MERRILL
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CHIEF INVESTMENT OFFICE

Investment Strategy Overview — Executive Summary

Over The Bridge to the Other Side

April 2020

To put it bluntly, for April and potentially the month of May market and economic activity are more than likely to exhibit some of the sharpest downswings in history as the economic shutdown measures due to the coronavirus take full effect. This is to be expected. In addition, the health data is likely to continue to show a significant rise in infection cases given the uptick in testing and the fact that we are still in the data catch-up phase with the aggressive social distancing and shutdown measures. Moreover, more states and cities are expected to show new outbreaks while others begin to crest.

This should confirm our overall view that science is what gets us back to the "new normal." Therefore, as we wait for the pandemic curve to flatten the economic numbers are more than certain to exhibit record levels of contraction. We believe the markets ultimately look through the economic abyss and take their full cue from the health data (both the curve and advancements of testing and treatments).

Given this, with all the talk about the shape of the market and economic recoveries it is important to understand that each crisis has different components even if the data regarding economic contractions and/or market volatility appears to be similar. Various crises produce a number of different responses from facilities/programs designed to address liquidity to stimulus bills passed into law to support the economy or even, as we all are experiencing now, aid packages produced to provide relief regarding individual cash flow needs and/or questions over solvency. Over the course of history there have been a number of different playbooks to address the situation at hand. The current situation has a third element to it that is a significant unknown, exogenous shock—a health crisis. As we have all been witnessing, the liquidity and economic playbooks of times past did not include today's most important element—a playbook for the war on the coronavirus.

The health crisis playbook is not only likely to take more time and effort, but a long-standing, strong public/private partnership with a significant investment across the entire healthcare spectrum. St. Louis Federal Reserve (Fed) President James Bullard described the aid package, basically, as pandemic relief and a massive "investment in humanity" rather than comparing it to previous policy packages driven by structural recessions or depressions. While the public and private sectors continue to do what is necessary to control and combat the virus and, hopefully, help cure this virus, we want to outline the inner workings of the financial and economic responses that have been released. We also outline the potential portfolio adjustments, including rebalancing strategies, that investors should consider through the bottoming process and into the path of recovery. As we have discussed recently we believe there are five signs that we should watch to better assess the length and ultimate level and stability of the bottoming process in markets, which are laid out in the following table.

We hope the insights that follow provide a better understanding of the past few weeks and, more importantly, the potential paths in the months and year ahead across a variety of areas. As we experience the "valley, travel over the bridge, to the other side, and on our way to the new frontier" we do this with an understanding that there is strength in numbers and strength in society.

Christopher Hyzy
Chief Investment Officer

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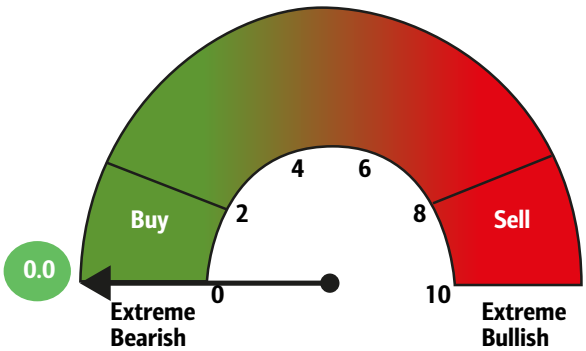
Exhibit 1: Our Five Signs of a Market Bottom

Signs	Description	Metrics to Watch	Current Status
1. Capital Flows More Freely	We are watching for signs of credit improvement and liquidity in the daily funding markets, which is being supported by the various facilities put in place by the Federal Reserve and Treasury Department.	Bond issuance and fund flows activity, across investment grade, municipal bonds and high yield.	Investment grade issuance has improved dramatically compared to earlier in the year, reaching a record $260.7B in March. Outflows have generally continued.
2. Stock/Bond Correlations Normalize	We need to see the relationship between bonds and stocks shift back to a somewhat normal inverse relationship. This will allow investors to manage risk in their portfolios more effectively by diversifying across asset classes.	Correlations between broad equity and bond market indexes (e.g. the correlation between the S&P 500 and the 10-Year Treasury Yield).	Bond yields are beginning to return to normal, as equity prices move in the opposite direction of bond prices.
3. Volatility Recedes on Down Days	We need to see the volatility recede when the markets are experiencing down days.	Chicago Board Options Exchange's (CBOE) Volatility Index (VIX) MOVE Index Daily/weekly equity and fixed income index price swings	Market volatility has fallen about 40% from record highs. Importantly, there has been a generally consistent downward trend on up days and even on some down days.
4. U.S. Dollar Starts to Weaken	A stronger dollar is a symptom of global financial stress and deflationary forces. Persistent dollar weakness could be confirmation that deflationary forces and funding pressures are abating and global growth is making a turn.	Bloomberg Dollar Spot Index	The dollar has started to show signs of peaking, falling by 4.1% for the week ending March 27 but still remains near an all-time high.
5. Markets Ignore Bad News Flow	Poor news flow regarding the virus and the overall economy/corporate profits needs to begin to be ignored by the broader market. This could start to happen once the number of new cases peaks.	The number of new coronavirus cases in the U.S. and globally including Italy, Spain and others.	The number of new cases in the U.S. and parts of Europe have continued to increase at a fast pace, while China's rate of new cases has slowed substantially.

