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CHIEF INVESTMENT OFFICE

Capital Market Outlook

June 22, 2020

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- **Macro Strategy**—Key lessons from the last remarkable 100 days: Policy makers learned that in times of crisis, "bigger is better." The health of nations equates to the wealth of nations. And major crises often lead to fundamental shifts in economic and social behavior, and this time we feel will be no different.
- **Global Market View**—The industrial sector has started to outperform in recent weeks, bouncing off of near 20-year lows in relative performance. As we start to see industrial manufacturing data recover from shutdown lows, supported by significant global stimulus and an improving macro backdrop, there is potential for industrial stock performance to continue to improve, favoring cyclical yet high-quality names for investors.
- **Thought of the Week**—In our view, the dollar may finally turn from a headwind for crude-oil prices into a tailwind. This, combined with aggressive monetary/fiscal policy around the world and massive global oil supply cutbacks, should continue to buoy prices. However, high global inventories and massive surplus production capacity are likely to keep a cap on crude-oil prices for the foreseeable future.
- **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

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

GLOBAL MARKET VIEW

Chief Investment Office
Macro Strategy Team

THOUGHT OF THE WEEK

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Data as of 6/22/2020 and subject to change.

MACRO STRATEGY

What a Difference 100 Days Can Make For The Markets and Investors

Joseph Quinlan, Managing Director and Head of CIO Market Strategy

Rewinding the clock, roughly 100 days ago, on March 11, the World Health Organization announced the COVID-19 outbreak as a pandemic—the coronavirus, once thought to be just an epidemic in China—had jumped borders and had morphed into one of the greatest global health crises in modern history. The next day—Black Thursday—globally, equities declined, with U.S. stocks suffering from the greatest single-day percentage fall since the 1987 stock market crash. U.S. equities staged a massive rally on Friday the 13th, but one of the most volatile weeks in market history ended with the U.S.

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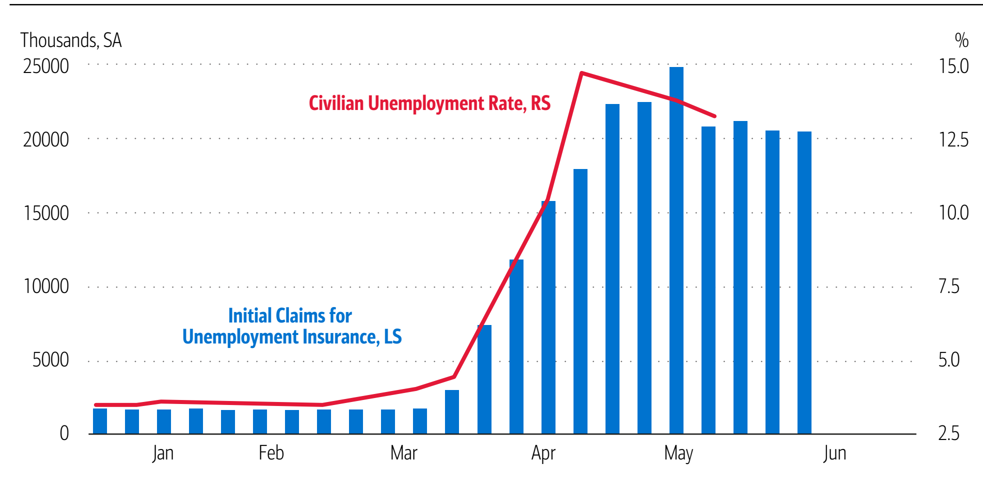
government declaring a national emergency owing to the coronavirus pandemic. It also ended with global equities, including the U.S., in a bear market. The great bull market was history.

The S&P 500 would bottom on March 23, closing 2,237, down roughly 34% from the all-time high reached on February 19. As March came to a close, stocks had already priced in the fallout from the coronavirus and COVID-19. The stock market is a forward-looking, discounting mechanism and sensed early on that what happens in China doesn't stay in China. However, while the capital markets were well on their way toward re-pricing risk, the pain to the real economy (Main Street) was just beginning.

April 2020 will be remembered as one of the most unique and unusual periods in modern history. The bulk of humanity was basically relegated to solitary confinement. Shutdowns by government fiat. "Shelter-in-place"—surely the phrase of the year—became the norm. The $90 trillion global economy came to a near standstill. Around the world, factories shuttered, trade collapsed, production plunged, and consumers—save for online sales—stopped spending. So dramatic was the global shutdown in April that carbon dioxide emissions levels in India dropped for the first time in four decades. China, as well as many other parts of the world, reported a dramatic decline in carbon emissions.

