Quarterly Portfolio Update

*Amundi Funds II – Global Multi-Asset Target Income**

28 September 2018

MULTI-CLASS

COMMENTARY

Market Review

Divergence in asset class and regional performance was a prominent feature in Q3 with the threat of trade wars and turmoil in EMs resulting in a risk-off market backdrop. The lack of clarity on the fiscal situation in Italy and Brexit negotiations resulted in further stress. Global macro data continued to slow-down from the highs registered earlier in the year while central banks continued to diverge on their monetary policy stance. Towards the end of the quarter, we saw the U.S. Federal Reserve ("Fed") signalling another rate rise before year end given increasing US wage levels feeding through into US inflation.

Despite heightened market uncertainty, equity markets outperformed with the MSCI World TR index up +5.0% in Q3. Performance was driven by US equities against a strong macroeconomic and earnings backdrop and positive investor sentiment. The Technology sector rallied helping Growth stocks outperform Value stocks. Regional disparity was quite pronounced in Europe with France (+3.4%) posting gains while UK (-0.7%) and Italy (-3.6%) posted losses amidst political turmoil. In Asia, performance was dominated by the Japanese market, with the Nikkei 225 returning +8.8%. Emerging Markets ("EM") struggled due to concerns over trade wars, with the MSCI EM returning -1.0% in Q3. EM Asia was the worst-performing region, with negative returns, whilst Latin America and European EM markets experienced positive returns.

Within fixed income markets, prospects of higher inflation and higher rates from the U.S. Federal Reserve ("Fed") kept US bond yields under upward pressure. US 10-year bond yields finished the quarter at 3.06%, the first decisive break above 3% since late May 2018. Whilst the US curve did steepen slightly in September, over Q3 as a whole it flattened. In Europe, the rise in yields was less pronounced but still significant. The 10-year German Bund yield finished the quarter at 0.47%, a rise of +17bps in Q3. Shorter-dated German yields fared a bit better and as a consequence the German yield curve steepened during Q3 2018. The well-publicised Italian political difficulties resulted in the agreement of a targeted 2019 budget deficit of 2.4% and the intention to keep the deficit at that level for the next three years. Unsurprisingly, investors were unimpressed and 10-year Italian BTP yields rose to 3.15%, a spread of +267bps over equivalent 10-year German yields.

Within EMs, recovering investor sentiment helped the JPM Emerging Markets Bond Index gain +1.48% for Q3. In credit markets, Investment Grade ("IG") and High Yield ("HY") sectors saw some dispersion across Euro and U.S. issues in Q3 with the US generally outperforming Euro credit indices against a strong macro and political backdrop. Higher beta sectors benefited more from spread tightening particularly in the US. Global HY (+2.2%) outperformed Global IG (+0.0%) as represented by Bloomberg Barclays Total Return Hedged USD indices.

Within currency markets, the U.S. Dollar Index gained +0.7% in Q3 due to modest gains against most major currencies apart from the Canadian Dollar. Despite Italian political worries, the Euro performed reasonably well, as did Sterling in the face of Brexit issues. EM currencies suffered amidst higher US bond yields with the JP Morgan Emerging Markets Currency Index down -3.7% in Q3.The two biggest losers were the Argentinean Peso and the Turkish Lira depreciating -42.8% and -31.9% against the U.S. Dollar.

Commodities experienced a mixed quarter, with the S&P GSCI Total Return Index rising +1.3% in Q3 due to a strong rally in oil markets. With US sanctions on Iran being heavily enforced, there is speculation that we may again see oil prices above US$100bbl, thus resulting in a +7.5% rally in Brent prices in September to finish Q3 up +5.5%. Metals such as Copper and Nickel ended down -5.5% and -15.6% due to a slow-down in global trade activity while Gold lost -4.9% as higher US bond yields weighed on demand. Agricultural commodities were generally weaker, falling -5.4% for Q3 as a result of better than expected weather conditions.

Portfolio Review

The performance of the fund during the 3rd quarter was positive with regional market and sector

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performance diverging strongly. In an environment of slowing economic momentum and elevated political risks, we reduced exposure to risk assets to neutral levels and maintained hedges in place to protect the portfolio from a risk-off scenario.

