CHIEF INVESTMENT OFFICE

Capital Market Outlook

July 17, 2023

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

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Macro Strategy—*Will All The Cyclical Red Flags Prove Wrong About A Coming Recession?:* Recent economic data show nominal growth still running well above prepandemic rates as inflation continues to bloat nominal cash flows such as business revenues, retail sales and consumer incomes.

However, nominal gross domestic product (GDP) growth is down from its 2021 peak rate in the high teens to the mid-single digits, and forward-looking indicators show momentum is still fading as the effect of higher interest rates squeezes demand.

Market View—*Midyear Market Observations:* While the strong uptrend helped to push the S&P 500 over the threshold for a new cyclical bull market, not all investors have fully embraced a bullish outlook. Under the surface, certain conditions have kept the debate on the next direction for the market more muddled.

As we move into the second half of the year, three market observations may be prudent to consider: 1) multiple expansion has powered the rally so far, but further upside could be more limited; 2) expectations for a recession have been pushed out, but the case for an economic slowdown persists and suggests that a gap is widening between the market and macro outlooks; and 3) volatility sentiment measures are telling different stories. Looking at every wrinkle in the data may create some noise but uncovering the developing trends under the surface of market conditions may help in monitoring the next stage of the market cycle.

Thought of the Week—*Student Loan Repayments Could Present Modest Headwinds:* The three-year hiatus on federal student loan repayments is entering its final months. 43 million borrowers will resume making average monthly payments of $383 in October, straining consumers who have spent the last few years spending that money elsewhere.

While the end to the moratorium will likely take a toll on consumers, household savings, and retailers alike, we see several mitigating factors that could make it less of a headwind to the U.S. economy than many expect.

MACRO STRATEGY ▶

CIO Macro Strategy Team

MARKET VIEW ▶

Kirsten Cabacungan
Vice President and Investment Strategist

THOUGHT OF THE WEEK ▶

Emily Avioli
Assistant Vice President and Investment Strategist

MARKETS IN REVIEW ▶

Data as of 7/17/2023, and subject to change

Portfolio Considerations

Given the level of portfolio drift in certain areas, we are actively rebalancing portfolios, and where appropriate, we are lengthening duration in Fixed Income. We are transitioning to a new macro-economic regime with overall risk still elevated amid slowing earnings, higher interest rates, and geopolitical uncertainty. We believe that as this transition firmly takes hold building diversified portfolios across and within asset classes, including alternatives, for qualified investors, is imperative. We continue to remain neutral Equities and Fixed Income relative to our strategic benchmarks.

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MACRO STRATEGY

Will All The Cyclical Red Flags Prove Wrong About A Coming Recession?

CIO Macro Strategy Team

Investment Implications

The trend toward slower nominal GDP growth is inconsistent with the outlook for rising profits, suggesting equity valuations are excessive.

The massive overdose of pandemic stimulus is receding, and policy is reining in the excess demand, allowing nominal GDP growth to slowly return to a more normal pace, consistent with lower inflation. It should not be surprising that the process is taking longer than expected. After all, this was the biggest peacetime stimulus in American history, similar in size to the World War II fiscal and monetary injections.

While real growth has stayed below trend over the past year, according to the Chicago Fed National Activity Index, and inflation has come down by half, bringing nominal GDP growth lower from its 2021 peak in the high teens to mid-single digits rates, this is still well above the sub-4% average nominal GDP growth pace of the sub-2% inflation prepandemic environment. Basically, money illusion makes the economy look strong despite more companies increasing their revenues by selling fewer units at higher prices. What's more, one-off factors have stalled the slowdown this year, as a second wave of fiscal boost, warm winter weather and China's reopening caused a surprise pickup in nominal GDP growth. Nevertheless, leading indicators show the bigger trend is still toward slowing nominal growth as inflation heads to 2%, or less, and real growth has trouble staying above zero.

