

Capital Market Outlook

January 3, 2022

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

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Macro Strategy—A New Dawn for Nominal Growth. The most powerful monetary and fiscal stimulus since World War II (WWII) has pushed inflation, as measured by the Consumer Price Index (CPI), to 9% at an annualized rate over the September-November period. That has far exceeded consensus expectations and boosted U.S. nominal gross domestic product (GDP) growth to the strongest levels in four decades.

Leading indicators of economic growth point to a strong first half for 2022, and with the Federal Reserve (Fed) itself projecting sustained massive accommodation for the foreseeable future, in our opinion, inflation, nominal GDP, corporate revenues and profits are likely to continue to surprise to the upside.

Market View—Three Hikes Isn't the Same as Three Strikes. High-single-digit total returns for the S&P 500 is our base case for 2022, or reversion to mean. Even in the face of a new tightening cycle, and the majority of Fed officials expecting three rate increases in 2022, three hikes is not the same as three strikes.

As we have stressed repeatedly, average S&P 500 returns are typically solid one year out from the initial interest rate hike because economic growth and corporate profits are robust, offsetting the nascent shift in monetary policy. Also, the latter works with a one-year lag, so the compounding effects of tighter monetary policies will likely be more of a headwind for the markets and economy later in 2022 and into 2023.

Thought of the Week—2022 The Return to Normal With Normal Returns? Buoyed by a strengthening economy, accommodative monetary policy and strong corporate earnings, major U.S. indexes yet again notched double-digit gains for 2021.

While equity markets are no stranger to mid-cycle lulls like in 2015 and 2018, it's worth noting that, according to Bloomberg, the past nine times the S&P 500 was up over 20% in a year, the index was higher that next year every single time. The above-average 2021 returns add to a recent string of exceptional Equity market performance, making "average" all the more relative.

MACRO STRATEGY ►

Chief Investment Office
Macro Strategy Team

MARKET VIEW ►

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Market Strategy

THOUGHT OF THE WEEK ►

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MARKETS IN REVIEW ►

Data as of 1/3/2022,
and subject to change

Portfolio Considerations

We expect a grind-it-out market environment in which valuations could remain flat or slightly decline but with profit growth to supersede this and Equity outperformance to continue. Within Fixed Income, we favor credit overall especially Investment-grade, and also prefer municipals relative to Treasuries. We continue to maintain a shorter duration stance. Qualified investors could also consider opportunities in Alternative Investments, which could add another layer of diversification to a portfolio.

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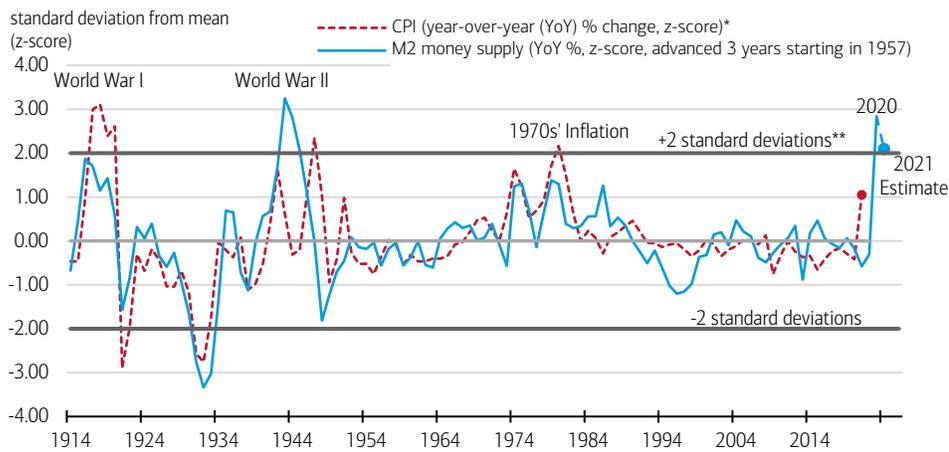
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A New Dawn for Nominal Growth

Chief Investment Office, Macro Strategy Team

After two decades of sub-4% nominal GDP growth, inflation below 2%, and fears of endless stagnation, the U.S. economy took off in 2021. The reason is simple. As shown in Exhibit 1, after the inflationary money growth of the 1960s and 1970s, then Fed Chair Paul Volcker reined in money growth, and it grew well below its historical average for three decades until the pandemic. As a result, inflation fell, reaching just-below 2% during the “secular stagnation” era between 2009 and 2019. Since 1900, including the sub-2% pre-pandemic decade, CPI averaged just over 3%. Sub-normal inflation kept risk aversion hovering over financial markets worried about the growing debt burden in the economy. The big debt burden and the slowest nominal growth since the 1930s kept downward pressure on interest rates and put a premium on Growth over Value that lasted longer and was among the biggest in history. As that era ends, the Growth-stock premium has begun to recede.

