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Principal Islamic Asset Management (Ireland) (PLC)

Global Sukuk Fund

I Class January 2023

Market Review

The US Treasury (UST) market started the new year with a bang in January, with yields plunging across the board as weak US economic data amplified recession concerns, thus fueling expectations for a slower pace of US rate hikes going forward. The positive sentiment in UST gained momentum after US CPI data for December signaled continued cooling inflationary pressures, with several US Fed members advocating a slower pace of rate increases. Benchmark 10-year UST yields sank 36bps lower m-o-m from 3.87% at end-December to 3.51%, as investors penciled in expectations of a smaller 25bps rate hike at the upcoming FOMC meeting in February, even though most US Fed members continued to emphasize the importance of an ongoing restrictive monetary policy environment until inflation is significantly subdued. The UST yield curve shifted lower and bull flattened m-o-m, with yields falling sharply by 32-40bps across all tenures, except for 2-year yields which fell by a smaller quantum of 23bps.

10-year UST yields fell from 3.87% at end-December to around 3.66% in early January, as weak US economic data supported investors' concerns over a potential US recession. The US ISM manufacturing index contracted further in December, from 49.0 in November to 48.4, the lowest since May 2020, amid a continued sharp drop in new orders from 47.2 to 45.2. Similarly, US ISM prices paid fell substantially from 43.0 to 39.4, hitting the lowest level since the height of the pandemic in 2020, as higher borrowing costs hamper demand. Meanwhile, minutes of the US Fed meeting in December underscored the committee's hawkish tone, as policymakers reiterated that inflation remains at an unacceptably high level, and cautioned markets against "an unwarranted easing in financial conditions". The US Fed also emphasized that maintaining a sustained period of higher policy rates remains necessary until inflation falls to its 2.0% target.

10-year UST yields dived further to touch 3.55% on 6th January, after the US ISM services index plummeted from 56.5 in November to 49.6 in December, far below consensus expectations of 55.0, despite the hawkish US Fed meeting minutes. The nearly 7-point decline from the prior month was the largest since the immediate aftermath of the pandemic, and may have been impacted by severe winter weather that upended holiday travel plans and caused widespread power outages. Meanwhile, the US economy created 223,000 new jobs in December (consensus: 205,000), with the highest additions in leisure and hospitality sector, pushing the unemployment rate lower from 3.6% (revised downwards from 3.7%) in November to 3.5%. Similarly, JOLTS job openings came out stronger than consensus expectations for a third consecutive month, although dipping slightly from 10.51 million in November (revised upwards from 10.33 million) to 10.46 million (consensus: 10.05 million). This shows that employees continue to feel comfortable switching jobs in pursuit of higher salaries or better working conditions, despite growing economic headwinds. Average hourly earnings slowed from 0.4% m-o-m in November (revised downwards from 0.6%) to 0.3% (y-o-y down from 4.8% to 4.6%), with the biggest declines in low-wage sectors such as childcare and food preparation.

10-year UST yields took a breather following the rally, after Atlanta Fed President Raphael Bostic and San Francisco Fed President Mary Daly (non-voters) stressed the importance of raising the Federal Funds Rate to above 5.00% before pausing for an extended period, despite supporting a smaller 25bps hike in the next FOMC meeting. UST yields subsequently plunged again to touch an intra-month low of 3.32% on 19th January, after headline US CPI dropped from 7.1% y-o-y in November to 6.5% in December (m-o-m down from 0.1% to -0.1%). This marked the lowest inflation print since October 2021 as lower gasoline and food prices offset the persistently sticky shelter costs, cementing investors' expectations for a smaller 25bps hike in February. Meanwhile, preliminary data from the University of Michigan report showed that consumer sentiment improved from 59.7 in December to 64.6 in January (consensus: 60.7), largely attributed to lower fuel prices and better financial market conditions. The preliminary shorter-term 1-year inflation expectations also eased from 4.4% to 4.0%, although the longer-term 5-10-year inflation expectations inched higher from 2.9% to 3.0%, as consumers are still wary of global uncertainties over the longer term.

The bullish sentiment in the UST market further gained momentum after US retail sales declined from -1.0% m-o-m (revised lower from -0.6%) in November to -1.1% in December (consensus: -0.9%), the lowest point in a year, as consumers tightened their belts amid higher borrowing costs. Meanwhile, US headline PPI fell significantly from 0.2% m-o-m (revised lower from 0.3%) to -0.5% (consensus: -0.1%, y-o-y down from 7.3% to 6.2%), adding to signs that pipeline inflationary pressures may continue to ease. several US Fed voting members including Dallas Fed President Lorie Logan and Philadelphia Fed President Patrick Harker advocated for a smaller 25bps interest rate hike going forward in response to this, although both indicated a high probability of a terminal rate above 5.00%. 10-year UST yields subsequently pared gains to around 3.50%, after hawkish remarks from several US Fed officials dampened market sentiment. US Fed Vice Chair Lael Brainard said she expects interest rates to be "sufficiently restrictive for some time" despite signs of easing inflation, while New York Fed President John Williams remarked that the US Fed still has more work to do to tame inflation as demand remains extremely strong compared to supply. Initial jobless claims unexpectedly declined from 206,000 for the

week ending 7th January to 190,000 for the week ending 14th January, far below consensus expectations of 214,000, affirming the US Fed's concerns that the labor market remains too tight. Benchmark 10-year UST yields traded within a tight range of 3.42-3.55% towards month-end, as investors awaited the outcome of the US Fed meeting on 1st February, before settling at 3.51% (m-o-m 36bps lower).

Brent crude oil prices pared gains to around USD 78/bbl in early January, after rebounding strongly in December 2022, as a milder-than-expected winter in Europe eased concerns of an energy crunch. Furthermore, the initial optimism after China's government announced an abrupt halt to its zero-Covid policies in early December 2022 waned, as the country faced a spike in Covid-19 infections, dampening economic activity. Brent prices subsequently recovered to around USD 84/bbl after China announced a reopening of its borders for travel and issued a fresh batch of crude oil import quotas, signaling rising demand for flights in China to celebrate the Lunar New Year holidays. Market sentiment was further bolstered by expectations of smaller US rate hikes going forward, in addition to growing optimism over Chinese demand recovery, after data showed that US inflation continued to ease in December.

Brent prices continued to recover in the second half of the month, touching USD 89.09/bbl on 23rd January, after the International Energy Agency ("IEA") said global oil supply will not be able to meet rising global demand in 2023, leading to a significant oil shortage by the end of the year. However, OPEC+ delegates expect the advisory committee to recommend that no changes be made to the group's existing production policy, which was announced in October 2022. On a brighter note, the International Monetary Fund (IMF) upgraded its 2023 global growth forecast from 2.7% forecasted in October 2022 to 2.9%, underpinned by China's reopening, as well as "surprisingly resilient" demand in the US and Europe.

Fund Review

The Fund outperformed the Dow Jones Sukuk index return by 51bps in January, with returns of 1.82% compared to the index return of 1.31%. The Fund added some longer maturities in 4Q22 as valuations turned attractive, and benefited from the market rally over the last three months. The Fund maintained overall overweight position in GCC markets as they remain the prime beneficiaries of elevated oil prices driven by China's border reopening, 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 elevated 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 has effectively lengthened duration in 4Q22 as valuations turned attractive. 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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