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Principal Asset Management℠

**Principal Morley**

# Interest rate strategy

JUNE 30, 2024

**DAN KANG, CFA**
Portfolio Manager

**Rates/Corporates**

## Highlights

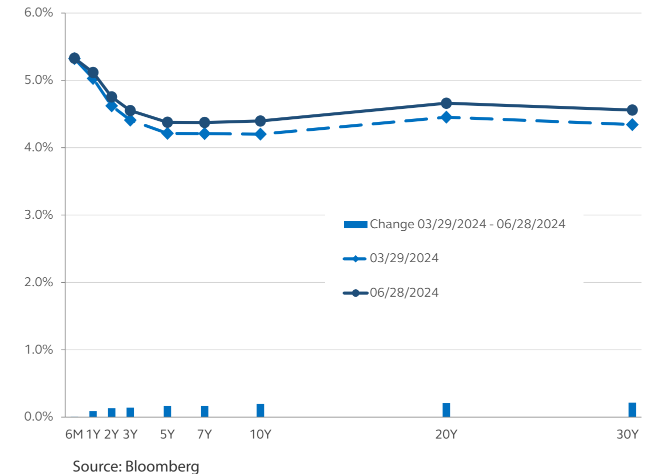
In the second quarter of 2024, the 10-year Treasury yield rose from 4.2% to 4.4%, with the yield curve bear-steepening. The 10-year yield peaked at 4.7% in April as markets reacted to robust economic data, higher-than-expected Consumer Price Index (CPI) and Personal Consumption Expenditures (PCE) readings, and geopolitical frictions between Israel and Iran, leading to increased market volatility. This caused a rise in Treasury yields and a fall in U.S. equity indices. Starting in May, the data releases were softer, with inflation indicators reversing the first quarter strength while consumer strength moderated. Headline non-farm payrolls continued to be solid, but initial jobless claims drifted upwards from low levels. Retail sales reflected a more discerning consumer and deteriorating confidence as inflation continued to be uncomfortably high.

At its June meeting, the Federal Reserve (Fed) held the Federal Funds Rate steady at 5.25-5.50%, with Chair Jerome Powell emphasizing a gradual approach to achieving the inflation target. The Fed's updated Summary of Economic Projections (SEP) kept the economic growth forecast unchanged at 2%, adjusted the Core PCE inflation forecast to 2.8% from 2.6%, and projected unemployment would rise to 4.2% next year. Notably, the long-term Fed Funds rate was revised higher to 2.8% from 2.6%, reflecting ongoing debates about the long-term neutral rate, or R*. At the May meeting, the Fed reduced the monthly cap on Treasurys to $25 billion from $60 billion, resulting in an annual reduction of $300 billion compared to $720 billion when the program began in June 2022, while keeping the potential mortgage roll-off unchanged at $25 billion a month. Additionally, several other central banks, including the Bank of Canada and the European Central Bank, began easing cycles in June by cutting rates by 25 basis points, supporting the strength of the U.S. dollar.

## Outlook

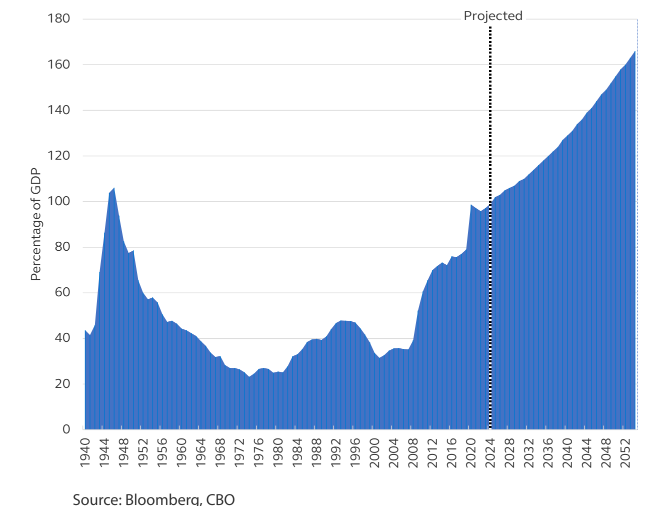
As we wait for the incoming data to provide more confidence for the FOMC to start cutting, we look to other factors that may dictate the direction of rates. Recent volatility driven by the French elections has sharpened the focus on potential implications for the upcoming U.S. elections. The policy implications are significant, as possible fiscal expansion, trade wars via tariffs, and tighter immigration would all have impacts on duration and curves. No matter the election outcome, we see limited scope for the upward trajectory of federal debt to veer off course. The most recent U.S. Congressional Budget Office (CBO) estimates that federal government debt held by the public as a percent of nominal GDP would rise from 97% to 166% by 2054. If either party sweeps this fall's elections, investors' consternation could spark an increased term premium as fiscal expansions are priced in.

