Quarterly Portfolio Update
Pioneer Funds – Global Subordinated Bond
30 June 2017

BOND COMMENTARY

Overview

There was a widespread focus on central banks during the second quarter (Q2) of the year, as markets anticipated monetary policy changes in both Europe and the U.S.

Concerns surrounding the French Presidential election and a possible “Frexit” did not materialise, having been widely feared by the global financial market during Q1. The general tone of economic data throughout the quarter was mixed, with the U.S. regaining momentum following a weak start to the year, Europe reporting strong growth but below target inflation, and the UK economy continuing to struggle due to Brexit related uncertainties.

Bond markets exhibited divergent performance during the quarter. The U.S. 10-year yield opened at 2.40%, and ended at 2.31%, signifying that the Trump “reflation” trade has been well and truly priced out of the market. In Europe, the 10-year German bund yield opened the quarter at 0.33%. Strong data out of the Eurozone, and comments from ECB President Draghi’s June speech drove bond yields (including Germany and the U.S.) sharply higher, with the 10-year bund closing the quarter at 0.47%. Finally in the UK, the 10-year Gilt closed at 1.26%, compared to 1.14% at the beginning of the quarter. Political instability, and weak economic data during the quarter were the main drivers of the increase in yield.

Data out of the U.S. during Q2 was weak, but there were some indicators of an improving economy in place. The Federal Open Monetary Committee (FOMC) delivered a widely expected 0.25% rate increase at its June meeting, which was well received by investors. The Fed also addressed its plan for normalisation of its $4.5trn balance sheet, which is likely to begin in September of this year. In Europe, markets reacted well to the win for Emmanuel Macron in France’s presidential election, and to his party En Marche’s absolute majority win at the national assembly in June. In Germany, Angela Merkel continued to cruise along for a likely victory in September and in Italy the next, yet unscheduled, election is most likely to take place in early 2018.

In the UK, the economy continued to struggle during Q2. The unstable political situation was highlighted by Theresa May’s calling of a snap election on 9 June. May’s position as Prime Minister seems less credible following her party’s defeat in the election, and the likelihood for a softer Brexit to unfold is now looking more likely. Finally, at the UK Monetary Policy Committee (MPC) meeting in June, the vote of 5-3 to leave the Bank Rate unchanged at 0.25% surprised the market.

On the monetary policy front, most attention during the first half of the year was focused on the ECB’s tapering of their Quantitative Easing programme – when it would be announced, by how much, and the timing of the first deposit rate hike. Economic data releases were strong during the quarter but surprisingly, the inflation target in the Eurozone fell below expectations for the quarter, and projections for 2017, 2018 and 2019 were all revised lower.

Subordinated Debt Review

Technicals Update

Additional Tier 1 issuance in the second quarter of 2017 was circa €9.5bn, an increase on the supply of €6.8bn from Q1. Most of the supply was from large, recurrent issuers including Banco Santander, HSBC, Intesa Sanpaolo and Unicredit. The largest issuance was a 10-year, $3bn issue with a 6% coupon from HSBC. Given the benign market environment there have also been some first time issuers during the quarter including Banco Sabadell, Raiffeisen Bank International and Portuguese Bank Caixa Geral de Depositos. Overall, UK issuers dominated the AT1 market. Three quarters of issuances this year have been from UK issuers, and have been predominantly dominated in Euro.

The most significant event for the quarter was, unmistakeably, the ECB’s Single Resolution Board (SRB) decision to take resolution action on Banco Popular as “the entity is failing or likely to fail” because of a “rapidly deteriorating liquidity situation”. The resolution involved the sale of Banco Popular to Banco Santander for a nominal sum of €1 following a full bail-in of the group’s sub debt (c. €1.9bn in total across AT1 and T2) while the Senior Unsecured bonds were preserved. Despite this being a very significant event, there was no spillover effect across the AT1 asset class, other than some momentary weakness of some second-tier Spanish names. More importantly, the resolution flagged the riskyness of Tier 2 bonds, which got resolved together with the AT1 bonds –which lead us to reconsider our allocations in that space for this portfolio.

Corporate hybrids issuance in 2017 came up at €9.2bn, with 13 bonds being issued, most of which were by Investment Grade (IG) rated companies. A strong demand fueled by a continued search for yield from investors has helped to drive the sector year to date. Investors recognise the significant uplift from Corporate Hybrids over other Senior

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bonds with similar maturities. Overall this quarter, corporate hybrids have outperformed in the credit universe and spreads are close to two-year lows.

