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Principal Fixed Income

Principal Asset Management℠

FOURTH QUARTER 2024

Fixed income perspectives

The outlook, themes, and investment implications for global fixed income markets

Introduction

As the Federal Reserve (Fed) embarks on its long-awaited rate-cutting cycle, the U.S. economy continues to display resilience despite mixed signals from global markets. Central banks worldwide are navigating their own paths toward monetary easing, but diverging approaches suggest an uneven road ahead.

1. Entering 4Q, central bank policies are diverging more clearly. The Fed initiated its rate-cut cycle in September, while the European Central Bank and the Bank of England are taking a more cautious, gradual approach.
2. The U.S. labor market remains solid, but signs of cooling are emerging, particularly in payroll and unemployment trends. This could signal a broader economic slowdown, reinforcing the need for more accommodative monetary policy.
3. Despite potential volatility linked to the upcoming elections, fixed income markets are positioned for outperformance, with opportunities across municipal bonds, high yield, and other sectors as investors seek to capitalize on falling interest rates and favorable technicals.

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Perspectives from the CIO

MICHAEL GOOSAY
Chief Investment Officer,
Fixed Income

It has certainly been an eventful quarter for fixed income. A significant repricing of Fed expectations and the start of the rate-cutting cycle has finally brought the return of positive-sloped yield curves. The combination of positive sloped yield curves and elevated yields has been a rare sight in the past few years, but this is, in fact, a return to more normal times for fixed income and implies that investors should take advantage of more traditional fixed income strategies.

We anticipate the Fed moving from restrictive to slightly accommodative policy and expect the Fed Funds rate to reach 3.25% by mid-2025. Historically, when the Fed begins to ease monetary policy, it often becomes an important tailwind for fixed income. Given that investors have heavily favored money market funds and short-term maturity products in recent years, the onset of the rate-cutting cycle should encourage savvy investors to extend further out on the yield curve. By reallocating funds into assets with higher yields and greater sensitivity to interest rate changes, they can better position themselves to benefit from the evolving market environment.

Core fixed income, including mortgage-backed securities and investment-grade corporates, stand to perform well in this environment. Although they have some sensitivity to changes in economic conditions, their performance is more driven by interest rate changes—investors should seek to lock in yields before the Fed gets too far into its cutting cycle.

Other, riskier fixed-income segments, such as high yield and emerging market debt, can also deliver positive returns if the U.S. economy can achieve a soft landing. While meaningful spread compression is unlikely from here, the extra yield offered by those lower-quality assets is still a prudent consideration for investors.

Given the current environment of gently slowing economic growth and monetary easing, maintaining exposure to fixed income is prudent for investors. Fixed income assets provide a reliable source of income and yield, offer mitigation against widespread market volatility, and present opportunities to enhance returns within investment portfolios.

Summary of investment implications

INVESTMENT GRADE CREDIT

Despite tight valuations, fundamentals and technicals are on sound footing. Although off its high, yield remains a stable factor from a technical standpoint. With the asset class likely to thrive in the lower-but-positive U.S. growth environment, investors should seek to lock in yields now ahead of further policy action.

HIGH YIELD CREDIT

High yield bonds offer compelling income opportunities as relative yields remain attractive, although capital appreciation may be limited. Investors should focus on high-quality issuers with solid fundamentals, given potential volatility in spreads. Strong technical support from inflows should sustain performance, even as deal activity increases.

SECURITIZED DEBT

Agency mortgage-backed securities are poised to perform well given their government guarantee of credit risk and tendency to outperform credit sectors during an economic slowdown. With more stable cash flows and lower prepayment risks atypical for the asset class, the sector should be able weather a substantial decline in interest rates. Investors should consider MBS for portfolio diversification and mitigation against credit risk.

MUNICIPALS

As monetary policy shifts, the municipal sector offers investors seeking credit exposure an opportunity to extend duration and lock-in attractive tax-advantaged income. With technical pressures likely to ease following the U.S. election and the near-term path of policy rates lower vs. higher, the fourth quarter may be the right entry point for investors.

EMERGING MARKET DEBT

Emerging market (EM) debt stands to benefit from widening growth differentials between emerging and developed markets as global rates fall. Investors should focus on economies with resilient fundamentals, especially in regions where inflation is moderating. EM debt provides a strong diversification opportunity with potential for yield outperformance as U.S. rates decline.

PRIVATE CREDIT

Private credit, particularly in the lower and core middle market, continues to offer attractive relative value compared to public markets. Investors should capitalize on tighter spreads, lower leverage, and favorable credit terms in these segments. Given the resilience of private credit amid economic volatility, it remains a valuable component for income-focused portfolios.

Global bond outlook

U.S. outlook

What a difference a year makes. At the Federal Reserve's Jackson Hole Symposium in August 2023, Fed Chair Jerome Powell spoke about inflation, noting that it had "substantial further ground to cover to get back to price stability." He also mentioned that labor market rebalancing had "continued over the past year but [remained] incomplete." Fast forwarding to this year's symposium, Powell's tone had noticeably changed; he acknowledged that inflation has fallen significantly, and the Fed's 2% target is within reach, stating that they "do not seek or welcome further cooling in labor market conditions."

With the Fed gaining confidence about inflation as well as concern about further cooling in the labor market, the much-anticipated rate cut has cycle begun with a 50 basis point (bps) rate cut at the September meeting. The magnitude of the cycle will depend most critically upon the evolution of the labor market. We view current market pricing as consistent with a Fed move toward less restrictive policy and expect the Fed funds rate to reach 3.25% by June of 2025. If the labor market resumes the uptrend that was recently broken (unemployment higher, non-farm payrolls lower), then a more aggressive and accommodative stance will be necessary, and rates would likely fall further.

