Principal Asset Management℠

Principal Morley

Interest rate strategy

DECEMBER 31, 2024

DAN KANG, CFA
Portfolio Manager

Rates/Corporates

Highlights

In 2024, U.S. Treasury yields experienced significant volatility as the Federal Reserve (Fed) shifted from tightening to easing monetary policy amid evolving economic conditions. The year began with the 2-year yield at 4.26% and the 10-year yield at 3.88%, reflecting anticipation of the start of the Fed's cutting cycle. By the end of the third quarter, the 10-year yield hit a low of 3.62%, driven by the Fed's initial rate cut expectations and elevated recession fears. However, yields surged toward year-end, driven by the Republican sweep, improved macro data, and a subsequent hawkish tilt from the December FOMC meeting. The 2-year yield ended the year nearly unchanged at 4.24%, while the 10-year yield finished higher at 4.57%. After 25 months, the 2-year/10-year Treasury curve uninverted in September and ended the year at +33 basis points (bps).

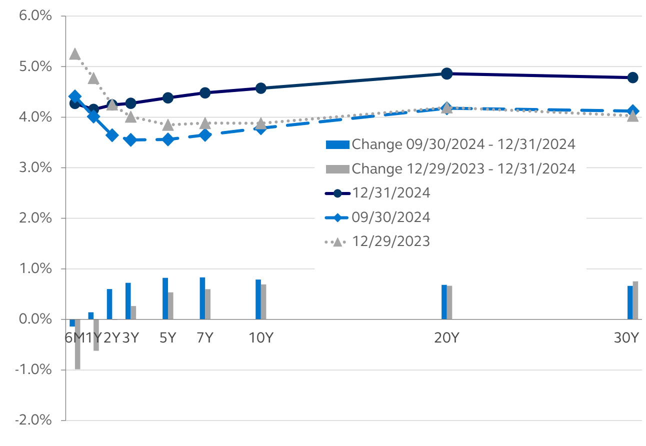
Over the year, the labor market normalized as the unemployment rate rose from 3.7% in January, peaked over the summer, and stabilized at 4.2% by November. November payrolls rebounded after October disruptions from hurricanes and strikes. Weekly jobless claims trended lower, and job openings (JOLTS) edged up, signaling steady employer demand, though a four-year low in the quits rate reflected reduced worker confidence. Inflation moderated steadily in the first half of the year, with Core Personal Consumption Expenditures (PCE) inflation easing from 3% in January to 2.6% by June. However, progress stalled in the latter months, rising slightly to 2.8% in November and remaining well above the Fed's 2% target.

The Fed sought to balance its dual mandate while recalibrating policies to reflect labor market normalization. It implemented 100 bps in rate cuts over the year, including two 25-bps reductions in the fourth quarter, bringing the federal funds target range to 4.25%–4.50% by December. The December Summary of Economic Projections (SEP) suggested two additional rate cuts in 2025, reducing the federal funds rate to approximately 4.0%—a more hawkish outlook than four cuts projected in September. Additionally, the committee pushed back reaching its inflation target to 2027 while raising 2025 Core PCE to 2.6% (an increase of 0.2 percentage points from September).

Outlook

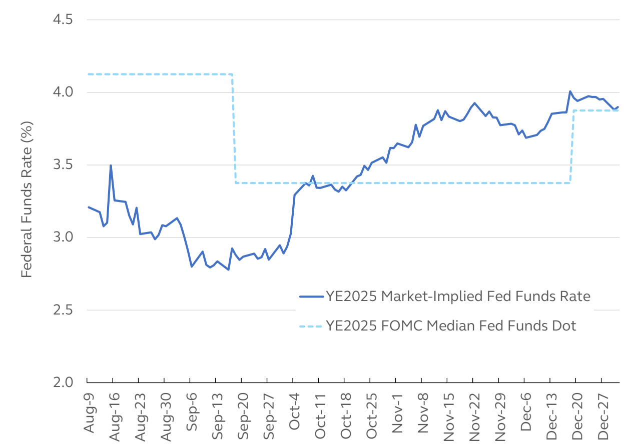
In the near term, we would expect the macro environment to be consistent with a "no-landing" scenario, characterized by stickier inflation and resilient growth. Further, the markets will be assessing the potential outcomes of a Trump 2.0 presidency as it sorts through headlines on fiscal, tariffs, deregulation, and immigration policies. Although policy announcements will come quickly, the implementation will take time as cabinet positions are filled, tax cuts are negotiated, and regulatory rules are written. At present, we view most of Trump's public policy goals as net inflationary and the magnitude would be a function of the scale and scope of the actual enactment of his policies.

