CHIEF INVESTMENT OFFICE

Capital Market Outlook

June 15, 2020

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

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- **Macro Strategy**—The business cycle expansion that started in June 2009 officially ended in February, according to the National Bureau of Economic Research (NBER). The 128-month expansion was the longest on record. Labor market data released over the last few weeks suggest the recession that followed is already over, making it the shortest recession on record.
- **Global Market View**—Last week's sharp decline in U.S. equities came after a swift 45% rise for the S&P 500 from the March 23 bottom. Bears continue to point to higher valuations, lack of earnings, U.S./China tensions and reopenings potentially leading to a second wave of infections. These are valid concerns, however equities are likely to remain in a higher trading channel owing to support by the A.B.C.D.Es.
- **Thought of the Week**—Innovation and patent leaders should be at the core of any portfolio. That means having long-term exposure in many cutting-edge technologies and positions in their respective countries and companies leading the way.
- **Portfolio Considerations**—The U.S. remains our preferred equity region relative to the rest of the world, and we remain slightly overweight investment-grade credit in fixed income. We expect curves to steepen slightly as the Federal Reserve (Fed) signals forward guidance. Consider staying diversified across growth and value assets and add to cyclical areas, including equities at the asset class level, over time as we still climb that tall "wall of worry."

MACRO STRATEGY

Jonathan Kozy
Director and
Senior Macro Strategy Analyst

GLOBAL MARKET VIEW

Niladri Mukherjee
Managing Director and
Head of CIO Portfolio Strategy

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THOUGHT OF THE WEEK

Joseph P. Quinlan
Managing Director and
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Data as of 6/15/2020, and subject to change.

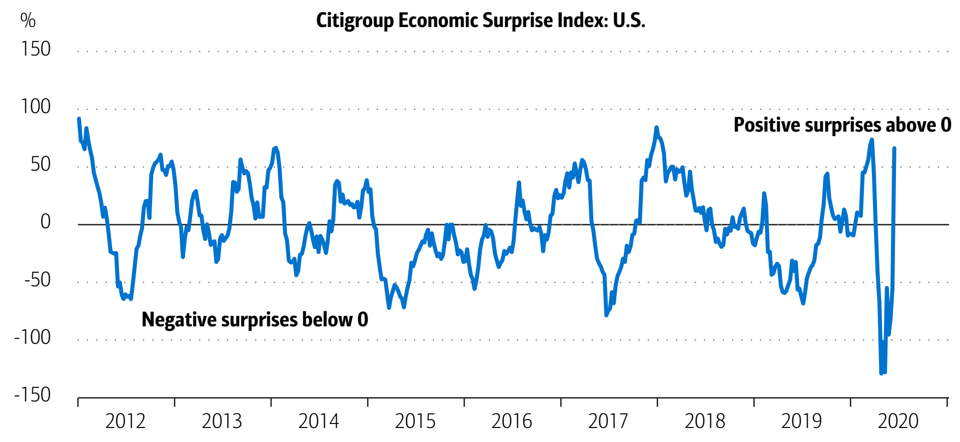
MACRO STRATEGY

In Claims We Trust

Jonathan Kozy, Director and Senior Macro Strategy Analyst

The National Bureau of Economic Research (NBER) is the arbiter of business cycle chronology and determined that economic activity peaked in February, marking the end of the longest expansion in U.S. history and the beginning of what will likely turn out to be the shortest recession in history. The previous record was the six-month recession from January 1980 to July 1980, while this one appears to have been two months long. The Business Cycle Dating Committee implicitly acknowledged this possibility by concluding in its recent report that "the unprecedented magnitude of the decline in employment and production, and its broad reach across the entire economy, warrants the designation of this episode as a recession, even if it turns out to be briefer than earlier contractions."[1] On the back of the recent jobs report and the V-shaped recovery in upside surprises to some U.S. economic data releases (Exhibit 1), it is increasingly clear that the economy pivoted in late April and May, perhaps signaling the end of the recession. The cyclical bull market in equities that began in March also suggests the worst is behind us, in our opinion. We look at a broad swathe of labor market indicators to not only assess the likelihood that the recession is already over, but more importantly to gauge momentum in economic activity overall.

