Quarterly Portfolio Update

Pioneer Funds – Strategic Income
29 December 2017

BOND COMMENTARY

Market Review

Fourth Quarter

Strong global GDP growth and corporate earnings, declining unemployment, modestly less accommodative global monetary policy, the U.S. tax cuts, and subdued inflation all contributed to strong equity and credit market performance over the quarter.

With the exception of the 30-year Treasury, interest rates rose over the quarter. The expectation for continued Fed rate increases contributed to a significant flattening of the yield curve. 2-year yields rose from 1.48% to 1.89%, 10-year yields rose modestly from 2.33% to 2.41%, and 30-year yields declined from 2.86% to 2.74%. TIPs outperformed, as inflation expectations rose, with 10- and 30-year break-evens rising to 2%.

Despite the inception of the Fed's tapering programme in October, which gradually reduces its purchases of Treasuries and agency MBS, agency MBS enjoyed relatively strong performance in the fourth quarter. The sector delivered excess returns of 0.24%, benefiting from stable rates and strong demand.

Investment Grade ("IG") corporates enjoyed the strongest returns among credit sectors, with absolute returns of 1.2% and excess returns of 1.0%, benefiting from strong profits and the U.S. tax cuts, as well as continued demand for high quality credit.

High Yield ("HY") corporates underperformed IG corporates, as investor concerns rose regarding specific sector risk, including Cable, Telecom and Retail, and the market sustained $11 billion of outflows over the quarter.

Emerging Markets ("EM") debt also underperformed over the quarter, impacted by the U.S. Dollar appreciation in October, higher U.S. yields and Venezuela's default in November.

With respect to floating rate assets, bank loans produced significantly better performance than high yield corporates, returning 1.1% for the quarter, benefiting from a strong CLO bid and demand for floating rate assets. Catastrophe bonds returned 3.9%, rebounding from their September sell-off, as investor demand grew in anticipation of higher premiums.

The U.S. Dollar wound up relatively flat compared to a broad measure of global currencies. After appreciating in October, it fell over the remaining part of the quarter. The Euro appreciated 1.6% vs. the U.S. Dollar while the Yen was almost flat vs. the U.S. Dollar.

Month of December

December markets continued the positive momentum which had characterised 2017 as a whole. On a global basis, strong corporate earnings, improving GDP growth, and higher oil prices amid benign inflation reports, encouraged equity and credit market investors.

In the U.S, the passage of the tax bill, which reduces the corporate tax rate from 35% to 21% beginning in 2018, along with the widely anticipated 0.25% hike in the target Federal Funds rate, drove U.S. equities to record highs and contributed to strong credit market performance.

Short-term interest rates rose over the month, as the Fed raised rates in December. Reflecting the view that the FOMC will continue to hike rates, the yield curve continued its flattening trend. TIPS enjoyed strong performance on rising inflation expectations.

Agency MBS benefited from continued strong demand, low volatility and stable long-term rates over the month, resulting in excess returns of 0.16%.

IG corporates enjoyed strong performance, bolstered by strong global growth combined with the tax bill that delivered a lower corporate tax rate, as well as a 14.5% one-time rate on repatriated cash.

HY corporates returned a modest 0.3%, reflecting $3 billion of net outflows. Investor concerns have risen in recent months regarding tight spreads, higher risk within the Retail and Telecom/Cable sectors and the impact of the U.S. tax bill's limit of the interest expense deduction.

EM debt enjoyed strong returns in the wake of better than expected China growth and rising commodity prices, with sovereigns returning 0.6% and corporates up 0.3%.

Finally, the U.S. Dollar fell 0.4% over the month, as global growth relative to the U.S. surprised to the upside and commodity-linked currencies rallied. The Euro rose 0.8% vs. the U.S. Dollar, while the Yen was close to flat vs. the U.S. Dollar.

Portfolio Review

The Portfolio underperformed it's benchmark, the Bloomberg Barclays U.S. Universal Index for the month, but outperformed for the quarter and the YTD respectively.

Yield curve positioning was the primary contributor to performance over the month:

Quarterly Performance:

Yield curve positioning was the largest contributor to performance. Sector allocation, the relative quality of the Portfolio's holdings and security selection also contributed.

Positive:

- The barbelled yield curve position outperformed, benefiting from the flattening of the yield curve. In particular, the underweight to the 2- and 5-year, and the overweight to the 30-year key rate durations, contributed to performance.
- Portfolio returns benefited from sector allocation, particularly from the 27% underweight to U.S. Treasuries and the 3.4% TIPS allocation.
- The Portfolio was also helped by the lower relative quality of its holdings within Financials and ABS.
- Security selection within Industrials and Financials contributed to performance; Financials reflected outperformance of European banking issues.
- The relative short duration position had a near-neutral impact on performance, as the negative cost of carry, offset the benefit derived from rising rates.

