

Searching for Yield Against the Backdrop of the Euro-Debt Crisis

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Outlook 2012



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Key Insights

About a year ago, we argued that the role of politicians in the management of economic affairs would be durable and reduce economic growth this year. In fact, politicians made things worse, as they turned a case of fraudulent accounting in a small euro country into a global scare. The EMU sovereign-debt crisis, originated by the Greek government's misconduct, is now almost two-years old and has prompted the same mobilisation and commitment from world leaders as in the aftermath of US bank collapses three years before. Policy mistakes have been made throughout the crisis and led to government changes following general elections or the resignation of under pressure political leaders. The inability to provide clear and convincing solutions has led to a standstill where politics are as important as economics in influencing the market view.

Political factors will remain dominant in 2012. The outcome of the crisis and, consequently, the economic and market scenario will essentially be binary, where things will either improve or deteriorate significantly from our base scenario depending on the solution found.

In our base scenario for 2012 we expect the euro crisis to be managed, although some periods of turmoil are still likely. In our view European institutions will play a key role in avoiding a blow-up of the eurozone alongside the work to be done by major peripheral countries to put their "houses" in order. However, we do not expect a full resolution of the crisis to take place over the course of the year.

In our base scenario, global GDP will rise by 3% in 2012. The eurozone economy will experience either a recession or weak economic growth (around 0.6% in 2012), while in the US the economy will continue to face sub-par growth (around 2% in 2012), inflation will remain under control and the Federal Reserve (Fed) will continue with its expansionary monetary policy. Higher growth is expected to come from Emerging economies, where policies set on curbing inflation may soon end. This is the case of China, where our base scenario is for a soft-landing of the economy. We foresee three major risks to our base case scenario. The first is a full-blown escalation of the euro crisis, with some countries either defaulting in a disorderly manner, or leaving the euro, which would prompt a credit crunch with a negative impact on the real economy; the second is the possibility of a hard landing for the Chinese economy, while the last risk factor relates to the price of oil. Our base scenario assumes that the price of oil remains around USD 100 per barrel, while a significantly higher price would definitely have a negative impact on global growth.

In this landscape, the investment environment remains one of the most difficult of the last twenty years. We estimate that the probability associated with the risk scenarios is quite low, although we take them into account in our investment decisions.

As a consequence, we retain a neutral position on global equities, where we prefer the Emerging Markets and the US to Europe. In equities our attention is on stock picking to identify companies that could better exploit the growth of the Emerging economies and companies that can provide stable cash flows and high dividends.

We expect sub-par growth as our base scenario

Major risks: euro-debt crisis unresolved, hard landing of China's economy and a sharp rise in oil price

Equity: neutral position, with focus on high dividend stocks

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*Fixed Income:
we prefer corporate and
emerging-markets bonds*

In the bond area, we are underweight government bonds in the so called “safe markets”, where we think that current yields are not rewarding.

Our major preference is for the corporate credit market, which could also benefit in a sub-par growth environment and that, in our opinion, may provide the best risk-reward profile. In this respect, we also favour emerging-market corporate bonds, whose credit fundamentals remain solid and could also benefit from stronger local currencies.

On the foreign exchange market, we expect the euro to remain weak as the sovereign-debt crisis broadens and the European Central Bank (ECB) takes an active role to deal with it by adopting a zero-rate policy much like the Federal Reserve. With this backdrop the USD may be less affected by an overly loose monetary policy and may even represent a cheap hedge to play during the year.



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2012 Investment Ideas

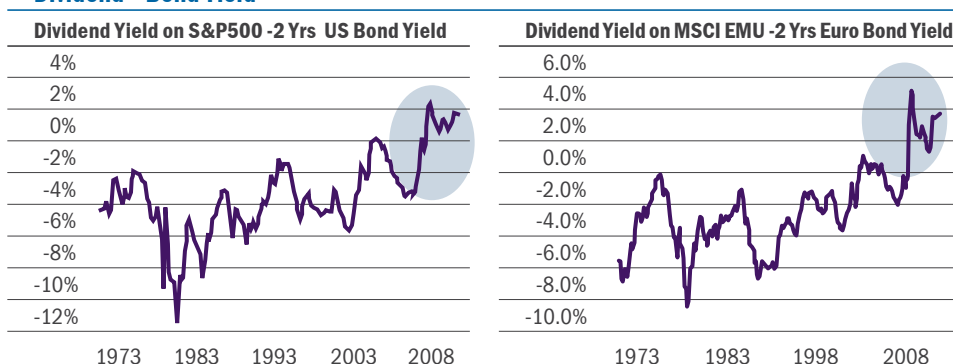
The Risk on / Risk off path will continue into 2012

- The year 2012 should be characterised by a difficult investment environment with the evolution of the Euro Area crisis crucial for financial markets, although we recognise that risky assets, equity and credit, offer considerable value to the long-term oriented investor.
- In this environment we believe that the investment decisions will be mainly driven by risk considerations, with the Risk-on / Risk-off path (high frequency of episodes of high volatility and high correlation) continuing.
- A dynamic approach to asset allocation should remain key; especially in order to actively manage any upcoming risk to our base scenario. Hereafter, we report our current asset allocation view derived from our base scenario.

