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CHIEF INVESTMENT OFFICE

Capital Market Outlook

June 17, 2019

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IN THIS ISSUE

- **Macro Strategy**—Evidence has continued to accumulate supporting the view that tighter monetary policy is the dominant force behind the global slowdown rather than the fears of a trade war. Falling inflation around the world is one of the main signs that policy is too tight. This contradicts the view that tariffs are causing higher inflation.

- **Global Market View**—While we are long-term bulls on technology, investors should keep in mind that change can come slowly on the frontier of technology. Regulatory pushback, the lack of funding, or just plain inertia—because of these factors, the embrace of new technology is more evolutionary than revolutionary. Ergo, investors should try to avoid the hype and separate the tortoise from the hare. We believe investment opportunities lie with the proven technology winners, with strong earnings, robust balance sheets, and global brand awareness.

- **Thought of the Week**—Deputy Prime Minister and head of The League Matteo Salvini has promised a "fiscal shock" to reinvigorate the stalling Italian economy, leading the government once again into a showdown with the European Union over its swelling budget deficit. The developments further underscore our concerns over geopolitical risk in the region, and support our preference for U.S. over non-U.S. equities.

- **Portfolio Considerations**—We still believe equities are more attractive relative to bonds at current valuations and prospects. We maintain our constructive view on U.S. equities versus non-U.S. equities in the medium term on the basis of stronger real economic growth and corporate profits.

MACRO STRATEGY

Chief Investment Office Macro Strategy Team

GLOBAL MARKET VIEW

Lauren J. Sanfilippo
Vice President and
Market Strategy Analyst

Joseph P. Quinlan
Head of CIO Market Strategy

THOUGHT OF THE WEEK

Brian T. Wilczynski
Assistant Vice President and
Investment Analyst

Data as of 6/17/2019 and subject to change.

MACRO STRATEGY

Nothing to Fear But Fear Itself

Chief Investment Office Macro Strategy Team

Market commentary has been focused on Federal Reserve (Fed) and trade policy. A look into the pattern of market and economic data suggests that Fed policy has been the dominant source of actual economic impact while trade-war worries appear to have been overblown.

One obvious differentiator has been inflation. Critics of tariffs have almost universally asserted that they hurt consumers by causing higher inflation. Yet inflation has been

declining and remains below central bank targets throughout most of the developed world. Since the Fed raised rates aggressively in 2018, inflation has been declining in just about every part of the world. Commodity prices are also lower this year, including oil and copper, which are down substantially from year-ago levels. Overall inflation dynamics are consistent with the view that monetary policy has over tightened and inconsistent with the view that higher tariffs are causing higher inflation.

Another indication that Fed policy rather than trade policy is dominating actual economic dynamics is the pattern of business and consumer confidence over the past year. Both measures of confidence were falling in the fourth quarter and made a final plunge in late December when Fed Chairman Jerome Powell doubled down on his "automatic pilot" view that more tightening was coming in 2019. Inflation had peaked near the Fed's target rate in July, but leading indicators had turned sharply lower and accurately predicted the drop that has seen inflation and inflation expectations fall about a half percentage point below the target level in recent months.

Once the Fed pivoted in early January, consumer confidence, business confidence and the equity market quickly began to recover. Despite the negative turn in the trade talks last month, consumer and business confidence continue to recover and in some cases have surpassed the prior highs.

For example, the National Federation of Independent Business (NFIB) survey of small business confidence showed big across-the-board gains in several categories in May. The overall optimism index has regained half of its late 2018 plunge and is currently back in the highest range of the past three decades. The percentage of firms reporting "now is a good time to expand" is back into a range only seen during the past two years. The percent of firms planning capital expenditures rose sharply in May and has recouped most of the plunge that occurred going into the December low point.

