

Weekly Compass

A Weekly Capital Markets Update by Parash Upadhyaya, Director of Currency Strategy, U.S. and Portfolio Manager

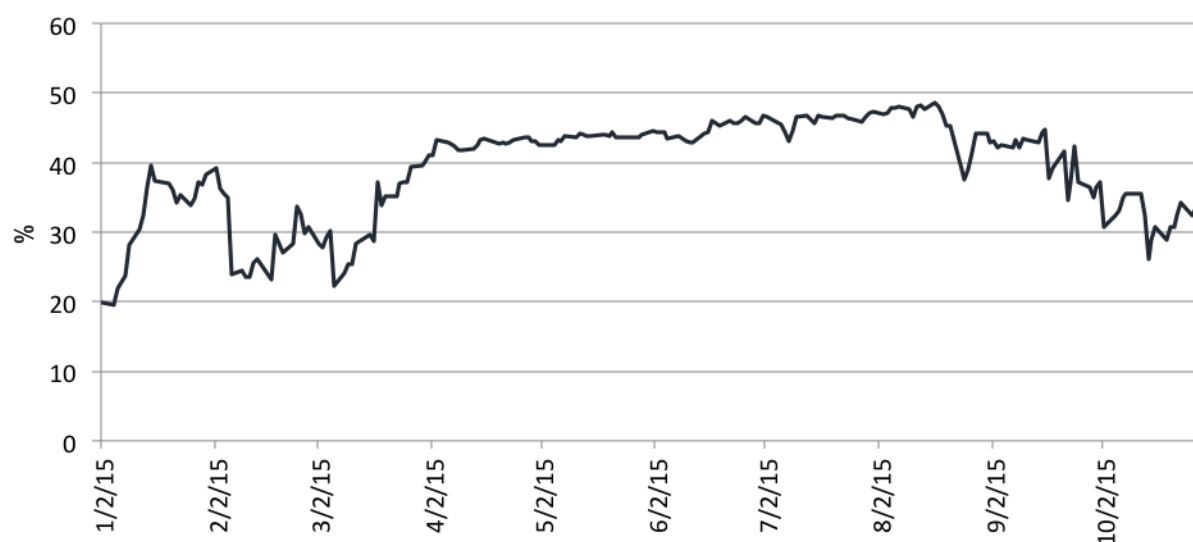
» Market Review: October 23 – 29, 2015

The Fed Moving A Step Closer

The Federal Open Market Committee (FOMC) meeting was a key driver in financial markets, with the tone of their statement decidedly hawkish. As a result, the market is now pricing in a 50% probability of a December rate hike for the first time this year (see chart below). The reaction in financial assets was mixed, with fixed income and commodity markets selling off, the U.S. dollar (USD) surging and stronger equity markets. During the last week, there was a broad based sell-off in global fixed income, led by the U.S., with U.S., Brazilian, German, Italian and South African 10-year yields rising 18 basis points (bps), 6bps, 4bps, 3bps and 2bps, respectively.

In other fixed income markets, investment grade, emerging markets (EM) debt and high yield sold off 1.3%, -0.31% and -0.22%, respectively. Commodity prices were weaker across the board with the lone exception of oil. Copper, gold, aluminum and the CRB Commodity Index declined 2.0%, 1.7%, 1.3% and 0.5%, respectively, while oil prices rose +1.5%. Not surprisingly, the USD appreciated sharply from rising prospects of a Federal Reserve (Fed) rate hike at the December meeting, rising nearly 1.0% against G10 currencies and 1.5% on a trade-weighted basis (includes key EM trading partners). Surprisingly, global equity markets remained on a sharp upward trend with the S&P 500 Index, Euro Stoxx 50 Index, Nikkei Index and the Shanghai Stock Exchange rising 1.8%, 1.8%, 2.7% and 0.6%, respectively. It remains unclear if equity markets can maintain this rally if the possibility of a U.S. rate hike continues to rise in the coming weeks. Overall, the choppy price action in global financial markets reminds us that we are in an uncertain and volatile period where concerns about the health of global growth, disinflationary pressures and U.S. rate normalization will dominate global asset prices.

