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Capital Market Outlook

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Macro Strategy—*A War-like Policy Response from a Unified Federal Reserve and Treasury: Parallels between WWII and Coronavirus Eras:* While no two business cycles are ever exactly alike, there continue to be significant parallels between the post-World War II (WWII) era and today. Both eras have been characterized by an interventionist Federal Reserve (Fed), higher-than-average public deficits, and excessive increases in money supply, which facilitated high nominal gross domestic product (GDP) growth and eventually very high inflation.

The post-WWII era then saw slowing monetary growth leading to disinflation and even deflation, although it took three separate spikes in inflation in a decade before inflation was finally contained. So far, post-pandemic has seen one inflationary spike and one ongoing contraction in money supply, which has also been similarly disinflationary thus far. The parallels and implications for the current environment are worth considering.

Market View—*Portfolio Construction for Turbulent Times: Think Hard Hats, Hard Assets and Hard Power:* U.S. industrial policies have never been as robust and muscular as today. While investors remain guarded and cautious near term for numerous reasons, investors should recognize and position for the coming multiyear boom in U.S. infrastructure and the concomitant surge in demand for energy and various commodities.

Think hard hats (or infrastructure) and hard assets (commodities). Also think hard power given the great power rivalry between the U.S. and China, and the boom in global military expenditures.

Thought of the Week—*SPACs: Proof That Fads Fade:* Special purpose acquisition companies (SPACs) surged to popularity during the pandemic era, as easy credit and abundant liquidity conditions stoked risk appetite and fueled gains in more speculative investments.

But now, the SPAC boom has started to go bust under the pressure of a shifting market environment. In our view, the swift rise and fall of SPACs emphasizes the importance of staying true to a carefully crafted long-term investing plan.

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Emily Avioli
Assistant Vice President and Investment Strategist

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Data as of 5/8/2023, 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.

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MACRO STRATEGY

A War-like Policy Response from a Unified Fed and Treasury: Parallels between WWII and Coronavirus Eras

Matthew Diczok, Managing Director and Head of CIO Fixed Income Strategy

Economists and policymakers who focus as much on history as they do on theory have a much better ability to understand the implications of monetary and fiscal policy on both economies and markets. In that vein, while no two business cycles are ever exactly alike, there continue to be significant parallels between the post-WWII era and today. Both eras have been characterized by an interventionist Fed, higher-than-average public deficits, and excessive increases in money supply, which facilitated high nominal GDP growth and eventually very high inflation. The post-WWII era then saw slowing monetary growth leading to disinflation and even deflation, although it took three separate spikes in inflation in a decade before inflation was finally contained. So far, post-pandemic has seen one inflationary spike and one ongoing contraction in money supply, which has also been similarly disinflationary thus far.

When considering both eras, it is instructive to understand that the Fed (by virtue of the Federal Reserve Act) has been and always will be a creature of Congress. The current preference of Fed independence from politics—separating monetary and fiscal policy to focus on maintaining price stability—is an idealized construct that unfortunately bears little to no resemblance to history. During WWII, the Fed was essentially a direct agent of the U.S. Treasury and did not shy away from this role: *"During the war, the primary duty of the Federal Reserve was to facilitate the financing of military requirements and of production for war purposes."*[1] Starting in 1942, the Fed simply fixed interest rates to aid the wartime financing effort. One-year rates were set at 0.875%, while bonds with 25 years or more to maturity were fixed at 2.5%. Creating an artificial and positively sloped yield curve caused banks to sell short-dated bills to the Fed (through open market operations) while buying longer-dated debt, increasing the Fed's balance sheet. This led to the Fed being the indirect financier of the federal government, but it soon became a direct financier as well. In 1942, the Second War Powers Act authorized the Fed to purchase securities directly from the U. S. Treasury as opposed to simply making purchases in the secondary market. In this way, auctions of U. S. Treasurys at fixed interest rates would never fail due to a lack of private demand. The public sector (via the Fed) could simply buy any unsold bonds from the U.S. Treasury and hold them for resale if and when the market would buy them below the fixed interest rate set by the Fed. Thus, the Fed was essentially an executor of the U.S. Treasury's financing activities. It directly supported the federal government's fiscal policies by helping finance them as opposed to acting as an independent body responsible for managing the monetary base and economic activity.

