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Interest rate strategy

MARCH 31, 2025

DAN KANG, CFA
Portfolio Manager

Rates/Corporates

Highlights

In the first quarter of 2025, U.S. Treasury yields were volatile amid persistent inflation, slowing growth, and the Trump 2.0 administration's adversarial trade policies. The 10-year yield initially rose after hotter-than-expected January CPI and PPI prints, peaking near 4.8%, but subsequently fell to 4.21% by quarter-end on weaker data and escalating policy uncertainty. The tariff announcements on Mexico and Canada, combined with expectations of imminent reciprocal and sectoral tariffs, signaled a more aggressive trade stance than anticipated.

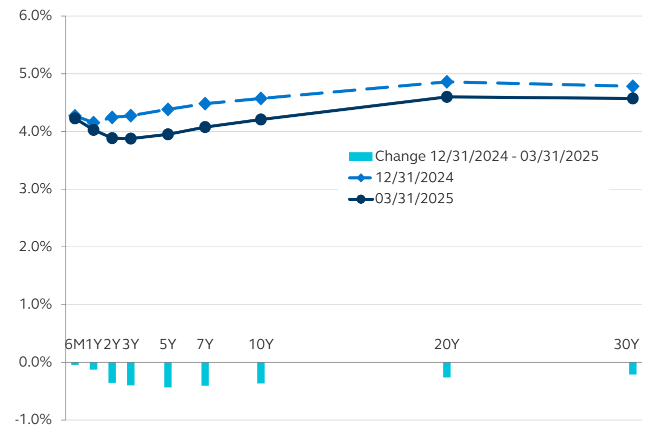
Growth momentum deteriorated meaningfully, with the Atlanta Fed's GDPNow estimate for Q1 falling to -2.8%, despite a solid Q4 print of +2.4%, as weaker consumption, slower investment, and surging imports mechanically reduced GDP estimates. However, during the quarter, "soft" and "hard" data diverged. Low consumer and business confidence contrasted with activity and demand data that pointed to stability. The labor market, while showing continued signs of moderation, remained broadly resilient, with payrolls averaging +138k in January and February and the unemployment rate at 4.1%. Consumer spending appeared to be rebounding after a soft start due to weather and wildfire distortions. Inflation remained sticky: February core CPI rose 3.1% year-over-year, and core PCE tracked 2.8%, driven by services and early tariff effects.

The Fed held the target rate at 4.25% to 4.50% in March and reaffirmed its data-dependent stance. The March SEP maintained the 2025 median dot at two cuts but raised the core PCE forecast to 2.8% and nudged the long-run neutral rate higher. Powell characterized tariff-driven inflation as likely "transitory," though several FOMC members flagged upside risks. Market pricing adjusted accordingly, converging toward two cuts for the year. In a further tapering of quantitative tightening (QT), the Fed announced that beginning in April, the monthly Treasury runoff cap would be reduced from $25B to $5B, with the $35B MBS cap unchanged. Treasury auction sizes remained steady, though issuance is expected to increase in the second half of 2025 to fund widening deficits tied to defense outlays, industrial policy, and structurally weaker revenues.

