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CHIEF INVESTMENT OFFICE

Capital Market Outlook

June 17, 2024

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

IN THIS ISSUE

Macro Strategy—*Fiscal Dominance Mitigation Measures:* As U.S. government debt accumulates at a more rapid pace, and interest rates rise to more historically normal levels, the pressure on the Federal Reserve (Fed) to accept higher inflation intensifies. The structural shift to much higher fiscal deficits since the pandemic has already triggered the early warning signs that the U.S. is headed toward a future where "fiscal dominance" overrides the Fed's ability to hit its 2% inflation target. In addition to possibly raising the inflation target, there are other measures the government can employ to reduce the pressures that spiraling deficits put on monetary policy. These include ending the payment of interest on bank reserves and raising reserve requirements, as well as engineering periodic bouts of unanticipated inflation that reduce the real value of outstanding Treasury debt.

Market View—*How Will Foreigners Vote in the U.S. Election?:* Foreigners are barred from participating in U.S. federal elections, but they still get to vote—not with a ballot, of course, but with their own capital. The amount of foreign capital sunk in the U.S.—roughly $50 trillion—is quite significant; foreigners, in other words, have a lot riding on the November election and the future direction of the U.S.

So too, by extension, does debt-laden America. How foreigners vote with their capital greatly matters given the decades-long dependence of the U.S. on foreign capital to help fund the government's borrowing needs and grease the financial wheels of the U.S. economy. For decades, America's savings deficit has been offset by importing the world's excess capital surplus. Against a backdrop of large U.S. budget deficits and elevated debt levels, the last thing the U.S. needs right now is for foreigners to vote "no." We are keeping a close eye on the U.S. dollar for early signs of weakness (foreign selling of U.S. assets) as the election approaches. Think of the greenback as the canary in the coal mine—a leading indicator as to how investors are assessing the future risks associated with the November election.

Thought of the Week—*Global "Guns & Butter:"* Akin to government spending on the military (guns) and social programs (butter), this motto gained popularity in the U.S. during the mid-to-late 1960s. From 1968 to 2019, the fiscal balance there averaged a deficit of 2.9% with 2009 the deepest year at 9.8%, according to the American Presidency Project. Remarkably, from 2020 to 2024, the International Monetary Fund (IMF) expects it to average 10%, with 4.2% in the European Union (EU) and 7.5% in China, all well above their long-term averages. Larger deficits have become a global trend.

Consequently, global debt is nearing 100% of gross domestic product (GDP). Higher-for-longer interest rates risk exacerbating these fiscal imbalances and have prompted calls for a long-term strategy to reduce them. How these fiscal imbalances are addressed is likely to have important implications for portfolio strategy.

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 ▶

Rodrigo C. Serrano, CFA®
Director and Senior Investment Strategy Analyst

MARKETS IN REVIEW ▶

Data as of 6/17/2024, 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 maintain our preference for quality across the segments and curve while considering liquidity and a slight above benchmark weight in duration.

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MACRO STRATEGY

Fiscal Dominance Mitigation Measures

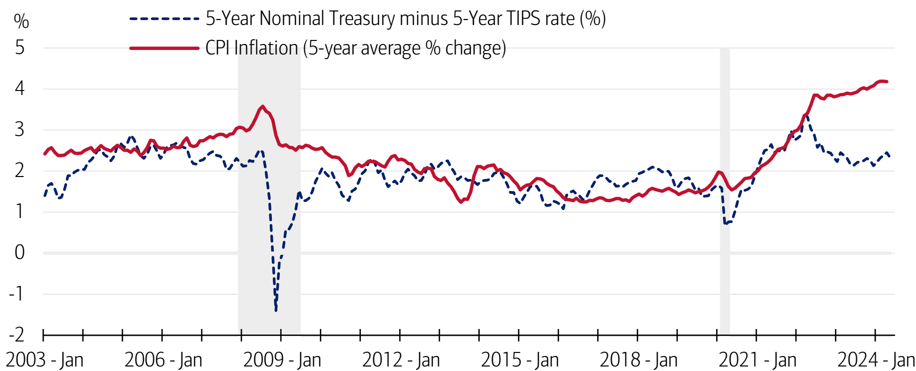
Chief Investment Office, Macro Strategy Team