The main force for slowing growth is the increasing mismatch between company pricing power in a normalizing demand environment and lagging wage pressures as workers try to catch up with the huge losses inflation has caused them. A tight labor market keeps wage pressures high and above diminishing company pricing power, squeezing margins. This margin pressure will continue until the labor market is significantly weaker, which means a recession is still likely, in our view.

Thus, while the mix of data has clearly remained more resilient than expected into midyear, we believe that it has cemented a false confidence in the sustainability of the expansion, reflected in the consolidation of the eye-popping equity market rebound out of the bear market, tight credit spreads and the below-average Chicago Board Options Exchange (CBOE) "market fear" Volatility Index (VIX). Indeed, notwithstanding another robust Bureau of Labor Statistics (BLS) employment report for June and a rock-bottom 3.6% unemployment rate, manufacturing conditions remain recessionary; bank lending standards have increased to levels seen during, or before, past recessions; business equipment investment has been contracting; and consumer credit demand has weakened. U.S. factory purchasing managers' sentiment remained pessimistic through June, as indicated by the Institute for Supply Management (ISM) manufacturing index falling to 46, deeper into contraction territory below the 50 mark. With its production, new orders, inventories, supplier deliveries and employment subcomponents all below the 50 recession mark, the short to near-term outlook for the factory sector remains dim.

As pandemic-related tailwinds to growth fade (i.e., pent-up goods demand is increasingly satisfied as supply chains normalize and pandemic stimulus effects dissipate), tight bank credit conditions restrain growth, and high interest rates hurt consumer and business credit demand, the outlook for consumer spending and business investment is unlikely to improve much, in our view. The fact that the ISM's global manufacturing equivalent also dipped further into recession territory in June is not helping. While the ISM services index did surprise to the upside with a reversal of its May drop, led by strength across its all-important production, employment and new orders subcomponents, this index tends to follow the manufacturing index and is likely to remain on a downtrend.

With the real economy operating below potential over the past year, it is not surprising to also see signs of softening labor demand. The share of industries reporting payroll growth narrowed from 61% in May to 58% in June (in line with the long-term average but much lower than 70% a year ago), and private-sector labor demand was up "just" 1.35% at an

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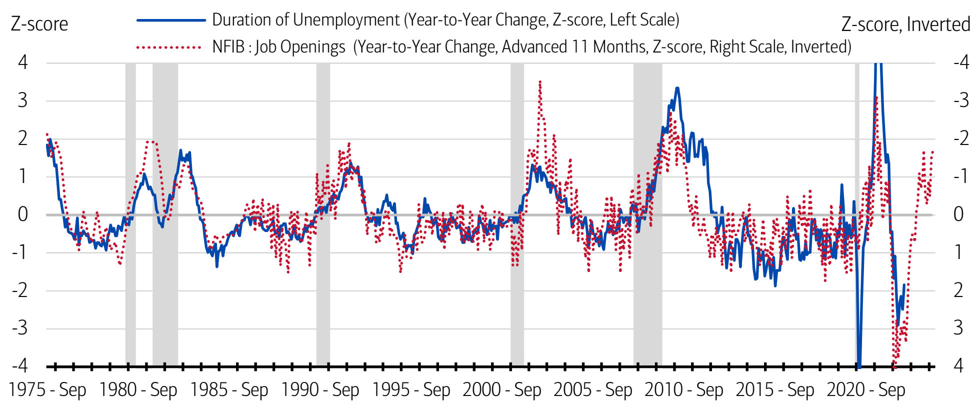
annualized rate in June, according to BLS data, versus 1.8% average growth in the past three months and 2% in the past six months.

What's more, big declines in job openings and temporary help services employment over the past six months suggest that labor demand is going to continue to lose steam. These are leading indicators of labor demand, as they tend to ease before employers begin to cut payrolls in an economic slowdown, thus offering early clues about the direction of the economy and hiring conditions.

