

Principal Fixed Income

SECOND QUARTER 2026

Fixed income perspectives

Policy, conflict, and credit

Introduction

At the start of the year, the macro environment was defined by resilient growth and moderating inflation—supporting expectations for gradual Fed rate cuts. Combined with attractive starting yields, this created a constructive backdrop for fixed income. That outlook has shifted with the escalation of conflict in the Middle East. With inflation still running above the Fed’s target, higher energy prices risk limiting the Fed’s ability to respond if growth slows or labor market conditions weaken. For now, economic growth and credit fundamentals remain intact, but the path forward is less certain. Despite heightened volatility, investor demand for income and portfolio ballast has not abated. While the conflict has pushed rates higher and modestly widened credit spreads, elevated yields provide improved compensation and support continued allocations to bonds.

Policy volatility: Navigating geopolitical and economic challenges

The current environment is marked by geopolitical volatility, as markets grapple with the war in Iran, surging oil and gasoline prices amid already sticky inflationary pressures, and a complicated U.S. labor market. The Fed’s easing cycle, occurring amid sustained inflation exacerbated by geopolitical tensions (with Iran now top of the list), creates a backdrop of uncertainty. This scenario complicates investor sentiment and contributes to a steepening yield curve. While this can create opportunities for agile investors, it also calls for close risk monitoring.

Credit fundamentals: Resilience amidst market dynamics

From a credit perspective, resilience is key. We believe that investors should maintain a focus on robust technicals and credit fundamentals while remaining attentive to the overall economic conditions. Companies still have healthy balance sheets, and earnings are running above expectations. Nevertheless, geopolitical headline risks, primarily the war in the Middle East, and lingering trade sensitivities can lead to significant sector dispersion, underscoring the importance of active issuer selection and credit discipline.

Valuations: Spreads widen in response to the Iran war and supply

Valuations present a complex picture as spreads widened in the first months of the year, driven by a surge in new issuance and uncertainty surrounding the war in Iran. While further spread widening is possible as the war continues, opportunities persist, especially within municipal bonds, investment grade credit, and high yield. As geopolitical and Fed policy uncertainty continue, careful security selection is critical. In this environment, disciplined active management will be essential to identify durable income, manage downside risks, and capture pockets of value amid ongoing volatility.

What’s inside

Perspectives from the CIO	2
Macro outlook	4
Investment grade credit	6
High yield credit	7
Securitized debt	8
Municipals	9
Emerging market debt	10
Private credit	11
Forward-looking sector views	12



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Perspectives from the CIO

The fixed income outlook is shaped primarily by geopolitical uncertainty—especially the conflict in Iran—which has driven volatile market behavior and elevated near-term risks to inflation. While the underlying economic backdrop entering 2026 was constructive, recent events have produced an erratic market: rates move sharply on news, while credit spreads reflect uncertainty about the implications for growth and inflation. Crude oil volatility has pushed net prices higher year-to-date, increasing the likelihood that headline inflation will drift upward over the next few quarters after a period of improvement. That, in turn, raises the real returns investors demand from fixed income, putting upward pressure on yields and steepening or repricing parts of the yield curve.

The central bank outlook is growing complicated

The earlier central bank divergence—where some central banks (e.g., Japan, Australia) were hiking while others (U.S., UK, Europe) were cutting—has given way to a more complex global picture: all central banks now face difficult choices about easing amid sticky inflation and macro uncertainty. Despite this, our view remains that the Federal Reserve will cut policy rates in 2026. With a new Fed Chair expected in June, the forecast is for one to two rate cuts in the second half of the year, driven by softer employment data and a tolerance for elevated inflation over time. However, near-term risks from geopolitical developments make the exact timing and magnitude of cuts uncertain.

Credit spreads are also mixed

In credit, corporate fundamentals are generally solid—companies have sound balance sheets and earnings have generally beat expectations—so wider spreads are seen as opportunities for selective investment rather than signals of systemic weakness. Heavy supply has contributed to spread widening, and geopolitical uncertainty may keep upward pressure on spreads. Emerging market debt faces more pronounced stress due to a stronger U.S. dollar and capital flight into perceived safe-haven developed market assets. At the same time, investment grade credit shows only modest spread widening, while high yield shows more meaningful widening.

Opportunities and risks

Taken together, today's fixed income landscape argues for discipline rather than defensiveness. While geopolitical risk, most notably in the Middle East, has injected volatility and distorted near-term price signals, there's little evidence that the fundamental pillars of U.S. growth are weakening. As a result, risk repricing has remained largely orderly, creating near term opportunities rather than enduring dislocations. Against this backdrop, we maintain a measured risk-on stance, with a moderate overweight to both risk assets and duration relative to benchmarks, and the flexibility to add exposure opportunistically as spreads widen toward attractive entry points. With Fed cuts increasingly pushed out but not eliminated, rates continue to offer a favorable risk-reward profile, supporting incremental extensions in duration and a preference for curve steepeners as volatility persists. In short, while the path forward may be uneven, fixed income investors are best served by taking risk selectively, guided by fundamentals and adding exposure only when market movements create genuinely attractive opportunities.

Summary of investment implications

INVESTMENT GRADE CREDIT

Investment grade credit appears able to absorb record issuance—now running ahead of forecasts—supported by robust investor demand. The 10-year Treasury remains the fulcrum for yields; with yields likely to stay around or above 4%, attractive carry and rolldown make the five- to ten-year belly of the curve the preferred allocation while keeping aggregate duration near neutral. Fundamentals are broadly supportive: favor deleveraging corporates, select regional and money-center banks with diversified franchises, and aerospace/defense names; avoid consumer cyclicals and food & beverage credits.