Exhibit 1: V-Shaped Recovery in Upside Surprises to U.S. Economic Data.



Source: Bloomberg. Data as of 6/5/2020.

According to the NBER, payroll employment is the most reliable estimate of employment, and employment is one of the "primary conceptual measures of economic activity." Nonfarm payrolls added over 2.5 million jobs in May, and the diffusion index showed the rebound was broad-based. The U.S. Bureau of Labor Statistics (BLS) household survey employment data, adjusted for population and the payroll-concept methodology, revealed an even bigger gain of nearly 5.3 million jobs following job losses that totaled around 31 million from February to April. The unemployment rate, a lagging indicator, also fell. The massive upside surprise led many analysts to question the veracity of the data. This is often the case at business cycle turning points and was a common theme coming out of The 2008/2009 Great Financial Crisis (GFC). While the BLS has noted the special circumstances associated with the pandemic that have made it difficult to categorize furloughed workers, momentum is clearly in one direction.

The underlying details in the jobs report were also mostly positive. The number of employees hired by the temporary-help industry tends to be a leading employment indicator and rose in May. Firms often let go of temporary-help workers before permanent workers, and, when the economy strengthens, they tend to hire temporary workers back before permanent workers. Heading into the GFC, temporary jobs fell by around 900,000 and, while the decline occurred mostly in one month this time around, the scale was similar. The ratio of persons working part time for economic reasons to all part-time workers is another leading indicator of labor market dynamics. In April, this ratio surged, but very few of these workers reported they are part time because they could only find part-time work. In other words, they are likely working part time because of the coronavirus. Similarly, a large percentage of the layoffs are categorized as temporary in the household survey. Seventy-three percent of job losers in May were on temporary layoff, down from 78.3% in April.

Another leading employment indicator, weekly initial claims for unemployment insurance (layoffs) data, are also consistent with a two-month recession. Claims made a decisive turn in April, and subsequent releases have reinforced the improving trend. Claims peaked

[1] Information on Recessions and Recoveries, the NBER Business Cycle Dating Committee, and Relate, June 8, 2020.

near 6.9 million at the end of March and since then have fallen for 10 consecutive weeks to 1.5 million for the week ending May 6. While the level of claims remains staggering in terms of job losses even with the recovery, the flow of jobs implied by looking at both the level of initial claims and continuing claims is consistent with a recovering labor market. People are returning to work, and this is reflected in the decline in the insured unemployment rate. Importantly, given the self-induced nature of the recession, we think the weekly claims data will provide relatively accurate and timely insight for assessing the strength of the recovery over the next few months. The headline unemployment rate will decline in fits and starts as workers re-enter the workforce but may lag the overall cycle as it did in 2009.

Consumer perceptions of labor market dynamics have been incredibly resilient relative to the hard data on job losses and also improved in May. The percentage of respondents who say they find "jobs hard to get" from The Conference Board's Consumer Confidence Survey, for example, peaked at 34.5% in April and fell to 27.8% in May. This compares positively to a peak of 49.4% during the last recession. The favorable comparison is likely related to the large percentage of job losses being viewed as temporary layoffs. The level of the index suggested that the unemployment rate would not be as bad as during the GFC if you judged it strictly in terms of how hard it is to get a job. Related to this is job openings, which were as low as 2.264 million in 2009 but were above 5 million through April of this year, higher than peak job openings during the previous expansion.

The job openings and household perceptions data are reinforced by National Federation of Independent Business (NFIB) Small Business Optimism survey data that showed 23% of firms in May reported that job openings are hard to fill. This also compares positively with a trough of 7% during the GFC. It is also noteworthy that the small business hiring plans index never reached contraction territory and rose from 1% to 8% in May. It took until August 2012 for this index to reach the same level coming out of the GFC.

