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CHIEF INVESTMENT OFFICE

Capital Market Outlook

August 17, 2020

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

IN THIS ISSUE

- **Macro Strategy**—Cyclical stocks that benefit from higher inflation and stronger growth have begun to outperform the defensive stocks that benefited from slow growth and the failed reflation policies of the past decade. Deeply negative real interest rates are stimulating faster growth and forcing investors to shift to real assets that are designed to preserve their wealth from higher inflation. The barbell portfolio of the past decade, built with secular-growth stocks and defensive companies for a slow growth economy, is being replaced by a new barbell portfolio of secular-growth stocks counterbalanced by cyclical companies that thrive in a stronger growth environment.
- **Global Market View**—The coronavirus crisis has accelerated the pace of digital transformation across a range of industries. Demand for extended reality devices, including both virtual reality and augmented reality, appears particularly well-placed to grow as physical distancing and prohibitions on large public gatherings make for a faster shift toward new patterns of economic activity.
- **Thought of the Week**—Investors recently experienced one of the more harshest moves to extreme sentiment levels during the first quarter as the pandemic induced sizeable shifts toward pessimism, but as many areas of the markets have rebounded, sentiment has moved closer to neutral. However, as sentiment is not euphoric and cash remains on the sidelines there remains potential support for higher equity values over the next 12-to-18 months, in our view.
- **Portfolio Considerations**—Global growth continues to grind higher. This month, we are upgrading International Developed equities, specifically Europe, to neutral as macro conditions have solidified, and structural progress toward a fiscal union is viewed as positive by reducing the magnitude of the U.S. Large-cap overweight. In addition, we are taking this opportunity to actively rebalance portfolios back to tactical targets given substantial drift over recent months.

MACRO STRATEGY

Fed Reflation Efforts More Likely To Succeed This Time Around

Chief Investment Office Macro Strategy Team

The U.S. and global economy are on a sharp V-shaped recovery track. U.S. consumer spending on goods surged much above pre-recession levels by June, with U.S. car sales up almost 70% from their April low point. Personal saving per capita and adjusted for inflation spiked

MACRO STRATEGY

Chief Investment Office Macro Strategy Team

GLOBAL MARKET VIEW

Ehiwario Efeyini
Director and Senior Market Strategy Analyst

THOUGHT OF THE WEEK

Nicholas Giorgi, CFA®
Vice President and Investment Strategist

Data as of 8/17/2020, and subject to change.

between April and June, averaging almost five times the long-term average and lending strong support to future consumption and growth. Deep inventory declines and a rapid rebound in U.S. and global demand have spurred a fast and strong manufacturing recovery, with the Institute for Supply Management (ISM) manufacturing new-orders index surging further in July and new export orders up sharply into growth territory. The housing sector is also a strong driver of U.S. growth as a result of pandemic-related preference changes boosting residential investment and home prices. Reflecting the swell in activity that followed the easing of shutdowns, surveys of homebuilders, truckers and retailers are all above January levels, helping the labor market recover relatively fast.

The recovery is broad-based, with Purchasing Managers' Index (PMI) composites (manufacturing and non-manufacturing) in the Eurozone, Australia, China, the U.K. as well as the U.S. in V-shaped recoveries. The July global composite PMI moved into growth territory from six standard deviations below average in April. German new orders and business sentiment, Chinese exports and car sales, and Eurozone retail sales have all been much stronger than expected, while the Organization for Economic Co-operation and Development (OECD) leading economic index has continued to rise. All in all, U.S. Q3 gross domestic product (GDP) is tracking at about a 26% quarterly annualized pace, led by real consumer spending (seen up 28%) and motor-vehicle production (seen up 200%). With global short rates at new record lows and more fiscal stimulus coming around the world, the global expansion is poised to accelerate further.

