For Public Distribution in the U.S. For Institutional, Professional, Qualified and/or Wholesale Investor Use Only in other Permitted Jurisdictions as defined by local laws and regulations.

Principal Asset Management℠

Principal Morley

Interest rate strategy

SEPTEMBER 30, 2023

DAN KANG, CFA
Portfolio Manager

Rates/Corporates

Highlights

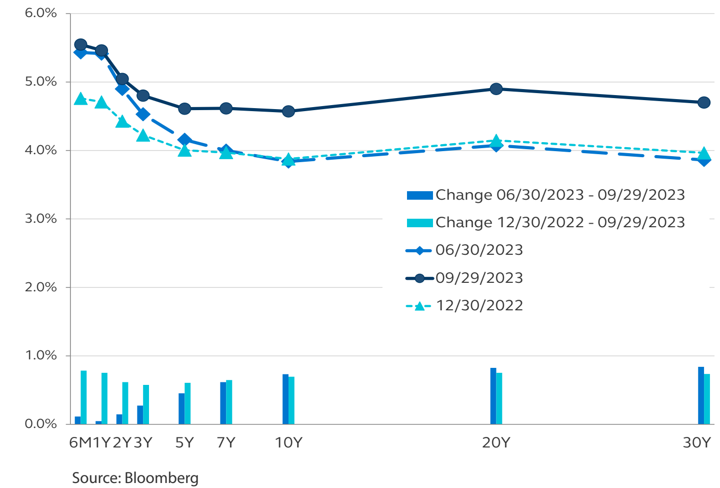
During the third quarter, the yield curve bear-steepened, with increased concerns around anticipated treasury coupon supply to fund larger U.S. fiscal deficits. Continued resilient economic data, Fitch's downgrade of U.S. sovereign ratings, ongoing balance sheet reduction under QT, and the potential shift in Bank of Japan's accommodative policies have led to questions on where the demand will be for this additional supply. With most of the expected supply coming from longer-dated coupons versus bills, Treasury yield curves bear-steepened with the U.S. 10-year Treasury rising 73 bps over the quarter. Given the jitters regarding the future supply/demand dynamic, term premiums increased significantly at the end of the quarter. The NY Fed's model of estimated 10-year term premia turned positive at the end of the quarter.

The Federal Reserve (Fed) left rates unchanged at their latest September meeting, leaving the range at 5.25% - 5.50%. Fed officials continue to insist on keeping rates "higher for longer" and leaving the option for additional hikes at the end of the year. Aggregate demand, led by a consumer still willing and able to spend, surprised to the upside during the summer months with experiential consumption driving activity. With the continued resilience and underlying momentum in the economy, the Fed's latest Summary of Economic Projections (SEP) upgraded its GDP forecasts and saw the median dot for the Federal Funds Rate at 5.1% by year-end 2024 which took two 25 bps cuts away from the previous forecast.

Outlook

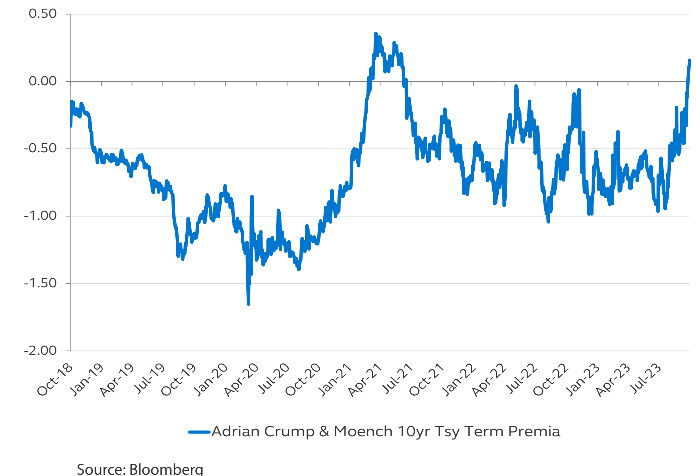
The near-term focus will continue to be on data releases which will determine whether a November/December hike will be implemented. Recently, the market discussion has transitioned from what peak policy rates will be to how long the FOMC will maintain its restrictive stance. Over the summer, Powell must have been pleased with the disinflationary trend and resilient labor market that led to the dominant soft-landing narrative. However, we highlight the risk of the disinflationary path stalling and possibly reversing over the course of the next quarter. Rising oil prices from OPEC curtailing supply, the nascent recovery in housing prices, and potential disruption from UAW strikes on automobile supply all could reverse the current inflationary path. These supply driven factors would be problematic for the FOMC as they are generally outside the control of their policy levers. Demand headwinds are anticipated as excess savings continue to dwindle, student loans repayments resume, and retail gasoline prices spike upwards.

