

CHIEF INVESTMENT OFFICE

Capital Market Outlook

October 3, 2022

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

IN THIS ISSUE

Macro Strategy—*Inflation Set to Surprise to the Downside After Peaking this Year.*

The massive pandemic monetary and fiscal stimulus has been followed by an abrupt withdrawal of that stimulus that is similar in duration and magnitude to the World War II (WWII) stimulus, which was also followed by an abrupt contraction of fiscal and monetary policy.

As a result, it should not be surprising that the U.S. economy is tracking the post-WWII pattern of 1946-1949 rather than the 1970s inflation paradigm many economists are using as a template for the current situation. This 1940s pattern suggests that inflation is likely to peak in 2022 with a recession probably to follow in 2023, including a larger than anticipated drop in inflation and possible deflation by 2024 if the Federal Reserve (Fed) sticks to its current schedule for quantitative tightening (QT).

Market View—*The I.C.E. is Cracking: Global Recessionary Risks are Rising:* Global markets continue to be hampered by the elevated inflation environment, China's inability to pivot from their zero-COVID policies, and Europe's growth shock from the energy crisis.

Rarely has the world had to deal with three seismic challenges simultaneously, requiring investor patience and focus on high-quality assets as we work through the end of the year.

Thought of the Week—*Are Equities Cheap?:* Stock valuations have fallen considerably from where they were at the start of the year, which has presented more reasonable entry points for longer term investors.

But earnings uncertainty, tighter monetary policy and rising real yields may present a few more tailwinds for valuations to potentially shift lower in the months ahead.

MACRO STRATEGY ►

Robert T. McGee

Managing Director and Head of CIO Macro Strategy

Irene L. Peters, CFA®

Director and Senior Macro Strategy Analyst

MARKET VIEW ►

Joseph P. Quinlan

Managing Director and Head of CIO Market Strategy

Lauren J. Sanfilippo

Director and Senior Investment Strategy Analyst

THOUGHT OF THE WEEK ►

Kirsten Cabacungan

Assistant Vice President and Investment Strategist

MARKETS IN REVIEW ►

**Data as of 10/3/2022,
and subject to change****Portfolio Considerations**

We maintain a neutral view on Equities, with a preference for U.S. Equities relative to International, as risks to economic growth and corporate profits remain skewed to the downside. We still expect high-quality Fixed Income to be a diversifier. We continue to emphasize broad portfolio diversification across asset classes, including alternatives for qualified investors where appropriate, as we continue to monitor a post-pandemic cycle that is unlike any other.

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Inflation Set to Surprise to the Downside After Peaking this Year

Robert T. McGee, Managing Director and Head of CIO Macro Strategy

Irene L. Peters, CFA®, Director and Senior Macro Strategy Analyst

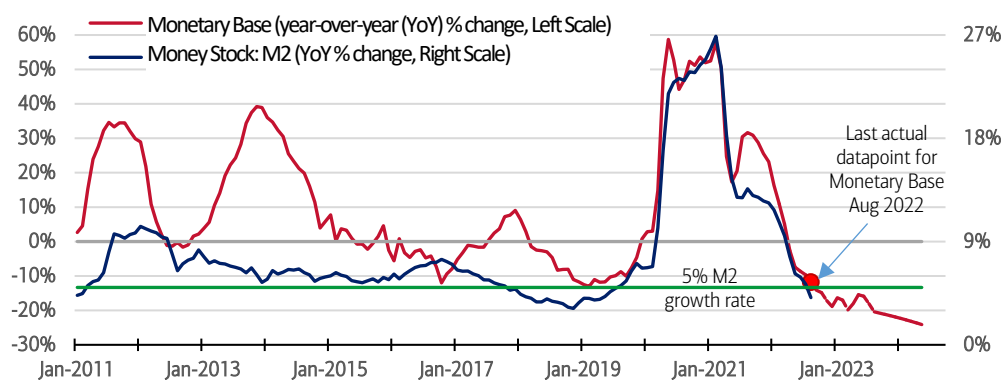
In a September 23, 2022 interview on CNBC, Wharton Professor Jeremy Siegel indicated that he thought that the Fed was making a big policy mistake. First, he said the Fed stayed easy for way too long, continuing quantitative easing (QE) until March 2022 while holding its policy rate at zero. That unleashed the sharpest, quickest acceleration in inflation since the 1940s. Second, because the Fed has lost its moorings on what causes inflation, he believes it is now overreacting on the tightening side.

