

Global Markets Strategy Report

February 2010

Rank: From weakest to strongest in ascending order:

Strong Underweight Underweight Slight Underweight Neutral Slight Overweight Overweight Strong Overweight

Please note that the rank is indicative and may not balance when summed.

Calling a US Growth Surprise

- Major economies relied on government action to overcome a deep recession, but economic growth is likely to remain below trend in developed countries as a struggling labour market will keep households from spending on consumer goods as much as in past recoveries.
- However, **signs of better conditions in the US labour market are surfacing and that may provide growth surprises** as early as this year. Temporary jobs have been added over the last four months and that has often been a leading indicator of an overall growth in employment.
- The confirmation of loose economic policies will also be growth-supportive. A wide output gap allows the Federal Reserve to keep interest rates at low levels as long as possible and the exit strategies will be carried out very gradually, also on the budgetary side.
- This scenario of **economic strength** calls for an overweight in cyclical assets, such as equities and corporate bonds. The risk of sharply rising government bond yields is subdued despite structural budget deficits and the need to issue more debt, as inflation looks set to remain under control.
- In the short term, while maintaining the positive bias in terms of risky assets a cautious approach would also be suitable. This is mainly due to the current pressure on some European peripheral countries stemming from the uncertainty about their debt situation, which may spark volatility.

Portfolio Strategy

On **fixed income** we maintain the case for **non-government bonds**. Credit spreads for corporate bonds have sharply declined and barely reflect lower default rates in the riskiest high-yield segment. They still provide value at the shorter end of the curve thanks to a favourable carry. The case for a low exposure to government bonds stems from budget fundamentals. The market has been supported by a policy of quantitative easing that is likely to be wound down in 2010. Without this help, investors may put renewed emphasis on the massive stimulus measures enacted by most governments, which will prompt an increased issuance of bonds.

On equities we are **upgrading the US** and the **Emerging Markets** where the growth potential is stronger. The first move is consistent with our upward revision to America's

GDP growth. The risk case is provided by a sharp rise in government bond yields as a result of inflation and budgetary concerns, but we see little reason for that to happen as core inflation is kept under control and a political consensus over budget discipline is likely to grow in the US before November's mid-term election.

For their part, Emerging Markets are down about 10% from 18-month highs and they stand to benefit from stronger US economic growth more than many developed regions. By restoring our overweight there we imply that China's efforts to keep bank lending and inflation in check will not translate into a real tightening with adverse effects on economic growth both domestically and abroad.

For now we are refraining from adding to Europe's allocation as the economic outlook is less rosy and may be endangered by fiscal policy mistakes, with too much stress by the European Central Bank on restoring budget discipline in order to enhance the euro area's credibility.

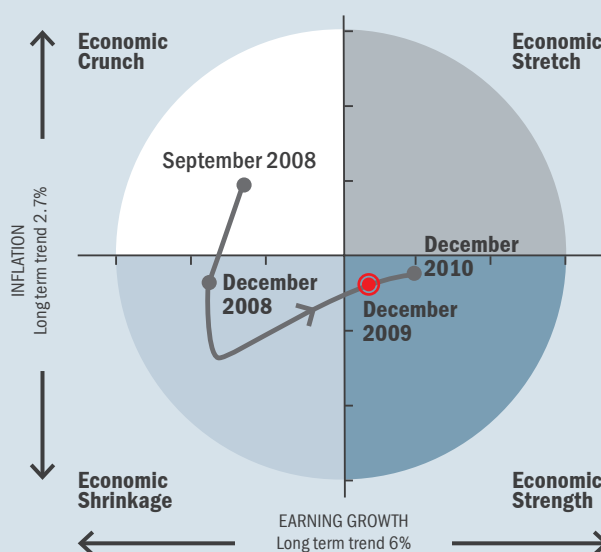
Recovery in earnings per share and no fears of inflation favour cyclical assets.

Economic strength

The stabilisation and the progressive improvement of the financial outlook began in the second half of 2009 and is confirmed. In September, we hit the turning point for US earnings momentum, while inflation does not represent a threat over the next 12 months. This case has been enhanced by our recently upgraded figure for US GDP growth.

Profit recovery

Earnings growth is again in the front seat. The next upgrade will be when sales revenues start to grow convincingly. We will get there as the macroeconomic scenario improves, even marginally. According to our indicator there is a 75% probability for that to happen.



(*) Data on US Earnings growth and US Inflation are analysed by a proprietary statistical model to get four different economic phases.

Source: Pioneer Investments Asset Allocation Research as of 26 January 2009.

Implied strategy

We name 'Economic Strength' a phase with above-trend operating earnings and below-trend inflation expectations. Over the last 30 years this environment has called for risky assets. The current stance leads to an overweight of global equities and investment-grade corporate bonds.

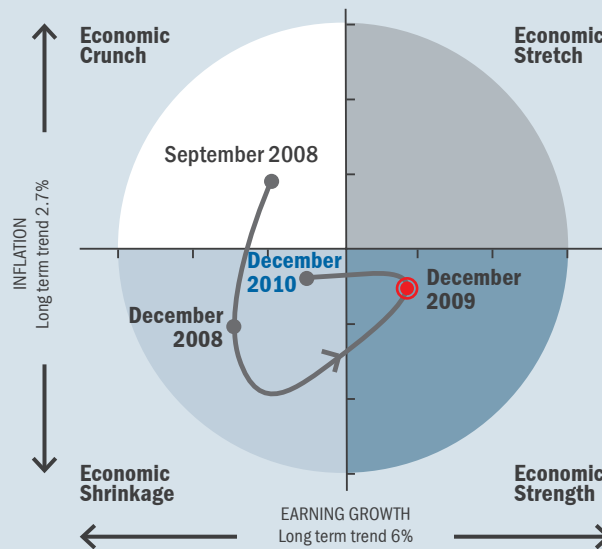
Alternative scenario

The main risk case is that the economy is unable to grow without the help of loose economic policies, on the monetary as well as on the fiscal side. We call this scenario 'Economic Shrinkage' but it is not marked by a double dip (rather by inadequate policy stimulus).

