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CHIEF INVESTMENT OFFICE

Capital Market Outlook

June 29, 2020

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

IN THIS ISSUE

- **Macro Strategy**—Every recession is similar to and different from previous downturns. The typical economic and financial-market patterns observed when new expansions begin are playing out just as they have in the past. At the same time, the response to the pandemic reveals important societal changes which, in our view, are likely to continue to shape the future investment landscape.
- **Global Market View**—We see several factors emerging as foundation for a long-term advance for U.S. equities in the form of low inflation dynamics and accommodative monetary policy, creative destruction leading to productivity improvements, re-shoring and new capital expenditure (capex) growth, and finally cautious investor sentiment and the search for high-quality assets.
- **Thought of the Week**—With both sides of the aisle ratcheting up the anti-trade rhetoric and In spite of the growing wave of de-globalization—foreign investors still want a piece of America. As a long-term bullish indicator, foreign demand for U.S. securities remains robust and supportive across multiple asset classes.
- **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

Chief Investment Office Macro Strategy Team

GLOBAL MARKET VIEW

Niladri Mukherjee
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Head of CIO Portfolio Strategy

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THOUGHT OF THE WEEK

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Data as of 6/29/2020 and subject to change.

MACRO STRATEGY

Something Old and Something New

Chief Investment Office Macro Strategy Team

The business cycle is playing out as it typically does. Economic data bottomed in mid-April and have begun to recover. Markets, including the credit and stock markets, have led the economic recovery, as they always do. Because of the well-defined cause of the downturn, namely the shutdowns around the world aimed at flattening the pandemic curve, the timing of the onset and of the end of recession were also well-defined. The damage, disruption and ultimate fallout from the shutdowns could have easily caused a severe depression had policy not intervened to prevent disaster. However, given the policy response, it appears that the disaster scenario is off the table.

In fact, fear of an unstoppable down spiral has caused monetary and fiscal policy to respond in an unprecedentedly aggressive manner that has dramatically changed the economic landscape from what seemed likely before the pandemic. In the U.S., for example, fiscal spending fueled by the biggest deficits since World War II (WWII) combined with the most aggressive monetary expansion in U.S. history showed a political will to err on the side of over-spending as opposed to the relatively stingy policies that followed the Great Financial Crisis of 2008-2009. The failure to generate sufficient growth and inflation to hit central-bank targets during the last expansion is prima facie evidence that policymakers were too timid not only in the U.S., but all around the developed world.

Having learned that lesson the hard way and given the threat that the shutdowns would cause an economic depression, policymakers have instead thrown caution to the wind. Economic and market variables are responding to that fact. It is not a coincidence that the U.S. equity market made its bear-market bottom in the third week of March, when the first Coronavirus Aid, Relief, and Economic Security Act ("CARES Act") package was signed into law, the biggest and fastest fiscal-spending initiative in the history of the United States. The strong recovery in market and economic leading indicators since the economy began to reopen shows that expectations are forming for a very strong and prolonged expansion.

A distinguishing feature of this new cycle is the speed with which it is unfolding: the fastest bear markets in stocks, the fastest and deepest economic plunge followed by the strongest and quickest equity bull market and economic recovery on record. In fact, the timing of the shutdowns pretty much fits the timing of the recession. As usual, the stock market fell in advance of the shutdowns and rose in anticipation of their expiration and the promised fiscal spending. The speed and scope of the U.S. economic recovery are directly proportional to the speed and scope of the policy response. This is true all around the developed world, where the policy response has been similarly gargantuan to that of the U.S. The stimulus in place and the stimulus yet to come imply a period of stronger economic growth not only in the U.S. but all around the world for at least the next couple of years. That's the apparent message in the equity market.

Also as is typical at the end of recessions, pundits look at the cycle low in profits and conclude that the strong gains in equity markets reflect a disconnect between the fundamentals and stock-market valuations. This narrative was as common after the last three recessions as it is now. However, it misses the fact that a brighter future raises the current value of stocks. What's more, the response to the pandemic implies a number of new forces driving the likely evolution of the global economy, with significant implications for investors. In some sense, the pandemic has altered the course of history. In many respects, it has simply sped up trends that were already under way.

