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CHIEF INVESTMENT OFFICE

Capital Market Outlook

June 1, 2020

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IN THIS ISSUE

- **Macro Strategy**—The pandemic has forced strong policy actions that also address lingering problems from the Great Financial Crisis (GFC) of 2008-2009. The failure of the Federal Reserve (Fed) and the European Central Bank (ECB) to hit their inflation targets kept nominal gross domestic product (GDP) growth low over the past decade, resulting in secular-stagnation concerns. Signs of a dramatic shift in the central banks' reflation efforts raise the odds that inflation will finally increase to their targets in the coming economic expansion. A budding European fiscal union will help this effort.
- **Global Market View**—Setting aside the daily barrage of pandemic-related headlines, we look at three dynamics investors could have missed: One pivots on America's baby bust and the attendant deflationary effects on asset prices. The second speaks to the boom in cyberattacks since the global pandemic began. Lastly, we discuss a critical sector of the U.S. economy that will get America up and running again: the U.S. healthcare industry.
- **Thought of the Week**—There are various measures of valuation that investors can use to evaluate whether equities are cheap or expensive. As opposed to other measures, the equity risk premium (ERP) proves useful as it takes into account the level of interest rates, which is especially relevant given historically low rates. A higher ERP makes equities more attractive relative to fixed income, and the current ERP is elevated on a historical basis.
- **Portfolio Considerations**—We favor equities relative to fixed income; consider 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 summer months.

MACRO STRATEGY

Chief Investment Office Macro Strategy Team

GLOBAL MARKET VIEW

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Vice President and
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Joseph P. Quinlan
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THOUGHT OF THE WEEK

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Data as of 6/1/2020 and subject to change.

MACRO STRATEGY

Moving Toward "Escape Velocity"

Chief Investment Office Macro Strategy Team

When the Fed resorted to quantitative easing (QE) during the GFC, many investors worried that the "exploding" central-bank balance sheet would set off a wave of inflationary excess. Instead, inflation remained subdued and risk-off assets, correlated

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with subpar, disinflationary growth outperformed those associated with a stronger economy and rising inflation pressures. Inflation was persistently below the Fed's target of 2%, and recurring bouts of debt-deflation-fear sell-offs reflected concerns not of higher inflation but rather outright deflation.

The pandemic has exacerbated this deflation risk. Market-based inflation expectations have dropped into the zone where Japan and Europe have been mired, rendering long-term U.S. interest rates near zero and shattering the Fed's credibility for achieving its inflation goal within the next decade. Clearly, the time has arrived for the Fed to move aggressively to re-anchor inflation expectations closer to its target.

Currently, the deflationary shock from the pandemic has been eclipsed by massive job losses and plummeting real economic activity. Yet, real data are expected to recover as the pandemic subsides. Inflation expectations, on the other hand, suggest the deflationary impact will last much longer. Already, we've seen the biggest monthly drop in the "core" consumer price index (CPI) since the data began in 1957, and forward-looking indicators suggest "core" personal consumption expenditures (PCE) inflation (the Fed's target inflation measure) will fall below 1% over the next year.

This shortfall provides policy space for the massive fiscal and monetary easing that has been necessary to counteract the economic shutdown. By plugging the income losses of tens of millions of temporarily unemployed workers, the policy response has created significant pent-up demand that is starting to flood the economy as states end their lockdowns. Just as with QE during the GFC, investors are once again worried that the money printing associated with the Fed's massive new balance-sheet expansion will unleash a wave of inflation. We expect the Fed will be more aggressive in its attempt to re-inflate the economy this time instead of prematurely truncating its reflation effort as it did repeatedly after the GFC, most recently with its misguided policy normalization attempt in 2017-2018.

In his memoir, *The Courage to Act*, former Fed Chairman Ben Bernanke, documents how monetary policy was hamstrung by counterproductive fiscal tightening during the early years after the GFC. Similarly, studies of the global policy response, such as Barry Eichengreen's *Hall of Mirrors*, find fiscal policy often worked at cross-purpose with monetary policy in many countries' responses to the GFC. Perhaps nowhere was this truer than in the eurozone, where the absence of a political union rendered the fiscal and monetary policy support much less effective than in the U.S.

