Principal Asset Management℠

Principal Morley

Interest rate strategy

SEPTEMBER 30, 2024

DAN KANG, CFA
Portfolio Manager

Rates/Corporates

Highlights

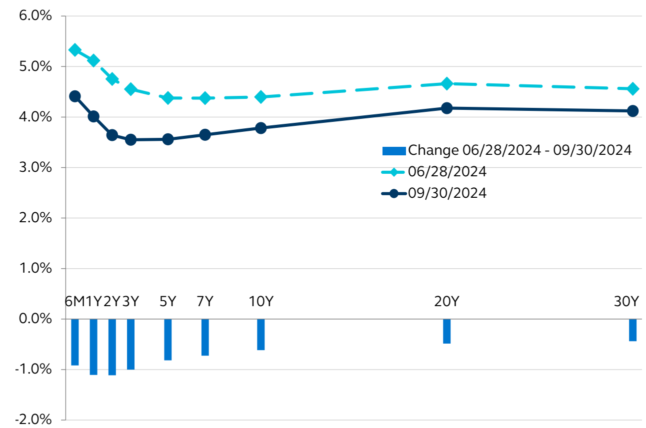
In the third quarter of 2024, U.S. Treasury yields experienced a sharp bull-steepener driven by weakening economic data and the start of the Federal Reserve's (Fed) rate-cutting cycle. The 2-year yield fell by 111 basis points (bps) to 3.64%, while the 10-year yield declined 62 bps to 3.78%, marking the end of the 26-month inversion of the 2-year/10-year yield curve. This shift was largely fueled by growing concerns over a slowing U.S. economy. The unemployment rose to 4.2%, which triggered the Sahm Rule during the quarter. Although inflation remained above the Fed's target, inflation measures moderated, with Core Personal Consumption Expenditures (PCE) inflation easing from 2.9% YoY at the beginning of the year to 2.7% by September. Despite inflation staying above the Fed's 2% target, market participants increasingly shifted their focus to signs of economic deceleration.

In response, the Fed cut rates by 50 basis points at the September FOMC meeting, marking the first cut of the current cycle and exceeding the market's expectation of a 25-basis point reduction. Chair Jerome Powell described the move as a "catch-up" decision, noting that if July's weak jobs report had been available at the prior meeting, the Fed might have acted earlier. Powell also clarified that this larger cut should not set a precedent for future rate reductions. The Fed's updated Summary of Economic Projections (SEP) mirrored this shift, revising the Core PCE inflation forecast for 2024 down from 2.8% to 2.6% and raising the unemployment forecast to 4.4% from 4.0%. Real GDP growth for 2024 was revised down slightly to 2.0%. The SEP also projected two additional 25 basis point cuts by year-end, followed by another 100 basis points of cuts in 2025, while the longer run dot was projected to be 2.9%. Despite cutting rates, the Fed maintained its quantitative tightening (QT) program from June's recalibration, continuing with $25 billion in monthly cap for Treasury roll-offs and $35 billion for mortgage-backed securities.

Outlook

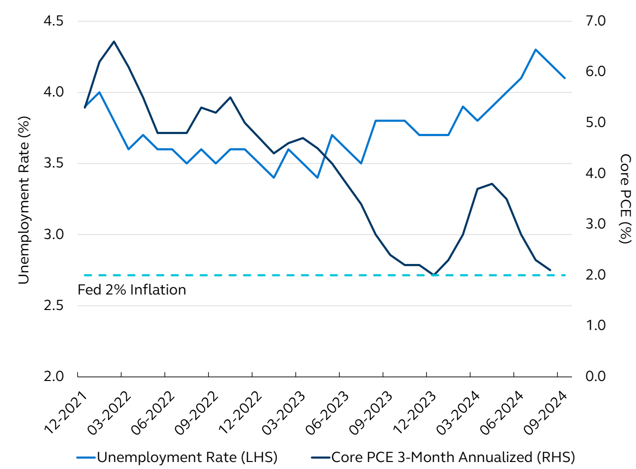
With the start of the easing cycle, the question of the pace of future cuts comes into focus. The contrast between the Fed's shallower dot plot projection and the steeper market pricing continues to be persistent. The soft patch of data over the summer has alleviated inflationary concerns, while left-tail risk of recession increased. The last three months annualized rate of the Fed's preferred inflation measure has effectively reached the 2.0% target, while the unemployment rate rose. We speculate that the uncertainty surrounding US elections have muted hiring intentions; however, that headwind could lift starting in 2025. In the near term, multiple union strikes, Hurricane Helene, the escalating Middle East conflict, and renewed Chinese stimulus all provide a confluence of macro events which should muddy the economic data. For the remainder of the year, we view the preponderance of the data to reflect resilience and normalization of activity versus a collapse. Therefore, the risks are more balanced than what the market is pricing in.