U.S. Treasury Yield Curve



Source: Bloomberg

Fed Dot vs Market Implied Expectation



Source: Bloomberg

Corporates

DECEMBER 31, 2024

Highlights

In the fourth quarter of 2024, the Bloomberg U.S. Intermediate Corporate Bond Index posted total returns of -1.40% and excess returns of 0.60%, bringing full-year total returns to 4.22% and full-year excess returns to 2.10%. Following the U.S. presidential election, optimism over potential fiscal stimulus and Federal Reserve (Fed) rate cuts drove risk-on sentiment, with credit spreads tightening from 79 basis points (bps) at the start of the quarter to a low of 64 bps. However, the December FOMC meeting resulted in a hawkish 25 bps cut, dashing hopes for a rally into the holidays. This resulted in an uptick in volatility, with both the MOVE and VIX spiking, leading to a modest spread widening into year-end.

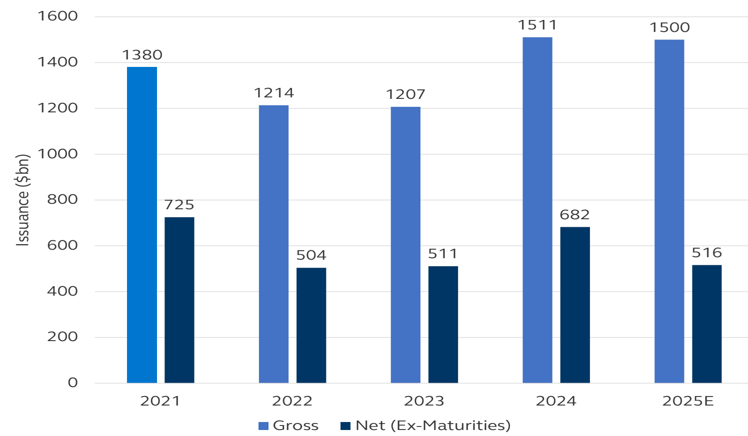
Economic data remained robust in the fourth quarter, with GDP growing at an annualized 3.1% in Q3, unemployment remaining near historic lows, and inflation staying above the Fed's 2% target. Solid third quarter earnings (S&P 500 companies +8.5%) and a continued upward ratings trajectory ($496bn of net upgrades in 2024) pointed to supportive fundamentals. In terms of technicals, investment-grade issuance remained strong, with Q4 gross issuance totaling $236 billion, 8% higher than the four-year Q4 average. Full-year issuance reached $1.55 trillion, the second highest on record after 2020's $1.8 trillion issuance. Issuers took advantage of tight spreads and declining yields, with financials comprising 60% of issuance. Longer-dated issuance (10+ years) rebounded after years of subdued activity, as lower rates made issuing out the curve more attractive. Elevated supply was met with a strong rebound in demand for the year. For 2024, high grade funds established a new all-time nominal record of $378 billion in inflows, compared to $182 billion in 2023. Moreover, foreign demand for corporates averaged $33 billion per month for 2024 versus a 10-year average of only $11 billion.

Outlook

A combination of a supportive macro environment and historically attractive yields should limit spread trading ranges for the time being. Fundamentals continue to be supportive for risk outside of specific, idiosyncratic sectors and credits. Further, under Trump 2.0, the mix of winners and losers requires close monitoring as certain sectors either gain or lose favor.

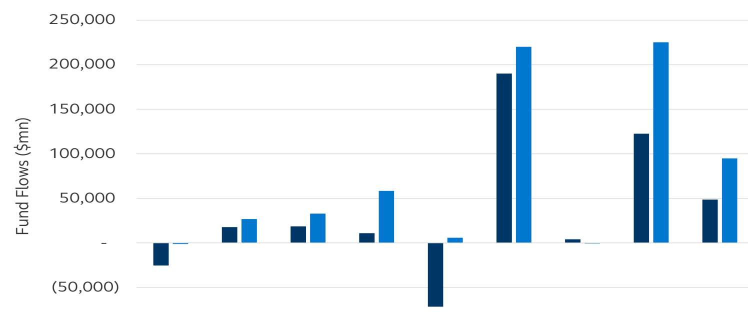
Heavy near-term primary issuance may pressure spreads momentarily, but any indigestion is expected to be temporary as net supply declines in 2025. As the Fed COVID-era programs backstopped record-setting corporate issuance in 2020, the significant refinancing of these maturities should occur in 2025. One upside risk to new issuance expectations would be exuberant animal spirits, facilitated by a more favorable regulatory environment, resulting in larger M&A-related financing. Demand in 2025 will continue to be robust driven by life insurance annuity sales, pensions immunizing their liabilities, and retail continuing to add duration.

Investment Grade Gross & Net Issuance



Source: J.P. Morgan

Investment Grade Fund Flows



	Short	Int	Long	Total	Short	Int	Long	Total	Total Ret
	Corp-only				Agg				
2023	(25,32	17,686	18,566	10,927	(71,62	190,09	4,044	122,51	48,653
2024	(1,308	26,748	32,873	58,313	5,805	220,08	(695)	225,19	94,801

2023 2024

Source: J.P. Morgan

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Mortgage-Backed Securities (MBS)

DECEMBER 31, 2024

Perpetua Phillips
Portfolio Manager

MBS/ABS/CMBS

Highlights

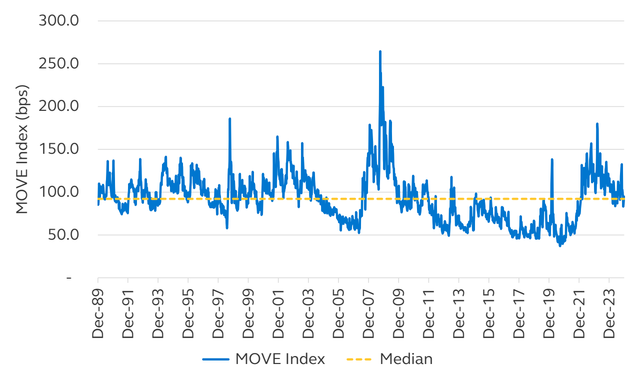
The Bloomberg U.S. MBS Index posted total and excess returns of -3.16% and -0.13%, respectively, during the fourth quarter, bringing full year 2024 total and excess returns to 1.20% and 0.37%. Treasuries sold off significantly during the fourth quarter, driven by a GOP sweep in the November elections that raised the prospects for higher economic growth and an increase in inflation. The two-year Treasury yield rose 0.60% to 4.24%, while the ten-year yield climbed 0.79% to 4.57% during the quarter. On a year over year basis ultra-short rates declined by over 1.0% while long rates rose by 0.70%.

After commencing their easing cycle with a 50 basis point (bp) cut in September, the FOMC lowered rates by 25bps at their November and December meetings, bringing the Fed Funds rate to a 4.25-4.50% range at year-end. The committee projected just two rate cuts in 2025 due to steady growth, stickier core inflation and uncertainty around fiscal policies under the new administration. The most impactful changes could arise from tax cuts, immigration curbs and protectionist tariffs.

MBS current coupon zero-volatility spreads (ZVS) widened by 10 bps during the quarter to close the year at +128 bps, close to the full year average of +134, but well off the October peak of +144 bps. The option-adjusted spread (OAS) of the overall MBS index peaked at close to +50 bps in October before closing the year at +43 bps. Rates volatility followed a similar pattern, with the MOVE index surging to 136 ahead of the November elections and FOMC meeting, before declining to close below 100 at year-end after these event risks subsided.

