Principal®

Principal Global Investors Funds

Global Sukuk Fund

I Class June 2024

Market Review

10-year US Treasury (UST) prices rallied significantly in June, with yields diving 31bps lower from 4.50% at end-May to touch 4.19% on 14th June, as softer US economic data bolstered expectations of rate cuts this year. The US Fed kept interest rates unchanged at 5.25%-5.50% at the FOMC meeting, and signaled one potential rate cut this year (vs. March: three cuts), and four cuts in 2025 (March: three cuts). Chairman Jerome Powell acknowledged during the press conference, that recent CPI readings have been encouraging, but maintained that the central banks needs to see further evidence that inflation is moving towards its 2.0% target. Nevertheless, 10-year UST yields edged higher to settle at 4.40% (m-o-m 10bps lower) towards month-end, weighed by hawkish Fedspeak, hotter-than-expected inflation data in Australia and Canada, as well as concerns that the Bank of Japan may reduce its bond purchases and raise rates in the coming months. The UST yield curve bull steepened m-o-m, with shorter 2-7 year UST yields falling by 12-13bps, while the longer 10-30 year yields declined by 6-10bps.

Following the rally towards end-May, benchmark 10-year UST yields plummeted further from 4.50% to touch 4.28% on 5th June, as weak US economic data bolstered expectations of rate cuts this year. In May, the US ISM manufacturing index contracted further from 49.2 in April to 48.7 (consensus 49.5) as new orders dropped by the most in nearly two years, suggesting that demand for goods is weakening. Meanwhile, JOLTS job openings dipped from 8.36 million (revised downwards from 8.49 million) in March to 8.06 million in April, the lowest level since 2021 (consensus 8.35 million); while ADP Employment dropped from 188,000 in April (revised lower from 192,000) to 152,000 in May (consensus 175,000), signaling that the US labor market may be cooling. However, 10-year UST yields jumped to 4.48% on 10th July, after nonfarm payrolls came in stronger than expected. In May, the US economy added 272,000 jobs, above consensus estimates of 180,000 (April revised lower from 175,000 to 165,000). In addition, average hourly earnings rose from 4.0% (revised higher from 3.9%) to 4.1% y-o-y (consensus 3.9%, m-o-m up from 0.2% to 0.4% vs. consensus 0.3%), fueling concerns over stubborn inflationary pressures. Meanwhile, the unemployment rate ticked higher from 3.9% to 4.0% (consensus 3.9%), the highest level in two years, amid a drop in the labor participation rate from 62.7% to 62.5%. US ISM services data also beat expectations, having expanded from 49.4 to 53.8, the highest in nine months (consensus 51.0), propelled by the largest orders growth since 2021.

Nevertheless, 10-year UST yields dived again to touch 4.19% on 14th June after US CPI eased more than expected, coupled with rising jobless claims. In May, US headline CPI cooled from 0.3% in April to 0.0% m-o-m (consensus 0.1%, y-o-y down from 3.4% to 3.3% vs. consensus 3.4%), while core CPI dipped from 0.3% to 0.2% m-o-m (consensus 0.3%, y-o-y down from 3.6% to 3.4% vs. consensus 3.5%), marking its slowest pace in more than three years. The pullback in CPI reinforces expectations that inflation is resuming its downward trend after exceeding expectations in 1Q24, and was largely driven by a decrease in gasoline and grocery prices. Moreover, initial jobless claims for the week ending 8th June jumped from 229,000 to 242,000 (consensus 225,000), the highest level in 9 months, led by an increase in California, while continuing claims for the week ending 1st June increased from 1.79 million to 1.82 million (consensus 1.79 million).

At the FOMC meeting on 12th June, the US Fed unanimously voted to keep interest rates unchanged at 5.25%-5.50%, and signaled only one 25bp rate cut in 2024, compared to its previous forecast in March of three rate cuts. Nevertheless, policymakers' individual dot plots indicate that it was a close call between one or two projected rate cuts this year, with eight members anticipating 50bps of cuts, seven policymakers penciling in 25bp cuts, while four expect no cuts. Meanwhile, the median Fed Funds Rate forecast for 2025 rose from 3.9% to 4.1%, indicating four potential cuts compared to three reductions projected in March. In its updated quarterly forecast, the committee also revised its 2024 PCE inflation projection slightly higher from 2.4% in March to 2.6% (2025: up from 2.2% to 2.3%), while core PCE inflation is revised up from 2.6% to 2.8% (2025: up from 2.2% to 2.3%). During the post-meeting press conference, Chairman Jerome Powell acknowledged that recent CPI readings have been encouraging, but maintained that the central banks needs to see further evidence that inflation is moving towards its 2.0% target.

