Quarterly Portfolio Update

Pioneer Funds – Emerging Markets Corporate High Yield Bond

29 December 2017

Bond

COMMENTARY

Market Review

2017 enters the records as a strong year for fixed income investing. Supported by abundant liquidity, investors were strong net buyers of Emerging Markets ("EM") and other riskier assets throughout the year. Near record high levels of inflows resulted in a bumper year for new issuance, which in turn supported some issuers with weaker fundamentals. The result was a year that generally rewarded strategies that allocated toward higher yielding countries and issuers. 2017 set records for size and consistency of inflows, and subsequently challenged records for new issuance, with the former greater than the latter.

EM corporates responded strongly to a positive liquidity environment and fears of rising rates by increasing issuance and pushing out duration. In 2017, corporates increased their debt issuance by 47% over the preceding year to $480bn. The trend for corporates recalling shorter term debt while reissuing longer term debt pushed the duration of JPMorgan CEMBI BD from 4.65 years in 2015 to 4.91 years currently. Among investment grade issuers, duration reached 5.4 years.

Results were vivid wherever the position in the capital structure. EM Equity posted a 34% return, a result nearly quadruple the return achieved the year before. EM sovereigns posted a 10% return, matching their 2016 performance while EM credit posted an 8% return, slightly below last year's strong result. This compares to 2.5% return on U.S. Treasuries and a 7.6% return on U.S. High Yield.

Within the corporate space, spreads tightened by 69bp to 231bp as part of a year where the overall return (8% on CEMBI Broad) printed above the long term average. Consistent with a rally supported by strong inflows, performance dispersion was sequentially lower. 2017 was a year where spread compression and carry explained most of the return, helped by a 10bp move in the 7 year U.S. Treasury and a below trend default rate (2.0% vs a 2.7% street expectation).

At 2%, default rates in 2017 were lower than we forecast in the beginning of the year. As global activity levels rose, apparently without associated inflationary pressure, the business environment proved favourable for many corporates. With stable margins and healthy revenue growth, most issuers delivered relatively stable servicing, which in turn supported a tighter spread environment in both Investment Grade ("IG") and high yielding bonds.

EM debt traded with a U.S. yield curve that spent most of the year rising before flattening in the fourth quarter. This reflected in a similar pattern in investment grade emerging market debt, while higher yielding EM curves generally continued to steepen. In Asia, the feature was notable toward the end of the year across some IG issuers. For some market participants, a flattening in the yield curve implies a moderating growth outlook, suggesting that focus has now shifted beyond the simple start of tightening, toward an argument around the scope and scale of those rate rises.

While performance was broadly positive, the quarter experienced the emergence of a number of situations that potentially could influence returns in 2018. Topping this list are the events surrounding Venezuela, which ISDA eventually ruled a sovereign default. With oil prices falling and production weakening because of sanctions, Venezuela's leadership faced the impossible task of servicing more than $150 billion in debt. Sanctions may further constrain resolution of Venezuela's situation, as U.S. institutions hold a substantial proportion of the country's debt.

Portfolio Review

In Q4, the Portfolio continued to outperform its benchmark, the JPM Corporate Emerging Market Bond Index (CEMBI) Broad Diversified Non IG Index. We finished the second consecutive quarter ahead of the benchmark and the full year performance moved into positive territory.

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The benchmark ended the quarter in negative territory while the Portfolio recorded positive returns.

Overall, 2017 has been notable for steady inflows, as investors sought exposure to both the shorter duration and higher yields offered by EM bonds. Furthermore, as the only asset class globally to offer both real growth and real rates in fixed income, EM appears well positioned to continue to attract positive flows in 2018. Nevertheless, in 2018, a short duration positioning should be central to a risk management approach, potentially mitigating the effects of rising rates, while also potentially suppressing some of the impact of volatility. At the year-end, the Portfolio effective duration stands 0.4 years shorter vs. the benchmark's 3.6 years with a spread duration as low as 3.7 years.

Looking at performance contribution for the quarter, overweight in Latin America and selective exposure in Nigeria were the main performance drivers. In Emerging Europe, selection strategies unlocked value in neglected names and outperformed the benchmark, while in Asia structural underweight contained losses as regions printed slightly negative returns. At the sector level, being overweight Materials and Utilities and underweight Financials and Consumer Staples helped us outperform, while underweight Industrials came at a cost.

