

# Capital Market Outlook

March 22, 2021

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

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- **Macro Strategy**—With valuations neither a headwind nor a tailwind and the U.S. economy currently set to significantly outperform developed market economies this year and next, the dollar has near-term support. Longer-term, the fiscal debt binge raises some concerns in the absence of fiscal discipline.
- **Global Market View**—A glimpse of the post-pandemic world looks slightly different from today, with many changes on the margins. There will likely be more Federal Reserve (Fed) hawks than doves a year from now. Against this backdrop, we continue to maintain our bias toward U.S. equities and long-term thematic growth segments.
- **Thought of the Week**—Value is currently staging a comeback—again. This time, however, the recent rotation into Value has overcome earlier attempts with Value returning its strongest outperformance in February relative to Growth since March 2001, a sign that the reflation trade is continuing to gain steam with the economy continuing to improve and rising expectations for inflation.
- **Portfolio Considerations**—This month we adjusted our sector views by raising Energy, which was balanced by a move lower in Technology and a downgrade to Consumer Staples. We reaffirm our positive view on equities relative to fixed income and expect participation to broaden across sectors, regions and styles.

## MACRO STRATEGY

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Managing Director and Senior  
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## GLOBAL MARKET VIEW

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## THOUGHT OF THE WEEK

### Kirsten Cabacungan

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**Data as of 3/22/2021,  
and subject to change**

## MACRO STRATEGY

### Dollar Trends For Investors To Watch

*Jonathan W. Kozy, Managing Director and Senior Macro Strategy Analyst*

Following the pandemic-induced surge in the U.S. dollar in March of last year, interest rate differentials that favored the dollar versus its biggest trading partners collapsed as the Fed immediately drove its policy rate to near-zero and began quantitative easing. Valuations were an additional headwind for the dollar at the time and the Bloomberg Dollar Index (BBDXY) ended up finishing 2020 down 6%. Many investors expected that trend to continue in 2021.

Thus far, the dollar has been resilient, particularly against the euro. While strong global growth and massive reflationary efforts will likely continue to benefit commodity currencies like the Australian dollar (AUD), the New Zealand dollar (NZD), and the Canadian dollar (CAD), the U.S. dollar should hold its own against the euro and Japanese yen as economic growth differentials and related interest rate differentials are increasingly to its advantage.

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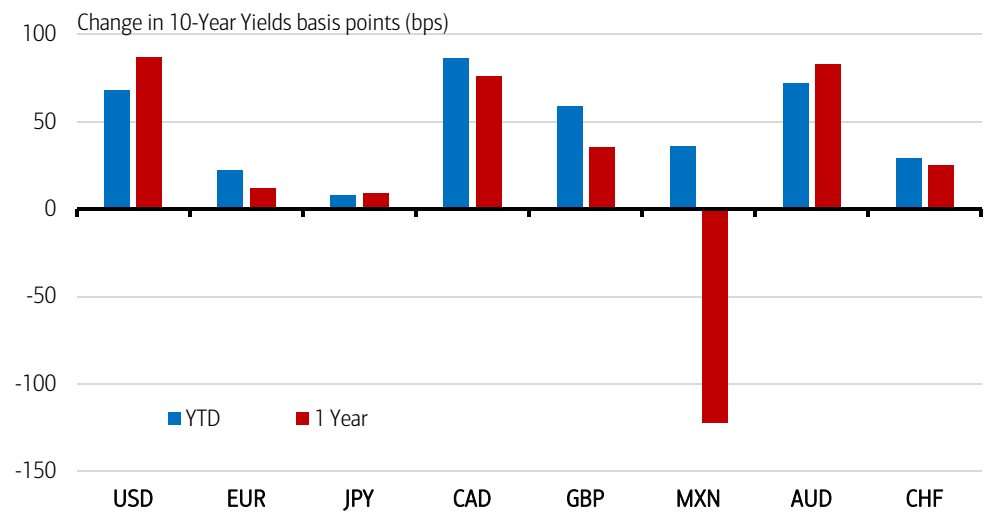
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**Fiscal stimulus is near-term support, but a long-term concern.** President Biden's \$1.9 trillion American Rescue Plan is supporting the reflation trade and the dollar's near-term stabilization versus the non-commodity and risk-off currencies. Growth expectations and long-term interest rates in the U.S. are moving higher on an absolute (Exhibit 1) and relative basis. The euro holds a significant weight in most trade-weighted indexes, and the upward move in long rates is confirming that the U.S. economy is set to outperform the European economy by a number of metrics. Following Biden's most recent fiscal stimulus plan, BofA Global Research now projects real gross domestic product will likely grow 6.5% in the U.S. this year, versus 4.3% in Europe. On the other hand, Australia, Canada and the U.K. have seen comparable gains in 10-year bond yields, among the major currencies, helped by faster global growth, reflation and post-Brexit relief in the case of the U.K. Not surprisingly, all have strong spot returns versus the dollar over the same time periods.