Source: Chief Investment Office. Data as of April 2, 2020.

In the past week, we have witnessed many of these signs already working their way through the capital markets. Most of the fixed income markets are functioning again as liquidity has been injected into the system at unprecedented levels while credit spreads have narrowed in key areas outside of high yield. The stock to bond relationship has returned to a more normal one in which equity prices move in the opposite direction of bond prices. Equity volatility has not only receded from record high levels, it has also begun to decline slightly in down markets during the past week. And as the new foreign exchange swap line facility opened up to more central banks outside the U.S. and the $2 trillion relief package was moving through Congress, the U.S. dollar began to crest and roll over. We will need to experience a consistent move lower as the realization of reflation takes hold, in our view. Finally, there have been limited instances in which bad news flow was ignored by the markets, one example being the record spike in unemployment claims, but this is an area that is likely to remain sporadic, especially given the fluidity of the data regarding the coronavirus and the expected very sharp contraction in Q2 economic numbers yet to be released. Combine these five signs with one of the more telling investor positioning gauges, the BofA Global Research Bull & Bear Indicator, which is at 0, the maximum bearish level on a scale of 0-10, and we are encouraged that the bottoming process is already underway with both fixed income and equity markets stabilizing at improved levels relative to the first half of March.

Exhibit 2: BofA Bull & Bear Indicator (scale 0-10)



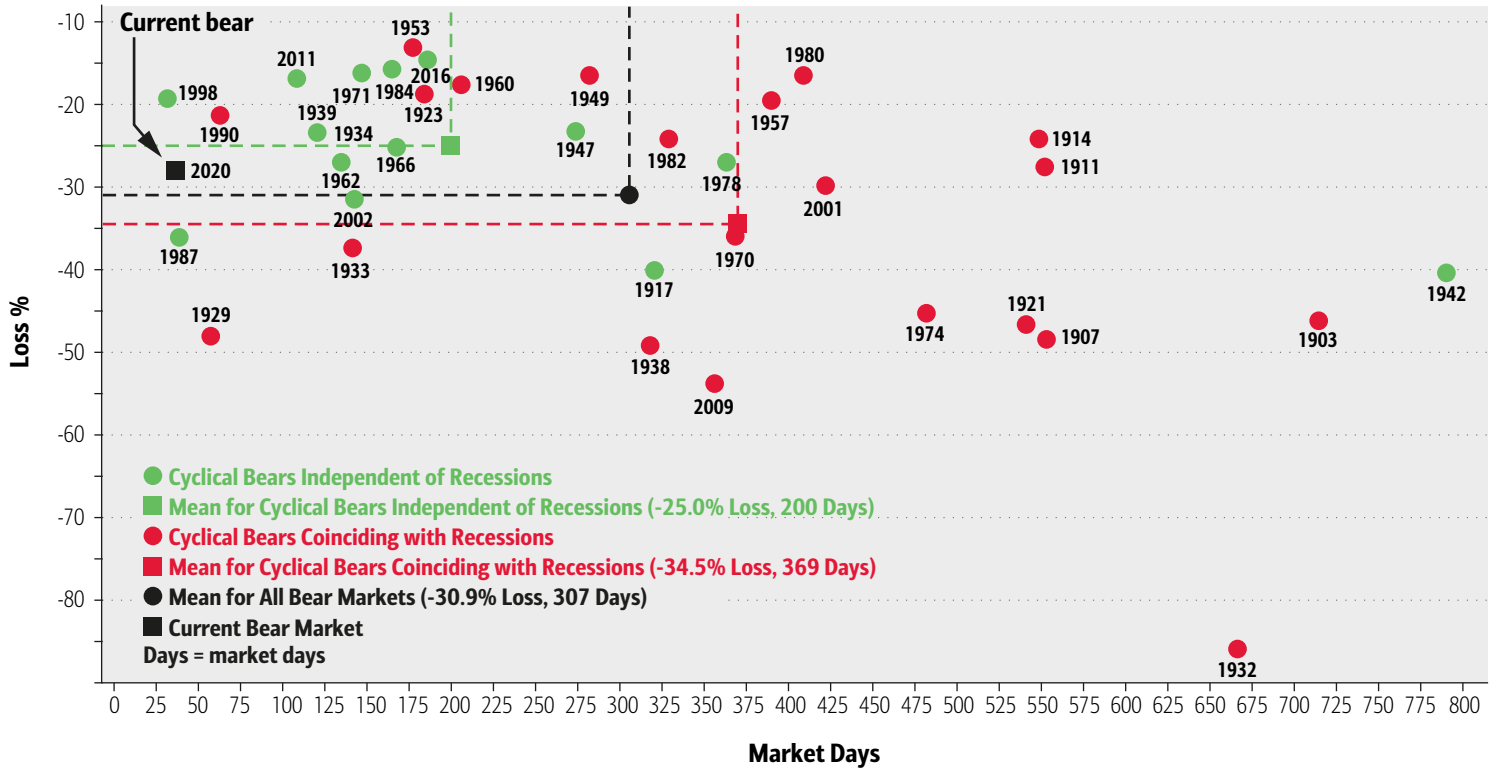
Components of BofA Bull & Bear Indicator

