

Global Fixed Income Strategy

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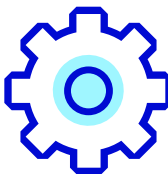
Fed Chair Jerome Powell's speech at the Jackson Hole Symposium suggested he is open to a rate cut in September. We believe a softening US labor market justifies a recalibration of monetary policy.



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Major rates and currencies 3-month outlook

We are overweight UK rates and underweight Japanese rates. We are neutral on US, European, Chinese and Australian rates. We are overweight the euro, the Chinese renminbi, the Japanese yen and Australian dollar. We are underweight the US dollar and British pound.



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With the average effective US tariff rate now nearly eight times higher than at the start of 2025, we explore how companies are responding with increased strategic precision, adjustments to cost structures and operational plans.



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Powell shifts tone at Jackson Hole

Federal Reserve Chair Jay Powell's Jackson Hole speech in August opened the door to potential rate cuts at the Fed's next meeting in September. His tone marked a clear shift from his July press conference, when he had adopted a "wait and see" approach.

The catalyst was labor market data. After recent revisions, the three-month average for job creation fell sharply to just 35,000 jobs. Downward revisions to prior months painted an even weaker picture of labor market momentum.

In Jackson Hole, Powell argued that the labor market remains broadly stable, citing the unemployment rate and other indicators. He noted that reduced immigration is limiting labor supply, while demand for labor is also softening—making it harder to gauge the overall balance.

Still, Powell acknowledged that risks to employment are rising. He warned that if these downside risks materialize, labor market deterioration could accelerate quickly—history has shown that such shifts can be non-linear. Given this shifting balance of risks, Powell suggested that policy recalibration may soon be warranted: "the shifting balance of risks may warrant adjusting our policy."¹

FOMC divisions: Inflation hawks vs. labor doves

There is a healthy debate within the Federal Open Market Committee (FOMC), with some participants more concerned about inflation and less focused on labor market softness. For example, Cleveland Fed President Beth Hammack opposes a September rate cut, citing rising inflation and a stable labor market, warning that easing now could worsen price pressures—especially if businesses pass on higher tariff-related costs.

There is also an evolving discussion around labor market dynamics. Both Chair Powell and Chicago Fed President Austan Goolsbee have noted that demand and supply factors are shaping labor outcomes, with reduced immigration potentially weighing on job creation. Goolsbee has urged focusing on labor market ratios rather than headline job gains—a point Powell echoed at Jackson Hole.

Indicators such as quits, layoffs, vacancy duration, the job openings-to-unemployment ratio, and nominal wage growth may offer a clearer view of labor market health than monthly job creation alone. On these measures, the jury is still out—it is not yet clear how strong or resilient the labor market truly is.

Fed Governor Christopher Waller sees rising risks in the labor market. He highlighted that private sector job creation has slowed sharply, averaging just 52,000 jobs per month from May to July—roughly half the pace of early 2025—a number that is likely to be revised even lower, potentially into negative territory. Quits rates and job-switcher wage gains have declined, unemployment among cyclical groups like teenagers is climbing, and businesses are holding back hiring amid tariff uncertainty and AI-related disruptions. Waller argued that these trends point to weakening labor demand rather than just reduced labor supply, and warned that waiting for unemployment to rise before cutting rates could mean acting too late.

Given this uncertainty, Chair Powell hinted at a risk management approach, and left open the possibility of a policy recalibration at the upcoming meeting. While he was not explicitly committal, his tone marked a noticeable shift from his previous stance.

Our take: The labor market has softened

We believe the labor market has softened to a degree that cannot be fully explained by supply factors alone, and it is therefore prudent for the Fed to consider cautious "insurance cuts" at the next meeting. We agree that the balance of risks has shifted, making this an appropriate time for policy recalibration.

One of the key variables is monthly non-farm payroll (NFP) growth, with net job creation averaging just 35,000 per month over the May–July period. This is a clear sign of labor-market softening, in our view.²

1. Source: Speech, Jackson Hole Economic Symposium, August 22, 2025.

2. Source: Bureau of Labor Statistics. Data as of Aug. 1, 2025

Some argue that lower immigration and labor supply constraints explain this weakness and that reduced net job creation is therefore less alarming than in the past. While labor supply has indeed slowed, we believe the sharp drop in labor demand is a concern in its own right. Moreover, average monthly job growth of just 35,000 is well below most estimates of the demographic trend—i.e., too low to be explained purely by supply factors.