Exhibit 1: Inflation Tends To Respond To Changes In Money Supply With A Lag Of Two to Three Years.



*Last data point shows the past six-month annualized rate for 2021. **Standard deviation is a measure that is used to quantify the amount of variation or dispersion of a set of data values. M2=a measure of money supply used by the various central banks. Z-score is a numerical measurement that describes a value's relationship to the mean of a group of values. Sources: Bureau of Labor Statistics; Fed Board/Haver Analytics. Data as of December 28, 2021.

As shown in Exhibit 1, the biggest monetary surge since WWII has broken the back of secular stagnation. The world economy has gone from chronic excess supply to chronic excess demand in less than a year. The supply shortages still baffling analysts are simply the result of too much demand relative to the capacity of current supply chains. Most of the baffled were not around in the 1970s when similar excess demand caused chronic shortages and sent inflation to record highs. Indeed, these excess demand and chronic supply shortages occurred during a similar period of sustained excess money-supply growth that funded massive federal government expansion during the Vietnam and Great Society eras much as the pandemic-motivated government expansion has fueled the biggest fiscal deficits since WWII. As in WWII, the Fed has monetized these record deficits, igniting inflation. For the markets, the main implication of this new era is that nominal growth will likely settle back into a more normal historical range of 6% to 7% after the unusually low nominal growth (3% to 4%), inflation and interest rates of the pre-pandemic secular stagnation era.

The dawn of this new era has caught the Fed and consensus economists by surprise. According to the consensus forecast in the Blue Chip Economic Indicators for January 2021, consumer prices were forecast to rise just 2% in 2021. The Fed maintained that the

Portfolio Considerations

As the Fed dials back this stimulus in 2022, investors may start to turn to more defensive areas of the market that lagged in 2021, such as Consumer Staples, Healthcare and Utilities. At the same time, the cyclical areas of the market that benefit from high inflation and strong growth should continue to do well as long as monetary policy remains accommodative, as the Fed currently projects. While helping financial stocks, higher interest rates have pulled the rug out from under the long-duration Growth stocks, which entered a severe bear market in 2021. We expect this Growth-to-Value rotation to continue in a world of excess demand.

higher inflation that was actually observed in 2021 was “transitory” even as it averaged above 7% by year end, marking the biggest forecast error by economists in at least 40 years. A simple look at Exhibit 1 a year ago would have suggested the high-single-digit inflation surge that actually occurred.

It's not just inflation forecasts that were wide of the mark. Economists also underestimated real GDP growth, nominal GDP growth, industrial production, personal income, consumer spending, business fixed investment and, particularly, corporate profits. For example, in January 2021, they forecast that profits would grow 8.1% in 2021. By December, with three quarters of huge positive surprises, profits growth was tagged just above 23%. These enormous profits surprises have driven the powerful Equity bull market in 2021.

These huge misses are the result of the unprecedented stimulus and its underestimated effect on nominal GDP, which is what governs business and consumer incomes, sales and investment, profits and production. Over the course of 2021, the consensus forecast for nominal GDP growth rose from 6% to almost 10%. Ever since the first Coronavirus Aid, Relief, and Economic Security Act (CARES Act) was passed in March 2020, economists have failed to properly gauge the effect of policy stimulus on the economy, focusing instead on the downside risks from coronavirus. However, the first CARES Act already plugged the economic hole from the shutdowns, causing incomes to rise for the first time ever in a recession that was also the shortest in history.

Concerns that the Fed is about to take the punch bowl away from the party have caused some typical late-cycle risk aversion to creep into recent Equity market positioning. Relative performance has started to improve in sectors like Consumer Staples, Healthcare and Utilities, which tend to outperform as expansions wind down. Nevertheless, inflation beneficiaries such as energy, materials and financial stocks continue to perform well despite their long mid-year consolidations while the market priced in 2022 rate hikes.

We expect this cyclical outperformance to continue since the Fed remains highly accommodative according to its own projections. One of the best leading indicators of the business cycle is the yield-curve spread between the fed funds rate and the 10-year Treasury note. That spread widened significantly in 2021 as the Fed funds rate stayed near zero and the 10-year yield rose about 50 basis points. A steeper yield curve is a sign that policy is getting easier, not tighter. Also showing that policy remains highly accommodative despite faster tapering and rate-hike expectations, real rates remain deeply negative across all Treasury maturities. Credit spreads also remain unusually narrow by historical standards, consistent with healthy profits and relatively easy financial conditions. Eventually, over the course of 2022, these indicators will reflect tightening financial conditions and weaker economic growth but not until the Fed gets ahead of the curve.

