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CHIEF INVESTMENT OFFICE

Capital Market Outlook

November 18, 2024

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

IN THIS ISSUE

Macro Strategy—*Rich Valuations Leave Risk/Reward Skewed to the Downside for High Yield:* We continue to suggest a slightly underweight positioning in High Yield (HY), a view primarily predicated on rich valuations—which are near some of the tightest levels of the past 25 years and have more than fully priced in a strong macroeconomic outlook and a reacceleration in corporate earnings, in our view.

Market View—*What Every Investor Should Know About China's Hukou System:* In the U.S., the consumer is king, accounting for nearly 70% of gross domestic product (GDP). In China? Not so much: Investment, manufacturing, and exports remain front and center, while consumer spending continues to contribute less than 40% of the mainland's economic output. And the latest round of stimulus measures, while fodder for markets in recent months, is unlikely to move the consumption needle, in our view.

Still less appreciated on Wall Street is this: China's hukou system, which designates individuals as "rural" or "urban" residents and determines access to a range of services (think healthcare, education, affordable housing), remains a key impediment to China consumption. Nearly 400 million rural migrant laborers who live and work in China's cities—the "floating population"—face unequal access to employment opportunities and social benefits, translating to lower consumption, greater savings, and a divided China. Read on for why China's hukou system matters, and how current reform risks leaving the China consumer behind.

Thought of the Week—*What's Shaping the Outlook on Oil?:* Oil prices have remained largely rangebound this year. The spike in global oil markets in early October amid concerns that a potential escalation of tensions in the Middle East could effect local energy infrastructure quickly eased by the end of the month as supply disruption concerns receded and as attention returned to some of the more bearish supply and demand overhangs that have capped market upside.

This push and pull in oil markets could persist next year. The prospect of an oversupplied oil market remains a primary risk, especially if the Organization of the Petroleum Exporting Countries (OPEC+) decides to unwind its current production cuts. Amid weak demand from China, waning global oil demand remains another major risk. A swell in oil supply without a corresponding increase in demand could pressure oil prices further. Given these headwinds, we remain slightly underweight the Energy sector within U.S. Equities.

MACRO STRATEGY ▶

Chief Investment Office
Fixed Income Team

MARKET VIEW ▶

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

Ariana Chiu
Wealth Management Analyst

THOUGHT OF THE WEEK ▶

Kirsten Cabacungan
Vice President and Investment Strategist

MARKETS IN REVIEW ▶

Data as of 11/18/2024, and subject to change

Portfolio Considerations

We maintain our tactical Equity overweight relative to Fixed Income, our diversified, balanced approach in Growth versus Value, and continue to favor the U.S. relative to the rest of the world as we close out the choppiness at the end of 2024.

Our highest conviction Fixed Income call remains that the yield curve will normalize by short rates moving lower, and investors, in our opinion, should therefore consider moving out investable cash in Fixed Income to their strategic duration target, as cash yields are likely to decrease relatively quickly from here, and the short-term backup in yields may be an opportunity.

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MACRO STRATEGY

Rich Valuations Leave Risk/Reward Skewed to the Downside for High Yield

Chief Investment Office, Fixed Income Team

Leveraged credit (HY and Leveraged Loans) has been one of the best-performing areas within Fixed Income in 2024. The spread on the ICE BofA High Yield Index started the year at around 330 basis points (bps) amid a building narrative of growth concerns, heightened interest rate volatility, and lingering geopolitical tensions. However, fast forward to today, HY spreads have tightened approximately around 70 bps to 264 bps (post-2008/2009 Global Financial Crisis tights), which, along with coupon carry, leaves total return for the asset class a robust 8.7% through November 14. This strong performance comes on the heels of better-than-expected economic data, a reacceleration of corporate earnings growth, and investor optimism post the presidential election. Leveraged loans have also benefited from renewed investor demand given the expectations of fewer fed funds cuts over the last several months (which improves expectations for floating-rate coupons)—with loans logging a year-to-date (YTD) total return of just under 8%.

With valuations across HY and loans now at some of the richest levels of the past 25 years—we continue to suggest a slightly underweight positioning. While fundamental and technical outlooks appear to tactically support valuations over the shorter term, we believe that spreads could be susceptible to widening and risk/reward is skewed to the downside. HY is subject to similar drivers as Equities, but unlike Equities, HY valuations tend to mean-revert over time—which puts a floor on spreads and potentially caps excess returns. Said differently, HY offers Equity-like risk, with sub-Equity returns, and we believe that, at current spread levels, the upside/downside return relationship is asymmetric. We do acknowledge the possibility that credit spreads could trend at low levels for an extended period, providing carry-like returns, especially if the risk backdrop remains favorable. However, we still prefer to spend our risk budget in Equities over HY.

