

Global Markets Strategy Report

December 2011

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 sum to equilibrium.

Leading theme. The bond market's growing influence

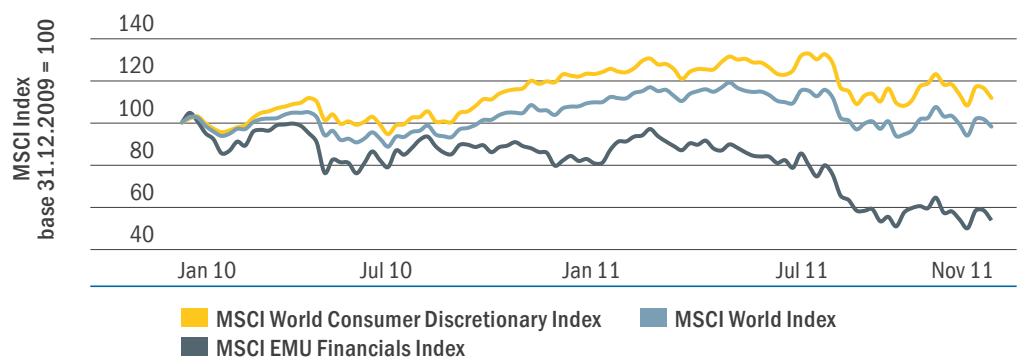
In the Special Edition of this report outlining Pioneer Investments' view on the current macroeconomic situation and the main asset classes, we look forward to next year by outlining the likely themes in the global economy and the key markets of the US, Europe, Asia and Emerging Markets.

About a year ago, we argued that the entry of politicians into the management of economic affairs would be durable and reduce economic growth this year. In fact, we believe politicians made things worse largely due to their own initiatives, as they turned a case of fraudulent accounting in a small euro country into a global scare. As the crisis involved government debt, they appear to have failed as managers of their own balance sheets rather than of assets inherited directly or indirectly from the recession.

The EMU sovereign-debt crisis, caused by the Greek government's misconduct, is 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 drama and led to government changes following general elections or the resignation of political leaders. International institutions were not blameless, however, and the inability to provide clear and convincing solutions has led to a devolution of powers to technical (and mostly unelected) officials, such as central bankers.

We should now wonder whether this handover of power will work better or if expectations about the technocrats' ability to redress government budgets and convince financial markets are somewhat overblown. Since the eurozone finds itself under the spotlight and is a potential catalyst for a global recession, we will begin our region-based review from there.

EMU Bank Stocks Put Global Markets Under Pressure



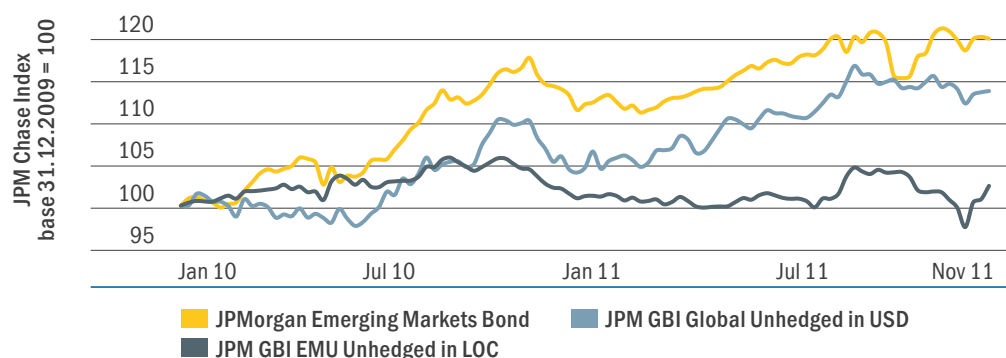
Source: MSCI, Bloomberg data as of 09 December 2011

We expect the political will to resolve the euro crisis to emerge at the urging of global institutions, which may even put the European Union under tutelage in order to protect the global banking system. Technocratic bodies, such as the IMF and major central banks, would be the agents of this handover. We expect technocrats to have more and more clout, and get the blame for stern and unpopular measures. They are likely to retain it even after the worst of the crisis is over, as elected politicians refrain from fighting bond market “guardians” and want to maintain a low profile.

Our inference for the global investment strategy is that risky assets should benefit from renewed confidence in the world economy, which can also regain the support of fast-developing emerging countries where economic policies set on curbing inflation may soon be ending. A soft-landing outcome in these economies is our favourite scenario, supporting developed economies and the most cyclical (non-financial) sectors of the stockmarket.

This is not to say that 2012 will be a fair-weather year and we argue in our US review that bond market “guardians” will cross the Atlantic. Also, the next crisis is likely to be about government finances and this time involve US Treasuries. The group of “core” bond markets, where the issuer’s credit risk is not at stake, might become smaller and even disappear. At its most extreme, emerging countries may enter the core group because of healthy budget ratios. Private companies could also replace more governments on the safer side of a very much enlarged credit market.

The Euro Crisis Changes the Risk Profile of Global Debt Markets



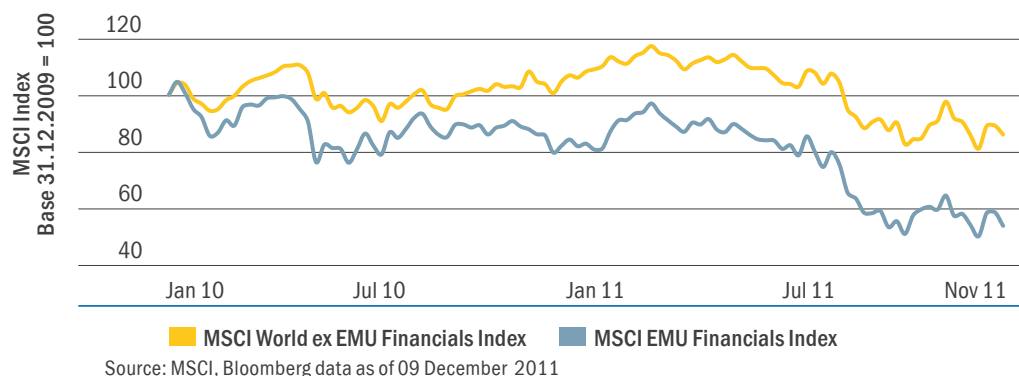
Source: JP MORGAN CHASE, Bloomberg data as of 09 December 2011

