

Principal Fixed Income

FOURTH QUARTER 2026

Fixed income perspectives

Higher income, broader opportunity

Introduction

As the fourth quarter begins, the macro backdrop is defined by resilient growth, stubborn inflation, and a sharp repricing of the policy outlook. Strong consumer spending, robust earnings, and AI-related capital investment continue to support the economy, but higher energy prices and limited progress toward the Fed's inflation target are keeping rates elevated. Fixed income markets have absorbed these pressures with notable resilience. More importantly, higher rates have restored bonds to their traditional role as a meaningful source of portfolio income. Credit fundamentals remain sound, yet tighter spreads, heavy issuance, and greater rate volatility leave less room for error, reinforcing the need to balance liquidity, quality, and selective credit risk.

Policy volatility: Higher for longer, with less guidance

Resilient growth, sticky inflation, and renewed energy pressures prompted a September Fed rate hike, and with less forward guidance, rate volatility is likely to persist. Elevated yields offer attractive carry and a return cushion, but abrupt moves can pressure valuations.

Resilient, with greater dispersion

Healthy balance sheets, solid earnings, stable leverage, and continued market access broadly support credit. High yield also benefits from improved index quality, while municipal, securitized, emerging market, and private credit offer distinct sources of resilience. Still, higher rates and energy costs affect borrowers differently. Active selection should favor durable cash flows, pricing power, seniority, structural protection, and adequate compensation for issuer-specific risks.

Valuations: Income is attractive, but selectivity matters

Attractive all-in yields stand in contrast to tight credit spreads. Strong demand, reinvestment flows, and manageable net new supply remain supportive, although heavy technology and municipal issuance may create pockets of pressure. With limited room for broad spread compression, returns should depend more on carry, security selection, and relative value across sectors and maturities. Liquidity also provides flexibility to add risk when volatility creates more compelling entry points.

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MICHAEL GOOSAY
Chief Investment Officer,
Fixed Income

Perspectives from the CIO

As we enter the fourth quarter, fixed income is offering something investors have largely gone without for more than a decade: meaningful income. Markets have absorbed higher rates, geopolitical conflict, tariffs, and policy uncertainty with surprising resilience. The economy remains solid, earnings are holding up, and inflation has improved, even as the path back to the Federal Reserve's 2% target remains uncertain.

I believe this changes the role that bonds can play in portfolios. Elevated yields can support total returns and provide flexibility as economic and policy conditions shift. However, opportunities vary considerably, making sector and security selection increasingly important.

Rates are higher, and spreads are tight—and that's OK

Policy rates may remain elevated or rise further, particularly at the front end of the yield curve. Yet today's yields provide a meaningful cushion and compensate investors for taking duration risk. If inflation holds near current levels or moderates, real yields should remain compelling. Treasuries, agency mortgages, and other high-quality bonds can therefore generate income while helping stabilize portfolios.

Tight corporate spreads do not necessarily signal trouble. In our view, valuations reflect healthy balance sheets, supportive earnings, and contained downgrade and default risks. The high yield market is also higher quality than 15 years ago, when CCC-rated issuers represented roughly 26% of the market, compared with only 9% today. That improvement supports lower spreads and attractive risk-adjusted income in select high yield bonds.

Looking beyond corporate credit

We see attractive risk-reward potential in parts of the securitized credit market, including select commercial real estate and single-asset, single-borrower securities. These markets require disciplined underwriting, but their complexity can create opportunities that broad corporate indexes do not. Our global fixed income teams continually evaluate collateral, lease structures, and repayment pathways to distinguish value from uncompensated risk.

Technology issuance is reshaping investment grade

The need for selectivity is also evident in investment grade credit. Borrowing related to data centers, in particular, is changing the market's composition. Technology now represents about 6% of the market and close to 9% of its spread duration, while heavy issuance farther out on the curve has affected relative value. We remain selective—not because of broad concerns, but because supply, duration, and complex structures can make opportunities elsewhere more attractive.

What could challenge our view?

Of course, the outlook is not without risk. Policymakers could pursue the 2% inflation target more aggressively than markets expect, slowing growth and pressuring credit fundamentals. Rising government debt and term premiums warrant attention as well. Still, our base case favors resilient growth, manageable inflation, and continued income opportunities.

For investors in this environment, active sector selection that balances Treasuries and mortgages with corporate, high yield, and securitized credit can help capture income while remaining prepared for volatility.

Summary of investment implications

INVESTMENT GRADE CREDIT

Investment grade credit remains supported by attractive all-in yields, healthy corporate fundamentals, strong reinvestment demand, and manageable net supply. Tight spreads and heavy technology issuance are increasing dispersion across issuers and maturities. AI-related financing, including secured data center structures and non-U.S.-dollar issuance, is also reshaping the market. Rate volatility remains the main risk, but solid earnings, healthy balance sheets, and steady demand continue to underpin the sector into year-end.

HIGH YIELD CREDIT

High yield remains supported by healthy earnings, improved index quality, shorter duration, and continued access to capital. Higher coupons and a carry-driven return profile have limited sensitivity to Treasury volatility, while active primary markets continue to meet borrower demand. Tight spreads and rising energy costs create greater differentiation, particularly for industrial, chemical, transportation, and consumer-sensitive issuers with less ability to absorb or pass through higher costs.

