

CHIEF INVESTMENT OFFICE

Capital Market Outlook

July 15, 2024

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

IN THIS ISSUE

Macro Strategy—*Slow Global Expansion Likely to Continue:* While economic surprises have been negative lately, leading indicators and easing global central bank policies point to the slow global expansion gaining traction in the second half of 2024 and 2025.

Tolerance for higher inflation than prevailed before the pandemic is keeping nominal growth in a new higher range that boosts corporate revenues and profits. The Federal Reserve (Fed) stands ready to support growth as the fiscal boost from the pandemic fades and unemployment rises. The key to further gains in risk assets is falling inflation.

Market View—*Thinking Longer-Term: We See Continued Upside for U.S. Equities:* Navigating a myriad of near-term market dynamics—from upcoming elections and lingering geopolitical tensions to elevated valuations and narrow market breadth—can make it easy to lose sight of the underlying market direction. Remember that the stock market moves cyclically with the business cycle, but it also follows a secular, or longer-term, trend that can prevail for several years or even decades.

It is our view that U.S. Equities remain well entrenched in a secular bull market. Secular market periods tend to be characterized by major regime shifts that play out over long time horizons (think technological revolutions, significant policy transitions or entrenched economic conditions like deflation). We see the foundation for further secular bull market growth coming together with forces from a new technological revolution and favorable investor trends providing powerful tailwinds for the long-term trend.

Thought of the Week—*Despite Robust Global Defense Spending, Outlays are Still Too Low and Headed Higher:* We remain constructive on Large-cap U.S. defense plays because the world, simply stated, remains messy and disorderly. Additionally, the world is relatively underinvested in defense: The world spent just 2.3% of world gross domestic product (GDP) on defense in 2023—a near-record low and well below the 3.5% annual average from 1960 to 2023. The relatively low spending to GDP ratio reflects the limited fiscal space of many nations, the U.S. included.

However, the world's a dangerous place. A global arms race is underway and includes increased spending not only on traditional munitions like tanks, missiles and aircraft but also cybersecurity capabilities. However, unless the doves of peace suddenly appear on the horizon, global defense spending is likely headed higher.

MACRO STRATEGY ►

Chief Investment Office
Macro Strategy Team

MARKET VIEW ►

Kirsten Cabacungan
Vice President and Investment Strategist

THOUGHT OF THE WEEK ►

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

MARKETS IN REVIEW ►

**Data as of 7/15/2024,
and subject to change**

Portfolio Considerations

We maintain an overweight to Equities, with a preference for higher quality U.S. Large- and Small-caps. We continue to incorporate cyclical-Value exposure in our sector views by maintaining overweight allocations to areas like Energy, Industrials and Consumer Discretionary and emphasize Healthcare to reflect a balance between Value and Growth

We still favor a significant allocation to bonds in a diversified portfolio, re-affirm our view to be slightly long duration and reiterate our preference for rate risk over credit risk generally within Fixed Income.

We view weak episodes in the markets as a buying opportunity for long term Equity investors.

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Slow Global Expansion Likely to Continue

Chief Investment Office, Macro Strategy Team

Quantitative measures, such as the Federal Reserve Bank of Chicago's National Financial Conditions Index (NFCI), have shown easier financial conditions since the Fed stopped raising rates last summer. Financial conditions have eased considerably further since the Fed pivot late last fall, when Fed Chair Powell signaled that policy would be cutting rates rather than raising them more. On balance, the NFCI shows financial conditions have reversed all of the tightening pressures that occurred while the Fed was raising rates in 2022 and early 2023.

In addition to telegraphing rate cuts for 2024, the Fed has dialed back the pace of quantitative tightening (QT), which has also helped ease financial conditions. Better liquidity is evident in improved money growth dynamics after the shrinkage that occurred while the Fed was raising rates. For example, Alpine Macro research found that their "money pulse indicator, which tracks the second derivative of M2¹, has improved significantly in recent months." This reacceleration of money growth coincides with Chair Powell's pivot last year and the ensuing global stock rally, which is a powerful leading indicator of economic growth.

While monetary policy has turned easier, the U.S. economy is still coming off the inflationary highs that were fueled by the pandemic fiscal stimulus. Most U.S. consumers are feeling the pressure from prices that have outstripped income gains over the past four years. This pressure is not evenly distributed. Low-income households are showing the most need to economize because of rising prices of essentials. High-interest income and rising asset prices have kept the highest income brackets spending, especially on leisure and travel activities. The Transportation Security Administration reports new highs for passengers moving through airports in recent weeks. This mix of consumer dynamics is reflected in an unusually diverse set of relative performance outcomes within the consumer discretionary sector.