As he made clear, inflation measures changes in the value of money. Increasing the supply of money too fast is the source of all major accelerations in inflation, causing money to lose value more rapidly. During the pandemic stimulus, the Fed increased the money supply at the fastest pace since WWII. Consequently, inflation jumped at the fastest rate since WWII. Conversely, all sharp decelerations in inflation have occurred when the money supply (M2) growth rate fell rapidly. The current swing from surging money supply growth to rapidly decelerating money supply growth is the biggest since the 1940s, when the rapid M2 growth of WWII fell from over two standard deviations—a measure of how dispersed the data is in relation to the mean—above its historical trend to about two standard deviations below. Inflation peaked with a lag in 1947 over 10% and fell steadily until bottoming in 1949 below zero because of this four standard deviation swing in M2 growth rates. In our view, a similar sharp decline in inflation is likely to surprise economists who are using the more desultory declines after the 1970s inflation as their template for the course of inflation in the years ahead.

As Professor Siegel noted in his interview, Fed Chair Powell’s refusal to acknowledge the role of the money supply in creating these policy mistakes is baffling. Nevertheless, the Fed’s policies are causing huge swings in M2 that are destabilizing the economy, first by overstimulating demand and now by excessively curtailing it. The withdrawal of liquidity that is stopping M2 growth will work its way through the economy over the next two years, stopping nominal gross domestic product (GDP) growth in its tracks. The bear market in stocks is anticipating this period of low growth and deflationary pressures.

Indeed, leading indicators of inflation are falling rapidly. The dollar’s strength reflects the tightening money supply situation as the Fed begins to curtail the monetary base with an unprecedented schedule of QT (Exhibit 1). Falling commodity prices are also a powerful sign of falling inflation pressures. Real interest rates have swung from sharply negative during the QE period to sharply positive during the QT period. Falling inflation, and possible deflation, will raise real rates even more if the Fed sticks with its QT schedule, further restraining the economy.

Exhibit 1: QT Causing Money Supply Collapse.



Sources: Federal Reserve Board/Haver Analytics, Chief Investment Office estimated path based on current Fed guidance. Data as of September 28, 2022.

The sharp rise in inflation in 2021-2022 is more similar to the 1940s post-WWII experience in 1946-47 because it is the result of a similarly large and quick fiscal and monetary impulse. During the pandemic policy response, the fiscal deficit and monetization of government debt were the greatest in U.S. history, with the possible

Investment Implications

The best time to extend duration is when the cyclical peak in rates approaches in the early stage of an impending recession. We believe that that time has come, and would begin to focus on longer duration, high-quality Fixed Income credits, especially Treasuries.

exception of the fiscal and monetary impulse during WWII. This quick, massive stimulus also caused inflation, which was low before the 1940s, to accelerate quickly to double-digit levels. The pre-pandemic era of low inflation gave way to a similarly fast jump in inflation. Analogous to the 1946-1947 reversal of monetary and fiscal stimulus, the 2022-2023 reversal in stimulus is the biggest since the 1940s.

As a result, those looking for a slow decline in inflation over a decade, such as the 1980s disinflation, are likely to be surprised, in our view. What's more, over the next two years, the Fed's current QT trajectory suggests growing disinflationary pressures, with inflation likely to fall to 2% or less. Of course, if the Fed overreacts to the anticipated 2023 downturn by re-embarking on a course of excessive easing in light of its flawed policy framework, another burst of inflation could occur, creating a potential third policy mistake on the heels of the two mistakes since the pandemic started.

The sharp up and down of the outsized pandemic policy stimulus helps explain why the U.S. economy seems to be tracking the 1946-1949 path rather than the more recent 1970s to early 1980s path that everyone is focused on. Even though the labor market remains strong, the rapid tightening of policy has already stopped 2022 real GDP growth, with two negative GDP growth readings in the first half. Before this year, 1947 was the last time the U.S. experienced two consecutive quarters of negative GDP growth without an official recession designation. That's because the labor market was also strong then, as it is now. Nominal GDP growth was high in 1947 because inflation, though peaking, was in the double digits. High inflation and low real output growth explain why labor productivity growth was so weak and unit labor cost increases so high in 1947. Now, in 2022, productivity growth is the weakest since that 1947 experience.

