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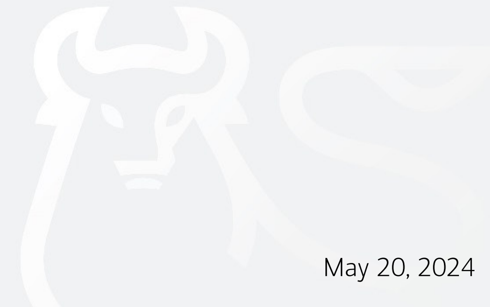
Capital Market Outlook



May 20, 2024

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

IN THIS ISSUE

Macro Strategy—*Is Stagflation Likely?:* With inflation stubbornly high after briefly surpassing levels not seen in 40 years, the term "stagflation" has been resurrected as a risk for the U.S. economy. Currently, however, the low unemployment rate is inconsistent with stagflation. What's more, inflation remains on a downtrend, and wage growth seems poised to moderate further. The economy has also changed since the 1970s, potentially limiting the risk of stagflation to just a brief episode.

That said, there are some similarities with the dynamics that eventually led to sustained stagflation in the 1970s, particularly as they relate to monetary policy accommodation of excessive fiscal spending. The "guns and butter" policies—which began in the mid-1960s and continued until monetary policy stopped accommodating inflationary government spending in the early 1980s—remain a cautionary tale.

Market View—*The Long View: Was the Last 80 Years Just an Illusion?:* The last eight decades have been among the best in history for peace, prosperity, profits—and market returns. But given today's geopolitical landscape, the past will not be prologue. The U.S.-led liberal economic order of the post-war era is shifting—national security trumps economics/profits; trade isn't free, it's managed; global capital flows aren't global; industrial policies are back; global supply chains are being reconfigured at substantial costs to companies; deregulation out, regulation in; and, in a world where might is right, the peace dividend has gone up in smoke. The Great Power Rivalry between the U.S. and China is on.

The shifting sands of geopolitics doesn't preclude solid investment returns in the future, but it does augur for the following: up-in-quality across all asset classes, dividend and income providers, more active over passive management of portfolios, as well as a preference for hard power (defense/cybersecurity leaders), hard assets (commodities) and inflation-sensitive sectors.

Thought of the Week—*Two Structural (Bullish) Variables Supporting the U.S. Labor Force:* Nothing has been more puzzling to the Federal Reserve (Fed) than the underlying strength of the U.S. labor market. Despite one of the most aggressive Fed-tightening cycles in history, the U.S. unemployment rate remains below 4%—and has been at sub-4% for 27 consecutive months. Energizing the labor market have been two key variables: 1) the jump in the number of foreign-born workers entering the jobs market and 2) the growth of the female labor force. More immigrants + more women = a tight labor market and a bewildered Fed. It also means a healthier-than-expected U.S. economy. Last year alone, immigrants accounted for 60% of the growth in the labor market; meanwhile, there are now more working-aged women employed than ever before in the U.S., with female employment hitting a record high of 75.5% in April. The one-two punch is supportive of future economic growth and earnings.

MACRO STRATEGY ▶

Chief Investment Office
Macro Strategy Team

MARKET VIEW ▶

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

THOUGHT OF THE WEEK ▶

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Lauren J. Sanfilippo
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MARKETS IN REVIEW ▶

Data as of 5/20/2024, and subject to change

Portfolio Considerations

We maintain an overweight to Equities, with a preference for higher quality U.S. Large- and Small-caps, and still favor a significant allocation to bonds in a diversified portfolio. We maintain our view of buying into equity market weakness and maintaining exposure to Fixed Income for the purpose of cash flow and diversification benefits. Within Fixed Income, we still suggest a slightly long-duration position versus a stated benchmark to take advantage of higher yields, and as prudent positioning against macro risk in the increased Equity positioning of a diversified portfolio.

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MACRO STRATEGY

Is Stagflation Likely?

Chief Investment Office, Macro Strategy Team

Mentions of U.S. "stagflation" picked up in recent months as inflation surprised to the upside, while economic data started to suggest slowing growth. For example, gross domestic product (GDP) growth and labor demand have cooled. On the other hand, inflation has remained elevated. Even after a welcome month-to-month moderation from a 4.4% annualized gain in March to 3.6% in April, inflation as measured by the consumer price index (CPI) excluding food and energy has averaged above 4% at an annualized rate over the past three and six months. Wage growth has also remained elevated compared to the last 40 years. The Institute for Supply Management (ISM) manufacturing and nonmanufacturing surveys for April gave a whiff of potential stagflation, as well, with contractionary employment readings alongside jumps in price pressures.

