CHIEF INVESTMENT OFFICE

Capital Market Outlook

September 14, 2020

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

IN THIS ISSUE:

- **Macro Strategy**—The labor market topped economists' expectations in August, posting one of the second-biggest declines in the unemployment rate ever as almost four million more people reported finding jobs. Labor-force participation increased after the emergency unemployment benefits expired in July. This continued an unprecedented string of positive economic surprises showing a sharp V-shaped U.S. economic recovery and causing large upward revisions to the outlook for third-quarter gross domestic product (GDP) and profits, helping to drive a rotation into more cyclical stocks that would benefit from stronger growth ahead.
- **Global Market View**—It's worth being mindful of geopolitical tension points since if we have learned anything from this pandemic, it is this: Bolts from the blue could emanate from nearly any place in the world and at any time. Consider better hedges/ plays to geopolitical tensions: U.S. Large-cap defense stocks, water infrastructure and developed markets versus emerging markets, with a bias toward the U.S.
- **Thought of the Week**—America's technical infrastructure appears to lag behind that of many other developed nations. Meanwhile, the coronavirus pandemic has brought the issue of digital inequality within the U.S. front and center. We believe the next generation of U.S. infrastructure build-out will extend beyond roads and bridges and focus on the development of important information communications technology investments and related applications. This should help support the U.S.'s long-run growth trajectory.
- **Portfolio Considerations**—For now, we do expect minor consolidation after earnings season as some enthusiasm wanes, cyclicals attempt to balance out the high growth sectors, and investors remain grounded with the presidential election approaching. This is an opportune time, in our view, to re-examine portfolio strategy and have plans ready for the next "breaking away" period in the economy and equity markets.

MACRO STRATEGY

Chief Investment Office Macro Strategy Team

GLOBAL MARKET VIEW

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

Lauren Sanfilippo
Vice President and
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THOUGHT OF THE WEEK

Kathryn McDonald, CFA®
Vice President and
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Data as of 9/14/2020, and subject to change.

MACRO STRATEGY

U.S. Economy Continues To Prove More Resilient Than Expected

Chief Investment Office Macro Strategy Team

Our outlook for a rapid rebound in U.S. and global growth has been validated by the surge in positive economic surprises and rapid retracing of most of the March-April declines in economic indicators. For example, manufacturing and nonmanufacturing surveys have continued their sharp improvement and appear likely to remain strong through year-end given the dollar decline, global reopenings, better-than-expected consumer spending, and a more favorable inventory and profits outlook than was apparent before the pandemic. With profit margins elevated and poised to increase in coming years, as discussed below, not only hiring looks to be recovering fast but also business investment, according to capital goods orders and other data, and from a smaller drop than had generally been feared. Hours worked in the private sector have surged to a 20-year high, and the current unemployment rate has declined rapidly, reaching 8.4% in August according to the Bureau of Labor Statistics, with more declines anticipated through the end of the year and a likely normalization by the end of 2021.

While limited progress in the reopening of service-sector activity remains a drag on the economy, we believe that housing, manufacturing and technology are likely to remain a strong source of growth ahead both for cyclical reasons and pandemic-related structural changes in consumer demand and business investment. These sectors employ many more people than retail, travel and leisure-related businesses and have much higher multiplier effects, suggesting that growth tailwinds are likely to overcome headwinds despite persistent worries about the state of the economy. As discussed below, we believe that the U.S. economy is fundamentally in good shape to continue to surprise to the upside, with pretax GDP profits likely up by mid-double-digits next year to new highs, a much better outlook than was likely before the pandemic.

