Spectrum Asset Management

Principal Asset Management℠

2024 OUTLOOK

Opportunities in preferred and capital securities remain attractive

MACRO AND MARKET OUTLOOK with Phil Jacoby, executive director and chief investment officer

MACRO AND CREDIT OUTLOOK with Joe Urciuoli, executive director and head of research

Overview

Macro and market

Main takeaways: the Federal Reserve (Fed) should be done raising rates; the U.S. Treasury market term premium should persist; discounted fixed-to-refixed hybrids foster an advantage of indifference to the direction of longer-term treasury rates; and relative values are attractive.

- **Rate hikes should be done**—inflation is waning and labor markets are cooling. Federal funds are priced 2% above inflation and quantitative tightening (QT) should continue to pressure economic velocity in favor of disinflation. Yet, fiscal demands should pressure real rates higher and impel a steeper yield curve next year.
- **The outlook is positive for hybrids next year** because credit fundamentals are sound, yields are still high, and seasoned prices are discounted.

Macro and credit

Stable financial system

Despite past concerns, banks remain in sound fundamental shape and should be able to manage commercial real estate and consumer credit challenges in the event of a more stressed than expected economy in 2024.

Geopolitical risks

War in eastern Europe, the Middle East crisis, and U.S.-China tensions over Taiwan will continue to disrupt world order in 2024, underpinned by the global threat of China, Russia, and Iran, and their power struggle with the U.S. and the West.

Key elections

The U.S. presidential and congressional elections in November 2024 could be tight races, but likely will not lessen congressional divisiveness or improve prospects for the passage of key legislation. The results of Taiwan's presidential elections in January 2024 should not materially impact the government, but relations with China will remain strained.

Low default rate of hybrid preferreds

Even with bank defaults in 2023, overall annual average preferred default rates remain markedly lower than high yield default rates.

Private and structured credit

Private capital has grown materially post-GFC. While U.S. life & annuity insurers have increased their private/structured asset exposures, traditional firms maintain higher-quality holdings. Yet, some newer insurance entrants have obtained higher returns from outsized positions and by moving risks offshore, which we see as a risk.

ESG regulation

Europe has implemented extensive regulations including mandated disclosures from asset managers and corporations. U.S. regulators continue to monitor "greenwashing" and have established rules on cybersecurity risk management, but there is still some political pushback at the state and federal levels.

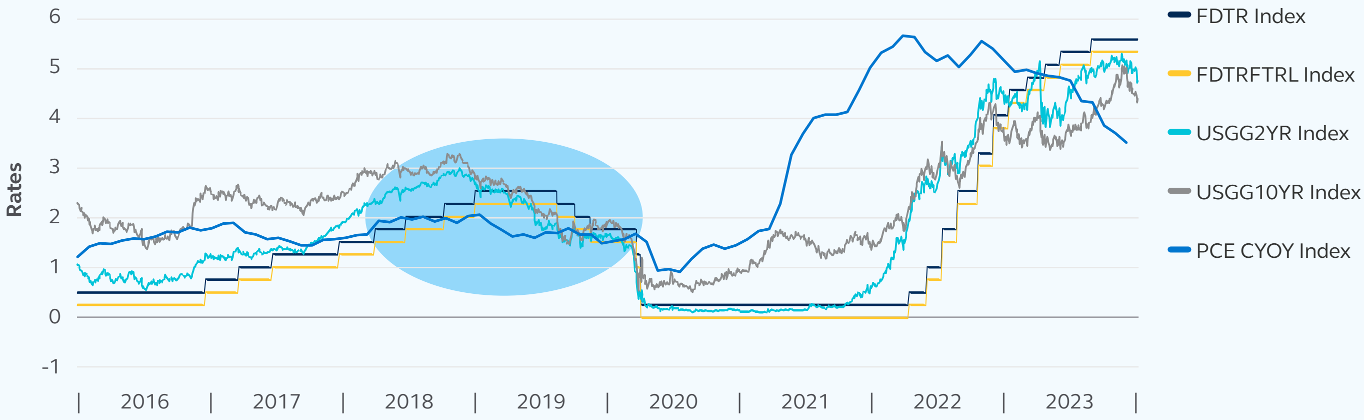
Macro and market outlook

PHIL JACOBY, executive director and chief investment officer

Track the gap.

The graph below shows the federal funds bound (FDTR) and the PCE Deflator Index (blue line) with a highlight in 2019.

EXHIBIT 1: Prior Fed rate cycles



Source: Bloomberg. As of November 30, 2023. FDTR Index: Federal Funds Target Rate - Upper Bound; FDTRFTRL Index: Federal Funds Target Rate - Lower Bound; USGG2YR Index: U.S. Generic Govt 2 Year; USGGT10Y Index U.S. Generic Govt TII 10 Year; PCE CYOY Index: U.S. Personal Consumption Expenditure Core Price Index YoY SA.

- Last year we said "watch the gap" because a gap that large between the PCE Deflator and the federal funds needed to converge as Fed Chairman Jerome Powell was steadfastly determined to create a positive real federal funds rate to restrict growth.
- Now, the real federal funds rate is about 2%, but the core inflation rate (3.47%) is still well above the Fed's long-run goal of 2%. Consequently, we expect the Fed to stay on pause until September 2024 while the Fed's continued QT and waning reverse repurchase agreement pushes private markets to clear the relentless U.S. Treasury supply. Headlines will likely spin this to mean inflation is over, yet it will still take time to anchor.

One of three key questions for Fed policy remain unanswered:

1. HOW HIGH?

Answer: 5.25% – 5.50%

Risk: 4.75% – 5.00%

2. HOW FAST?

Answer: Relax—we're there; no more hikes!

Risk: Longer-term rates (e.g., U.S. Treasury (UST) 10-year) rise from here

3. HOW LONG?

Answer: on hold from July 2023 to December 2024 (17 months)

Risk: hold for 14 months (cuts start September 2024)

The Fed has inverted the gap – why? Because it needed to make short-term interest rates sufficiently restrictive – and it has. The Fed's preferred measure of inflation is the PCE deflator; Chairman Powell wants to sustain the positive real federal funds rate for an extended period and does not want to repeat the errors of the 1970s.

Why it matters: The Fed always gets what the Fed wants (once it knows).

- We said, "watch the gap" last year; this year we say, "track the gap," but don't get too impatient thinking the Fed will cut rates at the first sign of labor weakness when weakness is the goal. Furthermore, due to inflation's breadth from the Fed's late start, which helped to permanently embed higher prices into a global economic framework, we believe that the Fed will move slowly (on cutting the policy rate) to allow time for assurance of a trend rather than a head-fake on its continued weakness.
- It's an election year. History shows that unless a series of rate cuts were already fully aligned with a sour economic mood that had carried a continuation of cuts into the election year from the prior year (e.g. 1992 and 2008), the Fed has not cut interest rates during an election year since 1984. The Fed has raised rates during an election

year though – but even that's been rare and only when real rates were negative (e.g., the 2004 lift-off from 1%; the 2016 lift-off from 0.50% after the election). It would likely take a significant clog in the financial system and a hard landing for the Fed to cut rates before November 7th — the Fed's balance sheet would be the tool to use (like it did last March) especially during an election year.