Components	Percentile	Sentiment
Hedge fund positioning	26%	Bearish
Credit mkt technicals	3%	V Bearish
Equity market breadth	5%	V. Bearish
Equity flows	42%	Neutral
Bond flows	2%	V. Bearish
Long-only positioning	29%	Bearish

Source: BofA Global Investment Strategy. Data as of April 2, 2020. The indicator identified above as the BofA Bull & Bear Indicator is intended to be an indicative metric only and may not be used for reference purposes or as a measure of performance for any financial instrument or contract, or otherwise relied upon by third parties for any other purpose, without the prior written consent of BofA Global Research. This indicator was not created to act as a benchmark.

Furthermore, we also believe it is important to understand the various types of bear market and, finally, the potential shapes of the recoveries. There are three main types of bear market structures and declines, in our view. Each has different components, reaction functions, and recovery speeds and shapes. The three are Structural, Cyclical and Exogenous Shocks. Briefly stated, the most common types of bear market are structural and cyclical. A structural bear market generally unfolds as significant imbalances have been built up and leverage is high (e.g., the Great Financial Crisis of 2008–2009). Policy responses are designed to help improve liquidity and solvency in some cases, which can take longer to pull through than expected. Cyclical bear markets (e.g., the dot-com bubble of 2000–2001) are generally due to some sort of policy error such as raising rates too quickly or too sharply, or instituting a new "growth" tax on the economy. These types of bear market tend to work in conjunction with recessions and have traditionally fallen on a median basis by some 34% from their peaks, according to Bloomberg data, before stabilizing and eventually recovering as central bank policy reverses. Lastly, an exogenous shock bear market like the current coronavirus crisis (secondarily the present oil price war shock) can generally occur without notice and with sharp force, include "unknowns," and be not as protracted, rather sharp, deep and most likely shorter than grizzly structural bear markets, given the enormous policy responses that usually develop and due to the health of the economy going into shock.

Exhibit 3: The 2020 Bear Market Compared to Cyclical Bear Markets



Sources: S&P Dow Jones Indices, Ned Davis Research Calculations. Data as of April 1, 2020.

We believe the current double exogenous shock has shifted from Phase I—liquidity concerns—to Phase II, which we characterize as the bridge period, in which relief packages are designed to plug the gap or buffer the resulting sharp contraction in the economy. Economic data during this period is likely to continue to be sharply negative given its "shock" nature, especially due to the unknown duration, at this point, of the health crisis. At this time we expect the markets to take their cue from the aforementioned five signs of a market bottoming process. We believe rebalancing portfolios during this phase as the bottoming process materializes (currently underway) makes sense and helps to adjust portfolios back to strategic and/or tactical asset

allocation targets. Current rebalancing strategies may include dollar cost averaging plans that re-risk a set amount over a set time frame. They may also incorporate combination strategies (rebalance back to targets but don't necessarily include set increments and/or time) that re-risk based upon the capital market activity that unfolds in the early phases as the business cycle matures and the profit cycle bottoms.

