MERRILL
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CHIEF INVESTMENT OFFICE

Capital Market Outlook

April 26, 2021

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

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- Macro Strategy—Housing plays an important role in U.S. business cycles. This cycle has been characterized by an unusually mild and short housing recession, followed by a very strong recovery and expansion. As a result, housing-related stocks have continued to outperform the market by a wide margin, and we expect the strong housing expansion to continue.
- Global Market View—The bull market in equities isn't built off a fairy tale. It's on solid footing. But that said, investors would do well to be wary of "not too hot, not too cold, but just right" talk and keep their eyes on the three bears.
- Thought of the Week—The president's American Jobs Plan lays out a sweeping set of priorities with the aim of creating jobs by addressing chronic infrastructure underinvestment, growing concerns from climate change, and demographic and development challenges. Investors should pay attention to the industries that could potentially benefit but be aware that the timing and magnitude of any spending will remain uncertain prior to legislation, and the financial benefit to companies involved may not be immediate.
- Portfolio Considerations—We retain our positive view on Equities based upon favorable relative valuations and improving global growth. We prefer a diversified mix between Growth and Value with an overweight still to the U.S. overall. In Fixed Income we prefer shorter duration exposure with a focus on credit relative to government bonds—even though we expect municipal bonds to benefit significantly from the latest fiscal rescue plan.

MACRO STRATEGY

Chief Investment Office
Macro Strategy Team

GLOBAL MARKET VIEW

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

Lauren J. Sanfilippo
Vice President and Investment Strategist

THOUGHT OF THE WEEK

Chief Investment Office
Equity Strategy Team

Data as of 4/26/2021, and subject to change

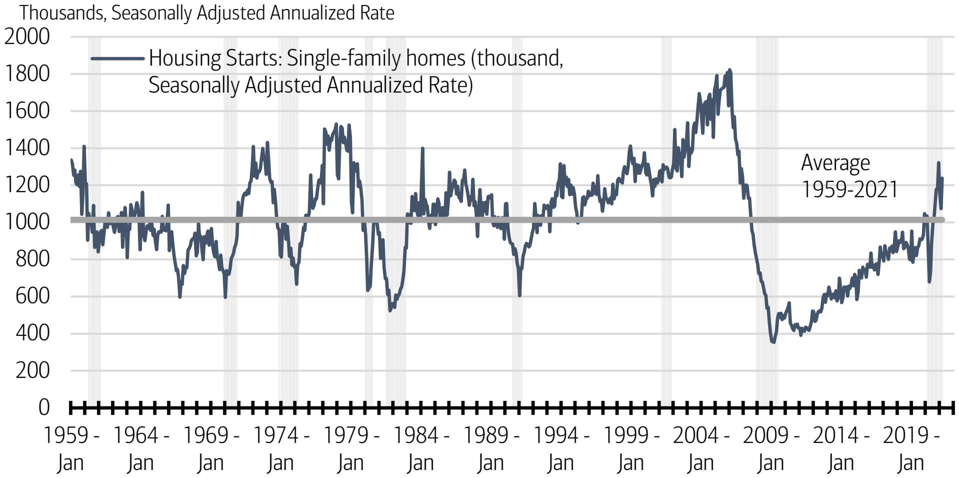
MACRO STRATEGY

Housing on Fire

Chief Investment Office, Macro Strategy Team

While accounting for only 4% of U.S. gross domestic product (GDP), residential investment has played a critical role in most business cycles, helping to power expansions and often providing early indications of impending recessions. The outsized role housing plays reflects its highly volatile pattern, largely driven by demographics, the Federal Reserve's (Fed) interest-rate policy, and other economic conditions. In the nine U.S. recessions since 1960, residential investment declined between a third and a half in all but two instances on a year-over-year (YoY) basis (Exhibit 1). On the flip side, housing usually grows faster than the overall economy during expansions. For example, even during the 2009–2019 secular-stagnation decade, residential investment grew about 5% annually on average while real GDP grew about half that pace. Despite stronger relative growth, housing construction was historically weak during this time, and as a result, the U.S. entered 2021 with a substantial shortage of new houses.

Exhibit 1: Housing Often Drives the Business Cycle.



Source: Census Bureau. Data as of April 22, 2021.