There's some evidence that the stress is moving up the income scale, however. Overall, the Atlanta Fed GDPNow estimate for Q2 consumer spending has steadily dropped from 4% on April 26 to just 1.1% in the July 3 estimate. Slowing consumer spending growth reflects softening job and wage growth, as businesses dial back hiring in this weakening demand environment, already pushing unemployment up from a 3.4% low point to 4.1% in June. Basically, in typical late-cycle fashion, wages are finally moving up faster than prices, pressuring profit margins and causing businesses to slow hiring. Downside margin pressure and slowing consumer demand seem to fly in the face of analysts' rising expectations for profits in the year ahead.

The apparent contradiction stems from the skewed distribution of profit gains and the different outlooks for profits around the world. Most of the gains in profits have been concentrated in the handful of U.S. companies that account for most of the gains in equity prices. The vast majority of U.S. companies have shown a more muted profits pickup or none at all. That's why most of their stock prices have failed to keep up with inflation.

The overwhelming source of profit growth in the past two years has been in those companies that are benefiting from the boom in new technology, which is transforming the economy at an accelerating rate. This new growth and wealth are disproportionately concentrated in the U.S. For example, just 1% of the U.K.'s FTSE 100 Index comprises technology companies compared to 33% of the S&P 500. This technology-centric U.S. market accounts for much of the big performance gap between different countries' equity markets.

Finally, the U.S. had more pandemic stimulus than most countries and thus more growth and more inflation. As a result, inflation is still higher in the U.S., interest rates are higher, and the economy is in more of a late-cycle phase. Other countries are already cutting rates and, with lower inflation, are showing more early-cycle tendencies. This is apparent in recent earnings revisions ratios, which are showing more improvement outside the U.S.

"The Fed put" seems to have reassured markets that monetary policy will ride to the rescue before rising unemployment causes a recession. This "soft landing" policy goal is

Investment Implications

Easy financial conditions favor Equities while big fiscal deficits have created a secular bear market in long-term government bonds despite some likelihood of short-term price appreciation when the Fed eases. Commodities can provide a hedge against the new, higher long-term inflation backdrop.

¹ M2 is a measure of the U.S. money stock that includes currency and coins held by the non-bank public, checkable deposits, and travelers' checks plus savings deposits (including money market deposit accounts), small time deposits under \$100,000, and shares in retail money market mutual funds.

keeping optimism elevated, and slowing inflation is boosting confidence in the Fed's ability to credibly lower rates. Longer term, however, the rising government debt is propagating a higher inflation outlook. While inflation is now below the 4%+ average of the past five years, easing policy while inflation remains well above the 2% target suggests current inflation is likely to reach its cycle low point during the next year or two before taking off again in the next easing cycle. Reluctance to let unemployment rise adds to the case for a new, higher-inflation environment.

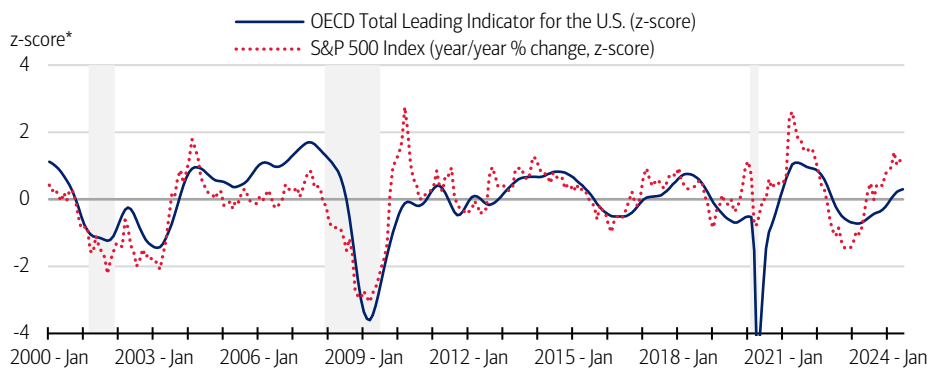
This helps explain why the correlation between stock and bond returns has shifted back to the old positive relationship that prevailed when inflation persistently averaged over 3%. For example, Bridgewater Associates researchers find the rolling five-year correlation between world Equities and developed world bonds has shifted back to strongly positive after a roughly two-decade period when it was persistently negative. Aside from brief intervals in the 1930s and late 1950s, such prolonged negative correlation was unprecedented in the experience of the past 100 years.