The success of policy stimulating these vast swaths of the global economy out of the abyss in such a short time is evident in better-than-expected earnings reports and substantial upward revisions to analyst earnings forecasts. Indeed, with massive policy stimulus helping demand weather the pandemic better-than-expected and weakening the dollar, S&P 500 revenue growth is likely to show a sharp recovery in coming quarters, with a likely increase of about 7% in 2021 following about a 7% decline in 2020. High levels of operational leverage and subdued labor/interest-rate costs imply that earnings per share are likely to increase by double digits next year.

Bullish financial markets have been pricing in all of this, with equity-market rallies, rapidly narrowing credit spreads—helped by Federal Reserve (Fed) programs to stabilize the corporate credit market—and a drop in the St. Louis Fed financial stress index to below-average levels. This tends to be an environment of easing bank-lending conditions and rising inflation expectations. Indeed, as reflected in surging gold prices, an almost complete recovery of the Bloomberg commodity price index to pre-recession levels (following a 25% dip from January to March), and a sustained rise in Treasury Inflation-Protected Securities (TIPS) breakeven inflation expectations, the risk of deflation has not only dissipated, but it has been replaced by incipient fears of inflation.

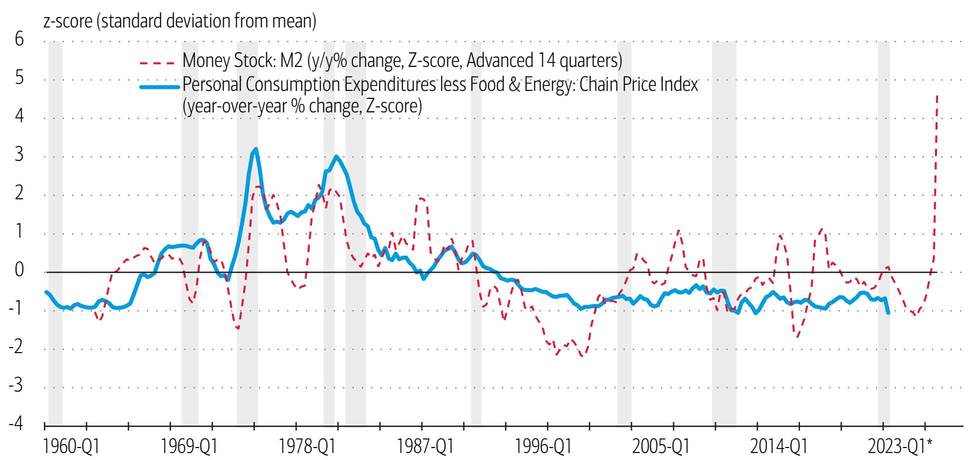
As we discussed in recent Capital Market Outlook (CMO) reports, TIPS breakeven inflation expectations tend to increase along with cyclical increases in PMIs, and so far their gains have tracked the PMI improvements. Even if PMIs settle only slightly above average before they start to revert to mean, inflation expectations still have more room to increase cyclically. Given the massive current and expected stimulus around the world, a stronger manufacturing cycle than we assume is highly possible, however, which would imply an even bigger increase in inflation expectations (TIPS prices thus continuing to outperform nominal Treasurys).

While inflation expectations have increased in a typical fashion, nominal Treasurys have remained extremely depressed, causing real rates to drop precipitously into negative territory. With money unable to find a positive real return, demand and prices for "real" assets, such as Gold, other commodities and real estate, which tend to maintain their real value over time, have increased.

The normalization of financial conditions and commodity-price rallies are early signs that the Fed's reflation efforts are working. However, similar early hopes of reflation success after the 2008/2009 Great Financial Crisis (GFC) fizzled out as central bank and fiscal-policy mistakes caused a long period of strong dollar appreciation, commodity bear markets, subpar economic growth and below-target inflation. For a number of reasons, we believe that the Fed's reflation efforts are more likely to succeed this time around:

