Monthly Portfolio Update

Pioneer Funds – U.S. Dollar Aggregate Bond

31 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 ("IG") 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 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%.

Portfolio Review

The Portfolio outperformed its benchmark, the Bloomberg Barclays U.S. Aggregate Index for the month.

We benefited from duration positioning as well as sector allocation and the lower relative quality of the Portfolio.

Positive:

- The 0.82-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.
- Sector allocation contributed to performance, particularly the 34% underweight to nominal U.S. Treasuries and the 3.4% exposure to long-term TIPS. 30-year breakevens rose from 2.02% to 2.14% over the month.
- The Portfolio benefited from the lower relative quality of its holdings within Industrials and CMBS. Industrials issues benefited from the overweight to BBB and HY issues.

Negative:

- Security selection had an overall neutral impact on performance; the outperformance of agency MBS issues was offset by the underperformance of Industrials issues. Within agency MBS, the Portfolio benefited from the overweight to higher coupon issues. A broad range of BBB-rated industrials underperformed.

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 Emerging Market ("EM") currencies. Markets have already priced the FOMC's forecasted rate increases. 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 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%, these levels remain below long-term averages.
- 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 including ABS and CMBS generally offer more attractive relative value than corporates, and find attractive opportunities with non-Index ABS issues.
- The Portfolio is maintaining an index weight 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, 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 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.
- 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. We have seen this inflation risk and accompanying volatility play out in the most recent market selloff in early February.

Important Information

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