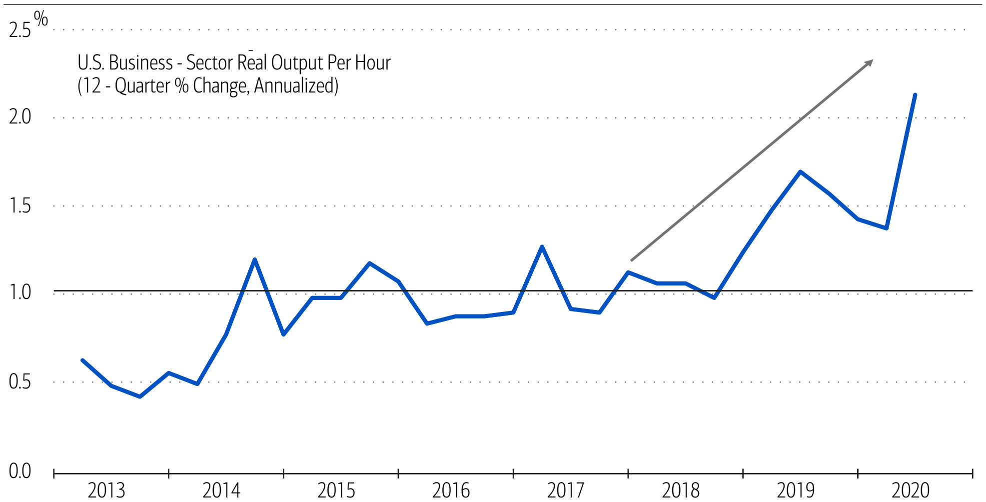
Much of this has to do with the reasons why we expected this to be a short-lived recession and with the nature of the shock itself. Structural pandemic-related changes to where people want to live and work were bound to cause a boom in housing and big-ticket items, a critical factor shaping our view, especially given favorable monetary/fiscal policy support and housing-specific conditions (low inventories of homes for sale, low household leverage levels, demographics). The fact that this was an event-driven recession caused by the forced shutdown of the economy was also important for the shape and duration of the recovery.

Indeed, in contrast to typical recessions, which tend to result from the need to unwind accumulated imbalances in the economy, event-driven recessions tend to be shorter, ending soon after the shock dissipates. That's why an unusually large 78% share of those unemployed in April according to the Bureau of Labor Statistics (18 million of 23 million people) reported that their job losses were temporary, which was significant for the consumer confidence and spending outlook. Sure enough, 14 million of those unemployed at that time are already back to work, helping advance the positive growth dynamic that started early on with the aggressive, well-targeted and successful monetary and fiscal-policy actions. The quick start of normalization of various financial-stress indicators and the unusually elevated consumer-expectation measures were early indications of a likely V-shaped recovery in manufacturing sentiment and earnings revisions ratios. Both subsequently rebounded faster than anticipated, validating the positive signals coming from the rally in risk assets since late March and helping bring unemployment lower much more than expected.

Also important, the surge in money supply, massive deficit spending and ample Federal Reserve (Fed) provision of dollar liquidity to overseas borrowers capped the dollar's appreciation by late March. Because the dollar tends to appreciate rapidly during global economic/financial crises and depreciate when conditions improve, the rollover in the dollar exchange rate was an early sign that things were quickly getting better not worse, both here and abroad. What's more, with the Fed more accommodative and interest- rate differentials no longer favoring the dollar as during the past decade, the dollar was more susceptible to the lagged effects of international trade imbalances and thus likely on course for sustained depreciation from overvalued levels, with positive implications for manufacturing activity, exports and profits. In turn, this was pointing to a quick rebound in manufacturing purchasing surveys, hiring and investment, in a positive self- reinforcing dynamic. The quick drop in credit spreads since the Coronavirus Aid, Relief, and Economic Security "CARES" Act of late March was consistent with this outlook rather than with a prolonged recession.

Our positive views about U.S. growth and the economy's resilience to the pandemic shock have also been shaped by our views about productivity and profit margins. For example, we have long believed that the Fed's policy mistakes in recent years have been caused by its underestimation of the positive effects of pro-growth policies on the productivity growth trend. Indeed, the dynamism of the U.S. economy and relatively uninhibited creative destruction occurring in the search for productivity and profits in the face of strong competition, a slowing labor-force growth trend, and a decade of dollar appreciation to quite overvalued territory, appear to have boosted the long- term trend in productivity more than generally appreciated (Exhibit 1). Automation, artificial intelligence, robotics and rising big-data capabilities are forces for stronger productivity growth and rising margins. A shift from the very weak productivity trend of the "secular-stagnation" period to a higher trend is very important because it would allow the economy to grow faster without inflation. This would allow the Fed to hold interest rates lower for longer, supporting profit margins. It is also important because it would keep unit labor costs from eroding margins any time soon.

