CHIEF INVESTMENT OFFICE

Capital Market Outlook

February 20, 2024

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

IN THIS ISSUE

Macro Strategy—*Yield Curve Inversions, Now and Then:* The aggressive use of fiscal stimulus and related surge in the U.S. deficit outlook are pressuring real interest rates higher and steepening the yield curve.

Over the past year, longer-term real and nominal interest rates have risen by about 60 basis points (bps) despite rapidly declining inflation and an expectation that the Federal Reserve (Fed) will be cutting interest rates over the next two years.

Market View—*Renewable Energy Equities: What Next After the Boom and Bust?:* The clean energy economy has been a major focus for global investors over recent years, particularly since the United Nations (UN) Paris summit in 2015 established the most comprehensive climate deal of any reached in recent decades. But after a strong post-pandemic run up, clean energy-linked equity markets have performed poorly.

We view the global transition toward a clean energy future as still very much in progress, but a range of factors has led to volatility and steep price declines for related equity markets over recent years. After the boom and bust, what should investors expect over the period ahead?

Thought of the Week—*U.S.-China De-Risking: A Closer Look:* It's official: For the first time in 20 years, the U.S. imported more from Mexico than China in 2023. With China's import share falling from 21.6% in 2017 to just 13.9% in 2023, according to the U.S. Census Bureau, the question becomes: Does this mean the U.S. has successfully "de-risked" from China? A deeper look into U.S. trade data shows that the short answer is no—particularly when it comes to key technologies of the future.

While China's role as "factory to the world" has been challenged in recent years, the nation has simultaneously doubled down on what they term the "New Three": electric vehicles, lithium-ion batteries, and renewables. And as our analysis of U.S. imports highlights, whereas reliance has fallen in areas like clothing and furniture, America's green transition—as well as its semiconductor and defense sectors—remain deeply dependent on China and increasingly so. The "de-risking" debate is far from over and will remain front and center as the 2024 election approaches.

MACRO STRATEGY ▶

Chief Investment Office
Macro Strategy Team

MARKET VIEW ▶

Ehiwario Efeyini
Director and Senior Market Strategy Analyst

THOUGHT OF THE WEEK ▶

Ariana Chiu
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MARKETS IN REVIEW ▶

Data as of 2/20/2024, and subject to change

Portfolio Considerations

The U.S. economy shows early signs of reaccelerating, consumers remain healthy, corporate profits turning higher and monetary policy is pivoting from tightening to easing. We continue to favor both stocks and bonds overall. This month we made tactical adjustments designed to increase our exposure to areas that are more correlated with easier financial conditions in the coming year by raising Equities to slight overweight from neutral—funded the increase in Equities from exposure to areas of richness in Fixed Income; increasing small capitalization shares to slight overweight from neutral with a tilt toward value in this asset class; and, increasing our exposure to cyclical Equity sectors.

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MACRO STRATEGY

Yield Curve Inversions, Now and Then

Chief Investment Office, Macro Strategy Team

Signs that the economy is picking up in 2024 despite an unusually long stretch of negative signals from the Conference Board's Leading Economic Indicator (LEI) have caused many forecasters to lose faith in the value of the index, which, despite its past accuracy, has been predicting a recession that never materialized. Prominent among the LEI's 10 components is the slope of the yield curve, which measures the difference between the 10-year Treasury note yield and the federal funds rate on overnight deposits. This component successfully predicted recessions in the past when the short-term funds rate exceeded the longer-term Treasury rate and gets the largest weight in the LEI.

Since this signal has proven false this time around, it's natural to ask why, and what's different this time? Basically, as with many historical empirical relationships, different macroeconomic environments can change what are incorrectly assumed to be fixed correlations or relationships between variables. A recent example is the correlation between stock and bond returns. Before the low inflation, secular stagnation, global savings glut era that characterized the prepandemic period for a couple of decades, stock and bond return correlations were generally positive. This relationship reversed during the roughly two decades before the pandemic, giving rise to the popularity of the risk-parity approach to portfolio management, where equity market selloffs were mitigated by rising bond prices and falling interest rates when recession fears dominated asset markets. The higher risk of deflation in low-structural inflation environments gives bonds an added benefit over Equities in risk off episodes.