Following the FOMC meeting, 10-year UST yields traded range-bound between 4.22%-4.29%, supported by weak US retails sales and declining consumer confidence. In May, retail sales expanded by 0.1%, lower than consensus expectations of 0.3%, while data for April was revised lower from 0.0% to -0.2%, pointing to heavier financial strain among consumers. The weaker consumer sentiment was also reflected in the preliminary University of Michigan consumer sentiment index, which unexpectedly fell from 69.1 in May to 65.6 in June, a seven-month low (consensus 72.0). Towards month-end, 10-year UST yields were pressured higher to settle at 4.40% (m-o-m 10bps lower), as sentiment was dented by hawkish Fedspeak, hotter-than-expected inflation data in Australia and Canada, as well as concerns that the Bank of Japan may reduce its bond purchases and raise rates in the coming months.

Brent crude oil prices started the month on a weak footing in June, as investors reacted to a potential unwinding of OPEC+'s voluntary production cuts from October onwards. Brent prices initially fell from USD 81.62/bbl at end-May to touch USD 76.76/bbl, before recovering substantially to close the month at USD 86.41/bbl (m-o-m 5.9% higher), driven by positive news of the return of global jet fuel demand, coupled with risk-on sentiment after the US CPI report showed that inflation may be resuming its downward trend.

Brent oil prices slipped in early June, following the outcome of the OPEC+ meeting on 2nd June. The committee announced that it will extend its original 3.66 million bpd cuts (due to expire at end-2024) until end-2025. Meanwhile, the group's voluntary 2.2 million bpd cuts (due to expire at end-June) will continue until end-September, and will be subsequently gradually phased out over the course of a year from October 2024 to September 2025. OPEC+'s decision to loosen its production curbs beginning October this year was earlier than the market expected, dampening sentiment and pressuring Brent prices lower. Under the new agreement, the eight nations participating in these additional curbs may add approximately 750,000 bpd into the market by January next year, raising concerns over a supply glut. Nevertheless, Saudi Energy Minister Prince Abdulaziz bin Salman said the alliance will retain their precautious and preemptive approach, which also includes the possibility of pausing or even reversing the unwinding of production cuts.

Subsequently, Brent oil prices rebounded strongly to touch USD 87.22/bbl on 28th June, before settling at USD 86.41/bbl (m-o-m 5.9% higher). The rally was driven by positive expectations that global jet fuel demand will return to pre-pandemic levels, as well as anticipation of easing US monetary policy amid cooling inflation. According to an industry data compiled by Bloomberg, 10.5 million flights are scheduled for third quarter of this year, with international travel set to see the biggest surge. Furthermore, the International Air Transport Association is expecting the highest number of passengers in 2024, and planes will be as full as they were before the pandemic hit, using record amounts of fuel. Separately, the American Automobile Association anticipates a record 71 million people to travel over the 4th of July US holiday, boosting demand for gasoline, diesel and jet fuel. In addition, Brent prices were also boosted by continued attacks on ships passing through the Red Sea by Yemen's Houthi rebels, which outweighed concerns over slowing demand for oil amid an unexpected increase in US crude stockpiles.

Fund Review

The Fund outperformed the Dow Jones Sukuk index return by 35bps in June, with returns of 0.81% compared to the index return of -0.46%. The sukuk market rallied as softer US economic data bolstered expectations of rate cuts this year. The primary Global Sukuk market remains active in June, with demand continued to be robust. Notable new sukuk issuances include Indonesia sovereign, Energy Development Oman and Sharjah Islamic Bank.

Portfolio Outlook and Strategy

The overall fixed income market outlook turned bullish again, as softer US economic data reinforced expectations of potential rate cuts this year. At The FOMC meeting in June, the US Fed kept interest rates unchanged at 5.25%-5.50% and signaled one potential rate cut this year, and four cuts in 2025.

In the UAE, GDP grew 3.6% in 2023, with the non-oil sector expanding by 6.2%. Contribution from non-oil sectors increased to a record high from 71.8% in 2022 to 74.3% in 2023. The fastest growing sector was Financial services, expanding 14.3% in 2023 (2022: 6.6%), followed by transport and logistics, construction and real estate services. In 2023, Dubai attracted 17.15 million international visitors, a 19% increase and higher than the pre-pandemic record of 16.73 million visitors in 2019. GCC countries' credit rating profiles are expected to remain solid in the near to medium term. Similarly, the macroeconomic outlook in Asian countries such as Malaysia and Indonesia remain strong and improving, supported by their resilient fundamentals and relatively benign inflation.

With the overall fixed income market outlook turning positive again, we will continue to be invested in selective sovereign and corporate 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 weather changes in economic landscapes.

Risk Considerations

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