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The Great Debt Binge

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The opinions are those of the author(s) and subject to change.

AUTHORED BY:

Jonathan Kozy
Managing Director and
Senior Macro Strategy Analyst

Jeffrey Miller
Director and Due Diligence Analyst

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CIO HIGHLIGHTS

Aggressive reflationary policy, including the fiscal debt binge, favors Equities over Fixed Income in the near term. Within Equities, the CIO has a tactical cyclical bias.

Governments, companies and households went on a $24 trillion debt binge in 2020, and global debt reached a new high of $281 trillion.[1] Not surprisingly, the fiscal response to the pandemic by governments accounted for more than half of the surge. In the U.S. and elsewhere, the fiscal spigot is still on, as evidenced most recently by the $1.9 trillion American Rescue Plan and a planned infrastructure package later in the year. Globally, the Institute of International Finance (IIF) expects government debt to increase another $10 trillion this year. There are few signs that fiscal discipline is right around the corner.

Investors are faced with the challenge of tactically and strategically navigating the debt binge, a difficult but manageable task. Prudent investors are revisiting debt sustainability across asset classes and balancing the tactical opportunities from massive reflationary efforts with the risk of a debt binge hangover and longer-term effects. Much of the outlook hinges on the path of inflation (and inflation expectations) and the effect on interest rates. The length of the current expansion, prospects for fiscal discipline and the future management of business cycle downturns are also top of mind, with the latter a focal point for strategic asset allocators navigating the mountain of debt over the long term.

In this chapter of the Chief Investment Office (CIO) Investment Insights "*The Great*" series,[2] we look at the ongoing debt binge and the key tactical and strategic implications for investors.

Fiscal Regrets Primed the Pump

While the pandemic was the trigger for fiscal stimulus and the ongoing debt binge, a number of factors teed up policymakers, particularly in the U.S., to be less frugal. For one, a key policy critique emerging from the Great Financial Crisis (GFC) was that fiscal policy underwhelmed, handicapping reflationary efforts and the expansion that followed. Former Federal Reserve (Fed) Chairman Bernanke noted in his memoir of the GFC that fiscal policy, "was blowing the wrong way"[3] even as central banks were introducing new, innovative tools to battle massive deflationary forces. All over the world, fiscal policy failed to fill the output gaps caused by that recession. As a result, over the next decade real output growth disappointed in most countries (in Europe there was a double-dip

[1] Source: Institute of International Finance (IIF) Global Debt Monitor. February 2021.

[2] The Great Separation, April 2020; The Great Acceleration: Speeding Toward a Post-coronavirus World, May 2020; The Great Convergence, May 2020; The Great Clash: The Crisis Doesn't Stop Change, June 2020; The Great Consolidation: Industry and Equity-Market Concentration after the Crisis, July 2020; The Great Rivalry: A New U.S.-China Cold War?, August 2020; The Great Reset: Work, Play and Live in a Post-coronavirus World, August 2020, The Great Rebalance, September 2020; The Great Shift: Shareholder to Stakeholder Capitalism, September 2020 and The Great Pandemic, October 2020.

[3] Ben Bernanke, *The Courage to Act*, 2015.

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recession) and central banks, including the Fed, European Central Bank (ECB) and Bank of Japan (BoJ), failed to meet their inflation mandates.

In the U.S., many policymakers also viewed the GFC as a missed opportunity to take advantage of low interest rates to invest in critical infrastructure, climate change initiatives or productivity-enhancing capital more broadly. Partisan politics and fiscal austerity silenced strategic dialogue.

Thus, policymakers' experiences with the GFC played a significant role in the unprecedented fiscal and monetary responses that followed this pandemic shock. For their part, central banks brought interest rates back to zero and re-engaged their expanded monetary toolkits, including aggressive quantitative easing. Private sector borrowing rates reached all-time lows, fueling household and corporate borrowing. Faced with pandemic restrictions, firms needed to bridge the gap to immunity. Others were simply looking to grab liquidity at record low rates. The IFF data show a $4.1 trillion increase in nonfinancial corporate debt in 2020.