Outlook

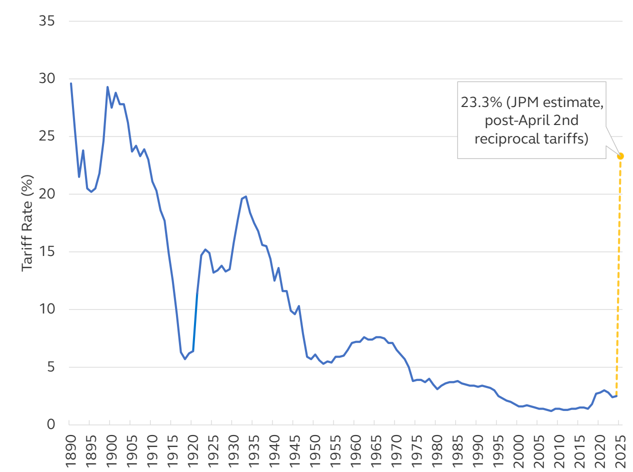
The global order and macro outlook have changed considerably during the quarter. The velocity of change and the resulting market volatility have been staggering, as Trump enacted tariffs under the International Emergency Economic Powers Act (IEEPA), and the Department of Government Efficiency (DOGE) aggressively sought cost reductions. As of this writing, the effective tariff rate is set to rise to approximately 10x its level at the beginning of the year, posing a significant drag on economic activity and upward pressure on inflation. This stagflation scenario would put the Federal Reserve in a difficult position as it navigates its dual mandate. Assuming inflation expectations remain contained, we would expect the Fed to view tariffs as a transitory, one-time price shock and to respond aggressively to any weakening in the labor market. Over the coming months, we will be monitoring whether trade negotiations can produce a viable off-ramp from the current trajectory and thereby de-escalate the trade war and policy uncertainty before the hard data deteriorates.

U.S. Treasury Yield Curve



Source: Bloomberg

U.S. Effective Tariff Rate on Imports



Source: Tax Foundation, JP Morgan

Corporates

MARCH 31, 2025

Highlights

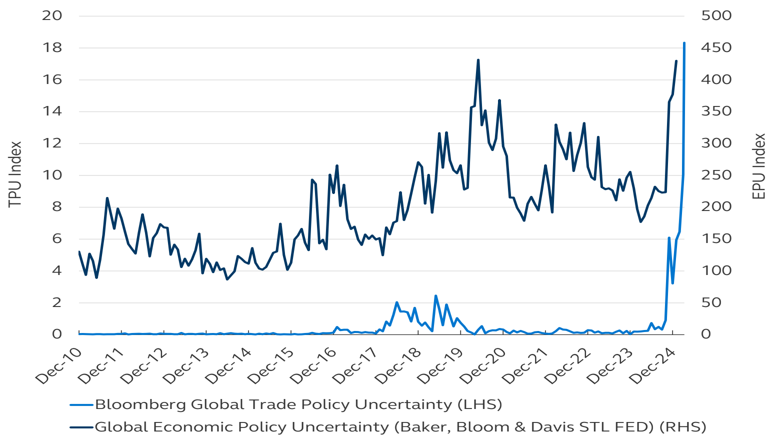
In the first quarter of 2025, the Bloomberg U.S. Intermediate Corporate Bond Index returned 2.27% in total and -0.29% in excess return, reflecting positive performance from rates but modest spread underperformance. Spreads began the year at 71 basis points after reaching cyclical tights of 64 basis points in December, the tightest since 2021, but widened to 87 basis points by March amid a broad risk-off move that steepened spread curves and saw A-rated credits outperform BBBs. Spreads ended the quarter at 82 basis points as volatility increased, largely due to concerns around Trump's proposed tariffs, while underlying softer macro momentum increased risks of a stagflationary outlook.

High-grade credit fundamentals remained stable, supported by resilient earnings and muted debt growth despite moderating GDP. Spread pressure in autos and consumer discretionary reflected tariff concerns, although broader credit risk remained idiosyncratic, with limited downgrade candidates. Supply totaled a record $539 billion in the first quarter, surpassing $530 billion from the same period in 2024. March ranked as the third busiest month on record, with $194 billion issued. Full-year gross supply is tracking toward $1.5 trillion, while net supply is expected to decline by approximately 20 percent due to a glut of 2020 five-year bonds maturing. The composition of supply has shifted, with a decrease in Yankee issuance and a greater share of domestic deals. M&A-related supply has increased, highlighted by jumbo transactions such as MARS financing $26 billion in March. Demand has softened relative to 2024's record pace; year-to-date investment-grade fund flows totaled approximately $66 billion—still positive and strong compared to other risk assets such as high yield, loans, and equities. However, foreign demand has begun to fade, as higher FX hedging costs and narrower rate differentials have reduced the relative appeal of U.S. corporates.