U.S. Treasury Yield Curve



Source: Bloomberg

NY Fed 10-yr Term Premia



Source: Bloomberg

Principal Morley

Principal Asset Management℠

Corporates

SEPTEMBER 30, 2023

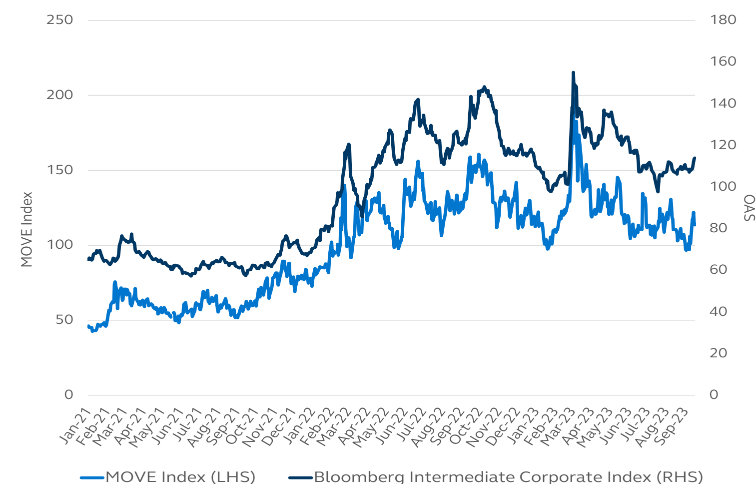
Highlights

During the third quarter, Investment Grade (IG) credit spreads remained resilient relative to other asset classes, as elevated yields amid the selloff in U.S. Treasuries drove demand for IG credit. The Bloomberg U.S. Intermediate Corporate Bond Index delivered a total return of -0.96% with an excess return of 0.12% for the period as U.S. Treasury yields rose. While U.S. Treasury yields rose and credit spreads leaked wider during the quarter, the sectors attractive yields drove demand for corporate bonds. The index's option-adjusted spread (OAS) widened from 109 bps to 115 bps (+6 bps) in Q3 and was flat year-to-date, while the index yield to maturity reached 6% for the first time since 2009. Corporate spreads as a percent of yields were under 20% at quarter-end, near the lowest point over the last year. Although interest rate volatility according to the MOVE Index has been trending lower from the March highs, the recent rise in volatility coincided with spreads resetting marginally higher.

