Quarterly Portfolio Update

Pioneer Funds – Strategic Income
29 September 2017

Bond COMMENTARY

Market Review

Robust, synchronised global growth and rising corporate profits, amid broadly supportive global central bank policy, drove strong performance in credit and equity markets; government yields ended the quarter modestly higher than in June. Continued strong employment and higher consumer confidence together with easy financial conditions, solid global growth and a depreciating U.S. Dollar contributed to better than expected 3.1% second quarter U.S. GDP growth. Eurozone, China and Japan second quarter growth surprised to the upside as well, with China's strong growth and demand for commodities being instrumental in supporting emerging market growth. Despite higher oil and commodities prices, inflation continued to moderate both in the U.S. and globally, so that major non-U.S. central banks maintained easy monetary policy. As expected, the FOMC announced the October commencement of balance sheet tapering; markets were surprised, however, that the FOMC held firm on its plan for a gradual increase in the target Federal Funds rate, in spite of the "mystery" in Chair Yellen's words, of the below-target inflation level.

The 10-year yield rose from 2.30% to 2.33% over the quarter, while the 10-year breakeven rose from 1.74% to 1.85%. 10-year U.S. Treasury bond prices rallied into early September on lower inflation and increased geopolitical risk. After bottoming at 2.06%, yields rose dramatically over the rest of the month in response to the FOMC's commitment to raise rates, higher inflation expectations driven by strong GDP growth, recovering oil prices,the potential for tax reform, and expectations of tighter global monetary policy. Agency MBS delivered strong excess returns of 0.47% for the quarter, primarily reflecting a September rally, when the sector benefitted from rising yields, the prospect for relative rate stability going forward, and the FOMC's well-broadcast taper announcement. Non-agency MBS and CMBS also outperformed Treasuries, although the CMBS underperformed RMBS, due to concerns about the impact of the Texas and Florida hurricanes on commercial real estate, and about higher new issuance. Investment Grade (IG) and High Yield (HY) corporates gained most or all of their excess return in the more positive September market environment, as investor concerns about geopolitical risk and the heavy new issuance dissipated, and oil prices rose. With respect to floating rate sectors, bank loans underperformed HY, returning 1.02%, compared to the 2.04% return of HY. Catastrophe bonds suffered a 5.0% loss over the quarter, reflecting a 6.3% loss sustained in late August and September from three consecutive U.S. hurricanes. Emerging Markets (EM) were the big winners in the third quarter, with both sovereigns and corporates returning over 2%, benefitting both from both strong Chinese growth and strong domestic demand. Unlike other credit sectors, EM did not post significant returns in September; sovereigns were down 0.1%, and corporates gained 0.3%. The broad Dollar Index fell a net 2% over the quarter, reflecting its decline until early in September, when it began to appreciate in response to the FOMC's unchanged rate projections, which included a December increase, as well as the upward revised second quarter U.S. GDP growth.

Portfolio Review

The Portfolio outperformed the -0.35% monthly return of its benchmark, the Bloomberg Barclays U.S. Universal Index, and performed in line with it for Q3.

Third Quarter Performance
The Portfolio benefitted from the lower relative credit quality of its holdings, as well as from security selection, particularly within the energy sector and EM issues.

Positive:

- Portfolio returns benefitted from the lower credit quality of its holdings within Industrials, Financials, ABS, and agencies, the last of which reflects EM exposures. BBBs and HY issues outperformed over the quarter.
- The Portfolio benefitted from security selection within Industrials and EM. In particular, select energy credits outperformed, as well as sovereign EM holdings.

Amundi ASSET MANAGEMENT

- Currency exposures contributed modestly to performance, particularly the proxy hedge of the long Norway/Sweden short Euro.

Negative:

- The relative short duration position of 1.25 years hurt performance, due to the impact of the negative carry associated with the position. This negative impact was mitigated by the benefit of the barbelled yield curve position.
- While overall sector allocation had a neutral allocation on the Portfolio, the benefit of the underweight to Treasuries was offset by the underperformance of the 2.6% allocation to catastrophe bonds.

