Principal Asset Management℠

PRINCIPAL INTERNATIONAL EQUITY ETF

Quarterly commentary

TICKER: PIEQ

Notable Themes

- **Tariff and trade turbulence** – early enthusiasm for expected U.S. policy reforms abruptly turned cautious due to tough talk and flip-flops on tariff penalties, reciprocity, and a worrisome deterioration of diplomatic relations, including among historically strong American allies
- **No monopoly on innovation** – the U.S. dollar weakened and international markets materially outperformed, particularly among technology shares in-part fueled by the unveiling of the surprisingly low cost and innovative "Deep Seek" Chinese AI platform
- **Defense to the forefront** – investor flows shifted away from big tech and consumer cyclicals, in favor of less volatile industries, with particularly strong gains among military defense contractors, led by European producers, amid heighted geopolitical uncertainty and increased spending commitments

Q1 Summary

A disorderly start to the year

At the start of the year, investors were anticipating a growth-friendly administration that would reinforce the narrative of U.S. exceptionalism and enact policies likely to strengthen the U.S. economy relative to the rest of the world. However, policy has not panned out quite as expected. Not only has the sequencing of economic policies been different, but the tariff policy proposals have been considerably more severe than anticipated. With policy uncertainty extraordinarily elevated, the U.S. economy has already begun to be negatively impacted.

The initial anticipation was that the new U.S. administration would prioritize shoring up the U.S. economy via deregulation in the first quarter. Instead, they prioritized tariffs and federal employee job cuts, with no corresponding moves to ease regulatory policy. Tariff proclamations were not only announced earlier than expected, but are likely to be meaningfully larger than anticipated, with frustratingly inconsistent messaging and numerous flip-flops in guidance along the way.

Uncertainty around the timing, magnitude, coverage, and duration of tariffs has undermined consumer confidence, business sentiment, and ultimately investor sentiment. Among business leaders, the uncertainty is already weighing on capex plans as companies decide to put investment and hiring plans on hold with several large corporates already sounding alarm bells across a host of industries and economic sectors. The lack of clarity also makes it more difficult for the Fed to determine the path of monetary policy. For now, their hands are essentially tied.

While this whirlwind of proclamations has been made in the name of strengthening America's competitive position, the early response by global equity markets has signaled quite the opposite.

A new twist in the AI arms race

Pressure on U.S. tech stocks was also elevated as investors reassessed lofty valuations following the release of a powerful open-source AI model by Chinese startup DeepSeek. The model, which seems to rival those from top U.S. developers but at a significantly lower cost, has raised concerns about the sustainability of current equity premiums.

While DeepSeek's initial development cost estimates were dubious, and its processing efficacy not yet fully confirmed, it's launch announcement was undoubtedly a seminal moment for the industry. The fact that it was quietly developed by a private organization in China surprised many. More importantly, its unveiling called into question the need for the previously anticipated massive capital spending on advanced chips, and having those chips come only from the most advanced semiconductor manufacturing companies (i.e. the hyper-scalers in the U.S., Taiwan and Belgium). Critically, however, it also could dramatically improve potential AI use-case scenarios, with a lower cost of entry for a broad swath of productive applications. In other words, it's an opportunity to democratize AI technology to the benefit of the broader economy and equity markets.

For context, note that technology stocks within the S&P 500 declined 12.7% during the quarter, while their counterparts within the MSCI China Index gained 25.6%.

Germany sparks a European sentiment boost

President Trump's decision to suspend military aid to Ukraine in early March, plus his evolving approach to global security, has prompted a significant re-think on defense spending in Europe and accelerated a long-awaited fiscal shift in Germany.

In response, the German government has changed its constitutional rules, bringing the following changes:

a. The creation of a €500bn infrastructure investment fund.
b. Exemption of defense spending above 1% of GDP from the debt brake rule, which restricts annual structural deficits to 0.35% of GDP (This effectively permits open-ended borrowing for defense).
c. Easing of fiscal constraints for federal states.