With U.S. economic activity frozen, U.S. unemployment (Exhibit 1) spiked to 14.7% in April, the highest rate since 1939, before dropping to 13.3% in May. Meanwhile, the number of daily deaths in the northeast from COVID-19 climbed steadily in the U.S. over the first half of the month, layering on more uncertainty and volatility to the U.S. economic outlook. Same for the oil price shock, with oil prices (West Texas Intermediate) dropping 12% in the month of April owing to a price war triggered by Saudi Arabia. Liquidity fears spiked as long-term bond yields reached record lows and credit spreads widened out.

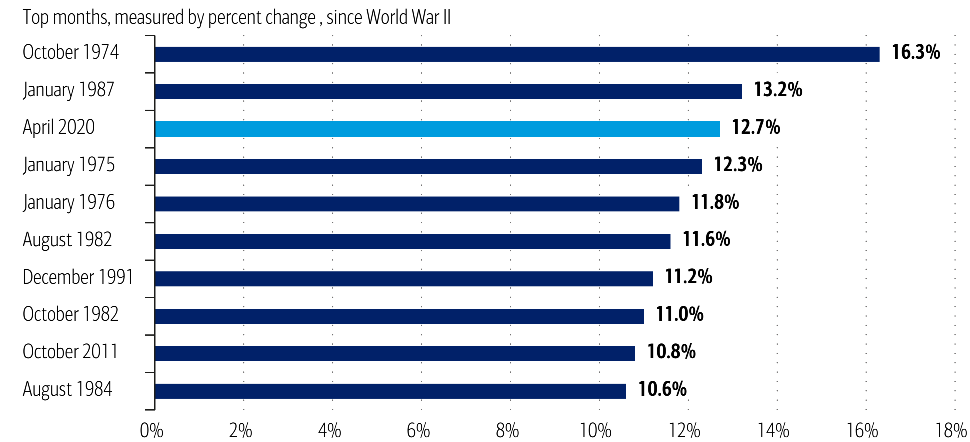
Exhibit 1: The Unemployment Curve starts to Bend



Sources: Department of Labor/Haver Analytics. Data as of 6/3/2020. **Past performance does not guarantee future results.**

The economic numbers in April were grim, but the stock market was already looking across the valley. As April came to a close, the COVID-19 curve was showing the first hints of flattening—daily deaths in the U.S. peaked on April 14. Social distancing was working in containing the disease. Also working: the massive monetary and fiscal response in not only the U.S. but around the world, which prevented a global health crisis from morphing into a global liquidity/solvency crisis. A floor was built underneath the economy and stock market in April. Against this backdrop, the S&P 500 notched one of its best monthly gains in over three decades in April, rising 12.7% for the month (Exhibit 2). The Dow Jones Industrial Average had its fourth-largest post-war monthly rally with an 11.1% gain, while the Nasdaq surged 15.5%, its best monthly rise since June 2000.

Exhibit 2: April 2020 The Best Month in Decades for S&P 500.



Source: CNBC. Data as of April 30, 2020. **Past performance does not guarantee future results.**

Not surprisingly, a swooning economy juxtaposed against a soaring stock market left many investors perplexed as May unfolded. But the flattening of the curve, the gradual reopening of many U.S. states, the trickle down effects from the massive fiscal and monetary stimulus, oil price stability—all of these variables helped the S&P 500 rise by another 4.5% in May and extend the rally into June. The same factors have created better-than-expected momentum for the U.S. economy entering the second half of the year, with various data points—housing, autos, retail sales—rapidly improving month to month. Real gross domestic product (GDP) growth in the second quarter of 2020 will be one of the weakest on record. But 100 days after the U.S. declared a national emergency due to COVID-19, the bear market in U.S. equities and U.S. recession are in the rear-view mirror.

Some key takeaways from a remarkable 100 days

So what did we learn in the past 100 days? What are some of the key takeaways?

Here are three:

First, with memories of 2008/ 2009 fresh in mind, policy makers learned that in times of crisis, "bigger is better"—in terms of both fiscal and monetary responses. On a global basis, and thus far, the combination of central bank liquidity injections and government fiscal stimulus measures equates to roughly 20% of world GDP—an unprecedented sum of capital that prevented a steep and prolonged economic downturn.

