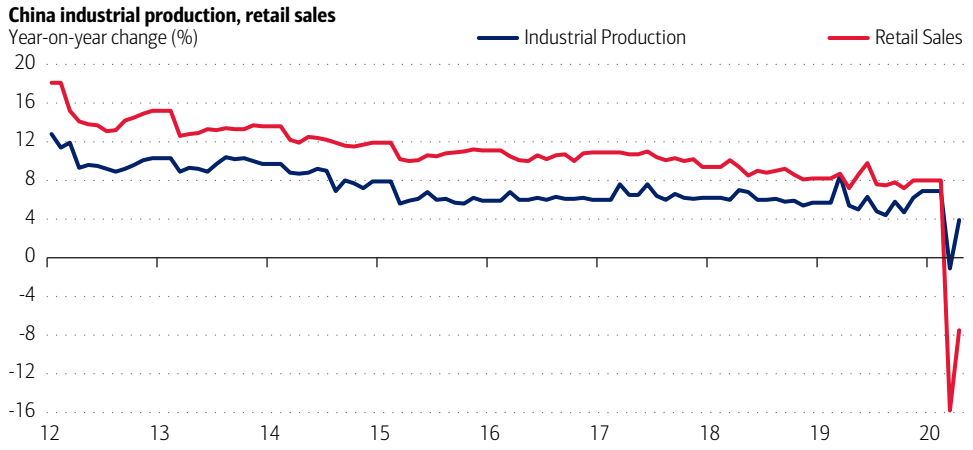


Source: Johns Hopkins, Bloomberg. Data as of May 19, 2020.

The widespread use of tracking technology in China has been central to keeping the virus under control. In conjunction with its leading internet companies, the Chinese government launched an app-based health code system in February that has become a broadly accepted measure of an individual's risk of transmission. Each user is assigned a status of red, yellow or green based on travel history, recent contacts, health condition and other personal details. And based on the code marker that has been given, individual access to public transportation, office buildings, stores and restaurants is either granted or denied. As well as allowing individual health status to be monitored across the population, the system has also helped the economy to recover more quickly. Real-time identification of people who could potentially pass on the disease (and the granting of access only to those who are not potential transmitters), has allowed building and service operators to lift capacity restrictions, reduce the required level of social distancing and increase economic activity.

On the latest projections from the International Monetary Fund for April, China now stands as one of only four countries in the EM index expected to register positive economic growth in 2020. Key cyclical measures such as auto sales and electricity consumption have already returned to the levels of one year ago. And on a sequential basis, the aggregate estimate across 41 private forecasters counted by Bloomberg is for real gross domestic product (GDP) to surge by 7.9% over the current quarter. The recovery has, however, been led so far by the investment side of China's economy, with consumption and service activity lagging due to their higher concentration in the most affected sectors such as retail, leisure and hospitality. Year-on-year retail sales growth, for example, contracted for a second consecutive month at -7.5% in April, in contrast to industrial production, which grew at 3.9% over the same period (Exhibit 4). Without a demand recovery either domestically or from global importers, this could potentially make for an inventory-led deceleration in the second half.

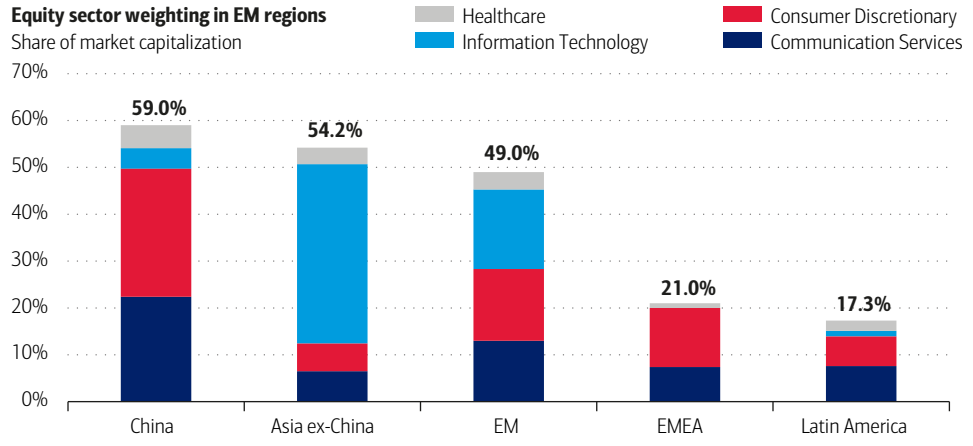
Exhibit 4: China Industrial Activity Has Led Consumer Spending In Economic Rebound.



