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CHIEF INVESTMENT OFFICE

Capital Market Outlook

August 31, 2020

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

IN THIS ISSUE:

- **Macro Strategy**—The Federal Reserve (FED) is doubling down on their 2% inflation target utilizing an average inflation targeting framework. What does this mean and what are key takeaways for investors?
- **Global Market View**—There is no shortage of verbiage on the presidential elections so rather than adding to the chatter, and in the spirit that "a picture is worth a thousand words," we've pointed to the exhibits that speak volumes about markets and presidential elections.
- **Thought of the Week**—Second quarter gross domestic product (GDP) results have now been released for most major countries around the world. The data confirm an expected trend: In general, countries more exposed to tourism suffered greater economic declines during Q2. The European economies of Spain, Portugal, France, Austria and Italy all rely heavily on tourism as a percent of GDP and, as a result, have been more severely affected by border closings, government shutdowns or social distancing measures.
- **Portfolio Considerations**—Global growth continues to grind higher. In August, we upgraded International Developed equities, specifically Europe, to neutral as macro conditions have solidified, and structural progress toward a fiscal union is viewed as positive by reducing the magnitude of the U.S. Large-cap overweight. In addition, we took that opportunity to actively rebalance portfolios back to tactical targets given substantial drift over recent months.

MACRO STRATEGY

Chief Investment Office Macro Strategy Team

GLOBAL MARKET VIEW

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

Lauren J. Sanfilippo
Vice President and Market Strategy Analyst

THOUGHT OF THE WEEK

Kathryn C. McDonald, CFA®
Vice President and Market Strategy Analyst

Data as of 8/31/2020, and subject to change.

MACRO STRATEGY

Anchors Aweigh

Jonathan W. Kozy, Director and Senior Macro Strategy Analyst

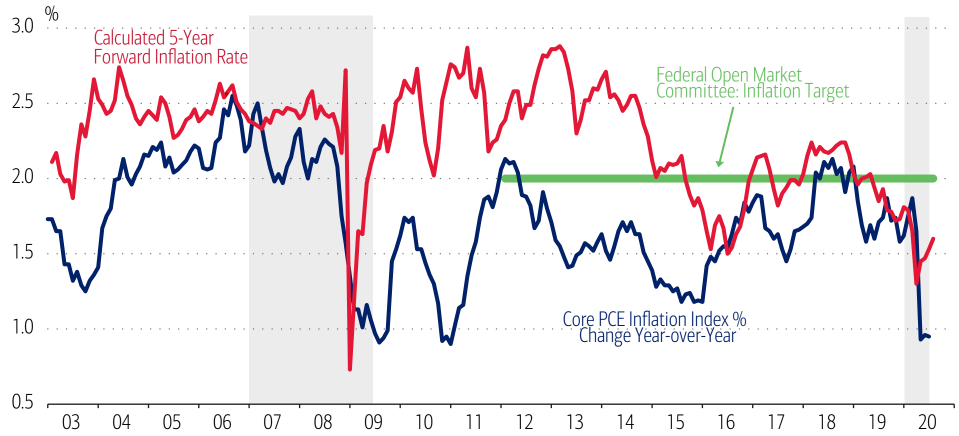
Fed Chairman Jerome Powell used his speech at the Kansas City Fed's Jackson Hole Symposium last week to discuss its monetary policy framework review that began early last year. With interest rates near zero, the Fed is taking stock of its existing toolset and implementing an average inflation targeting (AIT) approach as a means to re-anchor inflation expectations and reinforce their credibility. The new framework was rolled out with the release of a revised statement on its longer-run goals. Below we address key questions on the Fed's strategy review including what it means for investment strategy now and going forward.

What prompted the Fed to review its strategy and tools?

The Fed is adapting to a number of cyclical and secular challenges. Chair Powell noted a number of motivations for the framework review: 1) Estimates for long-run potential growth have been declining. 2) Related, the general level of interest rates have come down with growth and inflation estimates. 3) The record-long expansion that ended with the coronavirus pandemic included a record-tight labor market, but labor market tightness did not trigger a rise in inflation revealing that a robust job market can be sustained without runaway inflation.

