

Principal Fixed Income

FIRST QUARTER 2026

Fixed income perspectives

Resilient markets, selective opportunities

Introduction

Entering 2026, the fixed income landscape is increasingly being defined by a combination of sustained economic growth and the Federal Reserve's anticipated slow drip rate cuts. With U.S. inflation remaining elevated, the Fed faces the challenging task of balancing persistent price pressures against a cooling labor market, but with healthy growth in the background. This situation is likely to result in fixed income returns aligning more closely with long-term averages, particularly in higher-quality segments such as investment-grade and securitized debt, which are known for their sensitivity to interest rate movements.

Policy volatility: Navigating geopolitical and economic challenges

The current environment is marked by policy volatility, as markets grapple with ongoing inflationary pressures and a decelerating U.S. labor market. The Fed's easing cycle, occurring against a backdrop of sustained inflation exacerbated by geopolitical tensions (with Venezuela now added to the list) and the ever-present threat of tariff-based instability from the Trump Administration, creates a background of uncertainty. This scenario complicates investor sentiment and contributes to a steepening yield curve.

Credit fundamentals: Resilience amidst market dynamics

From a credit perspective, resilience is key. Investors should maintain a focus on robust technicals and credit fundamentals while remaining attentive to the overall economic conditions. The burst of growth in the third quarter of 2025 should help mitigate concerns about a recession, and that stubborn inflation can still be managed. Nevertheless, geopolitical headline risks and sensitivities to trade can lead to significant sector dispersion, underscoring the importance of active issuer selection and credit discipline.

Valuations: Further compression may be limited, but opportunities exist

Valuations present a complex picture: while further spread compression may be constrained, opportunities persist, especially within emerging markets, municipal bonds, securitized assets, and private credit. As dispersion replaces broad beta as the primary driver of returns, success in 2026 will hinge less on market direction and more on security selection. In this environment, disciplined active management will be essential to identify durable income, manage downside risks, and capture pockets of value amid ongoing volatility.

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Perspectives from the CIO

The trajectory of interest rates will be pivotal in shaping fixed income outcomes in the year ahead. The Federal Reserve is expected to gradually lower policy rates toward a neutral level—likely around 3%—as it balances persistent inflation pressures against a labor market that is cooling but not collapsing. Against this backdrop, the opportunity set remains constructive, with fixed income offering attractive prospects for both income generation and total returns.

The prevailing economic conditions have laid a solid foundation for fixed income. With inflation projected to remain above the Fed's 2% target, market expectations reflect a more accommodative approach to policy changes. This environment allows active investors to navigate sector dispersion and capitalize on favorable interest rates while remaining cautious.

The yield curve and duration positioning

Market participants should prepare for a potentially steeper yield curve as the Fed continues rate cuts. Historical patterns indicate that easing cycles typically lead to appreciation across the yield curve, providing prospects for capital gains alongside income generation. Investors are advised to maintain a moderately long duration stance to capitalize on shifts in the yield curve and evolving inflation expectations. Close attention to both ends of the curve will be essential for optimizing returns in this environment.

The intricate interplay of factors influencing the fixed income landscape cannot be overstated. Investors must remain vigilant regarding inflation trends and the Federal Reserve's policy shifts, as these variables will significantly shape the yield curve and sector performance. Overall, the environment presents more favorable income rates compared to years past, offering the potential for reasonable total returns in 2026.

A favorable outlook, but agility is key

Strong technical conditions, robust fundamentals, and a supportive macroeconomic environment continue to underpin the fixed income market. However, the current landscape is complicated by tighter spreads. While demand for corporate debt and high-quality securities is expected to remain steady, new supply may surpass demand as companies capitalize on the Fed's easing cycle to increase issuance. Additionally, consumer-focused credits may encounter challenges if the labor market shows signs of weakness. Overall, however, the market's resiliency provides active managers with opportunities for effective bottom-up credit selection and sector differentiation.

Summary of investment implications

INVESTMENT GRADE CREDIT

Investment Grade (IG) credit should continue in good stead as an asset class, supported by strong carry, stable fundamentals, and manageable supply. All-in yields are historically attractive, and investor demand remains firm amid rate stability. We favor the 5- to 10-year part of the curve and see relative value in large U.S. banks and certain BBB-rated tech issuers linked to AI investment. While supply is expected to rise, technicals start from a strong position, underpinned by prevailing yields and investor demand. We anticipate that high-grade companies will capitalize on this investor receptivity. Monitoring technicals will be key as spreads remain near historical tights.

HIGH YIELD CREDIT

We remain constructive on high yield as a source of income, but upside is constrained by tight valuations and rising supply. Fundamentals are stable, and defaults are declining; yet modest spread widening is likely as issuance accelerates. Sector rotation—particularly growth in tech-linked issuers—is reshaping the market, creating new risks and opportunities. In this environment, we favor disciplined credit selection over beta exposure, emphasizing improving credit stories, rising stars, and sectors with durable cash flows.

SECURITIZED DEBT

Structured credit remains supported by strong demand, but deeper credit bifurcation is driving increased dispersion across sectors. We favor targeted exposure in agency MBS, especially call-protected conventional MBS, and see opportunities in discounted Ginnie Mae securities and SASB CMBS deals. Consumer ABS requires issuer-level selectivity amid softening fundamentals. Duration extension is tactical, with curve positioning more constrained than in other sectors. Active selection remains essential as fundamentals diverge and convexity risk rises.

MUNICIPALS

Munis offer attractive taxable-equivalent yields and a steep curve that rewards duration extension—especially versus Treasuries. With federal tax exemption concerns resolved, demand is expected to strengthen even amid elevated supply. We favor revenue-backed bonds tied to infrastructure, housing, and energy projects, while remaining cautious on general obligation bonds in fiscally pressured states. Active selection is becoming increasingly critical as credit dispersion increases and federal aid declines.

