CHIEF INVESTMENT OFFICE

Capital Market Outlook

September 25, 2023

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

IN THIS ISSUE

Macro Strategy—*Rates, Dollar, and Oil Raise Downside Risks:* With the U.S. economy performing much better than expected in the face of sharp Federal Reserve (Fed) rate hikes this year, credit markets being calm, and the S&P 500 Index advancing, the historical link between an inverted yield curve and recessions has been called into question. While it remains to be seen whether the yield curve signal ultimately proves false, its past link to bank lending standards, credit availability, economic growth, and changes in the unemployment rate continues to give us pause.

Market View—*U.S.-China Decoupling: A More Nuanced View:* This week we present a more nuanced view of the U.S.-Sino decoupling thesis. While much has been made of the fact that U.S. imports from China have declined to multi-year lows, most of the decline in imports has been in basic and mundane goods—apparel, footwear, computers and furniture. On the other hand, the U.S. remains highly import dependent on China for many critical materials necessary to help drive America's green transition. An all-out, full-blown decoupling of the U.S. and China is not our base case—it would be too ruinous for both parties. Reality, or the world we live in, is far more complex than the headlines suggest.

Thought of the Week—*Time In The Bond Market, Not Timing The Bond Market:* Holding enough cash to cover any anticipated or unanticipated spending needs is key. Investors looking to compound real wealth over time, however, should continue to rely on market assets and not overweight cash no matter how tempting higher short-terms yields may be.

The Clock Is Ticking With barely a handful of legislative days remaining, Congress must agree on spending, or we face yet another shutdown on October 1. The more likely outcomes: (1) Congress passes a Continuing Resolution (CR) temporarily funding the government at current levels (a long-term CR could trigger automatic spending cuts next year because of the debt ceiling agreement). **Potential Outlook:** Possibly, given time constraints, but complicating the process is the likelihood that House leadership would consider including funds for disaster relief, but would leave out aid to Ukraine. If additional aid is to be approved for Ukraine, expect changes to border policies as well as an increase to border security. (2) Government shutdown. Non-essential parts of the Federal government shutdown on October 1, until political pressure builds to fund the government on a bipartisan basis. **Potential Outlook**: A likely and growing probability.

Should we be concerned? While it may not be too much to ask Congress to complete its routine tasks in a timely manner, we nonetheless see limited economic impact. A government shut down is mainly noise, often short lived, but could be more complicated going into an environment of an expected slowing economy. Markets have generally shrugged-off the effect of a shutdown, perhaps after an initial dip. Impact to gross domestic product (GDP) often range from 0.1% to 0.2% per week, but generally reversed as the government opens and employees receive back-pay.

MACRO STRATEGY ▶

CIO Macro Strategy Team

MARKET VIEW ▶

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THOUGHT OF THE WEEK ▶

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MARKETS IN REVIEW ▶

Data as of 9/25/2023, and subject to change

Portfolio Considerations

We expect a slight updraft in September, primarily due to investment flows coming back into the market as inflation gauges continue to move lower and bond yields back off a bit. In addition, we expect corporate earnings for Q3 to come in with a small beat again. Longer-term investors should consider using excess cash on a dollar-cost averaging approach into Equities over the last quarter of the year. Given both tailwinds and headwinds, we continue to maintain a balanced tactical portfolio strategy view and a high-quality bias in the near term.

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MACRO STRATEGY

Rates, Dollar, and Oil Raise Downside Risks

CIO Macro Strategy Team

Seemingly insensitive to the Fed's aggressive interest rate hiking cycle, incoming data, on balance, have remained "not too hot, not too cold," raising hopes of a successful "soft landing" of the U.S. economy. The latter entails moving from unsustainably high growth and inflation to a moderate growth and inflation environment without major economic and/or financial sector turbulence. There is an emerging Wall Street consensus that the U.S. will avoid recession, although that said, the S&P 500 Index rally has stalled as of late. Behind the drag: 1) seasonality, i.e., September is historically a tough month for Equities, and 2) the emergence of some new bumps in the road, namely, the rise in bond yields, the dollar and oil prices.

In this context, expectations for "higher for longer" interest rates to bring inflation sustainably down to the Fed's 2% target—confirmed by the Fed's recent upside revisions to its interest rate projections through 2024—have further weighed on the narrow market index rally off the October 2022 lows. The sharp rise in 10-year Treasury yields to new cycle highs will continue to spread throughout the economy, increasing mortgage rates further, for example. Rising mortgage rates have already caused a renewed downturn in housing-related sentiment, as reflected in the large August drop in the National Association of Homebuilders' survey back below breakeven after an encouraging first-half recovery.