Taken at face value, Germany is set to embark on a major fiscal expansion—over €1 trillion—far exceeding expectations. While a policy shift wasn't a surprise, the scale marks the biggest change in Germany's fiscal approach since reunification 35 years ago. The reforms could raise allowable structural net borrowing by more than 2% of GDP annually, though questions remain about how quickly the funds can be deployed.

Germany makes up about a third of Euro area GDP and is poised to lift broader European growth through its fiscal expansion. At the same time, the EU has proposed a modest but supportive fiscal shift, including looser budget rules to enable more defense spending, a "national escape clause" for member states, and a new €150 billion loan facility (SAFE) to support investment. While the EU-wide impact will be smaller than Germany's, it should still provide a slight boost to Euro area GDP in the coming years.

Perhaps unsurprisingly, this culmination of events, coupled with other ongoing geopolitical conflicts, sparked a sharp rally among military defense stocks, particularly among those based in Europe (including the U.K.).

By the numbers

International markets helped blunt the pain seen within the U.S. market, particularly amid weaker exchange rates for the U.S. dollar. The MSCI EAFE Index posted a solid 7.0% gain, while the World ex U.S. Small Cap index eked out a 3.8% advance. Similarly, the MSCI Emerging Markets Index a 3.0% rise, fuelled by the 15% rally in China. Conversely, Taiwan shed 12.6% in sympathy with the sell-off among U.S. mega-cap tech shares. Stylistically, high dividend and low volatility strategies finished in the black, countered by declines among high quality and momentum-oriented benchmarks.

While it is challenging to identify the silver-lining within the recent clouds, the events of 2025 thus far serve as a timely reminder of the case for international diversification.

Performance review

It was a strong start to 2025 for the International Equity ETF strategy on both an absolute and relative basis.

- The International Equity ETF (PIEQ) outperformed the MSCI ACWI Ex-USA Index for the quarter.
- For the quarter, the Communication Services and Financials sectors drove the outperformance while was partially offset by relative underperformance coming from the Materials and Consumer Discretionary sectors.
- Stock selection in developed markets drove the outperformance over the period led by Europe and Japan.

Attribution Overview

What helped performance in Q1?

Communication Services was the top performing sector in the 1st quarter.

- Deutsche Telekom - Germany's incumbent telecom operator. Beneficiary of its >50% stake in T-Mobile US as they continue to take market share from its U.S. peers following its Sprint acquisition that has expanded its network. The European business remains stable and offers a high-quality product though free cash flow generation remains underestimated.
- Tencent Holdings - operates a comprehensive portfolio of digital platforms and properties, including Wechat (Wexin), Tencent Games, QQ, QZone, Tencent Cloud, Tencent Music, and Tencent Video. Reported strong 4Q numbers on the back of domestic gaming and advertising while are also ratcheting up shareholder returns. They remain well positioned to leverage their existing userbase in Social/advertising/Gaming/Cloud.

Financials, including holdings AIB Group, National Bank of Greece and Hannover Re drove the outperformance.

- All are benefiting from total shareholder return yields of around 12%, better than peers, as balance sheets have been repaired. Further upside coming from recovering related economies that will drive volume loan growth off trough levels.

BAE Systems was top overall contributor to start the year.

- The UK-based defense company has been a prime beneficiary of escalating geopolitical tensions. By extension, governments have been dramatically increasing their defense spending and outlook for. Subsequently, BAE's wide swath of segments tied to this structural change will be the key driver of free cash flow growth in the coming years. At the forefront will be missiles (MBDA), land platforms + ammunition, Hagglunds CV90 & BvS10 + Bofors Archer Howitzer, and incremental Typhoon orders.

Japan was a particular area of strength in the 1st quarter.

- Sompo Holdings is a leading P&C insurance group. In its latest earnings report, profits made good progress versus guidance and expectations at both the Japanese domestic and overseas nonlife insurance operations as a result of lower natural disasters and stronger investment income. The economic solvency ratio (ESR) was 264%, above the top end of the company range of 200–250%. Surplus capital (above the 250% ceiling) stood at about JPY250 billion. This further increases the likelihood of share buybacks to adjust capital at the end of the year. Current expectations for share buybacks based on 50% of earnings is around JPY73bn and management has already increased SBBs at the 1h stage.