One example is Europe. Since WWII, European unification has proceeded in fits and starts. Progress toward a more unified Europe was often the result of a necessary response to crisis. The Great Financial Crisis of 2008-2009 revealed the shortcomings of European institutions for addressing systemic crises. Various baby steps have helped the European Central Bank (ECB), for example, gain the tools it needed to prevent a deflationary collapse and do "whatever it takes" to prevent a breakup of the euro. The need to create a "fiscal bazooka" to address the pandemic's fallout has precipitated a historic "Hamiltonian" moment for Europe. Germany has finally agreed to a European fiscal structure that mutualizes debt across the European Union member states. This allows Europe to match the power of U.S. fiscal spending and eliminates a major source of doubt about the viability of the euro. In addition, the ECB, which has borne the brunt of policy support in the absence of a centralized fiscal authority, has been freed to focus on monetary issues. It has recently revamped its negative interest-rate structure to allow banks to receive positive returns for lending while still paying negative rates to borrow. These important changes to European policy together with an outlook for a solid synchronized global expansion in 2021 and 2022 have caused European stocks to perform more in line with the U.S. after years of underperformance.

Another example is the accelerating move toward the "Singularity," which refers to the eventual merger of human brain power with the speed, capacity and information-sharing ability of advanced technology, and the distinctive potential effects of intelligence becoming predominantly non-biological. The pandemic has clearly accelerated a number of trends that were already under way, such as working from home and e-commerce. The growth of the economy is increasingly in the cloud, where this virtualization resides. Software is eating the world, and artificial intelligence is just increasingly sophisticated software. The momentum in the virtual world is always increasing, and the pandemic caused a step function higher in this already powerful trend. As such, it brings the future and its greater profits forward for the beneficiary companies. In short, it has made tech leaders more valuable. The accelerating momentum implied by the Singularity means their valuations are likely to keep surprising people to the upside. However, given the current positive setup for cyclical stocks, a frequent question is whether the better growth outlook implies a rotation out of tech. In our view, both can do well in a synchronized global expansion with tech bringing the future to us faster and faster.

The pandemic has also accelerated the forces causing the rest of the world to view China in a harsher light. China has chosen to develop its own global sphere of influence rather than abide by the standards that underlie the free world economy. The existential conflict between communism and democracy did not end when the USSR broke apart, and as new technology creates the future, an iron curtain of separation is rapidly descending to divide these alternative worlds, much as happened in the earlier Cold War. This accelerating separation is evident in the redirection of supply chains away from China to more trusted sources. It is driving the dialogue over 5G and Chinese influence. It is the major geopolitical issue markets will have to contend with in the years ahead.

GLOBAL MARKET VIEW

Foundation Building for the Secular Bull Market

Niladri Mukherjee, Managing Director and Head of CIO Portfolio Strategy

Kirsten Cabacungan, Investment Analyst

Every market cycle is simultaneously different and similar. New bull markets are born from the depths of despair when it seems all hope is lost with economic data at its worst, financial conditions tightest, and market volatility at extremes. In today's context, this was the situation in March and April. Then, seeing the economic and market carnage, policy makers panic and start providing liquidity and fiscal support, which then brings stabilization. We have seen this play out too since April.

We have often said that we are in a secular bull market with the pandemic-driven exogenous bear market an interruption similar to the dynamic in 1987. We see several factors emerging as foundation for a long-term advance for U.S. equities, in the form of low-inflation dynamics and accommodative monetary policy, creative destruction[1] leading to productivity improvements, re-shoring and new capital expenditure (capex) growth, and finally cautious investor sentiment and the search for high-quality assets.

Low inflation and a patient Fed: Investor worries about accelerating inflation given the massive monetary and fiscal expansion are unlikely to be realized in the medium term. Market measures of inflation such as the 5-year and 10-year breakeven rates are grinding higher on economic re-openings, but at 1.1% and 1.3%, respectively, are far below the Fed's target. The Fed may have increased its balance sheet by $3 trillion in a few short months, but that has merely gone to plug the hole between where nominal gross domestic product (GDP) is versus where it could have been absent the pandemic, i.e., not inflationary but trying to prevent deflation. A full economic recovery in the consumer and services sectors is contingent on vaccines and treatments that may be

[1] A concept in economics that describes the process of old business models being replaced by newer, more efficient models.

a year away on the optimistic side, as well as a palpable reversal in job losses, which is likely to be gradual over the course of the next several years. This ongoing labor market slack and rising investment in productivity-enhancing technologies should mitigate any potential upward pressure on wages and inflation.

