CIO LETTER

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Friendly Central Banks, Friendly Markets?

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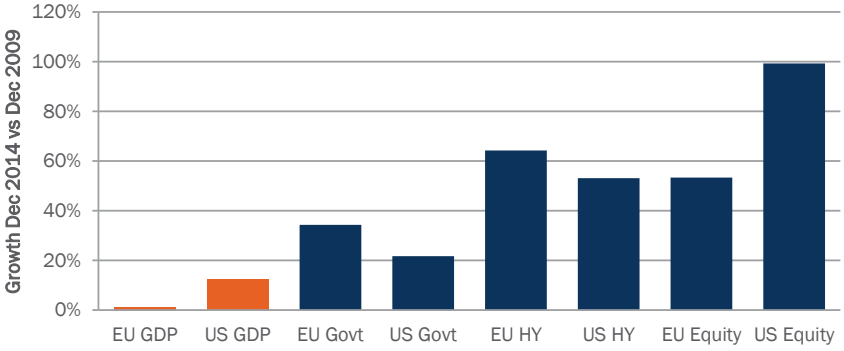
"A wise man will make more opportunities than he finds."
Francis Bacon

Since the last CIO letter, in November, the Central Bank bonanza has continued to lift financial markets, especially risky assets, towards new highs. This has happened in a weak economic framework, for most of the areas, further exacerbating the divergence between financial markets and economic fundamentals. The level of government bond yields has entered uncharted waters. In the Eurozone at the time of writing, 93% of bonds return less than 2%[1].

Buoyant Financial Markets Despite Slow Real Economy (Dec 2009-Dec 2014)



Source: Bloomberg. Data as of December 31, 2014. Performances in Local Currencies. EU Govt = BofA Merrill Lynch Euro Govt Bond Index, US Govt= BofA Merrill Lynch US Treasury Index, EU HY = BofA Merrill Lynch Euro High Yield Index, US HY = BofA Merrill Lynch US High Yield Index, EU Equity=MSCI Europe TR Net Index, US Equity = MSCI USA TR Net Index. Govt = Government Bonds, HY = High Yield Corporate Bonds.

Investment decisions remain constrained by a limited opportunity set, even when considering different scenarios.

First, investors need to evaluate whether the global economy is slowly, but inexorably, sliding towards structural deflation, or whether it is at a minimum dealing with a more benign *lowflation*.

We believe that this question is probably one of the most relevant today in terms of investment implications. If we believed that structural deflation is the most likely scenario, we would consider the above-referenced interest rates on government bonds as attractive and the other asset classes as already in bubble.

[1] Source: Bloomberg, using Eurozone government bond universe (yield to worst) at February 15, 2015. Investment grade ratings and all maturities included in the calculation.

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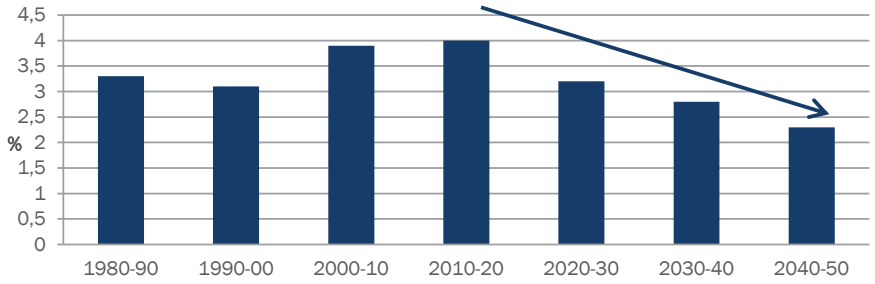
In case of *lowflation* (which we believe is more likely), current valuations for risky assets could still be sustainable, although with a perspective of very low potential returns.

We think continued debt deleveraging, an aging population and increasing income inequality will likely weigh on future economic perspectives.

A Slowing World: World GDP Growth Per Decade



Source: OECD forecast, Pioneer Investments data as of February 27, 2015.

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With their policies, Central Banks are now clearly trying to reflate the economy to create inflation. Whether they succeed or not is still to be seen, but in the meantime, financial repression[2] originated by their policies is shifting the burden of debt from debtors (especially public sector) to savers (households).

