# Outlook for 2014

David Greene,

Pioneer Investments

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# 2014 – A year of Transition

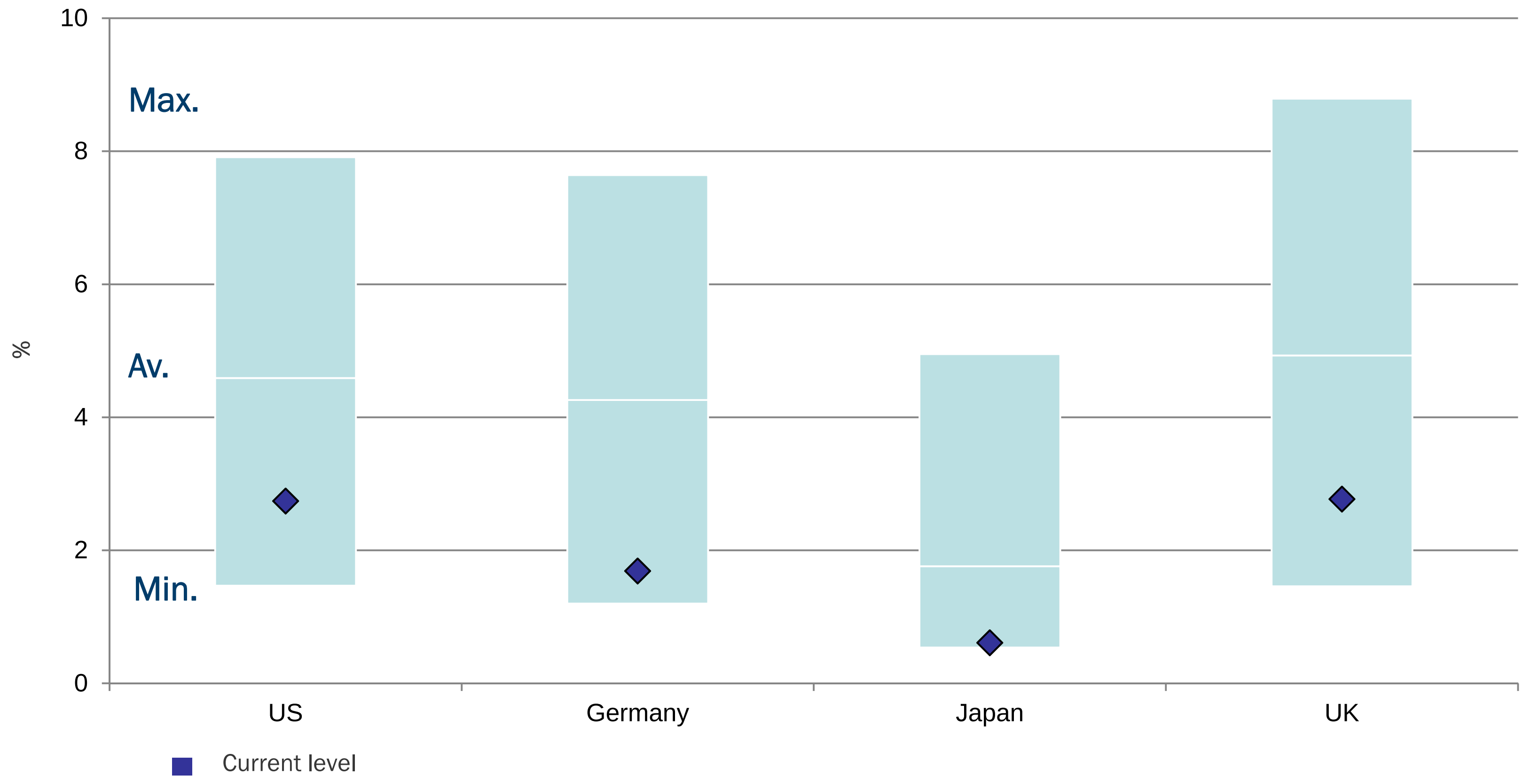
- Transitioning from fiscal tightening to less austerity.
- Transitioning from Euro-area recession to growth.
- Transitioning from Euro-area crisis to healing.
- Transitioning from historically low yields and volatility to normalised yields and volatility.
- Transitioning from multiple expansion to margin expansion in equities.
- We must move from a market model based on liquidity/credit creation to one driven by long-term economic growth fundamentals.

But the biggest Transition in 2014 will be about **managing the Transition** to **higher yields**

# DESPITE THE Q2 SELL-OFF IN FIXED INCOME, NOTHING APPEARS CHEAP. NOTHING.

# Bond Yields at Historical Lows

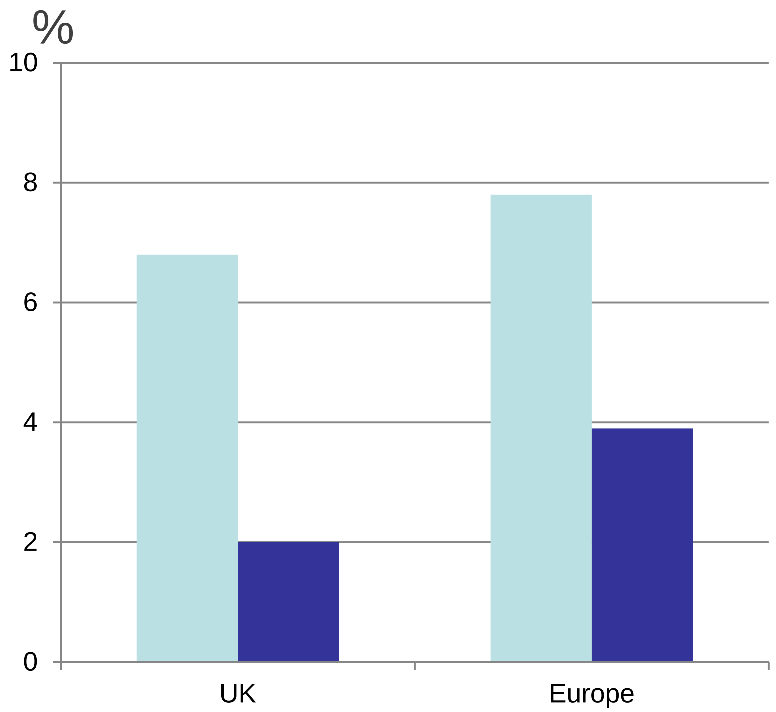
Core Government Bond Yields Still at 20-year lows



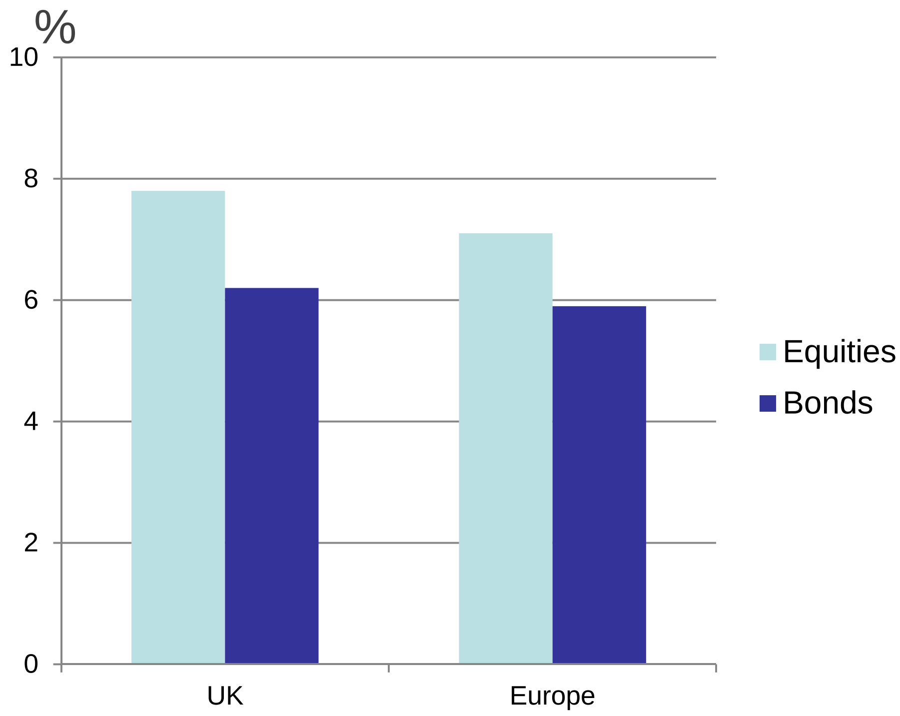

Source: Bloomberg. Data as of December 16, 2013.

