

Capital Market Outlook

June 7, 2021

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

IN THIS ISSUE

- Macro Strategy**—Coincident and leading indicators of U.S. business investment spending remain positive heading into the back half of the year, but pent-up demand will quickly evaporate at this pace of growth. For now, this backdrop is supportive of the overall business cycle and cyclical asset classes. The outlook is more ambiguous a year or more out.
- Global Market View**—The world is in the midst of a dramatic demographic shift. In a world rapidly aging and increasingly short of workers, we believe portfolios should be tilted toward healthcare and technology/innovation leaders in robotics, automation and artificial intelligence. On a country-by-country basis, the future leaders will be those nations successful in assimilating immigrants and boosting the female labor force participation rate, among other policies.
- Thought of the Week**—The recent selloff in European bonds has led to higher yields and pushed most 10-year government yields into positive territory, leading to a meaningful reduction in negative yielding debt. While we cannot rule out the role that the sharp rise higher in U.S. Treasury yields played in dragging European sovereign yields up, there are growing signs that yields continue to move higher as the economic outlook for Europe improves.
- Portfolio Considerations**— We are monitoring the possibility of higher yields and higher levels of inflation, although we generally would expect an increase in price levels to favor Equities over Fixed Income. Consider rebalancing through the summer months if risk assets drift materially higher over and above target allocation levels

MACRO STRATEGY

Jonathan W. Kozy

Managing Director and Senior Macro Strategy Analyst

GLOBAL MARKET VIEW

Joseph P. Quinlan

Managing Director and Head of CIO Market Strategy

Lauren J. Sanfilippo

Vice President and Investment Strategist

THOUGHT OF THE WEEK

Kirsten Cabacungan

Assistant Vice President and Investment Strategist

**Data as of 6/7/2021,
and subject to change**

MACRO STRATEGY

Keep on Keeping On Until Pent-up Demand Is Gone

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

The pandemic-induced capital expenditures (CAPEX) decline was shallower than most expected, and the recovery has been quicker and stronger as firms rush to meet the demands of the future economy. Business confidence is soaring on higher profits, and financing conditions are accommodative. This is a supportive backdrop for cyclical assets like industrial capital goods stocks and business-related technology equipment, but historically, a faster expansion can mean a shorter expansion when it comes to the highly cyclical investment sectors of the economy. In other words, investors will likely need to consider

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shifting gears when pent-up demand vanishes from the housing and business investment sectors. For now, though, a positive near-term outlook reinforces our cyclical asset allocation positioning.

Overall, core CAPEX spending in the U.S., as measured by shipments of nondefense capital goods excluding aircraft, has had a “check mark” shaped recovery. Shipments were back to pre-coronavirus levels by July 2020 and continue to march higher. From the April 2020 trough, core shipments of capital goods registered the fastest year-over-year gain on record, up 22%, and the level now far exceeds pre-coronavirus forecasts. Similarly, orders for core capital goods, a leading indicator, are running at an annual rate of more than 15% over the last three and six months, suggesting the CAPEX surge isn’t done yet.

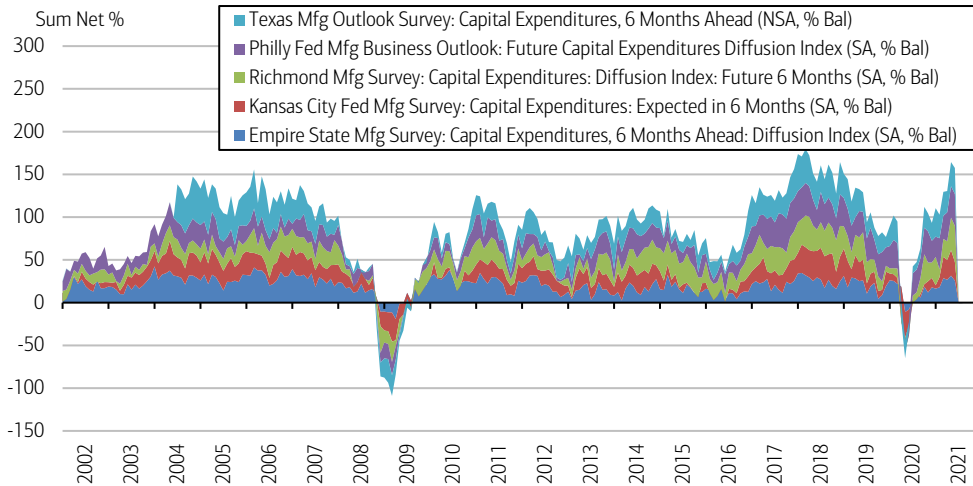
The stronger global backdrop is a key contributor to the CAPEX outlook and is reflected in corporate confidence and business survey data both here and abroad. The Organisation for Economic Co-operation and Development (OECD) projects that real global growth will be 5.8% in 2021, the fastest pace since 1973, setting up the accelerator effect whereby stronger growth and corporate profits feed business investment with a lag. Partially as a result, the May Conference Board’s measure of CEO confidence is at a record high, with data since 1976. The National Federation of Independent Business’s (NFIB’s) survey data also show small businesses are increasingly confident. In the April survey, a net 27% of firms reported planning capital expenditures in the next three to six months, up from 20% the month before.