HIGH YIELD CREDIT

High yield debt is cautiously constructive, but geopolitical risk, shifting rate expectations, and structural concerns in private credit warrant selectivity. Spread sensitivity to macro and Middle East shocks means episodic volatility may precede durable recoveries. Favor defensive sectors (utilities, banks, select consumer staples) and resilient subsectors like data centers; avoid discretionary consumer-exposed areas (automotive, leisure, airlines) and vulnerable software issuers. Maintain mostly neutral duration, employ sector tilts, and selectively deploy into well-priced primary issuance.

SECURITIZED DEBT

Securitized debt enters the quarter cautiously upbeat. Agency mortgage-backed securities (MBS) saw early spread compression, but rising rates and prepayment risks have clawed back some of the gains. Convexity-protected and credit-enhanced mortgage slices look attractive. Asset-backed securities (ABS) fundamentals are mixed, with high-income consumers supporting some pools, while subprime auto delinquencies remain elevated. CMBS shows recovery potential in SASB and sponsor-backed deals despite office delinquencies. Collateralized loan obligations (CLOs) face headwinds from private credit underwriting and collateral shocks. Favor front-end to five-year duration, high-quality credit selection, infrastructure-linked ABS, and active, disciplined underwriting.

MUNICIPALS

Municipal bonds offer compelling after-tax income and defensive characteristics amid geopolitical and economic uncertainty. Strong retail and growing institutional demand, elevated taxable-equivalent yields, and generally healthy credit fundamentals support price resilience despite elevated supply concentrated in longer maturities. Risks include state-level revenue sensitivity, stressed general obligation credits, and macro-driven hits to capital-gains-dependent tax receipts. Tactical positioning should be neutral-to-moderately extended duration with careful issuer selection, credit differentiation, and avoidance of overconcentration in politically or fiscally vulnerable GOs.

EMERGING MARKET DEBT

Emerging market debt faces greater uncertainty as the Middle East war and energy shocks raise a new, higher oil-price floor. Higher energy costs are inflationary (especially for importers), which limits central banks' ability to ease and raising currency risks. Oil exporters may benefit from windfalls, while importers and remittance-dependent countries face balance of payments strain. Fiscal pressures and refinancing risks should widen spreads for weaker issuers. But persistent yield-seeking flows may favor higher-quality names, increasing market dispersion and rewarding active, selective management.

PRIVATE CREDIT

Private credit faces an inflection point: strong deal flow, durable borrower fundamentals, and rising institutional demand counterbalanced by looser underwriting, liquidity mismatches, and scrutiny, especially among BDCs and broadly syndicated loans where weaker covenants and higher leverage prevail. Discipline favors lower- and core-middle-market direct lenders with rigorous underwriting, strong covenants, prudent leverage, and investor alignment. We believe that investors should prioritize managers with conservative structures and alignment to capture attractive risk-adjusted yields as capital reallocates from errant managers into resilient, well-managed segments.

Macro

U.S. outlook

The U.S. economy entered 2026 with several meaningful tailwinds, including resilient consumer spending, strong corporate balance sheets and near-record profit margins, AI-driven capital investment, policy support from the One Big Beautiful Bill Act, and the prospect of Federal Reserve rate cuts.

These supporting factors were disrupted in March as the Iran conflict became the dominant market driver, influencing oil prices, interest rates, and broader risk sentiment. Investors are now assessing the conflict's implications for energy markets, fertilizer supply, inflation, growth, and central bank policy. The duration of the conflict and potential long-term damage to Middle Eastern energy infrastructure introduce significant uncertainty.

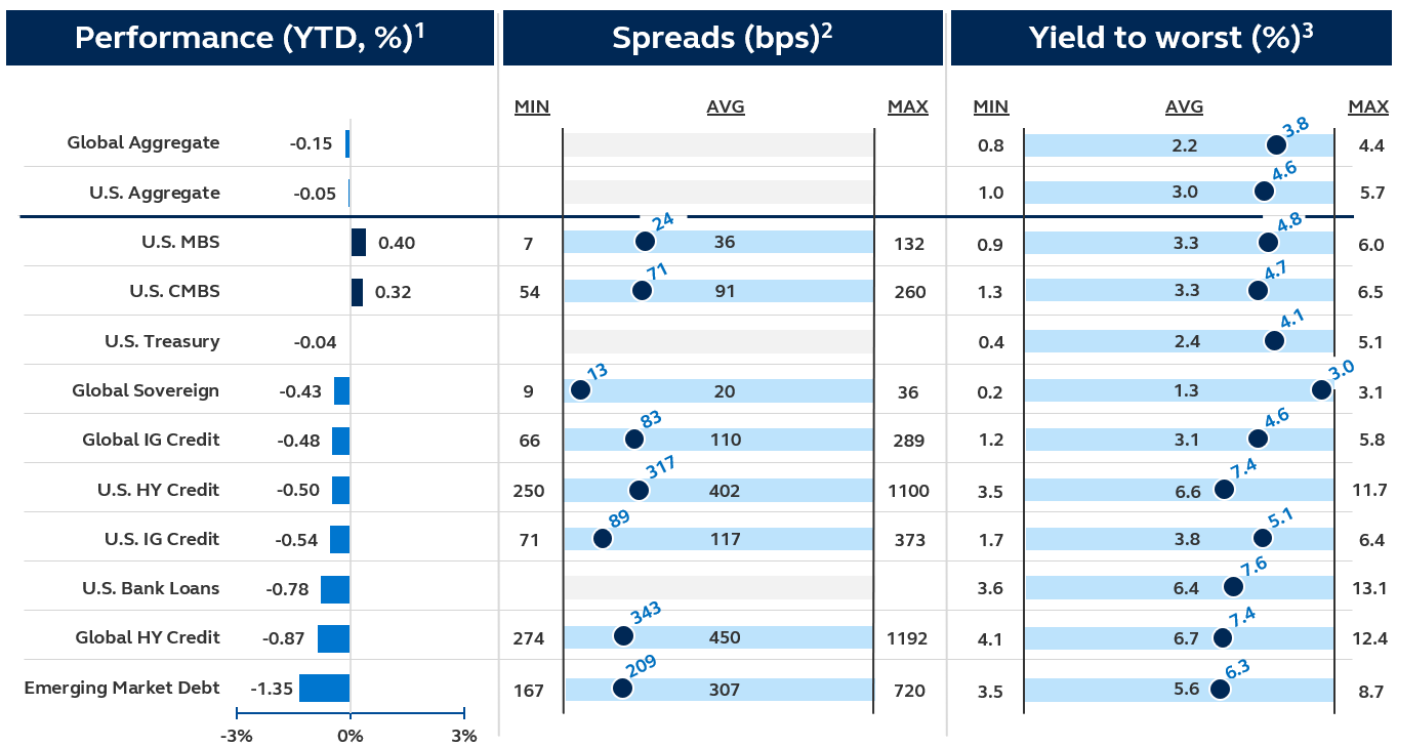
For fixed income investors, however, uncertainty can create opportunity. Using our 'FTV' framework—fundamentals, technicals, and valuation—we continue to see a constructive backdrop. Corporate fundamentals remain stable, and our sector teams do not expect a material increase to default risk. Technicals are balanced, with strong demand meeting elevated supply in an orderly and liquid market. Valuations, previously rich relative to history, have normalized as early-year expectations for Fed cuts have been priced out, improving the entry point for yields.

