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CHIEF INVESTMENT OFFICE

Capital Market Outlook

November 25, 2024

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

IN THIS ISSUE

Macro Strategy—*On Policy Changes, the Business Cycle and the Markets:* Equities tend to shift from a strong overweight in the early cycle to neutral by the end of the midcycle, as the central bank starts to contain inflation or other excesses. Only in the late cycle when growth and profits weaken under monetary policy restraint, and credit spreads start to widen, do allocations tend to shift to underweight Equities in preparation for a recession.

Aside from strikes and hurricane-related effects, incoming data continue to indicate robust U.S. growth with moderate inflation, however. The economy appears poised to grow near its newfound higher short-term potential rate into 2025, more akin to the early part of the midcycle. With policy closer to neutral than the Federal Reserve (Fed) was assuming just a few weeks ago, prospects for a continued "Goldilocks" environment tend to be favorable for Equity prices. Markets appear to agree, with cyclical sectors generally leading risk assets higher on optimism about the durability of the expansion and earnings growth. While policymakers and financial markets are facing a sea of change on the government policy front, market dynamics appear to indicate a sanguine view about their net impact on the economy. Uncertainty remains high, but most policy changes are unlikely to affect the growth trajectory before late 2025.

Market View—*Defense, China, Deficits and Money Markets: Four Charts of Interest to Investors:* With the U.S. presidential election behind us and 2025 in close reach, there's no shortage of topics of interest for investors. This week, we highlight four key metrics that are expected to shape the investment landscape in the year ahead. First, with geopolitical tensions flaring and a global arms race underway, defense spending at just 2.3% of gross domestic product (GDP) in 2023 is set to soar from here. Second, China's export-led growth strategy has fueled an alarm-ringing trade surplus approaching $1 trillion. Third, the U.S. federal budget deficit clocked in at 6.4% of GDP in FY 2024, with the so-called bond vigilantes on watch for how the incoming administration handles Uncle Sam's finances. Finally, with $6.6 trillion still sitting in money market funds, investors continue to remain on the sidelines amid U.S. equity markets near all-time highs. Each of these metrics and their implications for investors will be paramount to watch in 2025.

Thought of the Week—*The Black Friday Barometer:* Black Friday is just around the corner, marking the symbolic start to holiday shopping season. The closely watched year-end spending surge can serve as a barometer for the health of consumers, retailers and the broader economy. We see momentum heading into the kickoff, as elevated net worth, a solid labor market, a healthy pace of wage growth, and increasingly upbeat attitudes support consumer spending. Against this backdrop, the National Retail Federation estimates record holiday spending between $979.5 billion and $989.0 billion in 2024. This could portend a very merry holiday sales season indeed. However, there are caveats—dollars are stretched, as years of rising price levels have reduced purchasing power, consumers increasingly plan to trade down and seek value this holiday season, and fewer days between Thanksgiving and Christmas could be a drag. Even considering these headwinds, consumers seem well positioned to spend, which bodes well for retailers and the U.S. economy alike. We are cautiously optimistic heading into the season of sales, but developments will bear watching.

MACRO STRATEGY ▶

Chief Investment Office
Macro Strategy Team

MARKET VIEW ▶

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

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THOUGHT OF THE WEEK ▶

Emily Avioli
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MARKETS IN REVIEW ▶

Data as of 11/25/2024, 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

On Policy Changes, the Business Cycle and the Markets

Chief Investment Office, Macro Strategy Team

The U.S. economy continues to demonstrate remarkable cyclical resilience, defying nagging expectations of a late-cycle slowdown. The labor market remains healthy. In aggregate, the household balance sheet is strong, and the financial obligations ratio low. Abundant U.S. energy supply keeps fuel prices tame. Not surprisingly, consumer spending is red-hot. Business investment is also growing, and government spending remains strong. As discussed in recent reports, the preponderance of economic data—including narrowing credit spreads, low unemployment, and higher long-term Treasury yields—challenges the traditional late-cycle narrative characterized by rising inflation, restrictive monetary policy, and fading growth.

The fact that the expansion has continued unscathed in the face of elevated interest rates indicates that monetary policy is not as restrictive as perceived. First, tightening started from an unusually stimulative place, with the full effect of the Fed rate hikes mitigated by households and corporations' rush to lock in rock-bottom borrowing rates in 2020/2021. Second, discretionary fiscal stimulus offset much of the Fed restraint. Third, liquidity created to tackle the 2023 regional banking crisis helped reinvigorate growth. Fourth, much higher-than-expected productivity has boosted U.S. growth potential, helping the economy weather the rate hikes much better than anticipated.

As a result, notwithstanding temporary disruptions due to recent strikes and hurricanes, incoming data continue to suggest a "Goldilocks" mid-cycle environment of solid growth near potential with moderate inflation. Growth remains driven by robust consumer spending, which is on track to expand around 3% at an annualized rate again in Q4, if stellar retail sales in recent months are any indication. Reflecting the better-than-expected economic performance, the Citi Economic Surprise Index has remained on an uptrend, typically a positive for cyclical asset performance versus defensives.

Importantly, layoffs remain subdued, the Institute for Supply Management (ISM) nonmanufacturing survey's employment subcomponent rebounded sharply in October, and bank willingness to lend has continued to recover in Q4, according to the Senior Loan Officer Opinion Survey (SLOOS). These conditions are typically consistent with healthy employment growth of around 1.2% well into 2025. In turn, this suggests sustained labor income growth near its healthy current pace. Even with inflation stuck around 2.5%, our research suggests that aggregate payroll growth should support at least a 2% real consumer spending growth rate over the next few months, a positive for economic and profits growth.

Strong equity market gains over the past two years are also favorable for the consumer spending outlook. So is the fact that the pandemic-related "excess savings" have not been depleted yet, according to revised government data. In addition, consumer balance sheets have room for more borrowing, and banks' willingness to lend to consumers has increased, as noted above.

The SLOOS survey shows that bank lending conditions have eased over the past year on the corporate side as well, a positive for continued business investment and economic growth. According to the National Federation of Independent Business (NFIB) survey, small-business sentiment has been dour over the past two years. The Fed's Small Business Credit Survey shows that higher interest rates have caused 37% of small businesses to postpone expansion plans and capital investment. In October, the NFIB optimism index rose to its highest level since early 2022, however, on improved expectations for sales, credit conditions and capital outlays. Energized by easing credit conditions and rising optimism about upcoming tax cuts and deregulation, small business investment should help broaden and extend the expansion.

Portfolio Considerations

A tilt toward quality cyclical risk assets remains compatible with prospects for sustained expansion and earnings growth. Markets seem to expect tailwinds from deregulation/tax cuts to offset headwinds from higher/broader tariffs, lower immigration, or other potential policy-induced stress on the economy.

Sustained strong economic growth along with still elevated margins have kept S&P 500 corporate profits on a sharp uptrend into new record territory through Q3 amid upside surprises. Margins remain supported by cost-cutting and strong productivity growth. Driven by operating leverage, broadening Artificial Intelligence (AI) adoption, capital investment, and a surge in new business formation, productivity growth has averaged 2.3% over the past two years compared to 1.6% in the decade prior to the pandemic, according to the Bureau of Labor Statistics.

Ample liquidity, a favorable macroeconomic outlook, and strong corporate earnings have in turn kept the S&P 500 index on a steep uptrend, pushing the price-to-earnings (P/E) ratio into record territory. Characterized by a "Goldilocks" environment of moderate growth, steady inflation and neutral interest rates, mid-cycles tend to see reduced macroeconomic risk/uncertainty and high investor confidence. This boosts both equity prices and valuations.

In the current case, corporate revenue growth is on track for about a 5% increase in 2024, based on our analysis, closely tracking nominal GDP growth with a similar mid-single-digit growth rate likely in 2025 as well. This, combined with elevated margins supported by the productivity boom, suggests that earnings per share growth of up to 10% would not be surprising in 2025 and 2026, in our view. In addition, proposed tax cuts, along with other fiscal stimulus and anticipated deregulation, foster business sector confidence and capital investment, solidifying the "risk-on" environment of higher P/Es and cyclical sector outperformance.

Citing better-than-expected economic conditions, the Fed has tempered rate-cut expectations, prompting markets to now price in just three cuts in 2025. More importantly, however, rate hikes are not anticipated anytime soon, which reduces risks to the economy, profits growth, and the equity risk premium (ERP), likely sustaining the P/E ratio around current levels.