# We have been spoilt...

***Annualised returns on equities and bonds…..***




Since 1950 = Baby Boomers




Since 1980 = their children

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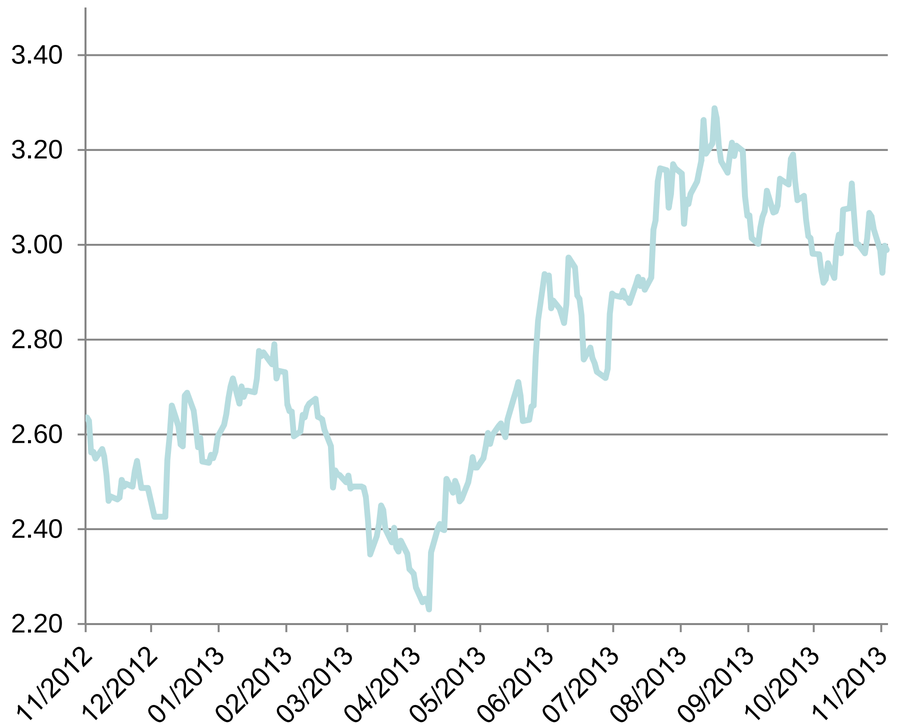
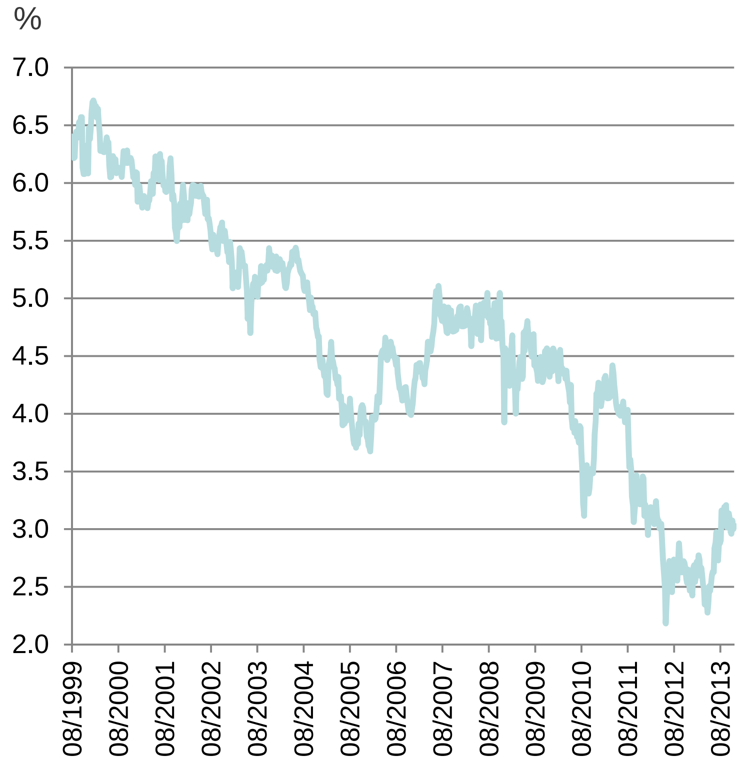
Source : NAPF, Pioneer. Data as of 30th November 2013.

# Even after the Q2 2013 sell-off…
# …nothing is cheap in Fixed Income




» 5y5y Euro swap, getting cheap over the 2013 but not over the longer period.

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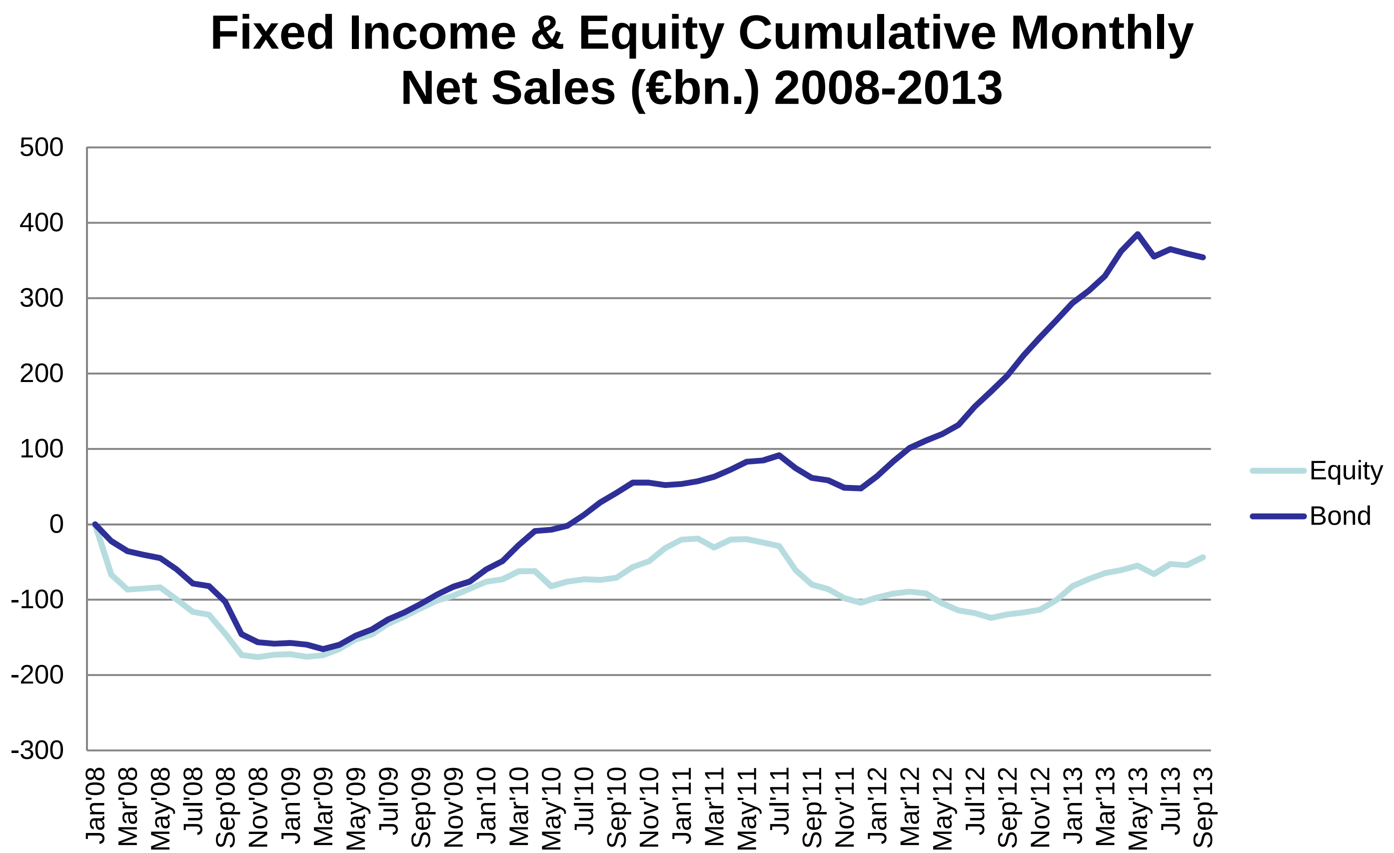
Source: Bloomberg , as at 27 November '13

