Principal Asset Management℠

PREFERRED SECURITIES FUND (UCITS) - USD | June 2025

Monthly Commentary

Month in review

Preferred security indices: Preferred markets have performed strongly this month with spreads tightening and rates falling.

Index	Monthly return
IIPS Index	1.84%
I0CS Index	1.68%
CDLR Index	1.39%
P0P4 Index	1.33%

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

- Despite the geopolitical violence this month, markets have demonstrated remarkable resiliency. U.S. equities have made new highs and U.S. Treasuries, and credit markets have performed well as investors are assuming the U.S. Federal Reserve (Fed) might be back on the rate cut path.
- In his testimony to Congress, the Fed Chair Jerome Powell pushed back on President Donald Trump's demands for immediate rate cuts. Chairman Powell signaled rate cuts are probably off the table at least until September; this testimony comes after two Fed governors backed a rate cut for July. Powell is concerned about the effect tariffs can have on prices, and hence wants to wait until at least September, to see the data for June and July before making a decision.
- The Fed has lowered estimates for growth in the U.S. economy to 1.4%, with unemployment increasing to 4.5% from 4.2% currently, and PCE inflation rising to 3% from a current level of 2.1%.
- Possible changes to the SLR ratio for U.S. banks could result in lower future issuance in U.S. bank preferreds. This has contributed to demand for the product and tighter spreads.
- The European Central Bank (ECB) cut rates in June by 25 basis points (bps) to 2%. Following the rate cut, the ECB President Christine Lagarde said the bank had "nearly concluded" this monetary policy cycle. ECB rate cuts began in June 2024 when rates were at 4%. The ECB also lowered its outlook for inflation for 2025 to 2%, from the prior estimate of 2.3% back in March, and lowered the 2026 outlook to 1.6% from 1.9%. The estimates for Eurozone GDP growth for 2025 and 2026 remained unchanged at 0.9% and 1.1%. Lagarde also noted "uncertainty surrounding trade policies" could weigh on "business investment and exports, especially in the short term."
- Given this background of uncertain 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 Fed easing cycle and weaker sentiment, coupons in our strategies remain robust and continue to grow as bonds that were issued as NC5s, in periods with lower rates and wider spreads, are now getting refinanced higher. The coupon on the IIPS Index has climbed from 5.49% to 5.92% over the course of 2024 and is currently at 6.14%. 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): 6.69%
- $1,000 par preferreds: YTW:
  - 5.80% investment grade (IG)
  - 6.58% below investment grade (BIG)
- $25 par preferreds: YTW:
  - 6.40% (IG)
  - 6.77% (IG and BIG)

Interest rates: Interests rates fell in the U.S. given a flight to quality bid; German rates rose.

- U.S. Treasury rates: Given the increased expectation of a Fed rate cut, U.S. Treasuries caught a bid with 2s, 5s, 10s, and 30s, falling by -18, -16, -17, and -16 bps, respectively.
- German yields increased with 5s, 10s, and 30s, up by 11, 11, and 12 bps, respectively. The ECB has indicated it's probably done with its cycle of rate cuts. That along with improving sentiment in Germany combined with the expectation of more supply due to the proposed defense and infrastructure spending has sent yields higher.
- United Kingdom (U.K.) rates fell with 5s, 10s, and 30s, down by -19, -16, and -9 bps, respectively. The weakening labor market and slowing inflation are resulting in markets pricing in an earlier cut.

Spreads: Spreads tightened in June, leaving spreads rich.

Index	Current	Prior	Change	Avg	Std Dev	Current-Avg	Z-value
$1,000 par Capital Securities (IIPS)	205	216	-11	267	61	-62	-1.02
All Capital Securities (I0CS)	216	221	-5	252	57	-36	-0.64
USD AT1 CoCos (CDLR)	263	264	-1	345	73	-82	-1.12
$25 par (P0P4)	227	221	6	217	63	10	0.16
IG Corps (C0A0)	88	93	-5	113	25	-25	-1.01
High Yield (H0A0)	321	351	-30	399	73	-78	-1.08

Figure 1: June 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)	136	147	-11	200	53	-64	-1.21
EUR IG Sub Non-Financials (ENSU)	172	183	-11	248	55	-76	-1.39
AT1 CoCos (CEUR)	315	343	-28	457	101	-142	-1.41
EUR IG Corps (ERS0)	84	91	-7	117	34	-33	-0.98

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

- The $25 par asset class has been perennially rich relative to the $1000 par bonds. But now, $25s are attractive from a spread and nominal yield perspective. The $25 par asset class has a positive 5-year z-value along with a yield of 6.77%.
- USD AT1 CoCos are rich with a z-value of -1.12 and a current spread of 263 relative to a 5-year average of 345.

- One can pick up double 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 triple the spread with an even shorter duration exposure than IIPS.
- EUR AT1 CoCos are richer relative to USD AT1 CoCos with a z-value of -1.41 compared to -1.12 for the USD.
- 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.

