Principal®

Principal Islamic Asset Management (Ireland) (PLC)

Global Sukuk Fund

I Class November 2022

Market Review

The US Treasury (UST) market initially started the month on a weaker note in November, after US Fed Chairman Jerome Powell warned that the peak Fed Funds Rate may be higher than previously indicated in September due to the strong job market and elevated inflation. However, UST subsequently changed course, with yields plummeting across the board after US CPI for October came in lower than expected, fueling expectations that the US Fed may slow the pace of rate hikes going forward. Benchmark 10-year UST yields initially rose from 4.05% at end-October to touch 4.24%, before plunging to close the month at 3.61% (m-o-m 44bps lower). The positive sentiment in UST was further boosted by Chairman Powell's speech on 30th November, where he indicated that a slower pace of rate hikes may begin as early as December, thus reaffirming market expectations of a smaller 50bp rate hike at the next meeting. The UST yield curve shifted lower and bull flattened m-o-m, with yields falling sharply by 39-49bps across all tenures, except for 2-year yields which fell by a smaller magnitude of 17bps.

10-year UST yields briefly slipped further by 13bps from 4.05% on 31st October to touch an intra-day low of 3.92% on 1st November, following the UST rally towards end-October, amid expectations that the US Fed may signal a slower pace of policy tightening, in line with several central banks recently (e.g., Australia, Eurozone, Canada). Yields rose after JOLTS job openings surprised on the upside, rising from 10.3 million in August to 10.7 million in September, far above consensus estimates of 9.8 million. 10-year UST yields continued to rise to above 4.00% after the US Fed raised interest rates by 75bps for the fourth consecutive meeting, to 3.75-4.00% on 2nd November. While Chairman Powell signaled a slower path of rate hikes going forward, he indicated that the terminal rate may be higher than previously projected during the September meeting (median rate of 4.6% for 2023), and reiterated that the risk of not tightening enough is higher than the risk of tightening too much.

10-year US Treasury yields continued to be pressured higher to touch 4.24% on 8th November despite mixed US economic data, as investors reassessed the peak level of Fed Funds Rate. The US economy created 261,000 new jobs in October, beating consensus expectations of 193,000 new jobs (September revised higher from 263,000 to 315,000). average hourly earnings was flat at 0.4% m-o-m (September revised up from 0.3% to 0.4%), indicating demand for workers remained robust despite rapid interest rate hikes, albeit moderating from 5.1% (revised up from 5.0%) to 4.7% on a y-o-y basis. Meanwhile, the ISM manufacturing index dipped from 50.9 in September to 50.2 in October (consensus: 50.0), as new orders remained in contraction territory. Similarly, US ISM services plunged from 56.7 to 54.4 (consensus: 55.3), the lowest since May 2020, as orders growth and business activity moderated, suggesting the broader economy continues to cool.

10-year UST subsequently reversed course, with yields plunging to 3.81% on 10th November, after US CPI data came in lower than expected, fueling expectations that the US Fed may start to slow the pace of rate hikes soon. US headline CPI cooled from 8.2% in September to 7.7% in October y-o-y (consensus: 7.9%; m-o-m flat at 0.4%), while core inflation moderated from 6.6% to 6.3% y-o-y (consensus: 6.5%; m-o-m down from 0.6% to 0.3%). Household staples such as shelter, food and gasoline prices remained among the largest contributors to rising inflation, although US inflation data came out lower than expected. US PPI numbers were also softer than expected, reinforcing market expectation that US inflation may have peaked. Benchmark 10-year UST yields continued to fall to around 3.67% despite stronger retail sales data (up from 0.0% in September to 1.3% in October, consensus: 1.0%). This marks the biggest jump in eight months, suggesting that consumer demand remains undeterred by rising interest rates and worsening economic outlook.

UST subsequently pared gains with yields rising to 3.83%, after St. Louis Fed President James Bullard raised his terminal Fed Funds Rate forecast from 4.75-5.00% to 5.00-5.25% at a "minimum level". Bullard's view was also echoed by Fed Governor Christopher Waller, who emphasized that interest rates still need to rise, and that it is premature to conclude that inflation is tapering off after only one month of positive data. Yields subsequently tumbled again, buoyed by a surge in new Covid-19 cases in China, coupled with weaker US economic data. The preliminary S&P Global US Manufacturing PMI index pulled back sharply in November, from 50.4 in October to 47.6 (consensus: 50.0), pushing it deep into contractionary territory. Similarly, the preliminary S&P Global US Services PMI shrunk further from 47.8 to 46.1 (consensus: 48.0), underscoring the impact of inflation and higher interest rates on consumer demand. Initial jobless claims surged from 223,000 for the week ending 12th November to 240,000 for week ending 19th November, the highest in three months (consensus: 225,000). This is consistent with the job cuts or hiring freeze announced by technology companies recently, e.g. Meta, Amazon and HP Inc.