During the third quarter, Macro Strategy and Satellites added to returns, while Hedging and Selection detracted. With respect to asset classes, exposure to equities was generally very positive as the asset class posted strong gains, specifically US and Japanese equities. Interest rate exposure detracted as yields trended higher globally over the quarter. Positions in Emerging Market bonds helped performance as well as spreads narrowed. Our positions in corporate bonds – both IG and HY – were positive as well.

In the equity sector, our allocation to US and Japanese equities added to returns as these markets posted positive results in Q3. Exposure to European and Emerging Markets Equities contributed as well. While our overweight in Health Care and Energy was positive, positions in Consumer Staples and Financials partly offset returns. Equity selection was negative overall, specifically in Europe where positions in Bayer, Intesa Sanpaolo or Vodafone detracted. Satellite equity strategies contributed to performance, specifically an underweight of small caps vs. large caps. Our volatility hedging strategies in various equity markets detracted from returns.

Within fixed income, exposure to interest rates in the US, UK and Europe was negative for performance as yields increased in most markets. Our duration exposure to Italy was at a minimum and as such the portfolio did not suffer from the spike in yields towards month end. Emerging Markets bonds added to performance as well, although the quarter was very volatile due to the turmoil in Turkey and Argentina. Overall, however, spreads in the sector tightened. Exposure to inflation was broadly neutral in Q3. While we decided to close the US inflation strategy, we are still positioned for higher inflation in Europe and Japan. Our holdings in Investment Grade and High Yield Credit were generally positive over the quarter. Specifically the overweight position in the financial sector and subordinated financials helped as these sectors outperformed. In addition, exposure to High Yield bonds added to returns as the segment benefitted from tighter spreads both in the US and Europe. However, our hedging position in US HY via Index CDS partly offset some of the gains. Satellite strategies in fixed income were slightly negative in total. While curve strategies in Euroland and the UK added to returns, a spread widening strategy between German and peripheral bonds detracted.

Within FX markets, an underweight of the US Dollar vs. a basket of Emerging Market currencies was a major detractor from returns as investors were afraid of contagion effects from Argentina and Turkey to other countries and sold the asset class. In order to limit losses, we decided to close the position early in September. Our overweight positions in the Japanese Yen vs. the USD was negative for performance as the Yen weakened. Exposure to Real Assets and commodities slightly added to returns, while our position in gold detracted.

Asset Allocation (Macro Strategy and Satellite Strategy)

The global expansion continues, however, growth momentum is softening on the back of protectionist threats, lower liquidity and increased political uncertainty (i.e. Brexit or Italian Budget). The negative (idiosyncratic) developments in Argentina and Turkey caused many investors to become more cautious as well. We maintain a neutral position on risk assets, clearly emphasising markets with strong earnings prospects like the US. We remain vigilant on Emerging Markets and prefer relative value strategies rather than directional positions.

In the portfolio, we maintain an overweight allocation to US equities as fundamental data in the US is still supportive, underpinned by continued strength in corporate results and expansionary fiscal policy. We expect US markets to be more resilient in the current environment. In Europe, we are becoming more constructive again after the market has suffered substantial outflows from international investors. Here we favour defensive stocks and value themes. We maintain our exposure to Japanese equities at a neutral level. With respect to Emerging Markets ("EM"), we continue to be cautious and selective. Although the market has sold off recently, we maintain a neutral view on EM with a strong focus on regional selection. We prefer countries with robust fundamental data and low external vulnerabilities. We like China, for example, due to its positive medium-term perspectives. Chinese equities are already discounting an escalation of the trade war with the US and fundamentals remain sound. Overall, the valuations of EM equities have improved after the recent sell-off, however, we prefer to search for entry points after the US mid-term elections as we expect the discussions on tariffs to ease thereafter.

On fixed income, we have slightly increased duration over the past quarter but maintain a generally low overall exposure to interest rates. We increased duration in the Eurozone and the US, while we reduced our position in the UK. We maintain an overweight in the US, where the Fed is advanced in the hiking cycle. In Italy, yields were very volatile due the high uncertainty around the budget plans. As the budget comes with a higher-than-expected deficit of 2.4%, there will likely be tensions with the EU. As such, we expect further volatility in Italian rates and have added a 2Y/10Y curve flattener as well as a relative trade long 10Y Bunds vs. 10Y Italian BTPs. In Japan, we maintain a negative duration exposure as we expect the BoJ rhetoric to turn a little more hawkish over the coming months. We maintain our positioning for higher break-even rates in Europe and Japan, where we anticipate an increase in price dynamics. In the US, where headline CPI has been rising above the 3% level in August, we closed our inflation exposure. Although the US yield curve has flattened considerably over the past months, we maintain our curve steepening strategy between 2 and 10 year maturities. We also added a strategy to benefit from a widening 5Y interest rate differential between the US and Germany. With respect to Emerging Market bonds, we reduced the overall allocation during the previous months. We maintain, however, some selective exposure to countries in Latin America, Africa, Asia and Eastern Europe for carry reasons. As with EM equities, issuer selection is key in the current market environment.