# MANY OF US ARE <u>NOT</u> POSITIONED FOR A BEAR MARKET.

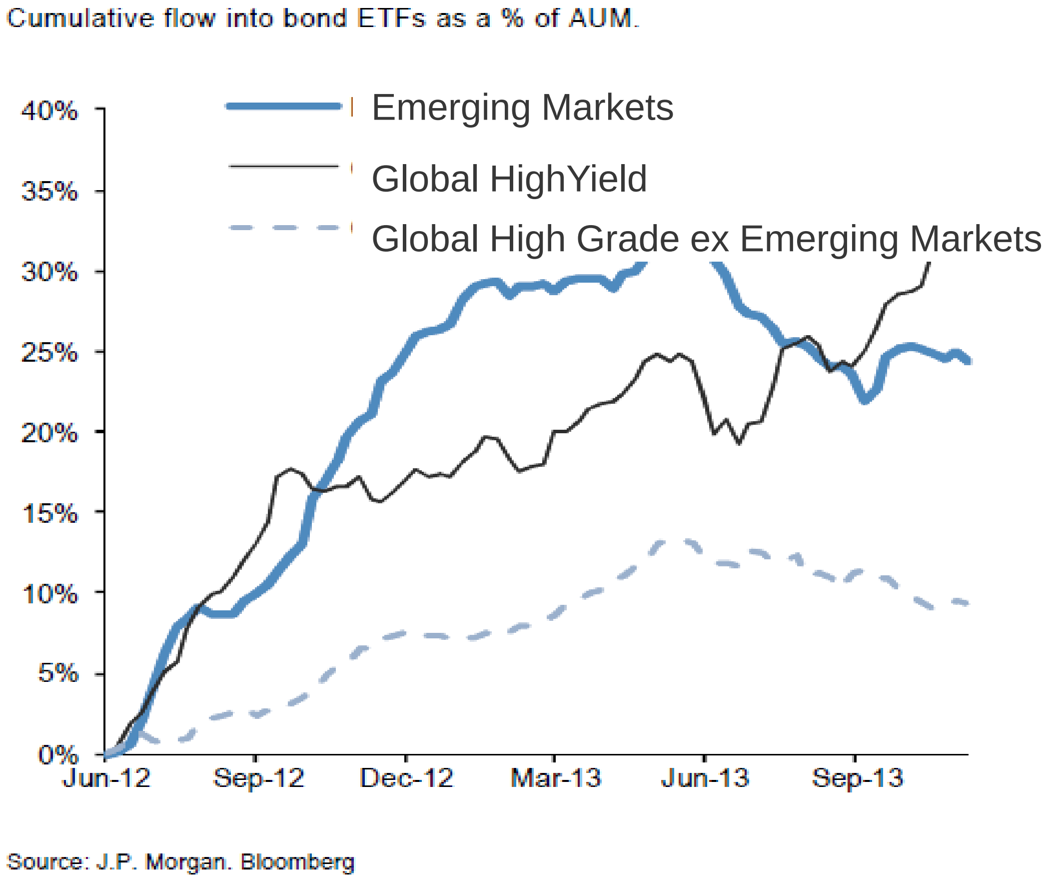
# Majority of flows….
# …are still into bond funds




Source: Pioneer, 2013. Universe is International/Cross-Border and local European funds.

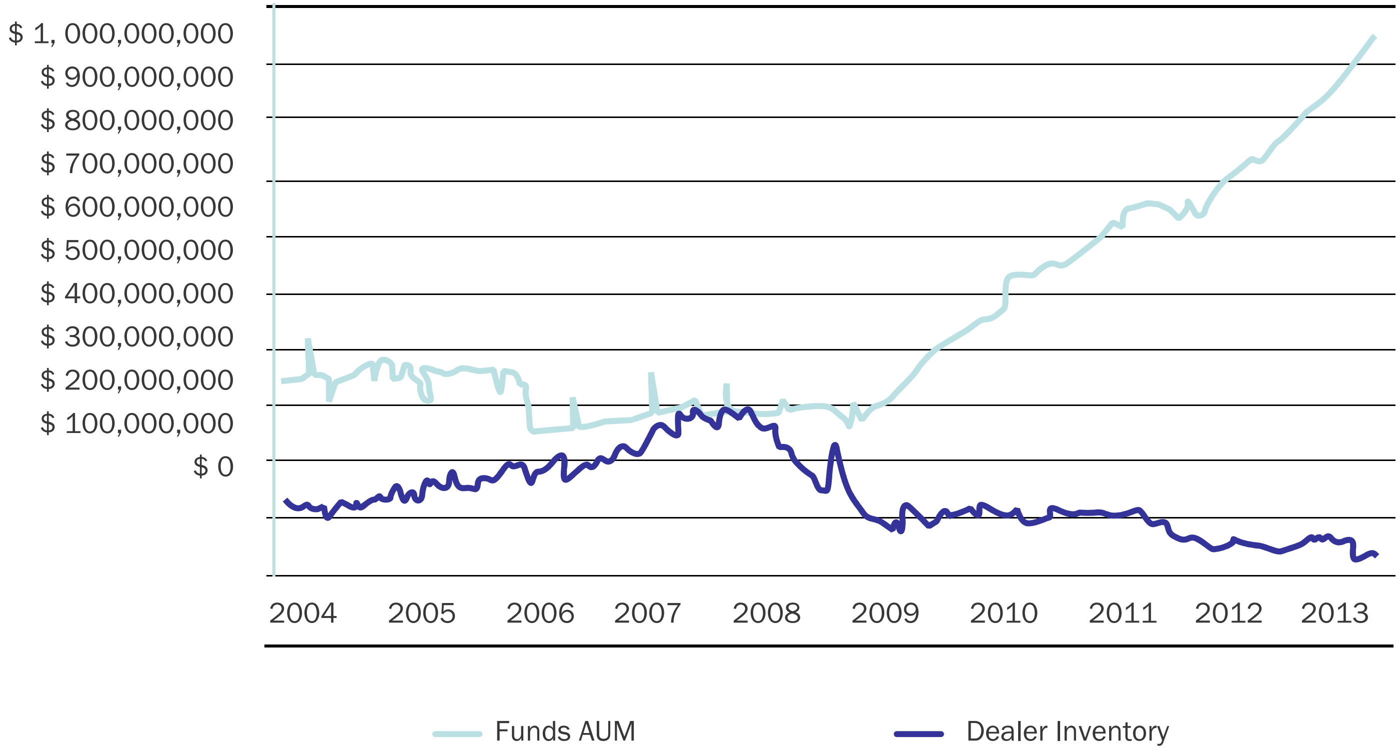
# Many pension schemes exposed to…
# …'riskier' fixed income

Cumulative flow into bond funds (ETF's) as a % of Assets Under Management



# Mind the (liquidity) Gap!

Credit Fund AUM vs. Primary Dealer Credit Inventory

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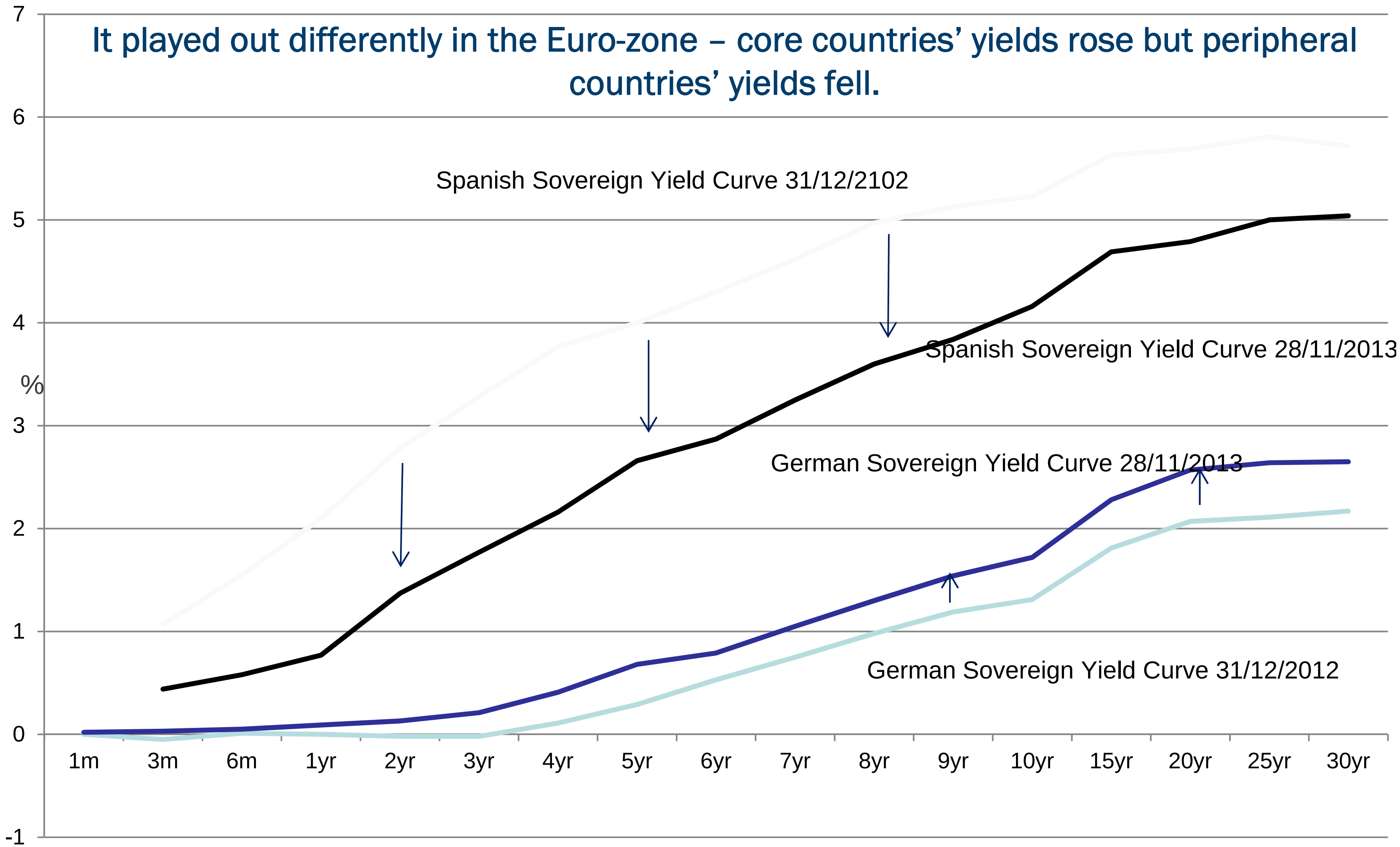
Source: Federal Reserve Bank of NY. AMG, EPFR. Data as at 5 June 2013