This boils down to the fact that in a higher inflation environment, policy eases when inflation falls below trend, as it is now, and tightens when it rises above trend. Equities rise and fall with inflation because policy responds to inflation. This creates the positive correlation between bond and equity prices observed since the pandemic for the first time since the 1990s. When policy responds to growth while inflation is persistently low, Equities fall and rise with growth, rendering the correlation negative and making risk-parity portfolio management appropriate.

Zero rates, quantitative easing (QE) and negative real interest rates characterized that anomalous period when monetary policy was working to support demand and avoid deflation while the private sector worked off its excessively leveraged balance sheet. Now, with private sector finances in good shape, the government sector is the source of what are likely to be increasing debt-related problems. Real interest rates fluctuated mainly between 2% and 4% during the decades before the negative real-rate period. As more of the burden for financing fiscal excesses falls outside the realm of central banks, it makes sense that Treasury bond investors will require a higher positive real rate to compete with other investment options.

The global shift from raising rates to cutting rates as inflation comes down has triggered an upswing in the Global Wave compiled by BofA Global Research. This indicator has improved for six straight months consistent with leading indicators showing the economy moving further into expansion territory (Exhibit 1). Risk and cyclical assets tend to do well in this environment, as we've seen with a broad array of global equity indexes so far this year. For many countries, this improving economic dynamic is relatively new.

Exhibit 1: Leading Indicators and Equities Up Since Fed Pivot.



*z-score=number of standard deviations from the mean of the data set. Source: The Organization for Economic Cooperation and Development (OECD) /Haver Analytics. Data as of July 8, 2024. **Indexes are unmanaged and do not take into account fees or expenses. It is not possible to invest directly in an index. Past performance is no guarantee of future results.**

Elections around the world are highlighting the backdrop of unsustainable government spending as, for example, in France. In the U.S., the election is not expected to change the outlook for a growing debt problem that is keeping long-term rates above their pre-pandemic levels and making the zero-rate QE policies of the prior decade unlikely to be revisited given the new, higher inflation environment. While the election outcome will affect the mix of taxes and spending in significant ways for the market, there is no appetite for fiscal retrenchment on either side. As a result, even though the Fed is likely to cut short-term rates as necessary to keep unemployment low, long rates are likely to remain relatively sticky while inflation remains above the Fed's 2% target.

Thinking Longer-Term: We See Continued Upside for U.S. Equities

Kirsten Cabacungan, Vice President and Investment Strategist

Navigating a myriad of near-term market dynamics—from upcoming elections and lingering geopolitical tensions to elevated valuations and narrow market breadth—can make it easy to lose sight of the underlying market direction. Remember that the stock market moves cyclically with the business cycle, but it also follows a secular, or longer-term, trend that can prevail for several years or even decades.

Secular market periods tend to be characterized by major regime shifts that play out over long time horizons (think technological revolutions, significant policy transitions or entrenched economic conditions like deflation). The path of the trend though is never linear. Cyclical bull and bear markets, where stocks rise or fall by at least 20%, and economic expansions and recessions exist within both secular bull and bear markets. Instead, it is the momentum in the market that marks the difference. Secular bull markets tend to see the long-term market trend slope upward where Equities recover from market drawdowns, go on to reach new all-time highs and make higher lows over multiple cyclical market cycles. Secular bear markets encompass a prolonged move sideways or even lower after no market cycle attempts to capture new highs can be sustained.

It is our view that U.S. Equities remain well entrenched in a secular bull market that started out of the 2008/2009 Global Financial Crisis (GFC) and broke out to the upside in 2013 when the S&P 500 recovered its prior GFC all-time high (Exhibit 2A). The trend remains higher even amid the pandemic-era pullback and the 2022 bear market drawdown following a spike in inflation and aggressive monetary policy tightening. From a cyclical perspective, the S&P 500 is up roughly 60% from its October 2022 low and has already claimed 37 new all-time highs this year (Exhibit 2B). From a secular perspective, the long term run over 733% from its 2009 generational low is modest at best compared to the last two secular equity bull advances that gained +1,159% and +2,353%.²

