Principal Asset Management Company (Asia) Limited

Principal Asset Class Series – Short Duration High Yield

March 2022

What is the current macro backdrop?

- Investors have experienced a turbulent start to 2022. The S&P 500 Index has once retreated 15% from its recent peak, as inflation stays elevated, Federal Reserve (Fed) prepares for its first hike since the outbreak of COVID-19 and geopolitical tension escalates.

- Global sovereign bond interest rates have continued to rise and market demand for bonds has declined. The total amount of negative-yielding bonds has fallen to a new low in more than seven years. This trend may continue as mature market central banks accelerate monetary policy tightening during the year.

- The current spread between U.S. 2-year and 10-year treasury yields has fallen back to the level not seen in more than two years. Going forward, short-term interest rates may rise further as the Fed may hike interest rates very soon, while slowing economic growth and extremely high scale of balance sheets would limit the increase in long-term rates to a certain extent. The yield curve may continue to flatten.

- This is a situation relatively unfavorable for traditional bonds, especially sovereigns, as this asset class is usually negatively correlated with rising inflation. The total return of global investment grade bonds may also be affected. Therefore, positioning within fixed income is becoming increasingly important as we navigate a higher volatility environment.

What is Short Duration High Yield?

- Short duration high yield, is a subset of the high yield market that includes bonds with final maturities of up to five to six years. Because high yield corporate bonds—unlike most other fixed-income securities, including investment-grade bonds—are usually issued with the ability for the issuer to repay them several years prior to their final maturity, these short duration bonds generally have an average expected life of less than three years.

Why Short Duration High Yield now?

1. Low yields, yet rising

- Today's environment of historically low yields makes it difficult for investors to generate income of any kind without taking on significant risk. At the same time, the Federal Reserve (Fed) is looking to execute its first rate hike right after the end of its bond purchasing program.

- As shown in Figure 1, over the last 20 years, short duration high yield bonds have outperformed traditional core bonds during rising rate periods. Supported by an above-trend economic growth and relatively healthy corporate earnings, with higher yields and shorter durations, this asset class may provide higher potential returns once again.

Figure 1: Changes in interest rates have less impact on the price of a short duration bond relative to one with a longer maturity, all else equal[1]