# IS EUROPE 'TURNING JAPANESE'?

# Q2 sell-off far from enough unless…
# … we are “turning Japanese”




Sources: Bloomberg 11 Nov 13

# Why we believe the Euro-zone…
# …will not become Japan

| Japan  | | Euro-zone  |
| --- | --- | --- |
| Rich | ≠ | Some Rich |
| Aging | = | Aging |
| Social Protection | = | Social Protection |
| Poor Leadership | = | Poor Leadership |
| Lack of Reforms | ≠ | Some Reforms |
| Huge Banking sector | ≠ | Deleveraging Banking sector |
| Zombie Banks | ≠ | Addressing Non-Performing Loans |
| Deflation | ≠ | Low inflation (?) |

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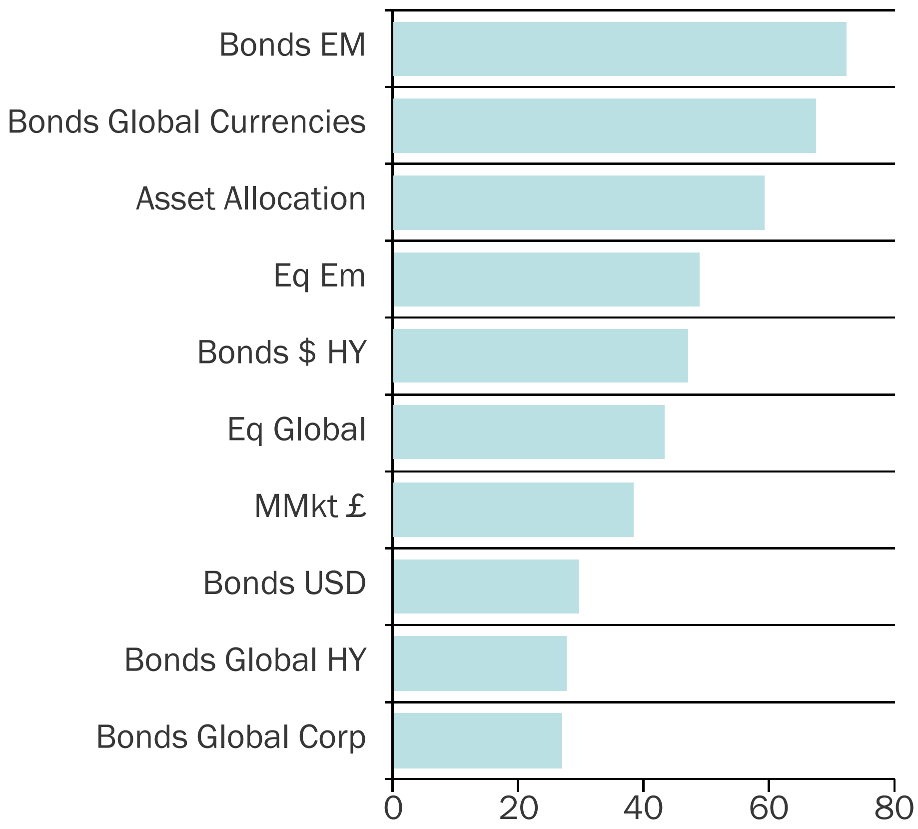
Source :Pioneer Investments

# QE WAS POSITIVE FOR RISKY ASSETS. WILL QE REMOVAL BE NEGATIVE FOR RISKY ASSETS?

# EM Bonds and US HG Bonds…
# …the biggest beneficiaries of QE3

Reaching for yield
Top selling fund categories in Europe, 2010-12 cumulative, €bn

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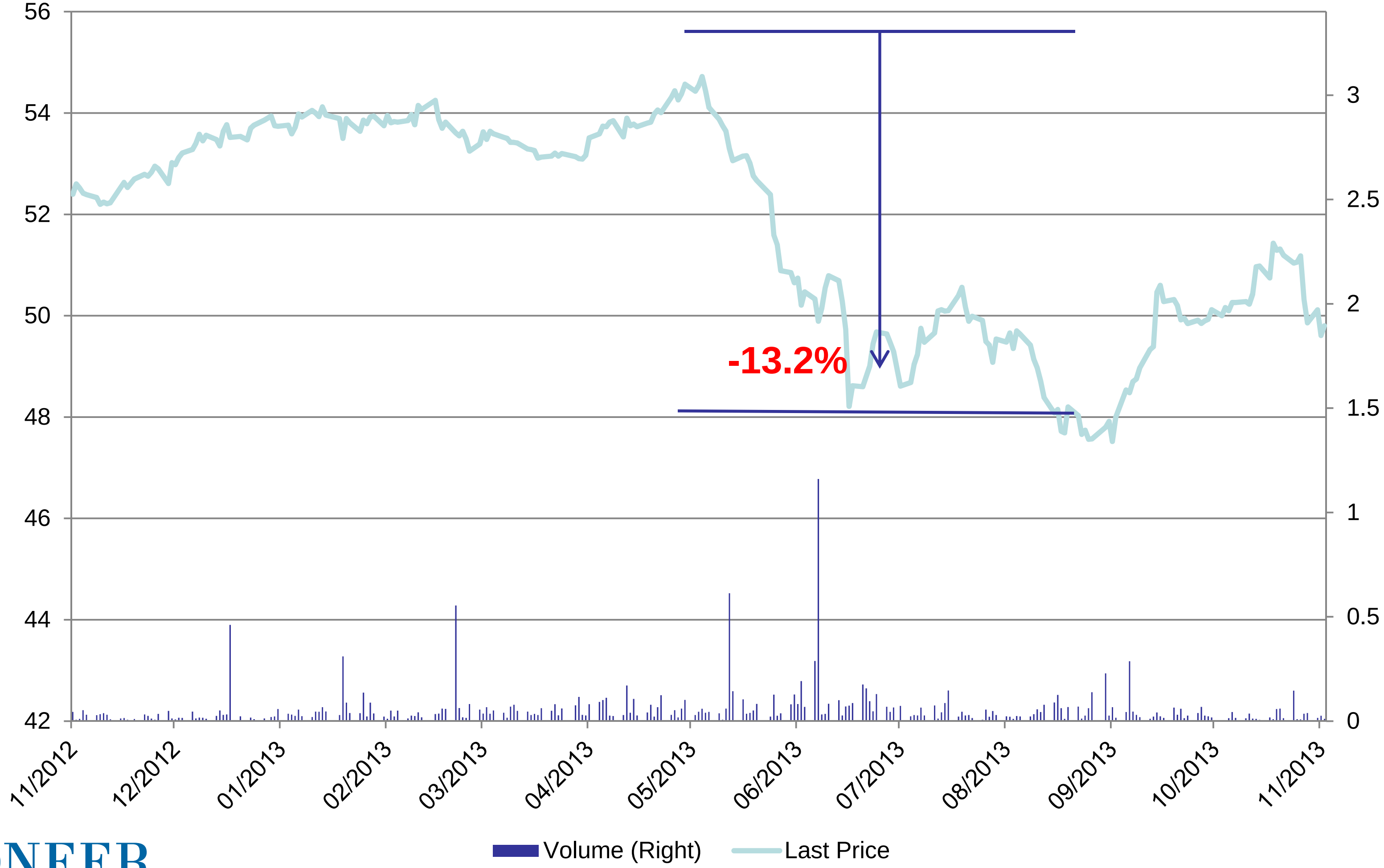
Source: HSBC, 26 August 2013