Equities: Neutral

Although from a historical perspective equity valuations appear attractive relative to governments bonds in core markets, we are mindful that the euro sovereign-debt crisis may undermine the outlook for global economic growth, amid possible policy mistakes. Therefore, we currently maintain a neutral position in equities, but we acknowledge that there might be opportunities for tactical directional strategies to be implemented during the year.

Dividend – Bond Yield



Source: Bloomberg, FactSet, Standard & Poor's, Pioneer Investments Global Asset Allocation Research. Data as of 31 December 2011.

We remain underweight in EMU markets

Since the risks of downside in the Euro Area are higher relative to the US and Emerging Markets, we remain underweight in EMU equity markets and, in contrast, overweight in US and Emerging Markets. Data on Earning Per Share expected for 2012 are supportive of our position. In particular, current European forecast earnings are lower than those for the US and Emerging Markets.

Our bottom-up analysis on Chinese Equity Markets ex-Financials emphasises their cheap valuation. Only in the case of a strong deterioration of the actual situation could we conclude that the market is no longer cheap. Financial securities are even more undervalued than the rest of the Chinese market.

Overall in equities our attention is on stock picking to identify companies that could better exploit the growth of the Emerging economies and companies that can provide stable cash flows and high dividends.

Government Bonds: Underweight

Compared to Government bonds, we believe that core markets are unattractive as real (inflation-adjusted) yields are negative. They reflect a high level of risk aversion that should fall as investors pay more attention to single-country fundamentals. In addition, they are not consistent with our expectations for persistent global growth and dynamics of consumer prices that remain positive.

Real Interest Rates on Safe Bonds



Source: Bloomberg. Data as of 30 November 2011.

The government bonds of peripheral countries may provide value opportunities

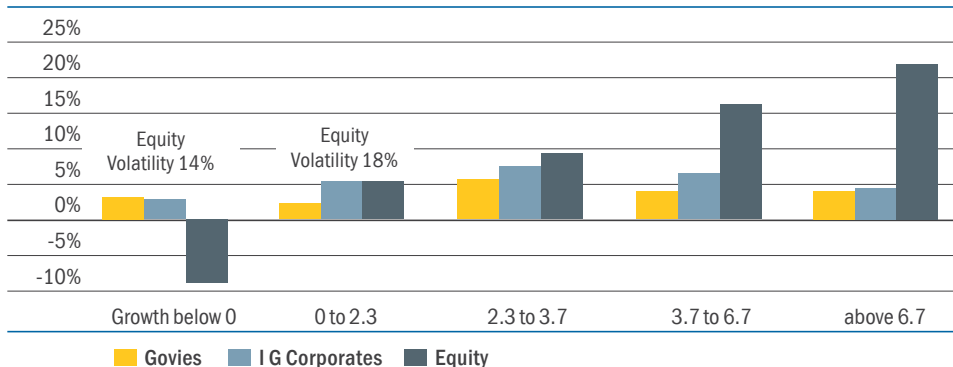
With reference to Euro Government bonds, the ECB is expected to continue to support liquidity in the Financial sector, indirectly affecting the stability of the sovereign bond market. This element, together with European countries' efforts aimed at budget consolidation and steps towards a higher intergovernmental co-ordination to solve the crisis, should eventually lead to lower credit spreads. Therefore, government bonds of EMU peripheral countries may provide good value in the medium term.

Credit: favoured in a low growth environment

Corporate Bonds: Overweight

The historical analysis shows that, in a low-growth environment, this asset class presents total return performance that is only slightly lower than that of equity.

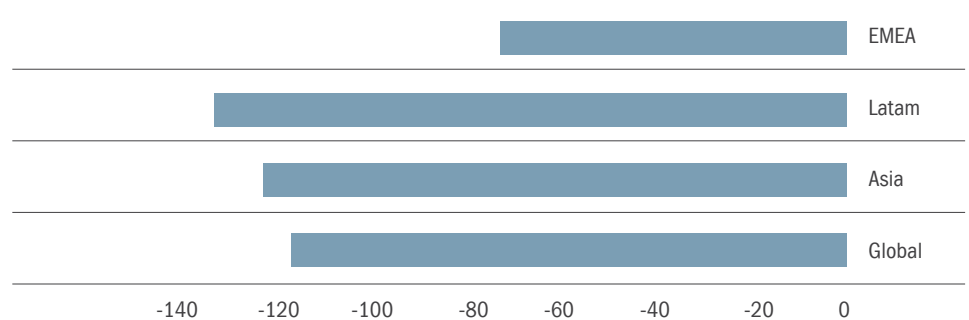
Asset Classes Behaviour



Source: Bloomberg Average Total Return Performance during Growth Regimes. Sample: 1948 - 2011. MSCI All countries, JPM Global, US Investment Grade.

