Principal Asset Management℠

Principal Fixed Income

THIRD QUARTER 2026

Fixed income perspectives

Income, resilience, and selectivity

Introduction

Fixed income enters 3Q with yields elevated but a path forward far less settled. Earlier expectations for a steady Federal Reserve easing cycle have given way to a more complicated backdrop, with inflation still above target, energy prices exposed to Middle East tensions, and policy flexibility more constrained if growth slows. Against that backdrop, bonds can still offer meaningful income. However, the more compelling opportunity is to capture elevated income while staying disciplined on duration, policy risk, and credit exposure. Higher yields and modestly wider spreads have improved compensation in parts of the market, but tighter valuations and a more uncertain macro path make selectivity increasingly important across sectors and issuers.

Policy volatility: Income opportunity amid an uncertain path

Rate volatility remains the central risk heading into 3Q, as markets reassess the path of Federal Reserve policy. Earlier confidence around cuts has shifted to a more cautious outlook, with inflation, energy prices, and geopolitical developments keeping higher-for-longer rates in view. Elevated yields continue to support demand and reinforce income, but also heighten sensitivity to policy expectations. Duration positioning should remain measured, emphasizing carry, curve discipline, and sectors that can withstand volatility.

Credit fundamentals: Resilient, but increasingly differentiated

Credit fundamentals in the fixed income market remain broadly supportive, with healthy corporate balance sheets, solid earnings, contained defaults, and stable cash flows across municipal, securitized, and private credit markets. Still, resilience is becoming more differentiated. Higher rates, cost pressures, and geopolitical uncertainty affect borrowers unevenly, increasing sector and issuer dispersion. This backdrop favors active security selection, with emphasis on credible balance sheets, durable cash flows, strong structures, and appropriate compensation for the risks being taken.

Valuations: Strong demand, tighter margins

The valuation backdrop entering 3Q is less forgiving. Demand for income remains strong and has absorbed heavy issuance, but spreads are tight across much of the fixed income market, leaving limited room for further compression. Opportunities remain where income is attractive and fundamentals are stable, but returns are increasingly tied to carry, relative value, and issuer-level selection rather than broad-market beta.

What's inside

MICHAEL GOOSAY
Chief Investment Officer,
Fixed Income

Perspectives from the CIO

Today's fixed income market is in a relatively strong position, though not an uncomplicated one. Yields remain attractive, fundamentals are broadly healthy, and demand for income continues to provide important support across the market. That combination gives investors a solid starting point. It also means a meaningful portion of the good news is already reflected in valuations.

That is particularly evident in credit spreads, which are tight across much of the fixed income universe. Tight spreads do not, by themselves, signal a problem. They do, however, reduce the margin for error. The opportunity remains compelling, but in today's market, investors need to ensure they are appropriately compensated for the specific risks they take.

Rate volatility remains the central risk

The main complication is the path of rates. Markets have moved from confidently anticipating Federal Reserve cuts to again debating whether policy may need to stay restrictive for longer. Inflation has moderated but remains a risk, and geopolitical developments could complicate the path ahead. That sensitivity matters across sectors, especially where rate volatility can affect flows, duration, or carry.

Technicals are supportive, but valuations leave less room for error

Still, this is not a market defined by broad fundamental deterioration. Corporate balance sheets remain generally sound, defaults are contained, and all-in yields continue to draw investors back into the asset class. Technical support also remains meaningful, with demand helping absorb supply across many parts of the market.

Income is still the anchor, but security selection matters more

Our view heading into the third quarter is constructive, but deliberately selective. Income should remain the anchor for fixed income returns into year-end, but security selection matters more when valuations are less forgiving. We continue to favor credits with durable cash flows, credible balance sheets, and structures that compensate investors for liquidity, duration, and credit risk. In an environment like this, discipline is not a defensive posture; it is the way to preserve the opportunity.

Bottom line: Own fixed income with discipline

Fixed income still deserves a meaningful place in portfolios, but this is not a market where investors want to be paid "average" compensation for above-average risk. The income opportunity is real, but tighter spreads leave less room for imprecision. From here, we would rather be selective, patient, and well-compensated than reach for yield in places where the upside feels largely captured. That may sound cautious, but in our experience, this is exactly the kind of market where discipline tends to matter most.

Summary of investment implications

INVESTMENT GRADE CREDIT

Investment grade credit remains on solid footing, supported by resilient consumer spending, AI-related productivity gains, healthy corporate fundamentals, and strong earnings growth. Demand has stayed firm as elevated Treasury yields keep all-in yields attractive, helping the market absorb heavy issuance tied to AI hyperscalers, bank funding, and M&A activity. However, tight spreads leave limited room for broad-based compression or issuer-specific disappointment. As a result, disciplined security selection is increasingly important, with emphasis on issuers that have strong balance sheets, clear deleveraging paths, and attractive relative value.

HIGH YIELD CREDIT

High yield remains notably stable despite geopolitical volatility, supported by strong fundamentals, shorter duration, and persistent demand for income. Spreads have widened only modestly, while yields in the low-7% range continue to attract investors and keep flows steady. Issuance has increased but remains manageable, with new deals generally well absorbed. With spreads compressed, broad beta is less compelling, making issuer-level selectivity and downside risk mitigation essential. The outlook is constructive, though geopolitical risks, inflation pressure, and liability management activity require active oversight.

SECURITIZED DEBT

Securitized debt remains constructive but uneven, with rates and shifting Fed expectations continuing to drive performance. Higher yields and renewed concerns about tighter policy have pressured mortgage-backed securities, though convexity risk appears more contained than in past cycles. Technicals are supportive, as limited refinancing and muted housing activity have kept mortgage supply low, while demand continues to absorb ABS, RMBS, and CMBS issuance. Fundamentals remain generally stable, though lower-income consumer borrowers and subprime auto loans require monitoring. From here, returns are likely to be driven by income and credit selection.

