Capital Market Outlook

Chief Investment Office

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IN THIS ISSUE

MACRO STRATEGY

LESSONS FROM THE 10-YEAR BULL MARKET

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March 9, 2019 marked the ten-year anniversary of the equity bull market. The climb has been challenging, at times, with bouts of episodic volatility littered throughout, but ultimately investors have been treated to ten years of impressive gains that have been founded upon certain observations. In the following passages we highlight a selection of lessons that have characterized this bull.

CYCLICAL CORRECTIONS HAPPEN AND CAN BE A GOOD BUYING OPPORTUNITY

This bull market has demonstrated that global economic momentum ebbs and flows with trends in manufacturing and trade, leading to market corrections as valuations reset to reflect increased uncertainty about the future. But if/when momentum re-gathers, equities can be able to continue their ascension higher. The first quarter of 2016 offers a good example. At that time, we saw global manufacturing showing signs of contracting amid fears of a slowdown in growth, which was reflected in continued declines in sovereign yields, especially in the U.S. and Germany. Markets had just seen lift-off from the Federal Reserve (Fed) at a time when oil prices had collapsed twice, leading to fears of weakening capital spending and a recession in the U.S. at a time when S&P 500 earnings were set to decline. But oil prices eventually bottomed in February as production appeared set to back off. The dollar also weakened as the Fed paused, contributing to a rebound in global equities, especially within emerging markets (EM), as the global economy regained momentum. Disciplined investors were rewarded for holding onto equities during this turbulent period, with the S&P 500 having risen 35% as of March 11, 2019.

Part of the reason why equity markets can be susceptible to cyclical corrections emanates from their bias toward cyclical sectors of the economy. For instance, Empirical Research Partners estimates that manufacturing makes up only around 10% of gross domestic product (GDP) in the U.S. but accounts for around 40% of pre-tax earnings for public companies. Bull

Data as of 03/18/2019 and subject to change.

markets in equities, much like economic cycles, aren't linear; instead they're comprised over smaller minicycles that follow economic momentum, at times causing short-term pain, but also providing strong entry points for patient investors.

DON'T UNDERESTIMATE THE FED'S ABILITY TO INNOVATE AND REPAIR

The 10-year-old bull has been shepherded along by a benevolent Fed that has demonstrated resourcefulness in periods of turmoil. Staring down the abyss during the throes of the financial crisis, the Fed began to expand its balance sheet by purchasing securities in an effort to ease financial conditions and stimulate lending. The concept of quantitative easing (QE) was not completely novel, but the scale and composition was unprecedented. Demonstrating their ingenuity and commitment to healing the economy, the Fed engineered three rounds of QE, ultimately expanding its balance sheet by around 350% since 2007. International central banks also crafted their own forms of QE in what amounted to a coordinated global effort to promote growth.

The Fed's ability to navigate uncharted waters with unconventional policy, in addition to the humility to modify policies, which the market or economy rejected, helped to feed the ten-year bull. As the Fed's balance sheet has added approximately $2T since the birth of the bull market, the S&P 500 has returned over 400%, including dividends, and its market cap has risen by $18T.

CYCLES DON'T DIE OF OLD AGE

Investors have learned that there is no inherent characteristic of a long expansion that makes it more likely to end than a shorter one; rather, expansions and bull markets end as a result of either restrictive monetary policy actions or from severe excesses in the economy or financial system. According to research from the San Francisco Fed, analyzing the conditional probability that a post- WWII expansion will come to an end given its age, there is no statistical evidence that the probability of recession increases over time. Rather, structural changes in the economy, namely the growing share of services and the increased role of the Fed, have made the relationship between an expansion's age and the risk of recession essentially non-existent.

