BANK OF AMERICA

CHIEF INVESTMENT OFFICE

Investment Strategy Overview

The Lighthouse and What Lies Ahead

July 2020

First and foremost, it's important for investors to have a plan, to think about goals and objectives, and to build a portfolio that is consistently good, not occasionally great. That should provide the potential for better and more effective compounded returns over time.

Christopher Hyzy
Chief Investment Officer

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Recently, you referred to the concept of the Lighthouse. What do you mean by the Lighthouse and how does it apply to the Chief Investment Office (CIO) team's midyear outlook?

Hyzy: The Lighthouse is our way of describing what we think we are likely to experience for the second half of the year and well into 2022–or what we are calling the New Frontier. We think the Lighthouse is important because it can provide insights for investors in the short and longer term. For example, it might light the way to the next business cycle or to accelerating business themes, such as innovations in healthcare. It might illuminate what the next economic recovery could look like and what's driving that recovery. At the same time, the Lighthouse can help us identify warning signals (storms), related to potential issues and concerns that may continue to overhang the market, and indeed life itself, especially when it comes to the effects of the virus.

In terms of the Lighthouse and the midyear outlook, we believe it's helped us understand that many investors seem more focused on what has already happened during the pandemic, and less focused on possible changes for the better that might lie ahead. What's already happened includes the significant increase in debt rates and the government deficit. It includes the earnings that have been lost so far in 2020 and what's happened on the geopolitical scene. There's also considerable concern about the potential changes to future regulation and taxes. Of course, it makes sense to be concerned about all of that. But we believe investors might benefit more from paying closer attention to possible changes for the better that have come out of or been accelerated by the crisis. Let me list some of those changes for the better:

1. Technological advances.
2. Research and development.
3. Business model resiliency, particularly in the U.S. corporate sector.
4. The changes that the government sector is going to have to go through to become more fiscally prudent, over the next 10 years.
5. Advancements in life sciences.
6. The development of new infrastructure and eventual fast-tracking that relates to the growing need for it.
7. The advancement of environmental, social and governance issues for the sustainability of the future of the economy, the corporate sector and communities.

You've also mentioned something you call the Workout Process. Briefly describe the workout process and its phases. Also where are we now in the process?

Hyzy: A workout process typically entails multiple phases and begins after very difficult times like a recession, a structural change in an economy, a big drawdown or selloff in the market, or a global demographic adjustment, such as the rise of the millennials. It can be almost anything that relies on government support and the broader economy working together, to help the private and public sectors.

The workout process this time around began after three major crises hit almost simultaneously: the human health crisis that resulted from the pandemic, the financial crisis and the economic crisis. Typically, the beginning of a workout process is where elements of support are put in place, some by legislation, some by the financial markets, and others by changes in the private sector. Here's what's shaped the phases of today's workout process.

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First Phase: The first phase of the current workout process was the liquidity phase, which began in March, when the Federal Reserve (Fed) acted to create liquidity in the markets. The speed with which the Fed acted was unprecedented, and their actions were greater than anything we've seen in our lifetime. That allowed financial markets to increase liquidity and stabilize themselves, starting with the fixed income market.

Second Phase: The second phase of the workout began when the government acted to reduce the loss of income, initiating the Paycheck Protection Program—a component of Coronavirus Aid, Relief, and Economic Security Act ("CARES Act"),—for example, as a way to support small businesses in continuing to pay employees. The government also sent checks directly to many of those who were unemployed during the pandemic. This helped to reduce the loss of income in households, increased small business lending and, overall, helped support the economy. We called it the Bridge phase or the Buffer.

Interestingly, it seemed to us that the markets thought that the Bridge phase would take many months, lasting possibly through the end of the year; however, the Bridge phase began to shorten as soon as economies started to reopen. Basically, many restrictions were put in place during the shutdown, but as soon as they started to reopen economies, the Bridge period began to shorten. That's basically what's happening right now.

Third Phase: We are just transitioning into the third phase of the workout, the Economic Recovery phase, which itself has multiple phases. Now, there's great debate around what kind of shape the recovery's going to take, when it's plotted on a graph. And that's often expressed in terms of letters of the alphabet. For example, initially, a recovery might look like a "V". Indeed, there are many V-shaped recoveries happening in the U.S. and globally: in the consumer sector, in the manufacturing sector, in housing. At the same time, some experts argue that "V"s often turn into "W"s. Some industries have even had L-shaped rather than V-shaped recoveries.

In the case of this recovery, we think it won't look like a letter at all but rather like a wave. It might start out as a "V" but is likely to develop into a wave, as the workout process continues and as we gather more information on the virus, such as treatment options, more widespread virus and antibody testing, the development of a vaccine, and so forth. As this information filters into consumer and business confidence, we think it will help dictate the overall shape of the recovery.

Fourth and Fifth Phases: The fourth and fifth phases are typically more about post recovery, or the start of a new cycle. What might they look like? The fourth phase is usually a pent-up demand cycle, which we think will come in 2021. And we expect Phase Five—what we are also calling the New Frontier—to start in 2022 and continue for some time thereafter. It's a bit early in the recovery to be more specific. That said, we believe the New Frontier will also bring with it a New Normal, so to speak, in how businesses operate—and, frankly, how people operate.

How do you see industries changing post-pandemic?

Hyzy: We think we will see the introduction and development of new industry groups that in a way will have been created out of their growing importance during the pandemic. They include the cloud, data storage, big data analytics in general, cybersecurity, life sciences, laboratory tools and equipment, and research and development within healthcare. We also see the need for a new infrastructure as public transportation gets used less and less and people turn to other more flexible means of transportation. Also, with people spending more time working, communicating, gaming, and learning online, we think there'll be significant growth in broadband and the 5G wireless spectrum and streaming.

Finally, we anticipate an increase in industry consolidation within old overbuilt industry groups such as retailing and segments of oil and gas; in short, we think they will "consolidate" their way to a new lifecycle. We also think air travel will see some major shifts, with airlines focusing more on consumer travel and less on business travel.

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Returning to our analogy of the Lighthouse, you could say that currently the sky is overcast. But as we move further into the recovery, we think the cloud cover will dissipate and the Lighthouse beam will highlight the areas we've been discussing that seem to have attracted more attention during the pandemic, as well as other areas of growing importance, including climate change, the acceleration of the new technologies already mentioned. With the acceleration of new technologies and business models we believe there is scope for positive adjustments to operating leverage across the private sector in the years ahead.

You recently described the market path as having the shape of a square root symbol. Can you take us through that line of thinking?

Hyzy: When market trends are plotted on a graph, they rarely follow any one particular letter. A recovery can move through a variety of shapes because new information comes to us each day. The market is a discounting mechanism, so how it's behaving is going to be at least six to 18 months ahead of what the economy is showing. And the market tends to look at leading indicators for clues as to the production of profit and, ultimately, much of what I described earlier, in terms of the workout process. The market does need help from time to time, and the form of help this time around was record levels of stimulus and liquidity. Therefore, we felt that the market could look more like a square root symbol. As with the symbol, we think the market, after the short expansion to record highs to start the year, then the sharp record plunge in prices, created the left side of the square root. Once liquidity and stability were created the market rebounded in a V-like fashion to create the initial middle of the square root. Now we are in a consolidation zone with a short jagged trajectory at the start before we eventually finalize the sign by having a trend line that extends itself in a narrow but positive angle upward to create the last section of the square root. This is just our view of the shape of the market's path but certainly this does not materialize without bouts of volatility.

This is largely because of the record stimulus that was put in place, and because the workout process is advancing faster than most observers expected, and because of the corporate sector's ability to shift, adjust and maintain operating leverage as it moves into a new expansion.

So, keeping with the square root analogy, we are about half-way through the symbol. We now believe we are once again in a long-term bull market advance. The next few stages of this climb will be a "grind"—they won't be easy—because the wall of worry among investors remains so high. In our Lighthouse analogy, we still have some storm clouds out there, and they're limiting our ability to see perfectly; but we believe the major storms that the Lighthouse gave us the warning signals about, so to speak, are mostly over, in our estimation. There are still clouds, but ultimately there are clearer skies ahead.

Why do you think we are already in a global expansion cycle and the early stages of another bull market advance?

Hyzy: This is a critical question for both the short- and the long-term investor. A global expansion needs to include not just the U.S., it also needs to include other economic zones. And we've seen that happening in Europe and Japan, in parts of the emerging markets (EMs), and in North America, dominated by the U.S.

The Fed has recently made some major changes. They had been fighting disinflation, and in some cases deflation, particularly since the global financial crisis some 12 years ago and, more specifically, in 2015-2016 and 2018. The Fed recently made a major pivot, due initially to the pandemic, and now with the understanding that the greatest concern has switched from producing inflation to actually stopping deflation. Increasing the money supply and subscribing to the "whatever it takes" plan is what they have committed to in order to create an environment that helps foster higher nominal gross domestic product (GDP) and potentially higher revenue growth.

