

CHIEF INVESTMENT OFFICE

Capital Market Outlook

March 6, 2023

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

IN THIS ISSUE

Macro Strategy—*Watch the Gap:* A wave of better-than-expected economic data over the past month has boosted expectations for a sustained U.S. economic growth reacceleration entailing continued Federal Reserve (Fed) rate hikes and higher-for-longer interest rates.

While the negative growth momentum apparent at the end of 2022 has been mitigated, warning signals from various leading indicators still suggest a dimming outlook. For example, as high labor costs continue to eat into profits, stronger-than-expected headwinds to corporate profits are likely ahead, forcing companies to curb hiring. Thus, we believe that the recent batch of positive surprises is unlikely to be sustained, with sharp current divergences among certain typically strongly correlated indicators likely to be resolved in favor of renewed weakness.

Market View—*Powell vs. the \$26 Trillion Hydra-headed Beast:* One year into the Fed tightening cycle, it confronts a U.S. economy refusing to roll over easily. The call for a U.S. recession continues to be pushed out. Corraling a \$26 trillion economy isn't easy given the diverse nature of the U.S. economy; our economy is hydra-headed—or having many branches.

Hence, while manufacturing has slowed, services have accelerated. While housing is down, energy is soaring. California struggles, while the Carolina's boom. We still maintain a bias toward U.S. assets due in large part to the higher-quality, diverse nature of the U.S. economy.

Thought of the Week—*U.S. Exports and the \$3 Trillion No One is Talking About:* Even in the face of a super strong U.S. dollar, China shutdown and a war in the heart of Europe, U.S. exports of goods and services hit a record high of \$3 trillion last year. Nothing better underscores the global competitiveness of Corporate America.

An export powerhouse, America's exports run the gamut, ranging from industrial supplies, to autos, advanced technology products, energy, and a host of service activities. One caveat: America's tilt toward trade and investment restrictions/protectionism threatens to impede global sales and future global earnings of U.S. multinationals.

MACRO STRATEGY ►

Irene L. Peters, CFA®

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MARKET VIEW ►

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THOUGHT OF THE WEEK ►

Joseph P. Quinlan

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MARKETS IN REVIEW ►

**Data as of 3/6/2023,
and subject to change****Portfolio Considerations**

Overall, we are neutral Equities and Fixed Income due to our base case of a grind-it-out environment in 2023, but we see opportunities in total return sectors, dividend payers, high quality overall and better opportunities in Small-caps and non-U.S. Equities later in the year. We maintain a preference for high-quality bonds, as nominal and real rates are some of the most attractive in over a decade, while the economy is deteriorating later in the economic cycle, and recessionary signals increase. In addition, the inclusion of Alternative Investments,* for qualified investors, to help mitigate risk and/or potentially enhance portfolio returns, should also increase in importance in 2023, in our opinion.

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Investment products:

Are Not FDIC Insured	Are Not Bank Guaranteed	May Lose Value
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Please see last page for important disclosure information.

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* Many products that pursue Alternative Investment strategies are available only to qualified investors.

Watch the Gap

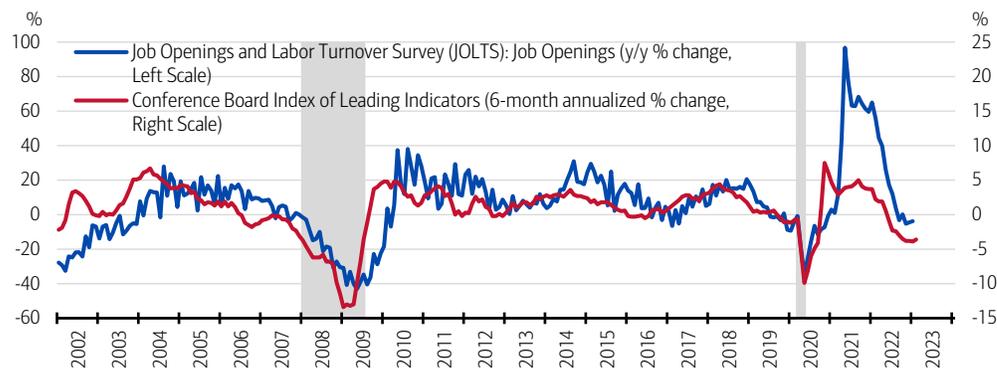
Irene L. Peters, CFA®, Director and Senior Macro Strategy Analyst

