BLUE PAPER

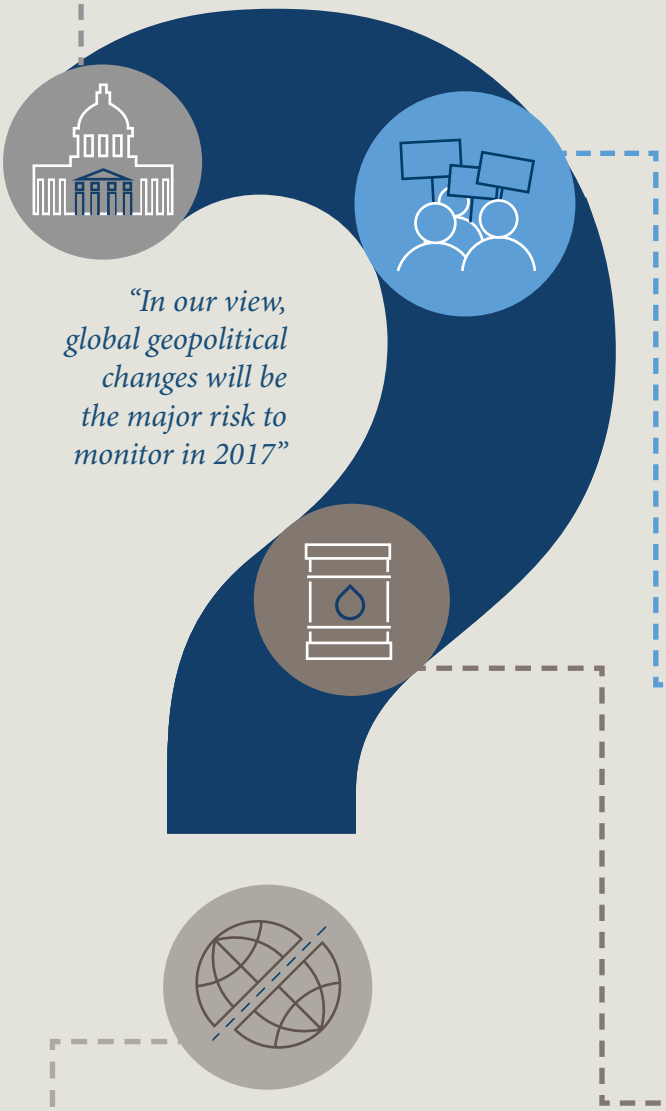
March 2017

Geopolitics and Investing: The Normality of the Unexpected

PIONEER Investments®

KEY QUESTIONS FOR INVESTORS ON GLOBAL GEOPOLITICS

MARCH 2017



How will the Trump Presidency Operate and How will it Affect Markets?

Trump Policy Positions

Some of Trump's policies are decidedly pro-growth, while others could pose serious risks to the economy.

Trump and the Grand Old Party

The area of most common interest between Trump and the Republican Party is on corporate tax and regulatory reforms.

Trump Euphoria in Financial Markets

Trump's election has had some positive effects on consumer and small business confidence. Markets may be underestimating the downside risks.

+15% Dow Jones Industrial Average
In the 4 Months since Trump Election

What will the Rise in Populism Mean for Europe's Economies?

Pessimistic Europeans

Europeans are becoming more pessimistic about their children's future, immigration, diversity, and the future of the EU. This sentiment has fueled the rise of populist forces across Europe.

Weaker Outlook for the European Union

Even if outright nationalist/populist governments are not elected, if they have growing representation in parliaments, they will pull governments to the right, making support for EU initiatives more difficult.

48% in 2016 VS **71%** in 2004 Europeans in favour of the EU*

What is the Main Geopolitical Theme Globally?

Nostalgic Nationalism is Strengthening all over the World

Anti-multiculturalism, anti-globalization, security and terrorism threats are common themes around the world. The combination of these three factors are making many people nervous and driving a sense of nostalgia for perceived better times and national glory. We believe that this trend is set to continue and will fuel the rise of populist parties in many developed economies.

Will the Oil Market be the Positive Surprise of the Year?

Increasing Oil Output Should Cap Oil Prices

Technological improvements are driving efficiency gains that should put a cap on oil prices around $60 a barrel (unless there is a major global geopolitical crisis).

$60 a barrel
Expected Cap for Oil Prices

Source: Pioneer Investments analysis on Bloomberg. Data as March 2, 2017. * Source PEW Research, average on Spain, France, Italy and Germany.
With the contribution of: Robert F. Wescott, Ph.D., President of Keybridge Research.