Alongside faster global growth, profits growth is boosting CAPEX potential, and nonfinancial firms have ample dry powder. According to flow-of-funds data from the Bureau of Economic Analysis, nonfinancial corporate balance sheets are increasingly liquid. The ratio of liquid assets to short-term liabilities, for example, is at a record high, with data since 1945. Profit growth is up, and balance sheets are improving in the rest of the world as well. The ZEW Financial Market survey in Germany shows profit expectations in the machinery space are the highest since 2007.

Domestic credit conditions are also supportive and tend to lead the CAPEX cycle. At a high level, monetary policy is providing support through a number of channels. Directly, firms are seeing low borrowing costs, while commercial banks that were tightening standards for commercial and industrial (C&I) loans have shifted into easing mode. The Federal Reserve’s (Fed’s) Senior Loan Officer Survey shows a growing net percentage of firms are easing standards for C&I loans. In previous CAPEX upturns, including 2018, these credit survey data were leading indicators, another piece of data suggesting the current acceleration in CAPEX growth has legs through year-end.

At the company level, the backlog of orders underpins the need to invest, as evident most recently in the semiconductor space. Supplier delivery times in the headline Institute for Supply Management (ISM) manufacturing survey have increased to a multidecade high at the same time the labor market is tightening. The survey data reflect the fact that production is not keeping up with new orders and that inventories are lean, a function of both supply and demand factors. Capacity utilization metrics are rising. Existing supply chain bottlenecks delay the production and shipment of capital goods but do not take away the orders, and firms will need to speed up production by investing in labor and capital to meet current demand and rebuild inventories. Regional Fed manufacturing survey data reflect the need to alleviate the backlog through CAPEX. The aggregate survey data of CAPEX expectations are at the highest level since February 2018 (Exhibit 1). That year, real equipment spending grew a strong 8%, and intellectual property investment grew 7.8%.

Exhibit 1: Manufacturing Survey Data Signaling Strong Business Investment Spending Growth.



Sources: Regional Federal Reserve Surveys/Haver Analytics. Data as of May 20, 2021.

U.S. consumer spending on goods will continue to play an important role in the speed of the CAPEX expansion both here and abroad. The strength in the Auto, Manufacturing (including Technology) and Housing sectors is likely to continue as U.S. consumer fundamentals remain strong, even if consumers switch their focus to services spending.

Capital equipment-related stocks already buoyed by the private sector could receive an additional boost from a federal infrastructure package that targets traditional infrastructure as well as electrification and clean energy. Policy could also indirectly support near-term CAPEX if firms pull forward investment decisions in anticipation of less business-friendly policies (including higher taxes) in the years ahead.

Technology continues to be the workhorse that drives the trend, and the pandemic reinforced the dominant role technology spending plays in the overall U.S. CAPEX cycle. Tech spending has historically played an important role in part because so much of it is mission-critical maintenance spending. The existing trends in cybersecurity, cloud computing, digitization and artificial intelligence are reinforcing the role that technology spending on software and research and development play in overall CAPEX trends. In addition to the pandemic fueling demand for work from home technology and virtual education solutions, recent cyberattacks on critical infrastructure in the U.S. highlight the vulnerability of private firms and the government and the need for large dollar flows (both private and government) to play cyberdefense. Lastly, the need for semiconductor firms to boost production globally is an additional near-term positive.