To illustrate the current valuation environment, consider inflation-adjusted yields in the investment grade credit index. The real yield, using 10-year TIPS breakevens as the inflation expectation, is approximately 2.83% as of March 31, offering a compelling risk/reward profile relative to history and a more attractive entry point for investors.

Headlines continue to be driven by geopolitical headlines, but fundamentals, technicals, and valuations are now aligned in a way that supports a favorable outlook for fixed income investors.

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 March 31, 2026.

Global outlook

The recent escalation in the Middle East has injected significant uncertainty into the global macro outlook. Near-term effects are clearly inflationary, but the longer-term consequences depend on the conflict's duration and scope. Policymakers and markets now face competing forces: higher fiscal spending needs, constrained growth prospects if the shock persists, and central banks' reluctance to move prematurely on policy amid ambiguous inflation and labor market signals.

The Iran war shock impacts are broadly negative

Higher oil and natural gas prices raise input costs for businesses and pressure household disposable income, with uneven geographic impacts. Advanced economies that are net exporters of energy face smaller direct shocks than energy importers such as Europe and much of Asia. Natural gas price moves are particularly acute for Asia and Europe, given storage and transportation costs, and a sustained spike could sharply dent industrial output in energy-intensive manufacturing and petrochemicals. As the war progresses, bottlenecks also emerge in the supply of by-products used in fertilizer production, which the world urgently needs for the spring planting season. Damage to aluminum production facilities in the region is also projected to permanently remove 5-10% of global supply.

Fiscal consequences are significant. Governments are likely to increase defense spending, replenish strategic reserves, and expand energy-related and agricultural subsidies or support programs for households, firms, and farmers. Those measures will strain public finances. In many economies—especially in Europe and in countries directly affected by supply disruptions—higher fiscal outlays will weigh on medium-term growth prospects as resources shift toward security and resilience rather than productivity-enhancing investment. The net effect is a heavier fiscal burden across a range of economies, with implications for sovereign budgets and global demand patterns.

Monetary policy faces a delicate balancing act

For central banks, inflationary impulses from energy prices argue for patience, while growth-sapping consequences of a prolonged shock argue for support. The result is likely to be “policy inertia” among many major central banks in the near term—rates may remain on hold until clearer data on inflation and unemployment emerge. This environment favors yield curve steepening trades and shorter-duration, income-oriented strategies in fixed income; it also raises the bar for reflationary or risk-on asset rallies absent a clear resolution to geopolitical tensions.

Geographically differentiated impacts matter

Unlike the U.S. economy, Asia and Europe are more sensitive to natural gas shocks, and sustained increases in oil prices still have measurable effects on growth and fiscal receipts. Asia's growth is most vulnerable given higher energy intensity and reliance on imported fuels; industrial output and manufacturing could face notable downdrafts if feedstock and petrochemical shortages persist. China's position is complex: increased reliance on Russian energy supplies would be undesirable, but geopolitical shifts may accentuate China's role as an alternative trading partner, potentially softening some external pressures while increasing strategic exposure.

Investor implications

Markets should be prepared for two broad scenarios: a relatively quick resolution that allows a snapback in risk assets, or a protracted conflict that amplifies fiscal drag and raises the risk of a recession. For now, positioning that preserves optionality and prioritizes downside protection while selectively harvesting yield appears most appropriate as events continue to unfold.

Investment grade credit

Investment grade credit appears poised to navigate a year of heavy issuance with resilience. While supply is surging, driven by large deals from hyperscalers and other corporate issuers, supportive technicals, attractive yields, and solid fundamentals should keep spreads rangebound, creating selective opportunities across the curve.

Supply: record volume, but robust demand

Investment grade issuance is already running ahead of forecasts. With record supply in the first quarter, suggesting the full-year tally may now exceed \$2 trillion.

Despite that massive volume, the responsive investor base took the issuance in stride as demand for yield remains strong. Issuers have found additional funding sources, with the recent growth of reverse Yankee issuance (U.S.-domiciled issuers tapping non-dollar-denominated markets), which is relieving strain on the U.S. dollar primary supply. Large order books and oversubscriptions allowed some issuers to upsize deals substantially—a clear sign that the buyer base remains receptive.