EARNINGS GROWTH MATTERS FOR EQUITY PERFORMANCE

This lesson is reflected in the relative performance of U.S. versus international equities since the turn of the century. While the economic recovery in the U.S. during this cycle has been tepid by historical standards, the past decade has seen the U.S. handily outpace international equities (up 311% versus 105%) as earnings growth for U.S. corporates has substantially outpaced that of their global counterparts (up around 159% versus 51%), a stark contrast to the cycle before.[1] This dynamic can be partially explained by differences in sector composition of the respective regions. For example, international markets tend to have a higher weight to financials (around 22% versus 13%) and materials (8% versus 3%), which have faced headwinds from lower rates and inflation around the world, especially in developed economies. A higher weight to energy has made international markets vulnerable to sharp declines in oil prices, including a fall from $107 in June 2014 to $26 in February 2016. Finally, a significant overweight to the technology sector (21% versus 8%) has helped drive robust relative performance in the U.S. markets during the current bull market, led by a key group of technology companies with tailwinds from secular growth trends.

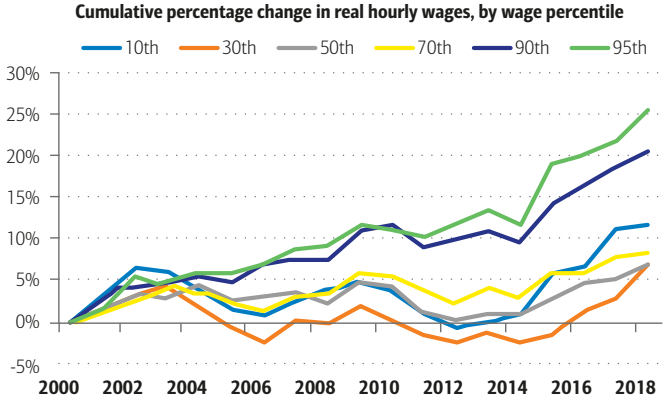
TECHNOLOGY'S POWER TO SHAPE THE ECONOMY AND MARKETS

If the "dot-com" phase laid the foundation for electronic technologies, the current bull has filled out the house. Startling advances in technology have characterized the last decade, traversing all industries. They have had a profound effect to spawn new micro-economies while benefiting companies and workers best positioned to leverage these technologies. For example, the oil & gas extraction workforce is essentially unchanged since 2009, while oil production in the U.S. has more than doubled due to new extraction technologies, according to Haver. Indeed, the technology sector has enjoyed average annual earnings growth of around 16% since 2009 according to FactSet Software Company. Consumers have also been given a boost via lower pricing pressures as a result of increased operating efficiencies. But despite impressive improvements in technology and productivity, the benefits to labor have been relatively muted. For example, despite having increased their productivity by 42% during this century, workers have only seen their real hourly compensation increase by 17%, according to the Bureau of Labor Statistics. These trends are exacerbated across pockets of society with certain groups finding it more difficult to keep pace. The implications for the divide are now a focal point of policy

[1] Sources: Bloomberg; Indexes: MSCI US and MSCI ACWI ex US. Earnings are 12 month trailing earnings per share from Q4 2008 through Q4 2018, price return is 3/9/2009 to 3/11/2019.

debate and have given rise to a wave of populism across the globe (Exhibit 1). The advent of advanced technologies has helped accelerate the economy while disrupting industries and markets on a micro basis. The "first-mover" advantage has allowed early adopters or developers of valuable technologies to gain market share and quickly surge ahead of competitors, while companies or industries slow to adapt can be left behind.

Exhibit 1: Gains At The Top Outpacing Gains For The Bottom.



Source: Economic Policy Institute. Data as of December 31, 2018.
Past performance does not guarantee future results.

GLOBAL MARKET VIEW

A BIG WEEK FOR BREXIT

Ehiwario Efeyini, Senior Vice President and Senior Market Strategy Analyst

The Brexit saga has taken yet another series of twists over the past seven days. On Tuesday, the latest version of the withdrawal agreement negotiated between the UK government and the European Union (EU) was voted down in the British parliament for a second time. On Wednesday, members of parliament rejected the prospect of leaving the EU without a deal. And on Thursday, they voted to extend Article 50—the legal clause giving notice of the UK's intention to leave the union. The past week has been chaotic, but this coming week should be the most consequential for the Brexit process since the original referendum of 2016.

