Principal Fixed Income

Principal Asset Management℠

FIRST QUARTER 2025

Fixed income perspectives

Finding opportunities in a dynamic global environment

Introduction

As the Federal Reserve continues its gradual rate-cutting cycle, the U.S. economy demonstrates resilience in the face of evolving policy shifts and geopolitical uncertainties. Fixed income markets are navigating diverging central bank approaches, presenting both opportunities and challenges for investors. With elevated yields, robust credit fundamentals, and selective opportunities across asset classes, fixed income offers an attractive landscape heading into the new year.

1. **Evolving Monetary Policies Shape Markets**
   Central banks worldwide are easing cautiously, with the Federal Reserve maintaining a measured pace of rate cuts while other central banks weigh policy adjustments amid uneven global growth and trade uncertainties.

2. **Resilient Fundamentals Support Fixed Income**
   From investment grade to high yield, municipals, and private credit, solid credit metrics and favorable demand dynamics are helping offset tighter spreads and volatility, creating a foundation for potentially attractive total returns.

3. **Selective Opportunities Across Asset Classes**
   Elevated yields across emerging market debt, securitized credit, and municipals highlight the importance of active management as investors capitalize on yield premiums, diversification benefits, and sector-specific strengths.

What's inside

Perspectives from the CIO

MICHAEL GOOSAY
Chief Investment Officer,
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As 2025 begins, the fixed income market is navigating a pivotal period shaped by the combined effects of monetary easing, shifting fiscal priorities, and evolving geopolitical risks. The Federal Reserve has begun its much-anticipated rate-cutting cycle, signaling a move from restrictive to accommodative policy. This transition, while gradual, underscores a renewed opportunity for fixed income investors to reposition portfolios and extend duration to capture compelling yields. Elevated yields across asset classes provide a foundation for attractive income generation, even as macroeconomic uncertainties persist.

In the U.S., economic resilience remains a cornerstone of the outlook. Consumer spending continues to drive growth, supported by strong wage gains and stabilizing inflation. However, fiscal and trade policy shifts under the incoming Trump administration could introduce new challenges. Potential tariff implementations and tax reforms may drive near-term inflationary pressures while creating mixed implications for global growth. These factors, coupled with tightening fiscal conditions, highlight the importance of adaptability in fixed income strategies.

Globally, divergent monetary policies reflect uneven economic recovery. While the U.S. leads with cautious rate cuts, central banks in Europe and Asia face their own unique challenges. Emerging markets present selective opportunities, with improving fundamentals and attractive carry balancing the risks of geopolitical instability and trade disruptions. Active management and careful credit selection will be critical to navigating these complexities.

At the sector level, municipals and securitized debt remain attractive for their defensive qualities and tax-advantaged yields, while private credit continues to shine as a source of portfolio diversification and incremental yield. Meanwhile, investment-grade credit and high yield provide stable income opportunities for investors focused on quality and relative value.

Looking ahead, we are optimistic about the potential for fixed income to deliver competitive returns. With a disciplined approach to risk management and an eye on structural opportunities, investors can likely navigate today's evolving market dynamics to build resilient, income-focused portfolios.

Summary of investment implications

INVESTMENT GRADE CREDIT

Investment grade credit remains a cornerstone of fixed income portfolios, offering comparative stability and income in 2025. Current yields above 5% provide compelling relative value, supported by strong fundamentals and tight spreads. Record levels of issuance in 2024 were readily absorbed, and net supply in 2025 is expected to decline, easing technical pressures. With robust corporate balance sheets and a supportive Fed, IG credit is well-positioned to deliver steady returns, with credit selection being key.

HIGH YIELD CREDIT

High yield credit offers attractive income opportunities, with yields currently above 7% and strong corporate fundamentals. While spreads are tighter than historical averages, the asset class benefits from a higher-quality index composition and shorter duration. Modest spread widening is anticipated due to softer technicals, but robust starting yields should support solid total returns.

SECURITIZED DEBT

Securitized debt sectors, including CLOs and SASB CMBS, present strong opportunities in 2025. Tailwinds from easing monetary policy, resilient consumer fundamentals, and competitive financing options underpin demand. AAA-rated CLOs offer attractive carry in a "higher for longer" environment, while SASB CMBS provides appealing spreads, duration flexibility, and exposure to property-specific recovery stories. New issuance is expected to remain strong, with robust demand balancing supply pressures, but selectivity will be crucial, as elevated non-mortgage debt burdens could pose challenges for weaker issuers.

MUNICIPALS

Municipals provide a unique combination of high yields, credit quality, and tax-advantaged income. Decade-high yields enhance their relative value compared to taxable fixed income, while strong fundamentals and favorable credit trends underpin the asset class. Record issuance is anticipated in 2025, driven by delayed projects and infrastructure needs, with robust demand from ETFs, mutual funds, and SMAs expected to absorb supply. Municipals' diversification benefits and capital preservation characteristics should enable them to deliver attractive risk-adjusted returns.

EMERGING MARKET DEBT

Emerging market debt continues to offer selective opportunities, with attractive carry near 6.5% and robust fundamentals across sovereigns and corporates. However, geopolitical risks, including U.S. trade policies and energy market dynamics, highlight the importance of active management. Strong domestic demand in EM economies provides a buffer against external volatility, while relative value in EM credit remains compelling despite tight spreads. Investors should focus on careful country and sector positioning to navigate potential challenges.

PRIVATE CREDIT

Private credit is poised for growth in 2025, with improving deal flow and strong technicals supported by disciplined credit structures. Middle market direct lending continues to offer attractive risk-adjusted returns, driven by robust corporate fundamentals and favorable valuations. Elevated yields and ongoing demand for diversification reinforce private credit's appeal in fixed income portfolios. Selective opportunities in lower and core middle market lending are expected to outperform as the asset class benefits from a stable economic environment and pro-business policy tailwinds.

Global bond outlook

U.S. outlook

The U.S. economy remains the envy of the world, demonstrating remarkable resiliency powered by robust and consistent consumer spending. The U.S. consumer has overcome several headwinds, including depleted excess savings from the pandemic, the resumption of student loan payments, and high interest rates. Notably, several tailwinds are helping to explain the resiliency: historically elevated Federal deficit spending; strong real wage gains/labor market; Social Security cost-of-living adjustments for retirees; record wealth gains due to a strong stock market; and insulation from high mortgage rates via locked-in record low rates during the pandemic.

Labor market is gradually slowing, while inflation remains sticky

In the labor market, while the data has been noisy of late, the underlying signal portrays a jobs market that continues to cool gradually. Hiring has slowed, but layoff activity remains relatively tame. The unemployment rate has been trending higher, yet at a measured pace. Markets will closely monitor layoff indicators, and if they trend higher, that may signal a more concerning deterioration in the labor market.

