Principal Asset Management[SM]

Principal Real Estate

Positioning portfolios for higher long-term interest rates

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Whether long-term interest rates will remain above their post pandemic high is an open question. The 10-year Treasury rate hit highs of 4.98% in October 2023 and 4.77% in January 2025. For those concerned about duration exposures and the valuation impact of higher rates on financial assets in general, real estate credit may offer a useful tool for managing this exposure.

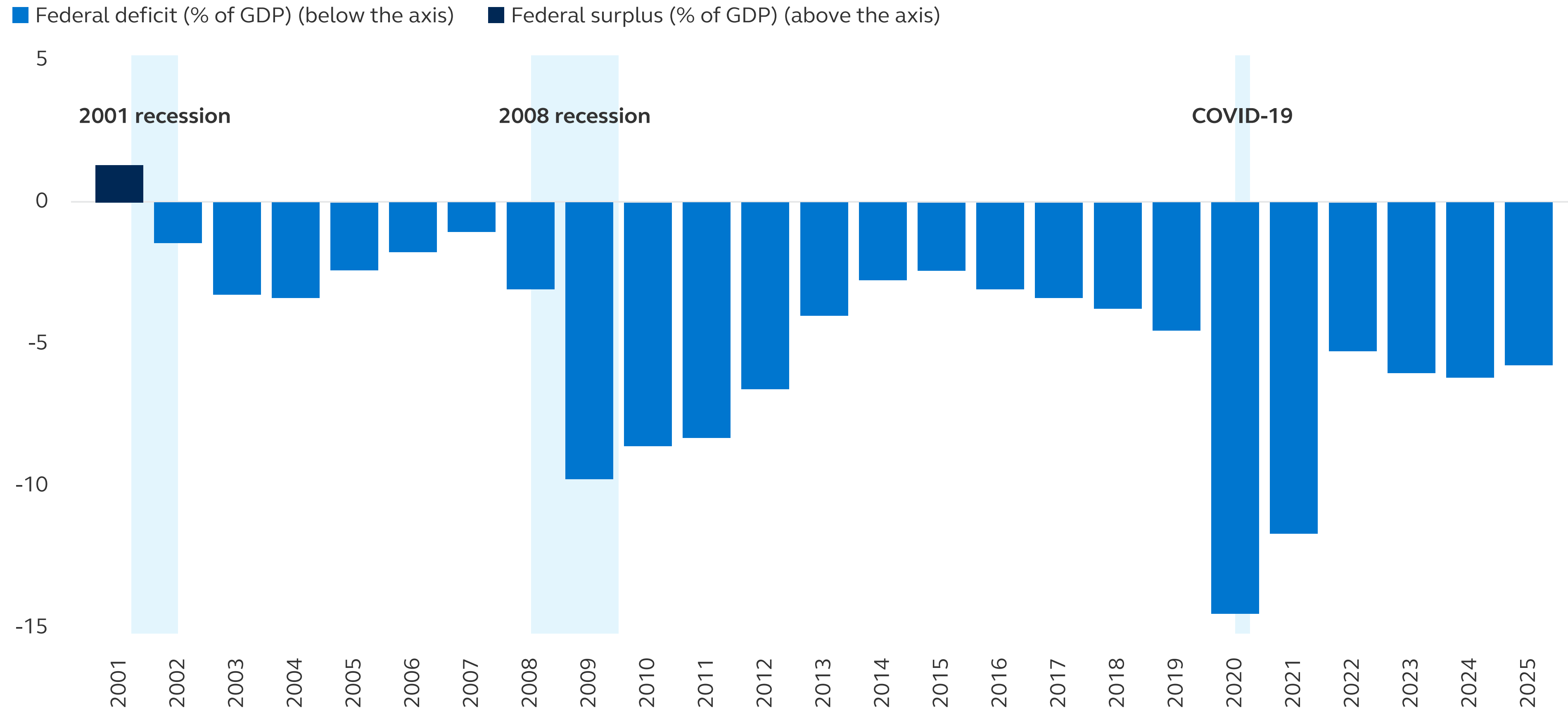
Background

Investors have witnessed interest rates climb higher, driven by factors such as inflation concerns and the size of the U.S. debt. In the near- to intermediate-term, assuming the conflict with Iran concludes and energy prices stabilize, it is reasonable to project a vigilant Fed winning its second bout against inflation of this decade. However, the path back to the Fed's stated inflation target may prove uneven. Factors such as trade policy could complicate and lengthen the time required to achieve sustained price stability.

Even if one accepts the premise outlined above, the longer-term trajectory of U.S. government debt remains a significant concern for investors. As illustrated in Exhibit 1, the United States has run persistent budget deficits for most of the period since 2000. As a result, the federal debt-to-GDP ratio has climbed to 122.6% in 2026 from 57.7% in 2000.[*1] Looking ahead, the prospects for meaningful political action to curb spending or reduce deficits appear limited. The experience of the past 25 years demonstrates just how difficult it is for elected officials to achieve and sustain balanced budgets, particularly when competing economic and political priorities are at play.

