CHIEF INVESTMENT OFFICE

Capital Market Outlook

September 7, 2021

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

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Macro Strategy—U.S. corporate earnings are expected to continue to grow at a fast pace this year and next, but historically high profit margins are under attack from an increasingly tight labor market and fading fiscal stimulus. Higher corporate taxes and rising interest costs are also a risk. While booming top-line growth is swamping these pressures for now, investors should watch closely for signs of a budding peak in corporate profit margins.

Global Market View—We see signs of improvement/rays of hope related to U.S.-China tensions. Notwithstanding all the chatter about decoupling and separating, key metrics suggest more integration, not less—a bullish prospect for U.S. investors.

Thought of the Week—The volume of chatter about the Federal Reserve's (Fed) next move will no doubt grow louder as we move into the final third of the year, but it will nonetheless be critical to keep in mind the broader macro environment, which is likely to remain favorable for prospective returns.

Portfolio Considerations—We believe the ultimate trend for Equities is still positive but with occasional bouts of weakness, which should provide investors with potential opportunities to rebalance portfolios; look to add to underweight positions in Equities or increase exposure as cash builds.

MACRO STRATEGY
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Data as of 9/7/2021, and subject to change

MACRO STRATEGY

How Durable Are Record-High Margins?

Jonathan W. Kozy, Managing Director and Senior Macro Strategy Analyst

The nonfinancial corporate (NFC) profit cycle features prominently in macroeconomic frameworks tailored for tactical investment strategy decisions. Given its clean tie to the economy, the broad profit cycle provides significant clues related to business cycle timing. Peak profit margins often signal an economic downturn well in advance of other leading indicators, an important factor for equity investors. And higher profits allow for productivity-enhancing investments that can lengthen the cycle. The profit cycle can also provide valuable information about corporate credit risk and spreads. Broadly speaking, staying tuned into the profit cycle helps give investors a better chance to navigate tactical over- or underweights to risk assets. Below we lay out some of the key features of this profits cycle with a focus on margins.

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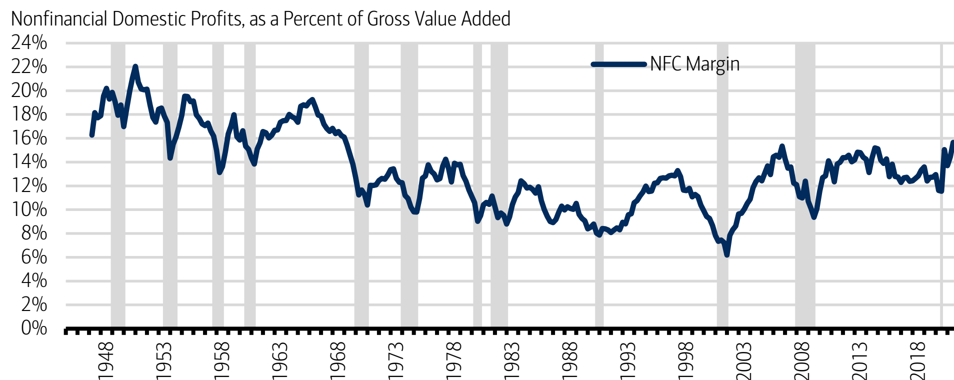
Recently released data for Q2 reflect a typical early-cycle profits boom when top-line growth picks up at the same time companies are lean. Domestic nonfinancial corporate profits ran at a 50% annual rate for the quarter and are currently 27% above pre-pandemic levels, a 17.3% annual rate, according to Bureau of Economic Analysis. The level of profits far exceeds even pre-pandemic estimates of earnings for this year and next, an important reason why equity performance has been so strong. Corporate profit margins are the highest in decades by several metrics. But a number of factors including rising labor costs, fading fiscal and monetary stimulus, and higher corporate taxes is a risk and an eventual peak in margins has important implications for investors.

For one, the peak in profit margins (to the extent it can be identified in real time) tends to give an advanced warning of a recession and therefore can provide a multiyear runway to begin paring back risk-assets. This pattern features prominently in Exhibit 1, where the blue line (profit margins) often peaks in advance of the gray bars (recessions). In the post-war period, on average, margins peak about two-and-a-half years before a recession starts. Since Paul Volker, former Fed Chair, broke the back of inflation in the early 1980s that lead time has extended to over four years, on average.