A recent report published by the Federal Reserve Bank of St. Louis focuses on the likelihood that "fiscal dominance" will overwhelm the Fed's ability to contain inflation at low levels.[1] Fiscal dominance refers to a situation where government deficits produce inflation that overwhelms central banks' stated goals of keeping inflation low. Arguably, that process has already started. As shown in Exhibit 1, inflation measured by the consumer price index (CPI) has averaged over 4% during the past five years even as the Fed has clung to its 2% target. Also shown in Exhibit 1 is the market-based expectation for inflation, as reflected in five-year Treasury Inflation Protected Securities (TIPS). The roughly 2-percentage point gap between actual inflation and expected inflation in the exhibit is a measure of unanticipated inflation, which is one of the tools governments can use to mitigate the consequences of an excessive government debt burden.

Investment Implications

The likelihood that inflation could run higher over the next decade has already decimated the value of long-duration Fixed Income assets. Spiraling government debt will likely keep the pressure on policymakers to reduce the real government debt burden via inflation. The result is a likely continued structural bear market in long-term Treasury securities.

Exhibit 1: Similar to the 1970s, Inflation Expectations Lagging Far Behind Actual Inflation, Reducing the Value of Outstanding Government Debt.



Gray bars represent recessionary periods. Sources: Federal Reserve Board; Bureau of Labor Statistics/Haver Analytics. Data as of June 11, 2024.

The study notes that, "Historically, high inflation is produced by growth in the supply of money that reflects the pressures of fiscal dominance. Every major inflation in world history is a fiscal phenomenon before it is a monetary phenomenon." The inflation that resulted from the monetization of the big pandemic fiscal deficits surprised those who ignored this basic economic fact.

Usually, governments prevent fiscal dominance by raising taxes and slowing spending to stop the excessive growth of government debt. However, the political polarization in the U.S. has made these traditional measures unlikely. Most of the spending is on automatic pilot through various entitlement programs that balloon with inflation, as many are indexed. Politicians are loathe to address this problem because cutting benefits is a sure way to lose an election.

In addition, interest expense is skyrocketing as the government debt reprices to the new, higher level of interest rates. Geopolitical instability has also increased over the past few years, putting constant pressure for more defense spending. In short, the outlook for big deficits as far as the eye can see seems assured. As the Treasury noted last year in its Financial Report of the U.S. Government, "The projected continuous rise of the debt-to-GDP ratio indicates that current policy is unsustainable."

With "fiscal dominance" likely to constrain monetary policy in coming years, the Fed will probably look for some new tools to slow the inflationary effect of big deficits. Essentially,

[1] "Fiscal Dominance and the Return of Zero-Interest Bank Reserve Requirements," Charles W. Calomiris, Federal Reserve Bank of St. Louis REVIEW, Fourth Quarter 2023.

these tools need to reduce the interest expense the Treasury pays on an ever-growing government debt. As we learned during the pandemic, an inflation tax is the easiest way to deal with surging deficits. For example, the St. Louis Fed report cited above notes that the market value of U.S. Treasurys declined from about 108% of GDP in 2020 to about 85% in 2023 thanks largely to the inflation surprises since 2021. Basically, this "inflation tax" on bond holders paid for the pandemic programs. There is a large body of economic research that documents how the 1960s and 1970s inflation created a very large capital gain for the government, as the market value of its debt plummeted because of unanticipated inflation.

Even anticipated inflation can garner some value for government spenders. For example, Fed provision of currency to the public monetizes debt that becomes interest free to the Treasury. The more money created this way, the less debt pressure on the government. Typically, governments that run into the "fiscal dominance" problem often use zero-interest reserve requirements, so the inflation tax falls on the banking system holding non-interest earning reserves just as it affects those who hold currency. In addition, reserve requirements can be imposed, and raised, to increase the part of the government debt that does not pay interest.