- Banking crises are deflationary and take a long time to heal. Also, household balance-sheet strains caused by the bursting of the housing bubble were never addressed, so policy failures prolonged the consumer-spending malaise, causing persistent headwinds to reflation.
- "Pandenomics" (coordination of the massive fiscal-monetary policy response to escape from the pandemic abyss) creates an environment far more favorable to growth and inflation than in the post-GFC expansion. Indeed, misguided attempts at fiscal rectitude during the 2010–2012 period hindered the Fed's reflation efforts. In addition, the European Central Bank (ECB) threw sand in the gears of the Eurozone recovery by tightening prematurely, causing a double-dip recession that undermined reflation long thereafter. China did its part with an aggressive growth-slowing anti-corruption campaign. Later in 2017–2018, it was the Fed itself that caused a major setback to achieving its 2% inflation target by overtightening and offsetting the Trump Administration's fiscal stimulus.
- Fed officials are increasingly expressing support for a significant change in their policy framework from the traditional inflation-forecast targeting to soft-inflation averaging over time (i.e., no more preemptive interest-rate policy hikes to preclude an overshoot of the 2% inflation target following sub-2% inflation).
- The surge in (forced) personal saving during the pandemic, massive expansion of demand for risk-free assets, large quantitative-easing (QE)-related Treasurys purchases, and strong Fed forward guidance suggesting a zero-rate policy through at least 2022 are likely to depress long-term yields for the foreseeable future. This implies a likely prolonged low and negative real interest-rate environment ahead, which is highly reflationary.
- Generally, there is a low correlation between rising U.S. government spending/debt and inflation when the Fed does not accommodate rising inflation. The 2017–2018 tightening episode is a good example. However, there's now an expectation of very low interest rates until the Fed has re-anchored inflation around its target.
- The Fed-engineered money-supply surge suggests a high probability of reflation success (Exhibit 1).

Exhibit 1: Historic Surge In Money Supply Suggests Increased Likelihood Of Reflation Success.



Sources: Bureau of Economic Analysis; Federal Reserve Board/Haver Analytics as of July 2020. *=Estimates

- The strong dollar appreciation of the past decade was highly disinflationary. Now, with the Fed increasingly willing to accommodate higher inflation, the dollar is expected to remain weaker, which would be reflationary.
- In contrast to the decade following the GFC, a softer dollar would be favorable for global growth and inflation.
- The slowing globalization trend is also seen moderating the disinflationary forces of the past three decades.

All in all, in contrast to the disinflationary constellation of the post-GFC decade, the stars are now aligned in a way conducive to successful reflation. This has major implications for investors and helps explain the dollar's trend reversal, strong recent cyclical-stock relative performance and defensive stock underperformance, as well as commodity and other real asset trend strength. Unusually low rates are positive for long-duration assets such as the secular-growth leaders of the past decade. Higher nominal GDP growth due to successful reflation is a better backdrop for cyclical stocks such as industrials, transports, homebuilders and materials companies. Their relative strength suggests they could be better candidates for the other end of barbelled portfolios with the secular growth leaders.