**U.S. Treasury Yield Curve**




Source: Bloomberg

**U.S. Federal Debt Held by Public as % of GDP**




Source: Bloomberg, CBO

# Corporates

JUNE 30, 2024

## Highlights

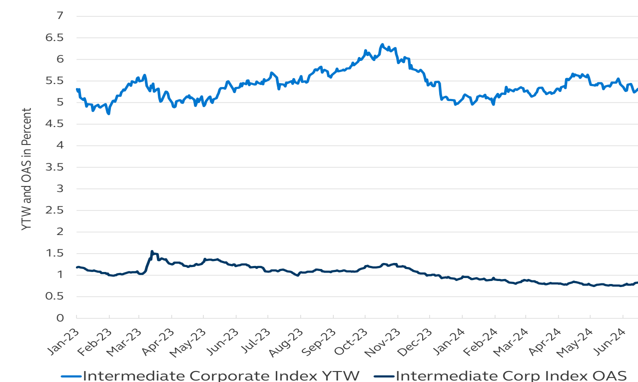
In the second quarter of 2024, the Bloomberg U.S. Intermediate Corporate Bond Index continued to produce positive returns, with total and excess returns of 0.74% and 0.23%, respectively. Spreads traded range-bound, with the rally stalling amid risk-off sentiment surrounding hotter-than-expected inflation reports and the Federal Reserve (Fed) dialing back anticipated rate cuts. Equities started the quarter lower as yields rose and the VIX increased, though from historical lows. May marked a turnaround as softer economic data, including lower inflation prints and a gradually softening labor market, combined with a more dovish tone from the Fed, sparked a rebound rally in Treasuries and risk assets, with equity indices hitting all-time highs and spreads at YTD tights.

Primary Investment Grade (IG) issuance totaled $351 billion for the quarter, with $111 billion in April, $137 billion in May, and $103 billion in June. This volume surpassed last year's levels and marked the second-highest first half since the record in 2020, driven largely by a rebound in financials (both domestic and Yankee issuance). This uptick was seen as opportunistic ahead of potential market uncertainties related to the upcoming U.S. elections this fall. High-grade fund flows into mutual funds and ETFs showed a $188 billion inflow during the first half of 2024, while foreign demand has seen robust buying, indicating that investors continue to take advantage of higher-than-historical average yields. Fundamentals remain robust, with Q1 sales and earnings growing at a solid pace and earnings recovery expected over the next year. Ratings upgrades continue to outpace downgrades, further supporting the strength of the market.

## Outlook

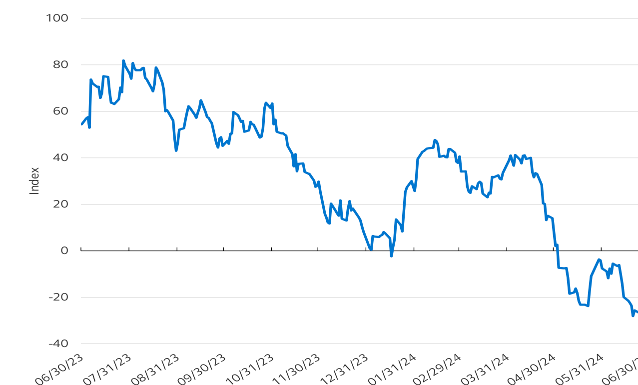
Several key questions will drive credit spreads for the second half of 2024. First, will we see further cracks in labor and aggregate demand that shift away from the soft-landing base view? Although we've been asking this question for the past year, we observe the recent soft patch in data, as seen in the Citigroup Economic Surprise Index, and the steady rise in the unemployment rate, which portends the triggering of the Sahm rule (coincidental indicator for recession). Second, will lower yields meaningfully diminish the appetite of the yield-based investor base for IG bonds? Part of the answer would be tied to the previous question on whether the yield was driven by economic weakness versus continued disinflation. Third, will the upcoming U.S. election results meaningfully change fiscal, trade, immigration, and monetary policies? If one party sweeps, a significant fiscal expansion would be priced in, while a change in the current administration would alter the list of winners and losers over the next four years.