While cooling demand for labor also implies a softening of year-over-year labor-income growth from current estimates of around 6% in June closer to 4% in coming months, Federal Reserve (Fed) concerns about still stronger wage growth than is consistent with its 2% inflation target boost the likelihood of more rate hikes following the June tightening pause. This suggests growing restraint on an economy already on track for a significant loss of steam. For example, as shown in Exhibit 1, the drop in the National Federation of Independent Business (NFIB) job openings over the past year already points to a big increase in the duration of unemployment over the next year, similar to that associated with past recessions.

Exhibit 1: Strong Red Signal For A Recessionary Increase In The Duration Of Unemployment Ahead.



Gray areas represent recession periods. Sources: NFIB; The Conference Board/Haver Analytics. Z-score=number of standard deviations from mean. Data as of July 12, 2023.

Leading employment indicators such as temporary help services and job openings also tend to closely track changes in other highly cyclical variables such as real manufacturing and trade inventories, for example, further evidence of their business-cycle tracking characteristics. Declines in the NFIB small business survey of job openings to date indicate significant potential weakness ahead for real inventories, akin to that typically observed ahead of past recessions. Comparable signals come from the decline in the BLS temporary jobs and job openings rate, as well as from the sharp drop in bank lending appetite reported in the Fed's senior loan officers survey for Q2.

All in all, the economy still appears likely to lose momentum in coming quarters. While business pricing power has remained strong enough to fund rapid wage growth and robust labor demand so far this year, we expect hiring and incomes to moderate meaningfully given weak late-cycle productivity growth and margin pressure, as price hikes increasingly lag wage gains. A further cooling of the labor market would clearly be welcome from the Fed's point of view given its efforts to bring inflation under control with a better balance between demand and supply, including for labor. However, red flags for a bigger-than-expected cyclical downturn over the next six to 12 months persist, and increasingly restrictive Fed policy will keep downward pressure on growth. This is not a recipe for a strengthening profits outlook. While it remains to be seen how deep the eventual downturn may prove to be, the risk of Fed overtightening as it tries to restore its inflation fighting credibility has increased, in our view.

MARKET VIEW

Mid-year Market Observations

Kirsten Cabacungan, Vice President and Investment Strategist

The run-up in stocks in the first half of the year came largely unexpectedly as investors entered the year more bearish amid expectations for an economic slowdown. Even amid rising risks as the Fed continued to tighten monetary policy, regional bank stress emerged, and debt ceiling negotiations dragged on, stocks continued to climb a "wall of worry." While the strong uptrend helped to push the S&P 500 over the threshold for a new cyclical bull market, a 20% rise off the bear market low, not all investors have fully embraced a bullish outlook. Under the surface, certain conditions have kept the debate on the next direction for the market more muddled. Below are three market observations to consider as we move through the second half of the year.

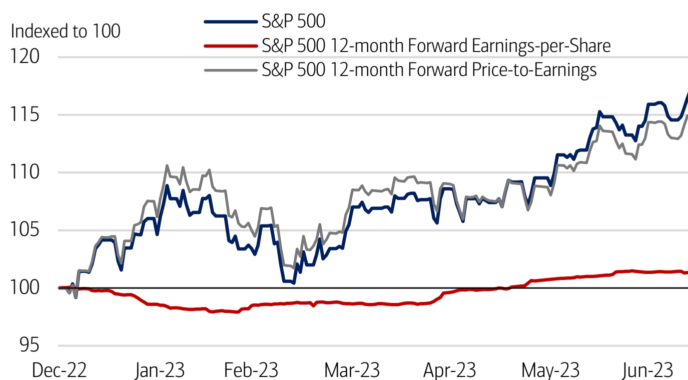
Investment Implications

Heading into the second half of 2023, we believe it is prudent to stay well diversified and maintain a balanced portfolio. We remain neutral across asset classes relative to strategic benchmarks at the highest level, while we wait for more data on the magnitude of an economic slowdown and conviction to make a tactical shift.

