

THIRD QUARTER 2024

Fixed income perspectives

The outlook, themes, and investment implications for global fixed income markets

Looking ahead: A resilient U.S. economy is keeping rate cuts on hold...for now

Despite policy rate cuts remaining elusive, several tailwinds are boosting a resilient U.S. economy. And while the Federal Reserve (Fed) continues to navigate a potential soft landing, global central banks are actively transitioning onto a path of easing policy.

1. Going into 3Q, there is less uniformity in the path forward among central banks; the European Central Bank and the Bank of England are guiding for more rate cuts this year, while rate cuts in the U.S. continue to be delayed and decreased.
2. A healthy labor market and resilient consumer have been the most significant part of the U.S. economy propping up growth and prices. However, those components are starting to show signs of cooling, a potential indicator of a more substantial slowdown.
3. Ahead of likely election-related volatility, many fixed income asset classes are poised for potential outperformance heading into the second half of the year.

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Perspectives from the CIO



MICHAEL GOOSAY
Chief Investment Officer,
Fixed Income

Today's economic backdrop offers everything that a fixed income investor could traditionally ask for: positive but moderating economic growth, easing inflation pressures, and a Federal Reserve on the verge of a new rate cutting cycle. Of course, prospects for the asset class were more attractive earlier this year when the market was pricing in multiple rate cuts, and potential duration gains looked significant. However, fixed income has handled the significant repricing in rate expectations well, helped by continued macro resilience and yields sitting near the top end of their range over the past two decades.

The main concern for the asset class is the narrowness of credit spreads. Currently, spreads are near the tight end of their long-term range, and with an economy that is no longer accelerating, further narrowing is unlikely to boost returns. However, a benign economic outlook and strong corporate balance sheets suggest solid fundamentals will persist. This makes a widespread rise in defaults unlikely, and significant widening of spreads improbable.

With that in mind, carry continues to be king. In investment grade credit, the compelling yields continue to attract demand. Consider that, after nearly \$800B in issuance in the first five months of 2024—including a record first quarter—investor receptivity has remained strong for new bond deals as buyers, 60% of whom are yield-focused, seek out the higher yields of IG. At the same time, the higher credit quality of IG continues to be a strong pull factor, particularly as economic activity is showing clearer signs of moderation.

In high yield credit, too, it is yield that matters. Even though spread levels are important, the starting yield, not the starting spread, is the more powerful gauge of HY's attractiveness. The asset class continues to be positioned to deliver long-term returns at these yield levels. And while the looming maturity wall still startles some investors, it should be very manageable for most issuers, helped by the higher quality tilt of the asset class and the prospect of lower rates as the Fed starts to ease monetary policy.

There remain many other income-focused opportunities across the credit spectrum. Municipals offer longer, attractive, tax-free yields, while their defensive attributes and longer-duration profiles are set to benefit from the macro environment of slowing growth and rate cuts. Emerging markets, although challenged of late by more hawkish Fed pricing, continue to draw interest due to their elevated yields, while recent political volatility is presenting interesting opportunities for investors.

That is not to say economic risks are absent in today's fixed income market. Rather, our outlook for the remainder of 2024 is for a sanguine U.S. economy that offers attractive yields and the potential for duration gains as the Fed normalizes rates.

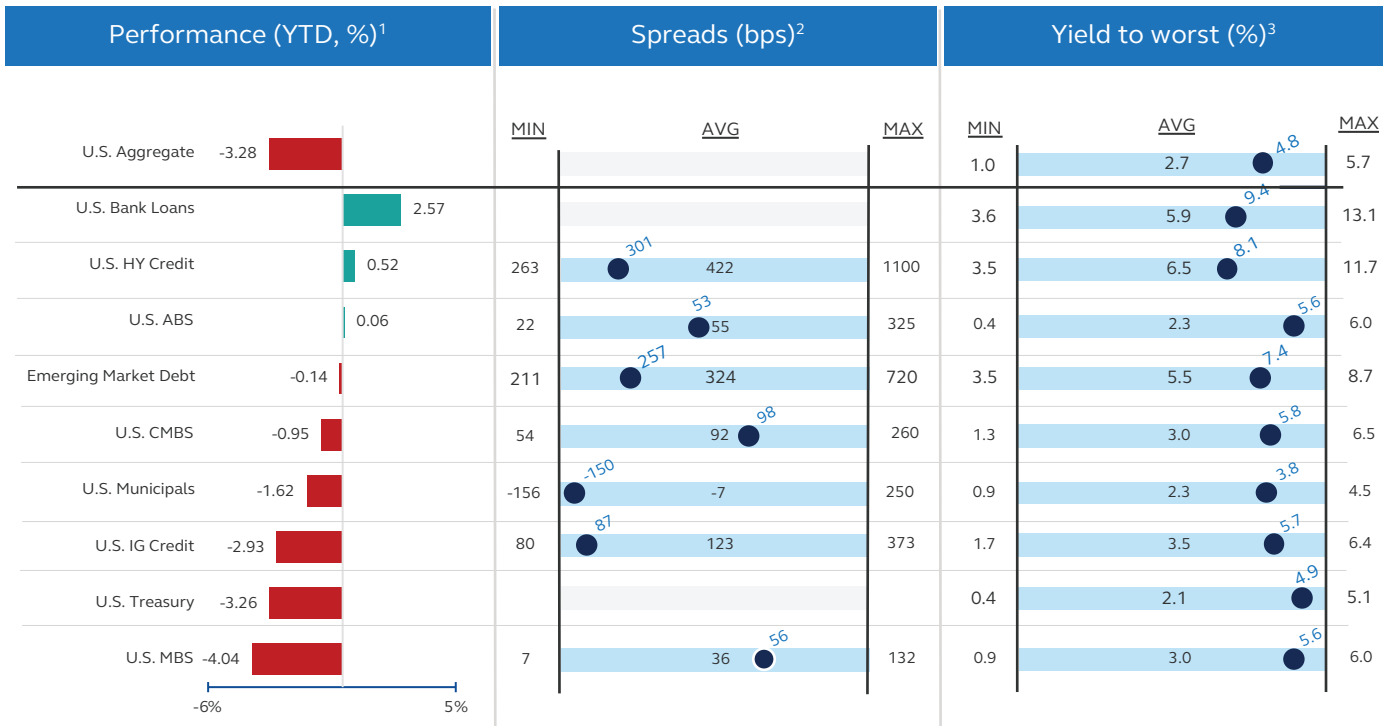
In light of these dynamics, our *3Q24 Fixed Income Perspectives* offers a comprehensive view of the current market landscape and the opportunities it presents. Thank you for your continued support and trust in our fixed income expertise. We are committed to providing you with unique insights and perspectives to help you navigate the evolving market landscape.

U.S. outlook

The combination of a resilient U.S. economy, improving inflation, attractive starting yields, and the potential for Federal Reserve (Fed) rate cuts presents a healthy backdrop for fixed income. After suffering two years of severe headwinds due to low starting yields and aggressive Fed hiking, the Bloomberg Aggregate Bond Index now offers yields near the top end of its range from the past two decades. Spreads, however, are not as attractive from a historical perspective; in most fixed income sectors, spreads are near the tight end of their long-term range.

Market environment

Year-to-date performance, spread, and yield for various fixed income indices



Source: Bloomberg. Data as of April 30, 2024. ¹Total returns for representative indices ²Spread to Treasury. Min, max and average based on last 10 years. ³Index yield to worst. Min, max and average based on last 10 years. Weighted average yield-to-maturity reflected for U.S. Bank Loans. Indices are unmanaged and do not take into account fees, expenses, and transaction costs and it is not possible to invest in an index. Indices used in order of appearance: Bloomberg U.S. Aggregate Index, S&P/LSTA (Loan Syndications and Trading Association) Leveraged Loan 100 Index, Bloomberg U.S. Corp HY 2% Issuer Capped Index, Bloomberg Asset-Backed Securities Index, J.P. Morgan EMBI Global Diversified Index, Bloomberg CMBS ERISA-Eligible Index, Bloomberg U.S. Municipal Bond Index, Bloomberg U.S. Credit Index, Bloomberg U.S. Treasury Index, Bloomberg U.S. MBS Index.

With consumer spending accounting for ~70% of the economy, robust and consistent expenditures have been a key driver of economic resilience. Several factors have been tailwinds for the consumer, including fiscal stimulus/deficit spending, excess savings from the pandemic, Social Security cost of living adjustments, positive real wages, stock market gains, and a strong labor market. However, there are increasingly signs of bifurcation within the consumer, specifically symptoms of stress appearing for lower income households. While still positive, real wages are moderating, and excess savings are largely depleted. Household non-mortgage interest payments have increased dramatically, while consumer delinquencies are also on the rise. This suggests that overall spending may moderate through the rest of the year but does not necessarily portend dramatic spread widening in credit sectors. A modest pullback in consumer spending would be beneficial for the demand side of the inflation equation, which would increase the probability of Fed rate cuts and may even support credit spreads. A more pronounced deterioration in the labor market is a key risk. While additional slowing in the labor market is anticipated, unemployment claims to date remain historically low, and payroll gains remain robust. Absent a more severe downturn in the labor market, our outlook for fixed income is positive given attractive yields and the potential for duration gains as the Fed normalizes rates.

Global outlook

Benign growth expectations meet cooling job markets

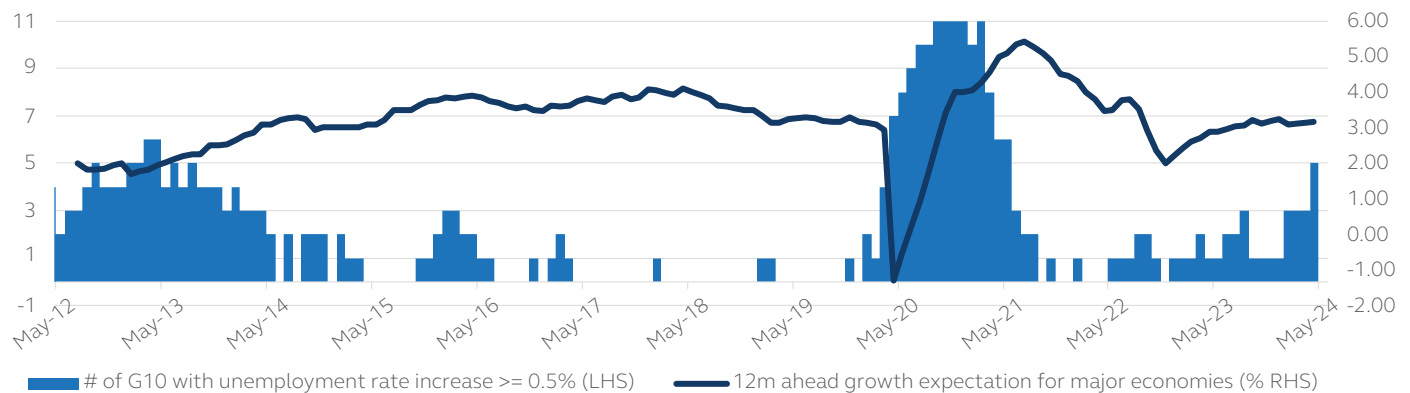
The theme of higher-for-longer policy rates continued to dominate market expectations in much of the second quarter, as growth data remained resilient and inflation data stayed sticky. The data swayed Federal Open Market Committee members to turn more cautious toward policy easing, leading to a very strong market reaction in April reminiscent of the 3Q 2023 move. To rein in market concerns, the Fed implemented the planned tapering of quantitative tightening to forestall a repeat of the liquidity shock experienced in 2019. At the same time, Fed Chairman Jerome Powell also pushed back on concerns that the Fed would need to hike again, noting considerable progress made in inflation and signs of a cooling labor market. On the other side of the Atlantic, both the European Central Bank (ECB) and the Bank of England (BoE) declared the independence of their respective monetary policies from the Fed—the ECB has already started cutting rates, and the BoE is likely to follow suit in the coming months. Our global policy outlook, which called for the commencement of the rate cutting cycle by major central banks, remains intact, though with fewer cuts than initially expected.

Given the lagged nature of policy transmission, last year's rate hikes are still working their way through the U.S. economy and will likely continue to do so even as rate cuts commence. However, the market has been more positive about the global growth outlook since 3Q 2022, when policy rates were deemed to have exited neutral territory and moved into a restrictive zone. This presents a remarkable divergence from the typical path of growth over the policy cycle. As is the case in the U.S., the most significant part of many global economies, holding up growth and prices, is the labor market. Looking across the major global economies, five out of 11 major industrialized countries have seen unemployment rates rising more than 0.5% above the cycle low, a recession indicator commonly known as the Sahm Rule. While the reliability of this indicator on a global scale remains to be seen, it illustrates a broad cooling in labor markets to levels last witnessed just before the pandemic. Given the stickier post-COVID labor market, there is good reason to believe that this may be the beginning of a more prolonged, albeit tempered, rise in the unemployment rate. Accordingly, there is significant scope for the market to re-align growth expectations toward the cooling labor market.