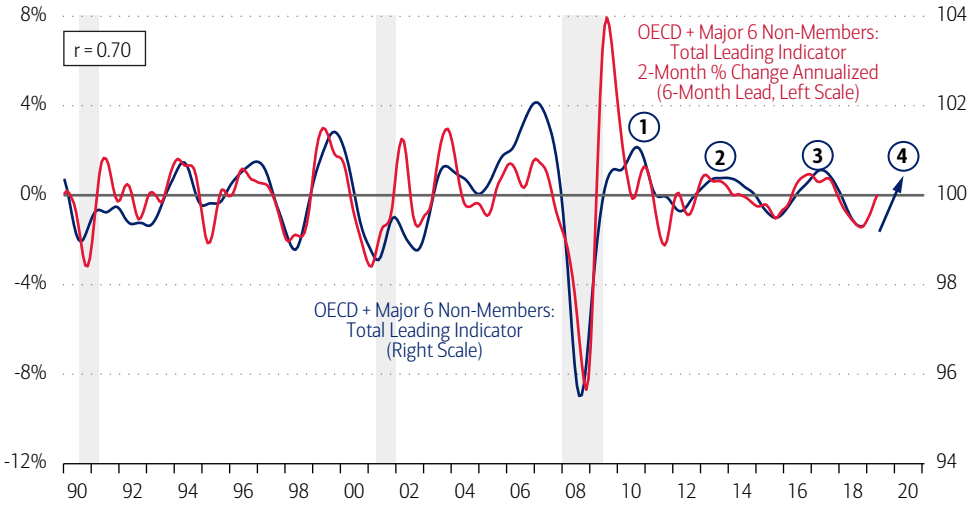
The main exceptions to the widespread improvement in these business confidence measures are the inflation-related measures. The percentage of businesses "planning to raise average selling prices" and "raising average selling prices" continued the plunge that the Fed's deflationary shock set off. Both metrics have reversed all the gains seen in 2018 and are back to 2017 levels. Despite tariffs, price pressures have been falling, not rising, because the Fed has over tightened monetary policy and is therefore falling further away from its target.

The recovery of confidence and equity prices since the Fed pivot is strong evidence that trade issues are of second-order importance compared to the deflationary shock the Fed delivered last year. That shock hit the rest of the world harder than the U.S., causing global equity markets to peak early in 2018 well before the trade tiff began in the spring. Earlier in the recovery, borrowers in other countries took advantage of low U.S. rates to borrow dollars while U.S. households and financial institutions were deleveraging. This left foreign economies more vulnerable to the early stage of Fed tightening. It also meant the Fed had to go even further to squeeze U.S. growth, especially the housing sector.

The net result has been a bigger slowdown outside the U.S. and the relative outperformance of the U.S. equity market. Exacerbating this differential is the fact that trade war effects are more punitive to countries outside the U.S., especially big trade surplus countries, like China and Germany.

Since the Fed pivot in January, a slow transition has begun (Exhibit 1) with the decline in global leading indicators beginning to slow. Leading indicators are starting to stabilize. A turn higher is being delayed by the Fed's slow response to its over tightening mistake. The deepening inversion of the spread between the 10-year Treasury yield and the Federal Funds rate is as indication that the Fed's patience has been a mistake.

Exhibit 1: Global Leading Indicators Show Fourth Wave Turn Slowly Forming.



Sources: Organisation for Economic Co-operation and Development; Haver Analytics. Data as of April 2019.

The longer the Fed waits to reverse its mistake, the more the deflationary impulse from last year's excessive tightening will build and slow the global economy. Monetary policy works with a lag that is most intense a year to 18 months after tightening is implemented. The plunge in bond rates reflects the fact that the longer the Fed postpones the inevitable, the bigger the mess it will have to clean up. That is, the more it will have to ease to put inflation back on track to reach its target.

The tragedy is that the U.S. economy was on track to move into a higher nominal growth range that would have reduced the risk of relapsing back to the zero-bound problem that still plagues Europe and Japan. The disproportionate impact of the Fed's mistake on the rest of the world has sent German rates to fresh record lows. U.S. 10-year rates, on the other hand, are currently well off the lows last seen in July 2016.

Hopefully, the Fed won't let the deflationary impulse continue to intensify and push the U.S. economy back to the zero-bound. The January pivot, in our view, has already started to mitigate the deflationary shock from last year's tightening. Simply by dropping plans for further tightening in 2019 the Fed has caused longer-term rates to come down. Real interest rates have dropped as a result. The 10-year real rate peaked just over one percent late last year and has declined by about 75 basis points. Mortgage rates have responded in kind, setting off a surge in refinancing and a revival of housing activity.

The drop in rates, resurgence in confidence and rebound in equity prices are all early leading indicators behind the turn shaping up in global leading indicators (Exhibit 1). By early 2020, this turn could be causing upward revisions to the U.S. and global economic growth outlook. Any progress on trade will just be icing on the cake. At some point the markets are likely to realize that tariffs are a means to an end, not an end in itself. That end is freer trade, which is a market positive.