September Performance
Positive:

- The 1.32 year relative short duration position was the major contributor to performance, reflecting the dramatic rise in yields over the month. The Portfolio had increased its relative short duration position in light of what we believed was an unsustainably low 10-year yield, and low market expectations for a rate increase. The barbelled yield curve position also contributed to performance, as the yield curve flattened.
- The Portfolio benefitted from security selection within Industrials, particularly from energy credits that responded to a 10% increase in oil prices over the month.
- Portfolio returns benefitted from the lower relative quality of the Portfolio's holdings within Industrials and, to a lesser extent, Financials.

Negative:

- Both sector allocation and currency exposures detracted modestly from performance. Sector allocation was hurt by the 2.4% exposure to catastrophe bonds. Non-Dollar currency exposure underperformed, as the Dollar rallied over the month.

Outlook

The team has become more constructive regarding both U.S. and global GDP growth. Within the U.S., solid employment may continue to support consumption and the housing market, while the economy may also continue to benefit from higher corporate profits, reflecting improved global growth, easy financial conditions and lower regulation. We believe tax reform may further bolster corporate profits and the economy in 2018. While the market has now priced in higher expectations for a 2017 December rate increase, the market has priced in a 1.66% Fed Funds rate by the end of 2018, well below the median level of the FOMC projections of 2.13%. We believe the market continues to be "behind the curve" in their views on the appropriate level of interest rates. Despite the Fed's concern about relatively low inflation, we believe they will proceed with their planned rate increases. Although the U.S. Dollar appreciated in September, we believe it will depreciate in the longer term, as yield differentials between the U.S. and developed markets narrow. Improving global growth may drive more central banks, including the ECB, to consider withdrawal from quantitative easing policies. In addition, Trump's preference for a lower Dollar, the openings on the FOMC, including the Chairman position in early 2018, and the potential for more expensive trade, may put a brake on dollar appreciation.

Positioning

The Portfolio continues to be positioned for rising interest rates, and a solid economy. It modestly reduced its relative short duration position, as yields rose in expectations of more rate hikes and higher inflation. We have moderated our views regarding relative value between agency MBS and IG corporates, based on outperformance of agency MBS over the past month; we currently slightly favour IG corporates, but on a highly selective basis.

- Overweight to diverse credit sectors, underweight to U.S. Treasuries. Most U.S. government debt is unattractive, while credit sectors may benefit from stronger growth, lower taxes, and less regulation.
- The Portfolio holds a 1.2-year relative short duration position compared to its benchmark. We believe the market may be behind the curve, given solid GDP growth, little slack in the labour market, and an average 1.5% to 2% inflation over the rest of the year.
- We hold long-duration TIPS, and believe the recent decline in breakevens does not accurately reflect the longer-term potential for 2% inflation.
- The Portfolio holds a near-neutral weight in agency MBS, but including the exposure to non-agency MBS, remains significantly overweight to RMBS. We hold this overweight to RMBS because we believe that MBS offer attractive

value. Fundamentals for the housing sector remain strong, given improving employment, the recent decline in longer-term rates, and attractive home price affordability.

- The Portfolio remains underweight to IG corporates, but continues to hold an overweight to high yield corporates. Tighter spreads and higher leverage is counterbalanced by strong fundamentals.
- Within corporates, we hold an overweight to Financials. We have increased exposure to European banks, and reduced U.S. bank exposure, based on more attractive relative value and the positive outlook for GDP growth in the Eurozone. More generally, we believe the Banking and Insurance sectors offer attractive relative value. While spreads are modestly lower than the broad corporate benchmarks, Financials should offer lower event risk of share repurchases or credit impairment due to M&A activity. Banks are currently focused on improving capital ratios to meet regulatory requirements. Banks should also benefit from rising global yields and steepening yield curves.
- We continue to hold an overweight to the Energy midstream sub-sector, a sector that shows relatively less sensitivity to oil price volatility. We expect continued spread tightening in the space, which remains one of the wider-trading subsectors in IG. While OPEC's extension of production cuts should help offset increased production from U.S. shale producers, we are watching the supply/demand balance carefully.
- We believe that the U.S. Dollar could depreciate modestly in 2017 and 2018, and are seeking to add select EM currency exposures.
- The Portfolio includes certain EM exposures, with a preference for countries undertaking important structural reforms, such as India, Indonesia, and Argentina. EM are benefitting from the stronger global growth and increased domestic demand.

Important Information

Date of First Use: 10 October 2017.

Doc ID: