

# 2<sup>ND</sup> QUARTER OUTLOOK



April 2017

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## Of Secular Fundamentals, Reflation Trends, and Brexit Beginnings

In this edition of PGIM Fixed Income's Quarterly Outlook, [Robert Tipp, CFA, Managing Director, Chief Investment Strategist and Head of Global Bonds](#), suggests that feelings of economic optimism and political pessimism will be outweighed by the secular fundamentals that continue to underpin the bond market, leaving it with relatively optimistic prospects.

Ellen Gaske, PhD, CFA, Principal and Lead Economist for the G10 Economies, [explains why the oft-cited "reflation" trend](#) is more about abating deflation risks and why the corporate sector may be more willing to invest going forward.

Finally, with the Brexit negotiation process underway, Edward Farley, Managing Director and Head of the European Corporate Bond Team, [looks at what are likely to be the more contentious issues](#) as the UK begins its historic break from the European Union. A snapshot of key Brexit dates and issues are below.

Brexit: Key Upcoming Dates	Key Negotiating Points Between the UK and the EU
<p><b>April 29<sup>th</sup></b>—27 members of the EU meet for Brexit summit.</p> <p><b>May / June 2017</b>—The European Commission (EC) and the Council prepare detailed negotiating directives and institutional arrangements.</p> <p><b>June / July 2017</b>—The EU's General Affairs Council adopts (i) a decision authorizing the opening of negotiations; (ii) directives on negotiating substance; (iii) detailed arrangements on the relationship between the various EU institutions; and (iv) a decision nominating the EC as the Union negotiator.</p> <p><b>July 2017</b>—Start of formal negotiations between the UK and the EC, represented by chief negotiator Michel Barnier. The UK negotiations will be led by David Davis.</p> <p><b>October / November 2018</b>—Target for a Brexit deal and start of the ratification process on the UK side and the approval process at EU level.</p> <p><b>March 2019</b>—Brexit (unless extension is agreed upon).</p>	<p><b>Financial Implications</b>—It is rumoured that the EU may demand £50 billion from the UK to compensate for unpaid budget appropriations and pension promises to EU staff. Against this, the UK will have a claim against the value of their share of EU assets. There are no clearly defined rules for how either of these should or would be calculated, and it is questionable as to whether the EU could force the UK to pay this bill if there is no deal.</p> <p><b>Future Trade Pact</b>—The debate hinges between access to the single market and freedom of movement of labour. Given the UK is extremely unlikely to agree to freedom of movement, it is a question of whether a trade deal can be struck (along the lines of the recent deal with Canada). If nothing can be agreed upon, both parties would revert to World Trade Organization (WTO) rules.</p> <p><b>Rights of EU / UK citizens</b>—This is unlikely to be a major stumbling block, although it will be a key focus for many of the new members of the 27 remaining member states.</p>

## Sector Views

**Corporate Debt (page 7, [click here to read](#)):** Positive given modestly attractive spread levels, strong investor demand, and economic growth momentum. Quantitative easing remains a huge technical support. Still favor U.S. money center banks.

**Global Leveraged Finance (page 8):** Cautiously optimistic for U.S. high yield as we believe spreads will grind tighter from current levels, but recognize that elevated macro tail risks could impact the asset class. European high yield remains modestly attractive, with a supportive technical backdrop and low default expectations.

**Emerging Markets Debt (page 9):** Positive. EM assets are likely to perform well given attractive valuations and the improved outlook for global growth. There are opportunities where spreads are higher than the index and its five-year average and where yields are well above that of the local index. With positive inflows and supportive technicals, EM local rates should outperform.

**Municipal Bonds (page 11):** Positive. Technicals should turn favorable by quarter end, and stable to declining interest rates should support mutual fund flows.

**Global Rates (page 11):** Optimistic as tactical opportunities exist throughout the developed rates markets, including long positioning in intermediate U.S. duration, swap spread wideners in the U.S., and shorts at the front of the bund curve.

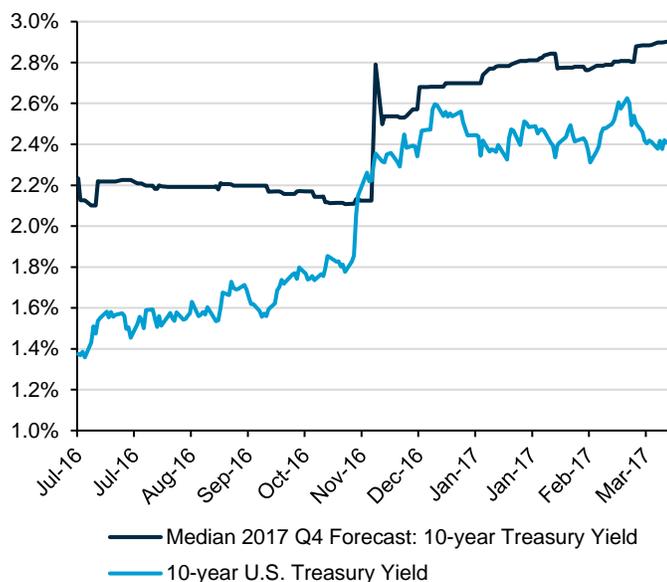
**Mortgages (page 12):** Remain underweight due to concerns around adjustments to the Fed's MBS reinvestment policy.

**Structured Product (page 12):** Positive on top-of-the-capital structure issues, although we believe carry will drive returns in Q2 rather than spread tightening. We're also positive on the fundamentals of GSE credit risk mezzanine cashflows, but are cautious at current spreads levels. We're negative on CMBS mezzanine tranches as conduit credit quality is unimpressive, and we are increasingly looking at financing trades rather than exposure to the underlying assets as spreads are tight and the demand for leverage is high.

## Bond Market 2017: Scaling the Wall of Worry

With a mini-upswing in growth and inflation combining with expectations for stimulative policies following the Trump sweep, the markets have had a 180-degree turn from the pessimism toward growth and fear of deflation that was prevalent in the first half of 2016. As a result, the BoJ and ECB are backing away from their hyper-aggressive policies (as discussed in the following economics section), leading to a bear steepening of their yield curves since the middle of last year. The U.S. elections brought expectations for stimulus, and commodity prices rose, not only driving U.S. bond yields higher, but also lifting those across the G-10 space as well. Risk appetite generally improved, boosting the returns of spread product and most currencies versus the dollar. As yields climbed, bearish sentiment continued to build—especially in the U.S.

### Higher Yields Spook Treasuries: Although Yields Levelled off in Q1, Yield Expectations Continued to Rise



Source: Bloomberg as of March 31, 2017

### 2017 Off to a Respectable Start

Following the wave of economic optimism that boosted yields in Q4 2016, ostensibly more bad news for the bond market came in Q1 2017 in terms of rising expectations for growth and inflation, as well as signals from the ECB about the potential for further tapering of purchases and / or possible rate hikes. Additionally, the Fed hiked rates in March and continued to signal that further hikes lie ahead. Despite all that, the march higher in G-3 yields more or less stopped in Q1, and spreads compressed as investors began to nibble at the higher yields. The net result? Modest, but positive, returns for investment grade bonds and better returns—low single digits—for high yield and emerging market debt (see accompanying table).

