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Viewpoint

A New Summit: Six Reasons For Higher Highs

May 2019

IN BRIEF

Short term: The latest drop in equity markets on the back of trade deal concerns is a buying opportunity (with or without a full deal) in our view.

Long term: Global and U.S. demographics and market internals in terms of sentiment, valuation, rates and consumer fundamentals signal a long-term bull market building again.

- We believed that given the Federal Reserve's (Fed's) 180-degree switch from a tightening bias to an extended hold status on short-term rates, a flattish U.S. Dollar and narrow credit spreads that financial conditions would become more attractive and ultimately underpin higher economic growth and, therefore, a better-than-expected profit picture.
- Although there are still risks to be wary about (geopolitical haziness, Brexit and U.S.-China trade deal stubbornness), the growth outlook is improving, globally, in our view.

With first-quarter earnings announcement season just about over, the results have been better than expected. The S&P 500 companies that have reported so far have produced an approximate 4% earnings beat, which equates to a growth rate for Q1 about 2% versus the recent downwardly adjusted negative 2% to 3% growth expected by consensus analysts. Heading into this quarter, the largest concern was that U.S. corporate earnings were headed for a profits recession, which would pressure price-to-earnings (P/E) multiples and weigh on equity markets. We did not agree with this line of thinking.

We believed that given the Fed's 180-degree switch from a tightening bias to an extended hold status on short-term rates, a flattish U.S. Dollar and narrow credit spreads that financial conditions would become more attractive and ultimately underpin higher economic growth and, therefore, a better-than-expected profit picture. We think this is unfolding as we speak. Although there are still risks to be wary about (geopolitical haziness, Brexit and U.S.-China trade deal stubbornness), the growth outlook is improving, globally, in our view. We believe the late cycle phase ended when the Fed hiked in late December and stopped growth in its tracks even though inflation had not reached its 2% target rate.

CIO ASSET CLASS VIEWS:

The Global Wealth & Investment Management Investment Strategy Committee did not make any tactical asset allocation adjustments this month, but we reaffirm our positive view on equities and negative view on fixed income, and continue to emphasize higher quality across the board.

View the CIO Asset Allocation Guidelines ▶

Asset Class	CIO View				
	Under-weight		Neutral		Over-weight
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	•	•	●	•	•
High Yield	•	●	•	•	•
U.S. Investment Grade Tax Exempt	•	•	●	•	•
U.S. High Yield Tax Exempt	•	●	•	•	•
International Fixed Income	●	•	•	•	•
Alternative Investments*	see CIO Asset Class Views				
Hedge Funds					
Private Equity					
Real Assets					
Cash					

* Many products that pursue Alternative Investment strategies, specifically Private Equity and Hedge Funds, are available only to pre-qualified clients.

With a policy error avoided, we feel the U.S. business cycle is now back in early stages, which begins a fourth mini-wave in the post-credit crisis era. This is the primary reason for our optimism regarding the extension of the bull market cycle powering ahead and the bearish sentiment focusing on the lagging indicators being overly pessimistic.

There are six major reasons why we expect further new highs in the coming months and an attractive growth backdrop well into 2020:

1. We are beginning a new early stage (fourth mini-wave post-credit crisis) growth phase, which should extend the current cycle well into 2020.

2. The Fed is on hold for short-term rates for an extended period of time and appears willing to allow the economy to run above trend until inflation rises well above its long-run target of 2%.

3. China's economic growth is more stimulative than what most believe and is already beginning to take shape. This should help Europe (the largest trade partner with China) stabilize its economy and grow back closer to trend in the next year.

4. Overall financial conditions, which include low rates, low inflation, narrow credit spreads, healthy consumer, stable U.S. Dollar helps support business confidence and an improved backdrop in the emerging markets (EMs).

5. Investor sentiment is still very fragile. In aggregate, according to Affiliated Managers Group (AMG), equity mutual fund flows have been negative (fixed income fund flows are significantly positive) through the first four months of 2019 despite the 16% plus gain in prices for the S&P 500. In addition, when examining the price return since year-end 2017 (approximately a 16-month period) the market is only up around 8.5% given the negative volatility downdrafts experienced in 2018. We believe that given easier financial conditions, supportive equity buybacks, and the profit recession worry off the table that equity valuation could head higher as investors' comfort level improves with a clearer outlook.

