Monthly Portfolio Update

Pioneer Funds – Euro Strategic Bond
31 August 2017

BOND COMMENTARY

Market Review

August was a lacklustre month in bond markets. Bucking the trend was emerging market issuances, which benefited from continued spread thightning and declining treasury yields.

Overall sentiment was weighed down by a continued lack of volatility, an uneventful meeting of Central Banks at Jackson Hole symposium, and the debt ceiling debacle which kicked off towards the end of the month. Investors were left wondering if the U.S. Congress may vote to raise America's debt ceiling or risk defaulting on its debt ahead of the 29 September deadline. Oil markets experienced some volatility as Hurricane Harvey made U.S. landfall on 25 August, with the price of Crude Oil down almost $3/bbl month-on-month as a result.

In aggregate, core bond yields fell across the board during August. Political disruption between North Korea and the U.S. was heavily influential in directing markets and was the main driver of yields. U.S. President Donald Trump's "fire and fury" threats to North Korea's Kim Jong-un resulted in a risk off environment which was supportive of bonds and other safe haven assets but was unfavourable for Corporate Credits. North Korea's missile launch over Japan at the end of the month further secured investors search for safe haven assets and bond yields continued to fall. At month end the U.S. 10-year Treasury yield had dropped 17 basis points month-on-month, closing at 2.12%. German 10 year Bunds fell 18 basis points to 0.36%.

There were no changes to monetary policy settings during the month. At its August meeting, the Bank of England's (BoE) Monetory Policy Committee (MPC) left interest rates unchanged, with a majority of 6-2 in favour of maintaining the current 0.25% rate. The Committee's assement of UK inflation pointed to a slow pick-up in the near term, partly fueled by the depreciation of the British Pound and uncertainties surrounding Brexit discussions. At the annual Jackson Hole symposium, Central Banks failed to deliver any news on important policy issues. The Bank of Japan's (BoJ) Governor Haruhiko Kuroda made reference to the pace at which the Japanese economy is growing (Q2 growth was stronger than expected at 4%), and stated that Japan would continue its monetary policy accomodation for "some time" but did not elaborate on this. The U.S. Fed Chairperson Janet Yellen focused her speech on the progression of theU.S. regarding financial regulation, but made no reference to raising U.S. rates or the scaling back of the U.S. $3trn Balance Sheet. The ECB's President Mario Draghi stuck to a theme of "fostering a dynamic global economy" and spoke about the importance of free trade. His distinct lack of reference to monetary policy decisions could lead investors to expect an adjustment to be made at September's ECB meeting.

In Emerging Markets (EM), Sovereign issuers outperformed their corporate counter parts marginally. Investors became more constructive on emerging markets 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.

In Currency markets, the Euro continued to strengthen during August and, at its highest, reached 1.20 against the U.S. Dollar and 0.93 against the British Pound. 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 it may be largely driven by tapering expectations regarding the ECB's bond-buying programme. Meanwhile the U.S. Dollar continued to fall during the month amid geopolitical risk, and the problems faced by President Trump's administration in enacting proposed legislations. The British Pound also struggled throughout August as doubts about economic growth and ongoing Brexit discussions continued. Safe haven currencies including the Japanese Yen and Swiss Franc had a good month, with both benefiting from the risk off environmint.

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ASSET MANAGEMENT

Portfolio Review

The Portfolio performance was marginally positive for the month of August and keeps trending up. 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 Sovereign allocations benefiting the Portfolio. Positioning in EM is biased towards the short-end, which held back some performance however.

We saw positive contributions from our positions in distressed debt, while our exposure to gold also rallied on the back of rising tensions on the Korean penisula. We took some profits from this positioning towards the end of the month as tensions seemed to be reaching a peak for now.

Sector wise, Banking and Metal & Mining had a good month.

Over the month, our hedging positons design to reduce volatilty 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 Federal Reserve. This position detracted as EM issuers continued to rally.

August was a quite period in terms of Portfolio activity. We took some profits in select names as pricing was reaching expensive levels in a relative illiquid market.

As a result, overall Portfolio positioning remains unchanged. We continue to favour HY over investment grade (IG), while we maintain a short duration positioning. While government bond yields declined further in August, we still expect rates ultimately to move up. Our duration positioning has trended lower as a result. Overall, we currently have a duration position of close to zero, with our credit spread duration at approximately 2 years. We continue to favour shorter dated issues, albeit we have extended spread duration exposure to some existing EM names in the Portfolios.

Our liquidity cushion remains high at c.18%, while we hold a long U.S. Dollar position of around 3%.

We retain a c.5% exposure to loans to diversify the Portfolio, enjoy stable returns and 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 may be dependent on Central Banks' outlooks and actions, with a lesser impact from geopolitical events. Thus far this year, Central Banks globally have indicated a desire to normalise monetary policy, despite some concerns about a lack of pick-up in inflation. We believe that Central Banks may remain accommodative but they are also gradually preparing the markets for their next move of potentially softening QE support.

In the U.S., the Fed are hinting at another rate hike in 2017, plus some imminent reduction in balance sheet size, which could begin as soon as September.

Market expectations on the Fed hiking cycle diverge however from the projections of the FOMC members ("the Dot Plan"), as the market expects a more gradual hiking cycle. Our anticipation is that economic growth should remain around current levels, and that, as the unemployment rate continues to drop towards the 4% level, we expect that the Fed may grow increasingly concerned about the outlook for inflation. Going forward, we believe that much of the focus in the U.S. may be on the implementation of President Trump's pre-growth policies and how they may impact growth and inflation. Should President Trump be successful in implementing some of his policies, such as Tax reform, this could provide a significant boost to growth and inflation expectations, which in turn could force the Fed into a tighter pace of tightening than currently envisaged.

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 now expect overall Euro-area GDP to be around or above 2% by year end. 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 2018. Previously, the ECB had suggested that they wanted to see a sustained and Euro-wide pick-up in inflation before starting to taper their Corporate Sector Purchasing Programme (CSPP). However, recent speeches by Governing Council members, and particularly ECB President Draghi, indicated that they are prepared to look through what they regard as temporary inflation weakness. We believe that the ECB's policy shift could be a major market theme for the remainder of the year and could drive European rates higher by year end. In European politics, Germany will go the polls, with Frau Merkel's chances of a 4th term as Chancellor looking increasingly likely. 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. While we are increasingly of the view that valuations are becoming stretched, in support of a continued grind tighter over the summer months is ongoing ECB CSPP buying, improving European economic data and the recent market friendly outcome to the French presidential and parliamentary elections. Also, 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 our positioning, our preference is for selected IG issuers of subordinated bonds both in Financials and Non-Financials, which offers less attractive risk-reward. In terms of sector preferences, we continue to view 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 BoJ 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., the British Pound 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 the British Pound 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 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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