

CHIEF INVESTMENT OFFICE

Capital Market Outlook

July 6, 2020

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

IN THIS ISSUE

- **Macro Strategy**—After two decades of failed reflation efforts, the Federal Reserve (Fed) finally seems positioned to hit its long-term inflation target. The aggressive monetary and fiscal response to the lockdown-induced recession has aligned the Fed's short-term need to support the economy throughout the pandemic with its long-term mandate to anchor inflation expectations around the 2% target.
- **Global Market View**—The coronavirus (COVID-19) crisis has interrupted the global clean energy agenda so far in 2020. But as economies around the world reopen, global growth resumes, and greenhouse gas emissions recover, we expect electricity generated from hydrogen fuel cells to remain a fast-growing segment of the alternative energy mix.
- **Thought of the Week**—The collapse in inflation breakeven rates earlier this year reflected risk-off sentiment and expectations for a low-inflation environment two years out. Since then, breakevens have rebounded substantially, consistent with receding risk-off sentiment. We believe that a continued increase in inflation breakeven rates and Treasury Inflation-Protected Securities (TIPS) outperformance is likely over the next year if our positive economic outlook proves correct.
- **Portfolio Considerations**—The U.S. remains our preferred equity region relative to the rest of the world, and we remain slightly overweight investment-grade credit in fixed income. We expect curves to steepen slightly as the Fed signals forward guidance. Consider staying diversified across growth and value assets and add to cyclical areas, including equities at the asset class level, over time as we still climb that tall "wall of worry."

MACRO STRATEGY

Chief Investment Office
Macro Strategy Team

GLOBAL MARKET VIEW

Ehiwarior Efeyini
Director and Senior
Investment Strategy Analyst

THOUGHT OF THE WEEK

Chief Investment Office
Macro Strategy Team

Data as of 7/6/2020 and subject to change.

MACRO STRATEGY

Market Rewarding Reflation Beneficiaries

Chief Investment Office Macro Strategy Team

Currently, inflation expectations in major developed markets, like the U.S., Europe and Japan, are still well below the 2% target. After over a decade of missing this goal, it should not be surprising that central-bank credibility is shot. Worse still, as we predicted before the pandemic struck, the Fed has joined the "Japanification" club of countries with policy interest rates stuck around zero.

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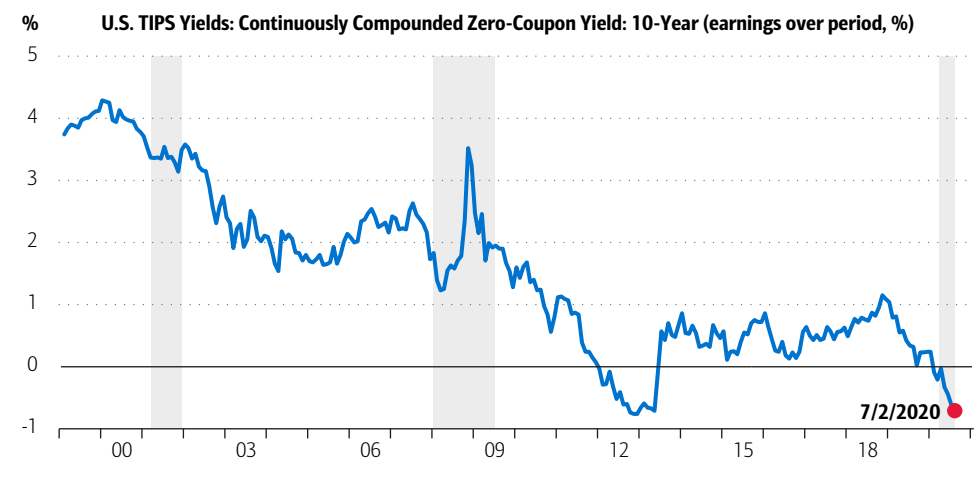
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Nevertheless, subtle rotations in relative performance since the March equity-market lows suggest the markets are buying into the idea that the Fed and other major central banks will succeed over time in raising inflation back to target levels more consistent with better economic growth. Within financial and commodity markets there is growing evidence that investors are anticipating a fundamental change in the growth and inflation outlook that will restore interest rates to more normal levels over time.

Some examples of fundamental changes in relative performance in recent months include a new bull market in gold, a relative bear market in utility stocks, and the improving relative performance of cyclical stocks like homebuilders. A key element driving these shifts is increasingly negative real interest rates (Exhibit 1), which are an important driver of higher inflation historically.