Turning to the inflation front, shelter inflation—which accounts for nearly half of core CPI—continues to slow, and further moderation is likely. Goods prices within the Fed's preferred core PCE measure have been negative for some time. Services ex-housing has pockets of inflation that need to improve to achieve the Fed's objective. The slowing labor market may help that materialize. While the path to the Fed's 2% inflation goal has been and will continue to be bumpy, the broader trend suggests that progress continues.

Investors eying ramifications of a second Trump administration

Notably, the removal of U.S. election uncertainty is a positive for markets, but several implications will take time to play out.

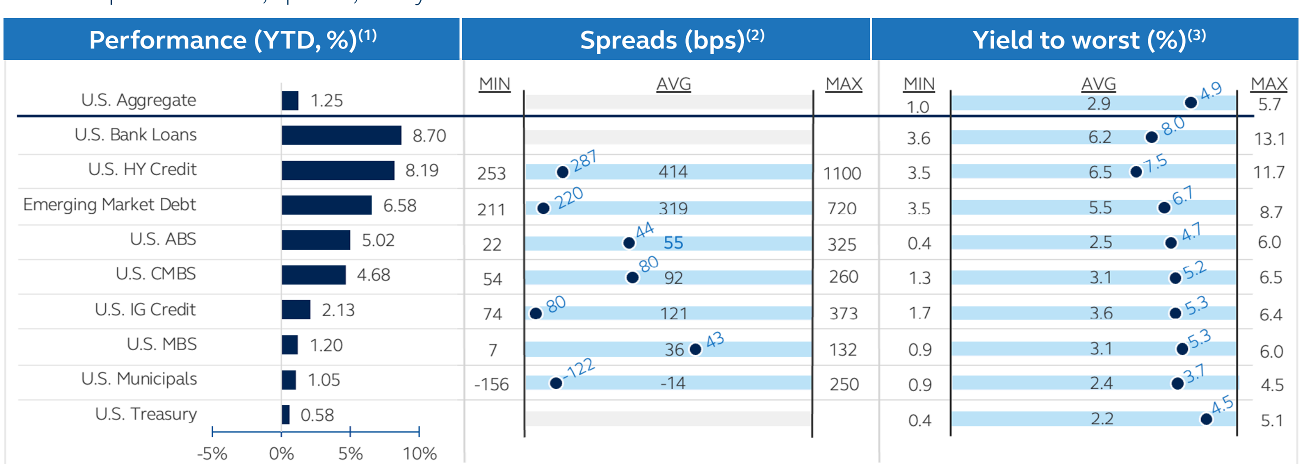
1. Inflation/growth implications of potential tariffs and retaliatory action from trading partners
2. Labor/wage growth repercussions of reduced immigration and potential deportation
3. Inflation/growth implications of renewed "animal spirits"
4. Fiscal/growth impact of the budget and potential tax cuts/extension

While many uncertainties arise from the election, the overall macro outlook is sanguine for fixed income and risk assets. A gradually cooling labor market, bumpy but improving inflation, attractive yields, and resilient consumers are a constructive mix that should support additional Fed policy normalization. We anticipate that the Fed will provide 25 basis point rate cuts at an every-other meeting pace through mid-2025, and we expect one additional cut in the second half of 2025 for a total of 75 bps incremental easing. Fed cuts support the front end of the curve, and ongoing Treasury supply from large fiscal deficits may weigh on term premium at the long end of the curve, leading us to a steepening bias. Therefore, we prefer duration positioned at the front end of the yield curve (2yr–5yr) versus the long end (>10yr).

While valuations are historically rich in most asset classes, fundamentals are solid (if past peak), and technicals remain overwhelmingly favorable, with strong demand and yield appetite across sectors. A correction in risk assets would not be surprising given the steady tightening in spreads and uncertainty revolving around the incoming Trump administration. Still, attractive yields should offer a buffer if a correction materializes.

Market environment

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



Data as of December 31, 2024, Source: Bloomberg, Principal Fixed Income.

(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. Indices used in order of appearance: Bloomberg U.S. Aggregate Index, S&P/LSTA (Loan Syndications and Trading Association) Leveraged Loan 100 Index, Bloomberg U.S. Corp HY 2% Issuer Capped Index, J.P. Morgan EMBI Global Diversified Index, Bloomberg Asset-Backed Securities Index, Bloomberg CMBS ERISA-Eligible Index, Bloomberg U.S. Municipal Bond Index, Bloomberg U.S. Credit Index, Bloomberg U.S. Treasury Index, Bloomberg U.S. MBS Index.

Global outlook

Global fixed income is entering 2025 at a fulcrum point as monetary policy easing meets fiscal and trade uncertainties. Outside Japan, central banks shifted monetary policy toward easing in 2024 or have opened the path for easing in 2025. This adjustment reflects inflation returning to target levels, prompting a transition from tight to neutral monetary policy stances. However, divergent growth paths remain evident, with U.S. growth showing resilience while much of the rest of the world struggles below potential.

Uncertainty surrounding incoming President Trump's trade and fiscal policies have investors on edge

The Trump-led Republican sweep in the November U.S. elections has injected uncertainty surrounding fiscal and trade policies in the world's largest economy. President-elect Trump's swift implementation of tariffs and proposed tax cuts are expected to create initial upward pressure on inflation, complicating the Federal Open Market Committee's (FOMC) efforts to stabilize prices and lower policy rates. These policies, if enacted, will more visibly weigh on growth in the rest of the world with questionable implications for U.S. growth.

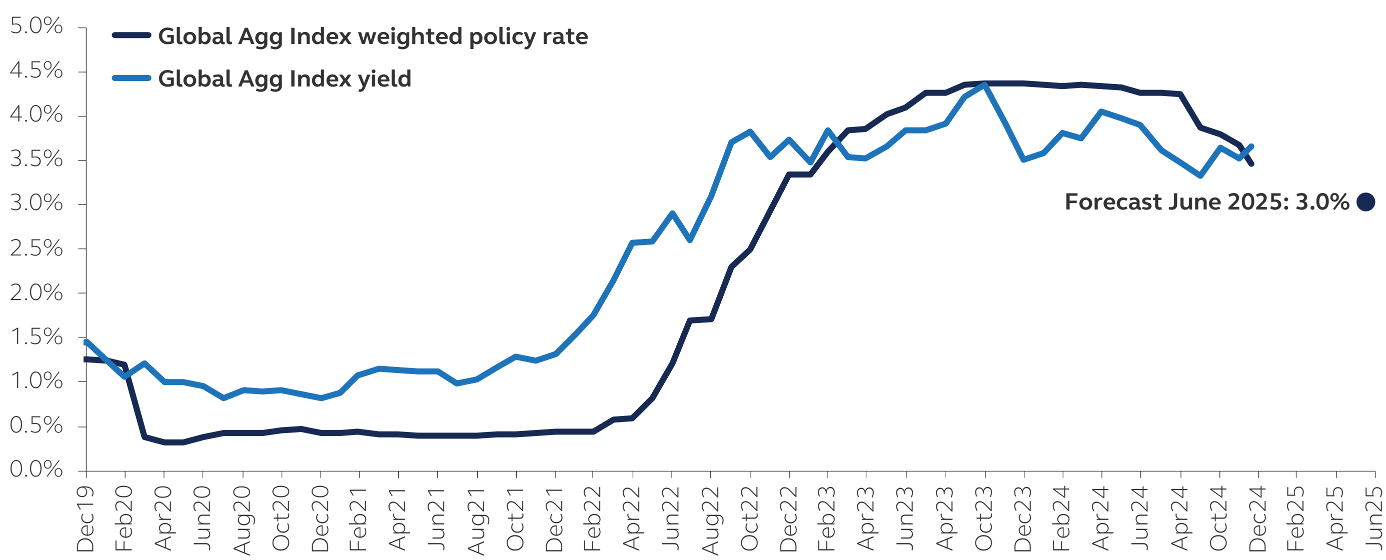
This uncertainty has created a ripple effect globally, leading to cautious central bank behavior. Rather than providing clear guidance on future policy paths, many central banks are waiting for more concrete economic outcomes. As 2025 progresses, the evolving implications for growth and inflation should bring policymakers out of their lethargy to normalize monetary policy to levels more consistent with historical economic cycles.

