Principal Asset Management®

Principal Morley

Interest rate strategy

DECEMBER 31, 2025

DAN KANG, CFA
Portfolio Manager

Rates/Corporates

Highlights

In the fourth quarter of 2025, the U.S. Treasury curve steepened as front-end yields declined on continued policy easing while the long end cheapened on higher term premium, driven by U.S. fiscal deficit concerns and increased inflation-expectations. Quarter-over-quarter, the 2-year U.S. Treasury fell from 3.61% to 3.48% (-13 bp), the 5-year slipped from 3.74% to 3.73% (-1 bp), the 10-year rose from 4.15% to 4.17% (+2 bp), and the 30-year rose from 4.73% to 4.85% (+12 bp). For full-year 2025, the front end rallied materially while the very long end backed up modestly: the 2-year declined from 4.24% to 3.48% (-76 bp), the 5-year from 4.38% to 3.73% (-65 bp), the 10-year from 4.57% to 4.17% (-40 bp), while the 30-year rose from 4.78% to 4.85% (+7 bp). Treasury volatility also trended sharply lower into year-end, with the MOVE index falling to the high-50s by late December.

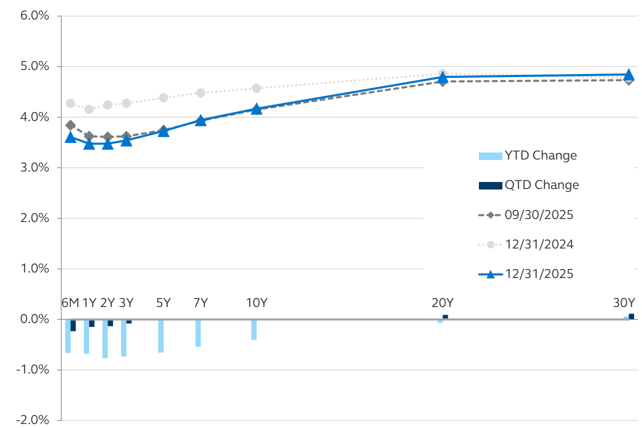
Macro data stayed strong but showed clearer signs of cooling, reinforcing this push-pull in the curve. Real GDP surprised to the upside in mid-2025, with BEA reporting 3.8% annualized growth in Q2 and 4.4% in Q3, supported by still-resilient consumer demand and robust AI investments. Due to the government shutdown, official economic data reports were delayed and incomplete for the fourth quarter providing a murky picture of the economy. However, alternative private data sources and eventual delayed economic releases showed further cooling in the labor market. The unemployment rate drifted upwards to 4.6% in November 2025 and job creation averaged just 17,000 jobs per month over the past six months, as slower immigration and AI adoption influenced hiring.

Against that backdrop, the Fed (Federal Reserve) delivered a three-meeting sequence of 25 bp cuts from Sept to December, framing the moves as risk management in response to slower job gains even as inflation remained somewhat elevated. Policy also turned more dovish on balance-sheet operations: the October statement signaled an end to QT runoff on December 1, and the December statement added that the Fed would initiate purchases of Treasury bills, as needed, for “reserve management” to maintain an ample level of bank reserves.

Outlook

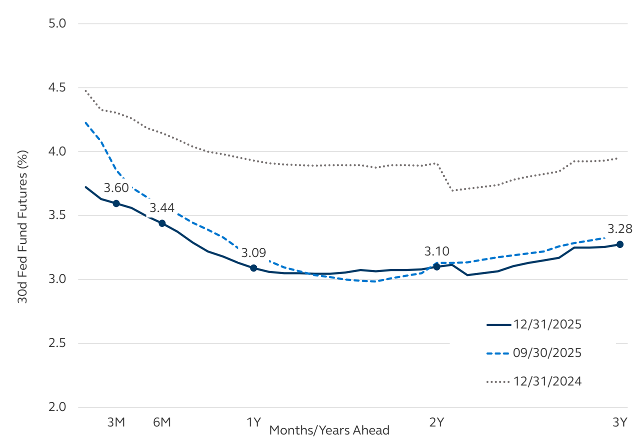
Our base case outlook anticipates a rebound in economic activity driven by increased fiscal impulse from the One Big Beautiful Bill Act (OBBBA) and looser financial conditions resulting from recent Fed rate cuts. Inflation is expected to run above the Fed’s policy target over the coming year but should broadly follow a disinflationary path. In the meantime, the continued gradual deterioration in labor conditions should provide the impetus for further rate cuts in 2026. As we noted previously, we will monitor any delayed impact from tariffs in upcoming months’ inflation reports.