Also, higher energy costs have reignited consumer price inflation in August. Rising gasoline prices reduce consumer discretionary incomes and, thus, could weigh on the outlook for real consumer spending growth. That said, a key offset to rising energy prices lies with a tight labor market and rising worker incomes.

Beyond the consumer, rising transportation costs could also create upside risks to goods and services inflation, weighing on near-term growth prospects. At the same time, dollar appreciation dampens the dollar value of corporate profits from overseas and restrains exports, but also serves as a dampener to inflation. A strong dollar is the Fed's friend, in other words. The key to all the above: There are multiple crosscurrents working through the economy, which, as we have highlighted in the past, is a $26 trillion hydra-headed beast that remains the most competitive and dynamic in the world. Yes, it is too early to declare "all clear" to the risks of recession; but by the same token, bumps in the road are not uncommon, and hence our balanced approach when it comes to portfolio construction.

Keeping a sharp eye on the yield curve The debate about the ultimate effect of all these speed bumps to growth remains intense, with the recession predictive power of the yield curve inversion particularly doubted. As discussed in past Chief Investment Office (CIO) *Capital Market Outlook* reports, researchers have long determined that the spread between long- and short-term interest rates contains useful information about the economic outlook, with negative term spreads (higher short-term rates than long-term interest rates) for decades providing accurate early warnings about incoming recessions and steep curves precursors of strong early-cycle rebounds in economic activity.

That makes sense, since the yield curve tends to not only reflect investors' views about the future state of the economy (as embedded in their aggregate long-term interest rates expectations), but these views also feed back to affect economic activity. For example, the link between the yield curve spread and subsequent economic activity is apparent in the correlation between the yield curve spread and bank lending appetite five quarters later. Despite a temporary desynchronization caused by the pandemic shock, their co-movement appears restored, suggesting that bank lending is likely to remain strained into 2024, typically an economic headwind.

The transmission channel from the monetary policy stance, as reflected in the yield curve spread, to economic growth has most recently been documented in a July 2023, Federal

Portfolio Implications

New risks to the outlook from surging oil prices, appreciating dollar and "higher for longer interest rates" suggest that a balanced tactical portfolio strategy with a high-quality bias remains prudent.

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Reserve Board research report[1] which provides "evidence on the effect of the slope of the yield curve on economic activity through bank lending." Using detailed data on banks' lending activities, the authors show that a steeper yield curve associated with higher term premiums boosts bank profits and the supply of bank loans. "Intuitively, a higher term premium represents greater expected profits on maturity transformation, which is at the core of banks' business model, and therefore incentivizes bank lending. This effect is stronger for ex-ante more leveraged banks." In our view, this link, combined with the fact that it takes about a year for a drop in bank lending appetite to result in rising unemployment, indicates significant risk of a potentially meaningful increase in unemployment over the next year (Exhibit 1and 2). That said, any rise in joblessness is coming off a low base and is unfolding in an economy still short of labor across multiple sectors like Construction, Semiconductors, truck drivers, Manufacturing, and other sectors. The backup in unemployment, in other words, could top out at levels below levels of the past.

Exhibit 1: Bank Willingness To Lend Followed By Changes In The Unemployment Rate One Year Later.