Regional growth, inflation, policy environment

	Growth vs. average cycle	Inflaton vs. target	Current monetary policy stance	Required policy stance
U.S.	At potential	Nearing target	Restrictive	Neutral
European Union	Low	At target	Neutral	Accommodative
Japan	At potential	At target	Accommodative	Neutral
UK	Low	At target	Restrictive	Accommodative
China	Low	Below target	Accommodative	Accommodative

Global Agg weighted policy rate vs. Index yield

December 2024 weights, 3-month rate proxy for non-policy rate driven central banks



Source: Bloomberg, Principal Fixed Income. Data as of December 18, 2024.

Investment grade credit

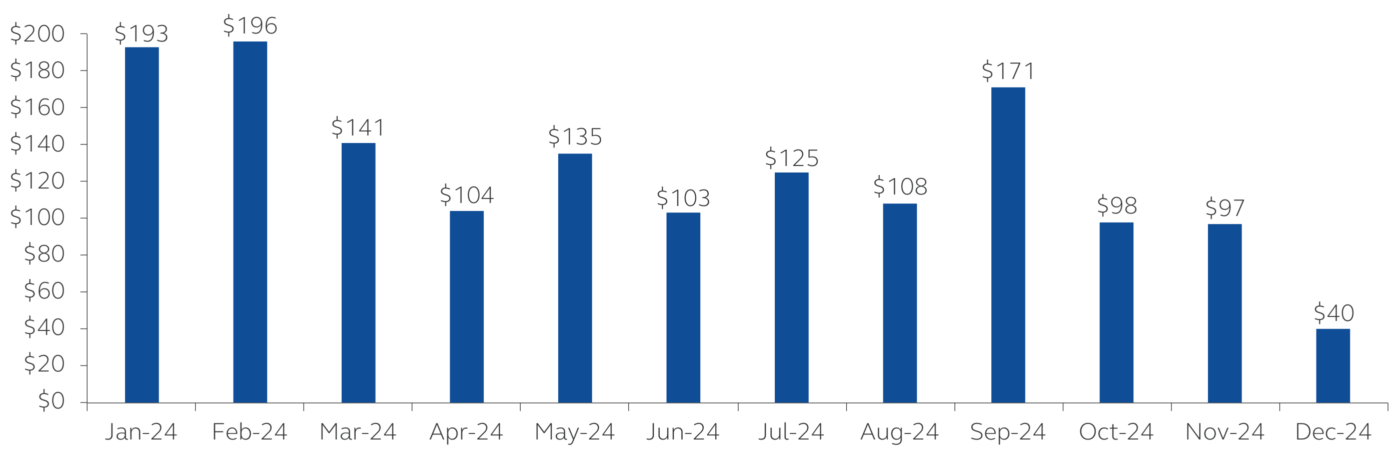
Investment grade (IG) credit thrives on moderation, and the current macro backdrop—characterized by steady growth, contained inflation, and moderate rates—has provided exactly that. As a resilient U.S. consumer continues to drive economic momentum, they have been supported by the Federal Reserve's cautious easing under Chair Powell's balanced approach to the dual mandate of employment and price stability. Meanwhile, the clear-cut outcome of the U.S. elections, with an emphasis on deregulation and tax cuts, adds another favorable dimension for IG credit. Although the labor market is cooling, the slowdown has been measured and remains within tolerable limits.

Higher yields feed the appetite for IG credit

IG technicals portray an encouraging picture. Despite seeing nearly $1.6 trillion of high-grade bond issuance in 2024—second only to 2020's record level—the IG market has readily absorbed this supply. In fact, spreads tightening 20 bps year-to-date (through December 19) in the face of such heavy issuance reflects the market's insatiable appetite for corporate bonds, as we saw the pace of bond supply slow in 4Q24. And, while projections for 2025's gross issuance levels appear comparable to this past year, net supply should be lower due to the slew of 5-year bonds maturing from 2020. Further, from a technical standpoint, yield continues to be compelling for institutional IG investors—75% of whom are income-focused— which helps explain the stable fund inflows of late. With yields above 5% and a reduced net supply on the horizon, IG technicals remain strongly supportive.

Investment grade monthly supply

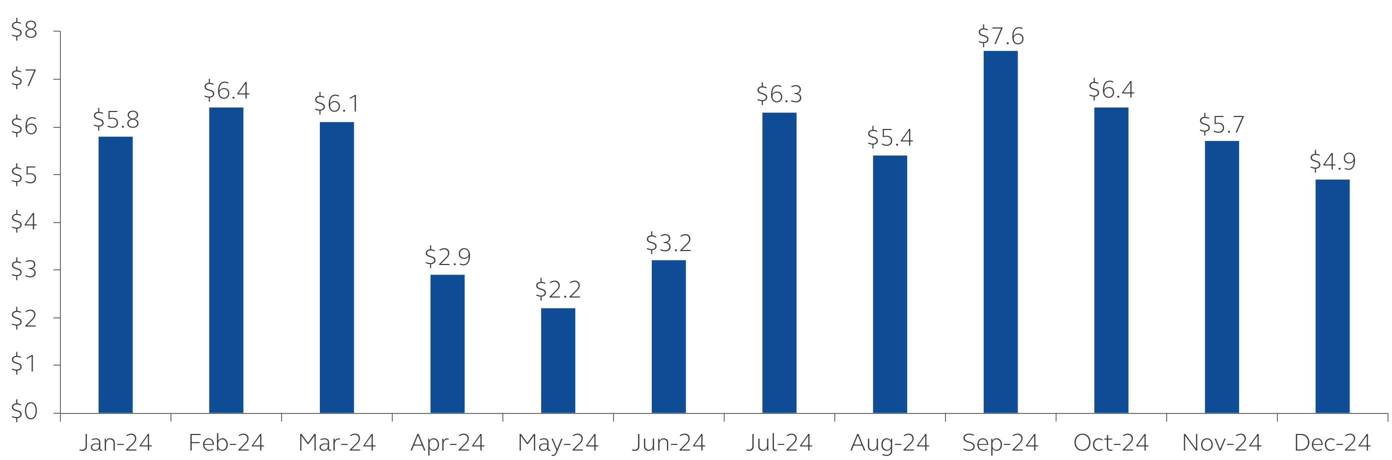
$billions, year-to-date 2024



Source: JP Morgan, Dealogic, Principal Asset Management. Data as of December 13, 2024.

