Quarterly Portfolio Update

*Amundi Funds II – Pioneer U.S. Dollar Aggregate Bond**

28 September 2018

BOND COMMENTARY

Market Review

Despite a significant rise in U.S. interest rates, U.S. equity and credit markets enjoyed breakout performance in the third quarter, outpacing European and most Asian markets, on the back of strong U.S. economic data. While U.S. equities saw their best performance in the quarter in July and August, U.S. credit and Emerging Markets (EMs) enjoyed a September rally. Second quarter U.S. GDP growth rose to 4.2% and third quarter growth may approach 4%. Initial jobless claims saw an all-time low (since 1969), small business optimism rose to its highest level since its 1974 inception, and consumer confidence was at its highest level since 2000. Although wage growth rose to 2.9%, the best level since 2009, inflation expectations remained contained. The Eurozone, on the other hand, suffered from a less positive outlook, grappling with risks posed by Brexit, the populist Italian government and Turkish exposure, as well as weaker manufacturing reports, higher oil prices and a fall in consumer confidence.

U.S. interest rates rose approximately 20 bps across the curve over the quarter and month, reflecting the expected 0.25% September increase on the short end of the curve. More notable, however, was the sharp increase in longer-term yields that occurred in September. Roughly 75% of the increase in yields reflected and increase in real yields and the term premium, suggested that the market is primarily pricing in a higher rate of real economic growth, perhaps encouraged by the strong economic data released over the quarter. The 10-year Treasury yield rose from its 2.85% levels of June 30 and August 31, to 3.06% at the end of September, returning -1.09% over the quarter. Agency MBS outperformed Treasuries of similar duration over the month and quarter, with respective excess returns of 0.11% and 0.17%. Mortgages benefitted from positive sentiment toward prepayment risk over the month and quarter, as well as from lighter than expected seasonal net supply. CMBS and ABS benefitted from the positive credit environment over the month and quarter, delivering excess returns of 0.77% and 0.31% over the quarter. Corporate credit markets led performance over the month and quarter, buoyed by the 7.7% return of the S&P 500, strong economic growth and corporate profits. Investment Grade (IG) credit delivered 0.78% and 1.69% excess returns over the month and quarter, representing the strongest excess returns since the third quarter of 2016 and second strongest over the past five years. Lower quality BBB corporates outperformed. With this performance, IG corporates recouped almost all their underperformance suffered in the first half of the year, with year-to-date excess returns rising to -0.11%. High Yield (HY) corporates returned excess returns of 1.15% in September and 2.62% for the quarter, for an absolute return of 0.58% and 2.44%. HY markets benefitted from strong corporate profits, high oil prices, limited new issuance and continued low defaults. With respect to floating rate assets, bank loans continued to deliver strong performance, returning 0.66% in the month and 1.82% over the quarter. Catastrophe bonds returned 0.14% for the month and 1.18% over the quarter, managing a positive return despite greater global hurricane activity.

Performance Attribution

The Portfolio outperformed its benchmark, the Bloomberg Barclays U.S. Aggregate Index, for Q3 and the month of September.

Month of September

The Portfolio benefitted primarily from duration positioning; sector allocation and the lower relative quality of the Portfolio also contributed to performance.

Positive

- As U.S. yields rose, the Portfolio benefitted from its 0.33 relative short duration position compared to the Index.
- Sector allocation benefitted from the 32% underweight to U.S. Treasuries, as credit outperformed over the month and the quarter.

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*Prior to 16 February 2018, Pioneer Funds – U.S. Dollar Aggregate Bond

Amundi ASSET MANAGEMENT

Marketing Material

In addition, Municipals and TIPS added modestly to performance.
- The lower relative quality of the Portfolio within Financials, Industrials and CMBS outperformed, as HY assets enjoyed strong performance and lower credit quality assets outperformed within IG.

