FTFS Luxembourg Shariah Funds

REPORT OF THE INVESTMENT MANAGERS — 6 months to 30 April 2022

Market Review

Global Sukuk markets, as represented by the Dow Jones Sukuk Index, retreated over the six-month review period. The declines in the Sukuk market were significantly less than those from broader global bond indices such as the FTSE World Government Bond Index and the Barclays Global Aggregate Index. Sukuk markets also fared better than emerging market (EM) bonds (represented by the JPMorgan Emerging Markets Bond Index Global (EMBIGD) Diversified, which tracks hard-currency EM government bonds), as faster monetary tightening in the US contributed to a rally in the US dollar, which strengthened against most major currencies.

Yields rose in the Sukuk market over the period, while spread narrowed. The prospect of central banks tightening monetary policies, which weighed on markets in late 2021, increased in early 2022 as supply chain issues and labor shortages accelerated inflationary pressures. In February, Russia invaded Ukraine, adding to supply concerns and spurred a defensive rotation as investors adopted a broad "risk-off' sentiment. Commodity markets surged and crude oil prices advanced overall, largely driven by geopolitical conflict and supply restraints.

Fund Performance

██████ Global Sukuk Fund returned -4.8% on a gross basis and -5.5% on a net basis in the 6 months to 30 April 2022, outperforming its benchmark, the Dow Jones Sukuk Index, which returned -6.0% over the same period, all in US dollars.

Yield-curve movements had a significant positive impact on relative returns, mainly due to US-dollar duration exposure. Exposure to the Egyptian rates also improved returns, though Malaysian rate exposure hampered performance. Currency exposure detracted from returns as a result of exposure to the Malaysian ringgit and Egyptian pound.

Security selection was positive for relative performance. Aiding results were selections among sovereigns and, to a lesser extent, corporate financials and quasi-sovereigns. Meanwhile, selection among corporate industrials weighed on relative returns. Asset allocation detracted as cash exposure and an overweight in corporate industrials held back performance, partially offset by the positive effects of an underweight in supranationals and an overweight in corporate financials.

Outlook

Regarding the increased geopolitical risks in Europe, Ukraine and Russia are remote from Sukuk-issuing countries and the linkages are not direct or easy to identify, but there is often an impact when geopolitical escalations such as this materialise. For sovereigns, the benefit of exposure to energy buffered the geopolitical volatility due to the rise in prices. The improvement to sovereign fiscal balances is significant. In fact, each US$10 increase in oil prices adds approximately US$75 billion to GCC revenues. So, in the short term the GCC is benefitting from higher oil prices, but if the crisis metastasizes, this will be tempered by economic slowdowns and pressure to increase oil supplies, as well as potentially forcing political compromise that could disrupt fiscal and structural reform momentum.

As for corporates, real estate companies in the GCC, particularly Dubai, do have some Russian and Eastern European clients but our research suggests it is minimal, below 3%. Banks may have some investment exposure, but this too is expected to be limited. In Qatar, for example, asset exposure to the “rest of the world” or “other countries” is between 1-3%. Fortunately, exposure is generally low for regional corporates.

Looking forward to benchmark rates, following the Fed’s first rate hike this cycle, we find that the market has priced a significantly hawkish path and an elevated peak policy rate. We are increasingly inclined to reduce our duration underweights and take advantage of regional credit curves that have steepened. Uncertainly around the geopolitical outlook is an added benefit to increasing duration as a hedge to an escalation in the current crisis.

Global Sukuk’s defensive characteristics appear set to stand out once again. So far, the market impact from the war in Ukraine has been minimal, and the sector is relatively well placed compared to other fixed income sectors, but we view recent developments as extremely serious and warranting a patient, risk-aware approach to deploying capital. We are starting to favour investment-grade credits over high-yield, and to increase our duration exposure to appropriately reflect the late stage of the cycle that we believe we are in. The correction in fixed income markets globally presents an attractive opportunity for returns outright but also as a complement to riskier assets, such as equities.