U.S. Treasury Yield Curve



Source: Bloomberg

Fed Dual Mandate (Core PCE & Unemployment)



Source: Bloomberg

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Corporates

SEPTEMBER 30, 2024

Highlights

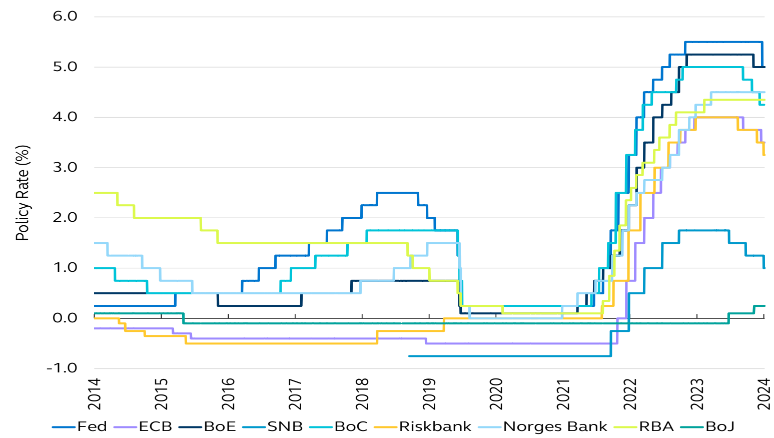
In the third quarter of 2024, the Bloomberg U.S. Intermediate Corporate Bond Index posted positive returns, achieving total returns of 4.66% and excess returns of 0.52%. After reaching year-to-date tight OAS (spreads) in May near 75 basis points (bps) on the index, spreads widened through early summer, peaking in August at 100 bps, before retracing back to 79 bps at quarter-end. This movement was driven by rising Middle East tensions, the unwinding of the Yen carry trade, and softer-than-expected economic data—most notably the July jobs report—which spurred market volatility. The VIX spiked to 65, indicative of the broad repositioning across risk assets. By quarter-end, the S&P 500 revisited all-time highs, and credit spreads neared YTD tights, bolstered by a 50-bps Fed rate cut as investors sought to lock in yields.

Primary Investment Grade (IG) issuance for the quarter totaled $425 billion, with monthly volumes of $103 billion in July, $141 billion in August, and $181 billion in September. Issuance remains on a record pace through the first nine months of the year, excluding 2020, largely due to a resurgence in financial sector offerings during the first half. However, non-financial issuance also increased starting in June, as issuers took advantage of lower yields and tight spreads. M&A activity and anticipated large transactions exceeding $10 billion contributed significantly to the volume. The post-Labor Day period set a new record for single-day issuance, as issuers sought to stay ahead of potential macroeconomic volatility related to the upcoming U.S. elections. The technical landscape remained resilient, with strong oversubscription levels and limited new-issue concessions. High-grade fund flows into mutual funds and ETFs demonstrated robust investor demand, with a $292 billion inflow in the first half of 2024, as investors continued to capitalize on yields above historical averages. Investment Grade issuer fundamentals also stayed solid, with Q2 sales and earnings growing at 5.2% and 10.2%, respectively, despite some weakness among cyclical sectors and BBB-rated names.