After World War II (WWII) but prior to the low inflation, secular stagnation era, the risk of deflation was not an issue, as inflation routinely averaged over 3%, making bonds much less attractive compared to Equities and making the correlation between stock and bond returns more persistently positive. With higher inflation the rule since the pandemic policy shift, that positive correlation has returned, undermining the basis for the risk-parity approach to portfolio allocation. This structural shift to higher inflation has caused a severe bear market in bonds in countries that have adopted the new higher inflation policies.

Likewise, the view that a yield-curve inversion signals an impending recession is based on the post-WWII experience in the U.S., which is characterized by persistent inflation with very little deflation risk and relatively moderate fluctuations in nominal gross domestic product (GDP) growth, with much less time spent in recessions because of proactive monetary and fiscal policies. This was not the case before WWII, when inflation was generally offset by deflation, causing money to hold its value over the long term, while the economy spent a much higher proportion of time in recession, with much greater volatility in nominal GDP.

A look at the yield curve that includes this broader spectrum of economic experience illustrates a more complex set of possibilities that create yield-curve inversions besides a slide into recession. This expanded view of the yield curve includes the possibility of inversions predicting recessions but also the possibility of inversions predicting just declining inflation or even deflation.

For example, if the long-term outlook is for persistent deflation, then a long-term bond will gain real value over time, and long-term yields should be lower than shorter yields, other things equal. In fact, this was the case in the second half of the 19th century in the U.S., as persistent deflation kept the yield curve inverted for much of the time despite an economy that managed to grow on the back of tremendous improvement in technology and productivity.

Investment Implications

A rising fiscal burden and higher real interest rates favor companies with high-quality balance sheets and low leverage, as rising refinancing costs squeeze profit margins.

RETURN TO FIRST PAGE

Thus, the view that an inverted yield curve predicts recessions is more aptly applied to a world where inflation remains persistent and relatively contained along with moderate fluctuations in growth. More specifically, the yield curve anticipates whether nominal GDP is likely to rise or fall. In a stable inflation environment, falling nominal GDP growth is more likely to reflect falling real growth, and hence a recessionary outcome.

This brings us to the post-pandemic experience, which, because of massive monetary and fiscal stimulus, saw the fastest, biggest jump in both inflation and real growth since WWII. As such, it was outside the set of economic data that made economists believe an inverted yield curve means a recession is coming. Seen in the more general context of history, however, the inverted yield curve did accurately predict the big decline in nominal growth from well over 10% at the peak to about 5% more recently. Inflation and growth have fallen by half, or more, from their peaks. However, because growth was so far above trend, it had room to fall by half yet still remain relatively healthy.

This lesson from the post-pandemic experience should spur economists to better understand that generalizations about indicators without regard to the underlying reasons why they work make surprises more likely, where indicators fail to predict the anticipated effect because the conditions under which they work are not in place. That seems to be the case with the yield curve, which did accurately forecast the massive slowing of nominal GDP, both its inflation and real components, but without a resultant recession because the slowing was from such an elevated peak. Based on the experience since 1945, the slowing would have been consistent with a recession, but not from the unprecedented levels of the pandemic boom.

An inverted yield curve means that nominal GDP growth is expected to slow. If nominal GDP growth fluctuates in a stable range with relatively steady inflation, this implies the slowdown would be mainly in real growth, making the risk of recession significant. If, however, the range of nominal GDP growth and inflation fluctuations is much wider, as prior to WWII in the U.S., then a much broader set of possibilities is implied by an inverted yield curve. Nominal GDP growth can drop without a recession when there is scope for big declines in either its inflation and/or real growth components, without real growth going negative as in recessions. This appears to be what happened in the post-pandemic economy, with its much wider fluctuations in both real growth and inflation.

Over the past year, nominal rates on one- to two-year Treasury maturities are flat despite a roughly three-quarter-point rise in the overnight funds rate since last winter. These shorter-term rates are priced for Fed easing over the next year or two. Longer maturity rates, however, have increased about a half percentage point over the past 12 months, both nominal and real rates in the Treasury Inflation Protected Securities market. Essentially, the market has priced in little change in inflation expectations, but about 50 to 75 bps of real rate increases over the longer term.

This bear steepening in real and nominal rates not coincidentally has happened as fiscal stimulus and the outlook for the U.S. budget deficit have increased dramatically over the past year despite a fully employed economy. This new, more aggressive use of fiscal policy to prop up economic growth helped the U.S. economy avoid recession in 2023 and continues to buoy growth in 2024. Faster growth gained by increased fiscal borrowing not surprisingly is being priced into the yield curve, with bigger consequences for the future while keeping the present economy looking good.

