

Capital Market Outlook

November 20, 2023

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

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Macro Strategy—Progress On The Inflation Front Likely To Continue: The favorable direction of the U.S. economic data in recent weeks has raised growth expectations for 2023 and 2024, boosting equity market benchmarks and reducing corporate debt spreads. Economywide cash flow growth, as proxied by the surge in nominal gross domestic product (GDP), strongly surprised to the upside in Q3, helping corporate earnings exceed expectations. At the same time, higher-than-anticipated labor force participation rates for women, related to the expanding possibility of working from home, and a surge in productivity have helped tame inflation, sharply reducing the probability of additional Federal Reserve (Fed) interest rate hikes, another positive for risk assets.

With economic growth still anticipated to ease next year and growing evidence of a broad-based disinflation trend, nominal GDP growth is likely to weaken ahead. In fact, there is a risk the disinflation trend may go too far, which, combined with growing downside pressures on margins, implies potential profit growth constraints in coming quarters.

Market View—Asia Opportunity Amid China’s Challenges: One of the big stories of 2023 has been China’s failure to build on its reopening-driven equity market gains of late 2022. But despite this year’s disappointment, we still see several reasons to de-emphasize China within emerging markets on a structural basis.

Looking across the rest of Asia, other markets have nonetheless outperformed the regional hegemon this year and are likely to wrest further market share from China over the period ahead. We examine regional prospects across North Asia, Southeast Asia, India and Japan.

Thought of the Week—Taking Stock of America’s Energy Security: The U.S. has solidified its status as the global leader in energy. As a net energy exporter and the No.1 oil producer in the world, the U.S. is less vulnerable to energy shocks than its competitors, including China.

However, a look at the recent past reminds us that it was not always this way. Now, as conflict erupts in the Middle East, we continue to monitor oil prices—with the knowledge that, when it comes to energy security, the U.S. is better set up than most.

MACRO STRATEGY ►

Chief Investment Office
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MARKET VIEW ►

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THOUGHT OF THE WEEK ►

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MARKETS IN REVIEW ►

**Data as of 11/20/2023,
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Portfolio Considerations

We believe a risk-neutral approach across asset classes makes sense for the foreseeable future. A balanced approach that is fully invested and uses Fixed Income for cash flow, Equities for long-term growth, and Alternatives* for a variety of portfolio factors makes sense in this transition phase. We recommend a slightly long-duration position versus a stated benchmark to take advantage of higher nominal and real yields and as prudent positioning against macro risk in the Equity portion of a diversified portfolio.

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

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Progress On The Inflation Front Likely To Continue

Chief Investment Office, Macro Strategy Team

U.S. economic performance has continued to impress, led by unexpectedly strong consumer demand in the face of high inflation, surging interest rates, decades-low housing affordability, and recessionary levels of consumer confidence. Mainly boosted by a sharp drop in personal saving, consumer spending contributed 2.7 percentage points (pp) to the 4.9% annualized real GDP growth in Q3.

Government spending contributed another larger-than-average 0.8pp to GDP growth. Indeed, given the lags involved between changes in policy and changes in economic conditions, government spending has been a strong force for growth this year. This is not only because of still percolating effects from the pandemic stimulus, but also from sustained large and rising deficit spending as well as strong state-and-local outlays. For example, as a result of government incentives for expanding semiconductor and electric vehicle production capacity, business investment in new manufacturing facilities has been particularly strong, up 65% year-over-year (YoY), according to the Bureau of Economic Analysis.

Overall, nonresidential fixed investment was unchanged from the previous quarter in Q3 and thus neutral to growth, as gains in structures investment and intellectual property were offset by a decline in real business equipment investment. On the other hand, residential investment made its first positive contribution to growth since early 2021, as a depressed housing stock relative to population growth has boosted demand for new homes. While international trade was a small drag on growth, inventories added significantly more. All in all, Q3 growth was strong and quite broad-based, helping raise growth estimates for both 2023 and 2024.