The result of this combined activity was higher-than-typical federal government deficits (financed by central bank balance sheet expansion), money supply growth, nominal GDP growth and—eventually and predictably—inflation. Annual U.S. deficits as a percentage of GDP peaked at more than 26% in 1942,[2] while money supply growth peaked at close to 35% in March of 1947.[3] Both those statistics have remained the highest levels ever seen by a wide margin; only the post-pandemic era has produced anything remotely similar.

This has obvious parallels to the current era. Instead of directly financing the federal government's wartime production spending as in WWII, the Fed indirectly financed the federal government's stimulus payments to American citizens effectively furloughed by the coronavirus. As opposed to fixing short and long rates as in WWII and buying bonds directly from the U.S. Treasury at new issue, the Fed set short rates at zero and bought longer-dated securities from commercial banks in the secondary market. While mechanically different, the outcome was the same: large deficits financed by a sizable increase in central bank balance sheet, which led to significantly higher money supply and high inflation with a lag.

In the WWII era, the lag between money supply growth and inflation was substantially longer by several years, as there were wartime price and wage controls that helped to

Investment Implications

We remain up-in-quality across Equities and Fixed Income, favoring U.S. Treasurys in Fixed Income. While normally our lean would be to get long duration at this point in the rate hike cycle, we are still cautious about Fed future actions reigniting inflation as has occurred historically, and therefore currently maintain our neutral stance on duration for now, looking for opportunities to lengthen duration in the future if conditions warrant.

[1] "The Federal Reserve System: Its Purposes and Functions," Federal Reserve, 1947. This article draws largely from *A History of the Federal Reserve, Volume 1: 1913-1951*, Allan Meltzer, 2003.

[2] Federal Surplus or Deficit as Percent of Gross Domestic Product, FRED Economic data, St. Louis Fed.

[3] M2 Money Supply, National Bureau of Economic Research.

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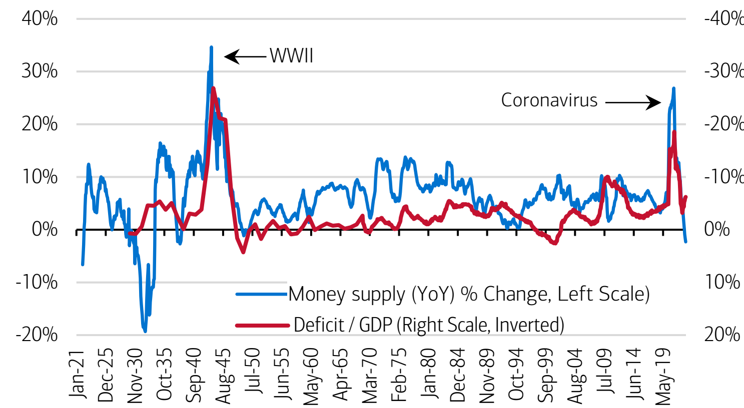
subdue inflation readings. The removal of those controls in 1946 finally let the inflation genie out of the bottle, and consumer price index (CPI) hit 19.7% year-over-year (YoY) by a year later. This entire episode led to the "Treasury-Fed Accord" in March of 1951, which effectively separated the federal government's debt management policy (via the U.S. Treasury) from its implementation of monetary policy (via the Fed). This "independence" is considered to be the foundation for the modern Fed.

Exhibit 1: Deficits, Money Supply and Inflation: The WWII and Post-Coronavirus Parallels.

1A) Massive Fed-Financed Deficits in the WWII and Coronavirus Eras Led to Significant Increases in the Money Supply.



1B) Massive Increases in Money Supply in the WWII and Coronavirus Eras Led to Significant Inflation, With a Lag.