By 1948, the U.S. economy was in an official recession that ended in 1949. In its typical leading indicator fashion, the stock market, which peaked in 1946, bottomed in June 1949, a few months before the recession ended. The best time in the business cycle to buy stocks historically is when the leading indicators are starting to rise near the end of recessions. Leading indicators have fallen for six months in a row, suggesting 2023 will be a recession year like 1948-1949. The best time in the business cycle to buy Treasury bonds historically is when the leading indicators say a recession is about to begin.

The surge in longer-term interest rates around the world suggests waning confidence in central banks' willingness to control inflation over the years ahead. U.S. rates have broken out of a four-decade downtrend. From 1982 until the pandemic, the federal funds rate and the 10-year Treasury rate reached lower lows and lower peaks in each successive business cycle. That trend has been broken, as the funds rate and 10-year Treasury note yield have now exceeded their prior cycle highs.

The cycle peak in long-term rates is unlikely to move much higher given our view that the Fed is over-tightening into a looming recession, with 2023 inflation likely to surprise to the downside as a result. Extending duration in high-quality credit is generally a good idea at this stage of the business cycle, as riskier assets are likely to suffer when earnings estimates come down and credit problems start to proliferate in a slower economy with declining pricing power. Within Equities, companies with strong cash flows, less sensitive to falling consumer demand as unemployment rises and household net worth shrinks may be good candidates.

Until the Fed adopts a framework that explicitly acknowledges the role that sharp swings in money supply growth play in the big swings in inflation and nominal GDP growth, it will be prone to the mistakes of the past few years. If Mr. Powell is trying to channel former Fed Chair Paul Volcker, he needs to pay attention to the money supply as Mr. Volcker did. Curiously, Mr. Powell has gone out of his way to dismiss the relevance of the former Fed Chair's main tool for controlling inflation.

Another historical policy mistake was the Fed sitting idly by during the 1929-1933 collapse in the money supply, which Professor Milton Friedman and Anna Schwartz—American economist—blamed for the Great Depression. Ben Bernanke, then a Fed governor, promised Mr. Friedman that the Fed would not let that happen again. The current Fed seems to have forgotten the lessons of monetary history and the role of money growth in the inflation process.

The I.C.E. is Cracking: Global Recessionary Risks are Rising

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

Lauren J. Sanfilippo, Director and Senior Investment Strategy Analyst

Rarely have the stars so misaligned for the global economy and for investors of all stripes. As we enter the final quarter of the year, the world is struggling with not just one seismic challenge, with elevated rates of inflation not seen in decades in the U.S. and a hawkish Fed. Nor two, with a pandemic that has sapped the economic vigor out of China, creating negative ripple effects for the rest of the world. But rather three tectonic, market-moving hazards, when the brutal conflict in the heart of Europe is added to the mix.

The upshot of this toxic trifecta: unprecedented price swoons for both U.S. Equities and bonds, with similar results around the world. Equities, credit, Fixed Income, Commodities, currencies—no asset class has been spared the sell off and the market volatility of 2022. Adding it all up, investment returns have been *annus horribilis*, with more downside risks ahead.

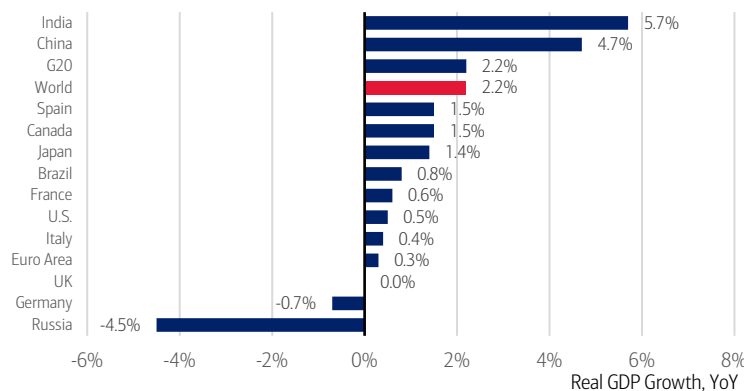
Indeed, the path forward is likely to remain choppy and volatile because the Big Three—the U.S., Europe and China—remain on thin I.C.E., a framework we presented earlier this year. Accounting for nearly two-thirds of world GDP, as the Big Three go, so goes the world. The near term trajectory of asset prices will be dictated by how the U.S. deals with sticky (I)nflation; China meets the challenge of (C)oronavirus; and Europe grapples with war and one of the worse (E)nergy crises in decades.