Recall that the ECB prematurely tightened policy in 2011, causing a double-dip recession that only ended when Mario Draghi, past president of the European Central Bank, came in and made his "whatever it takes" declaration in the summer of 2012. Still, it wasn't until March 2015 that the ECB implemented a QE program. In general, the ECB responses to the GFC and its aftermath have lagged behind even the Fed's insufficient steps to keep inflation near its target. Largely, this reflects the eurozone's political problems in creating a monetary-fiscal union adequate to respond to crises. Over the past 60 years, crises have acted as catalysts to prod the European Union (EU) closer to an ultimate political and economic union. This was certainly the case over the past decade, as recurring financial panics have pushed a reluctant Northern Europe toward a more flexible approach to Southern European problems. Draghi's efforts in this regard bore fruit in moving the ECB toward helping countries like Italy, despite German objections to mixing eurozone monetary policy with national fiscal policies. Still, a recent German court decision challenging the Bundesbank's participation in ECB QE has highlighted the limits to excessive reliance on monetary policy to fund fiscal relief within the eurozone. Moreover, the pandemic has created a need for major fiscal relief that would strain the capacity of the ECB to adequately address the problem.

As in past crises, this has spurred a major innovation in the eurozone policy arsenal as the continent slowly builds the policy architecture needed to respond to financial challenges. In what Anatole Kaletsky of Gavekal Research describes as "*Europe's*

Hamiltonian moment," German Chancellor Angela Merkel and French President Emmanuel Macron have agreed to the creation of bonds issued by the EU in its own name guaranteed by its own revenue rather than national tax revenues collected by individual countries. These bonds would finance a recovery fund aimed at repairing the damage caused by the pandemic. By relying on the EU rather than national governments to issue the bonds, the Merkel-Macron plan effectively creates the needed fiscal federation that Germany and other Northern European countries have resisted for so long.

In essence this is similar to the deal struck by Alexander Hamilton and Thomas Jefferson in 1790, which created national-level borrowing instead of relying on individual state budgets for national purposes. This is a landmark accomplishment that was overshadowed in the media on May 17, 2020, by news of minor progress on a coronavirus vaccine. *Nevertheless, the prospects of a consolidated European fiscal infrastructure fixes one of the major problems hampering Europe's policy response to crises and, therefore, raises the odds that the euro can survive as a single currency for its member states.*

To fund this fiscal federation, the EU will require tax revenues much greater than it currently receives. Merkel and Macron have proposed increasing the European Commission's (EC) budget from 1.2% to 2% of EU gross national income, or about 180 billion euros per year. There seems to be an emerging consensus that taxes to finance the EC's expanded budget should be based on activities that transcend national boundaries, like climate-control expenditures.

While 180 billion euros seems miniscule compared to the trillions of dollars the U.S. is pouring into pandemic-relief efforts, there is a third feature to the Merkel-Macron plan that makes it a powerful fiscal "bazooka" potentially amounting to trillions of euros. That is, the plan allows the EU to leverage its income stream. For example, Austria's 50-year bond currently yields about 50 basis points. At 50 basis points, 180 billion euros could easily fund trillions of euros of EU bonds in perpetuity. While the media focus on the pandemic has overshadowed this historic development, the strong stock markets and European equity and euro currency outperformance since the May 17 agreement likely reflects its significance: Europe will be in a position to finally respond aggressively to future financial crises without the overreliance on the ECB that has stymied past policy interventions.