Europe. A move towards a fiscal union to solve the EMU crisis

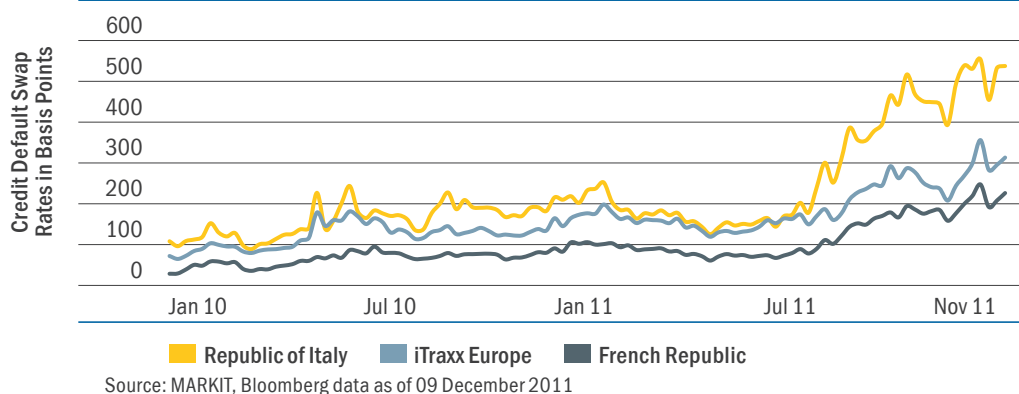
The new governments formed in the countries that were hit harder by the sovereign-debt crisis are said to be under the tutelage of the European Union and will be even more so when a new treaty drafted by the latest EU summit on 9 December comes into force. However, another partial loss of sovereignty may be in store for the European Union itself, as the rest of the world becomes increasingly concerned about a global contagion, notably through the EMU Banking sector. The memories of US banking crises in 2008 are still vivid and call for more worldwide co-operation to avoid a recession.

This “joint” administration may change the rules governing the EMU, with both monetary and fiscal policies set by common institutions and binding for national governments. Financial markets have forced such a change, particularly the bond market guardians who prompted EU leaders to draft new provisions, which may eventually lead to a full fiscal union.

How the EMU Debt Crisis is Affecting Non-EMU Bank Stocks



Moments of Fear and Relief in the Sovereign-Debt Crisis

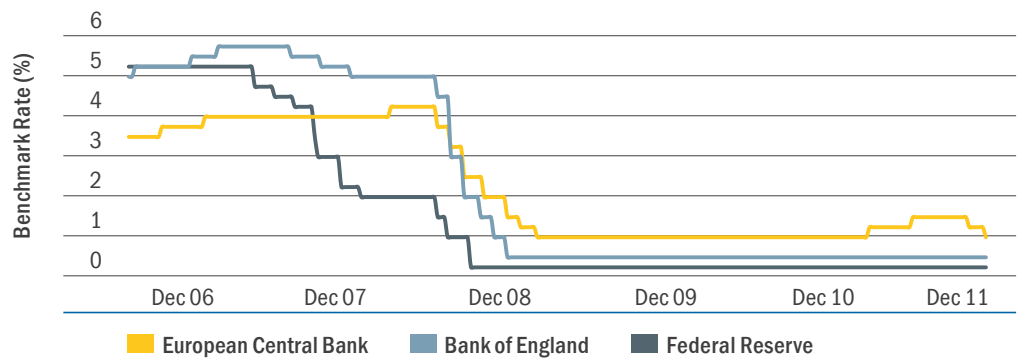


Germany's finance minister argues that the crisis provided an opportunity, as the pressure from financial markets prompts the countries stricken by the crisis to curb their budget deficits and increase competitiveness through economic reforms. In doing so, they should head towards a fiscal union. A less smooth process is likely, though, as the crisis extends from the periphery into what used to be the "core" area. The sharp increase in France's credit risk is following Italy's by about 5-6 months, which is not a long time. If no clear and convincing solution is adopted, the French presidential election next May may be the right catalyst for speculators, much like the referendum almost 20 years ago on the treaty forming the basis of EMU.

If political leaders are not up to the challenge, then technocrats will play a key role, and not only in newly-established governments. The European Central Bank (ECB) is the best case in point: as issuer of the currency, it can put unlimited resources to use (unlike the European Financial Stability Fund) and keep financial markets under close watch on a continuous basis. It is constrained by a charter provision setting "price stability" as the primary objective but this target maybe reached in the medium term. Moreover, price stability is also pursued with policies aimed at preventing deflation (a possible side effect of a deep recession).

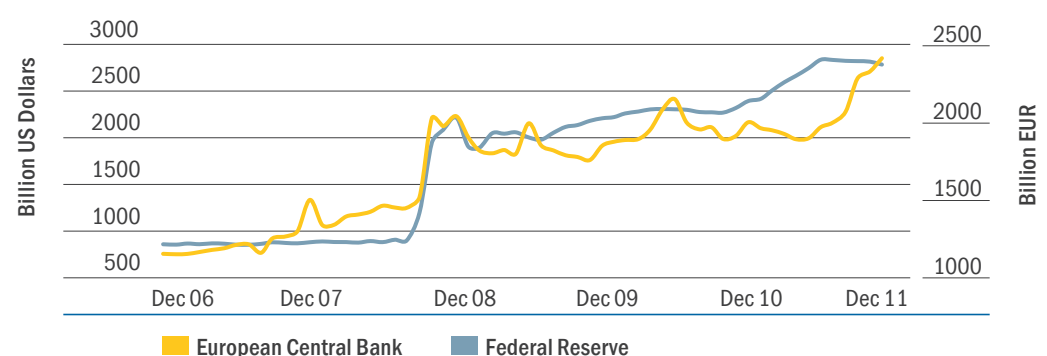
The sovereign-debt crisis led the ECB to join the ranks of central banks, which are pursuing growth-oriented policies as if inflation was no longer a problem. The ill-timed (with hindsight) tightening of 2011 was offset by two consecutive rate cuts under the new chairmanship of Mario Draghi, even as consumer prices grew above 2% (the medium-term ceiling).