Exhibit 1: Negative Real Interest Rates A Force for Higher Inflation.



Sources: Federal Reserve Board/Haver Analytics. Data as of 7/2/2020.

Negative real interest rates are often associated with monetary policy that sets the nominal rate and holds it below the inflation rate. This was the case in the 1940s, when the Fed maintained rates across the yield curve well below inflation rates during World War II as surging money-supply growth funded massive fiscal deficits, a process that has just begun in the U.S. and Europe. In quite different circumstances during the 1970s, the Fed's interest rates consistently failed to keep pace with inflation as money-supply growth surged while borrowers took advantage of increasingly negative real interest rates. Fed Chairman Volcker stopped this accelerating uptrend in inflation by raising nominal interest rates well above inflation, and a long period of historically high positive real rates characterized the 1980s and 1990s, causing inflation and money growth to decelerate back toward more normal levels as well as underperformance by the reflation asset beneficiaries of the 1970s.

The performance of gold during these different monetary regimes illustrates the role of negative/positive real rates for different asset classes. The biggest gold bull market in modern history saw gold prices rise by a factor of more than 10 during the 1970s, when real interest rates were kept negative by excessively easy monetary policy. Most of those price increases were reversed by the high real rate, disinflation policy that Volcker initiated. Negative real rates make gold relatively more attractive. High real rates make gold relatively less attractive.

We anticipate a prolonged period of negative real rates before the Fed and other central banks credibly restore inflation expectations to target, which implies a continuing bull market in gold. Indeed, in our view, it may be necessary for them to keep real rates negative on a persistent basis to overcome the hugely deflationary undertow from: (1) high debt levels; (2) aging demographics; and (3) the rapid advances in technology

making everything in the information-age economy cheaper and cheaper. In short, because of the powerful deflationary headwinds, it takes easier monetary policy than in the past to achieve a given rate of inflation.

An outlook for more aggressive reflationary policy, with implications for “lower for longer” negative real rates, is also bullish for residential real estate, helping to explain the relative outperformance of homebuilder composites, such as the S&P Homebuilders (XHB) index, which has risen twice as much as the S&P 500 index from the March lows. In addition to negative real interest rates, nominal rates on mortgages have set fresh record lows, and a major demographic tailwind from millennial household formation is fueling a surge in housing demand, which will take years to satisfy. Along with a scheduled third-quarter tripling in motor-vehicle production from the second-quarter lows, rising home building is part of the V-shaped recovery out of the lockdown abyss. We believe that the stock market is anticipating strong economic expansion over the next two years not least because of this strong contribution from housing and motor-vehicle demand. Importantly, high equity values and strength in home prices have put consumer balance sheets in record territory supporting this demand for big ticket purchases.

Strong auto and housing markets, along with expansion in the general economy, are consistent with the recent relative outperformance in industrial stocks, especially equal-weighted indexes, which better capture the subtle rotation taking place in smaller-cap stocks, which have lagged their big-cap counterparts for quite a while. Easier monetary policy and stronger growth are typical during periods when small-cap stocks outperform, especially during the early stage of a synchronized global expansion.

During the last six years of the previous expansion, these stocks underperformed, while defensive stocks, like utilities, outperformed as investors sought yield in a low-rate environment with persistent risk of deflation and recession. Utility company stocks seemed like a good bet in that environment, causing valuations to rise way beyond historical norms. In the new reflationary environment, utilities are massively underperforming as valuations revert to more normal historical levels.

Traditionally, financial-sector stocks are the biggest beneficiaries of negative real interest rates according to analysis by Renaissance Macro Research. Low real rates, rising inflation and strong economic activity are a prescription for robust bank lending. Typically, a steeper yield curve is part of this mix. A year ago, the yield curve was flat or inverted, nominal interest rates were around 200 basis points higher, and real interest rates were around 100 basis points higher. Today, lower rates and the steeper yield curve represent the typical setup going from recession to expansion, and financial stocks generally are one of the biggest beneficiaries. So far, that hasn’t happened. We suspect that a stronger-than-expected expansion, with the Fed funds rate on hold at zero, will eventually raise longer-term rates (though perhaps by less than inflation), helping beneficiaries of a steeper yield curve, like financial stocks, to catch up as the reflation process plays out.

Finally, we would note that low interest rates are particularly bullish for longer-duration assets, including growth stocks. Even though some cyclical stocks in value areas of the market have begun to outperform the overall market, the technology stalwarts that have led global stocks higher for a decade continue to outperform as well. Low interest rates are a powerful booster of the present value of their rapidly growing profits outlook.