GLOBAL MARKET VIEW

Tech Snapshots: The Tortoise or the Hare?

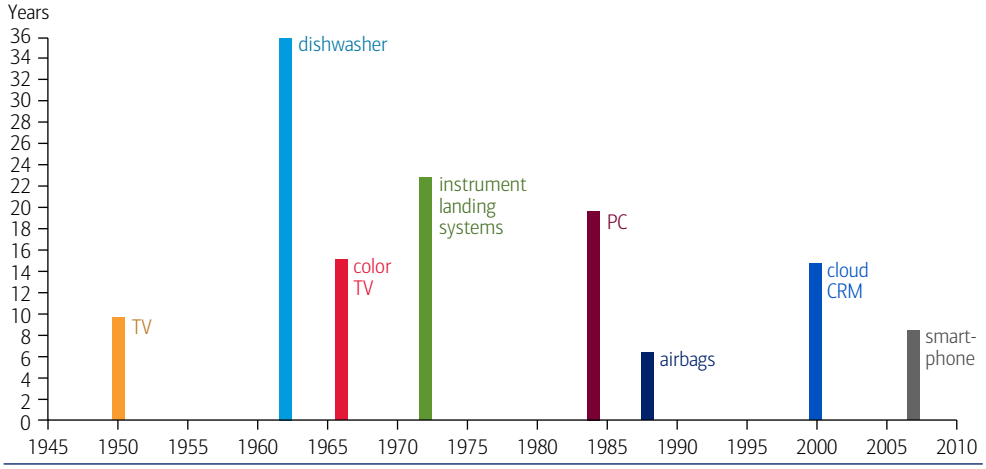
Lauren J. Sanfilippo, Vice President and Market Strategy Analyst

Joseph P. Quinlan, Head of CIO Market Strategy

It is commonplace to speak of seismic shifts in disruptive technologies and the life-altering ways technology is reshaping the future. From unmanned aerial vehicles to the

mass customization of shoes using 3-D printing, the telltale signs of automation are everywhere. Yet, while we are living in an era of technological transformation, change can come slowly on the frontier of technology due to a number of factors, ranging from regulatory pushback, the lack of funding, or just plain inertia. Technological adoption rates always take longer than expected; the internet, for instance, has been around for a quarter century, but only in the past year has 50% of the planet gone online. The embrace of new technology is always halting, more evolutionary than revolutionary, as depicted in Exhibit 2. The upshot: overinflated expectations on the one hand, and disappointed companies and investors on the other.

Exhibit 2: Years Taken for Various Technologies Throughout History to Achieve 80% Penetration Since Year of Introduction.



Source: McKinsey Global Institute. Data as of June 2019.

In this vein, we highlight three cases where the embrace of technology is more the tortoise than the hare—where the pace of change, while gaining traction, is moving at a slower speed than the headlines might suggest. The trio: facial recognition, the cashless society and the unpreparedness of many municipalities to the threat of cyberattacks.

Before delving into specifics, we are long-term bulls on technology and the transformational effects on the global economy. Notwithstanding building regulatory headwinds, we believe investment opportunities lie with the proven technology winners, with strong earnings, robust balance sheets and global brand awareness.

Your face or your privacy

Biometric security capabilities like facial recognition have many people not smiling for the camera. Surrounding many emerging technologies are concerns of unexpected applications of artificial intelligence (AI) as more and more sensors collect, analyze and distribute personal data at record levels.

What was initially used as an improved authentication/identification method (FaceID) for smartphones, facial recognition applications are exploding at a rapid pace, notably among law enforcement agencies, spawning fears of the rise of the "surveillance state." Indeed, face recognition is poised to become one of the most pervasive surveillance technologies of our times, although, ironic as it is, San Francisco, a city known for incubating some of the most advanced technologies, has become the first major American city to block police and other law enforcement agencies from using the software.[1]

Similar bans are under consideration in other major cities as part of a larger legislative package devised to govern the use of surveillance technologies. In other use cases,

[1] The New York Times, *Facial Recognition's Many Controversies*, May 15, 2019.

(and mostly in the name of efficiency), facial recognition has been employed in airports fostering an entire "biometric terminal" using your face at check-in, bag drop, security and boarding. It's the U.S.'s biggest step yet to normalize treating our faces as data that can be stored, tracked and—the inevitable—stolen.