Probability of a December Rate Hike



Source: Bloomberg, Pioneer Investments, October 2015.

» Economy Update

Global Growth/Event Risk



U.S. – Despite concerns about global growth, the U.S. economy is growing at trend with Q3 GDP tracking 1.3%, up slightly from stronger-than-expected net trade. The first estimate for Q3 GDP came in at 1.5% seasonally adjusted annual rate (SAAR), slightly weaker than market expectations of 1.6%. Inventory destocking was the key detractor to growth, lobbing a massive 1.4 percentage point off growth. Excluding inventories, Q3 GDP grew just about 3%. Private consumption led the way, rising 3.2% SAAR. Overall, the economy is still growing at a healthy clip. We received important wage and inflation data this week. The Employment Cost Index came in-line with expectations at 0.6% quarter-over-quarter (q/q) in Q3, while the Fed's measure of inflation, PCE Core, came in weaker-than-expected at 1.3% year-over-year (y/y). Finally, prospects for a government shutdown have greatly diminished following a tentative deal that would lift the debt ceiling and slightly ease fiscal policy.

Euroland – The economy continues to grow at trend, but there are nascent signs that slowing global growth may finally be taking a bite. The early flash PMI for EU manufacturing and nonmanufacturing came in stronger-than-expected with notable strength outside of Germany. In Germany, weaker global growth and the VW emissions scandal is hitting IFO business confidence.

China – The economy continues to grow below trend with downside risks still evident. In response to below trend economic growth and disinflationary pressures, the People's Bank of China (PBoC) cut the deposit and lending rate by 25bps to 1.5% and 4.35% and cut the reserve requirement ratio by 50bps. These measures should ensure there is plenty of liquidity in the economy. The Chinese government concluded the fifth plenum of the eighteenth Party Congress and approved the following proposals of the 13th five-year plan: target medium to high speed growth in order to double 2010 GDP and per-capita by 2020, eliminate the one-child policy by allowing two children, support emerging industries, improve social welfare and pension system and better protect the environment. We believe the government most likely lowered its growth target from around 7% to 6.5%. This move is significant because it means the government remains comfortable with the deceleration in economic activity and will not promote more aggressive stimulatory measures to propel the economy to a stronger trajectory.

Global – Argentina held general elections on October 25 and yielded another surprising result, with the frontrunner Daniel Scioli receiving 36.9% of the vote, barely ahead of the right-of-center candidate, Mauricio Macri, who received 34.3% of the vote. Macri's much stronger-than-expected result was due to last minute undecided voters breaking in his favor and the largest province in Argentina, Buenos Aires, voting for his party's nominee in a major upset. There will be a second round on November 22 between these two candidates to determine the next President. With Macri's strong performance, the outcome is now a toss-up. A Macri win is likely to lead to a structural upgrade in the Argentine credit.

Monetary Policy



U.S. – As regular readers know, we had predicted that if the Fed is seriously contemplating a hike this year, the tone of the statement would have to be hawkish. The Fed did not disappoint. The FOMC left monetary policy unchanged at the October 28 meeting, in line with expectations. The FOMC delivered two notable surprises. First, they excluded the September reference to global developments restraining economic activity. This is a clear indication the Fed is giving more weight to domestic factors rather than external. Second, the Fed explicitly referred to the possibility of raising rates at the next meeting. We read this as a sign that the December 16 meeting is a “live” meeting where rates could go up. For more details, please read Pioneer's latest *Investment Talks: The Fed: Setting Up for a Rate Hike*. With the labor market at or near the Fed's NAIRU (non-accelerating inflation rate of unemployment) rate and growing confidence that the Fed will hit its inflation target of 2%, from a medium-term perspective, we believe the Fed is likely to normalize interest rates at the December meeting. But again, we believe, it will be a close decision.