# I-Shares Emerging Markets Bond ETF

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Source: Bloomberg, data as at 5 Nov 2013

# Emerging Market Bonds & US High Grade Bonds…
# …adversely affected by tapering talk

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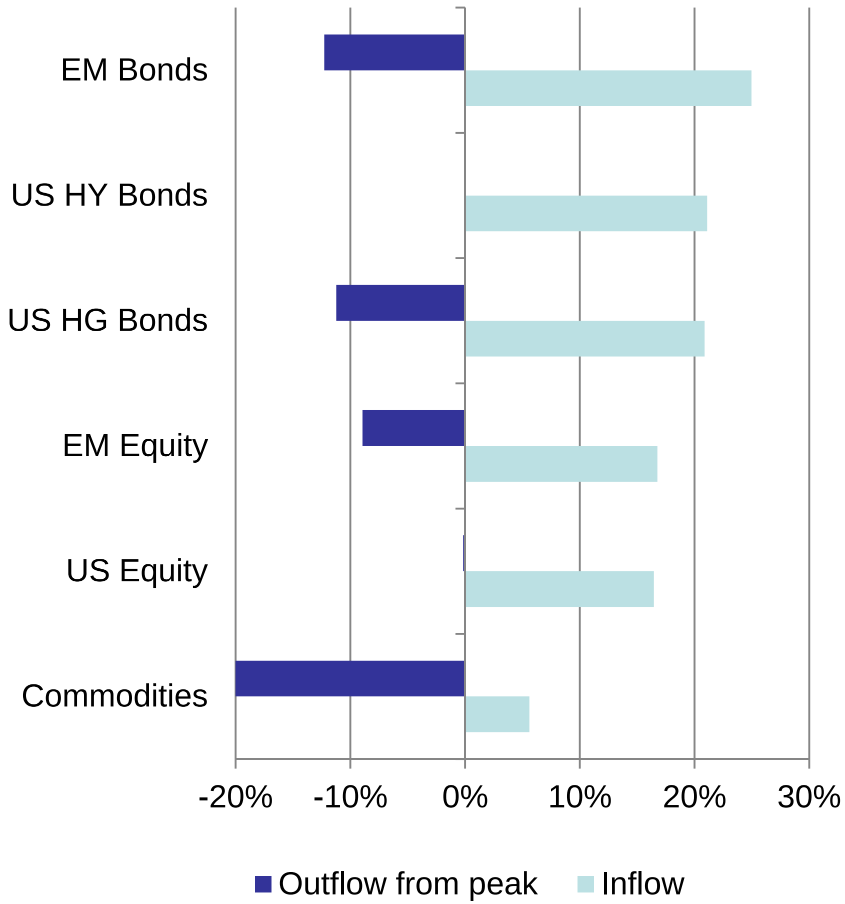
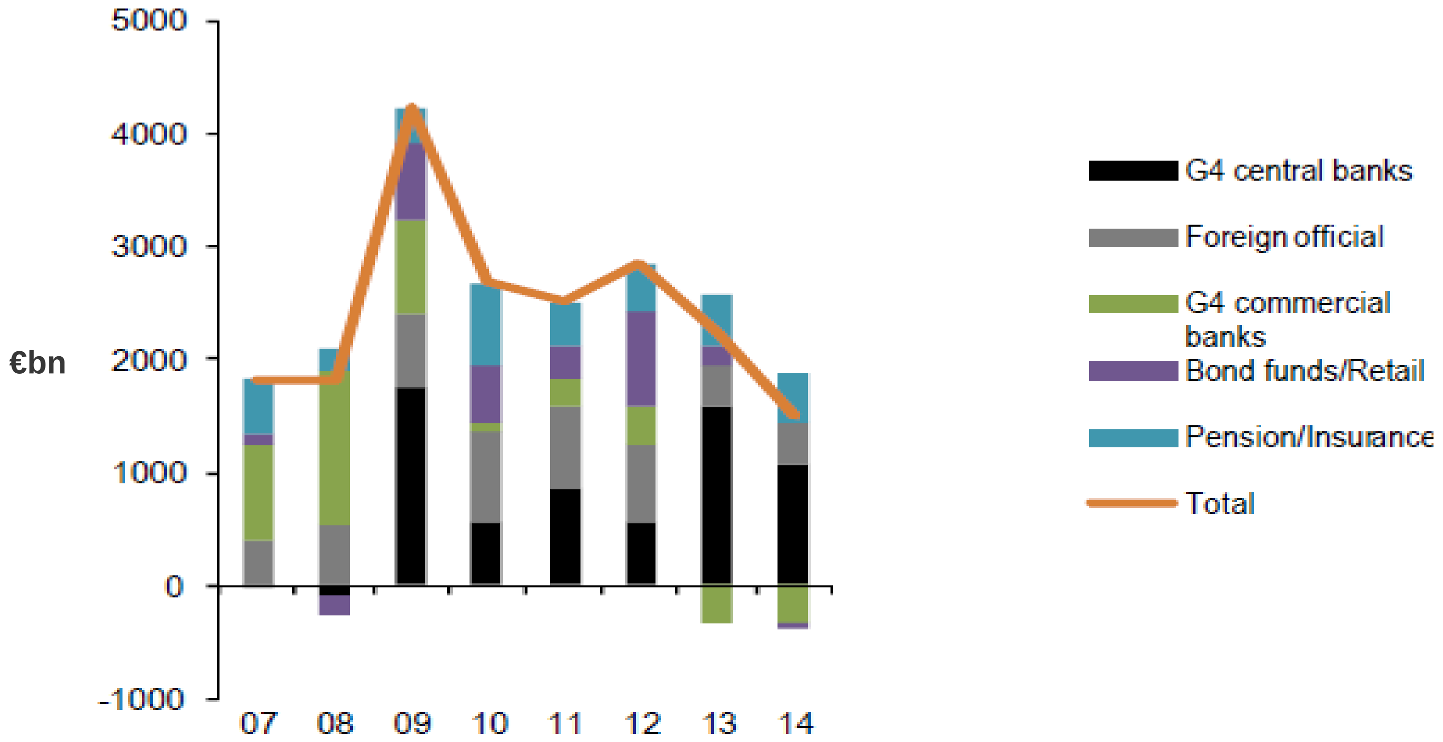
## Global Exchange Traded Fund Flows since Q3




| | Inflow | Outflow from peak |
|---|---|---|
| Commodities | 6% | -23% |
| US Equity | 16% | 0% |
| EM Equity | 17% | -9% |
| US HG Bonds | 21% | -11% |
| US HY Bonds | 21% | 0% |
| EM Bonds | 25% | -12% |

