

CHIEF INVESTMENT OFFICE

Capital Market Outlook

July 27, 2020

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

IN THIS ISSUE

- **Macro Strategy**—Unprecedented monetary expansion turbo-charged by the biggest fiscal stimulus in modern history has understandably raised concerns about an eventual inflation problem. Indeed, this policy stimulus has already ended the shutdown recession and set the stage for a strong new global expansion. Initially, however, such stimulus typically raises real growth, with inflation lagging by a couple of years, while slack in the economy/labor market is absorbed along with other lingering deflationary forces from the recession.
- **Global Market View**—Odds of a democratic sweep and a presidential nominee Joe Biden presidency have been rising since early March, while President Trump’s approval rating has slid in the face of the global pandemic. Markets could start pricing in election risks as we head closer to the election. Taking a micro view, we outline some key sectors and industries most sensitive to the election agenda.
- **Thought of the Week**—There’s a renewed appreciation for space. No, not the recommended six-foot social distancing measure, but the premium on space in the industrial real estate market, levered to tailwinds such as: increased e-fulfillment demand, information technology (IT) infrastructure spend, and near-shoring supply chain production.
- **Portfolio Considerations**—We believe we are in the early stages of another long-term bull market (one with higher-than-average valuation, slightly elevated volatility and lower rates for longer) and remain highly favorable on equities relative to fixed income and cash.

MACRO STRATEGY

Inflation Unlikely to Reach 2% Fed Target Over the Next Two Years

Chief Investment Office Macro Strategy Team

A bout of deflation from February through May caused “core” inflation as measured by the Consumer Price Index (CPI) to decline from a 2.4% year-over-year (YoY) rate before the shutdown to just 1.2% in June. As demand for a number of deeply affected goods and services improved with the reopening of the economy, “core” inflation increased from May to June at a faster-than-expected 2.9% annualized pace, raising inflation concerns. However, the gain was led by apparel and travel-related prices in a sharp reversal of particularly big declines during the shutdown and, in our view, is unlikely

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MACRO STRATEGY

Chief Investment Office
Macro Strategy Team

GLOBAL MARKET VIEW

Kathryn McDonald, CFA®
Vice President and
Investment Strategist

THOUGHT OF THE WEEK

Lauren Sanfilippo
Vice President and
Investment Strategist

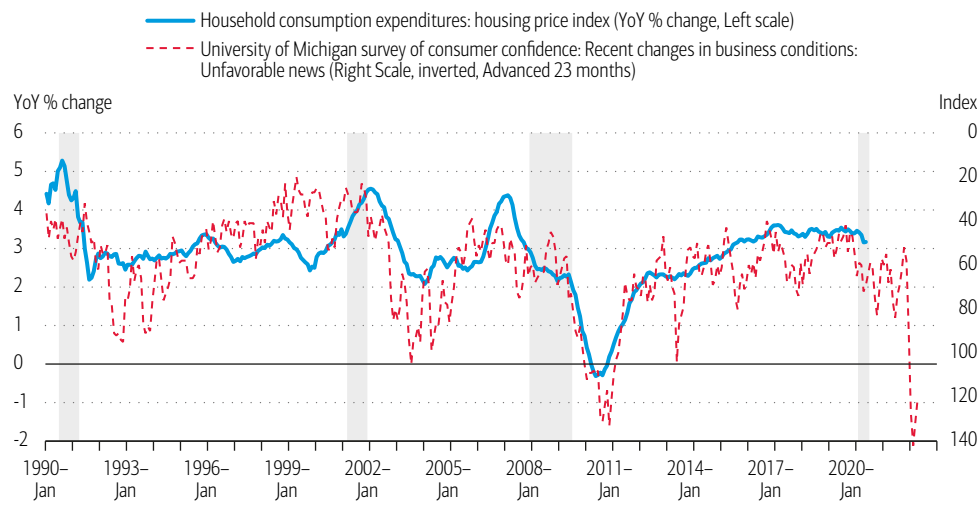
Data as of 7/27/2020 and subject to change.

to persist. Our analysis suggests that inflation, measured by YoY changes in the CPI and “core” personal consumption expenditures index (PCE), is likely to drop further, possibly dipping much below 1% over the next year. YoY “core” PCE inflation, the Federal Reserve’s (Fed’s) preferred measure of inflation, appears on track for the lowest inflation rate in 60 years before turning up toward 1.5% as 2021 progresses.