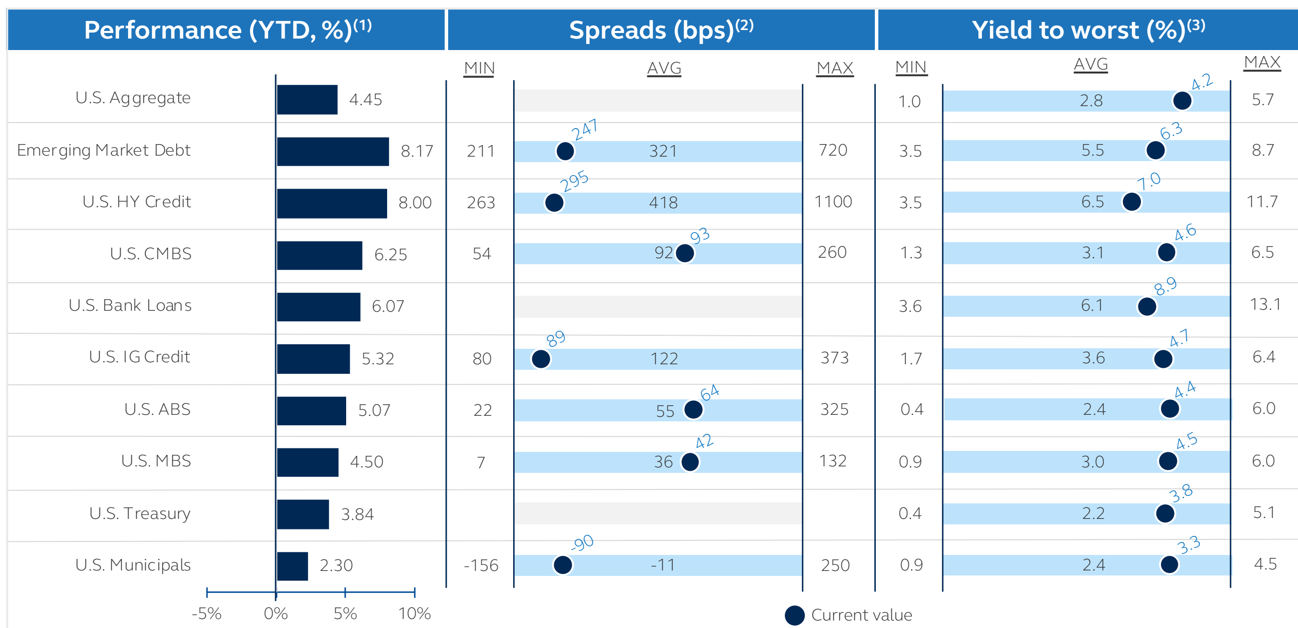
In fact, we view that path as likely, given how labor market data has recently benefitted from unusually favorable seasonal adjustments relative to prior years and a spike in government hiring, both of which are unlikely to persist.

Assuming our expectation for a soft landing is correct, significant Fed easing is already priced into forward rates. We are forecasting that the 10-year UST yield will be 3.50% by mid-2025, and as a result, are somewhat less enthusiastic about outright duration positions but continue to have strong conviction in yield curve steepener positions. The best opportunity in rates remains at the front end of the curve. However, if the Fed is unable to avoid a recession, there will be additional opportunities in outright duration.

Looking at fixed income spreads, a gradually slowing labor market combined with Fed rate cuts and global central bank accommodation is an environment that should be supportive. Today's spreads are fairly tight compared to historical averages, and potential catalysts such as geopolitical and election risk remain on the horizon. With corporate profit margins healthy, cost-cutting and layoffs are unlikely, meaning that the greatest risk to spreads (recesssion-related economic challenges) is unlikely.

Market environment

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



Data as of September 30, 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

In global markets, moderating inflation has given policymakers and markets a reprieve, opening the door to rate cuts across developed markets. While the Fed was slower to start, waiting until September to begin its rate-cutting cycle, the forward path for the European Central Bank and the Bank of England is a less aggressive pace of monetary easing than that of the Fed.