The Conference Board's Employment Trends Index (ETI) includes many of the leading employment indicators listed above and also two components of real economic activity that recognize cyclical momentum: Industrial Production and Real Manufacturing and Trade Sales. Both of these indexes are consistent with a sharp, deep recession but one that may have only last for two months. The consensus among economists for the change in industrial production in May is for 2.5% growth following declines of 11.25% and 4.5% in April and March, respectively. No grounds for celebration, but progress.

To be clear, 21 million people remain on unemployment insurance, a figure that cannot be dismissed. And the increase in the percentage of layoffs deemed permanent in the jobs report is a clear sign that some firms are failing and that not all companies (or workers) will emerge unscathed from this pandemic. Still, there is some evidence that new ones are stepping in to replace them. Business applications as reported by the U.S. Census Bureau remain firm and are following historical seasonal patterns. Businesses are adapting and new ones are emerging.

Overall, the balance of data provide plenty of reasons for a "glass-half-full" view of a brutalized labor market. Labor market momentum is picking up even as government programs provide monetary incentive for a large number of workers to remain unemployed. Even if the amplitude of job growth is error-prone over the next few months, synthesis of the data suggests the direction is clear. As job growth continues to pick up and reinforce the pent-up demand created by fiscal income-replacement programs, U.S. consumer spending should kick into high gear. Pent-up demand for autos, for example, should power consumer spending to unprecedented growth rates in the back half of the year. Lastly, equity market behavior (as measured by the S&P 500), more specifically the violent four-week cyclical bear market followed by the powerful cyclical bull market, is consistent with the depth, breadth and duration of economic activity (i.e., a short, sharp recession). Of course, all of this depends on continued progress on the health care front.

Equities Supported By the A.B.C.D.Es.

Niladri Mukherjee, Managing Director and Head of CIO Portfolio Strategy

Kishan Chhatwal, Assistant Vice President and Investment Analyst

Last week's sharp decline in U.S. equities came after a swift 45% rise for the S&P 500 from the March 23 bottom. Such pullbacks are to be expected during this consolidation period as equities change hands between speculators, reluctant holders and long-term pools of capital. Bears continue to point to higher valuations, lack of earnings, U.S./China tensions and reopenings potentially leading to a second wave of infections.

These are valid concerns, however equities are likely to remain in a higher trading channel owing to support by **(A)**sset classes confirming, **(B)**roadening participation, **(C)**redit improving in the near term to **(D)**emand recovering and **(E)**arnings emerging in the medium term and through 2021 as detailed below.

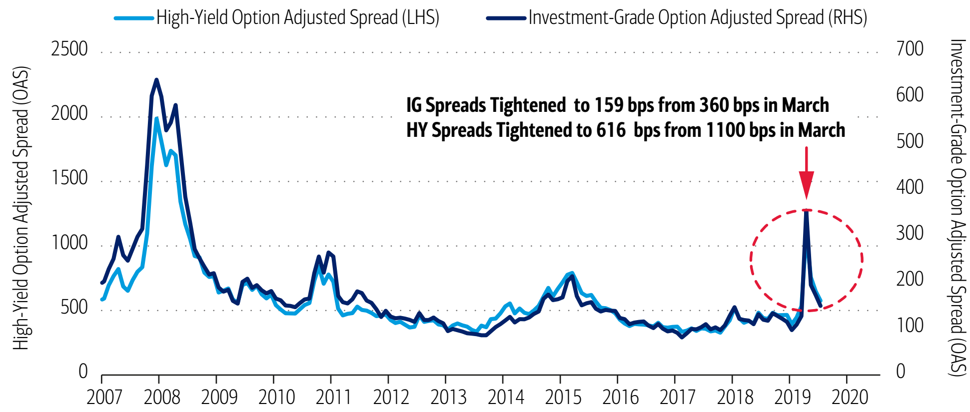
A.B.Cs. supporting the near term

(A)sset classes confirming: For a while it seemed that equities were living in an alternative universe, as other assets remained restrained in pricing in the ongoing improvement in data. Recently, bond yields have nudged higher with the 10-year Treasury yield attempting to break out from its recent stubborn 0.60% to 0.70% range. The 10-year to 30-year spread has risen to 75 basis points (bps), a level we last saw in 2016 when the global economy was on the cusp of a synchronized reacceleration. Also, oil prices have nearly doubled since the end of April as motor gasoline demand has risen, with movement of people and goods picking up. Meanwhile, the U.S. dollar has reversed its scorching rally in March to fall 6%. This is less about loss of faith in the U.S. fiscal position but more a signal of stabilization and confidence in global growth. The euro has also rallied on hopes that the struggling region may finally be pulling together from a monetary stimulus and fiscal union standpoint.

