Principal Fixed Income

Principal Asset Management℠

SECOND QUARTER 2024

Fixed income perspectives

Themes, outlook, and investment implications across global fixed income markets

Looking ahead at 2Q 2024: A pause before a pivot

Uncertainty surrounding the timing and depth of prospective rate cuts has risen and the resilience of the economy has been surprising. However, we believe evidence of lagged policy transmission will further reveal itself over the quarter ahead.

1. Owners' equivalent rent (OER)—a key indicator of inflation—has been noisy over 1Q, however, other leading inflation indicators suggest there's OER improvement to come in 2Q. This is supportive of a continued downward trend in inflation.
2. Unemployment claims remain low by historical standards, but signs of softening and a meaningful upsurge in claims could challenge the market consensus of a soft landing and increase pricing for the magnitude of cuts.
3. A confluence of headwinds, including depleting excess savings, tightening credit, and rapidly rising interest payments, could slow consumer spending, the main engine of economic growth.

What's inside

Macro Outlook

U.S.

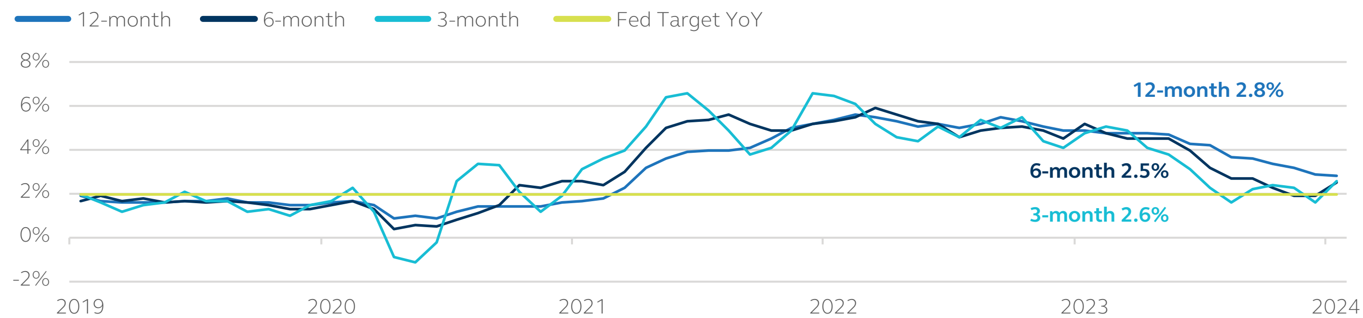
It's important to remember that the U.S. Federal Reserve (Fed) is charged with a dual mandate under the 1913 Federal Reserve Act, "to promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates." As Fed policy has shifted from a historically aggressive series of rate hikes to a pause phase, market participants are now looking forward to the start of a rate cut cycle. Given the Fed's dual mandate, however, the timing and magnitude of cuts will be determined by the evolution of inflation and employment.

Inflation

Despite the attention the Consumer Price Index (CPI) draws, the Federal Open Market Committee's (FOMC) preferred gauge for inflation is year-over-year (YoY) core personal consumption expenditures (PCE), which currently stands below 3%. Three- and six-month annualized core PCE remains even lower, and the "base effect" rolling out from the prior year is higher, meaning further improvement in YoY lies ahead. The Fed has said, given the lags, they intend to begin the process of reducing rates before the 2% goal is achieved, supporting recent guidance of rate reductions beginning around mid-year.

EXHIBIT 1

Core PCE



Source: Bloomberg. As of January 31, 2024.

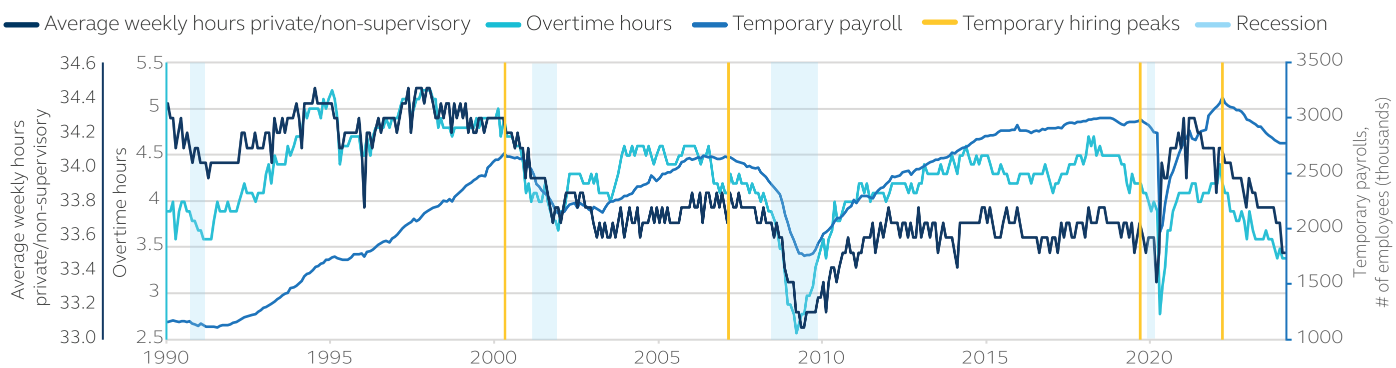
One of the key indicators for inflation is OER. While goods prices have declined, services will be the driver to get across the Fed's finish line, and shelter is the largest component of CPI and the second largest within PCE. While OER has recently been noisy, the leading indicators (primary rents, new lease signings, median home prices, home price appreciation, Cleveland Fed New Tenant Repeat Rent Index) all suggest that there is a significant amount of OER improvement to come in the next few quarters.

Employment

To the surprise of many, the U.S. jobs market has been incredibly resilient, and nonfarm payrolls have been re-accelerating of late. However, many details of the jobs market appear less favorable than headline nonfarm payrolls. The bulk of the growth in the jobs market has been part-time workers; in fact, full-time employment in the household survey peaked in the summer of 2023 and has steadily declined since. Leading indicators of the labor market—temporary employment, average weekly hours, overtime hours, and aggregate hours—have all been declining, consistent with prior late-cycle activity. If inflation continues to improve, a resilient jobs market won't preclude the FOMC from beginning to reduce rates, but a deterioration in jobs would increase expectations for the magnitude of cuts.