While the CAPEX expansion appears well entrenched for now, we are less optimistic on its longevity. For one, monetary policy could be less accommodative next year if inflation surprises to the upside. CAPEX could help alleviate that risk if it ends up boosting productivity. Second, the strength of the ongoing CAPEX expansion means pent-up demand could be largely exhausted in a number of sectors by next year. The most recent capital stock data show the age of capital equipment was falling leading into the pandemic and likely also dropped in 2020 and the first half of this year.¹ The economy's investment sectors like Housing and CAPEX tend to swing between periods of overinvestment and underinvestment, driving the business cycle and the under- or outperformance of cyclical stocks. Third, policy risk is elevated. A corporate tax hike would have a negative effect on after-tax earnings and margins. All in all, given the strength of

¹ Bureau of Economic Analysis. Haver Analytics, May 2021.

the recoveries in both housing and CAPEX, a more “neutral” cyclical state is likely sooner rather than later.

For investors the key message is to enjoy the cyclical upswing in CAPEX and the overall cycle while it lasts, but be cognizant of the state of the cycle (over-or-underinvestment). The pace of growth means pent-up demand will melt away, and cyclical assets will have to price a more mid-cycle outlook for the investment sectors of the economy within the next few years.

GLOBAL MARKET VIEW

The Global Baby Bust and Market Implications

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

Lauren J. Sanfilippo, Vice President and Investment Strategist

If demographics is destiny, then the future is poised to look significantly different. Think more adult diaper sales than those for babies. Think of schools being converted into elderly care facilities; municipalities consolidating as towns and villages de-populate; universities merging because of declining enrollment; and “ghost towns” in Japan, Italy, China and other parts of the world.

Economically, think lower potential real growth as working-age populations decline, as well as mounting fiscal strains thanks to a shrinking tax base and rising pension and healthcare costs. Finally, think of the potential for 1) declining capital investment as companies invest less in the future, and 2) falling consumer spending as worried retirees stockpile savings—all of which result in falling interest rates and stagnating growth. All of the above is another way of saying that the unfolding global baby bust will likely have substantial consequences for long-term investment returns.

As recently cited in *The New York Times*:

“All over the world, countries are confronting population stagnation and a fertility bust, a dizzying reversal unmatched in recorded history that will make first-birthday parties a rarer sight than funerals, and empty homes a common eyesore.”²

The global baby drought was emerging even before the pandemic, although the latter—by limiting social interaction and creating economic insecurity, and thereby dissuading couples from having babies—has only exacerbated the trend. Here are some of the salient figures:

- In China, births have fallen four years in a row, with the number of newborns in China in 2020—12 million—dropping to the lowest level since the era of Mao. Fertility rates in China are now just 1.3, lower than 1.7 in the U.S. and 1.4 in Japan (Exhibit 2).
- In Italy, births in 15 cities declined 22% in December 2020, nine months after the pandemic struck the nation.³
- Japan recorded the fewest babies on record in 2020.⁴
- The number of marriages in Singapore fell 10% in 2020.⁵
- In South Korea, the nation’s fertility rate dropped to 0.84 in 2020, the lowest in the world.

² “World is facing first long slide in its population,” *The New York Times*, May 23, 2021.

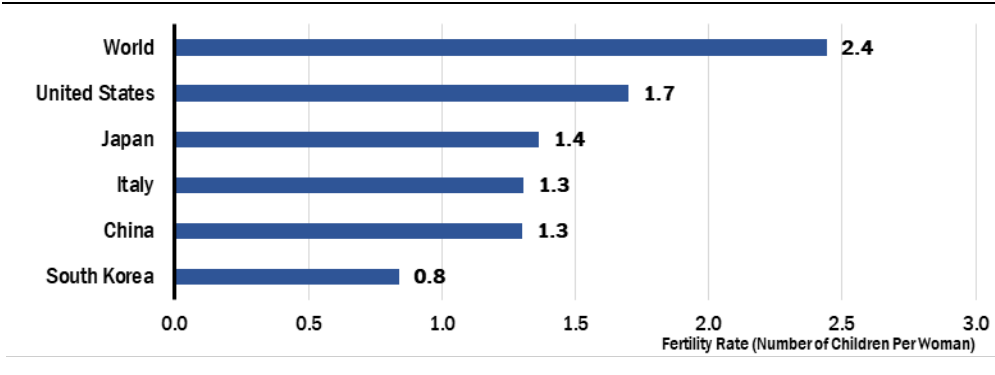
³ “Global Baby Drought of Covid-19 Crisis Risks Population Crunch,” Bloomberg, March 13, 2021.