Negative:

- Non-U.S Dollar currency exposures detracted from performance, including the Asian proxy hedge, as the short position in the Korean Won impacted performance, as well as the exposures to the Mexican and Argentine Peso.

Outlook

We believe growth will remain robust for both the U.S. and globally in 2018, buoyed by easy financial conditions, and in particular, continued expansion of global central bank balance sheets (which will remain true in 2018 on a global basis, despite the Fed's tapering programme and the ECBs reduction of its purchase programme). We believe, U.S. GDP growth may increase to almost 3% over the year, benefiting from significant tax cuts, deregulation and infrastructure spending; protectionist trade policy may temper this outlook. Solid employment may continue to support consumption and the housing market. Higher corporate profits, benefiting from strong global growth, tax cuts, and the 100% expensing of fixed investment, may also support increased fixed investment, in our opinion. Globally, we believe that the Eurozone and Japan may enjoy strong growth, reflecting lower political risk and quantitative easing. While China's growth may moderate in light of its goals to rein in credit growth from the shadow banking system and to improve the environment, we believe a modest decline in China's growth will not disrupt overall Asia or global GDP growth.

We believe, inflation could surprise to the upside in 2018 and the FOMC may be "behind the curve" in raising rates. Nascent signs of wage growth acceleration, service inflation, tighter labour markets in key industries such as homebuilding, and more restrictive immigration policies may contribute to higher price levels in the coming year. Tax reform could have the potential to further fuel inflation. In addition, producer price indices are already increasing, on the heels of higher oil and metals prices.

We expect the U.S. Dollar may depreciate relative to both EM and Developed market ("DM") currencies. Markets have already priced the FOMC's forecast rate increases. Furthermore, while GDP growth may rise in the short term in response to tax cuts, markets appear sceptical that fiscal stimulus will have any significant effect on long-term U.S. growth. Finally, growth differentials between the U.S. and the world should no longer favour the U.S. Only a sharp upward trajectory for inflation, causing an acceleration of Fed tightening relative to the current forecast, could change sentiment for the U.S. Dollar.

The Portfolio continues to be positioned for rising interest rates, and a solid economy. It holds the following positions:

- 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 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 core inflation that may reach 2% by year-end.
- We hold long-duration TIPS, which we believe could help protect the Portfolio should inflation surprise to the upside. While break-evens for 10 and 30 year Treasuries now stand at 2%, these levels remain below long-term averages.
- The Portfolio holds an overweight to agency MBS relative to the benchmark; including the 10% in non-agency MBS, it remains significantly overweight to the RMBS sector. We believe agency MBS currently offer fair value, but are more attractive relative to fixed income IG corporates, the spreads of which stand at post-crisis lows. In addition, we believe, the residential housing market remains strong, aided by low interest rates, strong employment and lack of supply.
- The Portfolio has added to its ABS exposure, and continues to maintain an overweight to IG CMBS. We believe structured securities generally could offer more attractive relative value than corporates, and find attractive opportunities with non-Index ABS issues.
- We remain underweight to IG corporates, but continue to hold a modest overweight to HY corporates. Total IG corporate spreads stand at post-crisis lows, adjusted for duration, and reflect lower quality and overall longer duration relative to their historical levels. Tighter spreads and higher leverage is counterbalanced by strong fundamentals. We believe, however, that corporates could face greater downside risk, in a higher volatility environment that may result from an unexpected change in central bank policies or from an unexpected slowdown in global growth.
- Within corporates, we continue to hold an overweight to Financials. We hold exposure to European banks, and reduced exposure to U.S. banks, 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 offer lower event risk of share repurchases or credit impairment due to M&A activity. Banks appear 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 believe spread should continue tightening in the space, which remains one of the wider-trading subsectors in IG. OPEC’s extension of production cuts should help offset increased production from U.S. shale producers, and the global demand outlook has improved.
- The Portfolio includes certain EMs exposures, at a level similar to the Index, with a preference for countries undertaking important structural reforms, such as India, Indonesia, and Argentina. EMs are benefiting from the stronger global growth and increased domestic demand.
- While we believe the U.S. Dollar may depreciate going forward, we continue to hold 97.2% net U.S. Dollar exposure. We hold most long exposures in select EM currencies that offer attractive carry, strong GDP growth and disciplined fiscal policy. In light of significant appreciation already enjoyed by

EM currencies over the past few years, and the significant volatility that can be associated with such currencies, we have chosen to limit overall exposure.

- We believe markets could face two major risks in 2018: higher than expected inflation, which could cause the Fed to raise rates more aggressively, and higher global growth (with accompanying higher inflation), which could spur tighter monetary policy by the ECB, and even the BOJ.

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