

# We Got the Beat

Taking the pulse on global markets

2026 INVESTMENT OUTLOOK





# Challenges to Handle, Opportunities to Pursue



**MATTHIAS SCHEIBER, PH.D., CFA**

+ Senior Portfolio Manager,  
Head of Multi-Asset

The year ahead will have its challenges—but we also expect to see opportunities arise. In our economic outlook, we share our expectations for both the U.S. and international markets, recognizing the distinct paths each region may take. Yet, amid the differences, one powerful theme stands out: our expectation for continued global growth.

## 5 key drivers as we look ahead

### 01 LOOK FOR GRADUAL GROWTH GLOBALLY

As the effects of lower interest rates make their way through the U.S. economy in 2026, growth should gradually recover. With lower mortgage rates and robust real earnings, a growth rate of 2–3% should be achievable. However, given uncertainty around the impacts of U.S. fiscal, tariff, and immigration policies on profit margins, it's probable that companies will save and hire carefully and consumers will remain cautious amid a slowing job market.

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“Data dependency will very likely remain the Fed's key focus in making rate decisions.”

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Outside the U.S., we expect growth to trend slightly higher given a robust labor market, better tariff deals negotiated, and more fiscal spending for defense and infrastructure. Germany in particular has set ambitious plans. China should provide more fiscal and monetary stimulus to support cautious consumers and cushion the negative impact of slowing exports to the U.S.

### 02 EXPECT INFLATION TO BE “STICKY” IN THE U.S. BUT LOW ELSEWHERE

While U.S. inflation should stabilize in 2026, the path to the Federal Reserve's (Fed's) 2% target will be longer than expected. Loose fiscal policy will likely be partly offset by government job cuts and the Fed's step-by-step approach for moving rates lower. We believe it will take further weakening in service prices and wages to bring inflation closer to the Fed target. Data dependency will very likely remain the Fed's key focus in making rate decisions, despite heavy political pressure to cut more quickly.

Outside the U.S., the inflation situation is quite different. Most countries' inflation targets have already been reached, so central banks can afford to be more stimulative—a favorable situation as consumer demand and sentiment remain weak in the eurozone and China. Eurozone inflation is expected to drop further below 2%, and the region's consumers are likely to keep their saving rate high and their spending muted. China remains pressured to do more as its economy struggles with deflation from a bursting property bubble and structurally higher U.S. tariffs.



### 03 NAVIGATE TRICKY U.S. RATE-CUT DECISIONS

Supporting its dual mandate of stable prices and stable employment will require delicate balancing by the Fed. We might not see as many Fed rate cuts as expected in 2026, mainly because the country's robust growth doesn't justify aggressive cutting. Fed Chair Powell's term ends in 2026, and the terms for the 12 regional Reserve Bank presidents—5 of them voting members—also expire. An ideology shift toward a more pro-growth approach in setting interest rates is possible. However, the Fed will need to very carefully communicate its outlook and method for handling the growth-versus-sticky inflation trade-off.

Internationally, the European Central Bank might have opportunities for more rate cuts if growth doesn't recover. China and Japan will likely remain the outliers: Japan will aim to carefully normalize monetary policy, while in China, more fiscal and monetary stimulus is expected.

### 04 KEEP INVESTORS ON THEIR TOES WITH GEOPOLITICS

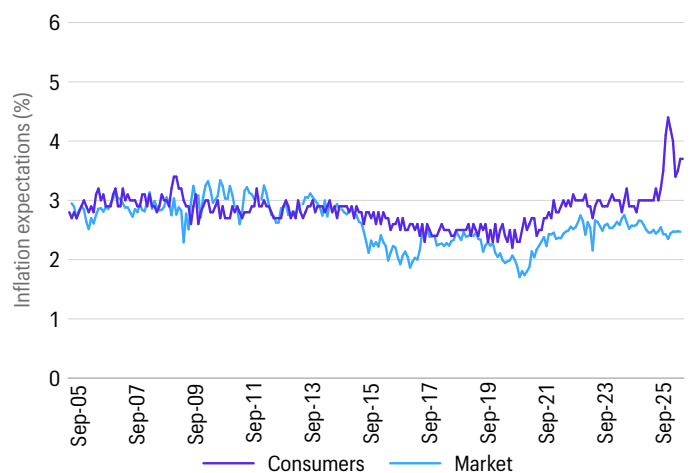
Geopolitical risks are expected to remain high in 2026. The Ukraine-Russia conflict is unlikely to be resolved as stances harden. More sanctions are likely via pressure on Russia directly—but also indirectly, on major consumers of Russian oil and gas such as China and India. In addition to ongoing direct conflicts in Ukraine and the Middle East, we believe investors should pay attention to the strategic rivalry between the U.S. and China. Tariff levels will likely remain high and trade tensions may flare up from time to time. Frictions are anticipated to remain elevated and have broader implications for global trade flows.

**"The longer-term consequences (of lowering rates too far) would be higher inflation and steeper yield curves."**

### 05 ANTICIPATE CONSEQUENCES FROM U.S. FISCAL POLICY DOMINANCE

Ever since the COVID pandemic, U.S. fiscal policy has overtaken monetary policy in supporting economic growth. Beyond expanding budget deficits through stimulus, however, we're seeing tendencies to use monetary policy to more actively support fiscal policy spending. The idea behind this is lowering interest rates in order to fund increased fiscal spending. While this approach may lower the fiscal bill over the short term, the longer-term consequences may be higher inflation and steeper yield curves—making it harder for the government to borrow at the long end of the yield curve and eroding confidence in the Fed to control prices. We believe the central bank's independence is important. Any perceived softening of the inflation target in favor of higher growth could increase investors' uncertainty and demand for higher risk premia. As the chart shows, consumers' inflation expectations have been shifting higher relative to the market's.

CONSUMERS' VS. MARKET'S INFLATION EXPECTATIONS CONTINUE TO DIVERGE



Sources: Allspring, Bloomberg Finance L.P., and University of Michigan Surveys, as of 30-Sep-25  
**Consumers' inflation expectations** = University of Michigan's Index of Consumer Sentiment  
**Market's inflation expectations** = U.S. 5-Year, 5-Year Forward Inflation Expectation Rate Index

**In the macro environment that we anticipate for 2026, we expect fiscal policy to dominate markets, creating opportunities for both equities and bonds.**

University of Michigan's Index of Consumer Sentiment is an economic indicator that measures U.S. consumer confidence levels. It is based on a monthly survey conducted by the University of Michigan. You cannot invest directly in an index.

U.S. 5-Year, 5-Year Forward Inflation Expectation Rate Index refers to the expected average inflation rate over a five-year period that begins five years from today. This is a key market-based measure of long-term inflation expectations, derived from inflation swap markets and reflects the market's consensus on future inflation trends in the U.S. You cannot invest directly in an index.

# Capturing the Next Wave of Market Breadth



**ANN MILETTI**

+ Head of Equity Investments,  
Chief Diversity Officer

The past year was marked by the resilience of equity markets in the face of heightened policy and geopolitical uncertainty. Despite volatility triggered by tariffs, elections, and shifting monetary policy, companies adapted swiftly. Although market breadth did improve, performance was heavily concentrated at the extremes. Large-cap names tied closely to artificial intelligence (AI) surged, while small-cap non-earners rallied as the 10-year Treasury yield declined and financial conditions eased.