What hurt performance in Q1?

Commodity-oriented areas detracted from performance for the quarter with Teck Resources and CRH culminating the period as the top detractors. Commodity prices have collapsed including copper on demand fears.

- Teck is a Canadian mining company with exposure to copper, zinc and met coal. Teck remains a preferred holding as they are focusing more on copper/zinc expansion and greenfield optionality. Free cash flows will outpace expectations as copper prices trough and capex spend slows.
- CRH is a cement and aggregates company focused on Europe and the U.S. Q4 results were a slight miss as poor weather in the Americas weighed. An improvement in residential activity in Europe would be helpful and the peer group are all pointing to this. German residential permits have suddenly picked up – will watch if this is sustained. France permits remain weak. Ultimately the direction of interest rates will be key, but there is underlying need for more housing.

Toyota Motor significantly lagged though was largely in sync with the rest of its auto-related peers. Latest results were inline ex. one-offs as the latter weighed on operating profits. Toyota remains an interesting capital allocation improvement candidate while being better positioned for tariffs than most and benefiting from a strong hybrid lineup as demand for these transition vehicles grows.

Weakness in Hong Kong during the 1st quarter was driven by luggage company Samsonite as well as luxury provider Prada.

- Aiming at the overall mid-to-high-end market, Samsonite owns Tumi, Samsonite, American Tourister and other brands that compete in different market segments and show diversified product positioning. Management gave cautious guidance for 1Q25 dragged down by weakness in the U.S. while positively Asia is showing signs of improvement. At 8x FY2 P/E, downside risk is limited from here.
- For Prada, sales momentum remains strong for its Miu Miu brand and it's coming through in results and guidance for 2025. Share price weakness over the quarter was driven by reports that they may be acquiring Versace as they look to expand their product lineup.

Other top detractors were Noble Corporation (energy) and ASML (IT)

Outlook and portfolio positioning

Looking ahead – views from our CIO

Heading into 2025, U.S. exceptionalism remained a dominant theme. But tech sector struggles, downward revisions to U.S. economic growth forecasts and tariff uncertainties have all culminated in U.S. equity weakness but a broadening into other parts of the world as well as better breadth. Protectionism remains a contentious point and likely to keep volatility prevalent on trade war concerns. This has become apparent in the first week of April following President Trump's coined "Liberation Day" and the sweeping tariff announcements.

The size and scope of the tariff announcement overwhelm the trade actions implemented during the 2018 Trade War, bringing average U.S. tariff rates even higher than those seen during the Smoot–Hawley Tariff Act of 1930. As a result, heightened worries about economic disruption have erupted.

The tariffs represent the largest U.S. tax hike in modern history, and the impact on consumers could be severe. We estimate the resulting hit to U.S. GDP growth at around 2.4%, with more considerable fallout if trade partners retaliate. The odds of a U.S. recession are higher as a result.

The dramatic nature of these tariffs and lack of ready softening measures implies equities will likely be in risk-off mode until something catalyses change. While markets priced in tariff risk, the actual measures announced are more severe than expected and future actions remain uncertain. This ambiguity, combined with the stagflationary nature of the shock, limits the Fed's ability to offset with policy support removing a pillar of potential market resilience.

We may be nearing peak uncertainty. There is an optimistic scenario where tariffs are a negotiating tactic intended to build credibility and pave the way for fiscal stimulus. This may be via tax cuts especially tied to onshoring or a market-driven reduction in rates. If paired with tighter immigration policy, this could support real wage gains at the lower-income cohort and incentivize pro-cyclical responses from foreign economies (e.g. China & Germany). But this outcome requires policy clarity, and we are not there yet.

Until a credible resolution emerges, either through de-escalation or fiscal offset, the market is likely to be defensive. Rising costs, limited visibility and uncertain policy path argues for caution in equity positioning. In this backdrop, companies with strong free cash flow generating capabilities remain attractive.

