Quarterly Portfolio Update

*Amundi Funds II – Pioneer Flexible Opportunities**

28 September 2018

BOND

COMMENTARY

Market Review

Financial markets have been dominated by worries about the tariffs the United States has threatened to impose on a number of other countries. However, at the end of the day, both stocks and bonds have delivered decent performances.

Those who expected the gap between the U.S. and International to be cut to size were disappointed, but it is a fact that financial markets climbed the 'proverbial wall of worry'. Thus, the S&P 500 delivered a nice 7.7% return in Q3; the MSCI Europe +1.4%; the MSCI Japan +6.3%; the MSCI China lost 7.7%. Most of the negative action was in Emerging Markets (EMs) with Argentina, Turkey, South Africa, and obviously China, heavily impacted. Towards the end of the quarter, India came under attack. In the Developed Markets (DMs), instead, the action was dominated by the nervousness generated by expectations for the Italian budget and scepticism around a solution to Brexit. As we speak, none of the above-listed problems have found a solution. Also, but that's pretty much a constant, scepticism on China abounds. As if not enough, China looks like the primary target of the tariff-war. We are not inclined to consider China, inevitably, the casualty in that 'war', but we believe caution is warranted.

Performance & Outlook

Performance was positive for the Portfolio during the period in an environment where markets were volatile, although most major markets were positive for the period with the exception of EMs, which finished the quarter down -1.09%. The S&P 500 returned 7.71%, European stocks were up 0.80%, and Japanese equities were up 3.68%. The volatility in markets was driven largely by noise associated with the threat of trade wars rather than any real deterioration in fundamentals.

As a result, performance was driven by our equity exposures in DMs, particularly those located in the U.S. related to our Healthcare and Aerospace & Defence investment themes. Detractors from returns during the quarter came from EM exposures from China as a result of systematic risks associated with continued tariff talk concerns.

During the third quarter, no material alterations have been made to the Portfolio and its positioning. We continue to maintain a globally diversified asset allocation by owning assets across both U.S. and foreign markets. We recognise that exogenous events can and will occur, and as a result we have the flexibility to shift our allocations as conditions evolve.

The Portfolio's asset allocation at the end of the quarter continues to be heavily biased towards equities, representing approximately 77% of the Portfolio. Within our equity exposure, approximately 39% was held in North American equities, 24% in other DMs (ex U.S.), and 14% was in EMs. For the Fixed Income sleeve, 5% of the Portfolio is allocated to EMs sovereign bonds with the remainder of the Portfolio allocated primarily to cash and REITs (5%) with smaller allocations to U.S. and International Investment Grade and High Yield corporate bonds. All of the above mentioned allocations, investment decisions and positioning reflect our understanding of the current economic climate. With that said, uncertainty persists with respect to how potential changes within major trade relationships, plus geopolitical tension could influence fundamentals and undermine growth. Fund Management remains acutely focused on whether these external considerations have the potential to impact our core outlook, and thus, our orientation and asset allocation. World economic growth might be in the process of slowing down somewhat, but it can still be considered healthy enough in our view. If anything, the growth gap between the U.S. and the rest of the world remains wide. We do not expect that gap to close (or even compress) anytime soon.

Another topic worth mentioning is related to the stance of monetary policy in the U.S. Here, the Federal Reserve (Fed) has brought the intended rate back up to 2.25%. We expect more rate hikes. CPI-inflation has increased slightly (the CPI 5yr/5yr swap has barely moved), but the FOMC, correctly, believes that policy should not be seen as 'behind the curve'.

Moreover, the Fed should be careful not to encourage excessive speculative activities. That said, the present attitude cannot be dubbed as ‘restrictive’: the intended rate is more or less in line with CPI-inflation and ½ the size of nominal GDP growth.

Plenty has been written about the slope of the yield curve. Our view remains that the negative term-premia observed ever since the Great Financial Crisis are reason enough to doubt the reliability of instruments that rely so much on 10- and 30-year yields. It is a fact that, over the same period, the gap between the 2-year note (or the 5-year note) and the official rate has widened: a recession does not seem to be around the corner in our view. The rest of the world may slow down, but unless the U.S. economy runs into trouble, there’s no reason to believe that something bad is on the cards. Even the issues with Argentina, Turkey, South Africa (Brazil?) can be managed. Were China to hit a recession, the situation would be very different.

The U.S. market has its merits, but we find the gap in valuations excessive. That does not mean, though, that we expect the gap to close (much less, significantly) any time soon. Ignoring the benefits of a potential arbitrage between the cost of capital and cost of debt comes at a hefty price for both Europe and Japan. Bottom-line: the potential in other DMs cannot be easily dismissed, but the U.S. remains the safest country, in our view. Most EMs are attractive on a valuation-basis, but it is tradition that the EMs are not the right place to be once the Fed has started a tightening cycle. We have kept the exposure stable, reduced the exposure to Europe, increased Japan, reduced EMs exposure significantly.
Exposure to equities remains above bonds (about 65%, net of some hedges) versus about 7%. We still do not see any value in fixed-income. Among the sectors with the highest weight, Aerospace & Defence, Healthcare, Luxury & Leisure.

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