Exhibit 1: Highest Nonfinancial Corporate Profit Margins Since 1968.



Nonfinancial corporations (NFC) are incorporated legal entities that largely produce goods and services for the market. Profits data represent domestic NFC profits with adjustments for inventory valuation and capital consumption. Gray bars represent recession periods. Sources: Bureau of Economic Analysis/Haver Analytics. Data as of June 30, 2021.

In the current environment, investors should also consider the fact that margins are historically very high and expected to trend even higher. The multidecade trend shown in Exhibit 1 is for higher highs in profit margins and higher lows, perhaps as a result of technology implementation and productivity. The combination of internet penetration starting in the early 2000s and the increased use of automation and robotics likely has benefited operating leverage. Lower interest rates have also played a role, as net interest costs as a percentage of gross value added for nonfinancial corporates are well below the long-term average. Overall this gives pause to investors who think a record high means mean reversion is inevitable. To be brief, companies have a cushion to deal with either a collapse in demand or rising costs, and, if margins peak, the relative level should also be considered.

In many economic cycles, the peak in overall profits coincides with the peak in margins. This occurred in both the 1990s expansion leading into the tech bubble burst and the 2000s expansion that ended in the Great Financial Crisis. Without earnings growth, equity markets are left with multiple expansion, and valuations are already not cheap. The fact that nonfinancial margins are reaching a multidecade high, while labor costs pressures are building, and top-line growth set to slow is consistent with the idea that overall profits growth is to slow as well, in our opinion. If an identifiable peak in margins emerges, investors should consider the chance that peak earnings are not far away.

The profit cycle also provides valuable information about corporate credit risk. The change in nonfinancial corporate profit margins has a strong relationship with the

change in corporate credit spreads. Rising margins signal tighter spreads, and vice versa. At a high level this makes sense because eroding profit margins removes a cushion for companies in the event there is a collapse in aggregate demand and top-line growth. If and when margins peak, investors should take a closer look at corporate balance sheets at both the macro level and individual company level. Contracting margins are a bigger issue for companies with weak balance sheets.

While margins typically expand for a number of years following the start of an expansion, this time may be different. Investors should be on the lookout for margins peaking sooner rather than later but remaining relatively high. The nonfinancial corporate sector's profit margin cycle is shaped predominantly by top-line growth and labor costs, with labor market compensation currently accounting for about 60% of gross value added. Nominal gross domestic product (GDP) is a good proxy for top-line growth and is set for a strong growth the next few quarters. Both inflation and real growth are well anchored, and leading indicators for both suggest they remain strong.

But labor costs are also rising fast as the labor market tightens. This was most evident in last month's jobs report. At some point in the cycle, as the labor market gets tight, labor costs start growing faster than output or output growth slows at a faster rate. We could be quickly moving toward that point even though the unemployment rate is not near what many would consider full employment. In past cycles, the unemployment rate continued to fall well after the peak in margins.

Another argument for margins peaking sooner-rather-than later is the fading of fiscal stimulus. In the recent GDP and profits data release, the Bureau of Economic Analysis (BEA) noted the effect of fiscal transfers on corporate profits, including the Payroll Protection Plan (PPP). This boost is likely to fade, and there is also growing risk that after-tax margins take a hit from potentially higher corporate taxes.

On the other hand, relative pricing power matters and will play an important role in this cycle because customers (both consumers and businesses) are flush with cash, giving companies ample pricing power even as input costs and labor costs go up. Consumers have the ability to pay higher prices, so companies can pass along higher costs.

An important takeaway for long-term investors that avoids trying to top-pick margins, a difficult task in real time, is to recognize that it appears as though business cycle risk could go up significantly in 2023–2024, in our opinion, as margins will likely have peaked and the Fed will likely be raising rates. A faster labor market recovery could pull that risk forward.

GLOBAL MARKET VIEW

U.S.-China Relations: Breaking Up is Hard to Do

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

If the U.S. and China are destined for an economic divorce—the prevailing consensus on Wall Street—then someone forgot to tell the twosome that the love affair is over.

