Principal®

Principal Islamic Asset Management (Ireland) (PLC)

Global Sukuk Fund

I Class December 2020

Market Review

10-year US Treasuries (UST) weakened in December, with yields rising to touch 0.98%, albeit remaining below the psychological 1.00% mark amid renewed optimism about US stimulus talks and positive vaccine news. Yields were also pressured higher as investors absorbed USD318 billion total new UST supply before the end of the year, which included USD38 billion 10-year notes as well as ultra-long USD24 billion 20-year and USD24 billion 30-year issuances. During the month, the shorter end of the UST yield curve edged lower by 1-2 basis points (bps), while yields on the longer end rose by 3-8bps, causing the curve to shift higher and bear steepen. The benchmark 10-year UST yields closed the month 8bps higher month-on-month (m-o-m), from 0.83% at end-November to 0.91% at end-December.

10-year UST yields jumped by 9bps on the first trading day in December, from 0.83% at end-November to 0.92% after better-than-expected manufacturing data from across the globe pointed to a continued international economic expansion, despite rising coronavirus cases in some countries. The Markit manufacturing Purchasing Managers' Index for the US and UK surprised on the upside in November, rising from 53.4 in October to 56.7, and from 53.7 to 55.6 respectively. 10-year UST yields continued to be pushed higher to touch 0.98% on 4th December, after disappointing US non-farm payroll data amplified the urgency for lawmakers to approve a new stimulus package immediately. Gains in nonfarm payrolls slowed in November, from 610,000 new jobs to 245,000, significantly below estimates of 460,000. While the unemployment rate improved from 6.90% to 6.70%, the decline was due to a drop in the labor participation rate from 61.70% to 61.50%. Initial and continuing jobless claims at end-November also remained elevated at 757,000 and 6.8 million respectively. Meanwhile US Consumer Price Index (CPI) for November was flat m-o-m at 1.20%, slightly higher than market consensus of 1.10% as costs of hotel stays, airfares and apparel jumped, though inflationary pressures elsewhere remained subdued. 10-year UST yields continued to hover below the psychological 1.00% resistance level, even after news that the UK became the first country to administer coronavirus vaccines to the public. The US also began its vaccine rollout in mid-December, after pharmaceutical company Pfizer Inc and its German partner BioNTech SE, started shipping its first 2.9 million doses to distribution centers following an emergency authorization by the US Food and Drug Administration (FDA), which came after the US death toll exceeded 300,000 lives. 10-year UST yields traded within a narrow range of 0.87% to 0.97% for the rest of the month, amid concerns over spiking Covid-19 infections and deaths.

The US Federal Reserve (Fed) held benchmark interest rates near zero, as widely expected, during its final meeting for the year on 16th December. Policymakers also voted to maintain monthly bond purchases of at least USD120 billion (USD80 billion for UST and USD40 billion for mortgage backed securities) until the committee sees "substantial further progress" in employment and inflation levels, which replaces its previous pledge to keep buying bonds "over the coming months". The change in language around the duration of asset purchases underscores the Fed's commitment to supporting the economy until the recovery is complete, therefore reinforcing prospects of a "lower for longer" US interest environment. Meanwhile, the US Fed was more upbeat about the economic outlook since their last forecast in September. For 2020, growth is expected to improve from -3.70% projected in September to -2.40%, while 2021 and 2022 projected GDP were revised higher from 4.00% to 4.20% and from 3.00% to 3.20% respectively. The committee is also forecasting better labor market conditions going forward (2020: unemployment rate revised lower from 7.60% to 6.70%; 2021: revised lower from 5.50% to 5.00%; 2022: revised lower from 4.60% to 4.20%). On inflation, policymakers expect CPI to continue to be shy of its 2.00% target until 2023. 10-year UST yields continued to fluctuate within a narrow range towards month-end, as investors wound down for the year-end, before closing the month at 0.91%, 8bps higher m-o-m.

Brent crude oil prices continued to recover in December, posting handsome gains of 8.10% m-o-m from USD47.84/barrel (bbl) at end-November to USD51.72/bbl at end-December. Gains were mostly driven by the Organization of the Petroleum Exporting Countries (OPEC)+'s decision on 4th December to increase output by 500,000 barrels per day (bpd) in January 2021, far less than the earlier scheduled increase of 2 million bpd. The compromise was made after some member nations were reportedly keen to increase production amid the brighter outlook for oil demand following the rollout of Covid-19 vaccines in several countries, while others were concerned that the ongoing spike in new cases may dent demand in the shorter term. Brent crude oil prices continued to extend gains, marching above the USD50/bbl mark amid renewed optimism that US lawmakers were edging closer towards approving a new stimulus package, which may provide an immediate boost for oil demand. Brent crude oil briefly declined on 21st December, from USD52.32/bbl, the highest level since the pandemic began in March, to below USD50/bbl on 23rd December following reports of a new, more infectious coronavirus strain in the UK, which triggered fresh lockdowns and international travel bans to and from the country. Brent crude oil prices recovered to above USD51/bbl after the Energy Information Administration reported a surprise draw of only 532,000 barrels of US crude oil inventories for the week ended 28th December, well below market expectations of 3 million barrels. Brent crude oil ended the year at USD51.72/bbl.

Fund Review

The Fund continued to generate strong returns of 1.05% in December, outperforming the Dow Jones Sukuk index return of 0.33% by 72bps. Over a 6-month period to end December, the Fund generated returns of 6.33%, outperforming the index returns of 2.84% by 349bps.

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. In December, the US Fed kept interest rates unchanged at near zero levels and strengthened its commitment to maintain its USD120 billion monthly bond purchases until there is "substantial further progress" towards its employment and inflation goals. US Fed officials also signaled that interest rates may stay at near zero levels until at least end-2023, reinforcing market expectations of a lower for longer US interest rate environment. Similarly, other major global central banks e.g. in Europe, UK, Japan and Australia are widely expected to hold benchmark interest rates at current low levels, and maintain their asset purchase programs to continue supporting growth The flush of liquidity globally may continue to anchor demand for fixed income assets in the near to medium term.

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. Furthermore, the spread compression theme that has benefited Emerging Market bonds and Global Sukuk in 2020 is expected to remain intact, driven by global investors' hunt for higher yields in a lower for longer interest rate environment.

Meanwhile, the rollout of coronavirus vaccines has lifted the outlook for oil consumption, underpinned by expectations of a broad-based pickup in economic activities globally, including logistics, tourism and travel. Furthermore, the world's largest oil importer, China remains a bright spot for global oil demand, with authorities raising the quota for use of foreign oil by non-state entities by more than 20.00% for 2021. As the first major country to rebound from the pandemic, China's economic recovery is expected to outpace other countries.

On the supply side, oil prices are expected to be supported by OPEC+'s ongoing production cuts, which will remain in place until at least 2022, coupled with the committee's continued commitment to protect the oil price recovery. In December, the committee decided to increase output by 500,000 bpd in January 2021, far less than the earlier scheduled increase of 2 million bpd. On 5th January 2021, Saudi surprised markets with a unilateral output cut of 1 million bpd for February and March, while Russia and Kazakhstan will increase supply by 75,000 bpd each, and other producers will keep supply unchanged. The news was warmly welcomed by the market, pushing Brent crude oil prices higher. The positive outlook for oil bodes well for GCC sukuk, which may push prices higher.

Going into 2021, we look to hold a higher weightage in corporate sukuk for yield pick-up. Nonetheless, given lingering uncertainties, we look to maintain an overall defensive strategy, and continue to prefer blue-chip government-related companies, utility companies, as well as those with strong financials and robust cash buffers.

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 2020.