Principal Islamic Asset Management (Ireland) (PLC)

Global Sukuk Fund

I Class August 2022

Market Review

US Treasury prices weakened in August, after a strong rally in mid-June and July, with yields pressured higher across the board, as US Federal Reserve (Fed) officials maintained their hawkish stance despite a decline in US inflation. Sentiment continued to be soft ahead of the highly anticipated Jackson Hole economic symposium at end-August, where global central banks (including the US Fed) are widely expected to remain resolute in their fight against inflation, despite slowing economic growth. US Fed Chairman Jerome Powell said the US Fed may need to maintain a restrictive policy stance for some time to prevent inflation from becoming entrenched, squashing market expectations for a dovish Fed pivot. He added that historical record cautions strongly against prematurely loosening policy, even if growth slows. The UST yield curve shifted higher and bear flattened month-on-month (m-o-m), with 1-10 year UST yields soaring by 54-71 basis points (bps) while the longer 20 and 30-year yields rose by a smaller magnitude of 28-35bps. Benchmark 10-year UST yields closed the month 54bps higher from 2.65% at end-July to 3.19%, the highest since mid-June.

The previous UST rally in July gained momentum in early August, with 10-year UST yields falling 14bps lower from 2.65% at end-July to touch 2.51% on 2nd August, the lowest since early April, as weakness in US economic data, particularly in the manufacturing and construction sector, further moderated US rate hike expectations. US Institute for Supply Management (ISM) manufacturing dipped from 53.0 in June to 52.8, marking its second consecutive drop and the slowest expansion in manufacturing activity since June 2020, as new orders continued to fall despite improved supplier deliveries. US ISM prices paid eased from 78.5 in June to 60.0 in July, the lowest level since August 2020, as supply chain disruptions abate. Meanwhile, US Construction spending declined sharply from 0.7% in May (revised upwards from -0.1%) to -1.1% m-o-m in June, amid a soft housing market outlook as rising mortgage rates and deteriorating consumer sentiment hamper demand. However, 10-year UST subsequently reversed course, with yields edging higher after data showed that the US labour market remains strong, and has recovered to pre-pandemic levels. In July, the US economy added 528,000 new jobs, the largest job creation in five months and more than double consensus expectations of 250,000 (June revised higher from 372,000 to 398,000), pushing the unemployment rate lower from 3.6% to 3.5%, matching the pre-pandemic low as well as a five-decade low. Furthermore, average hourly earnings rose from 0.4% (revised higher from 0.3%) to 0.5% m-o-m (consensus 0.3%), the strongest monthly gain since March, putting pressure on the US Fed to continue with its rapid pace of monetary policy tightening. Meanwhile, US ISM services surprisingly rose from 55.3 in June to 56.7 in July (consensus 53.5), the most in three months as consumers shift their spending from goods to services such as entertainment and travel. However, the ISM report cautioned that concerns over overland trucking availability, a limited labor pool, material shortages and inflation continue to present hurdles for the service industry.

10-year UST yields continued to march higher in mid-August, to around 2.90% even though US headline Consumer Price Index (CPI) eased from 9.1% y-o-y in June to 8.5% in July (consensus 8.7%), amid a chorus of hawkish remarks from US Fed officials, who emphasized that the central bank still has a long way to go before it can declare victory on inflation. The drop in headline CPI was largely attributed to a significant decrease in gasoline prices, fuel oil and natural gas although inflation remained high for food, housing and used car and trucks, where core CPI excluding fuel was unchanged at 5.9% year-on-year (y-o-y). Following the release of the inflation report, US Fed officials stressed while the lower CPI print was highly welcomed, it does not alter the Fed's planned path of future interest rate hikes. Chicago Fed President Charles Evans (non-voter) said he expects the committee to continue to raise interest rates from 2.25-2.50% currently to 3.25%-3.5% this year and to 3.75%-4.00% by end-2023; while Federal Reserve Bank of Minneapolis President Neel Kashkari (non-voter), historically among the committee's most dovish member, said he wants to lift rates to 3.90% by end-2022 and 4.40% by end-2023. Sentiment was also dented by the release of the US Fed meeting minutes for July, which confirmed that the US Fed remains committed to tightening monetary policy to quash inflation, even if it risks hampering growth.

US Fed Chairman Jerome Powell reiterated that the central bank will continue raising interest rates even if it brings some pain to businesses and households, to prevent inflation expectations from becoming entrenched in the economy. Powell also emphasized the US Fed's commitment in reaching its 2.0% inflation target, and that the central bank will not deter from its course until there is significant evidence that inflation is slowing. Powell added that historical record cautions strongly against prematurely loosening policy even if growth slows, referring to former Fed Chairman Paul Volcker, who prematurely cut rates in April 1980 in response to slowing growth, only to immediately increase them again as inflation remained stubbornly high. Powell also noted that another "unusually large" increase in interest rates at the September meeting remains on the table, subject to upcoming economic data. Following Powell's speech, UST yields rose across the board as investors reassessed the path of future interest rate hikes. Sentiment was further dented by Cleveland Federal Reserve President Loretta Mester's (voter) comments that the US Fed will need to raise interest rates above 4.00% by early next year. Mester also does not anticipate any rate cuts in 2023, and expects rates to remain