(B)roadening participation: During the market decline in March and most of the subsequent recovery, sectors with secular growth drivers like healthcare, technology and communication services remained the leaders, raising some concern about the breadth of the rally. However, since the middle of May, we have seen cyclicals like industrials, financials and energy emerge as leaders, as the reopening narrative has gathered pace and as China's manufacturing and services Purchasing Managers Indexes (PMI) are suggesting an expansion is afoot. Similarly, the outperformance has also broadened out to risker areas like Small Caps and Value. As highlighted by Strategas Research, the percentage of S&P 500 stocks that are above their 20-day moving average recently hit 68% (as of June 3), suggesting expanding breadth as laggards are receiving investor capital, a signal typically bullish for forward returns.

(C)redit is improving: In the early part of the crisis, the credit markets had stalled with companies unable to issue debt, which led spreads to spike, exacerbating the equity selloff. With aggressive Fed intervention through rate cuts, "unlimited" quantitative easing and liquidity facilities to support the primary and secondary debt markets, investor sentiment reversed. Companies have been able to issue record amounts of debt to shore up their balance sheets, and as a result credit spreads have declined to 159 bps (from 360 bps in March) for investment-grade (IG) and to 616 bps (from 1100 bps in March) for high yield (HY) (Exhibit 2). The wide-open issuance market and tightening spreads are indicating an economic and cash flow recovery faster than anyone imagined just a few weeks back and a lower probability of widespread bankruptcies.

Exhibit 2: High Yield and Investment-Grade Credit Spreads Have Recently Tightened.



Sources: Chief Investment Office; Bloomberg. Data as of June 12, 2020. **Past performance is no guarantee of future results.**

(D)emand recovery supports the medium term: There have been a growing number of green shoots in recent weeks indicating consumers had moved sooner than local authorities to embrace the economic reopening. Bank of America's credit card data showed rising spending after the The Coronavirus Aid, Relief, and Economic Security Act ("CARES" Act) stimulus checks started hitting bank accounts in April. Additionally, the U.S. housing market has been a bright spot and is holding up better than expected despite social-distancing guidelines. A lack of inventory has propped up prices, while low interest rates have pushed mortgage applications up for seven consecutive weeks. Auto sales also seem to have passed the worst after improving to an annualized 12.2 million units in May from 8.6 million in April.[2]

Going forward, healthy consumer balance sheets should support pent-up demand. Rising home and stock prices alongside higher bank account balances have pushed consumer net worth to over $118 trillion according to the Bureau of Labor Statistics, an all-time high. The savings rate rose to 33% in April as spending declined and income soared, supported by higher unemployment benefits and direct checks from the government. If May's surprising turnaround in the labor market where payrolls rose 2.5 million and the unemployment rate dropped to 13.3% from 14.7% in April continues, we would expect consumers to draw down those savings to spend, accelerating growth and corporate profits.

(E)arnings emerging: The current recession and market dislocation was caused by an exogenous shock i.e., a virus with its intensity, persistence and geographical spread unknown. The subsequent shutdown of economic activity, supply chains and global trade has been unprecedented, rendering any near-term forecasts for corporate profits less useful.