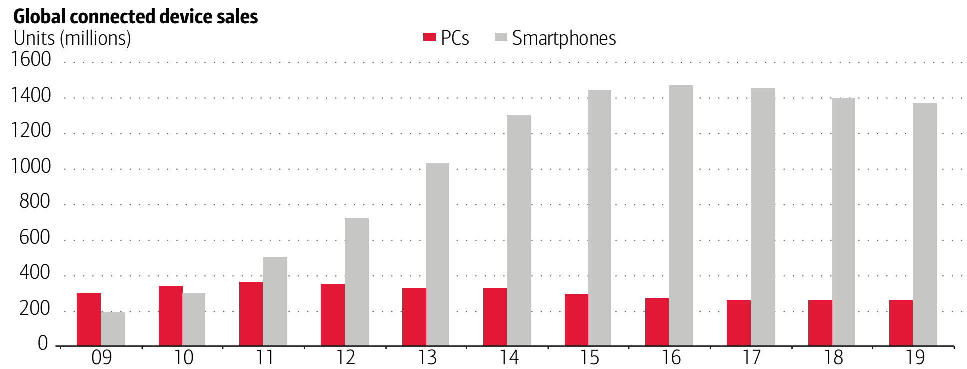
GLOBAL MARKET VIEW

The Growing Market for Virtual and Augmented Reality

Ehiwario Efeyini, Director and Senior Market Strategy Analyst

The coronavirus crisis has accelerated the pace of digital transformation across a range of industries in the global economy. Physical distancing and prohibitions on large public gatherings have reshaped societal behavior, making for a faster shift toward new patterns of economic activity such as remote work, distance learning, internet retail and digital media. The fiscal third-quarter earnings results released by a leading U.S. consumer electronics firm at the end of last month were a clear reflection of this need to replicate real-world interactions online, showing stronger-than-expected growth in demand for personal connected devices used for work, education and entertainment during the early months of the pandemic. Consumers are clearly spending more on information technology (IT) hardware to stay online throughout the crisis. But this nonetheless comes against the broader trend of maturing connected device penetration, particularly in developed economies. Following the rise of the personal computer (PC) in the 1990s and 2000s, global PC sales have seen a trend decline over the past decade. And the growth in global smartphone adoption that began in the late 2000s has also since crested, with annual worldwide unit sales reaching a peak of 1.5 billion in 2016 before slipping to 1.4 billion in 2019 (Exhibit 2).

Exhibit 2: Global Sales Of Smartphones And Personal Computers Peaked During The Last Cycle.



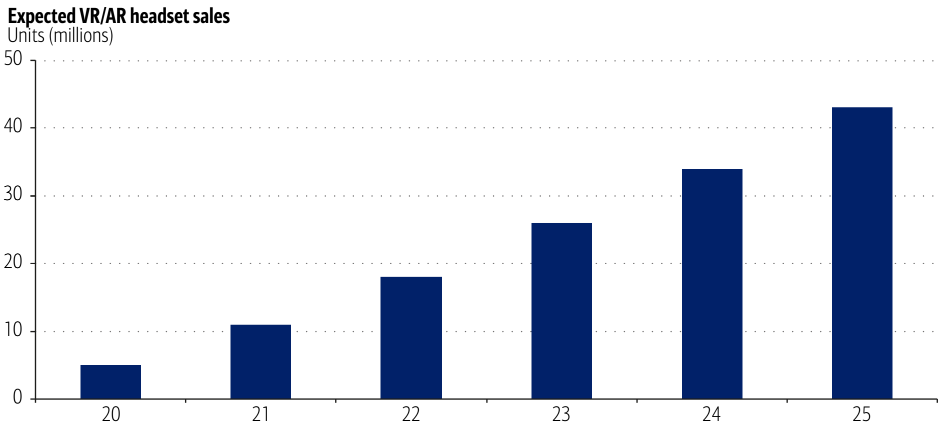
Sources: International Data Corporation; Gartner. Data as of 2019.

Traditional handheld and desktop device markets may therefore have reached a plateau, but innovations in IT hardware alongside the demands of the pandemic could kick-start a trend increase in adoption across new hardware categories. Demand for extended reality (XR) devices, including both virtual reality (VR) and augmented reality (AR), appears particularly well placed to grow in the current environment. Combining motion sensors, graphics processors, head-mounted video displays, and application software for gaming and other uses, VR systems are designed to recreate the physical world through digital 3D environments. And AR systems, by contrast, superimpose graphics onto the real world through either handheld or head-mounted screens. Both are essentially using digital tools to give users a fully or partially computer-generated experience that is distinct from their real-world surroundings.

Many of the leading technology companies in the U.S. and Asia have launched new VR/AR devices over the past five years since global smartphone sales began to peak. And even before the pandemic, these latest Extended Reality (XR) systems had started to gain more consumer traction than in previous industry attempts at mainstream adoption during the 1990s. For one, the products have been made more accessible to more users this time around, with entry-level devices for less. Prices for the most advanced XR systems are far higher at several hundred dollars or more. But these market-leading devices—which can deliver faster video frame rates at higher resolution with minimal time delay—are well suited to a wider range of potential uses than their lower-end counterparts. Gaming has been the dominant application over recent years, but the faster pace of digitization brought about by coronavirus may see XR deployed more quickly across other segments over the years ahead.