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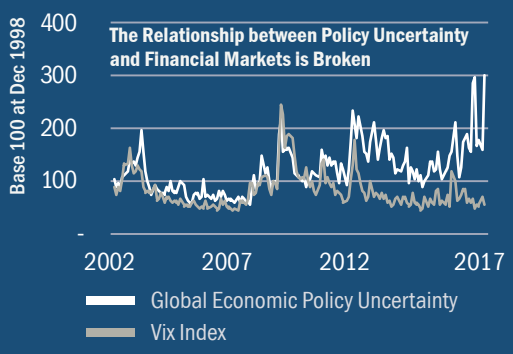
A GUIDE TO INVESTING IN A WORLD OF UNCERTAINTY

MARCH 2017

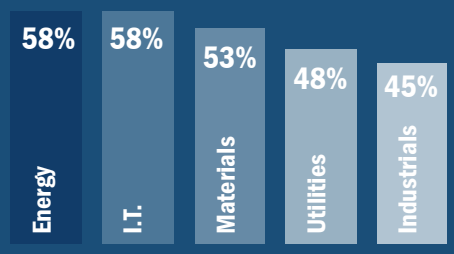
Risk of Tail Events

The low volatility environment is a false indicator of safety. In reality, we are experiencing an environment where global policy uncertainty is pointing towards a higher risk of tail events.



Selection

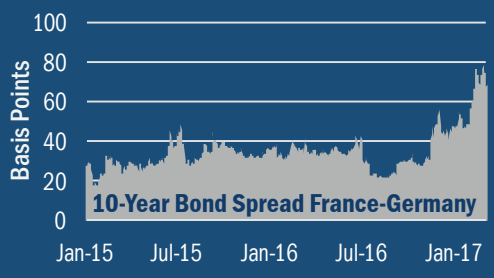
Countries, sectors and stocks have different degrees of exposure to globalism that need to be assessed in order to identify future winners and losers.



Top S&P500 Sectors' Exposure to Globalism
Foreign Sales as % of Total Sales in 2015

Tactical Opportunities

Currencies and government bonds tend to move ahead of geopolitical events offering opportunities for active investors. Ie: for example French/German bond spreads ahead of the French election.



Diversification

We believe that diversification across multiple investment strategies, combined with hedging to limit the downside in case of tail risks, are key to building resilient portfolios.

Source: Pioneer Investments analysis on Bloomberg and S&P Dow Jones Indices LLC. Data as March 3, 2017.
Date of First Use: March 15, 2017 Devised by: Claudia Bertino and Laura Fiorot, Financial Communication
Graphic elements from: thenounproject.com, freepik.com

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Robert F. Wescott is Founder and President of Keybridge Research LLC, an economic analysis firm in Washington, DC, that has served G-7 governments, major financial institutions, and Fortune 500 companies since 2001. Dr. Wescott concentrates on global macro-economics, financial risks, and public policy research. He provides global asset allocation advice to well-respected international financial firms and is a regular speaker to business and financial audiences around the world.
Dr. Wescott also testifies as an expert before U.S. Congressional committees on economic, financial, and energy policy matters.

This piece has been developed with the contribution of **Claudia Bertino, Laura Fiorot and Giovanni Liccardo.** They are part of a team dedicated to developing investment insights and thought leadership initiatives in conjunction with our global team of investment professionals, for our clients and the financial community.

Key Insights

The intersection of anti-globalization, anti-multiculturalism, and security/terrorism are driving nostalgia for eras of perceived better times and national glory.
This wave of the so-called "nostalgic nationalism" has fueled a rise in populism around the world. Consequently, global geopolitical changes will continue to be a major theme for investors in 2017.
For investors the three main geopolitical trends to watch in 2017 are:

1. **How the Trump presidency operates and affects the global economy.**
   Some of Trump's policies are decidedly pro-growth, while others may pose serious risks to the economy. Currently, markets may be paying too much attention to Trump's pro-growth policies while underestimating the risks of downsides.
2. **What the rise in populism means for Europe's economies.**
   Europeans are becoming more pessimistic about the future and this sentiment has fueled a rise in populism. This trend could weaken the European Union, even if a populist leader will not be elected.
3. **Oil price dynamics.**
   Technological improvements are driving efficiency gains in oil production, and are likely to keep oil prices in the range of $45-60 a barrel. Oil prices are not likely to back to $80 a barrel, unless there is some global geopolitical crisis.

In our opinion, these trends will all affect the world economy, international relations over the medium term and financial markets.

For investors we believe that this translates into three main implications.

1. **Investors should focus on building portfolios resilient to fat tail events.**
   The apparently low volatility environment we are currently experiencing is a false indicator of safety; in reality, market perception of the risk of tail events is rising. With tail risk being the new normality, we think portfolio construction should focus on the diversification[1] of risk across multiple, lowly correlated[2] strategies combined with drawdown[3] management through the hedging of alternative scenarios.
2. **Selection is paramount in an era of geopolitical risk.**
   The fundamental analysis of a country and its geopolitical position is an important tool in selecting investment opportunities, especially in Emerging economies that could be exposed to changes in trade policies, commodity dynamics and currency moves. Developed Market stocks also have different degrees of exposure to globalism that need to be assessed in order to identify future winners and losers.
3. **Tactical Opportunities from geopolitics.**
   In the search for tactical opportunities, currency strategies are particularly interesting, as they generally exhibit low correlation with other assets and offer the benefit of market liquidity. Government bond markets also move ahead of geopolitical events. An example is the European market, where political news flow often translates into movements in sovereign bond spreads, as we are currently seeing in the spread between 10-year French and German government bonds.

