CIO LETTER

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Fixed Income Stormy Waters

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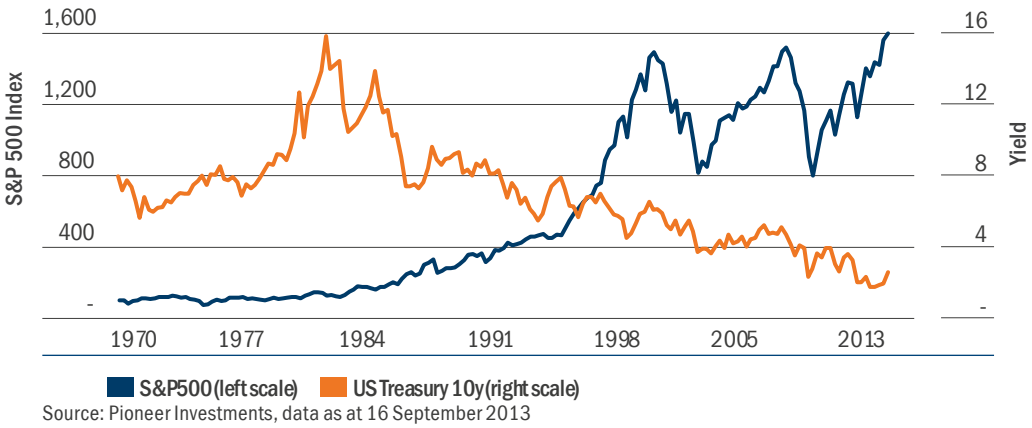
I am sailing, I am sailing/ home again 'cross the sea
I am sailing, stormy waters/ to be near you, to be free (Rod Stewart)

Recent market movements have reminded investors that the fixed income market is facing a secular change, after a 30-year-long bull market driven by a continuous decline in interest rates. The benchmark 10-year US Treasury yield has fallen from a peak of 15.8% back in 1981, to 1.4% in July 2012, which we believe is going to be the bottom in terms of yields in the secular bull market. In the next several years the space for further compression of interest rates is close to zero, while the likely long-term trend for rates is up. This may have potentially profound consequences not only for bonds, but for financial markets in general.

In this letter, we discuss the implications of a long-term scenario of rising interest rates, and their interaction with an unstable global economy, and we try to draw some conclusions in terms of investment strategies. We will argue that the announcements of the death of fixed income as an asset class are greatly exaggerated, just like Mark Twain's death to quote this famous author, but that fixed income investors and asset allocators need to adopt a significant change of approach to face the new reality.

We think the announcements of the death of fixed income as an asset class are greatly exaggerated.

S&P500 vs. 10-Year Treasury



Source: Pioneer Investments, data as at 16 September 2013

The period of declining interest rates started after the winning fight with inflation of the 70s and coincided with a boom in financial and economic conditions. It featured secular bull markets in equities (until 2000) and bonds, a marked increase of the size of the financial sector in developed economies, a boom of emerging economies. It's true that

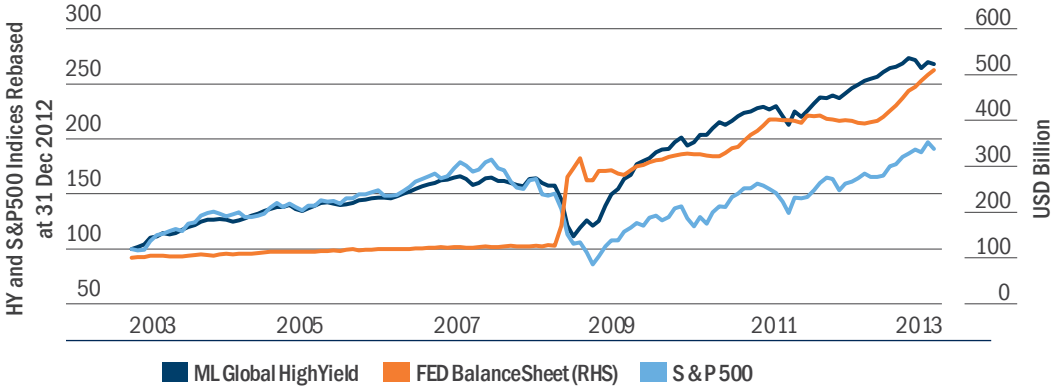
the increase in the level of globalization may have played a role also, with Asia in particular opening up to the market economy. But most of the boom was due to an unprecedented (in modern times) expansion of credit, both in the private and public sector. We can define it as a period characterized by a **credit-driven growth model.** (This period has also seen a very high volatility of financial assets, more prone than in the past to violent cycles of boom and busts.)