With the official exit date looming on March 29, Prime Minister May is expected to put the withdrawal deal to a third and final vote this Tuesday or Wednesday. Should it pass, the result will be a short three-month extension to Article 50 in order to complete domestic legal procedures before a postponed exit on June 30. Should the deal fail to pass, the UK will seek a much longer extension of up to two years, the granting of which will be subject to approval by the other 27 EU member countries at their end-of-week European Council summit. The British government would then essentially be handed the opportunity to reset the clock and rethink its entire approach to Brexit. This should initially mean cross-party consultation on renegotiating an alternative deal with the EU. But eventually, a long extension could give way to either a general election or a second referendum. Another referendum currently has little support within the ruling Conservative party but would become more likely if new elections produced a change of government.

In the meantime, it should also be noted that a March 29 'no deal' exit, though appears unlikely, is still possible. Last week's parliamentary motion to avoid 'no deal' was not legally binding. And if the withdrawal agreement is rejected for a third time without unanimous agreement on a time extension by the EU27, only a complete revocation of Article 50 by the UK government would prevent a "no deal" Brexit from taking place by default. By the end of this week, investors should therefore gain a much clearer sense of both the short- and longer-term trajectory for Brexit (Exhibit 2).

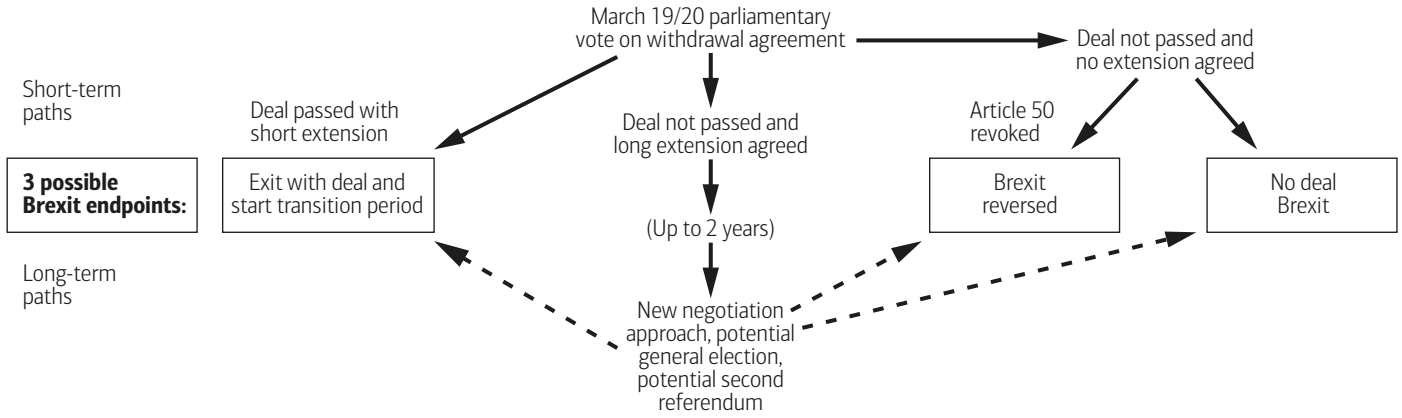
Exhibit 2: Key Provisional Dates in the Brexit Process.

Date	Event
March 19 or 20, 2019	Third UK parliamentary vote on EU withdrawal agreement
March 21-22, 2019	European Council summit with EU27 leaders expected to approve Article 50 extension
March 29, 2019	Potential 'no deal' UK exit if withdrawal agreement rejected and Article 50 extension not approved by EU
June 30, 2019	UK exit and start of transition/implementation period if withdrawal agreement passed by March 29
December 31, 2020	Planned end of transition period if withdrawal agreement passed by March 29
March 29, 2021	Potential UK exit and start of transition/implementation period under long Article 50 extension
December 31, 2022	Potential end of transition period under long Article 50 extension

Source: Chief Investment Office. Data as of March 18, 2019.

A long Article 50 extension represents the most uncertain route from here. But even in this event, only one of three possible endpoints would remain available: an exit with a deal, an exit without a deal or a reversal of Brexit altogether. And each of the potential paths that would follow a long extension—whether renegotiation, general election or second referendum—would eventually lead back to one of these three eventual endpoints (Exhibit 3).

Exhibit 3: Potential Routes to Final Brexit Outcome.



Source: Chief Investment Office as of March 2019.