Source: JP Morgan, 24 October 2013

# Global bond demand…



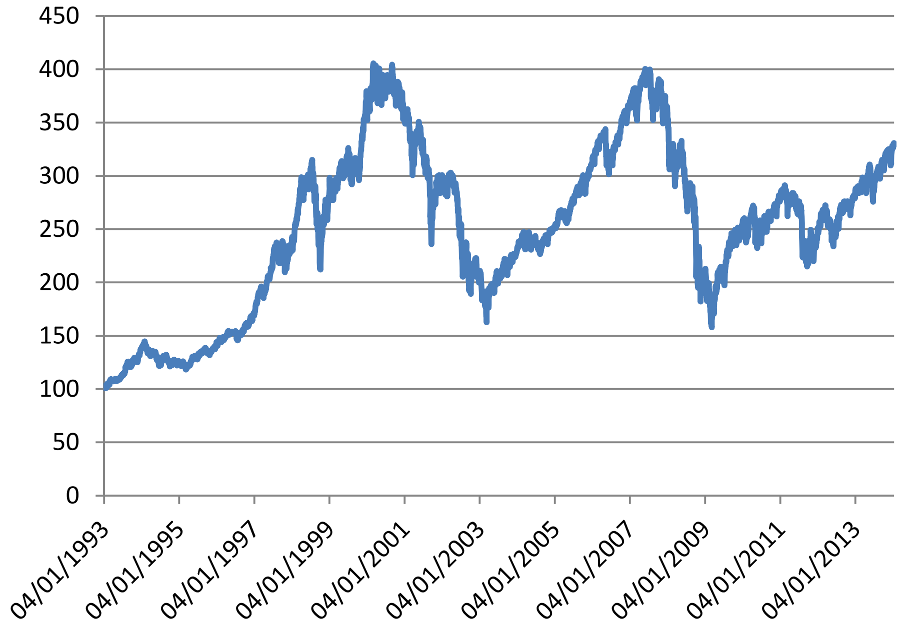

Source: Central bank sources, ICI, Bloomberg, IMF and J.P. Morgan calculations

**As of 31st Oct 2013. 2014 numbers are JP Morgan projections.**

# EQUITIES AT RISK OF A CORRECTION?

# Equity indices…
# …the last 20 years


S&P 500 at all-time highs…




Euro Stoxx 600 nearly there…

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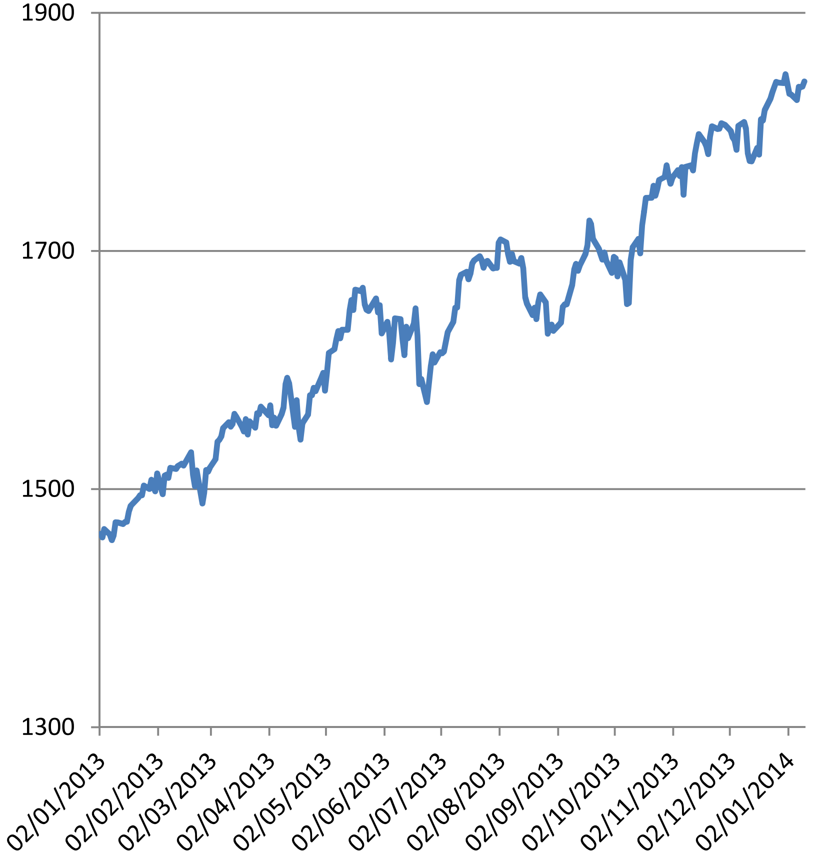
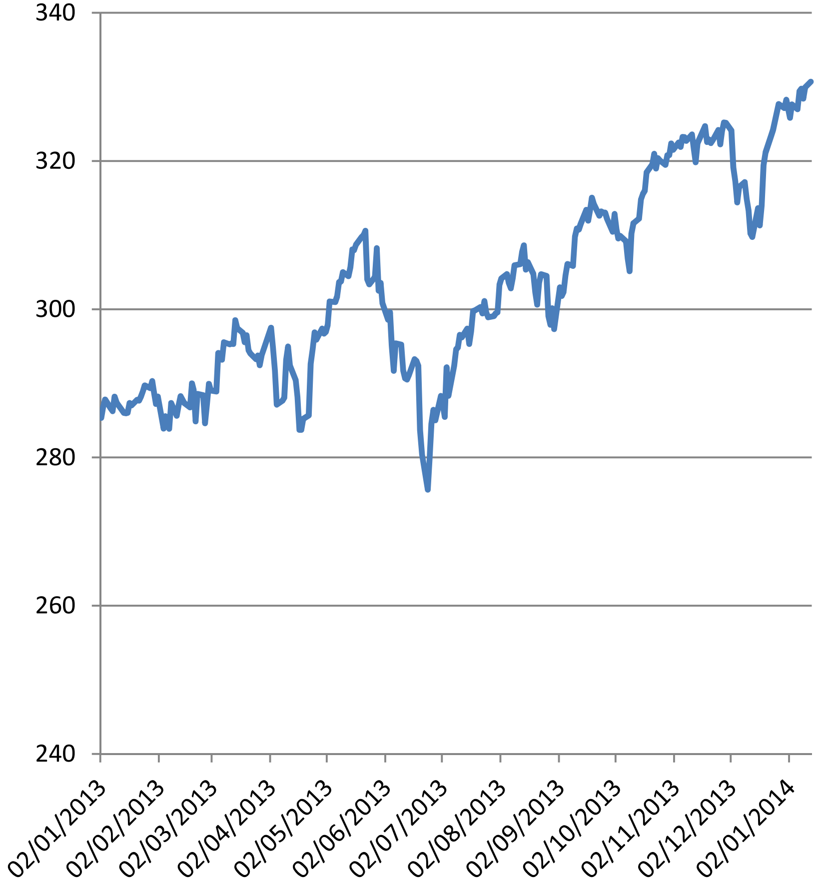
# Equity indices…
# …the last year

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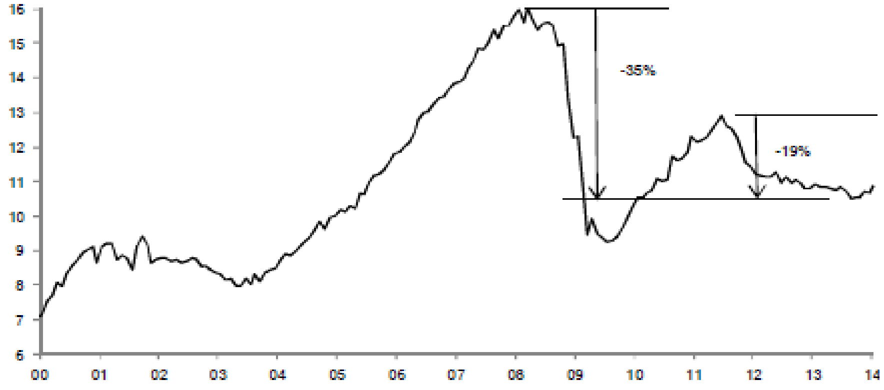
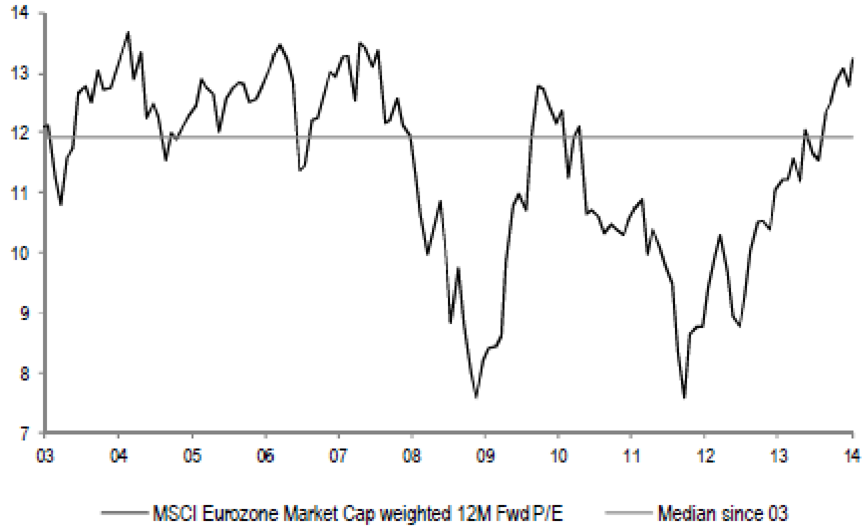
***Very limited corrections over the last 12/24 months…***

# Equities expecting stronger earnings growth in 2014

Although the Eurozone recession ended in the summer of 2013, Eurozone earnings remain close to recession lows.




MSCI Eurozone equities are trading at 13.1x 12mth forward P/E, which is a 9% premium to it's 10-year average.