In the post-pandemic environment, XR technology will give global enterprises a new medium for communication, instruction and training in their operations, while allowing them to offer virtual services across many domains including healthcare, retail, leisure and hospitality. In the years before the crisis, enterprise spending on XR had risen from $8.4 billion in 2017 to $13.1 billion in 2019 (a 25% annual rate) according to Nielsen. But forecasts from industry research firm Trendforce project a more than 50% annual rate of unit growth for XR headset sales over the next five years, from 5.1 million in 2020 to 43.2 million in 2025 (Exhibit 3).

Exhibit 3: Virtual And Augmented Reality Headset Sales Expected To Grow Rapidly Over The Coming Years.



Source: Trendforce. Data as of 2020.

Several major organizations across a range of industries have recently launched new products and initiatives that use XR systems to improve their internal operations and enhance their services:

- Israel's leading medical center is using U.S. telehealth applications and AR headsets to train its medical staff on how to run ventilators and monitor isolated patients during the coronavirus pandemic. AR and VR headsets are also being used by recovering patients for cognitive exercises, stress management and other steps in the rehabilitation process.
- A large U.S. aerospace company is using AR applications to assist factory floor workers where higher-skilled technicians are working remotely. AR devices are, for example, enabling offsite technicians to help field workers in the installation of electrical wiring for aircraft wings, saving the time that would otherwise be required to follow traditional 2D physical instructions.
- A leading U.S. retailer purchased high-end VR headsets to use in simulation-based training for its employees. Training in new store features has been a major focus, including in-store pickup towers for online purchases.
- Travel boards in Austria and Switzerland are offering VR-based experiences that simulate popular tourist attractions.
- A consortium of U.K.-based industrial, technology and engineering firms is using AR devices in the design and assembly process for rapidly manufactured ventilator systems to support the National Health Service during the pandemic.
- Medical students at a leading Canadian academic institution are using VR-based software in orthopedic surgery training. The program began before the start of the outbreak but could potentially be replicated by other educational institutions as distance learning becomes more widespread.
- An Israel-based startup has developed an AR-based virtual fitting room for a range of clothing brands, while a U.S. jewelry designer has recently introduced an AR-based tool that allows customers to virtually try on merchandise before making online purchases. Restrictions on apparel and other fittings are also likely to boost XR demand among other retailers.

In addition to the pandemic-induced growth in demand, VR- and AR-based services are also likely to be improved by the global buildout of 5G telecommunication networks over the next decade. The most advanced XR systems currently require a wired internet connection through a powerful PC to achieve real-time visual feedback through the head-mounted display. But the fast data speeds and low latency offered by 5G will give untethered XR devices more responsive controls, improving the user experience and reducing the all-in cost of higher-end XR systems without the need for a separate wired device. This should further support VR and AR deployment not only for new enterprise use cases but also for interactive consumer applications such as online gaming, digital media, live sports and concert events.

For investors, the major beneficiaries of the trend toward more widespread adoption of XR are likely to include VR and AR headset and system designers, as well as firms that can differentiate their services through new customer-driven XR tools. Content-driven demand for remote application software and graphics processing infrastructure should come as a further tailwind for cloud service providers. And producers of XR system hardware components such as motion sensors, high-resolution displays, haptic equipment for manual interaction with virtual environments, and advanced graphics chips should also be well positioned.

