Principal Asset Management[SM]

Principal Morley

Interest rate strategy

MARCH 31, 2024

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Portfolio Manager

Rates/Corporates

Highlights

In the first quarter of 2024, the U.S. Treasury market experienced a bear flattening, as the 10-year Treasury yield, which increased from 3.88% to 4.20%, increased less than the two-year Treasury yield. This upward movement in yields was propelled by strong economic indicators and inflation readings that exceeded forecasts. Notably, inflation for goods, including apparel and used car prices transitioned back to growth, while inflation in 'super-core services' categories continued to exert upward pressure. Moreover, robust Non-Farm Payroll figures, consistently adding well over 200,000 jobs per month resulted in a strong unemployment rate below 4%.

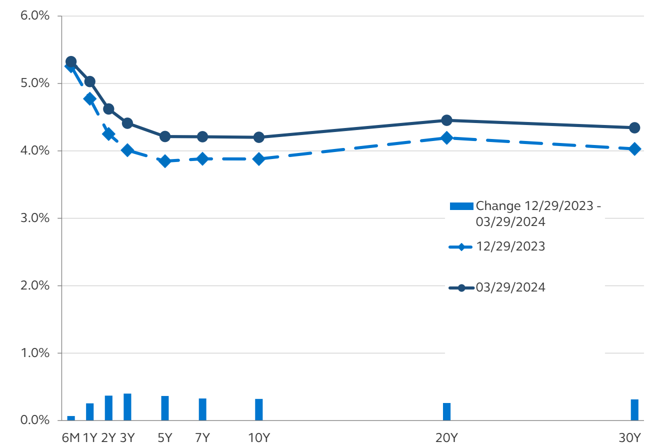
At the March Federal Open Market Committee (FOMC) meeting, the Federal Reserve (Fed) held the Federal Funds Rate steady at 5.25-5.50%. Chair Jerome Powell underscored the Fed's measured approach to future rate adjustments, citing unexpectedly high inflation figures and reiterating that it would be a "bumpy" journey toward disinflation. Contrary to initial market anticipations of aggressive monetary easing at the start of the year, market pricing has since aligned more closely with the Fed's forecasts, which upheld a projection of three rate cuts in 2024 in March's updated Summary of Economic Projections (SEP). Yet, there was a noticeable shift in sentiment among committee members, with more projections for fewer than three cuts this year—a departure from the December SEP. Additionally, the Fed signaled an adjustment to two cuts in 2025, revising down from the previous three-cut forecast, while nudging the longer-term terminal rate projection up to 2.6%. Economic growth projections for 2024 were adjusted upwards to 2.1% from 1.4%, with Core PCE inflation estimates revised to 2.6% from 2.4%. Additionally, Fed deliberations suggested an impending slowdown in the rate of balance sheet normalization, with Powell signaling this process would commence "fairly soon", as the Fed looks to avoid similar market stresses encountered during the preceding QT (Quantitative Tightening) program in 2019.

Outlook

The data continues to be resoundingly resilient and reflect more of a no-landing vs a soft-landing scenario. Consequently, the economic figures have afforded the FOMC to be patient in easing policy and the market has adjusted from its aggressive easing expectation at the start of the year. Despite the unwelcome uptick in inflation at the start of the year, we would expect the disinflationary trend to continue for the remainder of the year. Consequently, we still expect a summer start to the Fed's easing cycle as the data softens enough to re-establish confidence.

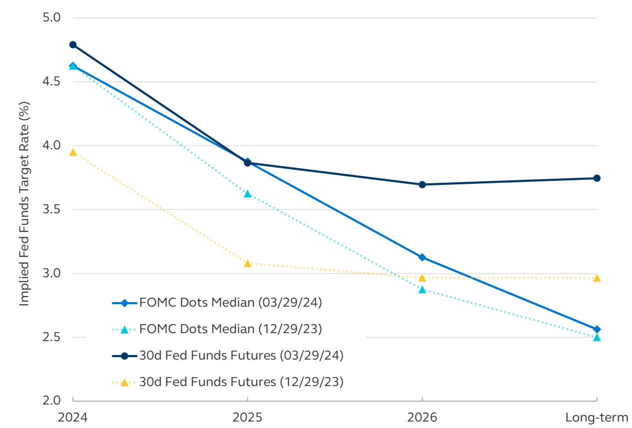
Currently, we are of the view that reignition of inflationary pressures and subsequent rate hikes are a tail risk. Furthermore, we believe that Fed policy is restrictive although we question how restrictive based on the continued strength in the data. Broad measures of financial condition have steadily eased since last March's regional banking crisis and the most recent Senior Loan Officers Survey reported banks tightening less than previously for C&I loans. Therefore, a shallower path of policy rates is a more reasonable risk for the markets if data continues to be expansive.