MARKET VIEW

Renewable Energy Equities: What Next After the Boom and Bust?

Ehiwario Efeyini, Director and Senior Market Strategy Analyst

The clean energy economy has been a major focus for global investors over recent years, particularly since the 2015 UN Framework Convention on Climate Change (COP21) in Paris established the most comprehensive climate deal of any reached over decades of international negotiations. But after a strong post-pandemic run-up, clean energy-linked equity markets have performed poorly. The MSCI Global Alternative Energy Index—primarily composed of renewable project developers and equipment suppliers in the U.S., Europe and Asia—more than tripled between its pandemic low of March 2020 and its price highs of January 2021. But it has since given up virtually all of those gains, falling by over 50% from its peak of three years ago. We view the global transition toward a clean energy future as still very much in progress, driven by emissions reduction policies at the local, national and international levels, growing energy security needs (particularly in Europe) and the falling cost of renewable energy hardware and generation. But a range of factors has led to volatility and steep price declines for related equity markets over recent years.

The backdrop for the initial phase of the price slump in early 2021 was one of extreme overvaluation. Market expectations for a significant increase in alternative energy investment following the election of President Biden in November 2020 drove a 40% price increase and 10 times price-earnings multiple expansion from 29x to 39x in the two months following the election result. This was immediately followed by a period of rapidly rising inflation from early 2021, which saw bond yields begin to increase from their pandemic lows as expectations for monetary policy tightening started to grow before the Fed delivered its first interest rate hike in March 2022. Renewable energy developers build out project infrastructure (primarily solar and wind farms) and then sell the power they generate to utilities or end-users. Reliance on debt financing therefore means that borrowing costs are a key factor in renewable project viability. Higher rates are a fundamental headwind for investor returns, due to both a higher cost of funding new equipment purchases and a lower present value of existing projects.

Steep declines in natural gas prices then compounded weakness in the sector from the second half of 2022. Lower fossil fuel prices make renewables less competitive and reduce the rates that developers can charge for their generated power. And the 70%-plus decline in wholesale natural gas prices in the year following their 2022 peak came alongside another major downleg for alternative energy Equities. Then in 2023, depressed natural gas prices and additional rate increases were joined by an economic slowdown in China that exerted yet further downward pressure on the clean energy sector. China accounts for the largest share of global renewable energy consumption (29%) and has by far the largest share of global capacity in wind (41%) and solar (37%) power generation, according to the Energy Institute Statistical Review of World Energy. Following its post-pandemic reopening in late 2022, a relapse in economic growth in China in 2023 (annualized GDP growth in Q2 of that year dipped below 3%) therefore came as an additional headwind for renewable energy Equities, which essentially fell back to prepandemic levels by year-end (Exhibit 1).

Investment Implications

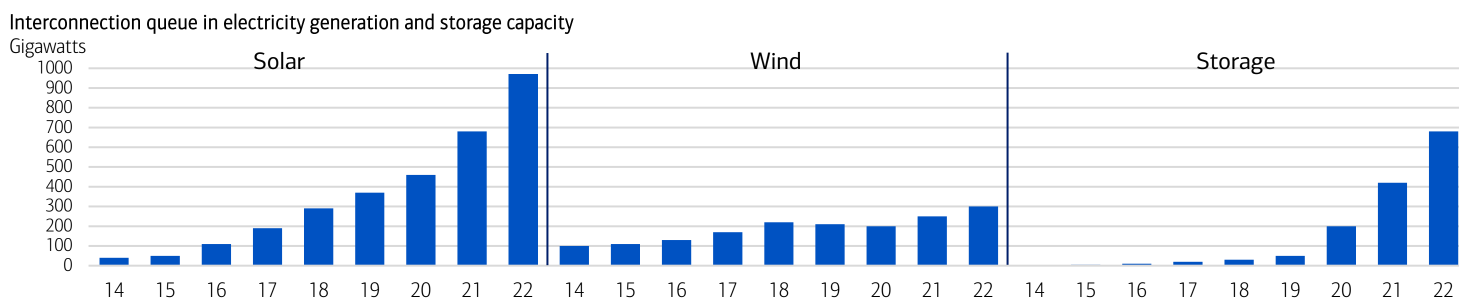
After a challenging few years for renewable energy equity markets, lower inflation and an eventual shift toward interest rate cuts in 2024 should be supportive for the sector. Renewable project developers should also benefit from structural growth in demand volumes, as well as national policy implementation. In the meantime, other market segments related to the green transition such as balance of system components and key commodity groups should also benefit from this ongoing shift in the energy mix.

