Principal Islamic Asset Management (Ireland) (PLC)

Global Sukuk Fund

I Class February 2021

Market Review

US Treasury (UST) yields rose across the board in February, as investors started pricing in earlier than expected US rate hikes, underpinned by expectations of faster US economic growth and inflation. 10-year UST yields soared to briefly touch 1.60%, the highest level since the pandemic began a year ago, as the already weak market sentiment was further dampened by a poor 7-year UST auction on 25th February. Even though US Federal Reserve (Fed) Chairman Jerome Powell continued to reiterate that the central bank will maintain its accommodative monetary stance until there is sustained progress in the economic recovery, he dismissed the sharp run-up in UST yields, calling it a "statement of confidence in the economic outlook"; putting further pressure on yields. The shorter end of the UST yield curve (1-3 years) edged 1-10 basis points (bps) higher, while yields on the longer end rose significantly by 31-40bps, causing the curve to bear steepened. Benchmark 10-year UST yields closed the month 33bps higher month-on-month (m-o-m), from 1.07% at end-January to 1.40% at end-February.

The UST yield curve resumed its steepening trend in February, after a weak start to the year, with 10-year yields marching higher by 13bps from 1.07% at end-January to 1.20% on 12th February, as the reflation trade gathered pace among investors. This is underpinned by expectations of faster US economic recovery amid the rollout of Covid-19 vaccines, and as investors anticipate more incoming fiscal stimulus from the Biden administration, coupled with higher inflation spurred by quicker growth and rising commodity prices. US President Joe Biden vowed to keep his proposed USD1,400 direct stimulus payments to eligible Americans in his USD1.9 trillion relief plan during a meeting on 3rd February with congressional Democrats, pushing back against the Republicans' proposed smaller fiscal aid of USD600 billion. Weaker than expected US jobs data further cemented the need for more stimulus from the government. Nonfarm payrolls rose by 49,000 in January, significantly below consensus expectations of a 105,000 gain (December revised lower from -140,000 to -227,000). While the unemployment rate fell from 6.7% to 6.3%, the decline is attributed to a dip in the labor participation rate from 61.5% to 61.4% as more Americans left the workforce. The January data also reported a broad-based decline in employment, raising concerns that the weakness which was assumed to be concentrated in sectors like leisure and hospitality may be more widespread. Meanwhile, US Institute for Supply Management (ISM) manufacturing softened slightly from 60.7 in December to 58.7 in January, while the ISM services index improved from 57.2 to 58.7 as Covid-19 restrictions eased.

10-year UST yields continued to climb in the second half of the month, to around 1.36% on 22nd February as the reflation trade gained momentum, amplified by a jump in oil prices after a winter storm in Texas, the heart of US shale oil output, disrupted supply, with the largest refinery in the country shutting down and other plants and pipelines reported issues. Sentiment was also dampened by strong US economic data, e.g. retail sales and personal income, which jumped significantly m-o-m, reflecting the arrival of stimulus checks from the USD900 billion package passed in December. The personal consumption expenditures (PCE) price index, the Fed's preferred inflation gauge, also rose from 1.3% year-on-year in December to 1.5% in January, slightly faster than the consensus expectations of 1.4%, albeit still below the Fed's 2.0% long-term target. UST yields continued to be pressured higher after US Fed Chairman Jerome Powell reiterated that the central bank is nowhere close to pulling back its support for the economy, despite voicing expectations for improved economic activities later this year. Powell also dismissed the sharp run-up in yields, calling it a "statement of confidence in the economic outlook", disappointing some investors who expected Powell to push back against the sharp selloff in the UST market, as surging borrowing costs may derail the economic recovery. 10-year UST yields vaulted from 1.37% on 25th February, the day before to touch 1.61%, the highest level since the pandemic began, as the already weak sentiment in the market was further wrecked by a disappointing 7-year UST auction at mid-day. The USD62 billion auction was met with poor demand of 2.04 times oversubscription rate, the lowest on record, reflecting investors' preference to stay defensive given the recent surge in yields. Nonetheless, 10-year UST yields subsequently recovered to end the day at 1.52%, before receding further on the last trading day to close the month at 1.40%.

Brent crude oil prices continued to recover in February, posting a remarkable gain of 18.0% m-o-m from USD55.89/barrel (bbl) at end-January to USD65.97/bbl at end-February. Crude oil prices have risen steadily since October last year as the rollout of coronavirus vaccines gathers pace globally, and as continued supply curbs from the Organization of the Petroleum Exporting Countries (OPEC) and its allies spur hopes that global stockpiles will continue to slide. Brent crude oil prices rose by 9.14% in the first half of the month, from USD55.89/bbl at end-January to hover around USD61/bbl, amid tightening global supplies and signs of strength in physical markets, underpinned by a brightening outlook for consumption. Sentiment was also buoyed by hopes for a new US stimulus package, albeit moderated slightly by a weaker demand outlook from OPEC and the International Energy Agency (IEA). Brent crude oil prices received a shot in the arm on 12th February, following news of a major winter storm in the US, which amplified demand for fuel. Brent crude oil prices continued to march higher to touch USD67.70/bbl on 25th February, amid a more constructive demand outlook and tighter view from a supply perspective, before paring gains to close the month at USD65.97/bbl.

Fund Review

Market sentiment was dampened by the rise in US Treasury yields. Nevertheless, Global Sukuk prices had been more resilient, supported by strong Brent crude oil prices which surged above the USD65.00/bbl mark. The Fund outperformed the Dow Jones Sukuk Index return by 57bps in February, with returns of -0.34%. Year to date, the Fund outperformed the index by 135bps, with positive returns of 0.26%.

Portfolio Outlook and Strategy

The Fund continued to produce positive returns year to date, despite the rise in US Treasury yields. Price weakness was mitigated by the surge in Brent crude oil prices, especially for Middle-East sukuk issuers. 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% 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 barrel per day (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 Gulf Cooperation Council (GCC) sukuk, which may push prices higher.

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, GCC countries now constitute about 17% of the JP Morgan Emerging Market Index, which may continue to sustain demand for GCC sukuk.

Meanwhile, the UAE has been at the forefront of the global vaccination exercise. As at end February, the UAE has inoculated more than 60% of its population, second after Israel at 93%, followed by the UK in third place at 31%. The UAE stands to be among the first beneficiaries of a broader economic reopening, with consumer spending, travel and tourism revival. Dubai, being a major aviation hub which operates the Emirates airline, one of the world's largest and with the most extensive reach of global flight destinations, will benefit from recovery in global travels.

Going into 2021, we look to hold a higher weightage in corporate sukuk for yield pick-up. Nonetheless, given lingering market 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.

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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