While forward-looking indicators of economic activity have overwhelmingly remained in territory typically associated with an approaching recession, coincident indicators have not reached the recession threshold yet. In fact, led by eye-popping employment data, many rebounded in January. Easing supply disruptions, favorable winter temperatures, robust personal income gains, and slowing inflation—from a 10.5% annualized three-month rate in June 2022 to 3.5% in January, according to the Bureau of Labor Statistics' (BLS) Consumer Price Index, for example—have lifted consumer spending and hiring in early 2023. Even housing enjoyed some reprieve, with January new home sales offsetting continued declines in existing home sales as a modest drop in mortgage rates and increase in inventory spurred fence sitters to jump in.

Despite this batch of positive economic surprises, there are reasons to believe that the macroeconomic environment is not conducive to a sustained growth reacceleration. Labor supply is stretched, sharp increases in wage costs and declining business pricing power are already biting into profit margins, and housing remains in a deep recession. Indeed, with building costs up and insufficient single-home construction over the past 15 years, the inventory of vacant homes for rent or for sale has dropped to a 40-year low when adjusted for population growth, rendering homes unaffordable for first-time buyers. The more than doubling of mortgage rates in less than a year has further amplified this affordability problem, deepening the housing recession. In addition, many existing homeowners have mortgages so far below current interest rates that they find it too expensive to move. As a result, mortgage demand has dropped to a 28-year low, and home sales are the lowest in 12 years, according to the Mortgage Bankers' Association and the National Association of Realtors.

In addition, surveys of manufacturing activity, including the Institute for Supply Management (ISM) Index for February, still remain at or close to recession territory. Twelve of 18 industries surveyed by the ISM reported a contraction in business activity, with a growing number reporting declining new orders. Thus, signals for weakening economic conditions ahead or an approaching recession remain too numerous and consistent with each other to be dismissed, in our view. Overall, the tenth straight monthly decline in The Conference Board Index of Leading Indicators (LEI) has been validated by a deterioration on numerous fronts, including manufacturing, bank lending and small business surveys, as well as various labor-market indicators, such as job openings (Exhibit 1).

Exhibit 1: Year-To-Year Drop In Job Openings Confirms The Signal From The LEI.



Gray area represents recession periods. Sources: The Conference Board; Bureau of Labor Statistics/Haver Analytics. Data as of March 3, 2023.

Out of the various positive recent economic surprises, labor-market data, in particular, have boosted growth and interest rate expectations. After all, the unemployment rate dropped to a rock bottom 3.4%, the lowest in more than 50 years, job-vacancy tallies rebounded from already unusually elevated levels, unemployment compensation claims have not budged from minimal levels (despite a surge in corporate layoff announcements), and labor income started the year with a surge, suggesting strong fuel for sustained consumer spending.