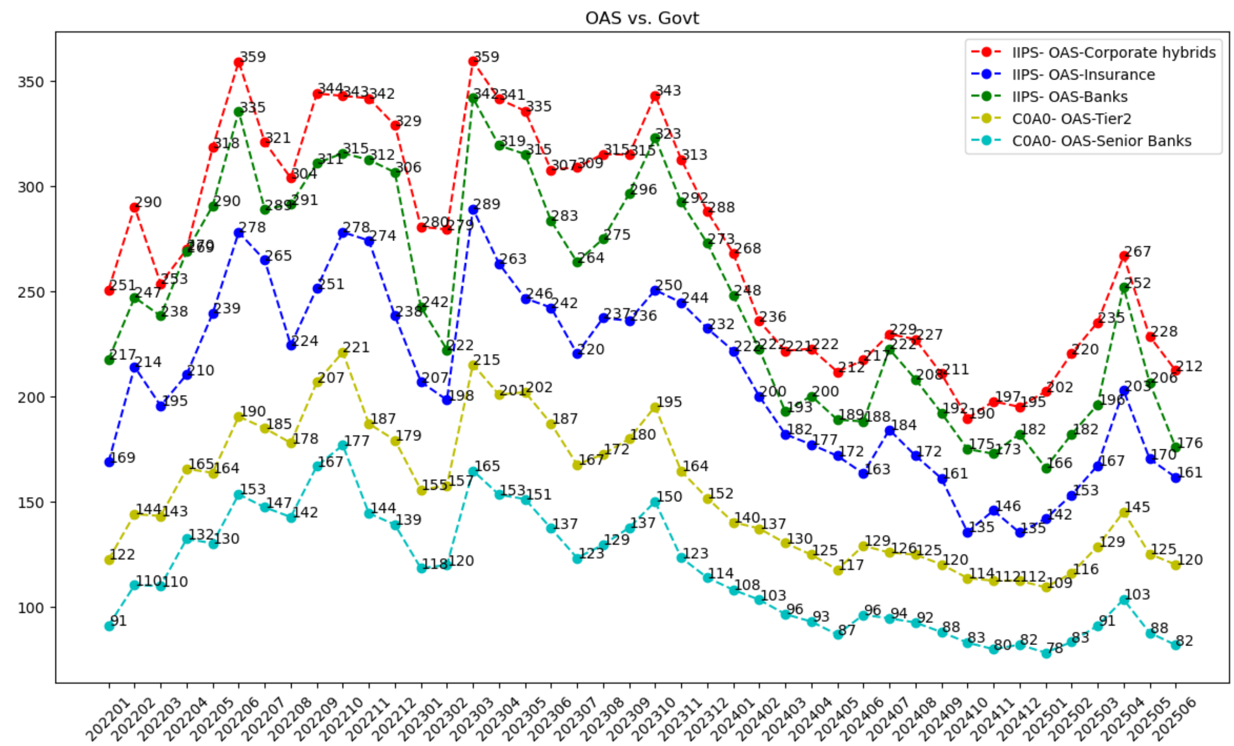

Figure 3: IIPS spread history by sectors. Source: Spectrum.

- From Figure 3, we can see that spreads have retraced their move higher in April. Corporate hybrids continue to offer the best relative value, but you can see compression across the spectrum.

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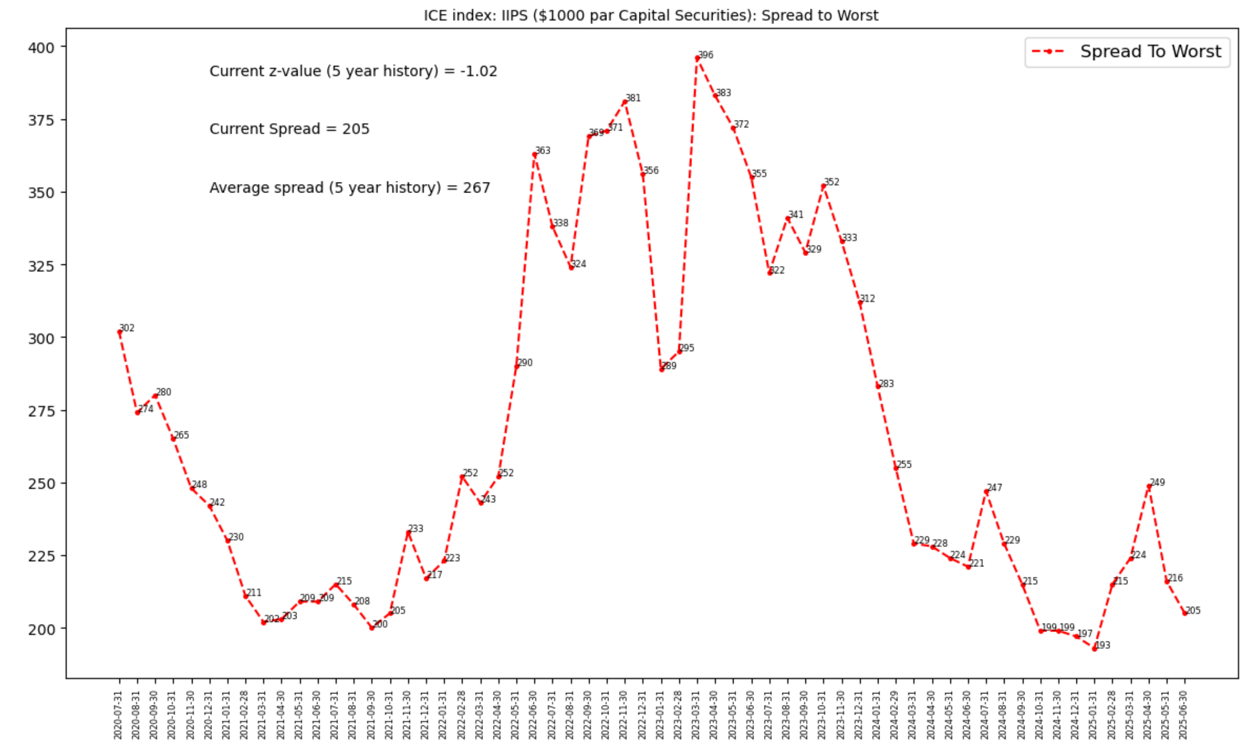

Figure 4: IIPS spread history. Source: Spectrum

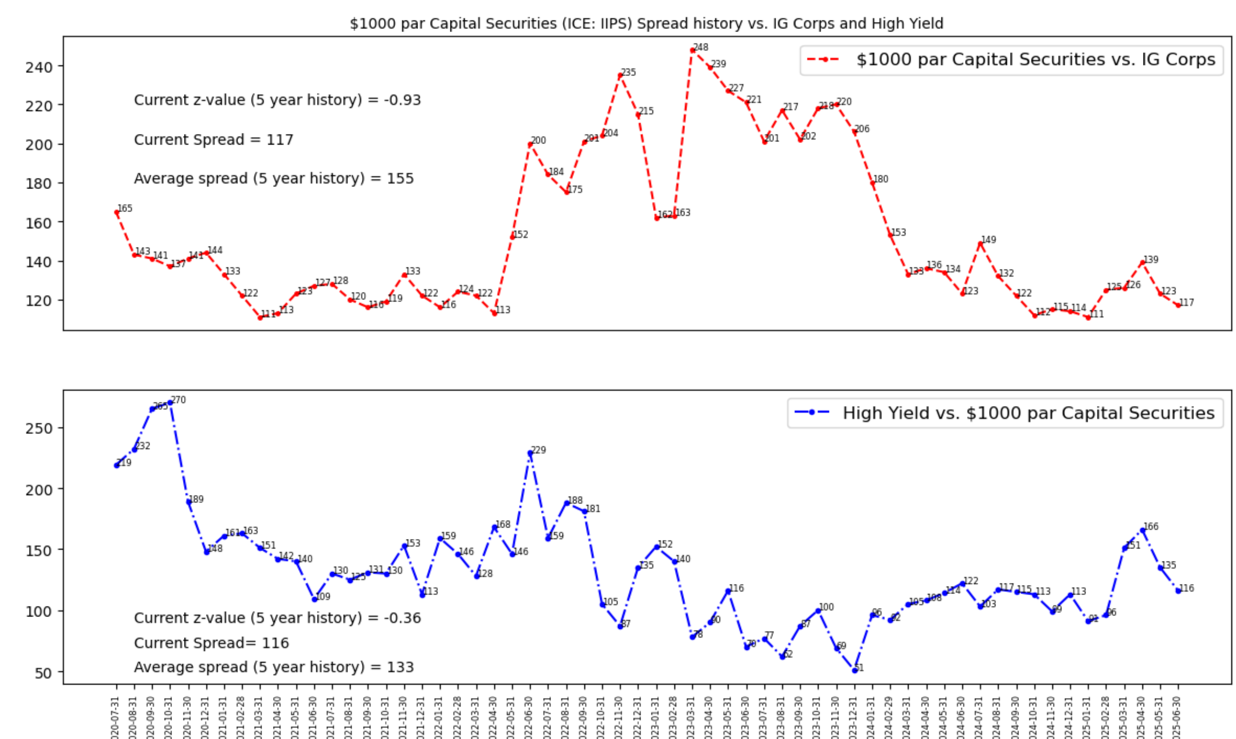

Figure 5 (two charts): IIPS spread history vs. C0A0 and H0A0. Source: Spectrum