Employment has remained robust in this context, although there are growing signs the labor market is cooling. The Institute for Supply Management (ISM) manufacturing survey's employment component dropped into contraction territory in October for the fourth of the five past months. Its global manufacturing employment counterpart has been in contractionary territory since August. In addition, according to the National Federation of Independent Business (NFIB) survey, the net percentage of firms planning to increase payrolls has remained on a downtrend in October. Manufacturing employment has flatlined this year and contracted sharply in October, resulting in a similar pattern for the sector's aggregate weekly hours, with negative implications for wage growth. The share of manufacturing industries cutting payrolls expanded for a second consecutive month in October to 58%, the highest since early 2020, according to the Bureau of Labor Statistics' (BLS) employment diffusion index. This index tends to reach 80% to 90% in recessions, however. Thus, while all these data point to further moderation in labor demand and labor income growth, until employment really starts to crack, risk appetite will stay high and credit spreads narrow, if past experience is any indication.

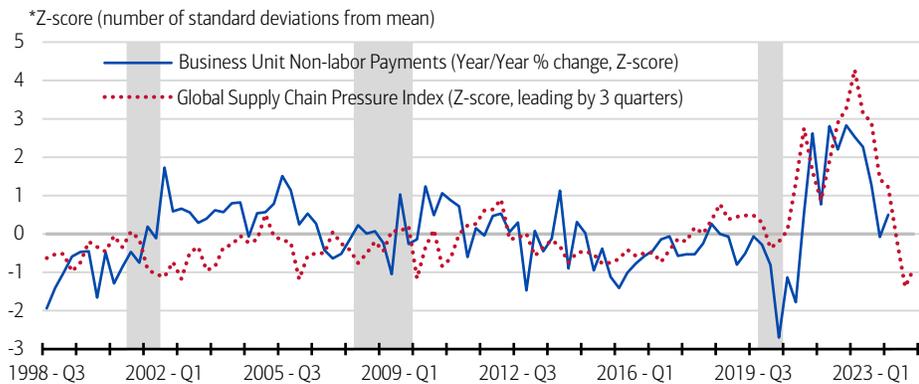
By helping ease labor market tightness, the surge in labor force participation rates for women (no doubt due to expanded work from home capabilities) has also lessened upside pressures on wages and inflation. At the same time, supply chains have normalized, making possible strong output and productivity growth, which in turn has helped temper labor and nonlabor unit costs (Exhibit 1), with favorable effects on inflation.

Indeed, both productivity growth and inflation data have been very favorable and received with great enthusiasm by equity and credit markets. Nonfarm business productivity growth surprised to the upside in Q2 and Q3, averaging a strong 4.1% annualized pace—much above the 2% average of the past 25 years and the weak 0.8% average of the 2010 to 2018 period, for example. The productivity surge in Q3 has helped reduce unit labor costs, allowing for robust economic growth with slowing inflation.

Portfolio Considerations

A balanced portfolio approach is recommended as profits adjust to a softer nominal GDP growth environment while real growth and inflation cool in coming quarters.

Exhibit 1: Supply Chain Normalization Positive For Further Moderation In Cost Inflation.



*z-score=the number of standard deviations from the mean value of the reference population. Standard deviation from mean is a quantity calculated to indicate the extent of deviation for a group as a whole. Gray shaded area represents recession periods. Sources: Bureau of Labor Statistics; New York Federal Reserve/Haver Analytics. Data as of November 15, 2023.

“Core” consumer price index (CPI) inflation significantly surprised to the downside in October, consistent with lagging disinflation effects from the aggressive Fed monetary policy tightening to date. The moderation was broad-based and appears likely to continue as the effects of the Fed tightening to date filter through to the full extent. Headline CPI changed little month-to-month and rose 3.2% YoY. “Core” inflation (excluding food and energy) showed an annualized month-to-month gain of just 2.8% versus 3.9% in September. This brought annual “core” CPI inflation down further from 6% a year ago to 4%, the lowest in two years.

Overall, incoming data show clear progress in the Fed’s efforts to bring inflation back to its 2% target and a continued likely softening of wage growth and inflation ahead. Labor markets have come more into balance as labor supply has outpaced labor demand this year, resulting in an increase in the unemployment rate to 3.9% in October (from 3.4% in April). Wage growth has cooled, as a result, and looks likely to remain on a downtrend. For example, YoY average hourly earnings (AHE) growth for private sector production employees has dropped over the past 18 months from 7% to 4.4%, moving closer to its 4% cycle tops of the past 30 years. On a month-to-month annualized basis, AHE advanced just 2.5% in October, according to the Bureau of Labor Statistics. Our research indicates that AHE growth remains on a downtrend, potentially falling below 4% on a year-over-year basis sometime next year.