**Exhibit 1: Long-term Interest Rates In The U.S. Have Moved Up Faster Than Non-commodity Currencies.**



Source: Bloomberg. Data as of March 16, 2021. Past performance is no guarantee of future results.

**Monetary policy may turn into a tailwind over the next few years.** The Fed's Summary of Economic Projections for March showed most Fed officials do not expect rate hikes this year or next. Four out of 18 officials are forecasting a possible rate increase in 2022. For dollar prognosticators, this is a mixed bag. Short-term rates are pinned near zero, but long-term rates are likely to move higher as both the Fed and fiscal policy are driving growth and inflation higher. And the Fed has given no indications that it is looking to put a cap on long-term rates anytime soon as long as overall financial conditions are accommodative.

The good news for the dollar is that neither the European Central Bank (ECB) nor the Bank of Japan (BoJ) is likely to raise short-term rates anytime soon either, and the BoJ has its 10-year bond yield pinned at zero. The Fed is likely to move first, supporting the view that the dollar could hold its own versus the euro and yen even if it takes a hit versus the beneficiaries of rising commodity prices and global growth (Australia, Canada and New Zealand, for example). If the Fed ends up moving up the timing of rate hikes, the dollar will likely benefit.

**The risk environment plays an important role in currency performance.** Massive fiscal and monetary policy efforts are supportive of global growth beneficiaries and a risk-on environment more broadly. Typically this favors cyclical currencies like the Australian dollar (AUD), New Zealand dollar (NZD) and Canadian dollar (CAD) versus risk-off currencies like the yen. Over the last year this has largely played out as the top-performing major currencies versus the dollar are the Australian dollar, Norwegian krone and New Zealand

dollar. From a risk perspective, an offsetting factor could be that higher frequency measures of cyclical momentum, like the U.S. manufacturing index, are elevated, leaving room for negative changes even if the level remains high. This period is also unique in the sense that U.S. growth is likely to be the fastest it has been in decades because of the scale of fiscal stimulus.

The coronavirus adds a layer of ambiguity to the risk environment. Even as vaccine diffusion advances there is uncertainty around the path of the virus and mutations. The dollar's status means it will likely benefit from bouts of risk-off sentiment if the pandemic resurges. On the other hand, if reopening expands faster than expected across the world, risk-on sentiment will likely stick around.

**Looking further out, valuations underpin the medium-term outlook, and the dollar is no longer running against the wind.** The balance of data suggests the dollar is near fair value on a trade-weighted basis. The euro holds the largest weight in trade- and liquidity-weighted indexes and by several valuations metrics, including purchasing power parity (PPP), the euro is close to fair value or perhaps slightly undervalued. Perhaps not coincidentally, the euro is currently trading near its long-term average versus the dollar while the Bank for International Settlements real effective exchange rate for the euro is slightly below its long-term average. The Japanese yen remains structurally undervalued and is likely to remain so, providing a tailwind for Japanese equities. AUD and NZD are increasingly expensive in PPP terms, something for investors to consider if the reflation trade loses momentum.

**Investors should also pay attention to the U.S. dollar reserve currency status, with a longer time frame.** Data from the International Monetary Fund (IMF) for the third quarter of 2020 showed that U.S. dollar reserves held by central banks or other monetary authorities as a percent of the global total dropped to 60.4%, the lowest share since the mid-1990s. The U.S. dollar's status as the primary global reserve currency status has been called an "exorbitant privilege," as it provides several unique advantages. These benefits include the ability to finance twin (current and fiscal account) deficits at lower rates, to use dollar-based sanctions and other financial controls as a tool in the international relations arena, and to be the global liquidity provider of last resort. More broadly, it makes it easier for U.S. companies to do business. In the era of great power competition, the Chinese renminbi (RMB) gets the most attention as a dollar alternative, despite the fact that it accounts for just 2% of global reserves. But it is the Japanese yen that has made up the most ground. Since 2013 the yen's share has gone from 3.5% to nearly 6%, perhaps reflecting Japan's success in threading the needle of security concerns with the benefits of free trade.

