CHIEF INVESTMENT OFFICE

Capital Market Outlook

May 30, 2023

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

IN THIS ISSUE

Macro Strategy—*Is the Fed Serious About a 2% Inflation Target?:* The debt ceiling forced the Treasury to drain its account at the Federal Reserve (Fed), flooding the banking system with new reserves. As a result, despite quantitative tightening (QT) by the Fed, the monetary base and bank reserves rose in recent months, retracing about half of their 2022 decline.

This reversal of liquidity flows helped sustain a rally in Equities, with the S&P 500 Index also retracing about half of its bear market losses to date. As the Treasury rebuilds its account at the Fed in coming months, the reserve drain from QT will no longer be offset, raising the risk that the bear market in Equities resumes.

Market View—*What's Driving the Rally in Big Tech?:* Big Technology (Tech) stocks have been on a tear this year, with just a handful of the largest companies leading the charge. The rally has had major implications for the broader equity market. Case-in-point: The three largest Tech stocks in the S&P 500 are responsible for over 50% of the year-to-date (YTD) gain in the index.

When considering this outsized effect, investors are left wondering—what's driving the rally, and is it sustainable? While we see several long-term tailwinds for big Tech, the durability of the rally is up for debate.

Thought of the Week—*Tactical Sympathy, Strategic Disagreement:* Greater diplomatic exchanges between the U.S., Europe and China suggest more clarity in the geopolitical outlook. Yet, there are reasons to believe that mutual sympathy may be more tactical in nature, masking strategic disagreements. National security concerns underpin efforts to reorganize supply chains and reorient information and capital flows.

In our view, while guardrails exist against a disorderly deglobalization, a general climate of mutual mistrust risks geopolitical flashpoints near term.

MACRO STRATEGY ▶

CIO Macro Strategy Team

MARKET VIEW ▶

Emily Avioli
Assistant Vice President and Investment Strategist

THOUGHT OF THE WEEK ▶

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MARKETS IN REVIEW ▶

Data as of 5/30/2023, and subject to change

Portfolio Considerations

We maintain a neutral view on Equities, as risks to economic growth and corporate profits remain skewed to the downside. We continue to look for upgrade opportunities in small-caps and international later this year. But for now, we remain neutral across the asset classes. In Fixed Income, we continue to stick to a higher-quality bias and are looking for opportunities to extend duration overall. The bottom line is that we foresee a "grind-it-out" range-bound market continuing in the U.S. with a wait-and-see attitude from investors throughout this year.

MACRO STRATEGY

Is the Fed Serious About a 2% Inflation Target?

CIO Macro Strategy Team

Recent Fed officials' comments have raised the possibility that they may pause at the June rate-setting meeting while communicating a willingness to hike interest rates again at subsequent meetings. This tightening bias is likely to continue until the central bank is convinced that inflation is anchored closer to the 2% target. Skipping a meeting between rate hikes would continue the process of slowing the pace of the tightening campaign, first from 75 to 50 basis points (bps), followed by 25 bps hikes at each meeting recently and then perhaps 25 bps at alternate meetings, giving the Fed more time to see how its tightening to date is affecting the economy. This possibility is reflected in the recent move of 6-month Treasury bills' yields above 3-month bills, an implicit sign that a further rate hike is being built into the summer Fed policy outlook. For now, the market is anticipating the possibility of only one more hike, but persistent inflation could keep the policy of alternate meeting hikes in play longer than the market anticipates.

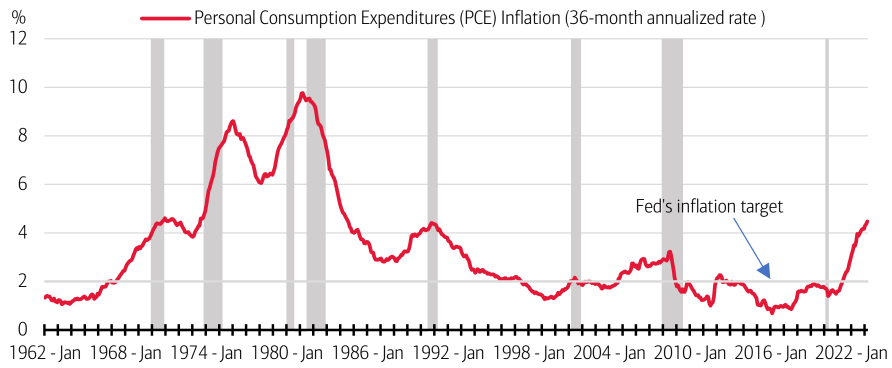
Investment Implications

Tight liquidity makes cash and high-quality Fixed Income assets more attractive as the economy slides into recession. Gold can provide a hedge if the Fed backs off its inflation fight.