The ECB Joins the Ranks of Growth-oriented Central Banks



Source: Bloomberg data as of 09 December 2011

Exploding Assets at the FED and the ECB

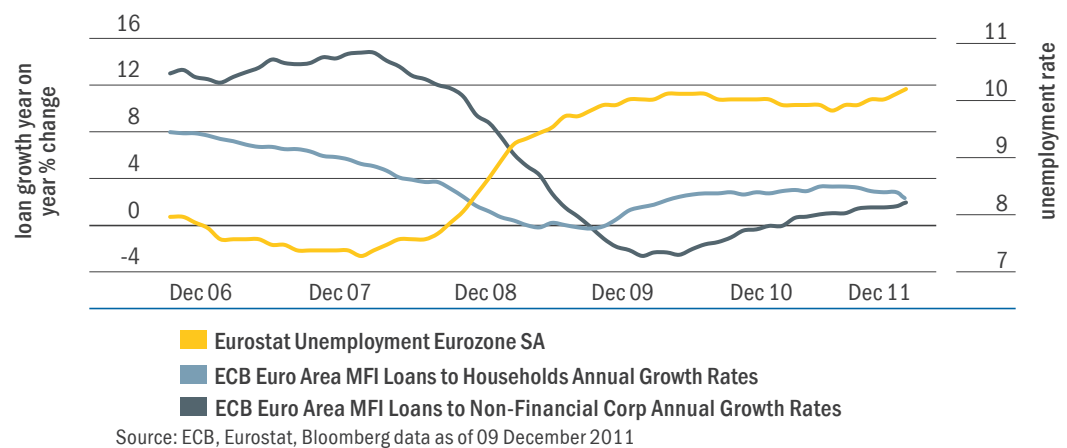


Source: Bloomberg data as of 09 December 2011

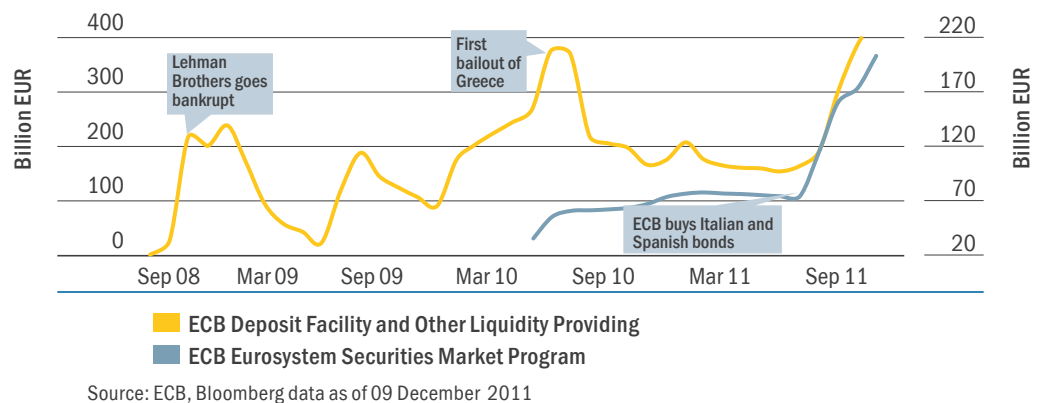
The new chairman of the ECB has spelled out the new approach since his first press briefing, when he said that inflation is to decline as a result of a weak economy and monetary policy would pay more attention to the indicators of economic activity. There is evidence of economic malaise in the eurozone with a record-high jobless rate, rapidly deteriorating business confidence and weak growth in bank loans to both households and non-financial companies. To ease the strains in financial markets and mitigate their effects on the supply of credit, the ECB and other major central banks have jointly provided liquidity support to commercial banks several times over the last few months.

The ECB is also stepping up the bond-purchase programme (known as securities market programme or SMP), while EMU banks are increasingly reliant on extraordinary liquidity facilities. By performing these operations, the ECB has already become a full-time crisis manager in spite of Germany's misgivings about this role. Allowing the ECB to buy government bonds on the primary market as a lender of last resort is a politically bold step that Germany still opposes, although it looks like the next step beyond the current situation. If Germany sensed the full impact of a euro blow-up in its own economy, the political will to overrule the provision, barring the role of lender of last resort, might emerge.

Weak Labour Market and a Bank Credit Crunch Point to a Euro Recession



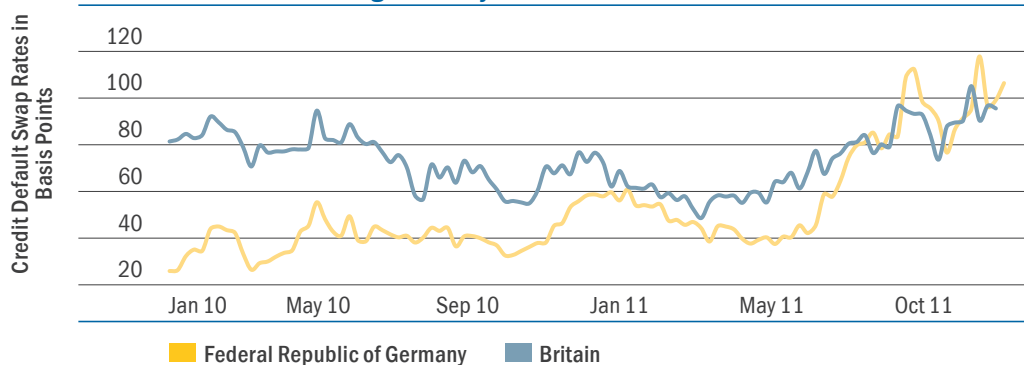
The ECB as a Crisis Manager for Banks and Governments



Some events should be worth considering. In late November an auction of German government bonds was poorly received amid weak demand from cash-strapped domestic banks. Years of convergence in government bond yields were reversed quickly by the sovereign-debt crisis but a convergence of sorts still remains in the Banking sector. As a result of the crisis, stocks and bonds issued by EMU banks trade at deeply discounted values, with negligible differences between banks based in strong and in weak countries. Germany does not seem immune from the crisis: also as a result of that bond auction, Germany's credit risk rose above Britain's (despite the latter's high budget deficit) suggesting that all EMU countries bear some credit risk for not possessing monetary sovereignty at a national level.