Central banks have played a vital role in this story, even if the marginal effect of their action has progressively become less incisive. They have played a role by underwriting financial asset' booms through their (largely loose) interest rate policies, and by trying to smooth the declining part of economic cycles through "unconventional" monetary policies. This hyper-activity of Central banks has helped to avert the most nefarious effects of financial crisis on the real economy, avoiding the creation of depression spirals. But now the action of Central banks has seemingly reached its upper limit in terms of impact. To generate "endogenous" growth, new growth models must be found.

After the last crisis markets have "front-loaded" improvements in the real economy which have not been confirmed yet by statistical evidence.

After the last crisis (the Great Financial Crisis of 2008), **markets have "front-loaded" improvements in the real economy** which have not been confirmed yet by statistical evidence. In effect, they have anticipated a recovery in growth patterns thanks to the support of massive liquidity creation from Central Banks. Now a "normalization" of monetary policies is expected, first in the form of a reduction of the programs of quantitative support and then with an increase of interest rates to long-term averages (mean-reversion). What does it mean for the real economy? For financial markets? And for us, as investors?

FED Balance Sheets vs. Global HY and S&P500



Source: Bloomberg, data as at 31 August 2013

One of the key point is whether the investment techniques and mental models we adopted in the last 30 years are also valid in the new phase.

The challenge we face is not just to confront the current situation with other periods of monetary policy tightening (such as in 1994). The point we want to make is to ask ourselves **whether the investment techniques and mental models we adopted in the last 30 years are also valid in the new phase.** (After all, most of the current professional market practitioners, including yours truly, have spent most if not all of their careers in a bond bull market!).

The hypothesis to be tested is one of long-term mean-reversion of interest rates. But how does it relate to the current and prospective features of the global economy? Is this hypothesis plausible? As we said, the economic landscape has changed dramatically after the Global Financial Crisis, and the old growth models, though not viable anymore, have not yet been substituted by new ones.

In a nutshell, **the global economy still confronts three big long-term challenges:** a deficit of global aggregate demand; large intra-country income inequalities; dysfunctional national and international mechanisms of political decision-making. In the US, the process of private sector deleveraging is at an advanced stage, but it is not clear whether this will be enough to sustain decent levels of growth when the long-term contingent liabilities in both the private and public sector will start to emerge. Europe has averted a systemic crisis thanks to the pre-emptive theory of Mr. Draghi ("whatever it takes"), but it has not yet found an effective mechanism of political decision and intra-EU cooperation to overcome its structural impediments to growth (same story as Japan). Emerging countries, and China in particular, are trying to execute a difficult transition from an investment and export-led growth model to one based on consumption, in a phase of structurally low global demand.Finally, the volatility of international capital flows is not helping all these transitions, and risks of protectionism and capital controls are resurfacing.

We see three possible scenarios for the next medium to long-term phase (five/seven years):

1. The global economy gradually reaccelerates to a normal growth pattern, because all the transitions just mentioned take place in an orderly way, together with a recovery in international cooperation. In this case, interest rates gradually rise "for a good reason" and financial market improvements are stably sustained. Goldilocks.
2. The instability remains, but at the same time the excess of liquidity created by Central Banks in the last few years starts to create inflationary spikes. The long part of bond markets gets out of control, and Central Banks have to tighten massively to regain control. Interest rates rise for a "bad reason" and economies fall back in deflationary crisis.
3. The mean reversion of interest rates is very muted. Global growth remains anaemic but inflation is under control because of the remaining slack in the economy. Central Banks adopt even more creative instruments of monetary policy which are less and less effective in improving economic fundamentals/supporting financial market prices. Volatility reigns.

We must move from a market model based predominantly on liquidity and credit creation to a market model driven mostly by long-term real economic growth fundamentals.

