Principal Global Investors Funds

Global Sukuk Fund

I Class February 2025

Market Review

Benchmark 10-year US Treasury (UST) prices continued to rally strongly in February, with yields plunging from 4.54% at end-January to 4.21% at end-February (m-o-m 33bps lower). During the month, yields initially trended higher to touch 4.66% on 12th February, after a hotter-than-expected US CPI report reaffirmed the US Fed's current stance of keeping rates unchanged for the foreseeable future. President Donald Trump's call for tariffs on all US imports of steel and aluminum to protect vital US industries also fueled inflationary concerns. In addition, minutes of the FOMC meeting in January reinforced the need for policymakers to see a further decline in inflation before resuming rate cuts, further weighing on sentiment. Nevertheless, 10-year UST yields plummeted in the second half of the month, after a sharp drop in US retail sales and consumer confidence data reignited concerns over a slowing US economy, prompting investors to price in additional rate cuts this year. The UST yield curve shifted lower and bull-flattened m-o-m, with yields sinking by 21-33bps across all tenures (2-30-year).

Following the rally in the second half of January, 10-year UST prices continued to strengthen, with yields falling 16bps from 4.54% at end-January to touch an intra-day low of 4.38% on 7th February, mainly due to mixed US economic data. In January, ISM manufacturing rose from 49.2 in December to 50.9 (consensus 50.0), marking its first expansion since 2022, as new orders grew and production increased, indicating a brighter manufacturing outlook. In contrast, ISM services unexpectedly slipped from 54.0 to 52.8 (consensus 54.0), as new orders shrank to a seven-month low, signalling easing momentum in the largest sector of the economy. Meanwhile, nonfarm payrolls plunged from 307,000 in December to 143,000 in January (consensus 175,000). Despite this, the unemployment rate fell from 4.1% to 4.0% (consensus 4.1%), while average hourly earnings rose from 0.3% to 0.5% m-o-m (consensus 0.3%), providing the US Fed with some leeway to keep rates on hold for the foreseeable future.

However, 10-year UST yields subsequently reversed course and spiked to 4.66% on 12th February, after the latest US CPI report showed that the central bank still has more work to do in taming inflation. In January, headline CPI surprised on the upside, rising from 0.4% in December to 0.5% m-o-m (consensus 0.3%, y-o-y up from 2.9% to 3.0% vs consensus 2.9%), while core CPI rose from 0.2% to 0.4% m-o-m (consensus 0.3%, y-o-y up from 3.2% to 3.3% vs consensus 3.1%). The rise in CPI was mainly contributed by higher natural gas costs due to January's abnormally cold weather, as well as groceries, led by price hikes in four out of six major grocery-store food groups (e.g., eggs rose by 15.2%). Sentiment was also dented by President Trump's order to impose 25% tariff on steel and aluminium imports, which may further fuel inflationary pressures. The tariffs will apply to all US imports of steel and aluminium, including from Canada and Mexico, among the country's top foreign suppliers. Nevertheless, 10-year UST yields subsequently eased to 4.45% on 14th February, after retail sales slumped from 0.7% in December (revised higher from 0.4%) in December to -0.9% in January (consensus -0.2%), the biggest drop in almost two years, suggesting that consumers are retreating after a spending spree in the last few months of 2024.

Subsequently, 10-year UST yields fluctuated, after minutes of the FOMC meeting in January revealed that policymakers agreed on the need to see inflation decline more before resuming rate cuts. The committee also expressed concerns over the impact of President Trump's tariffs, reduced regulations and taxes on inflation; and deliberated on the consequences of debt-ceiling negotiations and the implications for balance-sheet normalization. Despite acknowledging abundant policy risks from the Trump administration, US Fed members noted that current monetary policy is "significantly less restrictive" now, allowing time for policymakers to evaluate conditions before making any additional moves. Nonetheless, 10-year UST yields subsequently rallied to 4.40% on 21st February, after initial and continuing jobless claims increased, while the final University of Michigan consumer sentiment plunged from 71.7 in January to 64.7 in February (consensus 67.8), with long-term (5-year) inflationary expectations rising from 3.3% to 3.5%, the highest in nearly three decades, underscoring consumers' concerns that President Trump's tariffs will translate into higher prices.

Towards month-end, concerns over the health of the US economy intensified, prompting investors to price in a total of three rate cuts this year (vs. US Fed's expectation of two), with the first cut expected to take place in June. This caused 10-year UST yields to collapse by another 20bps to end the month at 4.21% (m-o-m 33bps lower), the lowest since early December 2024. Sentiment was also buoyed by US PCE inflation data for January, where headline PCE eased from 2.6% in December to 2.5% y-o-y (consensus 2.5%, m-o-m stayed firm at 0.3% vs consensus 0.3%), while core PCE inflation dipped from 2.9% to 2.6% (consensus 2.6%, m-o-m rose from 0.2% to 0.3% vs consensus 0.3%). Moreover, personal spending shrank more than expected from 0.8% to -0.2% (consensus 0.2%) despite higher personal income, as uncertainty over the Trump administration's policies continued to weigh on households. Reflecting this, the Conference Board of Consumer Confidence index tumbled from 105.3 in January to 98.3 in February (consensus 102.5), the lowest since August 2021.