The St. Louis Fed paper develops a model to illustrate how higher reserve requirements could reduce the inflation rate when fiscal dominance is pressuring the Fed to monetize government debt beyond low inflation limits. Just as there are limits to how much taxes can be raised before they start to erode the tax base so much that revenues begin to fall, there are limits to how much higher inflation can drive real revenue gains for the government. The inflation tax base, which includes currency, will likely begin to shrink if people start to reduce their holdings fast enough, as has always been the case in extreme inflation situations. Before inflation reaches such extremes levels, however, the model illustrates how raising reserve requirements can reduce inflation compared to a situation where there are no reserve requirements. Essentially, more non-interest-bearing reserves reduces the government deficit.

In general, "inflation taxes" are easier for politicians who cannot raise money through the normal legislative process. Regulatory rule changes don't require legislative action. Banks are likely to see profits hit if fiscal dominance reduces their interest income through these reserve requirement and interest-payment rule changes. The St. Louis paper also notes that "disintermediation" and resistance to financial innovation were hallmarks of the 1970s inflation period. For example, money market funds grew out of the 1970s inflation environment, as banks were constrained from paying market rates by interest rate ceilings, so money moved to places where higher market rates were available. This is somewhat similar to last year's disintermediation of regional banks when deposits moved out of banks to money market funds.

For investors, the implications of creeping fiscal dominance are crystal clear. As the head of a major insurer said in an interview in *Barron's* June 10, 2024, edition, "We are also aware of massive federal budget deficits and the high level of outstanding debt, which is one of the greatest risks this country faces. It keeps us from extending our duration too far." Long-duration Treasury assets lose most of their value over an extended period of fiscal pressure for inflationary monetary policy like the 1970s.

Real assets and companies that produce real products and, better yet, are financed with fixed-rate dollar liabilities, have outperformed those that can't keep up with the higher rate of inflation engendered by growing "fiscal dominance." Since World War II, fiscal pressure has been relieved by constantly reducing the real value of the U.S. dollar so that government bonds are always paid back, though with much reduced dollar purchasing power than when they were bought.

MARKET VIEW

How Will Foreigners Vote in the U.S. Election?

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

While foreigners are barred from participating in U.S. federal elections, they still get to vote—not with a ballot, of course, but with their own capital or cash. The latter—the amount of foreign capital sunk in the U.S.—is quite significant: think nearly $50 trillion in 2024 by our estimate (Exhibit 2A).

The $50 trillion total includes hard assets (foreign direct investment (FDI) in plants, equipment, real estate, research & development (R&D) facilities, etc.) and portfolio/capital flows (foreign purchases of U.S. securities like Treasurys, corporate bonds, government agencies and U.S. Equities). Bullish on America, the U.S. investment stakes of foreigners have increased nearly five-fold since the start of the century. And in another sign of U.S. exceptionalism, no country in the world has been at the receiving end of so much foreign capital this century.

All of the above is another way of saying that foreigners have a lot riding on the November election and the future direction of the U.S. So too, by extension, does debt-laden America.

How foreigners vote with their capital greatly matters given the decades-long dependence of the U.S. on foreign capital to help fund the government's borrowing needs and grease the financial wheels of the U.S. economy. For decades, America's savings deficit has been offset by importing the world's excess capital surplus. And that said, against a backdrop of large U.S. budget deficits and elevated debt levels, the last thing the U.S. needs right now is for foreigners to bolt, or vote "no."

Foreign Purchases of U.S. Securities. As Exhibit 2B illustrates, foreign investors have shown a remarkable penchant to "Buy America" over this century. Indeed, since 2000, the collective foreign ownership of U.S. Treasurys, U.S. agency bonds, corporate bonds and U.S. Equities has soared roughly eight-fold, from $3.7 trillion at the start of the century to over $28 trillion at Q1 of 2024.