The employment cost index (ECI) for wages and salaries reaccelerated in Q3. Although it has slowed from 5% in Q1 to 4.6% in Q3, this is still a 30-year-high annual growth pace. Still, cooler NFIB plans to raise pay, decelerating AHE growth, and slowing corporate revenue growth, suggest the ECI will also drop to about 4%, or less, in coming quarters.

The cycle tops of around 4% for the AHE and the ECI over recent decades are not a coincidence. With 2%, or less, productivity growth, wage growth in excess of 4% would result in a higher inflation than the Fed’s 2% target. On the other hand, wage growth much below 4% can generate disinflationary pressures, so an excessive cooling of wage growth wouldn’t be welcome either.

Our aggregate wage-and-salary-income growth proxy, which accounts for changes in the number of people employed, hours worked and average hourly earnings, has remained robust, supporting consumer spending as inflation moderated. However, this measure of income growth has weakened sharply, barely increasing in October and rising less than 3% on a three-month average basis. On a year-to-year basis, we continue to expect it to potentially ease over the next year below 4% from 5.2% in October.

All in all, a contracting money supply is slowing hiring, softening wage growth, cooling inflation, and raising real interest rates, suggesting a quicker-than-expected return to a “two handle” on inflation, in our view. Elevated borrowing costs and growing debt-servicing struggles are restraining demand for credit, while stricter consumer lending standards are constraining the supply of credit, further suppressing inflation pressures. This suggests a strong disinflationary trend is underway, keeping additional Fed hikes at bay. It also points to potentially strong headwinds to business pricing power and profits ahead. The possibility that the Fed pendulum may have swung too far on the excessive tightening side may become apparent in 2024.

Asia Opportunity Amid China's Challenges

Ehiwario Efeiyini, Director and Senior Market Strategy Analyst

One of the big stories of 2023 has been China's failure to build on its reopening-driven equity market gains of late 2022. China's share of emerging market capitalization touched a zero-Covid low of 27% last October (well off its 43% peak in 2020) and recovered to a post-reopening high of 33% this past January. But it has since fallen back to just 30% (Exhibit 2). Despite this year's disappointment, we nonetheless still see several reasons to de-emphasize China within emerging markets (EM) on a structural basis. The legacy of regulatory tightening in the technology sector is likely to weigh on future profitability, curbs on access to advanced semiconductors and equipment from U.S. export controls continue to tighten, deleveraging and a mature housing stock are making for fundamental weakness in the construction sector (the main driver of past recoveries in China), and a shrinking labor force represents a further constraint on the underlying growth rate. But looking across the rest of Asia, other markets have outperformed the regional hegemon this year and are likely to wrest further market share from China over the period ahead.

The combined market capitalization of technology-driven North Asian markets Korea and Taiwan still falls short of that of China alone, but these have been Asia's best-performing markets in 2023. The Information Technology sector accounts for 60% of North Asia—over half of it in semiconductors, which have been beneficiaries of growing global technology investment this year, most notably in artificial intelligence (AI). We would expect support from this source to persist over the medium-to-long term as the digital economy expands and AI adoption increases. And both markets should also remain well positioned as critical suppliers for the consumer electronics and auto industries on both sides of the U.S.-China technology rivalry, including for other fast-growing markets in Asia.

Investment Implications

Despite China's persistent underperformance, we nonetheless see opportunity across other markets in the Asia region. North Asia is expected to benefit from growth in the global digital economy. Key markets in Southeast Asia should help to enable the green transition, while India's internal reforms support growth—both markets are well positioned for a growing consumer class and higher foreign direct investments (FDI). Policy support in Japan is likely to reverse over the months ahead.

Exhibit 2: Asian Equity Markets And Sectors By The Numbers.