This view is based on a number of factors. First, because of lagged effects from the shutdown shock, the trend in average hourly earnings (AHE) growth appears sharply lower now compared to the pre-pandemic outlook. AHE growth was running at about a 3.5% YoY pace before the pandemic and was on track to finally move into the 3.5% to 4.5% range that prevailed during the late-expansion phases of all business cycles since the 1980s. Distortions caused by the massive shift in the mix of wage earners toward higher-wage workers during the shutdown—as lower-paid, typically service-sector jobs vanished—temporarily increased the average of AHE compared to the same period a year ago by almost 8% in April. As the economy opened and some of the lost service-sector jobs were recuperated, almost a half of this aberrant surge got erased by June, however, with sharp further weakening ahead, in our view. Indeed, underlying macroeconomic forces that typically lead AHE growth (including high unemployment, a drop in labor-force participation rates, elevated uncertainty) suggest a likely drop in YoY AHE growth from 5.4% currently to a 1% to 2% range over the next 12 months, with a return closer to 3% unlikely before sometime in 2022.

Such deceleration in wage growth would in itself be inconsistent with rising inflationary pressures for the foreseeable future. In addition, prospects for a strong reacceleration in productivity growth as a result of higher business operational leverage as the economy more fully opens up suggests suppressed inflation pressures over the next two years. Even taking into account our expectations for a continued gradual dollar depreciation, as discussed in our June 22 Capital Market Outlook—which would help nudge up the non-petroleum import-price index after a two-year downtrend, thus eliminating a key disinflation force—the negative lagged effects on inflation from the collapse in consumer spending on services and its much slower recovery potential compared to the sharp “V-shaped” rebound already observed in durable-goods spending point to additional “core” inflation weakness ahead. For example, as shown in Exhibit 1, rent-of-shelter inflation, which accounts for a large share of the consumer spending basket (about 40% of “core” CPI), is likely to remain under extreme downside pressure over the next two years based on past correlations.

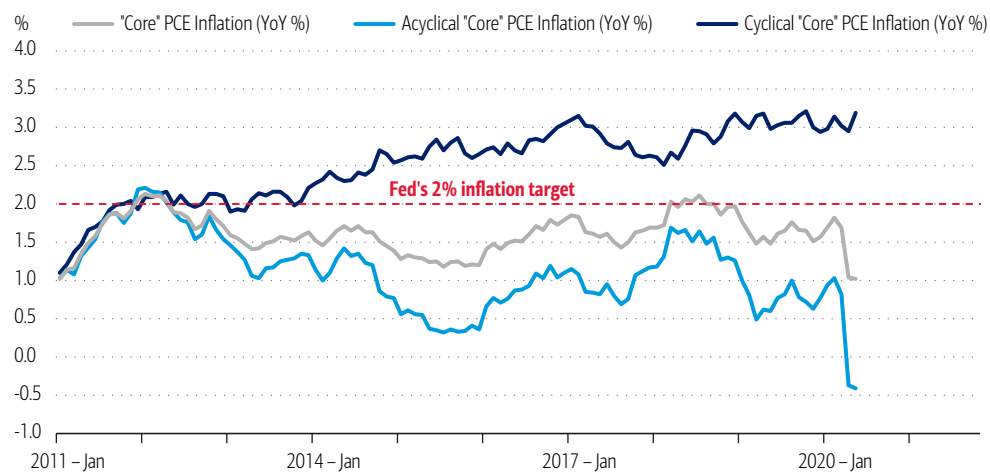
Exhibit 1: Rent-of-Shelter Inflation Likely to Weaken Further.



Sources: Bureau of Labor Statistics, University of Michigan/Haver Analytics. Data as of July 22, 2020.