The term "stagflation" became a mainstream economic topic in the 1970s because inflation and unemployment were rising at the same time, contradicting the economic orthodoxy of the time. That orthodoxy was based on the idea of a stable tradeoff between inflation and unemployment, aka the Phillips Curve.

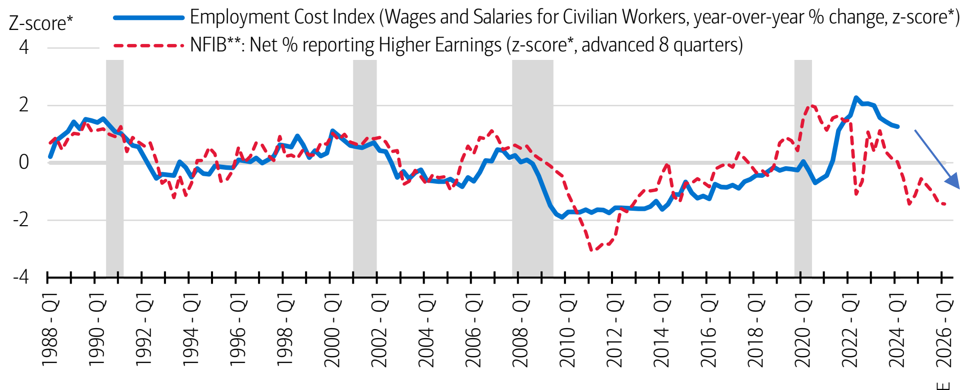
Starting in the early 1960s, President Kennedy's Council of Economic Advisors embraced new Keynesian ideas that included the notion that a higher tolerance for inflation would reduce the unemployment rate. Throughout the 1960s, this view, which involved the pro-active use of fiscal deficits to offset economic weakness, took on a life of its own, resulting in the "guns and butter" policies of that era.

However, as the 1970s progressed, inflation kept rising to successive highs while the unemployment rate also moved higher. This unwelcome combination, dubbed "stagflation," showed that there's no worthwhile tradeoff between high inflation and low unemployment in the longer run. Higher inflation was hard to justify if it resulted in higher, rather than lower, unemployment.

Milton Friedman had anticipated the negative, stagflationary implications of persistently inflationary monetary policy. In his December 1967 Presidential Address to the American Economic Association, he stated that "there is always a temporary tradeoff between inflation and unemployment; there is no permanent tradeoff."

Basically, since nominal wages don't adjust immediately to an inflation surprise, a bout of unexpected inflation causes labor costs to decline relative to prices, sustaining hiring. However, rising inflation creates price-signal distortions and investment misallocations. Eventually it retards growth, as workers' real spending power declines, reducing consumption, economic growth and employment. Once inflation is built into expectations and becomes anticipated, the gains from **unanticipated** inflation dissipate, and unemployment reverts to a higher level, with inflation rising as well.

Exhibit 1: Wage Growth Likely To Soften, Reducing Risks Of Sustained Stagflation.



E=estimate. *z-score=the number of standard deviations from the mean value of the reference population. Standard deviation helps measure how dispersed the data is around its mean. Gray bars represent recessionary periods. Sources: **National Federation of Independent Business (NFIB); Bureau of Labor Statistics/Haver Analytics. Data as of May 15, 2024.

Investment Implications

Higher-for-longer-inflation and interest rates favor Value stocks and Real Assets like commodities. Sectors such as Materials and Energy have typically outperformed in periods of high inflation. Dividends tend to constitute a larger share of Equity returns in stagflationary economies.

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Forecasters consistently underestimated the actual inflation outcome throughout the 1970s. Then, in the 1980s, when the Fed got serious about bringing inflation down, unanticipated inflation went from positive to negative, inducing a 40-year downtrend in interest rates. Aside from the 2008-2009 Great Recession and the pandemic spikes, unemployment also trended lower during this period, further invalidating the view that there's a tradeoff between inflation and unemployment in the long run.