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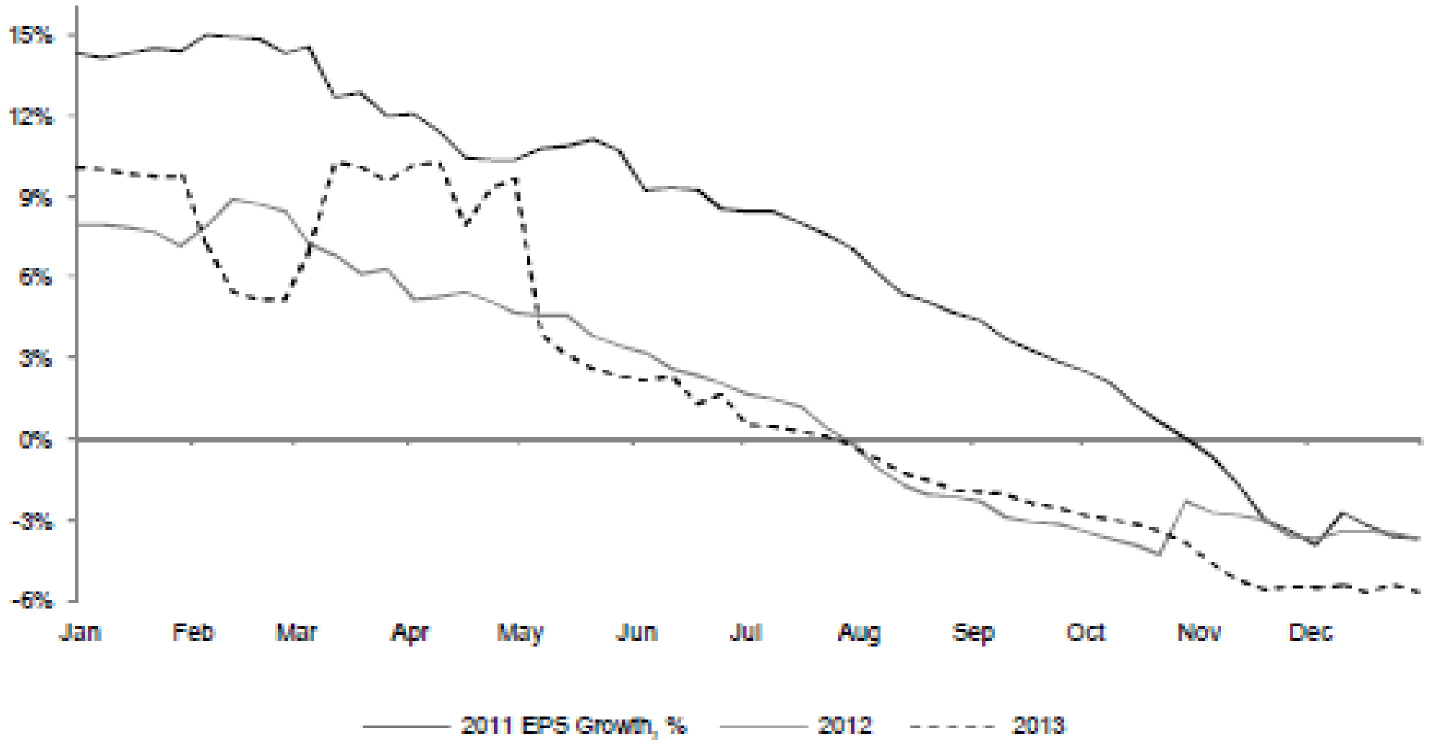
Source : IBES, JP Morgan. Data as of Dec 31st 2013.

# But analysts regularly get their earnings forecasts wrong…




*Change in consensus EPS growth projections during the last 3 years*

# FIXED INCOME 101:
# 'FAIR VALUE & DURATION'

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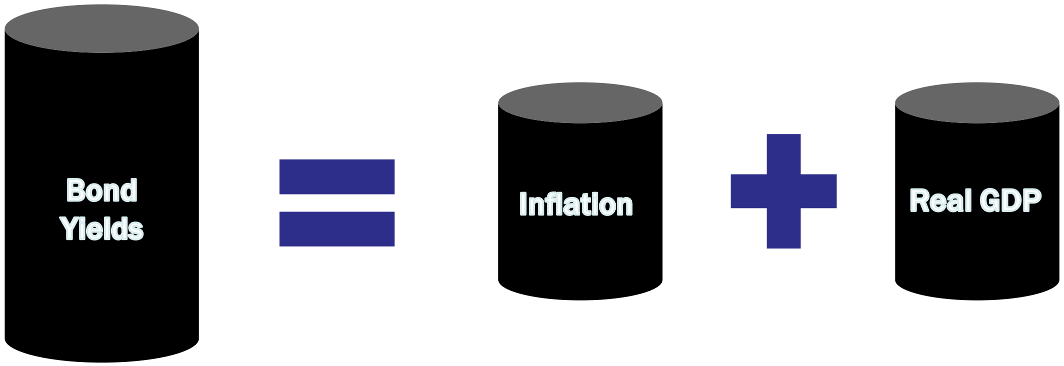
# Finding Fair Value For Bonds

**Bond yields are a function of inflation and GDP**




| | US | Europe |
|---|---|---|
| Trend GDP | 2.5% | 1.5% |
| Inflation | 2.0% | 2.0% |
| Fair Value Bond Yield | 4.5% | 3.5% |
| Current Yield | 2.6% | 1.7% |

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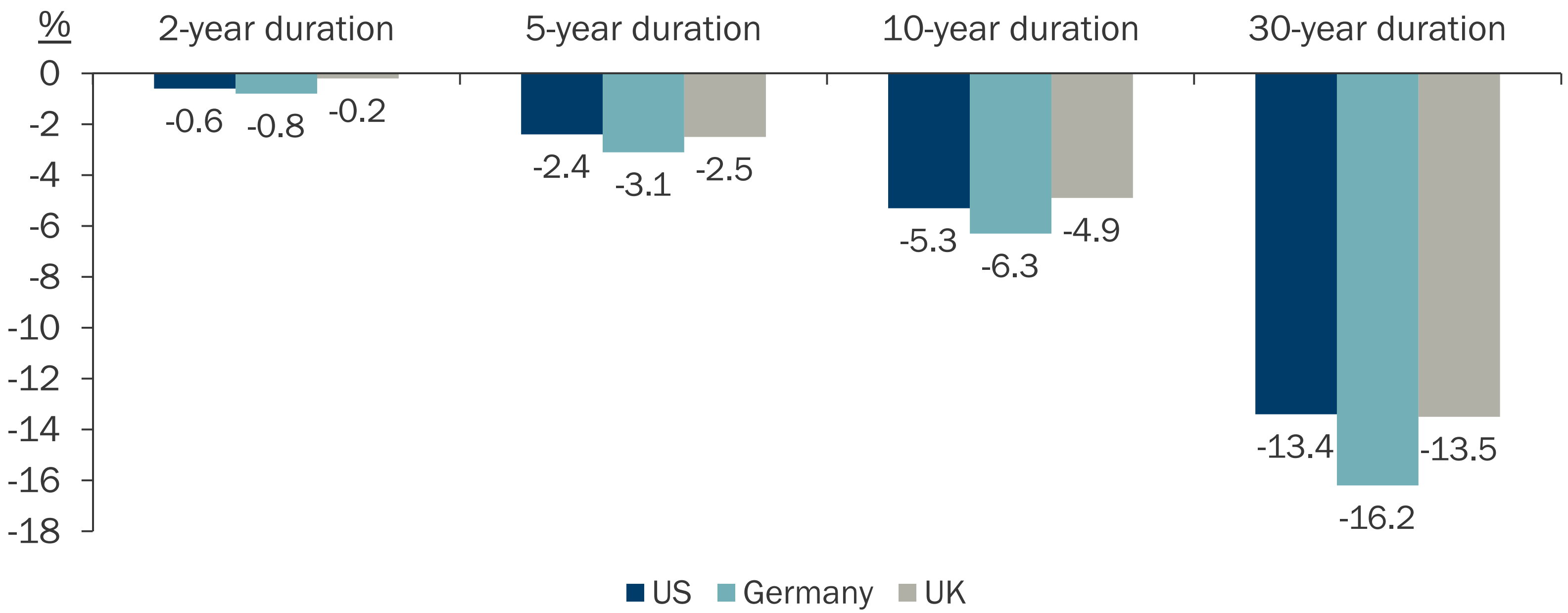
Source: Pioneer Investments. Data as at 31 October 2013

# The Danger of Duration

In a period of rising bond yields, any duration exposure can cause losses

*Effect of 1% rise in bond yields on bond returns over one year…*




*Duration now Dangerous??*

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Source: Bloomberg / Pioneer Investments. Data as at 23 August 2013