That said, shifts in the mix of the consumer-spending basket can cause some prices to accelerate and others to decelerate, clouding the overall inflation outlook. As shown in Exhibit 2, the Fed has not accommodated an increase in the general price index. For inflation to average below 2%, as it has during the past decade, some prices had to decrease when others increased. In contrast, when monetary policy is loose/accommodative, price increases in certain goods or services do not inhibit spending more on other categories, resulting in a general rise in inflation. Because central-bank policy determines the ultimate overall inflation outcome, it is more useful to look at changes in monetary policy, inflation expectations, the economic outlook, and financial-market signals to estimate the inflation outlook than to dissect a consumer price index and analyze price changes or trends in its subcomponents.

Exhibit 2: Overall Macro-Environment, Largely Affected by Fed Policy, Determines the Ultimate Inflation Outcome Despite Churn in Inflation Subcomponents.



Sources: Bureau of Economic Analysis (BEA); Federal Reserve Bank of San Francisco/Haver Analytics. Data as of July 22, 2020.

Ultimately inflation is always and everywhere a monetary phenomenon. Also, it is a long-lagging indicator because it responds slowly to changes in economic conditions, which in turn respond with a lag to changes in monetary policy. Since it is the monetary-policy setting and the economic outlook it engenders that determine inflation, the pandemic-induced setback in economic conditions is likely to continue to suppress inflation into late next year, when the fuller effects of the stimulus and more advanced economic recovery start to be felt. In other words, the inflation outlook over the next year or two is somewhat baked in the cake.

For inflation to get back up just to the 1.5% to 2% range by late 2021 it would take a big, immediate drop in uncertainty levels, a sharp dollar depreciation (at least down to the 2018 level on a dollar trade-weighted index basis), and much stronger consumer spending/economic growth than currently appears likely. Otherwise, while the inflation trend should turn up as 2021 progresses as a result of the fiscal and monetary backstop to date, “core” inflation is likely to remain below the Fed’s 2% target well into 2022, in our view.

In sum, without the massive fiscal and monetary stimulus to date, the recent dip into deflation territory, with its destructive effects on corporate revenues growth, economy-wide debt-servicing ability, and financial conditions would have persisted, eliminating any chance for a swift recovery. The pickup observed in the Treasury Inflation Protected Securities (TIPS) implied inflation expectations, rising metals prices, uptick in consumer inflation expectations, and positive financial-market signals (narrowing credit spreads, rising equity prices) continue to corroborate our view that the stimulus is working and the economy is likely to avoid a self-reinforcing deflationary down spiral in the wake

of the pandemic. Still, it is typical in the early stage of a new economic expansion for inflation to drop because of residual forces for disinflation from the recession and high unemployment. Initially, monetary stimulus mainly raises real growth and as the economy reaches fuller capacity utilization, the effect of monetary expansion begins to raise prices too. Thus, inflation is likely to get worse before it starts to get better. With the Fed unlikely to achieve its inflation objective anytime soon, the outlook for monetary policy to remain aggressively accommodative for the foreseeable future suggests continued support for risk assets and reflation beneficiaries.