Housing-related stocks tend to reflect this strong cyclicality as their profits grow faster in expansions and fall more in recessions than those of less cyclical stocks. This is reflected in the performance of housing-related stocks, which comprises homebuilder stocks and other housing-related companies, like building-materials stocks. From its low point in March 2020, housing-related stocks roughly tripled to its peak in April 2021, while the S&P 500, for example, almost doubled over the same period, underperforming those housing-related stocks by about 60%.

There are reasons to believe that this is likely to be an unusually long and strong housing expansion. Demand is very strong because the biggest demographic cohort in history is moving through the household-formation and peak home-buying stages of its life cycle. Coronavirus-related preference changes have also sharply boosted home buying demand. At the same time, supply is unusually tight, with available homes for sale at record-low levels. Double-digit price gains are rationing the supply, but over time supply will likely respond, keeping the outlook for building very strong into the future.

These solid fundamentals are one reason the housing recession was so mild last year. As shown in Exhibit 1, housing starts fell by about a quarter between March 2020 and April 2020 before beginning a sharp recovery. In essence, the housing recession lasted just a month when the shutdown was imposed, but the quick and massive stimulus, along with the designation of homebuilding as an essential service exempted from shutdowns, helped to save the industry, which has been growing robustly ever since.

The other counter example to housing's usually prominent role in economic downturns is the 2001 recession. Consumer spending and housing sailed through that recession relatively unscathed, because the weakness was concentrated in the Technology and capital expenditures (capex) sectors after the Y2K and tech-stock bubble burst. In fact, the housing uptrend that began in the mid-1990s continued until excessive financing conditions created the home-price bubble that burst a decade later. The 2002-2007 expansion and Great Financial Crisis (GFC) of 2008-2009 illustrate how dominant housing swings can be in a business cycle.

It took housing an unusually long time to recover from the excesses of the 2002-2007 boom. Unlike the V-shaped recoveries out of most recessions, housing activity lingered at very low levels for several years while the sector healed (Exhibit 1). Prior to the GFC, recessions usually saw housing starts fall to about 800 units per year before rebounding ahead of expansions. The housing market after 2008 saw starts linger below 800 units for the better part of three years as foreclosures and tight credit kept homebuilding depressed. The recovery since then has not kept up with demand, and today the problem is tight supply.

According to a recent analysis by mortgage finance company Freddie Mac, the U.S. housing market is almost 4 million single family homes below what is needed to meet the current level of demand. Quoting Freddie Mac's chief economist, Sam Khater, an April 15, 2021, *Wall Street Journal* article notes: *"We should have almost four million more housing units if we had kept up with demand the last few years,"* Mr. Khater said. *"This is what you get when you underbuild for 10 years."* Freddie Mac reached its shortage figure by assessing the amount of single-family home building needed to match demand from household formation, second-home purchases and replacements of damaged or aging U.S. homes, and comparing that with the pace of construction.

This shortfall of homebuilding during the last expansion as housing finance healed from the excesses of the prior decade are a key reason housing-related stocks and banks underperformed the general market in the decade to 2020. Making up this shortfall should help them continue to outperform in the current expansion, in our view.

Homebuilder stocks have reflected this slow recovery out of the GFC. While the stock market rose to new highs early in the last expansion, housing related stocks lagged behind, never attaining its peak of the prior decade, when the housing boom had pushed it to record highs. By late 2020, however, it broke above the range that had confined it over the past two decades, a sign that the housing market has fully healed from the excesses of the GFC.

Importantly, from a low point of around 600,000 in 2011-2012 at the end of the worst housing recession since the 1930s, household formation has almost tripled to over 1.6 million at the end of 2020, with a particularly strong spurt during the pandemic. This key demographic force from the biggest age cohort in U.S. history, the millennials, is a powerful tailwind for continued relative outperformance of housing as a key contributor to what's shaping up as the strongest economic expansion since the early 1980s. Indeed, the National Association of Homebuilders (NAHB) latest survey finds traffic of prospective homebuyers remains very high, with no sign of slowing. Residential construction is picking up as builders react to high prices and low inventories. The shortage that accumulated over the past decade has currently created one of the hottest housing markets in memory as multiple bids for available properties spread across the country. This is bullish for builders, materials and the institutions that finance them, especially in the low interest-rate environment that is likely to prevail for the foreseeable future.