### Bonds Follow up 2016's Solid Returns with a Positive Q1; Higher-Yielding Sectors Outperform

Sector	Q1 2017	Total Return (%)				
		2016	2015	2014	2013	2012
U.S. High Yield Bonds	2.71	17.5	-4.6	2.5	7.4	15.6
European High Yield Bonds	1.90	10.8	1.3	5.1	9.1	24.8
EM Debt Hard Currency	3.87	10.2	1.2	7.4	-5.3	17.4
U.S. Leveraged Loans	1.15	9.9	-0.4	2.1	6.2	9.4
Long IG Corporates	1.36	11.0	-4.6	15.7	-5.7	12.4
European Leveraged Loans	1.16	7.0	3.6	2.1	9.0	10.8
European IG Corporate	0.27	4.7	-0.6	8.4	2.4	13.6
EM Currencies	5.18	3.5	-7.6	-7.0	-2.0	7.5
U.S. IG Corporate Bonds	1.22	6.1	-0.7	7.5	-1.5	9.8
EM Local (Hedged)	2.08	4.7	-2.2	3.2	-4.2	8.9
Global Aggregate	1.76	2.1	-3.2	0.6	-2.6	4.3
Mortgage-Backed (Agency)	0.47	1.7	1.5	6.2	-1.5	2.6
CMBS	0.86	3.3	1.0	3.9	0.2	9.7
U.S. Aggregate	0.82	2.7	0.6	6.0	-2.0	4.2
U.S. Treasuries	0.57	1.0	0.8	5.1	-2.8	2.0
Municipal Bonds	1.58	0.3	3.3	9.1	-2.6	6.8

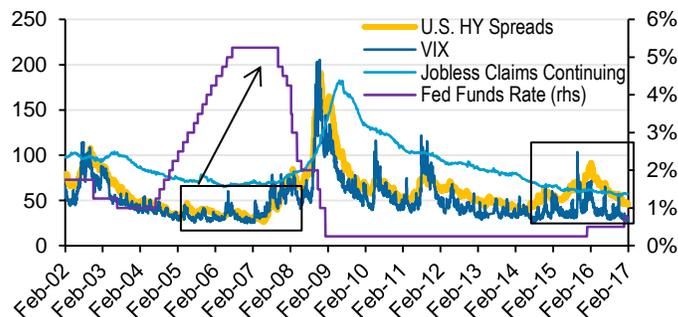
Sources: Bloomberg Barclays except EMD (J.P. Morgan), HY (Merrill Lynch), Senior Secured Loans (Credit Suisse). Performance is for representative indices as of March 31, 2017. See Notice for full index names. Past performance is not a guarantee or a reliable indicator of future results. An investment cannot be made directly in an index.

### Q2 Outlook: Excessive Optimism + Political Crosswinds = Continued Opportunities in Bonds

While it's tempting to get swept up in the optimism on growth and pessimism regarding politics, the fact of the matter is that fiscal stimulus in the U.S. will probably be slow in coming and / or limited in duration. Meanwhile, the underlying secular fundamentals that have been friendly to the bond market—aging demographics, high levels of indebtedness and inequality, and intense price competition resulting from globalization—remain. As a result, as the economic data level off, rates are likely to remain relatively stable or even drop a bit over the coming quarters.

As for spread product, the combination of less-compelling valuations and coalescing macro risks—including, but not exclusive to, the potential for simultaneous tightening by the Fed and the ECB as well as global political and policy risks—makes us more cautious and selective than in recent Outlooks. Nonetheless, central banks are likely to move cautiously, supporting our base case that spread contraction is likely to continue going forward.

### The Impact of this Fed Hiking Cycle on Spread Sectors may be Similar to 2004-2006: Spreads Fluctuated, but on Balance, Still Tightened, Showing that the Ultimate Enemy of Spread Product is not the Fed, but Recession



Source: Bloomberg as of March 29, 2017

**The Bottom Line:** Assuming U.S. stimulus doesn't surprise to the upside in a big way, we continue to see more opportunity than risk in the bond market.

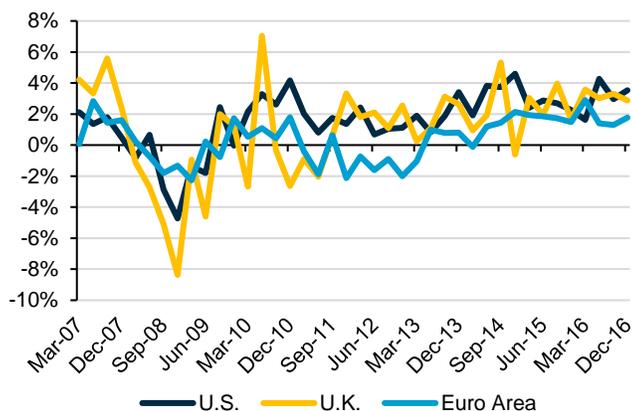
## Moderate Growth Pickup, Relatively Stable Core Inflation

### With Increasing Idiosyncratic Sources of Growth Across Countries Against a Backdrop of Elevated Political and Policy Uncertainty

As Q2 2017 progresses, positive economic growth is being experienced broadly across most countries around the globe, leaving expectations of a modest acceleration in 2017 global growth still intact. Real GDP growth in both DM and EM economies is expected to contribute to the acceleration this year, led by a 2.4% pace in the U.S., continued recovery at a 1.2% pace in the Euro Area, an above-trend 1.1% pace in Japan, and a rebound in economic activity in commodity-exporting countries as the lion's share of their difficult adjustments to lower commodity prices is now behind them, eased by the partial rebound in commodity prices in recent quarters. Aiding the pickup in global growth is the additional monetary stimulus injected last year by a broad swath of central banks, along with a rebound in economic momentum in China in the second half of 2016, as policymakers there pivoted back to growth-supportive fiscal and credit stimulus.

One shared trend and a key driver of growth across many economies over the last few years has been the boost to household purchasing power, and hence real consumer spending, from the drop in commodity prices (see following chart). More recently, though, this effect has gone into reverse to varying degrees—most notably now in the U.S., but also elsewhere—as the partial rebound in oil prices is currently feeding through to higher headline inflation. But with this squeeze on real household incomes expected to dissipate as the year progresses, we believe business investment is likely to pick up at least somewhat going forward, resulting in a modest rotation from consumers to businesses as sources of growth this year. In commodity-producing countries, the drag from the collapse in commodity-sector investment is also now ending. This includes the U.S., where investment in the energy sector is turning up again and a softening of the dollar since the start of the year is easing headwinds on manufacturers and other exporters.

### Real Consumer Spending

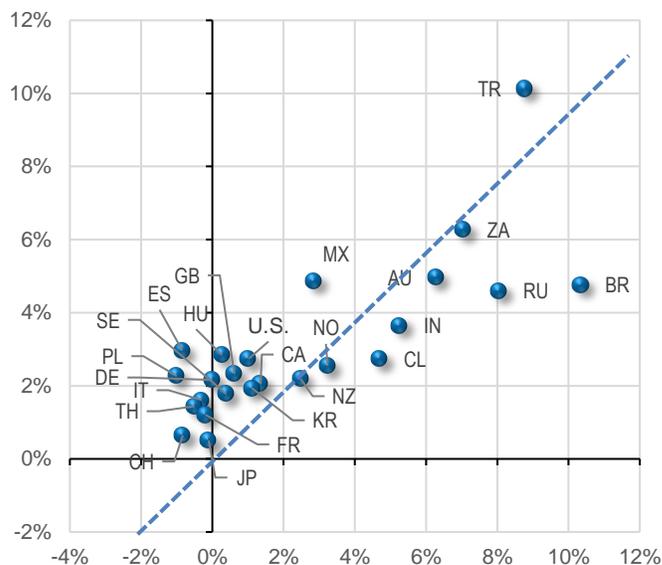


Source: BEA, Eurostat/Haver as of December 2016

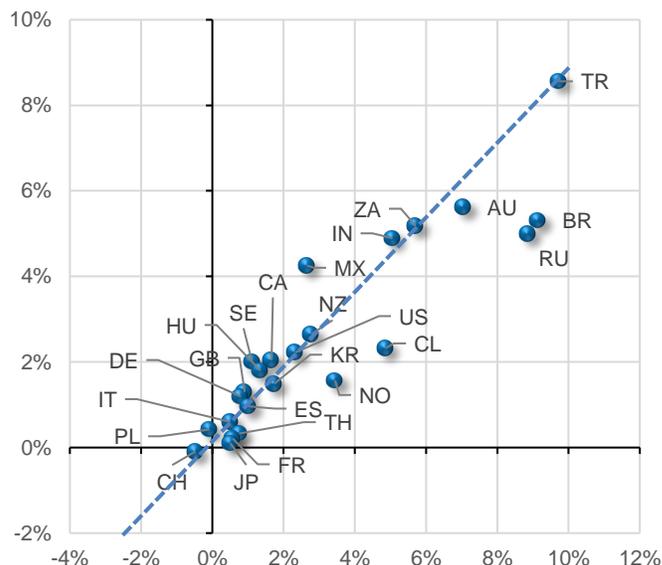
### What a Difference a Year Makes

At this time last year, an almost two-year decline in commodity prices appeared at risk of gathering pace and leading to a broader round of global disinflation—perhaps even outright deflation. In the first half of 2016, China's attempts to tighten fiscal policy and rein in credit growth was exacerbating downward price pressures, sharp declines in commodity exporters' incomes were transmitting into broader economic weakness, and the energy industry recession in the U.S. was spilling over to broader weakness in manufacturing, worsened by a strengthening U.S. dollar. The consumer benefit of lower commodity prices was at risk of being undermined by the severity of the hit to commodity producers, manufacturers, and related businesses.

