Principal Asset Management℠

PREFERRED SECURITIES FUND (UCITS) - USD | May 2025

Monthly Commentary

Month in review

Preferred security indices: Spreads sharply corrected tighter.

Index	Monthly return
IIPS Index	1.78%
I0CS Index	1.16%
CDLR Index	1.85%
P0P4 Index	-0.05%

IIPS: ICE U.S. Institutional Capital Securities Index
I0CS: ICE BofA U.S. All Capital Securities Index
CDLR: ICE USD Contingent Capital (CoCo) Index
P0P4 (Retail $25 par): ICE BofA Core Plus Fixed Rate Preferred Securities Index

- Preferred and capital securities sharply corrected this month to end at spreads that were similar to those at the beginning of April. It was almost as if the weakness and spread widening of April did not happen. U.S. equity markets rebounded after hitting a low on April 8. This was primarily due to the back-and-forth nature of the tariff policy from the U.S. government. For example, on April 9, the administration said that they were suspending the "reciprocal" higher tariff rates for 90 days, while retaining the 10% global levy on all imports, with China being the notable exception. Then on May 12, the U.S. and China agreed to roll back most of the tariffs and retaliatory tariffs that each country had imposed on each other for 90 days. The U.S. went from 145% to 30% while China said that it would cut its 125% tariffs down to 10%.
- Despite the respite from the volatility we have seen in markets this month, the damage to confidence in U.S. assets has been real. Moody's downgraded the sovereign credit rating of the U.S. from Aaa to Aa1. Since the end of March, the 10-year and 30-year Treasury rates have increased by 20 and 35 basis points (bps), respectively. The U.S. dollar is down about 4.7% over the past couple months (DXY). The outlook for longer term U.S. rates continues to be weak, given the budget bill that is making the rounds in Congress that is poised to add to the deficit in a meaningful manner.
- Given this backdrop of uncertainty in the macro outlook for U.S. rates, preferred and capital securities, given their predominantly five-year fixed-to-fixed reset coupon structures and subordination premiums, should be able to weather interest rate volatility relatively better than other fixed income asset classes such as investment grade (IG) corporates and high yield (HY). Despite a U.S. Federal Reserve (Fed) easing cycle and weaker sentiment, coupons in our strategies remain robust and continue to grow as bonds that were issued as NC5's in periods with lower rates and wider spreads are now getting refinanced higher. The coupon on the IIPS Index climbed from 5.49% to 5.92% over the course of 2024 and is currently at 6.13%. This growing coupon income should be able to support returns in a period of macro uncertainty.

Market sector yields:

- AT1 CoCos: yield-to-worst (YTW): 6.92% (CDLR)
- $1,000 par preferreds: YTW:
  - 6.14% investment grade (IG) (CIPS)
  - 6.90% below investment grade (BIG) (HIPS)
- $25 par preferreds: YTW:
  - 6.52% (IG) (P0P2)
  - 6.86% (IG and BIG) (P0P4)

Interest rates: Interest rates increased.

- U.S. Treasury rates: Given the deteriorating fiscal picture in the U.S. and the Moody's downgrade, Treasuries came under pressure this month with 2s, 5s, 10s, and 30s increasing by 29, 24, 24, and 25 bps, respectively.
- German yields increased more modestly with 5s, 10s, and 30s up by 8, 6, and 10 bps, respectively.
- United Kingdom (UK) rates also moved higher, with 5s, 10s, and 30s increasing by 23, 21, and 16 bps, respectively.

Spreads: Spreads tightened significantly in May.

Index	Current	Prior	Change	Avg	Std Dev	Current-Avg	Z-value
$1,000 par Capital Securities (IIPS)	216	249	-33	269	61	-53	-0.87
All Capital Securities (I0CS)	221	250	-29	255	58	-34	-0.58
USD AT1 CoCos (CDLR)	264	303	-39	347	72	-83	-1.14
$25 par (P0P4)	221	234	-13	220	67	1	0.02
IG Corps (C0A0)	93	110	-17	114	25	-21	-0.84
High Yield (H0A0)	351	415	-64	405	79	-54	-0.68

Figure 1: May end: Spread-to-worst across various USD preferred ICE indices (over past five years).
Source: Spectrum, Bloomberg. Note: The Z-value or Z-score, also known as the standard score, is the number of standard deviations by which the value of a data point is above or below the mean value of what is being observed or measured. The larger the absolute value of the Z-score, the more statistically unusual the data point.

Index	Current	Prior	Change	Avg	Std Dev	Current-Avg	Z-value
EUR IG Sub Financials (EBSU)	147	164	-17	202	53	-55	-1.05
EUR IG Sub Non-Financials (ENSU)	183	201	-18	250	54	-67	-1.23
AT1 CoCos (CEUR)	343	361	-18	461	100	-118	-1.18
EUR IG Corps (ERS0)	91	104	-13	118	34	-27	-0.8

Figure 2: May end: Spread-to-worst across various EUR currency capital security ICE indices (over past five years).
Source: Spectrum, Bloomberg.