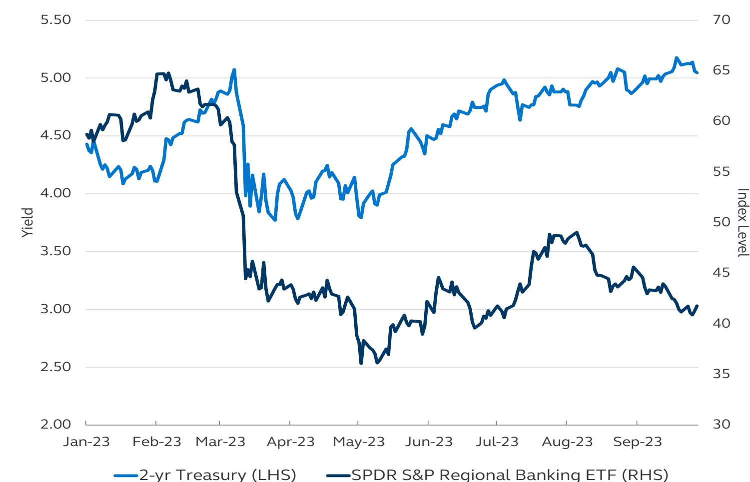
Despite the uptick in volatility, market technicals have been broadly favorable. Historically attractive all-in yields of the sector and the relative risk premium to other asset classes has spurred demand for IG corporate bonds from retail, pension, and overseas investors. At the same time supply has been tracking below last year's levels by -3% at $995bn, despite a strong first half of issuance. Meanwhile, the fundamental picture has been resilient in the face of tightening credit conditions, with U.S. economic strength leading to better-than-expected Q2 corporate earnings and minimal downward guidance from companies.

Outlook

With near term economic momentum still solid, expectations of an economic downturn have been pushed further out. Therefore, near term performance of the sector will be driven by macro/rate volatility and the technicals of the IG credit market. After peaking in March, rate volatility has trended downward. However, increased uncertainty on the path of Fed policy and the introduction of a term premium has reversed that trend recently. Geopolitical shocks and turmoil in Washington all add to the volatile macro environment. Alternatively, the technical dynamic continues to be supportive of the sector, as yield based buyers feast on the higher yields currently available, while conversely corporate treasurers seek to lower issuance as their cost of capital rises. The implication for the credit market continues to be a relatively narrower range for spreads until more significant evidence of economic deterioration emerges. Corporate fundamentals have modestly worsened outside of a few select sectors and we look for more color to come from the upcoming earnings season. One sector of renewed focus is the regional bank space as the "higher for longer" narrative has significant implications for deposit funding and commercial real estate exposures. Also, the uncertain path for UAW strikes have us keeping tabs on the largest automakers. Finally, the state of the consumer will be of interest as the upside summer spending spree faces the reality of less excess savings and a resumption of student loan payments as we move into the latter part of the year.



Source: Bloomberg



Source: Bloomberg

Principal Asset Management℠

Mortgage-Backed Securities (MBS)

SEPTEMBER 30, 2023

Perpetua Phillips
Portfolio Manager

MBS/ABS/CMBS

Highlights

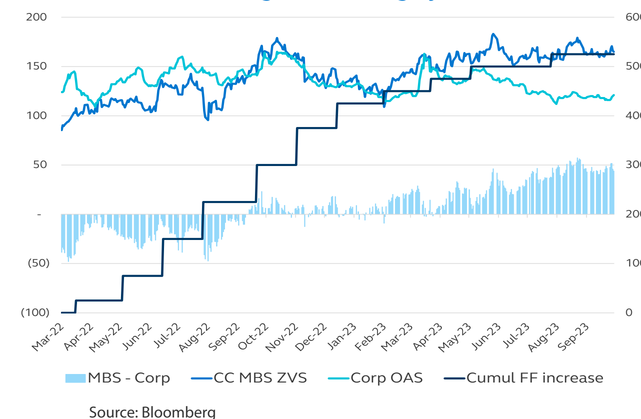
The Bloomberg U.S. MBS Index posted total and excess returns of -4.05% and -0.85%, respectively, during the third quarter. A combination of persistent inflation and resilient economic data reinforced hawkish central bank policy. The higher for longer messaging drove a sharp repricing in term premiums out the curve, with the five-year U.S. Treasury yield rising by 45 bps and the ten-year yield rising by 73 bps. By comparison, the two-year yield rose by just 15 bps.

The Federal Reserve raised its policy rate by 25 bps in July to 5.25-5.50% but opted to pause at their September meeting. The median dot plot projections were more hawkish, however, indicating one more rate hike in 2023 and two fewer rate cuts next year than their previous estimates in June. That elevated the year-end 2024 projected Fed Funds rate to 5.125% and caused longer duration assets, including MBS, to underperform.