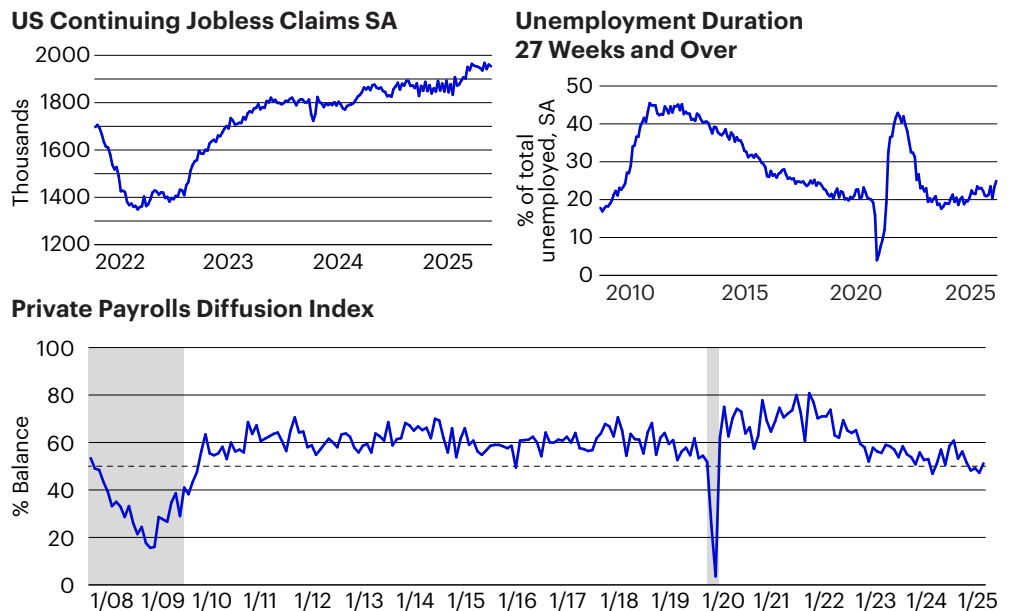
We also doubt that recent immigration policy changes would translate so quickly into a short-term decline in labor supply growth—though they may later in the cycle. Labor supply is not merely a function of immigration. Historically, when the economy strengthens and the labor market tightens, labor-force participation tends to rise, as previously discouraged workers reenter the labor force. Conversely, when growth slows, participation can cyclically decline, creating the appearance of weaker labor supply, even though this effect largely reflects so-called “hidden unemployment” or underemployment, rather than structural constraints. We, therefore, expect labor supply to improve when the economy regains momentum—meaning current low numbers are likely due more to cyclical weakness than immigration trends alone.

Beyond the headline payroll numbers

We pay close attention to a range of labor market indicators that are less affected by immigration, and we think they help capture underlying labor market dynamics. The standard indicators remain important, but in today’s low-hire, low-fire environment, we believe they need to be complemented by measures that better reflect hiring breadth and the time it takes for displaced workers to find new jobs.

In downturns, layoffs and initial jobless claims are the key metrics that capture labor market deterioration. But in today’s low-hire labor market, those indicators may suggest stability, while missing the weaker hiring side of the story. It is taking longer for workers who lose their jobs to find new ones, hiring is concentrated in a narrow set of sectors and job switching has slowed—with weaker wage gains for job-switchers. While initial claims remain low, continuing claims have risen because it takes longer to find work.

On balance, these characteristics are creating slack beneath the surface of the labor market. The following figures highlight some of the indicators we follow:



Sources: **Jobless claims:** Department of Labor. Data from Jan. 14, 2022 to Aug. 15, 2025. **Diffusion Index:** Bureau of Labor Statistics (BLS). Data from Feb. 29, 2008 to July 31, 2025. **Unemployment Duration:** Bureau of Labor Statistics (BLS). Data from Feb. 29, 2008 to July 31, 2025.

Note: The BLS Labor Market Diffusion Index measures the breadth of employment changes across industries. Specifically, it tracks the percentage of industries that are adding jobs versus those that are shedding jobs over a given period. A reading of 50 indicates a neutral point—roughly half of industries are expanding employment, while the other half are contracting. In a typical expansion, the index tends to hover around 60, signaling broad-based job growth across sectors.

Fed: Room for cautious cuts

We believe inflation will rise because of tariffs, but standard central bank practice is to look through one-off price level shocks, such as those stemming from tax adjustments or commodity price swings. That is, as long as there are no second-round effects, inflation expectations should remain well anchored, and the risk of a wage-inflation spiral is limited.

At present, those risks appear contained. Financial market pricing and economic survey measures broadly suggest that inflation expectations remain well anchored. Wage growth also appears broadly consistent with the Fed's price stability objective, based on historical patterns. Moreover, given some slack in the labor market—as discussed above—workers are unlikely to be in a position to push for wage gains above historical norms.

It is also notable that the Fed's policy rate remains roughly 100-125 basis points above what is generally considered neutral. This means that, even after a few cuts, policy would likely still be restrictive. If conditions change along the way, the Fed retains the option to pause rate cuts or even raise rates again. But given current data and consensus projections, we believe the time has come to adjust to the changing balance of risks and recalibrate policy.

We expect three insurance cuts starting in September. The Fed has been on hold since last December. Since then, growth and hiring have slowed, inflation has risen—though less sharply than feared—and labor market conditions have softened. The balance of risks to the Fed's dual mandate of maximum employment and price stability has shifted, creating room for recalibration. With labor market conditions likely to remain subdued, the case for easing should become more compelling. We expect the Fed to begin its adjustment this month, before settling at a new policy rate and adopting a renewed wait-and-see posture.

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Interest rate outlook

US: Neutral

Growth has slowed in the US, and inflation data, while generally benign, have shown increasing signs of a tariff impact. We expect tariff-driven price increases to keep inflation firm going into year-end, but we believe the Fed will cut rates twice by the end of the year. We expect longer-term yields to remain range bound, as concerns about the US budget deficit and Fed governance will likely keep yield curves steep. Steepening will likely continue to be the leading trade until growth data begin to improve.

Europe: Neutral

We expect the European Central Bank (ECB) to be on hold at its September meeting, after pausing in July. Recent communication has indicated comfort at the current policy setting while the governing council analyses the impact of the 200 basis points of cuts already delivered. While the outlook for the region's economy remains challenging this year, as tariff-related uncertainty weighs on global activity, next year and beyond are more encouraging, in our view. We expect to see the impact of fiscal expansion in Germany, supported by additional military spending across the continent, and there are still substantial grants and loans from the NextGenerationEU stimulus program to be distributed to Southern and Eastern Europe. While the ECB remains ready to lower rates further if the economic backdrop deteriorates, we expect any further cuts to be moderate.

China: Neutral

We continue to expect a steeper yield curve in the medium term, though volatility may increase in the short term as September and quarter-end approaches. As we have highlighted in previous months, we believe economic resilience and strong equity market momentum will likely provide a floor for onshore yields. At the same time, accommodative monetary policy should anchor short-term rates. Long-term rates could attract allocations from long-term investors if they post notable moves, such as local banks and insurance companies.

Japan: Underweight

Reduced tariff-related uncertainty following the US-Japan trade deal should clear the way for the Bank of Japan (BoJ) to hike rates, potentially as soon as the October meeting. Recent BoJ communication has shown increased confidence that inflation is sustainably rising to the BoJ's 2% target, with Governor Ueda noting at Jackson hole that wage gains are now percolating to small and medium-sized enterprises. The prospect of BoJ hikes should support short-term Japanese government bonds (JGB) yields. Long-term yields could also face some pressure over the remainder of the year, however, if Prime Minister (PM) Ishiba resigns, leading to a more fiscally loose policy stance from his successor. There will likely be a new Liberal Democratic Party (LDP) leadership election around October, with a new PM in place by year-end. Discussions about a coalition between the LDP and smaller parties will likely occur in Q1 2026. This backdrop of political uncertainty could lead to further volatility in the long end of the Japanese yield curve, as the market tries to discount the possibility of increased bond supply. It is possible for the Ministry of Finance (MoF) to do some fiscal stimulus without increasing bond issuance and it is possible that higher yields could lead to a cut in long-end JGB supply. But the market will likely remain nervous until new budget measures are clear, and the MoF will likely react to price action by adjusting its supply calendar.

