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Principal Islamic Asset Management (Ireland) (PLC)

Global Sukuk Fund

I Class June 2021

Market Review

10-year US Treasuries (UST) rallied in June after trading sideways in May, with yields sinking 12 basis points (bps) lower from 1.59% at end-May to 1.47% at end-June, as mixed US economic data continued to drive inflows into safe haven assets. The US Federal Reserve (Fed) surprised markets on 16th June, by signaling two potential interest rate hikes in 2023, compared to its previous statement that rates may remain at near zero levels until at least 2024. The committee also significantly raised its inflation expectations for 2021 by 1.0% from 2.4% to 3.4%; while the projections for 2022 and 2023 were revised upward slightly by 0.1%. Shorter-tenured UST yields jumped following the meeting, as investors priced in potential future rate hikes, while yields on the longer UST maturities plunged as the market repriced expectations for future growth and inflation against a backdrop of tighter monetary policy going forward. 2-5 year UST yields edged higher by 9-16bps month-on-month (m-o-m), while yields on the longer end declined by 12-19bps.

10-year UST yields remained fairly stable in the beginning of the month, trading within a tight range of 1.63-1.59% despite better-than-expected US manufacturing data. The US Institute for Supply Management (ISM) Manufacturing index climbed in May, from 60.7 in April to 61.2, slightly higher than consensus expectations of 61.0. Meanwhile, ISM Services index recorded the highest level on record since 1997, rising from 62.7 in April to 64.0 in May, beating consensus of 63.2. However, 10-year UST subsequently rallied on 4th June, with yields tumbling from 1.59% at end-May to 1.43% on 10th June, triggered by softer-than-expected US employment data. The US economy added 559,000 jobs in May, missing consensus forecast of 675,000, albeit higher than the 278,000 recorded in April (revised upward from 266,000). While the unemployment rate dropped from 6.1% to 5.8% and has fallen dramatically from the peak of 14.7% in April 2020, it is still below the pre-pandemic levels of around 3.5%. The payrolls data signaled that hiring did not grow as fast as economists had expected despite increasing signs of labor shortage; therefore validating the Fed's commitment to maintain accommodative monetary policy until there is substantial further progress in the labor market. 10-year UST continued to rally even after data showed that headline US inflation soared from 4.2% in April to 5.0% in May (consensus 4.7%), as investors heeded the Fed's view that the rise in inflation is expected to be transitory. Similarly, core Consumer Price Index jumped from 3.0% in April to 3.8% in May, the most since 1992. Nevertheless, 10-year UST subsequently took a breather, with yields drifting higher to around 1.50% ahead of the US Fed meeting on 15th and 16th June.

The US Fed kept interest rates at near zero levels as widely expected and maintained the pace of its asset purchase program at USD120 billion per month. However, the committee surprised markets by penciling in two potential interest rate hikes by the end of 2023, against previous indications that rates will stay at current levels until at least 2024. In the Fed's updated quarterly dot-plot projections, 13 of 18 Fed officials now favor at least one rate increase by the end of 2023 (vs. 7 of 18 in March); with 11 members expecting at least two hikes by the end of that year. Furthermore, 7 members expect the rate increase to happen as early as 2022, up from 4 previously. In addition, the central bank significantly marked up its Personal Consumer Expenditures (PCE) inflation forecast for 2021 by 1.0% from 2.4% to 3.4%, while the projection for 2022 and 2023 were revised slightly higher by 0.1% to 2.1% and 2.2% respectively. The upward revision to their inflation projections reflects the possibility that inflation may be more persistent than previously expected according to Fed Chairman Jerome Powell, as large and rapid shifts in demand, bottlenecks, hiring difficulties and other constraints may limit how quickly supply can adjust, therefore pressuring prices higher. The Fed upgraded its Growth Domestic Product projection for 2021 from 6.5% to 7.0% (2022: maintained at 3.3%; 2023: raised from 2.2% to 2.4%). Powell also confirmed that the committee has begun a discussion about scaling back their asset purchases, in line with recent comments from several committee members. In response, 10-year UST yields initially soared from 1.48% to 1.59% following the announcement, but subsequently rallied strongly by 24bps to briefly touch 1.35% on 21st June, as investors digested the Fed's statement and adjusted their expectations of growth and inflation moving forward. Similarly, longer-tenured 30-year UST yields also plummeted by 29bps from 2.22% on 16th June to an intra-day low of 1.93%, flattening the back end of the curve. Conversely, shorter tenured UST yields jumped as investors priced in potential future rate hikes. However, 10 and 30-year UST yields reversed direction in the later part of the trading session on 21st June to normalize at around 1.50% and 2.10% respectively. 10-year UST yields briefly spiked on 28th June, by 6bps 1.48% to 1.54% following the release of PCE inflation data for May (rose from 3.6% in April to 3.9% in May, matching consensus expectations), but quickly pared losses to close the month lower at 1.47% (m-o-m 12bps lower).

Brent crude oil prices continued to recover in June, posting handsome gains of 8.2% m-o-m from USD69.46/barrel (bbl) at end-May to USD75.13/bbl at end-June, as it continues to benefit from the revival of fuel demand for travel and leisure, especially in the US, China and parts of Europe. Gains were also driven by the Organization of the Petroleum Exporting Countries Plus (OPEC+) committee's decision on 1st June to keep to its schedule of restoring oil production by 450,000 barrels per day (bpd) in July, after increasing production by 350,000 bpd each in May and June. Including Saudi Arabia's previous 1 million bpd production cut, OPEC+

will replenish 2.1 million bpd of supply during the May-July period. The announcement signals the committee's confidence over the rebound in global oil consumption despite a resurgence of Covid-19 cases in parts of Southeast Asia, with Saudi Arabia reportedly raising its July pricing for all oil grades to Asian customers.

Brent crude oil briefly declined on 17th June, by 1.2% overnight from USD73.87/bbl to USD72.99/bbl, after the US Fed tilted towards a more hawkish stance during its policy meeting on 16th June. The committee signaled two potential interest rate hikes by the end of 2023, and said that it has begun discussions about tapering asset purchases. The unexpected outcome resulted in a strong US Dollar rally against other currencies, leading to a decline of commodity prices across the board. Brent crude oil prices quickly changed direction to march above the USD76/bbl mark, after the latest talks between world leaders and Iran on 20th June, to revive a nuclear deal ended without an agreement. Brent crude oil prices pared gains to close the month at USD75.13/bbl, after touching USD76.60/bbl on 28th June, the highest level since October 2018.

Fund Review

The Fund continued to generate positive returns of 0.17% in June, matching the Dow Jones Sukuk index movement. Global sukuk prices continued to gain following positive sentiment in US Treasury market and stronger Brent crude oil prices. Year to date, the Fund outperformed the index by 341bps, with Fund's returns of 2.50% compared to index returns of -0.91%. The portfolio continues to overweight corporate sukuk over sovereigns for the additional yield pickup, while keeping duration relatively low amidst current market volatility.

Portfolio Outlook and Strategy

Global sukuk prices continued to gain in tandem with buying momentum in US Treasury market, amidst weaker than expected employment numbers. Demand for global sukuk was also supported by rising Brent crude oil prices, driven by a rebound in fuel demand from the world's two largest economies, US and China.

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, the Gulf Cooperation Council (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. 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.

The Fund continues to overweight corporate sukuk over sovereigns for the additional yield pick-up, while keeping a shorter duration amidst current market volatilities. 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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