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CHIEF INVESTMENT OFFICE

Capital Market Outlook

September 20, 2021

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

IN THIS ISSUE

Macro Strategy—Incoming data continue to indicate excess demand, and negative effects on growth from supply constraints, as well as solid leading indicators for production, employment and capital expenditures (CapEx), suggesting that the U.S. economy remains overheated, with strong inflation pressures, monthly noise and volatility notwithstanding. Investment growth is likely to remain strong to expand supply capacity and ease shortages.

Global Market View—In a year-to-date of double-digit returns for global equities, emerging markets (EM) have been significant underperformers. Selected areas of the market may present investor opportunities, but nearer-term challenges for the group keep us tactically neutral at the index level, and we continue to favor an active[1] approach to the asset class.

Thought of the Week—With all the debate about short versus longer-term views for the Equity market following the 100% price return for the S&P 500 from the March 2020 lows, it's a good time for a reminder about the perils of market timing. Because of the substantial opportunity cost of timing the market, we prefer to rely on a disciplined approach to asset allocation, based on each individual's financial goals and time horizon, and diversification to help weather periods of uncertainty.

Portfolio Considerations—Given the impressive outperformance of Equities over bonds throughout the better part of 2020 and so far this year, Equity weights have drifted higher than our recommended tactical tilts, and Fixed Income weights have drifted lower. As such, the strategy to rebalance from Equities into bonds would bring them in line with our tactical weights, and we look to implement the same in our CIO Portfolios. Our tactical views are not changing as a result of this rebalance, and we still remain overweight Equities and underweight bonds as per our earlier recommended tactical asset allocation weights.

MACRO STRATEGY

Chief Investment Office
Macro Strategy Team

GLOBAL MARKET VIEW

Ehiwario Efeyini
Director and Senior Market Strategy Analyst

THOUGHT OF THE WEEK

Marci A. McGregor
Managing Director and Senior Investment Strategist

Data as of 9/20/2021, and subject to change

MACRO STRATEGY

Strong U.S. Capex Outlook

Chief Investment Office, Macro Strategy Team

The economic recovery out of the pandemic shutdown was not expected to be V-shaped, fiscal transfers were not expected to create labor shortages, and inflation was not

[1] Active management seeks to outperform benchmarks through active investment decisions such as asset allocation and investment selection.

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expected to be high and sustained. Instead, U.S. real gross domestic product (GDP) got back on its 1995-to-2019 trend by early 2021, businesses have never reported bigger difficulty finding labor, and annualized consumer durable-goods inflation averaged 17% between January and August, its highest reading since this Bureau of Labor Statistics inflation series began in 1956.

This shouldn't be surprising, since, as discussed in past reports, the nature of the shock and unparalleled government response to the pandemic have boosted inflation-adjusted demand for consumer durable goods this year 35% above its 1995-to-2019 trend, according to data from the Bureau of Economic Analysis, much in excess of domestic supply, even though manufacturing output also rebounded quickly. Indeed, despite supply-chain disruptions and headwinds from Hurricane Ida, Federal Reserve Board data show August manufacturing output at its highest level since early 2019 and capacity utilization at 76.7%, a rate exceeded only between October 2017 and January 2019 out of the entire period since the 2008-2009 recession.

Still, with domestic industrial equipment spending lagging since 2001, when China entered the World Trade Organization (WTO), manufacturing output flatlining, and reliance on imports increasing, it's not surprising to see the past year's surge in demand result in major logistical bottlenecks and shortages. Widespread shortages and surging inflation have started to affect consumer sentiment, with both the University of Michigan and Conference Board measures showing big deterioration in August, led by particularly large declines in sentiment about buying conditions for homes and durable goods. A 30-year low in the housing vacancy rate and unprecedented motor vehicle inventory declines—which limited August auto sales to about 75% of their normal rate, impeding necessary car replacements and thwarting new demand for cars—no doubt contributed to souring consumer confidence.