Inflation has been rising faster than interest rates over the past year, keeping real rates negative. Financing a home at negative real rates is part of the dynamic that drove the housing boom in the late 1970s, when baby boomers were at the household formation stage that millennials are today. Home prices rise in an inflationary environment, whereas cash and fixed-income assets tend to lose value in a negative real-rate environment like that of the late 1970s and early 2020s. This causes investors to shift to real assets, according to BofA Global Research.

The ratio of real assets to financial assets on household balance sheets peaked at the highest level since the 1920s at the height of the 1970s, negative real rate and high-inflation environment. Since then, it's been falling, as disinflation favored financial over real assets, reaching an all-time low in recent years. The great reflation of the 2020s favors real assets at a time when they represent a historically low proportion of household wealth. This structural rebalancing toward real as opposed to financial assets should be an additional impetus for housing to outperform in the years ahead.

GLOBAL MARKET VIEW

Don't Forget About the Three Bears

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

Lauren J. Sanfilippo, Vice President and Investment Strategist

A narrative is emerging that likens the current economic environment to a backdrop that is "not too hot, not too cold, but just right." In market speak, this means strong real U.S. economic growth with tame inflation expectations. The upshot: "just right" conditions for equities, with U.S. and many global indexes at or near record highs.

But playing off this theme, investors should not lose sight of the three bears.

Bear number one: The risk of stickier and sustained inflationary pressures as opposed to the Fed's expectations of transitory price increases. As the St. Louis Fed advised in December 2020, Americans may have to "prepare themselves for a temporary burst of inflation." Indeed, prepare they should—inflation is back, but for how long and at what level?

In March, the U.S. consumer price index (CPI) was 2.6% higher than a year earlier, the biggest increase since November 2009. Not to worry, according to the consensus, due to the "base effects" or the fact that in the spring of 2020, consumer prices fell for three consecutive months as the pandemic shut down the U.S. economy. A year later, and following massive dollops of fiscal and monetary stimulus, the YoY comparisons are trending ahead of the Fed's annual inflation target of 2%, stoking fears among some investors and prominent economists that the U.S. economy is likely set to overheat. Adding fuel to the fire, in March, the producer price index (PPI) for final demand rose to 4.2%, a figure well above consensus expectations and the biggest 12-month gain in almost a decade.

True, the pickup in inflation was expect by the markets and the Fed but the real test lies ahead. Market expectations pivot on whether or not rising prices are transitory or sticker, becoming more embedded in the cost structure of firms. What feels "just right" on the inflation front in April 2021 could be different in just a few months.

One final comment: Many economists like to note a slack labor market as a harbinger of muted inflation readings; however, when a fast food retailer was paying people $50 to just show up for a job interview and still struggles to fill positions, then maybe the labor market is a great deal tighter than consensus expectations, and wage inflation is poised to surprise on the upside.

Bear number two: The pandemic is not over, and the scar tissue from coronavirus will be deep and long-lasting. Well into the second year of the pandemic, the battle with coronavirus continues. Not only has the disease killed over three million people worldwide, but the pace and speed of coronavirus-related deaths is accelerating. Coronavirus claimed a million lives in the first nine months of the pandemic, but it took only four months to claim another million lives and just three months to claim a million more. Argentina, Brazil, Mexico, Peru, Turkey, Qatar, India—around the world the number of people infected and dying continues to rise, which portends to undermine the nascent global economic recovery and market expectations of upside global earnings growth.

The renewed surge in coronavirus is likely to create a two-speed global economy—one led by just a handful of nations like China, the United States, the United Kingdom, and Israel, with relatively effective immunization programs, versus the rest of the world struggling to contain the virus. According to Bloomberg, more than 944 million vaccinations have been given around the world—but that equates to just 6.2% of the global population; meanwhile, high-income nations are getting vaccinated about 25 times faster than lower-income states. As to the long-term effects of the disease, the World Bank estimates that the pandemic could push over 100 million into extreme poverty this year, reversing two decades of progress. According the Pew Research Center, 54 million people have slipped out of the middle class in the past year, with more falling through the cracks, notably in India, which has become the epicenter of the pandemic.