The Fed is fighting secular disinflationary forces from demographics, technology and globalization, to name a few, and is looking to stabilize inflation expectations to stimulate better economic outcomes and in recognition of its failure to achieve sustained realized inflation of 2% over the last decade. It started explicitly targeting inflation in January 2012, and since then the personal consumption expenditure (PCE) inflation index and the "core" PCE inflation index, the Fed's preferred measures, have averaged just 1.4% and 1.3%, respectively. The Fed is also battling related market-based inflation expectations that have fallen well below the target over the last few years (Exhibit 1). Similarly, survey-based measures of inflation expectations such as the Survey of Professional Forecasters outlook for medium- and long-term inflation have also dropped below the 2% target.

Exhibit 1: Is the Fed Missing Its Mark?



Sources: Federal Reserve Board; Bureau of Economic Analysis/Haver Analytics. Data as of July 31, 2020.

In short, it appears the Fed has failed to achieve its inflation objective, and the market, consumers, businesses and economic prognosticators are questioning its ability to do so. A key risk is that declining inflation expectations become entrenched. Chair Powell and team have been working on a new framework to achieve its inflation mandate and reinforce its credibility and to counter the popular, albeit exaggerated, narrative that they are "out of bullets."

Why does the Fed target 2% inflation?

The Fed has a dual mandate of full employment and stable prices and believes a 2% inflation rate is consistent with low and stable inflation. For one, 2% leaves room for measurement error in either direction. Related, if the inflation rate is too close to zero, shocks to aggregate demand can more easily generate deflation, which can have crippling effects on the economy and policy, as evidenced in Japan over the last few decades. The Fed does not want to flirt with deflation. While the Fed only explicitly started targeting 2% in January 2012, according to the St. Louis Fed president, the U.S. has had an implicit inflation target of 2% since around 1995,[1] coinciding with a global central bank push toward inflation targeting.

[1] Federal Reserve Bank of St. Louis, "The Fed's Inflation Target: Why 2 Percent", January 2019.

How will averaging inflation targeting be different?

The Fed needs well-anchored inflation expectations to achieve its inflation mandate. Under the current framework, the Fed considers past inflation only to the extent it influences current or future inflation or expectations in forecasting models. An AIT framework means the Fed will explicitly look to overshoot its target to make up for past periods of undershooting, which often coincide with recessions. The goal would be to average 2% inflation over the course of the business cycle. In the current environment, this means the Fed would look to run inflation over 2% for an extended period of time to make up for years of undershooting and to restore inflation expectations to an acceptable level. Chair Powell stated in this speech that the new framework would not be tied to a mathematic formula.

What does this mean for investors?

To be brief, it means reflationary policy is likely for longer than would have been likely under the previous framework. It also is specifically designed to help create better economic outcomes (a less volatile business cycle). These are both considered positive for risk assets like equities, corporate bonds and cyclical sectors within equities (financials, for example).

As a forward-looking example, given the low base effects from the coronavirus recession, it is possible that key inflation measures could run above 2% for a few months in the first half of 2021. In the past, this may have induced calls for an unwinding of easy monetary policy and put downward pressure on equities. Under the new framework, it may not as the Fed looks to compensate for lower inflation in the past. Therefore, it is more likely that even if inflation picks up next year, policy is likely to remain accommodative. Bottom line: Monetary policy will likely be more accommodative in 2021 and 2022 than it would have been under the previous framework.

One performance reference point might be to look at how U.S. asset classes have performed since the Fed started explicitly targeting 2% inflation in January 2012, as the Fed is doubling down on this target. 2012 turned out to be a year when a number of important macro currents coalesced and pivoted. In addition to the Fed's pursuit of an explicit inflation target, in 2012 interest rates were entering a flattish trend near zero after decades of a downward trend, and the shale revolution drastically altered the oil supply/demand balance. Demographically, this was also an important pivot year for millennials in the U.S., who started getting married and forming families with important implications for housing markets. Permits for single-family homes started to march higher in late 2011 and 2012. Investment strategists should consider 2012 as an important macro pivot for this reason. Looking at performance over this period, the S&P 500 had returned nearly 14% per year. In the fixed-income space, total returns for some asset classes had run near the average yields as one may expect as rates entered a flattish trend following a multidecade downtrend. High-yield corporate bonds, (ICE BofA U.S. High Yield Index Total Return) for example, had returned around 6.3% since then, near the average yield-to-worst over that time period. The ICE BofA U.S. Treasury Index returned 3.0% over that time period.

Commodities have suffered since 2012 for a number of reasons. For one, as mentioned, the targeting of 2% inflation in January 2012 coincided nearly perfectly with the beginning of the surge in U.S. oil production. Oil prices were around $125 per barrel and have since fallen to below $50 per barrel. This has implications for investors as well as central bankers, who must wrestle with incorporating commodity price forecasts into their inflation forecasts. In other words, the supply/demand dynamics in the oil markets may also point to lower-for-longer for the Fed.

Lastly, the U.S. dollar weakened following Fed Chair Powell's speech as the market expects short rates to stay lower-for-longer and inflation to run higher in the medium-to long-term. Inflation trends are a key driver of currency performance over longer periods of time. The dollar's reaction, along with the upward movement in long-term rates, could be early evidence that the market views the Fed's new framework to reinforce long-term inflation expectations.

GLOBAL MARKET VIEW

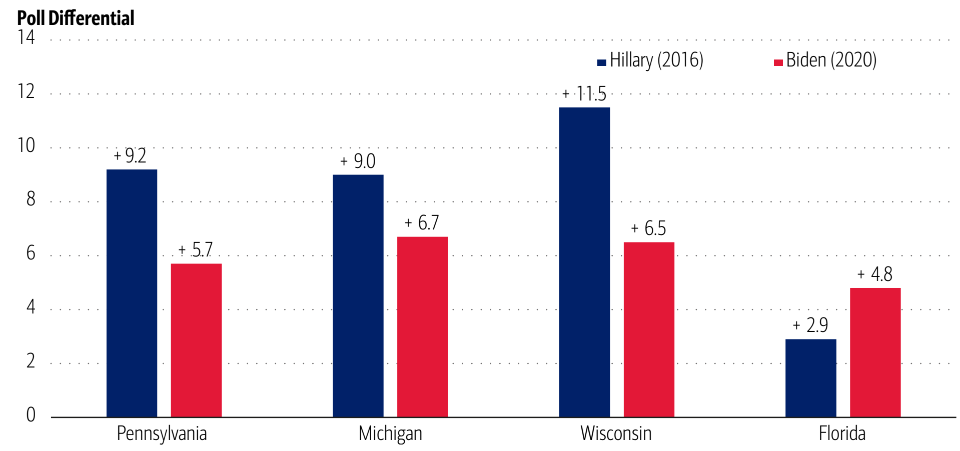
Election 2020 in Pictures

Joseph P. Quinlan, Managing Director and Head of CIO Market Strategy
Lauren J. Sanfilippo, Vice President and Market Strategy Analyst

There is no shortage of verbiage on the presidential elections—and we have yet to reach Labor Day. So rather than piling on and adding to the chatter, and in the spirit that "a picture is worth a thousand words," below are a few key exhibits that speak volumes about markets and presidential elections.

Picture One: Take election polls with a mountain of salt. The election results could very well come down to a few swing states, and as of late August, Joe Biden, Democratic presidential nominee, has been polling relatively well in Pennsylvania, Michigan, Wisconsin and Florida (Exhibit 2). Could this be good news for the Democrats? Well four years ago Hillary Clinton was polling even better numbers but lost all four pivotal states to President Donald Trump. Stay tuned.

Exhibit 2: Swing State Leads as of August 25th.

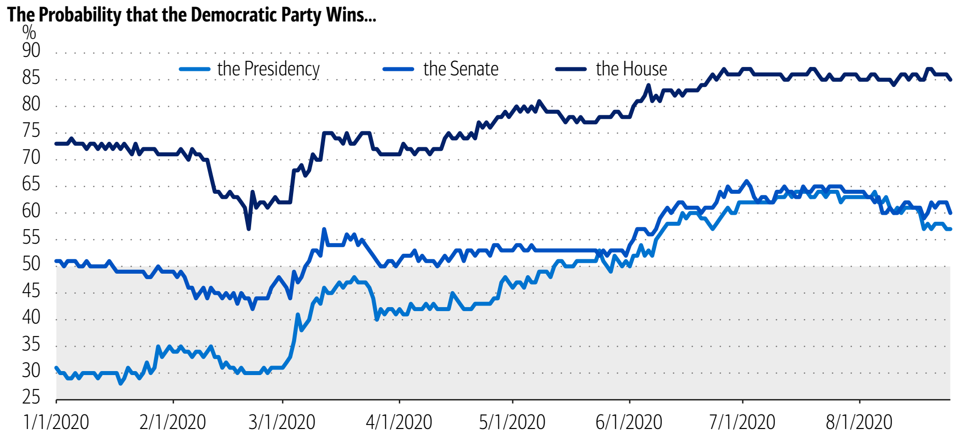


Source: Axios. Data as of August 25, 2020.