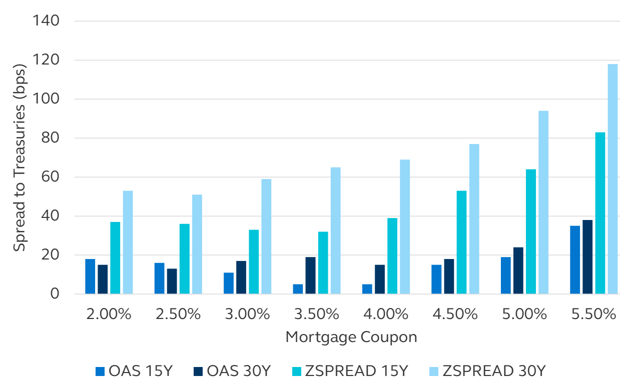
Thirty-year mortgage rates rose by nearly a percentage point during the quarter to close the year near 7%, leaving only 3% of mortgages outstanding refinanceable. As a result, both prepayment and extension risks are minimal for all but the most recent production coupons. Higher rates and slower housing seasonals depressed supply as well, with gross/net MBS supply in Q4 totaling $323B/$70B, bringing full year totals $1.12T/$212B.

Rates Volatility Near Long-term Ave



Source: Bloomberg

Relative Value in the Passthrough Market



Source: Yield Book

Outlook

MBS valuations are now near fair value after having traded significantly cheap to historical averages for much of the past two years. Implied volatility declined to near long-term averages during the year, leaving less of a tailwind for basis performance going forward, while the macro and rates outlook remains murky as uncertainty has shifted from monetary to fiscal policy risks. The Fed has indicated their intent to proceed cautiously with further rate cuts until the impact of tax, immigration and tariff policies come into clearer focus. This could keep rates and volatility elevated for longer, suppressing housing activity and MBS originator supply. However, net supply from the Fed's balance sheet runoff remains a headwind, with the roughly $180B rolling off this year expected to approach organic supply of $200-225B. Without an increase in buying from banks and foreign investors, money managers will once again have to absorb the largest share of this supply. This is further complicated by the new administration's intent to privatize the GSEs, which reintroduces uncertainty around the government's implicit backing of UMBS and the associated impacts on UMBS supply and demand. Given these ongoing headwinds it is difficult to envision a catalyst for MBS spreads to tighten meaningfully from here.

With limited upside for basis performance, we believe returns will be largely driven by carry and see better potential in higher coupon passthroughs and CMOs. Deep discount coupons carry poorly in this higher rate environment and carry the additional risk of continued bank selling of low yielding, longer duration MBS. We maintain a neutral stance on the sector and look for better entry points, which are likely to come with the volatile times ahead.

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Asset-Backed Securities (ABS)

DECEMBER 31, 2024

Highlights

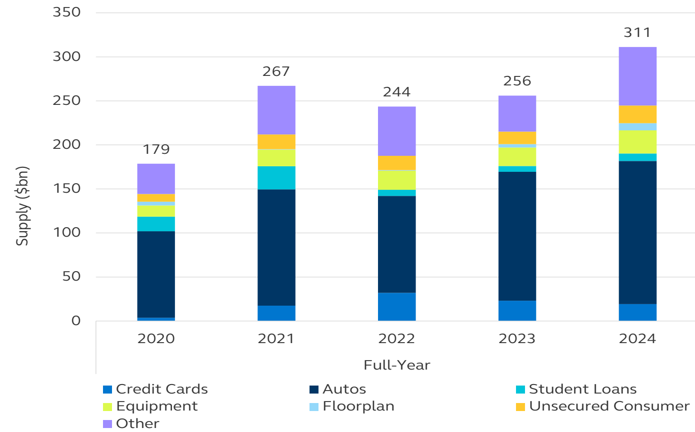
The Bloomberg AAA Asset Backed Securities (ABS) Index returned -0.12%, but outperformed like-duration Treasuries by 60 basis points during the fourth quarter. Year to date, the AAA ABS Index has gained 4.82% and outperformed Treasuries by 140 basis points. Despite uncertainty surrounding the U.S. election, shifting monetary policies, and rising geopolitical tensions, 2024 proved to be a remarkably strong year for the economy and financial markets. The U.S. economy demonstrated resilience, bolstered by robust consumer spending, with third-quarter GDP rising at an annual rate of 3.1%, surpassing expectations. Inflation continued its downward trend toward the Federal Reserve (Fed)'s 2% target in 2024, though momentum has slowed in recent months. The labor market has normalized after the extended post-pandemic boom, despite recent disruptions from strikes and hurricanes. With inflation improving and the labor market softening, the Fed, addressing both sides of its dual mandate, lowered interest rates by 100 basis points in 2024.