Firstly, Central Banks have to cope with deflation risks that are on the rise. With probably the lone exception of the US, every geographic area is suffering from its own version of "inflation disease". In Europe, the name of the game is the adjustment of internal imbalances, as a legacy of the crisis (high unemployment, high labor costs in peripheral countries). In China, the "disease" is the overcapacity in many sectors, which is exporting deflation through commodities to Emerging Markets (EM), among other regions. In Japan, the war against deflation has been running for two decades and even with quantitative easing the Bank of Japan is still struggling to generate inflation. The fall in oil prices, a consequence of both supply/demand imbalances and geopolitical factors, is a further complication to this scenario.

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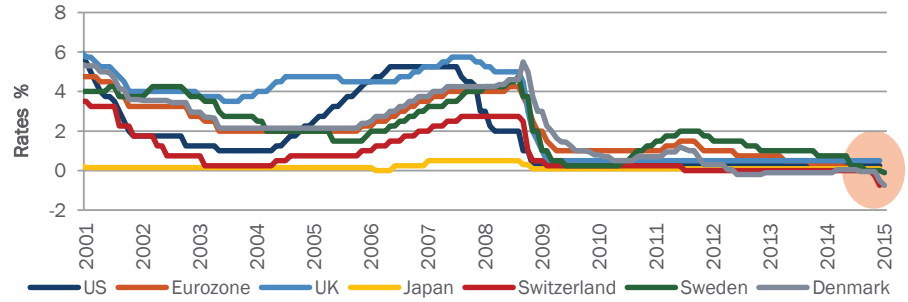
Central Banks' New Frontier: Negative Interest Rates



Source: Bloomberg; data as of February, 27, 2015.

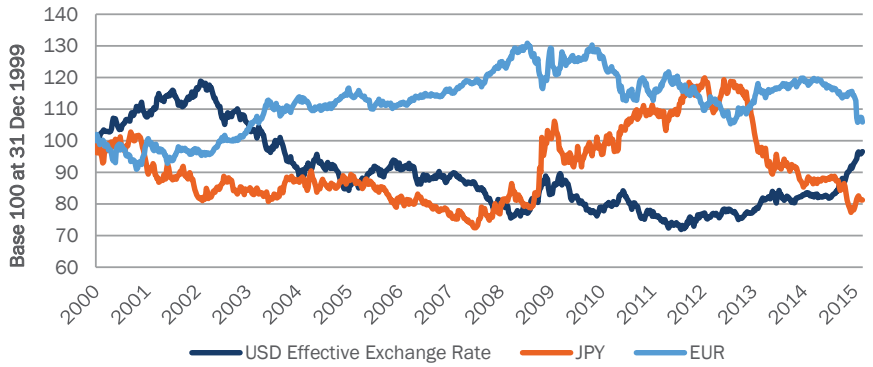
Secondly, we see Central Banks moving out of sync in response to different stages of economic recovery. On one side, the Federal Reserve and the Bank of England will likely

[2] Financial Repression is a concept introduced in '70s and it's relative to a set of policies to reduce government debt. In this case we are referring to zero or negative interest rate policies implemented by Central Banks.

In our view, with interest rates close to zero and Central Banks acting out of sync, the risk of a currency war is on the rise.

be the first to start a slow normalization, as their respective economies are posting solid performance. On the other side, we see the European Central Bank and the Bank of Japan as likely continuing along more unconventional paths.
With interest rates close to zero, we believe that exchange rate movements have a crucial role in the transmission mechanism of unconventional monetary policies to the real economy. Therefore, the **risk of a currency war is on the rise, and with it, the risk of a new wave of market volatility.**

Currency War?



Source: Pioneer Investments, Bloomberg. Data as of February 27, 2015.

In striking the fine balance between pro-growth policy (Keynesian) and structural reforms, a key role for investments will be played by the execution and quality of political leadership.