Thirty-year mortgage rates climbed to a multi-decade high of over 7.5% by the end of the quarter. By comparison, the average rate on outstanding mortgages is just 3.6%, creating a lock-in effect that has throttled housing market activity. With limited refinancings and turnover speeds falling below 4% CPR, the duration of the MBS fixed rate index extended to a record 6.4 years. This long duration profile proved challenging as investors sought out higher yields at the front end of the curve.

The technical backdrop for MBS remained negative as the Fed continued to reduce their MBS balance sheet by $15-20B/month and banks remained mostly sidelined. This left money managers as the marginal bid to absorb the lion's share of both originator supply and remaining FDIC sales. MBS valuations continued to cheapen despite manager overweights to the sector swelling to record highs. Nominal and option-adjusted spreads to Treasuries widened by 15 bps during the quarter to close at +97 bps and +66 bps, respectively.

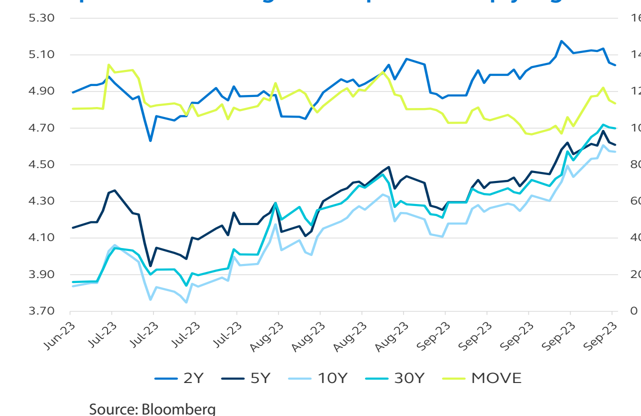
MBS valuations have cheapened vs IG credit through this hiking cycle



Outlook

The MBS sector's performance correlation with rates and volatility has kept it under pressure since Fed liftoff 18 months ago. The magnitude and pace of this hiking cycle is unprecedented and has had an outsized impact on the sector. Headwinds from surging rates and volatility were compounded by poor supply and demand technicals. Bank and foreign demand, which is sensitive to mark-to-market losses, have been waiting out this hiking cycle while nearly $80B in incremental FDIC supply further cheapened MBS valuations relative to other fixed income sectors, particularly IG credit.

Short rates and volatility remained elevated over the quarter while long rates repriced sharply higher



We expect the aforementioned headwinds to become tailwinds for performance in the coming quarters. Inflation should continue to moderate while the cumulative effects of higher rates and tighter credit conditions should slow the economy and increase the odds of a recession. The Fed appears to be nearing the end of this historic tightening cycle and with that, volatility should retreat to more normal levels, reducing option costs and providing a more favorable backdrop for the return of bank and foreign demand. FDIC pool liquidations have been concluded and mortgage origination is expected to dwindle through the rest of the year. MBS valuations are at historically cheap levels. In short, the sector is poised for a strong rebound after one of the most challenging periods in its history.

Principal Asset Management℠

Asset-Backed Securities (ABS)

SEPTEMBER 30, 2023

Highlights

The Bloomberg AAA Asset Backed Securities (ABS) Index posted total and excess returns of 0.15% and 0.28%, respectively, during the third quarter. Index outperformance was primarily driven by July returns as market volatility increased during the third quarter. Persistent inflation, combined with resilient economic data, caused the market to adjust expectations for future central bank actions and higher oil prices led to increased concern that inflation may pose a greater challenge for the Federal Reserve (Fed) as it nears the end of its hiking cycle. The Fed raised its policy rate by 0.25% in July, as expected, but left the range unchanged at 5.25% - 5.50% at its September meeting. Additionally, the Fed released a new dot plot that projects its policy rate to end 2024 and 2025 0.50% higher than it previously anticipated. The view that central bank policy rates will remain higher for longer led to heightened interest rate volatility and a sell-off in longer term bonds.