What are the risks of renewed stagflation? Prolonged stagflation during the 1970s and early 1980s resulted from a confluence of excessive fiscal spending, monetary policy mistakes, unanchored inflation expectations, supply shocks, and structural economic and regulatory rigidities. This mix retarded supply and created an upside inflation spiral that required aggressive monetary policy tightening to undo.

The big deficits and easy money policies of the past four years have also caused a surge in unanticipated inflation not seen in decades. However, the current U.S. economic and monetary policy context is quite different from that of the 1970s and early 1980s, suggesting a lower likelihood of an upside inflation spiral and sustained stagflation:

- Inflation expectations remain at moderate levels.
- The Fed can prevent prolonged stagflation by getting inflation back to target before inflation expectations become unanchored.
- The labor market is less rigid.
- Labor demand has come in better alignment with labor supply. Various leading indicators suggest wage growth remains on a downtrend (Exhibit 1), reducing upside inflation risks.
- Productivity has been stronger than expected. It's also likely to benefit from broadening Artificial Intelligence applications and accelerating technological advancement, suppressing inflation pressures.
- Profit margins are elevated, a positive for business investment and employment.
- There are fewer structural rigidities than during the past stagflation era.
- Supply shocks were a primary determinant of stagflation. The U.S. has become self-sufficient on the oil-supply front, reducing the risk of energy-supply shocks like those of the 1970s.
- Broad global agreement that inflation must stay low for best economic performance over the long run. Inflation has already come down in many countries following a pandemic surge.
- According to various indicators, global economic growth is picking up. This offers support for U.S. growth, while domestic demand and inflation moderate under the weight of Fed policy restraint.

In sum, interest rates are likely to remain higher for longer to bring inflation down to its target, causing unemployment to potentially increase further in the process. A brief "stagflationary" period would thus not be surprising in the aftermath of unsustainably high post-pandemic growth and inflation.

Premature Fed easing, on the other hand, would raise risks of reaccelerating inflation and prolonged stagflation, especially given unrestrained government spending in a fully employed economy. In the end, inflation is a monetary phenomenon, so it will be up to the Fed to keep it in check, which remains to be seen.

Until the Fed achieves its low and stable inflation target, investors need to protect against the corrosive power of inflation. Owners of real assets with fixed dollar liabilities are leveraged to benefit from inflation. By the end of the 1970s stagflation, sectors such as Materials and Energy accounted for more than 30% of the S&P 500 market capitalization from about half that share when the inflation began in the mid-1960s, as commodities also performed well during that time. In general, commodities tended to help portfolios in high inflation periods while bonds, the main laggard from high unanticipated inflation, underperformed, as we've seen over the past four years.

MARKET VIEW

The Long View: Was the Last Eighty Years Just an Illusion?

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

Whether investors know it or not, the last eight decades have been among the best in history for peace, prosperity, profits—and market returns. But given today's tempest of geopolitics—and the widening cracks in the foundation of the post-1945 world order—one has to wonder if it was all an illusion—a historical aberration. Are we destined to revert back to the pre-1945 era of protectionism, tribalism and war? And if so, what does this mean for market returns and portfolio construction?

Investment Implications

A new era of geopolitics augurs for up-in-quality across all asset classes, dividend and income providers, and a preference for hard power (defense leaders) and hard assets.

The World We Left Behind. Nothing is shorter than one's memory, so it helps to step back into history and take stock of the world prior to 1945. War or peace? Taking the very long view, it's worth noting that of the past 3,400 years, humans have been entirely at peace for 268 of them, or just 8% of recorded history.[1] In the sixteenth and seventeenth centuries, the great powers were at war 75% to 100% of the time.[2] Meanwhile, between 1850 and 1945, France and Germany went to war three times; Russia and Germany went to war twice; and Britain and France together fought Russia once.[3] Historically speaking, then, wars are common, peace elusive, and prosperity a rarity.

Speaking of the latter, for four centuries prior to 1950, global GDP rose by less than 1% a year.[3] Decade to decade, generation to generation, per capita incomes barely budged. Life was brutish—famines were not uncommon; malnutrition was widespread; sanitation conditions were deplorable. In 1900, horses fouled New York City streets with more than 2.5 million pounds of manure and 600,000 gallons of urine **daily**.[4] Yes, every day. Grinding poverty was commonplace—shortening life spans—the average life expectancy for a U.S. male was just 46.3 years in 1900.

