Principal®

Principal Islamic Asset Management (Ireland) (PLC)

Global Sukuk Fund

I Class August 2020

Market Review

US Treasuries (UST) retreated in August, with yields rising by 6 to 28 basis points (bps) across the 5-30 year tenures as demand for safe haven assets waned amid improving US economic data, and as investors digested additional long-end UST supply during the month. Month-on-month (m-o-m), 10-year UST yields climbed by 18bps from 0.52% at end-July to 0.70%, with yields touching a two-month high of 0.78% on 28th August, after Federal Reserve (Fed) Chairman Jerome Powell announced a major policy shift in its inflation target to an "average" of 2.00%. The change in strategy signals that the central bank would allow periods of inflation above its current 2.00% target to support the labor market and broader economy. The yields of longer-tenured UST, which are more sensitive to future inflation expectations, jumped to the highest level in weeks, causing the yield curve to steepen.

10-year UST yields were stable in early August despite better than expected US economic data such as Institute for Supply Management (ISM) manufacturing, durable goods order and ISM services index. US ISM manufacturing expanded in July from 52.6 in June to 54.2 (consensus 53.6), the fastest pace since March 2019, marking three straight months of expansion. The US ISM non-manufacturing index jumped from 57.1 in June to 58.1 in July (consensus 55.0), the steepest month of expansion since February 2019 as the economy recovers from the coronavirus hit. 10-year UST yields subsequently rose as markets shifted its attention towards better-than-expected US jobs data. The US economy added 1.76 million jobs in July, above expectations for a 1.48 million gain, albeit lower than the record 4.80 million new jobs added in the previous month as the resurgence of new Covid-19 cases dampened the recovery. Job gains were broad-based, with employment in leisure and hospitality increasing by 592,000, accounting for about one-third of the gain, while government employment rose by 301,000. The pace of initial jobless and continuing claims has slowed, the quantum remains elevated. Initial jobless claims improved in the beginning of the month from 1.19 million in the final week of July to 881,000 (pre-pandemic around 200,000), while continuing claims declined from 15.48 million to 13.25 million as of 21st August (pre-pandemic around 1,700).

10-year UST yields recovered by 10bps to 0.62% on 21st August, as buyers emerged to pick up UST at attractive levels. However yields drifted higher again after top US and Chinese trade officials reaffirmed their commitment to the Phase One trade deal, demonstrating a willingness to cooperate even as tensions rise between the world's two largest economies, therefore boosting risk sentiment. 10-year UST yields pushed higher towards the month end to touch 0.78%, the highest level in two months, after US Fed Chairman Jerome Powell announced a major policy shift in its inflation target to an "average" of 2.00% during the Fed's annual Jackson Hole symposium on 27th August. Despite Powell reaffirming that interest rates will likely stay low for the foreseeable future, UST retraced, with 10-year yields jumping 13bps to 0.78% following the announcement, before paring losses to close the month at 0.70% (+18bps higher m-o-m).

Brent crude oil prices rose by 5.70% in August m-o-m from USD 43.32/barrel (bbl) at end-July to USD 45.81/bbl at end-August, the highest level since March, supported by positive US economic data, drop in US crude inventories, weaker US Dollar and high Organization of the Petroleum Exporting Countries (OPEC)+ members' compliance with production cuts. Brent crude oil prices briefly jumped above USD 46/bbl in the beginning of the month, driven by positive data from the US, with manufacturing activity in July accelerating to its highest level in nearly one and a half years, as orders increased despite a resurgence in new Covid-19 infections. American Petroleum Institute reported a big drop in US crude inventories of 8.6 million barrels to 520 million barrels in the week ending 1st August, significantly larger than expectations for a 3.0 million barrel drop. The crude oil prices pared gains but remained buoyed between the USD 44.50-45.50/bbl range, supported by a weaker dollar, continued gains in risk assets, as well as affirmation from OPEC+ that its members are almost fully compliant with their respective production cut quotas. Saudi Energy Minister Prince Abdulaziz bin Salman urged members during the OPEC+ meeting on 20th August to continue to comply with their supply cut quotas, amid broad concerns that oil demand recovery was slow due to the ongoing pandemic. Brent crude oil prices briefly slipped towards month-end to USD 43.65/bbl on 21st August following mixed economic data from Europe and Japan, but subsequently marched higher to touch USD 46.53 on 31st August, before paring gains to close the month at USD 45.81/bbl.

Fund Review

The Fund continued to produce strong positive returns of 1.07% in August, outperforming the Dow Jones Sukuk index return of 0.24% by 83bps. In the 3Q20 up to end August, the Fund has generated returns of 3.55%, outperforming the index returns of 2.03% by 152 bps. This came on the back of the Fund's strong performance of 6.65% in 2Q20, outperforming the index returns of 5.78% by 87bps.

Portfolio Outlook and Strategy

Going forward, the outlook for fixed income asset classes remains positive, anchored by expectations that major global central banks will continue to maintain accommodative policy amid lingering uncertainties surrounding the Covid-19 pandemic. Expectations of a protracted global economic recovery, coupled with flush liquidity in financial systems as major central banks from the US, Europe, United Kingdom, Japan and Australia embark on quantitative easing, may continue to drive inflows into safe-haven fixed income assets.

Given the ultra-low interest rate environment, demand for Global Sukuk may continue to be supported by investors' hunt for higher yields and quality credits. Within the Global Sukuk market, Gulf Cooperation Council (GCC) countries now constitute about 17.00% of the JP Morgan Emerging Market Index, which may continue to sustain demand for GCC sukuk. Oil prices are expected to continue to recover as most governments around the world have begun lifting lockdown orders and resume economic activities, including tourism and leisure. Oil prices may also continue to be supported by OPEC+'s production cuts, which will remain in place for the next two years. In addition, both Saudi and Russia have pledged to further reduce production if necessary.

Disclosures

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All figures shown in this document are in US dollars unless otherwise noted. The information in this document has been derived from sources believed to be accurate as at 31 August 2020.