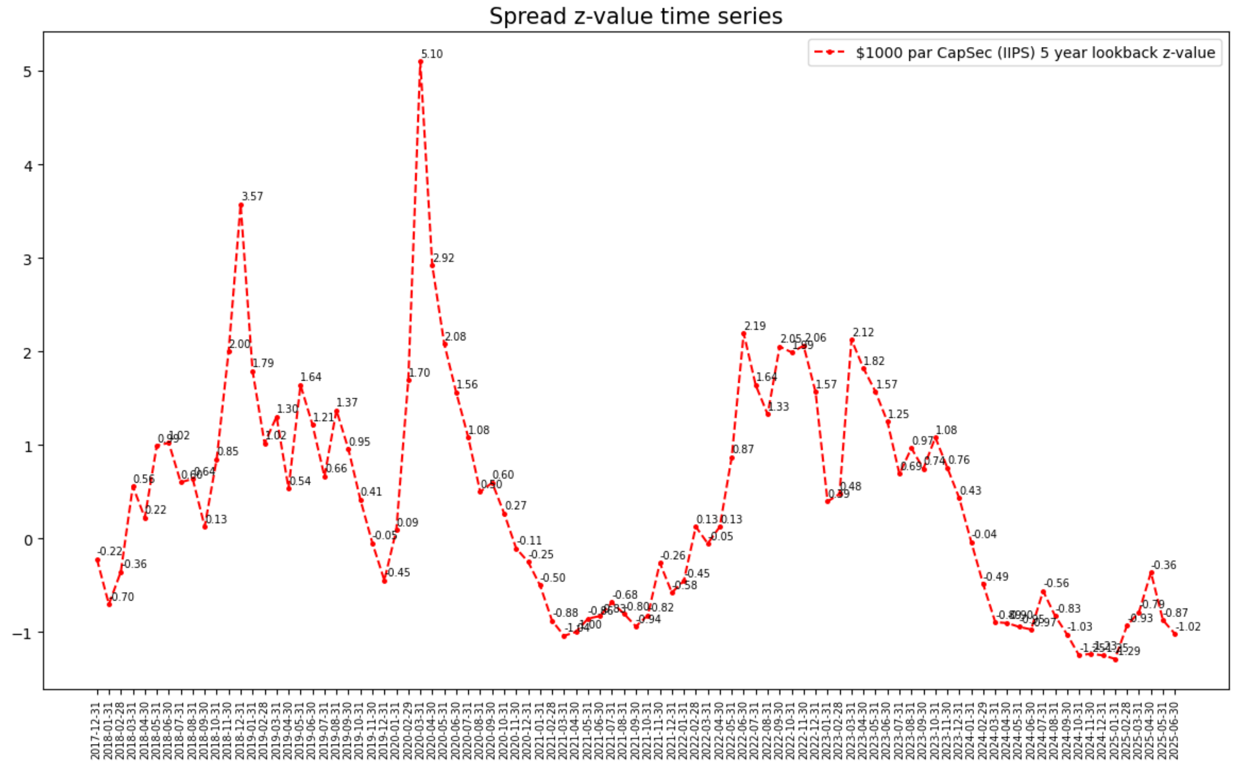

Figure 6: Time series of z-values on the IIPS Index. Source: Spectrum

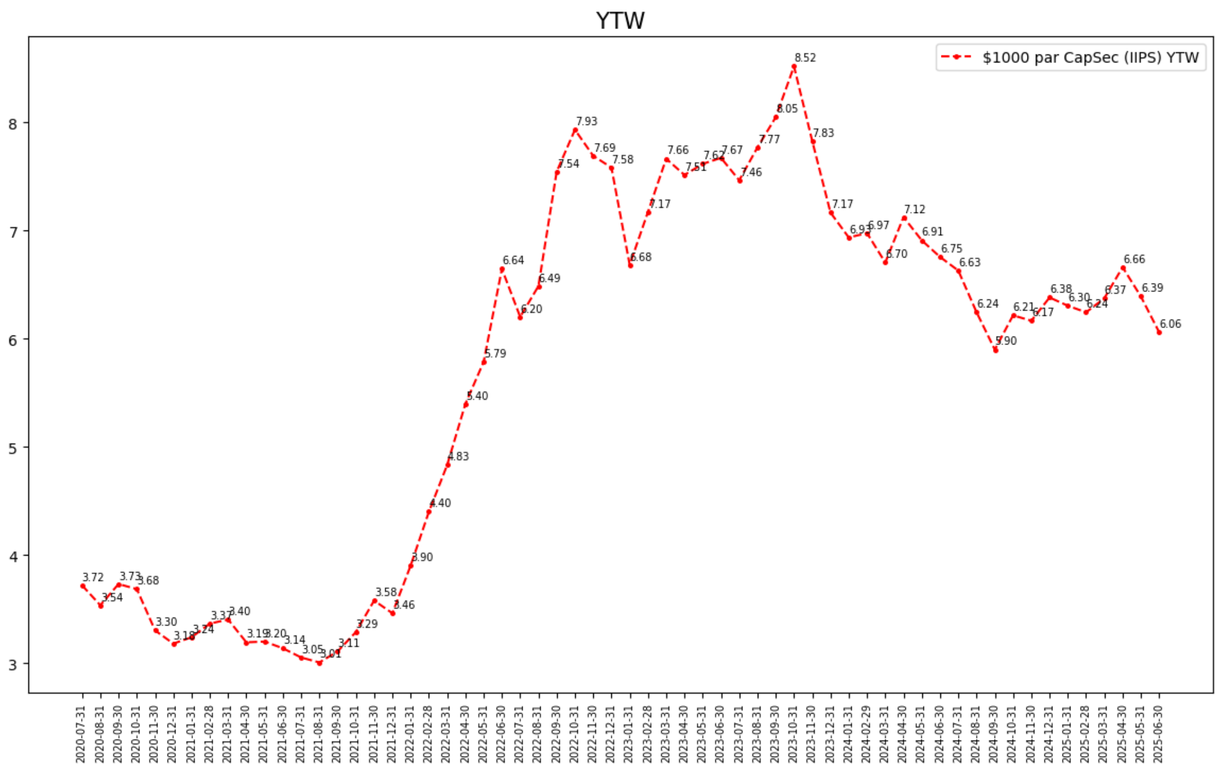

Figure 7: YTW on the IIPS Index. Source: Spectrum.