Geographically, our bias towards Latin America and Emerging Europe over Emerging Asia and the Middle East remains in place. Country-wise, we hold highest exposure to Brazil, Turkey and Argentina (all overweight) and balance this with a structural underweight in the Philippines, Hong Kong, Singapore and Thailand.

At sector level; we like Materials, Energy and Automotive; are neutral on Telecommunications and Media; and are underweight Turkish Banks, Real East and Hong Kong Leisure sector.

We think that Latin America will contribute significantly to global growth in the coming years. The region is poised to accelerate in 2018, with regional growth rising to 2.9%, led by recoveries in Brazil and Argentina. This comes after two years of recession, but it is welcome nonetheless, and is much higher than consensus forecasts of a year ago.
In this region we allocate the most to Brazil, where we like the Chemicals and Meat packaging sectors. On the back of rising Oil prices, Energy names also show opportunities. In Q4, we added some exposure to Petrobras and are now significantly net long.

Our stance on Argentina remains positive, especially after the gains made by the ruling Cambiemos coalition in the October mid-term elections with a view that the reform agenda will continue. However, the gradual approach to fiscal consolidation suggests that the anchoring of inflation expectations may be slower than what we expected. In the period, we were happy to add some exposure to the country as YPF and Transportadora added to the Portfolio returns.

In Emerging Europe, we moved from neutral to underweight in Russia and from overweight to neutral in Turkey.

In Turkey, economic activity has remained strong due to fiscal stimulus, but we feel this will slow down. We expect inflation will gradually decline as one-off factors taper off, and the current account deficit to widen as energy prices increase. Until we see material improvement, either on the currency or macro side, we decided to bring our exposure closer to neutral.

In Russia, with inflation undershooting the target, the CBR is likely to accelerate the pace of normalisation, as it is arguably the most hawkish major central bank in the world. According to Governor Nabiullina, it might take the CBR between 1-2 years to alter the monetary policy stance from restrictive to neutral. In that light, we like Oil and commodity-related names for which global factors rather than a domestic-driven agenda should act as a catalyst.

Emerging Asia saw dampened volatility and a positive macro backdrop, our analysis keeps us on the side-lines. In our view, high volumes of passive inflows brought lower quality issuers to the market and allowed higher quality ones to push out their duration profile. Lacking a more appealing regional opportunity to unlock value for our investors, we focus more on China (overweight). Financial deleveraging will continue in 2018, but the incremental shock to the system is likely to be lower. The PBoC is likely to maintain a neutral policy stance and keep reverse repo rates unchanged. We think Financials will benefit the most. Going into 2018 being positioned in credits that offer solid liquidity rather than performance might be preferred. In this regard, we would focus on the top four banks in China and their associated leasing companies.

Outlook

Loosening financial conditions and rising sentiment indicators in the U.S. suggest that the world's largest economy will continue to demand manufactured goods imports from EMs. We remain confident that the linkage between U.S. import demand and local currency strength – and thus economic growth – will continue to remain valid in coming quarters.

The debate and subsequent passing of U.S. tax reform was the dominant feature of the global investment world into the end of the year, simply because so much of global asset allocation hinges on the level, direction and rate of change of treasury yields. Having passed, the debate now shifts towards realising the impact of this legislation, especially as it reflects on the U.S Dollar and U.S. inflation.

In 2017, sentiment indicators moved ahead of activity indicators. What this may reflect is a shift in small business confidence following Washington's promise to lower the tax burden on many businesses; thus small business signalled relief through sentiment indicators like the PMI.

If every price marks a consensus, then current levels in EMs reflect an upbeat assessment of what might happen next. Barring unforeseen events, we continue to believe that the market remains supportive of both hard and local currency EM returns.

Risks to this position take several forms, some of which derive from EM's direct relationship with the U.S. and Fed policy. First, the reacceleration in the U.S. that has been further accelerated by tax reform could easily lead to the U.S. Dollar strengthening and a more rapid Fed tightening. This might negatively impact some EM returns. A second source of risk comes from sovereign risk, which could be challenged by policy decisions at a country level – of which South Africa is a case to watch or elections, or negative election fallout. In 2018 we are due to see elections taking place in Brazil, Mexico, Venezuela, Russia and Cuba.

Important Information

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