Investment Implications

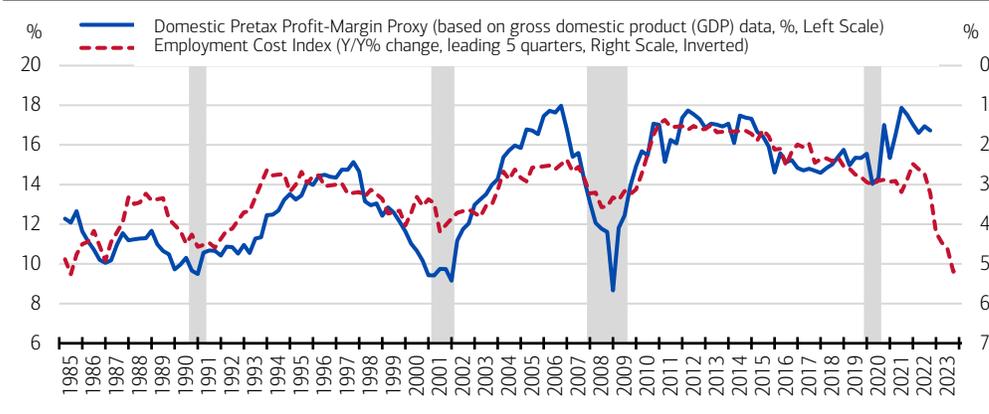
The surge in labor costs over the past year indicates that profit margins are likely to keep declining in coming quarters, suggesting that expectations for a renewed bull market in Equities remain premature. Corporate credit spreads are likely to widen as a result, while Treasuries should outperform both.

Still, employment and wage-and-salary growth indicators tend to lag other, more forward-looking indicators, typically only beginning to weaken when a recession has already started. It remains to be seen how long it will take for the typical late-cycle patterns to start showing up in labor market data, but we believe that an inevitable cyclical deterioration in employment is also at hand. Structural constraints to the weighted-average labor force participation rate due to an aging population as well as wealth and behavior considerations discussed in past reports also suggest limited potential for stronger labor supply growth. As shown in Exhibit 1, changes in labor demand are already tracking the direction suggested by the LEI.

A fundamental reason to expect deteriorating employment ahead is the surge in labor costs, given their negative effects on profit margins and the need for labor cost increases to moderate from their fastest pace since 1984 (as measured by the BLS Employment Cost Index (ECI)) to levels more consistent with the Fed's 2% inflation target. Assuming a 1% productivity growth trend, aggregate labor costs need to increase about 3% per year for the inflation goal to be achieved, compared to the 5.1% year-over-year jump over the past year. Previously, such a big deceleration occurred only after deep recessions.

For now, the fading business pricing power and revenue growth evident in fourth-quarter earnings reports combined with softening demand for labor (cyclical, Exhibit 1), and limited labor supply (structural) suggest that the ECI is likely to ease to only about 4% over the next year or two without a recession. Although welcome, this would not be enough to sustainably bring inflation to target or to prevent severe and persistent downward pressures on aggregate profit margins over the next six to eight quarters, given the strong past correlation between ECI growth rates and profit margins, and the lags involved (Exhibit 2). Based on our analysis, it would take a sharper slowdown in the ECI to about 2% to 3% in order to restore margins in 2024 after a 2023 decline potentially already baked in the cake (Exhibit 2). As noted above, however, such a labor cost deceleration is highly unlikely absent an immediate deep recession this year.

Exhibit 2: Surge In Labor Costs Typically Followed By Profit Margin Declines.



Gray areas represent recession periods. Sources: Bureau of Labor Statistics; Bureau of Economic Analysis/Haver Analytics. Data as of March 2, 2023.

All in all, the economy is likely to lose further momentum, one way or another, with employment and real GDP the next shoes to drop. Basically, the labor market strength of the past year has sowed the seeds of its own destruction, with more declines on the profit margins, hiring and economic growth fronts highly likely in coming quarters. The roughly 10% drop in S&P 500 company margins already reported for Q4 seems consistent with the negative signals coming from the correlation between surging labor costs and profit margins. If this correlation is any indication, a bigger drop in profit margins is baked in the cake over the next four quarters. How persistent and damaging to margins, hiring, capital expenditures (capex) and equity market prospects the effect of the surge in labor costs to date turns out to be depends on how soon and how much labor cost growth decelerates.

The prospect of a continuing sharp drop in profit margins combined with declining business pricing power following a year of abrupt money supply growth deceleration, slowing consumer spending, and tightening lending conditions suggests that more persistent than generally anticipated headwinds for Equities are in store. In this context, we are not surprised to see financial markets pare back their early-year exuberance while awaiting evidence about the direction of the economy and interest rates.