Finally, investors should be preparing for the potential market implications of the November U.S. presidential election. Historically, U.S. elections tend to focus on domestic issues, limiting U.S. attention and participation in new geopolitical hotspots. As such, the market may be more desensitized toward geopolitics leading up to the election compared to last year. In terms of monetary policy, the Fed has declared neutrality over the election. However, their window for policy adjustment may be narrowed to manage public perception. If polls swing strongly in favor of either candidate, the market may price in the anticipated winner's fiscal policy impact on growth and inflation for 2025.

Labor market vs. growth forecasts

May 2012 - present



Note: Major economies include Australia, Canada, Denmark, Eurozone, Japan, New Zealand, Norway, Sweden, Switzerland, United Kingdom, and United States. Source: Bloomberg, Principal Fixed Income. Data as of April 30, 2024.

Summary of investment implications

INVESTMENT GRADE CREDIT

Amid delayed monetary policy easing, investment-grade credit should continue to benefit from an attractive yield and a strong technical tailwind. Investors seeking to add yield without taking on undue risk should continue to favor high-grade corporate bonds.

HIGH YIELD CREDIT

In an environment of higher-for-longer policy rates, the argument for taking a longer-term approach to investing in the high yield asset class is amplified. Historically attractive starting yields help to more than offset unappealing credit spread entry points--particularly considering the strong fundamental picture and muted default expectations underlying the sector today.

SECURITIZED DEBT

Commercial mortgage-backed securities (CMBS): The positive news for the CMBS market is that there is not an immediate maturity wall, and loan maturities are quite balanced over the next two years. With AAA bonds more fairly priced, there is value in lower-rated bonds, especially in single-asset-single-borrower (SASB) deals.

MUNICIPALS

Whether inflation stays sticky, or a recession surfaces, high yield municipals should prosper due to their defensive attributes and longer-duration profiles. Investors can still today lock in longer, attractive tax-free yields.

EMERGING MARKET DEBT

A combination of positive fundamentals and technical factors has strengthened the emerging market debt sector. Developed market economic strength and expectations of U.S. rate cuts have provided a positive backdrop, while relatively benign emerging market sovereign fundamentals have lowered idiosyncratic macroeconomic risks.

PRIVATE CREDIT

Direct lending: Continued economic uncertainty and higher rates contribute to several supportive trends for middle market direct lending and an opportunity to enhance risk-adjusted returns relative to historic loan vintages.

Investment grade: Following an exceptionally busy June for investment-grade private placements, the market is likely to slow into the typically sluggish August issuance schedule before picking up in 4Q.

Investment grade credit

While monetary policy easing may be pushed back for now, recent dovish remarks by Fed Chairman Powell and softening pricing data form a firm macro environment for investment grade (IG) credit. Although the Fed is waiting for inflation to reach a sufficiently low level before cutting policy rates, the IG market appears content knowing that rate cuts are coming and are less concerned with the exact timing of the cuts. Meanwhile, the consumer-charged U.S. economy keeps growing in a way where neither inflation nor economic growth is too strong (or too weak) to alter the Fed’s course. As inflation diminishes from recent levels and the labor market continues to balance, the favorable window for IG should hold.

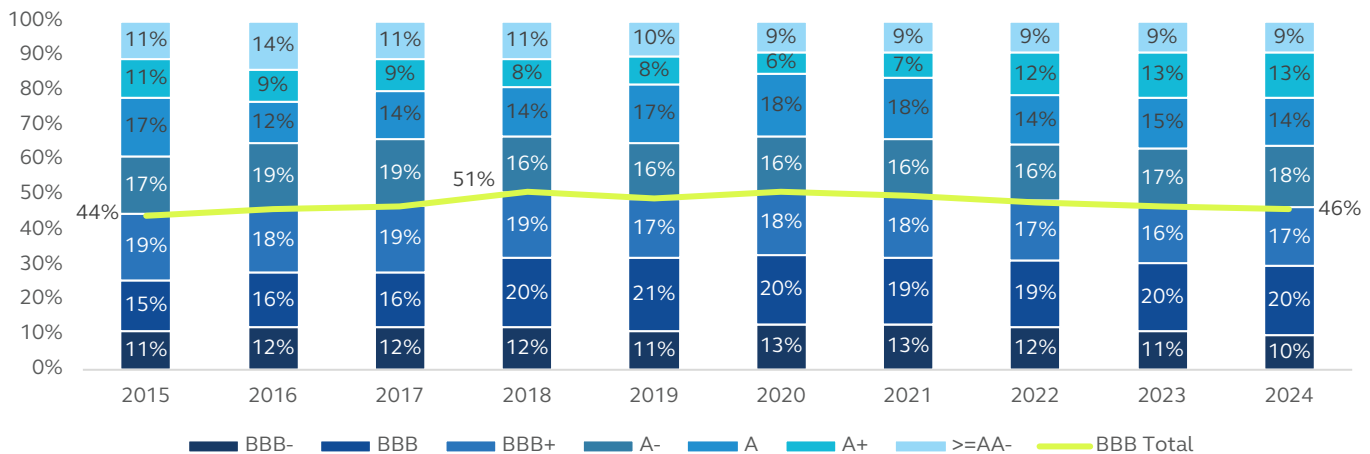
Despite tight valuations, IG’s compelling yield continues to attract demand. This strong technical factor, combined with the Fed outlook, serves to underpin IG credit. Furthermore, as demand remains robust, supply has responded. After nearly \$800B in issuance in the first five months of 2024— including a record first quarter— the pace of supply should start to moderate following frontloaded volume. Remarkably, investor receptivity has remained strong for new bond deals as buyers, 60% of whom are yield-focused, seek out the higher yields of IG.

Amid this backdrop, IG credit should benefit from attractive yields and a duration tailwind. With rates 500 basis points (bps) higher than at their trough, the income bonds provide is substantially higher now than a few years ago, while the Fed’s impending pivot promotes smooth sailing for duration-sensitive securities. As the Treasury yield curve normalizes, investors will look to extend duration, while some of the \$1 trillion that poured into money market funds will find a home “out the curve” in corporate bonds, supporting incumbent investors. As this transpires, shorter and intermediate-duration corporate bonds should be the first logical landing spot for demand as the market sets up for forthcoming Fed cuts. As the easing path becomes evident, investors will likely extend further on the yield curve, seeking longer-duration bonds.