U.S. Treasury Yield Curve



Source: Bloomberg

Fed Dots vs Market Expectations



Source: Bloomberg

Principal Morley

Principal Asset Management℠

Corporates

MARCH 31, 2024

Highlights

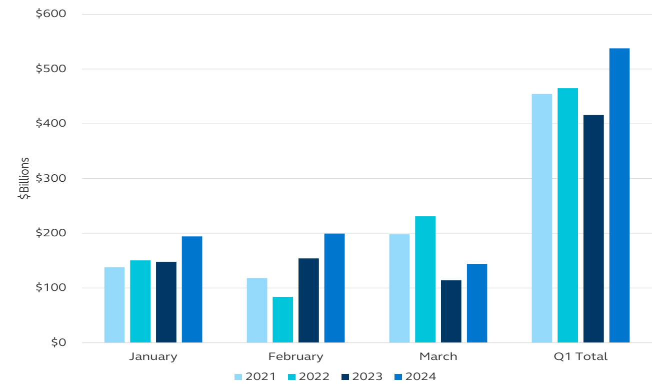
In the first quarter of 2024, the Bloomberg U.S. Intermediate Corporate Bond Index continued its strong momentum from the fourth quarter, with total and excess returns of 0.26% and 0.70%, respectively. Credit spreads continued to tighten from the previous spring's highs, reaching multi-year lows during the quarter. This momentum was fueled by optimism regarding a soft-landing scenario, solid corporate fundamentals, and investor appetite for attractive yield levels. Equity markets reached all-time highs during the quarter, even as hotter-than-expected inflation readings delayed the Federal Reserve's first anticipated rate cut to the summer.

Subdued rate and equity market volatility created an attractive funding environment for issuers, resulting in record January and February primary issuance. Despite being the second-highest gross supply quarter on record ($544B), investor demand effectively absorbed the influx, evidenced by high subscription levels and limited concessions. The issuance was primarily in the financial sector, with issuance volume so far year-to-date doubling that of 2023. Investment grade mutual funds have reported positive net inflows totaling $25 billion year-to-date, perpetuating the trend of strong inflows witnessed in 2023. From a fundamentals perspective, Q4 earnings results have demonstrated corporate resilience, even amidst tighter financial conditions and reduced consumer spending.

Outlook

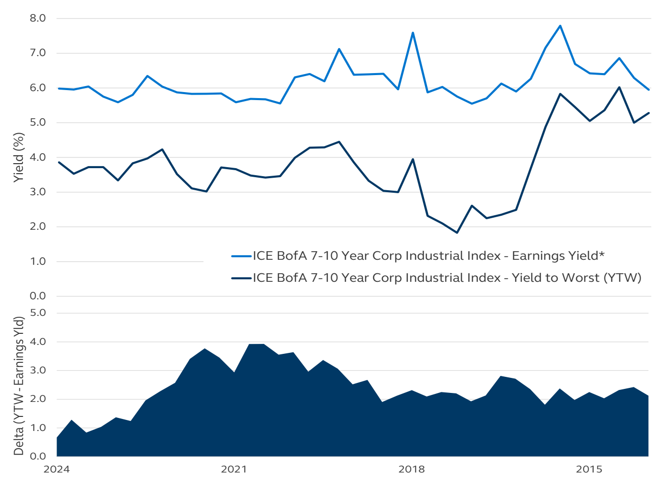
We maintain our constructive view of credit as the supportive macro-environment, stable credit fundamentals, and voracious demand continues. As of now, the risks appear to tilt towards a no-landing scenario with an extended higher-for-longer rate environment. Any spread widening would be modest due to a potential uptick in rate volatility and animal spirits. Although a higher-for-longer borrowing rate can be a modest headwind for credit fundamentals, presumably growing profits would mitigate the impact. Additionally, we are acutely focused on rising animal spirits from company management as the outlook brightens. In the most recent Conference Board Measure of CEO Confidence, the survey measure indicated the highest level of optimism since Q1 2022. In addition, the Bank of America Global Fund Manager Survey revealed that investors' desire for corporates to return cash to shareholders is at the highest level since Feb 2016. Currently, the relative attractiveness of levering up to fund share repurchases is modest, as corporate borrowing costs are still historically high. However, as greater confidence broadens and yields fall, we could see a subsequent re-leveraging.