I=Inflation and the U.S. U.S. headline inflation may have peaked, but the fed funds rate has not; indeed, according to the latest projections from the Fed, the peak rate (terminal rate) has been pushed up to 4.6% in 2023, suggesting another 1.25-1.50 basis points (bps) in additional hikes in the coming months. The current pace of tightening is the fastest since the 1980s, spooking many investors who believe the Fed is moving too fast and too aggressively in raising rates, boosting the odds of something “breaking,” à la the U.S. economy.

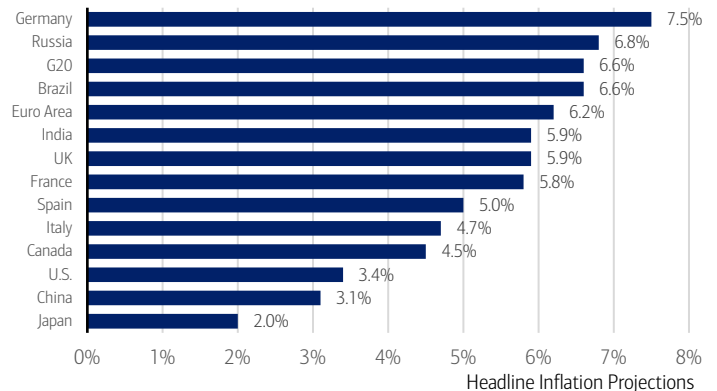
Adding to the credit angst: the Fed continues with its QT program, while central banks around the world have aggressively embraced the tightening mode of the Fed. The fear globally is that the cumulative effects of monetary tightening from all corners of the world will go too far and push the world economy into recession. The risks of the latter have risen considerably over the past few months, with the Organisation for Economic Co-operation and Development (OECD) recently lowering its 2023 world GDP growth to just 2.2% (Exhibit 2).

Exhibit 2: A Recent OECD Report Lowered Growth Forecasts And Raised Inflation Forecasts For 2023.

2A) OECD Downgrades to 2023 GDP Growth...



2B) ...and Inflation Forecast Upgrades.



Source: OECD Economic Outlook, Interim Report “Paying the Price of War”. Data as of September 2022.

C=Coronavirus and China. China’s battle with coronavirus is yet another risk to the global outlook. Rather than opting for science (aka, a vaccination) to combat it, Beijing has opted instead for a sledgehammer—including partial shutdowns or full shutdowns across the nation. China’s zero-Covid policies have brought the world’s second largest economy in the world to a near standstill, and have accentuated underlying weak spots in the economy (the over-leveraged property market, for instance) that has weighed on investor sentiment. Even if China avoids a recession this year, earlier GDP estimates/targets of 5.5% will not be met.

Investment Implications

Until policymakers gain the upper hand in dealing with inflation, the coronavirus and the energy crisis, global equity markets may remain choppy and volatile. In this elevated inflation environment and amid heightened geopolitical risks we continue to emphasize high-quality U.S. Equities and certain defensive sectors, where appropriate.

The OECD, in fact, recently estimated China’s real GDP growth at just 3.2% for this year, one of the weakest in decades.

E=Energy shock and Europe. Of the Big Three, Europe is the most at risk of a recession over the near term. Real GDP growth in the Eurozone surprised to the upside in Q2 thanks to a post-pandemic rebound in services and tourism. However, soaring energy costs over the past few months have hobbled one of the key pillars of the world economy.

Indeed, the latest figures from the S&P Global Flash Eurozone Composite Purchasing Managers’ Index, a gauge of business confidence, are plumbing all-time lows, with last month’s reading of 48.2 the lowest level since January 2021, and the third month in a row below the 50 mark that separates growth from contraction. Meanwhile, inflation in the Eurozone rose to 10.0% in September from 9.1% in August, reaching double-digits due in part to rising fuel prices. Price levels in the Eurozone have never been higher since it was created in 1999, with little relief in sight. Per the OECD: “with the recent spike in energy costs working its way through the economy and with monetary policy beginning later than the United States, both headline and core inflation are projected to remain elevated in much of Europe.”¹

Inflation will remain higher for longer across Europe—in contrast to the U.S.—and continue to squeeze real GDP growth and corporate earnings well into the first half of next year. Compounding matters: an even stronger greenback versus the euro and pound, with the euro down roughly 16% this year against the dollar, while the pound, due in part to the ham-fisted policies of the new government, hovering at record lows against the dollar. The upshot: falling European demand juxtaposed with a strong dollar represents a one-two punch to the bottom line of many U.S. firms. As an aside, roughly one-third of S&P 500 sales are generated overseas (and therefore exposed to a stronger dollar), with Technology and Materials having the highest overseas exposure.

