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CHIEF INVESTMENT OFFICE

Capital Market Outlook

October 15, 2019

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IN THIS ISSUE

- **Macro Strategy**—The rising uncertainty trend and stop-go growth pattern of this expansion have suppressed the buildup of the excesses typical of smoother growth cycles, creating downside support for the economy in each of the three mini-growth cycles of the past 10 years. While low inflation and Federal Reserve (Fed) interest rate cuts, together with subdued measures of risk-taking, argue against a recession over the coming year, in our view, the Fed must do more to avoid subpar growth and inflation well-below 2% over the next year.
- **Global Market View**—While the overall labor force growth is expected to slow as the U.S. population ages, upside surprises in the labor force participation of older Americans may help to mitigate this effect. Higher-than-expected workforce participation by baby boomers can also contribute to higher tax collections, greater stability for the U.S. government budget, and greater levels of U.S. consumption among older age cohorts.
- **Thought of the Week**—While the prior two quarters have narrowly staved off an earnings-per-share (EPS) decline, risk remains that the third quarter could mark the S&P 500's first such decline since 2016. However, we believe the current bar may be set too low and expect earnings to come in better than expected.
- **Portfolio Considerations**—A more highly diversified overall portfolio across and within asset classes makes sense, in our view, given the high level of macro uncertainty still overhanging the capital markets.

MACRO STRATEGY

Chief Investment Office Macro Strategy Team

GLOBAL MARKET VIEW

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

THOUGHT OF THE WEEK

Kishan Chhatwal
Assistant Vice President
and Investment Analyst

Data as of 10/15/2019 and subject to change.

MACRO STRATEGY

Recession unlikely but subpar growth and weak inflation remain risks

Chief Investment Office Macro Strategy Team

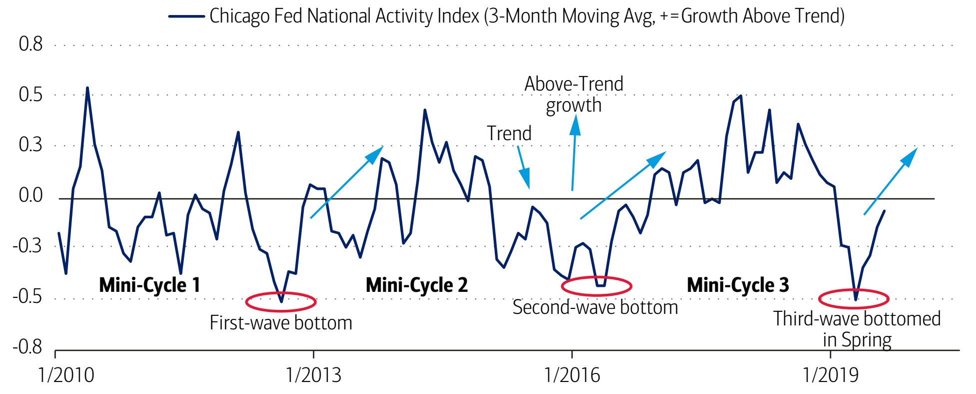
As we discussed over the past several weeks, central-bank easing and fiscal stimulus in a growing number of countries together with the Fed's pivot from hawkish to dovish appear to have arrested downward global-growth momentum. Economic data have indeed become more mixed rather than outright negative, consistent with this view. However, U.S. and global sentiment data have remained very weak, the yield-curve inversion has persisted, the dollar has continued to strengthen, and stress in the overnight interbank lending (repo) market has amplified, all signs that the Fed has still not added enough liquidity to maintain financial system stability, stimulate growth, relieve fears of recession, and preclude inflation from falling further below its 2% target over the coming year.

Faced with the inevitable, Chairman Powell has recently announced that the Fed is getting ready to resume "organic" balance-sheet expansion to address bank-liquidity concerns, and the market is priced for another 25-basis-point rate cut at the October 29-30 Federal Open Market Committee (FOMC) meeting, both critically necessary steps for an improved growth and inflation outlook. Despite a slow Fed response, substantial drag on global growth from Eurozone's ongoing malaise, and understandable fears that the current U.S. and global growth slump may devolve into an outright recession, based on incoming indicators and constructive changes in Fed policy, we continue to believe that a new upturn is in its early stages.