SECURITIZED DEBT

Securitized debt is being shaped by higher yields, reduced refinancing activity, affordability pressures, and uneven collateral performance. Senior, high-quality tranches benefit from stronger carry and structural protection, while lower-rated securities remain more exposed to policy and consumer uncertainty. Limited mortgage supply supports agency MBS, and demand for digital infrastructure continues to expand ABS issuance. Select CMBS also benefits from enhanced carry, although outcomes depend heavily on collateral, structure, and repayment pathways.

MUNICIPALS

Municipal bonds are being driven by elevated rates, record issuance, and improving taxable-equivalent yields. Heavy supply has outweighed seasonal reinvestment demand, shifting market leverage toward buyers, while curve steepening has improved relative value in intermediate and longer maturities. Credit fundamentals remain generally sound, particularly among essential-service revenue issuers, but a softer upgrade-to-downgrade trend, commodity inflation, and pressure on consumers and public finances reduce the sector's margin for error.

EMERGING MARKET DEBT

Emerging market debt faces pressure from high global real yields, dollar strength, crowded positioning, and higher energy prices. Its resilience reflects stronger policy credibility, positive real-rate buffers, improving fundamentals, lighter foreign positioning, and deeper domestic ownership. Elevated yields could improve prospective income if volatility in Treasury and currency markets stabilizes. Performance is likely to remain differentiated, with commodity exporters and highly rated Gulf sovereigns better placed than countries with weaker fiscal credibility or fewer policy buffers.

PRIVATE CREDIT

Private credit remains supported by resilient middle-market activity, floating-rate income, lower leverage, and stronger lender protections. Healthy sponsored and non-sponsored deal flow is sustaining the investment pipeline, while increased repayments are recycling capital at prevailing terms. Essential-service businesses with recurring demand and durable cash flows continue to anchor activity. Tighter monetary policy remains a risk for weaker borrowers, but lower loan-to-value ratios and yields around 10% strengthen the current vintage.

Macro

U.S. outlook

The fundamental backdrop for risk assets remains constructive. Economic growth continues to be supported by resilient consumer spending, near-record corporate profit margins, and ongoing capital investment. A significant portion of that investment is being driven by the AI infrastructure buildout, while favorable depreciation incentives continue to support corporate spending plans. Although the labor market has moderated from the exceptionally tight conditions of recent years, it remains stable, and strong productivity gains are helping sustain overall economic growth. Corporate balance sheets are healthy, characterized by strong interest coverage ratios and stable leverage levels. Most importantly, earnings growth remains exceptionally robust, providing a critical foundation for credit markets and risk assets more broadly.

At the same time, investors must contend with several meaningful challenges. Interest rates have risen sharply as markets reassess the path of monetary policy and the level of the Fed's neutral rate. At his September press conference, Chairman Warsh highlighted stronger-than-expected economic data, inflation's limited progress during the summer months, and geopolitical developments as key factors behind the Fed's current policy stance. With policymakers providing less forward guidance, rate volatility has persisted, creating uncertainty around financing conditions and market valuations. If sustained, higher rates could eventually weigh on consumer activity, dampen risk appetite, and increase recession risks.

Inflation remains another source of near-term concern. Core PCE inflation is unlikely to show significant improvement over the next several months, as challenging base effects are expected to persist through year-end. Longer term, the outlook is more favorable.

Global outlook

The global economy enters the fourth quarter with resilient growth, but renewed energy pressures have complicated the outlook for inflation and monetary policy. Geopolitical risk has proven more persistent than expected, as the Middle East conflict has altered the regional balance of power and heightened risks to critical energy routes. As a result, oil prices have moved sharply higher, reinforcing the view that the latest supply disruption may be more durable than the initial shock earlier this year.

Improving tariff comparisons, continued moderation in shelter inflation, and methodological changes that lessen the relationship between equity prices and inflation should contribute to further disinflation. Nevertheless, inflation is likely to remain uncomfortably elevated in the near term, while higher energy prices represent an additional headwind for both consumers and businesses.

Within credit markets, supply dynamics continue to warrant attention. While investors have largely anticipated ongoing issuance from hyperscalers to finance AI-related investments, capital expenditure guidance has consistently moved higher with each earnings cycle. As a result, new issuance is exceeding already elevated expectations, creating additional supply pressure across the market.

More broadly, uncertainty remains elevated. Geopolitical tensions, energy market volatility, the evolving inflation and Federal Reserve outlook, and continued changes to tariff policy all have the potential to generate periods of market turbulence.

Taken together, these crosscurrents support maintaining a constructive but disciplined investment posture. We continue to favor a risk-on orientation, supported by strong economic fundamentals, healthy corporate balance sheets, and robust earnings growth. However, given elevated policy uncertainty and the sharp rise in interest rates, we believe it is prudent to reduce risk modestly at the margin and maintain ample liquidity for future opportunities. With credit spreads near historically tight levels, the carry sacrificed by holding additional dry powder is relatively modest compared to the flexibility it provides. We expect periods of volatility and spread widening to create attractive opportunities to redeploy capital and add risk. As a result, while remaining mindful of near-term challenges, we continue to view the medium-term outlook for credit markets favorably.