# We Expect Volatility to increase over the next 12-18 Months…
# …possibly the highest of the last few years

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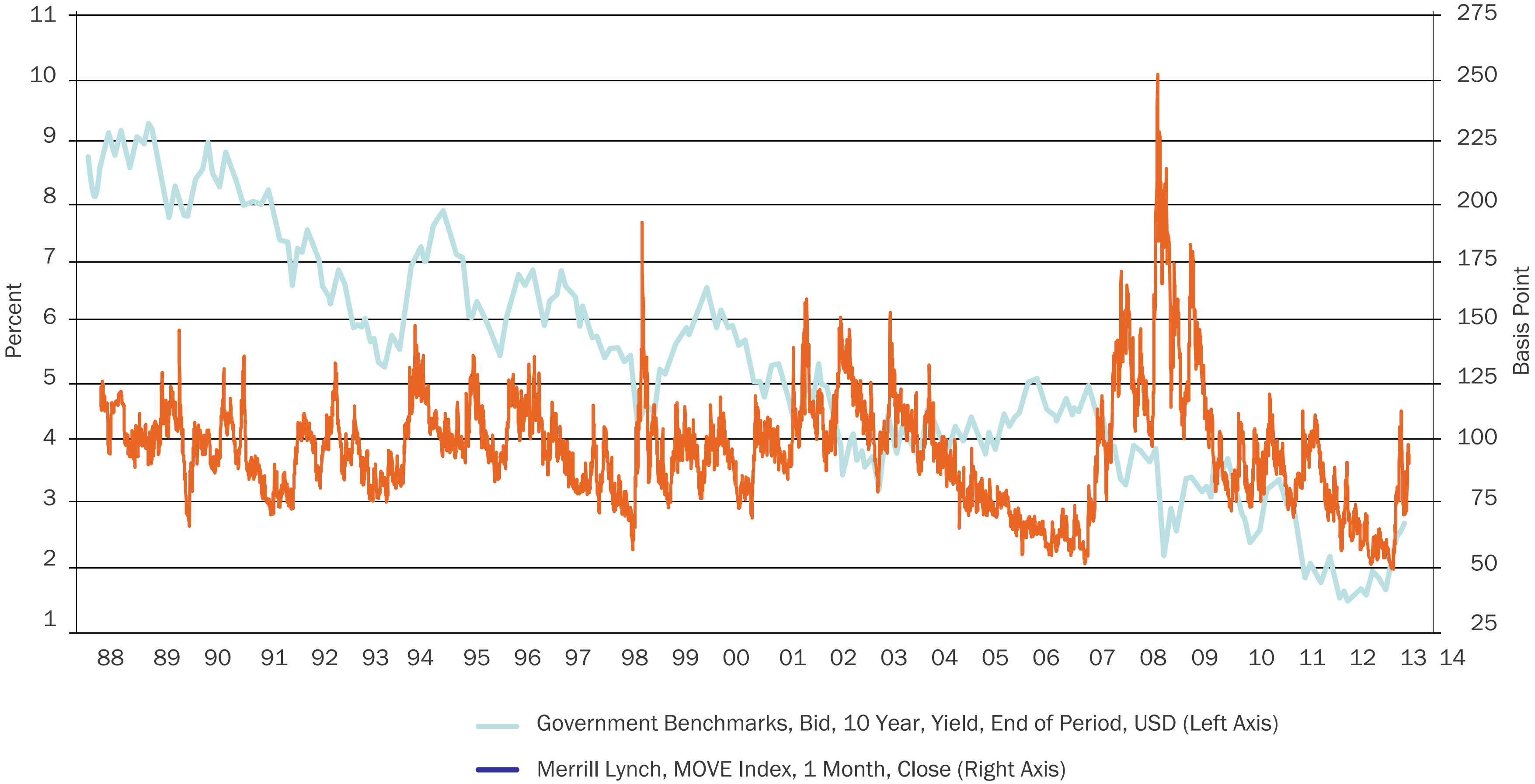


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Source: Reuters EcoWin

Source: Bloomberg, data as at 27 August 2013

# Plenty of Risks and…
# …Opportunities Ahead

**We expect the next few quarters to be among the most volatile of the last few years**

- Change in Fed policy and new leadership
- UK economy hitting BoE trigger points earlier than expected
- ECB flexibility
- Japanese QE
- Change in banks/brokers business models
- Ending of QE and it's effect on BRIC's

# What to expect in 2014…

## Major driver of bond markets in 2014 = US yield curves.

Will investors demand more term premia to compensate for potentially higher inflation in years to come? Can yield curves steepen further from current levels? If growth accelerates, will rate expectations be pulled forward?

Investors are positioned for very low inflation – what happens if inflation starts increasing? Peripherals now appear fair value, but what happens if Italy gets downgraded to sub-investment grade in 2014?

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Source : Pioneer Investments

# Fixed Income becoming a Return-Free Risk ?

- The combination of cheap QE money and low volatility has fuelled risk-taking and resulted in financial repression
- Forced investors to either accept return on investment below the rate of inflation or realise negative real returns on assets
- Yields are too low to compensate for the increased riskiness of sovereign debt
- Due to the concept of negative real returns, going forward investors are facing a return-free risk

*In Summary - Fixed Income should now be regarded...*
*...as a risky investment*

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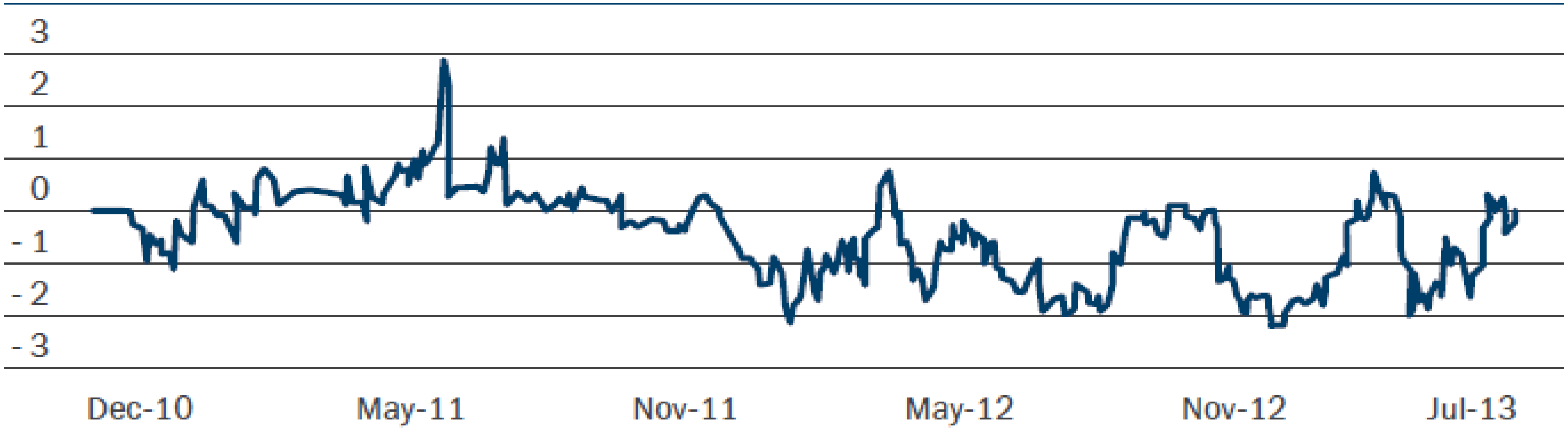
# The Solution

Implement an **Absolute Return Fixed Income** strategy that is **uncorrelated to duration** and has the ability to **generate returns in all market conditions**

**Duration Positioning of Pioneer Investments Absolute Return Bond Strategy Since Inception**




Source: Pioneer Investments as at 15 August 2013.

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# How to construct an Absolute Return Bond strategy?

Must have a number of key characteristics :

- A **cash benchmark** as opposed to being benchmark-constrained
- The **ability to run negative interest rate** and **credit spread duration** positions
- A return which is derived from a number of **well-diversified sources of alpha** and lowly-correlated strategies rather than having one or two primary drivers of performance
- Strong & disciplined **risk/drawdown management** techniques

*'Caveat Emptor' – be ABSOLUTELY sure it does what it says…*

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# What's gone wrong for some Absolute Return Funds ?

## Why many Absolute Return Bond funds suffered negative performance in 2013?

- Significant systematic risk (or market beta/risk)
- High correlations between positions/trades
- Poor (or no) risk management techniques
- Exposure to High Yield and Emerging Markets.....*and in some extreme cases equities !*

**Many such funds NOT actually Absolute Return Funds but Total Return Funds**

*When the tide goes out......you know who's been swimming naked...*

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