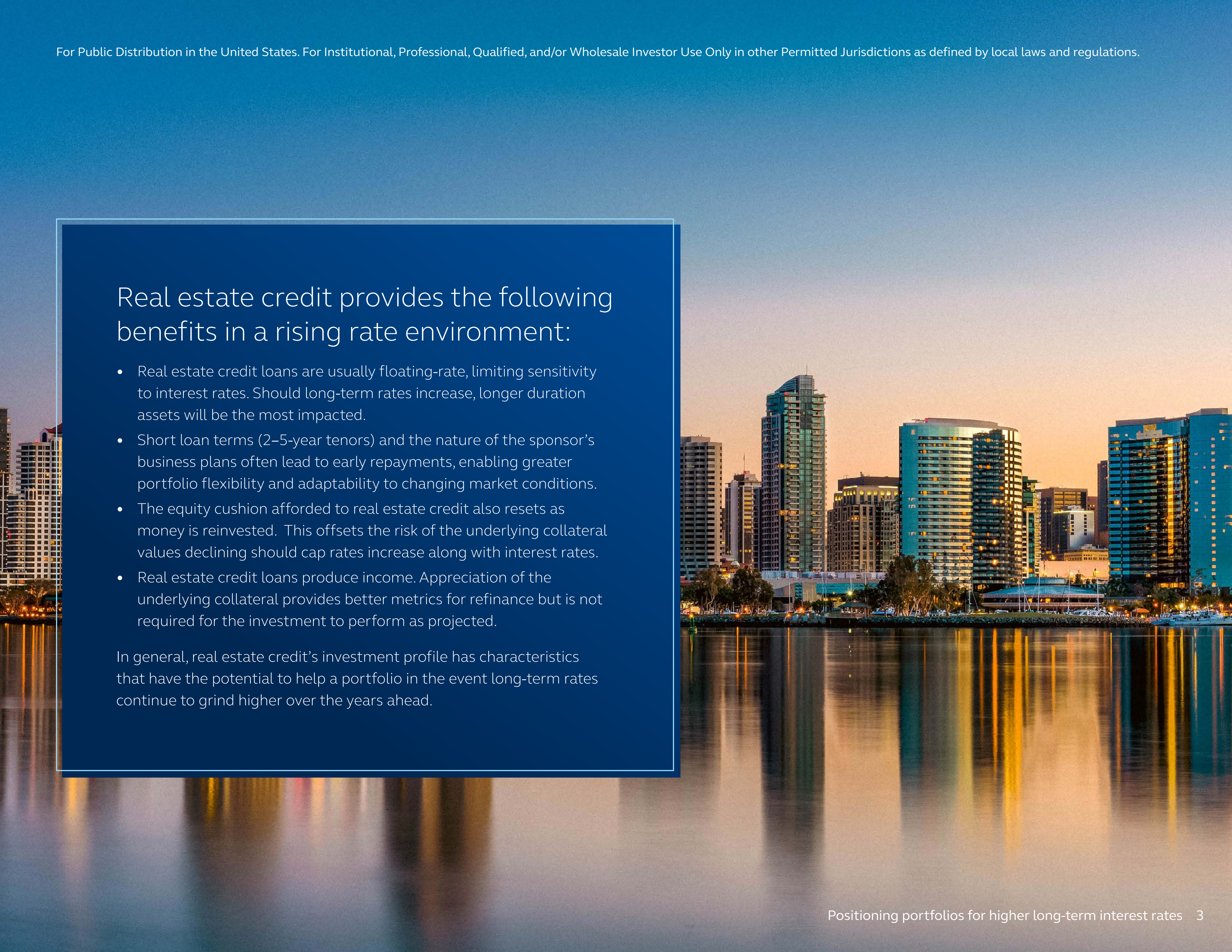
[*1] Source: U.S. Treasury and BEA via FRED. 2000 is 1/1/2000 and 2026 is 1/1/2026.

EXHIBIT 1: U.S. federal deficits have remained structurally elevated



Source: OMB via FRED, 31 December 2025.

With U.S. debt levels likely to worsen before they improve, there is a reasonable probability that longer-term interest rates trend higher over time. While periods of declining yields are inevitable as economic, geopolitical, and market conditions evolve, the fundamental drivers for structurally higher rates remain in place. Persistent fiscal deficits, growing Treasury issuance, and increasing capital requirements associated with large-scale investments in areas such as artificial intelligence infrastructure could all contribute to sustained upward pressure on long-term borrowing costs.



Real estate credit provides the following benefits in a rising rate environment:

- Real estate credit loans are usually floating-rate, limiting sensitivity to interest rates. Should long-term rates increase, longer duration assets will be the most impacted.
- Short loan terms (2–5-year tenors) and the nature of the sponsor's business plans often lead to early repayments, enabling greater portfolio flexibility and adaptability to changing market conditions.
- The equity cushion afforded to real estate credit also resets as money is reinvested. This offsets the risk of the underlying collateral values declining should cap rates increase along with interest rates.
- Real estate credit loans produce income. Appreciation of the underlying collateral provides better metrics for refinance but is not required for the investment to perform as projected.

In general, real estate credit's investment profile has characteristics that have the potential to help a portfolio in the event long-term rates continue to grind higher over the years ahead.

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Risk Considerations

Investing involves risk, including possible loss of principal. Past Performance does not guarantee future return. All financial investments involve an element of risk. Therefore, the value of the investment and the income from it will vary and the initial investment amount cannot be guaranteed. Potential investors should be aware of the risks inherent to owning and investing in real estate, including value fluctuations, capital market pricing volatility, liquidity risks, leverage, credit risk, occupancy risk and legal risk. All these risks can lead to a decline in the value of the real estate, a decline in the income produced by the real estate and declines in the value or total loss in value of securities derived from investments in real estate. Floating rate debt instruments are subject to credit risk, interest rate risk, and impaired collateral risk, which means that the value of the collateral used to secure a loan held by the fund could decline over the course of the loan. An equity cushion can disappear quickly in times of market stress, if property values decline, cash flow weakens, or the original valuation proves overly optimistic. Inflation and other economic cycles and conditions are difficult to predict and there Is no guarantee that any inflation mitigation/protection strategy will be successful.

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