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

- The Fed lowered estimates for growth in the U.S. economy to 1.4% with unemployment increasing to 4.5% from 4.2% currently, and PCE inflation rising to 3% from a current level of 2.1%.
- 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 after 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 expectations for long-term inflation had reached the highest level since 1993.
- Bond investors are concerned about the magnitude of the fiscal deficits the U.S. is running and the U.S. budget bill making the rounds in Congress is adding to the jitters.
- The distortion in trade caused by tariffs continues to affect the U.S. economy. U.S. goods exports fell 5.2% in May from the prior month. This was the steepest drop since the COVID-19 crisis in 2020.
- Consumer spending growth slowed from a month-over-month pace of 0.7% in March, to 0.2% in April and contracted in May to -0.1% as consumers became more cautious about spending. https://www.bea.gov/data/consumer-spending/main
- The U.S. Personal Consumption Expenditures Index (PCE), which is the Fed's preferred gauge of inflation, ticked up to 2.3%. Core PCE also moved up in May to 2.7%.
- The labor market is showing some signs of softness with the non-farm payroll number trending lower. The Fed will closely watch this number as the effects of tariffs take hold.

Eurozone economic data: European Union (EU) signals that rate cuts are "nearly concluded."

- The ECB cut rates in June by 25 bps to 2%. Following the rate cute, the ECB President Christine Lagarde said that the bank had "nearly concluded" this monetary policy cycle. The rate cuts began in June 2024 when rates were at 4%. The ECB also lowered its outlook for inflation for 2025 to 2% from the prior estimate of 2.3% back in March. The 2026 outlook was lowered to 1.6% from 1.9%. The estimates for Eurozone GDP growth for 2025 and 2026 remained unchanged at 0.9% and 1.1%. Lagarde also noted that "uncertainty surrounding trade policies" could weigh on "business investment and exports, especially in the short term."
- Eurozone inflation fell below the ECB's 2% target in May at 1.9%, for the first time in seven months. Services inflation, a proxy for domestic price pressure, fell to 3.2%, the lowest level since March of 2022.
- The Eurozone economy grew 0.6% 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. According to the *Financial Times*, this is Germany's 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 HCOB Composite Purchasing Managers Index was at 50.2 for May with manufacturing at 49.4. Manufacturing production has been contracting since July 2022.

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

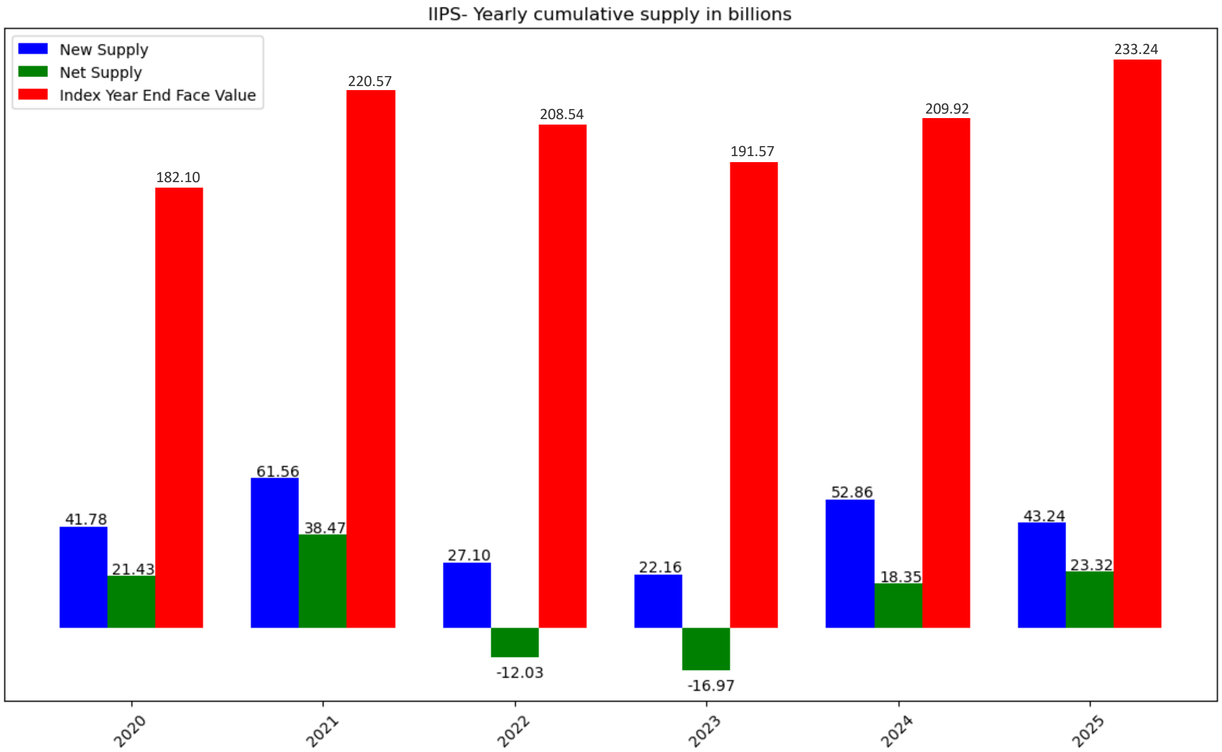

Figure 8: Supply: IIPS Index. Source: Spectrum.