### Intermediate Coporate Index Yield and Spread




Source: Bloomberg

### Citi Economic Surprise Index




Source: Bloomberg, Citi

# Mortgage-Backed Securities (MBS)

JUNE 30, 2024

**Perpetua Phillips**
Portfolio Manager

**MBS/ABS/CMBS**

## Highlights

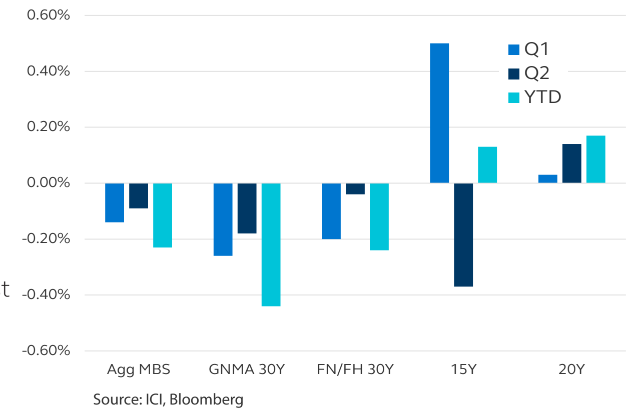
The Bloomberg U.S. MBS Index posted overall total and excess returns of 0.07% and -0.09%, respectively, during the second quarter, but performance varied widely within the sector. Excess return differentials were notable between agencies, coupons and tenors. Driving factors included supply/demand technicals, key rate duration profiles and carry, as Treasury rates rose by 10-20 bps, the curve bear steepened, and rates volatility receded from April highs by the end of the period.

During the quarter conventional 30-year MBS expanded their performance advantage over comparable Ginnie Mae's to +20 bps YTD as the $78B total net issuance came entirely from Ginnie's. On the coupon stack, production coupons maintained their triple digit YTD excess return advantage over deep discounts, which suffered from a carry disadvantage due to tighter spreads and the inverted curve. Additionally, technical pressures from bank selling of longer duration assets also weighed on lower coupons, while money manager and yield-based buyers supported premium coupons. Across WAM segments, 15-years gave back a large share of Q1 excess returns (-37 bps), while 20-years were the only MBS segment to post positive excess returns for the second quarter (+14 bps).

At their May meeting the FOMC announced a reduction in their Treasury runoff cap from $60B/mo to $25B/mo starting June 1st. The MBS cap was unchanged at $35/mo, which remains well above actual paydowns of $16-20B/mo. The Committee left the Fed Funds target rate at 5.25-5.50% and downgraded 2024 rate cut forecasts from three to one given "modest further progress" on inflation. The higher for longer narrative curbed the expected rebound in bank demand for MBS.

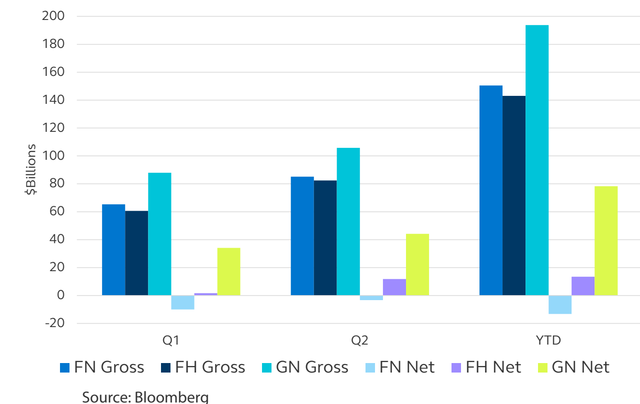
The nominal and option-adjusted spreads of the MBS index traded in a relatively stable range during the quarter, with the closing levels of +72 bps and +48 bps close to YTD averages. Primary mortgage rates near 7% kept prepays muted, with aggregate speeds across cohorts settling around 6% CPR, driven largely by housing turnover. Gross and net issuance for the quarter was $273B and $53B, respectively, with Ginnies accounting for 83% of net supply during the period.

**MBS Excess Returns**




Source: ICI, Bloomberg

**MBS Issuance**




Source: Bloomberg

## Outlook

Heading into the second half of the year valuations within MBS cohorts reflect their differing return profiles. Higher nominal spreads/yields on production coupons offer short duration and attractive carry opportunities in rangebound or higher for longer scenarios. By contrast, tighter nominal spreads on discount coupons are mitigated by their strong return potential in a rally given longer durations and positive convexity. This positions them well as a higher-spread alternative to Treasuries and an attractive hedge against a weakening economy compared to IG credit.

With the path forward for the economy and rates clouded by significant geopolitical risks heading into the November elections, we believe the varied return profiles available within the sector offer investors unique opportunities to express their views on the markets and rates outlooks. From our perspective, we expect the Fed to begin easing at a measured pace later this year as inflation continues to moderate and labor markets come into better balance. This should support a further decline in volatility and improve carry on lower coupon MBS. We also expect MBS to benefit from the return of bank buying as mark-to-market concerns and Basel III capital requirements ease. Finally, we believe a weakening economy would support flows into fixed income funds, allowing money managers to maintain or increase their MBS overweights, as we expect to do in our stable value portfolios.