Another factor supporting corporate bond demand centers on ratings quality, which has been slowly improving for the past five years with BBBs now almost half of the corporate bond index. While that portion is higher today than a decade ago, the positive trending upgrade/downgrade ratio and the surge in higher-rated issuance over the past two years have given the index a higher quality tilt.

Credit quality of investment grade corporate bond index

J.P. Morgan U.S. Liquid Investment Grade Corporate Index, 2015–present



Source: J.P. Morgan, Bloomberg, Principal Fixed Income. Data as of April 30, 2024.

Of the three factors we consider (fundamentals, technicals, and valuations), technicals remain the strongest driver of the IG market; it’s all about yield and moderating supply. Despite starting from a strong place, fundamentals have recently shown slight degradation. With record debt issued in 1Q, leverage ticked up on a gross and net basis as debt increased and companies spent cash faster. Still, fundamentals remain on strong footing, and solid 1Q earnings growth blunted some of that impact. To that end, earnings growth from the first quarter surprised to the upside, coming in at 9.8% year-on-year.

With valuations pinned at tight levels, credit picking and curve positioning remain key. Additionally, as strong technical factors remain in place, investors yearning for yield should continue to favor high-grade corporate bonds.

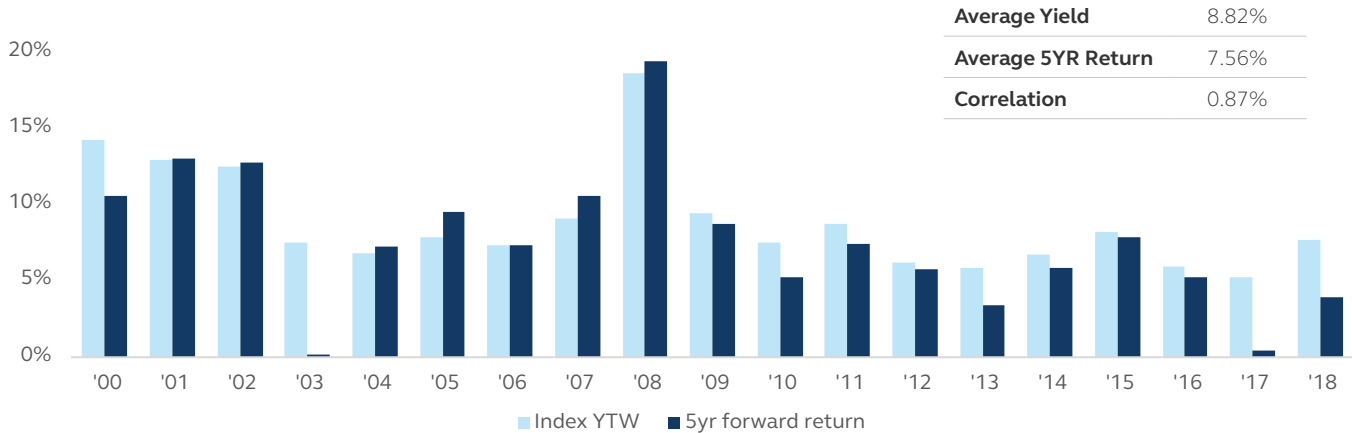
High yield credit

Never mind spread; it's yield that matters. Many investors look at credit spreads (the difference in yield between a security relative to a risk-free security with the same maturity) as the hallmark indicator for when to enter or exit credit markets. However, history suggests that tactically timing spread movements can be incredibly challenging, especially in high yield (HY) credit markets.

Though spread levels are important, we believe yield is a more powerful gauge of HY's attractiveness. When charting the asset class's starting yield against its corresponding five-year forward annualized returns, it produces a correlation of 0.87—higher than the correlation between the starting spread and corresponding five-year forward annualized returns. The substantial income produced by the yield should continue to deliver attractive returns in the asset class for investors.

High yield index yield and 5-year forward return comparison

Bloomberg U.S. Corporate High Yield Bond Index



Source: Bloomberg, Principal Fixed Income. Data as of April 30, 2024.

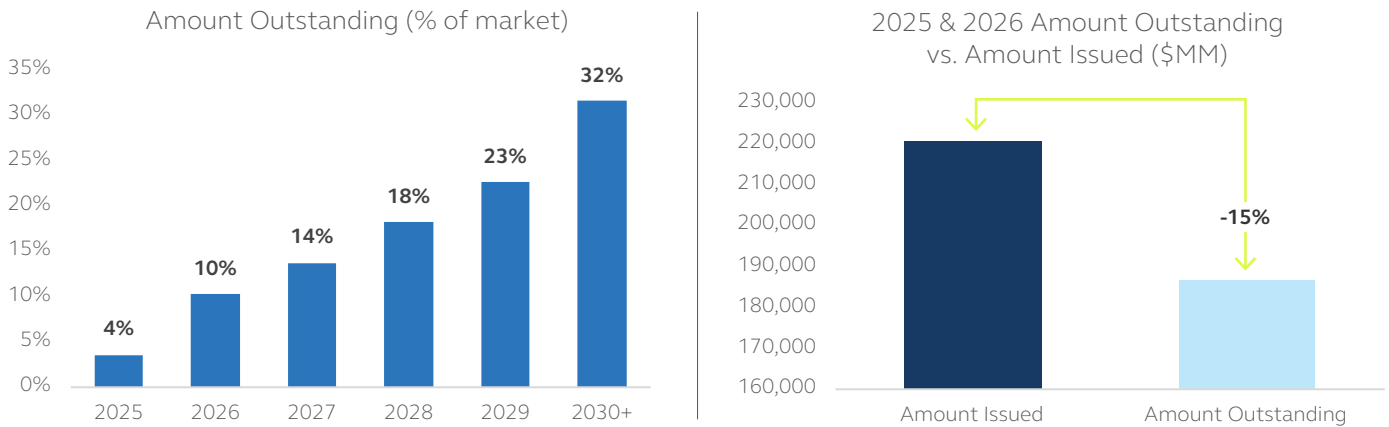
The shrinking default rate of high yield offers confidence that starting yields should translate into attractive returns. Conventional wisdom is that HY returns equal yield minus defaults, so the aim is to maximize the former while avoiding the latter. With high yield today in a historically higher-yielding environment, and defaults projected to be below historical averages (Moody's 12-month forecast of 2.95% vs. historical average of ~4%), investors may be in the midst of a particularly strong high yield market.

Despite concerns about inflation and slowing economic growth, a widespread rise in defaults is unlikely from here:

- Businesses have runway:**
 The maturity wall is very manageable and has been proactively addressed by corporates, as shown by the lower amount of debt outstanding versus the amount issued.
- Survival of the fittest:**
 The COVID-19 pandemic already brought a short, but painful, wave of corporate defaults. Most of the remaining businesses are better capitalized and have clear shareholder support.

