Principal Global Investors Funds

Global Sukuk Fund

I Class October 2024

Market Review

US Treasury (UST) yields were pressured higher across the board in October, amid a series of stronger-than-expected US economic data, pushing investors to adjust their expectations of the pace of future monetary policy easing. Furthermore, most US Fed officials said they favor a more cautious and gradual approach in cutting interest rates given the uncertainty over the eventual neutral rate, despite delivering an outsized 50bp rate cut in September. In addition, market sentiment was hampered by growing possibility of a second Trump administration which may feature more tariffs, tax cuts and increased spending, thus fuelling inflationary concerns. During the month, benchmark 10-year UST yields soared by 56bps from 3.78% as at end-September to touch 4.34% on 29th October, before settling at 4.28% (m-o-m 50bps higher). The UST yield curve shifted higher and bear flattened, with 2-10-year yields rising by 50-60bps, while the longer 20 and 30-year yields climbed by 36-42bps.

On the first trading day of the month, 10-year UST yields briefly dipped from 3.78% at end-September to touch 3.69%, after Iran launched rockets at Israel in retaliation for the assassination of Hezbollah's leader, Hassan Nasrallah. However, many rockets were intercepted by Israel and there were no known injuries from the attack. This allayed concerns over a sharp escalation of the war, resulting in an unwinding of the flight to safety trade. Furthermore, US economic data came in stronger than expected, pushing 10-year UST yields 29bps higher to 3.98% on 4th October. In September, ISM services expanded further from 51.5 in August to 54.9 (consensus 51.7), its highest level since early 2023, driven by a surprise jump in new orders and robust business activity. On the other hand, ISM manufacturing stayed in contractionary territory at 47.2 in September (consensus 47.5), despite stronger new orders as prices paid fell and employment declined. Market sentiment was also dampened by the surprisingly robust labour market. In September, nonfarm payrolls unexpectedly increased from 159,000 in August (revised higher from 142,000) to 254,000 (consensus 150,000), pushing the unemployment rate lower from 4.2% to 4.1% (consensus 4.2%), while average hourly earnings grew from 3.9% to 4.0% y-o-y (consensus 3.8%, m-o-m down from 0.5% to 0.4%). The leisure and hospitality sector led job creation for the month, followed by healthcare and government. Other jobs data such as JOLTS job openings and ADP Employment were also stronger than expected, as the pace of hiring in US firms picked up.

10-year UST yields continued to rise to 4.12% on 10th October after an upside surprise in US inflation data, bolstering expectations for a smaller 25bp US rate cut in November. In September, US headline CPI eased from 2.5% in August to 2.4% y-o-y, albeit higher than consensus expectations of 2.3% (m-o-m remained sticky at 0.2% vs. consensus 0.1%), mainly attributed to grocery prices (e.g. eggs, fresh fruits and butter). Meanwhile, core CPI rose from 3.2% to 3.3% y-o-y (consensus 3.2%, m-o-m stayed firm at 0.3% vs. consensus 0.2%), indicating a pause in the progress toward easing prices pressures, despite softer shelter costs. Subsequently, 10-year UST yields took a breather to touch 4.00% on 16th October, before resuming its uptrend after US retail sales grew from 0.1% in August to 0.4% in September m-o-m (consensus 0.3%). This was mainly boosted by miscellaneous stores, followed by clothing stores, health and personal care, as well as food and beverage stores, reflecting resilient consumer spending that continues to fuel the economy.

In mid-October, UST prices continued to be under pressure, with 10-year yields grinding higher to around 4.25%, driven by concerns over a potential Trump Presidency 2.0 amid a tightening race between him and Vice President Kamala Harris. As part of the "Trump Trade", investors started pricing in expectations of more tariffs and tax cuts, which may result in increased spending and government borrowing, as well as higher inflation, which may moderate the pace of future US rate cuts. Sentiment was also dented by a growingly cautious tone from Fed officials. On 21st October, Kansas City Fed President Jeffrey Schmid (non-voter) stated he favors a "cautious and gradual approach" in cutting interest rates given the uncertainty over the eventual neutral rate. His prudent views were also shared by Dallas Fed President Lorie Logan (non-voter) who reiterated her call for a measured pace in lowering interest rates as the economic environment remains uncertain. In addition, Minneapolis President Neel Kashkari (voter) echoed these views and added that he forecasts more modest cuts in the coming quarters. However, the Fed Beige Book showed that more than half of the US central bank's 12 districts reported "slight or modest" growth in employment, while most district said prices rose at a "slight or modest pace", suggesting that the US economy continues to slow despite upside surprises in employment, consumer prices and retail sales during the month.

