Principal Asset Management℠

PREFERRED SECURITIES FUND (UCITS) | March 2024

Monthly Commentary

Month in review

Preferred security indices: Spreads continue to tighten

Index	Monthly return
CIPS Index	1.45%
I0CS Index	1.02%
CDLR Index	1.87%
P0P2 Index	0.28%

CIPS: ICE BofA U.S. Investment Grade Institutional Capital Securities Index
I0CS: ICE BofA U.S. All Capital Securities Index
CDLR: ICE USD Contingent Capital (CoCo) Index
P0P2 (Retail $25 par): ICE BofA Core Fixed Rate Preferred Securities Index

- Spreads on preferred and capital securities continued to tighten this month. The U.S. Federal Reserve (Fed) has raised growth and inflation forecasts resulting in expectations for a steeper yield curve.
- Constrained supply and tight spreads in Investment Grade (IG) Corporates and High Yield (HY) has also contributed to the strength in preferred and capital securities. HY funds are buying preferreds given tight spreads in their asset class.
- Reinvestment opportunities in preferred securities continue to be attractive and coupon income in our strategies continue to rise.

Market sector yields

- AT1 CoCos: yield-to-worst (YTW): 7.54%
- $1,000 par preferreds: YTW: 6.44% (IG) and 7.35% below investment grade (BIG)
- $25 par preferreds: YTW: 5.56% (IG) and 6.07% (inclusive of BIG)

Interest rates: Interest rates were flat to down this period

- U.S. Treasury rates: 2-year rates were unchanged while 5s, 10s, and 30s fell marginally by 3, 5, and 4 basis points (bps), respectively.
- Rates fell across the German sovereign curve with 5s, 10s, and 30s decreasing by 11, 11, and 8 bps, respectively.
- Rates fell across the United Kingdom (U.K.) curve with 5s, 10s, and 30s decreasing by 22, 19, and 14 bps respectively.

Spreads: Preferred spreads are relatively cheaper than IG Corporates and HY (USD)

Index	Current	Prior	Change	Avg	Std dev	Current-Avg	Z-value
IG Capital Securities (CIPS)	203	225	-22	257	57	-54	-0.95
IG $25 par (P0P2)	117	97	20	148	109	-31	-0.28
USD AT1 CoCos (CDLR)	304	318	-14	364	77	-60	-0.78
All Capital Securities (I0CS)	213	221	-8	256	82	-43	-0.52
IG Corps (C0A0)	96	102	-6	126	36	-30	-0.83
High Yield (H0A0)	334	347	-13	440	106	-106	-1.00

March end: Spread-to-worst across various USD preferred ICE indices (over past five years).

Index	Current	Prior	Change	Avg	Std dev	Current-Avg	Z-value
EUR IG Corps (ER00)	107	115	-8	121	37	-14	-0.38
EUR High Yield (HE00)	377	366	11	429	98	-52	-0.53
EUR IG Subordinated Financials (EBSU)	191	203	-12	210	55	-19	-0.35
EUR IG Subordinated Non-Financials (ENSU)	226	240	-14	254	51	-28	-0.55
AT1 CoCos (COCO)	354	376	-22	405	83	-51	-0.61

March end: Spread-to-worst across various EUR currency capital security 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.

- IG Corporates and HY are expensive with spreads at about one standard deviation tight on a five-year historical basis. Preferred and capital securities are relatively cheaper with the I0CS (All Capital Securities Index) at -0.5.
- CIPS subordination premium relative to the IG Corporate Index (C0A0) is 203/96 or 2.1 times with an effective duration of 3.5 relative to 6.7 on C0A0 and CoCos are at 3.2 times relative to C0A0 with an effective duration of 3.
- Within the IG umbrella, one can pick up two times the spread by going down the capital structure into preferred securities with half the duration risk. Within AT1 CoCos, the relative pickup is even better, with three times the spread and an even shorter duration exposure than CIPS.

