

Investment Strategy Overview



December 2021

The Great New Dawn

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

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Chief Investment Officer

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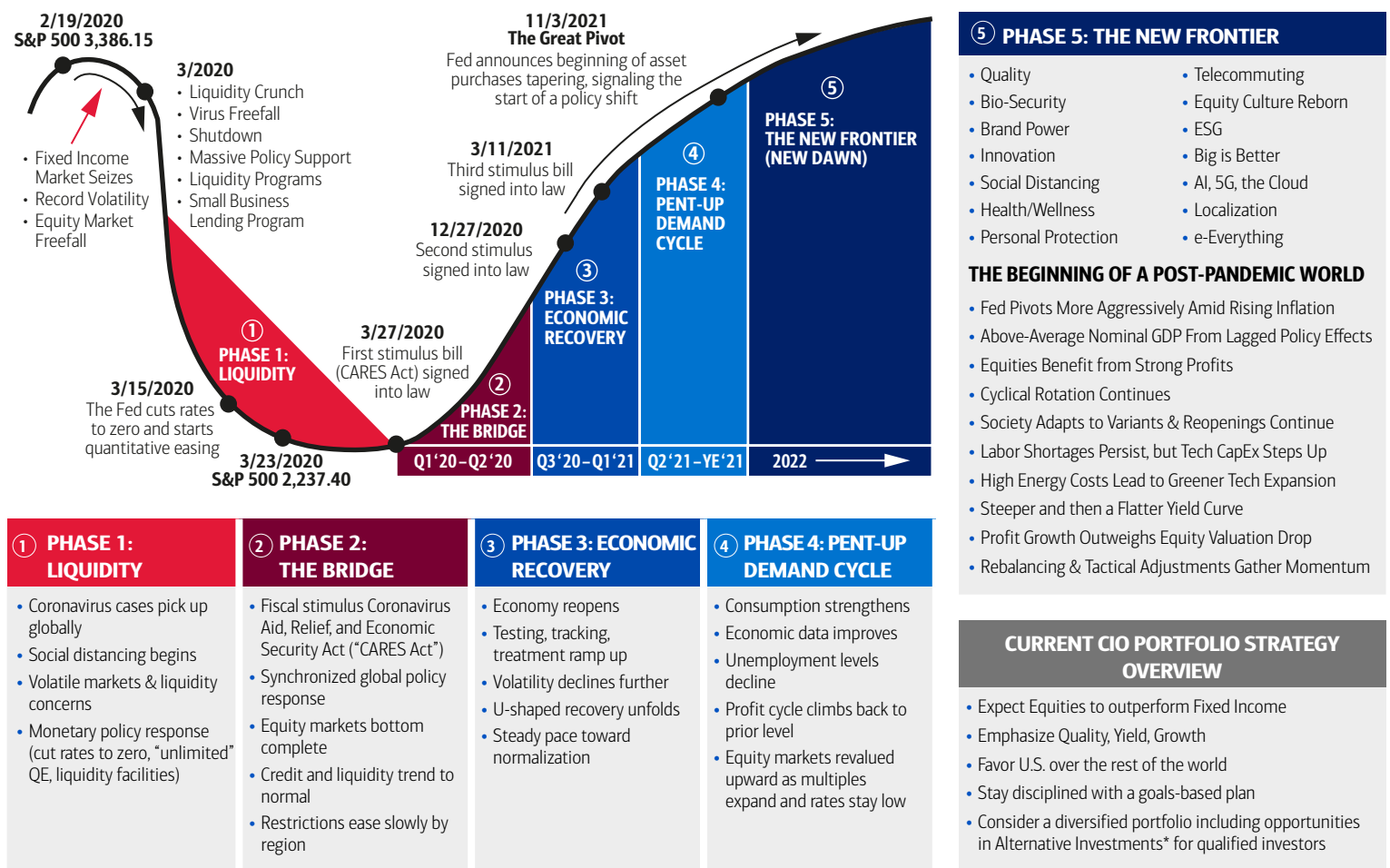
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The Great New Dawn is our version of the beginning of a post-pandemic world. This is a world led by the continued acceleration of innovation, balanced removal of a record level of global monetary accommodation, a shift toward infrastructure redevelopment, and a consumer that more aggressively shifts their spending toward services, including travel, leisure and entertainment. *The Great New Dawn* is the first light of a new “post-pandemic” day.

This era will contain new shifts, adjustments, some major pivots, and further structural changes away from what dominated the pandemic cycle as well as the post-Global Financial Crisis (GFC) period over a decade ago (Exhibit 1). Still, we believe a few core catalysts and concerns will likely remain. These include above-average nominal gross domestic product (GDP) growth, elevated inflation, labor market shortages, energy dislocations, a strong private sector, wage growth, new coronavirus variant concerns, worries over the U.S.-China relationship, and an Equity asset class that is still significantly favorable relative to Fixed Income.

The New Dawn means a transition from a pandemic-led, pent-up demand cycle with multiple waves of growth to a potentially lower and smoother, but still-above-average, nominal economic growth cycle. Inflation will remain a force that lasts longer than most expect, in our view. However, this could propel revenue growth in areas of strong pricing power and keep the profit cycle from rolling over too quickly, even if the Fed pivots more aggressively.

Exhibit 1: The Journey from the Great Separation to *The Great New Dawn*.



Black line represents the lifecycle of the CIO economic workout process and is not meant to represent any specific investment, index or performance of any kind. Phase 5 represents the CIO outlook for potential economic expansion. *Many products that pursue Alternative Investment strategies, specifically Private Equity and Hedge Funds, are available only to qualified investors. Source: Chief Investment Office. Data as of December 7, 2021. CIO views are subject to change. The economic and market forecasts presented are for informational purposes as of December 7, 2021. Economic or financial forecasts are inherently limited and should not be relied on as indicators of future investment performance.

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In our view of this period, the Fed begins its pivot from ultra-accommodation, dominated by emergency programs, liquidity and balance sheet expansion with zero interest rate policy, to tapering (slowing its bond purchases or less easing), ending the balance sheet expansion and lift off from the zero percent fed funds rate. In the private sector, balance sheets would remain healthy, labor issues abate somewhat, but structural deficiencies persist, operating leverage continues to drive record level profits, even as some favorable revenue and wide spread pricing power trends normalize somewhat, and supply chain disruptions maintain top of mind status but ease later in the year.

The catalysts of a post-pandemic economy shift toward increasing capital investment, more normal consumer spending patterns, less government stimulus outlays, more regionalization in supply chains, and above-trend economic growth, in our view. We also see the early stages of a Fed pivot, a private sector focused on building new industries, a profit cycle not ready to tire out and peak, greater penetration of coronavirus vaccinations even in the face of new variants, improved treatments and therapeutics, and a bull market that may not produce as many sunny days but can still shine its rays through the clouds.

This broader environment begins to pivot to today's "normal"—*The Great New Dawn*—and away from the past pre-pandemic cycle, which was driven by disinflation, anemic growth and debt overhanging the household and private sector.

THE CIO'S TEN NEW DAWN CHARACTERISTICS:

1. The Fed likely needs to eventually pivot more aggressively to ultimately bring inflation back down closer to their targets. Does the Fed raise its inflation target before all is said and done?
2. Above-average nominal GDP growth remains in place through 2022 as the lagged effect of ultra accommodative monetary and fiscal policies continue to filter through, despite tapering and no new fiscal packages. Strong aggregate demand, elevated inflation, wage growth and supply shortages are, to a degree, still expanding elements that underpin the macro backdrop.
3. Equity markets continue to benefit from better-than-expected revenues with profits tracking nominal growth expectations providing fundamental support.
4. The rotation in the equity capital markets is still early in its life cycle and should continue throughout 2022. Cyclical, higher quality, high free cash flow, Value, dividend growth and Small-cap segments of the Equity asset class should play catch up and look to the broader market, more defensive, longer-duration and higher-growth areas.
5. As new coronavirus variants are studied, society learns to adapt and continue toward a full reopening process, in our view. Some goods spending should shift back toward services over time.
6. Structural labor shortages are likely to remain in *The Great New Dawn* as the outgrowth of new areas (e.g. warehousing, infrastructure, etc.) attract workers from select traditional service industries. This dynamic helps drive a new capital expenditure (capex) cycle in spending on automation, robotics and other productivity-inducing activities.
7. Concerns over higher energy costs continue, given high demand and below-average capital investment in traditional sources. Greener technology investment expands as "trade-off" costs become more balanced; the shift toward more renewable energy sources sustains upside pressure on many minerals and metals, given the metal/material-intensity of electric vehicles, solar panels and wind power.
8. The yield curve between the fed funds rate and the 10-year Treasury yield steepens in the first half of 2022 before ultimately flattening later in the year. The negative real rate environment continues for the foreseeable future.

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9. Rising yields hamper bond market returns as Equity returns take their cue from the overall level of corporate profit growth. The growth in profits should outweigh the potential drop in Equity valuations, in our view.
10. More active rebalancing and tactical adjustments are likely needed in 2022, given that we expect the Fed's policy adjustment, elevated nominal growth, higher yields and cyclical rotation to gather momentum. Alternative Investments, for qualified investors, may be an important asset class for access to diversification, hedged market participation, yield, and enhanced returns, as appropriate. Additionally, investors have an opportunity to integrate environment, social and governance (ESG) metrics and overlays into their valuation and risk/return considerations.

As we begin transitioning from a pandemic-led pent-up demand cycle with multiple waves of growth to a potentially lower and smoother but still above-average nominal economic growth cycle, we believe "The Pivot Is On." This still-developing macro and investment environment could contain new shifts (elevated inflation), adjustments (Fed policy), some major pivots (cyclical rotation) and further structural changes (employment trends) away from some factors that dominated the pandemic cycle. We discuss three scenarios below.

1. Base Case

For 2022, we expect a grind-it-out market environment in which valuations could remain flat or slightly decline but with profit growth to supersede this and Equity outperformance to continue. With 2021 mostly about much higher profits than expected and 2020 more about expanding multiples, we believe that for 2022, return expectations, including dividends in the U.S., are likely to track profit growth. New variant worries should dissipate but the pandemic still keeps a full reopening at bay.

Rotation toward cyclicals and more Value-oriented areas including Small-caps is preferred, and the long-duration, high-growth, little-to-no-profit areas come under continued pressure.

Sectors and industries with pricing power (Energy, Materials, Industrials—infrastructure-related—and Financials), economic leverage and strong profits growth mixed with attractive valuations dominate the year, in our view. Included in this environment, we expect dividend growth and higher-quality areas with low balance sheet leverage to also outperform. We still expect high free cash flow, strong balance sheet and mega Technology also to do well. This scenario may carry higher volatility and perhaps multiple pullbacks but we would leverage these as potential buying opportunities, particularly as we begin the year.

Yield drifts could go higher tracking inflation and stronger economic growth. The curve may shift upward and steeper between federal funds and the 10-year Treasury. We favor credit overall, especially Investment-grade, and also prefer municipal relative to Treasuries, but we would maintain a shorter-duration stance.

Commodity exposure is favored via Equities, in our view, with gold being considered as a potential hedge on elevated inflation, although we do not foresee a direct correlation between its price and inflation throughout the year.

2. Most Bullish Case

This Most Bullish Case could include even better-than-expected profit growth as reopening worries fade, multiples slightly rise as capital investment, stronger consumer spending than anticipated, continued pricing power, liquidity remains high, and above-average revenue growth continues. In addition, new variants would turn out to be mild and the reopening of the economy accelerates.

The Fed removes ultra-accommodation, but the market is prepared for it given the high growth. The job market surpasses expectations, but inflation creeps higher maintaining a negative real rate environment. Nominal economic growth surpasses consensus expectations handily.

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Valuations actually expand slightly given the comfort level for risk rising. Yields back up and the curve steepens, keeping financial conditions stimulative.

Risk aversion wanes even if the “wall of worry” is maintained. A subtle rise in valuations mixed with very strong profit growth and still-healthy financial conditions would lead to Equity total returns closer to 15%-20% in the U.S., in our view.