Towards month-end, 10-year UST yields edged higher to touch 4.34% on 29th October before closing the month at 4.28%, as market sentiment remained weak ahead of the US presidential elections on 5th November, and as investors digested new UST supply totaling USD 183bil. Furthermore, US economic data releases continued to be robust. In October, ADP Private Employment rose significantly from 159,000 in September (revised higher from 143,000) to 233,000, far above consensus expectations of 111,000, led by education and health services, followed by trade and transportation. This suggests the labour market remained healthy despite Southeast US being hit by two hurricanes, and thousands of Boeing Co. workers going on strike. Reflecting optimism over the broader economy and labour market, the Conference Board of Consumer Confidence index jumped from 99.2 (revised higher from 98.7) in September to 108.7 in October (consensus 99.5), its highest level since the start of the year.

Brent crude oil prices initially surged in October, from USD 71.77/bbl at end-September to touch USD 81.16/bbl on 7th October, following the assassination of Hezbollah's leader in a massive Israeli attack. Brent prices subsequently pared gains and traded within the USD 71- 76/bbl range as investors shifted their focus on expectations of a substantial glut in oil supplies, before recovering to close the month at USD 73.16/bbl (m-o-m 1.9% higher).

In the beginning of the month, Brent prices marched higher from USD 71.77/bbl at end-September to touch USD 81.16/bbl, the highest level since August, amid concerns over a sharp escalation of the Israel-Hamas war. This came after the assassination of Hassan Nasrallah, the longtime leader of Hezbollah, by a massive Israeli attack in Beirut. Following the attack, Iran retaliated by firing rockets at Israel, igniting fears that Israel will target Iran's oil production capabilities. Iran has been pumping about 3.3 million barrels of crude a day in recent months, making it the third-largest producer in OPEC. Meanwhile, OPEC+ maintained its plans to gradually resume oil production by 180,000 barrels per day (bpd) in December, two months later than originally scheduled.

However, Brent prices pared gains to touch USD 72.50/bbl on 18th October, after a report that Israel may avoid targeting Iran's oil infrastructure eased concerns over tensions in the Middle East, prompting investors to shift their focus back to the softening oil demand outlook. On 14th October, OPEC trimmed its forecast for oil demand growth in 2024 and 2025 for a third consecutive month as the alliance acknowledged a slowdown in global fuel consumption. In its latest monthly report, OPEC reduced its global oil demand growth forecast by 100,000 bpd to 1.93 million bpd for 2024, and 1.64 million bpd for 2025. The downward revisions were prompted by lower-than-expected consumption in some regions. Nevertheless, OPEC highlighted that the demand growth figures were well-above the historical average of 1.4 million bpd seen before the COVID-19 pandemic. Separately, the International Energy Agency (IEA) reported that while the conflict in Iran poses a danger to the region's energy infrastructure, the oil market may face a sizeable glut in early 2025. The IEA also made small reductions to its demand growth projections and said extra capacity from OPEC+ nations is near record levels, pressuring Brent prices lower.

Subsequently, Brent prices briefly recovered to around USD 76/bbl on 24th October after China slashed its 1-year and 5-year loan prime rate (LPR) by 25bps each, as part of a package of stimulus measures to revive the economy, following reductions to other policy rates in September. The PBoC also indicated that the reserve requirement rate (RRR) for banks may be lowered by 25-50bps by year-end, depending on the liquidity situation. Nevertheless, Brent oil prices weakened again to touch USD 70.72/bbl on 29th October, after Israeli strikes against targets in Iran avoided the OPEC member's crude facilities in line with the Biden administration's request. The attacks were also more restrained than expected, providing comfort that hostilities in the region may potentially subside. Toward month-end, Brent prices recovered to settle at USD 73.16/bbl (m-o-m 1.9% higher), after US gasoline stockpiles for the week ending 25th October unexpectedly fell by 2.7 million barrels to 210.9 million barrels, the lowest since November 2022. Sentiment in the oil market was also boosted by reports that OPEC+ may delay its planned December oil output increase.

Fund Review

The Fund outperformed the Dow Jones Sukuk index return by 20bps in October, with returns of -1.62% compared to the index return of -1.82%. Year to date, the Fund outperformed the index by 263bps, with returns of 2.85% compared to index returns of 0.22%.

Portfolio Outlook and Strategy

In October, Saudi's Minister of Economy and Planning announced that the non-oil sector now accounts for 53% of Saudi's GDP. Private investment in the non-oil sector has surged by 70%, and the non-oil economy has grown 20% since the gov unveiled its reform plans. In 1H24, 184 companies such as PepsiCo and Deloitte relocated their regional headquarters to Saudi, while investment licenses jumped by 50%.

Meanwhile, Dubai approved its largest ever government budget for 2025-2027, featuring record-breaking revenues of Dh302 billion and planned expenditures of Dh272 billion. Around 46% of the spending will be allocated to infrastructure investments and related construction projects including the Al Maktoum international airport development and the new Blue metro line. The remaining 30% will be utilized for social development; 18% on security, justice, and safety sector; and the remaining 6% on supporting the public services sector.

While the overall outlook for fixed income remains positive amid expectations of further US rate cuts, the market may continue to fluctuate amidst mixed economic data releases, and ahead of the US general elections in November. The retracement in yields presents an attractive re-entry level, as the US Fed is widely expected to continue cutting rates in 2024 and 2025.

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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