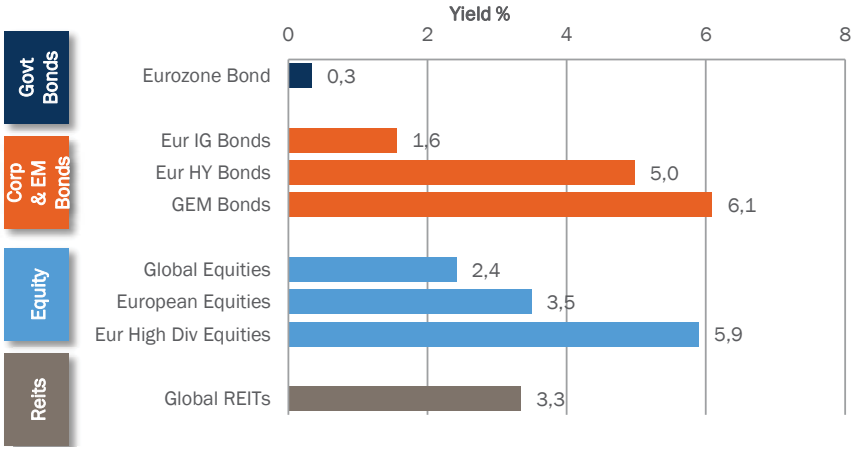
In the meantime, **a more active role of Governments, in terms of reforms, is another variable which we believe will attract investors' attention.** In fact, it's more and more clear to us that monetary policy alone may not be enough to restart growth, especially if the transmission mechanism between Central Bank liquidity and the real economy is not working properly.
In striking the fine balance between pro-growth policy (Keynesian) and structural reforms, **a key role for investment implications will be played by the execution and quality of political leadership.** With this in mind, in EMs, we see India, Indonesia and China as being in a better position than others (i.e. Brazil, Russia) to succeed. In the Eurozone, the situation is more complicated and the transition towards more solid growth is far from complete. Not only is there a lack of any common vision on possible solutions, but there is also disagreement on the nature of the problems (i.e., with respect to austerity, as in the case of Greece). So far, the political project of the Euro is not under discussion (and this explains the relative calm of financial markets despite the Greek crisis). However, we believe the immobility of European policy makers may create a fertile soil for anti-Euro parties, **generating another medium-term source of instability.**

We believe the hunt for yield, which has dominated the market in the last five years, will likely continue, spreading into the institutional space. Therefore, asset classes will likely be considered for their "income premium".

With respect to the investment implications, we believe that an increasingly policy-dependent world will likely be exposed to policy mistakes and volatile outcomes.
We do not expect inflation, the number one threat for bonds, to be an issue for the foreseeable future; on the contrary, structural deflationary forces may emerge, if not countered by a more aggressive policy action.
The excess of demand for bonds (from Central Banks and institutions, as a consequence of tighter regulation) may further weaken the traditional link between rates and economic fundamentals, including in areas with a stronger cyclical outlook, such as the US. We believe this would keep investment returns very low in a sort of "euthanasia of *rentier*" (Keynes in The General Theory of Employment, Interest and Money), both for retail and institutional investors. The latter will likely be forced to review their existing obligations they have with investors.
Therefore, the only option we see left to investors seems to scale up risk in an opportunity set which is not particularly attractive after a five year bull market, but in

which they are still (modestly) paid to take risk. We believe the hunt for yield, which has dominated the market in the last five years, will continue, spreading into the institutional space. Therefore, asset classes will likely be considered for their "income premium". **From this income perspective, European Equity and some areas of the credit market (i.e. EM debt) will continue to be appealing.**

Yields Across Asset Classes



Source: Bloomberg. Data as of February 15, 2015. Eurozone bond = Yield on 10 Years German Bund, Eur IG Bonds = Barclays Pan European Aggregate Corporate ISMA Yield to Worst, Eur HY Bonds = Barclays Pan European High Yield ISMA Yield to Worst, JPMorgan Emerging Markets Bond Index EMBI Global Blended Yields, Global Equities = MSCI World Dividend Yield, European Equities = MSCI Europe Dividend Yield, Eur High Div Equities = MSCI Europe High Dividend Yield. FTSE EPRA for Global Reits. Data represents past performance, which is no guarantee of future results. For illustrative purposes only. Not meant to represent performance of any Pioneer product.

In a scenario of deleveraging, slowing growth, risk of policy mistakes, risk management will be equally, if not more important, than return seeking.

Furthermore, relative value opportunities driven by divergent Central Bank policy and uneven economic transitions will be particularly important, in our view, to generate value (intra and cross yield curve, sectors, countries and forex opportunities, just to name few). In this environment, **we see alpha[3] as a dominant source of total asset returns.**

In the scenario pictured above (deleveraging, slowing growth, risk of policy mistakes) we expect risk management will be equally, if not more important, than return seeking. Not to mention that market liquidity risk is on the rise, as less liquid instruments such as EM debt, loans, high yields are ballooning in investor portfolios.

In conclusion, we believe that financial markets today offer few opportunities but, as with Francis Bacon's wise man, we will continue to look for them in the alpha space. In the meantime, we are maintaining a conservative approach, keeping significant liquidity in our strategies and partially hedging risky assets against tail risk events.

Important Information

Diversification does not guarantee a profit or protect against a loss.

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[3]Alpha — Measures risk-adjusted performance, representing excess return relative to the return of the benchmark.