Third Quarter

Contributors to performance were similar for the month and quarter. The Portfolio benefitted primarily from its sector allocation, the lower relative quality of the Portfolio's holdings and duration positioning.

Positive
- Sector allocation benefitted primarily from the 32% underweight to nominal Treasuries, as credit outperformed over the period. In addition, the overweights to convertibles modestly contributed.
- The lower relative quality within Industrials, Financials and CMBS outperformed.
- Rising yields in September drove outperformance of the relative short duration position.

Negative
- While sector allocation as a whole contributed to performance, the overweights to non-agency MBS and ABS detracted from performance, as structured sectors underperformed corporate assets.

Outlook

We believe U.S. GDP growth could achieve 3% this year, and modestly lower growth in 2019, as the benefits of tax cuts, deregulation, increased government spending and higher fixed investment contribute to growth. Solid employment and income growth may continue to support consumption and the housing market.

Globally, we believe the Eurozone and Japan may also grow above their potential GDP, benefitting from still supportive monetary policy. Risks have risen for Europe, however, from the lack of progress in Brexit negotiations, the populist Italian government and the potential impact of Turkey's economic challenges on European banks. Recent monetary and fiscal stimulus may help stabilise China's growth levels for the remainder of the year, which may offset the negative impact of U.S. tariffs, and China's earlier tightening of credit.

Global growth may suffer from Trump's more aggressive protectionist trade policy. While U.S. and European tensions have moderated, Trump's proposed higher tariffs on Chinese imports could have a negative impact on China, and by extension, on its Asian trade partners, on Europe, as well as on select commodity-dependent emerging market economies. We continue to believe that inflation may surprise to the upside. Wage growth acceleration, service inflation, tighter labour markets in key industries such as homebuilding, higher import prices resulting from tariffs, and more restrictive immigration policies may contribute to higher price levels in the coming year. Fiscal stimulus, including the tax cuts and higher spending from the budget has the potential to further fuel inflation.

Positioning

Duration: We have moderated our duration views over the past several months, and have taken a more neutral stance to U.S. duration, as the market has priced in more rate increases. While the market may still underestimate the FOMC's future rate increases, we also believe the FOMC is nearing the end of the tightening cycle. With the significant flattening of the yield curve we have seen over the year, we have also moderated our yield curve positioning. It is possible that inflation may continue to gradually trend higher, counteracting the flattening of the yield curve.

Credit Markets: In light of extended valuations, we have taken a more cautious approach to credit markets. With corporate valuations well below long-term averages and increased leverage within the IG and bank loan markets, these markets are more susceptible to what we believe could be a less benign credit environment going forward. We believe that structured credit sectors, including agency MBS, as well as non-agency MBS and ABS may offer more attractive relative value to investors, supported by the solid fundamentals of the U.S. housing market and the U.S. consumer, and by the strong credit protections they offer relative to their quality ratings. Agency MBS and high quality non-agency MBS also offer lower downside volatility. As rates have risen, short and intermediate-term Treasuries have become more attractive;

Within U.S. corporate credit, we believe selectivity has become increasingly important. While the outlook for corporate bond defaults is benign in the near term, with trailing twelve month HY defaults at 2.8%, elevated corporate leverage increases the negative impact of a turn in the economic cycle. We do not anticipate a recession over the next few years, so we continue to believe defaults will remain below long-term averages over the next few years. Nonetheless, higher leverage and fewer credit protections in both the IG and bank loan markets means that investors should upgrade the quality of their portfolios and avoid overleveraged sectors and companies, in our view. We hold overweights to Financials and the mid-stream Energy sectors, where we believe investors are better protected from event risk, and where we see superior downside protection. A key point on our midstream exposure is that the sector is still undergoing significant deleveraging from both debt reduction and growing EBITDA which underpins our decision to have a significant overweight to the sector. We also believe that the world will remain in supply deficit until late next year, and oil price risk has an upward bias, with curtailed supply from Iran and Venezuela.

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