Exhibit 1: Rising Productivity Trend Raises Profit-Margin Outlook.



Source: Bureau of Labor Statistics. Data as of 9/10/2020. **Past performance is no guarantee of future results.**

The atypical, event-driven nature of the economic contraction is another important reason margins held up at unusually high levels in this recession. As an expansion matures, most of the margin decline is usually due to faster increases in compensation costs than in revenues. Margins also decline as real interest rates rise, causing the economy to start slowing down meaningfully. This was the combination shaping up the outlook as the economy was entering late-stage expansion before the pandemic hit.

The pandemic shock has caused a quick labor-market reset and started a new global business cycle. A fast response to shocks with rapid cost-cutting measures explains why productivity growth and profits tend to surge as a new expansion begins. The quick drop in labor costs and interest rates combined with the fast economic growth reacceleration have substantially brightened the profit-margins outlook. Indeed, record-low real interest rates tend to be very favorable for corporate profit margins, and so is the increase in the yield-curve spread.

In short, we believe that margins are surprising to the upside both for idiosyncratic, cyclical and structural reasons. Intense global and domestic competition, a low inflation environment and a strong dollar have caused U.S. businesses to remain sharply focused on increasing efficiency and automation, which is good for margins. Labor-cost pressures are likely to remain favorable to margins until still-massive labor slack is reabsorbed. It would take a sharp increase in real interest rates to bring down domestic profit margins over the next two years, which is highly unlikely in our view. The Fed's new policy approach suggests a very slow interest-rate normalization process ahead.

Thus, low interest rates and low energy input prices should remain supportive of margins until later in the expansion when interest and materials costs start to rise faster than businesses can expand revenues.

If margins increase from their high current levels over the next two years, as we expect, domestic profits have the potential to reach new highs. Driven by strengthening global growth and a moderating dollar, profits from overseas activity are also likely to contribute substantially to U.S. profits exceeding pre-pandemic expectations through 2022. This suggests a quick normalization of economic conditions and continued outperformance by cyclical and reflation beneficiaries, such as industrials, consumer discretionary, housing, Treasury Inflation Protected Securities (TIPS) as well as commodities, temporary volatility notwithstanding.

GLOBAL MARKET VIEW:

Are the Markets Too Complacent About Mounting Geopolitical Risks?

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

Rarely has the global economy faced so many geopolitical hotspots at once. India versus China; Greece versus Turkey; Belarus/Russia versus the European Union (EU); the United Kingdom versus the EU; Egypt versus Ethiopia; and, of course, the granddaddy of them all: U.S.-China tensions that now go well beyond trade. Adding to the smog, of course, are the upcoming U.S. presidential elections, the pandemic of 2020 and the latter's endgame: a vaccination. "Vaccination nationalism" is mounting as nations race to be first with a cure.

Adding it all up, the world may not be on fire but there is a lot of smoke out there.

The capital markets appear to have taken the U.S.-China "Cold War" in stride only because the rift and rancor between the two largest economies in the world have been out there (aka, discounted) for some time. Recall that is was roughly two years ago—October 3—when Vice President Mike Pence delivered a highly confrontational speech on China that many believed heralded the beginning of the U.S.-Sino Cold War. Since then, it has been all downhill—notwithstanding the signing of the Phase One trade deal in January 2020. Tensions have spread from trade to technology standards, to medical supply chains, to human rights, to finance, among other things. The blame game over the coronavirus has only added to the bilateral schism.

So deep is the divide that some see echoes of the past—that today's great power economic rivalry between China and the U.S. is akin to the rivalry between Germany and Great Britain over a century ago. In an essay published in The Washington Quarterly, the authors note:

> *"The the rivalry between China and the United States in the twenty-first century holds an uncanny resemblance to the one between Germany and Great Britain in the nineteenth. Both rivalries take place amidst the emergence of economic globalization and explosive technological innovation. Both feature a rising autocracy with a state-protected economic system challenging an established democracy with a free-market economic system. And both rivalries feature countries enmeshed in profound interdependence wielding tariff threats, standard-setting, technology theft, financial power, and infrastructure investment for advantage."*[1]

[1] See "Beijing's Bismarckian Ghosts: How Great Powers Compete Economically," The Washington Quarterly, Fall 2018.