We believe that diversification across multiple strategies both top-down (macro and satellite) and bottom up (selection strategies), combined with hedging strategies to limit the downside in case of tail risk, are key ingredients to building portfolios that are resilient in a world where the unexpected is becoming the new normality.

[1]Diversification does not protect against a profit or a loss.
[2]Correlation. The degree of association between two or more variables; in finance, it is the degree to which assets or asset class prices have moved in relation to one another. Correlation is expressed by a correlation coefficient that ranges from -1 (never move together) through 0 (absolutely independent) to 1 (always move together).
[3]The peak-to-trough decline during a specific record period of an investment, fund or commodity, usually quoted as the percentage between the peak and the trough.

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Robert F. Wescott, Ph.D.
President of Keybridge Research

This material reflects the opinions of the above author at the time of writing.

1. Key Theme for 2017: Nostalgic Nationalism

A key theme for 2017 is nostalgic nationalism – a trend that is showing up all over the world. I believe there are three main causes that explain what is driving this wave of nostalgic nationalism.

The first and most important factor is **anti-multiculturalism**. In a British survey, 81% of the people who said they believed multiculturalism was a force for ill voted to leave the European Union. In the recent US presidential election, we observed a similar pattern with 69% of Trump supporters stating they believe immigrants are a burden to the United States.
Fear of immigration and a lost "social cohesion" are also fueling nervousness around migration crises worldwide. In Europe, the human migration pattern is a key issue and could be a game changer.

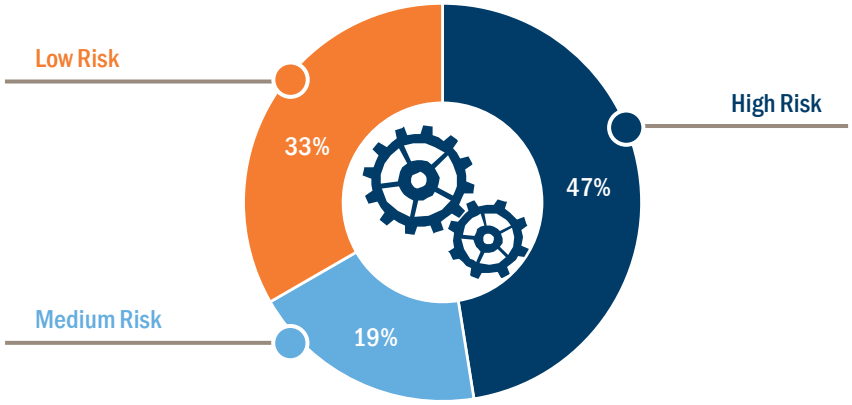
The second factor is the **anti-globalisation** backlash, which is significant even if it is not as dominant as the first factor. Both Trump voters and Brexit voters viewed globalization and free trade as a force for ill. Worries about losing jobs to foreign trade seems to be on the rise. We are now on the cusp of a large number of jobs at risk of being replaced by machines and people are, therefore, scared that technology is going to replace their jobs. A raft of new technologies from self-driving vehicles to improved voice recognition software to clerk-less stores, is shaking up many established industries. A groundbreaking 2013 study by Carl Fry and Michael Osborne at Oxford University estimated that 47% of all jobs are at high risk of being lost to automation over the next 20 years (Figure 1).

Anti-multiculturalism, anti-globalisation and security and terrorism threats are the key trends around the world.

The final factor is **security and terrorism threats,** as refugee flows around the world are challenging governments' ability to screen new arrivals.

The combination of these three factors are making many people nervous and driving nostalgia for eras of perceived better times and national glory. We are seeing a rise of populist parties in many developed economies that are able to capture this nervousness and people's worries about globalization, multiculturalism, and terrorism.

Figure 1. Jobs Susceptible to Computerization (Percent, by Level of Risk)



Source: Carl Fry and Michael Osborne, University of Oxford.

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2. Three Hot Questions on Global Geopolitics

Some of Trump's policies are decidedly pro-growth, while others will pose serious risks to the economy.

1. How Will the Trump Presidency Operate and How Will it Affect the Global Economy?

Trump's way of governing is still unknown, but it is helpful to think about his policy positions on one hand (either populist or classic conservative?), and his style of governance on the other hand (authoritarian or disorganized?).

If Trump governs as an authoritarian populist, we would expect a very tough stance against the media and against trade, potentially even triggering trade wars.

He may be more conservative, otherwise, governing more like a traditional Republican. In this case, we would expect to see tax reform – lowering the corporate tax rate – and entitlement reform – cutting Medicare spending, for example – as priorities.

There is also a risk that the Trump governing style could end up being disorganized, which would cause inefficiencies and poorly policy outcomes.

Reflecting on the first weeks of his presidency, it is my view that while Trump seems intent on following through with many of his campaign promises, he continues to face difficulty on execution. The departure of his national security adviser Michael Flynn after just three weeks on the job is just one example of the difficulties that the administration is facing.

The two areas where I believe there is most common interest between Trump and the Republican Party are the corporate tax and regulatory reforms.

Moving forward, there are two areas with common interest between Trump and the Republican Party: corporate tax reform and regulatory reform.

