Quarterly Portfolio Update

Pioneer Funds – Euro Strategic Bond
29 December 2017

BOND COMMENTARY

Market Review

The year ended with the passage in the U.S. of a sweeping tax bill that involved a cut in the corporate tax rate from 35% to 20%. The FOMC raised its Fed funds target rate by 25bps (to 1.5%) and left its post-meeting communication largely unchanged. Median interest-rate projections were left at three more hikes projected for 2018. U.S. Treasury yields rose as a result and the yield curve ended the year the flattest it has been since 2007.

The ECB also left its monetary policy and guidance unchanged while displaying greater optimism for the growth outlook. This was supported by a further pickup in Eurozone PMI's, in particular the Eurozone manufacturing PMI kept on accelerating despite the stronger Euro which hit its highest level since 1997.

Still inflation figures remained weak, both in the U.S. and Europe. The oil price saw only a modest bounce as OECD agreed to continue with production cuts.

In the week following the Fed decision, the U.S. 10-year rate rose from 2.37% to a 6-month high of 2.49% before falling back to 2.40% before year end. In Germany the 10-year rate jumped from 0.30% to 0.42% by year end.

Despite strong macroeconomic evidence, High Yield (HY) proved sluggish in the final months of the year after what has otherwise been a strong showing in 2017. High yield bonds ended the year posting marginal negative returns in December capping a modest positive final quarter. European HY outperformed US HY in the quarter and December amid rising U.S. core interest rates. As we approached December lower quality financial names outperformed despite market liquidity beginning to ebb.

Supported by abundant liquidity, investors remained strong net buyers of Emerging Markets (EM) in the quarter. Continued high levels of inflows resulted in a strong level new issuance, which in turn supported some issuers with weaker fundamentals. The result was a period that generally rewarded strategies that allocated toward higher yielding countries and issuers.

While performance in EM was broadly positive, the quarter did see the emergence of a number of situations that potentially could influence returns in 2018. Topping this list are the events surrounding Venezuela, which ISDA eventually ruled a sovereign default. With oil prices falling in 2017 and production weakening because of sanctions, Venezuela's leadership faced the impossible task of servicing more than $150 billion in debt. Sanctions may further constrain resolution of Venezuela's situation, as U.S. institutions hold a substantial proportion of the country's debt.

In currencies, the U.S. Dollar weakened vs the Euro on evidence of strong growth momentum in the eurozone and speculation about changes to ECB policy going forward.

Portfolio Review

The Portfolio performance was modest over the quarter as we held a more cautious stance going into the final part of the year. Year to date, the Portfolio has delivered solid positive absolute returns at very low levels of volatility.

The Portfolio has significant exposures to credit markets, with the majority invested in Corporate HY securities. Within these credit investments, the Portfolio has diversified holdings across both Emerging Markets and Developed Markets (DM), but retains an EM bias.

Overall, our allocation was positive with EM Corporate and HY allocations benefitting the Portfolio. Sector wise, our holdings in banking performed well.

Over the quarter, our hedging positions designed to reduce volatility in the overall Portfolio, detracted marginally from Portfolio performance. Notably, we held a tactical hedge of part of our EM exposure in efforts to reduce potential negative impact from uncertainty surrounding the next policy move by the Fed. This position detracted as EM issuers continued

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to rally. We took the opportunity to add to EM Sovereign debt risk in December.

We further decreased spread sensitivity over the period on increased markets' volatility and geopolitical tensions. We finished the year at 0.1 year and have credit spread duration of 2.1 years.

In the European HY space, the market remains at a tight spread range and we prefer to act in the primary market for both bonds and loans, where we see opportunities arise. We maintain our exposure to Financials, which are a beneficiary of Europe's economic recovery. We added to the IG market through senior secure financials floaters, favouring IG quality banks with global brands which improve the quality of investing in high capital structure within the Portfolio.

We retain a c.6% exposure to loans to diversify the Portfolio, enjoy stable returns and exploit the relatively attractive yield and volatility profile of the instruments.

Outlook

We enter 2018 with a moderately constructive outlook, despite expectations for a broad based and robust global expansion.

In our view, the most likely sources of risk in the market logically flow from the conduct of monetary policies and thus Central Bank behaviour. Thus we continue to believe that the outlook will be dependent on Central Bank's actions, with a potentially greater impact from geopolitical events.

With market returns running high on lower volatility, we note that risks appear skewed towards the downside. Central Banks globally have indicated a desire to normalise monetary policy, despite a seeming lack of pick-up in inflation. We believe that they should remain accommodative but are also very gradually preparing the markets for softening this policy stance. In addition, we continue to believe there could be more of a shift towards fiscal expansion in the U.S. and Europe which combined leads us to expect upward pressure on bond yields.

However, we do not see a trigger for default rates to move significantly higher from here as long as growth remains solid and interest rates low.

We reflect our moderate constructive view through our preference for EM and HY issues, which are well supported as a result of the higher yield on offer in a low yield environment and an improved macroeconomic backdrop. Flows remain positive albeit less favourable than before. This positioning is balanced with a short duration stance, whilst maintaining flexibility via a longer cash balance - a position which relatively reduces the rate sensitivity and therefore convexity of the overall portfolio.
We continue to look closely at our issuers for signs of fundamental performance trend change, as part of a process of active beta management. Another benefit of this approach is our ability to play specific yield opportunities as they arise, such as exposure to leverage loans.

Overall, political uncertainty and Central Bank volatility continue to play a major role both in the U.S. and Europe. We believe it is important to maintain a well-diversified Portfolio and to focus on active management, quality of assets and downside risk mitigation, which could be crucial in the current market.

Important Information

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