Looking ahead to 2026, headline index valuations remain elevated, but beneath the surface we see compelling opportunities that have room to move. Three areas stand out in particular:

- **Sector opportunities**, as capital spending and new depreciation incentives support broader adoption of AI across industries such as health care, manufacturing, transportation, and financial services
- **Profitable U.S. small- and mid-cap equities (SMID caps)**, which offer relative value and are positioned to benefit from lower interest rates and renewed merger and acquisition (M&A) activity
- **Emerging markets (EM)**, which remain meaningfully under-owned and undervalued relative to their weight in the global economy

## EXPANDING SECTORS FOR NEW OPPORTUNITIES IN 2026

The events of 2025 have demonstrated that equity markets can adapt to policy shocks more quickly than expected.

Thus far, technology infrastructure providers have been the main beneficiaries of AI adoption. In the year ahead, we anticipate broader implementation across industries such as health care, manufacturing, transportation, and financial services. This “AI 2.0” phase—moving from infrastructure build-out to enterprise-wide application—could provide a meaningful tailwind for corporate earnings growth in 2026.

We also expect 2026 to mark the beginning of a renewed capital spending cycle. New depreciation rules may provide significant incentives for corporate investment, coinciding with an innovation wave led by AI.

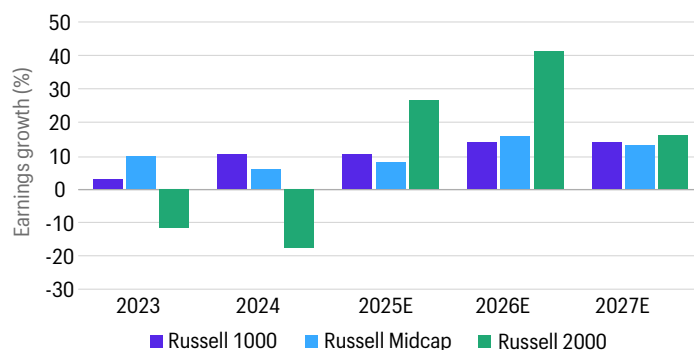
Added fiscal stimulus from the One Big Beautiful Bill Act (OBBA), coupled with deregulation and reduced policy uncertainty as the current administration enters its second year, could further reinforce the outlook. Together with lower rates, these conditions set the stage for broader earnings growth and a more favorable environment for areas of the market that have been overlooked.

## WHY SMID CAPS ARE BACK

Valuation spreads highlight ongoing imbalances in equity markets. While headline indexes like the S&P 500 appear expensive, opportunities exist further down the market-cap spectrum, where companies with stronger earnings growth, cash flow generation, and potential for multiple expansion create a more attractive risk/reward profile.

Market breadth has already begun to improve, and we expect this to continue as leadership extends beyond the handful of mega-cap growth stocks that dominated in recent years. While the AI trade remains well supported, we see growing room for earnings expansion outside the Magnificent 7, particularly given the historically wide valuation gaps between large caps and SMID caps.

## EARNINGS GROWTH EXPECTED TO BROADEN ACROSS MARKET CAPS



Sources: Allspring and FactSet, as of 30-Sep-25

Past performance does not guarantee future results.



Four catalysts could drive SMID caps in 2026:

- **Interest rates:** As the Fed continues its easing cycle, smaller companies with reliance on floating-rate financing should be among the primary beneficiaries.
- **Quality rotation:** The 2025 small-cap rally was led by lower-quality companies. Sustaining momentum this year will require a shift toward fundamentals. We believe earnings strength, cash flow generation, and balance sheet resilience will define the next phase of performance.
- **M&A activity:** Lower rates and greater policy clarity should encourage dealmaking. SMID caps are likely to be attractive targets, particularly in sectors such as financials, health care, and industrials.
- **Stronger earnings growth:** If macro conditions remain stable and the Fed pursues a moderate easing path, earnings breadth should improve across many industries, providing a rich backdrop for SMID-cap companies.

#### EMERGING MARKETS: UNDERVALUED AND UNDER-OWNED

Emerging markets present a compelling opportunity set. As the backbone of the global hardware build-out, they will likely continue to benefit from productivity gains across industries as AI adoption spreads. In addition, sovereign credit ratings are now at their highest levels in more than 30 years, reinforcing improved fundamentals alongside supportive drivers such as a relatively weak U.S. dollar, attractive valuations, and lighter positioning.

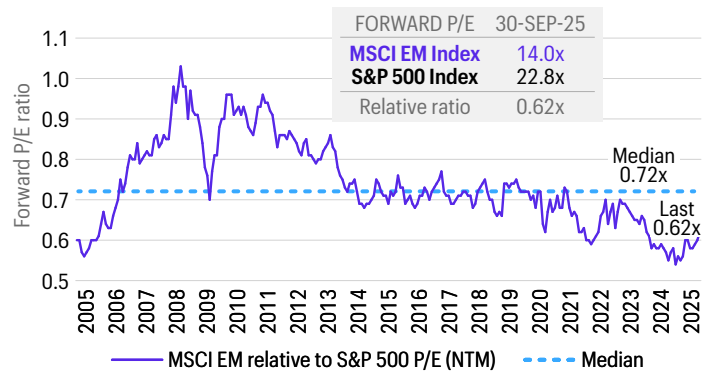
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**“SMID caps are likely to be attractive (M&A) targets.”**

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Global allocations to EM equities have fallen considerably over the past decade, leaving room for rebalancing and potential inflows. From our perspective, even a modest reweight could translate into significant capital moving into the asset class.

RELATIVE VALUATIONS FOR EM ARE AMONG CHEAPEST LEVELS IN 20 YEARS



Source: FactSet, as of 30-Sep-25

P/E = price/earnings; NTM = next 12 months

Past performance does not guarantee future results.

Policy support in China continues to create tactical entry points, though near-term uncertainty remains elevated. Brazil and India both showed solid momentum and policy steadiness in recent months, and we expect these trends to carry into 2026. More broadly, demographic advantages across several EM economies should provide a structural underpinning for long-term growth.

#### HOW TO FORGE THE PATH FORWARD INTO 2026

Multiple tailwinds underpin our outlook:

- The Fed's easing cycle, which should support valuations and a broadening of market performance
- Potential deregulatory shifts that could reduce costs for smaller companies
- A corporate investment revival, spurred by AI adoption and depreciation incentives

Our research underscores that long-term performance is rooted in quality and fundamentals, making investor discipline essential amid shifting market conditions. Maintaining diversification across sectors, market caps, and geographies—while staying anchored in quality—remains, we believe, the best way to capture the broadening opportunities we see ahead.



# Real Yields, Resilient Strategies



**GEORGE BORY, CFA**

+ Chief Investment Strategist,  
Fixed Income

Fixed income investors face a challenging mix of slowing growth, persistent inflation, and shifting policy. Global economies remain resilient, although momentum is decelerating. Inflation is easing but not yet back to target. Central banks are leaning toward accommodation, yet they remain cautious about moving too quickly.

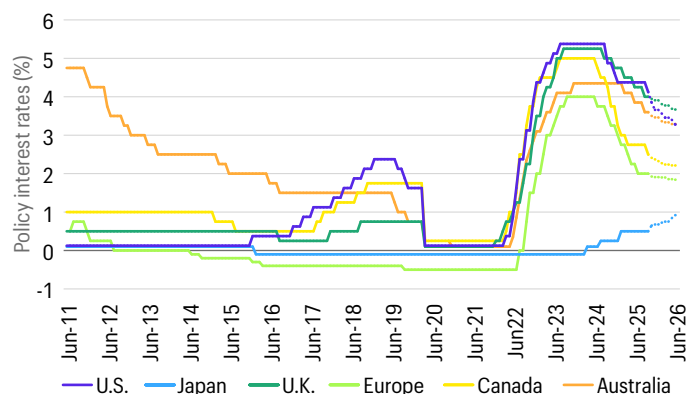
Against this backdrop, we believe bonds continue to offer real value. Nominal yields are high by historical standards; real yields remain firmly positive; and, looking ahead, we expect income generation to be the primary driver of total returns. The key, in our opinion, will be capturing that income while managing duration and preparing for risks that lie ahead.