MUNICIPALS

Municipal bonds enter the second half with strong technical support, as record issuance has been met by near-record demand from funds, ETFs, separately managed accounts, and seasonal reinvestment flows. Elevated yields continue to make after-tax income compelling, particularly as tax discussions raise the value of municipals' income advantage. Still, tight spreads require disciplined issuer selection. The outlook remains constructive, with rate volatility the primary external risk to monitor.

EMERGING MARKET DEBT

Emerging market debt continues to trade well, supported by firm global risk appetite, resilient carry, and lower volatility. However, tighter valuations suggest future returns will rely less on broad spread compression and more on income capture, rate management, and differentiated country and issuer selection. The macro backdrop is supportive but uneven, with strong U.S. growth and AI-related investment underpinning sentiment, while persistent inflation and energy dynamics complicate the rate outlook. Shorter duration, selective currency exposure, and idiosyncratic opportunities across countries and sectors are most attractive.

PRIVATE CREDIT

Private credit continues to benefit from resilient economic conditions, healthy deal flow, and steady sponsor activity. Momentum remains strong as uncertainty eases, valuations hold up, and sponsors look to deploy capital and realize gains. The asset class's floating-rate structure provides limited duration sensitivity and supports income as rates shift. Improved lender discipline is creating better structures, lower leverage, and more attractive pricing, particularly in the middle market. The outlook is constructive, but selectivity and underwriting discipline remain essential.

Macro

U.S. outlook

The Federal Reserve is entering a new leadership regime at a difficult moment. Core inflation has remained above the Fed's 2% target for more than five years, the labor market may be showing signs of re-acceleration, and political pressure for rate cuts is likely to build. For newly installed Chairman Warsh, the challenge is that both sides of the Fed's dual mandate are still arguing against easier policy, even as markets continue to debate whether the next move should be a cut, a pause, or something more hawkish.

Fed policy expectations have shifted, but spreads are relatively steady

That uncertainty has already shown up in market pricing. At the onset of the Iran conflict, fed funds futures implied more than 2.5 rate cuts by year end. Since then, expectations have reversed, with markets now pricing in roughly 1.5 rate hikes—a swing of about 100 basis points in the expected policy path.

Credit spreads have remained relatively stable despite elevated geopolitical uncertainty. However, the sharp repricing in Fed expectations has become a headwind for fixed income returns, particularly as investors reassess whether the economy still needs restrictive policy. Looking ahead, all eyes will be on the incoming data to see whether it validates the market's more hawkish tilt or whether expectations have moved too far, too fast.

The labor market may be rebounding, but is it temporary?

Recent labor market indicators have indeed shown signs of firming. That said, year-over-year labor force growth remains close to zero, and there's evidence that World Cup–related activity may be temporarily boosting hiring. Two categories—state and local government excluding education, and hospitality, including bars, restaurants, and hotels—have accounted for most of the recent improvement. If that strength is tied to temporary visitor-driven demand, it could fade quickly once the tournament concludes.

Inflation continues—stubbornly above target

Turning to inflation, year-over-year core PCE has been trending higher throughout 2026, and elevated energy prices have become a central concern for market participants. That limits Chairman Warsh's room to deliver politically popular rate cuts. Still, the inflation picture is not one-sided.

There are reasons to expect some moderation in inflation ahead. Inflation data in recent years has shown a seasonal pattern, with hotter first-quarter readings followed by softer results throughout the rest of the year. Shelter inflation has also been gradually improving, and leading indicators point to further easing. Tariff-related pressures may be fading as well: tariff revenue has peaked and begun to decelerate, while earlier tariff effects are starting to roll out of year-over-year comparisons.

Fed is likely to stay put, allowing itself to respond if needed

Against that backdrop, we do not believe rate hikes are warranted at this stage. The better path is patience. If inflation continues to moderate gradually, as we expect, the case for further tightening should weaken, giving the Fed more flexibility to respond if growth or labor market conditions soften.

For fixed income investors, that creates an important asymmetry. The duration headwinds that have weighed on returns throughout 2026 could ease, and potentially reverse, if markets begin to price out the need for additional hikes.

Global outlook

The global macro backdrop has improved, supported by easing geopolitical risk and continued U.S. resilience. Domestic demand remains firm, and the U.S. is still outperforming most developed peers. Outside the U.S., however, momentum looks less durable as earlier strength from inventory rebuilding and safety stocking begins to fade. That leaves investors with a more constructive backdrop than earlier in the year, but not one that justifies complacency. The key question is whether recent improvements can extend the risk rally, or whether markets have already priced in too much good news. With valuations no longer uniformly cheap, the margin for disappointment has narrowed.

Policy expectations remain the swing factor

The Federal Reserve remains central to that debate, but for global markets, the issue is less about the precise path of rates than whether financial conditions tighten enough to challenge growth. Markets have shifted toward a more restrictive interpretation of Fed policy intentions, weighing on duration-sensitive assets.

That may prove too aggressive if inflation moderates and growth cools without a sharper labor-market downturn. In that scenario, the Fed could remain patient rather than validate the market's more hawkish assumptions, which would support risk assets and fixed income. It would also

Global outlook continued

give investors more room to look through short-term volatility. Still, sticky inflation or renewed energy pressure could keep policy caution in place.

Oil is helping, but geopolitics remain unsettled

Geopolitical risk has also become less one-directional. The Middle East remains fluid, but lower oil prices suggest markets see a reduced risk of broader escalation or deeper U.S. involvement. That matters because lower oil would ease one source of inflation pressure, support real incomes, and reduce the need for central banks to stay defensive.

Even so, a calmer oil backdrop does not eliminate the risk of renewed volatility if negotiations stall or regional tensions re-escalate.

Regional risks are shifting

The U.S. still looks fundamentally stronger than most regions, but it may carry more political risk than markets are discounting. The midterm election cycle is not yet a major focus, creating room for surprise if fiscal, regulatory, or trade headlines become more disruptive.