Fundamentals Are Mixed, with Continued Deterioration in Lower-Quality Issuers.[1]
Corporate balance sheet health has been relatively stable, as gross debt levels have remained flat while earnings growth has been mixed across HY (modestly negative) and loans (slowing but still positive). However, earnings for the lowest-quality cohort of issuers (i.e., CCCs rated bonds) remain under pressure,[2] and a cycle of re-leveraging looms, increasing the potential for event risk, in our view. With a new presidential administration likely to dial back regulation, we're already seeing animal spirits stir, and we expect a potential rebound in debt-funded mergers & acquisitions (M&A) next year—which is generally negative for credit spreads.

Further, continued deterioration in interest coverage ratios (ICR) for weaker issuers is a key risk, as leveraged-credit borrowers carry elevated leverage and weaker profit margins compared to higher-rated issuers. Amid the higher interest rate environment, HY ICR stands at 4.2x, deteriorating from 4.8x a year ago, while loan issuer ICRs have fallen from 3.4x to 3.0x—with some lower-quality, loan-only issuers barely able to cover their annual interest expense with internally generated cash flow. We expect further modest pressure on ICR even with anticipated rate cuts next year, as coupons remain below current market yields.

Trends in default rates are also mixed across HY and loans. The loan market is skewed toward lower-quality issuers as compared to HY—which is reflected in elevated default rates in loans compared to relative stability and modest improvement in HY defaults over the last twelve months. Loan default rates hit 7.1% as of September 30, well above the 10-year average of 3.3%.[3] Trends in recovery rates also indicate rising risk for creditors, with recovery rates on first-lien loans now at around 40%, significantly below the 25-year

Portfolio Considerations

While spreads could trend at low levels for an extended period of time, tactically, we believe spreads are susceptible to volatility and that risk/reward is skewed to the downside. Consider maintaining an equal 50/50 mix between senior unsecured and loans within an allocation to HY.

[1] All data from BofA Global Research as of October 2024 unless otherwise noted.
[2] Source: S&P Global as of October 2024.
[3] Source: Moody's Ratings as of September 2024.

average of 64%.[4] Meanwhile, HY defaults have remained in the 3% to 4% range over the past year, slightly below their historical average of 4.2%.

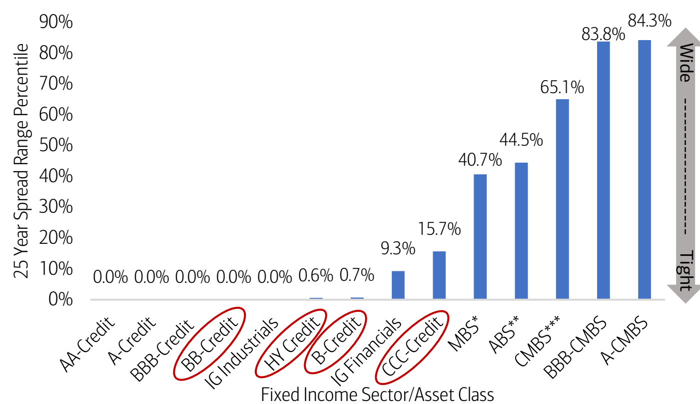
Similar to Investment-grade (IG), Technicals Are Providing a Supportive Backdrop for HY. Demand from yield buyers has been very strong across HY. Inflows into HY funds have been over $30 billion YTD after outflows in 2022 and 2023. Also supportive of the technical backdrop is negative net supply YTD, at around -$50 billion.[5] However, given our expectations for M&A to ramp up next year, more debt issuance could weigh on spreads modestly. That said, with yields at still-elevated levels, investor demand could remain robust unless the macro backdrop weakens, and investors' perception of credit risk rises.

Rich Valuations Leave Little Room to Run—Need CCCs to Participate for Index Spread to Compress Further. While the near-term backdrop is supportive, we advocate for caution in leveraged credit markets going forward, as these trends appear fully baked into valuations. Furthermore, we do not believe spread levels compensate investors for the inherent volatility of the asset class and the high likelihood of negative forward excess returns. Historical data indicates that when starting below 300 bps, 12-month forward excess returns for HY senior unsecured are -8.8% using ICE BofA Indexes. While investors may be drawn to elevated yields, spreads tell a different story. BB spreads are trading at the tightest level since October 1997, and the HY Index and single-Bs are near 25-year tights—the HY Index and B-rated bonds have traded tighter than current levels only around 60 days over the last 9,100 days.

Although CCCs remain wide to the tights of Summer 2021, they are trading at their 16th percentile. We anticipate that further spread compression at the index level would necessitate a continued rally in CCC spreads. However, given the distressed nature of CCCs, performance in this cohort tends to be driven by idiosyncratic factors. In the event of macroeconomic softness, the weakest issuers are more vulnerable to credit deterioration that leads to higher default rates and lower recovery rates. While this is not our base case, it should be considered when assessing risk premiums in leveraged credit—which, again, remain near record lows, warranting caution. We continue to view risks as balanced between the two asset classes and recommend an even 50/50 mix between senior unsecured and loans within an allocation to HY.

Exhibit 1: HY Valuations Near Record Lows Imply a Slim Margin for Error.

1A) Most of the HY Market Is Trading Near the Tightest Levels of the Past 25 Years.



1B) HY Spreads Continue to Screen Rich—Which Implies Underperformance vs. Treasurys 12 Months Forward.

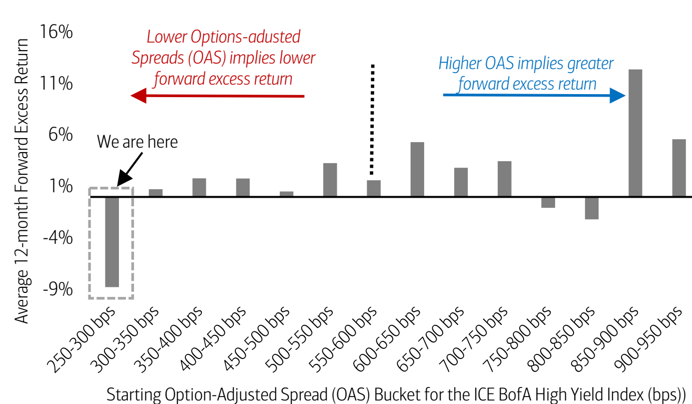


Exhibit 1A) *Mortgage-backed Securities; **Agency-backed Securities. ***Commercial Mortgage-backed Securities. Source: ICE BofA indexes. Data as of November 8, 2024. Exhibit 1B) Sources: Chief Investment Office; Bloomberg, ICE BofA. Data as of November 8, 2024. **It is not possible to invest directly in an index. Please refer to index definitions at the end of this report. Past performance is no guarantee of future results.**

[4] Source: JPMorgan as of November 8, 2024.

[5] Source: JPMorgan as of November 6, 2024. Calculated as gross issuance minus calls, tenders, maturities, rising stars, coupon reinvestments, and mutual fund flows.

MARKET VIEW

What Every Investor Should Know About China's Hukou System

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

Ariana Chiu, Wealth Management Analyst

One of the great distinctions between the U.S. and China economies lies with the role of the consumer. In America, the consumer is king—the omnipotent economic force that accounts for more than two-thirds of U.S. economic activity. In contrast, the China consumer is subordinate to an economy that is more investment-led and export-oriented. Despite lifting 800 million people out of poverty over the past four decades, consumer spending in China continues to account for less than 40% of GDP (Exhibit 2A).

That figure is low even by emerging market standards and isn't likely to change anytime soon. Indeed, amid all the recent government policies to stimulate economic growth in China, clearly lacking were any concert moves to boost personal consumption via government transfers or structural reforms. This oversight should not be lost on investors who have enthusiastically bid up China asset prices over the past few months based on greater government activism.

Despite the moves by Beijing, China's greatest source of untapped growth—the consumer—remains just that: untapped. At the moment, the bulk of China consumers are hunkering down, saving more and spending less owing to a soft jobs market and collapse in property values-cum-negative wealth effect. As a result, earnings expectations for a host of Western multinationals—ranging from automobiles to luxury brands—have been marked down this year.

But beyond the cyclical sting of weak employment and falling property prices, another impediment to consumer spending in China lies with the peculiarities of the country's hukou system—a system little understood on Wall Street but of great importance to the future of China.