⁴ Ibid.

⁵ Ibid.

- In the U.S., the number of newborns fell 4% in 2020 from the prior year, the sixth consecutive year of decline; the U.S. fertility rate is now at a record low.

Exhibit 2: Global Fertility Rates.



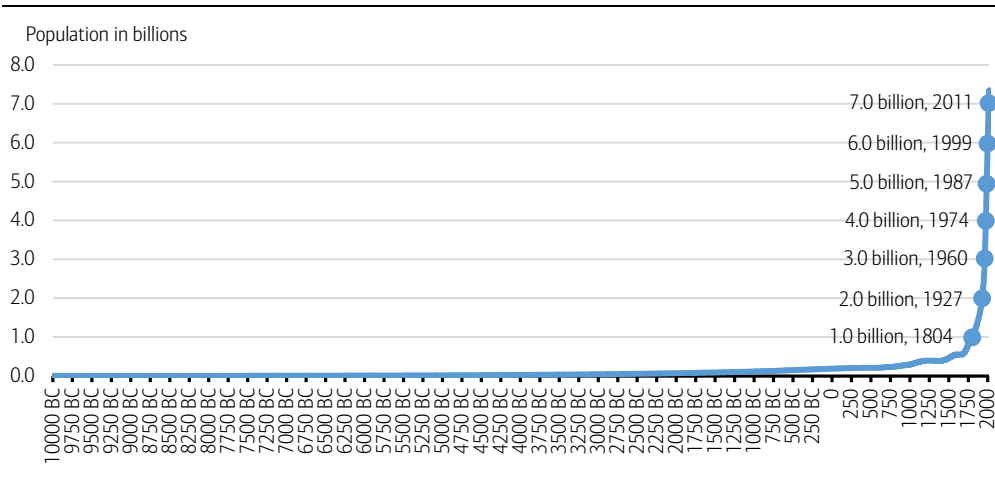
Sources: United Nations; National Bureau of Statistics of China; National Statistics Office of South Korea. Data as of June 3, 2021.

The New Normal of Global Demographics

“We do not face the challenge of a population bomb but a population bust—a relentless, generation-after-generation culling of the human herd.” From *“Empty Planet: The Shock of Global Population Decline”* by Darrell Bricker and John Ibbitson.

The brakes are being applied to population growth following a historic spurt in growth that changed the planet. To the latter point, it took from the dawn of humanity to the early nineteenth century for the world’s population to reach one billion. 1804 was the first year the earth hosted one billion people. While it took another 123 years before the world population reached two billion (1927), it took only 33 years to reach three billion in 1960. Then things really accelerated: only 14 years to get to the four billion mark (1974), just 13 years to reach five billion (1987), and 12 years each to get to 6 billion (1999) and seven billion (2011) (Exhibit 3).

Exhibit 3: Human Population Over 12,000 Years By The Billions.



Sources: United Nations Population Division; Our World in Data. Data as of June 3, 2021.

Summarizing, it took over 200,000 years for the world’s population to reach 1 billion, but only 200 years more to reach seven billion. According to the latest figures from Worldometer, the world’s population currently stands at 7.87 billion, while based on projections from the United Nations (UN), some eight billion people will inhabit the Earth by the middle of this decade.

The 8 billion milestone, however, belies the fact that the world’s population is expanding at its slowest pace since 1950, and, more importantly, many nations around the world are poised for a population bust in the decade ahead. According to UN estimates, the

populations of 55 nations are set to decline by at least 1% between 2019 and 2050 owing to falling fertility rates, and, in some cases, emigration. In the largest of these, China, the population is projected to shrink by 31.4 million, or 2.2%. Other nations facing falling populations include Germany, Japan, Russia, Greece, Estonia, Japan, Taiwan and Spain, to name just a few. The number of nations confronting fertility rates below 2.1 continues to rise, climbing from just four nations in 1955, to 61 in 1990, and an estimated 91 in 2020 and 124 in 2040.

In addition to the effects of the pandemic, the global baby bust reflects the shifting lifestyles of women. Around the world, whether in India or Ireland, China or Canada, women are becoming better educated, more empowered to pursue a career, and marrying later in life. They are also opting for city life, which entails fewer children, since a child on a farm is considered an asset/helping hand but a liability/cost in the city. The upshot: planetwide, women are bearing fewer children. On a global basis, the world fertility rate has dropped from 5.0 in 1955 to 2.4 today, and whether government policies can reverse the general trend, like China's new edict that married couples can now have three children, remains to be seen.

