Principal Islamic Asset Management (Ireland) (PLC)

Global Sukuk Fund

I Class October 2021

Market Review

The US Treasury (UST) yield curve bear flattened in October as investors priced in potential future interest rate hikes, driven by mounting inflationary concerns amid persistent supply chain issues and rising commodity prices. Sentiment was also dampened by rising bond yields globally, as major global central banks signaled that they may begin normalizing interest rates to contain higher prices. The shorter 2-5 year UST yields jumped by 22-25 basis points (bps) month-on-month (m-o-m), while 7-10 year yields rose by 7-17bps. On the flip side, the longest 20 and 30 year yields fell by 2-11bps, reflecting concerns over longer-term growth if the Federal Reserve (Fed) raises rates too quickly. 10-year UST yields initially soared by 21bps during the month, from 1.49% at end-September to touch 1.70% on 21st October, the highest level since March, before paring losses to close the month at 1.55% (m-o-m 6bps higher) after US Fed Chairman Jerome Powell acknowledged that inflation risks are rising as supply chain bottlenecks persist longer than expected. Nevertheless, Powell maintained that the Fed is not yet ready to normalize interest rates.

Selling momentum in UST gained pace in October following Treasury market correction in late September, as investors continued to price in potential future interest rate hikes, pushing yields higher. Sentiment was also dampened by overall positive US economic releases in the beginning of the month. US Institute for Supply Management (ISM) manufacturing unexpectedly grew for the second straight month in September, from 59.9 in August to a four-month high of 61.1 (consensus 59.5), driven by strong new orders despite a slight slowdown in production growth. ISM prices paid jumped at the same time, from 79.4 in August to 81.2 in September, defying consensus expectations for a drop to 78.5, reflecting persistent supply chain bottlenecks and higher raw material prices. US ISM services index also surprised on the upside, expanding above expectations from 61.7 to 61.9 in September (consensus 59.9), reflecting the industry's resilience despite the Delta variant and supply chain problems. 10-year UST yields continued to be pressured higher after US Automatic Data Processing (ADP) private payrolls jumped from 340,000 in August (revised lower from 374,000) to 568,000 in September (consensus 430,000), setting the stage for a potentially strong US nonfarm payrolls (NFP) report. However, NFP figures were disappointing – only 194,000 new jobs were created in September, far below consensus expectations of 500,000 (August revised higher from 235,000 to 366,000). Meanwhile, the labor participation rate dropped from 61.7% to 61.6% (consensus 61.8%), driving unemployment rate lower from 5.2% to 4.8% in September (consensus 5.1%). 10-year UST yields continued to trend higher despite the softer data, from 1.49% at end-September to 1.61% following the NFP release, as average hourly earnings jumped from 4.0% year-on-year (y-o-y) in August (revised downwards from 4.3%) to 4.6% in September, as companies were willing to pay more to attract employees, pressuring inflation higher.