Asset class	Shrinkage	Crunch	Strength	Stretch
Equity			Buy	Buy
Government Bond		Buy	Sell	
Corporate Bond			Buy	
Cash	Buy		Hold	

Base Scenario	
GDP growth (real)	4.2%
CPI YoY	2.5%
Saving Rate	5.3%
10YS Interest Rate	4.4%
Oil	75 \$
Global Growth	3.8%
EPS operating	78 \$

Alternative Scenario	
GDP growth (real)	1.0%
CPI YoY	1.5%
Saving Rate	6.0%
10YS Interest Rate	3.0%
Oil	65 \$
Global Growth	2.0%
EPS operating	58 \$

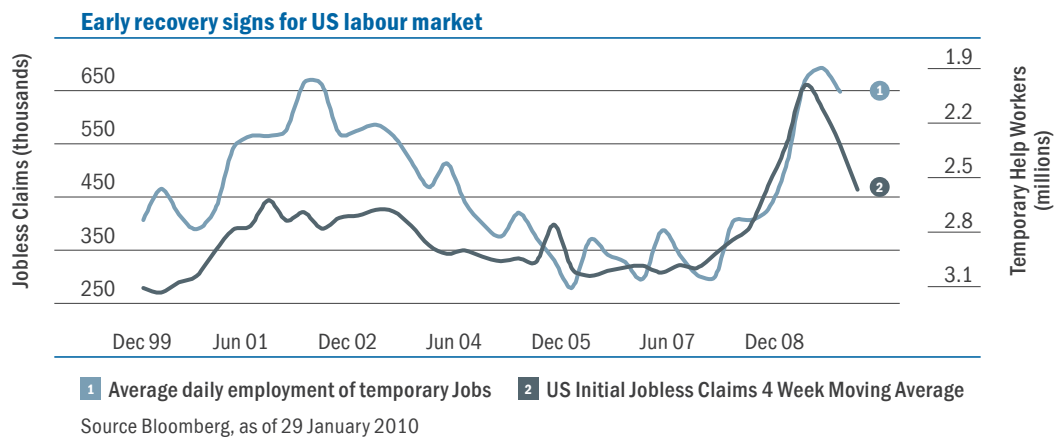


Source of both tables and chart: Pioneer Investments Asset Allocation Research as of 26 January 2009

Encouraging signs in US labour market

The labour market is expected to remain fragile in 2010, with wages still weak and the unemployment rate possibly set to peak throughout the year, but at different times for each country. The consensus view is that in this environment the rate of growth of households' consumption will remain below trend with only repeated rounds of government incentives occasionally boosting households' expenditure. Corporate profits recovered last year, mainly thanks to huge labour cost cutting and skyrocketing productivity. US companies have been pursuing these plans very aggressively but examples also abound in Europe and Japan.

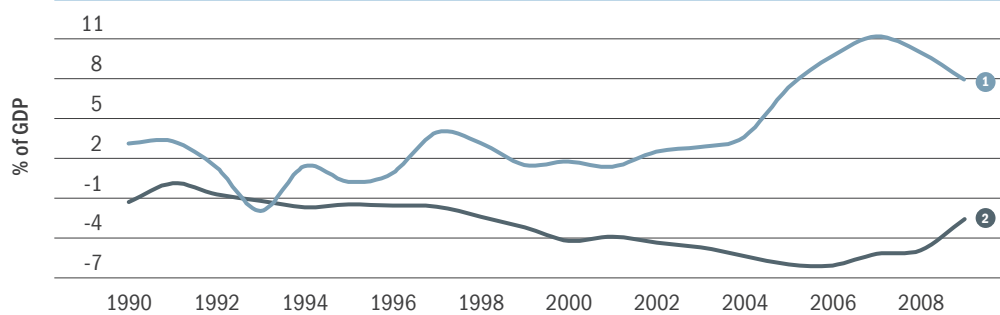
Despite the severity of the 2008-2009 recession, we can find evidence of a labour market turnaround at least in the United States. Companies have been deeply committed to cutting labour costs but they are hiring temporary staff as it happens early in a genuine recovery. Moreover the number of applicants for first-time jobless claims has declined at a quicker pace of late and that is usually a prelude to monthly jobs growth. The US non-farm payroll has shrunk for 24 months in a row since January 2008 but a positive reading is likely to hit the news sooner rather than later.



Our base scenario of 'Economic Strength' is enhanced by these data. We assign a low probability not only to the chance that the economy is still 'addicted' to government stimulus (especially on the consumer side) and cannot stand on its own feet, but also to the other risk scenario of 'Economic Stretch'. This is marked by a sudden rise in inflation, which would spark a sharp rise in bond yields. History shows that reported inflation remains close to cycle lows for about two years after the end of recession. Expected inflation may be more insidious, particularly with exploding budget deficits. However, we believe that a growing political consensus on budget consolidation will be built up ahead of November's US mid-term elections and that will limit a natural (growth-driven) rise in government yields. Equity markets will find it harder to repeat last year's gains on average, but moderately rising yields would not be disruptive.

A stronger US economy will have a favourable impact on global growth, with responsive emerging areas in Asia and Latin America standing to benefit the most. Both Europe and Japan are unlikely to exploit this added opportunity because of fresh problems. Most analysts focus on Japan where deflation has again reared its ugly face, but the outlook for growth in the euro area may worsen because of premature budgetary restraint in the wake of Greece's crisis.

Global imbalances correcting, still a long way to go



1 IMF China Current Account Balance 2 IMF United States Current Account Balance

Source IMF, Bloomberg, as of 29 January 2010

Government Bonds

Peripheral countries' strained budgets

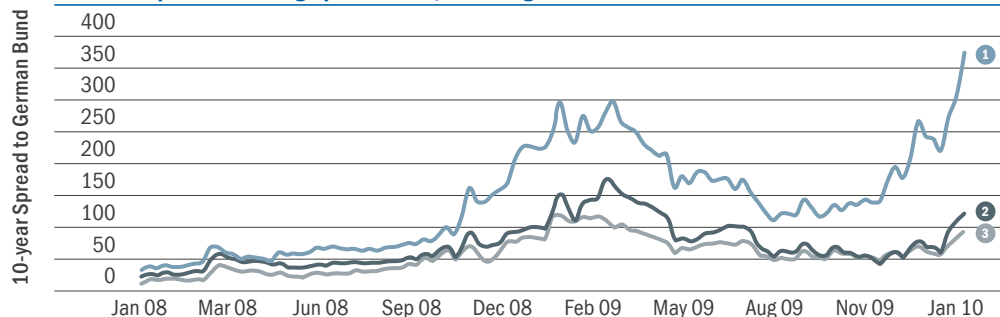
US Treasuries are a powerful trend setter and with concerns about an excessive budget deficit unlikely to fade soon, a downside risk for prices still remains. From time to time the yield curve will price in too aggressively such concerns and valuations will provide tactical buying opportunities when that happens. Overall, however, there is little reason for a strategic position on this market when our global allocation calls for cyclical assets, such as stocks and corporate bonds.

The Federal Reserve's (Fed) ability to manage the transition to monetary policy normalisation will be closely scrutinised and that will also be a source of volatility in the market. We believe that an exit strategy will be pursued with no hurry on the monetary side. However, even less can be expected on the fiscal side. The risk of a creditors' strike (notably Chinese) is probably overdone but with a projected massive increase in federal debt foreign investors will have increasing clout.

The euro market is likely to be affected by US trends, but there also a few specific factors at play. The European Central Bank (ECB) has, unlike the Fed, already set the stage for policy normalisation and the withdrawal of unconventional policies, such as bond purchases (quantitative easing), may remove a key support for the market.

In fact, there are few reasons to wind down this policy while the credit crunch remains. Data on monetary aggregates show no signs of recovery, as companies refrain from borrowing and banks are still very committed to deleveraging to loosen their lending standards.