UK: Overweight

UK rates have recently underperformed US and European equivalents, reflecting a more hawkish than expected Bank of England (BoE), somewhat stronger inflation data and rising concerns about the country's fiscal position. The market had been hoping the BoE would signal an acceleration in its cutting cycle at the August meeting but it came as a surprise when the Monetary Policy Committee voted five to four to cut rates, with four members voting to keep rates unchanged. The BoE continues to guide toward a "gradual" and "careful" cutting cycle, with an emphasis on uncertainty in both directions for rates. Recent employment data, while soft have shown some stabilisation and inflation remains sticky for the time being. The Chancellor will likely need to raise taxes to restore fiscal buffers at the November budget, due to a series of U-turns on spending cuts, higher bond yields and weaker growth projections. But there is nervousness that the government will fail to pass a credible fiscal package. Taking all the above into account, market pricing has shifted - only 10 basis points of cuts are now priced to year-end 2025, with only a further 25 basis points in 2026, leaving an elevated terminal rate of 3.6%.³ The BoE might have disappointed the market, which was looking for a dovish pivot, but it still sees rates declining in the future toward a more neutral level. Growth has been resilient, but impending fiscal tightening will likely be a headwind, particularly if private sector demand remains very soft. The bond market selloff could force the government to a more conservative stance. Furthermore, the BoE is likely to announce a reduction in active gilt sales in September, reducing pressure on long end supply, particularly if this combines with a further reduction in issuance of long gilts from the Debt Management Office.

Australia: Neutral

The Reserve Bank of Australia (RBA) cut interest rates by 25 basis points in August to 3.6%. Governor Bullock signalled that a further two 25 basis points of interest rate cuts are probable, as these were incorporated in the conditioning assumptions for the RBA's updated forecasts. However, market pricing is now fully incorporating this scenario, with 50 basis points of cuts priced in by February 2026.⁴ Recent data suggest that growth has shown improvement, consumer and business confidence is rising and this has fed into stronger retail sales. The housing market is also starting to respond to lower mortgage rates. The outlook for inflation remains relatively benign, particularly viewed from the perspective of wage pressures. Nevertheless, the downside for short-term yields is limited, in our view, as interest rates approach the RBA's estimate of the neutral rate. Longer-term rates are likely to be influenced by price action in larger developed markets, where greater bond supply, questions about policy credibility and lower demand for long duration assets is increasing the term premium. However, Australia's benign inflation picture, relatively steep yield curve and strong fiscal position should mean it is relatively shielded from these dynamics, potentially creating room for cross market outperformance.

3. Source: Bloomberg L.P. Data as of Aug. 26, 2025.

4. Source: Bloomberg L.P. Data as of Aug. 26, 2025.

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Currency outlook

USD: Underweight

We remain broadly underweight the US dollar due to several factors: The Trump administration seems to favor a weaker dollar, which could support US domestic manufacturing and encourage overseas investment; We also expect the US economy to slow relative to the rest of the world, despite record capital expenditure by US technology companies in AI; Higher tariffs and inflation may prevent the Fed from lowering rates until the labor market deteriorates, which may be a headwind to growth; Finally, we have seen flows into US assets slow in recent quarters and some international investors may hedge their currency exposure to US assets after a stellar period of performance for the currency. The path is likely to be volatile given wider market uncertainty but, given our macro views, we expect a gradual depreciation of the dollar over the medium term.

EUR: Overweight

We remain positive on the euro, given the expected improvement in the fiscal backdrop in 2026 and our expectation that the region's economy will likely recover next year. Even though the ECB lowered rates by 200 basis points in this cycle, the euro has performed well and we expect that trend to continue in the medium term. While the US tariffs remain a headwind to the wider economy, the service side of the economy is performing relatively well, supported by lower interest rates and a strong labor market.

RMB: Overweight

We remain overweight the renminbi, as we expect continued momentum in the selling of US dollars by exporters and in the development of the renminbi's internationalization process. A strong fixing by the central bank, the substantial growth of China's trade surplus and exporters' sizable holdings of foreign currency are likely to support the renminbi's performance. Positive momentum in China's equity and offshore renminbi bond markets is also a helpful factor in the currency's medium-term trajectory, in our view.