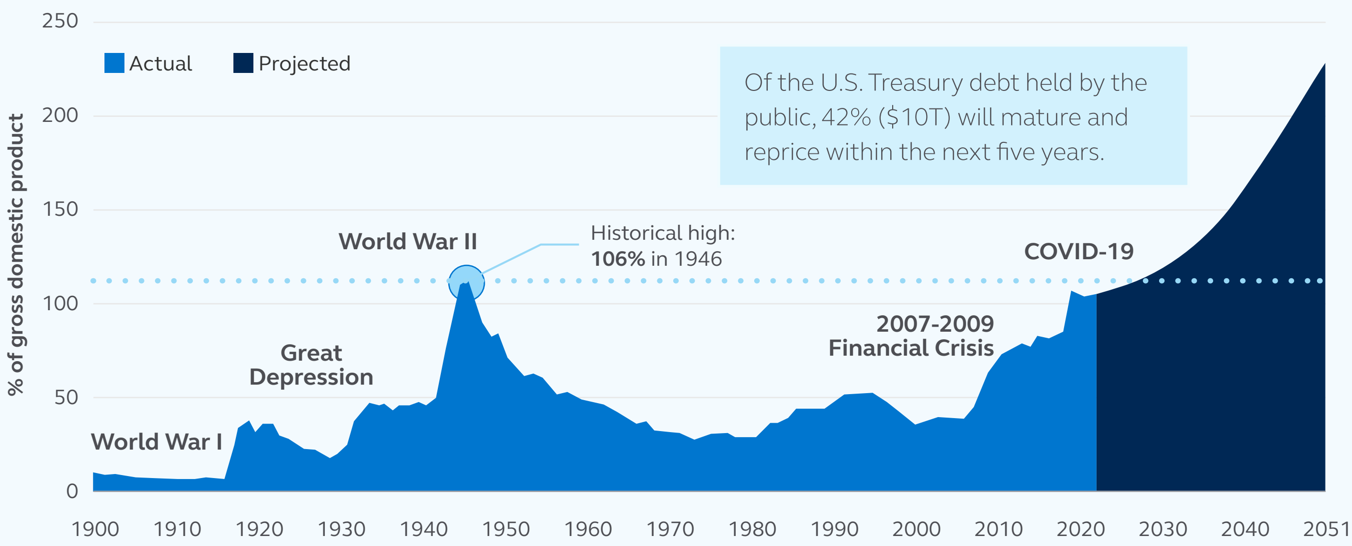
- Note that in our outlook last year, we expected the Fed to stop raising rates when the PCE deflator crossed under the federal funds bound to invert the gap, which it did in May; then we thought there would be one (last) 25 basis point (bp) hike to complete the cycle and anchor a trend toward the desired disinflation goal. That's exactly what happened on the policy rate. The uncertainty, however, is still whether inflation will indeed anchor near 2%. Time will tell, yet the markets appear very anxious for the Fed to cut rates – as soon as March 2024. The chances of that happening are slim to none because a rare rate cut during an election year would be a political "hot potato" (especially with a soft-landing which means no recession) and quicker cuts could also risk a Former Chair Arthur Burns mistake (reigniting inflation) that would destroy Chairman Powell's constructive legacy.

Why the context of the Fed's "higher for longer" narrative matters:

- The Fed will need to stay the course for credibility in its messaging and convictions on disinflation — especially after getting its "transitory" inflation conviction dead wrong two years ago. Keeping rates "this high for longer" should be the messaging and the Fed needs to follow through.
- The PCE cross under the federal funds rate started a positive real federal funds rate trend to keep friction on demand (and money velocity). The Fed needs to extend this trend to sustain disinflation. According to Chairman Powell, the committee needs to be "highly confident" that its inflation goal will be met before cutting policy rates.
- 2024 is an election year. Indeed, any administration in the White House would cheer an ability to say inflation is over; and would get giddy over direct stimulative help from the Fed with rate cuts to bolster employment and re-election chances. We are curious about why the Fed would volunteer criticism of its policy intentions as being politically motivated and potentially risk its independence when inflation will be a central political issue this election cycle.
- Supply benefits like lower oil prices may have little more to advance and the Federal Open Market Committee (FOMC) already believes that a recession will be avoided.
- Incremental restrictive pressures impelled by the rising UST term premium and declining equity prices were reversed in November, which completely eviscerates the lauded narrative that markets are fighting the inflation war alongside the Fed. The Fed says policy rates will be "higher for longer" but the bond and equity markets both say, "we'll challenge that view."

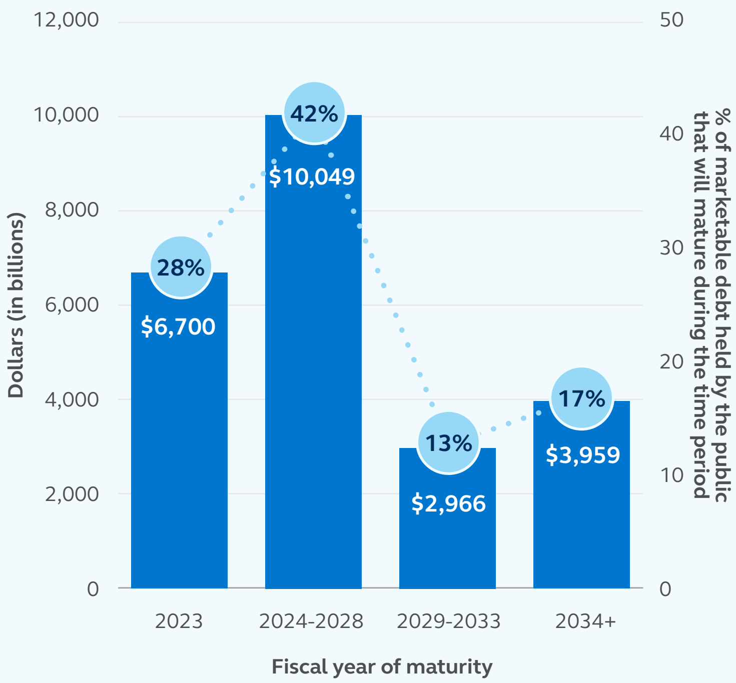
The big picture: Government spending gone wild

EXHIBIT 2: Debt held by the public projected to grow faster than GDP



Source: Congressional Budget Office data and GAO simulation. From "The Nation's Fiscal Health," an annual report to Congress, May 2023.

EXHIBIT 3: Marketable debt held by the public by year of maturity



Source: United States Government Accountability Office, Report to the Secretary of Treasury, May 2023. As of September 30, 2022.

- $6.7T (28% of marketable U.S. debt) was repriced higher this year, creating a $300B sudden surge in interest expense.
- Federal debt held by the public is virtually as high as it was during World War II (i.e., over 100%) but the difference is that, after WWII, GDP zoomed and the debt load on the economy declined significantly for decades. But now, the U.S. debt load is forecast to increase significantly for decades leaving little (if any) capacity to finance without the Fed printing new money and causing more inflation similar to the COVID-19 experience.
- U.S. debt expansion is forecast to grow twice as fast as GDP and 91.4% of new debt is financed under three-year terms (i.e., 87.4% in T-Bills[1]) so, add five years of $1.4T annually of new money deficit financing on top of the $10T rolling through and over $16.2T in U.S. debt will reprice without the Fed bidding for its balance sheet (well, for now).