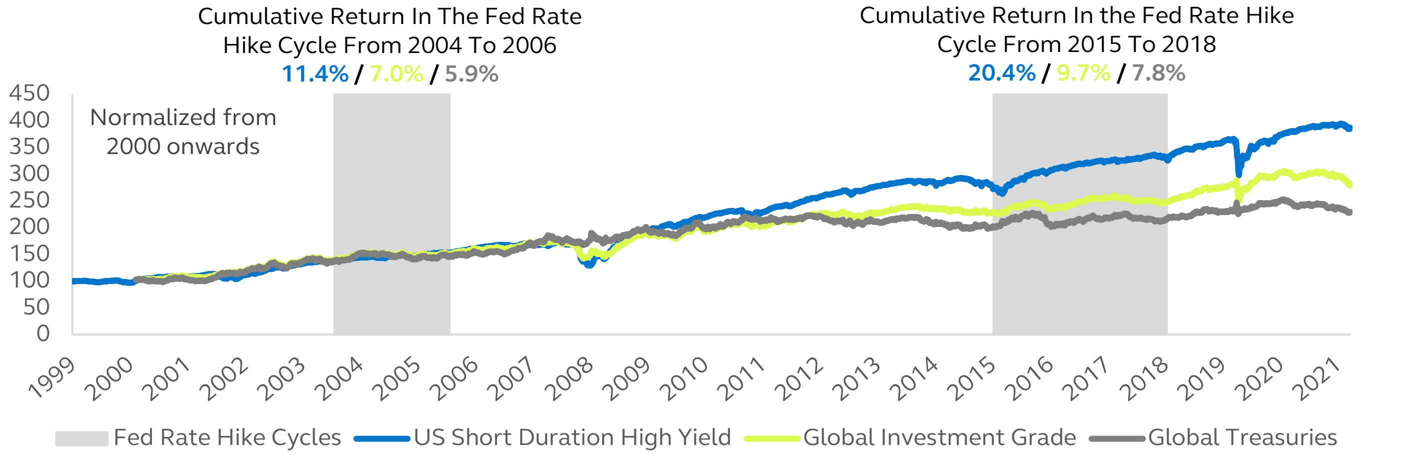
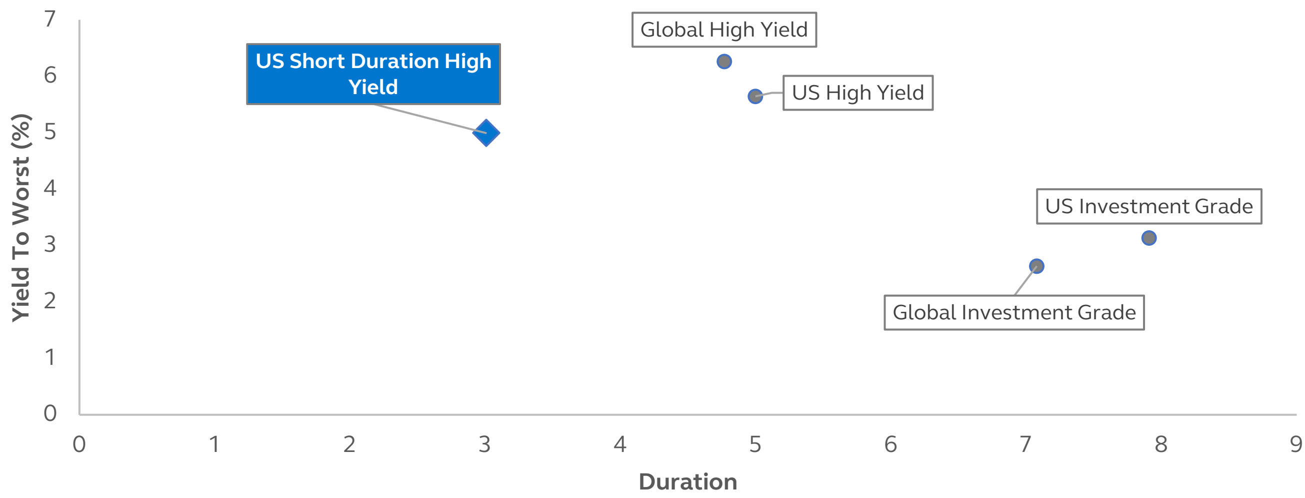


Figure 2: Short-duration high yield bonds offer relatively attractive yield with relatively low duration risk, which can be beneficial in protecting against rising interest rates[2]