Regarding corporate tax reform, we will likely see a reduction of the corporate tax rate. However, there is a risk that the Trump administration will push for the adoption of a border adjustment tax (BAT) as a part of an overall tax reform package. If a BAT plan is pursued, it almost certainly will open a deep rift between business groups. Big exporters would welcome such a tax, but retailers, oil companies and many other American multinationals, which import extensively, stand to lose a lot and would be against this. I personally think that tax reform will eventually happen and will end up with a reduction of rates within the historical tax system, but not a BAT.

Another common objective for the Republicans and Trump is a tax deal on companies' offshore profits, which would let American companies repatriate their foreign earnings at a lower rate of tax. We do not know how many companies would take advantage of such a deal, but if half of this offshore money is repatriated this would be a significant boost for corporate cash flow and capex spending. Trump also wants to reduce regulation, which would be a business friendly move and could boost growth.

Another important element of Trump's campaign is the $1 trillion infrastructure investment plan. However, given that this has less agreement from conservative Republicans and considering the difficulty in collecting private investment to support this, I think expectations of a big infrastructure-spending programme becoming reality should be measured.

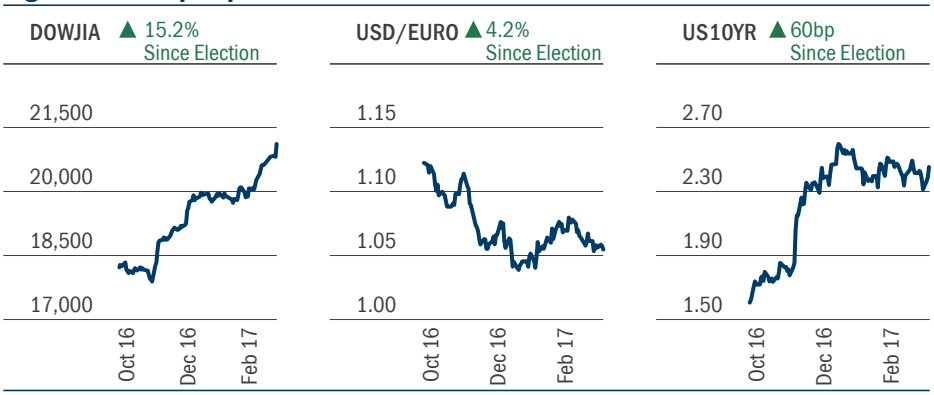
Trade policy is also in flux. While no specific plan has been put forward, Trump continues to insist on scrapping major multilateral trade deals, such as NAFTA, and replacing them with bilateral ones. However, in my opinion, a widespread move to dozens of bilateral trade agreements is impractical, even if pursued over 3-4 years.

Most importantly, there are risks that Trump's "America first" economic plan could raise trade frictions with major trade partners, like China and Mexico, and could even launch a full-scale trade war.
A final point of the Trump agenda is immigration. A travel ban on U.S. entry for citizens of seven majority-Muslim nations, instigated by Trump, faced swift intervention from the courts. At the same time, his administration is ramping up deportation actions. Trump has promised to deport 3 million unauthorized residents. Since it would be difficult for U.S. authorities to actually deport this many illegal immigrants in a year, part of the Trump plan appears to be to instill fear among immigrant communities, so many people just decide to leave the U.S. and return to their home countries.

Trump's election has had some immediate, positive effects, however, that should help boost economic growth in 2017. After the election, overall consumer confidence went up, which should be good for consumer spending. Trump's election ended up giving a big boost to optimism among small businesses too.
And the stock market has been focusing on all the positive things in Trump's plan and consequently stock market indices have reached record valuations – roughly $2.5 trillion has been added to market cap since the election. According to Modigliani wealth effect assumptions, this could add approximately $100 billion to consumer spending in 2017 if stock prices remain at elevated levels.

Markets may be paying too much attention to Trump's pro-growth policies and are still underestimating the risks of downsides.

Figure 2. "Trump Euphoria" in Financial Markets



Source: Keybridge LLC, Pioneer Investments, Bloomberg, data as of February 28, 2017.
DOWJIA = Dow Jones Industrial Average Index.

The combination of improved consumer confidence, higher small business optimism and rising stock market wealth – should position the economy well for growth in 2017. However, I worry some that markets may be paying too much attention to Trump's pro-growth policies and may still be underestimating the risk of downsides.

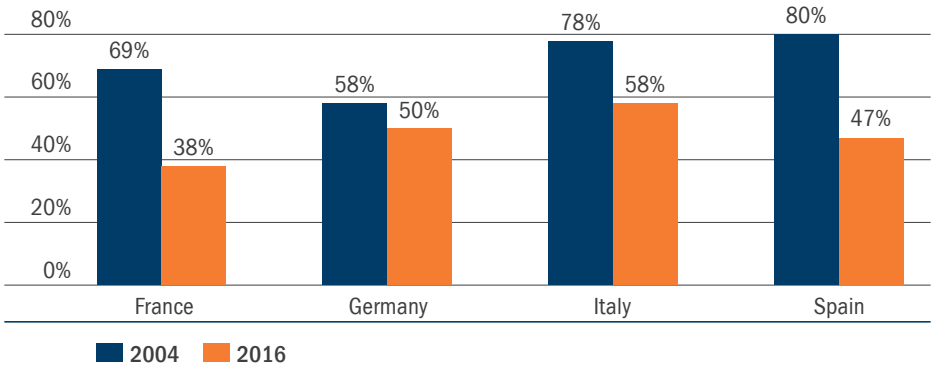
2. Is the Rise in Populism a Serious Threat to Europe?