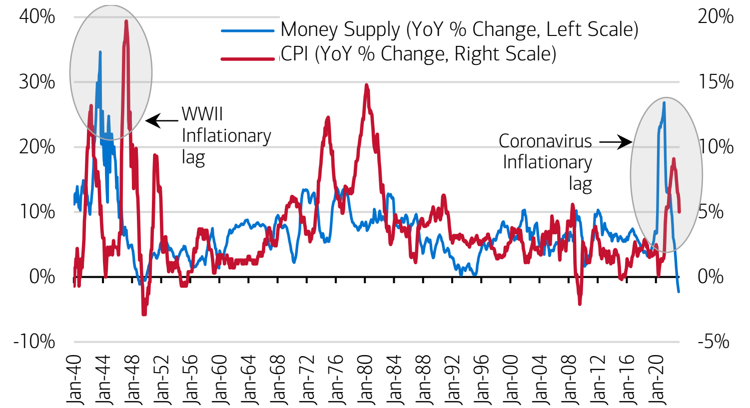


Exhibit 1A: Sources: National Bureau of Economic Research; Federal Reserve, FedEconomic Data (St Louis Fed.). Data as of April 2023. Exhibit 1B) Sources: National Bureau of Economic Research; Federal Reserve, Fed Economic Data (St Louis Fed); Bureau of Labor Statistics. Data as of April 2023.

The inflationary lag was approximately only 18 months in the post-pandemic era, which is more normal. Inflation reached "only" 9.1% this time, as changes in how inflation is calculated now versus prior eras—house prices used to be directly included in CPI, as opposed to the current construct of "owner's equivalent rent"—shave approximately 3% to 4% from annual CPI readings versus the prior methodology. What is most interesting about the current environment is that—unlike WWII—there was never any direct or indirect pressure from the federal government for the Fed to finance these deficits, nor was there any pushback from any Fed officials that this policy of balance sheet expansion was potentially unwise or even inflationary. In fact, it was completely the opposite. The Fed, in a historical echo of WWII, quite willingly (yet unwittingly) became again—effectively—an agent of the U.S. Treasury. Fed Chair Powell proclaimed that inflation was "transitory" and thereby helped the Fed aid and abet what former U.S. Treasury Secretary Larry Summers correctly warned was the federal government's "least responsible macroeconomic policy we've had in the last 40 years." The parallels are quite remarkable.

As money supply growth has now gone negative, deficits have normalized, interest rates have risen, central bank balance sheets have stopped expanding and started to contract, and bank lending standards continue to tighten, the strong disinflationary trends should continue in our opinion, and the peak of the inflationary spike should be behind us. However, we would note that in two prior episodes of high inflation—post-WWII and the 1970s—there were three separate and distinct inflationary spikes before inflation was finally subdued. Therefore, while we are up-in-quality across Equities and Fixed Income and favor U.S. Treasurys to spread products (corporates, Mortgage-backed Securities, municipals) in Fixed Income, we are still neutral on duration. While our lean would be to get longer duration potentially, we are still concerned about Fed future actions reigniting inflation as has occurred historically. We therefore maintain our neutral stance on duration for now, looking for opportunities to lengthen durations if rates rise further, the economy deteriorates so much that further inflationary spikes become less of a risk, or the Fed's resolve to meet the 2% inflation target—even if it engenders a severe recession—becomes clearer.

MARKET VIEW

Portfolio Construction for Turbulent Times: Think Hard Hats, Hard Assets, and Hard Power

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

Lauren J. Sanfilippo, Director and Senior Investment Strategy Analyst

We don't expect the chop and the churn of the capital markets to wane anytime soon. That said, and thinking opportunistically over the longer term, we suggest that investors gain exposure to 1) hard hats—or leading infrastructure-related industrial companies; 2) hard assets—or leading metal/minerals/material providers; and 3) hard power—or large and leading defense contractors. We briefly examine each investment solution below.

Investment Implications

Not unexpectedly, manufacturing activity in the U.S. is slowing due to weaker growth and tighter lending standards. A cyclical slowdown is ahead; however, on a secular, longer-term basis, the U.S. is on the cusp of a multiyear expansion in infrastructure spending, which is bullish for industrial leaders and various commodities. Meanwhile, the unfolding Cold War keeps us long defense and cybersecurity solutions.