Why should investors care? In addition to the advantages of dollar hegemony that were already laid out, currency status can be viewed as a proxy for economic power. Currencies reflect economic health, military might, governance, credibility, transparency and technology, to name a few factors. In brief, it is a geo-economics beauty contest.

**The fiscal-stimulus-driven debt binge across the globe could also lead to a hangover and add to currency volatility.** Currency markets often take on the role of rebalancing the global economy, and it's possible that history repeats itself here both tactically and strategically. Investors will need to raise due diligence standards for currency and debt risk in an environment of excessive debt. In the current environment this includes emerging markets where cost of debt exceeds the economic growth rate.

**April 2022**

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

*Lauren J. Sanfilippo, Vice President and Investment Strategist*

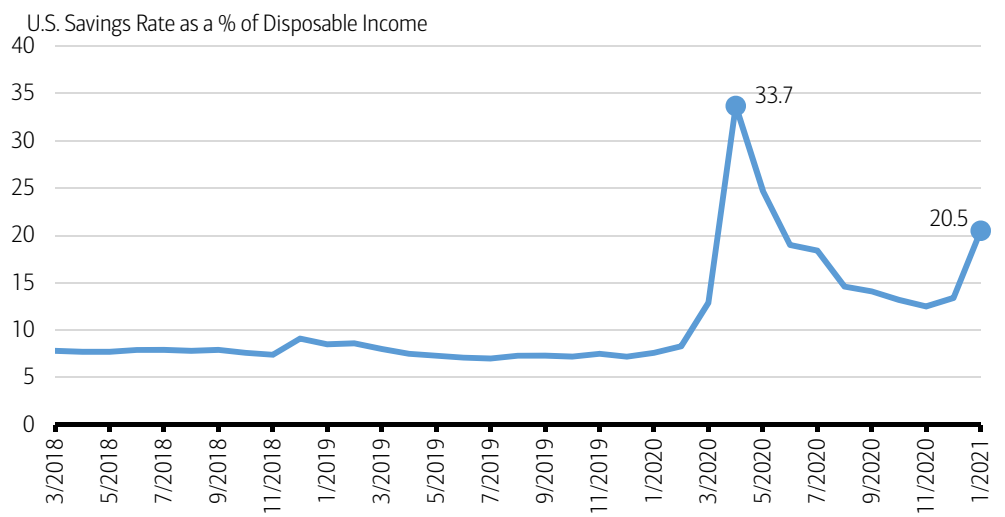
Playing the scenario forward, it's April 2022 and coronavirus is in the rearview mirror. No, the World Health Organization has yet to officially declare the pandemic over. But social distancing and the massive global vaccination efforts of 2021 have repelled a disease that in the end claimed the lives of roughly 3 million people around the world. Despite the staggering toll of the coronavirus, the world is healing.

Cities are coming back, but they're different. Many used the pandemic to re-create themselves—we see less vehicle traffic and greater mobility via bikes and electric scooters. Affordable and easy to haul around, e-bikes are everywhere. Electrical charging stations are ubiquitous. Parking garages have been converted into horizontal farms. Some department stores and shops that didn't survive the pandemic have been converted to mini-warehouses or pop-up shops for tenants launching new/seasonal wares. Falling rents over 2020-21 helped to reverse the pandemic-induced flight out of the cities, and many urban areas are again humming with workers and consumers.

Working remotely is still popular, but it's becoming increasingly clear that many companies and workers prefer a hybrid system—a few days of work at home balanced against a few days in the office. Business travel remains in a state of decline but domestic air traffic has soared over the past few quarters as once homebound consumers shed the restrictions of the stay-at-home economy. To many Americans, the vaccine was akin to a "get-out-of-jail" card. The U.S. service economy is booming, and the outlook for U.S. manufacturers has greatly improved from a year ago, when material shortages, supply disruptions and transportation bottlenecks restrained production across various sectors of the economy.