Average weekly IG fund flows

$billions, year-to-date 2024



Source: JP Morgan, TRACE, Principal Asset Management. Data as of December 13, 2024.

Healthy balance sheets and bank liquidity feed market stability

Investment grade fundamentals exhibit stability. Given the strength of companies' balance sheets, we remain constructive on high grade credit metrics and remain focused on those with stable-to-improving fundamentals. De-leveraging discipline and favorable funding conditions have positioned companies' credit profiles well. Moreover, the large U.S. banks remain well positioned with healthy capital levels and durable liquidity. Any forthcoming relief in regulations will be welcome news for the banks, which have been hamstrung by overly onerous costs and strictures over the last decade. Finally, the recent Fed Senior Loan Officer Survey shows steady credit availability, with most lending standards unchanged outside of tightening in credit cards.

Already tight spreads are likely to remain range bound as investors lock in yield

Finally, from a valuation standpoint, tight spreads rightly reflect the strong bid for and the solid standing of IG corporate bonds. The primary and secondary markets offer attractive entry points to credit with solid fundamentals and good relative value. Indeed, investors seeking to lock in yields before the easing cycle extends further may lead to more substantial inflows into the IG asset class.

Given strong technicals and stable fundamentals, we expect IG spreads to remain range bound. A supportive Fed, tight credit fundamentals, and an upward-sloping yield curve between 2- and 10-year Treasurys should anchor stability in the IG market heading into 2025. In today's favorable IG environment, we continue to focus on maximizing opportunities through quality credit selection and strategic curve segmentation, which remain central to our investment process.

High yield credit

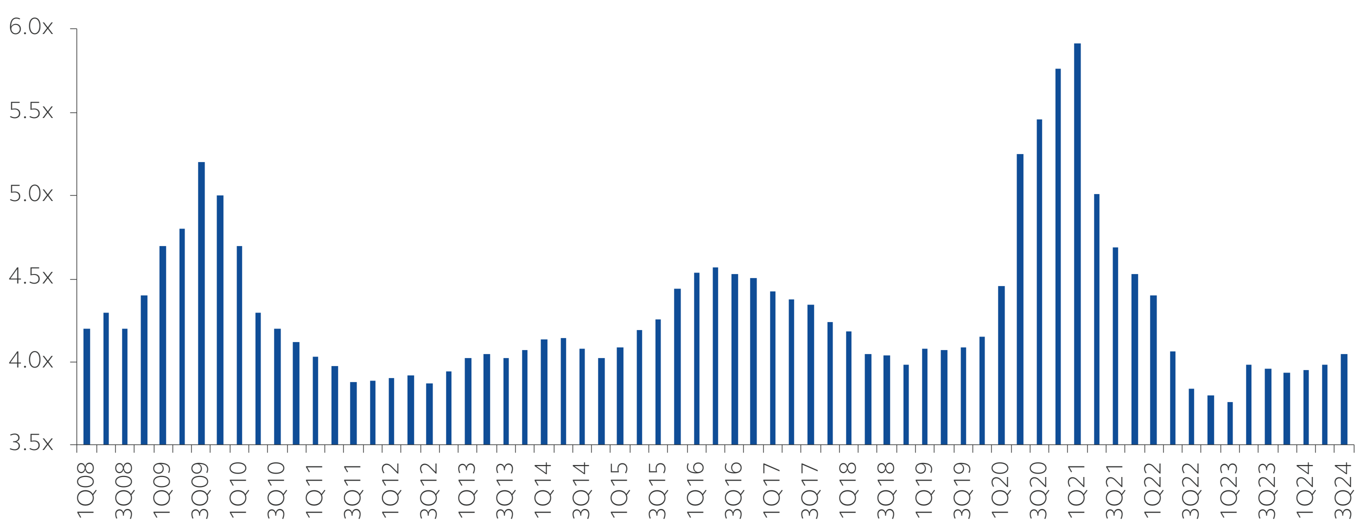
Heading into 2025, high yield credit offers a compelling outlook. Elevated yields, strong fundamentals, low default expectations, and supportive U.S. economic growth should help offset tight spreads and a less favorable technical backdrop.

High yield fundamentals remain robust despite some deterioration in balance sheets

Rates remaining higher for longer have taken their toll on high yield credit metrics, but they remain in strong. Leverage for the average high yield issuer remains comfortably below the long-term average of 4.3x. However, according to JP Morgan, leverage ticked up to over 4x in 3Q 2024. In addition, interest coverage— the ability for a company to pay its interest—is currently 4.7x, slightly above the long-term average of 4.5x but weaker than the previous quarter.

High yield leverage

LTM debt/EBITDA, 1Q08-3Q24



Source: JP Morgan, Principal Asset Management. Data as of December 19, 2024.

Nonetheless, we expect defaults to continue to drop in 2025 due to above-average credit ratios, along with easing lending standards.

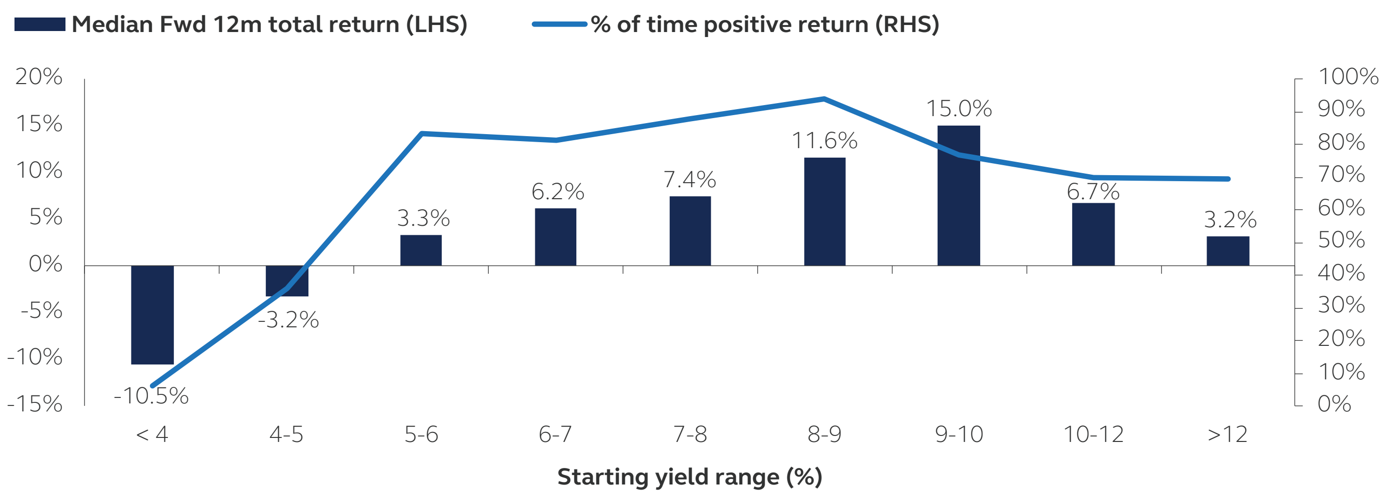
High yield technicals have benefited from strong inflows and limited net new issuance, yields comfortably above 7%

While we expect higher issuance levels in 2025—projected at approximately $350 billion—refinancings will still dominate, albeit to a lesser extent than in recent years. Notably, a greater share of issuance is expected to fund growth initiatives, and shareholder-friendly activities.