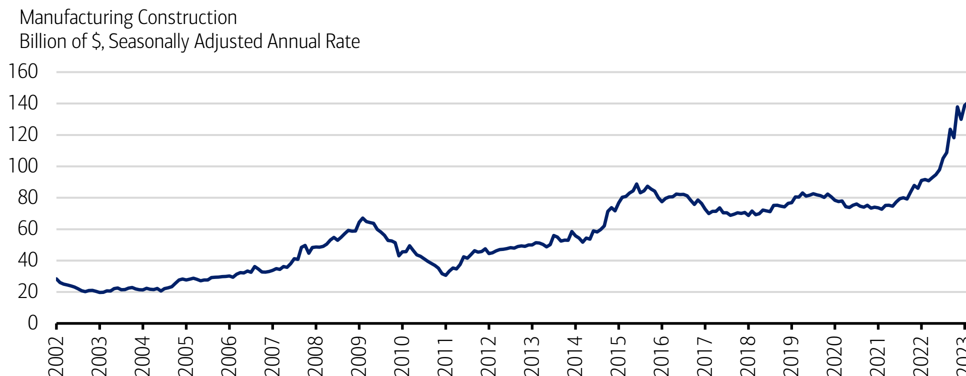
Hard Hats (Infrastructure)

While the U.S. economy pivots around services and consumption, building things (roads, bridges, airports, power stations, factories, machinery, etc.) is back in vogue in America. We believe the U.S. is in the early stages of a multiyear, supercycle in infrastructure spending for a number of reasons. One, America's physical infrastructure is simply crumbling after decades of public sector underinvestment. Two, the commitment to a more decarbonized future has spurred billions of dollars in new investment in the infrastructure of green energy/renewables. Three, the pandemic exposed glaring infrastructure inequalities around internet readiness in the U.S., with inner city and rural areas lagging in terms of internet accessibility and affordability. And four, with China now viewed as a strategic competitor, rather than strategic partner, the U.S.-China Cold War pivots around advanced capabilities in 5G, smart grids and a connected/tech-driven infrastructure. The latter will largely determine who leads the race for technological supremacy in the 21st century and was a key catalyst for the 2021 Infrastructure Investment and Jobs Act. The latter entails some roughly $1 trillion in spending on infrastructure over the next decade, according to government estimates.

Meanwhile, the Inflation Reduction Act includes some $369 billion in tax credits and other incentives for clean technologies, while the 2022 Chips and Science Act includes $39 billion in funds to underwrite more semiconductor manufacturing and another $24 billion in manufacturing tax credits. Separately and collectively, these are large figures; rarely have U.S. industrial policies been as muscular as today.

All the above, not surprisingly, has triggered a boom in manufacturing construction spending, which rose to a record annualized high of $147 billion in March of this year versus less than $80 billion during the depths of the recessionary period of the pandemic (Exhibit 2).

Exhibit 2: Record Spending on Manufacturing Construction Heralds a U.S. Production Rebound.



Source: Census Bureau. Data as of March 2023.

In terms of asset allocation, all the above means gaining more exposure to infrastructure-related industrial companies and leaders in renewables (solar, wind, electrical vehicles, biomass) and the required infrastructure behind each renewable energy source. Leaders in electricity distribution, charging stations and batteries, as well as low-carbon hydrogen, biomethane and advanced biofuels, should be included in portfolios. Ditto for leaders in low-carbon technologies (LED lightning, smart energy meters and storage), and leaders in transmission technologies.

Hard assets (energy/metals/minerals)
Going green and clean on energy, coupled with the massive upgrading of America's physical infrastructure, means more underlying secular demand for traditional energy resources as well as strategic metals/minerals like lithium, cobalt, copper and many other resources. As we have noted in the past, the push to boost renewable power capacity (think solar, wind and batteries) is extraordinarily metal-intensive, requiring more minerals than fossil fueled-based counterparts. Per a report from the International Energy Agency ("The Role of Critical Minerals in Clean Energy Transitions"):