Thanks to consumer pent-up demand and pent-up savings, U.S. consumption has come roaring back over the past year. The second half of 2021 was a spectacle of parties, reunions, packed stadiums and overflowing concert halls. "Revenge spending" was at its peak as Americans worked down the U.S. savings glut, while better-than-expected employment growth fueled growth in jobs and incomes. Similar spending splurges were evident in China, other parts of Asia and Europe (Exhibit 2).

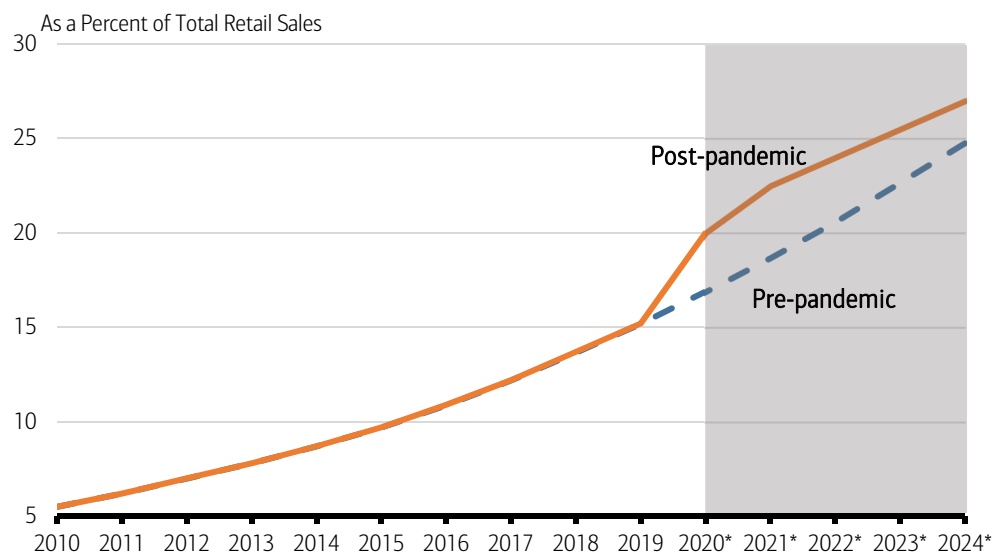
**Exhibit 2: U.S. Savings Glut.**



Source: Bureau of Economic Analysis. Data as of February 2021.

But still unknown is how much the pandemic has structurally changed the way consumers shop. Online shopping in the U.S., of course, accelerated during the pandemic (Exhibit 3) but traditional brick-and-mortar stores have staged an impressive comeback. Foot traffic at U.S. malls, after cratering by nearly 96% in April 2020, looks to be recovering as Americans do what they do best: shop. And stores are more than just stores now—merging online shopping with in-store experiences for consumers desiring both. Many stores have done away with traditional cashiers, many not accepting cash anymore and prefer—like many consumers—contactless payments systems. Some have morphed into fulfillment centers. And for convenience and purposes of distancing, curbside pickup from food to furniture remains popular.

### Exhibit 3: U.S. eCommerce Sales Reset.



\*gray box denotes estimates/forecasts. Forecasts are subject to change. Dashed line represents eCommerce without the step up from the Pandemic. Sources: Euromonitor; Prologis Research. Data as of June 2020.

For the Fed, life seems a lot more complicated today than a year ago. Then, Fed Chairman Jerome Powell and the Federal Open Market Committee were quite comfortable letting the economy rip, and were relatively steadfast in their belief that the Fed wouldn't have to adjust its near-zero interest-rate target until 2024. As the Fed expected, the economy boomed in 2021 (expanding by over 6%) and unemployment fell to close to its target year-end rate of 4.5%. However, the Fed's personal consumption expenditures (PCE) price deflator did breach the target of 2%—overshooting, in other words, triggering fears and volatility in the capital markets that the Fed would raise rates sooner rather than later.