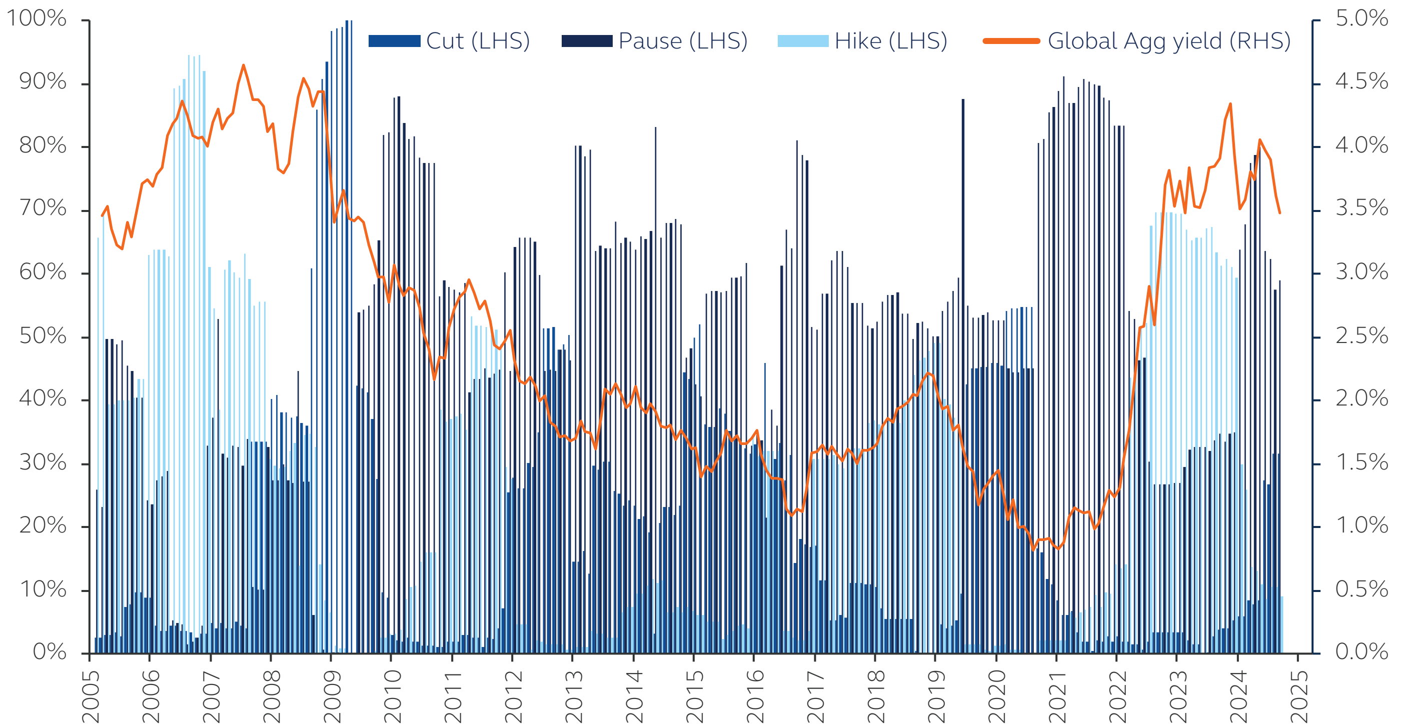
Outside the U.S., the Bank of Japan has continued its policy tightening cycle, and may continue from here. Despite the move being widely anticipated earlier in the year, the central bank's decision to hike rates in July sparked an unwind in the yen carry trade that had built up significantly over the business cycle, triggering a sharp negative reaction across risk assets. While the impact proved to be short-lived, the move marked a turn in the dollar, as is consistent with a turn in the monetary policy cycle in the U.S.

What happens to bond yields when major central banks begin an easing cycle? Currently, a soft landing of the global economy remains the consensus view, and despite pricing in aggressive policy cuts, the market projects next year's growth to be at potential. The eventual truth may lie somewhere in the middle, with growth falling below potential as is the norm for late-stage economic cycles.

Notwithstanding, recession is not a necessary condition for bond yields to fall significantly when major economies start to see growth moderate and central banks begin to ease. In fact, in the three previous easing cycles prior to COVID-19, a recession only occurred once, but each easing cycle saw global bond yields initially fall more than 50bps. As the easing cycles continued, rates fell more than 100bps. A similar outcome this time would dominate global fixed income performance beyond the coming elections and the evolution of growth expectations.

Global yields and policy rate cycle

Bloomberg Global Aggregate Bond Index yield vs. % of economies hiking, pausing, or cutting rates



Source: Bloomberg, Principal Asset Management. Data as of September 10, 2024.

Investment grade credit

Investment grade (IG) credit thrives on moderation, which is precisely the environment that appears to be taking shape on the macro front over the coming months as growth, inflation, and rates are all modulating downward. Despite a more vigorous phase for merger and acquisition activity recently, the moves high-grade companies are making appear manageable for leverage levels, and the market's appetite for IG corporate bonds remains undiminished. With company fundamentals strong and the technical outlook favorable, yields remain attractive from a long-term historical perspective – even after pulling back from recent highs – as the spread as a percentage of yield has risen above 20%.

While clearly not impervious to external factors, the IG market appears to be looking past daily and weekly data with comfort in knowing that Fed rate cuts have started. As such, IG investors have readily absorbed the recently heavy bond supply. While the economy is still growing – albeit slowly – consumers are spending, income growth is solid, and corporate balance sheets remain healthy.