Q1 IG Primary Gross Issuance



Source: Deutsche Bank

Corporate Earnings Yield vs Cost of Debt (YTW)



Source: Bloomberg. * Earnings yield applicable to the subset of publicly listed companies in the ICE BofA 7-10 Year Corporate Industrial Index, based on available financial data.

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Mortgage-Backed Securities (MBS)

MARCH 31, 2024

Perpetua Phillips
Portfolio Manager

MBS/ABS/CMBS

Highlights

The Bloomberg US MBS Index posted total and excess returns of -1.04% and -0.14%, respectively, during the first quarter, with a sharp divergence in excess returns between shorter WAM 15-years (+0.50%) and longer WAM 30-years (-0.20%). Resilient economic data and slower progress on the inflation front led rates markets to reprice into better alignment with the FOMC's higher-for-longer forecasts. The two-year Treasury yield rose by 37 bps during the quarter to close at 4.62%, while the 10-year yield rose by 32 bps to close at 4.20%. Rates volatility declined sharply in the latter part of the quarter and closed at the lowest level since the onset of the Fed's historic tightening cycle two years ago.

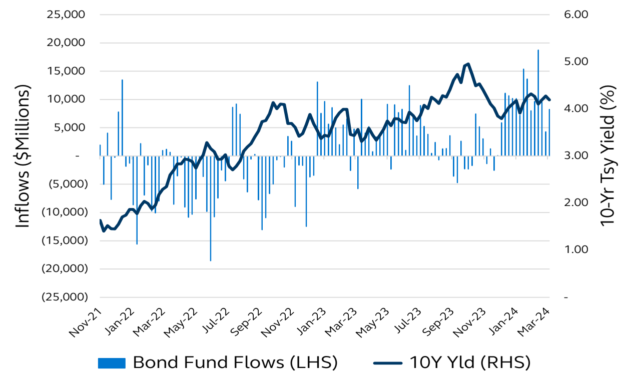
At their March meeting the FOMC left target rates unchanged at 5.25-5.50% and continued to signal three rate cuts later this year once they gain greater confidence that inflation is moving sustainably towards their 2% target. Chair Powell also indicated that the Committee expects to address the pace of balance sheet reduction at upcoming meetings, with the desire to eventually move to an all-Treasury, shorter maturity portfolio. Importantly for the MBS sector, this was deemed a longer-term goal and on a separate decision track from rates policy, making MBS sales unlikely in the near term.

MBS nominal spreads tracked rates volatility throughout the quarter, with the current coupon zero-volatility spread coming off a peak of +155 bps in February to close the period at +132 bps. The MOVE index declined throughout March, closing at the lowest level (86) since the Fed began rates liftoff in March 2022. Thirty-year mortgage rates remained in a stable 6.60% - 6.95% range during the quarter, keeping refinancing activity low in conventionals, though Ginnie Mae speeds surprised to the upside. MBS origination remained muted with gross and net issuance at $214B and $26B, respectively, during the quarter.

Outlook

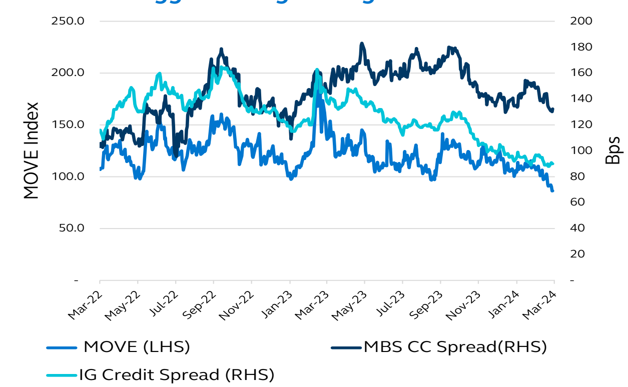
The combination of higher rates, lower volatility and attractive nominal spreads have created a favorable backdrop for MBS carry, particularly in higher coupons. Additionally, the ongoing outperformance of credit-sensitive fixed income sectors driven by the soft-landing thesis has left MBS relatively more attractive as a hedge against a weakening economy. Furthermore, aggregate fixed income flows are expected to remain positive as the Fed reduces policy rates, which should support MBS demand given high fund allocations to the sector. Bank demand for MBS also started the year strong at around $40B, after a nearly two-year hiatus in bank buying and could rebound further as final Basel III capital requirements are expected to be less onerous than originally proposed. Finally, both bank and foreign demand for MBS should benefit from a wind down of QT, as volatility and mark-to-market concerns ease.