China's hukou system: Where you are born matters in China. China's hukou system—or household registration program—is akin to an "internal passport" system that assigns and labels individuals as rural or urban residents, thereby determining their access to basic services and benefits. If your family is from the city, for instance, and your registration is urban, you and your family enjoy better access to medical facilities, schools, higher paying jobs and pensions, and affordable housing. In general, you have more disposable income, more savings, and enjoy better upward mobility over the long run.

In contrast, city life is more challenging and the future less certain for the nearly 400 million rural Chinese workers who have moved from the farms to the cities over the past three decades. This mass of humanity is known as China's "floating population" and has surged in recent years to exceed the entire population of the U.S.

Yes, the pay and incomes are better in the coastal factory cities that have transformed China into a 21st century manufacturing powerhouse. But for rural migrant workers, social mobility comes with a price. In addition to a persistent earnings gap between rural migrant workers and urban workers, the paychecks of China's army of migrant factory workers are stretched thin since these laborers confront multiple costs associated with basic urban services like health care, education, social benefits and housing. Their purchasing power is reduced by the need to spend and save for a child's education, healthcare costs and decent housing. And lacking a pension, migrant workers save a larger share of their income for retirement than their urban counterparts. They have no choice.

Basic public sector services in China's urban areas are designed for local/urban residents—not migrant workers—resulting in greater income disparities between rural and urban consumers. Two more headwinds facing migrant workers are unequal access to good schools and an unfair playing field when it comes to finding good jobs in the public sector. As an aside, because many migrant children cannot attend school in the cities due

Investment Implications

In addition to headwinds like weak employment and falling property prices, China's hukou system remains a structural drag on household consumption and, thus, broader economic growth. Recent stimulus measures are encouraging but appear unlikely to meaningfully boost consumption. We remain neutral Emerging Market Equities as growth in China remains constrained.

to their parents' hukou status, they are "left behind" in the rural areas, often raised by their grandparents or other adults while their parents work in the cities.[6] Between 2000 and 2020, the population of "left behind" children more than doubled to 67 million, according to the United Nations. Summing it all up, as *The Economist* recently noted, the bulk of migrant workers in China's largest cities "are treated as second-class."[7]

Recognizing these deficiencies, the government has initiated a number of hukou reforms over the past decade; notably, more cities are easing up on hukou restrictions, but the bulk of these cities are smaller—think 3 million to 5 million people. Meanwhile, in tier-one megacities like Beijing, where a large proportion of migrant workers reside, restrictions remain in place out of fears of the added costs/burden on social services from a bulge in rural migrants. While migrants can potentially change their hukou status via the "residence permit" system, the hurdles remain high and costly, and have done little in the end to narrow the gap between migrant workers and their urban counterparts.

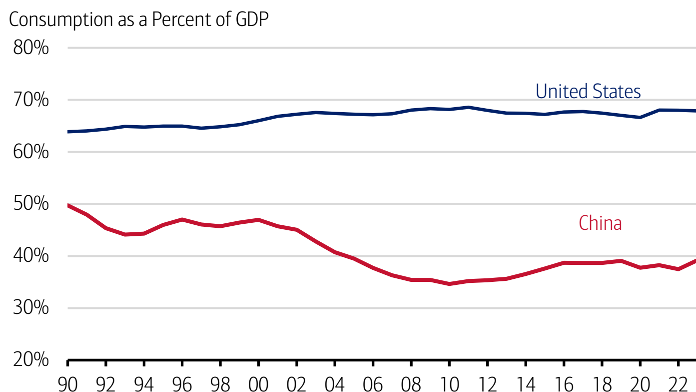
Structural shifts forget the consumer. Despite a bevy of policy initiatives to stimulate growth in China over the past few months, direct support for the Chinese consumer has been underwhelming. Yes, while stabilizing the property market and greasing the stock market will provide a short-term boost to consumption, the structural underpinnings for consumption-led growth in China remain absent today.

Indeed, if anything, the government remains more focused on the supply side of the equation (production) than demand (consumption). China's policymakers are shifting their growth priorities away from property and infrastructure-led growth toward more manufacturing in strategic sectors like clean energy, electric vehicles, semiconductors and batteries. This shift has already been felt globally, with China's ballooning global merchandise trade surplus expected to approach $1 trillion this year (Exhibit 2B). The U.S., by the way, is on pace to run another near-$300 billion merchandise trade deficit with China in 2024.