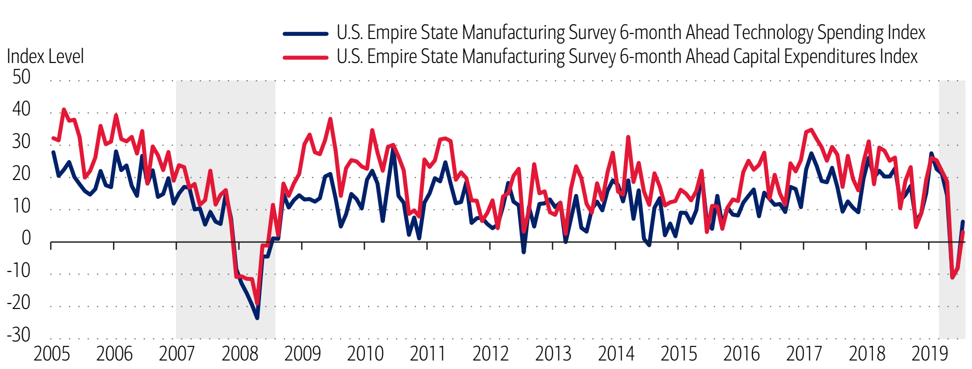
This will make the Fed err on the side of providing more accommodation. In a recent news conference, when asked how long the Fed would stick with zero interest rates if the economy surprises to the upside, Chair Powell said, “we’re not even thinking about thinking about raising rates.” The first Summary of Economic Projections (SEP) since December validated his statement. Every voter projected that the fed funds rate will remain at its current near-zero level for all of 2020 and 2021, and only two voters foresaw rate hikes in 2022. Easy financial conditions should nurse the economy and labor market along, providing the strongest foundation to this secular bull.

Creative Destruction: The pandemic has compressed the time frame on trends that were going to unfold over the next several years into a few months, and we believe that innovation will further move into hyperdrive creating new business models and industries. Think more creative destruction ahead as declining business models are replaced with faster growing ones, transforming the stock market in its wake. The average tenure of a company’s listing on the S&P 500 will likely shrink to just 12 years by 2027, according to Innosight’s work on corporate longevity, declining from 24 years in 2016 and 33 years in 1964.[2]

At this churn rate, a significant number of companies could be replaced in the S&P 500 index in the next decade. Declining business models will either shrink in market value, go out of business, be taken over to be fixed by stronger players or private equity, or be replaced by faster-growing and more digital oriented businesses. For sure, bankruptcies such as the ones being witnessed in the retail sector are messy and create near-term economic headwinds but are natural for a free market economy and ultimately lead to more efficient allocation of capital and greater productivity.

Reshoring and new capex growth: The reshoring trend already in motion prior to the pandemic is expected to further accelerate for reasons ranging from the need for greater supply chain resilience, national security concerns, and lower tax and labor cost arbitrage between the U.S. and China. But it will likely be an increased adoption of technology that should be the tipping point that fully facilitates this trend and ignites a renewed capex cycle. Recessions typically lead to a reduction in business investment, and, given the magnitude of recent job loss, companies could be holding off on any considerable capital spending in the near term. Still, the new economy tainted by necessary pandemic-related behavior adjustments ultimately demands investment—a move toward digital processes, which preserves margins and provides greater speed and efficiency to market. Encouragingly, as Exhibit 1 shows, capex intentions have risen as the worst of the economic data has seemingly passed.

Exhibit 1: Outlook for Technology Spending and Capital Expenditures Has Improved.

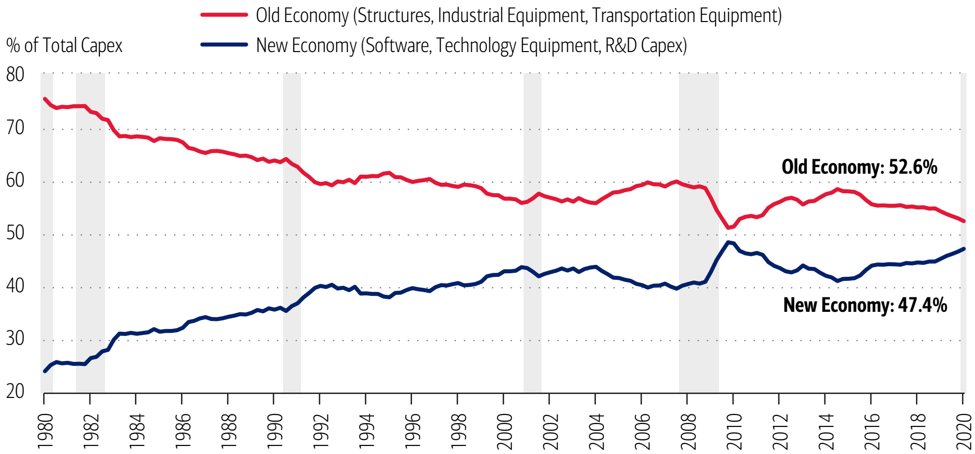


Source: Chief Investment Office. Bloomberg. Data as of June 24, 2020.