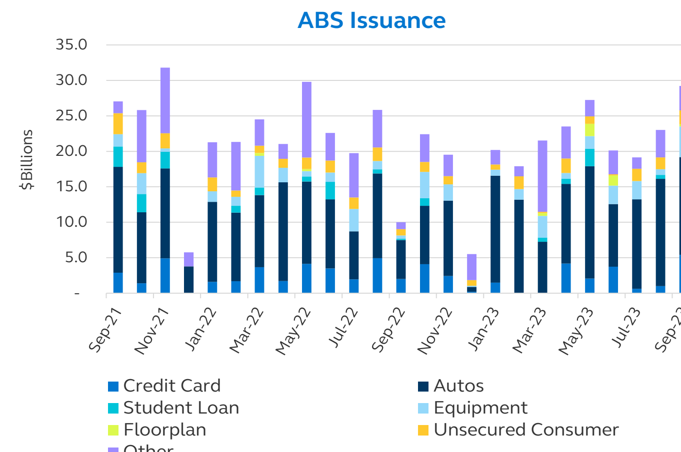
Both the unemployment rate and new jobless claims in the U.S. remain near pre-COVID lows. Hiring remains resilient, particularly due to manufacturing reshoring as companies seek to reduce their vulnerability to supply chain disruptions. ABS fundamentals remain on solid footing, supported by low unemployment levels. Although consumers are facing headwinds and delinquency rates are rising from low levels, ABS structures have proven their resilience through multiple economic cycles.

ABS new issuance totaled $71bn in the third quarter compared to $56bn for the same period in 2022. On a year-to-date basis, $202bn has been issued in 2023 compared to $196bn for the first three quarters of 2022. New issue prime auto loan ABS continues to drive primary supply and 2023 is on track to be the busiest year for prime auto ABS since the Global Financial Crisis. The $54bn of prime auto ABS originated YTD already exceeds the full-year total of $50bn for 2022. This has resulted in spread widening during recent months as investors digest heavy supply.

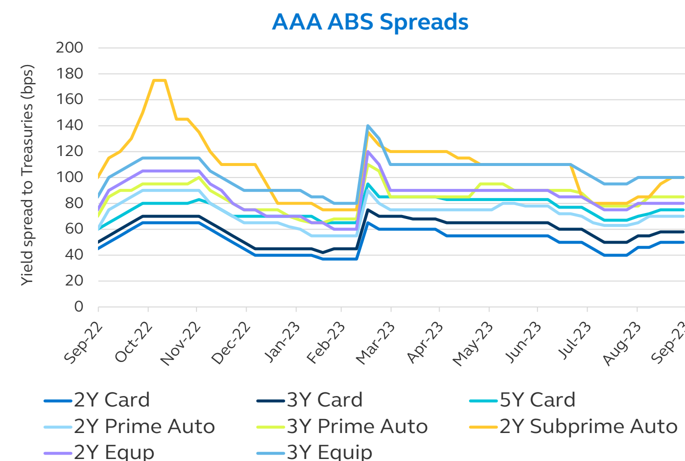
Outlook

High quality, short duration consumer ABS remain a compelling opportunity for investors, as robust supply and high benchmark rates have helped keep ABS spreads relatively wide and yields elevated. Prime auto ABS issuance is also expected to remain elevated with banks and credit unions continuing to optimize their balance sheets.

Broad measures of consumer and labor market conditions have shown resilience. However, we maintain an up-in-quality bias as lower credit quality borrowers have seen worsening delinquencies and defaults. This trend has moderated but continues to deteriorate now that the favorable seasonal impact from tax refunds has faded. The resumption of Federal student loan payments in October will add further stress, although the gradual on-ramp and expanded income driven repayment options have likely taken the worst outcomes off the table.