[1] Source: United States Government Accountability Office, Report to the Secretary of Treasury, May 2023

Why fiscal policy matters: The upward growth pressure of endless (massive) fiscal excess is just as much a prospective long-term inflation problem as COVID-19 was but there is no vaccine (or political will) to stop it. The spending is only going to get worse unless the Fed (and the treasury bond market) makes the cost of fiscal excess too costly for politicians to ignore.

The bottom line: Extreme and unchecked fiscal spending policies will likely make it more difficult for Fed monetary policy to manage down and sustain low (i.e., 2%) inflation – especially in the face of two core economic paradigm shifts for the U.S.:

1. Deglobalization of supply chains – COVID-19 has brought a great awareness to supply chains being keys to our national security; gradually re-building them with local labor is inflationary because it consumes our labor supply in an already developed economy.
2. De-carbonization or "sustainability" – divesting the U.S. hydrocarbon industries makes our economy (and the global economy) more dependent on alternative fuels and electrification of just about everything. The inflationary implications of this shift are energy dependence, high(er) oil prices, and a crippled ability to earn net foreign exchange through trade surpluses on hydrocarbons.

   Over the next few years, the Fed will likely need to become satisfied with more than 2% inflation (whether it says so specifically or not).

A Fed conundrum: If the Fed cuts rates too soon it could impair its credibility and forfeit the effectiveness of forward guidance in recruiting markets to assist it; but if the Fed leaves rates too high for too long it could prompt a fiscal fit (i.e., volatility in the U.S. Treasury markets) caused by the rising costs of the massive U.S. debt load – either way, it appears inflation will stay elevated (i.e., above 2%). Fiscal deficit spending growth is expected to be twice as fast as GDP growth for decades, which means the Fed will have to print money to absorb the debt – monetizing debt is inflationary.

Implication: A false dawn. Neither the bond market nor the equity market is appreciating the need for the Fed to keep interest rates high for longer because fiscal growth pressures (something the Fed cannot directly opine on) are trading against restrictive rates pressure. The bond market is discounting five federal funds rate cuts to 4% by December 2024, which is well below the median rate of 5.125% in the Fed dots report (and below the lowest dot in the 4.375%-6.125% range of opinions from the board of governors) for 2024. The bond market is not in agreement with the Fed's narrative and has dismissed its resolve to not repeat the policy mistake of the 1970s. The equity market is taking its cues from December 2024 SOFR futures in expecting an almost immediate series of rate cuts and has virtually ignored any risk of recession despite a continuously inverted yield curve.

- Can the U.S. government borrow at twice the speed of the economy without crowding out other asset classes to pay for it?
  - → We think not. What do you think?
- Will the Fed have to print the money again to pay for it?
  - → We think so. What do you think?

Dive deep into The Nation's Fiscal Health.

Implications for junior subordinated capital securities

There should be ample opportunities to buy attractive hybrid yields next year – have no fear of missing out on hybrids quite yet. December 2024 SOFR futures should trade back up toward federal funds parity as the year progresses to the election. We expect that level to finish more toward 5% than its current 4% by year end, which means the U.S. Treasury 10-year note should correct as well and make another move up toward 4.75% at some point during the year before rallying back toward 4% based on (post-election) December 2025 SOFR futures taking over leadership sometime in September.

Our credit team views hybrid credit fundamentals as generally sound, and the purchasing power matrix scores of hybrids are even better now than they were this time last year, despite the laudable credit performance in 2023 (especially in November). Hybrid yields are higher, breakeven inflation is lower, and inflation coverage is up as shown below.

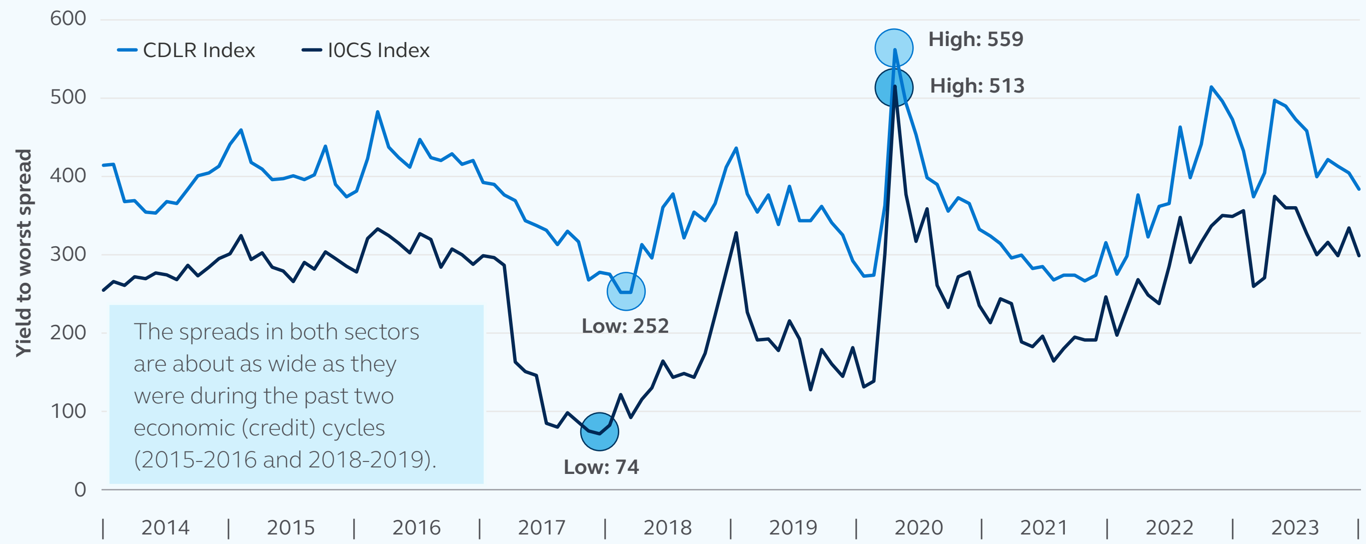
EXHIBIT 4: Purchasing Power Matrix

	A	B	C	D=B/C	E=D/A
Purchasing Power Matrix: financials	Modified duration	YTW%	5-year breakeven inflation%	Inflation coverage	Inflation coverage/ Modified duration
Retail $25 par (P0P4)	12.21	6.76	2.17	3.12	0.26
NoCos (STB8)	3.96	7.84	2.17	3.61	0.91
CoCos (CDLR)	2.66	8.36	2.17	3.85	1.45
More senior financials (E0BA)	4.70	5.77	2.17	2.66	0.57

Source: Bloomberg; ICE BofA Bond Indices. As of November 30, 2023. Source: Bloomberg, ICE BofA Bond Indices. Indices represented: P0P4: ICE BofA Core Plus Fixed Rate Preferred Securities Index, STB8: SAMI $1000 par Preferred Securities, CDLR: ICE USD Contingent Capital Index, E0BA: ICE BofA Eurodollar Banking Index.