Exhibit 1: The Boom and Bust In Renewable Energy Equities.

Sources: MSCI; Bloomberg; Chief Investment Office. Data as of January 2024. **Past performance is no guarantee of future results. Please refer to index definitions at the end of this report. It is not possible to invest directly in an index.**

Cyclical forces have clearly then played a key role in the underperformance of the alternative energy sector in recent years. But a further structural impediment in the form of growing backlogs of new capacity yet to be integrated into the grid has also been a major hurdle for project developers. This so-called “interconnection queue” refers to the number of projects awaiting approval by regional grid operators who must first assess the ability of the transmission network to absorb new sources of power generation. According to the U.S. Department of Energy’s University of California Berkeley Lab, over 1,250 gigawatts (GW) of zero-carbon generating capacity was awaiting interconnection approval in 2022 comprised of some 947 GW of solar and 300 GW of wind power, in addition to close to 700 GW of storage capacity (Exhibit 2). Interconnection wait times have also been rising. The median period from a connection request by a renewable developer to commercial operation increased from less than two years for projects built in 2000 to 2007 to almost four years for those built in 2018 to 2022, and five years for projects built in 2022. This trend has also dampened investor returns for the sector as a whole.

Exhibit 2: A Growing Interconnection Queue Remains A Structural Headwind for Renewable Energy Equities.



Source: U.S. Department of Energy University of California Berkeley Lab. Data as of 2022.

So, what should investors expect over the period ahead? Just as higher inflation and interest rates have held back the alternative energy indexes since 2021, ongoing disinflation and an eventual shift toward interest rate cuts in 2024 should be supportive. Renewable project developers should also benefit from structural growth in wind and solar power demand volumes as the longer-term drivers of clean energy demand from policy, energy security and falling costs persist. On the policy front, the 2022 U.S. Inflation Reduction Act will provide some $380 billion in subsidies and credits for renewable energy production, green infrastructure and clean energy equipment manufacturing over the next decade. And perhaps at least as important, any potential future regulatory reform to shorten the interconnection queue and reduce approval times would also buoy returns in the sector by increasing sales of generated power for project developers.

In the meantime, other market segments related to the green transition should also benefit from this ongoing shift in the energy mix. Key growth areas in our view should include suppliers of solar modules and wind turbines, as well as providers of balance of system components such as batteries, power optimizers and inverters. Developers of electrolyzers and fuel cells should benefit from growth in green hydrogen for energy storage and use in industrial applications such as steelmaking and fertilizer production, in addition to commercial transportation segments such as heavy-duty trucks and forklifts. And the commodities used to build renewable energy hardware and batteries such as copper, nickel, lithium, graphite and cobalt are also likely to perform well over the longer term, improving terms of trade for producer countries. At the same time, providers of smart grid features such as demand-response and vehicle-to-grid systems should benefit as greater volumes of alternative energy are connected to the power grid. And makers of industrial cables for long-distance power transmission and grid connections from renewable sources should also be well positioned, particularly against the backdrop of a growing interconnection queue. As we look further out into the green transition, providers of negative emissions technologies such as carbon capture, utilization and storage are also likely to become more mainstream as countries look to reach their net-zero targets.

THOUGHT OF THE WEEK

U.S.-China De-Risking: A Closer Look

Ariana Chiu, Wealth Management Analyst

Much has been made of America's declining imports from China—and for good reason. Since hitting a peak of 21.6% in 2017, China's share of total U.S. imports fell to just 13.9% in 2023[1], with Mexico, too much media hype, now the number one supplier of U.S. imports.

Yet as we have noted in the past, the aggregate decline in U.S. imports from China hides the fact that in several important areas, U.S. dependence on China has actually grown. This is particularly true in the areas China calls the "New Three" (electric vehicles, lithium-ion batteries, and renewables). Take electric vehicles, for example. Graphite accounts for over 30% of an electric vehicles' (EV) weight, and in 2023, 70% of U.S. graphite imports came from China versus 39% in 2018. Similarly, China's share of U.S. lithium-ion battery imports rose from 47% to over 70% between 2018 and 2023. The same cannot be said of the "Old Three" (furniture, clothing, household appliances), industries that China previously championed. Indeed, as Exhibits 3A and 3B highlight, while the U.S. has weaned itself off t-shirts and toasters from China, de-risking has been anything but equal. Finding an alternative source of graphite will be a different ballgame from shifting clothing production to Vietnam.