With that said, following the dramatic share price declines in a wide swath of equities, we view this as a great opportunity to add to positions where our financials models suggest significant upside over the long-term.

New Positions

Erste Group is an Austrian bank operating in Central & Eastern Europe. Cash flow growth is likely to be organic and leverage an existing footprint with ~15-20% market share in 5+ markets. Volumes are supportive both near-term and long term. After years of depressed economic activity and socialistic, state-owned economies, EBS's CEE markets have relatively low credit penetration. Shareholder returns continue to be core to the investment case for any bank. EBS currently has excess capital of ~€2.5B available for growth or payouts, which is ~15% of market cap. Organic capital generation is also strong, currently running ~15% of market cap per year. This combination allows above peer shareholder yields of 11-12% for the next several years (European peers ~9-10%).

Eliminated Positions

Noble Corporation is an offshore drilling contractor. The company reported good 4Q results, but the outlook was underwhelming. Management commentary suggests the demand recovery is being pushed further to the right with demand for 105-110 rigs in late 2026 or 2027 (versus 100 rigs currently). NE announced a 5G rig from DO would be scrapped. They have also stopped actively marketing the 6G Globetrotter I and Globetrotter II.

Top 10 holdings

	% of net assets
Deutsche Telekom Ag Reg	5.5
Unilever PLC	4.5
Sanofi	4.4
Nintendo Co Ltd	4.4
Tencent Holdings Ltd	4.2
JD.com Inc.	4.0
Bae Systems Plc	4.0
Hannover Rueck Se	4.0
AstraZeneca Plc	3.8
Erste Group Bank Ag	3.7
Total	**42.4**

As of March 31, 2025. Source: State Street.

The holdings listed do not constitute a recommendation to purchase or sell a particular security. Cash and/or derivative positions that are not part of the core investment strategy will not be reflected in the top holdings list.

PRINCIPAL INTERNATIONAL EQUITY ETF as of March 31, 2025

Performance

	Average annual total returns (%)							
	3-month	1-year	3-year	5-year	10-year	Since inception (11/05/2024)[1]	Expense ratio (gross/net)	Expense limit expiration date
Net asset value (NAV) return	8.13	—	—	—	—	4.69	0.48/0.48	—
Market price return	8.76	—	—	—	—	5.34	—	—
MSCI ACWI Ex-USA Index[2][3]	5.23	6.09	4.48	10.91	4.97	1.11	—	—

Source: State Street, Principal Global Investors, Morningstar. Morningstar percentile rankings are based on total returns. Morningstar ratings are based on risk-adjusted returns.

Performance data quoted represents past performance. Past performance is no guarantee of future results and investment returns, and principal value of the Fund will fluctuate so that shares, when redeemed, may be worth more or less than their original cost. Current performance may be higher or lower than the performance quoted. Visit www.PrincipalAM.com/ETF for current month-end performance.

(1) The net expense ratio reflects contractual expense limits, if any, which may lower net expenses and cause the gross and net expense ratios to differ. In such cases a date is listed through which expense limits are expected to apply; however, Principal Funds and the investment adviser may mutually agree to terminate the expense limits prior to the end of the period. Returns displayed are based on net total investment expense.

(2) The MSCI ACWI Ex-USA Index is a free float-adjusted market capitalization index that is designed to measure the combined equity market performance of developed and emerging market countries excluding the U.S.

(3) Index performance information reflects no deduction for fees, expenses, or taxes. Indices are unmanaged and individuals cannot invest directly in an index.

Investing in ETFs involves risk, including possible loss of principal. ETFs are subject to risk similar to those of stocks, including those regarding short-selling and margin account maintenance.

Investor shares are bought and sold at market price (not NAV) and are not individually redeemed from the Fund. Ordinary brokerage commissions apply.

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Companies may at any time choose not to pay a dividend, or dividends paid may be less than anticipated.

The commentary represents the opinions of the sub-advisor and may not come to pass.

This Fund is new and has limited operating history.

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