In sum, the pandemic has accelerated trends that were already in place. In the U.S., it has sped the process of using massive fiscal spending to help the Fed expand the money supply until long-term inflation expectations are re-anchored around the 2% target. The U.S. yield curve, which was flat-to-inverted just a year ago, has steepened to a more normal slope, a powerful leading indicator of economic expansion ahead. Surging money-supply growth and rebounding stock prices are also long leading indicators pointing to a strong expansion ahead. The new EU fiscal union is a historic development that would add a major long-underperforming region to the set of countries participating in this new economic upswing. For over a decade, poor policy has kept European growth depressed and European equities returns far behind those in the U.S. A new fiscal union would be a game changer for European growth and equities. It would also help solidify the euro as a major reserve currency that is here to stay. That seems to be the markets' message in recent weeks.

GLOBAL MARKET VIEW

Market Musings: America's Baby Bust, the Boom in Cyberattacks, and the Reopening of the U.S. Healthcare Sector

Lauren J. Sanfillipo, Vice President and Market Strategy Analyst

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

Setting aside the daily push and pull of the capital markets, this week we review some headlines investors may have missed amid the daily barrage of pandemic-related news.

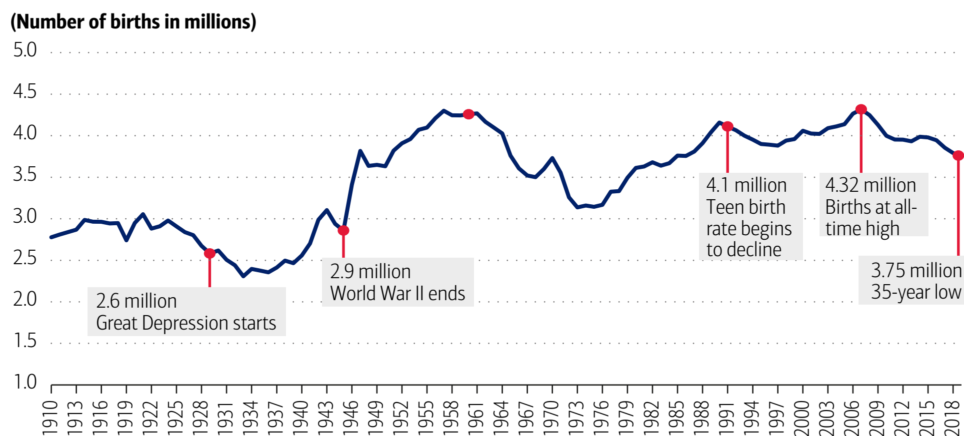
One pivots on America's baby bust and the attendant deflationary effects on asset prices. The second speaks to the boom in cyberattacks since the global pandemic began and the increased premium on cybersecurity spending. Lastly, we discuss a critical sector of the U.S. economy that will be key in getting America up and running again: the U.S. healthcare industry.

Key investment implications: 1) a shrinking global population and labor force favors technology/innovation leaders in robotics, automation and artificial intelligence; 2) the spike in cybercrime means more spending on cybersecurity, a bullish prospect for players in the cybersecurity space; 3) the rebound in the U.S. healthcare industry, decimated by the coronavirus, could unexpectedly boost U.S. growth in the second half of the year to the upside, a bullish prospect for U.S. equities.

The bear market in babies

If demographics is destiny, as some have argued, then the United States, like many other parts of the world, is on shaky ground. According to the Centers for Disease Control and Prevention (CDC), some 3.75 million babies were born in the U.S. last year, a 1% decline from the prior year and the lowest number since 1985 (Exhibit 1). Birth rates declined for almost all age groups of women under 35, but rose for those in their early 40s. Notably, the birth rate for teenagers aged 15 to 19 dropped by 5%. Meanwhile, the total U.S. fertility rate—or the average number of babies a woman has over her lifetime—ticked down to 1.7 in 2019, a slight decline from the previous year and another record low.

Exhibit 1: The Baby Bust.



Sources: National Center for Health Statistics, CDC. Data as of May 2020.

What's all of the above have to do with investing? Plenty.

Simply put: babies matter. Why? Because the long-term growth rate of any economy is dependent on population growth. The larger the population, the greater the labor force, the more capacity for consumption as workers per capita increases, and the deeper the base of taxpayers to support retirees. Throughout history, a nation's population has always been a marker of strength or weakness. Per the latter, three decades of economic stagnation in Japan reflects, in large part, the country's falling working-age population and overall decline in population. The same for Europe, where shrinking labor forces and declining fertility rates in many nations have sapped and undermined economic growth and contributed to the forces of global deflation.