JPY: Overweight

The resumption of the Fed rate cutting cycle and prospect of BoJ hikes should lead the US-Japan interest rate differential to narrow, helping to support the yen. Lower short-term US yields could also lead Japanese investors to hedge their US dollar asset exposure, as hedging costs will likely moderate with lower US yields. Although the issue of yen depreciation has been relatively absent from trade negotiations with the US, it could garner greater attention in future. The level of the yen is also becoming more of a salient issue in Japan, as consumers respond to rising import prices.

GBP: Underweight

Questions about fiscal credibility in addition to weak growth and a declining interest rate risk premium should weigh on the British pound in the future, particularly versus low yielding currencies, such as the euro, yen and Swiss franc. The pound has benefitted from the BoE's reluctance to cut rates rapidly, but if this conservatism undermines government finances and weighs on growth, it will likely not be a sustainable support for the currency. Positioning in the pound remains relatively long and could suffer a further flush-out if volatility increases as we approach November's Budget.

AUD: Overweight

The Australian dollar should benefit from improving growth and interest rate differentials relative to the US, as the economy benefits from lower short-term interest rates, easy fiscal policy and has limited exposure to the impact of US tariffs. Although Chinese growth remains a downside risk, the commodity prices relevant for Australia, like iron ore, have risen in price recently, creating some upside from the terms of trade. Australian domestic investors remain relatively underhedged on foreign assets but appear unwilling to hedge while the correlation between the Australian dollar and risk assets continues to be negative. However, this potential future hedging flow could reduce the Australian dollar's beta to selloffs in risk assets in the future.

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Global credit strategy

How are tariffs impacting key US investment grade sectors?

While capital markets—both credit and equity—remain near recent highs, tariffs and the uncertainty they introduce to corporate fundamentals continue to loom in the background. Now that S&P 500 companies have reported earnings for two full quarters under the current tariff regime, we have greater visibility into some of the many diverse strategies management teams are employing to (a) navigate the incremental costs and complexities of tariffs, while also (b) focusing on customer sensitivity and end-market dynamics. With the average effective tariff rate now nearly eight times higher than at the start of 2025, companies are responding with increased strategic precision, adjusting cost structures and operational plans accordingly, as we explore in more detail below.

Manufacturing and capital goods

Tariff exposure across the manufacturing sector varies, but we believe most investment-grade companies possess the global scale and operational flexibility to mitigate the impact.

Many companies have localized production and refined their supply chains since the first Trump administration, leaving them relatively insulated, in our view. Today, companies are now further optimizing supply chains to avoid tariffs where possible. When avoidance is not feasible, they are turning to pricing actions, tighter cost controls, and tariff engineering—such as shifting to partial assembly abroad and final assembly in low-tariff jurisdictions, a tactic notably used in aerospace. The net effect is that tariffs have typically created a neutral-to-modest headwind.

From a credit perspective, we focus on issuers with pricing power, supply chain agility, strong cash flow generation, and stable balance sheets. For example, medical device and life sciences/tools manufacturers report varying degrees of revenue exposed to China. We generally view this exposure as manageable, given these companies' favorable margin profiles and generally strong credit ratings, ranging from mid-BBB to higher. Mitigation strategies include multi-sourcing, SKU rationalization – i.e., analyzing and optimizing their product line, cost reduction initiatives, and selective price increases.

On the other hand, we are closely monitoring issuers with elevated exposure to tariffs, limited flexibility in dealing with them, weakening cash flow, high leverage, or constrained liquidity.

Healthcare

We anticipate pharmaceutical tariffs to be announced in the coming weeks as the Trump administration concludes its Section 232 investigation. Key details remain unclear—such as whether tariffs will apply to the cost of goods or transfer pricing within multinational companies, whether there will be a phase-in period, or if exemptions will be granted. Nonetheless, we do not expect a material near-term impact on investment-grade pharmaceutical credit metrics.

Many companies have already front-loaded inventory imports, particularly from Ireland and Switzerland, and are actively pursuing the onshoring of branded drug manufacturing. While most issuers remain cautious in their public commentary due to the lack of clarity, they have generally characterized the potential impact as “manageable.” A recent S&P Global report estimates that a 25% tariff could compress EBITDA margins by 450–500 basis points before mitigating actions, but most companies have sufficient ratings headroom to absorb such pressure.⁵ It is also worth noting that the potential “most favored nation” (MFN) drug pricing proposal—details of which remain unknown—could ultimately pose a greater risk to pharmaceutical companies than tariffs alone.