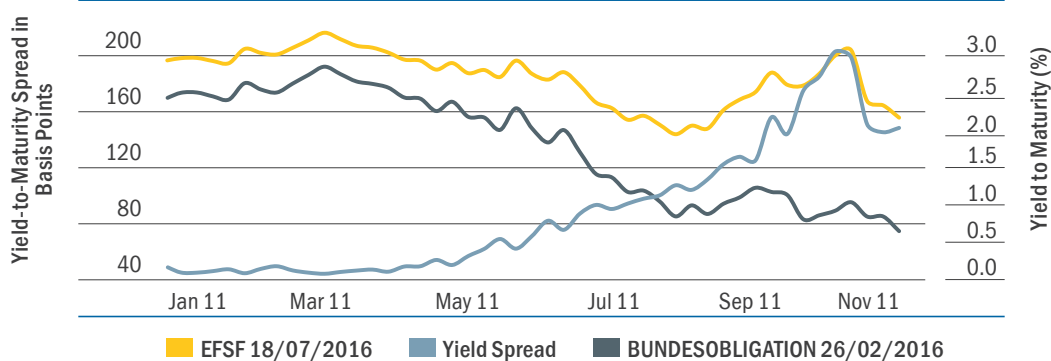
While retaining the higher ground, Germany could agree on the issuance of jointly-backed "Eurobonds" in exchange for new supervisory powers on national fiscal policies. This point was not agreed upon at the latest EU summit on 9 December, but we believe Germany's tough stance should be taken as a nudge to member States to strengthen their fiscal discipline rather than an outright rejection of Eurobonds. After adding the right provisions, such as leaving an excess debt level borne by the individual state, these should provide a better assurance of a country's debt burden than current EFSF issues (yielding as much as 200 basis points above the German equivalent). Before the new treaties come into force, the EU Commission should take up this role, while the ECB would become a sort of "law enforcer" thanks to its experience in crisis management.

The Euro Crisis Affecting Germany's Credit Risk



Source: MARKIT, Bloomberg as of 09 December 2011

Bonds Issued by the Stability Fund Not Immune From the Crisis

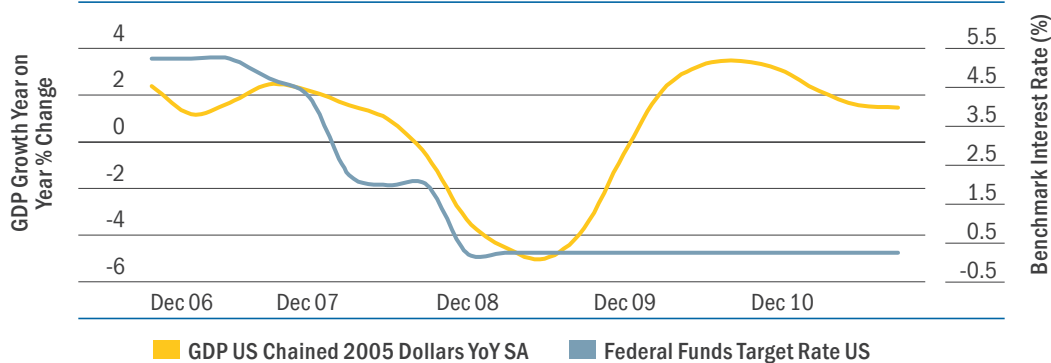


Source: Bloomberg data as of 09 December 2011

USA. The risks of an election year

Major central banks of developed countries have retained overly loose monetary policies as if downside risks to economic growth were a persistent threat. While the ECB has just joined the ranks due to the sovereign-debt crisis, the US Federal Reserve has never turned back, as the US economic recovery was tentative after the last recession and “strains in global financial markets continue to pose significant downside risks to the economic outlook” (as the latest statement of the policy-setting council says). The reference to the EMU debt crisis is not explicit but easily retrievable in these words.

The Persistence of Zero-rate Monetary Policies

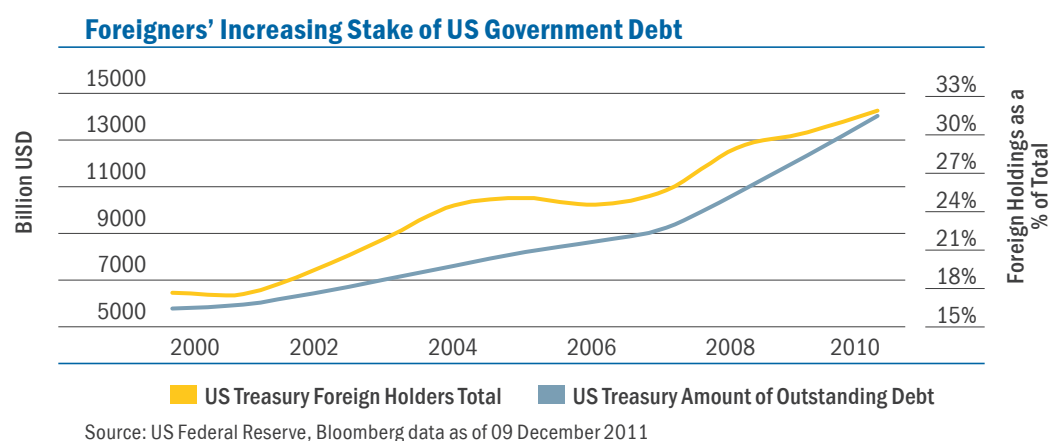
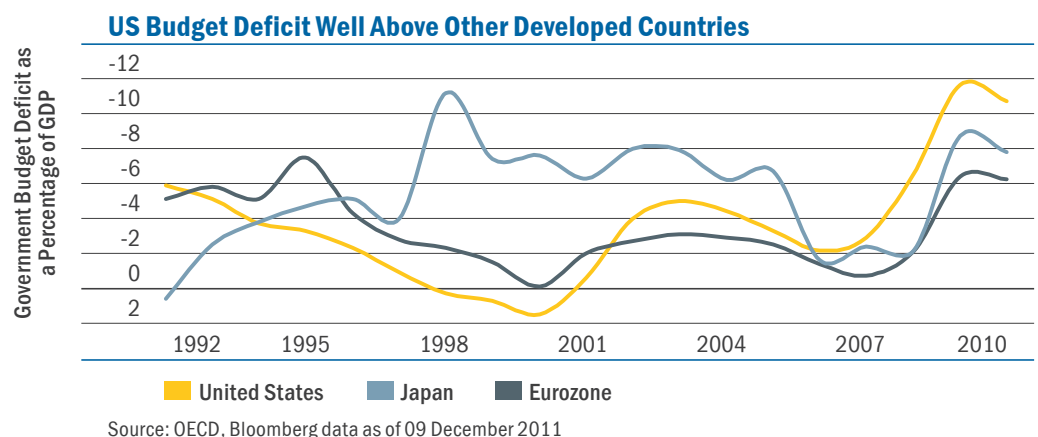


Source: US Bureau of Economic Analysis, Bloomberg data as of 09 December 2011

US monetary policy should also remain loose to offset deep cuts in government spending. A long period of easy money has not yet inflamed inflation expectations, with US Treasury yields near record lows, even suggesting a Japanese-style scenario of structural deflation. One reason why yields are below current inflation rates is that the euro crisis brought the sovereign credit risk to the fore and US Treasuries are among the few “core” bonds that are moved mostly by expectations on inflation and interest rates. They are treated almost as gold as a result.

