

Quarterly Portfolio Update

Amundi Funds II – Pioneer Strategic Income*

30 March 2018

BOND

COMMENTARY

Market Review

Markets faced a volatile first quarter of 2018, driven first by higher rate and inflation fears, and later by concerns over a potential trade war between the U.S. and China. The large U.S. fiscal stimulus in the form of tax cuts and higher spending plans in the budget, greater than expected wage inflation, and a more hawkish FOMC, contributed to unsettled markets early in the quarter. As wage inflation fears moderated and both the Fed and the ECB appeared more measured in their respective paths to monetary tightening, markets rallied in February, only to be caught up again in trade fears in March. U.S. President Trump took a more aggressive approach to tariffs, first through a 25% tariff on steel and aluminium imports (which was subsequently undercut by exempting four of the five largest producers), but more important, the announcement of tariffs on \$60 billion of China imports, as a first step in his goal to cut the \$300 billion trade deficit with China by \$100 billion.

U.S. Treasury rates rose most of February, only to pull back in March as inflation fears moderated and trade worries increased. The 2-year Treasury yield rose from 1.89% at the beginning of the year to 2.26% at the end of February, and stabilised at that level by quarter end, ending at 2.27%. 10-year Treasury yields began the year at 2.41%, peaking at 2.95% in late February, and ended the quarter at 2.74%. Posting a -0.39% excess return over the quarter, agency MBS sustained negative excess returns during every month of the quarter, as duration extended early in the quarter on higher rates, and due to a flight to quality in Treasuries, during the month of March. Corporate credit accelerated its selloff over the quarter, however, agency MBS wound up outperforming investment grade (IG) corporates. Other structured credit also fared better than corporates; CMBS sustained a -0.06% excess return, non-agency MBS and ABS (as reflected in fixed and floating rate asset-backed securities) returned 0.16% for the quarter. IG corporates delivered a -0.79% excess return and -2.32% total return for the quarter, representing their worst absolute quarterly performance since the financial crisis (and the ninth worst quarter since then

on an excess return basis). U.S. IG corporate spreads widened from 0.93% to 1.09%, impacted by higher rates, lower non-U.S. investor demand (who hesitated at higher currency hedging costs) and high issuance. In addition, spreads on short-term corporates widened as corporations repatriated non-U.S. cash, selling short-term corporate investments, and due to lower demand, in the face of high issuance of U.S. Treasury bills. High Yield (HY) corporates enjoyed relatively better performance, benefitting from their higher yield and low default outlook; over the quarter, they sustained a -0.14% excess return and -0.91% total return, as spreads widened from 3.63% to 3.73%. Floating rate assets enjoyed strong performance in the wake of rising rates; bank loans returned 1.53% over the quarter, and catastrophe bonds returned 1.76%.

U.S. Dollar Emerging Market (EM) Debt also sold off on higher rates, with sovereigns down 2% and corporates down 1.2%. The U.S. Dollar fell in January and was relatively range-bound for the rest of the quarter. Overall, it fell 2.9% over the quarter; the Yen rose 5.9% and the Euro rose 2.5% vs. the U.S. Dollar.

Portfolio Review

The Portfolio underperformed its benchmark the Bloomberg BarCap U.S. Universal Index, for the month and first quarter.

First Quarter Performance

Duration positioning, sector allocation and the relative quality of the Portfolio's holdings accounted for most of the outperformance over the quarter.

Positive:

The relative short duration position of 1.37 years contributed to performance, as rates rose across the curve. The barbelled yield curve position also contributed, as the yield curve flattened modestly, reflecting the decline in longer-term yields in March. The underweight to the 5-year and overweight to the

* Prior to 16 February 2018, Pioneer Funds – Strategic Income

30-year key rate durations were the most significant contributors along the curve.

We benefitted from sector allocation across a broad range of non-benchmark sectors. While the 26% underweight to nominal U.S. Treasuries impacted performance as credit sectors broadly underperformed over the quarter, this negative impact was more than offset by the benefits of the 14% exposure to CMOs, the 3.5% exposure to TIPS, 3% allocation to catastrophe bonds, and the 1% exposure to municipals.

We also benefitted from its lower relative quality relative to the benchmark within CMBS, ABS and industrials, particularly the relative overweight to BBB and high yield issues within each of these sectors.

Negative

While the U.S. Dollar depreciated over the quarter, overall currency exposure modestly detracted from performance, reflecting the underperformance of the Swedish Krone position.

The Portfolio was slightly impacted by security selection. Agency MBS issues outperformed, reflecting the benefit of the overweight to higher coupon issues, to conventional mortgages vs. Ginnie Maes, and to 30 year vs. 15 year mortgages. This outperformance was offset, however, by the negative impact of underperformance within government-related issues, and within Financials.