We must acknowledge first that the main factors which supported the last 30-year' market trend, i.e. the interest-rate secular decline, and the benign and effective intervention of Central Banks, are going to be largely absent from each of the above three scenarios. We think this means that **we must move from a market model based predominantly on liquidity and credit creation to a market model driven mostly by long-term real economic growth fundamentals.**

The "new growth models" have not emerged yet to substitute the credit-driven one.

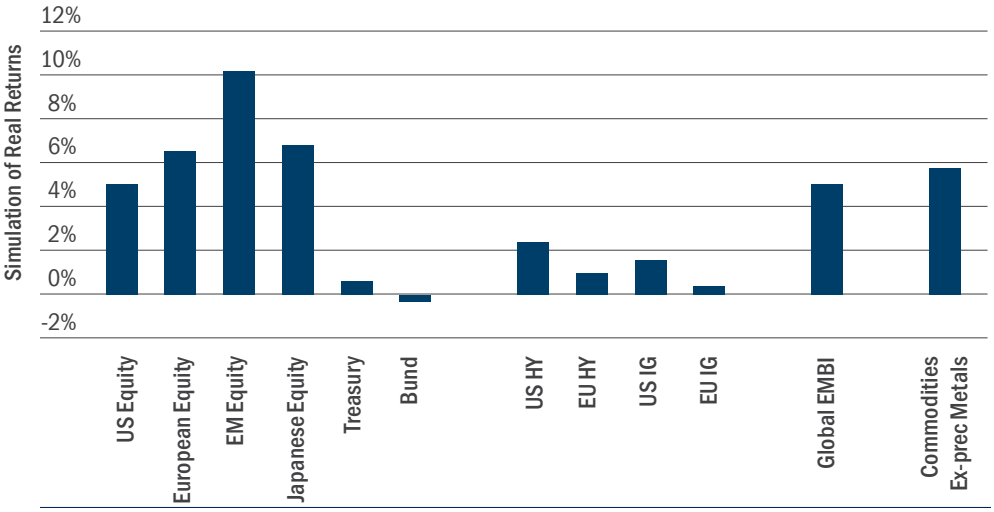
If we accept the previous statement, **asset allocators are confronted with a somewhat different task than in the past.** They should make more accurate assumptions about long-term trends in real economy patterns (productivity gains, demographic, institutional and regulatory patterns) because they will likely play a more important role than credit expansion and liquidity in the next few years. This is not to say that credit cycles will not matter anymore. I believe that they will, but they will act mainly as headwinds, as opposed to enablers, of long-term real economy trends.

For example, looking at our **current asset allocation positioning,** the next major strategic change will be implemented according to which of the above scenarios will receive the strongest signs of confirmation, in combination with an assessment of how much markets have priced it in. In fact, we have been keeping a long "risky" asset position since 2009, based on the premise that markets have front-loaded the improvements in the real economy thanks to Central Banks' liquidity injection. Recently, moving towards the end phase of Central Bank support, we have gradually reduced our risk exposure (first in the credit markets, then in the emerging markets complex, fixed income and equity).

We must say that the evaluation of the prospective long-term economic scenario is no easy task at present. Sell side strategists are divided. The visibility on the real economy improvements is low, based on current data evidence. The "new growth models" have not emerged yet, as we said, to substitute the old one. Therefore, looking at our three scenarios, they all seem quite possible.

We believe that market valuations will be the predominant guide to asset allocation for the foreseeable future.

Simulation of 10-Year Asset Class Real Returns (Annualized)



Source: Pioneer Investments, data as at 31 August 2013. These are Pioneer Investments estimations for illustrative purpose only. Opinions and estimates offered constitute our judgment and are subject to change without notice, as our statements of financial market trends which are based on current market conditions.
References to 10-Year Expected returns are not promises or even estimates of actual returns a client portfolio may achieve. Any forecast contained herein are for illustrative purposes only and are not to be relied upon as advice or interpreted as a recommendation[1].

In this context, we believe that **market valuations** will be the predominant guide to asset allocation for the foreseeable future. So, what to do? At present, none of the major asset classes seem cheap in absolute terms (and we deem quite inappropriate a choice purely based on relative valuations). Looking at expected long-term returns (as shown in the graph above), we see only European equities and selected emerging country equities as attractively valued. Hence, our overweight in these asset classes. In this context, I believe the best strategy is to help to protect ourselves from the most adverse outcomes, while placing enough dry powder aside to play the markets when conditions become more favourable. At the same time, bottom-up selection needs to be aware of highly leveraged issuers (countries or companies) which have tended to suffer their interest rate sensitivity.