EMERGING MARKET DEBT

Emerging Market Debt (EMD) offers attractive carry and diversification, as fundamentals are sturdy and inflow momentum continues. Higher yields and lower correlations to developed market risks support valuations, especially amid fiscal pressure and AI-driven credit expansion in developed markets. We favor maintaining exposure across sovereigns and corporates while being prepared to take advantage of supply-driven volatility. Emerging economies and local currency debt may benefit from Fed easing and dollar weakness, while selective distressed names offer alpha potential for active managers.

PRIVATE CREDIT

Middle market direct lending enters 2026 with renewed momentum, supported by macro clarity, easing rates, and recovering valuations. Deal flow is reaccelerating, fund structures are evolving to meet investor needs, and fundamentals remain resilient, marked by low non-accruals and stable coverage ratios. We see a favorable setup for new deployment, with strong risk-adjusted return potential and less volatility than public markets. Structural discipline and credit selection will be key to navigating the next phase of market maturity.

Macro

U.S. outlook

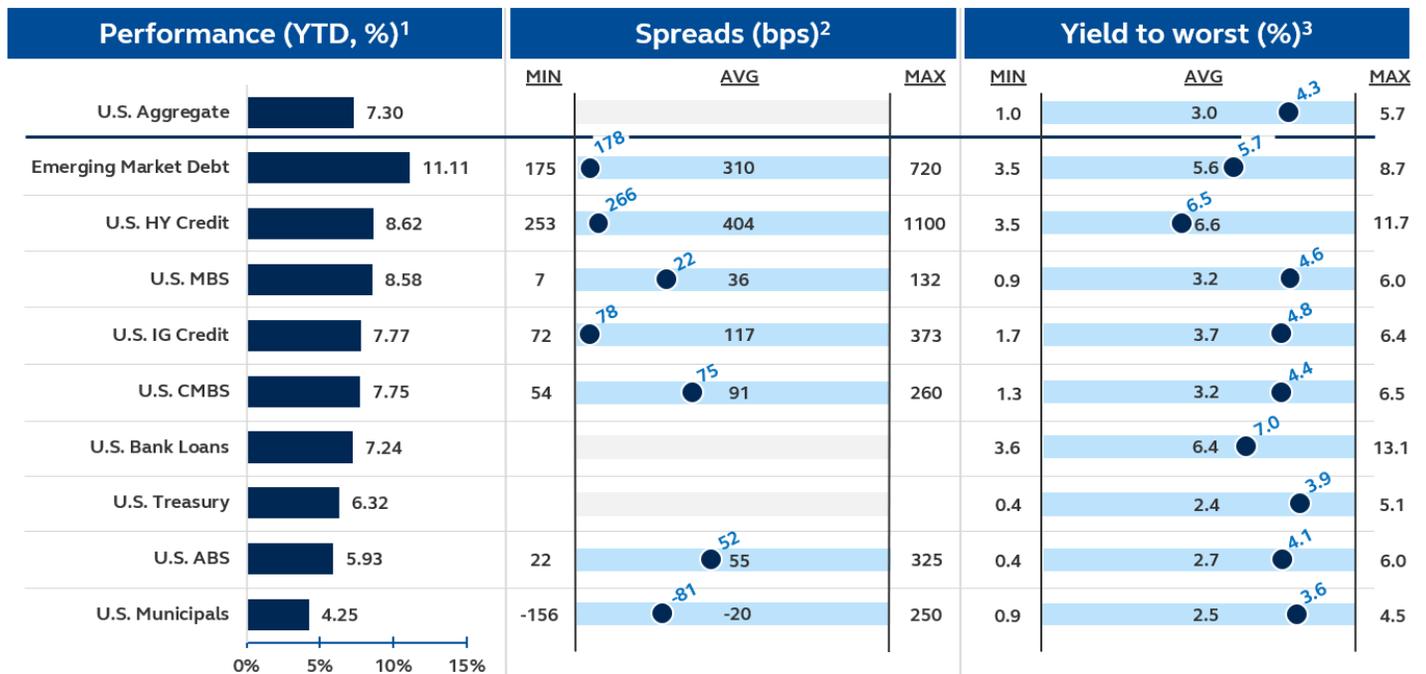
2025 was not without its challenges: sticky inflation, a cooling labor market, elevated supply across sectors, volatile trade policy, and ongoing geopolitical uncertainty. Yet despite these headwinds, fixed income markets delivered resilient performance—driven by a combination of disinflation, late-year Fed rate cuts, a resilient consumer, and the early effects of AI-driven capital spending. The result: the highest total return for the Bloomberg U.S. Aggregate Index in the post-COVID era.

Looking ahead to 2026, we remain optimistic about the outlook for fixed income, supported by a mix of cyclical and structural tailwinds:

- Continued labor market softening should keep the Fed on track for further rate cuts.
- Rising productivity—partly tied to early AI adoption—may help sustain economic growth even as employment moderates.
- Inflation is expected to peak in the first half of 2026 and trend toward the Fed’s 2% target by year-end.
- AI-related capex is projected to accelerate meaningfully relative to 2025.
- Consumer spending remains steady with limited signs of fatigue.
- Corporate fundamentals, including margins and balance sheets, remain robust.
- U.S. fiscal policy is pivoting from tariff and trade uncertainty toward pro-growth tax cuts and deregulation, delivering a strong fiscal impulse early in the year.
- Yields remain attractive by historical standards, offering favorable entry points for long-term investors.

Market environment

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



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.

Source: Bloomberg, Principal Asset Management. Data are as of December 31, 2025.

U.S. outlook continued

That said, several risks warrant monitoring. Tight credit spreads and elevated valuations limit room for error. Market expectations for rapid productivity gains may overshoot the near-term return on AI investment. Increased issuance tied to infrastructure and technology capex could challenge absorption, particularly if Treasury term premia continue to rise. Meanwhile, a deeper labor market slowdown could raise recession fears, and any perceived erosion of Fed independence could add volatility to the policy outlook.