[2] Innosight. “2018 Corporate Longevity Forecast: Creative Destruction is Accelerating.” Data as of 2018.

Reshoring efforts will also demand investment, with companies leaning on automation and robotics to support these production transitions. While the consumer remains the backbone of the U.S. economy, new economy capex comprising software spending, technology equipment, and research & development (R&D) should be the driving force for economic activity forward. As Exhibit 2 shows, it is notable that traditional capex made up of investment in structures and industrial and transportation equipment has steadily declined as a percentage of total capex, while new economy capex spending has risen from 24% of total capex in 1980 to 47% today and is soon expected to exceed 50% of total capex, according Cornerstone Marco. More technology investment should help increase productivity and boost profit margins, which will allow companies to further invest and support broader job growth.

Exhibit 2: The Share of New Economy Capex Looks To Be On the Rise.

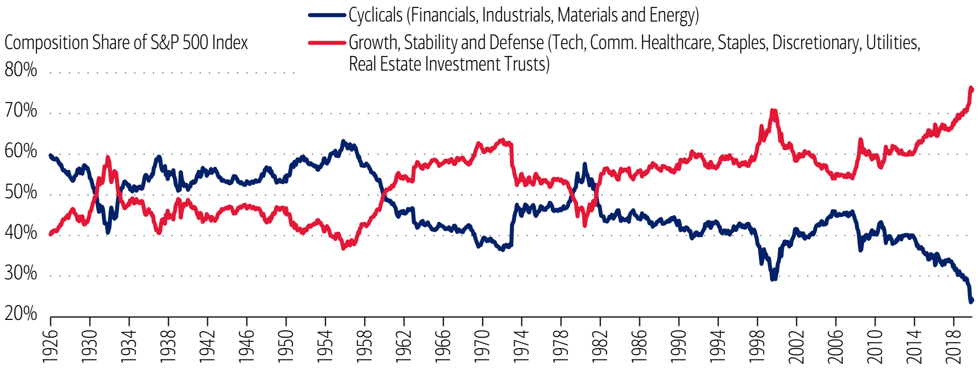


Source: Cornerstone Macro. Data as of June 24, 2020.

Restrained investor sentiment and the search for high-quality assets will enable a new equity culture: Despite a positive tone to equities with much of the deep March losses recovered at this point, investor sentiment remains restrained. Money market fund assets remain elevated at roughly $4.7 trillion, with cash inflows year-to-date at $1.2 trillion versus $24 billion for government bonds and equity outflows of $30 billion, according to BofA Global Research. And although money market funds have seen outflows in the past five weeks, the levels remain small relative to the overall inflows. The American Association of Individual Investors' well-followed survey similarly shows that bearish sentiment last week moved back up to 48.9 (95th percentile) from the recent low of 38.1. Clearly, investors remain cautious with risks on the horizon from a second outbreak and China tensions to U.S. elections.

As economic conditions improve and uncertainty subsides, the amount of cash on the sidelines will eventually have to be redeployed. Record low interest rates for longer means U.S. equities could remain a major beneficiary, given that the spread between the S&P 500 dividend yield and the 10-year U.S. Treasury yield is now 1.37%, sitting well above the 20-year average at -1.4% and in the 99th percentile. Amid this yield-scarce environment and numerous fragilities on both the domestic and geopolitical fronts as far as the eye can see, investors are likely to lean toward U.S. equities, which provide an appropriate balance of high-quality, secular growth and income opportunities. As Exhibit 3 shows, the composition of the S&P 500, as an example, has notably become more skewed toward Growth, Stability and Defensive industries in the last 10 years.

Exhibit 3: The Premium On Quality, Yield and Growth Has the Potential To Drive the Market Composition.



Source: Cornerstone Macro. Data of June 18, 2020. **Past performance is no guarantee of future results.**

Millennials are likely to drive this new equity culture that could prove resilient in the decade ahead. This cohort has now faced two major shocks in their prime wealth-building years—the pandemic and the 2008/09 crash. Based on the Fed's latest survey of consumer finances,[3] millennials had the lowest median net worth for adults younger than 35 in every pre-crisis period dating back to 1989 and only 10% held stocks, the second lowest in 30 years.[4] Now amid the COVID-19 shock, younger investors will likely need to increase their allocation to equities as they play "catch-up" in accumulating wealth, further supporting the secular bull market.