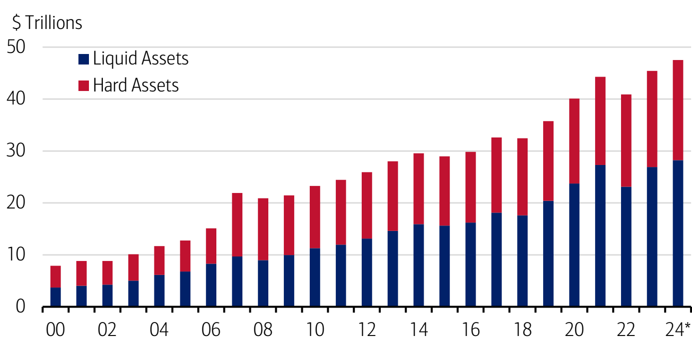
According to the latest Flow of Funds data from the Fed, foreign demand for U.S. securities remains relatively robust, with foreign holdings of U.S. Treasurys, U.S. corporate bonds and U.S. Equities presently at or near record highs. Foreign investors owned some $8.1 trillion in U.S. Treasurys at the end of Q1 of this year, up 6.6% from the prior year. The comparable number for U.S. corporate bonds was $4.2 trillion in Q1 24, a jump of 10.5% from the year prior period. Foreign demand for U.S. Equities, meanwhile, has soared over the past year, with foreign ownership of U.S. Equities rising to a record $14.5 trillion in Q1 2024, a jump of 26% from the prior year.

Investment Implications

We are keeping a close watch on the U.S. dollar as a proxy for how foreigners are assessing the risks associated with the election. Dollar volatility and slight dollar weakness would not be surprising as the election nears.

Exhibit 2: Coming to America: Foreign Investment in the U.S.

2A) Foreign Stakes in the U.S.: Hard and Liquid Assets.



2B) Foreign Ownership of all U.S. Securities.

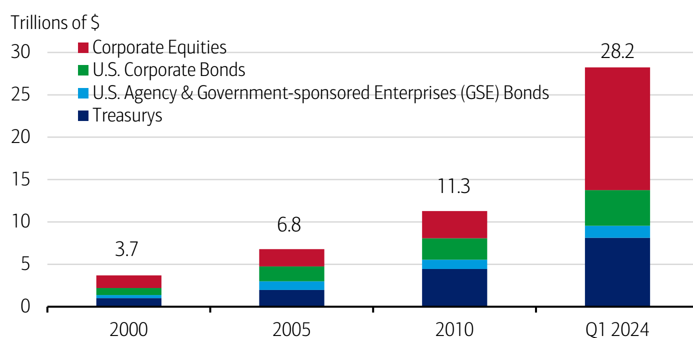


Exhibit 2A) *2024 data is for Q1. Total Assets of Multinational Enterprises in the U.S. are estimated for 2022-2024. Source: Fed Board; U.S. Bureau of Economic Analysis (BEA). Data as of June 12, 2024. Exhibit 2B) Source Fed Board. Data as of June 12, 2024.

On a percentage basis, foreign investors own roughly 30% of outstanding marketable Treasurys at the end of Q1, just over one-third of the corporate bond market, and one-fifth of tradable U.S. Equites (Exhibit 3A).

Why such strong demand for U.S. securities among foreign investors? Well, not lost on investors is the fact that the U.S. economy remains among the most competitive, innovative and resilient in the world. With just 4.2% of the world's population, U.S. economic output is

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now running at an annualized rate of $28 trillion, or roughly 28% of total world GDP. Aerospace or agriculture, energy or entertainment, transportation or technology, goods or services—pick any sector or activity, and there's a good chance the U.S. leads the rest of the world. All of this has helped fuel demand among foreign investors for U.S. securities of all stripes, notably U.S. Equities.

It has also sustained a steady inflow of FDI—or investment capital from some of the world's leading multinationals. A large and wealthy consumer market, strong institutions, a stable regulatory climate, top-ranked research universities, advanced innovation capabilities, and a skilled workforce—all of these factors have long contributed to the U.S. being the top destination in the world for FDI. To this point, FDI inflows to U.S. accounted for 17% of the global total between 2000 and 2022, according to data from United Nations, well ahead of second-place China (8.1%). Based on the latest statistics from the BEA, the total assets of foreign affiliates operating in the U.S. were valued at a staggering $17 trillion. From this massive asset base, foreign firms contributed some $1.1 trillion to U.S. GDP in 2021, the last year of available data from the BEA, while employing nearly 8 million American workers across various sectors of the economy.