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# Asset-Backed Securities (ABS)

JUNE 30, 2024

## Highlights

The Bloomberg AAA Asset Backed Securities (ABS) Index gained 0.94% and outperformed like-duration Treasuries by 14 basis points during the second quarter. Year to date, the ABS Index has gained 1.54% and outperformed Treasuries by 61 basis points. Despite some signs of a slowdown in economic data due to the Federal Reserve (Fed)'s aggressive rate hikes and quantitative tightening, the U.S. economy sustained positive momentum in the second quarter of 2024. This was driven by robust consumer spending bolstered by a tight labor market. The unemployment rate has remained at or below 4% over the past two years, while job growth has stayed solid even as the labor market normalized following the post-pandemic surge. Inflation continued its downward trend but persisted, largely due to high shelter costs, with the year-over-year headline CPI fluctuating between 3.1% and 3.5% since last October. Consequently, investors scaled back their expectations for rate cuts, aligning closely with Fed's expectations. At its June meeting, the Fed's updated dot plot indicated an expectation of only one rate cut this year, down from the three cuts projected in March. However, key risks, including the upcoming U.S. election, high policy rates, and elevated geopolitical tensions, could challenge the U.S. economy.

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 very tight labor market driving wage gains. However, several headwinds have converged for the consumer, including depleted excess savings, resumption of student loan payments, tightening consumer credit and higher funding costs for new borrowing. Per capita credit card debt, already at a record high, continues to rise, and some consumer delinquency metrics have surpassed pre-Covid levels, potentially indicating difficulties for low-income consumers in sustaining post-Covid spending patterns.

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.

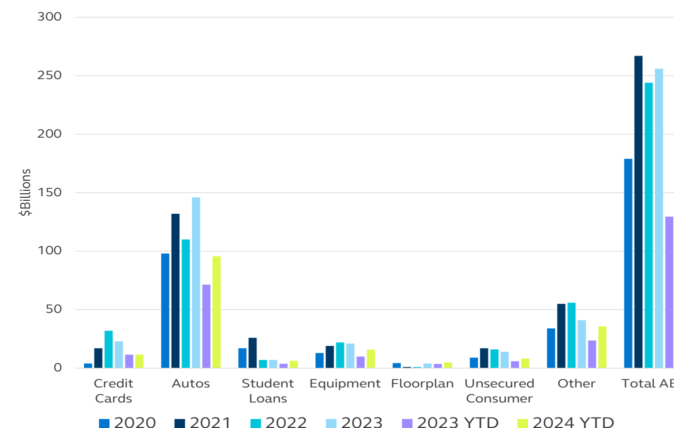
Heavy new issuance has been met with strong demand, which resulted in AAA ABS spreads moving tighter. ABS new issuance totaled $89bn in the second quarter as compared to $73bn for the same period in 2023. On a year-to-date basis, $178bn has been issued in 2024 compared to $130bn for the first half of 2023, a 38% increase.

## Outlook

High quality, short duration consumer ABS remain a compelling opportunity for investors. Supply is expected to remain elevated but compelling 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.

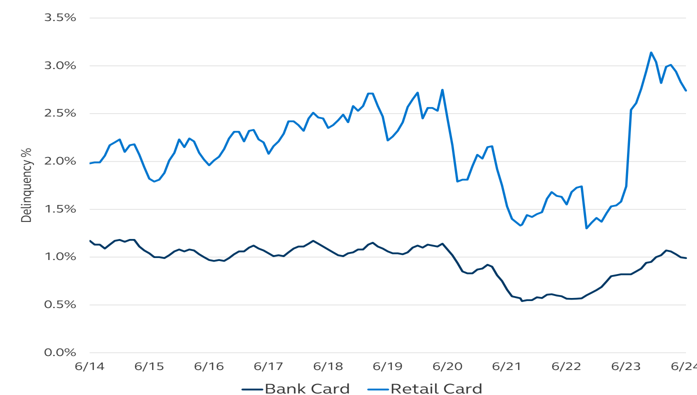
ABS fundamentals remain on solid footing, supported by low unemployment levels and tighter lending standards in recent years to offset inflated credit scores from COVID stimulus. Although consumers are facing headwinds and delinquency rates are rising from low levels, ABS structures have proven their resilience through multiple economic cycles. Attractive spreads, combined with the resilient ABS structures, presents appealing opportunities for investors.