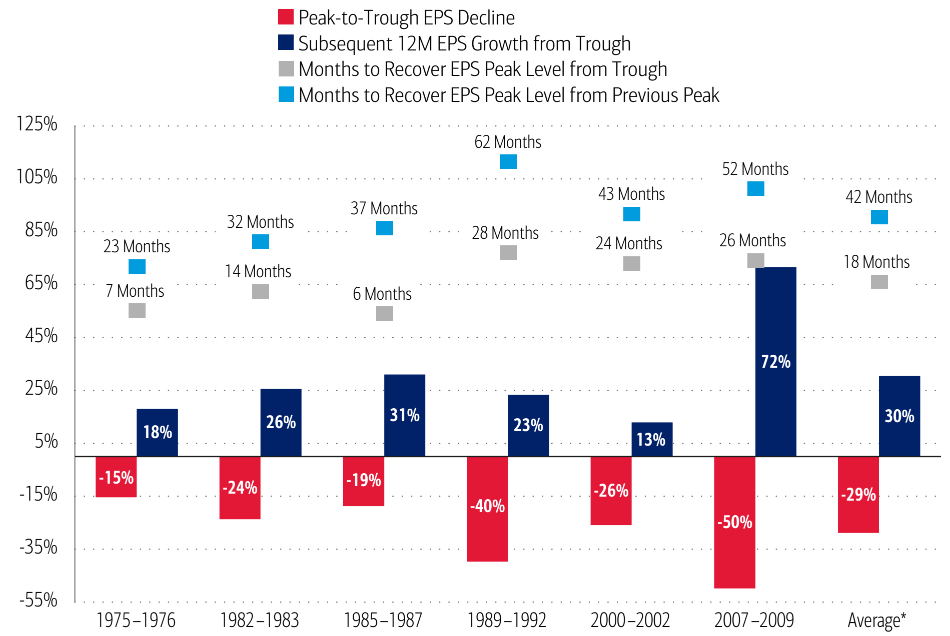
Back in February, earnings per share (EPS) estimates for the S&P 500 were $172 and $195 for 2020 and 2021, respectively.[3] Since then, these estimates have fallen sharply but seem to have stabilized at $128 per share for 2020 and $164 per share for 2021. Consensus is therefore implying a 22% decline in earnings this year followed by a 28% recovery in 2021. As Exhibit 3 shows, historically after periods of deep earnings declines, a V-shaped recovery is seen in the subsequent 12 months, which recoups a significant portion of the losses. This is typically due to the base effect of depressed earnings and companies emerging out of recessions with a lower cost base such that rising revenues translate into higher earnings.

[2] Ward's Automotive Group, Bloomberg.

[3] FactSet Consensus Estimates.

Exhibit 3: Earnings Recovery: A Matter of When, Not If…

*… Periods of EPS Declines Exceeding 15% Since 1950**



Note: Time periods on the x-axis refer to a respective peak-to-trough EPS decline, shaded in red, and the subsequent 12-month EPS growth, shaded in dark blue. Sources: Chief Investment Office; Bloomberg. Data as of June 2020. **Past performance is no guarantee of future results.**

Historically, the average peak-to-trough earnings decline (in instances exceeding 15%) is -28.8%, going back to 1950, and the average earnings growth seen in the subsequent 12 months from these depressed levels has been 30.4% on average. The point being, company earnings are more likely than not to come back and recover—so the question does not seem to be a matter of if, but of when they do. It typically takes about three to four years for the S&P 500 to recover lost earnings from the previous EPS peak level, and on average just 18 months to recover from the trough.

In recent weeks, guidance, which historically led earnings revisions, has also seen some improvement. So while current earnings trends may seem bleak, there is a growing probability in subsequent quarters of estimates moving higher or actual earnings surprising to the upside given the resumption of economic activity in China and accelerated re-openings in Europe and domestically. The BofA Global Research forecast for 2020 calls for an EPS target of $115, or a decline of -29% year-over-year, and currently expecting a recovery to around $145–$155 per share for 2021, indicating an EPS growth range of +25–35% year-over-year. This emergence of earnings should be one of the key pillars for additional gains in equities as this business cycle progresses to the “Other Side” and “New Frontier” phases of the workout process.

