BANK OF AMERICA

CHIEF INVESTMENT OFFICE

Fixed Income Spotlight

Cross-sector Year Ahead Outlook

December 2023

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

SUMMARY

- We are favorable on Fixed Income in 2024, as we believe the Federal Reserve (Fed) is at or near the end of the rate hike cycle.
- We are more positive on rate risk relative to credit risk as we are later in the economic cycle.
- With credit risk premiums now at or near year-to-date (YTD) tights, we see risks skewed to the downside for excess returns in 2024 and remain slightly underweight Investment-grade (IG) and High Yield (HY).
- Our slight overweight position to Mortgage-backed Securities (MBS) balances our optimistic view on valuations relative to our cautious approach towards technicals in the sector.
- For municipals, we expect modest supply growth, solid demand, and stable credit to support richer-than-average muni valuations.

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ASSET CLASS WEIGHTINGS

Asset Class	Underweight		Neutral	Overweight	
Fixed Income	·	·	●	·	·
U.S. Investment Grade Taxable	·	·	·	●	·
International	·	·	●	·	·
Global High Yield Taxable	·	●	·	·	·

These Chief Investment Office (CIO) views relate to fully-diversified, multi-asset class portfolio and use the asset class breakdown of the CIO "High Tax/Balanced" Allocation. Source: Global Wealth & Investment Management Investment Strategy Committee as of December 5, 2023.

FIXED INCOME U.S. RATES FORECAST

(% end of period)	Spot	Q423	Q124	Q224
Fed Funds Range	5.33	5.25–5.50	5.25–5.50	5.00–5.25
2-Year T-Note	4.59	4.85	4.75	4.50
5-Year T-Note	4.13	4.65	4.50	4.40
10-Year T-Note	4.15	4.50	4.40	4.30
30-Year T-Bond	4.26	4.75	4.70	4.65

Source: BofA Global Research U.S. Rates Research; December 8, 2023; spot price as of that date. Note: Federal funds rate forecasts are model expectations; other values are for market rates. The forecasts in the table above are the baseline 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. **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 outcomes.**

FIXED INCOME AT A GLANCE

Rates Markets	30-Nov	Last Month	Change
Fed Funds rate	5.38%	5.38%	+0 bps
3-month Treasury Bills	5.39%	5.47%	-8 bps
U.S. 2-year Note	4.68%	5.09%	-41 bps
U.S. 5-year Note	4.27%	4.86%	-59 bps
U.S. 10-year Note	4.33%	4.93%	-61 bps
U.S. 30-year Note	4.50%	5.10%	-60 bps
FF / 10s Curve	-105 bps	-44 bps	-61 bps
2s / 10s Curve	-36 bps	-16 bps	-20 bps
German 10-year	2.45%	2.80%	-36 bps
UK 10-year	4.18%	4.51%	-34 bps
Japanese 10-year	0.67%	0.94%	-28 bps

Credit Markets	30-Nov	Last Month	Change
U.S. Investment Grade (Spread)	+104 bps	+129 bps	-25 bps
U.S. High Yield (Spread)	+370 bps	+437 bps	-67 bps
U.S. High Yield (Yield)	8.43%	9.49%	-106 bps
Emerging Markets (U.S.$, Spread)	+306 bps	+332 bps	-26 bps
10-year AAA Municipal	2.68%	3.64%	-97 bps
10-year Muni / Treasury Ratio	61.8%	73.8%	-12.0%

Index Returns	1-month	12-months	Year-to-Date
U.S. Treasury	3.5%	0.1%	-0.5%
U.S. MBS	5.2%	0.3%	-0.7%
U.S. ABS	1.7%	4.2%	-0.3%
U.S. CMBS	2.7%	2.5%	-0.4%
U.S. Corporate	6.0%	3.6%	-0.6%
U.S. High Yield	4.5%	8.7%	-0.4%
U.S. Leveraged Loans	1.2%	11.9%	-0.1%
U.S. Municipals	6.3%	4.3%	-0.2%
U.S. Municipal High Yield	7.8%	5.9%	-0.3%