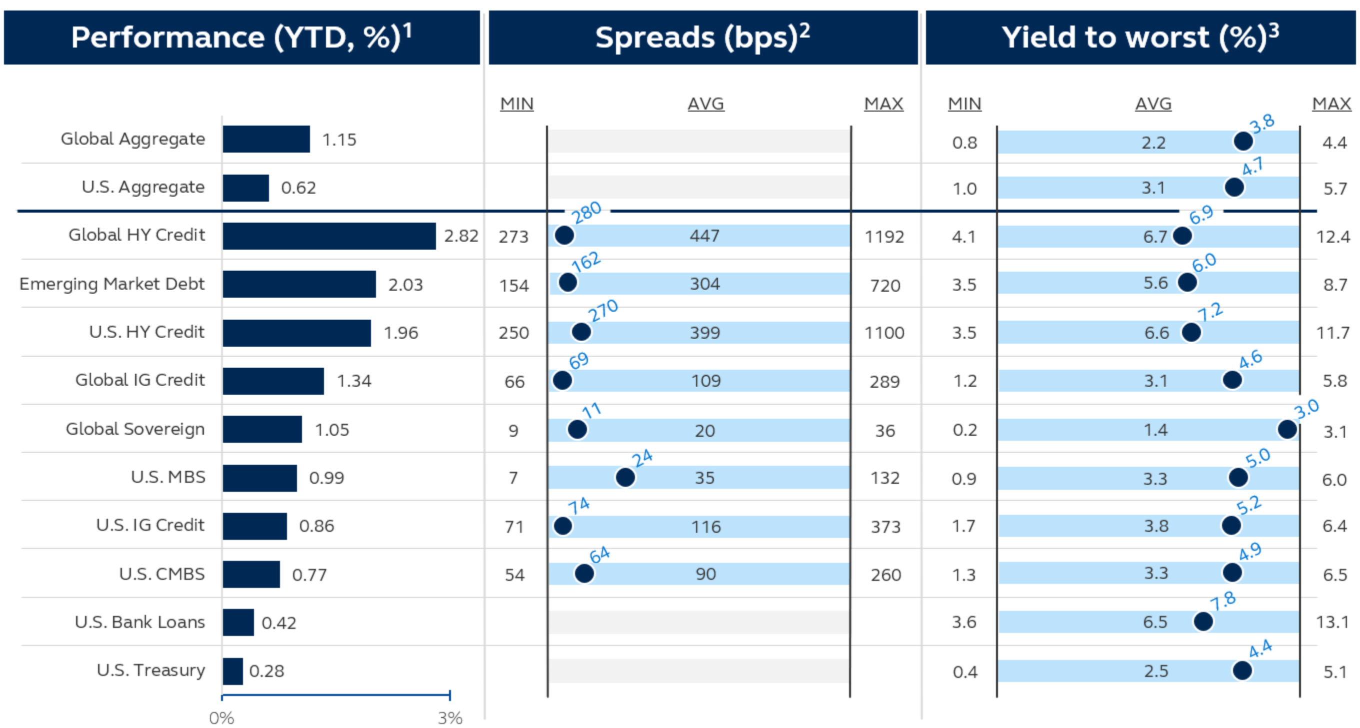
Europe presents a different mix of risks. Political headlines remain noisy, especially in the UK and parts of continental Europe, but the macro setup looks less fragile than it did earlier in the year. Growth may soften as front-loaded demand fades, yet that could reinforce the need for additional fiscal support and leave room for a better second-half profile, particularly if inflation continues to ease.

A more constructive, but still selective, outlook

Overall, the global outlook has become clearer and somewhat more supportive. Easing geopolitical stress, lower oil prices, and the possibility that markets have overestimated the need for tighter policy all point to a better near-term backdrop. But inflation risk, political uncertainty, and uneven regional growth still argue for a selective approach, with more confidence in high-quality assets and areas where valuations already reflect caution rather than perfection.

Market environment

Year-to-date performance, spread, and yield for various fixed income indices



[1] Total returns for representative indices. [2] Spread to Treasury. Min, max, and average based on last 10 years. [3] Index yield to worst. Min, max, and average based on last 10 years. Weighted average yield-to-maturity reflected for U.S. Bank Loans. Indices are unmanaged and do not take into account fees, expenses, and transaction costs, and it is not possible to invest in an index.

Source: Bloomberg, Principal Asset Management. Data are as of June 30, 2026.

Investment grade credit

Investment grade credit remains in a remarkably solid state. Resilient consumer spending, productivity gains tied to AI investment, and supportive fiscal dynamics continue to frame the macro backdrop, while corporate fundamentals remain healthy. Earnings growth has been solid, margins have held up well, and many issuers are funding capital expenditures internally rather than leaning predominantly on debt markets.

The sustained stability of IG has set up a situation where valuations reflect this strength. Spreads have remained in a narrow and tighter range, leaving less room for broad-based compression and, by extension, little cushion for issuer-specific disappointment. Still, the asset class has continued to deliver what investors have come to expect from high-quality fixed income: namely income, better volatility absorption than many risk assets, and a portfolio ballast during periods of market stress.

Demand supporting a heavy supply

Demand continues to serve as a key anchor. Elevated Treasury yields have supported all-in yields in the asset class, underpinning strong investor interest even as spreads remain relatively tight. This appetite has proven sufficient to absorb a prolific issuance calendar. Gross supply is tracking toward potentially record levels, yet market technicals remain healthy, supported by strong inflows and the reinvestment of coupon income and maturities. Issuance tied to AI hyperscalers, bank funding needs, and an active M&A pipeline has been significant, though some of the largest issuers have already addressed a meaningful portion of their anticipated funding requirements. In addition, overseas funding markets have provided incremental relief for debt financing and, on the margin, eased dollar-denominated supply pressures.

Selectivity becomes critical

In this stable environment, our focus has shifted intently toward selectivity. Tight spreads leave little margin for error, sharpening the focus of disciplined security selection and active management. As a result, our emphasis centers on identifying issuers with clear deleveraging paths, strong balance sheets, and attractive relative value. Sector views remain nuanced. To that end, banks and the aerospace and defense sectors stand out for their supportive fundamentals, though differentiation within each remains critical. Even in less favored industries, select issuers with improving credit profiles continue to offer opportunities. Conversely, industries and issuers with greater uncertainty around fundamentals or pricing require a cautious approach, with a preference for more stable names.

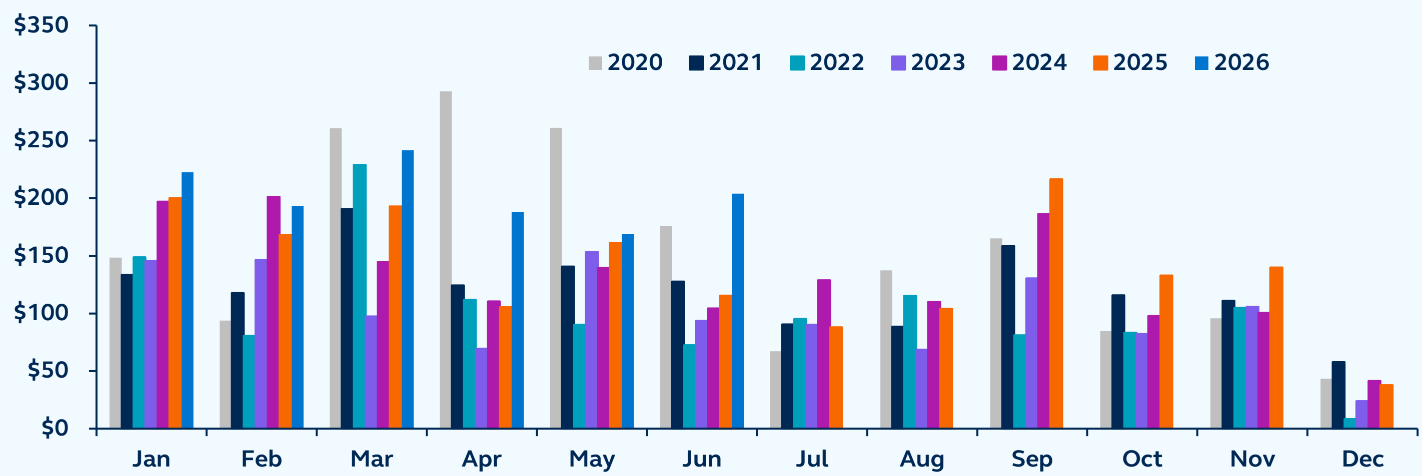
Positioning along the curve reflects a similar balance. The belly of the curve remains our preferred area, supported by carry and roll-down potential. At the same time, duration positioning in the aggregate stays close to neutral, with a slight bias toward longer duration.

Investor implications

Looking ahead, the outlook continues to be favorable but measured. The investment grade asset class has demonstrated resilience through a remarkable range of market conditions, supported by steady demand and strong fundamentals. The main risk hinges on interest rate volatility, particularly if yields move sharply in either direction, which could disrupt both demand and issuance dynamics. Nonetheless, the environment continues to favor a disciplined, selective approach as investors seek to capture income while managing downside risk.

Investment grade monthly supply

$Billions, 2020–YTD 2026



Source: Bloomberg, Principal Asset Management. Data as of June 30, 2026.

High yield

Recently, markets have had no shortage of reasons to reprice risk. Geopolitical developments, particularly in the Middle East, have added another layer of uncertainty to an already unsettled backdrop, driving sharp moves across equities and rates. Yet high yield has largely refused to follow the script. Spreads have widened only modestly from recent tights and continue to trade in a narrow range, leaving investors with a market that feels unusually steady given the noise around it.

Importantly, equities and Treasurys can react quickly to each new headline, but high yield has been anchored by a combination of stable fundamentals, shorter duration, and steady demand for income. The result is a market that has absorbed risk better than many expected, reinforcing high yield's role as a source of carry when broader markets are struggling for direction.

Income and fundamentals underpin demand

Fundamentals, too, remain supportive. First-quarter earnings were strong, and companies have continued to preserve margins by passing through higher costs. At the same time, yields in the low-7% range attract investor demand. In fact, yields are lofty enough so that investors remain reluctant to move to the sidelines given the income available. As a result, flows into the asset class have held steady. Supply has increased but remains manageable with new issuance generally well absorbed and often heavily oversubscribed.

Selectivity over broad exposure

With spreads at compressed levels, selectivity remains the key differentiator. Investors are focused on issuer-level fundamentals and on being appropriately compensated for risk, rather than relying on broad beta. Sector positioning reflects this approach. Financials are of interest, while exposure to consumer cyclicals and housing-related sectors is more limited due to interest rate sensitivity. Our exposure to energy is generally neutral, reflecting caution around oil prices. Utilities and electrification themes continue to draw our attention, supported by structural demand tied to data center growth. In AI and data center issuance, our participation is selective, with a preference for deals backed by high-quality counterparties.

A shorter-duration asset class

High yield remains a shorter-duration market, now closer to a three-year profile versus longer historical averages of over four years. This has reduced sensitivity to rate volatility and helped explain the relative stability in spreads compared to other fixed income sectors amid repetitive doses of geopolitical activity and uncertainty. Issuance continues to be concentrated in the five- to seven-year maturity range, reinforcing this shorter duration profile, and aligning with fixed income's aggregate focus on the belly of the curve.