EXHIBIT 2

Leading indicators of the labor market in decline



Source: Bloomberg. As of February 29, 2024.

One of the key indicators for employment is the four-week average of unemployment claims. To date, claims remain low by historical standards. When claims begin to deteriorate, it typically occurs late in the economic cycle, just ahead of a recession, and claims can increase rapidly. A meaningful upsurge in claims would challenge the market consensus of a soft landing and increase pricing for the magnitude of cuts.

Duration has been a powerful headwind for fixed income over the past couple of years. With market pricing now aligned with Fed guidance for rate cuts later this year, duration looks set to transition to a potent tailwind. For the first time in years, fixed income returns appear poised to benefit both from an attractive yield and a duration tailwind.

Global

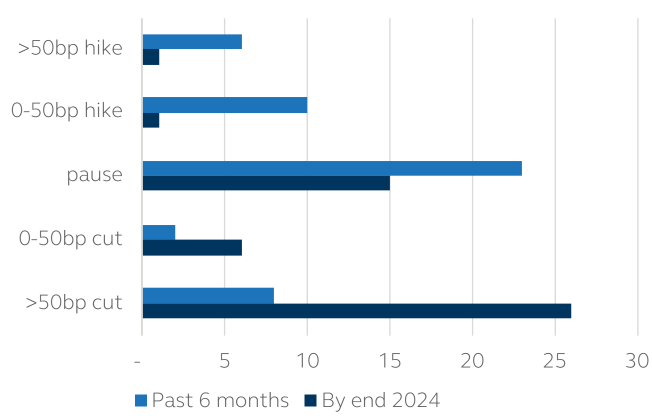
Led by the Fed, an almost unanimous pushback by global central banks against market expectations of imminent rate cuts has been the dominating theme driving the market so far this year. Reinforced by tight labor market data and a rebound in core inflation data heavily influenced by calendar seasonals, the market repriced U.S. rate cuts for 2024 from over six cuts for the year to just three. As yields repriced, the dollar also appreciated 3%. Global central banks cited uncertainty over continued improvement in inflation data and concerns about a stronger dollar bringing imported inflation and lifting inflation expectations in their respective economies as reasons for their joint pushback on rate cut expectations. The hawkish shift raised rate hike expectations for some economies such as New Zealand, which is unusual given the Reserve Bank of New Zealand governors' own estimates that the lagged transmission of rate hikes has yet to be fully passed through to the economy.

Underneath the consensus expectations of a soft landing—a view echoed by the G20 and International Monetary Fund (IMF)—there are signs of lagged policy transmission quietly working through the economy. Household disposable income across the G4 plateaued despite a robust labor market, as increasing amounts of income go towards servicing more expensive borrowing. Despite falling yields in bond markets, the weighted average mortgage rates serviced by households rose 10 basis points (bps) in 4Q 2023. There are also signs of increased delinquencies for both consumer and commercial lending. While far from being a cause for concern for the banking system, regulators are warning banks to increase provisions and reduce leverage provided to households and real estate-related lending. These are normal reaction functions of banks and borrowers, as higher policy rates filter through to the broader economy. This will continue to anchor growth and inflation pressures over the course of the year despite the recent upticks.

The bigger picture for 2024 remains that of policy rate cuts. These expectations have certainly been pushed back, but the policy course in 2H is unlikely to be derailed. Given the magnitude and synchronization of rate hikes over the last two years, the commencement of the rate-cutting cycle would be a momentous event that is currently underpriced by the financial markets. By the same token, Japan stood out in normalizing its monetary policy tighter, the significance of which continues to echo through its stock and currency markets.

EXHIBIT 3

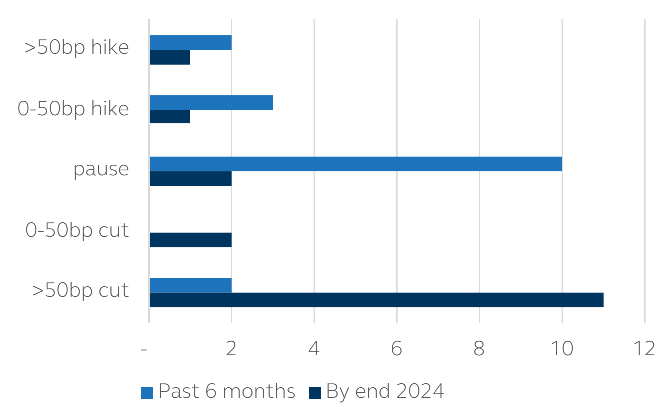
Number of economies (world) policy rate adjustment



Source: Bloomberg. As of February 27, 2024.

EXHIBIT 4

Number of economies (G20) policy rate adjustment



Source: Bloomberg. As of February 27, 2024.

Summary of investment implications

INVESTMENT GRADE CREDIT

With the Fed pivot in place, the macro backdrop appears supportive for investment grade (IG) credit. While IG spreads are tight, demand remains robust, and yields continue to be very attractive.

HIGH YIELD CREDIT

We anticipate more subdued returns in the near future, with limited potential for narrowing yield spreads and the possibility of some widening. Nevertheless, the substantial income produced by the high yield (HY) asset class should continue to be enticing for investors.

SECURITIZED DEBT

Mortgage-backed securities (MBS): A confluence of factors (bank demand, lower cash rates, attractive spreads) suggest the MBS sector is primed for performance for the balance of 2024.

Asset-backed securities (ABS): A unique combination of credit and technical factors has resulted in an opportunity to add high-quality, short-duration residential mortgage-backed securities (RMBS) as assets are expected to provide relatively stable performance across varying market scenarios.

Commercial mortgage-backed securities (CMBS): We see attractive value in single asset single borrower (SASB) loans, which offer exposure to specific property types in lower-leveraged, higher-quality commercial real estate.

MUNICIPALS

We expect the upcoming presidential election to begin to weigh on the municipal sector. Though credit spreads are not as wide as a year ago, we still see a relative value opportunity in 2024 with spreads compressing further based on diversification benefits and demand for high-quality, long-duration assets.