What about fixed income investing? Bonds will probably always play a role in investors' portfolios, but will it be the same role as before? On one side, we still have long-term investors who need to match their long-dated liabilities. And the so-called "search for yield" which has characterized the retail demand for investment products in the last few years is not destined to abate soon, given the lack of income growth in the developed world. On the other side, fixed income investors, who collectively own more than $5 trillion of assets[2], are not used to capital losses after a 30-year bull market. Recent

[1] 10-year equity market returns are obtained by the aggregation of the projected contributions to total returns from earnings growth, valuation re-rating and dividends (share buy backs are considered where meaningful). Earnings growth is calculated as the combination of sales growth and margin changes, valuation changes, impose a long-run mean reversion on long-term CAPE, while dividends are calculated on constant pay-out ratios. Government bond returns are obtained relying on the hypothesis of long-term mean-reversion of the related tenor of the rates curve. Credit returns are obtained by the aggregation of long-term mean-reversion in credit spreads, related government rates and default rates of rating class. In commodities precious metals are excluded. Real returns are calculated with local expected inflation.

[2] Data refers to US fixed income individual investors and defined contribution plan, When the Tide Turns: Building Next Generation Fixed Income Managers, Casey Quirk May 2013

events have shown how violent the outflows from the asset class can be in phases of volatility. Finally, "financial repression" from Central Banks is becoming a less powerful policy at the margin, as we said, and the rush to exit when expectations on future rates change can be quite destructive.

It will be key to move from a liquidity-driven and Central Bank dominated market interpretation, to one relying more on long-term scenario analysis, accepting and managing proactively the short-term market volatility.

Still, fixed income investors have a lot of opportunities to play with. First, they can play dynamically the carry linked to maturity extension. This can become a source of alpha, if played effectively, and not only of beta exposure. Historic experience tells us that, even in long-term trends, interest rates do not move in a straight-line fashion, and there are short-term cyclical bull and bear market phases to exploit. For example, we now believe that bond markets in the US and Europe have somewhat overshot and we have, therefore, increased our duration position tactically.

Besides, playing the duration cycles is not the only source of alpha that investors have. Modern risk budgeting techniques, such as the one we employ at Pioneer Investments, allow investors to exploit the full spectrum of risk premiums available in the fixed income space: credit, curve steepening, geographic exposure, currency, volatility, and so on. I believe that benchmarks will see their importance diminished (alongside what we have seen in the equity space in the last 10-12 volatile years) and dynamic and flexible approaches will tend to prevail. Investment products which are "duration agnostic" will likely be in high demand.

Other options for fixed income investing include:

1. Importing "alternative investments" techniques in the mainstream investment space; we have already mentioned risk budgeting; long/short investing in credit and global macro are the most obvious candidates.
2. Extending the scope of the fixed income asset class to a broader definition of income assets, which provide yield but they are less correlated to the macro trends in interest rates, and more to long-term structural trends: infrastructures and real estate.
3. Increasing portfolio leverage to enhance low fixed income returns (risk parity approach); it is an option we do not particularly like, due to its riskiness in case of adverse liquidity events.

In conclusion, we believe that the economic and financial landscape in the medium to long-term is not particularly favourable for financial assets in general (not just for fixed income). The tailwinds of secular interest rates decline and credit expansion are not going to be there to help in the new cycle. For asset allocators, I believe it will be key to move from a liquidity-driven and Central Bank-dominated market interpretation, to one relying more on long-term scenario analysis, accepting and managing proactively the short-term market volatility.

In my view, market valuations will continue to matter, and they will matter even more in the phases, such as the present one, in which the visibility of the underlying economic trends is low. Given the current return expectations, a mild exposure to equity and credit is reasonable until the signs of a stable improvement in the economic recovery are stronger. We think Central Banks will likely continue in their efforts of financial repression, but the marginal effect of their action will be lower and lower. That means that the return on cash is probably going to be still very disappointing. In my view, well diversified portfolio including equities (overweight) fixed income (underweight), commodities and real estate is an attractive option.

Finally, investors will need to be careful in the choice of their fixed income manager/advisor: it should be nimble and flexible, and aware of the new investment techniques available to help them navigate stormy waters as smoothly as possible.

Important Information

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