Sources: National Bureau of Statistics, Bloomberg. Data as of April 2020.

But crucially, the investment recovery has included a focus on "new infrastructure," which has been centered around the buildout of telecommunications and information technology capacity in structural growth areas like cloud computing and next-generation wireless networks. This should enhance China's longer-term growth potential as the immediate economic fallout from the crisis subsides and should also support local equity returns. More than other markets across the emerging world, the capitalization weightings within Chinese equities are geared toward our favored growth sectors of communication services, information technology, healthcare and consumer discretionary. These four combined account for 59% of market capitalization in China, compared to 54% in emerging Asia outside China, 21% in Europe, the Middle East and Africa (EMEA) and just 17% in Latin America (Exhibit 5). The two largest of these sectors in particular (communication services and consumer discretionary) contain China's leading internet companies and should be beneficiaries of the investment emphasis on technology and telecommunications, as well as the existing trend toward digitization across traditional industries. Having been a top performer through the crisis so far, China therefore remains well-positioned relative to other emerging markets as the worst of the global economic contraction reverses into mid-year.

Exhibit 5: Emerging Market Equity Exposure To Favored Sectors.



Source: MSCI. Data as of April 2020. Sector exposures based on MSCI country and regional indices.

One key risk to watch for China over the remainder of this year and into 2021 will be the external challenges from a resumption of tensions with the U.S. And this risk may

only increase as China redoubles its efforts to boost domestic technological capacity in the wake of the crisis. The U.S. Senate last week passed a bipartisan bill that would introduce new accounting requirements for Chinese companies, which could jeopardize current and future U.S. listings for its technology leaders. And separately, Nasdaq announced plans to introduce new auditing rules and fund raising minimums for initial public offerings that would also make it more difficult for Chinese companies to list in the U.S. These developments come on top of recent moves to block U.S. equity investment into the Chinese market by a $40 billion federal pension fund, and to further limit access to U.S. semiconductors. By themselves, these actions should have little impact on the funding, demand or returns for Chinese equities. But even if the moves have largely been symbolic, they indicate that the U.S.-China tensions of 2018–2019 have not disappeared. Perhaps more important, they represent a shift away from a focus on bilateral trade toward a new focus on financial markets. The trade tensions of the past two years were sufficient to cause significant equity underperformance in China and EM more broadly. And a new phase of the U.S.-China conflict targeting capital markets would have the potential to be even more disruptive were it to escalate.

China now accounts for 40% of the EM equity benchmark, making it pivotal to the outlook for aggregate EM returns. Alongside extremely weak performance this year in Latin America, EMEA and much of Asia outside China, the relative strength of Chinese equities has therefore limited the downside for EMs overall. But after China's effective actions and solid performance throughout the pandemic so far, risks from an intensifying strategic rivalry with the U.S. will have to be watched as the world emerges from the COVID-19 crisis. The potential for new tensions to interrupt China's growth rebound and market recovery could cause EMs to lag further over the period ahead, and we remain tactically underweight in EM equities.