Credit spreads blowing up in Greece, widening in the Euro area



1 Greece 2 Portugal 3 Spain

Source Bloomberg, as of 29 January 2010

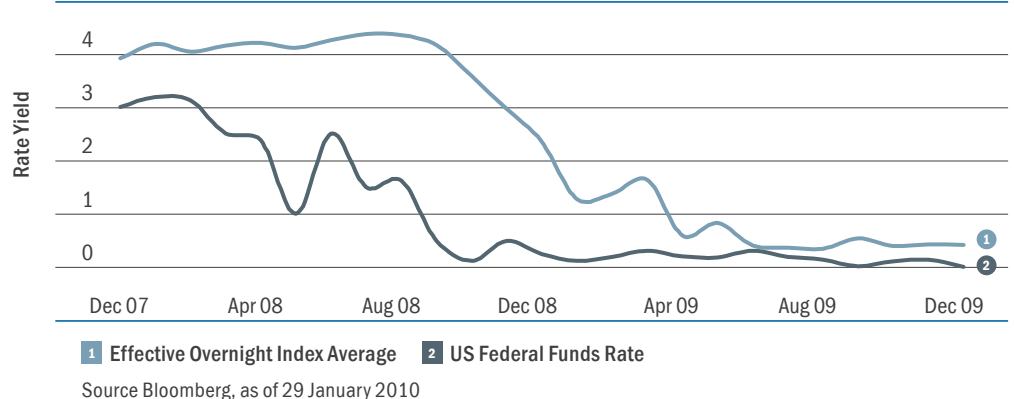
The ECB's tolerance of extraordinary measures will not turn the attention away from excessive budget deficits. The cost of bank bailouts and outright stimulative policies has been huge in most of Europe, but a few countries have definitely surpassed any threshold of good budget management. Greece's plight is obviously the most acute but other peripheral countries, like Spain and Portugal, have seen their finances seriously deteriorate due to the economic downturn (while others, such as Ireland, are regaining investors' confidence thanks to drastic budget cuts).

Against this backdrop the core markets may provide a Europe-wide safe haven and with this additional support German Bunds look expensive when compared to the global trend set by US Treasuries. We believe that a few buying opportunities are provided among peripheral countries due to the recent spread widening (with Italy providing the best risk-reward trade-off as of now) but, unlike what happened at the height of panic over the recession, the latest pattern is mostly driven by fundamentals rather than by global risk aversion. Our selective approach prompts us to stay away from Greece despite our belief that it will not be forced into some sort of debt default (if only because of possible ripple effects on the rest of the euro area).

German yields held down by safe-haven appeal



The recession is over, but policy rates are still at zero

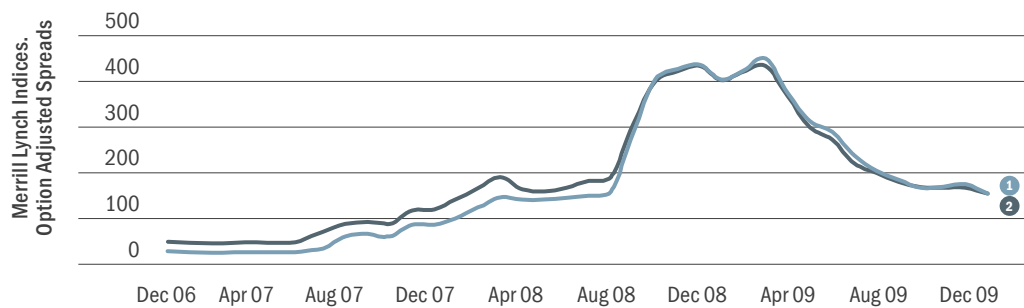


Credit Markets

More value on carry at the short end

We reiterate our preference for corporate bonds, notably in investment grade, but from a different perspective. We maintain that corporate profitability is benefiting from the economic recovery. Increased earnings on cost cutting paint an ideal picture for creditors as they improve a company's cash flow and ultimately its solvency.

Spreads more attractive at the short end



1 Euro Corporate LC 1-3 years 2 Euro Corporate Large Cap

Source Merrill Lynch, Bloomberg, as of 29 January 2010

Credit spreads have sharply declined indeed, leaving little room for further tightening. However, free-risk yields are still very low due to current loose monetary policies, notably at the short end where central banks can exert more influence. This policy maintains the case for portfolio diversification, with attractive opportunities for investment grade corporate bond.

The upside risk for credit spreads may stem from increased volatility in financial markets (shown most of all by the VIX Index), which is creeping up from two-year lows, but this will mostly involve the high-yield segment whose correlation with equity markets is usually higher.

United States

Upside growth surprise in 2010

America's economy is officially out of recession having posted the second consecutive GDP gain in the fourth quarter. The prevailing view is that after the turnaround economic growth will stay below trend. Unlike in past recoveries, consumer spending cannot be a driving force with government incentives to purchase cars and other durable goods playing a crucial role.

The slow-growth scenario is supported by a weak labour market. The unemployment rate is no leading indicator and a jobless recovery has been a feature in the past whenever the economy comes out of a recession. However, some analysts argue, companies' efforts to cut costs have been more aggressively pursued in the latest downturn. Layoffs are obviously included in restructuring plans and that will weigh on consumer confidence.

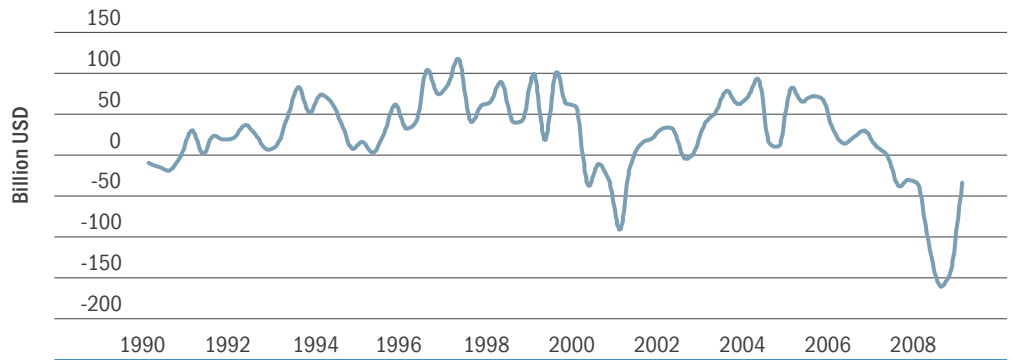
We are more upbeat, as we expect that after a 2.6% decline in 2009, the US economy will grow by 3% this year, which is close to the long-term average. Although employment figures will improve very gradually, some details are encouraging. This goes for the recent rise in temporary workers. It took longer for them to show up, but eventually companies are hiring more staff as they see evidence of a fledgling but genuine recovery. Moreover, jobless claims have declined sharply of late, with the 4-week moving average speeding up its decline and approaching the 400k mark. This usually leads to monthly gains very shortly.