U.S. Treasury Yield Curve



Source: Bloomberg

Market Implied Fed Policy Rate



Source: Bloomberg

Principal Asset Management®

Corporates

DECEMBER 31, 2025

Highlights

In the fourth quarter of 2025, the Bloomberg U.S. Intermediate Corporate Bond Index returned 1.29% in total and outperformed US Treasuries by 0.13%, bringing full-year 2025 results to 7.95% and 1.31%, respectively. Intermediate corporate spreads widened modestly in Q4 after tightening through the summer and early fall, with index OAS moving 4 bp wider over the quarter from 65 bp to 69 bp, but still finishing 2 bp tighter on the year. The quarter's softening coincided with heavy late-year supply, including AI-related issuance tied to hyper-scaler data center spending, a recalibration in market expectations for the pace of Fed rate cuts, and idiosyncratic credit headlines, including the First Brands and TriColor bankruptcies that drew attention to BDC and insurance exposures to private credit. With spreads already near cycle tights, quarterly performance was primarily carry-driven, and excess returns were muted despite a broadly supportive risk tone into year-end.

Primary market technicals remained constructive. Investment-grade (IG) issuance stayed heavy but was well absorbed, extending a year characterized by sustained borrower access and persistent investor demand. Fourth quarter supply totaled $332bn, up 43% versus the past four-year average of $231bn, though it was still the slowest quarter of the year. Total 2025 IG gross issuance reached $1.64 trillion, second only to 2020, as issuers continued to take advantage of receptive market conditions while inflows and investor demand, coupled with net issuance of just $612 billion, helped contain new-issue concessions and limit spread volatility.

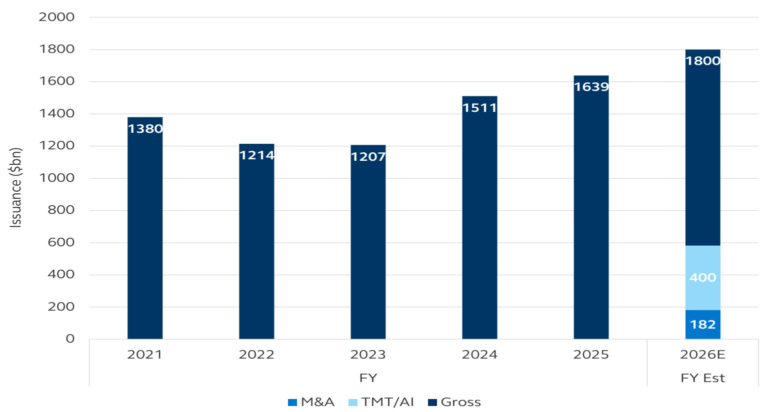
Fundamentals were steady into year-end. Corporate results in the third quarter were consistent with that backdrop, with FactSet showing S&P 500 earnings growth of 13.4% year over year and 83% of S&P 500 companies reporting actual EPS above estimates. The IG universe's EBITDA margins remained near their highest levels since early 2022, revenue growth ran 4.8% year over year (the strongest in eleven quarters), and net leverage held around 2.7x; interest coverage drifted lower but at the slowest pace in eleven quarters and stayed broadly in line with pre-COVID norms.