- The move tighter in spreads and the relative underperformance of the longer duration $25 par asset class has made the $25 par asset class relatively attractive with a 5-year z-value that is now positive at 0.02. USD AT1 CoCos look the richest with a z-value of -1.14.

- One can pick up two times the spread by going down the capital structure into preferred securities with half the duration risk (IIPS vs. C0A0). Within AT1 CoCos, the relative pickup is even better with three times the spread with an even shorter duration exposure than IIPS.
- Spreads in EUR AT1 CoCos continue to be wider relative to USD AT1 CoCos: 79 bps as of the end of May.
- The value in our asset class continues to be the story of growing coupon income and attractive nominal yields with limited duration sensitivity despite a tighter than normal spread environment.

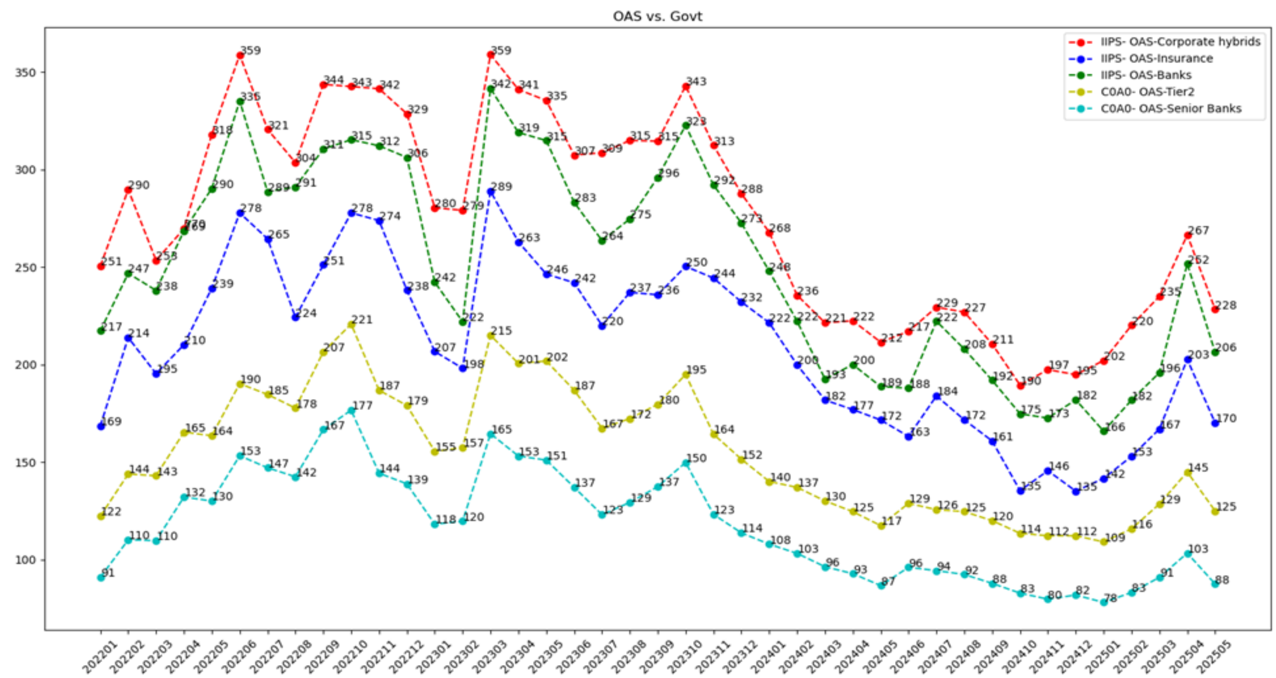

Figure 3: IIPS spread history by sectors. Source: Spectrum.

- From Figure 3, we can see that spreads have become more interesting now that they have moved upwards. Corporate hybrids continue to offer the best relative value, but the option-adjusted spread (OAS) in banks has caught up.