EMERGING MARKET DEBT

On the back of slowing developed market (DM) growth and stabilizing emerging market (EM) growth after a resilient performance in 2023, EMs are set to increase their growth outperformance versus DMs in 2024.

PRIVATE CREDIT

Though new loan volume origination for private middle market direct lending has been somewhat below the expected full-year 2024 pace, the volume that is being realized continues to present attractive value.

Investment grade credit

Similar to the way a stock price embeds expectations of a company's future earnings, today's corporate bond market appears to be pricing in expectations of future flows into the credit market. Even as spreads are pinned at tighter levels, money continues flowing into the asset class, and new bond deals are readily absorbed by investors focused on yields (currently 5.3%). Notably, the near-to-medium term expectation of money coming into IG credit is creating the receptive risk tone amid these tighter spreads. Investors are clamoring for corporate bonds, and the surging supply seen so far has come in response to demand.

Currently, IG demand centers on the compelling yield story and "goldilocks" backdrop. With the Fed pivot in place, the macro backdrop appears supportive for IG credit. Fed hikes have led to lower inflation, though the last mile might prove long. Meanwhile, the consumer continues spending and the U.S. economy growing. GDP rose 3.3% in 4Q, capping a strong year, and solid economic growth and job creation persist without appreciable jobless claims. Nevertheless, a confluence of headwinds could slow consumer spending, the main engine of economic growth. Excess savings are running out, banks are tightening credit (albeit at a decelerated rate), and interest payments are rising rapidly due to increased credit card debt and buy now/pay later financing. For now, though, consumer resiliency continues.

Although fundamentals have likely peaked and valuations appear stretched, the technical backdrop and Fed outlook serve to underpin IG credit. For the time being, yield—not spread—is driving this market as IG credit draws the attention of institutional investors. With strong demand, the historical pattern of supply following demand has played out. The year began with a pair of ~$200 billion new issue months (both record months), with February marking the fifth most active supply month ever. March supply followed suit with over $140B in new issuance, surpassing monthly estimates and setting a 1Q record for primary volume. The robust demand appears driven by both enticing yields and impending Fed rate cuts. Higher Treasury yields are supportive of IG spreads, and yield-focused buyers make up 60% of institutional fixed income investors.

Last year, $1 trillion poured into money market funds while equity markets returned nearly 25%. A normalizing yield curve may entice investors to extend duration and seek increased yield in IG corporates. Beyond the positive technical of a steepening yield curve, a desire for 60/40 funds to rebalance may also lead to IG inflows. Security selection and curve positioning come into sharper focus with IG valuations where they are. Meanwhile, technical factors remain strongly supportive, with investors yearning for yield galvanized to buy bonds.

EXHIBIT 5

Bloomberg U.S. Corporate Bond Index

Source: Bloomberg. As of February 29, 2024.

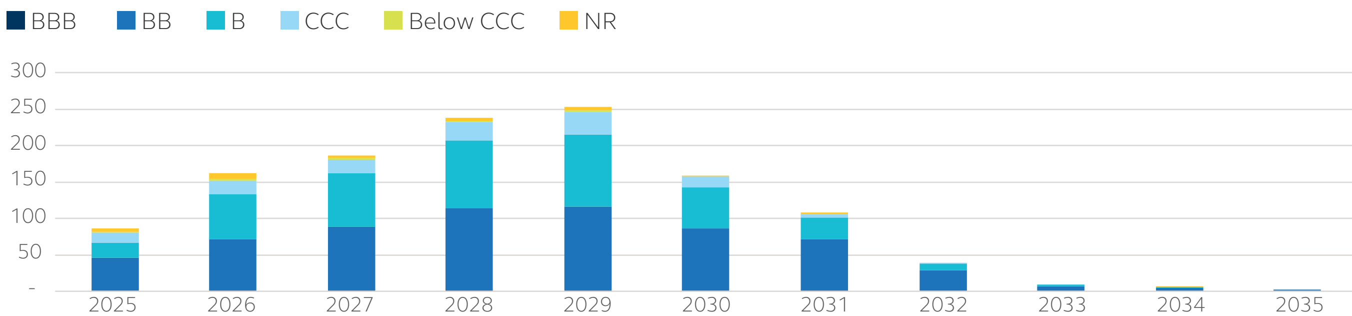
High yield credit

Despite ongoing geopolitical tensions and macroeconomic challenges (including stubborn inflation and shifting rate cut expectations), we remain positive about the prospects for HY. Admittedly, spreads are tight today, and we anticipate a slight widening through 2024. As we highlighted over the last few quarters, the asset class was appealing when bonds traded at an average "price" in the $80 range. With bonds now trading in the low $90s, we still see value but acknowledge that the potential for price appreciation has diminished. However, the asset class continues to offer a substantial amount of income, especially as default rates decline. With a manageable maturity ladder ahead, HY offers ample prospects for investor returns.

In terms of the maturity ladder, we do not view the approaching wave of bond maturities as a significant risk to the HY asset class. Looking forward, the Bloomberg U.S. Corporate High Yield - 2% Issuer Capped Index shows only $86 billion of HY bond maturities due in 2025, with over half of these bonds rated BB, indicating relatively lower risk. In 2026, we will see $162 billion in maturities. Despite an increasing volume of maturities extending into 2028, the market for new HY issues remains accessible for companies not experiencing long-term secular declines or facing specific idiosyncratic risks. In the early months of 2024, we have already seen nearly $60 billion in new issuance, 86% of which is being used to refinance debt maturing in 2027 and 2028. Barring any exogenous events, we anticipate that the "looming maturity wall" will not lead to an increase in default rates, demonstrating the market's resilience and the strategic management of refinancing needs.