5. Source: S&P Global, The Health Care Credit Beat: Tariff Uncertainty Continues to Loom Over Pharma, July 7, 2025.

Retail, consumer, and autos

Drawing from recent episodes of food inflation during the COVID-19 pandemic and the Ukraine war, we expect consumer-facing companies to take several quarters to fully assess the impact of tariffs and identify viable offsets. Initially, these businesses are likely to avoid passing costs on to consumers until it is confirmed that the increases are both real and persistent. In the interim, companies will likely pursue cost-cutting measures, reduce product variety and package sizes, and selectively reduce employee headcount. Only after exhausting these measures—and observing peer behavior—will they likely begin to raise prices to restore margins, a process that could take years to fully manifest itself in inflation data.

The low to middle-income consumer is already under pressure, and conditions are deteriorating. Tariffs function as a regressive tax—akin to sales taxes—disproportionately affecting lower-income households. With USD650 billion in annual sales taxes paid by consumers, USD300 billion in tariffs, and potential cuts to Medicaid and SNAP food benefits totaling another USD100 billion, the cumulative burden is potentially significant.⁶

In response, companies across the automotive and retail sectors are deploying a range of strategies to preserve margins and their competitiveness. Automakers are discontinuing models rendered unviable by tariff-driven cost increases—such as Volvo's ES90 and Nissan's QX50/QX55—or shifting production to the US to avoid import duties. Hyundai, Toyota, Honda, and Nissan are investing heavily in domestic manufacturing, while Ford and Stellantis are leveraging their US footprint to offer aggressive pricing. Luxury brands like Ferrari and Aston Martin are passing on costs directly to consumers.

Retailers are also pivoting away from Chinese sourcing. Target, GAP, and Macy's have significantly reduced their exposure, while Walmart and Home Depot are emphasizing US-made goods. Companies like Nike and Polaris are absorbing some tariff costs but are also raising prices and diversifying sourcing to countries such as Vietnam and Indonesia.

Across the board, companies are reconfiguring supply chains, scaling up domestic operations, and adjusting their pricing strategies to navigate the evolving trade landscape.

Conclusion

In summary, while capital markets remain resilient, the growing impact of tariffs is prompting companies across investment grade sectors to reassess their cost structures, production footprints, and operational strategies. From manufacturing and healthcare to retail and autos, firms are deploying a mix of supply chain localization, cost containment, and selective price increases to mitigate the effects. The most agile companies - those with pricing power, flexible sourcing, and strong financial profiles—are best positioned to adapt. However, for consumer-facing sectors, particularly those serving lower-income households, the full inflationary impact may take years to surface. As tariff pressures intensify, corporate responses are likely to be increasingly defined by strategic adaptation and long-term recalibration.

6. Source: **Sales tax data:** Federal Reserve Bank of St. Louis, FRED. Data as of April 17, 2025. **Tariff collection estimates:** Congressional Budget Office, An Update About CBO's Projections of the Budgetary Effects of Tariffs. Aug. 22, 2025. **Medicaid and SNAP cuts:** Kaiser Family Foundation, Congressional Budget Office. Data as of May 31, 2025.

Panelists



Mark Paris

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Team

The bottom line

Thoughts from the Municipal Bond Desk

Municipal new issuance continued to hit record highs this summer, as elevated inflation and declines in federal government funding incentivized issuers to bring more deals to market. We speak with CIO and Head of the Invesco Municipal Bond Team, Mark Paris, about the impact of this supply dynamic and other factors driving municipal markets.

Q: Municipal supply remained at record levels in July, with more than USD50 billion in new issuance for a fourth consecutive month.⁷ What do you think is driving these volumes?

Mark: In my view, issuers are trying to bridge the gap between their funding needs and their balance sheets. Inflation has pushed up costs, making it more expensive to start new projects or fund existing work, including the repair of aging infrastructure. At the same time, pandemic-era stimulus money has basically dried up, and the federal government is cutting spending. These factors are making it necessary for issuers to come to the municipal market to borrow. Uncertainty about the impact of President Donald Trump's One Big Beautiful Bill also led some market participants to pull deals forward. New issuance totaled more than USD53 billion in July, which was 29% higher than July 2024 volumes.⁷ And though July is historically a sleepy month for new issuance, it is notable that the record amount of supply was well absorbed by the market, as prevailing high yields attracted cross-over buyers, like banks and insurance companies.