A rotation to cyclicals is accelerated where Value, Small-caps, reflationary sectors and industries outperform. Financials, Energy, Materials and Industrials are most preferred. Some mega Technology with high free cash flow should also do well, in our view.

Yields would back up more-than-expected and the Fed would likely remove policy faster and hike interest rates more than expected but, again, investors would most likely take this in stride.

Non-U.S. markets would likely rise in sympathy with the U.S. and could exhibit some quarterly outperformance. If the new variants fade quicker or are milder than expected, emerging markets (EM) would likely outperform for the first time in years.

This scenario is not without worry or pullbacks, but we would be buyers on weakness as we begin the year in Equities in this scenario.

3. Downside Case

This case is somewhat straightforward but includes more complexity, in our opinion.

This Downside Case, our least probable case, is one that could include lower valuations (pressured by rising rates due to much higher inflation, much lower liquidity, and slower growth—in other words very low confidence in the future), a peak in corporate profits and a nominal economic growth backdrop that performs well below expectations.

The Fed would maintain its recent pivot, and accelerate tapering and raise rates into a much slower growth environment which creates rising real concerns over stagflation. In addition, new variants would become a force that slows growth down further but inflation creeps higher given extended goods buying and supply chain disruptions.

Cyclicals, Commodities and reopening investments correct with Technology and Growth segments declining as well, given the potential for both slower growth (new variant worries) and higher short rates (tighter Fed).

The yield curve ultimately flattens and recycles the worries over stagflation. Gold could be considered a potential hedge but not directly, in our view.

Risk assets, namely higher beta areas including non-U.S. markets, would likely also come under pressure as the U.S. dominates the growth curve globally—a slower U.S. and slower China would lead to a slowdown globally, in our view.

More defensive assets, sectors and industries would be preferred including investments with strong dividend growth.

Summary

In summary, our Base Case represents our highest probability scenario with the Most Bullish Case next and then the Downside Case. The commonality across all three scenarios is that we believe all things considered, high quality, free cash flows and dividend growth as factors are all attractive.

We still prefer more cyclical and Value exposure overall given our view that a large rotation toward these areas continues throughout 2022 mixed with strong mega Technology free cash flow companies. Finally, we significantly prefer Equities relative to Fixed Income in our Base Case.

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There will be time much later down the road, post 2022, to worry more about the magnitude of Fed tightening (less liquidity) and how this could affect the broader growth level in the economy, corporate profits and Equity valuations.

MACRO OUTLOOK

U.S. Boom to Keep Global Growth Strong in 2022

The pandemic marked a secular shift in policy that has created a kind of new dawn for the global economy, with major implications for investors. 2022 is likely to see further evidence of this new macro environment. In most basic terms, it is a shift from the low interest rate, low inflation, secular-stagnation environment that characterized the first two decades of the 21st century, to a higher nominal growth environment characterized by higher inflation, higher interest rates, and stronger real growth.

Nominal GDP growth in the U.S. averaged less than 4% during the pre-pandemic, secular-stagnation era, the lowest trend growth since the 1930s. The Fed fell persistently short of its 2% inflation target and real GDP growth was also very low, constrained by unusually weak productivity growth. There was a constant cloud of risk aversion in this low growth environment where frequent bouts of deflation concerns pushed investors into Fixed Income, velocity-reducing money hoarding, and an unusually pronounced preference for long-duration Growth stocks at the expense of short-duration, cyclical Value stocks. *The Great New Dawn* of faster, more historically normal GDP growth is likely to continue, in our view, reversing the main trends of the secular-stagnation era.

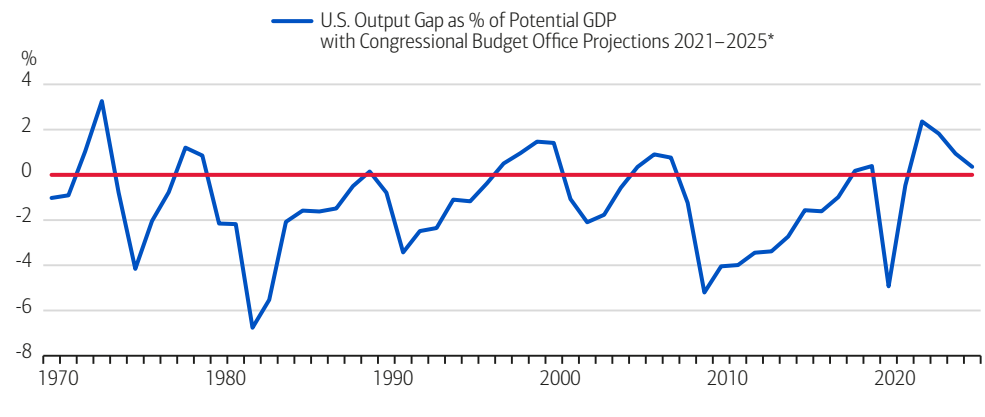
The Great New Dawn has been kicked off by the most aggressive fiscal and monetary stimulus since World War II (WWII). The Fed, which had been preparing for a shift in its policy procedures for two years, actually implemented this new change toward tolerating higher inflation when the pandemic hit in 2020. This provided cover for quantitative easing, which unleashed the biggest torrent of money-supply growth since WWII, about a three-standard deviation (amount of variation) rise in money printing above the historic trend. Like night follows day, this money printing has created inflation with the usual one-to-two-year lag. This implies 2022 will probably see inflation remain much higher than the Fed and consensus expect before the effect of the money-supply surge fully filters through and eventually peaks.

This 30% surge in money supply went to work rapidly as it financed fiscal transfers to households that more than offset the income losses from shutdowns. In fact, the 2020 recession was the first ever to see aggregate household income rise. As the economy quickly recovered, the fiscal transfers combined with rapid wage-and-salary growth to push consumer spending way beyond its pre-pandemic trend line.

While this excessive monetary and fiscal stimulus will be winding down in 2022, its effects will be moving through the economy over the next two years. Excess demand has created supply bottlenecks not seen since the 1970s. This has created a huge backlog of consumer pent-up demand throughout the economy that is evident in undelivered orders, including for big ticket items like cars and houses. As companies try to restock record low inventories, they will first have to deliver on their huge backlog of unfilled orders, which will keep the economy running at peak levels and prices rising in 2022.

Exhibit 2 illustrates the cyclical swings in the output gap, which measures how far above or below potential actual GDP is. The Congressional Budget Office (CBO) projects the gap will be the most above potential since 1973, higher than at previous cycle peaks in 1978, 1999, and 2006. These cycle peaks were associated with above-trend inflation and were usually a prelude to overtightening by the Fed that preceded recessions and GDP declines far below potential.

Exhibit 2: The U.S. economy is projected to be the most overheated since the 1970s.



* Estimate. Sources: CBO/Haver Analytics. Data as of December 2, 2021.

However, *The Great New Dawn* is characterized by a higher Fed tolerance for inflation. Fed Chair Powell has finally acknowledged that the spike in inflation is not transitory. It requires a policy response. Still, the Fed is so far following the post-Great Financial Crisis playbook: tapering first over an extended period before raising rates. More important, it is guiding toward the baby-step protracted rate-hiking trajectory that was appropriate for the old, low inflation era. As shown in Exhibit 2, the recovery out of the 2008–2009 recession was the slowest ever, taking over a decade for GDP to reach potential. This below-potential GDP environment was prolonged by inadequate demand growth that kept inflation below target. In contrast, with the fiscal and monetary spigots now open by orders of magnitude greater than during the pre-pandemic period, inflation has also jumped by orders of magnitude. The CBO projects excess demand in 2022 will reach levels not seen since 1973, which will keep upward pressure on inflation until the Fed normalizes money-supply growth, which is still running more than a standard deviation above trend, a pace associated with about 8% consumer price inflation over the subsequent two years.

Because the Fed is guiding toward an underwhelming policy template, it is likely to remain behind the curve in addressing inflation, much as it did in the 1970s when it thought it was tightening by raising interest rates while money supply growth remained too fast and real interest rates remained negative as inflation kept rising faster than the Fed hiked rates. Only when the Fed shifted to a direct money-supply control operating procedure in the early 1980s, did inflation finally recede. In our view, with inflation already in the high single digits, raising the fed funds rate 200 basis points (bps) over the next two years is likely to prove too little, too late to curb the booming U.S. economy.

Importantly, two major forces for persistent inflation are now kicking in with the usual lag following excessive demand stimulation. A wage-hiking cycle has begun as workers try to catch up with the inflation that is devastating their real incomes. This will be a strong force for higher inflation in 2022 given how tight the labor market is and how fast aggregate demand is likely to grow next year. In addition, rents, which make up a fourth to a third of various inflation measures, are another force for high inflation over the next two years. Back in the 1970s, home prices were part of the Consumer Price Index (CPI). In the 1980s, rents replaced home prices in the CPI. In 2021, home prices rose by the most on record, surpassing the prior record set in 1979. The CPI would already be over 10% this year if the old methodology was used. The new methodology means those big home price increases will be filtering through the rent component of the CPI in 2022 and 2023, according to research by the Federal Reserve Bank of Dallas, among others. Combined with accelerating wage growth, further big rent increases are likely to keep inflation much higher than the less than 3% pace that most economists are forecasting for the next two years.

The seismic shift in policy stimulus has lifted the economy onto a new higher plateau of double-digit nominal growth that is unlikely to recede until policy normalizes demand in

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line with potential GDP. However, the Fed is using its old template of policy tightening as if a new day has not dawned. Its slow response to high inflation is aimed at keeping the economy at escape velocity so it does not succumb to the old deficient demand growth world of the pre-pandemic era.

Ultimately, we believe the 2% inflation target was too low for the economy to grow at potential, given the high debt load that needs to be serviced. A sub-4% nominal GDP world kept the prospect of a deflationary collapse lurking in the background. In our view, raising trend nominal GDP growth to 5% or 6% implies a 3% inflation target that would be more consistent with achieving potential growth over time. It would also be more in line with the average inflation rate over the past 120 years. In any event, the challenge for the next few years will be achieving a soft landing from the two standard deviation jump in inflation from this historic 3% trend. *This Great New Dawn* of higher nominal growth also implies the secular stagnation playbook is being displaced as investors position for a new era with higher inflation, higher interest rates, and stronger growth in cash flows and profits.

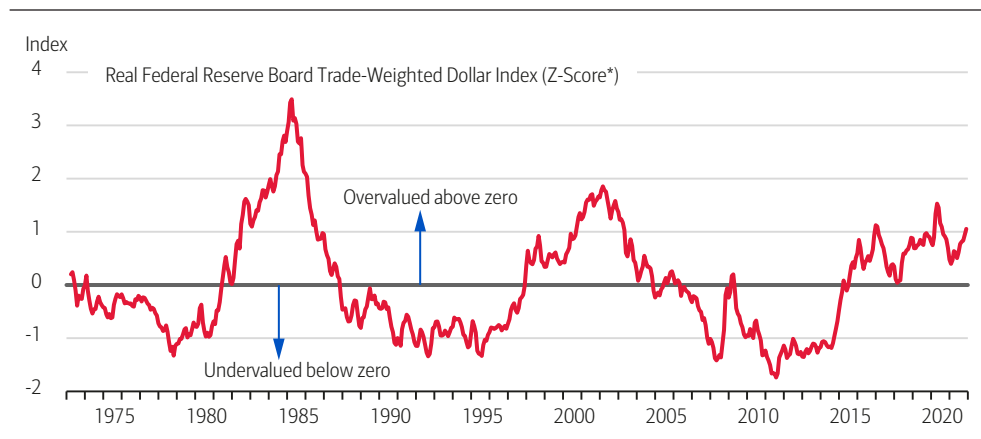
Given the relationship between the U.S. dollar and Commodities, what are the prospects for a weaker dollar next year?

While the U.S. dollar appears to have some near-term momentum from relatively strong growth and a more hawkish Fed, it could lose momentum over the next several years if risk-appetites fade, growth outside the U.S. picks up, and the valuation headwind (the dollar is expensive) features more prominently. Growth differentials favor the U.S. dollar versus most developed country currencies in 2022.