Outlook

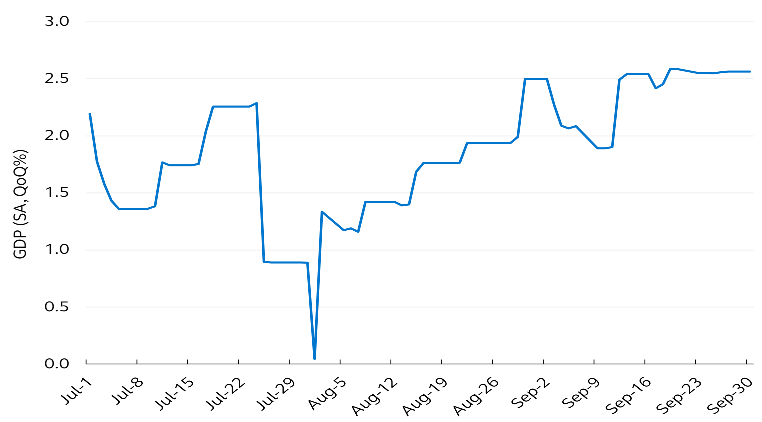
Our constructive view on credit for the remainder of the year is based on a stabilizing macro-outlook, combined with increasingly favorable seasonals. First, recent data points support a soft-landing view with further slowing, but not a collapse in economic activity. Recent GDP trackers have risen during the quarter after experiencing a soft patch during the summer. Second, after an abundance of issuance during the 3rd quarter, we would expect primary activity to slow meaningfully as we head into year-end. A combination of earnings blackouts, holidays, and elections has created a limited window for corporate treasurers to tap the market. Third, the start of the Federal Reserve's cutting cycle during the quarter should provide persistent demand for duration, which should benefit investment grade credit. Broadly, global central banks have initiated their easing cycle which should provide an impetus to move sidelined cash into fixed income.

Global Central Bank Policy Rates



Source: Bloomberg

Bloomberg U.S. GDP Nowcast for 3Q24



Source: Bloomberg

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Mortgage-Backed Securities (MBS)

SEPTEMBER 30, 2024

Perpetua Phillips
Portfolio Manager

MBS/ABS/CMBS

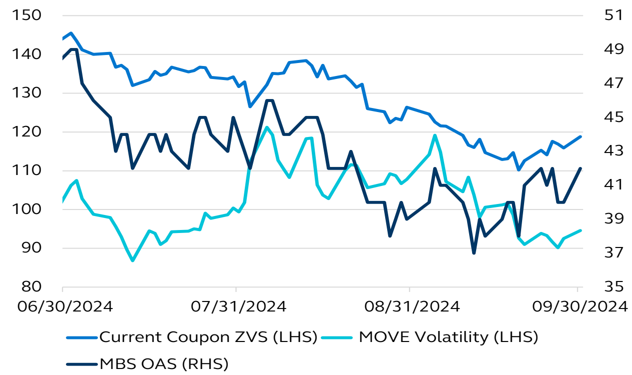
Highlights

The Bloomberg U.S. MBS Index posted total and excess returns of 5.53% and 0.78%, respectively, during the third quarter. Short term rates declined by over 100 bps as continued inflation progress and cooling labor markets paved the way for monetary easing late in the period. The yield curve disinverted as the two-year U.S. Treasury declined by 111 bps and the ten-year yield fell by 61 bps to 3.64% and 3.78%, respectively. Rates volatility declined towards the end of the quarter as the path forward for monetary easing came into better focus.

The FOMC delivered the widely anticipated first rate cut at their September policy meeting after remaining on hold in July. On an 11-1 vote they cut the Fed Funds target by 50 bps to 4.75%-5.00%, citing increased confidence that price stability and employment risks have come into better balance. The Fed maintained their balance sheet runoff cap for MBS at $35B/mo, which remained well above actual paydowns. The Fed's MBS holdings are concentrated in lower coupons that remained out of the money for refinancing despite the 1% decline in mortgage rates, which ended the period just above 6%.