Outlook

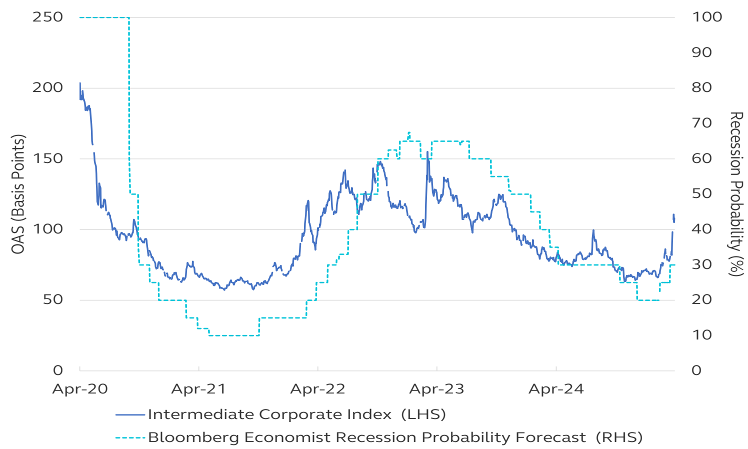
A combination of a deteriorating macro outlook and a high degree of policy uncertainty has weighed on credit markets. Current positioning and sentiment support sharp rebounds if headlines change; however, record-high policy uncertainty (see Chart 1) must retrace before a sustained rally can be accomplished. Over the next quarter, we are acutely focused on 1) the state of trade negotiations with the United States' largest trading partners, 2) upcoming earnings calls for any additional color management may provide in this new environment, and 3) progress on the tax bill and deregulatory efforts. Our base case assumes a long, negotiated process, but the broad contours of any deal could be agreed upon relatively soon. Broadly, we assume investment-grade companies should find a modest tariff rate manageable for their credit profiles, but we will listen for signs of a more meaningful impact. Further, we expect the policy agenda to shift toward more market-friendly items, including passage of the tax bill and additional deregulatory efforts. Until we see significant progress on those measures, we would expect the market to price in a significant risk of recession, consistent with trading ranges seen during 2022–2023 (see Chart 2).

Global Policy Uncertainty



Source: Bloomberg, Baker Bloom & Davis.
TPU Index- Derived index based on key word searches in Bloomberg News and First Word feeds.
EPU Index- Derived index based on key word searches in major newspapers.

U.S. 1-Yr Forward Recession Probability vs Corp Spreads



Source: Bloomberg

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Mortgage-Backed Securities (MBS)

MARCH 31, 2025

Perpetua Phillips
Portfolio Manager

MBS/ABS/CMBS

Highlights

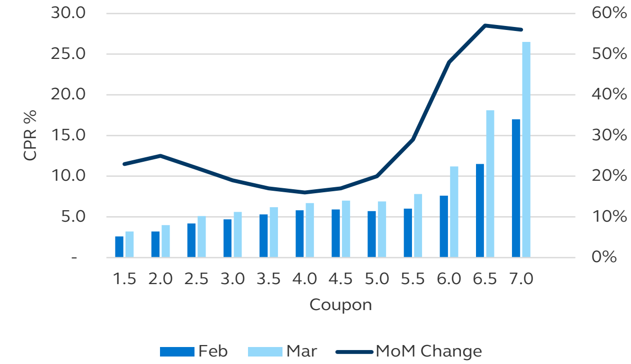
The Bloomberg U.S. MBS Index posted total and excess returns of 3.06% and -0.07%, respectively, during an eventful first quarter. Rangebound rates and muted volatility through mid-February gave way to a sharp risk-off move throughout the rest of the quarter. DOGE job cuts, immigration curbs and trade wars quickly brought fears of recession/stagflation to the forefront. A flight to safety drove Treasury yields 25-45 bps lower while equity markets sold off sharply. The 2yr, 5yr and 10yr Treasury yields closed the quarter at 3.88%, 3.95% and 4.21%, respectively.

