Quarterly Portfolio Update

*Amundi Funds II – Pioneer Dynamic Credit**
29 June 2018

BOND COMMENTARY

Market Review

While volatility pulled back from the high levels seen in the first quarter, in the second quarter markets continued to suffer from heightened volatility relative to the very low levels of 2017. Concerns about trade wars took centre stage, as President Trump stepped up the pursuit of tariffs against allies and adversaries alike. Fears that the new populist Italian government threatened the status quo of the Euro and European Union rose in late May, but abated as a new government was formed and officials toned down their anti-Euro rhetoric. Finally, the unexpected appreciation of the U.S. Dollar, which rose 5.7% from its mid-April low, as well as a continued rise in oil prices, which have climbed 23% year to date, including a 14% increase in the second quarter, contributed to a sell-off in Emerging Markets, particularly in countries with significant U.S. Dollar debt.

The U.S. Dollar appreciated in part due to a more hawkish FOMC, counterbalanced by a more dovish ECB. Citing continued strong GDP and employment growth and rising inflation, the FOMC raised rates in both of their March and June meetings, and brought forward projected rate increases, to include two more increases in 2018. However, they also adopted a symmetric view around their inflation target in June, indicating they would not necessarily take a more aggressive approach to increasing rates, should future inflation exceed target levels for a short time.

Treasury rates rose over the quarter and in June, led by short-term rates. While U.S. Treasury prices enjoyed a short-lived rally at the end of May driven by a flight to quality on the Italian crisis, they quickly shed their gains and yields rose modestly into the end of June. The 2-year U.S. Treasury yield rose from 2.27% to 2.41% over the quarter. The yield curve flattened, as the 10-year U.S. Treasury yield rose from 2.74% to 2.85%, after peaking at 3.11% in mid-May; 30-year U.S. Treasury yields remained relatively unchanged over the period, ending at 2.98%. Inflation expectations rose from 2.04% to 2.13% over the quarter.

Investment grade corporates delivered their worst semi-annual return since 2013, as they continued to sustain losses over the quarter and the month. Structured sectors and high yield assets generally outperformed U.S. Treasuries in the period. Investment grade corporates returned negative absolute and relative returns (vs. U.S. Treasuries) of approximately 1% over the quarter, and spreads widened from 109 bps to 123 bps in the wake of multiple factors: higher rates, trade fears, lower non-U.S. investor demand (who likely balked at increased currency hedging costs), the sales of corporates from repatriated offshore cash portfolios, deteriorating credit quality and high issuance due to increased M&A transactions. Agency MBS outperformed, delivering a 0.15% excess return, as rate volatility declined from the first quarter and the housing market continued to be strong, despite increasing rates and rising home prices. CMBS were flat to Treasuries, while ABS delivered 0.17% excess returns. High yield corporates enjoyed positive total and excess returns over both the quarter and the month, benefiting from their U.S.-focus, their higher yield and low default outlook. Over the quarter, they delivered positive total and excess returns of approximately 1%, as spreads remained almost unchanged, ending the period at 371 bps.

Outlook & Positioning

The Portfolio's total return was negative during the quarter largely due to duration, and our higher quality positioning as B and CCC have been outperforming this year. Additionally, spread widening in Europe due to geopolitical issues, particularly in Italy, put pressure on all of European credit that also negatively impacted performance. Our security selection was largely neutral to the Portfolio's attribution for the quarter. Although the U.S. continues to do well from an economic standpoint, we have seen Investment Grade spreads widen, which we believe may signal the start of weakness within credit, particularly as rates are rising. We anticipate the Fed will continue its tightening with another two rate hikes this year, followed by more during the next year which likely will cause risk assets to be highly volatile.

Flexibility – We believe the Portfolio is well positioned based on our analysis of the markets and global economic data resulting in no material changes during the period. However, we have modestly increased the overall credit quality as we do believe we are nearing the end of the credit cycle. During the quarter, we also increased duration positioning with a view to protecting the Portfolio from the risk of increased volatility, but remain short interest rate duration (about 3.5 years) relative to our neutral point of risk. We have recently reduced our risks related to both EM and Currency. With the aim of reducing sensitivity to U.S. Treasury and credit markets, we continue to diversify across a variety of asset classes including ILS and securitized credit, which have supported performance during the period. We moderately increased our exposure to securitized residential sectors such as CRTs and SFRs.

Focus – From a sector positioning standpoint we seek to find long-term value in sectors and with long-term stable cash flows. The Portfolio did not make any significant sector or corporate industry allocation shifts during the period. We are still weighted towards Financials and Midstream Energy along with exposure to European Corporates. In particular, we believe that Financials ought to benefit from higher and steeper interest rates along with the easing of financial regulations. Given stable housing market fundamentals, the Portfolio has maintained its exposure to housing related credits.

Discipline – We remain cautiously optimistic, given the economic environment and strength of corporate earnings. However, we also recognize that the market can shift quickly and that credit spreads are on the tighter side and valuations are less compelling. As a result, we continue to position the Portfolio more defensively, and tail risk hedges remain in place.

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