WHAT DOES IT ALL MEAN FOR MARKETS?

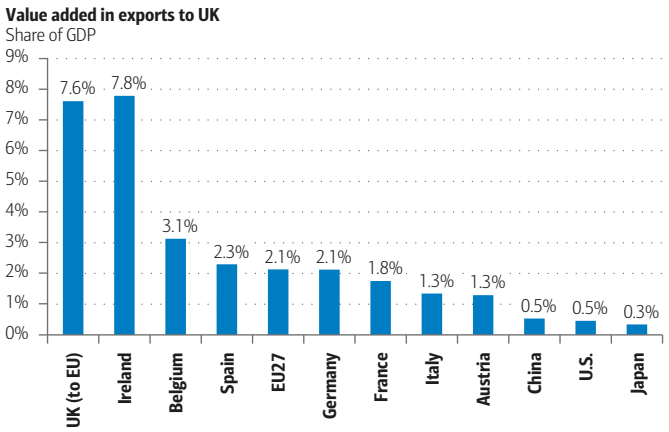
Despite the turmoil of the past seven days, last week's decisions in parliament should have one or both of two important effects: 1) the deferring of a final outcome on Brexit and 2) a reduction in the risk of a hard Brexit. Both of these could likely be positives for local markets in the EU and the UK (it was notable that the pound rallied on the week), while reducing downside risks for global markets outside Europe.

The main risk now remaining for investors is that of a near-term "no deal" exit should this week's vote on the withdrawal agreement fail, with no extension given by EU leaders. We believe this remains a low-probability scenario, but would pose the most downside for risk assets. Under the UK government's official scenario analysis, the trade and investment impact of a hard Brexit would leave the economy up to 10.7% smaller over a 15-year period. Foreign direct investment outflows could accelerate as more export-oriented manufacturing and financial services operations moved offshore to retain unrestricted access to the EU single market. Higher tariffs on imports from the EU would reduce real disposable incomes.[2] The UK exchange rate could fall, and the local equity market would likely decline in price, particularly across companies with higher domestic sales exposure due to both weaker domestic demand and a smaller boost to the value of overseas earnings from currency weakness. For the rest of the European Union, the aggregate impact of a "no deal" Brexit would likely be lower given that the value-added EU export exposure to the UK relative to EU gross domestic product (GDP) is close to one-quarter the size of the value-added UK export exposure to the EU relative to UK GDP. But the exposure varies by country.

[2] The UK government has announced that it would temporarily raise the share of all imports eligible for tariff-free access from 80% to 87% in the event of a "no deal" exit, which would nullify this effect in the short term.

By far the worst off would be Ireland, in our view, which has a comparable trade vulnerability to the UK, but would not likely have the same offset from exchange rate depreciation. While for major non-EU economies, trade exposure to the U.K. is low. As a share of GDP, value-added exports from the U.S., China and Japan are each no more than 0.5%—less than a quarter of the EU aggregate level (Exhibit 4).

Exhibit 4: UK and Ireland the Most Exposed to Weaker Trade as a Result of Brexit.



Sources: Organisation for Economic Co-operation and Development, World Trade Organization, International Monetary Fund. Data as of 2015 (latest available data).

Unlike the euro crisis of the first half of the decade, Brexit also does not appear to pose a systemic risk to global markets, even under a worst-case "no deal" outcome. The UK economy is one-fifth the size of the eurozone. The Bank of England and the UK government would be able to use monetary and fiscal policy to counteract the negative shocks to trade and investment—tools that were not available to peripheral countries during the euro crisis. And crucially, Brexit does not represent a systemic risk

for the financial system from credit spread widening (UK and European bond yields would likely fall as they did immediately following the 2016 referendum) or fear of currency redenomination. While we expect Brexit to dominate the headlines this week, any extension of Article 50—whether short-term on the back of a withdrawal deal or long-term if a deal fails to pass—is likely to be welcomed by investors. And even in the unlikely worst-case event of a March 29 "no deal" outcome, we would expect most of the fallout to remain confined to the UK, with a lesser market impact on continental Europe and an even smaller effect on the rest of the world.