elevated "for some time". In response, shorter 2-year UST yields jumped to close the month at 3.49%, the highest level since November 2007, while 10-year UST yields settled at 3.19% (54bps higher m-o-m).
Brent crude oil continued to fluctuate in August, with prices trading within a wide range of USD 91-105/bbl, as overall sentiment continued to be dampened by prospects of slower global growth as central banks around the world tighten monetary policy. Prices initially fell from USD 110.01/bbl at end-July to touch USD 91.51/bbl on 17th August, a six-month low, before recovering sharply to around USD 105/bbl towards month-end, only to reverse again to settle at USD 96.50/bbl at end-August (m-o-m 12.3% lower).

Brent crude oil prices slid to touch USD 93.56/bbl In early August, on 4th August, the largest weekly drop since April 2020, amid persistent concerns over a potential global economic slowdown. Market sentiment was also dampened by US House of Representatives speaker, Nancy Pelosi's visit to Taiwan on 2nd August, heightening tensions between the US and China. Furthermore, a report by the US Energy Information Administration (EIA) showed that crude inventories rose by 4.5 million barrels for the week ending 29th July, significantly higher than consensus expectations for a 600,000-barrel decline. The OPEC+ alliance on 3rd August, agreed to raise its production target by 100,000 barrels per day (bpd) in September as a concession to US President Joe Biden, who previously called for extra supply to combat rising oil prices. This was corroborated by the International Energy Agency (IEA), stating that idle supplies in the Middle East are down to "razor thin" levels of about 2 million bpd. With most OPEC members incapable of consistently increasing output, the actual increase in supply in September is expected to be considerably smaller, at around 34,000 bpd.

Brent prices recovered to around USD 100/bbl on concerns over supply disruptions, after a leakage in an oil pipeline component disrupted output at several offshore US Gulf of Mexico platforms. The shut-ins were expected to halt around 600,000 bpd of oil production from Shell, Chevron Corp and Equinor. However, Brent prices subsequently trended lower again, as supply disruptions caused by pipeline outages tend to be short-lived. Brent prices were also pressured lower after OPEC downgraded its 2022 forecast for global oil demand by 260,000 bpd to 100.3 million bpd. Its 2023 forecast was also revised downwards by a similar magnitude to 102.72 million bpd, leading to a projected surplus in the oil market. In contrast, the IEA upgraded its 2022 demand growth projection by 380,000 bpd, as consumers switch from gas to oil amid surging gas prices. The IEA also boosted its forecast for Russian oil supply by 500,000 bpd for the second half of 2022, as the country's output is more resilient than projected despite sanctions. Nevertheless, Brent prices continued to slip to touch USD 91.51/bbl on 17th August, after China unexpectedly cut interest rates despite signaling the opposite just a few days before, indicating that the economic situation in the world's second largest economy may be more dire than expected.

Brent crude oil received a shot in the arm towards month-end, with prices recovering to around USD 105/bbl after Saudi Arabian Energy Minister, Prince Abdulaziz bin Salman, who represents the largest oil producer in OPEC+, warned that the alliance may be required to tighten production when it meets in September, as Brent futures prices do not reflect the underlying fundamentals of supply and demand. A production cut may also partly negate any reintroduction of Iranian oil to the market if talks to revive the 2015 nuclear deal prove successful, lifting sentiment in the oil market. However, Brent prices tumbled during the last two trading sessions to close the month weaker at USD 96.49/bbl (m-o-m 12.3% lower), largely driven by weak risk sentiment after global central banks unanimously advocated for tighter monetary policy for longer to rein in inflation, even if it risks slowing growth.

Fund Review

The Fund outperformed the Dow Jones Sukuk index return by 108bps in August, with returns of 0.54% compared to the index return of -0.54%. Year to date, the Fund has outperformed the index by 319bps, with Fund's returns of -5.08% compared to index returns of -8.27%. In anticipation of upward movements in global bond yields, the Fund had shortened duration at the end of 2021, and trimmed it further at the beginning of 2022 by selling its longer tenured sukuk, hence buffering the Fund from excessive market correction. The Fund maintained overall overweight position in Gulf Cooperation Council (GCC) markets as they remain the prime beneficiaries of elevated oil prices, coupled with the GCC governments' ongoing fiscal reforms.

Portfolio Outlook and Strategy

Demand for Global Sukuk may continue to be supported by investors' hunt for higher yields and quality credits. GCC sukuk issuers remain the prime beneficiaries of higher oil prices and continued to receive credit rating and credit outlook upgrades from international rating agencies on the back of the region's significantly improved economic prospects.

The Fund maintained overall overweight position in GCC markets given the significantly improved macro outlook and elevated oil price. The Fund continues to overweight corporate sukuk over sovereigns for the additional yield pick-up. Any market weakness may present opportunities to accumulate.

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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