Yet, it wasn't all bad. The seismic waves from the Industrial Revolution kicked economic growth into a higher gear beginning in the 1820s, boosting global growth and trade while sending living standards and life expectancies higher across Europe and North America. Cities expanded as did factory jobs and the availability of goods. Factory conditions, however, were less than optimal for workers and the environment, resulting in rising unemployment, dirty and crowded cities, and the common spread of diseases. Wars, meanwhile, were a constant, with the first half of the 20th century among the bloodiest in history.

The World We Made Post-WWII. Our era has been near-golden—shaped more by peace than war, progress over poverty, and economic growth rather than stagnation. The foundation was laid by U.S. support of war-torn Europe and Asia after WWII and America's willingness to underwrite a liberal world order that encouraged democracy, free market economies and unfettered cross-border flows of trade and investment.

Out of the destruction of WWII emerged the most prolonged and prosperous era of global growth the world has ever experienced. Annual global GDP growth rose to nearly 4% between 1950 and 2000, versus 1.6% growth between 1820 and 1950 and a measly 0.3% between 1500 and 1820.[5] Against this backdrop, billions of people were lifted out of poverty. Democracies flourished. Expanding cross-border ties of trade and investment knitted the world together and allowed U.S. multinationals to gain access to new markets, resources and labor. Leading American brands became global brands. Emerging market workers-cum-consumers, notably in China, helped propel global growth and global earnings.

So did peace between superpowers. Save the Korean War, no great powers have gone to war against each other in decades—a historical anomaly. True, wars and armed conflicts have not been completely eliminated over the past few decades. But the collapse of the Soviet Union and the end of the Cold War in the late 1980s led to a global "peace dividend," while the shift in the "Commanding Heights" toward greater deregulation, privatization and unfettered

[1] See "What Every Person Should Know About War," by Chris Hedges, page1.
[2] See "Progress: Ten Reasons to Look Forward to the Future," by John Norberg, page 98.
[3] See "The World America Made," by Robert Kagan, page 17.
[4] See "Progress: Ten Reasons to Look Forward to the Future, " by John Norberg, page 34.
[5] See "The World America Made" by Robert Kagan, page 40.

cross-border flows of trade and capital helped to suppress global inflation, structurally lower the cost of capital, and fundamentally boost global earnings.

Yes, there were economic shocks along the way—but the U.S.-led liberal economic order of the past 80 years, while bending, did not break.

The World of Today. The rules-based, free market-led interdependent world of the past is fraying. It's different this time—national security trumps economics/profits; trade isn't free, it's managed; global capital flows aren't global; industrial policies are back; global supply chains are being reconfigured at substantial costs to companies; deregulation out, regulation in; and, in a world where might is right, the peace dividend has gone up in smoke.

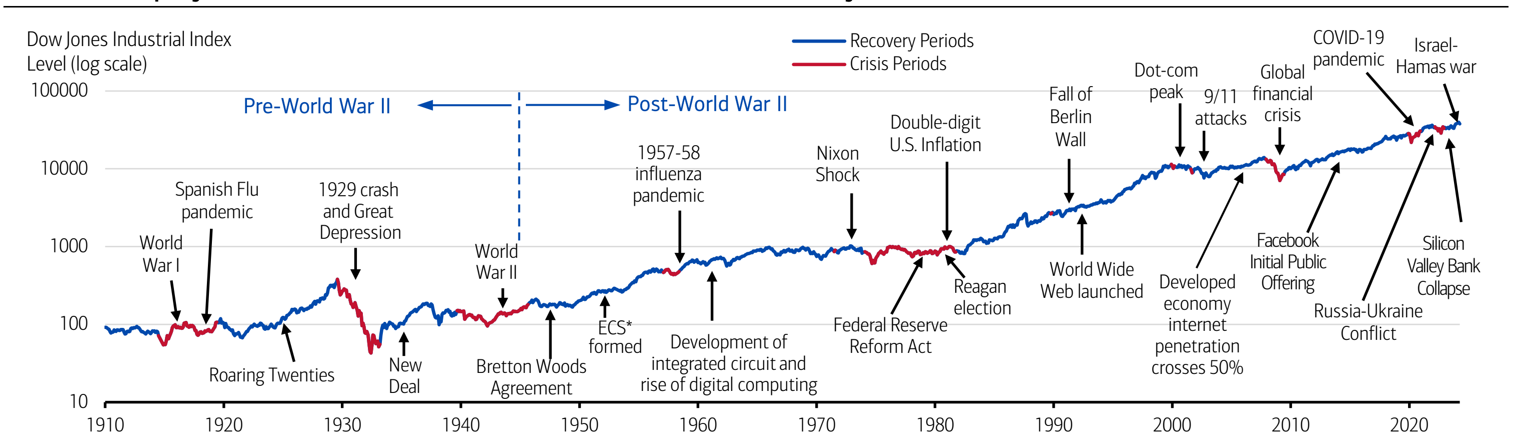
While the major geopolitical events of the past few years have had a minimal effect on global equities, investors should not be lulled into thinking that a ground war in Europe, conflict in the Middle East and tensions in the South China Sea don't matter to the capital markets. Nothing could be further from the truth.