All of which brings us back to China's hukou system—this should no longer be an unfamiliar topic/term to investors. Put simply, how this system evolves in the years ahead should help determine household consumption in China and therefore the nation's long-term economic growth prospects.

Exhibit 2: In Search for Growth, China Opts for Exports over Consumption.

2A) Consumption Rules in the U.S., Lags in China.



2B) China Nears $1 Trillion Merchandise Trade Surplus with the World.

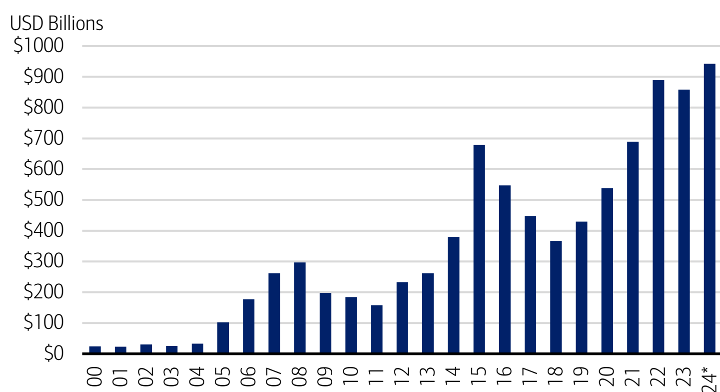


Exhibit 2A) Source: Bureau of Economic Analysis; National Bureau of Statistics. Annual data through 2023. Data as of November 2024. Exhibit 2B) *2024 = Annualized estimate based on year-to-date monthly trade surplus through October. Source: IMF, China Customs General Administration. Data as of November 2024.

[6] To read more about this topic, please see "*Private Revolutions: Four Women Face China's New Social Order*", Yuan Yang, July 2024.

[7] "Never forget class struggle," *The Economist*, September 28, 2024.

What's Shaping the Outlook on Oil?

Kirsten Cabacungan, Vice President and Investment Strategist

Oil prices have remained largely rangebound this year. The spike in global oil markets in early October amid concerns that a potential escalation of tensions in the Middle East could effect local energy infrastructure quickly eased by the end of the month as supply disruption concerns receded and as attention returned to some of the more bearish supply and demand overhangs that have capped market upside. These types of swings have kept oil prices settled for the most part in a sideways pattern (Exhibit 3A). West Texas Intermediate (WTI) crude oil is down 6.5% so far this year.[8]

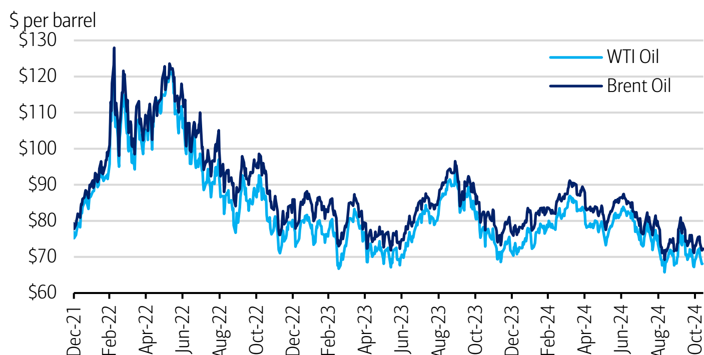
This push and pull in oil markets could persist next year. The prospect of an oversupplied oil market remains a primary risk. Global crude oil production ramped up in the last decade, with the U.S. emerging as the largest crude oil producer in the world for the last six years.[9] That's been a net positive for the U.S. in terms of energy independence (Exhibit 3B) but has meant more oil supply globally. The oil market faces a sizable surplus next year if the OPEC+ decides to unwind its current production cuts. That swell in supply without a corresponding increase in demand could pressure oil prices further, especially as weak demand from China, the world's largest importer of crude oil, remains another source of uncertainty (Exhibit 3C). OPEC+ seems to acknowledge slowing demand risks amid four straight months of cuts to its global oil demand forecasts and several postponed starts to production increases (Exhibit 3D). Still, the International Energy Agency expects global oil supply will likely outweigh demand by more than 1 million barrels per day next year even if OPEC+ cuts remain in place.[10] Given these headwinds, we remain slightly underweight the Energy sector within U.S. Equities.

