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Principal Morley

Interest rate strategy

JUNE 30, 2025

DAN KANG, CFA
Portfolio Manager

Rates/Corporates

Highlights

In the second quarter of 2025, U.S. Treasuries traced a pronounced arc. The 10-year note sank to 3.99% on April 4 after the Trump administration's reciprocal-tariff announcement pushed effective trade-weighted import duties into the mid-20% range. Volatility spiked as the MOVE Index rose above 130 but retraced when Trump announced a 90-day implementation delay to allow for negotiations. During several key Treasury auctions, yields reached the upper end of their recent trading ranges as concerns about fiscal sustainability grew after the House passed its version of the One Big Beautiful Bill Act, while continued tariff rhetoric by Trump exacerbated worries about foreign demand for U.S.-dollar assets. After peaking at 4.62%, the 10-year rallied into quarter-end as global demand remained strong and bombings by Israel and the United States against Iran heightened geopolitical risk.

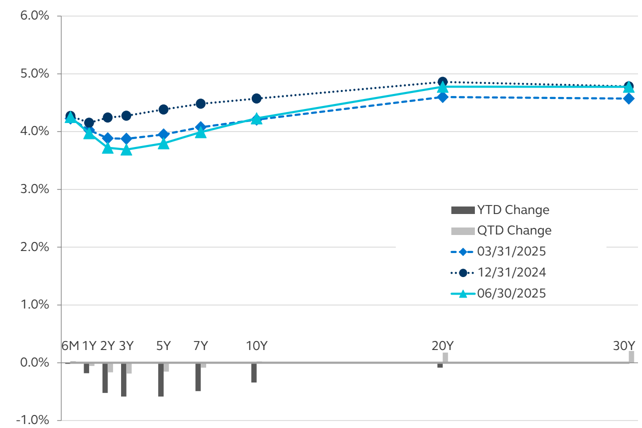
Hard data generally outpaced soft surveys. The Atlanta Fed GDPNow estimate climbed toward a 2.5% annualized pace by late June after the negative 1Q25 print. Payrolls added 158,000 jobs in April and 144,000 in May, and the unemployment rate inched up to a still-low 4.2%, signaling a labor market that is easing only gradually. Inflation progress stalled, but did not reverse. Headline CPI held at 2.4% y/y in May and core at 2.8%, with only limited early pass-through from higher import costs. Consumer and business confidence, by contrast, slipped to post-pandemic lows, underscoring a fragile sentiment backdrop and keeping markets highly sensitive to policy headlines.

After delivering 100 bp of insurance easing in the second half of 2024, the Federal Reserve kept the target range at 4.25%-4.50% at its May and June meetings. The June Summary of Economic Projections again showed a median of two cuts in 2025. Quantitative tightening continued at the slower pace adopted in April, with Treasury run-offs capped at $5 billion per month and MBS at $35 billion. Chair Powell repeated that tariff-driven price spikes are "likely transitory," yet emphasized that fiscal and immigration uncertainty keeps policy especially data-dependent.

Outlook

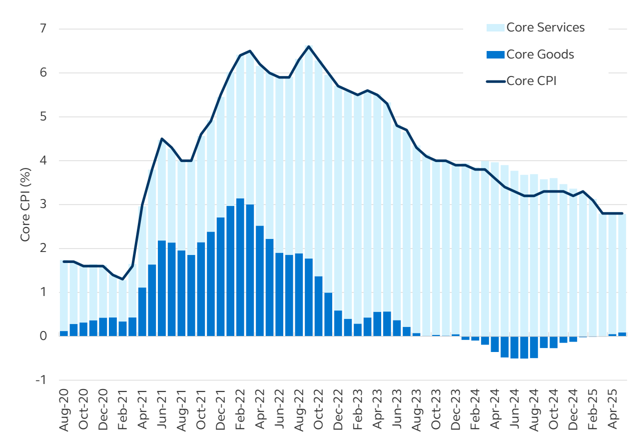
Near-term tariff-policy uncertainty remains high because negotiations between the major trading partners have been challenging, as expected. The relative calm in markets reflects a prevailing view that Trump's actions are a negotiating tactic and that he will not follow through on his most extreme tariff pronouncements. To date, the impact on economic activity and inflationary pressures has been limited; however, we believe it is only a matter of time before policy headwinds appear in hard data. A combination of front-loaded inventories and companies' initial reluctance to raise prices has delayed inflation pressures. Further, aggressive immigration enforcement has reduced labor supply, which may support the unemployment rate but could restrain growth over the medium term. Finally, the prolonged "kick-the-can" trade environment has cast a pall over economic activity as persistent uncertainty has muted potential hiring and capital investment.