We maintain a constructive view for 2026. Volatility is likely to present buying opportunities, not reasons to retreat. We believe fixed income remains well-positioned to potentially deliver solid, income-driven returns in the year ahead.

Global outlook

As 2026 begins, the global macro environment is shaped by defining forces that present a compelling mix of challenges and opportunities: a widening divergence in monetary policy across developed economies, a synchronized shift toward fiscal expansion, and evolving geopolitical dynamics. Together, these dynamics have significant implications for growth forecasts, capital flows, and relative value across global fixed income markets.

Diverging central bank paths signal an end to the synchronous easing cycle. While the Federal Reserve is expected to extend its easing cycle amid rising unemployment and political pressure, other major central banks are either nearing the end of their easing cycles—or actively preparing to hike. The ECB, Bank of Canada, and Reserve Bank of New Zealand have already signaled a shift away from further cuts, while the Reserve Bank of Australia and Riksbank (Sweden) are openly considering tightening scenarios in 2026.

Japan stands out as the most hawkish. The Bank of Japan brought forward rate hikes in late 2025 and advanced the timeline for further tightening—marking a historic pivot from ultra-accommodative policy, which had been cemented in place for generations. With policy rates likely to rise further in 2026, Japan's role as a global capital exporter may begin to shift, potentially leading to ripple effects across global duration markets.

Fiscal policy turns more expansionary

Fiscal expansion is re-emerging as a global theme, supported by political incentives and geopolitical realignment. Europe is experiencing renewed momentum in defense and infrastructure spending, despite previous concerns about fiscal discipline. Japan's new leadership is embracing an "Abenomics 2.0" approach—pursuing growth through aggressive fiscal policy and expanded public investment. Even the U.S., once expected to moderate its deficits, has turned the fiscal dial higher, and midterm election incentives are likely to drive proposals for household tax rebates and revived corporate tax breaks.

The investment implications are nuanced. We expect global yields to remain elevated in aggregate, although U.S. Treasury yields may ease somewhat in response to Fed cuts. That suggests limited scope for further capital appreciation in rates markets, and a renewed focus on carry and credit selection. At the same time, diverging rate paths are likely to support a weaker U.S. dollar, albeit with smaller depreciation than seen in 2025. This could continue to drive interest in local currency EM debt and other non-dollar assets.

Geopolitics remains in transition

Europe remains the focal point, while the ongoing conflict between Russia and Ukraine remains a concern, there is lingering hope for a potential ceasefire. Meanwhile, U.S.-China tensions have entered a temporary détente, reducing near-term trade risk as both governments prioritize domestic agendas ahead of the U.S. midterm elections. However, China faces its own challenges, including weak household spending and a decline in infrastructure investment, which may require targeted policy support moving forward. Lastly, the markets also face reduced concerns regarding trade wars compared to a year ago; however, investors will continue to monitor the upcoming U.S. Supreme Court decision on tariffs and the Administration's reaction.

Outlook: cautiously optimistic, with relative upside risk

While structural headwinds remain, particularly in Europe and China, there is scope for relative improvement compared to subdued guidance from official institutions like the IMF. For fixed income investors, the focus should remain on active allocation across regions, disciplined duration exposure, and a realistic outlook for returns—driven more by income than price gains in 2026.

Investment grade credit

Strong carry, manageable supply, and curve steepening support a favorable start to 2026

The outlook for investment grade credit remains constructive heading into 2026. While gross supply is expected to increase this year, driven in part by capital investment in AI infrastructure, the asset class continues to benefit from a stable economic environment, positive investor flows, and an attractive yield profile that serves as a stabilizing factor. Against this backdrop, IG credit remains an appealing asset class for investors seeking income with low default risk and relatively low duration.

Yield remains the anchor

Even with spreads near the tighter end of historical ranges, all-in yields for IG corporates remain in the 70th percentile historically. That’s been a key draw for investors, reflected in a 32-week streak of inflows—the second-longest streak ever—that lasted until mid-December 2025. The combination of resilient carry and low realized volatility continues to reinforce IG’s appeal versus other risk assets.

Rate stability has also played a role. While further policy easing is expected in 2026, the 10-year Treasury has traded within a tight range, and only a modest decline is expected from here. That stability supports roll-down strategies and relative value across the 5- to 10-year belly of the curve, which is a favored positioning segment.

Supply to rise—but remains digestible

The IG market is preparing for a manageable uptick in primary issuance in 2026. Gross supply could approach \$1.8 trillion this year, with net supply forecasts around \$300 billion. The expected increase in both gross and net supply is certainly tenable in the context of strong demand, elevated maturities, and a growing appetite from both domestic and international investors.

A key theme for 2026 is the anticipated rise in long-duration debt issuance, with technology companies leading the way by investing in generative AI infrastructure. High-quality “hyperscaler” names, such as Amazon, Meta, and Oracle, are expected to be active issuers, helping reshape the top tier of IG supply. These firms are expected to use IG debt to finance their investments in AI, with projections suggesting \$200 to \$300 billion in new issuance over the next five years. At the same time, bank issuance is likely to decline, partly due to regulatory changes such as SLR (supplementary leverage ratio) reform, which reduces supply pressures from the financial sector.