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The European Central Bank (ECB) has done something similar, as has the Bank of Japan (BoJ), and at times so has the central bank of China. On the fiscal side, in the U.S., there was the stimulus package with the potential for another fiscal package being announced by the end of July. There was the so-called Game Changer in Europe, or their pivot, which surprised many: outlining a potential future fiscal stimulus framework rather than imposing austerity, as they have done traditionally in years past.

Meanwhile, the inverted yield curve, pre-pandemic, was telling us that deflation was an issue, even though the Fed transitioned back to an easing bias. And now the yield curve has steepened; it is upward sloping and not inverted. That is suggesting that in the years ahead, we could see an expansion.

The dollar was strengthening over much of the past few years and it choked off growth. When central bank activity got too tight, that, combined with the strong dollar, drove equities down, hurting the wealth effect. Ultimately, the authorities had to pivot.

Now, though, it is the opposite. The dollar has stopped strengthening and is on a weaker path, the yield curve has steepened, and there's stimulus and liquidity. This is leading to reflation—and reflation typically leads to higher asset prices, particularly when you go through a global expansion. And that's where we are right now.

Another interesting sign is that while among investors the "wall of worry" remains high, and the list of concerns continues to grow, even so, some positive headlines (outside of the virus) are surprising the overall market and the economy. And that should strengthen investor confidence, if those positive developments come through.

We believe profits have the potential to surprise the broader investor consensus next year, both globally and in the U.S. But again, this does not come without risk or issues or concerns. And certainly the Lighthouse isn't spotlighting any green lights at this point. But we think that over the coming months, and well into 2021, clearer skies are ahead.

Three other important items. We were in a technological advancement cycle, prior to the pandemic. It was designed very efficiently, in our opinion, but it targeted social enterprise with limited or narrow exposure to hardware systems. The next part of the tech advancement cycle will, we think, match many of the greatest advancements in history, because of its relative importance to the overall economy, the private sector, the government sector, and communities. That next wave is likely to be less narrow, more widespread across multiple industries, and ultimately it should feed into another productivity cycle and investment cycle, starting in 2022 and onward, the likes of which we haven't seen in recent times.

This gets to the heart of our enthusiasm for a long-term bull market because it comes at a time when the largest generational cohort, the millennials, will be growing older and entering their highest-spending years. You get good consumer spending, you get advancements in healthcare and in technology, across most industries. And when all of that is combined with what is likely to be a new housing cycle, we believe that the surprise of the next 10 years is higher growth and not lower growth.

Last but not least, let's talk about the Scarcity Principle. This was going on pre-pandemic, and is likely to continue even more intensely in the post-coronavirus (COVID-19) world. In short, that is when there are fewer investments available over a certain time, and there is more money to invest in that same period. And as supply goes down and demand goes up, especially with rates so low, the Scarcity Principle hits at the heart of equities, in our view.

There are likely to be more industry consolidations, more bankruptcies, more leveraged buyouts, and more companies going from public to private than coming public, and still less residential real estate available. With fewer assets and more money available, that's the sort of supply-demand equation that the Lighthouse is more than likely to shine a bright light on.

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What new risks do you see developing that could pressure the capital markets through year end? Over the next few years?

Hyzy: Throughout the second half of 2020, with equity markets[1] moving up to about 8%, 10% off market highs in February, with fixed income markets having been more or less re-liquefied, and with credit spreads having come down, we are now in what might be called a "What have you done for me lately?" type of phase.

But the number-one issue for the rest of the year, in our estimation, is new virus outbreaks. Are they manageable or not? Does the virus data suggest that we're heading backwards, with a higher rather than a lower hospitalization rate? What will happen to the fatality rate? Will old restrictions be put back in place or new ones established? Will there be another lockdown? How about the corollary effects of demand shortfalls such as energy capital expenditures, rental payments, and state and local government jobs? Can another fiscal stimulus package address most of these issues and keep disposable income high enough until an effective vaccine is produced? And, of course, one last major question for us is: What does all of that do to the economy overall and, in particular, to the outlook for consumer spending trends? Even though we are experiencing solid V-recoveries at this point, the back half is still unclear. All of that said, we are looking through the clouds and we believe that ultimately, a combination of science (testing, research, and treatment) and technology (data analysis and tracking) should get us through to the other side. There are, however, some important elements that we'll need to see:

- One: Testing, treatment, and the prospect for a vaccination.
- Two: Will there be major policy and/regulatory changes coming out of the November elections? Will investors head to the sidelines over concerns of the potential for higher taxes in the future?
- Three: Overall, how is the profit cycle beginning to show itself? By the fourth quarter we will need to see the elements of a rising profit cycle, to provide momentum heading into 2021.
- Four: As we get to 2021, assuming high savings rates and solid balance sheets in the consumer sector, we will need to see signs that the consumer is not just spending a lot more than during the height of the pandemic, but is starting to spend money on areas that were most harmed: travel, leisure and entertainment. If they do spend more there, that show of consumer confidence should help feed into business confidence and then into a resumption of job growth.

Over the next few years, some of the biggest risks might be the ones that may've gotten pushed aside due to the pandemic. First is the relationship between the U.S. and China. If tensions continue to rise, might we see the development of true dual supply chains? Is it a manageable relationship? Second is the debt and the deficit and how we pay for them.

What's one final insight you'd like to offer about the remainder of the year and into the next two years, as we move through the workout process?

Hyzy: First and foremost, it's important for investors to have a plan, to think about goals and objectives, and to build a portfolio that is consistently good, not occasionally great. That should provide the potential for better and more effective compounded returns over time. It should allow them to build a more diversified portfolio and to potentially stay away from large drawdowns like the ones that occurred, at a record pace, throughout March. In short, be disciplined with that plan. Rebalance more frequently. Take advantage of volatility in the capital markets.

Traditionally, bull market advances include skeptical moves that have intermittent pullbacks, with some that are sharp and quick, and often more frequent. Rarely do the

[1] As measured by S&P 500 performance

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beginnings of bull markets have a slow trickle up and down. That is emblematic of a market that treads water with little catalysts and an investing public that is complacent or already bullish. If we think longer-term we worry less about year-to-year targets and whether headline risk pressures the broader equity markets from one week to the next. We believe that what is more important is why you are investing and the ability to fund future objectives past the calendar year end.

There is a large wall of worry still in place, at the moment, for obvious reasons. Bull markets tend to climb on large walls of worry. What does that mean? At some point, when skepticism is at its highest level and investor positioning most bearish, positive surprises tend to happen and begin to foster an advance in the markets. At that point, the long-term investor usually begins to deploy capital, and that increase in capital starts to have an effect—and ultimately a bull market forms, in our opinion. We believe we are in the early days of this shift. It will not be without volatility: We still expect choppiness through the remainder of this year. But over the next five years, by our reckoning, a number of factors—technological advances, record stimulus and liquidity, the reflationary tactics of the authorities, as well as the resiliency in the private sector, and ultimately, the creation of new industries—will build and foster the next long-term bull market advance.

In the immediate future, we would be buyers on weakness within equities, with a focus on the U.S. That said, on our watch list for improvement are some of the more cyclical areas outside the U.S. that have not participated much in recent years (particularly relative to the U.S, such as Europe and Japan). We would also pay attention to what we think will be the pent-up demand of the emerging markets consumer and the build-out of healthcare systems in the emerging markets.

We continue to believe that the production of free cash flow in the sectors of healthcare, technology and communications services will be very important, and should help support the next market advance. We would also diversify portfolios with some more cyclical sectors that should benefit from an expansion such as the Industrials. Overall, given the attractiveness of equities relative to fixed income, we would maintain a large equity overweight and use excess cash during periods of weakness in an effort to re-risk portfolios and bring them back to the stated objectives in terms of goals.

MACRO OVERVIEW

Every recession has similarities and differences with previous downturns. That's an example of why it is said that history rhymes, rather than repeats. In many respects, the patterns that are typical as recessions end and new expansions begin are playing out just as they have in the past. In other respects, the way society has responded to the pandemic reveals important insights into the future that are quite different from the past. Our outlook divides the discussion between what's similar to past cycles and what's special about this one that helps us see ahead.

A New Synchronized Global Expansion

First, the business cycle is playing out as it typically does. Economic data bottomed in mid-April and have begun to recover. Markets, including the credit and stock markets, have led the recovery, as they always do. Because of the well-defined source of the downturn, namely the lockdowns around the world aimed at flattening the pandemic curve, the timing of the onset and of the end of the recession were also well-defined. The damage, disruption, and ultimate fallout from the lockdowns could have easily caused a severe depression had policy not intervened to prevent disaster. However, given the policy response, it appears that the disaster scenario is off the table.