What's more, as ongoing semiconductor chip shortages caused by coronavirus-related Asian production disruptions and the government-stimulus-fueled surge in demand for consumer electronics and other "smart" goods starved carmakers of necessary components, motor-vehicle inventories are expected to remain depressed relative to demand. Indeed, according to a BofA Global Research September 10 report, the global auto industry is a low-priority market for chipmakers, as it accounts for just 8% of their revenues. Also, chips used in motor-vehicle are comparatively lower-margin products, causing the motor-vehicle industry to bear the brunt of the chips shortages.

The sudden global swing in favor of vastly boosting production of electric vehicles (EV), which reportedly use 10 times more chips than current internal-combustion car models, is likely exacerbating the shortage of chips. In its *Net Zero by 2050: A Roadmap for the Global Energy Sector* published earlier this year, the International Energy Agency (IEA) outlined the actions required for the world to achieve net-zero greenhouse emissions within three decades, with the elimination of new internal-combustion engine car sales within 14 years ranking supreme and suggesting that the current supply-chain shock will likely take longer to resolve. Shortages, combined with very elevated excess personal savings and labor-income growth running at an almost 10% pace through August and likely to remain robust because of exceptionally strong labor demand and accelerating wages, suggest that consumer demand should remain elevated, keeping economic growth and inflation high by the standards of the past two decades.

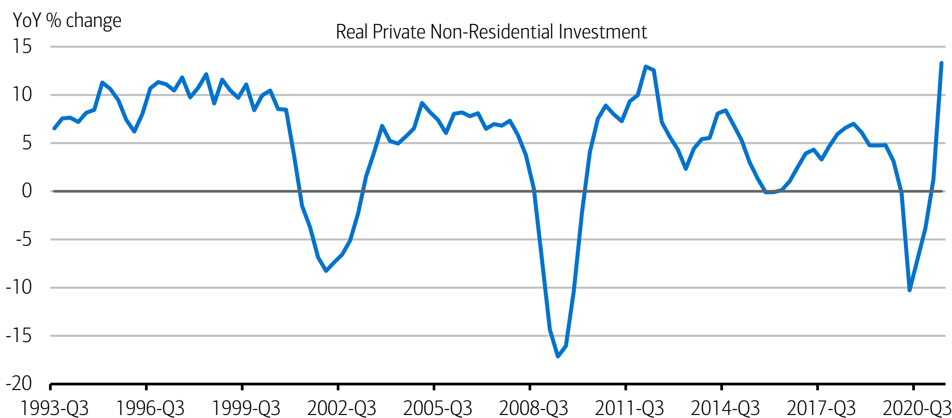
The aging of the population, work disincentives, pandemic-related retirements and other disruptions have kept employment growth in line with our expectations, with an average monthly payroll growth of 586,000 from January to August. Leading indicators of employment suggest hiring should increase at about a 3%-to-4% pace over the next year (twice, or more, as fast as between 2013 and 2019), resulting in millions more paychecks and a further decline in the unemployment rate to about 4% in 2022. With wages also rising the most in two or three decades, this implies strong income gains and firm support for economic activity. Thus, in our view, there's much fuel for consumer spending growth ahead even absent enhanced unemployment benefits. This means corporate revenue growth is likely to remain strong. Given our domestic income and spending outlook, as well

as improving pandemic-related conditions overseas and massive backlogs of unfilled manufacturing orders, we expect corporate revenue growth of about 10% to 14% in 2021 and 2022. This would be at the top of the range that prevailed in the past 30 years, and combined with low interest costs should help keep profit margins high, in our view, despite rising input costs.

So far, our expectations for upside margin surprises as a result of unprecedented fiscal stimulus, huge operating leverage as the economy reopened, low interest expense, and margin support from the former administration tax cuts, have been validated. Q2 GDP-based data show pre-tax domestic profit margins expanding to a 7-year high. What's more, company earnings reports have generally indicated management confidence in the ability to keep margins high, or rising, as a result of unprecedented pricing power. Supporting this view, the Evercore ISI Research proprietary survey of company pricing power has increased to a fresh record, while the National Federation of Independent Business (NFIB) survey for August showed the highest percentage of small businesses raising or planning to raise prices since 1979-1981.