As we approach the New Year with this scenario well entrenched in market valuations, very few people are criticising central banks’ commitment to economic growth. However, we should assess whether the extreme complacency on inflation will lead to nasty surprises and become another reason for turbulence.

The debate in the US over fiscal policy may provide a catalyst. The “super-committee” charged with proposing spending cuts reached no agreement amid sharp ideological differences. The cuts would have amounted to a very small fraction of GDP but the committee was appointed after last summer’s political stalemate over the federal debt ceiling and the threat of a technical default, so the failure sends a worrying signal to financial markets.



The Standard & Poor’s downgrade of the US in early August had a negligible impact amid a flight to quality. However, investors’ increasing awareness of government finances may pose a threat to US policy makers in the future. The federal budget deficit is almost as high as in the euro countries now under close scrutiny. The debt-to-GDP

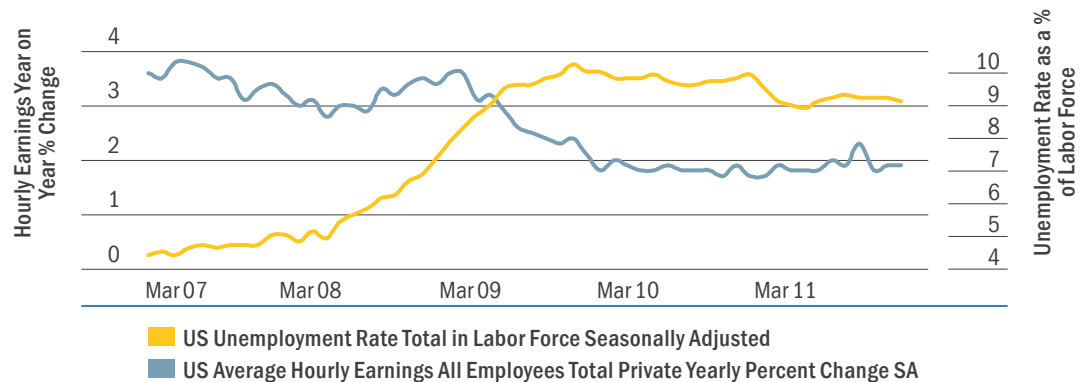
ratio looks manageable but an increasing part of it is funded by foreign investors, which may become less tolerant of US political wrangling.

On a fundamental note there is little reason to retain a loose budget policy. Households' efforts to reduce debt have not derailed growth in consumer spending, which may regain steam as a result of falling oil (and fuel) prices. The Federal Reserve remains confident that weakness in both labour and housing markets will hold down wage growth and dampen inflationary pressures. There are even renewed calls within the board for another round of quantitative easing. However, an extended period of sub-par growth does not mean a recession, so we should not rule out that the combination of an overly loose monetary policy and a lack of commitment on budget consolidation could be a negative for US Treasuries and eventually for the US dollar some time next year.

This might be the next crisis front in a market where investors' awareness of government finances may still dominate. Sharply rising US Treasury yields could even spark fears of a recession, if rising inflation expectations forced the Federal Reserve to raise interest rates and remind investors of the past hard-fought battle against the bond market "guardians".

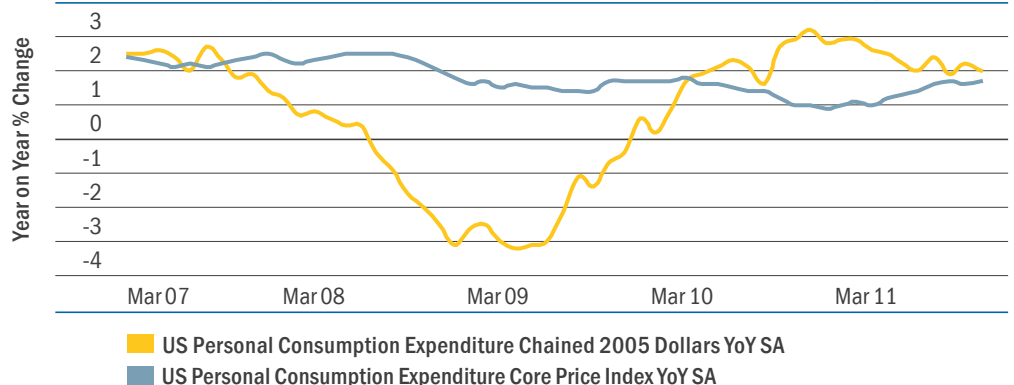
A notable difference with the eurozone is that the US can issue bonds in its own currency. However, market volatility often surges when a new risk scenario suddenly occurs. The guardians of the bond market woke up after a long period of inaction and triggered the euro crisis. If the run-up to November's US presidential election made budget consolidation less likely, the bond market guardians may be similarly unforgiving with regard to US Treasuries.