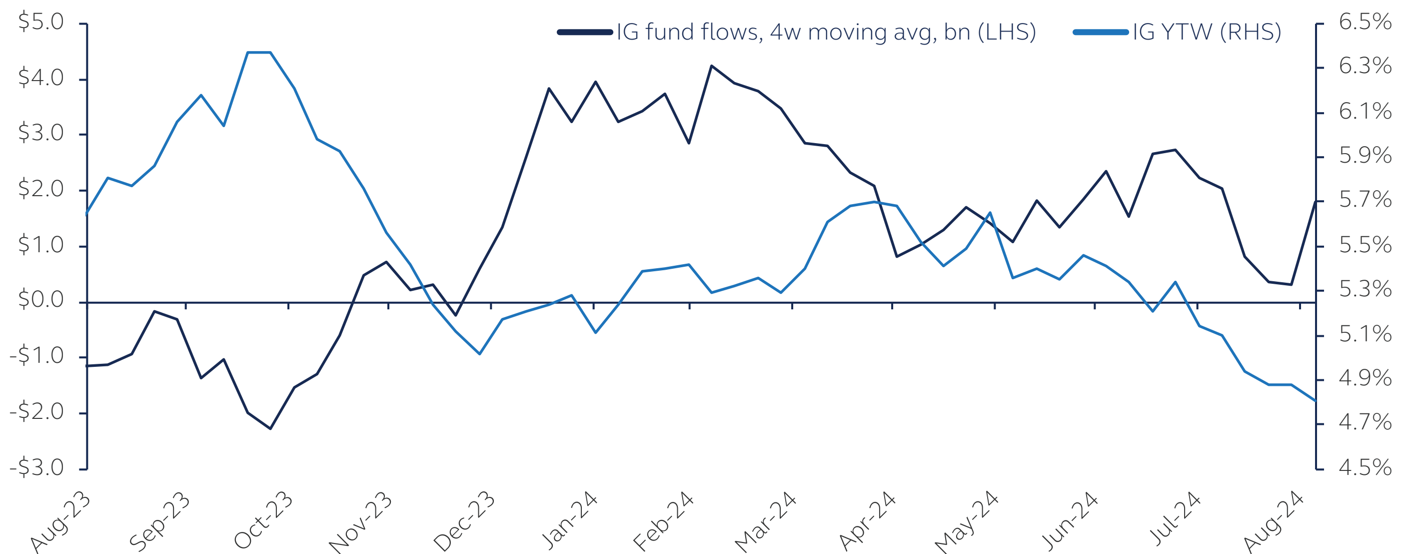
Both the fundamentals and technicals of IG credit are on sound footing. Given the strength of companies' balance sheets, particularly companies with stable-to-improving fundamentals, investor focus should remain on high-grade credit metrics. De-leveraging discipline and favorable funding conditions have companies' credit profiles well positioned. Although off its high, yield remains a stable factor for IG from a technical standpoint.

Despite September's seasonally heavy issuance across IG credit, supply should moderate heading into the fourth quarter, lending positive technical support even if all-in yields are marginally lower. Demand in the U.S. from both retail and institutional investors, as well as foreign demand, has remained strong. Even with rate cuts kicking off, an easing cycle has not halted IG bond buying demand.

Today's tighter spreads in the IG market rightly reflect the strong bid for and the solid standing of IG corporate bonds. However, both the new issue and secondary markets present appealing opportunities to invest in credits with solid fundamentals and good relative value. With IG credit set to thrive in the lower-but-positive U.S. growth environment, investors should seek to lock in yields before the Fed gets too far into its cutting cycle.

Investment grade credit fund flows and yield-to-worst

August 2023-present



Source: Barclays, Principal Asset Management. Data as of September 10, 2024.

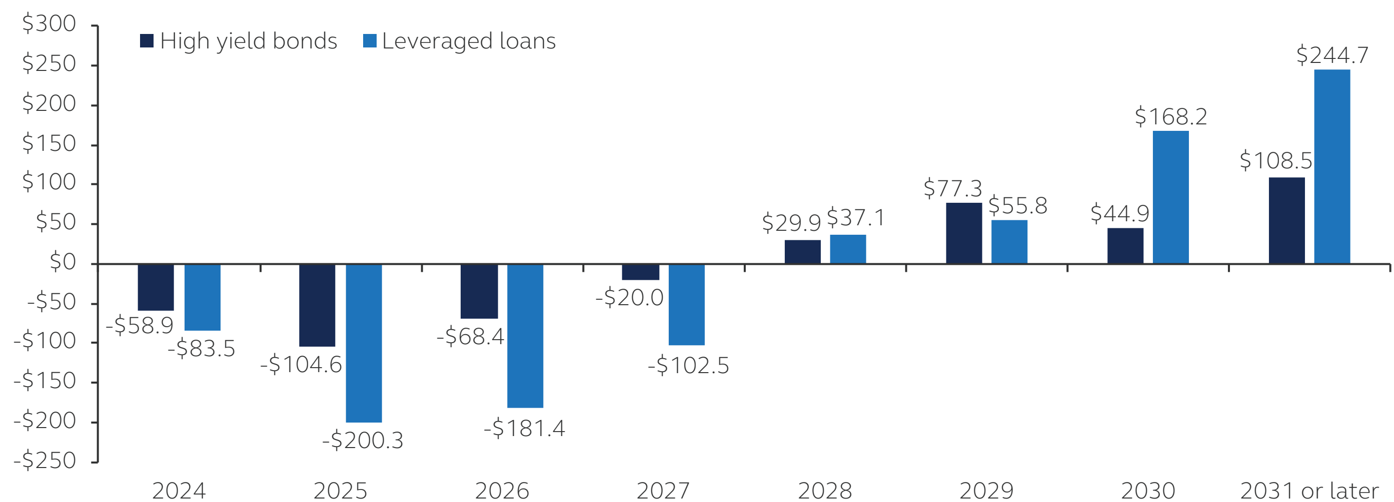
High yield credit

Although yields have come down substantially in the high-yield (HY) asset class and have rendered valuations historically expensive, investors will likely continue to harvest an appropriate return for the asset class. Not only does HY stand to benefit from the flow out of money market funds and into risk assets as the Fed's monetary easing cycle gets underway, still constructive credit fundamentals should offset the impact from a slowing economic environment.

Despite facing a slightly more challenging economic landscape, balance sheets of HY companies continue to reflect strong fundamentals. According to JPMorgan, corporate leverage is currently 4.0x, which is still below the long-term average of 4.3x. In addition, interest coverage (a measurement of how easily a company can service its outstanding debt) is currently 4.9x, also well above its long-term average of 4.5x.