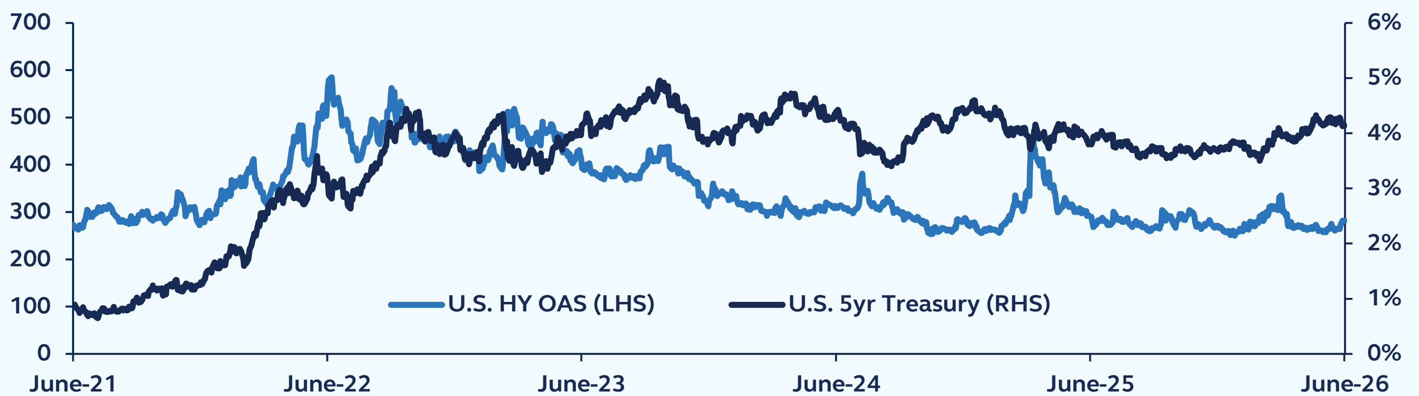
Investor implications

The outlook for high yield remains constructive, supported by attractive yields, steady demand, and low expected default rates. At the same time, risks remain. Reignited geopolitical uncertainty or sustained cost pressures could weigh on fundamentals if inflationary pressures continue to drag on consumer demand.

Another area of focus is the ongoing rise in liability management activity, where companies are actively restructuring balance sheets. Staying engaged in these processes is increasingly important, as outcomes can vary meaningfully depending on capital structure positioning, underscoring the importance of active management in this space. In this environment, downside risk mitigation is crucial. A disciplined, selective approach is likely to be key as investors navigate a market that continues to offer stability, but with less room for error at current spread levels.

High yield spreads vs. Treasury rate volatility

June 2021–June 2026



Source: Bloomberg, Principal Asset Management. Data as of June 30, 2026.

Securitized debt

Securitized markets continue to be shaped primarily by rates and evolving Fed expectations. That may sound familiar, but the backdrop has shifted significantly: markets have moved from expecting Fed cuts to again considering the possibility of higher rates. That repricing has pushed yields higher and put pressure on mortgage-backed securities, especially those with greater negative convexity.

Convexity remains a key risk, but its impact appears more contained today. The largest historical hedgers, i.e., GSEs, are less active today, and a meaningful share of the market is held by investors who do not hedge, i.e., the Fed. That reduces the likelihood of large, forced hedging flows, even though rate volatility still matters for performance and positioning.

The result is a market that remains constructive, but uneven. The wings of the coupon spectrum have held up better, while the belly of the curve has been under more pressure. Still, securitized assets have continued to outperform Treasurys on an excess return basis, supported by carry and broadly stable fundamentals.

Supportive technicals, steady supply trends

Technicals remain constructive. Net mortgage supply is still relatively low, with limited refinancing and muted housing activity keeping conventional issuance subdued. While ARM origination has accelerated, much of that supply is being retained on bank balance sheets rather than sold to the securitized market.

Across sectors, issuance trends are mixed. ABS supply remains firm, supported by consumer borrowing and strong investor demand for assets with lower correlation to corporates. RMBS and CMBS issuance may moderate if rates remain elevated and refinancing becomes more challenging. Overall, demand continues to absorb supply effectively.

Fundamentals remain largely intact

Fundamentals across securitized assets remain stable. Mortgage cash flows are predictable, with much of the index locked into low coupons that limit near-term refinancing risk. Consumer lending, by contrast, shows more divergence. Higher-income borrowers continue to perform well, while lower-income cohorts remain under pressure, particularly in subprime auto, where delinquencies are elevated. This contrast has been consistent for several quarters and is unlikely to abate as the K-shaped U.S. economy continues. At this stage, these trends are being monitored but aren't signaling broader stress, and most structures include sufficient credit enhancement.

Within commercial real estate, fundamentals are improving, with valuations and income stabilizing. Refinancing remains a key watch point, especially if rates stay higher for longer.

Positioning and sector preferences

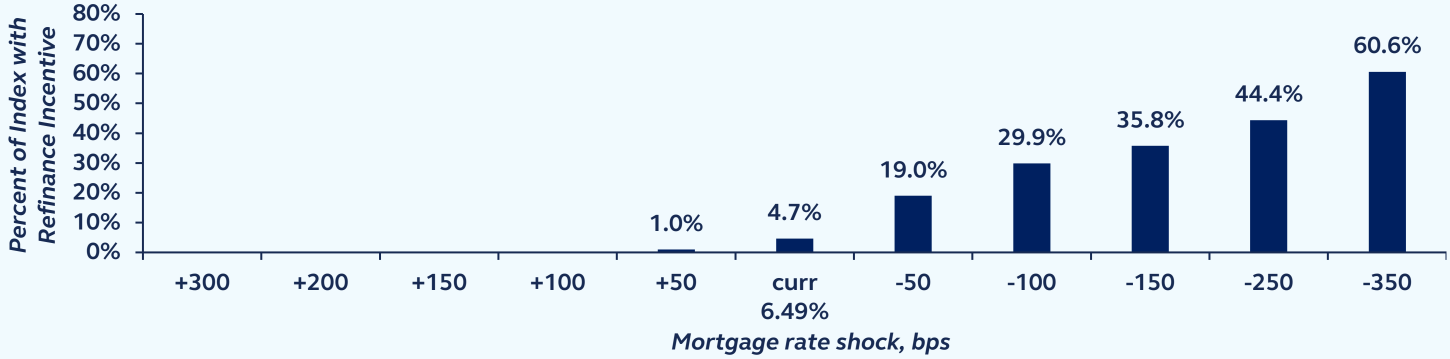
Positioning remains focused toward the front end of the curve, particularly the two- to five-year segment, while overall duration is kept close to neutral. Sector preferences lean toward higher quality exposure. In ABS, non-consumer and prime collateral are favored, while consumer exposure is more selective. In CMBS, we favor higher-quality single-asset structures. There is also interest in certain asset-backed segments, including established data center assets with proven cash flows.