### ABS Supply by Sector




Source: JP Morgan

### Credit Card 90+ Delinquency




Source: JP Morgan

# Commercial Mortgage-Backed Securities (CMBS)

JUNE 30, 2024

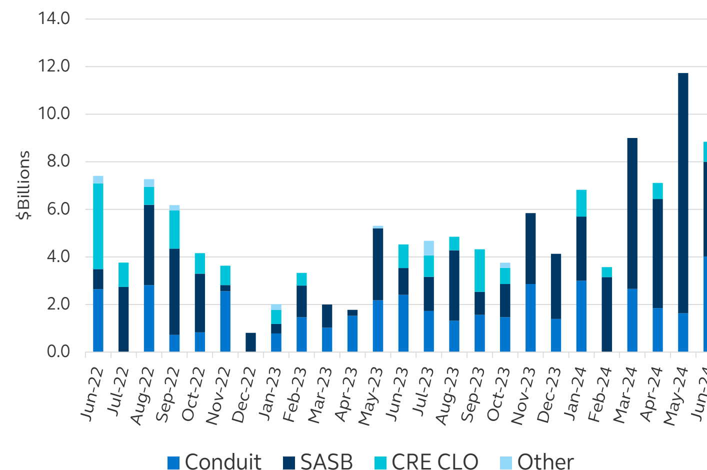
## Highlights

The Bloomberg AAA Commercial Mortgage-Backed Securities (CMBS) Index posted total and excess returns of 0.58% and 0.11%, respectively, during the second quarter. The themes during the quarter continued to center around changing market expectations for the Fed cutting rates, economic growth and the debate on whether a recession is still imminent. The expectations that the Fed would cut rates this year went from near zero in April to one to two cuts starting in September as the economy showed signs of slowing and inflation started to moderate . Even as the debate on rates continued, GDP and job growth supported a soft landing which resulted in equities rallying and credit spreads tightening. While the sector posted positive returns, CMBS ended the quarter mixed as a slower economy and negative headlines from the single asset office market spooked investors. As a result, AAA CMBS spreads ended the first quarter 13bps wider, AA spreads 23bps wider, A spreads 22bps tighter and BBB spreads 122bps tighter.

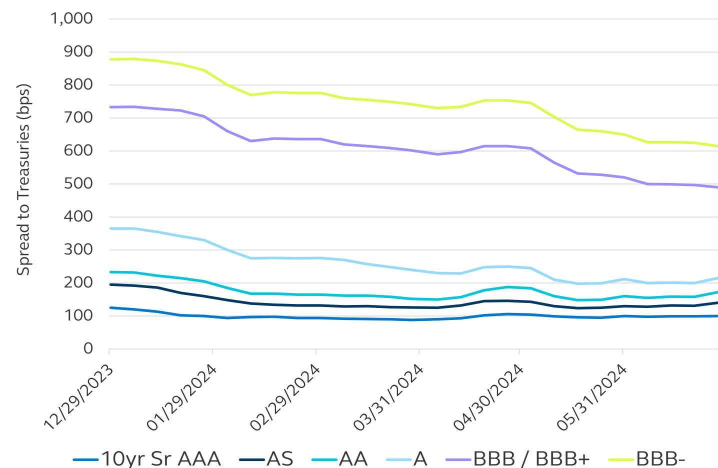
New issue activity increased during the quarter driven by higher SASB issuance. Both conduit and SASB issuance was met with strong but waning demand. The $26.3B of private label issuance, during the second quarter, was up 47% from first quarter 2024 and up 150% from second quarter 2023. Private label conduit issuance during the quarter was $7.5B compared to first quarter 2024 of $5.7B and second quarter 2023 of 6.1B. Private label SASB issuance was $18.8B compared to first quarter 2024 of $12.2B and second quarter 2023 of $4.4B. Secondary market activity was down during the second quarter as the market focused on new issue.

## Outlook

The outlook for CMBS remains primarily focused on refinancing loans that mature in 2024, the path of the economy, the path of interest rates and longer-term office loan fundamentals. Headline risk is also in the market after the AAA rated bonds from a SASB deal secured by a New York office building took a loss during the quarter. 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 cheap relative to alternatives.




Source: JP Morgan




Source: JP Morgan

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JUNE 30, 2024

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The Bloomberg U.S. 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 AAA ABS Index represents the asset-backed securities within the Bloomberg U.S. Aggregate Index.

The Bloomberg AAA CMBS Index represents the commercial mortgage-backed securities within the Bloomberg U.S. Aggregate Index.

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