6. The next solid catalyst to above-trend economic growth and still-stable inflation is productivity. We expect the collective efforts of automation, big data, artificial intelligence, cloud-based system infrastructure and advanced software cycles to drive a new productivity cycle in the years ahead, which should support corporate margins and balance out potentially higher competing wages. We are beginning to see these effects emerge as evidenced by the much better-than-expected Q1 2019 productivity report recently announced (3.6% versus 2.2% expected). We expect this trend to continue into 2020, which could keep the Fed on hold for longer while growth rises.

We continue to prefer equities relative to fixed income and favor the U.S. and EMs over other regions. We continue to prefer large caps relative to small caps as well. Growth and value opportunities continue to emerge in Technology, Financials, and Industrials, while segments of Consumer Discretionary are benefitting from consumer confidence and specific thematic growth trends.

We expect yields to drift higher through year-end and the curve to steepen slightly. Therefore, we continue to prefer shorter dated yields, investment-grade credit, but still see value in intermediate and long-term municipals for taxable investors.

Given the six major reasons, we believe that any equity market weakness represents an opportunity to add to allocations, particularly for investors who are either under-allocated or have missed the move back up from the lows in late December. For investors who are more opportunistic and have not drifted above their stated equity weights, we would use three separate periods between now and year-end (particularly in between earnings seasons) to raise equity allocations.

After a short period of consolidation in the markets, we expect to head toward a new summit and pierce the old highs.

As we progress through 2019, we look to our CIO Investor's Dashboard to monitor the key factors that should drive activity in the markets. Economic growth in the U.S. surprised to the upside in the first quarter of 2019, as a buildup in inventories and a narrower trade deficit helped to offset a slightly weaker slowdown in consumer spending, assuaging fears that a sharper slowdown in the economy was ahead. A strong labor market and low inflation should deliver a rebound in consumption over the near term, with gains in productivity continuing to support the U.S. expansion. This has helped to steepen the yield curve after it briefly inverted in March. Corporate profits have surprised to the upside given lowered expectations. A recalibration of earnings estimates upwards should support markets. A lack of inflationary pressures has kept the Fed on the sidelines so far in 2019 and suggests that a rate hike in 2019 is highly unlikely. We expect the Fed to stick to its "data dependency" approach, with its next move (rate hike or rate cut) to depend on the future path of inflation. A dovish posture by the Fed and corporate profitability should continue to support credit markets, where spreads remain around their 2019 lows. Against this backdrop, technical and sentiment indicators remain key items to watch, as equity volatility continues to trend lower and investor sentiment approaches more-neutral levels. An upcoming catalyst for equities could be a potential trade deal between the U.S. and China.

CIO Investor's Dashboard

Current readings on the key drivers of equities for investors to consider, with arrows representing the recent trend.

Factor	Implication for Equities (Negative – Neutral – Positive)	CIO View
1. Earnings		First-quarter earnings have come in better than expected thus far. The likelihood of an imminent earnings recession has diminished, and earnings revision ratios have begun to improve, led by the U.S.
2. Valuations		Valuations for the S&P 500 have become slightly less attractive, currently close to 16.6x forward earnings, around the same as last summer. Easier financial conditions with the Fed on hold should support equity valuations in the near term.
3. U.S. Macro		U.S. gross domestic product (GDP) growth surprised to the upside in Q1 as inventories and a narrower trade deficit helped to offset some moderation in consumer spending. Going forward we expect consumption to rebound, driven by a strong labor market and low inflation, and support solid economic growth in 2019. Stronger-than-expected productivity gains in recent quarters should help keep inflation low.
4. Federal Reserve		Further hikes this year by the Fed are unlikely, as inflationary pressures remained fairly muted. The next policy action by the Fed (rate hike versus rate cut) will depend upon how low and for how long inflation remains below target.
5. Trade/Fiscal Policy		While recent reports have indicated some friction in trade negotiations between senior delegates from the U.S. and China, we remain cautiously optimistic that the two sides can reach a meaningful deal.
6. Corporate Credit		**Shifted from Neutral to Positive:** Credit spreads remain around their lowest levels of the year, as a more accommodative monetary policy backdrop, along with improved economic data in the U.S., has helped support corporate credit markets.
7. Yield Curve		The yield curve has steepened modestly after a brief inversion in March, driven by stronger capital spending and jobs data in the United States. A more dovish posture by the Fed amid low inflation in the U.S. should support the yield curve over the near term.
8. Technical Indicators		**Shifted from Positive to Neutral:** Equity market volatility has come down substantially to start the year, while the ratio of put versus call option prices and percent of stocks above their 200-day moving average reflect a fairly neutral backdrop from a technical perspective.
9. Investor Sentiment		**Shifted from Positive to Neutral:** Some measures of investor sentiment have improved, such as the BofA Merrill Lynch Bull & Bear Indicator as well as surveys including the American Association of Individual Investors. However, despite the strong rally to start the year, fund flows into equities have been negative thus far in 2019.