Taxable bond fund & ETF flows rebounded in the first quarter as rates stabilized



Source: ICI, Bloomberg

MBS nominal spreads declined with rates volatility but lagged the tightening in IG credit



Source: Bloomberg

The sector still faces several challenges ahead, however. First, money manager overweights to MBS are near historical highs and increased origination supply from declining rates would need to be absorbed elsewhere. Second, the pace at which banks added MBS in the first quarter may not be sustainable enough to support current spread levels, which have moved closer to fair value. Third, the Fed is expected to begin reinvesting paydowns on their MBS holdings into Treasuries as soon as June, which is a modest negative for the basis. Fourth, investors will likely continue to favor credit sectors if the economy remains resilient. Finally, the outcome of the November elections could reopen GSE reform initiatives and reintroduce uncertainty around government backing for UMBS. We view these risks as manageable and believe the stable cashflows and attractive carry MBS offer longer term investors makes it well suited for our stable value portfolios.

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Asset-Backed Securities (ABS)

MARCH 31, 2024

Highlights

The Bloomberg AAA Asset Backed Securities (ABS) Index gained 0.59% and outperformed like-duration Treasuries by 47 basis points during the first quarter. After the sharp year-end Treasury rally, investors scaled back their expectations for interest rate cuts during the first quarter of 2024 in response to better-than-expected U.S. economic data. The economy expanded at a robust 3.4% annualized rate in the fourth quarter of 2023, buoyed by strong consumer spending. Economic performance was also supported by the continued strength of the labor market, with the U.S. adding an average of 265,000 jobs each of the past three months. In addition, inflation data contributed to the downward revision of rate cut expectations. The February CPI report indicated a modest increase in inflation as headline CPI rose 0.4% month-over-month (m/m) and 3.2% year-over-year (y/y). However, core PCE, the Federal Reserve (Fed)'s preferred inflation measure, slowed to 0.3% m/m, and to 2.8% y/y, aligning with expectations and suggesting inflation remains on a gradually declining path. At its March meeting, the Fed announced its intention to wait for a few more months of data before changing policy, and left rates unchanged at a range of 5.25% to 5.50%. However, the Fed continued to signal three rate cuts of 25 basis points each in 2024.

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, 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. Per capita credit card debt, already at a record high, continues to rise, and many 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 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.

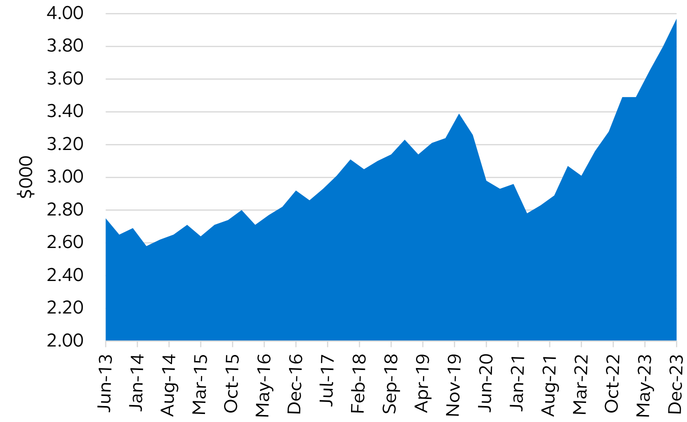
Heavy new issuance has been met with strong demand, which resulted in AAA ABS spreads moving tighter this quarter. First quarter supply totaled $89 billion compared to $57 billion for the first quarter of 2023, a 58% increase year-over-year.

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.

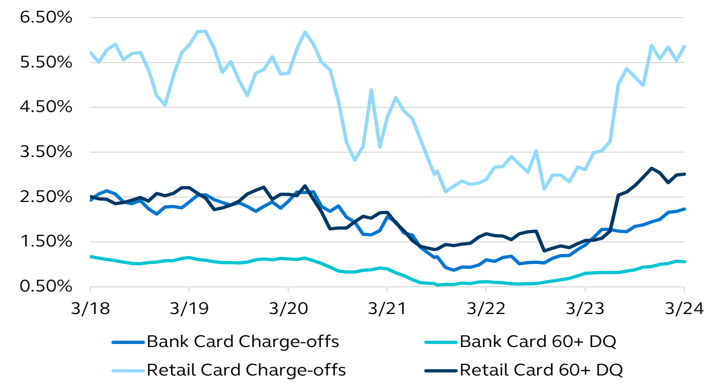
ABS fundamentals remain on solid footing, supported by low unemployment levels and tighter lending standards in recent years to offset inflated credit scores from COVID stimulus. Although consumers are facing headwinds and delinquency rates are rising from low levels, ABS structures have proven their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