Over the second half of 2021, U.S. equity prices oscillated between the optimism of strong real gross domestic product (GDP) growth and better-than-expected earnings, on the one hand, and fears of an economy overheating and the Fed taking away the punch bowl, on the other. Trading was choppy. And the push-pull continued into 2022. Other potential headwinds have emerged, namely the mounting U.S. federal budget deficit and the wherewithal to service the debt in the face of rising U.S. interest rates. Nary mentioned a year ago, the debate around the risks of America's twin deficits—current account and federal budget—is garnering a great deal more attention among investors.

### The Chief Investment Office (CIO) Investment Strategy

Given where we stand today, our investment strategy pivots on the following:

- We remain overweight equities to fixed income, believing the former are the primary means to help drive wealth accumulation over the long run. The latter, however, remains

a key diversifier of portfolios, a complement to equity risk and a source of coupon income.

- Given the continued build-out of the global digital economy, we continue to favor Large-cap Technology names, U.S. and non-U.S.
- We continue to favor thematic segments like cybersecurity, healthtech and the platform economy.
- As part of the super cycle in infrastructure spending, we continue to favor infrastructure-related industrial companies and leaders in renewables (solar, wind, electrical vehicles, biomass) and the required infrastructure behind each renewable energy source.
- Similarly, with the global push toward a zero carbon future, we like leaders in electricity distribution, charging stations and batteries, as well as low-carbon hydrogen, biomethane and advanced biofuels.
- In that the “Green revolution” is metal-intensive, we continue to favor commodities like copper, cobalt, lithium and rare earth minerals, among others.

In the end—and what has been the consistent message of the CIO for years—the best hedge against market cycles and one-off surprises is a diversified portfolio both across and within asset classes. Whatever the year, whatever the crisis, that never changes. Welcome to the future.

## THOUGHT OF THE WEEK

### Value’s Comeback Story

*Kirsten Cabacungan, Assistant Vice President and Investment Strategist*

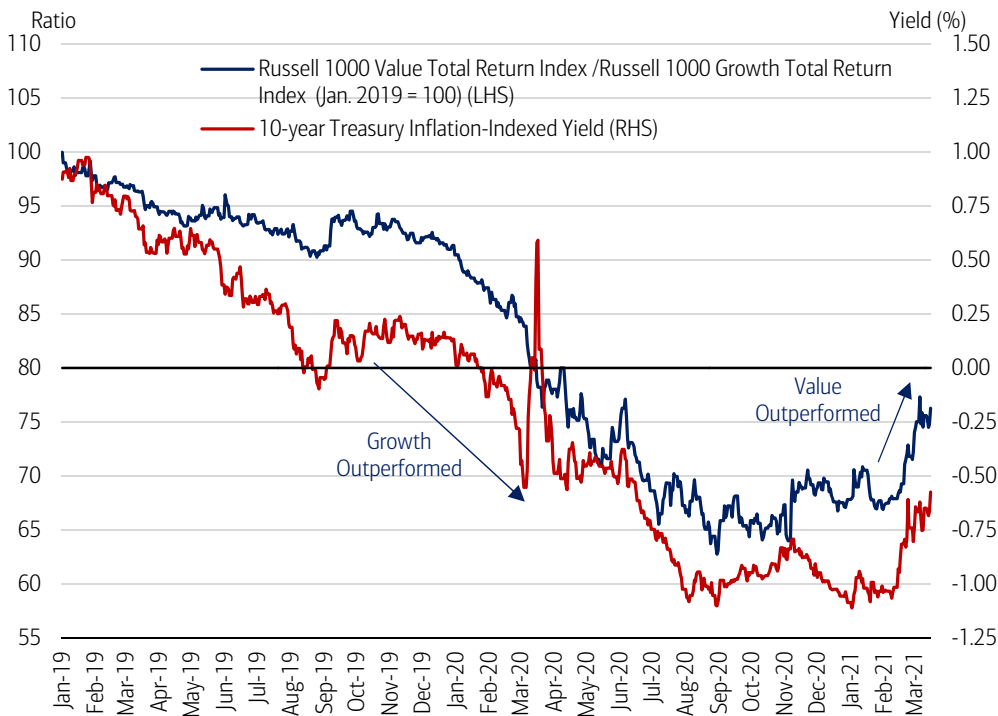
Value is currently staging a comeback—again. This time, however, the recent rotation into Value has bested earlier attempts with Value returning its strongest outperformance in February relative to Growth since March 2001, and amid more Value-oriented sector leaders so far this year with Energy and Financials up 30% and 16%, respectively. Both are signs that the reflation trade is continuing to gain steam with the economy improving and expectations for inflation rising.