Conclusion

After the momentum surge in equities, higher volatility will likely remain given the risks of a potential second wave and China trade tensions. However, we remain favorable on global equities relative to fixed income on a 12-18 month horizon and view any meaningful pullbacks as buying opportunities for long- term investors. In the near term, broadening participation from laggards and improving credit markets are important supports. Ultimately, consumer pent-up demand and earnings should enable fundamentals to catch up with prices, setting the stage for further upside.

THOUGHT OF THE WEEK

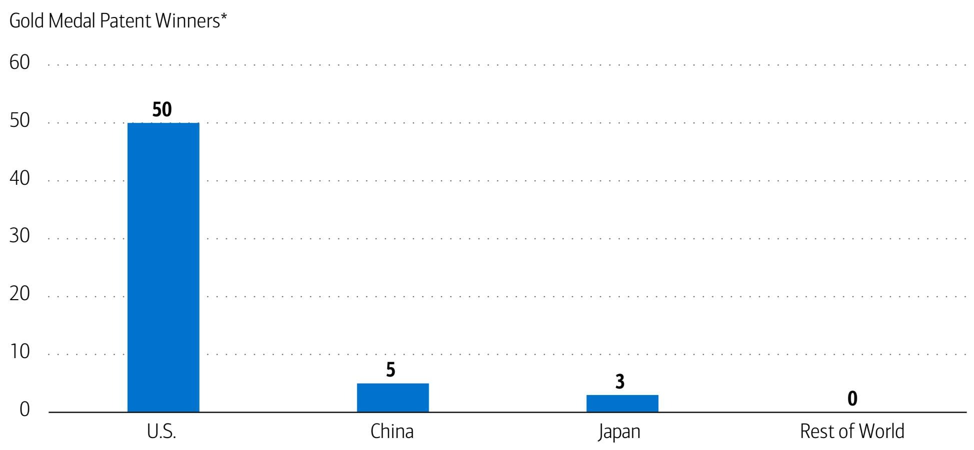
No Olympics, but the U.S. Takes Gold in World-class Patents

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

Innovation is the "mother's milk" of economic growth and corporate earnings, and nothing drives innovation more than a nation's patent portfolio. The latter is a mix of human talent, research and development outlays, capital funding, risk-taking culture, protection of intellectual property rights, and related dynamics. Simply put: Nations that patent not only prevail but also provide some of the best long-term investment opportunities for investors.

Enter the United States—an "unchallenged patent superpower" according to a new study from Germany's Bertelsmann Stiftung, "World Class Patents in Cutting-Edge Technologies." According to the report, the United States holds the largest number of world-class patents in 50 out of 58 cutting-edge technologies. China took five top spots, while Japan took three in the latest survey (Exhibit 4).

Exhibit 4: Number One Ranking of World-class Patents in 58 Cutting-edge Technologies.



*Number one ranking of world-class patents in 58 cutting-edge technologies. Source: Germany's Bertelsmann Stiftung, "World Class Patents in Cutting-Edge Technologies." Data as of June 2020.

The U.S.'s strength in patents runs the gamut, from carbon capture, biofuels, geothermics, precision framing, cloud computing, big data, artificial intelligence, quantum computing, augmented reality and many other cutting-edge technologies. China's patent strengths lie in recycling, water treatment, waste management, biocides and fertilizer. Japan, meanwhile, leads in electric vehicles, battery tech and advance coatings. South Korea didn't take any top spots but scored relatively well in 5G, battery tech and nanomaterials.

Some key quotes from that report:

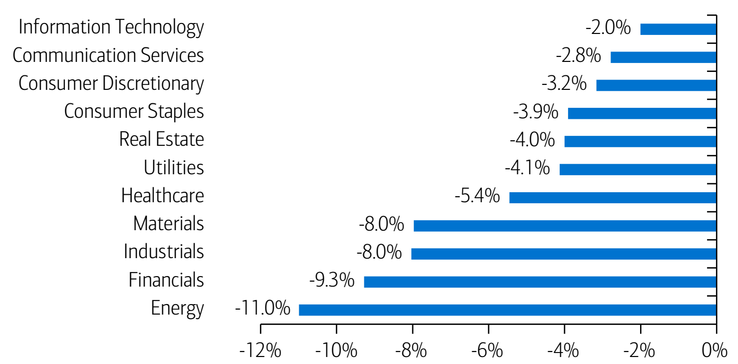
- "The number of American world-class patents is still showing extremely dynamic growth in essential cross-sectional technologies connected to digitalization. The USA is also the only industrial nation able to keep up with China where entirely new technologies are concerned."
- "East Asia is catching up in leaps and bounds: South Korea and China in particular have developed enormously in terms of patent quality in the last 10 years."
- "While still the strongest European patent power, Germany is losing ground worldwide."

