Principal Global Investors Funds

Global Sukuk Fund

I Class September 2024

Market Review

Benchmark 10-year US Treasury (UST) yields initially sank by 30bps in September, from 3.90% at end-August to touch 3.60% on 17th September, driven by weak US economic data and dovish comments from US Fed members, who hammered home the urgency of a rate cut. The US central bank cut interest rates by 50bps to 4.75-5.00% on 18th September, marking an aggressive start to its first monetary policy easing in four years, citing slowing job growth and greater confidence that inflation is moving towards the 2.0% target. Chairman Jerome Powell stressed during his press conference, that the central bank will "take it meeting by meeting", indicating that more rate cuts remain on the table, but the pace will continue to be data dependent. 10-year UST yields drifted higher following the FOMC meeting, to end the month at 3.78% (m-o-m 12bps lower), as investors reacted to mixed US economic data. The UST yield curve shifted lower and bull steepened m-o-m, with the shortest 2-year UST yields tumbling by 28bps, 5-7 year yields sinking by 14-15bps, while the longer 10-30 year yields fell by 8-12bps.

During the first week of the month, 10-year UST prices rallied strongly, with yields sinking by 26bps from 3.90% at end-August to 3.64% on 6th September, mainly due to weak US economic data and dovish comments by US Fed members. In August, ISM manufacturing rose from 46.8 in July to 47.2 (consensus 47.5), albeit still in contractionary territory as demand remained weak, with new orders declining from 47.4 to 44.6. Similarly, ISM services grew modestly from 51.4 in July to 51.5 in August (consensus 51.4), as business performance and sales traffic continued to be hampered by persistently high prices and interest rate pressures. Furthermore, JOLTS job openings unexpectedly tumbled from 7.91 million in June (revised lower from 8.18 million) to 7.67 million in July (consensus 8.1 million), marking its lowest level since the start of 2021, in line with other signs of softening demand for labour. ADP Employment also surprisingly slowed from 111,000 in July (revised higher from 122,000) to 99,000 in August (consensus 145,000), as US firms added the least jobs since early 2021. This is in line with the Fed Beige Book released on 4th September, which stated that economic activity was stagnant or declined across most regions in the US, while employment levels were generally flat or increased slightly. While reports of layoffs were scarce, some companies acknowledged reducing shifts and hours, leaving advertised positions vacant or lowering headcount through attrition.

In August, US nonfarm payrolls jumped from 89,000 (revised lower from 114,000) in July to 142,000 (consensus 165,000), pushing the unemployment rate lower from 4.3% to 4.2% (consensus 4.2%), while average hourly earnings grew from 0.2% to 0.4% m-o-m (consensus 0.3%, y-o-y up from 3.6% to 3.8% vs. consensus 3.7%). This suggests that the job market is softening, but the low layoffs signals that the economy may be on track for a soft-landing. In mid-September, 10-year UST yields rallied further to touch an intra-day low of 3.60% on 11th September, anchored by expectations of a soft US CPI report. However, 10-year UST yields pared gains to 3.70% on 12th September after US CPI data surprised on the upside, denting expectations for a 50bp rate cut at the September FOMC meeting. In August, headline US CPI remained sticky at 0.2% m-o-m (consensus 0.2%, y-o-y down from 2.9% to 2.5%), while core CPI unexpectedly rose from 0.2% in July to 0.3% m-o-m (consensus 0.2%, y-o-y stayed firm at 3.2%), primarily due to sticky shelter costs, as well as volatile hotel and airfare prices. Similarly, US PPI increased from 0.0% (revised lower from 0.1%) in July to 0.2% m-o-m in August (consensus 0.1%), mainly driven by an uptick in services, especially for guestroom rental. Nevertheless, 10-year UST yields drifted lower to 3.60% on 17th September, after former New York Fed President William Dudley said he sees scope for a 50bp cut at the September FOMC meeting, lifting sentiment. This was despite the preliminary University of Michigan consumer sentiment index improving from 67.9 in August to 69.0 in September, with the tamest short-term inflation expectations since the end of 2020. The survey also highlighted that a larger share of consumers find unemployment potentially more worrisome in current conditions rather than inflation.

On 18th September, the US Fed voted 11-1 to cut interest rates by 50bps to 4.75-5.00%, marking an aggressive start to its first monetary policy easing in four years, citing slowing job growth and greater confidence that inflation is progressing towards the 2.0% target. The decision was opposed by Governor Michelle Bowman who favored a smaller 25bp cut, representing the first dissent by a Fed governor since 2005. During the press conference, Chairman Powell said the larger 50bps reduction was a "recalibration" of policy, to pre-emptively avoid further weakening in the labour market, while asserting that the economy remains strong. Powell also emphasized that the US Fed will "take it meeting by meeting", indicating that more rate cuts remain on the table, but the pace will continue to be data dependent. Meanwhile, the US Fed's updated dot plot also showed additional 50bp of easing in 2024, another 100bps in 2025 and 50bps in 2026, to achieve its longer-run Fed Funds rate of 2.75-3.00%. FOMC officials also raised their 2024 unemployment rate projections from 4.0% in June to 4.4%, and lowered its core PCE inflation expectations for 2024 from 2.8% to 2.6%. On growth, the Fed reduced its 2024 GDP projection slightly from 2.1% in June to 2.0%, and maintained its 2025 GDP forecast at 2.0%.