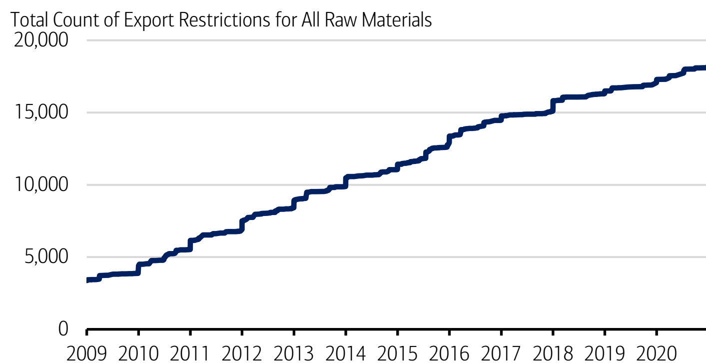
"A typical EV requires six times the mineral inputs of a conventional car, and an onshore wind plant requires nine times more mineral resources needed than a gas-fired plant. Since 2010, the average amount of new minerals needed for a new unit of power generation capacity has increased by 50% as the share of renewables has risen."

Meanwhile, juxtaposed against strong secular demand for strategic commodities is soaring resource protectionism, a combination that will likely keep, over the long term, a premium on resource prices and extraction. As depicted in Exhibit 3A, the number of export restrictions on critical minerals according to the Organisation for Economic Co-operation and Development (OECD) had increased more than fivefold over the past decade, surging to over 18,000 by December 2020 versus just over 3,000 in 2009. We remain long-term commodity bulls.

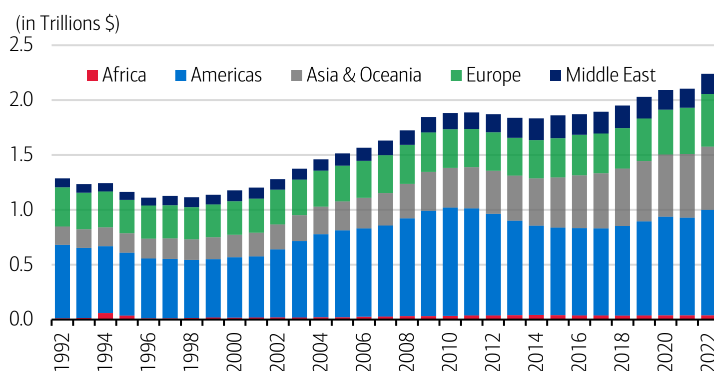
Hard Power (Defense/cybersecurity)
We are also long-term bulls on leading defense/cyber companies. Why? Because Russia's invasion of Ukraine and China's growing military might have upended the global geopolitical landscape. The Cold War of the 2020s means hard power is back; soft power is out. Arms sales are a growth industry, with global military outlays topping a record $2.24 trillion last year, according to Stockholm International Peace Research Institute (Exhibit 3B). Military expenditures, according to the Institute, have grown by nearly 20% over the past decade and have increased each year since 2015.

Exhibit 3: A Sign of the Times: Soaring Export Restrictions and Increased Defense Spending.

3A) Export Restrictions on Critical Materials.



3B) Global Defense Spending Ratcheted Up Last Year to $2.24 Trillion.



Left Exhibit: Source: OECD Database on Export Restrictions on Industrial Raw Materials. Data through December 2020. Right Exhibit: Source: Stockholm International Peace Research Institute. Data as of April 2023.

Leading the charge is the U.S., whose defense budget totaled a record high of $858 billion fiscal year 2023. Meanwhile, various nations in Europe (Poland, Germany and France, for instance) and Asia (Japan and South Korea) are also on track for record military outlays in the immediate years ahead. Ditto for China, whose military expenditures in 2021 ($293 billion) was more than 25 times the level of 1990 (roughly $12 billion), according to figures from the World Bank.

Wars are being fought both physically and digitally, with global expenditures on cybersecurity expected to reach a record high of $219 billion in 2023, according to International Data Corporation (IDC). That's an increase of over 12% from the prior year; by 2026, the IDC expects expenditures to top $300 billion due to rising risks of increased cyberattacks on both public and private sector institutions and activities.