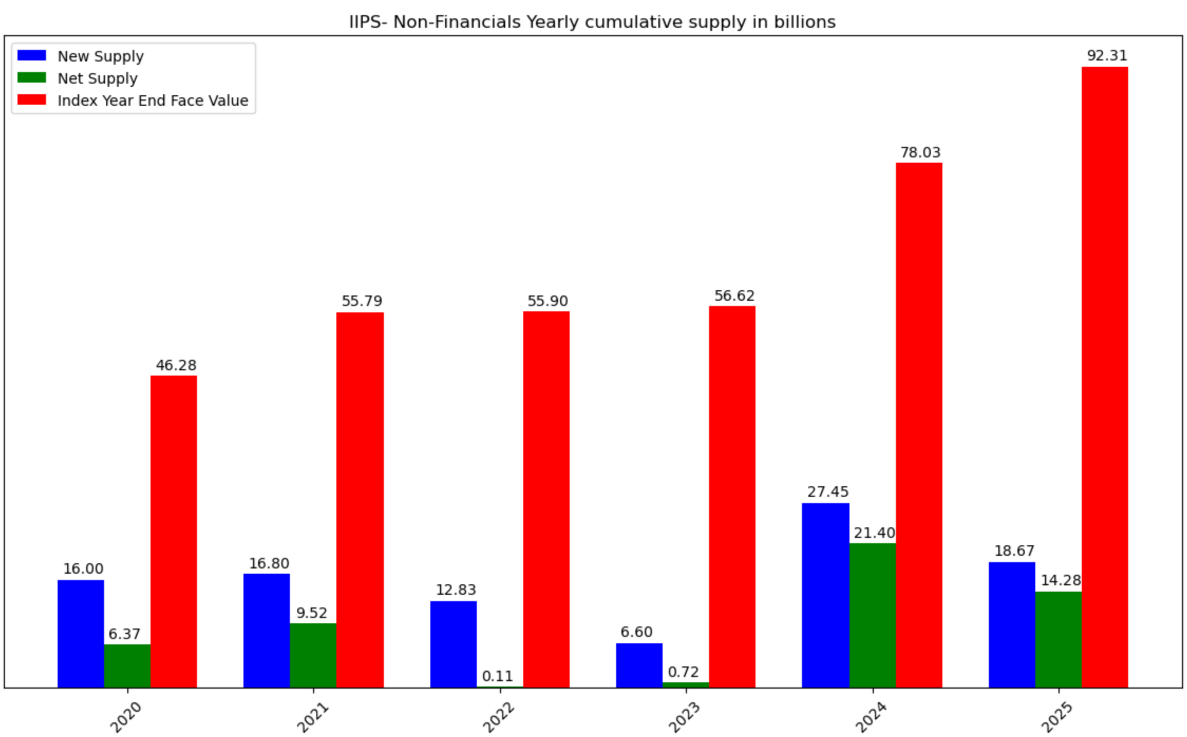

Figure 9: Supply: IIPS Index (Non-Financials). Source: Spectrum.