2. Market volatility on the rise

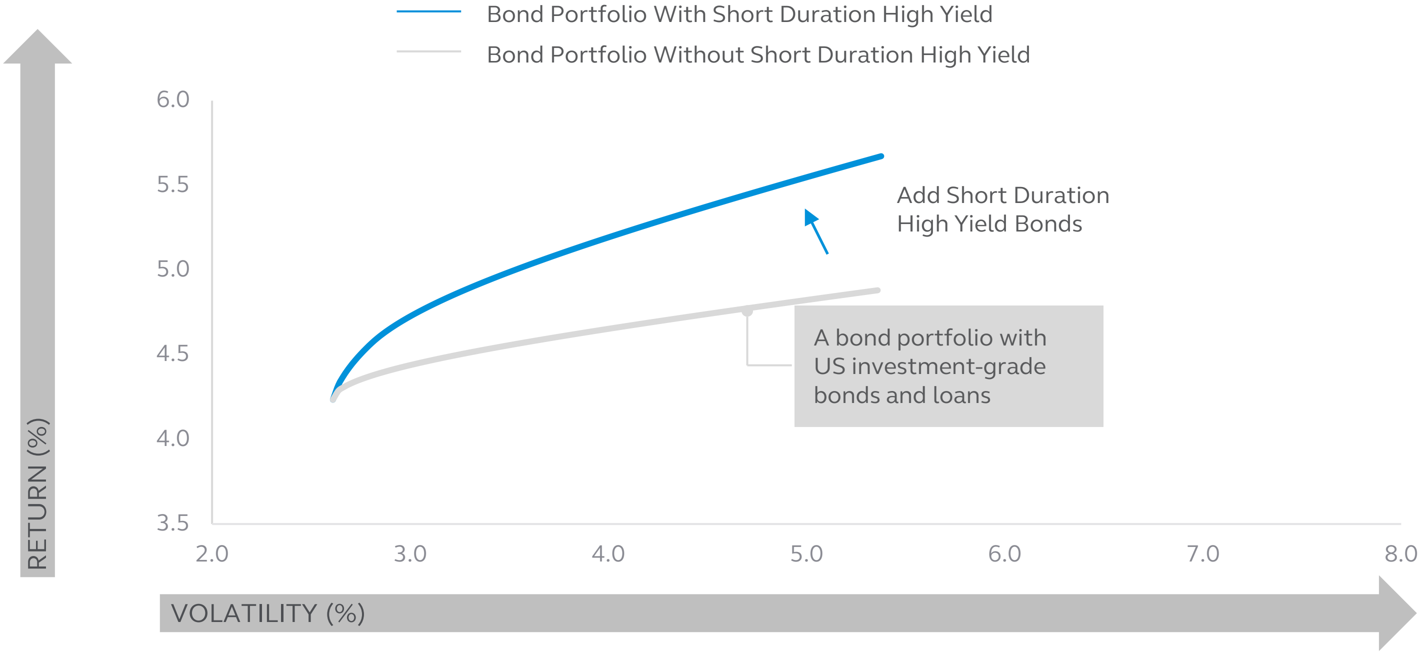
- With all the uncertainties in the headlines, short duration high yields may offer better downside protection, especially in an environment when 10-year Treasury yield is surging. Short duration high yield bonds have generally had lower drawdowns in specific market events, compared to other fixed income asset classes.

Figure 3: Short duration high yield bonds outperformed the other fixed income assets in most of the situations when yields are on the rise, even in the most recent incident when market started to price in more aggressive Fed tightening in 2022[3]

Principal® 信安

➢ Diversifying portfolio allocation is key with the lingering uncertainties. Short duration high yield bonds have had low correlations to other fixed-income and equity products in various market conditions historically, as reflected by 10-year correlations. Adding short duration high yield bonds to a bond portfolio may enhance returns and reduce risks.

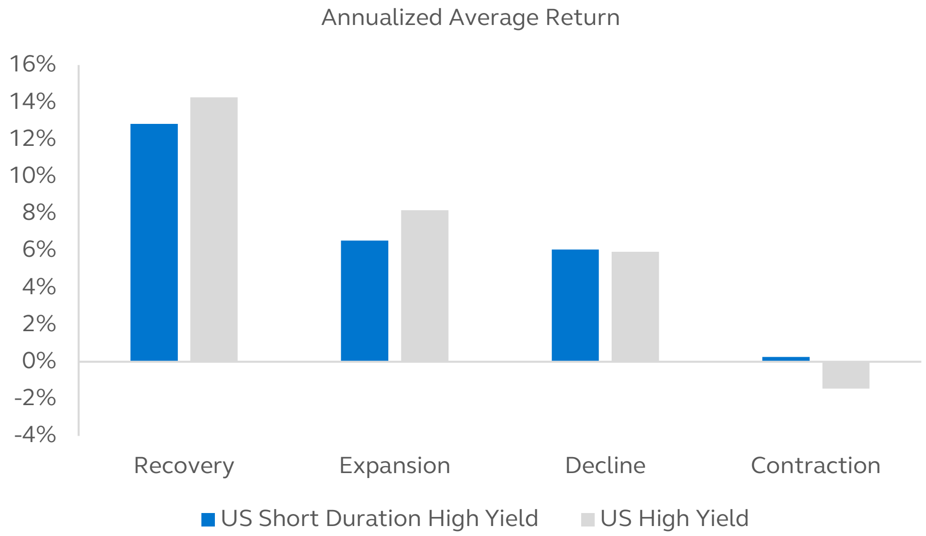
Figure 4: Short duration bonds may offer enhanced risk adjusted returns[4]