In light of S&P 500 revenue surging 15% in the first half and margins expanding, analysts have revised their 2021 profits estimates by the most in 45 years (about 25% from their January forecast), boosting equity prices and helping keep credit spreads much narrower than expected. With strong revenue growth, elevated margins, and record easing of bank lending terms for commercial and industrial (C&I) loans to firms large and small in Q3, we expect more upside for profits as well as real nonresidential CapEx, after its 13% year-over-year (YoY) surge in Q2 to a new record (Exhibit 1). Unprecedented labor constraints spurring automation and productivity enhancements alongside concerns about supply-chain resilience also suggest sustained robust domestic investment.

Exhibit 1: Continued Strong Investment Expansion Necessary To Ease Shortages.



Source: Bureau of Economic Analysis/Haver Analytics. Data as of September 14, 2021.

The rebound in capex has been led by real industrial equipment spending, which reached a fresh record 7% above the pre-pandemic peak in Q2, and by information processing equipment, which was 20% above its pre-pandemic peak. At the same time, inflation-adjusted business spending on structures remains 20% below its pre-pandemic level, according to the Bureau of Economic Analysis—not least restrained by unclear demand for office space, surging materials and labor costs, and a weak Energy sector recovery (as oil producers, for example, chose to enhance their returns by completing already-drilled wells rather than invest in new drilling structures to boost output). Encouragingly, new orders for nondefense capital goods ex transportation stood 16% above their pre-pandemic level in July, suggesting strong industrial production growth underpinnings, with the surge in oil prices also pointing to accelerating energy-space capex ahead. All in all, we expect real business investment to increase around 6% to 7% in 2021 and 2022, which would be on the strong side by the standards of the past 20 years.

GLOBAL MARKET VIEW

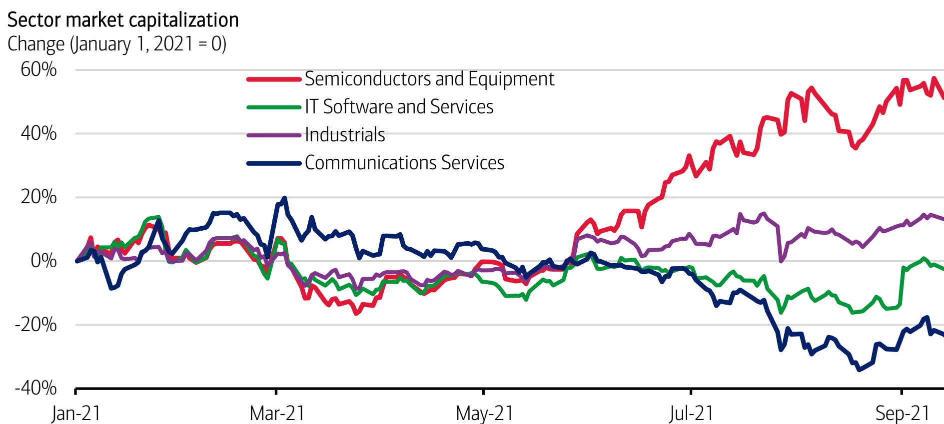
Surveying the Emerging Market Landscape: Opportunities and Challenges

Ehiwario Efeyini, Director and Senior Market Strategy Analyst

In a year-to-date of double-digit returns for global equities, emerging markets have been significant underperformers and remain essentially flat as we approach the final quarter of 2021. A large portion of the relative return weakness has been concentrated in China, which registered a peak-to-trough decline of over 30% between February and August after peaking at more than 40% of total EM market capitalization in the early months of the year. The regulatory policy overhang that precipitated the China selloff has not gone away. And though investors have seen some stabilization in Chinese equities over recent weeks, the roughly two-fifths of the MSCI China index that was hardest hit by the crackdown—digital media, internet software and services—remains stuck near its lows for the year.

But beyond the headlines, other segments of the Chinese market have performed relatively well in 2021, particularly those areas that are most aligned with the longer-term strategic goals of the Chinese leadership. The 14th Five-Year Plan initially drafted last October and formally adopted in March outlines key industries such as semiconductors, robotics and advanced manufacturing that are viewed as critical to the government's aim of becoming a high-income, self-sufficient, innovation-driven economy. And though recent regulatory pressures have weighed on areas of the market related to the consumer internet, the implication is that these strategic industries are less likely to be subject to such restrictions and should receive more official support as target areas for future growth. We would therefore expect them to continue leading investment returns in China as they have so far this year (Exhibit 2).

Exhibit 2: China's Strategic Sectors Outperform As Consumer Internet Remains Under Regulatory Pressure.

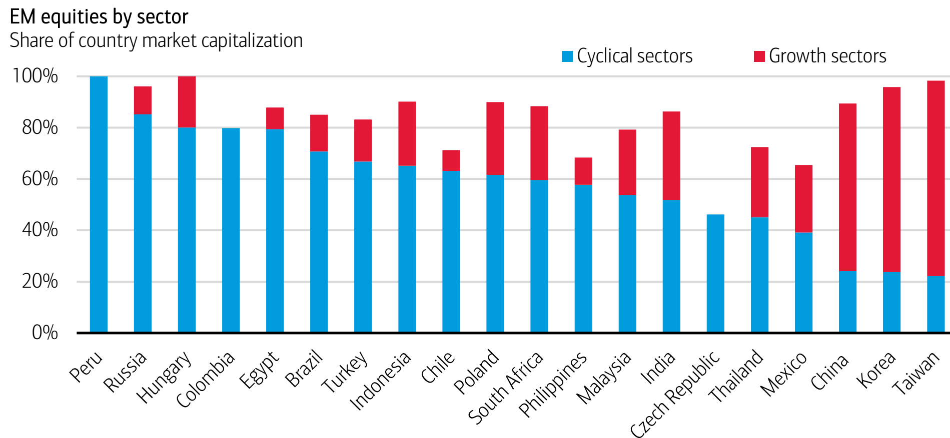


Source: Bloomberg. Data as of September 15, 2021.

Outside China, the strongest EM returns have been delivered in Europe, the Middle East and Africa (EMEA). Equity markets across this region have the highest concentration in the cyclical sectors of Materials, Energy, Industrials and Financials (Exhibit 3) and have therefore benefited most within the emerging world from the recovery in economic activity that began last year and remains in progress. On a global basis, the U.S. and other developed economies have led the economic recovery so far, driven by their large fiscal responses and rapid vaccine rollouts. And correspondingly, the relative return advance of cyclicals within the S&P 500 has outpaced that of EMs. The relative level of price-to-earnings multiples for cyclical sectors versus Growth sectors (Technology, Consumer Discretionary, Healthcare, Communication Services) within the S&P 500 currently stands at 0.85 times its 10-year average, well ahead of the EM level of 0.73 times. But as the

economic expansion continues, we would expect the EM valuation gap to close further, which should make for further gains in EM cyclicals.

Exhibit 3: Emerging Markets By Sector: Cyclical Vs. Growth.



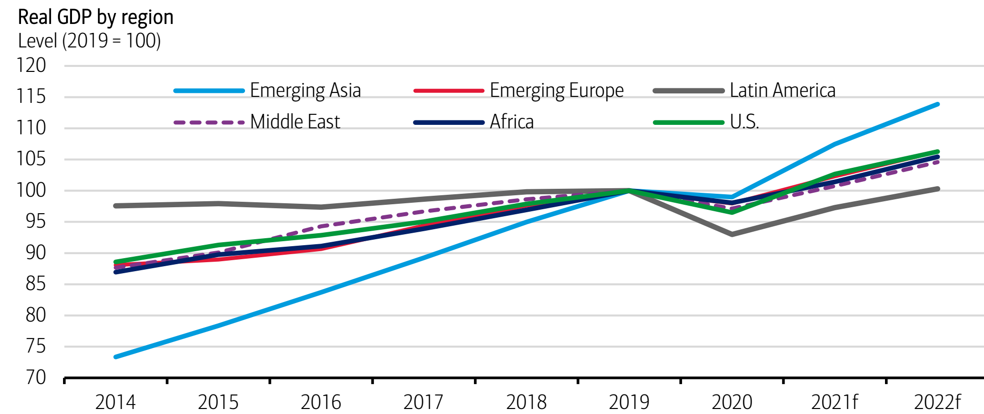
Source: MSCI. Data as of August 2021. Cyclical sectors are Materials, Energy, Industrials, and Financials. Growth sectors are Information Technology, Consumer Discretionary, Healthcare, Communication services.