From a valuation perspective, with yields comfortably above 7%, high yield should continue to offer compelling income, although capital appreciation will be more limited. Despite tighter-than-average spreads, the index is of higher quality (over 50% BB-rated), more secured (33%), and shorter in duration (around 3 years vs. the historical average of 4 years). According to Barclays, if we consider the all-time tight spread of 233bps in May of 2007 and adjust for quality, collateral and duration, the all-time tight would have been below 200bps (vs. 265 today). This is an important distinction—we are not calling for any tightening, but the index is quite different today than it was in 2007. While we foresee slight spread widening in 2025, driven by softer technicals, the asset class is well-positioned to deliver attractive total returns. Historically, starting yields in the 7–8% range, like the current 7.2%, have consistently produced compelling outcomes.

12-month forward returns by starting yield range

January 2000–November 2023



Source: Bloomberg, Barclays Research, Principal Asset Management. Data as of November 30, 2023.

Although modest spread widening is likely, the combination of supportive fundamentals and elevated starting yields should enable high yield credit to generate attractive returns for investors in 2025.

Structured credit

Structured credit is well positioned to potentially benefit from expected deregulation, easing monetary policy and a tempering but healthy economy. Stable fundamentals and strong demand for risk assets lead us to expect spreads to tighten entering 2025. Longer-term spread moves, however, are more uncertain and will likely be driven by policy impacts from the new Trump administration.

A resilient consumer and expected deregulation favor structured credit

The U.S. consumer has remained resilient, supported by lower unemployment and strong wage gains. However, non-mortgage debt burdens and diminished savings are weighing on low-income earners and subprime consumers. At the same time, gains in the stock market and modest home price appreciation have been supportive of expanding consumer wealth. The recent trend of increasing asset-backed securities (ABS) delinquencies should begin to moderate as interest rates decline, improving affordability and potentially boosting home sales volume. However, home price appreciation will likely be limited as new unsold inventories have increased. Residential mortgage-backed securities (RMBS) performance should remain stable as the majority of homeowners are locked into mortgages that are nearly 300 basis points lower than prevailing rates.

Deregulation from a pro-business administration should drive new business activity, while more conservative rates should ease the debt burden across corporate and commercial borrowers. In commercial real estate (CRE), we anticipate continued improvement, particularly in the CMBS market, driven by low unemployment, declining rates, and new transaction activity. While maturity risks and rising delinquencies—especially in office properties—present challenges, these headwinds are expected to be offset by broader economic tailwinds.

Strong supply issuance is likely to continue in 2025 and meet with healthy demand

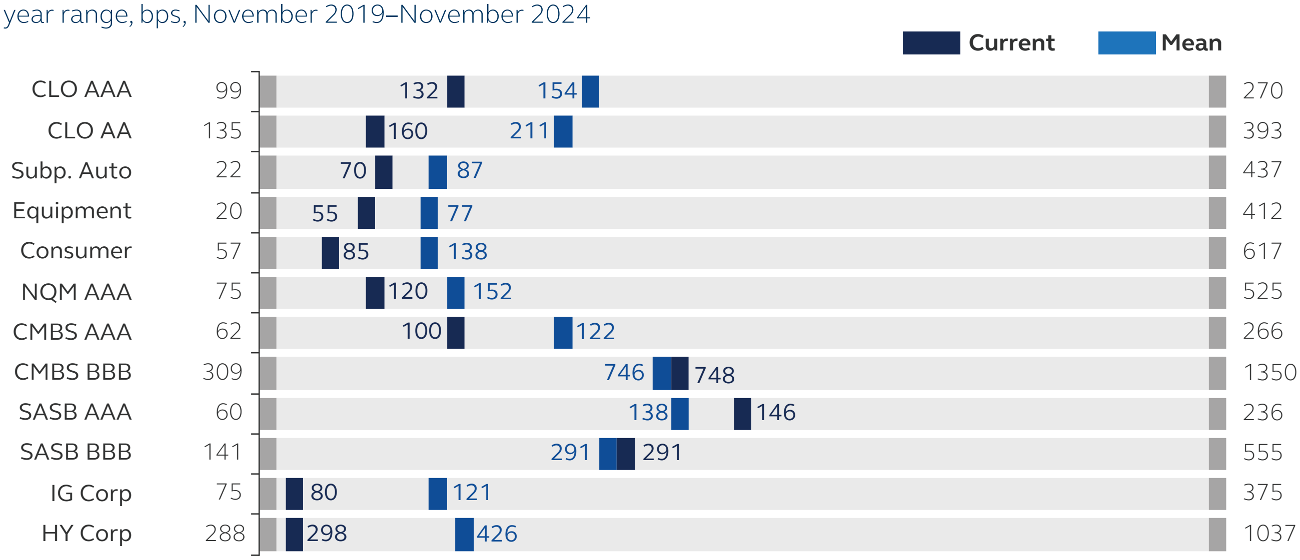
New issue deal supply for 2024 was strong across public structured markets with record-setting issuance in collateralized loan obligations (CLOs) and ABS. This strong supply trend is expected to continue into 2025, supported by the securitized market's competitive financing advantages for consumer, corporate, and commercial borrowers. Demand for structured credit should remain strong, fueled by increased bank participation and a risk-on sentiment prevailing through the market.

Even with spreads tight, we expect further tightening

Despite significant spread tightening in 2024, structured credit sectors remain attractive both on an absolute yield basis and relative to corporate bond sectors. We believe with the tailwinds of an accommodative and stable economy, the demand for risk assets will support spread tightening to start the new year.

Securitized credit new issue spreads

Five year range, bps, November 2019–November 2024



Source: Bank of America Securities, Wells Fargo Securities, Bloomberg, JP Morgan, Principal Fixed Income. Data as of November 30, 2024.