The equity rally has so far been lifted by multiple expansion. Multiple expansion fueled much of the 17% gain in the S&P 500 this year as growth in forward earnings estimates remains roughly flat (Exhibit 2A).[1] Two factors help to explain the bid up in stock prices: 1) a pickup in generative artificial intelligence enthusiasm, increasing optimism over possible long-term productivity gains and profits growth; and 2) various positive economic surprises suggesting a more resilient economy than anticipated. As a result, tech-related companies dominated the first-half advance and drove much of the returns. In fact, stripping out these shares reveals the index actually moved more sideways. But market participation has started to broaden out a bit. At the index's recent high, 73% of companies in the S&P 500 traded above their 200-day moving average versus just 50% at the beginning of the year.[2] Further runway for gains driven by valuations, however, may be more limited ahead. The S&P 500 12-month forward price-to-earnings multiple is now hovering around 19x, up from the roughly 15x levels at the October bear market low and well above its average of 16x for the last two decades. A sustained rally would require valuations and fundamentals to realign, but, with a recession expected, earnings could remain under pressure.

Exhibit 2: A Strong Rally In U.S. Equities In The First Half Of The Year.

2A) Multiple expansions drove Equity gains this year.



2B) The gap widens between the market and macro outlooks.

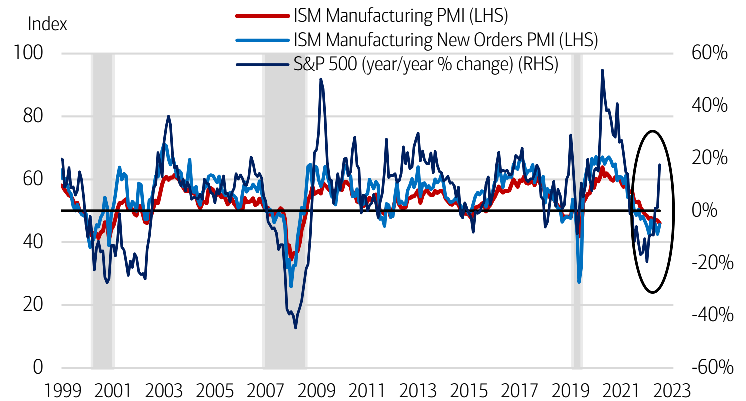


Exhibit 2A) Source: Bloomberg. Data as of July 13, 2023. Exhibit 2B) Source: Bloomberg. Data as of June 2023. **Past performance is no guarantee of future results. Please refer to index definitions at the end of this report. It is not possible to invest directly in an index.**

Equities appear disconnected from the weakening economic backdrop. While expectations for the much-anticipated recession were pushed out from 2023 to early 2024, the case for a recession remains intact. Leading indicators continue to point to further deterioration in economic activity ahead. The 14 straight months of decline in the Conference Board's U.S. Leading Economic Index suggests a sharp loss of U.S. economic momentum. The deep inversion in the fed funds/10-year yield curve emphasizes monetary policy remains restrictive, and a recession is likely ahead, as the curve has never substantially inverted without one following. Contraction in the manufacturing sector also

[1] Bloomberg. Year-to-date data as of July 13, 2023.
[2] Bloomberg. Data as of July 13, 2023.

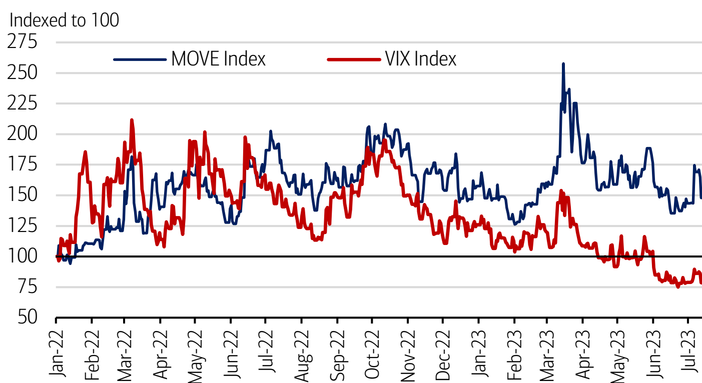
casts a shadow over the economy. The ISM Purchasing Managers' Index (PMI) showed U.S. factory activity shrank for an eighth consecutive month in June, the longest stretch of contractionary readings since 2009.