U.S. Treasury Yield Curve



Source: Bloomberg

U.S. Core CPI - Goods and Services Components



Source: Bloomberg

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Principal Asset Management®

Corporates

JUNE 30, 2025

Highlights

During the second quarter of 2025, the Bloomberg U.S. Intermediate Corporate Bond Index posted total and excess returns of 2.12% and 0.69%, respectively, lifting the first-half figures to 4.45% and 0.41%. At the start of the quarter, spreads on the index widened from 83 bps to 112 bps by April 8th after tariff headlines triggered risk-off selling. Spreads retraced during the quarter after implementation was delayed ending the quarter at 75 bps, only a few points wider than the December tights, even as geopolitical tensions in the Middle East flared in June.

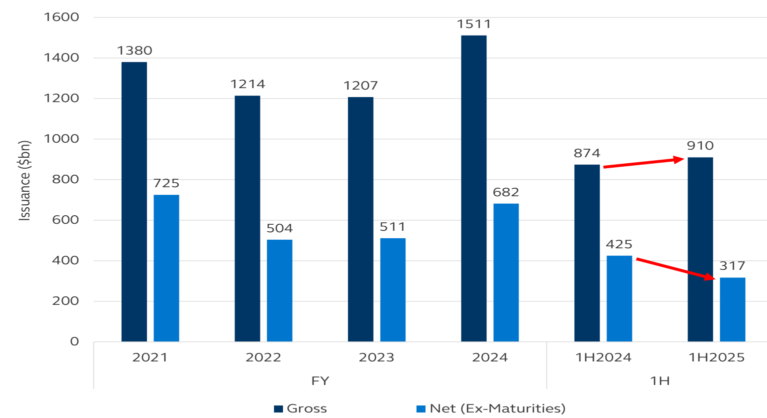
Primary-market technicals remained constructive in Q2 due to heavy maturities and a rebound in retail fund flows. Gross investment-grade (IG) supply totaled $910 bn in 1H25, the second-largest first half on record, including $106 bn in April, $164 bn in May, and $113 bn in June. Financial issuers, both domestic and Yankee, accelerated funding while spreads sat near historic tights, whereas long-end (>10-year) issuance subsided in the steeper-curve environment. Heavy maturities removed $593 bn in outstanding debt year-to-date as 2020 COVID five-year paper came due, leaving low net issuance ($317 bn), which was easily absorbed. Adding to this positive technical, tender-and-make-whole activity reached $40 bn year-to-date, led by Warner Bros. Discovery's (WBD) $15.4 bn June offer. Strong demand for duration and limited long-end issuance pushed dealer inventories at the long end to historically low levels.

Credit quality softened, but fundamentals held firm despite an increasingly uncertain macro backdrop. Downgrades exceeded upgrades, $94 bn to $78 bn, in Q2, producing $50 bn of fallen angels, including $31 bn from WBD, the fifth-largest fallen angel on record, and leaving roughly $65 bn of BBB- debt with at least one high-yield rating and a negative outlook (mainly Ford, Paramount, and Centene). Despite the downgrades, the quality mix improved: the BBB- share of the index slipped to a record-low 8%, and the A-rated share rose to 46% as upgrades within BBB names continued. Corporate fundamentals stayed supportive; Q1 S&P 500 earnings grew about 13% year-over-year, with roughly 78% of companies beating estimates, margins improved, and net leverage held near 2.9x, keeping underlying credit metrics stable despite the ratings drift.

Outlook

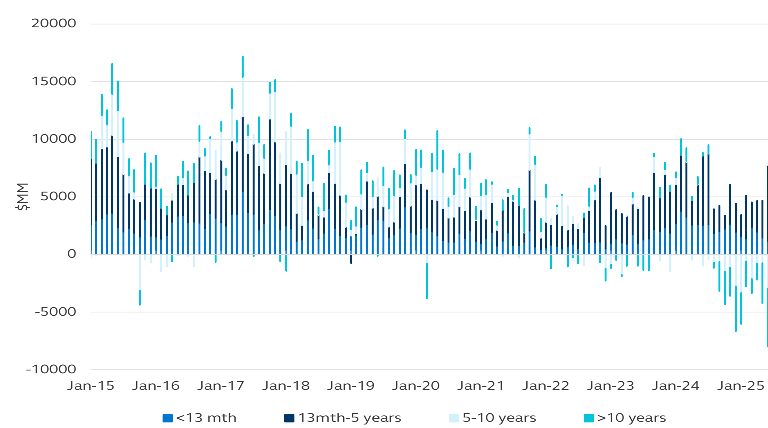
The near-term outlook for corporates will depend on whether the resilient macro narrative remains intact as trade and tariff agreements are resolved. Policy certainty at current tariff rates, combined with the imminent start of the Federal Reserve's cutting cycle, should continue to support credit spreads. Over the medium term, the passage of the One Big Beautiful Bill Act and further deregulatory efforts should bolster fundamentals. The favorable technical environment prevalent in the first half of the year should persist, with lighter net supply, historically attractive yields, and balanced dealer and investor positioning. However, valuations have retraced from their post-Liberation Day wides, providing little room for disappointment.