One reason this latest bull market has surprised so many investors is this new combination of outperformance by both the cyclical beneficiaries of reflation and the global high-tech leaders that have been the mainstay of this secular bull market. It’s a powerful combination.

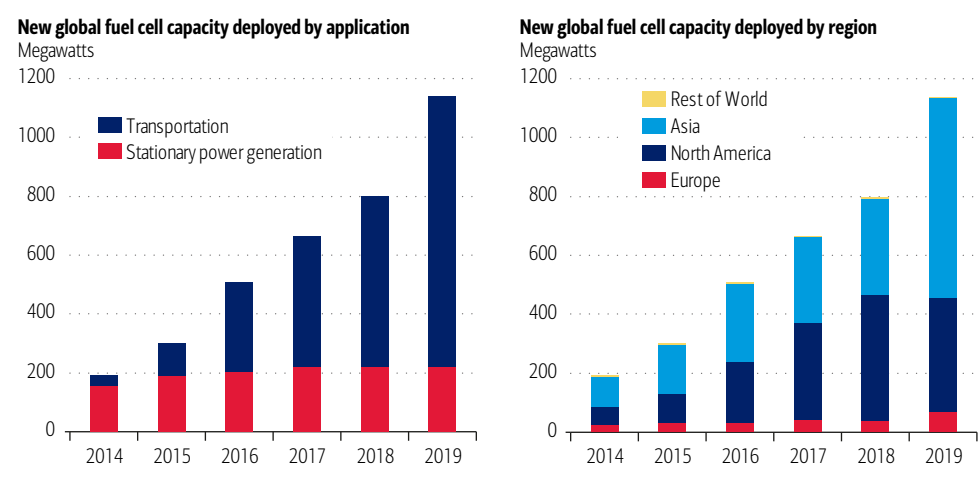
The Growing Market for Hydrogen Fuel Cells

Ehiwario Efeyini, Director and Senior Investment Strategy Analyst

The COVID-19 crisis has interrupted the global clean energy agenda so far in 2020. But as economies around the world reopen, global growth resumes, and greenhouse gas emissions recover, the longer-term trend toward decarbonization by households, governments and companies is likely to continue. In Europe, the Green Deal announced last December aims to deploy close to 1 trillion euro over the next decade on key goals of carbon neutrality by 2050 and a 50%-plus reduction in emissions from 1990 levels by 2030. In China, the recovery in domestic investment already underway is focused on “new infrastructure,” which includes spending on renewable energy and electric vehicles. And one week before the November 2020 date originally set for the first five-year review of national emissions targets set at the 2015 Paris climate conference (now postponed until 2021), the U.S. could potentially rejoin the agreement alongside ongoing efforts to decarbonize by states and private industry. The pandemic has brought forward global expenditure across a range of subsectors that were already growing prior to the outbreak such as medical technology, cloud computing and internet retail. And in the years ahead, we expect clean energy to remain a top priority for both public and private sector investment spending.

Across renewable energy sources, solar and wind power tend to receive the most attention. But electricity generated from hydrogen has also been a fast-growing component of the alternative energy mix albeit from a much lower base. Hydrogen fuel cells convert hydrogen gas and oxygen into water, generating electricity as a byproduct. The energy produced by fuel cells can be used across stationary power applications such as lighting and electrical appliances or (especially in emerging economies with underdeveloped grids) as back-up power for wireless telecommunication towers and data centers. It can also be applied in transportation segments such as electric car and truck motors. Over the past five years, transportation has led a six-fold increase in global fuel cell deployment, with capacity additions rising by over 1 gigawatt for the first time in 2019 and the bulk of the growth coming from Asia and North America (Exhibit 2).

Exhibit 2: Fuel Cell Demand Growth Led by Transportation Sector, Asia and North America Regions.