Opportunities in a "higher for longer" rate environment and neglected sectors of the market

Benefitting from strong bank and insurance company allocations, investors should seek opportunities in AAA rates CLOs. In particular, CLOs offer attractive carry from elevated short-term rates, which would remain compelling in a "higher for longer" interest rate environment. Additionally, we favor Single Asset Single Borrower (SASB) CMBS, which has lagged the recovery relative to conduit CMBS and is trading at attractive spreads compared to pre-COVID levels. The SASB market provides appealing spreads, duration flexibility, and the ability to select specific property exposures.

Municipals

As we enter 2025, municipal markets have shifted from one uncertainty, namely the outcome of the recent presidential election, to another set of unknowns, specifically President-elect Trump's economic and tax policies. Though not emanating from President Trump directly, a key concern is the potential scrutiny of the municipal tax exemption as the new administration searches for revenue offsets to extend the expiring provisions of the Tax Cuts and Jobs Act (TCJA) beyond 2025. Conceding that the risk has increased relative to prior years, we believe the exemption will remain fully intact, and any attempt to eliminate it would be a monumental political task and an extremely ineffective measure as it would likely raise financing costs for state and local governments already grappling with the withdrawal of federal pandemic stimulus.

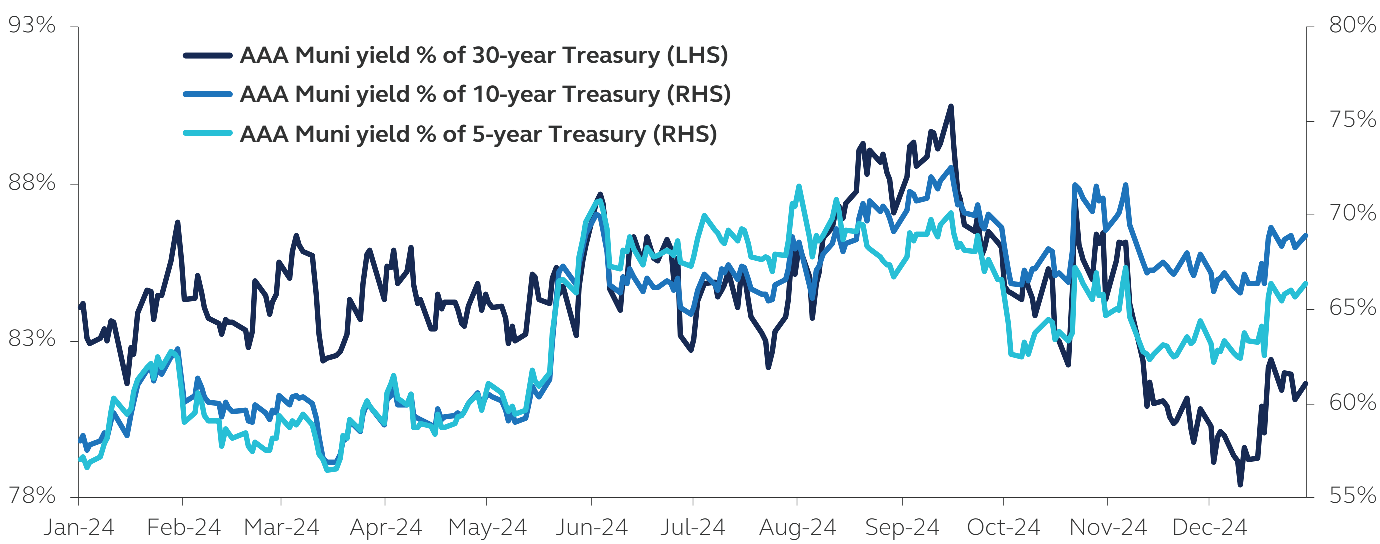
Attractive yields and anticipated rating activity leave munis well-positioned

The surprising late December selloff in longer-dated securities has only increased the value proposition of municipals. Municipal yields are at decade highs, further enhancing the relative worth of the tax exemption on a tax equivalent basis when compared to taxable fixed income alternatives. Though it will likely be an uneven path for all financial markets in 2025, we expect municipals to generate positive total returns as the asset's diversification benefits and capital preservation nature will likely produce attractive risk-adjusted returns.

Fundamentally, credit quality across the asset class is excellent and likely to remain so in 2025. We expect rating agency activity to reflect more credit upgrades than downgrades, although admittedly at a lower rate than in prior years. Like 2024, we again anticipate another year where revenue-backed debt outperforms traditional general obligation bonds while lower investment grade securities (A and BBB) exceed the returns on top-rated debt (AAA and AA).

Municipal to Treasury ratios

AAA municipal bond yields relative to Treasurys, August 2023–present



Source: Bloomberg, Principal Asset Management. Data as of December 31, 2024.

Issuance is expected to be strong, with transportation and utilities leading the way

We expect 2025 to be a record year of issuance for municipals. The tax exemption concerns noted above, coupled with the loss of federal stimulus, will most assuredly pull forward delayed issuance, with first half of 2025 volume to exceed second half volume. Public utilities, on rising energy demand, and transportation (airports, toll roads) projects, predicated on aging infrastructure, are two municipal sectors where we expect a notable increase in issuance.

2024 established a positive inflow cycle of demand for the asset class—momentum we see continuing for 2025. Though lower corporate tax rates have curtailed institutional demand among banks and insurance companies, record increases in ETFs and professionally managed separate accounts have more than offset that decline along with supportive inflows into the mutual fund complex. The attractive absolute and relative yields noted above should keep this three-legged stool of demand (funds, ETFs, SMAs) on track, easily absorbing record issuance and supporting valuations.

Emerging market debt

Exiting 2024, the backdrop for emerging markets (EM) looks economically sound, but with one eye toward new obstacles in 2025. Overall projected growth in the sector remains positive, likely near 4%, with inflation primarily contained and fiscal deficits still manageable. Trade policy and current account balances are where investors will likely see a divergence from 2024, with potential strains on EM currencies as a result. The potential for continued strong growth in the U.S., along with a tempered rate-cutting outlook, would add to EM currency volatility and slow the pace of easing from EM central banks.