3. A potential "All Weather Solution"

➢ While the economy continues to expand, we may have landed in a declining regime. Nonetheless, short duration bonds and loans have provided positive returns in different economic cycles. It has outperformed the broader high yield market in a declining phase, as well as during recession.

Figure 5: Short duration high yield bonds tend to deliver consistent positive return over the full cycle[5]



[1] Source: Bloomberg, as of 28 February 2022.ICE BofA 1-5 Year BB-B US Cash Pay High Yield Constrained Index, Bloomberg Global Agg Corporate Total Return Index Value Unhedged USD and Bloomberg Global Agg Treasuries Total Return Index Value Unhedged USD represent US Short Duration High Yield, Global Investment Grade and Global Treasuries, respectively.
[2] Source: Bloomberg, as of 28 February 2022. ICE BofA 1-5 Year BB-B US Cash Pay High Yield Constrained Index, Bloomberg Global Agg Corporate Total Return Index Value Unhedged USD, Bloomberg Global High Yield Total Return Index Value Unhedged, ICE BofA US High Yield Index and ICE BofA US Corporate Index represent US Short Duration High Yield, Global Investment Grade, Global High Yield, US High Yield and US Investment Grade, respectively.
[3] Source: Bloomberg, as of 28 February 2022. ICE BofA 1-5 Year BB-B US Cash Pay High Yield Constrained Index, Bloomberg Global High Yield Total Return Index Value Unhedged, Bloomberg Global Agg Corporate Total Return Index Value Unhedged USD and Bloomberg Global Agg Treasuries Total Return Index Value Unhedged USD represent US Short Duration High Yield, Global High Yield, Global Investment Grade and Global Treasuries, respectively.
[4] Source: Bloomberg, Principal Global Investors (PGI), as of 31 December 2021. Data goes from 12/2011 – 12/2021. The portfolio with short duration high yield consists of (1) the ICE BofAML U.S. Cash Pay High Yield BB-B Rated 1-5 Year Index, which is a subset of the ICE BofAML U.S. Cash Pay High Yield Index including all securities with a remaining term to final maturity less than 5 years and rated BB through B inclusive. (2) The Bloomberg U.S. Aggregate Bond Index, which is a broad-based benchmark that measures the investment-grade, U.S. dollar-denominated, fixed-rate taxable bond market, including Treasuries, government-related and corporate securities, mortgage-backed securities (agency fixed-rate and hybrid adjustable-rate mortgage pass-throughs), asset-backed securities, and commercial mortgage-backed securities. (3) Floating rate loans are represented by the S&P/LSTA Leveraged Loan Index, which is a broad index designed to reflect the performance of U.S. dollar facilities in the leveraged loan market.
[5] Source: Bloomberg, NBER, as of 28 February 2022. ICE BofA 1-5 Year BB-B US Cash Pay High Yield Constrained Index represents for US Short Duration High Yield. ICE BofA US High Yield Index represents for US High Yield. Average of annualized monthly returns grouped by phase. Recovery—ISM Manufacturing PMI accelerating (12/2001-6/2002, 7/2009–2/2011); Expansion—ISM Manufacturing PMI stable (7/2002-4/2006, 3/2011–8/2018); Decline—ISM Manufacturing PMI decelerating (5/2006–11/2007, 9/2018-3/2019). Contraction as reported by NBER and ISM Manufacturing PMI further decelerating (12/2007–6/2009, 4/2019-4/2020).

Disclosures:

Principal® 信安