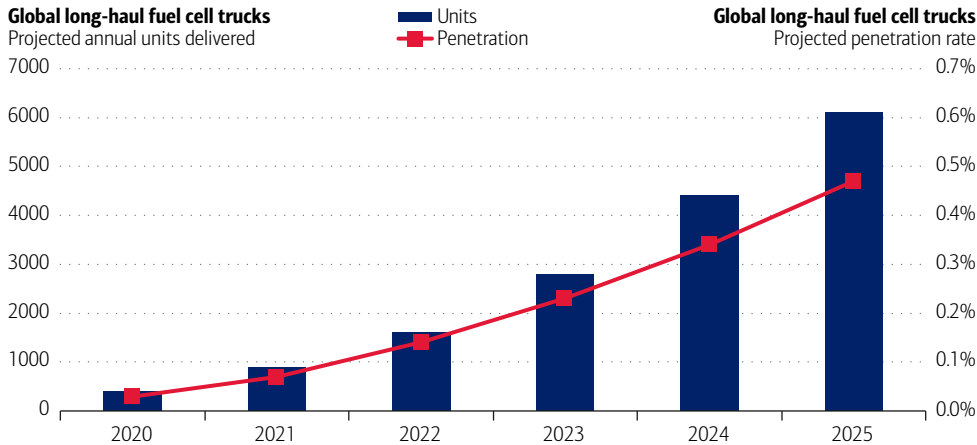


Sources: E4tech; Cowen. Data as of 2019.

The electrochemical conversion process used in hydrogen fuel cells is similar to the electricity generation process in batteries, but fuel cells have a number of distinct properties that potentially make them better-suited to some individual use cases. Unlike batteries, fuel cells do not expire as long as they are supplied with a continuous inflow

of hydrogen and oxygen inputs. This in effect means they can be constantly recharged in stationary applications. They have longer life cycles than electric batteries and do not need to be replaced every few years. And while battery-powered electric vehicles can take an hour or more to fully charge, refueling hydrogen fuel cell vehicles takes minutes. Hydrogen also has around 10 times the energy density of lithium-ion batteries, which gives fuel cell-powered vehicles a lighter weight and longer range. And though fuel cell gas storage tanks may still be too large for mainstream use in passenger cars, they may be better used in commercial vehicles. Class 8 trucks (the largest commercial vehicles classified as those weighing over 33,000 lbs) have an estimated fuel cell range of up to 750 miles with a refueling time of just 10 to 15 minutes, compared to around 350 miles and several hours for 100% battery electric powertrains. Fuel cell vehicles may therefore be well-suited for commercial applications such as long-haul trucking, and penetration rates in this segment are expected to increase rapidly from low levels over the next five years (Exhibit 3).

Exhibit 3: Fuel Cell Application in Commercial Vehicles Expected to Grow Rapidly.



Source: Interact Analysis. Data as of 2019. **Past performance is no guarantee of future results.**

Demand for fuel cell commercial vehicles in other industrial applications is also likely to grow over the years ahead. Fuel cell vehicle usage in warehouse logistics for example should be well-placed to benefit from the COVID-19 induced acceleration in internet retail. A number of major retailers are now using fuel cell-powered forklifts in their material handling operations, with the leading fuel cell provider having deployed over 30,000 systems across the U.S. Indeed over the past year, a number of major industrial and automotive companies have either launched their own fuel cell projects or formed closer strategic alignments with existing fuel cell producers:

- Two European automotive giants announced a joint venture to develop and commercialize fuel cell systems for heavy-duty vehicles (April 2020).
- A German multinational engineering and technology company increased its stake in a U.K. fuel cell developer from 4% to 18% (January 2020).
- Two French automotive parts manufacturers launched a new commercial vehicle fuel cell joint venture with an aim of reaching 1.5 billion euro in global sales by 2030 (November 2019).
- A global industrial conglomerate led a \$1 billion funding round for a U.S. maker of hydrogen fuel cell electric trucks, also agreeing to assist in engineering and manufacturing (September 2019).
- A global leader in engine design and power generation products closed a \$290 million acquisition of a Canadian fuel cell systems provider (September 2019).
- A major Chinese automotive equipment manufacturer ordered a mix of fuel cell products to be used as part of a 2,000 unit commercial fuel cell vehicle deployment by 2021 (May 2019).

Fuel cell buses are another potential growth area for the technology as global mass transit eventually begins to recover, and public transport authorities in cities around the world look to keep emissions low. Global deployment of fuel cell buses remains limited, but public sector programs are likely to be a key demand driver. The large Chinese cities of Shenzhen and Foshan last year joined the growing list of cities around the world committed to the procurement of only zero-emission buses. And the Joint Initiative for Hydrogen Vehicles across Europe project aims to deploy 152 new fuel cell buses and accompanying refueling infrastructure across 14 cities throughout France, Germany, Iceland, Norway, Sweden, the Netherlands and the U.K. out to 2024.