Bps refers to basis points. Source: Bloomberg. Data as of November 30, 2023 and subject to change. **Past performance is no guarantee of future results. Please refer to the end of the document for asset class proxies and index definitions.**

In December 2021, policy rates were 0.125%, and the market expected three 25 basis points (bps) hikes in 2022; it got effectively 17 instead. Policy rates were then 4.375%, and the market forecast two to three 25 bps rate hikes in 2023, followed by one to two rate cuts. 2023 saw four hikes and no cuts. The difficulty, therefore, of making correct point-in-time rate forecasts should not be underestimated, and thus the utility of relying on such forecasts should not be overestimated.

The market expects five rate cuts in 2024, helping to avert a recession with an economic "soft landing." We concur with this as a central tendency—the Fed has done enough for now in our opinion. There is still a tremendous amount of monetary policy tightening in the pipeline that is subject to a significant and unknowable lag, money supply is decreasing, and Fed balance sheet run-off continues. At the same time, the history of high inflationary episodes is definitive: High inflation episodes witness multiple spikes the vast majority of the time (Exhibit 1).

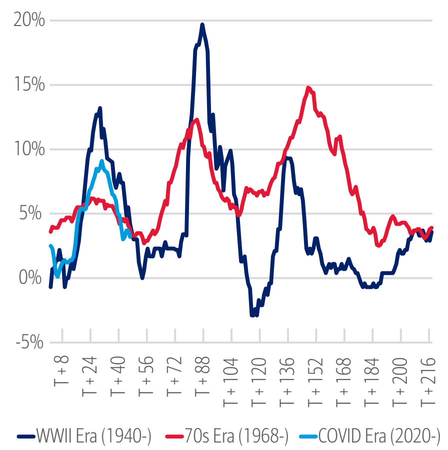
Therefore, our strategy is informed by our economic and rate views—but not beholden to them. The interest rate cycle is called a "cycle" for a reason; it has a relatively predictable pattern, as it is actively managed by policymakers. Yet there are, quite often, significant deviations in either direction. With valuations, the verdict is clearer—credit products across corporates and municipals are nowhere near recessionary valuations, while inflation-adjusted yields across Fixed Income look quite attractive. Therefore, while our forecasts are a reasonable average outcome across an infinite number of potential futures, we explicitly acknowledge the risk that the specific future that is ultimately realized may be very different from a theoretical "average" outcome expected ahead of time. With that lens, we remain slightly long duration—not excessively long. This balances our view that the end of the rate hike cycle is here against the unexpected (but historically more likely) outcome of another inflationary spike. We remain slightly positive on interest rate sensitive products, Treasurys and agency MBS—not excessively positive. This balances much more favorable nominal and real yields after two years of negative returns against the risk that a resurgence in inflation makes them even more favorable. We remain slightly negative on IG corporates and neutral on municipals—not excessively negative either. This balances valuations that underprice recessionary risk, in our opinion, while allowing us to take in additional spread in excess of credit losses—one of the most prudent and risk-aware methods for adding incremental, long-term portfolio returns over time, in our opinion.

Investment-grade & High Yield: Waiting for a Better Entry Point

2023 turned out to be a surprisingly good year for corporate credit. Despite pessimistic views on the macro backdrop and capital markets to start the year, data consistently came in better than expected. More importantly, the trend of disinflation remained largely intact outside of a blip in September. Market concerns of a recession have faded into the rearview for now, with below-trend but still positive gross domestic product (GDP) growth being the consensus view next year and into 2025. Despite the continued pressures of elevated interest rate volatility, and a gradual softening in fundamentals, IG and HY spreads are ending the year at year-to-date (YTD) tights—with the most significant and sustained rallies of the year playing out during November. Both markets are logging respectable positive excess returns year to date: 3.6% for IG and 6.4% for HY (Exhibit 2). For IG, assuming that spreads are range-bound through year-end, 2023 would be the best year for the market since 2019.