Powell vs. the \$26 Trillion Hydra-headed Beast

Lauren J. Sanfilippo, Director and Senior Investment Strategy Analyst

Calls for a U.S. recession have been rolling for months now—the downturn that was to begin at the end of 2022 was subsequently pushed into early 2023, although those forecasts have now been recast for the back half of this year. This begs the question: After one of the most aggressive monetary tightening cycles in decades—with the fed funds rate rocketing from a 0.00%–0.25% target range in March 2022 to 4.50%–4.75% in February 2023—how and why has the economy proven so resilient? The answer lies in part in the dynamic and diverse nature of the U.S. economy. Whether industry by industry, state to state or sector by sector, the Fed is learning it’s not easy wrestling with a \$26 trillion hydra-headed beast.

We are mindful of the multiple challenges in front of the U.S. economy, including a growth slowdown, a deteriorating profit cycle, a consumer now defaulting at pre-pandemic rates, and housing affordability at a record low. Layer on a tired physical infrastructure, burdensome entitlement expenditures, the 2024 political cycle seemingly underway and a widespread opioid crisis—the list goes on.

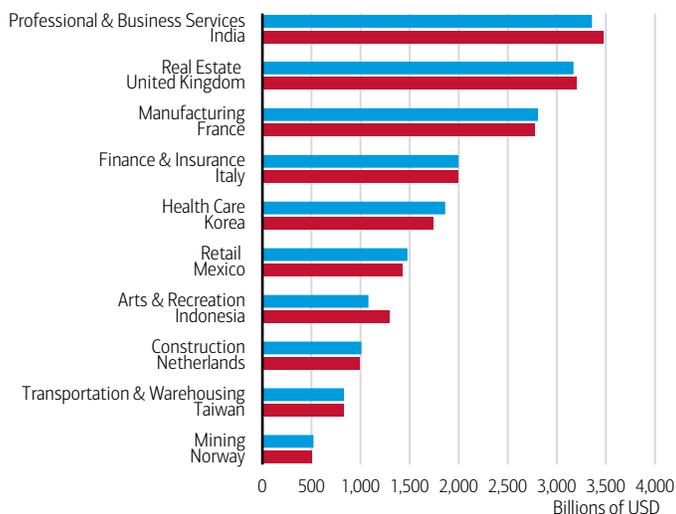
But all the doom and gloom around the ominous recession call and a domineering news cycle distracts from the fact that no economy in the world produces as much annual output (\$26 trillion) with as few people (less than 5% of the global population) across so many sectors.

A Hydra-headed Superpower

The U.S. is a superpower in many industries and activities: agriculture, aerospace, energy, technology, financial services, pharmaceuticals, higher education and entertainment. As housing activity has rolled over and manufacturing has contracted, the offset has been a pickup in services activities like travel and leisure, arts, entertainment and recreation. The U.S. economy isn’t a one-trick pony—in fact, standalone sectors/activities in the U.S. are greater than most nations’ output. America’s \$2.8 trillion in manufacturing activity is equivalent to the total annual output of France; our transportation and warehousing industry is comparable to Taiwan’s entire output. Exhibit 3A serves as a visual of how dynamic and multifaceted the U.S. economy is across industries as compared to similar size economies.

Exhibit 3: Sizing Up The U.S. Economy Industry-by-Industry and State-by-State.

3A) U.S. Industries Measure Up to Full Economies.



3B) Recession-like Conditions in 16 U.S. States.