While for decades the threats to the U.S.-led economic order were limited and minimal, today China and Russia, along with North Korea and Iran, have coalesced into an "axis of upheaval," whose shared ambition is nothing short of remaking the U.S.-led global liberal economic order of the past eighty years.[6] Their ambition is to overturn the principles and rules of the global economy, dethrone the U.S. dollar, and create their own technology standards, among other things. What's more, the strengths and capabilities of this cohort are formidable and on par with America's and its allies.

The costs associated with unpredictable geopolitics run the risk from rising global defense spending-cum-widening budget deficits to higher prices/inflation due to supply chain vulnerabilities and increased global populism/nationalism. And in this world where governments are imposing trade sanctions more than four times as often as they did in the 1990s, at risk are global earnings and the future profitability of many U.S. companies. More trade barriers, more inward-looking industrial policies, more capital diverted to defense spending—these variables are toxic ingredients for higher global inflation and a structural shift higher in global interest rates.

The New World. We are entering a new era characterized by factors investors have not had to contemplate for decades—i.e., rising geopolitical risks among the great powers; structurally higher inflation due in part to resource protectionism and industrial nationalism; and the shift of the "Commanding Heights" toward the public sector at the expense of the private sector. This doesn't preclude solid investment returns in the future, but it does augur for the following: up-in-quality across all asset classes, dividend and income providers, more active over passive management.[7] of portfolios, and a preference for hard power (defense/cybersecurity leaders), hard assets (commodities) and inflation-sensitive sectors.

Exhibit 2: Equity Market And Historical Periods Of Crisis And Recovery.



*European Coal and Steel Community. Source: Chief Investment Office; Bloomberg. Data as of April 2024.

[6] See "The Axis of Upheaval", Foreign Affairs, May/June 2024.

[7] Active management is an approach to investing. In an actively managed portfolio of investments, the investor selects the investments that make up the portfolio. Passive management is an investing strategy that tracks a market-weighted index or portfolio.

THOUGHT OF THE WEEK

Two Structural (Bullish) Variables Supporting the U.S. Labor Force

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

Lauren J. Sanfilippo, Director and Senior Investment Strategist

Nothing has confounded the Fed like the underlying strength of the U.S. labor market. Nearly two years after the Fed started raising interest rates to cool the economy and tame inflation, the U.S. unemployment rate remains below 4%. It's been sub 4% for 27 consecutive months—which runs counter to Fed economic models that suggest higher interest rates = slower growth = higher unemployment = lower inflation-cum-recession. No such luck.

Energizing the labor market have been two key variables: 1) the jump in the number of foreign-born workers entering the jobs market and 2) the rise in the female employment rate. More immigrants + more women = a bewildered Fed. And a healthier-than-expected U.S. economy.

According to figures from the Bureau of Labor Statistics, foreign-born workers (immigrants) now account for just under one-fifth of the U.S. workforce, a figure up significantly from the start of the decade (Exhibit 3A). Last year alone, immigrants accounted for 60% of the growth in the labor market, helping to alleviate labor shortages across a number of service-related activities like hospitality, caregiving and retail, in addition to construction trade. These workers were critical in backfilling many jobs shed during the pandemic and aided the post pandemic recovery. The upshot: moderate overall wage growth and more underlying demand for the U.S. economy.