The Baby Premium

Babies matter. Why? Because the growth rate of any economy is dependent on population growth. The larger the population, the greater the labor force, the more capacity for consumption as workers per capita increases, and the deeper the base of taxpayers to support retirees. Throughout history, a nation's population has been a marker of strength or weakness. Per the latter, three decades of economic stagnation in Japan reflects, in large part, the country's falling working-age population and overall decline in population. Ditto for Europe, where shrinking labor forces and declining fertility rates in many nations have long undermined economic productivity. The global decline in fertility rates, in other words, is already exerting a powerful force on global growth and demand. The fact that over 50 countries in the world are on track to experience declines in their population's decades from now matters today, right now.

The baby premium raises some important questions: will sliding demographic trends in China undermine the nation's long-term economic growth and great power ambitions? Will many developed nations, in the face of stiff opposition, have to raise their retirement ages? Will the Biden administration's more liberal immigration policies reverse U.S. population trends, separating the U.S. from the rest of the world? How will the effects of an aging population-cum-declining labor force effect the fiscal positions/sovereign debt of many countries, notably the U.S.? Is a stagnate global population the key to a more decarbonized future? And finally, and perhaps more importantly, with economic research from a number of central banks suggesting that sliding birth rates go hand-in-hand with falling growth rates and declining real interest rates, will today's baby bust ultimately prove deflationary, suppressing bond yields in the long run? Global demographics represent a potential headwind to the inflationary forces of the moment.

In terms of portfolio positioning in a world rapidly aging and increasingly short of workers, we believe portfolios should be tilted toward healthcare and technology/innovation leaders in robotics, automation and artificial intelligence. In addition, the forces of demographic deflation favor companies that can grow their dividends, and grow earnings at an above-average rate compared to the economy and their peer group. On a country-by-country basis, the future leaders in terms of market returns will be those nations successful in attracting and assimilating immigrants, boosting the female labor force participation rate, and implementing policies that keep elderly workers healthy and engaged in the formal economy.

THOUGHT OF THE WEEK

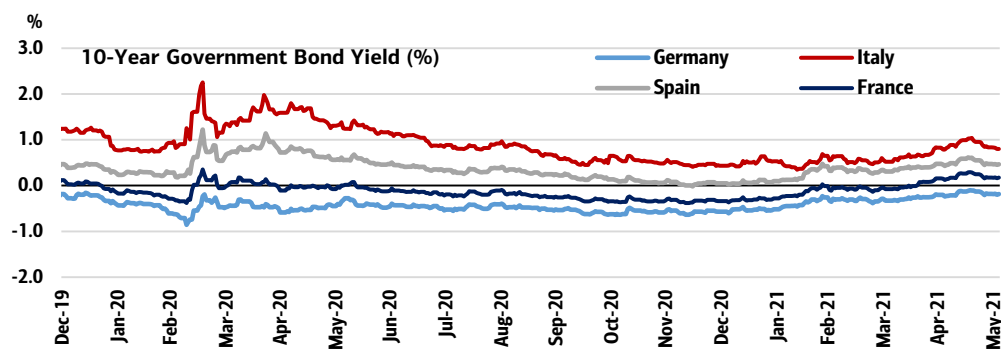
European Yields Are Turning Positive

Kirsten Cabacungan, Assistant Vice President and Investment Strategist

European sovereign bond yields have followed U.S. Treasuries on a similar path higher since the start of the year, leading to a meaningful reduction in negative yielding debt. The market value of the global supply of subzero bonds fell sharply as markets bottomed in March 2020 from roughly \$15 trillion to \$8 trillion. It slowly began to rise again over the course of the year, peaking at \$18 trillion as heightened uncertainty kept some investors willing to accept a loss in order to invest with more reliable borrowers. As a result, the yields on European sovereign bonds, which represent roughly 60% of total global negative yielding debt, fell further into negative territory.⁶