Source: JP Morgan



Source: JP Morgan

Commercial Mortgage-Backed Securities (CMBS)

SEPTEMBER 30, 2023

Highlights

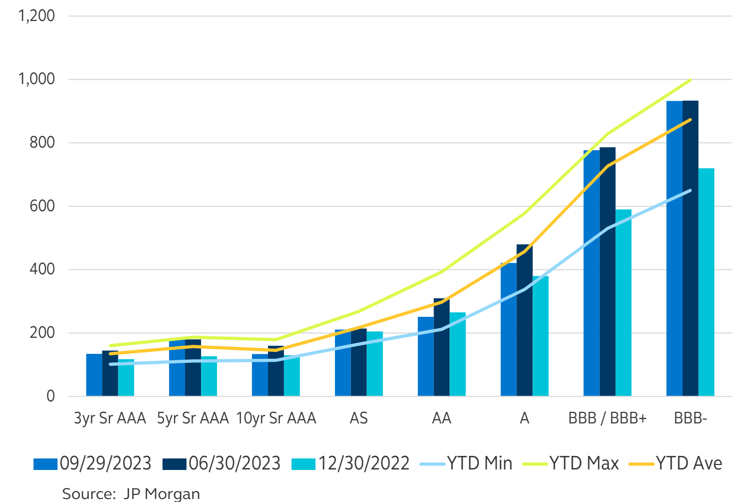
The Bloomberg AAA Commercial Mortgage-Backed Securities (CMBS) Index posted total and excess returns of -0.95% and 0.32%, respectively, during the third quarter. During the quarter, the consistent market risk themes of interest rate volatility, current and future monetary policy expectations and recession fears were magnified by Chair Powell's message that interest rates would be higher for longer at the Jackson Hole economic symposium at the end of August. The combination of higher rates, looming recession, softening office demand and banks tightening lending standards has kept commercial real estate, and especially refinancing loans that are maturing in the next 6-12 months, at the forefront of the market. The CMBS market did continue the relief rally that started with regional banks stabilizing after the crisis in March and has continued as the economy proves more resilient in the face of higher rates. As a result, AAA spreads ended the third quarter 26bps tighter, AA spreads 59bps tighter and A and BBB spreads 9bps tighter.

New issue activity moderated during the quarter for both conduit and SASB issuance. The $9B of private label issuance, during the third quarter, was down 15% from second quarter 2023 and down 32% from third quarter of 2022. Private label conduit issuance during the quarter was $4.6B compared to second quarter 2023 of $6.1B and third quarter 2022 of $3.5B. Private label SASB issuance was $4.4B compared to second quarter 2023 of $4.4B and third quarter 2022 of $9.7B. The YTD conduit issuance of $14B compares to $20B for the first three quarters of 2022 and YTD SASB issuance of $11.5B compares to the $42.6B in 2022. The secondary CMBS market slowed during the holiday summer months but picked up after Labor Day with strong two-way trading.

Outlook

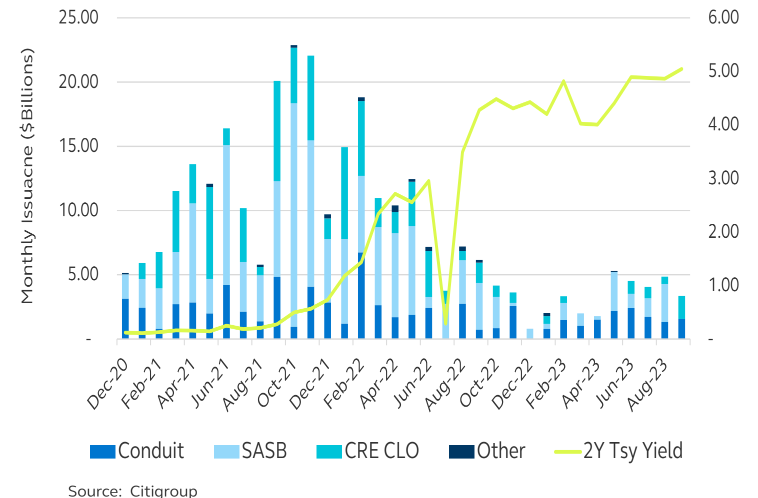
The outlook for CMBS remains primarily focused on refinancing loans maturing in 2023 and 2024, the depth of a potential recession in 2024 and longer-term office loan fundamentals. The real test for the market will be how well 2.0 CMBS underwriting holds up with property level incomes under pressure, 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.