Figure 4: IIPS spread history. Source: Spectrum

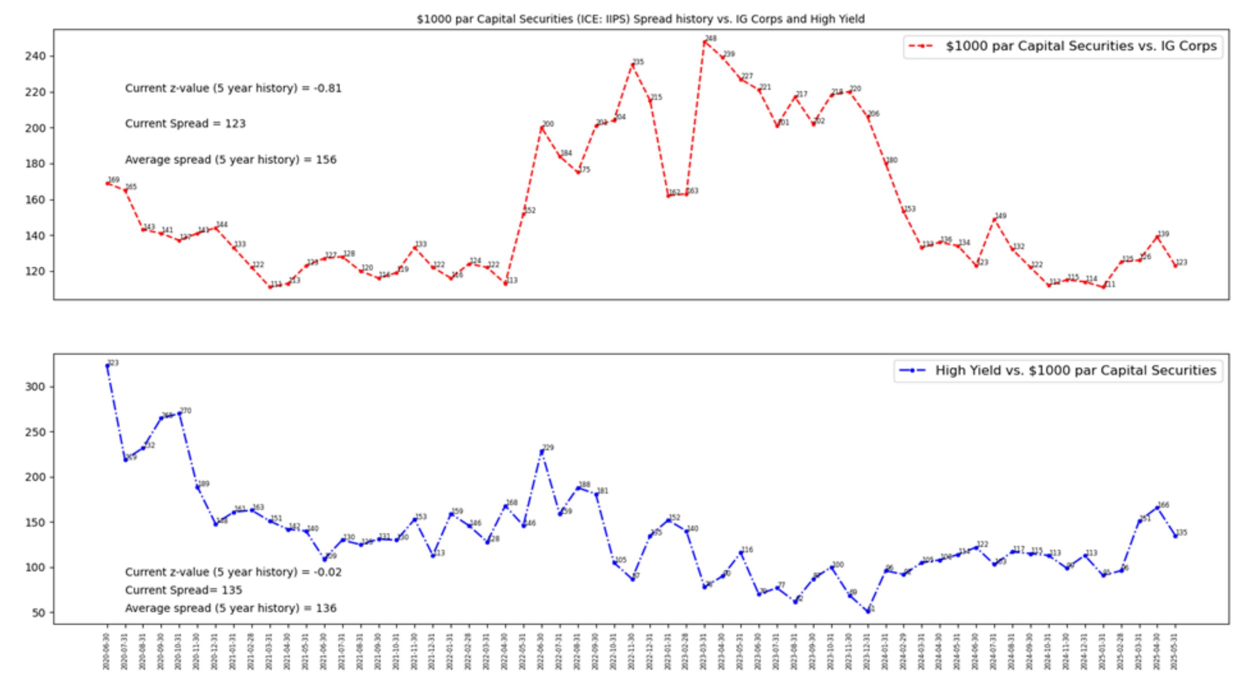

Figure 5 (two charts): IIPS spread history vs. C0A0 and H0A0. Source: Spectrum

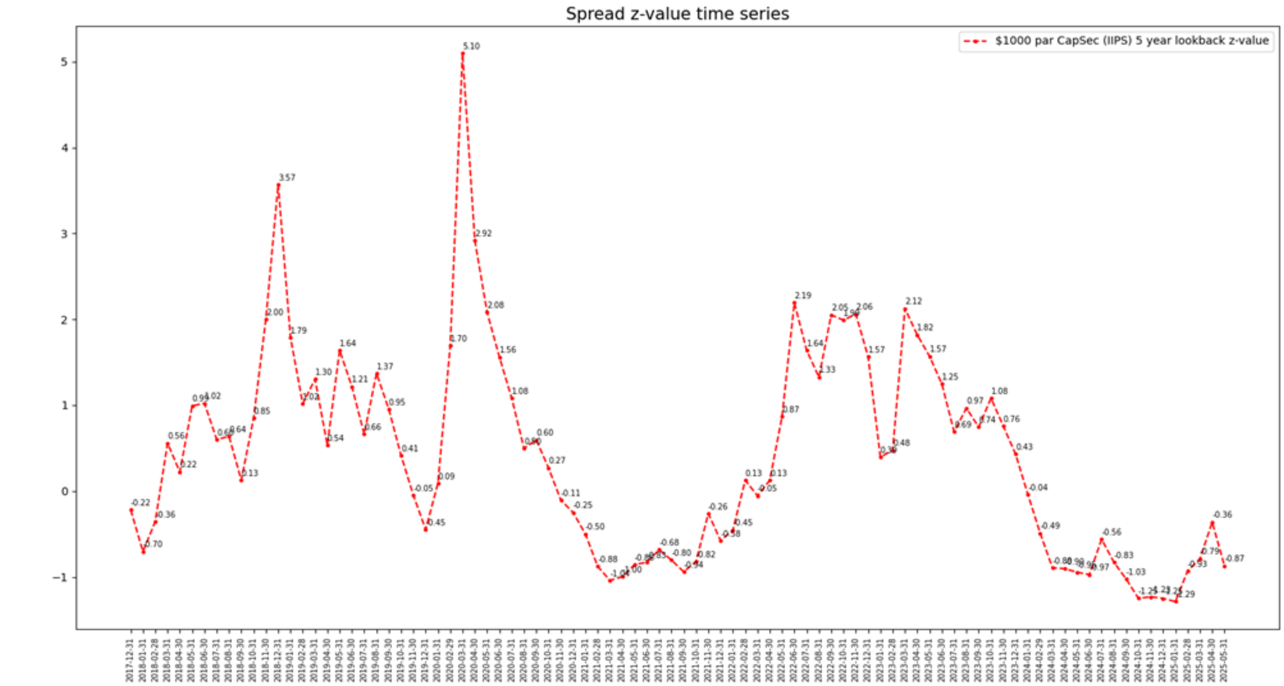

Figure 6: Time series of z-values on the IIPS Index. Source: Spectrum

Figure 7: YTW on the IIPS Index. Source: Spectrum.