With a higher fertility rate and liberal immigration policies, the United States has long stood apart from aging Japan and demographically stagnant Europe. But that's no longer the case: America's demographic profile looks increasingly like other developed nations.

As we discussed in our October 2019 Investment Insights, "*The New Normal of Global Demographics,*" the brakes are being applied to population growth around the world, the U.S. included. The world's population is expanding at its slowest pace since 1950, exerting a powerful deflationary drag on economic activity.

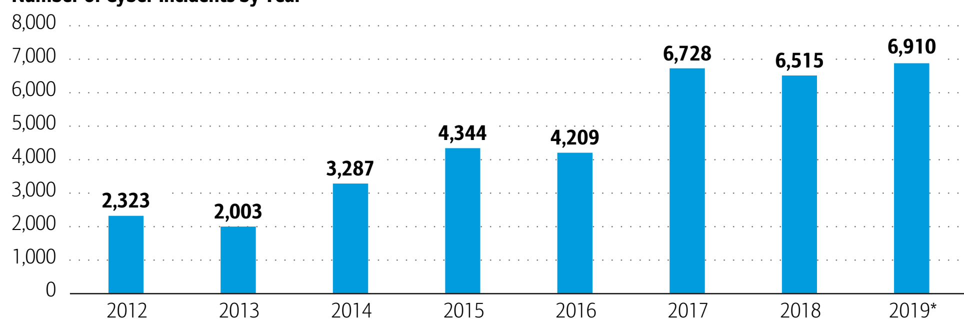
From an investment perspective, the cocktail of demographic deflation and low growth favors companies that have the potential to grow their dividends and grow earnings at an above-average rate than the economy and peer group. Moreover, in a world rapidly aging and increasingly short of workers, portfolios should be tilted toward healthcare and technology/innovation leaders in robotics, automation and artificial intelligence.

The Steepening of the Cybersecurity Curve

One curve that has yet to flatten is cybercrime, inclusive of the number of attacks, hacking, phishing and evasion capabilities. Indeed, in the rush toward everything digital in the COVID-19 world—think more eCommerce, online education, telemedicine, streaming—the new virtual world we live in is the transition hackers have been waiting for. According to figures from the Federal Bureau of Investigation (FBI), the number of cybersecurity complaints has jumped from roughly 1,000 per day to between 3,000 and 4,000 since the pandemic started.

Against this backdrop, protecting businesses, governments and personal data has become even more important given new and expanding trends in telework, health monitoring and contact tracing. A growth industry even before the pandemic, these trends point to a growing imperative and urgency for cyber resilience in the digital age. According to Cyber Security Ventures, the economic cost of cybercrime will be roughly $6 trillion a year by 2021, or 7% of global GDP. In the U.S., the average cost of a data breach increased from $7.91 million in 2018 to $8.19 million in 2019—the highest cost globally when compared to other countries or regions. The average size of a data breach exploited more than 25,000 records, with a lifecycle of 245 days from time of identifying through containing a breach. Exhibit 2 details since 2012, the number of cyber incidents has nearly tripled, while the number of records exposed just last year neared 10 billion records.

Exhibit 2: Cyber Breaches Nearly Tripled Since 2012.