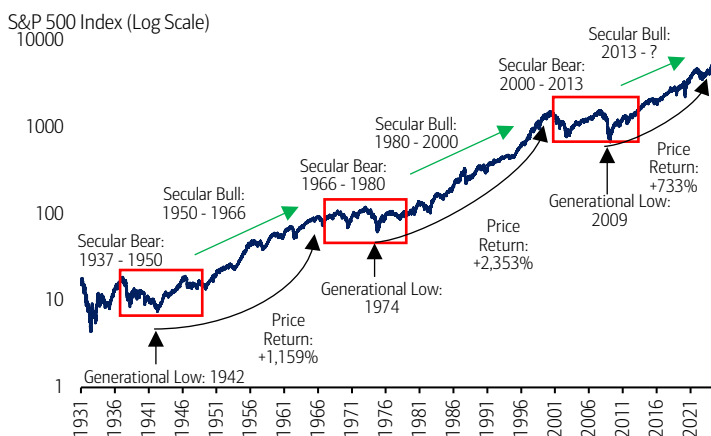
What happens next? Risks over the next decade persist especially amid structurally higher inflation and interest rates compared to the post-GFC period, boiling geopolitical instability and waning U.S. fiscal health. But we see positive offsets emerging that should be levers of future long-term growth in U.S. Equities.

Portfolio Considerations

Considering the near-term potential for elevated volatility, we continue to focus on the long-term outlook. We believe that the secular bull market remains intact and see powerful forces coming together to transform the economy and capital markets ahead. Therefore, we would view weak episodes in the markets as buying opportunities for long term investors and consider positioning portfolios to take advantage of secular themes like Artificial Intelligence (AI).

Exhibit 2: The Secular Bull Market Remains Intact.

2A) U.S. Equities See Both Secular and Cyclical Market Cycles.



2B) Secular Bull Markets Tend to See Several Years of New Highs.

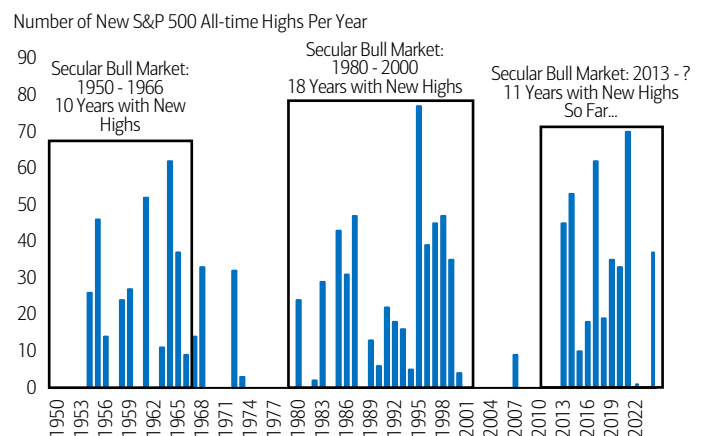


Exhibit 2A) Sources: Chief Investment Office; BofA Global Research; Bloomberg. Data as of July 10, 2024. Exhibit 2B) Sources: Chief Investment Office; Strategas Research Partners; Bloomberg. Data as of July 10, 2024. **Indexes are unmanaged and do not take into account fees or expenses. It is not possible to invest directly in an index. Past performance is no guarantee of future results.**

² Bloomberg. Data from March 9, 2009 to July 10, 2024. The last two secular bull market cycles refers to the 1950-1966 and 1980-2000 periods.

Two forces to consider when thinking about the longer term include:

An AI-led technological revolution: Technological advancement powered the prior secular bull market with the proliferation of computers and the advent of the internet age. A similar set up could be forming for the next phase of this secular bull market. Optimism over the potential boost to corporate productivity and profitability and growth in new industries and jobs from AI advancements has already been a strong cyclical tailwind for Equities.