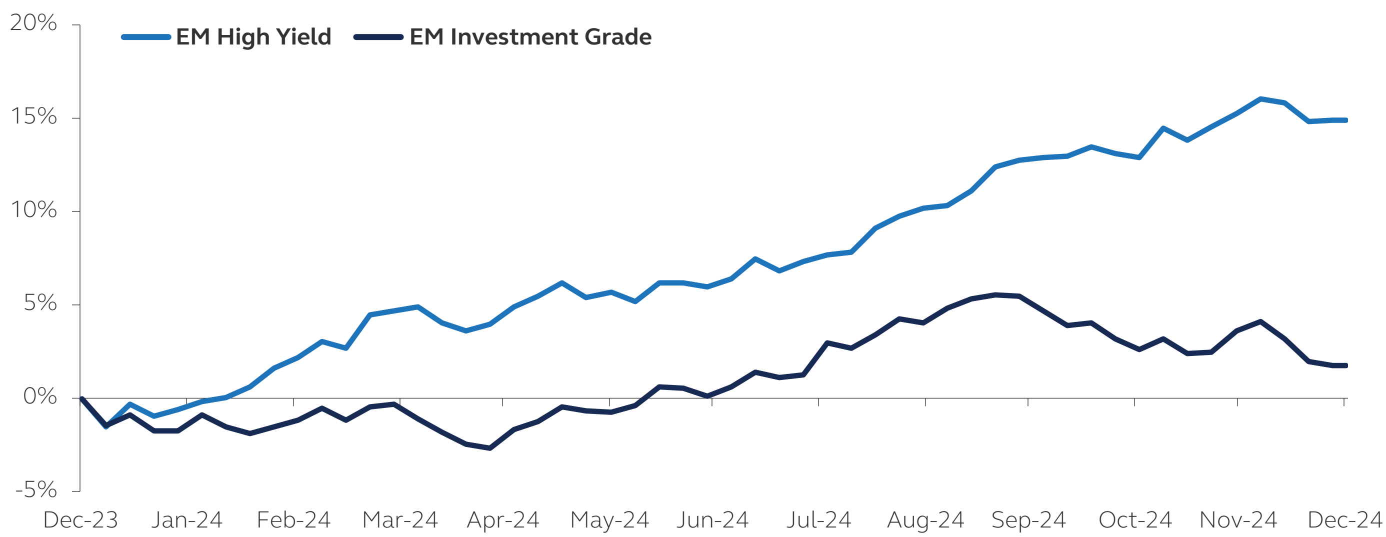
Trump tariff threat bears watching as do ongoing conflicts

A key focus within EM will be the renewed tariff pressures from the incoming Trump administration. While the specifics are still unclear, these policies are likely to exacerbate divergences within EM, with China and Mexico particularly exposed. Potential pass-through effects to manufacturers and commodity-linked economies could amplify these challenges. Additional potential market-moving geopolitical events of 2025 include some type of resolution to the Russia/Ukraine war, de-escalation of the Israel/Hamas Middle East violence, including more significant Iranian sanctions by the Trump administration, and pressure on OPEC as they struggle to maintain the energy supply/price balance in the global markets.

As with EM sovereigns, EM corporates fundamentally enter the new year in solid shape, with stronger credit metrics than their developed market counterparts. Given credit spreads are near record tights to U.S. Treasurys and U.S. corporates, there is the potential for widening next year as the U.S. pursues a more protectionist agenda. Robust EM growth should stabilize domestic demand, providing a buffer against external volatility. Therefore, relative investment outperformance within the EM corporate space will likely derive from a combination of name selection, carry, and top-down sovereign risk assessment.

Emerging market investment grade and high yield returns

Total returns, Calendar year 2024



Source: Bloomberg, Principal Fixed Income. Data as of December 31, 2024. Indices used are the Bloomberg EM USD Aggregate: Investment Grade Index and the Bloomberg EM USD Aggregate: High Yield Index.

Downward pressure on oil prices benefits some EM markets

Outside of the macro implications of U.S. exceptionalism and protectionism, the incoming administration's pledge to unleash energy production will put downward pressure on oil prices. We don't expect widespread stress in EM as most of the credits benefit from their linkages to sovereigns (e.g., Pemex) or low production costs (e.g., the Gulf Cooperation Council names). Many of the Asia Pacific names are oil importers and thus benefit from lower prices. As A- and AA-rated sovereigns in the Gulf diversify their economies and investments away from oil, we expect the associated corporates to drive a larger portion of the index.

Selectivity will be important in 2025

As we look to the broader EM markets in 2025, we continue to see opportunities in EM debt, although these will be more selective than the broadly positive tailwinds of 2024. Like many other parts of the market, valuations and spread levels are starting at near historically tight levels. Despite these starting levels, carry remains attractive, with the EM USD Aggregate Index yield near 6.5% (Baa2/Baa3 average rating). Technicals in the sector will likely remain somewhat balanced, with investor flows still tilted toward developed markets, particularly in the first half of 2025. Still, we see both sovereign and corporate issuance as more measured versus a strong 2024 calendar year.

Emerging market debt should play a part in investors' fixed income portfolio allocations. With issuance spanning sovereign, quasi-sovereign, and corporate denominated in U.S. dollars or local currency and risk categories from single-C to AA, EM debt allows investors to specify risk tolerances, carry, and return objectives. Across emerging market debt, 2025 will favor the active EM investor as performance and carry will focus on top-down and bottom-up credit selection.

Private credit

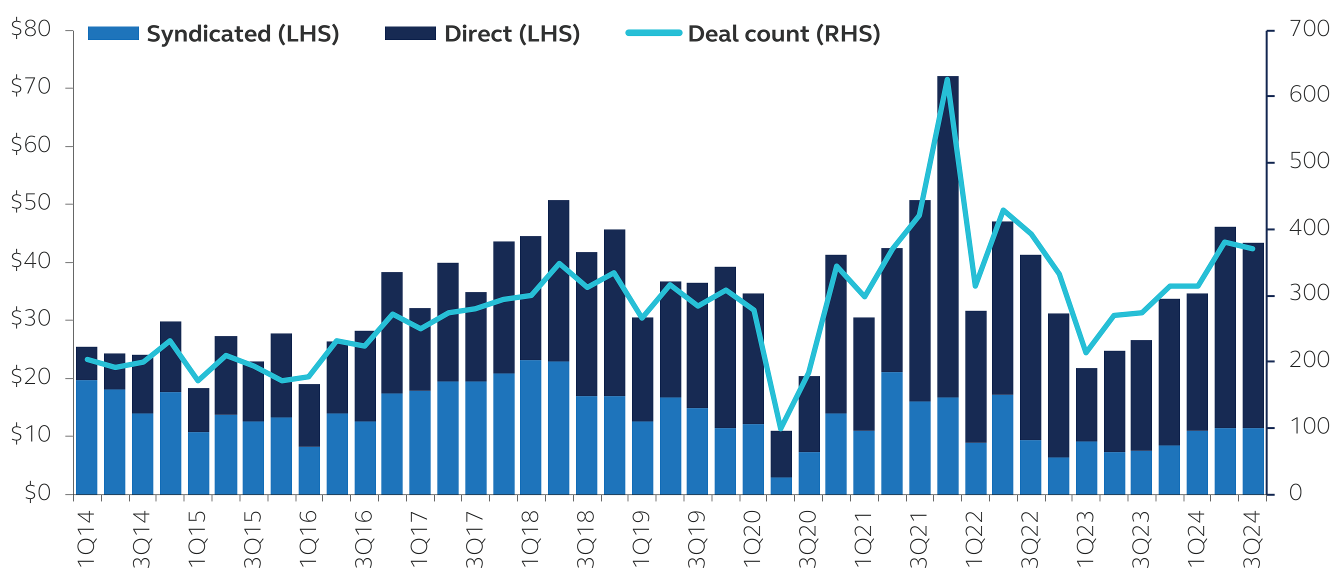
Private credit enters 2025 with optimism, supported by improving macroeconomic clarity and favorable conditions for middle market direct lending. Despite an uncertain economic backdrop, and volatile interest rate environment over the past couple of years, the asset class delivered steady performance and continued to grow market share relative to public high yield. Now with an expectation for increased deal flow and investor demand, private credit, and specifically middle market direct lending, is poised for continued growth and outperformance in the new year.