The increased importance and heft of a number of unusually fast growing, highly profitable technology and communication companies—strategically positioned to benefit from broadening AI applications and rapid global uptake—raises the S&P 500 Index P/E ratio relative to historical levels, as well as relative to other parts of the equity market. This structural shift likely renders the old average P/E somewhat misleading. Also important, excluding the large tech companies, the median P/E is not stretched, suggesting ample room for rotation and price appreciation within the index as earnings growth broadens further.

All in all, markets appear optimistic about the durability of growth and earnings. The equity market has been pricing in a "soft landing," with cyclical sectors leading the market higher. An outlook of sustained revenue growth and productivity-driven earnings underpins long-term valuation sustainability. Still, risks to valuations remain. Geopolitical or trade-related shocks, including potential retaliatory measures from trading partners in response to much higher tariffs, may disrupt global supply chains and dampen corporate profitability. A sharper rise in interest rates, driven by heightened government-debt concerns or rekindled inflation would increase the ERP and thus reduce the market P/E. Additionally, import tariffs tend to boost the dollar exchange rate. The dollar is already overvalued, though, so further appreciation would start to weigh on exports, corporate revenues and earnings.

MARKET VIEW

Defense, China, Deficits and Money Markets: Four Charts of Interest to Investors

Joseph P. Quinlan, Managing Director and Head of CIO Market Strategy
Ariana Chiu, Wealth Management Analyst

There's no shortage of topics of interest for investors, so below, we briefly examine four key metrics that are expected to help shape the investment landscape in 2025. On our watchlist are the following: global defense spending, which is set to increase; China's soaring trade surplus and expectations of rising global protectionism; the federal budget deficit, which we believe is still quite manageable; and the mountain of cash parked in money market funds, which we believe could gradually seep into other asset classes next year.

Global Defense Spending: Too Low but Set To Rise. The world is at war, but you would never know it looking at Exhibit 1A. Notwithstanding ground wars in Europe and the Middle East, rising geopolitical tensions in the South China Sea and the budding Great Power Rivalry between the U.S. and China, in addition to the 24/7 war in cyberspace, global defense spending as a percentage of world GDP remains near historic lows. The world spent just 2.3% of world GDP on defense in 2023—a near-record low and well below the 3.5% annual average from 1960 to 2023.

With a global arms race underway, however, defense outlays are in a secular upswing. Record outlays are expected again in 2024 and beyond unless the doves of peace suddenly appear on the horizon. We continue to favor Large-cap defense plays not only in the U.S. but also in Europe, as well as Japan and Asia.

China's Alarm-Ringing $1 Trillion Trade Surplus. There is no better indicator of China's growth model than its stunning trade surplus with the rest of the world. As Exhibit 1B highlights, the mainland is on track to print a near $1 trillion merchandise trade surplus this year, a figure that reflects Beijing's hyperfocus on supply (greater manufacturing of strategic products like electric vehicles, batteries, solar panels, etc.) at the expense of demand (suppressed consumer spending).

This imbalance has not gone unnoticed by the rest of the world. Both the U.S. and Europe have pushed back against the flood of China exports, i.e., raised various barriers to trade. Many developing nations including Brazil, India and Indonesia have done the same. The bottom line is that China's export-led growth blitz threatens to trigger/stoke more global trade and investment protectionism, with President-elect Trump leading the charge with proposed 60% tariffs on China imports. China's stunning trade surplus could contribute to volatility in global growth in 2025 and accelerate the global reconfiguration in supply chains.

Do Budget Deficits Matter? Federal budget deficits are not uncommon in the U.S., as Exhibit 1C shows. The deficit, not unexpectedly, ballooned during the pandemic but has remained historically high (as a percent of GDP) over the past few years, clocking in at 6.4% of GDP in FY 2024. With the incoming administration showing no inclination to rein in spending, investors remain acutely attuned to Uncle Sam's finances. The so-called bond vigilantes are on watch.

So is the Chief Investment Office. The good news, however, is that America enjoys more financial space than most other nations because Washington's finances are backstopped by the most dynamic, innovation-led private sector in the world, which entails greater fiscal sustainability over the long run. America's finances are also supported by the world's reserve currency, the U.S. dollar, which makes U.S. government securities still among the safest and most desirable in the world. And finally, the U.S. enjoys the benefit of issuing debt in its own currency, allowing for a higher debt-carrying capacity relative to other nations. In the end, deficits matter but just not yet in the U.S.