This shift comes on the heels of a strong year for Growth stocks. The Russell 1000 Growth Index returned 84% from the market bottom to the close of 2020, trouncing the Russell 1000 Value Index by a large margin with the index gaining 61%. The performance gap between the two factors widened in large part as result of a strong Technology sector, which accounts for roughly 45% of the Growth index. Still, rotations into more cyclical areas of the market ebbed and flowed in the latter half of 2020, with Value outperforming Growth by over two percentage points each month from September to November 2020. These rotations ultimately never fully solidified with investors favoring more secular growth areas during periods of uncertainty surrounding the elections and the coronavirus. Recent moves favoring Value beg the question if this broadening out of leadership will stick.

The dynamics between Growth and Value are closely tied to the economic cycle and profits. Growth generally sees stronger performance during the later stage of a cycle when economic growth starts to slow and when uncertainty may be higher, driving investors to favor companies that do not strictly depend on a strong economy to maintain growth in earnings. Stronger Value performance tends to happen at the early-to-middle stage of the cycle when the profit cycle accelerates and improving earnings growth is shared across the board. That period tends to be characterized by rising interest rates amid improving prospects for economic growth and inflation.

At this point, the recent move higher in interest rates proved to be the catalyst for the Value rotation to try once more after the low rates environment of the last year underpinned Growth's performance. The 10-year Treasury yield has moved up roughly 80 basis points from the end of 2020, sitting now at 1.7%. And while the main driver of the move higher in rates has been rising expectations for inflation given the massive stimulus filtering through the economy, real yields, or inflation-adjusted yields, have also started to move higher. Value has recently closely tracked the moves in real yields, as measured by the 10-year Treasury inflation-indexed yield (Exhibit 4), which could mean this catch-up in Value has more staying power given that real yields are still very negative.

**Exhibit 4: Value Has Closely Tracked The Moves In Real Yields.**



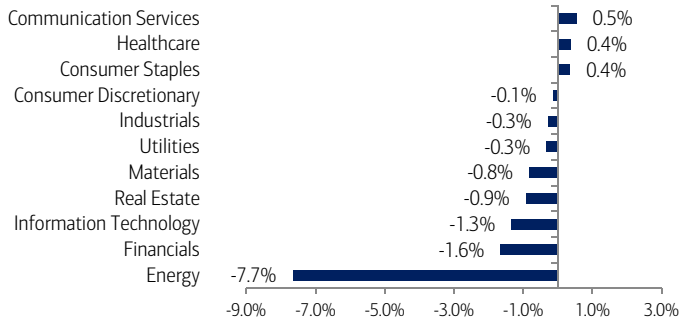
Source: Bloomberg. Data as of March 18, 2021. Short term performance shown to illustrate more recent trend. Past performance is no guarantee of future results.

## MARKETS IN REVIEW

### Equities

	Total Return in USD (%)			
	Current	WTD	MTD	YTD
DJIA	32,627.97	-0.4	5.6	7.1
NASDAQ	13,215.24	-0.8	0.2	2.7
S&P 500	3,913.10	-0.7	2.8	4.5
S&P 400 Mid Cap	2,614.15	-1.2	4.8	13.6
Russell 2000	2,287.55	-2.8	4.0	16.0
MSCI World	2,796.14	-0.4	2.7	4.2
MSCI EAFE	2,231.43	0.6	3.1	4.3
MSCI Emerging Markets	1,336.84	-0.8	-0.1	3.8

### S&P 500 Sector Returns



Sources: Bloomberg, Factset. Total Returns from the period of 3/15/2021 to 3/19/2021. <sup>1</sup>Bloomberg Barclays Indices. <sup>2</sup>Spot price returns. All data as of the 3/19/2021 close.

Past performance is no guarantee of future results.

### Asset Class Weightings (as of 3/2/2021)

	Under-Weight	Neutral	Over-Weight
<b>Equities</b>			
U.S. Large Caps			
U.S. Mid Caps			
U.S. Small Caps			
International Developed			
Emerging Markets			
<b>Fixed Income</b>			
U.S. Investment Grade Taxable			
International			
Global High Yield Taxable			
U.S. Investment Grade Tax Exempt			
U.S. High Yield Tax Exempt			
<b>Alternative Investments*</b>			
Hedge Funds			
Private Equity			
Real Estate			
Tangible Assets / Commodities			
<b>Cash</b>			

\*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.

