Principal Islamic Asset Management (Ireland) (PLC)

Global Sukuk Fund

I Class March 2024

Market Review

Benchmark 10-year US Treasury (UST) prices initially recovered in March, with yields tumbling by 22bps from 4.25% at end-February to touch 4.03% on the back of weaker US economic data, bolstering investors' expectations for an earlier or more than anticipated US rate cuts this year. 10-year UST yields subsequently rose to 4.35% after US inflation data came in hotter than expected for a second consecutive month. US Fed officials unanimously decided to keep interest rates unchanged at 5.25%-5.50% at the March FOMC, and indicated that it may begin slowing the pace of quantitative tightening soon. US Fed Chairman Powell signaled that the first interest rate cut would likely be "at some point this year" and largely dismissed the recent uptick in inflation. UST prices rallied in response, pushing 10-year UST yields lower to end the month at 4.20% (m-o-m 5bps lower). Meanwhile, the UST yield curve bull flattened with the shorter 2-year yields unchanged m-o-m, 5-7 year yields dipped by 3-6bps while the longer 10-30-year yields fell by 4-6bps.

10-year UST yields plunged by 22bps from 4.25% at end-February to touch 4.03% in early March, amid weaker US manufacturing and services activity. US ISM manufacturing shrank further in February, from 49.1 in January to 47.8 (consensus 49.5), as new orders, prices paid and employment contracted. US ISM services dipped from 53.4 to 52.6 (consensus 53.0), mainly due to a slowdown in employment. In line with this, the final University of Michigan consumer sentiment dropped from 79.6 in January to 76.9 in February (consensus 79.6), highlighting a bleaker economic outlook as short-term (1-year) and long-term (5-10-year) inflation expectations stayed firm at 3.0% and 2.9% respectively. Meanwhile, the US jobs report was mixed. The ADP National Employment jumped from 111,000 (revised higher from 107,000) in January to 140,000 (consensus 150,000) in February, led by leisure and hospitality, construction and trade and transportation. Nonfarm payrolls added 275,000 in February, beating consensus expectations of 200,000 new jobs. However, data for January was revised lower from 353,000 to 229,000, indicating some softness in the labour market. Furthermore, the unemployment rate climbed from 3.7% in January to 3.9% in February (consensus 3.7%), marking a two-year high, while average hourly earnings moderated from 4.4% (revised lower from 4.5%) to 4.3% y-o-y (consensus 4.3%, m-o-m fell from 0.5% to 0.1% vs. consensus 0.2%).

Subsequently, 10-year UST yields rose to touch 4.35%, following a second consecutive uptick in US inflation, further supporting the US Fed's cautious approach in cutting interest rates. US headline CPI rose from 0.3% in January to 0.4% m-o-m in February (consensus 0.4%, y-o-y up from 3.1% to 3.2% vs. consensus 3.1%), while core CPI remained sticky at 0.4% m-o-m (consensus 0.3%, y-o-y down from 3.9% to 3.8% vs. consensus 3.7%), as prices for used cars, air travel and clothes soared. Sentiment in the UST market was further dampened after US PPI (producer price index) jumped from 0.3% to 0.6% during the same period (consensus 0.3%), mainly attributed to higher fuel and food prices. The increase was the highest in six months, adding to signs of persistent inflation, and reinforcing recent remarks from several Fed members who advocated for patience before deciding to cut rates.

In mid-March, 10-year UST yields fell to around 4.20% as sentiment was bolstered by an overall dovish tone at the FOMC meeting, where the committee unanimously voted to keep rates unchanged at 5.25%-5.50% and maintained their outlook for 75bp cuts this year. However, the US central bank revised its rate cut expectations for 2025 from 100bps in December 2023 to 70bps (i.e. from 3.6% to 3.9%), while changing its forecast for 2026 from 70bp cuts to 80bps. The committee also sharply revised up its 2024 GDP projection from 1.4% to 2.1% (2025: up from 1.8% to 2.0%). Meanwhile, headline PCE inflation forecast was unchanged at 2.4% for 2024 (2025: up from 2.1% to 2.2%), but core PCE inflation is expected to accelerate from 2.4% to 2.6% in 2024 (2025: unchanged at 2.2%). Despite this, Fed Chairman Powell struck a more dovish tone during his press conference, as he reassured that the recent hot CPI reports has not changed the Fed's expectations that inflation is trending lower. Powell did not dismiss market expectations that the first rate cut may take place as early as May or June, if policymakers were to see "unexpected" deterioration in the labour market. He added that it will be appropriate to slow down the pace of quantitative tightening "fairly soon", after policymakers held a discussion on their asset portfolio.

Towards month-end, 10-year UST yields traded range-bound before settling at 4.20% (m-o-m 5bps lower, despite hawkish Fedspeak and mixed US economic data. Fed Governor Lisa Cook said the US central bank should take a cautious approach to lowering interest rates to allow more time for inflation to ease in some sectors of the economy. Fed Governor Christopher Waller concurred that there is no rush to cut rates, stressing that the recent strong economic data calls for delaying or reducing the number of cuts this year. Meanwhile, the US Fed's preferred gauge of inflation cooled, despite a rebound in household spending. Headline PCE inflation ticked lower in February, from 0.4% (revised upwards from 0.3%) in January to 0.3% m-o-m (consensus 0.4%, y-o-y up from 2.4% to 2.5%, in line with consensus); while core PCE inflation eased from 0.5% (revised upwards from 0.4%) to 0.3% m-o-m (consensus 0.3%, y-o-y down from 2.9% to 2.8%, in line with consensus).

In March, Brent crude oil prices initially traded within a narrow range of USD 82-84/bbl, after OPEC+ maintained oil production cuts, in line with expectations. Subsequently, Brent prices soared in the second half of the month to reach USD 87.70/bbl, driven by concerns over oil supply deficit due to tensions in the Middle East and disruptions in the Red Sea, before settling at USD 87.48/bbl (m-o-m 4.62% higher).

In the beginning of the month Brent prices were stable, mainly buoyed by OPEC+'s decision to extend oil production cuts of 2.2 million bpd until end-June, while Russia will cut supply by 471,000 bpd in 2Q24 (slightly lower than 500,000 bpd in 1Q24). Currently, OPEC+'s total pledged cuts amount to 5.86 million bpd (including 3.66 million bpd until end-2024), or 5.7% of global demand. OPEC also kept its oil demand projections for the next two years unchanged (2024: 2.2 million bpd growth, 2025: 1.8 million bpd growth), during its monthly meeting. However, the committee revised up its 2024 global GDP growth forecast slightly from 2.7% to 2.8%, citing strong performance from the US and India, despite acknowledging weaker performance from the Eurozone and Japan.

Brent prices jumped in the second half of the month to touch USD 87.70/bbl, after the International Energy Agency (IEA) reversed its earlier projection of an oil supply surplus to a deficit. Global oil markets may face a supply deficit throughout 2024 according to the IEA, if OPEC+ continues its production cuts in the second half of the year. Furthermore, the IEA boosted projections for 2024 global oil demand growth by 110,000 bpd to 1.3 million bpd, on a stronger US economy outlook and the increased need for ship fuel, as vessels take longer routes to avoid Houthi attacks in the Red Sea. The amount of oil aboard ships at sea jumped to almost 1.9 million barrels at the end of February, as a result of the reroutes, marking its second highest level since the height of the Covid-19 pandemic. The IEA expects global oil demand to average a record 103.2 million bpd this year.

Sentiment in the oil market was bolstered by growing concerns over heightened geopolitical risks, following news of Ukrainian drone attacks on several major Russian oil refineries. The attacks resulted in a sharp drop in Russia's average daily oil refining rate by around 400,000 bpd, the lowest in ten months. In addition, a Bloomberg survey estimates that between 480,000 and 900,000 bpd of Russia's daily processing capacity has gone offline as a result of the attacks, driving Brent prices higher. Brent prices remained buoyed by expectations that global central banks will start cutting rates soon towards month-end, supporting industrial and consumer demand. Brent prices closed the month 4.62% higher from USD 83.62/bbl at end-February to USD 87.48/bbl at end-March, the highest level since October 2023.

Fund Review

The Fund outperformed the Dow Jones Sukuk index return by 28bps in March, with returns of 0.63% compared to the index return of 0.35%. Sukuk prices staged some recovery in March in line with US Treasury movements, bolstered by Federal Reserve's outlook of 75bps rate cut this year. The overall fixed income market outlook remains positive, underpinned by expectations of future rate cuts. The primary Global Sukuk market remains active, with demand continued to be robust. Notable new sukuk issuance in March was Abu Dhabi's sovereign wealth fund, Mubadala.

Portfolio Outlook and Strategy

The overall fixed income market outlook remains positive, albeit somewhat hampered by the timing of the eventual US Fed interest rate cut. According to a survey done by consulting firm Kearney, the Middle East is increasingly emerging as one of the most desirable locations for foreign investors looking to deploy capital, with the UAE and Saudi Arabia posting the biggest jumps in Kearney's 2024 Foreign Direct Investment Confidence Index. The UAE and Saudi Arabia climbed ten spots from 2023, to 8th and 14th respectively. In 2023, Saudi's greenfield FDI more than doubled to USD28.8 billion, surpassing the previous peak of USD17.6 billion in 2018. The number of greenfield FDI projects reached a new record, increasing by 65% y-o-y to 359 projects.

Meanwhile in the UAE, the non-oil sector now accounts for 73% of the economy, with non-oil trade jumping 12.6% y-o-y to AED3.5 trillion (around USD953 billion), a new record high. Expanding services sectors in UAE include travel and tourism, information and communication technology, financial services and professional services, while major non-oil exports include gold, aluminum, jewelry, copper wire and ethylene polymers. In 2023, Dubai attracted 17.15 million international visitors, a 19% y-o-y increase and higher than the previous 2019 record of 16.73 million visitors. 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.

While the overall fixed income market outlook remains positive, the market may be subject to fluctuations amid lingering uncertainties. We will remain vigilant and continue to adopt a more defensive investment strategy through 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.

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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