That said, history, as Twain remarked, never repeats itself but it often rhymes. Just as the U.S. and the Soviet Union never came to fatal blows during the first Cold War, we believe Cold War 2.0 could play out in similar fashion. Both sides understand that it would be MAD (mutually assured destruction) to push too hard—step over the line.

Near-term geopolitical risks lie elsewhere, notably at the top of the world. High in the Himalayan mountains, tensions have escalated between two of Asia's largest economies—China and India. Tensions spiked on June 15 when troops from both sides rumbled with sticks, stones and just plain bare knuckles. Casualties were reported on both sides. In early September, however, shots were fired for the first time in decades. There were more reported casualties and an escalation of tensions between two economies expected to boost long-term global growth.

While the disputed border in the Himalayans couldn't be further from Wall Street, the ripple effects from the top of the world could be consequential for the global capital markets. Hammered by the pandemic, and confronting one of the steepest economic contractions in its history, the last thing India needs right now is an open conflict with China. An escalation in tensions could undermine economic growth in both nations, notably India; help promote the global spread of trade and investment protectionism, with India already banning/limiting the presence of a number of Chinese tech firms

in the country; and potentially stoke mounting anti-China sentiment in such key Asia-Pacific nations as Japan, Australia and South Korea. These are key markets for Chinese goods but are at risk over geopolitical tensions. Finally, per U.S. investors, consider U.S. large-cap hedges/plays. The standoff is expected to drive greater U.S.-Indian security agreements/cooperation, aka, rising U.S. arms sales to India.

Moving on, energy lies at the heart of rising tensions between Greece and Turkey in the eastern Mediterranean. Tempers flared in July when Turkey sent a research vessel into the waters between Crete and Cyprus to carry out drilling surveys for oil and natural gas. Given recent gas discoveries in the area, the underwater real estate has become more valuable and hotly contested. The Mediterranean crisis pits one North Atlantic Treaty Organization (NATO) member against another and could divide the EU in its response to the crisis.

Greece wanted the EU to impose sanctions on Turkey, but that could create havoc in that Turkey is currently housing some 4 million refugees from the Middle East and Africa. Brussels can't allow relations with Turkey to deteriorate to a point where Turkey opens the flood gates and allows the refugees to move north. Meanwhile, to fund its military capabilities, Greece raised nearly $3 billion in a bond auction last week.

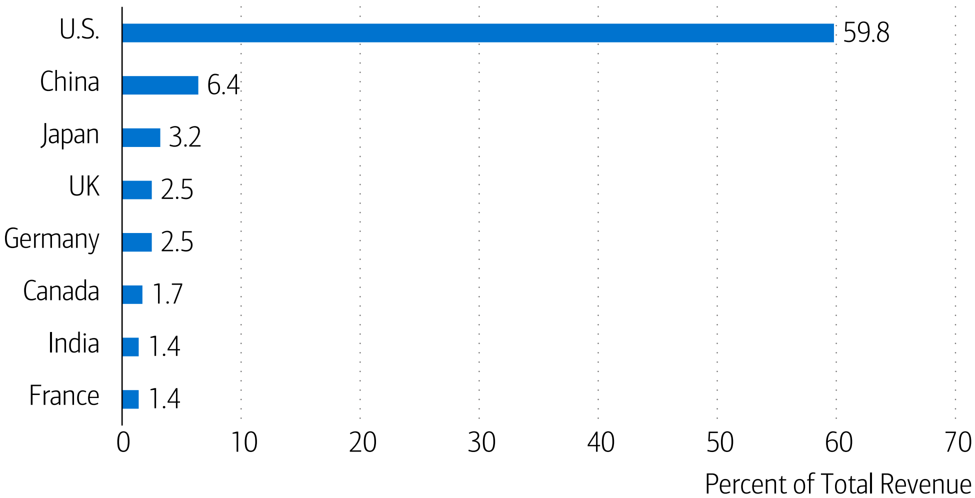
In addition to the simmering crisis in the Mediterranean, the EU is also at odds with Russia over the poisoning of opposition leader Alexei Navalny and the protests in Belarus. Adding to the muddle: the Nord Stream 2 Pipeline that, if completed, would deliver natural gas from Russia directly to Germany. The pipeline has become a sticking point between the U.S. and Europe, with the U.S. fearing Europe would become captive to Russian energy and preferring instead to export more of its own oil and gas to Europe. The U.S. is considering economic sanctions against European firms involved with the pipeline; meanwhile, the German government is under tremendous pressure to rethink Nord Stream 2 following the poisoning of Navalny. And lest investors forget, the United Kingdom and the EU have yet to iron out an agreement per Brexit.