Conclusion

The foundation is coming together for the ongoing secular bull market. As such, pullbacks during this consolidation phase would present an opportunity for investors to rebalance up in equities and put cash to work in high-quality investments. Also, a gradual economic recovery to prior GDP highs with accelerated creative destruction means that investors will have to be disciplined, nimble and focused on risk management to capture these opportunities.

THOUGHT OF THE WEEK

Bullish Indicator: U.S. Capital Inflows Remain Robust

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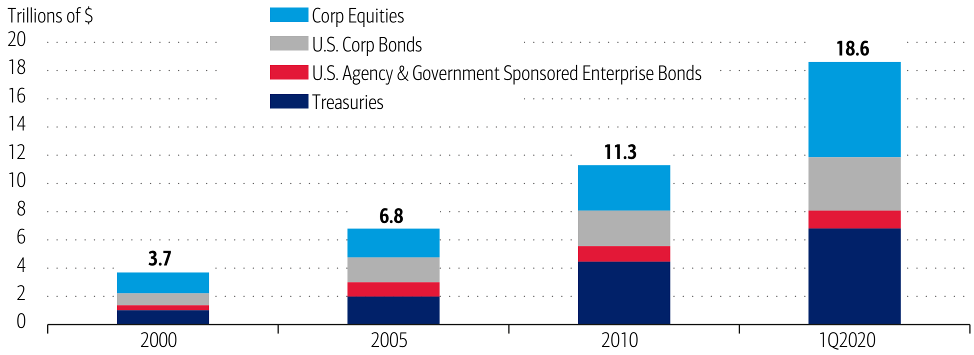
With both sides of the aisle ratcheting up the anti-trade rhetoric and In spite of the growing wave of de-globalization—foreign investors still want a piece of America.

According to the latest Flow of Funds data from the Fed, foreign ownership of U.S. securities (specifically: Treasuries, government agency bonds, corporate bonds and U.S. equities) remained robust in the first quarter of 2020, totaling $18.6 trillion. As denoted by Exhibit 4, foreign ownership of U.S. securities has surged over the past two decades, underpinned by a number of variables ranging from the depth and sophistication of the U.S. capital markets to ever-expanding global demand for U.S. dollars, the world's reserve currency and to the fact that the U.S. economy remains among the strongest and most competitive in the world, backstopped by an innovative economy housing corporate champions in a number of key sectors, ranging from agriculture to aerospace to e-commerce.

[3] The latest survey of consumer finances reflects data as of 2016.

[4] Bloomberg. "Millennials could be ready to save the economy." September 2019.

Exhibit 4: Foreign Ownership of all U.S. Securities.



Source: Federal Reserve Board. Data as of June 2020.

According to the latest figures, foreign investors owned some $6.8 trillion in U.S. Treasuries at the end of the first quarter of 2020, up 4.6% from the prior year. Notably, foreign investors, like U.S. investors, lowered their equity exposure in the first quarter, with foreign investors owning $6.8 trillion in U.S. equities versus $7.2 trillion in Q1 2019. As a critical component of the U.S. capital markets, foreigners owned roughly 35% of outstanding tradable U.S. Treasuries in Q1, 34.3% of U.S. corporate bonds, 13% of U.S. government agencies, and 19.2% of outstanding U.S. equities. These are market-moving levels of ownership.

And speaking of ownership, despite the spike in U.S.-Sino trade tensions, Chinese holdings of U.S. Treasuries have held relatively steady over the past few years, totaling $1.1 trillion in April 2020 (Exhibit 5). Japan's Treasury ownership, the largest foreign owner, was $1.2 trillion in the same month.

Exhibit 5: Holdings of U.S. Treasury Securities.

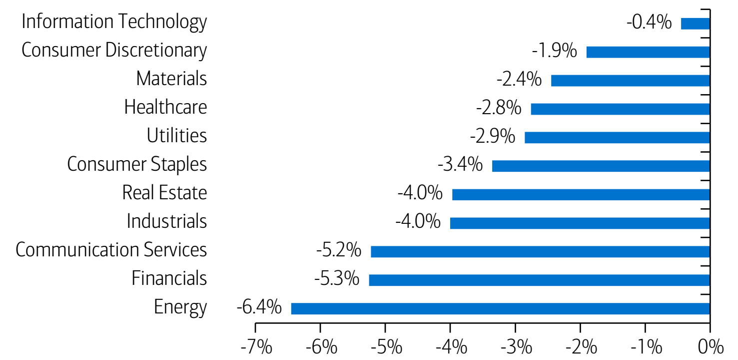
Source: U.S. Department of the Treasury. Data through April 2020.

