Quarterly Portfolio Update

Pioneer Funds – Euro Strategic Bond
29 September 2017

BOND COMMENTARY

Market Review

The third quarter of 2017 was dominated by three major themes: Economics, Politics, and Central Banks' communications. Bond yields experienced continued volatility throughout the quarter, driven in large by geo-political tensions, economic data and the impact of the hurricanes in the U.S. The major Central Banks of the world – the Fed, the ECB and the Bank of England (BoE) all sought to clarify their intentions regarding policy normalisation, and their message seemed clear; markets should prepare for a less accommodative Monetary Policy heading into 2018. Corporate Credit spreads, despite tight valuations, closed the quarter relatively unchanged.

In aggregate, core bond yields displayed a divergent performance during Q3 across the major markets. The German 10-year yield opened the quarter at 0.46%, climbed to nearly 0.60% in July, then dropped to 0.31% in early September following political tensions between North Korea and the U.S. By quarter end, the yield was back at 0.46% as a result of ongoing robust growth data in Europe and positive risk sentiment. The U.S. 10-year yield also closed the quarter relatively unchanged at 2.33% versus 2.30% at the end of Q2, but had dropped to 2.04% at one point, in response to political volatility and concerns about U.S. President Donald Trump's administration. Following indications by the U.S. Fed that it might start unwinding its balance sheet and would continue to raise U.S. interest rates, the yield climbed back to 2.33% at quarter end. In the U.K., the 10-year bond yield also had some volatile movements throughout the quarter (at one point dropping to 0.97%), but closed at 1.37% following the BoE's indications that a rate hike at its next meeting was imminent.

Emerging Market (EM) sovereign market (as measured by the JP Morgan Emerging Markets Bond Global Index) detracted -0.28% in September but has added +3.55 % over the quarter (in U.S. Dollar terms; the base currency for the asset class). Investors were more constructive on EM despite a number of local challenges. Investors shrugged off tensions with North Korea, while in EM Asia, a combination of benign inflation and policy easing led to strong inflows in the period, a result that lifted 2017's flows into record breaking territory. Local currency sovereigns were, however, adversely affected by the depreciation of many EM currencies in September.

The EM credit market (as measured by the JP Morgan Corporate Emerging Markets Broad Diversified Index) delivered 2.3% for the quarter.

Year to date, total inflows in EM bonds now stand at +USD 92.4 bn with USD 58.7 into hard currency bonds and the remainder into local currency bonds.

In currency markets, the Euro continued to strengthen during the quarter and, at its highest, reached 1.20 against the U.S. Dollar and 0.93 against Sterling. This is the first time since the beginning of 2015 that the Euro has seen such an appreciation versus the U.S. Dollar. We believe this is largely driven by tapering expectations regarding the ECB's bond-buying programme and supportive capital flows. Meanwhile the U.S. Dollar continued to fall during the quarter amid geopolitical risk, and the problems faced by President Trump's administration in enacting proposed legislations. At quarter end, the U.S. Dollar was down more than 14% against the Euro when compared to the beginning of 2017. Sterling was also down as doubts about economic growth and ongoing Brexit discussions continued. Safe haven currencies including the Japanese Yen and Swiss Franc had a good quarter, with both benefitting from the risk off environment resulting from geopolitical tensions.

Portfolio Review

The Portfolio performance was positive for the quarter. Year to date the Portfolio has delivered solid positive absolute returns.

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

Overall, our allocation was positive with EM Corporate and HY allocations benefitting the Portfolio. Positioning in EM is biased towards the short-end, which held back some performance.

Sector wise, Metal & Mining, Energy and Finance had a good quarter, while Consumer Staples underperformed.

Over the quarter, our hedging positions designed to reduce volatility in the overall Portfolio detracted marginally from Portfolio performance. Notably, we hold a tactical hedge 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 to rally.

In terms of Portfolio activity, we sold some sub-Saharan exposure in Nigeria,Ghana and Zambia, as well as reduced specific idiosyncratic risk on Egypt, Ukraine and Greece. Gradually over the quarter, we further added to our liquidity cushion and finished with a certain proportion in cash.

We continue to favour HY over Investment Grade (IG), as risk seems asymetric with IG not pricing sufficiently for risk although spreads have narrowed. We became positive on duration at quarter end, finishing at 1.34 years and have credit spread duration of 2.2 years.