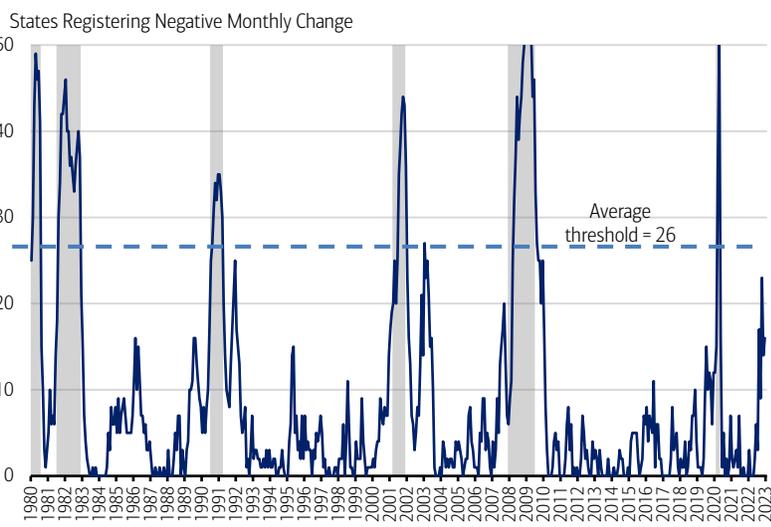


Exhibit 3A: Sources: Bureau of Economic Analysis (BEA); International Monetary Fund. Data as of Q3 2022 for BEA U.S. industries and International Monetary Fund Forecast for 2022 GDP. Exhibit 3B: Sources: Bloomberg; Philadelphia Federal Reserve. Data as of December 2022. Gray areas represent recession periods.

A key point: Consider the U.S.’s diversity an anomaly, especially among countries where a whole economy relies on a singular industry, like Germany’s knack for manufacturing, some commodity or agricultural producers in Latin America, or Taiwan’s dedicated manufacturing of semiconductors. Japan and South Korea are still levered to consumer electronics and

Investment Implications

We remain tactically neutral across Equities and bonds and cautious on risk assets, generally. Continue to maintain a high level of diversification across asset classes and focus on higher-quality investments through the slowing growth scenario and necessary reset ahead for earnings, which favors higher-quality, total return/dividend payers.

autos; China's economy rests on the shoulders of capital investment and real estate. In the Middle East, think of energy.

Another level of diversification is found on the U.S. state level. Recent migration patterns tell the story. The South took an influx of "net domestic migration"—like the population headed to Texas, North Carolina and Florida as the top three recipient states over the last year, according to the Brookings Institution. No wonder then, the amount of business formation happening from Texas to the Carolinas. According to the U.S. Census Bureau, with 420,987 applications nationally in the month of January, basically half (47%) were for business applications in the South region. It's both businesses and homes—consider that new home sales data showed the Southern region up 17.1% last month, climbing to the highest annualized pace in nearly a year.¹ All other regions declined, including a 19.4% slump in the Northeast. Indicative of the pandemic migration trend away from more urbanized areas, New York and California are preparing for a decline in personal income tax receipts²—sorely missed, thanks to the slowdown in activity in their finance and technology hubs.

Recession-like state economic conditions are tracked by the Philadelphia Fed's state coincident index using variables such as nonfarm payroll employment, average hours worked in manufacturing by production workers, the unemployment rate, and wage and salary disbursements deflated by the consumer price index. The most recent read suggests 16 states are registering negative monthly change, while on average 26 states is the threshold number for the Fed to have reasonable confidence that the national economy could enter a recession. As seen in Exhibit 3B, the indicator is closely correlated with past recessions, signaling six of the last major recessions. When the Fed started hiking rates in March of 2022, exactly zero states registered negative month-to-month readings. According to the index, the closest the states have gotten to reaching the threshold has been this past October, with 23 states registering negative monthly change.

