Principal Islamic Asset Management (Ireland) (PLC)

Global Sukuk Fund

I Class January 2024

Market Review

Benchmark 10-year US Treasury prices (UST) pared gains in January, following a steep rally in November and December 2023, as investors recalibrated their expectations for multiple rate cuts in 2024 amid stronger-than-expected US economic data. 10-year UST yields rose during the month, from 3.88% at end-December to touch 4.20% before plunging to close the month at 3.91% (m-o-m 3bps higher), fueled by renewed concerns over the health of regional US banks. Furthermore, the US Treasury Department reduced its estimate for net federal borrowing for 1Q24, from the previous forecast of USD816 billion in October to USD760 billion, alleviating concerns of heavier UST supply. The US Fed maintained its benchmark rate at 5.25%-5.50% on 31st January, and continued to signal potential rate cuts in 2024, while pushing back against market expectations for a cut in March. The UST yield curve bear steepened m-o-m, with the shorter 2-7-year yields declining by 1-4bps, 10 and 20-year yields were up by 3-7bps, while the longest 30-year yields rose by 14bps.

10-year UST yields jumped 22bps in early January, from 3.88% as at end-December to touch 4.10% on 5th January, amid a strong US manufacturing and jobs report. ISM manufacturing improved in December, from 46.6 in November to 47.4 (consensus 47.1) due to a pickup in production. However, it remained in contractionary territory for the 14th consecutive month, weighed down by unexpectedly weaker new orders, which fell from 48.3 to 47.1 (consensus 49.1), while ISM prices paid tumbled from 49.9 to 45.2 (consensus 49.5). Minutes of the US Fed meeting in December 2023 revealed that while policymakers concluded that rate cuts are imminent in 2024, they noted an "unusually elevated degree of uncertainty" about the economic outlook and policy path, indicating the committee was also careful not to commit to any immediate loosening of monetary policy. US jobs data came in hotter than expected, indicating continued strength in the labour market. ADP National Employment increased more than expected from 104,000 in November (revised higher from 103,000) to 164,000 (consensus 125,000), led by the services sector including leisure and hospitality, as well as education and healthcare. Similarly, nonfarm payrolls rose from 173,000 (revised lower from 199,000) to 216,000 (consensus 175,000). The unemployment rate stayed firm at 3.7%, while average hourly earnings unexpectedly rose from 4.0% to 4.1% (consensus 3.9%, m-o-m unchanged at 0.4%).

10-year UST yields traded range-bound between 3.91-4.06% amid mixed US economic data. US ISM services unexpectedly plunged in December, from 52.5 in November to 50.6 (consensus 52.5), led by a sharp decline in employment from 50.6 to 43.3, the deepest contraction since July 2020. Similarly, new orders slipped from 54.8 (revised lower from 55.5) to 52.8 (consensus 56.1), indicating a more subdued demand outlook due to concerns over economic uncertainty, geopolitical events and labour constraints. US consumer credit surged in contrast, from USD7.15 billion in October (revised up from USD5.13 billion) to USD23.75 billion in November (consensus USD8.55 billion), pushing credit balances above the USD5 trillion mark for the first time on record. The monthly increase was driven by higher revolving credit (mostly credit cards), which soared by nearly USD19.5 billion, as consumers racked up debt to spend during the holiday-shopping season. US headline CPI accelerated from 0.1% in November to 0.3% m-o-m in December (consensus 0.2%, y-o-y up from 3.1% to 3.4% vs. consensus 3.2%), mainly attributed to shelter costs, while core CPI stayed firm at 0.3% m-o-m (consensus 0.3%, y-o-y down from 4.0% to 3.9% vs. consensus 3.8%). On the other hand, headline US PPI unexpectedly remained flat at -0.1% m-o-m (consensus 0.1%, y-o-y up from 0.8% to 1.0% vs. 1.3%), while core US PPI was unchanged at 0.0% m-o-m (consensus 0.2%, y-o-y down from 2.0% to 1.8% vs 2.0%).