Per capita credit card debt is at a record high



Source: FRBNY

Credit card delinquencies and chargeoffs have reached or exceeded pre-pandemic levels



Source: JP Morgan

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Commercial Mortgage-Backed Securities (CMBS)

MARCH 31, 2024

Highlights

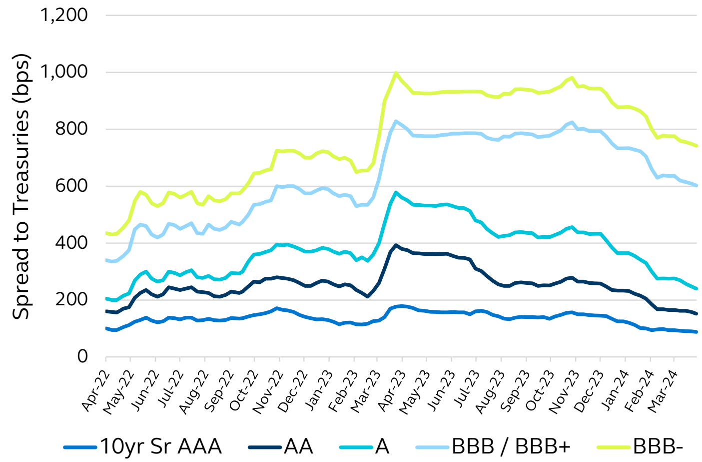
The Bloomberg AAA Commercial Mortgage-Backed Securities (CMBS) Index posted total and excess returns of 0.67% and 1.20%, respectively, during the first quarter. The themes during the quarter centered around changing market expectations for potential future Fed rate cuts, stronger than expected performance of the economy and the debate on whether a recession is still expected in 2024. Market expectations that the Fed would cut rates six times during the year were reduced to three cuts during the quarter as growth in jobs and GDP reinforced the continued strength of the economy and diminishing probability of a recession. Even as the market started to bring down rate cut expectations, the strength of the economy resulted in equity markets rallying and credit spreads tightening, with CMBS dramatically outperforming corporate bonds. During the period the 10-year Treasury yield increased 0.32% to end the quarter at 4.20%. AAA CMBS spreads ended the first quarter 37bps tighter, AA spreads 81bps tighter, A spreads 125bps tighter and BBB spreads 130bps tighter.

New issue activity increased during the quarter driven by higher SASB issuance. Both conduit and SASB issuance was met with strong demand. The $17.8B of private label issuance, during the first quarter, was up 39% from fourth quarter 2023 and up 198% from first quarter 2023. Private label conduit issuance during the quarter was $5.7B compared to fourth quarter 2023 of $5.7B and first quarter 2023 of 3.3B. Private label SASB issuance was $12.2B compared to fourth quarter 2023 of $7.1B and first quarter 2023 of $2.7B. Secondary market activity remained steady during the quarter.

Outlook

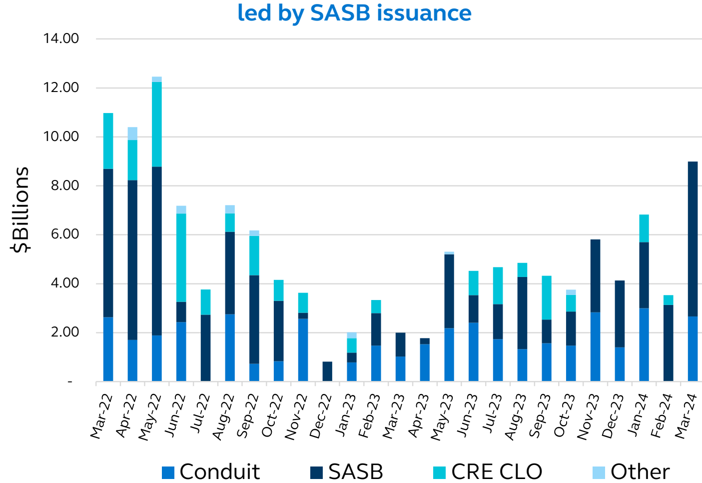
The outlook for CMBS remains primarily focused on refinancing loans that mature in 2024, the depth of a potential recession, the path of interest rates and longer-term office loan fundamentals. The real test for the market will be how well 2.0 CMBS underwriting holds up with property level incomes under 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.

Credit spreads rallied sharply down the capital stack on optimism the US economy will avoid a recession



Source: JP Morgan

New issue activity increased during the quarter, led by SASB issuance



Source: JP Morgan

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Important Information

MARCH 31, 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).

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