Economic tailwinds are driving activity

Deal flow in private credit markets is recovering to more typical levels and expected to remain robust through 2025. Following the slowdown in 2023 and 2024, mergers and acquisitions (M&A) and leveraged buyout (LBO) activity is recovering to more typical levels. This resurgence is driven by an improved economic outlook along with an expectation for generally business friendly tax and regulatory policies following the U.S. election. The Federal Reserve's measured rate cuts have also supported credit conditions, which is contributing to stabilizing enterprise valuations. Many private equity (PE) sponsors are also seeking to proactively deploy capital into new deal opportunities given the improved backdrop and slower than desired pace of deployment over the past couple years. All of this taken together is fostering a very supportive environment for M&A and LBO activity. In addition, the lower short-term rate environment is providing borrowers more financial flexibility and supporting liquidity.

Sponsored middle market loan volume and deal count

$billion, 1Q14–present



Source: LSEG, Principal Fixed Income. Data as of September 30, 2024.

Middle market lending remains resilient

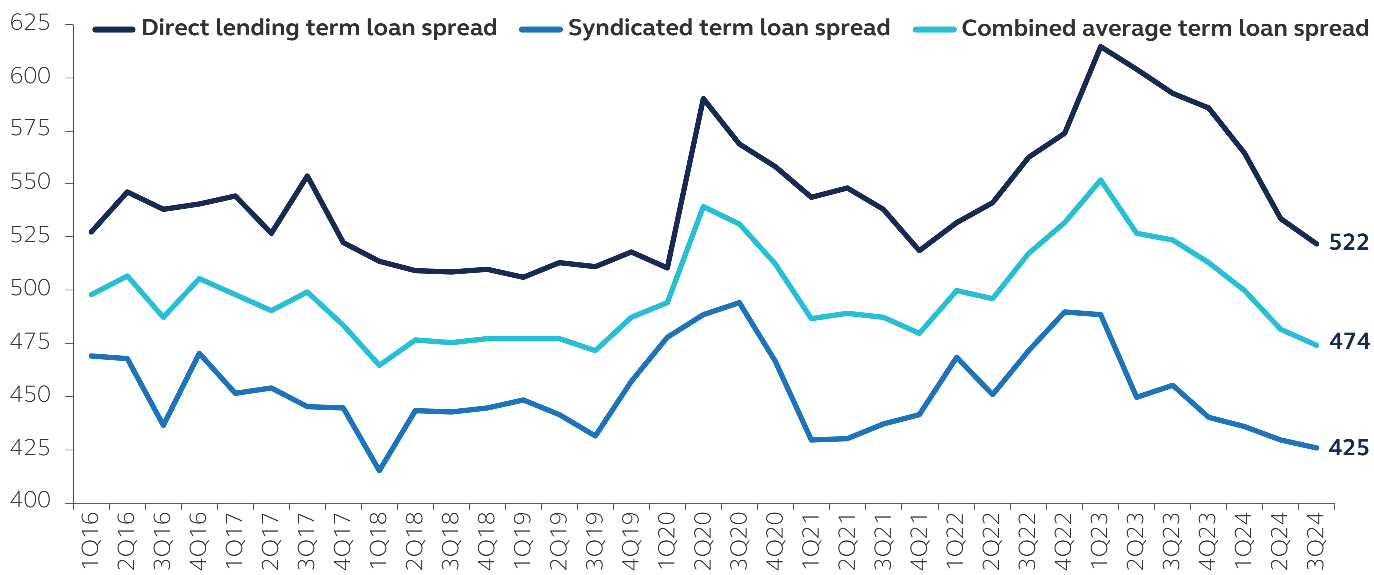
Middle market direct lending remains the cornerstone of private credit, offering attractive value for both borrowers and investors. Borrowers have navigated the higher rate environment by seeking to expand cash flow through operational efficiencies, pricing power, and strategic growth. For investors, the higher rate environment has driven strong returns, and the recent loan vintages (structured under tighter credit conditions) are expected to perform well as the economy transitions to a more constructive trajectory. Credit structures have been strengthened with lower leverage levels and tighter covenant cushions providing added security for investors. Meanwhile, default rates remain below the historical average of 2-2.5%, and well below current default rates for public corporate high yield.

Demand dynamics and investor appeal

Investor interest in private credit continues to grow, driven by yield premiums, diversification benefits, and improved capital deployment opportunities. Middle market direct lending offers spreads above public market equivalents, delivering a significant risk-adjusted income advantage. Additionally, the asset class provides exposure to less cyclical industries with lower correlation to public markets, reinforcing its role as a portfolio stabilizer. As deal activity rebounds, investors frustrated by slow capital recycling are now seeing greater prospects for deployment and return generation.

Average first-lien sponsored middle market term loan spend

Basis points, 2016-present



Source: LSEG, Principal Fixed Income. Data as of September 30, 2024.

Private credit stands at the nexus of expanding investor interest and improving market conditions. However, challenges remain, including policy implementation risks and potential economic disruptions. As rates remain elevated and global markets adjust, middle market direct lending is positioned to outperform, delivering robust yields, stable fundamentals, and represents a compelling opportunity for investors seeking incremental yield and portfolio diversification. The continued evolution of the asset class, including the democratization of private credit through accessible fund structures, will further broaden its appeal, helping to ensure its relevance in a dynamic investment landscape.

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 December 31, 2024. 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.

Conclusion

Entering 2025, the fixed income landscape reflects a blend of optimism and caution. The Federal Reserve's gradual rate-cutting cycle, combined with resilient consumer spending and moderating inflation, provides a supportive environment for fixed income investors. While uncertainties surrounding fiscal and trade policies under the new administration and global geopolitical risks may create pockets of volatility, attractive yields and solid credit fundamentals across asset classes present compelling opportunities. Active management and selective positioning will remain critical as investors navigate this dynamic landscape, with an emphasis on capturing value in sectors supported by robust technicals and strong fundamentals.

Principal Fixed Income: A leading global fixed income platform

Principal Fixed Income is the fixed income investment management platform of Principal Asset Management and manages U.S. $147.3 billion in assets under management as of September 30, 2024. Principal Fixed Income has capabilities that span all major fixed income sectors. Our globally integrated platform with investment centers worldwide and over 100 investment professionals, helps to directly access global fixed income markets and deliver a diversity of investment perspectives. Our structure and proprietary investment tools foster collaboration across sector-specialty teams, whether the sector is explicitly integrated into a portfolio or not. In our view, this diversity of insight helps each sector-specialty team formulate richer investment theses and make better-informed investment decisions on behalf of our clients.

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 is comprised of the senior-most investment professionals from across the platform and is responsible for identifying 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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Contact your Principal representative and visit PrincipalAM.com.

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