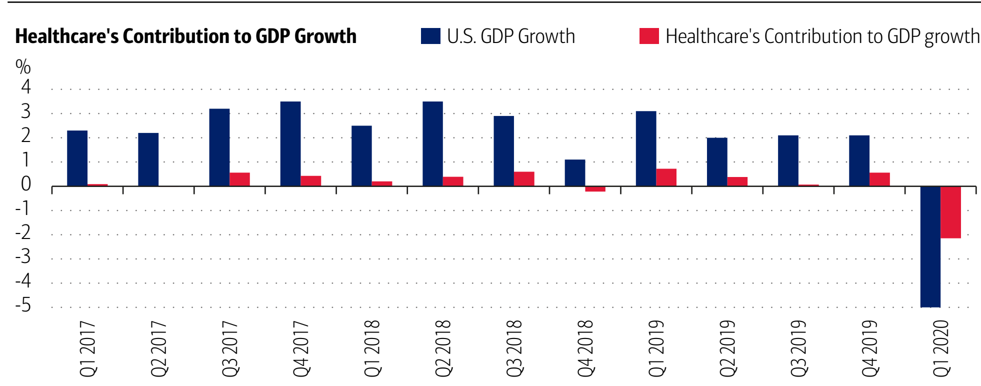
*Estimate. Data through Q3 2019 with average for Q4. Source: Breach Level Index Report. Data as of Q3 2019.

Given all of the above, traditional players in the cybersecurity space will continue to benefit from macro trends and the regulatory focus on data governance/protection. Companies will need to adapt to the developing attack landscape and growing sophistication of hacker techniques—including ransomware, social engineering and phishing—while expanding coverage of traditional firewalls to focus on cloud security and endpoint protection. Opportunities to invest in cybersecurity outside of traditional technology names include defense primes, government Information Technology (IT) service providers and multi-industrial companies—all likely to benefit from the pickup in public and private cybersecurity spending, barring a deterioration in the business spending environment. In the end, the very real reality of a more connected and tech savvy world has arrived—but with it, so have the susceptibilities and opportunities.

Doctors Without Work?

Intuitively, one would think a healthcare crisis would be good for the healthcare industry. Think increased demand for services, more spending, more patients, and a general boost in overall activity. To the contrary, however, the coronavirus pandemic has been devastating not only to the industry but also to the U.S. economy given that the U.S. healthcare industry accounts for roughly 18% of GDP. Note the drag on growth from healthcare in Exhibit 3, with the sector shaving more than 2 percentage points of growth off first-quarter GDP.

Exhibit 3: Reopening of the Healthcare Industry.



GDP growth is a seasonally adjusted annual rate. Offsetting positive contributions to GDP growth in Q1 2020 included net exports and government spending. Source: Bureau of Economic Analysis. Data as of May 2020.

What happened? As hospital and outpatient offices prepared for the coronavirus, other healthcare services—notably elective procedures and surgeries and emergency room visits—were shut down with devastating financial effects. According to Strata Decision Technology, in the six-week stretch covering March 1 to April 15, 2020, the number of high-paying, high-volume services plummeted across the country, with spine (45%), orthopedics (43%) and cardiology (35%) procedures all plummeting from the same period a year ago. Even cancer procedures—despite the necessity of urgent care—dropped 18%. Knee and hip replacements—forget it—procedures for the former dropped 68% when comparing the same six-week period in 2019 and 2020, while hip replacements plunged 52%.

The good news: Like many other parts of the economy, the U.S. healthcare industry is reopening. Hospitals and outpatient offices are resuming normal services, a bullish prospect for the U.S. economy in that the healthcare sector accounts for nearly 11% of total nonfarm employment and nearly one-fifth of aggregate output. Autos and housing are being highly touted as engines of near-term economic growth in the U.S; ditto for healthcare, which could give the U.S. economy a greater, unanticipated boost to growth than expected.

THOUGHT OF THE WEEK

A Quick Study of the Equity Risk Premium

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There are various measures of valuation that investors can use to evaluate whether equities are cheap or expensive. The popular P/E or price-to-earnings ratio measures current price levels relative to earnings. Similarly, other metrics compare price to cash flows, sales, book value, etc. One drawback of these absolute metrics is that they don't