Second, the health of nations equates to the wealth of nations. If we have learned anything from the COVID-19 pandemic, it's that health is a fundamental determinant to economic growth. Sick nations are handicapped in terms of production, consumption and aggregate growth. Healthy nations, in contrast, thrive—they produce, consume and grow. Their populations expand, creating more productive capacity (supply) and consumption potential (demand). COVID-19 has not only pushed healthcare to the top of the agenda of every government in the world, it has also brutally exposed cracks in the healthcare systems of rich and poor nations alike, portending more global spending on healthcare in the decade ahead.

Last, history has shown that major crises often lead to fundamental shifts in economic and social behavior, and this time will be no different. As discussed in greater detail in the May 2020 Investment Insights: "The Great Acceleration: Speeding Toward a Post-Coronavirus World," the current pandemic will result in structural changes to how we work, learn, shop, travel and other common activities. What may have taken years to evolve is likely to become reality sooner than anticipated. As Microsoft CEO

Satya Nadella stated, "We have seen two years' worth of digital transformation in two months." Against this backdrop, we anticipate a greater pace of digitalization and automation in the years ahead and a renewed focus on new online services, investment in telecommunications and healthcare infrastructure. We believe many leading U.S. companies are well positioned to capitalize on these trends.

There will be more lessons to be learned from the pandemic of 2020 because the crisis is not over. We recognize that. We are not close to "Mission Accomplished." The world needs a vaccination for COVID-19, and soaring federal deficits and debt levels need to be addressed and reconciled at some point in the future. The outlook for corporate earnings remains highly muddled. There are potential risks of a second wave. The presidential election is just around the corner—on it goes.

The wall of worry is infinite. But 100 days after what felt like the end of the world, there are plenty of reasons for investor optimism.

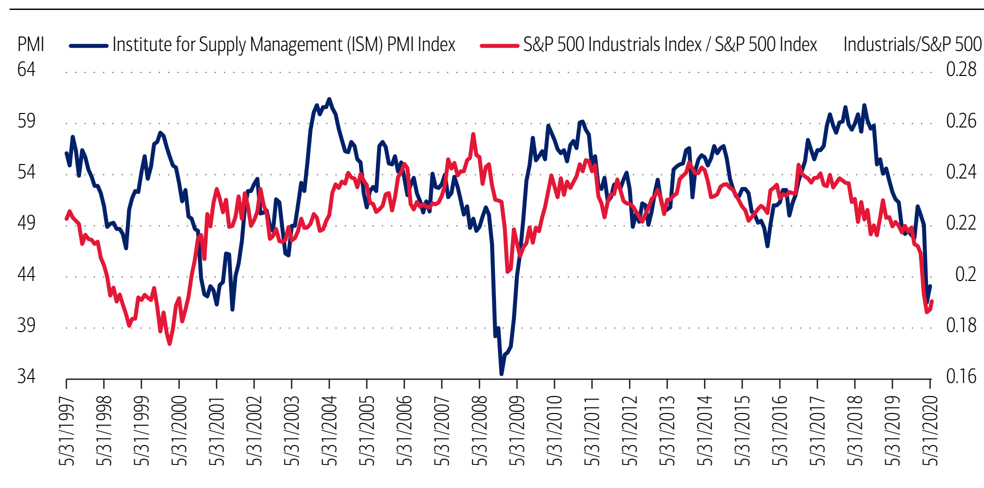
GLOBAL MARKET VIEW

Industrials: Flash in the Pan or the Next Superstar?

Chief Investment Office Macro Strategy Team

Industrials have had a tough time in 2020, underperforming the S&P 500 by over 10% year-to-date[1] as the affects of the pandemic and related shutdowns rippled through manufacturing supply chains and thwarted demand for capital goods, equipment and services. This underperformance has been so severe that at its low in mid-May, industrials were down 16% more than the market, taking the industrial sector to the widest degree of underperformance since the peak of the tech equity bubble in 2000 (Exhibit 3). Since that relative low, industrials have outperformed mightily, up over 9% more than the S&P 500, shaking off the potential of brief fears of a second virus wave and instead embracing the prospect of additional fiscal and monetary stimulus, along with signs that industrial activity has bottomed and that a recovery from extreme lows in data is underway. So can this outperformance continue or will the rally falter, only to see the industrial sector continue to underperform for yet another year?

Exhibit 3: Industrial Sector vs. S&P 500 and U.S. Manufacturing Purchasing Managers Index (PMI).