Bear number three: A messy geopolitical backdrop. It's not all quiet on the geopolitical front. At the beginning of the year, the market consensus following the four years under the Trump administration was that geopolitics as a lightning rod for market volatility and uncertainty were set to taper. That a post-Trump world would likely be defined more by diplomacy, multilateralism and cooperation versus late-night tweets, unilateralism and confrontation.

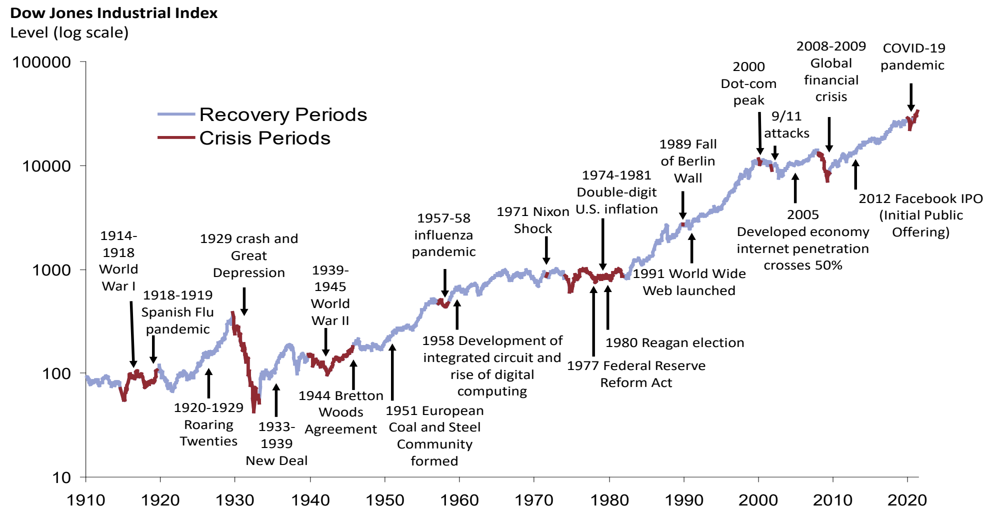
However, there has been no geopolitical reprieve under the Biden administration thus far. U.S.-Russia relations are plumbing new lows, with tit-for-tat sanctions and diplomatic expulsions sparking talk of a "new cold war." Russian military maneuvers around Ukraine have only added to bilateral tensions and upped the ante in dealing with a country that has emerged as a cyber-superpower, is a leading producer and exporter of energy (oil and gas), a global leader in weapons exports, and is the world's largest country by territory. On a purchasing power parity basis, the Russian economy is the sixth largest in the world.

Then there is China, with the U.S.-China strategic rivalry only hardening since January, a development the markets have generally ignored. Last month's U.S.-China summit in Alaska was highly contentious (at least in public) and has been followed by a number of moves and countermoves that suggest U.S.-Sino relations have gone from bad to worse in a matter of months. That's hardly a propitious indicator given that the more the U.S. and China spar over technology, trade and human rights, the greater the risk to global growth and trade. Per the latter, roughly half the world counts either China or the U.S. as their No. 1 export market. Meanwhile, as we have noted in the past, China is a significant source of earnings for many U.S. firms, with U.S. foreign affiliate income, a proxy for global earnings, totaling over $13 billion in 2020, well above what affiliates earned in 2000 ($1.2 billion). In the end, simmering geopolitical tensions could increase near-term market volatility and emerge as a stiff headwind to our expectations of a market grinding higher this year.

Investment implications: Are investors in for a mauling?

The short answer is "no." We expect the major U.S. indexes to grind higher over the near term, supported by unprecedented fiscal and monetary support, stronger-than-expected real GDP growth, above-consensus earnings growth and the gradual push toward global immunization of coronavirus. We remain constructive toward financial, industrials and energy, and long-term bullish on technology and health care. Our favored themes: cybersecurity, automation/robotics, and water and waste management. U.S. equities in our opinion remain a long-term source of wealth creation (Exhibit 2).

Exhibit 2: Equity Market and Historical Periods of Crisis and Recovery.



Sources: Chief Investment Office, Bloomberg. Data as of March 2021. Past performance is no guarantee of future results.

In the end, the bull market in equities isn't built off a fairy tale. It's on solid footing. But that said, investors would do well to be wary of "not too hot, not too cold, but just right" talk and keep their eyes on the three bears.