Asia Sector Weightings and Share of Emerging Markets (EM) by Region

Share of market capitalization (%)

	EM North Asia	EM Southeast Asia	India	Japan	China	EM
Communication Services	3.9	9.0	2.8	7.2	20.1	9.6
Consumer Discretionary	5.1	5.2	11.3	19.5	30.5	13.7
Consumer Staples	1.9	10.5	9.0	6.1	5.5	6.2
Energy	0.8	7.2	10.6	0.9	3.1	5.2
Financials	11.8	34.5	27.3	12.8	15.7	22.2
Healthcare	2.2	4.6	5.2	8.5	5.6	3.8
Industrials	7.1	10.3	7.4	22.5	5.2	6.7
Information Technology	60.0	2.3	13.2	13.6	5.8	20.2
Materials	6.9	7.6	8.6	4.6	3.3	8.0
Real Estate	0.1	3.7	0.6	3.1	2.9	1.7
Utilities	0.2	5.1	4.0	1.2	2.3	2.6
Share of EM	26.9	5.9	15.7	-	30.0	100

EM North Asia is Taiwan, Korea. EM Southeast Asia is Indonesia, Thailand, Malaysia, Philippines. Based on MSCI indexes. Source: MSCI. Data as of November 16, 2023. **Please refer to index definitions at the end of this report.**

China's longer-term ambitions for reunification with Taiwan have also been top of mind for investors this year—a factor that could potentially increase the risk premium for the larger of these two North Asian markets, particularly ahead of Taiwanese elections in 2024. But our view remains that this concern is currently overstated, primarily due to the economic cost that China would no doubt incur as a result of international sanctions and lost access to semiconductor manufacturing capacity in Taiwan (which itself relies on overseas equipment, chemicals and labor).

The Southeast Asian countries included in MSCI EM Equity Index—Indonesia, Thailand, Malaysia and the Philippines—account for just 6% of EM market capitalization but are among the fastest-growing economies in the emerging world. We expect the rise of the global consumer class to remain a key medium-term investment theme, and, on a per capita income basis, all four markets remain at or below Chinese levels. This puts the region on the steepest part of the discretionary consumption curve, where product penetration (in areas such as

autos, electronics, healthcare, media and travel) rises most quickly as countries move from low- through middle- toward high-income status.

Indonesia and Malaysia are also key global commodity suppliers across energy, base metals and agriculture. Over the years ahead, Indonesia in particular should retain more value added in raw material processing through export restrictions. And both markets should be long-term beneficiaries of global investment in clean energy infrastructure and equipment—Indonesia through exposure to nickel and copper, and Malaysia through exposure to aluminum. Thailand derives over 10% of its GDP from tourism and travel services. But with tourism arrivals from China (the largest cohort) still at less than 50% of prepandemic levels, it can look ahead to further support from this source, according to the Ministry of Tourism.

Per capita income and purchasing power across Southeast Asia should also receive a structural lift from increased foreign investment. Along with Mexico and India, the region is typically identified as a preferred reshoring destination in surveys of multinational firms, especially for labor-intensive industries such as basic manufacturing, electronics assembly and apparel that can be absorbed by its large, young labor pool—the third most populous globally, with a total population of close to 700 million across the Association of Southeast Asian Nations (ASEAN) countries. Increased regional integration, which has eliminated tariffs and nontariff barriers, loosened immigration restrictions, increased regional infrastructure development and competition policy, and linked internal production networks more closely, should further support this trend.

The Indian equity market has grown significantly over recent years, almost doubling its share of EM to 16% since the start of the decade to become the second largest behind China. Growth in the local market has been enabled by reforms under Prime Minister Modi to deregulate the labor market, coal production, land acquisition and banking sector resolution, as well as to lift FDI caps. Pro-market reforms are expected to continue over the medium term with Modi's governing coalition expected to retain a parliamentary majority in the 2024 general election.

Three key investment themes we think will develop for India over the medium term are the digitization of the local economy, the rise of the consumer class and the relocation of manufacturing supply chains away from China. The government has focused on digital public infrastructure, primarily through the Aadhaar digital identity system and the digital Unified Payments Interface system, leading to a surge in online transactions. Additional funding tailwinds for local fintech services in India could also result from the current regulatory constraints in China, and the ongoing expansion of these initiatives should support the Information Technology Services sector, which is one of the largest within the local equity market. Along with the official government scheme to expand the number of personal bank accounts within India, the growth of the digital economy should also help to boost consumption levels—both through the more efficient distribution of government transfers and through wider access to credit. Over the medium term, we would also expect to see India's manufacturing capacity expand as more FDI migrates away from China to alternative destinations. This should give a further boost to consumer sectors by lifting per capita income levels.