Yet another display of dynamism has been S&P 500 corporate earnings—which, up until the fourth quarter of 2022, were hanging on to aggregate positive quarterly earnings growth. It's another case of offsets—as five of the 11 sectors are reporting year-over-year earnings growth, led by the Energy and Industrials sectors, helping to partially offset the six sectors reporting a year-over-year decline in earnings, with the Communication Services, Materials, and Consumer Discretionary sectors as the biggest detractors. As the Technology sector's fortune reversed coming off years of over-earning and over-hiring, the Energy sector's contribution to overall index earnings has grown significantly. In aggregate, earnings are estimated to contract by 4.6% year-over-year over the fourth quarter—without Energy, closer to -8.7%, and without both the Energy and Industrials sectors, -11.7%.³

The bottom line: It's not easy being Fed Chairman Powell

Yes, we expect the U.S. economy to tip into a mild recession over the second half of this year. In the face of still simmering global inflation, an inverted yield curve, soggy growth in other parts of the world and the war in Europe (among other concerns), we maintain a bias toward U.S. assets due in large part to the higher-quality, durable nature of America's diverse and dynamic economy.

Luckily, the whole (U.S.) is greater than the sum of its hydra-headed parts (industries/sectors/states).

¹ Census Bureau. Data as of February 2023. Note: The South is the largest region as identified by the Census Bureau.

² According to Bloomberg, New York's estimated personal income tax payments in June declined to the lowest level since 2017. California's revenue from personal income, corporation and sales taxes will trail projections by \$5.5 billion for the year ending in June 2023.

³ Factset. Blended Growth as of March 1, 2023.

U.S. Exports and the \$3 Trillion No One is Talking About

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

To add an exclamation point to the preceding piece (Powell vs. the \$26 Trillion Hydra-headed Beast), U.S. exports of goods and services hit a record high of \$3 trillion in 2022 (Exhibit 4). That figure has not received much attention from either the media or Wall Street—but it should.

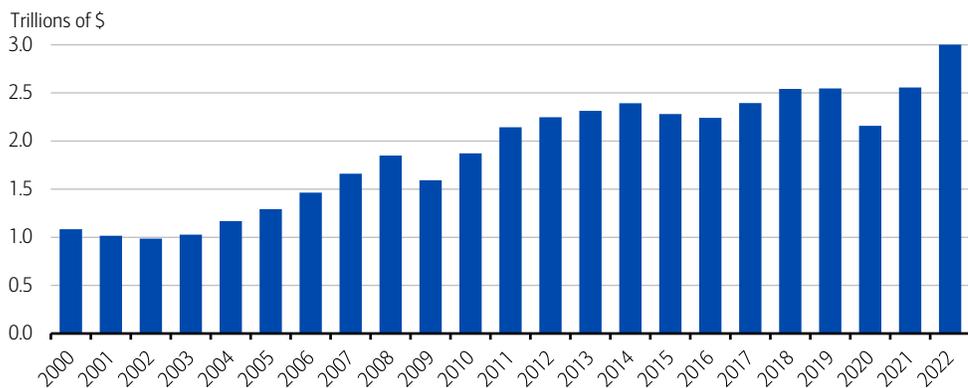
Why? Because America’s export prowess underscores the dynamic competitiveness of the U.S. economy. While U.S. exports are often considered a residual or nominal driver of growth here in the U.S., what America sells to the rest of the world in a year is roughly equivalent to the total output of India. And it’s well in excess of the total output of such nations as South Korea, Spain and Mexico. Just as impressive: Record exports came in the face of a super strong U.S. dollar last year. Only China exports more to the world than the U.S.

And speaking of China, U.S. exports (goods) to the mainland hit a record \$154 billion last year, with only North American Free Trade Agreement (NAFTA) partners Mexico and Canada consuming more U.S. exports, according to the Census Bureau. We highlight this fact because as U.S-Sino tensions turn more sour than sweet, there’s a great deal of commerce at stake for U.S. firms, a point we continue to emphasize.