“If you’re going through hell, keep going”

At the macro level, constructing a market bottom requires that the Fed gain the upper hand on inflation; that China aggressively reflates; and that Europe counters the spike in energy costs with fiscal and monetary levers that cushion the pain among households and business. All of these conditions remain unfilled or unmet at the moment, bringing to mind Winston Churchill’s famous wartime quip that “if you’re going through hell, keep going.” According to Evercore ISI Research, every tightening cycle has been associated with a financial shock or crisis and then met with a Fed shift in policy/reaction, as seen in Exhibit 3. With the global inflation shock of 2022 likely no different, policymakers have arguably never been more challenged than today. Their work has barely begun by some measures, and getting to the other side (out of the crisis) will require Churchill-like fortitude.

Exhibit 3: A Look At Financial Shocks Or Crises And The Fed’s Reaction.

<u>Financial Shock/Crisis</u>		<u>Fed Reaction</u>
1984	Continental Illinois	Eased
1987	Black Monday	Eased
1994	Tequila Crisis	Eased
1997	Asia	Paused
1998	Russia/Long-Term Capital Management	Eased
2012	Eurozone Crisis	More QE
2016	Oil Collapse	Paused
2020	Pandemic	Eased
2022	Global Inflation Shock	Tighten

Sources: Evercore ISI Research. Data as of September 28, 2022.

Given our more cautious investment stance, we are defensively-neutral U.S. Equities due in part to the weakening global backdrop and risks to growth and corporate profits skewed to the downside. As policymakers pursue a more aggressive tightening bias, and as global growth prospects continue to moderate, profit estimates are likely to follow. In this environment we continue to emphasize portfolio positioning that is underpinned by diversified, high-quality assets.

¹ See the OECD “The Price of War” Interim Report, September 2022.

THOUGHT OF THE WEEK

Are Equities Cheap?

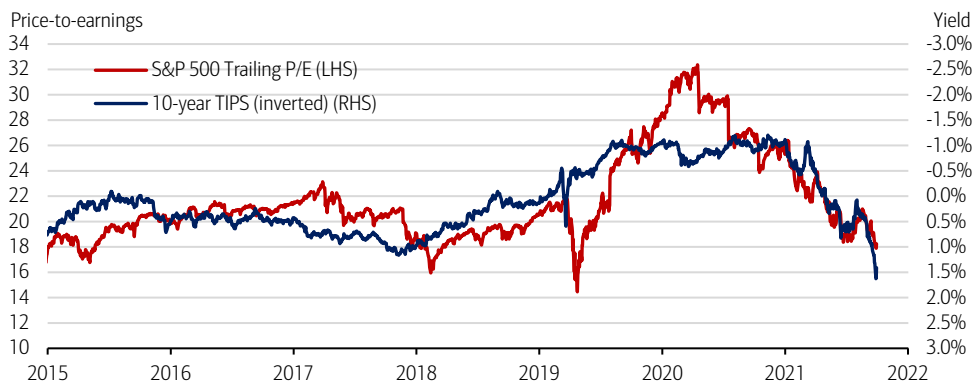
Kirsten Cabacungan, Assistant Vice President and Investment Strategist

Stock valuations have fallen considerably from where they were at the start of the year. The S&P 500's trailing 12-month price-to-earnings (P/E) multiple at around 18x sits far below the roughly 26x at which Equities were valued at the turn of 2022.² By that measure, Equities have cheapened, but a few developing conditions may become additional tailwinds for valuations to potentially shift lower in the months ahead.