The two main challenges for fuel cells over the coming years will be to make the process of hydrogen extraction less carbon-intensive and to make fuel cell units more cost competitive with other power sources. Hydrogen is one of the most abundant elements on earth but is rarely found in the pure form required for use in fuel cells. The majority of the hydrogen produced for energy today is instead derived from hydrocarbon fossil fuels, particularly natural gas. But individual research groups and a range of private companies are developing solar and wind-powered electrolyzers that can split hydrogen from water or water vapor. The number and size of renewable electrolyzer projects has risen over recent years, and a one-gigawatt wind power electrolyzer plant scheduled to open later this year in the U.K. would be the largest in the world. Price remains the principal barrier to wider fuel cell adoption, and beyond green hydrogen extraction, the cost of manufacturing fuel cells themselves will also have to decline before they can become more commercially viable. The platinum catalyst needed to separate electrons from the hydrogen gas feedstock is the main driver of fuel cell prices, while small scale production also keeps costs high. But industrial firms and auto companies are developing fuel cells that reduce the amount of precious metal catalyst required while maintaining performance, and economies of scale should improve as production volumes increase. It is still likely to be many years before manufacturing costs, production size and availability of refueling infrastructure become sufficient to make hydrogen fuel cells competitive with other electricity sources at scale. But the rapid growth of the fuel cell energy market suggests that it is a proven technology that should see more widespread adoption as we move further into the new decade. Developers and manufacturers of hydrogen fuel cell systems for transportation and stationary applications, as well as designers of commercial fuel cell vehicles should be well-positioned to benefit over the longer term.

THOUGHT OF THE WEEK

TIPS Likely To Continue To Outperform Conventional Treasuries

Chief Investment Office Macro Strategy Team

By construct, Treasury Inflation-Protected Securities' (TIPS) principal and coupons are adjusted for inflation, as measured by changes in the consumer price index (CPI). By paying a real interest rate, TIPS help reduce the inflation risk of a fixed-income portfolio. Nominal Treasury securities tend to outperform TIPS when economic conditions deteriorate and inflation and inflation expectations decline, and vice versa.

Because TIPS are adjusted for inflation while conventional Treasuries are not, the difference between the nominal Treasury yield and the TIPS yield—known as the breakeven inflation rate or market-implied inflation expectations—has a close correlation with real-time, observed inflation. Year-to-year changes in inflation breakevens tend to lead the direction of “core” inflation by about two years.

While the 5-year or 10-year inflation breakeven rate is generally understood to reflect the market's long-term inflation expectations, breakevens are not particularly good predictors of actual or realized long-run inflation. In other words, inflation breakevens do not appear to offer information about inflation dynamics beyond that coming from

macroeconomic conditions and leading economic indicators, which also tend to work best over a two-year horizon.

Instead, a view about the economic and inflation outlook can be used to evaluate when to overweight/underweight TIPS relative to conventional (nominal) Treasuries. Since by definition TIPS outperform when breakevens (market-implied inflation expectations) increase, TIPS should be overweighted when one's anticipated inflation rate exceeds the breakeven rate, or ahead of an expected improvement in manufacturing conditions. Indeed, inflation breakevens tend to correlate with credit spreads (negative correlation) and changes in manufacturing purchasing managers' surveys and oil prices (positive correlations). If one's expected inflation rate is below the TIPS breakeven rate—or economic conditions are on a deteriorating path—which implies an anticipated drop in the breakeven rate/TIPS underperformance—TIPS should be underweighted compared to conventional Treasuries.

Because of lower liquidity compared to nominal Treasuries, TIPS tend to particularly underperform in periods of extreme financial stress, as reflected in the collapse of the inflation breakevens in 2008 and in February/March 2020. As risk-off conditions started to ease with government intervention in support of the economy and financial markets in late March, the inflation breakeven rate also started to rapidly increase, a dynamic which we expect to continue.

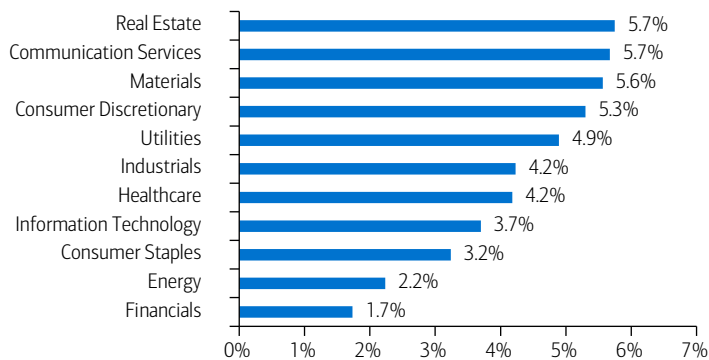
Aside from liquidity-related factors, the drop in inflation breakevens through late March 2020 was a symptom of worsening economic conditions and reduced inflation expectations about two years out. The same inflation message was coming from leading macroeconomic indicators, which were rapidly deteriorating. Currently, as discussed in recent Capital Market Outlook reports, conditions appear in place for continued economic rebound, in our view, with leading indicators suggesting narrowing credit spreads, a rising ISM index, and likely flat-to-higher oil prices. Given these indicators' correlation with inflation breakeven rates, we believe this outlook suggests further likely widening of breakevens from their still-depressed current levels. This means that it may still be a good time to consider an overweight in TIPS.