Outlook

Given recent events, we have been acutely focused on looking for "bubbles" and "cockroaches" in the markets but have not yet become concerned. With U.S. growth slowing, but still positive, we expect IG credit to continue performing well and attracting buyers. Fundamentals should stay healthy in the near-to-medium term, supported by solid corporate and household balance sheets. A further deregulatory policy environment and easing financial conditions should be positive drivers of healthy earnings growth.

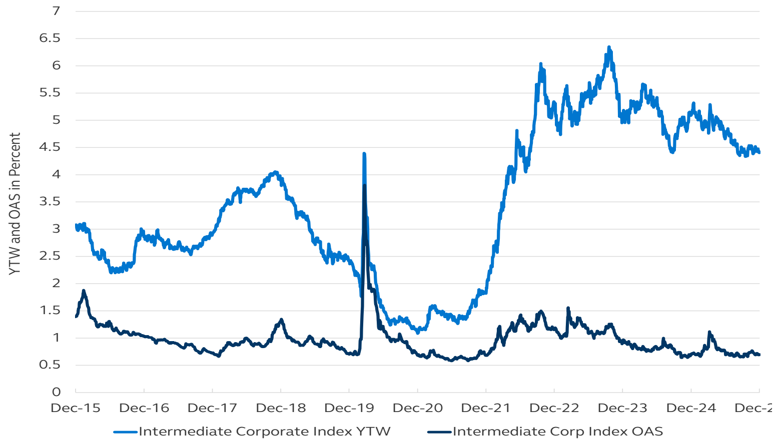
Looking forward to 2026, we do see the technical environment as less favorable than in 2025. The twin drivers of AI hyper-scaler capex ($400bn JPM est.) and M&A financing ($182bn JPM est.) should test resilience and appetite among IG credit investors. A key anchor for demand will be the yield provided by the asset class. IG yields are still at historically attractive levels (~64% 20-year rank percentile), and FX hedging costs have come down.

IG Total Gross Issuance



Source: J.P. Morgan

Intermediate Coporate Index Yield and Spread



Source: Bloomberg

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Mortgage-Backed Securities (MBS)

DECEMBER 31, 2025

Perpetua Phillips
Portfolio Manager

MBS/ABS/CMBS

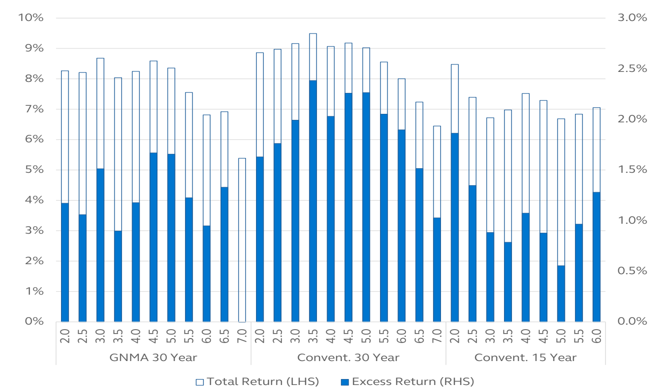
Highlights

The Bloomberg U.S. MBS Index posted total and excess returns of 1.71% and 0.69%, respectively, during the fourth quarter, extending year-to-date performance to 8.58% total and 1.71% excess, the strongest annual excess return since 2010, and outperforming other AAA securitized sectors on an excess-return basis driven by constructive technicals and subdued rate volatility. U.S. Treasury yields were mixed and the yield curve steepened during the quarter. The two-year yield fell 0.13% to 3.48%, the five-year fell 0.01% to 3.73%, the ten-year rose 0.02% to 4.17%, and the thirty-year rose 0.12% to 4.85%. Rate volatility continued to normalize from the April tariff-driven shock, with the MOVE Index dipping into the high-50s late in December and ending the year near 64, supporting tighter current-coupon and option-adjusted spreads. The 30-year current coupon spread finished at 110 bps to Treasuries, while the Bloomberg U.S. MBS Index OAS narrowed from 31 bps to 22 bps over the quarter to the tightest levels since 2022.

