Monthly Portfolio Update

Pioneer Funds – Global Multi-Asset Target Income
31 January 2018

MULTI-CLASS COMMENTARY

Market Review

Politics remained in focus in January; the most notable event was the gridlock in the U.S. Congress over the Government funding budget which led to a Government "shutdown". Volatility surged but the pick-up was short-lived. Equity markets shrugged off political uncertainty to rally to new highs. The divergence in the performance between bonds and equities was evident as a more hawkish stance from central banks resulted in a sell-off in bond markets. In the U.S, December minutes from the Fed meeting indicated that most members support 3 or more rate hikes in 2018 given their expectations for reaching the 2% inflation target in the medium term. In the Eurozone, markets moved forward expectations on rate hikes to end 2018 on the back of ECB's December meeting minutes.

Equity markets gained amidst resilient macro data and risk-on market sentiment. Developments on tax reforms and strong earnings growth in the U.S. helped domestic equity markets rally to historical highs (S&P +5.6%) while European (EuroStoxx 50 +3.0%) and Japanese (+1.5%) markets were more muted due to the continued strength of their domestic currencies. Emerging Markets ("EM") were outperformers benefiting from the weaker U.S. Dollar and recovering oil prices (MSCI[1] EM +7.7%).

Within fixed income, higher inflationary prospects and pushed up short yields, resulting in a further flattening of yield curves across most Developed Markets ("DM"). In the U.S, 2-year yields were also impacted by the domestic political turmoil rising by +25bps while 10-year yields rose by +31bps. Europe followed a similar trend with proxy German 2 and 10 year yields rising by +10bps and +25bps respectively. Notably, the generic 5 year Bund has ended the month with a positive yield for the first time since 2015.

Higher underlying sovereign bond yields also weighed on EM and corporate bond markets (particularly in the U.S.) but continued investor flows provided some resilience to higher yielding sectors. High Yield ("HY") sectors were also helped by being shorter in duration. For instance, in the U.S, the proxies for U.S. Aggregate and HY (Bloomberg Barclays Unhedged) returned -1.2% and +0.4% respectively.

In currency markets, strength in macro data and the relative divergence between the Fed and other DM central banks led to further weakness in the U.S. Dollar versus most currencies including the Euro (-3.6%), UK Sterling (-4.6%) and Japanese Yen (-3.5%). Resolutions on the political front in Europe including Brexit related talks also supported European currencies. Among EM currencies, big winners in the month were the Brazilian Real (+4.8%) and Chinese Renminbi (+3.4%) among others.

Commodity markets posted an overall good performance but with a marked difference between sectors. Oil (West Texas Intermediate +6.8%) was an outperformer supported by OPEC countries' continued compliance with production cuts and robust global demand. Industrial metals suffered from oversupply concerns and weakness in Chinese data prints for January; Copper and Aluminium lost -3.2% and -1.5% respectively. Precious metals benefited from the weak U.S Dollar with Gold rising +2.3%.

Portfolio Review

The Portfolio performed positively in January with gains contributing primarily by the Macro Strategy while Satellites added small gains. Meanwhile, Selection and Macro Hedging detracted. In terms of asset classes, gains were led primarily by equities and followed by smaller gains from duration, currency and alternative strategies. Spread strategies were the only negative contributors.

Equity exposures were successful primarily due to directional exposure led by Japan, U.S. and EM although Selection offset some gains. Volatility reduction strategies within Macro Hedging unsurprisingly detracted. Satellites, which include relative value and asymmetric reflationary focused strategies, posted positive performance (for instance: long U.S. Energy versus U.S. REITs).

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Within fixed income, rates strategies in the U.S. particularly gained due to an overall negative stance on duration versus the strategic asset allocation target. Duration hedges and short positioning in short-dated core Eurozone benefited as yields trended higher. Satellites, for instance the UK 10-2 year yield curve flattening strategy, also added gains. Within spread strategies, corporate bonds posted subdued gains primarily due to exposure to HY. Among detractors were inflation linked strategies in the U.S. and credit exposure, particularly Investment Grade ("IG") selection in UK and U.S.

Currency trading returned positively led by the increased exposure to Euro versus the U.S. within the Macro Strategy. Short Australian Dollar versus Euro as did the small positioning in EM currencies, for instance Long Indian Rupee versus the U.S. Dollar.

On option writing, in January, we sold call and put options (February maturities) primarily on select European listed names. For instance, we sold call options on select Mining stocks given our expectations for a possible consolidation after the strong rally since December. Similarly, we wrote puts on Energy stocks after a spike in volatility.

Asset Allocation (Macro Strategy and Satellite Strategy)

We maintain a moderate risk-on stance through an allocation to equities given the positive macro backdrop, which should continue to drive earnings growth. A capex recovery should be a positive catalyst as should a reacceleration of the reflation story in the U.S. in our view. Valuations appear expensive although not yet extreme if compared to other late cycles. In terms of relative valuations, we prefer Europe, Japan and select EMs. European and EM companies offer higher earnings growth prospects fuelled by higher margins from improved productivity rather than through share buybacks. Japanese companies should also benefit from a weaker Yen and the Bank of Japan's (BoJ's) equity purchase programme. In the US., we seek idiosyncratic opportunities which may benefit from the reflationary boost from the tax bill.

On fixed income, DM bond yields are continuing to trend higher on the back of hawkish central bank rhetoric. Yield curve flattening has been prominent, with short term yields under pressure especially in the U.S. as buoyant macro data and the potential of tax reforms should lift inflation expectations. Although we expect global policy tightening in 2018 to be gradual and data dependent, we acknowledge that markets remain complacent and that any spikes in inflation could change this benign rate outlook.