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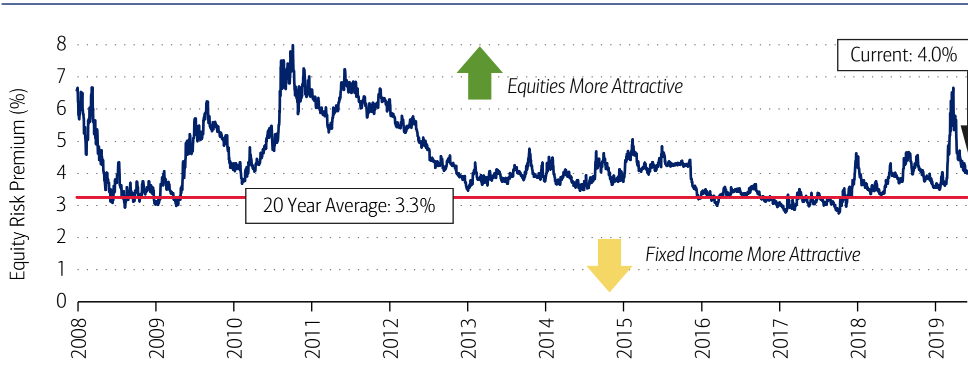
take into account the level of interest rates in the economy, which is especially relevant today given historically low rates. This is where the equity risk premium (ERP) proves useful. The ERP compares the earnings yield of equities, which is the ratio of earnings-to-price (the inverse of the P/E ratio) to a risk-free interest-rate such as the 10-year Treasury yield. A higher ERP makes equities more attractive relative to fixed income. The intuition is that assets compete with each other for investor dollars, and the marginal dollar should prefer one with better yield and/or growth.

Investors expect to be rewarded with higher returns, or a premium, for accepting additional risk. ERP essentially quantifies the excess return above the risk-free rate that investors command for owning stocks. A higher ERP suggests that investors demand a larger premium to hold stocks relative to less risky assets, like bonds, while a lower ERP indicates less risk-aversion to equities, boosting valuations. From an asset allocation perspective, an investor should consider assets possessing higher risk premiums, inferring they're being compensated for taking additional risk.

Currently, the spread between the S&P 500's earnings yield and the 10-year Treasury yield is 4.0%,[1] which represents the 80th percentile of its historical range and is above the long-term average of 3.3%. This is substantially less than its recent peak of 6.7% (99th percentile) on March 23 but still indicates that equities are attractively compensated for risk relative to bonds (Exhibit 4a). Since 1990, the S&P 500 has generated positive returns over one and three years after each time it breached the 95th percentile (Exhibit 4b).

Exhibit 4a: The Equity Risk Premium Currently Remains Attractive.



Sources: Chief Investment Office; Bloomberg. Data as of May 27, 2020. **Past performance is no guarantee of future results.**

Exhibit 4b: Subsequent Performance after the ERP Breached the 95th Percentile.

1 Month	+2.1%
3 Months	+4.6%
1 Year	+21.4%
3 Years	+54.4%

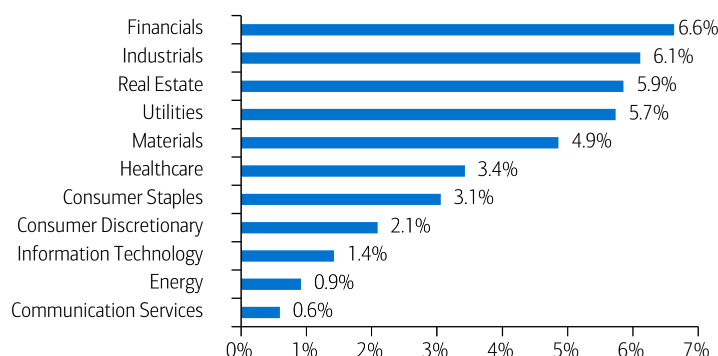
[1] Sources: Bloomberg; Chief Investment Office. Data as of May 26, 2020. Forward 12M P/E depicted.