Following a total of 100 bps of cuts in the federal funds rate last year, the Fed left policy rates unchanged at their January and March meetings, citing stalled progress on inflation and fiscal policy uncertainty. The committee maintained their projections for two rate cuts this year, but had more pessimistic forecasts for growth and inflation. On the balance sheet front, they reduced the Treasury runoff cap from $35B/mo to just $5B/mo while maintaining MBS runoff at a non-binding $25B/mo. MBS paydowns averaged just $14.8B/mo during the quarter.

Mortgage rates breached 7.0% early in the quarter before moderating to around 6.65% at the close. While March prepayment speeds increased by 30% MoM driven by higher coupon recent vintages, aggregate speeds were only 6.5% CPR as the overall MBS universe remains deeply out of the money. Originator supply was manageable at $252B gross and just $32B net for the quarter, driven by Ginnies as UMBS net issuance turned negative in February and March. Current coupon nominal spreads stayed relatively rangebound at around +125, but the OAS of the MBS index tightened by 7 bps to end at +36 bps as erratic news headlines pushed rates volatility (MOVE index) back into the triple digits.

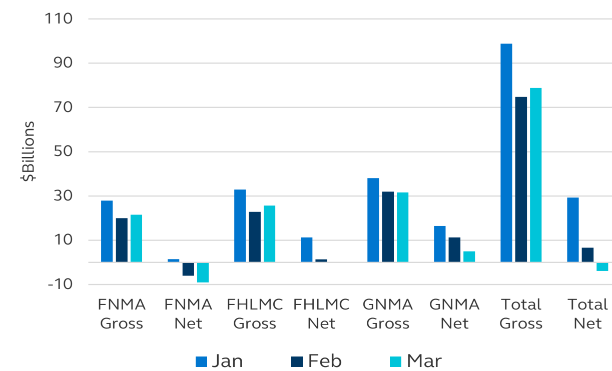
The agency MBS sector faces several risk factors that could impact performance over the medium term. First, the change in administration has brought personnel and policy shifts that introduce uncertainty to housing and MBS markets. Notably, the appointments of Scott Bessent (Treasury secretary) and Bill Pulte (FHFA director), have escalated discussions around government-sponsored enterprise (GSE) privatization, with both citing the possibility of incorporating the Treasury's Preferred Stock Purchase Agreement (PSPA) stake into a sovereign wealth fund. Top of mind for MBS investors is the nature of any future government guarantee (implicit, explicit or other) associated with potential changes. Further, Pulte made clear that he intends to steer the GSEs away from non-core initiatives and shift pricing away from cross-subsidization to a more risk-based approach, which could impact agency MBS supply and prepayments. In addition, expectations for looser regulations under the new administration has already spurred vertical consolidation within the mortgage industry – notably Rocket's acquisitions of Redfin and Mr. Cooper (formerly Nationstar), which should increase efficiencies in servicing and worsen convexity within the sector.

MBS Prepayments Were Subdued Outside of Recent Production Higher Coupons



Source: Bank of America

Q1 Agency MBS Issuance Led by Ginnie Mae



Source: Bank of America

Outlook

With increasing risks of a recession amidst unpredictable policy changes we believe MBS provide an attractive combination of income and a hedge against macroeconomic and credit downside risks. While we expect near term volatility to persist, the sector is relatively more buffered against the impacts of tariffs, trade wars and a weakening consumer, while prepayment risks remain manageable. Therefore, we view MBS as an attractive core holding within our stable value portfolios and look to increase allocations if valuations cheapen along with other fixed income spread sectors in the choppy seas ahead.