Portfolio Considerations

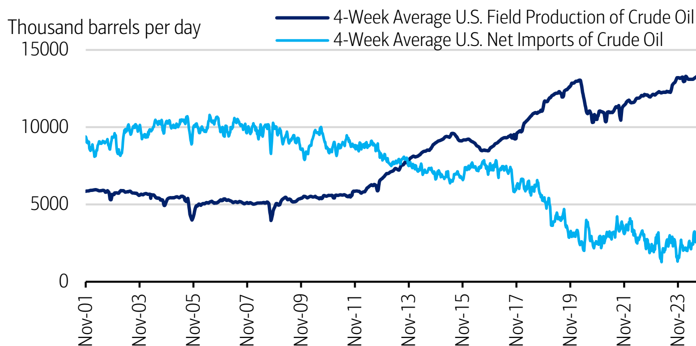
We recently reduced exposure to Energy, as weaker demand from China, combined with a growing supply outlook for 2025, is a concern and could weigh on oil prices, energy cash flows and earnings in coming quarters.

Exhibit 3: The Global Oil Market in Context.

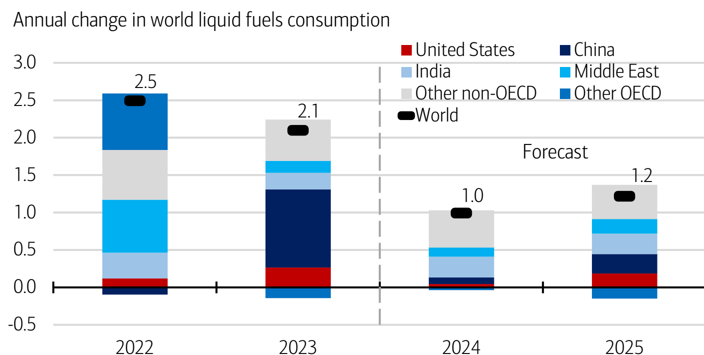
3A) Oil prices have been stuck in a range.



3B) U.S. oil production has expanded in the last decade.



3C) Waning China oil demand remains a risk.



3D) OPEC+ has been trimming its demand growth forecasts.

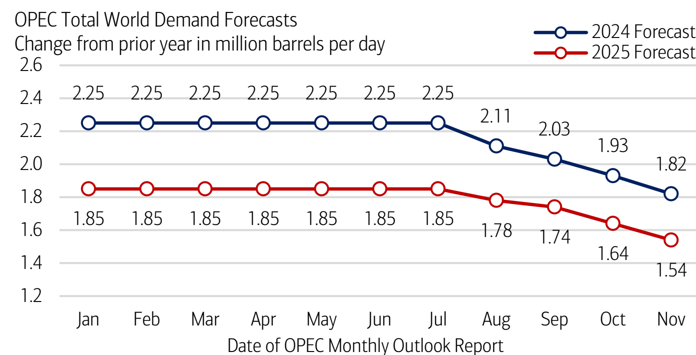


Exhibit 3A) Source: Bloomberg. Data as of November 13, 2024. Exhibit 3B) Source: U.S. Energy Information Administration. Data as of November 1, 2024. Exhibit 3C) Source: U.S. Energy Information Administration Short-Term Energy Outlook. Data as of November 14, 2024. Exhibit 3D) Source: OPEC+ Monthly Oil Market Report. Data as of November 14, 2024.

[8] Bloomberg. Data as of November 15, 2024.
[9] U.S. Energy Information Administration. March 11, 2024.
[10] International Energy Agency Oil Market Report. November 14, 2024.

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Equities

	Total Return in USD (%)			
	Current	WTD	MTD	YTD
DJIA	43,444.99	-1.2	4.1	17.1
NASDAQ	18,680.12	-3.1	3.3	25.2
S&P 500	5,870.62	-2.0	3.0	24.6
S&P 400 Mid Cap	3,207.52	-2.7	3.6	16.8
Russell 2000	2,303.84	-4.0	5.0	15.0
MSCI World	3,710.50	-2.1	1.8	18.6
MSCI EAFE	2,275.34	-2.6	-2.4	4.3
MSCI Emerging Markets	1,085.00	-4.4	-3.0	8.3