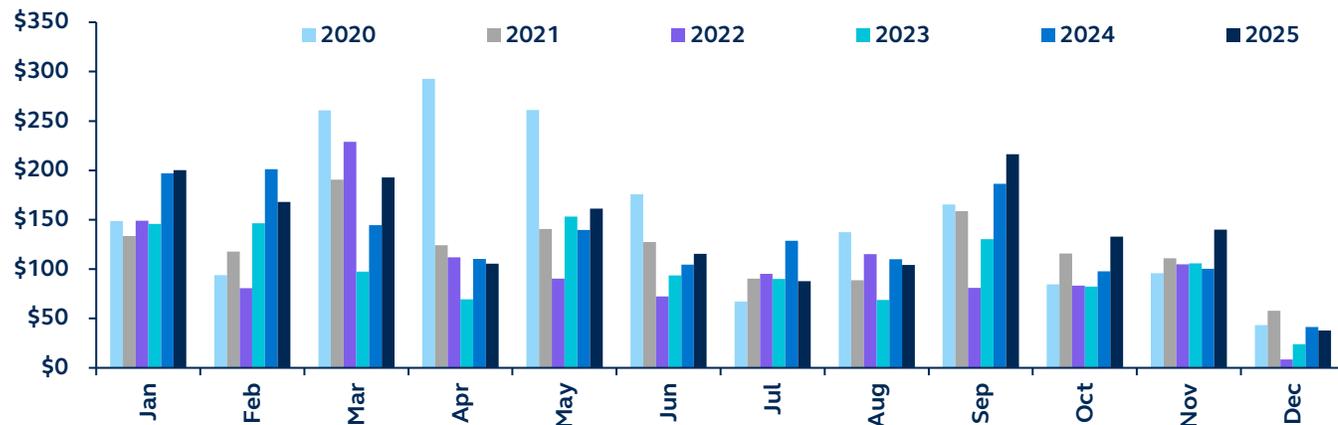
Sector themes and positioning

Financials remain a compelling sector. Fundamentals across large, diversified banks are robust, characterized by solid asset quality, stable deposits, and healthy capital levels. Banks are also well-positioned to capitalize on growing M&A activity. Ongoing deregulation could further support margins by reducing operating costs, making the sector increasingly resemble the “new utilities” of credit. Select Yankee banks (non-U.S. domiciled banks that issue in U.S. dollars) also offer relative value, particularly where regulatory clarity supports fundamental stability.

We also maintain a constructive view on AI-exposed technology issuers, particularly among BBB-rated names that play niche roles in the AI ecosystem. These include companies in chip design, enterprise infrastructure, and data storage—areas well-positioned to benefit from long-term investments in productivity gains. Meanwhile, within the consumer and industrials sectors, those with pricing power and structural barriers to M&A, such as aerospace, defense, and tobacco, are preferred.

Investment grade monthly supply

\$Billions, 2020–2025



Source: Bloomberg, Principal Asset Management. Data as of December 31, 2025.

Investment grade credit continued

Risks to watch

Despite the optimistic outlook, there are a few areas that warrant close monitoring. The balance of supply and demand will be critical. A sharp surge in issuance—beyond even the highest forecasts—could challenge market absorption and put pressure on spreads in the short term, potentially leading to some spread volatility. Additionally, abrupt swings in yield levels, particularly if interest rates decline too rapidly, could erode demand from yield-sensitive buyers, thereby affecting the overall attractiveness of IG. While neither scenario is our base case, they highlight the importance of closely watching technicals as the year unfolds.

High yield

Fundamental stability, moderate spread widening, and sector rotation define the path ahead

The high yield market enters the new year on a solid footing, but not without friction. The returns of 2025—driven by disinflation, favorable technicals, and soft-landing optimism—are giving way to a mixed environment of tight valuations, increased issuance, attractive carry, and easing technical tailwinds. In this context, investors should expect more volatility and greater dispersion in return profiles.

Tight starting valuations limit upside

High yield spreads are beginning 2026 near post-pandemic tights, particularly in BB-rated credits. With Treasury yields likely to drift lower on the back of Fed easing, spreads are expected to widen modestly, reflecting both supply dynamics and a more cautious pace of credit repricing. We anticipate spreads will inch out toward the 315 bps range, wider than the year-end level of approximately 270 bps.

Importantly, this is not a forecast for credit stress. The default rate is expected to decline to around 2.75% in

2026, down from over 4% in 2025, as refinancing activity picks up and fundamental credit conditions remain manageable. But with valuations stretched and new issuance set to rise, some repricing pressure is likely—particularly in lower-rated credits and event-driven situations.

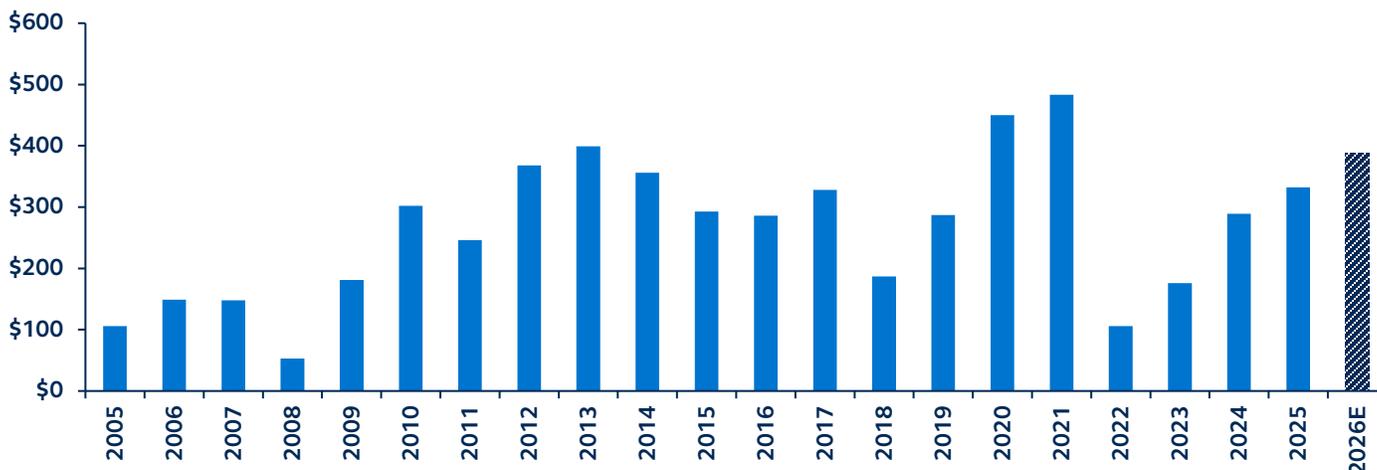
Supply to rise, but fundamentals remain sound

After a robust 2025, the primary market is poised to accelerate even more. Issuance is projected to grow from approximately \$330 billion in 2025 to \$375–\$400 billion this year, driven by a mix of mergers and acquisitions, leveraged buyouts, and shareholder-friendly activity. Crucially, this is not problematic issuance. Instead, companies are returning to the primary market to get ahead of an expected 2028 maturity wall, rather than plugging liquidity holes. That should help maintain stable credit quality, even as the volume of new deals increases.