Meanwhile, Brent crude oil prices fluctuated between USD 74-77/bbl in February, before settling 4.7% lower m-o-m at USD 73.18/bbl. Prices were supported by signs of a tighter oil market during the month, as President Trump reinforced sanctions on Iranian oil exports amid waning production from Russia. However in the final week of the month, Brent prices were hampered by easing geopolitical concerns after Trump initiated discussions on ending the war in Ukraine. Furthermore, weakening US economic data fueled concerns that President Trump's policies may hurt economic growth and oil demand, pressuring Brent prices lower.

In early February, Brent prices initially dipped from USD 76.76/bbl at end-January to USD 74.10/bbl, as concerns that the trade war between the US and its trading partners would hurt global growth outweighed the announcement of reinforced sanctions on Iran. On 4th February, President Trump signed a directive that targets to increase economic pressure on Iran. Over the past four years, sanctions evasion and more relaxed US enforcement have allowed Iran to ramp up oil exports by approximately 1 million barrels per day (bpd). Enforcing sanctions may reduce Iran's exports by about two-thirds, costing the country roughly USD30 billion a year. However, China's announcement of retaliatory measures against Trump's tariffs by placing levies on a range of US goods, including oil and liquified natural gas, raised concerns that an escalation in trade disputes between the world's two largest economies may have a broader impact and hurt global consumption. Nevertheless, Brent oil prices pared losses and rose to USD 77.29/bbl on 11th February, amid signs of a tighter supply market, after Russian oil production fell short of its OPEC+ quota last month, while soaring natural gas prices in Europe incentivized the usage of oil for power.

Subsequently, Brent prices declined to around USD 74/bbl again after US President Trump said he had begun talks with Russian President Vladimir Putin about ending the war in Ukraine, reversing three years of US policy on the conflict. Separately, despite the sweeping Western sanctions on Russian oil, the International Energy Agency (IEA) lowered its 2025 outlook for Russia's oil production marginally by 150,000 bpd to 9.25 million bpd, as the Paris-based organization expects the nation to come up with workarounds. Furthermore, the IEA slashed expectations for a global oil surplus this year amid stronger demand growth in Asia and sanctions on OPEC+ nations, namely Russia and Iran. The agency now expects an overhang of 450,000 bpd in 2025, marking a cut of around 50% in just two months. It also boosted growth forecasts for world oil consumption this year by around 100,000 bpd to 1.1 million bpd, while lowering projections for output from OPEC+ nations including Russia and Iran.

Brent oil prices recovered to around USD 77/bbl on 20th February, as investors again shifted their focus to concerns over tighter supply, amid uncertainty over global supplies and potential changes to production and pipeline flows. Earlier, a drone attack by Ukraine on Russian territory affected flows through Kazakhstan's Caspian Pipeline Consortium link, which ships about 80% of Kazakh oil exports. The attack halted an oil pumping station, possibly reducing flows by about 30% to accommodate two months of repairs. Nevertheless towards month-end, Brent prices tumbled to close the month at USD 73.18/bbl (4.7% lower m-o-m), as a slump in US consumer confidence exacerbated mounting concerns that President Trump's policies may dampen economic growth and deplete energy demand.

Fund Review

The Fund delivered 0.61% in February, 17bps lower than the Dow Jones Sukuk index return of 0.78%. During the month, we took profit on long tenured Indonesia sovereign, which rallied in tandem with US Treasuries.

Portfolio Outlook and Strategy

The economic outlook in GCC countries continues to be solid, anchored by the governments' ongoing efforts to diversify away from the hydrocarbon industry and strong growth in the non-oil sector, which have resulted in positive rerating actions by international rating agencies. The non-oil economy now accounts for 53% of GDP in Saudi, and 75% of GDP in the UAE.

In the UAE, Dubai welcomed 18.72 million visitors in 2024, a new record high (9.2% growth y-o-y). Visitors from Western Europe continued to account for the largest share of tourists (20%), followed by South Asia (17%), GCC and Russia. Dubai's average hotel occupancy increased from 77.4% in 2023 to 78.2% in 2024, while GDP grew 3.1% in 9M24. The Dubai government continues to invest heavily in developing the tourism sector, not only within the city, but also in rural areas e.g. the Saih al-Salam Scenic Route, which was recently approved with a USD106 million budget. Meanwhile in Saudi, the housing market is experiencing a surge in demand, with 72% of Saudis and expatriates expressing interest in homeownership, according to Knight Frank. In 2024, housing transactions totaled SAR267.8bil (up 27% y-o-y), with 236,690 sales recorded (up 37% y-o-y). As at end-2023, homeownership in Saudi stood at 63.7%, nearing the government's Vision 2030 target of 70.0%.

Overall, the fixed income market outlook for 2025 remains conducive, anchored by expectations that the US Fed may continue easing monetary policy, amid rising concerns that President Trump's policy may negatively affect economic growth. The market is now pricing in a total of three rate cuts this year (vs. US Fed's expectation of two), with the first cut expected to take place in June. Nevertheless, given increased uncertainties, we will continue to be adopt a nimble investment strategy to maneuver market fluctuations and capitalize on trading opportunities, with increased investments in sovereign sukuk. For corporate sukuk, we continue to prefer highly liquid, blue-chip government-related companies, utility companies, as well as those with strong financials and robust cash buffers, to enable a swift reaction to any changes in market sentiment or direction.

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Risk Considerations

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