Q: On the valuation side, long-term investment-grade municipal yields rose above 5% in July, which is pretty rare. What does that mean for muni market?

Mark: Yes, a highly rated, long-term municipal bond reaching a 5% yield is an infrequent occurrence, and yields on the Bloomberg Municipal Long Bond (22+) Index have surpassed 5% only three other times in the past ten years—this past April and before that in October 2022 and October 2023.⁸ In each of these cases, so-called “crossover buyers”, such as hedge funds, banks, and insurance companies, came into the municipal market to capture the relative value, and yields declined soon after. The muni market may remain choppy in the coming weeks, but I believe there is a lot of value in longer-term investment grade credits.

Q: High yield municipal bonds, which generally have a longer duration, appeared to be hard hit by the increase in longer-term investment grade yields.

Mark: Yes, high yield munis were hit by a double-whammy this summer. In addition to having relatively longer duration than investment grade bonds, high yield munis were also affected by volatility in the transportation sector. The catalyst came from news that the owner and operator of a train system between Miami and Orlando would defer an interest payment on its credits that financed a route expansion to Tampa. That postponement was not a default, as the company is permitted under the terms of its bond documents to defer up to three interest payments. However, all of the company's bonds traded lower, which weighed on the overall high yield transportation sector, as investors waited to see if the company could secure new financing to pay down those specific credits. Unexpected events like this one underline the importance of portfolio diversification, in my opinion, as diversification has the potential to mitigate portfolio risk.

7. Source: The Bond Buyer. Data as of Aug. 1, 2025.

8. Source: Barclays Municipal Research. Data as of July 18, 2025.

Q: On a more positive note, municipal credit fundamentals remain solid, as tax revenues continue to beat expectations.

Mark: That's right! I am encouraged by the trend of moderate revenue growth and fiscal responsibility practiced by municipalities. In their Spring Fiscal Survey of States, the National Association of State Budget Officers (NASBO) reported revenue projections for fiscal 2026 that are 2.8% higher than current fiscal 2025 estimates, translating to a fourth consecutive year of modest revenue growth.⁹ Many observers have predicted that economic growth may slow due to the imposition of trade tariffs and the decline in federal spending, especially cuts to Medicaid and food assistance that are expected to have a large impact on state budgets. The economic outlook has led a number of state governments to scale back spending plans in their 2025-2026 fiscal years, as they have during previous periods of uncertainty and economic downturns. For example, states' general fund spending growth is slowing, with budgeted fiscal year 2026 general fund spending only growing 0.8% above fiscal 2025's estimated levels.¹⁰ This should allow states to maintain or increase their rainy-day fund levels. So overall, muni credit conditions remain sound, with state governments seeing moderate revenue growth, while taking steps to prepare for potentially weaker economic conditions in the future.

9. Source: National Association of State Budget Officers. Data as of June 27, 2025.

10. Source: BofA Global Research, as of July 18, 2025.

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Investment risks

The value of investments and any income will fluctuate (this may partly be the result of exchange rate fluctuations) and investors may not get back the full amount invested.

Fixed-income investments are subject to credit risk of the issuer and the effects of changing interest rates. Interest rate risk refers to the risk that bond prices generally fall as interest rates rise and vice versa. An issuer may be unable to meet interest and/or principal payments, thereby causing its instruments to decrease in value and lowering the issuer's credit rating.

Non-investment grade bonds, also called high yield bonds or junk bonds, pay higher yields but also carry more risk and a lower credit rating than an investment grade bond.

Mortgage- and asset-backed securities, which are subject to call (prepayment) risk, reinvestment risk and extension risk. These securities are also susceptible to an unexpectedly high rate of defaults on the mortgages held by a mortgage pool, which may adversely affect their value. The risk of such defaults depends on the quality of the mortgages underlying such security, the credit quality of its issuer or guarantor, and the nature and structure of its credit support.

The risks of investing in securities of foreign issuers, including emerging market issuers, can include fluctuations in foreign currencies, political and economic instability, and foreign taxation issues.

The performance of an investment concentrated in issuers of a certain region or country is expected to be closely tied to conditions within that region and to be more volatile than more geographically diversified investments.

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