The key will be how rapidly inflation comes down over the rest of the year and, perhaps more importantly, how much inflation the Fed decides to tolerate over the next few years. While policymakers have made clear they still plan to target 2% inflation and are not thinking of raising that target as many suspect, they are operating with a statement of long-term goals that currently are inconsistent with inflation averaging as low as 2% over time. The Fed has not updated its amended long-term inflation goals statement from August 27, 2020, which explicitly called for inflation to run above 2% to make up for prior shortfalls. At that time, the formal Statement on Longer-Run Goals and Monetary Policy Strategy was changed to state that *"in order to anchor longer-term inflation expectations at this level, the Committee seeks to achieve inflation that averages 2% over time, and therefore judges that, following periods when inflation has been running persistently below 2%, appropriate monetary policy will likely aim to achieve inflation moderately above 2% for some time."*

Exhibit 1 shows the 36-month moving average of the Fed's preferred inflation gauge, the personal consumption expenditures (PCE) price index growth rate. A three-year average is used to indicate persistence rather than mere transitory fluctuations from target. As shown, prior to the 2020 shift in Fed policy noted above, which was the result of a prolonged examination of available options to better achieve policy goals, inflation had consistently fallen below its 2% target since the Great Financial Crisis of 2008-2009. As also shown in the exhibit, inflation has been persistently running well above the Fed's target since the 2020 shift toward tolerating periods of higher inflation.

Exhibit 1: Inflation Persistently Above the Fed's 2% Target.



Gray bars represent recession periods. Sources: Bureau of Economic Analysis/Haver Analytics. Data as of May 23, 2023.

This raises two questions. First, how long will the Fed let inflation run above target? Second, will the Fed acknowledge that the asymmetric bias toward higher inflation is inconsistent with the 2% average inflation rate over time? In other words, will the Fed explicitly recognize that a credible 2% inflation average also implies a moderately below 2% inflation average for some time following periods of persistently above 2% inflation?

As shown in Exhibit 1, inflation has been running near 5% for the past three years. How much of that excess, if any, does the Fed plan to correct with future policy? Fed Chair Powell has been silent on this issue. The market seems to be assuming that the Fed will be satisfied to get inflation back to 2% but not below. Assuming this is true, and that the Fed keeps its currently asymmetric bias, it follows that the actual inflation rate will run above 2% until policy also aims to correct for overshoots by letting inflation run below 2% after big upside misses.

If the Fed is serious about its 2% target, we would expect policy communication that would acknowledge that a period of below 2% inflation is necessary to offset at least some of the 2021-2023 inflation overshoot, the biggest in over four decades. If not, we would expect the market to assign a higher inflation premium to longer-term yields. What is unclear is just how much higher the Fed will allow inflation to run above target and for how long.

The issue of future Fed policy and inflation has created uncertainty in the equity market. It allows for a bull scenario where inflation runs higher over time and where the Fed turns easier sooner than the 2% inflation mandate would warrant. This view, which is predominant in the interest-rate markets where several rate cuts are priced in for the next year, assumes that policymakers would not tolerate the consequences of inflation being forced below 2% for a while to make it average 2% over time. This view is also embodied in analysts' earnings expectations, which show profits bottoming in the first half of 2023 and then rising through 2024. In this view, the earnings recession is over, and a new cyclical bull market has begun.

The bearish view believes the Fed will need to stay tight longer given the big inflation overshoot of the past three years. After 13 straight monthly declines, leading indicators clearly point toward a recession, and earnings are likely to decline substantially more in a recession rather than rise from here, as the bulls hope. In that case, the bear market has not hit bottom, and it would be premature to expect a new bull cycle to have begun.

One reason for the confusion over the earnings outlook is the unknown persistence of the new higher-inflation environment. Despite stagnating real growth for over a year, nominal growth remains relatively high in mid-single digits. Inflation supports higher earnings in a recession. A look back shows nominal earnings decline more in low-inflation recessions, such as those of the four decades prior to the pandemic, than in high-inflation recessions, such as in the 1970s. Money illusion and inflation buoy earnings and nominal stock prices even as real values are eroded.