THOUGHT OF THE WEEK

Not too hot, not too cold—Investor Sentiment Is Close To Neutral

Nick Giorgi, CFA ®, Vice President, Investment Strategist

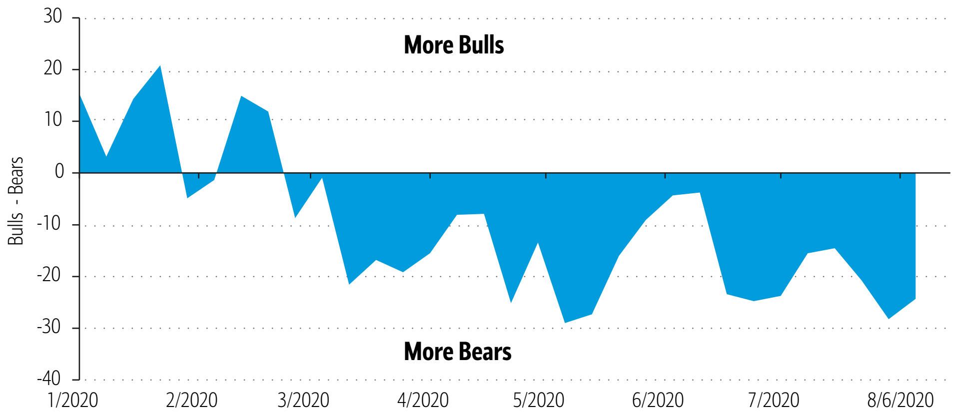
A classic investor adage is to be fearful when others are greedy and greedy when others are fearful. Of course, that advice is easier said than done as behavioral biases make it difficult for humans to set aside emotion and buck the crowd. Investors recently experienced one of the more harshest moves to extreme sentiment levels during the first quarter as the pandemic induced sizeable shifts toward pessimism and conservative positioning. As a global economic recovery now unfolds and many areas of the capital markets have rebounded, sentiment has moved closer to neutral.

The BofA Global Research Bull & Bear Indicator, which is an amalgamation of six sentiment-based inputs, ended January at a neutral level but skewed toward bullishness. By March 17, this indicator shifted toward a contrarian "buy" signal and hit max bearishness (0) within two weeks. Money manager positioning, credit market technicals, equity breadth and flows all reflected fear. It's worth noting that the S&P 500 has advanced by nearly 34% since that "buy" signal was initiated.

Today, sentiment is more neutral with a slight tilt towards bearishness. Positioning amongst investors, in particular, is mixed with hedge fund positioning more aggressive but managers still retaining relatively high cash allocations. Investors also have higher-than-average cash allocations, funded in large part by a reduction in fixed income. According to the American Association of Individual Investors, the sentiment of the retail community has not improved much even through a run-up in equity values with 48% of respondents bearish compared to just 23% bullish.

Typically, extreme levels of sentiment are more useful in foreshadowing near-term market moves, but current levels are not euphoric nor downtrodden and do not suggest a directional bias. However, as sentiment is not overly optimistic while cash remains on the sidelines, there remains plenty of potential support for higher equities over the next 12 to 18 months, in our view.

Exhibit 4: Individual Investors Remain Bearish Even As U.s. Equity Rebound Intensifies.



Sources: Chief Investment Office; American Association of Individual Investors. As of August 6, 2020.

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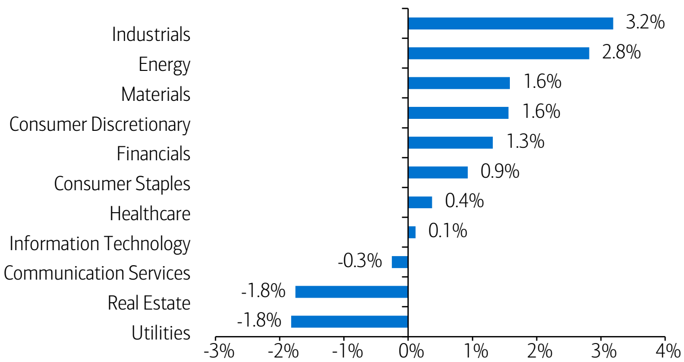
Equities