U.S. economic data: Consumer and business sentiment continues to weaken. The back and forth on tariffs adds to uncertainty. GDP contracts in Q1. The fiscal situation is of concern to debt investors.

- The U.S. budget bill that is making the rounds in Congress is adding to the jitters in U.S. Treasuries and the dollar.
- U.S. goods imports dropped 20% in April as a direct consequence of the tariffs; this is the largest monthly drop in the data going back to 1992. This contrasts with the March data when imports increased as companies tried to stock inventories before the tariffs went into effect. This would suggest that the U.S. GDP could get a boost from trade in the second quarter.
- Consumer spending growth slowed from a month over month pace of 0.7% in March to 0.2% in April as consumers become more cautious about spending. https://www.bea.gov/data/consumer-spending/main
- The published Federal Open Market Committee's (FOMC) May minutes showed that officials thought that the tariffs had increased chances that inflation would remain above the Fed's 2% target. The officials were also concerned that a change in the perceived safe-haven status of U.S. assets could have longer term implications for the U.S. economy. The Fed held rates steady at 4.25-4.5% and is signaling that rate cuts could be on hold until they are clearer on the impact of tariffs on prices.
- The narrative in the U.S. economy has shifted from growth to a weaker sentiment on the back of policies of the new administration. Markets rallied post the election due to the expectation of growth focused policies but recent uncertainty around tariffs has dented that enthusiasm. The University of Michigan Consumer Confidence Index fell sharply in February, March, and April with Americans concerned about the outlook for employment and prices. The survey also indicated that expectations for long-term inflation had reached the highest level since 1993.
- The U.S. Personal Consumption Expenditures Index (PCE) Index, which is the Fed's preferred gauge of inflation, ticked down to 2.1% from 2.3%. Core PCE ticked down to 2.5% from 2.6% the prior month. Therefore, the effect of tariffs have not made it into the data yet.
- The labor market is showing some signs of softness with the economy adding 177,000 jobs in April and the prior month being revised lower to 185,000 from 228,000. The Fed will closely watch this number as the effects of tariffs take hold.

Eurozone economic data: European Union (EU) cuts growth forecasts in the face of trade wars.

- The European Commission cut its growth forecasts for the Eurozone to 0.9% for this year from 1.3% published in November. The outlook for 2026 was lowered to 1.4% from 1.6%. The Commission also expects inflation to reach the European Central Bank (ECB) target of 2% faster than expected and fall to 1.7% next year. On a country basis, German GDP is forecasted to be flat for 2025, while France and Italy's growth expectations were lowered to 0.6 and 0.7%, respectively. Ireland, Spain, and Greece are expected to outperform.
- The Eurozone economy grew 0.4% in Q1. Despite this, economists expect growth to slow in the second quarter as the effects of U.S. tariffs play through. The German government has revised its outlook for growth for 2025 to zero from its previous prediction of 0.3%. German GDP fell by 0.2% in 2024 and 0.3% in 2023. This, according to the *Financial Times*, is its most protracted slump in postwar history.
- The U.S. imposed a 20% reciprocal tariff on the EU in April, but then issued a 90-day pause which has reset the rate to the universal 10% for now.
- The ECB cut rates in April to 2.25%, the seventh such cut since June. The ECB warned that the outlook for growth had "deteriorated owing to rising trade tensions."
- Eurozone inflation was at 2.2% for April with core at 2.7%.
- The HCOB Composite Purchasing Managers Index was at 50.4 for April with manufacturing at 49. Manufacturing production has been contracting since July of 2022.

Supply: Supply has been robust YTD with the bulk of the issuance in Non-Financials.

