Quarterly Portfolio Update

*Amundi Funds II – Real Assets Target Income**
28 September 2018

MULTI-ASSET
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 U.S. wage levels feeding through into U.S. inflation.

Despite heightened market uncertainty, equity markets outperformed with the MSCI World TR Index up +5.0% in Q3. Performance was driven by U.S. 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 (EMs) 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 Fed kept U.S. bond yields under upward pressure. U.S. 10-year bond yields finished the quarter at 3.06%, the first decisive break above 3% since late May 2018. Whilst the U.S. 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 U.S. generally outperforming Euro credit indices against a strong macro and political backdrop. Higher beta sectors benefitted more from spread tightening, particularly in the U.S. 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 U.S. 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 U.S. 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 U.S. 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

Although the Portfolio experienced some volatility during Q3, it recovered in September to post a modestly positive return for the quarter. Gains were split across the Macro Strategy, Satellite and Selection Strategies. Meanwhile, Macro Hedging was loss generating due to the protective puts on U.S. and European equity markets.

In terms of asset classes, equities were the top contributors to gains although commodities offset some of these gains. Within equities, we benefitted from allocation to Energy/Energy Infrastructure and Food Staples. Although the allocation to Transportation was loss generating, we were helped by our negative bias to the sector. Also loss generating was our positive bias to Energy.

Equity selection was successful due to stock picking within Materials, Transportation and Energy, while Real Estate was a detractor. Satellite strategies, where we hold our thematic positions, performed well primarily due to Global Aging & Healthcare, Global Water and Fish Farming themes. Option writing was mixed; Energy and Transportation were positive, while Food Staples and Real Estate generated losses.

Within commodities, losses were spread across a number of soft commodities and base metals. The most notable were the exposure to Coffee, Nickel, Silver and Gold via ETCs. Also a detractor was the exposure to Gold miners through our diversified Gold mining fund as well as through stock picking.

Fixed income exposure ended flat as losses from inflation linked bonds were mostly offset by the exposure to high yielding corporate and EM bonds.

On income generation in Q3, a majority of this came from option writing followed by stock dividends while bond coupons were small contributors.

Asset Allocation (Macro Strategy)

Our investment outlook remains constructive due to positive fundamentals amidst strong macro growth and resilient earnings prospects. Correspondingly, risks resulting from protectionism fears and political uncertainty cannot be ignored. In the U.S., the labour market continues to strengthen and an increased fiscal deficit puts pressure on inflation. Inflation remains subdued elsewhere in Developed Markets (DMs) but we expect it to pick-up.

Against this backdrop, we hold a reduced equity exposure moving into Q4. We have reduced exposure to bond sector proxies such as Food Staples and Real Estate, which may suffer against a backdrop of rising bond yields. Correspondingly, we have gradually increased exposure to some inflation sensitive sectors such as Materials and Energy to seek our objectives to generate income* and protect purchasing power over the long-term. However, given the backdrop of heightened uncertainty, we are utilising option writing to reduce overall equity exposure (via call option writing).

Our fixed income allocation remains limited with the majority of our exposure in government bonds, primarily inflation linked bonds. We maintain a small exposure to EM bonds. Although their carry and valuations are attractive, recent volatility in Turkey, Argentina, and to a lesser extent Russia and Brazil, has weakened the overall risk sentiment, especially during a period of low liquidity. We remain focused on high quality and liquidity in terms of our corporate bond exposure. Fundamentals are supportive, but spreads remain tight while leverage levels are higher.

On currencies, a majority of our allocation is to the U.S. Dollar with the remainder in Euro.

Macro Hedging

As markets remain vulnerable to negative news flow stemming from trade wars and European political risk, we maintain hedges through put options in Europe and the U.S.

Selection & Satellite Strategy

Materials is our largest sector allocation where we have focused on industrial gas producers such as French Air Liquide and industrials metals (BHP Billiton for example).

Within Energy, while we have temporarily reduced our exposure to the Permian Basin in the U.S. slightly, mainly due to infrastructure issues, we have increased our European and EM exposure by adding BP and Petrobras.

We remain selective within Energy Infrastructure by reducing the ETF exposure on the Alerian MLP Index (diversified exposure to mid-stream Energy companies in the U.S.) further in favour of single names such as Golar LNG and Halliburton.

We have reduced positioning in Real Estate as stated previously. We prefer selective holdings in Europe and the U.S. primarily as well as some exposure to Asia through a diversified ETF. We bias companies with office space and residential in Continental Europe, while focusing on data centres, industrials and senior homes in North America.

As we see less upside in Food Staples given more expensive valuations, rising input costs and sensitivity to volatile food prices, our activity in the sector was limited.

Among Utilities we focus on renewables and EM water utility companies such as Chinese Guangdong Investment Ltd. and Brazilian Saneamento Basico. The latter is a thematic trade within our low-correlated Satellite Strategies, where other top ideas include Fish Farming, Forest Paper & Packaging and Lithium.

Within fixed income sectors, we hold a bias to inflation linked bonds in the U.S. primarily followed by Europe.

Within Commodities, we hold exposure to gold through mining stocks and our gold mining fund to gain a diversified exposure to mid-cap gold miners. We also hold gold and silver through ETCs. Recent weakness in prices and expectations for stronger seasonal demand may help these precious metals. To diversify risk, we hold exposure to corn and wheat, which we prefer over soybeans, for instance, as we view this as susceptible to trade war uncertainty. We are also positive on natural gas given the upward pressure on prices from the continuous ramp-up of LNG exports and strong demand from Utilities and Industrials.

Outlook

The global economic expansion continues, but momentum is weakening. We are seeing some deceleration in certain EMs, 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 EMs space.

Yet that fear did not cause a "flight-to-quality" and subsequent outperformance of DM assets. Instead, the U.S. 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 U.S. equity market continues to post new highs while most other markets are either flat (European equities and aggregate bond indexes) or negative (EMs). 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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