Yields and Treasury dynamics: fulcrum is the 10-year

Treasury yields remain a central tenet in IG credit, particularly the 10-year. The term premium from Treasury issuance tied to large federal deficits keeps intermediate and long-term corporate bond yields elevated, and any Fed rate cuts are likely to affect the front end of the curve. This anticipated yield curve steepening means that investment grade credit can offer attractive carry even if policy rates move modestly lower, as the belly and long-end yields should remain well-supported by yield buyers.

In practice, the 10-year Treasury note acts as a fulcrum. If 10-year yields remain in a relatively narrow range at or above 4% as is expected, IG yields should remain supportive for institutional buyers seeking income and for retail investors rotating out of money market funds in search of higher intermediate-term yields.

Our prevailing strategy is to keep aggregate duration near neutral while overweighting the belly of the curve (i.e., five to ten years) where rolldown, carry, and spread per unit of duration appear most favorable. There are selective opportunities farther out the curve for high-conviction names, which are then balanced with futures to achieve a near-net-neutral duration position overall.

Fundamentals and sector tilts: carefully pick your risks

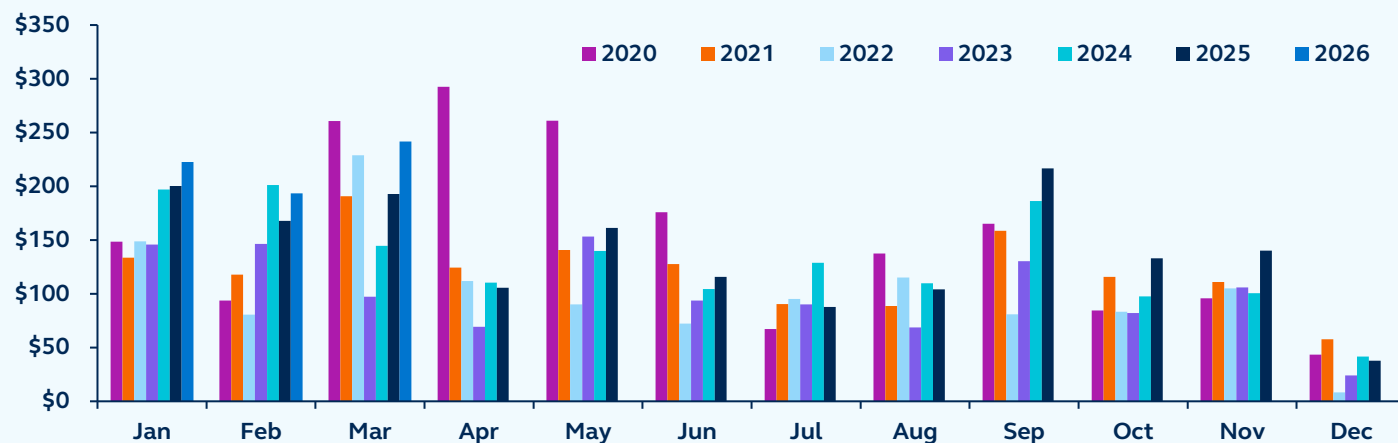
Corporate earnings and growth remain supportive, even as geopolitics introduce headline risk. Look for opportunities in sectors and issuers with supportive fundamental drivers, such as credits in the process of deleveraging, select regional and money-center banks with strong balance sheets and diversified fee businesses, and aerospace and defense companies that benefit from increased military spending. By contrast, caution is warranted in consumer cyclicals and food and beverage names facing margin pressure.

Investor implications

As a resilient asset class, investment grade credit appears to have the technical and fundamental underpinnings to withstand a record issuance cycle. Attractive IG yields attract demand, while well-executed jumbo bond deals and cross-currency issuance alleviate supply pressure. The path forward favors targeted opportunities focused on the carry-rich belly of the curve and high-quality names with both durable fundamentals and attractive relative value.

Investment grade monthly supply

\$Billions, 2020–YTD 2026



Source: Bloomberg, Principal Asset Management. Data as of March 31, 2026.

High yield

High yield debt is entering a cautiously constructive but uncertain phase. Elevated starting yields and selective issuance opportunities create potential for attractive total returns, yet geopolitical risk, shifting rate expectations, and structural concerns in private credit argue for prudence and selectivity.

Valuations and starting yields are the central strengths, as spreads react to shocks

With yields starting around the mid-to-high 7% range, high yield bonds now offer income that can materially support total returns, even in a range-bound spread environment. Historically, starting yields in this neighborhood have translated into mid-single- to high-single-digit total returns over 12 months, making the asset class appealing to investors seeking yield without the volatility of equities. There also appears to be a behavioral ceiling: should yields widen toward the upper end of recent ranges, buyer interest is likely to resume, given the income pickup versus other fixed income asset classes.

Still, spread dynamics are sensitive to macro and geopolitical shocks. The ongoing conflict with Iran has already pressured risk assets; if the situation persists or escalates, spreads could drift wider. The longer such uncertainty endures, the less resilient credit spreads become. Equity weakness tends to precede spread widening in higher-risk credit, and the high yield market has shown signs of strain amid the conflict. Investors should therefore be prepared for episodic pullbacks before a durable snap-back tied to a resolution in the Middle East.

Selectivity is critical in this environment

Sectors most exposed to discretionary consumer demand—automotive, leisure, lodging, and airlines—are vulnerable if higher energy prices and persistent inflation sap consumer budgets. Conversely, defensive sectors such as utilities, banks, and select consumer staples may offer stability, provided leverage and input-cost exposure are manageable. In technology, software names carry idiosyncratic disruption risk as AI evolves, potentially

threatening the survival of some software issuers. Data center credits, however, have emerged as a more compelling subsector given strong demand for digital infrastructure, though permitting and energy-use politics could slow issuance and development.