Source: Chief Investment Office. Data as of May 7, 2019.

- **We expect equities to outperform fixed income**: Global equities remain attractively valued relative to fixed income and should continue their uptrend as the economic expansion regains momentum. Dovish central bank policy, progress toward a trade deal between the U.S. and China, stronger-than-expected economic data (in the U.S. and China), and improving global earnings revisions should help sustain equity prices over the near/medium term. Within global equities, we prefer the U.S. and EMs, which stand to benefit from signs of improving cyclical growth in the U.S. as well as stabilizing activity in China. We retain our slightly underweight view on Europe given elevated political risks and lack of catalysts for more sustainable improvement in structural growth. We believe risks—such as a still-uncertain, albeit improving Chinese growth outlook, political risks abroad such as European Union (EU) parliamentary elections and Brexit, and a decline in investor risk appetite—argue for higher levels of episodic volatility.

- **We are overweight U.S. equities**: We maintain our constructive view on U.S. equities on the basis of improving economic growth and better-than-expected corporate profits. First-quarter earnings season has been better than expected so far, and we believe corporate profits could continue to surprise positively given low analyst expectations and signs of stabilizing earnings revision ratios. We expect earnings per share (EPS) growth to slow from the torrid pace of +20% in 2018 and settle toward roughly 4% levels in 2019, contingent upon improving manufacturing and trade data. Importantly, stronger productivity should help offset labor gains and preserve margins. We prefer exposure to industries that offer earnings streams from secular trends within Technology (digital revolution, artificial intelligence, robotics, cloud computing) and those offering cyclical value such as Financials (banks) and Industrials (capital expenditures [capex] beneficiary, defense, infrastructure).

  Given our expectation for episodic volatility, we recommend higher-quality exposure i.e., large- over small-caps and U.S. over international investments. We maintain a balanced view of Growth versus Value, given the mixed forces at play, including rate uncertainty and an earnings slowdown.

- **We are slightly overweight emerging market equities**: We maintain our slight overweight in EM equities, based on our view of a weaker dollar, light investor positioning and a dovish outlook from the major global central banks. In the near term, ongoing trade negotiations between U.S. and China will remain the primary driver of returns. We are optimistic that China's fiscal and monetary stimulus will help to support growth in coming months, potentially setting up the next leg for the rally as earnings, especially in Asia, improve. Stronger-than-expected manufacturing data and real GDP growth in the first quarter are encouraging on this front. Valuations for EM equities remain reasonably cheap compared to the U.S., suggesting an attractive entry point for patient, long-term investors. We continue to favor emerging Asia over other regions for its faster growth rates, stronger fundamentals and higher exposure to consumer-driven sectors. On a structural basis, we continue to expect strength in demand from EM consumers, as incomes and spending power have room to rise over the longer term. Key risks include a potential spike in the U.S. dollar, disappointing progress on trade talks, and further deterioration in Chinese growth.

- **We are slightly underweight international developed market equities**: Economic growth and profit momentum in Europe have continued to disappoint relative to other regions, especially key economies like Germany, Italy and France. Structural reforms will be tougher, given political fragmentation of mainstream parties across the region—Brexit and EU parliamentary elections remain key risks. Japan offers better risk/reward, as monetary policy remains supportive, and valuations remain attractive—P/E of around 12.4x, lower than the historical average, places it near the bottom end of its historical range. Key risks for Japan include weak global trade, slowing economic growth and a stronger yen.

EQUITY WATCH LIST

- Improved corporate profits and economic growth estimates
- Consumer confidence remaining elevated and continued strength in business spending
- U.S. trade negotiations with China, the EU and Japan
- Trends in wage growth, capex, productivity and consumer prices could impact the longevity of the cycle
- Elevated political risks in Europe (e.g., Brexit deliberations, EU parliamentary elections and leadership changes at the European Central Bank)
- Prolonged and uncontrolled slowdown in China, despite ongoing monetary and fiscal stimulus

- **We are slightly underweight fixed income**: We are neutral to very slightly short duration, balancing expectations of stable-to-somewhat-higher rates over time and periods of flight to quality. Within fixed income, we are overall neutral on credit and have a slight preference for short-dated investment-grade corporates—particularly banks—and municipals across the curve.