One way or the other, this week will provide more clarity on which path Brexit will take over both the short- and longer-term. The Brexit process will enter either the end of the beginning by a passage of the withdrawal deal with a summer exit and subsequent transition to a new UK-EU trade relationship by the end of 2020; or, a new beginning by a reset with another two years for the UK government to negotiate an alternative exit plan with the EU and with its own domestic parliament and electorate; or indeed, the beginning of the end by a "no deal" exit on March 29 in the event that the EU does not agree to extend Article 50. The last of these would appear to be the least favorable outcome for markets but also seems the most unlikely, while an exit deal or a long exit delay should help to lift risk appetite.

THOUGHT OF THE WEEK

POLICING THE FUTURE

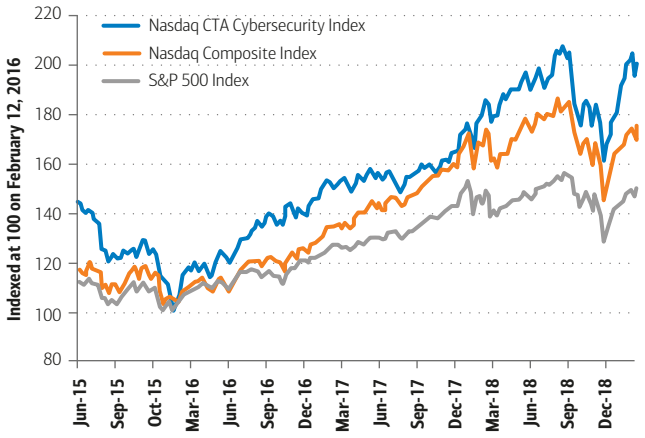
Rodrigo C. Serrano, CFA®, Director and Investment Strategist

It feels as if every day a major cyber-breach is reported. IBM recorded more than 2.9 billion leaked records globally in 2017. Ransomware attacks, one type of cybercrime, in which hackers demand ransom payments to unblock access to sensitive user data, were estimated to have cost businesses more than $8 billion.

The incidence of cybercrime is likely to increase, in our view. The U.S. and China have become engaged in a race for technological dominance, key to power future industries and economic growth. A pivotal domain in this competition is likely to be mastery of 5G and its role in enhancing the Internet of Things (IoT), a term that embodies the connections of millions of household devices—ranging from front-door security cameras to refrigerators, radios and automobiles—to the internet. In the eyes of criminal hackers, these multiplying connections are akin to multiplying opportunities for intrusion. Meanwhile, companies are scrambling to address the threat. Gartner, a research and advisory company, states that by 2020, 100% of large enterprises will require C-level executives to present an annual cybersecurity and technology risk report to their board of directors, up from 40% last year. With the internet an ever-increasing interest in our lives and in business, cybersecurity will need to increase in presence and capability.

Meanwhile, it's not just the private sector that will need to invest. Governments worldwide have also fallen victim to pervasive cyber-attacks, making national security an additional driver for intensified investment. We view cybersecurity as a unique opportunity for investors to consider in that it sits at the nexus of two secular trends: the advent of the "Digital Era," characterized by new technologies transforming our world, and a more complex geopolitical landscape, exemplified by the U.S.'s evolving relationship with its adversaries. Investors may be taking notice. After a period of underperformance during the 2015–2016 market volatility, bottoming in February 2016, the Nasdaq CTA Cybersecurity Index has returned almost 102%, outperforming the S&P 500 (which returned 51.0% over the same timespan) and the Nasdaq Composite (76.2%) by 51.0% and 25.5% respectively (Exhibit 5).

Exhibit 5: Can Securing the Future Suggest a Strong Tailwind for Cybersecurity?



