Principal Islamic Asset Management (Ireland) (PLC)

Global Sukuk Fund

I Class February 2024

Market Review

US Treasury (UST) yields climbed across the board in February, as investors continued to reassess their expectations of multiple rate cuts in 2024, taking cue from the US Fed's cautious tone about cutting rates too early during their FOMC meeting on 31st January. Furthermore, US economic data during the month e.g. inflation and labor market indicators came in stronger than expected, validating the US Fed's view that the committee can afford to be patient in deciding when to cut rates, given underlying strength in the US economy. Sentiment was also dented by large UST auction sizes during the month, pushing yields higher. Benchmark 10-year UST yields rose from 3.91% m-o-m, at end-January to touch 4.35%, before settling at 4.25% at end-February (34bps higher m-o-m). The UST yield curve bear flattened with the shorter 2-7 year yields rising 40-41bps, while the longer 20 and 30 year yields moved up by a smaller quantum of 21-25bps.

10-year UST yields briefly fell in early February, from 3.91% at end-January to touch 3.81%, as investors initially shrugged off the hawkish tone at the US FOMC meeting on 31st January, as well as strong US ISM manufacturing data. The US Fed kept interest rates unchanged at 5.25-5.50% and signaled openness to cutting them, though Chairman Jerome Powell pushed back against market expectations that reductions may begin in March, to recap. US ISM manufacturing unexpectedly jumped in January, from 47.1 in December (revised lower from 47.4) to 49.1, the highest in 15 months, strongly beating consensus expectations of 47.2. The rebound was mostly driven by a sharp increase in new orders from 47.0 to 52.5 (consensus 48.2), the strongest since May 2022, suggesting the manufacturing sector may be starting to stabilize. 10-year UST yields subsequently spiked to around 4.17%, after data showed that nonfarm payrolls grew from 333,000 in December (revised upwards from 216,000) to 353,000, much higher than consensus expectations of 185,000. Furthermore, average hourly earnings rose from 0.4% to 0.6% m-o-m (consensus 0.3%, y-o-y up from 4.3% to 4.5% vs. consensus 4.1%), defying expectations of a cooling labor market. US ISM services expanded more than expected from 50.5 in December to 53.4 in January (consensus 52.0), the highest in four months, bolstered by a pickup in orders and employment.

10-year UST yields continued to be pushed higher to around 4.33% after US CPI came in hotter than anticipated, raising concerns over prospects of sticky inflation, and compelling investors to reassess their expectations that the US Fed may begin cutting rates as early as March. US headline CPI rose in January, from 0.2% in December to 0.3% m-o-m (y-o-y down from 3.4% to 3.1% vs. consensus 2.9%), while core CPI edged higher from 0.3% to 0.4% m-o-m (consensus 0.3%, y-o-y flat at 3.9% vs. consensus 3.7%), mainly driven by shelter costs, which rose by the steepest pace since early 2023. UST yields took a breather after US retail sales fell sharply from 0.4% in December (revised lower from 0.6%) to -0.8% in January (consensus -0.2%), the biggest drop in nearly a year. Nevertheless, 10-year UST yields edged higher again after US PPI (producer price index) gained from -0.1% to 0.3% over the same period (consensus 0.1%), fueled by a sizeable jump in costs of services, and highlighting persistent inflationary pressures.

Sentiment in the UST market continued to be dampened by hawkish Fed speak during the month, pressuring 10-year UST yields higher to touch 4.35% on 23rd February, the highest level since November 2023. Minutes of the US Fed meeting in January illustrated both optimism and caution regarding inflation among policymakers. The central bank's policy tightening moves had succeeded in lowering inflation, from its 40-year high of 9.1% in June 2022 to 3.1% in January 2023. US Fed officials said they wanted to see more evidence that inflation is sustainably moving down towards its 2.0% target, noting the risks of easing monetary policy too quickly. Meanwhile, the minutes also noted upcoming decisions on when and how to stop reducing the size of the Fed's balance sheet, with "many participants" suggesting starting "in-depth" discussions on balance sheet policy at the next meeting in March.

10-year UST yields fluctuated but stayed around 4.30% towards month-end, as investors digested USD 169 billion worth of new 2, 5 and 7-year UST auctions in two days. Nevertheless, 10-year UST yields fell on the last trading day of the month to settle at 4.25% (34bps higher m-o-m), after US PCE inflation data matched expectations, despite increasing m-o-m. Headline PCE inflation rose in January, from 0.1% in December to 0.3% m-o-m (consensus 0.3%, y-o-y down from 2.6% to 2.4%, in line with consensus); while core PCE inflation edged higher from 0.1% to 0.4% m-o-m (y-o-y down from 2.9% to 2.8%).

Brent crude oil prices rebounded in by 2.3% m-o-m in February, from USD 81.71/bbl at end-January to USD 83.62/bbl at end-February, as investors continued to weigh prospects of a tighter supply market due to the ongoing Israel-Hamas war, against expectations of softer global demand.

