## Principal Islamic Asset Management (Ireland) (PLC)

# Global Sukuk Fund

I Class May 2024

## Market Review

The US Fed kept interest rates unchanged at 5.25-5.50% at the FOMC meeting on 1st May, citing concerns over lingering price pressures in the US economy. Policymakers also reaffirmed the need for more evidence that inflation is cooling before they begin cutting interest rates. In addition, the US Fed announced that they will slow the pace of balance sheet tapering beginning June, from USD60 billion to USD25 billion monthly. The US Treasury (UST) market rallied strongly in May, despite the overall hawkish tone of the FOMC meeting, with benchmark 10-year yields plummeting by 37bps from 4.68% at end-April to touch 4.31% in mid-May, after a series of weaker-than-expected US economic data reignited hopes for potential rate cuts. Nevertheless, 10-year UST yields subsequently rose to reach 4.64%, as several US Fed members stressed on the importance of keeping interest rates high for longer. Sentiment was also dampened by soft demand at the new 2, 5 and 7-year UST auction, totaling USD183 billion. 10-year UST recovered towards month-end, to close the month at 4.50% (m-o-m 18bps lower), after 1Q24 US GDP was revised lower, and PCE inflation data came in within expectations. The UST yield curve bull steepened m-o-m , with shorter 2-7 year UST yields falling by 16-21bps, while the longer 20 and 30-year yields declined by 17 and 14bps respectively.

At the May FOMC meeting, US Fed officials unanimously decided to keep interest rates unchanged at 5.25-5.50%, citing a “lack of further progress” toward its 2.0% inflation target, after CPI data in recent months surprised on the upside. The committee also emphasized the need for more evidence that price pressures are cooling before they can begin cutting interest rates, and that gaining more confidence to do so may take longer than previously expected. In addition, the FOMC statement said the economy continued to grow at a “solid pace”, while job gains have “remained strong”, and the unemployment rate staying low. Nevertheless, during his press conference, US Fed Chairman Jerome Powell adopted a more dovish tone than expected. He said, “it is unlikely that the next policy rate move will be a hike” and added that the Fed may consider cutting rates if unemployment unexpectedly rose.

Despite the overall hawkish tone of the FOMC meeting, 10-year UST yields plummeted by 26bps from 4.68% at end-April to 4.42% on 7th May, driven by weaker-than-expected US ISM and jobs data. In April, the US ISM manufacturing index contracted from 50.3 in March to 49.2 (consensus 50.0), dragged by slower new orders as suppliers struggle to gain traction amid elevated interest rates, higher input costs and sluggish overseas demand. Similarly, US ISM services unexpectedly shrank sharply from 51.4 to 49.4 (consensus 52.0), marking its first contraction since 2022, as new orders and employment weakened. Furthermore, the US economy added 175,000 jobs in April, below consensus estimates of 240,000 and the smallest gain in six months (March revised higher from 303,000 to 315,000). The unemployment rate ticked up from 3.8% to 3.9% (consensus 3.8%), while average hourly earnings declined from 4.1% to 3.9% y-o-y, the lowest since June 2021 (consensus 4.0%, m-o-m down from 0.3% to 0.2% m-o-m vs. consensus 0.3%). Similarly, JOLTS job openings dropped from 8.81 million (revised upwards from 8.75 million) in February to 8.48 million in March (consensus 8.68 million), as demand for labour eased.

In mid-May, 10-year UST yields dived further to touch 4.31%, after US CPI surprised on the downside and retail sales stagnated, prompting investors to bring forward expectations of the first US rate cut from December to September this year. In April, US headline CPI eased from 0.4% in March to 0.3% m-o-m (consensus 0.4%, y-o-y down from 3.5% to 3.4% vs. consensus 3.4%) after surprising on the upside in the first three months of the year, indicating that inflation may be resuming its downward trend. Core CPI fell by the same quantum m-o-m (y-o-y down from 3.8% to 3.6% vs. consensus 3.6%), with shelter prices slowing slightly from 0.41% to 0.35%. Meanwhile, retail sales declined from 0.6% (revised downwards from 0.7%) to 0.0% m-o-m (consensus 0.4%), suggesting that high borrowing costs and rising debt are encouraging greater prudence among consumers.

Nevertheless, 10-year UST yields subsequently surged to touch 4.64% on 29th May, driven by a slew of hawkish Fedspeak, stronger-than-expected consumer confidence data and soft demand for new UST auctions. Minutes of the May FOMC meeting revealed that while Fed members considered policy to be well positioned, “various” officials expressed willingness to tighten policy further if necessary. At the same time, Fed members also noted the pressure that inflation was having on consumers, especially those with lower income. The committee expressed concern that consumers were resorting to riskier forms of financing to make ends meet, e.g. increased usage of credit cards and buy-now-pay later service, as well as increased delinquency rates for some types of consumer loans. Sentiment in the UST market was also dampened by a strong US Conference Board of Consumer Confidence survey, which unexpectedly jumped from 97.5 in April (revised upwards from 97.0) to 102.0 in May (consensus 96.0), the first increase in four months, as Americans were more optimistic about the outlook of business conditions and labour market. Moreover, investors had to digest back-to-back new issuances of 2, 5 and 7-year UST totaling USD183 billion, pressuring UST yields higher.