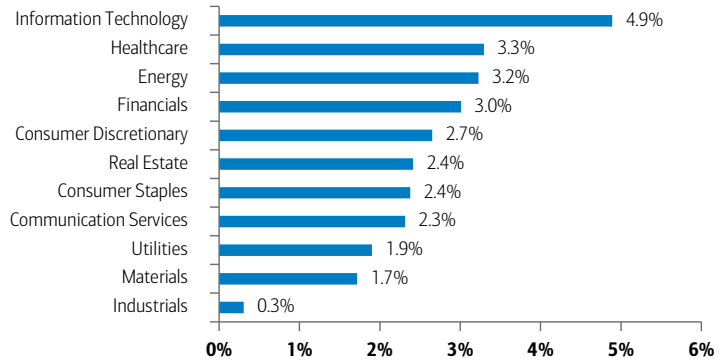
Sources: Bloomberg, Chief Investment Office as of March 13, 2019.
Past performance does not guaranttee future results. Performance would differ if a different time period was displayed. Short-term performance shown to illustrate more recent trend.

MARKETS IN REVIEW

Equities

	Current	Total Return in USD (%) WTD	MTD	YTD
DJIA	25,848.87	1.6	-0.1	11.5
NASDAQ	7,688.53	3.8	2.1	16.2
S&P 500	2,822.48	2.9	1.5	13.1
S&P 400 Mid Cap	1,895.86	2.0	-0.7	14.4
Russell 2000	1,553.54	2.1	-1.3	15.5
MSCI World	2,108.78	2.8	1.2	12.4
MSCI EAFE	1,890.31	2.8	1.1	10.5
MSCI Emerging Markets	1,057.30	2.7	0.7	9.7

S&P 500 Sector Returns



Fixed Income[1]

	Current	Total Return in USD (%) WTD	MTD	YTD
Corporate & Government	3.05	0.2	0.7	1.9
Agencies	2.66	0.1	0.5	1.0
Municipals	2.49	0.2	0.5	1.8
U.S. Investment Grade Credit	3.11	0.2	0.7	1.7
International	3.81	0.4	0.9	3.5
High Yield	6.54	0.7	0.3	6.6

	Current	Prior Week End	Prior Month End	2018 Year End
90 Day Yield	2.38	2.38	2.38	2.36
2 Year Yield	2.44	2.46	2.52	2.49
10 Year Yield	2.59	2.63	2.72	2.69
30 Year Yield	3.01	3.01	3.08	3.02

Commodities & Currencies

Commodities	Current	Total Return in USD (%) WTD	MTD	YTD
Bloomberg Commodity	170.70	1.4	0.3	6.9
WTI Crude $/Barrel[2]	58.52	4.4	2.3	28.9
Gold Spot $/Ounce[2]	1,302.48	0.3	-0.8	1.6

Currencies	Current	Prior Week End	Prior Month End	2018 Year End
EUR/USD	1.13	1.12	1.14	1.15
USD/JPY	111.48	111.17	111.39	109.69
USD/CNH	6.71	6.73	6.70	6.87

Sources: Bloomberg, Factset. Total Returns from the period of 3/11/2019 to 3/15/2019. Bloomberg Barclays Indices.[1] Spot price returns.[2] All data as of the 3/15/2019 close.
Past performance is no guarantee of future results.

Asset Class Weightings (as of 3/6/19)

	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*					
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 3/15/19)

	Q2 2018A	Q3 2018A	Q4 2018A	Q1 2019E	2018A	2019E
Real global GDP (% y/y annualized)	–	–	–	–	3.8*	3.4
Real U.S. GDP (% q/q annualized)	4.2	3.4	2.6	1.0	2.9	2.2
CPI inflation (% y/y)	2.7	2.6	2.2	1.6	2.4	1.8
Core CPI inflation (% y/y)	2.2	2.2	2.2	2.1	2.1	2.2
Unemployment rate(%)	3.9	3.8	3.8	3.9	3.9	3.7
Fed funds rate, end period (%)	1.91	2.18	2.40	2.38	2.40	2.63
10-year Treasury, end period (%)	2.86	3.06	2.68	3.00	2.68	3.00
S&P 500 end period	2718	2914	2507	–	2507	2900
S&P earnings ($/share)	41	43	41*	40	162.5*	170
Euro/U.S. dollar, end period	1.17	1.16	1.15	1.16	1.15	1.25
U.S. dollar/Japanese yen, end period	111	114	110	106	110	101
Oil ($/barrel, avg. of period, WTI**)	68	69	59	58	65	59

The forecasts in the table above are the base line view from BofAML Global Research team. The Global Wealth & Investment Management (GWIM) Investment Strategy Committee (ISC) may make adjustments to this view over the course of the year and can express upside/downside to these forecasts.