So yes, China's role as the "factory to the world" is being recast as firms diversify and "de-risk" their global supply chains. But remember that, for now, China remains the factory most strategically optimized for technologies of the future. Add to this China's status as reigning "refinery to the world," and the message becomes clear: When it comes to critical resources to power America's green transition, and to support the U.S. semiconductor and defense sectors, think more, not less, dependence on China.

The inconvenient truth is that America's technological aspirations remain deeply reliant on China. And while the U.S. and its allies are serious about diversifying their supply chains, efforts to de-risk won't be cheap and won't happen overnight. Headlines may harp on China's dethroning in 2023, but these transitions will take time, a great deal of capital, and the political will to overcome environmental concerns.

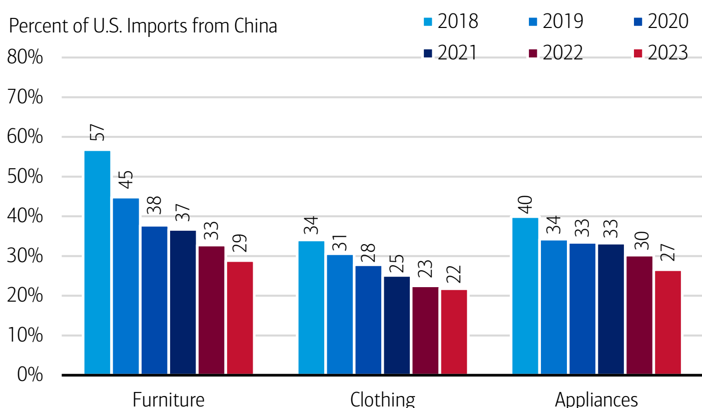
All of the above is a reminder that geopolitical risks—namely souring U.S.-China relations—remain a key consideration when it comes to portfolio construction and expected market returns. There is a great deal at stake as the "de-risking" debate swirls and gathers more traction as the 2024 election approaches.

Investment Implications

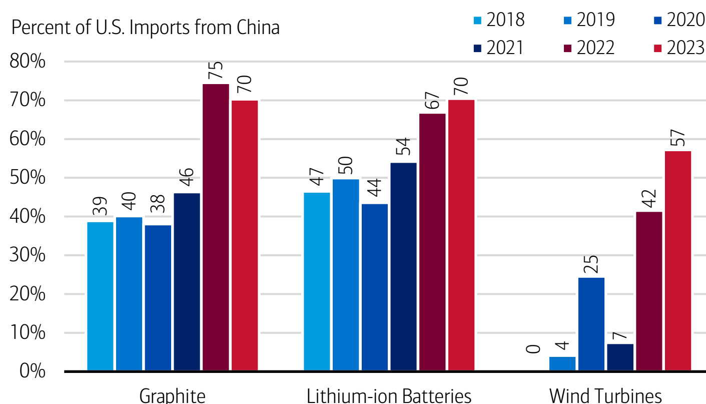
The state of U.S.-China relations, and its importance in the 2024 election, remain top of mind. Meanwhile, diversifying supply chains from China will take time. Importantly for investors, multiyear efforts to "de-risk" will also require significant spending. Expected beneficiaries include renewable infrastructure, artificial intelligence, and defense—all with a bias toward U.S. assets.

Exhibit 3: U.S. Imports From China: Out With The Old, In With The New.

3A) "De-Risking" is Happening in the "Old Three"...



3B) ...But What About "New Three" Industries?



Source: U.S. Census Bureau. Data as of February 7, 2024.

[1] U.S. Census Bureau. Data as of February 7, 2024.

RETURN TO FIRST PAGE

Equities

	Total Return in USD (%)			
	Current	WTD	MTD	YTD
DJIA	38,627.99	0.0	1.4	2.8
NASDAQ	15,775.65	-1.3	4.1	5.2
S&P 500	5,005.57	-0.3	3.4	5.1
S&P 400 Mid Cap	2,828.30	0.7	3.6	1.8
Russell 2000	2,032.74	1.2	4.5	0.4
MSCI World	3,285.12	0.2	2.6	3.8
MSCI EAFE	2,257.21	1.5	0.5	1.0
MSCI Emerging Markets	1,016.23	2.1	4.2	-0.7