As a result, we maintain a short duration stance (versus the strategic income target) through negative duration on short maturities where rate hikes may put upward pressure on bond yields. It is important to note that overall Portfolio duration is currently close to zero as result of these duration management strategies i.e. due to option strategies used to manage duration moving "into the money". However, we expect this to be temporary and for Portfolio duration to move towards our 1-1.5 years target shortly.

Overall, on rates, we are positive on Eurozone peripherals given their attractive carry over core bonds and support through ECB purchases and on inflation-linked strategies, which are expected to benefit from a gradual pick-up in inflation as central banks scale back on their monetary stimulus programmes, in our opinion. We believe, upward pressure on commodity prices from rising global demand and tighter labour markets may also be a driver of inflation in 2018. We hold limited exposure to relative value yield curve strategies, for instance a Swedish 2-10 year flattener expected to benefit from a potential policy shift by the Swedish central bank.

On spread strategies, we hold a positive outlook on EM debt (primarily hard currency) given the stabilising conditions in China. We note that spreads are tight and susceptible to monetary policy changes in the U.S. However, our macro outlook for the asset class seems to be supportive given the sustained improvements in survey data. We remain selective and focused on quality given the notable divergence between economies and thus maintain a tilt to EMs with stronger fiscal positions, credible reform agendas and relatively attractive valuations.

We remain constructive on credit due to improving corporate fundamentals and the acceleration on economic growth, which may continue to attract flows from yield seeking investors. However, valuations remain tight. A synchronised normalisation of central bank policies could cause a sudden reversal in investor flows and a squeeze on liquidity particularly in the most crowded sectors. Hence, we maintain hedges on spread duration to mitigate the impact from spread widening. Moreover, we remain vigilant on the overall credit quality and liquidity of the Portfolio.

In terms of credit sector allocation, we prefer Subordinated Financials compared to HY. On the latter, although strong fundamentals and low default rates (at least until H1 2018) limits downside risks, we note that valuations are artificially stretched. A backstop in ECB corporate purchases would remove this support. Non-Financial Subordinated bonds appear more vulnerable to idiosyncratic risks and hence we prefer to take profits selectively. In general, we are more constructive on Financials, which could benefit from improved fundamentals amidst higher interest rates and better asset quality. Moreover, deregulation could increase profitability especially for U.S. banks, in our opinion.

On HY, funding conditions remain cheap and earnings continue to improve. On the other hand, leverage levels have increased in some sectors especially in the U.S. due to M&A and share buyback activity while risk premia remains low and does not compensate for macro and potential default risks. Therefore, we hold a slight preference for Euro versus U.S. credits, where tax reform supports more IG than HY names.

On currencies, we hold a reduced exposure to the U.S. Dollar in favour of the Euro, which we believe should benefit from a solid recovery in the Eurozone and a less accommodative ECB. We remain short on Sterling versus U.S. Dollar and Euro due to continued political uncertainty in the UK and short Australian Dollar versus Euro. The former has been under pressure recently due to a bearish outlook on Australian interest due to inflation undershooting central bank and market expectations. We maintain a limited long EM exposure (Indian Rupee for instance) versus the U.S. Dollar.

To seek risk diversification[2] and benefit from a reflationary scenario, we maintain relative value and asymmetric equity strategies within Satellites. For instance, we hold a long positioning in U.S. Energy Infrastructure vs U.S. Real Estate to increase the reflationary bias in the Portfolio. We also hold a commodity basket, consisting of Energy, Agricultural, Precious and Base Metals to diversify risk further. Finally, we are exposed to an income-generating fund with a reflationary focus. Its objective is to generate income expected to grow with global inflation by investing in real economy sectors such as Infrastructure, Agriculture, REITs, etc.

Macro Hedging
We maintain partial hedges on duration (in U.S. and Europe), spread duration (European IG, U.S. HY and EM sovereign) and equity (via option spread strategies on the U.S., Europe, Japan and EM) to hedge against rising uncertainty. We also maintain volatility management strategies on European rates aiming to benefit from a pick-up in volatility.

Security Selection
In terms of equity sectors, we hold a tilt to pro-cyclical sectors where earnings growth has been encouraging such as Financials, Consumer Discretionary and Energy balanced across Europe and the U.S. primarily. On the other hand, we hold limited exposure to bond-proxy sectors such as Telecommunications and Utilities, which may suffer in an environment of rising yields.

Within credit, we hold a majority of our exposure in the crossover area (BBB+ to BB ratings). Lower default expectations amid improving fundamentals makes positioning attractive despite tight spreads. We maintain a tilt to Subordinated Financials, which are preferable for their carry and relatively attractive valuations.

Outlook

Risk assets continue to trend higher amidst strong macro data and buoyant investor sentiment. In the U.S, the expected fiscal reforms should boost an already resilient economy. In the Euro area, employment seems to be rising at the fastest rate in a decade and robust data points to a continuation of a recovery in 2018. Strong momentum has also been recorded in Japan, while a reacceleration in EM economies should be under way.

Despite the constructive macro backdrop, an environment of stretched asset valuations, high market complacency and geopolitical tensions dictates that we maintain a moderate risk-on stance while using hedges to mitigate downside risks. A revival in global capex activity could sustain the momentum in earnings growth, thus benefiting equities in particular in our view. We prefer to be selective however by holding an exposure to equity markets that could still benefit from a late phase of the market cycle (Europe, Japan) or from a revival of the reflation trade (U.S.).

We believe central banks in DMs should continue to gradually normalise their monetary policies with the U.S. Fed leading the way. However, market expectations may be too benign as any surprises on inflation could result in a sharp volatility on interest rates and a sell-off in risk assets. Therefore, on fixed income we maintain a cautious stance on duration and continue to actively manage credit and liquidity risk.

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

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