Picture Two: The odds of a Democratic sweep are good but not inevitable. The odds of a blue wave have steadily climbed this year, noticeably since the start of the pandemic and attendant decline in economic growth. It appears that the House will likely to stay with the Democrats, while the odds makers believe Biden has a 60% chance of becoming the next president (Exhibit 3). The real question mark pivots around control of the Senate: Republicans hold a 53-47 majority but are defending eight seats in the November elections that are considered competitive. As a recent Wall Street Journal editorial noted, the fight for the Senate is "the more important election."[2]

[2] The Wall Street Journal, "The More Important Election," August 26, 2020.

Exhibit 3: Rising Odds of a Democratic "Blue Wave."



Sources: Predictit, Bloomberg. Data as of August 25, 2020.

Picture Three: The markets prefer a divided government...or do they? If the Republicans maintain control of the Senate and Biden wins, investors will hear a lot of chatter about how a split government is best for the markets. Political gridlock, goes the fable, is preferred among investors since the government can do "less harm." Reality, however, is a little more nuanced.

As noted in the CIO Investment Strategy Overview (July 2020), over the 18 presidential cycles since World War II, the lowest market returns have occurred under a divided government, with returns averaging just 8.6% under a Republican president and Democratic Congress (Exhibit 4). Some of the strongest market returns have come when either party has had complete control of the government. As a historical sidebar: There has never been a Democratic president, Democratic House and Republican Senate—so this time could be different.

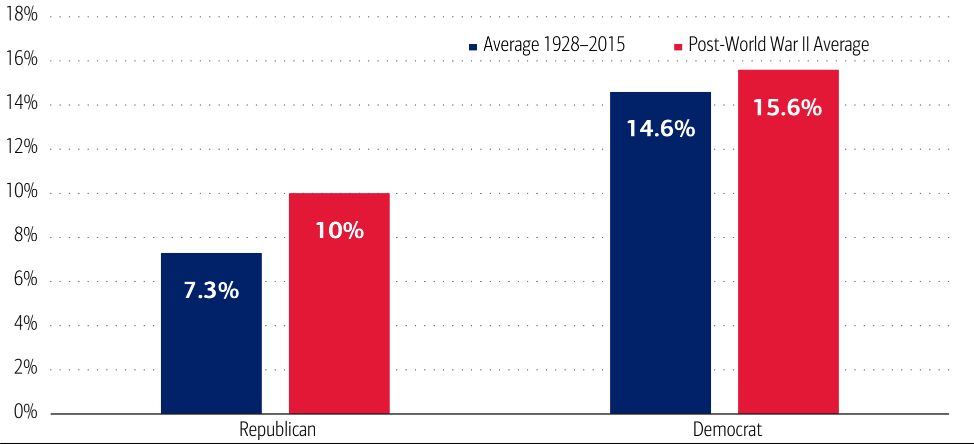
Exhibit 4: Market Returns and Historical Election Cycles from 1945 to 2016.

Government Configuration		S&P 500 total return		
President/House/Senate	**Number of years**	**Average**	**Maximum**	**Minimum**
Democrat/Democrat/Democrat	22	14.8%	36.3%	-10.0%
Republican/Republican/Republican	6	18.6%	52.3%	-0.9%
Democrat/Republican/Republican	10	15.9%	37.6%	-9.1%
Democrat/Republican/Democrat	4	16.1%	32.4%	2.1%
Republican/Republican/Democrat	2	-17.0%	-11.9%	-22.1%
Republican/Democrat/Democrat	22	8.6%	43.1%	-37.0%
Republican/Democrat/Republican	6	16.0%	31.7%	-4.9%

Sources: Predictit; Bloomberg. Data as of August 25, 2020. **Past performance does not guarantee future results.**

Picture Four: Over the long term, Democratic presidents had been more positive for equities than Republicans. And by a long shot. Many variables, of course, shape and influence equity prices over any presidential term, although taking the long view, average annual S&P 500 returns have been stronger under the Democrat controlling the White House versus the Republicans (Exhibit 5).