For the future of biometric security, look no further than China, where facial recognition is well past infancy stages. The technology is used for virtually everything, from cashless transactions to government and corporate surveillance of citizens and employees. If people jaywalk in Shenzhen, for instance, facial recognition can match them and display their faces and names on an LED billboard to "name and shame" them. Subsequently, a follow-up text will be sent with their fines. Not unexpectedly, many consider this an invasion of privacy, creating a groundswell of opposition to one of the next great things in technology: checking out or in with your face. In the future, your facial expressions will not only signal your mood—they will also reveal your name, date of birth, browser history and biometric data, as well as personal genomics information.

Cash is still king

It's doomsday for robbers everywhere, with cashless establishments and empty cash drawers on the rise. For years vendors have asked customers to pay cash in an effort to defray the premiums imposed on credit card transaction fees. Now, an increasing number of businesses have changed their minds as consumers face a new dilemma: establishments not accepting cash in hopes the transaction is done with plastic or with the smartphone. Cash is trash, in other words, for many establishments.

This trend, however, has not gone over well with many legislators and millions of Americans considered "unbanked." A huge concern for those "unbanked" people without access to checking or savings accounts (totaling 14.1 million U.S. adults): "do not have enough money to keep in account;" "don't trust banks;" and "avoiding banks gives me more privacy,"[2] according to the Federal Deposit Insurance Corporation (FDIC). Per the latter, many consumers plainly feel that paying electronically jeopardizes privacy and security rights, and gives too much personal data away to third parties or various digital platforms.

Against this backdrop, the shift to cashless has slowed. Cash-friendly legislation is moving its way across the U.S., as Philadelphia agreed in March to ban cashless stores, and San Francisco passed its ban in May, joining Massachusetts and New Jersey in prohibiting no-cash retailers.[3] The argument: retailers who have turned completely cashless allege that the growing cashless trend discriminates against low-income customers. Accordingly, the percentage of consumers using cash is highest among individuals with income levels of less than $25,000.[4]

In the end, it's not yet time to count those paper greenbacks out just yet. Cash still remains the most frequent method of payment in the country overall, representing roughly 30% of all transactions, more than electronic, mobile, credit, debit or checks, notably an overwhelming majority of smaller value transactions.[5]

American cities at war

Albeit not widely recognized by the majority of people, our cities are under attack. According to the Federal Bureau of Investigation (FBI), ransomware is a pandemic in the United States, with American cities increasingly in the crosshairs of the hackers.[6] Indeed, according to cybersecurity firm Recorded Future, some 170 county, city or state

[2] The Federal Deposit Insurance Corporation, *FDIC National Survey of Unbanked and Underbanked Households*, October 2018.

[3] The New York Times, *Philadelphia Bans 'Cashless' Stores Amid Growing Backlash*, March 7, 2019.

[4] Ibid.

[5] Federal Reserve, *2018 report on the Diary of Consumer Payment Choice*, November 2018.

[6] The Wall Street Journal, *Hackers Won't Let up in the Attack on U.S. Cities*, June 7, 2019.

government systems have been attacked since 2013, with 22 known attacks already this year. The latest city to be assaulted: Baltimore, which is still recovering from a cyberattack commenced on May 7.

Why attack cities? Because many are still using aging technology, have scarce resources and are devoid of cyber talent. They are easy targets, in other words. While the United States is a cyber-superpower, the talent and resources are at the federal level, not at the state and local levels, leaving cities like Baltimore but also locales like Newark, Atlanta and San Diego (all cyber victims) at the mercy of cyberattacks.

Hackers can wreak havoc on a city—in Baltimore, for instance, home sales were delayed, water bills were not issued, and basic services of the public sector (mass transit, emergency services, etc.) were delayed or shut down. The effects can be paralyzing and come with considerable economic costs, considering the output of state and local government was $2.2 trillion in annual gross domestic product in 2018. In other words, when hackers attack cities, they are attacking a vital organ of the U.S. economy, which comes with significant costs.

In the end, one of the top infrastructure challenges of today pivots around bolstering the internet forces/capabilities of America's cities (large and small). Boosting the cyber defenses of cities entails billions of new cybersecurity spending over the next decade.