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In fact, fear of an unstoppable downward spiral has caused monetary and fiscal policy to respond in an unprecedentedly aggressive manner that has dramatically changed the economic landscape from what seemed likely before the pandemic. In the U.S., for example, fiscal spending fueled by the biggest deficits since World War II (WWII) combined with the most aggressive monetary expansion in U.S. history showed a political will to err on the side of over-spending as opposed to the relatively stingy policies that followed the Great Financial Crisis of 2008-2009. The failure to generate sufficient growth and inflation to hit central bank targets during the last expansion is prima facie evidence that policymakers were too timid not only in the U.S., but all around the developed world.

Having learned that lesson the hard way and given the threat that the lockdowns could cause an economic depression, policymakers have instead thrown caution to the wind. Economic and market variables are responding to that fact. It is not a coincidence that the U.S. equity market made its bear-market bottom in the third week of March, when the first "CARES Act" package, the biggest and fastest fiscal-spending initiative in the history of the United States, was signed into law. The strong recovery in market and economic leading indicators since the economy began to reopen shows that expectations are forming for a very strong and prolonged expansion.

Second, a key distinguishing feature of this new cycle is the speed with which it is unfolding: the fastest bear markets in stocks and the fastest and deepest economic plunge followed by the strongest and quickest equity bull market and economic recovery on record. In fact, the timing of the lockdowns pretty much fits the timing of the recession. As usual, the stock market fell in advance of the lockdowns and rose in anticipation of their ends and the promised fiscal spending. The speed and scope of the U.S. recovery are directly proportional to the speed and scope of the policy response. This is true all around the developed world, where the policy response has been similarly gargantuan to that of the U.S. The stimulus in place and the stimulus yet to come imply a period of stronger economic growth not only in the U.S. but all around the world for at least the next couple of years, in our opinion. That's the apparent message in the equity market.

A Different Future

While it's typical for pundits to look at the cycle low in profits when a recession is ending and conclude that the strong gains in equity markets reflect a disconnect between the fundamentals and stock-market valuations—this narrative was as common after the last three recessions as it is now—this misses the fact that the brighter future is enhancing the value of stocks now. What's more, the response to the pandemic implies a number of special forces driving the likely evolution of the global economy with significant implications for investors. In some sense, the pandemic has altered the course of history. In many respects, it has simply sped up trends that were already under way.

Europe

Since WWII, European unification has proceeded in fits and starts. Progress toward a more unified Europe was often the result of a necessary response to crisis. The Great Financial Crisis of 2008-2009 revealed the shortcomings of European institutions for addressing systemic crises. Various baby steps have helped the ECB, for example, gain the tools it needed to prevent a deflationary collapse and do "whatever it takes" to prevent a breakup of the euro. The need to create a "fiscal bazooka" to address the pandemic's fallout has precipitated a historic "Hamiltonian" moment for Europe. Germany has finally agreed to a European fiscal structure that mutualizes debt across the European Union (EU) member states. This allows Europe to match the power of U.S. fiscal spending and eliminates a major source of doubt about the viability of the euro. In addition, the ECB, which has borne the brunt for policy support in the absence of a centralized fiscal authority, has been freed to focus on monetary issues. It has recently revamped its negative interest-rate structure to allow banks to receive positive returns for lending while still paying negative rates to borrow.

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These important changes to European policy together with an outlook for a solid synchronized global expansion in 2021 and 2022 have caused European stocks to perform more in line with those of the U.S. since March after years of underperformance.[2]

Singularity

The pandemic has clearly accelerated a number of trends that were already under way, such as working from home and e-commerce. The growth of the economy is increasingly in the cloud where virtualization resides. Software is eating the world, and artificial intelligence is just increasingly sophisticated software. The momentum in the virtual world is always increasing, and the pandemic caused a step function higher in this already amazing trend. As such, it brings the future and its greater profits forward for the beneficiary companies. In short, it has made tech leaders more valuable. The accelerating momentum implied by the singularity means valuations are likely to keep surprising people to the upside going forward.

Given the current positive setup for cyclical stocks, however, a frequent question is whether it implies a rotation out of tech. In our view, both can do well in a synchronized global expansion with tech bringing the future to us faster and faster.

China

The pandemic has accelerated the forces causing the rest of the world to view China in a harsher light. China has chosen to develop its own global sphere of influence rather than abide by the standards that underlie the free world economy. As new technology creates the future, an iron curtain of separation is rapidly descending to divide these alternative worlds similar to what happened in the earlier Cold War. The existential conflict between communism and democracy did not end when the Union of Soviet Socialist Republics (USSR) broke apart. This accelerating separation is evident in the redirection of supply chains away from China to more trusted sources. It is driving the dialogue over 5G and Chinese influence. It is the major geopolitical issue markets will have to contend with in the years ahead.

EQUITIES

What conditions or catalysts could propel U.S. equity markets higher?

The S&P 500 has climbed nearly 36% since the market bottom on March 23, but in order to continue the advance higher we expect that broadening participation, complementary credit conditions, improving demand, and ultimately a recovery in earnings will play a crucial role. It appears that much of the low hanging fruit has been harvested, as reflected in the rapid reflation in equity valuations by some measures, after a historic decline following the onset of the pandemic.

Most of the macroeconomic data remains depressed, with most components of BofA Global Research's Global Wave Indicator still weak. However, there have been green shoots of enhanced activity and equities have clearly begun to look beyond the backward-looking data and have pivoted towards the future with some degree of optimism for growth expectations. To some extent, this is being reflected in the positive market performance of pockets more sensitive to recovery such as cyclicals, commodities, and value. The U.S. dollar has also weakened considerably. These trends may be interpreted as a sign of confidence in stabilization and global economic reacceleration. If current market leadership from technology, communication services, and growth can be further buttressed by strength from more economically-sensitive channels, then we expect the broader market should benefit.

The credit markets serve as an indicator for the health of the economy and risk appetite of investors, and as a catalyst for the direction of stocks. The cost of credit broadly reflects liquidity and solvency risk for companies, therefore tighter spreads would

[2] Source: Bloomberg. Data as of June 30, 2020, covering the period from March 23 – June 30, 2020. Index proxies for U.S. and European equity returns are the S&P 500 and the Euro Stoxx 50 Index, respectively.

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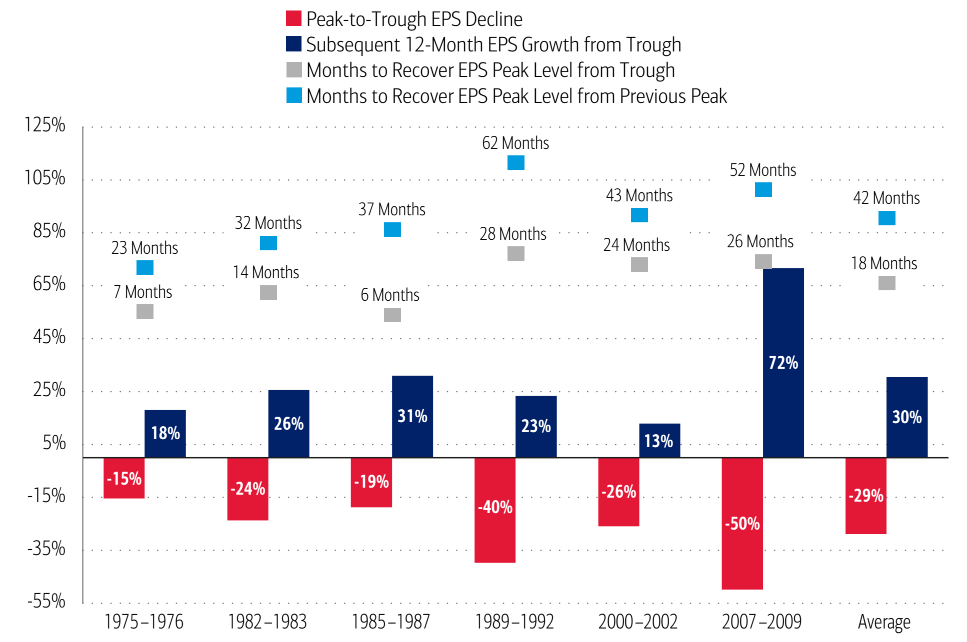
indicate that investors believe that business and market conditions are improving which should also bode well for equities. Furthermore, tighter spreads help lower the equity risk premium meaning that investors are requiring less compensation to take on risk, thereby supporting equity valuations. On a relative basis, lower yields elsewhere make equities more attractive, in our view.

To sustain a move higher in equities, there will need to be a follow-through of economic recovery. After an acceleration of regional economic reopenings, a surge in virus cases has forced some states to pause. The virus' path will ultimately decide the path for economic normalization and equities. Also, it's one thing to "open" the supply-side of the economy but another thing to have demand snap back. The personal savings rate in the U.S. had spiked to 33% in April, the highest level on record, according to the U.S. Bureau of Economic Analysis. Accommodative fiscal and monetary efforts to-date have helped to backstop financial markets, keep Main Street businesses solvent, support personal income, and keep workers employed but more assistance may be necessary. On aggregate, the total current stimulus commitment is approximately 44% of U.S. GDP, and the appeal for more to be done has been building with additional aid packages exceeding $1 trillion being proposed on Capitol Hill. More accommodative action from policymakers would be cheered by investors as an improving labor market or healthier consumer outlook would bode well for growth.