### Headline CPI



### Core CPI



Source: Haver Analytics as of March 2017. Y-axis is latest data, X-axis is 6-months prior.

Two critical developments helped turn the tide on deflation risks in the second half of 2016. First, there was a general easing of monetary policies around the globe as numerous central banks—including the ECB, BoJ, and BoE—injecting additional rounds of policy easing; in China, efforts by policymakers to tighten credit growth were unwound; while in the U.S., the Fed delayed delivery on a second rate hike until the very end of the year. The stimulus boost appears to have gained traction, helping to put a floor under global aggregate demand that has carried into 2017.

Perhaps equally important, commodity producers moved more aggressively to reduce supply, putting a critical floor under commodity prices. OPEC engineered production caps for its members that have seen a surprising degree of persistent compliance; China engineered a cutback in steel, iron ore, and coal production; and U.S. shale producers—slow to reduce output initially—rapidly cut back on rig counts and production. But while the cutbacks in production helped stabilize commodity prices and dissipate global deflation pressures, the supply-constraint driven increase in commodity prices is now acting akin to a tax on households. Consumers, enjoying a boost to their purchasing power from declining commodity prices over the last few years, are now getting squeezed by their partial rebound.

#### “Reflation” Trend Largely About Abating Deflation Risks

With crude oil prices at the end of Q1 almost double the lows reached early last year, headline inflation rates have staged a synchronized rebound across most DM countries. However, oil prices are now just past their peak increase on a year-over-year basis. If they remain roughly stable going forward, their upward pressure on inflation should begin to wane going forward. Meanwhile, core inflation in these countries has barely budged, hinting at the degree to which the rebound in commodity prices was supply-driven. And in many commodity-exporting countries, both headline and core inflation have actually been falling over the last year

An expected dissipation of headline inflation pressures going forward is key. With wage growth remaining generally muted across the globe—even in countries with labor markets that are at, or close to, full employment, including in the U.S., Germany, and Japan—real household purchasing power is currently being squeezed by the acceleration in headline inflation. If headline inflation rates indeed rollover later this year, as expected, an inflation-induced rise in wage pressures is also likely to remain capped, supporting business profits and thus their willingness to invest.

#### Political and Policy Developments May Prove Key to the Economic Outlook this Year

Political and policy uncertainty remains high, posing risks to our outlook for a modest acceleration in economic growth, particularly in the business sector. A key question is whether the decline in populist momentum in Europe, evident in recent Austrian, Dutch, and German state elections, will persist going into the French elections in the second quarter, German elections in September, and Italian elections by early next year. Uncertainty in both the UK and EU during Brexit negotiations over the next two years (see the following Brexit section) could have significant effects on certain industries, e.g. financial services. In China, where recent economic stabilization has been a key factor behind the improving global economy over the last year,

the change in top leadership after the 19th Congress of the Communist Party of China late this year also creates an overlay of uncertainty. Meanwhile, persistent geopolitical and military tensions emanating from the Korean Peninsula and Middle East are at risk of coming to the fore and overshadowing other global developments.

Policy uncertainty is particularly elevated in the U.S. where Republican’s slim majority in congress and disagreements within the party risk watering down and delaying an expected pro-business agenda that has been expected to set the U.S. apart over the coming year. We had been looking for tax reform in the U.S. this year, with a bit of tax cut stimulus as an aside. But with Republican party divisions highlighted in the recent healthcare reform debate, the probability of a reversal of that mix has increased, i.e. modest tax cut stimulus, alongside a small bit of structural tax reform. A rollback of U.S. regulations—easier to achieve than congressional legislation—is the main source of expected policy changes, at least over the near term. Meanwhile, other legislative hurdles loom, including congressional reauthorization of government funding by April 28, 2017 to avoid a government shutdown; the debt ceiling is projected to become binding again sometime this fall. So far, potential restrictive trade policies are largely being held at bay.

#### Gradual Fed Tightening Expected in 2017; Other Major Central Banks Largely Expected to Remain on Hold

Our forecast for Fed tightening has now shifted up slightly to a base case of three 25 bp rate hikes this year in total—in line with the Fed’s median projection as of March 2017—with the next hike most likely in June. We now anticipate that late this year or early next year, the Fed will also begin a gradual reduction of its \$4.2 trillion of securities holdings. Minutes of the Fed’s March 2017 meeting revealed Fed officials are lining up in favor of tapering/ceasing reinvestment of principal payments on their holdings of both Treasuries and MBS beginning later this year, assuming economic conditions unfold as they anticipate. Fed officials have sounded increasingly confident of underlying economic momentum, any temporary softening in Q1 2017 notwithstanding. But if headline inflation indeed decelerates back towards 2% later this year, as expected, and fiscal stimulus from Washington is reduced and delayed, we think there are modest downside risks to this outlook.

The ECB is expected to keep rates and its QE purchases at current levels through the end of this year, but signal later this year an intention to wind down its purchases in 2018. Similarly, the BoJ’s current policy of QQE with yield curve control appears to have improved monetary conditions and is thus anticipated to continue through most, if not all, of this year. An unexpected sharp rise in global rates—not our base case given expectations for a moderation in global headline inflation—would pose upside risk to the BoJ’s current target for 10-year JGB yields of around zero. Central banks everywhere are expected to remain cautious this year, creating a positive backdrop for global growth while watching how political and other policy developments play out.

## Brexit Begins

The complexity of the Brexit process—and the conceptual divide between the UK and the EU—will be apparent from the outset of prolonged and possibly contentious negotiations. Indeed, the sequencing of the talks will be an issue from the start: the EU wants to resolve the withdrawal issue—and its request for a separation fee of £50 billion—before negotiating future relationship terms, whereas the UK wants to negotiate both fronts simultaneously.

Another early issue to agree upon is the timeframe for implementing the UK's exit. While Brexit is set to occur in March 2019, both parties can agree to extend negotiations, or agree to a transitional period until the new agreement becomes binding. This would remove the much feared "cliff edge" of economic volatility that the corporate sector has been keen to avoid. It is important to note that any agreement in this regard would require agreement from each of the remaining 27 members of the EU.

In terms of the future relationship, a primary consideration is who has the most to gain from a trade deal—both economically and politically. From an economic perspective, a failure to agree to a deal would be a lose / lose situation. However, from a pure trading perspective, the impact on the UK as a percentage of GDP versus that against the EU's aggregated GDP clearly highlights that the UK stands more to lose. From a political perspective, much depends on how much the EU wants to punish the UK (as stated by Jean -Claude Juncker, President of the European Commission) in order to provide a disincentive for any other country considering leaving the EU. Within the UK, the Labour Party has stated that it would only support the Brexit agreement if the UK maintains full access to the single market, highlighting that there may be a few internal obstacles to ratifying a final agreement. This is magnified by the fact that UK Prime Minister Theresa May has a tiny majority and a party containing a few ardent Remainers.

### Impact on Industry

The UK is an important hub of the EU's financial system, and it is unclear as to whether the EU could successfully replace London, especially in the short term. Against that, the EU members will certainly all want a larger piece of this market, and the UK has the most to lose by far.

While the impact on other industries varies significantly, there are clearly issues across the board—the government recently did a "sweetheart" deal with Nissan in order to ensure further investment in UK plants, ensuring that whatever the result of Brexit they would be no worse off from a tax perspective. The tax issue is a concern within the UK auto industry, which mostly assembles vehicles, but generally imports the parts, as the imports could become very costly in the absence of a trade agreement. In addition, these firms would potentially be paying tax on both the import and export of the same parts after assembly.