Upside growth surprises may also be provided by the inventory cycle. The ratio between corporate inventories and GDP is still at historical lows, as a result of companies' pledge to cut costs. Just replenishing the warehouses to meet increased demand will boost GDP growth in 2010. If domestic demand remains weak, foreign demand is able to make up

for the shortfall. With the trade-weighted value of the US dollar at historical lows, export competitiveness will add to GDP growth.

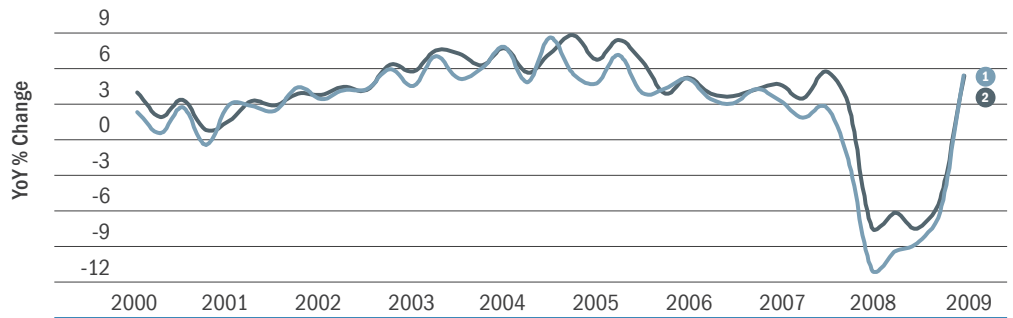
The Federal Reserve does not seem ready to acknowledge these encouraging signs. The latest policy committee, on 27 January, repeated the pledge to leave 'exceptionally low' rates for 'an extended period'. There was a dissenting opinion but the removal of this pledge in 2010, which would set the stage for an incoming rate increase.

US inventories providing a key support to growth in 2010



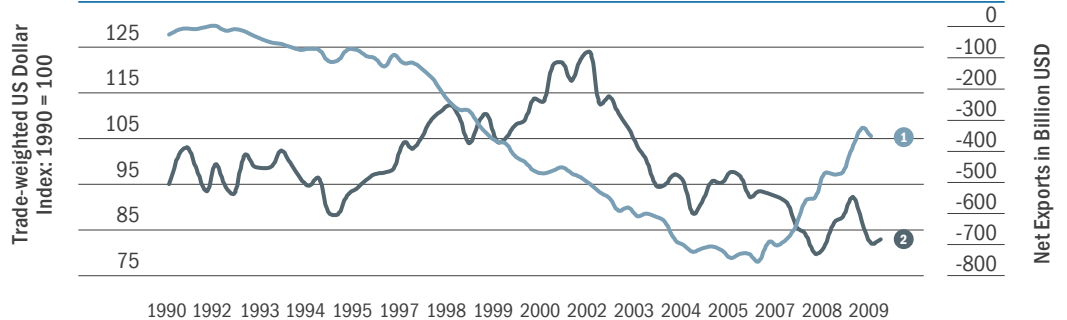
Source US Bureau of Economic Analysis, Bloomberg, as of 29 January 2010

Government incentives prop up retail sales



1 Adjusted Retail & Food Service 2 Adjusted Retail Sales Less Aut
Source Bloomberg, as of 29 January 2010

The weak dollar helps US exporters regain competitiveness



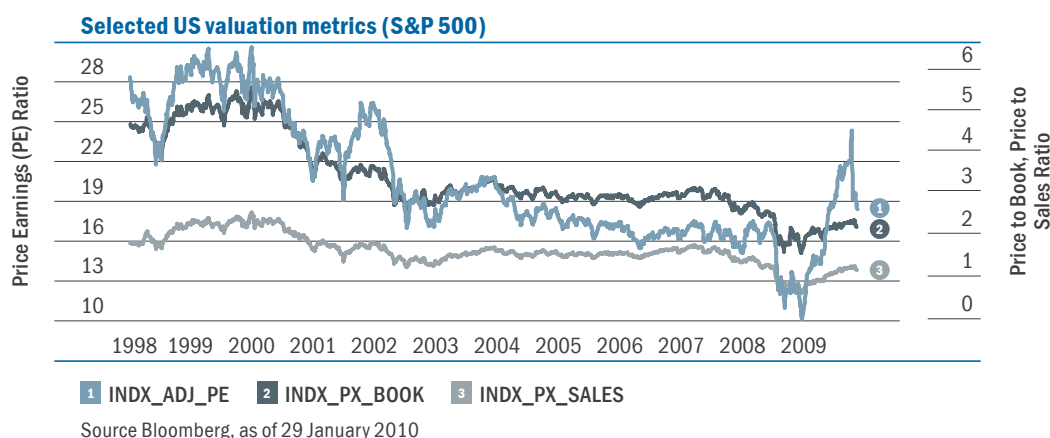
1 US Net Exports 2 BOE Trade Weighted Exchange Rate
Source Bloomberg, Bank of England, as of 29 January 2010

US Equities

We expect the US equity market to deliver a gain this year, although the road will be less smooth than in 2009 when abundant liquidity provided by major central banks fuelled a barely selective rally. Opposite forces are at play. On average, the macro-financial scenario looks more supportive than traditional valuations metrics and it provides the main reason why we have just upgraded our call on US equities.

Fundamentals Metrics are less supportive after the S&P 500 Index gained more than 23% in 2009 and erased half of the 2008 drop. A relief rally lasting nine months has pushed valuations to about 18 times its firms' reported earnings (P/E trailing 12 months), the highest in seven years. A jump in earnings expectations (+23,5%) also makes for some overstretched valuations.

Having powered most of last year's rally, bank stocks may lag the market average in 2010. Fourth-quarter figures released by major financial institutions were mixed. Net losses were mostly lower than expected even after giving back government funds, but core trends remain weak and do not suggest that the worst-hit companies are over the worst. There was a modest drop in credit write-downs from very high levels. Only a few have rebuilt a decent amount of reserves and therefore are less prone to downward revisions on earnings.



The renewed separation of commercial and investment banks, envisaged by reforms just unveiled by the US Administration, may add to the uncertainty over a key industry group. The banks that were helped, directly or indirectly, by government support and taking customer deposits should not engage in risky activities like proprietary trading (where no customer is involved), let alone managing private equity and internal hedge funds. Our Boston-based analyst argues that the actual changes will be less challenging than they sound today but we are inclined to add to our selected holdings of solid names rather than buy back most of the sector in the ensuing weakness.

We prefer companies deriving a substantial part (40%-plus) of their revenues from outside the United States, whose strong international presence may benefit not only from the competitiveness added by the US dollar's cheapness but also from the stronger growth potential of such overseas markets as China and the rest of Emerging Asia.