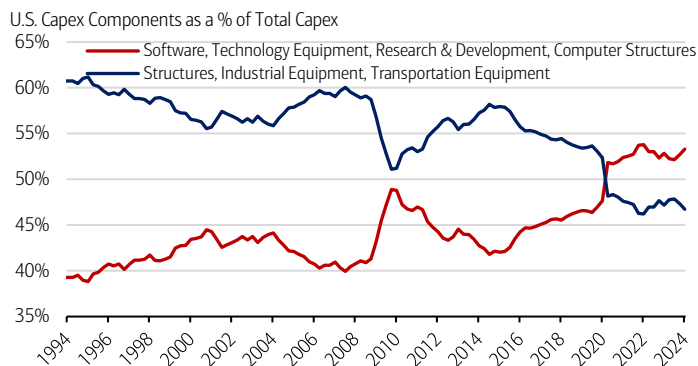
As the Fed moves toward an easing cycle and the cost of capital falls, broader AI adoption and investment is expected to ramp up. Technology-oriented capital expenditures (capex) now exceed greater than half of total capex (Exhibit 3A). Legislation like the CHIPS Act, which aims to support AI advancements, should further fortify this transition over the long term. We expect to see this technological revolution reshape the economy and capital markets to be more “asset light” versus “asset heavy,” which should allow companies to innovate quicker, support positive operating leverage and boost profit margins.

An Emerging Equity Culture: More U.S. households are investing than ever before. According to the latest Survey of Consumer Finances, around 58% of U.S. households owned stocks through direct stock ownership and indirect stock ownership via retirement accounts, pooled investment funds and other managed accounts in 2022. That marked the highest share on record and a step up from 53% in 2019 (Exhibit 3B). Direct stock ownership specifically saw its largest increase in the survey’s history, jumping from 15% in 2019 to 21% in 2022. Albeit the median inflation-adjusted value of direct stock holdings fell by about half over that period from around \$29,000 to \$15,000, suggesting smaller portfolio sizes for new investors compared to longtime stockholding families.³ Still, the change conveys a powerful new wave of stock market participation that accelerated during the pandemic era.

Other factors could further catalyze this rising interest in stocks. U.S. Equities could be major beneficiaries from a rotation of cash off the sidelines as yields move lower. U.S. households are sitting on record hordes of cash, with balance sheets holding \$18 trillion in liquid assets, including cash deposits, compared to \$13 trillion prior to the pandemic.⁴ Geopolitical fragility could see investors lean further on U.S. Equities for higher quality and secular thematic exposures. And as the baby boomer generation retires and lives longer, the search for more income opportunities may drive greater interest in dividend-paying stocks.

Exhibit 3: Factors Powering The Secular Bull Market.

3A) Capex Trends Are Shifting.



3B) Stock Ownership Interest Is Growing.

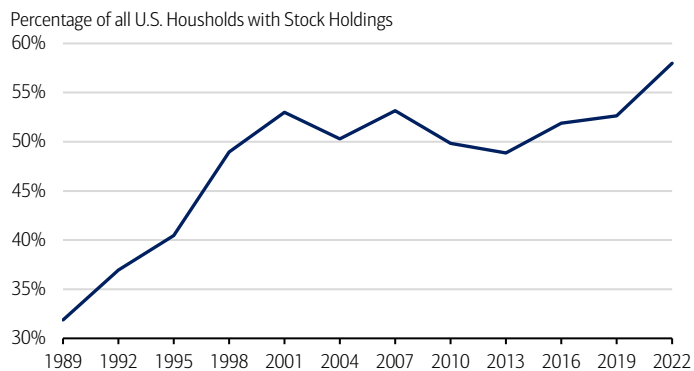


Exhibit 3A) Source: PSC Macro. Data as of March 31, 2024. Exhibit 3B) Sources: 2022 Survey of Consumer Finances; Federal Reserve. Data as of November 2, 2023. Latest data available

The upshot: Zooming out helps to put some of the nearer-term volatility into perspective. We believe the foundation for further growth in the secular bull market is coming together, which keeps us constructive on U.S. Equities over the longer term.

³ 2022 Survey of Consumer Finances; Federal Reserve. Data as of November 2, 2023. Latest data available.

⁴ Measures total currency and deposits including money market fund shares assets on U.S. household and nonprofit organization balance sheets. Source: Board of Governors of the Federal Reserve System. Data as of December 7, 2023. Latest data available.

Despite Robust Global Defense Spending, Outlays are Still Too Low and Headed Higher

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

The world is at war but you would never know it looking at Exhibit 4A. Notwithstanding a ground war in Europe and the Middle East, rising geopolitical tensions in the South China Sea and the budding Great Power Rivalry between the U.S. and China, in addition to the 24/7 war in cyberspace, global defense spending as a percentage of world GDP remains near historic lows. The world spent just 2.3% of world GDP on defense in 2023—a near-record low and well below the 3.5% annual average from 1960-2023.