With supply normalizing and technicals rebalancing, yields are likely to fluctuate above and below the psychological threshold of 7%. However, yields are unlikely to move sustainably higher without a more material shift in macro or credit conditions.

High yield gross issuance

\$billions, 2005–2025, 2026 is Principal AM estimate



Source: JP Morgan Asset Management, Principal Asset Management. Data as of December 31, 2025.

High yield continued

Sector rotation is in motion

The composition of the high yield market is changing. Technology is gaining prominence, driven by the demand for AI infrastructure, including data centers, grid suppliers, and utility issuers. While this sector has historically made up a smaller part of the high yield index, it could account for nearly 10% of the index by year-end, a shift from about 6.5% just a few years ago, which warrants closer attention to tech-driven volatility and equity correlations.

Other favored sectors include building materials and select utilities, where improving fundamentals and rising star potential offer upside. At the same time, energy exposures are cautioned, due to softer commodity prices and surplus conditions, especially in the oil market. Caution is also required in healthcare, where policy uncertainty and tight valuations cloud the outlook.

Risks skew toward asymmetric shocks

Two risks stand out—the first of which is AI-related volatility. If tech valuations reverse sharply, particularly among hyperscalers, it could reverberate across the high yield market via correlations to data centers and infrastructure issuers. Second is a potential weakening in the labor market. A material rise in unemployment, especially among lower- and middle-income cohorts, could challenge credits tied to consumer demand.

Carry remains compelling, but discipline is essential

While spreads may widen modestly, high yield continues to offer compelling carry in a stable default environment. The risk-reward equation is no longer skewed to beta or broad market exposure—it's about finding the right credits at the right entry points. With fundamentals intact and refinancing activity reducing credit stress, there is room for selective risk-taking. But with valuations full and supply picking up, discipline around structure, sector, and security selection will define outcomes in 2026.



Securitized debt

Demand strength, credit bifurcation, and selective duration shape opportunities

As securitized debt enters 2026, it faces a supportive yet increasingly complex environment. While technical conditions remain favorable, the fundamentals across various sectors are becoming more nuanced, necessitating a selective approach to both collateral types and structural profiles. The balance between yield, liquidity, and credit stability will be essential for unlocking value as disparities deepen in consumer, real estate, and mortgage-related markets.

Technical strength remains intact

Investor enthusiasm for securitized assets remains robust, driven by attractive relative values compared to corporates and limited net supply. Across asset-backed securities (ABS), commercial mortgage-backed securities (CMBS), and mortgage-backed securities (MBS), demand remains broad-based and resilient, with transactions often oversubscribed. This reflects ongoing interest from insurers, banks, and asset managers eager to seize incremental spreads in high-quality structures.

In agency MBS, 2025 marked the third consecutive year of positive excess returns, driven by constrained net issuance, selective participation from leveraged buyers, and renewed engagement from government-sponsored entities. Looking at 2026, supply is anticipated to increase modestly, with dealer forecasts fluctuating between \$140 and \$300 billion. Our base case projects net issuance around \$200 billion, supported by modest improvements in turnover and refinancing as mortgage rates begin to ease.

Despite the expected rise in supply, overall technical conditions are balanced. We maintain a preference for conventional MBS over Ginnie Maes, where net issuance is projected to be heavier. Within Ginnies, however, we see promising opportunities in discounted, seasoned pools that offer more favorable turnover dynamics.

Credit quality is stable, but dispersion is rising

While overall collateral performance remains solid in securitized markets, credit bifurcation—particularly among consumers and within commercial real estate—is becoming more pronounced. In the consumer ABS

Securitized debt continued

market, wage pressures and escalating delinquencies are creating noticeable divides between prime and subprime borrowers. We maintain a constructive outlook on subprime auto but stress the importance of issuer-specific selection, favoring issuers with strong underwriting histories and proven resilience through economic cycles.

In the commercial ABS sector, issuance tied to fiber and data infrastructure is expanding, providing structural clarity and attractive spread characteristics. The CMBS market continues to exhibit significant bifurcation, especially in the office and retail sectors. Investors would be well-suited to favor single-asset/single-borrower (SASB) deals, as they offer targeted exposure to high-quality properties with transparent cash flows, particularly in stronger-performing metropolitan areas.

Navigating duration and convexity

While the broader fixed income landscape is shifting toward longer duration, securitized debt presents a more limited path. Most sectors remain inherently short-duration or floating-rate, and longer-dated assets often come with embedded convexity risk.

Nonetheless, selective opportunities for duration extension do exist. In the agency MBS market, call-protected pools near par remain appealing due to their low prepayment risk. In CMBS, 10-year conduit deals are gaining traction as demand for duration increases. Additionally, some seasoned non-agency residential mortgage-backed securities (RMBS) may provide a balance of spread and rate stability for investors looking to tactically reposition ahead of further Fed rate cuts.