For now, the dollar appears to have some near-term support from a less dovish/ increasingly more hawkish Fed. And rate hike expectations and guidance from the Fed could continue to get pulled forward, giving a boost to the dollar against major currencies like the euro, the biggest weight in trade and liquidity weighted dollar baskets. Already the Fed is set to taper asset purchases by year-end, paving the way for upward pressure on both 2-year and 10-year yields in the U.S. on both an absolute and relative basis. BofA Global Research estimates the 2-year yield in the U.S. will increase much faster over the next year than for German bond yields (which are expected to remain negative), for example. A widening spread between Treasuries and Bunds typically supports the dollar versus the euro.

But the U.S. dollar has been modestly overvalued for several years and the real broad trade-weighted dollar is close to one standard deviation above the long-term average. While it does not match the overvaluation that was evident in 2002, it still looks persistently frothy (Exhibit 3).

Exhibit 3: Valuations support dollar weakness over the medium term.



* Z-score is a numerical measurement that describes a value's relationship to the mean of a group of values.
Sources: Federal Reserve Board/Haver Analytics. Data as of December 2, 2021.

Looking at the details, the dollar looks more expensive versus advanced economies than EMs. Relatively faster inflation growth in the U.S. continues to push purchasing power parity (PPP) valuations on a country-to-country basis. Foreigners looking to purchase U.S. goods (or visit as tourists) consider both the relative price of goods and the exchange rate, and by this standard the dollar looks overvalued versus most G-10 currencies including the euro (the biggest weight in trade-weighted indexes). PPP valuations tend to normalize over longer periods of time which vary depending on the currency, so PPP metrics also point to an eventual easing of dollar strength. Like with Equities, though, currency valuations are not good timing tools.

The U.S. dollar could also come under pressure if supply chain bottlenecks ease and global growth accelerates (anchoring demand for commodities simultaneously). A lot also depends on China's policy response to its broad-based domestic slowdown. The JPMorgan/IHS Global manufacturing Purchasing Managers' Index (PMI) rolled over in the spring, led by China, and BofA Global Research recently cut their real GDP growth forecasts for China to 4.0% for 2022.

The U.S. dollar also suffers from a deteriorating current account balance and a massive budget deficit, both on an absolute and a relative basis. Both make the dollar look relatively less attractive and the latter stokes concerns that policymakers will look to inflate their way out of debt burdens—potentially to the benefit of commodities, which are often viewed as a hedge against unexpected inflation. The U.S. trade balance in petroleum is nearly flat, but the non-petroleum balance has deteriorated since the GFC. A more competitive (i.e., cheaper) dollar would be the market's way to normalize the U.S. trade deficit. Higher energy prices would also help if it means the U.S. returns to a positive petroleum trade balance.

The prospects for a weaker dollar over the next few years should in no way be interpreted as feeding misguided rhetoric pointing to the “demise of the dollar.” Currencies are proxies for geoeconomic power and the dollar reigns supreme. It is the dollar's reserve currency status that anchors the relationship with commodity prices. The dollar still garners a large share of central bank reserves, cross-border trade, and foreign exchange trading. Dollar status is also anchored in the size of the U.S. economy, inertia, financial institutional strength and alliances and partnerships. In contrast, it is worth noting that by these metrics, cryptocurrencies have very little fortitude other than the underlying technology.

How does the CIO view the current state of U.S.-China relations, and what are the potential market implications?

Economic and geopolitical frictions between the U.S. and China were a major concern in early 2020 at the onset of the coronavirus pandemic. Two years later, U.S.-China tensions remain intact and we see limited moves to reverse the restrictions imposed under the previous administration in the near term. With the underlying sources of division between the two countries set to persist, we see the bilateral rivalry of recent years continuing over the period ahead.

These recent hostilities have ostensibly been centered on trade and tariffs, but the fundamental conflict remains much broader. Crucially, China continues to close the gap with the U.S. economically. The difference in GDP between the two nations fell by close to 15% last year alone, and, on International Monetary Fund (IMF) projections, GDP in China is likely to overtake U.S. GDP by the end of the decade. China's military budget is still only one-third the size of U.S. defense spending, but this gap is also falling. And perhaps most important, China continues to make gains in its technological capacity across domains such as advanced computer processing, artificial intelligence, electric vehicles and biotechnology. This comes on top of geopolitical and diplomatic disputes across a range of areas from the status of Taiwan and Hong Kong to human rights in

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Western China, territorial claims in the South China Sea and Chinese industrial policy. We expect these differences to lead to further decoupling of the two economies in order to protect intellectual property and data security, as well as help to reduce supply chain interdependence particularly in the wake of the pandemic.

We do, however, expect the current U.S. administration to take a more strategic approach to its relations with China. The November UN COP26 climate summit, for example, produced a joint declaration between the countries, affirming their common commitment to reduce greenhouse emissions. And following this agreement, a virtual summit between President Biden and President Xi on November 15 reopened a bilateral dialogue across the key topics of diplomatic antagonism. Further talks could potentially form the basis for any future thawing in relations and avoidance of conflict.

We also expect the Biden administration to take a more multilateral approach to addressing its differences with China alongside allied markets in Europe and the Indo-Pacific (including closer collaboration with the other Quad nations of Japan, India and Australia), and to do more to compete with China rather than pursue protectionist policies. For investors, this implies that U.S. policy toward China should become less uncertain, with a lower drag on trade from the imposition of new tariffs. We also see greater potential for increased trade and investment flows to benefit U.S. partners in Asia such as India as economic and diplomatic ties are strengthened. A greater emphasis on competition rather than containment in next-generation technology is also likely to boost investment within the sector across both markets as they aim to become more self-sufficient. Alongside the underlying expansion of digital economic activity, this should also support post-pandemic growth in the technology sector over the longer term.

EQUITIES

What are the key metrics on the CIO's equity market checklist, and where might investors be concerned?

Aside from some choppiness over the last couple of months, equity markets have been on a steady grind higher this year. The S&P 500 has made 66 new all-time highs so far, the second greatest number of new highs in a year since 1950, only behind the 77 made in 1995. Despite a growing list of concerns, from coronavirus spikes to persistently high inflation, the trajectory for Equities in the year ahead should continue to track higher, with our market checklist presenting supportive conditions for stocks at least through the first half of next year.

Strong profit growth has accounted for a large portion of the equity market's year-to-date gains, and should continue to support positive returns into 2022. Earnings have surprised to the upside every quarter since the start of the pandemic, with results beating consensus estimates by 17% on average over the past six months, according to BofA Global Research. Concerns over whether earnings may peter out from here have been raised, but strong consumer demand highlighted by company management teams should fuel the profit cycle forward. Consensus expectations are at \$222 for S&P 500 earnings-per-share for next year, a growth rate of roughly 8% from this year.¹ But, if nominal GDP growth comes in at 8% to 9% next year, then earnings estimates will likely head higher, in our opinion. Operating margins have increased to 15% from 13.5% before the pandemic, despite supply chain disruptions, rising oil and commodity prices and increasing labor costs, with companies able to pass on some of the higher costs without curbing demand. However, it's likely that companies will see some margin pressure as they work through supply chain issues, but we expect these disruptions to fade over time and eventually give way to a period of inventory rebuild.

¹ Source: Factset. Data as of December 2, 2021.

Macro forces tell a similar story. Certain metrics, however, may be signaling a slight cool down from 2021 economic growth levels, but growth should continue to sit well above long-term averages as economic activity remains robust. Capex is expected to pick up in the year ahead, following massive underinvestment in the last decade. With more job openings than unemployed people and stagnant labor market engagement, companies will likely focus capex on building out their technological capabilities to improve productivity and support profit growth.

Confidence has been rattled a bit by the new coronavirus variant and rising inflation, but consumer balance sheets remain healthy. With lower policy uncertainty following the reappointment of Fed Chair Powell and broader booster shot eligibility, confidence could start to improve, especially if the macro environment remains positive into next year, a tailwind for greater equity allocation. The shape of the yield curve following a surge in short-term rates has also been a top concern, but a flattening curve is not necessarily bearish for stocks. Based on the last three curve cycles, the 2-year/10-year (2s/10s) curve took 65 months on average from peak spread to inversion. During those periods, the S&P 500 rose 106% on average, driven largely by the continued rise in earnings which grew an average of roughly 100% during the flattening process.² If it turns out that the 2s/10s curve peaked in March 2021 at 158 bps, then being only nine months out suggests an inversion could be further down the line.

In the near term, the fate of Equities will be tied to pandemic-related developments. The rise of another variant will likely create uncertainty related to regional restrictions, lower consumer confidence and corporate profits; and complicate the monetary policy outlook by creating further inflationary pressures. However, for now, our checklist suggests that a breakdown in the bull market is unlikely, given a strong fundamental backdrop; but also backed by more secular forces including a new equity culture building out. We continue to maintain an Equity overweight relative to Fixed Income and cash, and would consider any periods of short-term weakness as potential buying opportunities.

How does inflation effect the CIO's Equity positioning?

In our view, investors should consider positioning for persistent levels of headline inflation along with robust economic growth as we approach *The Great New Dawn*. Certain areas of the market may be especially primed to benefit amid this backdrop, including shorter-duration, dividend growth-oriented Equities with exposure to cyclical areas of the economy.

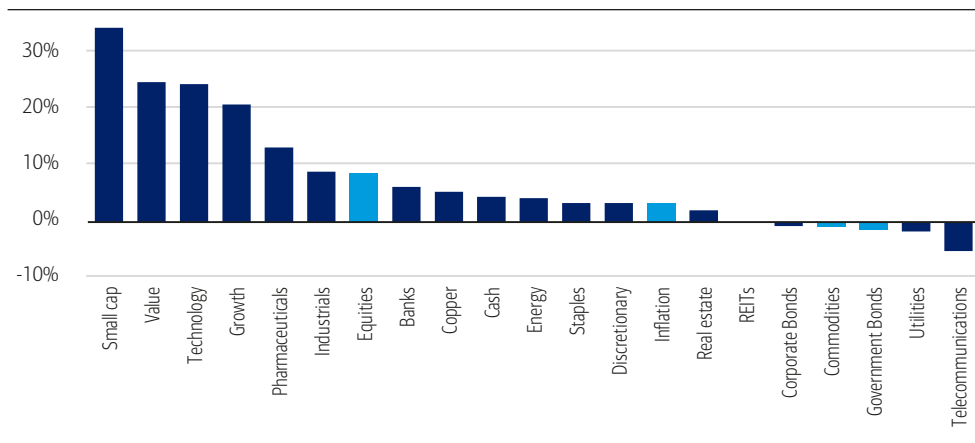
Elevated inflation paired with rising long-term interest rates should prompt investors to seek out Equities with short to medium durations, where cash flows are returned to investors more quickly through dividends and repurchases. This strategy may be more favorable than holding stocks whose values are tied largely to their terminal values, where an increase in the discount rate has a direct effect on a company's present value. In this sense, Value-oriented areas may be attractive.

Small-caps may also be poised to outperform, as they tend to have more exposure to cyclical areas that do well when the broader economy and inflation are strengthening—cyclical sectors make up about 46% of the S&P 600 Index, compared to 25% of the S&P 500 Index.³ Empirical Research found that Small-caps have a high positive correlation with changes in the five-year inflation breakeven rate and that their relative returns are currently over 50% correlated with changes in the Treasury bond yield, indicating that they may perform well amid rising interest rates and inflation. Small-cap and Value were the two top performers in the late-1960s, when inflation and interest rates started to rise on the back of large budget deficits and easy monetary policy (Exhibit 4).

² Source: Bloomberg. Data as of December 2021.

³ Source: Bloomberg. Data as of October 28, 2021. Refers to combined weightings of Financial, Industrial, Material, and Energy sectors.

Exhibit 4: Cross-asset and Equity sector annualized total returns, 1965-1968.