Basically, as the global economy got squeezed by excessive Fed tightening, Eurozone weakness, and structural change in the Chinese economic growth model, uncertainty and risk aversion surged over the past year from already elevated levels, curtailing growth and suppressing the buildup of excesses. Based on the roughly 18-month lead from turns in uncertainty to turns in economic growth momentum, this suggests that the downside adjustment to the Fed tightening is likely to prove less severe than in past cycles and should be mostly over by now. Also important, sluggish inflation has allowed the Fed to start easing before a major blowup of the economy. With housing already benefiting from Fed rate cuts, real money supply increasing again, a high aggregate personal saving rate, oil prices contained, and growth overseas in the process of slowly picking up as a result of monetary and fiscal stimulus in numerous countries and led by emerging markets, the U.S. and global economy appear increasingly likely to avoid a recession.

For example, Exhibit 1 shows the Chicago Fed National Activity index (CFNAI), which is a weighted average of 85 monthly indicators of economic activity from four broad categories: (1) production and income; (2) employment-related variables; (3) personal consumption and housing; and (4) sales, orders and inventories. This comprehensive activity index bottomed about half a standard deviation below trend in 2012, 2016, and the spring of 2019, marking the end of each recession-scare period. In contrast, in all of the recessions of the past 50 years, the CFNAI fell at least a full standard deviation, or more than double the decline of the three mini-waves of the current cycle. Significantly, despite all the hype about a manufacturing recession, U.S. industrial production also bottomed in the spring, as did manufacturing output overall, and separately for consumer goods and business equipment. Hard data show the manufacturing recession is over despite weak sentiment measures.

Exhibit 1: U.S. Growth Moving Back to Trend as a Fourth Wave Appears To Begin.



Source: Haver Analytics. Data as of October 8, 2019.

Encouragingly, while the U.S. manufacturing Institute for Supply Management index (ISM), widely used as a gauge for the direction of the economy, surprised to the downside with a deeper plunge into contraction territory in September, the global ISM manufacturing index advanced for a second consecutive month—getting closer to the 50 demarcation line between contraction and expansion—confirming our expectations. The month-to-month improvement in the leading indicator for Organisation for Economic Co-operation and Development (OECD)-plus-6-major-nonmembers has also continued in line with our view, consistent with further gains in the global ISM index in coming months given past correlations.

These global signals are favorable for global industrial production and global trade growth, both of which seem to be in the process of bottoming and soon likely to start increasing again, in our view. For example, even assuming the dollar remains flat at current levels, our expectations for further improvement in the OECD leading index and global ISM index—combined with the lagged effects of favorable credit conditions during the past year—point to renewed growth in global trade by early 2020, which would be inconsistent with a U.S. and global recession.

In terms of the surprise U.S. ISM index plunge in September, we believe that the index is in part overcorrecting for its extreme strength in 2017 and 2018, when it averaged about 1.5 standard deviations above average compared to roughly 0.5 standard deviations above mean for actual industrial production. In general, the U.S. and Eurozone purchasing managers' indicators (PMIs) and other sentiment data were much stronger than actual production growth and other "hard" data in 2017-2018 and have now become weaker than "hard" data. Excessive worry about potential impacts of the trade war seems to explain the shift from overconfidence to excessive pessimism.

In any case, although we expect the recent ISM index plunge to prove brief and thus to not track an economy-wide recessionary pattern, we believe that the manufacturing gauge will return to only modest growth by early 2020, still restrained by past Fed tightening, a strong dollar, the German-led Eurozone manufacturing recession, and the surge in uncertainty. Favorable credit conditions offer support for an improved outlook (i.e., they are not consistent with a recession-type plunge in the composite ISM index), but a softer dollar and sustained manufacturing production growth in Germany after the positive August reading would go a long way in meaningfully strengthening the index ahead. Unfortunately, the Eurozone economy is on track for its weakest growth rate since the double-dip recession in 2011-2012, and leading indicators suggest that Eurozone growth may start to slightly improve only in mid 2020, creating mild headwinds to U.S. and global growth.