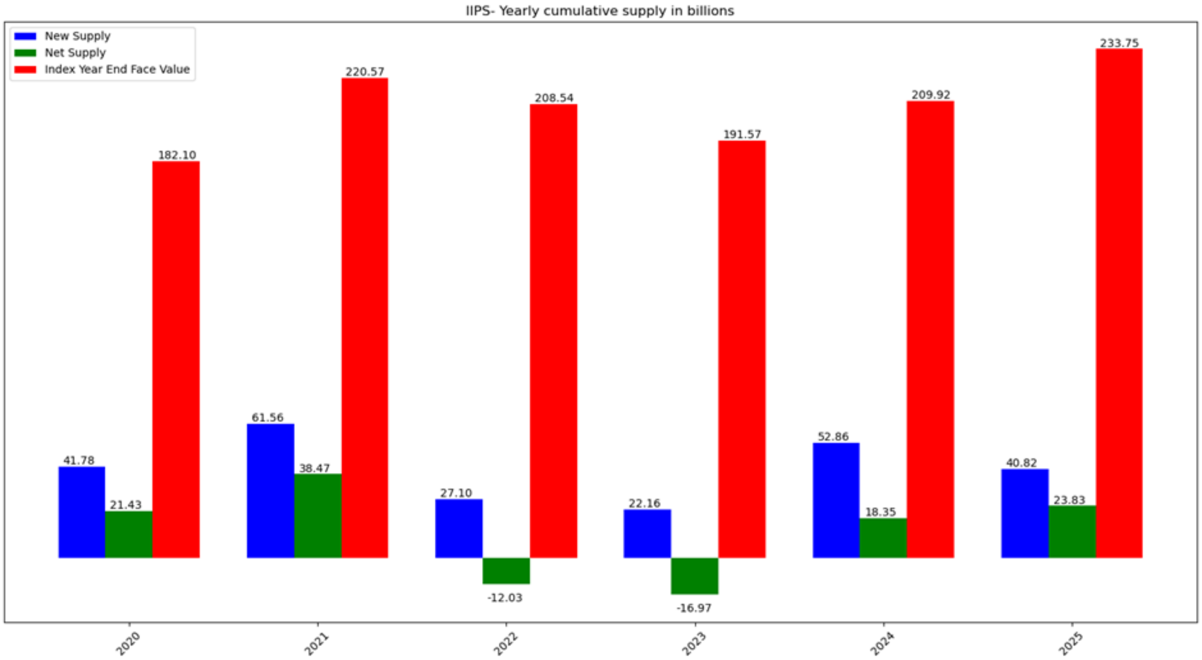

Figure 8: Supply: IIPS Index. Source: Spectrum.

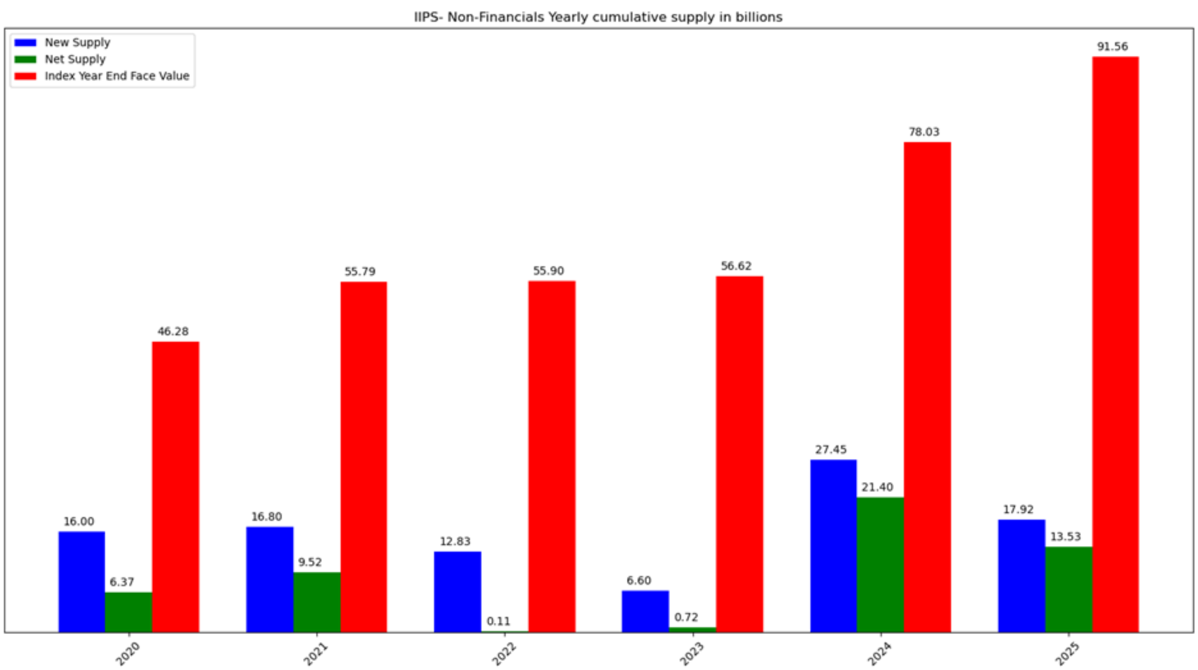

Figure 9: Supply: IIPS Index (Non-Financials). Source: Spectrum.