In terms of portfolio construction—and given an investment backdrop fraught with heightened geopolitical risks—we have and remain constructive on Large-cap U.S. defense contractors, and continue to favor cybersecurity leaders.

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THOUGHT OF THE WEEK

SPACs: Proof That Fads Fade

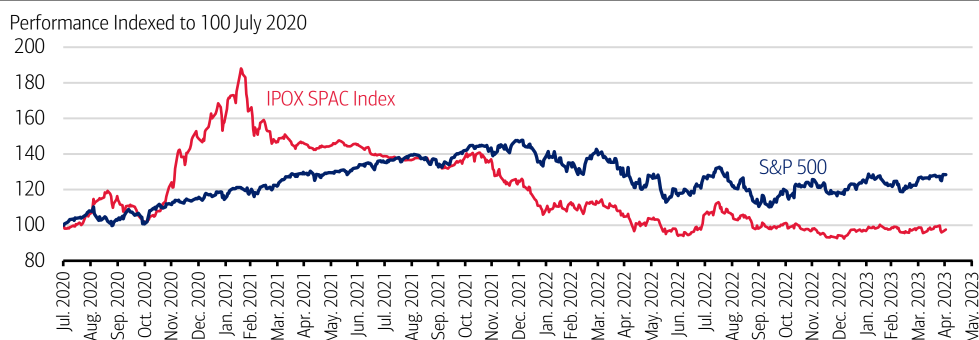
Emily Avioli, Assistant Vice President and Investment Strategist

Hayley Licata, Wealth Management Analyst

After surging to popularity during the pandemic-era investing frenzy, special purpose acquisition companies (SPACs) have swiftly come back down to earth. As a refresher: SPACs, also called "blank-check companies," essentially offer a publicly traded corporate shell with no business other than seeking a merger with a privately held company wishing to go public.

Several factors make SPACs particularly appealing to small, high-risk companies in an early growth stage. Compared to a traditional initial public offering (IPO), SPACs offered fewer regulatory demands, lower fees, and a much quicker end-to-end process (as little as three to five months, compared to nine to 12 for IPOs).[4] In 2019, 59 were created. In 2020, that number quadrupled to 248, and in 2021 the number of SPACs more than doubled to 613.[5] Now, these companies are running out of steam (Exhibit 4). Research conducted by Bedrock AI that scoured regulatory documents and filings of hundreds of former SPACs found red flags pointing toward the potential for bankruptcy in nearly 40% of companies examined.[6]

Exhibit 4: SPACs Underperformance Relative to the S&P 500 Continues to Deepen.



Source: Bloomberg. Data as of May 1, 2023. **Past performance is no guarantee of future results.**

How did this happen? The easy credit and abundant liquidity conditions of the past several years stoked risk appetite, fueling gains in both traditional risk assets and more speculative investments like SPACs. Growth-hungry investors saw SPACs as an opportunity to invest in an early-stage company with the perceived potential for rapid development. Many of these businesses presented themselves as unicorns (a privately held company with a valuation of $1 billion or more) before they hit the market and drew in retail investors that were excited to gain exposure to innovation by investing in areas such as space exploration or the latest electric vehicle technology.

But the SPAC boom started to go bust under the pressure of a shifting market environment. Valuations began to crumble as financial conditions tightened, liquidity dried up, and the economic and earnings outlook soured. Fast forward to today—25 companies that went public via SPAC have lost over $100 billion in combined market value since 2020.[7] Five companies that went public via SPAC merger have already filed for bankruptcy this year, matching the total for 2022. And for those left standing, many are trading substantially lower than their initial value and face the threat of being de-listed.[8]

While certain deals could continue to lure investors, we think the overall outlook for SPACs will continue to dim as we move further away from an easy money regime. For investors, the swift rise and fall of SPACs underscores the importance of avoiding market fads in favor of a carefully crafted long-term investing plan.

Investment Implications

We have long favored investors stick to a diversified portfolio that is in line with a well-defined long-term investing strategy. The current "grind-it-out" market environment warrants our preference for a defensive stance and a high-quality tilt across asset classes.