Energy pressures reshape the policy outlook

Central banks typically look through supply-driven energy shocks because higher policy rates cannot restore lost production. Two energy shocks within six months, however, make it harder to characterize the inflationary impact as temporary. With oil elevated and equity markets still signaling relatively easy financial conditions, policymakers have become more willing to remove accommodation.

Global outlook continued

This shift extends beyond the United States. Several developed-market central banks have already raised rates or indicated that tightening may be their next move, while Japan is attempting to accelerate policy normalization. While further hikes remain conditional on energy prices and risk markets, rate cuts appear quite unlikely across major economies through year-end. That should keep global yields elevated, even if the long end of the curve sees modest relief after its recent selloff.

Technology demand supports global growth

The growth outlook remains broadly constructive. AI and technology investment are supporting export demand across Europe and Asia, extending the benefits of the U.S. capital spending cycle through global supply chains. Japan, Korea, Taiwan, and China are participating in the semiconductor, server, components, and related manufacturing sectors. If U.S. technology investment remains firm, this external demand should help sustain global activity.

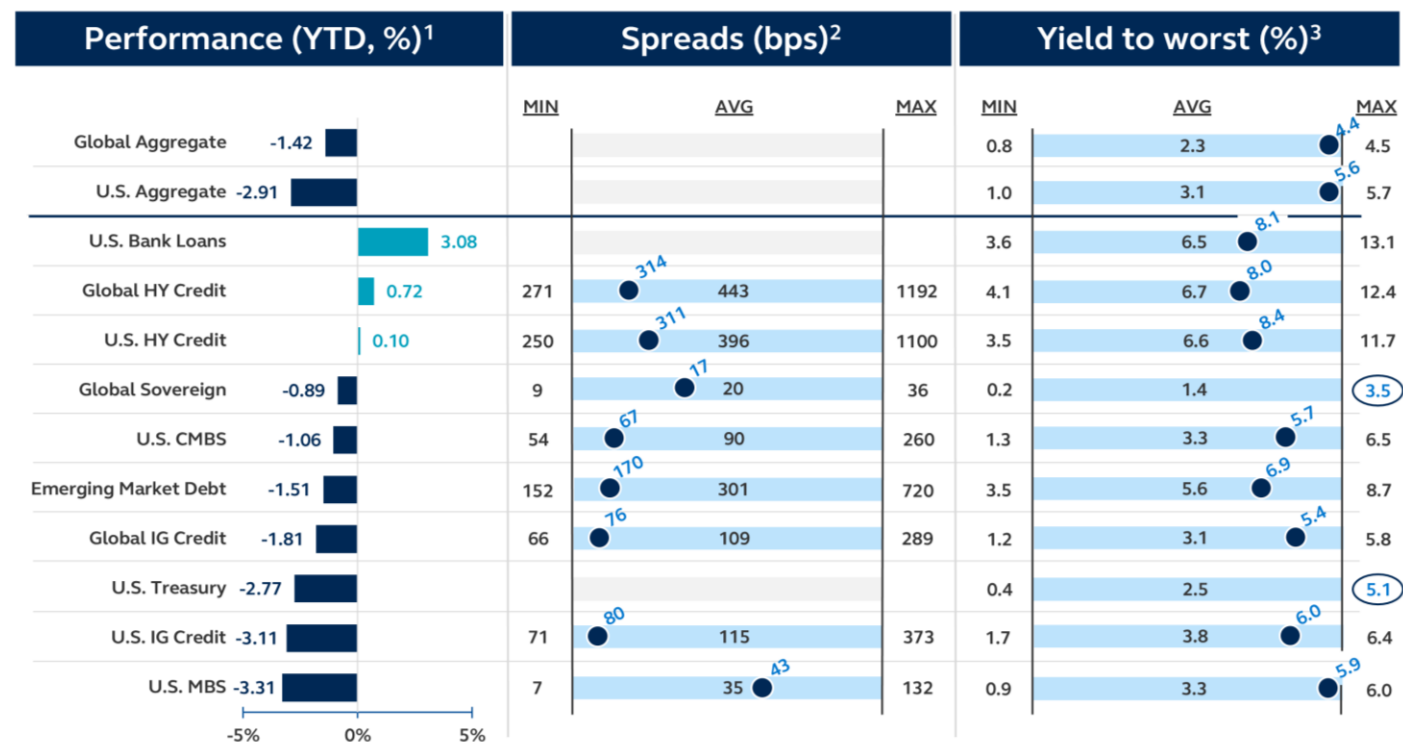
Europe is the notable exception. Higher borrowing costs and energy prices are already weighing on households and businesses, while drought and low river levels add headwinds to industrial activity. This has been negated by broader growth in the technology sector, which filtered through to export markets, offsetting some of these pressures, but upcoming data may reveal greater weakness than markets currently anticipate.

Investor implications

Fiscal risk appears somewhat less threatening than current market concerns, as elevated borrowing costs encourage greater restraint among governments. This may help stabilize longer-dated yields, although the broader higher-for-longer environment remains intact. This is because resilient growth, in no small part from the technology sector, is providing crucial support for global economic growth, while persistent energy pressures and frothy markets limit central banks' flexibility to provide accommodation. The outlook favors selectivity and greater regional differentiation, particularly as economies confront a varied mix of financial conditions and implications from higher energy prices.