## STAGFLATION RISKS AND THE PACE OF FED RATE CUTS

The U.S. continues to show signs of stagflation. Growth is decelerating, inflation is above the Fed's target, and the labor market is cooling. The Fed's recent rate cuts highlighted the difficult balance policymakers face. Fed Chair Powell described the outlook as "challenging" with "no risk-free path for policy." We believe further cuts are coming, but the pace will likely be gradual as inflation remains elevated.

For investors, this creates a mixed environment. Rate cuts have typically supported bonds, but ongoing inflation and fiscal pressures may keep long yields high. In this setting, careful curve positioning and focusing on real income are more important than relying on spread compression.

## FRONT END OF YIELDS REMAINS ANCHORED BY POLICY EXPECTATIONS



Sources: Allspring and Bloomberg Finance L.P.; data as of 30-Sep-25

U.S. = Federal Funds Target Rate Mid Point of Range (FEDRMID Index), Japan = Bank of Japan Policy-Rate Balance Rate (BOJDPBAL Index), U.K. = U.K. Bank of England Official Bank Rate (UKBRBASE Index), Europe = ECB Deposit Facility Announcement Rate (EUORDEPO Index), Canada = Bank of Canada Overnight Lending Rate (CABROVER Index), Australia = BIS Policy Rates Monthly Australia (BISMAUS Index)

## RISING DEFICITS AND DEBT ISSUANCE: A GROWING GLOBAL COST

Fiscal policy continues to be a major force in markets. In the U.S., deficits are projected to remain close to 7% of gross domestic product (GDP), pushing the debt-to-GDP ratio above 120% in the coming decade. Interest costs have already become one of the largest federal budget items, surpassing defense spending and consuming a larger share of tax revenues.

The U.K., France, Germany, and Japan are all running similarly large deficits tied to defense, infrastructure, and social spending. Government bond issuance should remain heavy, particularly at the long end of curves.

Debt-driven spending supports near-term growth, but it also risks embedding inflation and keeping yields elevated. The challenge is less about solvency—governments can service their debts—and more about sustainability. Rising interest costs will likely require difficult political trade-offs.

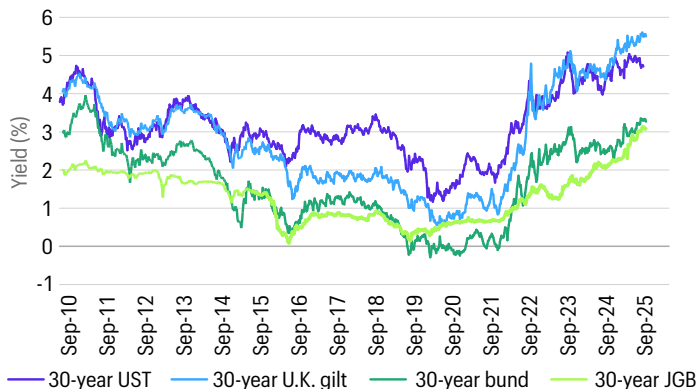
## LONG BONDS: A RELIEF VALVE FOR MACRO PRESSURES

Normalization of interest rates will likely remain the dominant theme in 2026. Short-term yields should stay anchored by central banks with a bias toward easing. At the long end, bonds should continue to act as a relief valve for macroeconomic pressures.





## A NEW NORMAL FOR BOND YIELD CURVES



Source: Bloomberg Finance L.P.; data as of 30-Sep-25

JGB = Japan government bond

Heavy government issuance and persistent inflation risks suggest that long yields could stay elevated, keeping upward pressure on the curve. The U.S. curve, still lagging its peers in Europe and Japan, has further room to normalize. We think this will likely materialize through a bull steepening as front-end rates decline faster than long yields.

## MANAGING DURATION IN A SHIFTING RATE ENVIRONMENT

Managing duration will be central to portfolio positioning in 2026. Slowing growth and the potential for additional Fed easing create opportunities to extend into the intermediate part of the curve. Mid-curve exposures, combined with global diversification, may help build resilience and enhance return potential. The challenge will be to capture income while maintaining enough duration to provide a cushion if growth slows more than expected.

## REAL YIELDS: A BRIGHT SPOT FOR FIXED INCOME INVESTORS

Real yields remain one of the most constructive features of the fixed income landscape. The U.S. 10-year Treasury real yield has held near 2%—well above its long-term average. Other developed market government bonds also continue to offer positive real yields.

This mix of anchored short-term rates and elevated long-term yields creates opportunities for investors. The process of yield curve normalization, which began in 2023, is likely to continue through 2026. Still, external shocks remain a risk. Another shock—whether geopolitical or economic—could disrupt real yield dynamics and inject new volatility. For investors with a longer time horizon, we believe that bonds should remain a reliable source of durable, inflation-beating cash flows.

## RESILIENT STRATEGIES: OPPORTUNITIES ACROSS BOND MARKETS

While broad dislocations are limited, certain sectors stand out to us.

- **Investment-grade corporates:** Credit fundamentals are sound, supported by profitability and balance sheet strength. Spreads are very tight, though—leaving more value for investors in absolute yields rather than in spreads.
- **High yield corporates:** Shorter-duration, higher-quality, higher-yielding credits (BBB to B) continue to offer attractive yields, particularly in the one- to three-year range. Selectivity is critical, as defaults could increase in public and private credit markets.
- **Structured products:** Certain asset-backed securities (ABS), particularly in more esoteric segments, may provide diversification and competitive yields.
- **Global government bonds:** Bonds from developed markets such as the U.K., France, and Japan—when swapped into U.S. dollars—may deliver AA-level yields at spreads comparable with BBB corporates.
- **Municipal bonds:** U.S. municipal bonds may offer some of the best relative value. Taxable municipal bonds often yield on par with BBB corporates but may carry stronger credit profiles, while tax-exempt municipal bonds look especially attractive for high-tax investors.

The current environment is unlikely to reward a static approach. Yield curves are steepening, spreads remain tight, and fiscal pressures are ever present. Active management provides the flexibility to adjust duration, rotate across sectors, and emphasize credits with resilient fundamentals.

In 2026, this adaptability should be decisive. Nimble curve positioning, global diversification, and disciplined credit selection will be central to achieving durable, inflation-beating returns.

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**“ The current environment is unlikely to reward a static approach.**

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# Top 6 for '26

## Allspring spotlights six investment ideas driving the market pulse.

The economic backdrop remains critical to the types of securities that will lead markets in 2026. While global central bank easing is expected to further support equities and fixed income, concerns around trade tensions and tight valuations are likely to cloud the path forward for investors. Allspring's history of managing portfolios is grounded in the belief that long-term performance is rooted in quality and fundamentals—making investor discipline essential amid shifting market narratives. We believe there will continue to be opportunities to generate alpha in both equities and fixed income across market cycles while supporting thoughtful risk-taking across our teams.

To kick off next year, we challenged our investment platform to [pitch their best investment ideas for 2026](#). The six ideas that rose to the top showcase our portfolio managers' pursuit for effective risk-adjusted returns on behalf of clients. Their ideas are the result of rigorous bottom-up fundamental research, market intelligence, collaboration among teams, and a shared commitment to helping our clients navigate what's next. Delivering innovative solutions to drive investor outcomes is at the heart of everything we do.