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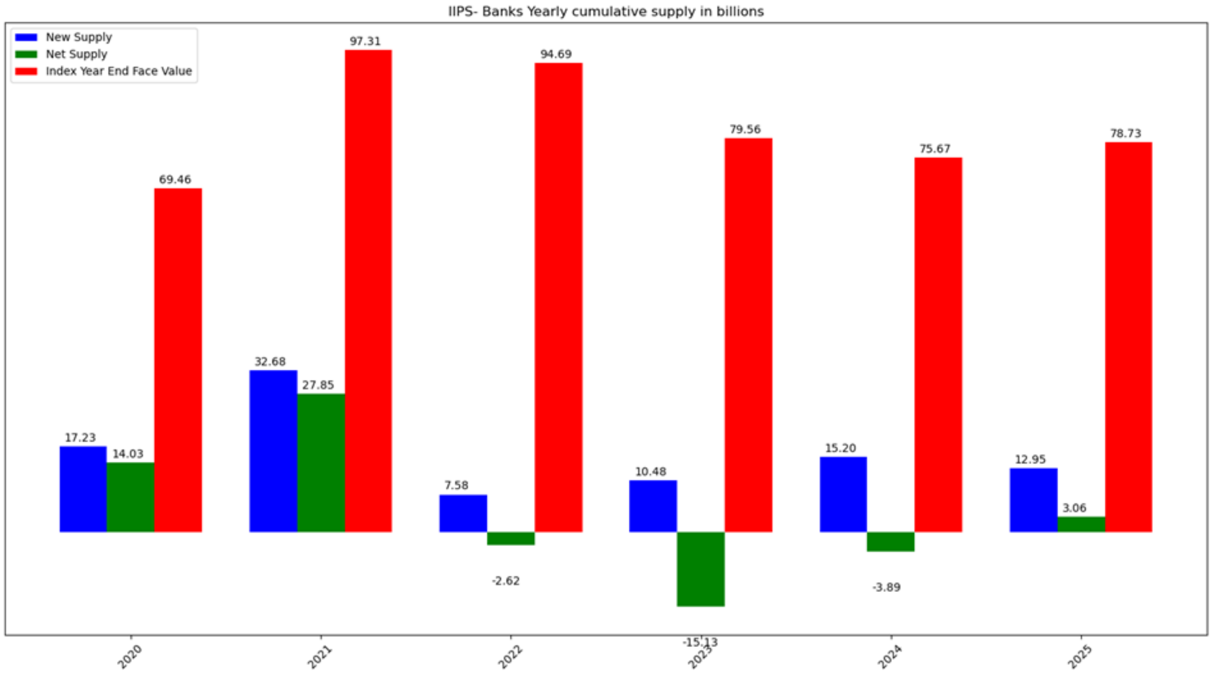

Figure 10: Supply: IIPS Index: Pfd-Banking & Pfd-Financial Services. Source: Spectrum.

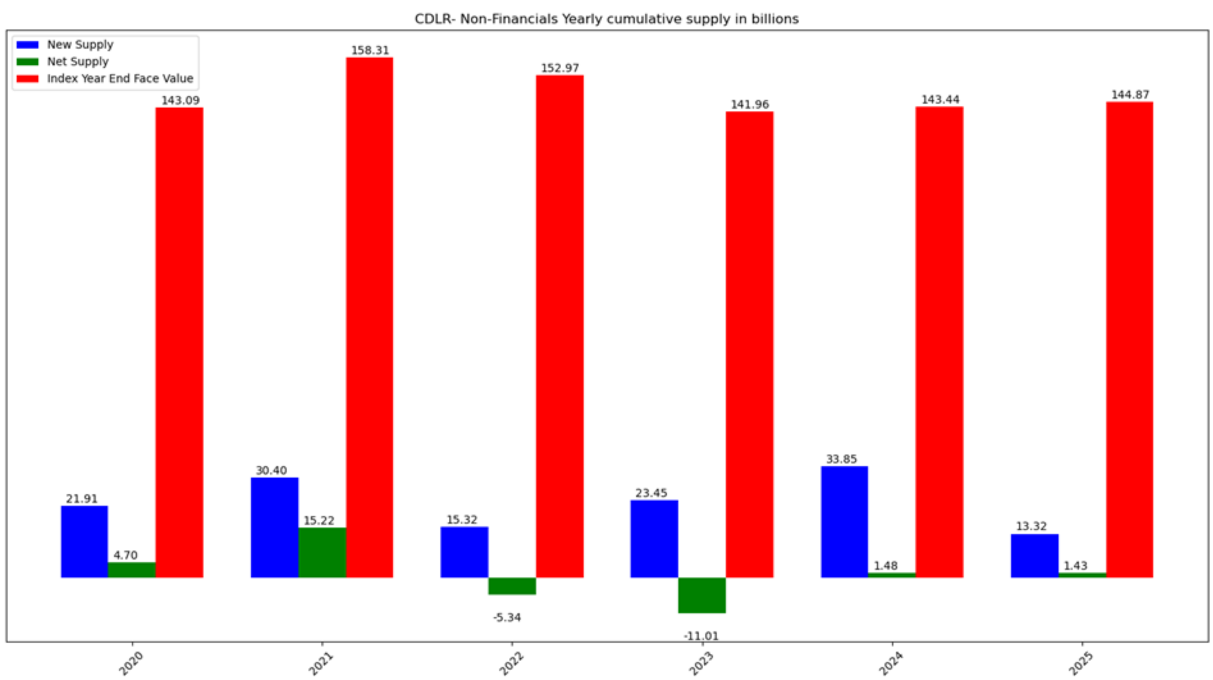

Figure 11: Supply: CDLR Index (CoCos USD). Source: Spectrum.