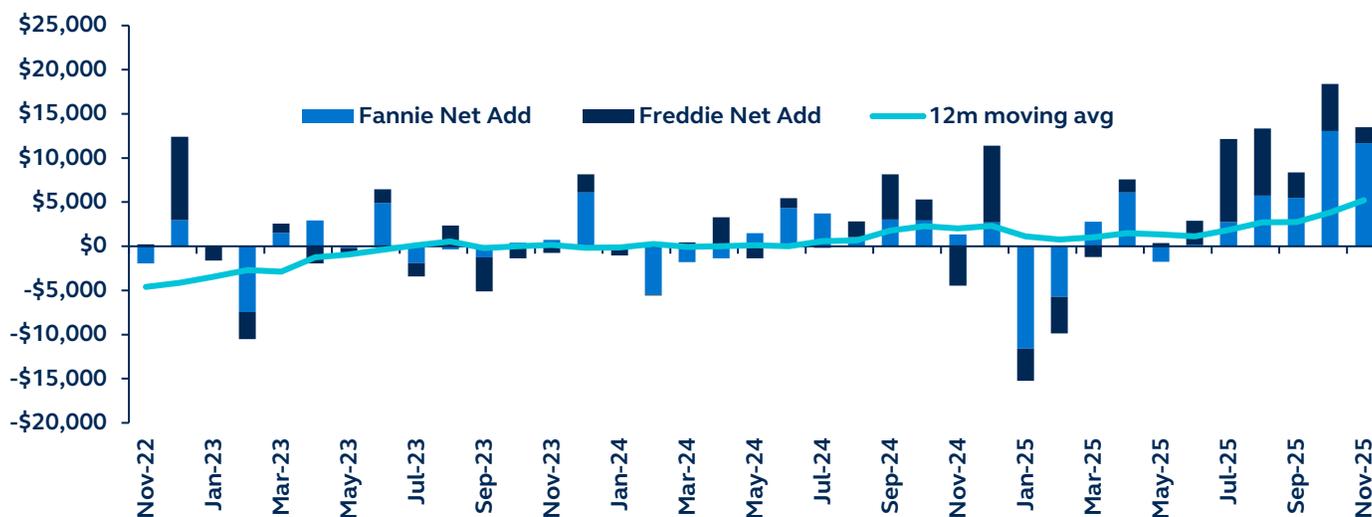
Key watchpoints

Looking forward, the health of the U.S. consumer presents a critical risk. Signs of weakness in lower-income segments, especially those related to employment and credit performance, merit close monitoring. A sharper-than-expected decline in mortgage rates could trigger prepayment waves, particularly in agency MBS, potentially leading to underperformance in higher-coupon pools. Currently, the mortgage index shows an imbalance, with approximately 50% of conventional MBS securities carrying rates under 4%, while more than 25% exceed 6%. This could create negative convexity risks if rates drop, driving a further increase in prepayments.

Nonetheless, strong investor demand continues to support securitized debt, which offers a differentiated risk-return profile compared to both investment-grade credit and broader fixed income markets. Selectivity—both in structural choices and sector allocation—will remain pivotal to successful positioning as we enter 2026.

GSE MoM change in mortgage portfolio

\$Millions



Source: Fannie Mae, Freddie Mac, Principal Asset Management. Data as of November 30, 2025.

Municipal bonds

Steeper curve, solid credit, and yield resilience support a constructive Muni outlook

The municipal bond market enters 2026 in a materially stronger position than it entered 2025. The removal of tax exemption uncertainty, a key overhang throughout much of 2025, has clarified the policy backdrop and helped restore investor confidence. Against that backdrop, compelling opportunities exist, driven by elevated yields, steep curve dynamics, and strong underlying credit fundamentals.

Curve steepness and elevated yields drive relative value

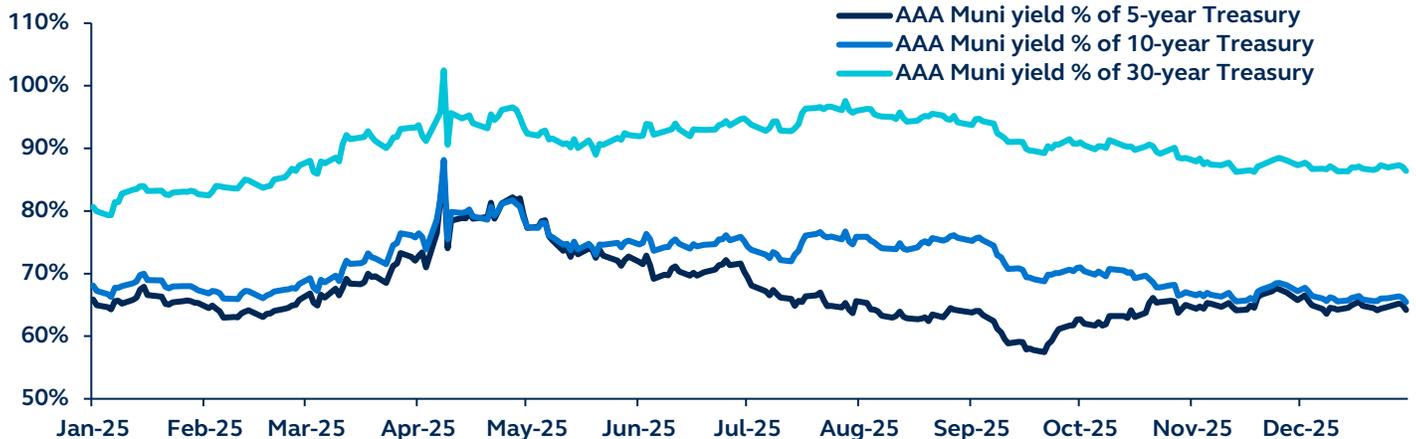
One of the most distinctive features of the municipal market today is the steepness of its yield curve—especially relative to Treasuries. The heavy long-end supply in 2025, which is expected to continue in 2026, has created a rare curve dynamic where investors are being paid to extend duration. This steepness offers a meaningful term premium that is not currently available in most other fixed income sectors and elevated yields, especially when adjusted for tax equivalency, positioning Munis as an attractive income-generating investment, particularly for those in higher tax brackets. With roll-down potential and favorable relative value, especially on a taxable-equivalent basis, municipals stand out as a source of high-quality income and total return potential in a world where carry is once again king.