Valuations could creep lower as earnings start to suffer. Consensus analyst earnings estimates for 2023 are still calling for S&P 500 earnings per share to improve to \$242 in 2023, or roughly 7.8% in earnings growth.³ But with inflation still running hot and the Fed proving its commitment to an aggressive monetary policy path amid a cumulative 300 bps in interest rate hikes so far this year, in addition to QT, the profit outlook looks set to weaken as rising costs eat into profit margins. The U.S. weekly earnings revision ratio, or the ratio of earnings estimate upgrades to downgrades, fell to 0.57 as of the third week of September, now the weakest earnings trend relative to other global regions.⁴

Rising real yields are also pressuring valuations. The yield on the 10-year Treasury Inflation-Protected Securities (TIPS) flipped positive in May for the first time since before the pandemic and surged at a rapid clip, rising to 1.4% as the Fed shifted hawkish.² Climbing inflation-adjusted yields tend to challenge Equity valuations as higher bond yields start to look more attractive and the opportunity cost of holding Equities rises, especially for longer-duration companies, which are expected to generate earnings farther out in the future (Exhibit 4).

Exhibit 4: Stock Valuations have Fallen as Real Yields have Surged.



Sources: Bloomberg. Data as of September 28, 2022.

The historical perspective only further bolsters the view that valuations could still be at a premium level. The current S&P 500 trailing 12-month P/E multiple remains well above where it stood at the end of the 11 previous bear market cycles since 1954.²

Ultimately, however, the answer to whether Equities look cheap depends on who is asking. Long term investors with excess cash to deploy may find valuations at their current level a reasonable entry point. Given the resiliency of the U.S. economy, it may be rational to expect that the bleak earnings outlook will eventually improve, especially once the Fed pauses and reverses course. Stock valuations at that point will likely reprice higher as the market starts to discount a higher profit cycle. For now, investors with cash on the sidelines should remain disciplined and invest over time as opportunities arise.

² Bloomberg. Data as of September 28, 2022.

³ FactSet. Data as of September 28, 2022.

⁴ BofA Global Research. "High Frequency Monitor: Earnings Slow," September 26, 2022.

Investment Implications

We remain neutral on Equities and a slight underweight to Fixed Income, and continue to emphasize broad portfolio diversification. Investors with excess cash on the sidelines and a longer time horizon should monitor opportunities to add to higher-quality positions in Equities at points of extreme weakness over the reset period.

Equities

	Total Return in USD (%)			
	Current	WTD	MTD	YTD
DJIA	28,725.51	-2.9	-8.8	-19.7
NASDAQ	10,575.62	-2.7	-10.4	-32.0
S&P 500	3,585.62	-2.9	-9.2	-23.9
S&P 400 Mid Cap	2,203.53	-1.5	-9.2	-21.5
Russell 2000	1,664.72	-0.8	-9.6	-25.1
MSCI World	2,378.65	-2.4	-9.3	-25.4
MSCI EAFE	1,661.48	-1.4	-9.4	-27.1
MSCI Emerging Markets	875.79	-3.3	-11.7	-27.2

Fixed Income[†]

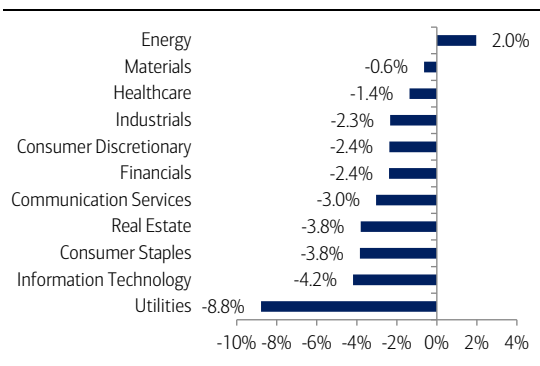
	Total Return in USD (%)			
	Current	WTD	MTD	YTD
Corporate & Government	4.71	-1.13	-4.08	-15.10
Agencies	4.40	-0.24	-2.10	-8.51
Municipals	4.04	-0.96	-3.84	-12.13
U.S. Investment Grade Credit	4.75	-0.99	-4.32	-14.61
International	5.69	-1.89	-5.26	-18.72
High Yield	9.68	-1.36	-3.97	-14.74
90 Day Yield	3.25	3.18	2.90	0.03
2 Year Yield	4.28	4.20	3.49	0.73
10 Year Yield	3.83	3.68	3.19	1.51
30 Year Yield	3.78	3.61	3.29	1.90

Commodities & Currencies

	Total Return in USD (%)			
	Current	WTD	MTD	YTD
Commodities				
Bloomberg Commodity	240.55	-0.7	-8.1	13.6
WTI Crude \$/Barrel ^{††}	79.49	1.0	-11.2	5.7
Gold Spot \$/Ounce ^{††}	1660.61	1.0	-2.9	-9.2