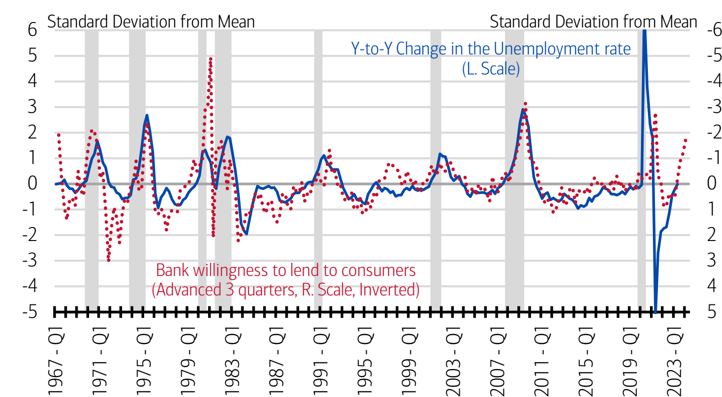
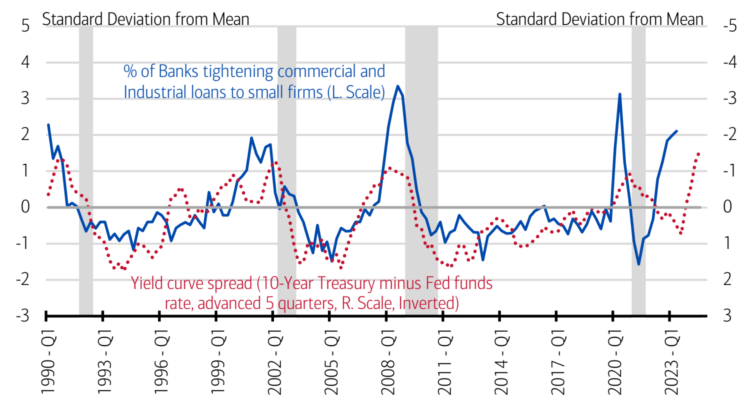


Exhibit 2: The Yield Curve Spread's Correlation With Bank Lending Appetite Helps Explain Its Recession Prediction Record.



Gray bars represent recession periods for both charts. Standard deviation is a statistical measurement of how far a variable, such as an investment's return, moves above or below its average (mean) return. Exhibit 1: Sources: Federal Reserve Board; The Conference Board/Haver Analytics. Data as of September 21, 2023. Exhibit 2: Sources: Federal Reserve Board; Bureau of Labor Statistics/Haver Analytics. Data as of September 1, 2023.

In sum, U.S. economic growth has surprised to the upside, and the unemployment rate has increased only modestly to just 3.8%, mainly because of a surge in the labor force participation rate (that is, for a good reason). However, government spending is expected to swing from significantly contributing to growth in 2023 to a more neutral factor on growth in 2024 and beyond. The outlook for consumer spending hangs in the balance: excess savings have been depleted, and the personal saving rate has dropped to rock-bottom levels. Bank willingness to lend to consumers is very low, typically a headwind to growth. The offset, however, remains a historically tight labor market.

Heading into the final quarter of the year, we continue to expect a "grind it out' market, punctuated by periodic bouts of volatility and risk-off moves. Current bumps in the road—notably the optics around the United Auto Workers strike, a potential government shutdown, and rise in oil prices—will weigh on investor sentiment near-term. However, we maintain a balanced, high-quality approach to portfolio construction given the structural competitive strengths of the U.S. economy.

[1] Camelia Minoiu, Andres Schneider, Min Wei, "Why Does the Yield Curve Predict GDP Growth? The Role of Banks," Board of Governors of the Federal Reserve System, July 2023.

MARKET VIEW

U.S.-China Decoupling: A More Nuanced View

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

Ariana Chiu, Wealth Management Analyst

Much has been made in the media about America's declining import share from China, with the percentage of total U.S. goods imports from China now at their lowest level since 2005. China's share of U.S. imports was just 13.5% in the first seven months of this year, down from 16.5% in 2022 and a peak of 21.6% in 2017, according to the U.S. Census Bureau. Totaling $239 billion over the January-July 2023 period, U.S. imports from China were off nearly 25% from the same period a year ago.

These numbers support the U.S-China decoupling narrative—and the prevailing consensus that the world's two largest economies are going their separate ways, as Beijing seeks greater economic self-sufficiency, and Washington works overtime to cajole U.S. firms to diversify their global supply chains beyond China. The proof, then, of decoupling is in the trade numbers. Or is it?

The much-cited import figures deserve a more nuanced view, in our opinion. Why? Because as Exhibits 3 and 4 illustrate, while America's import dependence on China for a range of basic and mundane products like apparel, footwear and toys has dropped precipitously over the past few years, U.S. dependence on China for critical material imports required to help power America's green transition not only remains high but, in many cases, has only increased this decade.

So memo to the decouplers—curb your enthusiasm. Don't hang your hat on the headline trade figures that are misleadingly screaming that the U.S. and China are inexorably on a path of disengagement. And don't bite on the false narrative that as America reduces its import dependence on China, the upshot is more U.S. leverage over Beijing in setting bi-lateral trade and investment policies. Nothing could be further from the truth.