In response to continued cooling in labor conditions and a less certain macro data backdrop, the Fed delivered two additional 25 bp cuts during the quarter, following a September 25 bp cut, bringing the federal funds target range down to 3.50% to 3.75% by year end. Balance sheet policy remained in focus as investors weighed the longer-run objective of moving toward a Treasury-only portfolio against near-term housing and market functioning considerations, particularly after the Fed decided to conclude the reduction of its aggregate securities holdings and to reinvest principal payments from agency securities into Treasury bills.

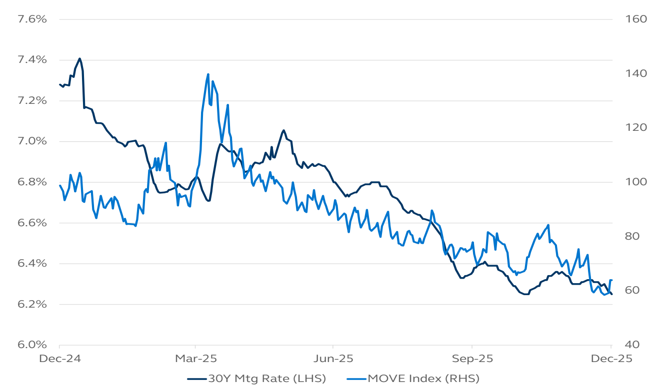
Mortgage rates moved lower into year end, bringing the 30-year fixed rate to 6.15%. Refinancing picked up at the margin in higher coupon cohorts, but most borrowers remained out of the money given the large share of outstanding mortgages originated at materially lower coupons. Technicals were constructive as light organic supply helped offset tepid demand from bank and traditional foreign investors, while aggregate fixed-income inflows and demand from REITs and non-traditional foreign buyers supported overall demand. Finally, sponsorship appeared to improve late in the quarter as retained-portfolio activity at the GSEs increased, providing incremental demand support alongside ongoing buying from money managers and other spread-sensitive investors.

Agency MBS Coupon Returns (Total & Excess)



Source: Bloomberg

Mortgage rate and rate volatility



Source: Bloomberg

Outlook

Refinancing activity is likely to remain concentrated in higher-coupon cohorts as mortgage rates ease, and we continue to favor specified pools over generic collateral within refinanceable sectors as pay-up dispersion remains meaningful. With implied volatility closer to long-run norms, the path of spreads should be driven more by net supply and the durability of marginal demand than by further volatility normalization. After a year of constrained net issuance that supported excess returns, supply is expected to rise modestly in 2026 as turnover and refinancing improve, making the buyer mix more important in determining whether spreads can remain anchored near current tights.

From a valuation perspective, spreads sit near the tight end of recent ranges, limiting the scope for further compression and leaving performance more dependent on stable volatility and steady sponsorship. Technicals remain the swing factor. Bank and traditional foreign demand has been less consistent, leaving the sector more reliant on money managers, REITs, and other spread-sensitive buyers. Policy and political focus on housing affordability can drive periodic headline risk and episodic technicals around agency demand, but absent concrete legislative or FHFA actions that alter the housing finance framework, the near-term backdrop remains primarily rate, volatility, and flows driven rather than reform driven.

Asset-Backed Securities (ABS)