Nevertheless, 10-year UST yields recovered to close the month at 4.50% (m-o-m 18bps lower), bolstered by softer US economic data. Headline PCE inflation remained sticky at 0.3% m-o-m (consensus 0.3%, y-o-y flat at 2.7%), while PCE core inflation fell from 0.3% to 0.2% m-o-m (consensus 0.2%, y-o-y stayed firm at 2.8%). This marked the smallest gain YTD, strengthening expectations that inflation may be resuming its downward trend, after having its progress interrupted in the first quarter of the year. Furthermore, personal income and personal spending also cooled more than expected, paving the way for potential rate cuts this year.

Brent crude oil started the month on a weak footing in May, after the Energy Information Administration (EIA) reported an increase in US crude inventories. Subsequently, Brent prices oscillated within the USD 81-USD 85/bbl range before closing the month at USD 81.62/bbl (m-o-m 7.1% lower), as concerns over supply disruption due to the ongoing Israel-Hamas war were overshadowed by worries over slowing demand for oil. Sentiment was also dampened by hawkish rhetoric by US Fed officials, who reiterated that interest rates should stay high for longer to bring down inflation to their 2.0% target, further fueling demand concerns.

In the beginning of the month, Brent oil prices slid from USD 87.86/bbl at end-April to touch USD 81.71/bbl, due to a surge in US crude stockpiles and signs of easing geopolitical risks in the Middle East. According to the EIA, US crude stockpiles rose by 7.27 million barrels for the week ending 29th April (consensus +4.91 million barrels), marking its largest gain since early February. Brent prices slumped further to touch USD 80.65/bbl on 15th May, after the International Energy Agency (IEA) trimmed its forecast for 2024 oil demand growth by 140,000 bpd to 1.1 million bpd, citing weak demand in developed OECD nations. The IEA said the lower forecast is linked to poor industrial activity and a mild winter sapping gas and oil consumption, particularly in Europe, where a declining share of diesel cars was already undercutting consumption. At the same time, the agency reduced its estimates for oil supply in 2024 from 102.9 million bpd to 102.7 million bpd, citing heavy outages in Brazil and logistical constraints in the US.

During the month, Brent prices were also dampened by signs of easing tension in the Middle East, amid reports that the US and Saudi Arabia were nearing a historic agreement, which would provide the kingdom security guarantees and possible pathway to diplomatic ties with Israel, if the latter ends the war in Gaza. If implemented, this pact could potentially reshape the Middle East, forming a three-way diplomatic relation for greater investment and integration in the region. In addition, Hamas and Israel have been negotiating indirectly through Qatar, Egypt and the US, for a temporary ceasefire which entails the release of Israeli hostages held in Gaza in exchange for Palestinians detained in Israeli prisons. Towards month-end, Brent oil prices recovered to touch USD 85/bbl on 29th May, following reports that a Greek-owned bulk carrier was attacked in the Red Sea, while Israel's military advanced into the center of Rafah in southern Gaza, reigniting geopolitical risk concerns. Nevertheless, Brent prices subsequently fell to close the month at USD 81.62/bbl (m-o-m 7.1% lower) after weaker-than-expected China PMI data brought back concerns over slowing demand in focus, and as investors remain cautious ahead of the OPEC+ meeting in June.

## Fund Review

The Fund outperformed the Dow Jones Sukuk index return by 18bps in May, with returns of 0.91% compared to the index return of -0.73%. The sukuk market rallied following a series of weaker-than-expected US economic data, reigniting hopes of potential US rate cuts. The primary Global Sukuk market remains active in May, with demand continued to be robust. Notable new sukuk issuances include Aldar Properties and Al-Rajhi Bank.

## Portfolio Outlook and Strategy

The overall fixed income market outlook turned bullish again, following a series of weaker-than-expected US economic data releases. Minutes from the US Federal Reserve meeting showed that policymakers grew more concerned about inflation, and noted the pressure that inflation was having on consumers, especially those with lower income. Nevertheless, data released in May indicated that inflation may be resuming its downward trend. Other US economic indicators also signal softening growth momentum: with retail sales slowing, and contraction in ISM manufacturing and ISM services numbers. New jobs creation dropped in April while 1Q24 US GDP was revised lower from 1.6% to 1.3%, largely due to softer personal consumption.

Meanwhile 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

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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