Finally, water lies at the core of simmering tensions between Egypt and Ethiopia. No nation can survive without water, particularly in parched North Africa. So when Ethiopia started to fill its Grand Ethiopian Renaissance Dam on the Nile this summer, potentially slowing the northward flow of water to Egypt, tensions flared between two of Africa's largest economies. Egypt is overwhelmingly dependent on the waters of the Nile, while Ethiopia, whose highlands supply more than 85% of the water that flows into the river, and whose booming population continues to exert tremendous demand on the supply of water, wants to hoard (dam) the water for its own use. Geopolitical tensions over water? Neither the first time nor the last. History is replete with such occasions.

Investment implications

Each geopolitical hotspot carries its own risk and reward. U.S.-Sino trade tensions had been largely discounted by the markets, but any further deterioration or tit-for-tat retaliatory measures could squeeze the earnings of many U.S. multinationals embedded in China's massive market. Per sectors, consider autos, food and beverages, technology, healthcare, logistics, transportation and many U.S. large-cap brand leaders. As Exhibit 2 highlights China is a consequential market for U.S. earnings relative to other nations.

Exhibit 2: S&P 500 Revenue Exposure by Country.



Source: FactSet. Data as of September 10, 2020. **Past performance is no guarantee of future results.**

If India-China relations reach a boiling point, risk off assets like gold, the U.S. dollar and perhaps the yen would get a boost. Global defense spending would accelerate. Confidence and flows into the emerging markets would recede, with capital preferring to stay closer to home.

Multiple hotspots in Europe could undermine EU unity at precisely the moment when Europe seems to be pulling together as one economic entity. The more discord and dissent among member states, the possibility of a softer growth outlook, the weaker the pound and euro, and the slimmer the chances of Europe working coherently to tackle its multiple structural challenges to growth. This is hardly an auspicious backdrop for U.S. foreign affiliate earnings, since according to the Bureau of Economic Analysis, Europe accounts for over 50% of the global total.

Finally, the Egypt-Ethiopian standoff is a reminder that water is the world's most precious commodity. As we have written in the past, we expect the global water infrastructure theme to play out over the next decade. Billons could be spent on waste water treatment, desalination, pipes, values, recycling and related activities.

In the end, while there's plenty of concerns right here in the U.S., it's worth being mindful of simmering geopolitical tension points. If we have learned anything from this pandemic,bolts from the blue can emanate from nearly any place in the world and at any time. Considerations of the better hedges/plays to geopolitical tensions: U.S. large-cap defense stocks, water infrastructure and developed markets versus emerging markets, with a bias toward the U.S.

THOUGHT OF THE WEEK:

