Monthly Portfolio Update

*Amundi Funds II – Pioneer Strategic Income**

30 April 2018

BOND COMMENTARY

Market Review

Developed financial markets stabilised, while Emerging Markets (EM) sold off in the wake of higher oil prices and higher interest rates over the month. Developed equity delivered modestly positive returns, while Investment Grade (IG) credit markets slightly outperformed governments, benefitting from a 7% increase in oil prices, as well as from reduced trade tensions, better than expected first quarter U.S. GDP growth, positive earnings outcomes, with almost 75% of companies exceeding estimates, and with lower volatility. Despite these positive factors, however, performance within these markets was negative affected by rising rates and inflation. High Yield (HY) markets outperformed, benefitting from significant energy exposure, their higher all-in yield, and a benign default outlook. EM suffered from higher U.S. rates, and a rally in the U.S. Dollar.

Rising inflation expectations, spurred by higher oil prices and more hawkish Fed minutes resulted in a broad sell-off in U.S. Treasuries across the curve. Two-year Treasury yields rose from 2.27% to 2.49%, while the 10-year yield rose from 2.74% to 2.94%, after peaking at 3.03% on April 25. German Bund yields followed in sympathy. Structured credit outperformed U.S. Treasuries, benefitting from a decline in volatility and demand for risk assets.

Agency MBS recouped almost half of their underperformance year-to-date in April, with a 0.2% excess return relative to U.S. Treasuries. Ginnie Maes outperformed as rates rose and as regulators cracked down on aggressive servicers who were generating a high churn of VA loan pools.

In addition, high coupon collateral outperformed. CMBS and ABS enjoyed excess returns similar to agency MBS. IG corporates eked out a small positive excess return for the month, as the benefit of generally strong earnings reports was offset by concerns around higher sector leverage, and higher issuance driven by increased mergers and acquisition activity in the wake of lower demand from non-U.S. investors. HY markets on the other hand enjoyed strong performance, delivering strong excess return of over 1% and an absolute return of 0.7%, as spreads narrowed from 372 to 346 bps.

EM debt fell victim to higher rates, with USD EM sovereigns returning -1.5% and corporates, -0.7%. Local EM debt, which had held up better than USD-denominated debt, underperformed, as the U.S. Dollar rallied. The U.S. Dollar rose 2.0% over the month, as investors priced in greater policy divergence between a more hawkish Fed and more dovish global developed central banks. The U.S. Dollar rose 1.8% vs. the Euro and 2.7% vs. the Yen.

Portfolio Review

Duration position and sector allocation accounted for Portfolio outperformance relative to the benchmark (Bloomberg Barclays U.S. Universal Index) over the month.

Positive:

- The relative short duration position of 1.5 years contributed to outperformance, as rates rose across the curve. Both the short duration position within the U.S. as well as the short German Bund/Bobl position outperformed.
- Portfolio returns benefitted from sector allocation, primarily reflecting the benefit of the 3.7% TIPS exposure and the underweight to nominal U.S. Treasuries. 30-year breakeven rates rose from 2.07% to 2.19%, as wage inflation and oil prices surprised to the upside.
- The Portfolio was also helped by the lower relative quality of the Portfolio's holdings within Industrials, particularly the overweight to HY issues, as HY markets outperformed.

Negative:

- The Portfolio was hurt by its currency exposures, particularly by the 3.1% exposure to the Swedish Krona. With its twin surpluses and stronger relative GDP growth, we anticipated that the Rijksbank would raise rates more quickly than the ECB. Instead, with relatively contained inflation, the Rijksbank kept rates on hold, and the U.S. Dollar outperformed the Krona by 4.6%.

Outlook

Despite recent disappointing data out of the Eurozone, we believe that growth may be strong for the U.S. and globally in 2018, buoyed by fiscal stimulus in the U.S. and strong global domestic demand. We believe U.S. GDP growth could accelerate to almost 3% over the year, benefitting from significant tax cuts, deregulation, and stronger fixed investment spending. We believe 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 continue to believe the Eurozone and Japan should also enjoy strong growth, benefitting from still supportive monetary policy. Eurozone growth may be lower than that achieved in 2017, as exports could suffer from the lagged effects of a stronger Euro. In addition, political risk, 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 we expect that China's growth might moderate in light of its goals to rein in credit growth, we believe a modest decline in China's growth should not disrupt overall Asia or global GDP growth.

Global growth could moderate, however, in the face of President Trump's more aggressive protectionist trade policy. While the U.S. and China are negotiating trade imbalances, he has taken a much more vocal stand on trade than expected, and China has responded in kind.

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. Nascent signs of wage growth acceleration, service inflation, tighter labour markets in key industries such as homebuilding, and more restrictive immigration policies should 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.

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

- Overweight to diverse credit sectors, underweight to U.S. Treasuries. Most U.S. government debt is unattractive, while credit sectors could 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, and little slack in the labour market. At 1.9%, core PCE has already reached the Fed's year-end target. With the unemployment at 3.9%, we anticipate that continued wage inflation will help drive core PCE to higher levels through the year.
- We hold long-duration TIPS, which we believe have the potential to help protect the Portfolio should inflation surprise to the upside. While breakevens for 30-year U.S. Treasuries now stand at almost 2.2%, we believe inflation expectations could overshoot; in addition, these levels remain below long-term averages.

- The Portfolio has modestly reduced its agency MBS position, resulting in a small underweight to the market; including the 12% in non-agency MBS, it continues to 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 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 trade approximately 1.0 point behind agency MBS, translating into a spread pickup of 20 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 near index weight in IG corporates, as the team added modestly to exposure over the past few months as spreads had widened. The Portfolio also continues to hold an overweight to HY corporates. Spreads in broad IG corporates now stand near fair value; but these spreads reflect lower average quality and overall longer duration relative to their historical levels. Leverage in IG corporates is significantly higher than in the past, with 23% of the market trading at greater than 4X leverage, compared to 11% five years ago. 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 in banks, insurance and REITS. 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, insurance and REITS offer attractive relative value and may perform well, despite a rising rate environment. 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 near-Index weight. We prefer countries that have undertaken important structural reforms, such as India, Indonesia, and Argentina. Notably, valuations in select EM have become more extended, although we believe they generally offer solid fundamentals.

- We believe the U.S. Dollar may be range-bound going forward, or may modestly appreciate should Eurozone growth disappoint. Given the higher volatility associated with currencies, and extended valuations across a number of currencies, we may reduce non-Dollar exposure going forward.

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