DECEMBER 31, 2025

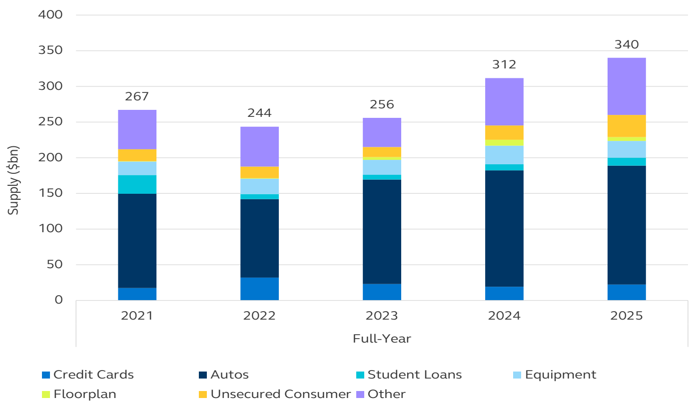
Highlights

The Bloomberg AAA Asset Backed Securities (ABS) Index returned 1.24% during the fourth quarter, which outperformed like-duration Treasury returns by 16 basis points and slightly outperformed the 13 basis points of excess returns from intermediate investment grade corporates. For full-year 2025, the AAA ABS index returned 5.87% and outperformed Treasurys by 48 basis points. The AAA ABS index OAS spreads started the year at 38 basis points over Treasurys and ended the year at 45 basis points, rising 4 basis points during the fourth quarter.

ABS new issuance totaled $83 billion in the fourth quarter as compared to $92 billion for Q3, bringing the year-to-date total to $340 billion as compared to $312 billion for 2024. The record-setting pace of 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 such as digital infrastructure and unsecured consumer ABS have also benefited from growing acceptance among insurance companies and other investors seeking higher yields and spreads.

Investment grade ABS secondary market trading volumes were $54 billion for the quarter, down slightly versus $58 billion traded in Q3. Investors were net buyers of $1.5 billion.

ABS Sector Supply



Source: J. P. Morgan

Outlook

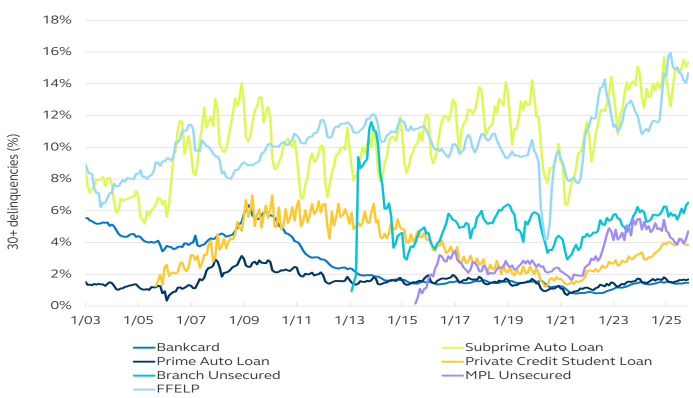
Focus is shifting from the uncertainty of tariff negotiations to the growth-friendly aspects of policy, including deregulation and tax cuts. The fiscal impulse is set to move from a drag on growth in the second half of 2025 to a solid tailwind in the first half of 2026, supported by tax refunds and federal spending.

Inflation continues to run well above the Fed's stated target and is likely to remain elevated for some time. However, the Fed is characterizing inflation as "near target" when stripping away tariff effects. As the labor market continues to soften, the labor data will guide the Fed's policy framework. A gradual weakening of the labor market is likely to support additional cuts to the target rate in 2026, which is supportive of risk assets.

Technicals remain solid, underpinned by healthy corporate fundamentals, a resilient consumer, a supportive Fed, and attractive fixed income yields. Incremental credit supply from AI hyperscalers weighed on markets late in 2025 as major tech firms shift from fully funding capex through free cash flow to tapping the credit markets to optimize cost of capital. Balance sheets for the large hyperscalers are quite strong, and ongoing supply is expected through 2026 as the AI buildout continues. M&A activity is also expected to ramp up, which could add additional supply.

Overall collateral performance remains solid in securitized markets; however, credit bifurcation is becoming increasingly pronounced. In the consumer ABS market, wage pressures and rising delinquencies are creating noticeable divides across borrowers. Investor enthusiasm for securitized assets remains robust, supported by attractive relative value compared with corporates and limited net supply, and we expect continued high gross issuance to be well received. Spreads remain near three-year tights, but stable performance and strong demand suggest a further tightening bias at the start of the year.