In the end, an openness to cross-border trade and investment has brought the world to America, with billions of dollars in foreign investment inflows over the past few decades helping to boost real U.S. growth, employment, worker incomes, tax revenues, R&D development, and many other activities supportive of the U.S. economy. Meanwhile, owing to the depth and sophistication of the U.S. capital markets, along with the supremacy of the U.S. dollar, foreign investors have been all too willing to park/invest their savings in the U.S. The double-barreled external financing has been good for America. However, whether the past is prologue remains to be seen.

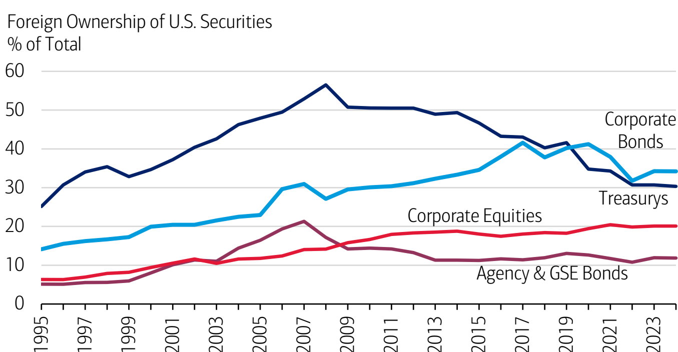
The U.S. Election: What Worries Foreign Investors. As a voting class, foreign investors are acutely concerned about an election outcome that leads to a more closed, isolated and protectionist America, and a White House occupant bent on a weaker U.S. dollar. All of the above could entail additional U.S. trade/invest restrictions, capital controls, weaker long-term growth in the U.S., higher inflation, expanding deficits and debt levels, and, in the end, lower investment returns for foreign investors long/bullish on America.

Meanwhile, should foreign investors decide to vote "no" with their capital, the consequences would be more than trivial for the U.S. America is a country that perennially lives beyond its means, which means deficit-financing aided and abetted by foreign capital is critical and essential. Meanwhile, foreign companies are embedded in all 50 states, creating jobs and incomes for American workers and local communities. Their absence—for whatever reason—would be sorely missed at the micro level.

Against this backdrop, we are keeping a close eye on the U.S. dollar for early signs of weakness (foreign selling of U.S. assets) as the election approaches. As Exhibit 3B shows, the dollar remains the preferred store of value for central banks. That said, think of the greenback as the canary in the coal mine—a leading indicator as to how investors are assessing the future risks associated with the November election in lieu of their massive investment stakes in the U.S. In the end, foreign investors have a vote in America's election.

Exhibit 3: Foreign Holdings and Central Bank Preferences.

3A) Percent of U.S. Securities Held by Foreigners.



3B) Currency Composition of Official Foreign Exchange Reserves.

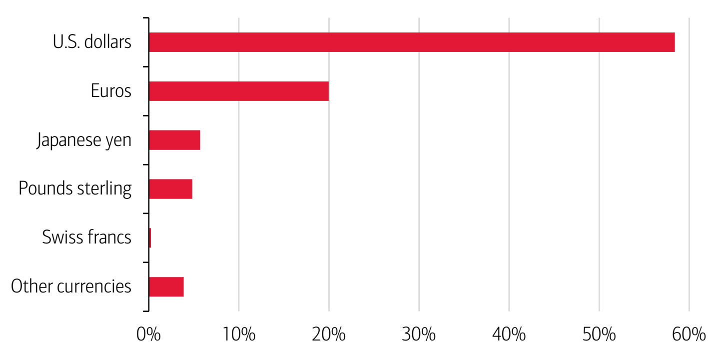


Exhibit 3A) *2024 data is for Q1. Source: Federal Reserve Board. Data as of June 12, 2024. Exhibit 3B) Source: International Monetary Fund. Data for 4Q 2023.

THOUGHT OF THE WEEK

Global "Guns & Butter"

Rodrigo C. Serrano, CFA®, Director and Senior Investment Strategy Analyst

Government spending on military initiatives, or "guns," and social priorities, historically dubbed "Butter," as well as in other projects, has fueled notable fiscal-related imbalances (see exhibits below).