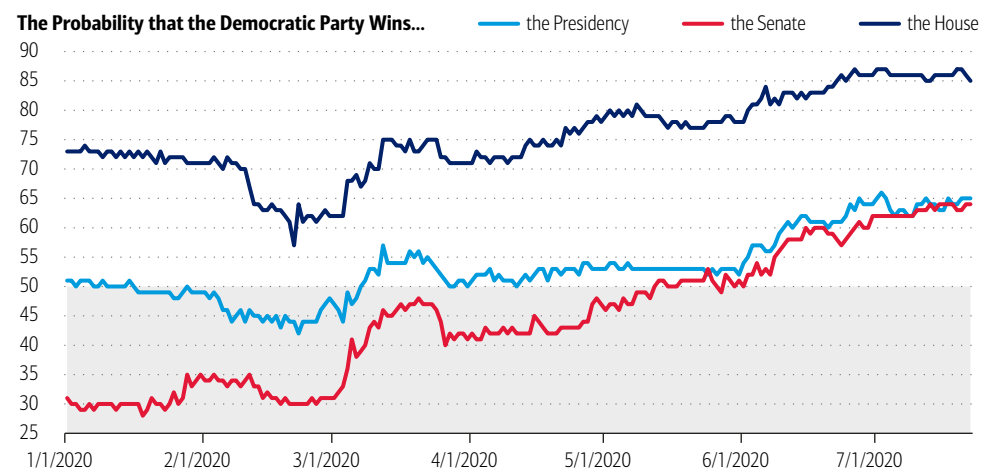
GLOBAL MARKET VIEW

100 Days Until The U.S. Election: Considerations for Investors

Kathryn McDonald, CFA®, Vice President and Investment Strategist

The 100 day countdown to the 2020 U.S. presidential election began yesterday. Odds of a democratic sweep and a Joe Biden presidency have been rising since early March, while President Trump’s approval rating has slid in the face of the global pandemic (Exhibit 3). President Trump is trailing in most swing states, and the senate race has begun to favor the Democrats, who need a net gain of four seats to win the majority. This recent shift has grabbed investor attention, with almost half of investors (polled by Strategas Research Partners in July) citing a Democratic sweep as the greatest risk to the equity market.

Exhibit 3: Rising Odds of a Democratic “Blue Wave.”



Sources: PredictIt, Bloomberg. Data as of July 22, 2020.

Given uncertainties surrounding the coronavirus recovery, the overall economic and market impact of a Democratic sweep has been difficult to gauge. Prospects for greater fiscal stimulus, an easing of trade tensions and reduced business uncertainty could potentially offset some of the less growth-friendly policies such as more regulations and greater taxes. In our view, the virus trajectory will be the most important factor for the markets in the near to medium term; however, markets could start pricing in election risks for specific industries and sectors as we head closer to the election. Taking a micro view, we outline some key sectors and industries most sensitive to the election agenda.

The Election Agenda

- 1. Corporate taxes**—A full Democratic sweep could lead to a reversal in the current tax policy. The corporate tax increases under a potential Joe Biden administration include i) an increase in the corporate tax rate from 21% to 28%, ii) a 15% minimum book tax on corporations with net income over \$100 million, and iii) an increase in the tax rate on global intangible low tax income (GILTI) from 10.5% to 21%. Various analysts have estimated that Biden's corporate tax agenda could result in a reduction of 2021 S&P 500 earnings-per-share in the range of 9% to 12%.
- 2. Individual taxes**—Democrats' plans for individual taxes include raising the top income tax rate, a payroll tax on wage income, taxing capital gains and dividends as ordinary income, and more, as discussed in our July 20 Capital Market Outlook.¹ Strategas estimates that the corporate and dividend tax hikes could result in an increase in the federal effective tax rate on dividends from 40% to 59%—which could lead to volatility in dividend-paying stocks. While not formally proposed in Biden's agenda, there could be a push from the Democratic Party for the repeal of the State and Local Tax (SALT) deduction cap, which could provide further impetus for a housing boom in high-tax states that have already benefited from recent demand and de-urbanization trends amid the pandemic.
- 3. Trade policy**—Trade tensions between the U.S. and China are likely to continue regardless of who wins the election. More nationalist policies to encourage reshoring of production to the U.S. could continue under the current administration, but also under Biden's "Buy American" plan. Trade relations with Europe and other U.S. allies could be eased under a Biden administration, while a second term for Trump could see harsher rhetoric against potential European Union (EU) digital taxes, potential carbon border taxes and auto tariffs. Thus, we believe European equities and U.S. multinationals with high exposure to Europe could benefit from an easing of U.S.-EU tensions and reduced uncertainty under a Biden administration.
- 4. Fiscal spending/deficits**—While both parties seem to have embraced greater deficit spending in light of the coronavirus crisis, the composition of Congress may be a key determinant of future budget expansion. In our view, a Democratic or Republican sweep would result in more fiscal spending, whereas a split government could lead to more constraint. Some budget sectors may be more sensitive than others. For instance, a Democratic sweep could restrain growth in the national defense budget, whereas a continuance of the status quo could benefit defense stocks.
- 5. Infrastructure/Research & Development/Capital Expenditures**—Increased taxes in a Democratic-wave scenario are likely to be accompanied by an increase in spending, and one of the main priorities for a Biden presidency is likely to be a large-scale infrastructure package. Biden's \$1.3 trillion proposed infrastructure deal (over 10 years) includes traditional infrastructure spending (highways, bridges, rail, transit, etc.) but also prioritizes spending on schools, digital connectivity and green infrastructure (broadband and 5G, green energy, electric vehicle (EV) charging, clean water, etc.). A Democratic sweep, therefore, could support the industrials and materials companies but also industries such as software, 5G, semiconductors and data centers to support the next generation of infrastructure. Republicans have also voiced support for infrastructure, but with a Biden presidency could face greater challenges getting a large-scale package through a more divided, fiscally conservative congress.
- 6. Energy**—Climate change is likely to be a top priority for Biden, who has already outlined plans to rejoin the Paris climate accord and for a \$2 trillion climate plan. A Biden victory and Democratic sweep would be bullish for clean energy sectors such as EVs, alternative energy (wind, solar), energy-efficient buildings and related green technologies and infrastructure. Traditional energy stocks may be more at