Investor implications

The primary risk remains tied to rates, particularly any unexpected shift toward more aggressive tightening that would increase volatility. Even without policy changes, shifts in expectations can move the market. Overall, the outlook is balanced. Fundamentals and technicals remain supportive, but valuations are generally fair. In this environment, returns are likely to be driven by income and careful credit selection rather than broad spread compression.

Mortgage index refinanceability

Bloomberg MBS Total Return Index



Source: Bloomberg, Principal Asset Management. Data as of June 5, 2026.

Municipal bonds

Municipal bonds enter the second half of the year with an unusually supportive backdrop, but also one that should not be mistaken for a risk-free setup. Record issuance has been absorbed by near-record demand, leaving the market in a rare high-supply, high-demand equilibrium. Flows into mutual funds, ETFs, and separately managed accounts remain robust, while seasonal reinvestment demand from maturities, calls, and income is tracking near historic highs through the summer months. That technical strength is a clear positive, but it also raises the bar for selectivity: with valuations well supported and spreads tight, investors need to be thoughtful about where they are taking duration, credit, and structure risk.

Income remains the primary driver

From a broader perspective, municipals stand out for their combination of income, credit quality, and diversification, which continues to attract both retail and institutional interest. The core story continues to be income. With yields elevated, municipals offer compelling after-tax income relative to other asset classes. That advantage becomes even more meaningful as the discussion around higher taxes at the state and local levels continues to build.

Positioning and sector views with a selective approach

Our positioning remains focused on the belly of the curve, and issuance has been concentrated there. That kept yields in the middle of the curve elevated relative to other maturities, supporting the segment's attractiveness.

Sector allocation continues to favor revenue bonds over general obligation bonds. Revenue bonds offer higher yields and are often supported by more stable, self-funding essential service sectors such as transportation and utilities, which generate consistent cash flows. Still, caution is warranted around certain areas, such as education (especially smaller private colleges and charter schools), and more idiosyncratic healthcare credits. As always, we seek to be compensated for risk and avoid areas where fundamentals are more uncertain.

With credit spreads tight, selectivity is increasingly important. The focus is on finding relative value at the issuer level and ensuring appropriate compensation for both credit and structure risk. This typically involves pairing higher-quality exposure with select opportunities where spreads remain more attractive, while remaining disciplined on pricing.

Risks remain externally driven

Current primary risks to the municipal market tend to be macro rather than credit-specific. Interest rate volatility is the most important factor to watch, particularly if it materializes through an unexpected and aggressive Federal Reserve tightening cycle in response to energy-related inflationary pressures. A rapid rise in rates could disrupt demand, especially given the retail-driven nature of the asset class, where investor sentiment can shift quickly in response to headlines.

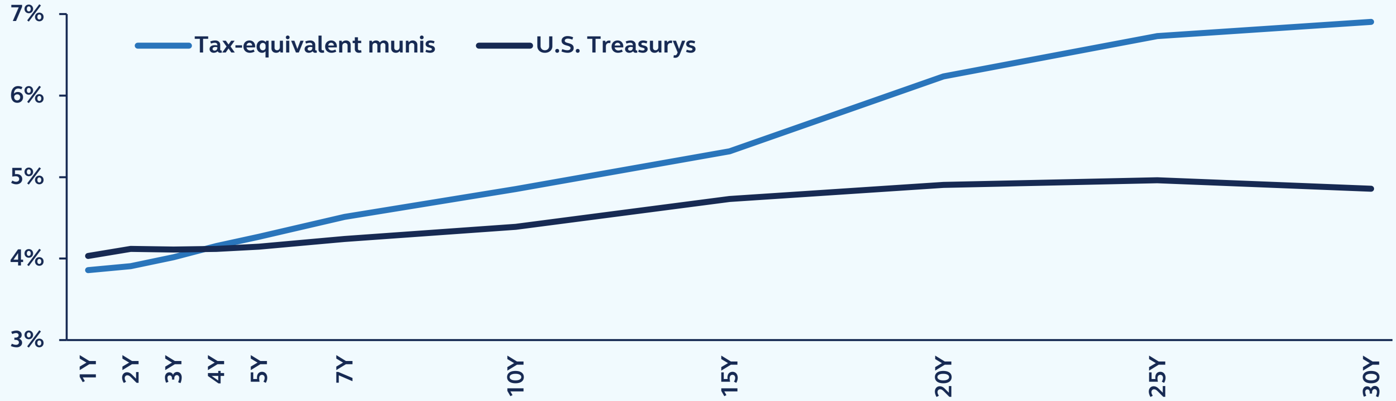
Investor implications

Overall, the outlook for municipals remains encouraging. The asset class continues to benefit from strong technical support, attractive income levels, and a favorable relative-value profile, now that the sector's tax status has been settled by the One Big Beautiful Bill. While risks are present, particularly around the path of rates, they are largely external and do not detract from the underlying strength of the market.

In this environment, a disciplined and selective approach remains critical. Investors who focus on income, relative value, and careful credit selection are well-positioned to take advantage of the current opportunity set in municipal bonds.