However, the pandemic caused the Fed to shift from a preemptive policy of “skating toward where it expected the inflation puck to be in the future” to a reactive policy of waiting until it saw the whites of inflation's eyes. Being behind the curve means the Fed is skating toward where the inflation puck was. In the 1970s, a similarly flawed reactive policy caused the Fed to sustain excessive money growth and inflation, much as it did in 2021. Right now, the composite index of leading indicators is up about 10% from a year ago, a very strong signal that the U.S. economy is entering 2022 with a full head of steam even as inflation is way ahead of expectations. This suggests strong incomes, spending, revenues and profits will continue well into 2022.

Three Hikes Isn't the Same as Three Strikes

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

Don't fear the Fed—at least not in 2022. While 12 of the 18 members of the Federal Open Market Committee expect at least three rate increases in 2022, investors should not equate three hikes with three strikes and, therefore, the end of the bull market in U.S. Equities. As we have stressed repeatedly, average S&P 500 returns are typically solid one year out from the initial rate hike because economic growth and corporate profits are robust, offsetting the nascent shift in monetary policy. Also, the latter works with a one-year lag, so the compounding effects of tighter monetary policies will be more of a headwind for the markets and economy later in 2022 and into 2023.

As a point of reference, the average total returns of the S&P 500 over 2004 to 2006—with the Fed raising rates 17 times—was 10.5%; over the 2016-18 rate hike cycle, returns were 9.8%.¹

As for timing, equity prices rollover at the end of a Fed tightening cycle, not at the start. That said, the consensus expects the Fed to be raising rates well into 2023 and beyond.

Whether the Fed opts for a rate hike in March or June remains an open question. According to the latest estimates from the Atlanta Federal Reserve, the economy expanded at a 7.6% annualized clip in the final quarter of 2021, following a soggy third quarter (2%). However, owing to the surge in the Omicron variant, Q1 2022 growth prospects have dimmed, notably among service-related activities like in-sitting restaurant visits, air travel, and in-store sales. Omicron—and its macro effects—could be a swing factor in whether the Fed moves sooner rather than later.

A question of when, not if

But with headline inflation at 6.8% in November (YoY) and core personal consumption expenditures up roughly 4.7% in the same period, the Fed, after a three-year hiatus, is poised to begin a new tightening cycle in 2022. The latter is synonymous with market choppiness and volatility as the Fed navigates a balancing act that hinges on moving neither too fast in draining liquidity from the capital markets, nor too slow. The former could ultimately tip the economy into recession; the latter risks inflation becoming even more embedded in the economy, requiring the Fed to be even more aggressive down the road. Outside of earnings expectations, no variable has more sway over market sentiment and relative asset prices than the cost of capital—and hence the importance of the Fed having a deft hand in setting monetary policy for 2022.

Speaking of earnings, the outlook for 2022 remains solid for a number of reasons, with above-trend nominal U.S. GDP growth chief among them. Catalysts for growth this year include not only the lagged effects of ultra-ease monetary policies and fiscal spending (roughly \$6 trillion since 2020) but also strong demand/spending from U.S. households and corporations. Both entities are flush with cash and poised to deploy it in 2022.

According to data from the Fed, U.S. corporations are currently sitting atop some \$7 trillion in cash owing to ultra-low interest rates and debt rescheduling, as well as strong earnings growth. How will this cash hoard be spent? Well, if history is any guide, think more capital expenditures (capex) spending, hiring, dividends and buybacks, and rising levels of mergers and acquisitions.

U.S. households are also flush. Strong employment gains, rising wages, government transfers, and booming stock and real estate markets—all of these factors have converged to push the level of U.S. household net worth to the stratosphere, with household net worth reaching nearly \$145 trillion at the end of Q3 2021. As depicted in

