Principal Asset Management℠

Principal Morley

Interest rate strategy

DECEMBER 31, 2023

DAN KANG, CFA
Portfolio Manager

Rates/Corporates

Highlights

In the final quarter of 2023, the US rates market experienced notable volatility, transitioning from a 'higher-for-longer' narrative to anticipating an end to the Federal Reserve's (Fed) rate-hiking cycle. This shift was largely driven by the Fed's dovish pivot in response to softer inflation figures. The quarter began with a sell-off in the rates market, as term premia were reintroduced into the curve. This was due to a combination of factors: sustained positive economic data, growing concerns over expanding fiscal deficits, increased Treasury issuance, and geopolitical tensions stemming from the Israel-Hamas conflict. This confluence of factors propelled the long end of the yield curve to cycle highs, with the 10-year Treasury yield briefly exceeding 5%. However, the narrative shifted in November, driven by a softer October Non-Farm Payroll (NFP) and Consumer Price Index (CPI) release. This development, coupled with the Fed's more dovish tone at the December meeting, as well as the Treasury's decision to issue a higher proportion of T-Bills relative to longer-dated coupons, catalyzed a technical reversal in the market. Consequently, the 10-year Treasury yield experienced a significant decline, dropping 60 bps to close the quarter around 3.88%, nearly mirroring its level at the year's start.

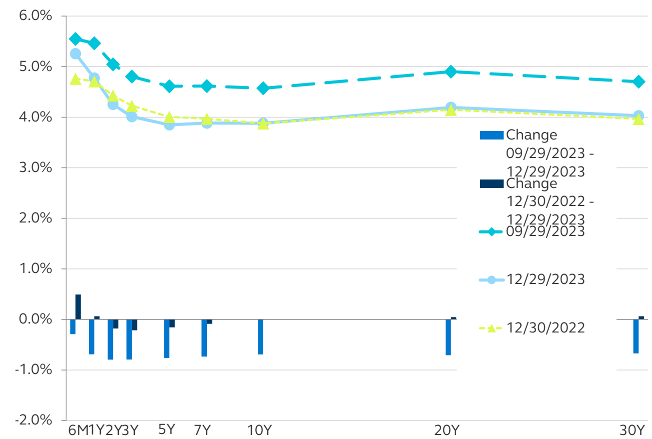
In December, the Fed maintained its interest rate at 5.25-5.50%, unchanged since the last hike in July. Additionally, the Fed's updated Summary of Economic Projections (SEP) paints a tempered outlook, with GDP growth expected to slow and unemployment to tick upwards, while inflation is expected to trend down toward the central bank's target. This mix of cooling economic indicators and a shift in monetary policy underscores a critical juncture for the rates market. Current expectations are leaning towards six rate cuts throughout 2024, with market probabilities suggesting the first reduction could occur as early as March, in notable contrast to the three cuts projected in the Fed's SEP median dot.

Outlook

For 2024, we expect the trend of disinflation to continue, although not necessarily in a straight downward path. Potential sources of "stickiness" are elevated wage inflation and resilient housing costs. Furthermore, the Middle East conflict has the potential to escalate and disrupt global supply chains and energy prices. Conversely, the resilience in demand and the labor markets have surprised the market. A broad slowdown is expected, but a cursory look at the Sahm Rule indicates that a recession is not imminent. The Sahm Rule, a favored metric by market participants and the Federal Reserve, signals the start of a recession when the 3-month moving average of the unemployment rates increases by 50 bps relative to the previous low.

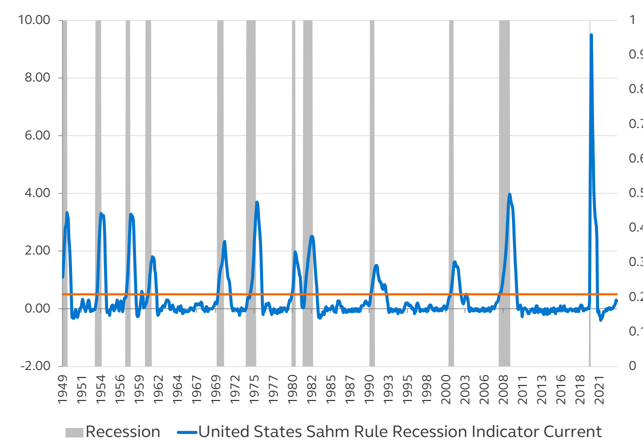
Our expectations would be for US Treasury curve to steepen as we move further along the cycle. The data-dependent Federal Reserve should recalibrate its restrictive policy as they grow more confident in the new inflationary regime. However, we believe the market has gotten ahead of itself in pricing 150 bps of cuts versus 75 bps in the SEP. A combination of stickier inflation and a persistently solid labor market would argue for later cuts. However, we affirm our view that policy tightening has peaked, and a duration bias is appropriate.

U.S. Treasury Yield Curve



Source: Bloomberg

Sahm Rule (Recession indicator)



Source: Bloomberg

Principal Morley

Principal Asset Management℠

Corporates

DECEMBER 31, 2023

Highlights

In the fourth quarter, the Bloomberg U.S. Intermediate Corporate Bond Index delivered impressive total and excess returns of 5.86% and 1.59%, respectively, culminating in a yearly performance of 7.29% in total return and 3.03% in excess return. The year commenced with spreads widening, reaching a peak of 156 bps in March, amid the U.S. regional banking crisis and the collapse of Credit Suisse. Investment grade spreads remained volatile throughout the year, culminating in a significant rally in the 4th quarter. This shift in sentiment was influenced by economic data indicating more disinflationary trends. The December FOMC meeting suggested a possible Fed pivot, igniting expectations for rate cuts in 2024. These developments triggered a risk-on rally, leading to credit outperforming other fixed income asset classes and driving spreads down to a year-end tight of 90 basis points. Lower quality credit outperformed higher quality counterparts, and the spread curve experienced significant bull flattening during the rally.

The investment grade credit market benefited from favorable technicals during the quarter as strong yield demand met muted supply. Historically attractive yields, coupled with an anticipated Fed cutting cycle, drove demand during the quarter. For the full year, retail investors and foreign investors returned after significant outflows in 2022. YTD inflows in 2023 of $182B from retail investors more than offset the outflows from 2022 ($164B). Meanwhile, 2023 gross supply witnessed slight growth of 0.4% to $1.21 trillion. With higher yields, corporate issuers focused on shorter maturities and decreased issuance of maturities longer than 20 years. Further, financial issuance surprised to the downside with an 18.7% year-on-year decline, while non-financial issuance increased by 14.7%.

Outlook

Our near-term 2024 outlook is a continuation of the recent supportive macro environment and solid fundamentals. After inflecting during the 3rd quarter, the earnings recovery is expected to continue, which should stabilize aggregate credit metrics. Over the course of the year, we will monitor if the soft-landing narrative still holds and whether animal spirits reverse corporate balance sheet conservatism. Recent announcements of large acquisitions reflect greater confidence by CEOs and could portend further proliferation of event risk.

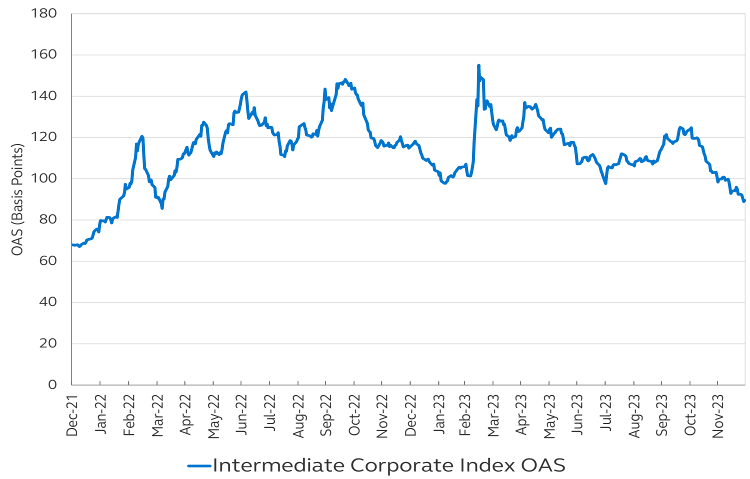
Initially, the IG market should see seasonally heavy issuance to start the year, focused on Financials. However, for the full year, we would expect manageable issuance relative to demand. IG yields are still historically attractive despite the recent rally and should benefit from the reallocation from $5.9T in money market funds. Also, money managers are relatively conservative in their allocations to corporate credit and should provide support on any widening.

Intermediate Corporate Index percentile ranges

Yield			
Current	1yr	5yr	10yr
4.97	10%	76%	88%
Low - High	4.73 - 6.35	1.08 - 6.35	1.08 - 6.35
OAS			
Current	1yr	5yr	10yr
90	1%	37%	35%
Low - High	89 - 155	57 - 390	57 - 390

Source: Bloomberg and Principal Global Investors

Intermediate Corporate Index spread



Source: Bloomberg

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Mortgage-Backed Securities (MBS)

DECEMBER 31, 2023

Perpetua Phillips
Portfolio Manager

MBS/ABS/CMBS

Highlights

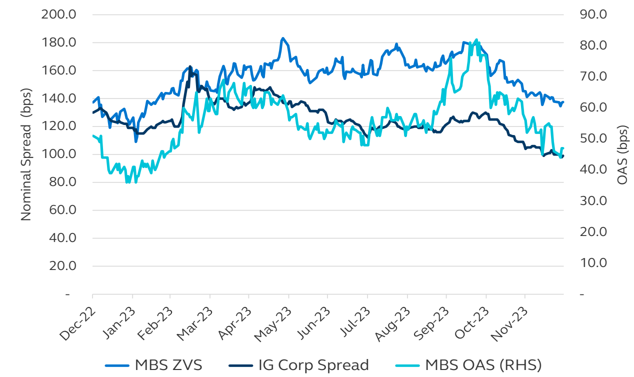
The Bloomberg US MBS Index posted strong total and excess returns of 7.48% and 1.33%, respectively, during the fourth quarter, powering full year 2023 total and excess returns to 5.05% and 0.68%. Steadily improving inflation data supported a shift in market expectations for Fed policy from a prolonged pause to as much as 200 bps of rate cuts in 2024. Risk assets and Treasuries rallied sharply in December, with yields down 70-80 bps quarter over quarter, but relatively unchanged year over year for all but the shortest tenors, which remained pegged to the Fed Funds Rate.

The FOMC held its policy rate steady at 5.25 - 5.50% at their September, November and December meetings. Notably, the Committee's December median "dots" forecast for year-end '24 was updated to reflected three rate cuts, while inflation and growth projections were downgraded. This more benign rates/volatility outlook spurred strong demand for MBS from both foreign buyers ($150B) and money managers ($455B), with the latter increasing MBS overweights to historic highs.

MBS current coupon zero-volatility spreads (ZVS) rallied from October highs of +180 bps to close the quarter at +137 bps, close to beginning of year levels. The option-adjusted spread (OAS) followed a similar pattern, starting the year at +51 bps, reaching a YTD wide of +88 bps in mid-October and finally retracing to +47 bps at year-end.

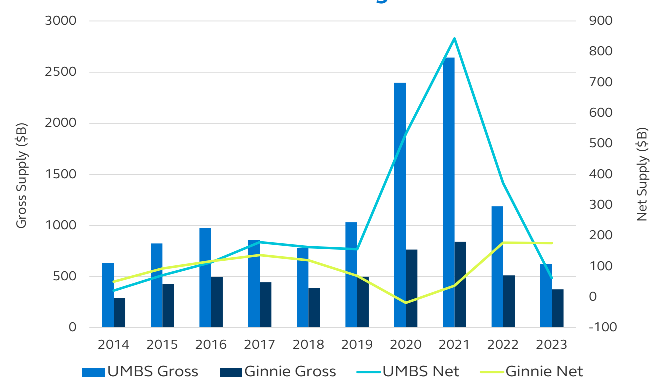
Thirty-year mortgage rates also did a year over year roundtrip, declining from a high of over 8% in October to return to around 6.5% at year-end. This brought recently originated mortgages into the money to refinance, though overall refi risk remains muted given the average rate on all outstanding mortgages remains below 4%. The duration of the MBS fixed rate index declined by half a year from the record high 6.4 years at the start of the quarter to close the year at 5.9 years. Gross and net supply declined to $236B/$60B for the fourth quarter and $1T/$238B for the year.

MBS spreads recovered from YTD wides but lagged the tightening in IG credit



Source: Bloomberg

Gross and net supply of MBS fell sharply in 2023 with Ginnie Mae leading net issuance



Source: Citigroup

Outlook

After a prolonged period of surprisingly strong economic growth, resilient labor markets and persistent inflation, the impact of the Fed's 5.25% of cumulative interest rate hikes is finally becoming evident. While we see the probability of a soft landing as having increased with the late year easing in financial conditions, our base case is for a mild recession in the second half of 2024 with inflation gradually moving towards the Fed's 2% target. This should allow them to cut rates at a more measured pace than that at which they raised them.

This environment should support a continuation of the recovery in MBS performance that began late in the fourth quarter, driven by several factors. First, the pivot to lower rates should dampen rates volatility, lowering MBS option costs. Secondly, supply-demand technicals may improve with bank demand expected to return after being largely sidelined over the past 18-months due to mark-to-market loss concerns. Thirdly, in the event of weakening growth or a recession, investors typically favor non-credit sensitive sectors like MBS, which could be magnified if inflows to fixed income funds increase. The defensive appeal of MBS is further amplified by historically cheap valuations relative to investment grade credit. Downside risks to sector performance stem from strong growth/no landing scenarios and the Fed's wind down of quantitative tightening, in which paydowns on their MBS portfolio would be reinvested into Treasuries rather than MBS. However, we view the latter risk as muted given the low level of MBS paydowns ($15-20B/month) and higher expected Treasury supply relative to MBS origination.

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Asset-Backed Securities (ABS)

DECEMBER 31, 2023

Highlights

The Bloomberg AAA Asset Backed Securities (ABS) Index gained 3.55% and outperformed like-duration Treasuries by 39 basis points during the fourth quarter, bringing full year total and excess returns to 5.46% and 1.18%, respectively. During the quarter, markets shifted from anticipating further rate hikes to pricing in the end of the Federal Reserve's (Fed) rate hiking cycle. Improving inflation data played a pivotal role in driving the market's shift, leading to a significant rate rally beginning in November. Year-over-year core CPI eased to 4%, reaching the lowest level in more than two years while year-over-year core PCE declined to just 3.2%. At its December meeting, the Fed kept rates at 5.25%-5.50% and hinted that rates are at the cycle peak with a new dot plot implying three rate cuts next year.

Both the unemployment rate and new jobless claims in the U.S. remain near pre-COVID lows. The U.S consumer has remained remarkably resilient, buoyed by excess savings, stock markets driving wealth gains, and a tight labor market driving wage gains. However, a number of headwinds are building for the consumer, including depleted excess savings, resumption of student loan payments, tightening consumer credit and skyrocketing interest payments for new liabilities.

ABS collateral performance reflects the nuanced state of the health of the consumer. Delinquencies and defaults have risen from their post-COVID lows but remain within normal historical ranges. Less financially secure borrowers have been negatively affected by elevated prices and this has contributed to weaker credit performance in some corners of the ABS market. However, tighter lending standards and strong, crisis-tested structures result in ABS remaining well protected.