Low-inflation cycles and deflation are more damaging to nominal profits, especially in a highly leveraged world. Since debt and debt service are nominal magnitudes, inflation makes it easier to maintain leverage, while deflation makes it very difficult. This has biased the Fed toward higher inflation. Nevertheless, we suspect the Fed's policy will nudge inflation closer to 2% than the 4% or 5% pace the market has currently embraced, making a cyclical upturn unlikely anytime soon.

In sum, the debt ceiling effect on the Treasury balance at the Fed and emergency Fed lending to troubled banks reversed the decline in the monetary base that QT caused in the second half of 2022. QT and the rebuild of the Treasury balance will pull massive reserves out of the banking system, reigniting the liquidity squeeze that is causing the money supply to shrink and pull down inflation. This is likely to force the Fed to curb QT in the second half. Rate cuts, however, require much lower inflation and earnings than the market wants to believe. In our view, the ingredients for a cyclical upturn in earnings are still missing given the ongoing tightness in labor markets, the declines in leading indicators, and the Fed's stated desire to bring inflation down. Whether it's to 2% or 3%, we doubt the Fed will surrender at the current 4% to 5% inflation rate.

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MARKET VIEW

What's Driving the Rally in Big Tech?

Emily Avioli, Assistant Vice President and Investment Strategist

Big Tech stocks have been on a tear this year, with just a handful of the largest companies leading the charge. Since these companies command heavy weightings in major equity indexes, the rally has major implications for the broader market. Case in point: The three largest Tech stocks in the S&P 500 are responsible for over 50% of the YTD gain in the index.[1] When considering this outsized effect, investors are left wondering—what's driving the rally, and is it sustainable?

Big Tech's resurgence gathered steam in the early weeks of 2023, when investors were enticed by perceived discounts after 2022's selloff. The Nasdaq 100 Index, home to many of the Tech juggernauts, fell by 33% in 2022 while its forward price-to-earnings (P/E) multiple declined by 27%.[2] Investor positioning in the large Tech stocks declined in 2022 as performance deteriorated over the course of the year. This weakness presented an opportunity for investors who might have been underweight mega-cap Tech to add back to their positioning in portfolios. Optimism surrounding China's reopening and short covering by hedge fund managers also helped to support share prices early in the year.

Then came a burst of excitement about generative artificial intelligence (AI) on the heels of ChatGPT's explosive growth. The International Data Corporation (IDC) estimates that the worldwide AI market, including software, hardware and services, will grow at a compound annual rate of 18.6% through 2026 to reach $900 billion. Every sector will likely be affected, but the big Tech companies that develop the AI-related software and the semiconductor chip makers that enable AI processes would be among the most obvious beneficiaries.

Banking sector stress provided an additional boon to Tech stocks after the failures of two prominent regional banks spooked investors and sparked concerns about the health of the broader industry. A flight-to-safety rotation ensued, with investors flocking to big Tech companies with strong fundamentals to hide out and weather the storm. Fund manager allocation to Tech has risen by 22% since the regional bank turmoil began in early March, marking the highest two-month increase in allocation since March of 2009.[3]

The regional banking stress also bolstered the outlook for the Fed to pause its aggressive interest rate hiking cycle at the June Federal Open Market Committee (FOMC) meeting, which is in line with BofA Global Research's forecast for a terminal rate of 5% to 5.25% and rate cuts beginning in early 2024. Growing expectations for a Fed pause provided yet another boost for rate-sensitive Tech stocks. That's because lower interest rates create a more favorable backdrop for long-duration, growth-oriented Equities, as their stock price is more closely tied to their terminal value rather than their near-term cash flows. Concurrently, lower interest rates support higher valuation multiples on Tech stocks.

At the same time, plans to reduce headcount, freeze hiring, and slash expenditures have been met with investor enthusiasm, easing concerns about pandemic-era spending sprees and bringing back more disciplined capital expenditures in the industry. Headline-grabbing cost-cutting programs helped produce Q1 earnings results that were largely better than feared. The blended year-over-year (YoY) Q1 earnings-per-share (EPS) decline for the S&P 500's Tech sector has improved to -10.4% today from -15.1% at the end of March, and positive surprises from the biggest Tech companies substantially contributed to the decrease in the estimated overall decline for the index.[4] Earnings results suggested that mega cap Tech companies generally maintain strong balance sheets, durable revenue streams, and above-average profit margins, adding fuel to the rally's fire.

Investment Implications

In our view, the competing headwinds and tailwinds for the Information Technology sector warrant a neutral stance for now. Overall, we remain neutral both Equities and Fixed Income with plans to remain tactical during any future bouts of volatility.