Fixed Income†

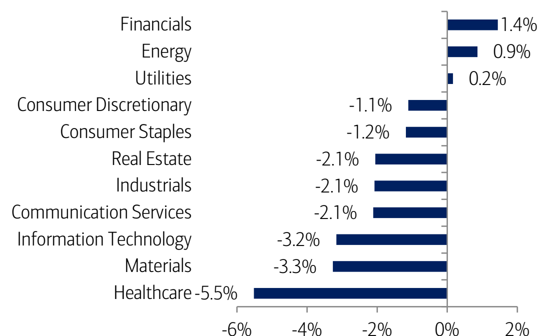
	Total Return in USD (%)			
	Current	WTD	MTD	YTD
Corporate & Government	4.72	-0.84	-0.58	1.31
Agencies	4.60	-0.22	-0.22	2.82
Municipals	3.59	0.12	0.64	1.46
U.S. Investment Grade Credit	4.84	-0.84	-0.52	1.33
International	5.25	-1.13	-0.39	2.37
High Yield	7.29	-0.36	0.43	7.88
90 Day Yield	4.49	4.52	4.54	5.33
2 Year Yield	4.30	4.25	4.17	4.25
10 Year Yield	4.44	4.30	4.28	3.88
30 Year Yield	4.62	4.47	4.48	4.03

Commodities & Currencies

	Total Return in USD (%)			
Commodities	Current	WTD	MTD	YTD
Bloomberg Commodity	230.90	-2.0	-1.8	2.0
WTI Crude $/Barrel††	67.02	-4.8	-3.2	-6.5
Gold Spot $/Ounce††	2563.25	-4.5	-6.6	24.2

	Total Return in USD (%)			
Currencies	Current	Prior Week End	Prior Month End	2022 Year End
EUR/USD	1.05	1.07	1.09	1.10
USD/JPY	154.30	152.64	152.03	141.04
USD/CNH	7.24	7.20	7.12	7.13

S&P Sector Returns



Sources: Bloomberg, Factset. Total Returns from the period of 11/11/2024 to 11/15/2024. †Bloomberg Barclays Indices. ††Spot price returns. All data as of the 11/15/2024 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 11/15/2024)

	2024E	Q1 2024A	Q2 2024A	Q3 2024A	Q4 2024E	2025E
Real global GDP (% y/y annualized)	3.1	-	-	-	-	3.3
Real U.S. GDP (% q/q annualized)	2.7	1.6	3.0	2.8	2.0	2.4
CPI inflation (% y/y)	2.9	3.2	3.2	2.6	2.6	2.4
Core CPI inflation (% y/y)	3.4	3.8	3.4	3.2	3.2	3.0
Unemployment rate (%)	4.0	3.8	4.0	4.2	4.2	4.3
Fed funds rate, end period (%)	4.38	5.33	5.33	4.83	4.38	3.88

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 November 15, 2024.

Asset Class Weightings (as of 11/5/2024)

	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	
Utilities				●	
Financials				●	
Healthcare				●	
Consumer Discretionary				●	
Information Technology			●		
Communication Services			●		
Industrials			●		
Real Estate			●		
Energy		●			
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 November 5, 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.

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.

High Yield/ICE BofA High Yield Index is an unmanaged index that tracks the performance of below investment grade corporate debt in the US.

ICE BofA Investment-grade (IG) Financials Index tracks the performance of investment grade corporate debt in the United States.

ICE BofA U.S. Investment Grade (IG) Industrials Index measures the performance of investment grade corporate and preferred securities in the U.S.

ICE BofA Mortgage-backed Securities Index is a broad measure of the performance of fixed-rate residential mortgage pass-through securities that are publicly issued in the US domestic market by US agencies.

ICE BofA Agency-backed Securities Index tracks the performance of investment-grade, US dollar-denominated fixed-rate taxable securities with a maturity of 7–10 years.

ICE BofA Commercial Mortgage-backed Securities Index measures the performance of US dollar-denominated investment grade fixed rate commercial mortgage-backed securities that are publicly issued in the US.

West Texas Intermediate (WTI) Crude Oil Futures is a principal international pricing benchmark in U.S. dollars per barrel that reflects the NYMEX Division light, sweet crude oil futures contract which is the world's most liquid forum for crude oil trading and the world's largest volume future contract trading on a physical commodity. The contract trades in units of 1,000 barrels and the delivery point is Cushing, Oklahoma, which is also accessible to the international spot markets via pipelines.

Brent Crude is a daily calculation of the average price of trading in the North Sea physical oil market for a given delivery month. It's based on the ICE Brent futures contract, which is the world's largest oil futures contract. The Brent Index is used as the final cash settlement price for the ICE Brent futures contract.

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