Monetary Policy (continued)



Euroland – The ECB is maintaining a clear easing bias with a strong likelihood of further easing to come at the December meeting. Last week, the ECB left monetary policy unchanged with the repo rate at 0.05% and the deposit rate at -0.20%, in line with market expectations. However, Mario Draghi's press conference was very dovish. The ECB President warned that downside risks remain to the growth and inflation outlook. In a significant development and in line with our view, the ECB stated that it will reexamine the degree of stimulus at the December meeting. We take that to mean the ECB is strongly likely to do more quantitative easing (QE) and extend the timing of the program beyond the current September 2016 end date. We would also not rule out the possibility of further cuts to either the repo or deposit rate or both. Interestingly, President Draghi mentioned recent EUR strength behind the fall in inflation—indicating elevated concerns over recent foreign exchange (FX) strength.

Japan – The BoJ left monetary policy unchanged, in line with expectations. However, there was a large minority that expected another round of QE. The statement and press conference was dovish. The Bank of Japan (BoJ) lowered its CPI forecast further for the next two years. We expect more QE in the coming two quarters.

Global

- **Sweden** – The central bank of Sweden (Riksbank) kept the key interest rate unchanged at -0.35%, in line with expectations. However, the tone was on the dovish side. The Riksbank announced more QE by purchasing an additional SEK65bn of Swedish fixed income securities. The Governor warned the repo rate could be cut further and they pushed back the start of the tightening cycle further into 2017. We believe the probability of another rate cut greatly increases if the ECB cuts the deposit rate at the December meeting.
- **Russia** – The Central Bank of Russia (CBR) kept the key rate unchanged at 11.00%, in contrast to market expectations of a 50bps rate cut. The CBR cited considerable risks to CPI behind the unchanged policy rate. With inflation expected to roll over sharply in 2016, we expect a more aggressive easing cycle next year.

Equity Markets



Despite indications that the Fed may raise interest rates in December, equities continue to perform well due to positive earnings surprises in the third quarter and merger and acquisition (M&A) activity – e.g. Pfizer/Allergan, Walgreens/RiteAid.

Sixty percent of companies in the S&P 500 Index have reported quarterly results and, so far, the results have been good relative to expectations:

- 73% of companies reported a positive earnings surprise
- 62% of companies reporting saw a positive stock price impact
- Health care and materials (low expectations) had the highest percentage of positive surprises at 85% and 84%, respectively
- Financials have had the lowest positive surprise at 61%, as net interest margins remain low

Overall, third quarter earnings are down slightly from a year ago due to energy, materials and currency. We expect fourth quarter earnings could be higher than a year ago and stocks may trend higher over the balance of the year as earnings growth recovers.

Interest Rates



U.S. – During the last week, U.S. Treasury yields traded in a wide range of 2.00-2.18%, closing toward the upper end and fueled by a more hawkish-than-expected FOMC statement. Over the week, the U.S. yield curve bear* steepened across the curve for the second consecutive week. Given market complacency on a Fed rate hike, the unambiguously strong signal sent with the FOMC statement did its intended job of raising market expectations for the December meeting. The market is now pricing in a 50% probability of a rate hike in December, the highest level we have seen all year. In addition, the probability of a January rate hike has risen sharply from 41% to 57%. We now expect the market to become even more data dependent and likely to keep rate expectations at or above 50%, ahead of the December meeting. We believe yields will continue to trade in a broad range of 2.00-2.30% with risks toward the upper end of the range.

* A curve bear steepener is a widening of the yield curve caused by long-term rates increasing at a faster rate than short-term rates. A curve bull flattener is a yield-rate environment in which long-term rates are decreasing at a rate faster than short-term rates, which causes the yield curve to flatten as the short-term and long-term rates start to converge.

Foreign Exchange (FX)



The USD has regained its momentum, particularly against the G4 and G10 currencies. The USD appreciated sharply from increasing prospects of a Fed rate hike at the December meeting, rising nearly 1.0% against G10 currencies and 1.5% on trade-weighted basis (includes key EM trading partners). Significantly, the euro (EUR) broke below 1.10 for the first time since early August and dragged other European currencies lower. In the near term, we believe the potential divergence in monetary policy will be the main driver fueling a broad-based USD rally.