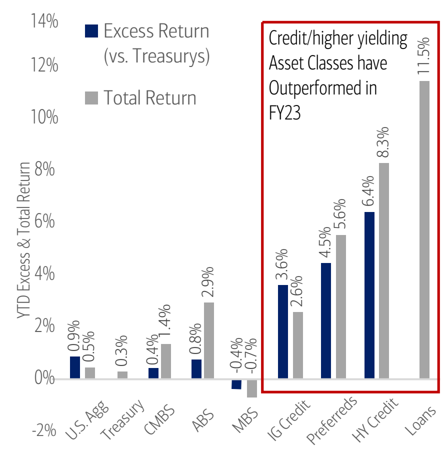
As we look toward 2024, we are advocating for an up-in-quality lean and remain slightly underweight both IG corporates and HY. This view is largely a function of less attractive valuations on a spread basis, which are still not yet discounting the risk of even a mild recession in late 2024/early 2025. IG spreads are now well through longer-term averages (i.e., 5- and 10-years), and looking at credit risk premiums as a percentage of total yield for both IG and HY, they are at the lowest levels seen since before the 2008/2009 Global Financial Crisis (GFC). At these levels, forward excess returns are skewed to the

Exhibit 1: High Inflationary Episodes Usually Witness Multiple Inflation Spikes.



Note: T (January of each legend year) + [X] = X months.
Sources: Bloomberg; Bureau of Labor Statistics; Chief Investment Office. Data as of October 30, 2023.

Exhibit 2: Down In Quality Has Outperformed in 2023—Tight Credit Risk Premiums Likely Constrain Excess Returns in 2024.



Source: BofA Global Research; Bloomberg as of November 24, 2023. Note: Total Return captures absolute price moves as well as coupon income, while Excess Return looks at returns relative to the Treasury index. It is entirely possible to have positive excess returns and negative total returns (and vice versa) in a scenario, for example, where you have a large move higher in Treasury yields but IG credit yields rise by less leading to outperformance and spread compression. It is not possible to invest directly in an index. **Past performance is no guarantee of future results.** Please refer to asset class proxies and index definitions at the end of this report.

downside—and on average, fall into modestly negative territory. Further, history shows that credit spreads generally peak several months/quarters after the end of a Fed hiking cycle, and we expect a similar trajectory for spreads to play out over the next 12 months. All of this supports our view that Treasurys and other high-quality Fixed Income alternatives are more attractive than IG credit on a relative basis.

In terms of fundamentals, we believe metrics such as leverage and debt-service coverage may continue to weaken due to higher borrowing costs and, more importantly, a deceleration in earnings growth. That said, this is not a treacherous setup for IG, but similar pressures in leveraged credit could ignite a flight to quality (i.e., Treasurys, municipal bonds [munis], MBS) and pressure credit spreads as default rates continue to move higher.

A key risk to our view remains a well-executed soft landing by the Fed, with the U.S. economy avoiding a technical recession in 2024 and 2025. In addition, further spread compression could result from easing interest rate volatility and a highly supportive technical backdrop in 2024 (i.e., low or negative new issuance). That said, spread tightening from current levels is limited, in our view. In this scenario, we see IG spreads moving from their current level of around 105 bps into the 95 to 100 bps range (+10 to 15 bps off the tights in 2021 before Fed liftoff). However, spreads could easily widen to 130 to 150 bps, which, all else being equal, we would consider a more attractive long-term entry point. As a result, we currently see a slightly greater risk of negative excess returns for credit in the year ahead.