Since the start of the year, however, that trend has reversed, with the recent selloff in European bonds moving yields higher and pushing most 10-year government yields into positive territory (Exhibit 4). For a period in May, German bunds were the only 10-year government bonds in Europe with a negative yield. Still, the German 10-year yield, which has been negative since May 2019, has moved up 37 basis points year-to-date and recently rose to its highest level in two years. While we cannot rule out the role the sharp rise higher in U.S. Treasury yields played in dragging European sovereign yields up, there are also growing signs that the economic outlook for Europe continues to improve. For one thing, monetary and fiscal stimulus remain a supportive backdrop for the region, continuing to provide the necessary conditions for the recovery to gain steam. But progress with vaccination rollout programs has also helped by moving economies closer toward reopening and boosting domestic demand. BofA Global Research expects Euro area real gross domestic product (GDP) to grow 3.7% in 2021, reflecting a strong rebound in growth from the -6.7% hit to GDP in 2020. The slight move higher in European inflation expectations has also played a role, as inflation continues to become a reality for many of the largest countries in the region already.

Exhibit 4: European Sovereign Bond Yields On The Move Higher.



Source: Bloomberg. Data as of June 3, 2021. 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.

In part, higher yields in Europe should be good news, especially for investors searching for income. The European Central Bank (ECB) is also likely optimistic about the environment as they continue to remain committed to their inflation mandate and “preserving favorable financial conditions.” The main beneficiary of rising yields will likely be European banks, which should help to support European equities given that Financials is the largest sector in the STOXX Europe 600, accounting for 16% of the index. But higher yields may also pose a risk for some of the vulnerable areas of the region that faced more devastating consequences of the pandemic as borrowing costs rise. Also important to remember is that yields, despite being on the rise higher, still remain at historic lows.

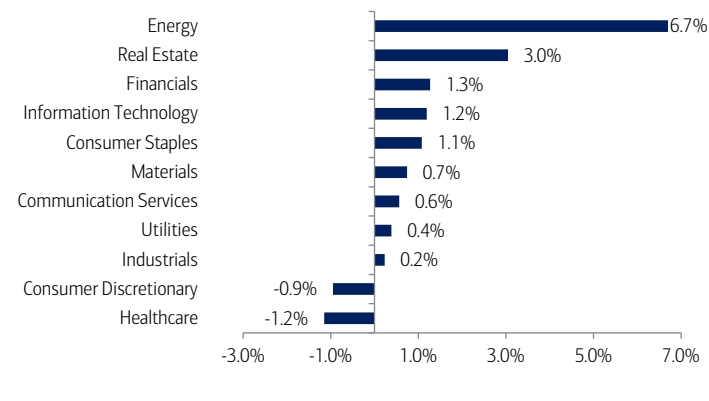
⁶ Bloomberg. “Upside down world of negative bond yields is shrinking at last.” May 2021.

MARKETS IN REVIEW

Equities

	Total Return in USD (%)			
	Current	WTD	MTD	YTD
DJIA	34,756.39	0.7	0.7	14.5
NASDAQ	13,814.49	0.5	0.5	7.5
S&P 500	4,229.89	0.6	0.6	13.3
S&P 400 Mid Cap	2,728.67	0.1	0.1	18.9
Russell 2000	2,286.41	0.8	0.8	16.2
MSCI World	2,997.36	0.6	0.8	12.2
MSCI EAFE	2,357.79	0.7	1.0	11.2
MSCI Emerging Markets	1,381.56	1.6	0.4	7.7

S&P 500 Sector Returns



Fixed Income[†]

	Total Return in USD (%)			
	Current	WTD	MTD	YTD
Corporate & Government	1.41	0.17	0.17	-2.78
Agencies	0.71	0.06	0.06	-0.86
Municipals	1.00	0.21	0.21	0.99
U.S. Investment Grade Credit	1.50	0.12	0.12	-2.17
International	2.11	0.23	0.23	-2.63
High Yield	4.01	0.28	0.28	2.53
	Current	WTD	MTD	YTD
90 Day Yield	0.01	0.00	0.00	0.06
2 Year Yield	0.14	0.14	0.14	0.12
10 Year Yield	1.55	1.59	1.59	0.91
30 Year Yield	2.23	2.28	2.28	1.64

Commodities & Currencies

	Total Return in USD (%)			
	Current	WTD	MTD	YTD
Commodities				
Bloomberg Commodity	202.17	2.0	2.0	21.3
WTI Crude \$/Barrel ^{††}	69.62	5.0	5.0	43.5
Gold Spot \$/Ounce ^{††}	1891.59	-0.6	-0.8	-0.4
	Current	Prior Week End	Prior Month End	2020 Year End
Currencies				
EUR/USD	1.22	1.22	1.22	1.22
USD/JPY	109.52	109.85	109.58	103.25
USD/CNH	6.39	6.36	6.37	6.50