Yes, U.S.-Sino relations are hardly sweet at the moment, and more sour with the Biden administration maintaining former President Trump's tough anti-China trade policies to the annoyance of Beijing. Yes, a great power rivalry is underway between the world's two largest economies, notably in tech, creating tail risks for U.S. investors. And yes, China's recent regulatory crackdown has spawned near-term commercial uncertainties that could impinge and inhibit bilateral flows of capital, trade and investment. Add in recriminations over the origins of coronavirus, tensions over the treatment of Hong Kong, and human rights violations in Xinjing, and there's plenty of fodder for the divorce lawyers.

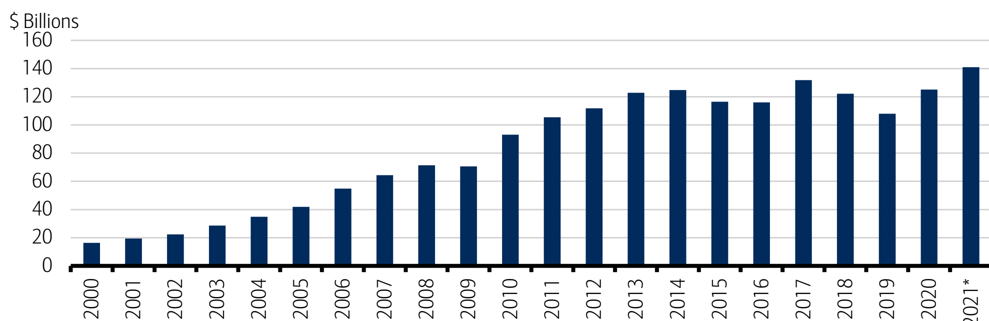
But that said, various data points speak to a bilateral relationship that is far from being a lost cause and of economic bonds that are mutually beneficial to both parties. Sure, risks

of a U.S.-China separation (aka, decoupling) are real, but a split isn't inevitable—which may be a bullish prospect for many U.S. and Chinese firms.

That breaking up is hard to do is evident by the following:

Trade in goods: After rising nearly 16% last year, U.S. goods exports to China soared 41.5% in the first seven months of this year ($82.8 billion) from the period a year ago and are expected to hit a record high of $141 billion in 2021 (Exhibit 2). Outside of America's North American Free Trade Agreement (NAFTA) partners, Mexico and Canada, China is the largest market in the world for U.S. exports. Top exports to China: think agricultural goods to advanced technology products and everything in between.

Exhibit 2: U.S. Exports of Goods to China.

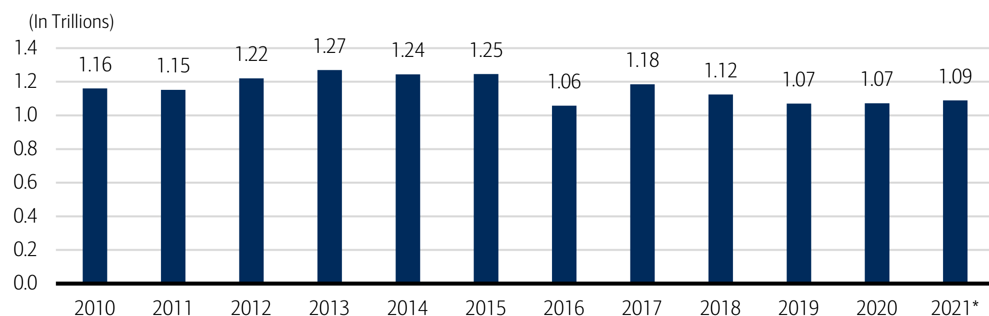


* Estimate. Source: BEA. Data as of September 2, 2021.

Trade in services: U.S. service exports to China remain depressed due in part to the collapse in bilateral travel receipts, but U.S. service exports to China in 2020 ($40 billion) were still some 36% larger than U.S. service exports to Germany, Europe's largest economy. What's more, when it comes to trade in services, the U.S. perennially enjoys a trade surplus with China, with the surplus totaling $25 billion in 2020.