On the developed market side, Japan has also been one of the top performers in Asia in 2023, with investors expressing more optimism on the local market. Despite tentative steps toward normalization over the past year, monetary policy has remained extremely accommodative relative to the rest of the world, and valuation has improved on the campaign by the Tokyo Stock Exchange to boost shareholder value by pushing corporates to use their cash holdings for more buybacks and payouts. We nonetheless remain somewhat cautious on Japan's prospects. The recent move to lift the hard cap of 1% on the 10-year yield is likely to be followed by an increase in the Bank of Japan's (BoJ) policy rate in 2024, particularly if ex-food inflation continues to overshoot its 2% target. This implies that Japan should become an even bigger global outlier next year if the BoJ is raising rates while the other major central banks are looking to cut them. These headwinds could be compounded by currency appreciation, which would come as another hurdle for the Japanese market given its exposure to exporters in large sectors such as Consumer Discretionary, Industrials and Information Technology.

Asian markets still account for the vast majority (78%) of total EM market capitalization. China continues to form an outsized proportion of this total, and we expect fundamental constraints to weigh further on the local market. But structural supports for other markets in the region should allow Asia ex-China to increase further in size relative to the Chinese market over the period ahead.

Taking Stock of America’s Energy Security

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

Ariana Chiu, Wealth Management Analyst

When it comes to energy, the U.S. holds a distinct competitive advantage over the world’s next largest economies: the European Union and China. The latter are net energy importers and therefore more exposed to the whims of global oil price movements. The U.S. is different. Starting in 2020, the U.S. energy script flipped, with the U.S. becoming a net energy exporter after decades of being a net energy importer (Exhibit 3A).

Against this backdrop, and as the Middle East simmers and investors keep a close eye on oil prices, the U.S. enjoys an energy security premium relative to both Europe and China, and many other parts of the world, notably oil-importing EM like India. A more secure and stable energy supply means lower energy costs in the U.S., which in turn means better prospects for economic growth, productivity and earnings. It’s little wonder then that in the face of two energy shocks in less than two years (from the wars in Ukraine-Russia and Israel-Hamas), the U.S. economy has powered ahead, outperforming many other parts of the world, including China.

It wasn’t always this way as Exhibit 3B makes clear. Indeed, at the start of this century, the U.S. was an energy minnow relative to Russia and Saudi Arabia. Over the course of 2008, U.S. oil production dropped to less than 4 million barrels per day (bpd), well below the output of the oil majors. But then the U.S. oil patch staged an energy renaissance that stunned the world. The “fracker revolution” upended the global oil calculus and was underpinned by 1) revolutionary technologies like horizontal drilling and hydraulic fracturing; 2) good old American entrepreneurship/risk taking; and 3) pro-market policies at the state and local levels. The combination helped push U.S. oil production to a record high of 13.2 million bpd in October of this year, just as the Middle East went on the boil.

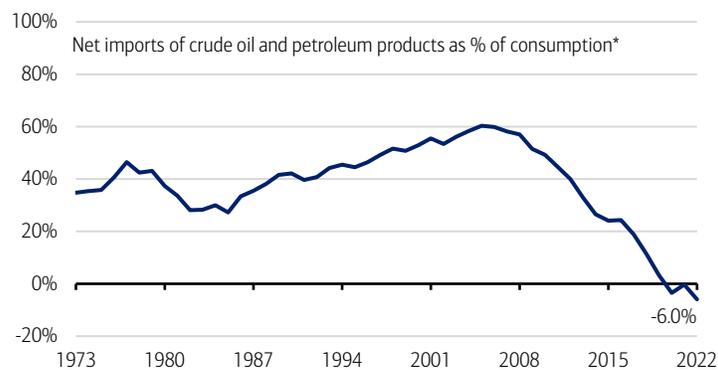
The Chief Investment Office remains overweight Energy amid tight global supply, strong energy demand, and ongoing tensions in the Middle East. Attractive valuations, earnings power, and higher cash flows continue to support the sector. Within Energy, remember this: In just 15 years, the U.S. transformed from being energy-reliant to energy-defiant. In the face of geopolitical uncertainty, add energy security to the list of reasons to stay bullish on the U.S.