Despite this backdrop, Equities continue to grind higher on increased optimism for a "soft landing," as the economy has shown greater resilience tied to strength in the services sector and the consumer at the same time as inflation has come down (Exhibit 2B). While moderating inflation may be a positive signal for the end of the monetary tightening cycle, it creates a headwind for corporate revenue growth as companies' pricing powers fade. With slowing nominal economic growth also weighing on revenues and with labor costs continuing to rise, margins could be squeezed even more and eventually lead to a rise in unemployment and, ultimately, weaker demand. Thus, as the lagged effects of monetary policy tightening also continue to filter through the economy, any narrative of a reacceleration in growth or a broad-based recovery in earnings in the near term looks less compelling. Therefore, attention will likely be on corporate guidance for the Q2 earnings season. Any signs of weakness ahead could lead to a downshift in earnings estimates and weigh on Equities going forward.

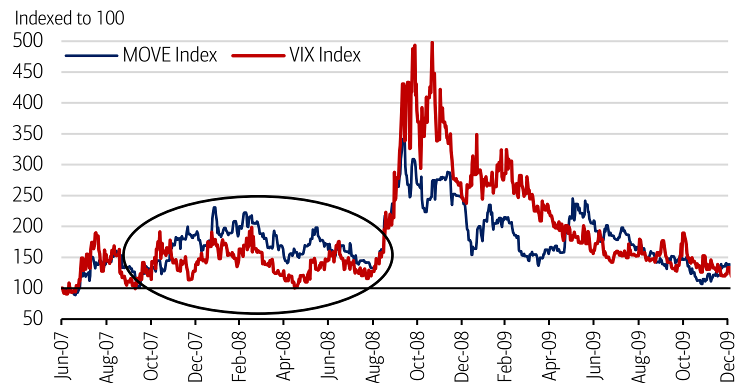
Volatility measures for Equities and Fixed Income are split. Stock and bond market sentiment measures are telling two different stories. The CBOE VIX, a measure of expected volatility in the S&P 500 over the next 30 days, reflects an extreme calmness in the Equity market with the index in a three-year-low range between 13 and 14 and well below its long-term historical average of 19.6.[3] Positive market sentiment has also come through the American Association of Individual Investors' Investment Sentiment Survey results. The spread between bullish and bearish respondents has flipped positive after being net bearish for over a year, barring a few weeks of bullish readings in February, and has now sat above its historical average for five consecutive weeks. Bond markets, on the other hand, seem to be more worried about the outlook. The MOVE Index, a gauge of interest rate volatility in the U.S. Treasury market, remains elevated relative to its long-term historical average and has seen frequent spikes in volatility as the Fed has aggressively hiked rates over the last year to fight inflation. The divergence in stock and bond volatility raises questions on whether the two gauges may converge in the same direction again and if that means equity volatility catches up or rate volatility falls. During the 2008/2009 Great Financial Crisis (GFC), a similar gap emerged with the MOVE index elevated relative to the VIX. Equity volatility eventually adjusted and spiked higher (Exhibits 3A and 3B). For now, until stock and bond markets get back on the same page, risks of increased periods of volatility likely remain.

Exhibit 3: Volatility Remains Elevated For Bonds But Subdued For Stocks.

3A) Stock and bond volatility are sending mixed signals.



3B) Stock volatility spiked during the GFC following a similar gap in signals.