U.S. economic data: Recent economic data has surprised to the upside

- The Fed raised growth and inflation expectations and left open the prospect of three rate cuts this year. Median forecast for 2025 rose to 3.9% from 3.6%. Median forecast for PCE inflation was unchanged at 2.4% for 2024 while core PCE projection rose 0.2% to 2.6%. The economic growth estimate for 2024 jumped to 2.1% from 1.4%. The Fed also maintained its pace of quantitative tightening with a maximum of $60 billion of Treasuries and $35 billion of mortgage-backed securities coming off its balance sheet every month.
- The U.S. economy grew at 3.3% over the fourth quarter while the estimate was 2%.
- The labor market continues to exhibit strength with the change in nonfarm payrolls at 275,000 for February, while the estimate was for more than 200,000.
- ISM services was in expansionary territory at 52.6 for February. Prices paid and new orders were also expansionary at 58.6 and 56.1. Overall, print points to strength in the service sector, with growing prices paid signaling that the strength in the economy could be inflationary.
- Core CPI continues to trend lower coming in at 3.8% for February.

- The Core PCE deflator, which is the Fed's preferred gauge of inflation, continues to trend lower and at 2.8% is the lowest it's been since June 2021.
- Manufacturing continues to contract with the ISM at 47.8 for the month of February. Manufacturing has been contracting for 16 months in the U.S.
- Housing prices, as evidenced by the S&P CoreLogic Case-Shiller 20-City Composite City Home Price Index, bottomed out in May and have been on a modest rebound since.

Eurozone economic data: Inflation is cooling, economy not as strong as the U.S.

- At a recent summit in Brussels, Christine Lagarde, President of the European Central Bank (ECB), told euro area leaders that she expects the easing of inflation in the Eurozone to persist thanks to the effectiveness of monetary policy.
- The market expects that the ECB could start cutting rates in June. In this regard, the ECB will take the lead from the Fed as inflation is cooling faster in the Eurozone. The Eurozone economy is not as strong as the U.S. by many measures and therefore the ECB has more leeway with rate cuts relative to the Fed.
- Prices: Inflation in the Eurozone is trending lower as a result of the rate hikes by the ECB. Eurozone CPI for February came in at 2.6%. Core CPI is at 3.1%.
- PMIs: Eurozone Services is barely growing at 50.2 while Manufacturing PMI is in contractionary territory.
- German GDP for the fourth quarter was -0.4% relative to 3.4% for the U.S.

Market Notes

- The Dutch Finance ministry put out a paper on AT1 CoCos which proposed modifying or abolishing the asset class. The market did not see the paper as being material to the AT1 asset class.
- The Bank of Japan (BOJ) ended its era of negative interest rates with its first rate hike in 17 years. The BOJ set the short-term interest rate at between 0% to 0.1% and said its main policy tool will now be short-term rates. The Yen sold off during the month as traders were not convinced about further rate hikes.
- We had some ESG related volatility in the French utility EDF. News headlines that the company could produce nuclear material for French nuclear weapons sent its hybrids lower due to ESG sellers.
- AT1 CoCo calls continue to happen. BNP 6.625 was called this month.
- In new issue activity, Standard Chartered issued a PerpNC5 at 7.875% or a spread of 357 bps while Societe Generale priced a PerpNC10 at 8.5% or spread of 415 bps. Bank of Montreal issued a LRCN that matures in 2084 which priced at 7.7% or spread of 345 bps. In U.S. bank $1,000 par preferreds, Citigroup issued a PerpNC5 at 7.2% (spread of 290) while JPM issued a PerpNC5 at 6.875% or spread of 273 bps. Sumibk issued a PerpNC10 AT1 CoCo that priced at 6.6% or spread of 228 bps. In the corporate hybrid sector, BP issued a PerpNC10 that priced at 6.45% or spread of 215 bps.

Outlook: Steeper yield curve, better reinvestment opportunities

- The Fed raised its growth and inflation expectations. The implication is that we could get a steeper yield curve and higher rates in the longer end.
- A steeper yield curve should be credit positive for banks specifically. Higher longer-term rates are also positive for insurance companies as it allows them to earn higher returns on their assets.
- 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.
- Call characteristics in the AT1 CoCo space are attractive. Most of our strategies have over half of their owned CoCo sleeve callable over the next couple of years. The bonds that are callable over the next two years are characterized by high reset spreads that make calls more likely.