IG Gross & Net Issuance



Source: JP Morgan

IG Primary Dealer Outright Inventories



Source: Bloomberg

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Mortgage-Backed Securities (MBS)

JUNE 30, 2025

Perpetua Phillips
Portfolio Manager

MBS/ABS/CMBS

Highlights

The Bloomberg U.S. MBS Index posted total and excess returns of 1.14% and 0.17%, respectively, during the second quarter as a Liberation-Day driven spike in volatility early in the period was followed by a more constructive backdrop in May and June. A 90-day pause on tariffs and favorable inflation data caused rates to rally and spreads to tighten amidst positive fixed income fund flows. The yield curve steepened by nearly 20 bps during the quarter as the 2yr yield declined by 0.16% to 3.72%, the 10yr yield was little changed at 4.23% and the 30yr yield rose by 0.20% to close at 4.77%. MBS were able to claw back April underperformance as volatility declined and buyers came off the sidelines.

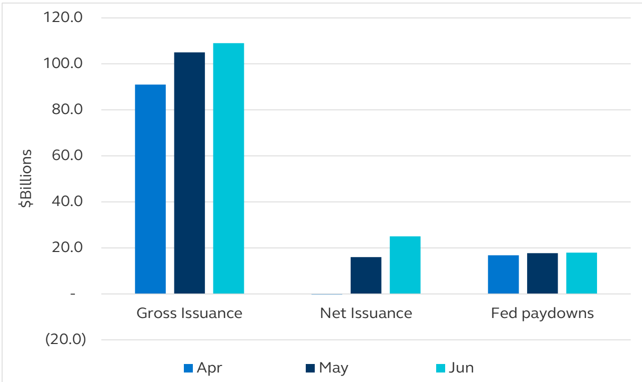
After cutting rates by 100 basis points in the second half of last year, the Fed maintained policy rates between 4.25% to 4.50% due to uncertainty around tariffs, immigration and deficit financing plans. Their median forecast continued to project two rate cuts this year, in line with futures markets. However, with Chair Powell's term ending in May of next year the markets began pricing an accelerated pace of easing in 2H'26. Balance sheet runoff on the Fed's MBS holdings averaged $17B/mo during the quarter, comfortably below the $25B/month cap.

Mortgage rates stayed in a modest range of 6.60-6.90% despite broader rates volatility that saw the MOVE index trade in a 50-point range during the quarter. This kept aggregate prepayment speeds contained near 7% Conditional Prepayment Rate (CPR), but newer in-the-money TBAs exhibited heightened rate reactivity. Originator supply totaled $305B gross and $40.7B net for the quarter, but subdued demand from banks and foreign buyers left already heavily overweight money managers to take down the bulk of net supply. Therefore, MBS spreads lagged the spread tightening seen in credit sectors, with the current coupon nominal spread declining by just 7 bps and the MBS index OAS down just 1 bps to close the quarter at +119 and +37 bps, respectively.

Outlook

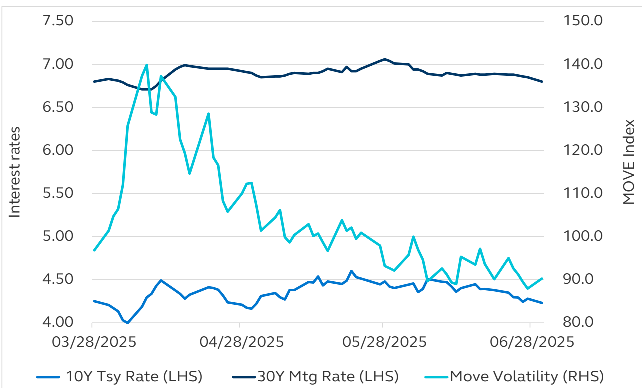
Due to elevated primary mortgage rates, refinancing activity remains low, resulting in stable cash flows for MBS investors. Meanwhile, implied volatility remains in line with long-term averages, and technical challenges persist due to the ongoing reduction of MBS holdings on the Fed's balance sheet. Light organic supply has helped offset tepid demand from foreign and bank investors. Although GSE reform poses headline risk due to potential disruptions in the mortgage market, we do not anticipate meaningful progress on this front anytime soon. Spreads remain attractive on an absolute basis and relative to other fixed income sectors.