Credit structure and duration considerations matter

We are mostly neutral duration, reflecting an eye toward limiting interest-rate sensitivity while focusing on spread opportunities. Given high yield's relatively low sensitivity to rates compared with investment grade or longer-duration securities, position tilts should emphasize the yield curve and sector views rather than duration.

Risk and opportunity in the primary market

Issuance was robust earlier in the year but slowed amid March's geopolitical volatility. Large, leveraged buyouts and sponsored deals remain in the pipeline and may offer concessions to patient buyers. The primary market still produces attractively priced new issuance with performance favorable for those deploying capital selectively.

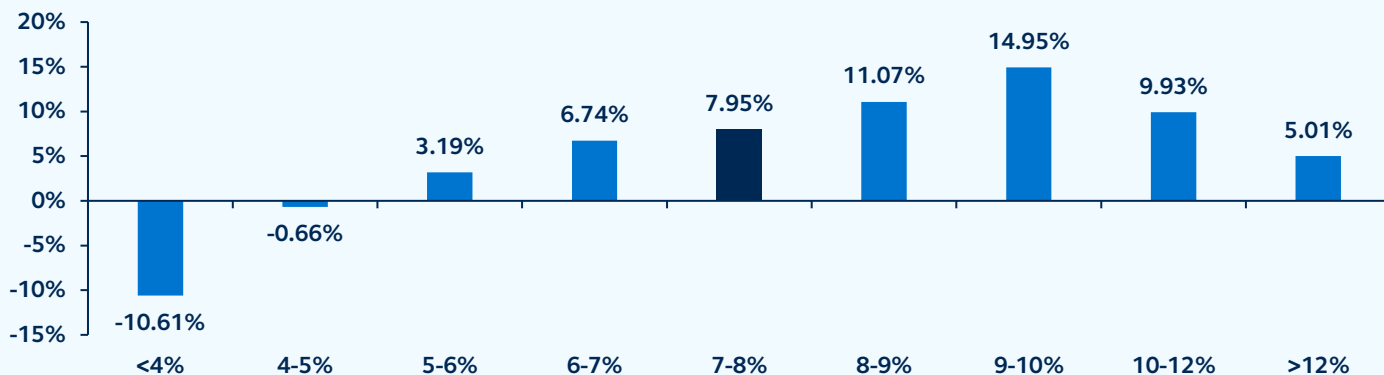
Structural shifts in private credit also influence high-yield demand. Concerns around private credit redemptions and gating may re-route some investor capital back to liquid high yield instruments, potentially providing incremental demand if stress in private funds intensifies.

Investor implications

High yield looks attractive on a risk-adjusted basis given current yields and selective primary opportunities, but it is not without near-term risk. A disciplined approach emphasizing sector allocation, careful underwriting, modest duration management, and readiness to capitalize on volatility will likely produce the best outcomes over the coming months.

High yield 1yr forward returns based on starting YTW

Median forward 12m total return



Source: Bloomberg, Principal Asset Management. Data as of March 31, 2026.

Securitized debt

Securitized debt enters the quarter on a balanced footing: technical support and selective fundamental improvements are countering the risks posed by rate volatility and geopolitical uncertainty associated with the war in Iran. The market has become more sensitive to headlines, but strong fundamentals and demand for spread assets have prevented significant spread widening.

Mortgage-backed securities remain a central focus.

Agency spread compression early in the year, driven by announcements on government-sponsored enterprise purchase activity, delivered meaningful excess returns in MBS. However, recent rate increases and volatility have reversed much of that performance. Prepayment dynamics are the key risk for par and premium coupons. With mortgage rates hovering around 6%, a modest “refi boomlet” has already appeared. If Treasury and mortgage rates remain rangebound, the spike in prepayments should be short-lived; however, a pronounced rate rally could trigger a larger refinancing wave and increase reinvestment risk for holders of higher-coupon pools. But given the increase in rates following the surge in energy prices, such activity may not arise until later in the year.

The nonagency residential mortgage market remains mixed. Affordability pressures are gradually easing as primary mortgage rates fell slightly before bouncing with energy prices, opening selective refinance windows and supporting some credit performance. Convexity-protected structures, second liens, and other credit-enhanced slices look attractive.

ABS fundamentals are broadly steady, but sectoral bifurcation persists

Consumer behavior is split by income cohort. Higher-income households continue to show stronger spending, while lower-income groups remain constrained and sensitive to rising energy costs. That divergence translates into differentiated performance across auto and credit card pools, as subprime auto delinquencies remain elevated, while other consumer loan segments are stable or improving.

Recovery in CMBS, while outlook for CLOs remains mixed

CMBS is showing signs of recovery: transaction volumes and valuations have picked up, supporting spread tightening. Delinquencies remain a concern in mature office exposures, but single-asset, single-borrower (SASB) structures and high-quality, institutionally sponsored assets can offer attractive risk-adjusted returns compared with similarly rated corporate debt. Careful selection in CMBS, focusing on strong sponsors and tenants with long leases, remains critical.

Credit-sensitive structured products such as CLOs face mixed pressures. Concerns around underwriting in private credit and headline-driven shocks to collateral valuations have introduced some softness, particularly in segments exposed to software or other AI-disrupted industries.