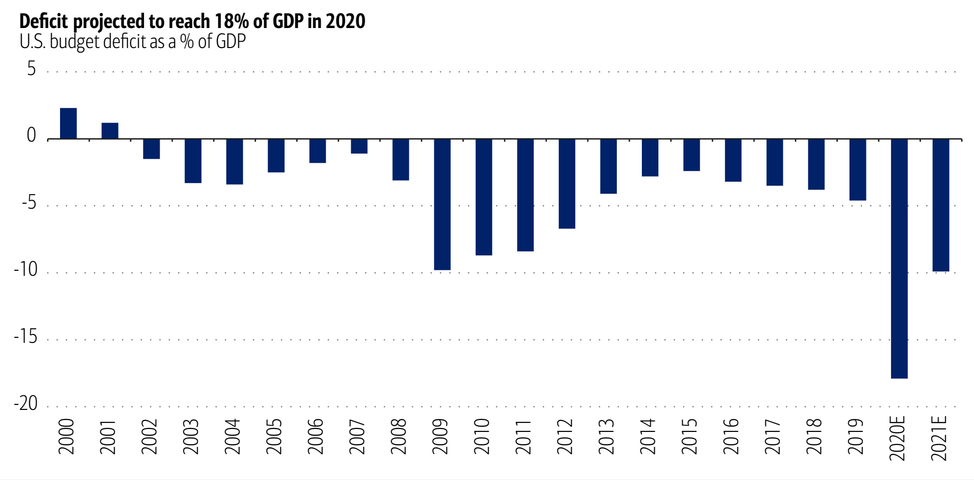
Exhibit 5: Average Annual S&P 500 Returns Based On Control of White House and Congress, 1928–Present.



Based on 43 years of Republican control and 48 years of Democratic control since 1928 (or 38 and 33 years, respectively, post-World War II).
Total returns 1936 - present and price returns prior to that. Exclude 2008, average under Republicans was 8.4% (11.3% post-World War II) — still weaker than under Democrats.
Sources: BofA Global Research; FactSet. Data as of August 2020. **Past performance is no guarantee of future results.**

Picture Five: The next government will start out in a massive fiscal hole. Whether Democrat or Republican, the next president will start his term confronting a massive fiscal deficit. How this deficit (and debt) is handled (or not) will have significant market implications. According to Strategas, the Biden tax increases—assuming they were fully implemented—would be the largest since 1968. Based on various estimations, Biden's tax proposals could reduce S&P earnings-per-share by 9% to 12% in 2021. Suffice it to say, the massive federal budget deficit is a significant overhang to the capital markets (Exhibit 6).

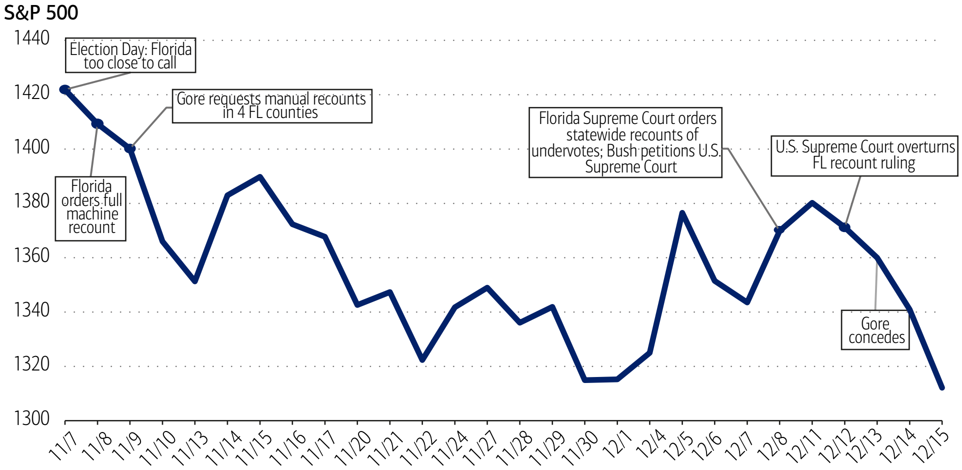
Exhibit 6: Deficit Projected To Reach 18% of GDP in 2020.