In the IG corporate sector, we are becoming more cautious as we expect higher spread volatility ahead. In the US, credits are still supported by the positive cyclical momentum, but funding conditions will get tighter going forward as the FED policy is not accommodative anymore. We maintain a preference for European credits, where balance sheets remain solid, valuations got more attractive and the credit cycle is younger than in the US. In terms of sector allocation, we maintain an overweight to Financials and Industrials. We get more cautious on Subordinated Non-Financials due to stretched valuations limited excess return potential.

High Yield bonds (“HY”) generally benefitted from low default rates and solid earnings. However, high leverage levels and tightening financing conditions warrant a more defensive stance and a strong focus on security selection. Thus we have become more defensive on HY and have reduced our overall exposure during the past quarter – both in Europe and the US. We have also implemented hedging strategies on US High Yield.

In the current late cycle environment combined with unpredictable political dynamics, we place a higher emphasis on uncorrelated, market-neutral Satellite Strategies. For example, we expect a more difficult environment for small caps in the US and UK compared to US large caps. Therefore we implemented a long position in S&P 500 vs. short positions in US and UK small cap indices. Reflecting the political risks around the Italian budget law, we implemented a spread widening strategy between German Bunds and Italian BTPs. We also keep our long position in the European Banking sector vs. the MSCI Europe, seeking to participate in a rebound of bank stocks.

In terms of currencies, we closed our short US Dollar position vs. a basket of EM - predominantly Asian – currencies after it reached the stop-loss limit. We maintain the long JPY position vs. the US Dollar due to its safe heaven character in case of a more volatile market environment. Scandinavian currencies like Swedish and Norwegian Krona should benefit from strengthening macroeconomic conditions. In Australia, we have implemented a short AUD position on the back of a weaker outlook for the real estate sector.

Macro Hedging

We have put hedges in place on spread duration for US High Yield bonds and closed option-based hedges of US equites exposure via put options. We also initiated a hedging strategy on EM bonds in August. In addition, we maintain positions to mitigate equity volatility and reduce downside risk from tail events in Europe, the US, Japan and Emerging Markets. We also keep volatility management strategies on US High Yield bonds and EUR IG via CDX HY and Itraxx Main index options, which should benefit from a pick-up in spread volatility.

Security Selection

Generally, we seek to improve overall credit quality in the portfolio by putting a higher emphasis on Investment Grade vs. High Yield. In the current environment, we prefer European issuers and maintain a tilt to Subordinated Financials, which are preferable for their carry and relatively attractive valuations. We also maintain selective positions in the crossover area (BBB to BB ratings) as it still offers attractive risk-return characteristics. In terms of equities, we are in favour of more defensive sectors such as Healthcare, Energy and Telecom Services.

In September 2018, we sold options by a notional amount of 2.9% of the net asset value where we have gathered an additional yield of 5.5 bps. On a sectoral base, we underwrote Energy driven by the increasing oil price, Metals/Miners due to the previous drawdown and a European car producer. Furthermore, we overwrote EU Consumer Staples and US Utilities for the September expiry.

Outlook

The global economic expansion continues, but momentum is weakening. We are seeing some deceleration in certain emerging markets, whilst political and geopolitical noise remains elevated (trade disputes, elections). As a result, the fragility in investor confidence can suddenly translate into a risk-off mode in some asset classes, as we have seen recently in the EM space.

Yet that fear did not cause a “flight-to-quality” and subsequent out-performance of DM assets. Instead, the US ended up as the clear winner, thanks to a combination of hope (earnings, productivity and capex growth), fear (safe-haven status, repatriation of funds) and momentum. Returns in Q3 clearly support this pattern, as the US equity market continues to post new highs while most other markets are either flat (European equities and aggregate bond indexes) or negative (EM). Against this backdrop, we remain cautious on risk asset exposure and we focus on themes that are backed by either strong economic momentum or by compelling valuations.

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