THOUGHT OF THE WEEK

Bottoming in Energy Sector Considered a Bright Spot for Markets

Matthew Diczok, Managing Director, Fixed Income Strategist

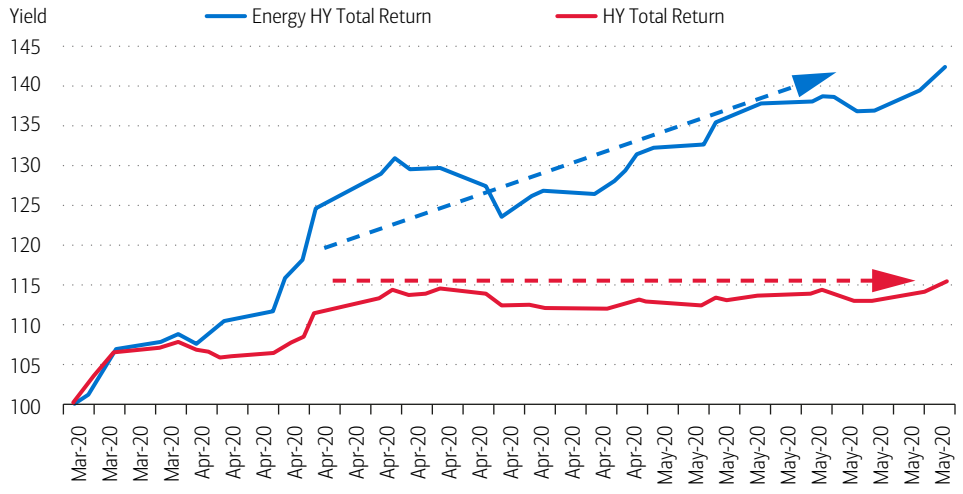
From a market perspective, the crisis has been defined by three phases. First, for almost all credit risk assets, widening to valuations never seen outside of the 2008/2009 Global Financial Crisis. This was exacerbated by massive liquidations both forced—for example, when the repurchasing (repo) market broke down and, when many investors liquidated corporate and municipal risk. Second, a quick return to "normal"—meaning levels in-line with a recession—levels due to strong fiscal and monetary policies. Finally, our current environment—a "holding pattern": average valuations held near recession-type levels, for six weeks running.

"Averages," however, belie interesting dispersions at the sector level. The energy sector, for example, has not been held in the same pattern.

In equities, energy has outperformed the S&P 500 by >10% over the last 30 days.[1] When cross-referenced with credit, this does not seem to be a one-off occurrence. High yield (HY) energy spreads have been confirming the equity moves, moving relentlessly tighter; new-issue activity likewise has been robust for even weaker energy credits. At the depth of this crisis, high yield energy yielded ~24%—the highest ever. This was a peak-to-trough total return drawdown of 45%—~11% worse than the overall stock market itself. For an asset class that functions like high-quality equity—high yield bonds are higher in the capital structure—this is considered a staggering loss. High yield energy has since clawed back more than half, yielding "only" ~12.5%; still distressed but an order of magnitude different from yields >20%.

[1] S&P Total Return (SPXT) vs. S&P 500 Energy Total Return Index (SPTRENRS). Source: Bloomberg as of 21 May 2020.

Exhibit 6: HY Energy Has Continued to Rally Even As Overall HY Market is in a Holding Pattern.



Source: Bloomberg Barclay. Data as of May 20, 2020. Total returns levels indexed to 100. **Past performance is no guarantee of future results.** Short term performance shown to illustrate more recent trend.

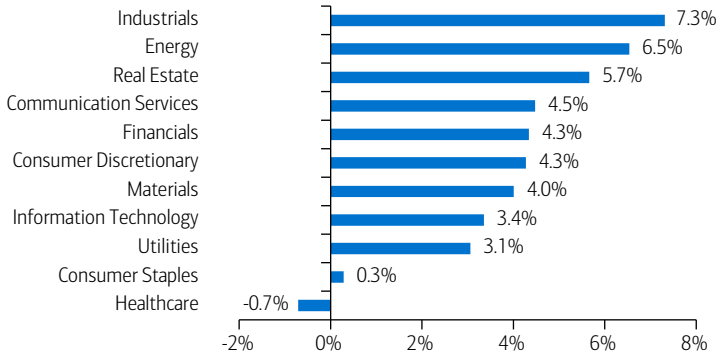
This is encouraging, highlighting how significantly sentiment has changed in less than two months. If one of the most unloved, beaten-down, economically sensitive sectors is able to stage such a remarkable comeback, it may help confirm that a market bottom has already occurred. While we do expect further volatility, the consistent read-across both energy equity and debt markets suggests that while we may not be at the beginning of the end, we are hopefully at least at the end of the beginning.

MARKETS IN REVIEW

Equities

	Total Return in USD (%)			
	Current	WTD	MTD	YTD
DJIA	24,465.16	3.4	0.8	-13.4
NASDAQ	9,324.59	3.5	5.0	4.4
S&P 500	2,955.45	3.3	1.7	-7.8
S&P 400 Mid Cap	1,695.33	7.4	3.1	-17.2
Russell 2000	1,355.53	7.9	3.5	-18.3
MSCI World	2,081.83	3.2	1.1	-11.5
MSCI EAFE	1,664.80	3.0	-0.7	-18.4
MSCI Emerging Markets	911.41	0.5	-2.0	-18.3

S&P 500 Sector Returns



Fixed Income[1]