  The relative value of credit is moderate at best. Investment grade spreads are very close to 12-month lows. Muni valuations are quite rich; 10-year Muni-to-Treasury yield ratios, for example, are plumbing lows not seen in over 20 years. Relatively, the shorter end of the corporate curve presents the best risk-adjusted value curve given a flat Treasury curve, while longer-dated municipals are relatively more attractive given higher muni-to-Treasury ratios on higher duration tax-exempt assets.

  While muni valuations are exceptionally tight in some aspects, we do not foresee a catalyst that will change that. Muni technicals remain strong, with low issuance and very strong demand. Muni credit fundamentals are generally stable, although pockets of weakness exist in jurisdictions with large unfunded pension liabilities, other post-employment benefit liabilities or both. Accordingly, we believe munis still provide value to tax-sensitive investors, especially for clients in the highest tax bracket. We believe Treasurys offer liquidity and relative safety and that an allocation is still preferred as a buffer to risk-off sentiment. We believe that active management can help improve risk-adjusted returns in a volatile yield environment.

- **We are slightly underweight high yield**: Spreads and yields are back to below-average post-crisis levels. Non-price terms—including covenant quality—remain weak. In particular, higher leverage and weaker covenants portend greater credit losses than are typical once the credit cycle turns. Within high yield, some allocation to leveraged loans may be advisable due to the floating-rate coupon, secured status and minimal yield give-up to unsecured bonds. Currently loans yield approximately the same as bonds, an usual anomaly due to the flatness of the curve, making loans relatively attractive even though the Fed has likely paused its rate hike campaign for now. However, given our overweight in other non-fixed income asset classes, our slight underweight to high yield is prudent risk management even though the asset class may provide coupon-like returns. High-yield allocations should be with an active manager favoring higher-quality securities, in our opinion.

FIXED INCOME WATCH LIST:

- Central bank policy error—particularly in Europe, which has yet to follow the Fed's pivot
- Unanticipated inflation—not our base case, hence why it is a risk—forcing the Fed's hand to slow the economy
- Change in risk sentiment regarding the credit cycle turning

- Credit spread widening ahead of the next recession likely to be significant
- For municipals, changes in law that would reverse currently positive technicals, and credit of governments with large and growing unfunded pension liabilities and/or other post-employment benefit liabilities

Given the differences in liquidity characteristics between alternative investments (AI) and traditional investments, the AI portfolio positioning and CIO asset class views have been neutral-rated versus our strategic allocations.

These types of investments, in our opinion, should not be viewed at the asset class level on a tactical basis, but rather the tactical positioning should be expressed at the sub-asset class level.

We will continue to provide strategy-level guidance for qualified AI investors. We believe allocations to AI can introduce differentiated returns that can complement existing traditional holdings by potentially enhancing returns, reducing risk and capitalizing on opportunities not available through traditional investments.

- **We favor a strategic approach when allocating to hedge funds**: We believe the environment for active management, and hence hedge funds, remains mixed and as such we continue to recommend a diversified approach when investing in hedge fund strategies. We continue to favor incremental allocations to equity long/short and equity market neutral strategies.
- **We favor a strategic approach when allocating to private equity** and view these strategies as long-term potential portfolio return enhancers with unique access to specialized deals unavailable to most investors. We recommend investors plan a disciplined multiyear commitment strategy that builds portfolio diversity among different managers, styles, geographies, and, importantly, vintages. Within the broad private equity universe, we continue to favor special situation strategies that can benefit from pockets of stress and offer important diversification benefits (due in part to their counter-cyclicality) to a strategic private equity program.
- **We favor a strategic approach when allocating to private real estate**: A favorable U.S. backdrop for economic growth, employment and low real interest rates provides continuing support for commercial real estate (CRE) aggregate demand. Occupier market fundamentals are healthy with continuing signs that the markets for rentable space are generally in balance across the country with a few property type and market exceptions, such as regional malls and power centers in the retail category, and in some multifamily and central business district (CBD) office markets. Construction is substantial and has been back in play for a while but appears largely in balance with current levels of demand. Notably, not all U.S. property sectors and markets are currently synchronized. Capital market fundamentals remain strong, though there is a slowing bid for U.S. properties. The markets are buoyant, with substantial dry powder available for investment, including roughly $150 billion in committed private equity and generally steady allocations to CRE by institutional investors. Debt markets are disciplined, simultaneously active on a flow basis and remain accommodative with respect to permanent, value-add and development.
- **We remain neutral on commodities**: Commodity prices tend to rise later in economic expansions as global demand approaches cycle-peak levels. We continue to believe that oil prices will fluctuate in a $50-to-$70-per-barrel range for the foreseeable future, with the various voluntary and involuntary supply cuts, a relatively steady dollar and a probable global growth upturn in the second half. Relatively stable oil prices are positive for continued U.S. and global expansion.
- **Tangible assets**: Over the long term, we expect tangible assets—such as real estate, timber, and farm and ranch land—to potentially benefit portfolios through increasing portfolio diversification, helping protect against the corrosive effects of inflation,