Source: Bloomberg. Data as of July 13, 2023. **Past performance is no guarantee of future results. Please refer to index definitions at the end of this report. It is not possible to invest directly in an index.**

Looking at every wrinkle in the data may create some noise but uncovering the developing trends under the surface of market conditions may help in monitoring the next stage of the market cycle. Given elevated risks, we remain cautious on Equities.

[3] Bloomberg. Data as of July 13, 2023.

THOUGHT OF THE WEEK

Student Loan Repayments Could Present Modest Headwinds

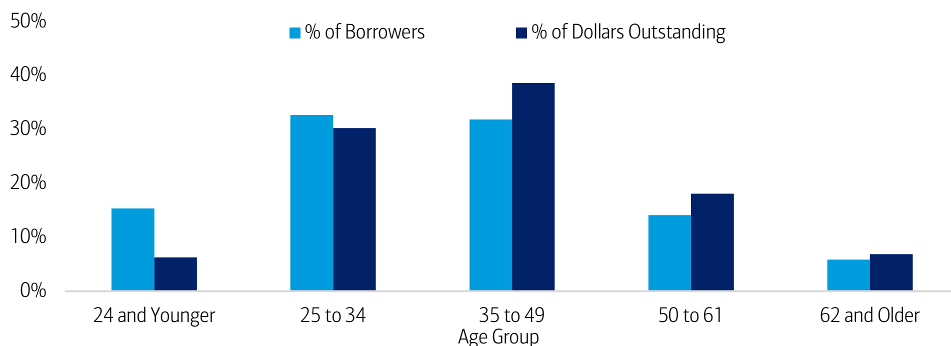
Emily Avioli, Assistant Vice President and Investment Strategist

The three-year hiatus on federal student loan repayments is entering its final months. Repayments will commence in October, with interest accruements resuming in September, as mandated by the debt-ceiling deal struck in June. Further diminishing borrowers' prospects for relief, the U.S. Supreme Court recently rejected the Biden administration's plan to forgive up to $20,000 for qualifying borrowers.

Federal student loans make up the lion's share of student debt, accounting for $1.6 trillion of the $1.8 trillion in total outstanding.[4] Forty-three million[5] borrowers will resume making average monthly payments of $383[6] this fall, straining consumers who have spent the last few years spending that money elsewhere. This comes as student borrowers are increasingly struggling with other debt. Eight percent of student loan borrowers were delinquent on at least one nonstudent loan obligation as of March, up from seven percent in September 2022.[7]

Affected consumers are already adjusting spending accordingly. Student debt holders skew toward younger generations—30% of federal student loan debt is held by borrowers aged 25 to 34, while 39% is held by borrowers aged 35 to 49 (Exhibit 4). High earners may also be more affected, as the top 20% of income earners hold the largest proportion of student debt.[8] Both younger generations and high-income earners have recently started to show relative weakness in spending growth, according to Bank of America Institute data.

Exhibit 4: Federal Student Loan Portfolio by Borrower Age Group.



Source: Department of Education. Data as of Q2 2023.

Slower spending could dampen retail sales as consumers increasingly trade down everyday essentials and defer discretionary "big ticket" purchases. Holiday shopping could be pulled forward as promotions and product deals focused on "everyday low pricing" ramp up before payments resume. Ultimately, retailers may need to adjust prices and hiring as consumption drags.

Fortunately, we see several factors that will soften the economic blow. Consumers still have a comfortable buffer of excess savings and plenty of available credit, especially the higher-income cohorts. The U.S. Department of Education has announced plans to institute a 12-month "on-ramp" to repayment, so that financially vulnerable borrowers who miss monthly payments during this period are not considered delinquent.[9] Nontraditional lenders could step in and refinance outstanding student loan balances with longer terms and adjustable rates, which would limit the size of payments in the first 12 months.

The bottom line is that while the end to the moratorium will likely take a toll on consumers, household savings and retailers alike, mitigating factors could make it less of a headwind to the U.S. economy than many expect.