Over the longer-term however, income convergence with the developed world and an expanding digital economy in vehicle and industrial automation, cloud services and other markets should provide tailwinds for Growth sectors and the Asia region, particularly as more countries look to increase their post-pandemic capacity for virtual activity. More than 50% of individuals in the emerging world still lack the internet access that has enabled the substitution of in-person for remotely delivered services across higher-income economies over the past 18 months. And the wide disparity with the developed world is only likely to narrow over the coming years.

Two key markets to watch in Asia should be Taiwan and India, each of which have outpaced both the rest of the region and the U.S. market this year. Semiconductors have been among the top-performing industries in 2021 and account for close to 60% of the Taiwanese market. And as the global leader in semiconductor manufacturing and a critical supplier on both sides of the U.S.-China technology rivalry, we would expect Taiwan to further outperform alongside the current output shortages in the sector. In India, the heavyweight IT services industry should remain a key beneficiary of the rapid adoption of digital finance. Kick-started by Prime Minister Modi's financial inclusion program in 2014, and accelerated by the demonetization program of 2016 and the acute phase of the coronavirus pandemic in 2020, growth in India's digital payments volume has ballooned over recent years. According to industry leader ACI Worldwide, India's 25.5 billion real-time online transactions last year surpassed China's 15.7 billion, and rapid declines in data rates and device costs from local providers are expected to fuel further growth within this segment. Additional funding tailwinds for local fintech services in India could also result from the current regulatory risks in China, as well as the 2021-2022 government budget, which estimates a sizeable expenditure increase of 65% in Information Technology and telecommunications.

The broader prognosis for EMs is nonetheless more uncertain, and we remain cautious on the group as a whole. Growth projections from the International Monetary Fund indicate that all EM regions except Latin America should see real activity return to pre-pandemic levels this year. But by the end of 2022, only emerging Asia will have added more to its level of real output than the U.S. (even though lower per capita incomes mean that emerging economies should grow more quickly than developed economies) since the start of the crisis (Exhibit 4).

Exhibit 4: Economic Output Relative To Pre-Pandemic Peak.



f=forecast. Source: International Monetary Fund. Data as of 2020.

Unlike in the majority of the developed world, activity in most emerging economies is yet to normalize, meaning that the economic effects of the coronavirus are likely to be more important for the speed of local recoveries in the near term. The structural and policy drivers that have helped developed economies to recover—fiscal support, domestic demand dependence, internet penetration and vaccine distribution—are still much weaker in the emerging world, which should make for a bumpier path to normalization over the coming quarters. As a share of GDP, fiscal outlays in the developed world (16.4%) have been roughly four times those in emerging economies (4.2%). This not only represents a near-term headwind for EM growth, but also a potential longer-term challenge in the form of premature capital scrapping for otherwise profitable firms that are not able to remain afloat on their own. Emerging countries such as Thailand and the Philippines also remain highly dependent on tourism and remittances and should therefore remain under pressure as the movement of people across borders lags behind the reopening of activity within borders. Internet penetration in EMs (44.4%) stands at close to half the rate in developed markets (86.7%). And current vaccination rates of 120 to 150 doses per 100 people across much of the developed world have only been matched by a handful of countries within the emerging world—China, Chile, Turkey, Malaysia and the United Arab Emirates—leaving most EM activity more vulnerable to new coronavirus outbreaks.

On the valuation front, price-to-earnings multiples in EM Equities remain below their long-term averages relative to developed markets. And this should help to enhance relative EM returns over time. But the nearer-term challenges for the group keep us tactically neutral at the index level, and we continue to favor an active approach to the asset class.