THOUGHT OF THE WEEK

Italy Heads Toward Another Budget Showdown with the European Union

Brian T. Wilczynski, Assistant Vice President and Investment Analyst

Following his party's strong showing in last month's Parliamentary elections, Deputy Prime Minister and head of The League Matteo Salvini has promised a "fiscal shock" to reinvigorate the stalling Italian economy, leading the government once again into a showdown with the European Union over its swelling budget deficit. The developments further underscore our concerns over geopolitical risk in the region, and support our preference for U.S. over non-U.S. equities.

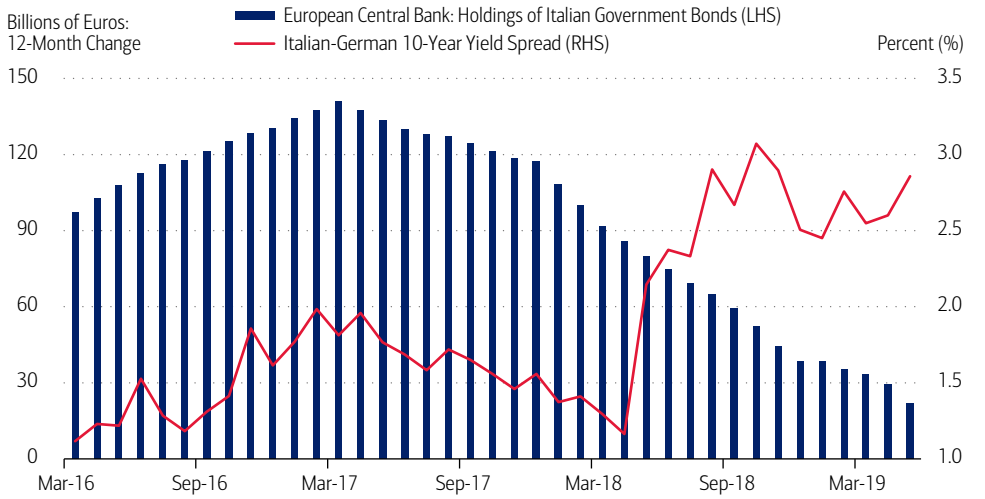
The EU recently announced that Italy could face disciplinary measures over its persistent budget deficit, declaring it needs to lower its structural deficit by 0.6% of gross domestic product (GDP)/year, despite forecasts for an increase of 1.2% in 2020. Brussels continues to insist on austerity measures to get the budget under control, estimating the government could generate revenue of around 1.3% of GDP by raising its value-added tax. Instead, Salvini recently proposed tax cuts of around 30B Euro or 1.7% of GDP, while Economy and Finance Minister Giovanni Tria pushed back against the EU's demands, noting that given the weakening state of Italy's economy, austerity would only make its budget problems worse.

Added to the mix is infighting between The League and its coalition partner Five-Star Movement over issues like infrastructure and immigration, which has intensified since the end of the Parliamentary elections. Recently, Prime Minister Giuseppe Conte threatened to resign and demanded that the two sides resolve their issues or call for a new election, further compounding concerns among investors. And with support from Quantitative Easing (QE) continuing to fade, Italian bonds could now be more vulnerable to market volatility than in the past (Exhibit 3).

Istat's recent downgrade to its economic growth forecast for 2019 to a meager 0.3% makes Italy's mounting debt load (now 132% of GDP) look less and less sustainable. So with these latest developments, the government truly finds itself in between a rock

and a hard place: resist the EU's budget demands and see its debt costs soar, or raise taxes and allow the economy to weaken further. Italy's fiscal targets will be published on September 27, followed by its budget submission by October 15, both likely to be flashpoints in sovereign bond markets, with significant headline risk along the way.

Exhibit 3: Slowing ECB Demand Could Spell Trouble for Italian Bonds.



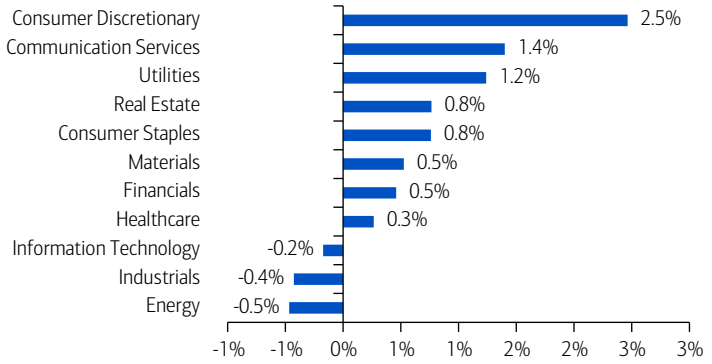
Note: Bond holdings data represent holdings under the Public Sector Purchase Program. Yield spread data represent end-of-month values through the end of May 2019. Sources: European Central Bank; Haver Analytics. Data as of June 10, 2019.