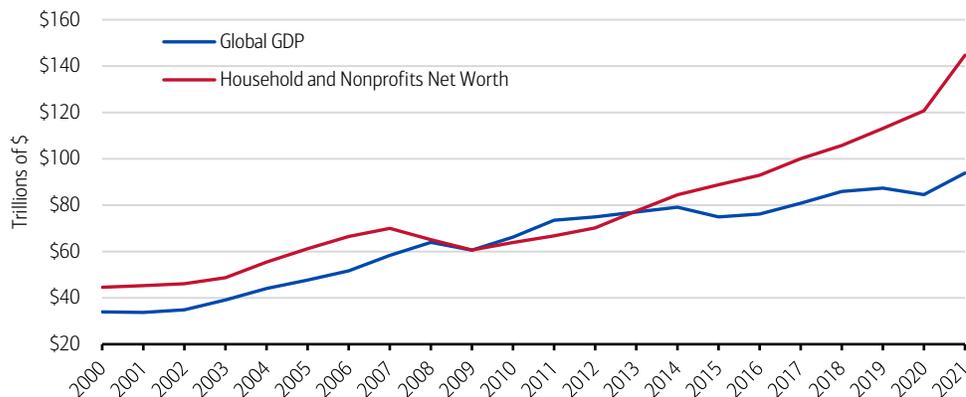
Portfolio Considerations

In terms of portfolio construction, we continue to prefer sectors and industries with pricing power (Energy, Materials, Industrials and Financials) and industries with high free cash flow and operating leverage, i.e., we remain long-term bulls on U.S. large-cap technology but acknowledge the volatility to these industries given the prospects of rising interest rates.

¹ See "Stocks' Rally Will Likely Survive the Fed's First Hike, Crossmark Says," Bloomberg, December 27, 2021.

Exhibit 2, U.S. household net worth, after closely tracking world GDP in the early part of this century, has soared over the past few years and is now nearly 50% larger than the entire output of the planet. The gap reflects many variables, including the depth and sophistication of the U.S. capital markets; the U.S. dollar as the world's reserve currency; U.S. global competitiveness, notably America's world-class technological capabilities; a skilled labor pool; and the U.S.' risk-taking, entrepreneurial culture that helps attract the world's best talent and incubates some of the largest and most dynamic companies in the world. All of the above is what we call American Exceptionalism—and remains, in our opinion, a key support for our long-term bull case for U.S. Equities.

Exhibit 2: American Exceptionalism: U.S. Household Net Worth vs. Global GDP.



Sources: Federal Reserve Bank of St. Louis; International Monetary Fund. Data as of July 7, 2021.

Near term, and powered by robust demand from households and corporations, we think the profit cycle continues to advance and that earnings estimates trend above expectations, at least over the first half of 2022.

Investment Implications

Top themes: automation and robotics; waste water treatment; everything storage (batteries, data centers, solar, wind, etc.) and healthtech—or the fusion of science and technology.

Finally, we would be remiss if we didn't mention some key "known unknowns" for 2022—or specific events or ongoing trends beyond the Fed that could alter our general outlook for the markets. What we are watching: geopolitical tensions between the U.S. and both China and Russia; the regulatory backdrop in Washington, Brussels and Beijing, with tech top of mind; the role/acceptance of cryptocurrencies; the prospects of a Republican sweep in November; supply chain bottlenecks; the explosion in the space economy; the global hunt for talent and the rising power of unions; and of course, the future path of the coronavirus and the risks of more infectious variants. More on those topics in the weeks ahead.

Equities

	Total Return in USD (%)			
	Current	WTD	MTD	YTD
DJIA	36,338.30	1.1	5.5	20.9
NASDAQ	15,644.97	0.0	0.7	22.2
S&P 500	4,766.18	0.9	4.5	28.7
S&P 400 Mid Cap	2,842.00	1.7	5.1	24.8
Russell 2000	2,245.31	0.2	2.2	14.8
MSCI World	3,231.73	0.8	4.3	21.8
MSCI EAFE	2,336.07	0.9	5.1	11.3
MSCI Emerging Markets	1,232.01	1.0	1.9	-2.5

Fixed Income[†]

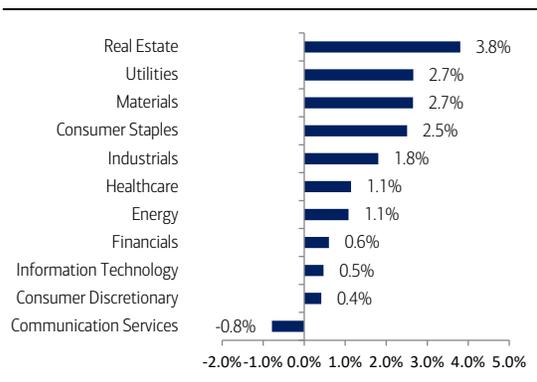
	Total Return in USD (%)			
	Current	WTD	MTD	YTD
Corporate & Government	1.66	0.18	-0.32	-1.75
Agencies	1.15	0.04	-0.31	-1.31
Municipals	1.11	0.05	0.16	1.52
U.S. Investment Grade Credit	1.75	0.16	-0.26	-1.54
International	2.33	0.32	-0.08	-1.04
High Yield	4.21	0.22	1.87	5.28
90 Day Yield	0.03	0.06	0.05	0.06
2 Year Yield	0.73	0.69	0.57	0.12
10 Year Yield	1.51	1.49	1.44	0.91
30 Year Yield	1.90	1.91	1.79	1.64