High yield debt outstanding

Bloomberg U.S. Corporate High Yield Bond Index



Source: Source: Bloomberg, Principal Fixed Income. Data as of April 30, 2024.

In looking at the current state of the market, CCCs make up a smaller portion of the market than they did in the past. With that, tighter spreads have prevailed—and deservedly so. This shift toward higher credit quality makes it more challenging for investors to sit on the sidelines and await a magic spread number to signal an attractive entry point. It likely won't materialize, and even if it does, investors will miss out in the meantime. It is important to remember that coupons aren't dividends. They aren't discretionary; they're contractual. The income component of the asset class makes up the bulk of the return, so maximizing this is crucial to long-term outperformance.

What remains of HY is a higher-quality asset class that is increasingly fundamental and income driven. Investors' ability to maximize their portfolios' income generation will be the key driver of forward-looking investment returns. The asset class continues to be positioned to deliver long-term returns at these yield levels.

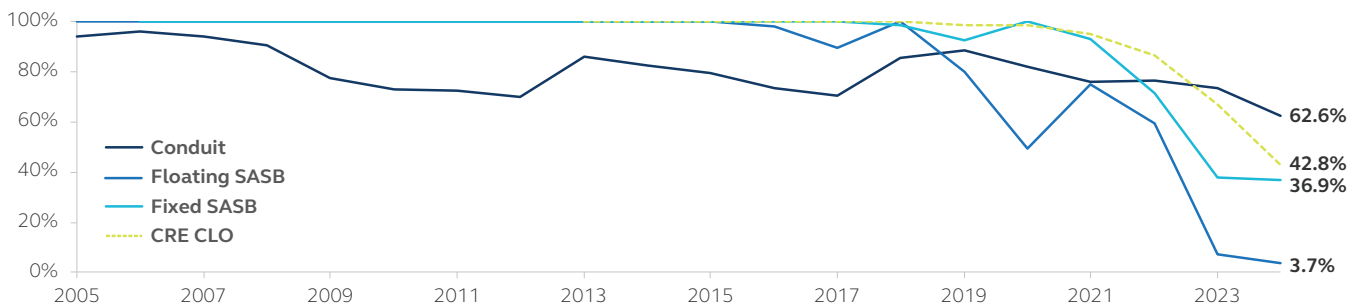
Commercial mortgage-backed securities (CMBS)

Demand for CMBS has kept pace with a larger-than-anticipated supply of new issuance in the first half of 2024. Spreads tightened and the credit curve flattened, with BBB "on the run" conduit bonds rallying 213 bps compared to AAA bonds tightening by 21 bps. We now see AAA bonds as fairly priced, while still believe there is value in lower-rated bonds, especially in single asset single borrower (SASB) deals. Given the expectation for a wide dispersion of credit performance across deals, security selection remains vital to any SASB investment strategy.

From here, a broad move tighter will be challenged by headwinds related to refinance risk and office performance. Conduit refinance success rates have remained in line with longer-term trends. However, there has been seen a significant deterioration in on-time pay-off rates for SASB transactions, while commercial real estate collateralized loan obligations (CRE CLO), as underlying loans with historically low interest coupons, struggle to refinance into a higher-rate environment. This is especially true for office loans that are only registering a 36% refinance success rate. We anticipate that borrowers willing to commit to their encumbered assets will be more likely to negotiate extension options on maturing loans.

Refinance success rate

By loan type, 2015–present

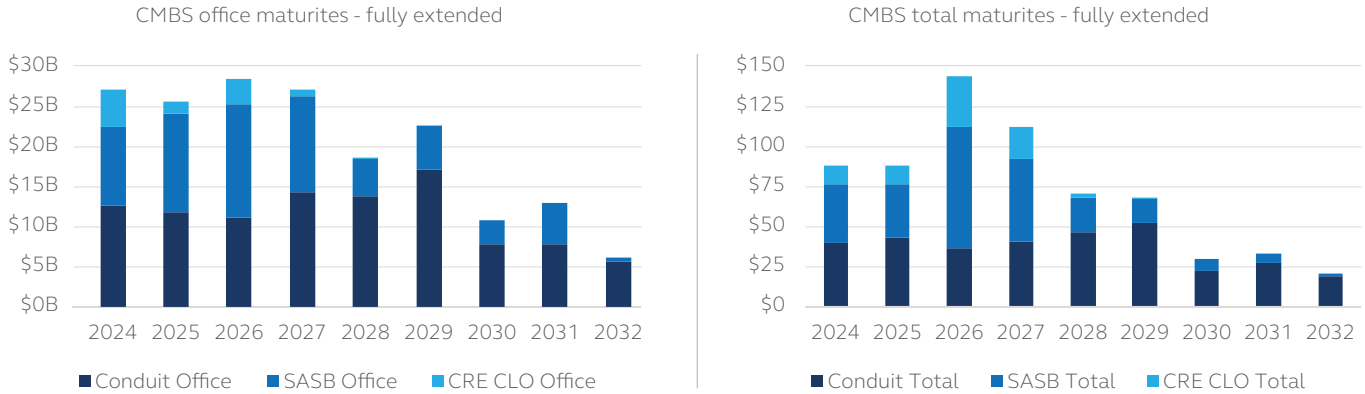


Source: J.P. Morgan, Trepp, Principal Fixed Income. Data as of April 30, 2024.

The positive news for the overall CMBS market is that there is no immediate maturity wall, and loan maturities are quite balanced over the next two years. Fully extended office loans within conduit and SASB account for \$22 billion, only 4% of the total outstanding private credit CMBS market.

CMBS maturities

Forecasted through 2032



Source: J.P. Morgan, Trepp, Principal Fixed Income. Floating rates loans are modeled as being fully extended. Data as of April 30, 2024.

Over the coming years, we expect ultimate loan resolutions to significantly vary in outcome, impacted by location, leasing demand, sponsor commitment, and interest rates. The ability to effectively underwrite and forecast areas of risk and opportunity will be critical to discerning between deals.

Municipals

The end of 2023 illustrated a municipals market where beta was rewarded. After a disastrous October in 2023, the last two months of the year witnessed record returns across all sectors/subsectors as the market anticipated upwards of six rate cuts in 2024. However, most of the gains in the municipal market were due to an expected parallel fall in interest rates across the curve. By early January, it didn't take long for the market to turn hawkish. Although the Fed conveyed confidence that rate increases were unlikely, the idea of a multitude of cuts in 2024 was eliminated. Inconsistent economic data illustrated stubborn inflation metrics. As a result, Treasury rates continued to rise throughout 2024, coupled with municipal benchmark rates.

