Monthly Portfolio Update

Pioneer Funds – Strategic Income
29 January 2018

BOND COMMENTARY

Market Review

Strong U.S. and global GDP growth, rising oil prices, improved earnings and positive momentum driven by the tax cuts and earnings repatriation, drove credit and equity markets higher over the month, despite rising interest rates. Higher real yields and inflation expectations contributed to rate increases; the 2-year Treasury rose from 1.89% to 2.14%, while the 10-year rose from 2.41% to 2.72%. Agency MBS underperformed, sustaining excess returns of -0.15% as higher rates and volatility took hold. Investment grade credit significantly outperformed, delivering a 0.72% excess return, buoyed by strong earnings, the prospect of tax cuts and earnings repatriation and continued strong demand. The option-adjusted spread narrowed from 0.93% to 0.83%, a post-crisis low. High Yield ("HY") returned 0.64%, for a 1.66% excess return. Like Investment Grade ("IG") corporates, the HY sector is benefiting from strong demand and tax cuts. Floating rate assets enjoyed strong performance with bank loans returning 0.99% and catastrophe bonds, 1.3%. Emerging Market ("EM") sovereigns were down 0.40%, impacted by duration, corporates averaged a 0.07% return over the month. The U.S. Dollar fell 3.4% against a broad basket of currencies.

Portfolio Review

The Portfolio underperformed its benchmark, the Bloomberg Barclays U.S. Universal Index for the month.

We benefited primarily from duration positioning. Currency exposures, the lower relative quality of the Portfolio and security selection also contributed.

Positive:

- The 1.33-year relative short duration position compared to the Index helped performance as rates rose across the curve. The barbelled yield curve positioning also contributed to performance as the long end of the curve modestly flattened.
- Currency exposure contributed, reflecting the benefit of the proxy hedge of long Swedish/Norwegian Krone/short Euro. We have added to the Swedish Krone position, given our view that Sweden enjoys superior GDP growth and may also see more hawkish central bank policy, relative to the eurozone.
- Security selection contributed to performance, benefiting from strong performance of Energy issues within Industrials and from the overweight to higher coupon issues within agency MBS.
- The Portfolio benefited from the lower relative quality of its holdings within Industrials and Financials. Both industry sectors benefited from the overweight to BBB and HY issues.
- Sector allocation contributed to performance, particularly the 24% underweight to nominal U.S. Treasuries and the 3.6% exposure to long-term TIPS. 30-year breakevens rose from 2.02% to 2.14% over the month.

Negative:

- No factor detracted significantly from performance.

Outlook

We believe that growth should 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 should remain true for the G4 banks until the third quarter of 2018. We believe U.S. GDP growth may accelerate to almost 3% over the year, benefiting from significant tax cuts deregulation and stronger fixed investment spending; only protectionist trade policy may temper this outlook. Solid employment and income growth 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. 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 should not disrupt overall Asia or global GDP growth.

In addition, the recent higher than expected increase in wage inflation reflects our belief that inflation may surprise to the upside on a number of fronts in 2018 and that 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 has 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 Developed Markets ("DM") and EM currencies. Monetary policy convergence is likely to be the key driver behind a weaker U.S. Dollar. Markets have already priced the FOMC's forecasted rate increases but have under-priced rate hike expectations for ECBs. Furthermore, while GDP growth may rise in the short term in response to tax cuts, markets are sceptical that fiscal stimulus could have any significant effect on long-term U.S. growth. Finally, growth differentials between the U.S. and the world 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. We hold 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.
- 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 Treasuries now stand at 2.12%, the rising upside risk to inflation has the potential to lead to an overshoot of the 10-year TIPs breakeven, perhaps to 2.4% or even beyond.
- The Portfolio holds a small overweight to agency MBS relative to the benchmark; including the 14% in non-agency MBS, we remain significantly overweight to the Residential Mortgage backed Securities ("RMBS") sector. We see more attractive valuations within structured securities, within both agency and non-agency RMBS. Fundamentals within the housing market remain positive, spurred by strong GDP growth and employment and 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 programme 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 almost 1% higher yields than agency MBS.
- We believe structured securities generally offer more attractive relative value than corporates, and find attractive opportunities with non-Index ABS issues.
- The Portfolio holds an underweight in IG corporates, but continues to hold an overweight to HY corporates. Total IG corporate spreads tightened further during the month and stand at post-crisis lows, adjusted

for duration. These spreads 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 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 are currently focused on improving capital ratios to meet regulatory requirements, they 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 are benefiting from the 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 going forward, and have begun adding more non-U.S. Dollar to DM and EM currencies. Most recently, 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.
- We believe markets 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 Bank Of Japan.

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