Ultimately, earnings will matter most. While investors can look past near-term uncertainty, the majority of intrinsic stock value is concentrated in future periods and the levels of those cash flows. Some of the output that has been lost through the pandemic may be recaptured going forward, and the outlook for earnings growth does appear to be improving. In June, the global earnings revision ratio turned higher with particular momentum in the U.S., representing a positive signal for equities. Historically after periods of deep earnings declines, a V-shaped recovery was seen in the subsequent 12-months, which recouped much of the lost profits (Exhibit 1). As it stands, we expect 2020 S&P 500 earnings of $115, or -29% year-over-year, but project earnings-per-share (EPS) growth of +25-35% in 2021.

Exhibit 1: Earnings Recovery: A Matter of When, Not If…

Periods of EPS Declines Exceeding 15% Since 1950



Note: Time periods on the x-axis refer to a respective peak-to-trough EPS decline, shaded in red, and the subsequent 12-month EPS growth, shaded in dark blue. Sources: Chief Investment Office; Bloomberg. Data as of June 2020. **Past performance is no guarantee of future results.**

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Finally, investor sentiment is slightly bearish on aggregate, and positioning remains conservative. The BofA Global Research Bull Bear Indicator sits at a bearish level, having moved off its zero-bound, and still signals a contrarian entry opportunity. Hedge Fund positioning is bearish, but less so versus May, retail sentiment is slightly negative and institutional cash levels still emit a contrarian bullish signal. There have been recent signs that risk appetite is beginning to pick up but overall there appears more runway for a rotation into equities.

Which areas should investors consider within global equities?

We believe that given elevated uncertainty investors should prioritize growth, quality, and yield exposure. Pockets of the market exhibiting these traits generally prospered prior to the coronavirus outbreak, fared relatively well during the period of heightened volatility, and appear to have emerged well positioned. On a regional basis, we prefer U.S. equities relative to the rest of the world, with large caps offering an appropriate mix of quality, growth, and yield. We prefer a balanced approach to both Growth and Value, and favor sectors that offer exposure to strong free cash flows and secular growth trends.

Stronger balance sheets on aggregate should help U.S. companies manage through periods of economic stress and volatility better than less capitalized regions. This is especially true of large caps, which broadly have a stronger credit profile than small caps and often have more stable sources of cash flow. The enormous fiscal and monetary policy response in the U.S. compared to Emerging Markets also helps to boost its relative attractiveness, as support for businesses and consumption are vital to ensuring economic health and earnings growth going forward. Some of these tailwinds have helped contribute a sharp recent rise in earnings revisions, with the U.S. one-month revisions ratio surging from 0.22 to 0.88 in June. U.S. large cap equities also enjoy a relative yield advantage over other assets including fixed income. Even without considering the growth prospects of equities, the S&P 500 dividend yield is nearly 70 basis points (bps) higher than the effective yield for the ICE BofA U.S. Broad Market Bond Index.

Within the U.S., we prefer the Technology, Communication Services, Healthcare, and Consumer Discretionary sectors in a balance of both Growth and Value. In recent years, Technology and Communication Services have been the source for many trends that have profoundly impacted consumers and businesses alike, and we continue to see each sector benefit from strong streams of cash flow and growth. In fact, the advancement and prevalence of technology may be amplified in the wake of the pandemic and we expect Healthcare to also benefit from these secular shifts, as it captures a share of spending on innovation, productivity, and health infrastructure. We expect Consumer Discretionary to benefit from a pickup in global consumption that should follow in the gradual path of re-openings and the pent-up demand phase of recovery. Ultimately, Industrials should benefit from an acceleration of global output and a new capital investment cycle.

Exhibit 2: U.S. equities provide an appropriate mix of quality, yield, and secular growth

3- Year Average (2017-2019)	Return on Equity (%)	Profit Margin (%)	Earnings Growth (Annual Average)	Dividend per Share Growth (Annual Average)	Dividend Yield (%)	Net Debt/ EBITDA*	Top 3 Sectors of Index Composition
U.S. Large Cap	13.4	8.6	10.9%	7.9%	1.9	1.9	Technology (26%) Healthcare (15%) Communication (11%)
Europe, Australasia, Far East (EAFE)	7.9	5.8	8.3%	6.0%	2.9	2.8	Financials (16%) Healthcare (15%) Industrials (15%)
Emerging Markets	9.9	7.8	4.5%	9.9%	2.7	2.1	Financials (20%) Technology (17%) Consumer Discretionary (16%)

*EBITDA is Earnings Before Interest, Taxes, Depreciation and Amortization. **Past performance is no guarantee of future results.** Sources: EPS and Dividend per share growth data are according to FactSet; all other data are according to Bloomberg. Indexes include the S&P 500, MSCI EAFE and MSCI Emerging Markets. ROE is Return on Common Equity. Data as of June 17, 2020. MSCI sector weightings as of June 2020.

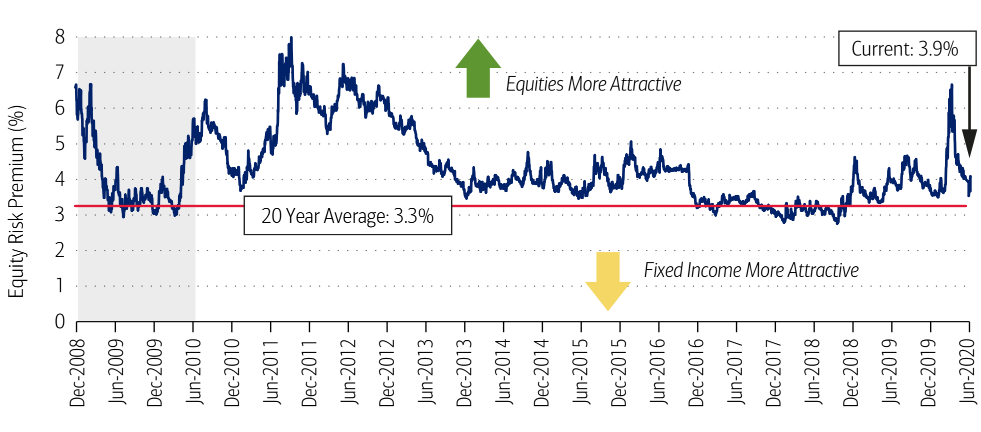
Given the historic rally off the bottom for the S&P 500, are valuations expensive?

Seeing that the S&P 500 index is currently trading at a 21x forward price-to-earnings (P/E) multiple, above the historical average of roughly 16x, some investors have been pointing to expensive equity valuations as reason for caution. In the near term, this is likely addressed by pullbacks within this consolidation stage and stabilization of earnings estimates as economic activity stirs back to life, and ultimately earnings potentially growing into price gains.

Investors should also note that structurally higher valuation multiples are more probable in a world of low rates and technological innovation. A gradual recovery in the consumer and services sectors should keep inflation and interest rates at low levels, often a tailwind for multiples. The Fed has also signaled interest rates may remain near zero bound for years to come, so valuation multiples could continue to hover in a higher range amid easier financial conditions, less uncertainty surrounding the path of rates, and as investors place a higher premium on quality, yield and growth. Finally, the S&P 500 index of today seems to be more exposed to secular industries, which arguably helps the market to see through near-term economic weakness. For example, the weight of secular growth sectors like Technology, Communication Services and Healthcare today is 50% of the index versus 30% in 2005.

We would also argue that traditional absolute valuation metrics like P/E may be less useful currently due to the uncertainty around corporate earnings and given that they do not take into account the level of interest rates in the economy. Instead, relative valuations measures such as the equity risk premium (ERP), which compares the earnings yield of equities (defined as the ratio of earnings-to-price, or the inverse of the P/E ratio) to a risk-free interest rate such as the 10-year U.S. Treasury yield may be more useful. Currently, the ERP for the S&P 500 is 3.9%, which represents the 77th percentile of its historical range and is above the long term average of 3.3%. The ERP peaked on March 23rd at 6.7%, touching 99th percentile. It's notable that since 1990, the S&P 500 has generated positive returns over every one and three year period after the ERP breached the 95th percentile. In our view, despite valuations seemingly elevated on an absolute basis, relative valuations remain favorable (Exhibit 3).

Exhibit 3: The equity risk premium currently remains attractive



Sources: Bloomberg; Chief Investment Office. Data as of June 15, 2020. Forward 12-month P/E depicted.

How could global reflation and economic acceleration impact international equities?