	Current	WTD	MTD	YTD
		Total Return in USD (%)		
DJIA	27,931.02	1.9	5.8	-0.7
NASDAQ	11,019.30	0.1	2.6	23.5
S&P 500	3,372.85	0.7	3.2	5.7
S&P 400 Mid Cap	1,949.56	0.6	4.7	-4.5
Russell 2000	1,577.88	0.6	6.7	-4.6
MSCI World	2,384.20	1.2	3.5	2.2
MSCI EAFE	1,899.51	2.5	4.5	-5.2
MSCI Emerging Markets	1,093.16	0.4	1.4	-0.4

S&P 500 Sector Returns



Fixed Income[1]

	Current	WTD	MTD	YTD
		Total Return in USD (%)		
Corporate & Government	1.14	-1.2	-1.1	8.1
Agencies	0.57	-0.4	-0.4	5.1
Municipals	1.19	-0.3	0.2	4.0
U.S. Investment Grade Credit	1.16	-0.9	-0.8	6.9
International	1.96	-1.6	-1.2	7.1
High Yield	5.60	-0.5	0.1	0.8

	Current	Prior Week End	Prior Month End	2019 Year End
90 Day Yield	0.09	0.09	0.08	1.54
2 Year Yield	0.15	0.13	0.11	1.57
10 Year Yield	0.71	0.56	0.53	1.92
30 Year Yield	1.45	1.23	1.19	2.39

Commodities & Currencies

Commodities	Current	WTD	MTD	YTD
		Total Return in USD (%)		
Bloomberg Commodity	151.10	0.5	3.1	-12.2
WTI Crude $/Barrel[2]	42.01	1.9	4.3	-31.2
Gold Spot $/Ounce[2]	1,945.12	-4.4	-1.6	28.2

Currencies	Current	Prior Week End	Prior Month End	2019 Year End
EUR/USD	1.18	1.18	1.18	1.12
USD/JPY	106.60	105.92	105.83	108.61
USD/CNH	6.94	6.97	6.99	6.96

Source: Bloomberg, Factset. Total Returns from the period of 08/10/2020 to 08/14/2020. Bloomberg Barclays Indices.[1] Spot price returns.[2] All data as of the 08/14/2020 close.
Past performance is no guarantee of future results.

Asset Class Weightings (as of 8/4/2020)

	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 08/14/2020)

	Q3 2019A	Q4 2019A	2019A	Q1 2020A	Q2 2020A	2020E
Real global GDP (% y/y annualized)	-	-	2.9	-	-	-4.3
Real U.S. GDP (% q/q annualized)	2.1	2.1	2.3	-5.0	-32.9	-5.6
CPI inflation (% y/y)	1.8	2.0	1.8	2.1	0.4	1.2
Core CPI inflation (% y/y)	2.3	2.3	2.2	2.2	1.3	1.6
Unemployment rate (%)	3.6	3.5	3.7	3.8	13.0	9.0
Fed funds rate, end period (%)	1.90	1.55	1.55	0.08	0.08	0.13
10-year Treasury, end period (%)	1.66	1.92	1.92	0.67	0.66	1.00
S&P 500 end period	2977	3231	3231	2585	3100	2900
S&P earnings ($/share)	42	42	163	33	25*	115
Euro/U.S. dollar, end period	1.09	1.12	1.12	1.10	1.12	1.08
U.S. dollar/Japanese yen, end period	108	109	109	108	108	103
Oil ($/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 Merrill Lynch Global Research; GWIM ISC as of August 14, 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.

Purchasing Managers' Index (PMI) is an index of the prevailing direction of economic trends in the manufacturing and service sectors.

Organisation for Economic Co-operation and Development (OECD) system of Composite Leading Indicators (CLIs) is designed to provide early signals of turning points in business cycles - fluctuation in the output gap.

St. Louis Fed Financial Stress Index is an index measuring the degree of financial stress in markets published by the Federal Reserve Bank of St. Louis.

Bloomberg Commodity Index is a broadly diversified commodity price index distributed by Bloomberg Indexes.

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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. 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. The risk that exchange rate fluctuations will reduce the value of returns. This arises when investments denominated in foreign currencies are purchased.