MBS Supply



Source: Nomura Securities

Rates and Volatility



Source: Bloomberg, Bankrate.com

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Asset-Backed Securities (ABS)

JUNE 30, 2025

Highlights

The Bloomberg AAA Asset Backed Securities (ABS) Index returned 1.34% during the second quarter, which outperformed like-duration Treasury returns by 25 basis points and lagged the 65 basis points of excess returns from intermediate investment grade corporates. Within the AAA ABS index, auto and credit card-related ABS underperformed longer duration assets.

ABS new issuance totaled $76 billion in the second quarter as compared to $89 billion in the first quarter, bringing the year-to-date total to $165 billion as compared to $179 billion for the first half of 2024. Strong ABS issuance has been met with strong demand. Relatively attractive yields and benign fundamentals, albeit with pockets of weaker credit performance, have continued to drive interest. Non-traditional sectors have also benefited from growing acceptance among insurance companies and other investors seeking higher yields and spreads.

Investment grade ABS secondary market trading volumes continued to be elevated at $61 billion for the quarter. Investors were net buyers of $0.7 billion, as accounts looked to rotate out of seasoned holdings and into new issue opportunities.

Outlook

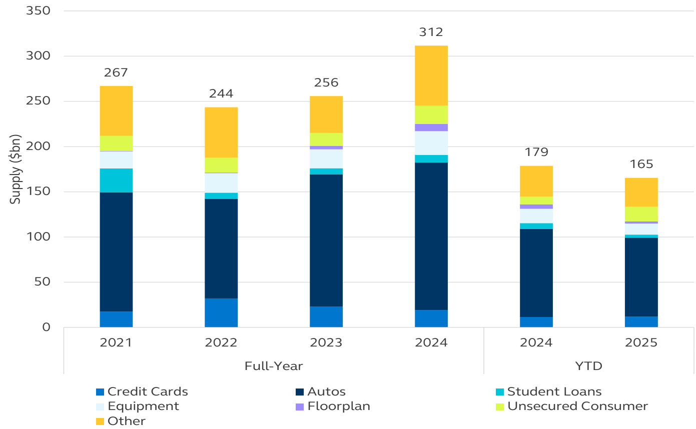
Mercurial tariff policy has introduced considerable uncertainty into the investment outlook this year. So far, this uncertainty has manifested in significantly weaker survey-based "soft data," reflecting declines in both consumer and business sentiment. From a policy sequencing perspective, the "bad news" of tariff policy has come first, while growth-friendly measures such as deregulation and tax cuts are expected to gain traction later in the year.

Although soft data has deteriorated notably, hard data has remained largely resilient. The next few months of labor and consumer spending reports will provide important insight into whether the downturn in sentiment translates into a pullback in consumer spending or a weakening of labor market "hard data."

Changes in immigration policies are likely to introduce additional noise into the data. We anticipate further volatility caused by softer labor data and a temporary inflation boost from tariffs later this year. Therefore, we favor a flexible and nimble approach, maintaining dry powder to capitalize on market volatility. We remain vigilant about any material changes in employment and consumer spending habits.

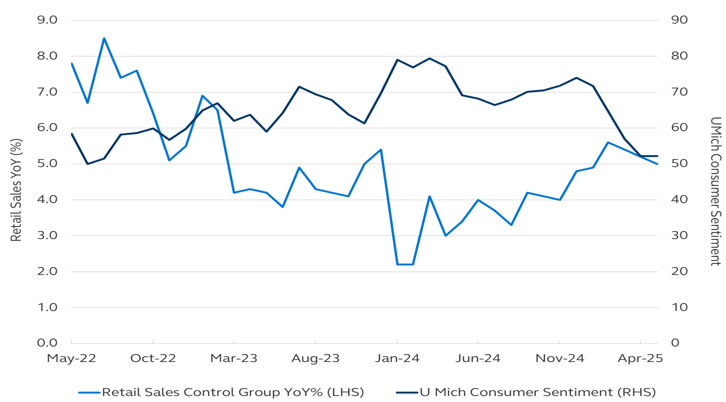
Structured credit fundamentals remain stable but are beginning to show signs of softening compared to earlier this year. The direction of employment and inflation will be key for securitized markets going forward. Technical conditions are balanced. After a brief pause in April, new issuance has picked up again and is drawing strong investor demand as buyers continue to seek spread and yield. Structured spreads have mostly recovered to pre-Liberation Day levels, but further tightening back to the early-year lows may be difficult given the ongoing macroeconomic and policy uncertainty.