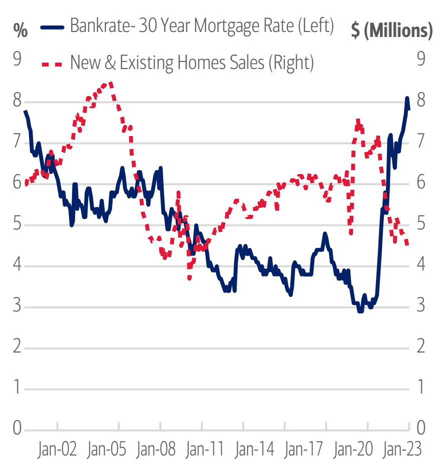
Mortgage-backed Securities

We suggest maintaining a slight overweight to MBS. This view is a function of several factors, including an easing of interest rate volatility and wider MBS spreads, which we see as a more attractive entry point into the asset class, providing a level of cushion not seen since the GFC against an adverse economic or exogenous affect.

Our slightly overweight position to MBS securities during Q4 2023 reflects our optimistic yet cautious approach toward the sector, considering the delicate balance the U.S. economy is expected to navigate in the coming year. We adopted this position in late 2023 when the MBS options-adjusted spreads (OAS) widened nearly 50% from the start of the year to the 70 bps range in conjunction with high interest rate volatility. This left MBS a more attractive option relative to other IG Fixed Income asset classes. As 2023 draws to a close, spreads have settled in a new range of 50 to 60 bps. Market concerns related to inflation, deficits, geopolitical tensions and supply chain disruptions have subsided but could linger into 2024, likely keeping rate volatility elevated and the Fed reluctant to ease.

Despite our positive view on the asset class, the potential for unfavorable supply-demand dynamics poses risks. The MBS sector, comprising 27% of the Bloomberg Aggregate Index, has benefited from the inflow of capital into Fixed Income as well as MBS funds. Once the rotation into MBS slows down, the lack of participation from major buyers, such as the Fed and banks—which collectively own two-thirds of the MBS market—may not provide the much-needed tailwind that the asset class enjoyed in the past decade. While MBS demand and supply have been falling in lockstep, any increase in MBS supply due to heightened mortgage origination may cause spreads to widen, especially in a scenario marked by a rate rally. On the demand side, as the Fed and banks are expected to play a smaller role, the majority of demand is shifting to money managers and foreign investors. However, some of the large investment managers are already close from 10 to 15% overweight and may have limited appetite in 2024. Similarly, foreign investors currently hold around 16% of MBS, approaching the maximum level seen during the last decade. Looking at fundamentals, housing credit remains robust despite slower housing activity due to affordability and lock-in effects from high mortgage rates (Exhibit 3).

Exhibit 3: Home Sales and 30-year Mortgage Rates.



Source: Bloomberg as of November 24, 2023.

This is evidenced by healthy levels of consumer income and spending, low consumer leverage, and a low unemployment rate. In addition, the equity built into homes is near a record high after home prices almost doubled[1] in the last decade. Forty percent[2] of homeowners have no mortgages, providing additional protection against defaults. Finally, banks and non-banks have maintained high underwriting standards to sell loans to Fannie Mae and Freddie Mac for securitization.

In terms of relative valuations, MBS spreads are comparable to IG corporate spreads. The MBS-to-Corporate OAS Ratio of 58% is attractive compared to the long-term average of 35% or the pre-GFC average of 47%, according to Bloomberg, indicating that MBS are inexpensive compared to corporates. Similarly, wider MBS spreads make carry more appealing than Treasurys. However, MBS become less attractive when considering the now-diminished buyer base.

[1] Federal Housing Finance Agency House Price Index Index and S&P CoreLogic Case-Schiller Index as of December 8, 2023.
[2] Bloomberg as of December 8, 2023.

Glossary

Duration is the weighted average of the times until those fixed cash flows are received.

Nominal yields are calculated by dividing total interest paid annually by the face, or par, value of the bond.

Real yields are the returns that a bond investor earns from interest payments after accounting for inflation.

Taxable-equivalent yield is the return that a taxable bond would need to yield in order to equal the yield on a comparable tax-exempt bond, such as a municipal bond.