¹ See Capital Market Outlook 7/20/2020, "Biden's Tax Policy Takes Center Stage."

risk, as a Biden administration could look to establish emissions targets, repeal traditional energy tax incentives, and implement stricter environmental regulations such as vehicle fuel efficiency standards, methane regulations and bans of fossil fuel extraction on federal lands.

- 7. Healthcare policy**—Spending in a Democratic sweep may also include greater healthcare expenditures, including expanded health insurance subsidies under the Affordable Care Act (ACA). Industries that may benefit from increased health spending could include hospitals, medical equipment and technology, and life sciences. Potential Democrat support of a public option could be a risk to the health care sector, however. Drug pricing legislation is also a risk in either administration. That said, some other risks have come down meaningfully. Medicare-for-all plans (a Bernie Sanders priority) have subsided, pharmaceutical companies working toward a coronavirus vaccine may have become less of a target, and odds of a Republican reversal of the ACA are lower than during the prior election.
- 8. Labor market reform**—Labor policies under a Biden administration could include protections for gig economy workers, a rise in the federal minimum wage (from \$7.25 to \$15/hr), legislation supporting unions and stricter employer penalties for workplace violations among others. Cornerstone Research has estimated these labor reforms would impose several hundred billion dollars of costs on U.S. businesses, which could lead to margin pressures or further automation efforts. Some of these regulatory changes could be implemented through executive action; however, others such as raising the federal minimum wage or unionization law changes would require approval from Congress (and a minimum of 60 votes in the Senate under current rules).
- 9. Big Tech**—Both sides of the political aisle have voiced concerns over the growing market power of big tech firms, though Democrats could adopt more strict antitrust and privacy/data policies than the current administration. Tax policies are also a major risk for tech firms, which, along with pharma companies, have benefited the most from shifting intangible assets overseas for tax savings.

Investment summary

Currently, investors may not be fully pricing in the costs of a Democratic sweep to equity markets. We believe that investors may begin to factor in election outcomes post-Labor Day. In general, growing investor fears of a Democratic sweep could be initially negative for equities given the potential for increased taxes and regulations, while bonds could benefit in the short term. The longer-term picture is less clear however, as other factors such as the virus trajectory, reduced trade tensions, fiscal stimulus, and reduced business uncertainty may prove to be more important for the markets over the long term. We would view any significant consolidation in U.S. equities as potential buying opportunities, especially in sectors with strong growth opportunities.

Other asset class implications: In a Democratic sweep, the U.S. dollar could weaken initially on the prospects for higher taxes and higher deficits, though U.S. growth differentials versus the rest of the world would be a key determinant in the medium term. Emerging markets could benefit from a weak dollar but China-U.S. tensions may prove to be a continued headwind. International developed equities could benefit from an easing of trade tensions, a rebuilding of alliances, and less uncertainty under a Biden presidency. Volatility is likely to increase in the months leading up to the election.