Strong credit footing—but differentiation is increasing

Municipal fundamentals remain broadly healthy, but we believe the best news may be behind us. Pandemic-era federal aid has largely rolled off, which will introduce greater dispersion in credit quality across issuers. In this environment, active management and project-level credit selection are increasingly critical.

Municipal to Treasury ratios

AAA municipal bond yields relative to Treasuries



Source: Bloomberg, Principal Asset Management. Data as of December 31, 2025.

We continue to favor revenue-backed bonds—securities backed by specific revenue-generating projects rather than the creditworthiness of states or municipalities—which have long been the foundation of our strategy. Sectors such as housing, prepaid gas, transportation, and Alternative Minimum Tax bonds offer strong income profiles and resilient fundamentals, especially in a soft-landing macro environment. Infrastructure-related projects—especially airports, subways, and bridges—align well with both fiscal stimulus trends and investor demand for long-duration assets tied to tangible outcomes.

Conversely, we remain cautious on general obligation (GO) bonds, particularly in states where fiscal policy uncertainty is rising. Ongoing debates around property tax reform in places like Florida and Texas, combined with rising unemployment and declining capital gains revenues in others (e.g., California), suggest more limited upside in broad-based state-level exposure.

Infrastructure and energy investments

The emphasis on infrastructure extends beyond transportation. Energy-related investments are also gaining attention. As the energy landscape evolves, municipal bonds associated with both renewable energy and traditional power sources are becoming increasingly relevant. Utilities are revisiting older models, including the role of nuclear and coal, as they navigate the evolving requirements for energy generation.

Prepaid gas debt also presents a unique opportunity in the current market. As these energy sources regain favor, municipalities that issue bonds supporting these sectors stand to benefit, making them a worthy consideration for investors seeking growth.

Municipal bonds continued

Policy clarity and demand tailwinds

Importantly, resolving federal tax exemption concerns removes a significant source of market volatility as it ends the uncertainty surrounding tax exemption issues, representing a significant win for the municipal bond market. Investors can now approach the market with renewed confidence, free from the headwinds that previously plagued the sector. This clarity enables a sharper focus on the fundamental attributes that typically drive performance in the municipal bond space.

With that policy risk in the rear view, we anticipate healthier demand dynamics in 2026—even in the face of continued heavy supply. The expectation that money market assets will rotate out the curve as short-term rates fall adds further support for Muni demand.

Managing risks and watchpoints

The primary risk to the muni outlook would be a material slowdown in the U.S. economy. A downturn could lead to higher unemployment, reduced consumer spending, and lower state tax receipts—particularly from capital gains. This would have direct implications for state and local revenues, affecting certain pockets of the muni market more acutely. However, such an environment would also likely keep Treasury rates anchored, further boosting the appeal of tax-exempt income from municipals.

Moving forward, the ability to actively adapt to changing conditions and actively manage exposure to various risks will be critical to taking advantage of the opportunities that lie ahead in the muni market.

Emerging market debt

Carry, resilience, and strategic diversification define the EMD opportunity in 2026

The EMD backdrop is constructive. Emerging economies, while not delivering breakaway growth, are anchored by credible monetary policies, more disciplined fiscal management, and healthier external balances than in prior cycles. Many EM countries spent the last decade strengthening their domestic debt markets, reducing reliance on external funding, and building resilience to dollar strength and global rate volatility. These efforts have created a more durable platform for EMD, both for sovereign and corporate entities.

Higher yields and steadier fundamentals are drawing capital back into the asset class.

For the first time in several years, sustained inflows are returning to EM credit, helping to anchor spreads even in the face of a record issuance calendar. Investment-grade EM debt is yielding close to 5.0%, while high yield EM sits above 7.0%—compelling levels in a world where real rates in developed markets are grinding lower. With emerging markets increasingly offering strong risk-adjusted returns and a diversified portfolio alternative, the stability in EMD may serve as an attractive counterpart to volatility in other sectors.

Given the robust demand and solid fundamentals, investor interest in EMD appears encouraging. Central banks across many emerging markets still retain the ability to cut rates further in response to disinflationary pressures, thereby creating a conducive environment for growth. As the Federal Reserve's policy unfolds, emerging markets will benefit from a weaker U.S. dollar.

Supply is expected to be heavy in early 2026

Issuers are front-loading new deals amid limited Fed action, and anticipation for strong supply at the beginning of 2026 may necessitate a cautious approach initially. The increase in issuance might lead to short-term dislocations, causing spreads to widen as the market digests the new supply. Any episodic spread widening would not signal deteriorating credit quality, but instead create tactical opportunities to add exposure. Being positioned for this supply-driven volatility and ready to rotate dynamically will be critical to maximizing excess returns.

Emerging market debt continued

Thematically, three dynamics are shaping the investment landscape:

1. AI infrastructure demand may benefit EM commodity exporters, particularly in copper and select industrial metals. While the AI theme is typically associated with U.S. and developed-market tech, its material footprint—electric grids, data centers, transmission infrastructure—leans heavily on commodities where EM exporters play a key role.
2. Idiosyncratic distressed opportunities remain relevant, particularly in countries or quasi-sovereigns working through restructuring processes. Selective positioning in these names can add meaningful alpha but requires active management and deep credit research. Amid varied global conditions, there remain pockets of distress within some emerging markets that could hold potential value for discerning investors.
3. With most of the price gains from 2025 behind us—EM sovereigns returned ~13% and corporates ~9% last year—2026 is shaping up as a carry-focused year. The aim is to compound income while using tactical dislocations from supply, geopolitical headlines, or Fed ambiguity to enhance return.