EXHIBIT 6

Maturity wall by quality, Bloomberg U.S. Corporate High Yield - 2% Issuer Capped Index ($B)

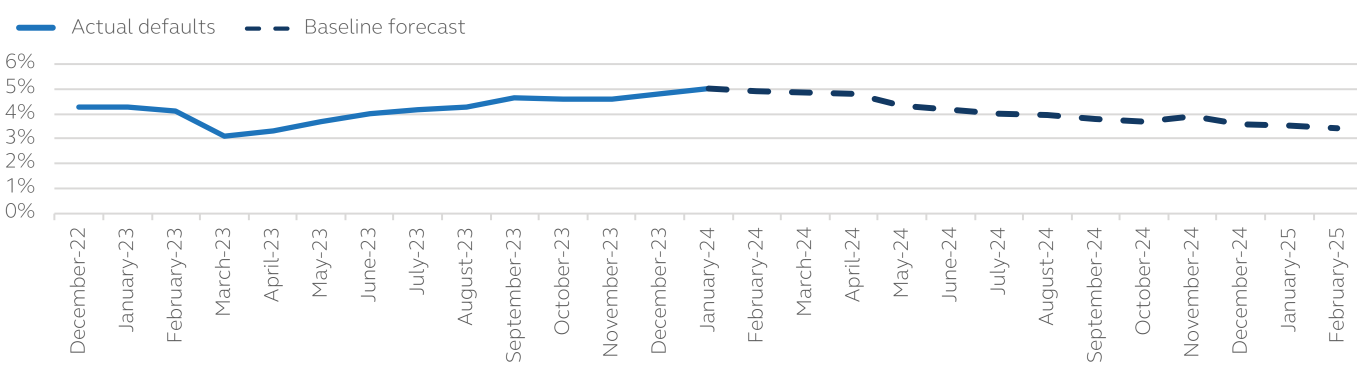


Source: Bloomberg. As of February 29, 2024.

We fully acknowledge that companies may default for reasons beyond approaching maturities, but we don't see the upcoming maturity wave as a significant obstacle for the HY asset class. Our outlook on the fundamental performance of these companies is positive, as well. A larger number of HY companies are guiding to optimistic earnings forecasts compared to those that are not. In fact, J.P. Morgan's research indicates that for every company issuing negative guidance, there are 1.4 companies providing positive outlooks.

EXHIBIT 7

Moody's global default rate forecast



Source: Moody's Default Report. As of March 14, 2024.

We anticipate more subdued returns in the near future, with limited potential for narrowing yield spreads and the possibility of some widening. Nevertheless, the substantial income produced by the HY asset class should continue to deliver attractive returns for investors. We do not expect an increase in default rates, and several factors—such as the manageable volume of upcoming maturities, strong balance sheets, and the prospect of strong corporate earnings—establish favorable positioning for HY for the rest of the year.

Securitized debt

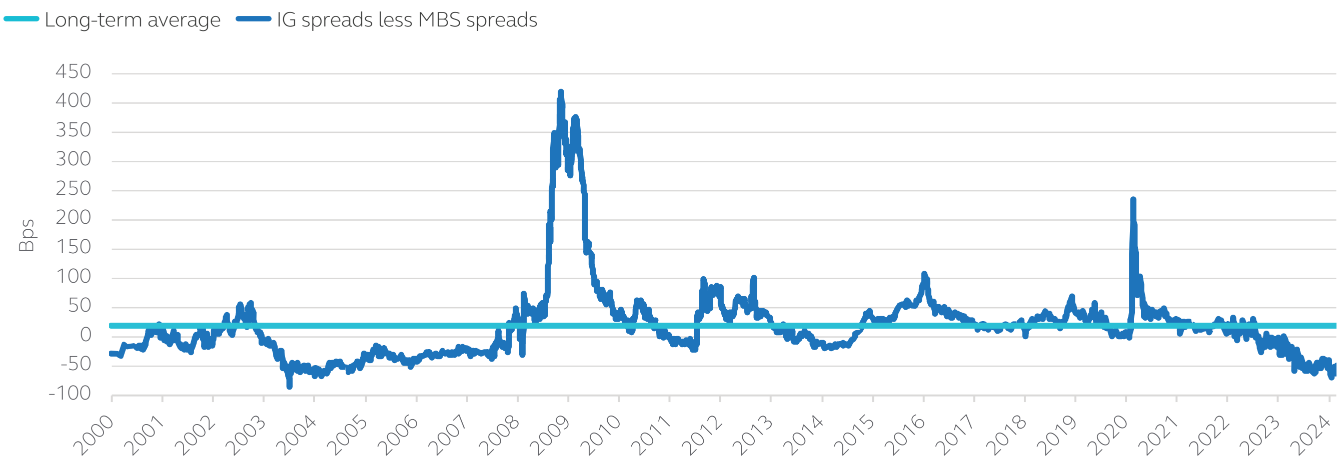
Mortgage-backed securities (MBS)

Even if a significant rate rally materializes, fundamentals should remain very constructive with stable cash flows and minimal refinancing risk. Implied interest rate volatility remains elevated, which tends to benefit investors if volatility normalizes. Given the banking crisis in 1Q 2023 and subsequent MBS liquidations for most of 2023, the technical environment to start 2024 is much more balanced. We expect money managers to be a critical driver of demand, while bank demand is expected to remain limited as the Fed continues its quantitative tightening. However, the expected burden is much lower for 2024 as compared to 2022 and 2023, primarily due to lower levels of net supply.

Considering these factors, valuations for the mortgage sector appear very attractive. Mortgages continue to trade with spreads well above historical averages and appear cheap relative to Treasurys and IG credit. The coupon mortgage currently offers a spread of ~137bps over Treasurys, and these securities, which benefit from a government guarantee, are trading ~45bps wider than IG corporates.

EXHIBIT 8

Agency MBS spread trading wider than IG credit

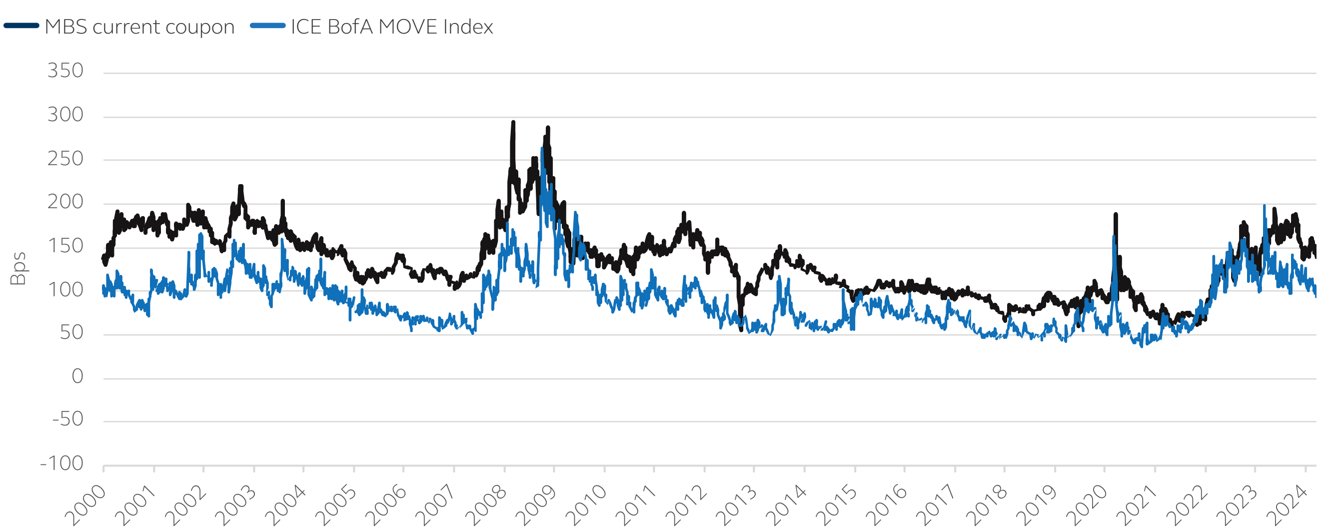


Source: Bloomberg. As of March 26, 2024.

While the mortgage basis remains attractive versus IG corporates, the basis is also benefiting from decreased implied rate volatility. As shown in Exhibit 9, the basis performance is tightly correlated to rate volatility, as measured by the MOVE index, over longer periods. With the market becoming more comfortable with the FOMC outlook, combined with the potential for a reduction in the amount of balance sheet run-off (QT), the outlook for rate volatility is more benign which should continue to benefit the MBS sector.

EXHIBIT 9

MBS spreads highly correlated to Fed expectations



Sources: Bloomberg. As of March 26, 2024.

Asset backed securities (ABS)

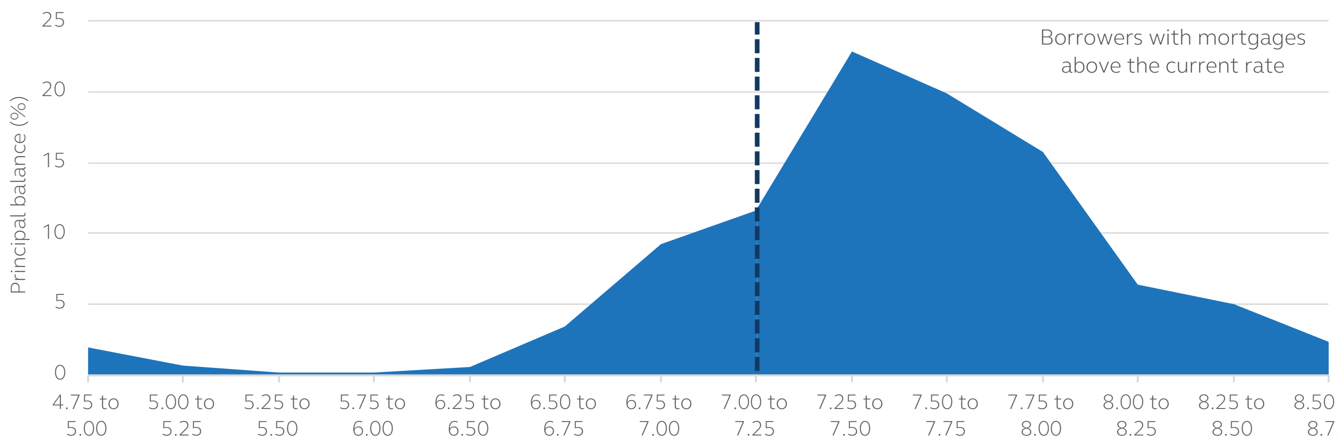
Given favorable curve positioning and the potential for policy cuts later this year, we are focused on bonds with shorter expected maturities and short duration opportunities in the non-agency residential MBS market where spreads look attractive versus consumer ABS. These super-senior, front cash flow (FCF) RMBS present an attractive relative value proposition supported by key credit fundamentals and market technicals.

New issue FCFs benefit from the same structural reforms that strengthened post-crisis non-agency RMBS. Significant structural enhancement, a first pay position, and stringent underwriting standards for the underlying mortgages offer a robust fundamental credit profile. We expect a more investor-friendly distribution of mortgage rates on the underlying loans and better starting valuations in 2024.

Many of the loans backing new issue RMBS today were originated in late 2023, when mortgage rates were approximately 100bps higher. This results in a quick expected repayment profile for FCFs due to the strong refinancing incentive and limits extension risk, even if rate volatility persists. At the same time, the wide agency MBS basis and curtailed bank demand have resulted in more bonds available at cheaper valuations. The unique combination of credit and technical factors presents an opportunity to add high-quality, short-duration assets expected to provide relatively stable performance across a range of potential scenarios.

EXHIBIT 10

Indicative distribution of underlying mortgage rates



Source: J.P. Morgan. As of February 29, 2024.

Commercial mortgage-backed securities (CMBS)

As we entered 2024, the tone for CMBS has strengthened. A lower, stabler rate environment and increased transaction activity would be positive for commercial real estate. We expect new issue supply will be unable to keep up with buyer demand. These positive factors have propelled conduit spreads, which have tightened materially this year. We see attractive value in SASB, which lagged the move and offer exposure to specific property types in lower leveraged, higher quality commercial real estate. We favor interest only strips off new issue conduit deals that exhibit a very strong yield profile for a shorter-duration, high-rated security.