Portfolio Review

We were quite active in the Portfolio during the quarter. Most of the new positions were bought participating in primary while remaining selective (some names we bought include Aroundtown/ Evonik/ Banorte/ Isbank/ Phoenix). After the Banco Popular event, we reduced our exposure to Spanish Tier 2 since we deem the risk-reward of the Tier 2 unattractive considering the spread differential with both Senior bonds (which have not been involved in European resolutions) but more importantly Tier 1 and AT1 bonds. As a consequence, we prefer to have exposure to the banks we like in AT1 given the relative value. Our goal is to increase the cash portion of the Portfolio over the next few months to take advantage of potential volatility. Some parts of the subordinated debt market are now much more vulnerable to rates move (long dated/call dates bonds),we therefore have a preference for maturities in the 5-7 year maturity bucket. The imbalance between supply and demand should support the asset class in the next few months.

Positioning

At June quarter-end, our Portfolio has a duration position of 4.10 years, a spread duration of 4.36 and a Yield-to-Maturity of 5.07%. The cash position is 2.4%, in the low end of our target of high-single digit cash levels. Our Portfolio Managers employ this low cash levels to retain flexibility in managing client flows without significantly altering positions and to avail of market opportunities – primary offerings or price volatility – whenever they arise.

The Yield-to-Maturity of our holdings in Financial Subordinated bonds (accounting for c. 55.5% of the portfolio) was 5.95%. Within this allocation, our largest sector allocation is in Banking, followed by Insurance and Financial Services. The Yield to Maturity of our allocation to Corporate Hybrids issued by Utilities (c. 10% of the Portfolio) was 4%, while the Yield to Maturity of our Corporate Hybrid bonds issued by Industrials (c. 30% of the Portfolio) is 3.2%. Our allocation to U.S. Preferred shares has been very limited throughout the past few months on valuation grounds.

Consistent with our other IG Credit portfolios, our preference within this asset class is for solid issuers, with a strong credit profile, a proven creditor friendly attitude (both in terms of financial discipline and track-record of calling bonds) as well as with attractive bond structures, in terms of both coupon reset after the call date (which incentivises the issuer to call the bond) and loss of equity credit (this being very important for Corporate Hybrids).

Performance

In terms of performance, the strongest contributors in Q2 were our allocations to Additional Tier 1 (AT1) and Subordinated Financial bonds.

Within our AT1 bucket, we make particular reference to our holdings in ErsteBank, Santander, Rabobank and BBVA all of which added to performance during the quarter. Within the Insurance space, our holdings in Delta Lloyd and Irish group RSA Insurance were strong contributors to performance during the quarter. We find Insurance Subordinated Bonds particularly interesting due to their strong capital positions and attractive spreads compared to other financial sectors.

Our bond selection in the Corporate Hybrid space also performed well in Q2. We make particular reference to our holdings in the Real Estate and Telecomms sectors, namely the bonds we chose to hold in German real estate issuers Aroundtown, Vonovia and GrandCity, and French telecomm provider Orange SA. We view the Corporate Hybrid universe as an attractive asset class that could have further potential to outperform.

Outlook

In our opinion, the outlook for the remainder of 2017 will be dependent on central banks' outlooks and actions, with a lesser impact from geopolitical events. Towards the end of Q2 2017, central banks globally appeared to indicate a desire to normalise monetary policy settings, despite some concerns about a lack of pick-up in inflation. We maintain our view that the reflationary theme across Europe should continue through the second half of 2017. Growth expectations have now caught up with actual growth levels, and most forecasters now expect 2017 Euro-area GDP to be in excess of 2%. Most attention is currently focussed on the ECB and their Public Sector Purchase Programme. We expect that at the September 2017 ECB meeting, the ECB will expand on their plans for their bond-buying programme in 2018.

In the U.S., the Fed are indicating another two rate hikes in 2017, plus some imminent reduction in balance sheet size, but markets remain to be convinced that this outcome will actually occur. Our anticipation is that economic growth will remain around current levels of 2.25%, and that as the unemployment rate continues to drop towards the 4% level, the Fed will grow increasingly concerned about the outlook for inflation. That, in turn, suggests that the market may have to reprice towards the Fed's outlook for rates, pushing bond yields higher.

In the UK, questions remain as to how long Theresa May can remain as Prime Minister which has weakened the UK's negotiating stance with Europe over Brexit terms. The political uncertainty is mirrored by monetary policy uncertainty, with the recent Bank of England MPC voting 5-3 in favour of keeping the current monetary policy settings unchanged.

Heading into the third quarter of 2017, 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 Corporate Sector Purchse Programme (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 is definitely on the rise in Europe, so far credit profiles have been relatively resilient, buoyed by low interest costs and rising operating earnings.

We reiterate though 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, off-benchmark positions across the IG credit universe. In terms of our positioning, we remain underweight spread duration but long DTS through our preference for selected IG issuers of subordinated bonds both in Financials and Non-financials, combined with an underweight positioning in European IG senior debt, which offers less attractive risk-reward, especially as CSPP tapering may become more of a market focus during 2H17. In terms of sector preferences, we continue to view value in Real Estate and Insurance, also Subordinated Financials with valuations still attractive and fundamentals in these sectors continuing to improve, also with earnings leveraged to a rising interest rate environment.

Important Information

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