Following the FOMC meeting, 10-year UST yields drifted higher to around 3.75% as investors digested the impact of the Fed's rate cut, and turned their attention back to US economic indicators. Initial jobless claims for the week of 14th September slowed from 231,000 to 219,000 (consensus 230,000) while continuing claims for the week ending 7th September declined from 1.843 million to 1.829 million (consensus 1.85 million), indicating a healthy labour market despite recent worries of a bigger slump as job gains slowed. Subsequently, UST prices temporarily gained after the US Conference Board Consumer Confidence index unexpectedly sank from 105.6 (revised higher from 103.3) in August to 98.7 in September (consensus 104.0), marking its largest decline in three years, underlining concerns on the labour market and broader economy outlook ahead of the US presidential election in November. However, 10-year UST yields rose again to touch 3.82% on 26th September, after the third reading of 2Q24 US GDP stayed firm at 3.0% q-o-q (consensus 2.9%), even though personal consumption was revised slightly lower from 2.9% to 2.8% (consensus 2.9%). Towards month-end, 10-year UST yields pared losses to close the month at 3.78% (m-o-m 12bps lower), after the US Fed's preferred gauge of inflation eased, boosting market sentiment. In August, headline PCE inflation cooled from 0.2% in July to 0.1% m-o-m (consensus 0.1%, y-o-y down from 2.5% to 2.2% vs. consensus 2.3%), while core PCE inflation decreased from 0.2% to 0.1% m-o-m (consensus 0.2%, y-o-y up from 2.6% to 2.7% vs. consensus 2.7%). The modest increase in PCE inflation suggests that consumers are becoming more frugal in their spending habits and the momentum in spending is tapering, further supporting the case for continued easing in US monetary policy.

Brent crude oil prices initially slipped in September, from USD 78.80/bbl at end-August to touch USD 68.68/bbl on 10th September, as continued weakness in the world's two largest economies ignited concerns of an oil oversupply starting next year, despite OPEC+'s decision to delay its output hike for another two months. Nevertheless, Brent oil prices subsequently recovered to USD 75.87/bbl on 24th September after Chinese policymakers announced stimulus packages to revive its economy, before closing the month at USD 71.77/bbl (m-o-m 8.9% lower) amid reports that Libya will resume oil production.

In early September, Brent oil prices plunged to its lowest level since December 2021, driven by worries over a supply overhang, after the US and China reported weak manufacturing and services data. Brent oil prices continued to be pressured lower even after OPEC+ announced that it will delay a planned oil output increase of 180,000 barrels per day (bpd) for October and November, until December at the earliest. Previously in June, OPEC+ extended its original 3.66 million bpd cuts (due to expire at end-2024) until end-2025. The voluntary 2.2 million bpd cuts was extended from end-June to end-September, and were supposed to be gradually phased out from October 2024 to September 2025.

Nevertheless, Brent oil prices subsequently recovered to USD 75.87/bbl on 24th September, after Chinese policymakers announced a series of stimulus packages, in the boldest attempt since the pandemic to revive its economy and achieve this year's annual growth target. The People's Bank of China cut key short-term interest rates and mortgage rates, reduced minimum downpayments for housing purchases and reduced banks' reserve requirement ratios (RRR) to the lowest level since 2018. This also marks the first time reductions to both interest rates and RRR were revealed on the same day since 2015. Sentiment in the oil market was also boosted by the OPEC alliance's positive outlook that global oil demand will continue to grow until the middle of the century. According to OPEC's annual long term outlook report, world oil consumption is set to grow by 17.9 million bpd, or approximately 18%, to 120.1 million bpd by 2050, citing growth led by India, Africa and the Middle East. Additionally, OPEC said their increasingly bullish outlook compared to last year reflects advanced economies' re-evaluation of the transition from fossil fuels as they address "the need for energy security". The surge in Brent oil prices was also bolstered by the US Fed's steep 50bp rate cut at its September FOMC meeting, as a softer monetary policy outlook fostered expectations of stronger future oil demand. However, Brent oil prices subsequently pared gains to close the month at USD 71.77/bbl (m-o-m 8.9% lower), amid prospects of resumed oil supply from Libya.

Fund Review

The Fund outperformed the Dow Jones Sukuk index return by 7bps in September, with returns of 0.95% compared to the index return of 0.88%. Year to date, the Fund outperformed the index by 247bps, with returns of 4.55% compared to index returns of 2.08%.

Portfolio Outlook and Strategy

In September, S&P upgraded Oman's sovereign rating back into investment grade from BB+ to BBB-, citing the government and its related entities continued balance sheet deleveraging. Oman looks set to be the first GCC country to introduce personal income tax. Based on preliminary data, foreign nationals will be taxed 5-9%, while citizens will be taxed 5%. Oman's corporate tax was introduced in 2009 and raised from 12% to 15% in 2017, while VAT was implemented in 2021 at 5%.

Meanwhile, S&P affirmed Saudi's A rating and upgraded its outlook from Stable to Positive, as the government's wide-ranging reforms and investments will underpin the development of the non-oil economy while upholding sustainable public finances.

UAE Central Bank revised up its 2024 GDP forecast from 3.9% in June to 4.0%, boosted by the non-oil sector (while 2025 GDP revised to 6.1%). Growth is expected to continue to be driven by transportation, financial and insurance services, construction and real estate, and communications sectors. In 1H24, UAE's airports recorded a 14.2% increase in passenger traffic at the Abu Dhabi and Dubai International Airports.

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.

Important Information

Disclosures

The information in this document has been derived from sources believed to be accurate. It contains general information only on investment matters and should not be considered as a comprehensive statement on any matter and should not be relied upon as such. The information it contains does not take account of any investor's investment objectives, particular needs or financial situation. You should consider whether an investment fits your investment objectives, particular needs and financial situation before making any investment decision.

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