### JON BARANKO

+ Chief Investment Officer



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## Authors



### BRYANT VANCRONKHITE, CFA, CPA

+Senior Portfolio Manager,  
Co-Head of Special Global Equity

*Discover which sectors we think are going to be hot or not in 2026.*



### MIKE SMITH, CFA

+Senior Portfolio Manager,  
Head of Growth Equity

*We're focused on the next two rings of [AI] opportunity: suppliers and consumers.*



### JOHN CAMPBELL, CFA

+Senior Portfolio Manager,  
Head of Systematic Core Equity

*Search downstream with active management to target high-quality companies outside of mega-cap tech.*



### JANET RILLING, CFA

+Senior Portfolio  
Manager, Head of  
Plus Fixed Income

*The "belly" of the yield curve, 3- to 7-year-maturity bonds, may be well positioned.*



### SCOTT SMITH, CFA

+Senior Portfolio Manager,  
Head of Investment  
Grade Income



### NICHOLOS VENDITTI, CFA

+Senior Portfolio Manager,  
Head of Municipal Fixed Income

*We believe there's a compelling entry point to consider locking in yields now.*



### MAULIK BHANSALI, CFA

+Senior Portfolio Manager,  
Co-Head of Core Fixed Income

*Securitized assets such as MBS and ABS may give investors the benefit of high-quality fixed income without the richness of credit spreads.*





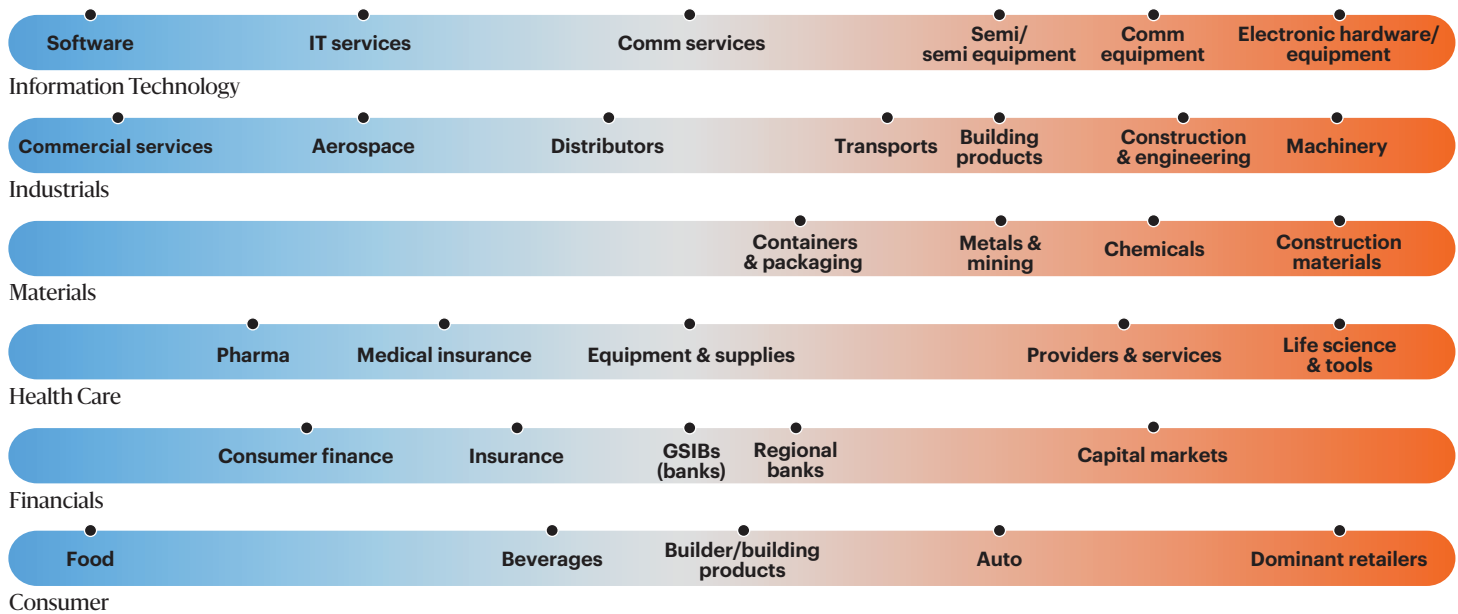
# Special Global Equity Team

**BRYANT VANCROKHTE, CFA, CPA**

+ Senior Portfolio Manager and Co-Head of Special Global Equity

2025 has been wild and unique. Since April, high-beta, non-earner, and low return-on-equity companies led the way in small- and mid-cap markets, while Magnificent 7 and AI themes dominated large caps. We expect small caps to enter a phase of quality-focused investing, while large-cap AI winners remain strong with room for broader participation.

## HOT OR NOT: WHAT SECTORS DO WE THINK ARE GOING TO BE “HOT” IN 2026?



Source: Allspring, as of 30-Sep-25. For illustrative purposes only.

### INFORMATION TECHNOLOGY: TRANSITIONING FROM EXPERIMENTATION TO IMPLEMENTATION

AI's next phase shift from infrastructure to broad value realization will require delivering more efficient data center power, solving security issues, resolving bottlenecks in semi manufacturing, and reorganizing workflows.

### INDUSTRIALS: CAPITAL EXPENDITURES (CAPEX) CYCLE—TIME TO BUILD AND FILL

Megaproject-led construction must be completed and used amid reshoring, rebuilding, and rearming on the back of the industrial complex. The OBBB pulls forward tax incentives, while easing monetary policy and an AI arms race should accelerate demand.

### MATERIALS: CAPEX CYCLE—THE LITTLE SIBLING

The industrials/AI capex cycle can't roll on without participation by the materials sector.

### HEALTH CARE: UNLOVED AND READY FOR A HUG

Health care stocks have been in the crosshairs of regulation, poor capital markets, and the ire of investors everywhere. Valuations are attractive to us; overhangs are subsiding; and, in our view, the sector is ready to return to historical form.

### FINANCIALS: POLICY MATTERS—RATES AND DEREGULATION

The financials sector is very diverse, with different drivers for each industry. Overall, lower regulatory burdens, a steepening yield curve, and investors' emotions—offset by credit risk—create a mildly positive short-term view but less optimistic longer-term perspective.

### CONSUMER: THE “K” SHAPED RECOVERY

Consumer sentiment toward the economy and future expectations is directly related to income levels and household net worth. We expect that connection to continue, although tax benefits from the OBBB could be incrementally helpful to the middle-income consumer.



## Growth Team

**MIKE SMITH, CFA**

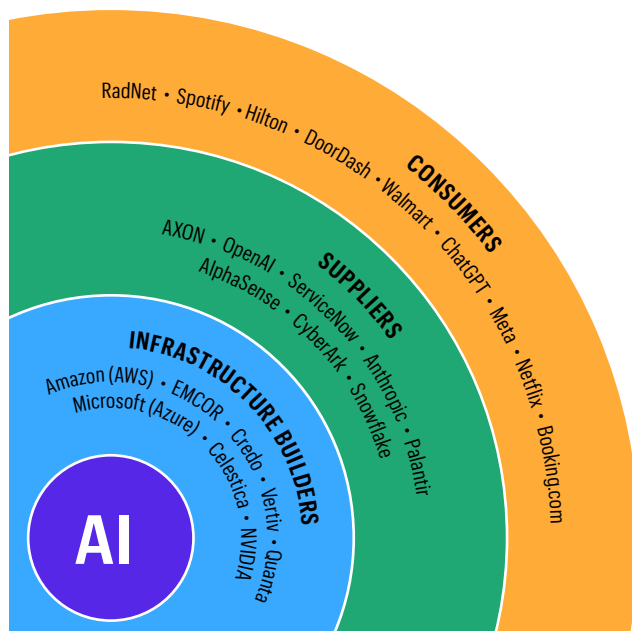
+ Senior Portfolio Manager and Head of Growth Equity

### WHAT INVESTMENT IDEA CAPTURES THE PULSE OF 2026?

**AI beneficiaries in a scarcity-driven market:** For investors, AI seized the spotlight in 2025. In our view, the real investment opportunity isn't in the infrastructure builders—the true beneficiaries are the businesses that are using AI to solve actual problems today and exploring new ways to use AI going forward. AI adoption has been accelerating 35 times faster than software-as-a-service adoption, creating a new class of potential winners.