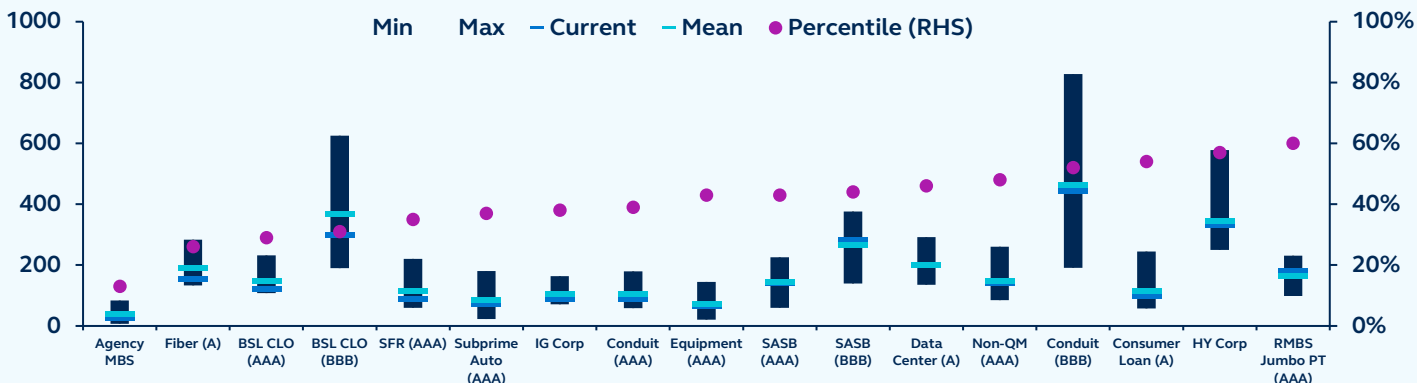
From a technical perspective, the securitized market has not experienced broad selling, and demand remains intact. Potential regulatory changes that encourage bank participation or alter capital treatment could be a structural positive later in the year, but clarity is still pending. Duration positioning favors the front end of the five-year part of the curve, where yield pickup and tightening potential in sectors like fiber ABS appear especially compelling.

Investor implications

The outlook for securitized debt is one of selective opportunities. Our focus is on high-quality credit selection, convexity-protected mortgage structures, SASB CMBS, and infrastructure-linked ABS, such as fiber, as well as a modest duration tilt toward the shorter curve while preparing for volatility driven by rate moves or geopolitical events. Active management and disciplined underwriting will be the primary differentiators in the coming quarters.

Securitized spreads

Five year history



Source: Bloomberg, JP Morgan, Bank of America, Wells Fargo, Principal Asset Management. Data as of March 27, 2026.

Municipal bonds

Municipal bonds enter the coming quarters with a favorable income story and defensive characteristics, making them particularly attractive amid heightened geopolitical and economic uncertainty. Strong demand, elevated taxable-equivalent yields, and solid credit fundamentals underpin the outlook, but investors should remain mindful of supply dynamics, state-level revenue sensitivity, and select idiosyncratic credits.

Demand dynamics are a clear tailwind

Retail flows into municipals have rebounded strongly so far this year, and institutional interest is increasing as valuations look compelling versus fixed income alternatives. The tax-exempt yield advantage remains a defining feature: on an after-tax basis, municipals offer an income profile that is difficult to replicate in investment grade corporates or taxable government debt. This value proposition has driven persistent demand even as supply has remained elevated, and it supports price resilience during risk-off episodes.

Supply is robust but digestible as fundamentals are supportive

New issuance remains above last year's record levels, with much of the paper concentrated in longer maturities. That dynamic steepens the Muni yield curve, enhancing the tax-exempt benefit for investors looking to extend duration. The 10s–30s segment of the curve stands out for its attractive compensation per unit of duration relative to corporate and Treasury curves, offering potential rolldown and income advantages.

Credit fundamentals are generally healthy. Upgrades continue to modestly outpace downgrades, and many credits retain strong balance sheets. Municipal revenues are diverse and largely driven by essential services—water, transportation, housing, and utilities—making much of the market inherently defensive. Still, credit quality is not uniform across issuers. Certain areas exhibit fiscal stress or revenue concentration, and local factors such as capital-gains tax dependence in some states (notably large coastal economies) add cyclical sensitivity tied to equity-market performance.

Sector selection matters: opportunities and risks

Housing finance bonds, prepayment-receiving municipal structures, and AMT bonds (Munis that are not exempt from the federal Alternative Minimum Tax) offer elevated current income with historically strong creditworthiness. Transportation and infrastructure credits tied to long-term project cash flows also appear attractive amid continued public investment needs. Conversely, general obligation (GO) bonds that rely heavily on volatile revenue streams or politically sensitive tax bases warrant caution.

Market risks stem from macro and geopolitical uncertainty. Elevated geopolitical tensions and related volatility can indirectly influence investor behavior and state revenues through energy prices, economic growth, and capital gains tax receipts. A material equity correction would reduce some states' near-term fiscal flexibility, while prolonged geopolitical disruption could slow economic activity and tax collections. These risks argue for selective portfolio management and careful issuer-level due diligence.

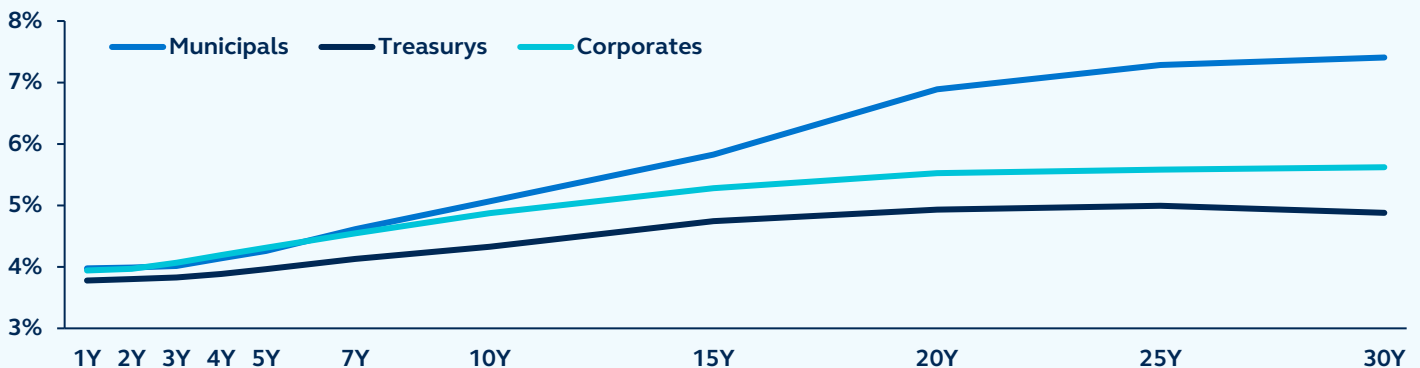
From a duration perspective, neutral-to-moderately extended exposure captures the richest parts of the tax-exempt yield curve. Investors should emphasize credit differentiation, avoid overconcentration in stressed GO credits, and selectively add long-duration positions in high-quality names to boost yield without unduly increasing risk.