As noted above, recessions tend to be preceded by signs of high confidence and growing business-sector excesses, such as big drops in the gold/copper ratio, for example, and euphoric investment sentiment as reflected in rising debt on margin accounts (which is a component of the Conference Board's index of leading indicators). Notably, none of these conditions have been observed for more than a year. Uncertainty and risk aversion as measured by the gold/copper ratio and margin debt growth are at levels that with a lead of about 18 months tend to precede uptrends in growth, not contractions. In other words, despite fears to the contrary, the leads and lags involved in economic cycles suggest the past year's surge in uncertainty and caution after a period of strong animal spirits in 2017-2018 is opening the door for better growth ahead, including a stabilization and eventual rebound in ISM indicators, tame credit spreads, and further improvement in the CFNAI and the OECD global leading indicators.

While leading indicators point away from a recession, the risk remains that the deflationary shock from over-tightening monetary policy intensifies and global inflation expectations continue to collapse. Encouragingly, Fed Chairman Powell appears more focused than ever on stopping the disinflation trend, as noted in his October 4 speech: "*…we are examining strategies that might better allow us to symmetrically and sustainably achieve 2 percent inflation. Doing so would help prevent inflation expectations among consumers, businesses and investors from slipping too low, as they appear to have done in several advanced economies.*" In our view, getting inflation "symmetrically and sustainably" around the 2% target implies a more accommodative monetary policy that will fuel the fourth wave higher over the next two years.

GLOBAL MARKET VIEW

Rethinking Retirement: Population Aging and Economic Growth in America

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

It's easy to get swept into the market hype associated with the first Friday of the month—"Jobs Day"—and lost in the fluctuations of high-frequency labor market data.

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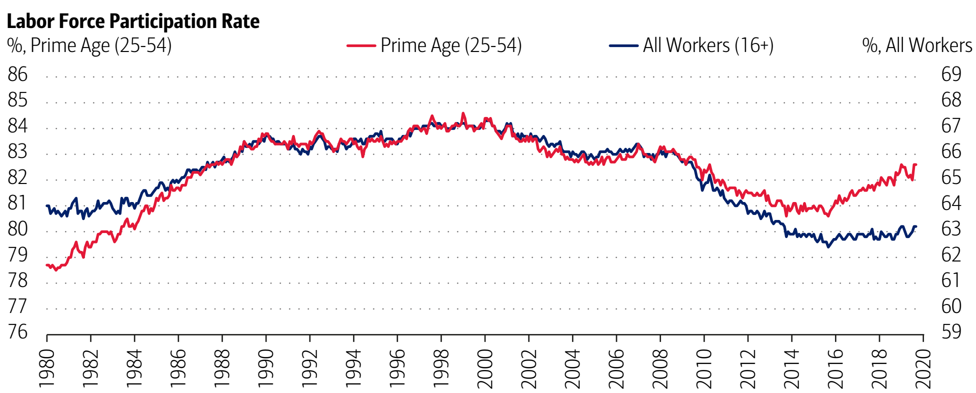
This month was no different. After a series of disappointing data releases (ISM surveys, ADP employment), traders and investors were glued to their screens as the U.S. Bureau of Labor Statistics (BLS) released its monthly assessment on the nation's labor market. The report showed a decent picture of the labor market, with jobs growth solid but slowing. Notably, the unemployment rate downshifted to 3.5%, the lowest level in 50 years. Meanwhile, wage growth was relatively constrained at a rate of just 2.9% year-over-year across all non-farm job sectors, but almost 3.5% for non-managerial positions.

Elsewhere in the BLS data trove, the labor force participation rate (LFPR) among working-age Americans continues to rebound, a bullish sign for the economy and corporate profits, given the tight jobs market. As we have written in the past, the positive supply-side effects of working age Americans re-entering the labor force can help to boost potential growth, despite large demographic headwinds from an aging population.

Exhibit 2 shows that while labor force participation has improved among prime-age workers in recent years, the overall rate remains far below levels achieved in the late 1990s. Since older workers are less likely to be in the labor force, the retiring of the baby boomers is forecast to drag down the overall participation rate in the coming decades. Indeed, the percentage of people aged 65+ in the United States is projected to grow from 16% in 2019 to 22% by 2040.

Exhibit 2: Prime-Age American Workers Expand the Labor Force.



Source: Bureau of Labor Statistics. Data as of October 2019.