Last year's jump in rates has either hurt municipal bond returns or left them at a stalemate year-to-date, exerting pressure on high yield municipals. However, weakness was mitigated by high average coupons, which dampened volatility, and tightening credit spreads, which augmented prices.

Active management remains important for navigating the complexities of the credit market and helping investors benefit from opportunities in the speculative portion of the tax-exempt market. In fact, there are still chances for additional spread compression in the municipal high yield market during the second half of the year. Furthermore, the term structure and back-end steepness of the exempt market (with a 10y-30y spread of 85 basis points) offers return potential that is not available in Treasury tenors (where the 10y-30y spread is 15 basis points). As a result, some investors are moving away from money markets to take advantage of these potential opportunities.

Whether inflation stays sticky or a recession surfaces, high yield municipals should prosper due to their defensive attributes and longer-duration profiles. Investors can still lock in longer, attractive, tax-free yields. Year to date, high yield and non-rated municipals have represented a wide breadth of sectors, allowing for diversification benefits, and, while speculative municipals have not been as frequent, there has been greater depth to the market, facilitating greater liquidity and bondholders.

Bloomberg fixed income indices total return

U.S. Municipal Index	-1.91%
U.S. Corporate Index	-1.11%
U.S. Treasury Index	-1.85%
U.S. Corporate High Yield	+1.62%
Municipal High Yield	+1.65%

Source: Bloomberg, Principal Asset Management. Data as of May 31, 2024.

Emerging market debt (EMD)

Emerging market (EM) credit has outperformed amid a shifting backdrop of surprising U.S. economic strength that has pushed back the Fed's easing cycle. Overall EM credit is 44 bps tighter year-to-date, with EM investment-grade (IG) 17 bps tighter and EM HY spreads leading the way at 94 bps tighter. The strength in the EM debt sector has been driven by a combination of positive fundamentals and technical factors. Developed market economic strength and expectations of U.S. rate cuts have provided a positive backdrop, while relatively benign EM sovereign fundamentals have lowered idiosyncratic macroeconomic risks. Investors' underweight positions in the asset class have helped offset receding Fed rate cut expectations and periodic volatility in U.S. Treasury markets. After starting the year quickly, new issuance has also slowed, with greater cross-over interest from other sectors and the market retaining an appetite to fund new issuance.

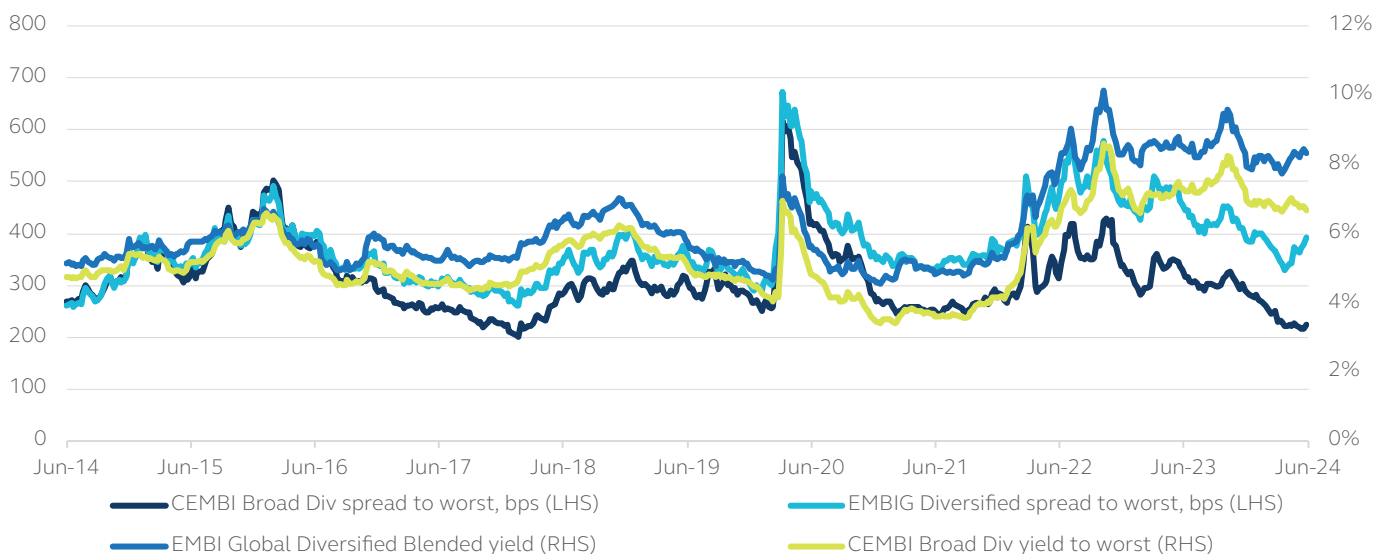
Emerging market economies have benefited from a relatively strong commodity cycle in 2024. Metals such as aluminum, copper, and nickel have benefited from CapEx spending related to green energy and artificial intelligence (AI) investments, along with constraints in global supply. Despite a backdrop of strong production and growing evidence of slowing consumer demand, crude oil has benefited from continued geopolitical tensions and strong demand. Continued discipline from OPEC+ should continue to support crude oil prices without incentivizing further production growth. Unfortunately, the likelihood of higher-for-longer U.S. rates has put EM central banks in a more difficult situation. Early expectations of EM central bankers leading developed markets in the rate-cutting cycle have been put on hold.

China, another key driver for EM, surprised with a growth upside of 5.3% year-over-year during 1Q 2024. Strong performance from exports, particularly in the electric vehicles segment, helped drive growth higher. In addition, the Chinese Communist Party's Politburo shifted its focus toward its embattled property sector to better handle existing housing inventory. It announced its strongest policy support package for the sector, easing mortgage terms to a historically easy level and launching a RMB300B relending facility by the People's Bank of China to help local governments buy completed but unsold apartments from developers. These are significant positive signals with the potential to clear 25% of China's completed unsold housing inventory. While a program of this size is subject to implementation risks, it is a crucial step in rebuilding buyers' confidence and driving a sustainable turnaround in the housing sector.

Against this backdrop, EM debt investors continue to balance an investment outlook focused on continued spread compression and excessive carry, as the asset class has successfully navigated numerous risks in recent years. Although spreads have reached the tighter end of the range for many performing issuers and have normalized for distressed issuers, EM's elevated yields remain the dominant investment theme. Idiosyncratic opportunities continue to exist in select corporate issuers and lower-rated countries that have benefited from continued orthodox economic policies and renewed engagement with the IMF. Recent volatility surrounding election outcomes in Mexico, South Africa, and India will likely present opportunities for investors.