#### AI'S MOMENTUM STARTED WITH INFRASTRUCTURE

We're focused on the **next two rings of opportunity: suppliers and consumers.**



Source: Allspring, as of 30-Sep-25

*Named companies are for illustrative purposes only. The securities named should not be considered a recommendation to purchase, trade, or sell any particular security. The securities may or may not be held in an Allspring portfolio.*

Where's the ultimate "sweet spot" for us? While most investors are chasing mega-cap AI infrastructure stocks, our focus is on **nimble small and medium-size companies using AI to drive higher productivity for businesses and consumers.**

As examples, several companies are using dynamic pricing/routing, AI-driven ad targeting/optimization, and even

AI-enhanced radiology/diagnostics. From our perspective, there are compelling mid-cap growth companies with AI-powered competitive advantages that the market has yet to appreciate.

### WHAT RISK COULD KEEP YOU UP AT NIGHT?

The power crunch: With AI chips (GPUs) consuming nearly four times as much energy as CPUs, **data centers are on track to consume as much energy as 38 million homes by 2030.** This pace of growth would create both risk and opportunity. Energy constraints could limit the AI infrastructure build-out and spark disillusionment with some of the current highflyers that have shaky fundamentals. We see massive opportunities, however, in power generation, grid modernization, and energy efficiency for experienced investors focused on sustainable growth.

To position for the power crunch, we've targeted high-quality companies across the power value chain—from independent power producers and grid infrastructure builders to renewable energy developers. The AI build-out will require massive energy investments, which may create multiyear tailwinds for companies that can deliver reliable, scalable power solutions. In our view, investments to modernize the U.S. power infrastructure could become the biggest capital deployment of the decade.

### WHAT WORD OR PHRASE DO YOU THINK YOU'LL USE THE MOST WITH CLIENTS IN 2026?

**Scarcity premium:** Growth is scarce, power is scarce, and true AI beneficiaries also are scarce. With only 15% of companies in the Russell 3000 Growth Index expected to deliver above 15% earnings growth in the future, robust growth will remain in short supply. This phenomenon has driven the long winning streak for U.S. growth stocks. We expect this environment to continue as investors embrace innovation and pay premium multiples in 2026 for companies that can demonstrate sustainable fundamentals in a growth-starved world.



# Systematic Core Team

**JOHN CAMPBELL, CFA**

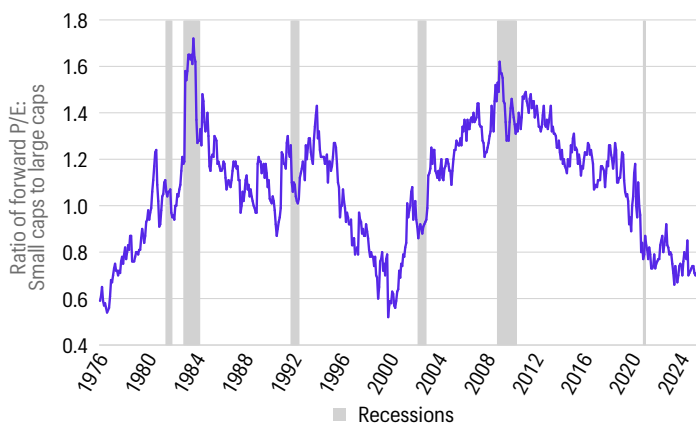
+ Senior Portfolio Manager and Head of Systematic Core Equity

## WHAT INVESTMENT IDEA CAPTURES THE PULSE OF 2026?

We believe the most compelling opportunities lie in **high-quality small- and mid-cap (SMID-cap) companies**—those with strong free cash flow (FCF) margins and disciplined capital allocation.

Today, the top 20% of small-cap companies by FCF margin trade at a meaningful discount to their large-cap counterparts on a forward P/E basis. This is a stark reversal from 10–15 years ago, when high-quality small caps commanded a 20–40% premium. The current discount—reminiscent of levels seen during the peak of the internet bubble—offers fertile ground for active managers to uncover value.

### HIGHEST-QUALITY SMALL CAPS TRADING AT A DISCOUNT



Sources: Allspring and Empirical Research Partners analysis; 1976 through early October 2025 Capitalization-weighted data: Comparison of highest-quintile of FCF margins forward P/E ratio in small-cap U.S. stocks (ex-commodities and biotech) and same cohort in large-cap stocks. U.S. large-cap stocks measured as largest 750 stocks by market capitalization. U.S. small-cap stocks measured as the next 2,000 stocks by market capitalization.

While this valuation gap has persisted for several years, we believe **2026 could be the year it begins to close**, driven by a set of emerging catalysts in the SMID space:

- **Rates.** The possibility of an easing cycle on the horizon is a tailwind for smaller-cap companies, as they tend to carry more variable-rate debt—and to be more indebted overall—than their larger-cap counterparts.
- **Tariff disruption.** We expect that SMID companies will see more domestic revenue than the global multinationals dominating the S&P 500. Continued

tariff headlines should be a relative benefit to the smaller companies, assuming the tariffs themselves don't drag the U.S. into recession.

- **Earnings growth.** Historically, SMID companies have produced similar (and, at times, superior) earnings growth relative to large caps.<sup>1</sup> Even at steady valuations, continuation of this trend should unlock opportunity for investors down cap.

## WHAT RISK COULD KEEP YOU UP AT NIGHT?

Looking ahead to 2026, we believe the U.S. large-cap equity market may be nearing a critical inflection point—what we refer to as **“peak passive.”** The extraordinary concentration of the top 10 companies in the S&P 500 Index—a group that represents over 40% of the index (as of 30-Sep-25)—has created structural risks for passive investors. These include rebalancing constraints and embedded capital gains that limit portfolio flexibility.

We believe there are three primary ways to deal with this risk:

- 01 Search downstream with active management** to target high-quality companies outside of mega-cap tech that are positioned for accelerating earnings growth.
- 02 Stay vigilant with risks in portfolio construction** because of market concentration. Unlike past periods of narrow leadership—such as the tech bubble—the current top large-cap names share highly correlated growth narratives, amplifying portfolio risk.
- 03 Scout for shifting markets** and consider the potential for a broadening market. Seek opportunities among the “other 490” S&P 500 constituents—as well as within mid- and small-cap U.S. equities, where valuation and earnings dynamics may offer upside.