At its final meeting of the year in December, the Fed cut rates by 25 basis points, lowering the Federal Funds rate to a range of 4.25% to 4.5%. However, the committee now expects only two rate cuts in 2025, down from the four projected in September. This hawkish shift reflects not only steady economic growth but also a more balanced labor market and ongoing inflation concerns. The unemployment rate reached 4.2% in November, which is above the cycle low of 3.4% in April 2023, but has stabilized in recent months and remains below levels seen for much of the past 50 years. The slow progress on inflation has raised concerns that momentum is stalling as the Core PCE rose 2.8% year-over-year in November, up slightly from the reading of 2.6% in the second quarter. Market expectations are even more hawkish than the Fed's forecasts, reflecting inflation uncertainty surrounding policies proposed by the incoming administration—such as extending the Tax Cuts and Jobs Act, imposing stricter immigration measures, and enacting more stringent tariffs. However, until there is greater clarity on President-elect Trump's policy agenda, the pace of rate cuts will continue to depend on incoming economic data.

ABS collateral performance reflects the nuanced state of consumer health. Less financially secure borrowers continued to be negatively impacted by higher 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.

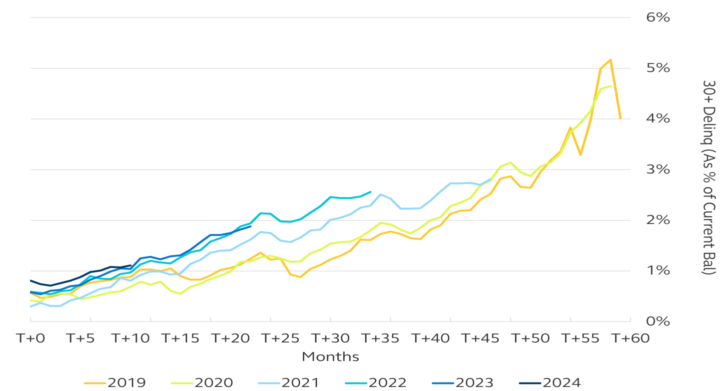
Strong ABS new issuance has been met with high demand, which has resulted in AAA ABS spreads grinding tighter. ABS new issuance totaled $54bn in the fourth quarter as compared to $78bn for the prior quarter. On a year-to-date basis, $311bn was issued in 2024 compared to $256bn for 2023, making full-year 2024 the busiest issuance year since 2006.

ABS Sector New Issue Supply



Source: J.P. Morgan

Prime Auto 30+ Delinquency by Vintage



Source: J.P. Morgan

Outlook

The resilience of the U.S. consumer has been remarkable. Consumer balance sheets remain healthy despite pockets of weakness. While we anticipate some modest slowing of consumer spending in the quarters ahead, the consumer is well positioned to support growth that is neither too hot nor too cold, unless there is significant deterioration in the labor market.

Fundamentals within securitized assets have likewise shown some moderation, with an uptick in delinquencies. However, the sector is well-positioned to benefit from a resilient consumer, expected deregulation, easing monetary policy, and a tempering yet healthy economy. Demand is expected to remain robust, driven by increased bank participation and a prevailing risk-on sentiment. While spreads tightened significantly throughout 2024, securitized sectors remain attractive both on an absolute yield basis and relative to the corporate bond sector.