Commodities & Currencies

	Total Return in USD (%)			
	Current	WTD	MTD	YTD
Commodities				
Bloomberg Commodity	211.80	0.3	3.5	27.1
WTI Crude \$/Barrel ^{††}	75.21	1.9	13.6	55.0
Gold Spot \$/Ounce ^{††}	1829.2	1.0	3.1	-3.6

	Total Return in USD (%)			
	Current	Prior Week End	Prior Month End	2020 Year End
Currencies				
EUR/USD	1.14	1.13	1.13	1.22
USD/JPY	115.08	114.38	113.17	103.25
USD/CNH	6.36	6.37	6.37	6.50

S&P Sector Returns



Sources: Bloomberg, Factset. Total Returns from the period of 12/27/2021 to 12/31/2021. [†]Bloomberg Barclays Indices. ^{††}Spot price returns. All data as of the 12/31/2021 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 12/31/2021)

	2021E	Q1 2022E	Q2 2022E	Q3 2022E	Q4 2022E	2022E
Real global GDP (% y/y annualized)	5.8*	-	-	-	-	4.3
Real U.S. GDP (% q/q annualized)	5.6*	4.0	4.0	3.0	2.0	4.0
CPI inflation (% y/y)	4.7*	7.0	5.6	4.5	3.1	5.0
Core CPI inflation (% y/y)	3.6*	6.2	5.1	4.4	3.5	4.8
Unemployment rate (%)	5.4*	3.9	3.7	3.6	3.5	3.7
Fed funds rate, end period (%)	0.07	0.38	0.63	0.88	1.13	1.13

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. **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.

Sources: BofA Global Research; GWIM ISC as of December 31, 2021. BofA Global Research is research produced by BofA Securities, Inc. ("BofAS") and/or one or more of its affiliates. BofAS is a registered broker-dealer, Member SIPC, and wholly owned subsidiary of Bank of America Corporation.

Asset Class Weightings (as of 12/7/2021)

Asset Class	CIO View			
	Underweight	Neutral	Overweight	
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. Source: Chief Investment Office as of December 7, 2021. 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

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

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 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 is a price index, the price of a weighted average market basket of consumer goods and services purchased by households.

Dow Jones Industrial Average is a price-weighted measurement stock market index of 30 prominent companies listed on stock exchanges in the United States.

NASDAQ/Nasdaq Composite is a stock market index that includes almost all stocks listed on the Nasdaq stock exchange.

MSCI Emerging Markets Index is a selection of stocks that is designed to track the financial performance of key companies in fast-growing nations.

MSCI China Index consist of a range of market capitalization weighted and alternative weighted indexes for the Chinese markets, intended for both domestic and international investors, including Qualified Foreign Institutional Investors (QFII) licensees.

MSCI All World Index excluding the U.S. is a market-capitalization -weighted index designed to provide a broad measure of stock performance throughout the world, with the exception of U.S.-based companies.

Russell 2000 Index refers to a stock market index that measures the performance of the 2,000 smaller companies included in the Russell 3000 Index.

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Cryptocurrency markets are highly volatile and risky, and may not be appropriate for most investors looking to meet long-term savings or retirement goals. Cryptocurrency and many crypto-related investments are subject to minimal regulatory oversight, and there may be no recourse should the cryptocurrency disappear due to a cybersecurity breach or hack. Cryptocurrency investors rely upon unregulated exchanges that may lack appropriate internal controls, making them susceptible to fraud, theft and hacking. Direct holding of cryptocurrency only exist on the Internet. Issuers can be located anywhere in the world, so it may be impossible to trace and recover lost funds through the courts. Cryptocurrency accounts are not insured by U.S. depository insurance. Creating a digital wallet to store cryptocurrency involves installing software on an investor's computer. As with any software download, hackers may include malicious code, creating unwanted files or programs that can cause harm to a computer or compromise data stored on a computer. Purchasers of cryptocurrencies rely on the strength of their own computer systems as well as systems provided by third parties to protect purchased cryptocurrencies from theft.

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