Investment Themes



Equity

- We remain positive toward health care stocks as demographics and increased health insurance coverage should result in continued growth in health care spending. Our view on pricing is that companies with innovative, value-added products will be able to continue raising prices, while undifferentiated products will suffer price declines.
- Within the consumer sector, we continue to like home improvement, off-price retailing, which may benefit from lower gas prices and iconic brands.
- We favor technology stocks that benefit from the shift towards cloud computing as growth in this area of technology continues to be strong.
- Within financials, we still favor the banks, which, despite low net interest margins, have been able to generate earnings growth through efficiencies, fee income growth and loan growth.
- We remain cautious on energy and materials as valuations are attractive and commodity prices are beginning to stabilize.

Investment Themes (continued)



Fixed Income

- With its more hawkish statement, the FOMC indicated that a December rate hike was still very much on the table.
- We believe spread sectors and floating rate are more attractive relative to governments, ahead of a potential Fed rate hike.
- Investment grade corporates have become more attractive as spreads have recently widened.
- In high yield, we remain cautious on metals/mining/energy. We continue to favor healthcare and homebuilders
- We believe bank loans remain attractive due to a benign default rate environment, improved underwriting standards, diminished supply and the potential for greater demand when Fed Fund rates begin to rise.

Risks



- Timing and trajectory of U.S. rate normalization
- Concerns about weaker global growth, especially China and EM
- Further RMB depreciation
- Prospects of a Greek exit from the single currency
- Volatility triggered by strong USD and falling commodity prices

What to Look for Next Week



U.S. – It is another important data week in the U.S. that will affect financial markets. The non-farm payroll data and Fed speakers will be the most important event/data points in the week.

- **PMI (Manufacturing/Non-Manufacturing)** – In line with the trend globally, consensus is looking for PMI Manufacturing to decelerate from 50.2 to 50 in October. The new orders, export orders and employment components will be closely monitored. PMI Non-Manufacturing is also expected to decline from 56.9 to 56.5 in October, still above the long-term average. A big drop may be viewed as a sign that domestic demand is slowing more than expected.
- **ADP** – This is the first reading in the labor market. The market is looking for ADP to gain 180k jobs in October, a decline from 200k in September.
- **Non-Farm Payrolls** – This is the most important data of the week and one that will garner market and Fed attention. The market is looking for a pickup in non-farm payrolls from 142k in September to 180k in October. The unemployment rate is expected to stay unchanged at 5.1%. Finally, average hourly earnings are expected to inch up from 2.2% y/y to 2.3% y/y in October. The market will pay close attention to any upward revision to non-farm payrolls, especially as the numbers have been coming in well below expectations in the last 2-3 months. Jobless claims, a good leading indicator of the labor market, is hitting its lowest level since 1973, suggesting a rebound in jobs growth is likely.
- **Fed Speakers** – Fed Governors Williams, Brainard, Harker, Yellen, Dudley, Fischer, Tarullo, Lockhart and Bullard are the speakers next week. Yellen, Williams, Dudley and Fischer will be the most important Governors to focus on and we are likely to glean some insight into the Fed's thinking about last week's rate decision and hawkish bias.

What to Look for Next Week (continued)



Euroland – It is a relatively quiet data week in the EU.

- **EU** – We get Markit manufacturing and non-manufacturing surveys for a number of European countries. The market will be looking for continued signs of a recovering service sector and signs of weakening global growth affecting the manufacturing sector.
- **Germany** – Industrial production is a key release this week. The market is looking for a rebound following a larger-than-expected drop in output the prior month. Given the recent declines in the IFO and ZEW business confidence surveys, we would not be surprised if output falls short of expectations.
- **Euroland** – The global manufacturing and non-manufacturing surveys will be critical, especially manufacturing as it will give us a great leading indicator of the state of global growth. The trend has been weaker for global manufacturing activity. We are looking for any signs of a trough in activity. The market will pay close attention to the U.S., China, Germany, Brazil, Taiwan and Korea.

Key to Global Currencies

AUD	Australian dollar
CAD	Canadian dollar
COP	Columbian peso
EUR	euro
GBP	British Pound
JPY	Japanese yen
KRW	South Korean won
MXN	Mexican peso
RMB	Chinese renminbi (yuan)
SGD	Singapore dollar
SEK	Swedish Krona
USD	U.S. dollar

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