[1] Bloomberg. As of May 22, 2023.

[2] Bloomberg. May 23, 2023.

[3] BofA Global Research Global Fund Manager Survey. May 16, 2023.

[4] FactSet Earnings Insight. May 19, 2023.

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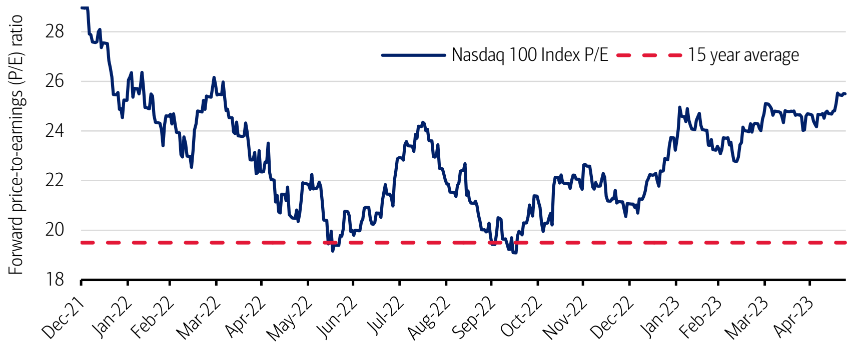
But despite these tailwinds, the durability of the big Tech rally is up for debate. Recently, the strong performance has ignited concerns about inflated valuations. The Nasdaq 100 Index's P/E has risen by about 20% in 2023 and is now hovering around 25.5x, well above its long-term average of 19.5x (Exhibit 2). The market's bifurcation is also raising eyebrows, with some speculating that weak equity market breadth could ultimately portend the rally. Furthermore, certain technical indicators are flashing worrisome signals—the relative strength of the Nasdaq 100 Index is at a level of roughly 69, with some investors believing that a level of 70 represents overbought territory.[5]

Exhibit 2: After Falling in 2022, Big Tech Valuations Have Risen in 2023.



Sources: Bureau of Economic Analysis/Haver Analytics. Data as of May 23, 2023.

The shifting macro backdrop could also present headwinds. The so-called "flight to safety" could start to reverse course when investors get more clarity about the immediate future—a resolution in debt-ceiling negotiations or more concrete signs of recovery in the regional banking industry could trigger this. Certain pockets of the economy could continue to show signs of resilience and reassure investors that the upcoming recession will be milder than anticipated, encouraging rotations toward more cyclical areas. And albeit unlikely, investors are still pricing in a 25% probability that the Fed could double down on its "higher-for-longer" stance and continue hiking interest rates at the June meeting, which could dampen big Tech's momentum.[5]

In the long run, however, we think that big Tech will benefit from numerous secular tailwinds. We remain positive on growth trends for cloud computing, machine learning/AI, data centers, software, cybersecurity and semiconductors. Tech is deflationary by nature, and we think that long-term investors should look to add to transformational and industry-leading businesses on any potential near-term weakness. Adding it all up, we think that neutral positioning in the Tech sector makes sense for now, with a bias toward higher-quality and more fairly valued companies with both strong free cash flows and solid balance sheets.

[5] Bloomberg. May 23, 2023.

THOUGHT OF THE WEEK

Tactical Sympathy, Strategic Disagreement

Rodrigo C. Serrano, CFA®, Director and Senior Investment Strategy Analyst

Efforts toward a rapprochement have characterized recent geopolitical developments. High-level diplomatic exchanges have been more frequent. Earlier this year, top-level European officials visited China, aiming to recalibrate the relationship. Their main message emphasized an economic "de-risking" instead of a more jarring "decoupling." Reflecting the agenda established by U.S. and Chinese presidents Joe Biden and Xi Jinping at the G20 summit in Bali last November, U.S. Commerce Secretary Gina Raimondo has spoken with her Chinese counterpart. Meanwhile, talks are underway to realize visits to Beijing by U.S. Treasury Secretary Janet Yellen and Secretary of State Anthony Blinken. Meanwhile, China's greater openness to these high-level exchanges reflects a mutual interest in stabilizing relations. Its effort toward negotiating peace between Russia and Ukraine constitutes greater diplomatic weight toward ending the war.