In European HY space, markets remain at the tightest 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 IG markets through senior secure financials floaters, favouring IG quality banks with global brands and improved the quality of the Portfolio investing in high capital structure.

We retain a c.5% exposure to loans to diversify the Portfolio, seek stable returns and potentially exploit the relatively attractive yield and volatility profile of the instruments.

Outlook

We maintain a cautious outlook for the remainder of the year. We believe that the outlook will be dependent on Central Banks' outlooks and actions, with a potentially greater impact from geopolitical events. Thus far this year, 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 gradually preparing the markets for their next move of potentially softening QE support.

In the U.S., the Fed's September meeting implied that another rate hike would be invoked by the end of the year and possibly a further two or three before the end of 2018, but markets appear unwilling to fully price this in. The Fed has also signalled the start of its balance sheet normalisation process. Our anticipation is that economic growth should remain around current levels, and that, as the unemployment rate continues to fall, the Fed may grow increasingly concerned about the outlook for inflation. The Tax Reform has returned to the forefront and should a reform package be passed, it could provide a significant boost to growth and inflation expectations, which the market is not discounting, and which in turn could force the Fed into a faster pace of tightening than currently priced.

In Europe, we continue to believe that the reflationary theme should continue, particularly given the strength of actual growth levels seen this year. Most forecasters anticipate that overall Euro-area GDP could be in excess of 2% by year end, and risks for 2018 forecasts are to the upside. In terms of monetary policy, the ECB has recently become more vocal in preparing the market for a normalisation of its unconventional policy, starting in early 2018. The ECB is likely to signal their next move before year end but markets remain divided on the speed and length of the tapering process. We believe a shorter and/or more aggressive taper could cause bond yields to spike higher whereas a longer and more gradual taper could see yields rising gently over the course of 2018.

In European politics, it appears that Chancellor Angela Merkel will most likely form the next government in Germany but as part of a rainbow coalition. This may result in positive fiscal impulse in Germany (which the market does not price) but also ultimately a less EU/Euro friendly approach. Italian elections now look likely to be pushed out into spring 2018, removing an immediate source of concern for the markets. We continue to believe there could be more of a shift towards fiscal expansion in Europe, which leads us to expect upward pressure on bond yields.

In Credit, we continue to see some value in selected portions of the European IG market and our positioning remains cautiously constructive. The ECB Corporate Sector Purchase Programme is bringing spreads tighter and improving European economic data. Furthermore, while idiosyncratic risk from shareholder friendly measures such as M&A may be on the rise in Europe, so far credit profiles have been relatively resilient, buoyed by low interest costs and rising operating earnings. However, we reiterate that there remain a broad range of potential known and unknown triggers for an increase in overall market volatility, ranging from Central Bank policies to geopolitical risks, and at current compressed valuations, there is as a whole declining reward for less liquid positions across the IG credit universe.

In terms of sector preferences, we continue to see value in Real Estate and Insurance and Subordinated Financials with valuations still attractive and fundamentals in these sectors continuing to improve, with earnings leveraged to a rising interest rate environment.

In currencies, we continue to believe that the U.S. Dollar, longer-term, should receive support from a potential “risk-off” environment, as politics and Central Bank risk assumes a greater role in investors’ minds over coming months. In Europe, as political risk diminishes and as economic data strengthens, overseas investors’ fears about a potential Euro break-up are reducing and the relative underperformance of Euro assets makes them look attractive from a valuation perspective. Out of Japan, with the Bank of Japan committed to maintaining the 10-year Japanese government bond yield around 0%, the divergence in yield differentials between Japan and the U.S. is expected to grow during 2017. This should undermine the Japanese Yen and we could see some further depreciation over the next 12 months. We continue to maintain a short Japanese Yen position, mostly against the Euro. Finally in the U.K., Sterling has been marking time between a depreciating U.S. Dollar and an appreciating Euro, but generally appears to be insulated from what’s happening with Brexit negotiations. We think that Sterling at current levels may already be discounting a positive economic outlook.

Overall, political uncertainty and Central Bank dampened volatility are playing a major role both in the the U.S. and Europe. We believe, it may be 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. In this context, a rigorous risk management approach should be followed, whilst maintaining flexibility via a longer cash balance.

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