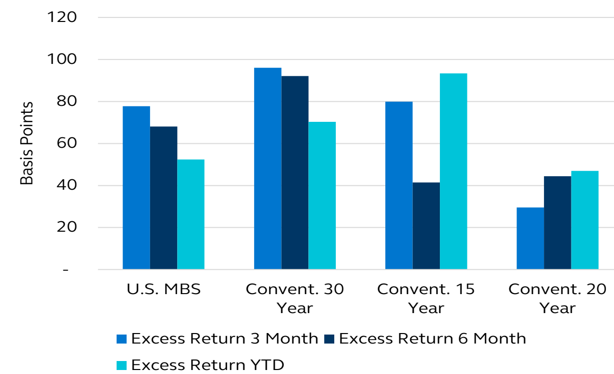
Favorable technicals and slowing economic data supported strong performance across the sector. Taxable bond fund and ETF inflows averaging over $8B/week supported money manager buying despite already significant overweights to the sector. Additionally, the start of the easing cycle prompted bank buying that helped absorb MBS gross and net supply totaling $309B and $64B during the quarter. Prepayment risk remained manageable as the majority of outstanding mortgages carry loan rates below 4%, limiting the impact of the recent rates rally to 2022-2024 higher coupon vintages. This combination of strong technicals and stable prepays drove MBS nominal spreads to tighten by nearly 30 bps during the quarter, besting the performance of both Treasuries and investment grade credit. Option-adjusted spreads tightened from +48 to +42 bps.

MBS Spreads and Volatility



Source: Bloomberg

MBS Excess Returns



Source: Bloomberg

Outlook

The MBS sector has had five straight months of outperformance versus Treasuries, driven by normalizing rates volatility, limited supply, a clearer path forward on rates and stable prepayment profiles. Valuations have adjusted accordingly, and MBS spreads are now on the tight side of one-year ranges, though they remain fair from a longer-term perspective. With money managers already significantly overweight the sector we see limited opportunities for spreads to tighten meaningfully from here, but potential catalysts could be stronger bank demand arising from rate cuts, less stringent Basel III capital requirements and duration extension out of cash to support net interest margins. Additionally, lower rates could spur renewed foreign demand as FX hedging costs decline.

With valuations on the rich side of fair value the sector has less cushion to absorb any market shocks and associated volatility at a time when geopolitical risks have intensified. The Fed's objective of engineering a soft landing has been complicated by Middle East tensions and union strikes that have the potential to set back inflation progress. A continued decline in rates could reignite broader risks to MBS prepayments and supply. Finally, the outcome of the U.S. elections in November will have repercussions for both the macro and policy outlooks with direct and indirect impacts to MBS. Most notably, GSE privatization is expected to reemerge as a core goal of a second Trump administration, which would reignite uncertainty around the government's implicit backing of UMBS. Thus, we hold a neutral view of the MBS sector and expect the majority of returns will come from carry rather than further spread compression, with the potential for many bumps along the way.

Asset-Backed Securities (ABS)

SEPTEMBER 30, 2024

Highlights

The Bloomberg AAA Asset Backed Securities (ABS) Index gained 3.36% and outperformed like-duration Treasuries by 14 basis points during the third quarter. Year to date, the ABS Index has gained 4.54% and outperformed Treasuries by 77 basis points. The U.S. economy maintained steady growth throughout the summer, driven by resilient consumer spending. Meanwhile, inflation has shown meaningful progress after a rocky start to the year, bolstering the Federal Reserve (Fed)'s confidence that it is on a sustainable path toward its 2% target. Year-over-year core PCE held a tight range around 5.0-5.5% from November 2021 to November 2022 but has since steadily declined to just 2.7% as of the August report. However, concerns about a slowing labor market have emerged as unemployment has risen. After hitting a cycle low of 3.4% in April 2023, the unemployment rate climbed to 4.3% in July before easing slightly to 4.2% in August. With inflation cooling, the Fed has shifted its focus to supporting the labor market, delivering a 50-basis point rate cut in September and signaling the possibility of two more cuts this year.

The labor market has normalized, following the extended post-pandemic boom, where strong demand met limited supply, resulting in one of the tightest labor markets in recent history. The JOLTS report indicates that job openings have steadily declined over the past two years, reaching 7.7 million in July, down from a peak of 12.2 million in March 2022. Similarly, the number of quits has decreased, as challenging market conditions make employees hesitant to leave their current positions. However, other data, despite some softening, suggests that the labor market is holding steady with layoffs at historically low levels. Initial claims for unemployment benefits have stabilized after a summer spike caused by disruptive weather and auto plant shutdowns.