offering the potential to generate streams of investment cash flow, and providing favorable social impact opportunities.

- **The dollar**: Higher rates relative to Europe, concerns over slower growth and a potential delay to the end of quantitative easing in Europe should continue to support the dollar relative to the euro in the near term. However, investor capital flows to "higher growth" areas, early in 2019, should limit a dollar advance. On balance, we expect a weaker-to-stable dollar over the coming year.

MACRO STRATEGY

- Economic data indicate that the U.S. economy is still strong, and the rest of the world should pick up as well. EMs are benefitting from lower interest rates and a more stable dollar. Overall global growth remains solid. Pro-business U.S. fiscal and regulatory policies, combined with low inflation and still-accommodative monetary policy around the world, are fueling a positive, self-reinforcing growth dynamic, boosting profits and potentially extending the economic cycle. We believe this is a positive backdrop for equities.
- Inflation pressures have fallen sharply since peaking last summer. The Fed's rate hikes and surprisingly strong U.S. productivity growth have created a strong deflationary shock to the global economy that should preclude further rate hikes this year, helping in our view to assuage recent worries about a recession in 2019.
- Volatility tends to be strongly correlated with the Fed's monetary policy stance. Low inflation gives the Fed space to remain accommodative for quite a while helping to keep volatility well below its historical average.

Table 1: Economic and Market Forecasts (as of 5/3/19)

	Q3 2018A	Q4 2018A	Q1 2019A	Q2 2019E	2018A	2019E
Real global GDP (% y/y annualized)	–	–	–	–	3.6	3.4
Real U.S. GDP (% q/q annualized)	3.4	2.2	3.2	2.1	2.9	2.6
CPI inflation (% y/y)	2.6	2.2	1.6	2.1	2.4	1.9
Core CPI inflation (% y/y)	2.2	2.2	2.1	2.1	2.1	2.1
Unemployment rate (%)	3.8	3.8	3.9	3.6	3.9	3.7
Fed funds rate, end period (%)	2.18	2.40	2.43	2.38	2.40	2.38
10-year Treasury, end period (%)	3.06	2.68	2.41	2.80	2.68	3.00
S&P 500 end period	2914	2507	2834	–	2507	2900
S&P earnings ($/share)	43	41	38*	42.5	161.5	168
Euro/U.S. dollar, end period	1.16	1.15	1.12	1.15	1.15	1.20
U.S. dollar/Japanese yen, end period	114	110	111	109	110	101
Oil ($/barrel, avg. of period, WTI**)	69	59	55	62	65	59

The forecasts in the table above are the base line view from BofAML Global Research team. 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.

Past performance is no guarantee of future results. 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. S&P 500 represents a fair value estimate for 2019. **West Texas Intermediate

Sources: BofA Merrill Lynch Global Research; GWIM ISC as of May 3, 2019.

When assessing your portfolio in light of our current guidance, consider the tactical positioning around asset allocation in reference to your own individual risk tolerance, time horizon, objectives and liquidity needs. Certain investments may not be appropriate, given your specific circumstances and investment plan. Certain security types, like hedged strategies and private equity investments, are subject to eligibility and suitability criteria. Your financial advisor can help you customize your portfolio in light of your specific circumstances.