Outlook & Positioning

We continue to believe that growth may be strong for both the U.S. and globally in 2018, buoyed by fiscal stimulus in the U.S. and strong global domestic demand, although financial conditions have tightened since the beginning of the year in the wake of rising interest rates. We believe U.S. GDP growth may accelerate to almost 3% over the year, benefitting from significant tax cuts deregulation and stronger fixed investment spending. Solid employment and income growth should continue to support consumption and the housing market. Higher corporate profits, benefitting from strong global growth, tax cuts, and the 100% expensing of fixed investment, may also support increased fixed investment.

Globally, we believe that the Eurozone and Japan may also enjoy strong growth, benefitting from still

supportive monetary policy. While European PMIs have come off their peaks, they still remain at high levels. Political risk, however, has risen in Europe, due to the triumph of populists in the Italian elections, as well as union resistance to Macron's implementation of labour reforms in France. 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 should not disrupt overall Asia or global GDP growth.

This growth may moderate, however, in the face of President Trump's more aggressive protectionist trade policy. While it is reported that the U.S. and China are negotiating trade imbalances, Trump has taken a much more vocal stand on trade than expected, and China has responded in kind. With China having the larger export exposure to the U.S., but also holding \$1.3 trillion in U.S. Treasuries, at the margin we believe China holds a stronger hand. Nonetheless, should a trade war erupt full-blown, there will be no winners.

We continue to believe that inflation could surprise to the upside on a number of fronts in 2018 and that the FOMC may be behind the curve in raising rates. Emerging 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. In addition, producer price indices are already increasing, on the heels of higher oil and metals prices. Fiscal stimulus, including the tax cuts and higher spending from the budget has the potential to further fuel inflation. Finally, should China reduce Treasury purchases, which could result in further U.S. Dollar depreciation, we would anticipate higher term premiums and inflation as a result.

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. In our view, most U.S. government debt is unattractive, while credit sectors may benefit from stronger growth, lower taxes, and less regulation.
- We hold a relative short duration position compared to the 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 can help protect the Portfolio should inflation surprise to the upside. While breakevens for 10 and

30 year U.S. Treasuries now stand at 2.1%, these levels remain below long-term averages.

- We hold a small underweight to agency MBS relative to the benchmark; including the 11% in non-agency MBS, we remain significantly overweight to the RMBS sector. Fundamentals within the housing market remain positive, spurred by strong GDP growth and employment, and still reasonable mortgage rates. In addition, we believe that agency MBS offer investors reasonable value at current spreads. While certain investors are concerned about the increased net supply of approximately \$400 billion forecast for 2018, we believe that the market has already priced in this forecast (which we witnessed earlier in 2017 when the Fed first announced the taper plan). The FOMC has been fully transparent in setting forth its tapering program with respect to both U.S. Treasuries and agency MBS. Moreover, agency MBS already extended duration in the fourth quarter of 2016, in response to higher rates, and we do not foresee significant extension risk going forward. High quality non-agency RMBS remain attractive, with pristine credit metrics and trade approximately 1.2 points behind agency MBS, translating into a spread pickup of 20 to 25 bps vs. agency MBS.
- We believe structured securities including ABS and CMBS generally offer more attractive relative value than corporates, and find attractive opportunities within non-Index ABS issues.
- The Portfolio holds a small underweight to IG corporates. Over the past month, the team added modestly to this exposure, with the aim of capitalising on spread widening within shorter term corporates. The portfolio also continues to hold an overweight to HY corporates. Spreads in broad IG corporates now stand at near fair value; but these spreads reflect lower average quality and overall longer duration relative to their historical levels. Tighter spreads and higher leverage is counterbalanced by strong fundamentals. We continue to believe, however, that corporates face greater downside risk than agency MBS, in a higher volatility environment that may result from a negative outcome on trade policy, 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 can 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 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. 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 EM exposures, at a modest underweight relative to the Index, with a preference for countries undertaking important structural reforms, such as India, Indonesia, and Argentina. EMs appear to be benefitting from stronger global growth and increased domestic demand. Valuations in EMs have also become extended, although we believe they generally offer solid fundamentals.
- We believe the U.S. Dollar may depreciate modestly going forward; given the higher volatility associated with currencies, and extended valuations across a number of currencies, we have been cautious in adding to non- U.S Dollar EM and developed market currency exposures. Since the beginning of the year, we have increased exposure to the Swedish Krone, based on its strong GDP growth and balance sheet, and an expectation for more hawkish monetary policy. We have also added exposure in the Japanese Yen, based on its strong GDP and export outlook. We hold long exposures in select EM currencies that offer attractive carry, strong GDP growth and disciplined fiscal policy.

Important Information

On the 16 February 2018, Pioneer Funds was renamed Amundi Funds II. Prior to 16 February 2018 the name of the sub-fund was with the prefix “Pioneer Funds”.

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Date of First Use: 13 April 2018.

Doc ID: 470229