Municipals

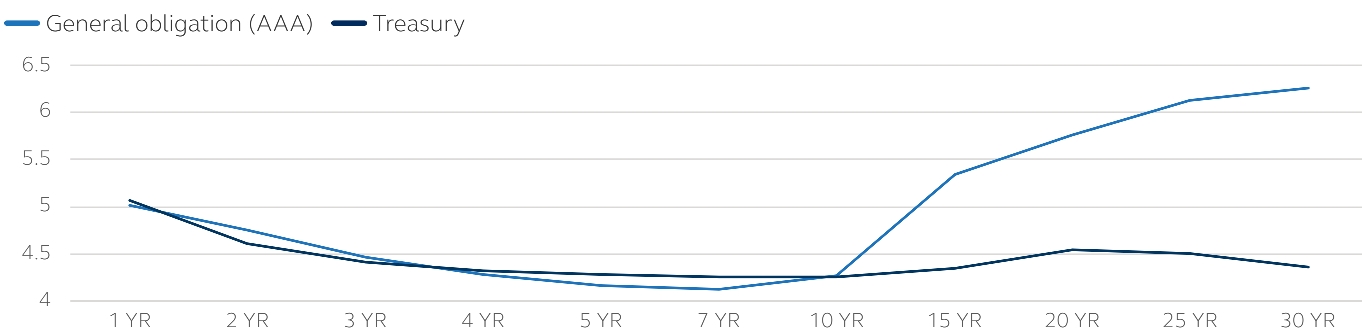
The U.S. financial markets obsession with the direction of future interest rate moves by the Fed will soon no longer be investors sole fixation. After resounding victories by both party candidates in state primaries and caucus elections to date, markets are starting to ponder the implications of the evolving political landscape as the presidential election has again come to the forefront. To be sure, key policy issues will be impacted depending on which party controls the White House and Congress, likely resulting in substantial volatility.

Chief among those issues are the expiring tax provisions of the 2017 Tax Cuts and Jobs Act (TCJA), especially individual taxpayer provisions that impact all voters. TCJA overhauled the individual tax code, cutting taxes across all income groups and is set to sunset in 2025, meaning the next administration will have some difficult decisions to make. We see three probable election themes taking root in municipal markets over 2Q 2024:

1. **Divided government:** With no single party determining policy, we expect the TCJA to expire, raising individual tax rates across all brackets. Top filers would see their rate rise back to 40%. This scenario would be constructive for tax exempt municipals as the value of the tax exemption increases, raising demand. The corporate tax rate, lowered to 21% under the TCJA, would most likely rise as well, reengaging demand from taxable buyers such as insurance companies that had been reducing interest at the lower tax rate.
2. **Democratic sweep:** This would be a positive for municipal demand. Under a "blue wave," we see both individual and corporate tax rates increasing. President Biden has already been on record advocating for higher taxes on top individual earners (those making more than $400k) as well as party members stating corporate tax rates are too low.
3. **Republican sweep:** Should a "red wave" occur, the impact on municipal demand would be neutral, as the expiring tax cuts would likely be extended, leaving the top marginal rate at the (still favorable) 37% level for individual muni buyers. Banks and insurance demand would remain low. As seen in Exhibit 11, at today's yields, even at 37%, the taxable equivalent yield advantage that municipals offer is significant (40.8% tax rate includes Obamacare 3.8% tax on unearned income from which municipals are exempt):

EXHIBIT 11

Taxable equivalent yield advantage of municipals assuming a 40.8% tax rate

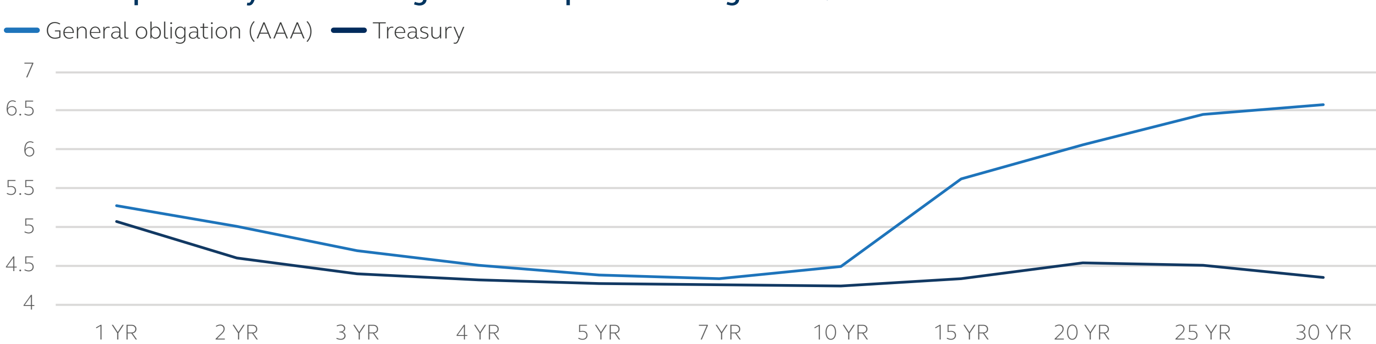


Source: Bloomberg. As of February 29, 2024.

Municipals could offer taxable equivalent yield advantage should the top marginal rate revert to 40% under election themes one and two noted above.

EXHIBIT 12

Taxable equivalent yield advantage of municipals assuming a 43.8% tax rate



Source: Bloomberg. As of February 29, 2024.

With an ever-increasing federal deficit (the highest in U.S. history) revenue will be a priority no matter which candidate and party wins this fall. Individual income taxes, according to the Tax Foundation, are the highest source of revenue for the U.S. We do not see that changing, and we do not see individual tax rates going lower. In fact, we think the opposite, further enhancing the value of the exemption and leading to greater investor demand for the asset class.

Emerging market debt (EMD)

On the back of slowing DM growth and stabilizing EM growth after a resilient performance in 2023 led by Brazil, Mexico, and India and the reopening of China's economy, EMs are set to increase their growth outperformance versus DMs in 2024. Despite investor skepticism on the asset class given ongoing geopolitical tensions, lack of recovery in China, and renewed socialist momentum in Latin America, one of the key factors to EM performance was orthodox policy in many EM nations, managing inflation dynamics with credible monetary policies. Coupled with the Fed's prolonged pause on the back of softening U.S. growth, growth outperformed and set the stage for a bounce in EMD, with many EM countries seeing slowing inflation and monetary easing. Recent policy easing measures in China to arrest decline in growth momentum and the turn in the technology cycle led by investments in artificial intelligence (AI) offer additional support to EM economies. Pockets of EM show stress from the post-pandemic environment or for legacy reasons, with these being well expected and suitably priced in the markets.