Source: Bloomberg, as of 6/17/20. **Past performance does not guarantee future results.**

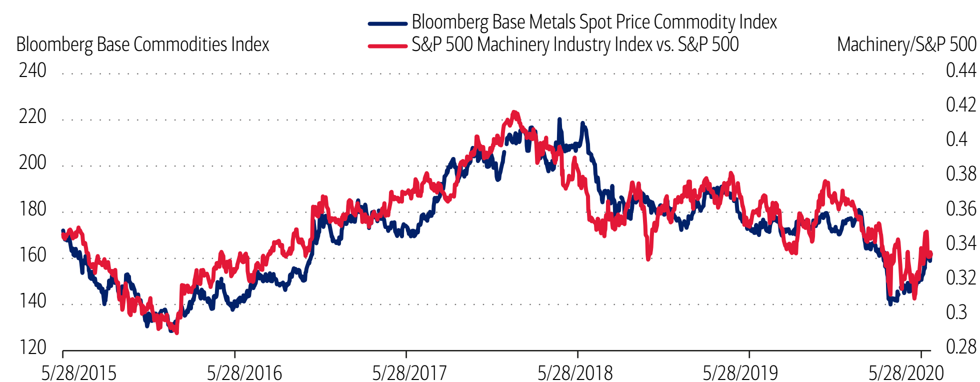
[1] Source: Bloomberg, as of 6/17/20.

Given the starting point of being near a 20-year low in relative performance, it is likely the industrial sector will be positively receptive to any hints of good news, such as early signs of a stabilization or recovery in fundamental data, which we currently are seeing. April appears to have been the low in industrial activity, as measured by a deeply contractionary 41.5 reading of the U.S. ISM PMI. The May PMI moved higher to 43.1, and given recent regional manufacturing surveys for June, such as the sharp recovery in the NY Empire State Manufacturing Index to -0.2 from -78.2 in April, there is optimism that this manufacturing recovery has continued nationally. There is typically a close relationship between industrial relative performance and the PMI, as shown in Exhibit 3, so it would be historically consistent to expect industrials to outperform if the PMI continues to recover. The other important observation from Exhibit 3 is that the underperformance of industrial stocks and the downtrend in the PMI have been occurring much longer than the virus, with the PMI decelerating since late 2018, paving the way for the possibility of a more sustained recovery in industrial activity.

Commentary direct from industrial companies confirms these early signs of stabilization and recovery, with most management teams speaking about improvement in May from the April standstill, noting strength in healthcare-related and consumer end markets, such as housing. Commentary is even more bullish from companies with China exposure, many of whom have spoken about the recovery in China sales far exceeding expectations, with some noting that demand has even surpassed pre-virus levels to reach new records. The strength appears to be broad-based, ranging from automation equipment for technology manufacturing to truck engines. As global economies embrace more aggressive stimulus measures and economic outlooks continue to improve, the industrial sector is positioned to benefit, with the sector deriving 30% of its revenue on average from foreign sources and many large industrial companies having a much higher percentage of overseas revenue.

As we consider the prospects for a continuation in industrial outperformance, we have to pay attention to the macro backdrop that is typically present during periods of broad and strong industrial sector outperformance. In addition to a recovering PMI described above, industrial stocks typically outperform when the dollar is weakening, commodity prices are rising, the yield curve is steepening, and inflation expectations are rising. These conditions are the greatest tailwind to the more cyclical portions of the sector, such as machinery and industrial equipment stocks. The last time we saw these macro conditions was 2016-2017, and that was the last time the industrial sector outperformed the market for an extended period of time. To illustrate this relationship, consider the relative performance of machinery stocks compared to the Base Metals Index in Exhibit 4 and note the improvement in stock performance as we have seen commodity prices recover in recent weeks. Early signs of improvement in the other macro conditions have emerged since the mid-May relative low for industrials, supporting the outperformance experienced since that time.

Exhibit 4: Machinery Industry vs. S&P 500 and Base Commodities Index



Source: Bloomberg, as of 6/17/20. **Past performance does not guarantee future results.**

Looking at valuations, on an absolute basis industrial stocks are trading near record high multiples on next year earnings. At 19x 2021 earnings,[2] which already contemplate a rebound in earnings from the 2020 lows, industrials haven't been this expensive since the end of 2017, which was followed in 2018 by a sharp reduction in multiples and significant industrial underperformance. The key difference is that relative to the market, industrials are trading at a 3% discount today, below the 10-year average of parity with the market and the 5% premium typically reached during expansionary industrial activity period, such as 2016 and 2017.