E = Estimate
Sources: Committee for a Responsible Federal Budget (Forecast as of June 2020); Office of Management and Budget. Data as of June 2020.

Picture Six: It ain't over til it's over. What happens if there is no clear winner the day after the election? 2020 = 2000? Missing chads then, missing mail-in votes now? For historical reference, the S&P 500 index fell 8.4% between Election Day November 7 and December 15, the day after former Vice President Al Gore conceded in the wake of the Supreme Court ruling that ended the Florida recount. While waiting on Florida, market volatility and uncertainty were the norm, although in the end, the election-induced downdraft proved to be a favorable entry point for equity investors (Exhibit 7). To wit, since the beginning of this century through August 1, 2020, the S&P 500 has returned some 232% percent to investors (total returns). Not bad.

Exhibit 7: Recounting the Count: How the S&P 500 Handled the Bush-Gore Presidential Election, 11/07/2000 – 12/15/2000.



Sources: uselectionatlas.org; Bloomberg. Data for S&P 500 as of November 7, 2000 to December 15, 2000

THOUGHT OF THE WEEK:

Taking Stock of the Coronavirus Demand Shock

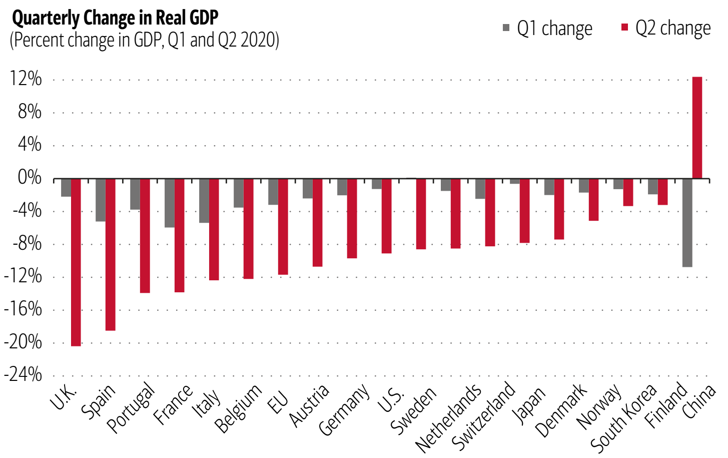
Kathryn McDonald, CFA®, Vice President and Market Strategy Analyst

Second-quarter GDP results have now been released for most major countries around the world, with many economies posting record declines (Exhibit 8A). Last week, the U.S. posted a positively revised 9.1% month-over-month decline in the second quarter, amounting to an annualized rate of -31.7%. The largest GDP decline came from the United Kingdom, with the country's economic output dropping to levels last seen in 2003. The consumer services sector, which accounts for 80% of U.K. GDP, was especially hard-hit, helping to explain the underperformance. Meanwhile, China's economy, which was affected by the coronavirus earliest, staged a sharp V-shape recovery in Q2, with GDP now above pre-crisis levels.

The latest data also confirms an underlying relationship between GDP declines and country exposure to travel and tourism industries. Exhibit 8B shows that countries more exposed to tourism suffered greater economic declines during Q2, with the exception of the U.K. On average, tourism directly contributes 4.4% of GDP for Organisation for Economic Co-operation and Development (OECD) nations, but this varies widely among countries.