Mind the Gaps in U.S. (Digital) Infrastructure

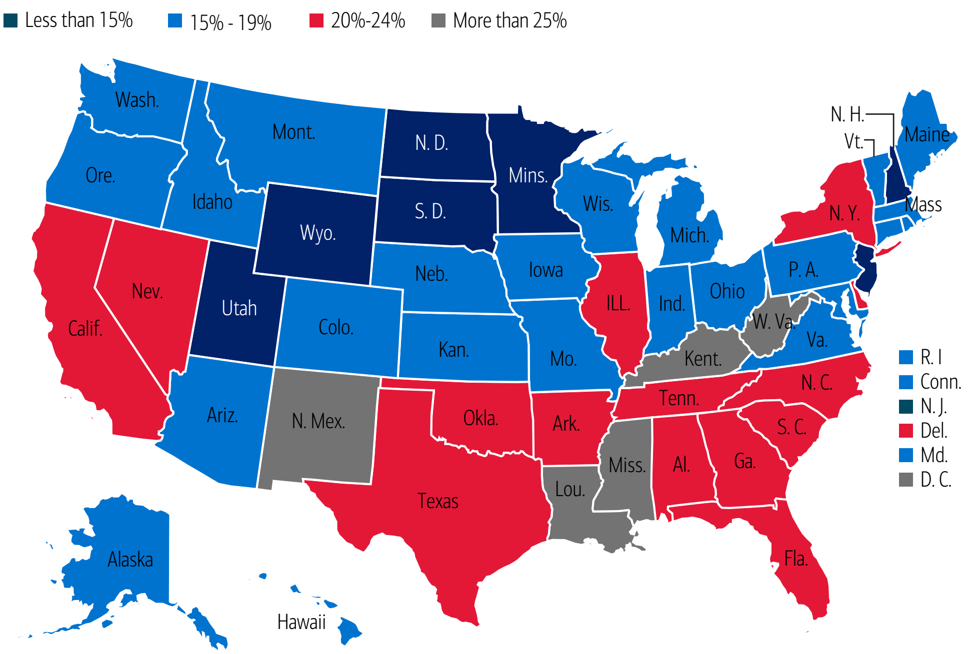
Kathryn McDonald, CFA®, Vice President and Investment Strategist

In 2017, the American Society of Civil Engineers released its latest scorecard for the quality of U.S. infrastructure. The result: a near-failing grade (D+), with inadequacies cited in such key areas as roads, airports, bridges, dams, drinking water, energy, waterways, ports, schools, transit and waste. It's a long list, to be sure, yet U.S. infrastructure gaps extend far beyond this assessment of physical infrastructure. The U.S. should also ramp up investments in its digital infrastructure (broadband, fiber optical equipment, 5G, data centers, software, cybersecurity, artificial intelligence, cloud computing, smart logistics, semiconductors and factory automation).

The U.S. faces two main digital infrastructure gaps. The first is the digital infrastructure gap between the U.S. and the rest of the world. America's tech infrastructure lags behind that of many other developed nations and even some developing economies. For example, America ranks second overall in the World Economic Forum's annual ranking of global competitiveness, but when it comes to the category of information communications technology (ICT) adoption, the U.S. ranks 27th. Meanwhile, according to Organisation for Economic Co-operation and Development (OECD) broadband statistics, among the 37 OECD member countries, the U.S. ranks 18th in broadband internet penetration and 28th in fiber internet connections.[2]

The second digital infrastructure gap is within the U.S. or a growing digital divide between the technology "haves" and "have nots." Recent estimates indicate that roughly 20% of students nationwide do not have a reliable internet connection, with wide disparities reported among states (Exhibit 3). This issue of digital inequality has come front and center during the coronavirus pandemic, as many parts of society struggled to adjust to remote work and online education.

Exhibit 3: Estimated Percentage Of Students Without A Reliable Internet Connection.



Sources: Education Super Highway; Wall Street Journal. Data for 2019.

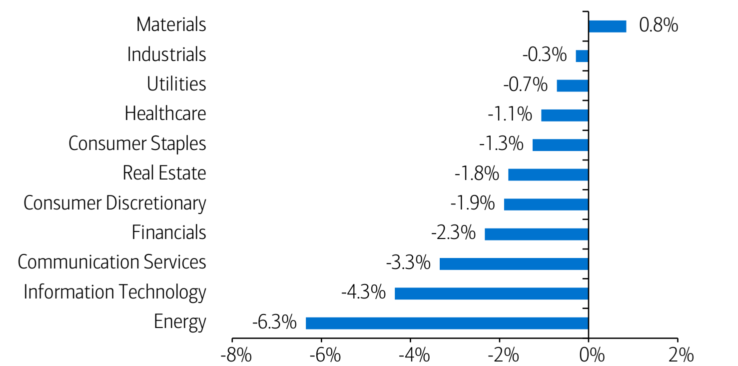
[2] OECD Broadband Statistics, December 2019. Data series: Fixed broadband subscriptions per 100 inhabitants; and fiber connections as a percentage of total fixed broadband subscriptions

There remains considerable runway for the U.S. to ramp up capital expenditures (capex) and technology infrastructure spending during the economic recovery. Given coronavirus pressures and U.S.-China tech war escalations, we believe governments, businesses and households could begin to pull forward much needed spending and investment on ICT infrastructure and related applications.