### Fixed Income<sup>†</sup>

	Total Return in USD (%)			
	Current	WTD	MTD	YTD
Corporate & Government	1.53	-0.24	-1.86	-4.59
Agencies	0.78	-0.12	-0.66	-1.57
Municipals	1.25	-0.51	0.21	-0.76
U.S. Investment Grade Credit	1.62	-0.28	-1.49	-3.61
International	2.32	-0.20	-2.39	-5.30
High Yield	4.55	-0.53	-0.75	-0.05

	Current	Prior Week End	Prior Month End	2020 Year End
90 Day Yield	0.00	0.02	0.03	0.06
2 Year Yield	0.15	0.15	0.13	0.12
10 Year Yield	1.72	1.62	1.40	0.91
30 Year Yield	2.43	2.38	2.15	1.64

### Commodities & Currencies

	Total Return in USD (%)			
	Current	WTD	MTD	YTD
<b>Commodities</b>				
Bloomberg Commodity	180.46	-1.7	-0.9	8.3
WTI Crude \$/Barrel <sup>††</sup>	61.42	-6.4	-0.1	26.6
Gold Spot \$/Ounce <sup>††</sup>	1745.23	1.0	0.6	-8.1
<b>Currencies</b>				
EUR/USD	1.19	1.20	1.21	1.22
USD/JPY	108.88	109.03	106.57	103.25
USD/CNH	6.51	6.50	6.48	6.50

### Economic & Market Forecasts (as of 3/19/2021)

	Q2 2020A	Q3 2020A	Q4 2020A	2020A	Q1 2021E	Q2 2021E	2021E
Real global GDP (% y/y annualized)	-	-	-	-3.2	-	-	5.7
Real U.S. GDP (% q/q annualized)	-31.4	33.4	4.1	-3.5	5.5	8.0	6.5
CPI inflation (% y/y)	0.4	1.3	1.2	1.2	1.8	3.5	2.7
Core CPI inflation (% y/y)	1.3	1.7	1.6	1.7	1.4	2.1	1.8
Unemployment rate (%)	13.0	8.8	6.7	8.1	6.2	5.7	5.5
Fed funds rate, end period (%)	0.08	0.09	0.09	0.09	0.13	0.13	0.13
10-year Treasury, end period (%)	0.66	0.68	0.91	0.91	1.70	1.85	2.15
S&P 500 end period	3100	3363	3756	3756	-	-	3800
S&P earnings (\$/share)	28	39	42	140	36	40	165
Euro/U.S. dollar, end period	1.12	1.17	1.22	1.22	1.20	1.18	1.15
U.S. dollar/Japanese yen, end period	108	105	103	103	105	104	106
Oil (\$/barrel, avg. of period, WTI <sup>**</sup> )	29	40	44	40	58	64	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. <sup>\*\*</sup>West Texas Intermediate. Sources: BofA Global Research; GWIM ISC as of March 19, 2021.

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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 Total Return 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.

**Bloomberg Dollar Spot Index (BBDX)** tracks the performance of a basket of 10 leading global currencies versus the U.S. Dollar.

**Manufacturing Index** is a monthly indicator of U.S. economic activity based on a survey of purchasing managers at more than 300 manufacturing firms.

**Russell 1000 Value Total Return Index** represents the top 1000 companies by market capitalization in the United States and comprises about 92% of the total market cap of all listed stocks in the U.S. equity market. It is considered a bellwether index for large-cap investing.

**Russell 1000 Growth Total Return Index** measures the performance of the large- cap growth segment of the US equity universe. ... The index is completely reconstituted annually to ensure new and growing equities are included and that the represented companies continue to reflect growth characteristics.

**10-year Treasury Inflation-Index** is indexed to an inflationary gauge to protect investors from the decline in the purchasing power of their money.

**Personal Consumption Expenditure Index** measure is the component statistic for consumption in gross domestic product collected by the United States Bureau of Economic Analysis. It consists of the actual and imputed expenditures of households and includes data pertaining to durable and non-durable goods and services.

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