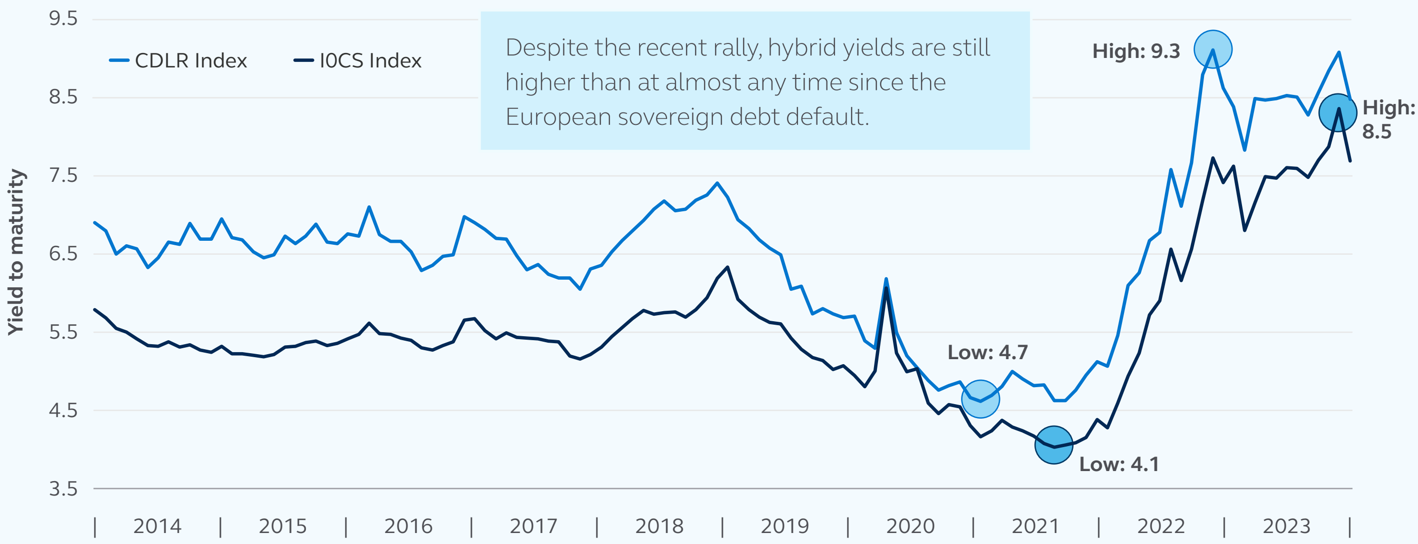
Hybrid spreads are above average as shown in Exhibit 5.

EXHIBIT 5: Spreads in Preferreds and CoCos



Source: Bloomberg. As of November 30, 2023. The ICE BofA All Capital Securities Index (i0cs) represents the preferred securities market; the ICE USD Contingent Capital Index (cdlr) represents large cap contingent convertibles (CoCos).

EXHIBIT 6: Hybrid yields are high (and prices are low)



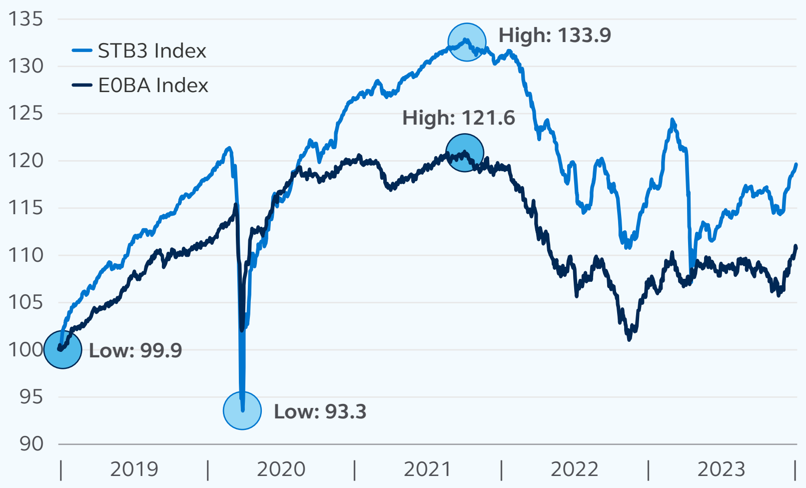
Source: Bloomberg. As of November 30, 2023. The ICE BofA All Capital Securities Index (i0cs) represents the preferred securities market; the ICE USD Contingent Capital Index (cdlr) represents large cap contingent convertibles (CoCos).

EXHIBIT 7: Fixed-to-refixed hybrids (STB3) are cheap compared to more senior financials (E0BA)

Source: Bloomberg. As of November 30, 2023.

- The chart to the left plots a custom index (STB3) made from three ICE bond indices for hybrids and when combined, it gauges being in primarily fixed-to-refixed paper of the institutional preferred stock, junior subordinated debt, and CoCos sectors. We then compare it to the ICE Eurodollar Bank and Brokerage Index (E0BA) going back five years to assume an average reset or refunding period.
- Relative values of the fixed-to-reset sector (which represents about 77% of the overall hybrid market) compared to corporate financials have been trending higher over the past two years. Despite the recent rally, hybrid spreads are still 0.62 standard deviations better than average.

EXHIBIT 8: A sample journey: Hybrid total returns beat seniors even with big defaults this year



Source: Bloomberg. As of November 30, 2023.

In 2020, hybrids fell more than corporates because of general liquidity fears in a sudden economic contraction. In 2023, hybrids fell because of large defaults in the banking sector (i.e., Silicon Valley Bank, First Republic Bank, and Credit Suisse; 3.92% of our hybrid universe). Yet despite the blowoff and permanent impairments, hybrids still retuned and average 6.01% annually while more senior financials returned 3.98% annually. This 2.03% annual differential compounded to an extra 12.28% over the five-year period, which highlights the power of high compounding relative income available in hybrids.

The bottom line: How bad can bad be?

- The past two years have been awful for the rates market and very nervous environments for bond investors. 2024 should have the Fed on pause looking for the time to cut rates. The 10-year sector of the term structure should trade within a narrow range of 75bps (i.e., from 4.00%-4.75% for the UST 10-year note), which mitigates duration risk significantly compared to the past two years. The 5-10-year curve should steepen by 20bps as the year progresses past the election.
- The range trade and sentiments that cause it should foster a backing and filling of yields, spreads, and credit prices over the course of 2024, no doubt. As we get deeper into the year to where visions can be clearer beyond the election, we should get closer to the Fed being "highly confident" that inflation can be contained, which should make for an environment for bonds and spreads that is commensurately less uncertain.
- That notwithstanding, even if we are wrong on rates and they zoom higher from here and stay there, how bad can bad really be when the hybrid market can predominantly re-fix its coupons higher if rates go significantly higher too — and stay there? We expect hybrid income to roll with the treasury five-year trend and today's discount prices to pull toward par in the process.
- This year (like we said last year) should be a range-bound market of opportunities that can be collected and held to build generous compounding income allocations compared to more senior bond classes. Consider the above five-year example as a potential guide and keep in mind the sample journey was through a historic rate hike and defaults for hybrids – again, how bad can bad be?
- As we concluded last year, "bad" will probably turn out to be pretty good by this time next year as markets tend to climb "walls of worry" — especially when worry already pins quality hybrid credit yields this high at the onset.