Asset class	CIO view					Comments
	Under-weight		Neutral		Over-weight	
Global Equities	•	•	•	●	•	Global equities should outperform bonds as the economic expansion continues, with better-than-expected earnings and global growth. We continue to prefer U.S. and EMs, which stand to benefit from signs of improving growth in the U.S. as well as stabilizing activity in China.
U.S. Large Cap Growth	•	•	•	●	•	Given our expectation for episodic volatility, we recommend higher-quality exposure which leads us to favor large-cap over small-cap equities. We recommend a balanced view across Growth and Value. At the sector level, we recommend being selective, with a preference for Technology (quality growth), Financials (cyclical value), and Industrials (depressed global cyclicals with bounce-back potential).
U.S. Large Cap Value	•	•	•	●	•	
U.S. Small Cap Growth	•	•	•	●	•	Given recent declines, small caps offer more attractive risk/reward. Some of the risks include more exposure to rising rates, widening credit spreads and moderating domestic economic activity.
U.S. Small Cap Value	•	•	●	•	•	
International Developed	•	●	•	•	•	We are cautious on Europe, given a weak growth backdrop and higher political risks. Economic activity is facing headwinds from the uncertainty from Germany, Italy and France. Brexit creates uncertainty for domestic companies, but multinationals are enjoying rising global trade and a weaker currency. Japan offers better risk/reward after the global selloff as monetary accommodation and valuations are a tailwind.
Emerging Markets	•	•	•	●	•	Based on our view of a weaker dollar, light investor positioning and a dovish outlook from the major global central banks, we remain slightly overweight, especially for long-term, patient investors. We continue to favor emerging Asia, on stronger fundamentals, exposure to consumer-driven sectors and faster growth rates. Structurally we see strength in demand from EM consumers.
Global Fixed Income	•	●	•	•	•	Bonds provide portfolio diversification, income and stability. Neutral to very slightly short duration is warranted, balancing expectations of stable-to-somewhat higher rates over time and periods of flight to quality. Flatter yield curve does not compensate for long duration risk.
U.S. Governments	•	●	•	•	•	Yields are still compelling versus sovereign peers. Overall, rate risk is only tilted slightly toward the upside. An allocation for liquidity and relative safety is advised. Fed on hold for now, and longer rates will be impacted by inflation, global growth, yields and central bank activity.
U.S. Mortgages	•	●	•	•	•	MBS spreads have widened and are approaching fair value level, but the Fed balance sheet unwind, lower mortgage rates and higher seasonals remain potential headwinds. We maintain our slightly negative view for now based on uncertainty around direction of rates, volatility and higher supply that needs to be absorbed by new investors; however, we are watching closely for catalysts for potential changes later in the year.
U.S. Corporates	•	•	●	•	•	Credit fundamentals should continue to improve over the next 12 months—absent a policy error—and demand remains strong. The Fed's pause should provide extended liquidity to the sector. Investment-grade spreads appear fairly valued. Neutral overall; short-end corporates preferred, sector bias remains U.S. banks and financials, though lower rates may present near-term overhang.
High Yield	•	●	•	•	•	Valuations are average to tight, and relative risk-reward not favorable enough. Prefer actively managed solutions that are higher in credit quality. Fundamentals have improved, but leverage remains elevated. Loans have underperformed HY bonds recently: A balanced allocation to floating-rate loans is advised.
U.S. Investment Grade Tax Exempt	•	•	●	•	•	Valuations have risen recently, but do not appear overpriced, given strong technicals and fundamentals that have pressured the muni yield curve lower and flatter. Munis still offer good relative value for tax-sensitive investors, particularly those in high-tax states. Credit is generally stable, but certain issuers face long-term challenges due to underfunded pensions.
U.S. High Yield Tax Exempt	•	●	•	•	•	Valuations are rich on a spread, yield and ratio basis. Prefer actively managed solutions that are higher in credit quality.
International Fixed Income	●	•	•	•	•	Compressed yields and risk premiums around the globe compared to the U.S., combined with potentially higher volatility in non-U.S. markets, present unfavorable risk/reward conditions for non-U.S. fixed income, justifying an underweight position.
Alternative Investments*						Given the differences in liquidity characteristics between Alternative Investments (AI) and traditional investments, the AI portfolio positioning and CIO asset class views have been neutral rated versus our strategic allocations. These types of investments, in our opinion, should not be viewed at the asset class level on a tactical basis, rather the tactical positioning should be expressed at the sub asset level. We will continue to provide strategy level guidance for qualified AI investors and believe allocations to AI can introduce differentiated returns which can complement existing traditional holdings by potentially enhancing returns, reducing risk and capitalizing on opportunities not available in traditional investments.
Hedge Funds			●			We believe the environment for active management remains mixed. We currently favor equity long/short and equity market neutral strategies. If recent trends persist, performance will likely be manager-specific in 2019; as such we recommend a diversified approach when investing in hedge funds strategies.
Private Equity			●			We view private equity strategies as long-term potential portfolio return enhancers. We recommend investors plan a disciplined multiyear commitment strategy that builds portfolio diversity among different managers, styles, geographies and, particularly, vintages. Currently, we see opportunities in special situations strategies.
Real Assets			●			General economic conditions remain good for commercial real estate. We place emphasis on direct investments in well-located properties in strong regions of the country that exhibit attractive rent-roll and cash flow characteristics, and have the potential to bridge into the next cycle, providing a long-term hedge against inflation.
Cash						