There is a near-endless list of issues across many areas, and one of the more important will be the UK's involvement in the EU's Common Security and Defense Policy, where the UK is a leading contributor. Theresa May has highlighted this benefit provided by the UK as one of her key negotiating tools. Indeed, May's Article 50 letter states that, "In security terms a failure to reach agreement would mean our cooperation in the fight against crime and terrorism would be weakened. In this kind of scenario, both the United Kingdom and the European Union would of course cope with the change, but it is not the outcome that either side should seek. We must therefore work hard to avoid that outcome." In what would be a lose / lose scenario, we expect an extension to negotiations to resolve this issue.

### Impact on the UK economy

To date, it is clear that the UK economy has comfortably outperformed the expectations of the Bank of England and economists, many of whom feared that a "No" vote would lead to a recession. However, it is worth noting that, thus far, the UK experienced a significant currency devaluation that has helped the strength of exports, and it has not lost access to the single market. This is unlikely to continue into Brexit as uncertainty may lead to a decline in capital investment and may dampen consumer activity, which has showed great resilience since the vote as consumer lending is currently at a higher level than in 2007.

## U.S. and European Corporate Bonds

U.S. corporate bond spreads tightened in Q1 2017 against a backdrop of ongoing investor demand, record quarterly issuance, and pro-growth optimism that waned somewhat as the quarter came to a close. U.S. corporate bonds returned +1.22% with an excess return to U.S. Treasuries of 68 bps.

European corporate bond spreads nominally tightened in Q1, supported by central bank buying policies, healthy demand, and generally solid fundamentals. Returns, however, trailed U.S. corporates, buffeted by growing political risk and a rise in sovereign yields.

	Total Return (%) Q1	Spread Change (bps) Q1	OAS (bps) 3/31/2017
U.S. Corporate	1.22	-5	118
European Corporate	0.27	-1	122

*Represents data for the Bloomberg Barclays U.S. Corporate Bond Index and the Bloomberg Barclays European Corporate Bond Index (unhedged). Source: Bloomberg Barclays as of March 31, 2017. Past performance is not a guarantee or reliable indicator of results. An investment cannot be made directly in an index.*

### U.S. Corporate Bonds

In many respects, the technical themes dominating the U.S. corporate bond market have been in place for some time: strong demand from yield-starved global investors, and an onslaught of new issuance. In Q1, supply approached \$400 billion, a quarterly record. Some of this issuance may have been “pushed forward” by companies in advance of the Fed’s proposed short-term rate hikes and/or potential corporate tax reform. The Federal Reserve’s rate hike in March was widely expected with the markets relieved it did not stake out a more aggressive path.

Positive economic momentum also remained supportive and, while the new U.S. administration has made little progress on its proposed stimulus policies, the market appears to have already discounted the possibility of higher growth and inflation.

Corporate fundamentals remained relatively healthy with Q4 2016 earnings coming in higher than expected. In fact, almost two-thirds of S&P 500 companies exceeded analysts’ earnings estimates. Gross leverage is still trending higher, although free cash flow remained positive before share buybacks, and new supply to fund mergers and acquisitions dropped from record levels over the period.

Across sectors, financials led the way in spread tightening to date, while energy and metals and mining companies continued to shore up their balance sheets, and the retail sector struggled.

Looking ahead, corporate tax reform, as currently proposed, could provide a boost to the corporate sector later this year. In addition to lower corporate tax rates, the repatriation of up to \$2 trillion of offshore profits may lead to reduced issuance, particularly in the technology and pharmaceutical sectors, and potential selling in short-maturity (1-5 year) spread product. Limiting the deductibility of interest expense could also incent companies to reduce future borrowing in favor of equity financing.

Currently, we continue to favor financial issues given their strong capital requirements (which should remain in place even if regulations are rolled back) and relative immunity to event risk. We see value in money center banks, including select preferred issues. We are also scrutinizing lower-rated financial companies and select European banks with stabilizing fundamentals and attractive spread levels.

We remain overweight BBB-rated, long-maturity corporates given the steep spread curve and higher pension funding contributions, which could lead to increased demand for longer-maturity corporates and help to flatten the curve. Higher currency hedging costs are also pushing non-U.S. demand down the risk spectrum and out on the curve, which may also help to flatten the curve. We remain underweight A-and-higher rated industrials due to event risk concerns. Attractive industries include electric utilities, and, within industrials, chemicals, health insurers, paper, select pharmaceuticals, and U.S.-centric issues. We still favor taxable municipals and lower-quality, shorter-maturity corporates, but are closely watching LIBOR pressures.

Overall, we look for U.S. corporate spreads to tighten in the coming quarter given modestly attractive spread levels, little to no risk of a U.S. recession, and on-going investor demand spurred by non-U.S. quantitative easing programs.

### European Corporate Bonds

European corporate bond spreads were nominally tighter in Q1 although rising political risk weighed heavily on market sentiment. The French political elections and fears of growing populism were the major sources of volatility. Following the recent Dutch election, however, market jitters receded slightly. After this spring’s French election, the markets will next focus on elections in German and potentially Italy, a potential Scottish independence referendum, and Brexit negotiations. Investors will also be watching the ECB for a timeline of when it may begin to taper its ultra-accommodative policies.

On a positive note, European economic data has been solid, if unspectacular, providing a far better base than in prior years. Management is generally cautious and credit fundamentals remain robust, although they have probably peaked for this cycle. Leverage has been increasing, primarily in response to weaker earnings, and M&A activity has picked up.

As in the U.S., new issuance activity has been brisk (including reverse yankee issuance), but for now investor demand and central bank corporate bond buying programs have been equally strong. The reluctance of the banks to hold inventory, however, can exaggerate bouts of volatility.

In this environment, higher-yielding corporates with little to no exposure to political risk were the top performers, led by subordinated financials. French and peripheral corporates lagged as they would be most affected by political upheaval and tapering.

In Q2, we expect issuance to remain heavy with ongoing support from the ECB and BoE corporate bond purchase programs, although the BoE is expected to end its program in late Q2. At current levels, European corporate spreads as a whole do not look cheap. However,

we believe there are still attractive opportunities across regions, industries, and issuers.

In European portfolios, we prefer non-euro zone issuers and those ineligible for the central bank bond purchase programs. We see value in select reverse-yankee issues that are priced at discounts to where they trade in U.S. dollars. We remain underweight European financials that are challenged by low interest rates and stressed loan books, and prefer Northern European issues over peripheral debt. Within euro-area industrials, we favor regulated companies with solid balance sheets, such as electrical grids and airport operators. We find value in certain corporate hybrids from stable, well-rated utility issuers and are avoiding hybrids issued to uplift ratings, including those in the telecom industry.

In global corporate portfolios, we hold a risk overweight that is fairly evenly split between euros and dollars, as well as an overweight in reverse yankee issues. In the euro currency, we prefer non-ECB eligible bonds given their more generous spreads and return potential. Within the financial sector, we are overweight U.S. money center banks and insurers and are underweight euro zone banks. We remain focused on BBB-rated issuers and U.S. taxable revenue municipals. We continue to take advantage of price dislocations and yield discrepancies between U.S. and euro bonds of the same and/or similar issuers.

In the coming quarter, we believe positive technicals will remain the strongest short-term driver in both the U.S. and European corporate markets. Although spreads have tightened meaningfully, they remain modestly attractive and may have room to grind tighter. Key risks include central bank policy changes, political risks across the U.S. and Europe, and, longer-term, China's high debt burdens.

**OUTLOOK: Positive given modestly attractive spread levels, strong investor demand, and economic growth momentum. Quantitative easing remains a huge technical support. Still favor U.S. money center banks.**

## Global Leveraged Finance

Although the U.S. high yield rally continued in Q1, it showed some fatigue later in the quarter as spreads encountered some volatility. Within the current backdrop, we expect some additional spread tightening to occur while acknowledging the presence of elevated macro tail risks. The European high yield market also posted positive Q1 returns, and the market remains modestly attractive with a supportive technical backdrop.