That said, the outlook is still highly uncertain. With a little over three months to go, a lot could change in terms of the economy and polling. The stock market tends to be a fairly accurate indicator of who could win the presidency.² The economy is another accurate

² According to research firm Strategas, in 87% of cases going back to 1928, the incumbent party has won when stocks are higher in the 3 months leading up to the election and the opposition has won when stocks are lower in the three months to election day.

predictor—incumbent presidents with recessions in the two years prior to the election have lost the presidency all but once, while all of those that had no recession were re-elected (See our Capital Market Outlook May 18). As we get closer to November, we will continue to closely monitor the equity market movements and the economic recovery.

THOUGHT OF THE WEEK

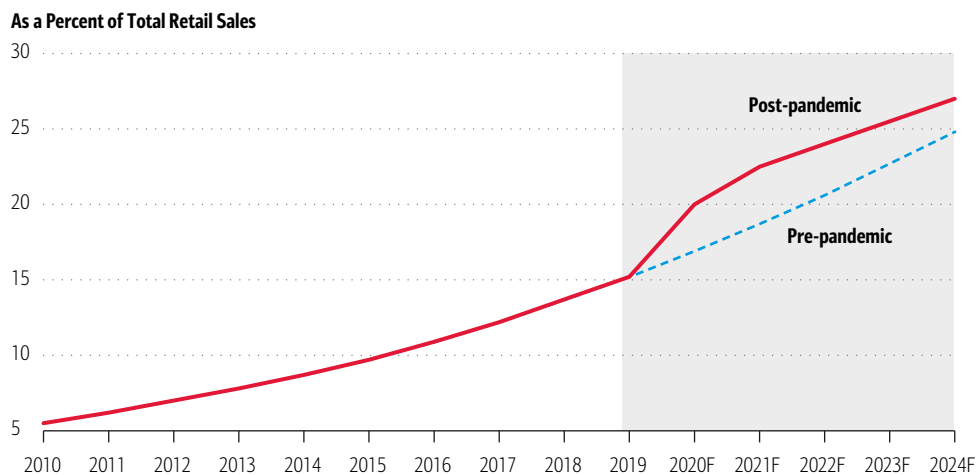
The Covid-19 Premium on Space

Lauren Sanfilippo, Vice President and Investment Strategist

Since the onset of the pandemic, there's been a renewed appreciation for space. No, not the recommended six-foot social distancing measure, but the premium on space in the industrial real estate market levered to tailwinds such as: increased e-fulfillment demand and the resulting shift from physical retail to logistics space; IT infrastructure spend around data centers and cell towers; and lastly, near-shoring supply chain production over the longer term.

U.S. e-Commerce accounted for 15% of retail sales at year-end 2019, and for the better half of the last decade has been growing faster than brick-and-mortar sales. Layer on the pandemic and Euromonitor estimates e-Commerce may represent 19% of retailing by year-end, pulling forward years of share gains made during the pandemic (Exhibit 4).

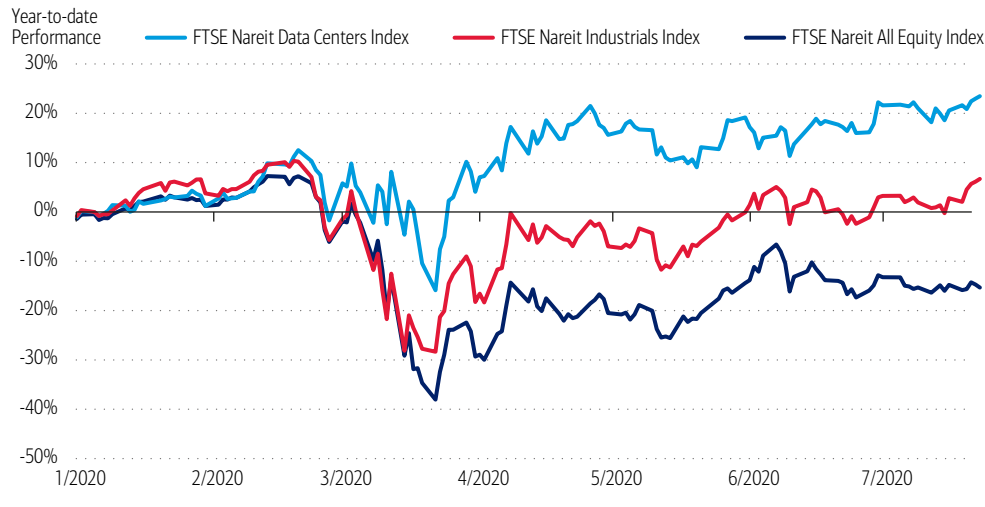
Exhibit 4: U.S. e-Commerce Sales.