Change in maturities since year-end 2022

$Billions



Source: J.P. Morgan, Principal Asset Management. Data as of August 31, 2024.

New issuance over the last couple of years has been almost entirely for refinancing purposes, and credit metrics are in very good shape. With the maturity wall pushed years into the future for HY issuers, future defaults should remain well below historical averages even as the economy enters a well-advertised slowdown.

Technicals for the asset class have been a tailwind all year, as high yield has experienced strong inflows but underwhelming new deal activity. As the Fed begins easing policy, deal activity should pick up; while that is welcomed now, it could become a headwind if fund flows reverse.

So far in 2024, the market has already surpassed all of 2023 issuance (which was mainly refinancing, as mentioned). Investors should expect a healthy pace of issuance for the rest of 2024, but the asset class should also benefit from a rotation out of money market funds into higher-yielding assets, including high yield.

With yields heading toward 7%, HY will continue to offer compelling income, but investors should expect that capital appreciation may be more limited. We expect flat to a slight widening of HY spreads, primarily from an expected robust primary calendar but also from the inability to keep up with an expected Treasury rally. Even with a slight spread widening, however, the asset class could produce higher-than-average total returns, making it an attractive option for investors as rates fall.

Heading into the fourth quarter, the strength of the fundamentals and supportive technical factors should allow investors to produce attractive income in HY, despite a modest widening of spreads.

Securitized debt

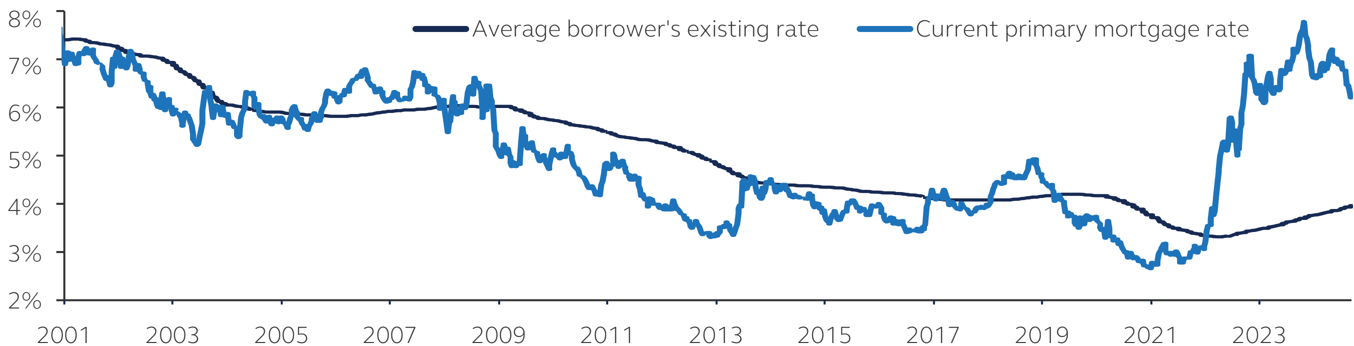
One sector uniquely positioned for a labor market slowdown is agency mortgage-backed securities (MBS). Due to the government guarantee of credit risk, agency MBS tends to outperform credit spread sectors in a late-cycle economy or recession.

As interest rates fall, one headwind that agency MBS investors ordinarily face is the convexity effect of a refinancing boom. When borrowers refinance their mortgages due to declining interest rates, there is an increase in principal repayment. Luckily for investors, current prepayment fundamentals are unusually strong for agency MBS.

The average 30-year fixed Fannie Mae borrower currently has a loan below 4%, while today's rate is still above 6%. That large "cushion" between current primary mortgage rates and the average financing rate means that cash flows should remain uncommonly stable even if rates rally substantially from current levels.

Current mortgage rates vs. average existing mortgage rate

2001–present

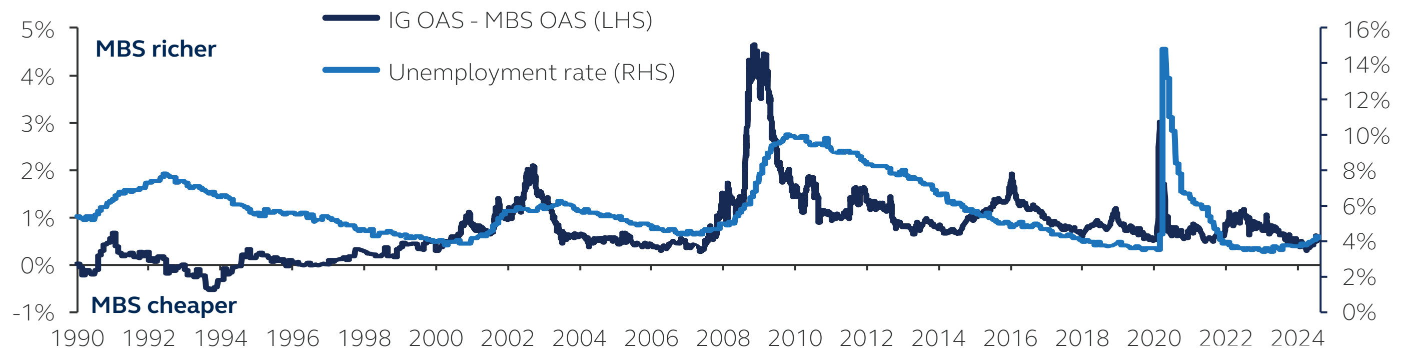


Source: Bloomberg, Principal Asset Management. Data as of September 12, 2024.