Europe

Budgetary concerns

The inflation rate has been slowly picking up since November as the base effect of plunging commodity prices in late 2008 disappeared. However, we believe that a wide output gap and a weak labour market will constrain wage increases and keep consumer prices at bay. The European Central Bank sets its target on the overall index, rather than

an index stripped of the volatility of commodities, but if this “core” index remains low it will have no basis for increasing interest rates.

Leaving key policy rates at 1% for most of 2010 will not keep the ECB from planning policy normalisation, notably in reducing the size of extraordinary refinancing operations. Germany’s representative at the ECB said the banks should not get used to cheap ECB funding and he is seen as the likeliest successor to the current president.

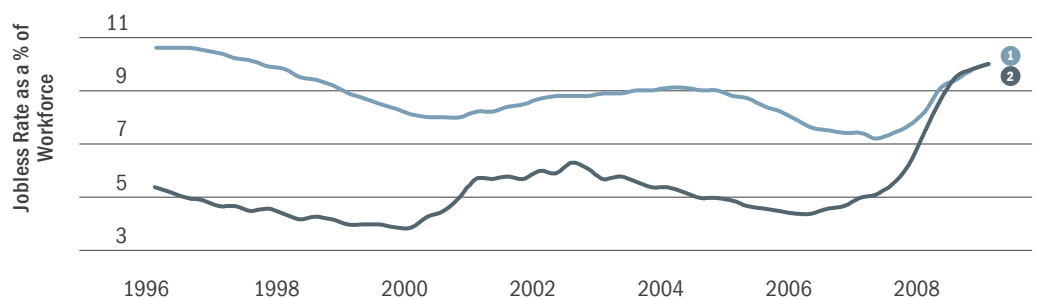
The ECB is also expecting the member countries to cut budget deficits in another sign of normalisation. Here comes the problem of deteriorating finances as a result of the crisis, with Greece clearly under the spotlight. The lack of a convincing plan for spending cuts has damaged Greece’s creditworthiness, as shown by a sharp rise in credit spreads across the yield curve. The new Greek government is not to blame as much as its predecessor but the patience of EU officials is wearing thin after the plan failed to address structural problems and relied on the beneficial effect of an economic recovery (based on optimistic growth estimates).

The ECB cannot only focus on Greece, though, as other peripheral countries have had their budget deficits sharply increased by the recession. Spain and Portugal are the most serious cases, with the former hit by the housing crisis and the latter eventually punished by bond investors because of unconvincing fiscal policies over the last few years.

Putting too much pressure on member countries to reduce budget deficits risks undermining a still-fragile recovery. That is another reason why the ECB will be hard pressed to maintain current loose policies for most of 2010. Indeed some cyclical leading indicators are rising strongly, notably the IFO Index of Business Confidence, but the foreign component accounted for much of the improvements. Germany is structurally export-oriented and relies heavily on industrial goods for which there is a strong bid from China.

The Domestic sector is much less supportive. Unemployment reached 10% in December, which is up almost 3% from early 2008. If we take the lower flexibility of Europe’s jobs market compared to the US this is a sharp increase. Against this backdrop both personal incomes and spending are unlikely to boost overall growth. Many businesses are still committed to deep restructuring plans involving a massive cost-cutting. Those willing to invest cannot easily borrow because of the credit crunch. The latest ECB data on money supply show bank lending still unable to pick up.

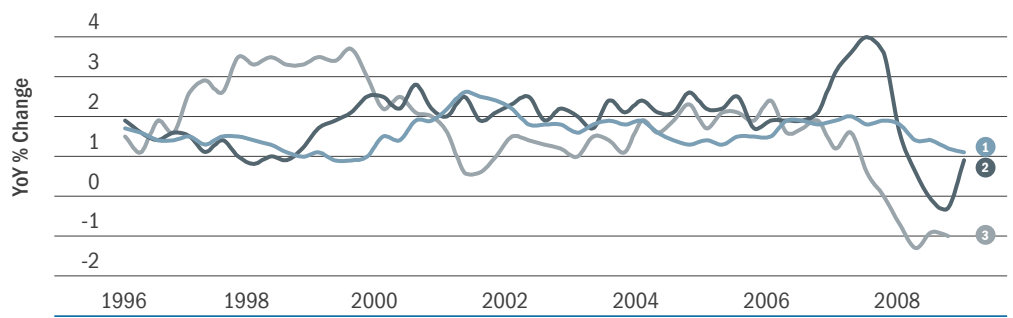
EMU unemployment mirrors the US and sets record highs



1 Eurostat Unemployment Eurozone 2 US Unemployment Rate

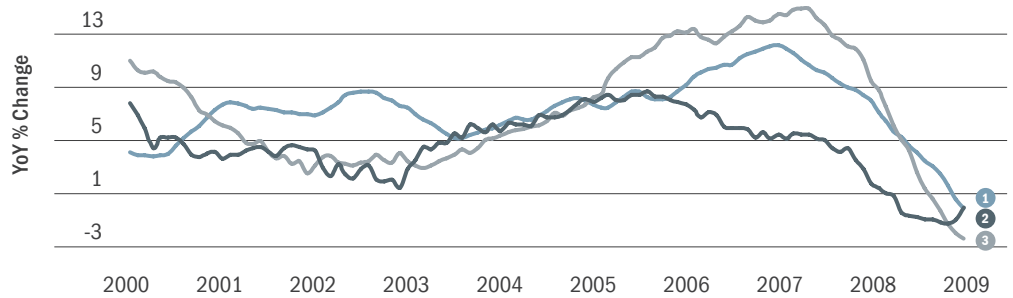
Source Eurostat, Bloomberg, as of 29 January 2010

Household spending growth subdued, keeping inflation low



1 Eurostat Eurozone Core CPI 2 Eurostat Eurozone CPI All Items 3 Eurostat GDP Constant 2000 Prices
Source Eurostat, Bloomberg, as of 29 January 2010

Bank lending is tight but demand for loans is also weak



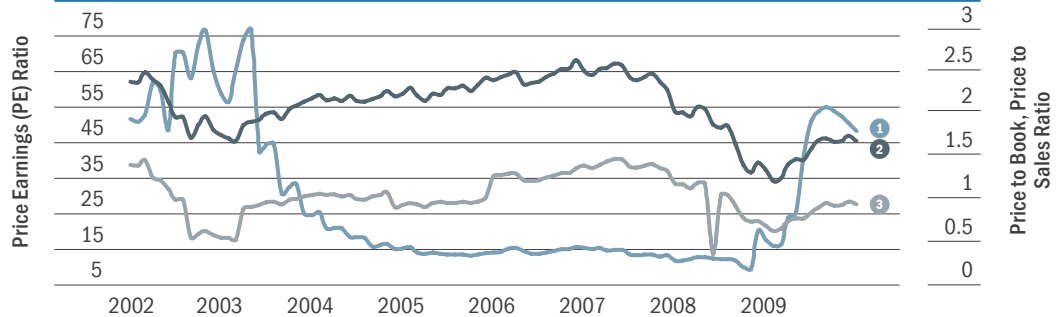
1 M3 Money Supply 3-month Moving Average 2 Euro Area Loans MFI to Households
3 Euro Area MFI Loans to Non Financial Companies
Source ECB, Bloomberg, as of 29 January 2010

European Equities

Market averages rose more than 20% in 2009, mostly in line with global trends, but they are still a long way from pre-crisis levels and that leaves most valuation metrics attractive. Eurozone equities experienced the deepest slump among developed markets during the recession if only because of the battered Financial sector's weight.