Tax-equivalent AAA municipal yields vs. U.S. Treasurys

Yield curves as of June 30, 2026



Source: Bloomberg, Principal Asset Management. Data as of June 30, 2026.

Emerging market debt

Emerging market debt continues to trade well, supported by a strong risk backdrop and resilient carry. Despite geopolitical uncertainty, spreads have tightened, volatility has declined, and the U.S. dollar has remained broadly stable versus EMFX. As a result, carry in hard and local currency assets remains the primary driver of returns.

With valuations reflecting this strength, future returns should depend less on broad gains in duration, spreads, or FX and more on income from short- to mid-duration credit and local bonds with attractive carry-to-volatility profiles. Selective idiosyncratic alpha, active rate and FX management, and tactical mitigation via CDS indices should also play a larger role.

Macro forces remain mixed

The macro backdrop remains supportive but differentiated. Strong U.S. growth, helped by AI-related investment and resilient earnings, supports risk sentiment, while persistent inflation tied partly to energy and geopolitics keeps central banks cautious.

Sovereign and corporate spreads are tight versus history, though they may grind tighter absent a major shock. EM local rates offer better value where central bank credibility remains solid, and EMFX volatility remains manageable as geopolitical risk stabilizes.

Oil remains central to inflation expectations and rates. While prices fell after the U.S.-Iran memorandum of understanding, low inventories may create a floor, sustaining near-term inflation and weighing on margins and consumers.

Income focus and selective positioning

Against this backdrop, the focus remains on income and low correlated alpha across relative value and asymmetric event-driven EM sovereign and corporate opportunities.

Short- to mid-duration assets offer an attractive balance between carry and volatility, particularly when the direction of rates is uncertain. Duration exposure remains measured, as further yield increases could create headwinds. Currency positioning is also selective. Opportunities remain in EMFX carry and relative-value trades, including Brazil and frontier markets such as Egypt, Nigeria, and Turkey, while exposure remains balanced amid a more stable dollar outlook.

Idiosyncratic opportunities drive returns

EMD continues to offer thematic opportunities across segments. Short- to mid-duration corporates remain compelling in areas such as African and Caribbean telecoms, Brazilian oil services, and Mexican IPPs. The Uzbek complex offers a BB terms-of-trade opportunity, while positive asymmetries remain in restructured or potentially restructuring sovereign debt, including Ukraine, Argentina, and Venezuela.

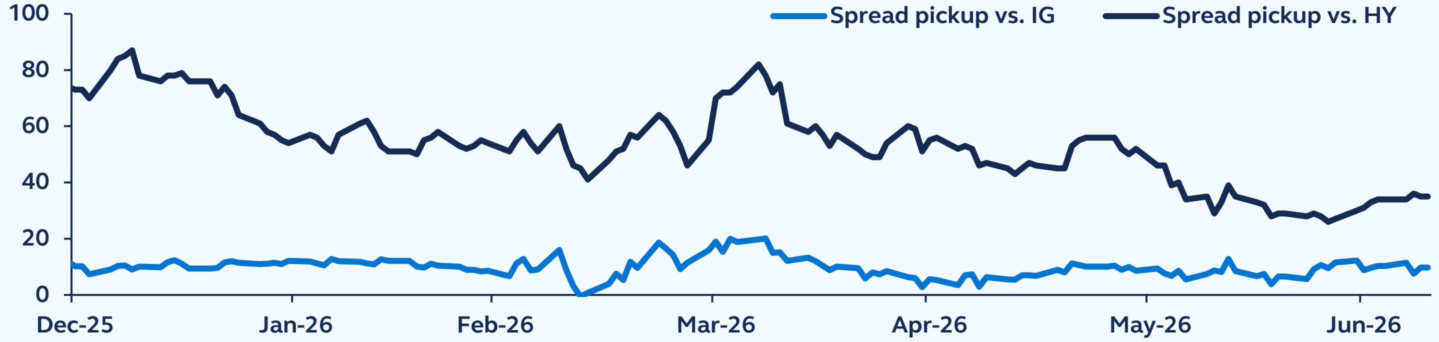
In local rates, elevated real yields continue to support carry, especially with the dollar unlikely to revisit 2024 highs. Elections may create positive event risk in Hungary, Peru, Colombia, Brazil, and Israel. EM currencies remain differentiated: Asia offers AI-related externalities despite low yields, CE4 currencies retain a yield advantage versus the euro, frontier FX remains high carry, and Brazil and Mexico continue to offer attractive carry-to-volatility profiles.

Investor implications

The outlook remains positive but balanced after the Iran conflict. EMD remains under-owned and offers a compelling income profile. With spreads tight, hard currency credit should remain primarily a yield proposition focused on shorter-duration assets. Local rates offer better value, while EMFX retains long and short opportunities as benign risk conditions allow country-specific factors to reassert themselves. That points to portfolios emphasizing carry in hard currency short-duration bonds and local debt, alongside differentiated alpha from elections and other event risks. Directional beta from spreads, U.S. duration, and FX should remain moderate, though conviction supports low cash balances.

Emerging market debt spread pickup

Basis points, option-adjusted spread, YTD 2026



Source: Bloomberg, Principal Asset Management. Data as of June 30, 2026.

Private credit

Private credit continues to benefit from a constructive backdrop, supported by resilient economic conditions and steady private equity sponsor and non-sponsor activity. Momentum remained strong through the first half of the year and should carry into the second half as uncertainty eases. Sponsors also remain motivated to deploy capital and realize gains, while valuations have held up despite modest rate moves.

A focus on resilient business models

Positioning remains focused on service-oriented industries, where cash flows tend to be stable and less exposed to cyclical headwinds. Commercial and professional services—including commercial landscaping, waste management, non-discretionary testing, inspection, maintenance and repair, and traffic safety—represent a meaningful overweight, reflecting confidence in business models capable of sustaining earnings growth.