THOUGHT OF THE WEEK

Ambitious Vision for American Jobs and Investment

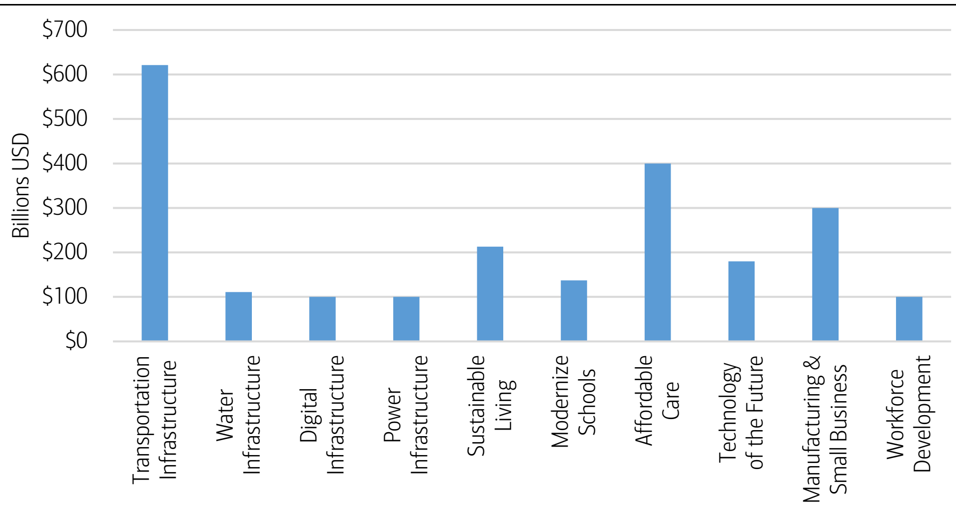
Chief Investment Office, Equity Strategy Team

The recently introduced American Jobs Plan is a wide-ranging proposal from the president that seeks to address the growing challenges of climate change and international competition while protecting and expanding the nation's advantages. This early iteration of the package indicates roughly $2.25 trillion in spending over eight years, which the White House states would be fully paid for within the next 15 years if passed alongside the Made in America Tax Plan. The amount and timing of any spending that is ultimately passed could differ based on further input through the Congressional approval and legislation process, but the broad strokes outlined thus far can be directionally indicative for investors.

The American Jobs Plan attempts to address many crucial areas from underinvestment in infrastructure to underserved and disadvantaged communities. With respect to infrastructure, the proposal targets transportation (highways, roads, bridges, ports and railways), drinking water, digital broadband and power generation, which altogether account for nearly $1 trillion in proposed spending. Another $750 billion aims to improve living standards via more affordable healthcare, sustainable housing, and modernization of schools. The remaining $500 billion is directed toward innovation for American small business, manufacturing, research & development, and evolution of the workforce.

There could likely be delays and cost overruns along the way, which would be typical for the types of projects being targeted, and the capacity available to respond to a surge in fiscal spending may fall short of expectations in the near term given the strength of the cyclical recovery already underway. Investors should expect uneven financial benefits and few windfalls for those involved. However, given the scale and scope of proposed spending, many companies could potentially benefit from a multi-year demand tailwind if the plan were enacted as outlined. Potential industry beneficiaries include: engineering and construction, metals and mining, renewable power generation, energy storage, electric vehicles, and battery manufacturing.

Exhibit 3: American Jobs Plan Proposed Spending.



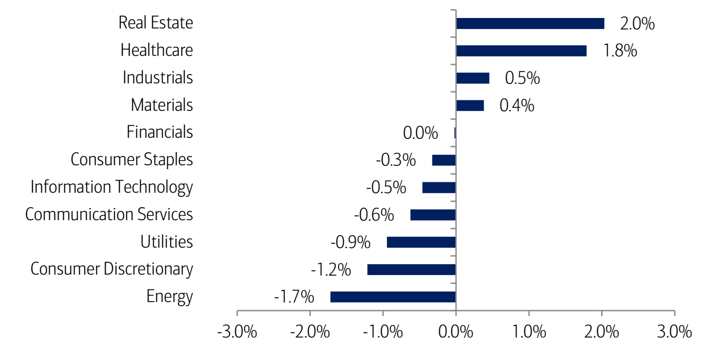
Source: whitehouse.gov. Data as of March 31, 2021.