And attention investors: The good news is that despite all the chatter about decoupling, U.S.-Sino trade and investment ties remain relatively thick across various strategic industries. That is bullish for U.S. assets, in our opinion. That said, however, the risks of a market-rattling divorce between the world's two largest economies remain real. The footprints of decoupling are plain to see—if they multiply, the risks to Corporate America also multiply.

Investment Implications

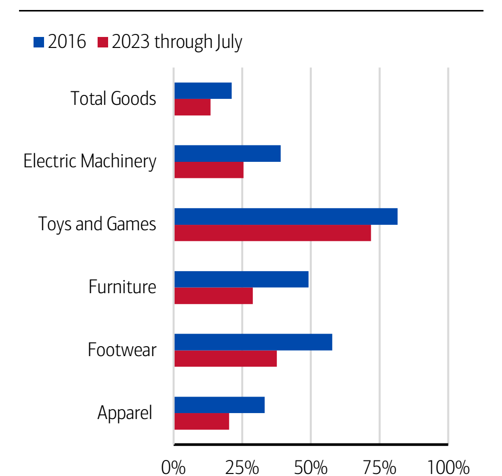
The CIO continues to monitor and assess the risks (and rewards) of deteriorating U.S.-China relations. The stakes are high; virtually every asset class—from Cash to Commodities—is affected by how well or by how badly U.S. and China engage with each other and with the rest of the world.

Decoupling: The first cuts were not the deepest Owing to the punishing tariffs of the Trump administration, and even tighter restrictions on trade and investment under the Biden administration, U.S.-China bilateral commerce has downshifted over the past few years, and has continued to decline in 2023. Both trade and foreign direct investment flows are moving to the downside.

As Exhibit 3 underscores, quintessential "Made in China" imports like toys, furniture, footwear and apparel have all plummeted since 2016, with the downturn reflecting rising wage costs in China and the start of the U.S.-China trade war in 2018. The latter spurred a number of rounds of tit-for-tat of tariffs on a variety of goods. Rising trade tensions also triggered a massive rethink of global supply chain vulnerabilities among suppliers, with the pandemic and ensuing supply chain bottlenecks in China giving the diversification narrative even more credence.

As part of the decoupling theme, U.S. importers, at the urging of Washington, have diversified away from China in recent years, boosting production in Vietnam, India, Mexico, Korea and Taiwan. Hence the massive shift in trade. Based on figures from the U.S. Census Bureau, U.S. electrical machinery imports from China—as a percent of total imports—dropped by nearly 15 percentage points between 2016 and 2023; the percentage decline in toys wasn't as great (10 percentage points), but the declines in

Exhibit 3: Decoupling from China The Factory: Goods Imports From China As A Percent of Total.



Source: U.S. Census Bureau. Data as of September 2023.

furniture (20 percentage points), footwear (20 percentage points) and apparel (13 percentage points) were quite dramatic. These products are among the largest categories of U.S. imports from China, and hence their declines have had an outsized effect on aggregate import demand and an outsized influence on fueling the decoupling debate.

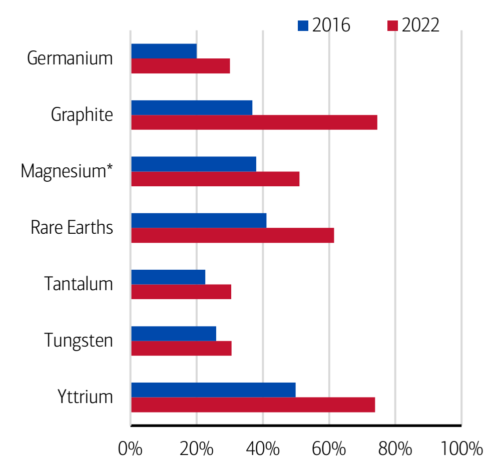
But here's the rub: Thus far, U.S.-China decoupling has been relatively painless for the U.S. economy and nonthreatening to the capital markets because finding alternative suppliers for dolls, hoodies, sandals and mother boards hasn't been that difficult or disruptive. These products can be produced virtually anywhere in the world. As goods import from China have gone down, imports from Vietnam, Taiwan and other nations have gone up.

America: Decoupling from China the factory, not China the refinery Yes, China's role as the "factory to the world" is being recast as more firms diversify and derisk their global supply chains. And yes, as the media seems to harp on daily, the percentage of imports to the U.S. from China is declining. But China does more than make "stuff"; it also refines "stuff".