This year should be a range-bound market of opportunities that can be collected and held to build generous compounding income allocations.

Macro and credit outlook

JOE URCIUOLI, executive director and head of research

The geopolitical landscape will be riskier and more complex in 2024.

Bloomberg contributor composite estimates indicate that the global economy will slow in 2023 from 3.5% in 2022 and drop further in 2024. U.S. economic output should decline to over 1% in 2024 from forecasted growth of around 2.5% for 2023. Estimates for Eurozone countries were essentially unchanged from the ~0.5% growth rate expected in 2023. Notably, Europe's largest economy – Germany – could experience a modest economic contraction in 2023, bouncing back to sub-1% growth in 2024.

Geopolitics

The geopolitical landscape will be riskier and more complex in 2024. The Ukraine-Russia war will be entering its third year, and the ongoing Israel-Hamas military conflict, whereby thousands of people have perished, all but eliminates a two-state solution between Israelis and Palestinians in the Gaza strip and West Bank. This has been exacerbated by Iran's efforts to undermine relations between Israel and Arab Gulf states. The "axis opposition powers" of Russia, China, and Iran share the goal of fostering an alternative to the international order long advanced by the U.S., Japan, and other Western allies. Prolonged military conflicts in the Middle East and eastern Europe, and ongoing disputes between the U.S. and China, add to concerns of more global disorder and loss of human life.

Taiwan elections and conflict with China

While China has always considered Taiwan as part of its territory, the island has long functioned as a democracy with elections and its own economy, currency, and military. Based on opinion polls, the incumbent Democratic Progressive Party (DPP) could likely stay in power following Taiwan's presidential elections on January 13, 2024. However, DPP's main competitor, the Chinese Nationalist Party (KMT), leans slightly toward a friendlier relationship with China and downplays a military solution to Chinese aggression, and is closing the gap. The Taiwan People's Party also may split some votes. The result of the election will likely maintain tense cross-strait relations, but should not materially change the geopolitical landscape.

Uncertain state of the U.S. union

The U.S. has been captive to divisive politics, exacerbated by misinformation on social media and politically biased news outlets. Mandatory federal spending on entitlement programs like social security continues to be debated, and there is considerable congressional disagreement, for example, on discretionary appropriations bills to fund various departments and agencies – which, if not completed, could prompt a government shutdown in 2024.

In the November 2024 general elections, the likely presidential candidates will be Democratic incumbent President Joe Biden and Republican Donald Trump. The election of either man as well as congressional choices for the House and Senate will be decided by what voters are most concerned about including economic conditions, fiscal spending, funding for Ukraine, Israel, and Taiwan, immigration policies, U.S.-China relations, and sustainability initiatives. One thing is for certain. The U.S. needs less attention-getting partisan fighting and more reliable bipartisan support for effective policy making and legislation which has been missing.

Political dysfunction has steadily eroded the once stellar creditworthiness of the U.S. – the government debt is now rated AAA by only one of the main nationally recognized statistical ratings organizations. In 2023, Fitch lowered its top rating of the U.S. to AA+ (aligned with S&P's) and Moody's placed its Aaa rating on negative outlook. Fitch's reasons included the potential for a recession, high rates, fiscal deterioration, a growing debt burden, political gamesmanship, and eleventh-hour congressional resolutions. Moody's pointed out that, in addition to high rates and large fiscal deficits, "continued political polarization within U.S. Congress raises the risk that successive governments will not be able to reach consensus on a fiscal plan to slow the decline in debt affordability."

Political dysfunction has steadily eroded the once stellar creditworthiness of the U.S. – the government debt is now rated AAA by only one of the main nationally recognized statistical ratings organizations.

Most banks had relatively low commercial real estate (CRE) exposure for the third quarter ended September 30, 2023, including $115B of office CRE accounting for less than 2% of total loans

Financial systemic risks are manageable

In early 2023, four U.S. banks, including California-based, venture-capital-focused Silicon Valley, and First Republic collapsed. In Europe, Switzerland-based Credit Suisse, which had long-standing problems, was rescued by Swiss peer UBS. As we stated then, these failures were specific to each bank – thus idiosyncratic in nature with no impact on the financial systems in the U.S. and Europe.

Silicon Valley was a poorly managed bank in a stable industry

Before management set Silicon Valley up for failure, the bank was financially healthy with $1.5B in profits, more than $200B in total assets and sound capital levels in 2022. However, the bank's rapid growth since 2020 prompted management to invest the influx of tech startup deposits in longer-term U.S. treasuries, betting rates would stay lower for longer. In 2022, the Fed began aggressively raising rates, and Silicon Valley Bank's government bond portfolio accumulated billions of dollars in unrealized market value losses. Venture capital dried up due to tighter monetary policy, and the bank was heavily exposed to potential deposit withdrawals by start-up and venture capital customers needing cash. Adding to managerial missteps, state regulators failed to oversee the bank's weak risk controls to deal with the bank's interest rate and asset liability risks, since Silicon's chief risk officer stepped down in mid-2022 with no replacement. In early 2023, management's surprise announcement of a securities portfolio restructuring which generated a large loss, to be followed by a common equity offering to replenish capital, made little sense and shocked investors who quickly took to social media, prompting a "digital run on the bank", draining all liquidity.

Better risk-reward attributes of preferred issuers, including banks, compared with high yield

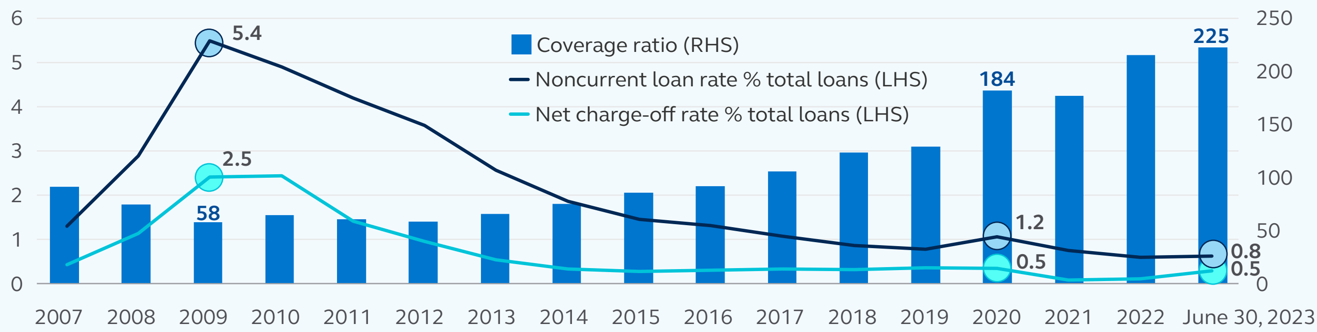
As stated in our 2023 outlook, the low average annual default rate of the hybrid preferred universe was due to the solid qualitative and quantitative fundamentals of banks, insurers, and non-financials. In the 10-year period through 2023, average annual preferred defaults were under 50bps, versus 10bps at the end of 2022. Preferred risk-adjusted returns compare favorably with the high yield sector which had an average annual default rate of 2.8%. We believe high yield losses will rise even higher driven by weaker single-B and lower-rated leveraged loans, which are often covenant-light and floating rate structures, exposing borrowers to high-rates and potential economic weakness in 2024. It is important to note that the failure of Credit Suisse materially contributed to the rise in the 2023 default rate.