What is America peddling to China and the rest of the world? Answer: plenty according to the Bureau of Economic Analysis. Think capital goods (\$572 billion last year), industrial supplies (\$811 billion), consumer goods (\$246 billion), food and beverages (\$208 billion), and autos and auto parts (\$158 billion). Add to this list soaring U.S. energy exports (a record \$269 billion) and record service exports (roughly \$1 trillion), with the latter encompassing everything from transport to telecommunications, business services to financial services. Rarely discussed, service exports now rank as one of America’s top exports.

On balance, whether it’s soybean or spacecraft, propane or plastics, accounting services or automobiles, the breadth of U.S. exports is virtually unparalleled. No nation exhibits more export dynamism than the U.S. That’s the good news. The bad news is that rising U.S. trade protectionism could undermine the primacy of U.S. exports—and squeeze future earnings growth of large-cap America. Stay tuned.

Exhibit 4: America As An Exporting Juggernaut.



Source: Bureau of Economic Analysis as of March 2, 2023.

Investment Implications

The CIO investment bias remains tilted toward U.S. assets because we believe Corporate America remains among the most competitive and dynamic in the world. Nothing underscores this point like the size and breadth of U.S. exports, which hit a record high last year.

Equities

	Total Return in USD (%)			
	Current	WTD	MTD	YTD
DJIA	33,390.97	1.9	2.3	1.2
NASDAQ	11,689.01	2.6	2.1	11.9
S&P 500	4,045.64	2.0	1.9	5.7
S&P 400 Mid Cap	2,648.27	1.9	1.8	9.2
Russell 2000	1,928.26	2.0	1.7	9.7
MSCI World	2,757.97	1.9	1.6	6.2
MSCI EAFE	2,070.64	1.8	0.9	6.8
MSCI Emerging Markets	988.03	1.7	2.5	3.4

Fixed Income[†]

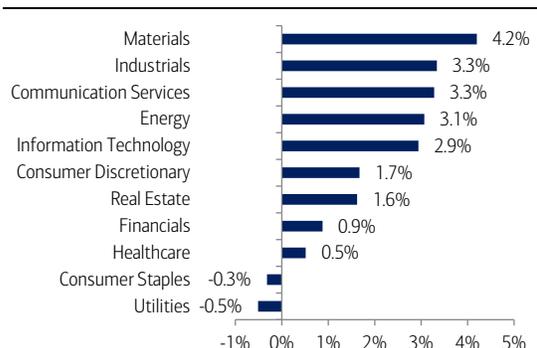
	Total Return in USD (%)			
	Current	WTD	MTD	YTD
Corporate & Government	4.84	0.22	-0.03	0.31
Agencies	4.92	0.02	-0.14	0.02
Municipals	3.65	-0.15	-0.18	0.36
U.S. Investment Grade Credit	4.85	0.12	-0.13	0.28
International	5.51	0.42	0.21	0.91
High Yield	8.55	0.78	0.31	2.79
90 Day Yield	4.84	4.78	4.77	4.34
2 Year Yield	4.86	4.81	4.82	4.43
10 Year Yield	3.95	3.94	3.92	3.87
30 Year Yield	3.88	3.93	3.92	3.96

Commodities & Currencies

	Total Return in USD (%)			
	Current	WTD	MTD	YTD
Commodities				
Bloomberg Commodity	238.01	2.7	2.1	-3.2
WTI Crude \$/Barrel ^{††}	79.68	4.4	3.4	-0.7
Gold Spot \$/Ounce ^{††}	1856.48	2.5	1.6	1.8

	Total Return in USD (%)			
	Current	Prior Week End	Prior Month End	2022 Year End
Currencies				
EUR/USD	1.06	1.05	1.06	1.07
USD/JPY	135.87	136.48	136.17	131.12
USD/CNH	6.90	6.98	6.95	6.92

S&P Sector Returns



Sources: Bloomberg; Factset. Total Returns from the period of 2/27/2023 to 3/3/2023. [†]Bloomberg Barclays Indices. ^{††}Spot price returns. All data as of the 3/3/2023 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 3/3/2023)

