Quarterly Portfolio Update

*Amundi Funds II – Pioneer Flexible Opportunities**
30 March 2018

EQUITY COMMENTARY

Market Review

The first quarter could be split, theoretically, into two parts, each telling a very different story: stocks peaked towards the end of January, bond yields in mid-February. The change in direction was caused more by overbought conditions (or oversold, in the case of bonds) than anything else. As a result, the stock market continues to experience its longest period in history without a serious correction. Besides technical analysis, the stock market fundamentals have continued to improve. As an example, two ISM (Institute for Supply Management) indicators of future economic activity showing constant strength in the first quarter. The New Orders components came in at a very robust 60; while the Supplier Deliveries components (an indicator of how tight capacity is, and therefore of corporate pricing-power) reached the highest level in a decade. Add to that the powerful upward revision in earnings expectations caused by fiscal policy, and our view remains unchanged: the U.S. remains in very good shape, and the Fed will slowly continue to raise interest rates.

It is, however, a fact that some of the other countries we monitor (such as 'core Europe' and Japan) have experienced less robust conditions. We monitor those countries, but our current impression remains that while a slowdown appears to be very moderate, the health of the two largest economies (the U.S. and China) will definitely exert their positive influence. The picture for the Emerging Markets (EM) is, as always, mixed, with a tendency towards blue skies. The leading indicators and the earnings revisions remain mostly positive, while U.S. Dollar strength – a circumstance that usually scares EM participants – has failed to materialise. Our preferences go first and foremost to China (about 7% of equities), but the exposure (about 18% of equities, including China) includes Brazil, Singapore, Thailand, Greece, Russia, Indonesia, Panama; plus Argentina and Vietnam, which are categorised as Frontier Markets. Valuations look high, especially in absolute terms.

This is true of the U.S. stock market in particular. Japan and some of the EM lie at the opposite end of the spectrum. We don't ignore the lower multiples at other Developed Markets, but we can't ignore the structural lack of domestic demand for stocks in places such as Continental Europe and Japan. To wit, corporate demand, in contrast to the U.S. is almost non-existent. That severely limits the upside potential in those areas. Since the dividend yield gaps (dividend yield on stocks less the yield on government and corporate bonds) both in the Euro-Zone and in Japan make stocks almost irresistible: in Europe and Japan it is close to impossible to find a company whose dividend yield is lower than the yield to maturity on its own outstanding bonds.

In contrast, we struggle to find any value whatsoever in bonds. Yields are lower than what is available in the 'bond-like' corners of the stock market and are also lower than the current rate of inflation. Such premium valuations could be only justified in light of the expectation of a severe recession (not even, in some cases). This represents a scenario we struggle to understand. It is also the case that, an increase in yields notwithstanding, according to the Federal Reserve Bank of New York the term premium on the U.S. 10-year Treasury Note remains negative. We are concerned by the attitude of too many institutional investors who, confronted with slim yields to maturity on investment-grade bonds, chose increasingly to raise their exposure to non-investment-grade paper.

We have accordingly continued to reduce the Portfolio's exposure to the fixed-income market to a new low of about 10% of the assets, almost entirely focused in EM. The rationale here is a combination of higher nominal yields and better fundamentals. We must confess we are not entirely convinced that, should the bear market in Developed Countries resume, EM paper would prove much more resilient. However, it is a fact that most of it at least offers positive yields in inflation-adjusted terms.

In terms of sector and theme exposure, Aerospace & Defence, "dividend aristocrats" and "buyback achievers" remain dominant. The Portfolio maintains (to a smaller scale) exposure to Hotels & Leisure; U.S. Healthcare; European Insurance; European and Singaporean Real Estate; European, EM, and Japanese Banks. That exposure is structural in

*Prior to 16 February 2018, Pioneer Funds – Flexible Opportunities nature, since we expect the fundamentals to benefit from multi-year tailwinds.

Portfolio Review

Performance was positive during the period, in an environment where major market indices were mixed. The S&P 500, returned -0.76%, European stocks were down -1.98%, and Japanese equities were up 0.83%. The volatility in markets has been driven largely by geopolitical conditions causing noise rather than a deterioration in fundamentals. However, we have maintained some of our hedges that, in turn, helped mute our drawdown during the period. During the first quarter, no material alterations have been made to the Portfolio and its positioning. We continue to maintain a globally diversified asset allocation by owning assets across both U.S. and foreign markets. We recognise that exogenous events can and will occur and, as a result, we have the flexibility to shift our allocations as conditions evolve.

The Portfolio's asset allocation at the end of the fourth quarter continues to be heavily biased toward equities, representing approximately 68% of the Portfolio. Within our equity exposure, approximately 26% was held in North American equities, 22% in other developed economies (ex U.S.), and 20% was in the EM. For the Fixed Income sleeve, which represented approximately 10% of the Portfolio, the lion's share of exposure is to EM sovereigns and corporates. At quarter end, the Portfolio had approximately 14% in cash and 9% in REITS.

Stocks remain the favoured asset class, with a preference for Aerospace and Defence, which we consider to be dividend aristocrats and buyback achievers, Healthcare (excluding the Pharma Sub-sector), and Real Estate (in a limited number of locations). The overall economic data has continued to be strong as new order activity and business/consumer optimism are all the pieces that should be in place for global expansion to continue. As the expansion continues the volatility of profitability continues to decline, and valuations are arguably cheap in the face of accelerating earnings.

Our view is that market volatility will likely continue, but our overall allocations will not change. Aside from the market noise the fundamentals for a global market recovery and growth in the domestic economy remain intact. As we observe economic data we see exceptionally strong new order activity, and PMI activity on both services and manufacturing remain in healthy expansion territory. Also, recently elevated unit labour costs have abated on a productivity-adjusted basis, suggesting companies are not feeling pressures on their cost structures which means margins are defensible and valuations should continue to expand. These factors lead us to maintain our overweight to equities and remain invested in the asset classes we have had in place over the last several months.

Our Portfolio holds a long history of maintaining a geographically diversified holdings, and that diversification[1] has provided meaningful net-benefit as global equity markets were strong in both North America and in EM.

Derivatives instruments are utilised within the strategy to:

a) effect tactical hedges against existing positions (such as currency, geographic or asset-type specific systematic risk, etc.), or

b) express a particular viewpoint on an economy or asset class without committing capital via cash security purchases.

Regardless of the investment premise, Fund Management is uncomfortable with underwriting/absorbing any semblance of tail risk, as we do not believe investors are appropriately compensated for doing so. This means that all strategies are effectively bounded. Security selection operates via a relative value framework that is identical in concept to management of the rest of the Portfolio.

All of the above mentioned portfolio allocation, investment decisions and positioning reflect our understanding of the current economic climate. With that said, uncertainty persists with respect to how potential changes within major trade relationships, plus geopolitical tension could influence fundamentals and undermine growth. Fund Management remains acutely focused on whether these external considerations have the potential to impact on our core outlook, and thus our orientation and asset allocation.

[1] Diversification does not guarantee a profit or protect against a loss

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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