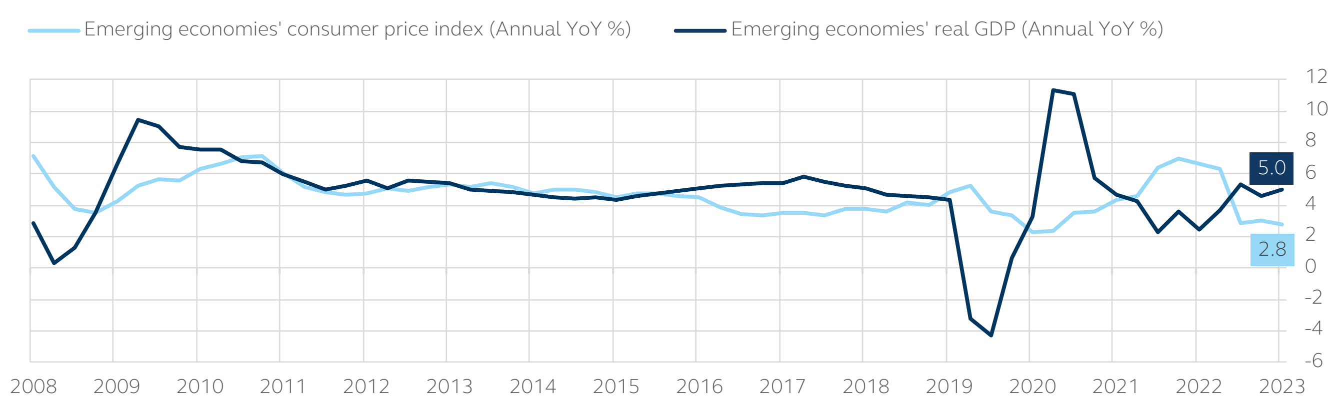
We expect 2024 to be an intense year of elections across the EM countries. Following Taiwan, national elections are scheduled for Indonesia, India, Mexico, Russia, Ukraine, and many other countries (40 in total). The outcome of the U.S. election could have deep implications for global geopolitics including shaping the way forward in the current wars between Russia-Ukraine, the Middle East, and U.S.-China strategic competition, as well as the broader relationships between the global south and the West and between Western allies themselves. In Mexico for example, while we expect the national elections outcome to favor policy continuity and improved political economy, a Trump victory may dampen these prospects given his campaign has been focused on economic nationalism tariffs.

Away from primary EM markets, we see the potential for select distress stories to find new life and possibly return to normal trading markets. These include new leadership and potentially a new policy direction in Argentina—while still struggling with a severely out-of-balance economy—and sanctions relief for Venezuela with the potential for some form of resolution of outstanding defaulted debt. The war in Ukraine looks likely to find some type of resolution, as funding and fatigue from both sides seems to be growing. The context of how that might occur remains unclear, but we are of the view that Russian sanctions are unlikely to be dropped during the year even with a cessation of fighting.

Investors will also be watching for the conclusion of the Israeli/Hamas conflict. Early fears of an expansion to the West Bank or Iran appear to have been contained. Currently, there has been limited market spillover to the greater Middle East, and we remain bullish on the region into next year. The speed of DM rate cuts and the broader opening of capital markets will be key determining factors in the frontier market players' ability to address their near-term debt maturities and avoid renewed debt distress. Our base case into 2024 remains optimistic on the EM sector. As always, top-down sovereign and bottom-up corporate analysis and issue selection will be keys to performance.

EXHIBIT 13

Economic growth and inflation picture improving for EM



Source: Bloomberg. As of December 31, 2023.

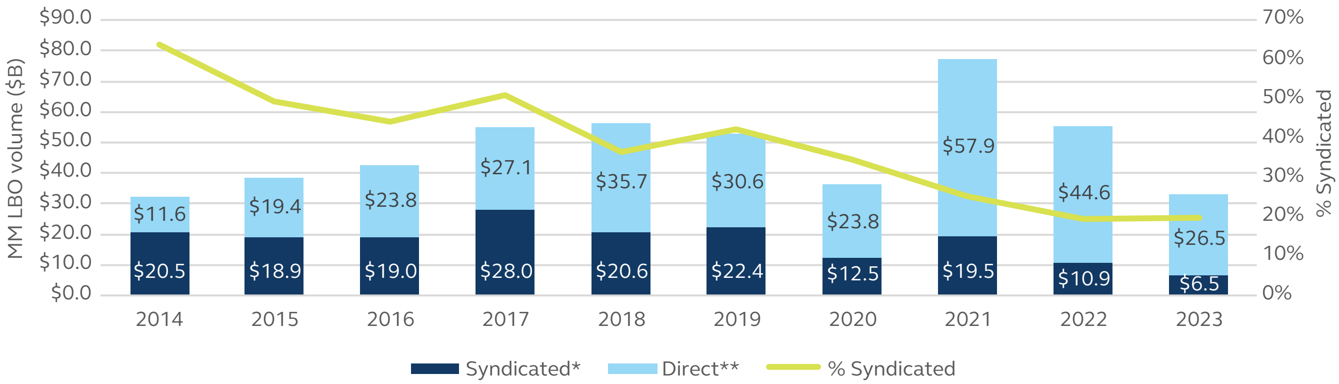
Private credit

Direct lending

Despite a slowdown in merger and acquisition and leveraged buyout activity in the direct lending space, middle market direct lending continues to fill the void led by commercial banks and the decline in syndicated loan market issuance.

EXHIBIT 14

Annual middle market leveraged buyout issuance ($B)



Source: LSEG LPC. As of December 31, 2023. *Syndicated Middle Market: Facilities syndicated to at least one participant up to U.S. $500 million in deal size or clubbed up to U.S. $150 million in deal size. **Direct Lending: Non-syndicated facilities, no non-titled lender. Unitranche and bilateral loans, deals clubbed over $U.S. $150 million deal size, facilities that go unreported, privately placed second-liens, mezzanine and seller notes.