Chinese holdings of U.S. Treasury securities—These are still robust notwithstanding numerous bilateral friction points. As depicted in Exhibit 3, Chinese holdings of U.S. Treasuries have remained relatively constant over the past decade, totaling $1.1 trillion as of the end of June 2021. Meanwhile, Chinese holdings of U.S. corporate bonds and U.S. equities rose 13.1% and 16.1%, respectively, in the first six months of this year versus the same period a year ago according to the latest Treasury International Capital (TIC) data. Capital flows have traditionally run one way—from China to the U.S. However, when it comes to investing in liquid securities, it's not a one-way street any more. According to estimates from the Rhodium Group, U.S. investors held $100 billion in Chinese debt at the end of 2020 and $1.1 trillion in Chinese equities. The latter figure has dropped with the crackdown in big tech in China, although the key point is that even with the swoon in Chinese equity prices this year, U.S. portfolio flows to China remain at or near record highs.

Exhibit 3: Holding Steady: Chinese Holdings of U.S. Treasuries.



*Average of first six months of data. Source: U.S. Treasury Department. Data through June 2021.

China as a source of U.S. corporate profits: Little recognized by investors, China has long been a profits engine for many U.S. multinationals. Indeed, it's now very common for U.S. firms to book larger annual profits in China each year than in Germany and France combined. While global U.S. foreign affiliate income (a proxy for U.S. global earnings) declined nearly 16% in 2020 due to aftershocks of the pandemic, U.S. affiliate income in China dropped by only 2.8%. Meanwhile, in the first quarter of this year, the most available data, affiliate income in China totaled $3.7 billion, more than double the level in Q1 2020 ($1.7 billion). The key takeaway, geopolitics loom large over U.S.-China relations, but that hasn't stopped U.S. firms from booking healthy profits over the past few years.

U.S. foreign direct investment (FDI) in China—Still strong. Contrary to the chatter of U.S. firms decamping China for other locales, there is scant evidence of a wholesale retreat. In fact, according to data from the BEA, U.S. FDI to China jumped 32% last year, to $9.3 billion, from the prior year. Inflows last year were the strongest since 2014, and the money keeps coming, with Apple recently announcing that it was actually increasing its number of Chinese suppliers for its iPhones at the expense of rivals in Japan, Taiwan and South Korea.[1]

Wall Street banks are also getting into the act, with a number of U.S. financial firms recently announcing joint ventures or wholly owned foreign entities in China in a bid to tap the country's massive savings pool. How big is this pool? According to Goldman Sachs, the investable assets of Chinese households will be in the neighborhood of $70 trillion by 2030, a staggering sum even by Wall Street standards.[2] Presently, most of this savings is parked in savings deposits or real estate, but Beijing, by liberalizing parts of its capital markets to foreign investors, hopes Wall Street will develop a wealth management industry more suited for China's future needs.

Speaking of Wall Street and love affairs, the *Financial Times* recently noted:
"In an era that is increasingly defined by geopolitical competition and a push towards economic "decoupling," American finance has never been closer to Chinese wealth. Seduced by China's growing and massive pool of savings, Wall Street's most storied firms are embedding themselves more deeply than ever into the country."[3]

The operative word here is "seduced," with both the U.S. and China long seduced and enamored with each other's massive consumer markets, technological capabilities and outsized investment opportunities, among other things. In addition, life styles, sports, entertainment, travel, education—all of these factors, and others, have strengthened the bonds between the U.S. and China over the past few decades. Hence, why it's so hard for this power couple to break up.

In the end, serious issues nag at the heart of U.S.-China relations, with the future of Taiwan, in our opinion, front and center. China's regulatory crackdown, cybersecurity threats, unbalanced trade, and climate change disagreements are decisive issues as well, and make for a choppy and unpredictable backdrop for U.S. investors struggling to make sense of U.S.-China relations.

The bad news is that this relationship has hit the rocks, creating bouts of market volatility and uncertainty for investors. Some counseling/therapy is urgently needed. The good news is that both parties realize the stakes of a breakup are exorbitantly high and continue to work through their problems, evident by various metrics (trade, investment, profits) that suggest this relationship is salvageable. Let's hope so.

[1] See "Apple taps more Chinese suppliers for its latest iPhones," Nikkei Asia, August 4, 2021.
[2] See "Wall Street's new love affair with China," *Financial Times*, May 30, 2021.
[3] Ibid.

