Principal®

Principal Islamic Asset Management (Ireland) (PLC)

Global Sukuk Fund

I Class December 2019

Market Review

10-year US Treasury (UST) yields rose by 14 basis points (bps) month-on-month (m-o-m) from 1.78% to 1.92% in December, as risk appetite improved amid optimism that tensions between US and China would defuse after both sides reached a Phase One trade deal. 10-year UST yields initially fell by 9 bps from 1.78% at end-November to 1.69% on 4 December, before reversing course to touch 1.94% on 13 December following the Phase One deal announcement, just two days before the 15 December deadline for additional US tariffs on Chinese goods. M-o-m, shorter UST yields fell while 5 to 30-year UST yields rose by 6-18bps higher, led by the 30-year notes, causing the curve to shift higher and bear steepen.

Policymakers indicated that they expect to keep interest rates on hold at 1.50-1.75% through 2020 at the US Federal Reserve (Fed)'s final meeting for the year, despite noting persistent downside risks to the US economy arising from global growth and trade negotiations. Furthermore, the committee expressed concerns that inflation continues to fall below their 2.00% target (Personal Consumer Expenditures (PCE) inflation 1.50% in November, core PCE inflation 1.60%). 10-year UST yields were briefly pushed 9bps lower in the beginning of the month, from 1.78% as at end-November to touch 1.69% on 4 December after US Institute for Supply Management (ISM) manufacturing shrank further from 48.3 in October to 48.1 in November, and sharply lower than consensus expectations of 49.2. This was the fourth consecutive contraction this year, following a decline in inventories (from 48.9 to 45.5) and new orders (from 49.1 to 47.2). UST yields were also supported by US President Donald Trump's unexpected move to restore tariffs on US steel and aluminum imports from Brazil and Argentina, citing massive devaluation of their currencies at the expense of US farmers. In 2018, President Trump had imposed tariffs of 25.00% on steel and 10.00% on aluminum, but subsequently granted some exceptions amid outcry abroad and in the US, where many manufacturers rely on foreign metal imports. 10-year UST yields reversed course after President Trump remarked that trade talks between the US and China were going well.

10-year UST yields continued to be pressured higher to an intraday high of 1.85% on 6 December, following better than expected US nonfarm payroll data. The US economy created 266,000 new jobs in November, significantly surpassing the consensus estimate of 180,000 and the 156,000 jobs created in October (revised upwards from 128,000). 10-year UST yields spiked to touch 1.94% on 13 December, as investors switched to risk on mode following (unconfirmed) news reports that the US was not only considering cancelling the planned 15.00% tariffs on all remaining Chinese imports set to take effect on 15 December, but also cut existing tariffs by up to 50.00% on USD370 billion of Chinese goods. Nevertheless, 10-year UST yields recovered after the official announcement of the Phase One deal lacked details of the actual agreement. Investors continued to be on risk-on mode, even though the Phase One deal left many major issues unresolved, which hampered demand for safe haven assets, therefore pushing 10-year US Treasury yields higher to end the year at 1.92%.

Brent crude prices strengthened by 10.50% from USD62.43 per barrel (bbl) in December, to touch a 3-month high of USD68.99/bbl on 30 December, fueled by shrinking US crude stockpiles, expectations of improved crude oil supply and demand dynamics going forward, as well as optimism surrounding the US-China Phase One trade deal, which investors hope would eventually lead to a gradual removal of tariffs and improved global economic outlook. The Organization of the Petroleum Exporting Countries+ members agreed to deepen production cuts by an additional 500,000 bpd to 1.7 million barrel per day (bpd) (about 1.70% of global production) on 6 December, effective 1 January 2020 through March 2020. Saudi surprised the market with deeper production cuts, sending the Saudi Arabian Oil Company valuation to surge past the elusive USD2 trillion valuation. Brent crude oil prices continued to rally towards month-end, after American Petroleum Institute reported that US crude stockpiles shrank by 7.9 million barrels for the week ended 20 December, significantly higher than consensus expectations of 1.8 million barrels. Brent crude oil prices weakened on the final day of the year to USD66.00/bbl following news of US airstrikes on Iranian-backed militia in Iraq. Nevertheless overall, Brent crude oil prices gained 5.70% m-o-m in December and 22.70% for the full year 2019, the biggest yearly gain since 2016.

Fund Review

The Fund continued to produce strong positive returns of 0.45% in December, outperforming the Dow Jones Sukuk index return of 0.04% by 41bps. Outperformance was driven by strong security selection in selective global sukuk securities despite a weaker US Treasury performance. The 10-year US Treasury notes was softer during the month, declining -1.28%. Year to date, the Fund has generated outstanding returns of 10.53%.

Portfolio Outlook and Strategy

The global sukuk asset class continued to perform strongly, despite a weaker US Treasury market affected by mixed economic data and renewed optimism on the US-China trade deal. The listing of Saudi Aramco shares has been diverting global investors attention to the Middle East region, with new issuances of Global Sukuk instruments well taken up. Oil prices remain resilient above the USD60/barrel mark, bolstering global investors' confidence in the oil-producing countries.

The outlook for the Global Sukuk market remains positive as major global central banks are expected to remain accommodative to support slowing growth. On 31 December 2019, the People's Bank of China cut the reserve requirement ratio (RRR) for commercial banks for the eighth time since early 2018, in an effort to lower financing costs and stimulate more lending. The 50bps cut will take effect on 6 January 2020, bringing the RRR to 12.50% for big banks and 10.50% for smaller lenders, and is estimated to release around 800 billion yuan into the financial system. In 3Q 2019, China's economy moderated from 6.30% year-on-year in 2Q 2019 to 6.20%, the weakest pace in almost 30 years.

Meanwhile in the US, minutes of the Fed meeting in December show that policymakers expect to keep rates on hold through 2020 despite noting persistent downside risks to the US economy, arising from global growth and trade negotiations. In December, the US ISM manufacturing index continued to contract for the fifth month in a row from 48.1 in November to 47.2, the lowest level in more than 10 years, as US-China trade tensions continued to crimp manufacturing activity. Going forward, trade tensions may still prolong even though US and China have reached a Phase One agreement, as both sides struggle to agree on specific areas such as intellectual property. Market expectations of potential interest rate cuts by the US Federal Reserve may continue to propel sukuk prices higher.

Meanwhile sentiment in the Gulf Cooperation Council (GCC) Sukuk market is also expected to continue to be buoyed by stable crude oil prices, which may translate to higher revenues for GCC governments. Furthermore, demand for GCC sukuk may continue to be sustained following the inclusion of sovereign and quasi-sovereign issuers from five GCC countries in the JP Morgan Emerging Market Bond Indices (EMBI) effective 31 January 2019. The inclusion is expected to represent about 11.20% in JP Morgan's EMBI Global Diversified and EMBI Global, therefore boosting the indices' allocation to the Middle East to up to 17.00%. Following the announcement of the inclusion, we have been seeing strong buying of GCC sovereign Sukuk, which has also spilled over into the corporate Sukuk space, therefore driving prices higher. Given the low interest rate environment, demand for Global Sukuk is also expected to be supported by investors' hunt for higher yields with strong credits.

Against a backdrop of slowing global economic growth, we will continue to mitigate credit risk by selectively investing in higher-rated sovereign Sukuk and issuers which display strong fundamentals and cashflow generating capabilities.

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 December 2019.