Indeed, when it comes to refining iron ore into steel or pulverizing cobalt into fine purity particles for batteries, most roads lead through China. The nation's processing infrastructure—think smelters, refiners, cracking activities, chemicals and related capabilities—is second to none on a global scale, and a potentially dangerous set up for a country like the U.S., which according to the U.S. Geological Survey, is 100% reliant on graphite and manganese imports, 70% per cobalt, and 50% net import reliant on lithium and nickel. The U.S. is also significantly dependent on imports of metals/minerals like antimony, rare earth minerals, barite, bismuth, gallium, germanium, tantalum, yttrium and many other minerals. The list goes on—indeed, according to the U.S. Geological Survey's "Mineral Commodities Summaries 2023" report, the U.S. is now more than 50% reliant on 51 foreign minerals, up from 47 from the prior report. Importantly, 43 of these 51 minterals are categorized as "critical" by both the U.S. Geological Survey and the Department of Energy.

From this list, China ranks as the number one supplier of 12 critical materials: antimony, arsenic, barite, bismuth, gallium, germanium, graphite, magnesium, rare earths, tantalum, tungsten and yttrium. Seven of these commodities are depicted in Exhibit 4, which shows that from 2016 to 2022, America's import reliance on China for these critical commodities actually went up, not down. Take graphite, for example. Essential for batteries used for electric vehicles, graphite imports from China as a percent of total more than doubled between 2016 and 2022, according to the U.S. International Trade Commission. In other words, when it comes to critical materials to power America's green transition, and to support the U.S. semiconductor and defense sectors, think more, not less dependence on China.

Exhibit 4: No Decoupling from China The Refinery: Critical Materials Imports From China As A Percent of Total.



*Magnesium compounds. Sources: U.S. International Trade Commission DataWeb, U.S. Geological Survey Mineral Commodity Summaries 2023. Data as of January 31, 2023.

Decoupling? Sure, that's possible for garments but not graphite; monitors not magnesium; athletic shoes not arsenic; rattan furniture not rare earth minerals; Toys not tantalum. The inconvenient truth is that the U.S. remains wedded—coupled—to the refining champion of the world. And while the U.S. and its allies are serious about diversifying its mineral/metals supply chain, efforts to diversify and derisk mineral supply chains won't be cheap and won't happen overnight. These transitions will take time and require a great deal of capital and the political will to overcome environmental concerns.

Investment takeaway For investors, all of the above is a reminder that geopolitical risks—namely souring U.S.-China relations—remain a key concern and consideration when it comes to portfolio construction and expected market returns. There is a great deal at stake as the decoupling debate swirls and gathers more traction as the 2024 election approaches. An all-out, full-blown decoupling of the U.S. and China is not our base case—it would be too ruinous for both parties. That said, we suggest investors take a more nuanced view of the decoupling headlines. Reality, or the world we live in, is far more complex than the headlines suggest.

THOUGHT OF THE WEEK

Time In The Bond Market, Not Timing The Bond Market

Matthew Diczok, Managing Director and Head of Fixed Income Strategy

Cash is a critical asset, allowing investors to cover both anticipated and unanticipated spending. Cash's principal value does not fluctuate, so it is considered a "risk-free" asset.

In reality, no asset is risk-free. Investors can never fully eliminate risk; they can only diversify and take different types. If investing to grow real (inflation-adjusted) wealth long term is the goal, cash is quite risky. That's because cash—using Treasury Bill (T-Bill) yields as a proxy—has historically only kept pace with inflation. Similar to running on a treadmill, cash leaves investors exactly where they start—with no growth in purchasing power.

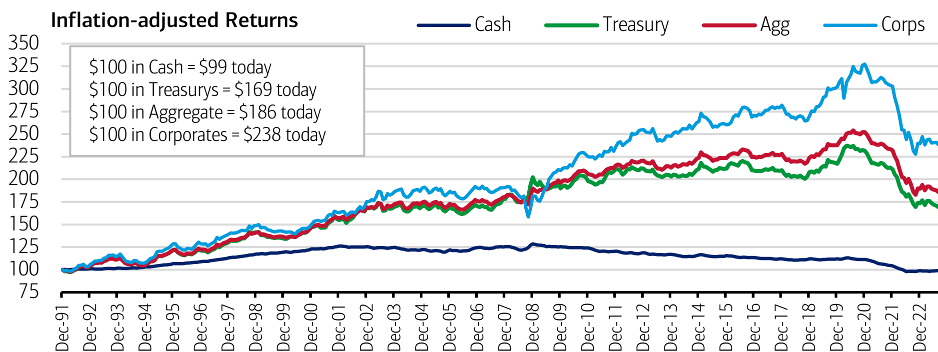
When the curve is inverted, as it is now—10-year Treasurys are around 100 basis points below 3-month T-Bill yields—investors may be tempted to replace long-term Fixed Income with cash. The thinking may be: With no interest rate risk and higher yields, cash offers the best of both worlds. This may be especially alluring after recent years of meager-to-negative bond returns.

