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Principal Fixed Income

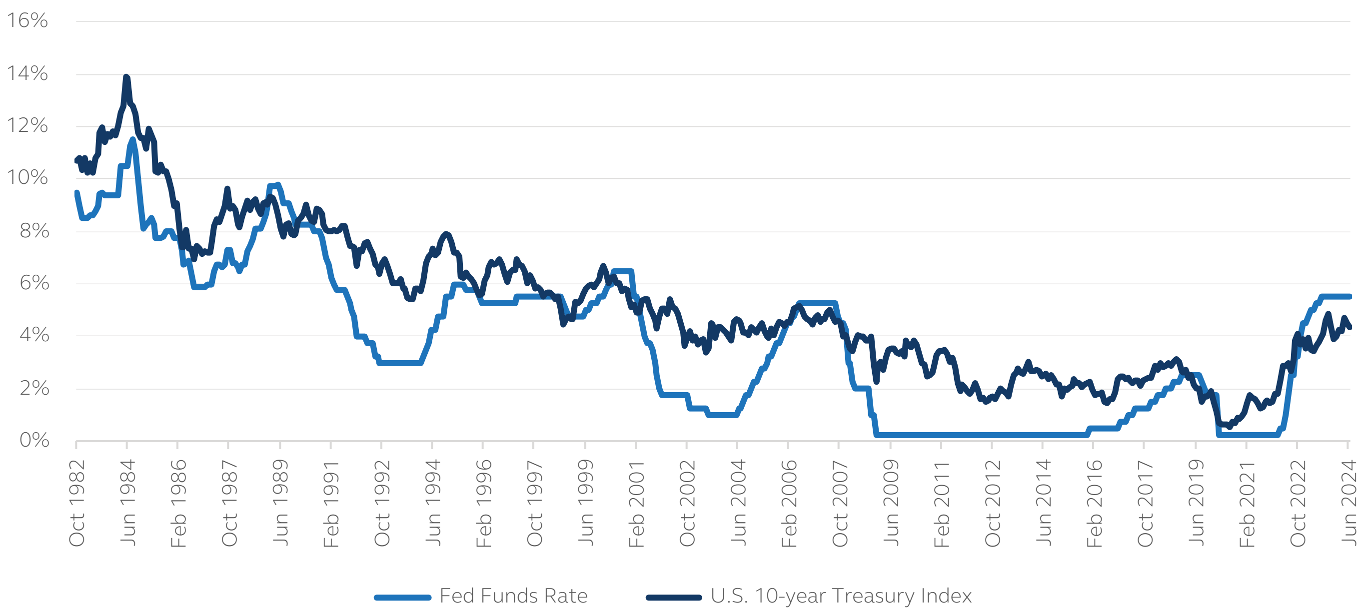
Principal Asset Management℠

Now may be the time to extend duration in high-quality fixed income

With the economy slowing and inflation moderating, the Federal Reserve (Fed) should be gaining the confidence it needs to start rate cuts in 2024—possibly as early as September. While the timing of the first cut is still uncertain, what is clear is the Fed's desire to begin a rate cutting cycle sooner rather than later—to cut before the data shows that the economy has weakened significantly. As shown in the chart below, **yields often drop before the Fed cuts;** therefore, investors do not have to wait for policy adjustments to start to benefit from extending duration.

Extend duration before rate cuts begin

Fed Funds Rate vs. U.S. 10-year Treasury



As of June 2024. Source: St. Louis Federal Reserve, Principal Asset Management.

Historically rate cutting cycles tend to be long with the average rate cutting cycle lasting 26 months and the average drop in Fed Funds falling 441 bps.[1] As the Fed begins cutting rates, cash and cash equivalents will fall until the rate cutting cycle is over. Over a long rate cutting cycle, investors remaining in cash and cash equivalents will continue to see their income and total return fall relative to longer duration alternatives. As the chart on the next page demonstrates, high-quality fixed income has outperformed 3-month T-bills after the start of rate cuts.[2]

[1] Since 1982 there have been six rate cutting cycles. Source: St. Louis Federal Reserve, Principal Asset Management.

[2] The returns on high-quality fixed income include the returns on the Bloomberg Municipal Bond Index, the Bloomberg U.S. Investment Grade Credit 1-3 Year Index, and the Bloomberg U.S. Aggregate Index.