Investment Implications

Looking ahead to 2025, we remain watchful of global defense spending's rise (think Large-cap defense plays in the U.S. and abroad), further trade and investment protectionism (expect diversifying supply chains and potential volatility in global growth), manageable U.S. budget deficits for now (watch U.S. growth led by the private sector), and sticky money market assets (monitor the path of interest rates).

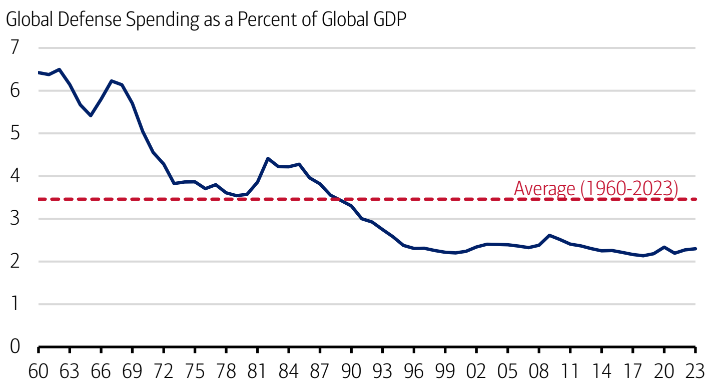
Money Markets: Cash Is Still King. Remember TINA—or the common lament that with real yields on debt near zero or negative in many parts of the world, "there is no alternative" to Equities? Well, those days have long passed as indicated by Exhibit 1D. Portfolio construction is a great deal more dynamic today, with Equities competing more against Fixed Income, Private Credit and good old cash.

As of mid-November, some $6.6 trillion was parked in money market funds, a record high and figure well above the long-term average of $2.4 trillion. Currently, the average money market fund is returning 4.5% versus 20%+ returns from the S&P 500 this year.[1] Sitting in cash, in other words, has come at a relative and absolute cost to investors this year.

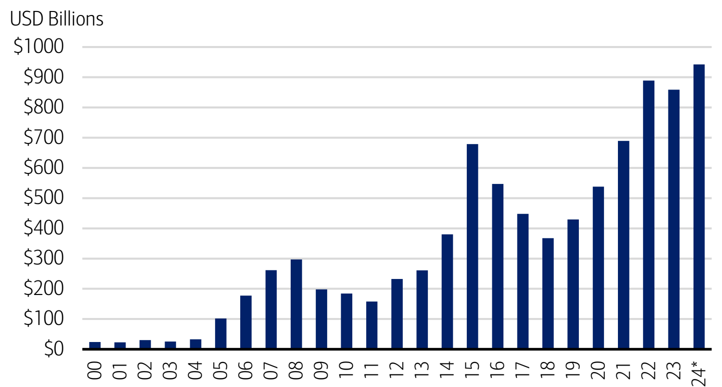
Election uncertainty, for sure, kept investors on the sidelines leading up to the November vote. Meanwhile, with Fed Chairman Powell's more recent hawkish commentary and rate expectations for 2025 continuing to evolve, the prospect of higher-than-initially-expected rates next year may be tempting investors to remain in cash. The bottom line: While appropriate levels of cash should be maintained in portfolios, we continue to urge investors to avoid camping out on the sidelines. It is time in the market, rather than timing the market, that matters.

Exhibit 1: Four Charts to Watch in 2025.

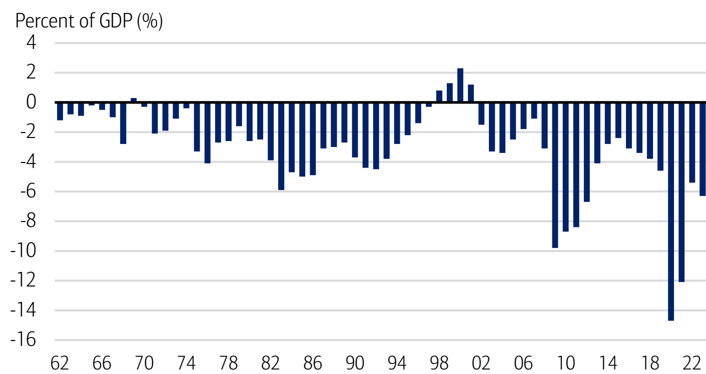
1A) Too Low: The Disconnect Between War and Peace.



1B) Shock and Awe from China: China Nears $1 Trillion Merchandise Trade Surplus with the World.



1C) Deficits Are as American as Apple Pie: U.S. Budget Deficit/Surplus FY 1962-2024.