THOUGHT OF THE WEEK

What Could Fed Tapering Mean for Equity Markets?

Ehiwario Efeyini, Director and Senior Investment Strategy Analyst

U.S. and global equity markets continued to reach new highs last week, taking the number of record-setting days for the S&P 500 past 55 for 2021 so far. But with the Fed expected to start winding down its $120 billion-per-month bond buying program in Q4, can investors expect the market advance to extend into the latter part of the year? Our view remains that the uptrend of the past 18 months should stay intact. The dovish message delivered by Fed Chair Powell at last month's virtual economic policy symposium suggests only a gradual tapering of Fed asset purchases over the coming quarters, with the market not currently expecting outright rate hikes to begin until 2023. And though we continue to watch for a broadening of inflation risk into large service categories such as owners' equivalent rent, the Fed's policy path at this stage is likely to remain driven by an absence of broad-based price pressures, limited wage increases and the persistence of disinflationary forces at the global level.

Past experience with Fed tapering indicates that equity markets can make gains even as asset purchases are scaled back. During the 2013 episode, the S&P 500 was moderately lower three months after tapering was signaled in May. But after a 12-month period, the market had recorded gains of over 15%, led by Industrials, Materials, Healthcare and Information Technology. A similar pattern has also followed past tightening episodes, with equities treading water immediately after the first rate hike before posting double-digit returns one year out (Exhibit 4).

Exhibit 4: Market Returns and Historical Shifts in Fed Policy.

S&P 500 Returns Around Start of Fed Policy Shifts

	From May 2013 tapering signal				Average from start of 7 rate hiking cycles*			
	-3 months	+3 months	+6 months	+12 months	-3 months	+3 months	+6 months	+12 months
S&P 500	11.7%	-1.0%	8.7%	15.5%	6.6%	0.5%	6.2%	10.2%
Energy	7.9%	-3.7%	6.5%	15.6%	6.7%	6.9%	12.0%	19.7%
Materials	9.5%	-1.3%	9.5%	19.5%	11.5%	2.3%	8.4%	7.3%
Industrials	9.6%	0.9%	14.0%	21.9%	10.5%	2.0%	5.7%	9.3%
Consumer Discretionary	15.8%	0.9%	12.7%	13.2%	7.7%	0.7%	6.8%	6.5%
Consumer Staples	9.7%	-3.7%	4.7%	9.2%	6.4%	-5.8%	0.7%	1.8%
Healthcare	14.6%	0.6%	11.6%	21.0%	4.5%	0.2%	3.7%	16.7%
Financials	14.9%	-0.7%	7.6%	11.2%	5.5%	-3.1%	0.5%	6.5%
Technology	9.8%	0.4%	9.3%	20.2%	8.6%	4.1%	13.8%	18.6%
Telecom	10.9%	-8.5%	-2.2%	0.8%	2.7%	0.3%	5.9%	8.0%
Utilities	10.2%	-6.7%	-1.8%	7.5%	1.4%	1.2%	3.8%	8.9%

Sources: Bloomberg; Chief Investment Office. Data as of September 1, 2021. *Average around seven hiking cycles beginning August 1980, May 1983, December 1986, February 1994, June 1999, June 2004, December 2015. Returns in total return terms. **Past performance is no guarantee of future results.**

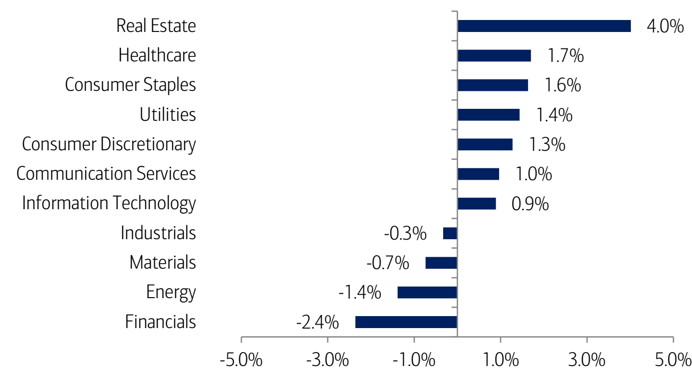
Through its influence on discount rates and the cost of capital, the future direction of monetary policy will be a fundamental driver of asset prices. But equity markets will also be driven by a range of other factors, most importantly the expected growth of corporate earnings. The Fed's monetary policy shift this time around comes alongside a robust profit outlook, with the 2021 rebound in S&P 500 earnings per share expected to be followed by high single-digit growth in 2022. Crucially, the underlying economic recovery is still at a relatively early stage (it had been underway for close to four years in the 2013 episode), and we see plenty of scope for ongoing expansion on the back of consumption support from rising personal income, record household net worth and a still-high saving rate. Therefore, while the volume of chatter about the Fed's next move will no doubt grow louder as we move into the final third of the year, it will nonetheless be critical to keep in mind the broader macro environment, which we believe is likely to remain favorable for prospective returns.