By contrast, software exposure remains limited. The issue is not a broad rejection of the sector, as existing positions continue to perform well, but a matter of balancing valuation, growth expectations, and downside mitigation. With some software businesses at risk of displacement from AI, the emphasis remains on cash-flow lending rather than annual recurring revenue-based deals, as well as critical software with sticky customer relationships.

Structural advantages in a shifting rate environment

The floating-rate structure of private credit remains a key advantage. With limited duration exposure, portfolios are less sensitive to rate moves, while income profiles can adjust as rates shift. This has helped the asset class maintain positive performance and deliver diversification and correlation benefits relative to traditional fixed income.

Repayment activity, which slowed in prior periods, is beginning to normalize. As transaction activity improves, repayment speeds are gradually returning toward historical averages. Strong origination is allowing capital to be redeployed into new opportunities without disruption.

Improving discipline and better opportunity sets

One constructive development has been the return of greater lender discipline. Recent headlines, particularly in larger-cap transactions, have introduced more caution. Rather than weakening the outlook, that caution is helping reset expectations around pricing, leverage, and structure. That shift has created a more favorable supply-and-demand dynamic across private credit, with particular benefit to lenders focused on the lower and core middle market. New deals are coming to market with stronger structures, lower leverage, and more attractive pricing than in recent vintages.

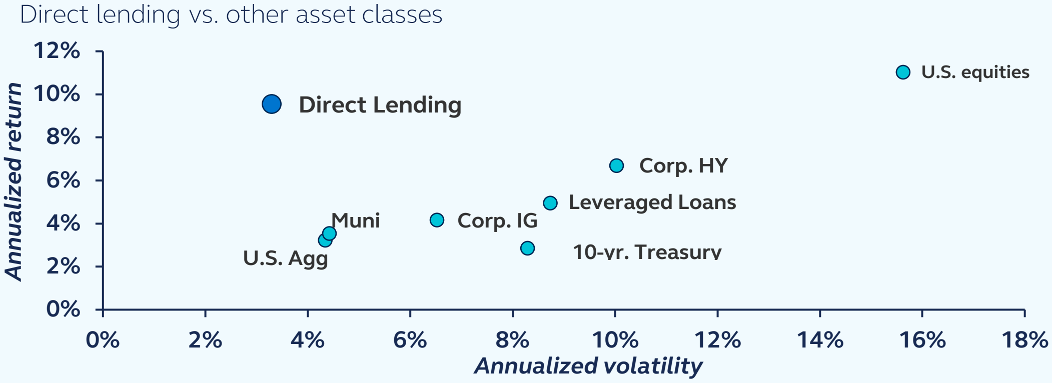
Investor implications

The outlook remains constructive, supported by strong deal flow, improving fundamentals, and sustained institutional interest. While demand continues to broaden, investors are becoming more discerning in how they allocate across segments, with particular focus on lower and core middle market direct lending. The primary risks remain macro-driven. While not our base case, tighter Fed policy, weaker growth, or a broader change in market sentiment could weigh on activity levels. Private credit is less exposed to daily liquidity pressures than public markets, but tighter financial conditions could still affect borrower fundamentals, valuations, and exit activity.

Overall, private credit remains well-positioned, but the opportunity is becoming more selective. Rather than relying on broad asset-class exposure, investors may be better served by managers who can identify resilient borrowers, structure deals with appropriate covenant protections, and maintain discipline in pricing and leverage. That selectivity will be key to capturing attractive income and return potential while navigating a more complex market environment.

Historical risk/return since 2004

Direct lending vs. other asset classes



Correlation

Direct lending vs.

Corp. IG	0.21
Muni	0.12
U.S. Agg	-0.15
10-year Treasury	-0.50

As of December 31, 2025. *Since inception of Cliffwater Direct Lending index on September 30, 2004. Sources: Bloomberg, Cliffwater Direct Lending Index, S&P 500 S&P/LSTA Leverage Loan Index, Bloomberg U.S. Aggregate Bond Index, Bloomberg U.S. Municipal Index, Bloomberg U.S. Corporate Bond Index, Bloomberg U.S. Corporate High Yield Index, Private Equity Total Return Index USD. Risk measured as standard deviation of quarterly returns. This chart is designed to show the amount of volatility compared to the annualized returns of the asset classes and is not intended to show the credit quality of the asset class itself.

Forward-looking sector views

	Underweight		Neutral	Overweight	
	— —	—	=	+	+ +
Investment grade					
U.S. agency MBS	○	○	●	○	○
CMBS	○	○	○	○ →	●
ABS	○	○	○	○ →	●
Mortgage credit	○	○	●	○	○
U.S. credit	○	○	○	●	○
European credit	○	○	●	○	○
Asia credit	○	○	●	○	○
Municipals	○	○	○	●	○
High yield					
U.S. credit	○	○	●	← ○	○
U.S. bank loans	○	○ →	●	○	○
European credit	○	○ →	●	○	○
Asia credit	○	●	○	○	○
Emerging market debt					
Hard currency	○	●	○	○	○
Local currency	○	●	○	○	○
Corporates	○	●	○	○	○
Alternatives					
Direct lending	○	○	○	●	○
Investment grade private credit	○	○	○	●	○

As of June 30, 2026. The above views reflect the relative value of the sectors shown based on forward-looking return expectations over the next 12 months. Arrows represent the quarter-over-quarter change in forward-looking views.

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The creation of the fixed income outlook is a collaborative effort led by the Principal Fixed Income Investment Strategy Group. The Investment Strategy Group comprises the senior-most investment professionals across the platform. It is responsible for identifying the key macroeconomic factors that are most likely to drive investment performance across global fixed income markets. Output from the Investment Strategy Group is formalized through Principal's proprietary Macro Risk Outlook framework and informs investment processes across the platform, acting as a top-down complement to the platform's bottom-up fundamental research capability.

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