2020F–2024F are forecasts. Sources: Euromonitor, Prologis Research. Data as of June 2020. Short-term performance shown to illustrate more recent trend.

A higher e-Commerce adoption rate means more space, and an intensive use at that, comparatively requiring more than three times the logistics space to brick-and-mortar sales. Prior to the pandemic, Jones Lang LaSalle (JLL) attributed 35% of its industrial leasing to e-Commerce and now expects leasing activity near 50%. With all things digital and cloud migration clear secular stories, this is reflected in market performance year-to-date (Exhibit 5). While the broader Nareit Index inclusive of office real estate, retail, lodging etc., is down 15.3% year-to-date, the Industrial Real Estate Investment Trusts (REITs) sector, which includes warehousing and distribution centers, rose 6.6%, versus the Data Center REITs sector, which jumped 23.3% year-to-date.

Exhibit 5: Secular Beneficiaries in Space.



Source: Bloomberg. Year-to-date data as of July 24, 2020. **Past performance is no guarantee of future returns.** Short-term performance shown to illustrate more recent trend.

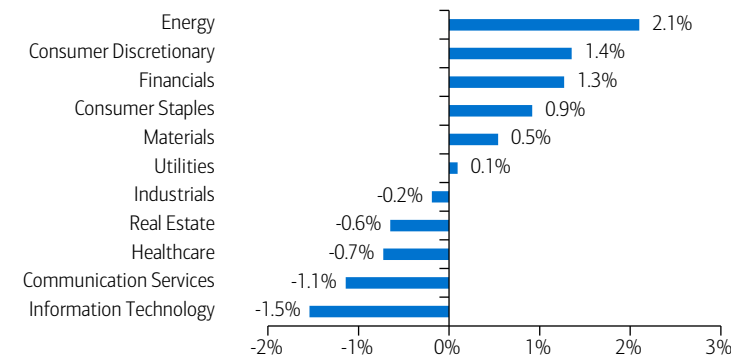
And lastly, as we've discussed, we think the re-shore and near-shore production will play out over the longer-term and businesses will be inclined to create more domestic supply chains. Out of necessity, companies could house higher levels of inventory with the shift from just-in-time to just-in-case. Although inventory-to-sales ratios have largely declined since the early 1990s, we think this is likely to reverse coincidentally with the near-shoring of supply chains as manufacturers and retailers worry about last-mile logistics. According to CBRE Research, even a 5% increase in business inventories requires an additional 400 million to 500 million sq. ft. of warehouse space—all of which benefits these secular winners in space.

MARKETS IN REVIEW

Equities

	Total Return in USD (%)			
	Current	WTD	MTD	YTD
DJIA	26,469.89	-0.7	2.7	-6.0
NASDAQ	10,363.18	-1.3	3.0	16.1
S&P 500	3,215.63	-0.3	3.8	0.6
S&P 400 Mid Cap	1,849.94	0.7	3.8	-9.5
Russell 2000	1,467.56	-0.4	1.9	-11.4
MSCI World	2,291.58	-0.1	4.2	-1.9
MSCI EAFE	1,859.81	0.4	4.5	-7.3
MSCI Emerging Markets	1,060.47	0.6	7.0	-3.4

S&P 500 Sector Returns



Source: Bloomberg, Factset. Total Returns from the period of 07/20/20 to 07/24/20. Bloomberg Barclays Indices.¹ Spot price returns.² All data as of the 07/24/20 close.

Past performance is no guarantee of future results.