THOUGHT OF THE WEEK

Time In The Market Is Still Much More Important Than Timing The Market

Marci A. McGregor, Managing Director and Senior Investment Strategist

With all the debate about short versus longer-term views for the Equity market following the 100% price return for the S&P 500 from the March 2020 lows, we think it's a good time for a reminder about the perils of market timing. We have long said that it was discipline in portfolio construction that helped us through the pandemic-led crisis of 2020—not market timing. The latter is a fool's errand and can be costly. Indeed missing the 10 best days in the market each decade can be painful. In Exhibit 5, we look at the S&P 500 back to 1930 and find that missing the 10 best days of each decade would have meant a return of just 52%, instead of >20,000% if you had stayed invested through all the ups and downs of the market, according to BofA Global Research. Also, the probability of loss over a full decade of investing is just 6%. If we zoom in and look at market returns since January 1, 2020, missing the 10 best days would result in a negative return of –21%,

compared to a price return of 40% by simply remaining invested—despite the sharp bear market decline of February/March 2020. Investors who lengthen their time horizons also have historically experienced lower average equity return volatility.

Exhibit 5: S&P 500 Returns Over The Decades.

Decade	Price return	Excluding Best 10 Days per Decade
1930	-42%	-79%
1940	35%	-14%
1950	257%	167%
1960	54%	14%
1970	17%	-20%
1980	227%	108%
1990	316%	186%
2000	-24%	-62%
2010	190%	95%
2020	40%	-21%
Since 1930	20,985%	52%

Source: BofA Global Research. Data as of August 31, 2021. **Past performance is no guarantee of future results.**

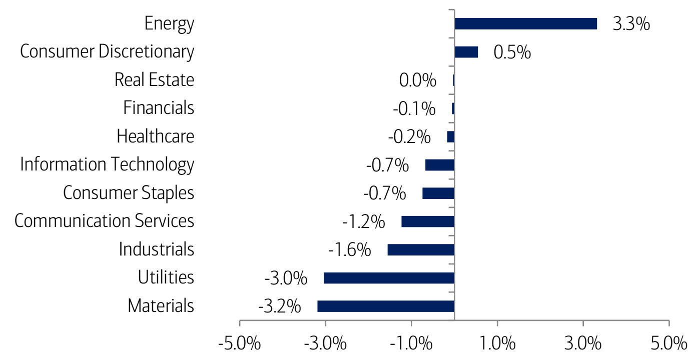
One reason for the dramatically different investment outcomes is that, generally, the best days in the market often follow the worst, and last year was no exception. The S&P 500 fell 9.5% on March 12, 2020, but quickly rebounded the next day, gaining 9.3%. Hence, the difficulty in engaging in market timing.

Instead of considering market timing-based investment decisions, we prefer to rely on a disciplined approach to asset allocation, based on each individual's financial goals and time horizon, and diversification to help weather periods of uncertainty. Ultimately it's our view that fundamentals like profits, policy (monetary and fiscal), and identifying where we are in the business cycle that will determine the direction of asset prices, and short-term periods of volatility or market pullbacks are a part of investing. At the end of the day, it's time spent in the market that is rewarded, not timing the market.

Equities

	Total Return in USD (%)			
	Current	WTD	MTD	YTD
DJIA	34,584.88	0.0	-2.1	14.6
NASDAQ	15,043.97	-0.5	-1.4	17.3
S&P 500	4,432.99	-0.5	-1.9	19.3
S&P 400 Mid Cap	2,678.06	-0.3	-2.6	17.1
Russell 2000	2,236.87	0.5	-1.6	14.0
MSCI World	3,096.62	-0.8	-1.4	16.3
MSCI EAFE	2,348.46	-1.4	-0.2	11.3
MSCI Emerging Markets	1,279.35	-2.2	-2.1	0.7

S&P 500 Sector Returns



Fixed Income†

	Total Return in USD (%)			
	Current	WTD	MTD	YTD
Corporate & Government	1.36	0.00	-0.07	-0.94
Agencies	0.75	-0.08	-0.15	-0.35
Municipals	0.98	0.01	-0.02	1.50
U.S. Investment Grade Credit	1.47	-0.03	-0.07	-0.77
International	2.02	0.08	0.10	-0.12
High Yield	3.76	0.14	0.44	5.01
90 Day Yield	0.03	0.04	0.04	0.06
2 Year Yield	0.22	0.21	0.21	0.12
10 Year Yield	1.36	1.34	1.31	0.91
30 Year Yield	1.90	1.93	1.93	1.64