1D) Cash Is Still King: Money Market Fund Assets Hit $6.6 Trillion (T).

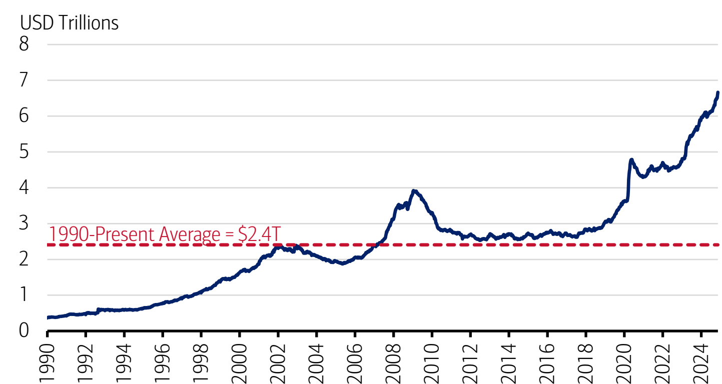


Exhibit 1A) Source: Stockholm International Peace Research Institute. Data as of November 2024. Exhibit 1B) 2024 = Annualized estimate based on year-to-date monthly trade surplus through October. Source: International Monetary Fund, China Customs General Administration. Data as of November 2024. Exhibit 1C) Source: Congressional Budget Office. Data as of November 12, 2024. Exhibit 1D) Source: Bloomberg. Data as of November 18, 2024.

[1] Average yield on 100 of the largest money-market funds tracked by Crane Data. Annualized 7-day current yield as of November 20, 2024

THOUGHT OF THE WEEK

The Black Friday Barometer

Emily Avioli, Vice President and Investment Strategist

Black Friday is just around the corner, marking the symbolic start to holiday shopping season. The closely watched year-end spending surge can serve as a barometer for the health of consumers, retailers and the broader economy. We see momentum heading into the kickoff.

Elevated net worth, a solid labor market, and a healthy pace of wage growth continue to enable consumer spending. In fact, most of the growth in Q3 GDP came from real consumer spending, which expanded at a torrid 3.7% pace. Strength was also underscored by the October retail sales report, which saw a greater-than-expected 0.4% month-over-month advance and a sharp upward revision to September data.

Meanwhile, consumer attitudes are increasingly upbeat amid expectations for lower rates and inflation. The University of Michigan Consumer Sentiment reading recently hit the highest level since April, and Conference Board Consumer Confidence jumped by the most since 2021 last month (Exhibit 2A).

Against this backdrop, the National Retail Federation estimates record holiday spending between $979.5 billion and $989.0 billion in 2024. Respondents to the BofA Global Research holiday survey said they were planning to spend an average of $2,100 outside of typical obligations and necessities this holiday season, up 7.0% from last year.

This could portend a very merry holiday sales season indeed. However, there are caveats. While nominal holiday spending is on the rise, consumer's dollars are stretched, as years of rising price levels have reduced purchasing power. Fifty-nine percent of respondents to the holiday survey said they are planning to trade down this year, echoing recent guidance from bellwether retailers. Lower-income consumers, who tend to allocate a greater share of their funds to essentials, are seemingly more pinched for gift spending (Exhibit 2B).

Fewer shopping days this season could also be a drag, with just 26 days between Thanksgiving and Christmas. This could drive more online purchases, which are already estimated to represent over 30% of total holiday sales amid an ongoing channel shift as consumers seek value wherever they can find it.

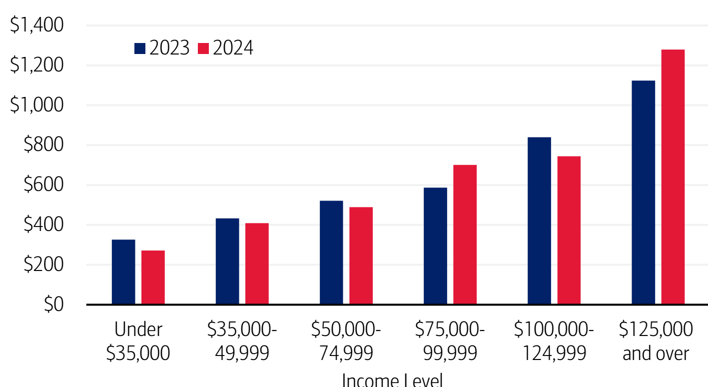
Even considering these headwinds, consumers seem well positioned to spend. This may bode well for retailers, as the holiday spending season alone accounts for 19% of their annual revenue on average,[2] and the U.S. economy, as consumer spending famously accounts for two-thirds of GDP. We are cautiously optimistic heading into the season of sales, but developments will bear watching.

Portfolio Considerations

Overall, consumers seem to have momentum heading into the holiday season. With a solid job market, lower interest rates on the horizon, and a better-than-expected economic backdrop, we are slightly overweight the Consumer Discretionary sector.

Exhibit 2: Consumer Moods Are Increasingly Jolly Heading Into Holiday Spending Season.

2A) Expected Holiday Season Spending by Income Level.



2B) Measures of Consumer Sentiment Have Rebounded.

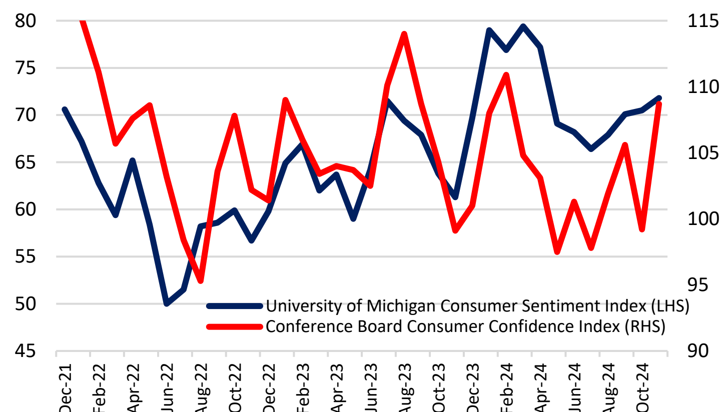


Exhibit 2A) Source: The Conference Board Holiday Spending Survey. Data as of November 20, 2024. Exhibit 2B) Source: Bloomberg. Data as of November 19, 2024.

[2] National Retail Federation. November 2024.

Equities

	Total Return in USD (%)			
	Current	WTD	MTD	YTD
DJIA	44,296.51	2.0	6.2	19.5
NASDAQ	19,003.65	1.8	5.1	27.4
S&P 500	5,969.34	1.7	4.7	26.7
S&P 400 Mid Cap	3,341.77	4.2	8.0	21.7
Russell 2000	2,406.67	4.5	9.7	20.1
MSCI World	3,765.96	1.5	3.4	20.4
MSCI EAFE	2,274.28	0.0	-2.4	4.3
MSCI Emerging Markets	1,087.27	0.2	-2.8	8.5

Fixed Income†

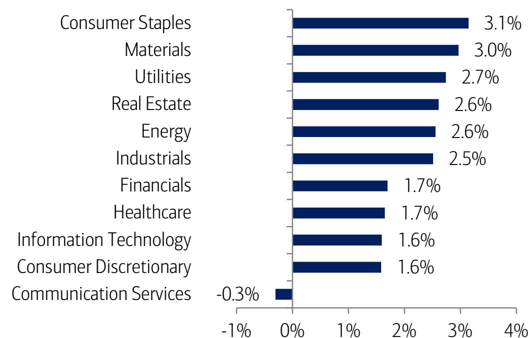
	Total Return in USD (%)			
	Current	WTD	MTD	YTD
Corporate & Government	4.73	0.12	-0.46	1.43
Agencies	4.62	0.09	-0.14	2.91
Municipals	3.56	0.24	0.88	1.69
U.S. Investment Grade Credit	4.84	0.19	-0.33	1.52
International	5.25	0.14	-0.24	2.52
High Yield	7.24	0.28	0.71	8.18
90 Day Yield	4.54	4.49	4.54	5.33
2 Year Yield	4.37	4.30	4.17	4.25
10 Year Yield	4.40	4.44	4.28	3.88
30 Year Yield	4.59	4.62	4.48	4.03

Commodities & Currencies

	Total Return in USD (%)			
Commodities	Current	WTD	MTD	YTD
Bloomberg Commodity	238.01	3.1	1.2	5.1
WTI Crude $/Barrel††	71.24	6.3	2.9	-0.6
Gold Spot $/Ounce††	2716.19	6.0	-1.0	31.7

	Total Return in USD (%)			
Currencies	Current	Prior Week End	Prior Month End	2022 Year End
EUR/USD	1.04	1.05	1.09	1.10
USD/JPY	154.78	154.30	152.03	141.04
USD/CNH	7.26	7.24	7.12	7.13

S&P Sector Returns



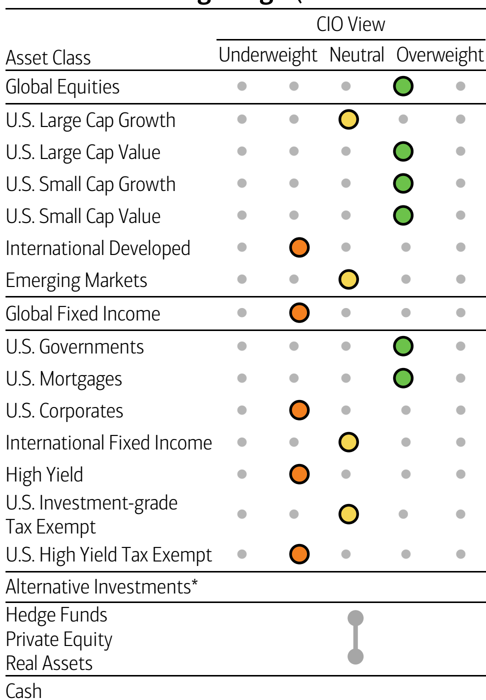
Sources: Bloomberg, Factset. Total Returns from the period of 11/18/2024 to 11/22/2024. †Bloomberg Barclays Indices. ††Spot price returns. All data as of the 11/22/2024 close. Data would differ if a different time period was displayed. Short-term performance shown to illustrate more recent trend. **Past performance is no guarantee of future results.**

Economic Forecasts (as of 11/22/2024)

	2024E	Q1 2024A	Q2 2024A	Q3 2024A	Q4 2024E	2025E
Real global GDP (% y/y annualized)	3.1	-	-	-	-	3.2
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

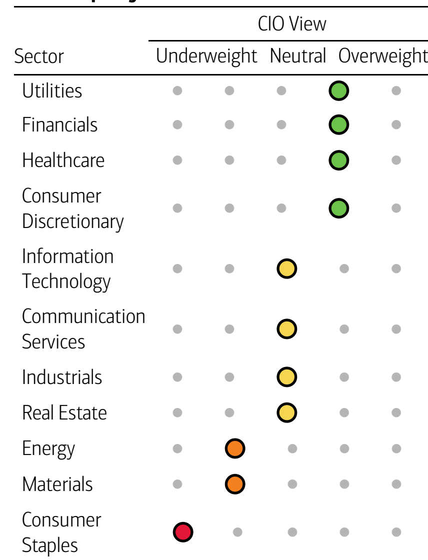
The forecasts in the table above are the base line view from BofA Global Research. The Global Wealth & Investment Management (GWIM) Investment Strategy Committee (ISC) may make adjustments to this view over the course of the year and can express upside/downside to these forecasts. Historical data is 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 22, 2024. **As of November 15, 2024.

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



Asset Class	Underweight		Neutral	Overweight	
Global Equities				●	
U.S. Large Cap Growth			●		
U.S. Large Cap Value				●	
U.S. Small Cap Growth				●	
U.S. Small Cap Value				●	
International Developed		●			
Emerging Markets			●		
Global Fixed Income		●			
U.S. Governments				●	
U.S. Mortgages				●	
U.S. Corporates		●			
International Fixed Income			●		
High Yield		●			
U.S. Investment-grade Tax Exempt			●		
U.S. High Yield Tax Exempt		●			
Alternative Investments*					
Hedge Funds			●		
Private Equity			●		
Real Assets			●		
Cash					

CIO Equity Sector Views



Sector	Underweight		Neutral	Overweight	
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.

Citi Economic Surprise Index is a widely followed index that measures how actual economic data compares to consensus analyst expectations and calculated by adding up the differences between the actual values of various economic data and their consensus forecast.

National Federation of Independent Business (NFIB) optimism index is a monthly report that measures the sentiment of small business owners in the United States.

University of Michigan Consumer Sentiment Index is a monthly survey that measures consumer confidence in the US economy.

Conference Board Consumer Confidence Index is an economic indicator that measures how confident consumers are about the economy and their financial situation.

Important Disclosures

Investing involves risk, including the possible loss of principal. Past performance is no guarantee of future results.

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