Guns (military spending): Beginning in the early 1990s, the fading of the Cold War yielded a peace dividend for the U.S. Reduced defense spending accounted for 60% of a fiscal adjustment during most of that decade to improve the nation's fiscal balance, according to *The Economist*. Today, geopolitical uncertainty may accelerate world defense spending, which reached a record $2.2 trillion last year, according to Bloomberg, signaling a reversal of this fiscal dynamic. Growing uncertainty over the future of a security framework in place over decades may spur expenditure in Europe in particular.

Butter (social spending): Meanwhile, an increase in populations above growth in GDP may lower living standards. Last year, this dynamic prevailed across many international developed economies, particularly in Europe, according to Bloomberg Economics. Its persistence may raise pressure for relief measures. According to a recent poll released by the European Commission, voters are focused on policy solutions to fight poverty and exclusion. Meanwhile, in the U.S., the rising cost of living has factored in lagging consumer confidence, in our view. Longer term, ageing populations globally may factor in greater social spending in areas such as health care.

In addition to "guns and butter", governments globally are undertaking other initiatives, compounding fiscal commitments. In the U.S., the Bipartisan Infrastructure Framework, the CHIPS and Science Act, and the Inflation Reduction Act comprise efforts to bolster supply chain relocation, as well as to develop the digital and green economies, also twin goals of Europe's Next-Generation EU fiscal package. A renewable energy leader, China's New Type Infrastructure framework aims to digitalize the country.

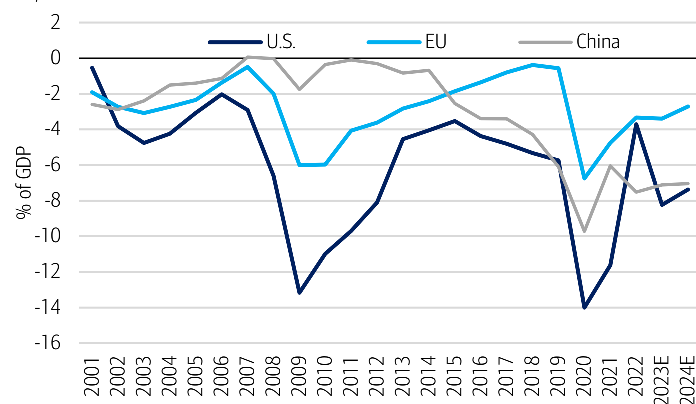
Investment in fostering digital and green economies may yield substantial productivity gains, helping ease fiscal adjustments like in the mid-to-late 1990s. Yet back then, paired with the economic tailwind fueled by a deregulation drive during the 1980s, the U.S. labor force participation rate was approaching its peak. Today, it's declined to levels comparable to the late 1970s amid a strengthening regulatory backdrop. More profoundly, a shift toward a more fragmented global economy may drag on trade, seen as an engine of growth for decades by many. In sum: Novel challenges face policymakers.

Investment Implications

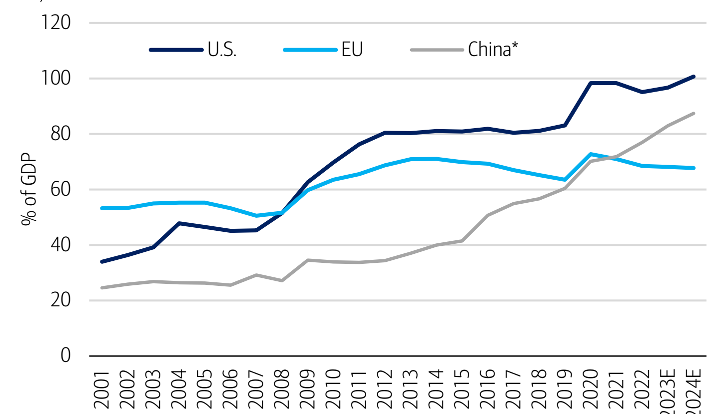
The U.S. election in November and China's Third Plenum in July may bring more clarity on how fiscal imbalances are tackled. Meanwhile, authorities have stressed the need for fiscal consolidation in Europe amid fresh political uncertainty. Globally, tax policy proposals have been presented. Overall, the path forward augurs for a well-diversified portfolio including holdings in Alternative assets such as Commodities including Gold and Real Assets in general.