"A full separation of our economies would be disastrous for both countries."—Janet Yellen, April 2023

We believe a major impetus behind these developments lies in mutually assured destruction, a principle of deterrence that prevailed during the Cold War. Today's version would deter a deleterious quickening of de-globalization, akin to a significant economic fragmentation which may regress productivity gains built over decades. This policy guardrail is illustrated not only by Europe's more circumspect approach to its relationship with China, among countries in other regions, but also by warnings from multilateral organizations of the potential fallout. Amid elevated economic uncertainty already, world opinion over how the U.S.-China relationship is managed constitutes a related check, in our view.[6] A positive long-term scenario may comprise a well-handled dual track where the effects of cooperation in areas of shared interest dominate those emanating from a surgical division within areas of competition.

Yet there are reasons to believe that these sympathies may be more tactical in nature and mask strategic disagreements, entangling national security concerns. We believe the calculus underpinning the political economy of globalization has shifted. From a business focus, rooted in minimizing costs and maximizing efficiencies, there is now a greater scrutiny of its long-run implications. Reflecting apprehension over some of these, certain governments have supported announcements by private sector firms, which aim to reshape technological supply chains.[7] Further measures to raise barriers to the flow of information and capital are contemplated.[8]

A shared view in China believes these measures are designed to suppress the country's development and undermine its political system while sustaining U.S. geopolitical hegemony. Among other initiatives is a crackdown on foreign consultancy firms, headed by China's current spymaster, the implementation of an austere cybersecurity regulatory framework and moves to incorporate the yuan in international trade.

In our view, these developments overall indicate a general climate of mutual mistrust that may strengthen political inertia while presenting near-term headline risk. One of various examples, skepticism of China's credibility as a reliable broker could jeopardize a quicker resolution to the Russia/Ukraine conflict. Moreover, measures seen as tilting the trajectory of the war or undermining its strategic aims could induce an escalation, in our view.

Investment Implications

Our tactical view is influenced by an uncertain geopolitical environment. Beyond these concerns, the consequences from the reorganization of supply chains may present opportunities within recipient countries of increased foreign direct investment, such as Japan, Mexico, India and Vietnam, among others. Efforts to ensure resource security also suggest long-term value in Real Assets, in particular Commodities.

[6] "G-7 Struggles to Win over Swing Nations Courted by China, Russia," Bloomberg, May 21, 2023.

[7] "Global chipmakers to expand in Japan as tech decoupling accelerates," *Financial Times*, May 18, 2023.

[8] "U.S. bill proposes to keep Chinese firms out of federal government retirement plan," *South China Morning Post*, May 18, 2023.

MARKETS IN REVIEW

Equities

	Total Return in USD (%)			
	Current	WTD	MTD	YTD
DJIA	33,093.34	-1.0	-2.7	0.7
NASDAQ	12,975.69	2.5	6.2	24.4
S&P 500	4,205.45	0.3	1.0	10.3
S&P 400 Mid Cap	2,442.85	-0.5	-1.8	1.2
Russell 2000	1,773.02	0.0	0.4	1.3
MSCI World	2,827.93	-0.5	-0.1	9.6
MSCI EAFE	2,080.91	-2.3	-2.4	8.8
MSCI Emerging Markets	972.86	-0.4	-0.3	2.5

Fixed Income†

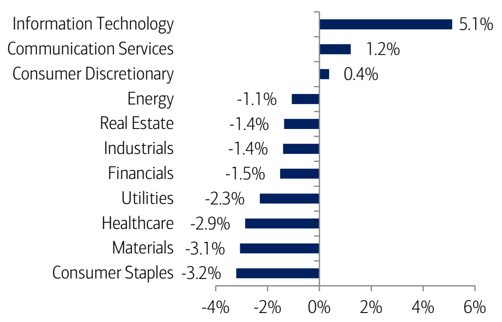
	Total Return in USD (%)			
	Current	WTD	MTD	YTD
Corporate & Government	4.74	-0.60	-2.31	1.42
Agencies	4.79	-0.53	-0.98	1.51
Municipals	3.71	-0.61	-1.38	1.13
U.S. Investment Grade Credit	4.79	-0.67	-2.31	1.20
International	5.55	-0.35	-2.57	1.62
High Yield	8.85	-0.36	-1.21	3.34
90 Day Yield	5.23	5.22	5.03	4.34
2 Year Yield	4.56	4.27	4.01	4.43
10 Year Yield	3.80	3.67	3.42	3.87
30 Year Yield	3.96	3.93	3.67	3.96