Supportive bank metrics

The banking industry comprises over 4,600 Federal Deposit Insurance Corporation (FDIC) insured banks. As reported by the FDIC, assets and deposits totaled $23.5T and $17.2T, respectively, as of June 30, 2023. Barclays data sourced from company reports and S&P shows that most banks had relatively low commercial real estate (CRE) exposure for the third quarter ended September 30, 2023, including $115B of office CRE accounting for less than 2% of total loans. Based on FDIC data, the following graphs illustrate the U.S. banking industry's good loan quality and lower, though steadying, net interest income from investment securities and loans.

In Exhibit 9, the rate of non-current loans and net charge-off for bad loans remained well managed at 0.8% and 0.5%, respectively, for the six months ended June 2023 from 2020. The loan loss reserve of 225% in the same period was more than adequate to cover non-current loans. To put this into context, the banking industry was far more affected during the Great Financial Crisis (GFC).

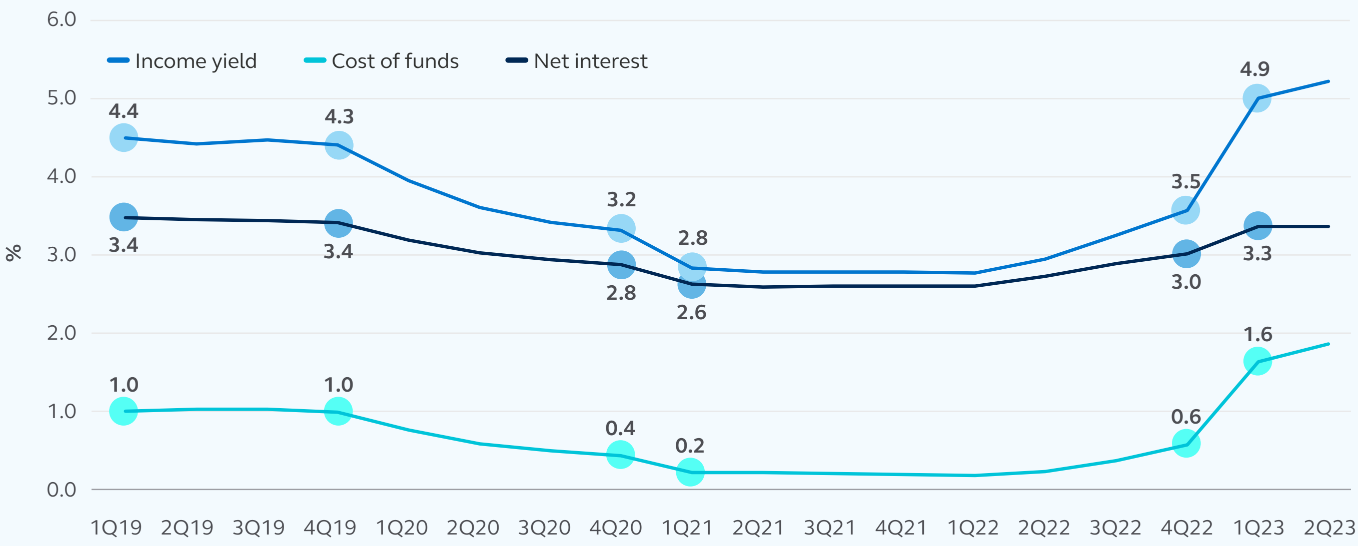
EXHIBIT 9: U.S. bank loan asset quality trends (%)



Source: FDIC. As of June 30, 2023. Coverage ratio: Loss reserve as a percentage of noncurrent loans.

In Exhibit 10, the rate of the cost of funds rose faster than the increase in the rate of income yield on earning assets from mid-2022 to mid-2023 due to aggressive Fed tightening. However, net interest margins trended toward higher pre-COVID-19 levels, supporting bank profits.

EXHIBIT 10: Quarterly U.S. bank net interest revenues (%)



Source: FDIC. As of June 30, 2023.

Bank credit in more detail

The funding challenges of 2023 are behind us, and the banking system has proved to be resilient – despite the idiosyncratic failures of Silicon Valley, Silvergate, Signature, and First Republic banks in the U.S., and Credit Suisse in Europe. Funding has stabilized, capital has remained solid, profits have been good, and asset quality has remained sound. Furthermore, the Fed, Bank of England, and European Central Bank stress tests in mid-2023 demonstrated major global banks' core strengths.

High rates

Banks will continue to face high interest rate challenges. In the U.S., the Fed's interest hikes, started in early 2022, have squeezed lenders' net interest margins (NIM) as cost of funds have risen, and drove down market values of many of the long-term securities U.S. banks hold – securities purchased in the prior low-rate environment. That said, these securities are almost uniformly of very high quality, dominated by U.S. Treasury or Agency securities. Thus, securities' quality is not a concern, and the market value challenge is a self-correcting one as these holdings will march to maturity, especially when the Fed decides to cut rates. We expect the recently improved NIMs for U.S. banks to stabilize in early/mid 2024, assuming rates remain flat, or drop. For Europe, which is on a different interest rate cycle, NIM support from rising rates should start to ease in 2024.

Loan quality has been normalizing since the COVID-19 bubble, and we expect this to continue.

Good loan quality

Loan quality has been normalizing since the COVID-19 bubble, and we expect this to continue. Though U.S. employment levels are strong – a key driver of consumer loan quality – U.S. auto and card delinquencies have been weakening as people struggle with inflation, higher interest rates, and lagging salaries. Even a moderate recession would further pressure consumer loan quality. Commercial real estate (CRE) has been resilient for the most part, with the office segment being the main concern, driven by higher interest rates, reduced desire by banks to lend, and reduced demand for office space driven by work from home. So-called B and C quality, and 'non-Green', offices in major central business districts are under the most value pressure. While banks' CRE losses will rise, we expect this to be a multi-quarter event as leases roll off and space is re-leased at perhaps lower rates or becomes vacant. In addition, big, and larger regional, banks tend to have well underwritten CRE loan books, and measured exposures. Whether the U.S. and/or Europe enters a recession in 2024, and its severity, will be key determinants to banks' loan quality, as will the level and direction of interest rates.

Insurers are generally long-term holders of mainly high-grade fixed income investments funded by long-term promises to policyholders, and thus there is little need to realize losses.

Costs

Operating costs, driven by inflation, regulatory and compliance efforts, sourcing and retaining qualified personnel, and the ongoing transition to digital finance, remain a key focus for banks, especially given NIM pressure and weakening loan quality crimping revenues. The old adage, 'You manage what you can' applies. In fact, banks' capacity to successfully compete is increasingly dependent on their ability to manage costs. Our view is that the many years of digital investment are beginning to pay off, and that banks' cost/income ratios should find greater support moving forward. Larger banks are best positioned to benefit from digital investments due to their size and the fixed cost nature of much digital infrastructure. So, we expect smaller regional and community banks will find it more challenging to profitably compete and be pushed more into mergers. Well executed, such mergers should help larger, acquiring banks (on which we focus) further solidify their franchises and spread out their costs. However, the ability to execute mergers involving large banks is often circumscribed by skeptical regulators.