- The Fed backstop to the banking system is very supportive of bank preferred valuations. Excess debt requirement for smaller U.S. banks should also be supportive of credit.
- U.S. and European bank stress tests have been positive and should provide comfort to investors.
- Recent new issuance in the AT1 CoCo sector possess coupons in the 8+ area with robust reset spreads; these bonds should perform well going forward. Deeply discounted bonds look attractive given that they have fixed-to-fixed reset coupons and thus have good positive convexity.
- The expectation for rate cuts from the Fed in 2024 could result in flows into more intermediate duration fixed income. Preferred and capital securities, given their higher yields, should benefit from these flows of capital.

What helped: Lower coupon/deeper discounts/spread duration

- Returns this month were driven by spread tightening. The AT1 CoCos in the portfolio returned 1.26% and contributed 39 bps with an average weight of 27.01%. Low coupon/deeply discounted bonds with longer duration outperformed with bonds like Standard Chartered 4.3 2/29-perp, ING 4.875 5/29-perp, and Santander 4.75 11/26-perp returning 2.95%, 2.87%, and 2.28%, respectively.
- The insurance hybrids in the portfolio returned 1.34% and contributed 39 bps with an average weight of 29.40%. Bonds with spread duration like Nationwide Financial 6.75 5/37-67, Liberty Mutual 7.8 3/37-87, and Zurich Finance 3 1/31-51 outperformed returning 4.77%, 2.69%, and 2.17%, respectively.
- The utility hybrids in the portfolio returned 2.09% and contributed 9 bps with an average weight of 4.50%. Again, lower coupon/discounted bonds outperformed with Duke Energy 3.25 1/27-82, Nextera Energy 3.8 3/27-82, and CMS Energy 3.75 12/30-50 returning 5.56%, 2.63%, and 2.76%, respectively.
- The BNS 4.9 6/25-perp NVCC AT1 in the portfolio performed well, returning 3.00% and contributing 8 bps with an average weight of 2.59%.
- The Canadian Bank LRCNs performed well, returning 1.50% and contributing 6 bps with an average weight of 3.93%.
- Addition of the Euro denominated UCITS funds to the portfolio. The PGIF High Grade Capital Securities Fund, which is 2.34% of the portfolio, returned 1.41%.

What hurt: SWK, AT&T, and DTE

- Stanley Black & Decker was weak, returning -0.79%. The portfolio had 0.44% on average in the name.
- AT&T $25 par hybrids in the portfolio detracted this period, returning -2.47% with an average weight of 0.11%.
- DTE $25 par hybrids in the portfolio detracted, returning -1.43% with an average weight of 0.35%.

What we did

- We added two UCITS funds to the portfolio: PGIF-Principal Capital Securities Fund and PGIF-Principal High Grade Capital Securities Fund. The rationale for this investment is as follows:
    - Diversification: Allows the portfolio to invest in high quality European credits which otherwise do not issue in USD. Investing in the Euro currency UCITS capital securities funds provides us with the liquidity and flexibility to invest/divest Euro currency capital securities efficiently.
    - Spread pickup: There is a persistent spread pickup in Euro currency capital securities relative to USD capital securities. Investing in the Euro currency UCITS funds allows the portfolio to pick up this spread.
- We sold out of subordinated debt bonds in the portfolio given tight spreads and valuations and invested the proceeds into the two European UCITS capital securities funds, thereby picking up spread.
- We were buyers of AT1 CoCos this period. Bonds added included Barclays 9.625, Swedbank 7.75, BNP 8, Santander 9.625, Intesa 7.70, Standard Chartered 4.75, Socgen 8.5, Julius Baer 6.875, ING 6.5, Natwest 4.6, and ING 5.75.
- In the insurance space, we added Prudential Financial 6.5 and 5.375.

Full details of the risks of investing in the Fund are contained in the prospectus. Investors should obtain and read a copy of the prospectus and Key Investor Information Document. These are available at http://www.PrincipalAM.com

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