	Total Return (%) Q1	Spread Change (bps) Q1	OAS (bps) 3/31/2017
U.S. High Yield	2.71%	-30 bps	392
Euro High Yield	1.90%	-21 bps	369
U.S. Leveraged Loans	1.15%	-16 bps	444
Euro Leveraged Loans	1.16%	-32 bps	448

Sources: BofA Merrill Lynch and Credit Suisse as of March 31, 2017. Past performance is not a guarantee or reliable indicator of results. An investment cannot be made directly in an index. European returns euro hedged.

The post-election rally that gripped the high yield market late last year continued into 2017, as spreads tightened within 20 bps of their post-crisis tightness amid expectations that lower taxes, regulatory rollbacks, and increased infrastructure spending would serve as drivers for economic growth. However, the large new issue calendar, heavy outflow activity, the pull-back in equities, and decline in oil prices stalled the rally late in the quarter.

Overall, the broad high yield index ended the quarter up +2.71%, with the lower-rated segments of the market once again outperforming. With CCCs having returned +5.17% in Q1—compared to +2.67% for Bs and +2.01% for BBs—this marks the fifth straight quarter in which CCCs outpaced the higher-quality segments of the market.

Sector performance was generally positive across the BofA Merrill Lynch U.S. high yield market, as retail was the only sector to post a negative total return. The sector has come under pressure, as several retailers—particularly department stores—have reported weaker than expected sales and earnings, while the implications of a border tax—which would likely serve as a headwind for most retailers—potentially looms ahead. Despite posting a positive total return in Q1, energy was also a laggard as oil prices declined almost \$5 per barrel amid concerns over growing inventory levels as production cuts from OPEC and other exporters were unable to balance the markets. Telecom, chemicals, and healthcare were the top performing industries, all of which returned over 3% in Q1.

Moody's 12-month U.S. speculative grade default rate ended February at 5.4%—down from 5.6% at the end of 2016—with the commodity sectors continuing to be the drivers of defaults, accounting for 46% of all default activity in Q1. Additionally, Moody's default forecast suggests the U.S. default rate will decrease to 3.1% over the next 12 months, with the highest likelihood of defaults emanating from the media sector. We expect default rates outside of the energy and basic materials sectors to remain benign through 2018.

High yield funds reported outflows of almost \$8 billion in Q1, much of which occurred in mid-March as \$5.7 billion left the asset class in one week. The outflow represents the second largest weekly outflow on record, and essentially unwound the steady string of inflows that followed the U.S. election.

Following the issuance slowdown in late 2016, new issue volume was robust to begin 2017. In Q1, 129 new deals came to market totaling \$75 billion—compared to 39 deals totaling \$28 billion over the same period in 2016. However, almost 70% of this year's activity has been refinancing related versus only 26% last year. By sector, issuance has been led by the energy sector, which has accounted for 13% of the total volume.

We believe the risk-reward is currently attractive for U.S. high yield, given the strong fundamentals and benign default outlook. As such, with the technical picture improving, our base case is for spreads to tighten. However, our optimism is tempered somewhat by elevated tail risks outside of the asset class given the asymmetric and exacerbated impact that these risks may impose on the market given current spread levels. Additionally, we are maintaining our overweight to less cyclical sectors, such as, electric power,

consumer, and healthcare, as well as our underweight to commodities.

Continued demand for floating rate paper amid expectations for rising rates created a supportive technical backdrop for U.S. leveraged loans, and the Credit Suisse Leveraged Loan Index returned +1.15% in Q1. Like high yield bonds, the lower quality segment of the loan market outperformed, as CCCs returned +5.2%, outpacing Bs and BBs by 437 bps and 388 bps, respectively.

Flows into the U.S. leveraged loan market remained strong—driven by retail inflows—with \$11.5 billion coming into the asset class in Q1. The strong demand for U.S. leveraged loans was highlighted by the positive flow activity that occurred for all but one week over a time period of more than six months.

New issue volume in the loan space has already surpassed \$250 billion so far this year, which represents the eight highest annual total on record. Similar to bonds, most of the activity—more than 80%—was refinancing and repricing related.

### European Leveraged Finance

Despite a meaningful rise in long-term bund yields, the potential for a Le Pen victory in the upcoming French elections, and uncertainty regarding the direction of U.S. politics, European high yield held in well to start the year, with the broad European high yield index returning +1.90% in Q1. CCCs returned +2.74%, outpacing BBs and Bs, which returned +2.01% and +1.42%, respectively.

Steady inflows in January and February were not enough to offset the outflows that occurred in March, as flow activity turned negative for the quarter—with approximately €300 million leaving the asset class in Q1. Through this point last year, inflows totaled more than €1 billion. Additionally, short-duration accounts reported their first weekly outflow in early February 2017—the first since October of last year—as concerns over rising rates remained prevalent.

Primary issuance was active to start the quarter and slowed somewhat as earnings season began. The €16.5 billion that came to market in Q1—a quarter of which was from debut issuers—represents a more than 600% increase compared to the same period last year, and came in various deal types, including multiple-currency, floating-rate, and reverse-yankee offerings. The market also saw a surge in sterling-denominated new issues, as U.K. issuers sought to bring deals to market in advance of the triggering of Article 50 as a part of the Brexit process.

Moody's default rate increased slightly to 2.2%—up from 2.1% at the end of 2016. However, we believe defaults should generally remain low over the next 12 months given that the European economy should continue to grind forward, issuers have been opportunistically taking advantage of favorable market conditions to refinance debt, and the lack of a major, near-term maturity wall.

For the quarter, European leveraged loans continued to push higher—returning +1.16%—as the asset class was supported by a flurry of repricing activity as issuers look to reduce their financing costs. For context, €13.6 billion has repriced so far this year, which is viewed as the longest repricing cycle on record. Additionally, technicals remain very strong, as there has been very little new, net supply to match the demand for floating rate paper.

Looking ahead, the European high yield market remains modestly attractive, with a supportive backdrop given expectations for a subdued new issue pipeline, passable earnings outlook for European high yield issuers, and low default expectations. We expect loans to outperform bonds in the near term, given the former's more attractive valuations and stronger technicals.

We will look for attractive relative value opportunities between sterling-denominated and euro-denominated bonds. Additionally, we will continue to maintain our overweight to B-rated credits, while tactically increasing our allocation to BBs through the primary market.

**OUTLOOK: Cautiously optimistic for U.S. high yield as we believe spreads will grind tighter from current levels, but recognize that elevated macro tail risks could impact the asset class. European high yield remains modestly attractive, with a supportive technical backdrop and low default expectations.**

## Emerging Markets Debt

In Q1 2017, the outperforming hard-currency sovereign and quasi-sovereign bonds included select commodity (energy) issuers, along with some idiosyncratic names. The top performers were lower-rated credits that posted double-digit returns, such as idiosyncratic Belize (+61.32% on restructuring), Mongolia (+12.68% on an IMF program), select African commodity names that were up between 6-7%, Iraq (+8.21%), Dominican Republic (+7.74%), and Brazil (+6.22%). Even Turkey was up 5.31% on supportive technicals and valuation, despite a deteriorating policy backdrop and credit ratings downgrade. We expect such trends to continue. We would also note that there are up to eight EM frontier countries with more recently announced IMF programs, which is supporting higher return expectations for the higher-yielding issuers. In addition, the credit ratings outlook was changed to positive on Russia and Argentina and to stable on Brazil. EM corporates were mixed during the quarter, but select areas of value exist and many have performed well. Relative to EM sovereigns and quasi-sovereign opportunities, we believe EM corporates appear fully valued.