Asset Class Proxies and 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.

ICE BofA U.S. Corporate Index tracks the performance of U.S. dollar denominated investment grade corporate debt publicly issued in the US domestic market.

Municipals/Bloomberg Muni Bond Index measures the performance of the Bloomberg U.S. Municipal bond market, which covers the USD- denominated Long-Term tax-exempt bond market with four main sectors: state and local general obligation bonds, revenue bonds, insured bonds, and pre-refunded bonds.

High-grade/U.S. Investment Grade/Bloomberg U.S. Corporate Bond Index measures the investment grade, fixed-rate, taxable corporate bond market. It includes U.S. dollar-denominated securities publicly issued by U.S. and non-U.S. industrial, utility and financial issuers.

U.S. High Yield/Bloomberg U.S. Corporate High Yield Index: The Bloomberg U.S. Corporate High Yield Bond Index measures the USD-denominated, high yield, fixed-rate corporate bond market. Securities are classified as high yield if the middle rating of Moody's, Fitch and S&P is Ba1/BB+/BB+ or below.

U.S. Municipal High Yield/Bloomberg High Yield Municipal Index is a benchmark that covers the high yield portion of the USD-denominated long-term tax exempt bond market. The index has four main sectors: state and local general obligation bonds, revenue bonds, insured bonds, and pre-refunded bonds.

Emerging Market/Bloomberg Emerging Market USD Index is a flagship hard currency Emerging Markets debt benchmark that includes USD-denominated debt from sovereign, quasi sovereign, and corporate EM issuers.

Cash/U.S. Treasury/Bloomberg U.S. Treasury Index Total Return measures U.S. dollar-denominated, fixed-rate, nominal debt issued by the U.S. Treasury. Treasury bills are excluded by the maturity constraint, but are part of a separate Short Treasury Index. STRIPS are excluded from the index because their inclusion would result in double-counting.

U.S. Mortgage-backed Securities (MBS)/Bloomberg U.S. Mortgage-backed Securities Index is the U.S. MBS component of the U.S. Aggregate index. The MBS Index covers the mortgage-backed pass-through securities of Ginnie Mae (GNMA), Fannie Mae (FNMA), and Freddie Mac (FHLMC).

Corporates/Bloomberg U.S. Corporate Index measures the investment grade, fixed-rate, taxable corporate bond market. It includes U.S. dollar-denominated securities publicly issued by U.S. and non-U.S. industrial, utility and financial issuers. The U.S. Corporate Index is a component of the U.S. Credit and U.S. Aggregate Indices.

Government/Credit/ICE BofA Global Govt Bond Index + ICE BofA Global Large Cap Quasi-Govt Index (i) The ICE BofA Global Government Index tracks the performance of publicly issued investment grade sovereign debt denominated in the issuer's own domestic currency. (ii) The ICE BofA Global Large Cap Quasi-Government Index tracks the performance of large capitalization investment grade quasi-government debt publicly issued in the major domestic and euro-bond markets, including agency, foreign government, local government, supranational and government guaranteed securities. Qualifying securities must have an investment grade rating (based on an average of Moody's, S&P and Fitch).

Preferreds/ICE BofA Core & Fixed Rate Preferred Securities Index tracks the performance of fixed-rate US dollar denominated preferred securities issued in the US domestic market.

U.S. Aggregate/Bloomberg U.S. Aggregate Bond Total Return is a broad-based flagship benchmark that measures the investment grade, US dollar-denominated, fixed-rate taxable bond market.

Bloomberg Capital Asset-Backed Securities (ABS) Index is composed of debt securities backed by credit card, auto and home equity loans that are rated investment grade or higher by Moody's.

Bloomberg U.S. Commercial Mortgage Backed Securities (CMBS) Index is the Bloomberg Non-Agency Investment Grade CMBS: BBB Total Return Index Unhedged.

