Highlights

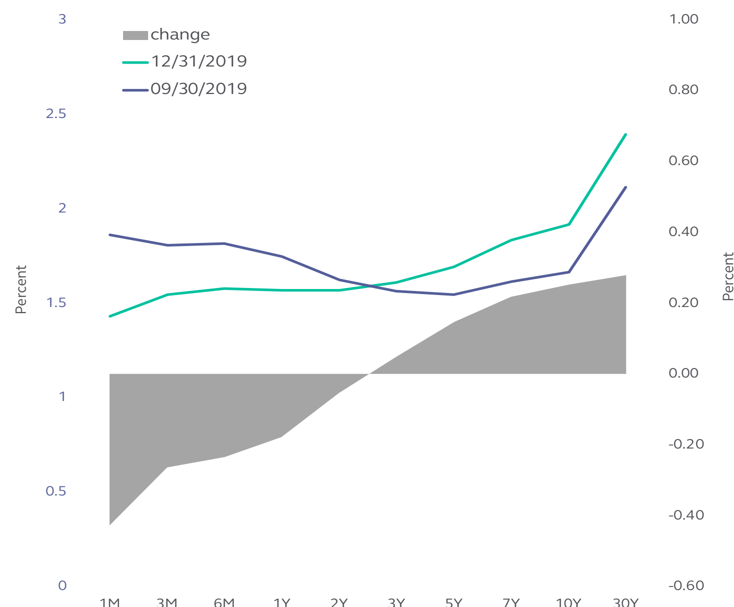
The Federal Open Market Committee (FOMC) lowered the target Fed Funds rate by a quarter point to a range of1.50% to 1.75% at their October meeting. It marked the third cut in 2019. At their subsequent meeting in December, their statement cited sustained economic expansion, strong labor markets and subdued inflation as support for the appropriateness of current monetary policy.

Fed Reserve (Fed) policy is now on hold, with a slight tilt toward ease. Fed Fund futures markets imply a reasonable chance of another rate cut a year out. The Fed's supply of liquidity to support the repo market is also accommodative. The policy outlook did stall the trend toward lower rates that characterized most of 2019.

During the fourth quarter, rates on two-year and shorter maturity Treasuries fell while cohorts beyond that rose modestly. As the year closed, the yield on the two-year Treasury note stood at 1.54%, down 0.05% from the last quarter, while the ten-year closed at 1.92%, up 0.25% for the same period. The increase in longer dated Treasuries led to a positively sloped yield curve by year end. Inflation remains below the 2% objective and we would expect that should it eventually move above the threshold, policy-makers will not consider it problematic. Policy will favor economic growth.

Outlook

Improving domestic and global economic fundamentals could provide modest upward pressure on longer term rates. However, subdued inflation should also limit the upward pressure on rates. Changes in short rates should be anchored by Fed policy resulting in further curve steepening. But as we have cited in the past, with over $13 trillion of negative-yielding debt worldwide, U.S. yields remain attractive globally.



Source: Bloomberg

Mark Kummerer, CFA
Portfolio Manager

The financial market outlook is based on current market conditions. There is no assurance that such events or projections will occur and actual conditions may be significantly different than that shown here. The potential for profit is accompanied by the possibility of loss.

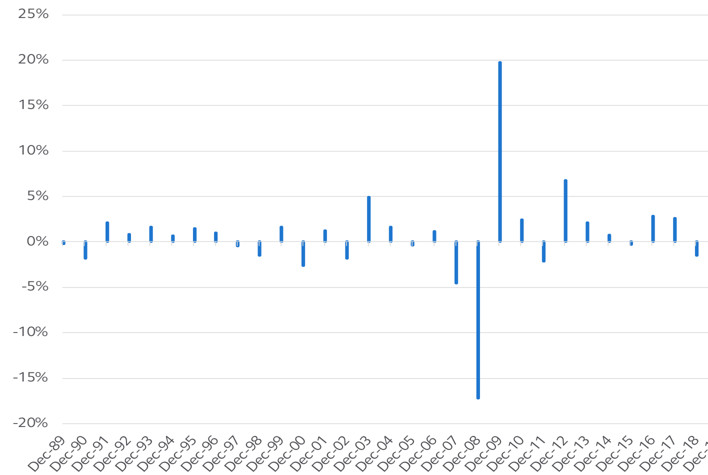
Please see Disclosures for important information.

Morley Capital Management

Highlights

The Bloomberg Barclays U.S. Intermediate Corporate index had total and excess returns of 1.10% and 1.21%, respectively for the fourth quarter. In contrast to last year's disastrous fourth quarter (1.8% negative excess returns), this quarter saw many factors favorably resolved. The quarter benefited from the de-escalating tensions related to U.S./China trade, greater clarity on Brexit, expected passage of the USMCA and an incrementally dovish Fed. Further, economic data continued to indicate a solid labor market with associated consumer confidence while manufacturing showed signs of stabilization.

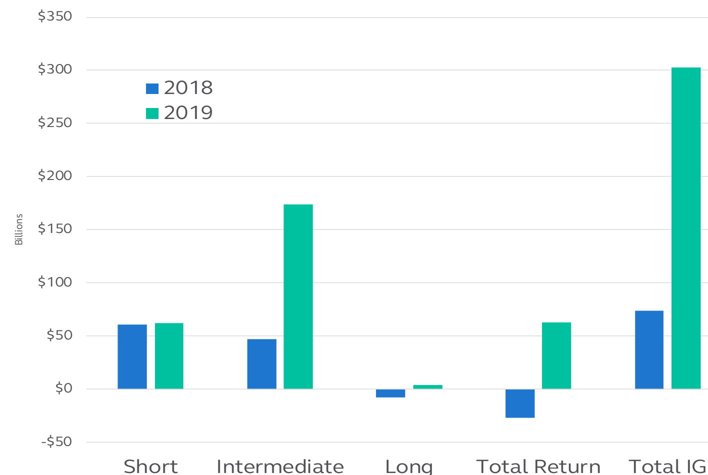
For the full year, the intermediate corporate index posted total returns of 10.14% which was the best since 2009. Excess returns of 4.54% were the best since 2012. Overall, 2019 total return performance was the 5th best over the past 30 years for investment grade (IG) corporate bonds. The past year's narrative was driven by the dovish pivot by central banks, the return of foreign buyers seeking positive yields and rebounding inflows by retail investors. For the full year, IG fund flows totaled $303B vs. only $74B inflows during 2018. The retail fund reversal was led by strong inflows into the intermediate segment. During the year, spread volatility spiked and receded based on the sentiment surrounding trade talks and probabilities of recessions. Finally, we saw stable credit fundamentals. In contrast to fears of significant downgrades to below investment grade by the BBB cohort, we saw BBB credits deleveraging (albeit at a moderate pace) and corporations engaging in liability management exercises.



Source: Bloomberg

Outlook

For 2020, we believe several of the key 2019 drivers will be intact for at least the first half of the year. Primarily, we expect stable trend like economic growth, supportive global central banks, negative yielding global rates and lower corporate supply. With the imminent signing of the Phase 1 trade deal with China and clearer path to Brexit, our focus will shift more to domestic election year politics. With the strong performance at the end of the year, we may have seen some of the credit performance pulled forward. We start off the year with challenging valuations but a rather benign outlook. Ultimately, we expect carry type returns for the full year with spread volatility as we get closer to year end.



Source: Wells Fargo Securities, EPFR Global

Dan Kang, CFA
Portfolio Manager

The financial market outlook is based on current market conditions. There is no assurance that such events or projections will occur and actual conditions may be significantly different than that shown here. The potential for profit is accompanied by the possibility of loss.

Please see Disclosures for important information.

Mortgage-Backed Securities (MBS)

Morley
Capital Management

Highlights

The Bloomberg Barclay's U.S. agency Mortgage Backed Securities (MBS) Index posted total and excess returns of 0.71% and 0.62%, respectively, during the fourth quarter, bringing full year 2019 returns to 6.35% and 0.61%. The strong showing in Q4 allowed the sector to claw back from underperformance relative to Treasuries through the third quarter. Nevertheless, MBS were unable to keep pace with the stellar returns in corporate credit, which experienced a banner year for performance.

Mortgage investors were whipsawed by sharp interest rate moves and volatility during the year. The MBS Index duration contracted from 4.7 years to 2.7 years YTD through the third quarter before closing 2019 at 3.21 years. Durations in the 15-year sector were considerably more stable, trading in a 2.8 - 3.5 year range and closing at just under 3.0 years. Convexity risks were concentrated in TBA collateral, weakening roll markets and amplifying demand for specified pools. This caused payups on the latter to soar and expanded the percentage of MBS trading at premiums to TBA to as high as 90%.

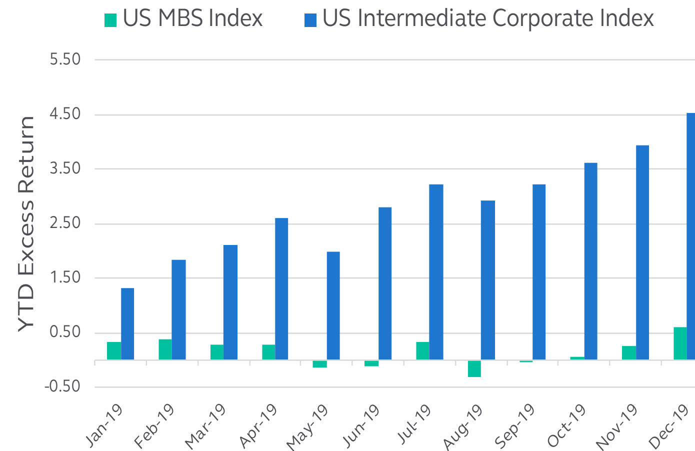
Escalating geopolitical risks and weakening manufacturing data over the third quarter prompted the Federal Reserve to cut the Fed Funds rate twice during that period, the first such cuts in over a decade. They followed this with an additional insurance cut in the fourth quarter, leaving the target range at 1.50-1.75% at year-end. Progress on U.S.-China trade negotiations and Brexit caused long rates to rise by 25 bps during the fourth quarter, combining with the Fed cuts to dis-invert the yield curve and assuage prepayment concerns.

Outlook

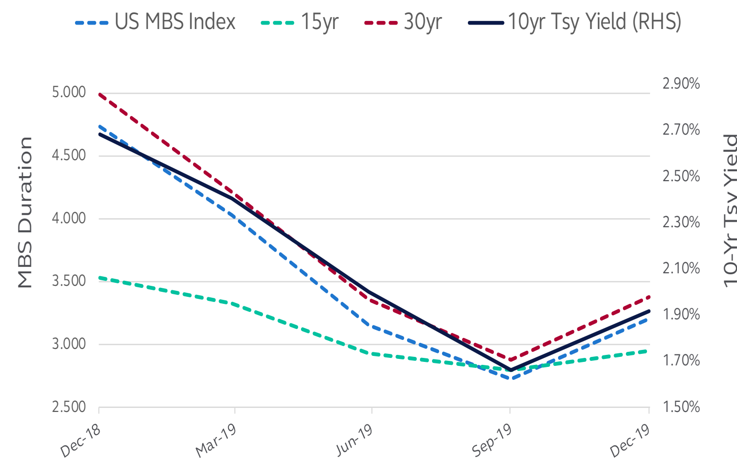
After a challenging year for the MBS sector the outlook for 2020 is considerably brighter for a number of reasons. First, the macro backdrop has improved and the Federal Reserve is likely to remain on hold through much of the year, creating a more supportive rates and volatility environment for MBS carry. Second, the sector has significantly lagged the spread tightening in corporates and valuations look relatively more attractive, particularly given the potential for geopolitical risks to flare up again with the U.S. presidential election and Middle East tensions. Third, prepays should be tamer this year due to higher rates, burnout from the 2019 refi wave and a host of measures taken by housing finance regulators to curb aggressive mortgage servicing practices. Finally, MBS originator issuance in 2020 is unlikely to reach the $224B net from 2019, while shorter maturity MBS segments continue to see negative net issuance. Although Fed balance sheet runoff could generate an additional $220B of supply to private investors, this will have the greatest impact on 30-year production coupons.

We expect MBS to benefit from strong bank, overseas and domestic money manager demand for high-quality carry alternatives to Treasuries and investment grade credit. A lower volatility environment should reduce option costs for TBA-like pools, allowing them to recoup some of last year's underperformance relative to more prepay-protected cohorts. We remain constructive on the sector as a low beta, high quality core holding within our stable value portfolios.

The financial market outlook is based on current market conditions. There is no assurance that such events or projections will occur and actual conditions may be significantly different than that shown here. The potential for profit is accompanied by the possibility of loss.



Source: Bloomberg



Source: Bloomberg

Perpetua Phillips
Portfolio Manager

Please see Disclosures for important information.

Asset-Backed Securities (ABS)

Morley
Capital Management

Highlights

The Bloomberg Barclays AAA Asset Backed Securities (ABS) Index posted total and excess returns of 0.37% and -0.05%, respectively, for the quarter.

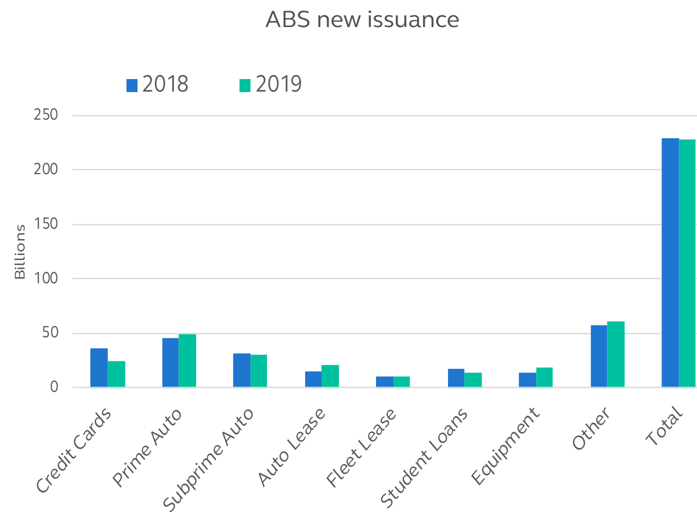
Risk assets posted strong returns in the final quarter of 2019 due to easing trade tensions and continued accommodation from global central banks. ABS spreads were range-bound in the fourth quarter. While spreads on ABS backed by credit cards and prime auto loans remain on the tighter side, we are finding relative value opportunities in other sub-sectors where spreads are still attractive versus historical averages.

With the significant rally in rates, investors reached for yield to meet return targets. As a result, lower-rated ABS classes at the bottom of the capital structure and “ABS Other” sectors generally outperformed higher-rated, benchmark ABS sectors.

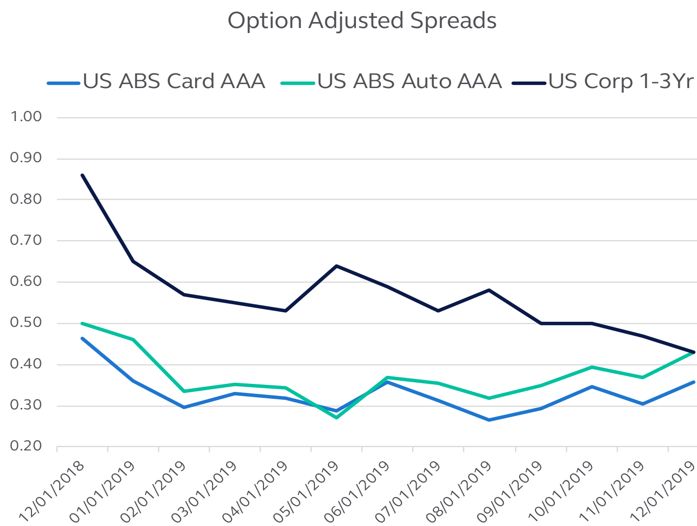
Outlook

The U.S. consumer remains healthy and new entrants continue to be drawn into the labor force. Although economic growth has moderated somewhat, a healthy U.S. consumer will remain supportive of the economy. This fundamental backdrop is further supported by accommodative central banks. The Fed completed a mid-cycle course correction after cutting rates for the third time in October.

Total Asset Backed Securities issuance for 2019 was $228bln. Total issuance was unchanged from 2018 and similar annual issuance is expected in 2020. We expect collateral performance of underlying assets within ABS to remain steady in 2020. Pockets of weakness in select auto and card sectors linger with delinquencies and losses expected to trend higher, albeit remaining within our base case assumptions and not to levels that would threaten extensive downgrades or losses.



Source: JP Morgan



Source: Bloomberg

Perpetua Phillips
Portfolio Manager

The financial market outlook is based on current market conditions. There is no assurance that such events or projections will occur and actual conditions may be significantly different than that shown here. The potential for profit is accompanied by the possibility of loss.

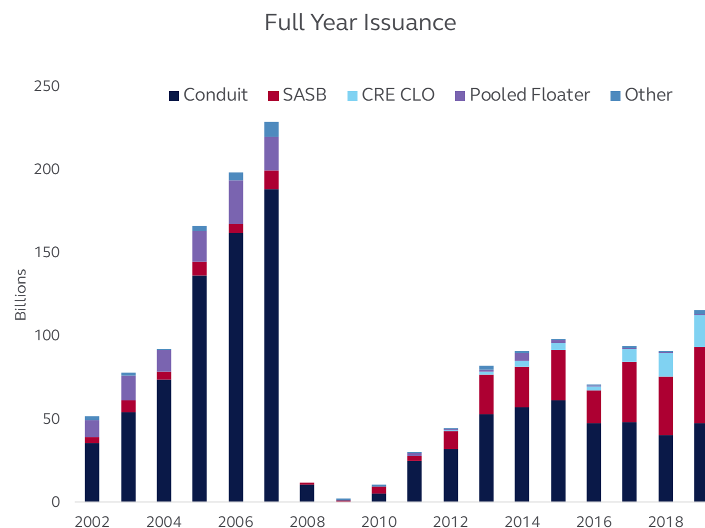
Please see Disclosures for important information.

Highlights

The Bloomberg Barclays AAA Commercial Mortgage-Backed Securities (CMBS) Index posted total and excess returns of -0.25% and 0.10%, respectively, for the quarter. Overall, fundamentals and commercial real estate pricing continued to remain firm during the fourth quarter as continued low interest rates helped support cap rates and expectations for income growth remain positive. The delinquency rate on loans originated after the Great Financial Crisis remains historically low and well within expectations for seasoned loans. The real estate recovery that started in 2012, low interest rates and conservative underwriting standards have helped support strong loan performance.

Total CMBS issuance in the fourth quarter of 2019 materially increased over the same period last year. Private label CMBS issuance was around $42.8B (+94%) and Agency CMBS was $29.5B (-2%). For the year, Conduit issuance was up 18% year-over-year ($48.6B), SASB issuance was up 31% ($46.2B) and CRE CLO issuance was up 35% ($18.9B). Total private label issuance during the year was up 25% at $112.6B.

The technical factors of higher conduit CMBS supply put pressure on new issue investment grade CMBS spreads relative to corporate bonds during the quarter, however, even with the elevated supply AAA spreads did end the quarter tighter and the credit curve steepened. During the quarter, AAA spreads tightened 12bps, AA- spreads tightened 2bps, A- spreads widened 3bps and BBB- spreads were flat. For the full year 2019, AAA spreads have tightened 21bps, AA- spreads tightened 33bps, A- spreads tightened 87bps and BBB- spreads tightened 150bps.



Source: JP Morgan

Mark Kummerer, CFA
Portfolio Manager

Outlook

CMBS spread tightening has continued to lag corporate bonds spreads, which leaves room for outperformance in the scenario where macro volatility causes credit spreads to widen. Further, if risk spreads continue to tighten, CMBS should perform. Looking forward from a risk perspective, the late cycle performance of CMBS should continue to be exposed to idiosyncratic risk in real estate markets such as exposure to energy, student housing or overbuilt hotel markets. Ten-year conduit loans are currently at a cyclical low for loan maturities considering that there were no conduit loans originated in 2009 and only $10B originated in 2010. This reduces the systematic risk of loan maturities during a potential market downturn over the next 12-24 months. The outlook continues to support the relative value of short duration CMBS as default driven cash flow volatility should be low and spreads are attractive relative to alternatives in the market.

The financial market outlook is based on current market conditions. There is no assurance that such events or projections will occur and actual conditions may be significantly different than that shown here. The potential for profit is accompanied by the possibility of loss.

Disclosures

Morley
CAPITAL MANAGEMENT

PAST PERFORMANCE IS NOT A GUARANTEE OF FUTURE RESULTS

Morley Capital Management is a specialized investment boutique of Principal Global Fixed Income. Principal Global Fixed Income is a specialized investment boutique within Principal Global Investors. Principal Global Investors leads global asset management and is a member of the Principal®.

Unless otherwise noted, the information in this document has been derived from sources believed to be accurate as of September 30, 2019. Information derived from sources other than Prin-cipal Global Investors or its affiliates is believed to be reliable; however, we do not independently verify or guarantee its accuracy or validity. This material contains general information only and does not take account of any investor's investment objectives or financial situation and should not be construed as specific investment advice, recommendation or be relied on in any way as a guarantee, promise, forecast or prediction of future events regarding an investment or the markets in general. The opinions and predictions expressed are subject to change without prior notice. Any reference to a specific investment or security does not constitute a recommendation to buy, sell, or hold such investment or security, nor an indication that Principal Global Investors or its affiliates has recommended a specific security for any client account.

Subject to any contrary provisions of applicable law, Principal Global Investors and its affiliates, and their officers, directors, employees, agents, disclaim any express or implied warranty of reli-ability or accuracy and any responsibility arising in any way (including by reason of negligence) for errors or omissions in this document or in the information or data provided in this document.

Investing involves risk, including possible loss of principal. All figures shown in this document are in U.S. dollars unless otherwise noted.
This material may contain "forward-looking" information that is not purely historical in nature. Such information may include, among other things, projections and forecasts or returns. There is no guarantee that any forecasts made will come to pass. Reliance upon information in this material is at the sole discretion of the viewer.

Fixed-income investments are subject to interest rate risk; as interest rates rise their value will decline. Fixed-income investment options that invest in mortgage securities, such as commercial mortgage-backed securities, are subject to increased risk due to real estate exposure. Lower-rated securities are subject to additional credit and default risks.

Market indices have been provided for comparison purposes only. They are unmanaged and do not reflect any fees or expenses. Individuals cannot invest directly in an index.

This document is issued in The United States by Principal Global Investors, LLC, which is regulated by the U.S. Securities and Exchange Commission.

Principal Global Investors, LLC (PGI) is registered with the U.S. Commodity Futures Trading Commission (CFTC) as a commodity trading advisor (CTA), a commodity pool operator (CPO) and is a member of the National Futures Association (NFA). PGI advises qualified eligible persons (QEPs) under CFTC Regulation 4.7.

This material is not intended for distribution to or use by any person or entity in any jurisdiction or country where such distribution or use would be contrary to local law or regulation.

Index descriptions:

The Bloomberg Barclays US Corporate Investment Grade Index is a component of the Bloomberg Barclays US Credit Index which includes publicly issued U.S. corporate and foreign debentures and secured notes that meet specified maturity, liquidity, and quality requirements within the Bloomberg Barclays U.S. Aggregate Index.

The Bloomberg Barclays US Agency MBS Index tracks agency mortgage backed pass-through securities (both fixed-rate and hybrid ARM) guaranteed by Ginnie Mae (GNMA), Fannie Mae (FNMA), and Freddie Mac (FHLMC).

The Bloomberg Barclays AAA ABS Index represents the asset-backed securities within the Bloomberg Barclays US Aggregate Index.

The Bloomberg Barclays AAA CMBS Index represents the commercial mortgage-backed securities within the Bloomberg Barclays US Aggregate Index.

Visit us online at ***www.morley.com*** *for the most recent market updates, Insights and Perspectives.*

1071520-012020