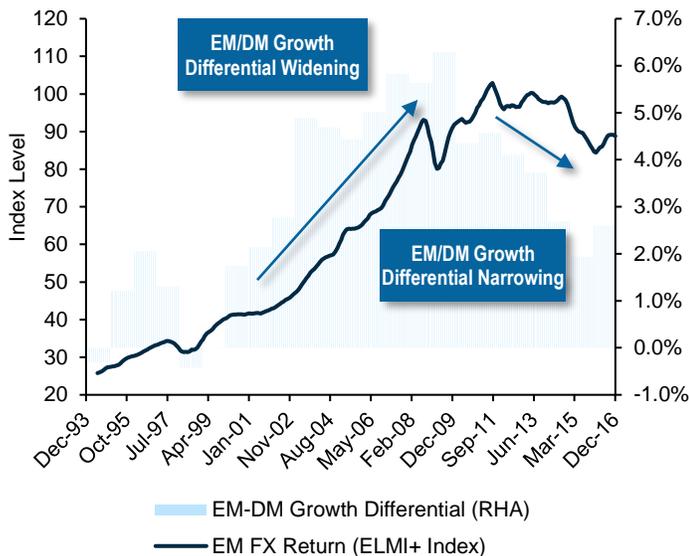
	Total Return (%) Q1	Spread/ Yield Change (bps) Q1	OAS (bps)/Yield % 3/31/17
EM Hard Currency	3.87	-31	310
EM Local (hedged)	2.08	-24	6.55%
EMFX	5.18	-90	3.73%
EM Corporates	2.97	-20	295

*Source: J.P. Morgan as of March 31, 2017. Past performance is not a guarantee or reliable indicator of results. An investment cannot be made directly in an index.*

The strong performance in EMFX reflected the outperformance of higher-yielding currencies versus the dollar on the reach for yield and the more optimistic growth outlook in EM. As the growth differential between DM and EM widens, this has historically proven to be a supportive tailwind for EMFX, as observed in the following chart. Select EM currencies did well even versus the dollar, with solid returns from the Mexican peso +10.98%, Russian ruble +9.16%, and Brazilian real +5.09%. Underperformers included lower-yielding Asian FX (Malaysian MYR +1.56%, Chinese RMB +3.28%, and

Philippines peso +0.30%), in part reflecting uncertainty regarding global trade in the Trump era and a weaker Chinese currency. The large underperformer was the Turkish lira as the outlook has deteriorated from a growth and balance of payments perspective, and returns were negative for the quarter at -1.21%. Overall, we expect current trends to continue in EMFX with a range-bound USD and higher growth. With EM growth accelerating, the next trade is likely in Central and Eastern European FX, a region which has recently lagged. An improved outlook for the euro calls for reduced euro funding relative to USD funding of EMFX.

**Emerging Markets/Developed Markets Growth Differential Compared to Emerging Markets FX**

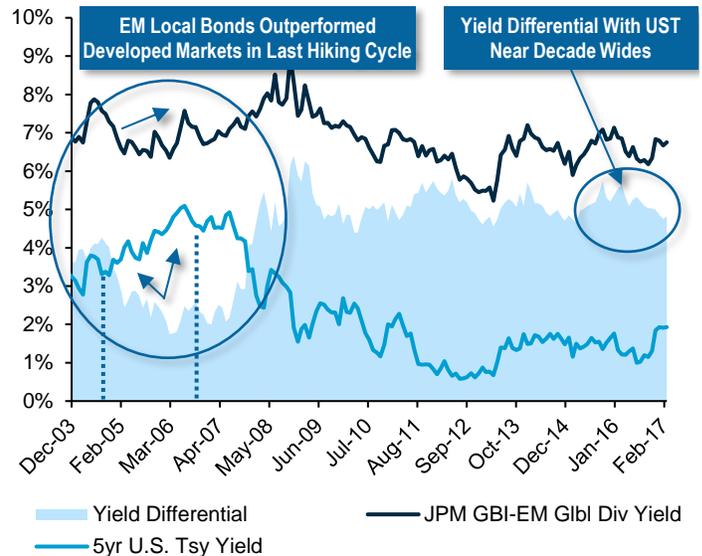


Source: IMF, J.P. Morgan, and PGIM Fixed Income. As of December 31, 2016.

EM hedged local bonds have lagged due to the moves in U.S. Treasury yields, but they remain attractive from an overall yield perspective. Brazil was the top performer again, returning +4.57% as the central bank continues to cut rates and will likely continue to do so at an accelerated pace. Other top performing rates markets were Peru, Indonesia, and the Philippines, all returning more than 4%. While the policy outlook is mixed in terms of rate-cutting or rate-hiking trajectories, inflation remains relatively benign. Turkey again trailed, with a return of only +0.46%.

A number of central banks are cutting rates, including Brazil, Chile, Colombia, and Russia. There are adequate premiums over policy rates in markets where the policy rate is going up. In Mexico, the central bank is hiking rates, and local bonds have been improving with the local bond curve flattening. This is likely to continue; the somewhat improved outlook in Mexico makes its bond market very attractive. Rates have lagged the currency and should do well over the course of the year. Given the overall yield level and the outlook for EMFX, we expect EM local rates will do well over the next quarter, notwithstanding additional Fed rate hikes.

**Emerging Markets Yields vs. 5-Year U.S. Treasury Yields**



Source: Bloomberg. Past performance is not a guarantee or a reliable indicator of future results. An investment cannot be made directly in an index. As of February 28, 2017.

EM technicals have been impressive so far in 2017. There has been over \$119 billion of new, gross issuance, with a significant amount from sovereigns and quasi-sovereigns. Most of this supply has been readily absorbed. Inflows into the sector reached just under \$22.9 billion, with about \$15.2 billion going in hard currency assets and \$7.7 billion going into local assets. The second quarter presents a significant amount of cash flow that is expected to be reinvested into the asset class amid generally strong interest in the sector.

Risks on the horizon include uncertainty around U.S. trade policy, China, and commodities. The transmission mechanism would be a lowering of global growth expectations. In the case of China, even with a focus on FX reserves and the currency, financial stability and growth are paramount for the Chinese leadership. All indications are that going into the Party Congress later this year, growth will be in the 6.7% range, which should support EM assets. While U.S. trade policy is a wildcard, the business-friendly cabinet is unlikely to go down the road of an all-out trade war where the U.S. stands to lose significantly. Regarding the politics of populism in the EU, the momentum may be fading for now, though we are watching the French elections closely. Even on the back of lower oil prices and the Fed's decision to hike rates in March, we are encouraged at how EM has traded as we appear to be in a "sweet spot" for the asset class.

**OUTLOOK: Positive. EM assets are likely to perform well given attractive valuations and the improved outlook for global growth. The Fed has increased the room to maneuver for many EM central banks, and local bonds may "catch-up" with the recent strength in EMFX. There are opportunities where spreads are higher than the index and its five-year average and where yields are well above that of the local index. With positive inflows and supportive technicals, EM local rates are expected to outperform.**

## Municipal Bonds

In Q1 2017, AAA-rated municipal bonds outperformed U.S. Treasuries through 10 years while underperforming on the long end. Demand was muted given the focus on the Fed and policy uncertainty, and mutual funds experienced marginally positive net flows. Municipal issuance totaled \$88 billion year to date, 12% lower vs the prior year. YTD total returns were +1.58% and +4.06% for high grade and high yield, respectively. High yield index returns were driven by the tobacco sector (+13.1% YTD) which bounced back following a weak Q4 2016. This is the most liquid sector in the high yield muni space and demand tends to drive performance.

Puerto Rico credits rallied through early March with the Oversight Board in place and a new Governor, who initially appeared more bondholder friendly than his predecessor. The tone turned more negative as a fiscal plan certified by the Oversight Board presented a less favorable scenario for bondholders. The Oversight Board has laid out a timetable for the commonwealth as they work to present a FY2018 budget. Toward the end of Q1, a group of GO bondholders reached out to the Board requesting a start to negotiations between creditors and the commonwealth.

Long taxable municipals returned 1.69% in Q1, slightly outperforming the long corporate index. The impending changes to the taxable muni index could present attractive buying opportunities for mandates less concerned with index eligibility.

Following the failure of the American Health Care Act to move beyond the House, expectations are that tax reform discussions will accelerate. However, as with any major legislation, the timing and ultimate outcome are highly uncertain. As we've stated in the past, a lower corporate income tax rate has the potential to impact demand from banks and insurance companies, depending on the new corporate tax rate. While there has not been a direct historical correlation between personal income tax rates and demand for tax-exempt municipals, any attempt to marginalize the tax-exemption would be viewed negatively.