## WHAT WORD OR PHRASE DO YOU THINK YOU’LL USE THE MOST WITH CLIENTS IN 2026?

We believe the extraordinary concentration in U.S. large-cap equity passive investments may be nearing a critical inflection point—what we refer to as **“peak passive.”**

1. Source: Comparison of the 10-year annualized earnings-per-share results for the S&P 500, S&P 400, and S&P 600 Indexes from 31-Dec-14 through 31-Dec-24



# Investment Grade Income and Plus Fixed Income Teams

**JANET RILLING, CFA**

+ Senior Portfolio Manager and Head of Plus Fixed Income

**SCOTT SMITH, CFA**

+ Senior Portfolio Manager and Head of Investment Grade Income

## WHAT INVESTMENT IDEA CAPTURES THE PULSE OF 2026?

**We believe higher-quality bonds with attractive yields and strong yield breakevens deserve attention—especially across the short to intermediate parts of the curve.**

The fixed income market in 2026 stands at a pivotal point, shaped by a sharp transition away from aggressive central bank tightening and toward a more neutral stance policy. 2026 is shaping up to present two-sided risks to both price stability and the labor market—with implications extending to growth—while geopolitical tensions persist as global powers continue to reshape the world order. We think investors should approach the market with discipline, favoring well-considered yield opportunities over indiscriminate risk-taking.

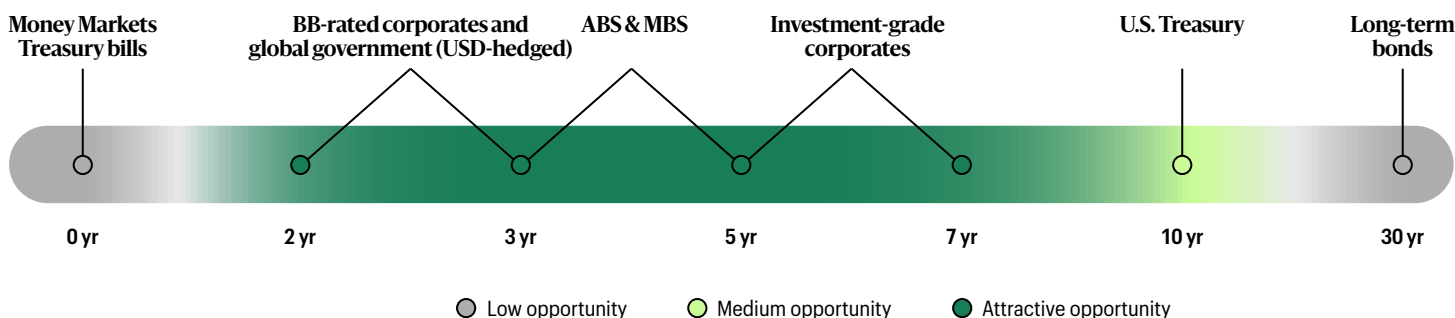
In evaluating the best investment idea for 2026, we view the elevated yields in high-quality bonds as compelling across a range of sectors and jurisdictions. Without taking

on long interest rate or deep credit risks, these bonds can help maximize income through their elevated yields. They can also help bolster portfolio resiliency through their substantial yield breakevens.

We're focused on opportunities in the short to intermediate parts of the yield curve, where investors can benefit by locking in the elevated current yields and position for future price appreciation if monetary easing materializes. Investors can access opportunities in this part of the curve in a number of ways:

- Short BB-rated high yield bonds
- Short global government bonds on a hedged basis
- Securitized credit sector (ABS & MBS) exposure
- Front-end to intermediate-duration investment-grade credit

## RIDING THE CURVE OF FIXED INCOME OPPORTUNITIES



Source: Allspring, as of 30-Sep-25

## SHORT-DURATION OPPORTUNITIES

We see opportunities to extend money off the very front end of the curve by strategically investing in short-term, non-U.S. government bonds across different regions. Even after hedging local currencies back to the dollar, these bonds may offer attractive yields and strong liquidity in secondary markets as well as price appreciation.

Another opportunity at the front end of the curve is to add exposure to short, BB-rated high yield bonds.

An allocation to these issues may offer a meaningful increase in total-return potential while being exposed to only the higher-quality names within high yield.

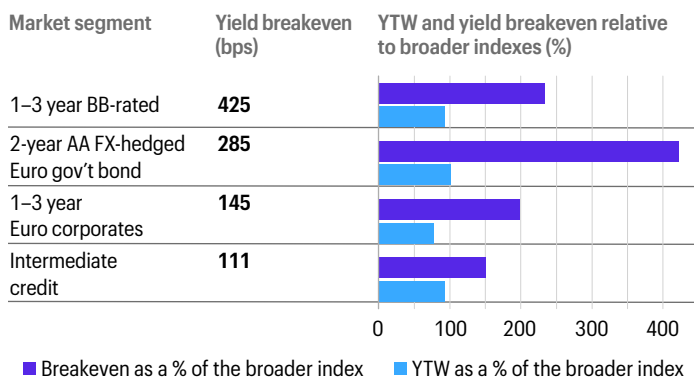
## INTERMEDIATE-DURATION OPPORTUNITIES

Both securitized sectors and short-to-intermediate investment-grade credit exposures, where credit curves are flatter, may offer opportunities to extend duration even further. The emphasis remains on prioritizing assets with superior credit



ratings while selectively adding incremental duration to seek enhanced portfolio flexibility amid shifting market conditions. Often called the “belly” of the yield curve, 3- to 7-year-maturity bonds may be well positioned to benefit from normalization. As front-end yields continue to fall, driven by rate-cut expectations, this part of the curve typically has outperformed on a total-return basis. Investors may use this approach without exposing themselves to the more volatile, longer end of the curve.

#### STAYING SHORT TO INTERMEDIATE MAY OFFER **MOST OF THE YIELD AND MORE OF THE BUFFER**



bps = basis points (100 bps equal 1.00%)

YTW = yield to worst

Sources: Allspring and Bloomberg Finance L.P., as of 30-Sep-25. **1–3 year BB-rated** = ICE BofA 1–3 year BB U.S. Cash Pay High Yield Index; Broader index = ICE BofA BB U.S. High Yield Index. **2-year AA FX-hedged Euro gov’t bond** = USD Hedged Generic Britain 2-Year Government Bond; Broader index = Bloomberg U.S. Treasury Index. **1–3 year Euro corporates** = Bloomberg Euro Corporate 1–3 Year Bond Index; Broader index = Bloomberg Pan-European Aggregate Index. **Intermediate credit** = Bloomberg U.S. Intermediate Credit Index; Broader index = Bloomberg U.S. Credit Index.

#### WHAT RISK COULD KEEP YOU UP AT NIGHT?

**Growing concerns about U.S./global fiscal deficits and the Fed’s independence** could prompt yield curves to steepen further. If the market has growth concerns and the yield curve steepens, this could mean credit spreads widen under a “bear curve steepener” scenario. This situation would create difficulties for low-quality bonds.

On the other hand, risk compensation could continue to stay extremely low even as risks in the marketplace grow and shift. Tight, lethargic credit spreads could lead to investor apathy until risks have grown substantially, which may lead to sharp market sell-off scenarios.

#### WHAT WORD OR PHRASE DO YOU THINK YOU’LL USE THE MOST WITH CLIENTS IN 2026?

**Stimulus**—whether fiscal, monetary, or regulatory—may support economic growth, though its effectiveness may vary depending on economic conditions and the timing of implementation. If growth does slow, we could see resilient demand and competitive absolute returns in fixed income.

“The “belly” of the yield curve, 3- to 7-year-maturity bonds, may be well positioned.

**ICE BofA BB U.S. High Yield Index** is an unmanaged index that generally tracks the performance of BB-rated U.S.-dollar-denominated corporate bonds publicly issued in the U.S. domestic market with maturities of one to five years. You cannot invest directly in an index.

**ICE BofA 1–3 Year BB Cash Pay High Yield Index** is an unmanaged index that generally tracks the performance of BB-rated U.S.-dollar-denominated corporate bonds publicly issued in the U.S. domestic market with maturities of one to five years. You cannot invest directly in an index.