Looking ahead: Risks and challenges

While the outlook for EMD in 2026 appears promising, several risks are worth noting. Investors must closely monitor geopolitical developments and shifts in trade dynamics, as these factors can have a significant impact on economic performance. While the decision by the Trump administration to seize Venezuelan dictator Nicolas Maduro evinces renewed focus on the Western Hemisphere, those circumstances are unique and unilateral. U.S. military action in other countries in the region is unlikely. That being said, ideologically-aligned and resource-rich nations in Latin America will likely deepen security and trade relations with the U.S. and underscore the importance of watching geopolitical developments.

At the end of the day, EM offers a portfolio hedge against stress in overheated areas of developed credit markets. EMD offers a cleaner, more traditional value proposition: yield, diversification, and macroeconomic resilience.

Yield pickup: EM vs. U.S. Corporate credit

Basis points, calendar year 2025



Source: Bloomberg, Principal Asset Management. Data as of December 31, 2025.

Private credit

Market clarity revives deal flow and investor appetite

After a mid-year slowdown in 2025 driven by tariff policy uncertainty, the private credit market is entering 2026 with renewed momentum. Macro clarity, policy stability, and easing rates have helped reaccelerate U.S. middle market direct lending activity—particularly in sponsor-backed deals. With ample dry powder and pent-up private equity demand, deal pipelines have expanded sharply post-Labor Day, marking a return to more favorable transaction dynamics.

Enterprise valuations are beginning to recover, supported by improved growth and lower discount rates. For lenders, this creates a more supportive backdrop for deployment, especially in the lower and core middle markets, where capital structures remain conservative, and underwriting discipline has largely been maintained. Many current deals are benefiting from lower leverage, stronger equity cushions, and service-oriented business models, which help mitigate broader macro risks.

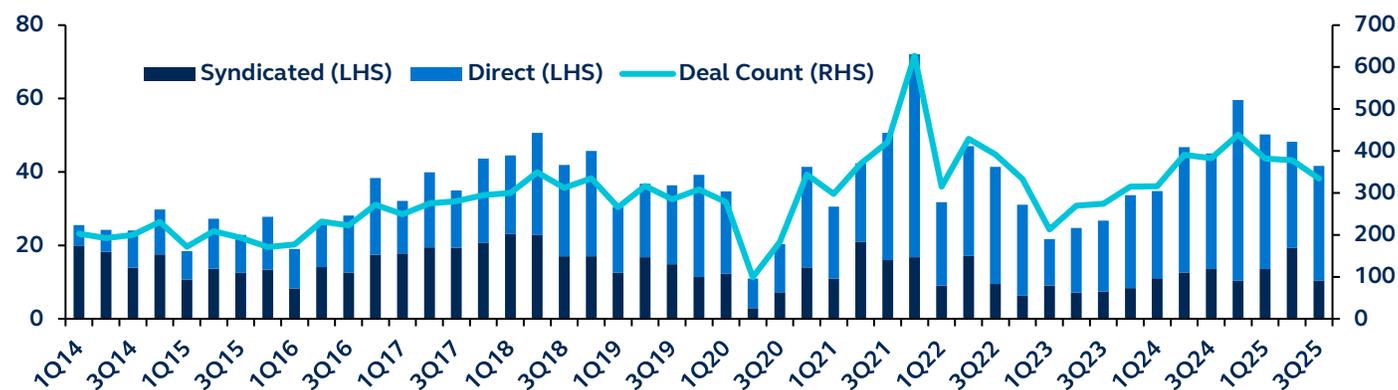
Structural evolution reflects market maturity

A maturing private credit ecosystem is reshaping how capital is structured, deployed, and recycled. Fund economics are evolving, with managers leveraging continuation vehicles, secondaries, and flexible capital solutions to manage longer hold periods and investor liquidity needs. These are not signs of stress but rather signals of a more institutionalized and adaptive market, better equipped to navigate shifting conditions.

This structural flexibility, combined with fund lock-up periods and limited redemption features, continues to insulate private credit from the volatility often seen in public markets. As such, technicals remain relatively stable—even during periods of headline-driven drawdowns in public high yield or broadly syndicated loans.

Sponsored middle market loan volume and deal count

\$ billions, 1Q14–present



Source: LSEG, Principal Asset Management. Data as of September 30, 2025.

Fundamentals remain resilient and differentiated

Private credit fundamentals remain stable and show signs of improvement. Cash flow coverage ratios are strengthening, and non-accrual rates remain low—just 1.35% as of Q3 2025, well below both historical private credit averages and public market default rates. Importantly, the recent credit events generating headlines have been concentrated in the broadly syndicated loan market, not in true direct lending.

By contrast, middle market direct loans continue to feature stronger covenants, tighter underwriting timelines, and greater access to borrower diligence—hallmarks of a structure built for durability. These characteristics continue to differentiate true private credit from its more liquid counterparts.

Positioned for disciplined growth in 2026

The 2026 vintage is shaping up favorably. The Fed is continuing to pursue expected to continue pursuing its accommodative cycle, inflation is stabilizing, and economic visibility has improved. Combined, these conditions foster a more constructive environment for leveraged buyouts and M&A activity, characterized by lower financing costs and more balanced valuation expectations between buyers and sellers.

As deployment ramps up, we expect yield spreads to remain attractive relative to liquid credit, with risk-adjusted return potential anchored by strong structural protections. While the market is not immune to macroeconomic shocks or idiosyncratic risks, the discipline across underwriting, structure, and pricing suggests that middle market direct lending remains on a solid footing.

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, 2025. The above views reflect the relative value of the sectors shown based on forward-looking return expectations over the next 12 months. Arrows represent the quarter-over-quarter change in forward-looking views.

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