Sources: Bloomberg, Factset. Total Returns from the period of 5/31/2021 to 6/4/2021. [†]Bloomberg Barclays Indices. ^{††}Spot price returns. All data as of the 6/4/2021 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.**

Asset Class Weightings (as of 6/1/2021)

Asset Class	CIO View		
	Underweight	Neutral	Overweight
Equities	●	●	●
U.S. Large Cap	●	●	●
U.S. Mid Cap	●	●	●
U.S. Small Cap	●	●	●
International Developed	●	●	●
Emerging Markets	●	●	●
Fixed Income	●	●	●
U.S. Investment Grade Taxable	●	●	●
International	●	●	●
Global High Yield Taxable	●	●	●
U.S. Investment Grade Tax Exempt	●	●	●
U.S. High Yield Tax Exempt	●	●	●
Alternative Investment*	●	●	●
Hedge Funds	●	●	●
Private Equity	●	●	●
Real Estate	●	●	●
Tangible Assets / Commodities	●	●	●
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.

Economic & Market Forecasts (as of 6/4/2021)

	Q4 2020A	2020A	Q1 2021A	Q2 2021E	Q3 2021E	Q4 2021E	2021E
Real global GDP (% y/y annualized)	-	-3.2	-	-	-	-	6.0
Real U.S. GDP (% q/q annualized)	4.3	-3.5	6.4	10.0	9.0	5.0	7.0
CPI inflation (% y/y)	1.2	1.2	1.9	4.5	4.2	4.0	3.6
Core CPI inflation (% y/y)	1.6	1.7	1.4	3.4	3.4	3.4	2.9
Unemployment rate (%)	6.7	8.1	6.2	5.8	4.9	4.2	5.3
Fed funds rate, end period (%)	0.09	0.09	0.06	0.13	0.13	0.13	0.13
10-year Treasury, end period (%)	0.91	0.91	1.74	1.85	2.00	2.15	2.15
S&P 500 end period	3756	3756	3973	-	-	-	3800
S&P earnings (\$/share)	42	140	42*	46	48	49	185
Euro/U.S. dollar, end period	1.22	1.22	1.17	1.18	1.16	1.15	1.15
U.S. dollar/Japanese yen, end period	103	103	111	107	110	113	113
Oil (\$/barrel, avg. of period, WTI**)	44	40	58	64	60	58	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. **West Texas Intermediate. Sources: BofA Global Research; GWIM ISC as of June 4, 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 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.

STOXX Europe 600 Index has a fixed number of 600 components representing large, mid and small capitalization companies among 17 European countries.

Corporate & Government: Bloomberg Barclays US Government/Credit Bond Index is a broad-based flagship benchmark that measures the non-securitized component of the US Aggregate Index.

Agencies & Municipals: Bloomberg Barclays US Treasury Index measures US dollar-denominated, fixed-rate, nominal debt issued by the US Treasury.

U.S. Investment Grade Credit: Bloomberg Barclays US Corporate Bond Index measures the investment grade, fixed-rate, taxable corporate bond market.

International: Bloomberg Barclays US Corporate Bond Index measures the investment grade, fixed-rate, taxable corporate bond market

High Yield: Bloomberg Barclays US Corporate High Yield Bond Index measures the USD-denominated, high yield, fixed-rate corporate bond market.

Bloomberg Commodity Index reflects the returns that are potentially available through an unleveraged investment in the futures contracts on physical commodities comprising the Index plus the rate of interest that could be earned on cash collateral invested in specified Treasury Bills.

Dow Jones Industrial Average (DJIA) is a widely-watched benchmark **index** in the U.S. for blue-chip stocks.

Nasdaq Index is the market capitalization-weighted **index** of over 2,500 common equities listed on the **Nasdaq** stock exchange.

S&P 400 Mid Cap Index refers to a benchmark **index** published by Standard & Poor's (**S&P**).

Russell 2000 Index is a small-cap stock market index of the smallest 2,000 stocks in the Russell 3000 Index.

MSCI World Index is a market cap weighted stock market **index** of 1,583 companies throughout the world.

MSCI EAFE Index is a stock **index** offered by **MSCI** that covers non-U.S. and Canadian equity markets.

MSCI Emerging Markets Index captures large and mid cap representation across 27 Emerging Markets (EM) countries.

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