That said, an important (and underestimated) offsetting factor to the aging population/ secular stagnation story is the fact that the baby boomer generation (born 1946–64) isn't retiring in droves as expected. Labor force participation rates are rising for older American workers. According to the BLS, one in five Americans over the age of 65 is currently working or looking for work, an increase from just 12% at the start of the century. That equates to an additional 4 million people added to the pool of workers (more than the combined workforce of Walmart, Amazon, Target and UPS).[1] This trend toward delaying retirement remains in early innings, with the potential for significant upside to the long-term growth rate of the U.S. economy. While the increased participation rate will not entirely offset the drag on the economy from unfavorable demographics, it could prove a significant positive surprise versus what is currently baked into long-term consensus growth forecasts.

A Silver Lining

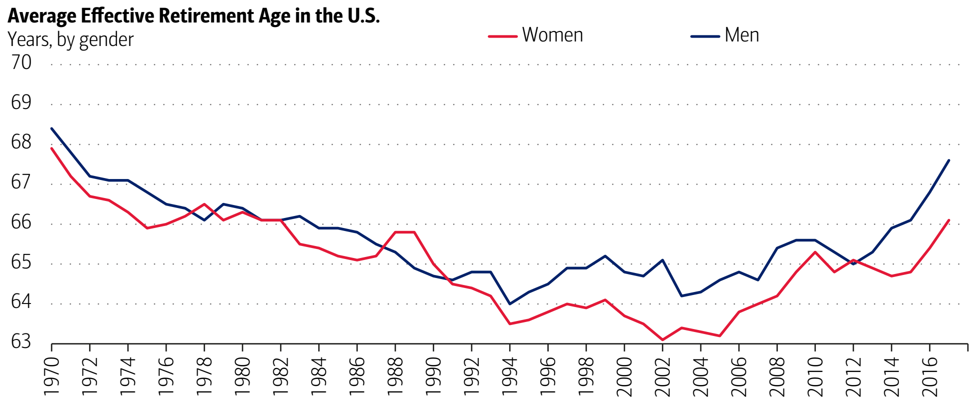
Each year from 2011 to 2029, an average of 3.8 million baby boomers are expected to reach retirement age (10,000 per day). However, as a recent report from the Pew Research Center notes, this shift has not been entirely reflected in the labor market. Instead, baby boomers have been exiting the workforce at a rate of just 2.2 million per

[1] Stephanie Flanders and Matthew Boesler for Bloomberg, "Can't Stop Won't Stop Working," May 2, 2019.

year on average (5,900 per day). We expect this trend to continue—according to a survey conducted by the Insured Retirement Institute, one-third of baby boomers plan to retire at age 70 or older, up from 23% when the survey was conducted back in 2012.

Data from the OECD confirm this trend, with the U.S. average effective age of retirement increasing sharply in recent years (Exhibit 3). Various reasons for the rebound are described in Exhibit 4, including longer and healthier lifespans, higher educational attainment, and insufficient retirement savings, which force middle class workers to continue in the labor market.

Exhibit 3: Another Bullish Labor Surprise for the Decade.



Source: Organisation for Co-operation and Development. Data through 2017.

The Bottom Line

While the overall labor force growth is expected to slow as the U.S. population ages, upside surprises in the labor participation of older Americans would help to mitigate this effect. Increasing labor force participation of boomers can help add to the labor supply and improve the potential path for growth in the economy. It also helps alleviate some of the stress of a declining working-age-to-retirement-age ratio. This trend should also help to keep the unemployment rate near historically low levels, as boomers choosing to stay in the labor force are more likely to have a job. An increased pool of labor for employers comes at a time when businesses are faced with significant labor shortages. Total job openings in America remain in excess of 7 million, although this figure has been declining in recent months.

Higher-than-expected workforce participation by baby boomers can also contribute to higher tax collections, greater stability for the U.S. government budget, and greater levels of consumption among older Americans. Average annual spending for consumers 75+ is relatively low, with the cohort spending just $43,000 in 2018 versus overall average annual spending of U.S. consumers of $61,000. Consumers aged 65 to 74 also underspend compared to younger generations, yet working longer can help boost incomes and consumption for those in retirement. In addition, and widening the lens, while marketers are smitten with the spending power of the millennials, U.S. baby boomers control 70% of the disposable income of the United States. This is supportive of key sectors where older consumers are more likely to allocate additional spending—sectors such as healthcare, entertainment, autos, travel and leisure.