CMBS conduit spreads have held in well at top of capital stack but lower rated tranches continue to reflect weaker CRE fundamentals



Source: JP Morgan

CRE transaction volume and CMBS issuance have declined sharply following the surge in borrowing costs since Fed liftoff



Source: Citigroup

Principal Asset Management℠

Important Information

SEPTEMBER 30, 2023

Past performance is no guarantee of future results. Investing involves risk, including possible loss of principal. Fixed Income investments are subject to interest rate risk; when interest rates rise, the price of debt typically declines. Fixed-income investment options that invest in mortgage securities, such as commercial mortgage-backed securities, are subject to increased risk due to real estate exposure. Lower-rated securities are subject to additional credit and default risks.

The financial market outlook is based on current market conditions. There is no assurance that such events or projections will occur, and actual conditions may be significantly different than that shown here.

This material covers general information only and does not take account of any investor's investment objectives or financial situation and should not be construed as specific investment advice, a recommendation, or be relied on in any way as a guarantee, promise, forecast or prediction of future events regarding an investment or the markets in general. The opinions and predictions expressed are subject to change without prior notice. The information presented has been derived from sources believed to be accurate; however, we do not independently verify or guarantee its accuracy or validity. Any reference to a specific investment or security does not constitute a recommendation to buy, sell, or hold such investment or security, nor an indication that the investment manager or its affiliates has recommended a specific security for any client account. Subject to any contrary provisions of applicable law, the investment manager and its affiliates, and their officers, directors, employees, agents, disclaim any express or implied warranty of reliability or accuracy and any responsibility arising in any way (including by reason of negligence) for errors or omissions in the information or data provided.

All figures shown in this document are in U.S. dollars unless otherwise noted.

This material may contain "forward-looking" information that is not purely historical in nature. Such information may include, among other things, projections and forecasts or returns. There is no guarantee that any forecasts made will come to pass. Reliance upon information in this material is at the sole discretion of the viewer.

Market indices have been provided for comparison purposes only. They are unmanaged and do not reflect any fees or expenses. Individuals cannot invest directly in an index.

This document is issued in The United States by Principal Global Investors, LLC, which is regulated by the U.S. Securities and Exchange Commission.

Principal Asset Management℠ is a trade name of Principal Global Investors, LLC. Principal Morley is an investment team within Principal Global Investors. Principal Global Investors is a member of the Principal Financial Group®, Des Moines, Iowa 50392.

Principal Global Investors, LLC (PGI) is registered with the U.S. Commodity Futures Trading Commission (CFTC) as a commodity trading advisor (CTA), a commodity pool operator (CPO) and is a member of the National Futures Association (NFA). PGI advises qualified eligible persons (QEPs) under CFTC Regulation 4.7.

© 2023 Principal Financial Services, Inc. Principal®, Principal Financial Group®, Principal Asset Management, and Principal and the logomark design are registered trademarks and service marks of Principal Financial Services, Inc., a Principal Financial Group company, in various countries around the world and may be used only with the permission of Principal Financial Services, Inc.

Index descriptions:
The Bloomberg U.S. Corporate Investment Grade Index is a component of the Bloomberg U.S. Credit Index which includes publicly issued U.S. corporate and foreign debentures and secured notes that meet specified maturity, liquidity, and quality requirements within the Bloomberg U.S. Aggregate Index.

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.

For Public Distribution in the U.S.
For Institutional, Professional, Qualified and/or Wholesale Investor Use Only in other Permitted Jurisdictions as defined by local laws and regulations.

Visit us online at ***www.morley.com*** *for the most recent market updates, Insights and Perspectives.*

3190121 -022024