	Total Return in USD (%)			
	Current	WTD	MTD	YTD
Corporate & Government	1.35	0.5	0.3	6.0
Agencies	0.62	0.0	0.1	4.8
Municipals	1.65	1.0	3.0	1.0
U.S. Investment Grade Credit	1.38	0.4	0.2	5.2
International	2.51	1.5	0.8	2.3
High Yield	7.47	2.6	2.6	-6.4

	Current	Prior Week End	Prior Month End	2019 Year End
90 Day Yield	0.11	0.10	0.08	1.54
2 Year Yield	0.17	0.15	0.20	1.57
10 Year Yield	0.66	0.64	0.64	1.92
30 Year Yield	1.37	1.33	1.28	2.39

Commodities & Currencies

	Total Return in USD (%)			
Commodities	Current	WTD	MTD	YTD
Bloomberg Commodity	133.84	1.8	3.0	-22.2
WTI Crude $/Barrel[2]	33.25	13.0	76.5	-45.5
Gold Spot $/Ounce[2]	1,734.68	-0.5	2.9	14.3

Currencies	Current	Prior Week End	Prior Month End	2019 Year End
EUR/USD	1.09	1.08	1.10	1.12
USD/JPY	107.64	107.06	107.18	108.61
USD/CNH	7.15	7.13	7.08	6.96

Source: Bloomberg, Factset.Total Returns from the period of 05/18/20 to 05/22/20. Bloomberg Barclays Indices.[1] Spot price returns.[2] All data as of the 05/22/20 close.
Past performance is no guarantee of future results.

Asset Class Weightings (as of 5/6/2020)

	Under-weight		Neutral		Over-weight
Global Equities	•	•	•	●	•
U.S. Large Cap Growth	•	•	•	●	•
U.S. Large Cap Value	•	•	•	●	•
U.S. Small Cap Growth	•	•	•	●	•
U.S. Small Cap Value	•	•	●	•	•
International Developed	•	●	•	•	•
Emerging Markets	●	•	•	•	•
Global Fixed Income	•	●	•	•	•
U.S. Governments	•	●	•	•	•
U.S. Mortgages	•	●	•	•	•
U.S. Corporates	•	•	•	●	•
High Yield	•	●	•	•	•
U.S. Investment Grade Tax Exempt	•	•	●	•	•
U.S. High Yield Tax Exempt	•	●	•	•	•
International Fixed Income	●	•	•	•	•
Alternative Investments*	see CIO Asset Class Views				
Hedge Funds					
Private Equity					
Real Assets					
Cash					

* Many products that pursue Alternative Investment strategies, specifically Private Equity and Hedge Funds, are available only to pre-qualified clients.

Economic and Market Forecasts (as of 05/22/20)

	Q3 2019A	Q4 2019A	2019A	Q1 2020A	Q2 2020E	2020E
Real global GDP (% y/y annualized)	–	–	2.9	–	–	-4.2
Real U.S. GDP (% q/q annualized)	2.1	2.1	2.3	-4.8	-40.0	-8.0
CPI inflation (% y/y)	1.8	2.0	1.8	2.1	0.5	0.8
Core CPI inflation (% y/y)	2.3	2.3	2.2	2.2	1.3	1.4
Unemployment rate (%)	3.6	3.5	3.7	3.8	17.5	11.2
Fed funds rate, end period (%)	1.90	1.55	1.55	0.08	0.13	0.13
10-year Treasury, end period (%)	1.66	1.92	1.92	0.67	0.50	1.00
S&P 500 end period	2977	3231	3231	2585	–	2600
S&P earnings ($/share)	42	42	163.0	34*	25.0	115
Euro/U.S. dollar, end period	1.09	1.12	1.12	1.10	1.02	1.05
U.S. dollar/Japanese yen, end period	108	109	109	108	105	103
Oil ($/barrel, avg. of period, WTI**)	56	57	57	46	20	32

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 the year-end target for 2020. **West Texas Intermediate.
Sources: BofA Global Research; GWIM ISC as of May 22, 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.

MSCI Emerging Markets Index is used to measure equity market performance in global emerging markets. The index captures mid and large caps in 26 countries including China, India, Korea, Mexico, Taiwan, and the United Arab Emirates. Investors can invest in the index directly.

S&P 500 Total Return Index tracks a market-cap-weighted index of US large- and midcap stocks (the S&P 500), excluding firms in the tech sector.

S&P 500® Energy comprises those companies included in the S&P 500 that are classified as members of the GICS® energy sector.

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