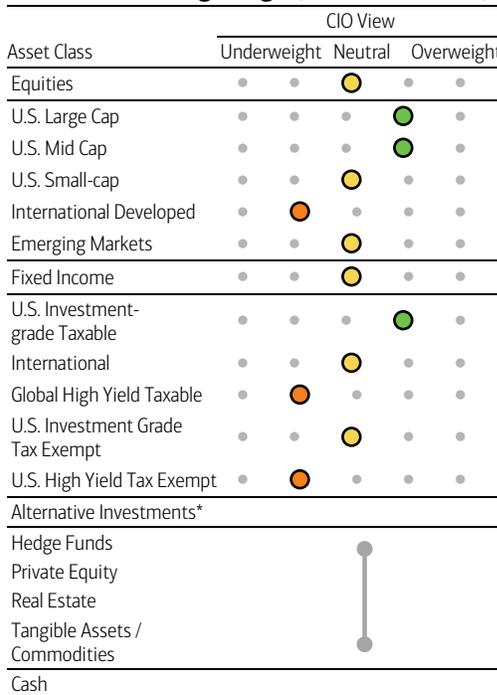
	Q4 2022A	2022A	Q1 2023E	Q2 2023E	Q3 2023E	Q4 2023E	2023E
Real global GDP (% y/y annualized)	-	3.4*	-	-	-	-	2.6
Real U.S. GDP (% q/q annualized)	2.7	2.1	1.0	0.5	-1.0	-2.0	1.0
CPI inflation (% y/y)	7.1	8.0	5.8	4.4	3.7	3.2	4.3
Core CPI inflation (% y/y)	6.0	6.1	5.5	4.9	4.0	3.3	4.4
Unemployment rate (%)	3.6	3.6	3.4	3.3	3.6	4.1	3.6
Fed funds rate, end period (%)	4.33	4.33	4.88	5.38	5.38	5.38	5.38

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.**

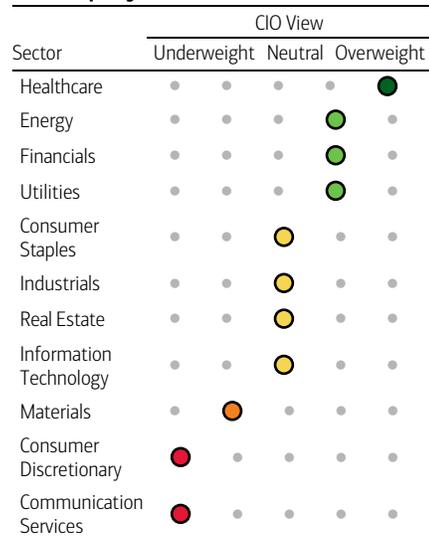
A = Actual. E/* = Estimate.

Sources: BofA Global Research; GWIM ISC as of March 3, 2023.

Asset Class Weightings (as of 2/7/2023)



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 February 7, 2023. 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.

Bureau of Labor Statistics Consumer Price Index is a measure of the average change over time in the prices paid by consumers for a representative basket of consumer goods and services.

Institute for Supply Management (ISM) Index measures the change in production levels across the U.S. economy from month to month.

Conference Board Index of Leading Indicators (LEI) is an American economic leading indicator intended to forecast future economic activity.

Employment Cost Index essentially measures the change in total employee compensation each quarter.

Bureau of Labor Statistics' Employment Cost Index (ECI) measures the change in the cost of labor, free from the influence of employment shifts among occupations and industries.

Philadelphia Fed state coincident index includes four indicators: nonfarm payroll employment, the unemployment rate, average hours worked in manufacturing and wages and salaries. The trend for each state's index is set to match the trend for gross state product.

Sectors: Consumer Discretionary, Consumer Staples Energy, Financials, Healthcare, Industrials, Information Technology, Materials, Real Estate, Communication Services, Utilities) structure consists of 11 sectors, 24 industry groups, 69 industries and 158 sub-industries into which S&P has categorized all major public companies.

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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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