MARKETS IN REVIEW

Equities

		Total Return in USD (%)		
	Current	WTD	MTD	YTD
DJIA	26,089.61	0.5	5.3	13.2
NASDAQ	7,796.66	0.7	4.7	18.1
S&P 500	2,886.98	0.5	5.0	16.3
S&P 400 Mid Cap	1,899.92	0.5	5.0	15.1
Russell 2000	1,522.50	0.6	4.0	13.6
MSCI World	2,130.95	0.2	4.2	14.4
MSCI EAFE	1,870.17	-0.3	3.0	10.8
MSCI Emerging Markets	1,015.08	0.9	1.9	6.1

S&P 500 Sector Returns



Fixed Income[1]

		Total Return in USD (%)		
	Current	WTD	MTD	YTD
Corporate & Government	2.54	0.0	0.5	5.8
Agencies	2.16	0.0	0.3	3.7
Municipals	2.07	-0.1	0.1	4.8
U.S. Investment Grade Credit	2.63	0.0	0.4	5.2
International	3.36	0.1	0.7	7.9
High Yield	6.13	0.4	1.3	8.9

	Current	Prior Week End	Prior Month End	2018 Year End
90 Day Yield	2.12	2.19	2.29	2.36
2 Year Yield	1.84	1.85	1.92	2.49
10 Year Yield	2.08	2.08	2.12	2.68
30 Year Yield	2.59	2.57	2.57	3.01

Commodities & Currencies

		Total Return in USD (%)		
Commodities	Current	WTD	MTD	YTD
Bloomberg Commodity	163.82	0.9	0.2	2.6
WTI Crude $/Barrel[2]	52.51	-2.7	-1.9	15.6
Gold Spot $/Ounce[2]	1,341.85	0.1	2.8	4.6

Currencies	Current	Prior Week End	Prior Month End	2018 Year End
EUR/USD	1.12	1.13	1.12	1.15
USD/JPY	108.56	108.19	108.29	109.69
USD/CNH	6.93	6.94	6.94	6.87

Source: Bloomberg, Factset.Total Returns from the period of 6/10/19 to 6/14/19. Bloomberg Barclays Indices.[1] Spot price returns.[2] All data as of the 6/14/19 close.
Past performance is no guarantee of future results. Please see the Index Definitions at the back of the document.

Asset Class Weightings (as of 6/4/19)

	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.

Economic and Market Forecasts (as of 6/14/19)

	Q3 2018A	Q4 2018A	Q1 2019A	Q2 2019E	2018A	2019E
Real global GDP (% y/y annualized)	–	–	–	–	3.6	3.3
Real U.S. GDP (% q/q annualized)	3.4	2.2	3.1	1.9	2.9	2.4
CPI inflation (% y/y)	2.6	2.2	1.6	1.8	2.4	1.6
Core CPI inflation (% y/y)	2.2	2.2	2.1	2.0	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	1.88
10-year Treasury, end period (%)	3.06	2.68	2.41	2.05	2.68	2.00
S&P 500 end period	2914	2507	2834	–	2507	2900
S&P earnings ($/share)	43	41	39*	42	161.5	166
Euro/U.S. dollar, end period	1.16	1.15	1.12	1.10	1.15	1.17
U.S. dollar/Japanese yen, end period	114	110	111	109	110	101
Oil ($/barrel, avg. of period, WTI**)	69	59	55	60	65	56

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 June 14, 2019.

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.

NFIB Small Business Optimism Index is a composite of ten seasonally adjusted components calculated based on the answers of around 620 NFIB members

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Economic or financial forecasts are inherently limited and should not be relied on as indicators of future investment performance.

It is not possible to invest directly in an index.

Asset allocation, diversification, dollar cost averaging and rebalancing do not ensure a profit or protect against loss in declining markets. Dollar cost averaging involves continual investment in securities regardless of fluctuating price levels; you should consider your willingness to continue purchasing during periods of high or low price levels.

Past performance is no guarantee of future results.

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