In the US, the rise in risk premiums has been the result of very high risk aversion amid the euro-debt crisis as businesses are largely committed to cost cutting. The lowest-rated (high-yield) bonds have been excessively hurt by this tough environment and are likely to provide selective buying opportunities. In the Euro Area, the Financial sector represents a high proportion of the issuance in the market and it is particularly penalised by the sovereign-debt crisis: we believe that efforts by the ECB and other central banks to avoid any liquidity shortfall are supportive for several buying opportunities with reasonable risk. Non-Financial companies are still firmly committed to sound budget policies, which should lead eventually to lower risk premiums. In Emerging Markets, both government and corporate bonds should be supported by strong fundamentals, such as improving budget ratios and low debt. These are not entirely priced into market prices and credit spreads, and therefore we expect most of these markets to perform in 2012.

Emerging Market Spreads: Difference between Fair Value* and Actual Spreads



Source: Forecast of Pioneer Investments Global Asset Allocation Research on JP Morgan Markets and Bloomberg data. Data as of 15 December 2011. *The Fair Value is calculated according to Economic and Financial Fundamentals.

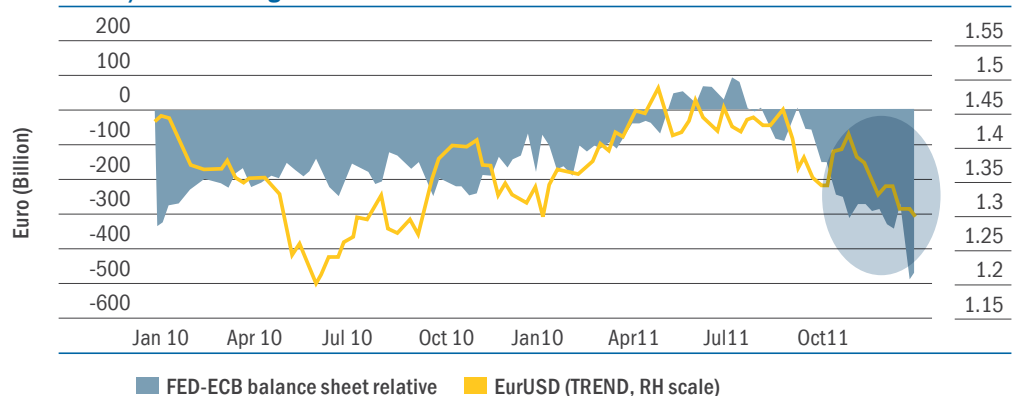
Euro under pressure but limited appreciation of the US dollar is expected

Currencies: the Euro and US dollar, a battle of weak opponents

We believe that the ongoing problems for the Euro Area will put downside pressure on the euro: both expectations of lower policy rates and a more active role of the ECB in government bond markets will limit the euro’s attractiveness as a tool for diversification. The US dollar may benefit from being one of the few safe-haven major currencies besides the yen. However, the depreciation of the Euro vis-a-vis the US dollar should be limited by the sub-par US economic growth, which may spur another round of Quantitative Easing by the Fed.

Against this backdrop, the US dollar can be effectively used as a hedge in a portfolio with exposure to risky assets due to its “safe-haven” behaviour during the recent crisis.

EUR/USD Exchange Rate



Source: Fed, ECB, Pioneer Investments Global Asset Allocation Research. Data as of 31 December 2011.

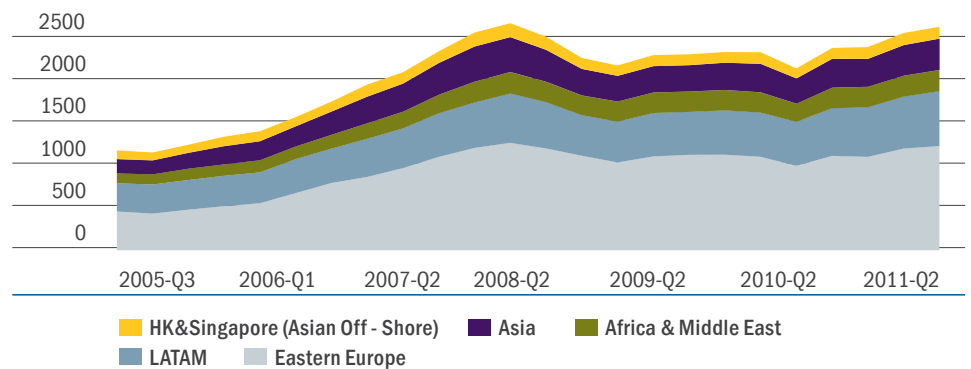
EM currencies are favoured in the medium term

We also believe that the Japanese yen will remain strong in the upcoming months because of a risk-averse environment that makes carry trade less attractive, and favours safe-haven assets. In this climate, the Bank of Japan's one-sided interventions to support other currencies may not be very effective.

On the other hand, in the medium term the Emerging Markets currencies are the main beneficiaries of the zero-rate policies adopted by major central banks; they can also be supported by an improving global economic cycle and a return of risk-on investment strategies.

Emerging Market Forex

Exploding eurozone bank claims exposure leaves EM very vulnerable to eurozone deleveraging



Source: BIS, Pioneer Investments Global Asset Allocation Research. Data as of Q2 2011.

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