This is a siren's song that long-term investors should ignore, in our opinion. Cash is not Fixed Income; it is variable income and not an appropriate substitute for longer-term bonds. Cash yields fluctuate with the business cycle. Investors do not eliminate interest rate risk by moving to cash; they replace rate risk with reinvestment risk. The risk that as the economy slows, the Fed lowers rates, and cash yields become less attractive. Cash yields are consequently positively correlated with the economy: higher when the economy is strong, lower when it weakens. This is the opposite of high-quality Fixed Income, which is negatively correlated with the business cycle (lower yields in a recession increase bond prices). Replacing Fixed Income with cash thus increases positive macroeconomic risk already a major risk factor for Equities in a diversified portfolio. Therefore, increasing cash at the expense of Fixed Income increases overall risk in a diversified, multi-asset class portfolio by making it more correlated to the macroeconomy.

As cash offers stable principal value, the trade-off is also worse for long-term returns, both nominal and real. Since 1991, $100 invested in cash would only be worth $99 in current purchasing power (Exhibit 5). A diversified Fixed Income portfolio would have almost doubled real wealth over the same time period.

Cash is key for any spending needs. Investors looking to compound real wealth over time, however, should continue to rely on market assets, and not on cash, no matter how tempting higher short-term yields may be.

Exhibit 5: Cash Has Significantly Underperformed Fixed Income Over Longer Investing Horizons.



Sources: Bloomberg Indexes; Bureau of Labor Statistics; CIO Calculations. Data as of August 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.**

Investment Implications

Investors should choose a strategic duration target for their Fixed Income portfolios that considers their goals, risk tolerance and time horizon. Relative to that target, we suggest investors have a slightly longer duration position currently. Cash would not be considered a substitute for Fixed Income, as it increases macro risk and reinvestment risk in a portfolio.

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Equities

	Total Return in USD (%)			
	Current	WTD	MTD	YTD
DJIA	33,963.84	-1.9	-2.1	4.1
NASDAQ	13,211.81	-3.6	-5.8	27.0
S&P 500	4,320.06	-2.9	-4.1	13.9
S&P 400 Mid Cap	2,495.51	-2.8	-5.6	3.9
Russell 2000	1,776.50	-3.8	-6.4	2.0
MSCI World	2,879.85	-2.7	-3.5	12.1
MSCI EAFE	2,064.71	-2.0	-2.0	8.6
MSCI Emerging Markets	964.24	-2.1	-1.5	3.0

Fixed Income†

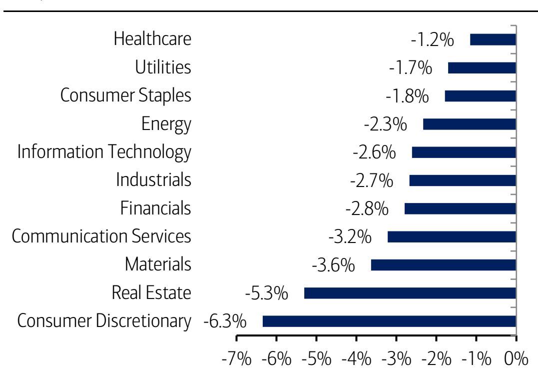
	Total Return in USD (%)			
	Current	WTD	MTD	YTD
Corporate & Government	5.20	-0.44	-1.54	-0.04
Agencies	5.17	-0.15	-0.52	1.50
Municipals	4.06	-1.07	-1.42	0.15
U.S. Investment Grade Credit	5.26	-0.50	-1.59	-0.24
International	5.88	-0.34	-1.51	1.21
High Yield	8.73	-0.65	-0.76	6.31
90 Day Yield	5.47	5.45	5.44	4.34
2 Year Yield	5.11	5.03	4.86	4.43
10 Year Yield	4.43	4.33	4.11	3.87
30 Year Yield	4.52	4.42	4.21	3.96