Investor implications

Municipals offer compelling after-tax income and defensive attributes amid volatility. Robust demand, solid credit fundamentals, and attractive term structure support a constructive allocation stance, provided investors remain selective and maintain flexibility to respond to evolving macro and political developments.

Yield curve: Municipals, Treasuries, and corporates

Steeper municipal yield curve boosts tax-exempt advantage



Source: Bloomberg, Principal Asset Management. Data as of March 31, 2026.

Emerging market debt

Emerging market debt faces a more uncertain outlook as geopolitical tensions and energy-market disruptions reshape inflation, fiscal dynamics, and investor behavior. A recent reassessment of the 2026 environment highlights several structural shifts: a higher oil-price floor driven by risk premia grounded in the Iran war, constrained issuance for vulnerable borrowers, and continued investor demand for yield that will selectively favor higher-quality issuers.

The energy price shock will drive EM debt volatility

War in the Middle East is the primary catalyst for near-term market stress. Outages and production cuts across major regional producers have removed several million barrels per day from global supply, elevating the probability of sustained higher oil prices. Even if the conflict proves short-lived, a new structural floor for oil—materially above pre-crisis levels—is likely as importers rebuild strategic reserves and adjust sourcing. For many emerging markets, energy accounts for a larger share of inflation baskets, so the inflation pass-through will be stronger than in developed markets. That reduces central bank flexibility: policymakers have less room to ease without risking currency weakness and imported-price inflation, and in some cases may need to tighten policy to defend exchange rates.

The energy shock produces regionally divergent outcomes. Net oil exporters (Latin America, Africa) should benefit from higher commodity receipts, improved current account flows, and fiscal relief from export windfalls. These countries may enjoy spread resilience and could attract inflows as investors hunt for yield with a structural commodity tailwind. Conversely, major oil importers and countries that rely on remittances across Asia and parts of Eastern Europe face balance-of-payments pressure, higher inflation, and potentially slower growth.

Fiscal and refinancing risks also bear monitoring

Across emerging markets, fiscal and refinancing risks will move to the foreground. Governments are politically incentivized to shield households from energy price increases through subsidies or direct transfers. Those responses will weigh on public finances and could widen

credit premia for sovereigns and quasi-sovereigns with weaker balance sheets. On the corporate front, tightening financial conditions will make access to external markets selective: high-quality issuers with global franchise and strong credit profiles will still be able to borrow, while lower-rated or idiosyncratic borrowers may see reduced access.

Despite challenges, opportunities exist for investors

Investor flows are an important countervailing force. Despite the shock, demand for yield remains robust; recent weeks have still shown inflows into the asset class. This persistent search for yield should keep aggregate EM external spreads relatively contained for a time, even as fundamentals are reassessed. Still, the durability of flows is uncertain; if the conflict persists or energy prices remain elevated, flows could reverse or become more concentrated into higher-quality names, increasing differentiation within the asset class. That, in turn, favors active management in EMD.

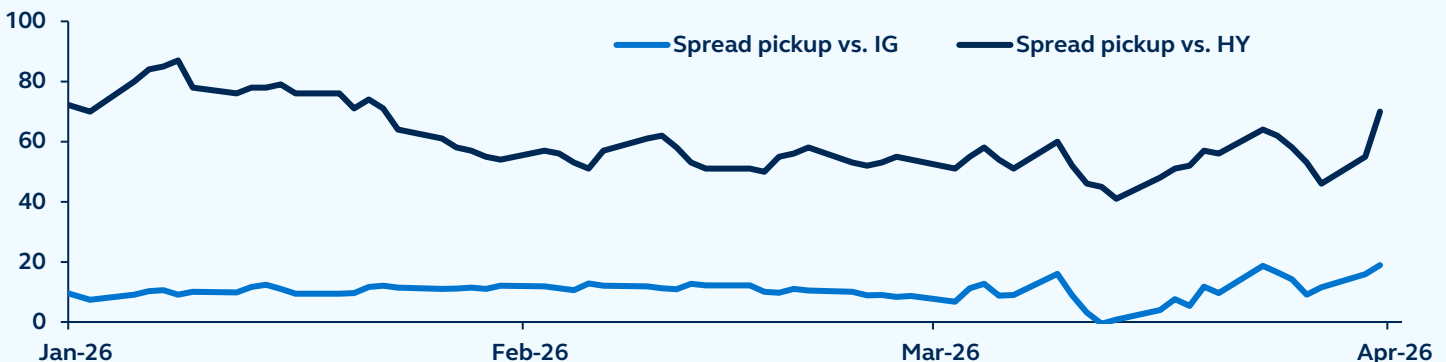
Opportunistic pockets are emerging. Latin America, benefiting from a mix of commodity exposure and relative insulation from Middle Eastern geopolitics, looks attractive for certain hard-currency exposures. By contrast, local-currency strategies in countries with limited central bank space or currency vulnerability merit caution.