Tactical qualitative investment strategy weightings are relative in nature versus the strategic weightings for a fully diversified portfolio. Weightings are based on the relative attractiveness of each asset class. Tactical strategy weightings are for a 12- to 36-month time horizon. Because economic and market conditions change, recommended allocations may vary in the future. Asset allocation cannot eliminate the risk of fluctuating prices and uncertain returns. All sector and asset allocation recommendations must be considered in the context of an individual investor's goals, time horizon and risk tolerance. Not all recommendations will be suitable for all investors. Alternative investments such as derivatives, hedge funds, private equity funds and funds of funds can result in higher return potential, but also higher loss potential. Changes in economic conditions or other circumstances may adversely affect your investments. Before you invest in alternative investments, you should consider your overall financial situation, how much money you have to invest., your need for liquidity and your tolerance for risk.

* Many products that pursue Alternative Investment strategies, specifically Private Equity and Hedge Funds, are available only to pre-qualified clients.

Source: Global Wealth & Investment Management Investment Strategy Committee.

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.

S&P 500 Index 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 an ideal proxy for the total market

Important Disclosures

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

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 suitable for 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.

Alternative investments such as derivatives, hedge funds, private equity funds, and funds of funds can result in higher return potential but also higher loss potential. Changes in economic conditions or other circumstances may adversely affect your investments. Before you invest in alternative investments, you should consider your overall financial situation, how much money you have to invest, your need for liquidity, and your tolerance for risk. Alternative investments are speculative and involve a high degree of risk. An investor could lose all or a substantial amount of his or her investment. There is no secondary market nor is one expected to develop and there may be restrictions on transferring fund investments. Alternative investments may be leveraged and performance may be volatile. Alternative investments have high fees and expenses that reduce returns and are generally subject to less regulation than the public markets. The information provided does not constitute an offer to purchase any security or investment or any other advice.

Hedge funds are speculative and involve a high degree of risk. An investor could lose all or a substantial amount of his or her investment. There is no secondary market nor is one expected to develop for investments in hedge funds, and there may be restrictions on transferring fund investments. Hedge funds may be leveraged and performance may be volatile. Hedge funds have high fees and expenses that reduce returns.

Private equity investments involve a significant degree of risk and should be regarded as speculative. They are only made available to qualified investors under the terms of a private offering memorandum. Holdings in a private equity fund may be highly leveraged and, therefore, more sensitive to adverse business or financial developments. Private equity investments are long term and unlikely to produce a realized return for investors for a number of years. Interests in a private equity investment are not transferable. The holdings of a private equity pool may be illiquid—very thinly traded or assets for which no market exists. A private equity investment may use leverage, which even on a short-term basis can magnify increases or decreases in the value of the private equity investment. The business of identifying private equity investment opportunities is competitive, and there is no assurance that the private equity pool will be able to complete attractive investments or fully commit its capital. In addition, a private equity fund's high fees and expenses may offset the fund's profits. Private equity investments should be discussed with financial, tax and legal professionals in light of an individual's objectives, liquidity needs and tolerance for risk.

References to indices, or other measures of relative market performance over a specified period of time (each, an "index") are provided for illustrative purposes only, do not represent a benchmark or proxy for the return or volatility of any particular product, portfolio, security holding or alternative investments. The figures for the index reflect the reinvestment of dividends but do not reflect the deduction of any fees or expenses which would reduce returns. Merrill does not guarantee the accuracy of the index returns and does not recommend any investment or other decision based on the results presented.