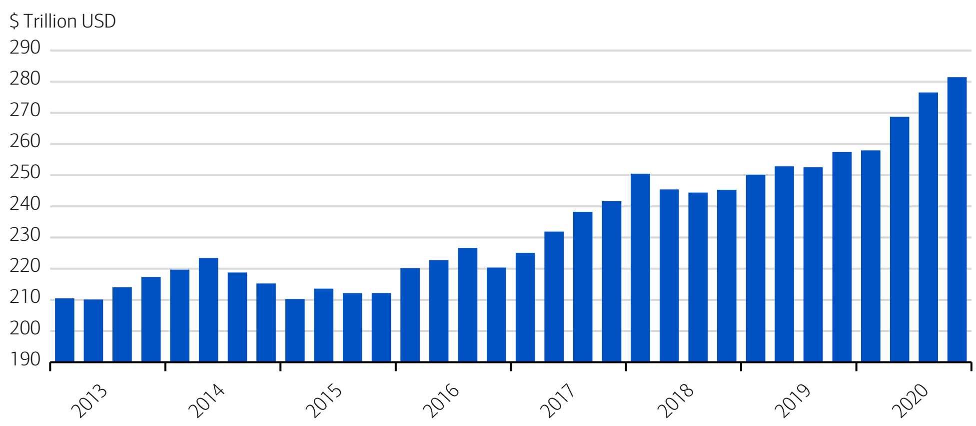
In the U.S., for better or worse, both political parties seem to have embraced modern monetary theory (MMT), the idea that neither the size of the deficit nor public debt matter as long as inflation is low.

Even in Europe, where a lack of fiscal coordination and integration has long been a primary concern for investors, policymakers broke bread and made a deal. In aggregate, global government debt rose by $12 trillion last year, accounting for more than half of the increase in total debt last year.

Policymakers also did not have much of a choice to be frugal this time around. Monetary policy was simply insufficient to restore demand for goods and services when the global economy was forcibly shut down by the pandemic. The alternative to a fiscally induced debt binge—namely deflation, depression, and an out-of-control pandemic—was not an option.

All-in-all, government, corporate and household debt across the globe is quickly approaching $300 trillion (Exhibit 1).

Exhibit 1: Global Debt.



Sources: Institute of International Finance (IIF), Bank of International Settlement (BIS), International Monetary Fund (IMF), National sources as of February 17, 2021.

Reflation Favors Equities—For Now (And Maybe Later)

Investors are left trying to navigate the ongoing debt binge. At a high level, the shift to a more coordinated, aggressive, reflationary macroeconomic management framework means bond yields are likely to continue to move higher in the near term as markets raise expectations for growth and inflation. The CIO is positioned for this reflationary environment with an overweight to Equities versus Fixed Income and a preference for economically sensitive sectors like Materials, Industrials and Energy. Infrastructure-related industries within these sectors could get an additional boost later in the year if the U.S. administration moves forward with the next phase of the debt binge, an infrastructure investment package that will likely only be partially paid for. We are also overweight Financials as beneficiaries of a steeper yield curve.