Investor implications

The outlook for EMD is for greater dispersion. Higher structural oil-prices and renewed geopolitical risks heighten inflationary and fiscal pressures, compress central bank maneuverability, and amplify refinancing risks. Persistent investor demand for yield may blunt headline spread moves, but will likely favor higher-quality credits, producing a more bifurcated market where active selection and careful country-level analysis determine success.

Emerging market debt spread pickup

Basis points, option-adjusted spread, YTD 2026



Source: Bloomberg, Principal Asset Management. Data as of March 31, 2026.

Private credit

Given current market headlines, private credit faces an inflection point: attractive deal flow, durable borrower fundamentals, and rising institutional demand sit alongside increased scrutiny, liquidity mismatches in some vehicles, and looser underwriting in parts of the market. These tensions create opportunities for disciplined managers focused on lower and core middle market direct lending.

Credit dispersion is noticeable, while structural risks emerge with certain managers and products

Private credit is not homogeneous. Underwriting rigor, covenant strength, and investor alignment vary widely across managers and strategies. Rapid capital growth and a long credit bull market have driven some managers to drift from original strategies, prioritizing deployment over alignment with investor expectations. A subset of large firms and business development companies (BDCs) moved upmarket into large private deals, public high yield, and broadly syndicated loans (BSLs) to absorb outsized capital flows. Many problematic headlines stem from BSL's underwritten-to-sell framework—where investment banks seek placement fees rather than underwriting to own—resulting in looser covenants, weaker structures, and higher leverage than in typical private credit deals.

Many public BDCs now trade at sizable discounts to NAV. To maintain distribution yields amid lower Secured Overnight Financing Rate (SOFR) and compressed spreads, many increased leverage, amplifying potential NAV volatility and increasing the risk of investor losses.

Opportunities are plentiful for disciplined allocators

Despite these risks, opportunities abound for disciplined allocators. Current dynamics favor managers who operate in segments that allow strong covenants, prudent leverage, and meaningful alignment between sponsors and borrowers, while delivering appropriate compensation for risk. As larger managers face strategy drift and investor relations challenges, capital is likely to reallocate toward core and lower-middle-market direct lenders that maintain

rigorous underwriting and alignment with investors. Recent volatility has already pushed terms and pricing in a more lender-friendly direction, and resilient deal flow in middle markets should create an attractive pipeline for well-positioned lenders.

Interest rate and macro risks are manageable for middle-market direct lending. Unlike long-duration, fixed-rate credit, these loans are less sensitive to rate moves because spreads and pricing can adjust to preserve nominal returns. Nevertheless, prolonged geopolitical shocks or severe public market turmoil could still impair economic conditions, sponsor activity, valuations, and overall credit appetite.

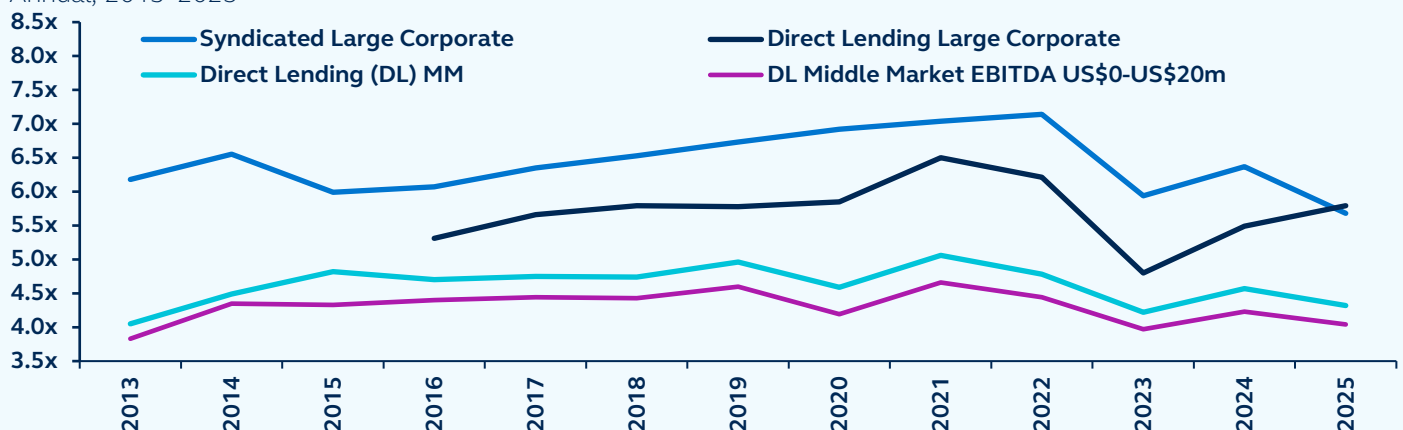
Investor implications

For investors, the private credit secular thesis remains intact: strong demand from borrowers and private equity sponsors; opportunities to deploy capital in growth-oriented industries and economic segments; resilient borrower revenues and cash flow; and an ongoing retreat of banks from commercial lending. These factors support the case for private credit as a source of incremental yield with potentially lower downside and volatility than comparable public credit exposures.

The key differentiator going forward will be investor discipline: selecting lenders with proven processes, rigorous underwriting, and alignment of interests; insisting on proper credit structures with meaningful covenants; and focusing on market segments backed by long-term growth and recession resilience. Investors who prioritize alignment, conservative leverage, and lender-friendly structures should find attractive, risk-adjusted returns in the evolving private credit landscape.

Leveraged Buyout total leverage across markets

Annual, 2013–2025



Source: LSEG, LPC's, Principal Asset Management. Data as of December 31, 2025.

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 March 31, 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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