10-year UST yields were pressured higher again to around 3.80%, as hawkish Fedspeak weighed on sentiment. New York Fed President John Williams said he expects interest rates to be on a higher path than previously forecasted to bring inflation back to 2.0% level, while St. Louis Fed President James Bullard remarked that markets were underestimating the chances of higher interest rates. Nevertheless, 10-year UST rebounded sharply on the final trading day of the month, with yields falling 20bps intra-day to settle at 3.60% (m-o-m 44bps lower) after US Fed Chairman Jerome Powell signaled that a slower pace of rate hikes will begin as soon as December, reaffirming market expectations of a smaller 50bp hike in the next meeting. Data released towards end-November further supported Chairman Powell's less hawkish tone, with the US Conference Board consumer confidence index falling sharply from 102.2 (revised downwards from 102.5) in October to 100.2 in November, a four-month low, as households grow more reluctant to splurge on big-ticket items in the next six months amid high inflation and rising borrowing costs.

Brent crude oil prices initially rallied in November, supported by hopes of looser Covid-19 restrictions in China. However, Brent prices subsequently trended lower to touch USD 80.61/bbl on 28th November, a ten-month low, as Covid-related protests and tighter restrictions in China hampered broad risk sentiment and dented the outlook for oil demand. Brent prices fell 9.9% m-o-m, from USD 94.83/bbl at end-October to USD 85.43/bbl at end-November.

Brent prices edged higher in early November, from USD 94.83/bbl at end-October to reach USD 99.56/bbl on 7th November despite a more hawkish US Fed in November, driven by reports that China may be considering abandoning its zero-Covid policy, which will boost demand for oil from the world's biggest importer. This came after the Chinese government announced minor easing measures such as shortening quarantine period for Covid positive close contacts and scrapping airline penalties for bringing Covid cases into the country, even though authorities insist their "war" against the pandemic remains unchanged. Brent prices subsequently fell to around USD 92/bbl after China reaffirmed its unwavering commitment to zero-Covid policy, despite growing frustration from the public after almost three years of forced lockdowns, mass testing, and travel restrictions. ("EIA") cut its world oil demand growth forecast in 2023 by 320,000 bpd to 100.98 million bpd, even though it raised its forecast for 2022 by 140,000 to 99.82 million bpd. However, Brent prices briefly recovered on 11th November to around USD 97/bbl, after data showed that US CPI cooled more than expected in October. Sentiment was also bolstered by comments from Saudi Arabia's energy minister, who said OPEC+ will remain cautious on oil production, noting that members saw "uncertainties" in the global economy.

Brent prices pared earlier gains and weakened to around USD 86/bbl, after OPEC reduced its 2022 forecasts for global oil demand again, the fifth time since April, and further trimmed next year's figure, citing mounting economic challenges including high inflation and rising interest rates. Brent prices extended losses towards month-end to around USD 81/bbl, the lowest level since January, amid escalating protests in China over its strict Covid-19 curbs, intensifying concerns over the oil demand outlook and global growth slowdown. Moreover, sentiment was also dented by discussions between European Union ("EU") members to impose a higher-than-expected price cap on Russian crude oil. In contrast, a lower price cap may lead to a physical reduction in Russian oil supply to the global market, driving prices higher. Nevertheless, Brent prices recovered to close the month at USD 85.43/bbl, boosted by reports of a potential output adjustment from OPEC and its allies at their upcoming meeting in December.

Fund Review

The Fund underperformed the Dow Jones Sukuk index return by 32bps in November, with returns of 1.87% compared to the index return of 2.19%. Year to date, the Fund has outperformed the index by 351bps, with Fund's returns of -7.71% compared to index returns of -11.22%. The Fund added some longer maturities earlier in October and benefited from the market rally in November. The Fund maintained overall overweight position in GCC markets as they remain the prime beneficiaries of elevated oil prices, 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 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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