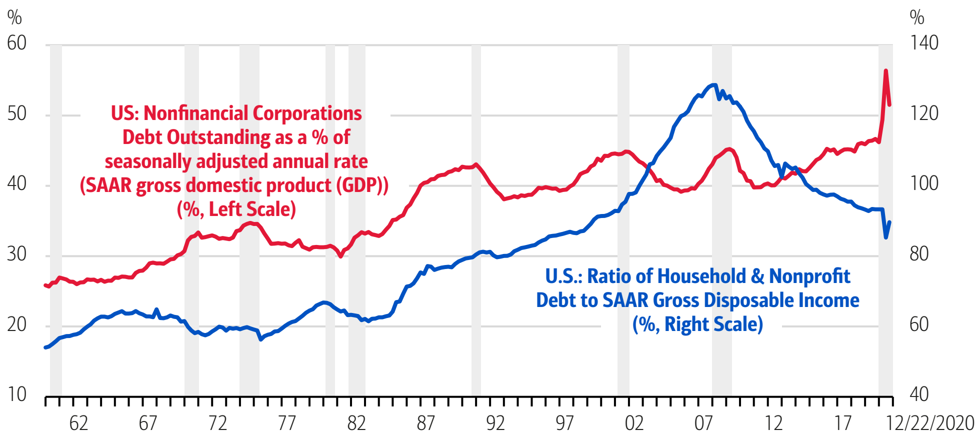
Commodities will also likely benefit from the policy backdrop and can offer investors both tactical and strategic diversification benefits in a pro-inflation environment. Commodities have performed well in periods of high inflation like the 1970s.

CIO HIGHLIGHTS

Commodities have the potential to offer diversification benefits if the debt binge leads to faster-than-expected inflation while also benefiting in the current environment from faster global growth.

Investors should also consider that much of the debt binge in the U.S. was a transfer of public sector debt to households through direct fiscal stimulus and enhanced unemployment benefits. Fiscal outlays in the U.S. are up over $2.3 trillion over the last 12 months.[4] Over the same period, the personal savings rate rose from 7.6% to 20.5%. Within Equities we remain overweight the Consumer Discretionary sector partially for this reason. Combined with the substantial rise in equity prices and housing prices, household net worth is reaching record highs, while household leverage and debt-to-income is hitting multidecade lows (Exhibit 2). The government and corporations extended leverage, but household balance sheets are reinforced. This will likely have important strategy implications for the next recession.

Exhibit 2: Corporate Debt In 2020 Increased Dramatically Even As Household Leverage Remained Low.



Sources: Federal Reserve Board/Haver Analytics as of December 22, 2020.

Government debt-funded transfers to consumers have in part been transferred to financial assets and distorted markets (bubbles) are considered a risk associated with an ongoing debt binge. In the aggregate, U.S. consumers are flush with cash at the same time, risky assets like Equities and nontraditional asset classes are increasing in value. There is a risk that this business cycle expansion ends like the 1990s cycle, with a bursting asset bubble and a contraction in business investment spending.

CIO HIGHLIGHTS

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Navigating the Debt Binge in Corporate Bonds

As seen in Exhibit 2, corporate debt in 2020 increased dramatically even as household leverage remained low. Global corporations issued a record $4.4 trillion of bonds in 2020. It is not surprising that companies took advantage of historically low rates for Mergers

[4] Source: Haver Analytics. Data as of January 2021. 12-month total sum of outlays, 1-year change.

& Acquisitions (M&A), debt refinancing and in the case of less credit-worthy borrowers to avoid defaults, which were much lower than the market anticipated. A concerning trend has been the increasing portion of issuance from the lowest-quality-high-yield issuers that traditionally have had to pay a much higher interest rate on their debt to compensate investors for the higher credit risk. The lowest-rated part of the high-yield market as represented by CCC-rated issuers saw yields inside of 7% in early 2021 in a market that normally yields in the 8% to 9% range, demonstrating how far spreads have come in. It would be hard to argue that investors are being adequately compensated for the heightened default risk in CCC-rated issuers with sub-7% yields.

The recovery in profits partially mitigates near-term concerns that we just postponed defaults in lower-quality issuers that benefited from low rates and government support of the bond markets. The more cyclical high-yield companies will likely benefit from post-coronavirus openings and a resurgence in consumer demand, although it remains to be seen whether they can meet debt service if rates increase faster than projected. The market indicates defaults in the low single digits for 2021 compared to an 8.4% default rate in 2020 with peak levels in Q2'20.[5] We may not see the true effect until the next recession, which could be deeper and longer when deleveraging unfolds. This leaves some runway for active managers* to gauge what companies will look like when the tide goes out and for now, the CIO maintains a quality bias.