- Figure 8 shows that the IIPS Index grew for the first time in 2024 since hitting a peak in 2021. The driver for this expansion in the index has been the utility/energy sectors primarily given increased demand from data centers and increased capital spending.
- Figure 9 shows that the non-financial component of the IIPS Index grew by $21.4 billion in 2024 with a total issuance of $27.4 billion. The trend has continued in 2025, with $17.92 billion of new issuance in non-financials.

- From Figure 10, it can be seen that the banking component of the IIPS Index has been flat with $12.95 billion of new issuance and $3.06 billion of net issuance. This scarcity of U.S. bank issuance has resulted in strong performance in U.S. bank preferreds.
- Figure 11 shows the USD AT1 CoCo market has grown YTD with $13.32 billion of new issuance and $1.43 billion of net issuance.

Performance and market notes:

- Given the rise in rates, the longer duration retail $25 par securities came under some pressure with the P0P4 Index returning -0.05%. AT1 CoCos were the best performing asset class with the CDLR Index returning 1.85%. CoCos have benefitted from bonds trading yield-to-call (YTC) given tighter spreads and therefore a lower effective duration of 3.28. In contrast, the $1000 par IIPS Index has an effective duration of 3.90 and the $25 par sector (P0P4) of 8.69.
- Supply: Among the notable issuance, ZurichRe issued a 30NC10 bond that priced at 6.25% or spread of +167 (reset is +267). HSBC issued $2 billion of a perpNC5 bond that priced at 7.05% or a spread of 298 bps. The demand for the bond was very strong with a $11 billion+ book, given the IG ratings that the bond has.

Outlook: We would expect coupon income in our strategies to continue to be elevated despite a central bank easing regime. Interest rate sensitivity in our asset class remains limited.

- **Income**: Capital security issuance has become standardized with fixed-to-fixed reset coupon structures. This reduces duration risk in our asset class, given the ability for the portfolio to earn higher coupon income in rising rate environments. Discounted fixed-to-fixed reset bonds can move up in price as coupons get reset higher. Coupons on the IIPS Index have gone from about 6.75% to a low of 5.25% in early 2022 as central banks kept rates low. Since then, the coupon has climbed to about 6% today. This time around the Fed is cutting rates while the economy is not in a recession. The U.S. economy remains resilient, this has resulted in a steepening of the yield curve. The expectation for intermediate rates in the future are higher, as per the forward curve. Back in late 2021 and early 2022, rates were very low, and bonds were typically issued as long dated NC5 or PerpNC5. These bonds issued in a lower rate environment have coupons with 3 and 4 handles which will either get called away in 2026 and 2027 or get reset higher. This should be constructive for coupon income in our asset class and will put preferred and capital securities in the unique position of being able to increase coupon income in a central bank easing cycle.

- **Lower interest rate sensitivity**: The commoditization of fixed-to-fixed coupon structures has resulted in our asset class having lower effective durations and has therefore lowered interest rate sensitivity in preferred and capital securities.

- **Supply**: The investment universe has grown as a result of issuance from utility and energy companies given the increased demand for power as an offshoot of the AI boom. This is constructive from an income perspective because spreads on non-financial hybrids are typically wider than their financial counterparts. It also allows for diversification benefits. The investment universe has also grown given Tier1 issuance from Canadian banks. Recently issued corporate hybrids are structured as 30nc10 bonds that have a strong incentive to be called at the first call date given that equity credit from S&P falls off then. Additionally, European and Japanese 30nc10 insurance issuance have 100 bps step-ups, which makes extension a more remote possibility.

- **Credit**: The Bloomberg Financial Conditions Index (BFCIUS Index) has moved back to positive territory after going negative in April. Credit conditions at banks and insurance companies remain robust. The policies of the new administration should be constructive for U.S. bank earnings.

- **Nominal yields** are at decade long highs despite the recent spread tightening. A steep yield curve will be constructive for total return as we would expect capital to exit the short end of the curve and look for yield in strategies such as ours.