At the end of last year two key ratios, such as Price/Earnings (trailing 12 months) and Price/Cash Flows, were still well below 2007 levels. Also within the "cheap" area are other indicators, such as those comparing dividend yields with risk-free bond yields.

Selected european valuation metrics (DJ STOXX Europe)



1 INDX_ADJ_PE 2 INDX_PX_BOOK 3 INDX_PX_SALES
Source Bloomberg, as of 29 January 2010

Therefore, we expect positive returns in 2010 but more discrepancy sector-wise. The outlook for industrial companies with a strong exposure to developing countries' demand is still bright, with only a few very cyclical industries (Basic Resources) already pricing very upbeat earnings expectations.

Companies selling goods to domestic consumers may not enjoy the same growth in earnings per share. We are mindful that fiscal policies may turn overly restrictive in an effort to enhance the euro area's credibility. That could hamper household spending and overall growth. The case for cyclical assets is therefore better made by our overweight in corporate bonds.

Last but not least, stock selection may take size into proper account in 2010, as large-cap companies can raise money on capital markets more easily and are less reliant on bank credit than medium-sized ones.

Japan

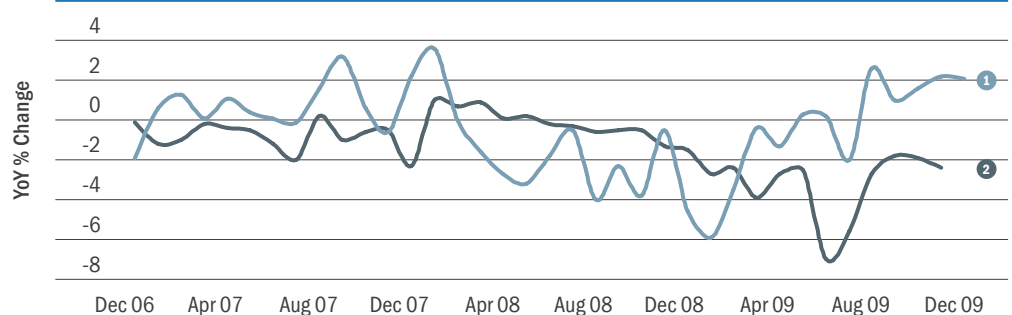
Deflation comes from within

Deflation is back. Prices excluding fresh food have fallen year-over-year for nine consecutive months. Due to the wide output gap in the economy, the inflation rate is likely to remain in negative territory for most of the year. In this environment the Bank of Japan (BOJ) not only clings to a de-facto zero-rate policy as if the worst of the recession was not over, but it is also resorting to unlimited quantitative easing that harks back to the 1990s (a period known as the lost decade).

The newly-appointed Minister for Economic and Fiscal Policy is leaning on the BOJ to fight deflation and stimulate the economy. In a recent report he quoted falling prices and a weak labour market as the main risks for growth and by urging the central bank to be an active player he acknowledged that the government's hands are tied up (in terms of fiscal policy). Actually, the size of all the stimulus packages under the old and new government is already huge (a quarter of overall GDP).

Therefore, the burden is almost entirely on the central bank and its few tools available. In fact, the scenario is not so gloomy. On the employment side the key ratio, jobs-to-applicants ratio, has been slowly picking up in the second half of 2009 and that may revive consumer confidence over time. More remarkably, on the output side the recovery of industrial production has continued apace and has now almost offset last year's collapse in a steep V-shaped upturn.

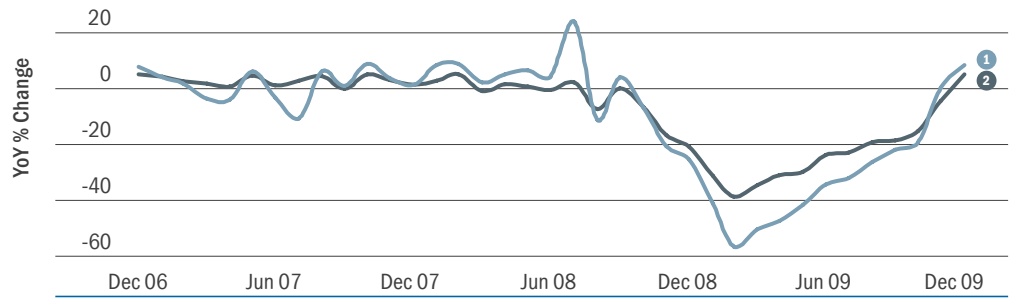
Household spending helped by cash handouts, amid subdued wage growth



1 Japan All Households Expenditure 2 Japan Avg Monthly Cash Earning

Source Bloomberg, as of 09 December 2009

Industrial output growth back to positive territory, led by cars



1 Japan Vehicle Production YoY 2 Japan Industrial Production YoY

Source Bloomberg, as of 29 January 2010

Japanese Equities

While we expect economic growth to rebound from last year's deep recession we are still concerned about corporate fundamentals. Banks were not to blame for the current recession but their loan portfolio is at risk of further write-downs in an economic downturn compounded by deflation. Policy actions are closely watched to stimulate the economy but the government's response is likely to remain feeble. Therefore, the burden will be on a weaker yen, which leaves more room for higher earnings-per-share in export-oriented sectors. Valuations in relative and absolute terms are attractive with last year's underperformance providing some upside potential. In 2009 the Topix Index scored a modest 6%, which left its value still down 36% from the beginning of 2008. The central bank's move to a zero-rate policy with no apparent time limits is likely to support the overall market by improving the comparison between risk-free and earnings yields.

Asia and Emerging Economies

Emerging economies have rebounded strongly with the help of a massive monetary and fiscal stimulus, although the potential for domestic growth in countries like China is out of the question.