With banks no longer reducing exposure to the MBS market as they were for most of 2022 and 2023, technicals in MBS are solid and improving. For the first time since 2018, the Bloomberg U.S. MBS Index outperformed the Bloomberg IG Credit Index on an excess return basis for four of the last five months (through September 30, 2024). Since 1990, MBS has often outperformed credit late in economic cycles as the unemployment rate increases. Therefore, while the appetite for credit risk remains strong, the recent MBS outperformance more likely reflects increasing comfort among investors with the interest rate risk inherent in MBS over credit risk. For investors, MBS valuations appear fair both outright and relative to credit, even with recent outperformance.

MBS vs. IG option-adjusted spread and unemployment rate

1990-present



Source: Bloomberg, Bureau of Labor Statistics, Principal Asset Management. Data as of September 12, 2024.

Looking ahead, the MBS market offers an attractive opportunity for investors due to improving investor demand as the Fed cuts interest rates and unemployment increases, an unusually large cushion for refinancing risk, and a lack of credit risk.

Municipals

Heading into the fourth quarter, the municipal bond market stands out as a key destination for investors seeking credit exposure. With the Fed initiating a rate-cutting cycle and valuations appealing, the fourth quarter may present the optimal moment for investors to extend duration in municipal bonds—both for the remainder of the year and potentially throughout the rate cycle.

The fundamentals in munis remain strong year-to-date, with the number of issues being upgraded outpacing the number downgraded by 3.5x. Technical factors for the asset class, however, have not been as supportive. Municipal supply has surged nearly 40% year-to-date, and additional cheapening is likely as substantial net supply through October, combined with election-related uncertainty, continues to pose a headwind. Compared to other high-quality fixed income, these factors have contributed to recent underperformance; 10- and 30-year municipal versus Treasury yield ratios are at their widest levels of 2024.

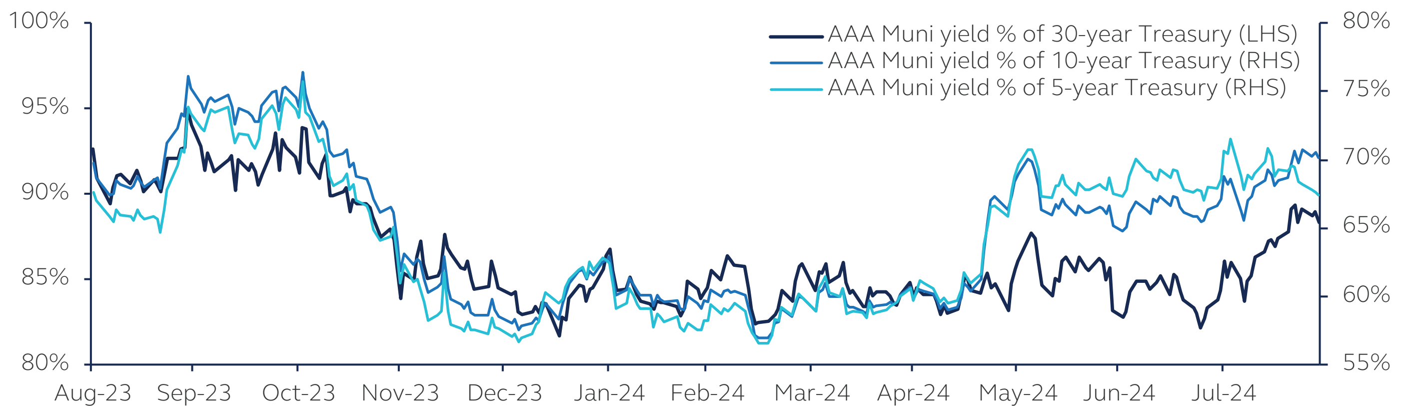
As the Federal Reserve adjusts its policy during an easing cycle, bond yields typically decline. This drop in yields can create a favorable opportunity for investors to extend duration, locking in attractive tax-advantaged income and potentially benefiting from price gains. Additionally, municipals have consistently outperformed 3-month T-bills after the start of rate cuts, regardless of whether the economy enters a recession or not. This is a particularly attractive prospect in an environment where the base case is a soft landing, but recession risk is elevated.

Importantly, for tax-sensitive investors seeking to maximize after-tax income or are concerned about the potential for future tax increases, the municipal tax-exemption value is at its highest since 2008, providing additional incentives to explore high-quality municipals.

Given that the technical pressures that have hurt municipals are expected to ease in the fourth quarter following the U.S. election, and that bond yields have historically fallen during easing cycles, 4Q 2024 may be the right entry point for investors to extend duration into munis.

Municipal bond yields as a percentage of Treasury yields

Last twelve months



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

Emerging market debt

While hopes are high for a soft landing in the U.S., EM economic fundamentals remain in a solid position to weather a broader developed market (DM) slowdown. Overall, EM growth should come in near 4% for 2024, and growth differentials (the difference between real GDP growth for EM vs. that of DM economies) should improve relative to the U.S.heading into 2024 – acknowledging that headwinds from a slowdown in China and broader DMs may endure. While inflation across most emerging markets should moderate, exceptions are likely to persist across Latin America and EMEA (Europe/Middle East/Africa) due to buoyant domestic demand and/or depreciation of local currencies. Although China's introduction of long-awaited stimulus in September should support the equity market and generate optimism for further fiscal action, it is unlikely to reverse the country's structural economic slowdown.