Corporate bond spreads are at historically tight levels and have not budged despite recent rate-induced volatility in the bond and equity markets. Given the narrow-spread levels, we have concerns about valuations in Corporate Bond markets, another reason to remain overweight Equities.

However, the CIO still expects Fixed Income to be a diversifier in the long term, as coupon income becomes more of a determining factor to total returns. Spread products including corporates and securitized assets could provide significantly more yield and may be a better diversifier than Treasurys over longer periods of time.[6] A notable longer-term risk is the moral hazard of corporate markets relying on support from the Fed and fiscal policy.

In the taxable markets, bank loan demand has increased with managers highlighting favorable relative value opportunities and the floating rate structure given recent rate volatility. Bank loan yields have fallen along with other credit markets, although prices remain modestly below par. Similar to high-yield bonds, there remains considerable downside risk in below-investment grade bank loans. The CIO believes that high-yield and bank loan valuations present mediocre absolute long-term returns after factoring in an appropriate estimate of credit losses. Within High-Yield, at least an equal allocation to floating-rate loans and high-yield unsecured is advised.[6]

Business Cycle Dynamics Pose Medium-Term Risk

The length of this cycle will be an important factor in determining when overextended corporates face their day of reckoning. Over the medium term, business cycle expansions become more vulnerable to shocks as private sector (household plus nonfinancial corporate) leverage builds (Exhibit 3). Investors should consider the medium-term effect of the debt binge on the length of the current expansion, as this will likely dictate the path of risk assets. If a rapid household debt binge coincides with the current housing boom, adding to the already-extended nonfinancial corporate balance sheets, this expansion could be shorter and the next could be deeper and longer. For now, though, the Chicago Fed's National Financial Conditions Index (NFCI) which has a good track record of raising red flags prior to recessions, is currently signaling a benign backdrop (Exhibit 3).

CIO HIGHLIGHTS

The ongoing investor search for yield, an accelerating profits recovery and operating leverage are supportive of Corporates over Treasurys.

Within an investor allocation to corporate bonds, the CIO has a quality preference in Corporates with the best relative value opportunities in select BBB-rated Industrials in addition to U.S. Financials.

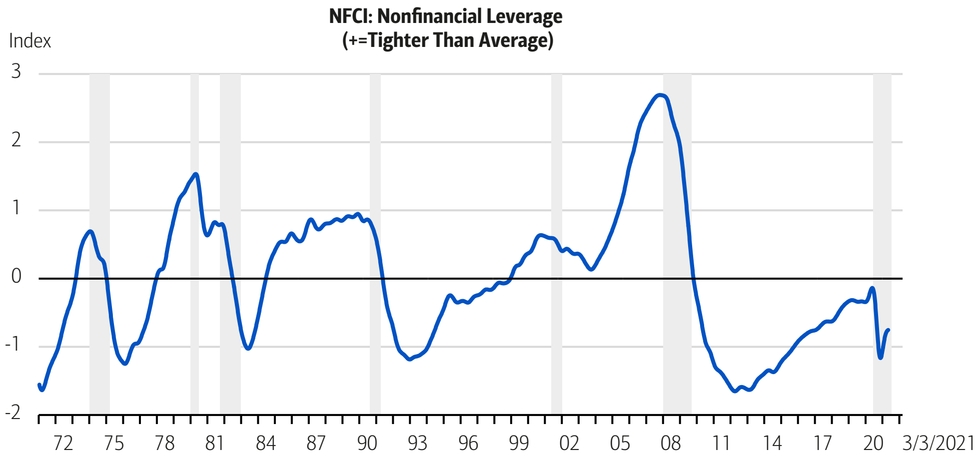
Nonfinancial corporate balance sheets are stretched at the same time valuations in high-yield corporate debt are less than compelling. Any additions to high-yield risk need to have a very long time frame, in our view.

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

5 Source: Moody's as of December 31, 2020.

6 Source: CIO Viewpoint March 2, 2021.

Exhibit 3: Chicago Fed's National Financial Conditions Index (NFCI) Is Signaling A Benign Backdrop.



Sources: Federal Reserve Bank of Chicago/Haver Analytics as of March 3, 2021. Past performance is no guarantee of future results.

Business cycle timing is also heavily dependent on the path of inflation, as that could drive the Fed to tighten policy faster than markets expect. We think given the size of the fiscal stimulus and the increase in personal incomes, inflation is likely to reach and exceed the Fed's 2% target sooner rather than later. For investors that could mean the risk of a Fed-induced recession increases as we look out to 2023 and beyond with an obvious follow-through to risk assets like Equities.

Investor Appetite

An important consideration is whether investor demand will continue to support heightened levels of sovereign and corporate debt over the next few years. Fixed Income asset managers are counting on investor demand for yield to continue to meet the rising issuance levels even if rates rise modestly. Buyer support for the sovereign bond markets comes from both central banks and institutional buyers in a yield-starved environment. Central bank support of asset purchases exceeded $5 trillion in 2020 with the Fed leading the way with an additional $3 trillion expansion on its balance sheet.[7] This has supported both Government and Corporate bond markets where government support stabilized corporate and securitized asset markets in early 2020 with even high-quality money markets requiring support during the height of the crisis.

In addition to support by central banks, the bond markets will also continue to benefit from dedicated institutional fixed income buyers. These investors will likely stay invested in Fixed Income while just moving to the shorter end of the curve if they are concerned about rising interest rates. One potential headwind to this shift is that with a steepening yield curve the short end continues to yield close to zero, with money market funds yielding a few basis points after expenses.

Sovereign Sustainability

An important piece of the transition from a market less reliant on government intervention will likely be calculations of sustainability. Investors are rightfully concerned about the sustainability of U.S. sovereign debt, which is a function of the level of debt, the interest cost, the growth of revenues, who owns the debt (from an international bond perspective) and inflation.

[7] Source: Bloomberg. The Covid 19 Pandemic Has Added $19.5 Trillion to Global Debt. January 27, 2021.

In theory, in both the private and public sector a low debt ratio and a high debt ratio like we have now can be equally sustainable depending on the interest cost versus the rate of growth. If the U.S. economy grows at 5% in nominal terms (likely higher in the next few years) and the cost of debt is 2% (or less), the fiscal discipline required to stabilize GDP is less stringent. The fiscal requirements become more burdensome for policymakers and economies if interest rates rise significantly. Economists are most concerned with stabilizing the debt-to-GDP ratio, even if it is at a high level.

Despite the decline in the cost of debt and strong growth this year and next, an outsized move in interest rates could quickly increase the cost of debt, creating a more urgent need for fiscal discipline. And the U.S. still has not addressed ballooning entitlement spending that was the primary cause for concern pre-pandemic.

Non-U.S. Sovereigns

Government support continues to drive investor behavior in European bond markets, with investors continuing to buy up sovereign debt of the European peripheral countries that were at the center of European sovereign debt crisis in the years following the 2008 GFC. With negative yields in the higher credit-worthy European countries, investors seem to be focused on peripheral countries (Greece, Spain, Italy) to generate even a modest yield. They see little risk in these bonds in the near term given the bond-buying program by the ECB and investor demand for yield. The possible challenge to this scenario would be if the ECB reaches a limit in their level of support for these markets as rates increase and the cost of debt becomes less manageable. The CIO favors short duration and due to compressed yields and risk premiums around the globe compared to the U.S., our view is to maintain an underweight position in non-U.S. Fixed Income.[6]

Emerging Markets

Emerging Market (EM) countries also needed to borrow heavily to combat the economic effect of the coronavirus. The IIF data show an increase of $11.1 trillion in EM government debt. With the caveat that the most recent large-scale debt crisis occurred in the developed markets with the European sovereign debt crisis, historically, EMs have been more vulnerable to debt crises. Debt outstanding denominated in a foreign currency (i.e., hard currency debt) remained stable in 2020, with the increase in issuance in EM being predominantly in local currency debt. This has become the preferred source of funding for all but the largest EM borrowers, since debt issued in a country's local currency is supported by the ability of local central banks to print money while minimizing the currency risk for local investors.