Europeans are becoming more pessimistic about the future and this sentiment has fuelled the rise of populism that could weaken the EU.

Europeans are becoming more pessimistic about their children's future, immigration, diversity, and the future of the EU. This sentiment has fueled the rise of populist forces across Europe. Nationalistic and anti-European parties that used to be on the margins are now gaining support.
We are seeing the same nervousness in Europe that we have already seen among Brexit and Trump voters. In particular, there are many similarities between the rise of Trump and the rise of right-wing populism in Europe.

I believe these populist forces are slowly undermining European confidence and prospects. Even if outright nationalist/populist governments will not be elected, if they have growing representation in parliaments, they will pull governments to the right, make support for EU initiatives more difficult, and hurt the outlook for a healthy and thriving European Union.

Figure 3. Favourable View of the EU



Source: PEW Research Center. Spring 2016 Global Attitudes Survey.

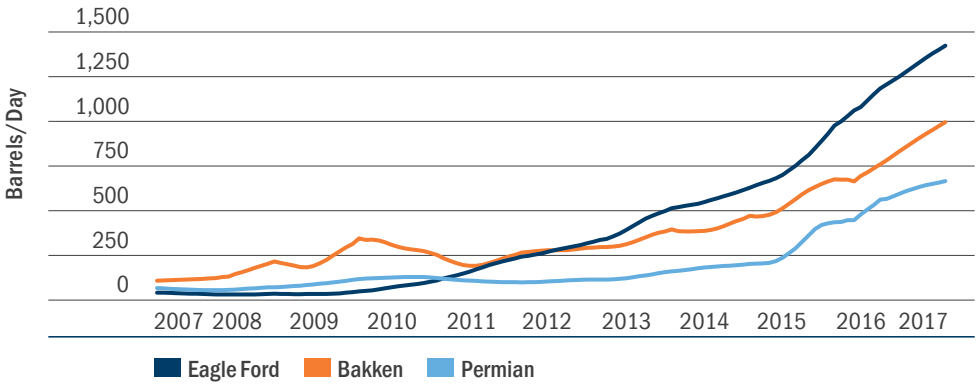
Technological improvements are driving efficiency gains that should put a cap on the oil price around the range of $45-60 a barrel.

3. Will the Oil Market be the Positive Surprise of the Year?

The most important question in the commodity markets is: will the price of oil go back to $70-80 a barrel? I believe it will not anytime soon. We have seen a dramatic increase in oil output because of fracking in the United States; this technology is getting much better and such innovations are improving production efficiency.

Onshore American shale oil production poses virtually no technical or geopolitical risks for drilling, which greatly favors the economics of such oil.
New deposits are still being discovered with immense production potential.
I think this will put a cap on the oil price around the range of $45-60 a barrel and I do not think we are going back to $80 (unless there is some major global geopolitical crisis).

Figure 4. US New-Well Oil Production per Rig



Source: US Energy Information Administration: Drilling Productivity Report, 2017.

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Matteo Germano
Global Head of Multi-Asset Investments

This material reflects the opinions of the above author at the time of writing.

3. Investing in 2017: When the Unexpected is Normality

Global geopolitical change will continue to be a major theme for investors in 2017. The intersection of anti-globalization, anti-multiculturalism and concern about security are driving nostalgia for eras of perceived better times and national glory. The rise of the so-called "nostalgic nationalism" has fueled a rise in populism across developed economies. What this means for the world is still up for debate, but we expect to see some impact on the world economy and international relations over the medium term.

For investors I believe this translates into three main implications:

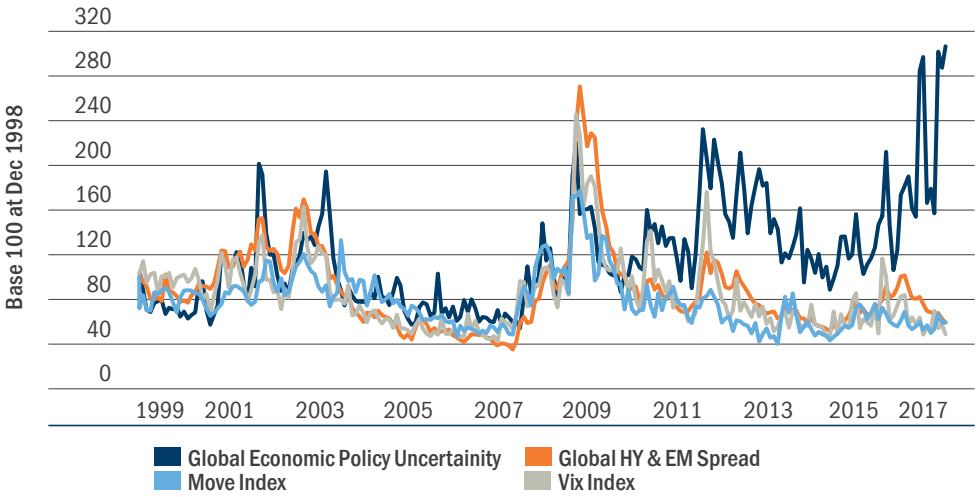
1. In an era of geopolitical risk, investors should focus on building portfolios that are resilient to fat tail events;
2. Assessing geopolitical risk will be crucial in selecting investment opportunities especially in Emerging Markets, but also in Developed Markets;
3. Geopolitics can offer tactical opportunities to be played across asset classes.