ABS collateral performance reflects the nuanced state of consumer health. Less financially secure borrowers have been negatively impacted by elevated prices and this has contributed to weaker credit performance in select segments of the ABS market. However, tighter lending standards and strong, crisis-tested structures result in ABS remaining well protected.

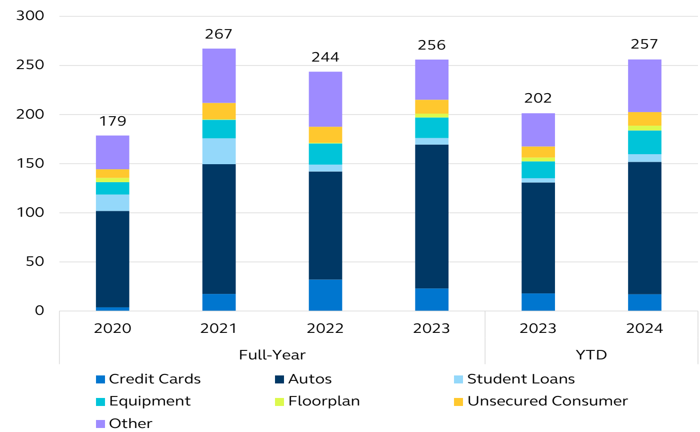
Heavy new issuance has been met with strong demand, which has resulted in AAA ABS spreads grinding tighter. ABS new issuance totaled $78bn in the third quarter as compared to $71bn for the same period in 2023. On a year-to-date basis, $257bn has been issued in 2024 compared to $202bn for the first nine months of 2023 and more than the full-year 2023 volume of $256bn.

Outlook

High quality, short duration consumer ABS remains a compelling opportunity for investors. Supply is expected to slow in the fourth quarter from elevated issuance as issuers have tried to come to market prior to the Presidential election and holiday calendar. 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.

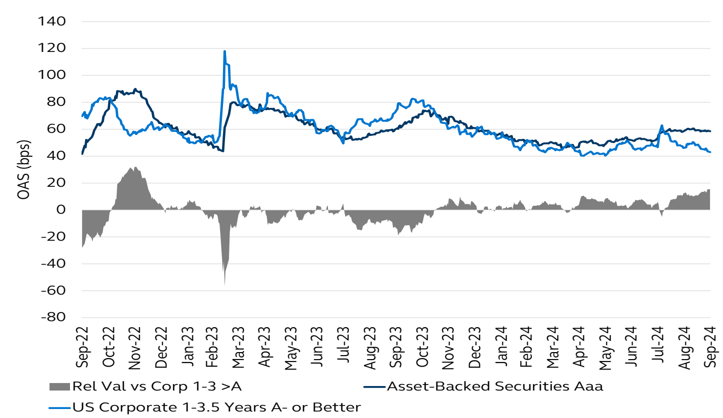
ABS fundamentals remain on solid footing, supported by low unemployment levels and tighter lending standards in recent years to offset inflated credit scores from COVID-period stimulus. Consumers are facing headwinds and delinquency rates have increased from the low levels experienced immediately post-pandemic. Year to date, consumers exhibited the typical, albeit weaker, tax season improvement and subsequent deterioration with the pace of rising delinquencies now showing signs of slowing. In addition, ABS structures have proven their resilience when consumer fundamentals weren't as favorable. Attractive spreads, combined with resilient ABS structures, should present appealing opportunities for investors.