Exhibit 4: Taming Larger Fiscal Deficits And Debt Loads Has Increasingly Become A Policy Focus.

4A) General Government Fiscal Balance.



4B) General Government Debt.



*Gross government debt used. Net debt used for U.S. and EU. E=estimate. Source: International Monetary Fund (IMF). Data as of June 14, 2024.

Equities

	Total Return in USD (%)			
	Current	WTD	MTD	YTD
DJIA	38,589.16	-0.5	-0.2	3.3
NASDAQ	17,688.88	3.3	5.8	18.3
S&P 500	5,431.60	1.6	3.0	14.6
S&P 400 Mid Cap	2,895.31	-0.8	-2.8	4.8
Russell 2000	2,006.16	-1.0	-3.0	-0.4
MSCI World	3,492.05	0.4	1.4	11.1
MSCI EAFE	2,306.41	-2.6	-2.0	4.9
MSCI Emerging Markets	1,076.89	0.5	2.9	6.4

Fixed Income†

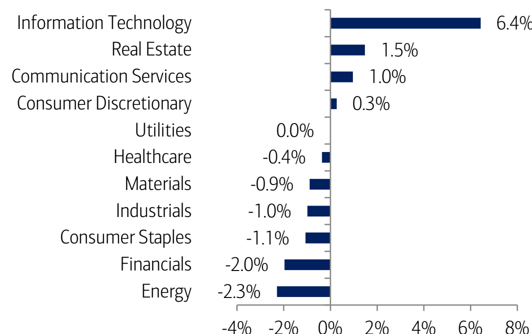
	Total Return in USD (%)			
	Current	WTD	MTD	YTD
Corporate & Government	4.78	1.27	1.66	0.11
Agencies	4.86	0.69	0.90	0.96
Municipals	3.65	0.70	1.77	-0.17
U.S. Investment Grade Credit	4.87	1.31	1.76	0.09
International	5.34	1.22	1.59	0.46
High Yield	7.91	0.26	0.69	2.33
90 Day Yield	5.38	5.39	5.40	5.33
2 Year Yield	4.70	4.89	4.87	4.25
10 Year Yield	4.22	4.43	4.50	3.88
30 Year Yield	4.35	4.55	4.65	4.03

Commodities & Currencies

	Total Return in USD (%)			
Commodities	Current	WTD	MTD	YTD
Bloomberg Commodity	240.99	0.7	-0.3	6.4
WTI Crude $/Barrel††	78.45	3.9	1.9	9.5
Gold Spot $/Ounce††	2333.04	1.7	0.2	13.1

	Total Return in USD (%)			
Currencies	Current	Prior Week End	Prior Month End	2022 Year End
EUR/USD	1.07	1.08	1.08	1.10
USD/JPY	157.40	156.75	157.31	141.04
USD/CNH	7.27	7.26	7.26	7.13

S&P Sector Returns



Sources: Bloomberg; Factset. Total Returns from the period of 6/10/2024 to 6/14/2024. †Bloomberg Barclays Indices. ††Spot price returns. All data as of the 6/14/2024 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 6/14/2024)

	2023	Q1 2024A	Q2 2024E	Q3 2024E	Q4 2024E	2024E
Real global GDP (% y/y annualized)	3.1	-	-	-	-	3.0
Real U.S. GDP (% q/q annualized)	2.5	1.4	2.0	2.0	2.0	2.4
CPI inflation (% y/y)	4.1	3.2	3.3	2.9	2.7	3.0
Core CPI inflation (% y/y)	4.8	3.8	3.5	3.4	3.3	3.5
Unemployment rate (%)	3.6	3.8	3.9	4.0	4.0	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 June 14, 2024.

Asset Class Weightings (as of 6/4/2024)

	CIO View				
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

	CIO View				
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 June 4, 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.

Important Disclosures

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