Elevated DM interest rates have proven to be a headwind for EMD for several years, and the sector has witnessed substantial investor outflows as a result. However, with the advent of the Fed's policy pivot, the direction of flows should reverse in the fourth quarter and become more pronounced in 2025. Fortunately, in advance of this expected reversal in demand, lower bond issuance and overall negative net issuance (maturities + interest > new bond issuance) have helped to offset the impact on many EM countries due to lower onshore yields. While supply is expected to increase in the near term, it will likely remain manageable.

In terms of valuations, EM spreads remain near historical tights, with the Bloomberg EM USD Aggregate Index OAS at +270bps*. For the remainder of 2024, spreads are likely to remain rangebound with a bias toward moderate widening but with episodic volatility due to falling U.S. rates and a predictably turbulent election season.

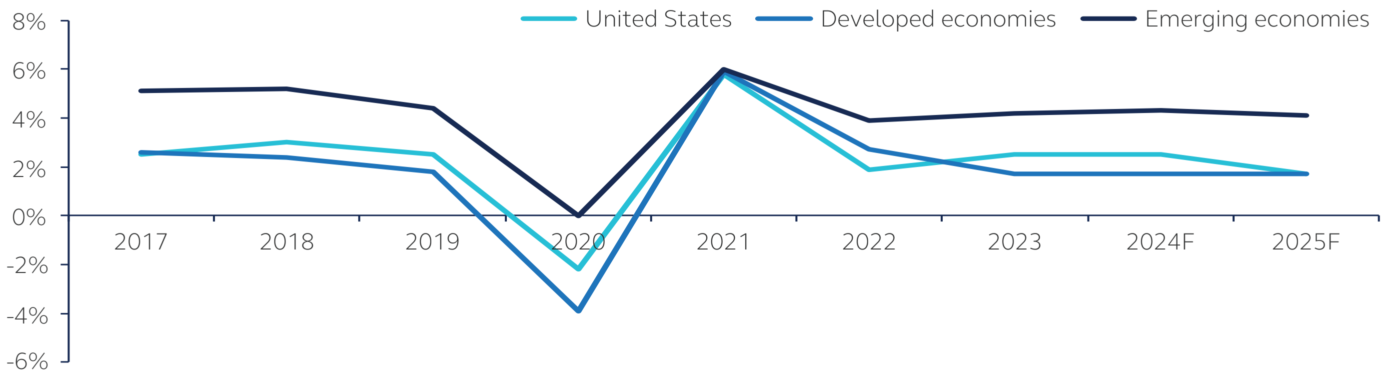
Despite the performance of EM credit being less correlated to growth than EM FX and equity returns historically, flows into EMD have been highly correlated with growth differentials. While today, the growth differential is not at the historical wide of over +300bps*, we view an EM growth differential of >200bps as a technical draw for investment flows away from slowing DMs.

As investors look to the remainder of 2024 and into 2025, the key sectors in the EM debt markets (hard currency and local markets) appear to be well positioned, both fundamentally and technically, and should continue performing.

**as of September 17, 2024. Historical comparisons may be affected by index composition changes.*

Real GDP growth

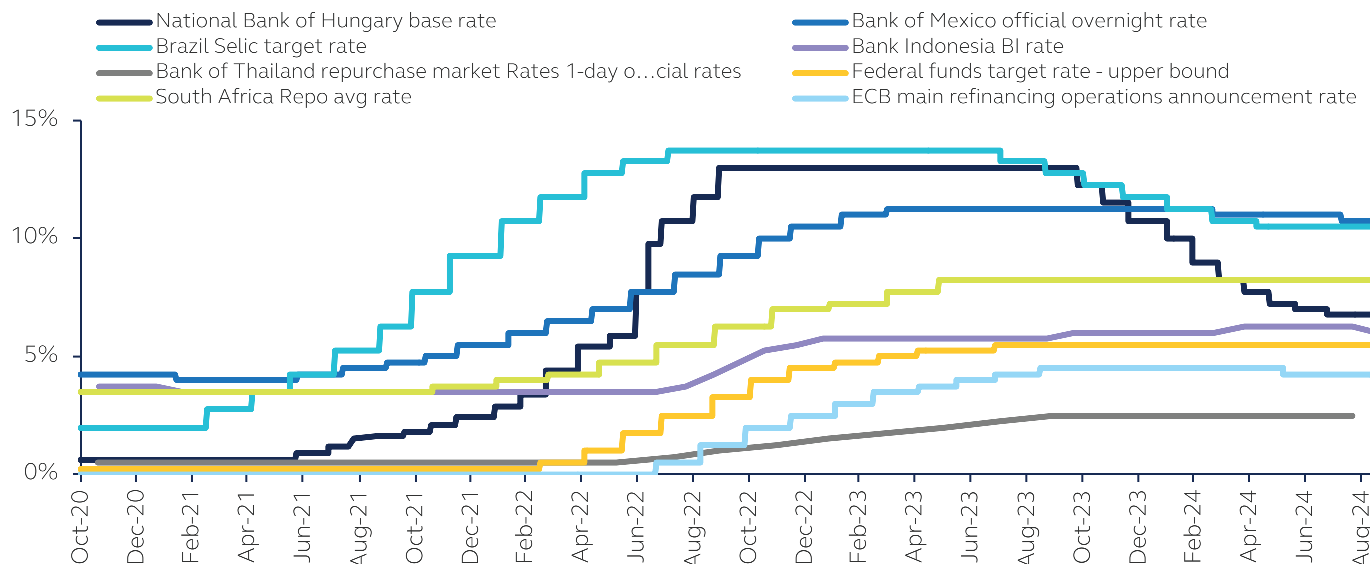
2017-median forecasts through 2025



Source: Bloomberg, Principal Asset Management. Data as of September 18, 2024. "F" = forecast.