Phase III then becomes the "other side" of the bridge, which could also entail strategies to re-position portfolios given new data materializes. This phase includes a potential recovery that slowly unfolds with the consumer starting out tentatively as the workforce comes back online in stages and, possibly, in rolling geographies before the full pent-up demand takes over. The pent-up demand stage, in our opinion, is Phase IV, which involves a more robust economy and a profit cycle that climbs back to previous levels. Finally, Phase V is years away, in our view, but it is the beginning of the "new frontier" (the newly adjusted economy and consumer and business behaviors).

Exhibit 4: Our Five Phases of the Workout Process from an Exogenous Shock

Phase	Timeframe	Description
Phase I: The Liquidity Phase	March/April 2020	Unprecedented liquidity facilities put in place to stabilize capital markets, covering Money Market Funds, Commercial Paper, Asset Backed Securities, Corporate/Municipal securities and others. Total liquidity injections could total $2T (approx. 10% of gross domestic product [GDP]). The Fed's balance sheet has already risen by about $1.6T over the past month.
Phase II: The Bridge or Economic Buffer Period	Q2 and Q3 2020	Relief package known as Coronavirus Aid, Relief, and Economic Security Act ("CARES Act") of some $2T, including household payments, small business relief, support for state/local governments and corporations at its core. Policymakers are likely to consider additional measures as necessary. The fiscal stimulus measures announced around the world over the past two months add up to $5T, which represents 5.8% of global GDP; focus on the healthcare system, low-income workers, paid sick leave, small businesses and corporations.
Phase III: The Other Side	Q4 into 2021	After an initial snap-back from a numbers perspective a more tentative "social" entrance back into the economy creates an expected U-shape economic recovery and markets climb the wall of worry. Forecast U.S. real economic growth of 30% and 6.1% in Q4 and 2021 respectively.
Phase IV: The Pent Up Demand Cycle	2021–2022	Economic growth builds and gathers momentum as pent up demand builds and is released and the tentative social nature fades a little. Positive news regarding virus treatments and vaccines could accelerate.
Phase V: The New Frontier	2022–2025	A new frontier builds as new behaviors cement themselves into daily consumer and business life. New industries are born and innovation accelerates into high gear. Expect an increase in healthcare spending, especially outside the U.S., and changes to global supply chains including the drug supply chains. Also expect a boost to everything "E": e-health, e-sports, e-groceries, e-learning, e-finance, e-entertainment. Also automation and robotics.

Sources: Chief Investment Office; BofA Global Research; Cornerstone Macro. Data as of April 2, 2020. The economic and market forecasts presented are for informational purposes as of the date of this report. Economic or financial forecasts are inherently limited and should not be relied on as indicators of future investment performance.

Moreover, there have been many discussions about the potential shape of the economic and/or market recovery. The BofA Global Research recently described the expected economic recovery as U-shaped due to the "saucer" turn beginning in Q3/Q4 2020 and into 2021 as consumers and businesses will likely increase spending cautiously. Economic shapes can be very different than market recovery shapes given the "discounting" nature of the capital markets. In fact, a recovery in "the numbers," particularly after such a deep contraction as we expect, could resemble a V simply because of how the numbers shake out. For example, the BofA Global Research is forecasting -6% GDP for 2020 and a +6% GDP growth for 2021. This is in effect a V in numbers over a 12-month timeframe. However, the path is different. The path is more like a U-shaped recovery due to the impact on behavioral tendencies of the consumer and how, and in what way, they come back into the broader economy.

Therefore, it is possible that a U-shaped economic recovery can include a V-shaped market recovery well beforehand. Many market participants have been signaling this in the past few weeks. In our view, the market recovery path or shape is more akin to a square root type of shape but with a W bottom. Without getting too detailed in this regard we expect a "sawtooth" equity market path with an upward bias in time as the five signs mature and the first three to four phases evolve.

Our portfolio strategy has been rebalanced (re-risked upward in equities and lower in duration in fixed income where appropriate) back to our tactical targets from earlier this year. We believe investors should consider this strategy through the bottoming process if portfolios are below pre-determined targets. Maintain high levels of diversification as an anchor in a core multi-asset class approach and consider more active management* given the still high levels of volatility.

Our preferences remain the U.S. relative to the rest of the world (both developed international and emerging markets [EMs]), and large caps and higher quality exposure across asset classes in general. Current equity yields are more attractive than bond yields. We have lower-than-benchmark duration in fixed income and view investment grade credit as attractive and Treasury exposure as still a "ballast" in portfolios against equity volatility.