MARKETS IN REVIEW

Equities

		Total Return in USD (%)		
	Current	WTD	MTD	YTD
DJIA	34,043.49	-0.4	3.3	11.9
NASDAQ	14,016.81	-0.3	5.8	9.0
S&P 500	4,180.17	-0.1	5.3	11.8
S&P 400 Mid Cap	2,745.71	0.9	5.3	19.4
Russell 2000	2,271.86	0.4	2.3	15.3
MSCI World	2,946.11	-0.2	4.9	10.0
MSCI EAFE	2,287.85	-0.4	3.8	7.4
MSCI Emerging Markets	1,353.02	0.3	2.9	5.2

S&P 500 Sector Returns



Fixed Income†

		Total Return in USD (%)		
	Current	WTD	MTD	YTD
Corporate & Government	1.43	0.18	1.13	-3.20
Agencies	0.74	0.08	0.54	-1.06
Municipals	1.01	0.06	1.00	0.64
U.S. Investment Grade Credit	1.50	0.13	0.97	-2.43
International	2.16	0.23	1.40	-3.31
High Yield	4.04	-0.03	0.88	1.74

	Current	WTD	MTD	YTD
90 Day Yield	0.02	0.01	0.02	0.06
2 Year Yield	0.16	0.16	0.16	0.12
10 Year Yield	1.56	1.58	1.74	0.91
30 Year Yield	2.23	2.26	2.41	1.64

Commodities & Currencies

		Total Return in USD (%)		
Commodities	Current	WTD	MTD	YTD
Bloomberg Commodity	188.75	2.2	5.9	13.3
WTI Crude $/Barrel††	62.14	-1.6	5.0	28.1
Gold Spot $/Ounce††	1777.2	0.0	4.1	-6.4
Currencies	Current	Prior Week End	Prior Month End	2020 Year End
EUR/USD	1.21	1.20	1.17	1.22
USD/JPY	107.88	108.80	110.72	103.25
USD/CNH	6.49	6.53	6.56	6.50

Sources: Bloomberg, Factset. Total Returns from the period of 4/19/2021 to 4/23/2021. †Bloomberg Barclays Indices. ††Spot price returns. All data as of the 4/23/2021 close.
Past performance is no guarantee of future results.

Asset Class Weightings (as of 4/6/2021)

	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*					
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.

Economic & Market Forecasts (as of 4/23/2021)

	Q4 2020A	2020A	Q1 2021A	Q2 2021E	Q3 2021E	Q4 2021E	2021E
Real global GDP (% y/y annualized)	-	-3.2	-	-	-	-	5.8
Real U.S. GDP (% q/q annualized)	4.1	-3.5	7.0*	10.0	9.0	5.0	7.0
CPI inflation (% y/y)	1.2	1.2	1.9	3.6	3.0	2.8	2.8
Core CPI inflation (% y/y)	1.6	1.7	1.4	2.4	2.1	2.2	2.0
Unemployment rate (%)	6.7	8.1	6.2	5.2	4.5	4.2	5.0
Fed funds rate, end period (%)	0.09	0.09	0.06	0.13	0.13	0.13	0.13
10-year Treasury, end period (%)	0.91	0.91	1.74	1.85	2.00	2.15	2.15
S&P 500 end period	3756	3756	3973	-	-	-	3800
S&P earnings ($/share)	42	140	42*	46	48	49	185
Euro/U.S. dollar, end period	1.22	1.22	1.17	1.18	1.16	1.15	1.15
U.S. dollar/Japanese yen, end period	103	103	111	107	110	113	113
Oil ($/barrel, avg. of period, WTI)**	44	40	58	64	60	58	60

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.

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 the year-end target for 2021. **West Texas Intermediate.
Sources: BofA Global Research; GWIM ISC as of April 23, 2021.

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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 dollars.

S&P 500 Index is a stock market index that measures the stock performance of 500 large companies listed on stock exchanges in the United States. It is one of the most commonly followed equity indices.

Consumer Price Index (CPI) is a measure that examines the weighted average of prices of a basket of consumer goods and services, such as transportation, food, and medical care.

Producer Price index (PPI) is a price index that measures the average changes in prices received by domestic producers for their output.

Dow Jones Industrial Average is a stock market index that measures the stock performance of 30 large companies listed on stock exchanges in the United States.

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