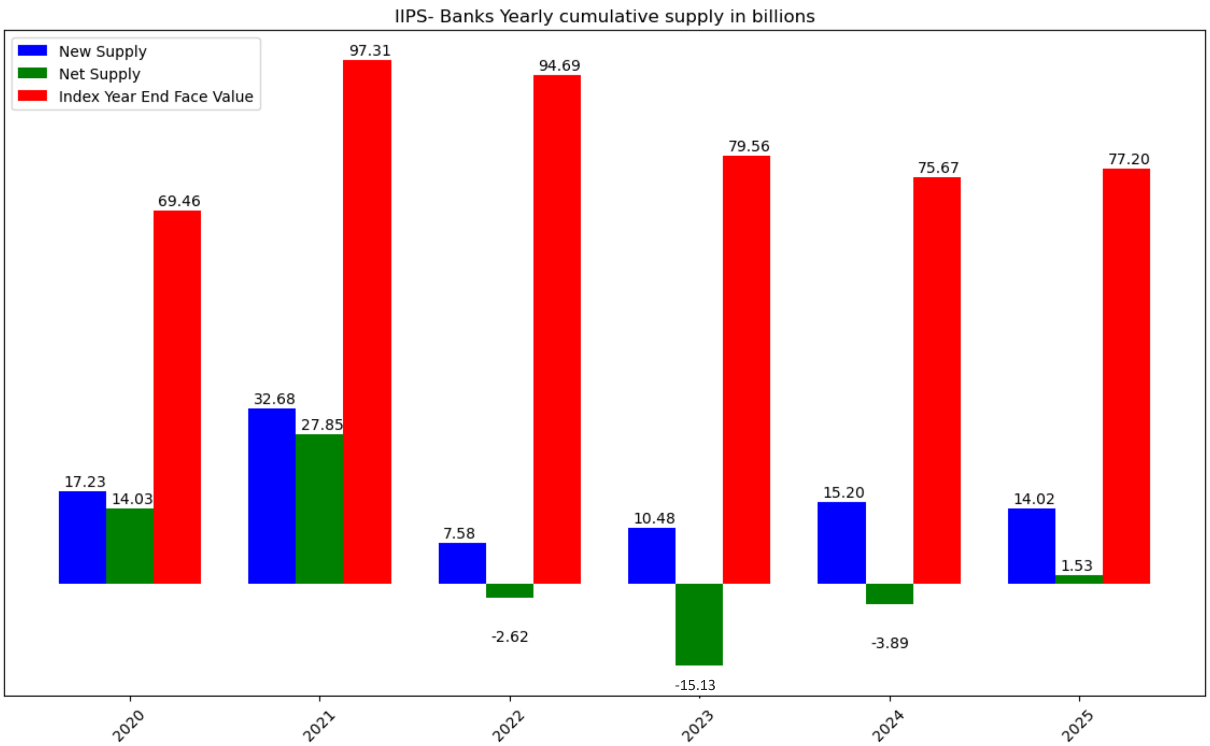

Figure 10: Supply: IIPS Index: Pfd-Banking & Pfd-Financial Services. Source: Spectrum.

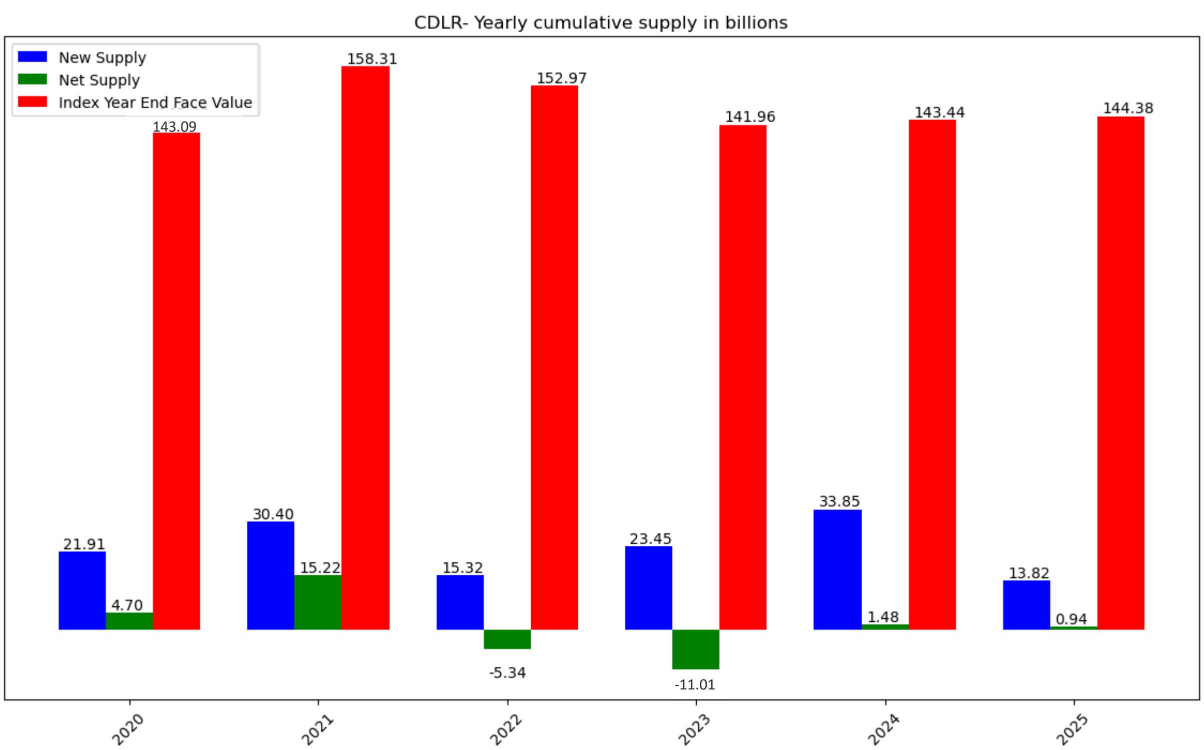

Figure 11: Supply: CDLR Index (CoCos USD). Source: Spectrum.

- 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 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 $18.67 billion of new issuance in Non-Financials.
- From Figure 10, the banking component of the IIPS Index has been flat with $14.02 billion of new issuance and $1.53 billion of net issuance. This scarcity of U.S. bank issuance has resulted in strong performance in U.S. bank preferred.
- Figure 11 shows the USD AT1 CoCo market has also been flat year-to-date with $13.82 billion of new issuance and $0.94 billion of net issuance.

