Monthly Portfolio Update

Pioneer Funds – Emerging Markets Bond Short-Term
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 leaderboard (in local currency); Bovespa (+11.1%), Hang Seng (+9.9%), Greek Athex (+9.5%), Russian Micex (+8.6%), and 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. On the EMBI side, as per EMTA's latest guidance, 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 Venezuelan Republic bonds were retracted from the indices, as a one-time adjustment. PDVSA bonds were not impacted by this specific market guidance and continue to trade with accrual. On the corporate side, following Gazprom's rating upgrade by Moody's to Baa3 from Ba1, it will have an IG rating from two of the three rating agencies and as a result, the issuer is expected to move from the High Yield (HY) sub-indices into Investment Grade (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 monthly price increase, 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 benefited from the weak dollar with Gold rising +2.3%.

Portfolio Review

Pioneer Funds – Emerging Markets Bond Short-Term Portfolio came under pressure in January as weakening dollar (vs EUR) pushed portfolio performance into negative territory.

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,

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where independent positive pull factors have dominated (in USD). 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, and we deem short duration positioning (currently as low as 1.7 years) essential to portfolio risk management.

Looking at the performance contribution, all regions saw negative returns (in EUR) with Latin America dropping the most. However, the same region (in USD) was at the top of the performance scoreboard, followed by Africa and Emerging Europe.
In terms of sectors (in EUR), Financials, Energy and Materials lost ground, while in USD they were all slightly positive.

In terms of positioning, EMEA and Latin American remain our preferred regions (70% of the Portfolio), with Brazil and Turkey being the biggest country exposures. In Asia, we allocate primarily to China and India, and are less positive on low-yielders like Korea, Hong Kong and Singapore.

As U.S. Treasuries continue their upward path, and demand for shorter term papers increases, one would expect market inefficiencies to disappear. While that might be the case in the DM markets, our semi-efficient EM investment universe still, from time to time, offers unforeseen buying opportunities. In January, two such chances played out; mid-month Argentinian sovereign and Energy names traded sharply lower on the back of big new supply that the market absorbed rather slowly; and in Kazakhstan quasi sovereign Energy sector offered higher yield than sovereign with what we estimate was better spread per unit of leverage. In both cases we bought roughly 1% exposure, bringing country weights to 6.8% and 4% respectively.

At this point in time we are also turning slightly more bullish on local government bonds in Russia, Brazil and South Africa.
In Brazil, reduction in political premium surrounding the October presidential election, implementation of social security reform, and the prospect of one more policy rate cut should benefit local government bonds.
In Russia, there is a combination of restrictive fiscal policy and loose monetary policy that should continue to drive local bond yields lower.
In South Africa, besides falling inflation and signs that policy rates have peaked, political risks have receded. The recent election of Cyril Ramaphosa (business-friendly politician) as the President of the ruling African National Congress (ANC), show further improvements and saw us revising growth expectations upwards.

Outlook

After two years of strong returns (in USD), it is tempting to turn cautious and position for a weaker market outlook going forward. A more potentially challenging global liquidity backdrop, also call for vigilance. Despite these risks, in our view, a range-bound 10-year U.S. Treasury yield, and a USD 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 obvious risk to our positive EM outlook is inflation, along with tighter global financial conditions. So far, global Central Banks are treading a careful line, and that is still our central forecast together with subdued global inflation.

The correlation of EM rates with U.S. rates appears to be breaking down, and EM rates seem to have become more coupled 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 tactical basis we also like South Africa and Turkey. Where we are less positive is Philippines, Hungary, Poland and Czech Republic.

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