High Unemployment, Low Wages Keep the FED Confident on Inflation



Source: US Bureau of Labor Statistics, Bloomberg data as of 09 December 2011

US Consumer Expenditure is Resilient while Core Inflation is Picking up

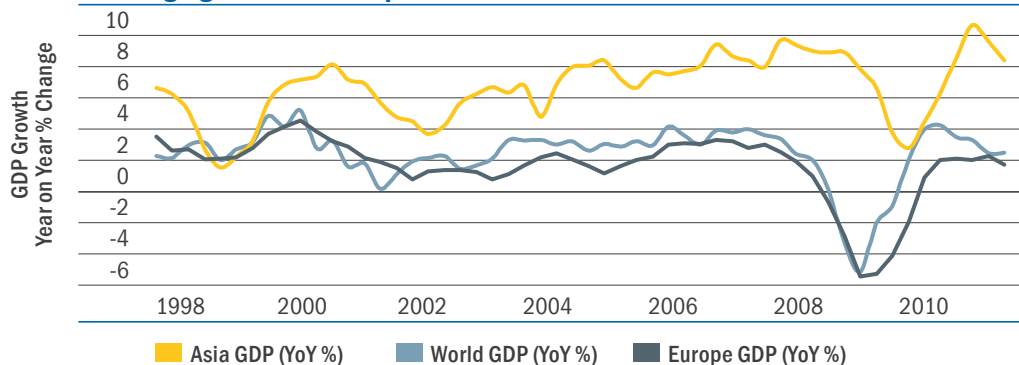


Source: US Bureau of Economic Analysis, Bloomberg data as of 09 December 2011

Asia and Emerging. The case for a soft landing

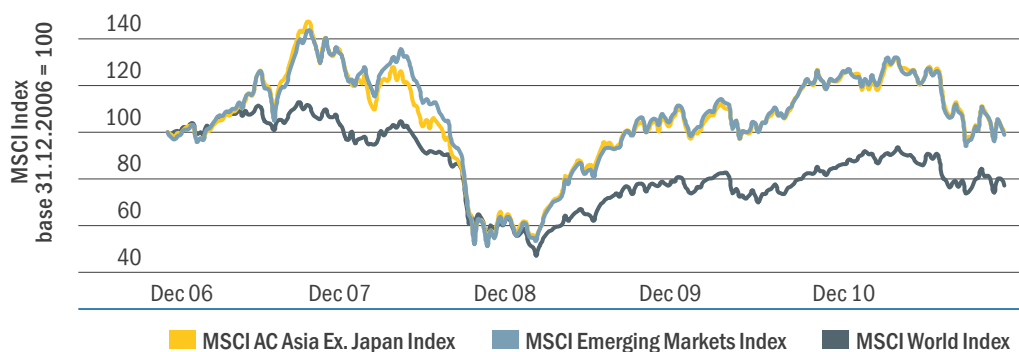
Fast-developing regions helped developed countries to overcome the last recession and can do the same now that policy mistakes have heightened the risk of a recession, notably in Europe. Investors and analysts were rightly worried by a slowdown in emerging economies and by the policies pursued there, with China getting the most attention.

Emerging Economies' Superior Growth



Source: Bloomberg data as of 09 December 2011

Emerging Stockmarkets Follow Global Indices Down



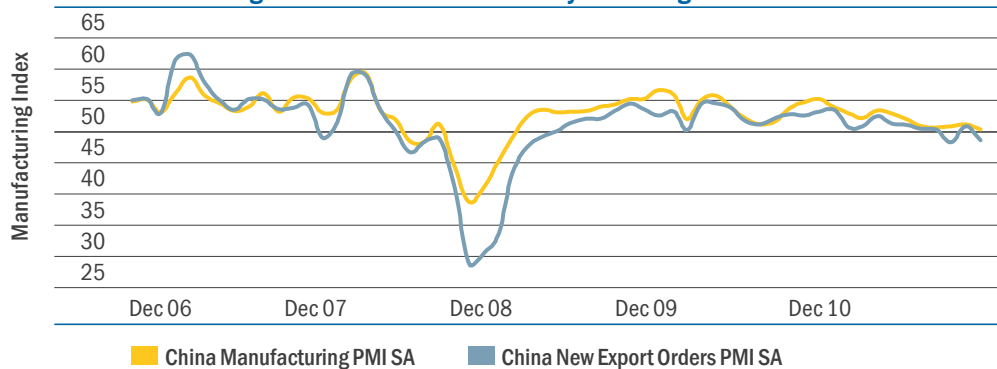
Source: MSCI, Bloomberg data as of 09 December 2011

The current debate is whether China's efforts to curb inflation both in consumer and in asset prices (particularly in housing) have succeeded in engineering a soft landing for the economy. Investors appear to be pessimistic, as stockmarkets in both China and in other major emerging markets (where tight monetary policies were also pursued) have posted even sharper declines than the world average in 2011.

This was a disappointment for those claiming a decoupling of emerging and developed-country markets. It can be explained both by the importance of foreign investment flows in a world dominated by risk-on and risk-off strategies (leaving very little room for stock picking) and by the weight of economically-sensitive sectors in most emerging markets, which are more under pressure when fears of recession become widespread.

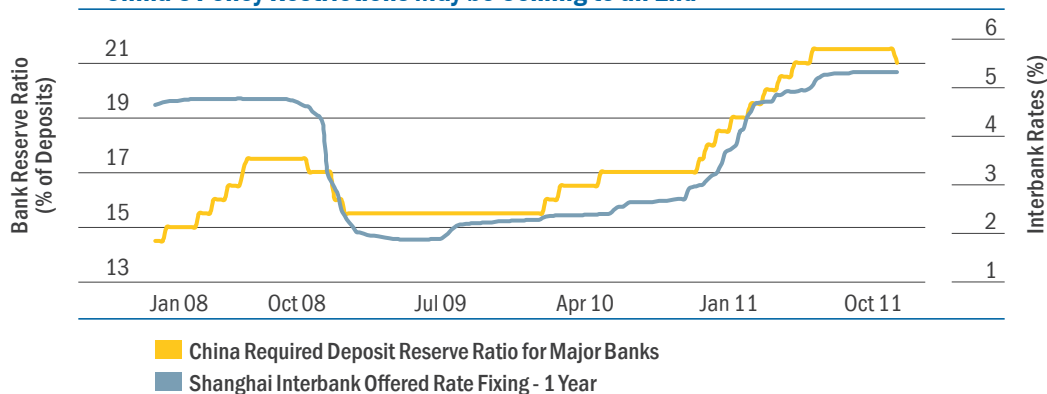
Economic data are providing a more upbeat picture. In China some reliable leading indicators, such as electricity output and manufacturing indices, have moderately receded of late but have not declined as sharply as in 2008. These cyclical indicators could regain ground soon, as slower economic growth brought consumer inflation down and prompted Chinese officials to discuss the possibility of monetary easing.

China's Leading Economic Indicators Mildly Receding



Source: Bloomberg data as of 09 December 2011

China's Policy Restrictions May be Coming to an End

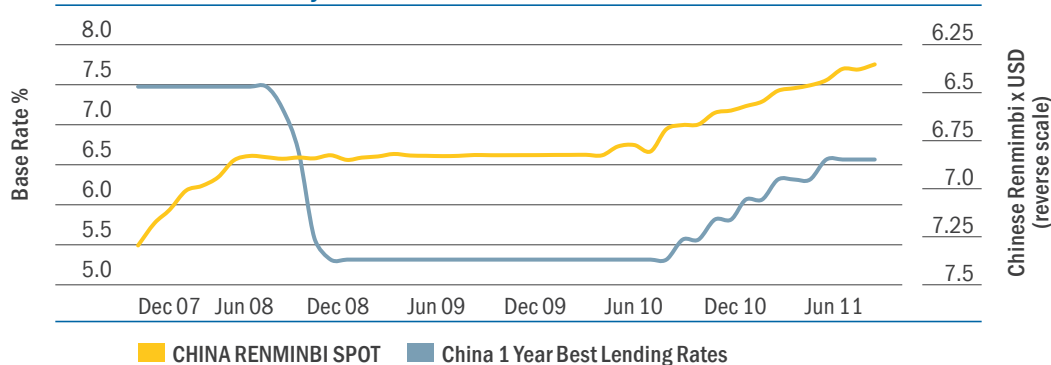


Source: Bloomberg data as of 09 December 2011

The recent central bank's decision to lower the mandatory reserve ratio for major banks is a step in that direction but hopes for a change of policy may be premature, even as inflation in China dips below the 5% mark (a supposed target for the government) and GDP growth falls to 9% (from 12% in 2010). Some curbs are unlikely to be removed any time soon, as major commercial banks account for a smaller part of total loans than in developed markets, while a "shadow financial system" of local institutions is mostly controlled by imposing credit quotas. In a country where corporate investment accounts for a large part of GDP growth and is mostly funded by loans, the risk of a credit crunch and of a hard landing is not likely to disappear as long as these very restrictive measures remain in place.