Performance and market notes:

- U.S. bank preferreds performed strongly this month given the possibility that relaxing leverage requirements for U.S. banks could result in lower amounts of AT1 required resulting in reduced supply. The search for yield has continued to compress yields in AT1 CoCos. Supply in Utility and Energy hybrids continue to be absorbed by the market with valuations continuing to trend tighter.
- Supply:

Issue Date	Amt Iss	Moody	S&P	Security	Cpn	B Px	A Px	Fltr Sprd	Reset Index	Bench	Nxt Call	Notes	BBID	FIGI	Industry
06/05/2025	2MMM	Baa3		HSBC 7.05 PERP	7.05	101.5	101.7	298.7	H15T5Y	5Y	06/05/2030	AT1 Coco	YO9827602	BBG01V90XVC2	Banks
06/10/2025	1MMM			CEMEX 7.2 PERP	7.2	101.1	101.3	352	H15T5Y	5Y	06/10/2030	Corporate Hyb	YN1351876	BBG01VCXTY71	Building Materials
06/11/2025	1.25MMM	Baa2	BBB	RY 6.75 2085	6.75	100	100.3	281.5	H15T5Y	5Y	08/24/2030	LRCN	YN1256968	BBG01VCT0R03	Banks
06/12/2025	550MM	Baa3	BB	XRAY 8.375 55	8.375	100.5	101	437.9	H15T5Y	5Y	06/12/2030	Corporate Hyb	YN1019390	BBG01VCKMB76	Healthcare-Products
06/13/2025	400MM	Baa3	BB+	FIHL 7.75 55	7.75	102.5	103.2	428	H15T5Y	10Y	12/15/2034	Insurance Hyb	YO6846639	BBG01V47SXF1	Insurance
06/24/2025	1MMM	A3		HLINSU 6.3 55	6.3	103.15	103.3	229.2	H15T5Y	5Y	06/24/2030	Insurance Hyb	YN2364076	BBG01VG130D2	Insurance
06/27/2025	1.5MMM	Ba1	BBB-	BNP 7.45 PERP	7.45	100.9	101.1	313.4	H15T5Y	10Y	06/27/2035	AT1 Coco	YN6449121	BBG01VQXLGW5	Banks
06/27/2025	600MM	Baa2		ATH 6.875 55	6.875	99.438	99.94	258.2	H15T5Y	10Y	03/28/2035	Insurance Hyb	YN6983061	BBG01VRMBM47	Insurance
06/27/2025	700MM	Baa3	BB	TCN 6.625 55	6.625	100.625	100.8	276.9	H15T5Y	5Y	07/15/2030	Corporate Hyb	YN6993490	BBG01VRMJD21	Telecommunications
06/27/2025	800MM	Baa3	BB	TCN 7 55	7	100.875	101.1	270.9	H15T5Y	10Y	07/15/2035	Corporate Hyb	YN7018586	BBG01VRMXWT4	Telecommunications
07/01/2025	1MMM	Ba3		NOMURA 7 PERP	7	101.375	101.4	308.4	H15T5Y	5Y	07/15/2030	AT1 Coco	YN6776739	BBG01VR78G29	Diversified Finan Serv

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 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: Longer duration sectors such as insurance hybrids, utility/pipeline hybrids

- Given the move in rates and spreads this month, sectors with longer duration performed well. As such, corporate hybrids, specifically Utilities and pipelines that are being issued as 30NC10 structures, performed strongly. The utility hybrids in the portfolio returned 1.73% and contributed 14 bps with an average weight of 8.16%. Bonds like American Electric Power 6.95 9/34-54, Duke Energy Corp 6.45 6/34-54, and NiSource Inc 6.375 3/35-55 returned in excess of 2%. Pipeline names like TransCanada and Enbridge performed strongly with certain bonds returning over 3%.
- The AT1 CoCos in the portfolio continued their strong performance this month returning 1.30% and contributing 39 bps with an average weight of 29.66%. The lower coupon/discounted bonds performed strongly with bonds like Barclays 4.375 9/28-perp, Natwest 4.6 12/31-perp, and BNP 4.625 2/31-perp returning over 2%.
- The insurance hybrids, given their longer duration profile, performed strongly, returning 1.64% and contributing 45 bps with an average weight of 27.52%. MetLife 10.75 8/39, Liberty Mutual 7.8 3/37, and Corebridge 6.375 9/34-54 posted returns over 2% this month.

What hurt: $25 par hybrids, shorter duration bonds

- The $25 par hybrids underperformed, returning 0.91% with an average weight of 2.83%.
- Shorter duration bonds underperformed. About 25% of the portfolio has call terms that are 2-years, and underperformed relative to the bonds with longer call protection.

What we did:

- The portfolio was hit by significant outflows this period amounting to $450 million. The bulk of the investment activity centered around funding these redemptions. For the most part, we sold short call bonds and bonds with lower yields. As such, we reduced our subordinated debt holdings by 2.43% to 1.98%. Our AT1 CoCo holdings decreased by 2.08% to 26.36%.
- We added to our LRCN holdings this period by adding Royal Bank of Canada 6.75 8/30-85. As an offshoot of the portfolio reducing in size and the addition of the RY 6.35, the LRCN weight of the portfolio increased by 184 bps to 11.58%.
- The reduction in the size of the portfolio also resulted in the utility hybrid weight of the portfolio increasing by 76 bps to 8.53%.

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MM10509-77 | 07/2025 | 4658521-102025