Monthly Portfolio Update

Pioneer Funds – Emerging Markets Bond
31 January 2018

Bond

COMMENTARY

Market Review

January was a fascinating month, with one of the largest divergences between global equity and bond returns for some time. The S&P extended its record run of positive monthly total returns to 15 months and January was in fact the strongest of these. On the other hand, Treasuries had their worst month since Mr. Trump was elected in November 2016.

Equity markets gained amidst resilient macro data and risk-on market sentiment. With higher beta equity markets dominating the top of the leader board (in local currency); Bovespa (+11.1%), Hang Seng (+9.9%), Greek Athex (+9.5%), Russian Micex (+8.6%) the wider Emerging Markets (EM) index MSCI EM equities (+8.3%) surpassed the S&P 500 (+5.7%) while European equity markets – although still positive – have generally lagged other markets.

Within fixed income, higher inflationary prospects 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.

Despite the jump in U.S. Treasury yields, so far this year EM rates have continued to edge lower. The weakening correlation with U.S. Treasury yields reflects greater influence of local factors in the respective markets and reinforces our view that EM local rates should prove resilient to concerns surrounding QE exit by the ECB and the BoJ, a well telegraphed Fed hike in March, trade protectionism, and any revisit of a temporary U.S. Federal shutdown.

In our investment universe, we saw two notable events during January. As per EMTA's latest guidance, as of 9 January2018, Venezuela Republic bonds that are on the U.S. sanctions exceptions list were marked dirty (or settled at an all-in price). Any past due coupon and accrual for the VE Republic bonds were retracted from the EMBI indices, as a one-time adjustment on that date. PDVSA bonds were not impacted by this specific market guidance and continue to trade with accrual. In the corporate space, following Gazprom's rating upgrade by Moody's to Baa3 from Ba1 on 29 January, it will have an Investment Grade (IG) rating from two of the three rating agencies. As a result, the issuer is expected to move from the High Yield (HY) sub-indices of the CEMBI family into IG on February month-end. Notably, Gazprom's $16.1 billion of debt stock is expected to translate into a weight of 1.86% in CEMBI Broad Div IG and 3% in the CEMBI+ IG, 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%). 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 prices have extended their rally into the start of 2018, as both Brent and WTI saw their fifth consecutive month of monthly price increases reaching price levels not seen since 2014. ICE Brent was up +3.73% over January while NYMEX WTI increased +7.22% over the same period. 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 benefitted from the weak U.S. Dollar with gold rising +2.3%.

Portfolio Review

The Portfolio outperformed its benchmark[1] for the month. However, due to a weakened U.S. Dollar (vs EUR), performance was negative.

[1] JPM EMBI Global Diversified 95%, JPM Cash 1 Mnth Euro 5%

So far this year most EM bond market yields have edged lower, not higher. Some EM high yielders have even decidedly decoupled from U.S. Treasuries with yields sharply lower such as Indonesia and Brazil, where independent positive pull factors have dominated. More generally, FX has been of key importance for EM per se on several fronts. Aside from EM currency appreciation capping inflationary pressures, it also clearly enhances the local currency bond returns.

As a risk asset class, EM fixed income's investment thesis is anchored in the premium it provides to investors over and above what they could earn in U.S. Treasuries, the global proxy for a risk free return. Rising yields at the long end of the curve therefore challenge the asset class. With Fed rate normalisation well in progress, we deem short duration positioning essential to Portfolio risk management and are 1.3 years short duration and 1.7 years short spread duration.

Looking at regional/country shifts (in January), a reshuffle in Latin America and increased risk appetite in EMEA were the only notable actions.
We have been lowering our exposure to Energy names in Brazil and Mexico while increasing Argentinian sovereign exposure.
In EMEA, we like Turkish sovereign as a recent sell-off now offers buying opportunity and in South Africa, the favourable result of the ANC election raised market hopes that South Africa will avoid Moody's downgrade. Positive political developments also provide the possibility that FY 2018-2019 could see some progress towards fiscal consolidation which, combined with the disinflationary effects of the ZAR's rally, may increase the likelihood of the resumption of monetary policy easing by the SARB.

In terms of positioning, geographically, our preference for Latin America is overweight, we are neutral in Emerging Europe and an underweight in Emerging Asia credit markets remains in place. Country wise, we hold the highest exposure to Brazil, Argentina and Turkey (all overweight) and balance this with a structural underweight in low yielders; Philippines, Hungary, Poland and Malaysia. At the sector level, apart from significant cash buffer (11.6%) our overweight is in Banking, Basic Industry and Telecommunications funded through an underweight in sovereign exposure.

Looking at the performance contribution, all regions saw negative returns (in absolute terms) while Latin America and Emerging Europe generated strong positive relative returns. At the sector level, we saw selection strategies and allocation in more favourably risk adjusted shorter term corporates vs longer maturity sovereign bonds benefitting the Portfolio. Sectors that outperformed (in relative terms) were Industrials and Metals & Mining while TMT and Consumer Staples lost some ground.

Outlook

After two years of strong returns (in U.S. Dollars), it is tempting to turn cautious and position for a weaker market outlook going forward. A more potentially challenging global liquidity backdrop also calls for vigilance. Despite these risks, in our view, a range-bound 10-year U.S. Treasury yield, and a U.S. Dollar that might stay on a sideways path against the EUR should be supportive of EM risk appetite.

Moreover, the overall global liquidity is likely to continue to rise, albeit at a slower pace. In addition, elevated commodity prices broadly enhance EM economies' terms of trade. Finally, high real interest rates in EM compared to DM should keep EM attractive.

We expect hard currency EM sovereign bonds to underperform local government bonds in 2018, though a modest compression in spreads is expected. The supply outlook is also supportive for a modest compression in spreads.

The correlation of EM rates with U.S. rates appears to be breaking down and EM rates seem to have become more aligned with FX and equity markets. While strengthening EM FX helps in improving the inflation outlook and enhances local currency bond returns, higher equities are also associated with low risk aversion and the need for a lower risk premium in EM local rates.

We are bullish on local government bonds in Russia, Brazil, Indonesia, Malaysia and China. On a tactical basis we also like South Africa and Turkey. Where we are less positive is The Philippines, Hungary, Poland and Czech Republic.

The obvious risk to our positive EM outlook is inflation, along with tighter global financial conditions. Thus far, global central banks are treading a careful line, and that is still our central forecast together with subdued global inflation. The current environment is still supportive of broader EM risk, in our view.

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