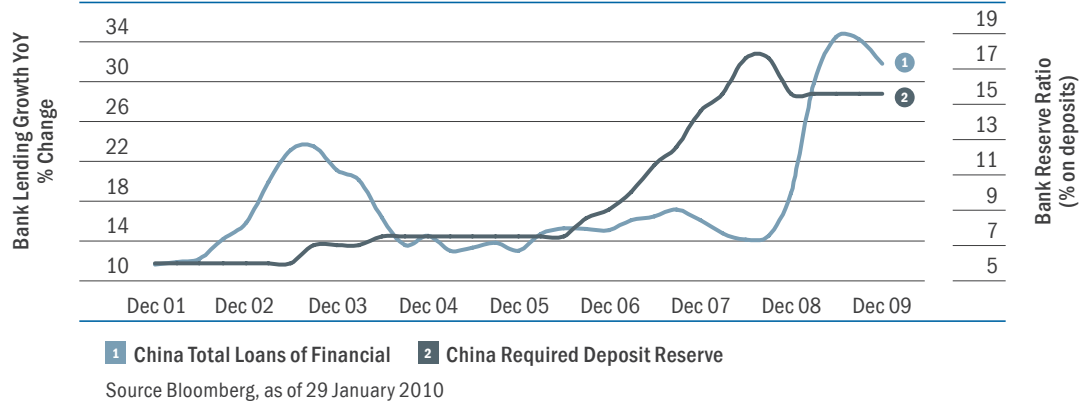
In China industrial production has completed a V-shaped recovery. After another climb in December the year-on-year growth rate is much closer to pre-crisis levels. Imports have literally surged at the end of last year by posting a record +55% growth rate year-over-year, with a strong contribution from car sales.

As a result GDP growth is back above the 10% mark year-on-year. The fourth-quarter performance boosted annual growth to 8.7% and above the official 8% target. Investments played the usual key role thanks to an aggressively loose credit policy. Bank lending is growing more than 30% year-on-year and is mostly channelled to state-owned firms for infrastructure projects.

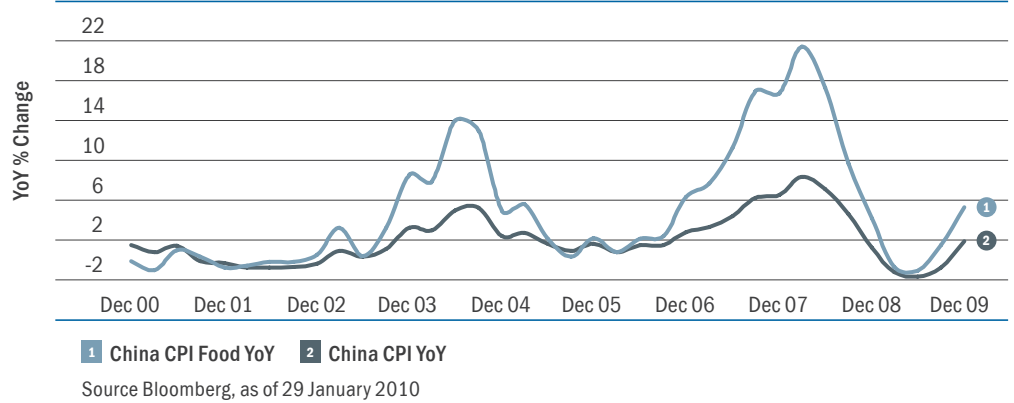
The authorities are aware of the risk of an increase in non-performing bank loans and are trying to crack down on the excesses of this policy, first by raising interest rates and then by imposing lending quotas or even telling banks to stop lending money.

The case for a tighter policy is made by a recent spurt in inflation. Although the year-on-year comparison is exaggerated by a low base, the authorities are genuinely concerned about impending pressures. Food prices are up 5.3% year-on-year in December after regaining positive territory only last August.

China's bank lending growth cools down



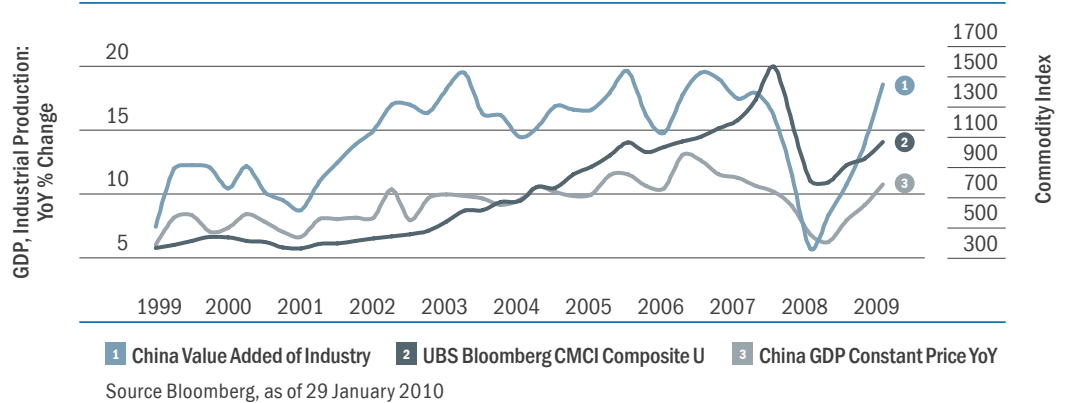
Inflation rising in China, still under control



China's demand is able to drive growth in many places, starting of course with surrounding East Asia (see Japan's case) but it can also boost prospects as far away as in Latin America where several countries are net commodity exporters.

The resilience of Latin America, especially Brazil, has surprised on the upside but has a lot to do with China's super-charged recovery. Brazil, in particular, looks set to grow by 5% in 2010, which is much more than its neighbours. It adopted the right economic policy to get out of a short recession (lasting just two quarters) but the Export sector accounted for a substantial part and is mainly made up of basic commodities (minerals) with China as a prime buyer.

Global commodity prices supported by China's growth



Emerging Markets

We have upgraded our exposure to global emerging markets and in particular to Asia and Latin America, as our more upbeat expectations on the US economy add to global growth. The rebound in global growth is brightening the outlook even for countries in Emerging Europe but most of them still rely substantially on foreign investment flows, especially from the rest of Europe. The latter may lag global growth because of fiscal policy restraint.

The main risk facing the area, notably Asia, is an asset price bubble along with a surge in inflation. Government action has quickened the pace of recovery in countries like China by boosting growth in bank lending to barely sustainable levels. Monetary conditions cannot remain too loose without entailing rising asset prices, especially in property and financial markets.

China's driving role for global emerging markets



Source Bloomberg, as of 29 January 2010

Providing a proper policy response will not be easy if inflation starts to rise too soon. We will closely watch how the central banks (in China as well as in the developed world) will behave in more challenging conditions. In China's case, we have already seen a sharp decline in stock prices when tightening measures were announced last August and this kind of volatility may be repeated.

However, our specialists in Emerging Markets believe that, unlike Japan in the 1990s, China is acting pre-emptively to head off a speculative bubble in asset prices and notably in housing. With this in mind, we put more emphasis on China's position as the world's second-largest economy and largest exporter.