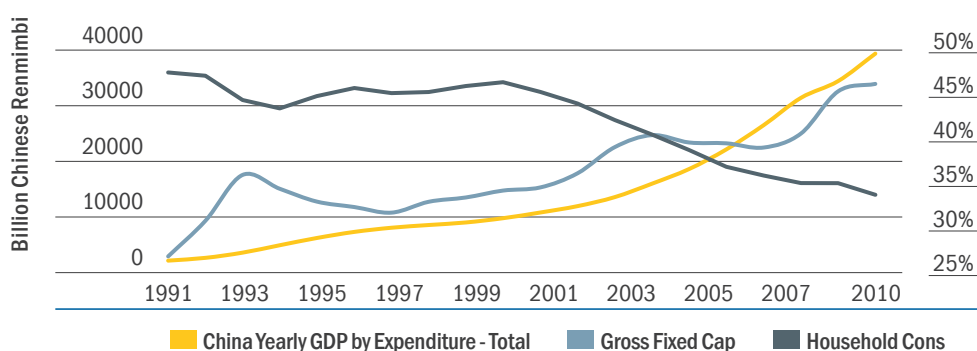
Nevertheless, we believe that a soft landing is possible and this remains our base case for an overexposure to global emerging markets, with East Asia at the top. Interest rates may not be cut any time soon and bank reserve ratios may stay close to record highs, but fighting inflation is unlikely to remain the top priority. In China's case, not all policy tools were fully exploited: allowing a much stronger currency rather than the slow-moving appreciation against a weak US dollar would be the most effective way to fight inflation. However, the recent decline in exports to the US and Europe worried the Chinese government and prevented a radical change for fear of undermining competitiveness.

The Chinese Currency's Controlled Fluctuation



Source: Bloomberg data as of 09 December 2011

Investments Still Lead China's Growth



Source: Bloomberg data as of 09 December 2011

On the bright side, the room for fiscal policy easing is much larger than in major developed countries, now embroiled in a massive debt-reduction process, and could be exploited again. In most emerging countries, both public debt and budget deficits are remarkably lower in relation to GDP, and even if monetary policies proved too tight, the fiscal stimulus would revive domestic demand.

Currency markets. Euro resilience in the face of the debt crisis

The euro is approaching this year's lows against both the US dollar and a trade-weighted basket as we write this report. However, we have been somewhat surprised at its resilience in the wake of the sovereign-debt crisis, as if currency markets were not in tune with the deep concerns of bond investors. Sovereign credit spreads rose to record highs amid the risk of EMU collapse, but the euro is still stronger than in the early stages of the crisis when Greece received the first aid package.

We can explain this apparent inconsistency by arguing that exchange rates are the most relative price in financial markets. The euro looks strong against the US dollar, which is undermined by the Federal Reserve's very loose policy. If this was the only explanation, the latest change of policy bias by the ECB would remove most of the interest-rate support for the euro.

Another possible explanation is that demand is supported by EMU banks' need for cash in the face of the debt crisis. This situation can be compared to the autumn of 2008, when the US dollar unexpectedly strengthened after the collapse of Lehman Brothers and the near-death of the insurer AIG, as US financial companies were committed to repatriate funds.

This demand for funds is unlikely to recede any time soon as EMU banks' assets are impaired by losses on government bond holdings and the new stringent capital requirements become increasingly elusive targets. Major central banks have stepped up the provision of extraordinary funding in order to ease liquidity shortfalls but the risk remains. This is indeed a sign of malaise for the euro, highlighting the role of flows in driving currency markets (which makes it so hard to produce reliable forecasts based on purely economic fundamentals).

The outlook for currency markets is complicated ever more often by political manipulation. China and other countries with plenty of foreign reserves are often criticised for that reason. However, the central banks of developed regions are also in favour of keeping currencies cheap as a means of stimulating the economy (as long as they do not see upside risks to inflation).

If the FED and the ECB are pursuing the same policies, there are indeed few reasons for investors to prefer the US dollar to the euro or vice versa. The other major central banks of the developed world are finding themselves in the same boat, so differences in economic fundamentals should not be driving currencies here.

The Japanese yen may provide the exception, if the euro crisis exacerbated further and prompted a renewed demand for safe-haven assets. The Bank of Japan's one-sided intervention is unlikely to be effective, while a global co-ordinated effort would be needed to dampen the yen's strength.

There are reasons, instead, for the currencies of emerging economies to gain from their superior long-term economic growth, which translates into a structurally wide spread in short-term interest rates. As we said, most of these countries have such big reserves that they can afford a "managed float" and often attract the criticism of other countries for being market manipulators (as in China's case).

Nonetheless, the case for allowing a more flexible policy remains in place and is likely to prevail when it becomes clear that it provides more leeway to overall economic policy (monetary and fiscal alike). The US debt crisis, that we assumed to be next year's loose cannon, would be felt much less if the link to the US dollar was severed by countries who can really afford it.