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**Bloomberg Euro Corporate 1–3 Year Bond Index** measures the performance of fixed-rate, investment-grade, euro-denominated, fixed-rate corporate securities with maturities between one and three years. You cannot invest directly in an index.

**Bloomberg Pan-European Aggregate Corporate Index** measures the performance of fixed-rate, investment-grade, corporate securities issued in the following European currencies: euro, British pound, Norwegian krone, Danish krone, Swedish krona, Czech koruna, Hungarian forint, Polish zloty, and Slovakian koruna. You cannot invest directly in an index.

**Bloomberg U.S. Credit Index** measures the performance of publicly issued U.S. corporate and specified foreign debentures and secured notes that meet the specified maturity, liquidity, and quality requirements. To qualify, bonds must be registered with the SEC. Each qualified issuer’s exposure is then capped on a market-weighted basis at 3%, and the residual is allocated on a pro-rata basis to all remaining constituents. You cannot invest directly in an index.

**Bloomberg U.S. Intermediate Credit Index** measures the performance of investment-grade, U.S.-dollar-denominated, fixed-rate, taxable corporate and government-related bonds with maturities greater than 1 year and less than 10 years. You cannot invest directly in an index.

**Bloomberg U.S. Treasury Index** measures U.S.-dollar-denominated, fixed-rate, nominal debt issued by the U.S. Treasury. You cannot invest directly in an index.

**USD Hedged Generic Britain 2-Year Government Bond Index** measures the performance of 2-year U.K. government bonds (gilts) with returns hedged into U.S. dollars to eliminate currency risk for USD-based investors. You cannot invest directly in an index.



# Municipal Fixed Income Team

**NICHOLOS VENDITTI, CFA**

+ Senior Portfolio Manager and Head of Municipal Fixed Income

## WHAT INVESTMENT IDEA CAPTURES THE PULSE OF 2026?

While it can sound self-serving for a municipal professional to say, **“Buy munis!”**, we believe the asset class looks very attractive for several reasons:

- Most states in the U.S. continue to sit on strong cash reserves and have built up sizable rainy-day funds.
- The credit profile of most issuers remains strong.
- Municipal bond yields continue to trade at or above multiyear highs.

A huge sell-off in April 2025, which was painful at the time, handed investors a great opportunity to capture yields that hadn’t been seen in municipals in over a decade. Given how tight credit spreads currently are across fixed income markets, we see attractive opportunities to transition into higher-quality municipals in more “vanilla” sectors—for example, local general obligation or essential service revenue bonds—without having to sacrifice yield.

**For investors in the top tax brackets**, the taxable-equivalent yields are even more compelling. A municipal bond yielding 4.00%, for example, may have a taxable-equivalent yield over 6.00% for investors in the highest tax brackets. For investors in higher-tax states, the benefit is likely even greater. The value of the tax-exempt status is powerful—especially in a world where many investors are sitting on large tax bills.

**For individual and institutional investors** with accounts that don’t qualify for tax exemptions, there are still opportunities to seize. One way to diversify exposures away from corporate bonds and U.S. Treasuries is through taxable municipals—which, while a small part of the \$4 trillion U.S. municipal market, may offer a compelling option. Over 85% of the taxable municipal market is rated AAA or AA, compared with 14% of the corporate bond market. Taxable municipal bond yields may be similar to those of investment-grade U.S. corporate bonds and potentially higher than yields of U.S. Treasuries, with comparatively lower default rates, historically.

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**“Over 85% of the taxable municipal market is rated AAA or AA, compared with 14% of the corporate bond market.”**

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## WHAT RISK COULD KEEP YOU UP AT NIGHT?

**The two risks that keep me up at night are tariffs and the future credibility of the Fed.** With tariffs, it’s still uncertain what the overall impact may or may not be. Tariffs will either be paid by suppliers or passed on to consumers. In a case where they’re paid by suppliers, it’s likely that profit margins will suffer and equity prices (especially at stretched valuations) will be negatively affected. If tariffs are passed on to consumers, those at the lower end of the economic spectrum—who are already stretched thin—would be forced to cut spending even further. This could lead to a slowdown, weakening equity prices.

As for the Fed, political noise will likely persist. Continued erosion of the Fed’s independence could threaten the foundation of all asset prices. Near-term strength will most likely revolve around the strength of the dollar and the bond market’s reaction to further Fed intervention.

## WHAT WORD OR PHRASE DO YOU THINK YOU’LL USE THE MOST WITH CLIENTS IN 2026?

**Income. Specifically, tax-exempt income.** As I mentioned above, municipal yields are at levels we haven’t seen in many years. The tax exemption’s value can be significant, especially for high-tax-bracket investors. Given municipal bonds’ current taxable-equivalent yields—which are similar to or higher than many high-grade corporate bond yields—and their historically lower default rates and volatility, we believe there’s a compelling entry point to consider locking in yields now for a steady stream of tax-exempt income.

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**“ (For U.S. investors) the value of the tax-exempt status is powerful.”**

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# Core Fixed Income Team

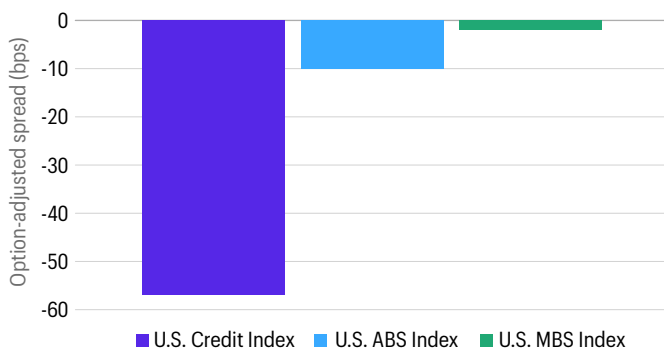
**MAULIK BHANSALI, CFA**

+ Senior Portfolio Manager and Co-Head of Core Fixed Income

## WHAT INVESTMENT IDEA CAPTURES THE PULSE OF 2026?

**We view U.S. securitized assets as a key opportunity in 2026.** Mortgage-backed securities (MBS) and ABS offer attractive yields, spreads, and security selection prospects as well as structural features that we believe are underappreciated. Despite tariff impacts and weaker but still positive growth, we believe the conditions are good for high-quality fixed income to perform well into the future. Securitized assets such as MBS and ABS may give investors the benefit of high-quality fixed income without the richness of credit spreads, and the structural features typically make them less sensitive to an economic downturn. In fact, some sectors, such as agency MBS, benefit from implicit government support. The chart below shows how option-adjusted spreads have tightened since March 16, 2022—the date of the Fed’s first interest rate increase following the period of U.S. COVID stimulus/relief. In comparing these three aggregate sectors from that date forward, we see that the Bloomberg U.S. Credit Index spreads have meaningfully tightened to the point where there’s currently minimal opportunity to gain from price appreciation.

CHANGE IN OPTION-ADJUSTED SPREADS SINCE FED’S FIRST POST-COVID INCREASE IN FEDERAL FUNDS RATE



Sources: Allspring and Bloomberg Finance L.P., as of 29-Sep-25

U.S. Credit Index = Bloomberg U.S. Credit Index; U.S. ABS Index = Bloomberg U.S. ABS Index; U.S. MBS Index = Bloomberg U.S. MBS Index

Credit spreads have largely rallied in 2025 to near their all-time highs, yet demand remains robust, net supply is low, and corporate fundamentals are strong. We believe the potential for event risk within credit markets (including M&As, spin-offs, and other leveraging activities) could potentially surprise investors. This risk is not as pronounced, however, in the top of the capital structure of most securitized markets, as built-in credit enhancement, rules on collateral quality, the governance of cash flows, and other characteristics often insulate bondholders from large negative surprises. Overall, the U.S. economy seems on track for a slow rate of growth, although with further downside risks. Within U.S. securitized assets, the team continues to favor overweight allocations to agency MBS, and AAA-rated ABS also present opportunities—both offer attractive real yields and exposure to high-quality fixed income.