Elsewhere, the state of Illinois continues to operate without a budget. While the state Senate had been working on a series of bills to address the budget gap and pension issues, those efforts have stalled. The rating agencies all have negative outlooks on their mid-BBB ratings. Additional downgrades can be expected if the state fails to enact a budget prior to the start of fiscal year 2018. Moody's downgraded the state of New Jersey's GO bond rating to A3 from A2 based on ongoing pressures related to significant underfunded pensions.

Despite policy initiatives that have the potential to disrupt the municipal market, positive supply/demand technicals should emerge by end of Q2, which should support the market. A range bound interest-rate environment should also provide support to mutual fund flows. Tax-reform discussions will be closely monitored, but are not expected to negatively impact the market in Q2. From a credit perspective, the market's focus will remain on credits with significant unfunded pension obligations—as well as other post-employment benefit (OPEB) obligations. Volatility will likely continue in Puerto Rico as investors follow any restructuring negotiations between creditors and the commonwealth as well as any actions taken by the

Oversight Board. Looking ahead, we expect taxable municipals to perform in line with corporate bonds, with potential to outperform should corporate M&A activity pick up.

**OUTLOOK: Positive. Technicals should turn favorable by quarter end, and stable to declining interest rates should support mutual fund flows.**

## Global Rates

While the market reaction to the global reflation trade garnered many headlines in Q1, the U.S. 10-year Treasury yield retraced its increase since the start of the year and ended the quarter about 6 bps lower at 2.39%.

The earlier increase in rates occurred globally amid signs of accelerating growth and inflation. Indeed, the increase in inflation in both Europe and the U.S. appeared to approach targets set by the respective central banks. Yet, we continue to see the increase in inflation as largely driven by the concurrent rebound in commodity prices. In the U.S., we anticipate headline inflation will peak around 2.6% before declining back toward 2.0% by year end. As such, we expect U.S. TIPS to trade flat going forward.

A similar situation could occur in Europe as core inflation readings have remained relatively flat, while headline readings have exceeded the ECB's target of "close to, but less than 2%." As the rise in commodity prices slows, we also expect inflation readings in Europe to abate. Within the European real yield markets, we view UK linkers as essentially priced for "stagflation," thus creating an attractive short opportunity.

Even with the retracement in long-term U.S. yields in late Q1, we maintain a constructive view on U.S. duration going forward. We believe that the terminal Fed funds rate and the U.S. term premium remain relatively elevated on a global context and expect the intermediate portion of the U.S. curve to consequently flatten. Should our thesis prove incorrect and 10-year yields spike to 3%, we would view the higher yields as an attractive roll down opportunity on a relatively steep curve.

As we evaluate the broader opportunity sets across the global rates markets going forward, we continue to see attractive relative value opportunities for levered and unlevered investors within the U.S. Treasury market, particularly in coupon strips, compared to spread sectors that have consistently rallied since the U.S. elections.

Elsewhere in the U.S., swap spread wideners remain attractive, even as interest-rate swaps widened during the quarter. As the quarter concluded, two-year swap spreads reached their widest level in five years, while seven-year swaps widened to about where they were when China devalued the yuan in August 2015. Yet, two-year five-year forward swap spreads have only started to move off their recent tight, and that dynamic continues to support our conviction on the swap spread widener trade.

In Europe, we see the potential for a flatter bund curve as investors have piled into the front of the curve heading into the French presidential elections. We believe the front of the curve could

underperform significantly if Marine Le Pen loses the election and these positions are consequently unwound. We also remain constructive on the intermediate part of the bund curve.

Finally, we await several global macro developments that will likely impact the U.S. fixed income complex for the rest of the year. First, we will watch if overseas demand for U.S. assets picks up with the recent cheapening in the USD/JPY cross-currency basis, making dollar funding more accessible. Second, we will monitor the pressure the Fed may face in addressing its balance sheet in the second half of 2016. An updated plan to scale down the balance sheet could come to the fore with a huge roll off of \$460 billion in Treasuries set to occur in 2018 and Chair Yellen's term set to conclude in February 2018. Finally, increased political cohesion in the U.S. could reignite anticipation regarding tangible fiscal stimulus and renewed momentum behind the reflation trade.

**OUTLOOK:** Optimistic as tactical opportunities exist throughout the developed rates markets, including long positioning in intermediate U.S. duration, swap spread widenings in the U.S., and shorts at the front of the bund curve.

## Mortgages

Although mortgage prepayments declined in Q1 as expected, increased concern about a more aggressive pace of Fed rate hikes combined with statements regarding potential adjustments to the Fed's balance sheet led agency MBS to underperform other high-quality spread sectors in Q1. However, on a LIBOR OAS basis, agency MBS maintained a narrow spread range given the underperformance of interest-rate swaps.

In terms of excess return by agency and coupon, higher coupons performed well in Q1 as prepayment speeds declined toward the lows reached in 2014. Thirty-year 4% coupons outperformed lower coupons as dollar rolls improved, reflecting lower prepayment speeds. Fed purchases also helped to improve the TBA deliverable.

GNMAs had a volatile quarter as the surprise cut in the mortgage insurance premium (MIP) that was announced by the Obama administration was quickly reversed on President Trump's inauguration day. In addition, higher GNMA origination relative to FNMA/Freddie, coupled with reduced domestic bank/overseas investment amid rising rates, weighed on the sector.

Fed MBS reinvestments declined as expected given the surge in primary mortgage rates following the U.S. elections in the fourth quarter of 2016. Monthly reinvestment amounts have varied from \$10 billion in 2011 to a high of \$44 billion per month in September 2016 following the Brexit-induced rate rally. Unless primary mortgage rates break materially below the lows reached in the fourth quarter of 2012 or the third quarter of 2016, we expect Fed MBS reinvestment needs to remain low, reflecting the slower prepayment environment.

In terms of potential positives for the sector, Q2 brings a new fiscal year in Japan and the potential for an increase in demand from Japanese investors. In addition, primary mortgage rates remain near recent highs (back to early 2014 levels), and new origination has

averaged only \$2 billion per day. Finally, refinancing activity is expected to remain slow (matching 2014 levels), while dollar rolls continue to trade well, which would make mortgages more attractive from a carry perspective.

As for negative issues facing the sector, origination could increase due to spring seasonals, net supply for the year will be positive, slow prepayments will restrain the Fed's reinvestment needs, and the potential that Fed officials will likely continue to speak about balance sheet normalization in order to prepare the market.

Given that backdrop, we maintain our underweight positioning as MBS spreads remain on the tighter end of the range and should move wider from ongoing Fed MBS balance sheet concerns. More specifically, we favor the middle of the coupon stack and a neutral GNMA position ahead of potential Japanese buying (up from an underweight), and we continue to prefer seasoned bonds over recent origination.

**OUTLOOK:** Remain underweight due to concerns around adjustments to the Fed's MBS reinvestment policy.

## Structured Product

Structured products had an extremely strong quarter. Legacy non-agency tightened about 25 bps, GSE credit risk transfer about 50 bps, CMBS seniors by about 20 bps and CLOs by about 17 bps. This is consistent with the traditional seasonal pattern for spreads, but not what happened in last year's Q1. We believe the market is more treacherous at this juncture. While our base case is for spreads to remain well bid at currently levels, we suspect that a significant leg tighter is unlikely in Q2. We are advocating a more defensive positioning with an emphasis on senior financing trades and favor on-the-run vs off-the-run structures. While structured products are noteworthy for favorable supply technicals, they remain vulnerable to spread volatility in other spread products.