So given the depressed starting point for industrials and indications that the fundamental and macro data are becoming more supportive, how should investors be positioned to take advantage of the potential for improving industrial performance? The first step is to maintain a commitment to staying high quality, as defined by strong balance sheets, robust free cash flow generation, adept management teams and attractive business models. Though lower-quality names can rebound the most in the early days of a recovery, usually as liquidity and solvency risks abate, this outperformance can be short-lived as the reality of elevated leverage and structural industry challenges persist into the next cycle. Quality tends to compound value through cycles, which is the ultimate goal for long-term investors.

From this selection of quality companies, the next step is to add cyclicality. This can be achieved through select machinery names, which are starting to see forward indicators, such as orders, start to stabilize and, as mentioned above, are sensitive to rising commodity prices. Further, machinery companies tend to reflect optimism for long-awaited infrastructure spending. Multi-industry and industrial equipment companies may also be used to add cyclicality, looking for names that have exposure to more challenged end markets that have the most room to recover, such as auto, consumer electronics, general industrial and even oil and gas. Many of these multi-industry names also have exposure to end markets that have remained and likely will continue to be robust, such as pharmaceutical, semiconductor and certain automation. Rails are considered another way to add cyclicality, as these high-margin, partial-monopoly businesses typically see volumes return and earnings rebound as the economy recovers.

Powerful rallies in some of the lowest-quality and/or most structurally challenged industries, such as commercial aerospace and airlines, could be used opportunistically to reduce positioning. Outside of the cyclical cohort, on defense contractors, even though the industry has outperformed substantially year-to-date, the stocks are trading at a historically wide discount to the market on 2021 earnings, possibly indicating that election and budget risk are already being priced into shares. We note that defense contractors, which are typically countercyclical, tend to lag when more cyclical portions of the industrial sector start to outperform.

All in all, we see early signs that the industrial sector's three-year string of underperformance has the potential to come to an end, allowing for the addition of cyclicality to portfolios while remaining high quality to support long-term returns.

[2] Source: Bloomberg, as of 6/17/20.

THOUGHT OF THE WEEK

Dollar Likely To Support Oil Prices Ahead But Supply Discipline Remains Critical

Chief Investment Office Macro Strategy Team

The broad trade-weighted dollar index (TWDI) has softened along with other risk-aversion indicators since late March, when $3 trillion in U.S. fiscal stimulus became law, and the Fed cut interest rates to zero in response to the coronavirus pandemic. We believe the dollar is likely to continue to depreciate ahead. The U.S. and global economy is rebounding much faster than out of previous recessions, and accelerating economic growth is typically associated with increasing risk appetite which generally works against the dollar. Aggressive Fed programs aimed at supporting the financial system have prevented a dollar liquidity crunch overseas, also limiting upside pressure on the dollar compared to past global crises. In addition, U.S. monetary policy is similar to other developed economies, and the Fed plans to remain on the sidelines through 2022, likely keeping yield differentials from favoring the dollar, in contrast to the past two to three years. Typical lagged dollar-depreciation effects from the widening trade deficits of the past six years are also likely to start weighing on the greenback, in our view. Furthermore, the real TWDI (which adjusts for relative inflation) tends to revert to mean or neutral valuation over long cycles, so its appreciation since 2014 to a current 20-year high likely sets it up for a period of depreciation.

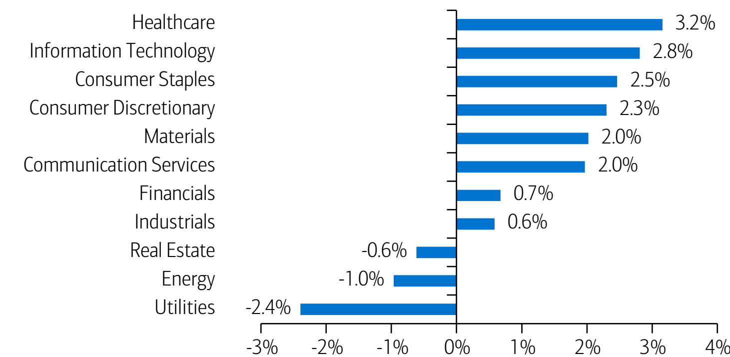
This suggests that the dollar may finally turn from a headwind for crude-oil prices into a tailwind, which combined with aggressive monetary/fiscal policy around the world and massive global supply cutbacks, should buoy prices ahead. Indeed, oil consumption has improved faster than expected around the world (led by a strong rebound in gasoline demand) and global supply dropped precipitously since late April's oil-price crash, helping stabilize inventories and prices. According to the U.S. Energy Information Administration's (EIA) June 2020 Short-term Energy Outlook, U.S. crude-oil production was down 12% in May from its late-2019 record high. With drilling at its lowest level since 1987 and sharp cutbacks in well completion activity, the EIA expects U.S. production to decline another 7% by March 2021 (followed by a slight increase through late 2021). Globally, the International Energy Agency (IEA) expects average oil supply to drop about 7 million barrels per day (mb/d) in 2020, followed by less than a 2 mb/d increase in 2021. With an anticipated gain of more than 5 mbd next year, demand is seen outpacing supply in 2021. Rapidly rebounding demand suggests a potentially quick erosion of inventories and spare capacity after 2021, which is why oil prices are generally expected to remain on a gradual uptrend. A dollar depreciation, as discussed above, would support this outlook.