The Euro/USD Rate Amid the Most Recent Banking Crises



Source: MSCI, Bloomberg data as of 09 December 2011

Our Investment Phazer*

Confirmed growth in earnings per share and expectations of moderate inflation favour cyclical assets

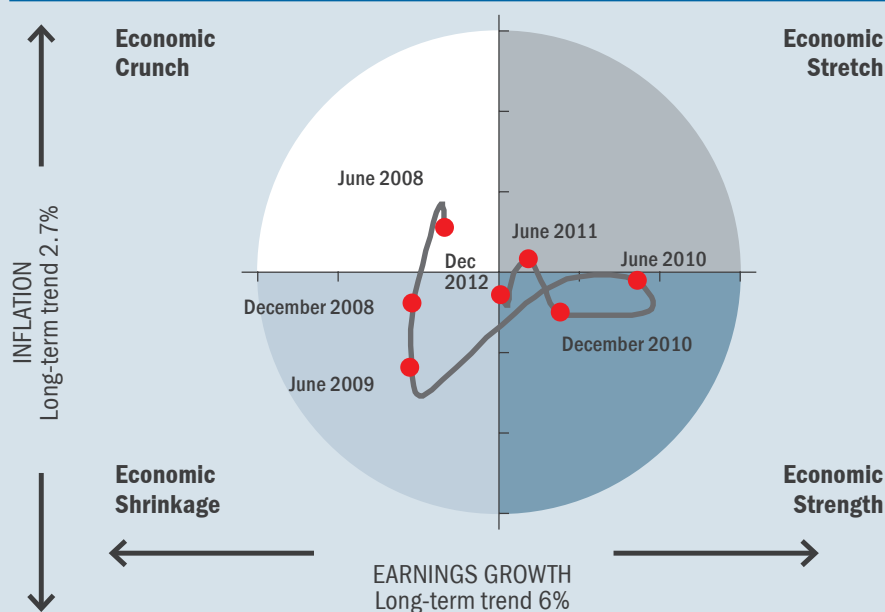
Earnings Growth

Solid earnings growth has been confirmed by corporate quarterly reports since the first quarter of 2009, even before the economic recession (GDP) officially ended, and has been little affected by the current economic slowdown, which is also reducing inflation expectations.

Cost-cutting Still on Top

Cost-cutting accounts for much of earnings growth in the early stages of an economic upturn and a large number of companies are still wary of bold expansion plans. Sales revenues increased last year but are very sensitive to the economic cycle and their contribution is likely to recede.

The Investment Phazer, December 2011



(*) 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 24 October 2011.

Implied Strategy

Based upon 30 years of observations, when above-trend operating earnings combine with below-trend inflation expectations, risky assets (equities and corporate bonds) have provided the best returns over a 12-month horizon. However, risk factors may lead to a lower risk profile, notably on global equities, in times of turbulence, whereas corporate bonds are more supported by prudent policies.

Alternative Scenario

We do not anticipate a double dip thanks to emerging markets' support to global growth, but the need for debt reduction (deleveraging) by both households and governments in developed regions may hold back economic growth for quite some time. This makes the case for a tactical exposure to safe-haven assets.

Asset Class	Double Dip	Deleveraging	Strength	Rebound
Equity	Sell	Sell	Buy	Buy
Core Government	Buy	Buy	Sell	Sell
Credit	Sell	Buy	Buy	Sell
Cash				Buy

Asset Allocation Recommendations as we Enter the New Year

Global Equities: Neutral

The base case for economic strength favours cyclical asset classes and equities among them, as evidence of strong earnings growth should overcome recurrent risk factors. Dividend yields also look attractive, on average, compared to low-yielding core government bonds. We are mindful, of course, that the euro sovereign-debt crisis threatens the outlook for global economic growth amid policy mistakes and investors remain shy of risk. However, the broader risk of a recession triggered by a hard landing in emerging economies has become more remote, in our view, and this leads us to retain the overweight in non-EMU markets, both developed and emerging.

USA: Overweight

The quarterly reporting seasons have provided mostly positive news and confirm solid earnings growth by S&P 500 companies, especially in Non-Financial sectors (including the most cyclical). More encouraging evidence from macroeconomic data may also be supportive, as investors become less sensitive to the Federal Reserve's stimulus policies (notably another round of quantitative easing).

Europe: Underweight

Banks account for a large stake of the broad market and investor concerns about their financial health will not disappear as policy mistakes keep the sovereign-debt crisis on investors' minds. Other sectors are conveniently exposed to fast-growing regions where policy restrictions to counter inflation may be withdrawn soon and lessen the risk of an economic hard landing.

Japan: Underweight

Economic growth is recouping more quickly than expected what was lost as a result of last March's earthquake. However, exports account for most of overall GDP growth and may still be curbed by a strong yen and weak demand abroad (especially in EMU).

Pacific ex Japan: Neutral

Markets in this area are highly reliant on China, where efforts to cool down inflation may eventually succeed and avoid the risk of a hard landing for the economy.

Emerging Markets: Overweight

Most of these regions retain a strong potential for domestic growth, with East Asia standing in the first tier. The global economic slowdown may help inflation to recede and make tight monetary policies less compelling. Moreover, most emerging countries are light in debt and can revive the economy with looser fiscal policies.

Global Bonds: Underweight

Government bonds in core markets are barely attractive as yields barely cover current inflation rates. Valuations are consistent with an impending recession, which would bring inflation down sharply. We do not envisage a recession and also the long-held safe-haven value of benchmark markets, such as the US and Germany may not last forever as investors pay more attention to single-country fundamentals.

Euro Government: Underweight

The ECB is likely to put more emphasis on the economy and pursue the same overly loose policies as in other developed regions due to growing concerns about a recession in the euro area next year. Record-high credit spreads may provide excellent buying opportunities in peripheral countries. However, they need to enact economic reforms alongside austerity plans in order to structurally improve government finances.

Euro Corporate: Overweight

Banks account for a good proportion of issuance in the euro market and their exposure to the sovereign-debt crisis is significant. Investors' fears about this have pushed credit up sharply and we believe that there are several buying opportunities with reasonable risk, amid efforts by the ECB and other central banks to avoid any liquidity shortfall. Outside of the Financials sector, companies are still committed to sound budget policies and the default rate implied in current spreads looks excessive.

US Government: Neutral

Economic growth should remain below-par for an extended period of time and that should keep inflation expectations subdued. This is supportive for the market, but we look forward to cutting our exposure as the Presidential electoral campaign gets under way and any commitment to budget consolidation is delayed.

US Corporate: Neutral

US businesses are largely committed to cost cutting so the rise in risk premiums has been the result of very high risk aversion amid the euro-debt crisis. The lowest-rated (high-yield) bonds have been excessively hurt by this tough environment and are likely to provide selective buying opportunities.

Emerging Markets: Neutral

Credit spreads held reasonably well in the face of the euro sovereign-debt crisis as major emerging countries also pursue the right economic policies in difficult circumstances. Local-currency issues should not be overly affected by international investment flows and prove less volatile as a result. Another support may come from receding inflation expectations as the economy slows down.

Tactical Asset Allocation Summary

Global Summary Table

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

Regional Summary Table

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

Foreign Currency Exposure

US Dollar	Overweight
Euro	Underweight
Yen	Underweight
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 sum to equilibrium.

Important Information

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