Despite rising global economic policy uncertainty, financial market volatility remains quite low.

1. Geopolitics and Fat Tail Risk

The most important geopolitical events in 2016 (i.e. Brexit; Trump's victory; TPP's failure; Turkish coup d'état) did not have a significant impact on financial markets and investors also did not discount other broader political risks (e.g. North Korea's missile crisis; terrorism threats; refugee crisis).
This broken relationship between economic policy uncertainty and traditional financial market risk indicators (such as volatility) is not new.

Figure 5. The Broken Relationship Between Policy Uncertainty and Financial Markets



Source: Bloomberg. VIX Index is an indicator of future volatility on the S&P500 Index implied in the option market, Move Index is the Merrill Lynch Option Volatility Estimate indicator of the volatility on the Treasury, the Global HY & EM Spread shows the changes in the spread levels of the Merrill Lynch Global HY & EM Plus Index. Analysis on month end data. Updated at January 31, 2017.

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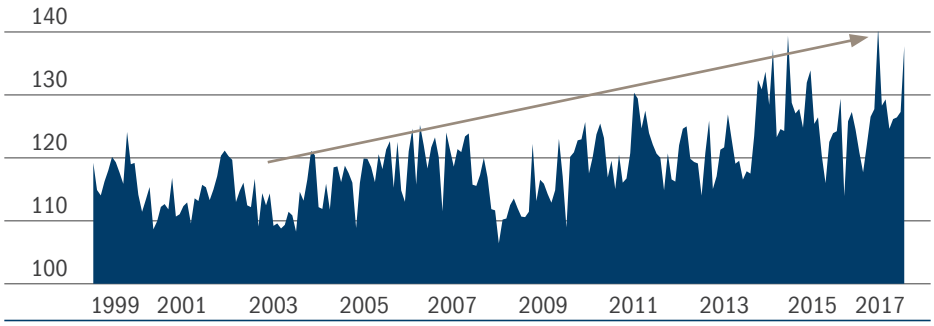
The apparent low risk environment is a false indicator of safety as, in reality, what we are experiencing is an environment where the risk of tail events is on the rise.

In my opinion, there are two fundamental drivers for this complacency.
The first is the low risk environment induced by the extraordinary monetary policies from Central Banks that has persisted for the last 5 years.
The second, which is a consequence of the first, is that this apparent low risk environment is a false indicator of safety as, in reality, what we are experiencing is an environment where the risk of tail events is on the rise.
The skewness implied by the equity options market better captures this concept. The CBOE Skew Index (SKEW) is "an option-based indicator that measures the perceived tail risk of the distribution of S&P500 log returns". This index is reaching new highs, signaling that the perceived tail risk in the market is rising, despite the low volatility environment we are currently experiencing.

Figure 6. Fat Tail Risk on the Rise – CBOE Skew Index



Source: Bloomberg. Updated at January 31, 2017.

In my opinion, the rise in fat tail risk is directly linked to the geopolitical trends mentioned above, as these may take longer to unfold and provide no clarity on their implications on the economy and markets at this stage.

With tail risk being the new normality, I think that portfolio construction should have a strong focus on drawdown management through the hedging of alternative scenarios. Gold, in my view, will continue to be a safe-haven asset against geopolitical risk and potential spikes in volatility, but also currencies, such as the US dollar or the Swiss Franc, can play a role in hedging against tail risk events. For example, the Swiss Franc enjoyed a rally in 2016 in anticipation of a possible period of uncertainty surrounding the Brexit vote.

Figure 7. The Swiss Franc vs Euro

Source: Bloomberg. Data from 12/31/2015 to 02/17/2017.