Market environment

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



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

Investment grade credit

Investment grade credit enters the final months of the year on a steady footing, offering a compelling income story for investors cautious about risk assets or rate volatility. Attractive all-in yields, healthy corporate fundamentals, and resilient demand continue to support the asset class, even after more than \$1.7 trillion in gross issuance and despite macro headwinds ranging from tariffs and geopolitical conflict to substantial AI-related financing needs.

Yield and reinvestment support demand

Yield remains the primary driver of demand. Higher Treasury rates have helped sustain income-focused buying of investment grade credit, while coupon payments and maturities have generated substantial reinvestment demand. As a result, investors have focused more on net issuance than gross issuance, with net supply remaining far more manageable. Overseas demand, including for foreign-currency bonds issued by US companies (i.e., “reverse Yankees”), has provided additional support. Several large issuers have already completed much of their anticipated funding for the year, suggesting supply could remain within normal bounds into year-end. Larger deals requiring concessions have, for the most part, cleared in an orderly fashion, reinforcing market depth and appetite for high-quality credit.

Fundamentals remain in excellent shape

The fundamental backdrop remains supportive for maintaining an allocation to high-quality credit. Consumer spending has held up, household and corporate balance sheets remain healthy, and corporate earnings continue to grow at a solid pace. Although inflation has moderated across several measures, the final stage of disinflation remains uneven, with higher energy prices due to the Iran conflict. The Fed remains committed to ensuring inflation returns sustainably to target. Importantly, the resilience of the US economy has allowed policymakers to raise rates while leaving broader growth expectations intact.

AI-related capital spending remains an important area to monitor, particularly as hyperscalers continue to access the investment grade market. The rise of secured data

center financings, off-balance-sheet structures, and non-U.S.-dollar issuance has broadened the funding toolkit and helped reduce pressure on the U.S. market. Select data center opportunities may offer additional spread relative to unsecured corporate bonds, but require careful evaluation of structure, collateral quality, and issuer fundamentals.

Selectivity remains essential

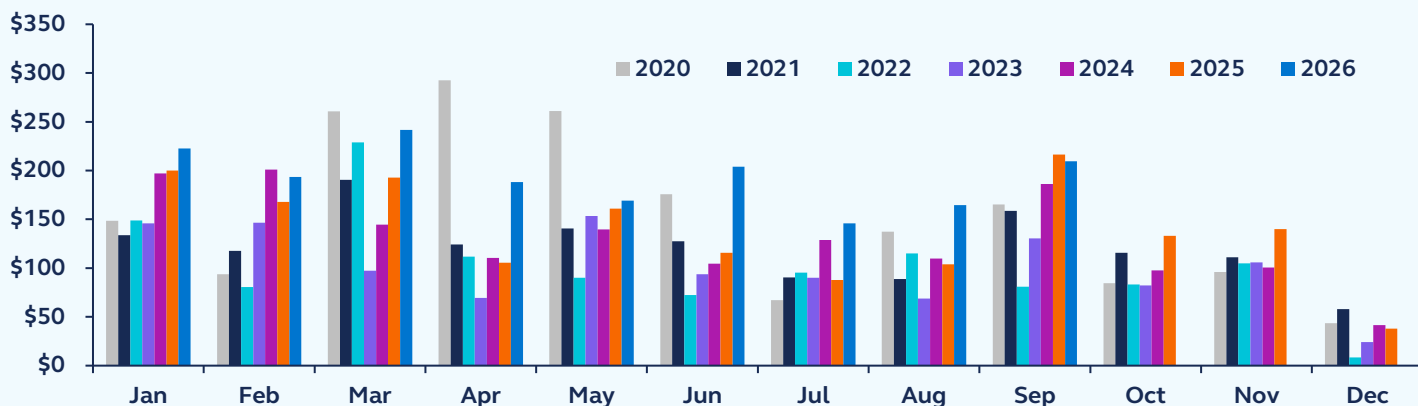
With spreads near historically tight levels, excess returns are likely to depend more on issuer selection than broad market beta, making disciplined credit selection increasingly important. Simply put, issuers with durable fundamentals whose bonds continue to offer attractive relative value should stand out. At the same time, a neutral duration posture in aggregate and a focus on the five- to ten-year key rate segment of the credit curve may help balance income and rate sensitivity.

Investor implications

Despite a range of macro and geopolitical uncertainties, the factors that matter most to investment grade credit investors, namely fundamentals, demand, and net supply, remain supportive. Indeed, it remains a mainstay for portfolios seeking quality income, diversification, and generally lower volatility than many other risk assets have exhibited this year. Abrupt or marked moves in rates remain the primary risk, but solid fundamentals, continued reinvestment demand, and balanced technicals support a steady outlook for the asset class into year-end. For investors pursuing quality income, attractive yields remain the primary driver of demand and the foundation of the investment grade credit opportunity.

Investment grade monthly supply

\$Billions, 2020–YTD 2026



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

High yield

High yield remains supported by solid fundamentals, but faces a more challenging backdrop. Corporate earnings exceeded expectations, guidance remained broadly constructive, and management teams have not indicated any major signs of consumer-led deterioration. This strength has helped keep spreads tight and the market supported through most of the third quarter. Recently, however, rising Treasury yields, higher energy prices, and weakness in equities have weighed on the asset class, adding uncertainty and heightened spread widening.