Commodities & Currencies

	Total Return in USD (%)			
Commodities	Current	WTD	MTD	YTD
Bloomberg Commodity	222.48	-0.9	-3.7	-9.5
WTI Crude $/Barrel††	72.67	1.6	-5.4	-9.5
Gold Spot $/Ounce††	1946.46	-1.6	-2.2	6.7

	Total Return in USD (%)			
Currencies	Current	Prior Week End	Prior Month End	2022 Year End
EUR/USD	1.07	1.08	1.10	1.07
USD/JPY	140.60	137.98	136.30	131.12
USD/CNH	7.07	7.02	6.93	6.92

S&P Sector Returns



Sources: Bloomberg; Factset. Total Returns from the period of 5/22/2023 to 5/26/2023. †Bloomberg Barclays Indices. ††Spot price returns. All data as of the 5/26/2023 close. Data would differ if a different time period was displayed. Short-term performance shown to illustrate more recent trend. **Past performance is no guarantee of future results.**

Economic Forecasts (as of 5/26/2023)

	2022A	Q1 2023E	Q2 2023E	Q3 2023E	Q4 2023E	2023E
Real global GDP (% y/y annualized)	3.6*	-	-	-	-	2.9
Real U.S. GDP (% q/q annualized)	2.1	1.3	1.0	-1.0	-2.0	1.1
CPI inflation (% y/y)	8.0	5.8	4.1	3.3	2.9	4.0
Core CPI inflation (% y/y)	6.1	5.6	5.2	4.4	3.6	4.7
Unemployment rate (%)	3.6	3.5	3.5	3.8	4.3	3.8
Fed funds rate, end period (%)	4.33	4.83	5.13	5.13	5.13	5.13

The forecasts in the table above are the base line view from BofA Global Research. The Global Wealth & Investment Management (GWIM) Investment Strategy Committee (ISC) may make adjustments to this view over the course of the year and can express upside/downside to these forecasts. Historical data is sourced from Bloomberg, FactSet, and Haver Analytics. **There can be no assurance that the forecasts will be achieved. Economic or financial forecasts are inherently limited and should not be relied on as indicators of future investment performance.**

A = Actual. E/* = Estimate.

Sources: BofA Global Research; GWIM ISC as of May 26, 2023.

Asset Class Weightings (as of 5/2/2023)

	CIO View				
Asset Class	Underweight		Neutral		Overweight
Global Equities			●		
U.S. Large Cap Growth			●		
U.S. Large Cap Value				●	
US. Small Cap Growth			●		
US. 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*					
Hedge Funds			●		
Private Equity			●		
Real Assets			●		
Cash					

*Many products that pursue Alternative Investment strategies, specifically Private Equity and Hedge Funds, are available only to qualified investors. CIO asset class views are relative to the CIO Strategic Asset Allocation (SAA) of a multi-asset portfolio. Source: Chief Investment Officse as of May 2, 2023. All sector and asset allocation recommendations must be considered in the context of an individual investor's goals, time horizon, liquidity needs and risk tolerance. Not all recommendations will be in the best interest of all investors.

CIO Equity Sector Views

	CIO View				
Sector	Underweight		Neutral		Overweight
Healthcare					●
Energy				●	
Utilities				●	
Consumer Staples			●		
Information Technology			●		
Communication Services			●		
Industrials			●		
Financials			●		
Materials		●			
Real Estate		●			
Consumer Discretionary	●				

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Index Definitions

Securities indexes assume reinvestment of all distributions and interest payments. Indexes are unmanaged and do not take into account fees or expenses. It is not possible to invest directly in an index. Indexes are all based in U.S. dollars.

S&P 500 Index is a stock market index tracking the stock performance of 500 of the largest companies listed on stock exchanges in the United States.

Personal consumption expenditures (PCE) price index is a measure of the prices that people living in the United States, or those buying on their behalf, pay for goods and services.

Nasdaq 100 Index is a stock market index made up of 101 equity securities issued by 100 of the largest non-financial companies listed on the Nasdaq stock exchange.

S&P 500 sub-sectors and industry groups Global Industry Classification Standard (GICS®) Index including Information Technology; Consumer Discretionary; Industrials; Real Estate; Communication Services; Materials; Financials; Consumer Staples; Utilities; Energy; Healthcare; Pharmaceuticals; Banks; Telecommunications; REITS.

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Nonfinancial assets, such as closely-held businesses, real estate, fine art, 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 in the best interest of all investors. Always consult with your independent attorney, tax advisor, investment manager, and insurance agent for final recommendations and before changing or implementing any financial, tax, or estate planning strategy.

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