	Total Return in USD (%)			
	Current	Prior Week End	Prior Month End	2020 Year End
Currencies				
EUR/USD	0.98	0.97	1.01	1.14
USD/JPY	144.74	143.31	138.96	115.08
USD/CNH	7.14	7.14	6.91	6.36

S&P Sector Returns



Sources: Bloomberg; Factset. Total Returns from the period of 9/26/2022 to 9/30/2022. [†]Bloomberg Barclays Indices. ^{††}Spot price returns. All data as of the 9/30/2022 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 9/30/2022)

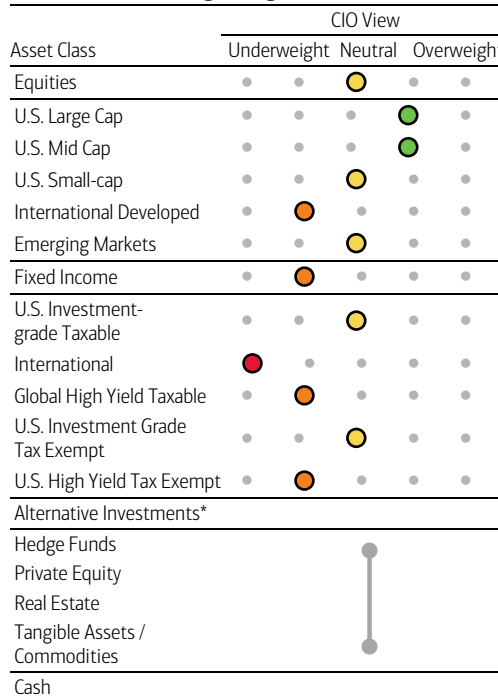
	2021A	Q1 2022A	Q2 2022A	Q3 2022E	Q4 2022E	2022E
Real global GDP (% y/y annualized)	6.1	-	-	-	-	3.4
Real U.S. GDP (% q/q annualized)	5.7	-1.6	-0.6	1.0	0.5	1.6
CPI inflation (% y/y)	4.7	8.0	8.6	8.2	7.0	7.9
Core CPI inflation (% y/y)	3.6	6.3	6.0	6.2	6.1	6.2
Unemployment rate (%)	5.4	3.8	3.6	3.6	3.6	3.6
Fed funds rate, end period (%)	0.07	0.33	1.58	3.08	4.38	-

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.**

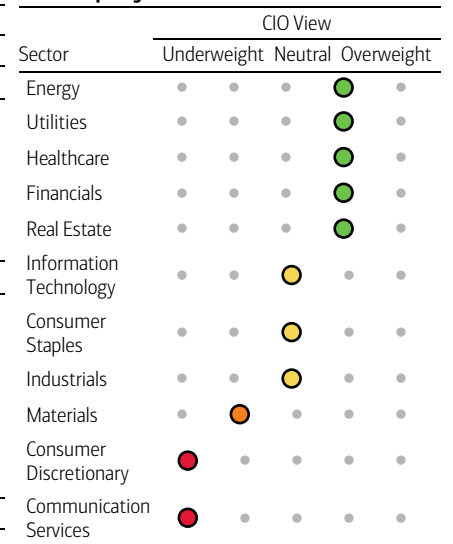
A = Actual. E/* = Estimate.

Sources: BofA Global Research; GWIM ISC as of September 30, 2022.

Asset Class Weightings (as of 9/6/2022)



CIO Equity Sector Views



*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 September 6, 2022. 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.

S&P Global Flash Eurozone Composite Purchasing Managers' Index is based on original survey data collected from a representative panel of around 5,000 manufacturing and services firms

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Alternative investments are speculative and involve a high degree of risk.

Alternative investments are intended for qualified investors only. Alternative Investments such as derivatives, hedge funds, private equity funds, and funds of 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.

Nonfinancial assets, such as closely held businesses, real estate, fine art, oil, gas and mineral properties, and timber, farm and ranch land, are complex in nature and involve risks including total loss of value. Special risk considerations include natural events (for example, earthquakes or fires), complex tax considerations, and lack of liquidity. Nonfinancial assets are not in the best interest of all investors. Always consult with your independent attorney, tax advisor, investment manager, and insurance agent for final recommendations and before changing or implementing any financial, tax, or estate planning strategy.

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