The prospect of global reflation and economic acceleration argues for a tide that lifts most boats. However, the landscape becomes more differentiated when observing other

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factors. For developed international markets, we remain slightly underweight but see some encouraging developments. Our underweight in Emerging Markets considers the potential for more intractable challenges ahead.

Facing the economic fallout of the coronavirus, Europe's response seems to be shifting away from austerity and towards greater policy coordination. Governments in Germany, France and Italy have authorized fiscal and liquidity stimulus, as well as state guarantees equating to roughly 20% or more of GDP, according to the International Monetary Fund. Under its multiple programs, the ECB has vowed to purchase up to €1.95 trillion in bonds in 2020-2021, enough to cover Eurozone government's anticipated deficits in the period, according to Gavekal Research. Most notable is Franco-German support for the European Commission's proposed €750 billion "Next Generation EU" recovery fund. By financing the package on behalf of the EU, the initiative marks a step towards debt mutualization and fiscal union, long seen as necessary steps for greater clarity on Europe's long-term prospects.

Nonetheless, we remain cognizant of continued uncertainty. Despite an urgent need, the recovery fund may run into significant opposition, particularly from Austria, Denmark, the Netherlands and Sweden, known collectively as the "Frugal Four." A significant second wave of the virus may stall the economic reopening process. With more policy support versus other European countries, the economic gap between Germany and the rest may widen, stressing relations within the bloc. Finally, an agreement on the future trade relationship between the United Kingdom and Europe remains pending.

In Japan, total financing assistance from the government and the Bank of Japan amounts to roughly ¥200 trillion ($1.9 trillion), equivalent to about 40% of GDP.[3] The size of the stimulus ranks among the world's largest, rivaling America's package of $2.3 trillion. Meanwhile, Japanese companies are in aggregate more cash rich compared to their position during the 2008 financial crisis. Together these developments lower near-term liquidity risk, despite the severe downturn in sales. As a leader in robotics, Japan would be better-positioned to benefit from a shift towards faster growth and reflation, in our view.

What is our view on emerging markets?

Despite some recent outperformance versus developed markets, we remain underweight on EM equities. Emerging markets lagged behind the U.S. market for much of the pre-coronavirus expansion, underperforming in seven out of 10 calendar years between 2010 and 2019. This stands in contrast with the pre-financial crisis expansion in which EM outperformed in every calendar year. As we now look ahead to the post-COVID-19 cycle (in which EM has once again trailed U.S. and global markets so far), two key questions will therefore be, first, what drove the underperformance of the last decade and, second, is this new cycle likely to look more like the pre-COVID-19 expansion when EM underperformed, or more like the pre-financial crisis expansion when EM consistently outperformed.

On a macro basis, three main headwinds in our view drove the EM underperformance of the past 10 years. Low commodity prices were a negative for resource exporters concentrated in Latin America and Europe, Middle East and Africa (EMEA). Weak global trade was a negative for exporters in Asia, with the trend of globalization to localization gaining momentum due to rising trade tensions, declining labor and tax arbitrage opportunities, and national security concerns. And zero interest rate policy was a negative for profitability within the banking sector, which is far more important for local credit creation in emerging markets than it is in the U.S., and which accounts for close to twice the equity market cap weighting in EM relative to developed markets. By contrast, in the pre-financial crisis cycle, commodity prices were elevated, trade was growing well above the rate of GDP and global interest rates were much higher, all of which helped EM to outperform.

[3] Source: Bank of Japan. Data as of June 2020.

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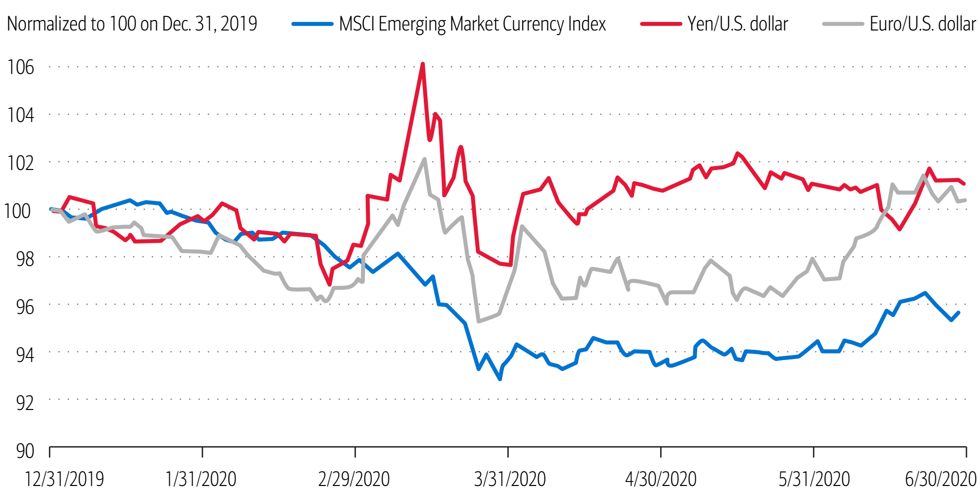
We expect the post-COVID-19 cycle to look more like the pre-virus cycle in these areas, and therefore maintain a tactical underweight in EM for now. Commodity prices are likely to remain low due to weak transportation demand and robust global supply in energy, as well as mature demand across metals and mining as China shifts further away from heavy industry and toward services and consumption. Trade growth should remain subdued on account of a likely acceleration of the trend toward more localized supply chains in the wake of COVID-19 and the ongoing frictions between the U.S. and China, a risk likely to increase as China, which comprises nearly 40% of the MSCI EM Index, redoubles efforts to boost domestic technological capacity. And global interest rates are expected to remain low for an even longer period as central banks seek to insure against deflation risk.

These longer-term trends may raise concerns over the sustainability of foreign currency debt taken on by EMs. According to the Institute of International Finance, this measure has more than doubled to $8.3 trillion, with U.S. dollar debt accounting for over 85% of this increase. Meanwhile, EM currencies have remained sluggish, despite improved equity market performance (Exhibit 4).

Exhibit 4: Emerging market currencies have lagged versus the U.S. dollar

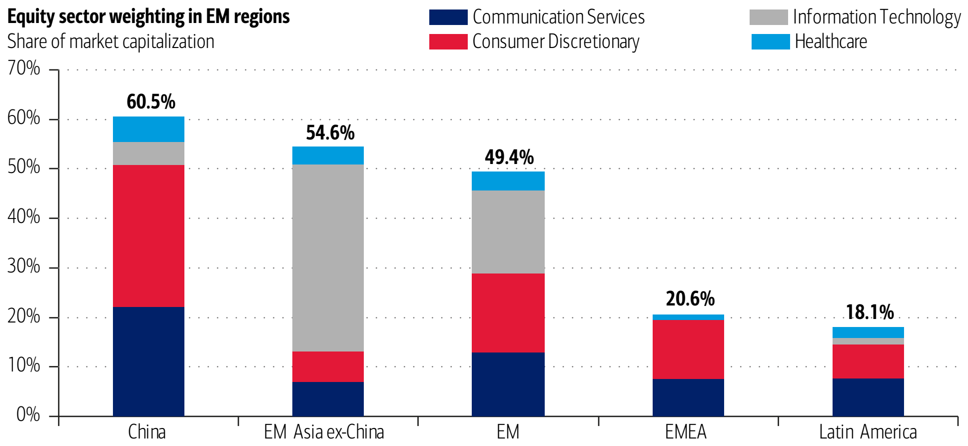


Sources: Chief Investment Office, Bloomberg; Year-to-date through June 16, 2020. **Past performance is no guarantee of future results.**

Beyond these concerns, we are particularly cautious on emerging markets outside China and north Asia, which have been behind in dealing with the underlying health crisis. Large economies such as India, Brazil and Russia now have some of the fastest growing COVID-19 case counts in the world. And lower-income markets in South Asia, Africa and Latin America could be at greater risk for a range of reasons including much weaker health systems, high levels of urban density, lower capacity for fiscal stimulus, vulnerability to dollar strength and lower rates of digitization.

China and other north Asian markets such as Korea and Taiwan should also be better-positioned compared to other emerging markets due to their sector composition. We remain most constructive on a sector basis toward areas of secular growth related to online activity, automation and health services, favoring Information Technology, Communication Services, Healthcare and Consumer Discretionary. Exposure to these sectors is fairly uneven across EM, with a high concentration in China (61%) and Asia ex-China (55%), most of which is in Korea and Taiwan, but with much lower weightings in EMEA (21%) and Latin America (18%) (Exhibit 5). This is likely to weigh further on EM returns relative to the rest of the world.

Exhibit 5: Emerging Market Equity Exposure to Favored Sectors



Source: MSCI. Data as of May 2020. Sector exposures based on MSCI country and regional indices.

FIXED INCOME

What are interest rates, the yield curve, and Treasury Inflation-Protected Securities (TIPS) signaling for post-COVID-19 markets?