While volume is up in the syndicated loan market to start the year, much of this is refinancing and repricing of existing loans. Though new loan volume origination for private middle market direct lending has been somewhat below the expected full year 2024 pace, the volume that is being realized continues to present attractive value. Importantly, there is virtually no repricing activity, especially for direct lenders focused on the lower and core middle markets (companies generating $5-$50 million earnings before interest, taxes, depreciation, and amortisation (EBITDA)). So compared to the public markets, investors are more assured to maintain the attractive economics from transactions completed over the past year to 18 months, driven by call protection and attractive original issue discounts (OID) provided in the direct lending market.

Relative to the size of the debt capital structure, frictional costs to refinance are a deterrent for borrowers and sponsors. Loan repricing isn't a generally accepted practice in the private market, as the relationship lending benefits override any sponsor or borrower incentive. Unlike the public markets, there isn't a banker working to realize fees associated with a refinance or repricing. So those attractive spreads, OID, and all-in yield continue to drive desired performance for investors who have allocated to the private loan middle market.

The public and private credit market are displaying some easing credit conditions, with spreads considerably tighter over the past year in the public market and relatively modest spread tightening in the private market. Though spreads have tightened, the relative value of private credit is up, given the spread compression has been much less than realized in public HY and bank loans. Couple the favorable economics with reasonable leverage levels driven by lenders requiring sufficient debt service coverage in a higher rate environment, the current vintage continues to represent an attractive opportunity for investors.

Easing credit conditions may contribute to the resiliency of the economy and ultimately borrower performance through the cycle. As the market may be getting ahead of itself in anticipating a soft landing, lenders must remain focused on underwriting through a potentially challenging cyclical downturn. Continued economic uncertainty is contributing to several supportive trends for middle market direct lending and ultimately an opportunity to enhance risk-adjusted returns relative to historic loan vintages.

Direct lending market summary

	2021 typical terms	Current market conditions	Difference
Market tone	Credit bull market; increased capital raising; healthy levels of prepayments	Concerns over economic cycle and low prepayment activity given increase in spreads	Lenders' market
Expected yield	7.0% – 9.0%	11.0% – 14.0%	4.0% – 5.0%
Secured overnight financing rate spread*	500 – 650bps	550 – 750bps	50 – 100bps
Secured overnight financing rate floor	1.0%	1.0%+	0
Original issue discount (OID)	Up to 2.0%	2.0%	0.25% – 0.5%
Debt multiple	2.5x – 6.0x	2.0x – 5.0x	0.5x – 1.0x
Loan-to-value	Less than 50%	30% – 45%	5% – 20%
Covenants	Trending towards looser covenants; upper middle market deals covenant-lite	Tighter covenants; renewed focused on fixed-charge coverage ratios (FCCR)	Tighter
Market sectors of concern	Typical avoidance of heavy cyclicals	Consumer goods, physician practice management businesses focused on government payors, and cyclicals	Increased sectors of concern
Competitive changes	Larger players shifting significantly up market	Focus by upper middle market lenders to compete with public loan market, while lower and core remain less sensitive to pricing changes in public markets	Varied by private credit segment
Borrower profile	Typical direct lending borrower profile	Focus on less cyclical industries and borrowers with steady cash flow	Less cyclical

*Estimated range based on 1st lien position. Source: Principal Asset Management as of December 31, 2023. The information shown above is for illustrative purposes only and are based on current market conditions and observations, which will fluctuate and may change over time and are not guaranteed. This material is not intended to forecast or predict future events, but rather to indicate the characteristics that Principal Asset Management has observed on the market generally. References to yields and other characteristics are not promising or even estimates of actual returns a client portfolio may achieve.

Investment grade private credit

In February, the Annual Private Placement Market Conference took place, and one of the key takeaways from meetings with the leading deal originating banks was that 2024 could be a strong year for IG private credit strategies. The pipeline of mandated deals is as strong as it has ever been as CFOs get over the shock of rapid interest rate increases. Sources of co-investment opportunities also have strong 2024 pipelines of large deals offering creative financing solutions involving data centers, renewable power, music and media assets, and possibly an office property portfolio. While deal flow volumes are expected to be robust in the 1H, a wave of potentially contentious elections in key markets make projecting 2H activity a challenge. A number of $1 billion or larger transactions are in the pipeline, highlighting the depth of the IG private credit market. Examples of large deals include a liquified natural gas (LNG) project, data center and fiber financings, and an electric vehicle) EV battery manufacturing facility.

Forward-looking sector views

	Underweight −−	Underweight −	Neutral =	Overweight +	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, 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

Given the resilience of the economy and mixed inflation signals over 1Q, we expect the FOMC to remain highly data-dependent and wary of cutting interest rates prematurely in the quarter ahead. That said, we believe that the evolution of inflation and economic data over 2Q will be supportive of a policy pivot and our base case is for rate cuts coming as early as June 2024. Importantly, we continue to believe that lagged policy transmission and a slowdown in underlying growth will become more evident over the course of 2024. Against this backdrop, fixed income returns appear poised to benefit both from an attractive yield and a duration tailwind for the first time in years. In the near-term, rotating away from cash and cash equivalents (e.g., money market funds, certificates of deposits, etc.) into high-quality fixed income that allows for a relative extension in duration should be rewarded. Amid the pause, high-quality shorter-duration fixed income should continue to benefit as the market seeks out greater conviction on the timing and degree of prospective rate cuts. As rate cuts become more evident, high-quality longer-duration fixed income should outperform on a risk-adjusted basis as the yield curve normalizes and an economic slowdown becomes more apparent. Over a long-term investment horizon, adding incremental risk now should be rewarded as the greater likelihood for the lasting path of rates continues to be lower versus higher.

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. $137.9 billion in assets under management as of December 31, 2023. Principal Fixed Income has capabilities that span all major fixed income sectors. Our globally integrated platform with investment centers worldwide and over 110 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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