Investment Implications

The resumption of student loan repayments could present a modest headwind for consumers and retailers in the coming months. From a sector perspective, we emphasize more defensive sectors like Consumer Staples over Consumer Discretionary.

[4] Federal Reserve, Q1 2023; Department of Education Q2 2023.
[5] Department of Education. Q2 2023.
[6] Strategas. July 5, 2023.
[7] The Consumer Financial Protection Bureau. June 7, 2023.
[8] The Federal Reserve Survey of Consumer Finances, 2019.
[9] The White House, "FACT SHEET: President Biden Announces New Actions to Provide Debt Relief and Support for Student Loan Borrowers," June 30, 2023.

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Equities

	Total Return in USD (%)			
	Current	WTD	MTD	YTD
DJIA	34,509.03	2.3	0.3	5.3
NASDAQ	14,113.70	3.3	2.4	35.5
S&P 500	4,505.42	2.4	1.3	18.4
S&P 400 Mid Cap	2,673.94	2.7	2.0	11.0
Russell 2000	1,931.09	3.6	2.3	10.5
MSCI World	3,017.94	3.2	1.8	17.1
MSCI EAFE	2,188.99	4.9	2.7	14.7
MSCI Emerging Markets	1,028.49	4.9	4.3	9.4

Fixed Income[†]

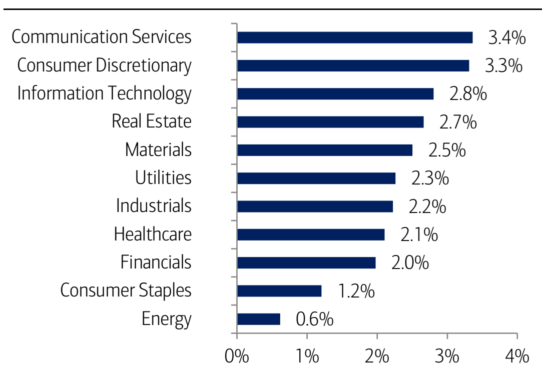
	Total Return in USD (%)			
	Current	WTD	MTD	YTD
Corporate & Government	4.74	1.44	0.16	2.37
Agencies	4.84	0.83	0.37	2.01
Municipals	3.51	0.48	0.16	2.84
U.S. Investment Grade Credit	4.76	1.51	0.20	2.29
International	5.45	1.60	0.16	3.37
High Yield	8.31	1.60	0.99	6.42
90 Day Yield	5.35	5.34	5.28	4.34
2 Year Yield	4.77	4.95	4.90	4.43
10 Year Yield	3.83	4.06	3.84	3.87
30 Year Yield	3.93	4.05	3.86	3.96

Commodities & Currencies

	Total Return in USD (%)			
Commodities	Current	WTD	MTD	YTD
Bloomberg Commodity	234.19	2.7	3.3	-4.8
WTI Crude $/Barrel[††]	75.42	2.1	6.8	-6.0
Gold Spot $/Ounce[††]	1,955.21	1.6	1.9	7.2

		Total Return in USD (%)		
Currencies	Current	Prior Week End	Prior Month End	2022 Year End
EUR/USD	1.12	1.10	1.09	1.07
USD/JPY	138.80	142.21	144.31	131.12
USD/CNH	7.16	7.23	7.27	6.92

S&P Sector Returns



Sources: Bloomberg; Factset. Total Returns from the period of 7/10/2023 to 7/14/2023. [†]Bloomberg Barclays Indices. [††]Spot price returns. All data as of the 7/14/2023 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 7/14/2023)

