Principal Global PERSPECTIVES

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Principal Global Investors

MARKET VOLATILITY FIXED INCOME

The volatility in global markets is widespread, and the ramifications can affect each region and asset class differently. To help provide perspective on these issues, we asked some of our investment boutiques one question:

WHAT OPPORTUNITIES DOES THE RECENT MARKET TURMOIL OPEN UP IN YOUR ASSET CLASS?

Principal Global Fixed Income

Darrin Smith, Portfolio Manager, Principal Global Fixed Income

Within investment-grade corporate bonds, the recent turmoil, and widening in spreads have opened opportunities in a couple areas: banks/financials, where credit fundamentals are following improving trends; and non-financials, including high-quality energy, media, and pharmaceuticals. Niche strategies focused on secular credit fundamental improvement that have limited exposure to commodity and event risk can weather the volatile time quite well.

Within the high-yield space, our favorite sectors right now are finance, life insurance, leisure, automotive, and pharmaceuticals. For the most part, these sectors will benefit from reduced gasoline prices and are more tied in to the consumer. The near-term default potential for these sectors is very low. Similarly, we think European high yield also offers value, because of the limited exposure to energy companies. Commodity weakness actually provides tailwinds for economic growth in the European high-yield region.

SPECTRUM

Phil Jacoby, CIO, Spectrum Asset Management

The current market volatility should be viewed against the backdrop of choppy yet persistently low longer-term, deflated U.S. Treasury yields. And given that backdrop, we see one primary implication of market volatility on the hybrid preferred markets. We see nominal hybrid yields declining and for spreads grinding tighter as quality investment yields become scarcer amidst the friction of the shift towards greater global moderation. Hiccups along the way – as is the case now – foster buying opportunities in hybrid securities.

For example, as of 25 August, long-term U.S. Treasury rates are now essentially unchanged since the beginning of the year. However, the volatility in the S&P 500 has preferred yields (and spreads) 32 basis points cheaper since January. We have warned that volatility fits are likely as the global expansion matures and is pushed along by intermittent policymaking. But rather than sell hybrids when prices misbehave, we continue to believe that investors will be well served to "buy the dips" because supplemental income opportunities are likely to grow scarcer and scarcer as the global battles against deflation persist for some time to come.

MORLEY FINANCIAL SERVICES, INC.

Dan Kang, Senior Fixed Income Analyst, Morley Financial Services

The investment-grade credit market hasn't been immune to the turmoil in risk assets. Expectedly, the epicenter of the risk-off trade has been any credits related to China, commodities, and energy. Although valuations are tempting in the metals and mining space, we still remain cautious until we see further clarity on supply/demand dynamics for the individual commodities.

One area we see opportunities is in the automotive sector. With July sales of passenger vehicles in China reaching 17-month lows, and with the devalued yuan, the market is worried about the manufacturers' exposure to China. However, we see several credit positives that should support spreads. First, North America, which is still the most important market for the domestic original equipment manufacturers (OEMs), continues to have a strong fundamental outlook driven by an improving labor market, greater credit availability, and a record vehicle age – the average age of vehicles on the road in the United States is at a high of 11.5 years. Second, Europe continues its recovery, with 2015 year-to-date auto sales up 8.6% over the same period of 2014. Third, sustained low commodity prices should help input costs, while lower gasoline prices support higher-margin pick-up and SUV purchases. Finally, we view the China automotive slowdown as a sign of a maturing, but still growing, market. Relatively low vehicle density penetration rates, growing per capita income, and greater utilization of credit should support longer-term growth.

CIMB Principal ISLAMIC ASSET MANAGEMENT

Michael Zorich, CIO, CIMB Principal Islamic Asset Management

Given our focus primarily on the Middle East and South East Asia, we are cautious on certain Middle East names because of their sovereign fiscal budgets, which are based on high break-even oil prices, and the loss of the trickle-down benefits of those spending levels. An extended period of low oil prices, which is in line with our expectations, will continue to be a challenge for Middle Eastern investors and will require expertise to pick the outperformers over the medium to long term. In the shorter term, we see oversold opportunities in Asia, such as the U.S. dollar-denominated Indonesian sukuk, where the nine-year sukuk are yielding over 5% after the recent sell-off. This is an attractive spread for USD fixed-income securities given the solid fundamentals we see for Indonesia in the near term, despite their growth challenges.

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