Brent prices tumbled in early-February, from USD 81.71/bbl at end-January to around USD 77/bbl, after the Energy Information Agency (EIA) reported that US crude oil and fuel inventories rose to their highest levels since June 2021, as demand remained weak. For the week ended 27th January, US crude inventories climbed 4.1 million barrels to 452.7 million barrels, much steeper than consensus expectations of a 0.4-million-barrel rise. This also marked the sixth straight weekly build, as refining utilization declined, and net imports climbed. Meanwhile, the OPEC+ Joint Ministerial Monitoring Committee (JMMC) said they made no recommendation to change the group's existing production policy in its latest meeting. OPEC+ agreed on 30th November, to slash output by additional 2.2 million bpd in 1Q24, with Saudi Arabia extending its voluntary cut of 1 million bpd, while Russia will deepen its supply reduction from 300,000 bpd to 500,000 bpd, to recap. These cuts, lasting until end-March, are in addition to OPEC+'s existing 3.66 million bpd output cuts, which are set to last until end-2024 (total cuts 5.86 million bpd, equivalent to around 5.7% of global demand). The OPEC+ committee will review the 2.2 million bpd cuts again in March.

Brent prices jumped to around USD 83/bbl as tensions over the Israel-Hamas war grew after Israeli Prime Minister Benjamin Netanyahu dismissed a potential cease-fire, stating he sees "no other solution other than total victory". Brent prices were also supported by rising concerns over supply disruptions, after major shipping companies warned that the security situation in the Red Sea is continuing to deteriorate. Meanwhile, the International Energy Agency (IEA) expects global oil demand in 2024 to lose momentum. The IEA projects global oil demand growth to slow from 2.3 million bpd in 2023 to 1.2 million bpd in 2024, mainly attributed to slowing demand from China. Nevertheless, Brent prices remained steady, as investors welcomed news that the People's Bank of China decided to cut the 5-year loan prime rate (LPR) by 25bps from 4.20% to 3.95% on 20th February, the largest reduction since the reference rate was introduced in 2019. The larger-than-expected rate cut signals Beijing's willingness to unleash more broad-based stimulus to support the economy, which may drive demand for oil. Brent prices stayed firm towards month-end, to reach USD 84.80/bbl, before closing the month at USD 83.62/bbl (m-o-m 2.3% higher).

Fund Review

The Fund outperformed the Dow Jones Sukuk index return by 61bps in February, with returns of 0.00% compared to the index return of -0.61%. Sukuk prices softened in tandem with US Treasury movements in February. Nevertheless, the overall fixed income market outlook remains positive, underpinned by expectations of future rate cuts. Meanwhile, the primary Global Sukuk market remains active in February, with demand continued to be robust. Notable new sukuk issuances include Saudi Electricity, Saudi Public Investment Fund (PIF), and Saudi's Alinma Bank.

Portfolio Outlook and Strategy

The overall fixed income market outlook remains positive, albeit somewhat hampered by the timing of the eventual US Fed interest rate cut. Meanwhile, the macroeconomic outlook in the GCC region remains strong, anchored by resilient oil prices and a robust non-oil sector. The International Monetary Fund (IMF) expects the UAE and Saudi Arabia to lead non-oil sector growth in the short-term as the GCC region in general remains strong, driven by higher domestic demand, increased gross capital inflows, and reform implementation. The region's fiscal balances remain healthy, supported by fiscal reforms and high oil prices, with higher non-oil revenue reflecting sustained fiscal and structural reforms and contained expenditures. Hence, GCC countries' credit rating profiles are expected to remain solid in the near to medium term. Similarly, the macroeconomic outlook in Asian countries such as Malaysia and Indonesia remain strong and improving, supported by their resilient fundamentals and relatively benign inflation.

While the overall fixed income market outlook remains positive, the market may be subject to fluctuations amid lingering uncertainties. We will remain vigilant and continue to adopt a more defensive investment strategy through increased investments in sovereign sukuk. For corporate sukuk, we continue to prefer highly liquid, blue-chip government-related companies, utility companies, as well as those with strong financials and robust cash buffers, to enable a swift reaction to any changes in market sentiment or direction.

Risk Considerations

Investing involves risk, including possible loss of principal. Past Performance does not guarantee future return. All financial investments involve an element of risk. Therefore, the value of the investment and the income from it will vary and the initial investment amount cannot be guaranteed.

Important Information

The interest rate used is a general economic indicator that will have an impact on the management of the Fund regardless whether it is a Shariah-compliant Fund or otherwise. It does not in any way suggest that the Fund will invest in conventional financial instruments. All the investments carried out for the Fund are in accordance with Shariah requirements.

Proprietary model output is based upon certain assumptions that may change, are not guaranteed and should not be relied upon as a significant basis for an investment decision. Forecasts for each asset class can be conditional on economic scenarios; in the event a scenario comes to pass, actual returns could be significantly higher or lower than forecasted. Because of the inherent limitations of all models, potential investors should not rely exclusively on the model when making an investment decision. Forecasts of financial market trends that are based on current market conditions constitute our judgment and are subject to change without notice.
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