MARKETS IN REVIEW

Equities

| | Total Return in USD (%) | | | |
|-----------------------|-------------------------|-----|------|-------|
| | Current | WTD | MTD | YTD |
| DJIA | 25,827.36 | 3.3 | 0.1 | -8.3 |
| NASDAQ | 10,207.63 | 4.6 | 1.5 | 14.4 |
| S&P 500 | 3,130.01 | 4.1 | 1.0 | -2.1 |
| S&P 400 Mid Cap | 1,778.95 | 3.5 | -0.2 | -13.0 |
| Russell 2000 | 1,431.86 | 3.9 | -0.6 | -13.5 |
| MSCI World | 2,226.40 | 3.3 | 1.1 | -4.7 |
| MSCI EAFE | 1,804.35 | 1.5 | 1.4 | -10.1 |
| MSCI Emerging Markets | 1,033.09 | 3.7 | 4.0 | -6.2 |

S&P 500 Sector Returns



Source: Bloomberg, Factset. Total Returns from the period of 06/29/20 to 07/03/20. Bloomberg Barclays Indices.¹ Spot price returns.² All data as of the 07/03/20 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 | • | • | • |
| Cash | • | • | • |

Fixed Income¹

| | Total Return in USD (%) | | | |
|------------------------------|-------------------------|----------------|-----------------|---------------|
| | Current | WTD | MTD | YTD |
| Corporate & Government | 1.20 | 0.1 | 0.2 | 7.4 |
| Agencies | 0.58 | -0.1 | -0.1 | 5.0 |
| Municipals | 1.52 | 0.0 | 0.0 | 2.1 |
| U.S. Investment Grade Credit | 1.25 | 0.1 | 0.1 | 6.3 |
| International | 2.10 | 0.7 | 0.6 | 5.6 |
| High Yield | 6.62 | 0.3 | 0.7 | -3.1 |
| | Current | Prior Week End | Prior Month End | 2019 Year End |
| | | | | |
| 90 Day Yield | 0.14 | 0.14 | 0.13 | 1.54 |
| 2 Year Yield | 0.15 | 0.17 | 0.15 | 1.57 |
| 10 Year Yield | 0.67 | 0.64 | 0.66 | 1.92 |
| 30 Year Yield | 1.43 | 1.37 | 1.41 | 2.39 |

Commodities & Currencies

| | Total Return in USD (%) | | | |
|----------------------------------|-------------------------|----------------|-----------------|---------------|
| | Current | WTD | MTD | YTD |
| Bloomberg Commodity | 140.04 | 3.8 | 1.0 | -18.6 |
| WTI Crude \$/Barrel ² | 40.65 | 5.6 | 3.5 | -33.4 |
| Gold Spot \$/Ounce ² | 1,772.05 | 0.0 | -0.5 | 16.8 |
| | Current | Prior Week End | Prior Month End | 2019 Year End |
| | | | | |
| EUR/USD | 1.12 | 1.12 | 1.12 | 1.12 |
| USD/JPY | 107.51 | 107.22 | 107.93 | 108.61 |
| USD/CNH | 7.07 | 7.09 | 7.07 | 6.96 |

Economic and Market Forecasts (as of 07/03/20)

| | Q3 2019A | Q4 2019A | 2019A | Q1 2020A | Q2 2020A | 2020E |
|--|----------|----------|-------|----------|----------|-------|
| Real global GDP (% y/y annualized) | - | - | 2.9 | - | - | -4.1 |
| 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 | 0.5* | 1.0 |
| 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 | 1.05 |
| 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.

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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 3, 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.

S&P 500 Homebuilders (HXB) Index tracks a broad-based, equal-weighted index of US companies involved in the homebuilding industry.

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

Institute for Supply Management a monthly composite index that is based on surveys of 300 purchasing managers throughout the United States in 20 industries in the manufacturing area.

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