In the end, there are many strengths to the U.S. economy—with the rising labor participation rate among older American workers one of them. The U.S. economy is supported by both young and old workers.

Exhibit 4: Why Are People Working Longer?

1. **Life expectancies have increased.** According to the Social Security Administration, U.S. citizens who live past the age of 65 can expect to live to 84 (men) and 87 (women). As lifespans increase, there is more demand for older people to stay engaged and active later in life through employment.
2. **On average, workers are healthier.** Seventy-eight percent of the labor force that is aged 65 or older reported being in good health or better (up from 69% in 1985).
3. **Higher levels of educational attainment** causes the labor force to defer retirement to an older age. In 1985 just 25% of the 65+ labor force had a college degree or greater, whereas today that number has soared to over 50%.
4. **Shift in types of jobs being done.** More workers are now employed in the services sector—work that tends to be less physically demanding than the traditional agricultural and manufacturing sectors popular for past generations.
5. **Change in retirement plans.** Generous private-sector pension plans have largely been replaced with employee-driven retirement savings plans. These plans are less secure and are driven by individual savings rates, leaving many boomers unable to afford to retire at the same ages as prior generations.
6. **Social Security reforms.** Reforms to increase the full retirement age for Social Security, as well as increasing incentives to delay benefits, have contributed to the rise in the average retirement age.
7. **Increased opportunities for part-time work.** Many older Americans may choose to continue to work part time later in life, while still receiving Social Security.
8. **Insufficient retirement savings.** The great recession of 2008 and subsequent era of low interest rates have left many employees unprepared to give up work. According to the Boston College Center for Retirement Studies, 54% of middle-income households don't have enough saved to maintain their quality of life in retirement. The average Social Security payout in retirement of $1,471 per month is less than half the average monthly wage.
9. **High debt levels.** Total household debt per capita for the 60+ age cohort has surged to roughly $44,000. Older Americans are increasingly burdened with rising student loan debt (taken out for graduate degrees and children's education), credit card debt and auto loans, and many have unpaid mortgage balances.
10. **Declining availability of company-sponsored health insurance for retirees.** The Kaiser Family Foundation reports the percentage of large companies offering retiree health benefits was 28% in 2019 versus two-thirds of companies in 1988. Without these plans, it is less likely for workers to retire in the years before Medicare kicks in.

Sources: Social Security Administration data as of October 2019; United Income data as of April 2019; Boston College Center for Retirement Studies data as of October 2018; Federal Reserve data as of Q2 2019; Bureau of Labor Statistics data as of September 2019. Kaiser Family Foundation data as of September 2019.

THOUGHT OF THE WEEK

Earnings Preview: To Q3 and Beyond

Kishan Chhatwal, Assistant Vice President and Investment Analyst

With the third quarter coming to a close and the beginning of reporting season upon us, consensus expectations are calling for -4.4% growth year-over-year (YoY), far below the +12% figure estimated in late 2018 (Exhibit 5).[2] Earnings estimates have fallen over 4% since July, more than the typical 3% pre-season cut, according to BofA Merrill Lynch Global Research. While the prior two quarters have narrowly staved off an earnings-per-share (EPS) decline, risk remains that the third quarter could mark the S&P 500's first such decline since 2016. However, we believe the current bar may be set too low and expect earnings to come in better than expected.

Despite the numerous headline risks, revenue growth has held up relatively well in the U.S. and is on track to expand nearly 4% YoY, according to FactSet. Investor sentiment, however, remains incredibly defensive given the backdrop of weak manufacturing, rising geopolitical risks, lingering global trade uncertainty, and concerns regarding business and consumer confidence. Therefore, numerous companies have lowered investor expectations in recent weeks, ahead of upcoming earnings releases, likely placing further downward pressure on the already depressed analyst expectations. Considering the average quarterly EPS surprise over the past four years exceeds 4%,[3] this lowered