## WHAT RISK COULD KEEP YOU UP AT NIGHT?

**We’ll be monitoring for possible landmines in credit markets.** With so much money chasing credit—especially private credit and now investment funding for AI—the potential exists for an unseen buildup in leverage that may need to be unwound if underwritten metrics don’t pan out. For example, we’re seeing increasing use of complicated financing techniques to fund AI investment, and some of those investments are being made by entities that have yet to demonstrate clear pathways to consistent revenue generation. We do believe the AI boom has strong secular support and can continue for some time—however, all booms typically lead to pockets of excess. If AI demand falls short of the aggressive growth rate underpinning these recent leveraged financing deals, the resulting misalignment could expose landmines across the credit landscape.

## WHAT WORD OR PHRASE DO YOU THINK YOU’LL USE THE MOST WITH CLIENTS IN 2026?

**Be prepared to jump on volatility opportunities.** This means having plenty of dry powder to take advantage of opportunities as they arise—and being extremely nimble when they do.

## For further information

We're committed to thoughtful investing, purposeful planning, and the desire to deliver outcomes that expand above and beyond financial gains. **Click or scan the QR code to check out Allspring's insights:**



### GLOSSARY

**Alpha** measures the excess return of an investment vehicle, such as a mutual fund, relative to the return of its benchmark, given its level of risk (as measured by beta). Alpha is based on historical performance and does not represent future results.

**Credit-quality ratings** apply to underlying holdings of the fund and not the fund itself. Standard & Poor's rates the creditworthiness of bonds from AAA (highest) to D (lowest). Standard & Poor's rates the creditworthiness of short-term notes from SP-1 (highest) to SP-3 (lowest). Ratings from A to CCC may be modified by the addition of a plus (+) or minus (-) sign to show relative standing within the rating categories.

**Diversification** does not ensure or guarantee better performance and cannot eliminate the risk of investment losses.

**Duration** is a measurement of the sensitivity of a bond's price to changes in Treasury yields. A fund's duration is the weighted average of duration of the bonds in the portfolio. Duration should be interpreted as the approximate change in a bond's (or fund's) price for a 100-basis-point change in Treasury yields. Duration is based on historical performance and does not represent future results.

**Forward P/E ratio** is a forward-looking perspective on a stock's valuation. A lower ratio suggests the stock is undervalued relative to its projected earnings while a higher ratio suggests it is overvalued based on projected growth.

**Free Cash Flow (FCF)** is a profitability metric that shows how well a company converts sales into cash and how efficiently it turns revenue into cash flow.

**Hedging a bond** means using a separate investment to offset the potential risks of the bond.

**The "Magnificent 7"** is composed of the seven largest stocks in the S&P 500: Alphabet, Amazon, Apple, Meta Platforms, Microsoft, Nvidia, and Tesla.

**Yield breakevens** are estimates of how much yields could rise or spreads could widen before a fixed income investment would see a negative total return over the following year.

**Bank of Canada Overnight Lending Rate (CABOVER Index)** tracks the target interest rate set by the Bank of Canada for overnight loans between major financial institutions. You cannot invest directly in an index.

**Bank of Japan Policy Rate Balance Rate (BOJDPBAL Index)** tracks the short-term policy interest rate set by the Bank of Japan (BOJ), represented by the interest rate applied to the policy-rate balances held in current accounts at the BOJ. You cannot invest directly in an index.

**BIS Policy Rates Monthly Australia (BISPMAS Index)** is tracked by the Bank for International Settlements (BIS) and represents the main policy rate used by the Reserve Bank of Australia (RBA) to implement monetary policy—typically the cash rate target, which is the interest rate on overnight loans in the money market. You cannot invest directly in an index.

**Bloomberg U.S. ABS Index** is a broad-based benchmark that measures the investment-grade, U.S.-dollar-denominated, fixed-rate taxable bond market. The index includes only asset-backed securities (ABS) with maturities of one year or more. You cannot invest directly in an index.

**Bloomberg U.S. Credit Index** contains publicly issued U.S. corporate and specified foreign debentures and secured notes that meet the specified maturity, liquidity, and quality requirements. To qualify, bonds must be registered with the SEC. Each qualified issuer's exposure is then capped on a market-weighted basis at 3%, and the residual is allocated on a pro-rata basis to all remaining constituents. You cannot invest directly in an index.

**Bloomberg U.S. MBS Index** measures the performance of investment-grade mortgage-backed pass-through securities (MBS) issued or guaranteed by U.S. government agencies or sponsored entities. In addition, the securities in the index must be denominated in U.S. dollars and must be non-convertible. The index is market capitalization weighted. You cannot invest directly in an index.

**ECB Deposit Facility Announcement Rate (EUORDEPO Index)** tracks the interest rate set by the European Central Bank (ECB) for its deposit facility. The deposit facility rate is the interest rate banks receive when they deposit excess funds overnight with the ECB. You cannot invest directly in an index.

**Federal Funds Target Rate Mid Point of Range (FDRTRMID Index)** represents the midpoint of the target range for the federal funds rate as set by the Federal Open Market Committee (FOMC). You cannot invest directly in an index.

**The Morgan Stanley Capital International (MSCI) Emerging Markets (EM) Index (Net)** is a free-float-adjusted market-capitalization-weighted index that is designed to measure equity market performance of emerging markets. You cannot invest directly in an index.

**The Russell Midcap® Index** measures the performance of the 800 smallest companies in the Russell 1000® Index, which represent approximately 25% of the total market capitalization of the Russell 1000 Index. You cannot invest directly in an index.

**The Russell 1000® Index** measures the performance of the 1,000 largest companies in the Russell 3000® Index, which represents approximately 92% of the total market capitalization of the Russell 3000 Index. You cannot invest directly in an index.

**The Russell 2000® Index** measures the performance of the 2,000 smallest companies in the Russell 3000® Index, which represents approximately 8% of the total market capitalization of the Russell 3000 Index. You cannot invest directly in an index.

**The Russell 3000® Growth Index** measures the performance of those Russell 3000® Index companies with higher price/book ratios and higher forecasted growth values. You cannot invest directly in an index.

**Standard & Poor's MidCap 400 Index (S&P 400 Index)** consists of 400 mid-sized stocks chosen for market size, liquidity, and industry group representation. It is a market-value-weighted index with each stock's weight in the index proportionate to its market value. You cannot invest directly in an index.

**Standard & Poor's SmallCap 600 Index (S&P 600 Index)** consists of 600 small-sized stocks chosen for market size, liquidity, and industry group representation. It is a market-value-weighted index with each stock's weight in the index proportionate to its market value. You cannot invest directly in an index.

**Standard & Poor's 500 Index (S&P 500 Index)** consists of 500 stocks chosen for market size, liquidity, and industry group representation. It is a market-value-weighted index with each stock's weight in the index proportionate to its market value. You cannot invest directly in an index.

**U.K. Bank of England Official Bank Rate (UKBRBASE Index)** tracks the interest rate set by the Bank of England's Monetary Policy Committee, central to the U.K.'s monetary policy and financial system. You cannot invest directly in an index.

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