The good news is that higher levels of synchronized global growth helps EMs in near term although it is imperative that emerging market countries maintain growth rates that are higher than their local interest rates. Given projections by the Organisation for Economic Co-operation and Development (OECD) that growth rates in emerging economies are projected to remain 3 to 4 percent below their pre-pandemic growth path by the end of 2022, there is considerable risk in servicing debt in select emerging market countries. Interest rates in many emerging market countries remain higher than rates in developed markets and therefore they are spending a higher percentage of revenues on interest payments.[8] Investors should remain cautious given past issues in these markets with inflation and the ability to access capital markets in times of market stress. Given the inherent idiosyncratic risk with EM countries, well diversified portfolios are essential with a preference for managers that can allocate to both hard currency and local currency emerging market debt.

[8] Source: Financial Times. Feeble growth and chunky debt piles hold back emerging economies. March 15, 2021.

The Path Forward

To help make the hangover more manageable for investors, fiscal discipline (sovereign and corporate) is required at some point. In the U.S., fiscal policy needs to be disciplined enough to allow the Fed to return to its normal course of business—its mandate of full employment and stable prices with inflation around 2%. Historically a Fed focused on low and stable inflation has lowered business cycle volatility and raised standards of living. Investors are already wrestling with this issue as long-term Treasury rates move higher and the Fed confronts the benefit of re-anchoring inflation expectations higher with the higher cost of debt and massive debt issuance.

If the Fed is now entering a period where it is constantly battling inflationary pressures from fiscal policy running hot (versus the past decades where it has been battling disinflation), then there are likely consequences for strategic asset allocation models and assumptions. It could ultimately lead to growing strategic allocations to risk assets like equities to balance the risk of rising interest rates and bond defaults. As mentioned, business cycles could also be more volatile.

Fiscal discipline will be difficult in an environment full of persistent fiscal shocks and the temptation to politicize short-term stimulus. Another pandemic (or a resurgence of this one), wars, natural disasters—all are relentless and could derail any progress on debt stabilization and dampen appetites for fixed income products. This could raise the imperative to address long-term budget issues that have been ignored for decades and help drive the trend in deficits.

Currency markets often take on the role of re-balancing the global economy, and it is possible that history repeats itself here both tactically and strategically. Investors will need to raise due diligence standards for currency and debt risk in an environment of excessive debt. Strategically, China has long been eyeing a more global role for the Renminbi. The debt binge could prove to be a catalyst for gradually gaining more ground, which presents both opportunities and risks for U.S.-based investors.

For now, we expect investors to ride the tailwind of massive reflationary policy financed at near-zero rates and backstopped by central banks all over the world. But tactical and strategic adjustments will be necessary in the years ahead to navigate the headaches associated with the debt hangover.

CIO HIGHLIGHTS

The insertion of monetary and fiscal policy likely arrested the long-term decline in interest rates. Tactically, the CIO favors shorter durations. Strategically, the debt binge could likely lead to changes in strategic asset allocation guidelines and capital market assumptions if expectations for a flat-to-upward trend in long-term interest rates (and bouts of higher inflation) alter projected diversification benefits. This could lead to greater allocations to Equities or alternative, less risky assets.

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.

Chicago Fed's National Financial Conditions Index (NFCI) provides a comprehensive weekly update on U.S. financial conditions in money markets, debt and equity markets and the traditional and "shadow" banking systems.

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