MARKETS IN REVIEW

Equities

	Total Return in USD (%)			
	Current	WTD	MTD	YTD
DJIA	35,369.09	-0.1	0.1	17.1
NASDAQ	15,363.52	1.6	0.7	19.7
S&P 500	4,535.43	0.6	0.3	22.0
S&P 400 Mid Cap	2,760.55	-0.2	0.3	20.6
Russell 2000	2,292.05	0.7	0.8	16.8
MSCI World	3,163.99	1.0	0.8	18.8
MSCI EAFE	2,389.45	1.8	1.5	13.2
MSCI Emerging Markets	1,315.91	3.4	0.6	3.4

S&P 500 Sector Returns



Fixed Income†

	Total Return in USD (%)			
	Current	WTD	MTD	YTD
Corporate & Government	1.33	-0.09	-0.10	-0.97
Agencies	0.71	0.02	-0.02	-0.22
Municipals	0.98	0.00	-0.04	1.49
U.S. Investment Grade Credit	1.43	-0.06	-0.07	-0.76
International	2.01	-0.08	-0.09	-0.31
High Yield	3.77	0.41	0.19	4.74
90 Day Yield	0.03	0.05	0.04	0.06
2 Year Yield	0.21	0.22	0.21	0.12
10 Year Yield	1.32	1.31	1.31	0.91
30 Year Yield	1.94	1.92	1.93	1.64

Commodities & Currencies

	Total Return in USD (%)			
Commodities	Current	WTD	MTD	YTD
Bloomberg Commodity	207.38	0.8	1.2	24.5
WTI Crude $/Barrel††	69.29	0.8	1.2	42.8
Gold Spot $/Ounce††	1827.73	0.6	0.8	-3.7

	Total Return in USD (%)			
Currencies	Current	Prior Week End	Prior Month End	2020 Year End
EUR/USD	1.19	1.18	1.18	1.22
USD/JPY	109.71	109.84	110.02	103.25
USD/CNH	6.44	6.46	6.45	6.50

Sources: Bloomberg, Factset. Total Returns from the period of 8/30/2021 to 9/3/2021. †Bloomberg Barclays Indices. ††Spot price returns. All data as of the 9/3/2021 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 8/3/2021)

Asset Class	Underweight		Neutral	Overweight		Colour
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				●		green
International Developed			●			yellow
Emerging Markets			●			yellow
Global Fixed Income		●				orange
U.S. Governments		●				orange
U.S. Mortgages			●			yellow
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*						
Hedge Funds			●			grey
Private Equity			●			grey
Real Assets			●			grey
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 9/3/2021)

	2020A	Q1 2021A	Q2 2021E	Q3 2021E	Q4 2021E	2021E
Real global GDP (% y/y annualized)	-3.2	-	-	-	-	5.8
Real U.S. GDP (% q/q annualized)	-3.4	6.3	6.6	4.5	6.0	5.9
CPI inflation (% y/y)	1.2	1.9	4.8	5.3	5.2	4.3
Core CPI inflation (% y/y)	1.7	1.4	3.7	4.1	4.1	3.3
Unemployment rate (%)	8.1	6.2	5.9	5.2	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 3, 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.

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.

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.

Telecommunication Sector Index is made up of companies that make communication possible on a global scale, whether it is through the phone or the Internet, through airwaves or cables, through wires or wirelessly.

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

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