Two additional points. When oil prices ultimately trough, the secular low in inflation expectations could be upon us. Therefore, a portfolio strategy shift (increase inflation hedges, real assets, increase in EMs) may be appropriate at a later date in the future. Alternatively, if rates stay low for a lot longer than expected, with short-end yields marginally higher than the zero line if not slightly negative, then free cash flow yield (Technology and Healthcare sectors mainly) and high-quality dividend yield in equities should be rising further in demand, in our view. Investors are likely interested in hearing about the "deflation versus inflation debate" in the years ahead. The Fed has told us that they plan to be aggressive and that they understand the need to establish more assertive efforts to get inflation up to enough over their inflation target. Simply put, they do not want to follow the same path as Japan or Europe. This realization and whether or not the Fed sticks to inflation targeted policies is likely to drive portfolio decisions (specifically - the stock versus bond trade off) for years to come, in our opinion.

What are some of the risk factors that could delay or alter our expectations for a recovery and eventual move through the phases?

- The pandemic curve continues to steepen well into Q3, or consumer behavior remains cautious coming out of the crisis, hampering the service sector and stalling our expected economic recovery;
- A potential deep credit default cycle develops starting with the energy sector given the collapse in oil prices as well as some targeted consumer-based areas that rely on entertainment, travel, leisure and off-line retail spending;
- Lack of a large enough and coordinated fiscal plan in Europe leads to another sovereign debt crisis with Italy in focus;
- The U.S. dollar experiences an unexpected large decline as global investors question the U.S. fiscal standing; and
- Lack of virus containment in vulnerable developing countries with weak healthcare systems and crowded populations leads to funding crises and inability to prevent seasonality of the disease.

None of these risk factors are included directly in our base case but we will be watching for any new developments. It is difficult to parse through and the data remains fluid at this point but the most important factor to determine the ultimate strength and sharpness of the recovery remains the overall control and management of the virus.

We hope these insights provide a better understanding of the past few weeks and, more importantly, the potential paths in the months and year ahead across a variety of areas. As we experience the "valley, travel over the bridge, to the other side, and on our way to the new frontier" we do this with an understanding that there is strength in numbers and strength in society.

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

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.

The **S&P 500** 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 market.

The **Bloomberg Dollar Spot Index** tracks the performance of a basket of leading global currencies versus the U.S. dollar. The index represents both developed and emerging market currencies that have the highest liquidity in the currency markets and the biggest trade flows with the U.S.

The **Chicago Board Options Exchange's (CBOE) Volatility Index (VIX)** is a market index that represents the market's expectation of 30-day forward-looking volatility. Derived from the price inputs of the S&P 500 index options, it provides a measure of market risk and investors' sentiments.

The **FTSE MIB Index** measures the performance of 40 Italian equities and seeks to replicate the broad sector weights of the Italian stock market. The Index is derived from the universe of stocks trading on the Borsa Italiana (BIt) main equity market.

The **Korea Composite Stock Price Index (KOSPI)** is an index of all common stocks traded on the Stock Market Division. It is calculated based on market capitalization.

The **Merrill Lynch Option Volatility Estimate (MOVE) Index** is a well-recognized measure of U.S. interest rate volatility that tracks the movement in U.S. Treasury yield volatility implied by current prices of one-month over-the-counter options on 2-year, 5-year, 10-year and 30-year Treasuries.

The **Nikkei 225** is the leading index of Japanese stocks. It is a price-weighted index composed of Japan's top 225 blue-chip companies traded on the Tokyo Stock Exchange.

China's composite **Purchasing Managers Index (PMI)** is calculated by the Chinese government using the results of a monthly survey of purchasing managers. The index is intended to capture the prevailing direction of economic trends in the manufacturing and service sectors. The purpose of the PMI is to provide information about current and future business conditions to corporate executives, analysts, and investors.

The **Shanghai Composite Index** is a market composite made up of all the A-shares and B-shares that trade on the Shanghai Stock Exchange. The index provides a broad overview of the performance of companies listed on the Shanghai exchange.

The **STOXX Europe 600 Index** represents 600 large, mid and small capitalization companies across 17 countries of the European region: Austria, Belgium, Denmark, Finland, France, Germany, Ireland, Italy, Luxembourg, the Netherlands, Norway, Poland, Portugal, Spain, Sweden, Switzerland and the United Kingdom.

The **Taiwan Stock Exchange Weighted Index** is comprised of companies traded on the Taiwan Stock Exchange (TWSE). The TSEC weighted index is made up of all the stocks in the Taiwan Stock Exchange and each is given a weight based on its market capitalization.

Important Disclosures

Opinions and market data are current as of April 6, 2020 unless otherwise specified.

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