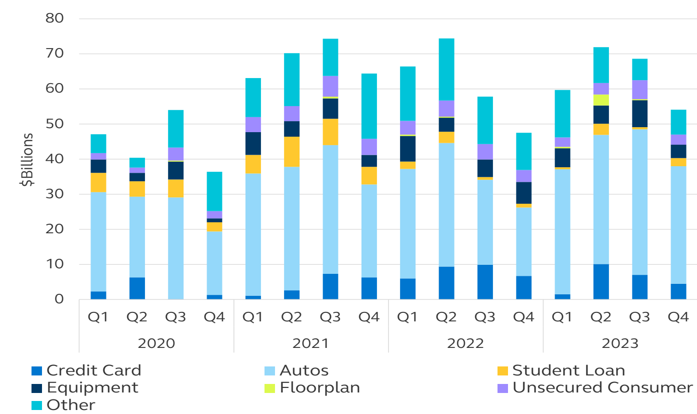
Heavy new issuance in October and early November resulted in AAA ABS spreads leaking wider, before ultimately tightening late in the quarter on improving investor sentiment and limited supply in the slow holiday period. Fourth quarter supply ultimately totaled $54 billion, down 24% from the prior quarter, but up 4% versus the prior year. Full year 2023 volumes were up 5% versus the prior year and was one of the busiest years since the Global Financial Crisis with $256 billion of supply.

Outlook

High quality, short duration consumer ABS remain a compelling opportunity for investors. Supply is expected to remain elevated but compelling starting valuations, attractive positioning at the front-end of the yield curve and robust investor demand should provide meaningful tailwinds. Changing views on Fed policy and pockets of uneven supply, particularly in sectors such as prime auto ABS, could create opportunities for active investors.

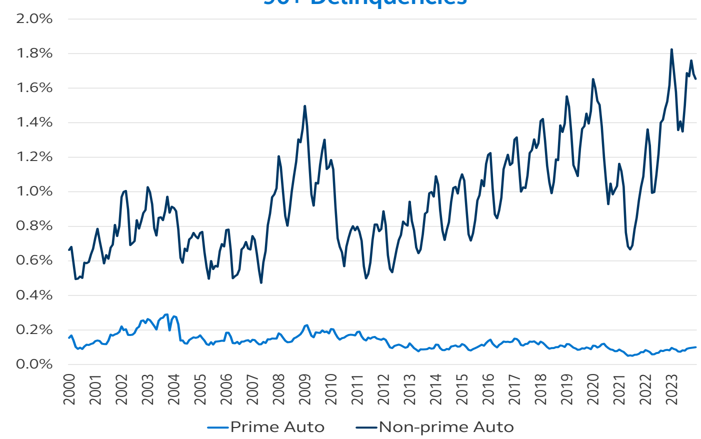
ABS credit should also begin to show improvement during the first quarter of 2024, driven by tax refund activity, while longer-run improvement will need to be driven by continued consumer resilience, further wage growth and improving inflation pressures. As a result, we maintain an up-in-quality bias and a preference for established asset classes with proven structures.

ABS supply



Source: JP Morgan

90+ Delinquencies



Source: JP Morgan

Commercial Mortgage-Backed Securities (CMBS)

DECEMBER 31, 2023

Highlights

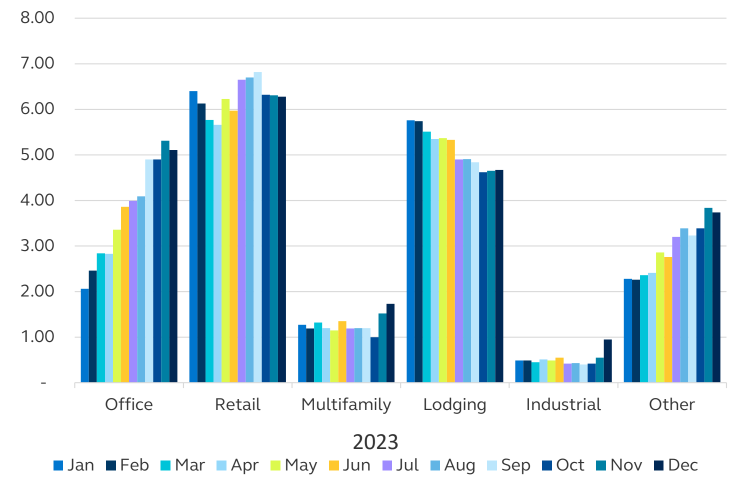
The Bloomberg AAA Commercial Mortgage-Backed Securities (CMBS) Index posted total and excess returns of 5.02% and 0.63%, respectively, during the fourth quarter. For the year, the Index posted a total return of 5.47% and outperformed Treasuries by 1.25%. Early in the quarter, ongoing concerns about inflation, future monetary policy uncertainty and recession fears weighed on the market with 10-year Treasury yields rising to 5% and credit spreads widening. The tone shifted in November and December as relatively strong job growth and two CPI prints that signaled inflation was trending lower brought hope to the market that the Fed was done tightening and would start lowering rates in 2024. This belief was strengthened when the Fed was perceived to make a dovish pivot at the December FOMC meeting by lowering its inflation forecast 50bps and signaling three interest rate cuts in 2024. Expectations of lower rates in the coming year resulted in equity markets rallying, credit spreads tightening and the 10 year Treasury yield falling 69bps during the quarter to end the year at 3.88%. As a result, AAA CMBS spreads ended the fourth quarter 9bps tighter, AA spreads 18bps tighter, A spreads 56bps tighter and BBB spreads 44bps tighter.

New issue activity increased during the quarter for both conduit and SASB issuance and the new issuance was met with strong demand. The $12.8B of private label issuance, during the fourth quarter, was up 28% from third quarter 2023 and up 85% from fourth quarter 2022. Private label conduit issuance during the quarter was $5.7B compared to third quarter 2023 of $4.6B and fourth quarter 2022 of $3.4B. Private label SASB issuance was $7.1B compared to third quarter 2023 of $5.4B and fourth quarter 2022 of $3.5B. For the year, conduit issuance of $19.7B compares to $23.4B for 2022 and 2024 SASB issuance of $19.6B compares to the $46.1B in 2022. Secondary CMBS market activity picked up during the quarter with trading volumes increasing for both AAA and lower rated credits.

Outlook

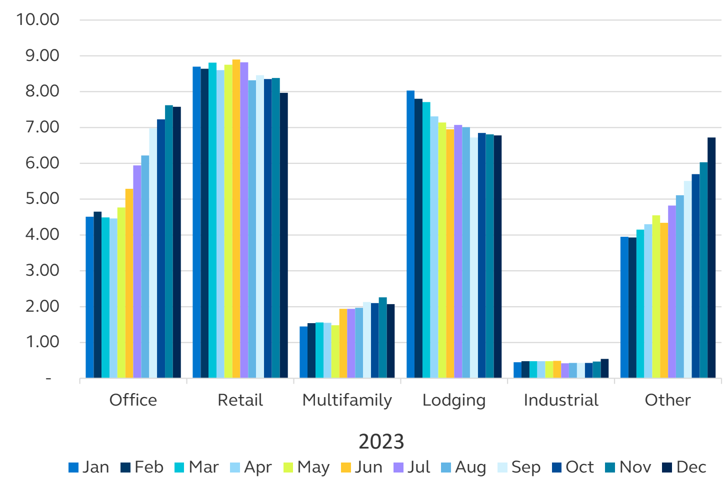
The outlook for CMBS remains primarily focused on refinancing loans that mature in 2024, the depth of a potential recession, the path of interest rates and longer-term office loan fundamentals. The real test for the market will be how well 2.0 CMBS underwriting holds up with property level incomes under pressure, especially for office. Current market pricing implies that term defaults will also increase along with maturity defaults. Our outlook is that 2.0 CMBS should protect from term defaults becoming systematic, but the depth and duration of the recession, if it happens, will determine how far income levels drop.

Conduit delinquency rates by property type



Source: Morgan Stanley, Trepp

Conduit special servicing rates by property type



Source: Morgan Stanley, Trepp

Important Information

DECEMBER 31, 2023

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