Source: BofA Global Research. Data as of March 11, 2021. **It is not possible to invest directly in an index. Past performance is no guarantee of future results. Please see index definitions at the end of this report.**

Research suggests that cyclical sectors tend to be the most highly correlated with CPI, with Energy and Financials having among the strongest relationships. Revenues for the Energy sector could get a boost from elevated energy prices, while Financials tend to benefit from a steeper yield curve. Sectors like Real Estate and Commodities could also get a tailwind, since they have direct exposure to underlying hard assets.

Additionally, selective areas of the equity market that offer higher quality and rising dividend payouts should perform better along with businesses which have pricing power and are less labor intensive. BofA Global Research found that if dividends grow at trend growth over the next 10 years, the difference between price return and total return could be equivalent to roughly 15% on the S&P 500 Index.

It is our view that we are moving into an environment characterized by persistent inflation and higher levels of economic growth, aka an inflationary boom. Amid this macroeconomic backdrop, investors should consider incorporating Value and Small-caps, with added emphasis on cyclical sectors, as part of a well balanced portfolio.

What are the CIO's current thoughts on Value vs. Growth?

While Growth should continue to benefit from accelerated secular trends, we see conditions coming together to support a cyclical and Value-driven Equity uptrend. These include higher levels of persistent inflation, rising global interest rates, further normalization in economic activity, and attractive relative valuations.

Economically sensitive areas of the market like Value could be favored as investors continue to digest signals that point to more persistent levels of inflation. The Institute for Supply Management (ISM) New Orders Index logged its 18th consecutive month of expansion in November, indicating that robust demand is likely to continue despite supply constraints. Meanwhile, the Consumer Price Index has been above 5% for six consecutive months and jumped to 6.8% on a year-over-year (YoY) basis in November.

These upticks in inflationary signals have also led to a pull forward of expectations of Fed interest rate hikes, with BofA Global Research now expecting the Fed to start raising rates in June 2022. As the pandemic-era wave of monetary stimulus continues to subside, Value-based sectors should be supported by a trend toward higher interest rates.

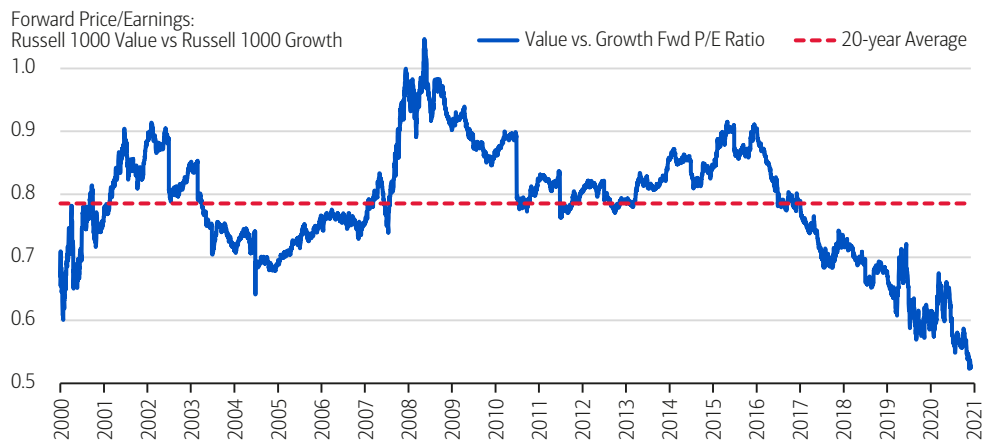
And despite the emergence of the Omicron variant and the Delta case growth having risen recently, we still see encouraging developments on the pandemic front that should help lead to further normalization in economic activity. Vaccination rates have risen

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in developed nations with potential improvement in emerging nations into 2022, and medical advances have progressed in the form of booster shots and the potential for antiviral pills. These developments should help support the release of pent-up consumer demand into the services side of the economy, providing a tailwind to cyclical and Value-oriented Equities.

Attractive relative valuations could also help further propel Value. Value stocks carry a forward price-to-earnings (P/E) ratio of 15.5x, far lower than Growth's 29.3x. Growth does typically trade at a higher multiple than Value, but that gap is stretched by historical standards, making Value appear relatively attractive (Exhibit 5).

Exhibit 5: Value remains historically attractive relative to Growth.



Source: Bloomberg. Data as of December 1, 2021.

In a portfolio context, we advise an appropriate balance between both Value and Growth within a long-term financial strategy. However, current economic conditions suggest that investors may want to consider emphasizing cyclical Value-oriented Equities over secular Growth-oriented Equities, where appropriate.

Is sentiment running too strong, and will it ultimately prove to be detrimental to the rally?

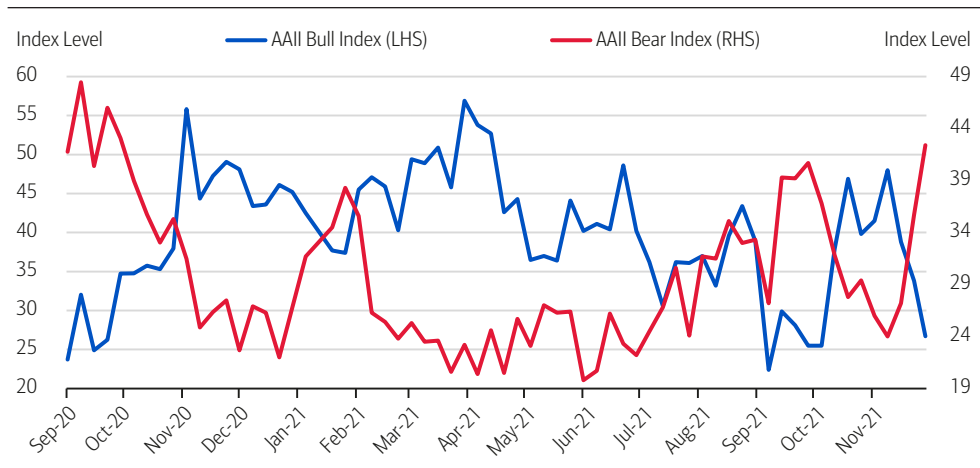
Having dipped amid a tumultuous September for markets, investor sentiment sharply rebounded alongside a comeback in U.S. Equities. But as we approach the end of the year, sentiment has moderated well below worryingly euphoric levels that could prove detrimental to the rally.

In the American Association of Individual Investors (AAII) December 1 sentiment survey, around 27% of voters expressed a bullish sentiment on the stock market for the next six months, dipping below its historical average. This figure is down from 48% three weeks prior, but up from its year-to-date low of 22% in September. Meanwhile, the percentage of voters expressing a bearish sentiment on the stock market has inched back above its historical average of 31% (Exhibit 6). BofA Global Research's Bull & Bear Indicator confirms stabilizing sentiment, with a recent neutral reading of 5.0⁴ inching away from the contrarian bearish territory. Additionally, cash on the sidelines still remains elevated from levels seen in both March 2009 and March 2020. Total assets parked in money market funds are currently \$4.6 trillion, higher by a trillion dollars since the end of 2019, and by \$110 billion this year.⁵ This may be one reason why market pullbacks have proven to be shallow and quickly bought up, especially by individual investors.

⁴ As of December 10, 2021. Indicator level of 0-2 = extreme bearish, 8-10 = extreme bullish.

⁵ Source: Bloomberg. Data as of December 2021.

Exhibit 6: Investor sentiment is well below euphoric levels.



Source: Bloomberg. Data as of December 1, 2021. (AAIL = American Association of Individual Investors.)

On the negative end, there are certain indicators that still signal investor complacency. Investors opened brokerage accounts during the pandemic at a historic pace and are using increasingly high amounts of leverage to buy securities, with investor margin debt reaching a record \$936 billion in October.⁶ The number of initial public offerings (IPOs) has also hit the highest level since the tech-bubble days, with many more non-earnings companies joining the public markets via traditional IPOs or through mergers with special purpose acquisition companies (SPACs).

When looking at equity markets from a technical perspective we continue to see the secular bull market, or multi-year upcycle for equities, that began in 2013 to remain intact as we look to 2022 and beyond. However, as a midterm presidential year, 2022 could mark a bump in the road of the secular bull for investors as the cyclical bull market that emerged off the March of 2020 market lows shows signs of maturing, according to BofA Global Research Technical Strategist Stephen Suttmeier. In the near term, individual investor sentiment data from the AAIL shows bears now outnumber bulls, a contrarian indicator. Markets tend to experience strong seasonality from November to March, so with sentiment showing investors remain skeptical, technicals point to markets continuing to climb the wall of worry early in the new year.

On balance, while sentiment is elevated from the lows seen earlier this year, current readings indicate a lack of euphoria among investors. In our view, this implies there could be further upside for stocks as the secular bull market moves forward.

What are the key catalysts for the markets in 2022?

The new year could see more market-moving events as economic activity further normalizes and as policymakers face the lagging effects of decisions made over the course of the pandemic. Investors should keep watch for catalysts that have the potential to contribute to higher levels of volatility. Despite these forces, we still believe the potential outcomes should ultimately play out in favor of staying invested in Equities.

With the Fed's removal of the word "transitory" from their inflation narrative, any additional upward inflation surprises could shift the central bank tone even further away from ultra-accommodative to more hawkish and translate into a more aggressive policy outlook. Central bankers continue to relay a consistent message that the Fed will slowly start to retire its accommodative policies starting with tapering of asset purchases. Even when the rate hiking cycle begins, the bull market should continue to march forward, although valuation expansion may be more limited. Based on previous hiking cycles,

⁶ Source: FINRA. Data as of November 30, 2021.

equities still managed to see double-digit returns 12-months out on average (Exhibit 7). In fact, the S&P 500 generally peaks far after the Fed starts hiking rates, peaking after 14 hikes in 2007 with the policy rate at 5.25% and after nine hikes in 2018 with the policy rate at 2.50%,⁷ whereas price-to-earnings multiples typically ended flat when comparing six months prior to six months after Fed tightening.⁸ Although if shareholder yields in the form of buybacks and dividends increase and continue to remain above the 10-year U.S. Treasury yield, valuations could be further supported. Cyclical areas of the market could potentially outperform in the interim, especially as investor positioning starts to reflect a rising bond yield environment. Funds globally are still underweight short duration stocks at a record level, according to BofA Global Research.

Stronger efforts to improve vaccination uptake could be a positive support for global economic expansion, even as countries contemplate local and travel restrictions amid a surge in cases and a new coronavirus variant. Any signs of another coronavirus wave underway globally would likely dampen investor confidence, though broad and effective booster shot programs could potentially level off some of the uncertainty. Reopenings so far have helped to lift global manufacturing activity. Any blips in consumer spending strength from renewed coronavirus fears, however, should be closely monitored.

A recovery in EMs, especially China, could be a surprise factor for investors in 2022. While EMs are still weighed down by the pandemic, and outside of China there is less capacity for stimulus, an economic acceleration and an improvement in investor confidence would set the global cycle up well. In this scenario, supply chain bottlenecks would likely ease as more factories come online, goods start to move around more efficiently and the dollar stays stable, taking the heat off tighter financial conditions.

Exhibit 7: Market returns and historical shifts in Fed policy.

S&P 500 and relative sector returns around start of Fed tightening

Average returns for past seven tightening cycles*

		-3 months	+3 months	+6 months	+12 months
	S&P 500	7.20%	0.30%	6.50%	10.90%
Relative to S&P 500	Energy	-0.40%	5.30%	4.90%	8.30%
	Materials	4.10%	1.60%	2.00%	-2.00%
	Industrials	3.10%	1.60%	0.30%	0.00%
	Consumer Discretionary	1.50%	0.40%	1.10%	-3.50%
	Consumer Staples	-0.40%	-5.80%	-5.30%	-8.10%
	Healthcare	-1.50%	0.00%	-1.80%	6.40%
	Financials	-0.50%	-3.10%	-5.10%	-3.80%
	Technology	1.50%	3.30%	6.80%	8.00%
	Telecommunications	-3.50%	-1.10%	-1.60%	-3.70%
	Utilities	-4.70%	-0.10%	-3.40%	-2.20%

Sources: Bloomberg, Chief Investment Office. Data as of April 2021. *Average returns for past seven tightening cycles around May 2013 "Taper Tantrum" and seven hiking cycles beginning August 1980, May 1983, December 1986, February 1994, June 1999, June 2004, December 2015. Sector returns shown relative to S&P 500. Performance in total return terms.

Past performance is no guarantee of future results.

What is the CIO's outlook for International Equities next year?

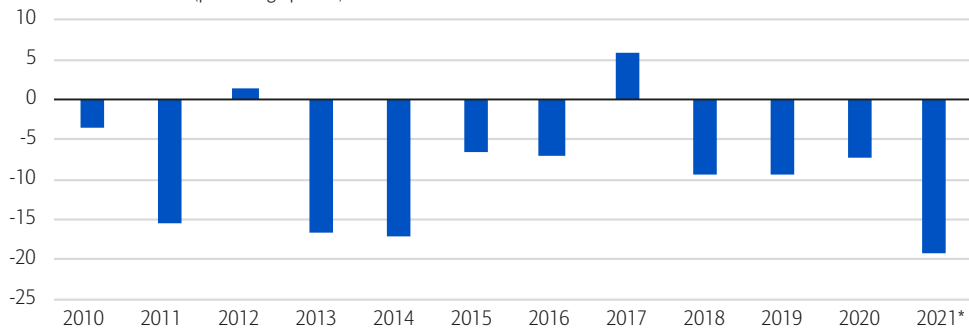
As of this past month-end, non-U.S. Equities are on course to underperform U.S. markets for a 10th year in the 12 years since 2009. During this decade-plus stretch, each of the major non-U.S. regions of Europe, Japan and emerging markets have registered similar cumulative price return deficits relative to the S&P 500 of 281 percentage points (ppts), 238 ppts and 287 ppts, according to Bloomberg, respectively. And this year has so far marked the single largest annual return difference over the period (Exhibit 8). As we now look ahead into 2022, it will be important for investors to consider whether this span of underperformance can extend further or whether it could begin to reverse.

⁷ Source: Evercore ISI. Data as of December 2021.

⁸ Source: Bloomberg. Data as of December 2021.

Exhibit 8: Non-U.S. Equities have underperformed the U.S. by the most in over 10 years.

Global ex-U.S. Equities vs. U.S. Equities
Price return differential (percentage points)



Source: Bloomberg. Data as of November 2021. *2021 as of November-end. U.S. Equities is represented by the S&P 500. Global ex-U.S. Equities is MSCI All-Country World ex-U.S. Index. **Past performance is no guarantee of future results.**

As the fundamental basis for corporate earnings, the outlook for nominal growth continues to favor the U.S. over most other major markets. Official estimates from the IMF project slower nominal GDP growth of 7.4% for the eurozone and 5.5% for Japan than the 8.1% forecast for the U.S. in 2022. And though emerging economies are projected to lead growth in global nominal GDP next year at 8.4%, the biggest driver of the group in China is set to post a significant slowdown due to local credit and regulatory tightening, slower residential construction and an ongoing structural shift away from fixed investment. At the same time, pockets of stress from runaway inflation are expected to cause a sharp deceleration in real activity within other major regional economies of emerging Europe, Middle East and Africa (EMEA), Turkey, Latin America and Brazil.

To the extent that supply chain bottlenecks eventually begin to moderate next year, manufacturing output could nonetheless receive a lift in key areas such as autos and machinery. And this would come as a source of support for more trade-dependent economies outside the U.S., such as Western Europe and emerging Asia, especially on the back of currency weakness across these regions in 2021. But the new risk from coronavirus variants could still shift the outlook here, with the potential to cause significant interruptions to output. This is likely to depend in part on local vaccination rates, which have moved ahead of the U.S. in Europe and Japan but which remain relatively low in many individual economies in the emerging world—particularly within lower-income countries.

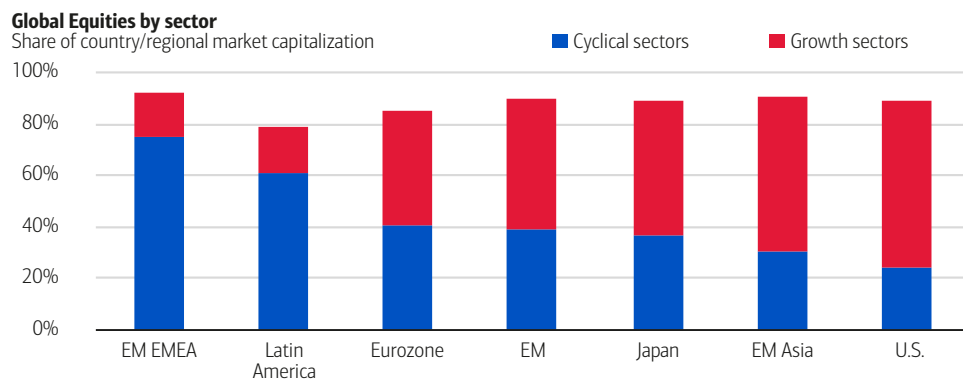
China's ongoing "zero-covid" strategy and the willingness of individual governments in Western Europe to reimpose new domestic restrictions could also be potential headwinds for local output into next year, while the risk of new travel controls would weigh disproportionately on countries in southeast Asia that are highly dependent on tourism and remittances. Emerging economic activity overall continues to be more vulnerable to new outbreaks given a rate of internet penetration (44%) that stands at close to half that of developed markets (87%), resulting in a lower capacity to sustain output levels with less in-person service activity.

At this stage, however, our central case remains for the reopening and recovery process to continue into 2022, and within non-U.S. markets this should remain a relative tailwind for those regions with larger exposure to cyclical sectors such as emerging EMEA (Exhibit 9). Over the longer term, an expanding digital economy in areas such as vehicle and industrial automation, internet retail and cloud services should also support growth markets such as information technology and the emerging Asia region, particularly as more countries look to increase their post-pandemic capacity for virtual activity. In

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China, for example, regulatory pressures may continue to weigh on areas of the market related to the consumer internet, but key industries such as semiconductors, robotics and biotechnology that are viewed as critical to the government’s aim of becoming a high-income, self-sufficient, innovation-driven economy should receive more official support as target areas for future growth. In Japan, technology has been by far the best-performing sector outside energy, and the biggest positives here are likely to remain its exposure to machinery and equipment for automation.

Exhibit 9: Regional exposure to cyclical sectors versus Growth sectors.



Source: MSCI. Data as of Q3 2021. Cyclical sectors are Materials, Energy, Industrials, Financials. Growth sectors are Information Technology, Consumer Discretionary, Healthcare, Communication Services. Shares based on MSCI country indexes.

The outlook for local monetary policy is also likely to influence returns for regions and sectors across non-U.S. markets next year. European Central Bank (ECB) asset purchases could slow in 2022 after the Pandemic Emergency Purchase Plan expires in March, but ECB quantitative easing of at least 20 billion euros per month will likely extend into 2023, with outright rate hikes unlikely until 2024. Credit spreads in the eurozone will also bear watching in the runup to the French presidential election in April given the risk posed by the potential rise of euroskeptic candidates. But interest rates across the major international developed markets are nonetheless likely to stay much lower than in the U.S., and this should remain a relative drag on European and Japanese financials compared to U.S. financials, which have fared much better in 2021. The outlook for rates may be most challenging for the highest inflation emerging economies of Brazil and Turkey, and this would only be compounded by any potential acceleration in tapering by the Fed.

On the valuation front, both price-to-earnings and price-to-book multiples remain well below their long-term averages for Europe, Japan and emerging markets compared to the U.S., which should help to enhance relative returns over time. But we still see a range of nearer-term hurdles for non-U.S. markets, particularly from nominal growth, local constraints from monetary, fiscal and regulatory policy, and risks to both domestic and external demand from any potential resumption of pandemic-related restrictions. These vulnerabilities keep us tactically neutral in both International Developed and EMs, and, despite closing in on yet another year of underperformance in non-U.S. Equities, we retain our preference for the U.S. market looking ahead into 2022.

FIXED INCOME

What does the CIO expect from the Fed next year, and how can the yield curve help interpret the potential effect of the Fed’s policies?

As we look to next year—with the caveat that markets are always uncertain—we feel there is significantly greater uncertainty for 2022 than there has been in 2021,

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particularly as to how the market reacts to monetary policy moves. The Fed seems to be increasingly concerned about high inflation. After initially starting the taper in November—after telegraphing it to the market for months, and at a more accelerated pace than the tapering in 2013–2014—Fed officials are already discussing potentially adjusting it at December’s meeting to be at an even-quicker pace. This relative quick change of plans—less than a month—was a large surprise to markets, which have been conditioned to expect a very patient and methodical Fed. With Fed Chair Powell’s renomination out of the way, a potentially accelerated taper, and Fed policymakers speaking out more aggressively about the threat of inflation, we believe we may see a more proactive rate hiking cycle start by the middle of next year, with the potential for three more hikes if inflation remains at elevated levels as we expect.

How the yield curve reacts will be telling. Generally, a steeper curve is a reliable signal that growth and inflation may accelerate, a flat curve is a sign that growth and inflation will be moderate and positive, while an inversion is usually a sign that a recession is a much higher probability. Both the 2-year/10-year curve (2s/10s) and the 10-year/30-year curve (10s/30s) are starting to indicate that the Fed may have to choose between its dual mandate—maximum employment and price stability—and sacrifice economic growth in order to tame inflation. From a peak of 158 bps, the 2s/10s curve has been almost cut in half, to 82 bps—a normal level, and not anywhere near concerning, but still significantly flatter. The 10s/30s curve, however, has dropped even more rapidly, from 86 bps to only 32 bps. While neither level is indicating a recession is likely, the trend is very notable, and 10s/30s in particular are certainly at levels signaling that economic growth may moderate significantly. If the curves continue on this trend—and particularly if we start to see inversions—then a recession in the medium term may be more likely, although this sign—even at this pace—would be several months away at least. Of note, when 10s/30s flattened to below 20 bps in 2018, that was a sign that the Fed was becoming too restrictive, and they eventually eased. We are seeing some significant flattening in certain parts of the yield curve (7s/10s) and minor inversions in others (20s/30s). While these are idiosyncratic—and some may be exacerbated more by liquidity concerns—they can often be precursors to more significant moves in parts of the curve that are more significant from an economic forecasting perspective. In our view, the verdict from the market, for now, is clear: the Fed is going to be more aggressive, and this will be the necessary and correct course to slow inflation but—at this point—the Fed does not need to induce a recession to slow the pace of inflation, and the recovery should continue. Call the yield curve—and ourselves—“cautiously optimistic,” but continue to watch this space.

How might municipal bonds fare in 2022?

We are bullish on munis from a fundamental perspective and neutral from a technical perspective. The credit outlook for munis is positive, thanks to:

- Higher state and local government income, sales, and property tax revenues, up 17.9% for the 12 months ending June 2021, according to the U.S. Census.
- Unprecedented federal support to states, local governments and public enterprises, through the Coronavirus Aid, Relief, and Economic Security Act (“CARES Act”), the American Rescue Plan Act of 2021 and the Infrastructure Investment and Jobs Act, totaling over \$1 trillion.
- Improved pension funding levels due to higher equity prices; average funding levels for the 100 largest U.S. public pensions rose to an estimated 85% June 30, 2021, from only 71% a year earlier, according to Milliman.

While fundamental conditions for munis should remain strong, we do expect some softening in the technical environment. Overall, technicals should remain supportive, just not as strong as they were in 2021.

- We expect modest growth in tax-exempt supply from new money bonds. While many state and local government issuers are flush with cash and may choose to fund capital expenditures from internal resources, some issuers with larger infrastructure needs will likely choose to leverage their federal stimulus funds by issuing tax-exempt bonds.
- There is likely to be a significant increase in taxable issuance, mainly from advance refundings, now that the reauthorization of tax-exempt advance refundings has been removed from the Build Back Better Act. However, increased taxable muni issuance should have little effect on tax-exempt valuations.
- We expect demand for munis to be solid, although likely not as strong as in 2021, when taxpayers were anticipating higher tax rates; initially proposed increases in the top individual and corporate tax rates were eliminated from the Build Back Better Act. The likely inclusion of a 5% surtax on individual income over \$10 million and an additional 3% surtax on income over \$25 million should have a positive effect on demand, but only a minor one, since it would apply to a relatively small number of taxpayers.
- Potential drags on muni demand could come from a new 15% alternative minimum tax on corporations, which hold nearly 25% of outstanding munis, as well as a lifting of the state and local tax (SALT) deduction cap, although a means-testing plan being considered in the U.S. Senate, if included in the final bill, would likely help mitigate this effect.

Given a strong fundamental backdrop, but more neutral technical conditions, we expect municipal bonds to continue to provide value for tax-sensitive investors, but probably not outperform as strongly as they did in 2021. We believe investors may be able to potentially enhance returns on their municipal bond portfolios by selectively increasing their exposure to mid-to-lower-rated credits.

MARKET STRATEGY

What's the CIO's outlook for Commodities?

For investors, there is a growing list of reasons to shore up strategic exposure to commodity prices heading into 2022. Supply-side shortcomings related to the coronavirus, bad weather and crop failures are short-term factors that may fade as tailwinds, but rising maritime-based geopolitical risk and positive commodity supply/demand dynamics related to decarbonization efforts appear to have staying power. A weaker dollar, potentially driven by valuations, could eventually emerge as an additional catalyst. At the same time, investor flows are revisiting the diversification benefits of Commodities. From a business cycle-timing perspective, Commodity allocations often exhibit relative outperformance versus stocks and bonds when the labor market is tight and inflation is bubbling over. Ultimately, we believe global growth anchors demand and is the most important factor to consider when allocating to Commodities, and that outlook is positive for 2022, in our view.

Business Cycle Positioning Supportive of Relative Performance

Historical analysis of business cycles suggests that Commodities could be entering a sweet spot of relative performance versus Equities and Fixed Income. Commodities tend to benefit on a relative basis from a more mature expansionary phase of the business cycle when the labor market is tight and capacity utilization and inflationary pressures are high. Central banks are often raising interest rates to ward off inflation when growth is peaking, favoring commodities over Fixed Income, which tends to struggle when interest rates are moving higher. And Equities tend to perform well early in a business-cycle expansion because they are discounting faster future growth. Indeed, Equities have been on a tear the last year and a half. Most importantly, Commodities as an asset class have tended to offer important diversification benefits at this stage of the cycle because various commodity investment strategies can benefit from the inflation that hurts other asset classes.

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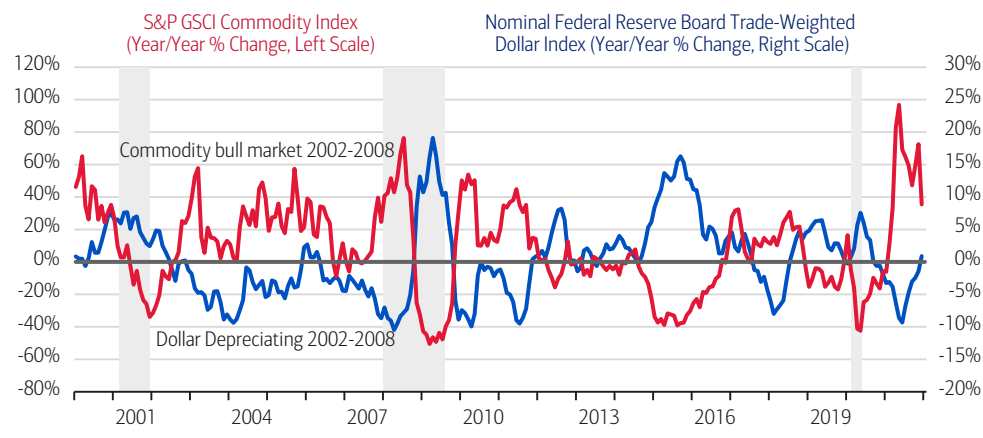
Global Growth Underpins Demand for Commodities

Fundamentally, two key drivers of commodities are global growth, which underpins demand, and the dollar. On the growth side, BofA Global Research expects solid real global growth of 4.2% even as the growth recovery in EMs lags. Across the globe, monetary policy is likely to remain accommodative even as the global monetary tightening cycle expands and accelerates. In aggregate, central bank balance sheets will likely still expand for the calendar year 2022, and fiscal stimulus is supportive of growth and demand for Commodities.

Dollar Is a Wild Card

The dollar outlook is a mixed bag, but it is worth noting that dollar weakness has historically been a tailwind for Commodities. The “super cycle” in commodity prices that began in 2002 and lasted until mid-2008 coincided with a weakening trend in the broad trade-weighted dollar. During that period, the Federal Reserve Board’s nominal broad trade-weighted dollar deteriorated at nearly a 5% annual pace, while the S&P GSCI Commodity Index appreciated at around a 30% annual rate before collapsing in the wake of the GFC. Importantly, a strong negative correlation between the YoY change in Commodities and the broad trade weighted dollar persisted even in the post-2012 environment when U.S. shale technology led to a ramping up of U.S. crude oil production and less reliance on imports (Exhibit 10).

Exhibit 10: The inverse dollar-Commodity relationship still holds.



Note: Gray bars indicate recessions. Sources: Standard & Poor’s; Federal Reserve Board/Haver Analytics. Data as of December 1, 2021.

While the U.S. dollar appears to have some near-term momentum from relatively strong growth and a more hawkish Fed, it could lose momentum over the next several years if risk appetites fade, global growth remains strong, and the valuation headwind (the dollar is expensive) features more prominently.

Commodities Increasingly Attractive For Diversification Benefits

Looking at additional factors for strong performance of Commodities, flows into Commodities and commodity funds are likely to continue to gain attractiveness as investors look to shore up strategic exposure to position for upside surprises to inflation. For investors, Commodities may offer a higher and more stable correlation to inflation relative to Equities and bonds, in our view. Cyclical Commodities like energy and industrial commodities tend to benefit in this environment.

Inflationary pressures are increasingly broad-based and accelerating in coronavirus-insensitive areas. In the U.S., the most recent personal consumption expenditures (PCE) data divided into coronavirus sensitive and insensitive components by the Federal

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Reserve Bank of San Francisco showed YoY coronavirus-insensitive inflation accelerating to 2.5%, up from 1.0% at the beginning of the year. BofA Global Research views inflation remaining high next year and the balance of risk of inflation surprising to the upside given the amount of monetary stimulus still in the system.

Shifting Geopolitical Backdrop Adds to Diversification Attractiveness

The end of the multidecade war in Afghanistan and the U.S. strategic shift toward Great Power Competition with China have important implications for investors' strategic and tactical exposure to Commodities as an asset class. In short, the battle for control of the seas associated with the U.S.-China rivalry has massive geo-economics implication. The vast majority of global trade (including Commodities) moves by sea, and ocean-based flows are central to the health of the global economy.

Maritime defense issues and macroeconomic supply chains overlap, and both the U.S. and China seek dominance, making conflict of all shapes and sizes more likely. This is already the case in the Western Pacific and is increasingly likely in waters closer to the U.S. as China's navy expands its reach. Ultimately this calls for diversification to hedge supply chain disruptions.

Risks and Positioning

Rising real interest rates are an often-cited risk to the performance of real assets like Commodities. We would not dismiss this risk, but real rates are set to remain below zero for some time. In the U.S., core PCE inflation is running over 4%, while the Fed has policy rates pinned near zero (a negative real rate of over 4%). By the Fed's forecasts, the terminal rate for the federal funds rate could be as low as 2.25% during this upcoming tightening cycle, implying a maximum real interest rate of near zero, assuming inflation comes back down near its 2% target. At that level, real rates are likely to remain very low.

In addition to higher real interest rates, additional risks associated with adding to Commodities in the current environment include weaker demand for metals related to a slowing real estate market in China and a surge in non-Organization of the Petroleum Exporting Countries (OPEC) energy supply (U.S. shale oil, for example). The latter seems constrained by capital discipline in the U.S. With respect to the growth outlook for China, BofA Global Research believes it will slow to 4.0% next year, below consensus expectations.

Positioning within Commodities could be important to mitigating these risks. Rising real interest rates would have the biggest effect on Commodities like gold because the price of gold is largely determined by speculation relative to other more fundamental Commodities. For this reason and others, BofA Global Research favors cyclical commodities (industrial commodities and Energy, for example) over gold.

How should investors think about active vs. passive investing going into next year?

Any discussion about active management should be nuanced and dependent on consideration for the entire investment process. Active management can be expressed in its simplest terms as a disciplined investment process designed to implement a strategic asset allocation that effectively helps to achieve future investment goals. A strategic asset allocation can potentially be enhanced by additional active decisions such as tactical asset allocation positing for near-term opportunities, short-term equity sector rotations, blending active versus passive investments, selecting investment strategies as well as security selection. Each decision contributes to the overall active risk—and overall active risk needs to be taken into consideration as opposed to only focusing on security selection. As we head into 2022, we believe it is more productive to implement and follow a tactical asset allocation and/or sector allocation process with the goal

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of capturing opportunities within a shorter six- to 12-month outlook, given some of the uncertainty that lies ahead with regard to inflation, Fed tapering and interest rate policies, new virus variants, U.S. mid-term elections, etc.

As far as security selection, as we head into 2022, we would expect a greater focus from investors on earnings growth as we move further away from the recovery phase and into the latter stages of the cycle. At the same time, the health crisis continues to ebb and flow, at times upsetting the progress of the cycle and creating more uncertainty. Both of these facets speak to a greater opportunity for active management to add value through their security selection. On the flip side, some of the relevant market metrics we examine, such as the dispersion in and the correlation of individual stock returns, tell a mixed story at best. Correlations remain at unremarkable levels, while dispersion had been quite high (generally favorable for active management) although it recently declined back toward average levels. While these metrics can reveal much about the current environment, they are not very predictive, and on balance we continue to favor active management but would complement that with passive investments.

How is the CIO thinking about positioning the Fixed Income portion of a total portfolio given projections for higher yields?

We continue to favor positioning for less sensitivity to movements in interest rates. This can be partially achieved through an underweight to Fixed Income relative to our strategic asset allocation, as we prefer to allocate our risk budget to Equities. Additionally, we prefer shorter than benchmark duration bias within our Fixed Income holdings. While yields have risen from the lows at the beginning of the pandemic, in March 2020, interest rates continue to remain historically low. There also is the prospect of waning policy support, as the Fed has taken its first steps toward peeling back its ultra-accommodative stance. Tapering began in November and that is likely to be followed up by the Fed beginning to raise interest rates next year. Finally, there's pervasive growth across all major economies and no indication that a recession is on the horizon, which should also help lead to a gradual rise in interest rates. We expect Fixed Income returns to remain challenged as we head into a higher inflation and higher interest rate regime. Of course there will be moments where risk-off sentiment comes back into the market and bond yields head lower. Such episodes will make our positioning appear contrarian in the short term, but in our view, this is the right type of exposure to have over the timeframe of our tactical calls, which are focused on the next 12 to 18 months.

In constructing portfolios for 2022, what are some of the key considerations to keep in mind?

We believe that portfolio investments can and should change over time, but the fundamentals of portfolio construction should not vary significantly from its core tenets. While 2022 might be more volatile than previous years due to rising inflation and interest rates, we suggest vigilance in portfolio construction discipline. Research has shown again and again that it is difficult to try to time the market. Missing just the 10 best days for the stock market in a decade has shown to significantly lower returns for that time period. By maintaining a diversified and balanced portfolio, it is easier to stay with the investment discipline. Portfolio rebalancing is recommended on a regular, but as needed basis, and not in reaction to any short-term market gyrations but with a view looking forward six to 12 months. However, staying the course does not mean inaction, and we will make changes to tactical positioning throughout the year as necessary, to be mindful of tracking error.