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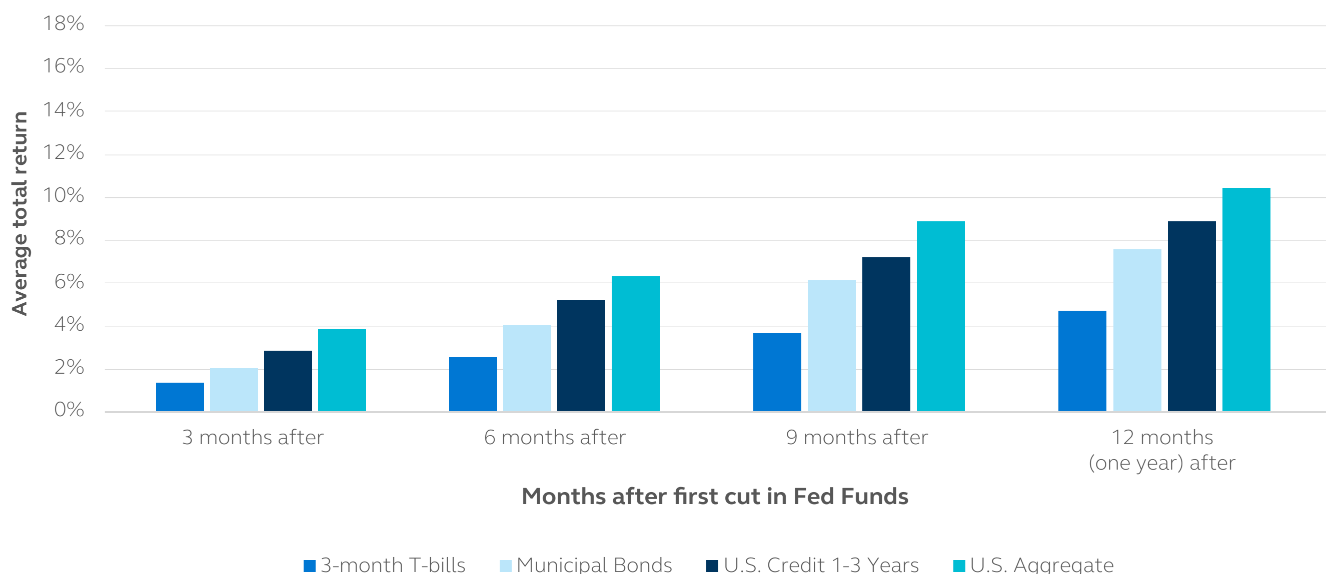
Outperformance of high-quality fixed income continues to increase once cuts start

Returns of 3-month T-bills and high-quality fixed income after the Fed starts cutting



Source: Principal Global Investors. Reflects the average total return in relation to the six rate cuts over the time period from October 1982 to June 2024. The beginning of the rate cut dates: August 1984, June 1989, July 1995, January 2001, September 2007, August 2019. Data represented by St. Louis Fed 3-month T-bill, Bloomberg U.S. 1-3 Year Index, Bloomberg Municipal Index, and Bloomberg U.S. Aggregate Bond Index.

High-quality fixed income does well with cuts regardless of the type of landing. There have been six rate cutting cycles since 1982—three times the U.S. economy went into a recession within 12 months after the first cut and three times the U.S. economy avoided a recession—yet in all six instances, high-quality fixed income had positive returns.[3]

From short to long duration, we believe now is the time to extend duration by investing in high-quality fixed income. Investors who are in cash and seeking to maintain income and liquidity could look at short duration investment grade credit as a lower-risk option. For investors seeking ballast for equities, intermediate duration core fixed income offers attractive yields and the potential to benefit from price appreciation should a meaningful slowdown occur. For tax-sensitive investors seeking to maximize after-tax income or for investors concerned about the potential for future tax increases, the value of the municipal tax-exemption is at its highest level since 2008.

Extending duration in high-quality fixed income as the Fed begins a rate cutting cycle has the potential to meet a broad set of investor objectives.

Principal Fixed Income

Principal Fixed Income is the fixed income investment management platform of Principal Asset Management and manages $137.6 billion in assets under management as of June 30, 2024. Our globally integrated platform with specialized teams worldwide 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, which we believe helps our sector-specialty teams formulate richer investment theses and make better-informed investment decisions on behalf of our clients.

[3] The returns on high-quality fixed income include the returns on the Bloomberg Municipal Bond Index, the Bloomberg U.S. Investment Grade Credit 1-3 Year Index, and the Bloomberg U.S. Aggregate Index.

Index descriptions:

Bloomberg U.S. Aggregate Bond Index is the most widely followed broad market U.S. bond index. It measures the investment grade, US dollar-denominated, fixed-rate taxable bond market.

Bloomberg U.S. Treasury Index measures U.S. dollar-denominated, fixed-rate, nominal debt issued by the U.S. Treasury. Treasury bills are excluded by the maturity constraint. STRIPS are excluded from the index because their inclusion would result in double-counting.

Bloomberg Municipal Index covers the USD-denominated Long-Term tax-exempt bond market with four main sectors: state and local general obligation bonds, revenue bonds, insured bonds, and pre-refunded bonds.

Bloomberg U.S. 1-3 Year Index measures the performance of investment grade, US dollar-denominated, fixed-rate, taxable corporate and government-related debt with 1 to 2.9999 years to maturity. .

Risk considerations

Past performance does not guarantee future return. Investing involves risk, including possible loss of principal. Fixed-income investment options are subject to interest rate risk, and their value will decline as interest rates rise. Potential investors should be aware that Investment grade corporate bonds carry credit risks, default risk, liquidity risks, currency risks, operational risks, legal risks, counterparty risk and valuation risks. Lower-rated securities are subject to additional credit and default risks.

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