It's not that global defense spending isn't rising—in fact, it is, with global military expenditures hitting a record \$2.4 trillion in 2023. Rather, the relatively low ratio of spending to output reflects the limited fiscal space of many nations, the U.S. included, and other budget priorities, like mandatory outlays on healthcare, social security, and lately, rising interest payments on existing debt. There are, in other words, competing demands for defense dollars.

That said, it's a dangerous world out there. A global arms race is underway and includes increased spending not only on traditional munitions like tanks, missiles and aircraft, but also cybersecurity capabilities. Wars are being fought both physically and digitally, with global expenditures on cybersecurity expected to have reached a record high of \$219 billion in 2023 according to International Data Corporation (IDC). By 2026, the IDC expects expenditures to top \$300 billion due to rising risks around increased cyberattacks on both public and private sector institutions and activities.

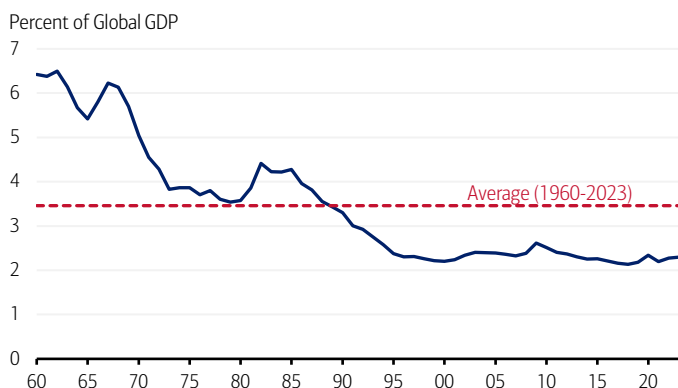
The need for more defense spending on the one hand, versus budgetary constraints on the other, is highlighted in Exhibit 4B. Nine out of 32 members of North Atlantic Treaty Organization (NATO) are not expected to hit the organization's target of 2% defense spending/GDP in 2024, including large nations like Italy and Spain. Many states are stuck between a rock (the need for more defense spending) and a hard place (stretched public finances). However, unless the doves of peace suddenly appear on the horizon, global defense spending is likely headed higher. Like it or not, the geopolitical backdrop is fraught with risk and uncertainty, a situation that makes us favor Large -cap defense plays for the long run.

Portfolio Considerations

Given an investment backdrop fraught with heightened geopolitical risks, we have and remain constructive on Large-cap U.S. defense contractors and continue to favor cybersecurity leaders.

Exhibit 4: Global Defense Spending Can Only Go Up.

4A) Global Military Expenditure as a Percent of World GDP.



4B) Defense Spending as a Share of GDP.

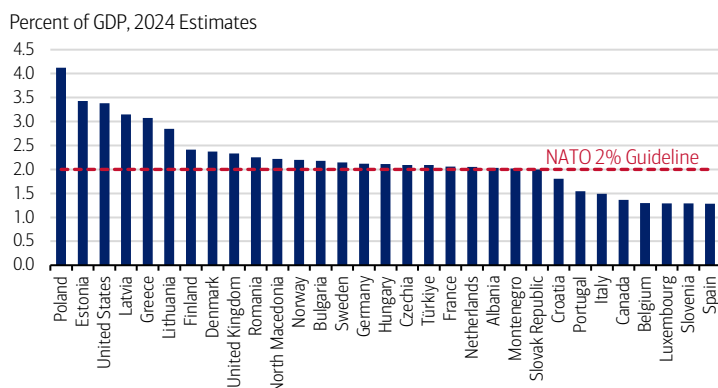


Exhibit 4A) Source: Stockholm International Peace Research Institute. Data as of July 10, 2024. Exhibit 4B) Iceland is omitted as the country has no armed forces. Source: North Atlantic Treaty Organization. Data as of July 10, 2024.