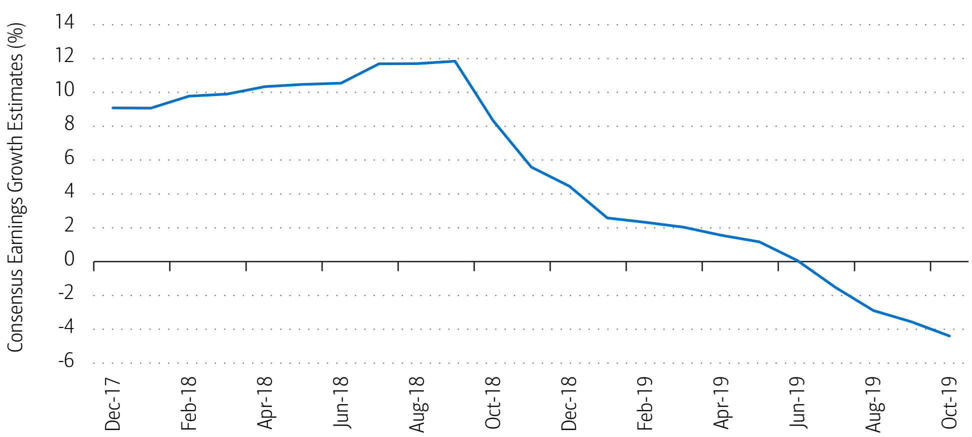
[2] FactSet Research Systems. October 9, 2019.

[3] Evercore ISI. October 8, 2019.

threshold may prove to benefit U.S. companies for yet another quarter, aided by historically healthy profit margins, strong consumer spending and robust stock buybacks.

We believe earnings may trough in Q3 and subsequently improve as economic growth potentially surprises on the upside, with the Fed staying and becoming more accommodative. In fact, consensus expects Q4 earnings to rise by 3% YoY and by 11% in 2020. Next year's estimates seem a bit optimistic, in our view, as nominal growth trends remain at moderate levels, but still supportive enough for the S&P 500 to generate roughly 6% EPS growth. If the trade outlook improves, leading to an expansion in the manufacturing sector, then earnings growth could surprise to the upside given that manufacturing accounts for 40% of the S&P 500's pre-tax earnings.[4]

Exhibit 5: S&P 500 Q3 Earnings Expectations Have Fallen Dramatically.



Sources: Chief Investment Office; FactSet Research Systems. Data as of October 8, 2019.

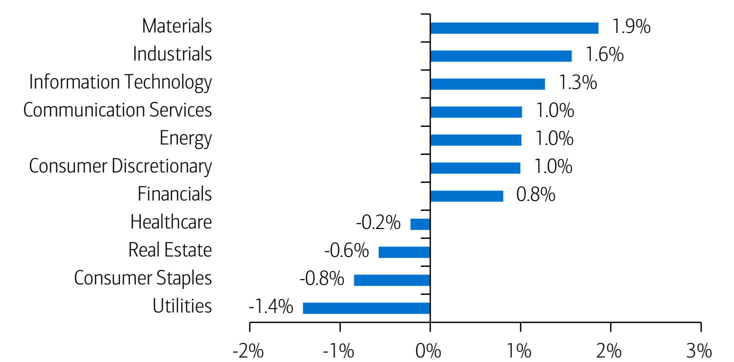
[4] Empirical Research Partners. Data as of 2018.

MARKETS IN REVIEW

Equities

		Total Return in USD (%)		
	Current	WTD	MTD	YTD
DJIA	26,816.59	0.9	-0.3	17.1
NASDAQ	8,057.04	0.9	0.7	22.5
S&P 500	2,970.27	0.7	-0.1	20.4
S&P 400 Mid Cap	1,916.57	0.7	-0.9	16.8
Russell 2000	1,511.90	0.8	-0.7	13.4
MSCI World	2,179.33	1.2	0.0	17.6
MSCI EAFE	1,896.66	2.3	0.4	13.3
MSCI Emerging Markets	1,011.54	1.5	1.1	7.1

S&P 500 Sector Returns



Fixed Income[1]

	Total Return in USD (%)			
	Current	WTD	MTD	YTD
Corporate & Government	2.23	-1.3	-0.4	9.3
Agencies	1.88	-0.8	-0.2	5.8
Municipals	1.81	-0.3	0.3	7.0
U.S. Investment Grade Credit	2.31	-1.0	-0.3	8.2
International	2.96	-1.3	-0.4	12.7
High Yield	5.79	0.3	-0.2	11.2