In the meantime, however, oil inventories remain extremely elevated, having surged as a result of record-high Organization of the Petroleum Exporting Countries (OPEC) April production/exports and collapsing consumption. What's more, mainly because of record subsequent OPEC output cuts, surplus production capacity has spiked. This surfeit is expected to restrain global production and to likely keep Brent oil prices within a $40-to-$50-per-barrel range over the next 12 months, in our view. Great production discipline is necessary to prevent a flood of oil from overwhelming the market again over the next two years.

Equities

	Current	Total Return in USD (%) WTD	MTD	YTD
DJIA	25,871.46	1.1	2.0	-8.2
NASDAQ	9,946.12	3.7	4.9	11.4
S&P 500	3,097.74	1.9	1.9	-3.2
S&P 400 Mid Cap	1,784.72	1.4	1.3	-12.8
Russell 2000	1,418.63	2.3	1.8	-14.4
MSCI World	2,208.97	2.1	2.9	-5.5
MSCI EAFE	1,803.74	2.0	4.7	-10.3
MSCI Emerging Markets	1,001.36	1.5	7.9	-9.4

S&P 500 Sector Returns



Fixed Income[1]

	Current	Total Return in USD (%) WTD	MTD	YTD
Corporate & Government	1.23	0.4	0.6	6.9
Agencies	0.59	0.0	0.0	4.9
Municipals	1.54	0.1	0.6	1.9
U.S. Investment Grade Credit	1.30	0.2	0.4	5.9
International	2.16	1.0	1.9	5.0
High Yield	6.44	0.9	2.5	-2.3

	Current	Prior Week End	Prior Month End	2019 Year End
90 Day Yield	0.14	0.15	0.12	1.54
2 Year Yield	0.19	0.19	0.16	1.57
10 Year Yield	0.69	0.70	0.65	1.92
30 Year Yield	1.46	1.46	1.41	2.39

Commodities & Currencies

Commodities	Current	Total Return in USD (%) WTD	MTD	YTD
Bloomberg Commodity	137.77	1.4	1.6	-19.9
WTI Crude $/Barrel[2]	39.75	9.6	12.0	-34.9
Gold Spot $/Ounce[2]	1,743.87	0.8	0.8	14.9

Currencies	Current	Prior Week End	Prior Month End	2019 Year End
EUR/USD	1.12	1.13	1.11	1.12
USD/JPY	106.87	107.38	107.83	108.61
USD/CNH	7.07	7.08	7.13	6.96

Source: Bloomberg, Factset.Total Returns from the period of 06/15/20 to 06/19/20. Bloomberg Barclays Indices.[1] Spot price returns.[2] All data as of the 06/19/20 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 06/19/20)

	Q3 2019A	Q4 2019A	2019A	Q1 2020A	Q2 2020E	2020E
Real global GDP (% y/y annualized)	–	–	2.9	–	–	-4.0
Real U.S. GDP (% q/q annualized)	2.1	2.1	2.3	-4.8	-35.0	-5.7
CPI inflation (% y/y)	1.8	2.0	1.8	2.1	0.5	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	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	29	40

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 19, 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.

The NY Empire State Index is the result of a monthly survey of manufacturers in New York state. Known as the Empire State Manufacturing Survey, it is conducted by the Federal Reserve Bank of New York.

Bloomberg Base Metals Spot Price Commodities index measures the price movements of Precious Metals included in the Bloomberg CI and select subindexes. It does not account for the effects of rolling futures contracts or the costs associated with holding physical Precious Metals and is quoted in USD.

Trade Weighted Dollar Index measures weighted average of the foreign exchange value of the U.S. dollar against the currencies of a broad group of major U.S. trading partners.

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