ABS Sector Supply



Source: JP Morgan

"Hard" vs "Soft" Data



Source: Bloomberg

Commercial Mortgage-Backed Securities (CMBS)

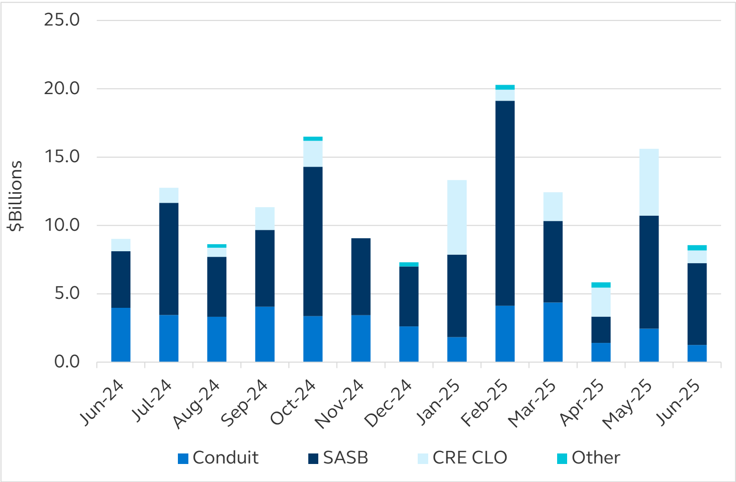
JUNE 30, 2025

Highlights

The Bloomberg AAA Commercial Mortgage-Backed Securities (CMBS) Index posted total and excess returns of 1.92% and 0.47%, respectively, during the second quarter. Liberation Day kicked off the quarter with a dramatic market sell-off as recession fears spiked. The market spent the rest of the quarter recovering as the delay in tariffs, relatively strong economic data and the consensus that interest rates will be lower at the end of the year helped calm those recession fears. The ten-year U.S. Treasury yield ended the quarter up only slightly from the end of the previous quarter at 4.23% and traded within a range of 4% the first week in April to 4.60% in mid-May. The improved outlook for the economy was positive for real estate and refinancing debt. Demand for higher quality CMBS was strong as the broader market recovery progressed throughout the quarter, but BBB spreads lagged as the risk of tariffs and growth still looms over the economy. CMBS spreads on issues rated "AA" and higher ended the quarter tighter, but the credit curve steepened. As a result, AAA CMBS spreads ended the second quarter 9 bps tighter, AA spreads 10 bps tighter, A spreads 3 bps wider and BBB spreads 117 bps wider.

New issue activity was down during the quarter as April's volatility slowed the pace of issuance. The $21B of private label issuance, during the second quarter, was down over 40% from the first quarter of 2025. Private label conduit issuance during the quarter was $5.1B compared to $10.3B in the first quarter of 2025 and second quarter 2024 of $26.3B. Private label SASB issuance was $16.2B compared to the first quarter 2025 of $27.0B and second quarter 2024 of $18.8B. Secondary market activity picked up after April.

CMBS Issuance

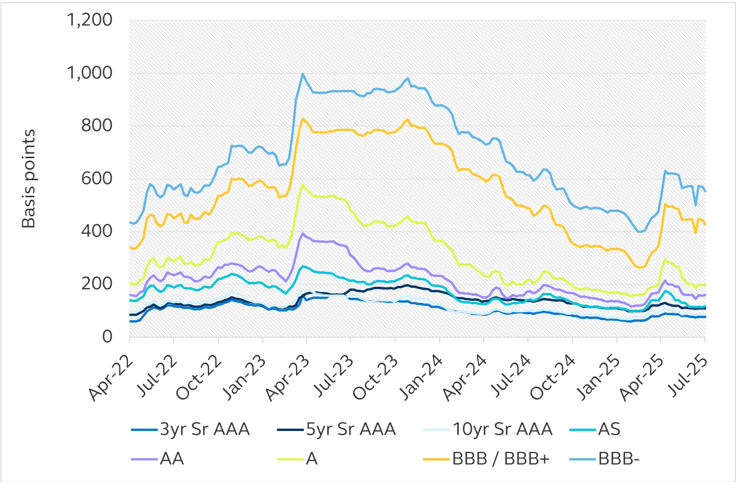


Source: J.P. Morgan

Outlook

The outlook for CMBS remains primarily focused on refinancing loans that mature in 2025, the path of the economy, the path of interest rates and longer-term office loan fundamentals. 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 attractive relative to alternatives.

CMBS Spreads to Treasuries



Source: J.P. Morgan

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JUNE 30, 2025

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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.

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