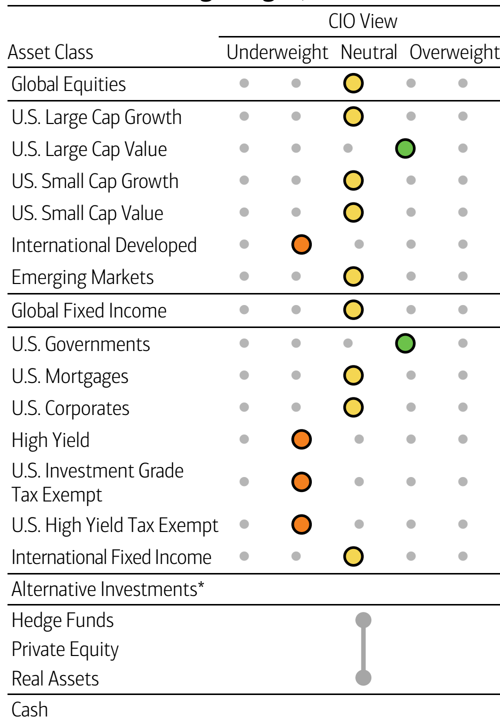
	2022A	Q1 2023A	Q2 2023A	Q3 2023E	Q4 2023E	2023E
Real global GDP (% y/y annualized)	3.6*	-	-	-	-	3.0
Real U.S. GDP (% q/q annualized)	2.1	2.0	1.5*	1.0	0.5	1.8
CPI inflation (% y/y)	8.0	5.8	4.1	3.3	2.9	4.0
Core CPI inflation (% y/y)	6.1	5.6	5.2	4.3	3.8	4.7
Unemployment rate (%)	3.6	3.5	3.5	3.6	3.7	3.6
Fed funds rate, end period (%)	4.33	4.83	5.13	5.63	5.63	5.63

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.

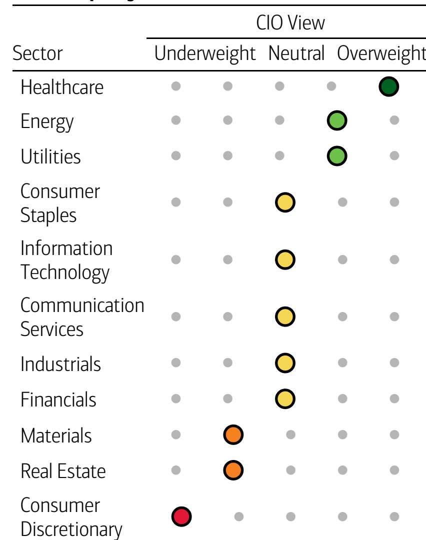
Sources: BofA Global Research; GWIM ISC as of July 14, 2023.

Asset Class Weightings (as of 7/11/2023)



Asset Class	Underweight		Neutral		Overweight
Global Equities			●		
U.S. Large Cap Growth			●		
U.S. Large Cap Value				●	
US. Small Cap Growth			●		
US. 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*					
Hedge Funds			●		
Private Equity			●		
Real Assets			●		
Cash					

CIO Equity Sector Views



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

*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 July 11, 2023. 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 stock market index tracking the stock performance of 500 of the largest companies listed on stock exchanges in the United States.

Chicago Fed National Activity Index is a monthly index designed to gauge overall economic activity and related inflationary pressure.

Chicago Board Options Exchange (CBOE) Volatility Index (VIX) is a real-time market index that represents the market's expectation of 30-day forward-looking volatility.

Institute for Supply Management (ISM) manufacturing index is a monthly gauge of the level of economic activity in the manufacturing sector in the United States versus the previous month.

Institute for Supply Management (ISM) services index is a composite of four equally weighted components: business activity, new orders, employment, and supplier deliveries.

Conference Board U.S. Leading Economic Index is one tool to take the pulse of the overall U.S. economy and forecast potential downturns.

The MOVE Index is a market-implied measure of bond market volatility.

ISM Manufacturing Purchasing Managers' Index (PMI) is economic indicators derived from monthly surveys of private sector companies.

ISM Manufacturing New Orders Purchasing Managers' Index (PMI) is a monthly indicator of U.S. economic activity based on a survey of purchasing managers at more than 300 manufacturing firms.

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