While virtually every asset class including investment grade, high yield, preferreds and equities has seen a significant rebound towards pre-COVID-19 levels, the rates market has not. As of June 30, the 10-year Treasury is yielding 0.66%—only about 10 bps above its COVID-19 low, and more than 125 bps lower than its level to start the year. Inflation breakevens, moreover, are also skeptical that the recovery will allow the Fed to get back to its inflation target. Forecasts in the TIPS markets are currently for increases of about 1.35% for the Consumer Price Index (CPI) annually on average for the next 10 years, substantially below the Fed's target. This disconnect between risky assets and risk-free assets has some investors wondering whether risk assets have moved too far and if Treasury rates are predicting a more dour outcome for the economy.

While the outcome is not certain, we are not as pessimistic. Rates are low from the Fed Funds rate to the 10-year part of the yield curve for a good reason—the Fed has brought rates to zero, has signaled it will likely keep them there for years, and appears to have no need to worry about inflation near-term as they have failed to hit their 2% target for more than a decade running. By looking at a part of the curve where the Fed is having less direct intervention–long-dated Treasury bonds–we see a slightly different picture. The 10s/30s curve–the spread differential between 30-year and 10-year Treasury yields–has effectively almost doubled from its pre-COVID-19 level. It finished 2019 around the 40 bps level and is currently 75 bps. This is a highly accommodative level and close to peak levels seen after normal recessions (around 100 bps). This level of steepness is a good sign, in our view.

Clearly, however, we believe the absolute level of the 30-year Treasury is a real concern. At 1.40%, this is distressingly below the Fed's target. While there are a number of factors affecting rates that are out of the Fed's control (e.g., the global yield environment, demographics in the developed world), the main driver—inflation—is fundamentally in their control. With the threat of inflation being non-existent at this point, and millions of Americans out of work, the Fed has essentially been given a green light by the government and markets to do "whatever [they] can, for as long as it takes," as Powell recently put it, to get the economy operating closer to full potential, as soon as practicable. This is not a time for half-measures, and so far in terms of risk assets the Fed has proved decisive, proactive and aggressive. The Fed should likewise aggressively seize the opportunity with regards to the key part of its mandate: re-doubling its efforts to generate the desired level of inflation and restore its credibility with markets in our opinion.

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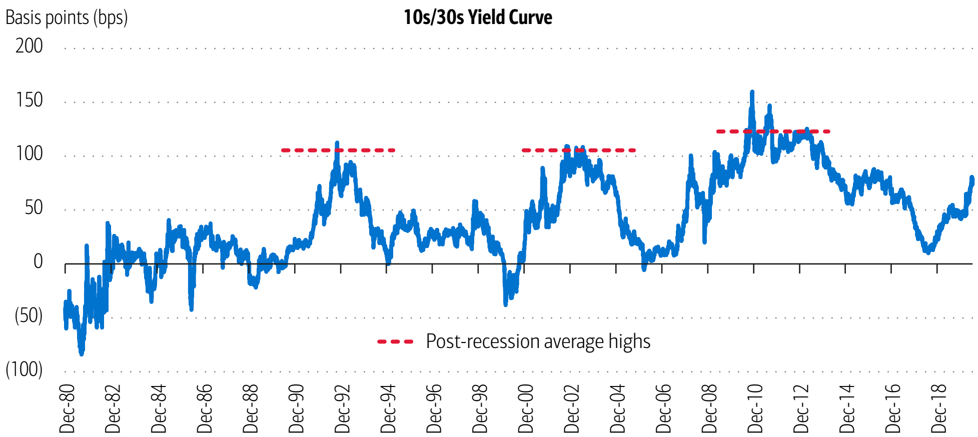
To the extent it does so, rates and inflation would move higher, and risk-free bonds should suffer price declines. Even so, Treasurys should remain a core part of diversified investors' portfolios as a hedge against equity exposure. One way to help insulate portfolios from the possibility of substantially higher inflation is to include TIPS in a measured way. While TIPS will likely decline in price if inflation and rates increase–TIPS are bonds first, and even inflation-linked bonds generally decline when rates rise–if inflation or inflation expectations rise substantially, TIPS should generally outperform regular Treasurys by declining less in price in relative terms, in our opinion. For investors with the risk tolerance and time horizon, replacing a portion of nominal Treasurys with TIPS may be appropriate.

Exhibit 6: The spread differential between 30-year and 10-year Treasury yields has effectively almost doubled from its pre-COVID-19 level



Sources: U.S. Treasury Department; Chief Investment Office. Data as of June 2020. **Past performance is no guarantee of future results.**

How much has fiscal and monetary stimulus helped the municipal recovery, and is more needed?

Fiscal and monetary stimulus targeted to states, local governments, and other municipal issuers were key to reversing a sharp decline in municipal bond prices.

In early March, state lockdowns, deferral of tax-filing deadlines, social distancing, and other reactions to COVID-19 threatened to cause significant declines in state and local tax collections, as well as revenues to a number of municipal revenue bond issuers, particularly in the transportation, education, and senior-living sectors. This caused many retail investors to sell their municipal bonds, mutual funds and exchange-traded funds (ETFs) into a market with few interested buyers, and the impact was profound.

From March 9-20:

- The Bloomberg Barclays Municipal Index declined 11.9%, and the High Yield Municipal Index declined 17.7%.
- 7-day Variable Rate Demand Note (VRDN) yields spiked from 1.28% to 5.20%, while 10-year muni yields rose 207 bps to 2.88%.
- 5-year and 10-year muni-to-Treasury yield ratios (typically under 100%), peaked at 650% and 365%, respectively.

Fortunately, the Fed and Congress took quick and powerful steps to put a floor under the municipal market. The Fed made high-quality short-term munis eligible for its Money Market Liquidity Facility (MLF), and announced the creation of a $500 billion MLF to buy newly-issued state and local government notes, while Congress provided over $300 billion to municipal issuers through the CARES Act. This monetary and fiscal stimulus had the desired effect of stabilizing the municipal market; from March 23 through June 5:

- the Muni and High Yield Muni Indexes rebounded 9.60% and 12.97%, respectively
- VRDN yields dropped to 0.11% and 10-year muni yields declined to 0.86%
- 5-year and 10-year muni-to-Treasury yield ratios normalized to 97.8% and 96.0%, respectively.

While the municipal market has stabilized, many states and local governments, as well as airports, transit authorities, senior-living facilities, and private colleges face significant revenue and budget pressures. We understand Congress is considering another stimulus package, expected to pass in late July. Providing significant additional funds to states and local governments should help to stabilize municipal credit and shore up confidence among retail investors.

Additional monetary support at this point is probably not as important. The Fed has already taken incremental steps to expand its MLF, but very few municipal issuers have used it so far, because market rates for most municipal issuers are now lower than the MLF's lending rates. The MLF seems to have had the desired effect of lowering borrowing costs for municipal issuers, including those for which market access would otherwise have been quite expensive.

Have corporate credit markets overshot fundamentals, and what is the outlook for corporate credit?

The investment grade and high yield credit markets have recouped the majority of COVID-19 spread widening—and some have questioned whether or not we have come too far too fast. In short, the answer to that question is nuanced. Credit spreads are generally between levels that would normally indicate recessionary conditions and a level that would suggest a more positive outlook. We term this range as 'no man's land' as spreads typically don't stay here very long—i.e. are either on their way tighter or wider. In our view, the market is at least partially looking through the fundamental impact of the COVID-19 pandemic. This is largely driven by the improvement in technicals, sentiment, and supportive Fed policies. Longer term, however, fundamentals and credit losses should be the ultimate drivers of spread performance and returns—this leaves us more favorable toward investment grade versus high yield, at this time.

To be clear, we believe that the deterioration in corporate credit fundamentals over the next several quarters is going to be material. Gross leverage in both the investment grade and high yield credit markets will peak at record levels in the second or third quarters as earnings and cash flow contract at the fastest pace since the financial crisis. The default cycle is going to accelerate and the risk of downgrades is nearly at an all-time high—with acute pain for the lower-rated and highly leveraged parts of the credit markets. Investment grade issuers should fare better but we continue to believe that fallen angel risk[4] is elevated, particularly for low BBB-rated cyclical issuers and/or companies that entered the most recent crisis with stretched balance sheets for their respective rating category.

Having said that, leverage and other key credit metrics should quickly revert back to more normal levels in the fourth quarter and into 2021 as earnings growth turns positive. Despite extremely negative hard data persisting over the next several quarters, we have a positive view on investment grade as liquidity is strong and issuers have ready access to capital markets thanks largely to the unprecedented actions announced by the Fed. Although we expect the Fed's programs to indirectly support the high yield market, we maintain our slightly negative view. This is largely driven by yields (about 6%) which

[4] A fallen angel is a bond that has been reduced to junk status because its issuer has fallen into financial trouble. Its bonds pay higher returns than investment-quality bonds but are riskier.