Equities

	Total Return in USD (%)			
	Current	WTD	MTD	YTD
DJIA	27,665.64	-1.6	-2.6	-1.3
NASDAQ	10,853.54	-4.1	-7.8	21.8
S&P 500	3,340.97	-2.5	-4.5	4.8
S&P 400 Mid Cap	1,854.87	-2.2	-3.7	-9.0
Russell 2000	1,497.27	-2.5	-4.1	-9.4
MSCI World	2,368.14	-1.3	-3.5	1.6
MSCI EAFE	1,896.99	1.4	-0.6	-5.2
MSCI Emerging Markets	1,091.79	-0.7	-0.8	-0.4

S&P 500 Sector Returns



Fixed Income[1]

	Total Return in USD (%)			
	Current	WTD	MTD	YTD
Corporate & Government	1.11	0.3	0.2	8.3
Agencies	0.51	0.3	0.1	5.4
Municipals	1.32	0.0	0.0	3.3
U.S. Investment Grade Credit	1.14	0.2	0.2	7.0
International	1.95	0.3	0.3	7.2
High Yield	5.56	-0.2	-0.3	1.3

	Current	Prior Week End	Prior Month End	2019 Year End
90 Day Yield	0.10	0.10	0.09	1.54
2 Year Yield	0.13	0.14	0.13	1.57
10 Year Yield	0.67	0.72	0.70	1.92
30 Year Yield	1.41	1.47	1.47	2.39

Commodities & Currencies

	Total Return in USD (%)			
Commodities	**Current**	**WTD**	**MTD**	**YTD**
Bloomberg Commodity	152.71	-1.2	-2.4	-11.2
WTI Crude $/Barrel[2]	37.33	-6.1	-12.4	-38.9
Gold Spot $/Ounce[2]	1,940.55	0.3	-1.4	27.9

Currencies	**1.41**	**1.47**	**1.47**	**2.39**
EUR/USD	1.18	1.18	1.19	1.12
USD/JPY	106.16	106.24	105.91	108.61
USD/CNH	6.83	6.84	6.85	6.96

Sources: Bloomberg, Factset. Total Returns from the period of 09/08/2020 to 09/11/2020. Bloomberg Barclays Indices.[1] Spot price returns.[2] All data as of the 09/11/2020 close.
Past performance is no guarantee of future results.

Asset Class Weightings (as of 9/1/2020)

	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 09/11/2020)

	Q3 2019A	Q4 2019A	2019A	Q1 2020A	Q2 2020A	2020E
Real global GDP (% y/y annualized)	-	-	2.9	-	-	-4.0
Real U.S. GDP (% q/q annualized)	2.6	2.4	2.2	-5.0	-31.7	-4.3
CPI inflation (% y/y)	1.7	2.3	2.3	1.5	0.6	1.2
Core CPI inflation (% y/y)	2.4	2.3	2.3	2.1	1.2	1.6
Unemployment rate (%)	3.6	3.5	3.5	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	3250
S&P earnings ($/share)	42	42	163	33	28	125
Euro/U.S. dollar, end period	1.09	1.12	1.12	1.10	1.12	1.14
U.S. dollar/Japanese yen, end period	108	109	109	108	108	103
Oil ($/barrel, avg. of period, WTI**)	56	57	57	39	31	40

The forecasts in the table above are the base line view from BofAML 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. Historical data is sourced from Bloomberg, FactSet, and Haver Analytics.

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

A = Actual. E/* = Estimate. S&P 500 represents the year-end target for 2020. **West Texas Intermediate.
Sources: BofA Merrill Lynch Global Research; GWIM ISC as of September 11, 2020.

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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.

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.

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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.

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. Investments in foreign securities 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. 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. 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.