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Asset-Backed Securities (ABS)

MARCH 31, 2025

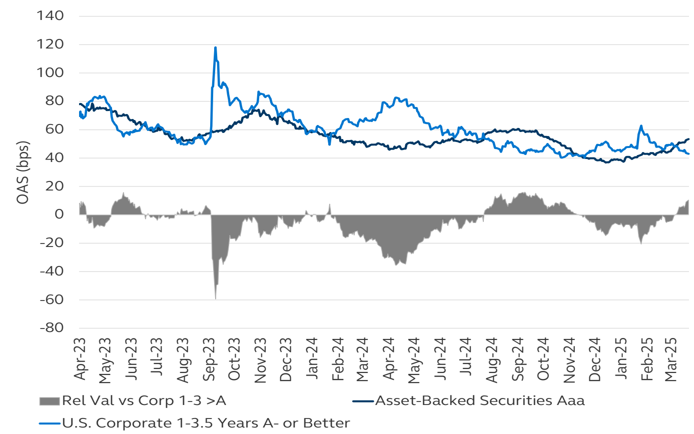
Highlights

The Bloomberg AAA Asset Backed Securities (ABS) Index returned 1.51% during the first quarter, which underperformed like-duration Treasury returns by 33 basis points. Within the ABS index, auto and credit card-related ABS outperformed longer duration sectors, underperforming like-duration Treasuries by a more modest eight and five basis points, respectively.

ABS new issuance totaled $88 billion in the first quarter as compared to $55 billion for the prior quarter and $89 billion in the first quarter of 2024. 2024 was the busiest year for ABS markets since 2006 and current supply is running at a similar pace. 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 of $63 billion marked the busiest quarter in at least the past five years. Investors were net sellers of $1.7 billion, as accounts looked to rotate out of seasoned holdings and into new issue opportunities.

ABS Relative Value



Source: Bloomberg

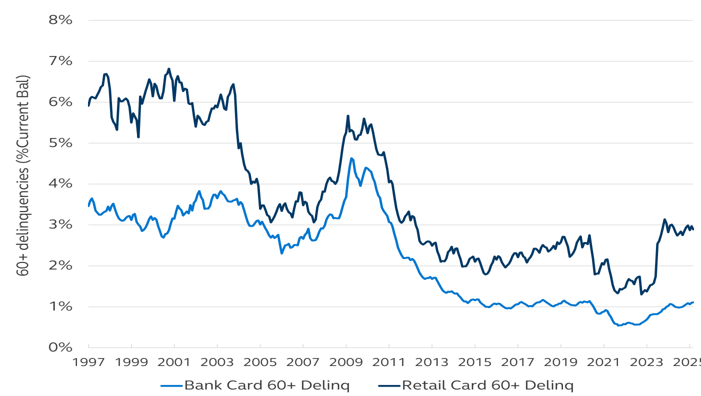
Outlook

The resilience of the U.S. consumer has been remarkable. However, signs of bifurcation are becoming apparent, with delinquencies on consumer loans increasing, savings rates below historical averages and excess savings depleted. Despite this, overall consumer balance sheets remain healthy. Wage growth has exceeded inflation for well over a year for the working population and Social Security cost-of-living adjustments have helped retirees' incomes keep pace with inflation. Looking ahead, consumer spending resilience is likely to be tested in 2025. Wealth effects from booming asset prices in prior years are unlikely to continue as the stock market has become more volatile, and job and spending cuts from the Trump administration begin to take hold.

The labor market continues to slow, but the gradual balancing from overheated conditions provides a favorable backdrop for risk. We expect the unemployment rate to resume its gradual uptrend, though leading indicators do not currently suggest that layoffs will accelerate sharply, which could potentially disrupt the low hiring/low firing balance in the labor market.

Fundamentals for securitized products have moderated slightly, but remain balanced, with an uptick in delinquencies. Direction of employment and inflation will be central for securitized assets. New issuance in 2025 has maintained the heavy pace seen in 2024, but investor demand has begun to cool due to supply fatigue and ongoing economic and policy uncertainty. Spreads have widened from recent tights, retracing to early fourth quarter 2024 levels. Tariff announcements early in the second quarter have resulted in significant market volatility and ABS sectors have not been immune, with spreads resetting wider across asset classes. Further spread widening could present opportunities to selectively add risk in high-quality, fundamentally supported pockets of the market.