Resilience amid higher rates

High rates present a risk, though high yield remains somewhat insulated by its shorter duration profile, higher coupons, and the fact that carry largely drives returns. Market duration has declined to approximately three years as issuance has shifted toward shorter maturities, leaving the asset class less sensitive to Treasury volatility than many other fixed income sectors. In fact, recent correlations to rates have been near zero or negative, helping explain high yield's resilience.

While higher yields may create near-term uncertainty, access to capital remains intact. Companies continue to tap the market, and recent issuance suggests borrowers remain comfortable. If the Federal Reserve hikes rates again, the market may already have priced in much of the impact, particularly if investors view it as a limited tightening cycle.

Supply remains supportive

The primary market remains active despite volatility. Demand for new issuance has, for the most part, stayed healthy after a year in which investors struggled to find enough supply. Some borrowers are increasingly favoring floating-rate bank debt as long-term rates remain elevated, creating opportunities to add shorter-duration exposure.

Data center issuance remains an important theme. Opportunities are attractive when supported by large, well-established hyperscaler tenants, though selectivity is critical. More broadly, preference remains with companies

that possess pricing power and are better positioned to manage higher input costs if inflation stays elevated

Income and quality support the outlook

The recent pullback in the fixed income markets has pushed all-in yields back toward attractive levels, improving income potential. At the same time, market quality continues to improve. BB-rated issuers make up a much larger share of the high yield index, while much of the recent issuance has come from higher-quality segments, including some quasi-investment-grade borrowers.

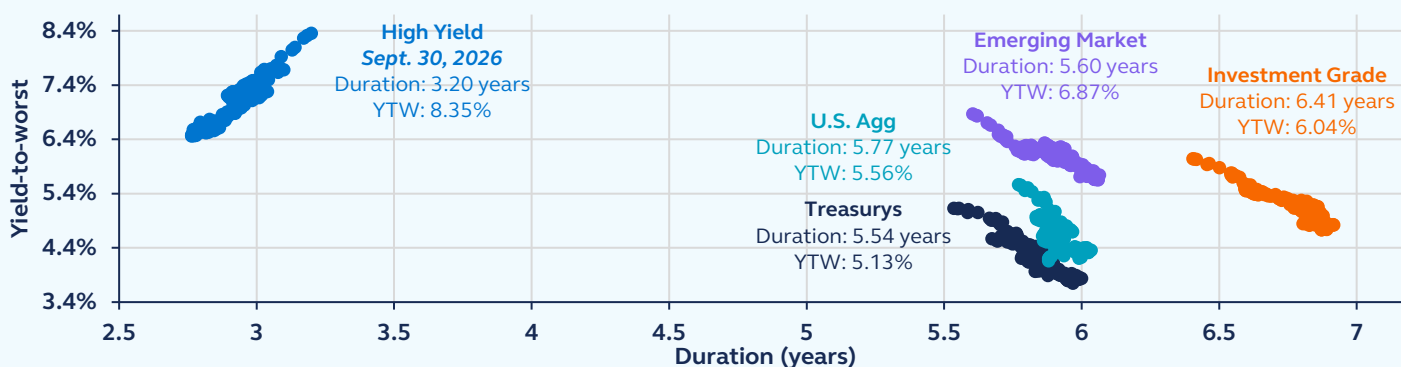
Investor implications

The outlook remains constructive, supported by healthy earnings, high index quality, and now very attractive income levels. The primary risk is that elevated oil prices prove more persistent than expected. That could put undue pressure on the cost structures of industrial, chemical, and transportation borrowers. While companies have generally been able to absorb or pass through higher costs, a prolonged period of elevated energy prices could pressure margins, weigh on consumer demand, and create a more meaningful earnings headwind heading into 2027.

For now, fundamentals remain supportive, and the recent steep rise in yields continue to provide an attractive backdrop. Even so, selectivity remains critical as investors navigate a market where spreads remain tighter than historical averages, risks are becoming more differentiated, and higher energy prices could test companies with less flexibility to pass through costs.

Yield-to-worst vs. duration year-to-date

High yield vs select fixed income sectors



Source: Bloomberg, Principal Asset Management. U.S. Agg = Bloomberg U.S. Aggregate Index. High Yield = Bloomberg US High Yield 2% Iss Index. Treasuries = Bloomberg US Treasury Total Return Index. Investment Grade = Bloomberg US Corporate Total Return Index. Emerging Market = Bloomberg EM USD Aggregate Total Return Index. Data as of September 30, 2026.

Securitized debt

Securitized debt has a clear advantage through the final months of the year: attractive all-in yields are giving investors room to earn income without reaching for risk. And yet, the opportunity set is far from uniform. Higher rates, uncertain Fed policy, and pressure on rate-sensitive borrowers are reshaping where value is most compelling, making selectivity essential across the securitized debt spectrum.

Agency Mortgage-Backed Securities (MBS) performed reasonably well into the September Federal Open Market Committee meeting but have underperformed as rates have moved north of 5%. Much of the index has already moved through the larger convexity zones, reducing the impact of further rate moves on extension risk. Meanwhile, mortgage rates north of 7% have curtailed refinancing and purchase activity, limiting new supply. Adjustable-Rate Mortgages (ARMs) have reemerged as borrowers seek lower initial payments. Still, today's fully underwritten loans typically use more stable 5/1, 7/1, or 10/1 structures with longer fixed rate periods before adjustment, in sharp contrast to the loosely underwritten 2/28 and 3/27 loans common before the financial crisis.