	Current	Prior Week End	Prior Month End	2018 Year End
90 Day Yield	1.59	1.64	1.74	2.36
2 Year Yield	1.59	1.40	1.62	2.49
10 Year Yield	1.73	1.53	1.66	2.68
30 Year Yield	2.19	2.02	2.11	3.01

Commodities & Currencies

	Total Return in USD (%)			
Commodities	Current	WTD	MTD	YTD
Bloomberg Commodity	167.04	1.2	1.4	4.6
WTI Crude $/Barrel[2]	54.70	3.6	1.2	20.5
Gold Spot $/Ounce[2]	1,489.10	-1.0	1.1	16.1

Currencies	Current	Prior Week End	Prior Month End	2018 Year End
EUR/USD	1.10	1.10	1.09	1.15
USD/JPY	108.29	106.94	108.08	109.69
USD/CNH	7.08	7.11	7.14	6.87

Source: Bloomberg, Factset.Total Returns from the period of 10/7/19 to 10/11/19. Bloomberg Barclays Indices.[1] Spot price returns.[2] All data as of the 1011/19 close.
Past performance is no guarantee of future results.

Asset Class Weightings (as of 10/1/2019)

	Under-weight		Neutral		Over-weight
Global Equities				●	
U.S. Large Cap Growth				●	
U.S. Large Cap Value				●	
U.S. Small Cap Growth				●	
U.S. Small Cap Value			●		
International Developed	●				
Emerging Markets		●			
Global Fixed Income		●			
U.S. Governments		●			
U.S. Mortgages			●		
U.S. Corporates			●		
High Yield		●			
U.S. Investment Grade Tax Exempt			●		
U.S. High Yield Tax Exempt		●			
International Fixed Income	●				
Alternative Investments*	see CIO Asset Class Views				
Hedge Funds			●		
Private Equity			●		
Real Assets			●		
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 10/11/19)

	Q1 2019A	Q2 2019A	Q3 2019A	Q4 2019E	2018A	2019E
Real global GDP (% y/y annualized)	–	–	–	–	3.6	3.2
Real U.S. GDP (% q/q annualized)	3.1	2.0	2.1*	1.3	2.9	2.3
CPI inflation (% y/y)	1.6	1.8	1.8	2.0	2.4	1.8
Core CPI inflation (% y/y)	2.1	2.1	2.3	2.4	2.1	2.2
Unemployment rate (%)	3.9	3.6	3.6	3.6	3.9	3.7
Fed funds rate, end period (%)	2.43	2.40	1.90	1.38	2.40	1.38
10-year Treasury, end period (%)	2.41	2.01	1.66	1.25	2.68	1.25
S&P 500 end period	2834	2942	2977	2900	2507	2900
S&P earnings ($/share)	39	41	42*	42	161.5	164
Euro/U.S. dollar, end period	1.12	1.14	1.09	1.08	1.15	1.08
U.S. dollar/Japanese yen, end period	111	108	108	101	110	101
Oil ($/barrel, avg. of period, WTI**)	55	60	56	55	65	56

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.

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 a fair value estimate for 2019. **West Texas Intermediate

Sources: BofA Merrill Lynch Global Research; GWIM ISC as of October 11, 2019.

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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.

Purchasing Managers' Indexes (PMI) are economic indicators derived from monthly surveys of private sector companies

Chicago Fed National Activity index is a coincident indicator of broad economic activity that is a weighted average of 85 indicators based on economic data covering production and income, employment, personal consumption, housing, manufacturing, trade sales, inventories, and orders.

OECD system of Composite Leading Indicators (CLIs) is designed to provide early signals of turning points in business cycles - fluctuation in the output gap, i.e. fluctuation of the economic activity around its long term potential level.

Conference Board Leading Economic Index is an American economic leading indicator intended to forecast future economic activity.

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Economic or financial forecasts are inherently limited and should not be relied on as indicators of future investment performance.

It is not possible to invest directly in an index.

Asset allocation, diversification, dollar cost averaging and rebalancing do not ensure a profit or protect against loss in declining markets. Dollar cost averaging involves continual investment in securities regardless of fluctuating price levels; you should consider your willingness to continue purchasing during periods of high or low price levels.

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