Europe:

- Increased fiscal spending by Germany should be constructive for growth. This should bode well for re-invigorating growth in the German economy and by extension should be positive for European financials.
- Robust capital levels, healthy asset quality, and ongoing ECB rate cuts should be constructive for performance in EUR denominated capital securities. Given the outlook for 0-1% growth in the two major European economies, namely France and Germany, the ECB will be able to cut rates deeper than the U.S. Fed which should bode well for European sovereign bonds and consequently EUR fixed income. European bank shares performed handsomely in 2024 with the SX7E Index returning 32%. This performance in bank equity has been driven by strong banking fundamentals, a higher interest rate environment, and the return of capital by banks. ECB rate cuts should be supportive of valuation for bank Tier2 and AT1. Rate cuts, while applying downward pressure on net interest margin, could bolster underlying economies and support bank asset quality.
- Lower rates as a result of ECB rate cuts should once again stimulate mortgage lending in the EU, thereby benefitting banks. In 2024, European banks had very little growth in mortgage lending as a result of higher rates, but this should change in 2025. Mortgages are important for banks because they account for almost half of all lending in the Eurozone.
- Insurers across Europe are expected to continue to issue Solvency 2 eligible capital instruments – including Restricted Tier 1 (RT1) and Tier 2 – while replacing legacy securities to optimize their strong capital positions ahead of the end of the 10-year grandfathering period.
- On the cautionary side, credit spreads could come under pressure if European economies are stressed by the imposition of tariffs by the Trump administration. Europe also has less fiscal flexibility and fiscal deficits are being managed lower post the pandemic spending. China continues to compete with European manufacturing, while domestic demand weakness in China has hurt European exporters.

Corporate hybrids:

- Utilities are in a growth phase due to unprecedented demand for power from data centers. Increased electricity demand should bode well for utility equities and corporate hybrids.
- The risk profile of corporate hybrids has improved over the past few years:
  - Large and well diversified investor base – Insurance companies to real money. Corporate hybrids have a place in investor portfolios as a means to add alpha.
  - Issuers are fundamentally sound and are committed to preserving their IG ratings.
  - Favourable structural evolution.
- Evolution of more defensive structures
  - Changes to Moody's rating methodology has allowed for the issuance of 30nc5 structures that have 50% equity credit at all three rating agencies. This allows for a wider investor base relative to a 60+ or perpetual maturity.
  - In the U.S., the changes to Moody's methodology have prompted issuers to liability manage their perpetual preferred and issue dated junior subordinated debt in its place. This increases the universe of bonds that are eligible for inclusion in NRA portfolios that could not buy the preferreds due to withholding taxes but will be able to add the dated junior subordinated debt.
- Solid IG issuers
  - These companies are committed to hybrid capital as a means of managing their capital structure, rating stability, and market reputation.

What helped: Canadian bank LRCNs, AT1 CoCos

- The Canadian bank LRCNs were the top performer this month, returning 2.58% and contributing 25 bps given an average weight of 9.73%. TD 7.25 7/29-84, BNS 8 1/29-84, and CIBC 6.95 1/30-85 returned 3.45%, 3.62%, and 3.56%, respectively.
- The AT1 CoCos in the portfolio returned 1.89% and contributed 54 bps with an average weight of 28.40%. Lower coupon/discounted bonds performed the best given the spread rally with bonds like Natwest 4.6 12/31-perp, Standard Chartered 4.75 7/31-perp, and ING 4.25 11/31-perp returning 4.08%, 3.24%, and 3.82%, respectively.
- The corporate hybrids in the portfolio performed strongly with the pipelines returning 1.74% and utilities returning 1.70%, contributing a cumulative 23 bps to performance given a cumulative weight of 13.52%.
- The Euro denominated UCITs funds in the portfolio performed well returning 1.14% and contributing 5 bps with an average weight of 4.56%.

What hurt: $25 par securities

- The $25 par securities in the portfolio underperformed given their longer duration in a period where interest rates rose.
- SwissRe 6.191 1/45-46 continued to underperform given its longer duration returning -0.68% this month.
- Given the strong rally this month, the subordinated debt holdings in the portfolio, which is a lower beta holding, unperformed relatively, returning 0.55%. The portfolio had 4.96% on average in subordinated debt this period.

What we did:

- The AT1 CoCo concentration of the portfolio increased by 47 bps this month. We added Socgen 8.5 9/34-perp, BNP 4.625 2/31-perp, BBVASM 7.75 1/32-perp, and the new issue HSBC 7.05 12/30-perp.
- In utility hybrids, we added to our Exelon 6.5 12/34-55 position. We switched out of Dominion 7 6/34-54 into Dominion 6.625 5/35-55 and picked up yield.
- From a credit perspective, we sold out of Stanley and Black Decker this month given concerns around the effect of tariffs on its business.
- We added some BNS 8 1/29-84.
- In insurance, we added new issue Zurich 6.25 5/35-55 and recent new issue Meiji Yasuda Life 6.1 6/35-55.

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