MARKETS IN REVIEW

Equities

	Total Return in USD (%)			
	Current	WTD	MTD	YTD
DJIA	25,383.11	3.8	4.7	-10.1
NASDAQ	9,489.87	1.8	6.9	6.2
S&P 500	3,044.31	3.0	4.8	-5.0
S&P 400 Mid Cap	1,763.95	4.1	7.3	-13.9
Russell 2000	1,394.04	2.9	6.5	-15.9
MSCI World	2,147.88	3.7	4.8	-8.2
MSCI EAFE	1,725.09	5.1	4.4	-14.3
MSCI Emerging Markets	930.35	2.9	0.8	-16.0

S&P 500 Sector Returns



Fixed Income[1]

	Total Return in USD (%)			
	Current	WTD	MTD	YTD
Corporate & Government	1.30	0.3	0.6	6.3
Agencies	0.58	0.1	0.2	4.9
Municipals	1.61	0.2	3.2	1.2
U.S. Investment Grade Credit	1.34	0.2	0.5	5.5
International	2.40	0.7	1.6	3.0
High Yield	7.02	1.8	4.4	-4.7

	Current	Prior Week End	Prior Month End	2019 Year End
90 Day Yield	0.14	0.11	0.08	1.54
2 Year Yield	0.16	0.17	0.20	1.57
10 Year Yield	0.65	0.66	0.64	1.92
30 Year Yield	1.41	1.37	1.28	2.39

Commodities & Currencies

	Total Return in USD (%)			
Commodities	Current	WTD	MTD	YTD
Bloomberg Commodity	135.54	1.3	4.3	-21.2
WTI Crude $/Barrel[2]	35.49	6.7	88.4	-41.9
Gold Spot $/Ounce[2]	1,730.27	-0.3	2.6	14.0

Currencies	Current	Prior Week End	Prior Month End	2019 Year End
EUR/USD	1.11	1.09	1.10	1.12
USD/JPY	107.83	107.64	107.18	108.61
USD/CNH	7.13	7.15	7.08	6.96

Source: Bloomberg, Factset.Total Returns from the period of 05/25/20 to 05/29/20. Bloomberg Barclays Indices.[1] Spot price returns.[2] All data as of the 05/29/20 close.
Past performance is no guarantee of future results.

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

	Under-weight		Neutral		Over-weight
Global Equities	•	•	•	● (green)	•
U.S. Large Cap Growth	•	•	•	● (green)	•
U.S. Large Cap Value	•	•	•	● (green)	•
U.S. Small Cap Growth	•	•	•	● (green)	•
U.S. Small Cap Value	•	•	● (yellow)	•	•
International Developed	•	● (orange)	•	•	•
Emerging Markets	● (red)	•	•	•	•
Global Fixed Income	•	● (orange)	•	•	•
U.S. Governments	•	● (orange)	•	•	•
U.S. Mortgages	•	● (orange)	•	•	•
U.S. Corporates	•	•	•	● (green)	•
High Yield	•	● (orange)	•	•	•
U.S. Investment Grade Tax Exempt	•	•	● (yellow)	•	•
U.S. High Yield Tax Exempt	•	● (orange)	•	•	•
International Fixed Income	● (red)	•	•	•	•
Alternative Investments*	see CIO Asset Class Views				
Hedge Funds			● (gray)		
Private Equity			|		
Real Assets			● (gray)		
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 05/29/20)

	Q3 2019A	Q4 2019A	2019A	Q1 2020A	Q2 2020E	2020E
Real global GDP (% y/y annualized)	–	–	2.9	–	–	-4.3
Real U.S. GDP (% q/q annualized)	2.1	2.1	2.3	-4.8	-40.0	-8.1
CPI inflation (% y/y)	1.8	2.0	1.8	2.1	0.6	1.0
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	17.6	11.4
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.

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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 29, 2020.

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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.

Consumer Price Index (CPI) is a measure that examines the weighted average of prices of a basket of consumer goods and services, such as transportation, food, and medical care.

Breach Level Index is a global database that tracks data breaches and measures their severity based on multiple dimensions, including the number of records compromised, the type of data, the source of the breach, how the data was used, and whether or not the data was encrypted.

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

Keep in mind that dollar cost averaging cannot guarantee a profit or prevent a loss in declining markets. Since such an investment plan 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.

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