Asset Class Weightings (as of 5/6/2020)

	Under-weight	Neutral	Over-weight
Global Equities	•	•	•
U.S. Large Cap Growth	•	•	•
U.S. Large Cap Value	•	•	•
U.S. Small Cap Growth	•	•	•
U.S. Small Cap Value	•	•	•
International Developed	•	•	•
Emerging Markets	•	•	•
Global Fixed Income	•	•	•
U.S. Governments	•	•	•
U.S. Mortgages	•	•	•
U.S. Corporates	•	•	•
High Yield	•	•	•
U.S. Investment Grade Tax Exempt	•	•	•
U.S. High Yield Tax Exempt	•	•	•
International Fixed Income	•	•	•
Alternative Investments*	see CIO Asset Class Views		
Hedge Funds	•		
Private Equity	•		
Real Assets	•		
Cash	•		

* Many products that pursue Alternative Investment strategies, specifically Private Equity and Hedge Funds, are available only to pre-qualified clients.

Fixed Income¹

	Total Return in USD (%)			
	Current	WTD	MTD	YTD
Corporate & Government	1.08	0.6	1.7	9.0
Agencies	0.54	0.1	0.3	5.3
Municipals	1.27	0.4	1.3	3.4
U.S. Investment Grade Credit	1.15	0.4	1.2	7.4
International	1.90	1.0	3.0	8.2
High Yield	5.57	1.6	3.8	-0.1

	Current	Prior Week End	Prior Month End	2019 Year End
90 Day Yield	0.10	0.10	0.13	1.54
2 Year Yield	0.15	0.15	0.15	1.57
10 Year Yield	0.59	0.63	0.66	1.92
30 Year Yield	1.23	1.33	1.41	2.39

Commodities & Currencies

Commodities	Total Return in USD (%)			
	Current	WTD	MTD	YTD
Bloomberg Commodity	145.42	2.5	4.9	-15.5
WTI Crude \$/Barrel ²	41.29	1.7	5.1	-32.4
Gold Spot \$/Ounce ²	1,902.02	5.1	6.8	25.4

Currencies	Current	Prior Week End	Prior Month End	2019 Year End
EUR/USD	1.17	1.14	1.12	1.12
USD/JPY	106.14	107.02	107.93	108.61
USD/CNH	7.02	6.99	7.07	6.96

Economic and Market Forecasts (as of 07/24/20)

	Q3 2019A	Q4 2019A	2019A	Q1 2020A	Q2 2020A	2020E
Real global GDP (% y/y annualized)	-	-	2.9	-	-	-4.0
Real U.S. GDP (% q/q annualized)	2.1	2.1	2.3	-4.8	-35*	-5.7
CPI inflation (% y/y)	1.8	2.0	1.8	2.1	0.4	1.1
Core CPI inflation (% y/y)	2.3	2.3	2.2	2.2	1.3	1.4
Unemployment rate (%)	3.6	3.5	3.7	3.8	13.0	9.0
Fed funds rate, end period (%)	1.90	1.55	1.55	0.08	0.08	0.13
10-year Treasury, end period (%)	1.66	1.92	1.92	0.67	0.68	1.00
S&P 500 end period	2977	3231	3231	2585	3100	2900
S&P earnings (\$/share)	42	42	163.0	34*	25*	115
Euro/U.S. dollar, end period	1.09	1.12	1.12	1.10	1.12	1.08
U.S. dollar/Japanese yen, end period	108	109	109	108	108	103
Oil (\$/barrel, avg. of period, WTI**)	56	57	57	46	29	40

The forecasts in the table above are the base line view from BofA Global Research team. 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.

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 2020. **West Texas Intermediate. Sources: BofA Global Research; GWIM ISC as of July 24, 2020.

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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 dollars.

S&P 500 is a stock market index that tracks the stocks of 500 large-cap U.S. companies. It represents the stock market's performance by reporting the risks and returns of the biggest companies.

Consumer Price Index measures changes in the price level of a weighted average market basket of consumer goods and services purchased by households.

Non-Petroleum Import-Price Index measures changes in the prices of goods and services coming in and out of the United States.

House Price Index measures the price changes of residential housing as a percentage change from some specific start date.

Trade-Weighted US Dollar Index is a measure of the value of the United States dollar relative to other world currencies.

FTSE Nareit All REITs Index is a market capitalization-weighted index that includes all tax-qualified real estate investment trusts (REITs) that are listed on the New York Stock Exchange, the American Stock Exchange or the NASDAQ National Market List.

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