Fixed Income†

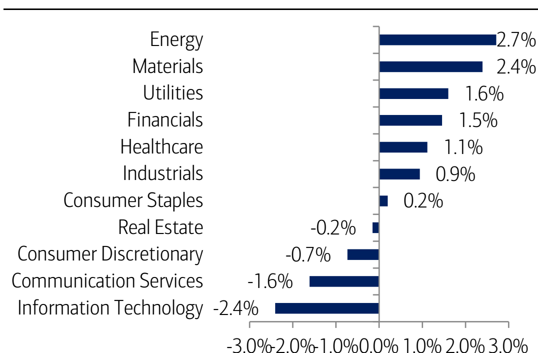
	Total Return in USD (%)			
	Current	WTD	MTD	YTD
Corporate & Government	4.84	-0.53	-1.72	-1.95
Agencies	4.79	-0.33	-0.96	-0.68
Municipals	3.44	-0.10	-0.20	-0.71
U.S. Investment Grade Credit	4.92	-0.55	-1.74	-2.01
International	5.40	-0.45	-1.73	-1.90
High Yield	7.87	-0.32	-0.15	-0.15
90 Day Yield	5.37	5.37	5.36	5.33
2 Year Yield	4.64	4.48	4.21	4.25
10 Year Yield	4.28	4.18	3.91	3.88
30 Year Yield	4.44	4.37	4.17	4.03

Commodities & Currencies

	Total Return in USD (%)			
Commodities	Current	WTD	MTD	YTD
Bloomberg Commodity	222.53	-0.6	-2.1	-1.7
WTI Crude $/Barrel††	79.19	3.1	4.4	10.5
Gold Spot $/Ounce††	2013.59	-0.5	-1.3	-2.4

	Total Return in USD (%)			
Currencies	Current	Prior Week End	Prior Month End	2022 Year End
EUR/USD	222.53	-0.6	-2.1	-1.7
USD/JPY	79.19	3.1	4.4	10.5
USD/CNH	2013.59	-0.5	-1.3	-2.4

S&P Sector Returns



Sources: Bloomberg; Factset. Total Returns from the period of 2/12/2024 to 2/16/2024. †Bloomberg Barclays Indices. ††Spot price returns. All data as of the 2/16/2024 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 2/9/2024)

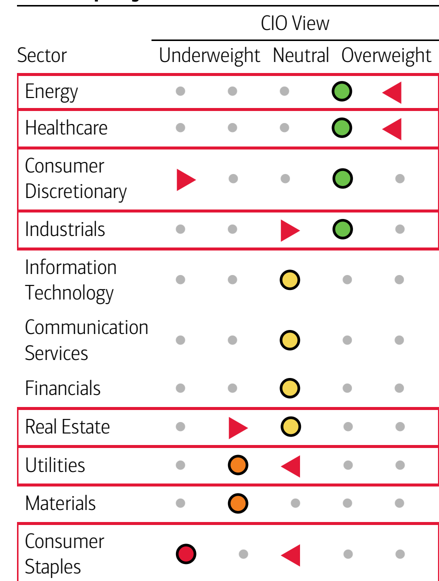
	Q4 2023A	2023A	Q1 2024E	Q2 2024E	Q3 2024E	Q4 2024E	2024E
Real global GDP (% y/y annualized)	-	3.0*	-	-	-	-	2.8
Real U.S. GDP (% q/q annualized)	3.3	2.5	1.0	1.0	1.5	1.5	2.1
CPI inflation (% y/y)	3.2	4.1	2.9	2.9	2.6	2.4	2.7
Core CPI inflation (% y/y)	4.0	4.8	3.6	3.2	3.2	3.0	3.3
Unemployment rate (%)	3.8	3.6	3.8	4.0	4.1	4.2	4.0
Fed funds rate, end period (%)	5.33	5.33	5.38	5.13	4.88	4.63	4.63

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 February 16, 2024.

Asset Class Weightings (as of 2/6/2024)

*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 6, 2024. 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.

CIO Equity Sector Views



RETURN TO FIRST PAGE

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 is a stock market index tracking the stock performance of 500 of the largest companies listed on stock exchanges in the United States.

Conference Board's Leading Economic Indicator (LEI) is an American economic leading indicator intended to forecast future economic activity. It is calculated by The Conference Board, a non-governmental organization, which determines the value of the index from the values of ten key variables.

MSCI Global Alternative Energy Index includes developed and emerging market large, mid and small cap companies that derive 50% or more of their revenues from products and services in Alternative energy.

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RETURN TO FIRST PAGE