The rate backdrop remains a double-edged sword

Higher yields enhance carry and make senior, high-quality tranches more compelling, but they also pressure affordability, slow origination, and reprice existing debt. In non-agency Residential Mortgage-Backed Securities (RMBS), stronger underwriting, low prepayments, and limited defaults continue to support recent production. ARMs have reemerged as borrowers seek lower initial payments. Still, today's fully underwritten loans typically use more stable 5/1, 7/1, or 10/1 structures, in sharp contrast to the loosely underwritten 2/28 and 3/27 loans common before the financial crisis.

Selectivity remains essential

Inflation data are mixed, the Fed's reaction function is difficult to read, and fiscal deficits, Treasury supply, geopolitical risk, and AI-related corporate issuance are influencing the long end of the curve. This is not a moment for aggressive duration bets or reaching down the capital stack. The best opportunities appear where investors can capture income while staying senior and structurally protected.

CMBS and select ABS stand out

Single-asset, single-borrower Commercial Mortgage-Backed Securities (CMBS) can offer compelling

returns through enhanced carry while keeping investors high in the capital structure. In Asset-Backed Securities (ABS), digital infrastructure—including fiber-to-the-home, fiber-to-the-premise, and data centers—continues to attract attention. While AI-related issuance has added volatility, securitized structures may offer stronger collateral protection, better structural features, and incremental spread versus corporate alternatives.

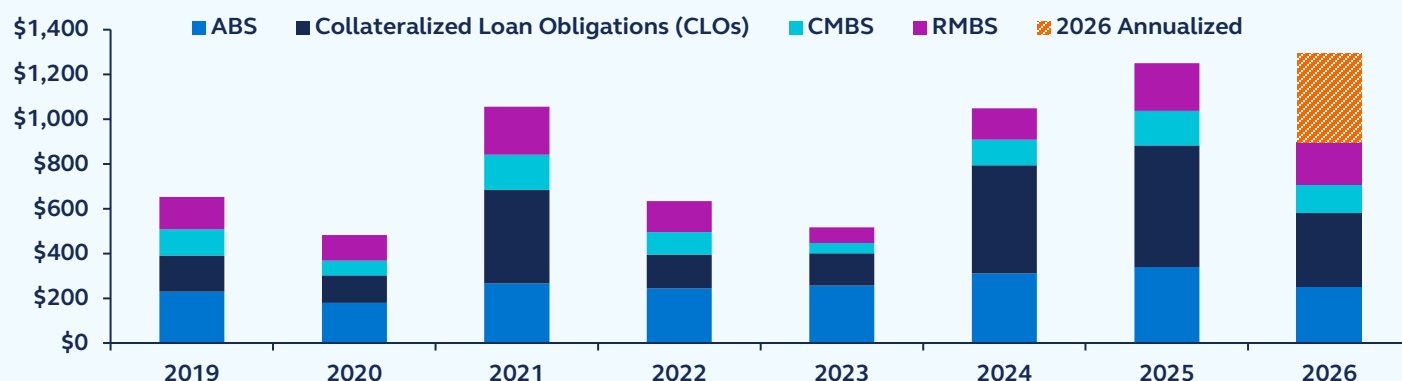
Consumer ABS and lower-rated securitized tranches warrant caution. Consumer headwinds have not disappeared, and volatility across rates, regulation, monetary policy, and administrative policy argues for more compensation before moving into equity-like risk. That helps explain why triple-B and double-B tranches have widened even as higher-rated securities have held in better.

Investor implications

The fourth-quarter message is balanced but constructive: securitized debt offers attractive income potential, but the opportunity is uneven. Investors should emphasize carry over directional rate calls, quality over leverage, and structure over spread alone. With rates still capable of driving volatility, the strongest opportunities may come from limiting broad duration and credit exposure while selectively taking risks that offer attractive compensation.

Annual securitized debt issuance

\$Billions, 2019–2026



Source: Bloomberg, Principal Asset Management. Data as of September 11, 2026.

Municipal bonds

Municipal bonds enter the fourth quarter with improving value, even after a surprisingly difficult period for performance. Record summer reinvestment demand was not enough to offset a sharp rise in rates, and macro forces overwhelmed otherwise supportive technicals. The adjustment has been orderly, not a repeat of 2022's severe performance drop, spurred by aggressive Fed tightening, which led to record outflows from the sector. Still, today's activity has reinforced a key point: in a higher-rate environment, buyers have more control, and the opportunity set is increasingly centered on income.

Higher yields shift control toward buyers

Elevated rates and heavy issuance remain the market's defining forces. Supply is roughly 9% to 10% above last year's pace and is expected to stay near record levels through year-end, limiting the technical support investors had anticipated earlier in the year. Yet the same price pressure on Munis has increased taxable-equivalent yields and improved value, especially for investors willing to be patient as volatility persists.