Currencies

Euro under the spotlight

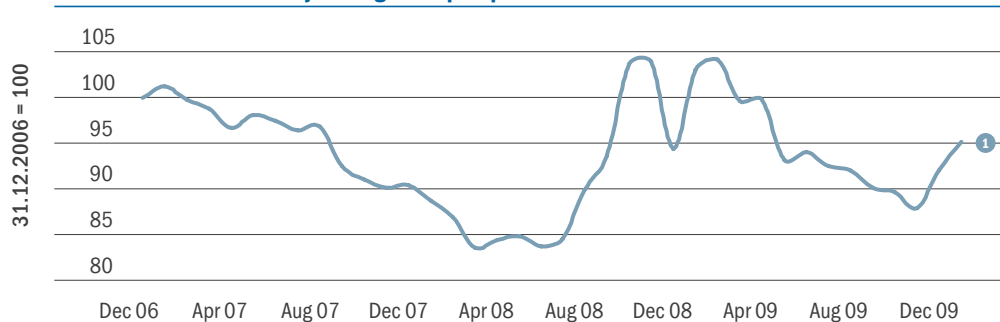
The US dollar gained against major currencies even without a marked improvement in US economic figures. Both the euro and the yen have sharply declined from last year's highs because of deteriorating fundamentals.

The pressure on the euro can be explained by concerns about budget discipline in the wake of Greece's crisis. Other peripheral countries are urged to fix their finances and tighter fiscal policies may undermine growth prospects. A weaker euro seems to provide a comfortable escape route.

Japan would also have its recovery prospects improved by a more competitive yen. With the central bank playing a key role in helping the economy through a zero-rate policy, the yen is again a funding currency of choice in carry trades, replacing the US dollar.

Tactical Asset Allocation Summary

The Euro undermined by weak growth prospects



1 USD-EUR X-RATE

Source Bloomberg, as of 29 January 2010

Our improved outlook for the US economy supports a stronger US dollar at least with respect to currencies of other developed countries or regions.

Over a longer horizon the US dollar is still vulnerable. The federal budget deficit shot up dramatically and convincing creditor countries, like China, to let their currencies appreciate will not be easy. As other ways to avoid a US financial collapse are politically unpalatable (reform of entitlements, for example) the US dollar's prospects may structurally improve only if the two main parties agree on a fiscal consolidation in the run-up to November's mid-term elections.

Equities: Overweight

Our improved estimate for US economic growth prompts us to restore a global equity overweight as it enhances our base scenario of 'Economic Strength'. Growth in corporate earnings will continue in 2010 and will eventually get stronger when sales revenues rise as well. As we explain in detail below, with this move we increase our holdings in almost all regional areas although for differing reasons.

USA: Overweight

UPGRADED. We concede that the recovery will not be as quick as after the end of past downturns, as consumer spending remains subdued in a weak labour market. However, jobs may be created again earlier than consensus expectations. Companies are hiring temporary workers in spite of cost-cutting plans and jobless claims are declining more speedily. This may lead to renewed growth in sales revenues, which will add to earnings more than cost cutting.

Europe: Underweight

We are not overly optimistic about Europe's economic prospects, but the strong correlation with the US prompts us to turn our long-held underweight into a bullish call. Cyclical sectors stand to benefit from improving global economic conditions with less downside risks to earnings. Industrial companies with a strong exposure to developing countries' demand for capital goods meet these requirements, with a recovery in earnings per share less affected by the mixed outlook for Europe's domestic demand (which may also be hurt by overly restrictive fiscal policies).

Japan: Neutral

After a dramatic underperformance valuations look compelling, but the burden is on the central bank to get the economy out of recession. This reminds us of the indefinite loose policy of the lost decade (the 1990s), which left the market lagging behind global trends most of the time. Export-oriented sectors can have earnings per share enhanced by their exposure to global growth, particularly to demand from the rest of Asia.

Asset Allocation Summary

Pacific ex Japan: Underweight

DOWNGRADED. In terms of regional stock indices this area is not centered on East Asia's most dynamic countries, such as China. Australia accounts for a large part of them and within it much of the recent performance came from miners and other basic-resources companies, whose earnings expectations already look overstretched, in spite of their exposure to strong developing markets in Asia.

Emerging Markets: Overweight

UPGRADED. Emerging markets magnify global trends and stand to benefit from our improved call on the US economy. We are particularly confident on the regions where domestic demand is a key driver of growth and without serious current-account imbalances. Most of emerging Asia meets this requirement, although China's attempts to check growth in bank lending may prompt increased volatility. However, we believe that China is acting pre-emptively to head off a speculative bubble in asset prices.

Fixed Income: Underweight

We confirm our overweight in credit markets, with the best opportunities left in the investment grade segment. For their part government bonds still look expensive and account for the global underweight. Yields are being kept down across the curve by loose monetary policies but governments' reluctance to reduce the budget deficits may prompt more issuance and eventually put upward pressure on yields.

Euro Government: Underweight

Inflation does not pose a problem and the European Central Bank (ECB) is set to withdraw unconventional policies gradually. Yields are too low in core markets, such as Germany, amid the current turmoil in Greece and other peripheral countries, and they are also prone to an upward correction because of the US market's role as a global trend setter.

Euro Corporate: Overweight

Credit spreads have dropped sharply and should have little room left for further tightening. We see the better risk-reward ratio at the short end of the investment-grade segment on a selective basis, as government yields are kept artificially low by policies of quantitative easing.

US Government: Underweight

The US Federal Reserve's quantitative easing has kept yields lower than a recovering economy would imply. Foreign investors will be key in funding the deficit and without convincing plans to cut it they may remain nervous about a resurgence of inflation. We do not anticipate, however, a sharp rise in bond yields as a growing political consensus about budget consolidation may be found before the November mid-term elections.

US Corporate: Overweight

The drop in credit spreads has been considerable and leaves little room for further tightening, especially in the high-yield market. For its part the investment-grade segment retains some value as companies are still deeply committed to cut costs and improve their cash flow profiles.

Emerging Markets: Neutral

We are not yet ready to upgrade this class for its strong correlation with the high-yield market where our expectations are also not high. However, the renewed uptrend in commodity prices supports the finances of countries, notably in Latin America, that are net exporters of raw materials and accounts for a large stake of this market. Moreover, sound economic policies will lead to a steady decline in credit risk over time.

Tactical Asset Allocation Summary

Global Summary Table

Asset Class	Recommendation
Equity	Overweight
Government Bonds	Underweight
Corporate Bonds	Overweight
Liquidity	Overweight

Regional Summary Table

Asset Class	Recommendation
Euro Cash	Underweight
2yr Euro Corp	Overweight
Total Liquid Assets	Overweight
Euro Bond	Underweight
US Bond	Underweight
Japan Bond	Underweight
Government Bonds	Underweight
US Corporate	Overweight
US High Yield	Neutral
Euro Corporate	Overweight
Euro High Yield	Neutral
Emerging Market Bonds	Neutral
Corporate Bonds	Overweight
North America Equity	Overweight
Europe Equity	Underweight
Japan Equity	Neutral
Global Emerging Mkts	Overweight
Pacific Ex Japan	Underweight
Equity	Overweight

Foreign Currency Exposure

US dollar	Overweight
Euro	Underweight
Yen	Neutral
Other	Neutral

FROM WEAKEST TO STRONGEST IN ASCENDING ORDER:

Strong Underweight Underweight Slight Underweight Neutral Slight Overweight Overweight Strong Overweight

Please note that the rank is indicative and may not balance when summed.

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