Investment Implications

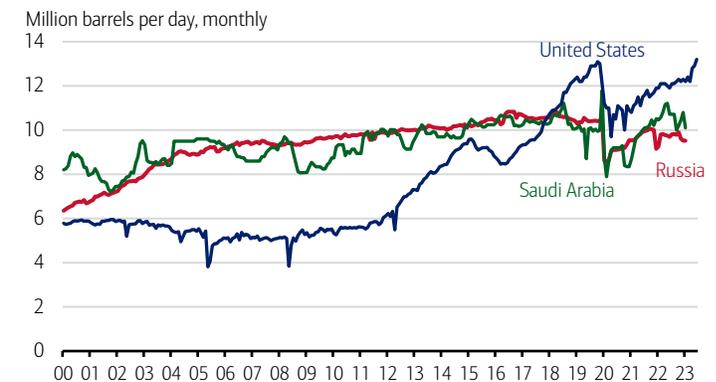
We remain overweight energy given tight global supply and strong energy demand. Amid ongoing conflict in the Middle East and energy price uncertainty, energy security remains top of mind for investors. We continue to monitor oil prices with the belief that the U.S. is better positioned than its competitors to weather the storm.

Exhibit 3: The U.S. Goes from Energy Reliance to Energy Defiance.

3A) U.S. Relying Less on Foreign Oil for Domestic Consumption



3B) U.S. Emerges as Leader in Crude Oil Production.



Left Exhibit: *Negative percentages indicate U.S. as net exporter. Source: U.S. Energy Information Administration. Data as of August 2023. Right Exhibit: Russia and Saudi Arabia production as of May 2023. Sources: U.S. Energy Information Administration; Bloomberg. Data as of November 13, 2023.

Index Definitions

Securities indexes assume reinvestment of all distributions and interest payments. Indexes are unmanaged and do not take into account fees or expenses. It is not possible to invest directly in an index. Indexes are all based in U.S. dollars.

S&P 500 Index includes a representative sample of 500 leading companies in leading industries of the U.S. economy. Although the index focuses on the large-cap segment of the market, with approximately 75% coverage of U.S. equities, it is also an ideal proxy for the total market.

Bureau of Labor Statistics' (BLS) employment diffusion index measure the breadth of employment changes across industries, which is helpful in assessing the overall state of the economy.

Consumer price index (CPI) is a measure of the average change over time in the prices paid by urban consumers for a market basket of consumer goods and services.

Global Supply Chain Pressure Index is a barometer that incorporates metrics throughout the supply chain to give an overview of the condition of the industry.

Employment cost index (ECI) measures the change in the hourly labor cost to employers over time.

MSCI Taiwan Index is designed to measure the performance of the large and mid cap segments of the Taiwan market.

MSCI Korea Index is designed to measure the performance of the large and mid cap segments of the South Korean market.

MSCI Indonesia Index captures large and mid cap Indonesian securities exhibiting overall value style characteristics.

MSCI Thailand Index is designed to measure the performance of the large and mid cap segments of the Thailand market.

MSCI Malaysia Index reflects Sharia investment principles and is designed to measure the performance of the large and mid cap segments of the Malaysian market that are relevant for Islamic investors.

MSCI Philippines Index aims to measure the performance of the large and mid cap segments of the Philippine market.

MSCI EM Equity Index is a selection of stocks that is designed to track the financial performance of key companies in fast-growing nations.

MSCI India Index is designed to measure the performance of the large and mid cap segments of the Indian market.

MSCI Japan Index is designed to measure the performance of the large and mid cap segments of the Japanese market.

MSCI China Index captures large and mid cap representation across China A shares, H shares, B shares, Red chips, P chips and foreign listings (e.g. ADRs).

S&P 500 Sector Index constitute a method of sorting publicly traded companies into 11 sectors-Information Technology, Health Care, Financials, Consumer Discretionary, Communication Services, Industrials, Consumer Staples, Energy, Utilities, Real Estate (REITs), and Materials. Also known as the Global Industry Classification Standard (GICS) sorts companies into sectors based on their primary business activity.

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