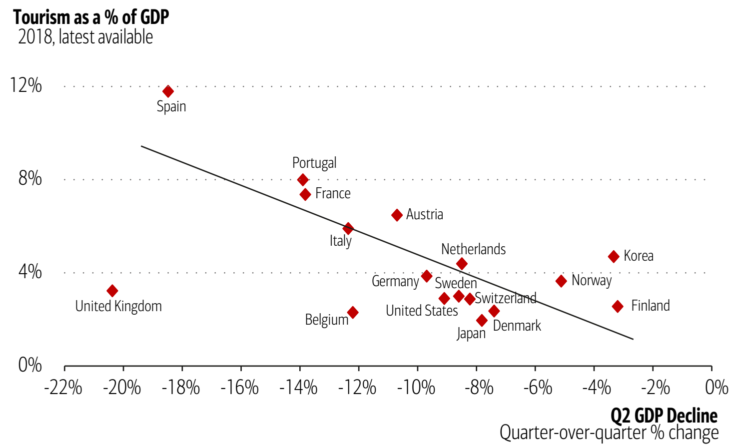
The U.S. economy is relatively less exposed to travel and tourism receipts, with tourism making up 2.9% of U.S. GDP. By contrast, many European economies are highly exposed to tourism consumption—with a large portion of their economies dedicated to activities such as accommodation, food and beverage, transport, travel services, and culture and recreational activities. For example, in Spain, tourism represents 11.8% of GDP and 13.5% of total employment. Similarly, the economies of Portugal, France, Austria and Italy all rely heavily on tourism as a percent of GDP and, as a result, have been more severely affected by border closings, government shutdowns or social distancing measures (Exhibit 8B). Of course, there are other factors driving the economic outlook for these nations—the coronavirus severity and response, and fiscal and monetary policies, to name a few—however, the composition of GDP toward tourism is an important factor in the equation.

Exhibit 8A:
Coronavirus Demand Shock.



Sources: Eurostat and Individual Countries' Statistics Offices; Haver Analytics. Data as of August 2020.

Exhibit 8B: Countries With Greater Tourism Exposure Saw Larger GDP Declines.

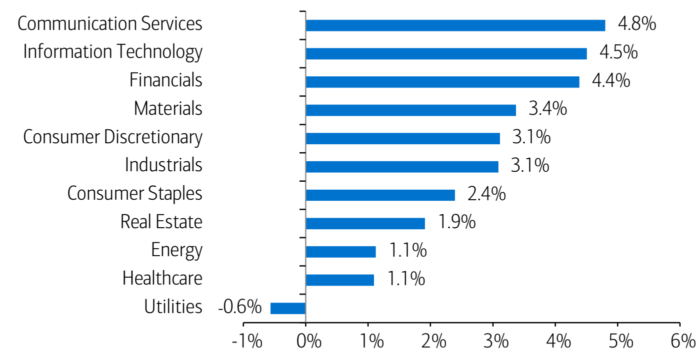


Sources: Eurostat and Individual Countries' Statistics Offices; Organisation for Economic Co-operation and Development; Haver Analytics. Data as of August 2020.

Equities

	Total Return in USD (%)			
	Current	WTD	MTD	YTD
DJIA	28,653.87	2.6	8.7	2.0
NASDAQ	11,695.63	3.4	9.0	31.2
S&P 500	3,508.01	3.3	7.4	10.0
S&P 400 Mid Cap	1,946.51	1.9	4.6	-4.6
Russell 2000	1,578.34	1.7	6.7	-4.5
MSCI World	2,456.86	2.7	6.7	5.4
MSCI EAFE	1,910.82	1.7	5.2	-4.6
MSCI Emerging Markets	1,121.60	2.8	4.1	2.3

S&P 500 Sector Returns



Fixed Income[1]

	Total Return in USD (%)			
	Current	WTD	MTD	YTD
Corporate & Government	1.14	-0.7	-1.5	7.7
Agencies	0.55	-0.2	-0.4	5.1
Municipals	1.31	-0.3	-0.5	3.3
U.S. Investment Grade Credit	1.18	-0.5	-1.0	6.6
International	1.99	-0.9	-1.8	6.5
High Yield	5.35	0.8	0.9	1.6

	Current	Prior Week End	Prior Month End	2019 Year End
90 Day Yield	0.09	0.09	0.08	1.54
2 Year Yield	0.13	0.14	0.11	1.57
10 Year Yield	0.72	0.63	0.53	1.92
30 Year Yield	1.50	1.34	1.19	2.39

Commodities & Currencies

	Total Return in USD (%)			
Commodities	Current	WTD	MTD	YTD
Bloomberg Commodity	156.08	2.3	6.5	-9.3
WTI Crude $/Barrel[2]	42.97	1.5	6.7	-29.6
Gold Spot $/Ounce[2]	1,964.83	1.3	-0.6	29.5

Currencies	Current	Prior Week End	Prior Month End	2019 Year End
EUR/USD	1.19	1.18	1.18	1.12
USD/JPY	105.37	105.80	105.83	108.61
USD/CNH	6.86	6.92	6.99	6.96

Sources: Bloomberg, Factset. Total Returns from the period of 08/24/2020 to 08/28/2020. Bloomberg Barclays Indices.1 Spot price returns.2 All data as of the 08/28/2020 close.
Past performance is no guarantee of future results.