Working-aged women (25 to 54 years old) have also contributed to U.S. labor market strength. As Exhibit 3B depicts, there are now more working-aged women employed than ever before in the U.S., with female employment hitting a record high of 75.5% in April. More flexible hours, higher pay and greater access to remote work have been key in encouraging women to jump back into the labor market. And the more women work and earn income, the better the outlook for the U.S. economy in general.

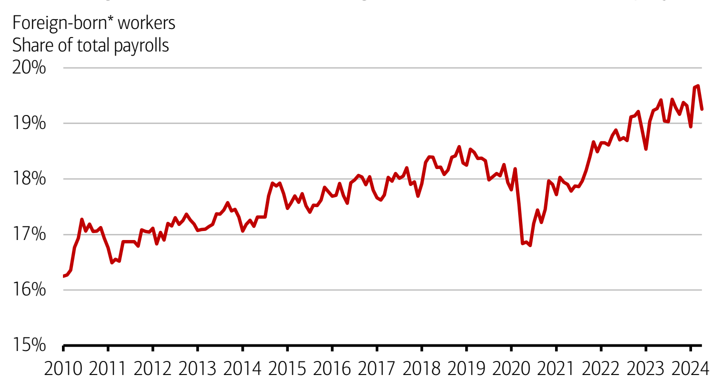
That said, we highlight two caveats to watch: First, immigration is a hot-button issue in an election year, and any curtailment/restrictions on immigrant inflows could negatively ripple through the labor force down the road. Two, with the end of pandemic-related funding for childcare, many working mothers are struggling with childcare access/costs, which could reverse the upward momentum of the all-important female labor force. Stay tuned.

Investment Implications

U.S. supply (workers) and demand (consumers) remains relatively healthy and is a bullish marker for future economic growth and corporate earnings.

Exhibit 3: More Immigrants + More Women = A Befuddled Fed But A Stronger Economy.

3A) Immigrant Labor Has Been Rising as a Share of Total U.S. Employment



3B) Working Women Make History.

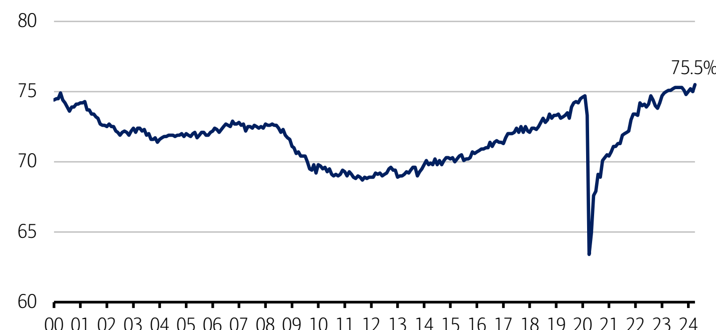


Exhibit 3A) *The foreign born are persons who reside in the United States but who were not U.S. citizens at birth. Specifically, they were born outside the U.S. (or one of its outlying areas such as Puerto Rico or Guam), and neither parent was a U.S. citizen. The foreign born include legally-admitted immigrants, refugees, temporary residents such as students and temporary workers, and undocumented immigrants. Sources: Bureau of Labor Statistics; Bloomberg. Data as of April 2024. Exhibit 3B) Sources: Bureau of Labor Statistics; Haver Analytics. Data as of May 14, 2024.

Equities

	Total Return in USD (%)			
	Current	WTD	MTD	YTD
DJIA	40,003.59	1.3	5.9	6.9
NASDAQ	16,685.97	2.2	6.6	11.5
S&P 500	5,303.27	1.6	5.4	11.8
S&P 400 Mid Cap	3,016.25	0.8	5.5	9.0
Russell 2000	2,095.72	1.8	6.3	3.9
MSCI World	3,472.52	1.6	5.2	10.3
MSCI EAFE	2,381.35	1.7	4.8	8.1
MSCI Emerging Markets	1,099.79	2.7	5.3	8.3