Governance

Environmental, Social, and Governance (ESG) matters continue to affect bank strategies, particularly in Europe. Regulatory and legislative ESG initiatives are ramping up, as are pressures from advocacy groups. Governance, which drives controls and risk management, is most important to credit strength. Rising environmental concerns will influence lending decisions, with banks needing to transition customers from carbon-generating activities and support greener energy solutions. While this will be a measured transition, likely substantial government subsidies could help make this a profitable business. In addition, environmental issues are increasingly affecting banks' loan quality from storms, fire and variable weather, and evolving disclosure rules are boosting costs. We believe global banks will be able to manage these ESG issues well.

Insurance credit

Traditional life & annuity (L&A) and property & casualty (P&C) re/insurance companies maintain strong balance sheets, resilient to a possible economic slowdown. P&C firms are well positioned to withstand larger claims, for example, from severe weather and inflation.

Effect of rising rates

In our 2023 outlook, we stated that gradually rising interest rates are positive for insurers. And while tighter financial conditions resulted in some market vulnerabilities such as liquidity challenges in the U.K. pension system and for select U.S. regional banks, insurers typically maintain robust liquidity with lower levels of confidence-sensitive funding than banks. Insurers are generally long-term holders of mainly high-grade fixed income investments funded by long-term promises to policyholders, and thus there is little need to realize losses.

Property and Casualty (P&C) Re/insurance

P&C insurers continue to face higher claims including from severe weather, economic price pressures, and tort "social" inflation. Aggressive attorney involvement and litigation finance and societal influence on juries have resulted in larger legal awards. A rise in lawsuits related to latent liabilities like health issues tied to opioids, and polyfluoroalkyl substances (PFAS) which breakdown slowly over time are an emerging concern.

Personal automobile insurers continue to work with state regulators to restore profitability after getting hit by higher car repair/replacement and injury claims costs post-pandemic. Given the competitive and highly regulated nature of this line, it is taking longer to restore profitability, especially in states with more challenging legislative and regulatory setups.

In contrast, reinsurers retain exceptional pricing power following years of large catastrophe losses and have lessened exposures to more recurrent severe weather events such as localized wind and hail. As such, their customers (primary insurers) have suffered from many midsized weather-related losses in 2023, while the reinsurers have performed well given few mega-CATs (e.g., hurricanes).

As a result of claims pressures, a tighter supply of reinsurance capacity, and emerging risks such as those tied to latent liabilities and cyber threats, reserving practices remain prudent and pricing firm in most P&C lines, supporting current and prospective earnings for most.

Life & Annuity (L&A) Insurance and Private/Structured Credit

More conservative traditional bank lending post-GFC has supported material growth in private capital. U.S. L&A insurers have increased their exposure to illiquid/private assets in recent years without having to commit significantly more regulatory capital, partly by holding investment-grade-rated structures, though these may be backed by lower rated assets (e.g., subordinated tranches can absorb credit impairments on the underlying assets). While incumbents have generally maintained higher-quality holdings, some newer and private equity (PE) backed L&A companies have engineered higher investment returns from outsized positions and by moving certain risks offshore. We remain cautious about the rapid growth and size of PE-backed L&A insurance, and the potential for conflicting stakeholder interests.

Substantial growth in private capital has created market depth, but with fewer public companies there is also greater market opacity. In many instances, deep-pocketed private capital providers may continue to support struggling portfolio companies, helping to extend the cycle. Yet, there is great demand for investment to achieve goals, such as for the energy transition, which is a key credit and ESG topic for electric utilities. Utilities are actively seeking to optimize their funding for significant investments in the energy transition and its supporting infrastructure, while managing credit metrics and customer bills.

ESG regulatory update

European regulation is underscored by the European Union (EU) Taxonomy (a classification system for sustainable economic activities), the Corporate Sustainability Reporting Directive (CSRD – a legislative framework that oversees companies' sustainability reporting), and the Sustainable Finance Disclosure Regulation (SFDR). Under SFDR, so-called Level 1 asset management activities require transparency around sustainability claims made by financial market participants. Under SFDR Level 2 rules, asset managers are required to disclose sustainability performance data through Principal Adverse Indicators (PAIs) such as carbon emissions and exposure levels of companies to fossil fuels. In 2024 and 2025, companies will be required to disclose and assess the materiality of sustainability issues.

Greenwashing practices have come under regulatory scrutiny at the federal level, and the U.S. Securities and Exchange Commission (SEC) has made progress in other areas including the requirement for corporations to provide cybersecurity disclosures. However, the U.S. continues to face political opposition whereby some states have enacted laws rejecting the consideration of ESG factors like climate change.

ESG regulation timeline

Date	U.S. SEC
Mar 2022	• Proposed climate change disclosure for corporations (timeframe TBD)
May 2022	• Proposed ESG Fund Disclosure Rule for asset owners/managers (timeframe TBD)
Sep 2023	• Corporate disclosure on cybersecurity • Proposed human capital management + corporate board diversity disclosure rules (timeframe TBD)
Oct 2023	• California Climate Disclosure Bill: companies which operate in California with annual revenue over $1B will be required to disclose emissions data
Dec 2023	• SEC's Names Rule: "80% investment policy" – i.e., 80% of the value of its assets has to be consistent with the fund's name

Date	The EU and U.K.
Mar 2021	• The EU's SFDR Level 1 was implemented for asset managers
Jan 2023	• Implementation of SFDR Level 2 – mandatory disclosure of Principal Adverse Indicators (PAIs)
Nov 2023	• The U.K. released a sustainability guidance for asset managers • The EU reached a provisional agreement on regulating methane emissions
Jan 2024	• Corporates start to report under the Corporate Sustainability Reporting Directive (CSRD) • Environmental delegated act under EU Taxonomy applies
2025	• European Sustainability Reporting Standards (ESRS): large companies listed on the EU market will start reporting 12 ESRS topics covering a range of sustainability issues

Index definitions

ICE BofA U.S. All Capital Securities Index (I0CS): The ICE BofA U.S. All Capital Securities Index tracks the performance of fixed rate, U.S. dollar denominated hybrid corporate and preferred securities publicly issued in the U.S. domestic market.

ICE USD Contingent Capital Index (CDLR): The ICE USD Contingent Capital Index tracks the performance of USD denominated investment grade and below investment grade contingent capital debt publicly issued in the major domestic and eurobond markets.

ICE BofA Core Plus Fixed Rate Preferred Securities Index (P0P4): ICE BofA Core Plus Fixed Rate Preferred Securities Index tracks the performance of fixed rate U.S. dollar denominated preferred securities issued in the U.S. domestic market.

ICE BofA 5-7 Year U.S. Financial Index (CF03): The ICE BofA 5-7 Year U.S. Financial Index is a subset of ICE BofA U.S. Corporate Index including all securities of Financial issuers with a remaining term to final maturity greater than or equal to 5 years and less than 7 years.