[4] Harvard Business Review "SPACs: What you Need to Know," August 2021.
[5] SPAC Insider, April 2023.
[6] Bedrock AI "Almost 50% of de-SPAC Filings Reported Material Weakness," September 2022.
[7] Bloomberg. May 5, 2023. Refers to change in market capitalization for the De-SPAC Index.
[8] Renaissance Capital "Five SPAC Mergers Have Gone Bankrupt This Year". April 2023

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Equities

	Total Return in USD (%)			
	Current	WTD	MTD	YTD
DJIA	33,674.38	-1.2	-1.2	2.3
NASDAQ	12,235.41	0.1	0.1	17.2
S&P 500	4,136.25	-0.8	-0.8	8.3
S&P 400 Mid Cap	2,461.10	-1.2	-1.2	1.8
Russell 2000	1,759.88	-0.5	-0.5	0.4
MSCI World	2,821.99	-0.4	-0.4	9.1
MSCI EAFE	2,144.63	0.2	0.2	11.7
MSCI Emerging Markets	981.66	0.5	0.5	3.3

Fixed Income†

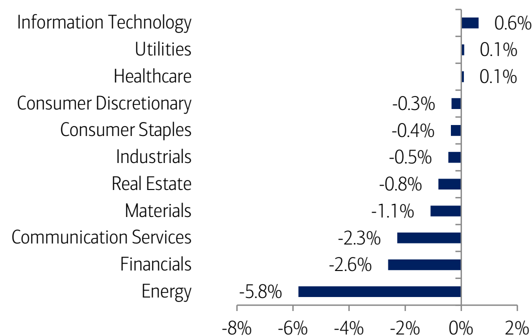
	Total Return in USD (%)			
	Current	WTD	MTD	YTD
Corporate & Government	4.25	-0.16	-0.16	3.65
Agencies	4.24	0.28	0.28	2.80
Municipals	3.34	0.35	0.35	2.90
U.S. Investment Grade Credit	4.31	-0.05	-0.05	3.53
International	5.15	-0.59	-0.59	3.68
High Yield	8.57	-0.38	-0.38	4.21
90 Day Yield	5.20	5.03	5.03	4.34
2 Year Yield	3.91	4.01	4.01	4.43
10 Year Yield	3.44	3.42	3.42	3.87
30 Year Yield	3.75	3.67	3.67	3.96

Commodities & Currencies

	Total Return in USD (%)			
Commodities	Current	WTD	MTD	YTD
Bloomberg Commodity	228.19	-1.2	-1.2	-7.2
WTI Crude $/Barrel††	71.34	-7.1	-7.1	-11.1
Gold Spot $/Ounce††	2016.79	1.3	1.3	10.6

	Total Return in USD (%)			
Currencies	Current	Prior Week End	Prior Month End	2022 Year End
EUR/USD	1.10	1.10	1.10	1.07
USD/JPY	134.80	136.30	136.30	131.12
USD/CNH	6.92	6.93	6.93	6.92

S&P Sector Returns



Sources: Bloomberg; Factset. Total Returns from the period of 5/1/2023 to 5/5/2023. †Bloomberg Barclays Indices. ††Spot price returns. All data as of the 5/5/2023 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 5/5/2023)

	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	1.1	1.0	-1.0	-2.0	1.0
CPI inflation (% y/y)	8.0	5.8	4.2	3.4	3.0	4.0
Core CPI inflation (% y/y)	6.1	5.6	5.1	4.2	3.5	4.6
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 5, 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					

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	●	·	·	·	·

*Many products that pursue Alternative Investment strategies, specifically Private Equity and Hedge Funds, are available only to qualified investors. CIO asset class views are relative to the CIO Strategic Asset Allocation (SAA) of a multi-asset portfolio. Source: Chief Investment Office as of 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.

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 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.

Consumer Price Index (CPI) measures the overall change in consumer prices based on a representative basket of goods and services over time.

IPOX SPAC Index is designed to track the aftermarket performance of Special Purpose Acquisition Companies (SPACs) which pursued initial public offerings (IPO) in the U.S.

De-SPAC Index is a rules-based pure-play portfolio of twenty-five of the largest U.S.-listed companies to come public.

Important Disclosures

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