10-year UST yields edged higher in mid-January, to 4.20% on 25th January, as market sentiment was dampened by continued resilience in US economic data and hawkish Fedspeak. The preliminary University of Michigan consumer sentiment improved markedly from 69.7 in December to 78.8 in January (consensus 70.1), as both short-term and long-term inflation expectations softened more than expected. 10-year UST yields trended lower towards month-end, after the US PCE inflation report (the US Fed's preferred gauge of inflation) showed continued disinflation momentum despite robust gains in personal income and spending, setting the stage the Fed to consider lowering interest rates and reduce the pace of quantitative tightening in coming months. Headline PCE inflation was unchanged at 2.6% y-o-y in December (consensus 2.6%, m-o-m up from -0.1% to 0.2% vs. consensus 0.2%), while core PCE inflation cooled more than expected from 3.2% to 2.9% y-o-y (consensus 3.0%, m-o-m up from 0.1% to 0.2% vs. consensus 0.2%). UST yields were also pushed lower amid renewed concerns over the health of regional US banks, after New York Community Bancorp reported increased stress in its commercial real estate portfolio. Sentiment was also lifted after the US Treasury unexpectedly reduced its estimates for 1Q24 borrowing from USD816 billion in October to USD760 billion, driving yields lower to close the month at 3.91% (m-o-m 3bps higher). The US Fed kept interest rates unchanged at 5.25-5.50% on 31st March 2023, as widely expected, and signaled openness to cutting them, though Chairman Jerome Powell pushed back against expectations that reductions may begin in March. Powell reiterated that the committee will only begin cutting rates when it has "gained confidence" that inflation is on a sustainable path to its 2.0% goal. Powell said a rate cut is not conditional on growth and the labour market cooling at the same time, stating "strong employment won't necessarily forestall rate cuts, but weak employment gains would absolutely hasten rate cuts".

Brent crude oil prices were steady during the month and traded within a narrow range of USD 75-80/bbl, supported by strong US economic data, continued resilience in commodities demand from China, and declining US crude oil stockpiles. Nevertheless, Brent prices rose towards month-end to settle at USD 81.71/bbl (m-o-m 6.1% higher), as escalating tensions in the Israel-Hamas war renewed concerns over a disruption in oil supply. Brent oil prices remained firm in the first half of January, buoyed by rising tension in the Middle East region. Brent oil prices were also supported by China's robust appetite for commodities imports in recent months, mainly due to Beijing's increased fiscal support in boosting infrastructure investment to support the economy. Furthermore, news of a full shutdown of Libya's Sharara oil field due to protests also buoyed Brent prices, as the disruption would reduce around 300,000 bpd of oil supply from the market.

Brent prices gained in the second half of the month, after data showed that crude stockpiles in the US tumbled by 2.49 million barrels to 429.91 million barrels for the week ended 12th January, the lowest since October 2023. barrels to 429.91 million barrels for the week ended 12th January, the lowest since October 2023. Sentiment was also bolstered by the People's Bank of China's announcement that it will reduce the reserve requirement ratio for banks beginning 2nd February, and signaled that more support measures will ensue, aiding the outlook for energy consumption in the world's largest crude importer. Brent prices continued to rally towards month-end, to touch USD 84.80/bbl on 29th January before closing the month at USD 81.71/bbl (m-o-m 6.1% higher) following a drone strike at a US military base in Jordan.

Fund Review

The Fund underperformed the Dow Jones Sukuk index return by 10bps in January, with returns of -0.80% compared to the index return of -0.70%. Sukuk prices softened in tandem with US Treasury movements in January. Nevertheless, the overall fixed income market outlook remains positive, underpinned by expectations of rate cuts. Meanwhile, the primary Global Sukuk market remains active in January, with demand continued to be robust. Notable new sukuk issuances include Kuwait Finance House, Banque Saudi Fransi, Qatar International Islamic Bank and Oman Telecommunications.

Portfolio Outlook and Strategy

The overall fixed income market outlook for 2024 is positive, underpinned by expectations that the US Fed will cut rates as inflation declines towards its 2.0% target and economic growth slows. Meanwhile, the macroeconomic outlook in the GCC region remains strong, anchored by stable 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. Furthermore, the IMF said 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. As a result, 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 remains strong, supported by their resilient fundamentals and relatively benign inflation.

While the overall fixed income market outlook is 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.

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