Credit Cards 60+ Delinquency



Source: J.P. Morgan

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Commercial Mortgage-Backed Securities (CMBS)

MARCH 31, 2025

Highlights

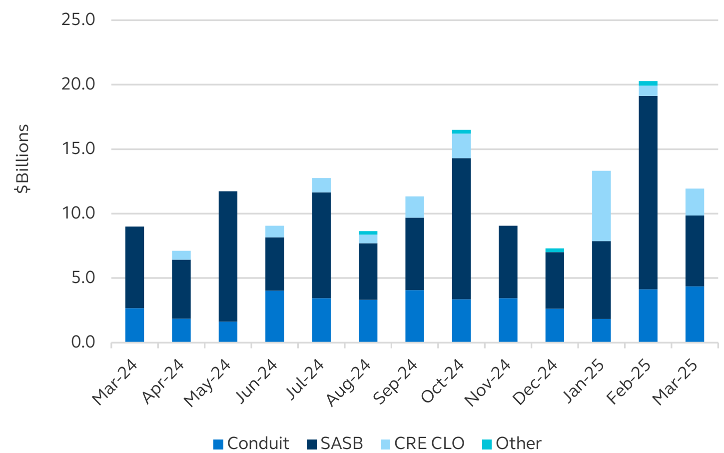
The Bloomberg AAA Commercial Mortgage-Backed Securities (CMBS) Index posted total and excess returns of 2.46% and -0.12%, respectively, during the first quarter. The themes during the quarter centered around U.S. economic growth and inflation fears in the face of new tariff policies coming from the Trump administration. Longer term Interest rates moved lower with the yield curve staying relatively flat as the Fed is expected to cut rates more aggressively in 2025. The move lower in rates was positive for real estate and refinancing debt, but demand for CMBS was negatively impacted in March as economic growth concerns started to take hold. CMBS spreads ended the quarter wider and the credit curve remained relatively flat. As a result, AAA CMBS spreads ended the first quarter 21bps wider, AA spreads 32bps wider, A spreads 26bps wider and BBB spreads 8bps tighter.

New issue activity continued the strong trend that started the 2nd half of 2024. The $36B of private label conduit and SASB issuance during the first quarter was up 20% from fourth quarter 2024. Private label conduit issuance during the quarter was $10.3 compared to fourth quarter 2024 of $9.4B and first quarter 2024 of $5.7B. Private label SASB issuance was $26.5B compared to fourth quarter 2024 of $21.0B and first quarter of 2024 of $12.2B. Secondary market activity slowed down in March as spread and interest rate volatility increased.

Outlook

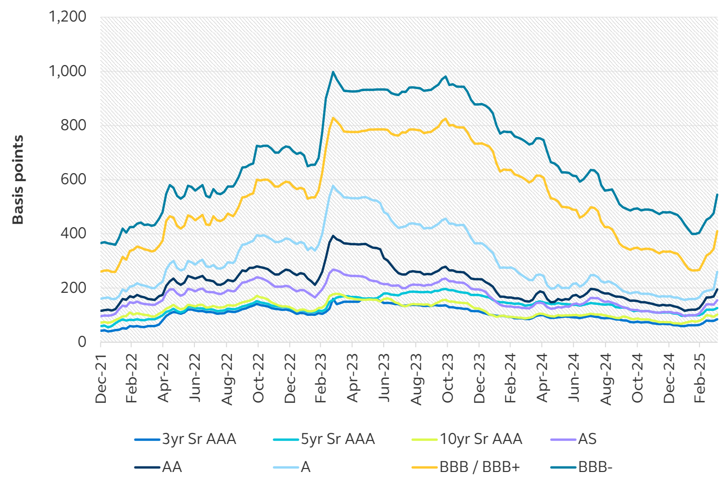
The outlook for CMBS remains primarily focused on refinancing loans that mature in 2025, the path of the economy, the path of interest rates and longer-term office loan fundamentals. Our outlook is that 2.0 CMBS underwriting should protect from loan defaults becoming systematic and headline risk remaining idiosyncratic which makes CMBS spreads and yields continue to look attractive relative to alternatives.

CMBS Issuance



Source: J.P. Morgan

CMBS Spreads to Treasuries



Source: J.P. Morgan

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Important Information

MARCH 31, 2025

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