MARKETS IN REVIEW

Equities

	Total Return in USD (%)			
	Current	WTD	MTD	YTD
DJIA	40,000.90	1.6	2.3	7.2
NASDAQ	18,398.45	0.3	3.8	23.0
S&P 500	5,615.35	0.9	2.9	18.6
S&P 400 Mid Cap	3,020.71	4.3	3.1	9.5
Russell 2000	2,148.27	6.0	4.9	6.8
MSCI World	3,627.52	1.3	3.3	15.5
MSCI EAFE	2,418.31	2.3	4.5	10.1
MSCI Emerging Markets	1,123.56	1.8	3.8	11.5

Fixed Income[†]

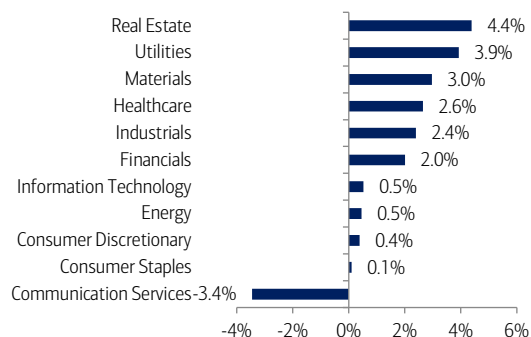
	Total Return in USD (%)			
	Current	WTD	MTD	YTD
Corporate & Government	4.66	0.75	1.47	0.79
Agencies	4.71	0.45	0.85	1.70
Municipals	3.62	0.53	0.59	0.18
U.S. Investment Grade Credit	4.75	0.82	1.54	0.82
International	5.22	0.82	1.79	1.29
High Yield	7.67	0.80	1.08	3.69
90 Day Yield	5.33	5.37	5.35	5.33
2 Year Yield	4.45	4.60	4.75	4.25
10 Year Yield	4.18	4.28	4.40	3.88
30 Year Yield	4.40	4.48	4.56	4.03

Commodities & Currencies

	Total Return in USD (%)			
	Current	WTD	MTD	YTD
Commodities				
Bloomberg Commodity	238.01	-1.6	0.0	5.1
WTI Crude \$/Barrel ^{††}	82.21	-1.1	0.8	14.7
Gold Spot \$/Ounce ^{††}	2411.43	0.8	3.6	16.9

	Total Return in USD (%)			
	Current	Prior Week End	Prior Month End	2022 Year End
Currencies				
EUR/USD	1.09	1.08	1.07	1.10
USD/JPY	157.83	160.75	160.88	141.04
USD/CNH	7.27	7.29	7.30	7.13

S&P Sector Returns



Sources: Bloomberg; Factset. Total Returns from the period of 7/8/2024 to 7/12/2024. [†]Bloomberg Barclays Indices. ^{††}Spot price returns. All data as of the 7/12/2024 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 7/12/2024)

	2024E	Q1 2024A	Q2 2024A	Q3 2024E	Q4 2024E	2025E
Real global GDP (% y/y annualized)	3.2	-	-	-	-	3.3
Real U.S. GDP (% q/q annualized)	2.6	1.4	2.0*	2.5	2.0	2.1
CPI inflation (% y/y)	2.9	3.2	3.2*	2.8	2.3	2.1
Core CPI inflation (% y/y)	3.4	3.8	3.4*	3.2	3.1	2.6
Unemployment rate (%)	3.9	3.8	4.0*	4.0	4.0	4.1
Fed funds rate, end period (%)	5.13	5.33	5.33	5.38	5.13	4.13

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 July 12, 2024.

Asset Class Weightings (as of 7/9/2024)

Asset Class	CIO View		
	Underweight	Neutral	Overweight
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	●	●	●
International Fixed Income	●	●	●
High Yield	●	●	●
U.S. Investment-grade	●	●	●
Tax Exempt	●	●	●
U.S. High Yield Tax Exempt	●	●	●
Alternative Investments*			
Hedge Funds			
Private Equity			
Real Assets			
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. Source: Chief Investment Office as of July 9, 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

Sector	CIO View		
	Underweight	Neutral	Overweight
Energy	●	●	●
Healthcare	●	●	●
Consumer Discretionary	●	●	●
Industrials	●	●	●
Information Technology	●	●	●
Communication Services	●	●	●
Financials	●	●	●
Real Estate	●	●	●
Utilities	●	●	●
Materials	●	●	●
Consumer Staples	●	●	●

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 market-capitalization-weighted index that is widely regarded as the best single gauge of large-cap U.S. equities. The index includes 500 leading companies and covers approximately 80% of available market capitalization.

National Financial Conditions Index is a weighted average of a large number of variables (105 measures of financial activity) each expressed relative to their sample averages and scaled by their sample standard deviations.

U.K. FTSE 100 Index is the United Kingdom's best-known stock market index of the 100 most highly capitalized blue chip companies listed on the London Stock Exchange.

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