ABS Sector Supply



Source: JP Morgan

ABS Relative Value



Source: Bloomberg

Commercial Mortgage-Backed Securities (CMBS)

SEPTEMBER 30, 2024

Highlights

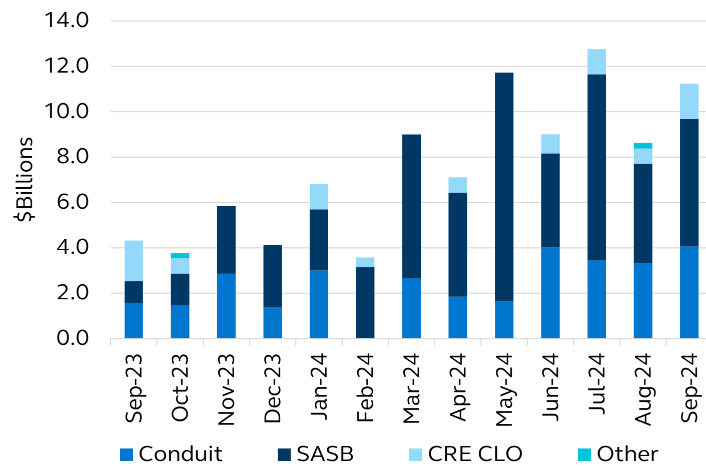
The Bloomberg AAA Commercial Mortgage-Backed Securities (CMBS) Index posted total and excess returns of 4.62% and 0.43%, respectively, during the third quarter. The theme early in the quarter centered around economic data indicating a slowing economy with a lower than expected jobs number in August spiking market volatility on recession fears. The concern subsided mid-month with lower than expected inflation data opening the door to Fed cuts that was confirmed in September with the Fed lowering rates by 50bps. The market's reaction to the rate cut and expectations for lower rates in the future was positive from an economic soft landing perspective and especially positive for real estate as lower rates should help take the pressure off borrowers looking to refinance maturing loans. CMBS spreads ended the quarter tighter and the credit curve flattened based on this more optimistic outlook. As a result, AAA CMBS spreads ended the third quarter 10bps tighter, AA spreads 15bps tighter, A spreads 28bps tighter and BBB spreads 123bps tighter.

New issue activity spiked during the quarter driven by higher SASB issuance and both conduit and SASB issuance was met with strong demand. The $29.0B of private label issuance, during the third quarter, was up 10% from second quarter 2024 and up 191% from third quarter 2023. Private label conduit issuance during the quarter was $10.8B compared to second quarter 2024 of $7.5B and third quarter 2023 of $4.6B. Private label SASB issuance was $18.8B compared to second quarter 2024 of $18.8B and third quarter 2023 of $5.4B. Secondary market activity also picked up during the third quarter on renewed demand for seasoned CMBS. Trailing 12-month average quarterly issuance as of 9/30/24 was $21.5B compared to $8.4B for the same period ending 9/30/23.

Outlook

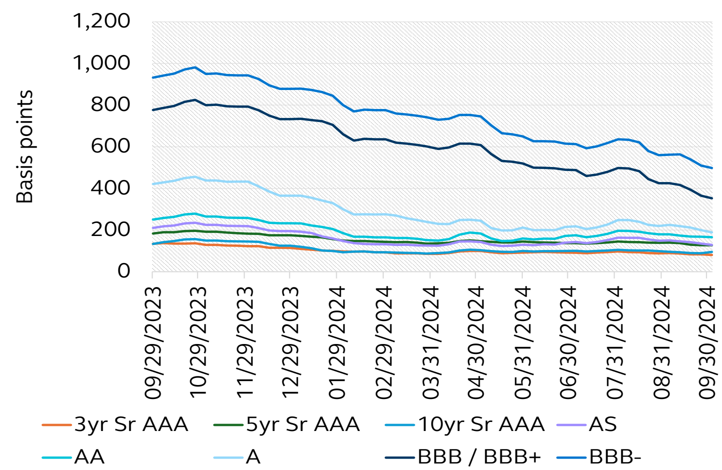
The outlook for CMBS remains primarily focused on refinancing loans that mature in 2024 and 2025, the path of the economy, the path of interest rates and longer-term office loan fundamentals. Our outlook is that 2.0 CMBS underwriting should protect from loan defaults becoming systematic and headline risk remaining idiosyncratic which makes CMBS spreads and yields continue to look attractive relative to alternatives.

CMBS Issuance



Source: JP Morgan

CMBS Spreads to Treasuries



Source: JP Morgan

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SEPTEMBER 30, 2024

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