Asset Class Weightings (as of 8/4/2020)

	Under-weight		Neutral	Over-weight	
Equities	•	•	•	●	•
U.S. Large Caps	•	•	•	●	•
U.S. Mid Caps	•	•	●	•	•
U.S. Small Caps	•	•	•	●	•
International Developed	•	▶	●	•	•
Emerging Markets	●	•	•	•	•
Fixed Income	•	●	•	•	•
U.S. Investment Grade Taxable	•	●	•	•	•
International	●	•	•	•	•
Global High Yield Taxable	•	●	•	•	•
U.S. Investment Grade Tax Exempt	•	•	●	•	•
U.S. High Yield Tax Exempt	•	●	•	•	•
Alternative Investments*					
Hedge Funds			●		
Private Equity			|		
Real Estate			|		
Tangible Assets/ Commodities			●		
Cash					

* Many products that pursue Alternative Investment strategies, specifically Private Equity and Hedge Funds, are available only to pre-qualified clients.

Economic and Market Forecasts (as of 08/28/2020)

	Q3 2019A	Q4 2019A	2019A	Q1 2020A	Q2 2020A	2020E
Real global GDP (% y/y annualized)	-	-	2.9	-	-	-4.2
Real U.S. GDP (% q/q annualized)	2.1	2.1	2.3	-5.0	-31.7	-5.3
CPI inflation (% y/y)	1.8	2.0	1.8	2.1	0.4	1.2
Core CPI inflation (% y/y)	2.3	2.3	2.2	2.2	1.3	1.6
Unemployment rate (%)	3.6	3.5	3.7	3.8	13.0	9.0
Fed funds rate, end period (%)	1.90	1.55	1.55	0.08	0.08	0.13
10-year Treasury, end period (%)	1.66	1.92	1.92	0.67	0.66	1.00
S&P 500 end period	2977	3231	3231	2585	3100	2900
S&P earnings ($/share)	42	42	163	33	25*	115
Euro/U.S. dollar, end period	1.09	1.12	1.12	1.10	1.12	1.14
U.S. dollar/Japanese yen, end period	108	109	109	108	108	103
Oil ($/barrel, avg. of period, WTI**)	56	57	57	46	29	40

The forecasts in the table above are the base line view from BofA Global Research team. The Global Wealth & Investment Management (GWIM) Investment Strategy Committee (ISC) may make adjustments to this view over the course of the year and can express upside/downside to these forecasts.

Past performance is no guarantee of future results. There can be no assurance that the forecasts will be achieved. Economic or financial forecasts are inherently limited and should not be relied on as indicators of future investment performance.

A = Actual. E/* = Estimate. S&P 500 represents the year-end target for 2020. **West Texas Intermediate.
Sources: BofA Merrill Lynch Global Research; GWIM ISC as of August 28, 2020.

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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.

S&P 500 is a stock market index that tracks the stocks of 500 large-cap U.S. companies. It represents the stock market's performance by reporting the risks and returns of the biggest companies.

Organisation for Economic Co-operation and Development (OECD) system of Composite Leading Indicators (CLIs) is designed to provide early signals of turning points in business cycles - fluctuation in the output gap.

Personal Consumption Expenditure index measure is the component statistic for consumption in gross domestic product collected by the United States Bureau of Economic Analysis. It consists of the actual and imputed expenditures of households and includes data pertaining to durable and non-durable goods and services.

ICE BofA U.S. Treasury index is an unmanaged index that tracks the performance of the direct sovereign debt of the U.S. Government having a maturity of at least one year and less than three years. It is not possible to invest directly in an unmanaged index.

ICE BofA U.S. High Yield Index Total Return tracks the performance of US dollar denominated below investment grade rated corporate debt publicly issued in the US domestic market.

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All recommendations must be considered in the context of an individual investor's goals, time horizon, liquidity needs and risk tolerance. Not all recommendations will be in the best interest of all investors. Asset allocation, diversification and rebalancing do not ensure a profit or protect against loss in declining markets.

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