In a higher inflation, rising interest rate environment, how can Alternative Investments help in portfolio construction for qualified investors?

In a higher inflation, rising interest rate environment, there are several ways that AI for qualified investors can help in portfolio construction. After a very strong run since the recent market bottom in the spring of 2020, Equities have become richly valued.

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Shifting some pure beta exposure to a hedge equity strategy has substantial benefits. Not only does this alleviate choosing between Growth and Value (which have both done well and poorly at different times over the past 2 years), it helps to lower the volatility of the entire Equity exposure. As we have seen recently, equity volatility has increased substantially and this is a trend that will likely persist into 2022, in our view. The majority of our Equity Long/Short managers are fundamental stock-pickers that have the potential to take advantage of temporarily spikes in volatility. As the effect of pandemic-induced government stimulus abates, equity hedge fund managers are generally optimistic that company fundamentals should be a more significant driver of stock performance going forward. Such an environment should be conducive to alpha generation on both longs and shorts. Equity Hedge Funds tend to have a quality bias in their long books. At the start of an economic recovery, low quality stocks tend to lead the early stages of a rally but then underperform once the recovery peaks. Some managers believe we are entering this second phase where higher-quality stocks tend to outperform. If true, this could be a tailwind to equity hedge funds' alpha generation going forward.

An area that could pose a challenge for investors in portfolio construction is Fixed Income. If inflation does become a sustained issue, higher interest rates are likely to follow, and a traditional Fixed Income portfolio will not be able to provide the counter-balance to Equities that are the underpinnings of the standard 60/40 portfolio. For those investors that are qualified and can tolerate a less liquid structure, Private Credit offers an interesting alternative. Private Credit funds have stepped into the void, so to speak, that was left when financial institutions stepped back from providing loans to small and mid-cap companies. These types of loans are senior in the capital structure, carry a relatively high rate of interest, are generally floating rate and relatively short duration, with an average tenor of three to four years. While these loans have a higher credit risk than investment-grade Fixed Income, they have a lower default ratio than high yield bonds over the last several years. The credit risk may be somewhat mitigated by extensive research performed by the Credit Fund manager before making the investment. Returns are generally enhanced by the Fund by adding a small degree of leverage. For a qualified investor, that can assume a modest amount of credit, illiquidity and leverage risk, Private Credit funds have the potential to outperform a traditional Fixed Income portfolio in a rising interest rate environment.

How might the tax code change if pending legislation in Washington is passed?

The finish line is within sight, but like a marathon, the final stretch may be the hardest. After a protracted path to passing the president's Build Back Better (BBB) agenda, the House passed a slimmed-down version of the agenda on November 19. The House's BBB Bill (frequently referred to as a human infrastructure bill and a counterpart to the recently enacted Bipartisan Infrastructure Bill) has a price tag of about \$2.2 trillion, with revenue of about \$1.8 trillion to offset its cost. Revenue is derived, in large part, from \$814 billion in corporate tax changes, \$655 billion from individual tax changes and \$125 billion from an increase in IRS enforcement. If some, or all, of the temporary spending measures are renewed or made permanent, the cost is estimated to be far higher: approaching \$4 trillion.

The House's BBB Bill may receive more attention for what it excludes than for what it includes: Increases to marginal individual and corporate tax rates were eliminated along with capital gains rates, and changes to estate and gift tax laws, including gain recognition events at death, have all been jettisoned.

Just like a marathoner may "hit the wall" after an extended period of running, the BBB's long path to the finish line could see a similar fate in the Senate, as it needs to comply with budget reconciliation rules and an evenly divided chamber. The near certainty that all 50 Senate Republicans will oppose any version of the Bill will give every Senate Democrat veto power over the Bill. To be sure, the Bill will likely change in the Senate.

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Likely targets will be the elimination of the paid family leave provision, purging of the immigration provision (for failure to be within the scope of budget reconciliation rules) and a reworking of the state and local tax deduction cap (perhaps by means-testing the deduction for taxpayers). Another target is simply the overall cost of the Bill. This will put greater pressure on modifying the spending side of the Bill. In our view, the House's tax provisions are likely baked-in and modifications in the Senate could be minimal.

While the finish line appears within view, it is seemingly getting further away due to self-created hurdles placed in the way. Passage of the Bill, if at all, could easily slip into early 2022. Before resuming its race to the finish line, the Senate was distracted with three unrelated hurdles: (1) government funding that was set to expire early December—this was addressed early December and the government will remain funded until February 18, 2022, (2) addressing a defense policy bill—a compromise was reached mid-December and will clear the way for the President's signature and (3) lifting the looming cap on the government's ability to borrow (the so-called "debt ceiling")—this was addressed by the Senate in a novel two-step process which raised the debt ceiling by \$2.5 trillion and is expected to be signed by the President.

Here is a brief summary of tax changes in the House's BBB Bill (the Senate released its preliminary tax provisions, with limited modifications on several corporate provisions and no modifications to the individual provisions—however, the Senate has not yet voted on the reconciliation bill):

- Two-tier tax surcharge for high income taxpayers and trusts beginning in 2022: For individual taxpayers, a 5% surcharge would apply for all income in excess of \$10 million, and an additional 3% surcharge for income in excess of \$25 million. For trusts, the 5% surcharge would apply to all income in excess of \$200,000, and the 3% additional surcharge on income over \$500,000. Taxpayers could consider the merits of pulling income into 2021 to avoid the surtax in 2022 or subsequent years. Likewise, trusts could consider the same, but could also have the option in future years of making distributions to beneficiaries which could lower trust income below the surcharge thresholds.
- For high earning taxpayers (\$450,000 of income for married couples and \$400,000 for single taxpayers) with total retirement plan balances exceeding \$10 million, proposed new rules include: (1) limitations on additional IRA contributions, (2) mandatory withdrawals of 50% of the excess of total retirement account balances over \$10 million, and (3) mandatory withdrawals of all Roth accounts, if and to the extent that retirement balances are over \$20 million. These rules would be effective beginning in 2029.
- All taxpayers, regardless of income level, would be prohibited from converting after-tax amounts held in IRAs and employer sponsored plans to a Roth IRA or Roth 401(k), effectively eliminating so called "back-door" Roth conversions beginning in 2022.
- High-income taxpayers (again defined as \$450,000 of income for married couples and \$400,000 for single taxpayers) would be prohibited from converting tax deferred retirement accounts to Roth accounts beginning in 2032.
- Qualified small business stock provisions, which currently may permit taxpayers to exclude up to 100% of any realized gain from income (generally capped at \$10 million per taxpayer), would be limited to a 50% exclusion for taxpayers with \$400,000 or more of adjusted gross income. Trusts would be subject to this limitation regardless of income. If enacted, this would be effective for any sale occurring after September 13, 2021.
- A 3.8% surtax, which currently applies to net investment income, will also apply to active business income unless the business income is subject to FICA or self-employment taxes. This surtax would be assessed on single taxpayers with modified adjusted gross income exceeding \$400,000 and married taxpayers with modified adjusted gross income in excess of \$500,000, as well as trusts and estates with income over the top income tax bracket threshold (currently \$13,050). The expansion of the surtax to active business income would be effective beginning in 2022.

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- The limitation on deducting state and local taxes for federal income tax purposes would be increased from \$10,000 to \$80,000. The \$80,000 limit would be in effect from 2021 through 2030. For 2031 the limit would again be set at \$10,000, with all limits being eliminated from 2032 onward. For married taxpayers filing separately, as well as trusts and estates, the new limit would be set at \$40,000.
- Constructive sale rules, which seek to tax transactions as sales even if an asset is not disposed of, would be expanded to include digital assets, such as cryptocurrencies. Currently the constructive sale rules apply only to financial assets. This would be effective as of the date of the Bill's enactment.
- Wash sale rules, which prevent taxpayers from deducting a loss on the sale of a security that is purchased or repurchased within the 30 days prior to or after the sale, would be expanded to include several additional types of assets including cryptocurrency, foreign currency and certain commodities. This expanded application of the rule would apply beginning in 2022.
- Corporate marginal rates would remain the same, but a new alternative minimum tax would be imposed to the extent 15% of financial statement income exceeds the general corporate tax. This would commence in 2023 and would generally apply to businesses reporting over \$1 billion in book profits. This tax will fall primarily on entities with significant capex and companies for which stock-based compensation is a large share of their expenses. Small Cap stocks should largely be unaffected.
- An excise tax of 1% would be imposed on publicly traded corporations on the value of its stock that is repurchased (subject to several exclusions) during the taxable year commencing in 2022.
- Multinational corporations would be subject to an increase in taxes (Global Intangible Low-Taxed Income and Foreign-Derived Intangible Income) and a broadening of the tax base on which those taxes are computed beginning in 2023, among other more nuanced changes. This change would impact companies in certain sectors more than others, such as Technology and Pharmaceuticals.

What might outside investment managers rotate toward in 2022?

For domestic Equity managers, focus areas are heavily influenced by expectations of higher interest rates, higher taxes and peaking growth. With added concerns around high valuations, many fund managers seem to be focused on areas that offer secular growth or offer more value and income. Managers like less capex dependent areas of Technology. Strong demand for high speed data/telecommunications, digitization, automation/robotics is expected as more of the population work from home. Demand for healthcare should rise as patients resume on-premise treatments and progress in therapeutics continues. Beneficiaries of the infrastructure spending bill, including renewables, is another area of interest. The less sanguine managers believe Value stocks and dividend oriented stocks are strong valuation buffers and can offer greater total return potential with lower volatility, with dividend growth rates typically outpacing inflation.

For international equity managers, particularly with Growth investment styles, relative exposure to emerging Asia and off-benchmark positions in U.S. stocks will likely be continued sources of return dispersion within peer groups. Off-benchmark positions in U.S. stocks has been beneficial for international managers that have allowed themselves that flexibility to drift outside the geographic domicile mandate. China exposure—both for international and EM managers—will continue to be a market that cannot be ignored and after the challenging market environment of 2021 led managers to trim exposure, 2022 could see a pickup in interest.

How did the recent United Nations (UN) Climate Change Conference, known as COP26, demonstrate the important intersection of the environmental (E), social (S) and governance (G) of sustainable investing, and what could the outcomes and commitments mean for investors?

COP26 concluded with an agreement, adopted by nearly 200 countries, to speed up the timeline for addressing climate change in this “critical decade”. Negotiations in Glasgow ran into extra time, so it’s no surprise then that overall commitments appeared to fall short of the target of capping global temperatures from increasing more than 1.5 degrees Celsius. However, the Glasgow Climate Pact does mark important progress in some areas and potentially a new model of operation for the future. Here were the highlights:

- Countries are to revisit and strengthen their 2030 emissions-reduction targets by the end of 2022.
- The pact reiterated (and encouraged significantly increasing) a \$100 billion-per-year developed-country-financing commitment to aid developing countries in dealing with climate impacts.
- It urged those same nations to at least double their collective provision of climate finance to help developing nations mitigate and adapt to the effects of climate change.
- Financial institutions and the private sector are called on to enhance financial mobilization to deliver the scale of resources needed to achieve climate plans.
- A coalition of the willing saw meaningful commitments around methane reduction and deforestation, with 100 countries pledging to curb methane emissions by 30% by 2030, and world leaders representing 85% of the world’s forests pledging to stop and reverse deforestation.
- Coal power and inefficient fossil fuel subsidies will be phased down, a first for a climate agreement, yet a dilution of the initial proposal that called for the phasing out of unabated coal use.
- Discussions around agriculture were notably missing from the agenda, a critical issue that will need to be tackled in the coming years.
- The U.S. and China, the top two greenhouse-gas emitters, announced an unexpected agreement that declares an intent to take “concrete actions” on emissions reductions and limitations.

COP26 demonstrated clearly that governments cannot and will not succeed or act alone, and action lies increasingly in the hands of corporations. In our view, people will play a crucial role in the success of the agreement made in Glasgow and ultimately in the essential shift to a more sustainable planet, be it through holding companies to account for their emissions targets, insisting on broad implementation of climate-related financial disclosures, and identifying—and investing in—the opportunities associated with the path to net zero. As we recently noted,⁹ for investors we would expect clean energy and related materials, equipment and infrastructure to be the principal beneficiaries over the course of the 2020s and beyond, as companies and countries look to reach their net-zero targets.