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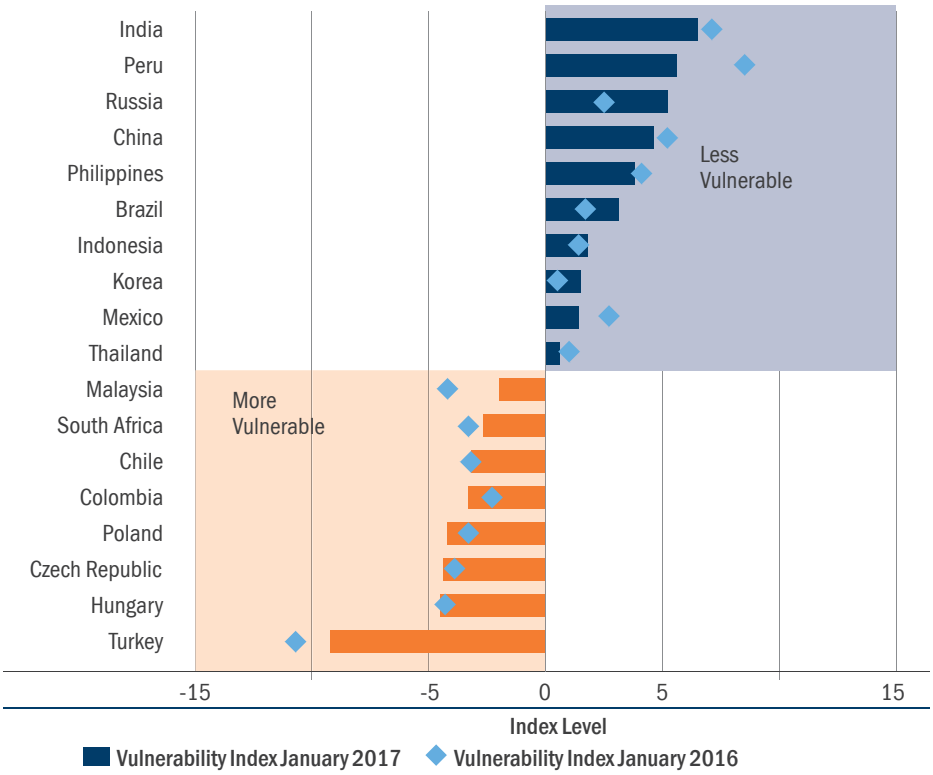
In addition, the ability to take directional market views through options can also be of benefit in this period of low volatility, positive economic backdrop and tail risk, as options can limit downside while participating in the upside.

The fundamental analysis of a country and its geopolitical position is an important tool to selecting investment opportunities in Emerging Economies.

2. Selection is Paramount in an Era of Geopolitical Risk

Policy uncertainty, especially relating to global trade, could have meaningful implications for investors, particularly in Emerging Markets (EM). In fact EMs, that are more vulnerable to protectionist tendencies, could be subject to rising risks. Countries that were winners in the globalization era could lose ground if there is a contraction of global trade driven by protectionist policies. Global trade is just one of the geopolitical factors to watch when selecting opportunities in EMs. Oil prices and more general commodity dynamics also play a major role in this world, as well as US dollar moves, since these economies can be highly exposed to the US dollar. Consequently, the fundamental analysis of a country, and its geopolitical position, is an important tool when selecting investment opportunities in EMs.

Figure 8. Pioneer Investments' Emerging Markets Vulnerability Indicator



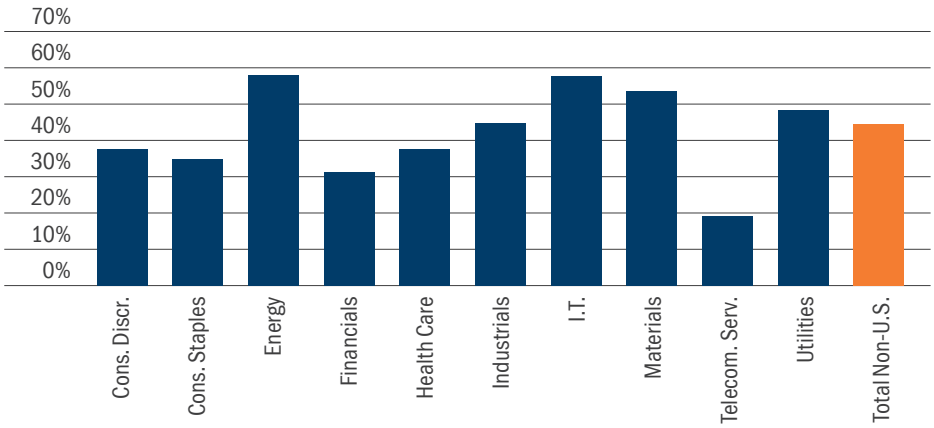
Source: Analysis by Pioneer Investments - Global Asset Allocation Research. Vulnerability Index takes into account: CA and Funding; External Debt and ST External Debt; Reserve Adequacy; Domestic variables. January 2017 compared to January 2016. Data as at February 1, 2017.

Nevertheless, Emerging Markets are not the only area exposed to geopolitics. In Developed Markets (DM), stocks and sectors can have different levels of exposure to globalism. Therefore, geopolitical trends will also become more important in DM stock picking, providing opportunities for active managers able to identify how geopolitics will determine future winner and losers.

Developed Market stocks and sectors have different levels of exposure to globalism that need to be assessed in order to identify future winners and losers.

Figure 9. S&P500 Sectors' Exposure to Globalism

Foreign Sales as Percentage of Total Sector Sales, S&P 500 Index, Year 2015



Source: "S&P500 2015 : Global Sales" by S&P Dow Jones Indices LLC. Published in July 2016.

Geopolitical events are a major driver of exchange rates dynamics and therefore currencies can be a valuable tool to playing these events tactically in a highly liquid market.