That backdrop favors a focus on coupon and cash flow. Portfolio activity has leaned toward tax swaps that move out of lower-coupon bonds and into higher-coupon structures, which can add income and provide some price protection if rates remain elevated. At the same time, credit spreads are not offering sufficient compensation to justify a broad risk-on move. Higher yields should not be mistaken for wider spreads, making quality and income a more compelling combination than a wholesale move down the credit spectrum.

Relative value improves further out on the curve

Recent curve steepening has made the intermediate and longer portions of the municipal market more attractive relative to the short end. Municipal-to-Treasury ratios have cheapened in these maturities, while the five-year area remains comparatively rich. That relative value could help bring insurance companies and other long-duration buyers back into the market, particularly as the 30-year ratio has moved well above more typical breakeven levels.

Revenue bonds remain a key area of interest, especially for essential-service issuers with high barriers to entry and durable cash flows. The emphasis is less on making a broad defensive shift and more on owning credits whose balance sheets can withstand macro volatility while allowing income to drive a greater share of total return.

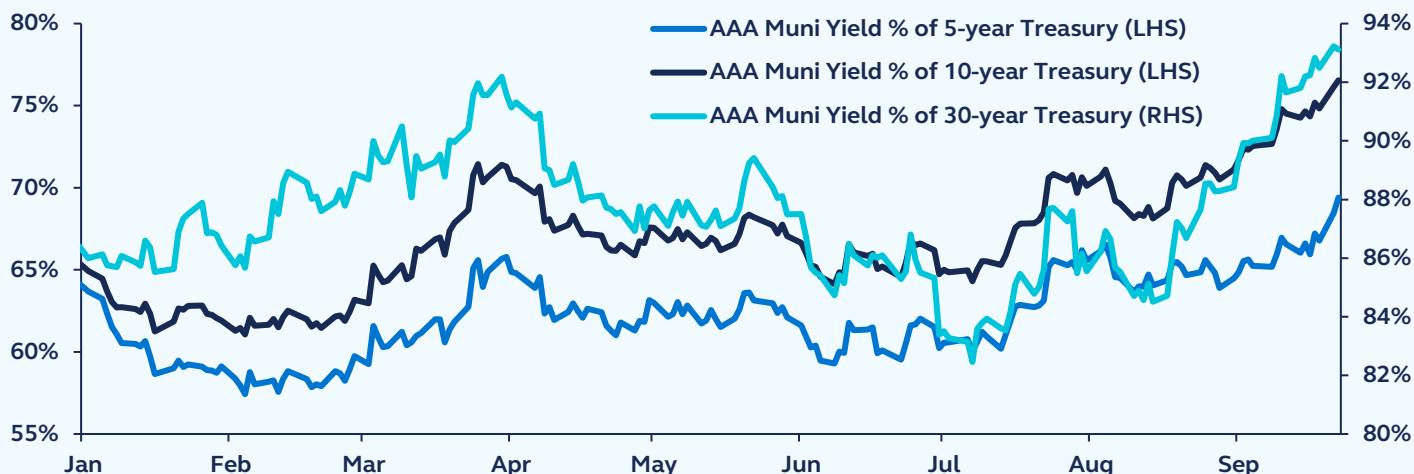
Investor implications

The outlook is more attractive, but not without headwinds. Rate uncertainty, elections, geopolitical risks, and commodity inflation could continue to pressure consumers and state and local finances. Balance sheets remain generally sound, but the upgrade-to-downgrade trend has weakened, suggesting less cushion than earlier in the cycle.

For investors, the recent adjustment has created a better entry point for compounding tax-exempt income. The opportunity lies in being selective across maturity, coupon, structure, and credit quality as the market absorbs record supply and navigates a higher-rate backdrop.

Municipal to Treasury ratios

AAA municipal bond yields relate to Treasuries, YTD 2026



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

Emerging market debt

Emerging market debt (EMD) faces a near-term test as higher energy prices, resilient U.S. growth, and concern over developed-market debt and deficits push global real yields toward 20-year highs. The speed of the move could pressure EM currency carry trades and crowded positions in EM credit and local rates.

So far, however, EMD's response to rising U.S. yields and a stronger dollar has been modest relative to history. That resilience reflects stronger policy credibility, high real-rate buffers, improving fundamentals, lighter foreign positioning, and deeper domestic ownership of both local and external debt.

Risk reduced tactically

We have reduced portfolio risk in response to the market move. Value at risk fell to a 2026 low of 48 basis points before rising to about 60 basis points with recent volatility. Duration was cut from 4.9 years at the end of August to 3.8 years at the end of the quarter, while the FX allocation declined from 32% to 11%.

These changes are tactical, not a retreat from EMD, remaining alert to Treasury and currency volatility, dollar strength, and signs that wider global credit spreads are spilling into EM assets. If real yields stabilize near current levels, higher yields should create opportunities to rebuild hard and local currency duration at more attractive income levels.

Stronger foundations support the long-term case

EM policymakers have generally remained orthodox since the pandemic, maintaining positive real-rate buffers and responding credibly to inflation and fiscal risks. Many countries have also pursued a trend of fundamental improvement and reform since 2022. In contrast, weaker fiscal credibility in developed markets has reduced the relative appeal of traditional safe havens and limited the dollar's rise against EM currencies during periods of stress.