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we don't believe appropriately compensate investors for the expected pickup in default losses and the potential risks that a resurgence and upcoming election season pose for the lower-quality and more highly leveraged parts of the credit market.

MARKET STRATEGY

What are some of the indirect effects of the coronavirus that could play out over the longer term?

The shift in global supply chains is expected to accelerate in the post-coronavirus era. Re-shoring trends and the "localization" of supply chains were already in motion prior to the coronavirus, amid rising U.S.-China tensions and increased nationalism and populism. The China supply chain shock from coronavirus, coupled with increased medical and food trade protectionism, has further exposed the weaknesses in global supply chains. Indeed, 89 countries are reported to have introduced some export curbs on medical supplies, equipment or medicines this year.[5] As a result, we expect countries will rethink their reliance on interdependent global supply chains and opt to be more self-sufficient in producing certain goods and services. Various leaders around the world have highlighted the need to produce critical goods at home. In our opinion, key winners from this trend include technology leaders in artificial intelligence, 3D printing, and robotics.

Another beneficiary of the rethink of supply chains: global research and development (R&D) expenditures. We expect a renewed focus on R&D from central governments around the world as countries fortify their healthcare systems and seek self-sufficiency in developing and producing critical goods and components, and as the race for technological leadership in many key industries accelerates. Corporations should continue to drive R&D spending, and we expect a greater adoption of public-private partnerships coming out of the crisis. Top innovators that are able to maintain their R&D investments during the downturn have the potential to emerge from the crisis providing stronger returns for shareholders than the overall market.

Given these trends, we believe investors with long time horizons should consider allocations to disruptive innovators in sectors such as technology, healthcare, communication services and e-commerce consumer discretionary. As the technological rivalry between China and the U.S accelerates, we believe investment opportunities lie in both U.S. and Chinese tech leaders. A key risk on the U.S. side is the growing political scrutiny surrounding Big Tech, including more tech regulations, antitrust pressures, and the potential implementation of digital service taxes in some countries. We continue to monitor these developments.

Given the latest surge in government spending, what is your outlook for government debt and deficits?

The economic fallout from the coronavirus has led to a massive fiscal response from governments around the world. Globally, over $13 trillion in fiscal stimulus has been announced to date, amounting to roughly 15% of global GDP, which is already more than triple the fiscal stimulus during the entire financial crisis of 2008-09. In the U.S., authorized fiscal programs to date are estimated at $3.3 trillion (15% of GDP). On top of higher spending, a dramatic drop in demand has reduced revenue collections, further expanding the deficit. All totaled, the U.S deficit is expected to rise to $3.7 trillion (17.9% of GDP) for the fiscal year 2020, while government debt held by the public is likely to rise from 79% of GDP in 2019 to 101% in 2020 (up from estimates of 81% before the crisis). Thereafter, the growth in debt is forecast to moderate, rising to about 107% of GDP by 2025.[6]

[5] Source: University of Switzerland, St. Gallen Global Trade Alert. Data of June 12, 2020.

[6] Sources: 2020 forecasts are from the Congressional Budget Office, as of April 2020. The 2025 forecast is from the Committee for a Responsible Federal Budget, as of April 2020.

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In our view, the swift and aggressive fiscal response from Washington was necessary to prevent an even more severe, depression-like economic scenario, which would have left U.S. finances on an even less sustainable path. Low interest rates and an extremely weak demand environment provide a high payoff for expanding government debt.

The Fed has been the main buyer of the incremental U.S. debt, which has caused inflation worries among investors. An upside surprise in inflation is a key risk to the budget outlook, as it could cause the Fed to pull back from monetary accommodation and raise nominal interest rates, which would push up borrowing costs on the debt. However, as discussed above, we believe current U.S. policies in place effectively serve to stop deflation, and it would require significant money supply growth for a long period of time to get inflation up to 2%.[7] Market expectations for U.S. inflation deteriorated during the crisis, and are still far below pre-crisis levels.

That said, we continue to closely watch the trajectory of interest rates and inflation to assess the sustainability of U.S. finances. While it is encouraging that the U.S. can borrow at ultra-low rates today, the federal government eventually has to repay the debt, which would likely mean having to roll over debt at potentially higher rates in the future. However, demand for U.S. debt remains strong, given the dollar's role as the world's primary trade and reserve currency, which can help keep a lid on rates. By contrast, emerging market countries, which have also rapidly expanded government borrowing during the crisis, may face greater challenges in financing debt and controlling inflation than the U.S.

Do you expect recent dollar weakness to persist? What does that mean for risk assets?

Since its peak in mid-March, the Bloomberg Dollar Spot Index has weakened significantly and is now only slightly higher year-to-date. The dollar has looked less attractive on a relative basis for a number of reasons. For one, as the global economy reopens international growth is recovering. At the same time, the Fed has been more aggressive than many central banks in its reflationary efforts, and its own outlook is for rates to remain near zero for several years. Third, financial market risk appetites have recovered more broadly. These shorter-term factors coincided with a dollar that was significantly overvalued prior to the pandemic. We think the trend toward a weaker dollar is likely to persist over the medium term as the Fed keeps rates pegged near zero for the next few years, global growth recovers, and valuations normalize. This is a positive dynamic for global reflationary efforts and risk assets overall.

In the near term, there is the potential for bouts of dollar strength coinciding with broad risk-off sentiment, as dollar strength has followed negative pandemic news closely. This theme will also play out at the individual country level. In countries where the pandemic has faded, the ability to reopen raises growth expectations and supports currencies, and several countries have proven more successful at containing the coronavirus relative to the U.S. For example, Australia and New Zealand have maintained a steady suppression of the virus. This has supported their currencies versus the dollar. On the contrary, in several emerging markets (Brazil, for example), a more significant health crisis has weighed on growth expectations and the currency.

Medium-term factors also suggest a neutral to bearish view on the U.S. dollar. Prior to the coronavirus pandemic, the dollar had tailwinds from relatively favorable economic growth and interest rate differentials versus a number of major currencies, particularly the euro. The euro is the largest weight in the broad dollar indexes and fiscal stimulus via a fiscal union in Europe has both significantly reduced the risk of a euro breakup while also narrowing the relative growth differential with the U.S. Further, prior to the coronavirus pandemic, interest rate differentials (both current and expected) were being powered by the Fed raising rates while other major central banks like the European

[7] See CIO Capital Market Outlook, May 11, 2020, "Stopping Deflation."

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Central Bank and the Bank of Japan had rates pegged at zero. While the virus outbreak created a risk-off scenario that led to strong near-term demand for dollar liquidity, it also brought to a close this stark difference in the current and projected direction of monetary policies. In its most recent statement, the Fed has indicated rates will likely remain locked near zero through 2022.

Valuation, a longer-term mean-reversion factor in currency markets, points to further dollar weakness as the U.S. dollar remains overvalued versus most major currencies by a number of metrics, including purchasing power parity (PPP) using both consumer and producer prices. The normalized broad dollar real effective exchange rate index also suggests the dollar is expensive.

For investors, dollar weakness eases global financial conditions and aids in global reflation efforts. We view this as a positive dynamic for equities.

How do we see the U.S.-China frictions evolving over the rest of the year?

Trade tensions between the U.S. and China escalated throughout 2018 and 2019, and we expect a continuation and potential broadening of U.S.-China frictions over the remainder of this year and into 2021. At the center of the conflict remains China's emergence as an economic and technological power, as well as its rising investment and growing influence abroad, which puts it into close strategic competition with the U.S. This strategic rivalry is only likely to grow as China redoubles its efforts to boost domestic technological capacity in the wake of the crisis.

The conflict of the past two years, and the Phase One deal agreed to in late 2019, have mainly emphasized the bilateral trade relationship. But U.S. efforts to accelerate the shift of manufacturing operations away from China, to limit China's access to U.S. semiconductor technology and to block Chinese equipment from Western telecommunications networks have been driven by wider aims of intellectual property protection and data security. As a result, we would expect these technology-driven frictions to continue even as China looks to increase its purchases from U.S. exporters in an effort to reduce the trade deficit.

Though we expect continuing growth within the information technology sectors of both markets, further escalation over the months and quarters ahead could risk a slower build-out of next-generation telecommunications infrastructure in China, and could also risk loss of access to the large and fast-growing Chinese market for U.S. technology leaders.

On top of this, a growing concern over recent months has been the shift in focus of the U.S.-China tensions from trade to financial markets. U.S. regulators and lawmakers have proposed new rules that would tighten accounting and auditing requirements for Chinese firms, in addition to separate measures that would increase fundraising minimums for initial public offerings and block U.S. investment into the Chinese equity market. By themselves, these actions should have little impact on demand or returns for Chinese equities. But the trade tensions of the past two years contributed to equity underperformance in China and emerging markets more broadly. And a new phase of the U.S.-China conflict targeting capital markets would have the potential to be even more disruptive were it to escalate. U.S.-China frictions are also likely to intensify as the 2020 U.S. presidential election approaches. This will be a key risk to watch as we move into the second half of the year.