S&P/LSTA Leveraged Loan Index is a market value-weighted index designed to measure the performance of the U.S. leveraged loan market based upon market weightings, spreads and interest payments.

Bloomberg 1-10-year Municipal Bond Index is a total return performance benchmark for municipal bonds that are backed by insurers with Aaa/AAA ratings and have maturities of at least one year.

Bloomberg 1-10-year U.S. Treasury Index measures the performance of public obligations of the U.S. Treasury with maturities of 10 years and greater, including securities that roll up to the U.S. Aggregate, U.S. Universal, and Global Aggregate Indices.

ICE BofA Investment-grade Index tracks the performance of U.S. dollar-denominated, investment grade (IG), asset-backed securities publicly issued in the U.S. domestic market.

ICE BofA High Yield tracks the performance of U.S. dollar denominated below investment grade corporate debt publicly issued in the U.S. domestic market.

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Asset allocation, diversification and rebalancing do not ensure a profit or protect against loss in declining markets.

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Investing in exchange funds is speculative and involves substantial risks including the risk of investment loss. In addition, there are fees and expenses associated with investing in exchange funds, which may make them more expensive and/or less attractive to a particular client. Also, exchange funds may provide tax benefits only when certain conditions are met. Other risk considerations include the loss of voting rights and dividends on the contributed stock, the chance that future legislation may disallow exchange funds, a lack of management control by investors and the fact that exchange funds are not transferrable. This is not a complete list of the risk considerations for exchange funds.

Exchange-Traded Funds are subject to risks similar to those of stocks. Investment returns may fluctuate and are subject to market volatility, so that an investor's shares, when redeemed or sold, may be worth more or less than their original cost. You should carefully consider the investment objectives, risks, charges, and expenses before investing in this product.

Investing in fixed-income securities may involve certain risks, including the credit quality of individual issuers, possible prepayments, market or economic developments and yields and share price fluctuations due to changes in interest rates. When interest rates go up, bond prices typically drop, and vice versa. Income from investing in municipal bonds is generally exempt from Federal and state taxes for residents of the issuing state. While the interest income is tax-exempt, any capital gains distributed are taxable to the investor. Income for some investors may be subject to the Federal Alternative Minimum Tax (AMT). Tax-exempt investing offers current tax-exempt income, but it also involves special risks. Single-state municipal bonds pose additional risks due to limited geographical diversification. Interest income from certain tax-exempt bonds may be subject to certain state and local taxes and, if applicable, the alternative minimum tax. Any capital gains distributed are taxable to the investor. Investments in high-yield bonds (sometimes referred to as "junk bonds") offer the potential for high current income and attractive total return but involve certain risks. Changes in economic conditions or other circumstances may adversely affect a junk bond issuer's ability to make principal and interest payments. Treasury bills are less volatile than longer-term fixed income securities and are guaranteed as to timely payment of principal and interest by the U.S. government. For investments in Agency Mortgage-backed Securities (AMBS) and Mortgage-backed Securities (MBS), generally, when interest rates decline, prepayments accelerate beyond the initial pricing assumptions, which could cause the average life and expected maturity of the securities to shorten. Conversely, when interest rates rise, prepayments slow down beyond the initial pricing assumptions, and could cause the average life and expected maturity of the securities to extend, and the market value to decline. Most senior/leveraged loans are made to corporations with below investment-grade credit ratings and are subject to significant credit, valuation and liquidity risk. The value of the collateral securing a loan may not be sufficient to cover the amount owed, may be found invalid or may be used to pay other outstanding obligations of the borrower under applicable law. There is also the risk that the collateral may be difficult to liquidate, or that a majority of the collateral may be illiquid. Investing directly in Master Limited Partnerships, foreign equities, commodities or other investment strategies discussed in this document, may not be available to, or appropriate for, clients who receive this document. However, these investments may exist as part of an underlying investment strategy within exchange-traded funds and mutual funds.

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