Fixed Income†

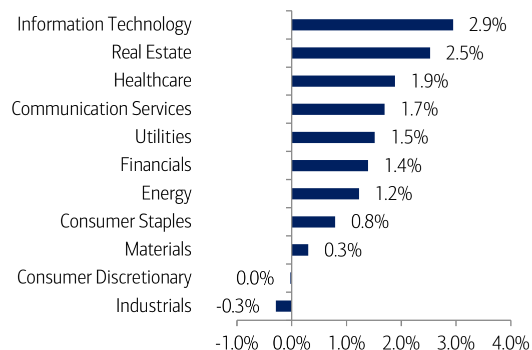
	Total Return in USD (%)			
	Current	WTD	MTD	YTD
Corporate & Government	4.95	0.58	1.78	-1.35
Agencies	5.00	0.28	0.97	0.05
Municipals	3.65	-0.06	1.02	-0.61
U.S. Investment Grade Credit	5.04	0.57	1.94	-1.40
International	5.47	0.68	2.04	-0.96
High Yield	7.85	0.39	1.33	1.85
90 Day Yield	5.39	5.40	5.39	5.33
2 Year Yield	4.82	4.87	5.04	4.25
10 Year Yield	4.42	4.50	4.68	3.88
30 Year Yield	4.56	4.64	4.78	4.03

Commodities & Currencies

	Total Return in USD (%)			
Commodities	Current	WTD	MTD	YTD
Bloomberg Commodity	247.75	3.0	4.3	9.4
WTI Crude $/Barrel††	80.06	2.3	-2.3	11.7
Gold Spot $/Ounce††	2415.22	2.3	5.6	17.1

	Total Return in USD (%)			
Currencies	Current	Prior Week End	Prior Month End	2022 Year End
EUR/USD	1.09	1.08	1.07	1.10
USD/JPY	155.65	155.78	157.80	141.04
USD/CNH	7.23	7.23	7.25	7.13

S&P Sector Returns



Sources: Bloomberg; Factset. Total Returns from the period of 5/13/2024 to 5/17/2024. †Bloomberg Barclays Indices. ††Spot price returns. All data as of the 5/17/2024 close. Data would differ if a different time period was displayed. Short-term performance shown to illustrate more recent trend. **Past performance is no guarantee of future results.**

Economic Forecasts (as of 5/17/2024)

	2023A	Q1 2024A	Q2 2024E	Q3 2024E	Q4 2024E	2024E
Real global GDP (% y/y annualized)	3.0	-	-	-	-	3.0
Real U.S. GDP (% q/q annualized)	2.5	1.6	2.0	2.0	2.0	2.5
CPI inflation (% y/y)	4.1	3.2	3.5	3.3	3.0	3.3
Core CPI inflation (% y/y)	4.8	3.8	3.6	3.6	3.5	3.6
Unemployment rate (%)	3.6	3.8	3.8	3.9	3.9	3.9
Fed funds rate, end period (%)	5.33	5.33	5.38	5.38	5.13	5.13

The forecasts in the table above are the base line view from BofA Global Research. 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. **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.
Sources: BofA Global Research; GWIM ISC as of May 17, 2024.

Asset Class Weightings (as of 5/7/2024)

Asset Class	Underweight		Neutral		Overweight
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		●			
International Fixed Income			●		
High Yield		●			
U.S. Investment-grade Tax Exempt		●			
U.S. High Yield Tax Exempt		●			
Alternative Investments*					
Hedge Funds Private Equity Real Assets			●		
Cash					

CIO Equity Sector Views

Sector	Underweight		Neutral		Overweight
Energy				●	
Healthcare				●	
Consumer Discretionary				●	
Industrials				●	
Information Technology			●		
Communication Services			●		
Financials			●		
Real Estate			●		
Utilities		●			
Materials		●			
Consumer Staples	●				

*Many products that pursue Alternative Investment strategies, specifically Private Equity and Hedge Funds, are available only to qualified investors. CIO asset class views are relative to the CIO Strategic Asset Allocation (SAA) of a multi-asset portfolio. Source: Chief Investment Office as of May 7, 2024. All sector and asset allocation 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.

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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 U.S. dollars.

S&P 500 Index is a market-capitalization-weighted index that is widely regarded as the best single gauge of large-cap U.S. equities. The index includes 500 leading companies and covers approximately 80% of available market capitalization.

Consumer price index is a price index, the price of a weighted average market basket of consumer goods and services purchased by households.

Dow Jones Industrial Average Index is a stock market index of 30 prominent companies listed on stock exchanges in the United States.

Employment cost index is a quarterly economic series detailing the changes in the costs of labor for businesses in the United States economy.

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

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