Shareholder engagement saw an unprecedented year. How does this uptick in activity impact different sectors, and what do investors need to know?

In 2021, we’ve seen investor support for environmental and social shareholder resolutions reach unprecedented levels, an acceleration of a multi-year trend that had

⁹ Source: Chief Investment Office, Capital Market Outlook. Data as of November 1, 2021.

seen a series of small gains. With climate action being the driving force behind many of the resolutions, the Energy sector (and in general the largest greenhouse gas emitters) faced the most activity.

A shifting dynamic between shareholders and corporate leadership could be seen playing out through the proxy season, with shareholders more active in voting against company management. In turn, advocates of ESG resolutions have the potential for a greater platform and chance of success than in prior years, which we have already begun to see played out.

Large institutional investors in U.S. corporations became increasingly active on certain proxy ballot items, fueling voting momentum. Notably, more were in support of climate change proposals that were in alignment with the Paris Agreement goals set in place at COP21 back in 2015. This included pressing heavy emitters to set climate targets and report progress toward decarbonization, and net-zero, or transparency around climate related lobbying activities. The largest managers of index based funds may also continue to engage companies in alignment with stated ESG priorities of their firms as “universal owners,” which should include, but not be limited to, climate related matters; they will likely also span the breadth of issues under the umbrella of stakeholder capitalism, like companies’ impact on consumers, employees, and communities.

Consequently, the energy transition was front and center in the 2021 proxy season— notably, a U.S. oil and gas giant lost a number of board seats at the hands of a successful contest by a startup hedge fund that sought support from the three largest institutional shareholders in the company; meanwhile, several of the largest U.S. pension funds publicly backed the campaign. Elsewhere in the sector, its major competitors faced shareholder votes to take action on emissions reductions. This particular scenario was also notable in that it was not from the “usual suspects” of large activist investors and indicated a potential broadening population of shareholders rallying behind ESG-related causes.

The pressure for companies to be at the front of the energy transition—and to adequately manage the businesses most at risk—has become, and is likely to continue to be, a critical component of corporate governance. From a social perspective, the pandemic amplified focus on the labor force, be it how they are treated, the diversity and gender pay gap, or transparency around executive compensation. And from an ESG perspective, many shareholders are using engagement as a way to hold companies to account.

Yet many boards remain outliers when it comes to embracing sustainability, in part due to lack of expertise; a Harvard Business Review study¹¹ found that just a third of the Fortune 100 Boards of Directors reviewed had relevant ESG expertise, while Pricewaterhouse Coopers’ 2020 Annual Corporate Directors Survey found that only 38% of board members think ESG issues have a financial impact on a company.

In turn, boards may need to actively source members who understand the risks and opportunities of material ESG issues now and in the future, embed a sustainability strategy in the company’s business strategy, and provide transparent reporting—or it will probably soon be demanded of them by their shareholders. Boards will not only want to be diverse in gender and racial make-up, they will also want to integrate a third dimension of varied expertise and professional backgrounds. Indeed sustainable asset managers are using engagement as a lever for change. The landscape for shareholder engagement has pivoted, and companies need to keep pace.

By the numbers:¹⁰ Support across 171 shareholder-sponsored resolutions averaged 34%, around 5% higher than the previous record set in 2019. A record 36 resolutions earned majority support—including more than 20% of all environmental and social items voted on. Interestingly, the overall number of proposals voted on declined from 220 in 2017 to 171; this was due in part to the withdrawal of proposals prior to a vote as corporate management proved receptive to the policy changes. This was an indication of a transitioning landscape.

¹⁰ Reflects July 1, 2020 to June 30, 2021. Source: Morningstar, “The 2021 Proxy Season in Charts.” Data as of August 5, 2021.

¹¹ Source: Harvard Business Review, “Boards Are Obstructing ESG at Their Own Peril,” January 18, 2021.

Given a range of investment options, how should investors approach thematic investing opportunities?

For investors who are interested in having exposure to “future-oriented” investment ideas, exposure to thematic strategies can be an option. These are investments that typically cover themes such as electric vehicles or cybersecurity. These themes offer exposure to trends that reflect ESG and demographic dynamics.

It is important to keep a time horizon in mind for thematic investing. A typical time horizon for the tactical asset allocation views discussed elsewhere in this document is generally six to 12 months. But the time horizon for themes tends to be longer—they may need five years or longer to play out. As a result, day to day headlines are less relevant when assessing thematic portfolios.

Additionally, thematic strategies tend to have certain inherent biases such as being more growth oriented. Their growth sensitive nature is notable since conditions appear to be forming for a market that could favor cyclicals and Value. While this means that there could be challenges for thematic investments in the near term, it is important to keep in mind that thematic portfolios are usually designed for the long term.

From a portfolio perspective, we would use themes as a “satellite” within an equity exposure. Due to their “go almost anywhere” nature, thematic strategies tend to have higher tracking errors and wider performance swings versus the broader equity market, and as a result, are more appropriate as a complement to a diversified portfolio.

Glossary

Active management implies that a professional money manager is tracking the performance of a client's investment portfolio and regularly making buy, hold, and sell decisions about the assets in it. The goal of the active manager is to outperform the overall market.

Purchasing power parity (PPP) is a popular metric used by macroeconomic analysts that compares different countries' currencies through a "basket of goods" approach. PPP allows for economists to compare economic productivity and standards of living between countries.

Passive management mirrors the investment holdings of a particular index in order to achieve similar returns.

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.

Consumer Price Index (CPI) measures the average change in prices over time that consumers pay for a basket of goods and services.

Copper/Dow Jones Commodity Index is designed to track the copper market through futures contracts.

The Federal Reserve Board (FRB) Broad Trade-Weighted Dollar Index was created by the Fed to measure the value of the U.S. dollar, based on its competitiveness versus trading partners.

Government Bonds/ ICE BofA AAA U.S. Treasury/Agency Master Index tracks the performance of U.S. dollar denominated US Treasury and non-subordinated US agency debt issued in the US domestic market. Qualifying securities must have an investment grade rating (based on an average of Moody's, S&P and Fitch). In addition, qualifying securities must have at least one year remaining term to final maturity, at least 18 months to maturity at time of issuance, a fixed coupon schedule and a minimum amount outstanding of \$1 billion for sovereigns and \$250 million for agencies.

Growth/Russell 2000 Growth Total Return Index measures the performance of the broad growth segment of the U.S. equity universe. It includes those Russell 2000 companies with higher price-to-book ratios and higher forecasted growth values.

The Institute for Supply Management (ISM) New Orders Index—The ISM conducts a monthly survey to monitor changes in employment, production, inventories, supplier deliveries, and new orders. This is a monthly index that measures the number of participants who have reported increased customer orders compared to the previous month. An index reading of more than 50 indicates that the number of new orders has risen compared to the previous month.

The MSCI ACWI ex USA Index captures large and mid cap representation across 22 of 23 Developed Markets (DM) countries (excluding the U.S.) and 27 Emerging Markets countries. With 2,350 constituents, the index covers approximately 85% of the global equity opportunity set outside the US.

The Purchasing Managers' Index (PMI) is a measure of the prevailing direction of economic trends in manufacturing. The PMI is based on a monthly survey of supply chain managers across 19 industries, covering both upstream and downstream activity.

Real Estate Investment Trust (REIT)/Case-Shiller Index is made up of several indexes that track the value of single-family detached residences using the arms-length and repeat-sales methods.

The S&P 500 index includes a representative sample of 500 leading companies in leading industries of the U.S. economy. Although the index focuses on the large-cap segment of the market, with approximately 75% coverage of U.S. equities, it is also a proxy for the total U.S. stock market.

The S&P 600 Index includes a representative sample U.S.-based Small-cap stocks, tracking a broad range of small-sized public companies that meet specific liquidity and stability requirements.

S&P 500 Banks Sector Index comprises stocks in the S&P Total Market Index that are classified in the GICS asset management & custody banks, diversified banks, regional banks, other diversified financial services and thrifts & mortgage finance sub-industries.

S&P 500 Financials Sector Index seek to track major economic segments and are highly liquid benchmarks. Stock classifications are based on the Global Industry Classification Standard (GICS®). Capping is applied to ensure diversification among companies within each index.

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

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

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

S&P 500 Information Technology Sector Index comprises those companies included in the S&P 500 that are classified as members of the GICS® information technology sector.

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

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

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

S&P 500 Pharmaceutical Sector Index comprises discovery, development, and manufacture of drugs and medications (pharmaceuticals) by public and private organizations.

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

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

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

The S&P GSCI Commodity Index is a composite index of commodities that measures the performance of the commodities market. The index often serves as a benchmark for commodities investments.

Value/Russell 2000 Value Total Return Index measures the performance of the large-cap value segment of the U.S. equity universe. It includes those Russell 2000 companies with lower price-to-book ratios and lower expected growth values.

Important Disclosures

Opinions and market data are current as of December 14, 2021 unless otherwise specified.

Investing involves risk, including the possible loss of principal. Past performance is no guarantee of future results.

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Asset allocation, diversification and rebalancing do not ensure a profit or protect against loss in declining markets.

Dividend payments are not guaranteed, and are paid only when declared by an issuer's board of directors. The amount of a dividend payment, if any, can vary over time.

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. Small cap and mid cap companies pose special risks, including possible illiquidity and greater price volatility than funds consisting of larger, more established companies. 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. When interest rates go up, bond prices typically drop, and vice-versa. Bonds are subject to interest rate, inflation and credit risks. Municipal securities can be significantly affected by political changes as well as uncertainties in the municipal market related to taxation, legislative changes, or the rights of municipal security holders. Income from investing in municipal bonds is generally exempt from federal and state taxes for residents of the issuing state. While the interest income is tax-exempt, any capital gains distributed are taxable to the investor. Income for some investors may be subject to the Federal Alternative Minimum Tax. Investments in high-yield bonds (sometimes referred to as "junk bonds") offer the potential for high current income and attractive total return, but involves certain risks. Changes in economic conditions or other circumstances may adversely affect a junk bond issuer's ability to make principal and interest payments. Treasury bills are less volatile than longer-term fixed income securities and are guaranteed as to timely payment of principal and interest by the U.S. government. Mortgage-backed securities are subject to credit risk and the risk that the mortgages will be prepaid, so that portfolio management may be faced with replenishing the portfolio in a possibly disadvantageous interest rate environment. Investments in foreign securities (including ADRs) 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. Investments in real estate securities can be subject to fluctuations in the value of the underlying properties, the effect of economic conditions on real estate values, changes in interest rates, and risk related to renting properties, such as rental defaults. 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.

Impact investing and/or Environmental, Social and Governance (ESG) managers may take into consideration factors beyond traditional financial information to select securities, which could result in relative investment performance deviating from other strategies or broad market benchmarks, depending on whether such sectors or investments are in or out of favor in the market. Further, ESG strategies may rely on certain values based criteria to eliminate exposures found in similar strategies or broad market benchmarks, which could also result in relative investment performance deviating.

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Alternative investments are speculative and involve a high degree of risk.

Alternative investments are intended for qualified investors only. Alternative Investments such as derivatives, hedge funds, private equity funds, and funds of funds can result in higher return potential but also higher loss potential. Changes in economic conditions or other circumstances may adversely affect your investments. Before you invest in alternative investments, you should consider your overall financial situation, how much money you have to invest, your need for liquidity, and your tolerance for risk.

Nonfinancial assets, such as closely-held businesses, real estate, oil, gas and mineral properties, and timber, farm and ranch land, are complex in nature and involve risks including total loss of value. Special risk considerations include natural events (for example, earthquakes or fires), complex tax considerations, and lack of liquidity. Nonfinancial assets are not appropriate for all investors. Always consult with your independent attorney, tax advisor, investment manager, and insurance agent for final recommendations and before changing or implementing any financial, tax, or estate planning strategy.

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