Emerging market bond index spread and yield

June 2014–present



Source: J.P. Morgan, Bloomberg, Principal Fixed Income. Data as of June 6, 2024.

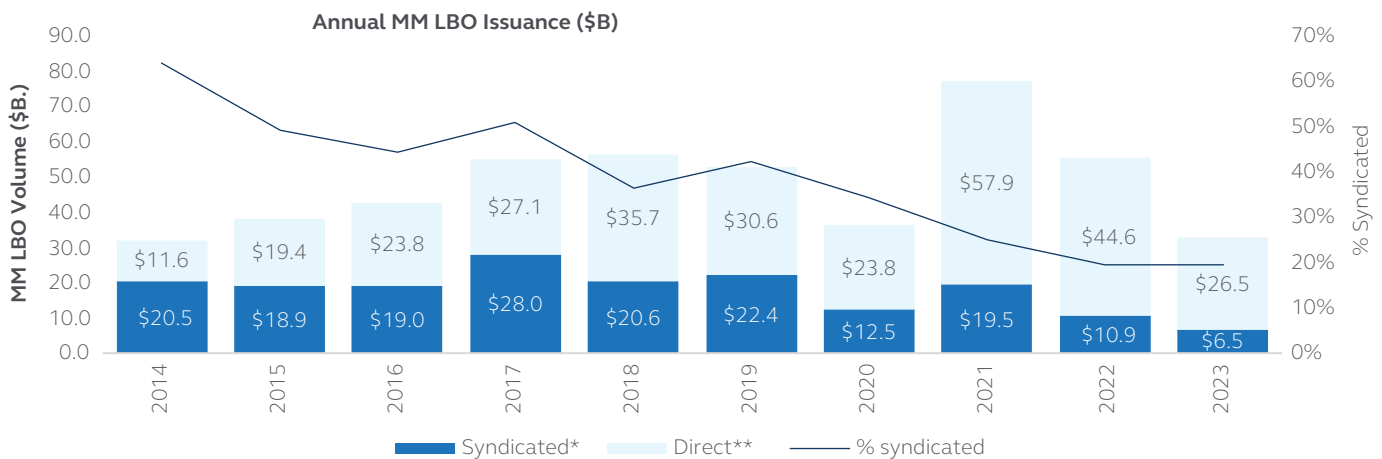
Private credit

Direct lending

Deal activity in the private equity and private credit markets has picked up in 2024. Tightening credit conditions, an uncertain economic environment, and declining enterprise value multiples slowed merger & acquisition and leveraged buyout (LBO) activity in 2023, thus reducing loan volume in direct lending. Despite this, middle market direct lending has continued to fill the void left by commercial banks and the continued decline in syndicated loan market issuance.

Middle market LBO volume and percent syndicated

\$US billions, 2014–2023



Source: LSEG LPC, Principal Asset Management. Data as of March 31, 2024. *Syndicated Middle Market: Facilities syndicated to at least one participant up to U.S. \$500 million in deal size or clubbed up to U.S. \$150 million in deal size. **Direct Lending: Non-syndicated facilities, no non-titled lender. Unitranche and bilateral loans, deals clubbed over \$U.S. \$150 million deal size, facilities that go unreported, privately placed second-liens, mezzanine and seller notes.

While volume is up more significantly in the syndicated loan market compared to last year, much of this is refinancing and repricing of existing loans. Though new loan volume origination for private middle market direct lending started the year much like 2023, the volume is beginning to increase to more typical levels. Notably, the volume is primarily financing new opportunities for LBOs and M&A, with modest refinancing activity and very little repricing activity, especially for direct lenders focused on the lower and core middle markets (companies generating \$5 million to \$50 million EBITDA). This refinancing is typically associated with companies at the upper end of the middle market (borrower EBITDA of \$50 to \$100 million) and beyond. Lenders that focus on these larger deals are making attractive proposals to borrowers/sponsor owners while still achieving value in pricing and terms compared to the public broadly syndicated loan market.

Based on our observations, deals that are getting done in the lower and core middle markets continue to reflect strong value. In addition to the relative value of new private loans compared to public markets, investors are more assured of maintaining attractive economics from transactions completed over the past 12-18 months. This ability to continue to harvest the favorable economics from 2022 and 2023 vintage loans is driven by call protection and attractive original issue discounts (OID) in the direct lending market. Relative to the size of the debt capital structure, frictional costs to refinance are a deterrent for borrowers and sponsors considering refinancing. Attractive spreads, OID, and all-in yield continue to drive desired performance for investors who have allocated to the private loan middle market.

The public and private credit markets continue to display easing credit conditions, with spreads considerably tighter over the past year in the public market along with more modest spread tightening in the private middle market. Though spreads have tightened approximately 75 bps from the widest levels of 2023, the relative value of middle market private credit is up, given the spread compression has been much less than realized in public high yield and bank loans. OID remains relatively attractive, typically two bps for lower and core middle market loans. Driven by lenders requiring sufficient debt service coverage in a higher rate environment and with favorable economics and reasonable leverage levels, the current vintage represents an attractive opportunity for investors.

Easing credit conditions may contribute to the economy’s resiliency and borrower performance through the cycle. As the market may be getting ahead of itself in anticipating a soft landing, lenders must remain focused on underwriting through a potentially challenging cyclical downturn. Continued economic uncertainty and higher rates contribute to several supportive trends for middle market direct lending and an opportunity to enhance risk-adjusted returns relative to historic loan vintages.

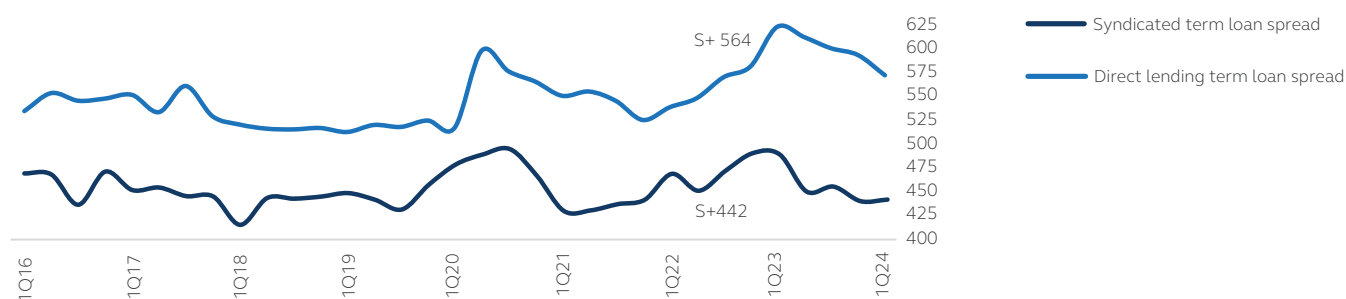
Increased focus on economically resilient business models: PE sponsor and lender focus will remain on the more cyclically resilient industries and borrowers that can generate steady financial performance through a cyclical downturn.