Commodities & Currencies

	Total Return in USD (%)			
Commodities	Current	WTD	MTD	YTD
Bloomberg Commodity	208.31	0.5	1.6	25.0
WTI Crude $/Barrel††	71.97	3.2	5.1	48.3
Gold Spot $/Ounce††	1754.34	-1.9	-3.3	-7.6

	Total Return in USD (%)			
Currencies	Current	Prior Week End	Prior Month End	2020 Year End
EUR/USD	1.17	1.18	1.18	1.22
USD/JPY	109.93	109.94	110.02	103.25
USD/CNH	6.47	6.44	6.45	6.50

Sources: Bloomberg, Factset. Total Returns from the period of 9/13/2021 to 9/17/2021. †Bloomberg Barclays Indices. ††Spot price returns. All data as of the 9/17/2021 close. Data would differ if a different time period was displayed. Short term performance shown to illustrate more recent trend. **Past performance is no guarantee of future results.**

Asset Class Weightings (as of 9/7/2021)

Asset Class	CIO View				
	Underweight		Neutral	Overweight	
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*					
Hedge Funds			●		
Private Equity			●		
Real Assets			●		
Cash					

*Many products that pursue Alternative Investment strategies, specifically Private Equity and Hedge Funds, are available only to qualified investors.
CIO asset class views are relative to the CIO Strategic Asset Allocation (SAA) of a multi-asset portfolio.

Economic Forecasts (as of 9/17/2021)

	2020A	Q1 2021A	Q2 2021A	Q3 2021E	Q4 2021E	2021E
Real global GDP (% y/y annualized)	-3.2	-	-	-	-	5.9
Real U.S. GDP (% q/q annualized)	-3.4	6.3	6.5	4.5	6.0	5.9
CPI inflation (% y/y)	1.2	1.9	4.8	5.2	5.2	4.3
Core CPI inflation (% y/y)	1.7	1.4	3.7	4.1	4.1	3.4
Unemployment rate (%)	8.1	6.2	5.9	5.3	4.5	5.5
Fed funds rate, end period (%)	0.09	0.06	0.08	0.13	0.13	0.13

The forecasts in the table above are the base line view from BofA Global Research. 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. Historical data is sourced from Bloomberg, FactSet, and Haver Analytics.
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.
Sources: BofA Global Research; GWIM ISC as of September 17, 2021.
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S&P 500 Index is a stock market index that measures the stock performance of 500 large companies listed on stock exchanges in the United States. It is one of the most commonly followed equity indices.

Information Technology Sector Index provides investors with a benchmark that represents U.S. securities classified under the GICS® information technology sector as well as the internet & direct marketing retail, interactive home entertainment, and interactive media & services sub-industries.

Healthcare Sector Index designed to measure the performance of narrow GICS® sub-industries. The Index comprises stocks in the S&P Total Market Index that are classified in the GICS health care services sub-industry.

Consumer Discretionary Sector Index comprises those companies included in the S&P 500 that are classified as members of the GICS® consumer discretionary sector.

Financials Sector Index comprises those companies included in the S&P 500 that are classified as members of the GICS® financials sector.

Industrials Sector Index comprises those companies included in the S&P 500 that are classified as members of the GICS® industrials sector.

Consumer Staples Sector Index comprises those companies included in the S&P 500 that are classified as members of the GICS® consumer staples sector.

Communication Services Sector Index comprises those companies included in the S&P 500 that are classified as members of the GICS® communication services sector.

Materials Sector Index comprises those companies included in the S&P 500 that are classified as members of the GICS® materials sector.

Energy Sector Index comprises those companies included in the S&P 500 that are classified as members of the GICS® energy sector.

Semiconductor and Equipment Industry Index comprises those companies in the S&P 500 that are classified as members in the design and fabrication of semiconductors and semiconductor devices, such as integrated circuits; and, that produces and maintains machines for consumers, the industry, and most other companies in the economy.

MSCI China Index measures large and mid-cap representation across China securities listed on the Shanghai and Shenzhen exchanges.

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