The bottom line: Innovation/patent leaders should be at the core of any portfolio. That means having long-term exposure in many cutting-edge technologies and positions in their respective countries and companies leading the way.

Equities

	Total Return in USD (%)			
	Current	WTD	MTD	YTD
DJIA	25,605.54	-5.5	1.0	-9.2
NASDAQ	9,588.81	-2.3	1.1	7.4
S&P 500	3,041.31	-4.7	0.0	-5.0
S&P 400 Mid Cap	1,759.91	-7.9	-0.2	-14.0
Russell 2000	1,387.69	-7.9	-0.4	-16.3
MSCI World	2,164.46	-4.5	0.8	-7.4
MSCI EAFE	1,768.14	-4.2	2.6	-12.1
MSCI Emerging Markets	987.01	-1.5	6.2	-10.7

S&P 500 Sector Returns



Fixed Income[1]

	Total Return in USD (%)			
	Current	WTD	MTD	YTD
Corporate & Government	1.29	0.9	0.3	6.6
Agencies	0.60	0.6	0.0	4.8
Municipals	1.54	0.6	0.6	1.8
U.S. Investment Grade Credit	1.30	0.7	0.2	5.7
International	2.28	0.4	1.0	4.0
High Yield	6.77	-1.4	1.7	-3.1

	Current	Prior Week End	Prior Month End	2019 Year End
90 Day Yield	0.16	0.15	0.12	1.54
2 Year Yield	0.19	0.21	0.16	1.57
10 Year Yield	0.70	0.90	0.65	1.92
30 Year Yield	1.46	1.67	1.41	2.39

Commodities & Currencies

	Total Return in USD (%)			
Commodities	Current	WTD	MTD	YTD
Bloomberg Commodity	135.92	-1.5	0.3	-21.0
WTI Crude $/Barrel[2]	36.26	-8.3	2.2	-40.6
Gold Spot $/Ounce[2]	1,730.75	2.7	0.0	14.1

Currencies	Current	Prior Week End	Prior Month End	2019 Year End
EUR/USD	1.13	1.13	1.11	1.12
USD/JPY	107.38	109.59	107.83	108.61
USD/CNH	7.08	7.07	7.13	6.96

Source: Bloomberg, Factset.Total Returns from the period of 06/08/20 to 06/12/20. Bloomberg Barclays Indices.[1] Spot price returns.[2] All data as of the 06/11/20 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 06/12/20)

	Q3 2019A	Q4 2019A	2019A	Q1 2020A	Q2 2020E	2020E
Real global GDP (% y/y annualized)	–	–	2.9	–	–	-4.4
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	0.4	0.9
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	13.1	9.0
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	–	2900
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 June 12, 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.

ISM Purchasing Manager's Index (PMI) measures manufacturing activity based on a monthly survey of purchasing managers at more than 300 manufacturing firms.

Citigroup Economic Surprise Indices are objective and quantitative measures of economic news. They are defined as weighted historical standard deviations of data surprises.

A diffusion index refers to the common tendency within a group of numbers or statistics. In the stock market, a diffusion index refers to whether more stocks are declining or falling within an index like the S&P 500.

Conference Board Employment Trends Index aggregates eight labor-market indicators, each of which has proven accurate in its own area.

Small business optimism index takes into account several critical components that measure the mood of small businesses — the index is derived from 10 components: Plans to Increase Employment.

Market-capitalization-weighted index is a type of market index with individual components, or securities, weighted according to their total market capitalization.

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