Past performance is no guarantee of future results. There can be no assurance that the forecasts will be achieved. Economic or financial forecasts are inherently limited and should not be relied on as indicators of future investment performance.

A = Actual. E/* = Estimate. S&P 500 represents a fair value estimate for 2019. **West Texas Intermediate.
Sources: BofA Merrill Lynch Global Research; GWIM ISC as of March 15, 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.

Dow Jones Industrial Average is a price-weighted measure of 30 U.S. blue-chip U.S. companies. The index covers all industries except transportation and utilities.

NASDAQ Composite Index is a broad-based capitalization-weighted index of stocks in all three NASDAQ tiers: Global Select, Global Market and Capital Market. The index was developed with a base level of 100 as of February 5, 1971.

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.

Nasdaq CTA Cybersecurity Index is designed to track the performance of companies engaged in the Cybersecurity segment of the technology and industrial sectors.

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Investing involves risk, including the possible loss of principal. No investment program is risk-free, and a systematic investing plan does not ensure a profit or protect against a loss in declining markets. Any investment plan should be subject to periodic review for changes in your individual circumstances, including changes in market conditions and your financial ability to continue purchases.

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.

Past performance is no guarantee of future results.

Stocks of small-cap companies pose special risks, including possible illiquidity and greater price volatility than stocks of larger, more established companies.

Companies may reduce or eliminate dividend payment to shareholders. Historically, dividends make up a large percentage of stocks' total return.

Investing in fixed-income securities may involve certain risks, including the credit quality of individual issuers, possible prepayments, market or economic developments and yields and shareprice fluctuations due to changes in interest rates. When interest rates go up, bond prices typically drop, and vice versa. Income from investing in municipal bonds is generally exempt from Federal and state taxes for residents of the issuing state. While the interest income is tax-exempt, any capital gains distributed are taxable to the investor. Income for some investors may be subject to the Federal Alternative Minimum Tax (AMT).

Investments focused in a certain industry may pose additional risks due to lack of diversification, industry volatility, economic turmoil, susceptibility to economic, political or regulatory risks and other sector concentration risks.

Investments in real estate securities can be subject to fluctuations in the value of the underlying properties, the effect of economic conditions on real estate values, changes in interest rates, and risks related to renting properties, such as rental defaults.

Nonfinancial assets, such as closely-held businesses, real estate, 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 suitable for 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.

Investments in tangible assets are highly volatile and are speculative. There are special risks associated with an investment in commodities, including market price fluctuations, regulatory changes, interest rate changes, credit risk, economic changes, and the impact of adverse political or financial factors.

Alternative Investments such as private equity funds, can result in higher return potential but also higher loss potential. Changes in economic conditions or other circumstances may adversely affect your investments. Before you invest in alternative investments, you should consider your overall financial situation, how much money you have to invest, your need for liquidity, and your tolerance for risk.

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The investments discussed have varying degrees of risk. Some of the risks involved with equities include the possibility that the value of the stocks may fluctuate in response to events specific to the companies or markets, as well as economic, political or social events in the U.S. or abroad. Bonds are subject to interest rate, inflation and credit risks. Investments in high-yield bonds may be subject to greater market fluctuations and risk of loss of income and principal than securities in higher rated categories. Investments in foreign securities involve special risks, including foreign currency risk and the possibility of substantial volatility due to adverse political, economic or other developments. These risks are magnified for investments made in emerging markets. Investments in a certain industry or sector may pose additional risk due to lack of diversification and sector concentration. Investments in real estate securities can be subject to fluctuations in the value of the underlying properties, the effect of economic conditions on real estate values, changes in interest rates, and risk related to renting properties, such as rental defaults. There are special risks associated with an investment in commodities, including market price fluctuations, regulatory changes, interest rate changes, credit risk, economic changes and the impact of adverse political or financial factors. Income from investing in municipal bonds is generally exempt from federal and state taxes for residents of the issuing state. While the interest income is tax exempt, any capital gains distributed are taxable to the investor. Income for some investors may be subject to the federal alternative minimum tax (AMT).

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