30+ Delinquency



Source: J. P. Morgan

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Commercial Mortgage-Backed Securities (CMBS)

DECEMBER 31, 2025

Highlights

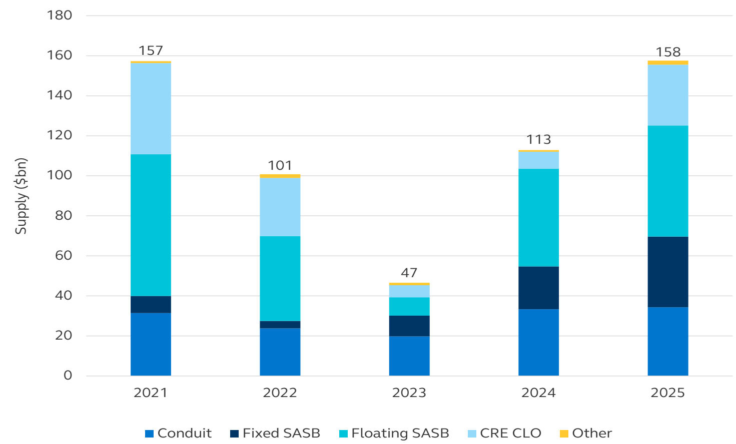
The Bloomberg AAA Commercial Mortgage-Backed Securities (CMBS) Index posted total and excess returns of 1.31% and 0.14%, respectively, during the fourth quarter and 7.68% and 1.02% for the year. Despite spikes in market volatility in October and November, the market ended the year in risk-on mode. The outlook for lower interest rates and lower inflation in 2026 helped to offset concerns about a weakening labor market and drove investor demand for credit. Longer term Interest rates ended the quarter 2bps higher at 4.17% with a range of 3.95% mid-October to 4.17% to end the year. The prospect for lower interest rates and the consensus that commercial real estate activity and values will start to recover in 2026 also helped drive demand for CMBS. CMBS spreads ended the quarter flat to tighter with the credit curve flattening. AAA CMBS spreads ended the fourth quarter largely unchanged, AA spreads 9bps tighter, A spreads 6bp tighter and BBB spreads 7bps tighter.

New issue activity remained strong during the quarter. The $33B of private label issuance, during the fourth quarter, was in line with the $33B print in the third quarter and up from the $30B issued 4th quarter 2024. Private label conduit issuance during the quarter was $9.7B compared to $9.1B in the third quarter of 2025 and $9.4B in the fourth quarter of 2024. Private label SASB issuance was $23B compared to $24B in the third quarter of 2025 and $21B in the fourth quarter 2024.

Outlook

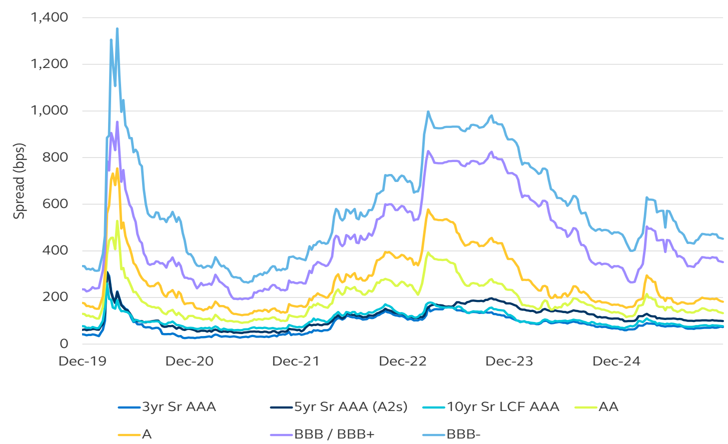
The outlook for CMBS remains primarily focused on refinancing loans that mature in 2026, the path of the economy and specifically job growth, the path of interest rates and longer-term office loan fundamentals. Our outlook is that 2.0 CMBS underwriting should protect from loan defaults becoming systematic with headline risk remaining idiosyncratic which makes CMBS spreads and yields continue to look attractive relative to alternatives.

CMBS Private Label Supply



Source: J.P. Morgan

CMBS Spreads to Treasuries



Source: J.P. Morgan

Important Information

DECEMBER 31, 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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