Commodities & Currencies

	Total Return in USD (%)			
Commodities	Current	WTD	MTD	YTD
Bloomberg Commodity	240.31	-1.1	0.5	-2.3
WTI Crude $/Barrel††	90.03	-0.8	7.7	12.2
Gold Spot $/Ounce††	1925.23	0.1	-0.8	5.5

	Total Return in USD (%)			
Currencies	Current	Prior Week End	Prior Month End	2022 Year End
EUR/USD	1.07	1.07	1.08	1.07
USD/JPY	148.37	147.85	145.54	131.12
USD/CNH	7.30	7.28	7.28	6.92

S&P Sector Returns



Sources: Bloomberg; Factset. Total Returns from the period of 9/18/2023 to 9/22/2023. †Bloomberg Barclays Indices. ††Spot price returns. All data as of the 9/22/2023 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 9/22/2023)

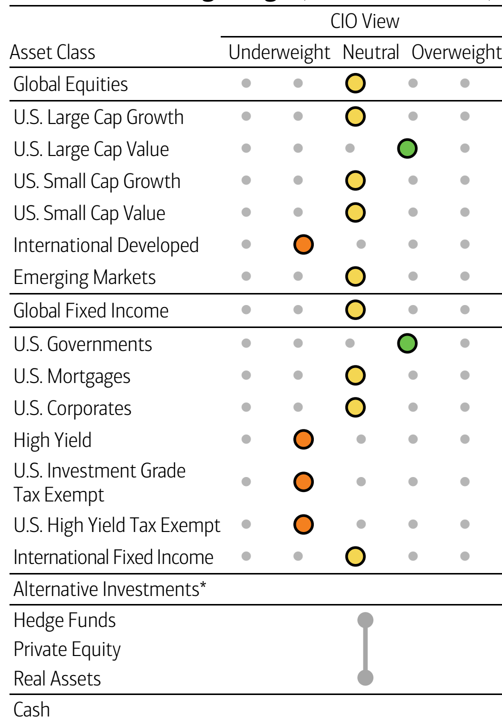
	2022A	Q1 2023A	Q2 2023A	Q3 2023E	Q4 2023E	2023E
Real global GDP (% y/y annualized)	3.6	-	-	-	-	3.0
Real U.S. GDP (% q/q annualized)	2.1	2.0	2.1	2.0	1.5	2.1
CPI inflation (% y/y)	8.0	5.8	4.0	3.5	3.5	4.2
Core CPI inflation (% y/y)	6.1	5.6	5.2	4.4	3.9	4.8
Unemployment rate (%)	3.6	3.5	3.5	3.7	3.8	3.6
Fed funds rate, end period (%)	4.33	4.83	5.08	5.38	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.**

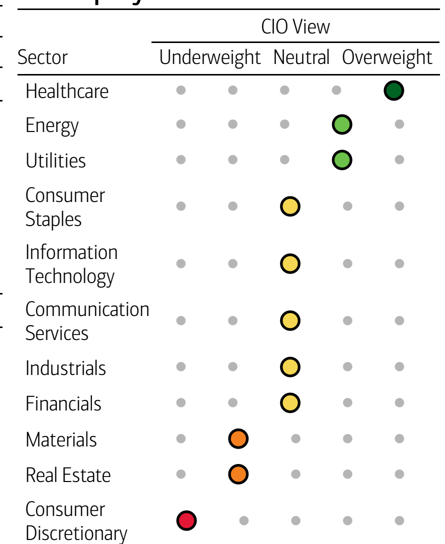
A = Actual. E/* = Estimate.

Sources: BofA Global Research; GWIM ISC as of September 22, 2023.

Asset Class Weightings (as of 9/5/2023)



CIO Equity Sector Views



*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 September 5, 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.

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.

Cash/Bloomberg US Treasury Index measures US dollar-denominated, fixed-rate, nominal debt issued by the US Treasury.

Bloomberg US Aggregate Bond Index is a broad base, market capitalization-weighted bond market index representing intermediate term investment grade bonds traded in the United States.

Bloomberg US Corporate Bond Index measures the investment grade, fixed-rate, taxable corporate bond market.

Important Disclosures

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