Subsequently UST took a breather, with 10-year yields easing by 10bps to 1.51% on 14th October even though data showed that inflation remained elevated in September, as businesses passed on rising labor and raw material costs to consumers. Headline inflation inched higher in September from 5.3% y-oy in August to 5.4% (consensus 5.3%), while core inflation remained high at 4.0% y-o-y (consensus 4.0%). Meanwhile, minutes of the US Fed's meeting in September showed that policymakers may begin to taper its bond purchases in either mid-November or mid-December, at a pace of USD10 billion and USD5 billion per month for UST and mortgage-backed securities respectively. The tapering process is expected to end in mid-2022, as long as the economic recovery stays on track. According to the minutes, "various" participants thought that rates should stay at or near zero for a couple of years, while "in contrast, a number" of Fed officials said that rates may need to increase next year. Contrary to Powell's reiteration that the surge in inflation is expected to be transitory, some members are concerned that inflation may remain elevated in 2022 with risks to the upside, owing to persistent supply disruption and labor shortages. UST came under pressure again after US retail sales in September surprised on the upside, registering m-o-m growth of 0.7% (consensus -0.2%), albeit slightly lower than the 0.9% expansion recorded in August (revised upwards from 0.7%). 10-year UST yields continued to march higher to touch 1.70% on 21st October, the highest level since March, as sentiment soured following softer-than-expected demand for the new USD24 billion, 20-year UST auction on 20th October. The new issuance was oversubscribed by only 2.25x, lower than 2.36x in September as well as the 2.35x average, indicating lukewarm demand for UST even after prices have cheapened significantly. Subsequently, UST reversed course, with 10-year yields tumbling to 1.54% on 27th October, after Powell raised concerns over persistently high inflation due to longer and more persistent supply bottlenecks, a deviation from his past rhetoric that inflation is transitory. However, he stressed that the Fed has the tools to manage a range of plausible outcomes, while reiterating that any potential interest rate hike is still a long way off. The rally in 10-year UST prices also gained momentum as government bond yield curves flattened in several developed countries e.g. the UK, Europe, Australia and New Zealand, as investors priced in aggressive rate hike expectations amid soaring inflation, which may negatively impact longer-term growth. Nevertheless the rally in 10-year UST took a breather towards month-end, with yields settling slightly higher at 1.55% at end-October.

Brent crude oil prices continued to trend higher in October, gaining 7.5% m-o-m from USD78.51/barrel (bbl) at end-September to USD84.38/bbl at end-October as it continues to benefit from the ongoing natural gas shortage in Europe and China. Gains were also driven by the OPEC+'s decision to maintain production levels, despite market expectations of a temporary boost in supply to contain the sharp rise in prices. Brent crude oil prices stepped into the month of October on a strong footing, as commodity prices continue to benefit from the ongoing global energy crunch. Prices gained 5.2% from USD78.51/bbl to USD82.56/bbl on 5th October, after OPEC+ announced that it will keep to its existing plan to increase supply by 400,000 barrels per day (bpd) for November, despite calls from major consumers such as the US and India to boost production. Nevertheless, crude oil prices subsequently stumbled on 6th and 7th October to around USD80/bbl, following news that the US may be open to releasing its emergency oil reserves to contain prices, while Russia announced that it will ramp us gas exports to stabilize energy markets.

However, Brent crude oil prices rebounded after the US Energy Department debunked the news, and gained further momentum as the global energy crunch showed no signs of easing. The International Energy Agency (IEA) estimated that demand for oil may increase by 500,000 bpd over the next six months, with many governments forced to turn to crude oil as an alternative source of energy. According to the Energy Information Administration (EIA), US crude inventories dropped by 431,000 barrels to 426.5 million barrels for the week ending 15th October, the lowest level in three years, compared to estimates for a 1.9 million increase. Brent crude oil prices pulled back from the high, declining by 4.7% from around USD86.50/bbl to an intraday low of USD 8245/bbl on 28th October, after US crude oil stockpiles rose more than expected for the week ending 22nd October, even as fuel inventories dropped and tanks at the nation's largest storage hub emptied further. Nevertheless, Brent crude oil prices subsequently recovered to settle at USD84.38/bbl at end-October (m-o-m +7.5%).

Fund Review

The Fund outperformed the Dow Jones Sukuk index by 13bps in October, with fund's returns of -0.34% compared to the index returns of -0.47%. The fund continues to widen its outperformance against the index, with the Fund's year-to-date returns of 2.07% compared to the index returns of -1.88%, outperforming the index by 395bps. The portfolio maintained overall overweight position in the Gulf Cooperation Council (GCC) markets given the improving macro outlook and well supported oil price.

Portfolio Outlook and Strategy

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. 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, boosted by the ongoing Dubai World Expo 2020 taking place for 6 months from October 2021 to March 2022. 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 maintained its overall overweight position in GCC markets given the improving macro outlook and well supported 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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