How could the U.S. presidential elections in November shape and impact the financial markets?

The 2020 U.S. presidential election will grow in importance for investors as we move deeper into the second half of the year, and as the Democratic and Republican party conventions take place in August. Progress on economic reopening, economic growth, earnings, monetary policy and fiscal policy should remain the biggest drivers of market direction, but headline risk tied to changes in polling and policy pronouncements by the two nominees should become a greater source of investor focus as the election approaches.

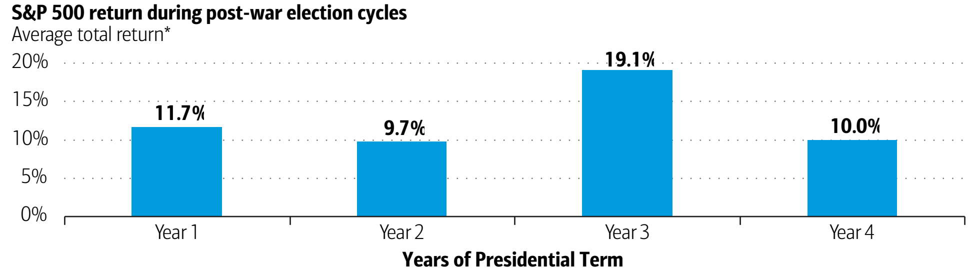
We would expect the election outcome to influence the economy and markets primarily through potential legislative changes and through potential shifts in fiscal policy. As a result, it will be most important to assess the policy priorities of the party nominees. Some of the key policy areas that could affect projections for the underlying economy and influence market direction include infrastructure investment, trade policy (particularly toward China), minimum wage legislation, immigration and changes to tax policy for households and corporations.

Meanwhile it will also be important to watch for sector-specific policies that could affect a range of individual sectors and industry groups. In our view, the segments most likely to be affected by new regulations and budget plans that have been under discussion by the two parties include healthcare, financials, energy, defense, telecommunications and information technology. And we will continue to assess the potential market impact of new policy proposals as they are developed in the run-up to November.

In addition to the presidential contest, we will also be watching for potential changes in the makeup of Congress. Divided government is typically considered the best configuration for market returns, as it leads investors to expect less interference from changes in economic policy and therefore a greater degree of business certainty. But support for this view has not been conclusive in practice. Indeed over the 18 presidential cycles since World War II, the lowest returns have in fact occurred under a divided government with returns averaging just 8.6% under a Republican president and Democratic Congress. The number of years spent under each combination has of course varied, but divided governments have not necessarily always produced the strongest returns. The clearer pattern from post-war electoral cycles is that the third year has been by far the strongest, followed by the first (Exhibit 7). Each individual cycle is different, and the coronavirus crisis has of course been the dominant market driver in the final year of this current cycle. But these historical patterns will nonetheless be worth keeping in mind as we move into the second half of 2020 and approach the start of the next four-year presidential cycle in 2021.

Exhibit 7: Market Returns and Historical Election Cycles

Government Configuration*		S&P 500 total return*		
President/House/Senate	Number of years	Average	Maximum	Minimum
D/D/D	22	14.8%	36.3%	-10.0%
R/R/R	6	18.6%	52.3%	-0.9%
D/R/R	10	15.9%	37.6%	-9.1%
D/R/D	4	16.1%	32.4%	2.1%
R/R/D	2	-17.0%	-11.9%	-22.1%
R/D/D	22	8.6%	43.1%	-37.0%
R/D/R	6	16.0%	31.7%	-4.9%



Sources: Bloomberg, House.gov, Senate.gov, Chief Investment Office. Data as of 2020. *For election cycles from 1945 to 2016.
Past performance is no guarantee of future results.

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 dollars.

The ICE BofA U.S. Broad Market Bond Index measures the performance of US dollar-denominated, investment grade debt securities, including US Treasury notes and bonds, quasi-government securities, corporate securities, residential and commercial mortgage-backed securities and asset-backed securities. Securities are cap-weighted based on their amount outstanding times the market price plus accrued interest.

The S&P 500 includes a representative sample of 500 leading companies in leading industries of the U.S. economy. Although the index focuses on the large-cap segment of the market, with approximately 75% coverage of U.S. equities, it is also a proxy for the total market.

The MSCI EAFE Index is a stock market index that is designed to measure the equity market performance of developed markets outside of the U.S. & Canada. The EAFE acronym stands for Europe, Australasia and Far East.

The MSCI Emerging Markets Index captures large and mid cap representation across 26 Emerging Markets (EM) countries. With 1,403 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country.

The Bloomberg Dollar Spot Index tracks the performance of a basket of 10 leading global currencies versus the U.S. Dollar. It has a dynamically updated composition and represents a diverse set of currencies that are important from trade and liquidity perspectives.

The Bloomberg Barclays U.S. Municipal Index is a broad-based benchmark that measures the investment grade, U.S. dollar-denominated, fixed tax exempt bond market. The index has four main sectors: state and local general obligation bonds, revenue bonds, insured bonds, and pre-refunded bonds.

The Bloomberg Barclays High Yield Municipal Index is a benchmark that covers the high yield portion of the USD-denominated long-term tax exempt bond market. The index has four main sectors: state and local general obligation bonds, revenue bonds, insured bonds, and pre-refunded bonds.

Glossary

Treasury Inflation-Protected Securities (TIPS): Treasury Inflation-Protected Securities, or TIPS, provide protection against inflation. The principal of a TIPS increases with inflation and decreases with deflation, as measured by the Consumer Price Index.

Consumer Price Index (CPI): The Consumer Price Index is a measure that examines the weighted average of prices of a basket of consumer goods and services, such as transportation, food, and medical care. It is calculated by taking price changes for each item in the predetermined basket of goods and averaging them. Changes in the CPI are used to assess price changes associated with the cost of living. The CPI is one of the most frequently used statistics for identifying periods of inflation or deflation.

Variable Rate Demand Note (VRDN): A variable-rate demand note is a long-term municipal bond which is offered to investors through money market funds. The notes allow a municipal government to borrow money for long periods of time while paying short-term interest rates to investors.

Municipal Liquidity Facility (MLF): The Municipal Liquidity Facility is an initiative by the Federal Reserve to provide up to $500 billion of credit to state and local governments that have seen their revenues collapse during the COVID-19 crisis.

Important Disclosures

Opinions and market data are current as of July 1, 2020 unless otherwise specified.

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All 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. Asset allocation, diversification and rebalancing do not ensure a profit or protect against loss in declining markets.

Investments have varying degrees of risk. Some of the risks involved with equity securities include the possibility that the value of the stocks may fluctuate in response to events specific to the companies or markets, as well as economic, political or social events in the U.S. or abroad. Small cap and mid cap companies pose special risks, including possible illiquidity and greater price volatility than funds consisting of larger, more established companies. Bonds are subject to interest rate, inflation and credit risks. Municipal securities can be significantly affected by political changes as well as uncertainties in the municipal market related to taxation, legislative changes, or the rights of municipal security holders. Income from investing in municipal bonds is generally exempt from Federal and state taxes for residents of the issuing state. While the interest income is tax-exempt, any capital gains distributed are taxable to the investor. Income for some investors may be subject to the Federal Alternative Minimum Tax. Investing in lower-grade debt securities ("junk" bonds) may be subject to greater market fluctuations and risk of loss of income and principal than securities in higher rated categories. Treasury bills are less volatile than longer-term fixed income securities and are guaranteed as to timely payment of principal and interest by the U.S. government. Mortgage-backed securities are subject to credit risk and the risk that the mortgages will be prepaid, so that portfolio management may be faced with replenishing the portfolio in a possibly disadvantageous interest rate environment. Investments in foreign securities (including ADRs) involve special risks, including foreign currency risk and the possibility of substantial volatility due to adverse political, economic or other developments. These risks are magnified for investments made in emerging markets. Investments in a certain industry or sector may pose additional risk due to lack of diversification and sector concentration. Investments in real estate securities can be subject to fluctuations in the value of the underlying properties, the effect of economic conditions on real estate values, changes in interest rates, and risk related to renting properties, such as rental defaults. There are special risks associated with an investment in commodities, including market price fluctuations, regulatory changes, interest rate changes, credit risk, economic changes and the impact of adverse political or financial factors.

Nonfinancial assets, such as closely-held businesses, real estate, oil, gas and mineral properties, and timber, farm and ranch land, are complex in nature and involve risks including total loss of value. Special risk considerations include natural events (for example, earthquakes or fires), complex tax considerations, and lack of liquidity. Nonfinancial assets are not suitable for all investors.