3. Tactical Opportunities from Geopolitics

Geopolitical events can also offer opportunities for investors. Financial markets tend to anticipate possible outcomes of political events and we often see areas of market inefficiency that can offer tactical opportunities.

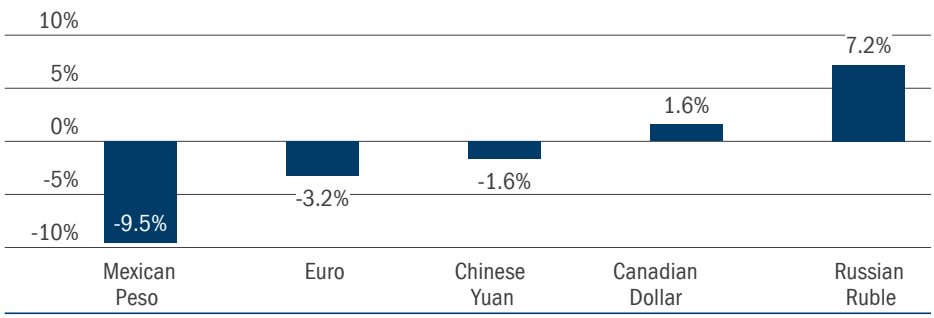
Geopolitical events are a major driver of exchange rate dynamics and therefore currencies can be a valuable tool to playing these events tactically in a highly liquid market.

The Brexit vote is a clear example of this, with the impact of the vote mostly being absorbed by the drop in sterling, which moved significantly overnight as the result started to become clear.

Another example is Trump's election that resulted in major currency moves, especially among Emerging Market currencies.

Figure 10. Three Months Performance vs USD since Election Day

Spot Exchange Rates Moves vs USD, 11/07/2016 – 02/07/2017



Source: Bloomberg, as of February 7, 2017.

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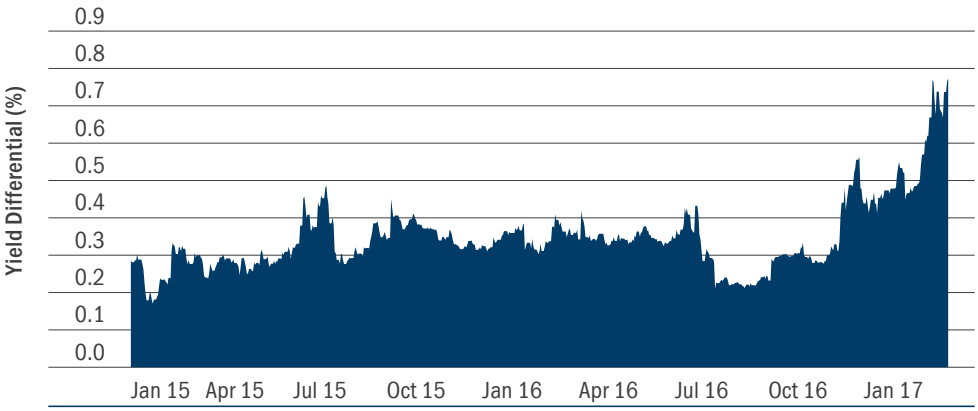
Government bond markets are also an area where opportunities may arise in an era of geopolitical tension. A major example is the European market, where political news flow translates into movements in sovereign bond spreads.
A recent example of this trend is French Government Bonds, where the spread of the 10-year bond versus the Bund has started to widen amid the uncertainty surrounding the upcoming elections in France.

Bond market movements ahead of the elections in France could offer opportunities for active investors.

Figure 11. The 10-Year Government Bond Spread France-Germany



Source: Bloomberg. Data from 1/1/2015 to 02/21/2017.

We believe that diversification across multiple strategies both top-down (macro and satellite) and bottom-up (selection strategies), combined with hedging strategies to limit the downside in case of tail risk, are the ingredients to build portfolios that are resilient in a world where the unexpected is becoming the new normality.

Hope for the Best, Be Prepared for the Worst

As we have seen, investing in a low volatility environment where fat tail risk is on the rise is becoming the new normality. Therefore, we believe that investors should try to exploit all the opportunities available in the market, while also aiming to limit drawdowns in case of tail risk events that could have a meaningful impact.
How can investors search for the best opportunities? One way is to assess the base economic scenario and embed it into macro investment themes. Additional investment ideas can also come from selection and tactical approaches, that may also benefit from low correlation with the macro views and can therefore help to provide further diversification.

What if something goes wrong? While searching for the best opportunities, investors should also be prepared for the worst. A way of doing this, in our view, is by listing the main risks to the base scenario and attributing these with a probability of occurance. It's also important to try to estimate their possible impact through stress test scenarios. This allows events that could either have an high probability of occurance or have a significant negative impact on investor's portfolio to be identified.

So what can investors do? One option is to implement hedging strategies that can help to limit a drawdown should this event occur. Hedging opportunities should be dynamicallly adjusted according to the reassessment of the risks through the year.

We believe that diversification across multiple strategies both top-down (macro and satellite) and bottom-up (selection strategies), combined with hedging strategies, to limit the downside in case of tail risk, are the ingredients to build portfolios that are resilient in a world where the unexpected is becoming the new normality.

INSIGHT

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Blue Paper

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