**Non-Agency RMBS:** We believe the strength of the housing market will continue, though at a more moderate pace. We project 2-4% for 2017 home price appreciation vs 6% in 2016. We believe the loosening of underwriting and origination standards is the most likely source of an upside surprise to housing. Further, despite the backup in mortgage rates, housing remains affordable on a payments-to-income basis relative to the long-term average. On mortgage servicing, modifying troubled mortgages has become the standard course of action. Past principal forgiveness modifications offer the potential for lower loss severities in the future, but elevated foreclosure timelines have maintained upward pressure on severities. As a result, loss severities have been slow to drift down from stubbornly high levels. Technicals remain overwhelmingly favorable with the non-agency float declining 10-15% on an annual basis. Additionally, demand from long-only asset managers remains strong, making non-agencies less vulnerable to pressures in the hedge fund industry, which we see as a risk to other parts of the structured product market. We believe that current spreads can persist, driven by strong technicals and still-improving fundamentals, but valuations appear stretched. There are significant opportunities in financing unrated securitizations: 1) loan pool dispositions from money center banks and the GSEs, and 2) pools of legacy bonds. Senior financing

spreads are generally in the LIBOR +200-300 bps range and approach the spreads on the assets being financed. Access to deal flow is only provided to select asset managers who have the expertise and capacity to analyze and close these deals. Away from the U.S., non-conforming UK RMBS have tightened on stable credit performance and reduced supply expectations, due to the cheaper loan funding provided by the Bank of England's Term Funding Scheme. While we are neutral on senior non-conforming paper with generic spreads currently GBP L+80-90 bps, we find value in select seasoned 2nd pay classes trading GBP L+150-180 bps. The fallout from Brexit and the pullback in UK housing appears to be contained for the time being but we are cautious having only seen the opening acts of what is likely to be a protracted negotiation.

**CMBS:** Spreads tightened in Q1 with conduit 10-year seniors narrowing from Swaps + 110 bps to Swaps + 92, agency from S+65 to S+60, Single Asset/Single Borrower from Libor + 130 to Libor + 90. The cash/synthetic basis in AAAs collapsed 29 bps over the course of Q1. At current spreads, we think cash is fair to the index. Conduit issuance for the first quarter was around \$9.5 billion, down from \$11.5 billion in Q1 2016 and \$15.5 billion in Q4 2016, which had front-loaded issuance given the issuer risk retention requirements that went into effect in late last December. We project 2017 conduit issuance to be at or slightly below 2016's total of \$47 billion, despite the increase in maturities from 2007 vintages during the first half of this year. We expect net outstandings to decline \$30 billion this year, which should provide technical support to spreads. In terms of fundamentals, we remain cautiously positive on the overall commercial real estate market in the near term. Capitalization rates for commercial real estate have not materially moved despite the backup in interest rates since the election, as the historically wide risk premium in cap rates had room to compress. We do, however, have concerns over specific sub-sectors and sub-markets such as hotels and regional malls, and negative headlines for the retail sector are attracting attention. CMBX referencing mezzanine tranches from deals originated in 2012 and 2013 struggled due to the large concentration in Class B/C retail malls in those vintages, but senior tranches held up better. CMBX6 (2012) BBB- widened 160 bps in Q1 and CMBX 7 (2013) BBB- widened 65 bps, while CMBX6 and CMBX7 AAA were basically unchanged. For recent vintages, the story was different. The on-the-run CMBX BBB- index tightened 5bps to +487 bps; however, cash BBB- bonds tightened about 240bps to Swaps+350. Despite this spread tightening, we remain defensive on that portion of the capital structure given unimpressive conduit loan quality and our concerns about the hospitality and retail sectors. In our view, the implementation of risk retention has yet to improve credit underwriting standards.

**CLO:** Global CLOs continue to be fundamentally and relatively cheap to many fixed income assets. U.S. CLOs currently offer AAA spreads between 3-month LIBOR + 124-139 bps for new issue deals depending on the manager tier. European deals currently offer nominal spreads of 3 month Euribor + 90 bps plus the value of the zero Euribor floor (which we believe is worth about 15 bps). Despite risk retention regulations and the market's expectations for lower issuance this year, we believe strong demand from both debt and equity investors will lead to higher than expected issuance. So far this year the US market has seen an unexpected wave of refinancings of 2014 vintage deals that is close to \$35B versus about \$20B in all of 2016. We have also seen several deals in both the U.S. and Europe "reset" their capital structures, which is effectively akin to

new deal. Year to date we have also seen about \$14B in primary from U.S. CLOs as well as a modest €1.6 billion in Europe. We continue to see strong demand from banks, insurance companies, and asset managers in the senior part of the capital structure. In the most junior parts of the capital structure, we are observing a higher number of risk retention funds and have begun seeing more "real money" buyers participate as they continue to chase nominal yields.

Going forward we believe CLO spreads have some room to tighten across all parts of the capital structure as demand remains very strong. Underlying loans continue to reprice and loans spreads

continue to compress with support from the extraordinarily strong technicals driven by demand from retail funds, separate accounts and CLOs. We believe that despite a "slow" new issue pipeline in loans, CLOs creation will continue due to strong demand from risk retention vehicles and investors who need to invest in equity to meet performance hurdles. We also continue to see strong demand for U.S. AAAs as many investors recognize both the absolute cheapness from a spread perspective and/or the great carry as 3-month LIBOR continues to rise. For global investors, we continue to observe that despite some loss in spread from cross currency swaps, global CLOs remain very attractive.

**ABS:** We remain positive on credit fundamentals of the US consumer and related assets from established issuers. That said we recognize that competition among originators is increasing for consumer credits, but not a concern for now. Traditional 3-year fixed rate credit cards and autos recently traded at tight levels inside of Swaps+20 bps. Instead, we prefer fundamentally sound non-benchmark sectors such as consumer loan and refinanced private student loans with seniors and subordinates trading L+100-200 bps. We also favor average life roll-down investments in high quality 5-year fixed revolver prime autos and floating rate credit cards with the opportunity to earn +70-100 bps in total return over a 1 year period from carry and roll-down. We remain constructive on AAA rental car ABS at Swaps+100 bps, as deal structure provides significant protections to insulate ABS bonds from a rental car company bankruptcy; corporate parent earnings variability could provide a bumpy ride, particularly for Hertz. We remain cautious on marketplace lenders due to unproven and shifting business strategies and regulatory ambiguity.

**Outlook:** We remain very positive on top-of-the-capital structure issues, although carry may be the driver of returns in Q2 rather than spread tightening, and macro risks are increasing. We remain positive on the fundamentals of GSE credit risk mezzanine cashflows, but are cautious on spreads at current levels. We are negative on CMBS mezzanine tranches as conduit credit quality is unimpressive and the Q1 widening in CMBX6 shows that bad fundamentals ultimately prevail over good technicals. We are increasingly evaluating financing trades rather than exposure to the underlying assets as spreads are tight and the demand for leverage is high.

## Notice

Source of data (unless otherwise noted): PGIM Fixed Income and Bloomberg as of March 2017.

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### Performance for each sector is based upon the following indices:

- U.S. Investment Grade Corporate Bonds: Bloomberg Barclays U.S. Corporate Bond Index
- European Investment Grade Corporate Bonds: Bloomberg Barclays European Corporate Bond Index (unhedged)
- U.S. High Yield Bonds: BofA Merrill Lynch U.S. High Yield Index
- European High Yield Bonds: Merrill Lynch European Currency High Yield Index
- U.S. Senior Secured Loans: Credit Suisse Leveraged Loan Index
- European Senior Secured Loans: Credit Suisse Western European Leveraged Loan Index: All Denominations Unhedged
- Emerging Markets USD Sovereign Debt: JP Morgan Emerging Markets Bond Index Global Diversified
- Emerging Markets Local Debt (unhedged): JPMorgan Government Bond Index-Emerging Markets Global Diversified Index
- Emerging Markets Corporate Bonds: JP Morgan Corporate Emerging Markets Bond Index Broad Diversified
- Emerging Markets Currencies: JP Morgan Emerging Local Markets Index Plus
- Municipal Bonds: Bloomberg Barclays Municipal Bond Indices
- U.S. Treasury Bonds: Bloomberg Barclays U.S. Treasury Bond Index
- Mortgage Backed Securities: Bloomberg Barclays U.S. MBS - Agency Fixed Rate Index
- Commercial Mortgage-Backed Securities: Bloomberg Barclays CMBS: ERISA Eligible Index
- U.S. Aggregate Bond Index: Bloomberg Barclays U.S. Aggregate Bond Index

2017-1771