The energy shock also underscores the importance of differentiation. Highly rated Gulf sovereigns have remained resilient, while commodity exporters such as Brazil, as well as markets in Central Asia and Africa, may benefit. More vulnerable countries either retain meaningful buffers or receive support from International Monetary Fund programs.

Investment implications

EMD remains under-owned, with global allocations still well below pre-pandemic levels. At the same time, local investors provide a broader and more stable ownership base. This combination may help cushion the asset class from global volatility while preserving its diversification benefits.

Near-term caution remains appropriate, but elevated global yields are improving prospective income. Hard currency credit and high-yielding local bonds may soon offer opportunities to lock in yields near the year's highs. EMD's attractive income, improving fundamentals, differentiated return drivers, and relatively low correlation with developed-market assets continue to support a confident long-term outlook.

Emerging market debt spread pickup

Basis points, option-adjusted spread, YTD 2026



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

Private credit

The backdrop for private credit remains constructive heading into the final months of the year. U.S. economic growth has remained resilient, supporting the operating performance of many middle-market companies. Although mergers & acquisitions activity and large-cap transaction volumes have been uneven, healthy sponsored and non-sponsored activity in the lower and core middle market is supporting a robust investment pipeline.

Floating rates adapt to tighter policy

The floating-rate structure of middle-market direct lending remains a key differentiator. Most first-lien senior secured loans are priced over the short-term Secured Overnight Financing Rate (SOFR), so income adjusts as rates change. With modified duration of roughly a quarter-year, the asset class has limited exposure to price declines that can affect fixed-rate bonds, helping mitigate volatility. Higher rates can pressure some borrowers, but many middle-market companies have adapted to a higher rate environment and continue to show strong performance.

Repayment activity has increased as transaction markets have become more active, supporting capital recycling. Prepayments create reinvestment considerations but also allow capital to be redeployed at prevailing market terms. Investors often receive a large portion of return through recurring cash coupons, while call protection and accelerated original issue discount can provide additional opportunities.

Defensive services anchor the opportunity set

Portfolio construction remains as important as individual deal selection. We favor local businesses that provide essential products and services, benefit from recurring demand, and exhibit resilient cash flows. Areas of focus include landscaping, collision repair, electrical, HVAC and other maintenance businesses, early childhood education, and RIA platforms. Many operate in fragmented markets with growth drivers, limited exposure to supply shocks, and opportunities for organic expansion and consolidation.

We tend to avoid industries that are more sensitive to economic cycles, commodity price volatility, or shifting

consumer preferences, while favoring businesses with durable competitive positions, strong free cash flow generation, and management teams focused on disciplined growth. We seek borrowers positioned to maintain credit quality through market cycles while reducing operational and financial risk over time.

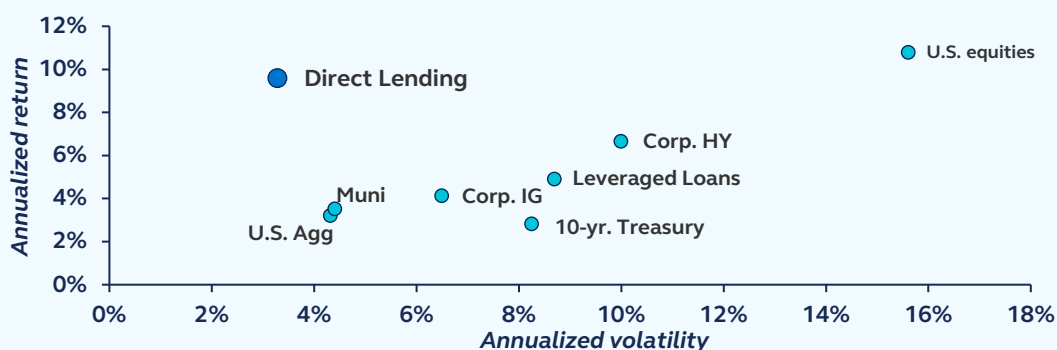
Investor implications

The 2026 vintage appears attractive in middle-market direct lending. Spreads offer a premium to public high yield and broadly syndicated loans and remain about 25-50 basis points wider than a year ago. Leverage for the current loan vintage has declined, averaging under 4x debt-to-EBITDA and 40% loan-to-value across many lower and core middle-market opportunities. Upper-middle-market leverage has also declined but remains above 5x debt-to-EBITDA with higher loan-to-value. More attractive credit structures, higher risk premiums, and SOFR base rates that push yields to around 10% or more support attractive income and diversification relative to public fixed income.

Key risks include tighter monetary policy and stretched public market valuations, which could fuel volatility and weigh on consumer and business confidence and spending. Although economic conditions remain strong, the pace of capital investments may slow as policy tightens. We remain focused on middle-market businesses benefiting from secular trends and with less exposure to cyclical downturns. This resilient orientation, combined with more attractive credit structures, should support relative performance across economic environments.

Historical risk/return since 2004*

Direct lending vs. other asset classes



Correlation

Direct lending vs.

Corp. IG	0.21
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Muni	0.12
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U.S. Agg	-0.14
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10-year Treasury	-0.49
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As of March 31, 2026. *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	○	○ → ●	○	○	○
Private credit					
Direct lending	○	○	○	●	○
Investment grade private credit	○	○	○	●	○

As of September 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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Investment Strategy Group

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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