Global central bank rates

October 2020-present



Source: Bloomberg, Principal Asset Management. Data as of September 18, 2024.

Private credit

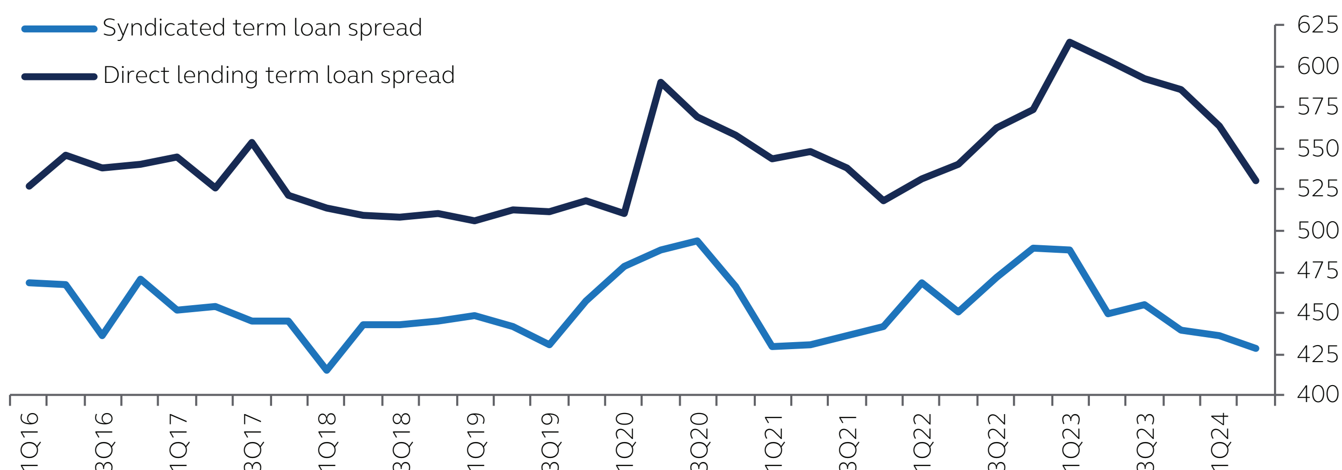
The pace of deal activity in the private equity and private credit markets has been picking up throughout the year, driven by expectations of Fed easing and the resulting stabilization in economic growth.

Provided Fed rate cuts are sufficient to ward off systemic events and prevent a shift back to tighter credit conditions, M&A and leveraged buyout (LBO) activity are likely to continue picking up for the remainder of the year and into 2025. The private direct lending middle market will most likely continue to finance a greater portion of the activity as commercial banks and the public loan market remain less compelling for private equity sponsors and borrowers seeking to grow their businesses.

With the move toward easier credit conditions, credit spreads have tightened. In fact, spreads are considerably tighter over the past year in the public market as well as the upper middle market and large-cap private credit markets that compete directly with the public market. There has been more modest spread tightening in the lower and core direct lending middle market, but that has also realized spread tightening of approximately 75 bps from the widest levels of 2023. The spread movement across markets has improved the relative value of lower and core middle market private credit compared to public and larger private credit opportunities. When also considering other important aspects of relative value, such as lower leverage levels and virtually no payment-in-kind (PIK), meaningful maintenance covenants, relatively attractive original issue discount (OID), and more favorable call protection, the attractive value of lower and select core middle market opportunities is even more noticeable for investors.

Average first-lien sponsored middle market term loan spend

Basis points, 2016–present



Source: LSEG, Principal Asset Management. Data as of June 30, 2024.

With public high yield bond and bank loan markets moving to more aggressive pricing and terms in 2023 (and into 2024), upper middle market participants were forced to compete to maintain share and win new lending opportunities. This has resulted in the less favorable aspects of the public markets spreading into the upper middle market (companies generating $50 million to $100 million EBITDA) and large-cap private credit market, including covenant-lite structures, higher leverage levels with more PIK, aggressive pricing on new deals, and existing loans being repriced to lower spreads. As a result, lower middle market (companies generating $5 million to $15 million EBITDA) and many core middle market opportunities (companies generating $15 million to $50 million EBITDA) continue to represent attractive value.

The first lien senior secured nature of the direct lending middle market, coupled with the attractive risk premiums and orientation to more resilient industries, should contribute to attractive relative value during the coming quarters. If the public markets remain "risk-on," the Fed rate path is likely measured and in conjunction with an economy working into and through a soft landing. If the economic path becomes bumpy, the Fed's rate path will likely accelerate in reaction to public markets experiencing significant volatility and drawdown. In either case, middle market direct lending should provide the diversification and resiliency it has provided in many other uncertain market environments.

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 September 30, 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

Moving into the final quarter of 2024, the landscape for fixed income has shifted meaningfully, with the Fed initiating its long-awaited rate-cutting cycle and the U.S. economy displaying signs of resilience amid global uncertainty. While the upcoming U.S. presidential election and potential labor market volatility may introduce some headwinds, easing monetary policy provides a favorable backdrop for fixed income investors. With attractive yields and strong fundamentals across asset classes, we remain optimistic about the potential for further gains, particularly as duration opportunities emerge and global central banks continue to ease their policies.

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. $137.6 billion in assets under management as of June 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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Risk considerations

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