More conservative leverage profile: Leverage expectations for sponsors and borrowers are considerably lower than levels targeted just a couple of years ago in a much lower rate environment. Focusing on the less competitive lower middle market borrower segment can allow for leverage levels below the broader middle market industry.

Compelling valuation: Valuations remain attractive with the base secured overnight financing rate (SOFR) remaining at a relatively high level and the spread premium to public high-yield loans moving even higher, as spread tightening of the public market outpaces lower and core middle market loans.

Average first-lien sponsored middle market term loan spend

Basis points, 2016–present



Source: LSEG, Principal Fixed Income. Data as of April 30, 2024.

More lender-friendly transaction terms: The structure of transactions should remain sound, with reasonable original issue discount, improved call protection, tighter financial covenants, and more conservative EBITDA adjustments.

Manageable default rates: Despite annual default rates potentially moving higher and approaching 2-3% for the private middle market, credit losses should remain in the 75-125 bps range. In this scenario, the return to investors will be quite compelling, as the typical yield for performing first-lien, floating-rate lower and core middle market direct loans remains over 12%.

Intentional industry exposure, a disciplined credit structure, and a highly selective process to identify companies that exhibit steady performance through a down cycle should result in more favorable risk-adjusted returns.

Investment grade

Following an exceptionally busy June for IG private placements, the market will likely slow into the typically sluggish August issuance schedule before picking up in 4Q. That said, the current pipeline is robust, with a heavy flow of deals coming from infrastructure, particularly anchored in energy, renewables, and technology. Data center deals have also been popular, and more are expected in 2024. It is the hot sector in infrastructure debt and real estate assets, and the complexities of the structures are ushering the deals into the investment grade private credit market.

Relative value to public comparables has finally started to compress from very attractive levels, and we expect that to continue in 3Q, albeit while still offering value above historical long-term averages. The bid side of the market is very strong, and most deals in 3Q are likely to be well oversubscribed by investors looking for long-tenor IG private fixed income opportunities. Given the global investment incentives, the need for renewable projects, the mandate for additional LNG, and the strong demand in the private market, infrastructure will still represent a larger-than-historical portion of the deals in the IG private market in 3Q. Issuers have pushed to issue heavier in the 10-year-and-under tenors, while investors are strongly bidding 15-year-and-longer notes – a dynamic that we expect to continue in 3Q given current rates.

Forward-looking sector views

	Underweight		Neutral	Overweight	
	--	-	=	+	++
Investment grade					
U.S. agency MBS	●	●	●	●	●
CMBS	●	●	●	●	●
ABS	●	●	●	●	●
Mortgage credit	●	●	●	●	●
U.S. credit	●	●	●	●	●
European credit	●	● ←	●	●	●
Asia credit	●	●	●	●	●
Municipals	●	●	●	●	●
High yield					
U.S. credit	●	●	●	●	●
U.S. bank loans	●	●	● →	●	●
European credit	●	● →	●	●	●
Asia credit	●	● →	●	●	●
Emerging market debt					
Hard currency	●	●	●	●	●
Local currency	●	●	●	●	●
Corporates	●	● →	●	●	●
Alternatives					
Direct lending	●	●	●	●	●
Investment grade private credit	●	●	●	●	●

As of April 30, 2024. The above views reflect the relative value of the sectors shown based on forward-looking return expectations over the next 12 months. Arrows represent the quarter-over-quarter change in forward-looking views.

Conclusion

While the first half of 2024 has felt like a perpetual state of “hurry up and wait,” a pivotal U.S. presidential election and the potential for elusive rate cuts to begin make the second half of the year a more interesting story for fixed income investors. Heading into 3Q, a strong and resilient economy presents numerous opportunities across fixed income asset classes. We will be keeping a close eye on the labor market, but absent a severe downturn in the labor market, we remain optimistic about fixed income given attractive yields and the potential for duration gains as the Fed normalizes rates.

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The creation of the fixed income outlook is a collaborative effort led by the Principal Fixed Income Investment Strategy Group. The Investment Strategy Group is comprised of the senior-most investment professionals from across the platform and is responsible for identifying key macroeconomic factors that are most likely to drive investment performance across global fixed income markets. Output from the Investment Strategy Group is formalized through Principal's proprietary Macro Risk Outlook framework and informs investment processes across the platform, acting as a top-down complement to the platform's bottom-up fundamental research capability.

Investment Strategy Group members

MICHAEL GOOSAY

Chief Investment Officer & Global Head of Fixed Income

WILLIAM C. ARMSTRONG, CFA

Multi-Sector Portfolio Manager

JON CURRAN, CFA

Investment Grade Credit Portfolio Manager

BRYAN DAVIS, CFA

Multi-Sector & Securitized
Portfolio Manager

MARK DENKINGER, CFA

High Yield Portfolio Manager

JOHN FRIEDL, CFA

Multi-Sector Portfolio Manager

PRAKASH GOPALAKRISHNAN

Emerging Market Debt Portfolio Manager

JASON HAIGH

Securitized Debt Portfolio Manager

CHEE SIN KOH

Global/Macro Portfolio Manager

JIM NOBLE, CFA

Municipal Portfolio Manager

TINA PARIS, CFA

Liability Driven Investing (LDI)
Portfolio Manager

MARC PETERSON, CFA

Securitized Debt Portfolio Manager

SCOTT PETERSON, CFA

Multi-Sector Portfolio Manager

JOSHUA RANK, CFA

High Yield Portfolio Manager

LAURA RANK, CFA

Securitized Debt Portfolio Manager

DARRIN SMITH, CFA

High Yield Portfolio Manager

DARRYL TRUNNEL, CFA

Investment Grade Credit Portfolio Manager

HOWE CHUNG WAN

Head of Asian Fixed Income

TIM WARRICK, CFA

Head of Principal Alternative Credit

JAMES WELCH

Municipal Portfolio Manager

MICHAEL ZORICH

Head of Investment Grade Private Credit



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