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Commercial Mortgage-Backed Securities (CMBS)

DECEMBER 31, 2024

Highlights

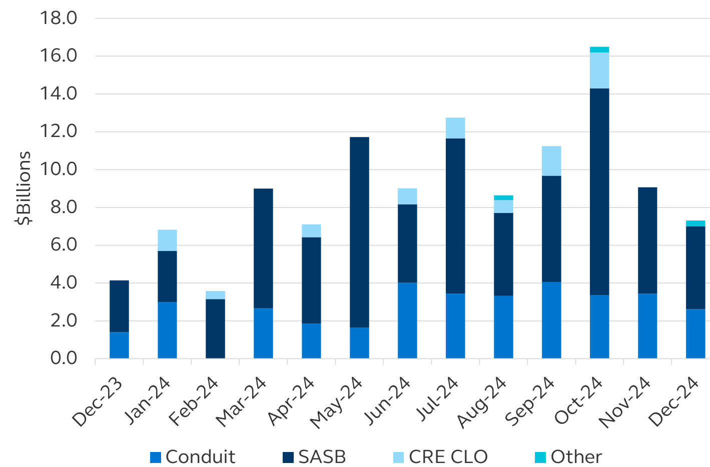
The Bloomberg AAA Commercial Mortgage-Backed Securities (CMBS) Index posted total and excess returns of -1.40% and 0.61%, respectively, during the fourth quarter. The themes during the quarter centered around the November election results and a growing consensus that the Fed would have to be less aggressive in lowering rates given stronger than expected economic growth and relatively tame inflation. Longer term Interest rates moved 60 bps higher ahead of the election and ended the quarter 80 bps higher as the Republican sweep elevated concerns that growing deficits and tariffs will both be inflationary. Despite the move higher in rates and the potential negative implications for real estate and refinancing debt, demand for CMBS remained strong. 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 17 bps tighter, AA spreads 23 bps tighter, A spreads 20 bps tighter and BBB spreads 93 bps tighter.

New issue activity continued the strong trend that started in the 2nd quarter. The $32.9B of private label issuance during the fourth quarter was comparable to the third quarter 2024 but up 139% from fourth quarter 2023. Private label conduit issuance during the quarter was $9.4B compared to third quarter 2024 of $10.8B and fourth quarter 2023 of $5.7B. Private label SASB issuance was $21.0B compared to third quarter 2024 of $18.2B and fourth quarter 2023 of $7.1B. Trailing 12-month average quarterly issuance as of 12/31/24 was $25.9B compared to $9.8B for the same period ending 12/31/23. Secondary market activity was also robust during the fourth quarter on continued demand for seasoned CMBS.

Outlook

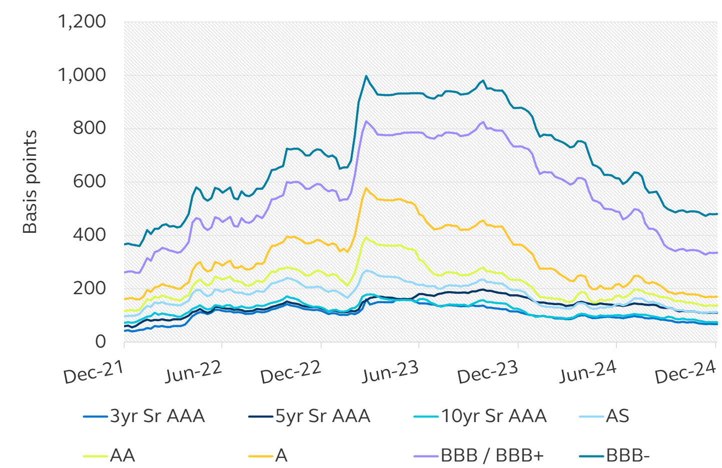
The outlook for CMBS remains primarily focused on refinancing loans that mature in 2025, the path of the economy, the path of interest rates and longer-term office loan fundamentals. Our outlook is that 2.0 CMBS underwriting should protect from loan defaults becoming systematic and headline risk remaining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

CMBS Issuance



Source: J.P. Morgan

CMBS Spreads to Treasuries



Source: J.P. Morgan

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