The bottom line: politics and diplomacy aside, and as a long-term bullish indicator, foreign demand for U.S. securities remains robust and supportive across multiple asset classes.

Equities

		Total Return in USD (%)		
	Current	WTD	MTD	YTD
DJIA	25,015.55	-3.3	-1.3	-11.3
NASDAQ	9,757.22	-1.9	2.9	9.3
S&P 500	3,009.05	-2.9	-1.0	-6.0
S&P 400 Mid Cap	1,719.32	-3.7	-2.4	-15.9
Russell 2000	1,378.78	-2.8	-1.0	-16.8
MSCI World	2,157.19	-2.3	0.5	-7.7
MSCI EAFE	1,779.71	-1.3	3.3	-11.4
MSCI Emerging Markets	998.90	-0.2	7.7	-9.5

S&P 500 Sector Returns



Fixed Income[1]

		Total Return in USD (%)		
	Current	WTD	MTD	YTD
Corporate & Government	1.21	0.3	0.9	7.2
Agencies	0.56	0.2	0.2	5.1
Municipals	1.51	0.1	0.8	2.0
U.S. Investment Grade Credit	1.27	0.2	0.6	6.1
International	2.17	-0.1	1.9	4.9
High Yield	6.77	-1.2	1.4	-3.4

	Current	Prior Week End	Prior Month End	2019 Year End
90 Day Yield	0.14	0.15	0.12	1.54
2 Year Yield	0.17	0.19	0.16	1.57
10 Year Yield	0.64	0.69	0.65	1.92
30 Year Yield	1.37	1.46	1.41	2.39

Commodities & Currencies

		Total Return in USD (%)		
Commodities	Current	WTD	MTD	YTD
Bloomberg Commodity	134.89	-2.1	-0.5	-21.6
WTI Crude $/Barrel[2]	38.49	-3.2	8.5	-37.0
Gold Spot $/Ounce[2]	1,771.29	1.6	2.4	16.7

Currencies	Current	Prior Week End	Prior Month End	2019 Year End
EUR/USD	1.12	1.12	1.11	1.12
USD/JPY	107.22	106.87	107.83	108.61
USD/CNH	7.09	7.07	7.13	6.96

Source: Bloomberg, Factset.Total Returns from the period of 06/22/20 to 06/26/20. Bloomberg Barclays Indices.[1] Spot price returns.[2] All data as of the 06/26/20 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			●		
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 06/26/20)

	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.

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 June 26, 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.

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.

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All recommendations must be considered in the context of an individual investor's goals, time horizon, liquidity needs and risk tolerance. Not all recommendations will be in the best interest of all investors. Asset allocation, diversification and rebalancing do not ensure a profit or protect against loss in declining markets.

Investments have varying degrees of risk. Some of the risks involved with equity securities include the possibility that the value of the stocks may fluctuate in response to events specific to the companies or markets, as well as economic, political or social events in the U.S. or abroad. Treasury bills are less volatile than longer-term fixed income securities and are guaranteed as to timely payment of principal and interest by the U.S. government. Municipal securities can be significantly affected by political changes as well as uncertainties in the municipal market related to taxation, legislative changes, or the rights of municipal security holders. Income from investing in municipal bonds is generally exempt from federal and state taxes for residents of the issuing state. While the interest income is tax-exempt, any capital gains distributed are taxable to the investor. Income for some investors may be subject to the Federal Alternative Minimum Tax. Investments in high-yield bonds (sometimes referred to as "junk bonds") offer the potential for high current income and attractive total return, but involves certain risks. Changes in economic conditions or other circumstances may adversely affect a junk bond issuer's ability to make principal and interest payments. Investments in foreign securities involve special risks, including foreign currency risk and the possibility of substantial volatility due to adverse political, economic or other developments. These risks are magnified for investments made in emerging markets. Investments in a certain industry or sector may pose additional risk due to lack of diversification and sector concentration. There are special risks associated with an investment in commodities, including market price fluctuations, regulatory changes, interest rate changes, credit risk, economic changes and the impact of adverse political or financial factors. Investing in fixed-income securities may involve certain risks, including the credit quality of individual issuers, possible prepayments, market or economic developments, and yields and share price fluctuations due to changes in interest rates.