SAMI $1000 par Preferred Securities (STB8): 69.7% ICE BofA U.S. Investment Grade Institutional Capital Securities Index (CIPS) tracks the performance of U.S. dollar denominated investment-grade hybrid capital corporate and preferred securities publicly issued in the U.S. domestic market. 30.3% ICE BofA U.S. High Yield Institutional Capital Securities Index (HIPS) tracks the performance of U.S. dollar denominated sub investment-grade hybrid capital corporate and preferred securities publicly issued in the U.S. domestic market.

ICE BofAML Eurodollar Banking Index (E0BA): ICE BofA Eurodollar Index tracks the performance of U.S. dollar denominated investment grade quasi-government, corporate, securitized and collateralized debt publicly issued in the eurobond markets.

ICE BofA U.S. Investment Grade Institutional Capital Securities Index (CIPS): The ICE BofA U.S. Investment Grade Institutional Capital Securities Index (CIPS) tracks the performance of U.S. dollar denominated investment grade hybrid capital corporate and preferred securities publicly issued in the U.S. domestic market.

ICE BofA U.S. High Yield Institutional Capital Securities Index (HIPS): The ICE BofA U.S. High Yield Institutional Capital Securities Index (HIPS) tracks the performance of U.S. dollar denominated sub-investment grade hybrid capital corporate and preferred securities publicly issued in the U.S. domestic market.

Custom Institutional Capital Securities (STB3) is a customized index that is 40% ICE BofA U.S. Investment Grade Institutional Capital Securities Index (CIPS), 17% ICE BofA U.S. High Yield Institutional Capital Securities Index (HIPS), and 43% ICE USD Contingent Capital Index (CDLR)

For public distribution in the U.S. For institutional, professional, qualified and/or wholesale investor use only in other permitted jurisdictions as defined by local laws and regulations.

This material is provided by and reflects the current views and opinions of Spectrum Asset Management, Inc., is an affiliate of Principal Global Investors. Spectrum is a leading manager of institutional and retail preferred securities portfolios and manages portfolios for an international universe of corporate, insurance and endowment clients.

Risk Considerations

Past performance is no guarantee of future results. Investing involves risk, including possible loss of principal. Fixed-income investment options are subject to interest rate risk, and their value will decline as interest rates rise. Risks of preferred securities differ from risks inherent in other investments. In particular, in a bankruptcy preferred securities are senior to common stock but subordinate to other corporate debt. Contingent Capital Securities carry greater risk compared to other securities in times of credit stress. An issuer or regulator's decision to write down, write off or convert a CoCo may result in complete loss on an investment.

Important Information

This material covers general information only and does not take account of any investor's investment objectives or financial situation and should not be construed as specific investment advice, a recommendation, or be relied on in any way as a guarantee, promise, forecast or prediction of future events regarding an investment or the markets in general. The opinions and predictions expressed are subject to change without prior notice. The information presented has been derived from sources believed to be accurate; however, we do not independently verify or guarantee its accuracy or validity. Any reference to a specific investment or security does not constitute a recommendation to buy, sell, or hold such investment or security, nor an indication that the investment manager or its affiliates has recommended a specific security for any client account. Subject to any contrary provisions of applicable law, the investment manager and its affiliates, and their officers, directors, employees, agents, disclaim any express or implied warranty of reliability or accuracy and any responsibility arising in any way (including by reason of negligence) for errors or omissions in the information or data provided.

All figures shown in this document are in U.S. dollars unless otherwise noted.

This material may contain `forward looking' information that is not purely historical in nature. Such information may include, among other things, projections and forecasts. There is no guarantee that any forecasts made will come to pass. Reliance upon information in this material is at the sole discretion of the reader.

Neither this document, nor the sustainability considerations contained therein, relate to a specific investment strategy/product managed by Principal Asset Management (or its affiliates) nor their classification under the Sustainable Finance Disclosure Regulation (EU) No. 2019/2088. More information on the Principal Asset Management Sustainable Investing Policy can be found at https://www.principalam.com/eu/about-us/esg.

This material is not intended for distribution to or use by any person or entity in any jurisdiction or country where such distribution or use would be contrary to local law or regulation.

This document is intent for use in:

- **The United States** by Principal Global Investors, LLC, which is regulated by the U.S. Securities and Exchange Commission.
- **Europe** by Principal Global Investors (Ireland) Limited, 70 Sir John Rogerson's Quay, Dublin 2, D02 R296, Ireland. Principal Global Investors (Ireland) Limited is regulated by the Central Bank of Ireland.
  Clients that do not directly contract with Principal Global Investors (Europe) Limited ("PGIE") or Principal Global Investors (Ireland) Limited ("PGII") will not benefit from the protections offered by the rules and regulations of the Financial Conduct Authority or the Central Bank of Ireland, including those enacted under MiFID II. Further, where clients do contract with PGIE or PGII, PGIE or PGII may delegate management authority to affiliates that are not authorized and regulated within Europe and in any such case, the client may not benefit from all protections offered by the rules and regulations of the Financial Conduct Authority, or the Central Bank of Ireland. In Europe, this document is directed exclusively at Professional Clients and Eligible Counterparties and should not be relied upon by Retail Clients (all as defined by the MiFID).
- **United Kingdom** by Principal Global Investors (Europe) Limited, Level 1, 1 Wood Street, London, EC2V 7 JB, registered in England, No. 03819986, which is authorised and regulated by the Financial Conduct Authority ("FCA").
- This document is marketing material and is issued in **Switzerland** by Principal Global Investors (Switzerland) GmbH.
- **United Arab Emirates** by Principal Global Investors LLC, a branch registered in the Dubai International Financial Centre and authorized by the Dubai Financial Services Authority as a representative office and is delivered on an individual basis to the recipient and should not be passed on or otherwise distributed by the recipient to any other person or organization.
- **Singapore** by Principal Global Investors (Singapore)Limited (ACRA Reg. No. 199603735H), which is regulated by the Monetary Authority of Singapore and is directed exclusively at institutional investors as defined by the Securities and Futures Act 2001. This advertisement or publication has not been reviewed by the Monetary Authority of Singapore.
- **Australia** by Principal Global Investors (Australia) Limited (ABN 45 102 488 068, AFS Licence No. 225385), which is regulated by the Australian Securities and Investments Commission and is only directed at wholesale clients as defined under Corporations Act 2001.
- **Hong Kong SAR (China)** by Principal Asset Management Company (Asia) Limited, which is regulated by the Securities and Futures Commission. This document has not been reviewed by the Securities and Futures Commission.
- **Other APAC Countries/Jurisdictions.** This material is issued for Institutional Investors only (or professional/sophisticated/qualified investors, as such term may apply in local jurisdictions) and is delivered on an individual basis to the recipient and should not be passed on, used by any person or entity in any jurisdiction or country where such distribution or use would be contrary to local law or regulation.

Principal Global Investors, LLC (PGI) is registered with the U.S. Commodity Futures Trading Commission (CFTC) as a commodity trading advisor (CTA), a commodity pool operator (CPO) and is a member of the National Futures Association (NFA). PGI advises qualified eligible persons (QEPs) under CFTC Regulation 4.7.

Principal Funds are distributed by Principal Funds Distributor, Inc.

MM9073-08 I 12/2023 I 3297406-012024